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**MTEF Framework and  
Implementation Strategy for  
Korea :  
Key Issues for Introducing MTEF and  
Top-down Budgeting in Korea**

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*Session 1-2 : Conceptual Framework*  
**PRESENTERS**



# Key Issues for Introducing MTEF and Top-down Budgeting in Korea

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## 1. Introduction

Budget reforms usually reflect specific political, social, and economic problems and issues. The rationale to undertake fiscal reform is invariably one of tackling problem areas and addressing identified weaknesses. Even traditional line-item budgeting, for example, was itself an evolutionary reform in response to serious concern about the lack of adequate spending control and substantial corruption. So too were performance budgeting, program budgeting, and zero-based budgeting.

Medium-term expenditure framework (MTEF), along with top-down budgeting, has drawn particular attention from many OECD and developing countries over the last decade or so.<sup>1</sup> MTEF, by integrating long-term perspectives into budgeting, is a practical tool to control fiscal risk and facilitates effective allocation of resources through strengthened strategic decision making in resource allocation. For example, Sweden adopted MTEF to contain and reduce fiscal deficit. Since the introduction of MTEF, fiscal balance has improved from a deficit of 10.8% of GDP in 1994 to a surplus of 4.8% in 2001.<sup>2</sup> On the other hand, U.K. intended to increase public investment, which continued to decrease. Through MTEF, public investment has increased from 20 UK billion pounds in 1997 to 31 billion pounds in 2003.<sup>3</sup> Recognizing its value, the World Bank has advocated MTEF as part of fiscal reform to improve fiscal discipline, strengthen effective resource allocation, and improve policy efficiency and effectiveness. To this end, World Bank has promoted operations to introduce MTEF into client countries.<sup>4</sup>

Korea has initiated a series of fiscal reforms since the East Asian financial crisis hit in late 1997. The new Administration, since its inauguration in 2003, has been striving to further plans for reform, central to which is MTEF along with top-down budgeting. The primary objective of MTEF is to integrate national policy priority into budgeting and set up a new strategic decision-making mechanism. The reforms to introduce these new initiatives are due to be implemented in 2004 with the aim of full application for the 2005 budget. This change will be a turning point in Korean public expenditure management (PEM), because it is not limited to bringing about changes to the budgeting process, but

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<sup>1</sup> More than 20 OECD countries surveyed prepare multi-year expenditure estimates and 7 OECD countries surveyed prepare a medium term fiscal framework. [http://www.oecd.org/document/61/0,2340,en\\_2649\\_34119\\_2494461\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/61/0,2340,en_2649_34119_2494461_1_1_1_1,00.html)

<sup>2</sup> Swedish Ministry of Finance, *Budget Statement 2003*, p. 7.

<sup>3</sup> The number is expressed in nominal term. Liz Passman, *Presentation on Public Expenditure Planning and Control*, UK Treasury, November 2003, p.4.

<sup>4</sup> World Bank has provided assistance, financial and/or technical, to at least 45 client countries as of 2003 to implement MTEF to help strengthen countries' public expenditure management system.

seeks to set up a strategic decision-making mechanism which, through a top-down and more discretionary approach, will alter managerial behaviour and organisational culture in the government.

This paper deals with Korea's MTEF and top-down budgeting reform plan by analyzing key issues which may affect successful implementation of reform. More specifically, the paper identifies why MTEF is considered necessary and what new budget process it will involve. Then, this paper addresses key challenges which Korea may confront and provides suggestions for implementation strategy to mitigate risks for successful reform. While this paper deals mostly with Korea's PEM system and addresses issues pertaining to Korea, it will be useful for other countries to draw some policy implications and lessons.

## **2. Background and Features of MTEF Initiatives in Korea**

More than most countries, public finance in Korea played a critical role in propelling economic growth during its development era. However, this arrangement also created numerous problems such as input and growth-oriented budgeting, restrictions of line ministries' discretion, and lack of transparency in the fiscal system.<sup>5</sup> These issues came to the fore at the time of the Asian financial crisis and prompted the Korean government to introduce many fiscal reform measures.<sup>6</sup> The results of these measures however, have been mixed. Aware of many unresolved problems, the new Administration has initiated PEM reforms focusing on MTEF with top-down approach. This chapter elaborates on the current problems which MTEF may address, characteristics of the new initiatives, and the budgeting process under the new system.

### **A. Why MTEF?**

#### ***Short-term Perspective with Bottom-up Approach***

Korea's current budget process operates on a short-term perspective, *i.e.* yearly based, and is highly tilted toward bottom-up approach. Under this system, revenues are calculated for only the upcoming year and expenditure prepared based on anticipated revenues for that year only. Although a medium-term fiscal plan was developed in 1999 to handle these short-comings, this plan has not been integrated into the annual budgetary process and has failed to significantly impact budget decision-making. The most pronounced problem in the current system thus is the lack of medium/long-term perspective and weak linkage between national policy priorities and budget.

Bottom-

up approach tends to lead to gradual yet consistent increases across almost all budget items. Due to this incrementalism, the structure of public expenditure has barely changed over the past decades.

For example, expenditure on 'economic affairs', the biggest item by function, has remained at relatively the same level between 1970 (27.4% of GDP) and 2000 (25.2%) even though the purpose of thi

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<sup>5</sup> Ministry of Planning and Budget (MPB), *How Korea Reformed the Public Sector (1998-2002)*, 2003, p.124-125.

<sup>6</sup> Some of these reforms were the preliminary feasibility study requirement, tighter management of project ceiling budgets, performance-oriented budgeting, reforms to the public fund system, consolidation of quasi-taxes, double-entry accounting. MPB, *Ibid*, pp.126-149.

s expenditure, spending for economic development, has become less relevant in today's market-oriented economy.

Another concern regards the strategic decision making mechanism in resource allocation. At present, little high-level discussion is conducted in the executive body between ministries and within the Ministry of Planning and Budget (MPB) regarding how public spending should be related to policy priorities. This lack of communication means consensus is seldom achieved during the early stage of the budgeting process. As a result, national policy objectives receive less than proper consideration in the resource allocation process. This also contributes to the lack of transparency in decision-making for resource allocation and setting policy priorities.

### ***Future Fiscal Risk***

Since the early 1980s, the Korean government has maintained strong fiscal discipline through tight fiscal and monetary policy. Notably, the deficit of the consolidated central government budget averaged 1.5% of GDP from 1981-1986 and the size of government debt was successfully restrained at a manageable level. Further, the Korean government, having experienced fiscal deficit at 4% of GDP in 1998, has made consistent effort to contain expenditure growth. Largely attributed to the rapid growth in revenue arising from a dramatic rebound in the economy and well-controlled expenditure increases, the fiscal balance returned to surplus of 1.3% in 2000, 2.0% in 2001 and 2002.<sup>7</sup>

However, there are many dormant problems, threatening fiscal soundness in the future. Unless properly handled, these threats could burgeon beyond manageable levels, necessitating that they be addressed sooner rather than later.

One of the most serious risks lies in social welfare demands. These represent a major upcoming burden on Korea's public finances. Especially, major public pension schemes have many problems such as generous benefits relative to contributions, implying that the reserve will be depleted in a foreseeable future.<sup>8</sup> Lee (2003) outlines Korea's expected social welfare burden from the four public pension schemes showing that benefits due will peak at 11.1% of GDP by 2035.<sup>9</sup>

This problem becomes more serious in the context of Korea's aging society. The aged - those 65 years old and above - population in Korea was 7% of total population in 2000 but that figure is expected to reach 14% by 2019. It should be emphasised that a key dimension to the aging population in Korea is the speed with which the demographics of society are shifting. What this fast aging phenomenon implies is that expenditure demand will rise rapidly and on a large scale and revenue source will decrease near in the future.

The second issue is restructuring of the financial sector. The fiscal support to financial restructuring mostly took the form of government guaranteed loans. Consequently, high net lending during financial sector restructuring in the aftermath of the financial crisis has left irretrievable debts of 69 trillion won, equivalent to 12% of GDP

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<sup>7</sup> The consolidated budget surplus is arguably overstated due to the National Pension Fund, net lending, and obligations for repayment of restructuring bonds. A perhaps more accurate picture of the fiscal balance appears after adjusting for these, showing fiscal balances of -0.5%, 0.1%, and 0.1% in 2000, 2001, and 2002 respectively. Koh, Young-Sun, *Public Expenditure Management in Korea*, KDI, 2003, p.10.

<sup>8</sup> The four main pension schemes are the National Pension Scheme (NPS), Government Employees' Pension Scheme (GEPS), Private School Teachers' Pension Scheme (TPS), and Military Personnel Pension Scheme (MPPS).

<sup>9</sup> Koh, *Ibid*, p.13.

in 2002.<sup>10</sup> This will inevitably make it harder to maintain fiscal balance for quite a long time.

Thirdly, of no small concern is the current division of the Korean peninsular and financial burden this situation continues to place on expenditure demands. This unique issue

whose outcome remains very ambiguous, requires sufficient planning in terms of public finance. The future of Korea, including possible unification with North Korea, is unclear but suffice to say all contingencies warrant due consideration. Reducing the negative effects of unification under any circumstances, will depend heavily on preparation and organization prior to such an eventuality.<sup>11</sup>

Moreover, the revenue side poses as high a risk to the fiscal balance as the expenditure side. Further aggravating the potential danger of threats is the outlook of Korea's economy growth rate, which is expected to slow markedly in the coming years. Reduced economic growth rates necessarily imply declining rates of revenue, which will test Korea's fiscal discipline.

### ***Inefficiency from Managerial Inflexibility***

Under the current system, there is a lack of managerial flexibility and limited autonomy in line ministries both in planning policies and implementing budget. It is believed that the existing centralized, input-control based, bottom-up approach in budgetary decision-making is one of the main causes of inefficiency and frugality.

Currently, the MPB reviews all projects in the budget review stage, thus it intensely influences line ministries. This induces line ministries to exaggerate budget proposals and often leads to laborious bargaining between line ministries and MPB. Such circumstances also, often incur enormous transaction costs and foster informality in the public sector,<sup>12</sup> representing a misuse of time toward unproductive efforts.

It also causes accountability problems. The link between responsibility and the discretion to perform flexibly and autonomously may be tenuous, creating a mismatch between policy and accountability. The lack of managerial flexibility in the public sector has undermined government's efforts, by performance management system, to improve accountability.

## **B. Korea's Reform Initiatives<sup>13</sup>**

Korea is in the process of preparing public expenditure reform plans with the following characteristics representing the main directions.

*Long-term Perspective* : Under the new system, the MPB will prepare a 'Long-term Financial Management Plan', which makes a long term - more than 10 years - projection of the overall fiscal balance and sectoral allocation. For this projection, MPB will factor in various macroeconomic and social variables including sustainable debt level and tax

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<sup>10</sup> Koh, *Ibid*, p.1.

<sup>11</sup> IMF estimates that it will cost 975 trillion won, equivalent to 820 US dollars if the two Koreas were united as of 2001 and North Korea's GDP will reach the same level as South Korea in fifty years. Funke, Michael and Holger Strulik, "Growth and Convergence in a Two-Region Model: The Hypothetical Case of Korean Unification," *IMF Working Paper*, 2002, p.18.

<sup>12</sup> For informality in the culture of government, see Schick, Allan, "Why Most Developing Countries Should Not Try New Zealand's Reform," *The World Bank Research Observer*, Vol. 13, No. 1 (February 1998), pp.127-129.

<sup>13</sup> This plan is in the process of being prepared so this section is not necessarily representative of the official position of the Korean government.

burden, national policy agenda, and sectoral expenditure demand. This Plan will serve as a baseline to determine fiscal balance and sectoral allocation for the upcoming three years and be reviewed and updated on a rolling basis to reflect any unexpected changes.

*Top-down Budgeting* : Fiscal targeting, of which sustainable fiscal balance over the economic cycle is a core aspect, will be driven by the Long-term Financial Management Plan and macro-economic forecasting. Based on fiscal targeting and revenue estimates, the decision is to be made for the budget aggregate for three years. Following this, and with consideration to policy objectives and priorities, sectoral and ministerial expenditure limits, for three years, will be finalized.

*Strategic Decision Making Mechanism* : As part of the new strategic decision-making mechanism, cabinet level meetings will be held to discuss long-term plans, macro-economics, budget aggregate, and sectoral limits. The main purpose of the cabinet meeting is to establish a forum wherein consensus-building on national policy priorities and expenditures will be made at the early stage of budget formulation. The additional objective is to obtain strong commitment from the cabinet, and enhance transparency through open and direct discussions. To support this meeting, the MPB should prepare a draft fiscal target, fiscal aggregate, and sectoral ceilings. During the preparation process, the MPB should interact closely with the President, who will preside over the cabinet meeting, on proposals in order to foster greater coordination and obtain critical support.

*Decentralization* : Currently, MPB is heavily involved in preparing appropriations for individual projects in the budget process, which leaves very little room for line ministries to manoeuvre. In contrast, the new system will result in the line ministries playing a much more substantial role. Within the boundary of the sectoral ceiling and policy priorities set by the cabinet meeting, line ministries will have more autonomy to prepare their own budget proposals. MPB will focus its efforts on reviewing budget proposals to ensure that sectoral ceilings have been respected and that proposed requests sufficiently reflect policy priorities. Increased line ministries' discretion over their budget preparation can significantly contribute to enhancing the accountability of line ministries, for line ministries will be held accountable for what they can control rather than for what they can not. A proper system of checks and balances including performance management should be in place to align managerial discretion with accountability.

Under the above direction, Korea's budgeting process will undergo fundamental change. The changes, incorporating the introduction of MTEF, will lead to new processes and stages outlined below:

#### ***Stage 1 : Long-term Financial Management Planning***

This stage covers medium-term macro-economic forecasting, and review of social and economic factors that may affect public finance. Various national debt levels such as the debt ratio to GDP or total expenditure would also be reviewed at this time. Contingent upon the findings and reviews conducted at this stage the Long-term Financial Management Plan should be constructed by the MPB. In the Plan, the long-term national agenda and sectoral expenditure demands should also be checked and a strategic, long-term resource allocation plan suggested.

#### ***Stage 2 : Fiscal Targeting and Budget Aggregate***

In this stage, based on the macro-economic forecasting and the Long-term Financial Management Plan, the fiscal target and important fiscal policy for three years will be set. The core fiscal target under consideration should be fiscal balance policy. Additionally,

along with analyses of other important factors including revenue estimates, the budget aggregate for three years should be suggested.

### ***Stage 3 : Sectoral and Ministerial Ceilings***

Following stage two, the MPB should suggest strategic resource allocation in line with sectoral and ministerial expenditure ceilings. In this stage, the national strategic policy objective and sectoral objectives are considered and major budget projects are classified according to strategic importance.<sup>14</sup>

### ***Stage 4 : Cabinet Meetings***

For this stage, a special Cabinet meeting will be convened to discuss and agree on macro-economic forecasting, long-term plans, fiscal targeting, and expenditure aggregates and sectoral ceilings. Consensus among cabinet members should be built through constructive and informed discussion and unanimous support attained at the cabinet level. It is perceived that cabinet meetings should be convened twice during the fiscal year. The first, held in March, would discuss and agree on the fiscal target, total size of budget, and sectoral ceilings. The second in August would update macroeconomic conditions and review the necessity of adjustments, and finalise the coming year's budget proposal. After consensus is reached at the cabinet meeting, the MPB should present and explain the proposal to the National Assembly.<sup>15</sup>

### ***Stage 5 : Line Ministries' Requests***

Line ministries should prepare their budget proposal so that it clearly reflects policy priorities and respects sectoral ceilings. Through this, line ministries would have more autonomy and discretion and the MPB, to facilitate line ministries' preparation, would provide guidelines, including criteria for common expenses. In case of complicated projects which involve more than one ministry such as R&D, or regional development projects, the MPB could consider establishing committees, consisting of relevant stakeholders inside and outside of government, to reach an objective and concerted decision.

### ***Stage 6 : Review and Budget Documentation***

MPB reviews line ministries' budget requests for sectoral ceiling compliance and policy priorities. In this stage, negotiation/bargaining between the MPB and line ministries will still occur. Even where budget proposals remain within sectoral ceiling, the MPB may raise questions and suggest changes to line ministries if the MPB believes policy objectives can be better achieved with different projects/programs. The type and frequency of discussion between the MPB and line ministries, however, will change such that discussion will be based upon transparent and fact-based rules.

## **3. Key Issues to be Addressed**

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<sup>14</sup> One possible classification scheme considered by the MPB is to sort all budget projects as A, B, or C, where A is projects related to national strategic objectives and sector objectives, and mandatory expenditures such as debt payment and debt interest; B is core projects in each sector; and C is projects that are classified neither A nor B.

<sup>15</sup> The role of the National Assembly and legislative procedures are integral to the budgeting system and important for reform. However, legislative issues are beyond the scope of this paper.

The principle of linking policy with budgeting, which MTEF embodies, is useful and popular for many countries around the world. However, not every country has been successful in introducing MTEF or fully realizing its benefits. One of the commonly cited reasons for less successful MTEF in many countries, developing and developed alike, is that too much attention is given to the technical aspect of MTEF and little consideration on how to change the institutional framework, decision-making process, and organizational culture of public sector. International experience clearly suggests that basic principles of MTEF must be carefully adjusted to fit into country context.

In this regard, it will be necessary to analyse key issues Korea may face down the road of reform and suggest how Korea can prepare itself to address these challenges. Special attention should be paid to country context in the areas of macro-economic forecasting, strategic decision-making, setting the level of line ministries' discretion, designing incentive systems, and reforming budgetary basics such as budget structure, scope and improving information system.

### **A. Macro-economic Forecasting**

Questions concerning macroeconomic forecasting are two-fold, *institutional and functional*. Institutional questions are, *how can a macro-economic forecasting function be set up in the MPB under the current institutional setting, and how can capacity be developed in the MPB?* Functional questions are, *how can unbiased macro-economic forecasting be undertaken, and how can macro-economic uncertainty be overcome?*

Korea has organizational complexity regarding macro-economic forecasting and policy coordination. Currently, the Ministry of Finance and Economy (MoFE) has macro-economic forecasting and policy coordination functions, while MPB's duties lie in fiscal policy and budgeting.<sup>16</sup> In addressing organizational complexity, dramatic change of organizational structure is likely to not only be unfeasible but also create significant resistance to the change that MTEF will bring in. Rather, it is recommendable to clarify roles of each ministry under the current system and set up a coordination mechanism.

Although the MPB will conduct macro-economic forecasting under the new scheme, its role should be limited, considering the current institutional environment. MPB's macro-economic forecasting function should be implemented only within the range of fiscal policy making. This may help avoid undesirable institutional conflict in government. Beyond that, it would be valuable for the MPB to embrace the findings of other government agencies and organisations, and coordinate the works from each source for better macro-economic forecasting. To this end, forming an advisory committee, comprising of MoFE, Bank of Korea, and public and private research institutes might be worth considering. However, it is the MPB who should be in the driver's seat

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<sup>16</sup> By way of background of Korea's institutional changes, economic forecasting and budgeting has seen several important changes. These changes have occurred at the institutional level directly impacting the decision-making mechanism and coordination functions. In 1994 the EPB was merged with the Ministry of Finance to form the Ministry of Finance and Economy (MoFE). This was soon fractured leading to the establishment of the Planning and Budget Commission (PBC) and Office of National Budget (ONB) as separate bodies from the MoFE. Shortly thereafter, the PBC and ONB themselves were merged to create the MPB, leaving the MoFE and MPB as two independent ministries.

when it comes to deciding on macro-economic forecasting, at least for setting the baseline for the Long-term Financial Management Plan and fiscal policies.

Unbiased, honest, and realistic forecasting is essential. MPB's well-trained technocrats and the independent advisory committee may be a way to move toward this end. It is advisable to devise a macro-economic forecasting formula for objective analysis and avoid pressure from outside political circles. In developing this formula, a conservative method would be preferable to contribute to fiscal soundness.<sup>17</sup>

It is recommended to establish a unit/department within MPB responsible for macro-economic forecasting and assessment of social/political factors that affect fiscal policy. This new organization could comprise of one or two divisions. Having such an organization within the ministry could allow MPB staff to appropriately deal with macro-issues, undergo training to enhance their capacity, and to coordinate greater links with outside experts. The MPB may make both judgemental and predictive errors, but will perform better over time as they build up experience.

Lastly, to cover macro-economic uncertainty, the concept of 'budget margin' should be created in the annual budget. The budget margin acts as a kind of buffer and mainly aims "to absorb fluctuations in the expenditure level due to changes in the cycle and other macro-economic uncertainties."<sup>18,19</sup> It can be utilized in cases of forecasting deviations and new presidential policy initiatives. The size of the budget margin may depend on accuracy of information. The budget margin should be no larger or smaller than what is considered enough to fulfil its role of accommodating uncertainty. It is perceived from international experience that, over time, macro-economic forecasting tends to become more accurate allowing the size of the budget margin to decrease.<sup>20</sup>

## **B. Strategic Decision Making on Budget Aggregate and Sectoral Ceiling**

*How should decisions about total budget aggregate and sectoral ceilings be made and by whom?*

Regardless of the type of decision-making mechanism, consensus and commitment at the highest level of government is a critical component for reliable fiscal targeting, budget aggregate and sectoral ceiling levels. In some OECD countries, such as Sweden, Norway, and the Netherlands, decisions are made through cabinet meetings. On the other hand, in the UK, H.M. Treasury fulfils the leadership role which is enhanced through a close relationship with the Prime Minister. Different again, in the USA there is a close informal interaction between OMB and the President, with informal cabinet level discussions, resulting in a strong commitment at the highest level and across the board. In all these countries' systems, the common and important characteristic is consensus and

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<sup>17</sup> For example, the Canadian Department of Finance systematically revises the private sector forecasts downwards as a further measure of prudence. This takes the form of the government adding 50-100 basis points (0.5-1.0 percentage points) to the average private sector economic forecasts for interest rates and then feeding this through its entire econometric model, thus producing lower forecast economic activity. This provides a buffer in order to maintain the government's fiscal objectives. OECD, *Budgeting in Canada*, 1999, p.9.

<sup>18</sup> Swedish Ministry of Finance, *The Swedish Medium-term Budget Framework*, 2002, p.13

<sup>19</sup> Budget margin is different from 'budget reservation' in Korean budgeting which represents a permanent allocation in the budget for unexpected demands such as natural disasters.

<sup>20</sup> The Sweden case shows the budget margins for 1997-2001 being 3.33%, 0.28%, 0.20%, 0.65%, and 0.59% during that time and its projection figure for 2002-2004 being 0.04%, 0.05% and 0.07% respectively. Swedish Ministry of Finance, *Ibid*, p.13.

commitment at the highest levels of government.

Korea is now strongly pursuing top-down decision-making mechanisms to link policy and budgeting.<sup>21</sup> In this regard, cabinet meetings should provide the forum where strategic decisions on fiscal targeting, total aggregate, and sectoral ceilings take place. Through this meeting, agreement will be reached in the Cabinet ensuring commitment at the highest level. The MPB should play a key role by preparing its proposal on fiscal policy, total budget aggregate, and sectoral ceiling for the cabinet meeting. Furthermore, it is important that the MPB works in close consultation with the President in preparing the proposal. From this, mutual benefit can be achieved as the President can input his policy priority into the budget and the MPB can gain political support.

A concern may arise over the possibility of disagreement at the Cabinet meeting, particularly over sectoral ceilings. This concern arises because Korea has been weak in forming consensus through consultation and negotiation processes. Added to this, lack of negotiation experience is the growing voice from numerous interest groups as Korea becomes a more democratized society. While valid demands should be heard and brought to the table for discussing national agenda, many not-in-my-back-yard type protests are becoming ubiquitous as well. This situation calls for special attention to be paid to the design and implementation of MTEF, since the cabinet meeting is likely to experience difficulty reaching agreement.

Given this situation, it may be advisable that the cabinet meetings adopt a two-stage approach. The first stage would be to decide the budget aggregate, and the second stage would determine the sectoral allocation. If these two were placed on the table together, it would be very difficult to reach an agreement. Thus, division of these two in decision-making becomes important as the decision on the total budget aggregate turns the discussions on sectoral ceilings into a zero-sum game. Against all these efforts, if cabinet meeting fails to reach an agreement, it should be understood that the President will make the final decision, with MPB's objective and professional support.

### **C. Discretion of Line Ministries**

*How much discretion should line ministries be given?*

A centralized budgeting process has been with Korea for a long time, with MPB's deep involvement in almost all facets of the budgeting process. Entrenched in this all-under-my-control mechanism, the MPB may be reluctant to relinquish its influence over appropriations. Meanwhile, concern over line ministries' lack of capacity and experience in areas such as prioritising within a sector may also lead to hesitation for greater discretion to line ministries.

Such barriers, however, can only be overcome by making steps to directly address these issues. A new incentive system must be introduced so that MTEF can be perceived by the MPB as being beneficial to them and that their influence over appropriation will be upgraded to more professional and legitimate influence. Ultimately, discretion to prepare a budget request within sectoral and ministerial ceilings should be granted to line ministries. This may afford line ministries greater ownership over their respective budget proposals and make them more likely to

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<sup>21</sup> However, it should be noted that MTEF consists of top-down resource allocation and bottom-up approach for cost estimation. In this sense, the bottom-up element should not be overlooked.

identify policy priorities within their sectors as well as grant managerial flexibility resulting in greater efficiency. Through these experiences, line ministries can also build up necessary in-house capacity to manage increased discretion over their policy and budget more effectively and responsibly.

On the other hand, Budget proposals prepared by line ministries should be subject to MPB's review. This review should mainly act as a checkpoint to ensure that line ministries' proposals are in line with the national policy priority agreed on at the Cabinet meeting and stay within the sectoral ceiling. Also the MPB should provide guidelines, including criteria for common expenses, and perform monitoring and coordinating roles to ensure line ministries' proposal is prepared according to the provided guidelines.

In addition, an incentive system should be developed to promote more efficient spending for line ministries. Presently any money left over at the end of fiscal year is returned to the General Account. Obviously, this system provides little or no incentive for line ministries to save money. One way to alter the incentive of line ministries is to classify any remaining funds at the end of the fiscal year into two categories; *savings and over-budgeting*. The first, *savings*, would refer to amounts arising due to efficient spending and genuine efforts to reduce spending and improve efficiency. For funds falling into this category, a certain percentage of savings - empirically at least more than half of the savings should be allowed<sup>22</sup> - could be retained by the line ministry for use in the upcoming fiscal year. The second category, *over-budgeting* should be returned to the General Account as per the current system.

#### **D. New Incentive System**

*How can the new incentive system overcome resistance to implementation, and what should be the new role of the MPB and line ministries under this new system?*

It is possible that both the MPB and line ministries will resist reforms for many reasons. The MPB may be concerned with potential loss of influence and power through the proposal to diminish its role in allocating resources. On the other hand, line ministries may be skeptical about receiving more discretion in their own budget preparation. Both the MPB and line ministries may also perceive the changes as merely additional work without granting any real benefit.

Two main considerations should be given to deal with resistances to the new system. First, some resistance may arise from a lack of knowledge regarding the real nature and characteristics of the proposed new system; how a annual budgeting process changes under MTEF, what will be the new roles of MPB and line ministries, what kinds of benefits can be expected from MTEF. Secondly, uncertainty over individual incentives under the new system, if not handled appropriately, may lead to resistance. MPB and line ministries' staff may not be sure how the changes will affect their personal interest.

For MPB, the existing system places a large work burden on the staff at MPB and much time is devoted to micro-level decision on individual activities.<sup>23</sup> However,

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<sup>22</sup> Allen, Richard and Daniel Tommasi, *Managing Public Expenditure: A Reference Book for Transition Economies*, OECD, 2001, p.359.

<sup>23</sup> The number of projects per budget examiner in the MPB has jumped 81 in 1994 to 150 in 2003; and the portion of budget allocated per budget examiner increased from 1.0 trillion won in 1994 to 4.6 trillion won in 2003. MPB, National Resource Allocation Improvement Plan, 2003, p.8.

under the new system, focus will shift to higher level decision-making, analyses of macro-economics and national policy priorities, and preparation of draft proposals for the cabinet meetings. Furthermore, the MPB could have the privilege to interact closely with the President. From all these, the MPB will not lose its current standing as a 'prestigious' ministry. On the contrary, its influence and power may be strengthened. MPB's influence will remain high through monitoring and coordination over line ministries' budget proposals during the budget review stage and through performance evaluations of major projects.

On the other hand, line ministries have an opportunity to enhance their level of influence, providing an incentive to gain greater discretion in decision making. Line ministries, firstly, will be granted discretion in planning and prioritisation within their sectors and secondly, they will have flexibility in implementing policy and executing budget. There will be a learning curve when introducing these changes which will further allow line ministries to build up capacity to deal with their new role. The timeline for granting discretion may need to be done gradually to plan a path for granting discretion over to line ministries.

Besides, gaining greater discretion over budgetary decisions can also increase the legitimacy of holding line ministries accountable for the performance of their output. Under the new system, unlike the current situation here line ministries are sometimes held accountable even though they don't have any control over resources and decision-makings, line ministries should be accountable for the decisions they make and their performance only.

## **E. Performance and Accountability**

In an effort to enhance performance, the Korean government launched a pilot project in 1999 to implant performance-based budgeting (PBB). Under this project 39 participating agencies prepared and submitted performance plans to the MPB specifying objectives, strategies, and indicators. They also compiled an *ex post* performance report for comparison against the original plan. The impact of this pilot project between 1999 and 2002, however, was analysed as falling short of expectation.

The MPB, recognising that it may be too ambitious to link performance and budgeting, is in the process of designing an alternative, applicable management system. In the new system, line ministries are asked to develop objectives, indicators, and measurement methods for certain projects under the guidelines provided by MPB.<sup>24</sup> In this way, line ministries will have strong sense of ownership and the MPB can ensure performance indicators are appropriate and consistent over all ministries.

The new performance management system should ideally follow a long-term phased approach. Since this can be a daunting task, it may be beneficial to formulate a viable, short-term plan, which sets reasonable goals and fits within the broader program, to facilitate early and successful implementation. Pilot projects to develop and introduce output-based indicators would be a preliminary step followed by expanding into all programs and developing outcome-based indicators.

Expectations are high regarding the latest tools and techniques for performance management. Evidence from international experience, however, indicates that performance management or PBB adds value only when the existing institutional

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<sup>24</sup> According to MPB's plan, a certain number of projects, amounting to 30% of the total ministerial budget, will be evaluated.

arrangement in the public sector is conducive to support performance orientation. Therefore, the Korean government would need to foster an environment which supports performance orientation while fully introducing PBB or outcome budgeting. For example, personnel management and organizational structures that provides incentives for improving performance should be in place along with a performance management device.

The *quid pro quo* for the increase in discretion is that the line ministries be held accountable for results. The new system should bring a fundamental change in terms of accountability. It should make the MPB and line ministries more responsible for their results, and not their processes. Thus, instead of input control, the focus should be on what they achieved.

The first step to enhance accountability is to emphasize that ministers should hold ultimate responsibility for programs operated under their discretion.<sup>25</sup> Presently, the Korean government has little *ex post* evaluation, although it has introduced some *ex ante* evaluation systems, including the preliminary feasibility study. To move further along this path, the MPB should embrace the role of watchdog by performing more comprehensive monitoring and evaluation of projects. Setting up policy objectives for the cabinet meeting and discussing projects objectives with line ministries during the budget review stage will be a sound basis for this process. To further contribute to this mechanism, budgeting and accounting systems should be linked and information exchange between MPB, MoFE, line ministries, and Board of Audit and Inspection integrated.

## F. Budget Structure, Classification and Scope

Another lesson from international experiences with MTEF is that success of fiscal reform largely depends upon 'budgetary basics' such as budget structure, scope, and classification, accounting, information, evaluating, and auditing. Unless these basics are firmly set up, introducing MTEF may not generate anticipated benefits due to a weak public expenditure management environment.

Unfortunately, many weaknesses exist in the Korean PEM system. First, the budget structure is too complicated; a fragmented assortment comprising one General Account, 23 Special Accounts, and 45 Funds. Second, its expenditure classification is far too subdivided; consisting of more than 2,200 appropriation accounts (*Se-Hang*) and more than 6,000 sub-accounts (*Se-se-Hang*). Each of them is subject to negotiation between MPB and line ministries. Third, the coverage of the budget is limited; excluding some important fiscal activities of the government, like the National Health Insurance and quasi-government activities.<sup>26</sup> Current coverage of the budget is not consistent with Government Finance Statistics (GFS), an international standard for public expenditure statistics issued by the IMF.<sup>27</sup>

The fragmented budget structure, complex classification, and limited budget coverage cause several problems.

First, it is difficult to control public financial resources, which impedes allocative efficiency. Second, the inherent opaqueness of the system leads to transparency and accountability issues. Thirdly, these budgetary basics problems also

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<sup>25</sup> A serious problem is that the tenure of ministers has been notoriously short with the average term of a minister being less than one year, during 1993-2002. Maeil Economic Newspaper, March 10, 2003.

<sup>26</sup> For more details, see Koh, *Ibid*, pp.29-31.

<sup>27</sup> It is however important to note that GFS is for statistical purposes rather than budgetary management purposes. IMF acknowledges that countries are not obliged to prepare an annual budget completely in line with GFS. Rather, it requires a country to *ex-post* prepare and rearrange expenditure according to GFS.

contribute to managerial inflexibility and make results orientation more difficult to attain.

These problems, all together, make it technically prohibitive to allocate resources within sectoral limits down at the level of sub-accounts, and this would hold even if the Korean government introduced a new system incorporating sectoral ceilings.

Much effort to realign the budget structure, classification, and coverage are needed. The Korean government should make all the special accounts and funds subject to the same level of scrutiny as budgetary expenditure. And, extra-budgetary funds should be discouraged unless very strong justification exists. The budget subdivisions, currently classified by line items with its heavy emphasis on input control, should be more simplified and, in the long run, managed with expenditure classification on a functional and program basis. Also, the consolidated budget report should embrace all activities that fall into public spending.

There also exists an urgent need to improve the information base and establish efficient information flows to facilitate strategic decision-making. Core functions of a financial management system like budgeting, accounting, cash-debt management, and auditing-reporting need to work as one entity even though it consists of multiple, geographically dispersed organizations. The information outflow from one component should be an inflow to all other related components so all components share a common financial evaluation and measurement base and decision makers can make timely and informed decisions.<sup>28</sup> For example, as line ministries would have more discretion in preparing their budget, the MPB needs to verify that each ministry uses the same set of macroeconomic indicators such as the unemployment rate and inflation rate.<sup>29</sup> Another important benefit from the integration of financial information is enhanced transparency of financial management procedures. Increased information flows and accuracy strengthens the checks and balance system within administrations, between the MPB and line ministries, and between public sector and citizen

#### 4. Some Suggestions for Implementation Strategy

For the successful implementation of MTEF, it is important to acknowledge the unique public sector environment of a country. Consideration of country context is all the more important for Korea, because Korea's public sector has very distinctive features from western countries where MTEF was originally developed and practiced. This section first briefly discusses a few aspects of Korea's public sector which may require special attention when developing an MTEF implementation strategy. Following this, some selected observations and suggestions regarding Korea's path to implement MTEF and top-down budgeting are provided.

First, Korea has shown a strong track record in linking planning and budgeting in the past. Korea's Economic Planning Board (EPB), a super-ministerial economic agency in Korea from 1961-1994, was empowered to handle both planning and budgeting functions under one roof f

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<sup>28</sup> An integrated information system becomes a more vital issues under Korea's divided organizational structure where treasury management and budget execution reporting is under MoFE and budget formulation and execution is under MPB. The current two stand-alone information systems in the two ministries need to be seamlessly linked to each other.

<sup>29</sup> This is not to say that MPB should handle macroeconomic conditions for all purposes. Rather, MoFE should be in charge of monitoring and setting macroeconomic conditions for general purpose and MPB's concern should be limited to those related to budget formulation.

or better directing economic growth. It is regarded that the EPB played an important role in directing economic development and was a crucial player in Korea's economic success story. The minister of the EPB was Deputy Prime Minister and enjoyed strong political support through visible Presidential involvement. In retrospect, Korea has, in substance, exercised MTEF without calling it MTEF.

Second, it is important to note that the current reform initiative is initiated within the executive branch and led by a number of technocrat 'champions'. This creates a strong sense of ownership within the government and helps to design workable features of reform and to implement it. Traditionally, technocrats have played very strong roles in Korea's public sector.<sup>30</sup> Among the reasons to explain this predominance of career technocrats are historical and social respects for government officials. This has attracted many well-educated and highly trained people to join public sector and become career technocrats. This also means that technocrats relatively distance themselves from political pressures. At the same time, the executive body and technocrats need to draw together to present a broad and united front of political support for its reforms as demands of various interests increasingly enter into the decision-making process.

Past experience of linking planning closely with budget during the EPB period and strong sense of ownership for the reform within the government and technocrats creates a favourable environment for MTEF to be successful. But that is not to say that the path of this reform will be easy. Challenges and obstacles lie ahead making the successful implementation of the new system no guarantee. In order to overcome these obstacles, the key issues outlined in the previous chapter need to be carefully addressed and detailed plans prepared. Besides these key questions, below are some select observations and suggestions regarding Korea's path for implementing MTEF and top-down approach.

### ***Pre-conditions***

There are several important pre-conditions for successful implementation of MTEF in Korea. Among these are strong political support, MPB's willingness and commitment to the new system, compliance of line ministries, capacity building for the MPB and line ministries, and development of a legal framework for the new system. Some have been met but not all. Although not all the pre-conditions are in place, the Korean government, rather than delay reform, should focus on putting them in place in parallel with proceeding with reforms. Most OECD countries also had, and still have, some shortcomings in their expenditure management. Instead of waiting till everything becomes impeccable, they used MTEF as an instrument to alter the *status quo* and improve along with strengthening policy linkage with budget. Considering its highly skilled civil service, Korea may opt to introduce MTEF while simultaneously striving to improve these pre-conditions.

### ***Bureaucracy and Organisational Culture***

Central to success of the proposed reform will be the evolution of Korea's bureaucracy and organisational culture. Korea's civil service system is characterised by life-long job security, seniority-based systems for promotion and non-merit based salary, short-term tenure of high level policy makers, and lack of performance-oriented culture, all of which leave little incentive for bureaucrats to accommodate change. These characteristics have contributed in part to the failure of past public sector reforms which

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<sup>30</sup> It is indicative to point out that most political appointees in economic related ministries, particularly MPB and MoFE, have been actually been awarded to career technocrats over the last four decades.

government ambitiously tried to implement and end up, only causing superficial changes and limited tangible results.

Fiscal reform, due to its potential impact on resource allocation, can be a strong driving force in broader public sector reforms. However, fiscal reform is a type of reform that requires a holistic approach; as public expenditure touches almost all realms of public sector, meaningful change in PEM must be complemented with other public sector reforms. Therefore, it is important to reignite various public sector reform efforts that were initiated at the time of the Asian financial crisis but remain incomplete. It will not only create a favourable environment for MTEF to be introduced, but also will create a synergy effect for building a more effective and transparent public sector.

### ***Leadership and Capacity***

Strong leadership is essential in any reform. For MTEF and top-down budgeting, direct involvement of the President and active engagement of cabinet are necessary. Also, MPB's strong leadership is crucial to initiate the reform. It will be particularly essential to have key individuals in the ministry to "champion" change both initially and to sustain the momentum. Expanding from this initial step, a core group should be identified to lead and promote the initiative throughout the ministry.<sup>31</sup>

Capacity building is another important element to implant this new system. For MPB staff, skills in macroeconomic and policy analysis, policy prioritisation, coordination and conflict resolution, and problem-solving abilities should be built up. Line ministries should develop capacity in planning and policy analysis, development of implementation strategy and tools, and problem-solving abilities.

The MPB and line ministries can build up capacity through job training and seminars for all levels of MPB and line ministry staff. Not just the technical features of MTEF but the benefits of MTEF should be conveyed to all staff levels. More important, however, is to create an incentive system that motivates self-development and capacity building. Once sufficiently motivated, MPB and line ministry staff will benefit from the learning curve as they internalize MTEF process.

### ***Big Bang and Gradual Approach***

Devising a specific implementation strategy will increase the likelihood of success of the reform. Reform can be implemented *via* a big bang or gradual approach, *i.e.* introducing the whole plan at once or on a piecemeal basis. For Korea, a combination of a big bang approach and gradual approach together would be more desirable. Top-down decision-making may be adopted *via* a big bang approach and should see strategic decision-making for budget aggregate and sectoral ceiling introduced together with resource allocation policy making. However, in areas not covered in strategic decision-making, a more gradual approach should be adopted. This includes various budget stages, such as budget proposal preparation, review, monitoring, and evaluation. A comprehensive long-run plan should map out smaller steps designed to realise the gradual approach. In the process of implementation, attention should continually be paid to meeting the pre-conditions referred to above.

### ***Performance-orientation***

Improvement of PEM requires serious focus on results achievement or performance from government expenditures. Accordingly, MTEF and performance management repre

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<sup>31</sup> Muggeridge, Elizabeth, Mozambique: Assistance with Development of a Medium-term Expenditure Framework, Draft Report, World Bank, 1997, p.32.

sent two sides of the same coin. Even if MTEF is successfully introduced, it may be vulnerable unless performance-oriented management is implemented correspondingly.

International experience shows that nurturing a performance-oriented environment is of central importance before new tools and techniques for performance management or PBB can be fully introduced. In the case of Korea, performance orientation in the public sector is considerably underdeveloped. In the current system, life-long tenure, seniority-based promotion and salaries are the norm. There is little managerial flexibility, to the extent that even ministers cannot make changes in the organisational structure, nor do they have the discretion to hire career officials. Thus, it is at least equally important for Korea to make efforts to realign the public sector environment, especially the civil service system, to fit into performance-oriented management while efforts to introduce performance management system needs to continue.

A suggestion to exemplify the advantages of such a culture would be to select one or two government ministries/agencies and designate them as regulation-free organisations. All regulations would be removed, allowing ministers/CEOs full discretion over personnel, organizational structure, management, *etc.*<sup>32</sup> At the same time, the chosen agencies would have clear assignments and a vision to achieve the objectives. In such an organization, performance would be a key driver for the minister and senior officials for they would be judged on *what was achieved* rather than *how things were done*. This should also lead to positive spill-over effects. Through this pilot project a performance-oriented culture could spread out in the public sector.

Korea's PEM is currently in transition, having already begun some reforms to move forward, but still many more issues remain to be addressed. Many challenges lie ahead that must be confronted, but there is also cause for optimism. The Korean government is dedicated to reform, initiatives have been derived and pushed from the inside, and there are positive dynamics for change. A budget system is a communication system, conveying symbols and signals about behaviour, priorities, intentions, commitment, and price. The new PEM system, thus, is much more than simply fiscal reform; it's about creating new value and changing behaviour, making public sector more performance-oriented, accountable, and transparent.

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<sup>32</sup> This idea is borrowed from Special Economic Zones, which are designated areas dispensed of regulations in order to boost investment and create a free and competitive business environment for economic activities

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