

# REGULATORY REFORM IN KOREA<sup>1</sup>

## *Visions and Strategies for Better Governance*

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### INTRODUCTION

1. Governance is defined as the process of making collective choices and the way such choices are implemented. Different stages of economic development call for different governance structures for governments and businesses. If there is a mismatch in this relationship, the consequences could be quite costly, as we have observed in the economic crisis of East Asia in the late 1990s.
2. In the early stages of economic development when market institutions do not function efficiently, direct intervention and allocation of resources can be an efficient policy for reducing transaction costs and uncertainties for economic development. However, as an economy grows in size and its structure becomes increasingly complex, certain limits in the government's ability to control the economy are inevitable, and the cost of government failures outweigh the benefits of government intervention. In particular, government intervention creates inefficiencies by distorting incentives and causing rent-seeking behaviors. Research on this matter confirms that an inverse correlation exists between the degree of government intervention and the rate of economic growth.
3. The economic crisis of 1997 in Korea resulted from a combination of poor governance in the political system, financial institutions, and corporate management structure. Banks and financial institutions were heavily regulated, but poorly supervised. Most of the big business groups in Korea, the *Chaebols*, were under exclusive and closed operations by their respective owners and their family members. With such a system that lacked necessary means of supervision and accountability, bad debts accumulated rapidly during the 80s and 90s in both the financial and corporate sectors. However, the Korean government and political leaders throughout this period were unable to make difficult but necessary decisions to solve the problem.
4. The most important goal of economic reform since the onset of financial crisis was to reinstate effective governance structures in the government, financial institutions, and the corporate sector in Korea. The

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reforms were intended to change the traditional relationship between the government and the market, as well as the role and behavior of individuals by redefining the rules of the game in their interactions.

5. There were four major components to economic reform in Korea to revive its economy: i.e. labor reform, *Chaebol* reform, financial reform, and public sector reform. They were all designed to promote efficiency and discipline using market principles and market forces. Many of the reform measures included changes in regulatory methods and policy tools, and they were all regulatory reforms in a broad sense.
6. This paper discusses the objectives of regulatory reform; the types of low quality regulations; the causes of and remedy for low quality regulations; the Korean regulatory reform experience; and the principles and strategies for successful regulatory reform. Although most of the observations and analyses are based on the Korean experience, the implications and lessons can be applied to most countries.

#### Box 1 **What is regulation and regulatory reform?**

There is no generally accepted definition of regulation applicable to the very different regulatory systems in OECD countries. In the OECD work, **regulation** refers to the diverse set of instruments by which governments set requirements on enterprises and citizens. Regulations include laws, formal and informal orders and subordinate rules issued by all levels of government, and rules issued by non-governmental or self-regulatory bodies to whom governments have delegated regulatory powers. Regulations fall into three categories:

- **Economic regulations** intervene directly in market decisions such as pricing, competition, market entry, or exit. Reform aims to increase economic efficiency by reducing barriers to competition and innovation, often through deregulation and use of efficiency-promoting regulation, and by improving regulatory frameworks for market functioning and prudential oversight.
- **Social regulations** protect public interests such as health, safety, the environment, and social cohesion. The economic effects of social regulations may be secondary concerns or even unexpected, but can be substantial. Reform aims to verify that regulation is needed, and to design regulatory and other instruments, such as market incentives and goal-based approaches, that are more flexible, simpler, and more effective at lower cost.
- **Administrative regulations** are paperwork and administrative formalities -- so-called "red tape" -- through which governments collect information and intervene in individual economic decisions. They can have substantial impacts on private sector performance. Reform aims at eliminating those no longer needed, streamlining and simplifying those that are needed, and improving the transparency of application.
- **Regulatory reform** is used in the OECD work to refer to changes that improve regulatory quality, that is, enhance the performance, cost-effectiveness, or legal quality of regulations and related government formalities. Reform can mean revision of a single regulation, the scrapping and rebuilding of an entire regulatory regime and its institutions, or improvement of processes for making regulations and managing reform. Deregulation is a subset of regulatory reform and refers to complete or partial elimination of regulation in a sector to improve economic performance.

Source: OECD (1997a)

## **VISIONS OF REGULATORY REFORM**

7. Regulatory reform is aimed at improving national productivity and the overall welfare of a nation. By removing protective regulations and reducing barriers, a government can make its economy more open and competitive. This creates new businesses and job opportunities. Enhanced competition raises productivity and efficiency. As opportunities for monopolistic rent diminish, the waste of resources caused by rent-seeking behavior will also decline.
8. Regulatory reform is aimed at relieving businesses from excessive regulatory burdens. Virtually all regulations put monetary burden on the regulatees, such as compliance costs and circumventing costs. Also, the social costs caused by distorted incentives and price signals can be burdensome. In this sense, regulations are a form of hidden tax with direct monetary consequences for the regulatees, as well as being the cause of loss of efficiency in the economy. Regulatory reforms aimed at reducing compliance costs will have the same effect as tax cuts.
9. Regulatory reform is also aimed at reducing corruption and abuse of power by making rules and procedures more transparent and predictable. When rules and procedures are vague and subject to discretionary interpretation by regulators, the opportunity for corruption arises. Oppressive and unrealistic regulations also create incentives for regulatees to evade and circumvent such regulations. By making rules and procedures more clear and simple, and by making the results of regulatory enforcement more predictable, regulatory uncertainties facing regulatees can also be reduced.
10. Regulatory reform is also aimed at improving the quality of life for people by making regulatory enforcement more effective. Especially in the area of social regulation, such as environmental protection and safety, the major problem is not the lack of regulations, but the loose enforcement of existing regulations. As compliance rates of regulation improve, the quality of life will also improve. In many cases, loose enforcement of regulations results from unrealistic rules and procedures which both regulators and regulatees cannot comply by. Making rules and procedures more reasonable and easier to follow is an important element of regulatory reform.
11. Regulatory reform is aimed at encouraging private sector initiatives and creativity. Uniform and rigid rules and regulations discourage creativity and diversity in private sector activities. Regulatory reform is also aimed at facilitating economic integration between countries by making rules and procedures more compatible with each other.

## WHAT ARE LOW-QUALITY REGULATIONS?

### *Not a Matter of Quantity*

12. Regulatory burden is not necessarily proportional to the number of regulations that apply to a regulatee. Regulatory burden can actually be greater with a relatively small number of regulations, when they require heavy compliance costs and create severe uncertainties. Therefore, excessive regulatory burden does not necessarily come from the fact that there are too many regulations. In correlation, reducing the number of regulations alone would not necessarily reduce the burden caused by those regulations. If regulatory reform is to be effective, the quality of regulation must be controlled as well as its quantity.

### *Vague Rules and Unpredictable Results*

13. Many regulatory rules and their standards are not concrete or specific enough. Consequently, regulators have wide discretionary power in interpreting and applying these rules. In practice, this has created a situation where nothing is certain, but nothing impossible either. In addition, many government interventions are based on "past practices" or in the name of "administrative guidance," and are sometimes without a clear legal basis. The subsequent opaque procedures, ambiguous rules, and unpredictable results create uncertainties in business activities, which in itself is a cost-raising factor, and creates an environment conducive to corruption and abuse of power. Therefore, it is important to note that the excessive regulatory burdens are caused not only by the quantity and complexity of regulations, but also by the way in which regulations are enforced.

### *Low Compliance*

14. In some regulations, requirements and standards are so idealistic and stringent that following them is virtually impossible. Excessive compliance costs arise when regulatory requirements and standards are very difficult to meet. Under such circumstances, both regulators and regulatees have an incentive to by-pass the law so that the enforcement of the regulation is compromised in that particular field, thereby reducing the effectiveness of the regulation.

### *Excessive Social Costs*

15. For some regulations, social costs are so high that they do not justify the benefits expected. However, the high cost of such regulations is not the result of some incompetent or irresponsible bureaucrats. There are more fundamental structural problems than those caused by human incompetence. Costly regulations exist because the social cost of a regulation is externalized: i.e., regulators do not have any incentives to

consider the full social costs of that regulation. Regulators would be more concerned about their administrative costs and their budget constraints than the indirect social costs and private sector compliance costs.

#### *Unfair to Honest People*

16. Many regulatory rules and procedures are designed based on the premise that regulatees are so unreliable that, if they are unregulated and left alone, there would be disastrous results. Consequently, licensing and permits became the primary tools of regulation in many areas. "Prohibition in principle, permission in exception" became a common practice in regulatory enforcement. Sometimes a registration procedure is administered like a permit system. This type of regulatory culture may be the unfortunate result of the regulators' occupational tendency to suspect the civilian sector's ability to self-regulate and maintain order, as well as the general lack of confidence in the market functions. In such a regulatory culture, virtuous people would have little incentive to remain honest, because their virtue is not rewarded by the system.

### **REGULATORY REFORM IN KOREA**

17. Regulatory reform has been an official government policy in Korea since the early 1980s for almost 20 years now. The drive for regulatory reform was initiated mostly out of political need and by popular demand from businesses to reduce the bureaucracy and regulatory interventions. As a result, there have been a number of successful regulatory reform measures. Some examples include: flexible labor and employment rules, financial deregulation, competition in wholesale industries, gas station, liquor manufacturing, trucking, and telecommunications, etc.

#### *Two Different Concepts of Regulatory Reform*

18. Regulatory reform in Korea carries two seemingly conflicting meanings. One is "soft" reform as demanded by businesses, which calls for reduced bureaucratic intervention and red tape. This will make the business environment of existing businesses better and freer. The other is "hard" reform which promotes competition and market principles. This will make the business environment of existing businesses more competitive. As a result of these differing concepts of regulatory reform in Korea, there has been agreement on the principle of regulatory reform, but much disagreement on the details.
19. As existing data on this subject indicates, regulatory reform in Korea has focused more on soft reform. Since soft reform cuts red tape and reduces regulatory control over business activities, the burden of reform has fallen mostly on the bureaucrats, and this is why they have been passive throughout the

regulatory reform process.

20. Hard reform, on the other hand, has a direct impact on existing companies and their vested interests. As a result, as can be seen in many other countries, these companies resist such regulatory reforms. Whether it is soft or hard, regulatory reform is bound to face resistance by its very nature. Despite strong political rhetoric in support of regulatory reform in Korea, it has faced strong resistance and obstacles, and its process has been quite slow to unfold.

#### *Limiting Factors on Regulatory Reform up to 1997*

21. The reform methods employed up to 1997 can be described as a "bottom-up" approach. Under the "bottom-up" approach, regulators themselves are responsible in determining which regulation to reform or abolish. Calling for a "bottom-up" approach in reforms is tantamount to the public asking the regulators to admit that their rules were somehow mistaken or misguided. In the past, although some efforts were made to collect suggestions from the private sector, it was always the regulating bureaucrats who had the final authority to make decisions on whether the suggestion should be accepted or not. Occasionally, when there was strong opposition to changes from any of the concerned ministries, such changes would not take place. Even if such changes are enforced upon a ministry by political pressures, the ministry that opposes it still has the means of diluting the effect of those changes, because the ministry itself usually implements the proposed changes to the regulation.
22. Many ministries have also maintained a long "cooperative" relationship with interest groups and organizations under their jurisdiction. Naturally, the regulators tended to sympathize with the regulated interest groups that supported them. Thus, it has been particularly difficult for the ministries to voluntarily propose regulatory reforms, which may negatively affect their interest groups.
23. New regulations have been continuously introduced, even while the government was officially pursuing regulatory reform. Admittedly, it is inevitable that existing regulations have to be modified, and new regulations have to be introduced in response to continuous social and economic changes. The problem has been, however, that the methods and overall quality of the newly introduced regulations were just as low in quality as the old ones.
24. Since the scope of regulatory reform has mostly been on procedural reforms and reduction in red-tape, many of the important but controversial areas were not even considered, leaving a major proportion of regulations untouched as "sacred". It has been argued that since these regulations are intended to achieve

important national policy objectives, they have to remain in tact unless national policy objectives are changed. Examples of these sacred regulations are the regulations on banking and financial systems, the regulations on real estate transactions to prevent speculation, the regulations on *Chaebols* to limit concentration of economic power, the regulations to protect environment, consumers, workers, etc. Many people believe that these regulations should be left untouched since they have the right objectives. However, these regulations are actually the core regulations which put heavy burdens on business and economic activity in Korea.

25. Public officials are in general passive or defensive about regulatory reforms. This is not only because they want to hold onto their power and jurisdiction, but is also because they are generally risk-averse. Government officials are in general more concerned about unexpected negative side effects than beneficial results from any kind of changes.

#### Box 2 Examples of “Sacred” Regulations in Korea

Areas of Potential Conflicts between National Policy Goals and Regulatory Reform:

- *Regulations to Protect Small and Medium Sized Enterprises*
- *Regulations to Stabilize Prices*
- *Regulations to Stabilize Employment*
- *Regulations on Chaebols (Conglomerates)*
- *Regulations to Prevent Real Estate Speculation*
- *Prudential Regulations on Financial Institutions*
- *Regulations to Protect the Environment*
- *Regulations to Protect Consumers and Workers*
- *Regulations to Protect Farmers*
- *Regulations on Education and Culture*

#### *New Approaches since 1998*

26. In 1998, the new government of President D. J. Kim initiated an entirely different approach of reform. By the end of 1997, the problems and limitations of the traditional reform method were readily apparent. In response to the criticism of previous reform methods, the Korean government began implementing very bold and sweeping reform measures. Since the new government was inaugurated in the middle of the economic crisis, the need for regulatory reform, as well as in other areas of government policy, was all the more urgent and widely accepted. In a very real sense, regulatory reform was forced upon Korea by the economic crisis of 1997. The need for foreign direct investments, promotion of exports, and relieving domestic business of regulatory burdens all required radical reform of existing Korean regulations.

27. The major difference of the reform in 1998 can be seen in the method of reducing the total number of regulations. The past administrations employed the "bottom-up" approach, where regulatees had to suggest and justify the regulatory changes, and the officials in charge of the regulations decided whether they would accept them or not. However, now the burden of proof has been put on the regulators themselves. That is, regulators have to justify the need for the regulations to continue at the Regulatory Reform Commission. If they cannot convince the Commission (the majority of the Commission members are civilian representatives), those regulations shall be abolished or changed. Moreover, the president set a quantitative target of abolishing at least 50% of existing regulations by the end of 1998. Considering the authoritative nature of the Korean government's operation, this presidential order has carried with it significant weight and authority. As a result, the total number of regulations in Korea became substantially reduced. 5,430 regulations or 49% of the existing regulations were simply eliminated, and 2,411 of the remaining regulations were improved upon through this process.
28. Introduction of new regulations and amendment of existing regulations must go through a review process by the Commission. The Basic Law of Administrative Regulation mandates this process, so that ministries cannot evade this requirement. The law specifically requires Regulatory Impact Analysis (RIA) for each new and amended regulation. OECD recommendations and guidelines on RIA (1997b) were instrumental in shaping and introducing the RIA process in Korea.
29. Managing regulatory quality became a part of the administrative process by law in 1998 (in the form of regulatory impact analysis: RIA). As a result, the introduction and revision of regulations are no longer the exclusive rights of the regulating agencies. However, RIA is still at a primitive stage in Korea. RIA requires accumulation of experiences and know-how, which the Korean government does not yet have enough of.
30. The regulatory reform in 1998 was a very radical one, and therefore some errors and side effects were inevitable. In particular, some important social regulations were abolished without introducing any necessary complementary measures, thus antagonizing and raising concerns among some public interest groups.
31. Although the method was authoritative and perhaps even crude in nature, it did make the stagnant bureaucracy move and managed to substantially reduce the number of regulations in Korea. However, the degree of regulatory intervention is still considered to be quite high in Korea. Although half of the



previous regulations have been eliminated from the law, the quality of remaining regulations has not been addressed. In addition, at the regulatory window where people come into contact with the bureaucracy, changes in behavior and attitude have been very slow to come. It will take some time before Korean people feel the full impact of the regulatory reform of 1998.

## **IMPLICATIONS AND LESSONS**

### *Control Regulatory Quality by an Independent Agency*

32. As mentioned earlier, there is a structural bias in favour of introducing new regulations, even though the total social cost of a regulation does not justify the expected benefit of that regulation. In addition, regulating agencies tend to overemphasise the expected benefits of a new regulation, underestimating the potential social costs and negative side effects. To correct this problem, an independent non-regulating agency should be designated to have the authority to control the quality of regulations. RIA could serve just such a function, as an effective tool to control regulatory qualities.
33. In addition, it is desirable for this agency to have the authority to check and inspect administration of regulatory changes to make certain they are actually enforced at the regulation windows. This is particularly important because, at the window level, regulators can easily dilute the effectiveness of any regulatory changes, if they wish, by practising administrative guidance and informal intervention methods.

### *Harmonize Policy Goals with Regulatory Reform*

34. In the process of executing regulatory reform, conflicts between national policy goals and regulatory reform occasionally occur. For example, easing industrial emission standards could be viewed as sacrificing the environment for economic interests. Similarly, promotion of competition in some industries may, in turn, hurt small and medium sized enterprises.
35. However, these seeming conflicts do not have to be viewed as a trade-off between policy goals and regulatory reform. Since regulatory reform is aimed at improving the quality of regulatory methods in achieving certain policy goals, it does not necessarily follow that changing the regulatory methods by reforming them implies compromising national policy objectives.
36. In Korea, as mentioned earlier, there are a certain group of regulations that are considered too important to be changed, although they impose a heavy burden on business activities. These are the “sacred” regulations. These are precisely the kind of regulations that have the potential to cause conflicts between

national policy goals and regulatory reform measures.

37. These regulations are generally in a packaged form, in which a multitude of individual regulations and other complementary policy measures are interwoven. For these regulations, piecemeal changes of individual regulations are almost meaningless. The most effective approach in reforming these packaged regulations would be to review the entire package of regulations and reconstruct from scratch the system of regulations to achieve the policy goal with the most efficient means. Opponents of such an approach claim that any changes of these sacred regulations are to retract on important national policy goals. For regulatory reform to be effective and successful, however, these sacred regulatory packages should be included in the reform measures.

*Make Rules and Procedures More Transparent and Predictable*

38. As mentioned earlier, one of the most costly qualitative problems of regulations is that many of the regulatory rules and procedures are unclear and subjective. As a result, regulators have wide discretionary power, and the regulatees are put into a very uncertain position in the regulatory processes. These uncertainties directly translate to increased business costs. Making the regulatory rules and procedures more transparent and predictable can substantially reduce such regulatory burden.

*Make Requirements and Standards More Realistic and Easier to Meet*

39. Excessive burden caused by regulatory compliance can also result from regulatory requirements and standards that are unrealistically restrictive. This type of regulations creates strong incentives for the regulatees to evade and circumvent these regulations. Typically these regulations have a low compliance rate, making the regulations less effective.
40. A negative side effect of loose enforcement and low compliance is that those who voluntarily observe the rules would be put into a disadvantageous position compared to those who by-pass the rules. This is not only unfair to those who follow the rules, but also discourages them from keeping the rules. In reality, the most restrictive regulations can also be the least effective ones. By making regulatory requirements and standards more realistic and easier to follow, regulations can actually be more effective, and compliance costs would decrease.
41. One way to make this happen is to set minimum compliance requirements and make it the responsibility of regulators to maintain a compliance rate above the minimum. By putting the blame of low compliance on the regulators rather than the regulatees, this measure would have the effect of making regulators more

prudent in setting regulatory requirements and standards.

### Box 3 Principles for Better Regulation

Reformers should apply these principles to improve regulatory qualities and to set priorities among policy options and regulatory measures.

- *The principle of free and fair competition:* protective regulations create economic rents and rent-seeking behaviors. Once a protective regulation is in place, it is very hard to change or abolish. There is no competitiveness without competition.
- *The principle of maximum net social benefit:* the net social benefit of a regulation is the social benefit minus the total social costs of a regulation. The total social costs of a regulation include explicit costs such as administrative cost and compliance cost, and the implicit costs such as the costs to evade and circumvent the regulation and the waste of resources caused by distortions from the regulation. When we consider all the social costs, some regulations are hard to justify despite their expected benefits.
- *The principle of effectiveness:* regulations must be enforced effectively to achieve the intended goals. A regulation with low compliance rate is worse than no regulation, because it puts low-abiding citizens in a disadvantageous position. Also, violators who are caught would think they were unfairly targeted.
- *The principle of transparency:* the rules and procedures must be clear and transparent. This is important to prevent corruption and abuse and to minimize uncertainties from regulation.
- *The principle of international compatibility:* regulations must comply with globally accepted standards and practices. As the world economy becomes more integrated, compatibility of regulations and standards between countries becomes more important. Restrictive domestic regulations and procedures can be considered as unfair trade practices by the trading partners.

### CONCLUDING REMARKS

42. Regardless of whether the nature of reform involves political or economic structural operations, reform is aimed at changing the way people behave and make decisions. The success of reform is measured by how much behavioral change it has brought about and whether the changes are permanent. Likewise, regulatory reform is aimed at changing the role of the government and the way the government, businesses, and citizens interact in the market. Thus, if regulatory reform is to be successful, it must change the way economic agents behave and make decisions. The best way to change their behavior is to change the economic constraints and conditions surrounding them: i.e., change the governance structure of the government and the businesses.

43. In general, the degree of regulation seems to be proportional to the degree of mistrust and suspicion regulators have on the people they regulate. Regulations become excessive and restrictive when regulators

are suspicious about the civilian sector's ability to self-regulate and maintain order by themselves. However, the ability to self-regulate and maintain order is not inherent, nor is the market function. These qualities should be cultivated and the private sector should be given an opportunity to practice self-regulate and become more involved in market functions. Economic liberalization through regulatory reform will allow citizens just such an opportunity. However, this will take time and must go through a process of trial-and-error. Therefore, one should consider the private sector's ability to self-regulate and maintain order to be a consequence of regulatory reform, not a prerequisite for regulatory reform. Regulatory reform is an important necessary step toward a freer and more open society.

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