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### The Impact of Fiscal Conservatism: A Case Study of the 2007 National Pension System Reform in Korea

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#### ABSTRACT

This research intends to identify the influential factors in the 2007 National Pension System (NPS) reform in Korea (the Republic of Korea) which drove the NPS toward a structural transformation. This research also examines the applicability of the theory of Clemens and Cook (1999) to the Korean policy shift, who argue that the innate driving force of a policy, an internal contradiction, can be a critical source of structural policy change. A literature review based case study was carried out in this research. The findings are as follows. Firstly, rising fiscal conservatism was the main determinant of the 2007 NPS structural reform. The processes and conditions of the reform documented were: the fiscal conservatism embedded in NPS generated serious policy problems and led to an accumulation of the internal contradictions within NPS by raising the question on its fundamental policy goal. As time passed without any self-correction mechanism with respect to the problematic policy, the NPS lost credibility in the eyes of the public and also lost policy legitimacy. At the same time, there was a competing policy alternative to the NPS. This was the universalistic tax-based Basic Old-Age Pension System. This has been a challenge to NPS in that it had been designed based on the social insurance financing principle. The pre-conditions for the structural NPS reform were fully complete and they could be exploited by self-interested political parties in the following policy-making stages. Secondly, the theoretical assumption that the internal contradiction of a policy can be a decisive power for structural transformation, as suggested by Clemens and Cook (1999) among others, was proven to be theoretically and practically accurate in the Korean public pension reform case.

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*Keywords: Public Pension System, National Pension System, Korea, Fiscal Conservatism, Public Pension Reform, Structural Pension Reform*

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#### 1. Introduction

What were the dominant factors which drove the National Pension System of Korea (NPS<sup>1</sup>) toward structural reform in 2007? This research<sup>2</sup> seeks to answer this question

through an institutional analysis of the reform. The NPS is a public pension system covering almost all of the population, except for public sector workers, in Korea. The reason this research chooses this reform case is that it clearly shows structural reform, which is generally known to be much more difficult than parametric reform,

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<sup>1</sup> The NPS is one of the public pension systems in Korea. The NPS is designed as a semi-funded financing scheme and is operated by a public organization, the National Pension Service (NPSrvc).

<sup>2</sup> This research is based on the doctoral thesis of the researcher, completed at the University of Kent in the UK. The doctoral thesis

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is titled 'An Analysis of the 2007 National Pension System Reform in Korea: A Political and Institutional Approach to Its Reform'. Through the 2007 NPS reform, the one-tiered public pension system, the NPS alone, was structurally fragmented into a two-tiered public pension system, the NPS and the Basic Pension. The reform is important because it still has many meaningful implications for academia and it was controversial in terms of its causes, processes and results.

both financially and politically (see Pierson, 1997; Bonoli, 2000). The NPS was structurally transformed, through the 2007 reform, from a mono-pillar system (the NPS alone) to a two-pillar system (the Basic Old-Age Pension System (the 'Basic Pension') and the NPS). What, then, made this difficult public pension reform possible?

Firstly, this research assumes the policy itself (i.e., the NPS) to be one of the critical sources of the reform. While policy itself is normally set as a dependent variable in political analysis research designed to assess the determinants of policy change, this research treats it as an independent variable: a kind of determinant. The theoretical concept of 'internal contradiction' is borrowed from the theory of the historical institutionalists Clemens and Cook (1999), and it is the key element by which this research will trace the sources of radical change in the NPS. Unlike other institutionalists' approaches, which try to identify the determinants of policy change from the outside of the policy, the authors' research focuses on the policy itself, hence the centrality of the concept of 'internal contradiction'. The term 'internal contradiction' is defined as the 'instability inherent in certain systems of belief or practice' (Clemens and Cook, 1999: 449).

Secondly, this study assumes that a resilient policy paradigm or principle may be embedded in the NPS and that it continually accumulates internal contradictions if it is not adapted to the changed environment. Thus, the question arises: what is the influential policy paradigm which strongly has influenced on the design of the NPS? This research hypothesizes that the fiscal conservatism embedded in the NPS could be the key source of internal contradiction, which increases when the NPS does not adapt itself properly to the changed environment or necessary policy requirements. According to Clemens and Cook (1999: 449), once a policy is established, its internal contradiction starts its accumulation as a grave-digger digs its own grave. As a policy produces its constituency, the accumulated internal contradiction produces opponents to the present policy (ibid). In this sense, if fiscal conservatism had continuously increased the internal contradictions of the NPS, the NPS might have produced too many opponents against itself so that radically changed the NPS in certain conditions. What is 'fiscal conservatism' then? The Korean welfare state is categorized as a 'developmental welfare state'. The influential trait of a developmental welfare state is that governmental subsidy for welfare programs is strictly limited. This is because tax

revenue should be fully invested for economic growth: i.e., industrial infrastructure construction (Kwon, H. J. 1997, 2005; Goodman and Peng, 1996; White and Goodman, 1998). The general definition of the term 'fiscal conservatism' is that the government operates a budget or financial policy under the principle that a deficit should be reduced at the expense of redistributive transfers (Gilles, 2001). This research, however, simply defines it as 'the conservative financial operation principle under which governmental subsidy is strictly limited and the state's financial responsibility is not institutionalized for welfare programs'. In this sense, the NPS can be seen as a representative welfare program which is designed and operates based on fiscal conservatism (see Lee, H. K. 1994, 2004; Kim, Y. H. and Seok, J. E., 1999).

Thirdly, this research will carry out a procedure to look at the impact of fiscal conservatism on structural reform in the case of the 2007 NPS reform in Korea. The first step of this research will be to attain theoretical understanding. The path-breaking power of 'internal contradiction' and the developmental logic of it toward radical policy change will be discussed in Chapter II. Based on the theoretical understanding of the historical institutionalists, Clemens and Cook, (1999), the main discussions will be followed step by step in the next stage. The conditions, processes and outcomes of the theory will be examined in reference to the NPS reform case in Korea. In the first section of the chapter, III, this study will look at the overall feature of the NPS to give general understanding to readers. In the second section, the real features of the NPS, which express best the internal contradiction caused by fiscal conservatism in the NPS, will be addressed. The serious policy problems, old-age income insecurity and long-term financial insecurity issues, will be explained. The fundamental cause of the policy problems, fiscal conservatism, will also be discussed. In the third section, the phenomena of policy failure, and distrust of the general public in the NPS, will be presented. The NPS, which lost credibility with the public, might not survive without fundamental transformation. In the fourth section, the decisive role of a strong policy alternative will be demonstrated. The existence of a competing alternative may continuously erode the present policy, the NPS, to the extent that it causes a loss of legitimacy on the part of the policy. The emergence of the Beveridgean model, the Basic Old-Age Pension System, and the completion of the last condition for the path-break-

ing policy change, based on Clemens and Cook's (1999) hypothesis, will be discussed. The conclusion of this research will be added lastly.

## II. Theoretical Understanding of a Policy's Ability to Bring About Structural Change

Most institutionalists, like Myles and Quadagno (1997), Ferera (1996) and Pierson (2004), emphasize that a policy, once it is established, hardly changes as interest groups are formed that are resistant to a change in the policy. Such institutional inertia well explains why a cut-back or structural change to a welfare program is so difficult. How can we understand the structural change of the NPS in 2007, then? Can a general assumption of institutionalism, path-dependency, explain effectively the contradictory results of considerable benefit cuts in the NPS combined with the introduction of the Basic Old-Age Pension System? With regard to this question, there have been many theoretical attempts to identify the explanatory logic of institutionalism when it comes to radical institutional change. Most authors, such as Krasner (1984) and Stinchcombe (1978), find the source of institutional change outside of the institution, treating it as an exogenous variable. Clemens and Cook (1999), however, paid attention to the internal power of a policy which leads to a radical policy change, and named it internal contradiction. According to Clemens and Cook (1999), the 'internal contradiction' of a policy leads a policy to the point of having the potential for radical change. How, then, does the internal contradiction have strong influence on radical reform?

According to Clemens and Cook, the sustainability of a policy leads relevant actors to expect a certain result, and it improves the stability and efficiency of society. But at the same time, it is difficult for a policy to react actively to environmental changes due to such inertia. Therefore, the instability and ineffectiveness of the policy are likely to increase simultaneously in the long run (ibid). In other words, the general nature of a policy, which becomes stable and then improves in effectiveness, consequently makes the policy less effective, and makes it inappropriate. Such an internal contradiction can be much greater when both a demand for policy change

and its opponents' power to change it are significant. In such cases, the contradiction will eventually lead to a policy failure. If a policy failure is not addressed quickly and effectively within an existing policy paradigm, furthermore, structural or fundamental change is likely to occur. Once the failure becomes obvious, the existing policy is challenged by a competing policy alternative with a new paradigm, and an ambitious political entrepreneur may exploit the alternative in order to claim credit and gain the support of the public (ibid).

Clemens and Cook (1999: 449) provide us with a good understanding of the fact that the firm belief or practice of a society in maintaining a policy or an institution can be a potential source of reform. Institutions or policies have a tendency to be unchangeable or path-dependent in spite of their innate incompleteness and instability. However, the characteristics of an institution can be an influential factor leading to its own fundamental change in some circumstances. This concept is innovative and closely related to the dialectic insight that 'highlights the instabilities inherent in a certain systems of belief and practice' (ibid: 449). Researchers focusing on the elements of internal contradictions claim, similarly to the Marxian insight into 'macro historical change', that 'institutions may produce their own grave-digger' (ibid: 449).

In this sense, a welfare policy chosen by the political elite and preceded by path-dependent frameworks might have a great potential to become a grave-digger. According to the theory of 'policy feedback effects' on politics (Pierson 1993, 2001), a policy, once established, creates strong political supporters who benefit from the policy. However, it is also argued that a policy which has a severe internal contradiction could also inevitably produce opponents who suffer because of the existing policy but cannot realize their interests because of their weak position in the power distribution. From this perspective, the following questions are raised: what elements of an institution make it more contradictory and what conditions enable the opponents who have been disadvantaged in their power configuration to realize their interests? These questions should be at the core of explaining the vigorous reform debates and confrontation between present and alternative institutions related to welfare policies. Clemens and Cook also suggest the concept of 'multiplicity' (Clemens and Cook, 1999: 449). Multiplicity refers to the existence of diverse alternative institutions. Institutional conflicts can be stimulated by strain between 'multiple institutions'

as well as internalized contradiction (Sewell, 1992: 16-19). Revolution can happen when the present institution is no longer accepted as inevitable due to the existence of competing alternatives (Stinchcombe, 1978: 40).

Given the aforementioned comments, the existence of the competing alternative can be an important condition of significant institutional change. In this regard, if some internally contradictory factors disrupt the legitimacy of existing policy, competing policy alternatives emerge and confront each other at a critically strategic point. Subsequently, any political innovator will seek to advance his/her interests by raising the issue of a fundamental change of a present policy to the competing alternative (Clemens and Cook, 1999). In addition, political or policy experimentation may be experienced by the people who have been disadvantaged by the present policy at a critical point. Politically marginalized individuals and groups are especially likely to try to experiment with policy alternatives because they need to invest relatively little in changing institutions (ibid). Political challengers or entrepreneurs exploit this situation to gain votes by using alternatives for, and mobilization of, socially marginal actors.

Let us look at the processes and the conditions of a fundamental policy change. Institutions, including policies, provide firm guidelines for the public about how to act. In this sense, institutions make people's real lives more efficient by providing stable expectations and rules of the game. However, institutions have to adapt to the changing environment in order to survive. Nevertheless, an institution does not change easily because the people with vested interests who seized decision-making power in the present institutional configuration will prevent the institution from being changed until some critical juncture arises (Krasner, 1984). Even if an institution (or a policy) needs to be changed in a path-breaking way by adapting to the changed environment, it will not change fundamentally, which results in the ineffectiveness of its function over time. As Clemens and Cook (1999: 449) have stated, institutions which do not adapt to the changed environment produce grave-diggers by accumulating opponents of the present policy. This research argues that, in advanced democratic societies, institutions, including political ones, evolve gradually, as in North's (1990) argument. However, in immature democratic societies with deformed institutions (political or social) it is difficult for an institution (or a policy) to change gradually in regard to its core policy principle or policy paradigm. Rather, in less demo-

cratized societies, institutions do not evolve until the internal contradictions and inherent instabilities fully accumulate, as Krasner (1984) argues. The accumulated internal contradictions result in diverse policy problems as time passes and those policy problems, again, erode the legitimacy of the present policy. The policy's loss of legitimacy will be recognized by the public and this situation can be exploited by ambitious political actors when a competing alternative emerges (Clemens and Cook, 1999). The final outcome of the policy competition ignited by internal contradiction comes about after a long political confrontation among political actors under the given political configuration and decision-making rules of the game. What, then, happened in the NPS reform, which was completed in 2007?

### III. The Causes, Conditions and Processes of the Structural Change of the NPS

As mentioned in the introduction, a fundamental (structural or radical) change of a policy often follows four steps. Firstly, the policy problems clearly emerge and the problems are recognized by the public. Secondly, the policy failure and the loss of its legitimacy take place. Thirdly, the policy is recognized as not a necessary one if a competing alternative emerges. Fourthly, political entrepreneurs try to exploit this situation in pursuit of their own interests. Even so, other factors, such as institutional conditions which instigate the political actors' self-interest are necessary for a fundamental policy change to take place. We will look at these step by step after looking at the general features of the NPS.

#### A. General Features of the NPS and Fiscal Conservatism

The public pension systems of Korea can be categorized into two groups: 1) public pension systems for public sector employees, such as the Government Employees Pension System (GEPS), the Military Personnel Pension System (MPPS) and the Private Teachers Pension System (PTPS); and 2) the NPS for all private sector workers and other voluntarily insurable people, such as the

non-working spouses of insured individuals. Much later than the introduction of other public pension systems for public sector workers, the NPS was introduced in 1988 by the enactment of the National Pension Act in 1986 and the establishment of NPSrcv, which operates the NPS and the NPS fund, in 1987.

The NPS covered regular employees who were over 18 to under 60 in businesses with more than 10 employees (except for those that already had occupational pensions) when it was introduced and it was expanded to businesses with more than five employees in 1992. Lower income classes without the ability to make contributions and employees in businesses with fewer than five employees were excluded, as were those who were over 60 at the time of the pension system implementation (Oh, G.H., 2006: 169). Moreover, in July 1995 there was an expansion of pension participants to include farmers, fishers and residents in farming and fishing villages and the self-employed in those districts, and in the latter half of 1998 an expansion to include self-employed people in cities (NPSrcv, 2010). The expansion of the NPS, in terms of legal coverage, was very fast: it took only 11 years for the NPS to cover the entire nation from the time of its introduction. The real coverage of the NPS, however, was much lower. The real coverage of the public pension systems was only 57.5 percent of the eligible workforce in 2007 (NPSrcv, 2008). Moreover, the average insured years of pensioners under the NPS was less than 20 years until the major reform was completed in 2007. The expected long-term average insured years of the NPS in 2050 also was only 21 years (Oh, S.H. and Jung, C.L., 2012). This was mainly because there were too many vulnerable people who could not pay contributions to the NPS. Most of them were poor and/or unstable incomers in work, such as irregular workers, self-employed, those who had been laid off and family carers who needed financial subsidy from the state. However, there was no financial subsidy from the tax revenue for them to be encouraged to pay contributions to join the NPS, which had a very favorable redistribution mechanism. Moreover, up until the 2007 reform was completed there were no pension credit systems under which insurers who could not work because of being engaged in socially desirable activities, such as national defense and child care, could increase their contribution history. The NPS was designed as a semi-funded contributory social insurance scheme. For that reason, the elderly who were over 60 years old

at the time the NPS was introduced were totally excluded from the scheme. Instead, the fund could be incredibly increased because it was designed as the semi-funded scheme for accumulating national capital (see Lee, H. K., 1994). The NPS fund was the third largest public pension fund in the world by the year 2015. What does the amount of fund mean in Korea where the old-age poverty ratio is the highest among the OECD countries, and has been each year this ratio has been recorded (i.e., 45.7 percent in 2015)? This is one of the clear pieces of evidence that the principle of fiscal conservatism is being applied, which protects the fund instead of the income of the old.

The benefit level of the NPS has been radically cut, moving from 70 percent of the replacement ratio in 1988, to 60 percent in 1999 and 50 percent in 2008, and planned to gradually decrease by 0.5 percent per year to 40 percent in 2028. In particular, the radical reduction of the replacement ratio of the NPS, from 60 percent to 40 percent, was executed in 2007, instead of the introduction of the Basic Old-Age Pension System. The contribution rate of the NPS started at 3 percent of the participant's income in 1988, moving to 6 percent in 1993 and 9 percent in 1999. Even though the contribution rate of the NPS has been quite low compared to its benefit level, it has been difficult for vulnerable people to properly pay contributions without any financial support from the state. Most importantly, we have to remind ourselves that the NPS was designed to be financially independent from the state (Lee, H. K., 1994).

## B. Serious Policy Problems in the NPS

What were the serious and continuous problems of the NPS and what were the main causes of them? In this research it is argued that the most significant policy problem was the vast range of uninsured people due to the large blind spot of the real coverage of the NPS. Approximately 60 percent of elderly persons aged 60 and over did not have any type of public pension benefit in 2007(NPS, 2008). The average insured years of the subscribers in the NPS, which is one of the core factors representing the level of the pension payment, was expected to be about 24 years even in 2050 (Oh, S. H. and Jung, C.L., 2012). This clearly shows the old-age income insecurity of Korean people at present and in

the future. However, on the other hand, conservative politicians, bureaucrats, news media and neo-liberal economists, which take core positions of Korean society, have always criticized the NPS for the over-generous benefit scheme (Jung, C.L., 2012). This phenomenon represents well the dominance of developmental welfare and neo-liberalism in Korean society. The neo-liberalists, the hegemonic major group of Korean society seeking economic growth first and most, have emphasized the long-term financial stability without governmental subsidy to the NPS (Lee, H. K., 1994). According to the two phenomena mentioned above, this study assumes that the most serious policy problems that necessarily erode the legitimacy and so increase the possibility of radical reform of the NPS are 'income insecurity' and 'long-term financial instability'. Then, one question can be raised that "would it be possible for the NPS to achieve the two basic missions of the NPS, income security and long-term financial stability, under the social insurance contributory public pension scheme? If we simply define the 'fiscal conservatism', in this research, as 'the strict ideology or principle that social insurance welfare systems like the NPS should be operated independently from government subsidy, the fiscal conservatism would not allow for the social minorities to be fully insured in the NPS because of the vulnerability of their income. In this sense, the fiscal conservatism may be the critical source of the instability, internal contradiction, of the NPS.

This research suggests 'fiscal conservatism' as a core source of 'internal contradictions' in the NPS since the fiscal conservatism embedded in the design and operational principle of the NPS is assumed to be the main cause of the two policy problems mentioned above paragraph. We will examine the real features of the two policy problems of the NPS and discuss their causes to prove the causal relationship between fiscal conservatism and the two main problems.

### *1. Income insecurity problems*

The NPS expanded its coverage very quickly. Eleven years after it was introduced, it achieved universality in terms of legal coverage for the whole nation under a single-pillar system. Moreover, the last stage of the expansion to the urban self-employed was accomplished in the midst of the harsh economic crisis in 1998. The Kim Dae-Jung government publicized the fact that Korea

made pension systems available to all people. In fact, there had been many significant achievements in expansion of welfare program coverage in the Kim Dae-Jung government. Some scholars such as Kim, Y.M. (2001) see the coverage expansion as significant in that it was the turning point towards a real welfare state that views individual welfare as the state's responsibility on the basis of universalism (Kim, Y.M. and Kim, K.S., 2005). However, others such as Jo, Y.H. (2002) and Yang, J.J. (2003) assess the welfare policy of Kim Dae-Jung's government as promoting a workfare state based on neo-liberalism with the main intention being to support the efficiency of the market and economy. The NPS seems to have two distinct characteristics. On the one hand, it is very generous, universal and solidarity-promoting in legal terms. On the other hand, it has very vulnerable, discriminatory and fragmented content in reality. It is generally accepted that there exists a huge gap between the legal and real content of the NPS (Kim, Y. M. & Kim, K. S. 2005; Lee, H. K. 1994, 2004; Kim, Y. H. & Seok, J. E. 1999). This study argues that this contradictory feature of the NPS is the most symbolic trait of the Korean welfare state including income security systems such as the NPS. This trait is closely related to the most complex problems of the NPS, particularly the distrust in the NPS. This contradictory feature of the NPS increased and remained strong until recently. The contradictory characteristics of the NPS, grew, together with coverage expansion of the NPS to encompass the self-employed in urban areas in 1999. Let us take a look at these contradictory features one by one.

Firstly, there were too many contribution exemptions in the NPS that legally enabled individuals to not make contributions for a long time. Even though everyone who was aged from 18 to 59 could be covered by the law (National Pension Act), many people legally did not make contributions. The people who were allowed contribution payment exemption totalled 12.7 per cent of total local insured people<sup>3</sup> (3.2 per cent of the total insured) in 1995. However, this figure reached 56.3 per cent (28 per cent of the total insured) in 2007 (National Pension Service, 2008). This covers all the people who legally

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<sup>3</sup> These are region based insured, consisting of the self-employed, farmers and fishers, irregular workers, etc. They also have to make contributions if they earn income but income detection is nearly impossible if they are engaged in an unstable and low income business.

did not pay contributions over a long time and may not have accumulated the necessary contribution history: at least 10 years for a reduced pension or at least 20 years for a complete pension. Most of them were very vulnerable people whose income was very low and unstable. For example, contribution exemptions were granted in cases of unemployment, lay-off, bankruptcy, etc. Additionally, about 12 per cent of total insured people in the NPS illegally failed to pay contributions for more than 3 months in 2007 (National Pension Service, 2008). They are not supposed to receive a proper pension benefit. As a result, a considerable number of the NPS members who legally or illegally did not pay for a long time could face old age poverty on a large scale. As mentioned above, there was a too big portion of the population not covered by the public pension system in Korea. A so-called ‘blind spot problem’ was occurring in the NPS. According to Seok, J. E. (2004: 203–206) there are two possible types of blind spot problems:

- (i) traditional types that normally occur in developing countries mainly due to system design limitations; and
- (ii) non-traditional types which emerge in advanced industrial countries mainly due to their flexible labour market policy.

The traditional blind spot problem is caused mainly by a system design in which only a limited number of formal workers can be covered by the income security system because of administrative and economic limitations in including many social minorities. In Korea, many informal workers such as unpaid housewives, part-time workers and people working in very small businesses are excluded from the NPS in real terms. The non-traditional blind spot problem can exist even in advanced welfare states because of post-industrial social change where a flexible labor market policy is strongly required. Employment has been the underpinning of the traditional welfare state design (insurance-based male breadwinner model), under which many irregular workers and unemployed people cannot be adequately supported by the income security system (Walwei, 1995).

In Korea, even though the expansion of legal coverage was successfully completed in 1999, 11 years after the introduction of the NPS, the ratio of real participation<sup>4</sup>

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<sup>4</sup> Here the real participation ratio refers to the portion of the insured which are regularly making contributions to the public pension system

in the public pension systems was only 57.5 per cent of the eligible workforce in 2007 (National Pension Service, 2008). This is because there were too many legal contribution exemptions on the one hand as mentioned above, and on the other hand a considerable portion of other insured people who did not pay contributions for a long period illegally. Most significantly, there were no income security measures in the NPS for the elderly who were already 60 and over when the NPS was introduced in 1988. They have been the poorest cohort even after the introduction of the general public pension system in Korea, in contrast to Western welfare states, where the elderly have normally been a richer group. As a result, the beneficiaries of public pension systems among the elderly aged 60 and over amounted to only 27.9 per cent in 2007 (National Pension Service, 2008). Secondly, even those who participated in the system did not always receive enough pension benefits after retirement because the contribution history they had accumulated was too short. According to the long-term simulation research of the National Pension Research Institute, the average insured period of the participants will be about 21 years until the 2050s (Oh, S.H. and Jung, C.L., 2012). This means that even though the work period ceiling was designed to be 40 years, the length of the real work period of those insured by the NPS is almost half of that even after the NPS matures. There are many reasons for the short work experience of retirees benefitting from the NPS: relatively late participation in work because of higher education, involuntary early retirement, family care or childbirth work leave (for women), compulsory military service (for men), lay-off, etc. While most Western welfare states have adopted various types of pension credit programs to give extra contribution records to members through the state’s contribution payment, there was no form of pension credit system in the NPS until the 2007 NPS reform was completed (National Pension Service, 2008). According to the empirical research of Choi, H.S. (2002: 236), the future projection of the average replacement rate of the NPS is only 30–35 per cent until 2024 under the former NPS scheme which provides a 60 per cent of legal income replacement rate for workers with a 40-year work career (before the 2007 NPS reform). In addition, this tendency is not expected to improve

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divided by the people aged from 20 to 59.

even far in the future according to Choi, H.S. (2002). Moreover, the average real replacement would be from about 20% to 23% or more under the reformed NPS in 2007 because the replacement rate will be decreased gradually to 40 per cent for workers with a 40-year work career by 2028. For example, according to the research of Choi, H.S (2002), the empirical replacement rate of the NPS for the average income earners by the year 2024 was shown as 34.54 per cent under the NPS scheme before the 2007 reform. This is a very low replacement rate which demonstrates the inadequacy of the benefit provided by the NPS in reality and may make system participants regard their benefit as pocket money even though the legal benefit structure of NPS was very generous relative to their contribution rate. The replacement rate of the NPS before the 2007 reform was 60% for workers with a 40-year work career. The replacement rate of the NPS was in the middle among OECD countries' ones (Kwon, M.I. 1999). It is comparatively generous given the contribution rate of 9 per cent. Most Western countries' contribution rates are around 20%, which is much higher than the contribution rate of the NPS (see Table 1).

However, the replacement rate itself has to be considered in terms of recipients' politics. Many Korean people consider the contribution to the social insurance as a tax rather than compulsory saving. These citizens think that the tax system is unfair in terms of both collection and expenditure. They also do not understand the public pension financing pay-as-you-go system (Nam, C.S., 2005). They are very anxious about the depletion of the NPS fund because they think they will not be able to receive the pension benefits which they saved for. Various neo-liberals such as pension experts, bureaucrats and con-

servative major newspapers over-emphasized the fund depletion (Jung, C.L., 2009). As a result, most Korean people have been very reluctant to make contributions to the NPS. This is a very different attitude toward the pension system than that found in Western welfare states. Generally, people in Western countries prefer increasing the rate of contribution to decreasing the pension benefit (Taylor-Gooby, 1999). However, most people in Korea prefer benefit reduction to an increase in the contribution rate (Nam, C.S., 2005). As the NPS system did not provide any credit system for people who were taking part in socially valuable work such as military service, higher education and sick family care, unlike in Western countries most retirees had to receive benefits based on a very short contribution period before the 2007 NPS reform. The pension credit system for compulsory military service and childbirth was first introduced in the 2007 reform on a very limited scale. Additionally, if we consider the people in the blind spot, the replacement rate drastically falls to 24.3% (Choi, H.S., 2002: 236). This figure shows clearly the reality of the Korean old age income security system, particularly the very limited function of the NPS in old age poverty prevention. The research shows that what is important is not the legal coverage or benefit structure but the real impact.

Let us look at this feature in detail based on the empirical data of Choi, H.S. (2002). Firstly, the present NPS system in Korea has fundamental problems in terms of real system coverage. Almost 40% of eligible people do not join the scheme. This means that the NPS takes responsibility only for haves, not for have-nots. This results in distortion of the national redistribution structure and thus increases the income inequality among the elderly<sup>5</sup>. It is crucial

**Table 1.** Pension contribution rate (per cent of gross earnings)

	1994	1999	2004	2007	2009	Employee 2009	Employer 2009
Canada	5.2	7.0	9.9	9.9	9.9	5.0	5.0
France	21.5	16.7	16.7	16.7	16.7	6.8	9.9
Germany	19.2	19.7	19.5	19.9	19.9	10.0	10.0
Japan	16.5	17.4	13.9	14.6	15.4	7.7	7.7
Korea	6.0	9.0	9.0	9.0	9.0	4.5	4.5
United States	12.4	12.4	12.4	12.4	12.4	6.2	6.2
Sweden	19.1	15.1	18.9	18.9	18.9	7.0	11.9
<b>OECD34</b>	<b>19.2</b>	<b>19.3</b>	<b>20.0</b>	<b>19.8</b>	<b>19.8</b>	<b>8.4</b>	<b>11.2</b>

Source: OECD (various years), Taxing Wages; OECD (2008), Revenue Statistics; Social Security Administration, United States (various years), Social Security Programs throughout the World; OECD pension and tax models.

<sup>5</sup> Even though the NPS has a strong redistribution scheme, this scheme is operating only among participants; outsiders cannot benefit from the scheme. This necessarily increases the inequality gap between insiders and outsiders of the NPS.



to recognize that those who are excluded from the NPS in real terms are the most vulnerable people and are the most in need of social protection. Secondly, Korea has been experiencing both the traditional and non-traditional blind spot problems at the same time. This is because Korea has expanded its coverage without proper measures to address the blind spot problems, such as various credit schemes for the social contributors or a contribution supplement system for the poor. The term 'blind spot' is defined as 'the people who cannot receive pension in the old age because their contribution period did not reach the required minimum guide line' (NPSrvc, 2006). Korea has sought a top-down coverage expansion strategy unlike most Western countries such as the UK and Germany, in which the pension systems were introduced for the most vulnerable groups such as miners (Park, C.Y. et al., 2000). This caused the people who are in the blind spot to be the most vulnerable group in terms of old age income (Choi, H.S., 2002: 225). Moreover, national restructuring for increasing market flexibility in the economic crisis, started in 1997, produced many irregular workers and vulnerable self-employed individuals. This means that radical coverage expansion of the NPS has not been effective in protecting the social minority from the direct threats of globalization and neo-liberalism. The pragmatic top-down approaches along with a developmental state ideology plus neo-liberal ideas in the post-industrial context have not allowed for any space for social rights for the institutional minority. A path-dependent NPS change without overcoming the policy paradigm does not seem to work appropriately for the institutional minority. In this respect, paradigmatic institutional change, or structural change with different policy goals, was strongly suggested by many scholars such as Kim, Y.H. (2004), Kim, Y.H. and Seok, J.E. (1999) and Choi, H.S. (2002) as a core answer in terms of enhancing income security and equality for all within the limited resources of the NPS. Thirdly, Korea has been producing many irregular workers who are weak in political power. Irregular labourers receive much lower payments than regular workers who have strong trade unions. According to the statistics of the Korean Statistical Office in 2002, the average wage of irregular workers is only about 50 per cent of that of regular workers and this situation has not improved over time (Yang, J.J. 2003: 413–414; also see Figure 1).

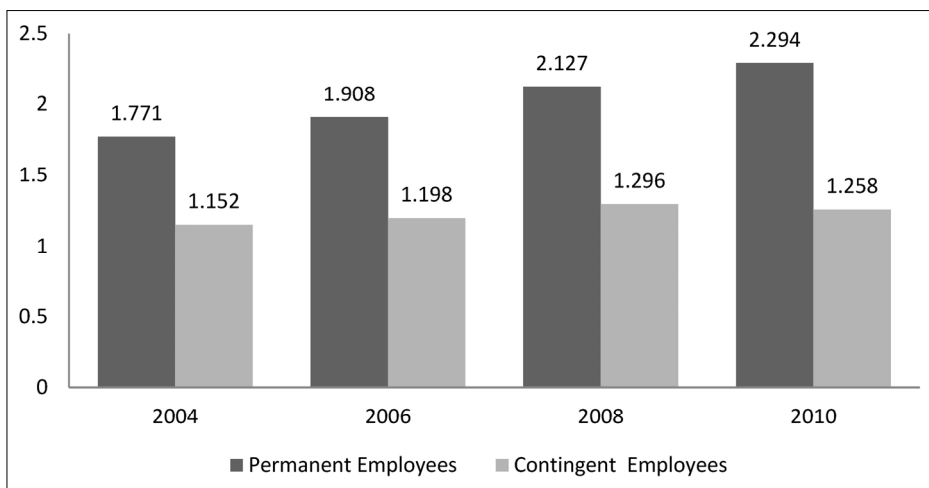
In addition, irregular employees are very weak in their political power because they are excluded from large,

well-organized company trade unions. Trade unions in Korea have exercised only a limited effect in enhancing the welfare state because the authoritarian government had controlled the labor movement for long time with a divide and rule strategy to weaken political negotiation with the government (Han, S.K., 1999) The Korean authoritarian government introduced a corporate trade union system and this made individual trade unions of companies seek their own corporate welfare prior to state welfare for all labor (Yang, J.J., 2004a). This tradition has impacted negatively on the irregular labor force until recently. The labour market flexibilization policy in Kim Dae-Jung's regime resulted in both producing a massive number of irregular workers<sup>6</sup> and loading the cost of market flexibilization onto irregular workers (Yang, J.J., 2003: 408–413). This unfavorable power structure implies that the blind spot problem cannot be easily eliminated. As a result, only around 20% of irregular workers are joining the public social insurance welfare systems; this is a significantly low level compared with about 90% of regular workers by the year 2001, and the situation is not expected to improve (Lee, H.G., 2001). Recent statistics also shows that situation has not improved much (see Figure 2).

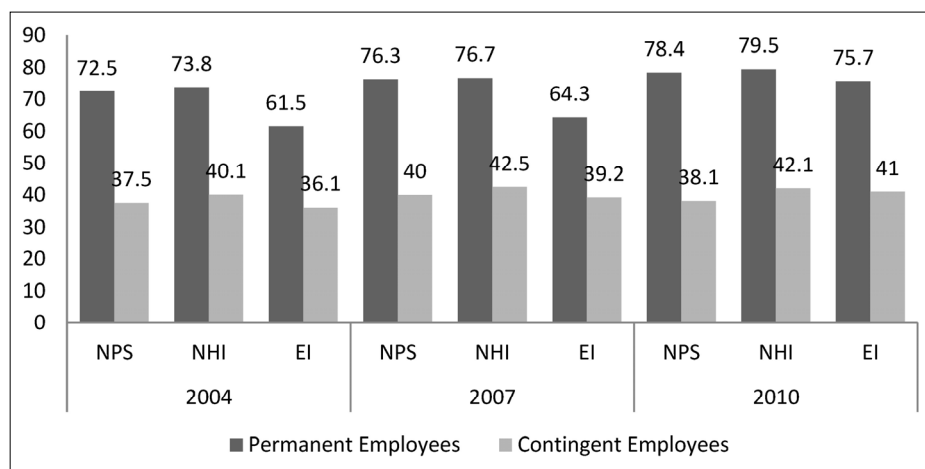
Fourthly, the very nature of a pension system based on social insurance like the NPS inevitably results in institutional exclusion because its financial resources come from the contributions of workers. Social insurance is a system built on the basic assumption of perfect employment. However, labor market flexibilization in the post-industrial society made this assumption useless. Without consideration of the flexible labor market, it is almost impossible for government to prevent poverty and income inequality by using only the traditional social insurance principle (Yang, J.J., 2003: 408). This means that the other old age income security schemes designed on the basis of other principles (e.g. tax-based financing) should complement the old age income security programs based on the principle of social insurance. For this reason, most advanced welfare states have reformed since the 1980s with effective measures to supplement this weakness. The countries that have a basic state pension system have

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<sup>6</sup> According to the research of Kim, Y. B. (2001), the portion of irregular workers out of total salaried workers rapidly increased after the foreign currency crisis started in 1997, from 43.4% in 1996 to 52.9% in 2000. This symptom emerged in most industries, particularly the service industry.



**Figure 1.** Average Monthly Wage Unit: Million Won (thousand US\$)  
 Source: Statistics Korea : <http://kostat.go.kr/portal/eng/index.action>



**Figure 2.** Percentage of employees insured by social insurance schemes  
 Source: Statistics Korea : <http://kostat.go.kr/portal/eng/index.action>

fewer blind spot problems because the benefit of the basic pension system is not directly linked with contributions. Almost all Western welfare state countries, including the countries with earnings-related social insurance pension systems such as Germany, have been providing many measures such as pension credit systems and contribution exemptions without reduction of their benefits (Seok, J.E., 2004). However, Korea, which has a strong tradition of fiscal conservatism for welfare programs, has maintained its contributory financing principle strictly without introducing any proper measures to counteract the weak-

nesses before the 2007 NPS reform. The NPS did not provide any credit systems for the people who are doing socially useful work for the nation such as military service and family care. A very generous benefit structure without proper measures for the institutional minority had been the main source of blind spot problems. In this sense, the two sources of policy problems in the NPS, the pension system design and financing resource principle, should be the key points to discuss.

The blind spot problems in the NPS emerged in various aspects. Firstly, the most vulnerable generation among

the people in the blind spot were the elderly who did not have the chance to enrol in any public pension scheme. As there was not proper consideration of the elderly when the NPS was introduced, they have to survive without a pension benefit. They had sacrificed themselves to construct the industrial country, educating their children and supporting their parents. However, most of them were unable to save money for themselves because the daily survival of their extended family was the most important issue. They had to support parents and their children without necessary state income provision. They also strove to educate children as much as they could by spending most of their income<sup>7</sup>. The state fully exploited them and their well-educated children for the industrialization of Korea. While the government should have prioritized their income security when the NPS was introduced, the NPS was designed as a contributory semi-funded scheme and the collected contributions were saved for the future old age income of present workers, not for the present elderly. However, even after democratization, the Korean government never gave up the 'economy first' policy and made clearer the financial neutrality (non-interventionism) of the NPS<sup>8</sup>. One of the outcomes of this idea was neglect of the elderly. The old age have to depend on their children for care and income. As mentioned above, the income dependency ratio on children for the elderly was 63.7 in 1988. Although the Old Age Pension (allowance) was introduced in 1998 by Kim Dae-Jung's regime to compensate for exclusion of the elderly from the public pension system, it was a very tiny benefit and had strict eligibility requirements<sup>9</sup>. The Old Age Pension was designed to pay a flat-rate benefit only to

the elderly aged 65 and over as of 1 July 1998. For this reason the beneficiaries were to decrease over time and this scheme was abolished in 2008 when the Basic Old Age Pension became effective. In this sense, this scheme can be regarded as a provisional measure by the government to alleviate the complaints of the elderly who had not been given any benefit from the public income security provision scheme. As a result, only 14% of the old aged 60 and over were benefitting from the Old Age Pension System as of the end of 2006. On the other hand, only 18 per cent of the elderly aged 60 and over were benefitting from the public pension systems (including the NPS) and only 28.5% of the total elderly aged 60 and over were receiving any type of provision from public income security systems by the end of 2003. Moreover, their benefit level was minimal. 90.5% of them were receiving the benefit under the minimum living cost. By the criterion of minimum living cost, 95.2% of total elderly could be regarded as experiencing the blind spot problem under the public old age income security system (Seok, J.E., 2004). This phenomenon has not improved much over time. For example, only 27.9% of the elderly aged 60 and over were receiving any type of pension benefit from the public pension system in 2007 (National Pension Service, 2008).

This research argues that the blind spot problem should be regarded as the most serious policy problem among issues of the NPS. The seriousness of the blind spot problem of the NPS is broadly accepted by most scholars (see Kim, Y.M. and Kim, K.S., 2005; Moon, H.P., 2004; Yun, S.M., 2004a). Even though we accept that it is inevitable for the social insurance welfare model to leave some blind spots, Western welfare states have reduced these significantly through various financial support measures such as pension credit systems, the minimum income guarantee method, and introduction of a basic pension scheme based on tax financing (National Pension Service, 2008). In detail, the cost of redistribution measures and pension credits should be covered by the state (Lee, J.W., 2002). The financing resource issues have been the top priority in debates on public pension system reform in continental European welfare states of the social insurance-based Bismarckian model. As Natali and Rhodes (2004: 1) argue:

The political debate has centered on the distinction between contributory and non-contributory benefits and

<sup>7</sup> Koreans have been raised within the Confucianist tradition to see education as the most important job in people's lives in terms of both becoming a gentleman/lady in society and increasing one's social status. Many parents sold a cow, the most precious property of their household, for higher education for their children, particularly the eldest male child. The word 'Ugoltap', which is translated as 'Tower Made of Cow Bones' and represents the sacrifice of parents for children's university education with a cow, was popular. This illustrates the fact that in the early NPS era the elderly could not save anything for themselves, instead expecting their children's support when they are in their old age.

<sup>8</sup> When the NPS was reintroduced one of the basic principles in its design was the non-intervention principle. The financial problems of Western welfare states at that time was taken as a good excuse for that principle (Lee, H.K., 1994).

<sup>9</sup> The level of the highest benefit was US\$ 50 (£25) in 2002. The eligibility can be assessed through income and means testing for the partner or children.

the need, emphasised especially by the unions, to clearly distinguish expenses directly attributable to the state (and to be covered by general taxation), from those attributable to the pension scheme (and to be financed from contributions).

As a result, academics and politicians in the European countries broadly agree (notably unlike the USA) on the necessity of the state bearing financial responsibility even in the social insurance public pension systems. In reality most countries, whether or not they have adopted the Bismarckian or Beveridgean model, share a considerable part of the cost of public pension benefits. Specifically, most states contribute about 20% to 30% of total expenses of the public pension benefit (Lee, J.W., 2002; National Pension Service, 2008). For example, Germany shares about 30% of total expenses of the public pension benefit.

However, in Korea, because of the strict financing principle of fiscal conservatism, there is little possibility for social minorities to obtain proper pension benefits through the state's financial support. The majority of academics, bureaucrats, politicians and media in Korea do not claim that the state should be financially responsible. Rather, they emphasize the danger of fund depletion (for the NPS) which was expected when it was designed to eventually be depleted; the fund depletion time could be controlled by partial adjustment of the contribution rate and by the state's financial subsidy (Jung, C. L., 2009). The seriousness of the insecurity of old age income for the present and future elderly does not seem to significantly matter for them. This institutional and political situation surrounding the NPS has kept the NPS from evolving toward gradually adopting proper measures for state financial responsibility. This attitude increased the internal contradiction that led to the great distrust of the public in the NPS. As Clemens and Cook (1999) explained and this research assumed, the incredible distrust of the people in the NPS showed that the NPS lost the legitimacy and was exposed to policy failure. The pre-condition of the radical reform including structural change of the NPS was already established. The principle of fiscal conservatism was a decisive driving force coming from the innate feature of the NPS and leading to fundamental reform. So, how did the principle of fiscal conservatism affect the financial instability debate? We will now trace the relationship of fiscal conservatism and the long-term financial instability issue in Korea.

## *2. Long-Term Financial Instability*

Many scholars in Korea, particularly economists, believe that 'the priority among pension system issues to urgently solve is the problem of long-term financial sustainability and the actual cause of the problem is the unbalanced benefit structure: disproportionate structure between contribution and benefit' (Moon, H.P., 2004: 16). Yun, S.M. (2004b: 3) states his judgment of the NPS' financial situation as:

If the current system remains unchanged, it has been projected that the NPS will run a deficit starting from 2036 and that its fund reserve will be depleted by 2047. To address this problem, the National Pension Scheme contribution rate should be increased to 30.0 per cent by 2050 and to 39.1 per cent by 2070.

Yun, S.M. (2004b) argued that reducing benefits and increasing contributions were urgently needed because if the NPS matures, the retrenchment reform will be more difficult. He suggests evidence to support his argument. Firstly, in line with trends of Western countries, the NPS should follow the direction of reinforcing funding features without being over-dependent on the next generation. Secondly, reinforcing the pay-as-you-go trait is not fit for a post-industrial social structure with population ageing (extended life expectancy) due to low economic growth, unstable employment and low fertility. Reinforcing pay-as-you-go traits such as tax-based basic state pension system introduction is counter to world-wide trends. Depending on actuarial calculations focused on population ageing, economists such as Moon, H.P. strongly raised the financial instability issue of NPS in 1995 and this instigated the first round of NPS reform in 1997–1998, in which two issues, coverage expansion and financial sustainability, were confronted (Kim, Y.M. and Kim, K.S., 2005: 214). The NPS was planned as a defined benefit (DB) structure with contribution rates set at 9% of salary and a 60% income replacement rate before the 2007 NPS reform. The benefit level, 60% income replacement, can be regarded as moderate but too generous compared to the 9% of contribution rate. This research argues that the total contribution rate should be raised to the proper level. However, we should consider why the majority of Korean people do not agree with increasing the contribution rate, rather preferring the benefit reduction.

Korea has produced a lot of vulnerable people, mainly after the East Asian economic crisis started in 1997. The portion of irregular workers and the self-employed is much bigger than in any other OECD country. Many of them have been laid-off in the turmoil of national restructuring. It would be more difficult for them to make contributions if the contribution rate increases. This is why the government and politicians could not raise the contribution rate in the 2007 NPS reform. For them, a basic pension scheme that is tax-based and universal (Beveridgean scheme) or a contributory earnings-related benefit scheme like the NPS, with supplementary subsidizing measures such as a minimum pension guarantee and pension credits, is necessary. For both changes, the abolition of the principle of fiscal conservatism is a prerequisite.

Like in other developed countries, the main factor in the financial sustainability issue in Korea is population ageing (Kim, S.S., 2011). Using the United Nations' (UN) definition of old age, the average population rate of old persons in the OECD countries was 8.7% in 1960, 10% in 1970 and 13.7% in 2000, with this ageing trend continuing. The old age support rate (dependency ratio), then, will dramatically increase from 23.8% in 2000 to about 50% in 2050 (Jung, H.W., 2004, cited in Yun, S.M., 2004a). The dependency ratio<sup>10</sup> is very important for welfare programs, particularly old age income security pension systems, in terms of financial sustainability. Most Western welfare states maintain pay-as-you-go financing schemes in which the working generation finances for the older generation's benefits. If the support rate becomes higher, the working generation should have a higher rate of contribution to support them. In this regard, Korea has very serious population ageing problems. Population ageing is proceeding very rapidly in Korea. Korea became an ageing society in 2000, much later than other OECD countries. However, the period in which a society is transformed from an ageing society to an aged society<sup>11</sup> will in Korea be the shortest in the world. For instance, according to the research of the OECD (2001), the period for the ageing society to be transformed into an aged society will be only 22 years in Korea, compared with 115 years

in France, 85 years in Sweden, 47 years in the UK and 24 years in Japan. As a result, the old age support rate in Korea will increase from 11.3% in 2000 to nearly 70% in 2050. Korea will take second place following Japan in its dependency ratio among OECD countries (Yun, S.M., 2004a).

The majority of scholars, as well as the bureaucrats of the Rho Moo-Hyun government and former regimes, seem to have a clear policy preference for system security (financial sustainability) instead of social security for the aged based on the assumption of the population ageing. However, some welfare-oriented scholars such as Kim, Y.M (2004)<sup>12</sup> do not agree with the logic of urgently needed retrenchment reform or even with the proposition of retrenchment. Firstly, he argues that even if the proposition suggested by scholars favoring retrenchment is accepted, the expected contribution rate after the 2030s, 19.5% of salary, is maintainable in the future. This is because this is a similar level to the present contribution rates of Western countries<sup>13</sup>. In addition, the expected levels of total pension benefit expenditure in 2050, 7% of GDP, would also be endurable because this is similar to the level of European countries' pension benefit expenditure in the late 1990s. Secondly, radical reduction of welfare benefits based on unclear long-term projections could result in serious social security problems because present pension system participants in Korea mostly have a very short contribution period because of the system's immaturity and unstable work conditions. Thirdly, the present generation has a right to be better supported by the next generation because it is in a situation of double payments: contributions for themselves and private transfers to their parents who do not benefit from the NPS. Fourthly, the contribution rate expected in the future to

<sup>10</sup> This is the index that represents the level of burden imposed on the working generation by the old generation. This is the population aged over 65 divided by the population of 20-to-64-year-olds.

<sup>11</sup> According to the UN definition, an ageing society is a society in which people aged over 65 years comprise more than 7% of the total population and in an aged society the proportion is more than 14%.

<sup>12</sup> Kim, Y.M. is Professor in the Department of Social Work in the Jung-Ang University in Korea (Chief Social Secretary for the Moon Government from in 2018) and he has had the leading role in developing the position on social welfare issues and alternatives for a progressive NGO: The Unity for Participatory Democracy. He argues that recent debates on retrenchment of the NPS have some dangers which may result in serious social security problems for many elderly people in the future. Therefore many aspects, such as the negative prospects based on an uncertain long-term proposition, should be questioned (see Kim Y. M. (2004)).

<sup>13</sup> This argument is reasonably based on the clear evidence of the Western welfare states. However, the argument should be supported by the fact that a substantial amount of the state's financial subsidy based on tax revenue is applied to the public pension system at the same time.

maintain the present income replacement ratio can be affordable if it is effectively adjusted by, for example, necessary taxation. Kim, Y.M. (2004) asserts that the argument for retrenchment over-emphasizes only financial aspects and that it sees the situation around the pension system too negatively, with some neglect of the real welfare situation of the present generation. Judging from these two arguments, the issue of financial sustainability seems to call for further discussion. Regarding the general theoretical logic about financial methods and practices in actual policy, and world-wide multi-pillar public pension recommendations by international organizations such as the ILO, World Bank and OECD, the combination of contributions and taxation as a source of public pension financing is necessary. The state's financial subsidy for the public pension system must be the 'Majungmul', which in Korean implies a few spoonful of water being poured into the mouth of the water pump to attract a lot of bucketful of water from the deep earth.

However, it is clear that the debates on reform of the public pension system had been dominated by the long-term financial sustainability issue in both special occupational public pensions and the NPS in Korea. This one-sided debate necessarily resulted in the radical benefit reduction, leaving the contribution rate at a lower level. The income replacement rate of the NPS fell from 70% to 60% in the 1998 reform (and then to 40% in the 2007 NPS reform). The benefit level before 2007 reform was not low compared with that of the advanced Western countries. However, the real replacement rate, indicating the very short insured period (about 21 years), meant that other reform measures were highly needed. Nevertheless, even just after the 1998 NPS reform, whose focus was radical retrenchment for increasing long-term financial sustainability, voices calling for further retrenchment were raised again. This may be clear evidence of fiscal conservatism because further retrenchment reform enables the government to not subsidize tax revenue for the NPS. The reformist Rho Moo-Hyun government, persuaded by welfare bureaucrats, initiated another retrenchment NPS reform in 2003 just after the inauguration of the regime, against Rho's election promise. Even though the bill was blocked in Parliament in the first reform stage, the income replacement rate of the NPS was radically reduced from 60 per cent to 40 per cent until 2028. This is a clear representation of the resilient policy orientation of financial stability reform, rooted in fiscal conservatism.

So, what was the destiny of the parametric reform bill?

The NPS reform bill proposed by the government in 2003 to Parliament was blocked by the majority opposition party and lost legitimacy because of the online Anti-Pension Movement while the retrenchment reform bill was in Parliament. Additionally, the opposition party backed by the Netizens<sup>14</sup> strongly raised the blind spot problems and suggested a structural NPS reform. According to Clemens and Cook (1999), a certain policy containing clear internal contradiction, if it does not evolve gradually, can produce grave-diggers, increasing the opponents to the present policy over time. The principle of fiscal conservatism, representative of a force seeking financial sustainability reform, was proven to be the prominent factor of radical NPS reform. What, then, was the clear evidence of NPS' loss of legitimacy among the public? We will discuss the distrust of the people in the NPS and the effect of this in the next section.

### C. Policy Failure and Distrust of the Public in the NPS

The effect of the NPS on the people's life seems to be best expressed by the public's distrust in the system (Kim, Y.H., 2004). Even though the benefit scheme was unrealistically generous in appearance, the level of credibility of the people was excessively low and the resistance to the system was strong. Even though we consider the NPS to have been immature in its existence, and thus the usefulness of the system was not fully recognized by people in general, the level of the distrust was difficult to understand. In-depth study of the causes of distrust in the NPS is still scarce and preceding studies have been mostly superficial, with the exception of the study by Kim, Y.B. (2003)<sup>15</sup>. He saw the crisis of social insurance as a crisis of trust, which should be the basis for the system to survive. A definitive analysis of the causes of the lack of credibility in the system, thus, seems to

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<sup>14</sup> This term Netizens is an abbreviation of 'Network Citizen' and refers to persons who are actively using internet for non-profit purpose.

<sup>15</sup> He analyzed health insurance and national pension systems in Korea with the three criteria developed by Rothstein (2001): 'substantial justice', for which the system is believed to be necessary; 'procedural justice', which the system is believed to exercise fairly; and 'just distribution of burden', where the system is believed to share the costs and benefits rationally among all participants.

be difficult. He argues that the trust of the insured in the social insurance system is the most important element for the system's long-term sustainability. If the majority of subscribers to a policy do not trust the scheme, it is inevitable that they will engage in various opportunistic behaviours and thus reduce the efficiency of the system. The inefficient system reinforced by the negative feedback effects would result in more severe distrust. Widespread distrust in a pension system shows the critical viewpoint of people regarding the system and leads to strong demand to radical change of the system. In this sense, it can be said that the deeper the extent of the distrust, the greater the demand for a fundamental change in the system. There is plenty of evidence on how and to what extent the public pension systems of Korea are distrusted by people. Even though the area of emphasis is different, relatively conservative economists also agree on the seriousness of distrust in the public pension system in Korea (see Moon, H.P., 2004). According to a survey of employees that was carried out by the Insurance Development Institute (IDI) in August 2004, the average level of satisfaction over the NPS in Korea was only about 1.53 out of 5. This shows the extreme dissatisfaction with the NPS among the population in Korea (Ryu, K.S., 2004). The survey also showed employees' opposition to the present NPS scheme. It was seen that 78.8% of respondents preferred a structural reform towards a two-tiered pension system including a basic state pension (Ryu, K.S., 2004). On the other hand, a member of Parliament publicized an internal survey of the National Pension Service (NPSrvc), mentioning that only one out of ten people in their 20s–30s years old was satisfied with the present NPS (Korea Herald Daily 24 Feb. 2005). Kim, Y.B. (2003) concludes that social insurance such as the NPS in Korea had lost credibility of the people concerned because it did not show fair redistribution both in policy design and in the development process (Ryu, K.S., 2004: 19–21). The research argues that the clearest evidence of people's deep distrust in the NPS was the 'Anti-NPS Movement', which was inspired by a Netizen in May of 2004. This movement was instigated by an ordinary person with a short article titled '8 Secrets about the National Pension System' in which severe complaints about the NPS were expressed. This rapidly spread on the web with opinions being added. Within a few days, strong anti-pension sentiment overwhelmed the whole country. This affected most policy-making actors as well as the general public.

Underlying distrust in the NPS was recognized by all political actors as well as the general public. The process of passing the NPS reform bill focusing on financial sustainability without proper government subsidy was stopped and structural reform was recognized as necessary by the public (Kim, S.K. 2010; Seoul Daily 31 May 2004). Contrastingly, the people in the European countries express their best preference for the public pension systems among modern welfare programs (Wim van Oorschot, 2000). From the historical institutionalists' point of view, members' distrust in an institution can be an internal force for institutional change (Clemens and Cook, 1999). In this sense, the serious level of insured members' distrust can be regarded as representative of strong demand for fundamental reform of the NPS. If distrust becomes abnormally severe due to certain factors, this would magnify the potential power for change in the system. What, then, can be regarded as the influential factors that have provoked such severe distrust in the public pension system in Korea?

On the other hand, two aspects are central to understanding the true features of this incredible phenomenon of distrust. Firstly, the fact that the NPS does not successfully achieve the basic missions of it as an old-age income security system would be one of the critical causes of the people's distrust. As mentioned before, welfare systems such as pension systems have to provide income security as well as poverty prevention for most participants (Flora and Heidenheimer, 1981). Moreover, adequate benefits, with which the middle and upper classes can maintain their living standards, must also be secured through ensuring effective saving mechanisms<sup>16</sup>. As a result, securing the system coverage and benefit adequacy would be the basic missions of public pension systems. A system which does not exercise properly these basic roles may not obtain people's trust. Secondly, it is self-evident that members will feel betrayed if the government continuously emphasizes the necessity of retrenchment of the system which was introduced only a decade ago by the government without social dialogue and consensus (National Pension Research Institute, 2006; Kim, Y.H., 2004). Although

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<sup>16</sup> Although the income of the middle class is not normally transferred from redistribution within a generation, middle class people can gain extra income from various other mechanisms such as inter-generational income transfers, credit support from tax and investment returns from funds.

there may be some dissent among participants regarding the content of the NPS, had it evolved through genuine procedural justice<sup>17</sup>, then it would not bring about such an extreme blaming reaction as the demand for its abolition. In this respect, it appears that along with the substantial problems of the system's contents such as problems of coverage, adequacy and equality as well as financial sustainability, the loss of legitimacy of the policy-making procedure has also been a critical cause of distrust in the public pension system in Korea. What, then, did make clear the loss of legitimacy of the NPS to the eyes of political actors and general public?

#### D. The Emergence of Competing Reform Alternative: Beveridgean Pension Model

This research adopts the concept of 'multiplicity' based on Clemens and Cook (1999). Multiplicity is defined as 'the existence of multiple institutions' (Clemens and Cook, 1999: 450). In the situation of a policy failure, if there is a competing policy alternative, the legitimacy of the policy can be intensively eroded. In this sense, there was a strong challenge by the Beveridgean model to the conventional Bismarckian type scheme represented by the NPS, which had maintained the strict principle of fiscal conservatism.

##### 1. *The Bismarckian Model's Pitfalls with the Strict Principle of Fiscal Conservatism*

As discussed above, a social insurance scheme has pitfalls in the coverage and benefit adequacy for the subscribers in cases when it is not appropriately supported by the state. This is a problem because there is a high possibility of unemployment in modern post-industrial society due to the increased flexibility of labor markets. There are also many irregular workers, late entrants into the labor market due to higher education, self-employed workers with low income in the service industries, etc. These are the significant new risks in the post-industrial society (Taylor-Gooby, 1999). Social insurance systems are designed on the presumption of full employment. However, this is almost impossible in a post-industrial

society. In this sense, social insurance welfare programs based on social insurance principles should be supplemented with a tax-based universal scheme for those with a lack of proper contribution history. Even though social insurance welfare programs such as public pension systems started without a clear logic of state financial subsidization, the social insurance contributory elements were supplemented by a universal tax-based scheme or the state's subsidization over time (Bonoli, 1997, 2003).

In general, a social insurance system plays the role of exercising the basic functions of the state for the whole nation as well as the function of insurance for eligible insured people. Among them, insurance takes the role of a risk spread function among participants and helps smooth individual income distributions from working life to after retirement. As a function of the state, there is redistribution to encourage social harmonization and stability. There are other functions of the state which are entrusted to the social insurance system because it is effective (Lee, J.W., 2002). For example, there are diverse pension credits in Western countries which operate within social insurance welfare systems. Pension credit is a program whereby the state pays contributions for the subscribers who sacrificed paid work for the common good of the society. Those pension credits are for national defence duty, higher education, childbirth or maternity leave. Most Western countries introduced and expanded the pension credit system and supplement the lack of contribution history so that the insured acquire proper pension rights. However, in contrast to Western countries, there was no credit system in the NPS before the 2007 reform. Only a tiny part (5 per cent in 2007) of administrative costs was financed by tax revenue (National Pension Service, 2008). The portion of state financing in the NPS in 2006 was only 0.004% of total annual income. This is quite a contrast with the Western countries, which share about 20% to 30% of annual expenses (see Lee, J.W., 2002; National Pension Service, 2008). In the diverse discussions on the financing principle of the NPS, fiscal conservatism was proven to be one of the critical causes of the financial instability of the NPS as well as income insecurity of the elderly.

##### 2. *The Challenge of the Beveridgean Model*

Contrastingly, the level of financial assistance by the state for the social insurance system in foreign countries

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<sup>17</sup> Rothstein (2001) suggested 'procedural justice' as one of the key criteria by which the credibility of a policy can be measured.



is significantly higher than in Korea in terms of the amount and content. For example, in Switzerland, the portion of state support is  $\frac{1}{3}$  of the total expense of the public pension system. In France and Germany, it is about 20% and 30 % of total expense of the public pension system respectively. For the farmer's pension insurance in Germany, the government subsidizes three-fourths of the total expense (Kim, S.W., 2007; National Pension Service, 2008). In many European countries such as Germany, France and Sweden, the government pays all contributions for people who are on leave for family care, national defence duty, and higher education. The portion of the state subsidy in the social insurance model should be decided in accordance with the type of function of the source of financing for a welfare program (Schmahl, 1985). Based on this principle, the cost of the function of income security should be financed by subscribers' contributions. Conversely, the costs of exercising the functions of the state should be financed by tax (Lee, J.W., 2002). In this regard, most international organizations regardless of their policy orientation have suggested tax-based public pension schemes for poverty prevention. Among them, the International Labour Organization (ILO) has maintained welfare-oriented policy guidelines. In contrast, the World Bank has preferred the economic growth policy. Due to the huge blind spot in the social insurance contributory public pension schemes, a tax-based universal pension scheme has been an essential requirement for the complement of social insurance scheme. However, the financing principle based on the implicit international consensus was not adopted in the NPS by the Korean government. Even though the NPS has maintained strong redistribution measures for low-income participants, the government does not provide a proper level of finance from tax revenue to the NPS except for a tiny portion of administration cost. In this respect, the NPS has clearly maintained the principle of financial conservatism under which the Korean government has not provided proper tax revenue to the NPS. The outcome of this financing policy of Korea must be the prevalence of old age poverty and long-term financial instability in welfare programs such as NPS. What will happen in the public pension systems, particularly in the NPS, in the next stage of following the long-run conservative financing principle?

We can examine the general viewpoint of the policy experts in the NPS reform policy-making circle in 2002 under the Kim Dae-Jung government. For instance, there

was a resolution on the principles of the NPS reform direction by the Institution Expertise Committee on 20 November 2002. It contained the reform principles that 1) financial stability measures with adjustment of benefit structure should be the first policy priority and 2) social security measures with adoption of a multi-pillar system should be the second priority (Kim, S.K., 2010). The ensuing decision was the declaration that the government would not use tax revenue to ensure both income security and financial sustainability of the NPS. It was a principle of financial stabilization first and resolution of the blind spot problem next. It became the clear guidance of the 2007 NPS reform. The reform board developed three retrenchment reform alternatives without any measurement for the state's financial subsidy. This is another example of the resilient principle of fiscal conservatism in the NPS because the principle and the alternatives guided by this principle absolutely excluded the other options based on Beveridgean principle. There was no option for President Rho Moo-Hyun to choose in 2003. The Rho, Moo-Hyun government, issued a retrenchment reform bill to the Legislature in 2003. However, increased internal contradiction of the NPS originated from the fiscal conservatism and the emergence of competing alternatives resulted in the government's reform bill being blocked and even abolished in the first stage of the 2007 NPS reform. The alternative reform bill was suggested by the opposition party and the reform debates were dominated by the blind spot issue and introduction of the Beveridgean poverty prevention scheme in the next reform stage. In this situation, there was a competing alternative, a basic pension system based on tax revenue. The basic pension system as the first pillar in the multi-pillar system had been supported by all major international organizations such as the ILO and World Bank. It was also suggested by the World Bank to the Korean Government when the national restructuring caused by the East Asian economic crisis was in progress in 2002. In practice, the structural NPS reform alternative was set as the recommended one by the reform board in the Kim Young-Sam government in 1997. There was already a strong reform alternative, the basic pension, and the tax-based basic pension was greatly preferred by the general public in Korea (Ryu, K.S., 2004).

If the government of Korea had taken necessary financial responsibility for the public pension system step by step, both the income insecurity problem and financial

instability problem would have been considerably mitigated and the severe distrust in the NPS would not have emerged. As a result, the demand by the public for structural reform would not have been so great. The financial conservatism of Korea was the most significant element which resulted in the internal contradiction of the NPS so that it increased the potential for radical reform. If the ambitious political entrepreneurs, political parties, try to exploit this situation for their interests, the influential reform alternative, Beveridgean model, could be introduced. The Basic Old Age Pension in the 2007 NPS reform was introduced through this procedure in the changed political institutions and the changed political configurations which were the extra conditions for the structural NPS reform.

#### IV. Conclusion

The NPS was designed as a contributory social insurance system in which accumulated contributions paid by the insured were the main sources of pension benefit. Under the contributory social insurance scheme, social minorities with low or unstable income could not pay contributions over the necessary period and at the necessary level to be entitled to adequate pension benefits. Thus, this system should have been complemented by other schemes based on a universal tax-based financing principle. However, the NPS, which maintained a strict principle of fiscal conservatism, could not be transformed to meet the necessary needs of the insurable persons through an evolutionary process.

The principle of fiscal conservatism in Korea resulted in income insecurity among the old. Real coverage of the NPS in 2007 was only 57.5% of the eligible workforce. Only 27.9% of the elderly aged 60 and over were receiving any type of public pension benefit in 2007. 90.5% of beneficiaries were receiving a benefit that was below the minimum living cost. Judging from the number of beneficiaries receiving less than the minimum living cost, about 95% of the elderly could be regarded as in the blind spot of the pension benefit. As a result, Korea took first place for relative old-age poverty among OECD countries. On the other hand, public distrust in the NPS was incredibly high. This implies the NPS's loss of legitimacy among the public. The online anti-NPS movement,

which arose in 2004, was a symbol of the phenomenon. In this situation, a strong policy alternative, the Basic Pension System, presented a challenge to the NPS. The Basic Pension System had already been prepared and even suggested by the World Bank, and the reform board of the Kim Young-Sam government recommended it as the preferred alternative<sup>18</sup>. The multi-pillar Basic Pension System, based on tax, not on contributions, emerged in 2002 as a presidential election pledge of the presidential candidate of the opposition party. Moreover, the tax-based Basic Pension System was much preferred by the Korean public. Following the framework of Clemens and Cook (1999) and Sewell (1992), the other significant condition, multiplicity (the existence of strong alternatives), was thus achieved.

Through the 2007 NPS reform, the benefit level, the income replacement ratio, was radically reduced from 60 percent to a planned 40 percent by 2028. However, the Basic Old-Age Pension System, with about 5 percent of average earnings of the insured, was newly introduced, with coverage of 70 percent of the elderly aged 65 and over. The Basic Pension System's benefit level was increased twice, to about 10 percent of the average income of the participants in 2015 and to 13 percent in 2018.

In conclusion, the internal contradiction of the NPS, caused by the principle of fiscal conservatism, can be proven to have been the determinant of the radical NPS reform, as certain institutional conditions were met. In the 2007 NPS reform process, the prerequisite for fundamental reform of the NPS seemed to be fully achieved. The process exactly followed the assumptions of Clemens and Cook (1999). Firstly, fiscal conservatism embedded in the NPS produced policy problems, such as serious income insecurity and long-term financial insecurity. It also continuously accumulated internal contradictions within the NPS. Secondly, the accumulated internal contradictions resulted in the policy failure and loss of trust of the public in the NPS. Thirdly, a competing reform alternative (a tax-based basic pension scheme) emerged. Accordingly, the legitimacy of the present NPS, based on strict fiscal conservatism, was lost. So, what will be

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<sup>18</sup> The structural reform alternative recommended by the reform board of the Kim, Yeong-Sam government was rejected by the subsequent Kim Dae-Jung government because the policy focus of the alternative was regarded as the reflection of a neo-liberalist idea of the privatization of welfare programs (see Yang, J.J., 2004b).

next? According to the assumptions of Clemens and Cook (1999) and other historical institutionalists, the next stage we have to discuss in the next piece of research relates to the behavior of ambitious political entrepreneurs. They may actively attempt to co-opt the competing alternatives to compete with opposing political actors. The outcome was found to be the transformation of the NPS into a two-tier public pension system structure: the NPS and the Basic Old-Age Pension System (renamed as Basic Pension System later).

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