Initiative for Policy Dialogue
IPD Tax Task Force

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Korea's tax system

The tax structure in Korea does not much resemble those found in developed countries: the personal income tax is of relatively minor importance (14.1 percent of total tax revenue in 2003; the share for corporate taxes was 17.3); the corporate taxes are paid primarily by large manufacturing companies (0.1 percent of the corporations paid 55 percent of corporate taxes); and the use of earmarking is extensive (the revenue from earmarked taxes amounted to 3.5 percent of GDP or 17.2 percent of total taxes; taking into account a fixed proportion of general revenue earmarked to local spending, almost 35 percent of total tax revenue was earmarked in 2003); import duties collected 4.6 percent of total revenues (exports were subsidized); about 20 percent of total taxes were collected at the local level; and transaction taxes are important (stock transaction tax in lieu of capital gains tax for most investors; acquisition and registration taxes, imposed mostly on motor vehicles and real estate transactions, represented about 40 percent of local taxes or 1.9 percent of GDP).

Growth objectives have been a major force shaping Korea's tax system. A significant portion of tax revenue has been used to finance infrastructure and education. Various tax incentives were provided to the export and other targeted industries (heavy-chemical). Implicit tax subsidies were also present, particularly for highly-leveraged manufacturing firms: tax savings from interest deduction were huge for the *chaebols* (big conglomerates) to which bankruptcy and agency costs were perceived to be low (cross-guaranteeing among subsidiaries and directed loans from state-controlled banks). In addition, low (almost absent) capital gains tax rates relative to dividend tax rates helped big firms to retain earnings for reinvestment.

Note that nontax subsidies such as directed loans led to implicit tax benefits, which have long lasted even after targeted tax credits were reduced. The role of tax policy in economic growth has often been downplayed (a World Bank study found that tax polices contributed only 6 percent of Korea's growth for the period of 1962-82); but the extent of implicit tax benefits possibly dominated that of explicit preferences for big manufacturers (I have some initial results from firm panel data). Nontax benefits can also be interpreted as a means of protecting corporate tax bases, since most of corporate taxes are collected from a small number of big firms.

While the VAT has been the most important source of revenue in Korea , their share is not particularly remarkable (22.5 percent of total taxes, 4.6 percent of GDP in 2003) compared to other VAT-using countries. *Tax enforcement* problems might be a facor: due to the lack of reliable tax information on the self-employed and small firms, the bases of income and value added taxes are narrow. While the government has recently made various efforts to reduce the extent of cash transactions (allowing tax deduction for credit card uses, lowering the sales-threshold for simplified bookkeeping, streamlining tax administration, etc.), their effects on the revenue, behavior and the size of the informal sector have yet to be studied.

Earmarking in Korea appears to be *revenue-motivated*. Assigning revenues from designated sources to finance designated expenditures could be an attractive way of avoiding *resistance* from the taxpayers (six taxes to finance education; surcharges on top of regular taxes to finance agricultural development, etc.) and of getting *tax information* by letting tax payers reveal their preferences (benefit taxation) and/or letting tax collectors identify tax payers more easily. The special accounts (into which revenues from earmarked taxes flows) and public funds (financed by various quasi-taxes as well as transfers from the general account) together accounted for about 45 percent of the consolidated central government expenditure, leaving barely over half of central government activities for the general account. The tax-expenditure linkage appears to be *weak* for the special accounts (on-budget) and *strong* for the public funds (off-budget).

Other issues: (1) public funds, which are independently administered by a ministry, could be subject to inefficiency (fragmentation / accountability) and rent-seeking, but “competition among ministries”(say, to finance a growth-oriented activity) may have enhanced efficiency and reduced the scope for corruption; (2) progressive rates for special excise taxes and property holding/transaction taxes; (3) export subsidies and restrictions on FDI (to protect tax base?); (4) the impact of the financial crisis on the use of the financial sector and the size of the informal sector

Data: (1) I complied an extensive firm panel (large vs. small; chaebol vs. non-chaebol; listed vs. non-listed, etc); (2) industrial variation of CIT, VAT; (3) tax on the financial sector (huge; an alternative way of taxing the manufacturing..)   (4/15/05)