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Tax

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Korea's tax system does not much resemble those found in developed countries. The tax bases are narrow and the overall tax burden is relatively low. Tax revenue as a fraction of GDP has increased steadily over the past decades, but at around 20 percent it is still among the lowest in the OECD (Table 6.1).¹ Including social security contributions, Korea's tax burden amounted to 25.3 percent of GDP in 2003, about two-thirds of the OECD average of 36.3 percent. Three decades ago, the gap was even wider, with Korea collecting only half of the revenue that OECD countries did as a percentage of GDP.² The tax burden rose noticeably in the late 1970s, reflecting the introduction of a broad-based VAT in 1977. The 1997 financial crisis triggered a wide array of changes in tax policy and economic structure, and thus had a significant impact on tax revenue.

Table 6.1. Tax Revenue in Selected OECD Countries
(As a percentage of GDP¹)

	1975	1980	1985	1990	1995	2000	2003	1975-2003 change
Korea	14.9	17.1	16.1	17.9	18.1	19.6	20.4	5.5
	(15.1)	(17.2)	(16.4)	(18.9)	(19.4)	(23.6)	(25.3)	(10.2)
OECD total ³	23.5	24.5	25.7	26.7	26.5	27.9	26.8	3.3
	(30.3)	(32.0)	(33.5)	(34.8)	(35.7)	(37.1)	(36.3)	(6.0)
United States	20.3	20.6	19.1	20.5	20.9	23.0	18.8	-1.5
	(25.6)	(26.4)	(25.6)	(27.3)	(27.9)	(29.9)	(25.6)	(0.0)
Sweden	33.8	33.6	36.2	38.7	35.1	39.1	35.8	2.0
	(42.0)	(47.3)	(48.2)	(53.2)	(48.5)	(53.9)	(50.6)	(8.6)
Mexico	-	13.9	15.0	15.0	13.9	15.4	15.8	1.9 ²
	-	(16.2)	(17.0)	(17.3)	(16.7)	(18.5)	(19.0)	(2.8)

Source: OECD (2005), *Revenue Statistics 1965-2004*.

¹Figures in parentheses are with social security contributions included.

²For Mexico, the change for 1980-2003 is reported.

³Unweighted averages.

The personal income tax, a dominant source of revenue among rich countries, is of relatively minor importance in Korea. As shown in Table 6.2, taxes on individual income accounted for only 11.5 percent of total tax revenues in 1980 and have increased very modestly to 12.7 percent in 2003. Taxes on corporate income have instead grown to be a more important source of revenue over the same period, collecting 15.3 percent of total revenue in 2003.³ Taxes on consumption are by far the dominant source of revenue, at 34.4 percent in 2003, although their share has been on a declining trend. More than half of consumption tax revenues come from the VAT with the rest contributed by a variety of excise taxes. In contrast to the situation in developed countries, property taxes raise a significant share of tax revenue, at 12.8 percent in 2003.⁴ In the early 1980s, customs duties were as important as individual income taxes, but their revenue share has steadily declined in reflection of trade liberalization. Social security contributions have increased markedly, with a strong jump in the late 1990s as noted in Table 6.1, although their share is still small compared to the cases in most developed countries.

Table 6.2. Tax Revenue by Type of Tax, 1980 and 2003

	1980		2003	
	% of GDP	% of Total	% of GDP	% of Total
Total tax revenue	17.2	100.0	25.3	100.0
Individual income	2.0	11.5	3.2	12.7
Personal income tax	1.7	9.9	2.9	11.3
Surtax on personal income tax	0.3	1.6	0.3	1.3
Corporate income	1.9	11.0	3.9	15.3
Corporate income tax	1.3	7.3	3.5	14.0
Surtax on corporate income tax	0.7	3.8	0.3	1.4
Consumption	8.0	46.6	8.7	34.4
Value added tax	3.8	22.0	4.6	18.2
Excise taxes	3.9	22.4	3.3	13.0

Surtax on excise taxes	0.4	2.2	0.8	3.3
Property	1.5	8.9	3.2	12.8
Taxes on transactions	0.8	4.4	2.0	7.8
Surtax on transaction taxes	0.0	0.0	0.2	0.9
Taxes on wealth holding	0.8	4.4	0.9	3.4
Surtax on wealth taxes	0.0	0.0	0.2	0.6
Customs duties	2.6	11.4	1.0	3.9
Customs duties	2.0	11.4	0.9	3.7
Surtax on customs duties	0.6	3.8	0.0	0.2
Social security and payroll	0.3	1.6	5.0	19.8
Other	0.9	5.2	0.3	1.2

Sources: National Tax Service (1981, 2004), *Statistical Yearbook of National Tax*; OECD (2005), *Revenue Statistics 1965-2004*; and author's calculations.

Note: See Table 5.A.1 in appendix for a detailed description of individual tax items.

The tax level and structure are influenced by the nation's tax policy objectives, economic structure and the enforcement capacity. In the early stages of economic development, growth objectives were a dominant force shaping the tax system in Korea. Various tax incentives were provided to the export and other targeted industries, particularly in the heavy and chemical sectors, while there were generous savings incentives at the personal level. In addition, highly-leveraged manufacturing firms were able to make substantial tax savings through interest deductions.⁵ They also benefited from low effective taxation of capital gains that facilitated their investment financing with retained earnings.⁶ Such tax preferences are still in place, although their nature and extent have been modified in accordance with changes in economic structure and policy objectives.

Raising revenue to finance infrastructure and education has been an integral part of the growth strategies in Korea.⁷ Due to enforcement problems with the self-employed and with smaller firms, however, the income and consumption tax bases are very narrow. Personal income tax collected was less than revenue from tariffs until the mid-1980s, and

most of the corporate and value-added taxes have been paid by a limited number of large corporations. Until recently, the revenue contribution of the VAT, which is the most broad-based tax, seldom exceeded 4 percent of GDP.⁸

To compensate for this revenue shortfall, the Korean government made extensive use of earmarked taxes, which appeared to arouse less resistance from taxpayers. Its lack of enforcement capacity also led the government to impose flat-rate withholding taxes on most capital incomes and to tax property transactions more heavily than property holdings.⁹ About two-thirds of property-related revenue comes from transaction taxes (Table 6.2), which face less resistance from the taxpayer than holding taxes. Also noticeable has been the wide use of surtaxes, levied on top of other taxes payable. Such “hidden taxes” amounted to about 8 percent of total revenue in 2003.¹⁰

Overall, the Korean tax system has not evolved along the lines found in developed countries. Efficiency and equity have been emphasized as the guiding principles in most tax debates, but actual tax policy has focused more on specific policy objectives: promoting savings, investment, and R&D, as well as securing sufficient revenue to finance public infrastructure and education. Korea’s tax policy has thus been highly growth-oriented. At the same time, the tax structure appears to have been influenced by various enforcement problems. It is argued in this paper that many of the tax incentives provided might have served not so much the purpose of promoting targeted activities as keeping taxpayers from disappearing into the informal sector. Generous non-tax compensations have also been available for heavily-taxed large corporations. To the extent that these preferences have supported tax base protection by mitigating evasion

pressures, the revenue and efficiency costs associated with them in most discussions of Korean tax policy have been overstated.

In a word, tax design in Korea has reflected its own unique policy objectives and economic structure, which differ significantly from those in other countries. Unless these underlying factors change, more conventional tax policies observed among developed countries should be considered with caution.

This paper provides a critical review of Korea's tax system, summarizing its key statutory features and emphasizing the ways in which enforcement problems as well as policy objectives influence tax design. We begin by describing the basic structure of the tax system. The following section then examines the implications of growth objectives and tax enforcement for tax design. We next consider the impact of the 1997 financial crisis on the nation's economic structure and policy objectives and the resulting changes in the tax revenue structure. The final section concludes by summarizing key challenges facing the system.

The Basic Structure

The Korean tax system is highly complex, as illustrated in Table 6.3,¹¹ with taxes being collected both at the national and the local level. National taxes consist of three groups: internal taxes, three officially earmarked taxes,¹² and customs duties. As of 2003, the personal and corporate income taxes and the VAT accounted for about half of total tax revenue or 70 percent of national taxes.¹³ While only 22.4 percent of tax revenue was collected at the local level, local governments accounted for more than half of total

government spending,¹⁴ implying significant grants and transfers from the central government.¹⁵ Property-related taxes account for more than half of local tax revenues; the resident tax, the local education tax, and the tobacco consumption tax ranked as the other most important items.¹⁶ Social security taxes are levied at the rate of 4.5 percent on both employers and employees and on the self-employed at lower rates.

Table 6.3. Tax Structure of Korea, 2003

	Billions of won	% of GDP	% of Total	
Total taxes	147,797	20.5	100.0	-
National taxes	114,664	15.9	77.6	100.0
Internal taxes ¹	92,231	12.8	62.4	80.4
Personal income tax	20,787	2.9	14.1	18.1
Corporate income tax	25,633	3.6	17.3	22.4
Value added tax	33,447	4.6	22.6	29.2
Special excise tax ¹	4,733	0.7	3.2	4.1
Liquor tax ²	2,726	0.4	1.8	2.4
Security transaction tax	1,607	0.2	1.1	1.4
Inheritance and gift taxes	1,315	0.2	0.9	1.1
Other ³	1,983	0.3	1.3	1.7
Earmarked taxes	15,583	2.2	10.5	13.6
Transportation tax ²	10,000	1.4	6.8	8.7
Education tax ²	3,651	0.5	2.5	3.2
Special tax for rural Development ²	1,932	0.3	1.3	1.7
Customs duties ¹	6,847	1.0	4.6	6.0
Local taxes	33,133	4.6	22.4	100.0
Property-related taxes	18,851	2.6	12.8	56.9
Acquisition and registration taxes	13,053	1.8	8.8	39.4
Taxes on property holding ⁴	4,019	0.6	2.7	12.1
Automobile tax	1,778	0.2	1.2	5.4
Resident tax ⁵	4,558	0.6	3.1	13.8
Tobacco consumption tax ¹	2,384	0.3	1.6	7.2
Local education tax ²	4,009	0.6	2.7	12.1
Other ⁶	3,331	0.5	2.3	10.1
Social security contributions²	35,870	4.9	-	-
Total revenue	183,667	25.3	-	-

Sources: National Tax Service (2004), *Statistical Yearbook of National Tax*; Bureau of Local Finance and Economy, Ministry of Government Administration and Home Affairs (2004), *Financial Yearbook of Local Government*; and author's calculations.

¹Partially earmarked to specific uses; see Table 5.A.1 in appendix for details.

²Fully earmarked to specific uses; see Table 5.A.1 in appendix for details.

³The stamp tax, excess profit tax, carryover from the previous year.

⁴The property tax, tax on aggregate land holdings, urban planning tax, community facilities tax, and business place tax on property.

⁵Imposed as a surtax; see Table 5.A.1 in appendix for details.

⁶The license tax, motor fuel tax, agricultural income tax, butchery tax, leisure tax, business place tax on income, regional development tax, and carryover from the previous year.

The marginal tax rates for the personal and corporate income taxes are moderate by international standards. As shown in Table 6.4, the personal statutory tax rates and the number of brackets have been reduced during the past couple of decades, in a pattern similar to those seen in developed countries. However, the personal income tax base has not been broadened enough to make a significant revenue impact.¹⁷ The narrow base of the personal income tax is attributable in part to generous allowances and credits and in part to the low effective taxation of the self-employed and of capital income, which in turn reflects various enforcement problems. Tax subsidies to wage and salary workers include an initial wage deduction, a special wage credit, basic and extra exemptions for family members, and standard or itemized deductions.¹⁸ These tax breaks have been provided partly as a savings incentive and partly as a means of maintaining horizontal equity between employees and the self-employed, the compliance of the latter being very low.

Table 6.4. Statutory Tax Rates of the Personal Income Tax

Year of change	Number of brackets	Bottom rate	Top rate	Top rate inclusive of surcharges¹
1980	17	6	62	79.05
1982	17	6	60	76.50
1983	16	5	55	70.13
1989	8	5	50	63.75
1991	5	5	50	53.75
1993	6	5	50	53.75
1994	6	5	45	48.38
1996	4	10	40	44.00
2002	4	9	36	39.60
2005	4	8	35	38.50

Source: Ministry of Finance and Economy.

¹Currently, a 10% resident tax is levied on personal income taxes payable.

The corporate income tax has two brackets, and the tax rates have been steadily reduced, as shown in Table 6.5. At 27.5 percent (inclusive of the local resident tax), the top corporate rate is close to the OECD average.¹⁹ The bottom rate is applied to small corporations with taxable incomes below 100 million won.²⁰ A wide range of incentives are available in the corporate tax system, including exemptions, deductions, accelerated depreciation, investment tax credits, and tax-free reserves for bad debts and R&D. Losses can be carried forward for five years, but not backward. A partial credit for corporate taxes paid is available for dividend payments. Investment incentives are currently focused on small and medium-sized enterprises, R&D, and foreign direct investment. There is a minimum tax which partially offsets the effects of these incentives.

Table 6.5. Statutory Tax Rates of the Corporate Income Tax

Year of change	Bottom rate	Top rate	Top rate inclusive of surcharges¹
1981	25	40	53.00
1982	22	38	50.35
1983	20	30	39.75
1991	20	34	36.55
1994	18	32	36.40
1995	18	30	34.25
1996	16	28	30.80
2002	15	27	29.70
2005	13	25	27.50

Source: Ministry of Finance and Economy.

¹Currently, a 10% resident tax is levied on corporate income taxes payable.

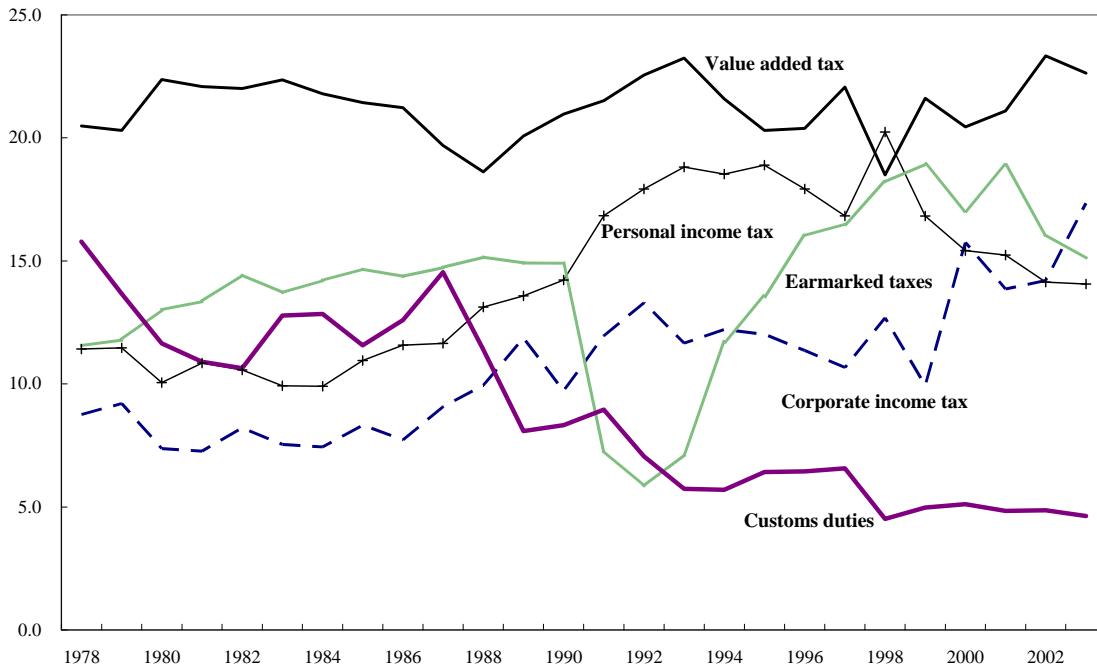
Since its introduction in 1977, the statutory features of the VAT have not changed much: the tax is charged at a single rate of 10 percent on a broad range of goods and services with a zero rate applied to exports and to certain selected goods and services.²¹ There is a variety of exempted supplies including unprocessed foodstuffs, agricultural products, and finance and insurance services, among others.²² In addition, a simplified scheme is applied to businesses with annual turnover between 24 and 48 million won, with those having turnover less than 24 million won being exempt. In this simplified scheme, the tax is levied by applying a prescribed value-added ratio, which varies across industries,²³ to the turnover of a business.

The excise tax system is very complex and includes a variety of earmarked surcharges. The special consumption tax, introduced to alleviate the distributional consequences of the VAT, is levied on some luxury goods and consumer durables including automobiles. Financial transactions are subject to various excises. The securities transaction tax and the special tax for rural development are levied at 0.15

percent each on the value of stock transactions on the Korea Stock Exchange.²⁴ The education tax is imposed on the gross receipts of financial institutions, at 0.5 percent.

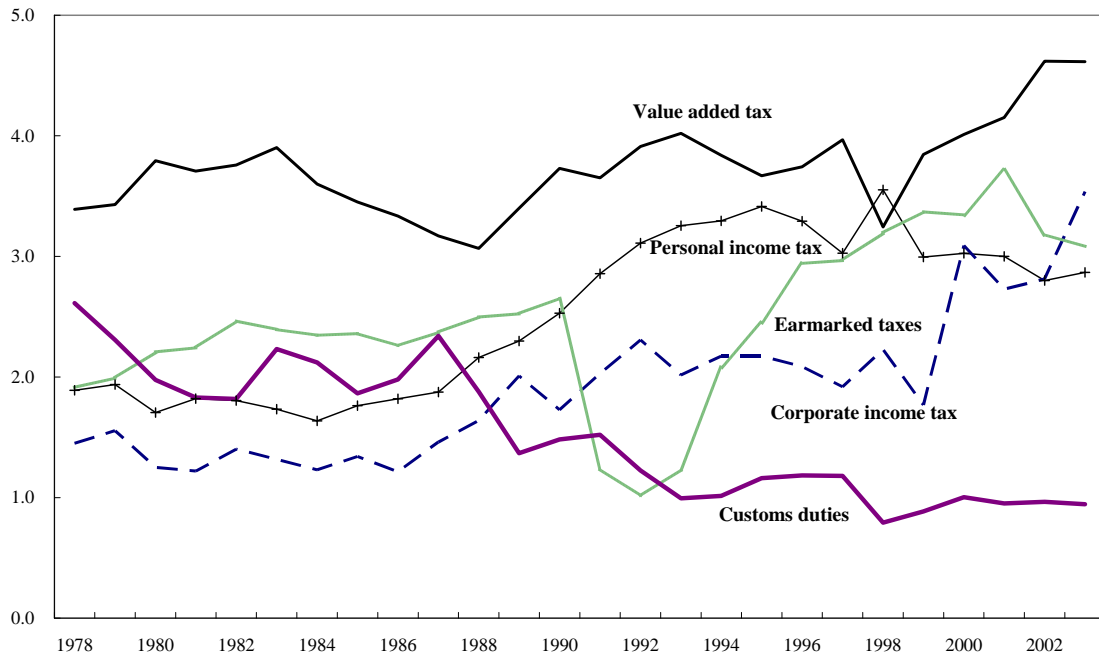
Earmarking is important in Korea. The three national earmarked taxes alone provided 10.6 percent of total and 13.6 percent of national taxes. In addition, the revenues from the special excise tax on automobile sales and the liquor tax are also earmarked to finance certain specific expenditure needs.²⁵ At the local level, the revenues from the local education tax and about half of revenues from the tobacco tax are earmarked to finance local education. Bird and Jun (2005) estimated the total revenue from earmarked taxes to be 3.5 percent of GDP or 17.2 percent of total taxes collected, or about as much as the corporate income tax. In addition to these earmarked taxes, a fixed proportion of internal tax revenue is earmarked for central government grants.²⁶ If these grants are taken into account, almost 35 percent of total tax revenue was earmarked in 2003.²⁷

Graph 6.1. Trends in Major Taxes, 1978-2003
(As a percentage of total tax revenue)



Source: National Tax Service.

Graph 6.2. Trends in Major Taxes, 1978-2003
(As a percentage of GDP)



Source: National Tax Service.

Graphs 6.1 and 6.2 show the trends of major Korean taxes as percentage of total revenue and GDP, respectively. The VAT has been the most important source of revenue since its introduction in 1977. Its revenue as a share of total taxes is comparable to the cases in other OECD countries at 22.6 percent in 2003, but as a percentage of GDP it is relatively low at 4.6 percent. The personal income tax and the corporate income tax had both increased steadily in importance up until the time of the financial crisis in 1997. Interestingly, the revenue share for the personal income tax has since declined, while that for the corporate income tax has sharply increased. As discussed later on, changes in economic structure and government policy in the wake of the crisis appear to be the cause behind these contrasting trends. Tariffs were a more important source of revenue than either the personal or the corporate income tax until the late 1980s. However, their share

has since fallen sharply in accordance with the acceleration of free trade arrangements during the 1990s. The graphs also show that with the exception of a few years in the early 1990s, earmarked taxes have been an important source of revenue throughout the period shown.²⁸

Growth Objectives and Tax Enforcement

In the setting of tax policy objectives in Korea, growth has come before redistribution. Generous savings and investment incentives were provided to promote domestic capital formation. Raising revenue to finance public infrastructure and education was another central concern of tax policy. In contrast, the fiscal system has played a very limited role in income redistribution. As shown in Table 6.6, the effects of the tax-transfer system on income distribution are weak in Korea; its implementation reduced the Gini coefficient only moderately, which is in sharp contrast to the experiences in the other countries shown. The redistributive role of the transfer scheme is especially weak in Korea reflecting the lack of a strong safety net that is observed in rich countries. Table 6.6 also shows that income inequality before taxes and transfers is very low in Korea relative to other countries in the sample, although it has increased significantly since the financial crisis.²⁹

Table 6.6. Redistribution in Korea and Selected Developed Countries

Country	Gini coefficients			Reduction in Gini (in percent)	
	Market income	After transfers	After taxes and transfers	Overall (C-A)/(A)	From transfers alone

	e (A)	(B)	(C)		(B-A)/(A)
Korea					
1995	0.244	0.242	0.233	4.5	0.4
1998	0.314	0.311	0.303	3.5	0.8
2003	0.282	0.277	0.266	5.7	1.5
United States, 1999	0.513	0.457	0.433	15.6	10.9
United Kingdom, 2001-02	0.530	0.390	0.360	32.1	26.4
Japan, 1996	0.441	0.372	0.361	18.4	15.7
Canada, 2001	0.431	0.359	0.320	25.8	16.7

Source: Sung, Mung-Jae et al. (2004).

The weak redistributive role of taxation in Korea is largely a reflection of the small scope of the personal income tax as well as the low overall tax burden. Raising revenue of less than 3 percent of GDP, the personal income tax is unlikely to have a meaningful effect on income distribution, even though its progressivity appears to be in line with the situations in developed countries. The distributional consequences of consumption taxes are probably more important than those of the personal income tax in Korea. Charged at a single 10 percent rate, the VAT might have negative distributional implications. In an attempt to enhance vertical equity, the government has introduced special consumption taxes on luxury goods and applies progressive rate structures to taxation of real property holdings and capital gains. These efforts do not seem to have had a serious impact on distribution, however.³⁰

With regard to the growth objectives of Korean tax policy, the effectiveness of savings and investment incentives has been a source of controversy. As shown in Table 6.7, the ratio of total tax expenditures to actual tax payments in 2003 was 16.3 percent for

the tax items shown.³¹ About 70 percent of total tax expenditures were accounted for by the personal and corporate income taxes, which is a disproportionately high level compared to their revenue share. For these two taxes, tax expenditures amount to 30.9 and 22.9 percent of tax actually paid, respectively.³² A significant portion of the allowances and credits available under the personal and corporate tax systems represents savings and investment incentives, as discussed in the previous section. The question is then whether these incentives have enough impacts on domestic capital formation and technology development to justify their associated revenue and efficiency costs. While evidence on the benefits of these incentives is very sparse and, if anything, unfavorable,³³ their efficiency costs are estimated to be very high, due to distorting behavior and creating arbitrage opportunities.³⁴

Table 6.7. Tax Expenditure by Type of Tax, 2003

	Taxes paid (billions of won) (A)	(%) (B)	Tax expenditures (billions of won) (C)	(%) (D)	(C)/(A)
Direct taxes	47,735	44.4	12,331	70.4	25.8
Personal income tax	20,787	19.3	6,429	36.7	30.9
Corporate income tax	25,633	23.8	5,870	33.5	22.9
Inheritance and gift taxes	1,315	1.2	32	0.2	2.4
Indirect taxes	52,978	49.3	5,056	28.9	9.5
Value added tax	33,447	31.1	3,263	18.6	9.8
Special excise tax	4,733	4.4	268	1.5	5.7
Liquor tax	2,726	2.5	44	0.3	1.6
Transportation tax	10,000	9.3	1,032	5.9	10.3
Security transaction tax	1,606	1.5	403	2.3	25.1
Stamp tax	457	0.4	47	0.3	10.2
Telephone tax	8	0.0		0.0	0.0
Customs duties	6,847	6.4	121	0.7	1.8
Total	107,560	100.0	17,508	100.0	16.3

Source: Ministry of Finance and Economy.

Tax Base Protection

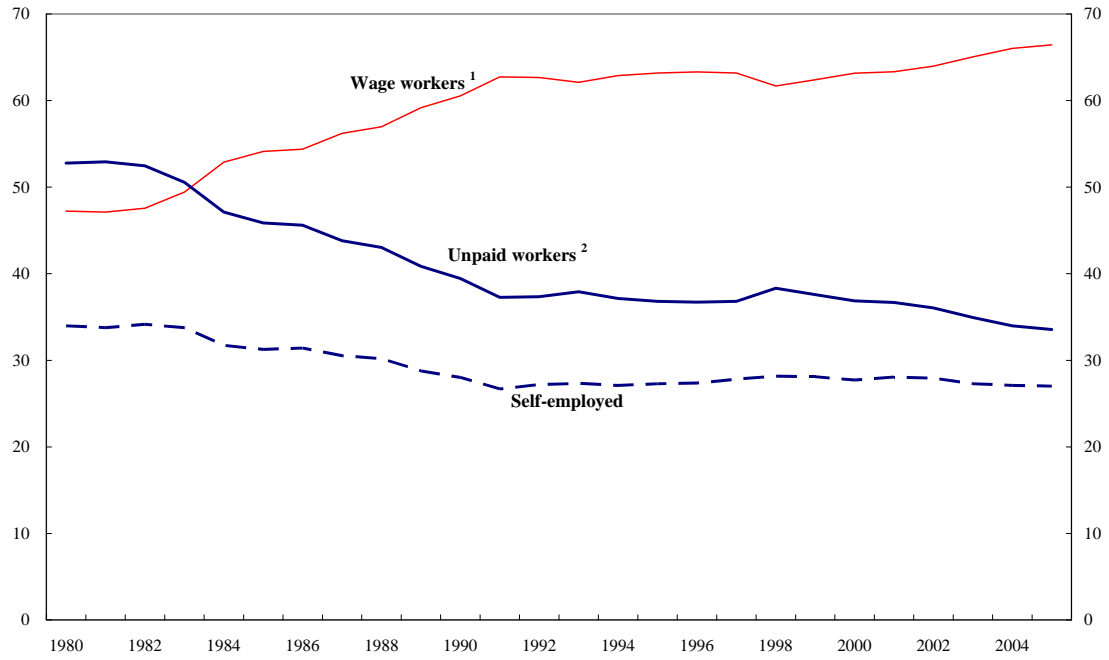
If tax allowances and credits do not sufficiently encourage savings and investment behavior, why then would the government keep these incentives in place despite their implied revenue and efficiency costs? One thought is that some of these tax breaks might have been intended, from the beginning, to have inframarginal impacts for equity purposes. Yet, another possible explanation is that, in the face of enormous evasion pressures, the government might be using these incentives, along with certain nontax benefits, as a means of preventing erosion of the tax base into the informal sector. The government might well perceive these base protection effects to be large enough to justify the associated costs. As a clue, some tax incentives in the personal income tax and the VAT system have been intended to facilitate enforcement itself,³⁵ raising the possibility of a similar line of policy intention prevailing through the whole tax system.

From the early stages of economic development, raising sufficient revenue to finance public infrastructure has been a primary concern of tax policy in Korea. The government's ability to collect taxes, however, depends on the extent of information available to it on the earnings of firms and individuals. It is very unlikely for the government to know exactly the taxable sales and incomes of businesses operating in the informal sector or the cash economy. Tax enforcement hinges critically on use of the financial sector by firms, since cash-only transactions leave no paper trail necessary for the collection and checking of relevant information. The design of a country's tax system is then likely to be influenced by the size of its cash economy, since unobservable transactions are not taxable. Gordon and Li (2005) explore various policy choices for

protecting the government's tax base, given monitoring difficulties with firms operating in the informal sector.³⁶

The size of the informal sector in Korea is non-negligible by international standards. According to Schneider (2004), the estimate for Korea for 2002-03 is 28.8 percent of GDP, a much higher level than in developed countries.³⁷ In particular, informal financial markets (curb markets) have played an important role in investment financing for small businesses, while the state-controlled banks have been more focused on large manufacturing corporations. Graph 6.3 shows the trends in Korea in non-wage workers and the self-employed (including their family workers), as a percentage of total civilian workers.³⁸ This ratio is also very high compared to other countries. At 34 percent in 2004, the self-employment ratio in Korea is the fourth largest among the OECD countries.³⁹ Note that more than half of civilian workers in Korea were self-employed in the early 1980s. The share of self-employment declined significantly during the 1980s and has remained stable since then.

Graph 6.3. The Self-Employed as a Percentage of Total Workers

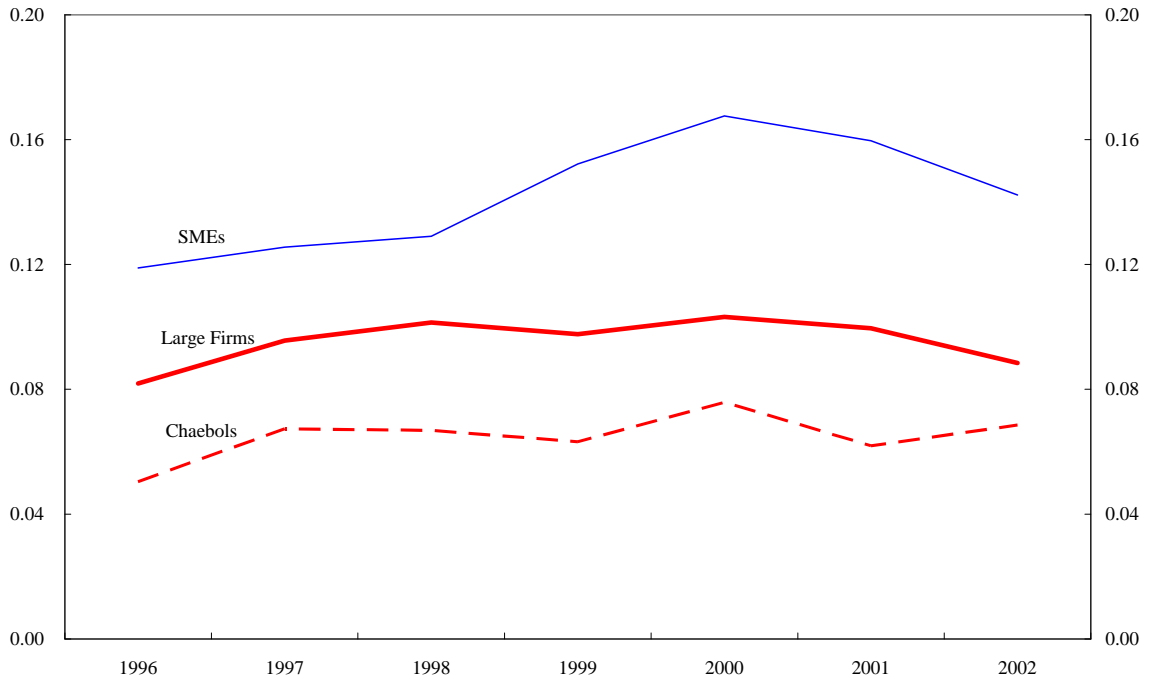


Source: Korea National Statistical Office.

¹Wage workers include regular, temporary and daily workers.

²Unpaid workers include the self-employed and their unpaid family workers.

Graph 6.4. Cash Holdings, by Firm Size¹
(As a percentage of total assets)



Source: Author's calculations using KIS-VALUE firm database.

¹Cash, cash equivalents and short-term financial instruments are included.

²The sample consists of firms registered with the Financial Supervisory Service. An SME is defined as a company with 300 or fewer employees. A *Chaebol* is a large business group whose combined assets exceed a certain limit. The Korea Fair Trade Commission announces the list of *chaebols* each year. Large firms include *chaebol firms*.

Smaller businesses tend to rely more on cash transactions. While evidence on such informal transactions is hard to obtain, Graph 6.4 reveals that smaller firms tend to hold greater amounts of cash relative to their assets.⁴⁰ As a percentage of total assets, cash holdings of small and medium-sized firms have exceeded those of large firms by about 5 percentage points in recent years, with the ratios for the *chaebols*, large business groups in Korea, being even lower. Interestingly, the cash-holding ratios for smaller firms have shown a declining trend in recent years.⁴¹

To sum up, the size of the informal sector and the share of self-employment in Korea are quite high by international standards, and the tendency to hold cash appears to be higher for smaller firms. Considering this, the narrow bases for the personal income tax, the VAT, and the corporate income tax are likely to reflect enforcement problems of the Korean tax system. As noted in the preceding section, generous tax breaks in the personal income tax system are often justified by a need to subsidize wage and salary workers vis-à-vis the self-employed and the owners of financial capital who are taxed relatively lightly. The low effective taxation of the self-employed and capital income in large part reflects enforcement difficulties.

Personal Income Tax

The business incomes of the self-employed do not receive preferential treatment as do wages and salaries, but statutory loopholes and a weak bookkeeping culture, along with a limited auditing capacity, lead to a very low level of compliance. To alleviate the burdens of bookkeeping for small businesses, the government allows those within certain turnover limits to use an estimation method for their tax calculation, which typically reduces their effective tax burdens. Accordingly, the self-employed have a very strong incentive to underreport their turnover, which also leads to underreporting of taxable income at the personal level.

The moderate taxation of financial income also reflects difficulties in gathering information for tax enforcement. Before the introduction of the real name system for ownership of financial assets in 1993, it was practically impossible to subject financial

income to global taxation. Interest, dividends, and capital gains were either exempt or subject to final withholding taxes at varying rates. Since 1997, individual interest and dividends combining to exceed 40 million won have been taxable under the global income tax system.⁴² Nonetheless, the withholding nature of capital income taxation is very much alive, as the first 40 million won of dividends and interest is still subject to a final withholding rate.⁴³ In addition, capital gains on securities and real property are subject to separate scheduler taxation.⁴⁴

Table 6.8 shows the mix of the personal income tax revenue in 2003. Taxes on wage and salary income are mostly withheld at their sources and account for about 40 percent of total personal taxes.⁴⁵ The revenue share for taxable dividends and interest income which are subject to final withholding is 16.2 percent, bringing the proportion of personal income tax payment through withholding to 56.4 percent. Capital gains on securities and real property, which are either exempt or subject to separate scheduler taxation, account for another 14 percent of personal income taxes.⁴⁶ Personal income that is not subject to scheduler taxation is to be taxed under the global taxation scheme.⁴⁷ Since the amount of dividends and interest that are taxed as global income is estimated to be small, the main component of “global income” is the taxes paid on self-employed income.

Table 6.8. Personal Income Tax, 2003

	Trillions of won	% of GDP	% of PIT
Personal income tax	20.8	2.9	100.0
Wage and salary income (withholding)	8.4	1.2	40.2

Global income (tax returns)	4.2	0.6	20.4
Dividend and interest income (withholding)	3.4	0.5	16.2
Capital gains (tax returns) ¹	2.9	0.4	13.9
Other income ²	1.9	0.3	9.2

Source: Ministry of Finance and Economy.

¹Gains on real property were 2.5 trillion won (0.34 percent of GDP). The rest is gains from share transactions.

²Withheld parts of business and retirement income, timber income, etc.

The narrow base of the personal income tax is shown in the distribution of tax payments across taxpayer groups. As Table 6.9 indicates, 45.8 percent of wage and salary earners did not pay taxes at all in 2003, mainly owing to the generous allowances and credits available under the system.⁴⁸ Among actual taxpayers, the upper 10 percent account for about half of total taxes paid. With the next decile group added, about three-quarters of taxes on wages and salaries are paid by the richest 20 percent of taxpayers. As for the global income tax, which requires filing a tax return, about half of eligible taxpayers are under the threshold point. Among those who owe taxes on their business income, about one-half use the estimation method instead of accounting to derive their taxable income. As noted earlier, this method is very likely to lead to underestimations of true tax liability. By deciles, the highest 10 percent of taxpayers account for 78 percent (the top 20 percent almost 90 percent) of global income taxes. This is a higher degree of concentration than for employees and means that the tax base is narrower for business income than for wage income.

Table 6.9. Distribution of Personal Income Tax by Taxpayer Type, 2003

	Taxpayers	Taxes paid
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	(thousands)	(%)	(%)
Wages and salaries tax (withholding)	11,547	100.0	
Under-threshold	5,289	45.8	
Paying taxes	6,258	54.2	100.0
Top 10%			56.6
Next 10%			17.9
Global income taxes (tax returns)	4,227	100.0	
Under-threshold ¹	2,112	50.0	
Paying taxes	2,115	50.0	100.0
Bookkeeping	1,018	24.1	69.8
Income estimation	1,096	25.9	30.2
	2,115	100.0	100.0
Top 10%			78.3
Next 10%			10.6

Sources: National Tax Service (2004), *Statistical Yearbook of National Tax*, and author's calculations.

¹Also includes those who do not file tax returns, the number of which are estimated by the National Tax Service using business-registration information.

Value Added Tax

With regard to the VAT, special arrangements for small businesses as well as generous exemptions and a zero-rating policy have been major causes of base erosion. Small businesses in the simplified scheme receive tax subsidies in two forms. First, the value-added ratios prescribed in the law have typically been lower than the actual values (Table 6.10), implying tax benefits. Second, these small firms are allowed to claim a partial input tax credit⁴⁹ while paying taxes on value added, not turnover.⁵⁰

In addition, the simplified scheme provides opportunities to evade taxes. Since there is no invoicing obligation, firms in this scheme can easily underreport their turnovers. Even general taxpayers will have opportunities to evade taxes on the parts of their turnovers supplied to firms in the simplified scheme. In the presence of generous tax benefits, firms that are not eligible for this scheme may also have strong incentives to

push their reported turnovers under the threshold. Moreover, this base erosion of the VAT can also lead to personal tax evasion, since turnover reporting is closely linked to income reporting by the self-employed.

Table 6.10. The Value-Added Ratio for the Simplified Scheme,¹ 2004

	Prescribed ratios for the simplified scheme (A)	Actual ratios for general taxpayers² (B)	(A)-(B)
Agriculture, hunting, forestry, and fishing	30	34.9	-4.9
Manufacturing	20	23.6	-3.6
Electricity, gas and water	20	18.5	1.5
Retail sales	20	19.3	0.7
Construction	30	29.7	0.3
Restaurants	40	50.6	-10.6
Hotels	40	30.8	9.2
Transportation, storage, and communication	40	54.2	-14.2
Agent, intermediary, and contract	30	43.0	-13.0
Other services	30	38.1	-8.1
Total	-	24.7	-

Sources: National Tax Service (2005), *Statistical Yearbook of National Tax*; Ministry of Finance and Economy; and author's calculations.

¹Value-added ratio = (turnover-inputs)/turnover*100

²These ratios are for the first half of 2004.

³Businesses in mining, wholesale, and real estate dealing are not eligible for participation in the simplified scheme.

Table 6.11 shows that the current VAT system collects very little from those businesses in the simplified scheme (0.3 percent in 2003), while the number of taxpayers who use this scheme or are exempt approaches half of the total. Among general taxpayers, the share for corporations is more than four times that for the self-employed. According to a more detailed breakdown not shown here,⁵¹ the top 10 percent of firms subject to the general scheme account for about 80 percent of total taxes paid for this group.

Table 6.11. Value-Added Tax by Taxpayer Type, 2003

	Taxpayers (thousands)	(%)	Taxes paid (billions of won)	(%)
General	2,221	55.6	33,246	99.7
Corporations	359	9.0	27,303	81.9
Individuals	1,862	46.6	5,943	17.8
Simplified + Exemptions	1,774	44.4	103	0.3
Total	3,995	100.0	33,349	100.0

Source: National Tax Service (2004), *Statistical Yearbook of National Tax*.

Although the simplified scheme does not contribute much to tax revenue, tax relief implicit in the system might reflect a fine balance the government must maintain between the need to bring as many small businesses as possible into the formal sector and the ease with which these firms can disguise their turnover in the prevalent culture of cash transactions and weak bookkeeping. Since the extent of cash transactions is large for small businesses, it is difficult to gather adequate information about their true tax liabilities. A strong enforcement effort in this case would push these businesses further into the informal sector, aggravating the information problem.

Corporate Income Tax

The importance of the corporate income tax has been increasing steadily in Korea, and it has brought in more revenue than the personal income tax in recent years. Its revenue as a fraction of GDP is around 4 percent, an impressive level considering the moderate marginal tax rates and widespread allowances and credits. The relatively high compliance

among large conglomerates might be a reason why there is less base erosion here than in the case with the personal income tax. As shown in Table 6.12, a surprisingly small number of firms at the top pay the majority of corporate taxes. Only 185 firms or 0.06 percent of the total account for 60.8 percent of all corporate taxes. An additional 14 percent of revenue comes from the next 650 firms, so that about three-quarters of corporate tax revenues are accounted for by 835 firms, or 0.27 percent of the total. On the other hand, a tiny portion of corporate taxes come from the corporations in the lower bracket.

Table 6.12. Distribution of Corporate Income Tax by Tax Base Size, 2003

Tax base (millions of won)	Taxpayers (number of firms)	(%)	Taxes paid¹ (billions of won)	(%)
Low bracket (15%)	259,079	85.37	514	2.30
Deficit	102,387	33.74	4	0.02
0 - 10	70,913	23.37	29	0.13
10 - 100	85,779	28.27	481	2.15
High bracket (27%)	44,383	14.63	21,832	97.70
100 - 1000	37,927	12.50	1,796	8.04
1000 - 10,000	5,621	1.85	3,323	14.87
10,000 - 50,000	650	0.21	3,126	13.99
50,000+	185	0.06	13,587	60.80
Total	303,462	100.00	22,346	100.00

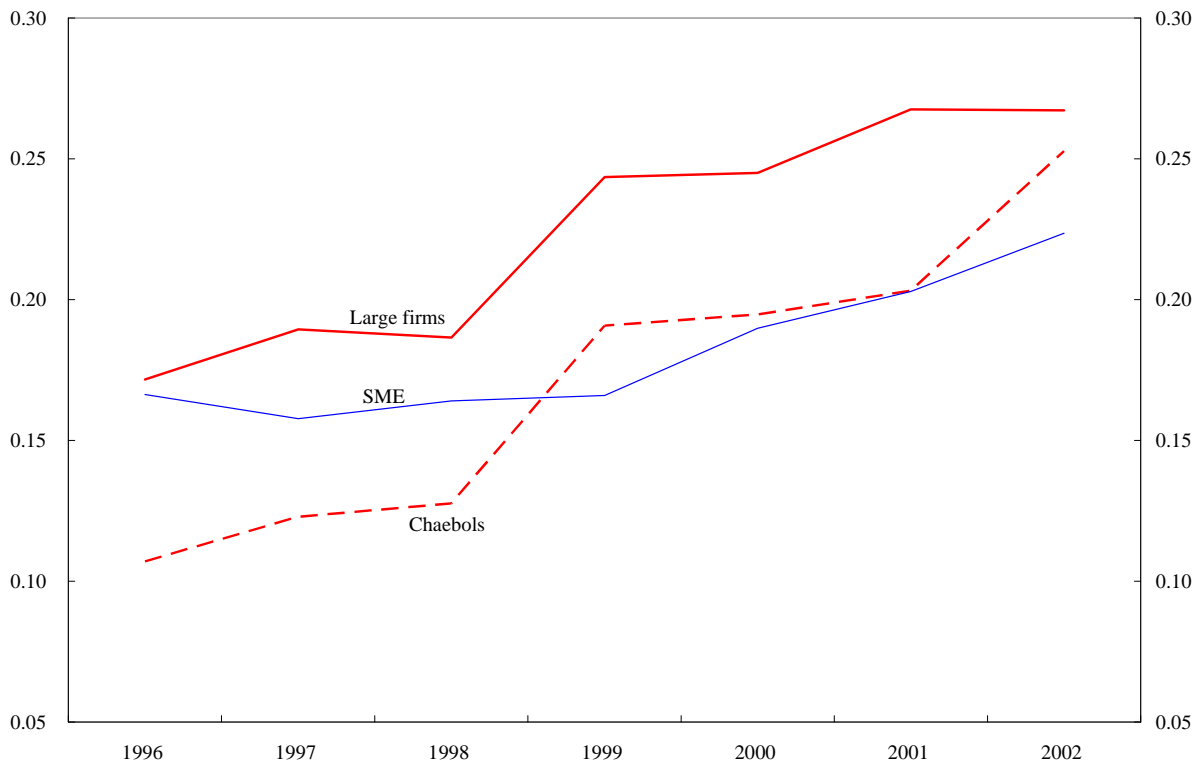
Source: National Tax Service (2004), *Statistical Yearbook of National Tax*.

¹These figures are based on tax returns, so differ slightly from final payment, as reported in Table 3.

This high concentration of corporate taxable income among a small number of large firms may be a combined effect of high concentration of economic activities among these firms and their relatively high compliance. Unlike small businesses, large firms find it very difficult to bypass services of financial institutions. As shown in Graph 6.4, larger

firms in Korea tend to hold less cash relative to their assets than do smaller firms in Korea. To the extent that larger firms are more dependent on the financial sector, their profits are more likely to be exposed to tax authorities through financial transaction records. To the extent that the benefit from use of the financial sector is greater than the resulting tax liabilities, the firm will stay in the formal taxed sector. This implies higher effective tax rates for large and capital intensive firms, which presumably receive greater benefits from financial transactions.⁵²

Graph 6.5. Corporate Tax Paid
(As a Percentage of Operating Surplus)



Source: Author's calculations using KIS-VALUE firm database.

As shown in Graph 6.5, the effective corporate tax burden is greater for large firms than for small and medium-sized companies in Korea, a result predicted in the

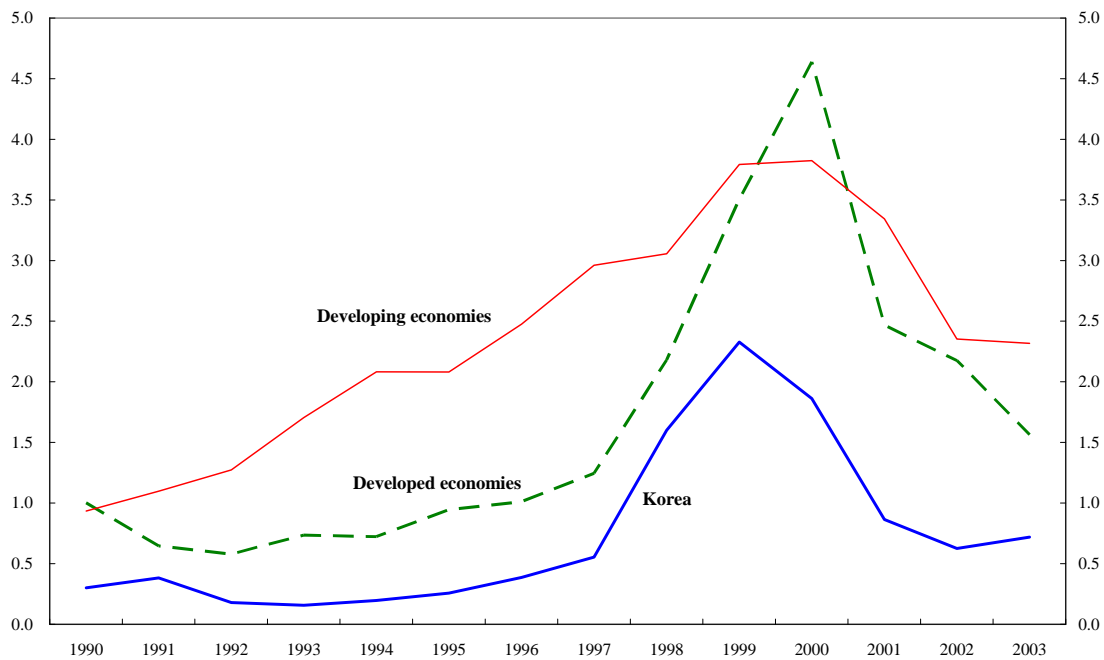
above discussion.⁵³ Surprisingly, the effective tax rates for large conglomerates classified as *chaebols* are lower than those for other large firms. Since economic activities are highly concentrated among these top manufacturing firms, however, their revenue shares could still be high, as suggested in Table 6.12. Their relatively low effective tax rates are likely due to the following factors. First, these firms are highly capital-intensive and export-oriented, so they usually benefit more from generous investment incentives as well as export subsidies.⁵⁴ Second, they are typically more leveraged than other large firms, and thus reap more tax benefits from interest deductions. This is because directed loans from state-owned or controlled banks with explicit and implicit loan-guarantees⁵⁵ as well as the practice of cross-guaranteeing loans among *chaebol* affiliates have made bankruptcy risks associated with debt financing very low.

These tax and nontax benefits from the government and the state-controlled banks seem to have played a critical role in protecting the corporate tax base, since firms have had to remain in the formal sector and use banks to receive such benefits. While these subsidies lead to some revenue and efficiency costs, the government also gains in part from the extra revenue on new investment induced by investment incentives or subsidized loans and in part by keeping marginal firms from disappearing into the informal sector. This prediction appears to fit well with the experience in Korea.

The Korean government has not been as enthusiastic in inviting multinationals into the country as have other developing countries. As shown in Graph 6.6, foreign direct investment as a percentage of GDP has been much lower in Korea than in most other countries. Foreign capital has instead been typically imported in the form of loans, which were in the past redirected through state-controlled banks to domestic firms. What

triggered this avoidance of direct foreign ownership of local firms is not clear, but it might have helped to protect tax revenue, since multinationals typically pay lower effective tax rate through income-shifting activities across borders.

Graph 6.6. FDI Inflows, 1990-2003
(As a percentage of GDP)



Source: UN, *Comtrade Database*.

Actual corporate taxes paid by large manufacturing firms might not fully reflect the benefit of protecting these firms. There are two additional aspects in which protection of the corporate tax base might have contributed to the total tax receipts. First, there are a wide variety of so-called quasi-taxes consisting of fees, charges and contributions, most of which are imposed on corporations. The revenues from these highly discretionary sources, estimated at 1.3 percent of GDP (Son et al. 2004), are used mainly to finance

off-budget expenditures. Second, quite a significant amount of taxes is collected from the financial sector (Table 6.13), which could be an implicit burden on firms using bank services. The corporate tax share for the financial firms reaches almost half of that for the manufacturing, and taxes on financial services are non-negligible. These taxes could be shifted in the form of higher financial charges. Since major Korean manufacturing firms used to rely heavily on bank loans for capital financing, they might have paid higher charges in reflection of the taxes on banks.

Table 6.13. Taxation of the Financial Sector, 2003

	Financial (A)	Manufacturing (B)	(A)+(B)	All industries
Corporate income tax				
Billions of won	4,228	8,669	12,897	22,346
% of corporate income tax	18.9	38.8	57.7	100.0
% of GDP	0.6	1.2	1.8	3.1

	Billions of won	% of GDP
Taxes on Financial Services		
Education tax	515	0.07
Security transaction tax	1,607	0.22
Special tax for rural development	708	0.10
Total	2,830	0.39

Sources: National Tax Service (2004), *Statistical Yearbook of National Tax*; OECD (2005), *Revenue Statistics 1965-2004*; and author's calculations.

¹The education tax is levied on financial institutions at 0.5 percent of gross receipts.

²The securities transaction tax (0.15 percent and up) and a special tax for rural development (0.15 percent) are levied on the value of securities transactions.

Changes after the Financial Crisis

After the outbreak of the financial crisis, the most immediate concern of tax policy was to alleviate the adverse effects from the crisis and to promote structural adjustments. The government introduced various tax measures to boost economic activity, mitigate adverse distributional consequences, facilitate restructuring of the corporate and financial sectors, and encourage foreign direct investment and capital inflows.

Wage and salary earners received tax relief in the form of increased deductions and a cut in the marginal tax rates.⁵⁶ The tax burden on the self-employed was reduced by introduction of a tax credit for formal bookkeeping and expanding the allowances for credit card sales. Global taxation of capital income was suspended in 1999 and 2000 to prevent negative impacts on the financial markets,⁵⁷ and the personal capital gains tax rate were reduced to boost the real estate market. To encourage private consumption, special consumption taxes have been reduced or eliminated.⁵⁸ To stimulate investment, tax incentives were provided to small and medium-sized enterprises, including tax exemptions on capital gains and stock options in venture capital businesses. Temporary investment tax credits were reinstated, and eligibility for them was expanded. In an effort to promote inflows of foreign investment, tax preferences were introduced and expanded.⁵⁹ With regard to restructuring, the focus of changes in the tax code was on reducing the costs of asset and equity transactions and debt payments.⁶⁰ Tax relief was also provided for financial sector restructuring.⁶¹

While these tax changes were mostly focused on short-term policy objectives, changes in the economic structure triggered longer-run and probably much more important impacts of the crisis on the level and structure of tax revenue. There are three particular cases in point. First, the capital structures for most Korean firms changed

dramatically in a few years after the crisis, with the debt-equity ratios of large manufacturing corporations dropping from around 500 percent before the crisis to below 200 percent in the early 2000s. This change had an immediate impact on the effective tax rates as depicted in Graph 6.5,⁶² leading to a sharp increase in revenue from the corporate income tax after the crisis (Graphs 6.1 and 6.2). The long-run implications for tax revenue of this change in the corporate capital structure are unclear, however. The elimination of preferential treatment for debt-financing means such as cross-guaranteeing and directed loans will possibly have negative consequences on corporate tax revenue, since new investment and production could be curtailed unless firms can obtain adequate equity financing.

Second, financial sector restructuring can have strong implications for the scope of the informal sector by facilitating use of banks among small businesses. As the function of the financial sector improves, the benefits that firms receive from using this sector will increase. Indeed, the financial sector in Korea has undergone drastic structural changes, resulting in more market-based operations and a sharp increase in foreign ownership. In particular, competition and advanced techniques from foreign-owned banks will not only increase the overall profitability of the Korean financial sector, but also provide more value added to businesses. To the extent that these changes improve financial intermediation among existing users of the financial sector and pull businesses that used to rely on cash transactions or the curb markets into the formal sector, the government can collect more revenue.

Lastly, restrictions on the inflow of foreign capital were substantially reduced, making Korean markets more open. The revenue implications of increased foreign

ownership of local assets and firms are unclear. A more open economy will expand business opportunities and taxable profits accordingly. At the same time, however, the scope for tax evasion and avoidance will increase, since transactions through foreign financial intermediaries are not easily observable. In addition, multinationals can shift profits among their affiliates by manipulating transfer pricing, and thus report smaller domestic taxable incomes.

The above-mentioned changes in the Korean economic structure have conflicting implications for tax enforcement, and their long-run revenue impacts are uncertain. A better functioning financial sector will likely lead to a reduction in size of the informal sector, whereas a more open economy will lead to increased opportunities for tax avoidance. Nonetheless, these structural changes have had a clear impact on the focus of tax enforcement and the structure of tax revenue. In the aftermath of the crisis, the government implemented several measures to enhance tax compliance, with a particular attention given to the self-employed sector.

In 1999, an incentive for use of credit cards was introduced, under which taxpayers became able to deduct parts of their credit card usage in excess of a threshold, up to a certain limit.⁶³ A similar incentive was available for sales by the self-employed paid by credit cards.⁶⁴ These incentives for credit card usage appear to have had an important role in increasing the fraction of consumption expenditures paid for by credit cards, as shown in Table 6.14. Between 1999 and 2002, this ratio increased about three times. Boosted by this success, the government introduced a similar incentive for cash transactions based upon receipts in 2005.⁶⁵ Apart from such incentive measures, the government also reduced the scope of the simplified scheme under the VAT in 2000 by

lowering the turnover limit from 150 to 48 million won.⁶⁶ In addition, a number of administrative changes were made in an effort to improve taxpayer service and the function of the National Tax Service.⁶⁷

Table 6.14. Private Consumption Expenditures Attributable to Credit Card Usage
(Trillions of won, %)

	Credit card usage (A)	Private consumption expenditures (B)	(A)/(B)
1990	5.3	93.5	5.7
1994	18.9	176.0	10.7
1998	30.8	250.3	12.3
1999	42.6	274.9	15.5
2000	79.5	312.3	25.5
2001	135.3	343.4	39.4
2002	174.0	381.1	45.6
2003	170.5	389.1	43.8
2004	167.0	401.5	41.6

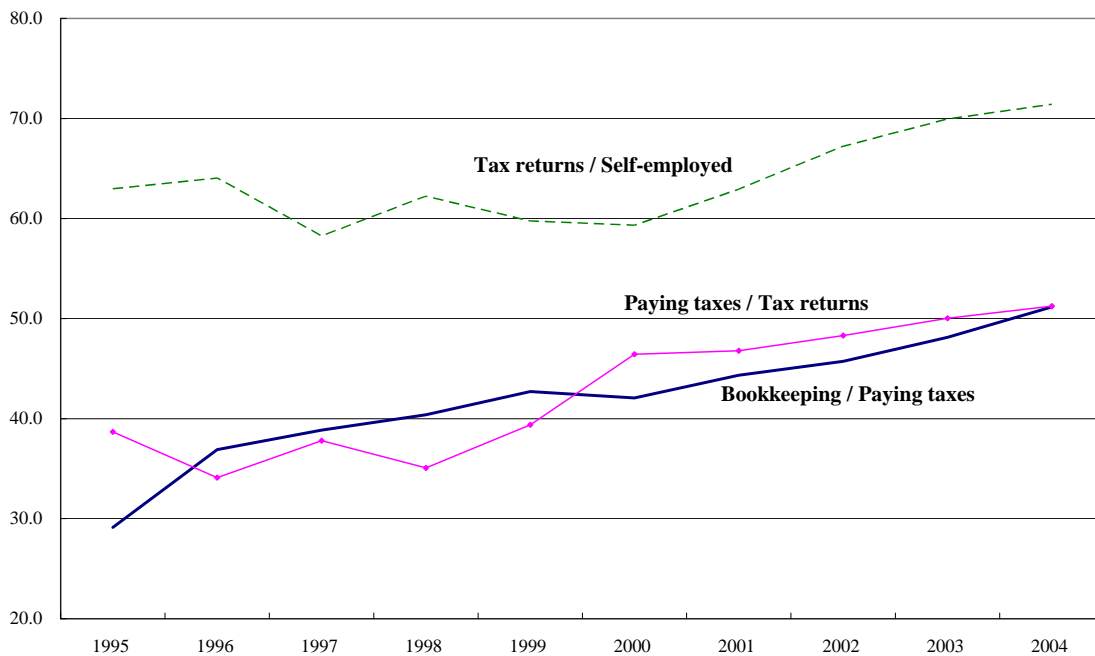
Sources: National Tax Service.

One particular point to note is that the effectiveness of these policy changes in broadening the tax base is very likely to be linked to the quality of tax information, which appears to have improved significantly as a result of the structural changes discussed above. The credit card incentives were unlikely to be effective unless retailers and buyers found the benefits of using credit cards per se to be small. More usage of credit card could lead to better-termed bank loans, for example.⁶⁸ The scaling back of the simplified scheme for the self-employed and small firms could have pushed some taxpayers into the informal sector, rather than increasing their taxable income. While the administrative changes were desirable steps in reducing administrative and compliance costs, a more fundamental issue regarding enforcement is the availability of information, as stressed in

this paper. The self-assessment scheme, for example, will be of little value unless taxpayer information is adequately available.

The suggestion that the financial sector improvement may have led to a reduction in informal activity is speculative at this point. Nonetheless, there are some descriptive pieces of evidence in favor of such an argument. Graph 6.7 shows that the number of the self-employed filing tax returns, paying taxes, and doing bookkeeping have all increased relative to their respective populations since the financial crisis. We also noted in Graph 6.4 that the ratios of cash-holding to assets for smaller firms have been declining in recent years. A more rigorous statistical investigation will be a necessary next step.

Graph 6.7. Changes in Tax Compliance for the Self-Employed¹

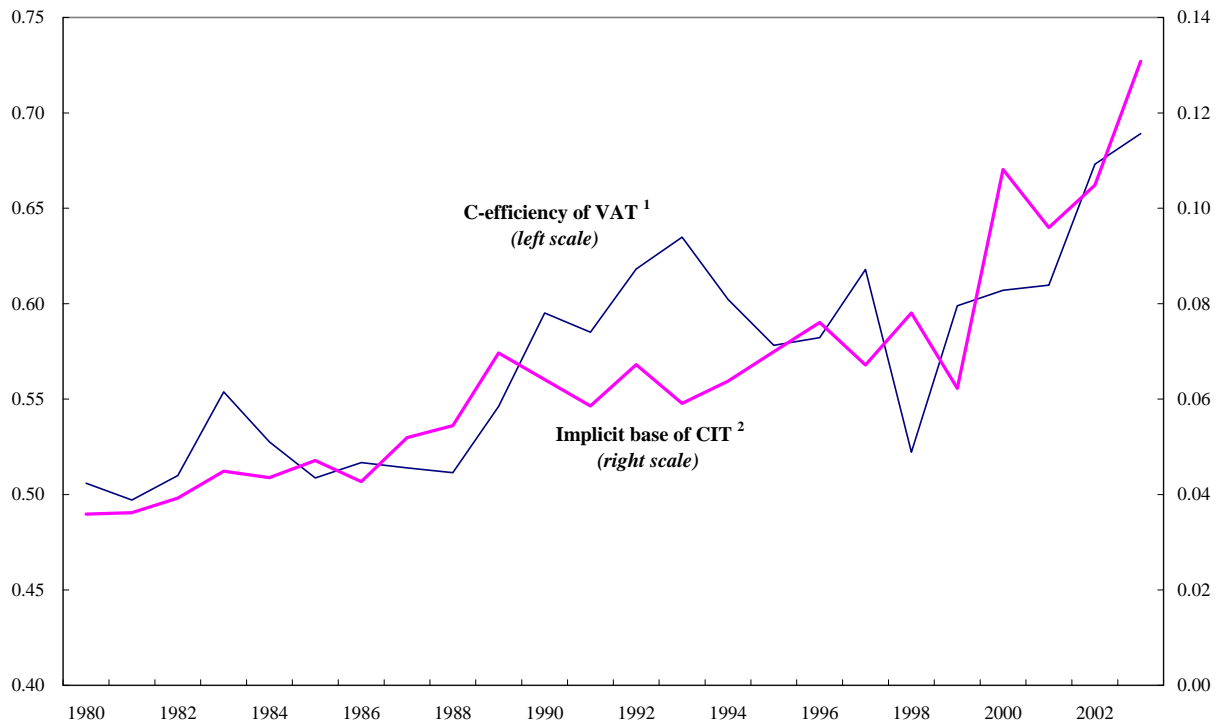


Sources: National Tax Service; Korea National Statistical Office.

¹The terms used here are explained in Table 6.9.

In summary, the increase in the level of tax revenue as a percentage of GDP (Table 6.1) and the sharp change in revenue structure since the financial crisis (Graphs 6.1 and 6.2) reflect changes in both the tax rates and bases. Structural changes in the corporate and financial sectors appear to have had base-broadening effects by reducing interest deduction for most corporations and encouraging use of the financial sector instead of cash transactions for the self-employed and small firms. As shown in Graph 6.8, the ratio of the VAT base to private consumption and the ratio of the corporate tax base to GDP have both increased sharply since the financial crisis. The improvement of financial services may also have increased the effectiveness of policy measures aimed at enhancing compliance, such as the deduction for credit card usage, by making more businesses sensitive to marginal incentives available in the financial sector.

Graph 6.8. Efficiency Ratios, Korea, 1980-2003



Sources: The Bank of Korea, *National Accounts*; National Tax Service, *Statistical Yearbook of National Tax*; and author's calculations.

¹VAT revenue / (tax rate * private consumption)

²Corporate tax revenue / (top marginal tax rate * GDP)

Conclusion

Over the past several decades, Korea's tax policy has been focused on protecting the revenue base to finance economic growth, in the face of significant enforcement problems. With a non-negligible size of the informal sector and a weak bookkeeping culture, the government had to focus on a small number of large corporations in collecting revenue. A wide range of tax and non-tax subsidies were provided to protect businesses from disappearing into the informal sector. Many of the tax incentives in place might have been more effective in mitigating enforcement problems than in promoting the targeted activities.

To the extent that this base-protection effect has been significant, the revenue and efficiency costs associated with these tax preferences in most tax debates appear to be overstated. Statutory loopholes and lenient enforcement, which have been criticized as sources of inefficiency and tax evasion, often reflect a rational response by the government caught between evasion pressures and base-broadening needs. The proportional taxation of capital income and the simplified scheme for taxation of the self-employed are representative cases in point. The government has also had to adopt some unconventional means of raising revenue, such as earmarked taxes and surcharges.

All of these factors have made the tax revenue structure in Korea quite different from what is observed in developed countries. The personal income tax is of relatively minor importance in Korea, and the bases for the corporate and VAT are quite narrow. Earmarked taxes and property transaction taxes both account for significant shares of total tax revenue. Unless these underlying factors change greatly, a drastic reshaping of the tax structure is unlikely to be either feasible or desirable. A shift to the more conventional tax policies observed among developed countries could possibly generate more revenue and efficiency costs than theories suggest.

The financial crisis in Korea provides an interesting case study of how tax design can be affected by a change in the economic structure. In the aftermath of the crisis, the Korean corporate and financial sectors underwent drastic restructuring, and the economy was made more open. These structural changes led to a lower-leveraged capital structure for most corporations and a more open and better-functioning financial sector. To the extent that businesses come to receive more benefits from using the financial sector, the relative size of the informal sector will shrink. Indeed, the base for the VAT, the most

important source of revenue, appears to have been improving in the years since the crisis. The long-run revenue implications of these changes are inconclusive, however. A reduction in debt financing may lead to declines in new investment and production. In addition, an increase in capital mobility will lead to more opportunities for tax avoidance.

Considering the potential costs of re-unification and the soaring welfare expenditures stemming from the rapid aging of the Korean population and the maturing of public pensions, the top priority for taxation is to expand the revenue base in an efficient and equitable manner. For base-broadening, conventional prescriptions include the elimination of “unnecessary” deductions and exemptions in the personal income, corporate income, and VAT systems.⁶⁹ Reducing the scope of earmarked and transaction taxes is also a favorite menu item, with various inefficiencies associated with these taxes being cited. As emphasized in this paper, however, some of these instruments play a role in protecting the tax base from erosion into the informal sector, and this offsets their revenue and efficiency costs. Probably a more useful and urgent task is to create an environment in which tax information is more readily available. Further reform of the financial sector as well as more efficient sharing of information among government agencies will be a step in the right direction. Financial incentives for compliance and administrative changes toward self-assessment will also likely be more effective when taxpayers find it useful to remain in the formal sector.

Appendix

Table A.1. Tax Revenue by Type of Tax, 1980 and 2003

	1980			2003		
	Billions of won	% of GDP	% of total	Billions of won	% of GDP	% of total
Total tax revenue	6,687	17.2	100.0	183,667	25.3	100.0
Individual income	766	2.0	11.5	23,245	3.2	12.7
Personal income tax	661	1.7	9.9	20,787	2.9	11.3
Surtax on personal income tax ¹	105	0.3	1.6	2,457	0.3	1.3
Corporate income	738	1.9	11.0	28,149	3.9	15.3
Corporate income tax	485	1.3	7.3	25,633	3.5	14.0
Surtax on corporate income tax ¹	253	0.7	3.8	2,516	0.3	1.4
Consumption	3,119	8.0	46.6	63,247	8.7	34.4
Value added tax	1,471	3.8	22.0	33,447	4.6	18.2
Excise tax	1,500	3.9	22.4	23,791	3.3	13.0
Special excise tax	583	1.5	8.7	4,733	0.7	2.6
Liquor tax ²	298	0.8	4.5	2,734	0.4	1.5
Tobacco consumption tax (local) ³	0.0	0.0	0.0	2,384	0.3	1.3
Leisure tax	0.0	0.0	0.0	896	0.1	0.5
Transportation tax ⁴	0.0	0.0	0.0	10,001	1.4	5.4
Securities transaction tax	0.0	0.0	0.0	1,607	0.2	0.9
Special tax for rural development on security transactions ⁵	0.0	0.0	0.0	708	0.1	0.4
Education tax for financial institutions ⁶	0.0	0.0	0.0	515	0.1	0.3
Other ⁷	619	1.6	9.3	1,109	0.2	0.6
Surtax on excise taxes ⁸	148	0.4	2.2	213	0.0	0.1
Property	594	1.5	8.9	23,443	3.2	12.8
Taxes on transactions	295	0.8	4.4	14,368	2.0	7.8
Registration tax (local)	122	0.3	1.8	7,550	1.0	4.1
Acquisition tax (local)	163	0.4	2.4	5,503	0.8	3.0
Inheritance and gift taxes	10	0.0	0.1	1,315	0.2	0.7
Surtax on transaction taxes ⁹	0	0.0	0.0	1,704	0.2	0.9
Taxes on wealth holding	296	0.8	4.4	6,255	0.9	3.4
Property tax (local)	119	0.3	1.8	903	0.1	0.5
Tax on aggregate land holdings (local) ¹⁰	0.0	0.0	0.0	1,603	0.2	0.9
Automobile tax (local)	57	0.1	0.9	1,778	0.2	1.0
Other ¹¹	120	0.3	1.8	1,971	0.3	1.1
Surtax on wealth taxes ¹²	2	0.0	0.0	1,116	0.2	0.6
Customs duties	1,014	2.6	15.2	7,174	1.0	3.9
Customs duties	762	2.0	11.4	6,847	0.9	3.7
Other ¹³	252	0.6	3.8	327	0.0	0.2

Social security and payroll	107	0.3	1.6	36,291	5.0	19.8
Social security contributions ¹⁴	73	0.2	1.1	35,870	4.9	19.5
Taxes on payroll and workforce (local) ¹⁵	34	0.1	0.5	421	0.1	0.2
Other ¹⁶	349	0.9	5.2	2,116	0.3	1.2
<i>Memorandum items</i>						
Taxes on financial services ¹⁷	n/a	n/a	n/a	7,058	1.0	3.8
Surtax	873	2.3	13.1	14,157	2.0	7.7
Earmarked taxes ¹⁸	856	2.2	12.8	22,322	3.1	12.2
GDP	38,775			724,675		

Sources: National Tax Service (1981, 2004), *Statistical Yearbook of National Tax*; OECD (2005), *Revenue Statistics 1965-2004*; and author's calculations.

¹Defense tax as a surcharge on income tax and the exemption of income tax (repealed in 1990); resident tax on income tax; special tax for rural development on the exemptions of income tax (since 1994).

²Fully earmarked for local spending.

³Forty five percent of tax revenue earmarked for local education.

⁴Earmarked: 85.8% for transportation facilities; 14.2% for local spending (environment from 2005).

⁵In addition to securities transaction tax, special tax for rural development is levied on special excise tax, and as a surcharge on the exemptions of corporate income tax, personal income tax, customs duties.

⁶0.5% of gross receipts of financial institutions. Education tax is also levied as a surcharge on special excise tax, transportation tax and liquor tax.

⁷Monopoly profit (repealed in 1988), telephone tax (repealed in 2001; earmarked for local spending), defense tax, leisure tax, butchery tax, license tax, and regional development tax.

⁸Defense tax, special tax for rural development, education tax, motor fuel tax as a surcharge on transportation tax, and local education tax as a surcharge on tobacco consumption tax and leisure tax (since 2001).

⁹Special tax for rural development as a surcharge on acquisition tax and the exemption of registration tax and acquisition tax; local education tax as a surcharge on registration tax

¹⁰Replaced by comprehensive real estate holding tax since 2005.

¹¹Urban planning tax, community facilities tax, stamp tax, revaluation tax (repealed in 2000), and business place tax (since 1990).

¹²Defense tax as a surcharge on inheritance and gift taxes; special tax for rural development as a surcharge on tax on aggregate land holdings; local education tax as a surcharge on tax on aggregate land holdings, property tax, and automobile tax.

¹³Education tax as a surcharge on special excise tax on imported goods; special tax for rural development as a surcharge on the exemption of customs duties.

¹⁴National welfare pension fund, unemployment insurance, health insurance, teachers' pensions, government employees pensions (employees), military personal pensions(employees), and industry workers' insurance fund (employers).

¹⁵Business place tax on income (0.5% of wages and salaries).

¹⁶Taxes on previous year base.

Notes

¹ The tax burden in Korea is close to that in the U.S., much lower than that in Sweden, and higher than that in Mexico.

² The respective ratios were 15.1 and 30.3 percent in 1975, when Korea's tax burden was much lower than even that of the U.S.

³ The OECD average for personal income and corporate income tax shares are about 24.9 and 9.3 percent, respectively, according to the OECD Revenue Statistics Database. The corresponding figures for the U.S. are 35.3 and 8.1 percent.

⁴ The average share for property taxes in OECD is about 5.6 percent, and the share for the U.S. is about 12.1 percent.

⁵ This had been true at least until the late 1990s when the corporate sector restructuring took place in the wake of the financial crisis.

⁶ For most minority shareholders, capital gains from stock transactions are tax-exempt.

⁷ In 1996, these two categories together accounted for 43.4 percent of the expenditures of the consolidated central government (26.2 and 17.2 percent, each). The shares for welfare and defense spending are 19.3 and 24.3 percent, respectively. The spending mix has not changed much after the financial crisis while the share for welfare spending began to rise (20.2 percent in 2003).

⁸ These three major taxes together accounted for 11 percent of GDP or 54 percent of total tax revenue exclusive of social security contributions in 2003.

⁹ Since property transfer should be registered at the government authorities, its information is readily available for taxation purposes. The government may have preferred taxes on property transactions to those on holdings because the former faces less resistance from taxpayers. Transaction taxes on real estate, along with the capital gains tax, have also been partly motivated by the objective of curbing housing-price speculation, although possible lock-in effects may have led to opposite results by reducing transactions.

¹⁰ These include a resident tax levied on top of personal and corporate income taxes payable as well as several earmarked taxes (education taxes and special tax for rural development).

¹¹ A detailed description of individual tax items is provided in the appendix.

¹² These are the transportation tax, the national education tax, and the special tax for rural development. While the transportation tax is imposed on the sales of petroleum products, the other taxes take the form of surcharges on other taxes as shown in the appendix.

¹³ The tax share figures reported in Table 6.3 do not account for social security taxes.

¹⁴ In 2003, the share for local government spending was 53 percent.

¹⁵ Unlike in developed countries, local autonomy is very limited. By the constitution, the central government has the power to set the tax bases and rates. Local governments instead have some discretionary power to apply flexible rates on certain tax items such as the resident tax.

¹⁶ Taxes on transactions involving real estate and automobiles are a dominant type of property taxation, providing about 45 percent of total local tax revenues. The resident tax is levied on top of personal and corporate income taxes payable.

¹⁷ Tax brackets are not indexed for inflation, resulting in a downward base-broadening effect.

¹⁸ Additional exemptions are available for family members 65 years or older and six years old or younger, for handicapped, and for female heads of families with dependents. Itemized deductions are available for insurance premiums, medical expenses, educational expenses, interest and mortgage loans for housing, and charitable donations.

¹⁹ According to OECD revenue statistics, the unweighted average was 30.7 percent in 2003 when the Korean rate was 29.7 percent.

²⁰ This low level of threshold allows only very small firms to be eligible for the lower rate.

²¹ Indirect exports: certain machinery and materials for agriculture, fishery, livestock and forestry industries; services supplied by ships and aircraft in international traffic; and social infrastructure and building projects supplied to government authorities.

²² Basic necessities, social welfare services, certain goods and services of cultural content, personal services of specified categories, and others.

²³ As of 2005, the ratios include 20 percent to manufacturing, utilities, and retail; 30 percent to agriculture, fisheries, construction, and real-estate rental; and 40 percent to transportation, warehousing, communication, restaurants, and hotels.

²⁴ The securities transactions tax rates are higher for securities listed on the KOSDAQ and for unlisted securities.

²⁵ Revenue from the liquor tax is earmarked to finance local spending, while the proceeds from the special excise taxes on automobile sales are split into transportation facilities, local spending and local education.

²⁶ Fifteen percent for local expenditures and 13 percent for local education in 2003; these ratios were increased to 19.13 and 19.4 percent in 2005, respectively.

²⁷ Customs duties imposed on railroad-related imports are also earmarked to an account for railroad facilities. In addition to taxes, numerous fees, charges and levies are earmarked to various government activities, many of which are operated through on- or off-budget funds.

²⁸ During the 1980s, the defense tax, imposed as a surcharge on a wide range of income and consumption taxes, was the most significant example of earmarking, deriving revenues of up to about 2 percent of GDP. When this tax was repealed in 1991, the government initially struggled to make up the lost revenue. It did so essentially by introducing new earmarked taxes such as the transportation tax and the special tax for rural development. Revenue from earmarked sources has reached about 3 percent of GDP in recent years.

²⁹ Comparison of the Gini coefficient across countries is tricky because the definition of income used often differs. The Korean measures are based on income of urban working households, and do thus not include self-employed and capital income, which are likely to be more unequal than wage income.

³⁰ Properties transactions are taxed more heavily than property holdings. Taxes on real property gains are non-negligible at 0.3 percent of GDP, but their impact on distribution is limited.

³¹ Tax expenditures are defined in the Korean tax laws as revenue losses caused by the exclusion of some item from tax base and take many forms: exclusions, exemptions, deductions, credits, a preferential rate of tax, or a deferral of liability. There were no tax expenditures for the education taxes and the special tax for rural development, which are mostly collected as surcharges.

³² The VAT is the next largest tax-expenditure item.

³³ Since Korea is already a country with high savings, it is often argued that the impact of tax preferences might largely be inframarginal and not inducing much new savings. According to unpublished government studies, the effects of most investment incentives are very limited. The World Bank (1993) reports a very modest contribution of tax policy to economic growth, i.e. about 6 percent of total GDP growth for the period 1962-82.

³⁴ Domestic evidence on the efficiency costs is also very limited and unreliable. Considering empirical estimates from the U.S. (e.g., Feldstein and Feenberg 1996), however, these costs could be very large since the tax bases are narrower in Korea than in the U.S.

³⁵ These incentives are discussed in a later section.

³⁶ State-owned banks will allow the government easier access to information about firms. They also predict tariff protection and directed credits for the taxed sector as well as other instruments hindering activity in the untaxed sector.

³⁷ The average for the OECD is 16.3 percent. The ratio for Mexico is 33.2, for the U.S. 8.4, and for Sweden 18.3.

³⁸ The broadly-defined self-employed includes unpaid family workers.

³⁹ According to OECD (2006), Turkey, Greece, and Mexico are the top three. The OECD average is 17.4 percent.

⁴⁰ These figures are calculated from the author's firm data base, consisting of 2,340 firms which are either listed on a stock exchange or registered with the Financial Supervisory Service.

⁴¹ Of course, this is not a direct evidence on the extent of cash transactions, since firms may hold cash for reasons other than transactions purposes.

⁴² Global taxation of capital income was suspended during 1998-2000 to prevent negative impacts on the financial markets.

⁴³ It was 15 percent as in 2003 and had declined to 14 percent in 2005.

⁴⁴ Final withholding rates depend upon the sources of gains, characteristics of ownership, and holding periods, with share gains at 10 to 30 percent and real property gains at 9 to 70 percent in 2005. Gains from share transactions are tax-exempt for most minority shareholders (having share ownerships less than 3 percent and share values less than 10 billion won).

⁴⁵ Those who have only wages and salary income are not required to file tax returns for global taxation.

⁴⁶ Out of 2.9 trillion won of capital gains taxes, 2.5 trillion won (86 percent) are accounted for by real property gains. The rest is for share gains.

⁴⁷ The self-employed and salary and wage earners with other income sources are subject to global taxation.

⁴⁸ Employees find it very difficult to evade taxes since their income is taxed on a withholding basis.

⁴⁹ This amounts to the product of the prescribed value-added rate and input taxes paid.

⁵⁰ In a normal case, input tax credits are available only for taxes due on total turnover.

⁵¹ Author's calculation based on data available from the National Tax Service.

⁵² See Gordon and Li (2005) for a formal model. Capital-intensive firms are presumed to be closely tied to the financial sector, for example, because their needs to raise capital make bank loans valuable.

⁵³ The effective tax rates for small firms are not as low as institutions forecast before the financial crisis, possibly implying a tax shifting between personal and corporate income. Note that the relative tax burden on personal income dropped due to sharply increased personal allowances after the crisis, implying a reduced incentive to shift personal income into corporate income.

⁵⁴ Export subsidies were repealed in 1999.

⁵⁵ Korean banks were either state-owned or under strict government control before the financial crisis.

⁵⁶ Deductions for earned income, educational expenses, and charitable contributions were raised, and deductions for pension income were introduced. The elderly and disabled received additional deductions and tax-exempt savings opportunities. Income tax rates were reduced by 10 percent across the board, from 10-40 percent to 9-36 percent, effective from 2002.

⁵⁷ Instead, withholding taxes were imposed on all dividends and interest at the source.

⁵⁸ In 1999, special excise taxes on electronic goods, food and beverages, and other necessities were eliminated.

⁵⁹ Foreign investors and firms investing in high-technology or investing more than \$100 million in a Foreign Investment Zone were made exempt from personal and corporate income taxes for seven years and granted a 50 percent reduction for a further three years. Additional tax incentives for such investments were made available by local governments in the form of reduced property, acquisition, and registration taxes.

⁶⁰ Taxes on revaluation profits following mergers and acquisitions have been deferred; taxes on capital gains on asset and equity transactions for restructuring were put off; acquisition, registration, and securities transaction taxes were exempted on transactions related to restructuring; and taxes on capital gains accruing to assets that were sold to repay debt were exempted.

⁶¹ To facilitate the closures of non-viable financial institutions, proceeds from their liquidations, mergers, or sales of assets were exempted from taxation.

⁶² The author's analysis of the sources of changes in the corporate effective burden for listed Korean companies confirmed that the changes in the debt ratio were the dominating factor raising corporate tax burn after the crisis (see Jun 2004). A follow-up and on-going study using an expanded sample shows similar results.

⁶³ As of 2005, a taxpayer can deduct 20 percent of credit card consumption in excess of 15 percent of income, up to 5 million won. For a rough illustration, a person who earns 50 million won a year and exhausts the deduction limit can reduce the effective tax rate by 10 percent of the marginal tax rate. This appears to be a strong incentive. The size of this incentive was increased further in the years following its adoption and has begun to be scaled down recently.

⁶⁴ A tax credit for credit card sales has been available since 1994. In 2000, the government increased the credit rate from 1 to 2 percent and the maximum credit from 3 to 5 million won. In 2004, the credit rate was reduced back to 1 percent.

⁶⁵ Like the case with credit card incentives, the purpose of this scheme is to create an audit trail of retail transactions. When a merchant issues a cash-receipt, the transaction is electronically reported to the tax authorities.

⁶⁶ In addition, the government introduced a penalty (a 10 percent surcharge) for underreporting of taxable income, and an incentive (a 10 percent tax credit, up to 1 million won) for bookkeeping by those operating under the simplified scheme.

⁶⁷ These include adoption of a self-assessment system and Charter of Taxpayers' Rights, overhaul of the organizational structure of the National Tax Service, and use of information technology in tax processing and in maintaining a taxpayer database.

⁶⁸ Most Korean banks provide preferred rate loans to those customers with high levels of credit card usage.

⁶⁹ See Dalsgaard (2000) and Ministry of Finance and Economy (2005), for example.

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