# Chapter 23

## *Asia*
# Republic of Korea

***A centralized fiscal system, tight controls on borrowing, and preferential loans from the center have curbed the interest in subnational borrowing in the credit markets.***

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### Lessons Learned

The Republic of Korea is a unitary state that started on the path to devolution relatively recently. One of the rapid-growth "Asian Tigers," it has developed impressive economic power and a good-sized domestic capital market and banking system. Having this financial system in place, however, does not mean that subnational governments will access it. Local borrowing decisions, and subnational finances generally, are closely supervised and regulated by central government authorities. Most local borrowing occurs through specialized government-owned institutions that are tied into national line ministries. These typically offer better rates and longer loan terms than are available in the markets. Thus local borrowing decisions are largely choreographed by a network of centrally controlled regulations and inducements. Given Korean concerns about the national economy and the strong tradition of centralization, fiscal decentralization does not appear to be imminent.

Even so, as devolution continues, the twin forces of greater local autonomy and a need to raise capital more efficiently are likely to increase interest in developing more competitive markets for local debt. The country's robust economic growth and urbanization require heavy capital outlays, and capital investment projects account for a large share of local spending. While these outlays are heavily supported by central government transfers, the need for credit will grow. Moreover, large Korean cities have experience in raising capital funds locally through compulsory bonds, a borrowing instrument unique to Korea.

Seoul illustrates some of the features of subnational financing. Responding to the crises of the late 1990s, it rapidly restructured its operations, reduced its workforce, pushed capital spending out to corporations (public and private), and paid down debt. With the swift recovery in the Korean economy, it has seen its revenues rebound and its bond rating upgraded. Although its bonds are not guaranteed by the central government, its creditworthiness, at least as perceived by the credit rating agencies, benefits from the strict state oversight of its operations.

A democratic and highly centralized Asian country that has enjoyed record-setting economic growth, the Republic of Korea has elected to fiscally decentralize its governmental structure slowly and carefully. While spending activities have been increasingly devolved to local government units, these units act in many ways as agents of the center. The central government has retained a tight grip on their spending decisions, fiscal systems, and borrowing authority.

Nonetheless, there are pressures for further devolution, with the hope of achieving the greater political accountability and spending efficiency expected with greater local autonomy. The nation's relatively well-developed capital markets provide a potential mechanism for helping to accomplish this, although access to capital markets by local authorities has been both limited and closely supervised by the central government. State-owned specialized lending institutions, offering attractive terms to local government units whose capital plans are blessed by the central government, still dominate the local government credit scene.

## Subnational Finances

Korea has come to decentralization and devolution relatively late. Aside from a brief experiment in the 1960s, Korea has long remained a highly centralized unitary government, with relatively little autonomy at the local level.[1] Starting with local elections in 1994, Korea moved toward a system of political decentralization. But that decentralization has been largely administrative, involving little in the way of local fiscal autonomy. Local finances are still controlled from the center, with minimal local control over revenue and spending decisions.

Local government in Korea is organized at two levels. The first level, the regional governments, consists of Seoul and five other large cities and nine provinces. In the second level are 250 smaller district, city, and county units, known as the local governments. (Both types of government are generally referred to as local governments here.) As in most decentralized unitary states, each tier has its responsibilities and some own resources. However, as is true in many unitary states, the lines of demarcation between local responsibilities and those of the central state are vague (Kim 2002). The system depends heavily on transfer payments from higher levels of government. In Korea the entire network is thoroughly regulated and overseen by the central authorities.

In Korea, as in many countries, local economies and fiscal resources vary widely. The capital region of Seoul, with a population of 10 million, accounts for about 22 percent of the nation's population, 25 percent of its GDP, and 22 percent of local government spending. The focal point of much of the country's development, Seoul weighs disproportionately heavy in its economic development plans.

### Revenue Sources

The system's high degree of centralization is reflected in the disparity between local government spending and own-source revenues: although local governments account for about 50 percent of total general government spending, they raise only 20 percent of revenues from their own sources, with the rest derived from central government transfer payments. The intergovernmental transfers are largely specific and conditional, and the central government exercises considerable administrative control over local activity. A large share of local unit spending is for capital projects, which are tied into national planning processes and requirements. This emphasis on capital projects limits the revenues available for operating purposes (Chu and Norregard 1997).

Local taxes are heavily skewed toward real, personal, and commercial property. These taxes are applied both *ad rem* and *ad valorem* on tax bases, with varying rates of assessment, and especially on property transactions. Local tax revenues have been growing in significance in Korea but are still relatively small as a share of GDP (4 percent) compared with those in other OECD countries. Although local units may set rates within wide ranges, all were using the same standard rates at least until the mid-1990s. Because expenditures are largely controlled by central decisionmaking, there is little local initiative to alter local tax rates (Kim 2002).

The Korean intergovernmental transfer system is complex. It takes into account expenditure needs and resource capacities and excludes several better-off jurisdictions (including Pusan and Seoul) from the distributive calculations. It also has provisions for funding special projects, over which members of the legislature have influence. The national transfer system is largely duplicated by a mandated regional transfer scheme under which regions make transfers to their local governments. Thus, all transfers are strictly regulated by the national government (Chu and Norregard 1997).

The current system of governance, with little devolution of fiscal authority to the local level, has been criticized for not reaping the efficiency advantages that should come with greater local autonomy. Subnational borrowing is subject to a complex regulatory framework and process in which consistency with national development plans takes precedence. The Ministry of Government Administration and Home Affairs takes the lead regulatory role, and local governments must obtain both its approval and that of local councils before undertaking borrowing (for international borrowing, the Ministry of Finance and Economy is the key player). Line agencies of the national government (such as the Ministry of Transportation and Environment) also get involved in particular projects and in the extension of subsidized credit.

Because of the historically close integration of the central and local governments and the center's approval process and close oversight, the financial risks in subnational lending are viewed as shared between the local and national governments, even in the absence of a formal central government guarantee. However, given the close national supervision and the little latitude afforded local governments, the risk of moral hazard appears to be minimal. The center is firmly in control of what is being done and the risks being taken.

One result of the firm central controls has been that the growth in subnational government debt has been subdued and its relationship to the economy has remained fairly constant. Local government debt as of 2001 represented only 3.3 percent of GDP compared to the central government debt of 20.7 percent. Local debt over the past few years has grown at roughly the same pace as the economy, while central government debt doubled in relationship to GDP between 1995 and 2001 (Kim 2002).

A market-oriented system of local borrowing would help increase the accountability and efficiency of local governments. Although the existing system of highly regulated and largely subsidized local borrowing has kept close control over local activities, Korea lacks a good credit allocation system in which local units would benefit from market terms and conditions. In the mid-1990s local units were borrowing at 6 percent with long grace periods, while market interest rates were at 9 percent. Moreover, the method of offering local bonds—usually through negotiation with banks with which the bond issuers have customary relationships—suffers from a lack of competitiveness (Chu and Norregard 1997).

### Central Domination through Carrots and Sticks

Korea's developed economy could provide the financial basis—sufficient savings, large capital flows, and a developed market infrastructure—for developing a local credit market. Countering these advantages is the strong central political control of local government affairs. This domination is exercised both by controlling access to preferred financing from government-owned banks and through close monitoring and approval of local government debt issuance and detailed project review.

Government-owned banks and institutions provide about three-quarters of local government credit, and bonds issued by the local governments provide most of the remaining quarter.[2] The terms of the loans from government banks and institutions are more favorable than those available on bonds. The loans carry interest rates in the range of 3 to 7 percent, with tenors of up to 30 years. In contrast, bonds have interest rates of up to 10 percent and tenors of 10 years.

Government control is manifested through bureaucratic guidelines and edicts of the Ministry of Government Administration and Home Affairs on the eligible source of funding for specific projects. These essentially induce—if not direct—local government units to borrow on favorable terms from government sources, inhibiting the development of the private market for loans and bonds. Nonetheless, Korea has the largest domestic subnational government bond market by volume in Asia, even though this market is a small fraction (about 0.5 percent in 1999) of the overall Korean bond market.

Contrast the Korean approach with that in the United States, for example, where the federal government controls project development primarily through programmatic control of grants (as in the allocation of funds for transport) rather than through direct control of local government project funding or of the local debt market. If the federal bureaucracy ever gets involved, it does so only to require local governments to show how they can fund a project before it provides a grant. It does not monitor, control, or interfere in the local municipal credit market.

## Legal and Regulatory Framework for Subnational Borrowing

Many broad legal and regulatory issues condition the development of a local government credit market. These include banking and municipal regulations that determine where subnational governments can deposit their funds and from whom and how much, if any, they can borrow; requirements for approvals by government (central, regional, and local); eligible uses of loan proceeds; types of borrowing instruments; repayment mechanics; and regulations relating to private loans and underwriting.

Korea has several laws relating to local government borrowing, codified in the Local Autonomy Act, the Local Financial Act, and the Enforcement Decree of the Local Financial Act. These acts define the procedures for borrowing by local governments and the approvals they must obtain from higher levels of government. The acts also define the general terms and conditions of the loans, eligible projects, and other details. Generally, the laws are very restrictive and local borrowing is tightly controlled by the central government.[3]

The borrowing procedures used in Korea are bureaucratic and complex, involving multiple approvals by both local and central government agencies. Although the local city council has the final say on whether a municipality will borrow funds for a specific project, the Ministry of Government Administration and Home Affairs reviews project plans and budget estimates and approves central government loans, which often involves other central government ministries and agencies. Since these loans are on favorable terms, the Ministry encourages their use. However, the Ministry of

Government Administration and Home Affairs also decides what projects are "appropriate" for any incurrence of local debt, so they have effective veto power over all local borrowing (Kim 2002).

One purpose of reviewing projects at the planning stage is to compile nationwide data on required borrowing from government financial institutions for input into the central government's annual budget cycle. This gives the Ministry of Finance a sense of the maximum demand for funds and the impact that local borrowing may have on credit supply. The Ministry of Government Administration and Home Affairs approves specific projects, but the Ministry of Finance clearly has overall control.

The elaborate project review and approval process illustrates the high level of central government involvement in local government capital budgeting. Although local governments make the final decision on projects, the central government and its institutions, primarily the financial institutions, still have much influence over what types of projects local governments may pursue and how they will be financed.[4]

The national government uses a set of regulations to determine whether local governments can borrow. Under these regulations a local government may borrow if it meets the following conditions (Darche 2002):

- It is not delinquent on principal and interest payments.
- The ratio of its average annual debt service (principal and interest payments) in the past four years to its average annual local revenue (local taxes, general shared taxes, current revenue, and grants) in the past four years does not exceed 20 percent.
- The ratio of its general fund balance (revenue minus expenditure) in the past fiscal year, minus its local fund balance carried forward to the next fiscal year, to its local revenue in the past fiscal year is greater than –10 percent.
- Its local tax revenue in the past fiscal year is more than 90 percent of that in the previous fiscal year.
- It has not violated laws and regulations relating to subsovereign borrowing.

While it is unclear what documents the Ministry of Government Administration and Home Affairs uses to ensure that local governments meet these conditions, project applications probably require financial statements or other financial information to measure compliance with these debt indicators.

Different types of subnational borrowing instruments are authorized by different laws. For example, compulsory bonds are authorized by article 19 of the Local Finance Act, and regional bonds are authorized by article 12 of the Urban Railway Act. These laws demonstrate the diversity of legal and procedural requirements faced by local government units in Korea, consistent with the advanced development of the country's financial system. The laws define such things as the eligible use of the proceeds and the security for repayment (whether collateral or a pledge of specific revenues). Borrowing in both the domestic and the international bond market requires adequate disclosure. Bank loans are less transparent, but borrowing is subject to local legislative approval.

## Local Government Debt Instruments

Subnational units in Korea may use a large number of debt instruments, although two basic types—bonds and loans—may be used in two types of markets—domestic and foreign. The diversity of debt instruments reflects the relatively high development level of the Korean capital markets. The forms of security can vary as well, with the debt being secured on the general account, special accounts, or enterprise revenues.

Korea has a well-developed private domestic bank lending system, though it was radically restructured after the 1997 East Asian crisis. However, the private banking system rarely provides loans to regional and local units. Local units may borrow from private banks, but these loans are a small share of their total borrowing. Government-owned financial institutions dominate subnational borrowing, accounting for more than 80 percent of borrowed funds. Other financial institutions (private mutual and other funds, housing societies, pension funds, domestic contractual savings institutions) also lend to local governments through direct placement or bond purchases.

The government financial institutions and local government units negotiate the terms of loans. Private banks prepare bids based on the prime rate, often higher than the interest rates local governments can obtain from the government financial institutions, and local governments must compete with regular commercial customers. Almost all bank loans are secured by a "full faith and credit" pledge, which, given the high level of central government oversight, has political as well as financial implications.

The full faith and credit pledge assumes that the political relationship between the lending bank and the local unit is sufficiently strong to ensure loan repayment. Although no data are available on the performance of local government loans during the Korean financial crisis beginning in 1997, the government financial institutions do not appear to have had any significant loan delinquency problems. One reason may be the political (and perhaps financial) support of local units by higher-level governments. Another may be that, by delaying projects, local governments could use the large capital-spending component of their budgets as a buffer. Moreover, while the 1998–99 downturn in the Korean economy was sharp, it was also brief and followed by a vigorous recovery.

Local governments can also borrow from foreign banks, but these loans are rare and available only to the larger metropolitan areas. Korean cities have also ventured into the international bond markets. Any foreign borrowing, whether bank loans or bond issues, requires approval by the Ministry of Finance and the Ministry of Government Administration and Home Affairs.

Korea has three types of domestic bonds—public, compulsory, and government compensation—and two primary types of foreign bonds. For public bonds, also known as flotation bonds, the issuer hires a securities firm that solicits purchase offers from investors. These are general obligation bonds secured by the full faith and credit of the issuer. Compulsory bonds are unique to Korean finance. Their name comes from the fact that purchase of the bonds is compulsory for individuals and firms receiving certain services or privileges from the borrower, such as when purchasing a car, receiving a license, or registering a local company. The proceeds from these bonds are used to fund water services, subways, and other regional projects in the 15 largest metropolitan areas and major cities. These bonds are supposedly secured with the revenues generated by the improvements they finance and may be seen as an early application of the benefit principle. The issuing government sets the terms, typically a sub-market interest rate and extended grace periods.

Compensation bonds are used in construction financing. A form of vendor financing, they are given in lieu of direct cash payments to construction companies that build urban infrastructure. The city using these bonds negotiates their terms and conditions with the construction company. Compensation bonds have interest rates of 0 to 10 percent and tenors of one to five years.

Foreign bonds, issues payable in foreign currency, are sold in both domestic and international markets. The metropolitan governments of Seoul and Taegu have issued foreign currency general obligation bonds in international markets. These bonds received the sovereign ceiling rating because of the cities' status in Korea and the strong central government oversight.[5] Foreign borrowing, in both bank loans and bonds, represents only about 4 percent of all subnational debt; since the financial crisis of the late 1990s, interest in this source has declined (Kim 2002).

Debt proceeds fund a variety of activities. Seoul uses loans and bonds to fund construction of its subway, water, and sewerage systems, and other projects. The major metropolitan areas use debt proceeds mostly for housing and for agricultural and industrial estates, while the provinces use them primarily for housing and water and sewerage systems.

## Debt Marketing and Sales

Korea's advanced bank and bond markets have led to the establishment of a large debt financing "skills infrastructure" to service these markets. There are numerous underwriting firms, financial advisers, and trust banks on the sell side, and institutional and retail investors on the buy side. However, to date, most local unit borrowing is done through special central government funds or through the use of the compulsory and compensation bonds.

The marketing process for local government bonds can be quite complex. Private bond placements are negotiated with the lending party (a public or private pension fund or some other contractual savings entity), with the bond terms and conditions usually based on current market rates. For public offerings a number of marketing devices may be used. In some cases the local unit hires an underwriter (or a private bank), one with which it may have a long-term relationship, to negotiate the sale of the bonds to its institutional and retail clients. In other cases the local borrower offers a competitive tender for underwriting services, which means that the financial agent takes on the marketing risk of reselling the bonds in the capital markets.

For compulsory bonds, the terms are set by the issuing government, and the retail buyers (purchasers of cars and houses, for example) must purchase the bonds at the given rates. In other words, local governments use their regulatory powers to compel a "tied-in" bond sale on preferential terms. For compensation bonds the issuing government negotiates the terms and conditions with the contractor. It is unclear whether these terms and conditions are negotiated with the price of the contract or only after the contract is awarded to the company. For foreign bonds underwriters are selected on a negotiated basis and then provide the borrower with either a firm price for the sale of the securities on the international markets or a "best efforts" underwriting basis, depending on the terms of the underwriting agreement between the issuing government and the senior underwriter.

## Seoul's Management of Debt and Capital Spending

As the national capital, Seoul represents the largest local government in Korea. The city is the economic and political heart of the country and its largest local government borrower. Like other local governments in Korea, Seoul directs much of its spending to capital projects. Capital spending has accounted for about 40 percent of the total, though that share has declined in recent years.

The international currency crises of 1998 caused a sharp but short retrenchment for Seoul, which then recovered rapidly along with the rest of the country.[6] The city took quick and dramatic steps to restructure during the crisis. Besides delaying capital projects, it reduced its workforce by 22 percent. Although the crisis slowed borrowing and investment, the strong recovery greatly increased current revenues, and Seoul recently has been able to pay down debt and restore its investment program. Between 1998 and 2001 the unemployment rate fell from the crisis level of 7.6 percent to 4.5 percent, and in 1999–2001 the city generated substantial surpluses.

After earlier rapid growth, net debt outstanding has peaked and is being reduced (table 23.1). Debt outstanding as a share of total revenues, which was as high as 110 percent at the time of the crisis, fell to pre-crisis levels (about 87 percent) in 2001 and was projected to continue dropping. In the fall of 2002 Moody's rewarded Seoul with an upgrade of its foreign currency debt rating to A-3, recognizing its rapid recovery and generally sound prospects (Moody's Investors Service 2002).

Seoul has achieved greater autonomy in recent years, but this has not resulted in a larger city government. It is shifting more infrastructure spending to public corporations responsible for rapid transit services and, following the reduction in its workforce, has been outsourcing activity to the private sector. Moreover, the central government maintains close oversight, a factor that figures prominently and positively in its credit rating:

> Although Seoul's debt is not guaranteed by Korea, the national government's role in requiring budgetary balance, monitoring the city's budget condition, and approving borrowings is an important contributor to the [city's] rating (Moody's 2002, p.3).

**Table 23.1. Debt and Capital Spending of the Seoul Metropolitan Government, Republic of Korea, Fiscal Years 1996–2001**
**(billions of won, except where otherwise specified)**

| Indicator | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| Net debt outstanding | 4,865 | 5,635 | 5,609 | 5,969 | 6,197 | 6,075 |
| Total revenues | 5,665 | 5,595 | 5,178 | 6,107 | 6,994 | 7,015 |
| Debt as a share of total revenues (percent) | 86.4 | 100.7 | 110.6 | 96.7 | 88.6 | 86.6 |
| Capital expenditures | — | 2,869 | 2,116 | 1,982 | 1,982 | 2,105 |
| Capital expenditures as a share of total expenditures (percent) | 48.2 | 40.9 | 36.2 | 32.1 | 23.7 | 20.2 |

— Not available.
Source: Moody's Investors Service credit reports for Seoul Metropolitan Government.

Seoul has tapped offshore financing, through the sale of Yankee bonds (dollar-denominated bonds sold in the New York market) in the amount of $500 million in 1994. In August 1999 investors opted to exercise a five-year put option for $158 million, which Seoul met by drawing on reserves and floating a local currency bond issue. In mid-2000 more than 90 percent of the city's debt was denominated in Korean won.

Seoul relies on compulsory bonds as well as domestic bond sales and bank loans, an array of credit sources that gives it much flexibility in debt management. The large share of capital spending in its annual budget, much of it financed from current sources, provides a cushion of postponable expenditures if times get rough. In response to the events of the late 1990s, the city sharply reduced its capital investments as it redirected funds to repaying debt, shifted projects to corporations, and privatized some functions. Given the large menu of capital needs for which it is responsible, this flexibility is critical.

## Prospects for a Stronger Subnational Government Credit Market

With a well-developed infrastructure of financial markets and intermediaries, Korea has good prospects for developing an extensive subnational government credit market if that were a national priority. The important elements of such a market are all in place: high per capita GDP and savings, well-developed and competitive financial intermediaries, a well-developed legal and regulatory system to support this competitiveness, and competitive public and private contractual savings institutions.

However, having the framework for a subnational debt market in place does not mean that the market will function. There are other pieces to the puzzle. For a market to develop also depends on effective demand for funds. This, in turn, depends on such things as the degree of effective decentralization of the municipal finance system, the regulation of municipal financial activities, and the political relationship between central and local government officials. Furthermore, the young Korean decentralization must contend with the perception that local borrowing is in fact a means of receiving central government grants over time and, correspondingly, that there is little need for, or interest in, raising local taxes or fees when central subsidies are on the horizon (Kim 2002). These factors hold back the development of subnational finance in Korea. Perhaps the biggest constraint on the development of a local credit market is the limited capacity of (and incentives for) local government officials to manage revenues and expenditures to achieve financial viability and creditworthiness. Lack of local fiscal autonomy and managerial capacity impedes the development of credit markets in which local governments would rely on private capital and be accountable to the market.

Korea illustrates the tradeoffs between securing macroeconomic stability and control and undertaking a more liberal process of political and fiscal devolution. It illustrates the development of a local government credit market that is closely controlled by the central government and relies primarily on the relationships among government-owned banks, special funds, and local government units. The top-down political relationship between the central and local governments has constrained the development of a more efficient local credit market. Subsidized interest rates and extended loan tenors that are unavailable in the private markets have made continued dependence attractive.

## Notes

1. The Korean Constitution spends little time on the question of local autonomy. The relevant section (article 117) essentially states that subnational governments should exist at regional and local levels, should have

powers to serve local needs, and should have their own legislative bodies. Until 1994 the chief local officials were appointed by the central government. The framework and powers of subnational governments are defined by national legislation (the Law on Local Government Autonomy).

2. The government-owned banks and institutions include the Housing and Commercial Bank, Industrial Bank, Small and Medium Industry Promotion Corporation, Energy Management Corporation, and Environment Management Corporation. The specialized agencies tend to be organized by financing purpose and have close ties with the government line agencies.

3. Article 115 of the Local Autonomy Act states that governments can incur debt, with central government permission either when a permanent improvement in citizens' welfare is guaranteed or in the event of natural disaster. Article 7 of the Local Government Act declares a "no debt principle" that local budgets must be balanced (except in cases allowed under Article 115).

4. In interpreting what is an appropriate use of local debt, the Ministry can be flexible. All the soccer stadiums for the 2002 World Cup were financed by local government borrowing and a 30 percent national subsidy (see Kim 2002, p. 28).

5. Moody's Investors, "Service Web site, Seoul Metropolitan Government: Global Credit Report" (November 2002) .

6. Korean real GDP grew by 5 percent in 1998, shrank by 7 percent in 1999, and then snapped back, growing by 11 percent in 2000 and 9 percent in 2001.