The contemporary needs of general and earmarked grants in Korea: An assessment

Hyun-A Kim

Korea Institute of Public Finance
79-6 Garak-Dong, Songpa-Gu,
Seoul 138-774, Korea
hyuna@kipf.re.kr

September 2009

Abstract

This paper basically explains overall intergovernmental fiscal transfers and introduces recent changes with ongoing policies. It inquires into the appropriateness of the system in the 21st century. By examining Korean intergovernmental fiscal relations in political perspective, this paper will attempt to reflect on recent changes of intergovernmental fiscal system. Concluding that the present grants system is unfair, the paper offers a suggestive policy direction that the contemporary needs of social service expenditure should be considered first.

Some evidence of intergovernmental fiscal operation in Korea tends to support earmarked grants. Since the grants system cannot be alone with the degree of fiscal decentralization, the paper raises the questions of relevance of the current intergovernmental fiscal system. For sound management of local public finance, the tight linkage between marginal increases of revenue and local governments' works is recommended to relieve transfer burden to ultimate fiscal charger.

1. Introduction

Fiscal decentralization began again in 1991 with the appointment of council members, and established in 1995 by the election of local representatives in Korea. By instituting local elections, local governments can now employ their own developmental initiatives since elective local government officials will have to be sensitive to the needs of the constituents. Hypothetically, in an electoral process, people articulate their demands by their voting preference, likewise, local representatives has to obtain these voters' preference. This change as brought about by the electoral process has profound effects on the process of political decision-making and the agenda of public administration as shown by the significant relationship between the results of re-election and the size of local expenditure by using *grants (*Kim 2005). There is an incentive to utilize money from central government instead of rising *local tax rate*. Given the political, global and fiscal trends ongoing in Korea, as well as other hosts of reason, local government's role has to be expanded alongside the increase of its fiscal *size*. However, fiscal *power* of local governments has not symmetrically grown. In reality, local expenditure sourced through intergovernmental transfer has steadily grown since the last decade. As a way of improving intergovernmental fiscal relations, restructuring of intergovernmental fiscal relations has been a very important issue in Korea.

This paper basically explains overall intergovernmental fiscal transfers and introduces recent changes with ongoing policies. It inquires into the appropriateness of the system in the 21st century. By examining Korean intergovernmental fiscal relations in political perspective, this paper will attempt to reflect on recent changes of intergovernmental fiscal system. Concluding that the present grants system is unfair, the paper offers a suggestive policy direction that the contemporary needs of social expenditure should be considered first. Some evidence of intergovernmental fiscal operation in Korea tends to support earmarked grants.

Since the grants system cannot be alone with the degree of fiscal decentralization, the paper raises the questions of relevance of the current intergovernmental fiscal system. For sound management of local public finance, the tight linkage between marginal increases of revenue and local governments' works is recommended to relieve transfer burden to ultimate fiscal charger.

This paper starts with explanation of fiscal environments between central and local governments in section 2 and 3. Section 4 reviews the intergovernmental fiscal grants with recent change. And, section 5 evaluates the ongoing relevance of general and earmarked grants in Korea. In section 6, the recent change by political and social needs such as the tax-sharing way for increasing local revenue and the expenditure needs for welfare are mentioned. Section 7 concludes.

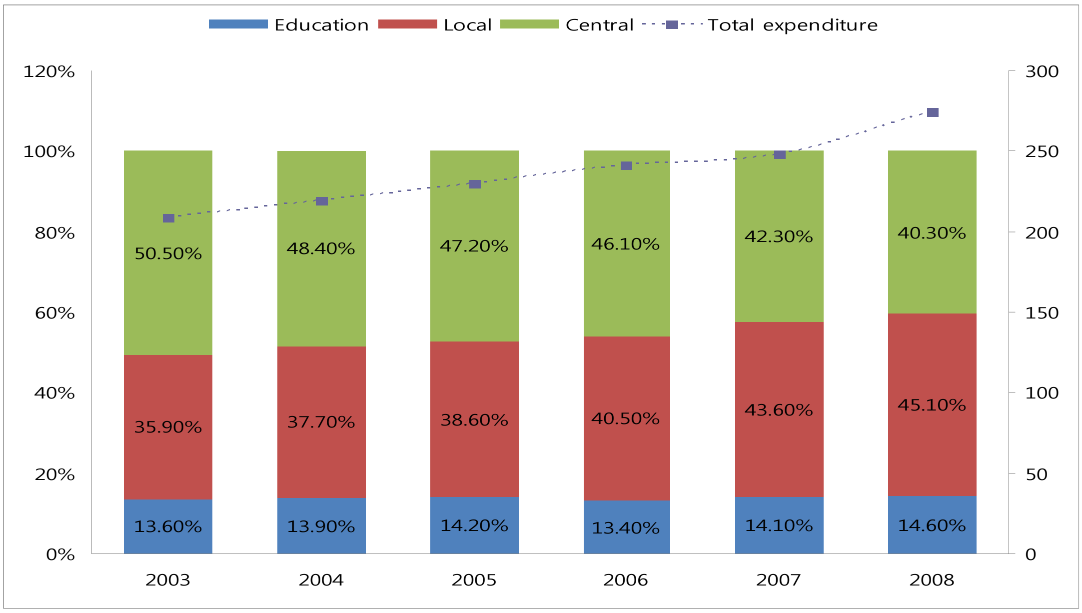
2. Increasing local expenditure by using intergovernmental fiscal transfer

Local share in the total government expenditures has been rising since the last decade. Ratio of sub-national government's expenditures including local education is around 60% in 2008. Local government share in expenditure was 35.9% in 2003 increasing to 45.1% to date hence, local government has the biggest role in the total public expenditures. The average trend of other countries shows that the ratio of sub-national government to total expenditure increased from less than 31 to more than 33 percent in a statistically significant way (OECD 2008). As picture (below) shows, Korea ranked high in local expenditure share level among OECD countries. Like many other countries, reliance on grants increased in Korea due to insufficient tax bases of local governments (OECD 2008) and the central government's preference to intergovernmental grants vis-à-vis expanding the tax bases of local governments. The share of sub-central transfers in total government expenditure is the highest at 26% with an average of around 14% among OECD countries.

From 2003, share of central government slowed down to around 10%. With the expanding trend of welfare demand, local expenditure share is projected to get bigger. During the last administration from 2003 through 2007, social welfare expenditure has been expanded. Local governments used fiscal transfers, such as general and specific grants, as the main tool in welfare expansion. Average annual change of fiscal grants from central government risen 12.1 percent as compared to that of 8.7 percentage rise of local tax.

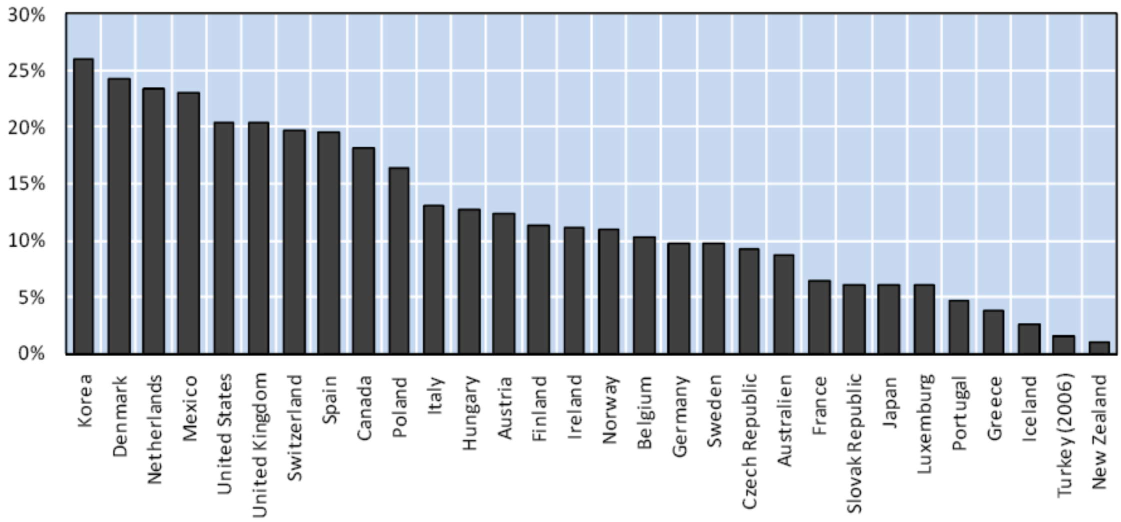
Figure 1. The budget size and expenditure share of general government in Korea

(unit: %, trillion won)



Source: Summary of local budget for fiscal year 2008, Ministry of Public Administration and Security

Figure2. Transfers to total government expenditure in 2005

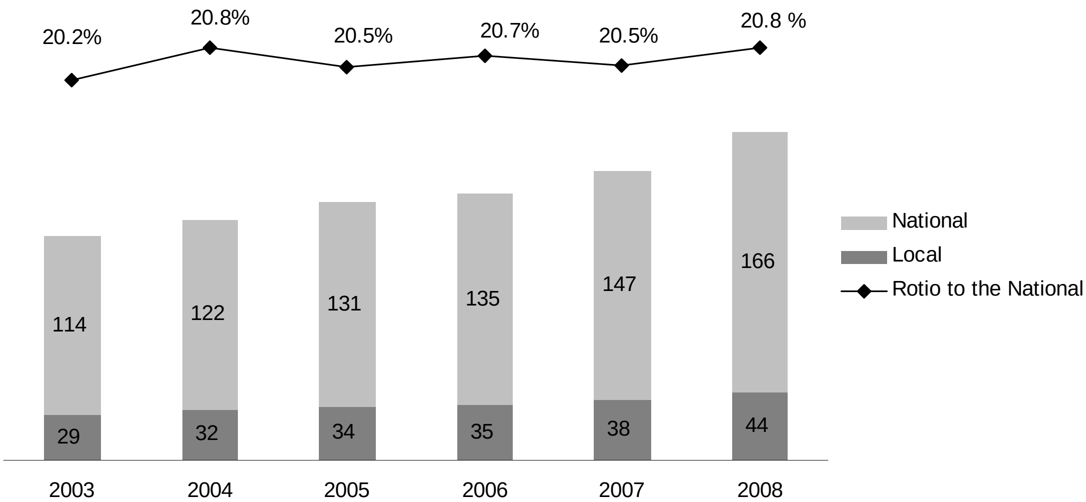


Source: OECD (2009)

2. Limited local tax share and taxing power

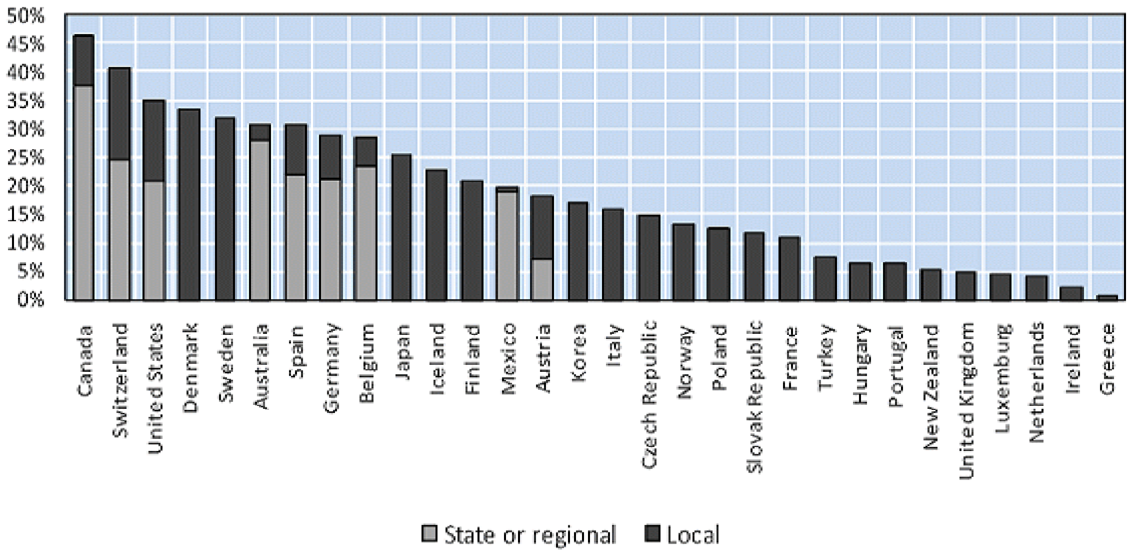
While the majority of expenditure are done at the local level, only very limited autonomy is available to local governments in their spending decisions. 20 percent of local tax share to national tax has been kept last two decades. Also, local tax rate and bases are determined by central government. Legally, local governments and councils can adjust rates as much as 50% above or below the standard rate. Indeed, 'flexible tax rates' are at hands in local authorities. However, the tax rates among jurisdictions are almost same because local governments fear that a relatively high tax rate may affect residents' relocating decisions. At the provincial level, only four of 16 jurisdictions had changed a tax rate from its standard rate as of 2004, and only ten of the 250 lower level government (OECD 2005). Active operating of flexible tax rate was the only case for *lowering* property tax rate at capital region after the reform of property taxation. In contrast to the limited use of flexible tax rate, tax reduction and exemptions of local governments is considerable amount as around 10% of local tax revenue. Asymmetric behavior of local governments is the result of inefficient relations between central and local governments.

Figure3. The share of local tax to national tax (Unit : trillion won)



Source: Summary of local budget for fiscal year 2008, Ministry of Public Administration and Security

Figure 4. Share of sub-central taxes to total taxes in 2005



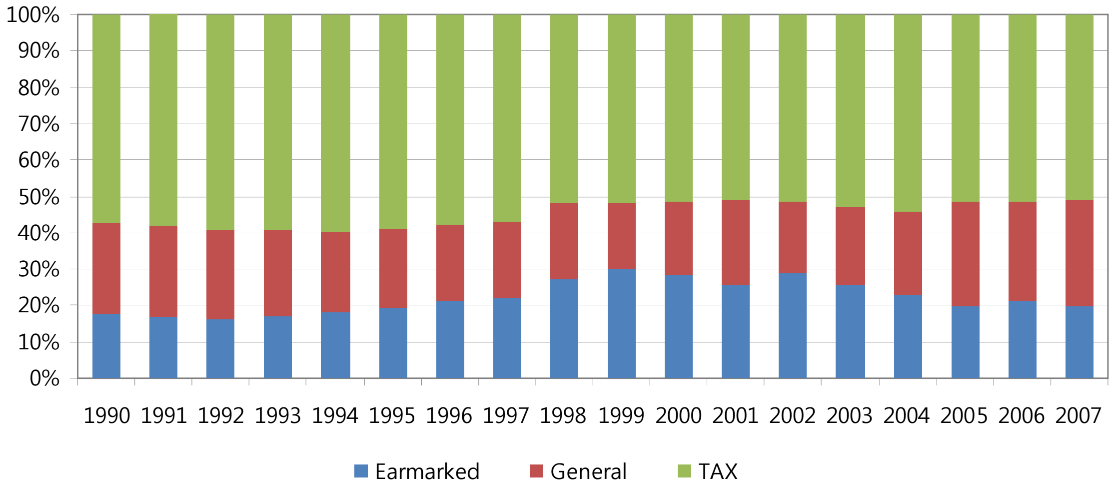
Source: OECD (2009)

In addition, local politicians tend to avoid increasing tax rate or bases. Because of soft budget characteristics, local governments easily lean on central government financially. Higher share of intergovernmental fiscal transfer explains one side of strategic behavior of local governments. With these aspects, active local taxing power is not operating in Korea in comparison with other countries (OECD 2006). From the perspective of taxing power at lower level of government, the introduction of Local Consumption Tax (LCT), which is tax-sharing method, may not be desirable for enhancing autonomy right. Note that tax sharing is not classified as a true local tax with taxing power in OECD standard.

As a result, tax competition in inter-jurisdictions is rarely used in Korea. There are several reasons of absence of adjusting taxing power. First, fiscal responsibility is only the part of central government instead of local government. Korea government does not allow bankruptcy of local level until now. Current budget system allows that central government plays an ultimate role of local government under the financial crisis. Second, the expanding size of intergovernmental fiscal transfer demands more grants to central government rather than raise tax rates.

Steady increase in Local Tax

Figure 5. Local tax and grants share in Korea



Note: Data excludes ‘Non-tax revenue’ and ‘Education grants’.

Table 1. The composition of tax and grants in local revenue

year	Share to local revenue (%)		
	TAX	General	Earmarked
1990	57.3	24.9	17.9
1991	58.1	25.0	17.0
1992	59.2	24.6	16.2
1993	59.3	23.7	17.0
1994	59.8	22.0	18.3
1995	58.7	21.7	19.5
1996	57.6	21.1	21.3
1997	56.8	20.9	22.3
1998	51.6	21.2	27.2
1999	51.7	18.2	30.1
2000	51.2	20.5	28.3
2001	51.1	23.4	25.5
2002	51.4	19.7	28.9
2003	53.0	21.4	25.6
2004	54.3	22.6	23.1
2005	51.5	28.7	19.8
2006	51.6	27.1	21.3
2007	50.9	29.5	19.6

Even though the central government has continued to enlarge local tax revenue, local tax covers only a part of local spending and the share has not been rising up the last decade. For example, a tobacco sales tax became part of the local tax base in 1989. The immediate impact of the tobacco tax on local finances was that local governments' tax revenue share of total revenues increased from 30 percent in 1988 to 39 percent in 1989. In 2007, local revenue is composed of own source revenue such as local tax (33.0%), non-tax revenue (29.7%) and local bonds (3.0%), and intergovernmental fiscal transfer such as revenue sharing (Local Shared Tax (LST), 20.9%) and national subsidy (13.8%). Without non-tax revenue, the share of local taxes is around 50%. The share of general and earmarked is 29.5% and 19.6% respectively.

Also, the ratio of the growth rate of local tax to GDP growth rate is 1.23 from 1996 to 2006. Note that the ratio of the growth rate of national tax to GDP growth rate is 1.17 the same period. Recently, bubble price of real estate has been one of the reasons for active transaction in house, land, etc. Speculative transaction made the trend stir up after 2002. Considerable amount of local tax is related with property transaction such as Acquisition Tax, Registration Tax and surcharge taxes. With this *de facto*, total collection amount of local tax has been risen up very fast after. Myopically, significant relationship between real-estate business cycle and local tax could be advantage when business is in higher stage. However, revenue buoyancy tends to be higher impact in lower stage and weak budget conditions. With current composition of local tax, the ratio of local tax out of total local revenue should be considered when the structure of local revenue is reformed.

3. An overview and recent changes of the intergovernmental grants

Figure 2. Types of grants in Korea

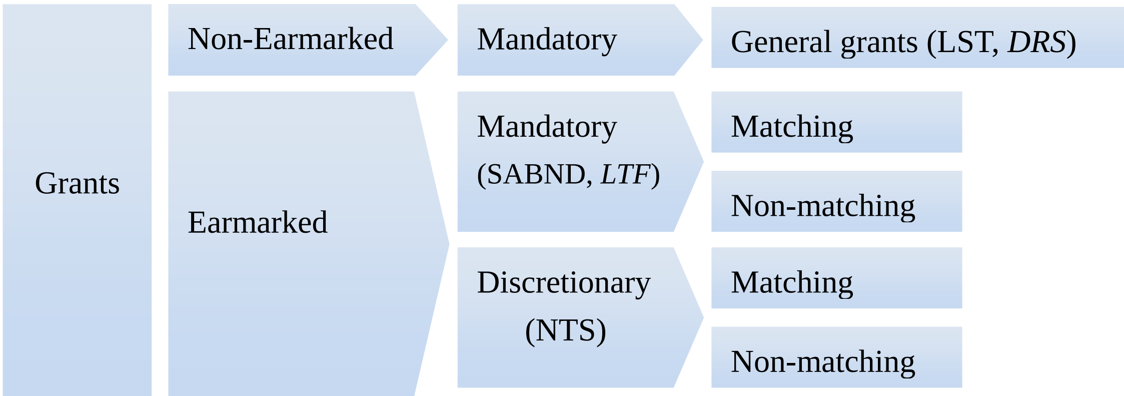
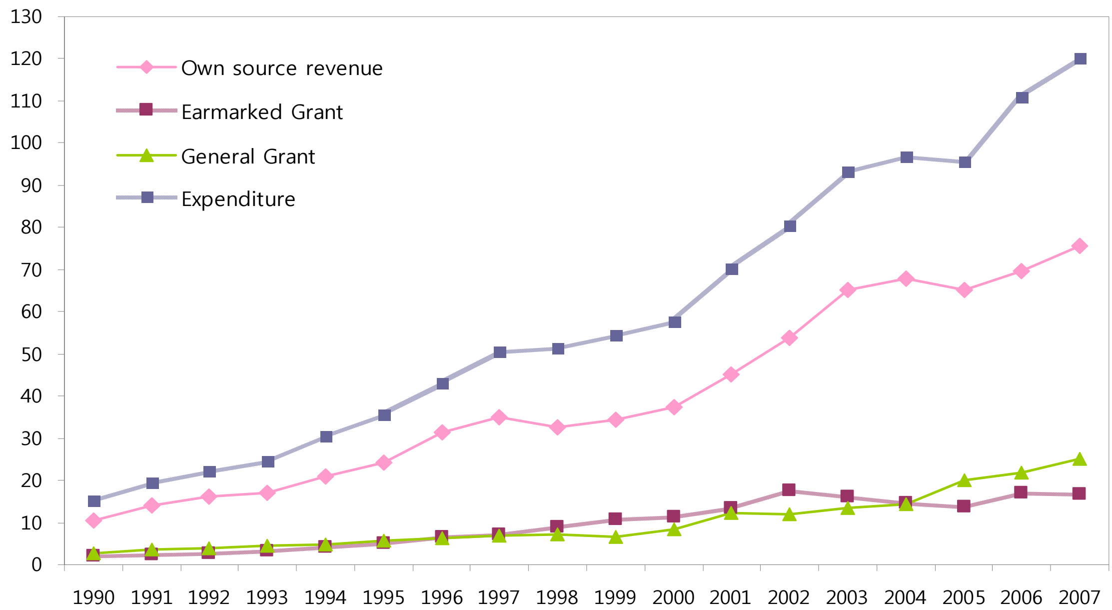


Figure 3. Fiscal trends in local governments (unit: trillion)



Local Shared Tax

There are two main grants sources such as Local Shared Tax (LST) and National Treasury Subsidy (NTS) in Korea. LST is divided into *ordinary* local shared tax and *special* local shared tax. The objective of *ordinary LST* is to equalize the fiscal capacities of jurisdictions. The equalization formula used to distribute LST calculates for each local government that standardized fiscal needs, revenue and their difference. Calculation of the standardized figures and their adjustment for special local circumstances are made based on pre-determined formula for objectivity and transparency. Ministry of Public Administration and Safety (MOPAS) controls formula, then determines the distribution of equalization grant within jurisdictions.

The ratio of intergovernmental fiscal transfer out of local revenue has been stable for the last five years. LST is major fiscal equalization system. An intergovernmental transfer system can be decentralized in a way to minimize central control. Since 1982, the size of local shared taxes has been determined as a fixed percentage (13.27%) of the Domestic National Tax. Before then, its size was determined on an *ad hoc* basis. Also, the distribution method of the fund has determined by a formula that is based on a budget deficit concept – the difference between basic financial demand (standardized fiscal needs) and basic financial revenue (standardized fiscal revenue). This reform makes it possible for local governments to cast a reliable forecast of intergovernmental revenue. The rate of LST to National domestic tax rose 15% from 13.27% in 2000 and it is up to 19.24% from 2006.[1]

Notably, dependence on Local Shared Tax (LST) to local revenue has increased significantly from 15.0% in 2002 to 20.9% in 2007. In contrast, reliance on earmarked grants has been reduced from 22% to 13.8% in the same period. In comparison with OECD countries, the 2.5% share of LST to GDP in Korea seems to be quite higher than other developing countries. Note that among unitary countries, Japan is the highest in 4% share of general grants and northern European countries (Finland 3.8%, Sweden 2.6%, and Denmark 2.8%) have the second biggest share (OECD 2009).

Decentralization Revenue Sharing as general grants

When the reform of NTS has proceeded in 2005, 'Decentralization Revenue Saring (DRS)' was established under the *general grants* umbrella. The reason of 'revenue sharing' is that funding source is from 0.94% of National domestic tax like

[1] There are two more general grants among sub-central governments, which are 'Fiscal Adjustment Grant (FAG)' and 'Provincial Government Transfer (PGT)'.

LST. DRS support the financial resources around 150 programs transferred to local governments. The funding source is changed from specific (NTS) to general grants (LST). It was scheduled that DRS will be absorbed to original LST from 2010. At that time, the law designated DRS as ‘temporary grant’ from 2005 through 2009. DRS system apparently focuses on a transfer which provides relatively high degree of fiscal autonomy to local governments by distributing the grant money. However, it has been evaluated that DRS failed to be operated its real sense. There were many arguments and advocacy of the system change.

The DRS programs are from NTS projects such as social welfare related expenditure. The rationale of the implementation of DRS was *the devolution* of welfare provision from central to local governments. While NTS are controlled by each Ministry from central government, DRS system is operated by local governments.

From the perspective of designing grants system, the change from earmarked to general grants for social welfare programs, it is easily expected that the under-provision of welfare spending. Fundamentally, as a general grant, money is fungible without earmarked tag. Also, local representatives do not have incentive to use money for beneficiaries who do not have ‘voting power’. Under the lower fiscal capacity and political reason, the reduction of social service budget in metropolitan area would be more serious than rural area. Empirical study supports that there is strongly linked between social service expenditure and earmarked grants with regional base data in Korea.

Local Transfer Fund

From 1991 to 2004, Korea had ‘Local Transfer Fund’ as a conditional block grant tool used for five broad local functions: roads, sewage, regional development, rural area development, and juvenile care. The fund was also a kind of tax sharing between the central and local governments since the revenue does not come from the central Government’s general revenue but from 100% of the liquor tax and 14.2% of the national transportation tax. The fund was transferred directly to local governments from the designed tax revenue without first being accounted for in the central government budget. Around 70% of the LTF was to be used for local road maintenance to strengthen the local fiscal base and to ensure balanced regional development. In other words, the fund was meant to increase local governments' revenue to prepare for local autonomy (Kim 2003). However, LTF was not qualitatively different with National Treasury Subsidy (NTS), and the money source from 'liquor tax' was vulnerable for revenue stability. These were the background for abolishment of LTF in 2004.[2] Finally, a part of LTF was absorbed to LST.

National Treasury Subsidies and Special Account for Balanced National Development

NTS has been the main transfer mechanism for specific grants subsidies. NTS are categorical grants provided by the central governments for specific projects. Political expenditure like social welfare and the increase of fiscal needs after local autonomy are the reasons of expanding NTS. For example, health care and subsidy for low-income households are national programs but delivered by local governments and funded by NTS. The fiscal responsibility of NTS is in the national budget office in Ministry of Strategy and Finance. In consultation with other ministries, ultimate size and number of projects are determined by Parliament where representatives exercise significant influence. The share of the subsidies has been rising rapidly since 1995 and was much greater than that of the local shared tax in 1999.

In 2005, NTS was reformed with the implementation of block-grant as called Special Account for Balanced National Development. In April 2004, the law of SABND was enacted. Article 4, 6 and 7 defines planning and evaluation of Enforcement Plans. The purposes of the law's enactment are (i) co-development metropolitan and rural areas based on cooperation; (ii) correction of imbalance among regions and independent localization through innovation & individual characteristic-based development; (iii) creation a balanced and individual society were all the people in the nation can enjoy high quality of life. The reasons of reform are that transparency and simplicity for distribution as the first concern and fiscal autonomy in local spending as the concern. The reform of NTS gave birth to SABND. The Presidential Committee on Government Innovation & Decentralization and the Ministry of Strategy and Finance rearranged totally national projects and categorized it into three parts, namely - national projects with NTS, local projects with local tax, and SABND projects. SABND supports projects which are in intermediate stage between local own projects and local delivery for

[2] Around 70% of LTF went to LST and the rest to NTS in 2005.

redistribution of national public goods. As a result of the reform, SABND was created by combining more than 100 specific grants with an objective to make it block grant.

SABND is a conditional block grant by using the distribution formula. Local governments can expect stable amount of transfer while the amount of NTS varies every year discretionary and is discretionary after 2005. The formula-based grants covered 87 projects and 8 Ministries. To distinguish the different characteristics of the 15 regions except that of Jeju, the formula used regression mainly factoring population, area, the ratio of old aged people, fiscal capacity index, and regional income ratio out of the Inhabitant Tax. The discretionary power of the line ministries in deciding the allocation of funds had been reduced because nearly half of the SABND grants are formula based (OECD 2005).

To allow local governments to spend these funds in line with their specific priorities, they are given flexibility to shift them to other purposes. At the province level, fiscal flexibility in SABND is achieved by devolving local planning power and allowing the province to carry over the grants up to 20% of the total budget during a specific period.

When the SABND begun in 2005, it is expected that devolution to local governments of national projects would force local public officials to plan and prioritize their own projects. However, the three-year implementation evaluation did not manifest local efforts to promote high quality of public delivery. In 2008, SABND needs improving due to the rearrangement of number of projects and enlargement of the grant size, among other reason. The process is incomplete, however, and SABND is needed to be modified further to become a block grant in its real sense.

Table 1. Comparison of NTS, SABND and NTS after reform in 2005

From 2005	Determination Method of Financial Resource	Distribution Method among Regions
Local Shared Tax, Decentralization Revenue Sharing	Constant Portion of Domestic Tax Revenue	Formula Based
Special Account for Balanced National Development	. 100% of Liquor tax . Specific Transfer . Other Fees	Formula Based

National Treasury Subsidy	Determined Every Year	at discretion

Although the notion of a matching rate to reflect spillovers works in theory, in practice it is difficult to measure the magnitude of spillovers for specific services. The basic idea is to set the price of the service to each local government in such a way as to neutralize differences in capacity by varying the matching rate (Bird 2000). This rationale may thus introduce an equalizing element by varying matching rates inversely with income levels (Feldstein 1975).

Different matching rate instead of uniform rate has been used for the equity concern in Korea. Reforming of NTS and SABND in 2005, different matching rate was activated. For an effective operation of matching rate, the committee of examining matching rate was introduced in 2007. Generally, metropolitan contribution has been larger than before. It is expected that the rearrangement of different matching rate in recent changes helps rural areas to loosen the burden of welfare spending.

4. Assessing the ongoing relevance of general and earmarked grants in Korea

In theory, grants expenditure-effect has been developed by economists and international empirical results. The expectation is that matching grants, that have both income and substitution effects, stimulate more local service output and spending than general grants, that have only an income effect. In other words, pure specific matching grants are price subsidies that will lower the price of the grant-eligible commodity and so they alter the price relations of locally-produced commodities. General grants do not change the price relativities and so they have only an income effect, which means that the local government spending on different services should reflect each service's income elasticity of demand (Gruber 2005, Oulasvirta 1997, etc.).

To understand the theory as policy manner, the transfer rationale in the economics literature can be for spill over to other jurisdictions with the *different price of public goods*. To correct way to deal with this problem is with some form of *matching grant.*

As a rule, in the circumstances of most developing countries, some *conditionality* therefore often seems desirable particularly when important national services such as education and health are provided by local governments (Bird and Fiszbein 1998).

Fiscal control by using earmarked grants such as LTF and NTS

This paper tries to examine the theory and the policy performance. Has been this theory fitted for intergovernmental fiscal decision in Korea? The case of LTF in Korea could be an example.

First, LTF played an important role on infrastructure construction in local authorities from 1991 to 2004. One of matching earmarked grants was LTF which was abolished now. Nearly, 3/4 of earmarked grants are (conditional) matching grants in Korea. In developing stage, capital investment projects like roads, SOC infrastructure might be crucial for economic growth. Though main feature of LTF has been changed like other National Subsidies, road construction during those periods played an important role for filling the gap of quantitative level in SOC within local authorities. Seeing the cases of other countries, the function and performance of LTF is also well matched with European experience. As Lotz (2009) mentions, direct funds to where the cost arises by using *matching grants* would be better for investment projects. Also, there have been relatively few empirical studies of the effect on local expenditures of matching grants. But, it appears that local governments may be more responsive to grants for capital projects such as roads than to grants for such social services as education and welfare (Slack 1980).

Another rationale for matching grants may be equalized differences in need or in preferences for spending where these differences are unobservable by the central government (Bird and Smart 2001). The experience of Portugal supports previous study. Portugal finances local spending for social assistance by earmarked grants in order to protect a minimum qualification of equal service while other non-social compensations are general grants (Lotz 2009). The case of NTS in Korea may be one of examples. NTS is also earmarked and mainly matching grants. Earmarking grants served as instruments of central control in Korea. If the central government wants to stimulate local government to deliver new service, matching earmarked grants may be efficient and are used in many countries. The share of social expenditure has drastically risen after 1995.

Vertical and horizontal fiscal imbalance

In most countries, sufficient mismatch in the revenues and expenditures assigned to different levels of government remains for balancing role be assigned to be assigned to intergovernmental fiscal transfers (Bird and Smart 2001, Boadway and Hobson 1993). To match this revenues and expenditures, so called 'equalization grants (LST)' are mainly used in Korea. Fiscal decentralization in Korea was the main agenda in last administration. From 2003 to 2007, many changes occurred in local public finance and local tax system. The severe problem of vertical fiscal imbalance between central and local governments was highlighted. Weak local tax bases and fiscal imbalance within jurisdictions caused the central government to systematic fiscal intervention. In fact, local government became highly dependent on national grants to finance their infrastructure. Revenue capacities are unevenly distributed despite the requirement of the national laws for the local governments to provide public services in accordance with the uniform standard. Nowadays, majority of public services are related with redistribution. These trends of redistribution as it relates to public services exacerbate the fiscal gap between central and local governments.

In addition to vertical imbalance, horizontal imbalance is also a major issue in intergovernmental fiscal relations in Korea. A sizable share of grants is the results of disparities in tax bases or financial needs between jurisdictions that central governments want to correct. For example, Seoul metropolitan city is in solid financial status because of exceptional concentration of population. Most of counties in rural areas seem to be able to finance on their own the residents' needs at only around 17.2% while a Ward in Seoul has Fiscal Independency Index (FII) of 86%.[3] Explicitly, LST has contributed to reduce the horizontal fiscal disparities. Much of empirical studies support the rich

[3] Fiscal Independency Index (FII) calculates the ratio of own-sourced revenue versus the total revenue. A high value of indicator means high self-financing capacities.

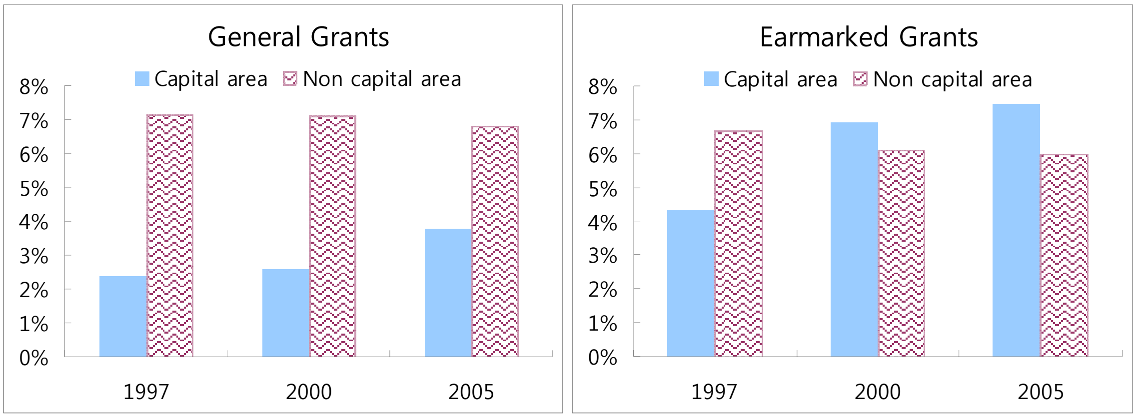
	Seoul	Metropolitan Cities	Provinces	Cities (>50,000)	Counties	Wards
Average	85.7	60.5	35.4	40.7	17.2	37.1
Highest		71.2 (Incheon)	66.1 (Kyonggi)	74.0	56.9	86.0
Lowest		47.8 (Gwangju)	11.0 (Jeonnam)	10.8	6.4	13.0

Source: Summary of local budget for fiscal year 2006, MOPAS performance of LST to equalize fiscal capacities within local authorities in Korea.

The bar graph shows the difference of distribution of each grants between urban and rural areas as goes on. The bar in Capital area is the average share out of total grants in Seoul, Kyoung-gi and Incheon. And, another bar in Non-capital area is also the average portion of each grant among the rest of areas, 13 regions. The graph shows that major amount of general grants have gone to rural areas consistently over time. Empirical studies do not always hold this result. Slack (1980) shows that an increase in population is accompanied by an increase in unconditional grants of provincial-local transfer of Ontario case. A study of transfers in Tanzania also indicates that urban areas with major expenditure responsibilities receive larger grants, even though they have greater fiscal capacity than rural areas (Boex 2003).

Figure 8. The distribution of each grant between urban and rural area

(16 regions)



As a “federalist” approach like Shah (1994), simple lump-sum transfers with no conditionality would be desirable for adequate resources to provide such services at acceptable minimum standard. This implies that it is neither necessary nor desirable for the central government to attempt to interfere with local expenditure choices. According to the context of federalist approach, Korea is one of the leading countries to use as general grants for fiscal federalism. Local governments in Korea have quite a big share of equalization grant in local revenue as it is mentioned. Recent change from specific to general grants such as DRS, SABND and the merge of LTF to LST stimulates the emphasis of fiscal flexibility like general grants.

However, for fiscal soundness in both central and local government, the size of equalization grants should be investigated. Due to the revenue sharing method of LST, it is often argued in accountability and fiscal responsibility. Intrinsically, local governments have incentive to enlarge local needs while reduce local capacity. A large equalization grant to correct fiscal disparities tends to make poor local authorities weaker. In addition, the size of general grants between sub-central governments (FAG and PGT) is hard to ignore. For example, considerable share (33.1% in 2008) of total revenue goes to municipality level in Seoul.

In addition, the complicated formula leads many local officials to believe that the amount of LST that they receive will be reduced if they raise local tax rates. The process of calculating the incentive revenue is not legally binding. The ambiguity leads local governments to believe that efforts to boost their tax revenue reduce the amount of the LST that they receive. It also leads to erratic fluctuation in the standard fiscal needs calculation, which it difficult for local government planning.

Identification of own purpose of grants

From the theory, matching grants are expected to favor large cities and metropolitan areas that are able to match funds, equalization grants are expected to favor poorer, smaller areas with low fiscal capacity (Slack, 2007). With this point, figure 8 says an important notion in Korea. The contrasting graphs show that general grants and earmarked grants had been fungible before 2000. The distribution of earmarked grants in urban areas has been greater than in rural areas after 2000.

In other words, grants are not qualitatively distinctive. It means that grants have various objectives at the same time until 2000. Both general and earmarked grants went to poor areas such as non-capital areas. This can easily lead to inefficiencies when a single grant is used to accomplish several objectives simultaneously (OECD, 2005). Fortunately, with the increase of transfers after 2000, main feature of grants as general or earmarked way has been evolved with identification. In recent years, the share of earmarked grants seems to be increasing in Capital areas with large population. From now on, grant system allows for a separation of objectives and control of grant characteristics. For example, the rearrangement of SABND and NTS projects might be one of the ways to reform.

Getting the prices right in the public sector

Transfers should not be designed to discourage municipalities from charging the right price for services (Slack, 2007). As Bird and Smart (2002) points, the basic task in transfer design is thus to get the prices right in the public sector- right, that is, in the sense of making local governments ‘accountable’ to both local residents and higher level of government.

Under the soft budget fiscal environments and the strong control by central government, local authorities do not have responsible behavior to allocate resources. There is no incentive to be efficient when someone else is responsible for funding. Considering these points, local governments in Korea are one of the least responsible and accountable in OECD in terms of comparing the discrepancy between local revenue share (around 20%) and expenditure share (45.1%, Education districts 14.6%).

To encourage an efficiency effort, merge of jurisdictions as the reduction of sharing costs might be one of ideas. Current administration considers the rearrangement of districts classification. Presidential Council on National Competitiveness (PCNC) declares regulatory reform and public sector innovation for efficiency. Now, rearrangement and merge of local districts is discussed. Restructure of regional based areas will differentiate fiscal structure between central and local government. And, the structure of local administration and financing method may be redesigned. In order to concrete the right mission, funding structure of fiscal transfer needs to be considered first.

Political needs: Tax sharing or general grants?

With a long debate, new “tax-sharing” way of revenue increasing in local authorities has been determined by the introduction of Local Consumption Tax (LCT) and Local Income Tax (LIT) at this year, 2009. Since 2005, local governments along with the Ministry of Public Administration and Safety tried to introduce LCT and LIT. For the LCT, 20% of total tax rate of VAT goes to local authorities like in Japan. In terms of administration costs, the introduction of LIT might be somewhat easier since the Inhabitant Tax is a kind of surcharge of Income Tax, hence, a simple increase of surcharge rate of Income Tax could qualify simply as Local Income Tax already. Until the last year, 2008, many argued about the way, amount, the timing of LCT and LIT introduction.

There were two main impediments for negotiation among Ministries and levels of governments. The first one was the differentiation from the current *revenue sharing (LST)* and the other one was the validation of the effect of fiscal disparities. Since VAT and Income Tax are associated with regional based fiscal capacity, tax bases of LCT and LIT are concentrated on Capital Area. Therefore, fiscal gap between rich and poor area would be wider than simple increase of the rate of the LST. Local governments wanted to have partial ownership of National tax bases. Obviously, LCT and LIT are not local taxes but tax-sharing. Political consensus of fiscal transfers in Korea decides tax-sharing way to increase local revenue instead of general grants.

Nominally, they are called as ‘local taxes’ regardless of real sense. Even if local authorities do recognize above facts, they prefer the symbolic name like *Local Consumption Tax and Local Income Tax* to general grants. The reason is to be interpreted as *political reason*. With an effort of Congressman and local representatives, this event is evaluated for development of local autonomy. Political rationale has been dominant than theoretical and practical alternatives in Korea. The notion of ‘Second generation of fiscal federalism’ with political matter has been applied in Korea (Boex 2009, Weingast 2006).

5. Which factors should be considered to reform grants system in Korea ?

Increase of local governments revenue by using “tax sharing”

From a policy perspective, the implementation of LCT and LIT may affect the amount of general grants (LST) because of the same source of money. From the donor side of budget operation, central government, the stagnancy or reduction of general grants may be expected for the time being. However, from the perspectives of recipients of grants, local authorities, more money will go to rich areas, then, the wider fiscal gap between urban and rural areas. Eventually, the demand of general grants for poor areas may be stronger. So, there exist countervailing effects on the size of general grant, LST. Policy suggestion for the determination of the total amount of general grants may be arguable for the time being.[4]

Expenditure needs: enlargement of social service in local expenditure

Economic development and education has been major items in local government expenditures until 2000. However, as explained above, intergovernmental fiscal grants are focused to social service function. Because of redistribution characteristics, low birth rate, and increase of graying population, the role of central government increased alongside the increasing demand for the transfer of role from higher-level government. Approximately, 60% of national subsidy goes to Ministry of Health, Welfare, and Family Affairs. Presently, social service (up to 50%) represents the biggest share of local expenditures. The majority of local fiscal needs are related with people's daily lives such as social protection, public health, and education.

Even though social service expenditure has risen after 2000, social service share (health, social protection) is still smaller as compared to other developed countries. The expenditure of social service ratio to GDP is ranked the lowest level in OECD countries (2005 data). Therefore, in a policy manner, it is expected that the need for welfare expenditure would be greater than before.

In addition, expenditure needs of earmarked grants might be captured in empirical results. Municipal local representative may increase the ratio of public-service related expenditure such as welfare, health, and sanitation, in order to be re-elected, expand local welfare projects and lobby for more matching grants earmarked specifically for their votes (Kim 2005).

From the theory, advocate of general grants assume that budget flexibility in local authorities may be superior to increase people's utility level. Also, in the aspect of the efficiency of resource allocation, general grants might be useful under the circumstances of asymmetric information about local needs. However, international experiences do not always support this point. Most of new services in Sweden are provided by using

[4] Moreover, 'Property Tax Sharing' system between regional and municipal governments in Seoul was also begun from 2007.

earmarked grant in the beginning periods. Such earmarked grants become general grants after a couple of years (Lotz 2008). It is possible to be with a certain level of fiscal autonomy like developed countries. The system change from earmarked to general grants may have negative effect on local authorities' provision of public services. The switch to block grants from matching grants in 1996 US welfare reform has also caused the same arguments. Brueckner (2000) shows the downward pressure on welfare spending comes from the adoption of block grants. And, the 1993 Finnish grant reform was also that the case of change to general grants without government supervision might mean more power to the central management in the local government and a diminished power for sector officers and services (Oulasvirta , 1997)

The empirical studies support that earmarked grants in Korea have played an important role for expanding welfare spending such as social expenditure. An increase in social expenditure is not accompanied with general grant (LST) but a subsidy from central government, NTS (Kim 2005, etc.).

Figure 9. Composition of local expenditure between Korea and OECD in 2005

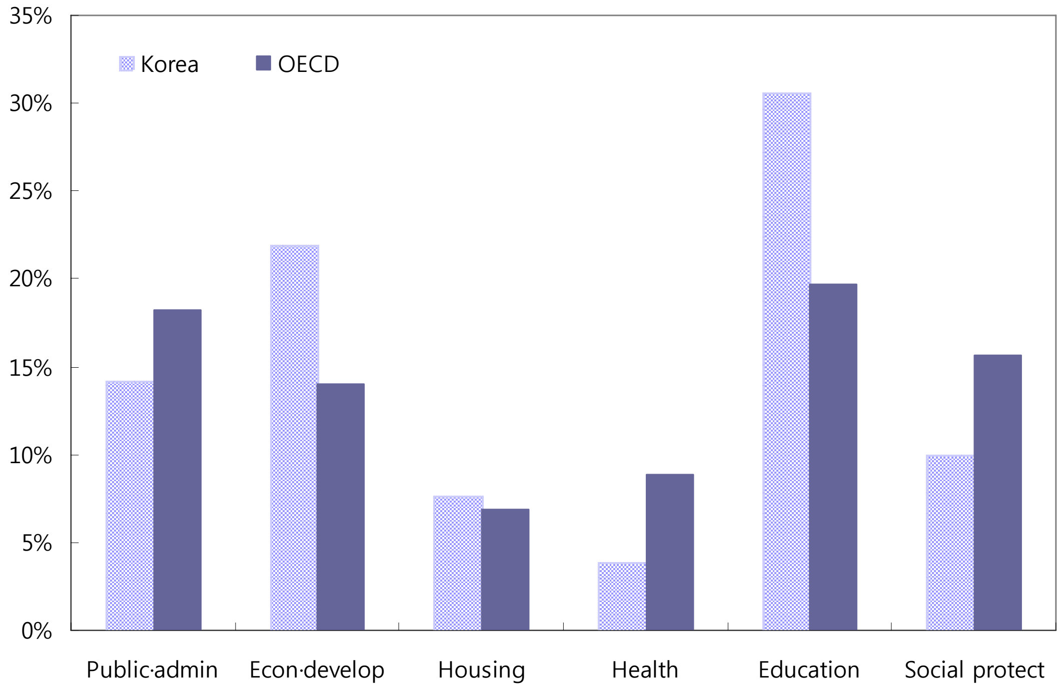


Figure 10. Ratio of local expenditure by function

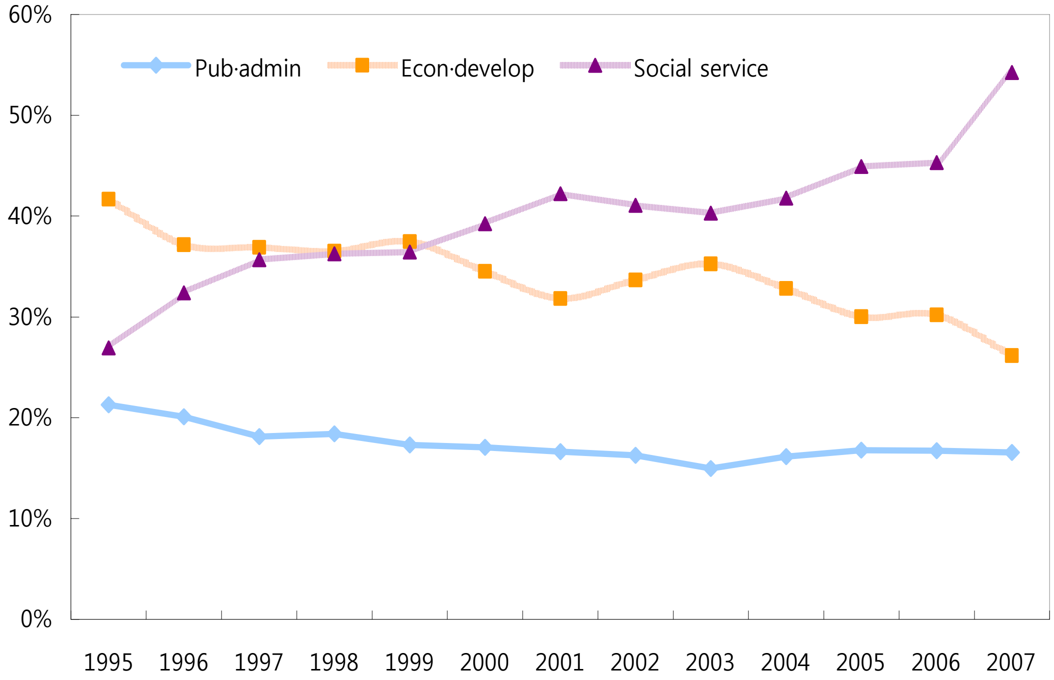
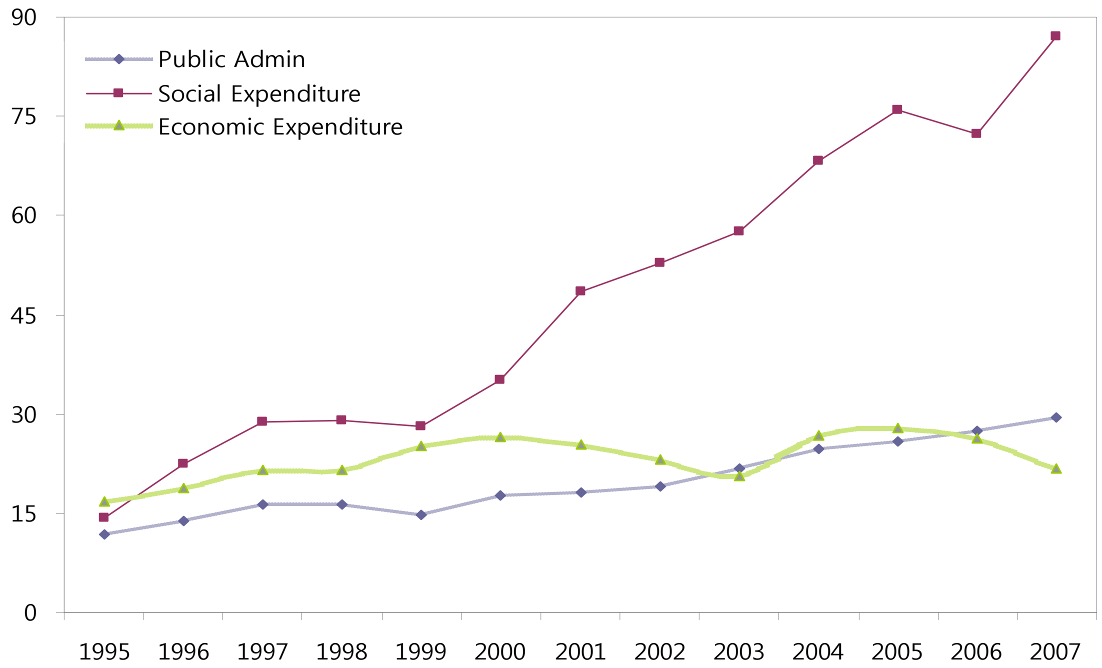


Figure 11. Per capita social expenditure in Seoul (unit: ten thousands won)



What conclusion can we reach through analyzing the intergovernmental fiscal transfer system in Korea?

To answer this question, pre-requisites under the current fiscal relations should be mentioned first. The analysis of grant effects is linked to the distribution of power between central and local governments. Underlying assumption of strategic behavior in local governments is due to 'soft budget problem'. Fiscal power structure in Korea is asymmetric between central and local governments. In other words, fiscal power is skewed in favor of central government. Lower fiscal power encourages poor local authorities to lean on higher level of government easily. Since ultimate fiscal responsibility and accountability have been under the central government, local government seemed unwilling to raise local taxes to fund increasing expenditures. Current soft budget system does not force local government to do so. In the aspects of fiscal control, fiscal concentration into central government has bright side. However, excessive central government authority hurts fiscal independency and deteriorates soft budget problem. Fundamentally, soft budget relations between donor and recipient may exacerbate the effectiveness of grant purpose regardless of the choice of grants.

In order to smooth soft budget problem, tight linkage between marginal increase of revenue and their works might be one of the ideas to relieve transfer burden to ultimate charger. One of the most important deficiencies in the current system is that the cost signal of changing local expenditure is not apparent to local taxpayers in Korea. The Tiebout's idea is based on that spending with strong tax-benefit linkages should occur at the local level (such as public safety), while spending with weaker tax-benefit linkages (such as redistributive services) should occur at higher levels of government. To link between local tax rates and provision of public goods in Korea, in depth-spending reform must be done. It helps policy makers to determine what and how much fiscal power should be delivered to local governments.

6. Conclusion

Even though skeptics of decentralization points out negative relationship between grants and fiscal performance around the world (Rodden, 2002, etc.), fiscal decentralization may by inevitable choice in many countries. Although local governments in Korea have limited discretion as to their revenue sources, the empirical results also show that fiscal decentralization may be a very effective means of self-government because more fiscal resources become available for local governments. Like other countries, the transfers have been used the main tool for increase local revenue in Korea.

This paper cannot conclude an obvious choice between general and earmarked grants in Korea. Moreover, recent changes such as tax-sharing from political needs and earmarked grants from expenditure needs add the ambiguity of choice between general and earmarked grants. However, NTS reform in 2005 makes it issue on the table whether the change from earmarked to general grants would be desirable or not. The paper tends to focus more on the effectiveness of earmarked grants in Korea as a developing economy.

There are several notions to compare the relative advantage between general (LST) and earmarked (NTS) grants. First, the respective role of general and earmarked grants under the tight control was not distinctive until 2000. When the size of grants, especially welfare spending, is growing in recent years, earmarked grants are focused on their own purposes. Second, in practical way, the introduction of tax-sharing with the same source of money would have an effect on the reduction of general grant, LST. Also, soft budget issue and disincentive for self-financing in local governments seem to impede the justification of the increase of general grants. With these observations, the function of earmarked grants in comparison with general grants might be more suggestive.

References

Blochliger, Hansjorg and Oliver Petzold, "Taxes or grants: what revenue source for sub-central governments?", Economic department working papers No.706, ECO/WKP(2009) 47, July 2009.

Blochliger, Hansjorg, "Taxes versus grants: on the revenue sources of sub-central governments", OECD Network of Fiscal Relations Across Levels of Government, 2008.

Boadway, Robin, "Grants in a federal economy: a conceptual perspective", in : Boadway, R. and A. Shah: Intergovernmental Fiscal Transfers, Principles and Practice, Washington: WorldBank, 2007.

Bird, Richard M. and Michael Smart, "Intergovernmental fiscal transfers: some lessons from international experience", Symposium in intergovernmental transfers in Asian countries: Issues and practices, University of Toronto, 2001

Bird, Richard M. and A. Fiszbein, "Columbia: The central role of central governments in fiscal decentralization," in Bird and Vaillancourt, Eds., 1998

Boex, Jameson, "Fiscal decentralization and intergovernmental finance reform as an international development strategy", IDG Working paper NO.2009-6, Urban institute center on international development and governance, June 2009

Boex, Jameson, "The incidence of local government allocation in Tanzania", working paper 03-11, Georgia state university, Andrew young school of Policy studies, International studies program, Atlanta, GA, 2003

Boex Jameson, and Jorge Martinez-Vazquez, "The determinants of the incidence of intergovernmental grants: A survey of international experience", *Public finance and management* 4(4): 454-79, 2004

Brueckner, J.K., "Welfare reform and the race to the bottom : Theory and Evidence", *Southern Economic Journal*, 66(3), 505-525, 2000

Charbit, Claire, "Intergovernmental transfers and decentralized public spending", OECD working paper, 2005

Jones, Randall and Tadashi Yokoyama, "Getting the most out of public-sector decentralization in Korea", OECD Economic Department Working Papers No.468, 2005

Kim, Hyun-A, "Fiscal decentralization and regional income in Korea", *The Korean Journal of Public Finance*, vol.21, No.2, 1-22, February 2007 (Korean)

Kim, Hyun-A, "Does political decentralization cause fiscal decentralization in local government expenditure in Korea", *the 60th Conference in International Institute of Public Finance, 2005*

Kim, Junghun, "Local government finance and bond markets: Republic of Korea", *Local government finance and bond market* edited by Y. Kim, Asian Development Bank, 2003

Lotz, Jorgen, Member states' practices for the funding of new competences of local authorities, Unpublished manuscript, Directorate General of Democracy and Political Affairs, Council of Europe, 2009

Oulasvirta, Lasse, "Real and perceived effects of changing the grant system from specific to general grants", *Public Choice* 91: 397-416, 1997

Rodden, Jonathan, "The dilemma of fiscal federalism: Grants and fiscal performance around the world", *American Journal of Political Science*, vol.46, No.3, July 2002, p.670-687

Shah, Anwar, "The reform of intergovernmental fiscal relations in developing and emerging market economies", Policy and research series No.23, Worldbank, 1994

Slack, Enid, "Grants to large cities and metropolitan areas", Intergovernmental fiscal transfers : Principles and Practices, Boadway and Shah, Worldbank, 453-478, 2007

Slack, Enid, "Local fiscal response to intergovernmental transfers," *Review of economics and statistics* 62, 364-70, 1980

Weingast, Barry, "Second generation fiscal federalism: Implication for decentralized democratic governance and economic development," working paper, 2006