

Study Series 14-05



Fiscal Segmentation and Economic Changes in North Korea

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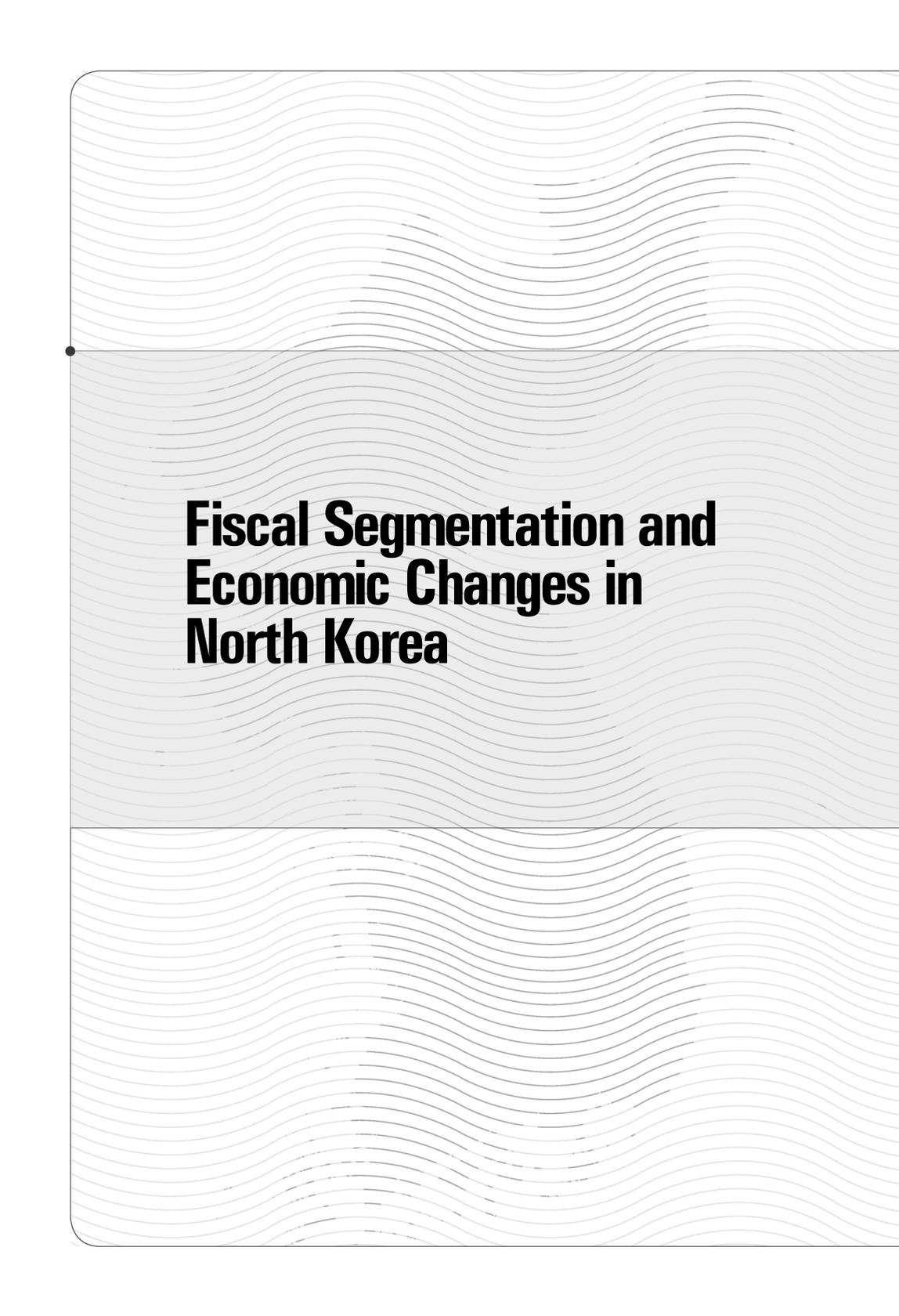
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Fiscal Segmentation and Economic Changes in North Korea

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Fiscal Segmentation and Economic Changes in North Korea

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Fiscal Segmentation in North Korea

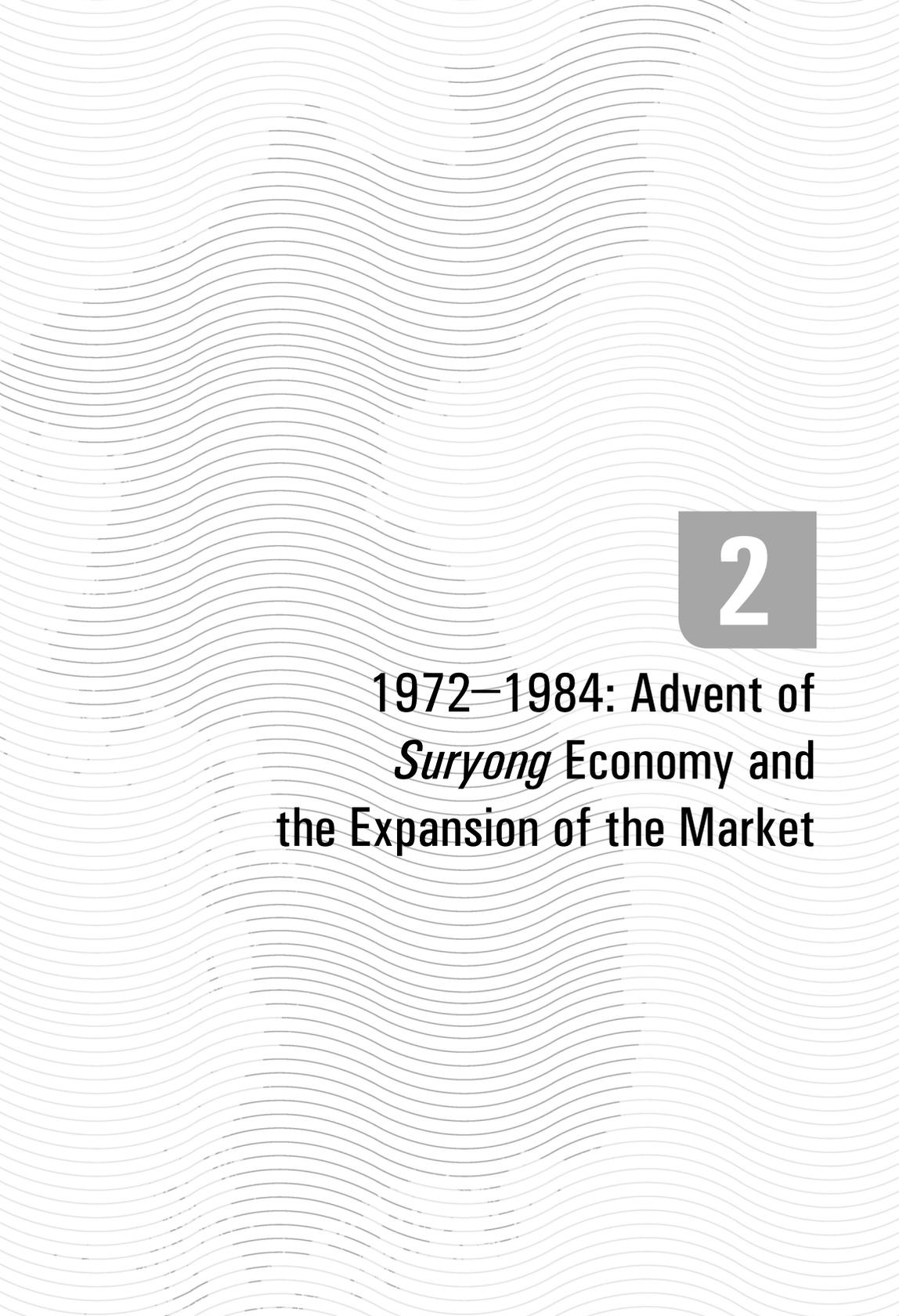
1. Fiscal Segmentation in North Korea¹⁾

North Korean taxation and fiscal systems display unique aspects. The key characteristic is that the national fiscal system is not uniform, but segmented. Indeed, a modern system did exist in North Korea; it constituted a part of the planned economy and formed the grounds for a unified national fiscal system. However, at the latest since the 1990s in North Korea, each party-state body has been earning part of its budget through privileged commercial activities taking advantage of the scope of their prerogatives and political clout.

The history of North Korea's fiscal segmentation can be categorized largely into four periods in the following order: 1953 to 1972, 1972 to 1984, 1985 to 1994, and post 1995. During 1953-1972, Kim Il-sung manipulated North Korea's economic policy as a part of his power struggle, usually resorting to non-economic means such as mass mobilization and on-the-spot guidance to create a special

1) This paper is an extracted and abridged version of Chapter 3 "The Fiscal Fragmentation and Economic Changes in North Korea" in Park Hyeong Jung and Choi Sahyun, *Fiscal Segmentation and a Variety of Taxation in North Korea*. Seoul: Korea Institute for National Unification, 2013. (in Korean)

budget for political purposes. The period between 1972 and 1984 gave birth to ‘*suryong* (leader) economy’ (also called court economy) as a follow up measure for the concentration of political power to the *suryong*. Kim Jong-il, at the time the designated successor, focused his effort on expanding the *suryong* economy to form political funds for hereditary power succession through foreign currency earning activities based on export and import monopoly. From years 1985 to 1994, in addition to the *suryong* economy, party-state’s major powerful special bodies have entered into the foreign currency earning activities. From 1995 to the present is the period in which the current taxation and fiscal system began and was established. The main point of this period is that, in addition to the *suryong* economy and major party-state bodies, the foreign currency earning activities of party-state bodies for off-budget revenue have been generalized and become the backbone of North Korean party-state bodies’ budget system. This paper addresses the process of fiscal segmentation from the second period onwards.



2

1972–1984: Advent of
Suryong Economy and
the Expansion of the Market

2. 1972 – 1984: Advent of *Suryong* Economy and the Expansion of the Market

Two political factors led to significant changes in the North Korean economy in the 1970s. First, the establishment of the *suryong* political system in the late 1960s drove the formation of the *suryong* economy in the early 1970s. Second, the designation of Kim Jong-il as the successor in 1974 made it necessary to prepare political funds for this cause. Thus, the years 1972 and 1974 acted as crucial turning points.

A. The Rise of *Suryong* Economy

Suryong economy is comprised of two parts: the party-economy and the Second Economy. The party-economy is a privileged economic sector revolving around the central party and served the purpose of procuring governing funds for the *suryong* dictatorship. The Second Economy acquires fund for North Korea's military industry, managing revenues earned via weapons exports. The two

sectors originally formed an integral part of the official People's Economy and were supervised by the National Planning Commission. However, the concentration of power to Kim Il-sung in the late 1960s and the beginning of the succession system in 1974 separated the party-economy and Second Economy from the People's Economy and was changed to the '*suryong* economy.'

First, this paper will look at the emergence of the Second Economy as an independent sector of North Korea's national economy. In 1972, the Second Economy was detached from the planned-economy, and the Second Economic Committee was established.²⁾ This happened in concert with the overall transition of North Korea's system which prioritized national defense. North Korea pushed forward a very pugnacious policy towards South Korea and chose a dual policy of simultaneously promoting national defense and economy to support it. In 1966, at the 15th Plenary Session of the 4th Party Congress, Kim Il-sung's absolute one-man dictatorship was established and Kim Il-sung legitimized his cause for the one-man dictatorship and eternal rule with anti-foreign and South Korea revolution. Such trend resulted in the formation of the Second Economic Committee in 1972.

Next, considering the separation of the party-economy, 1974 was

2) Kwang-min Jung, "The Unique System of Kim Il-Sung and the Change of Economic System – Focus on Economic Change in the late (1972-1978) of '1972 system,'" *The Quarterly Journal of Defense Policy Studies*, Vol.25, No.4, (Winter, 2009), p. 120. (in Korean); There are some who claim that the Second Economic Committee was already separated in the late 1960s.

the year when the party-economy was established in North Korea. Kim Jong-il was internally boosted as the successor in February 1974, but to ensure a successful succession, an enormous amount of political fund was required. To procure such a colossal political fund, Kim Jong-il created a new economic organ under the party called Office 39 in 1974. Starting with the Daesung Trading Company, formerly subordinate to the Ministry of Foreign Trade, being integrated into Office 39, major trade businesses became subsidiary parts of the party-economy.³⁾ The party-economy took control of companies and businesses that were the source of foreign currency income by monopolizing most of the gold and zinc mines and refineries and exporting high quality marine product and pine mushrooms.⁴⁾

B. Economic Hardship and the Expansion of the Market

In the mid to late 1960s, the North Korean economy encountered several challenges.⁵⁾ First, the shortfall of consumer goods became a

3) Ibid. p. 134.

4) Gwang-jin Kim, "Changes in North Korea's Currency Exchange Control" (MLitt. Diss., University of North Korean Studies, 2008), p.67. (in Korean)

5) Jin-yi Choi "The Internal Changes in North Korea after the Economic Hardships" in Dae-woo Lee eds., *North Korean Problems from the Perspective of North Korean Defectors and Korean Scholars*, (Seoul: Oreum Publishing House, 2012) p. 133.; For details on population issues, see Min Hong, "The Population Politics and Food Regime in North Korea – Origin and Dynamics," *Unification Policy Studies*, Vol. 22, No. 1 (2013), pp. 297-334. (in Korean)

serious issue to demographic variables such as the baby-boom generation of the late 1950s reaching school age in the late 1960s. Second, as the monolithic ideology system spread nationwide after 1967, massive amount of resources were lavished unproductively for the construction of gigantic monuments to ‘express loyalty to the *suryong*.’ Third, when the time came for North Korea to repay its debt to the Soviet Union and Eastern European countries, economic ties with socialist countries acted as a heavy burden on North Korea’s economy. Fourth, in the mid-to-late 1960s, the share of North Korea’s military expenditure in the national budget reached a historic peak as it pushed for a dual policy of national defense and economic development, while adopting a very belligerent South Korea policy.

The economic downturn rendered by such factors surfaced with disorder and destruction of the nation’s planned commerce. Reflecting on such circumstances, the disappearing farmers’ markets were revived in the late 1960s to mid 1970s.⁶⁾ Farmers’ markets were disappearing with the completion of cooperative unionization among rural independent farmers and city businessmen in 1958, and the establishment of a collective farming system in the unit of *ri* (town) in 1962. It was replaced by a state-run commerce network acting as the people’s supply system. This also was transformed by the abolishment of the agricultural tax-paid-in-kind policy in 1966 along

6) Geun-o Lim, “The breakdown of Economic Cycle and ‘Marketization – DPRK-PRC Trade,’” *Imjingang*, No. 10 (Imjing Publishing, 2010), pp. 72-73. (in Korean)

with the inclusion of farmers into the rations distribution system. This was because farmer households' revenue came more from private farms, rather than through labor in collective farms. The path for revitalization of the farmers' market opened with the decline of supply capacity of the national commerce network in accordance with the adverse economic situation. The farmers' market provided economic convenience to farmers and to municipal residents. Farmers' markets not only appeared in the countryside but also in the cities such as Pyongyang, Hamhung, Cheongjin, and Shinuiju in relatively large scales. Market goods have diversified; agricultural and local products are supplied, along with considerable amounts of consumer goods produced and supplied by state-run factories and companies.

In addition, the supply of Japanese products introduced by the repatriate community in this period stimulated the market. The North Korean authorities promoted 'patriotic support' from the General Association of pro-North Korean Residents in Japan as one of their means to resolve the difficult economic situation. However, the Association's support provoked the elites' strong appetite for capitalist goods. These products could not be satisfied through the nation's planned commerce network. Meanwhile, as the North Korean government worsened treatment of Chinese residents in the period of the Cultural Revolution, the economic activity of the repatriates increased.⁷⁾

C. The Monopoly of Foreign Currency Earnings by the Party Center

In 1977 at around the time when the farmers' market expanded, the Party Center engaged in full-fledged monopolistic foreign currency earnings. The purpose was to procure slush funds to show off Kim Jong-il's achievements including 'gift (giving) politics' and building monumental edifices through earnings from on-the-side businesses. Every year on the birthday of Kim Il-sung, the Party Center, the then code name for Kim Jong-il, made a pompous display of how deeply the *suryong* was concerned about people's wellbeing. 'The April 15th gift' project was a large-scale plan to distribute gifts -such as school uniforms and treats- to all children and students at the nurseries, kindergartens, primary schools, middle schools, and universities nationwide. The objective was to boast the greatness of the *suryong* and his successor. However, because it was impossible to manage such a vast project by the type of commerce operated by the nation's planned-economy, the argument was that the Party Center should take charge of securing necessary 'party funds'

7) On market activities of repatriates and Chinese emigrants, see: Eun-lee Joung, "Re-illumination of North Korean System through Life of Korean Residents in Japan Returning to North Korea: Focusing on Testimony of North Korean Defectors in Japan," *The Journal of Asiatic Studies*. Vol. 52, No. 3 (2009), pp. 202-203. (in Korean); Eun-lee Joung, "The Level of North Korea's Market System - based on the physical development of the public market," *KDI Review of the North Korean Economy*. Vol. 12, No. 5 (2010), pp. 14-47 (in Korean); Institute on Northeast Asian Micro-society Research, "The Lifestyle Changes in North Korean Population and the way to North-South Communication," (Manhae Academic Symposium, 2010), pp. 110-114 (in Korean); p. 72 Geun-o Lim, "Marketization, Abnormalization and the Changes in Lifestyle of the Population" *Imjingang*, No. 8 (2010), p. 72. (in Korean)

through monopolized foreign currency earning activities.

Under the pretext of procuring such funds, the Party Center founded an organization to take charge of foreign currency earnings. Office 39, established in 1974, began to professionally earn foreign currency, having organizations such as the Daesung Trading Company under its control. Office 39 had ‘No. 5 Management Division’ (*ohogwanlibu*) as its direct subordinate, which was the procurement agency to obtain ‘loyalty party fund’ through various export goods by mobilizing party organization of provincial and municipal offices, state-run enterprises, and collective farms of each city and district. ‘No. 5 Management Division’ set up regional headquarters and aimed to produce local products enabling to draw in one million dollars annually. Initially, these headquarters, called the ‘No. 5 Management Office’ (*ohogwanliso*), were supervised by the Organization Department of the local Party Committee of province, city, and district, but was renamed as the ‘No. 5 Management Division’ after 1989 when foreign currency earnings became active and diversified.⁸⁾

The ‘No. 5 Management Division’ utilized two methods of profit making. One was, through Office 39, allocating various foreign currency earning assignments to the Primary Party Committee of

8) Ju-il Lee, “Lee Ju-il’s North Korea Story – The reality of North Korea’s Foreign Currency Earning Activities by Mass Mobilization,” *DailyNK*, May 2003, <http://www.dailynk.com/korean/keys/2003/34/04.php>. (in Korean)

factories, companies, and collective farms and supervising and controlling the process. The other was a semi-coercive mobilization of the population to fulfill individual obligatory foreign currency earning targets to collect and gather local products such as gold, pine mushrooms, and fatsia and to sell them to the monopsony agencies of the local No. 5 Management Division. Regional administrative organizations also participated in earning foreign currency by engaging in businesses to expand local finances. However, because these regional businesses did not have the authority to dispose of the resources, they had to be delivered to Office 39 for export. Additionally, after 1977, foreign currency only stores for imported goods were opened in the cities and districts to soak up foreign currency among population.

Then how did they earn foreign currency? In the 1970s the Party Center's foreign currency earning agencies had monopoly over the collection and export of resources. Thus, the Party Center could prevent cost increases caused by competition with other shops. This meant that there was a huge margin between the domestic price and international price of exported goods and the Party Center's foreign currency earning agencies took hold of such margin.⁹⁾

The Party Center's foreign currency earning export items were

9) Eun-lee Joung, "The Level of North Korea's Market System – based on the physical development of the public market," pp. 122-124 (in Korean); Kyong-won Ryu, "The Merchants use South Korean Goods to spread Fantasy about the Enemy- What does the 2007 Market Restrictions particularly imply?" *Imjingang*, No. 2 (2008), pp. 87-92. (in Korean)

‘plan reserves’ (commodities that planned-economy did not yet control) of which people were expectedly mobilized to find out and set to use. One major export item monopolized by the Party Center’s foreign currency earning agencies was pine mushrooms. The following is Choi Jin-yi’s explanation of how pine mushrooms were used to collect foreign currency.

Pine mushrooms are mostly found on the area of north above Hongwon County, South Hamgyong Province. About 20 cities and counties are located here, and during the 1970s and the 1980s, approximately 800 to 1200 tons of pine mushrooms were naturally grown annually in a single county/city. Until then, pine mushrooms were not regarded as commodity not only for export but also for domestic mass consumption and were not controlled by the planned-economy. ... When pine mushrooms are in season, the Party Center’s foreign currency earning agencies open up local offices to purchase mushrooms in different cities and counties that produced them. During the working hours, soldiers and local residents who receive rations or wages from their official employer left their official working units ‘systematically’ because the local party organizations mandated individuals to gather a certain amount of mushrooms. People would search mountain after mountain, collect mushrooms, hand them over to the places that govern the purchasing of mushrooms, get receipts, give the receipts to their organizations and return to their units. A standard ‘high quality goods’ received in exchange for receipts at

the purchasing sites states that nine kilograms of sugar equaled a kilogram of high quality pine mushrooms. And those who received the ‘high quality goods’ would take it to the farmers’ market and exchange it for cash or daily consumer goods.¹⁰⁾

In this way, the Party Center’s foreign currency earning activities contributed greatly to the expansion of market activities in North Korea. From the beginning, foreign currency earning took up a considerably large portion of the entire national economic activities. In terms of working hours, people spent almost more than a quarter of a year. This is because members of all organizations and groups were individually assigned to collect one kilogram of pine mushrooms and several grams of gold per year as a demonstration of one’s loyalty in earning foreign currency. The requests were quite specific, as individuals had to collect old or damaged copper, abandoned metal, fur, fish and shellfish, herbs and handicrafts, which all required considerable time to collect. In addition, as the party realized that the unpaid labor of ‘loyalty-based contribution to earning foreign currency’ is hard to achieve, they created a new mechanism for foreign currency earning, where people get paid. On average, workers and organizations had to put at least a quarter of a year into efforts to garner foreign currency in order to meet the target set by the Party. People were even issued travel permits if it was clear

10) Choi, “The Internal Changes in North Korea after the Economic Hardships,” p. 147.

that they were trying to earn foreign currency. Also, groups were organized to be dispatched to different places as well. It was not only the working hours that were diverted to bringing in more foreign currency. From the 1980s, raw materials, electricity and facilities – resources set aside for the planned-economy – and the workforce of economic groups were allocated to earning foreign currency.

D. The Decay of the Planned-Economy

From the late 1970s, foreign currency earning agencies – those other than the Party Center – increased in number. As a result, an independent segment, made of foreign currency activities of powerful party-state agencies and distinct from the planned-economy, appeared in the North Korean economy. Three characteristics define this segment. First, it was created by the exclusive request from the *suryong* dictatorship. Second, it had the authority to unilaterally mobilize and utilize resources of the planned-economy, operating parallel with the planned-economy, using independent and extra-economic means. Third, it was a special entity commercially linked with capitalist states, unlike agencies under the planned-economy that could only trade with other socialist states.

The appearance of such agencies had two major impacts. First,

conflicts over the distribution of rights to earn foreign currency intensified and carried out as a competition of loyalty among the Ministry of the People's Armed Forces, the Department of Public Security (currently the Ministry of People's Security), the Youth League, the Kumsusan Assembly Hall, and the Central Committee. Each agency was similar in that it presided over a huge mass of young adults and middle-aged men, those who could serve as the labor force. Also, they submitted similar proposals, promising to carry out national projects that were a burden for the national budget such as political events, monumental constructions, and building of highways, railroads and flood gates with their own means.

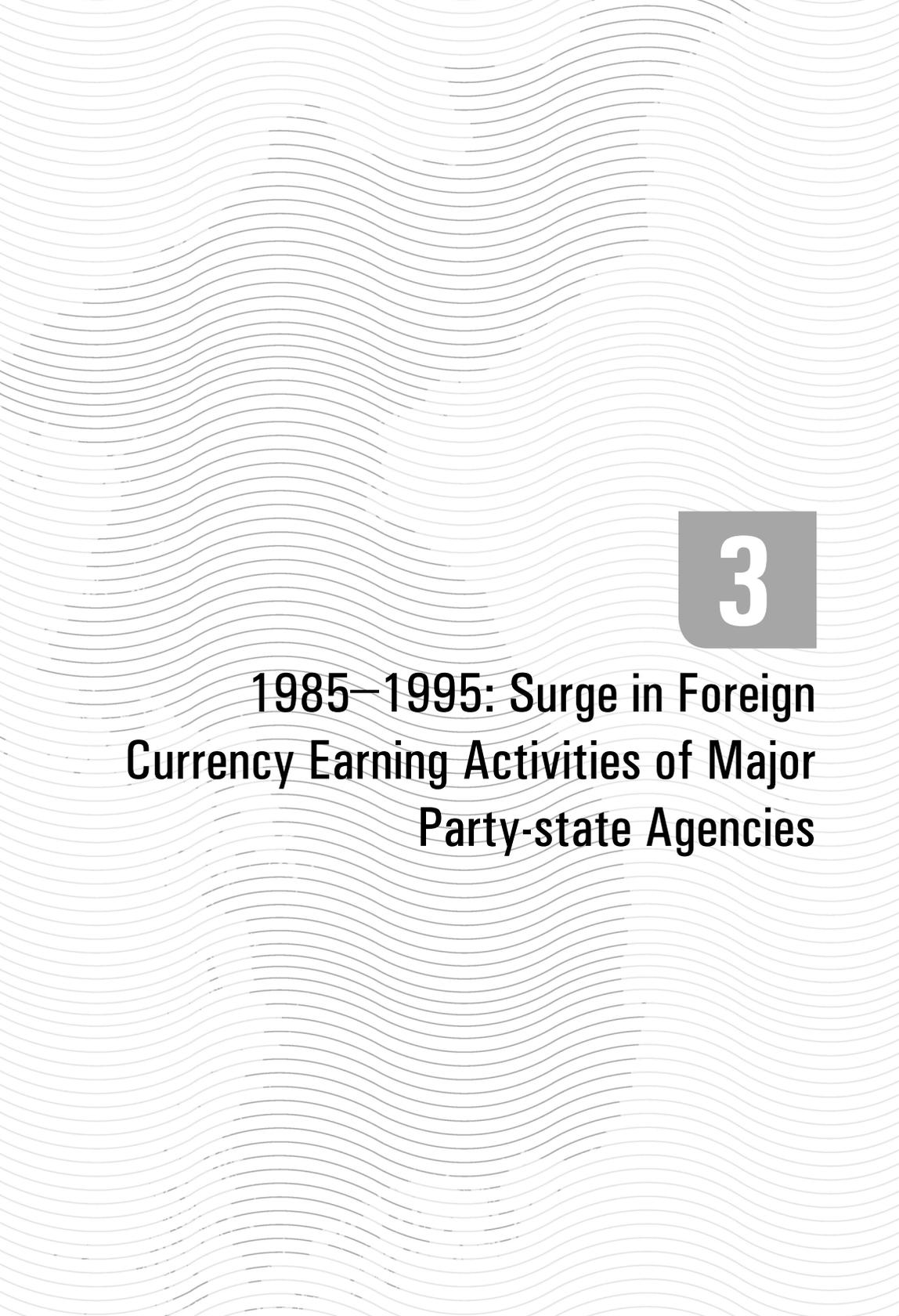
Second, the increase in the foreign currency earnings was inversely proportional to the scope of the national budget and the national planned-economy. The *wak* (trading licenses) were distributed unilaterally through proposals of the major party-state institutions and through party's unitary management system, as (Kim Jong-il's) means of issuing directives. Despite the fact that the distribution of *wak* caused problem as the planned-economy lost its facilities and resources to foreign currency earning agencies, there was no agreement or coordination beforehand concerning the distribution of *wak* with the organs dealing with the planned-economy and the national budget. This was because there was no structural way or venue through which economic authorities could interfere or negotiate in the activities of extra-economic means.

Until the mid-60s before the *suryong* system, Kim Il-sung controlled only the Party, the administration and the military; and in fact was subject to restriction and control by ‘proletarian dictatorship organs’ such as the Supreme People’s Assembly or the judiciary. But after establishing the Monolithic Ideology System, he dominated all authority. State planning lost its legal characteristics and its priority was lowered. In contrast, foreign currency earnings, even if it was in the form of guidance or directive, became the absolute priority. Therefore, the existing planned-economy always had to be revised or conceded, depending on the decision regarding *wak* distribution in the *suryong* dictatorship period.

In the 1980s, more and more party-state agencies took part in foreign currency earning activities. In turn, the expansion of foreign currency earning entities gave rise to a “movement for foreign currency earning” among elites for capitalistic (commodity) consumption or private enrichment. The foreign currency earning activities for securing off-budget revenue for major party-state agencies have transformed into those for private enrichment of elite members. In turn, this boosted participation of party-state agencies in the foreign currency earning activities, as the purpose of personal wealth accumulation was added to the original purpose of production.

Ruling families and central party-state agencies – where the country’s elites were included – all took part in the movement competitively. These groups received *wak* by the proposals which

were more about funding housing construction in Pyongyang or about financing the budget (deficits) of their offices on their own rather than about financing national large-scale projects. In the 1980s, almost all central agencies obtained *wak* to earn foreign currency, and came to have foreign currency budget for their self-sufficiency. The purpose and mission of earning foreign currency became diverse.



3

**1985–1995: Surge in Foreign
Currency Earning Activities of Major
Party-state Agencies**

3. 1985 – 1995: Surge in Foreign Currency Earning Activities of Major Party-state Agencies

The mid-1980s was an important turning point in North Korean history, both politically and economically. According to Hwang Jang-yeop, while 1974 to 1985 was an era of dual leadership by ‘Kim Il-sung - Kim Jong-il,’ from 1985 to 1994, the dual regime can be said to have been characterized by ‘Kim Jong-il - Kim Il-sung.’¹¹⁾ Also, there were many new changes in the economy from the mid-1980s. Officially, North Korea introduced a series of economic measures after the 10th Plenary Session of the 6th Central Committee on December 1984.¹²⁾ Essentially, they were ‘phenomenal measures to change the administrative management system of the People’s Economy to reflect the on-the-ground demands of development.’¹³⁾ Such transition brought about huge changes in the relative economic

11) Jang-yeop Hwang, *Hwang, Jang-yeop’s hidden story: the sunshine on the dark side cannot light the darkness*. Seoul, Monthly Chosun Publications: 2001, p. 89. (in Korean)

12) See, Hyeong Jung Park, *North Korea’s Economy Management System*. Seoul, Haenam Publications: 2002, pp. 16-20. (in Korean)

13) Korean Central News Agency, *North Korea Central Almanac*. Pyongyang, Korea Central News Agency, 1986. p. 199. (in Korean)

role and weight of *suryong* agencies, major party-state agencies, and agents of the private economy after the mid-1980s.

A. Expansion of Foreign Currency Earning Agencies

In the midst of worsening economic crisis in the early 1980s, there was a sharp increase in foreign currency activities of major party-state agencies. In the early 1980s, other socialist countries went through reforms and opened up their markets. Also there was a surge of nationalism in these countries. As a result, the North Korean economy, which depended on the socialist countries, had lost its major source of revenue and supply. This meant the revenues of the planned-economy sharply decreased, and the host role of the planned-economy for parasitic foreign currency earning agencies, was eroding quickly. Economic situations aggravated domestically and internationally, and major party-state agencies were under pressure of a possible fiscal collapse without earning foreign currency.¹⁴⁾ During this period, the military, League of Socialist Working Youth, and other privileged agencies, not to speak of the Central Committee, all jumped into the business of earning foreign currency under different pretexts. They either proposed to finance

14) Choi, "The Internal Changes in North Korea after the Economic Hardships," p. 147. (in Korean)

themselves by earning foreign currency or complete a large-scale construction projects without relying on the planned-economy.¹⁵⁾

At the start, there were four sections in foreign currency earning activity: The Central Committee (or the Party Center) section, Presidential Palace section (which no longer exists), the military section and the League of Socialist Working Youth section. The Central Committee section first appeared with the commemoration the 65th birthday of Kim Il-sung (15th April, 1977) providing school uniforms for the country's students and children as presents. The 'April 15th Gift' was a large-scale economic project, and from the beginning, the Party took charge and financed the event. From then on, there was a nationwide 'battle to produce gifts for commemoration of the April 15th,' under the instruction of the Central Committee. Under this pretext, the Central Committee governed and controlled the nation's trading companies, banks, foreign currency stores, and the system of purchasing sources of foreign currency income. This happened as part of making achievements in preparation for hereditary power succession to Kim Jong-il. Since 1972, Kim Il, who assumed important posts like the vice premier and the first premier of the State Administration Council, had always been a reliable guardian of Kim Jong-il.

There was once a Presidential Palace section, as the second

15) Ibid., p. 147. (in Korean)

important section, but no longer exists at present. After 1972, the Kumsusan Assembly Hall (Presidential Palace), where Kim Il-sung resided, possessed the Finance and Accounting Department which allowed it to operate the Neungra Trading Company out of the planned-economy's reach. The military had already started to earn foreign currency on a large scale, having the right to construct the West Sea Barrage. In particular, in 1984 and 1986, Kim Jong-il instructed the Ministry of the People's Armed Forces to be fiscally self-sufficient.¹⁶⁾ The League of Socialist Working Youth also started earning foreign currency on a large scale, with its right to construct the Northern railway (Manpo-Hyesan) from 1985. Moreover, the League of Socialist Working Youth participated in the 13th World Festival of Youth and Students (Pyongyang Festival) which was held in 1989, and by doing so, expanded its business of earning foreign currency.

In 1984, the Joint Ventures Law was passed; this was good news to major party-state agencies' trading companies. Also, in the 1980s, the Ten Major Prospective Goals of Socialist Economic Construction were declared. Although the state fell miserably short of meeting the targets as those targets were set excessively high, foreign currency earning activities had flourished under the pretext of meeting the

16) Lee, "Lee, Ju-il's North Korea Story – The reality of North Korea's Foreign Currency Earning Activities by Mass Mobilization." (in Korean) According to the Beginning and Transition of Foreign Currency Earning Movement, Kim Jong-il directed to do such thing in 1984. Jong-chang Woo, "[Pursuit] Kim Jong-il's Slush Fund," *Chosun Monthly*, November 2000. (in Korean) In this article, it is written that Kim Jong-il made this decision on 20 June 1986 according to Kim Sung-min's testimony.

targets. In particular, there were large-scale construction projects in Pyongyang for the 1989 Pyongyang Festival, and it was a good occasion for supplying pretexts for earning more foreign currency. Meanwhile, People's Economy was struck hard due to the squandering of the budget. Under different pretexts, major party-state agencies like the Presidential Palace Bureau, Presidential Guard Bureau, State Security Department and the Department of Public Security rushed to open up foreign currency stores and places to purchase sources of foreign currency. Even agency such as *Juche* Science Institute had its own trading company and started earning foreign currency on its own, in order to hold international forum on *Juche* Ideology.¹⁷⁾ Also, millions of teenagers were forcefully assigned to collect fractured copper, fur and apricot seeds – those that could be used to earn foreign money. To meet these targets, entities had no choice but to rob state properties.¹⁸⁾ Added to that, construction and operation of Sunchon Vinalon Plant and Sariwon Potash Fertilizer Plant, into which the state poured a lot of money amidst the economic crisis in the 1980s, radically failed.

When more party-state agencies began to earn foreign currency, the market naturally expanded. For many other reasons, North Korea's market and unplanned economic activities expanded in earnest in the 1980s, especially because the economic crisis

17) Choi, "The Internal Changes in North Korea after the Economic Hardships," p. 148. (in Korean)

18) Ibid., p. 147. (in Korean)

worsened for many reasons.¹⁹⁾ In response to the worsening economic crisis, the state encouraged unplanned economic activities more actively and chose not to intervene in those activities during the 1980s. From 1980, in addition to the private cultivating garden permitted to the farmers, North Korean authorities distributed infertile land of 1,000 to 2,000 *pyeong* (1 *pyeong* = 3.3058m²) to each organization such as workplaces or work units in the cities, which were formerly reliant solely on rationing. In 1987, the state allowed 50 *pyeong* for each individual as a sideline work, and allowed the individuals to sell all the crops sowed on that land.²⁰⁾ Added to that, it connived at individuals' patch of field, a land that people cultivate illegally, by means such as slashing and burning the fields. North Korean authorities started the 'August 3 Production of People's Consumer Goods Program' to increase the production of light industry goods.²¹⁾ This was actually allowing a small-scale form of private production.²²⁾ As private light industry developed and more food was privately produced, farmers' market and the

19) Suk Lee et. al., *The Change in North Korean Planned Economy and Marketization*. Seoul: Korea Institute for National Unification, 2009, pp. 90-91. (in Korean); Geun-o Lim, "The breakdown of Economic Cycle and 'Marketization - DPRK-PRC Trade,'" *Imjingang*, No.10, (Iimjing Publishing, 2010), pp. 75-76. (in Korean)

20) Su-ho Im, *Coexistence of Planning and Market: Prospects for Economic Reform and System Change in North Korea* (Seoul: Samsung Economic Research Institute, 2008), pp. 79-80. (in Korean)

21) *Ibid.*, pp. 77-78. (in Korean)

22) The number of work-at-home group and the sideline work group reached 47,000 around 1993. Assuming the number of members in a group as five, it means that the laborer in the private domain of light industry reached 250,000.

market distribution channel expanded as well. In 1984, farmers' markets were announced to be permanent. Each district installed one or two daily market places additionally, and for each city and county, there were three to four daily markets.²³⁾ As people earned more money by selling goods than by receiving wages, there were now those who quit their jobs and focus only on selling goods on the market.²⁴⁾

In this period, it is important to take note of the cross-border trade between North Koreans and the ethnic Koreans in China. From 1982, trade resumed between North Korea and Yanbian, an autonomous prefecture of ethnic Koreans in China.²⁵⁾ From 1984, ethnic Koreans living in China were allowed to visit their relatives in North Korea. Taking advantage of such change, many people had become a moving shop, packing goods in a sac and selling them in the northeastern border area like Hyesan, Musan and Hoeryong.²⁶⁾ A few North Koreans started to sell goods with the stimulus provided by their ethnic Korean relatives in China.²⁷⁾

23) Im, *Ibid.*, pp. 80-81. (in Korean)

24) Keum-Suk Im, "The Characteristics of Self-Employment of North Korea and its Direction of Development" *The Unification Economy*, No. 80, p. 57. (in Korean)

25) Duk-nam Hwang, "On Vitalizing the Cross-Border Trade between North Korea and Yanbian," *The Korean Journal of Unification Affairs*, Vol. 12, No. 2, p. 57. (in Korean)

26) Myung-seo Park, *DPRK-PRC Trade and the Situation of North Korea's Market* Seoul: Korea Institute for National Unification, p. 66. (in Korean)

27) *Ibid.*, p. 66. (in Korean)

B. The Generalization of Foreign Currency Earning Activities of the Party-State Agencies in the Early 1990s

It was the opening of the 13th Pyongyang Festival in 1989 that gave the final blow to the collapse of the already struggling North Korean economy. The League of Socialist Working Youth, masterminded by the Central Committee, prepared for the event and in the midst, the basis of the state planned-economy was severely undermined. During the preparation for the 13th Pyongyang Festival, there were symptoms indicating serious problems in the economy. From the year 1987, rationing stopped in the North Hamgyong and Yanggang Provinces. The state failed to reduce the number of areas that are not being rationed. Consequently, as time went by, the nation's southern areas were not being rationed as well and in 1991, even people in Pyongyang could not receive rations. As rationing was halted in more regions, North Korea's planned-economy collapsed in the early 1990s. All branches of the Central Bank of the DPRK were virtually bankrupt. The state's technological and material infrastructures like power grid, transportation and logistics system were in their worst situation. Most production sites had their facilities destroyed and stocks lost, as a result of robbery and plundering. Commerce and food rationing under the local People's Committee were virtually hit the hardest.

Meanwhile, the cutting off of rations spread corruption rapidly

across officials of the party, administration, and judiciary. All employees including managers created a corporate culture and climate in which everyone was on the alert to search for opportunities to steal state property. Administrative systems of the central and local governments collapsed and became unreliable. The central government created an ad hoc group of inspectors in order to maintain the system by either making them reside in the countryside or dispatching different individuals there in turn. But even the ‘group against anti-socialist phenomena (*Bisagroupa*)’ who were sent to the countryside by the central government, were bought off by corrupt local officials or they even asked for bribes and submitted false reports to the head office. Such practices became commonplace. Soldiers and officers started to plunder and exploit supplies by using their status when they experienced shortage of supplies. During this period, ‘*Youngsil-i*’ (those suffering from severe malnutrition) appeared in the army. Then the military authority would strongly demand more military supplies, and as a result, the General Staff Department of the military would start to directly engage in economic activities.

As the economic crisis accelerated during the late 1980s and the 1990s, this, ironically, was a good opportunity for foreign currency earning companies. In the early 1990s, the number of party-state agencies’ trading companies skyrocketed, and it was natural for government organizations to trade goods for commercial purposes.

In the 1990s, almost all privileged agencies including the Party, the cabinet, the military, the Department of Public Security, the State Security Department and major subcontractors operated companies that earn foreign currency. In 1991, a ‘new trade system’ was introduced to make each institution and state enterprises earn foreign currency on their own, as well as finance and operate rations by themselves. The system allowed all provinces (local administrative unit) and the departments of the cabinet in charge of production to create trading companies not just the Ministry of Foreign Trade.²⁸⁾ After such measures were taken, almost all institutions of the Party, the government and the military set up their own trading companies and started earning foreign currency. State institutions, state enterprises and local institutions joined the trend as well by doing the same.²⁹⁾ In the early 1990s, nearly all institutions of the Party, the government and the military founded trading companies or engaged in commercial activities to earn foreign currency on their own by any means possible. Since the mid-1990s, when the cutting off of rations was finalized, more agencies and state enterprises participated in earning foreign currency.³⁰⁾ Even the State Security Department, Prosecutor’s Office, and police stations that should be monitoring

28) Moon-Soo Yang, *Marketization of the North Korean Economy: its Shape, Nature, Mechanism and Implications*, (Paju: Hanul Publishing Company, 2010), pp. 133-136. (in Korean)

29) Park Hyeong Jung, “Commercial Engagements of the Party-State Agencies and the Expansion of Market in the 1990s,” *Unification Policy Studies*, Vol. 20, No. 1 (2011), pp. 221-222. (in Korean)

30) *Ibid.*, p. 220. (in Korean)

such activities, let alone local agencies of the party competitively took part.³¹⁾ It was the instruction in 1994 – calling for agencies and state enterprises to solve the food problem on their own – that served as a catalyst.³²⁾

Large numbers of major party-state agencies' trading companies were also set up around the early 1990s. According to the research by Eun-lee Joung, major trading companies were established in the following years: 'For trading companies of the military, under the direct management of Ministry of the People's Armed Forces were Maebong Trading Company (1980) and Yujin Trading Company (1992), under Ministry of the People's Armed Forces' General Logistics Bureau were Ryongsung Trading Company (1992) and Namhae Trading Company (1991), under Ministry of the People's Armed Forces' Reconnaissance Bureau were Birobong Trading Company (1998) and Moran Company (1992), under Ministry of the People's Armed Forces' Road Construction Bureau was Eunhasu Trading Company (1991), under Ministry of the People's Armed Forces' Logistics Management Bureau was Manpung Trading Company (1987), under Ministry of the People's Armed Forces' Strategy on Enemy Disruption Bureau was Whisung General Trading

31) Young-ja Park, "The Structure and Operation of Social State Organ in North Korea: The Dual Control's Continuance of Central Power and the Change of the Lower Part" *Korean Political Science Review*, Vol. 39, No. 5, 2005, p. 320. (in Korean)

32) Yang, *Marketization of the North Korean Economy: Shape, Nature, Mechanism and Implications*, p. 420. (in Korean)

Company (1992), under Ministry of the People's Armed Forces' Military Supply Mobilization Bureau was Yongheung Trading Company (1990), and under the Ministry of Korean People's Air Force Command was Danpung Trading Company (1988).³³⁾ According to Eun-lee Joung, in Shinuiju, the number of trading companies that earn foreign currency jumped to 20 around 1989, and when the rationing system collapsed in the 1990s, they increased to 200.³⁴⁾ In 1992 and 1993, Office 38 was separated from Office 39.³⁵⁾

33) Eun-lee Joung, "Research on Trading Companies of North Korea: Focus on the DPRK-PRC border city Shinuiju" in Ministry of Unification, *2012 Ministry of Unification Policy Assignments for New Scholars*, 2012, Seoul, p. 9. (in Korean)

34) Ibid., p. 10. In addition, refer to Moonsoo Yang, *North Korea's Trade System and its Reality*, University of North Korean Studies, Seoul, 2008, pp. 9-11. (in Korean) regarding the increase of establishment of the trading company by the Party and the military.

35) Republic of Korea Defense Intelligence Command, *Handbook of North Korea's Organizational Structure*, 2004, p. 30. (in Korean)

4

Post 1995: '*Songun* (Military First)' Policy and the Expansion of the Market

4. Post 1995: '*Songun* (Military First)' Policy and the Expansion of the Market

A. The Generalization of Public Agencies' Foreign Currency Earning

As mentioned above, major party-state agencies' trade activities greatly increased in the late 1980s. In the 1990s, subordinate and low-level offices of major party-state agencies and party agencies also took part in trade activities. These activities were pursued under the government's connivance, or in fact, under their encouragement. As the national budget could not afford to finance state and quasi-state organizations, it made organizations engage in commercial activities by taking advantage of governmental authority and power, and thus finance themselves.

In reality, the only way each group could earn foreign currency was collecting, hunting and distributing primary commodities like marine products, forest products, and mineral products and eventually exporting them. In this process, each group found its own commercial trading companies, and then scouted and made use of

private merchants who had the capital and commercial talents. Private merchants who were part of authorities' trading companies and subordinate offices were protected by the agencies and engaged in commercial activities related to the collection, gathering, and distribution of primary products under such protection. After the mid-1980s, budgets for the *suryong* (successor), budgets for major party-state agencies, and budgets for the Cabinet were separated from the state budget. Consequently, 'budgets for the planned-economy' were scarcely left and were synonymous with 'budgets for maintaining the rudimentary infrastructure.'

From the 1990s, both the substance and the form of the North Korean economy were threatened due to the strong political impacts from the disintegration of the Soviet Union and the death of Kim Il-sung. To make matters worse, economic sanctions were imposed on the state due to the launch of Rodong Missile and the nuclear issue and wholly devastated the substance of the planned-economy. In response to such circumstances, from 1994 to 1995, institutions and state enterprises were instructed to supply foods on their own and thus, the market activities of many different groups flourished. Moreover, it was in this period that the '*songun*' policy began. This allowed agencies related to the military and their trading companies to benefit most from the expansion of the market and trade activities – they thus played a crucial role in the expansion of North Korea's market.³⁶⁾ During this period, it was the military that played a key

role in keeping the foundation of the national economy intact. Meanwhile, the military acquired lots of *wak* for exports. Also, the military had an advantage over the agencies' trading when collecting, gathering and distributing primary products. For one thing, the military had a large workforce and numerous means of transportation. It was also responsible for guarding the coast, where seafood, the major export item from North Korea, was produced, and was free from the interference of the Ministry of People's Security or the State Security Department. The military transferred management rights of many factories of civilian demands to those for military demands, and it was able to order state enterprises to supply goods without having to provide resources.

B. Kim Jong-il's Style of Economic Management

To overcome such crisis, North Korea shifted to what was called *Shilli-ism* (pragmatism for securing real benefit) and *songun* revolution, an alternative way of managing the economy during the *songun* era. In a financial sense, Kim Jong-il's *Shilli*-pragmatism can be interpreted as ordering each party-state organization to meet all

36) The detailed explanations of the period were laid out in another part, so it is omitted here. See Park, "Commercial Engagements of the Party-State Agencies and the Expansion of Market in the 1990s."

the economic demands from the *suryong* without endeavoring to recover from economic devastation since the late 1980s amid the deepening economic crisis.

There were reasons why Kim Jong-il had not attempted to normalize the fragmented national fiscal system: Kim Jong-il was the only one who possessed enough money to enable the overcoming of the economic crisis. This means that Kim Jong-il had to give up the most of his wealth for the national fiscal system to be re-habilitated. In other words, Kim Jong-il's personal wealth had to be spent to save the economy. In fact, in 1992, Kim Il-sung said "the party congress could be convened (and the post of general secretary could be handed over to Kim Jong-il) if only one hundred million dollars were in hand." However, (internal sources in North Korea reportedly said that) Kim Jong-il acted as if he had not heard of such, even though he had "billions of dollars" to himself. This was because he had already dominated the Party by then, and had already assumed the supreme commandership. Likewise, Kim Jong-il turned to extra-economic means, so that he could hold onto his assets – which might be lost if he resorted to economic means or the rehabilitation of the fiscal integration.

The key to such disintegrated fiscal system was the system of proposals and directives to and from the *suryong*. Privileged agencies had to submit proposals to Kim Jong-il, explaining the necessity to earn foreign currency on their own and had to receive Kim Jong-il's

approval. Once the proposals were approved, they were then known as directives and could be put into practice. Under this system of proposals and directives, all party-state agencies could have their own commercial enterprises, and handed some profit to Kim Jong-il. Simultaneously, all state enterprises that were part of the planned-economy were instructed by the National Defense Committee to hand over special budgets called ‘revolution funds’ to Kim Jong-il – in addition to the funds they had to hand over as part of the official state planning. The National Defense Committee ordered state-owned enterprises to pay ‘revolution funds,’ and owners of those enterprises that did not pay the fund were tried at the military court.

Only the supreme commander or the general secretary, i.e. Kim Jong-il, had the power to distribute the ‘revolution funds.’ Revolution funds were first set aside by Kim Jong-il for the Manpo tire plant in 1997. In the approved proposal for this pilot project, there were instructions to put the tire imports on hold for three years and to allow domestic tires to be sold at international prices. This was forcing people to buy the domestic Manpo tires, made with revolution funds, at the same price as imported tires. In essence, this was a public announcement that the government will rely on extra-economic means and will not open up nor carry out reforms, even when the economy was on the verge of collapse.

Here, the regime was able to use three types of monetary manipulations to make transaction terms favorable to itself. First, it

could buy goods at a price set by the state, not at the price determined by the market. This was possible because legally speaking, market prices were still illegal. Thus, the state could force through extra-economic means and buy goods at a state-set price when the state (state offices or state officials) were buying them. The state could compensate the state firms which supplied goods in state prices, while conniving at latter's activities of selling part of its products on the market at market prices.

Second, North Korean authorities could print money and increase the currency circulation inside North Korea. In particular, in the seven-year period between the July 1, 2002 Economic Management Improvement Measures and the November 2009 Currency Reform, the price of rice increased 53 times, and the dollar exchange rate jumped 26 times.³⁷⁾ In the three-year period between the November 2009 Currency Reform and 2012, the price of rice increased 260 times, and the dollar exchange rate rose 170 times.³⁸⁾ The cause of hyperinflation during this period was probably the increase in money circulation.³⁹⁾

Third, the state could intervene in the domestic black market for foreign exchange. Particularly after the November 2009 Currency

37) Young-hoon Lee, "The Hyperinflation and the Prospect of Economic Reform in North Korea," *North Korean Studies Review*, Vol. 16, No. 2, 2012, p. 54. (in Korean)

38) Lee, *Ibid.*, p. 55. (in Korean)

39) Lee, *Ibid.*, p. 55. (in Korean)

Reform, rapidly rising inflation rate made it natural to use foreign currency in North Korea while avoiding the usage of the domestic currency. But still, using foreign currency was illegal. Therefore, the state could always forfeit or ban the use of foreign currency. Also, it could reduce the exchange rates by threatening to forfeit or ban the use of foreign money, and making groups and individuals sell foreign currency so that the exchange rate would fall and then purchased foreign currency in such period. Also, the state could print a lot of domestic currency and buy foreign currency at a higher price than other consumers did. In addition, trading companies under major party-state agencies, those with a lot of foreign currency could manipulate the opening and closure of the customs at the border. By doing so, they could influence the prices of imports. For example, they were able to gain foreign-exchange profits because of several factors: the demands and exchange rates for foreign currency would increase in the beginning of the year as the demands for imports increased for the purpose of buying gifts for public distribution on birthdays of Kim Il-sung and Kim Jong-il; and the utilization of seasonal fluctuation of foreign currency demands such as the time when the trading companies have to buy commodities to export and taking the exchange gain.

C. Agents of the Private Economy Strengthened

Agents of the private economy grew rapidly during this period, as major party-state agencies contributed to the rapid growth of markets. The prosperity of ‘marketplace economy’ (*jangmadang* economy) and ‘personal enrichment of the upper class’ were what propelled these changes. Concerning ‘marketplace economy,’ first, the ‘marketplace-style national distribution network’ emerged, replacing the corrupt national provisions system and was more outwardly open. Labor forces or those who lost jobs at state enterprises flowed into the marketplace, but lost their jobs again due to the oversupply of Chinese goods. In the midst of the influx of Chinese goods, North Korean raw materials were systematically collected and exported to China. Second, there was a division of labor in the marketplace. Among producers, specialists emerged for each good and each stage of distribution. Also, this marketplace allowed all citizens to participate and also encompassed all aspects of their lives. Geographically, marketplace economy connected different parts of the country and linked the domestic and the international sphere. Also, it covered the everyday lives of the people, since everything from housing, production materials, aid supplies, and illegal services (accommodation-linked sex trafficking, prostitution, South Korean soap operas, drugs, money-related crimes, and transactions that link corrupt officials) was on sale.

Also, although on the surface, this was an era of the ‘*songun* politics,’ the reality was the unjust re-distribution of state property caused by the unprecedented collapse of food rationing and the failure of provisions, thus leading to the amassing of wealth by the upper class. During the 1990s, the regions that did not receive the regime’s food supply expanded. One of the main reasons was the misappropriation by the ruling class. The embezzled rice was sold in the marketplace. Officials embezzled resources in many different ways: there were private embezzlement by those in managerial positions, and ‘official’ embezzlement was justified as a way to buy materials needed in operating factories. In such practice, the party and the judiciary received bribes or split shares as compensation for being silent. Workers stole goods, and the mechanism in the process of widespread inspection was corrupt and the officials were bribed. These were all part of the accumulation of personal wealth of the upper class. As a result, possessing ‘used bicycles’ and ‘video recorders’ were the trends in the North Korean society, despite the fact that citizens were suffering from the ‘Arduous March’ and lack of food supplies. Some started riding Japanese bicycles; the prices were equivalent to 8 years of average wages. In spite of strict regulations, the rich and the top officials were accumulating a huge amount of wealth. However, no economic or social reforms in which the rich could make sound investments took place.

The authorities were quite ambivalent towards marketplace

economy. Earning foreign currency, the core of the elites' economic activities, in essence, relies on both the planned-economy and the 'marketplace economy.' Earning foreign currency, the economically vested rights of the elites, requires the economic infrastructure sustained by the planned-economy. At the same time, they manage to withhold the legal framework of the nearly collapsed planned-economy, so that they dominate the means and justification to constrain the illegal activity conducted in the 'marketplace economy.'

Nonetheless, the marketplace economy was a crucial foundation for the elites' economic activity to make huge profits in foreign currency earnings. They could no longer make profits only under the planned-economy, which used to take advantage of people's loyalty and coercively mobilize people to collect pine mushrooms. In the 2000s, in addition to the exports of the North Korean goods, foreign aid was flowing in abundantly, meaning that the elites had an additional source of income. This opened them to an exclusive opportunity to make exorbitant profits because they were able to sell other international aid supplies, foodstuff free of charge that were not for sale. If the marketplace had not existed and if the food rationing system of the planned-economy had no problems, the elite would have had no means of making such profits.



5

Summary and Conclusion

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In North Korea, there existed a single taxation and fiscal system based on a socialist plan system. But with time, the fiscal system disintegrated through four phases and into four sections, headed by different principal entities: *suryong* agencies, specialized agencies (proletarian dictatorship), party agencies, and agents of the private economy.

The first phase of the disintegration was characterized by Kim Il-sung's arrangement of a special budget to maintain his political power under the socialist planned-economy. In the 1950s, Kim Il-sung mobilized the masses and in the 1960s, used political means centered on on-the-spot guidance activities to set aside financial resources for himself.

During the second phase, the *suryong* economy became independent from the planned-economy. The power concentration on Kim Il-sung in the 1960s and the process of Kim Jong-il's succession since the mid-1970s was the background of the birth of *suryong* economy. *Suryong* economy included party-economy and the Second Economy. From the mid-1970s, the Party Center expanded the

monopolized activities of earning foreign currency to create massive amount of political fund. Earning foreign currency, under the party-economy, greatly damaged the planned-economy, contributing to the expansion of the marketplace. This is because in the process of collecting sources to export, the party-economy made use of the resources and efforts of the planned-economy without permission.

During the third phase, major party-state agencies' earning foreign currency expanded rapidly emerging as an independent sector, separated from the *suryong* economy. In the 1980s, amidst the worsening economic crisis, major party-state agencies started to bring in foreign currency in earnest. Also, the Joint Ventures Law took effect and Ten Major Prospective Goals for Socialist Economy Construction were announced in the mid-1980s, justifying more major party-state agencies' practice of earning foreign currency. In particular, the extension of the economic crisis in the late 1980s and the 1990s ironically provided opportunities for trading companies to earn foreign currency.

During the final phase, it became natural for all public agencies to earn foreign currency. Also the disintegration of the national fiscal system was comprehensive and general. Kim Jong-il neglected such disintegration and used it as a means to meet all the economic demands of his dictatorship. In addition, as almost all public agencies brought in foreign currency, the market was rapidly amplified. As a result, the practice of the elites personally accumulating wealth

became rampant which led to a rapid growth of the agents in the private economy.

Therefore, as the existing fiscal system of North Korea is a result of such historic changes, it is now a decentralized and disintegrated system. In North Korea, the central authority (*suryong*) distributes economic licenses for subsidiary agencies so that they could finance themselves. The licenses are made of two: licenses to monopolize the production, distribution, and export of certain primary products (also known as *wak*); and licenses to engage in commercial activities by establishing and running trading companies in charge of this process. The *suryong* distributes these licenses to state or quasi-state organizations in a politically biased way. By doing so, the state guarantees each group to make monopoly profits that are commensurate to their political importance and hierarchy.

Such finance system means that large parts of financial resources which should have been concentrated on the *suryong* or central government are dominated by various levels of groups and their officials. This is because under the decentralized and disintegrated finance system, the central authority has difficulty grasping, supervising, and controlling the surplus revenues that could potentially be considered as tax. Therefore, when subsidiary organizations and their officials supply finances for themselves by using their commercial privileges granted by the *suryong* or the state, the central authority finds it difficult to grasp and control how it is

produced, distributed and disposed of. Also, depending on the level of power hierarchy, the principal-agent relationship problem becomes immensely serious in societies where the party-state remains undisciplined and corruption is generalized like North Korea. In other words, in every stage of the hierarchical order, the subordinate, or the agent, benefits the most by hiding and distorting information; that way, he could offer fewer bribes or pay less tax. That is why the central authority tries periodically to deprive of and redistribute the licenses to different agencies. It has to continuously intervene politically and economically, so that subsidiary organizations and their officials do not become too financially independent.

Fiscal Segmentation and Economic Changes in North Korea

The history of North Korea's fiscal segmentation can be categorized largely into four periods headed by different principal entities. First, between 1953 and 1972, Kim Il-sung created special budget to maintain political power. Second, from 1972 to 1984, Kim Jong-il gave birth to suryong economy to consolidate hereditary power succession. Third, from 1985 to 1994, party-state agencies began foreign currency earning activities. Finally, from 1995 to the present, in addition to the suryong economy and major party-state bodies, the foreign currency earning activities of party-state bodies for off-budget revenue have been generalized and become the backbone of North Korean party-state bodies' budget system. This paper addresses the process of fiscal segmentation from the second period onwards.