

Korea's Economy

Korea's Economy 2009

Korea's Near-Term Economic Prospects and Challenges

Global Financial Crisis and the Korean Economy: Issues and Perspectives

The Impact of U.S. Financial and Economic Distress on South Korea

The Wall Street Panic and the Korean Economy

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Tax Reform in Korea

U.S.-Korea Economic Relations: View from Seoul

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North Korea and International Financial Organizations: Political and Economic Barriers to Cooperation

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TAX REFORM IN KOREA

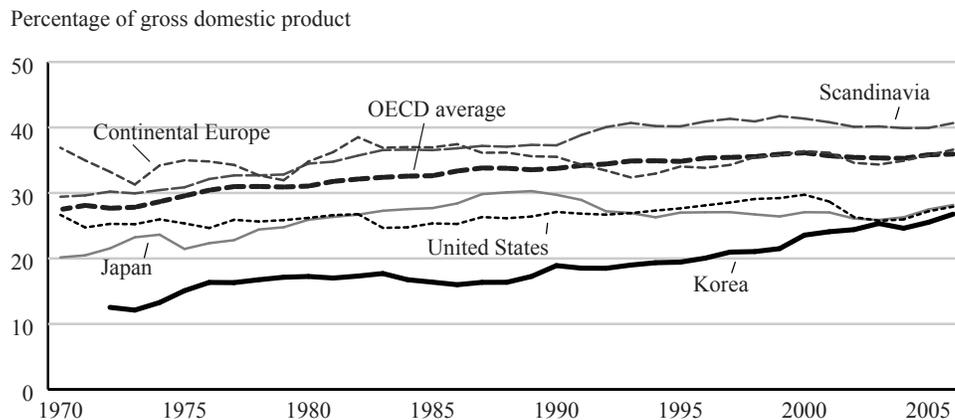
By Randall S. Jones

The tax burden in Korea—at 26 percent of gross domestic product (GDP)—was well below the average of the member countries of the Organization for Economic Cooperation and Development (OECD)¹ in 2006 (*Figure 1*), reflecting Korea’s low level of government spending for pensions, health care, and social welfare. In fact, public social spending amounts to only 7 percent of GDP, far below the OECD average of 21 percent (*Figure 2*). The low level of social spending is explained primarily by Korea’s relatively young population; the elderly dependency ratio² in Korea is the third lowest among OECD countries. Population aging in Korea, however, is expected to be the most rapid in the OECD area, making the elderly dependency ratio the fourth highest by 2050. Korea already has an extensive

social security system in place with the introduction of insurance for medical care in 1977, pensions in 1988, unemployment in 1995, and long-term nursing care in 2008. Demographic forces will thus sharply increase government social outlays.³

Rising government spending will require increased government tax revenue. The challenge will be to boost tax revenue in a way that limits any negative impact on economic growth while also addressing rising income inequality and relative poverty. This paper will first address the challenges making tax reform a priority and then provide a short overview of the Korean tax system. The following section presents a comprehensive tax reform plan.

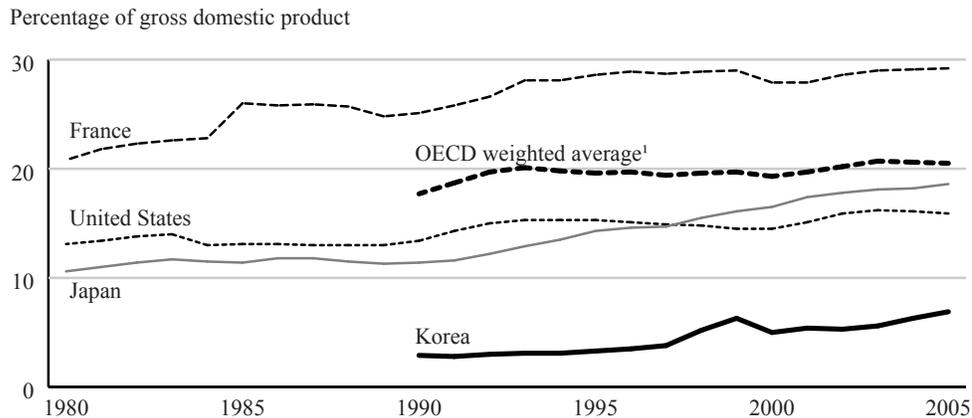
Figure 1: Tax Burden in Selected Countries and Regions, 1970–2006



Sources: *Revenue Statistics 1965–2007* (Paris: Organization for Economic Cooperation and Development, 2008). Note: Continental Europe comprises France, Germany, and Italy; Scandinavia comprises Denmark, Norway, and Sweden.

1. The OECD is a forum where the governments of 30 advanced countries work together to address the challenges of globalization; Korea has been a member since 1996.
2. Defined as the number of persons over the age of 65 as a share of the population between 20 and 64.
3. For example, the government’s Vision 2030 plan, announced in 2006, projected that public social spending would rise to the current OECD average of 21 percent of GDP by 2030. According to OECD simulations, Korea’s public spending on medical and long-term care alone will rise by six to nine percentage points of GDP by 2050. The cost of increased economic cooperation with North Korea may also boost public spending.

Figure 2: Public Social Spending in Selected Countries, 1980–2005



Sources: *OECD Economic Surveys: Korea* (Paris: Organization for Economic Cooperation and Development, 2008).

Note: The OECD weighted average does not include Hungary and the Slovak Republic because of lack of data.

National data are converted to U.S. dollars using 2005 purchasing power parity exchange rates. Social spending includes outlays for pensions, medical care, long-term nursing care, social welfare, and unemployment; social spending does not include costs for education.

Major Challenges Face Korea's Tax System

Supporting Economic Growth Despite Rapid Population Aging and Globalization

Several studies suggest that raising the overall tax burden can reduce growth.⁴ The extent of the negative impact depends on the structure of the tax system. A high tax burden on labor income, for example, impinges on growth by pricing low-skilled persons out of employment, thus reducing labor inputs, and discouraging human capital formation, thereby slowing technological progress. Similarly, firms have become more sensitive to cross-country variations in corporate tax rates in the context of globalization. High tax rates on corporate income thus make a country less attractive as a location for investment.

Coping with Widening Income Inequality and Rising Relative Poverty

Korea has experienced a significant increase in income inequality since the 1997 Asian financial

crisis. One factor is the expanding share of nonregular workers, who are paid about 30 percent less than regular workers; they now make up more than one-third of employment. Greater inequality has contributed to a rise in the rate of relative poverty⁵ to 14.6 percent in the mid-2000s, the sixth highest in the OECD area. High relative poverty also reflects the small impact of the public sector: the tax and social welfare systems reduced the relative poverty rate by less than three percentage points in Korea, from 17.5 percent to 14.6 percent in the mid-2000s. In contrast, the average reduction in OECD countries was 16 percentage points, lowering the relative poverty rate to an average of 10.6 percent. Reversing these trends would require greater use of the tax system, together with more social welfare spending, as in other OECD countries, including the United States. However, strengthening the redistributive function of the tax system needs to be weighed against any negative impact on work incentives, which would reduce potential growth. The challenge is to address income inequality and poverty while minimizing the negative impact on growth.

4. An increase of about one percentage point in the tax-to-GDP ratio could be associated with a direct reduction of about 0.3 percent in output per capita in the long run. If the investment effect is taken into account, the overall reduction would be around 0.7 percent, according to Andrea Bassanini and Stefano Scarpetta, "The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries," *OECD Economic Studies* 33, no. 2 (2001): 9–56.

5. Defined as the share of individuals with disposable income below 50 percent of the median for the entire population.

Korean Tax System in an International Perspective

In addition to having low tax rates, the tax structure in Korea is unique in a number of respects (*Table 1*):

- **Direct taxes on households** are exceptionally low, accounting for only 15.2 percent of total tax revenue in 2006, the fifth lowest in the OECD area. Only one-half of wage earners pay personal income tax owing to a number of deductions that exempt one-half of wage income from tax.
- **Corporate income tax** revenue provided 14.3 percent of tax revenue in 2006, well above the OECD average of 10.7 percent.
- **Social security contributions** have become the largest single source of government revenue. However, the share of contributions in GDP, at 5.7 percent, is well below the OECD average because of a relatively low contribution rate and weak compliance with the social insurance systems.
- **Taxes on goods and services** account for approximately one-third of government revenue, in line with the OECD average.
- The **property tax** provided 13.2 percent of tax revenue in 2006, well above the OECD average of 5.7 percent. This is due to transaction taxes on property although taxes on property holdings are in line with the OECD average.

In September 2008, Korea's government announced a tax reform package aimed at boosting private consumption and business and housing investment:

- Personal income tax rates will be cut by two percentage points by 2010, lowering the range from 8–35 percent to 6–33 percent, while the personal income tax deduction will be increased.
- The corporate income tax rate (central government level) will be lowered from 25 percent to 22 percent in 2009 and to 20 percent in 2010.

Table 1: Tax Mix in OECD Countries, as a Percentage of Total Tax Revenue, 2000 and 2006

Tax types	2000		2006			Change 2000 to 2006	
	Korea	OECD	Korea	Rank	OECD	Korea	OECD
Direct taxes on households	14.6	26.1	15.2	26	24.8	0.6	-1.3
Direct taxes on firms	14.1	10.1	14.3	5	10.7	0.2	0.6
Social security and payroll	16.9	25.5	21.2	21	26.2	4.3	0.7
Goods and services	38.3	31.6	32.6	12	31.5	-5.6	0.0
Value-added tax	17.0	18.5	16.8	21	19.3	-0.2	0.7
Taxes on specific goods and services	16.9	12.4	12.7	8	11.6	-4.2	-0.7
Customs and import duties	4.3	0.6	3.1	3	0.6	-1.2	0.0
Property	12.4	5.5	13.2	1	5.7	0.8	0.2
Property holding	2.5	2.6	3.1	9	3.0	0.6	0.3
Taxes on property transactions	8.5	2.0	9.1	1	2.1	0.6	0.1
Estate, inheritance and gift taxes	1.4	0.9	1.1	3	0.6	-0.3	-0.2
Other	3.7	1.2	3.5	3	1.1	-0.2	-0.1
Total	100.0	100.0	100.0		100.0	0.0	0.0

Source: *Revenue Statistics 1965–2007* (Paris: Organization for Economic Cooperation and Development, 2008).

- The capital gains tax on housing will be reduced by increasing the threshold at which the tax is applied, expanding deductions for long-term ownership, and reducing tax rates.
- The Comprehensive Property Tax, a national tax introduced in 2005 on households and firms owning housing with a combined value exceeding 600 million *won*,⁶ will be significantly scaled back.

Although this plan contains a number of positive elements, it is aimed at reducing taxes and so will not meet the need for increased revenue over the long run. In fact, the government expects that these reforms will lower tax revenue by approximately 2 percent of GDP. Moreover, the plan does not fully address the challenges of sustaining growth and addressing poverty.

Proposal for Comprehensive Tax Reform

From a political perspective, fundamental tax reform is never easy. In Korea, there has been stiff resistance to higher tax and contribution rates. To ensure the financial sustainability of the National Pension Scheme, for example, the government proposed in 2003 to raise the contribution rate from 9 percent to 15.9 percent by 2030 while it would cut the replacement rate⁷ from 60 percent to 50 percent. However, this reform was rejected in favor of leaving the contribution rate at 9 percent and reducing the replacement rate to 40 percent. This reform did not ensure long-run financial sustainability, which would have required a contribution rate of 12.9 percent or a further cut in the replacement rate.

Implementing a comprehensive tax reform requires clear communication of the plan and its objectives, based on transparent and well-articulated principles, so that taxpayers understand what the government is trying to achieve. This should include a number of aspects:

- The authorities should demonstrate their commitment to improving the efficiency of spending

before asking the public to pay higher taxes. The recent plan to privatize some state-owned enterprises and increase the efficiency of public organizations is helpful in this regard.

- It is important to recognize that the tax burden in Korea is one of the lowest in the OECD area owing to Korea's relatively young population and low level of income per capita. As rapid population aging turns Korea into one of the oldest countries in the world and as its income level converges to the OECD average, it will be difficult to maintain such a low share of taxes in GDP.
- The reform must be fair across different segments of the population. In particular, it is essential that the broadening of the tax base includes the self-employed, thus avoiding an unfair burden on salaried workers.
- Nearly all OECD countries have launched major tax reforms in recent years, driven by the need to provide a fiscal environment that is more conducive to investment, risk taking, and work. Although Korea's tax system has many pro-growth features, it is important to avoid falling behind in an increasingly integrated and competitive world economy.

The elements of such a tax reform are shown in *Table 2*. The following sections present the rationale for the proposed changes.

Taxes on Corporations

Corporate tax rates have fallen in many countries, including Korea, reflecting a growing recognition that taxes on corporate income distort saving and investment decisions and thereby reduce economic growth. In addition, there has been active competition to lower rates to attract foreign direct investment (FDI) in a world of increasingly mobile capital; research suggests that differences in corporate tax rates affect international flows of capital and profits

6. This is approximately \$450,000 at an exchange rate of 1,350 *won* per dollar.

7. The replacement rate is an individual's pension benefit as a percentage of the individual's average wage.

Table 2: Summary of Recommendations for Tax Reform in Korea

Types of taxes	Raising revenue	Promoting growth	Reducing inequality
Corporate income tax	<ul style="list-style-type: none"> • Broaden the tax base by reducing tax expenditures 	<ul style="list-style-type: none"> • Lower the statutory tax rate on firms to promote Korea's international competitiveness • Reduce the share of corporate taxes in total direct taxes • Phase out quasi taxes 	—
Personal income tax	<ul style="list-style-type: none"> • Broaden the personal income tax base • Further increase compliance of the self-employed by improving enforcement and hiking penalties for tax evasion 	<ul style="list-style-type: none"> • Increase the share of personal income tax in total direct taxes • Reduce the preferential treatment of retirement allowances • Cut tax rates to promote foreign direct investment, entrepreneurship, and education 	<ul style="list-style-type: none"> • Expand the earned income tax credit introduced in 2008 • Increase taxation of fringe benefits
Value-added tax (VAT) and other consumption taxes	<ul style="list-style-type: none"> • Raise the VAT rate • Further broaden the base by reducing special treatment of small- and medium-size enterprises • Strengthen environmentally related taxes 	<ul style="list-style-type: none"> • Rely on the VAT for increased revenue, and reduce the share raised from more distortive taxes • Maintain a unified VAT rate and a broad base to limit distortions • Phase out individual consumption taxes unless they are justified by health or environmental concerns • Phase out earmarked taxes 	<ul style="list-style-type: none"> • Avoid lower VAT rates on daily necessities as these tend to benefit higher-income persons
Property taxes	<ul style="list-style-type: none"> • Increase local taxes on property holding, thus offsetting declining revenue from transaction taxes 	<ul style="list-style-type: none"> • Increase local property holding taxes, thereby reducing reliance on more distortive taxes and promoting efficient land use • Further reduce taxes on transactions to promote mobility and reduce lock-in effects 	<ul style="list-style-type: none"> • Base the capital gains tax on the size of the gain rather than the number of houses owned
Social security contributions	<ul style="list-style-type: none"> • Improve compliance by establishing a unified collection agency 	—	<ul style="list-style-type: none"> • Expand coverage of nonregular workers by improving compliance

Source: OECD Economic Surveys: Korea (Paris: OECD, 2008).

and the location decisions of firms.⁸ The statutory corporate tax rate in Korea fell from 30.8 percent (including the local government tax) in 2000 to 27.5 percent in 2005, a rate close to the OECD average. The planned cut to 22 percent by 2010 would make Korea's rate the third lowest in the OECD area. The government's concern is to compete with other Asian countries with low corporate tax rates such as China (25 percent), Taiwan (25 percent), Singapore (18 percent), and Hong Kong (16.5 percent). In addition to lowering tax rates, quasi taxes,⁹ which reduce transparency and predictability, should be phased out to reduce the burden on firms.

Because the government expects the cut in the corporate tax rate in 2009–10 to lower revenues, as was the case following the 2005 reduction, lower tax rates should be accompanied by base broadening to limit any decline in revenue. Base broadening would also reduce distortions and improve the allocation of capital. Achieving the positive impact of tax cuts on growth depends in part on the efficient allocation of the higher level of investment. The corporate tax system accounted for 84 of the 219 tax expenditures¹⁰ in 2006 and amounted to about one-fifth of corporate tax revenue, a relatively high level compared with other countries. There is scope, therefore, to reduce incentives, including those aimed at promoting inflows of FDI, which do not appear to have been very effective given the declining trend in inflows. In addition, Korea should ensure that the generous incentives to promote spending on research and development do not outweigh their costs. As for small- and medium-size enterprises (SMEs), it is doubtful whether the lower tax rate (11 percent) is the best way of addressing the problems facing smaller firms. Moreover, a lower tax rate encourages SMEs to remain small in order to benefit from

the lower rate. Finally, it is important to limit the introduction of new tax expenditures.

Taxes on Personal Income

Personal income tax revenue in Korea accounted for only 4.1 percent of GDP in 2006, the fourth lowest in the OECD area. The top rate was cut from 40 percent in 1999 to 35 percent in 2005 compared with the OECD average of 43 percent. In addition, only half of workers pay income tax owing to the large number of deductions allowed. As a result of the low rate and extensive deductions, the personal income tax burden for a single individual at average earnings in Korea is less than 5 percent of gross earnings, well below the OECD average of 16 percent.

Given that taxes on labor (including social security contributions) tend to reduce labor supply and demand, saving, and capital investment, the Korean tax system is favorable for growth. According to a cross-country study by the OECD, a 10-percentage-point reduction in the tax wedge on labor (including social security contributions) would boost the employment rate by 3.7 percentage points.¹¹ Taxes on labor can also reduce hours worked, especially for women. Korea's low marginal tax rate thus boosts working time, which is the highest among OECD countries at 2,357 hours per year. The planned cut in income tax rates included in the September 2008 reform will further reduce the tax burden, thus helping to sustain labor input, which is also the highest in the OECD area in terms of hours worked relative to the population.

Rate cuts would also boost economic growth by enhancing entrepreneurship and incentives for FDI and education. An OECD study shows that a five-

8. An OECD study found that a one-percentage-point increase in the effective corporate tax rate reduces the stock of FDI by between 1 and 2 percent; see Dana Hajkova et al., "Taxation, Business Environment and FDI Location in OECD Countries" (working paper no. 502, OECD Economics Department, Paris, 2006).

9. Quasi taxes include a wide range of fees, charges, and contributions that are not imposed by the tax laws. Most are levied on firms in a discretionary and nontransparent manner for financing off-budget spending.

10. Tax expenditures are losses to the government from granting certain deductions, exemptions, or credits to specific categories of taxpayers.

11. *OECD Employment Outlook* (Paris: OECD, 2006). The tax wedge measures the difference between total labor compensation paid by the employer and the net take-home pay of employees, as a percentage of total labor compensation. The tax wedge in Korea, including social security contributions, was only 16 percent in 2006, the second lowest among OECD countries.

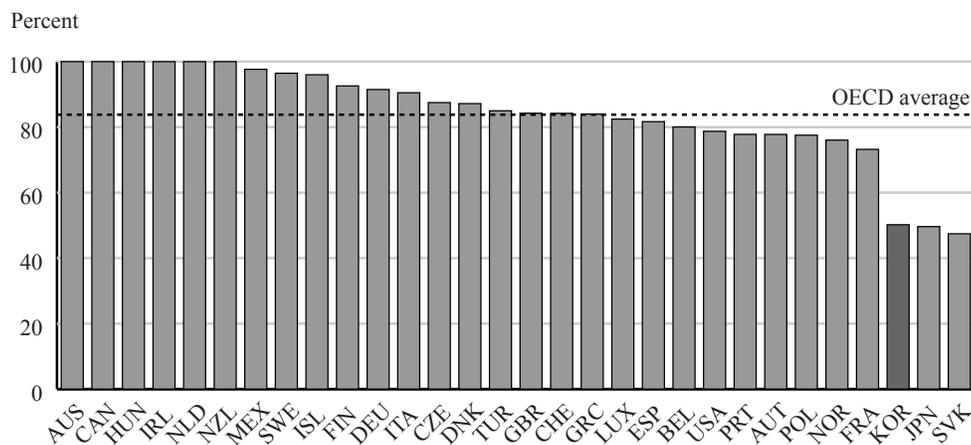
percentage-point decrease in the marginal tax rate leads to a 0.3-percentage-point rise in the university graduation rate. Another study found that the impact of labor taxes on FDI inflows is substantially larger than that of corporate tax rates. As for entrepreneurship, reductions in top personal income tax rates have been found to raise productivity in industries with high rates of enterprise creation.¹²

In addition to low rates, personal income tax is limited by the fact that only half of wage income is subject to tax, well below the OECD average of 84 percent (**Figure 3**). This is due primarily to a deduction for earned income, which is intended to create a level playing field between employees and the self-employed, who face a lighter effective tax burden for a number of reasons, including outright evasion. Only 60 to 70 percent of income from self-employment is reported to the tax authorities, compared with more than 80 percent for wage income. The tax compliance of the self-employed is a major issue in Korea, given that they account for almost one-third of the labor force.

Greater revenue from the personal income tax system may be necessary to cope with the cost of

population aging and the planned cuts in corporate tax revenue. Because of the pro-growth effect of low personal income tax rates, additional revenue should be generated by base broadening rather than by raising rates. One key is to increase further the share of the self-employed who pay tax, which rose from less than 40 percent in 1997 to 63 percent in 2006 as a result of a number of measures that enhanced the transparency of the income of small businesses. Additional steps, including more audits and strengthened penalties for tax evasion, would further boost the proportion. It is also important to reverse the decline in the share of employees paying income tax from 60 percent in 1997 to 50 percent in 2006. Given the rising share of taxpayers and tax revenue from the self-employed, the amount of deductions for wage income needed to level the playing field with the self-employed is declining. In sum, generating more personal income tax revenue by expanding the compliance of the self-employed and reducing exemptions for wage income, while keeping tax rates low, would raise necessary revenue while supporting economic growth. However, increasing the proportion of workers subject to personal income tax would have negative implications for equity.

Figure 3: International Comparison of Wage Income Subject to Personal Income Tax, 2007, at the central government level



Source: *Taxing Wages 2006–2007* (Paris: Organization for Economic Cooperation and Development, 2007).

12. The sources for these estimates are Oliveira Martins et al., “The Policy Determinants of Investment in Tertiary Education” (working paper no. 576, OECD Economics Department, Paris, 2007); Hajkova et al., “Taxation, Business Environment and FDI Location in OECD Countries”; and Åsa Johansson et al., “Tax and Economic Growth” (working paper no. 620, OECD Economics Department, Paris, 2008).

The best approach to coping with income inequality and poverty is an earned income tax credit (EITC), which can “make work pay” for low-skilled persons, thereby boosting employment.¹³ The EITC can thus help meet distributional objectives without the negative impact on output growth that may result from raising marginal tax rates on high-income earners. An EITC is used in a number of countries, including the United States, the United Kingdom, and Sweden; and it is likely to be effective in Korea given its wide earnings distribution, low tax rates on labor, and low benefits for the non-employed. In 2008, Korea introduced an EITC although it has been limited initially to salaried workers with two or more children who do not own a home. Consequently, the government expects that only 1.8 percent of households will receive the EITC in 2009.

The EITC is likely to have a positive effect on both aggregate employment and poverty in Korea, and it should be expanded to cover a larger share of the 14.6 percent of the population in relative poverty. The major challenge to successfully implementing and expanding the EITC is a lack of transparency about the income of daily and temporary workers. A broadening of the income tax base could help finance an expanded EITC. Another way to improve income distribution would be to increase taxes on fringe benefits. At present, many benefits, such as subsidies for employees buying houses or using lodging or cars owned by their employers, are deductible for firms and not taxable for employees. Fringe benefits are thus a means of avoiding taxes.

Taxes on Consumption

Consumption taxes, notably the value-added tax (VAT), should be the primary source of additional government revenue in the future, given that consumption taxes have less negative impact on economic growth than income taxes. Another advantage is that the VAT is simple and relatively difficult to avoid or evade. Moreover, Korea has considerable scope to boost its VAT rate, which since its introduction in 1977 has been fixed at 10 percent—well

below the OECD average of 18 percent. The need for rate hikes would be limited by further broadening the VAT base. It is also important to maintain a single rate instead of introducing lower rates for food and other necessities, an approach used in some European countries. Differentiating VAT rates is not an efficient way to provide assistance to low-income households, as high-income households tend to benefit most from lower rates on some items. In addition, introducing multiple VAT rates entails higher administrative and compliance costs and opportunities for fraud while distorting consumption decisions.

Excise taxes on specific goods and services are relatively numerous in Korea. Although the number of individual consumption taxes was reduced from 27 to 20 in 2004, their revenue remains significant at approximately 0.6 percent of GDP. The wide variation in excise tax rates distorts consumption choices. Excise taxes are linked to the complicated system of earmarked taxes, which accounted for 14 percent of total tax revenue in 2007. The education tax, for example, is financed by surcharges on tobacco and liquor.

Earmarking is used in many countries as a political tool to foster public support for tax increases to cover specific expenditures. It can allow a closer link between those who pay the tax and those who benefit, although the connection between taxpayers and beneficiaries is quite weak in Korea. However, earmarking has a number of disadvantages. First, it reduces the flexibility of policymakers to adjust spending as expenditure needs change over time. Second, when earmarked revenues exceed the expenditures for which they are targeted, it can be difficult to reallocate the additional funds to other more productive purposes, encouraging excessive spending in the targeted area. Third, earmarked taxes significantly increase the complexity of the tax system. Fourth, earmarking nurtures vested interests within and outside the government. In sum, reducing earmarking would promote the efficient management of public finances.

13. OECD research suggests that an EITC has a positive effect on aggregate employment. There are potential negative effects as well, however, such as the decline in working hours resulting from the withdrawal of the credit as income rises and the weakened incentives for human capital formation.

Excise taxes should be focused on addressing externalities rather than on raising revenue. This suggests limiting them to products such as tobacco and liquor for health reasons and to energy for environmental reasons, with the rate based on the size of the externality. In particular, increasing environmentally related taxes, which are around the OECD average at 3 percent of GDP, would be another way to broaden the tax base.

Taxes on Property

Property-related taxes are high in Korea, as noted above, because of transaction taxes. Such taxes amounted to 2.4 percent of GDP, the highest in the OECD area—thus limiting mobility by creating lock-in effects. The government has reduced transaction taxes¹⁴ and plans to lighten capital gains tax as well. There is further scope to reduce transaction taxes. In addition, the capital gains tax should be based on the size of the gain rather than on the number of houses owned.

A tax on property holding is more favorable for growth than other taxes as it has less impact on decisions to supply labor, produce, invest, and innovate. Increasing the share of property tax in the overall tax mix would reduce the need for other more distorting taxes and in addition promote the efficient use of land. However, the effort to increase property holding tax through the introduction of the Comprehensive Property Tax (CPT) in 2005 has proven problematic for a number of reasons. In 2006, only 1.3 percent of households were subject to this tax, the revenues of which are transferred to local governments to reduce regional inequalities. The CPT is very progressive, ranging from 1 percent to 3 percent, 20 times higher than the lowest rate of local property tax on households.¹⁵ In contrast, most OECD countries impose a flat rate, or moderately progressive rates, on property holding.

Following the introduction of the CPT, the total tax on holding property rose to 0.8 percent of GDP in 2006. It is still well below the OECD (weighted) average of almost 2 percent, indicating scope to fur-

ther increase property taxes in order to meet future revenue needs. A higher effective rate should be achieved by gradually raising the overall holding tax rather than through the CPT, which led to a sudden increase for a small group of taxpayers. Moreover, the CPT was aimed at controlling short-term fluctuations in housing prices and redistributing income. Property taxes should instead be based on long-term efficiency considerations and government revenue needs. Finally, the role of a national property tax limits the scope for local authorities to raise the local property tax, which is an ideal revenue source for local government. In most OECD countries, property tax is a purely local tax; in Korea, however, it accounts for only 8 percent of local government revenue.

The government's plan to revise the CPT by reducing the rates to 0.5 percent to 1 percent and raising the threshold for paying the tax to 900 million *won* is thus appropriate. Over the medium term, the CPT should be merged into the local property tax, which would allow a larger role for local property taxes, thereby providing local governments with sufficient revenue-raising autonomy to make them accountable to local citizens and encourage fiscal discipline to improve efficiency. In contrast with the drawbacks of using income and consumption taxes to finance local governments, a tax on property holding has a number of desirable properties: it is visible, it imposes discipline on local authorities, and it is relatively resistant to tax-base flight. Greater local government taxing authority should be accompanied by expanded spending responsibilities to enhance the autonomy of local authorities. Major services such as education and police services in Korea are funded primarily by the central government.

Improving Administration of Tax and Social Insurance Systems

Upgrading the management of tax and social insurance contributions is important for expanding the coverage of the social safety net and reducing the cost of compliance. Korea's social security system has developed gradually with the introduction of

14. The combined rate of the acquisition and registration taxes fell from 5.8 percent in 2004 to 2.3 percent in 2007.

15. Local property tax rates range from 0.15 percent to 0.5 percent.

insurance for industrial accidents (1964), medical care (1977), pensions (1988), employment (1995), and long-term care (2008). Each insurance system has evolved independently, with a lack of coordination, especially in terms of collecting contributions. Collection processes have differed in terms of the definition of the wage base, the payment intervals, end-year adjustments, employer identification codes, and other features, making it administratively costly for the government and preventing the sharing of information and cross-checks between the different systems.

These problems have contributed to low insurance coverage, particularly for nonregular workers and employees at small firms. Although three-quarters of regular workers were covered by pension and medical insurance at their workplaces in 2005 and two-thirds by employment insurance, the share was only around 40 percent for nonregular workers. At small firms, only one-quarter of regular workers and fewer than 10 percent of nonregular workers were covered. With existing manpower, the social insurance systems and the National Tax Service (NTS) do not have the capacity to enforce compliance by nonregular workers and small firms. Weak compliance hinders the capacity of the social insurance schemes to achieve their intended goals. For example, the gaps in the coverage of employment insurance help to explain why only one-third of unemployed persons receive benefits. Moreover, lower social insurance contributions encourage firms to hire nonregular workers.

A number of reforms were introduced in 2005 to align the various social insurance schemes, but legislation to create a single agency in 2009 for the collection of social insurance payments, under the direction of the NTS, failed to pass the National Assembly. The creation of a unified collection agency is necessary before social insurance coverage can be expanded significantly. This would also ease compliance costs for firms. According to a study by the World Bank, complying with labor taxes, including

social security contributions, requires 120 hours a year for firms in Korea, more than triple the OECD average.¹⁶

Conclusion

A comprehensive tax reform, which relies primarily on consumption taxes for additional revenue, the EITC for income redistribution, and property-holding taxes for local government, would limit income tax rates, thus promoting growth. OECD experience shows that taxes on personal and corporate income tend to reduce saving and investment, labor supply and demand, inflows of FDI, entrepreneurship, and education. The government's reforms to reduce direct taxes are in line with international trends and will help support competitiveness. The planned cut in the corporate and personal income tax rates should be accompanied by a reduction in deductions and exemptions to broaden the base and, in the long run, an increase in the VAT rate as population aging boosts government spending.

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16. *Paying Taxes 2008: The Global Picture* (Washington, D.C.: World Bank and PricewaterhouseCoopers, 2007).



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