

# Toward Financial Transparency: The Republic of Korea’s Experience Introducing the Real-Name Financial Transaction System

## Introduction

After the devastating Korean War that left the country in ruins in 1953, the Republic of Korea achieved rapid economic growth, often referred to as the “Miracle on the Han River” (Johnston 2016). The government prioritized rapid economic growth and industrialization, which gave rise to a unique group of large family-owned conglomerates called *chaebols*<sup>1</sup> that wielded large influence in the Korean economy. These chaebols and the military elite formed a strong network and accumulated substantial wealth, often through illicit means. Dubious financial transactions under borrowed names or pseudonyms were widespread to avoid taxation on capital gains and real estate speculation (Kim 2015).

To combat these issues, the government of Korea attempted to introduce a real-name financial transaction system (RNFTS).<sup>2</sup> An RNFTS seeks to enhance financial transparency by banning all financial transactions that are made under borrowed names or pseudonyms or anonymously. Within such a system, only the verified, real name of an individual or legal entity can be used for financial transactions. By improving the integrity and transparency of a country’s financial system, an RNFTS aims to promote fair taxation, reduce corruption, and provide reliable data necessary for other reforms (Lim 2019). However, introducing an RNFTS requires a substantial amount of resources to set up data infrastructure and safeguard privacy. Such policies also face resistance from parties that have vested interests in keeping financial transactions secret. This delivery note examines the case of Korea, showing how it introduced an RNFTS to promote financial transparency.

## Development Challenge: Increasing Transparency to Combat Corruption

Korea’s financial system lacked transparency, which made tax evasion and illegal transactions possible. The lack of transparency also raised concerns about fairness as fair taxation is an important nondiscretionary tool for redistributing wealth (Carter 2012). Not only was it nearly impossible to detect tax evasion and eradicate corruption without reliable financial data, but also it was difficult to assess and address income inequality without information on income and wealth distribution. The need for financial transparency reached its tipping



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### PROJECT DATA

**SECTOR:**

Finance and markets

**DEVELOPMENT CHALLENGE:**

Combating corruption and tax evasion and enhancing financial transparency

**DELIVERY CHALLENGES:**

Opposition and Lack of Consensus; Change in Priorities and Commitment; Information and Communication Technology

**COUNTRY:**

Republic of Korea

**REGION:**

East Asia and Pacific

**PROJECT DURATION:**

1982–1993

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1 In the 1960s, with the full-fledged support of the government, chaebols emerged from family-owned businesses and evolved into large industrial conglomerates with a number of diversified affiliates. Chaebols, namely Samsung, Hyundai Motors, and the SK and LG groups, have continued to dominate Korea’s economy. Although their influence has declined, the top 10 chaebols still own more than 27 percent of all business assets in Korea (Pae 2018).

2 See Kim (2013).

point in the 1980s and 1990s, when Korea witnessed a series of major financial scandals involving funds held under borrowed-name accounts.

## Intervention

To enhance transparency in financial transactions in order to curb corruption and tax evasion, the Korean government introduced the RNFTS. This policy ultimately took three separate attempts to implement as the Korean government strove to address its technical and political challenges.

The initial attempt to implement the RNFTS began in 1982, when reform-minded government officials of the Chun Doo Hwan administration formulated the Law on Real Name Financial Transactions. However, implementation was not able to proceed because of strong opposition from chaebols, military power cliques, and the ruling party, which feared the RNFTS would reveal its own illicit financial transactions involving political contributions and bribery. President Roh Tae Woo also promised immediate introduction of the RNFTS on his inauguration in 1988, but it was once again suspended, given the strong opposition of the Grand Conservative Coalition as well as the political interests of the ruling party.<sup>3</sup> Only when President Kim Young Sam took office in 1992 and declared immediate introduction of the RNFTS through an emergency presidential decree in 1993 was the system finally implemented.

## Addressing the Delivery Challenges: ICT, Opposition and Lack of Consensus, and Changing Priorities

As demonstrated by the two derailed attempts over almost 15 years, introducing the RNFTS entailed both technical challenges and political-economy hurdles. Lim (2019) identifies the following major technical challenges: (a) setting up identification systems, (b) establishing information and communications technology (ICT) and institutional infrastructure, (c) minimizing the risk of financial turmoil upon the introduction of the RNFTS, and (d) safeguarding privacy. In terms of political economy, overcoming the resistance of those with an interest in concealing financial transactions was critical.

- **Creating identification systems for individuals and legal entities.** A national identification system needed to be in place to verify the identities of individuals and legal entities (such as corporations) engaged in financial transactions. Using residence information and biometric data, individuals had to be assigned unique identification numbers with corresponding identification cards. For legal entities, a similar identification system based on registration information had to be set up. Korea had already established a national identification system and a resident registration number system in the 1960s that was based on the Resident Registration Law of 1962. The names used in transactions were required to be verified by resident or business registration cards.
- **Establishing ICT and institutional infrastructure for financial and tax data.** Basic ICT infrastructure for financial and tax data (such as computerization) and relevant legislation (such as penalty provisions for noncompliance) needed to be in place to ensure that financial transactions were made on a real-name basis and verified in a cost-effective manner. Following the initial attempt to introduce an RNFTS in 1982, the Korean government strengthened its infrastructure for financial and tax data. By 1984, income data had been computerized, and in 1988, the Roh Tae Woo administration began computerizing land records. The government encouraged the use of real names in financial transactions by applying different tax rates to real-name and non-real-name accounts.<sup>4</sup> As a result, the share of bank accounts held under a real name increased from 76.5 percent in 1983 to 97.8 percent in 1989 (Lim 2019).
- **Minimizing the risk of financial turmoil triggered by the introduction of the RNFTS.** Government officials planning the RNFTS feared that some parties who felt their interests were threatened by its introduction might try to quickly move their assets outside the formal financial system, resulting in decreased investment, capital flight, or even a financial crisis. Such risks could be mitigated through a well-planned introduction of the RNFTS.

3 Lim (2019, 6) suggests that “politicians may have shared a common interest in keeping financial transactions on [a] confidential basis so as to complete the three-party merger” between the ruling (conservative) party and two opposition (pro-democracy) parties to create a supermajority party.

4 The tax rate on interest and dividend income accruing to real-name financial accounts was held at 10 percent, while the corresponding tax rate for non-real-name financial accounts was increased from 15 percent in 1983 to 20 percent in 1985 and then to 40 percent in 1989 (Lim 2019).

The scope of financial institutions and assets subject to the RNFTS should be comprehensive enough to prevent a capital exodus, and foreign exchange control measures may need to be put in place. Once introduced, the system should be implemented swiftly to minimize transition problems. In Korea, the plan to implement the RNFTS set a comprehensive scope with very few exceptions to minimize the risk of capital flight through uncovered financial transactions. Preexisting foreign exchange control measures were already in place. Drawing lessons from earlier failed legislative attempts, the implementation plan was well conceived and put into effect swiftly to minimize transition problems.

- **Addressing public concern about undue invasion of financial privacy.** To prevent public prosecutors and tax authorities from abusing their power, the 1993 Presidential Emergency Order introduced new procedural rules for official requests for information on financial transactions and mandated that financial institutions refuse to provide unlawfully requested information. In particular, the new rules stipulated that public authorities must make requests in writing to particular branches of financial institutions and that each request must include the name of the person concerned, the requested information on financial transactions, and the intended use of the information.<sup>5</sup>
- **Political economy challenges.** Despite the numerous benefits to transparency, an RNFTS had its opponents. Those who have been circumventing regulations and benefiting from non-real-name financial transactions are most likely to resist and mobilize interested groups to prevent the introduction of an RNFTS. As such, the implementation of the RNFTS in Korea experienced twists and turns and took more than a decade. Resistance from groups with vested interests in the status quo—mostly composed of politicians, chaebols, and other elites—was fierce, and commitment to implementing the RNFTS fluctuated depending on political and economic conditions. As RNFTS reform is a case of concentrated costs and dispersed benefits, reform-minded citizens had to play “entrepreneurial politics” in order to elicit support from the general public,<sup>6</sup> who would, in turn, appeal to politicians who could benefit from implementation of the RNFTS. Only when the RNFTS garnered widespread public support and pro-democracy President Kim Young Sam took office did its introduction become possible. As soon as President Kim took office, he broke up a secret group of military elites (Hanahoi) and mandated public disclosure of high-ranking officials’ assets with an aim to increase financial transparency. Following the initial step, President Kim decisively declared the implementation of the RNFTS in a presidential emergency order instead of going through a lengthy legislative process to prevent vested interest groups from thwarting the legislative process.

## Lessons Learned

Korea’s experience introducing an RNFTS underscores the importance of both creating a conducive political environment and addressing technical challenges for implementing this kind of policy.

### Technical Aspects

Successful introduction of the RNFTS required a considerable amount of time and preparation. Identification systems for individuals and legal entities needed to be established in order to verify their identities. Basic ICT infrastructure, including a certain level of computerization in the government and financial sectors, was also necessary to manage private data and facilitate verification in a secure and cost-effective manner. To minimize the risk of financial turmoil upon the introduction of the RNFTS, the financial transactions subject to the RNFTS needed to be comprehensive in scope, and foreign exchange control measures were put in place to prevent capital flight. The RNFTS also needed to be implemented swiftly to minimize transition problems.

### Political Economy

In terms of political economy, a combination of decisive leadership and widespread public support was critical to overcoming the strong opposition of political and business elites and ensuring successful implementation of Korea’s

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5 The provision on data protection and confidentiality is stipulated in article 4 (Confidentiality of Financial Transactions) of the Act on Real Name Financial Transactions and Confidentiality and in the Act on the Submission and Management of Taxation Data.

6 Nongovernmental organizations such as the Citizens’ Coalition for Economic Justice played a major role in mobilizing public support for the adoption of the RNFTS. The Federation of Korean Industrialists also endorsed the RNFTS and became openly critical of politicians demanding slush funds.

RNFTS. Although the mode of introduction for this sort of policy—a presidential mandate, as in Korea, or an agreement among decision makers—could vary across countries, creating a conducive political environment was key to introducing the RNFTS in Korea. In certain circumstances, when a small group of reformers would acquire greater gain than other political rivals, this reform provides both concentrated costs and concentrated benefits. To successfully implement the RNFTS in Korea, reformers engaged in “entrepreneurial politics” in which they created opportunities for reform by raising public awareness of the reform’s benefits and mobilizing support for the reform. To ensure compliance and address public concern about undue invasion of privacy, the government introduced relevant legislation, such as provisions for noncompliance penalties and procedural rules for official information requests.

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