Fiscal and Public Policy in Korea

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Preface

Korea is a fascinating country for economists around the world. Policymakers in Korea have always faced a new set of challenges and adjusted to the rapidly changing internal and external environments. For better or worse the Korea's economic performance, its policies and institutions are of great interest to a wide audience and worthy of serious examination. Careful evaluation of the problems, policy responses, and performance of the past help overcome new challenges ahead and make the best use of potential.

This volume is a collection of papers written on various occasions in last quarter of century. Most of them were commissioned by concerned authorities or previously published in professional journals and edited volumes. Papers in the volume were written to show how the nation coped with the arduous task of setting up new policy strategy to meet the challenges at the time when each paper was written. In retrospect questions or issues raised and answers or suggestions made are pretty robust and indicative even for today. Though the volume is limited in the subject areas, it throws a great deal of light on answers to the frequently raised questions. I hope that this edited volume and accompanying volume, entitled *Tax Policy and Tax System in Korea*, serve as a pivot and stimulant in understanding fiscal policy, public policy, and tax policy in Korea.

I would like to express my special thanks to my family: father, Yeap Jong Choi; mother, Cheon Il Jo; wife, Soon Hee Jo; sister, Jeong Sook Choi; and sister's husband, Byung Rae Jo, for their support and encouragement for so many years. I am very grateful to Mr. Ju Seok Sung and Ms. Sang Mi Choi for their editorial assistance and Ms. Min Joo Kang for her word processing support. I am also grateful for publication assistance from Mr. Byung Gyu Choi.

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Table of Contents

Table of Contents

Table of Contents

Table of Contents

Chapter Ⅰ. The Role of Government in Industrialization in Korea

Ⅰ. Introduction

Just how influential the Korean government has been in the country's development is a point of considerable debate. It is a difficult question to assess since opinions on the government's role differ because of different attitudes to the relationship between the individual and the state and different views on the relative importance of the various causes for Korea's economic success.

Such differences exist not only among foreign observers but also among Koreans. On the one hand, many foreign observers have conjured up the vision of a monolithic, government-directed economy, which might be labeled "Korea Incorporated." According to this view, the "economic miracle on the Han River" is the result of strong political leadership and outstanding government management that used development planning as its primary instrument, along with sensible policies and budgets. On the other hand, some argue that the government's main contribution to Korea's rapid economic growth has been the creation of a favorable economic environment for private enterprise. Thus, according to their view the unprecedented rapid economic growth that Korea has experienced over the last 25 years or so has been accomplished predominantly without the government's help.

More accurate is the view that Korea has achieved its economic miracle through a strong partnership between the government and the private sector, a relationship that also exists in Japan. This conclusion, of course, raises the question of which sector, the public or the private, has played the dominant role.

It is the authors' view that in the area of industrialization, the Korean government, as the senior partner, has played a very significant role since the early 1960s. This role entailed choosing appropriate development strategies, demonstrating leadership commitment, implementing government organizational reforms, and allocating budgetary and financial resources. The industrialization drive was engineered through cooperation between business and bureaucrats, with the government providing leadership and guidance.

A few points can be offered to support the position that the government played an active role in Korea's remarkable industrial development and served as the senior partner in the business-government partnership.

First, the government dominated the relationship between government and business. The Korean people have long been psychologically oriented toward powerful leadership by an elite and a centralized hierarchical bureaucracy. Furthermore, the government exerted extensive influence on business activities by owning financial intermediaries and controlling access to foreign capital.

Second, reasonably well-educated and experienced Korean works and businessmen had several attributes conductive to development, namely loyalty, punctuality, hard work, and respect for authority. An important factor In Korea's modernization was the government' s ability to act as a catalyst to unleash the underlying forces favorable to rapid economic development. In essence, the political leadership inspired the people to stove harder for a better life.

Third, the government played a key role in rapid industrial development through effective planning and development strategies. The apparatus of planning and policymaking was more centralized and streamlined. Although the government has not always been in a position to dictate policies to the private firms by introducing a number of important reforms, including the implementation of five-year plans and an outward-looking development strategy.

This chapter's aim is to deal with the role of the government in Korea's industrialization from the early 1960s through the early 1980s, focusing on the major aspects of industrial and fiscal policy. The first section reviews the industrial policies Implemented by the Korean government at different stages of industrial development. The second section focuses on expenditures and tax policies and identifies the changes in the priority of government policies and identifies the changes in the priority of government policies and the influences the government has exerted on the private sector. The historical development of tax incentive policies and their effects are reviewed in some detail. The review of industrial and fiscal policies is followed by an examination of the economic planning and management system, with an emphasis on its orientation, organizational structure, and actual performance in the third section. The concluding section contains a discussion of some broad lessons which could be relevant to the economic management of other developing countries.

Ⅱ. Industrial Policy

Throughout the process of industrialization, the government has been very influential in shaping Korea’s industrial structure. While pursuing an outward-oriented development strategy, it has undertaken an industrial policy that vaned In response to changes in domestic as well as external factors. The past 24 years (1962-85) can be divided into the three phases of government industrial policy.

1. The Take-off Period (1962-1972)

This is the period during which the government introduced incentive schemes to promote exports and construct basic industries and a social infrastructure.

To promote exports, several policy measures were enacted. First, the exchange-rate system was reformed to become a uniform flexible system in which the Korean won was pegged to the U.S. dollar The won had, however, a tendency to become overvalued because of chronic domestic inflation and thus required periodic devaluation. Second, the nominal rate of interest, which had been kept below the inflation rate for a long time, was drastically raised to 30 percent, sufficient to induce increased domestic savings. Third, fiscal and monetary stabilization to induce increased domestic savings. Third, fiscal and monetary stabilization policies were adopted to curb inflation. Even though the inflation rate was still high, averaging 12.4 percent annually during this period, it was moderate compared with the 18.2 percent of subsequent years(1973-79). Fourth, a negative list system of trade. Finns were exempted from import duties on intermediate goods and raw materials imported for exports at preferential interest rates that were usually lower than the market rate.

<Table Ⅰ-1> Changes in Industrial Structure

(Unit: %)

Industry	1962	1966	1972	1976	1982	1985
Agriculture, forestry, and fisheries	36.6	34.9	26.4	23.5	14.6	13.8
Mining and manufacturing	16.2	20.5	23.1	28.4	29.8	29.6
Heavy industry[1)]	25.8	34.1	34.9	45.9	51.2	54.4
Light industry[2)]	74.2	65.9	65.1	54.1	48.8	45.6
Social overhead capital and other	47.1	44.7	50.5	48.1	56.6	56.6

Notes: 1) Ratio of output of heavy and chemical industries to total output of mining and manufacturing.
2) Ratio of output of light industry to total output of mining and manufacturing.
Source: EPB, *Major Statistics of the Korean Economy*, 1980, 1986.

As a result of these incentives, exports grew from US$54.8 million in 1962 to US$1.7 billion in 1972. Initially, exports consisted only of low-skilled, labor-intensive products such as wigs, plywood, footwear, and low-quality textiles, but by 1971 they diversified into 983 items and higher-skilled, labor-intensive appliances such as electric products began to be exported.

This remarkable performance in export growth paved the way for high economic growth and helped accelerate industrialization. During this period, the economic growth rate averaged 9.1 percent annually, as compared with 4.3 percent between 1954 and 1961. The rapid export growth brought in foreign exchange, which was badly needed for industrialization, and gave entrepreneurs access to foreign markets and opportunities to learn managerial techniques.

Under the first two five-year economic development plans (1962-66 and 1967-71), Korea built its basic industries. During this period, the investment to GNP ratio averaged 23.4 percent, while the domestic savings rate was 14.6 percent. This gap in financing investment projects was met with foreign capital inflows. The Foreign Capital Inducement Act of 1966 encouraged private firms to borrow abroad by providing guarantees on their foreign loans. Foreign loans amounted to

US$2.5 billion during this period.

By 1971, the construction of the basic industries such as steel, fertilizer, cement, oil refining, and electricity and the social infrastructure such as highways, harbors, and irrigations facilities were either completed or underway. Thus, by the end of this period, Korea had made the transition from an agriculture to a manufacturing-centered economy <Table Ⅰ-1>.

2. The Heavy Industry Drive Period (1973-1980)

In 1973 the Korean government promulgated the Heavy and Chemical Industry Declaration, which was designed to strengthen heavy engineering and petrochemical processing industries, including iron and steel, nonferrous metals, shipbuilding, industrial machinery, electronics, and petrochemicals. Accordion to the long-term plan prepared by the Heavy and Chemical Industry Promotion Committee, the heavy and chemical industries(HCI) share of GNP was to increase from 35.2 percent in 1971 to more than 60 percent in 1981, and US$9.6 billion was to be invested in the above six strategic industries from 1973 to 1981.

One to the major characteristics of this industrial policy was the government's deep involvement in the decision process of investment projects by providing direct and indirect assistance to the construction of plans and facilities. The government's direct investment in these industries increased, raising the heavy and chemical industries' share in the total economic development budget to 14.5 percent.

Using the industrial development plan as its guide, the government also direct1y allocated financial resources. Funds were mobilized thorough deposit money banks and the National Investment Fund and allocated to different industries. In addition to these loans, the government provided the heavy and chemical industries with so-called "policy loans" at a preferential low interest rate. As <Table Ⅰ-2>

shows, the proportion of financial resources available to the heavy and chemical industries relative to total loans increased and loans to the heavy and chemical industries exceeds those to light industries by the middle of the decade. In addition, tax benefits to the heavy and chemical industries were also given through exemptions and reductions of corporate taxes(<Table Ⅰ-3>).

<Table Ⅰ−2> Loans and Discounts of Deposit Money Banks by Industry, 1965-1982

(Unit: 100 million won)

Industry	1965	1975	1982
Agriculture, forestry, hunting, and fishing	19.5	3,033.0	1,530.0
Mining and quarrying	1.1	34.9	174.0
Manufacturing	28.8	1,660.4	9,636.0
	(39.9%)	(57.1%)	(47.6%)
Heavy and chemical[1]	10.9	681.0	5,222.0
	(37.8%)	(41.0%)	(54.2%)
Light[2]	18.0	979.3	4,414.0
	(62.5%)	(59.0%)	(45.8%)
Social overhead capital	2.5	368.2	2,689.0
Services	13.8	329.6	3,230.0
Other	6.3	209.1	2,964.0
Total loans and discounts	72.1	2,905.5	20,225.0

Notes: 1) Figures in parentheses are the ratios of loans and discounts to manufacturing to total loans and discounts.
2) Figures in parentheses are the ratios of loans and discounts to heavy and chemical industries to loans and discounts to manufacturing.
Source: Bank of Korea, *Economic Statistics Yearbook*, various issues.

The heavy and chemical industries were also protected under the label of infant industries with prohibitive tariffs and import restrictions. Thus, in 1978 the effective rate of protection for them was 72.8 percent, where as that of light industry was only 7.8 percent. The effective rate of protection for transportation machinery, electrical machinery, and chemical processing products exceeded 100 percent.

In response to these measures, the share of th heavy and petrochemical industries in the manufacturing sector increased from 38.0 percent in terms of value added in 1973 to 54.5 percent in 1980, and exports exceeded 50 percent of total exports by 1983. This heavy industrialization in turn helped the entire economy grow at an average rate of 7.2 percent. This growth occurred at an enormous cost, however, creating several problems.

<Table Ⅰ-3> Exemptions an Reductions of Corporate Tax in Manufacturing, 1973-1980

(Unit: 100 million won)

Sector	Tax (A)	Exemptions and reductions(B)	Standard taxable amount(C)[1)]	Ratio of exemptions (B/C)
Manufacturing sector	2,122.3	966.6	3,088.9	31.9
	(100%)	(100%)	(100%)	
Heavy and chemical	1,350.5	904.3	2,254.8	40.1
	(65.5)	(93.6%)	(74.4%)	
Light	771.8	62.3	834.1	7.5
	(34.5%)	(6.4%)	(25.6%)	

Note: 1) C=A+B
Source: Ministry of Finance, internal reference

First, it was the single most important domestic factor responsible for the acceleration of domestic inflation in the 1970s, the international factor being, of course, the 1973 oil shock. The annual inflation rate accelerated from an 11.1 percent average between average between 1965 and 1973 to 19.3 percent between 1973 and 1980. The government financed investments for heavy industrialization by printing money and creating the National Investment Fund. Both the prohibitive tariffs and import restrictions also contributed to inflation. Since nominal rates of interest on savings were 15.5 to 20.0 percent a year and the annual inflation rate was 19.3 percent during this period, the real rate of interest was actually negative. Firms investing in heavy industry were provided with loans at a negative real interest rate, and given the opportunities for higher-yielding speculative investments such as real estate, they may have diverted funds fueling further inflation.

Second the heavy industrialization lacked economic rationale because it was not based on comparative advantage. As the six strategic heavy and chemical industries were picked for national security as well as economic reasons, their factor intensity varied widely, ranging from 0.54 in nonferrous metal to 2.24 in light metal. This meant that their international competitiveness also vaned widely from industry to industry.

Third, economic power was concentrated among several major corporations and there was subsequent economic inequality. Since they were mostly large companies and were given preferential credit and subsidies, they became even bigger

3. Structural Adjustment and the Liberalization Period (1980-1985)

In 1980 the Korean economy was faced with some serious problems that had their origin in external factors as well as certain past industrial policies. The worldwide recession following the second oil shock in 1979 dealt a major blow to the Korean economy. In addition, it suffered from domestic inflation and political instability following President Park’s assassination. Industrialized countries began to lose their comparative advantage in many of their traditional manufacturing Industries and grew more protectionist, while developing countries, such as China and the Southeast Asian nations, began their racialization, specializing in the production of low-skilled, labor-intensive items. Sandwiched between them, Korea felt the need to change its industrial structure,

Among the numerous policies adopted at this time were perhaps five measures that most distinctly characterized the role of the government. First was the macroeconomic policy implemented in 1980 that aimed at stabilizing inflation, galloping at an average annual rate of 19.7 percent measured in terms of the wholesale price index (WPI) since 1977. The growth of money supply was reduced to the target zone of between 11.5 percent and 15.0 percent (1983-1986), as compared with the average annual rate of 24.7 percent during the Fourth Five-Year Economic Development Plan(1977-81). Fiscal policy was also strictly regulated, with expenditures growing only at 7.5 percent annually from 1980 to 1985 in real terms. The ratio of the government budget to GNP thus remained less than 30.0 percent until 1984. As a result of these measures, the inflation rate dropped to a single digit and the economy regained its industrial competitiveness in the world market.

The second policy involved a structural readjustment of the heavy and petrochemical industries. Due to overlapping and excessive investments in the 1970s and a lack of demand caused by the world recession, the capital utilization rate in the heavy machinery industry was no more than 20 percent In 1981 and most of the firms suffered large losses. The government was forced to initiate mergers, cancel some investment projects, and promote product specialization in power-generating equipment, automobile assembly, heavy electrical motors, electronic switchboard systems, diesel engines for marine use, and copper smelting.

The third policy introduced to help reshape the economy was a revocation of the large incentives given the heavy and chemical industries in the1970s. Loans no longer carry preferential rates of interest. While they are still encouraged to invest in those areas that look promoting from the viewpoint of dynamic comparative advantage, they are not protected with prohibitive tariffs or import restrictions. For the most part, they are no longer exempt from taxation. In addition, the government now only suggests directions of growth, providing neutral and passive rather than active support.

<Table Ⅰ−4> Changes in the Import Liberalization Ratio

(Unit: %)

	1978	1980	1982	1983	1984	1985
Import liberalization ratio[1)]	64.9	68.5	76.6	80.7	84.8	87.7
Total number of import items	1,097	1,010	7,560	7,915	7,915	7,915
Number of import-liberalized items	712	692	5,791	6,386	6,712	6,945

Note: 1) Import liberalization ratio $= \frac{\text{number of import liberalized items}}{\text{total number of import items}}$

Source: Bank of Korea, internal reference

One of the major differences distinguishing the now policy from previous ones is that now the government provides various tax and financial assistance on a function-specific rather than a sector-specific basis. Energy-saving firms or firms investing in technological development were given loans. By changing from a sector-specific to a function-specific policy, the government means to avoid earlier mistakes and allow market forces to play a greater role.

The fourth measure involved the promotion of market competition and thee-nation of various factors inhibiting a competitive environment. By promoting market competition, the government sought to enhance efficiency. Toward this goal it enacted the Fair Trade Act in 1981, the main aim of which was to eliminate a monopolistic structure and to prevent the concentration of economic power in large conglomerates. The act also encouraged cooperative alignments between large and small firms.

In order to further promote competition, import liberalization was also persistently pursued during this period. As shown in <Table Ⅰ-4>

the import liberalization ratio increased from 68.5 percent in 1980 to 87.7 percent In1985. In addition, the average tariff rate fell from 24.9 percent in 1980 to 21.3 percent in 1985. This policy has contributed to greater competitiveness by lowering the cost of imported intermediate materials and curbing domestic inflation.

The fifth measure was the government's emphasis on the growth of the small and medium-sized firms. To this end, the government promoted the manufacture of technology-intensive or skilled labor-intensive products such as color televisions, computers, semi-conductors, and machine tools.

The industrial policies adopted during this period seem to be on the right track, even though some of them have been ineffective in implementation. The policy for small and medium-sized firms, for example, has often resulted In the neglect of those needing assistance. Loans have been made more available to large firms than to small ones, despite the mandatory ratio of loan allowance for small firms imposed on financial institutions,

Ⅲ. Fiscal Policies

Characteristics of the Korean fiscal policy during the industrialization period include a relatively small public sector, adherence to a balanced budget, comparatively low taxes, liberal use of tax incentives for investments, heavy reliance on indirect taxes, increased public savings, relatively little spending for redistributive social services, and the budgeting of significant resources for industrial development.

1. Size of Public Sector and Expenditure Pattern

The expenditure policy has been basically restrained, with the ratio of the central government expenditures to GNP remaining at 20 to 23 percent throughout the 1962 to 1985 period(<Table Ⅰ-5>).

The ratio of the government's fiscal investment averaged 26.7 percent in the 1962-66 period, but gradually declined to 15.6 percent during the 1982-85 period, indicating that the government's role in capital formation was important but declining. Public savings were negative until the early 1960s, when there was an almost uninterrupted improvement due to the government's efforts to curtail expenditures and increase revenues. The ratio of public savings to GNP reached 6.7 percent between 1982 and 1985.

An important characteristic of the central government expenditure pattern is the small share of social development expenditures throughout the industrialization period. It has, however, risen relatively sharply in recent years, with most of the funds for social development expenditures or 13-20 percent of the total social development expenditures.

Economic development expenditures were the second largest item in both the 1960s and 1970s. Their share of the government budget, however, has steadily declined to 16.2 percent in 1985, reflecting the declining role of government in economic development (EPB, Summary of the Budget, various issues).

<Table Ⅰ−5> Fiscal Indicators

(Unit: %)

Industry	1962-66	1967-71	1972-76	1977-81	1982-85
Ratio of central government expenditure to GNP	22.8	23.5	20.4	21.6	21.7
Ratio of central government general account expenditure to GNP	15.0	15.5	14.6	16.2	17.4
Ratio of local government expenditure to GNP	-	3.7	3.5	5.3	7.6
Ratio of total tax to GNP	9.1	13.9	14.1	17.3	18.9
Ratio of local tax to GNP	1.4	1.2	1.4	1.9	2.3
Ratio of government investment to gross capital formation	26.7	24.4	19.4	16.5	15.6
Ratio of government savings	0.3	5.5	3.9	5.9	6.7

Sources: EPB, *Major Statistics of the Korean Economy*, 1982, 1986.
Bank of Korea, *Economic Statistics Yearbook*, 1986.
____________, *New National Accounts*, 1986.

2. Tax Policies

The primary objective of the tax policy was to mobilize resources for capita1 formation in the public sector, while not discouraging investments in the private sector.

Major tax reforms were undertaken at numerous times during the industrialization process. Tax treatment of businesses grew more favorable with the introduction of tax exemptions in 1956, accelerated depreciation in 1971, investment tax credit in 1956 and 1971, and lowered tax rates in 1961, 1971, 1974, and 1982

The most important reform in fiscal management since the beginning if the modernization effort may be the creation of the Office of National Tax Administration (ONTA) in 1966. This had the clear mandate of increasing tax collections and received full support from political leaders. One of the consequences of the strengthened machinery for tax administration has been a more powerful instrument for monitoring business performance and steering businesses toward objectives consistent with national policy goals.

Another important aspect of the tax policy is the tax-incentive system. The Korean government has applied various tax incentives to promote industrial development and export growth. Most enterprises engaging in the heavy and chemical industries and export industries have benefited from these tax incentives.

In the 1960s the core of Korea's industrialization policy was export promotion and tax incentives were provided accordingly. In the 1970s more diversified and sophisticated tax incentives were instituted for heavy industrialization, while incentives for export promotion were actually reduced. Although direct policies, including credit allocation, continued to play a major role during the decade, tax-incentive policies began to receive increasing emphasis in the allocation of resources in line with the growing reliance on market forces.

Generally speaking, investment-incentive policies were employed to affect the sectoral allocation of investment resources: in only a few cases were they employed as countercyclical policy measures. The complex tax-incentive system incentive system includes incentives for (1) export promotion; (2) key industries; (3) small and medium-sized firms; (4) local industrial development; (5) technical innovations;, (6) foreign investment; (7) counter-cyclical investment; (8) energy conservation and environmental protection; and (9) resource development.

It is certainly difficult to evaluate how effective tax incentives have been in achieving the goals set by the government. Some sophisticated studies have been conducted, however, to examine the net benefits derived from various tax incentives to a typical key industry, such as machinery and to calculate the effective marginal tax rates by sector. From these studies, a number of interesting features can be observed. First, the key industries received most support during the latter half of the 1970s. In addition, this support came mainly from the tax-holiday option in the special tax treatment for key industries provided by the Tax Exemption and Reduction Control Law (TERCL). In effect, one of the major reasons for terminating this option in 1981 was that direct exemption-type incentives had been utilized too heavily in relation to other types of incentives. Due to the lower tax rate and the stabilization of interest rates, the actual benefits of tax incentives have drastically decreased in recent years (Choi et al. 1985).

To examine the role tax incentives have played in allocating resources among industrial sectors, Kwack (1984) calculated the effective marginal tax rate by sector, as shown in <Table Ⅰ-6>, which incorporates a detailed account of Korea's complicated tax incentives. As can be seen the relative size of the incentives provided to the key industries. As can be seen, the relative size of the incentives provided to the key industries was substantial, particularly during the latter half of the 1970s.

<Table Ⅰ-6> also shows that a typical Korean firm had been paying corporate income taxes at an extremely high effective rate in spite of the complicated and numerous tax incentives. It should be noted that the effective rate is affected not only by the statutory tax rate and tax incentives, but also by the discount rate and inflation rate. The major reason for the high effective tax rate in <Table Ⅰ-6> is the high inflation in the capital goods market and the tax depreciation system based on historical cost.

<Table Ⅰ−6> Effeetive Marginal Tax Rate by Sector

(Unit: %)

	1973	1975	1978	1980	1981	1982	1983
Processed food, beverage, and tobacco	50.6	55.1	42.8	46.7	57.1	58.6	39.5
Textile, leather, paper, and printing	49.8	54.3	42.1	46.1	56.2	57.6	38.7
Construction materials	50.3	54.6	42.8	46.5	56.6	58.1	39.7
Chemical products							
General	48.9	54.2	41.1	45.3	55.8	57.1	37.6
Special	46.3	38.8	29.5	32.0	42.4	50.8	34.8
Basic metal and products							
General	49.0	53.2	41.9	45.5	55.0	56.4	38.1
Special	46.9	38.7	31.0	32.9	42.6	50.8	35.8
Machinery, electrical and electronic equipment							
General	49.3	53.7	42.0	45.8	55.6	57.0	38.4
Special	47.1	39.1	30.9	33.0	43.02	51.2	36.0
Statutory maximum tax rates	40.0	40.0	40.0	40.0	40.0	40.0	40.0
Inflation rates in capital goods market(3-year moving average)	17.0	33.7	8.2	19.4	24.3	21.5	9.7

Notes: General rates are applicable to firms not qualified to get the special tax treatment. Special rates are for firms that qualify for this special tax treatment.

Source: Kwack(1984).

Ⅳ. Economic Planning and Management System

The role of the government in Korea's industrialization exceeded that of setting the right policy direction and incentives. The political leadership was committed to economic development, which was translated into action by an efficient bureaucracy and by private firms, creating: a climate conducive the conduct of business. The alliance between business and government was supported by a set of strong institutional mechanisms,

The dynamics and inner workings of industrialization have been reflected in and integrated into the development planning, and it is widely held that Korea's rapid economic growth has been greatly aided by its successful development planning. It would thus be worthwhile to review the development planning efforts of the government, with special emphasis on their orientation, organizational structure, and actual performance,

After some unsuccessful attempts to formulate a medium-term development plan during the post-Korean War reconstruction period, Korea formally adopted its First Five-Year Economic Development Plan(1962-66) in 1961 and began implementing it in 1962. Since the launching of the first plan, Korea has formulated and completed five additional ones. Korea is currently implementing the Sixth Five-Year Economic and Social Development Plan(1987-91).

1. Political Leadership and Ideology

Development plans and strategies exist in almost every developing country. What is unique in the case of Korea has been its ability to put the plans and strategies into practice.

For all the incentives to be correct, for the administrative arrangements guaranteeing access to those incentives to be efficient, and for the institutional mechanisms for adjusting those incentives to be effective, there had to be a strong political commitment to development and an able bureaucracy. This was precisely the case in Korea.

The Korean War and the subsequent poverty left a deep impression on Koreans who desired to improve their social and economic status. The “growth first” ideology also came from the geopolitical reality that Korea would have to become economically self-reliant in order to defend itself against aggression from the north, as well as from the fact that foreign aid was dwindling. Therefore, Korea needed only an effective mobilization of its resources and a fuller expression of the longings of its people. It was the leadership’s commitment to development and development plans the provided the opportunity for these.

One characteristic of the Korean approach to policy planning with regard to industrialization was that, except for their commitment to anticommunism, political leaders and the general public alike seemed pragmatic and displayed no ideological bias. The pragmatism that prevailed in the policymaking process allowed the government to use all available instruments to achieve its goals. In the policy planning process, particularism also prevailed, permitting the government to apply a certain policy to a limited number of clients In a specific situation. Pragmatism with no ideological basis also had the drawback of causing frequent changes in policy, which reduced public confidence in the government’s economic leadership.

2. Institutional Framework for Development Planning and Economic Management

Long-term development planning and the formulation of short-term economic policies require organizations and institutions to gather information, formulate, implement, and evaluate policies, and bring about the consensus necessary for success.

The leadership's commitment to economic development was reflected in the various organizational reforms that were aimed at institutionalizing policy formulation. The first attempt was the establishment of the Economic Planning Board(EPB) in 1961, which was responsible for economic planning, central budgeting, foreign capital management, and statistics, and had the authority to coordinate policies and programs of all the economic ministries. Since 1963 the minister of the EPB has concurrently served as the deputy prime minister, under whose jurisdiction both economic planning and budgeting functions fall in order to narrow the gap between planning and implementation.

The EPB is a central planning organization but it cannot prepare and implement a development plan without the collaboration of the relevant ministries. Each ministry participates in planning through its Office of Planning and Management, which is a higher-level organization than the bureau and reports directly to the minister. The office handles both development planning and budgeting for its ministry and is responsible for monitoring performance and evaluating the ministry's projects and policy measures.

In line with the greater emphasis on economic planning, the Office of Planning and Coordination was established under the prime minister in 1961 and has since been responsible for assisting him in monitoring the performance of major projects and policies.

The private sector has been concerned not only with the government's long-term development plans, but also its short-term economic management policies, which may or may not be connected to the implementation of a development plan. In either case, short-term policies have directly influenced decision-making in the business sector.

Short-term government policies are addressed to areas such as aggregate demand management, taxes, exchange rates, interest rates, preferential credit, farm prices, and industrial promotion. They are normally initiated or designed by officials at a relevant ministry For instance, short-term proposals that concern aggregate demand management, taxation, exchange rates, and interest rates are normally prepared by the Ministry of Finance in consultation with the central bank and other related ministries. Farm price policy is, of course, the responsibility of the Ministry of Agriculture and Fisheries. These policy proposals have to be reviewed by and coordinated with other related government agencies. Before the president's final approval is granted, therefore, the proposals have to be approved at the Economic Ministers Meeting, which is comprised of the ten economic ministers and the deputy prime minister as chairman.

In cases requiring emergency economic measures, policy proposals are not necessarily prepared by the relevant ministry officials, but sometimes by a small number of elite officials who have access to the president and wish to promote certain ideas. If the group succeeds in persuading the top decision-maker that a certain policy should be adopted, proposals are worked out quickly (and usually secretly) and then reported directly to the president without going through the normal channel of the Economic Ministers Consultation Meeting. If the president accepts the proposals, the decisions are sent to the appropriate ministry for the formal process of cabinet approval, announcement, and implementation.

Even in normal circumstances, when policies are discussed at the Economic Ministers Consultation Meeting, the actual policymaking process involves a relatively small number of government officials. Although a ministry might have a special committee for the deliberation of certain policy issues and a few private experts might participate. In such a committee, the committee is usually believed to function as a rubber-stamp body. Since Korea's economic policymaking appears to involve only a small number of government officials, it is able to produce policy decisions rapidly.

The president himself chairs various meetings, of which a representative sample might include the Monthly Economic Review Meeting, the Monthly Trade Expansion Meeting, and the Quarterly Science and Technology Promotion Meeting. These are attended not only by policymakers, but also by business and political leaders. Furthermore, the meetings serve as a mechanism for sharing information and enhancing coordination among the ministries and between the government and the private sector

3. Collaborative Efforts by the Government and Business

Since the institutional framework for economic decision making is crucial to economic development and a fundamental part of that framework is the relationship between business and government, it is necessary to explore this relationship in detail in order to understand Korea's high economic growth.

There are differences in opinion with regard to the roles the government and the private sector have played separately and collaboratively in promoting industrial development in Korea. Some orthodox economists believe that Korean industry has succeeded in spite of the government's industrial policy and development planning and not because of it. They reject the view that the high economic growth in Korea is the result of government intervention in the economy. Others, however, ascribe Korea's success to the role of a strong and effective government in guiding and coordinating the directions of industrialization, while operating within a basically market-oriented system.

All Korean governments since independence in 1945 have been committed to maintaining an economy in which the private sector played a central role. Therefore, planning in Korea played the role of providing little more than a framework, leaving most practical decisions in the hands of the private sector. Thus, plans were supposed to point out directions, offering incentives to those who complied, but not forcing anyone to do so.

The importance of entrepreneurship in Korea's rapid economic growth should be emphasized. While the general environment-favored enterprise, it was the business leaders who seized the opportunities. Talented entrepreneurs could not have been closely guided and directed by a cadre of civil servants, no matter how well educated. The development plans were masterminded by the government, but were ultimately executed by private entrepreneurs. The public, as a whole, was receptive to the entire scheme. Policies and targets were set by the government, but private business leaders were consulted before and after the decisions were made and, as already noted, decisions could be changed if the desired results did not follow.

In soliciting the fullest cooperation of the private sector, the government resorted not only to material, but also to moral suasion, examples of which are numerous. The top government priorities - economic growth, industrialization, and export growth - and a whole away of incentives were widely publicized. In many instances, the government did not leave things entirely to the good will of entrepreneurs. Businesses were often urged to raise their own internal targets annually.

A more complex approach is required than the reasoning associated with a simple government-market dichotomy. The basis of Korea's success has been a collaborative effort by the government and private firms. It Is not due either to purely public economic decision-making. The combined efforts and the concordance between personal initiative and public action have been responsible for Korea's economic achievement.

V. Concluding Remarks

The primary reason for Korea's rapid economic progress since the early 1960s has been the concentration of energies on a single purpose economic development and industrialization.

While not all aspects of the Korean experience could or should be repeated elsewhere, it does provide some broad lessons, many of which may prove relevant to the economic management of other developing countries, such as the importance of Korea's outward-oriented development strategy. The Korean government attempted to promote economic growth even in the absence of evidence about the merits of the strategy or the comparative advantage of labor-intensive manufactured exports as an outlet for Korea's massive unemployment. Although this outward-looking strategy was vulnerable to external shocks, it has proven to be a better option than an inward-oriented one. The former enables a country to better exploit international economic opportunities, to overcome the limitations posed by the domestic market, and to benefit from the stimulus associated with greater exposure to foreign competition.

The Korean experience also affirms the importance of market price signals. Scarce resources were allocated by basically correct market price signals on the initiatives of energetic entrepreneurs operating in a competitive environment. The government's role was to let businesses exploit favorable opportunities by providing appropriate incentives and eliminating disincentives for their activities. Although it exerted a pervasive influence on activities of private firms and the use of economic resources, the government allowed free competition to reign whenever possible

With regard to the importance of the role the market plays, Korea has learned from its own experiences. The structural imbalances that developed in Korea's industries in the late 1970s were caused in part by the arbitrary selection of strategic industries and the distorting policies supporting them. As the economy grows in size and complexity excessive intervention by the government is not a good substitute for the market mechanism, which is a better means of achieving efficient allocation of resources. The increasing complexity of the Korean economy demands greater decentralization of economic decision-making, with more autonomy given to the private sector and greater reliance placed on the market. At the same time, the growing concentration of power in the hands of giant corporations demands more effective government control over monopolistic abuses of the market.

A few lessons of beyond economics. The political leadership's strong commitment to economic growth is important for efficient economic management and rapid industrialization. The Korean experience shows that social and political stability is a critical precondition for economic development. In an unstable sociopolitical environment, the nation's entrepreneurs, who played a critical role in Korea's development, could not have undertaken risky long-term investments.

Korea's system has one weakness that other developing countries should avoid in their policymaking it lacks a consensus-building process. Although the government tried to build a consensus in policymaking, not only within the government but also among various sectors of the society with different interests, Korea essentially failed in this. Important policy decisions were often made by a small number of bureaucrats or government officials without much public debate. Hasty decision-making without public support produced many policy reversals. The lack of understanding and positive participation on the part of the people made it difficult for some policies to be successfully implemented, indicating a need for more refined ways of building a national consensus.

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Chapter Ⅱ. Korean Financial Crisis and Fiscal Policy

Ⅰ. Introduction

The financial crisis that began with financial turmoil in late 1997 pushed Korea to the verge of requesting a moratorium on debts and saddled many Koreans with severe burdens. In late 1997, the financial contagion that had originated in Southeast Asia landed in Korea. The impact was truly devastating. What had initially started as a currency crisis in the foreign exchange market quickly spread through and paralyzed the financial sector in Korea. The real sector followed suit and the economy contracted by 5.8 percent in 1998, an 11 percent downswing from the positive growth of 5.5 percent in 1997.

There are diverse explanations for the causes of the financial crisis in Korea, but most analysts agree that a liquidity shortage lies at the heart of the crisis that resulted from excessive borrowing of hedge funds by the private sector or, to put it another way, a mismatch between short term borrowing and long term investment, even though Korea's economic fundamentals were strong prior to the onset of the crisis. Needless to say, there were many other underlying causes, including structural weakness in banking and corporate governance, inadequate transparency, and lax bank supervision.

The National Assembly passed supplementary budgets twice each year for both 1998 and 1999, increasing budget deficits to more than 5 percent of GDP in two consecutive years. The budget authority encouraged ministries to spend the allocated money on schedule in order to maximize the stimulus effects of the increased budget. The recent economic recovery is quite fragile since it is not based on new investments and productivity increase. Despite pressing demands to grapple with the immediate difficulties Korea faces today, it is important not to forget the importance of nurturing the growth potential of the economy through continued investment. The crisis is not over yet though we have begun to see the light at the end of the tunnel.

For the last eighteen months or so, the Korean government and the IMF made repeated mistakes in examining and prescribing for the recovery of the economic health of Korea. In the early months of the crisis, policymakers did not avail themselves of fiscal flexibility. Rather, the IMF and the government agreed to extend the prudent fiscal stance by maintaining a more or less balanced budget. The IMF not only wrote out an incorrect prescription in the initial stage of the financial crisis in Korea, but it continues to make unsuitable recommendations to the Korean government. The IMF has recently been recommending that the Korean government expand budget deficits in order to stimulate the economy. Such a recommendation, seems to reflect the worries on the part of the Western world over the alarmingly shrinking economies of Asia and the inexplicably increasing current account surpluses in Korea. Such an IMF recommendation to which the Korean government acquiescences for political reasons, is expected to considerably impair the health of the Korean economy in the long run.

The main objective of this chapter is to review fiscal policies as implemented in response to the financial crisis in Korea, and to examine whether the fiscal sector can accommodate the cost of structural reforms without having an unbearable impact on the welfare of the people in the coming years.

Ⅱ. Competitiveness of the Korean Government

Since the 1960s, the Korean government has been deeply involved in economic development. Rapid economic growth and drastic social development led to the growth of the public sector in size and role. The public sector, or the government, has been viewed as an inefficient monolith incapable of providing quality services to the nation or the people. Some even argue that the government has become a hindrance to Korea's continued economic development. They feel that excessive government regulation and intervention in the market have stifled Korea's competitiveness at home and abroad. Any reform undertaken in Korea must begin with the public sector because without making necessary changes in the public sector, reform of any other targeted segments will surely fail.

In the past, the government's frequent intervention, authoritative dictates and unnecessary regulations seriously hindered the development of a free market economy. Non-transparent policies and an inaccessible administration nurtured dubious collusion between the government and businesses, arbitrary regulations, and corruption. In terms of the government's inner management, promotion of government employees was based on seniority, not ability. Government employees as a group, in turn, grew extremely resistant to reform as their motivation was to preserve the *status quo*, not to serve the public.

The organization and size of the government bureaucracy grew, irrespective of the demand for its services. A good illustration of this trend is the 500 percent growth of the number of agricultural civil servants, despite a 33 percent decrease in the farming population over the past thirty years. In addition, concentration of power and authority in the central government prevented local officials from exercising any substantial autonomy, which led to futile attempts at local governance.

<Table Ⅱ−1> Competitiveness of the Korean Government

	1992	1993	1994	1995	1996	1997	1998	1999
Overall Ranking	29	28	32	26	27	30	35	38
Government Ranking:								
National Debt	13	9	8	8	7	10	14	15
Government expenditure	14	13	12	14	13	12	6	14
Fiscal Policies	9	7	8	9	9	8	11	18
State Efficiency	39	39	41	36	38	42	44	43
State Involvement	42	41	46	42	46	44	46	46
Justice and Security	28	28	27	26	31	31	31	38

Sources: IMD, *The World Competitiveness Yearbook*, 1997~1999.
IMD, *The World Competitiveness Report*, 1992~1996.

<Table Ⅱ-1>, which ranks the international competitiveness of the Korean government, shows some characteristics and interesting features of the Korean public sector. While the pecuniary section of the Korean government has been relatively much smaller than that of other countries, the government sector of Korea has been evaluated as being much less productive and more involved than those of other countries.

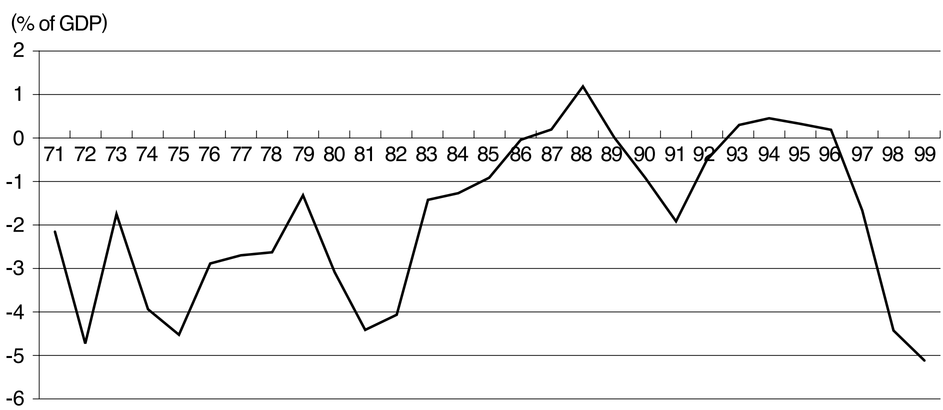
In 1997 for example, the Geneva-based International Institute for Management Development (IMD) ranked the efficiency of the Korean government as forty-second out of forty-six countries. The degree of government intervention was even more serious, leaving Korea at the forty-fourth rank among all the countries evaluated. Although Korea’s overall rank was thirtieth out of forty-six countries on the IMD 1997 scoreboard of national competitiveness, it placed twelfth in the government expenditure category and eighth in fiscal policies. Overall, the competitiveness of the Korean government improved until 1997, but has been drastically deteriorating for the last two years.

Ⅲ. Fiscal Policy before the Financial Crisis

During the 1960s and 1970s, the Korean government successfully employed fiscal policy as a means to support rapid economic growth. In the 1980s the focus of fiscal policy shifted to economic stabilization through strict discipline that required that spending be limited within revenue. Not much attention has been paid to the possibility of utilizing counter-cyclical fiscal policy as an instrument for smoothing out short-term fluctuations.

During the 1970s and into the early 1980s, the Korean government ran a persistent budget deficit. On average, the consolidated budget deficit of the central government amounted to 3 percent of GDP during this period, as shown in [Figure Ⅱ-1]. The chronic deficit was brought to an end by a major shift in policy stance in the early 1980s. The new government that came into power in 1981 responded by tightening monetary and fiscal policies rather drastically.

[Figure Ⅱ-1] Surplus and Deficit of the Central Government Consolidated Budget



From the late 1980s onwards, greater priority was given to social objectives, including income redistribution and social services. These were met despite a fall in the total expenditure/GDP ratio, thanks largely to a sharp cut in defense expenditure as a proportion of GDP. The general government fiscal balance averaged 0.6 percent of GDP for the period 1993-1996.

The balanced budget principle kept the public debt to a minimal level. In 1996, just before the crisis, the gross debt of the central government was less than 10 percent of GDP, and the net debt was negative, that is, the central government was a net creditor to the private sector. The local governments were generally in good shape as well.

Of course, there were costs as well as benefits associated with the balanced budget principle. The counter-cyclical role of fiscal policy was ignored, and essential investments in social infrastructure were often sacrificed to contain the overall expenditure. However, the important result was that strict application of the principle kept the size of the government debt at a manageable level, which left the economy with considerable maneuvering room when it was stricken by the crisis.

Ⅳ. IMF's Diagnosis and Prescription

On November 21, 1997, the Korean government was forced to request bail-out loans from the IMF in the face of unmanageable external liabilities. After a few days, Korea signed an agreement with the IMF for a financial aid package totaling 58.3 billion dollars, subject to a broad range of conditions, including macroeconomic stabilization and structural reform. Since then, Korea has undergone far-reaching and dramatic changes in all walks of life under the supervision of the IMF.

The policy measures stipulated by the IMF broadly fell into two categories. First, there were the short-term, macroeconomic policies aimed at quick restoration of stability to the Korean won. Next, there were the micro-oriented policy measures, necessarily more long-term in nature, that aimed to rectify the economy's structural problems.

The macroeconomic measures initially prescribed by the IMF can be summarized as a policy regime of high interest, tight money, and fiscal austerity. As a whole the program called for austerity in economic policy, with the goal of moving the trade account back into surplus by limiting aggregate demand. The rationale behind this was that the key to overcoming Korea's foreign exchange crisis lay in securing sufficient foreign reserves to ensure the ability to honor external debts, which would be achieved mainly by running a trade account surplus.

The terms of fiscal austerity originally required the Korean government to keep the budget at balance or slight surplus. The original budget for 1998, adopted before the crisis, had projected a small surplus of 0.3 percent of GDP. This was slightly relaxed in February 1998 to a prudent target deficit level of 0.8 percent of GDP for 1998 despite a sharp decline in tax revenue. Meeting this target required a substantial cut-back in expenditure. Accordingly, the National Assembly passed a first supplementary budget at the end of the first quarter, in which large cuts were made in infrastructure investment, agriculture, and military spending.

<Table Ⅱ-2> chronologically summarizes the agreements between the IMF and the Korean government on major economic indicators.

<Table Ⅱ-2> Korea-IMF Agreements

	Initial Agreement (1998.1.8)	1st Agreement (1998.2.17)	2nd Agreement (1998.5.22)	3rd Agreement (1998.7.28)	4th Agreement (1998.11.18)	5th Agreement (1999.2.2)
Growth rate	1-2 percent	1 percent	-1 percent	-4 percent	Positive Growth	2 percent
Price index	9 percent	Around 9 percent	One digit	9 percent	5 percent	Around 3 percent
Current account	+	8 billion dollars	21-23 bil. dollars	33-35 bil. dollars	20 billion dollars	Maintain a sizable surplus
Budgetary deficit (Compared to GDP)	-	3.8 tril. won (-0.8 percent)	4.8 tril. won (-1.2 percent, max. -1.75 percent)	71.5 tril. won (-4.0 percent)	-5.0 percent	-5.0 percent
Unemployment rate	Under 5 percent	Under 6 percent	6 percent range	6 percent range	-	-
Money supply reserve base		24 tril. won (15.7 percent 3/4Q)	25 tril. won (14.2 percent 3/4Q)	25 tril. won (13.9 percent 4/4Q)	No specific ceiling	No specific ceiling
Usable forex reserve		30 bil. dollar	34 bil. dollar	410 bil. dollar	Continue to be built up	Continue to be built up
Interest rate	High interest rate	Cautiously and gradually down	Additionally down	Flexibly adjust	Maintain low interest rate	Maintain low interest rate

Source: Ministry of Finance and Economy.

One can easily see that judgements and predictions varied often and from one extreme to another. For example, the initial agreement assumed a growth rate of 1~2 percent in 1998. Only six months later, the IMF predicted that the growth rate would fall from 1~2 percent to -4 percent. Compared to the IMF's projection in February 1998 of the budget deficit to be 0.8 percent of GDP, July's projection of the budget deficit amounted to an astonishing 4 percent of GDP.

The Korean government and the IMF must have had close policy consultations with each other, and jointly produced policy programs since Korea was hit by the unprecedentedly severe financial crisis and obtained a bailout loan from the IMF. One can imagine that experts from both sides worked hard trying to come up with solutions that best fit the different and difficult situations in Korea. Also, not infrequently, they would have had different opinions as to how to approach problems. At this juncture, it might be interesting to try to determine the viability of, and the existence of justification behind some of the recommendations the IMF made to the Korean government.

To begin with, the IMF may have made some grave mistakes in properly addressing Korea's financial crisis in its initial stage of development. It was clear to everyone that the foreign exchange crisis in Korea came against a backdrop which was substantially different from that of a number of South American countries where the primary causes were excessive money supply and expansionary government expenditures. In contrast, Korea maintained a sound monetary policy and a balanced budget. In utter disregard of this difference, the IMF applied its favorite prescriptions to Korea, which were drastic remedies consisting of a credit squeeze and retrenchment in fiscal management.

Even before the financial crisis in Korea, a good number of IMF experts had frequently visited Korea and had consulted with Korean government officials. However, the recommendations from the IMF almost completely disregarded the structural characteristics of the

Korean economy.

Everyone agreed that there was a need to restructure big businesses. However, the reality in Korea, where the debt-equity ratio of these companies was very high, was not in any way reflected in IMF's recommendations which were used in the formulation of Korea's economic policies. This was very wrong. Granted that the high interest rates and retrenchment policies were needed to cope with the financial crisis in its initial stage for the sake of stability of the foreign exchange, the IMF provided recommendations on the basis of incorrect economic predictions and in disregard of other economic indicators in Korea. It also overlooked the degree of economic depression of the country, and this fully exposes the IMF recommendations to critical reviews.

It is true that Korean policymakers are also to blame, indeed, but the IMF failed in properly predicting the economic growth rates which formed the basis of all the economic policies. When the IMF and the Korean government had their first consultation towards the end of 1997, they predicted that the economic growth rate for 1998 would be 3 percent. In January 1998, however, they amended it to 1 or 2 percent for the first quarter of the year at the time of the adjustment of the nation's macroeconomic indicators. Then in May 1999, at the time of their second consultation, they reduced it further to minus 1 or 2 percent. The most optimistic prediction at this time is minus 6 percent.

In other words, the Korean government and the IMF were formulating economic policies without an accurate assessment as to what the situation would be in the next six months or even in the month that immediately followed. For the past year, Korea was left at the mercy of the policy recommendations of the IMF during the nation's worst financial crisis in history, when the IMF was not even able to see an inch before its nose.

We have never seen an economic organization that forecast a growth of 3 percent and changed it to minus 1 percent within six months - and then saw the actual growth rate predicted at minus 6 percent by other experts in another six months. If an organization, whose primary business is to make economic forecasts, should make the kind of wrong predictions as were made by the IMF, clients would no longer wish to buy any information from that organization. Such an organization would be eliminated from the market through the process of natural selection.

Given the possibility of a conflicting relationship between the stability of the foreign exchange market and the economic condition, if the IMF had predicted a minus 6 percent growth rate for the Korean economy for 1998 (instead of plus 3 percent), the IMF would not have written out a prescription that required high interest rates, tight credit and fiscal retrenchment. One would consider it ridiculous to try to venture a hypothesis about what has already become history. However, if the economic growth rate of 1998 had been set at minus 2 percent instead of plus 3 percent as predicted by the IMF, and economic policies had been implemented accordingly, the Korean economy would have achieved a minus 2 percent growth instead of minus 6 percent.

Nobody will deny the difficulty involved in making accurate economic predictions during the panicky financial situation in Korea in late 1997, nor do we want to one-sidedly criticize IMF. However, this still does not warrant a carefree attitude on the part of the Korean people to watch with folded arms the repeated mistakes made by the IMF in examining and prescribing for the recovery of the economic health of Korea. This is especially so given the fact that the IMF is to continuously exercise a great measure of influence on the Korean economy for the time being. The IMF not only wrote out a wrong prescription in the initial stage of the financial crisis in Korea, but continues to make incorrect recommendations to the Korean government.

The IMF has recently been recommending that the Korean government expand budget deficits in order to stimulate the economy. Such a recommendation seems to reflect the worries on the part of the Western world over the alarmingly shrinking economies of Asia and the inexplicably increasing current account surpluses in Korea. Such an IMF recommendation is expected to considerably impair the health of the Korean economy in the long run.

V. Two Special Fiscal Measures in Response to the Financial Crisis

Fiscal policy has played a crucial role in Korea’s response to the financial crisis. Besides providing the stimulus that jump-started the economy back to life, it has also been instrumental in marshalling financial resources for the ongoing structural adjustments in the financial and corporate sectors. Furthermore, fiscal policy has funded the expansion of the social safety net, providing a stable social and political backdrop to the painful restructuring process.

1. Fiscal Burden of Financial Reform

The Korean financial sector has long been criticized for its inefficiency, caused mainly by excessive government intervention. Some even say such a retarded financial sector was the main cause of the current crisis. Clearly recognizing this, the Korean government launched massive financial sector reform right after the foreign exchange crisis began.

The financial restructuring in Korea has proceeded as follows: First, banks that failed to satisfy the BIS ratio of 8 percent are to be closed or merged. Second, non-bank financial institutions that cannot meet self-rehabilitation standards are to be closed or suspended. Finally, to revitalize the banking sector and normalize credit flows, the Korean government is to provide fiscal support to dispose of non performing loans (NPLs).

Right after the currency crisis broke out, the total amount of bad loans in all financial institutions stood at 69 trillion won. However, the amount of bad loans accumulated tremendously between the end of 1997 and March 1998, reaching 118 trillion won, because many firms went bankrupt during this period due to the high interest rates and the credit crunch. Fortunately, next came a declining trend in bad loans, mainly due to the government's efforts to reduce them as well as a natural decline due to the restoration of financial stability.

The government injected huge amounts of the taxpayers' money into banks to support their restructuring process. As shown in <Table Ⅱ-3>, by the end of March 1999, 43.5 trillion won had been injected into banks, and by the end of 1999, the amount will have escalated to 64 trillion won. The Financial Supervisory Commission recently estimated that the total scale of NPLs of domestic financial institutions amounts to 130 trillion won, an increase of 12 trillion won from the 1998 estimate of 118 trillion. Therefore, additional injections seem inevitable in order to handle the increased NPLs.

Such injections of taxpayers' money for the purchase of NPLs and financial aid seemed inevitable in order to enhance the international credibility and health of the banking industry. However, some criticize that the government overly compensated the losses of the banks that acquired the five shutdown banks. The government had promised those five acquiring banks that it would compensate for any additional loss related to the acquisition for one year after the acquisition. Then it apparently overcompensated for such losses by calculating the asset value of shutdown banks on a book value basis, not even taking into account the value of their good will. Besides, some criticized that the Korea Asset Management Corporation purchased the NPLs of banks at too high a price during early purchases. It purchased 12 trillion won worth of NPLs at a price of 62.6 percent of the book value in early 1998, while the vulture funds of the U.S. normally purchase such NPLs at 10~20 percent of the book value.

<Table Ⅱ-3> Governmental Support for Financial Restructuring (as of March 1999)

(Unit: trillion won)

	Purchase of support for			
	Non-performing loans	Capital increase	Deposit payment	Total
Total amount of funds	32.5	31.5		64.0
Commercial banks	14.0(29.6)	8.6	5.8	28.4
Special-purpose banks	2.7(5.7)	-	-	2.7
Non-banks	3.2(8.7)	-	9.2	12.4
Amount of injected funds	19.9(44.2)	8.6	15.0	43.5
Remaining fund	12.6	7.9		20.5

Note: Figures in ( ) are the book value of non-performing loans.
Source: Financial Supervisory Commission.

However, the total amount of bad loans to be cleared out during the entire restructuring period is likely to be higher than the government's initial assessment of 120 trillion won. The reason for this conjecture is that the government might introduce new standards for categorizing bad loans. If "watch list" loans include loans for which interest has not been paid for 1-3 months, the number of bad loans will increase sharply. If the category of bad loans is extended to include normal loans which are given to businesses that will possibly be unprofitable in the future, the amount of bad loans to be cleared out is expected to increase even more. If that is the case, the estimation of the fiscal burden of financial reform rises sharply. As is reported in <Table Ⅱ-4>, when the assumed amount of bad loans increases, the amount of public funds to be financed by bond issuances also rises accordingly. For instance, if the assumed amount of bad loans is 140 trillion won, the public funds to be financed amounts to over 81 trillion won and the eventual fiscal burden would be a maximum 65.4 trillion won. If the bad loan rise to 160 trillion won, the final fiscal burden would reach over 73.7 trillion won.

<Table Ⅱ-4> Estimating the Fiscal Burden of Financial Reform

(Unit: trillion won)

Assumed amount of bad loans to be cleared	Assumed amount of public funds financed by bond issuance[1]	Interest on government bonds[2] (1998-2003)	Losses on principal of bonds[3]	Fiscal burden
120	69.7	30.7	16.5-27.5	47.2-58.2
130	75.5	31.7	18.8-30.3	50.5-62.0
140	81.3	32.2	21.1-33.2	53.3-65.4
150	87.1	33.7	23.4-36.0	57.1-69.7
160	92.9	34.8	25.7-38.9	60.5-73.7

Notes: 1) The first figure of 69.7 trillion won is based on the government's assumption that the total amount of bad loans to be cleared out within the whole restructuring period is 120 trillion won. Other figures are based on the assumption that the public funds needed to be raised by issuing government bonds increase monotonically as the amount of bad loans to be cleared out increases.

2) The interest rate on government bonds is assumed to be 13 percent for the first half of 1998 and 10 percent for the second half of the same year. From 1999 onward, it is assumed to be 7.5 percent.

3) Payments for insured deposits are assumed to be perfect losses, while purchased bad loans are assumed to be re-sold at a 40-60 percent discounted price. The public funds for a financial institution's recapitalization are assumed to be returned by the value of 130-150 percent of the initial amount.

Source: Jae Chill Kim, "Fiscal Burden of Financial Reform in Korea," *VIP Economic Report*, March 1999.

<Table Ⅱ-5> Public Support for Financial Restructuring (as of June 1999)

(Unit: trillion won)

	Korea Deposit Insurance Co.	Korea Asset Management Co.	Others	Total
Issuance of Financial Restructuring Bond	31.5	32.5	-	64.0
Overseas Public Borrowing	1.4	-	-	1.4
Subsidies from the General Account	-	-	1.6	1.6
In-kind Capitalization	1.5	-	7.7	9.2
Assignment of an Obligation	-	-	5.9	5.9
Total	34.4	32.5	15.2	82.1

Note: Subsidies for interest payments of 6.6 trillion won (1.3 trillion won and 5.3 trillion won for 1998 and 1999, respectively, are not included)

Source: Ministry of Planning and Budget.

2. Budget for the Unemployed and the Social Safety Net

While progress in reforming the business sector was rather slow, unemployment rates kept on increasing, thus aggravating the grievances of laborers, who believed themselves to be bearing a disproportionate share of the economic restructuring burden. Laborers claimed that the tripartite agreement between government, firms and laborers did not distribute the burden of reform fairly, and protested for a greater contribution by the government for the establishment of proper social safety nets. If the economic reforms are to be carried out within the framework of democratic processes with sustained social cohesion, an effective and harmonious operation of the Tripartite Commission is *sine qua non* for the success of the reform efforts.

The Korean government has responded to the sharp increase in unemployment by putting forth a comprehensive unemployment benefits package, which was agreed upon by the Tripartite Commission which consists of business and union leaders, and public officials. The package included an expanded unemployment insurance system, subsidized loan programs to the unemployed and venture businesses, active labor market policies, public work programs, and others.

Budgetary measures for unemployment support packages were undertaken in sequence as the National Assembly approved the first and second supplementary budget in March and September 1998, respectively. The Comprehensive Unemployment Policy was initially financed with 7.9 trillion won, but later increased to 8.5 trillion won with an additional 600 billion won from the Employment Insurance Fund on June 1998. Even so, the number of the unemployed was greater than expected with the continuation of the economic recession and financial and corporate restructuring entering full swing. Accordingly, the government increased its support package to about 10.1 trillion won in the latter half of 1998. Details of the budget for the Comprehensive Unemployment Policy are shown in <Table Ⅱ-6>.

<Table Ⅱ-6> Budget for the Comprehensive Unemployment Policy

Minimization of unemployment (2,117.4 billion won)	Job creation (3,817 billion won)	Vocational training & job placement services (901.1 billion won)	Social safety net for the unemployed (3,235.2 billion won)
Management Stabilization for SMEs (1,695 billion won) • Increase in trust guarantee (900 billion won) • Rescheduling dollar-denominated bonds (795 billion won) Support to reduce lay-offs (122.4 billion won) Subsidy for housing Construction (300 billion won)	Expansion of transmission facilities of the Korea Electric Power Corporation (600 billion won) Support to ventures and start-ups, etc. (400 billion won) Support for start up or return to the farming or fishery industries (22 billion won) Support to start software Companies (100 billion won) Expansion of major SOC facilities and revitalization of regional economies (2,695 billion won)	Vocational training (737.7 billion won) Training for the rehiring of displaced, and first-time job hunters. Renovation of employment agencies and job centers (66 billion won) • Expansion of Manpower Banks • Increasing private job counselors • Establishing employment information networks Support to the highly qualified unemployed and women (97.4 billion won)	Unemployment benefits (850 billion won) Loans for basic welfare (750 billion won) Basic welfare for the low-income unemployed (216 billion won) Subsidy for tuition fee for secondary school children of the unemployed (100 billion won) Distribute state-held rice (39.8 billion won) Support of unpaid wages to workers of bankrupt firms (190 billion won) Public works projects (1,044.4 billion won) Assisting daily workers (45 billion won)

Source: Ministry of Finance and Economy, *DJnomics: A New Foundation for the Korean Economy*, 1999.

Unemployment in Korea was not a major policy issue until the financial crisis, because historically high labor demand boosted up by high growth was always sufficient to keep the unemployment rate at around a low 2 percent. In April 1998 the unemployment rate in Korea soared to a high level of 6.7 percent. With major structural reforms in the financial, corporate and public sectors, unemployment continued to increase in early 1999, bringing the rate up to the 8 percent level, with the number of unemployed at almost 2 million. As unemployment become the number one policy issue in Korea, the government responded by providing various programs based not only on budgetary appropriations, but also on institutional changes in the welfare system.

<Table Ⅱ-7> Budget and Beneficiaries of Social Safety Net Program

	Total budget	Financial resources		Number of new jobs or beneficiaries (thousand persons)
		Supplementary Budget	Other sources	
Job creation	64,457	11,509	52,948	233
Provision for short-term jobs	10,500	10,500	-	248
Jobs for highly-educated	2,552	2,552	-	51
Internship program for high school graduates, etc	948	948	-	34
Local governments' public works projects	7,000	7,000	-	163
Reinforcement of vocational training	1,028	1,000	28	(27)
Promotion of social safety net	7,208	2,561	4,647	(323)
Total	83,193	25,570	57,623	481(350)

Note: The figures in ( ) is the number of beneficiaries of the corresponding program
Source: Ministry of Finance and Economy.

All the policy measures by the government to combat unemployment and provide a social safety net involve every means possible, including allocation of the supplementary budget to substantially reinforce the existing policy measures for the unemployed, focusing on active creation of new jobs and taking full account of the features of the current unemployment problem.

As summarized in <Table Ⅱ-7>, in 1999 a special budget of 5.76 trillion won was added to the supplementary budget of 2.55 trillion won, bringing the total reserve for these policy measures to 8.3 trillion won. The government expected the new budget for 1998 to generate 481,000 new jobs and enable 350,000 persons to have access to vocational training and social safety net benefits.

The total budget allocated for unemployment measures in 1999 amounts to 16 trillion won: the original budget of 7.7 trillion won which was reserved for protection of the unemployed and promotion of the social safety net, plus an additional budget of 8.3 trillion won.

Ⅵ. Budget Deficits and Medium-Term Fiscal Outlook

Overall, the most important economic issue for Korea is maintaining the momentum of the structural reform drive. Almost as equally important is the possible explosion of government debt, in view of the fact that substantial budget deficits will continue for a number of years. As described in the previous section, huge government expenditures had to be made, particularly for the restructuring of the financial sector and the provision of the social safety net, including unemployment benefits. On the other hand, due to the depression, tax revenue decreased sharply. As a result, a large amount of fiscal deficit was inevitable.

The fiscal deficit in 1998 is estimated to be 21.4 trillion won (including public funds), which amounts to 5 percent of GDP. In 1999, it is expected that the budget deficit will be around 22.7 trillion won or 5.1 percent of GDP, as shown in <Table Ⅱ-8>.

The central government debt increased from less than 10 percent of GDP in 1996 to 15.9 percent in 1998, and is expected to reach 20 percent at the end of 1999. When debt guarantees are included, the total debt increases to over 40 percent of GDP. When implicit debts such as legal obligations of the National Pension are taken into account, the total public debt amounts to more than 70 percent of GDP, as shown in <Table Ⅱ-9>

<Table Ⅱ-8> Surplus and Deficit of the Unified Budget

(Unit: 100 million won and %)

	1994 (Actual)	1995 (Actual)	1996 (Actual)	1997 (Actual)	1998 (Budget)	1999 (Budget)
Central Government	20,565	21,159	17,625	13,286	-196,692	-206,273
General Account	96,580	131,920	139,983	139,835	67,741	112,307
Special Account	-70,798	-97,928	-113,565	-130,533	-187,845	-221,737
Funds	536	-2,377	-4,366	8,710	-64,375	-84,503
Others	-5,750	-10,456	-4,427	-4,726	-12,213	-12,340
Nonfinancial public enterprises	-6,725	-8,743	-6,635	-12,118	-16,970	-20,389
Surplus or deficit	13,840	12,416	10,990	1,167	-213,662	-226,662
(Percent of GDP)	(0.5)	(0.4)	(0.3)	(0.03)	(-5.0)	(-5.1)

Source: Office of National Budget, *Summary of Budget for Fiscal Year 1999*, 1999.

<Table Ⅱ-9> Government Debt Outstanding

(Unit: 100 million won and %)

	1990	1995	1996	1997	1998
Domestic borrowing	27,534	30,006	29,130	31,700	29,313
(Percent of GDP)	1.5	0.9	0.7	0.8	0.7
National bonds	137,422	232,947	256,574	285,543	466,022
(Percent of GDP)	7.7	6.6	6.6	6.8	11.0
Contract authorization	24,903	40,891	31,408	34,081	30,288
(Percent of GDP)	1.4	1.2	0.8	0.8	0.7
Foreign borrowing	55,593	52,416	50,506	153,216	187,848
(Percent of GDP)	3.1	1.5	1.3	3.6	4.2.
Net national debt	245,452	356,260	367,618	504,541	714,473
(Percent of GDP)	13.8	10.1	9.4	12.0	15.9.
Guarantee	71,881	150,289	76,121	130,389	735,540
(Percent of GDP)	4.0	4.3	2.0	3.1	17.3
Grand national debt	317,333	506,549	443,739	634,930	1,450,013
(Percent of GDP)	17.8	14.4	11.4	15.1	32.2.

Source: Office of National Budget, *Annex to Summary of 1999 Budget*, 1999.

Although Korea's past fiscal rectitude has given considerable fiscal flexibility in dealing with the crisis today, Korean authorities are quite aware of the dangers of chronic budget deficits. In order to restore the budget to balance as soon as possible, the Korean government announced a "Medium-Term Fiscal Plan" covering the period from 1999 to 2002, as summarized in <Table Ⅱ-10>. This is a flexible, indicative plan that outlines target levels for key macroeconomic variables over the next several years. Although not legally binding, the plan takes precedence over annual budgets in determining both the level of annual government spending and its allocation amongst different priority areas.

<Table Ⅱ-10> Medium-Term Fiscal Plan: Key Indicators

(Unit: %)

	1998	1999	2000	2001	2002
GDP Growth					
Nominal	0.8	4.2	7.8	8.9	9.0
Real	-5.8	2.0	4.7	5.1	5.3
Expenditure Growth[1)]					
Nominal	13.5	6.2	6.5	6.0	6.2
Deficit/GDP	-4.2	-5.2	-4.5	-3.7	-2.6

Note: 1) Refers to the expenditures of the General Account and the Fiscal Financing Special Account, which together make up 70 percent of the consolidated budget

Source: Planning and Budget Commission, *Summary of the Medium-Term Fiscal Plan 1999-2002*, January 1999.

In guiding the nation's spending over the next four years, the Medium-Term Fiscal Plan embodies the following priorities: (1) Enforce fiscal discipline to hold down fiscal deficit at a prudent level and ensure return to fiscal balance as early as possible; (2) Reform the fiscal framework and its operation toward a performance- and consumer-oriented system; (3) Renovate the tax system and tax administration to be more transparent and equitable; (4) Foster the principle of market economy and support the creation of new jobs; and (5) Prepare for the 21st Century, where knowledge, information, and culture will be the new impetus for growth and prosperity.

According to the Plan, the annual budget expenditure growth will be around 6 percent each year through 2002, about 2 percentage points below nominal GDP growth. The Plan emphasizes restraining expenditure over increasing revenue to achieve balance. In contrast, past expenditure growth used to hover around 15 percent, well above the nominal GDP growth rate of 10 to 14 percent. Though the Plan proposes to return to a balanced budget by 2006, it remains to be seen whether the projection comes true or not.

<Table Ⅱ-11> Sectoral Priorities in Government Expenditures

(Unit: %)

	Sector	1999	Average (1999-2002)
Priority sectors	SOC investment	6.0	Relatively high growth rate of expenditure
	Culture & tourism, Information	32.1	
	Investment in R&D and human capital	0.5	
	Social welfare	2.4	
	Environment	-2.6	
Sectors Requiring Efficiency Improvement	Primary & secondary education	-0.7	Moderate growth rate of expenditure
	Agriculture	-5.1	
	National defense	-0.4	
	Int'l affairs, security	-4.3	
	Administration	-4.4	
Short-term Priority sectors	Financial restructuring	190	To be provided as needed
	Unemployment measures	36.4	

Source: Planning and Budget Commission, *Summary of the Medium-Term Fiscal Plan 1999-2002*, January 1999.

In addition to specifying the total expenditure growth over the next few years, the Medium-Term Fiscal Plan also provides guidelines for priority levels among several sectors by indicating the growth rate of expenditures for each of those sectors, as summarized in <Table Ⅱ-11>. “Priority Sectors” with higher increases in spending include infrastructure investment, R&D and information technology, culture and tourism, social welfare, and the environment. Other sectors are designated for lower funding priority, but are nevertheless required to improve efficiency through re-engineering or reform. These sectors include education, agriculture, national defense, international affairs and security, and general administration. Financial restructuring and unemployment measures, whose funding requirements are large but hopefully temporary, will receive full need-based support from the budget.

Ⅶ. Concluding and Evaluating Remarks

It is true that the Korean economy has stumbled in the course of globalization. Yet, from a historical perspective, the current crisis may be viewed as the necessary price of transition and renewal for the coming century. In that sense, what is happening in Korea now is developmental in nature. Thus, the current economic crisis is a blessing for the Korean economy so long as ongoing reforms promise to bring about a new economic order in which free and fair competition prevails and all economic players are better able to exert their best efforts for themselves and society. Everything depends on how successfully Korea carries out true reforms in all the sectors concerned. The Korean economy is currently showing some signs of recovery. The recovery is being led by an increase in domestic demand. The GDP growth rate of 4.6 percent in the first quarter of 1999 is a notable increase from the annual growth of -5.8 percent for 1998. Though the unemployment rate is still much higher than the pre-crisis level of 2 to 3 percent, it is also declining. The April 1999 figure was 7.2 percent, down from the peak of 8.7 percent in February. GDP growth in 1999 is projected to be over 4 percent. Some experts expect the growth rate to exceed 5 percent.

Sound fiscal policy has long been a hallmark of Korea, which has avoided using public finances for macroeconomic management or to attain income redistribution objectives. The emphasis on sound public finances has left Korea with a very low gross government debt to GDP ratio and made the Korean government a net creditor. The initial IMF program included significant fiscal restraint in Korea, targeting a balanced consolidated central government budget in 1998.

However, the initial envisaging of a zero deficit was disrupted by several factors: (1) The economy was much weaker than was initially projected; (2) The government had to expand social welfare programs to alleviate the hardships of the sharply higher number of unemployed people and to limit the extent of poverty; and (3) The government had to use fiscal resources to promote rapid rehabilitation and recapitalization of the financial system. Despite the government's efforts to restrain spending by cutting public investment and reducing the salaries of government employees, the central government exhibited a consolidated budget deficit of about 5.5 percent of GDP in 1998.

The fiscal deficit in 1999 will be increased in order to enhance the government's ability to stimulate the economy through fiscal measures, strengthen and expand the social safety net, and rehabilitate the financial system. It is still very difficult to quantify the cost of financial restructuring with any accuracy. The ratio of total public sector debt to GDP was 27.2 percent before the financial crisis, and after crisis management, according to an estimate by the Ministry of Finance and Economy, the ratio will rise to 53-57 percent. To allay possible fears about Korea's growing fiscal deficits, the Korean government developed its medium-term fiscal spending plans. Mindful of the experiences of developed countries, the government should guard against the danger of chronic budget deficits.

The Korean experience differed in one important respect from most of the other countries that had previously undergone a currency crisis. The Korean government had maintained fiscal soundness for some time when the economy was stricken by the crisis. This meant that budget deficits and government debt were not responsible for the crisis. Rather, the structural distortions of the system were identified as the root cause of the Korean crisis, and a consensus formed that fundamental structural reform was required if the country were to overcome the crisis. Another implication of Korea's fiscal rectitude was that the government had far greater fiscal flexibility available as a policy option.

The lesson from the Korean experience is that there is room for using proactive fiscal stimuli to overcome a financial crisis, especially when fiscal policy was not a causal factor of the crisis. After reviewing the role of the Korean fiscal policy under the economic crisis, one may conclude that in view of the great pain and turmoil caused by the severe credit crunch and the resulting contraction of the economy, it would certainly be worthwhile to investigate whether some middle ground could not have been found, especially when the government's fiscal position was so favorable.

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Chapter Ⅲ. Public Sector Reform in Korea

Ⅰ. Introduction

The so-called economic "miracle" of Korea has come to a sudden end. This economic crisis at the outset was characterized as a short-term liquidity problem. However, it soon became apparent that at the root of the problem was the inability of Korean government and the various sectors comprising its financial and business community to cope with the new world order characterized by an unprecedented degree of competition.

The Korean government has implemented wide-ranging reform measures to beef the foundation for economic stability while reforming the economic structure in entirety. As a part of the initiatives to overcome the economic crisis, the government moved to reform virtually every facet of society, focusing on four major sectors: finance, business, labor and the public sector.

This chapter aims to review the reform policies of the public sector being framed in response to the financial crisis and progress being made thereof.

Ⅱ. Competitiveness of the Korean Government

Since the 1960s, the Korean government has been deeply involved in economic development. Rapid economic growth and drastic social development led to the growth of the public sector in size and role. The public sector, or the government been viewed as an inefficient monolith incapable of providing quality services to the nation or the people. Some even argue that the government has become a hindrance Korea's continued economic development. They feel that excessive government regulation and intervention in the market have stifled Korea's competitiveness at home and abroad. Any reform undertaken in Korea must begin with the public sector because without making necessary changes in the public sector, reform of any other targeted segments will surely fail.

In the past, the government's frequent intervention, authoritative dictates and unnecessary regulations seriously hindered the development of a free market economy. Non-transparent policies and an inaccessible administration nurtured dubious collusion between the government and businesses, leading to arbitrary regulations and corruption. In terms of the government's inner management, promotion of government employees was based on seniority, not ability. Government employees as a group, in turn, grew extremely resistant to reform since their motivation was to preserve the status quo, not to serve the public.

The organization and size of the government bureaucracy grew, irrespective of the demand for its services. A good illustration of this trend is the 500 percent growth of the number of agricultural civil servants, despite a 33 percent decrease in the farming population over the past thirty years. In addition, concentration of power and authority in the central government prevented local officials from exercising any substantial autonomy, which led to futile attempts at local governance.

<Table Ⅲ−1> Competitiveness of the Korean Government

Overall Ranking	1992	1993	1994	1995	1996	1997	1998	1999
	29	28	32	26	27	30	35	38
Government Ranking:								
National Debt	13	9	8	8	7	10	14	15
Government Expenditure	14	13	12	14	13	12	6	14
Fiscal Policies	9	7	8	9	9	8	11	18
State Efficiency	39	39	41	36	38	42	44	43
State Involvement	42	41	46	42	46	44	46	46
Justice and Security	28	28	27	26	31	31	31	38

Sources: IMD, *The World Competitiveness Yearbook*, 1997~1999.
IMD, *The World Competitiveness Report*, 1992~1996.

<Table Ⅲ-1>, which ranks the international competitiveness of the Korean government, shows some characteristics and interesting features of the Korean public sector. While the pecuniary section of the Korean government has been relatively much smaller than that of other countries, the government sector of Korea has been evaluated as being much less productive and more involved than those of other countries.

In 1997 for example, the Geneva-based International Institute for Management Development (IMD) ranked the efficiency of the Korean government as forty-second out of forty-six countries. The degree of government intervention was even more serious, leaving Korea at the forty-fourth rank among all the countries evaluated. Although Korea's overall rank was thirtieth out of forty-six countries on the IMD 1997 scoreboard of national competitiveness, it placed twelfth in the government expenditure category and eighth in fiscal policies. Overall, the competitiveness of the Korean government improved until 1996, but has been drastically deteriorating for the last three years.

Ⅲ. Objectives and Strategies of Public Sector Reform

Successful government reform requires a general consensus on the need and basic direction for change. Without it, efforts made toward reform face insurmountable opposition. Therefore, to create such a consensus, it is necessary for the government to explain the necessity for reform to the public. In addition, priority should be given to those areas where results can be demonstrated at an early stage and gradually expand the scope of reform implementation.

Soon after the new Administration assumed its responsibilities, the government set three objectives for carrying out the public sector reform program in Korea: (1) to realize a small but efficient government by streamlining government functions and by vastly reducing its size; (2) to achieve a highly competitive government by incorporating the principle of competition among civil service organizations and personnel; and (3) to pursue a customer-oriented government by fostering desirable actions and attitudes in government employees. In order to achieve these three objectives, the government has launched a very wide-ranging set of programs, as summarized in <Table Ⅲ-2>.

<Table Ⅲ−2> Goals and Strategies of Public Sector Reform

Goals:
Principle of customer priority
Entrepreneurial government management
Flexible and transparent administration
Strategies:
Redesign government's role
Promote competition in the government sector
Introduce a responsible management organization
Maximize the use of information
Establish a competitive personnel compensation system based on ability
Increase delegation of responsibility and authority to subordinates
Transfer authority to local governments
Base budget decisions on results
Transparent administration
Creation of a responsible work ethic

Source: Ministry of Finance and Economy, *DJnomics. A New Foundation for the Korean Economy*, 1999.

Ⅳ. Restructuring of the Government Machinery

The move toward restructuring the government administration existed before the financial and economic crisis, but the crisis served to expose the problems of the governing infrastructures and made their restructuring and reform an immediate necessity. Even before its inauguration, the current administration began its work on reorganizing the government structure. The three basic directions established for government reorganization were to consolidate redundant functions while expanding services in those areas with increasing demand such as the environment and welfare, to encourage competition in the private sector by reducing government regulations and privatization, and finally, to devolve the authority of the central government to local governments.

In February 1998, a fairly extensive reorganization of the administrative branch was carried out, merging several Ministerial functions, downsizing two super Ministries (Finance and Economy and Reunification), upgrading two semi-Ministries to full Ministries (Science and Technology and Office of General Affairs), and strengthening the mandate and power of supervisory organizations (especially the Board of Audit and Inspection and the Fair Trade Commission). The Ministry of Political Affairs Ⅱ, which had served as the national coordinating body for women's affairs, was replaced with a Special Presidential Commission. To monitor the reform programs, the government established the Planning and Budget Commission, Supervisory Commission, and the Regulatory Reform Committee.

The government structure was reorganized and downsized from the previous two boards, fourteen ministries, five councils, and fourteen offices to seventeen ministries, two councils, and sixteen offices. The second phase of government reorganization was completed in May 1999.

The current government should be given credit for its policy designed to reduce the size of the bureaucracy. The government reduced number of the employees of the central government by 5.6 percent or 9,084 in 1998. It plans to dismiss 25,955 personnel, which accounts for 16.0 percent of the total central government employees excluding public school teachers and policemen, by 2001. Local autonomies also streamlined their organizations. In 1998, 35,149 jobs or 12 percent of the total were eliminated. Local government employees will be reduced by 87,000 or 30 percent of the total by 2002.

Ⅴ. Reforming the Budget System

Reform of the budget system is an essential part of the public sector reform. Thus, many measures to fix the Korean budget system have been announced. Some of them were implemented while others require further study. The objective of restructuring the budget is to allocate and spend the budget wisely to meet public needs. The scheme for the budget system reform is summarized in [Figure Ⅲ-1].

[Figure Ⅲ−1] Scheme of Public Expenditure Reforms

Maximizing customer satisfaction

Result-oriented	Promoting budget efficiency	Promoting budget probity and responsibility
• Reforming budget items • Flexible budget management • Reviewing medium-term funding	• Checking business relevance • Classifying spending priorities • Efficient use of funds by field	• Reforming the funds system • Introducing accrual-based accounting • Solidifying the link between budget and expenditures

Public expenditures are classified into five categories: chapter, section, clause, sub-clause and sub-item. Although such detailed classifications allow for strict control and execution of the budget, it is difficult for government agencies to be flexible enough to adapt promptly to changes in circumstances. Such rigidity can lead to waste and inefficient government spending. To alleviate this problem, in

1994, the budget authority decided to increase the discretionary power vested in the head of each central government agency. For that purpose, similar items were consolidated and unnecessary or duplicated items were abolished. As a result, the number of items in government spending decreased from 113 in 1993 to 46 in 1994.

The new administration made further efforts to streamline budget items so that each ministry or agency was given more flexibility and discretion for budget execution. The "total operational expense system" was introduced. Under this system, the Ministry of Planning and Budget sets only the ceiling for total operational expenses while each ministry and agency determines the priorities and amounts of operational expense items.

In 1998, about 1,000 small appropriation items which had previously required detailed review by the budget authority were consolidated and placed under the responsibility of individual ministries. The number of appropriation items reviewed by the budget authority was reduced from about 3,500 to 2,500.

Under the previous budget system, there was no incentive for ministries and agencies to curtail expenses. If budget funds were left over, the corresponding ministry or agency was penalized by a reduction in the forthcoming budget allocation. This system worked as a strong disincentive to save on the budget. Therefore, ministries and agencies tended to spend the budget unnecessarily at the end of each fiscal year. To correct this problem, the government introduced the "budget carry over system," which permits ministries and agencies to use left over budget funds for increases in salaries or operational expenses the following year.

Those civil servants who propose creative ways to save on spending can internalize a portion of the savings under conditions specified by the budget authority. In 1998, when the scheme was first introduced, the savings amounted to 12.6 billion won and 4.3 billion won was disbursed as compensation for the saving.

The budgeting process is undergoing major changes in the direction of an open government, inviting greater participation by citizens as taxpayers and ultimate customers of the services provided by the government. Notable among the reforms taking place is the setting up of recognized channels through which opinions can be voiced and public consensus is sought. An advisory budget board has been set up to solicit expert advice from members who represent a wide spectrum of social and economic fields. The board meets regularly to discuss and offer recommendations on major budget categories, including support for small- and medium-sized enterprises and investment in social overhead capital projects.

To increase the accountability for results, performance budgeting will be introduced over the next few years. Plans for the implementation will be announced and pilot studies will begin in 1999. To enhance the transparency of financial management, full accrual accounting will be introduced by 2003. A new government accounting standard will be announced in 2000, the first consolidated financial report for the whole government will be prepared in 2001, and an automated accounting system will be developed by 2002.

In addition, work is under way to consolidate various special accounts and public funds. This will enhance transparency in public sector spending and make it easier to bring public sector spending under control. Currently there are one General Account, 22 Special Accounts, 37 Public Funds, and 38 “Other” Funds. In June 1999, the government announced a plan to reduce the number of Funds from 75 to 55.

Ⅵ. Privatization of Government-Owned Enterprises

Government-Owned Enterprises (GOEs) in Korea are characterized by their bloated size and inefficient management practices. In 1997, 108 public corporations, excluding financial institutions, employed over 210,000 people, with a budget exceeding 100 trillion won. The monopolistic market environment of many government-owned corporations created inefficient management, which resulted in a culture of administrative opportunism and unmotivated employees.

<Table Ⅲ-3> Reform Plan for GOEs

Modality	Schedule	Targeted GOEs
Full immediate privatization	By end-1999	• 5 parent companies, including Pohang Iron and Steel Co., Korea Heavy Industries and Construction Co., Korea Chemical Co., Korea Technology and Finance Co., and National Textbook Co. • 3 subsidiary companies
Gradual privatization	By end-2002	• 6 parent companies, including Korea Telecom, Korea Tobacco and Ginseng Co., Korea Electric Power Co., and Korea Gas Co. • 21 subsidiary companies
Management reform and restructuring	Ongoing	• 13 parent companies, including Korea Securities Printing and Minting Co., Korea Trade and Investment Promotion Agency, Korea National Tourism Co., and Korea Coal Corporation • 37 subsidiary companies

Source: Ministry of Finance and Economy, *Korea's Economic Reform*, October, 1998.

To address these problems, the government implemented widespread privatization of inefficient public corporations based on market principles, although the present administration is not the first to attempt privatization of GOEs. The government announced privatization plans for some public corporations in July and August 1998, as summarized <Table Ⅲ-3> and <Table Ⅲ-4>.

<Table Ⅲ−4> Current Status of Privatization of GOEs

Government-Owned Enterprises	Time	Status Details
Korea Telecom	1998. 11 1998. 11 1998. 12. 23 During 1999	- Managing underwriter selected for DR issuance (Morgan Stanley) - Strategic alliance advisor selected (Lehman Brothers) - Listing on stock market - Limit on single shareholder to be raised from 7% to 15%
Korea Electric Power	1998. 11. 10 1998. 11. 16 1999. 1/4 During 1999	- Managing underwriters selected (Hyundai Securities, Salomon Smith Barney, IMG Baring) - Public Hearing for Reform of Electric Industry - DR for 5% of government's stake to be issued - One power generation company to be privatized
Pohang Iron and Steel	1998. 8. 20 1998. 10. 2 1998. 10. 22 1998. 12. 11 During 1999	- Limit on single shareholder raised - Managing underwriters selected (Salomon Smith Barney, Merrill Lynch, Dongwon Securities) - Registration documents submitted to SEC - 350 million dollars worth of DR issued after SEC approval - Sale of Mini-mill
Korea Heavy Industries and Construction	1998. 10. 8 1998. 11. 14 1999. 2.	- Stock value appraisal begun - Firm selected for fixed asset appraisal - Public announcement for bids
Korea Tobacco and Ginseng	1998. 8. 27 1999. 1.	- Stock value appraisal commissioned - 25% of DR issued
Korea Gas	1998. 8. 28 Present	- Advisor selected for overseas paid-in Capital Increase (Schroder, Daiwa) - Due diligence in progress

Source: Planning and Budget Commission.

When the government announced that 11 of Korea's 26 GOEs would be privatized, about half of the 11 companies attracted a lot of attention both locally and internationally because of their size and also because they were virtual monopolies that played important roles in the Korean economy. Twenty public enterprises of the 109 GOEs and their subsidiaries were privatized In 1998. Through the privatization of GOEs, the government aims to attract more foreign capital in the public sector and improve their management.

Ⅶ. Regulatory Reforms

Korea was unable to reduce burdensome regulations because of insufficient government resolve and intense opposition from interest groups. Excessive administrative restrictions and a permit system not only interfered with free enterprises, but also harmed the health of the nation, including environmental protection, fair trade, and financial supervision.

In February 1998, the Regulatory Reform Committee (RRC) was set up under the direct control of the President to attain the highest possible standard of living and working conditions in Korea by eliminating unnecessary or irrational economic and social regulations.

The following numbers speak for the government's strong commitment to drastically reduce unnecessary regulations. In its first year of operation, RRC scrapped about five thousand administrative regulations, a reduction of 48 percent. 23 laws were abolished and 248 laws were revised. RRC reduced the number of areas in which foreign investors were limited from 52 to 31. Moreover, mergers and acquisitions, foreign currency transactions, and capital investments were opened to foreigners. The ongoing reforms try to make Korea's regulatory system more in line with the frameworks of the WTO and OECD,

In order to simplify and reduce existing nules rather than create new ones, in June 1998, the government established the Regulation Effect Analysis System, under which newly-updated regulations automatically terminate after five years. For a regulation to stay effective for more than five years, a new evaluation is mandatory.

Ⅷ. Concluding Remarks

It is true that the Korean economy has stumbled in the course of globalization. Yet, in a historical perspective, the current crisis may be viewed as the necessary price of transition and renewal for the coming century. In that sense, what is happening in Korea now is developmental in nature. Thus, the current economic crisis is a blessing for the Korean economy so long as ongoing reforms promise to bring about a new economic order in which free and fair competition prevails and all economic players are better able to exert their best efforts for themselves and society. Everything depends on how successfully Korea carries out true reforms in all the sectors concerned.

Public sector reform is a central component of a wide strategy of economic reforms in Korea. Korea has not found it easy to carry out public sector reform. The government has undertaken many measures and many ideas, old and new, were suggested. However, overall, public sector reforms seem to be in disarray, although the developments in the past year or so have made some progress. While most programs try to get rid of excessive government intervention, they provide neither clear-cut ideas nor a basic stance. They fail to deliver a clue as to how such ideas should be transformed into reality.

The major reason why public sector reforms are in disarray is that the government is adrift between the interventionist theory and free market principles. The basic stance with regard to both the public sector reform and fiscal policies is contradictory because the proposed reform programs call for the privatization of some government organizations and the elimination of unnecessary regulations while the government intends to keep its control on most aspects of the economy and the society. The absence of a clear-cut perspective on the future role of the government is another reason that leads one to have no faith in the substance of the proposed reforms.

All the rhetoric notwithstanding, the idea of a small but efficient government is not coming true. Revamping the governmental organization does not remove deep-rooted authority from the bureaucracy. The leadership has not present to the public a clear road map that shows where we are and where we hope to be in the near future.

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Chapter Ⅳ. Social Welfare and Distribution Policies in Korea

Ⅰ. Introduction

If the goal of human beings is in finding happiness and the goal of human society is in building a utopia based on a welfare society, the ideology that makes it possible to realize these goals can be looked upon as the highest and foremost ideology. For whoever commands political power, he cannot choose but to build a welfare state.

Although historically the welfare state got its start from the government trying to save farmers and workers from social poverty, nowadays it has been developed into holding a more broadened, more active meaning, including education, improvement in the distribution of income, and even countermeasures to environmental degradation. The welfare state of today is no longer a simple cure for social problems, but it is being perceived as the final goal of state progress.

Welfare holds a very broad meaning and is closely linked to every basic economic problem such as growth, stability, equity, and the quality of life. The heart of welfare policies is the social security policy. Additionally, policies which concern the stabilization of the economy, the distribution of income, housing, education, environment, small- and medium-businesses, and agriculture can all be included in welfarism. However, since every policy has its own characteristics, social policies and welfare will be dealt with either in connection with, or separated from, problems concerning the distribution of income and wealth.

In Korea, political, economic, and social contradictions, which have resulted from the last 30 years of rapid industrialization, are striking a blow to the growth-first ideology. Many social welfare policies have been introduced to meet the rising calls for a more humane society. It is a fact that social insurance systems, such as medical insurance for all citizens and the national pension system, and public assistance to the poverty-stricken and the aged, have already become a part of everyday life for many people. However, questions from many different angles are being raised as to the effectiveness of these social welfare systems, and also as to how these systems should be further developed.

National development strategies of the past, have placed more importance on economic efficiency than on social equity. It can also be stated that the social development policy was very primitive, emphasizing simple income-transfer. In other words, social policy in Korea in the past was constrained by the growth-first and welfare-next strategy.

The main objective of this chapter is to review social welfare and distribution policies as implemented in Korea and to describe the institutional settings and specific programs in each policy.

Ⅱ. Historical Development of Social Welfare Policy

In order to make an inquiry into the welfare policy and the distribution policy of Korea, a close examination of the changes in Korean society is needed beforehand. Development of welfare and development policy in Korea was dominated by economic elements such as the rapid industrialization, high economic growth and international competitiveness, and also by the traditional family-oriented confucian culture. Korea's compressed experience of rapid changes are hardly found in the experience of any other country on this planet, and it is almost impossible to explain this experience through various theories expounded by scholars for other developed or under-developed countries.

The political, economic, and social changes that Korea has experienced for last half century were truly amazing. The depth and width of social changes, which are represented by population growth and movement, economic growth and changes in industrial structure, advancement in education, changes in social structure, changes in family structure, changes in housing, step-up in international status, were truly unprecedented in history. Especially after the rapid economic growth after the 1960s, the number of poverty-stricken has decreased rapidly, but the relative gap in income is known to have risen, and conflict among generations, regions, labor and management, and between the sexes do exists.

The welfare policy of Korea has developed over four stages: the 1950s, 1960s to mid-1970s, mid-1970s to late-1980s, and from the late 1980s to the present. The government's concern differs greatly at each stage of development. Roughly, the government's concern and support toward welfare have gradually risen as time has passed, and it can be stated that as far as the welfare system itself is concerned, the basic structure of the welfare system has been completed because Korea has introduced almost all kinds of welfare policies ever known.

The Characteristics of Korea's social welfare policy by each decade can be summarized as follows: welfare in the 1950s was based on relief work; social service was the biggest concern in the 1960s; public assistance was the main concern in the 1970s; and social insurance was highlighted in the 1980s. Of course, these social welfare policies have jointly developed, but during the last 50 years the social welfare policy has rapidly gone from curative to proactive. This development is the result of political, economic, and social changes that appeared in each era and by efforts toward fulfilling the social needs that came with the changes.

1. The Rebuilding and Reconstruction Period: 1945-1959

The Korean society during the late 1940s and the 1950s was literally and unconditionally poverty-stricken. The late 1940s saw Korea's independence from Japan and the military rule of the United States, and the 1950s began with the internal struggle of the Korean War. The social work of this stage was the concern of the minority of humanitarians who put emphasis on sharing, even in the times of absolute poverty. Although the concern of social work came to be based on helping war refugees due to the conflict on the peninsula, social work was considered the same as charity, philanthropic work of western Christians or millionaires, or local enlightenment culture movements of nationalists involved in the independence movement. For humanitarians of the time, welfare problems were not yet considered to be worldly social problems caused by changes in capitalistic distribution principles or family structure. As prevailing poverty and family collapse were thought to be the results of colonial plundering and division of the peninsula because of the war, they were thus not thought to be corrigible by a policy.

Until the late 1950s, the parameter of the Korean social welfare system was mainly made up of aid from private charity groups, especially foreign relief groups. Through this period of the independence, division of the country and the war, demand for public relief (government aid) became bigger than ever. This, of course, was not the fault of capitalism, but more due to national calamity and insufficient productivity. At the time, most of the nation was poor, unconditional poverty was common, and the nation itself was one of the greatest foreign aid provided countries in the world.

From establishment of the Korean government in 1948 till the military coup d'etat on May 16, 1961, it was a stage in which social problems largely were increased with the nation in chaos due to the Korean War and the establishment of a new government with the whole nation in poverty. People in need of protection, such as orphans and widows/widowers and poverty on a large scale, increasingly called for intervention in social welfare, but the social welfare system failed to function well due to weak administration. Therefore, social welfare before the 1960s was limited to facilities and commodities for the needy supported by foreign aid groups and charity work on a private level.

2. The High Growth Period: 1960's

The Third Republic Government, which came into power through a military revolution, set up economic growth and construction of a welfare state as major goals. Amendments to the National Constitution clearly state the people's right to live (Clause 1, Article 30) and the obligation of the welfare nation (Article 2). Also, because legislation for social welfare was enacted in large numbers, this period is at times referred to as the 'mass formation period' of legislation for social welfare. Security for the right to live via welfare policy, adjustment of market allocation functions and reinforcement of the role of the family were declaratory objectives or far-reaching and long-term objectives of the new government in order to secure the legitimacy of their political power.

The government clarified the “growth-first” and “distribution-next” logic while launching a five-year economic development plan based on labor intensive export-led industrialization. The leaders believed that the family relations and mutual-aid customs were morally superior to the state’s relief policy. They thought that poverty, prevalent during that time, was caused by the war, calamities, colonial exploitation, and lack of natural resources.

The Park Chung-Hee regime of the 1960’s advocated ‘liberalization from poverty’ and actively pursued economic growth. Since the greatest goal of economic policy was to attain high economic growth, both distribution and welfare issues were neglected. Government effectively achieved its high economic-growth objective, and owing to the export-drive policy, the real wage increased while the rate of unemployment decreased greatly. Also, distribution of income and wealth was satisfactory.

Korea’s social welfare in the 1960’s got systemized at least in its appearance, as the government’s welfare administration took shape, and related laws were enacted. It was the period when the relief administration was consolidated and the basic legislative system was formed. Also, the direction of the administration was converted from temporary emergency relief to long-term and self-support relief, and from a gratuitous relief to a compensation relief.

Although much effort was made in order to establish the social security system based on social insurance in the 1960’s, it was thwarted by the primary task of economic development and limitations in national finance. Thus, since social policy in this period was merely passive ex-post management for ‘relief’ or protection instead of a well-designed welfare program for the classes socially and economically weak, the main thrust of governmental aid was comprised of the provision of subsidies for operational costs, grain supplies and guidance supervision for special facilities, such as homes for orphans, single parents, children, infants, old people, and provision of relief programs to the afflicted, destitute, and indigent, etc.

During the early years of the Park Jung-Hee regime, emphasizing establishment of a welfare state as one of its major objectives, many social welfare related laws were legislated. However, these were no more than propaganda promises to obtain legitimacy that the military regime needed. Out of the many laws, those that were actually carried out were pensions for civil servants and pensions for military personnel. In other words, social insurance systems introduced were occupational pensions. The industrial calamity compensation insurance plan, a modification of social insurance, was introduced, but instead of being social insurance as an intervention into regular industrial relations, it was legislation emphasizing benevolence and responsibility of employers.

During the 1960's, the Third Republic put all effort into rapid growth of the economy, and this resulted in success of securing legitimacy of the regime. However, no interest was shown in raising productivity of general laborers or in securing their political loyalty by welfare programs. The welfare expenditure was assumed to be an unproductive and prodigal outflow, and government tried to suffice the needs of everyone by increasing income through rapid economic growth. Especially, the life protection plan had no relationship to the guarantee of the right to live but rather held the characteristic of being a relief for the poor.

3. The Period of Structural Change and Intensive Growth: 1970's

During the 1970's, owing to successful implementation of its economic development plan, the government was able to deviate from the ‘relief’ or ‘protection’ policy, and brought attention to the life motivation, the social outcast class and the socially weak class, and helped them to support themselves by voluntarily rehabilitating them. On the other hand, a social welfare policy to protect and prevent general self-supporting families from falling behind to the protected subject family class due to calamities or unexpected accidents was pursued, so that they could enjoy a healthful and stable life.

To pursue a more active welfare policy, the Social Welfare Business Law was enacted in January 1970 to outline basic items regarding social welfare business. The National Welfare Pension Insurance Law was enacted in December 1973 to guarantee stability of people’s lives and promotion of welfare by stipulating a pension scheme concerning people’s aging, incurable diseases, or deaths, etc. The Law on the National Welfare Pension Special account was enacted in February 1973 in order to run effectively the national welfare pension plan and its pension fund.

The national welfare pension plan was scheduled to come into operation from 1974, but operation was reserved for one year relying on Presidential Emergency Measure No. 3, because the enforcement condition was not satisfactory due to the economic instability resulting from the oil crisis. It was then deferred again for one year owing to the law amendment of December 1974, and in December 1975 it was amended so that the enforcement period would be determined by presidential order. However, it was not carried out since the enforcement period had still not been determined. Finally, as the National Pension Plan was enacted in 1986, it was put into effect from 1988. Furthermore, the Health Insurance Law (enacted in December 1963) was amended in full text in December 1976 and enforced the insurance allowance for not only the laborers working at places of business but also for all people’s sicknesses, injuries, childbirths, or deaths, in order to enhance social security and to improve national health.

In relation to the welfare policy, the most representative policy attained during the 1970's was legislation of the national pension plan and introduction of health insurance. A unique and interesting fact is that, although the Third Five-Year Economic Development Plan did not mention the national pension plan, it was enacted in 1973, only in the second year of the Third Five-Year Economic Development Plan.

The national welfare pension plan was not a subject of consideration at the time the Third Five-Year Economic Development Plan was prepared. However, once key policy makers recognized the pension plan as a method for internal resources mobilization for development of heavy and chemical industries, it was legislated within a year. Although the social security deliberation committee had pushed for the introduction of a social security plan for quite a long period of time since the early 1960s, it was never considered within the national development planning process. But, once it was brought to policy makers' attention as an internal resources mobilization method, the long and tedious process involved in the national development planning mechanism was cut off, and the national pension was introduced in a very short period of time.

Although Korea's health insurance plan was enacted and proclaimed as statute No. 1623 on December 16, 1963, it started out as a trial run. It was initially amended on August 7, 1970, but could not deviate from trial run form. From its second amendment on December 22, 1976 to statute No. 2942, it secured a firm place as a national health insurance scheme.

4. The Period of Consolidation and Structural Change: 1980-1995

During 20 years of development, from the first five-year economic development plan in 1962 to the fourth five-year economic development plan terminated in 1981, the Korean economy experienced a rise in income level and an increase in employment owing to rapid economic growth. Furthermore, based on industrial and agricultural development, the foundation of independent growth was constructed and national economic power greatly expanded. However, a development strategy, which did not provide equal opportunities throughout the development period, continued, and the role of the government expanded in its eagerness to accelerate economic development. Since the government's roles of responding to changes in the economy and society were not appropriately adjusted, many side effects, such as the distortion of income distribution, continuance of the dual structure, lack of basic needs facilities, confusion of values and deterioration of trust, were produced during the development process. In reaching the 1980's, the Korean economy faced the task of changing the method of economic management while pursuing a well-balanced policy between economic and social development.

Therefore, in the early 1980's the government established a government goal and searched for change in policy direction. Under the new policy goal the government emphasized the construction of the welfare state, pursuit of an equitable society, innovation in education, and promotion of culture.

The Fifth Republic constitution, enacted in October 1980, incorporated the welfare state ideology by adding the pursuit of happiness right (Article 9), the appropriate wage demand right (Article 30, Clause 1), the social welfare right (Article 32, Clause 2), the environment right (Article 33), etc. to the people's rights and obligations. In particular, in the economic articles and clauses, there were many regulations to protect socially weak people. On the other hand, the Fifth Five-Year Economic and Social Development Plan was pursued from 1982. This Fifth Plan was unlike the previous planning in that it did not set an annual investment target, and was merely indicative. It also focused on institutional reform in order to solve structural problems. In addition, from the Fifth Plan, the term "economic and social development" was used. This emphasis on "economic development" as well as "social development" indicated a change in development strategy, from a quantity-centered growth strategy to a quality-centered growth strategy.

Taking a turn in the international balance in September 1986 as an opportunity, the government became confident that the economy was able to grow without any help. Based on prospects that the GNP per capita was about to reach the level of 4,000 dollars by the early 1990's, it established and proclaimed expansion of the social welfare plan, to be pursued in the late 1980's, the national welfare promotion policy, and a basic plan for enhancement of income distribution. This plan put into enforcement health insurance for farmers and fishermen, the national pension plan, and the minimum wage plan from 1988. The basic strategy was that the growth rate of income of the low-income class was to exceed the rate of the national average income growth. Thus, government developed the basic framework for the social welfare plan corresponding to the changed environment. Furthermore, the government also provided several welfare measures to support positively the life of the low-income class, such as city indigents and the handicapped who were more or less alienated from the benefits of growth of the national economy.

Although the Fifth Regime put pursuit of the welfare state as the government's major policy objective, there was nothing new in that the Fifth Regime followed the policy set by the Third Regime. Expenditures spent in pursuing welfare policies were still seen as unproductive and introduction of related plans failed to be accepted.

Starting from 1987, the structure of social welfare received three epoch-making changes in the system: enforcement of the nation-wide health insurance system, the national pension plan, and the minimum-wage law. Introduction of these three systems was a big step forward for social welfare in Korea. Furthermore, by employing specialized social welfare workers, an attempt to establish the system of life protection and social welfare services was made.

Although Article 34 of the Labor Standard Law, enacted in 1953, stated that the minimum wage could be determined for workers engaged in certain industries or occupations, the minimum wage system was not officially introduced. During the Fifth Five-Year Economic Development Plan period, introduction of the minimum wage was discussed. However its enforcement was to be readdressed during the Sixth Plan period because many feared that the minimum wage system might weaken Korea's international competitiveness owing to the increase in labor costs. In January 1986, discussion to introduce the minimum wage system began, and the minimum wage law was enacted and proclaimed in December 1986. As the Enforcement Ordinance was enacted in July 1987, the minimum wage system began to be carried out for the manufacturing businesses of more than 10 employees from January 1988. From 1990, coverage was expanded to firms employing more than 10 workers in all industries.

Welfare policies from the 1960's to the mid-1980's had been discussed as if the market economy could not sustain the welfare state and demands of workers on industrial sites could not be met. However, beginning with 1987, the government began to realize the need for a more balanced approach, which viewed welfare indispensible for both politics and the economy. Welfare policies of the Sixth Republic were closer to the market-oriented welfare state than to the state-oriented welfare state.

In 1993, the civilian government finally succeeded in its establishment, and by substituting policy based on the Seventh Five-Year Economic and Social Development Plan (1992~96) with the Five-Year New Economy Plan in June 1993, the content of social welfare changed a bit. The main characteristic of the new regime's welfare policy is that instead of emphasizing introduction of new systems, it is centered on promoting the substantiality of the existing system and establishing a system that harmonizes welfare promotion with economic development by making welfare policies and their management efficient.

One major representative welfare system that the civilian government introduced is legislation and introduction of an employment insurance law. Employment insurance (“or unemployment insurance”) is one of the social insurances that guarantee income security during a fixed period for workers when unemployed. Employment insurance has been invented as a system that provides not only income security while unemployed but also better employment conditions for workers like unemployment prevention, employment promotion, and training for the unskilled.

The employment insurance system became effective as of June 1995, and applicable targets were industrial firms with over 30 full-time workers. Employment insurance will be extended to industrial firms employing more than 10 people from 1998.

By introducing the employment insurance system from June of 1995, Korea has been able to possess all the core systems of social security, except for child allowances. Korea has introduced all important social security systems in a very short period of time. There is no other country in the world that has completed the introduction of the social security system in such a short period of time.

Ⅲ. Social Security Programs and Policy Direction

1. Outline of Major Social Security Programs

Korea’s existing social security system consists of social insurance, public assistance, social welfare services, and social security-related services, including public housing and public health, among others. Of these, social insurance is the most important in terms of the number of people covered and the amount of benefits paid. In particular, health insurance plays a major role. Pension insurance for the general public has just been introduced and will be expanded in the coming years. Employment insurance has also been introduced in July 1995.

In view of its objectives and functions, social security can be classified into three categories: health security, income security, and welfare services. As is well known, health insurance is a principal means of support for health security, and pension insurance assumes an important responsibility in income security. Public assistance provides support for the poor. Industrial accident or workers’ insurance compensation has both components of health security and income security. Welfare services are provided for specific segments of the needy, including elderly people and orphans.

Administration of the social security system in Korea is primarily under the jurisdiction of the Ministry of Health and Welfare (MOHW). In addition, the Ministry of Labor (Industrial Accident Insurance), the Ministry of Government Administration (Civil Servants Pension), the Ministry of National Defense (Military Personnel Pension), and the Ministry of Education (Private School Teachers Pension) assume legal responsibility in carrying out respective programs under their jurisdiction.

A. Health Security

Health security in Korea mainly consists of health insurance and Medicaid (medical aid) under the public assistance scheme. In addition, health care services are partly provided under the Industrial Accident Insurance program and the Veterans Relief Program. In 1977 the Health Insurance Program was initiated, and in the same year the government also initiated a program to cover subsistence benefits, including acute care and hospital care for the poor.

B. Income Security

Income security in Korea is mainly provided by means of a pension program. The loss of income as a result of illness is not covered by health insurance benefits. It is customary in Korea, however, for employers to pay their sick employees for a considerable duration of time. As for loss of earnings due to occupational accidents, benefits are given under industrial accident insurance. For the needy, various benefits are provided under the livelihood assistance program.

C. Pension Plans

Existing pension plans consist of four different types - pension for civil servants, military personnel, private school teachers, and a national pension - in similar fashion to health insurance. The first three types are special systems in the sense that each program has occupation-specific insured persons. The remaining one is called the National Pension Plan since this program is open to all citizens aged l8 to under 60 who reside in Korea, excluding people who belong to the three occupations mentioned above. Although these public pension programs cover only about 27 percent of the working population in 1994, the entire working population will be covered by the early 21st century. Private pensions were introduced by private insurance companies in 1994.

1) Program Features

Under the National Pension Program, employees of industrial firms with 10 or more workers were insured in the initial stage. Coverage was expanded from l992 when employees of industrial firms with five or more workers became insured. The insured are classified into two groups. Workers in enterprises having five or more regular employees are compulsorily insured under the program. Meanwhile, the self-employed, including farmers and fishermen, can be insured on a voluntary basis.

2) Benefits

There are four kinds of benefits under the National Pension Scheme: old-age pension, invalid pension, survivor pension, and lump-sum refund. The basic old-age pension is based on an estimated 35 percent of the last remuneration paid during the term, and whose monthly remuneration level is the mean value of the total amount of standard remuneration per month of all insured persons.

The amount of benefits ranges from 35 percent up to 100 percent of the last remuneration if the amount of monthly remuneration is lower than the mean value mentioned above. Meanwhile, less than 35 percent will be paid if the opposite is true. The level of benefits is shown as in <Table Ⅳ-1>.

Public pension plans vary in terms of benefits and contributions. With regard to benefits, the first three types are related to earnings while the National Pension Plan has a redistributive benefit schedule. Under the National Pension Scheme, the amount of pension received is divided into two parts - one is the basic amount and the other is the additional amount. The basic amount consists of average monthly remuneration of all insured persons (equal distribution) and the average amount of the monthly standard remuneration of insured individuals (income-proportional distribution). The additional amount varies according to type and number of dependents. Benefits are granted to the insured or their survivors when the insured lose their earnings due to old age, disability, or death.

<Table Ⅳ−1> Level of Benefits under the National Pension Scheme

Pensions	Benefits
Old-age Pension	
Basic Old-age Pension	Basic pension amount (100%) plus additionals
Reduced Old-age Pension	Certain rate of basic pension Amount (72.5-92.6%) plus additionals
Old-age Pension for Active Seniors	Certain rate of basic pension amount(50-90%)
Early Old-age Pension	Certain rate of basic pension amount (75-95%) plus additionals
Special Old-age Pension	Certain rate of basic pension amount (25-75%) plus additionals
Invalidity Pension	Certain rate of basic pension amount (60-100%) plus additionals
Survivor Pension	Certain rate of basic pension amount (40-60%) plus additionals
Lump-sum Refund	Contributions already charged and legally fixed rate of interest

3) Finance

The sources of funds for the National Pension Scheme consist of contributions from employees and employers, from government subsidies for administrative costs, and interest accrued from the accumulated fund.

Contributions are charged equally to employees and employers on the basis of a fixed-rate formula. Contributions to the National Pension start with a low percentage (3 percent of income) for the first five years in order to lessen the financial burden on employees and employers. In addition, part of the severance pay reserve is scheduled to be converted to contributions. Contribution rate was increased to 6 percent for five years beginning in 1993 and will finally be increased to 9 percent after 1998 (see <Table Ⅳ-2>).

<Table Ⅳ−2> Annual Contribution Schedule of National Pension Plan

(Unit: % of income)

	1988-92	1993-97	1998-
Insured at firms	3.0	6.0	9.0
Employees	1.5	2.0	3.0
Employees	1.5	2.0	3.0
Conversion from severance pay reserve	-	2.0	3.0
Insured in communities	3.0	6.0	9.0

4) Financial Trends

Financial trends of the National Pension Scheme are presented in <Table Ⅳ-3>. There were some special old-age pension payment in l993. Most of the payments, in the meantime, will be lump-sum refunds. Total payments have rapidly increased from 301 million won in 1988 to 6 billion won in 1989 and 519 billion won in 1994, while total contribution increased from 5 billion won in 1988 to 33 billion won in 1994. However, as the pension program ages, the proportion of disability or survivor pension payments will increase, resulting in a decrease of lump-sum refunds.

Since real benefit payment has not been made, the size of the reserve fund has been increasing. This trend of increase will continue until the National Pension Plan begins to show a deficit. Such deficit is caused by an overly generous benefit schedule even if it is an adjusted funded scheme. According to KDI's projection, the national pension will begin to have a deficit from 2031 and the fund will be exhausted ultimately by 2050 unless some measure that prevents a deficit is introduced.

<Table Ⅳ−3> Financial Trends of the National Pension

(Unit : 100 million won, %)

	1988	1989	1990	1991	1992	1993	1994
Revenues							
Contributions (A)[1]	5,069	6,279	8,340	9,848	12,234	26,394	33,258
Operational profits from Fund	201	799	1,849	2,943	4,394	5,834	10,157
Expenditures							
Benefits(B)	3	60	423	1,109	2,165	3,331	5,191
B/A	0.06	1.0	5.1	11.3	17.7	12.6	15.6
Funds	5,279	12,332	21,987	33,275	47,503	76,118	113,557

Note: 1) Sum of employee contributions paid by the government and insured contributions.

Source: National Pension Corporation, *National Pension Statistics*, 1995.

5) Major Policy Issues

Several policy issues should be raised in relation to implementation and expansion of pension programs. Because the pension programs were introduced in a hurry without much preparation, several thorny problems arise. The first problem has to do with financial soundness. The military personnel pension is already in deficit, while the other three programs will be in deficit in the future. Thus, either contributions must be increased or benefits decreased.

Second, there is the issue of optimal integration. When certain important characteristics of pension design such as probability of death or disability are not so different, it would be quite natural for them to be protected by the same pension scheme. Thus, in discussing the possibility of integrating public pension plans, we must first find out which characteristics distinguish some groups from others. If it is concluded that these pensions should be integrated, the next question is how that can be done. The most important difference among current Korean pension programs is the benefit scheme, as explained previously. Therefore, to integrate these pension programs, the type of benefit scheme should be selected.

A third problem is optimal management of funds for pension programs. Particularly in the case of the national pension, huge amounts of reserve funds will be accumulated for awhile, since retirement benefits will not be paid for at least 15 years under the adjusted funded system. Managing such large amounts will raise serious issues in the financial market.

A fourth problem is the expansion of coverage. The number of people covered by the public pension is about 6 million as of December 31, 1991 (31.6 percent of the economically active population). As the national pension wi1l gradually expand its coverage, effective management of such expansion will be a major policy issue.

Expanding the program to the self-employed and the working poor raises administrative as well as philosophical problems. It is difficult to collect premiums from the self-employed. Therefore, a possible hot issue would be how to subsidize premium payments for the poor self-employed. In addition, a way must be found to assist the elderly who are over 60 years old now, such as by provision of conditional pension benefits.

The fifth and important question is how to reconcile possible areas of overlapping and/or conflicts between the pension system and other social security branch systems such as severance pay, health insurance, and industrial accident compensation. Accordingly, follow-ups should be taken in order to make due adjustments among different social-security branches.

6) Policy Suggestions

As for the deficit problem, an increase in the contribution rate is inevitable for all four public pension programs. In addition, an increase in the retirement age is necessary for the National Pension Plan. For the military personnel pension, a means test should be introduced as well. With such measures, switching from the fully funded system to the pay-as-you-go system in the future must be considered.

To integrate the pension programs, the following is suggested. The civil servants pension and the private school teachers pension should be merged into the current National Pension Program because they cover groups of people who do not have any special characteristics differentiating them from others. On the other hand, it is optimal to have a separate public pension scheme for military personnel because they are a unique group of people due to the nature of their profession. However, a redistributional factor must be introduced in this system.

D. Public Assistance

The public assistance program is designed to guarantee the minimum standard of living for those who are indigent and cannot afford to make a living by themselves. What is more important in this area is to help the poor become self-supporting by expanding employment opportunities.

Public assistance centers on the livelihood protection program covering the target population based on the Livelihood Protection Act of 1961 (amended in 1982). This act offers assistance to two different groups of people: those unable to work, including the physically and mentally handicapped, men over 65, women over 55, children and youngsters under 18, and those who have too low incomes to meet their survival requirements. Pregnant women in similar circumstances also fall in this second category.

To qualify for livelihood protection, beneficiaries' income cannot exceed a certain amount set annually. The same limits for income and assets also apply to persons who are legally responsible for the support of those who are unable to work.

There are two types of benefits: in-kind and cash. In-kind benefits rely heavily upon food, free tuition for the lower levels of secondary education, and medical assistance. Those who are unable to work, whether institutionalized or not, are entitled to free medical care. All other welfare clients and their dependents carry some part of the in-hospital expense in the form of repayable interest-free loans. Cash benefits consist of regular monthly payments, rent and fuel subsidies, and funeral grants.

A self-help loan program offers to the poor opportunities to start small business or to expand existing ones. Because the business loan program is very effective among poor people, the amount of money allocated per person should be gradully expanded.

E. Workers' Compensation

Workers' compensation in Korea was the subject of early attention as in most other countries. The Labor Standard Law of May 10, 1953 (most recently amended in 1987) established the liability of the employer for a number of benefits. The Industrial Accident Compensation Insurance Law of 1963(most recently amended in 1989) now applies to enterprises with five or more employees.

Contributions (insurance premiums) are paid only by the employer to the central public fund according to the industry's frequency of accidents, and ranges between 0.2 percent and 40.0 percent of the payroll with an average of 1.94 percent in 1992. The government bears the cost of administration, which accounts for 1.0 percent of total expenditures.

In order to receive work-injury benefits, no minimum qualification period is required. In the case of temporary disability, medical treatment along with 70 percent of wages are provided while under medical treatment. After the medical treatment, a lump sum is paid according to the degree of disability. The severely disabled have a choice between a pension and a lump-sum payment. The less severely disabled receive only a lump sum. In the case of death, a lump sum payment, equal to 1,300 days' average earnings or a pension, is provided to the surviving family with a funeral grant.

Firms that are not compulsorily covered by the Industrial Accident Compensation Act remain subject to the liability imposed by the Labor standard Act. The only recourse that insured workers have, in the case of employer default, is the non-binding arbitration procedure available through the Ministry of Labor Affairs, MOHW, and the courts.

Industrial Accident Compensation Insurance is a typical social security branch which has undergone an evolutionary process during the past three decades. There are still, however, remaining problems and issues to be tackled for further improvements in the program, such as coverage extension to small firms, and introduction of an efficient safety management system. The program covered 7,059,000 (more than 7 million) workers in 1992, 37.3 percent of the employed labor force or 16.2 percent of the population.

The Workers' Compensation Program maintains eight hospitals and three rehabilitation centers outside of the capital city of Seoul having a total of 2,050 beds. There emerges a question of whether government funds should be used to accelerate the additional construction of rehabilitation centers in the future while government admitting that there are a large number of urgent needs in this area.

F. Welfare Services

Social welfare services provide benefits either in kind or cash for target populations. Beneficiaries include those who are more than 65 years old, widows and prostitutes, unmarried mothers, handicapped persons, and children who must take care of themselves. They are entitled to use various welfare facilities and rehabilitation centers. Those who want to be employed have the privilege of being hired under the Employment Promotion Law for the elderly and the handicapped.

This social-security branch, however, is still in its infancy due mainly to lack of budgetary support and social attention. In the coming years, private organizations are expected to participate more actively, including thriving NGOs.

2. Policy Directions for Improving the Social Security System

Today's political transition to civil autonomy implies a small government, but this small government does not mean transfer of government's original functions to the private sector. The basic direction of social security policy in the future should stem from a denial of the assertion that economic development is necessarily accompanied by improvements in national welfare.

Welfare policies should not be simple income transfers to alleviate harmful effects of economic development, but should actively remove and prevent the cause of these adverse economic effects. For this purpose, investment in social welfare should be a higher fiscal priority with emphasis placed on government's responsibility, and on minimum protection and intervention in economic development.

For an effective social security system, various social organizations that can address welfare demands of each class systematically should be encouraged. In addition, centralized welfare administration must be reduced by strengthening local autonomy.

The social security system in Korea is changing rapidly to one similar to those in advanced countries, focusing on the social insurance system as well as social welfare services and public assistance programs. Therefore, problems of adjustment and resolving interrelationships among welfare programs should be addressed without delay.

Since the Korean social security system is still in its developmental stage, and has been segmented into competing legislative initiatives, the partial overlapping of benefits and lack of cohesion among systems may result in wasted resources. Accordingly, a new administrative organization should be charged with overseeing adjustments needed to form an integrated social security system.

Social insurance should maximize risk diversification and should be financed by contributions from beneficiaries, while the public assistance program should aim at alleviating poverty by providing work incentives.

The current age demographics in Korea contain a modest elderly population, but this group is expected to grow rapidly to the level of advanced countries. Therefore, the government's social security program will have to include provisions for the elderly.

Since the overall social security system for the elderly is not well established, reemployment after retirement and expansion of job options are required. To guarantee income for the elderly while maintaining fiscal stability and benefit equity, the social security system will have to be a reserve system in the short run, but must eventually change into a pay-as-you-go system. Consequent intergeneration cost-sharing should be agreed upon in advance by national consent.

Since the elderly can gain security by living with their children, benefits to households supporting the elderly (for example, subsidies for buying houses, raising of family allowances, or income-tax exemptions) should be strengthened. In particular, benefits to those who support the moving of the elderly from rural to urban areas should be considered.

In order to meet national welfare demands and to manage public expectations, the "feeling" of relative poverty should be attacked through improvement of social consciousness and social development policy as well as the expansion of social security.

In order to improve the welfare of the lower class and those who are neglected by society, it is necessary to expand livelihood security, health protection, and welfare institutions with asylums for the aged, nursery schools, and physical rehabilitation centers. Along with these efforts, various private sectors' activities to reshape family relations and to revitalize cooperation need to be encouraged as a complement to government initiatives. In particular, NGO's self-help movements in the residential areas should be supported.

In light of advanced countries' experience, excessive welfare programs may bring about a feeble and stagnant society, and too much reliance on government will weaken family unity and deepen intergenerational conflict.

Expansion of social security inevitably increases the tax burden. However, tax incidence and real distribution of benefits should be considered with much care. Ignoring all social injustice fails to solve the relative sense of poverty and isolation, but excessive expansion of social security only brings about fiscal inflation, not to mention disincentive to work or save. Therefore, removal of irrational contradictions to social justice should be the basis of addressing the relative poverty problem.

In conclusion, a balanced social security and social welfare policy is important not only to achieve social equity but also to enhance economic efficiency. Promotion of national welfare to improve living conditions encourages workers' spirits, brings about just income redistribution by raising the living standards of the poor, and increases productivity by relaxing social tensions harmful to economic efficiency.

However, introduction and expansion of the social security system will raise the problem of equity for distribution of the welfare expenditure burden among income classes as well as for generations.

Therefore, balanced social welfare expansion should be pursued by readjusting financial priorities among social welfare programs rather than through financial expansion alone.

Ⅳ. Distribution of Income and Wealth

Equity in distribution of income and wealth is one of the thorny problems facing policy-makers in Korea. Although income distribution in Korea is fairly good compared to that in other countries, both developed and underdeveloped, Koreans have always been keenly concerned with the state of income and wealth distribution because many somehow feel that they are deprived. In particular, industrial workers have been asserting that government's "growth-first" strategy should be replaced with a "distribution-first" policy.

Progress of empirical studies on the distribution of income and wealth is often hampered by a lack of reliable and consistent data. Korea is not an exception in this regard.

Until recent years, empirical studies on income distribution in Korea used to be based on two household surveys, namely the urban household income and expenditure survey by the National Statistical Office (NSO), and the farm household survey by the Ministry of Agriculture and Fisheries. Although these two household surveys are undertaken annually and their results are reasonably reliable, the major difficulty in estimating income distribution in Korea arises from the fact that some groups of households are not covered in these surveys.

1. Income Distribution

Empirical findings on trends in the distribution of income in Korea are summarized in <Table Ⅳ-4>, which presents estimates of income distribution by three different groups: Choo and the Economic Planning Board, Kim and Ahn, and the Korea Development Institute. <Table Ⅳ-4> clearly shows that income distribution in Korea is rather equitable by international standards, and that income distribution improved during the 1960s and deteriorated in the 1970s, although specific numbers are subject to debate.

<Table Ⅳ−4> Overall Distribution of Income and Measures of Inequality

10 Decile	1965	1970	1976	1980	1985	1988
1	1.32	2.78	1.84	1.56	2.59	2.81
2	4.43	4.56	3.86	3.52	4.37	4.58
3	6.47	5.81	4.93	4.86	5.48	5.65
4	7.12	6.48	6.22	6.11	6.47	6.64
5	7.21	7.63	7.07	7.33	7.57	7.60
6	8.32	8.71	8.34	8.63	8.73	8.67
7	11.31	10.24	9.91	10.21	10.10	10.01
8	12.00	12.17	12.49	12.38	11.97	11.80
9	16.03	16.21	17.84	15.93	15.10	14.62
10	25.78	25.41	27.50	29.46	27.62	27.62
Bottom 40%	19.34	19.63	16.85	16.06	17.71	19.68
Top 10%	41.81	41.62	45.34	45.39	43.71	42.24
Decile distribution ratio	0.4626	0.4716	0.3716	0.3538	0.4052	0.4659
Gini coefficient (1)	0.3439	0.3322	0.3908	0.3891	0.3450	0.3360
Gini coefficient (2)	0.37	0.35	0.40	0.39	0.41	0.40

Note: Gini coefficient (1) is based on the estimate by Choo and the Economic Planning Board while Gini coefficient (2) is based on the estimate by Kim and Ahn(1987), and Kwon(1992).

Sources: Choo(1992), the Economic Planning Board(1987, 1990), Kim and Ahn (1987), and Kwon(1992).

Relatively equal distribution of income in Korea has been traced to several factors, including the decimation of Korean society by Japanese, post-liberation land reforms, asset destruction during the Korean War, confiscation of illegally accumulated wealth after the downfall of some previous regimes, a labor-intensive strategy during the early development stage, and the abundance of higher education opportunities.

The downward shift in the Gini coefficient from 0.344 in 1965 to 0.332 in 1970 may reflect the positive contribution to income distribution in the latter half of the 1960s of the rapid increase in employment opportunities that commenced after the early 1960s and the significant rise in real wages every year after 1965. The upward shift in the Gini coefficient to 0.391 in 1975 and 0.389 in 1980 may reflect a negative contribution to the distribution of income of the amplified concentration of economic power in the hands of large business groups and of the increased skewedness in wage rates among labor groups as well as increasing income disparity between farm households and urban households (during 1970~76). The decline in the Gini coefficient to 0.336 in 1988 (from 0.345 in 1985) may reflect a positive contribution of the active labor union movement in the late 1980s to the labor share of national income.

Deterioration in the distribution of income during the 1970s deserves a detailed analysis. During this period, the government mobilized resources to promote heavy and chemical industries and put out new measures (such as credit allocation) that initially gave benefits to particular industries and corporations, tax expenditures, and policy loans under which sometimes the rate of the real interest was negative. These special policy measures were factors that contributed to the aggravation of the income distribution. Furthermore, inflation was accelerated during this period and resulted in more aggravated income distribution. Consumer prices rose on average at an annual rate of 10% from 1962 to 1973 and reached an annual average level of 20% during 1974 to 1979. Furthermore, aggravation of income distribution can be explained by other factors such as a relative contraction of wage earners, a rise in the price of real estate, and an increase in the income gap between urban and rural areas.

On the other hand, the study by Hackchung Choo clarifies the reason for the increase in income inequality during the 1970's by referring to income inequality of rural families, urban working families, and independent business families. According to his estimate, the Gini coefficient of the independent businessmen rapidly increased from 0.353 in 1970 to 0.449 in 1976 and was much higher than the Gini coefficients of 0.327 and 0.355 of rural families and urban working families, respectively, in 1976. Therefore, owing to urbanization, urban dwellers, who are mainly specialists, businessmen, and capital owners, earned very high incomes. This in turn resulted in aggravation of income distribution. In other words, the fact that income distribution is less equalized in urban areas than in rural areas signifies that urbanization contributes to a deepening of inequality. Furthermore, according to Leipziger, et al. (1992) in the 1960's, the weight of the urban sector was yet small, and the rural exodus decreased inequality within rural areas. Thus overall income imbalance decreased. The fact that the imbalance deepened after the 1970's could be similarly explained, because the potential surplus of population in the rural area declined, and relative weight of the urban and industrial sector increased.

According to a government publication, income distribution gradually improved during the 1980's. The Gini coefficient calculated based on the social indicator survey was 0.3450 in 1985 and decreased to 0.3360 in 1988. The decimal ratio was 0.4053 in 1985 and increased to 0.4659 in 1988. Official government data concerning the nation's income distribution after the 1990's have not been published yet. Although official publication shows merely income distribution of working families based on the urban household survey, income distribution of urban working families since 1990 is steadily improving, as shown in <Table Ⅳ-5>.

There are several reasons for improving income distribution during the 1980's and thereafter. First, the government took many notable measures, including various tax supports, abolition of preferential policy loans, and stability in price levels. These measures gradually improved the income distribution. Also, as there was a shortage of low-skilled production workers during this period, wage gaps among education levels decreased, and the income distribution of urban households in particular improved.

<Table Ⅳ−5> Distribution of Income for Urban Employee Households

	1990	1991	1992	1993
Decile distribution ratio	0.5573	0.5775	0.5870	0.5917
Gini coefficient	0.2948	0.2870	0.2836	0.2817

Note: Decile distribution ratio is a ratio of income share of the bottom 40 percent to income share of the top 20 percent.
Source: National Statistical Office, *Social Indicator in Seoul*, 1995.

Despite clear improvement in income distribution, the problem of income distribution has continually been brought forward today in Korea. Many people expressed concern at the rise in inequality and the feeling of being deprived was increasingly sensed by many after the late 1980’s. This may be related to the gap between actual and perceived income distribution and between the statistical and the real distribution.

When we compare statistics of Korea’s income distribution with those in other countries, perplexity deriving from the gap between public perception and actual statistical value of the income distribution enlarges. In making international comparisons of income distribution by class, Korea’s income distribution is comparatively satisfactory. Korea’s Gini coefficient during the last 20 years was below 0.4 according to the classification of Professor H. C. Chenery.

Korea is one of those countries that maintains a rather fair distribution of income. Factors that contributed to a rather equal distribution of income in Korea are as follow: first, the most successful reform of land in the world, executed during 1947~1950; second, the Korean War of 1950~1953, which gave everyone an opportunity to start again from the very beginning after total destruction and poverty; third, the high mobility between social classes owing to homogeneity of culture and religion; fourth, Koreans' high respect for education and equal educational opportunity; fifth, high economic growth, which created many job opportunities; and sixth, promotion of various equalization-oriented government policies.

Given that distribution of income in Korea is less unequal compared to that of other countries, and income distribution has been steadily improving after the 1980's, then how can we explain the fact that the feeling of relative deprivation and alienation increased gradually, and that an allegation for a more equal distribution was brought up.

First, there exists a possibility that many indicators of income distribution obtained from official statistics may not correctly represent the actual income distribution. Most income distribution statistics are based on household surveys. However, the urban household survey up to 1977 excluded not only the high-income class but also the low-income class who were receiving public assistance. In the surveys since the 1980's, the survey sample widened to include many of these households in the survey, but still not to a satisfactory degree.

Furthermore, a study by Kim and Ahn (1987) provides different results by expressing doubts on the consistency of the time series of Dr. Choo's study and of government publications. In linking Kim and Ahn's results with Soonwon Kwon (1992) it can be seen that income distribution during the 1980's had not improved. Based on household surveys of his own design, Kwon estimated a Gini coefficient of 0.40 for 1988, a much higher figure than one from government sources.

Another reason why there exists a gap between statistical figures on income distribution and the income inequality people actually feel lies in the definition of distributive justice. The Gini coefficient or decimal ratio mentioned above merely gives an outline of income distribution and does not consider the comprising factors of income distribution at all such as impartiality, justifiability, needs, and qualification to receive output. One can raise doubts whether the current income distribution conditions in Korea are the outcome of an impartial game.

Foreign experts observe that income distribution in Korea is fairly equal. However, many Koreans do not agree. The fact that opinions of foreigners and Koreans are different is quite interesting, and surely many reasons must exist to explain this differences in their views. However, one important reason can be explained through the differences in the way of thinking between Occidentals and Koreans. Koreans believe in community ideology or the equalized collectivism idea. Thus, the degree of distributive inequality that Westerners can endure is recognized as unequal in sentiments of Koreans.

Finally, we should understand that measurement of inequality or equality of distribution by using income as an appropriate indicator has limitations in understanding fairness. In the case where studies on inequality of distribution in assets and wealth, which represent more clearly potential consumption ability and economic power, are non-existent, the report on the trend of distribution by using income, a flow variable, does not have any convincing power in revealing the degree of fairness. This can be easily understood when our attention is paid to the fact that consumption ability of a family depends on whether one owns a house or not.

2. Distribution of Wealth and Property

Studies on income distribution should be complemented through research on poverty and economical wealth for understanding the inequality and distributional problems of Korean society. But studies of inequality and economic wealth or property are not many and are not readily available. Among studies on distribution of the total wealth, including real and financial assets, Mr. Kwon’s study (1992), which used KDI's household survey data, is the most representative. Research on distribution of land was conducted by the Committee on Public Control of Land on the basis of land area. Dr. Jin Kwon Hyun did research on inequality of land possession using land price as a base. Studies on financial asset distribution are hardly found in Korea.

<Table Ⅳ−6> Concentration of Landownership in Major Cities (as of June 1988)

(Unit: %)

	All Korea	Seoul	Pusan	Daegu	Inchon	Kwangju	Daejon
Top 5%	65.2	57.7	72.3	72.6	64.2	55.7	65.1
Top 10%	76.9	65.9	81.4	82.4	77.8	69.4	76.4

Sources : Commission on Public Control of Land Ownership, *Report on the Public Control of Land Ownership*, 1989.

<Table Ⅳ−7> Gini Coefficient of Household Landownership

	Seoul	Pusan	Daegu	Inchon	Kwangju
Share of landowning households in total households (%)	28.1	33.1	38.3	30.1	69.7
All households	0.911	0.946	0.944	0.937	0.838
Landowning households	0.709	0.846	0.867	0.812	0.808

Sources: Commission on Public Control of Land Ownership, *Report on the Public Control of Land Ownership*, 1989.

Uneven distribution of real estate possession is a very well known phenomenon. As shown in <Table Ⅳ-6> and <Table Ⅳ-7>, 65.2% of Korea's total land is owned by the top 5% of landowners, and the top 10% owns 76.9%, which demonstrates a severely uneven distribution. The concentration degree of landownership, measured by the Gini coefficient, is 0.838~0.746 for the total household, and 0.769~0.867 for landowners, attesting to higher concentration of land ownership than that of financial assets or income. Data of land possession distribution used the land area as a base for analyzing the unevenness. But unevenness of land distribution based on area could distort real distribution given the fact that land prices differ from one region to another. For instance, when one simply analyzes the actual situation of land possession on the basis of area, the land area of rural and urban areas could dangerously be evaluated at the same level. Therefore, in order to have a precise understanding of the degree of unevenness in land possession, there is a need to analyze land possession with attention given to land value. Dr. Hyun (1995) has analyzed the uneven distribution of land possession on the basis of publicly assessed land value as shown in <Table Ⅳ-8>. The top 1% of people own 27.9% of the land, and the top 5% own 50.6%. Also, when one compares the figure based on the area to that based on the value, one can see that the richer class generally owns land with higher value per unit.

<Table Ⅳ−8> Concentration of Landownership (1993)

	Land Value Based on Publically Assessed Price			
	Average	Low	Share	Cumulative Share
Top 1%	1,855,988	744,180	27.9	27.9
Top 2%	575,572	457,469	8.7	36.6
Top 3%	389,602	333,592	5.9	42.4
Top 4%	298,710	269,748	4.5	46.9
Top 5%	247,198	224,928	3.7	50.6
6-10%	170,781	134,850	12.8	63.4
11-20%	100,660	74,839	15.1	78.6
21-30%	59,305	46,658	8.9	87.5
31-40%	39,270	33,252	5.9	93.4
41-50%	26,791	20,700	4.0	97.4
51-60%	14,366	8,917	2.2	99.6
61-67%	3,758	32	0.4	100.0
68-100%	0	0	0.0	100.0

Source: Hyun (1995).

According to Leipziger, et al. (1992)'s findings, considerable wealth is concentrated in the hands of the top 1% of the population, almost exclusively through landownership.

Now let us look at distribution of financial assets in Korea. <Table Ⅳ-9> shows empirical findings by Bong Kyun Kang. The Gini coefficient for the distribution of financial assets is 0.5610 while that of income is 0.3567. Financial assets for <Table Ⅳ-9> and <Table Ⅳ-10> include household deposits, bonds and equity stocks.

<Table Ⅳ−9> Comparison of Income and Financial Assets Distribution

	Year	Gini coefficient	Decile distribution ratio
Income	1984	0.3567	0.45
Financial assets	1988	0.5610	0.13

Source: Kang (1989).

<Table Ⅳ−10> Gini Coefficient of Income and Wealth Distribution

	Income	Wealth		
		Financial assets	Real assets	Total assets
City	0.373	0.738	0.604	0.584
Rural	0.445	0.835	0.557	0.549
Overall	0.404	0.770	0.596	0.579

Source: Kwon (1992).

<Table Ⅳ-10> shows Gini coefficients of income and asset distribution based on KDI's survey data. Asset distribution is more unequal than income distribution. Furthermore, financial assets are more unevenly distributed than real assets.

3. Functional and Regional Distribution of Income

Another effective way to see the true state of income distribution is to look at the functional distribution of income. With the functional distribution of income, we mean the process in which total income is divided into factors of production: labor, capital, and land. By looking at the functional distribution of income, the changing relationship between income distribution and economic growth can be more closely analyzed. At the same time we should be interested not only in overall income distribution but also in income differential among specific groups, such as wage differentials for those with different educational backgrounds, professions, and sex. Dissatisfaction from inequality is not really a protest against inequality problems resulted but a protest against inequality problems of processes.

A. Functional Distribution of Income

The core concept in understanding functional distribution of income is LIS (Labor Income Share). LIS is the ratio of labor income (wages, pay and imputed wages from unincorporated firms) to the net national product. In other words, when one classifies factors of production into labor and capital, it is that part of value added provided by labor.

LIS can change much depending on the manner in which independent businessmen’s income is divided into labor income and capital income, and on how wages paid to government employees and net factor income from the rest of the world are treated.

<Table Ⅳ-11> shows the change of Korea’s LIS for 40 years from 1953 to 1993. We can discover a long-term trend in LIS slowly increasing with short-term fluctuation. Korea’s LIS during the past 40 years has been marked by a great increase from 25.8% in 1953 to 60.6% in 1993.

Though LIS in Korea had risen over time, Korea’s LIS is low by international comparison. One of reasons for this rise is the shift in labor out of agriculture (not included in LIS) to industry (included in LIS). Park and Kim (1982) analyzed why LIS in Korea is internationally low by investigating the relation between wage and labor productivity. According to Park and Kim, it is the fast growth of big business that accounts for the low LIS in Korea. That is, since the LIS of conglomerates is the lowest, rapid growth of the conglomerate has led to the low level of LIS.

<Table Ⅳ−11> Share of Labor Income in National Income

(Unit : %)

	Employee Share	Labor Share
1953	22.5	25.8
1955	26.0	30.1
1960	30.0	37.4
1965	26.3	31.8
1970	34.0	41.4
1975	33.1	40.6
1980	40.2	52.1
1985	41.4	53.9
1990	45.9	59.0
1993	47.3	60.6

Source: Bank of Korea, *National Accounts*, 1994.

Meanwhile Mr. J. H. Bae (1991) analyzes increasing trends of LIS since the late 1970’s by invoking the turning-point theory. In short, before the mid and late 70’s, the turning point of Korean economy, LIS was low owing to unlimited supply of labor. But since then LIS tends to increase because of limited supply of labor, accompanied by an increase in relative wage, and low elasticity of substitution among input factors. And Mr. Bae pinpoints rapid growth of manufacturing industries for export which strongly absorbed unskilled labor during this period as a decisive element that “turned the point.”

B. Income Distribution by Group and Region

Income inequality among specific groups has a special meaning in the discussion of income distribution. This is because the discrimination problem is directly related to fairness of rules of the game or justness of the process. Discrimination means differences in employment or wages because of race or sex among workers with no difference in capability such as academic background, experience, or productivity. Discrimination does not have a reasonable basis and therefore cannot be justified since it is derived from social and personal bias. In societies in which discrimination is prevalent, a high barrier exists among specific groups, and because of this barrier, class consciousness spreads at great speed.

<Table Ⅳ−12> Wage Level by Educational Background

	Middle school graduate	High school graduate	Technical college graduate	University graduate
1975	57.2	100.0	136.2	214.4
1980	68.8	100.0	146.3	228.5
1985	74.7	100.0	129.8	226.5
1990	83.8	100.0	117.4	185.5
1993	88.1	100.0	109.5	161.3

Source: Ministry of Health and Social Welfare, *Social Indicators in Korea*, 1994.

In the Korean case, income differentials or discrimination among specific groups are gradually being resolved. If we look at wage differentials according to academic background as presented in <Table Ⅳ-12>, it has decreased a great deal owing to the fall in unemployment rate in the production line from 1990 and the shortage in supply of workers. When one puts the wage level of high school graduate workers at 100, the wage level of university graduate workers was 228.5 in 1980 (more than 2 times higher) but dropped to 161.3 in 1993.

<Table Ⅳ−13> Ratio of Female Wages to Male Wages

(Unit: %)

	Female wages/Male wages
1975	42.2
1980	42.9
1985	46.7
1990	53.4
1993	54.6

Source: Ministry of Health and Social Welfare, *Social Indicators in Korea*, 1994.

<Table Ⅳ−14> Ratio of Rural Household Income to Urban Household Income

(Unit: %)

	Rural household income/Urban household income
1965	99.7
1970	75.6
1975	111.0
1980	95.9
1985	112.8
1990	97.4
1993	95.5

Source : Ministry of Health and Social Welfare, *Social Indicators in Korea*, 1994.

Next, if we look at wage differentials between the sexes, the differential has been reduced but is still wide by international standards. Wages of women workers compared to men have increased from 42.2% in 1975 to 54.6% in 1993, as shown in <Table Ⅳ-13>.

Income differentials between rural and urban regions are shown in <Table Ⅳ-14>. The income gap between rural and urban regions does not really demonstrate a clear secular trend. When we compare the ratio of monthly income of a rural household to that of an urban household, it increases from 75.6% in 1970 to 95.5% in 1993.

4. An Evaluation

Income inequality in Korea, as shown by official statistics, is steadily declining from the 1980's. One can easily assert that not only distribution of income but also the distribution of wealth is far more equal when compared to foreign countries. If the distribution of income and wealth based on official statistics are internationally on the less unequal side, then how can we explain the dissatisfaction of people with regard to this distribution? One inevitable choice is to be interested in other aspects that are not revealed by the statistics.

Not only problems with data on which income and wealth distribution are based, but also the limit on distribution statistics seen from the point of view of distributional justice have already been mentioned and widely acknowledged. The need to pay attention to unevenness of distribution of wealth has been pointed out as an opportunity to make the difference between what we feel and what statistical numbers indicate. Korea's unequal distribution of wealth is far more serious than unequal distribution of income, and it is from this point that we can take a step closer to the inequality that people in general sense.

Data on the distribution of wealth presented above have many problems. First, statistics on distribution of total assets, financial assets, and real assets based on household survey data cannot be freed from the underreporting problem which is inherent in any survey. In the case of the household survey, underreporting of the highest income class particularly underreporting of stocks and bonds which the rich possess to a great extent, is known to be one of the biggest factors.

Also in the case of landownership concentration, there is a danger of underestimating the actual state of inequality, because statistics for landownership are based on individual data rather than on household data. When members in a household own land under different names, each ownership is counted as a separate unit. Given the fact that each household member in Korea registers properties under his or her own name, the actual state of landownership concentration is much more unequal than statistical data shows.

When we discuss the gap between what people sense and what statistics show, the role of the tax system should be mentioned as another explanation. Among three functions of taxes (equity, efficiency, and revenue-raising), the one that people have the most interest in is that of equity, the redistributive function of taxes. If Korean people think that the tax burden is unfair while the tax system fails in playing the redistributive role, naturally people's feeling about the equity of distribution are likely to be negative. When Korea's tax system is not faithful to the principle of progressive taxation, dissatisfaction with distributional injustice will only become greater.

V. Welfare Policy and Redistribution of Income

All kinds of social security systems, i.e., social insurance, public assistances, and social welfare services, have a great effect on income distribution. In the case of specific welfare programs that aim at redistribution of income or reduction of poverty, like public assistance, it is very important that specific policies be well designed to achieve the goal set beforehand.

Positive analysis of the redistributive effect of social welfare policies is very difficult to handle. In the case of health insurance, it is not possible to acquire data on the rate of contribution and benefits. In the case of the pension scheme, it takes quite a long time for an employee to receive benefits in retirement, and it is hard to acquire data that reflect the actual developments. In case of public assistance, since it is possible to indirectly calculate the level of assistance rendered to each household's characteristic, positive research is relatively active.

Research on the effect of the social security system on income redistribution is limited even in numbers. While Ha Cheung Yeon (1989) studied the redistributive effect of the social security system by international comparison, Kyung Bae Cheung et al. (1991) produced a study in which the redistributive effects of public assistance, health insurance, and national pension were empirically analyzed with redistributive effects in mind. Yeon (1982) analyzed national pension while Kwon (1989) studied the medical insurance system. Using a tax-benefit model, Na and Hyun (1993) studied redistributive effects of social assistance.

1. Public Assistance and Income Redistribution

Na and Hyun aggregated urban and rural household data to measure the effect of public assistance on income redistribution and reduction of poverty. Their study examined the redistributive effect of a wide range of public assistance policies, including livelihood protection, self support protection, and medical protection. Before enforcement of public assistance policies, 7.64% of total households were poor, but after introduction of public assistance policy, households below the poverty line have decreased to as little as 7.56%.

<Table Ⅳ−15> Distributional Consequences of Public Assistance (1991)

(Unit: %)

Decile	Decile share before income tax and public assistance	Decimal share after income tax and public assistance
1	3.09	3.35
2	4.86	5.08
3	6.02	6.24
4	7.02	7.27
5	7.98	8.22
6	9.04	9.22
7	10.29	10.38
8	11.98	11.97
9	14.69	14.47
10	25.01	23.80
Gini coefficient	0.3138	0.2962

Source: Na and Hyun (1993).

Since public assistance policy focuses on the poor, the effect on total income distribution is very small, but since income tax and public assistance policy have the same goal as far as distribution is concerned, we should examine the combined overall effect of the two policies on income distribution. The effect of public assistance policy (including income taxes on income distribution) is shown in <Table Ⅳ-15>. Before enforcement of the income tax and public assistance policy, the Gini coefficient of income distribution was 0.3138, but after enforcement the Gini coefficient decreased a great deal to 0.2962. It must be pointed out that this reduction in the Gini coefficient is mainly due to the redistributive effect of income tax rather than the public assistance program.

2. Health Insurance and Income Redistribution

Under assumption that the total medical insurance benefit received covers down to the lowest class, Kyung Bae Cheung et al. (1991) examined the redistributive effect of health insurance, as shown in <Table Ⅳ-16>. Income distribution before and after introduction of health insurance system showed the Gini coefficient of 0.3355 and 0.3338, respectively. This small change in Gini coefficient is due to the fact that the total health insurance benefit received is small compared

<Table Ⅳ−16> Distributional Consequences of Health Insurance (1991)

(Unit: %)

Decile	Decimal share of income before health insurance	Decimal share of income after health insurance
1	2.81	2.94
2	4.58	4.57
3	5.65	5.64
4	6.64	6.63
5	7.60	7.59
6	8.67	8.66
7	10.01	10.00
8	11.80	11.78
9	14.62	14.60
10	27.62	27.58
Gini coefficient	0.3355	0.3338

Source: Kyung Bae Cheung(1991).

to the total amount of income, even if the lowest class is totally included in the benefit.

Another study by Kwon(1989) on the redistributive effect of the health insurance system shows a similar result, as shown in <Table Ⅳ-17>. Income distribution before introduction of health insurance shows a Gini coefficient of 0.2186, and income distribution with health insurance shows a slight decrease in the Gini coefficient to 0.2153. All these mean that the health insurance system plays only a slight role in income redistribution.

<Table Ⅳ−17> Distributional Consequences of Health Insurance

(Unit: %)

	Before contribution	After contribution
1	4.4	4.5
2	6.2	6.2
3	7.1	7.2
4	7.9	8.0
5	8.7	8.7
6	9.7	9.7
7	11.0	11.2
8	12.4	12.4
9	14.5	14.4
10	18.1	18.0
Gini coefficient	0.2186	0.2153

Source: Kwon (1989).

3. National Pension and Income Redistribution

<Table Ⅳ-18> from Cheung et al.’s study shows that the national pension hardly contributes to redistribution of income. With pension contribution, the Gini coefficient rises from 0.31007 to 0.31010, but with pension benefits it decreases from 0.31007 to 0.30893. Since this study is not based on actual data, but a result from a simulation experiment based household characteristics, the redistributive effect of the National Pension scheme should be interpreted with care.

<Table Ⅳ−18> Distribution Consequences of the National Pension Program

(Unit: %)

Decile	Income share with no contribution	Income share with contribution	Income share after benefit
1	23.12	23.12	23.08
2	15.27	15.27	15.34
3	12.72	12.72	12.71
4	10.77	10.77	10.76
5	9.40	9.40	9.41
6	8.21	8.21	8.22
7	7.05	7.05	7.07
8	6.06	6.06	6.08
9	4.85	4.85	4.87
10	2.55	2.55	2.56
Gini coefficient	0.31007	0.31010	0.30893

Source : Cheung (1991).

4. An Evaluation

As the discussions above show, redistributive effects of the social welfare policy in Korea are not that striking or noticeable as expected. In general, it is well known that among three major categories of the social security system, what has the strongest redistributive effect is public assistance, followed in order by the national pension and health insurance. Since in Korea cash or in-kind benefit from public assistance is small relative to overall income level, public assistance is of limited help in redistributing income from the rich to the poor. Public assistance contributes a bit to reduction of poverty of the low income class.

The social security system aims to achieve many goals, including redistribution of income as well as efficient allocation of resources. Redistribution of income is one of the goals that the social security system of any country is supposed to achieve. The social security system should not discourage workers in their labor supply, and at the same time it should guarantee to meet minimum needs for everyone in the society.

Ⅵ. Concluding Remarks

There are two kinds of decision-making processes in any society which exert great influences on allocation of resources and distribution of income. One is a market decision-making process and the other is a nonmarket or political decision-making process.

In capitalistic society, the market mechanism is basically supposed to solve all economic problems: What, how, how much, and for whom to produce. But the market decision making process or the market mechanism does not always solve economic problems to a satisfactory degree. Left to itself, the market system of any economy is unlikely to operate efficiently. In the extreme case, the market may fail to exist. The government or political decision making process intervenes to deal with problems that the market, itself, cannot solve at all or completely. The political decision making process tries to correct market failures.

The welfare state or welfare system operates under different principles from those of the market decision-making process. In general, details of the welfare system are determined through a political decision-making process rather than through a market decision-making process. In the market decision-making process, production and consumption are determined by those who can afford the price of goods and services based on individual benefit. However, in the political decision-making process, consumption and production of goods and services are based upon needs, rather than ability to afford.

The market decision-making process varies in content from one country to another, and even within the same country it changes from time to time. The political decision-making process also varies by time and country, and goes through changes. There exists an interaction between market decision-making and non-market or political decision making.

In Korea, the political decision-making process has played a major role in our society and economy. But, ironically, the powerful and leading political decision-making process has merely accompanied or supported the market decision-making process. In Korea, although the market decision-making process has never been left free to function powerfully, the political decision-making process has always allowed and backed up the market to perform its role.

The task for developing a Korean welfare model, reflecting particularity and universality of Korean society, still has much to be discussed. A country's welfare system reflects its political, economic, and social circumstances, concomitantly on top of its cultural tradition and heritage.

Social security in Korea has rarely been thought of as a major means to provide a national minimum for all, though the government paid lip service to this ideal. Work incentives have always been of primary concern, and economic efficiency and economic growth have been the last things to concede. Many policy issues related to the social security program have been raised, and most of them have been caught among values of equity, efficiency, growth, international competitiveness, and domestic stability.

The social security program in Korea expanded under the common understanding that a high income level through economic growth is a necessary condition but not a sufficient condition for increase in the people's well-being. Various kinds of welfare systems were introduced to meet the need for minimum living and to mitigate social danger.

In order to settle the widespread awareness of social inequality, estrangement, alienation, relative deprivation, and regional disparity, the distribution of income and wealth has to be improved, and a master plan for reduction of poverty has to be strongly implemented. All these imply that a sound welfare system has to be designed to provide proper welfare benefits with a fair burden.

Although Korea's current economic condition cannot and need not pursue extensive social welfare policy adopted by most industrialized Western countries, we are in a position where we are able to introduce a substantial level in welfare. Since welfare philosophy and policy in western countries are based on historical and cultural backgrounds of each nation in question, we should adopt a system appropriate to our needs and circumstances; somewhere waste, inefficiency and inconsistency are eliminated.

In making a policy on social welfare, we should not resort to a temporary expedient or we should not be extemporaneous. It is very important to establish a fair compensation and remuneration system. Social welfare policy must be ex-ante rather than ex-post. It should be preparatory and preventive rather than retrospective. Rather than granting unemployment benefits, for example, it would be better for the government to create more jobs and provide workers with jobs. Rather than making compensation to those who are suffering from environmental degradation, it is desirable to prevent pollution in advance through various measures and plans.

As people ask for more welfare, and as industrialization engenders demand for the better life, social security should not be introduced for its own sake. We should design the welfare system so that socially needy people receive most of the benefits and do so directly. Since introduction of any welfare program inevitably involves a higher tax burden or higher transfers, we should come to mutual agreement as to who will bear the cost and how much efficiency cost we are willing to pay.

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Appendix <Table 1> Development of the Social Insurance System in Korea

Five-Year Plan Period	Pension Insurance	Medical Insurance	Industrial Accidents Insurance and Others
From the First Five-Year Plan to the Third Plan(1962-76)	•Introduction of the pension program for civil servants(1961) •Introduction of the pension program for military personnel (1963) •Introduction of the pension program for private school teachers(1975)		•Introduction of the industrial accidents insurance program for workers at workplaces with 500 or more workers(1964) •Coverage expanded to include workers at workplaces with 16 or more workers(1976)
From the Fourth Plan to the Fifth Plan(1977-86)		•Implementation of the employee medical insurance program for workers at workplaces with 500 or more workers(1977) •Implementation of the medical insurance program for civil servants and private school teachers(1978) •Coverage of the employee medical insurance program expanded for workers at workplaces with 16 or more workers(1986)	•Coverage expanded to include workers at workplaces with 10 or more workers(1986)
The Sixth Plan(1987-91)	•Implementation of the National Pension System for workers at workplaces with 10 or more workers(1988)	•Introduction of the regional medical insurance program for the self-employed in rural areas(1988) •Expansion of coverage of the regional medical insurance program to include the self-employed in urban areas(1989) •Coverage of the employee insurance program expanded to include workers at workplaces with five or more workers(1988)	•Coverage expanded to include workers at workplaces with five or more workers •Introduction of the minimum wage system initially applied to the manufacturing sector(1988), and later to all industries(1990)
The Seventh Plan(1992-96)	•Coverage expanded to include workers at workplaces with five or more workers(1992) •Government plans to introduce a pension program for farmers and fishermen during the latter half of the Plan period	•Financial stability of the regional medical insurance program •Strengthening the institutional basis of the public health programs	•Introduction of the employment insurance program during the latter half of the Plan period

Appendix <Table 2> Trends in Major Social Indicators

Industry	1965	1970	1975	1980	1985	1990
Ⅰ. Population and Dependency						
① Total population(1000 persons)	28,705	32,241	34,679	37,407	40,420	43,500
② Population under 14 years old(%)	43.8	42.5	38.6	33.9	30.2	25.5
③ Population aged 15-64 years old(%)	53.2	55.1	58.4	62.3	65.3	69.6
④ Population 65 years and over(5)	3.3	2.8	3.5	3.9	4.3	4.9
⑤ Total dependency ratio(%)	88.3	83.8	72.5	60.7	52.5	44.6
Ⅱ. Illiterate Rate and Unemployment Rate						
① Daily calorie intake(K cal)	2,189	2.70	2.90	2.85	2.87	2.53
② Advance rate to middle school(%)	42.3	57.0	74.2	94.6	99.7	99.9
③ Piped water supply rate(%)	-	33.2	43.1	54.6	67.2	83.0
④ Life expectancy(year)	61.9	63.2	64.7	65.9	69.3	71.0
⑤ Infant death rate (per 1000 persons)	61.8	53.0	38.0	36.8	32.6	32.6
⑥ Illiterate rate(%)	-	24.4	17.0	13.3	10.0	8.1
⑦ Unemployment rate(%)	7.3	4.4	4.1	5.2	4.0	2.4
Ⅲ. Public Assistance Recipients(1000 person)						
① Livelihood protection persons	354	369	385	329	345	420
Home care persons	282	306	330	282	282	339
Institutional care persons	72	63	55	47	63	81
② Low income persons	3,564	2,116	904	1,500	1,928	1,835
③ Total recipients	3,918	2,485	1,289	1,829	2,273	2,256
④ Total recipients to total population	13.6	7.7	3.7	4.9	5.6	5.2
Ⅳ. Minimum Living Cost (1000 won per person per month						
① Rural area	-	07	1.8	16	-	-
② Big city	-	08	2.4	20	-	174
③ Small city	-	08	2.4	18	-	174
Ⅴ. Population in poverty						
① Absolute poverty population(1000 person)	11,750	-	5,198	3,644	3,476	3,316
② Absolute poverty rate	40.9	-	14.6	9.8	8.6	7.7
③ Relative poverty rate	12.2	-	12.4	13.3	-	-
④ Absolute poverty level(1000 won per person, per month)	1.5	2.5	8.8	18.4	27.1	55.0
⑤ Poverty level(1000 won per person, per month)	2.4	5.1	-	51.0	67.0	96.0

Source: National Statistical Office, *Social Indicators in Korea*, 1995.

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Chapter Ⅴ. Welfare Policy in Korea: Issues and Strategy

Ⅰ. Introduction

In the 21st century, social welfare will continue to play a key role since rapidly developing information technology gives rise to a higher inequality through the widening digital divide between high and low income classes while reducing the portion of middle income class. And a rapidly moving to the aged society will result in crises of pension and health programs. For these reasons, many countries pursue a new paradigm for social welfare.

In Korea, an emphasis on the growth-oriented policies since the 1960s had prevented social welfare from playing its relevant role for the vulnerable and the elderly, up until the late 1980s. The welfare of the nation's citizens had been neglected in the process of promoting rapid economic growth. However, the rapid development of political and social democratization in the late 1980s had the quality of life to be the major concern of the citizens, and sharply increased the demand for welfare. Such a sharp increase in the demand for welfare had created and had enhanced many welfare programs up until 1997. The financial crisis in 1997, however, changed the content of the welfare demand in Korea. Korea began to re-experience the old problems of unemployment, poverty and inequality from which the less developed countries including Korea before the 1960s suffered.

Since 1997, two types of demand for welfare co-exist in Korea; the short-run increase in demand for welfare (type of developing country) and long-run demand for welfare (type of developed country). The former type of demand caused by the financial crisis requires the policies for reducing unemployment, poverty and inequality, while the latter type aims at enhancing the quality of life. If these two types are not distinguished in considering welfare policies measures, it may result in a mere increase in welfare budget without enhancing the welfare of people. It also increases the social risk and decreases productivity of the nation as a whole. Thus, we need to introduce a new paradigm based on the distinction of two different types of the welfare demands and to find the efficient way of welfare fund raising.

In section Ⅱ, we begin to review the historical development of social welfare policy. In section Ⅲ, we discuss the social and economics causes determining the types of welfare demand and analyze the optimality of the current welfare budget. In section Ⅳ, we evaluate the new welfare paradigm of 'DJ Welfarism' which had been chosen by the current government in power since 1998, and also investigate the appropriateness of the current welfare programs in terms of their roles in meeting various demands for welfare. In section Ⅴ, we attempt to find strategies for enhancing welfare funding. Finally, policy measures for improving the role of current welfare programs will be discussed in section Ⅵ.

Ⅱ. Historical Development of Welfare Policy

Welfare holds a very broad meaning and is closely linked to every basic economic problem such as growth, stability, equity, and the quality of life. The heart of welfare policies is the social security policy. Additionally, policies which concern the stabilization of the economy, the distribution of income, housing, education, environment, small-and medium- business, and agriculture can all be included in welfarism. However, since every policy has its own characteristics, social policies and welfare will be dealt with either in connection with, or separated from, problems concerning the distribution of income and wealth.

In order to make an inquiry into welfare and distribution policies in Korea, a close examination of the changes in Korean society is needed beforehand. Development of welfare and development policy in Korea was dominated by economic elements such as rapid industrialization, high economic growth and international competitiveness, and also by the traditional family-oriented Confucian culture.

The depth and width of Korean social changes for the last half century, (which are represented by: population growth and movement, economic growth, and changes in industrial structure; advancement in education ; changes in social structure, changes in family structure ; changes in housing, and advancement in international status) were truly unprecedented in the history of the world. After the rapid economic growth of the 1960s, the number of poverty-stricken had decreased rapidly, but the relative gap in income rose, and conflict among generations, regions, labor and management, and between the sexes began to sprout.

Welfare policy in Korea has developed over four stages: the 1950s; 1960s to mid 1970s; mid-1970s to late 1980s; and from the late 1980s to the present. The government's concern has differed greatly at each stage of development. Roughly, the government's concern and support toward welfare have gradually risen as time has passed, and it can be stated that as far as the welfare system itself is concerned, its basic structure has been completed by mid-1980s because Korea has introduced almost all the kinds of welfare policies ever created.

Characteristics of Korea's social welfare policy by each decade can be summarized as follow; welfare in the 1950s was based on relief work; social service was the biggest concern in the 1960s; public assistance was the main concern in the 1970s; and social insurance was highlighted in 1980s. Of course, these social welfare policies have jointly developed, but during the last 50 years the social welfare policy has rapidly gone from curative to proactive. This development is the result of political, economic, and social changes that appeared in each era and the efforts toward fulfilling the social needs that came with the change

1. The Rebuilding and Reconstruction Period: 1945-1959

Korean society during the late 1940s and the 1950s was literally and unconditionally poverty-stricken. The late 1940s saw Korea' independence form Japan and the military rule of the United States, and the 1950s began with the internal struggle of the Korean War. The social work of this stage was the concern of the minority of humanitarians who put emphasis on sharing, even in the times of absolute poverty. Although the concern of social work came to be based on helping war refugees due to the conflict on the peninsula, social work was considered the same as charity, philanthropic work of western Christians or millionaires, or local enlightened culture movements of nationalists involved in the independence movement. For humanitarians of the time, welfare problems were not yet considered to be worldly social problems caused by changes in capitalistic distribution principles or family structure. As prevailing poverty and family collapse were thought to be the results of colonial plundering and division of the peninsula because of the war, they were thus not thought to be correctable by policy.

Until the late 1950s, the parameters of the Korean social welfare system were mainly made up of aid from private charity groups, especially foreign relief groups. Through this period of independence, division of the country and war, demand for public relief became bigger than ever. This, of course, was not the fault of capitalism, but more due to national calamity and insufficient productivity. At the time, most of the nation was poor, unconditional poverty was common, and the nation itself was one of the greatest foreign aid recipients in the world.

From establishment of the Korean government in 1948 till the military coup d'eata on May 16, 1961, social problems increased due to the Korean War. People in need of protection, such as orphans and widows/widowers as well as the generally high level of poverty, led to increasing calls for intervention in social welfare. But the social welfare system failed to function well due to weak administration. Therefore social welfare before the 1960s was limited to facilities and commodities for the needy supported by foreign aid groups and charity work on a private level.

2. The High Growth Period: 1960s

The Third Republic Government set up economic growth and construction of a welfare state as its major goals. Amendments to the National Constitution clearly state the people's right to live (Clause 1, Article 30) and the obligation of the welfare nation(Article 2). Also, because legislation for social welfare was enacted in large numbers, this period is at times referred to as the 'mass formation period' of legislation for social welfare.

During the 1960's, the Third Republic put all its efforts into the rapid growth of the economy, and this granted the legitimacy that the regime needed. However, no interest was shown in raising productivity of general laborers or in securing their political loyalty by welfare programs. The welfare expenditure was assumed to be an unproductive and prodigal outflow, and government tried to suffice the needs of everyone increasing income through rapid economic growth. Especially, the life protection plan had no relationship to the guarantee of the right to live but rather held the characteristic of being a relief for the poor.

Korea's social welfare in the 1960's got systemized at least in its appearance, as the government's welfare administration took shape, and related laws were enacted. It was the period when the relief administration was consolidated and the basic legislative system was formed.

During the early years of the Third Republic, emphasizing establishment of a welfare state as one of its major objectives, many social welfare related laws were legislated. However, these were no more than propaganda promises to obtain legitimacy that military regime needed. Out of the many laws, those that were actually carried out were pensions for civil servants and pensions for military personnel. In other words, the social insurance systems introduced were occupational pensions. The industrial calamity compensation insurance plan, a modification of basic social insurance, was introduced, but instead of being social insurance as an intervention into regular industrial relations, it was legislation emphasizing the benevolence and the responsibility of employer.

3. The Period of Structural Change and Intensive Growth: 1970s

During the 1970s, owing to successful implementation of its economic development plan, the government was able to deviate from the relief's or 'protection' policy, and brought attention to the development for the socially weak and outcast sectors of Korean society, helping them to support themselves by voluntarily rehabilitating themselves. To pursue a more active welfare policy, the Social Welfare Business Law was enacted in January 1970 to outline basic items regarding the business of social welfare. The National Welfare Pension Insurance Law was enacted in December 1973 to guarantee the stability of people's lives and work for the promotion of their welfare by stipulating a pension scheme concerning with aging, incurable diseases, or deaths, etc. The Law on the National Welfare Pension Special Account was enacted in February 1973 in order to effectively run the national welfare pension plan and its pension fund.

The national welfare pension plan was scheduled to come into operation from 1974, but operation was reserved for one year relying on Presidential Emergency Measure No. 3 because the enforcement condition was not satisfactory due to the economic instability resulting from the oil crisis. It was then deferred again for one year owing to the law amendment of December 1974, and in December 1975 it was amended so that the enforcement period would be determined by presidential order. However, it was not carried out since the enforcement period had still not been determined. Finally, as the National Pension Plan was enacted in 1986, it was put into effect from 1988. Furthermore, the Health Insurance Law(enacted in December 1963) was amended in full text in December 1976 and created an insurance allowance for not only the laborers working at places of business but also for all people's sicknesses, injuries, childbirths, or deaths, in order to enhance social security and to improve national health.

In relation to the welfare policy, the most representative measure enacted during the 1970's was the legislation of the national pension plan and the introduction of health insurance. A unique and interesting fact is that, although the Third Five-Year Economic Development Plan did not mention the national pension plan, it was nevertheless enacted in 1973, during the plan's second year.

The national welfare pension plan was not a subject of consideration at the time the Third Five-Year Economic Development Plan was prepared. However, once key policy makers recognized the usefulness of the pension plan as a method for internal resources mobilization for development of heavy and chemical industries, it was legislated within a year. Although the social security deliberation committee had pushed for the introduction of a social security plan for quite a long period of time since the early 1960s, it was never considered within the national development planning process. But, once it was brought to policy makers' attention as an internal resource mobilization tool, the long and tedious process involved in national development planning was cut off, and the national pension quickly replaced it.

Although Korea's health insurance plan was enacted and proclaimed as statute No.1623 on December 16, 1963, it started out as a trial run. It was initially amended on August 7, 1970, but could not deviate from trial run form. Upon its second amendment on December 22, 1976, to statute No. 2942, it secured a firm place as a national health insurance scheme.

4. The Period of Consolidation and Structural Change: 1980-

During 20 years of development, from the First Five-Year Economic Development Plan in 1962 to the Fourth Five-Year Economic Development Plan(terminated in 1981), the Korean economy experienced a rise in income levels and an increase in employment owing to rapid economic growth. Furthermore, based on industrial and agricultural development, the foundation for independent growth was constructed and national economic power greatly expanded. However, a development strategy, which did not provide equal opportunities throughout the development period, continued, and the role of the government expanded in its eagerness to accelerate economic development. Since the government's role of responding to changes in the economy and society were not appropriately adjusted to the situation, many side effects, such as the distortion of income distribution, continuance of the dual economic structure, lack of basic needs facilities, confusion of values and deterioration of trust, were produced during the development process. In reaching the 1980' s, the Korean economy faced the task of changing the method of economic management while pursuing a well-balanced policy between economic and social development.

Therefore, in the early 1980's the government established a new goal of government and searched for change in policy direction. Under the new policy goal the government emphasized the construction of the welfare state, pursuit of an equitable society, innovation in education and promotion of culture.

The Fifth Republic constitution, enacted in October 1980, incorporated the welfare state ideology by adding the pursuit of happiness right (Article 9), the appropriate wage demand right (Article 39, Clause 1), the social welfare right (Article 32, Clause 2), the environment right (Article 33), etc. to the people's rights and obligations. In particular, in the economic articles and clauses, there were many regulations to protect socially weak people. However, the Fifth Five-Year Economic and Social Development Plan was pursued from 1982. This Fifth Plan was unlike the previous planning in that it did not set an annual investment target, and was merely indicative. It also focused on institutional reform in order to solve structural problems. In addition, from the Fifth Plan, the term "economic and social development" was used. This emphasis on "economic development" as well as "social development" indicated a change in development strategy, from a quantity-centered growth strategy to a quality-centered growth strategy.

Taking a turn in the international balance in September 1986 as an opportunity, the government became confident that the economy was able to grow without any help. Based on prospects that the GNP per capita was about to reach the level of 4,000 dollars by the early 1990's, it established and proclaimed expansion of the social welfare plan, to be pursued in the late 1980's, the national welfare promotion policy, and a basic plan for the enhancement of income distribution. This plan put into enforcement heath insurance for farmers and fishermen, the national pension plan, and the minimum wage plan from 1988. The basic strategy was that the growth rate of income in the low-income class was to exceed the rate of the national average income growth. Thus, government developed the basic framework for the social welfare plan corresponding to the changed environment. Furthermore, the government also provided several welfare measures to support positively the life of the low-income class, such as city indigents and the handicapped who were more or less alienated from the benefits of growth of the national economy.

Starting from1987, the structure of social welfare system went through three ground-breaking change; enforcement of a nation-wide health insurance system; the implementation of the national pension plan; and the enactment of the Minimum-Wage Law. Introduction of these three systems was a big step forward for social welfare in Korea. Furthermore, by employing specialized social welfare workers, an mm attempt to establish the system of life protection and social welfare services was made.

In 1993, the civilian government finally succeeded in its establishment, and by substituting policy based on the Seventh Five-Year Economic and Social Development Plan(1992-1996) with the Five-Year New Economy Plan in June 1993, the content of social welfare changed a bit. The main characteristic of the new regime's welfare policy was that instead of emphasizing introduction of new systems, it centered on promoting the substantiality of the existing system and establishing a system that harmonizes welfare promotion with economic development by making welfare policies and their management efficient.

One major example of the new welfare system that the civilian government introduced is legislation and introduction of an Employment Insurance Law. Employment insurance(‘or unemployment insurance’) is one of the social insurances that guarantees income security during a fixed period for workers when unemployed. Employment insurance was created as a system that provides not only income security while unemployed but also better employment conditions for workers through like unemployment prevention, employment promotion, and training for the unskilled. The employment insurance system became effective as of June 1995, and applicable targets were industrial firms with over 30 full time workers. Employment insurance was extended to all industrial firms.

By introducing the employment insurance system from June of 1995, Korea has been able to possess all the core systems of social security, except for child allowance. Korea has introduced all important social security systems in a very short period of time. There is no other country in the world that has completed the introduction of the social security system in such a short period of time.

Ⅲ. Changes in the Demand for Social Welfare

In late 1997, the financial contagion that had originated in Southeast Asia landed in Korea. The impact was truly devastating. The financial crisis saddle many Koreans with severe burdens. The economy contracted by 5.8% in 1998. There was an 11% downswing from the positive growth of 5.5% in 1997.

1. Unemployment, Poverty, and Inequality since the 1997 Financial Crisis

<Table Ⅴ-1> summarizes major indicators of employment trend since the financial crisis. The 1997 financial crisis increased the unemployment rate from 2.6% in 1997 to 8.6% in February 1999. Since then, the unemployment rates have declined to 3.6% in September 2000. A rapid economic recovery since the financial crisis led to the decline of unemployment. However, the employment structure became much worse such that labor market instability and employment risk increased the share of temporary workers, long-term unemployed and young workers. The proportion of regular workers has been reduced from 54.1% in 1997 to 48.7% in 2001, since most firms attempted to employ more temporary or daily workers in order to avoid uncertainty through enhancing flexibility in labor demand. The proportion of the long-term unemployed (more than 1 year) increased from 10.6% in 1997 to 15.1% in 2001. And the unemployment rate of workers aged between 15 and 24 appears to be twice of that of total unemployment rate.

<Table Ⅴ-1> Employment Trend

(Unit: 1,000 people, %)

	1997	1998	1999	2000	2001
Economically active people	21,662 (2.0)	21,456 (-1.0)	21,634 (0.8)	21,950 (1.5)	22,181 (1.1)
Participation rate	62.2	60.7	60.5	60.7	60.8
Employed	21,106(1.4)	19,994(-5.3)	20,282(1.4)	21,061(3.8)	21,362(1.4)
Unemployed	556	1,461	1,353	889	819
Unemployment rate	2.6	6.8	6.3	4.1	3.7

Note: figures in parentheses represent the percentage rate of change
Source: Bureau of Statistics, *Labor Force Survey*, 2001.12.

Trends in the poverty ratio are similar to those in the unemployment rate, as shown in <Table Ⅴ-2>. In the 3rd quarter of 1998, the poverty ratio had increased to 7.5%, which amounted to the 2.5 times of the ratio before the crisis. Since then, the poverty ratio has been reducing to 5.1% in the 4th quarter in 1999. The current ratio, however, is still much higher than the ratio prior to the crisis.

<Table Ⅴ-2> Absolute Poverty Ratio Trends (Urban Worker Household)

(Unit: %, Household number)

	1997	1998					1999		
			1/4	2/4	3/4	4/4	1/4	2/4	3/4
Ratio of poor household	3.0	6.8	6.4	7.1	7.5	6.2	6.9	6.8	5.5
Poor household	183,180	391,249	374,872	410,078	426,082	380,965	380,267	379,104	308,550
Total household	6,110,381	5,741,017	5,824,491	5,775,409	5,673,797	5,690,371	5,490,033	5,562,796	5,573,648

Source: H. Moon, “Policy Measures for Improving Income Distribution”, Mimeo, Korea Development Institute, April, 2000.

Trends on both unemployment and poverty appear to be the inverted-U shaped graph; higher since the crisis and lower since a certain point of time around the mid 1998. Unlike the unemployment and poverty, the income inequality shows different trend such that it has continuously been worse since the financial crisis. In 2000, the highest income class takes almost 5.3 times of the income share of the lowest income class, as shown in <Table Ⅴ-3>. If we observe the wealth distribution, the inequality must be much worse, since wealthy people became richer and possess bigger wealth through the higher interest rate of almost double digit since the crisis together with more generous interest income taxation.[1)]

2. Aging Society

Currently, problems associated with the aging society are not that much present in Korea, since the ratio of the aged population is still low, 7.6% in 2001. Most developed countries experience the high ratio

<Table Ⅴ-3> Income Distribution

	Income shares by classes (%)					Ratio of class I to class V	Gini coefficie
	Income class I	Income class II	Income class III	Income class IV	Income class V		
1990	8.4	13.2	17.2	22.5	38.8	4.64	0.295
1995	8.5	13.5	17.5	23.0	37.5	4.42	0.284
1996	8.2	13.3	17.5	23.1	37.9	4.63	0.291
1997	8.3	13.6	17.7	23.2	37.2	4.49	0.283
1998	7.4	12.8	17.1	22.9	39.8	5.41	0.316
1999	7.3	12.6	16.9	22.9	40.2	5.49	0.320
2000	7.5	12.7	17.0	22.7	40.1	5.32	0.317

Source: Bureau of Statistics, *Annual Report on the Household Income and Expenditure Survey*, 2001.5

1) Since 1998, the financial income including interests and dividend became subjected to the separate taxation with the rate of 20%. Before 1998, the financial income had been subjected to the global taxation with the highest income tax rate of 40%.

over 10%. However, in 2019, the ratio is expected to be over 14%, which may record the fastest aging speed in the world.

The time span during which the ratio increased from 7% to 14% will be only 19 years in Korea, while that was 45 years in U.K., 85 years in Sweden, and 115 years in France. The excessively generous benefit formula in the Korean public pension systems together with rapid aging of population will definitely generate the severe crisis in next 30 years.

<Table Ⅴ-4> Proportion of the Aged

(Unit: 10 thousands person, %)

	1960	1970	1980	1990	1999	2000	2001	2002	2005	2010	2019	2026
Total population	2,501	3,224	3,812	4,287	4,686	4,701	4,734	4,764	4,846	4,959	5,062	5,061
Population of 65 and over	95	104	145	220	320	340	358	377	437	530	731	1,011
Ratio of the aged of 65 and over	2.9	3.1	3.8	5.1	6.8	7.2	7.6	7.9	9.0	10.7	14.4	20.0

Source: Bureau of Statistics, *Future Population Projection*, 2001

<Table Ⅴ-5> International Comparison of Aging

	Japan	U.S.A	U.K	France	Germany	Italy	Korea
7%	1970	1942	1929	1864	1932	1927	2000
14%	1994	2013	1976	1979	1972	1988	2019
20%	2006	2028	2021	2020	2012	2007	2026
Years spent (7%-14%)	24	71	47	115	40	61	19
Years spent (14%-20%)	12	15	45	41	40	19	7

Source: Bureau of Statistics, *Future Population Projection*, 2001

3. Increasing Budget Deficit and Public Debt

The financial crisis of 1997 also changed national budget condition significantly. Up until 1997, Korean government in the past 50 years had maintained balance in the national budget based on the principle of ‘expenditures within revenue’. The balance budget principle kept the public debt to a minimal level. The gross debt of the central government was less than 10% of GDP and the net debt was negative. Such a longtime budget balance enabled the Korean economy to overcome the financial crisis of 1997 by using the revenue in the financial reconstructing and anti-unemployment policy. Since the financial crisis, however, the budget deficit and public debt increased sharply and became the major concern in Korea. The consolidated budget deficit increased to 4% of GDP from the balanced budget prior to the crisis. And public debt drastically increased from 10% of GDP to 20%. More recently, the public debt continues to increase, almost to over 30% of GDP. Moreover, recent rise in the oil prices and the expected slowdown of the economy in coming years might lead to an increase in budget deficit and public debt in the future. Such the budgetary condition can make negative effect on the welfare budget, which is currently at the low level.

<Table Ⅴ-6> Consolidated Budget and Government debt

(Unit: billion won and %)

	1996	1997	1998	1999	2000	2001p
Size	84,429	100,327	115,430	120,960	128,007	142,487
Balance	1,099	-6,959	-18,757	-13,120	5,577	-404
(ratio to GDP)	0.3	-1.5	-4.2	-2.7	1.1	-0.1
General Account	13,998	13,984	7,139	14,621	24,304	19,673
Special Account	-12,020	-14,265	-18,697	-22,574	-19,574	-20,388
Public Fund	-436	871	-1,043	-3,615	1,110	592
Extra	-443	-7,549	-6,157	-1,552	-263	-281
Government debt						
(tril. won)	49.7	65.6	87.6	107.7	119.7	-
(ratio to GDP)	11.9	14.5	19.7	22.3	23.1	-

Note : p is predicted value

Source: Ministry of Planning and Budget, http://www.mpb.go.kr/

Ⅳ. Welfare Budget and Welfare Programs

1. Welfare Budget

Comparing to the welfare budget of OECD countries, that of Korea has been continuously low. In particular, public assistance and public health appear to be lowest among the welfare areas. Such a low level of welfare budget can be attributed to the growth-oriented policy, which has been pursued since the 1960s. As shown in <Table Ⅴ-7>, the ratios of the social welfare expenditure to GDP in the developed countries are more than three times higher than that of Korea. This comparison continuously justifies a need for an increase in the social welfare budget in Korea as much as possible. However, such a comparison should be cautiously made for determining the extent to which the welfare budget increases. When we compare welfare expenditure internationally, we need to take into account the tax burden rate together with the ratio of welfare budget to GDP. Most countries with a high ratio of welfare budget to GDP show the high rate of tax burden, implying that citizens' willingness to pay bigger tax is required for higher share of welfare budget to GDP. The lower share of welfare budget along with lower tax burden rate in Korea implies that Koreans are willing to pay lower tax and to receive smaller welfare benefits relatively to the developed countries. Considering the low tax burden rate of 20.7%, we can observe smaller gap between the share of welfare budget in Korea and those of other countries.

There exists one more factor to be considered in judging relevance of Korean welfare budget. Although national pension system began in 1988 in Korea, pension benefits will be paid for the normal retirees from 2008. Until 2008, pension funds will be accumulated since the Korean national pension adopted the funded system. Thus, we need to exclude the pension benefit expenditures from the welfare budget. Then, the Korean welfare budget share without the pension benefits appears to be not as low as it appears with the pension benefits. The last row in <Table Ⅴ-7> shows a more appropriate way to compare each country's welfare budget. Korean welfare budget is still much lower than that of other countries. However, the gap becomes smaller when adjustments for pension benefits and tax burden are made.

<Table Ⅴ-7> Social Welfare Budget and Tax Burden Rate in OECD Countries

(Unit: % of GDP)

	Korea	Japan	U.S.A.	U.K.	Germany	Sweden	France
Social Welfare Expenditure(A)	4.42	12.44	15.64	22.84	28.27	38.03	28.73
Pension benefits(Old aged, Disabled, Survivors) (B)	1.24	6.00	7.07	9.03	13.01	12.87	12.66
A-B=C	3.18	6.44	8.57	13.81	15.26	25.16	16.07
Tax burden rate(D)[1)]	20.7	29.1	27.0	33.5	39.2	50.1	43.9
A/D	21.4	42.7	57.9	68.2	72.1	75.9	65.4
C/D	15.4	22.1	31.7	41.2	38.9	50.2	36.6

Note: 1) Social security contribution is included.
Source: OECD, *Social Expenditure Statistics of OECD Members Countries*, 1996

2. Welfare Budget by Category

As shown in <Table Ⅴ-6>, the welfare budget of Korea has been continuously low comparing to the welfare budget of OECD countries. But during the period of present Kim Dae Jung government, welfare budget have increased drastically. <Table Ⅴ-8> summarized the trend of welfare budget. The ratio of Social security budget to general account increased from 5.64% in 1995 to 10.84% in 2001. And the ration of Budget of the Ministry of the Welfare and Health to general account increased. from 3.82% in 1995 to 7.52% in 2001.

There exists one more factor to be considered in judging Korean welfare budget. The welfare budget can be divided into 8 categories; Social insurance, Patriots & Veterans affair, Welfare for laborer, Relief for the livelihood & Social Welfare, Job training, Employment policy, Public health & Medical care, and General expense for health and welfare. The share of relief for the livelihood and Social welfare is more than 35% of the total welfare budget. And the share of social insurance is 33.68% in 2001. But the share of welfare for laborer, Job training, and Employment policy is low. It is only 7.28% in 2001. And the share of public health & medical care is only 5.16% in 2001.

<Table Ⅴ-8> General Account and Social Welfare Budget

(Unit: hundred million won, %)

	Relief for the livelihood(A)	Ministry of Health and Welfare(B)	Social security (C)	General Account (D)	A/D	B/D	C/D
1995	273	1,984	2,925	51,881	0.5	3.82	5.64
1996	361	2,371	3,528	58,823	0.6	4.03	6.00
1997	436	2,851	4,207	67,579	0.6	4.22	6.23
1998	575	2,113	5,576	75,583	0.8	4.12	6.05
1999	1,135	4,161	6,150	83,685	1.4	4.97	7.30
2000	1,377	5,310	8,074	88,736	1.6	5.98	9.10
2001	1,680	7,458	10,746	99,118	1.7	7.52	10.84

Source : Ministry of Health and Welfare, *Health and Welfare Statistics Yearbook*, 2001.

<Table Ⅴ-9> Welfare Budget by Category

(Unit: %)

	2000	2001
Relief for the livelihood & Social Welfare	35.71	38.89
Social insurance	32.14	33.68
Patriots & veterans affair	16.67	15.00
Welfare for laborer, job training, and employment policy	9.52	7.28
Public health & Medical care, and General expense for health and welfare	4.76	5.16
Total	100.00	100.00

Source : Ministry of Health and Welfare, *Health and Welfare Statistics Yearbook*, 2001.

3. Role of Welfare Policy in Distributive Policy

Using the National Survey of Family Income and Expenditure conducted by Korea National Statistical Office, which covers two time periods of 1991 and 1996, Kim and Lim (2000) showed that tax policy played more important role in redistribution than public transfer. The share of public transfer in total income amount is only 0.6% in 1991, and 0.92% in 1996. Even though it shows the increasing trend over time, public transfer with tiny proportion might not have important role in distributive policy. The proportion of tax liability in total income indicates -9.07% in 1991, and -7.81% in 1996. Total tax liability seems to be decreased slightly. It is because the income tax policy has the tendency to decrease tax liability by raising deduction and exemption threshold over time.

Government policy for income redistribution provided an interesting result. Public transfer had the relative contribution of 1.2 in 1991, and 0.61 in 1996. Although the absolute amount of public transfer is too low, its relative impact is moderate. The role of relative contribution of public transfer was decreased. Tax policy exhibits a different pattern. The relative contribution of tax policy in reducing the level of income inequality was is 2.2 in 1991, and 2.66 in 1996. This indicates that tax policy had a very strong impact in reducing the income inequality in Korea at least until 1996.

4. Public Assistance

The Minimum Living Standards Security Act (MLSSA) was legislated in August 1999 in response to pleas from all walks of society to reform the former Living Protection Act. Starting from October 2000, the Government will ensure that basic needs, including food, clothing, housing, education and healthcare, are met for all people living below minimum living standards. Based on the minimum living cost of 930,000 Won for a 4-person household, cash benefits of the gap between the minimum living cost and the household income are paid to the poor regardless of their ability of work. There are two problems in MLSSA. First, it discourages work, since it appears to be simply the Negative Income Tax, in which some of low-wage earner can receive less amount of after transfer income by working more hours than by not working at all. Second, we cannot observe the real amount of income level of the low-income earners unless they honestly report. If some beneficiaries report less amount of their income, this discourages the honestly reporting beneficiaries so that most people report smaller amounts eventually. Simultaneously downward report of income amount can give rise to the inevitable increase in the budget expenditure.

5. Social Insurance

All four public occupational pension schemes in Korea are suffering from serious financial problems. The Military Pension exhausted its reserve fund in 1977 and its deficits have been met by budget subsidies while the remaining three schemes are projected to exhaust their reserve in 2001 for the Civil Service Pension, 2030 for the Private School Teachers Pension and the National Pension Scheme in 2040, respectively.

<Table Ⅴ-10> Overview of Current Pension System

Pension	National Pension	Civil Servants	Teachers	Military	Retirement Allowance	Private Pension
Started	1988	1960	1975	1960	1961	1994
Pension benefit	60% of lifetime income, payable at age 60.[1)]	76% of last salary before retirement (for retiree with 33 year), payable at retirement.[2)]			Last salary x Years.	Depend on Contribution Payable at age 55.
Contribution rate	9%	15%			8.3%	Free up to 1 mil. Won
Fund depletion	2040	2001	2030	1977	-	-
Contribution rate needed	17%	30~35%			8.3%	-
Budget support	2,200 Won per month for fishermen	Retirement allowance, compensation pension for injury			-	-
Tax concessions	Pension income exempted	Pension income exempted.			Favor on Contribution	Deduction 0.72mil. Won
Policy issues	• Financial. instability • Generational equity	• Financial unsustainability • Inter-generation conflict • Special treatment for military personnel.			Finance payment guarranty conversion	• Tax favors • Protection of accounts • Fund yields

Note: 1) To be extended to 65 years by 2033.
2) 60-years for those who participate after 1996.

Source: Pension Reform Task Force, *Basic Plan for Pension System Reform*, September 2000.

The other social insurance programs also face financial problems. The National Health Insurance (NHI) programs suffer from deficit as well. Deficits for NHI might become even larger although the programs for workers and the self-employed are unified since July 2000. Unemployment Insurance program rapidly expands its coverage after launching in 1995. Eventually, all the workers have been covered since October 1998. The rapid expansion of coverage with higher unemployment rate since the financial crisis can be major factors of the financial problems. Workers' Compensation Insurance also expands its coverage as all the workers have been covered since July 2000. The current Workers' Compensation Insurance classifies industries into 67 categories for the purpose of applying insurance premium, so that each company does not have incentives to lower its premium by investing solely into safety facilities and reducing accident rate.

<Table Ⅴ-11> Expansion of Coverage in the Unemployment Insurance

(Unit: thousand)

	1995. 7	1998. 1	1998. 3	1998. 10
Coverage	30 and more	10 and more	5 and more	all
Company	43	118	199	664
Worker	4,280	5,190	5,710	8,342

Source: Ministry of Labor, *Improving the Unemployment Insurance and the Workers' Compensation Insurance*, 2000. 1.

Ⅴ. A New Welfare Paradigm and Principles of Welfare Funding

1. Productive Welfare Policy as a New Welfare Paradigm

The present Kim Dae Jung government announced a new welfare paradigm of 'productive welfare'.[2] Productive welfare was introduced to correct Korea's weak welfare system and to deter deterioration of basic human rights, caused by the quantitative growth policies of the past, while developing a system that nurtures both growth and equity. Productive welfare is composed of primary distribution through an equitable market system, a fair redistribution of wealth by the government for meeting basic human needs, social investment for self-support, and expansion of investment to enhance the quality of life for everyone in society. Although philosophical foundation of productive welfare is sound, policy measures appropriate to productive welfare are still immature. Because productive welfare pursues two conflicting goals, sustained economic growth and broad-based democracy, it is difficult to find appropriate policy measures that harmonize these two goals. Thus, we need to focus on the present environment for welfare policy, which is summarized as increasing demands in two different types for welfare, short-term demand and long-term demand mentioned shortly in Section Ⅱ, with a tight budget condition. Instead of building a vague philosophical model for social welfare, we need to find more

2) Refer to Presidential Committee for Quality of Life, Office of the President, DJ Welfarism: A New Paradigm for Productive Welfare in Korea, January, 2000. Kim Young Sam government also attempted to build a new welfare paradigm in the era of globalization. Such a new paradigm was required for long-term balanced development, which would signify a break from the previous conception of a dichotomy between growth and welfare. (http://www.mohw.go.kr/html/e00040101.html)

detailed and relevant policies measures in order to meet increasing demands for welfare with a limited funding for welfare.

For this reason, it is desirable to introduce the concept of 'target efficiency,' which measures the cost-effectiveness of welfare programs; how various welfare programs compensate for welfare losses of welfare recipients who had experienced various events of being poor, unemployed, injured, aged, and so on. However, when we evaluate welfare programs, we have focused on the program provider's respect rather than the recipients' respect. An individual becomes a recipient at the final stage passing through various paths between event occurrence and decision making on whether or not he/she applies for welfare programs and on how many programs he/she applies for. Thus, we can measure the target efficiency of welfare programs in terms of the welfare changes of individuals between events occurrence and welfare program reception in the various cases of the paths. In more details, under each category of the path, the Target Efficiency of multiple programs can be measured as 'Post-program welfare (income) divided by expected pre-event welfare (income),' where the expected pre-event welfare is the welfare that individual would have earned unless the events have occurred.[3)]

Therefore, we attempt to revise a new welfare paradigm of productive welfare in the way of incorporating the target efficiency concept. Based on the re-evaluation of the present welfare programs in terms of target efficiency, we can improve cost-effectiveness of the welfare programs as well as welfare recipients' welfare level.

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3) Chong-Bum An (2000) attempted to measure the target efficiency of four major U.S. welfare programs such as AFDC, Unemployment Insurance, Worker's Compensation and Food Stamp using the PSID. Refer to Chong-Bum An, "Target Efficiency of Multiple Welfare Programs," presented at the 56th Congress of the International Institute of Public Finance, Seville, Spain, August 28-31, 2000.

2. Welfare Policy Meeting Different Types of Welfare Demand

We discussed two different types of demands for welfare and emphasized that different policy measures should be designed to meet those demands. The short-term demand for welfare caused by the financial crisis can be satisfied by recovering the potentials for economic growth through the effective re-structuring of the economy, eventually resulting in increasing employment and income levels. The short term increases in unemployment should be handled by anti-poverty policy rather than provision of unemployment allowance. We should protect not those who become unemployed but those whose income level drops below poverty line because of being unemployed. Anti-poverty policy should begin with re-constructing the Infrastructure for Welfare Program, which guarantees relevant delivery of benefits to those who need protection.

Satisfying the long-term welfare demand concerned with quality of life requires re-assignment of the roles of central government, local government and private sector. Social welfare service should be a major role of local government, which has the best knowledge regarding what and how much welfare services are provided in order to reflect their own characteristics of regions. And private sector can also participate in welfare funding, so that government should find incentive scheme to provoke private sector's voluntary participation. Finally, the long-term demands for welfare can also be met by social insurance reforms, which strengthen the insurance function relatively more than the redistribution function and provide a room for private sector participation.

3. Principles of the Social Welfare Funding

Fund raising for social welfare programs is a important and urgent task in Korea. Four steps for the social welfare fund raising can be considered. In other words, we should consider following four steps before raising the social welfare funds.

Evaluation of the current welfare programs on a zero base.

Evaluation of the current welfare programs in terms of target efficiency enables us to figure out which programs spent more than they needed for achieving their own goals. Hence, we can reallocate welfare budget among various welfare programs, correct loopholes or drawback in each program and eventually save welfare budget as a whole. Such an effort to evaluate the current system in terms of target efficiency should be accompanied by an additional welfare fund raising.

Improving the structure of government expenditures

As discussed before, welfare expenditure took a small share in the government expenditure, implying that welfare budget should be expanded. Before we expand welfare budget, we should see if there exist expenditures of some areas which occupy higher share of total expenditure than they should given both the present economic and social environment, and the size of citizen's demand for corresponding public goods. For example, the share of national defense expenditure can be reduced since we expect peace mood between South and North Korea to continue. Such a reduction in national defense expenditures can be transferred to welfare budget.

Supporting from the related policies

Unequal distribution of income and wealth is a key factor determining the demand for welfare. The more unequal the income or wealth distribution a society faces, the larger welfare benefits the poor and other welfare recipients demand, since relative poverty becomes more important than absolute poverty in the era of high inequality. The strength of the demands can be lessened by getting assistance from other policies such as education policy and tax policy. If education subsidies or job training coupon can be provided for low-income earners, they can show smaller demand for welfare. Here, education and labor policies appear to replace welfare demands. Tax policies such as global taxation of financial income, tax on capital gains from stock transactions and heavier taxation of inheritance and gifts can partially crowd out the demand for welfare. The crowding out effects of the related policies end up with significant saving of welfare budget.

Combination of welfare policy with other policies

Welfare program can play its role more powerfully when it is well combined with some other policies. As far as welfare infrastructure is concerned, it is more effective to combine labor policy administration and tax administration with welfare administration. Recently, the scrutiny of exact income amount of self-employed is of interest since national pension system was expanded to cover the self-employed and the low income self-employed are covered in the Minimum Living Standards Security system. Such a task of investigating true income can be conducted more effectively by tax administration. Therefore, tax administration should guide labor policy and welfare policy administration in investigating the self-employed' income. This is an important step to construct welfare infrastructure efficiently and can save administrative costs of welfare programs.

Ⅵ. Reform on Social Welfare Systems

1. Harmonization of Welfare Policy with Tax Policy

Two critical problems are found in the Minimum Living Standards Security System, which has begun to be implemented since October 2000. Firstly, the MLSSS discourages work in the sense that more work may end up with less after transfer income. Secondly, it reveals a severe problem of underreporting of income by the self-employed, which in turn results in a significant expansion of welfare budget expenditures. With this regard, MLSSS violates the idea of productive welfare. Now, we want to replace MLSSS by some other policy. As a policy mix of welfare policy and tax policy, we can consider the Earned Income Tax Credit (EITC), which had been introduced in U.S.A. EITC is a refundable tax credit for earned income and provides assistance through tax system to low-earning households. If the credit exceeds the tax-payment-before-credit, then the households can receive the difference as the assistance. As a result, EITC can partially replace MLSSS by covering low income earners with ability to work. The low income earners without ability to work will be still covered by MLSSS.

Introduction of EITC can connect government expenditures to government revenue, so that unnecessary expenditures can be minimized and then welfare expenditure becomes more efficient. EITC also minimizes the administrative costs by having tax administrative to guide all other institutions attempting income scrutiny.

The labor income tax system also has some problems in income maintenance. Its exemption level is so high that the rate of taxpayers among labor force participants is very low, compared with that of many developed countries. Here, we propose to introduce EITC along with reducing the exemption level to almost half. When we introduce

EITC, we have to lower basic income guarantee level in MLSSS and exemption level in the current labor income tax system. These new schemes require the overall reform of both welfare and tax system.

2. Pension Reform

A two pillar pension system had been recommended by the Commission on National Pension System Reform in 1997 and the World Bank.[4] However, the 1998 amendment of National Pension System Act (NPSA) did not adopt the device of two-pillar pension. Instead, two major changes were included; reduction of replacement rate from 70% to 60% based on 40 years participation and gradual increase in the eligible age from 60 to 65. This amendment was not enough to prohibit exhaustion of pension fund, so that we still need to amend NPSA. Next amendment should adopt the previous recommendation of ‘two pillar system.’

The two-pillar system divides the current system into a basic pension and the earnings related pension. A basic pension is proposed to be newly established and the earnings related portion of NPS will be reorganized as a National Pension. The basic pension is a universal basic pension covering all nationals over 18 years and older, thereby achieving “one pension for everybody.” National pension will be operated as an earnings related pension covering only those participants with assessed income. The current participants of public occupational pensions will also join the basic.

In Korea, Retirement Allowance System (RAS) has played roles of corporate pension and unemployment payment since the allowance can be paid to workers leaving a job regardless of their ages. Because the unemployment insurance had been introduced, RAS should be converted to corporate pension system. Corporate pension can be

4) Refer to Commission on National Pension System Reform (1997) and the World Bank (1994)

operated as a fully funded scheme with outside deposit. It is important to encourage employees and employers to adopt the new scheme. For this, two policies should be considered; tax incentive to corporate pension and contract-out of earnings related portion in the new NPS system, the two-pillar system.

A new corporate pension licensed by the State will be established, which will be designed to provide income protection for the self-employed and farmers who are excluded from the corporate pension. Tax concessions to this new corporate pension will be same as that provided to the corporate pension.

Ⅶ. Concluding Remarks

The financial crisis in 1997 changed social and economic situation significantly. In particular, the old-fashioned welfare demand emerged such that poverty, unemployment and unequal distribution became major social issues. Currently, two types of demands for welfare co-exist in Korea; short-run increase in demand for welfare (type of less-developed country) and long-run demand for welfare (type of developed country). The former type of demand caused by the financial crisis requires policy measures for reducing unemployment, poverty and inequality, while the latter type aims at enhancing the quality of life. If these two types of entirely different nature are not distinguished in considering welfare policy measures, budget for social welfare continues to increase without curtailing the demand for welfare. Furthermore, we may observe an increase in the social risk and decline in productivity as a whole. Thus, we need to introduce a new paradigm based on the distinction of two different types of the welfare demands and to find the efficient way of welfare fund raising.

We should consider following four steps before raising the social welfare funds. 1) evaluation of the current welfare programs in terms of target efficiency on a zero base, 2) increase in the share of welfare budget through improving the structure of government expenditures, 3) supporting from the related policies such as education, labor, and tax policies, 4) harmonization of welfare policy with other policies.

Finally, we have to design policy measures to reform and improve current welfare programs. In particular, anti-poverty policy like MLSSS and social insurance programs should be reconsidered and replaced by better policy measures, which guarantee cost-effectiveness and target efficiency.

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Chapter Ⅵ. Health Policy in Korea

Ⅰ. The Korean Health Care System

1. A Short History of Korean Health Policy

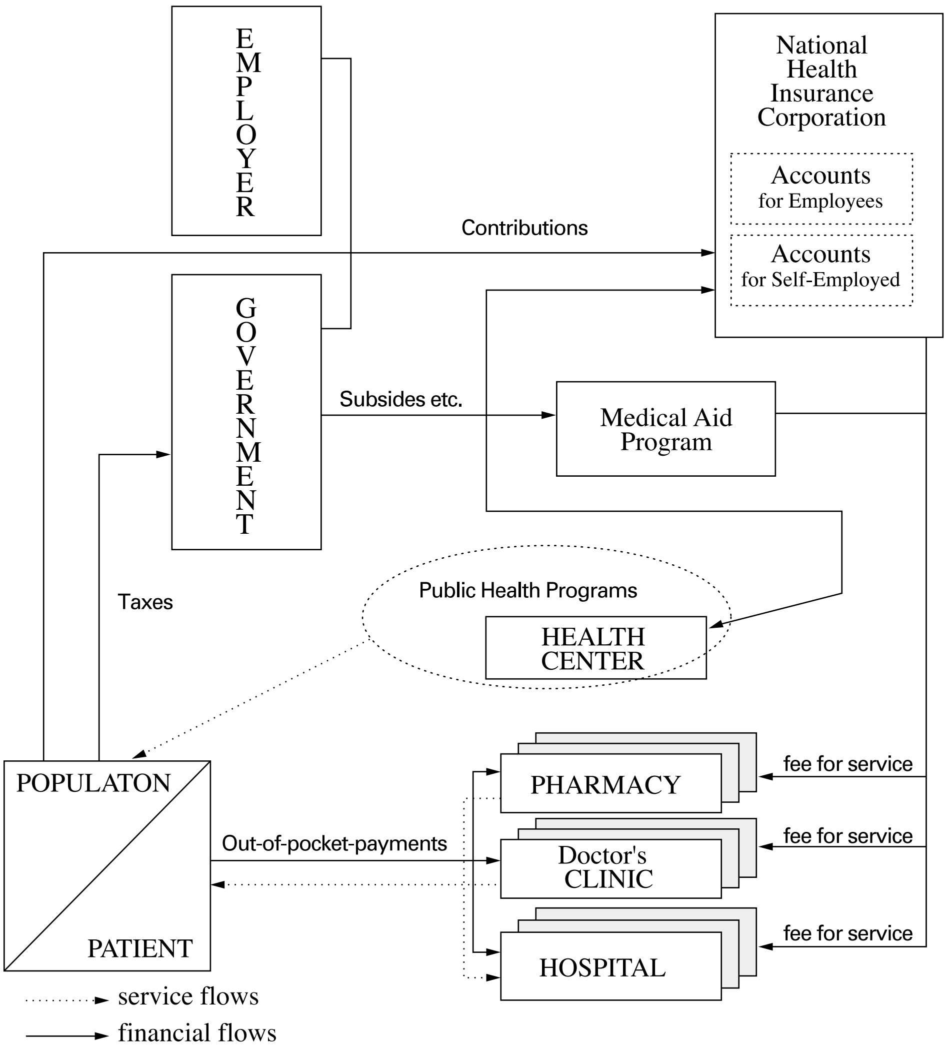
Health policy and its priorities in Korea have varied since the 1950s, reflecting the rapidly changing economic and social conditions of the society. Following the creation of the Korean government in 1948, health policy focused on controlling communicable diseases, promoting primary health care services in certain underserved areas, and family planning. Government priorities shifted to establishing secure and equitable access to a minimum set of curative services towards the end of the 1970s. The establishment of National Health Insurance (NHI) represented a landmark change in the Korean health care system and the main focus remained on demand side interventions until universal insurance coverage was completed in 1989. NHI and rapid economic growth boosted a remarkable increase in the demand for health care services, which spurred the private sector to establish new medical facilities and private medical schools to expand. Public policy towards the supply side has been inspired by a laissez faire approach. Two recent reforms in July 2000, the one integrating multiple insurers into a single payer (Integration Reform) and the one separating the roles of prescribing and dispensing drugs between doctors and pharmacists (Separation Reform) have brought significant changes to the system.

2. Players in Korean Policy Making

The Korean health care system is dominated by the private sector. About 90% of physicians and the great majority of hospital beds are private. Private providers, hence, supply the majority of health care services, with public providers playing a residual role. The government has a limited role as a provider of curative services and has responsibilities for public health services but still plays a modest role in disease prevention and health promotion. Basically the government has a laissez faire policy towards regulating private suppliers. NHI is financed through contributions by employers, employees, the self-employed, and government subsides. Providers are mainly paid fee-for-service, and payments for insured services are directly settled between the insurer, the National Health Insurance Corporation (NHIC), and providers.

The NHIC purchases insured health care services for the entire population and contracts with mostly private providers for the delivery of these health care services. However, the NHIC plays a limited role as an insurer in general. The insureds are required to pay high co-payments on insured services. In addition, a fairly large private market exists for uninsured services which are supplied in a competitive setting with market-based prices. Sometimes the nongovernmental organizations (NGOs) play an important role. They have an experience of producing a compromised scheme of the separation of prescribing and dispensing. [Figure Ⅵ-1] illustrates the Korean health care system.

[Figure Ⅵ−1] The Korean health care system



3. International Comparison of Korean Health Service[5)]

Korea has experienced a period of fast economic development and rapid industrialization since the 1960s, which was accompanied by

5) All statistics were cited from OECD(2002).

unprecedented improvements in health status. Although life expectancy, which was 78.1 years for females and 70.6 years for males in 1997, is still among the lowest in OECD countries, it has been rapidly catching up with the OECD average. The number of potential years of life lost (PYLL under age 70 per 100,000) is worse than OECD average for males, but much better for females. Infant mortality rates have been steadily reduced. In 1970, Korea lagged much behind the OECD average with 45 deaths per 1,000 live birth. In 1990, while infant mortality was still high by OECD standards, the gap between Korea and other Member countries had been much reduced <Table Ⅵ-1>.

Mortality and morbidity patterns have changed from communicable diseases to chronic and lifestyle-related diseases. The three main causes of deaths in Korean are cardiovascular diseases, cancer, and accident & injuries <Table Ⅵ-2>. Deaths linked to cardiovascular diseases have been decreasing over the years but still are the major cause of death. Cancer has on the contrary augmented in importance. 20% of all deaths from malignant neoplasm are from lung cancer, up from 10% in 1985. Deaths from car accidents are rather high by OECD standard. In 1997, they represented 4.4% of overall deaths, contrary to an OECD average of 1.9%. Finally, deaths linked to the digestive system, particularly diseases of the liver and cirrhosis were in 1997 the second highest in OECD countries after Hungary.

These data suggest that much improvement in health status could be achieved by investing in preventive interventions. Daily smokers account for about a third of the population, one of the highest proportions in OECD countries, which can in part explain the high rates of lung cancer. Alcohol consumption is below the OECD average, but about half of the male drinkers consume alcohol at a harmful level, which could explain, in part, the high level of digestive diseases by OECD standards.

<Table Ⅵ－1> Trends in Infant Mortality Rate, 1960-1999

(Unit: %)

	1960	1970	1980	1990	1999
Iceland	1.3	13.2	7.7	5.9	2.4
Sweden	16.6	11.0	6.9	6.0	3.4
Japan	30.7	13.1	7.5	4.6	3.4
France	27.5	18.2	10.0	7.3	4.3
Germany	33.8	23.6	12.6	7.0	4.6
Canada	27.3	18.8	10.4	6.8	5.5[1)]
Australia	20.2	17.9	10.7	8.2	5.7
New Zealand	22.6	16.7	13.0	8.4	6.8[1)]
United States	26.0	20.0	12.6	9.2	7.3[2)]
Korea		**45.0**	**17.0**	**12.0**	**7.7**[3)]
Slovakia	28.6	25.7	20.9	12.0	8.3
Hungary	47.6	35.9	23.2	14.8	8.5
Poland	54.8	36.7	25.5	19.3	8.9
Mexico	74.0	68.0	40.0	24.0	14.5
Turkey	189.5	145.0	117.5	57.6	37.5
OECD Average	37.6	28.3	17.5	10.8	6.7

Notes: 1) Data refer to 1997.
2) Data refer to 1998.
3) Data refer to 1996.

Source: *OECD Health Data 2001*, Reprinted from OECD(2002).

<Table Ⅵ－2> Leading Causes of Mortality in Korea, Selected Years

(Unit: %)

	Circulatory system	Symptoms & ill-defined conditions	Malignant neoplasm	External causes, injury & accidents	Digestive system
1985	33.64	27.10	12.79	6.60	7.57
1990	32.97	20.37	17.48	9.78	6.77
1995	28.71	18.98	19.42	9.66	6.43
1997	24.98	21.91	20.15	9.44	5.63

Source: *OECD Health Data 2001*, Reprinted from OECD(2002).

4. Major Characteristics of Korean Health Care System

The Korean health care system has made remarkable progress over the last decades, but some drawbacks of the system have emerged. Current problems are in part linked to existing weaknesses. But new challenges are anticipated to arise from the forecasts of key variables affecting the demand for health care, such as demographic changes, or affecting the supply, such as the adoption of technology and investment in medical capacity.

Korea has reached universal if partial public health insurance coverage over a very short period, and at low cost. Three factors explain the low cost of achieving universal coverage: limited benefit coverage (due to high co-payments and service exclusions), low fees imposed on providers for insured services, and growth of fees kept within the general price increase.

Patients enjoy freedom of choice of provider within the system. In addition, they can choose between traditional and western medicine, an advantage from the point of view of satisfying individual preferences. Patients receive medical treatment without long delays. The market orientation of the delivery system undoubtedly helps to make it responsive to consumer' demands.

While the private sector dominates supply, public facilities seem to be of a good standard. Health centers are numerous (over 200), well spread (one per administrative local district). Limited government investment in health delivery, rather than poor quality of public sector provision, seem to account for the pervasive use of private health facilities.

The health care system leaves many citizens relatively unprotected in times of financial distress. Financial barriers to access become insurmountable for the people at the bottom end of the income distribution. High co-payments, high fees for uninsured services and the widespread practice of informal treatment charges severely constrain individuals’ access to care. The Medical Aid Program (MAP), which provides a safety net for the most destitute, covers only 3.5% of the population.

The Korean health care system has strong built-in incentives for growth and may well be on a growth path which in the long run will be unsustainable for the NHI. Fee for service reimbursement, the lack of effective gatekeeping, and unconstrained freedom of choice of provider have significant positive effects on health expenditure per capita in ambulatory care and create incentives to overprovide. Tight regulation of medical fees within the NHI system created additional incentives for doctor to increase volumes, reduce consultation times, substitute drugs for their labour, and substitute uninsured services for insured ones. The privately dominated hospital sector has a propensity to adopt and utilize medical technology vigorously. Cost containment has relied heavily on controls of fees, leaving volume to find its own level.

An effort to control the quality of clinical care is needed. There are no institutionalized mechanisms to stimulate the reduction of variations in medical practice, such as best practices or standards of treatments. Assessment of new medical technology is also weak. The mix of services is strongly geared towards curative services while there is very limited investment in health promotion.

A final weakness regards governance. The efficacy of the government approach to health policy, traditionally laissez-faire towards the supply side and authoritarian on fee setting, has been faltering. The reactions to the July 2000 reforms were strong and unexpected. Doctors’ strikes, fee rises and the subsequent financial crisis brought much adverse publicity. There are now public demands for better value for money, greater transparency, and a new accountability framework for national health insurance and medical practice.

Korea has undergone a period of fast economic development and industrialization since the 1960s, which was accompanied by a dramatic transformation of Korean society and a rapid demographic transition. While the Korean society is among the youngest within OECD member countries, its population is aging fast following drops in fertility and in mortality rates at older ages. The proportion of the population above age 65 moved from 4.3% to about 7% in 2000, and is projected to reach 14% in 2022. It will take Korea 22 years to double the 2000 share of elderly population, what took 41 years in UK and 115 years in France.

Ⅱ. National Health Insurance in Korea

1. History and Development of NHI

Until the mid-1970's, patient's medical care was his/her own responsibility, except for those insured under pilot health insurance programs and for indigents, who were cared for by the government and/or private charity hospitals. In 1976, the Korean government introduced a health insurance law to provide its citizens with compulsory medical care. There was a considerable discussion concerning who should be covered first. It was proposed that those in great need, such as poor farmers and the self-employed, be considered first. However, since it was very difficult to collect premiums, it would have been necessary to provide a large amount of government subsidy, and in addition, there was concern about lack of health resources in rural areas. As a result, the government made a decision to begin with large workplaces with 500 employees or more in July 1977. At the same time, the government-sponsored Medicaid program was introduced for those under the poverty line. Since 1977 coverage has been gradually expanded to small workplaces.

There was also a growing need to cover regional residents. After implementation of demonstration projects and considerable discussion, the government expanded coverage to rural residents in 1988 and urban residents in July 1989, where a substantial portion of total expenditures are subsidized by the government. Thus, Korea was able to achieve universal health insurance in twelve years.

Up to September 1998, NHI had been administered by 373 independent funds, of which 227 were regional funds based on the geographical area of local governments, and 145 were corporational funds. Furthermore there were two more funds. One is civil servants' fund and the other is private school teachers' fund.

The new government has driven to consolidate the whole administrative system to enhance social solidarity since February 1998. The integration was enforced with two step strategy, and enforced with an accelerated power because the financing of regional funds, especially the rural and small cities' funds were not sustainable under the economic crisis. In the first step, 227 regional funds were integrated in October 1998. And in July 2000, the whole funds have been integrated including 145 corporational funds. But still financial integration has not been implemented. Two types of financial pools exist, that is, regional pool and worker-and-salaried workers pool. The financial consolidation will be accomplished beginning July 2003.

<Table Ⅵ－3> Major Development of Health Insurance in Korea

(Unit: %, US$)

Year	Major Development	Population coverage[1)]	per capita GNP
1977	Compulsory health insurance implemented for large Workplaces with 500 employees or more Medicaid provided for low income earners under Public Assistance	14.5	1,012
1979	Government employees, private school teachers and Employees are compulsorily insured Expanded coverage to employees with more than 300 employees	26.9	1,644
1981	Expanded to workplaces with at least 100 employees	29.6	1,734
1983	Expanded to workplaces with 16 Employees or more	39.3	2,002
1987	Insurance coverage includes oriental medicine	-	3,110
1988	Rural residents compulsorily insured Expanded to workplaces with five employees or more	79.1	4,127
1989	Urban residents compulsorily insured Coverage includes drugs dispensed at pharmacy	99.9	4,994
1995	Extended coverage from 180 days to 210 days	-	10,076
1996	Extended insurance from 210 to 240 days Elderly and disabled are covered without limit CTs(computerized tomographs) are covered in benefits	-	-
1997	Extended insurance from 240 to 270 days	-	-
1998	Extended insurance from 270 to 300 days Integrate civil servants/private school teachers insurance and regional residents insurance(Oct. 1998)	-	6,823
1999	Extend insurance coverage from 270 to 330 days	-	8,581
2000	Extend insurance coverage from 270 to 365 days Integrate a whole administration (July 2000) Prescription-and-dispense system adopted (July 2000)	-	9,770
2001	RBRVS fee schedule adopted	-	-

Note: 1) Includes population under Medicaid.
Sources: MOHW and Bank of Korea

2. Financial Aspects(Sources and Uses) of NHI

The Korean population was estimated at 46.8 million in 1999. The entire population is covered for the risk of medical illness, either through the NHI, a social health insurance scheme financed by mandatory contributions, or throughout the Medical Aid Program (MAP), a social assistance scheme for the very poor financed through general taxation. Benefit coverage is standardized and there are no differences in benefits between NHI and MAP patients. All patients except some MAP beneficiaries have to make substantial payments towards their treatments.

People pay for health services and health insurance coverage in four main ways. First, all individuals (excluding dependants and the eligible poor) pay contributions to the NHI. Contributions amounted to about 33% of total health financing in 1999. Second, patients share the cost of insured services and make direct payments for uninsured services for another 44% of total health financing. Co-payments represented about a third of this share. Third, individuals pay taxes, a share of which is allocated to health. While most tax revenues are from general progressive income tax, there are also local government taxes. Individuals also pay an earmarked tobacco tax. Tax financing amounts to around 11% of total health financing in 1999 and is mainly utilized for subsidizing the MAP and the NHI. Last, private health insurance premiums are collected for about 7.4% of total health financing. Half of this is accounted for by compulsory health insurance covering medical treatments in case of car accident. The other half comprises voluntary cash-benefits insurance policies that provide financial support in case the insured develops certain chronic diseases, such as cancer.

NHI is financed through mandatory contributions. The contribution rate (3.63%) applies to employees' gross salary and is equally shared between the employer and the employee. Contributions for self-employed individuals are assessed through income, assets, standard of living and rate of participation in economic activities. The income-related share of the contribution is calculated from taxable income or from their income, age, sex, and property for individuals whose taxable income is unavailable or lower than 5 million won. The second component of the contribution varies with the asset base and car ownership of the insured. Dependants of insured are also covered by the NHI scheme

While NHI benefit coverage guarantees broad protection against the risk of illness, it remains somewhat shallow due to exclusion of certain high-cost services from the cover and high co-payments. The co-payment schedule is set by the MOHW. It applies to all services and to all medical facilities nation-wide, but varies with the type of service and facility. There is no ceiling or cap to co-payments although some compensation is given for high-cost cases.

<Table Ⅵ−4> Expansion of Coverage for the NHI and MAP

	Population covered		Coverage (population and benefits)
	NHI (insured and dependants)	MAP	
1977	8.6	5.7	Includes firms with over 500 employees
1980	24.2	5.6	Includes firms with over 300 employees, government employees and teachers (since 1979)
1985	44.1	8.0	Includes firms with over 16 employees (since 1982)
1990	93.9	9.2	Universal coverage in 1989: includes firms with over 5 employees, urban and rural self-employed
1995	97.6	3.1	Benefits expanded to 180 days. Health examinations and high-cost technology (e.g., CT) included
1999	96.4	3.5	Benefit days expanded to the whole year

Notes: Differences can exist between total population and total covered population.
The concept of ‘benefit days’ refers to the overall duration of medical and drug treatments.

Sources: Shin, 1995.
MOHW, *National Health Insurance Statistical Yearbook*, 1999.

<Table Ⅵ−5> Co-payments on Services Covered by the NHI

Health service and facility	Co-payment
In-patient	20% of total treatment cost
Outpatient	
General hospital	Per-visit consultation fee + 55% of treatment cost
Hospital	Per-visit consultation fee + 40% of treatment cost
Clinic	30% of treatment cost (3,200 won if total cost is less than 12,000 Won)

Source: MOHW, *White Book on Social Welfare*, 1999.

3. Issues in Korean NHI

Prior to the integration reform, the NHI was fragmented across multiple quasi-public insurance societies. Insurance societies for industrial workers had been the first to be created since the establishment of the NHI system in 1977. New insurance societies for government employees and private teachers and for the self-employed were gradually added to the system. There were as many as 373 insurance societies in 1997 which, though functioning as autonomous bodies, were not-for-profit and not competing for enrollees.

The government decided to merge all the insurance societies into a single payer for two main reasons.

One is to increase equity in health financing. While societies did not differ according to the benefits they offered or according to provider reimbursement procedures, they differed widely in methods for calculating contributions. Individuals with similar income could pay different contributions for the same benefits across different insurers, giving rise to horizontal inequity. This occurred for two reasons. First, no government regulation established how to set contributions. Insurance societies for employed individuals applied the contribution rate to different bases: some to the standard monthly wage, others to the overall compensation. Self-employed insurance societies calculated contributions based on income, property, cars and family composition, but applied different threshold for each to these criteria. Second, insurers were responsible for making ends meet. Those facing higher-than-average expenditures set higher-than average rates, because contributions raised reflected benefits paid. In particular, the more high-risk and old individuals were concentrated within certain insurers, as in the case of societies in poor and rural areas. Clearly, this correlation between need and contribution rates contradicted the principles of solidarity underpinning the establishment of the NHI.

The other is to improve efficiency of the NHI system. The establishment of many insurance societies helped the government achieve universal coverage gradually. However, it left the NHI system with an inefficient financing structure under three aspects. Many insurance societies lacked the size to guarantee an efficient pooling of revenues and hence fiscal stability because many small societies could not spread the risk across a sufficiently large number of the insured. Moreover, administrative costs tended to be high because the multiple insurers system could not take advantage of economies of scale in management. While the claim review process was already centralized before the reform, much potential for improving management efficiency existed, including the rationalization of the geographical coverage of insurers and the modernization of management information systems. Finally, before the reform the NHI could not act as a single purchaser and prudent buyer of health care services.

Prior to the reform many insurers experienced financial instability and insolvency. The integration of multiple insurers with differing fiscal status helped to solve the problems of the most financially unbalanced societies. This is because it levelled the finances of all insurers by merging financially distressed societies with those better-off. Of course, pooling per se did not change the overall fiscal balance of the NHI, which has been worsening over the years and, since 1997, showed a fiscal deficit. But it did not itself exacerbate expenditures, nor reduced revenues.

Concerning expenditures, the reform appears to have slightly decreased administrative costs. Moreover, the possibility for prudent purchasing of health services has been created. Insurance societies were not more efficient before the reform in this regard. They functioned purely as financial intermediaries, they were not involved in health care review or evaluation, and could not contract selectively with providers.

Concerning revenue collection, the integration reform appears to have had a little net effect. Concerns were expressed prior to the reform that by shifting decision making further from the contributors, the insured and insurance administrators would lose their sense of "ownership" of the fund resulting in moral hazard in the payment and collection of contributions. Although sporadic episodes of free riding seem to have occurred in the immediate aftermath of the reform, no decrease in revenue collection has been observed after the reform. Rather the major issue pending the successful completion of the reform concerns the assessment of income from the self-employed categories. Underreporting, which is most likely to be continuing as prior to the reform, is an obstacle to integrate the finances of employees and self-employed and raise contribution rates.

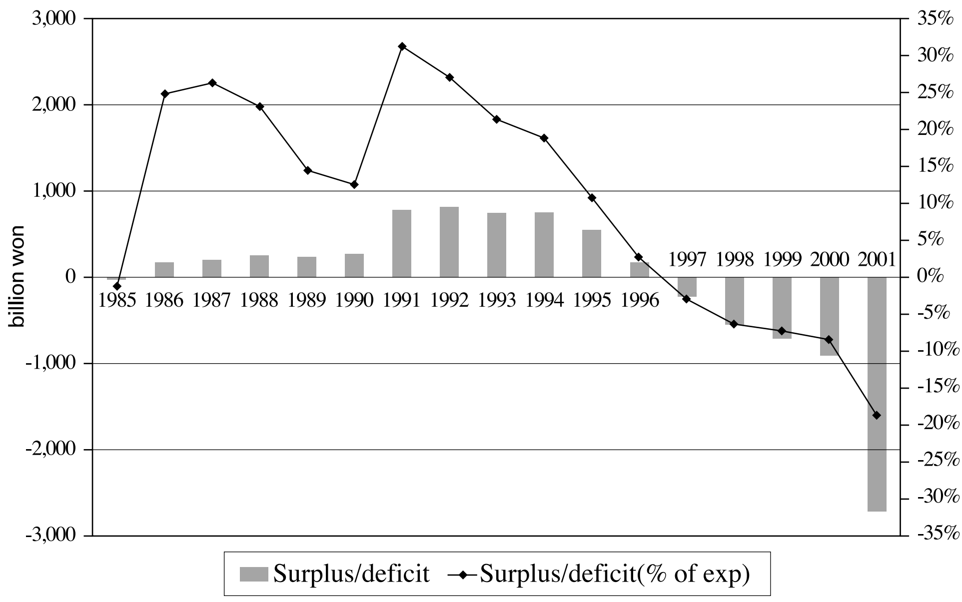
<Table Ⅵ−6> Contributions before and after the Integration Reform

	1998	1999	2000	2001
Total contributions (million won)	6,107,232	7,291,110	8,609,784	11,217,478
Rate of increase from previous year(%)	8.31	19.38	18.09	30.29
Contribution per capita (won)	136,742	162,925	187,430	243,400
Rate of increase from previous year(%)	8.74	19.15	15.04	29.86

Source: MOHW, *National Health Insurance Statistical Yearbook*, 2002.

A financial crisis exploded in the NHI system since the end of 2000 as shown in [Figure Ⅵ-2]. The crisis has become the most urgent health issue on the national agenda for the Korean health care system. Deficits in health insurance skyrocketed in 2001, although they had appeared since the mid-1990s. At the end of 2001, the financial deficit had reached 2.7trillion won, or about a fifth of total NHI expenditures for the year. The government announced in May 2001 a comprehensive set of measures to improve the financial soundness of the NHI system, although loss of public confidence and the crisis-management situation seems to make it difficult to implement all of them.

[Figure Ⅵ−2] The Evolution of Surpluses/Deficits within the NHI, 1985-2001



Source: MOHW, *National Health Insurance Statistical Yearbook*, 2002.

Public opinion has been heavily criticizing the government for the financial crisis, linking it to the July 2000 reform. The separation of doctors′ and pharmacists′ roles certainly accelerated the crisis, but other underlying pressures on fiscal stability pre-existed the July 2000 reforms. The financial position of the national health insurer had been deteriorating before the July 2000 reform because of very rapid spending growth and inadequate increase in revenues. The NHI system would have continued to develop losses even if the reforms had never been implemented because of structural determinants of fiscal unbalances that arise, in part, from certain features of the health care system. The crisis exacerbated the need to address some among these features, for example low contributions and inflationary incentives underpinning the payment system.

It is nonetheless true that the separation reform contributed to the overall deficit, albeit it is difficult to estimate accurately the extent. Assuming NHI revenues had also grown in 2000 and 2001 along the same trend as during the 1990s, the fiscal deficit of the NHI might have been a third of the 2001 level.

As to the integration reform, the overall impact on the level of surplus/deficit of the NHI system was neutral. Integration smoothed the variability in fiscal status that existed across insurance societies differing for risk structure and contributory capacity. However, contrary to concerns emerged prior to the integration, it had no pejorative effect on the NHIC ability to collect revenues. In addition, it did not add to expenditures. On the contrary, early evidence suggests a decrease in administrative costs, and it also created a potential for more prudent purchasing of health services.

Overall, there is a certain government responsibility for the pace at which the fiscal status of the NHI worsened after, in particular, the separation reform. First, the raising fees might have overcompensated doctors for the loss of margin from the sale of drugs (not all the fee increase, however, determined a rise in NHI health expenditure because the NHI is no longer paying for doctors′ margins from the sale of drugs). Second, the extent of the expenditure increase was perhaps underestimated so that no measure was taken in advance to control its impact. This exacerbated the already unstable fiscal position of the NHI system. Third, while the integration reform did not aggravate the overall fiscal balance of the NHI, the government might have taken this opportunity to address, in part, some symptoms of fiscal stability of the system. Particularly, the contribution rate was chosen to have a neutral fiscal impact on the accounts of the NHI. The decision to increase the contribution rates, a necessary measure to improve the fiscal status of the NHI but clearly an unpopular one, was delayed to the moment when the financial crisis erupted in 2001. In April 2002 the contribution rate was increased by 6.7% and medical fee was decreased by 2.9%.

The Health Insurance Finance Stabilization Special Act (HIFSPA) modifies some of the provisions of the National Health Insurance Act. First, the HIFSPA introduces measures to rationalize responsibilities for revenues and expenditures of the NHI system. The Act gives responsibility for establishing medical fee schedules and contribution rates, previously fragmented across different committees, to a single body, the Health Insurance Policy Deliberation Committee (HIPDC). It also unifies previously differentiated procedures for calculating contributions for the employed and self-employed individuals, by prescribing that contribution rates for all individuals should be decided by Presidential Decree via the HIPDC. Second, the HIFSPA introduces measures to prevent fraudulent behaviours by providers (by specifying rules for providers' filing of claims to the NHIC) and the insured (by removing entitlement to NHI benefits for individuals with contributions in arrears for more than three months). Lastly, the Act commits the government to maintain a certain level of subsidies to the health insurance system, set at 40% of the administrative and benefits cost of the self-employed pool. In addition, 10% of the funds raised through the Health Promotion Fund would be directed to the NHI system to subsidize the costs of elderly people.

Ⅲ. Projection of National Medical Expenditures in Korea

1. National Health Expenditures in Korea

Korea has a relatively low, but rapidly growing, level of health expenditure compared to other OECD countries. Public sources of health expenditure account for less than half of total funding while private funding is almost entirely represented by out-of-pocket payments. Drugs expenditures are high but the way expenditures were reported until July 2000 did not enable accurate monitoring of their share of expenditure. The share of expenditure represented by in-patient care is relatively low by OECD standards but is growing.

Korea spends 5.1% of its GDP on health care, the third lowest share among OECD countries after Turkey and Mexico and well below the unweighted OECD average of 7.9%, as shown in <Table Ⅵ-7>. Per capita health expenditure (US$ 868 PPPs in 1999) was about half the OECD average of US$ 1,774 PPPs

[Figure Ⅵ-3] shows that for almost the entire period 1987-1999, the increase in real per capita health expenditure has been rapid and higher than increases in real GDP per capita. This represents a considerable health expenditure increase considering that Korea featured the highest average annual growth rate of real GDP per capita in OECD countries in the period 1970-1999. The pace of health expenditure growth has however varied over the years. A rapid rise in per capita health expenditure in the second half of the 1980s resulted from the progressive establishment of national health insurance and explains the increase in the share in this period. Upon attainment of universal coverage and the introduction of measures to stabilize expenditure growth, such as per-visit co-payments and the strict regulation of

<Table Ⅵ-7> Health Expenditures as a Percent of GDP, 1970-1998

Year[1]	1970	1980	1990	1998
Australia	5.7	7.0	7.9	8.6
Austria	5.3	7.6	7.1	8.0
Belgium	4.0	6.4	7.4	8.6
Canada	7.0	7.1	9.0	9.3
Czech Republic		3.8	5.0	7.1
Denmark	8.0	9.1	8.5	8.3
Finland	5.6	6.4	7.9	6.9
France	5.7	7.4	8.6	9.4
Germany	6.3	8.8	8.7	10.3
Greece	5.6	6.5	7.5	8.4
Hungary				6.8
Iceland	4.9	6.1	7.9	8.4
Ireland	5.1	8.4	6.7	6.8
Italy	5.1	7.0	8.1	8.2
Japan	4.6	6.5	6.1	7.4
Korea			**4.8**	**5.1**
Luxemburg	3.5	5.9	6.1	6.0
Mexico			4.4	5.3
Netherlands	7.2	8.0	8.5	8.7
New Zealand	5.2	6.0	7.0	8.1
Norway	4.4	7.0	7.8	
Poland			5.3	6.4
Portugal	2.7	5.6	6.2	7.4
Slovakia				
Spain	3.6	5.4	6.6	7.0
Sweden	6.9	9.1	8.5	7.9
Switzerland	5.4	7.3	8.3	10.4
Turkey	2.4	3.3	3.6	4.8
United Kingdom	4.5	5.6	6.0	6.8
United States	6.9	8.7	11.9	12.9
G-7 average	5.7	7.3	8.3	9.2
20 country average[2]	5.3	6.9	7.6	8.2
27 country average[3]			7.2	7.9

Notes: 1) Note that 1970 data for Australia and Denmark refer to 1971, and 1970 data for the Netherlands refers to 1972

2) 20-country average includes only those 20 countries with a relatively complete set of data for the years 1970-1998 and have not reported any major breaks in their series. There are suggestions of breaks in the expenditure series for Belgium, and Portugal

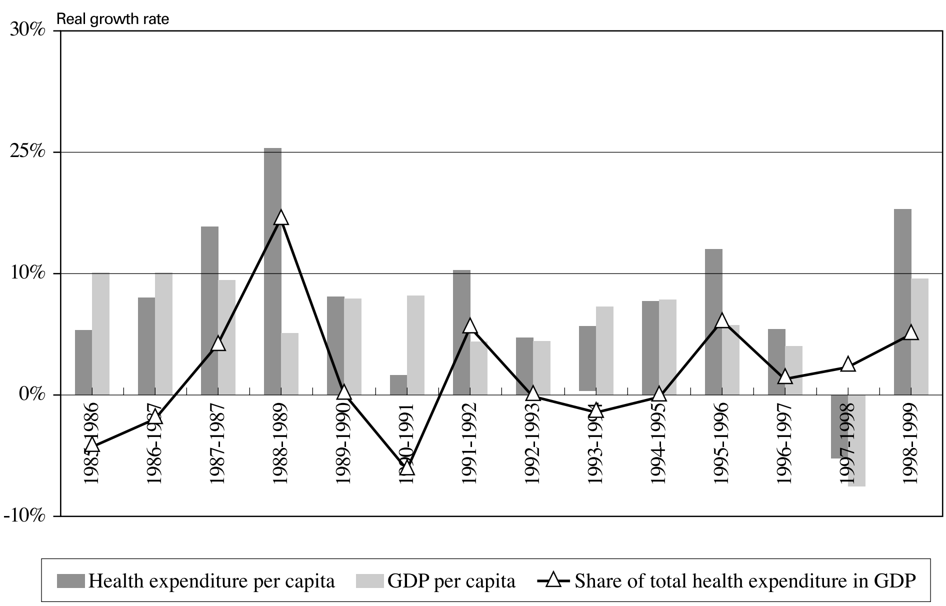
3) All member countries except Hungary, Norway and Slovakia.

Source: OECD, *Health Data*, 2001.

providers' reimbursement fees, health expenditure growth slowed down. This brought about a decrease in the GDP share of total health expenditure in GDP between 1989 and 1991, followed by relative stability between 1992 and 1995. During the second half of the 1990s, signs of economic slowdown were observed in the Korean system, while health expenditure rose as a result of the widening of NHI benefits, growing population expectations, and the lack of effective cost control mechanisms. The increase in the GDP share in this period is an effect of these combined phenomena. Overall, while it was a slowdown in health expenditure growth that brought about the decrease of the GDP share in the first half of 1990s, it was largely a fall in the GDP growth which brought about the increase in the GDP share in the second half of the 1990s.

The Korean public share of health care funding is low by the standards of other OECD countries. Although it rose from 36.6% in

[Figure Ⅵ−3] Rate of Change of Total Health Expenditure and GDP per capita, 1985-1999



Source: OECD, *Health Data*, 2001.

1990 to 46.2% in 1998, it remains the second lowest share after the USA, and well below the OECD average of 75.2%. The high private financing share is linked to substantial out-of-pocket payments, contrary to the US case where private financing derives from widespread private health insurance arrangements. Patients have to pay high co-payments towards their treatment charges, moreover they pay the full cost of services not included in the National Health Insurance benefit range.

Korea belongs to the group of OECD countries with a low public expenditure share that is moving towards a higher share. The public funding share has been increasing since 1985 because public expenditure on health has generally increased faster than private expenditure. In particular, the increase has been brought about by the expansion of social health insurance. Public health expenditure expanded rapidly with widening population coverage during the 1980s, particularly between 1987 and 1989. Between 1990 and 1997, the increase in the public funding share reflects the progressive extension of social health insurance benefits and the increase in the government subsidy to the health insurance scheme for the self-employed. During the 1997-1998 financial crisis, the public share increased as the result of a higher utilization of insured services and reduced investment by private medical institution

Korea has the second lowest inpatient share of total health expenditure and the highest drug share (almost double the OECD average) among OECD countries for which data are available. The inpatient share has been gradually increasing over the last decades. In part this could be explained by a rapid rise in hospital beds and the average length of stay. The high drug share can be seen, in part, as the result of two factors. First, Koreans seem to have a strong propensity to consume pharmaceuticals. Second, doctors shifted the mix of treatment inputs from their own services towards drugs to compensate for limited consultation time (due to a low doctor to population ratio) and low NHI fees.

<Table Ⅵ−8> Public Funding in Total Health Expenditures, 1970-1998

(Unit: %)

	Public share in health expenditure				Average annual growth rate			
	1970	1980	1990	1998	1970-80	1980-90	1990-98	1970-98
Australia	62.8	62.8	67.4	70.0	0.0	0.7	0.5	0.4
Austria	63.0	68.8	73.5	71.8	0.9	0.7	-0.3	0.5
Belgium				71.2				
Canada	6.9	75.6	74.6	70.1	0.8	-0.1	-0.8	0.0
Czech Republic	96.6	96.8	96.2	91.9	0.0	-0.1	-0.6	-0.2
Denmark	83.7	87.8	82.7	81.9	0.5	-0.6	-0.1	-0.1
Finland	73.8	79.0	80.9	76.3	0.7	0.2	-0.7	0.1
France	74.7	78.8	78.2	77.7	0.5	-0.1	-0.1	0.1
Germany	72.8	78.7	76.2	75.8	0.8	-0.3	-0.1	0.1
Greece	42.6	55.6	62.7	56.3	2.7	1.2	-1.3	1.0
Hungary				76.5				
Iceland	81.7	88.2	86.6	83.9	0.8	-0.2	-0.4	0.1
Ireland	81.7	81.6	71.7	76.8	0.0	-1.3	0.9	-0.2
Italy	86.9	80.5	78.1	67.3	-0.8	-0.3	-1.8	-0.9
Japan	69.8	71.3	77.6	78.5	0.2	0.9	0.1	0.4
Korea			**36.6**	**46.2**			**3.0**	
Luxemburg	88.9	92.8	93.1	92.4	0.4	0.0	-0.1	0.4
Mexico			40.8	48.0			2.1	
Netherlands	61.0	69.2	67.7	68.6	1.6	-0.2	0.2	0.4
New Zealand	80.3	88.0	82.4	77.0	0.9	-0.7	-0.8	-0.1
Norway	91.6	85.1	82.8		-0.7	-0.3		-0.4
Poland			91.7	65.4			-4.1	
Portugal	59.0	64.3	65.5	66.9	0.9	0.2	0.3	0.4
Slovakia								
Spain	65.4	79.9	78.7	76.4	2.0	-0.2	-0.4	0.6
Sweden	86.0	92.5	89.9	83.8	0.7	-0.3	-0.9	-0.1
Turkey	37.3	27.3	61.0	71.9	-3.1	8.4	2.1	2.4
United Kingdom	87.0	89.4	84.3	83.3	0.3	-0.6	-0.1	-0.2
United States	36.3	41.5	39.6	44.8	1.3	-0.5	1.6	0.8
21-country average[1)]	**71.8**	**75.4**	**75.8**	**75.2**	**0.5**	**0.1**	**-0.1**	**0.2**

Note: 1) OECD average is for those 21 countries that have a relatively complete data set.
Source: OECD, *Health Data, 2001*

<Table Ⅵ−9> Health Expenditure by Type of Health Service (late 1990s)

(Unit: %)

	Inpatient	Outpatient plus drugs		
		Outpatient	Drugs	Sub-total
Greece	24.8	n.a.	14.7	n.a.
Korea[1)]	28.9	28.0	30.0	58.0
Turkey	29.3	64.1	n.a.	n.a.
Luxembourg	29.8	49.9	11.7	61.6
Germany	34.0	28.9	12.7	41.6
Belgium	34.6	34.0	16.1	50.1
Czech Republic	35.1	27.4	27.0	54.4
Norway	36.1	20.9	9.1	30.0
Portugal	36.2	n.a.	25.8	n.a.
Japan	37.6	32.8	16.8	49.6
United States	40.5	32.7	11.0	43.7
Finland	40.7	30.6	15.1	45.7
Canada	42.3	26.1	15.4	41.5
Australia	43.3	22.0	11.4	33.4
France	43.8	22.8	22.8	45.6
Italy	44.5	27.7	17.5	45.2
Spain	44.8	n.a.	20.7	n.a.
Switzerland	50.3	40.1	7.6	47.7
Netherlands	52.7	20.4	11.0	31.4
Hungary	53.1	n.a.	26.5	n.a.
Denmark	53.9	25.0	9.0	34.0
Iceland	55.7	22.3	15.4	37.7
New Zealand	59.1	n.a.	14.4	n.a.
23-country average[2)]	41.4	30.9	16.4	47.5

Notes: 1) For Korea, data are estimates from: Commission on Health Care Reform (1998). Health Care Reform (in Korean). In OECD Health Data, Korean figures do not enable to appreciate the relative share of outpatient and drug expenditure, because drugs dispensed by doctors were classified under the outpatient share until the July 2000 Separation Reform.

2) All 23 countries in the table.

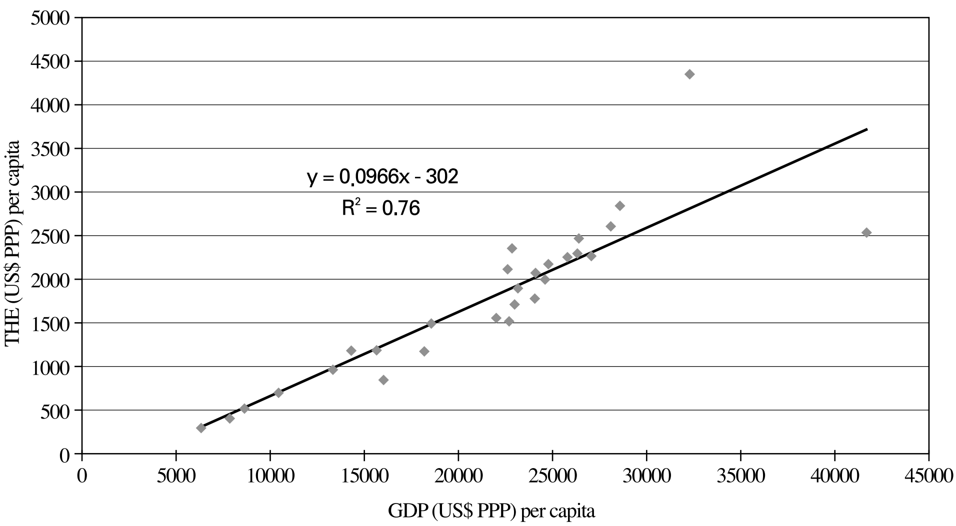
Source: OECD, *Health Data, 2001*.

2. Projection of Health Expenditures

It is difficult to identify the ‘right’ level of expenditure on health compared with expenditure on other goods and services. There are nonetheless three sets of considerations that can inform judgements about macroeconomic efficiency. First, how health expenditure compares with the level for a country at the same stage of economic development. Second, whether health expenditure growth, particularly public expenditure, is maintained along a fiscally sustainable rate. Third, how well the health system seems to respond to societal preferences for the allocation of resources between health and non-health goods and services, considering both the level and trend of health expenditures.

Per capita health expenditure in Korea is below the level expected for a country with her level of income, as shown in [Figure Ⅵ-4]. The

[Figure Ⅵ−4] Per capita Health Expenditure and per capita Income, 1999



Source: OECD, *Health Data, 2001*.

expected level is calculated along a regression line fitted to observations of per capita health expenditure and per capita income for OECD countries. [Figure Ⅵ-4] shows the distance existing between per capita health expenditure (868 US$ PPPs) and expected per capita health expenditure (1,249 US$ PPPs).

There are various explanations for why actual the level of health expenditures in Korea appears below the expected level.

First, historically the government set low priority to health over other sectors of the economy and invested little in medical facilities and services. The establishment of universal social health insurance, which led to a drastic increase in health expenditure, is a relatively recent achievement. Meanwhile, some high cost, high-technology services, whose diffusion and utilization are linked to government propensity to include them in the social insurance benefit package, are predominantly uninsured. This might have deterred consumers from purchasing health care, particularly costly services. It might also have initially slowed down investment in private western medicine facilities, although only for a limited period of time as Korean hospitals have a relatively high (and unconstrained) propensity to diffuse new medical technology

Secondly, contrary to the other OECD countries, Korea has a high level of private out-of-pocket payments. When other OECD countries had the same per capita level of GDP as Korea today they spent relatively more on health but they also had a significantly lower share of out-of-pocket expenditure and more comprehensives public systems. Although this does not imply per se the existence of an inverse relationship between health expenditure per capita and the proportion of out-of-pocket payments in total health financing, it might be in line with evidence that more generous insurance leads to more consumption. It might be probable that the poor benefit coverage and high co-payments of the Korean NHI are dampening demand for unnecessary, and possibly also necessary, health care services.

<Table Ⅵ−10> Per capita Health Expenditure and OOP Share, various OECD countries

	GDP per capita (US PPPs)	THE per capita (US PPPs)	Share of out-of-pocket Expenditure in THE
Korea (1999)	16,059	868	43.8
US (1984)	16,523	1,617	22.7
France (1989)	16,611	1,420	11.7
Germany (1988)	15,865	1,487	11.1
Japan (1989)	16,294	1,012	23.4
UK (1990)	16,105	968	10.6
Canada (1987)	15,869	1,338	14.7

Source: OECD, *Health data, 2001*.

Thirdly, like Japan, the Korean government used fee control as a tool to contain expenditure growth within the NHI. This policy has been rather successful on three aspects. All medical providers are under compulsory contract with the NHI system and the government fee schedule applies to all of them. Second, the MOHW managed to enforce a fee schedule below market prices when the NHI was first established. Last, the government maintained the rate of increase of fees below the general increase in prices until mid 1990s, shows the rate of growth of the total expenditure on health index and the GDP index, and of consumer prices and the fee schedule index. The idea behind fee control was to contain expenditure growth by constraining the rate of increase of health prices. Fees were not however set or modified with the purpose of stimulating consumption of certain services over others, for example on the basis of cost-effectiveness or need[6].

6) In Japan, conversely, the government used the Fee Schedule to promote primary care in relation to acute hospital care (Jeong and Hurst, 2001).

The last is a methodological warning. While there is a positive difference between the expected and the actual level of health expenditure for Korea using data on OECD countries, the regression might give different results for a different cluster of countries, for example if Asian or a larger number of middle income countries are considered.

3. Intergenerational Burden of Health Expenditures

The health expenditures for the elderly in NHI have been increased by almost 10 times during the last ten years, comparing to 5 times for whole population. In 1990 and 2000 the NHI expenditures for the elderly were 162 billion won and 1 trillion 582 billion won, respectively. The ratio of the elderly in NHI were 4.9% and 6.6%, respectively, during the same period. Since this phenomenon seems to be continued, the burden of younger generation will be heavy.

IV. Regulations in the Korean Health Market

The main responsibilities of the Korean government in relation to the health care system concern regulation and policy-making, insurance, and to a minor extent, provision.

Historically, the government has combined both a laissez-faire and an authoritarian attitude in its regulatory roles. On the one hand, it sought to minimize its involvement and supervision of private providers and did not adopt an intrusive role in health care markets. On the other hand, it kept almost unilateral power over such things as medical fees and systemic changes.

1. Demand Regulations

As we discussed before, patients enjoy freedom of choice of provider within the system, and also receive medical treatment without long delays. Relatively they have less regulation on utilizing medical services. However, review system towards utilization of medical services is tightening and patients' burden of financing in NHI seems to increase as financial imbalance is bigger.

2. Supply Regulations

Regulation of supply-side is minimal. Apart from health centers, there is no plan for the geographical distribution of medical facilities, which are therefore left to private initiative. The only requirement governing the opening of hospitals is that they should have minimal number of beds and departments. Above such minimal requirements, the number of hospital beds is entirely decided by the medical institutions themselves. The purchasing and diffusion of medical technology is also unplanned. Planning of human resources is indirect. The MOHW consults with the Ministry of Education and Human Resource Development over the number of students entering medical schools. However, control over numbers is not firm because medical schools are private. The number of schools more than doubled from 19 in 1980 to 41 in 2000.

3. Price and Quality Regulations

Regulation of public health insurance focuses especially on the medical fee schedule and the list of NHI benefits. While fees are now negotiated, the government had maintained unilateral control over setting and revising fees until recently. As to insured medical services and drugs, there are no explicit criteria, such as cost-effectiveness, need or burden of illness, according to which services and drugs are prioritised.

There has been a limited effort at controlling the quality of clinical care. All medical facilities that registered or reported their establishment according to the Medical Service Act or the Pharmaceutical Affairs Act provide medical services under the contract of its fee schedule with the NHIC, but they do not need to meet any specific quality standard. Hospitals need to receive ‘accreditation’ before commencing to practice. However, ‘accreditation’ only regulates minimum staffing and speciality requirement. The MOHW has attempted to launch a nation-wide Hospital Service Evaluation Program but this is not fully established yet. The hospital standardization review, which is run by the Korean Hospital Association, is only meant to guide the allocation of resident doctors[7] into hospitals, and does not entail disciplinary procedures or peer review to enhance quality of medical care.

7) Resident doctors include young or newly graduated medical students and constitute very cheap labour for hospitals.

V. Towards the Reforms in Health Policy

1. Deregulations in Health Market

The efficiency of health delivery depends not only on the level of resources spent in the system and the incentives motivating providers, but also on the choice of services itself. Changes in the mix of services may help improving health outcomes.

The cost effectiveness of public health interventions is well documented. A recent OECD work on the determinants of variations in mortality across OECD countries suggests that premature mortality is positively associated with lifestyle variables such as alcohol and tobacco consumption[8]. Illness prevention and public health services are weak in Korea. Health promotion and illness prevention have been historically seen as a matter of individual rather than collective responsibility, which explain in part limited investment in population health. Korea spends only about 4% of its total expenditures on prevention and public health. Spending responsibilities lie with local and central governments. Hence, contrary to curative services, the budget for population health expenditure is capped.

The government has proceeded to strengthen health promotion by investing increasingly in population health activities over the past few years. The occurrence of the NHI financial crisis has nonetheless diverted attention and priorities to the health insurance system. Earmarked taxation on tobacco was increased by six and a half times, but revenues thus generated will be channelled to the NHI accounts until balance is achieved in the system. There is clearly a risk that expenditures on curative services may crowd out population health resources, unless clear priority is given to focus

8) Or (2000, 2002).

on these latter activities.

A promising development in this respect is the introduction, since April 2002, of a new People's Health Promotion Plan. The plan includes a comprehensive set of actions aimed at enhancing government's responsibilities for the management of health risks, improving public health, strengthening quality of health services, and maintaining fiscal stability of the health insurance system. It also includes detailed actions to encourage providers to operate more efficiently, which is based on a mix of planning and pro-competitive tools. The plan is wide in scope and covers a comprehensive set of measures reaching beyond health promotion and disease prevention. Its ability to meet objectives will depend upon the extent to which the plan will be realized in practice and the process of implementation. Feasibility analysis for each of the plans' measures, and the creation of broad partnerships to discuss and support implementation modalities will be critical factors underpinning its effectiveness.

The separation reform removed doctors' right to dispense drugs, but did not build the incentives to make the consumption and prescription of pharmaceuticals more cost-effective. As drugs are a key component of health care expenditures, in Korea as in all OECD countries, establishing an overall framework to influence consumption and prescription patterns would be desirable.

Measures to improve the cost effectiveness of drugs should encompass a mix of regulations and incentives to affect the consumption, prescription and dispensing of drugs.

Korea relies heavily on demand side cost control measures, such as co-payments and listing of drugs eligible for public reimbursement, to limit patients' consumption of drugs. Obviously, the choice of the co-payment level and the generosity of the list have an impact on overall drug expenditures because consumer demand is price elastic. In addition, reference pricing has been proposed as a part of the government measures to stabilize NHI finances. With reference pricing, public reimbursement is set at the level of an alternative lower-priced drug, making patients liable to pay the difference between the reference price and the higher costs of other drugs. These policies, which are prevalent in many OECD countries[9], help to contain frivolous demand and steer it towards cheaper pharmaceuticals.

Policies to influence prescribing are also needed. Steering doctors' behaviours requires a combination of restrictions, publication of guidelines, and monitoring. Restrictions may include formularies and lists of recommended drugs. They may also directly limit excessive prescription by setting budgets and ceilings on volumes of drugs prescribed, which can be effective tools, but can alienate the medical profession. Monitoring through systematic audit and appraisal of prescription behaviours needs to be accompanied by clear prescription guidelines, and associated with sanctions and rewards for providers. Partnership - among HIRA, the NHIC and the medical profession can help to build consciousness of the doctors' role in promoting cost-effective drug consumption. The involvement of the medical profession in self-regulation, via the development of prescription guidelines, peer reviewing, and continuous education, need to be supported and stimulated.

Finally, the role of pharmacists should not be downplayed. Pharmacists can promote the consumption of cheaper, but equally effective, drugs by exercising their right to substitute generic products for branded ones. The substitution right is an important tool to counterbalance to doctors' tendency, following the separation reform, to prescribe branded products more intensively.

The regulation of the quality of clinical care could benefit from further attention in Korea. The government has limited its involvement in such regulation because the medical profession has better information to regulate itself. However, self-regulation seems weak in Korea. There seems to be lack of routine peer group scrutiny of

9) S. Jacobzone (2000).

practice. Moreover, self-regulation does not per se deliver medical safety and it may insufficiently scrutinize whether the scope and level of care are appropriate.

Better clinical regulation is therefore needed. There is scope for supporting self-regulation. There is also for turning the Hospital Service Evaluation Program run by the MOHW into an effective mechanism for monitoring hospital services and assessing technology. Having modernized its information systems, the NHIC could systematically collect and analyze performance measures of medical institutions. The results of such an evaluation program could help to create an evidence base for setting performance targets and could be opened to public scrutiny. Protocols of clinical practice and quality assurance programmes would also need to be developed. This requires reinforced collaboration among the NHIC, medical professions, and the MOHW.

One way to stimulate quality improvements in health provision could be paying providers on the basis of performance. The current fee-for-service arrangement encourages doctors' productivity and discourages undertreatment, but does not provide incentives for doctors to avoid provision of unnecessary care, nor compensation for the development and adoption of guidelines and standards of practice. As the single public health insurer, the NHIC could utilize its purchasing power to regulate practice and promote quality of care. Financial incentives could be linked to performance in the contract between the NHI and providers. For example, the Corporation could negotiate higher quality standards of care with groups of 'good practice' providers. The reward for adherence to quality protocols could be higher fees or higher increases in medical fees from one year to the next. In addition, in order to motivate individuals to choose best practice medical facilities, co-payments for patients treated in those facilities could be lowered. In this case medical fees would have to be increased to include the doctor's loss of revenue resulting from the reduced patients' payment, which would involve a further increase in NHI expenditures[10]. The idea of rewarding medical facilities which demonstrate good practice is not new. 'Green facilities' are currently exempted from audit of claims for the following two years. Such reward could nonetheless be more appealing if it included financial incentives. The feasibility of implementing payment by performance will hinge upon the ability to set guidelines and protocols of good practice, and to monitor providers' behaviour.

The weak role of self-regulation in Korea is linked to three institutional features of the system: highly idiosyncratic medical practice, fee for service payments, and de facto for-profit institutions. Idiosyncratic medical practice arises in the variety of training programmes in Korean medical schools. This suggests that there is a lack of agreement about appropriate care. Fee-for-service reimbursement has not encouraged co-operation across medical professionals to adopt evidence-based best practices because it provided no compensation for the development and use of protocols or guidelines. The profit-oriented nature of most facilities could discourage appropriate care if commercial incentives do not lead to appropriate practice.

Improvements in quality of care could be stimulated by effective self-regulation. Incentives are needed to encourage the development and adoption of evidence-based best practices by the medical profession. Recent OECD work highlights indeed how self-regulation can benefit from financial support[11]. Clinical guidelines are needed to help to smooth variations in treatments across providers and improve quality of care. They could also pave the way to the use of performance targets.

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10) In this case medical fees would have to be increased to include the doctor's loss of revenue resulting from the reduced patients' payment, which would involve a further increase in NHI expenditures.

11) Z. Or (2002).

2. Reform in National Health Insurance

Coping with the financial crisis of the NHI remains a top priority in the short-term. Government measures to cut the deficits of the NHI system encompass a number of interventions both to increase revenues and to reduce expenditure growth. The net impact of these measures will depend on the extent to which they are implemented as planned. The adoption of reference pricing for drugs and the rise in contribution rates are among the measures that seem to encounter much resistance. Meanwhile, the crisis has caused some underlying weaknesses of the system to emerge which needs to be addressed in the medium-term if the performance of the system is to be improved. Interventions to address such weaknesses are presented below.

Stronger protection against catastrophic illness could improve affordability of care and income security for low-income households and the chronically ill. Health insurance is a risk transfer mechanism which transfers the risk of a large unexpected loss from the individual to the insurer, against the payment of a small certain premium. This mechanism is certainly very effective in protecting individuals against unlikely, high-cost risks. It is less important as a risk protection devise for regular, small payments, where consumption is subject to moral hazard. Co-payments and deductibles are good way of discouraging frivolous demand but they constitute a large financial barrier to appropriate access to care when catastrophic illness occurs.

Out of pocket expenditures are high in absolute and relative terms in the case of high cost in-patient and outpatient NHI bills. The NHI has a mechanism to protect insureds against catastrophic risks, which covers 50% of the co-payment for bills exceeding 1.2 million won during the period of a month. Yet the mechanism mitigates the burden of payment for patients with high bills only marginally. Taking the case of in-patient services, it is likely that even 50% of the average out-of-pocket expenditure on bills above 1.2 million won is too high a financial burden for low-income individuals or those chronically ill who need regular high cost care. This sum could easily account for a third of the minimum standard of living[12).

One low cost and administratively simple option to improve equity would be to strengthen catastrophic insurance, financing it by general taxation. One way to do this could be to increase the share borne by the NHI for high cost cases or set a ceiling that would apply when the monthly or annual bills of an individual exceeds a certain amount. Assuming that the NHI paid the entire amount of in-patient bills exceeding 3 million won and outpatient bills exceeding 1 million won, the extra cost for the NHI would have been 301 billion won in 2000. This sum is only 3% of total benefit expenditures for the year, and about a fifth of the government subsidy to the NHI.

Financing equity in the National Health Insurance system can also be improved by setting annual income-related caps on individuals' co-payments. This alternative would have a higher cost and greater administrative complexity, but is preferable when one considers the current financial barriers to access to health care. Implementation of this system could be done in two ways. First, individuals whose annual accumulated co-payments exceeded certain income-related ceilings could apply retrospectively for reimbursement of the extra payments. This would require them to submit to HIRA the invoices for the treatments they received as evidence of the payments they made. Their income could be assessed from their contributions data. Second, if a system of electronic patient cards is introduced, it would be possible for HIRA to check automatically whether individuals reached the ceiling and reimburse them at year end.

Interventions are needed to ensure that sufficient revenues are raised to match forecasts of outlays, and that the growth of public health expenditure is kept within sustainable rates.

12) 50% of the average out-of-pocket expenditure for in-patient claims above 1 million won was 94,890 won in 2000, while the minimum cost of living was 320,000 won.

Contribution rates need to be raised. While new NHI benefits have been added and utilization has risen over the years, contributions have not been increased accordingly. Steps taken to address this imbalance in the May and October 2001 countermeasures for improving the NHI financial stability should be implemented without delay. Estimates on how much contribution rates should rise in the longer term will depend on expenditure plans. The government can improve individuals' and employers' willingness to pay for higher contribution rates by implementing interventions to control expenditure growth, strengthen cost-effective and quality care, and improve accountability of providers and the NHI towards insureds. Greater tax-financing is also envisaged, not only because government subsidies to the NHI have been progressively reduced over time, but also the government tries to finance improved catastrophic insurance.

Better expenditure control is needed. Reliance on containing cost via unilateral fee setting and co-payments are likely to be inadequate. Fee increases need to be bargained: providers cannot be forced to accept low fees without negotiation. While the government measures to stabilize the NHI finances proposed certain increases in co-payments, these cannot be further increased without weakening equity of financing and of access, and giving patients awareness of cost has not been sufficient to control cost. The institutional features of the supply side in the Korean health care system, private profit-oriented providers and fee-for-service payments, have encouraged providers to increase volumes, supply more intensive and specialist care, and duplicate technology. In order to maintain sustainable expenditure growth, Korea may need to adopt additional cost containment measures.

The government should adopt an explicit policy to increase public health expenditures, setting implicit or explicit aggregate spending targets for the next 2 to 3 years. Expenditure plans should be linked to forecasts of revenues, based on estimates of an acceptable contributory burden for the taxpayer and on other revenues such as government subsidies. Mechanisms will then be needed to maintain expenditure within the plan. The recent establishment of the Health Insurance Policy Deliberation Committee that presides over decisions on changes in benefit coverage, contribution rates and medical fees is an important step in that direction. Negotiations among the government, the medical profession, and labour union will take place within this body. The existence of an expenditure target would make the negotiation among such bodies more open and transparent.

The government should maintain a firm negotiating position over increases in medical fees. While medical prices should not be set unilaterally by the government, fee levels remain an important variable to maintain NHI expenditures within the target.

Mechanisms should also be developed to discourage escalation of volumes after medical fee increases have been agreed upon. The expenditure plan could work by continually adjusting the amount paid per claim in order to keep within the yearly cap. The Resource-Based Relative Value Scale offers an opportunity to compensate for volume expansion of certain treatments because the MOHW can adjust the value of the scores in inverse relation to the volume of services provided, for example quarterly. Transparency about how this mechanism would work is needed. The aggregate spending target may also be broken down by sector (e.g., physician, hospital, and drug expenditures) or by specialty[13].

Expenditure planning and spending targets have been adopted by various OECD countries. Their experiences suggest that such budgets have had success in controlling health expenditures, for example containing hospital expenditures in France and helping to slow down expenditure growth in Germany. The adoption of specialty budgets

13) Global budgets for hospitals are prospective payments whereby the budget for individual hospitals is fixed in advance. Specialty budgets work the same ways as an aggregate cap, by adjusting fees downwards as volumes increase.

might also stimulate specialists' self-regulation, such as peer reviewing and the development of specialties guidelines. Nonetheless, budgets may be necessary but not sufficient to achieve the best value for money from expenditure growth and achieve the 'optimal' level of health expenditure growth[14]. The optimal level will require judgements to be made both about the benefits and opportunity cost of different growth path for public spending on health care. It will be important to inform these judgements with appropriate data. In particular, as Korea still spends a relative low proportion of GDP on health, the target should not be to cap expenditure per se, but to ensure both the fiscal sustainability of the NHI and certain needed improvement of the efficiency and quality of health spending. Other measures, such as active purchasing and changing incentives for providers, are needed to have a long-lasting effect on the level and quality of health expenditure growth.

Providers' incentives for making efficient use of resources, which are embedded in payment mechanisms, should be strengthened. Fee-for-service reimbursement of providers, as in the case of Korea, rewards provision of unnecessary treatments and higher use of more expensive specialist care to treat simple cases. It also provides no compensation for efforts to reduce unjustified variations in treatment across providers. Other 'pure' methods of paying physicians, such as capitation and salary, are not optimal either. Capitation can reward doctors for aspects of their performance that are discouraged by fee-for-service, such as avoiding oversupply. On the other hand, capitation scores poorly for aspects of providers' performance that are best achieved by fee-for-service arrangements, such as treating risky patients with worsening medical conditions and boosting productivity. A certain consensus is emerging in the theoretical and empirical literature that the optimal way to pay providers should lie somewhere in between pure mechanisms. Blending aspects of process-based,

14) Imai, Jacobzone and Lenain (2000); OECD (2001).

retrospective compensation (such as fee for-service), with elements of prospective payment (pre-determined rates, population-based capitation), would help to improve providers' performance.

The Korean government has taken important steps towards the adoption of mixed payments for both physicians and hospitals. First, the resource-based relative value scale (RBRVS) was introduced in 2001. This system provides for a better basis for regulating fees because payment is contingent upon the resources needed to supply the treatment. The MOHW could actively manage the scale to encourage certain cost-effective treatments and discourage excessive use of others, for example by adjusting scores from one year to the next. Second, with the May 2001 stability measures, provisions have been made for adjusting the reimbursement of single providers for their volumes of treatments. This mechanism discourages overprovision by outliers, but should be accompanied by the development of protocols of practise to reduce provision of unnecessary care by the average physician. Third, Diagnostic Related Groups (DRGs) have been introduced on a voluntarily basis for selected treatments in various medical institutions. Positive results have been achieved in terms of decreasing average cost, reducing length-of-stay, and non-worsening of quality of care. This indicates that there is a potential for expanding DRGs to all medical institutions and possibly to a larger list of diagnoses.

The efforts to implement mixed payments should continue and their results should be monitored. The introduction of other blended and prospective payment schemes might also be beneficial, particularly if they encourage appropriate scope of care and dampen unnecessary treatments. The blending of capitation and fee-for-service payments could be implemented, for example, for general practitioners treating medical aid beneficiaries. Low-income beneficiaries could be encouraged to register with specific doctors who would be paid by a mix of capitation and fee for service for such patients and would act as gatekeepers for specialists. Co-payments would be zero under such arrangements[15].

Implementing providers' payment changes is likely to encounter resistance. Improved efforts at dialogue and re-building trust is needed, particularly in the current conflictual climate. Any change would first require to be negotiated in the light of estimates of the effect of payment changes on the price and volumes of uninsured services. If changes in providers' payments were first implemented through voluntary pilots, incentives could be used to encourage providers' participation, as was the case with the experimentation of DRG payments.

While providers' incentives can be improved by blended payment mechanisms, there is no perfect combination of incentives that can reward and discipline providers, and overcome the asymmetry of information between purchasers and providers. This is why payment methods work best if combined with other screening and monitoring tools used in support of more prudent purchasing of medical services.

A new framework for governance of the NHI emerged with the integration reform. The Health Insurance Review Agency has assumed new responsibilities for evaluating the appropriateness of medical benefits. The Corporation has taken on a more active role in facilitating decisions over benefit extensions, medical fee changes, and contribution rates within a newly established committee[16]. The management of the NHI system is now exposed to demands for greater

15) This is the case of Ireland, where physicians receive capitation payments for individuals in possession of a health card granting free access to primary care services.

16) The committee includes representatives from trade unions, the government, the medical profession, and civil society. Prior to the reform, decisions over contribution rates were made by each society independently. The list of benefits covered by the NHI was decided and released annually by the MOHW. And decisions over changes in fees were almost unilaterally taken by the MOHW, after consultation with the Ministry of Finance and Economy.

transparency and accountability towards insureds.

These new mechanisms for improving the performance of the NHI system require further work. HIRA has to develop the capacity to manage purchasing decisions more actively. Within the new committee, the NHIC negotiates medical fee increases with representatives of the professional associations and contribution rates increases with trade unions. However, the Corporation is still in the process of learning how to use the rich data set it now collects[17] to inform and negotiate evidence-based decisions over the setting of fees, benefits and contribution rates. The creation of an integrated health insurance administration can be a long and costly process. Training might help the administration to take up new competencies, both at managerial and at operational levels.

3. Efficient Use of Information Technology

Currently information technology of Korea has been developed rapidly. The diffusion of information technologies will be helpful for both patients and providers in terms of cost containment and quality of care. The government and the NHIC are giving incentives to providers, especially to the hospitals, to increase in the volume of insurance claims with EDI process. It is expected that review process of claims will be shortened and production of new statistics for the evidence-based policy making will be easier.

4. Restructuring the Elderly Health Care System

Korea has undergone a period of fast economic development and industrialization since the 1960s, which was accompanied by a

17) Information systems have been upgraded allowing the collection of a comprehensive set of nation-wide data.

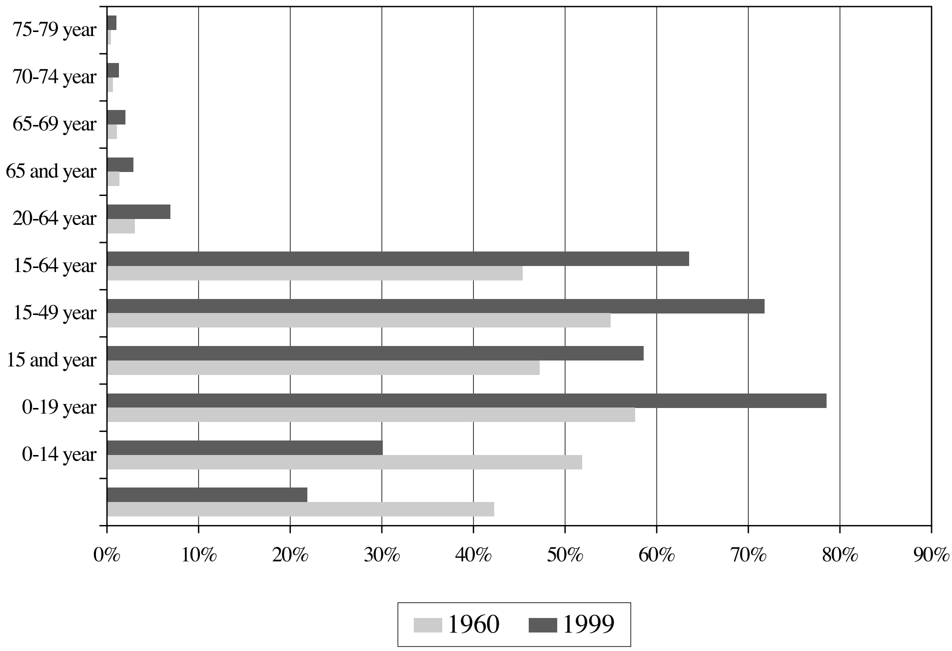
dramatic transformation of Korean society and a rapid demographic transition. While Korean society is among the youngest within OECD member countries, its population is aging fast following drops in fertility and in mortality rates at older ages. This is illustrated in [Figure Ⅵ-5], which shows the growing share of older population groups between 1960 and 1999, which shows the rapidly decreasing age dependency ratio[18) for Korea compared to the OECD average. The proportion of the population above age 65 increased from 4.3% to about 7% in 2000, and is projected to reach 14% in 2022. It will take 22 years for Korea to double the 2000 share of elderly population, what took the UK 41 years and France 115 years (<Table Ⅵ-10>).

While no link between the share of population over 65 and the GDP share of health expenditure exists at aggregate level across OECD countries, population ageing might exercise large pressures on the health care system over time. Health care expenditures per NHI claims of persons over 65 were 1.6 times higher than claims for other age groups. Jacobzone (2001) estimates that health expenditures for those above 65 to be 2.4 times the expenditures of younger groups (which is a low ratio compared to estimates for other OECD countries and might rise in the future)[19). Higher health costs for older age groups reflect their more intensive use of resources, higher costs of technology and larger pharmaceutical consumption. Population ageing also exercises pressures on the delivery system because new institutional arrangements and medical facilities may be necessary to provide long-term care.

18) The dependency ratio is the ratio between the population 0-19 & 65+ and the population 20-64.

19) According to Jacobzone (2001), the over-65 age group accounts for 40-50% of health care spending and their per capita health care costs are three to five times higher than those under 65.

[Figure Ⅵ−5] Population by Age Group in 1960 and 1999



Source: OECD, *Health Data*, 2001.

<Table Ⅵ−11> International Comparison of Aging Societies

	Elderly share of 7%	Elderly share of 14%	Elderly share of 20%	Time period taken	
				7-14%	14%-20%
Korea	2000	2022	2032	22	10
Japan	1970	1994	2006	24	12
France	1864	1979	2020	115	41
Germany	1932	1972	2012	40	40
UK	1929	1976	2021	47	45
Italy	1927	1988	2007	61	19
US	1942	2013	2028	71	15
Sweden	1887	1972	2012	85	40

Source: UN, *The Sex and Age Distribution of World Population*, as cited in H. Lee (2001).

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Chapter Ⅶ. Strategies for Structural Adjustment and Rapid Development in Korea

Ⅰ. Introduction

For over three decades Korea has sustained remarkable economic growth. The average annual rate of growth during 1962-92 was nearly 9%. As a result of such rapid and sustained growth, Korea today is recognized as one of the most successful newly industrialized economies (NIEs), with the promise of making a successful transition to a mature, advanced industrial economy by the turn of the century.

Korea's economic progress was not a smooth one, however. In fact, Korea encountered many new problems and difficulties in different stages of its development. To overcome them, it undertook many structural adjustments. In some cases these adjustments were highly successful, while in others they were not.

Just how influential the Korean government has been in the country's development is a point of considerable debate. It is a difficult question to assess since opinions on the government's role differ because of different attitudes to the relationship between the individual and the state and different views on the relative importance of the various causes for Korea's economic success.

Such differences exist not only among foreign observers but also among Koreans. On the one hand, many foreign observers have conjured up the vision of a monolithic, government-directed economy, which might be labeled "Korea Incorporated." According to this view, the "economic miracle on the Han River" is the result of strong political leadership and outstanding government management that used development planning as its primary instrument, along with sensible policies and budgets. On the other hand, some argue that the government's main contribution to Korea's rapid economic growth has been the creation of a favorable economic environment for private enterprise. Thus, according to their view the unprecedented rapid economic growth that Korea has experienced over the last 30 years or so has been accomplished predominantly without the government's help.

Korea's experience should be reviewed for two reasons. On the one hand, a review may well provide useful insights as to how the nation should undertake further structural adjustments in the future. On the other hand, it may provide useful lessons for other developing nations in connection with their current efforts to bring about rapid development and major structural adjustments in their economies.

The main objective of this paper is to review strategies for rapid development and structural adjustment over the past 30-year period and try to infer some lessons which may be of use to other developing countries. Section Ⅱ reviews the industrial policies implemented by the Korean government at different stages of industrial development. Section Ⅲ focuses on fiscal and monetary policies and identifies the changes in the priority of government policies and the influences the government has exerted on the private sector. A review of industrial, fiscal and monetary policies is followed by a brief examination of the economic institutions and management system, with an emphasis on its orientation, organizational structure, and actual performance in Section Ⅳ. Section Ⅴ contains a discussion of some broad lessons which could be relevant to the economic policy of other developing economies.

Ⅱ. Industrial and Developmental Policies

Korea's 30-year development between 1961-1992 can be divided into four periods. During the period from 1962-1971, Korea for the first time in its modern history implemented an outward-looking development strategy with great success. During the second period from 1972-1978, the country was engaged in industrial targeting practices to promote an accelerated development of heavy and chemical industries. In this process, the government greatly interfered with the operation of the market mechanism. The country achieved high growth during this period but at the cost of high inflation and severe structural imbalance in the economy. During the third period from 1979-1986, the government undertook wide-ranging policy reforms in large measure to undo the structural distortions caused during the previous period. As a result, by 1986 the country regained not only price stability and high growth momentum but also much of its international competitiveness. The last period from 1987-1992 was a period during which the economy underwent considerable structural changes due to the democratization process at home and the end of the Cold War abroad. Certain serious adverse consequences of the structural changes of this period are still being felt by the economy today.

1. Outward-Looking Development Strategy, 1962-1971

In the early 1960s, economic conditions in Korea were similar to those of any resource poor, low income developing country today. Korea's GNP per capita in 1961 was a meager $82, and the level of domestic savings was negligible. While the population was growing nearly 3% a year, Korea was experiencing widespread unemployment

<Table Ⅶ－1> Major Economic Indicators, 1955-1990

(Unit : US$, %)

Year	Per capita GNP	Growth rate of GNP	Inflation rate(GNP deflator)	Gross fixed investment to GNDI	National saving to GNDI	Growth rate of exports	Exports to GDP
1960	79	1.1	11.7	10.8	0.8	20.8	4.1
1961	82	5.6	14.0	11.7	2.9	38.7	6.3
1962	87	2.2	18.4	13.7	3.2	13.0	6.0
1963	100	9.1	29.3	13.5	8.7	9.0	5.4
1964	103	9.6	30.0	11.3	8.7	23.5	6.7
1965	105	5.8	6.2	14.8	7.4	35.9	9.5
1966	125	12.7	14.5	20.2	11.8	42.9	11.9
1967	142	6.6	15.6	21.4	11.4	27.9	13.6
1968	169	11.3	16.1	25.0	15.1	42.2	14.7
1969	210	13.8	14.8	25.8	18.8	36.7	15.4
1970	252	7.6	15.6	24.3	18.0	34.2	14.1
1971	289	8.6	12.9	24.8	16.0	27.8	15.4
1972	319	5.1	16.3	21.0	17.2	52.1	19.9
1973	396	13.2	12.1	25.2	22.6	98.6	29.5
1974	542	8.1	30.4	31.8	20.3	38.3	27.8
1975	594	6.4	24.6	28.8	18.2	13.9	27.8
1976	803	13.1	21.0	26.6	24.3	51.8	31.0
1977	1,012	9.8	15.9	28.3	27.6	30.2	31.6
1978	1,396	9.8	21.6	32.6	29.7	26.5	29.7
1979	1,644	7.2	20.0	35.9	28.4	18.4	27.9
1980	1,592	-3.7	24.0	32.0	23.1	16.3	34.0
1981	1,734	5.9	16.9	29.9	22.7	21.4	36.5
1982	1,824	7.2	7.1	28.9	24.2	2.8	34.5
1983	2,002	12.6	5.0	29.2	27.6	11.9	35.6
1984	2,158	9.3	3.9	30.3	29.4	19.6	36.0
1985	2,194	7.0	4.2	29.9	29.1	3.6	34.6
1986	2,505	12.9	2.8	28.9	32.8	14.6	38.6
1987	3,110	13.0	3.5	29.6	36.2	36.2	41.5
1988	4,127	12.4	5.9	30.7	38.1	28.4	39.9
1989	4,944	6.8	5.2	33.5	35.3	2.8	34.2
1990	5,659	9.3	10.6	37.1	36.0	4.2	31.0
1991	6,498	8.4	10.9	38.3	36.1	10.5	34.6

Source: National Statistical Office, *Major Statistics of the Korea Economy*, various years.

<Table Ⅶ−2> Employment Structure by Industry

(Unit: %)

year	Agr. force. & fish	Min.& mfg.	Soc. & others
1963	63.1	8.7	28.2
1965	58.6	10.4	31.0
1970	50.4	14.3	35.3
1975	45.7	19.1	35.2
1980	34.0	22.5	43.5
1985	24.9	24.4	50.6
1991	16.7	30.5	52.8

Source: National Statistical Office, *Major Statistics of the Korean Economy*, various years.

<Table Ⅶ−3> Output Structure by Industry

(Unit: %)

year	Agr. force. & fish	Min.& mfg.	Soc. & others
1955	46.7	8.7	44.6
1962	37.0	16.4	46.6
1965	38.0	20.0	42.0
1970	26.0	22.4	51.6
1975	24.5	27.6	47.9
1980	14.9	31.0	54.1
1985	12.8	31.3	55.9
1991	10.1	32.9	57.0

Note: All values are ratios of industrial outputs to GNP.
Source: National Statistical Office, *Major Statistics of the Korean Economy*, various years.

as well as underemployment. The nation had no significant exports and had been running a chronic balance of payments deficit. In 1961, Korea's total exports amounted to $43 million, or less than a quarter of its imports. In addition, the country had not yet met the most critical requirement for economic development. Throughout the 1950s, the nation's political leadership had failed to provide social stability and economic policy directions. Under such conditions, it was not possible to channel effectively the creative energy of the Korean people towards development. In 1962, when the Korean government launched its First Five-Year Plan, Korea had in principle two alternative approaches to economic development. One was an inward-looking development strategy based on import substitution. The other was an outward-looking development strategy emphasizing trade. Because of its poor natural resource endowment and small domestic market, Korea chose the latter. That choice was, however, by no means an easy one to make. For one thing, Korea had been literally a "Hermit Kingdom" over several centuries. Thus, it is truly to the credit of the political leadership that an outward-looking strategy was adopted.

The essence of the outward-looking strategy adopted in the early 1960s was to promote labor-intensive manufacturing exports in which Korea had a comparative advantage. In order to implement this strategy, the government mobilized both internal and external resources by making use of the market mechanism. For example, to mobilize domestic savings, the government allowed in 1965 commercial banks to raise interest rates on deposits from 12% to as high as 26.4%. For three consecutive years after interest rates were raised, deposit savings in the banking system nearly doubled each year[20]. To increase domestic savings and also minimize price distortions due to inflation, the government reduced its budgetary deficits by revamping the administration of taxes.

In addition, the government readjusted the exchange rate to promote exports. In 1964, the multiple exchange rate system was replaced by a unified exchange rate system while the Korean won was devalued by nearly 100%, thus eliminating a bias against the export sector. The

20) For evidence of this statement, see K. Kim(1984), Table 4, p. 44. For a discussion of the salutary facts of the interest rates reform of this period, see Mckinnon(1973) pp. 105-111.

government also made available short-term export financing and allowed tariff rebates on materials imported for export production. Furthermore, the government greatly simplified customs procedures. In 1966, it also enacted a comprehensive Foreign Capital Inducement Act, under which the government provided guarantees for the loans made by foreign banks to domestic entrepreneurs.

In the area of import policies, a shift began from a "positive list" system of import controls to a "negative list" system as a first step towards liberalizing imports. The government also modified its traditional agricultural policy aimed at self-sufficiency in major grains when it allowed the importation of these grains in large quantities. As for the utilization of labor, the government for the most part relied on the operation of a competitive market.

All these policies allowed Korean exporters to conduct their businesses as if they had been operating under a free trade regime,[21] and their results surpassed all expectations. Between 1962 and 1971, the annual growth of exports in real terms was more than 36%. Propelled by this growth in exports, real GNP grew at an annual rate of 8.7%.

These impressive results, of course, should not be solely attributed to the set of policies implementing the outward-looking strategy. There were at least three other factors working to Korea's advantage. First, Korea was fortunate to be endowed with a well-educated population.[22] For centuries, the Korean people have placed a high value on education. This respect for learning combined with the desire for

21) For this kind of assessment of the policy effects, see Frank, Jr., et al. (1975), pp. 197-200, and Hasan (1976), pp. 56-78, 93-94.

22) It has been estimated that between 1960-74 about 8.4% of the increase in Korea's output was accounted for by an improvement in the quality of education received by the labor force, while 31.4% by the increase in capital input, 23.2% by the increase in labor input, and by 37.0% in "others". No doubt, the 8.4% estimate for the contribution of improvement in the quality of education are also embodied in the residual "others" category. See Y. Kim (1980), p. 251.

economic and social improvement gave way to Korea having one of the most literate populations among developing countries.

Secondly, the outward-looking strategy would not have succeeded without the energy and spirit of dynamic Korean entrepreneurs who were able to exploit the new opportunities presented to them. Furthermore, Korea possessed highly trained managerial manpower. Many Koreans had obtained advanced degrees at universities abroad while the military itself was a source of managerial skill and experience. Many officers who had retired from military service made successful transitions to managerial careers in private businesses.

Finally, the international economic environment was extremely favorable. Throughout the 1960s, the volume of world trade was expanding nearly 8% per annum, and major industrial nations were still abiding by the original GATT rules and regulations.

2. Heavy and Chemical Industry Drive, 1972-78

In spite of such outstanding success with the outward-looking development strategy in the 1970s, the Korean government began to depart significantly from such a strategy in the early 1970s by adopting a kind of import substitution strategy in many sectors of its economy. A number of critical changes in Korea's external environment were largely responsible for this shift in policy.

In 1971, under the Nixon Doctrine, the US reduced the level of its ground troops in Korea by one third. This was perceived by Koreans as the first of several moves towards the eventual withdrawal of all US troops from Korea. At that time, tensions were also growing on the Korean peninsula after a number of attempts to establish serious dialogue with the North had failed.[23)]

23) For an insider account of the effects in this change in the security environment on the government industrial policy, see C. Kim (1990), pp. 315-330.

The early 1970s also saw a conspicuous surge of protectionism in industrially advanced countries, particularly against labor-intensive manufactured products from developing countries such as Korea. After a decade of rapid growth based on the export of these products, Korean policy makers were concerned about the vulnerability of further growth based on such a strategy.

In short, Korean policy makers felt that there was an urgent need to achieve two objectives simultaneously: (a) to develop self-reliant defense capability and (b) to upgrade the nation's industrial structure to produce more high value-added exports which were less likely to encounter protectionist barriers. Policymakers found the proverbial "one stone that could kill two birds"[24)] in the promotion of heavy and chemical industries (HCIs) which included iron and steel, non-ferrous metals, shipbuilding, automobiles, machinery, petro-chemicals, and electronics. To promote these "strategic" industries, the Korean government proceeded to restructure its credit, tax and trade policies.

As a means to finance large-scale investment projects in the HCIs, the government established a National Investment Fund mobilizing public employee pension funds and a substantial portion of bank funds.[25)] When these sources proved to be insufficient, banks were directed to make additional loans to HCIs on a preferential basis.

Partly because investment projects in the "strategic" industries had long gestation periods, such policy preference loans were extended at low nominal interest rates which in most cases were negative in real terms. For example, during the second half of the 1970s when the WPI inflation rate was 16%, interest rates on export related and equipment investment loans for the "strategic" industries averaged 8% and 13% respectively, compared with 17% for general bank loans.

The elaborate tax incentives that had been introduced in the early

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24) This expression is borrowed from S. Nam (1989), pp. 137.

25) For a discussion of other policy considerations which led to the establishment of this fund, see D. W. Nam (1992), p. 16.

1960s for rapid export expansion were subsequently reduced to achieve neutrality in resource allocation. With the inauguration of the HCI drive, however, this policy was reversed. The 1974 Tax Exemption and Reduction Control Law, for instance, provided generous tax holidays, investment tax credit and a 100% depreciation allowance for investments in "strategic" industries. These resulted in the effective marginal tax rates of less than 20% for the "strategic" industries compared to the marginal tax rates of about 50% for other industries.

Trade policy was also restructured to accelerate the development of the "strategic" industries. In both 1973 and 1976, the government increased tariffs on imports competing with HCI products, and quantitative restrictions were placed on the importation of these products. A low fixed exchange rate throughout the latter half of the 1970s was also maintained in part to benefit the HCIs. Had the nominal exchange rate depreciated, the effective cost of financing the purchases of equipment from abroad for HCIs would have been higher.

The results of these changes in the credit, tax and trade policies were predictable. Almost 80% of all fixed investment in the manufacturing sector during the second half of the 1970s took place in the HCIs. Furthermore, as long as the high level of investment in HCIs lasted, the country experienced extraordinary high growth. The average annual growth rate between 1972 and 1978 was 10.8%. Heavy investment in HCIs also contributed to the upgrading of Korea's export structure. The share of HCI products in Korea's total exports rose from 21.3% in 1973 to 34.7% in 1978.

<Table Ⅶ−4> Trend of Development of HCIs

(Unit: %)

	1970	1975	1980	1985	1988
Industrial Structure:					
Agriculture/fishery	17.0	12.8	8.3	7.7	6.3
Mining	1.1	0.9	0.8	0.7	0.6
Manufacturing:	40.3	50.4	51.0	50.0	52.7
Light	28.4	29.5	24.7	21.7	21.4
HCIs:	11.9	20.9	26.3	28.3	31.3
Petrochemical	5.9	10.8	12.6	11.4	10.0
Basic metal	2.0	3.4	5.1	4.9	5.3
Metal/machinery	4.0	6.7	8.6	12.0	16.1
Power/construction	9.8	7.7	10.2	10.4	9.3
Service	31.8	28.2	29.7	31.2	29.4
Total	100.0	100.0	100.0	100.0	100.0
Import Coefficient:					
Light	9.2	10.6	7.3	7.0	8.5
HCIs:	36.9	29.5	23.7	21.6	22.5
Petrochemical	23.5	19.7	14.9	17.0	19.1
Basic metal	35.1	27.6	18.9	17.6	20.4
Metal/machinery	50.5	41.7	35.8	26.9	25.1
Composition of Export:					
Light	49.4	45.6	35.2	30.0	29.1
HCIs:	12.8	29.0	38.3	47.5	51.4
Petrochemical	5.4	9.2	9.9	12.4	11.0
Basic metal	1.5	4.0	8.1	5.8	5.1
Metal/machinery	5.9	15.8	20.3	29.3	35.4

Source: Yoon Je Cho and Joon-Kyung Kim(1993).

<Table Ⅷ−5> Commercial Bank Borrowing Costs for HCI Projects

(Unit: %)

Year	Discount rate on commercial bills	Interest rate on equipment loans for HCI projects
1970	24.30	12.00
1971	23.00	12.00
1972	17.79	11.17
1973	15.50	10.00
1974	15.50	10.00
1975	15.29	12.00
1976	16.33	12.42
1977	17.25	13.00
1978	18.02	14.17
1979	18.75	15.00
1980	23.33	20.50
1981	19.50	18.00
1982	12.38	12.75
1983	10.00	10.00

Source: Bank of Korea, *Economic Statistics Yearbook*, 1970-85.

<Table Ⅷ−6> Effective Marginal Tax Rate of HCI

(Unit: %)

Year	Petro-chemicals	Basic metals	Fabricated metals and equipment	HCI (average)	Non-HCI[1)]
1972	29.5	24.8	28.8	27.7	29.8
1973	33.6	30.8	36.1	33.5	38.6
1974	33.8	33.7	22.3	29.9	37.7
1975	16.9	12.4	18.3	15.9	52.1
1976	19.1	11.9	21.3	17.5	49.5
1977	19.3	11.9	21.3	17.5	49.5
1978	18.2	11.0	21.6	16.9	48.4
1979	21.6	10.6	22.7	18.3	48.5
1980	17.2	15.0	22.8	18.3	48.5
1981	19.5	16.4	26.0	20.6	51.1

Note: 1) The average of food and beverages, textiles and apparel, wood and furniture, paper and printing, nonmetallic mineral products, and other manufacturing.

Source: Taewon Kwack(1985).

However, such positive economic achievement must be weighed against many negative consequences brought by the HCI drive. For one thing, the low interest rates on loans to HCIs created excess demand for credit, which in turn stimulated growth in the money supply. During the 1971-1979 period, M1 and M2 expanded at about 30% per annum. This rapid expansion of the money supply accelerated inflation. Inflation measured in consumer prices rose from 9.4% in the 1970-1973 period to 16.2% in the 1974-1978 period.

Furthermore, the government's response to inflation left a great deal to be desired. When inflationary pressure became pervasive in the economy, the government responded with price controls. As inflation was suppressed in this manner, the structure of relative prices became seriously distorted, thus hindering the efficient allocation of resources in the economy.

When the development of HCIs was planned, the need for skilled manpower was seriously underestimated. With the expansion of HCI projects, there was a rapid rise in the demand for highly skilled workers. This pushed up wages for skilled workers, resulting in a widening gap between wages for skilled and non-skilled workers. When the widening wage gap became a political issue, the government pressured employers to pay higher wages to non-skilled workers, which in effect amounted to a minimum wage legislation. This measure, coupled with the effect of a construction boom in the Middle East, where Korea sent a large number of its workers, caused a rapid increase in the overall wage level. With the rapid increase in the overall wage level, Korea's external competitiveness suffered, particularly in the case of labor-intensive, light manufactured goods.

While funds were generously supplied to HCIs, small and medium industries were starved of funds and thus unable to undertake investment to increase their production capacity. This created not only a structural imbalance in the economy but also a problem in terms of income distribution.[26] As small and medium industries, which for the most part specialized in the production of daily necessities, were unable to increase sufficiently their production capacity, the prices of daily necessities rose faster than those of other commodities. Since low income groups spent a larger portion of their incomes on these necessities, they experienced a greater decline in their purchasing power.

Adverse developments in income distribution occurred for other reasons as well. Since HCI projects were very capital-intensive, their contribution to employment generation was rather limited. In addition, once inflation got under way, people started to engage in real estate speculation as a hedge against inflation. This increased the prices of real estate much faster than the prices of other commodities or services and ultimately resulted in a drastic redistribution of wealth. Since low income groups had less means to engage in real estate speculation, the redistribution of income and wealth took place at their expense. Needless to say, this was detrimental to the social and political stability of the country.

The preemption of financial resources by HCIs had a lasting effect on the industrial structure of the nation as well. It should be remembered that it was the large industrial groups that were in a position to undertake large HCI projects and thus benefit from preferential credit and tax treatment. There is little question that the concentration of economic power in the hands of large conglomerates, often called "chaebol" and a large social issue in recent years,[27)] has its origin in the HCI drive of the 1970s.

The HCI drive also had an important adverse consequence for the banking system of the country. Forcing banking institutions to extend loans at interest rates below the market clearing level reduced the

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26) The extent to which income distribution deteriorated in the 1970s can be seen in part from the fact that the Gini coefficient which had been 0.332 in 1970 rose to 0.391 by 1976.

27) For a discussion of chaebol issues, see S. Cho (1989)

profitability of the banking system, thus retarding its growth. In addition, the extension of loans at low interest rates gave rise to many “irregular” practices in banking operation. The backwardness of the banking sector, which remains a key structural weakness of the Korean economy to this day, also has its origin in the industrial policy of the 1970s.

With the rise in inflationary expectations, financial and real savings suffered. With a stagnation in savings, the nation’s balance of payments deficits increased. Balance of payments deficits worsened for other reasons as well. The quadrupling of oil prices in the wake of the first oil shock and the doubling of oil prices following the second oil shock enlarged these deficits. Maintaining a low fixed exchange rate at a time when domestic inflation was higher than that of Korea’s major trading partners also aggravated these deficits[28).

Apart from this, maintaining a low fixed exchange rate was a direct cause for the decline in Korea’s export competitiveness. In 1979, export growth in real terms became negative. With negative real export growth, the real growth of GNP dropped from 9.7% in 1978 to 6.5% in 1979.

In short, the HCI drive of the 1970s contributed to high growth and the shift in Korea’s export structure towards HCI products. But they were achieved at the cost of high inflation, structural imbalance between light and heavy industries, deterioration in income distribution, concentration of economic power, retardation of the banking system, and an eventual decline in the nation’s competitiveness and economic progress.

3. Stabilization and Reform of the Economy, 1979-1986

Even before the death of President Park Chung Hee in October 1979, many of the economic difficulties just noted were readily

28) The nominal exchange rate of the Korean won remained unchanged at 484 won to the dollar between December 1974 and January 1980.

apparent to Korean policymakers. Thus, in April 1979, the government announced a comprehensive stabilization program with an aim to restructure the whole economy and to regain the nation's competitiveness. The approach it adopted to attain these objectives was to make maximum use of the market mechanism and private initiative - a sharp break from the interventionist approach followed in the preceding years. Given the far-reaching goals and the unique approach, the program was more than the usual short-term stabilization program with an emphasis on demand management.

This stabilization program was comprised of three major components. First, the government set lower targets for the growth of the money supply. Second, to correct structural imbalances between HCIs and other industries, the government suspended all new HCI projects and realigned credit priorities in favor of light industries. Third, the government decontrolled prices on many commodities and stepped up import liberalization. In short, the program was meant to be the first major policy effort to deal with the serious internal macro and micro imbalances.

The efforts to correct external imbalances came somewhat later. In January 1980, the won was devalued by 20%. In place of the fixed exchange rate system that pegged the value of the won to the US dollar, a flexible exchange rate based on a basket of currencies was adopted. Interest rates on bank loans and deposits were then sharply raised to offset the inflationary impact of devaluation. Interest rates on policy preference loans were raised more than those on ordinary loans - obviously an attempt to narrow the interest rate differential between the two types of loans.

Although the fundamental direction and approach were sound, the results of the 1979 stabilization program and the 1980 devaluation measures were not immediately apparent due to three developments. First, three months after the stabilization program was put into effect, OPEC began to increase oil prices. This nearly doubled Korea's oil import bill and increased its deficit by $3 billion per annum. Such deterioration in the balance of payments made it difficult to push import liberalization as vigorously as the government had wanted. Second, there was much social and labor unrest following President Park's death. Between January and April of 1980, as many as 848 strikes took place, and one of these strikes turned the coal mining town of Sabuk into a state of anarchy for three days. This served to reinforce the negative attitude that the Korean public had traditionally held toward labor unions[29]. Meanwhile, student demonstrations escalated throughout the country, culminating in the tragic Kwangju uprising in May. Under these circumstances, it was only prudent to ease the highly restrictive monetary and fiscal policies.

After the worst of the political and social crises was over, the restrictive monetary and fiscal policies were restored. In addition, fears that restrictive demand management alone might overly contract economic activities led the government to make use of incomes policy. The incomes policy included guidelines for wage increases, a limited increase in the government purchase prices of major food grains, and controls on interest and dividend payments.

By 1982, the combined effects of all these policies became apparent. Inflation measured in consumer prices plunged from 28.7% in 1980 to 7.0% in 1982; in 1983 it fell further to 3.4%. The current account deficit fell from $5.3 billion in 1980 to $2.6 billion in 1982. The negative economic growth of 3.7% in 1980 was followed by a positive 6.2% growth in 1981, a 5.5% growth in 1982 and 9.5% in 1983.

In retrospect, it was extremely fortunate that the government that came into power in September 1980 not only endorsed the short-term

29) The union movement in Korea was infiltrated by Communist elements in the early post World War II years. As a result, the Korean government and the general public have always had a tendency to look upon the unions with great suspicion and have considered it a potential source of subversion.

stabilization policies already under way but also provided the political leadership for long-term structural adjustments and institutional reforms. Without such commitment and leadership at the highest level, both the stabilization policies and structural reforms could not have been implemented as successfully.

The structural reforms undertaken in the early 1980s were truly broad in scope. On the external side of the economy, they included the liberalization of policies on trade, direct foreign investment and the inflow of foreign technologies. On the internal side, they included a set of new policies designed to promote competition, improve efficiency in budgetary allocation, restructure industrial incentives and liberalize the financial sector. In addition, the government attempted to deal with problems in the labor market by instituting a new system of labor-management relations.

As late as 1979, Korean imports eligible for automatic approval as a percentage of total imports, i.e., the import liberalization ratio, was less than 68%. In the Fifth Five-Year Social and Economic Development Plan (1982-1986), the Korean government committed itself to raising this ratio to the level of OECD countries by 1986. These efforts to remove non-tariff barriers were accompanied by measures to reduce not only the average tariff rate but also the tariff differentials among different products. As a result, the average tariff rate dropped from about 25% in 1980 to 18% by 1986. In addition, by 1988 a standard tariff rate of around 20% was to be applied to nearly two thirds of all imported items.

<Table Ⅶ−7> Import Liberalization Ratios

(Unit: %)

	1980	1985	1989	1990	1991
Overall average	68.6	87.7	95.5	96.4	97.2
Industrial products	70.0	89.7	99.6	99.8	99.9
Agricultural products	55.9	66.4	71.9	83.3	84.9

Source : Ministry of Finance.

<Table Ⅶ−8> Tariff Rates

(Unit: %)

	1984	1985	1989	1990	1991
Total average	23.7	21.3	12.7	11.4	7.9
Industrial products	22.6	20.3	11.2	9.7	6.2
Agricultural products	31.4	28.8	20.6	19.9	16.6

Source : Ministry of Finance.

Since 1965, Korea had followed the policy of relying rather heavily on foreign borrowing rather than on direct foreign investment. It had also been very strict in requiring local partnerships for foreign direct investment(FDI). The new FDI policy, announced in 1980, allowed a maximum equity share of up to 100 percent in many industries while maintaining the existing tax incentive and other privileges offered to foreign investors. In 1984, the foreign investment policy was further liberalized. For the first time, a negative list system was adopted for approving foreign investment applications. Under the previous positive list system, foreign investment was allowed only in those industries listed on the positive list and prior approval was needed in all cases. Under the new negative list system, approval was to be automatic if the industrial area of an investment project was not on the negative list. In 1984, some 39% of Korean industries were on the negative list, and by 1986 this figure fell to 24%.

With regard to the inflow of foreign technologies, in 1984 the government replaced the system which required importers of foreign technologies to obtain official pre-approval with a new system which required them only to notify the government of their intention to import foreign technologies.

One of the important internal reforms undertaken by the Korean government was the policy on competition and monopoly. As a way to curb such monopolistic practices as cartel arrangements, price collusion, price discrimination and artificial barriers to entry, the government passed the Anti-Monopoly and Fair Trade Law in 1980.

In line with the philosophy of relying on the market mechanism for the efficient allocation of resources and equity in income distribution, the government also restructured the industrial incentives. The guiding principle was to replace industry-specific incentives with uniform incentives for investment and technical innovation applicable to all industries. To this end, the 1981 tax reform abolished all special tax treatments for "strategic" industries except the 100% special depreciation allowance. In addition, the Industrial Development Law, which became effective in 1986, replaced seven separate individual industrial promotion laws and defined the role of government as a trouble shooter in only two areas of "market failures." One of these areas was comprised of industrial sectors whose international competitiveness yielded positive externalities to the economy, and even in this area, the role of the government was limited to promoting technological advancement.

In the 1970s, the consolidated government budget was chronically in deficit. On the average, the annual deficits amounted to 3.7% of GNP in the 1971-1975 period. The deficits eased somewhat in subsequent years when the government introduced the defense surcharge and value added tax. But the deficit grew again to over 3% of GNP by the early 1980s when the government was forced to undertake many expenditures in the face of mounting social and economic crisis.

In a determined effort to eliminate chronic budgetary deficits, to check the growth of public expenditures relative to GNP, and to restructure the expenditures in line with the changing needs of the country, in 1983, the government decided to freeze its 1984 aggregate spending at the 1983 level and place all spending categories on a zero-base budget principle. What was most remarkable about this policy was that it was implemented just a year before the general election.

Financial liberalization started with the divesture of government equity shares in five nationwide commercial banks in 1982. By 1983, all these were in private hands, paving the way for autonomy in banking operations. In order to increase competition in the financial sector, the government also allowed two new commercial banks and many non-bank financial intermediaries such as mutual savings and short-term finance companies to be established.

In 1982, a major step was also taken to normalize the structure of interest rates. Most policy loans were no longer extended at preferential interest rates. In addition, the government began to lift restrictions on bank management by relaxing regulations governing the appointment, organization, budgeting, branch operation, and other business practices of banks. The government also reduced the restrictions on the kinds of services that different categories of institutions could engage in, thus breaking down the artificial business boundaries of different categories of institutions.

It is important to note, however, that the efforts to liberalize the financial sector were greatly hampered by the legacy of the past policies. As the stabilization policy took hold, many firms experienced serious financial difficulties. This was embarrassing to the government, because many financially troubled firms were those large conglomerates that had been supported through preferential credit. Apart from this reason, the government could not let these firms go bankrupt for fear of rising unemployment. Furthermore, the banks' own financial positions were weak due to the large amount of non-performing assets in their portfolio. The government tried to resolve these problems in a variety of ways including the postponement of financial liberalization itself, the extension of subsidized central bank credit and the granting of exemptions for capital gains tax on the disposition of real estate collateral supplied by the troubled firms.

The one area of the domestic economy where the government failed to restructure properly was labor. A system of labor-management relations consistent with the liberal economic policy reform of the early 1980s would have been one that promoted competition in all segments of the labor market. In areas where competition was impractical due to the monoposonistic power of employers, allowing workers to form unions to serve as a countervailing force would have been justified. Ideally, Korea should have adopted such a system of labor-management relations in the early 1980s.

However, because of the unfavorable perception that the Korean public traditionally had of labor unions as well as their memory of the radical and extremist tactics used by labor leaders in the spring of 1980, the adoption of such a system was precluded. The unfortunate upshot was the adoption of very stringent labor laws instead.

The 1980 amendments to the Trade Union and Labor Dispute Adjustment Laws weakened the power of unions in a number of ways. They barred “third parties” from any role in organizing unions, collective bargaining or strikes, made the forming of unions difficult procedurally and empowered the government to dissolve any union that either violated or threatened to violate the laws of the country. In addition, they gave the government the power to determine if a dispute was for a justifiable cause, virtually making strikes an unfeasible option for workers[30].

30) For a concise analysis and evaluation of the changes to the labor laws in the 1980s, see Bognanno (1988), pp. 21-32.

<Table Ⅶ-9> Labor Market Trends

(Unit: %)

	1971-75	1976-78	1979-82	1983-85	1986-90
Labor force growth	3.92	4.34	2.07	1.23	3.46
(Participate rate)	(58.1)	(59.6)	(58.9)	(56.7)	(58.7)
Employment growth	3.99	4.68	1.76	1.35	3.80
Unemployment rate	4.2	3.6	4.5	4.0	2.9
(Non-farm households)	(7.0)	(5.6)	(6.4)	(5.1)	(3.5)
GNP growth	8.70	11.70	3.45	9.6	10.8
Nominal wage increase[1)]	20.9	34.2	22.0	9.6	14.6
(Manufacturing)	(21.8)	(34.3)	(21.4)	(10.1)	(17.0)
Rise in product wage[1)2)]	3.7	14.9	3.5	6.7	8.8
(Manufacturing)	(5.7)	(18.4)	(4.8)	(7.13)	(11.1)
Increase in labor productivity[1)2)]	6.1	6.0	0.7	5.4	5.5
(Manufacturing)	(5.6)	(8.2)	(4.8)	(8.0)	(5.4)
Labor share of national income[3)]	39.8	43.9	51.2	53.6	55.1

Notes: 1) Non-agricultural sector excluding government services.
2) Product wage = nominal wage/own deflator.
3) Labor productivity = value added/employment.

Sources: EFB, *Annual Report on the Economically Active Population Survey,* 1990.
Ministry of Labor, *Report on Monthly Labor Survey,* various issues.

The question is how did the economy fare under the stabilization and reform policies just outlined? For one thing, the success of the stabilization policy removed distortions in the relative price structure and did away with inflationary expectations. This not only paved the way for greater reliance on the market mechanism but also prepared the country to open its markets to the outside world. The stabilization programs together with other competition enhancing measures led to a noticeable improvement in the quality of products and a significant increase in innovation. The success of the stabilization program also had the effect of dampening the demand for imports. As a consequence, even when imports were liberalized, Korea did not experience an undue increase in imports.

In addition, the improvement in the business environment due to the success of the stabilization program and the substantial liberalization of imports and direct foreign investment brought about a dramatic rise in the flow of foreign investment and technology[31)]. All this greatly contributed to the full recovery of external competitiveness by 1986. That year Korea achieved a trade surplus of $4.2 billion.

As for the replacing of industry-specific incentives with uniform incentives for all industries, although concrete empirical evidence is hard to come by, there is little doubt that the measure went far towards mitigating the structural imbalance between light and heavy industries on the one hand and between small and medium firms and large firms on the other.

Introduction of fair trade regulations did not produce tangible results in the short run, but over time the flagrant abuses of market power were lessened, and the share of total industrial shipment or output accounted for by the top 30 largest business groups appreciably declined. For example, the top 30 largest business groups accounted for a 40.3 % share of the total industrial shipments in 1984, but this share declined to 35.2% by 1989[32)].

With regard to the effect of freezing government spending and implementing the zero-based budgeting principle, there is little question that the measure eliminated remaining deficits in the consolidated budget. In addition, it reduced total government

31) The amount of direct foreign investment that came into Korea between 1982-86 amounted to 1.8 billion dollars (approval basis). This almost equaled the amount of investment that had come to Korea for the entire period of 1960-1981. The number of technical licensing agreements concluded between Korean and foreign firms between 1982-86 was 2,078. This exceeded the total number of agreements concluded in 1962-81. For more a detailed discussion, see K.Kim (1989), particularly Tables 1 through 7.

32) For a more detailed discussion on this point, see Chung and Yang (1992), particularly pp. 38-43.

expenditures as a percentage of GNP from 22.4% in 1980-83 to 18.9% in 1984-87. Applying the zero-based budgeting principle also went far toward realigning government expenditures with new priorities. For example, expenditures on national defense which had accounted for more than 33% of the general budget in 1983 was reduced to about 30% by 1987.

Reducing the interest rate differential between ordinary and policy preference loans no doubt worked to the advantage of small and medium enterprises. Furthermore, as the government allowed the establishment of a large number of non-bank financial intermediaries, the share of these intermediaries in the total domestic credit extended by the formal financial sector increased[33]. This had the effect of enlarging access to credit for small and medium enterprises.

Achieving price stability together with positive real interest rates resulted in a steady increase in savings. The savings/GNP ratio rose from 23% in 1980-1981 to 31% in 1985-1986. By increasing financial savings, price stability also contributed to financial deepening. The M2/GNP ratio, which had remained unchanged at about 30% between 1973-1980 when real interest rates for the most part were negative, rose to 43% in the 1984-86 period.

The success of the stabilization and structural adjustment policies also brought about an improvement in income distribution. The ratio of the percentage share of income for the lower 40% of households over that of the upper 20% was 0.35 in 1980 but 0.41 in 1985. The Gini coefficient for 1985 was 0.3631 compared to 0.3891 for 1980.

The stringent set of labor laws adopted in 1980 contributed to the stabilization of the critical labor situation in the early 1980s. They were also instrumental in containing the rise in real wages within the bounds of improvement in labor productivity, thus helping to restore Korea's international competitiveness. But there is little question that in the

33) The share of total domestic credit extended by non-bank financial intermediaries rose from 17.2% in 1981 to 29.6% by 1986.

course of time strict enforcement of these laws gave rise to many labor-management conflicts. Since workers had few legal avenues to resolve their grievances, their frustration grew, and in many cases, they sought help and guidance from dissident groups.

4. Structural Adjustments under Democratization, 1987-1992

Given the great momentum of wide-ranging structural reforms carried out in the early 1980s, one would have expected the 1987-1992 period to be also one in which many fundamental reforms would be undertaken on a wide front. This, however, was not the case. What actually happened was very uneven progress at best. In many instances, there were failures to undertake timely reform, while in others, even the basic trends of reform were reversed.

A case in point was reform in the banking sector. In December 1988, the Korean government announced the deregulation of interest rates on a large number of bank loans and some long-term deposits. But the government reversed the decision soon thereafter. In the early 1980s, the government refrained from interfering in the appointment of managerial personnel for commercial banks. But in the late 1980s, for all practical purposes, this policy was abrogated. In addition, in the early 1980s, the scope of policy preference loans had been continually reduced. As a result, the amount of policy preference loans as a percentage of total credit extended by the banking system declined steadily. However, this decline halted in 1989[34].

Another case in point is the foreign exchange rate policy. In the period after the Plaza agreement in September 1985, most major currencies in the world were appreciating against the U.S. dollar. For the Korean won, this was not the case, and there is little doubt that the Korean authorities deliberately maintained a weak Korean won.

34) For the past four years, the policy preference loans as a percentage of total domestic credit remained unchanged at the 38-39% level.

Beginning in the second half of 1987, however, the Korean government allowed the won to appreciate more rapidly against the U.S. dollar[35]. In 1990, it also adopted the market average system for the determination of the exchange rate in place of the currency basket system that had been in use since 1980. As far as the control on the uses of foreign exchanges were concerned, in 1992 the Korean government adopted the negative list approach in place of the positive list approach. But to this date, the size of the negative list itself remains rather limited.

35) The nominal exchange rate of the Korean won against the US dollar appreciated by 24% between the fourth quarter of 1985 and the first quarter of 1989. On a real effective basis, the won depreciated vis-a-vis the dollar up until the third quarter of 1987. Until late in 1987, the Korean government resisted as much as possible the pressure from the US to appreciate the won for fear that such appreciation would have adverse effects on domestic economic activities. This fear was particularly strong, because the Korean government was then anticipating a presidential election before the end of the year.

<Table Ⅶ−10> Nominal and Real Effective Exchange Rate for Exports and Imports

Year	Nominal exchange rate (won per U.S. dollar)			Wholesale price index(1985=100)		Real exchange rate (won per U.S. dollar)			Ratio of exchange rate for exports to imports
	Official rate	Effective rate		Korea	Major trading partners	Official rate	Effective rate		
		Exports	Imports				Exports	Imports	
1962	130.0	141.8	146.3	5.6	30.1	697.0	762.3	786.5	0.99
1963	130.0	177.6	148.1	6.7	30.2	586.1	800.0	667.1	1.20
1964	213.8	263.1	246.4	9.1	30.8	725.0	891.8	835.3	1.07
1965	266.4	276.3	294.2	10.0	30.9	821.3	852.3	908.0	0.94
1966	270.3	276.7	295.4	10.9	31.8	789.3	809.1	863.7	0.94
1967	268.3	281.3	293.8	11.5	31.6	731.1	766.5	800.5	0.96
1968	276.3	293.3	302.2	12.5	32.8	725.8	769.8	793.2	0.97
1969	288.4	306.4	312.9	13.3	33.6	730.6	773.2	792.2	0.98
1970	310.4	330.6	336.1	14.5	34.3	729.4	776.3	788.9	0.98
1971	350.1	374.1	371.9	15.8	35.7	790.3	844.5	839.5	1.01
1972	394.0	408.6	417.9	19.3	43.1	889.3	912.0	932.8	0.98
1973	398.5	408.5	417.9	19.3	43.1	889.3	912.0	932.8	0.98
1974	406.0	413.2	424.5	27.4	55.8	827.3	841.5	864.6	0.97
1975	484.0	494.1	508.9	34.6	61.2	856.9	841.5	864.6	0.97
1976	484.0	496.3	515.4	38.8	62.3	776.4	796.6	827.3	0.96
1977	484.0	493.4	519.7	42.3	74.6	853.2	870.2	916.6	0.95
1978	484.0	495.0	526.9	47.3	77.1	791.1	808.8	860.9	0.94
1979	484.0	495.0	522.3	56.1	84.6	730.2	746.6	787.8	0.95
1980	607.4	628.0	642.9	78.0	96.3	750.8	776.3	794.7	0.98
1981	681.0	696.0	717.6	93.9	101.0	734.0	750.0	773.3	0.97
1982	731.0	734.0	774.1	98.2	98.7	734.6	737.7	778.0	0.95
1983	775.7	775.7	734.4	98.4	99.0	780.3	780.3	839.4	0.93
1984	805.9	805.9	857.9	99.1	100.2	814.8	814.8	867.4	0.94
1985	870.0	870.0	920.3	100.0	100.0	870.0	870.0	920.3	0.95
1986	881.4	881.4	942.9	98.5	101.8	910.1	910.1	974.0	0.94
1987	822.5	822.5	888.2	99.0	109.5	910.0	910.0	982.5	0.93
1988	731.4	731.4	781.1	101.7	122.4	880.1	880.1	939.9	0.94
1989	671.4	671.4	705.8	103.2	126.7	825.3	825.3	867.1	0.95
1990	707.7	707.7	747.3	107.5	130.6	860.1	860.1	908.0	0.95
1991	733.3	733.3	775.4	113.3	134.7	875.5	875.5	921.9	0.95

Notes: 1. Nominal exchange rate; Data for 1962-65 were obtained from Westphal and Kim(1982, 218), and others were calculated by the author.
2. Effective rate; The effective exchange rate for exports includes exchange premiums due to multiple exchange rates, direct cash subsidies, direct tax reductions, and interest subsidies per dollar of exports, but excludes indirect-tax and tariff exemptions. The effective exchange rate for imports includes actual tariffs collected per dollar of imports but excludes the price effects of quantitative restrictions on imports.
3. Major trading partners; Major trading partners include the United States, Japan, West Germany, France, and the United Kingdom. the wholesale price index was calculated by a geometric average of those of these five nations using their trade volumes with Korea as weighs.
4. Real exchange rate; 1985 is taken as a base year.

Sources: Bank of Korea, *Economic Statistics Yearbook*, various years,
International Monetary Fund, *International Financial statistics*, various years.

As for the liberalization of imports, during the 1987-92 period much progress was achieved. In 1989, the government introduced a new round of tariff reductions with the aim of lowering the average tariff rate to 8% by 1993. Furthermore, quantitative restrictions were also greatly reduced. This was particularly true of manufactured products. By 1991, more than 99% of manufactured imports were liberalized. Agricultural imports were a different story, however. At the end of 1992, less than 89% of agricultural imports were liberalized.

With regard to direct foreign investment, the government substantially reduced several times the number of industries placed on the negative list so that by 1991 less than 12% of the industry categories remained on the list. Nevertheless, foreign investors have continued to complain about the substantial administrative red tape they encounter in starting and doing business in Korea[36].

<Table Ⅶ－11> Tariff and Non-tariff Import Restrictions in Korea, 1957-1991

(Unit: % and case)

Year	Simple average tariff rates(%)	Prohibited or restricted items	Automatic approval items(A)	Total import items(B)	Rate of import liberalization (A/B)(%)
1957	30.3				
1962	39.9				
1967	39.9	520	792	1,312	60.4
1973	31.5	629	683	1,312	52.1
1975	31.5	668	664	1,312	49.1
1977	29.7	621	664	1,312	52.7
1979	24.8	928	682	1,010	67.5
1981	24.9	1,911	5,649	7,560	74.7
1983	23.7	1,482	6,078	7,560	80.4
1985	21.3	970	6,945	7,915	87.7
1987	19.3	499	7,408	7,911	93.6
1989	12.7	465	9,776	10,241	95.5
1991	11.4	283	9,991	10,274	97.2

Note: The classification of import items was based in the SITC basic codes through 1977, 4-digit CCCN codes for 1979, 8-digit CCCN codes during 1981-1987, and 10-digit HS codes during 1989-1991.

Source: Korean Traders Association, *Annual Report on Foreign Trade*, various Years.

36) For a compilation of such complaints, see American Chamber of Commerce in Korea (1993).

<Table Ⅶ−12> Investment Liberalization Ratio

(Unit: %)

	1984	1987	1989	1990	1991
All industries	66.1	78.9	79.0	79.3	79.4
Manufacturing	86.0	97.5	97.5	97.7	97.7
Services	47.2	60.8	61.0	61.4	61.8

Source: Ministry of Finance.

In December 1988, a timetable was announced for the opening of the domestic capital market to foreign investors. In accordance with this timetable, foreign securities firms were able to open branch offices and form joint ventures in 1991. In 1992, they were allowed to buy directly stocks in the domestic market. However, a foreigner could not buy more than 3% of the total amount of stocks issued by a particular company, and in no circumstance could the total amount of stocks of a given company bought by foreign investors together exceed 10% of that company’s total.

In the area of intellectual property rights, it is true that the Korean government agreed to provide both process and product patent protection in 1987. In addition, the government enacted new laws providing protection to computer software and copyright protection under the Universal Copyright Convention. Nonetheless, to this date, foreign companies have not ceased voicing their concerns over frequent infringements of their rights, particularly in such areas as trademarks and products designs.

The one area where the 1987-92 period saw more than full implementation of reforms was labor. There is little question that today, Korean workers not only enjoy the so-called three basic labor rights - the right to organize unions, the right to engage in collective bargaining, and the right to strike - but also certain rights and privileges not available elsewhere in the world[37).

The question is why was there such uneven progress with structural reforms? A large part of the answer is to be found in the fact that shortly after Presidential Candidate of the ruling Democratic Justice Party Roh Tae Woo made his Pledge for Democratization on June 29, 1987, Korea was thrust into a rapid process of democratization under very weak political leadership[38].

The combination of weak political leadership and rapid democratization left little room for the government to take initiative for fundamental reforms. While the government was unable to take initiative, many other social and political groups gained in power and influence. The nation's farmers and small and medium enterprises were cases in point. The farmers in particular wanted protection from imports of foreign agricultural products and higher subsidized prices for their products[39]. They also wanted greater access to policy preference loans, and they even demanded public funds to repay their debts to curb market lenders.

The 1987-1992 period was also a time in which trade pressure from foreign governments, particularly, the US government, became very strong. No doubt, this was an indirect result of the ending of the Cold War. In the days of the Cold War, security concerns always had the effect of moderating trade pressure. In any case, the Korean government had no choice but to respond to new trade pressure. This resulted in a rapid opening of the domestic market to foreign products, especially in areas where domestic resistance was weak. In

37) For example, it is not illegal for Korean unions to stage strikes and sit up picket lines on business premises. Furthermore, management is not allowed either to replace striking union workers or to hire non-union workers to maintain minimum business operations while unions are on strike.

38) Weak political leadership was partly due to the fact that during the first two years of his presidency, President Roh had to deal with a national legislature in which the opposition parties had the majority of votes.

39) The farmer demand for higher subsidized prices led to the adoption of a policy whereby the national legislature had the final authority to determine the prices at which the government purchased rice barley from farmers.

areas where domestic resistance was strong, such as agricultural imports, however, the government postponed market opening as much as possible. In areas such as direct foreign investment and the protection of intellectual property rights, the Korean government reached necessary agreements with foreign governments to meet their demands, but it was found very difficult politically to implement them.

In areas such as labor, the Korean government was more or less forced to undertake whatever were changes necessary to resolve the social conflicts rapidly developing at home. It may be recalled that under the stringent set of amendments to the labor laws adopted in 1980, Korean workers had few legal avenues to resolve their grievances. In 1986, the government missed the opportunity for the fundamental revision of the laws[40)]. Unfortunately, this paved the road for an unprecedented eruption of labor disputes and strikes following Roh's Pledge for Democratization.

Korean workers took the Pledge as a signal that the government would no longer clamp down on strikes. In the following two months, there were no less than 2,600 strikes, exceeding the total number of strikes of the preceding quarter century. For the whole of 1987, over 3,500 strikes were recorded. The total numbers of strikes and disputes in 1988 and 1988 were less, but the average duration of strikes was longer. This increased the number of work days lost and the loss of output. Under these circumstances, the Korean government had no choice but to make changes in the labor laws precisely in the way labor

40) Following the general election in 1985 in which the party in power failed to gain strong labor support, the party and the government proceeded to revise the 1980 labor laws. However, they failed to appreciate the full extent of the problems associated with these laws and subsequently made only one substantive change. The single change was in regards to the highly controversial "third party" provision which was revised in 1986 to no longer bar national and industrial federations from a role in organizing unions and participating in collective bargaining. Needless to say, this change was not sufficient to satisfy the workers.

unions wanted[41].

It is not at all difficult to surmise the economic consequences of the structural changes described so far. Because structural changes were implemented with little initiative and consistency on the part of the Korean government, their effects were mixed. Put differently, they failed to have their desired effects in terms of enhancing the overall efficiency of the economy.

To be more specific, as the government accommodated demands for preferential treatment from various groups all in the name of democracy, overall government expenditures rapidly increased, leading to a reemergence of deficits in the consolidated budget[42]. The scope of policy preference loans also re-expanded. In this process, the managerial autonomy of banks suffered. In addition, the failure to carry out a comprehensive interest rate reform in the banking system prevented an efficient allocation of investment and discouraged the growth of savings in line with the growth of income. All this contributed to growing inflationary pressure, to say nothing of the conspicuous rise in "irregularities" in banking practices.

The failure to keep the overall budget balanced and the failure to carry out interest rates reform were not of course the only cause of inflationary pressure. The failure to make timely adjustments in the value of the won in response to increases in the nation's balance of payments surplus was yet another factor. Since the won was kept weak even relative to the US dollar for a long period after the Plaza Accord, the balance of payments surplus became excessively large, amounting to 8% of GNP in 1988. What is more, even after the balance of payments surplus became large, there was a prolonged delay in relaxing controls on the uses of foreign exchange. This prevented the

41) The reason why the government was so limited in its ability to make policy choices in this period also had to do with the fact that opposition parties held the majority of votes in the legislature.

42) This deficit amounted to nearly 1% of GNP in 1991.

surplus from being automatically siphoned off for such purposes as direct investment abroad.

With growing inflationary pressure, prices began to rise sharply in the second half of 1987. Inflation measured in consumer prices rose from 3% in 1987 to 7.1% in 1988; in 1991 it reached 9.3%. With the resurgence of inflation, people began to act according to their inflationary expectations. This once again triggered feverish speculation in real estate. Feverish speculation caused the prices of houses and apartments to jump 4 to 5 times as fast as the prices of ordinary commodities in 1987 and 1988. This forced the government to undertake in 1988 an ambitious program of constructing 2 million housing units over a 4-year period. As a result of such government policies, housing investment as a percentage of GNP rose from 4-5% in 1986-87 to 9-10% by 1991-92. With so much resource being committed to meeting internal demands such as housing, a decline in the nation's competitiveness, particularly in manufacturing exports, was inevitable.

The failure to implement a rapid liberalization of agricultural imports not only reduced the benefits of import liberalization for consumers but also prevented a timely restructuring of the agricultural sector itself. Furthermore, as long as agriculture remained protected, Korea was unable to resolve trade frictions with its major trading partners.

The failure on the part of Korea to resolve fully the frictions in areas such as direct foreign investment and the protection of intellectual property rights negatively affected Korea's interests. It damaged Korea's image in the eyes of the international community, and together with the resurgence of inflation and the rapid rise in wages, this led to a significant slowdown in the inflow of foreign investment and technologies into Korea.

The effects of the failure to undertake timely reforms in the areas discussed so far pale in significance compared to the effects of the failure to implement timely reforms in labor. The eruption of labor disputes and strikes on an unprecedented scale following the Pledge for Democratization resulted in an annual wage increase of more than 20% in the manufacturing sector from 1987 to 1989. As a result, by 1990 the average wage level in Korea had risen above that in Hong Kong and Singapore whose GNP per capita far exceeded Korea's. As a matter of fact, by 1989, Korea became the country with the highest wage level in Asia after Japan.

Of course, such rapid wage increases were far in excess of improvement in labor productivity. This gap, in turn, led to a rapid rise in Korea's unit labor costs. As the Korean won appreciated against the US dollar during most of this period, unit labor costs measured in dollars were rising even faster. This doubly squeezed the profitability of Korean exporters and accelerated the decline in Korea's competitiveness. With the decline in competitiveness came a decrease in Korea's dependence on exports. In 1987, the export/GNP ratio for Korea was nearly 37%. In 1992 it was less than 28%. For an economy with a limited domestic resource base, this decline in export dependence was and still is a serious matter, to say the least.

Ⅲ. Fiscal and Monetary Policies

1. Fiscal Policy

Fiscal policy played a supporting role in the Korean industrialization process by contributing to the overall savings rate and by minimizing the tax disincentives of investment. Though the focus of fiscal policy in Korea changed sharply over time, its major characteristics for the last three decades have included a relatively small public sector, comparatively low taxes, liberal use of tax incentives for saving and investment, heavy reliance on indirect tax, increased public savings, and relatively little emphasis on spending for redistributive social services. Korean fiscal planners applied the logic of supply-side economics much earlier than their counterparts in the USA and the UK.

<Table Ⅶ-13> provides four indicators of the capacity of the government to influence the economy: share of the budgetary expenditures(general account) of the central government in GNP, the total tax burden, measured as a ratio of total (national and local) tax revenue to GNP, the government final consumption as a proportion of GNP, and the government saving rate.

<Table Ⅶ−13> Fiscal Indicators, 1955-1991

(Unit: %)

	As a percentage of GNP			
	Budget expenditure	Total tax	Government consumption	Government saving
1960	17.1	10.3	14.5	-2.1
1961	19.4	9.7	13.6	-1.8
1962	24.9	10.6	14.0	-1.6
1963	14.3	8.6	10.9	-0.4
1964	10.5	7.1	8.5	0.4
1965	11.6	8.6	9.3	1.7
1966	13.6	10.7	10.0	2.7
1967	14.1	12.0	10.2	4.1
1968	15.9	13.9	10.4	6.1
1969	17.2	14.6	10.3	5.9
1970	15.4	14.3	9.5	5.2
1971	15.1	14.4	9.8	4.5
1972	16.6	12.5	10.2	1.9
1973	12.2	12.1	8.4	3.0
1974	13.3	13.4	9.7	2.0
1975	15.1	15.3	11.1	2.4
1976	15.4	16.6	11.0	4.3
1977	15.4	16.6	10.8	4.5
1978	14.7	17.1	10.4	5.3
1979	16.4	17.4	9.9	6.5
1980	17.6	17.9	11.5	5.2
1981	17.4	18.0	11.6	5.3
1982	17.6	18.2	11.5	5.7
1983	16.5	18.5	10.7	6.9
1984	15.8	17.7	10.0	6.5
1985	15.9	17.3	10.1	6.3
1986	15.2	17.0	10.1	6.2
1987	14.9	17.5	9.9	6.8
1988	14.3	17.9	9.8	8.2
1989	15.3	18.5	10.5	8.3
1990	16.0	19.4	10.7	8.8
1991	15.1	19.6	10.8	8.2

Source: National Statistical Office, *Major Statistics of the Korean Economy*, various years.

Despite the heavy and active involvement by the government in activities of the private sector, the size of government, whether measured as budgetary expenditure as a percentage of GNP or the overall tax burden, is still somewhat low compared with that of other countries, developed and developing.

The total budgetary spending of the central government has fluctuated widely during 1957-1991, without showing any consistent trend. The share of government final consumption in GNP has fluctuated less than that of general account budgetary expenditures in GNP. Due to the concerted effort by the government to raise revenue, the share of total(national and local)tax revenue as a percentage of GNP, or the tax burden, increased from 6-7% in the mid-1950s to 19.6% in 1991. There has been an almost uninterrupted increase in government savings since 1964 when the government sector moved from a position of net dissaver to one of net saves.

The expenditure policy has been basically restrained, with the ratio of the central government expenditure to GNP remaining at 20 to 23% throughout the 1962 to 1992 period. The ratio of the government's fiscal investment averaged around 27% in the 1962-1966 period but gradually declined to around 15% during the 1987-1992 period, indicating that the government's role in capital formation was important but declining.

An important characteristics of the central government expenditure pattern is big share of defense expenditures and small share of social development expenditures throughout the industrialization period. In 1980 defense expenditures accounted for 35.6% of total government outlays and 6.3% of GNP. The shares of defense expenditures in government outlays and GNP have continuously declined to 25.4% and 3.9%, respectively in 1991. Social development expenditures remained smaller than defense expenditures and economic development expenditure though the social development expenditure has increased gradually from 13.3% of total expenditure in 1971 to 24.5% in 1991.

The increasing trend in the tax burden has not been smooth, due partly to fluctuations in economic activity and partly to revenue loss from extensive tax incentives and major tax reforms that reduced the tax burden. <Table Ⅶ-14> presents a summary of tax efforts in Korea. Since no adjustments are not made for discretionary changes, estimates of the income elasticity do not reflect the automatic or built-in elasticity. Korea's tax system as a while shows an observed income elasticity of greater than unity except for the fifth plan period of 1982-1986. The relatively high elasticity during the initial period of development can be attributed to a combination of economic growth, inflation and discretionary actions while a low elasticity during the fifth plan period in excise taxes and to a substantial cut made in the high marginal rates for both personal and corporate income taxes.

<Table Ⅶ−14> Measures of Tax Revenue Growth during the Five-Year Plan Periods

(Unit: %)

Period	Average tax rate	marginal tax rate	Income elasticity
First Plan Period(1962-1966) average	9.3	12.3	1.27
Second Plan Period(1967-1971) average	14.5	18.4	1.28
Third Plan Period(1972-1976) average	15.6	16.8	1.04
Fourth Plan Period(1977-1981) average	17.6	18.4	1.04
Fifth Plan Period(1982-1986) average	17.7	16.2	0.91
Sixth Plan Period(1987-1990) average[1)]	18.3	21.6	1.18

Note: 1) Four-year average

Sources: Roy Bahl, Chuk Kyo Kim, and Chong Kee Park, *Public Finances During the Korean Modernization Process*, Cambridge, Harvard University Press, 1986.

National Statistical Office, *Major Statistics of Korean Economy*, 1991,

Any country's tax effort has three dimensions: level, structure and administration. The structure is the centerpiece, as it determines the ease with which any given level can be achieved and the efficiency with which taxes will be administered. It also holds the key to the allocating, redistributing and stabilizing functions of tax policy.

Korea has been run by a highly centralized government. Although the country is divided into five special cities and nine provinces for the purposes of local administration, the heads at all levels of local government are directly appointed by the central government. Local autonomy was briefly in effect during the late 1950s and early 1960s, but it was abolished by the military government in 1961, was reinstated in 1991, thirty years after the abolishment. As a result, Korea's local governments have acted merely as agents carrying out the decisions of the central government. They have neither their own kinds of tax nor the power to raise or lower taxes in response to the needs of local residents.

Taxes on wealth at central government level in Korea, such as inheritance and gift tax, assets revaluation tax, and securities transaction tax, are hardly significant in terms of their revenue yield. Revenue collected from the above taxes comprise only 2.3% of the central government's total tax revenue. Wealth taxes at local government level such as acquisition tax, property tax, registration tax, city planning tax, fire services facilities tax and automobile tax are major fiscal resources for local governments, accounting for 49.6% of their total tax revenue. Revenue from wealth taxes as a percentage of total tax revenues of both governments at all levels is about 9.9%, which is quite low by international standards.

<Table Ⅶ−15> Structure of National Taxes 1970-1990

(Unit: %)

Decimal	As % of GNP					As % of total national taxes				
	1970	1975	1980	1985	1990	1970	1975	1980	1985	1990
Taxes on income, profit, capital gains	4.7	3.4	4.1	4.4	6.2	35.0	24.3	25.5	28.7	37.5
Social security contributions	0.1	0.1	0.2	0.3	0.8	0.8	1.0	1.2	1.7	5.1
Taxes on property	0.3	0.5	-	0.1	0.4	2.5	3.9	0.6	0.7	2.4
Taxes on goods and services	6.3	7.1	8.4	7.6	6.3	46.5	51.1	52.4	49.0	38.4
Taxes on international transactions	1.9	2.0	2.8	2.5	2.1	13.8	14.4	17.2	16.2	13.0
Other taxes	0.2	0.7	0.5	0.6	0.5	1.3	5.5	3.0	3.8	3.6
Total	13.5	13.5	16.0	15.5	16.5	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance, *Government Finance Statistics in Korea*, 1980 and 1992.

According to <Table Ⅶ-15>, which shows the structure of the national tax system, Korea heavily depended on domestic indirect taxes on goods and services and import duties, which account for 52.4% and 17.2% respectively, of total tax revenue of the central government in 1980. Taxes on income and profits accounted for only 25.5% of the total national tax revenue. Though Taxes on income have gained their importance in recent years, income taxes do not occupy the central position in the revenue structure of Korea.

One important characteristic of the structure of tax in Korea is that it relies very heavily on indirect taxes. As shown in the first two columns of Table E, more than 70% of total tax revenues, national and local, were revenues from indirect taxes until mid-1980s, though the share decreased to 64% in 1990. Many people have mistakenly believed that the overall tax burden and share of indirect taxes in the total tax revenue increased with the introduction of VAT. Introduction of VAT in Korea led to neither an increase in the overall tax burden nor a heavier reliance on the indirect taxation for government revenue. As <Table Ⅶ-16> shows, the ratio of indirect taxes to GNP had been rising during 1974 to 1983 and there was not any significant difference in the tax burden ratio before and after introduction of VAT. As shown in <Table Ⅶ-16>, the share of indirect taxes in total taxes exhibited only a minor increase after the introduction.

The most important change in the tax structure in connection with the introduction of VAT is that the Korean indirect tax system became more reliant on general consumption tax than on selective excise taxation. It must, however, be pointed out that the revenue yield of the general consumption tax, VAT, relative to that of excise taxes, is still lower in Korea than in other countries which adopted VAT.

While the ratio of total tax revenues to GNP has increased markedly over the 1955-1990 period, the composition of total tax revenues has not changed very much. During 1970s and 1980s national government revenues have accounted for more than four fifths of the total tax revenues and local government for the remaining less than one fifths. In contrast to the national tax burden, the local tax burden remained more or less unchanged until the mid-1970s, but it increased somewhat to reach more than 2% in the 1980s and 3% in 1990.

<Table Ⅷ−16> Characteristics of the Tax Structure, 1970-1990

(Unit: %)

Year	Direct taxes to total taxes[1]	Indirect taxes to total taxes[1]	Income taxes to national income	Indirect taxes to GNP	National taxes on goods and services to private consumption	General sales tax to taxes on goods and service[2]	National to taxes total taxes	Local taxes to total taxes	Local taxes to GNP
1970	33.9	66.1	5.9	9.4	8.3	18.1	91.7	8.3	1.2
1971	36.9	63.1	6.2	9.1	8.4	17.4	91.9	8.1	1.2
1972	32.4	67.6	4.9	9.2	7.4	21.2	91.9	8.9	1.1
1973	29.8	70.2	4.4	8.5	7.6	20.8	88.6	11.4	1.4
1974	29.9	70.1	4.9	9.4	8.4	21.4	89.4	10.4	1.4
1975	25.8	74.2	4.6	11.4	9.9	27.6	89.8	10.6	1.6
1976	29.6	70.4	4.8	11.7	10.8	26.3	90.5	9.5	1.6
1977	28.2	71.8	4.2	11.9	11.6	34.3	88.6	11.4	1.9
1978	28.0	72.0	4.3	12.3	11.8	47.9	89.2	10.6	1.9
1979	27.9	72.1	4.5	12.6	12.0	46.3	88.8	11.2	1.9
1980	25.2	74.8	4.0	13.4	12.5	47.6	88.3	11.7	2.1
1981	25.7	74.3	4.3	13.5	12.5	47.3	88.9	11.1	2.0
1982	26.0	74.0	4.7	13.9	12.9	47.7	88.2	11.8	2.2
1983	24.5	75.5	4.6	14.6	14.0	49.0	87.8	12.2	2.4
1984	24.8	75.2	4.3	14.0	13.8	48.0	87.8	12.2	2.3
1985	27.8	75.2	5.0	12.7	12.4	48.9	87.8	12.2	2.1
1986	27.3	72.7	4.9	12.6	12.8	48.8	88.3	11.7	2.0
1987	29.8	70.2	5.6	12.3	12.5	49.8	88.2	11.8	2.1
1988	33.3	66.7	6.1	12.1	12.7	50.0	86.3	13.7	2.5
1989	36.5	63.5	7.0	11.9	10.7	63.7	81.1	18.9	3.5
1990	35.9	64.1	7.9	12.4	11.8	64.0	83.9	16.1	3.0

Notes: 1) The classification of direct and indirect taxes is based on national income accounts.

2) General sales tax in Korea before July 1977 was business tax, which was replaced by the VAT.

Sources: Bank of Korea, *Economic Statistics Yearbook*, 1991.
Ministry of Finance, *Government Finance Statistics in Korea*, 1991.
National Statistical Office, *Major Statistics of the Korean Economy*, 1991.

After showing how the tax structure was modified over time to support Korea's growth strategy and by developing a general equilibrium model with which to estimate the contribution of the tax structure to Korea's growth rate, Irene Trela and John Whalley concluded that less than 10 percentage point of growth or 1 percentage point of the growth rate was contributed by the tax structure.

The most important aspect of Korea's tax policy in connection with her rapid industrialization has been the tax incentive system. The Korean government has applies various tax incentives, such as a preferential depreciation allowance and tax reductions and exemptions, to induce the private sector to engage in certain economic activities that seemed desirable for industrial development and export growth. Only in a few cases were they employed as countercyclical policy measures.

Korea's complicated tax incentive system includes: (1) incentives for export promotion; (2) incentives for key industries; (3) incentives for small-and medium-sized firms; (4)incentives for technical innovations; (5) incentives for local industrial development; (6) incentives for foreign investment; (7) countercyclical investment incentives; (8)incentives for energy conservation and environmental protection; (9) incentives for resource development; (10) incentives for business reorganization; and (11) incentives for social welfare

Computing the benefits of tax incentives and evaluating the extent of their effectiveness are not easy tasks. The benefits of tax incentives can be measured in terms of tax concessions per unit of tax revenue collected, benefit per dollar invested, effective tax rates, and cost of capital. Of course, since all these measurements are interrelated with each other, one can be translated into another.

While Korea's export take off started from an unusually low base, and was supported by a general expansion of world trade, it would not have been possible without decisive and innovative policies. These included a rationalized exchange regime, strong tax incentives, selective import liberalization, directed credit, and a host of finely tuned, export-promoting schemed. Any proper investigation into the effects of government policy on exports should take into account not only tax incentives but also other policy instruments.

In a study, Kwack evaluated the effectiveness of export incentives in promoting exports. One notable aspect of his study is that he provides a base for comparing effects of tax incentives, as explained in some detail above, with those of financial incentives. Kwack based his estimates of the effects of export incentives on the concept of cost of capital, as shown in <Table Ⅶ-17>. The effects of the tax and financial incentives are measured by variations in cost of capital when the incentives are individually or jointly introduced. The first four columns of <Table Ⅶ-17> show the cost of capital based on alternative assumptions about the nature of export incentives, while the last three represent the historical effects of export incentives. The first of the last three columns shows the aggregate effects of both tax and financial incentives because it represents the difference in the cost of capital without either tax or financial incentives, and the cost of capital with both. Likewise, the second-to-last column shows the partial effects of financial incentives, and the last column shows the partial effects of tax incentives.

Several interesting features can be observed from <Table Ⅶ-17>. First, measured in terms of the cost-of-capital effects, the export sector has been enjoying substantial benefits from the export incentive scheme. Second, the most lavish provision of export incentives was during the 1960s and 1970s, while the effects of the export promotion scheme were notably reduced. Third, the tax incentives to promote exports have played only a minor role, while financial incentives have assumed a major role in the export-led development process, as a comparison of the last two columns shows. The relatively strong effects of the tax incentives during the early 1970s was due to the existence of tax-free reserves. Fourth, the fact that in the 1960s the effects of the financial incentives were greater than the total effect means that, in that period, the tax incentives had actually had a negative effect on export promotion.

<Table Ⅶ−17> Effects of Export Incentives: Cost of Capital

(Unit: %)

Year	Reference Case(A)	All Incentives (B)	Financial Only(C)	Tax Only(D)	(A-B)	(A-C)	(A-D)
1960	40.61	22.58	20.80	38.41	18.02	19.80	2.20
1961	35.87	28.40	26.74	34.76	7.47	9.13	1.11
1962	35.78	24.95	23.63	34.83	10.38	12.15	0.95
1963	42.11	29.98	28.57	39.67	12.13	13.54	2.44
1964	42.56	32.73	29.26	38.21	9.83	13.30	4.36
1965	53.35	38.90	35.71	46.63	14.45	17.64	6.71
1966	63.44	46.89	42.29	53.58	16.55	21.15	9.87
1967	60.03	38.57	34.76	52.48	21.46	25.27	7.55
1968	62.29	37.39	31.95	51.74	24.90	30.34	10.55
1969	66.15	40.03	35.12	53.51	26.11	31.03	12.64
1970	61.85	35.08	30.35	50.74	25.77	31.51	11.11
1971	58.03	33.46	28.81	47.83	24.58	29.22	10.21
1972	42.96	29.28	25.25	37.36	13.68	17.71	5.60
1973	33.29	23.23	24.59	31.15	10.05	8.70	2.13
1974	35.28	21.97	23.23	32.88	13.31	12.05	2.40
1975	42.47	27.50	29.26	39.46	14.97	13.31	3.01
1976	44.94	30.85	32.73	41.85	14.09	12.21	3.09
1977	45.85	32.65	34.64	42.77	13.20	11.21	3.08
1978	54.03	35.88	37.92	50.45	18.15	16.11	3.57
1979	56.08	34.58	36.59	52.29	21.51	19.58	3.79
1980	52.38	32.35	34.11	48.96	20.02	18.27	3.42
1981	38.19	26.07	27.62	35.67	12.12	10.57	2.52
1982	48.09	35.10	36.84	45.48	12.99	11.25	2.60
1983	37.00	30.36	31.66	35.37	6.64	5.34	1.62
1984	35.83	29.93	31.22	34.26	5.90	4.61	1.56
1985	34.89	29.00	30.24	33.37	5.89	4.65	1.52
1986	33.84	28.40	29.62	32.37	5.44	4.22	1.47

Source: Taewon Kwack (1988).

2. Monetary Policy

The Korean government has depended heavily on monetary and credit policies for rapid economic growth. It has employed a fairly strict fixed interest rate policy in order to supply corporations with bank credits at low cost. This has been quite instrumental in promoting corporate investment and exports. At the same time, the government has also been concerned about the acceleration of inflation and has adopted monetary targeting for a long period of time. The contradictory policy measures inevitably led to strong government intervention in the allocation of financial resources.

Monetary policy, in general, has been accommodative and seems to have contributed greatly to Korea's economic growth. However, it gave birth to formidable problems and side effects: chronic inflation; an underdeveloped financial sector; concentration of economic power among a relative few; and very large conglomerates. Because Korea was a closed economy under authoritarian rule, these problems were underestimated and went unsettled. Today, the country is accelerating its democratization and is planning to open its financial and commodities markets.

Financial institutions in Korea can be divided broadly into banking and non-banking institutions. The banking institutions consist of commercial and specialized banks. Under the provisions of the General Banking Act and regulations of the Monetary Board, commercial banks regularly and systematically engage in short and long term financing, sales of commercial bills, securities investments, foreign exchange business, and other financial services, with funds acquired through liabilities offered in the form of deposits, securities, or other evidence of debt.

Most specialized banks were established in the 1960s in order to provide funds to particular sectors having no access to commercial banks due to restrictions specified in the General Banking Act.

Initially, these banks were expected to raise funds by relying mainly on the issuance of their own debentures and borrowings from the government. Gradually, however, they have become more dependent on deposits from the public.

Most of the non-banking financial intermediaries were established in the 1970s to attract curb market funds into the legitimate market and thereby help finance economic development plans. This sector has grown rapidly in both the number of institutions and volume, and recently their share of total deposits exceeded that of deposit money banks.

In response to the rapidly changing financial environment, there have been enormous changes in the structure of the financial system in recent decades, and these are reflected in the market shares of the different institutions. The market share of banking institutions has shrunk considerably while that of non-banking financial institutions in terms of total deposits in won currency shrank from about 79 percent in 1975 to around 42 percent at the end of 1990 while that of non-banking financial institutions jumped from about 21 percent to around 58 percent during the same period. In particular, the share of investment companies has risen rapidly. Similarly, the market share of banking institutions for loans and discounts dropped sharply from about 73 percent to about 49 percent from 1975 to 1990.

In Korea, the government has had tight control over financial institutions. Private institutions like commercial banks, let alone the specialized banks, are subject to extensive government intervention. Forms of control included: tight regulations and directives by monetary authorities; entry barriers; practical public ownership of banking institutions; and strict bank supervision.

The financial developments in Korea during the last three decades can be best understood in the following framework. Once the target rate of economic growth is set, the growth rate multiplied by the capital output ratio yields the required investment rate. The amount of realized investment equals the sum of domestic saving and external borrowing. Domestic saving is composed of planned private and public saving and the increase in monetary liabilities. Therefore the amount of realized investment in excess of planned private and public saving must be financed by the expansion of monetary liabilities and by borrowing from abroad.

<Table Ⅶ−18> Composition of Financial Savings (as of the year-end)

(Unit: %)

Year	Bank time & savings deposits including CDs	Nonbank deposits	Securities	(Public debentures)	(Stocks)	(Corporate bonds)	Inter-sectoral transactions
1972	70.0 (82.2)	22.2	13.2	9.3	3.1	0.8	5.4
1975	60.2 (65.8)	27.6	15.6	5.6	8.1	1.9	3.4
1976	57.7 (63.2)	31.3	18.0	4.6	10.4	3.0	4.2
1977	54.9 (60.1)	30.0	18.7	4.8	9.5	4.4	3.6
1978	53.1 (57.6)	30.0	19.1	9.9	6.1	3.1	2.2
1979	48.9 (53.3)	32.0	21.3	4.2	8.8	8.3	2.3
1980	45.9 (51.5)	37.8	21.8	4.8	7.2	9.8	5.4
1981	44.2 (49.8)	40.8	22.1	5.9	6.3	9.9	7.1
1982	41.4 (46.2)	45.7	24.1	8.1	5.8	10.2	11.2
1983	38.4 (42.6)	47.8	24.8	8.2	5.8	10.8	11.0
1984	36.4 (40.9)	50.7	25.1	8.5	5.8	10.8	12.1
1985	36.3 (42.3)	53.6	24.4	8.5	3.7	12.2	14.3
1986	34.5 (41.3)	56.9	25.0	8.3	5.3	11.4	16.4
1987	32.6 (41.8)	59.0	24.4	7.9	6.1	10.3	16.0
1988	30.2 (41.0)	59.9	26.8	6.8	10.8	9.2	16.9
1989	25.5 (38.4)	59.4	31.1	6.5	15.6	9.0	16.1
1990	25.6 (38.8)	60.3	29.9	6.3	13.3	10.3	15.8
1991	25.3 (38.9)	59.5	30.1	7.1	11.9	11.1	15.0
1992	24.7 (41.0)	64.2	27.9	6.8	10.6	10.5	16.7

Source: Bank of Korea, *Economic Statistics Yearbook*, 1992.

<Table Ⅶ−19> Trend of Growth, Investment and Saving in Korea

(Unit: %)

	1962-66	1967-71	1972-76	1977-81	1982-84	1985-91	1962-91
GNP growth rate	7.9	9.7	10.2	5.7	7.3	10.0	8.6
Investment ratio	16.3	25.4	29.0	31.0	28.2	32.7	27.4
Domestic saving ratio	8.0	15.1	20.4	25.5	24.8	34.8	22.1
Foreign saving ratio	8.6	10.0	6.7	5.6	3.2	2.1	6.0

Sources: Economic Planning Board, *White Book on External Debts*, 1988.
Bank of Korea, *The National Accounts*, various issues.

Within this broad framework, the financial sector was assigned the role of mobilizing sufficient financial resources and allocating them in such a way as to attain the growth target. In addition to ensuring sufficient financial resources and their effective allocation, the government attempted to maintain price stability. The task of maintaining price stability was carried out by meeting the target of various monetary aggregates. However, whenever a conflict arose between growth and price stability, the government chose growth at the expense of price stability.

Setting the target growth rate is a difficult job. It requires forecasting the real GNP growth rate, the tolerable inflation rate, and expected changes in velocity. Proponents of monetary targeting have argued that velocity is stable or predictable, but it turned out to be quite volatile.

In Korea, before the annual stabilization program or economic management program has been finalized, there has always been heated debate on the target growth rate. Usually, the Minister of Trade and Industry and the private sector argue that the preliminary target growth rate set by the Ministry of Finance and BOK is too low. Either the Minister of the Economic Planning Board or the Senior Presidential Counselor will play the role of coordinator to reach a compromise. From the 1960s through the 1970s, the target rates were also subject to IMF consultation.

Technically, at the BOK, both micro and macro methods have been employed in setting target growth rates. At the macro level, the EC method or a modified version of the Fisher equation were used to calculate the target rates[43]. In addition, more complicated forms of money demand equations were also employed for this purpose, making use of expected changes in real and financial variables. At the micro level, the BOK prepared sources and uses of funds tables. The tables represented expected demand for funds in major sectors for the coming year. Once the target rate was set, it was announced around the end of the year together with other economic goals of the government. The BOK then employed all its instruments to meet the targets.

43) According to the EC method, the monetary growth rate should be equal to the sum of the real GNP growth rate and tolerable or target inflation rate. The method is ignoring the possibility of changes in velocity of money.

<Table Ⅶ−20> Nominal And Real Interest Rates

(Unit: %)

Year	Nominal rate of [1] time deposit	Inflation rate [2]	Real rate
1962	15.0	18.4	-3.4
1963	15.0	29.3	-14.3
1964	15.0	30.0	-15.0
1965	18.8	6.2	12.6
1966	30.0	14.5	15.4
1967	30.0	15.6	14.4
1968	27.6	16.1	11.5
1969	24.0	14.8	9.2
1970	22.8	15.6	7.2
1971	22.2	12.5	9.7
1972	15.7	16.7	-1.0
1973	12.6	13.6	-1.0
1974	14.8	30.5	-15.7
1975	15.0	25.2	-10.2
1976	15.5	21.2	-5.7
1977	16.2	16.6	-0.4
1978	16.7	22.8	-6.1
1979	18.6	19.6	-1.0
1980	22.9	24.0	-1.1
1981	19.1	16.9	2.2
1982	11.0	7.1	3.9
1983	8.0	5.0	3.0
1984	9.3	3.9	5.4
1985	10.0	4.2	5.8
1986	10.0	2.8	7.2
1987	10.0	3.5	6.5
1988	10.0	5.9	4.1
1989	10.0	5.2	4.8
1990	10.0	8.9	1.1

Notes: 1) Average annual rate of 1-year time deposits.
2) Rate of change in GNP deflator(annual rate).
Source: Bank of Korea, *Economic Statistics Yearbook*, 1992.

<Table Ⅶ−21> Allocation of Bank Loans[1] and Output Share by Industry

(Unit: %)

	Loans(A)			GDP(B)			A/B		
	1970	1980	1990	1970	1980	1990	1970	1980	1990
Agr/fish/mining	12.6	7.8	6.6	28.0	16.2	9.6	0.45	0.48	0.69
Manufacturing	46.1	53.8	44.0	21.3	29.7	29.2	2.16	1.81	1.51
(HCI: C)	(22.6)	(32.1)	(30.2)	(8.5)	(16.5)	(18.1)	(2.63)	(1.95)	(1.67)
(Light: D)	(23.5)	(21.7)	(13.8)	(12.7)	(13.2)	(11.1)	(1.85)	(1.64)	(1.24)
C-D	-0.9	10.4	16.4	-4.1	3.3	7.0	0.78	0.31	0.43
Power/construction	12.7	14.6	9.3	6.5	10.4	15.4	1.95	1.40	0.60
Service[2]	28.6	23.8	40.1	44.2	43.7	45.8	0.65	0.54	0.88
Total	100.0	100.0	100.0	100.0	100.0	100.0			

Notes: 1) Bank loans include loans from the DMB and the KDB.
2) Service sector includes wholesale, retail trades, hotels, transportation, real estate, recreational and entertainment business.

Sources: Bank of Korea, *Monthly Bulletin*, various issues.
Korea Development Bank, *Monthly Bulletin*, various issues.

To allocate financial resources in a manner that is perceived to be desirable on social and economic grounds, the government authorities first have to control the interest rates on loans to keep them below a market = clearing level. Low interest rates generate an excess demand for credit supplied by the regulated financial institutions. The excess demand, in turn, requires either the government or the management of the financial institutions to ration the available supply of institutional credit to borrowers according to a set of loan allocation criteria. Second, the government authorities will have to exercise the credit-rationing power to effect a desired allocation of resources. This exercise often necessitates government ownership (or control over the management) of banks and nonbank financial institutions. Third, the government will have to institutionalize a system of credit rationing.

Monetary accommodation - that is, easy credit to export industries resulting in a rapid expansion of the money supply - was a logical consequence of the government's use of the financial system and policy as a means of intervening in the allocation of resources. As a result, the scope of monetary policy as an instrument of anti-inflationary policy was severely restricted. The majority of subsidies to preferred industries had been financed by borrowings from the central bank, and these borrowings were immune to stabilization policy. In addition, a large fraction of bank credit had been earmarked in the form of "policy" or "directed" loans for strategic industries and uses. These loans thus escaped from monetary tightening.

Government control over financial institutions also complicated the effective management of monetary policy. With government control, deposit-money banks, which dominate Korea's financial system, have been no more than a banking bureau of the government. Their main role was to allocate deposits and new credit supplied by the central bank to the sectors and industries and often to individual borrowers designated by the government.

Under these circumstances the portion of lendable resources the banks could allocate under their own discretion was greatly limited. In recent years more than 50 percent of the deposit-money banks total loans could be classified as "directed" policy loans whose volume and allocation were determined by the government itself, often independently of monetary stabilization. To the extent that the government attempts to mobilize domestic resources by means of excessive credit creation and inflation, it becomes logical and perhaps unavoidable to allow continuous rollovers of short-term loans and the accumulation of overdue loans when the deposit-money banks are confronted with a huge chronic excess demand for loans.

The large share of "directed" loans and the practice of rollovers have made deposit-money banks' portfolios extremely illiquid. This illiquidity has made it difficult for the banks to adjust their asset portfolios in response to changes in financial market conditions or monetary policy. Thus, credit tightening has elicited little response from the banks in the short run and has become ineffective as an anti-inflationary measure.

<Table Ⅶ−22> Share of Policy Loans[1] of Deposit Money Banks

(Unit: %)

	1973-81	1982-86	1987-91	1973-91
Government fund	7.2	7.2	6.9	7.1
National Investment Fund	4.7	5.0	2.6	3.9
Credit to KDB/KEXIM	4.0	2.1	13.7	6.6
Foreign currency loans	20.3	19.3	16.7	18.8
Export loans	20.4	16.5	4.5	13.8
Commercial bills discounted	7.7	13.6	14.2	11.8
Special funds for SMC	5.7	5.5	5.6	5.6
Loans for Agriculture and Fishery	5.9	5.2	6.4	5.8
Housing loans	7.7	12.8	12.2	10.9
Others[2]	16.9	12.8	17.3	15.6
Policy Loans Total	100.0	100.0	100.0	100.0
Policy Loans/Total Credit	65.6	60.7	69.0	65.1

Notes: 1) Figures are annual averages.
2) It includes loans for import of key raw materials, loans on mutual installment, loans for machinery, equipment loans to export industry, special equipment funds, special long-term loans.

Sources: National Statistical Office, *Korean Economic Indicators*, various issues.
Bank of Korea, *Monthly Bulletin*, various issues.

It is not easy to define policy-based loans in Korea. In the situation where all major banks were owned by the government, and the interest rates of bank loans were set substantially lower than the market rate, all bank loans could be potentially policy loans[44]. There have been essentially two ways of generating credit supports for priority industries. The first one is through explicitly ear-marked credit programs such as export credit, National Investment Fund, credit programs for agriculture, fisheries, small and medium corporations, and etc. These loans are based on the explicit programs, setting the eligibility of borrowers at preferential rates.

The second one is through government directives, administrative guidance, and ad hoc interventions. These loans are not specifically ear-marked; their conditions are the same as general bank loans, with no preferential rates. But in the presence of excess demand for loans and severe credit rationing, the allocation of bank credit itself was a great favor. In Korea, the banks were under government control and the loans allocated by the government's discretionary interventions were substantial (i.e., the second type of policy loans), if not more than the loans allocated under explicit programs. These loans are usually provided, based on the government assessment of the progress of specific key projects and constraints faced by specific firms or industries[45]. The decisions are usually based on the government consultation with business sectors and close monitoring of the progress of the project.

In Korea, what contributed most to the effectiveness of credit policies seems to be "good economic management" and "competitive business environment." Other factors, which we discuss in the previous Chapter and the following Chapter, also contributed; but they are also linked to these two factors. For example, Korea had favorable international environments; but how fully such opportunities could be seized depended on the type of management in both government and firm level. Clearly focussed industrial goals and macroeconomic environment which were conducive to the effective operation of credit policies also owed to good economic management. In Korea, close consultations between the government and business and the government risk partnership with business made what could have been a very distortive interventionist approach quite an effective

44) But, of course, the government did not direct all of bank loans.

development strategy.

According to our observations, it was not specific selective credit programs as such that contributed to overcoming market imperfections and helped the growth of industries in Korea. But, more broadly, it was the control over finance and the use of it as industrial policy instruments and corporate governance that contributed to rapid industrialization and growth. The government, through control over finance, became an effective risk partner as well as monitor of business. Selective credit programs are established and continuously adjusted in the process of close government-business consultations. The government did not simply provide selective credit programs; it ensured that the programs worked to help the exporters and industrial producers. When it was deemed that additional policy measures were necessary to help them succeed, it took such measures by correcting exchange rates, building infrastructure, extending tax exemptions, and sometimes, taking extraordinary measures such as the August 1972 Emergency Decree. Market imperfections were addressed in this way rather than simply providing preferential credit programs and interest rate subsidies. They too were provided, but the government role went beyond that.

The Korean experience of finance and development suggests that the government can play an important role in laying the ground for rapid industrialization in the early stage of economic development. If government involvement in the credit allocation is based on close consultations with industry, and if it is implemented under competitive business environments, it can be reasonably successful in overcoming financial market imperfections, and thereby contributes to rapid industrialization. When the risk capital market was poorly developed, the Korean government coordinated a close relationship between banks

45) Financial packages to rescue troubled firms or industries includes large-sum of this second type of policy loans.

and industry through its control over bank management, became effective risk partner of industry. This government-industry-banks implicit co-insurance scheme allowed the credit-based economy and its highly leveraged corporate firms, to explore risky investment opportunities and to operate without major financial crisis.

But the Korean experience also suggests that the cost of this approach could be substantial and would increase as economic development advances. The Korean approach has been effective in achieving rapid industrialization, but it interfered with the efficient development of the banking system. The government's risk partnership with industrial firms put a heavy burden on the banking system with large nonperforming loans, and raised social equity issues. The extensive government interventions in finance, especially the low interest rate ceilings, slowed the growth of financial savings. Korea was able to overcome this negative impact of government intervention through heavy foreign borrowing. Korea's special relationship with U.S. and Japan helped her ready access to foreign borrowing. Furthermore, the continuation of strong government intervention in credit allocation when the industrial sector was well established and economic organizations became sophisticated, put itself in a greater risk of distortive allocation. The co-insurance practices between the government, industry and banks, fostered moral hazard of banks and firms despite its contribution to the development of entrepreneurship and expansion of industrial investment. Consequently, the government became captive of a vicious circle of interventions. It also became captive of its own bureaucratic interests.

Ⅳ. Economic Institutions and Economic Management System

The role of the government in Korea's industrialization exceeded that of setting the right policy direction and incentives. The political leadership was committed to economic development, which was translated into action by an efficient bureaucracy and by private firms, creating a climate conducive to the conduct of business. This alliance between business and government was supported by a set of strong institutional mechanisms.

The dynamics and inner the workings of industrialization have been reflected in and integrated into development planning, and it is widely held that Korea's rapid economic growth has been greatly aided by its successful development planning. It would thus be worthwhile to review the development planning efforts of the government, with special emphasis on their orientation, organizational structure, and actual performance.

After some unsuccessful attempts to formulate a medium-term development plan during the past-Korean War reconstruction period, Korea formally adopted its First Five-Year Economic Development Plan(1962-66) in 1961 and began implementing it in 1962. Since the launching of the first plan, Korea has formulated and completed five additional ones. Korea is currently implementing the Sixth Five-Year Economic and Social Development Plan(1987-91).

1. Political Leadership and Ideology

Development plans and strategies exist in almost every developing country. What is unique in the case of Korea has been its ability to put the plans and strategies into practice.

For all the incentives to be correct, for the administrative arrangements guaranteeing access to those incentives to be efficient, and for the institutional mechanisms for adjusting those incentives to be effective, there had to be a strong political commitment to development and an able bureaucracy. This was precisely the case in Korea.

The Korean War and the subsequent poverty left a deep impression on Koreans who desired to improve their social and economic status. The “growth first” ideology also came from the geopolitical reality that Korea would have to become economically self-reliant in order to defend itself against aggression from the north, as well as from the fact that foreign aid was dwindling. Therefore, Korea needed only an effective mobilization of its resources and a fuller expression of the longings of its people. It was the leadership’s commitment to development and development plans that provided the opportunity for these.

One characteristic of the Korean approach to policy planning with regard to industrialization was that, except for their commitment to anti-communism, political leaders and the general public alike seemed pragmatic and displayed no ideological bias. The pragmatism that prevailed in the policymaking process allowed the government to use all available instruments to achieve its goals. In the policy planning process, particularism also prevailed, permitting the government to apply a certain policy to a limited number of clients in a specific situation. Pragmatism with no ideological basis also had the drawback of causing frequent changes in policy, which reduced public confidence in the government’s economic leadership.

2. Institutional Framework for Development Planning and Economic Management

Long-term development planning and the formulation of short-term economic policies require organizations and institutions to gather information, formulate, implement, and evaluate policies, and bring about the consensus necessary for success.

The leadership's commitment to economic development was reflected in the various organizational reforms that were aimed at institutionalizing policy formulation. The first attempt was the establishment of the Economic Planning Board(EPB) in 1961, which was responsible for economic planning, central budgeting, foreign capital management, and statistics, and had the authority to coordinate policies and programs of all the economic ministries. Since 1963 the minister of the EPB has concurrently served as the deputy prime minister, under whose jurisdiction both economic planning and budgeting functions fall in order to narrow the gap between planning and implementation.

The EPB is a central planning organization, but it cannot prepare and implement a development plan without the collaboration of the relevant ministries. Each ministry participates in planning through its Office of Planning and Management, which is a higher-level organization than the bureau and reports directly to the minister. The office handles both development planning and budgeting for its ministry and is responsible for monitoring performance and evaluating the ministry's projects and policy measures.

In line with the greater emphasis on economic planning, the Office of Planning and Coordination was established under the prime minister in 1961 and has since been responsible for assisting him in monitoring the performance of major projects and policies.

The private sector has been concerned not only with the government's long-term development plans, but also its short-term economic management policies, which may or may not be connected to the implementation of a development plan. In either case, policies have directly influenced decision-making in the business sector.

Short-term government policies are addressed to areas such as aggregate demand management, taxes, exchange rates, interest rates, preferential credit, farm prices, and industrial promotion. They are normally initiated or designed by officials at a relevant ministry. For instance, short-term proposals that concern aggregate demand management, taxation, exchange rates, and interest rates are normally prepared by the Ministry of Finance in consultation with the central bank and other related ministries. Farm price policy is, of course, the responsibility of the Ministry of Agriculture and Fisheries. These policy proposals have to be reviewed by and coordinated with other related government agencies. Before the president's final approval is granted, therefore, the proposals have to be approved at the Economic Ministers Meeting, which is comprised of the ten economic ministers and the deputy prime minister as chairman.

In case requiring emergency economic measures, policy proposals are not necessarily prepared by the relevant ministry officials, but sometimes by a small number of elite officials who access to the president and wish to promote certain ideas. If the group succeeds in persuading the top decision-maker that a certain policy should be adopted, proposals are worked out quickly (and usually secretly) and then reported directly to the president without going through the normal channel of the Economic Ministers Consultation Meeting. If the president accepts the proposals, the decisions are sent to the appropriate ministry for the formal process of cabinet approval, announcement, and implementation.

Even in normal circumstances, when policies are discussed at the Economic Ministers Consultation Meeting, the actual policymaking process involves a relatively small number of government officials. Although a ministry might have a special committee for the deliberation of certain policy issues and a few private experts might participate in such a committee, the committee is usually believed to function as a rubber-stamp body. Since Korea's economic policymaking appears to involve only a small number of government officials, it is able to produce policy decisions rapidly.

The president himself chairs various meetings, of which a representative sample might include the monthly Economic Review Meeting, the Monthly Trade Expansion Meeting, and the Quarterly Science and Technology Promotion Meeting. These are attended not only by policymakers, but also by business and political leaders. Furthermore, the meetings serve as a mechanism for sharing information and enhancing coordination among the ministries and between the government and the private sector.

3. Collaborative Efforts by the Government and Business

Since the institutional framework for economic decision making is crucial to economic development and a fundamental part of that framework is the relationship between business and government, it is necessary to explore this relationship in detail in order to understand Korea's high economic growth.

There are difference in opinion with regard to the roles the government and the private sector have played separately and collaboratively in promoting industrial development in Korea. Some orthodox economists believe that Korean industry has succeeded in spite of the government's industrial policy and development planning and not because of it. They reject the view that the high economic growth in Korea is the result of government intervention in the economy. Others, however, ascribe Korea's success to the role of a strong and effective government in guiding and coordinating the directions of industrialization, while operating within a basically market-oriented system.

All Korean governments since independence in 1945 have been committed to maintaining an economy in which the private sector played a central role. Therefore, planning in Korea played the role of providing little more than a framework, leaving most practical decisions in the hands of the private sector. Thus, plans were supposed to point out directions, offering incentives to those who complied, but not forcing anyone to do so.

The importance of entrepreneurship in Korea's rapid economic growth should be emphasized. While the general environment favored enterprise, it was the business leaders who seized the opportunities. Talented entrepreneurs could not have been closely guided and directed by a cadre of civil servants, no matter how well educated. The development plans were masterminded by the government, but were ultimately executed by private entrepreneurs. The public, as a whole, was receptive to the entire scheme. Policies and targets were set by the government, but private business leaders were consulted before and after the decisions were made and, as already noted, decisions could be changed if the desired results did not follow. In soliciting the fullest cooperation of the private sector, the government resorted not only to material, but also to moral suasion, examples of which are numerous. The top government priorities - economic growth, industrialization, and export growth - and a whole array of incentives were widely publicized. In many instances, the government did not leave things entirely to the good will of entrepreneurs. Business were often urged to raise their own internal targets annually.

A more complex approach is required than the reasoning associated with a simple government-market dichotomy. The basis of Korea's success has been a collaborative effort by the government and private firms. It is not due either to purely private or purely public economic decision-making. The combined efforts and the concordance between personal initiative and public action have been responsible for Korea's economic achievement.

Collaborations was managed through industrial discussion groups and monthly export promotion meetings. These industrial groups and monthly meetings consisted of representations from the industry, the bureaucracy responsible for the industry, and, academic and research institutions. Together these groups formulated and recommended plans for industry based on information pulled and shared among themselves. Meetings were held regularly in order to update information base, kept track of new developments in and out of the country, and recommended changes when the market condition so dictated.

In a pure market model, information is transmitted indirectly through price signals, because of bounded rationality and asymmetry, the information is not likely to be utilized to a maxim degree. The industrial groups and monthly meetings provided a means to partially circumvent these problems, and enabled the bureaucracy to formulate plans and programs that maximized use of information. The bureaucracy was able to monitor more closely what happened in the market place and adopt more quickly to changes. It was also able to internalize simultaneous and sequential externalities which otherwise would escape the decision calculus of the private sector. However, it is important to note that the bureaucracy did not supplant the market as the coordination of economic activity. It acted to complement the market by synthesizing the different pieces of information that the business firms had about their respective industries and translated them into coordinated plans among the industries.

V. Concluding Remarks and Lessons

The primary reason for Korea’s rapid economic progress since the early 1960s has been the concentration of energies on a single purpose: economic development and industrialization.

While not all aspects of the Korean experience could or should be repeated elsewhere, it does provide some broad lessons, many of which may prove relevant to the economic management of other developing countries, such as the importance of Korea’s outward-oriented development strategy. The Korean government attempted to promote economic growth even in the absence of evidence about the merits of the strategy or the comparative advantage of labor-intensive manufactured exports as an outlet for Korea’s massive unemployment.

Before its economic “take-off” in the early 1960s, Korea was a highly regulated economy. Furthermore, Korea had been an inward-looking society for over several centuries. This tradition had remained basically unchanged even in the 1950s when the country was rebuilding itself from the ruins of the Korean War. The basic strategy guiding the reconstruction efforts then was one of import substitution. Basic shifts in the attitude and the institutions from an inward to an outward orientation have been therefore a constant theme in Korea’s development efforts over the past three decades.

With this in mind, one might suggest at least seven general lessons. The first of these relates to the merits of an outward-looking development strategy. By now, the merits of outward-looking development are well known. As a country engages actively in world trade, it can make use of its comparative advantages. As a country sells its products in the world market, it can take advantage of economies of scale. As the country opens itself to the outside world, it has numerous opportunities to make use of capital and technologies from abroad. In addition, as a country tries to develop by selling its goods in the highly competitive international market, it is under greater pressure to innovate or perish. This results in more dynamic technological progress. Finally, as a country actively engages in world trade, its entrepreneurs acquire not only more information regarding business opportunities abroad but also more know-how for exploiting these opportunities. Over time, this enables the economy to become more adaptable to changes in the external environment. Without all the advantages of an outward-looking development strategy, Korea's economic progress to date would have been impossible.

A second and related lesson has to do with the need to reaffirm the role of the market. Scarce resources were allocated by basically correct market price signals on the initiatives of energetic entrepreneurs operating in a competitive environment. The government's role was to let businesses exploit favorable opportunities by providing appropriate incentives and eliminating disincentives for their activities. Although it exerted a pervasive influence on activities of private firms and the use of economic resources, the government allowed free competition to reign whenever possible.

For a small developing country committed to an outward-oriented growth strategy, prices are determined in the international market. This means that the government cannot arbitrarily change prices to cover the consequence of inefficient allocation of resources provided by the government to the favored industries or firms. Because of this externally imposed constraints, an inefficient allocation of credit and tax subsidies supporting wrong projects or programs at the firm level results in financial losses and even in bankruptcies. Therefore, the government as well as individual firms will be forced on average to correct their pattern of resources mobilized in favor of them. In fact, this is the case for Korea. At the same time, the commitment to the export-led strategy means that individual firms are subject to market competition which insures the survival of only those that choose on average the right products and production techniques.

As market competition is necessary to ensure the survival of efficient firms, so competition is necessary to ensure that political regime committed to economic growth make efficient allocation of resources. This was true of the extremely authoritarian regime of the Korean government whose survival and legitimacy depended critically on how well the economy performed. For the political regime, such competition is secured only if it is exposed to competitive forces in world markets. For these reason, it is essential that any country be committed to an outward-oriented strategy for economic success.

With regard to the importance of the role the market plays, Korea has learned from its own experiences. The structural imbalances that developed in Korea's industries in the late 1970s were caused in part by the arbitrary selection of strategic industries and the distorting policies supporting them. As the economy grows in size and complexity, excessive intervention by the government is not a good substitute for the market mechanism, which is a better means of achieving efficient allocation of resources. The increasing complexity of the Korean economy demands greater decentralization of economic decision-making, with more autonomy given to the private sector and greater reliance placed on the market. At the same time, the growing concentration of power in the hands of giant corporations demands more effective government control over monopolistic abuses of the market.

The third, and perhaps one of the most critical lessons is concerned with the importance of maintaining price stability through macroeconomic balance. If excess aggregate demands are allowed to develop, prices are bound to rise. This will increase the demand for imports from abroad leading to balance of payments difficulties. In addition, once prices start rising, inflationary expectations are formed, and the relative price structure becomes distorted. With a distorted price structure, prices can no longer serve as correct signals for the efficient allocation of resources. With inflation and a distorted price structure, income distribution deteriorates - a development highly detrimental to social and political stability. With a lack of social and political stability, the inflow of foreign capital and technology drops. The final result is that integration into the world economy becomes an impossible task.

The fourth lesson has to with the importance of developing financial institutions. In the final analysis, a country's economic development depends on the level of savings, and how efficiently these savings are utilized for investment. In any market-oriented economy, these functions are performed by financial institutions. Korea's experience clearly shows that whenever its financial institutions were allowed to perform their functions with minimum interference from government, both high growth and price stability were achieved, while this was not the case when the opposite was true. Events of the 1960s and the early 1980s support the former while events of the 1970s and the most recent several years support the latter.

The fifth lesson is concerned with investment in human capital, namely, education. In the long run, the capacity of an economy to continue to grow depends critically on its ability to absorb and develop new technologies, and such capacity stems from education. Apart from this role, education permits a country to reap continually the benefits of increasing returns. Without good education, the country will soon run into decreasing returns and face economic stagnation.

In this regard, Korea has been lucky. On the eve of its economic take-off in the early 1960s, the level of education in Korea was unusually high compared to other comparable countries. Furthermore, Korea has continued to invest an unusually high percentage of its GNP (8~9%) in education. However, it is now time for Korea to make better use of its large educational investment by reforming its educational system in such a way that the system will produce a greater number of people with more creativity. Otherwise, the country will have little chance of winning in the global scientific and technical race ahead.

The sixth lesson relates to the utilization of manpower. As already noted, in the 1960s, Korea relied heavily on the operation of a competitive labor market for the efficient utilization of human resources, and the results were very satisfactory. The competitive labor market ensured both a maximum absorption of the labor force into employment and a high mobility of labor.

In the 1970s, a significant departure was made from such a policy. As substantial gaps developed between the wages of skilled workers in HCIs and those of non-skilled workers in non-HCIs, the government took measures to boost wages for the non-skilled workers. This greatly undermined Korea's export competitiveness.

The government policy on labor in the early 1980s can be seen in large measure as an attempt to resolve this problem. Thanks to the stringent set of new labor laws adopted in 1980, wage increases were restrained within the bound of improvement in labor productivity. This helped the country regain its competitiveness. However, this objective was attained at the expense of worker satisfaction, which eventually led to the eruption of labor disputes on an unprecedented scale in 1987. In the face of such an eruption, the government had no option but to undertake a reform which was much too pro-labor in character. Needless to say, such pro-labor policies have been extremely costly to the nation as a whole.

The proper policy lesson one might draw from the Korean experience in the labor field seems to be that insofar as possible, a nation should rely on the operation of a competitive labor market for an optimal utilization of manpower. If this is not feasible due to the presence of either a monopsony or monopoly power, however, the government should permit the emergence of a countervailing force.

The penultimate lesson goes beyond economics. The critical condition for economic development in any country is political and social stability under effective political leadership strongly committed to development. Without such stability, it is impossible for entrepreneurs to plan ahead and undertake investments for the future. The rapid growth in Korea in the 1960s would not have been possible without the social and political stability provided by the new government that came into power in 1961. For that matter, the speedy recovery and regaining of competitiveness in the mid-1980s would not have come about if the country had failed to restore social stability in the early 1980s. By the same token, there is no doubt that the basic cause for the decline in Korea's competitiveness in recent years had much to do with the weak political leadership that befell the country. In light of such experience, the importance of political stability under effective leadership cannot be overemphasized.

Korea's system has one weakness that other developing countries should avoid in their policymaking: it lacks a consensus-building process. Although the government tried to build a consensus in policymaking, not only within the government but also among various sectors of the society with different interests, Korea essentially failed in this. Important policy decisions were often made by a small number of bureaucrats or government officials without much public debate. Hasty decision-making without public support produced many policy reversals. The lack of understanding and positive participation on the part of the people made it difficult for some policies to be successfully implemented, indicating a need for more refined ways of building a national consensus.

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Chapter Ⅷ. The Changing Role of the State in Asia

Ⅰ. Introduction

1. Role of the State

The role of the state in the economy or the relationship between the state and the economy is one of the oldest topics in economics, yet controversies still rage with passion and camps are divided on old lines even today. However, the experiences of state activism during the last four decades or so, give us some fresh perspectives in looking at some of the old issues.

Just how influential any government is in the country's economic development is a point of considerable debate. It is a difficult question to assess since opinions on the government's role differ because of different attitudes with regard to the relationship between the individual and the state, and also, the different views on the relative importance of various causes for the country's economic success.

Early development economists recognized the role of government in providing "social overhead capital" or "infrastructure" to facilitate economic development. However, most analyses focussed on a second role : government should, they believed, undertake activities that would compensate for market failures.

Although the market operates inadequately in many spheres, it performs an important function in disciplining producers against the wasteful use of resources. In a changing world the required institutional changes in markets do not always take place automatically. The state can play an important role in prompting and supporting the right kind of market institutions.

The purpose of this chapter is twofold: to summarize the facts about the role of the state in Asian countries and to examine the relationship between the state and economic performance. This chapter deals with the role of the government in Asian countries primarily with regard to fiscal and monetary policies. The concluding section contains a discussion of some major findings and broad lessons.

2. The Story of the East Asian Miracle

Before undertaking our own study on the role of the state in Asia, it would be helpful to summarize the story told by one well-known institution on a similar subject.

The World Bank's recent Policy Research Report, The East Asian Miracle(1993), based on the experiences of eight high performing Asian economies(HPAEs), interprets East Asian growth through neoclassical, revisionist, and market-friendly lenses. The countries covered by the World Bank's study include Japan, Hong Kong, Korea, Singapore, Taiwan, Indonesia, Malaysia, and Thailand.

The neoclassical view is that growth is best ensured by allocating resources through markets in the context of macroeconomic stability and limited inflation. The revisionist view "sees market failure as pervasive and as a justification for governments to lead the market in critical ways"(p. 83). The market-friendly view is that "the appropriate role of government is to ensure adequate investment in people, provision of a competitive climate for enterprise, openness to international trade, and stable macroeconomic management"(p. 84). It recognizes both market failure and government failure(p. 84).

The World Bank report listed "positive lessons" as follows: keep the macroeconomy stable; focus on early education; do not neglect agriculture; use banks to build a sound financial system; be open to foreign idea and technology; and let prices reflect economic scarcity.

The most interesting and compelling part of the story is the role of basic education in enhancing the quality of labour. This is complemented on the demand side by a pattern of export-led growth which made productive use of labour, the poor’s most important asset. The stronger performance on education plus a high savings rate provided the bulk of the supply-side capital and labour accumulation for Asia’s miracle. Exports, meanwhile, delivered the demand side along with the discipline of market prices.

The World Bank report emphasizes that basic education is necessary for rapid growth. Growth is necessary for persistent reduction in poverty. Adjustment is necessary for the resumption of growth. And fiscal and monetary restraints are necessary components for the adjustment. These conditions, met in the success stories of the past twenty-five years, cut across diverse experiences and have withstood the test of time. But the necessary conditions are not sufficient.

HPAEs have also been unusually successful at sharing the fruits of growth. The HPAEs enjoyed much higher per capita growth at the same time that income distribution improved by as much or more than in other developing economies, with the exceptions of Korea, and Taiwan, which have begun with highly equal income distributions. The HPAEs are the only economies that have high growth and declining inequality.

According to the World Bank report, technological spillovers, contrary to what is sometimes claimed, do not satisfactorily explain much of the rapid East Asian growth. Measured total factor productivity for many of the East Asian countries does not account for more than 20 to 30 percent of GDP growth.

3. Sample Countries and Major Economic Indicators

There are 37 regional member countries under the Asian Development Bank. The sample countries covered in the present paper consists of 20 countries in Asia. Countries such as the Maldives and the South Pacific Islands, for which no reliable consistent data are available, have had to be excluded. The chosen composition of the sample countries as well as the sample period were largely determined by data availability. <Table Ⅷ-1> provides a summary of the major economic indicators for the sample countries.

The countries covered in this paper represent a highly diversified group, with the mid-1992 population ranging from a low of 1.5 million in Bhutan to a high of 1,162.2 million in China, as shown in <Table Ⅷ-1>. This diversity also applies to income and wealth in the region, with GNP per capita ranging from $170 in Nepal to $28,190 in Japan, in 1992. In terms of annual growth of total GDP between 1980 and 1992, Korea grew the fastest at 9.4 percent, followed by Taiwan at 7.6 percent, the Philippines and Myanmar, oddities, at 1.2 and 0.6 percent, respectively. The structure of the economy exhibits a substantial difference, though not shown in <Table Ⅷ-1>. The share of the agriculture in the total 1992 GDP in two city states was none, only 2 percent in Japan, and 8 percent in Korea, while in Myanmar, agriculture contributed 59 percent to total GDP in 1992.

<Table Ⅷ-1> shows the rates at which Asian economies grew in the last twenty years or so. There is a big spread of observed growth rates among countries. Differences in growth rates, measured in terms of the increase in gross domestic product span 7.5 percentage points during 1970-1980 and span 8.8 percentage points during 1980-1992.

<Table Ⅷ−1> Major Economic Indicators

Countries	Population (millions) (1992)	Per Capita GNP(dollars) (1992)	Average Annual Growth Rate of GDP(%)		Average Annual Rate of Inflation(%)		PPP Estimated per Capita GNP(US=100)	
			1970-80	1980-92	1970-80	1980-92	1987	1992
Low-income economies								
Nepal	19.9	170	2.7	5.0	8.5	9.2	4.3	4.8
Bhutan	1.5	180	-	6.9	-	8.7	2.7	2.7
Bangladesh	114.4	220	2.3	4.2	20.8	9.1	5.1	5.3
Lao PDR	4.4	250	-	-	-	-	7.5	8.3
India	883.6	310	3.4	5.2	8.4	8.5	4.6	5.2
Pakistan	119.3	420	4.9	6.1	13.4	7.1	8.3	9.2
China	1162.2	470	-	-	-	6.5	6.5	9.1
Sri Lanka	17.4	540	4.1	4.0	12.3	11.0	11.1	12.2
Indonesia	184.3	70	7.2	5.7	21.5	8.4	10.5	12.8
Myanmar	43.7	-	4.7	0.6	11.4	14.8	-	-
Middle-income economies								
Philippines	64.3	770	6.0	1.2	13.3	14.1	10.9	10.7
Papua New Guinea	4.1	950	2.2	2.3	9.1	5.1	8.6	8.7
Thailand	58.0	1,840	7.1	8.2	9.2	4.2	17.2	25.5
Mongolia	2.3	-	-	-	-	-	-	-
Upper-middle-income economies								
Malaysia	18.6	2,790	7.9	5.9	7.3	2.0	26.6	34.8
Korea, Rep.	43.7	6,790	9.6	9.4	20.1	5.9	28.8	38.7
High-income economies								
Taiwan, China	20.7	10,200	9.7	7.6	10.4	4.5	-	-
Hong Kong	5.8	15,360	9.2	6.7	9.2	7.8	74.4	86.7
Singapore	2.8	15,730	8.3	6.7	5.9	2.0	55.7	72.3
Japan	124.5	28,190	4.3	4.1	8.5	1.5	74.9	87.2

Sources: World Bank, *World Development Report 1994*, Oxford University Press, 1994.
Republic of China, *Taiwan Statistical Data Book*, 1994.

<Table Ⅷ−2> Level and Growth Rate of Real Per Capita GDP

(Unit: $, %)

Countries	Level of Real Per Capita GDP				Real GDP Per Worker	Growth Rate of Per Capita GDP		
	1960	1970	1980	1985	1985	1960-73	1973-80	1980-88
Nepal	345	359	405	729	1,771	0.2	1.9	1.2
Bangladesh	355	370	432	700	2,441	-1.0	3.1	0.8
India	428	450	498	870	2,059	0.2	0.0	2.8
Pakistan	404	564	663	1,790	5,162	1.9	1.3	4.0
China	-	-	-	2,472	3,823	2.3	3.7	7.8
Sri Lanka	961	765	838	2,120	5,259	-0.1	2.1	3.1
Indonesia	-	-	-	1,822	4,404	-	6.7	2.3
Myanmar	248	320	359	659	1,458	2.2	3.2	3.2
Philippines	644	781	1,022	2,168	5,431	2.5	3.2	-0.5
Thailand	486	791	1,181	3,282	5,532	3.8	4.2	3.8
Malaysia	888	1,242	2,204	5,070	11,945	3.9	6.0	0.8
Korea Republic	631	1,112	2,007	5,682	12,275	6.7	5.2	6.9
Taiwan, China	733	1,298	2,522	6,528	13,524	7.5	6.3	5.3
Hong Kong	919	2,005	3,973	14,014	25,006	7.0	5.9	6.0
Singapore	1,054	2,012	3,948	10,417	21,735	6.4	6.1	4.9
Japan	1,674	4,215	5,996	13,645	24,417	8.7	2.7	3.0

Sources: Robert Summers and Alan Heston, "The Penn World Table(Mark 5): An Expanded Set of International Comparisons, 1950-1988", *Quarterly Journal of Economics*, May 1991, pp. 357~358.
Robert Summers and Alan Heston, "Improved International Comparison of Real Product and Its Comparison, 1950-80", *Review of Income and Wealth*, Vol. 30, June 1984, pp. 207~262.

During 1970-80, Korea and Taiwan exhibited the highest growth rates of 9.6 percent and 9.7 percent per annum, respectively, while Bangladesh and Papua New Guinea recorded a growth rate of 2.3 percent and 2.2 percent respectively. One interesting observation from <Table Ⅷ-1> is that, compared to the growth rate during 1970-80, growth rate in low-income Asian economies accelerated during 1980-92 in contrast to the fact that growth rate in the upper middle income and high income countries decelerated from the 1970-80 period to the 1980-1992 period.

The Penn World Table designed by R. Summers and A. Heston display a set of national accounts covering a large number of countries. Its unique feature is that its expenditure entries are denominated in a common set of prices of a common currency, so that real international quantity comparison can be made between countries and over time.

<Table Ⅷ-2> provides a summary of real GDP per capita based on the Summers-Heston method. One important result obtained by comparing nominal GDP per capita of <Table Ⅷ-1> with real GDP per capita of <Table Ⅷ-2> is that nominal figures are quite misleading. According to the nominal base in 1992, the income level of the highest income country(Japan) is 166 times higher than that of the poorest country(Nepal), as shown in <Table Ⅷ-1>. <Table Ⅷ-2> clearly reveals that in 1985, the real income level of the highest income country(Japan) is just about 21 times higher than that of the poorest country(Myanmar). Calculation of per capita GDP growth rate based on the Summers-Heston method leads to quite a different result. With the allowance for the increase in population, comparative growth performance in <Table Ⅷ-2> and <Table Ⅷ-1> is not similar.

Ⅱ. Expenditure and Tax Policies

1. Introduction

Even though in detail there have been considerable differences between countries, an important common characteristic in the post World War Ⅱ era has been the rapid expansion of the public sector in each one of them. The seemingly marked increase in the size of the public sector has given rise to a great deal of comment, mostly adverse, in the media. Unquestionably, the common perception is that government and bureaucracy are too big, too costly, and too powerful, and that the government of the day has acted imprudently or unwisely.

Until recently, the interest of economists was confined almost exclusively to the analysis of the economic effects of budgetary policy and to the development of normative theories seeking to provide criteria that would determine the revenue and expenditure policies of a government rather than to the examination of the overall impact of the growing public sector, along with the private sectors, on the performance of the economy. The economics profession has sadly neglected the analysis of the government sector. In almost all textbook discussions, the modern government sector is simply viewed as an exogenous black box whose basic characteristics are never examined in depth. In economics, the theory of government behavior has not been developed compared to the established theories of consumer and firm behavior.

Where economic analysis requires that some recognition be given to the role of the public sector, government is usually treated as an exogenous factor outside of the particular model's area of mutual interdependence, or is incorporated into it by postulating simple relationships between such magnitudes as government expenditure and other variables in the model. In the latter case, the assumed relationship usually appears to be determined by analytical convenience rather than by facts. As early as in 1948, R. F. Harrod(1948, p. 20) states: “Government is the most troublesome of the three [forms of expenditure] because we have no theory of government expenditure. In its absence we may dump government expenditure on the top of the other two as an exogenous factor, merge it with consumer expenditure ... or assume it away altogether. This last suggestion is certainly the most convenient of all and such treatment of a troublesome factor is richly supported by precedents in economic theory”.

Recently, because of the considerable broadening of the public sector’s impact on the economy, and on the continuing poor performance of the economy in many important policy areas, particularly with regard to inflation and economic growth, some interest has been directed toward studying the behavior of government activities on the basis of empirical and historical facts, with a view to discovering whether generalizations can be made about their impact on the economic performance. In particular, a number of recent studies raise the strong suspicion that a large and growing public sector actually causes slower economic growth.

2. Expenditure and Tax Indicators

No single, absolute measure summarizes the multimensional term, “the size of the public sector.” On an a prior basis, one may suggest a number of possibly relevant variables indicating the importance of the public sector with the view of government as (1) a consumer, (2) a producer, (3) an employer, (4) a redistributor, and (5) a reallocator of resources. Since there remain many unresolved questions concerning the appropriate definition of government, and as there is no one magic number that measures the importance of government activity in any country at any time, the appropriate measure of government activity depends, in theory, on the purpose for which we are interested in measuring it, and in practice, on the availability of data. Several measures have been suggested.

The discussion of the familiar difficulties indicates that there are a number of ways in which the size of the public sector can be measured and that there is a substantial element of arbitrariness in any measure and definition. After a long attempt to find ideal measures of government activity, Richard M. Bird(1970, p. 206) concludes: “While there is no one measure of government’s importance that is satisfactory for all purposes, the best single ratio indicating the “importance” of government appears, under moderately reasonable assumptions, to be the ratio of total government expenditure (including transfer payments) to gross national product at market prices”.

Disaggregated spending figures at the level of consolidated general government are required to examine the full impact of public expenditures on economic growth. Unfortunately, such data do not exist in sufficient quantity for the majority of developing countries. For this reason, the data used in this paper are confined to central government expenditures. The operations of state and local governments as well as expenditures of government owned or controlled public sector enterprises are not included. In some federal systems, the bulk of health and education expenditures are carried out by sub-national government.

<Table Ⅷ-3> provides four indicators of the government’s capacity to influence the economy: share of the budgetary expenditure of the central government in GNP, total tax burden, measured as a ratio of total tax revenue to GNP, the government final consumption as a proportion in GDP, and the proportion of real GDP devoted to government.

Though the focus of expenditure and tax policies in the sample Asian countries have to be examined in some detail, the major characteristics for the last two decades include a relatively small public sector, comparatively low tax, and heavy reliance on indirect tax.

Despite the heavy and active involvement by the government in the activities of the private sector, the size of the government in Asian countries, whether measured as budgetary expenditure as a percentage of GNP or as the overall tax burden, is still somewhat low compared with that of other countries, developed and developing.

For the sample of 16 Asian countries in <Table Ⅷ-3>, the median percentage of national income accounted for by government expenditure was 18.4 percent in Japan in 1980 and did not rise much and reached 19.4 percent in Philippines in 1992. For the sample countries in <Table Ⅷ-3> we note that the largest public sectors are found in Bhutan, Sri Lanka, and Papua New Guinea which are all low-income or middle-income economies. Total government expenditure in these three countries is over 35 percent of GNP. Myanmar, Thailand and Japan maintain the smallest public sector in Asia. The public sector has not grown in all countries. The share of general government consumption in GDP did fall in Sri Lanka, Papua New Guinea, Malaysia, Taipei, and Singapore between 1970 and 1992. In view of the fact that government in developing countries spend an average of 26 percent of GDP on goods and services(World Bank, 1992), the size of the government in Asian countries are small relative to other developing countries.

The total budgetary spending of the central government has not fluctuated much during 1980-1992, without showing any consistent trend. The share of government final consumption in GNP has fluctuated less than that of total budgetary expenditures in GNP.

<Table Ⅷ-3> provides average levels of total tax revenue, expressed as a percent of GNP. The share of total tax revenue in GNP is much lower than that of total expenditure in GNP. The level of taxation was remarkably stable throughout the entire 1980-1992 period. In seven out of fifteen countries, the tax burden

decreased in 1992, compared to 1980.

The nominal size of the public sector, represented by a simple ratio of government expenditure to a certain measure of total economic activity, has been the dominant concern of most economists. Studies by Morris Beck (1976, 1979), and Kravis, Summers and Heston(1980, 1984, 1991) indicate the importance of developing a measure of the public sector that takes into account relative price changes. The main point is that there is no reason for the deflator of GNP to be the same as that of government expenditure, given the fact that the input mix for government goods and services may be different from the aggregate input mix for all economic activities. If the prices of the goods and services purchased by the government rise relatively more quickly than the general price level, the relative size of the public sector must increase in nominal terms to maintain the same size in real terms.

Beck's study covers industrialized developed countries while Kravis, Summers and Heston provides data covering more than 100 countries for the 1950-1988 period. Kravis, Heston and Summers undertook a major research project on the international comparison of real product. Their studies provide the share of total output devoted to public consumption based on real terms and constant prices. They developed tables of real gross product and shares of GDP devoted to private and public consumption and investment for over 100 countries individually, in the years since 1950, based on structural relationships estimated from data obtained in a benchmark study of expenditures and prices.

The last four columns of <Table Ⅷ-3> summarizes, among many important data produced, only the share of real GDP devoted to public consumption for the Asian countries on which Summers and Heston provides data.

<Table Ⅷ−3> Major Fiscal Indicators

(Unit: %)

Countries	Total Expenditures as a % of GNP (Central Government)		Total Tax Revenue as a % of GNP (Central Government)		Share of General Government Consumption in GNP			% of Real GDP Devoted to Government			
	1980	1992	1980	1992	1970	1980	1992	1960	1970	1980	1985
Low-income economies											
Nepal	14.2	18.7	6.5	8.0	-	-	10	11	11	26	16.9
Bhutan	40.6	40.9	6.3	4.6	-	-	24	-	-	-	-
Bangladesh	10.0	14.9	7.7	-	13	7	14	10	19	17	17.4
Lao PDR	-	-	-	-	-	-	-	-	-	-	-
India	13.2	16.8	9.8	11.1	9	10	11	20	18	19	25.1
Pakistan	17.7	21.7	13.5	12.2	10	11	14	26	21	18	37.5
China	-	-	-	-	-	-	-	-	-	-	16.1
Sri Lanka	41.6	28.2	19.2	18.1	12	8	9	36	31	17	30.6
Indonesia	23.1	19.2	21.1	18.2	8	13	10	-	-	-	17.3
Myanmar	15.9	15.5	9.7	5.9	-	-	-	21	21	20	19.6
Middle-income economies											
Philippines	13.4	19.4	12.5	15.2	9	8	10	15	16	17	22.3
Papua New Guinea	35.2	36.0	21.0	20.8	30	26	23	-	-	-	-
Thailand	19.1	15.4	9.7	16.3	11	12	10	12	13	16	25.3
Mongolia	-	-	-	-	-	-	-				-
Upper-middle-income economies											
Malaysia	29.6	29.4	24.4	22.0	16	17	13	15	16	17	20.9
Korea(ROK)	17.9	17.6	16.0	16.4	10	12	11	18	13	12	13.6
High-income economies											
Taiwan, China	15.1	20.5	10.2	9.5	18	21	18	30	25	20	18.3
Hong Kong	26.0	16.6	-	-	7	7	9	3	11	10	13.1
Singapore	20.8	22.7	18.2	18.8	12	11	10	11	16	12	6.6
Japan	18.4	15.8	11.0	13.7	7	10	9	11	7	7	10.6

Sources: Robert Summers and Alan Heston, “The Penn World Table(Mark 5): An Expanded Set of International Comparisons, 1950-1988”, *Quarterly Journal of Economics*, May 1991, pp. 357~358.
Robert Summers and Alan Heston, “Improved International Comparison of Real Product and Its Comparison, 1950-80”, *Review of Income and Wealth*, Vol. 30, June 1984, pp. 207~262.
The World Bank, *World Development Report*, each year.
The Republic of China, *Taiwan Statistical Data Book*, 1994.
Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries*, 1994.

The figures confirm the general observation that the share of public consumption to the aggregate output - when measured in real terms, particularly in constant international relative prices - has not grown as much as it is usually assumed over the last three decades. Taking the median for the sample of 18 countries, the percentage of real GDP accounted for by government consumption rose by only 1 percent, from 14 percent in 1950 to 15 percent in 1977. In almost all countries, the ratios of public consumption to GDP are less than 25 percent.

Various components or the structure of central government expenditure in Asia is shown in <Table Ⅷ-4>. An important characteristic of the central government expenditure pattern is the large share of defense expenditures and the small share of social services expenditures. In 1980, defense expenditures accounted for more than 30 percent of total government outlays in three countries: Pakistan, Korea, and Taiwan. In most Asian countries, shares of defense expenditures in government outlays have continuously declined. Social development expenditures remained smaller than defense expenditures and economic development expenditures. The share of social services expenditures has risen somewhat in recent years. Economic development expenditures were the largest item in both 1980 and 1992.

<Table Ⅷ-5> provides a breakdown of the revenue data for the sample countries, displaying some noticeable differences in the revenue structure among these countries. For Bhutan, Myanmar, Taiwan and Singapore, non-tax revenue amounted to more than 30 percent of the total revenue, both in 1980 and 1992. While for Sri Lanka, Indonesia, Thailand, Korea, and Japan, less than 10 percent of total revenue was derived from the non-tax revenue. A systematic relationship between the level of income and the share of non-tax revenue is not discernible.

<Table Ⅷ−4> Structure of Central Government Expenditure

(Unit: %)

Countries	Share in 1980						Share in 1992					
	Defense	Education	Health	Social Services	Economic services	other	Defense	Education	Health	Social Services	Economic services	other
Low-income economies												
Nepal	6.7	9.9	3.9	1.7	58.8	19.1	5.9	10.9	4.7	6.8	43.0	28.8
Bhutan	0.0	12.8	5.0	4.9	56.8	20.5	0.0	10.7	4.8	8.2	48.2	28.2
Bangladesh	9.4	11.5	6.4	5.3	46.9	20.4	-	-	-	-	-	-
Lao PDR	-	-	-	-	-	-	-	-	-	-	-	-
India	19.8	1.9	1.6	4.3	24.2	48.3	15.0	2.1	1.6	5.7	18.6	57.0
Pakistan	30.6	2.7	1.5	4.1	37.2	23.9	27.9	1.6	1.0	3.4	11.6	54.6
China	-	-	-	-	-	-	-	-	-	-	-	-
Sri Lanka	1.7	6.7	4.9	12.7	15.9	58.2	8.5	10.1	4.8	16.1	24.0	36.5
Indonesia	13.5	8.3	2.5	1.8	40.2	33.7	6.8	9.8	2.8	2.0	29.6	49.1
Myanmar	21.9	10.6	5.3	10.6	33.7	17.9	22.0	17.4	6.8	12.1	19.5	22.1
Middle-income economiesl												
Philippines	15.7	13.0	4.5	6.6	56.9	3.4	9.9	15.0	4.1	4.4	26.8	39.8
Papua New Guinea	4.4	16.5	8.6	2.6	22.7	45.1	4.2	15.0	7.9	1.4	21.6	49.9
Thailand	21.7	19.8	4.1	5.1	24.2	25.1	17.2	21.1	4.1	6.7	26.2	20.7
Mongolia	-	-	-	-	-	-	-	-	-	-	-	-
Upper-middle-income economies												
Malaysia	14.8	18.3	5.1	7.0	30.0	24.7	10.9	19.6	5.1	11.6	19.4	32.7
Korea(ROK)	34.3	17.1	1.2	7.5	15.6	24.3	22.1	16.2	1.2	12.5	16.5	31.5
High-income economies												
Taiwan, China	38.2	6.8	39.1			15.9	25.3	15.3	18.1		20.1	21.2
Hong Kong	-	-	-	-	-	-	1.6	17.5	11.0	6.3	20.2	43.4
Singapore	25.2	14.6	7.0	7.6	17.7	27.9	22.1	22.9	7.0	7.2	10.7	30.9
Japan	5.2	10.7	21.3		9.2	53.6	6.3	7.9	19.1		5.8	60.9

Sources: The World Bank, *World Development Report*, 1993, 1994.
Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries*, 1994.
Republic of China, *Yearbook of Financial Statistics of the Republic of China*, 1994.

<Table Ⅷ−5> Structure of Central Government Expenditure

(Unit: %)

Countries	Share in 1980						Share in 1992					
	Taxes on Income	Social Security Tax	Tax on Goods and Services	Tax on International Transactions	other	Nontax revenue	Taxes on Income	Social Security Tax	Tax on Goods and Services	Tax on International Transactions	other	Nontax revenue
Low-income economies												
Nepal	5.5	0.0	36.8	33.2	8.2	16.2	9.9	0.0	36.7	30.8	5.5	17.1
Bhutan	13.8	0.0	39.1	0.4	2.3	44.3	7.5	0.0	16.6	0.4	0.6	75.0
Bangladesh	10.1	0.0	25.5	28.6	3.9	31.9	-	-	-	-	-	-
Lao PDR	-	-	-	-	-	-	-	-	-	-	-	-
India	18.3	0.0	42.5	22.0	0.6	16.6	17.0	0.0	34.4	25.5	0.4	22.8
Pakistan	13.8	0.0	33.6	34.4	0.2	17.9	10.0	0.0	32.2	30.2	0.3	27.2
China	-	-	-	-	-	-	-	-	-	-	-	-
Sri Lanka	15.5	0.0	26.8	50.5	1.9	5.3	11.2	0.0	47.8	27.6	3.5	9.8
Indonesia	78.0	0.0	8.6	7.2	1.2	4.9	58.0	0.0	26.3	5.1	2.8	7.8
Myanmar	2.9	0.0	42.3	14.9	0.0	39.9	11.4	0.0	32.6	16.5	0.0	39.6
Middle-income economiesl												
Philippines	21.1	0.0	41.9	24.2	2.2	10.6	29.3	0.0	26.2	28.7	3.2	12.6
Papua New Guinea	60.5	0.0	12.1	16.4	0.6	10.5	45.1	0.0	11.7	24.1	2.0	17.0
Thailand	17.7	0.2	46.0	26.2	1.8	8.1	27.5	1.0	41.6	16.7	3.2	9.9
Mongolia	-	-	-	-	-	-	-	-	-	-	-	-
Upper-middle-income economies												
Malaysia	37.5	0.4	16.8	33.0	1.8	10.5	34.2	0.9	20.0	14.9	3.2	26.9
Korea(ROK)	22.3	1.1	45.9	15.0	3.2	12.5	33.9	5.3	35.7	8.4	6.8	9.9
High-income economies												
Taiwan, China	16.1	0.0	16.9	24.7	6.4	35.9	24.9	0.0	9.9	7.4	13.6	44.2
Hong Kong	-	-	-	-	-	-	-	-	-	-	-	-
Singapore	32.5	0.0	15.8	6.9	13.9	30.9	27.0	0.0	22.8	2.2	14.5	33.5
Japan	70.8	0.0	20.8	2.4	0.8	5.2	69.2	0.0	16.9	1.3	7.4	5.2

Sources: The World Bank, *World Development Report*, 1993, 1994.
Republic of China, *Yearbook of Financial Statistics of the Republic of China*, 1993.

Unlike <Table Ⅷ-4>, <Table Ⅷ-5> displays no noticeable differences in the tax structures of the sample Asian countries. The well documented inverse relationship between per capita income and international transactions tax revenue (Easterly and Rebelo, 1993) is not discernible. The only difference in the tax structure among the sample Asian countries is that the low income countries rely more heavily on indirect tax - tax on goods and services and tax on international transactions - while the upper middle income and high income economies rely more heavily on direct tax - income tax.

The contribution of the social security tax to the total revenue is negligible in all Asian countries. Given the increased openness and mobility of capital among the world economies, there have been clear economic pressures in recent years on countries to harmonize their tax policies. Whether these pressures led to a convergence in the major tax revenue to GNP ratios among the sample countries is one interesting point which needs to be analyzed. One notable fact in <Table Ⅷ-5> is that between 1980 and 1992 the share of taxes on income decreased in most countries. As economies develop, they tend to rely more on income tax but in the case of the sample Asian countries, this general trend is not found. Contrary to the fact that in advanced industrialized countries income tax contributed more over time, our sample Asian countries stopped following the historical trend long before they reached a mature stage of development.

Ⅲ. Macroeconomic Policy

1. Stabilization and Structural Adjustment Policy

The experience of the 1970s and 1980s indicates that macroeconomic stability is necessary for sustainable growth. Sound fiscal and monetary policies create a hospitable climate for private investment and thus promote productivity. Certainly, macroeconomic stability, by itself, does not lead to development but without it, all other efforts are likely to be futile.

Countries often experience external or internal macroeconomic shocks. Flexibility in adjusting quickly to the fiscal and monetary problems that arise from these shocks is crucial if growth is to be sustained. Lack of adjustment may result in high inflation, an overvalued exchange rate, and a balance of payments crisis. In turn, these lead to low investment and slow growth. Good macroeconomic policies also make it easier to attract foreign savings.

The objective of the stabilization policy is to avoid, and if necessary, to correct domestic and external imbalances that threaten to disrupt the economy in the short run. A high inflation rate and/or a large current account deficit signal the need for policy responses to restore financial stability. Stabilization is pursued through a combination of corrective fiscal, monetary, and exchange rate policies, all of which are interdependent. A tightening of monetary policy alone is potentially damaging to the private sector, as either interest rates rise, or, with interest rate controls, credit is rationed. A depreciation of the nominal exchange rate will only have temporary consequences, if domestic prices rise and the real exchange rate appreciates so.

A prudent fiscal policy is the foundation of a stable macroeconomy. Taxes and public spending affect resource allocation, and fiscal deficits affect both the balance of payments, and depending on how they are financed, the rate of inflation.

The monetary policy in developing countries largely follows fiscal policy. In many countries, the absence of well-developed capital markets limits the instruments of monetary policy to credit controls, interest rate ceilings, and changes in reserve requirements. The degree of central bank autonomy may affect the conduct of the monetary policy.

In the 1980s, many countries embarked on programs of stabilization and structural reform. Stabilization policies work mainly on the demand side to reduce inflation and external deficits, though they also have supply-side effects. Structural policies are concerned with the supply side: they address the efficiency of resource use, emphasizing reforms in specific sectors-especially trade, finance and industry. It is possible to postpone structural reforms during stabilization but the reverse is rarely true: structural reforms are preceded or accompanied by stabilization. Similarly, stabilization is unlikely to be sustainable without structural reforms.

Structural adjustment policies are directed toward the more long-term growth objective, by promoting efficient resource use. Instruments of stabilization policy are also instruments of structural adjustment policy. Little progress is likely to be made on structural reform. Structural policies that are destabilizing can not be sustained. But stabilization policies alone are not enough, since in and of themselves fiscal retrenchment and monetary restraint can inhibit growth.

However, these policies can be designed to fulfill their stabilization function while at the same time stimulating the supply side of the economy. In the case of fiscal policy, the focus shifts from the size of the fiscal deficit to the characteristics of the tax system and the composition of expenditure. In the case of monetary policy, the focus shifts from the rate of growth of money and credit to the process of interest rate determination and credit allocation.

Fiscal deficits received much of the blame for the assorted economic ills that beset developing countries in the 1980s: overindebtness, high inflation, and poor investment performance and growth. On recurring question is whether larger public deficits are always associated with higher inflation. Sargent and Wallace's(1985) "monetarist arithmetic" answered this question affirmatively. But the relationship is ambiguous because governments finance deficits by borrowing as well as by printing money. The relationship is further muddied by other influences such as unstable money demand, inflationary exchange rate depreciations, widespread indexation, and stubborn inflationary expectations.

2. Macroeconomic Indicators and Macroeconomic Performance

<Table Ⅷ-6> provides a set of major macroeconomic policy indicators for our 20 Asian countries. Some interesting observations are to be made. Despite different economic circumstances among our sample Asian countries, the annual nominal growth rate of money is surprisingly similar. As expected, as countries become developed or as countries become wealthier, money, outstanding as a percent of GDP, becomes higher. In all but three countries - Taiwan, Hong Kong, and Singapore - government budget recorded deficits. In countries like Nepal, India, Pakistan, Sri Lanka, budget deficits were quite big. Trade balance turned around from deficit to surplus in recent years. Still many governments are suffering from budget deficits.

Given the above macroeconomic indicators, one might question the degree of effectiveness demonstrated by the Asian countries in coping with inflation through fiscal and monetary policies. As shown in the 4th and 5th columns of <Table Ⅷ-1>, the average rate of inflation in the 1980s was somewhat lower than that which can be observed in the 1970s. Despite this difference, Asian countries experienced no notable

<Table Ⅷ−6> Major Macroeconomic Policy Indicators

(Unit: %)

Countries	Monetary Indicator							Budget Surplus or Deficit as a % of GNP		Openness : (Export +Import) /GDP	Trade Surplus or Deficit as a % of GNP	
	Average Annual Nominal Growth Rate of Money		Money Outstanding as a % of GDP			Nominal Deposit Interest Rate						
	1970-80	1980-92	1970	1980	1992	1980	1992	1980	1992		1975	1992
Low-income economies												
Nepal	19.9	19.9	10.6	21.9	35.7	4.0	8.5	-3.0	-6.3	33.1	-	-6.0
Bhutan	-	30.7	-	-	22.7	-	8.0	0.9	-2.5	-	-	-2.4
Bangladesh	-	18.7	-	18.4	31.1	8.3	10.5	2.5	2.2	22.5	-1.8	2.1 1)
Lao PDR	-	-	-	-	-	7.2	14.0	-	-	-	-	-4.6
India	17.3	16.8	23.9	36.2	44.1	-	-	-6.5	-4.9	16.4	-0.2	-
Pakistan	17.1	13.7	41.2	38.7	39.0	-	-	-5.8	-6.2	33.4	-9.4	-2.9 2)
China	-	25.6	-	25.5	66.6	5.4	-	-	-	28.8	-	1.8
Sri Lanka	23.1	15.3	22.0	35.3	35.2	14.5	18.3	-18.4	-7.2	59.8	-2.9	-4.3
Indonesia	35.9	26.3	7.8	13.2	42.6	6.0	20.4	-2.3	0.5	48.5	-3.8	-1,2 1)
Myanmar	15.1	15.8	23.9	23.9	27.9	1.5	-	1.2	-0.5	-	-2.1	-
Middle-income economiesl												
Philippines	19.2	17.0	29.9	26.4	34.3	12.3	14.3	-1.4	-1.2	48.5	-6.0	-5.9 1)
Papua New Guinea	-	8.3	-	32.9	33.1	6.9	7.9	-2.0	-5.9	-	-2.7	-
Thailand	17.9	19.2	23.6	37.3	71.5	12.0	12.3	-4.9	3.0	70.7	-4.2	-5.7
Mongolia	-	-	-	-	-	-	-	-	-	-	-	-3.2
Upper-middle-income economies												
Malaysia	25.2	12.6	34.4	69.8	-	6.2	7.2	-6.2	0.3	124.6	-5.5	0.3 1)
Korea(ROK)	30.4	21.6	32.1	31.7	57.9	19.5	10.0	-2.3	-0.9	73.0	-9.1	0.1 1)
High-income economies												
Taiwan, China	26.2	20.6	40.8	64.0	170.5	10.3	6.5	1.3	5.6	-	-3.8	2.7 1)
Hong Kong	18.9	26.8	-	69.5	203.8	-	-	2.5	2.9	266.8	-	-
Singapore	17.1	13.6	66.2	74.4	129.0	9.4	2.9	2.2	9.2	-	-10.2	3.6 1)
Japan	16.0	8.5	94.7	134.1	184.6	5.5	2.7	-7.0	-1.6	23.2	1.0	3.6

Notes: 1) refers to 1993.
2) refers to 1991.

Sources: Robert Summers and Alan Heston, “The Penn World Table(Mark 5): An Expanded Set of International Comparisons, 1950-1988”, *Quarterly Journal of Economics*, May 1991, pp. 357~358.
The World Bank, *World Development Report*, each year.
The Republic of China, *Taiwan Statistical Data Book*, 1994.
Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries*, 1994.

difference in the rate of inflation among themselves.

<Table Ⅷ-7> shows simple regression results of the relationship between inflation and various policy measures enforced by the government. In only two cases can one find a significant correlation between inflation and policy measures. First, growth of money exerted a noticeable effect on inflation for the period of 1970-80. Second, a discernible but insignificant correlation is found between inflation and budget deficits. In terms of monetary and fiscal conducts by the government, one can conclude that governments in Asian countries maintained a restrictive monetary policy and an expansionary fiscal policy. Needless to say, no statistical correlation other than that of the above two cases can prove that government policy was not successful in containing inflation.

<Table Ⅷ−7> Macroeconomic Policy and Inflation : Empirical Findings

Period	Independent Variable	t-statistics	R^2
1970-80	Growth Rate of Money	3.69	0.53
1980-92	Growth Rate of Money	1.10	0.09
1970-80	Budget Deficit or Surplus	0.40	0.01
1980-92	Budget Deficit or Surplus	2.12	0.23
1970-80	Openness	0.80	0.06
1970-80	Trade Surplus or Deficit	0.30	0.01
1980-92	Trade Surplus or Deficit	0.50	0.02
1970-80	Government Expenditure	0.77	0.04
1980-92	Government Expenditure	0.45	0.01
1970-80	Tax Burden	0.04	0.00
1980-92	Tax Burden	1.18	0.10

3. Central Bank Independence and Inflation

Institutions cannot absolutely prevent an undesirable outcome, nor ensure a desirable one, but the manner in which they exercise decision-making authority within the public sector can make some policy outcomes more probable and others less likely. An important example of this principle concerns the balance of authority between the central bank and the executive and legislative branches of the government. Many have believed that the degree of independence of the central bank from other branches of the government affects the expansion rates of money and credit, and through them, important macroeconomic variables, such as inflation and the size of the budget data, are affected.

Making the central bank an agency with the mandate and reputation for maintaining price stability is a means by which the government can strengthen its commitment to price stability.

Cukierman, Webb and Neyapti(1992) developed four measures of central bank independence and explored their relationship with inflation outcomes. The four indicators include an index of legal independence, the turnover rate of central bank governors, an index based on a questionnaire answered by specialists, and an aggregation of the legal index and turnover rate. <Table Ⅷ-8> lists two measures of determining the central bank's independence and the inflation rate based on the study by Cukierman, Webb, and Neyapti.

Simple regressions were run based on the data of <Table Ⅷ-8>. Empirical testings show that the independence of the central bank has little to do with inflation in the Asian countries.

<Table Ⅷ−8> Central Bank Independence Indicators

Countries	Legal Independence (1980-89)	Inflation rate (1980-89)	Turnover Rate of the Central Bank Governor		
			1950-89	1972-79	1980-89
Low-income economies					
Nepal	0.18	10	0.24	0.25	0.10
India	0.34	9	0.33	0.50	0.30
Pakistan	0.21	7	0.25	0.25	0.30
China	0.29	8	0.34	-	0.30
Indonesia	0.27	9	0.23	0.13	0.20
Middle-income economies					
Philippines	0.43	13	0.13	0.38	0.10
Thailand	0.27	6	0.20	0.25	0.10
Upper-middle-income economies					
Malaysia	0.36	4	0.13	0.00	0.20
Korea, Rep.	0.27	8	0.43	0.13	0.50
High-income economies					
Taiwan, China	0.21	5	0.13	0.00	0.20
Singapore	0.29	3	0.37	0.00	0.60
Japan	0.18	3	0.20	0.13	0.30

Notes: 1. (a) The potential range of the index for legal central bank independence is from zero(minimal independence) to one(maximal independence).
(b) Inflation is computed in logs.
2. Turnover rates were calculated if at least three years of data were available for the decade.

Source: Alex Cukierman, Steven B. Webb and Bilin Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes," *The World Bank Economic Review*, Vol. 6, September 1992.

Ⅳ. Concluding Remarks

Examining the role of the state in a country and/or in a region is a difficult task simply because the role of the state itself is controversial. The state can play an important role in promoting and supporting the right kind of market institutions and in ensuring the provision of a competitive climate for the enterprise, adequate investment in people, openness to international trade, and stable macroeconomic management. These conditions for success stories cut across diverse experiences and withstood the test of time, but although these conditions are necessary, they are not sufficient.

Selecting any set of economies and attempting to understand the origins of their success are necessarily arbitrary process. Most striking about the comparative developments of the past 20 years or so is the diversity of regional experience in a common turbulent environment.

The examination of budgetary, tax, and monetary policies in Asian countries with focus on these policies' effect on economic performance reveals some interesting results.

Many facts about the economies in Asia are incorrectly perceived. First of all, despite the conventional view that only a limited number of countries such as the four dragons or the eight high performing Asian economies have exhibited high economic growth, almost all countries in Asia have enjoyed high economic growth, particularly so in recent years. Furthermore, discrepancies in the level of real per capita GDP between low-income and high-income Asian countries are not that big, as are usually understood with the data based on nominal national income accounts.

Some trends observed in other countries or regions do not bear out in Asian countries. For example, in most Asian countries tax burden decreased over time between 1980-1992 and our sample Asian countries stopped following the historical trend of relying more on income tax as the economies developed.

Asian countries maintained a more or less restrictive stance in monetary policy while the fiscal policy was expansionary. Despite the heavy and active investment by the government in the activities of the private sector, the size of the government in Asia is still somewhat low compared with that of other countries, developed and developing. Similar annual nominal growth rate of money and no notable difference in the rate of inflation in Asian countries does not necessarily lead one to conclude that there is no significant correlation between inflation and policy measures.

One thing very noticeable is that many of the empirical findings found in previous studies are not borne out. The independence of the central bank has little to do with inflation in Asian countries. No significant correlation is found between inflation and budget deficits. The well documented inverse relationship between per capita income and international transactions tax revenue is not discernible. Even though economies are developing, Asian countries still tend to rely more on indirect taxes.

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Chapter Ⅸ. Military Revolution and Comparative Perspective on Military Government

Ⅰ. Introduction

Korea has seen rapid economic and social development in the 1960's. It is now generally understood that this development has, to a considerable extent, been engineered by the elites from military and the developmental performance has been largely the result of change in administrative elite.

The main purpose of this chapter is to analyze the characteristics, or Korean military regime in comparative perspective. In this chapter Korean military regime refers to Park Administration in power since Military Revolution in May 1961 until now(1973). One can raise such a question whether the civilianized government under the leadership of President Chung Hee Park is military regime or not. The major reason why I treat Park regime as a military one is that Park regime have retained key military figures who initiated the military coup and established several military types of institution within the political structure. Of course the civilianized Park regime represents a mixed milieu in which it becomes nearly impossible to isolate purely military characteristics from non-military ones

A brief history of political developments in Korea is outlined in chronological order at the outset, its purpose being to give a clear overview. The next part of this paper deals with causes, developments and impact of military revolution in Korea. In the last section Korean experience is analyzed on comparative base. Comparison is not made with a specific country but in general view and with theoretical assumptions on which some scholars analyzed military regime.

Ⅱ. A Historical Overview

- Liberation of Korea in August 1945 from Japanese colonial rule.
- Establishment of the First Republic on August 15, 1948.
  Syngman Rhee was elected as President.
- Korean War during June 1950-July 1953.
- April Revolution by students on April 19, 1960.
- The Second Republic was established on August 1960.
  John M. Chang as Prime Minister under parliamentary system of government.
- Military Revolution on May 16, 1961.
- Establishment of the Third Republic on December 17, 1963.
  Chung Hee Park as President.
- Presidential election on May 3, 1967.
  Mr. Park was reelected as President.
- Constitutional amendment allowing President Park's third consecutive term on October 17, 1969,
- Presidential election on April 27, 1971.
  Mr. Park as President.
- Coup in office-Birth of Fourth Republic in November 1972 by revising Constitution giving the President almost unlimited power. Election of Mr. Park as President on December 23, 1972.

Ⅲ. The Military Revolution

1. Environmental Factors

The key to the unexpectedly easy success of the military coup on May 16, 1961 lies not so much in the efficiency with which the coup was executed as in the widespread apathy of the populace. In the years since liberation, the civilian regime had failed to carry through a modernization programs which might have given Koreans some faith in the intentions of their government, Instead the opportunity to change was lost, The inability and unwillingness of civilian leadership to meet the increasing demands made by the people gave rise to a political environment in which a military coup was condoned or reluctantly accepted as the last recourse. The assumption of power by the military can be treated as a reaction against civilian inefficiency, first under the personalized and centralized rule of Syngman Rhee, and then under the decentralized and directionless rule of John M, Chang. The desire for a return to the functionally efficient administrative system of an earlier period was another important factor.

2. Other Factors

The environmental factors leading to the downfall of the civilian government do not fully explain the revolutionary conduct of the military forces. Attention must be paid to the factors within the military establishment which led some military officers to risk their lives in staging a coup d́etat. These can be divided into two, personal and institutional. Personal factors, such as the individual motives of those who engineered the coup, account for the immediate reasons why the coup was carried out. A full understanding requires the examination of institutional factors with preference to (1) recruitment of officers (2) intraservice factionalism (3) civil military relationship (4) friction between low-ranking officers. In this paper only last two are briefly examined.

3. Different Outlook between Civilian and Military Sector

The entrance of military into tlne political arena is usually precipitated by a breakdown or mutual respect for the distinctive spheres of civil and military authority, Often this occurs when one or both violates the basic rule which delineate their separate functions and responsibilities. Long influenced by nonviolent and ascetic Buddhism as well as by aesthetic and quiescent confucianism, the Korean people encouraged mental and spiritual development rather than physical prowess. Culturally and historically in Korea the man of arms was considered to be inferior to the man of letters. Hence a career in the military was seldom sought by young men with established family background and/or university education. In view of the foregoing reasons, both military and civilian leadership had problems of adjustment when the military suddenly emerged as an entirely political, social and economic force in 1950’s.

At the heart of the matter is the fundamental difference in outlook between civilian and military sector. While the civilian world has changed little, the military has undergone a vast transformation. The Korean Army, like other modern armies today, is a microcosm of the state; it possess its own separate and self-contained systems of supply, communication, engineering and education. Army training, geared to the use of scientific rationale to produce the most efficient group actions, results in a major change in problem-solving techniques. The reliance on the utilitarian value of discipline and rank on esprit de corps as the foundation of group action, and on mechanized intercommunication and transportation, has made the military much more efficient and functional than its civilian equivalent. As a result, military men tend to see any problem as amenable to direct and concerted scientific action and they therefore pay little attention to due process, This functional outlook is in conflict with civilian mentality of the order, which is shackled by greater inertia, inefficiency, skepticism, and greed in products of modern science.

The conflict between military and civilian value system became increasingly pronounced as the economic situation deteriorated and the political situation became more acute, particularly after the downfall or the Rhee Government. As a consequence, the military began to consider itself as the only remaining cohesive and disciplined organization to supplant politically corrupt and scientifically backward civilian rule.

4. Friction between High-ranking and Low-ranking Officers

The Korean coup of 1961 was not unique. It followed losely in time coups in Burma and Pakistan. Like some other in Asia and Middle East, the coup was planned and led by junior officers without the support -and to a degree against- the senior officers or the armed forces as a whole. The rapid growth or the military during the Korean War created a strains within its internal structures. The war had the initial effect of catipulating many young officers, some with minimal experience and training, into senior positions within a very short time. The promotion pattern of the much larger numbers who followed them, products of somewhat longer term and better training institution, was considerably slower. The high-ranking senior officers was under firm political control and some of them became deeply involved in the corruption of the Rhee government. Their political involvement in the system precluded any reformist tendency. For these reasons it was puritanical and self-righteous junior officers who demanded reform within and outside the military. Junior officers became increasingly bold, particularly after the success of the Student Revolution.

5. Legitimacy

The military overthrow of the constitutionally elected government, no matter how justifiable it might be in terms of inefficiency of the civilian leadership and nobility of the military intentions, clearly constituted a violation of legitimacy. Hence it aroused in the Korean intellectual community a general sense of negativism and skepticism. Also there was inevitable postrevolutionary trauma, stemming from the threat from other aspiring military officers and from internal power struggle. To surmount negativism, skepticism, antipathy, and postrevolutionary uncertainty, the military junta immediately undertook several actions: the restoration or stability, the institution of needed reforms, a massive internal and external propaganda campaign, and the creation of anti-coup mechanism, the CIA.

Basically, legitimacy problem which military government faced continuously and seriously, especially during its initial military revolution, hinges upon the timing of the end of regime. If the definition of military government in introduction is relevant, this issue still remain unsolved.

6. Impact of Military Revolution

The impact of the military rise upon Korean society was manifold, There were some positive contributions mixed with some negative consequences.

After being in power more than ten years since May 1961 the military regime has undergone inevitable changes altering the overall scenery of the republic. Previously dominant civilian politicians have been gradually pushed aside by ex-soldiers and former military officers have formed a new Gebraltar of power in the political arena. Such a massive advance of the military into civilian sectors was not lacking in negative consequences, Absence of a long-term ideology are intensifying moral laxity in both public and private sector.

The most general contribution of the military to the development of administration in Korea was its introduction and vigorous application of a "managerial. approach." This approach took many concrete forms, including the adoption of a long-range development plan, institution or a comprehensive planning and control system, and revamping of many sluggish government corporation.

A specific contribution that left a lasting legacy was the initiation or the Five Year Economic Development Plan. The adoption of a systematic long-range view by a general administration is by any standard a general. administrative innovation, In this respect, the Military government was the effective change agent on a general scale. Rather than tackling the philosophic aspect of political modernization the Park regime has opted for the more immediate and concrete task of economic development as the first order of business.

Ⅳ. Comparative Perspective

1. Negative View and Korean Case

Comparisons of the modernizing impact of the military in Korea with that of military government in other areas become a problem for a number of reasons having to do with the unique condition or circumstances of Korea.

There are two major schools of thought on the potential of the military as a modernizing force in developing nations: One holds that the military can perform such a function, and the other seriously questions it. From this debate a number of observations regarding the general pattern of the military revolution and its nation-building role have emerged.

Edward Shills, S. E. Finer and Edwardo Santos are those who make a strong case against military intrusion into civil politics. In discussing various detrimental qualities of the military as an innovating force they emphasize; that the military is not a complete regime given its limited educational preparation and practical experience. As an incomplete regime the military places more stress on order and clean-up than progress, and when it has a program for progress, its ideas are rather scant and unimaginative even where well-intentioned. The military has no provision for succession and like other totalitarian hierarchies it allows no place for opposition. Temporary gains in terms of restoring order and stability are far outweighed by the losses resulting from military rule. Accustomed to the blind obedience of their inferiors, the dry voices of command, and the narrow horizon of their profession, the military leadership lacks the courage to rectify mistakes, to ask for and listen to advice, to have patient, to realize that one owes one’s power to the will of the people. Janocwity points out that the military approach to problem-solving is detrimental to the political process. He also argues that military leaders are conditioned to regard any problem as amenable to direct and simple scientific action, and that they shun and repulsed by indirect solution and the willingness of political leaders to temporize as a way of solving problems.

These concerns and fears above expressed by interested scholars seem to have only limited relevance to the Korean case. The military did not place its supreme effect on order, but on progress and organization-building. Developmental progress was not just scant and unimaginative but precise and well-conceived as records or the economic growth indicate. Except during the initial stage of the revolution and except for quite recent developments, the military oligarchy did not degenerate into absolutism nor permanently silence the opposition. In overall. view it demonstrated an ability to absorb the former political opponents and counter-revolutionaries into the power structure. Military elite gained a popular mandate through an effective political organization and through an undeniable and concrete record of economic development (Average 9.0% increase per annum in real GNP from 1961 to 1972).

The scholars who have a negative view on the military regime tend to treat the rise of the military as equivalent to the total retreat of the civilian elite. Certainly this was not the case in Korea in overall sense. The military leadership did not replace the civilian administrative personnel nor alter the existing public and private institution. Not only were the capable people retained in spite of their earlier political involvement as the appointees of previous regime, but also many well-known and new talents were mobilized for economic planning and governmental efficiency. The military elites themselves did not possess skill needed and talent to plan various policies. As mentioned before this is due to their limited educational preparation and practical experience. However they were clever enough to perceive their role. The result has been continuity and stability in the administrative and economic sectors.

The above comments, however, should not be construed as implying that the military leadership has been entirely pure and problem free. There are a myriad of unsolved economic and social problems, In particular following the 1969 constitutional amendments to remove the third-term limitation 1972 was the year Korea’s Fourth Republic was born though a coup in office, following a well staged scenario, without a firing single shot and without a single change in the personnel of the existing power structure of the Third Republic, created in 1963 with Mr. Park, the Junta leader of the 1961 coup, as president. The circumstances that brought about the birth of the Fourth Republic are very different from those surrounding the establishment of the Third.

2. Positive View and Korean Case

Samuel Huntington and Lucian Pye express an opposite view-point on military potential as a modernizing force. They view the reform coup as a genuine alternative in nations without a constitutional tradition of peaceful change and state that the military may be able to play a role in promoting mobility while maintaining stability, in facilitating change while preventing chaos. The efficiency with which the military can be made to perform this role may depend upon the successful outcome to the transition in many societies. Lucian Pye argues that in seeking a realistic estimate of the potential role of the military in the political development of particular countries it is necessary to avoid being excessively influenced by ideological considerations which may be relevant only in advanced societies.

With a positive outlook on military potential several observations can be made in Korean military revolution. Can the undeniable and remarkable economic development in 1960’s be considered as being solely due to the role played by the military as a modernizing force? Following observations are at variance with those claimed by the scholars who see the military revolution as a genuine alternative for reform.

First, the military's rise in Korea did not touch off a social revolution which uproots and alters the basic structure of Korean society. It was a simple change of leadership, called "the change of generation" at the expense of the civilian politicians.

Second, the civilian leadership in Korea was not supplanted by the military. The failure of the civilian leadership as a modernizing force only provided the military with a justification for the overthrow of civilian government; it was not the immediate cause of the revolutionary undertakings. The military played the role of cohesive force capable of under-taking modernization. As mentioned before the military revolution resulted from the intramilitary dysfunction and the civilian tampering with the military. Unlike similar upheavals in Pakistan, Burma, and Turkey where the military coup was the work or the top military hierarchy, the Korean coup was under-taken by second and third echelon officers in the military.

Third, some accomplishments by the military as an innovating force was not the result of training and education received by the military. Rather they were the result or urgency that the situation required. As a revolutionary enterprise which overthrow a constitutionally elected government, the military coup leaders had to demonstrate a sincere and ambitious nation-building spirit by initiating, developmental programs if it was to justify their extraconstitutional action. To convince the public and other military leader of authenticity as a reform government, they were compelled to undertake and succeed in some innovating task. For these reasons at the initial stage of revolution the junta plunged into the task of modernization in almost haphazard fashion. Indeed the military's ambitious development plan and high records in economic indicator generated enough momentum for the junta to carry through a successful conversion of the military government to a civilianized regime. Of course scientific orientation toward problem-solving, organization theory for efficiency and stability, and youthful enthusiasm facilitated the developmental programs initiated by coup leaders.

3. Inherent Characteristics

There are factors and developments which make the Korean military experience different from others. These make it difficult to identify the Korean military rule with one particular pattern or with a universal hypothesis. Korea has her own cultural, sociological, political, military and economic characteristics. Among them are the following worth mentioning.

Significant in this connection is the fact of Korea's relative insularity. Having centuries ago closed its borders to other ethnic groups and its ports to outsiders, and discouraged commercial activity, Korea emerged into the twentieth century a remarkably homogeneous society. There was no significant minority groups and no important alien groups. There also were no significant regional or separate political loyalties to compete seriously with the authority of central regime. Unlike China and especially Japan, Korea lacked a strong warlord or military class. The absence of strong religious group is also a characteristic of Korea which has inflicted so many emerging nations. As a result of all these factors, Korea has been unusually cohesive.

A second important characteristic is the fluidity of the class structure. As far back as the end of seventeenth century the rigidities in the class system had begun to decline. The leveling process was greatly accentuated by Japanese rule, which not only did away with opportunities for access to the top but also took over much of the land by which many of the aristocrats had maintained their position. By independence the lines of class division had been greatly blurred. Hence military regime did not face so much resistance as in other countries in its endeavor to consolidate powers.

On above two accounts G. Henderson holds quite an opposite viewpoint. He sees the homogeneity of Korean culture and the fluidity or class structure as having had detrimental effects on Korean capacity for modern political organization. Most Korean scholars, typically Hanbeen Lee, expressed the view that above two characteristics were conducive to the modernization program.

Third, in contrast to other nascent nation under direct or indirect military rule, political ecology in Korea is quite different. Political consciousness and the literacy rate are both high. Indeed, in non-Western world, Korea ranks second only to Japan in education and voting participation. What should thus be recognized is that Korea was a relatively fertile ground for modernization prior to the inauguration of developmental design under the auspices of the military lader-ship. Because of education and political consciousness by the public general, the military regime in Korea races no task of unifying a diverse society, one of the major problems facing many such governments in other countries,

As pointed out by D. C. Cole and P. N, Lyman, the fundamental problem that clouds the future is in the political realm. Korea, like so many other developing countries has so far failed to devise a means for orderly change of government leadership. Some developments in recent past indicate that leaders who initiated military coup will remain in office indefinitely. Interesting future development remains to be Seen.

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