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5 Tax Reform in Korea

Taewon Kwack and Kye-Sik Lee

5.1 Introduction

In the early stage of Korea's development, the nation's growth depended heavily on strong government leadership because of a lack of both know-how and risk-taking entrepreneurs. The demand of the people for the government to make greater development efforts legitimized an interventionist policy. Thus, the Korean government took the lead in development.

The Korean tax system, which contains a rich assortment of policy tools, has been used in almost all kinds of government development efforts. Tax tools, however, have not been very effective in carrying out the intended goals. First, in the earlier stages of development, the Korean market did not function well enough for price incentives to operate efficiently. The government's extensive intervention was one of the major reasons for this problem. Second, tax administration was inefficient. Third, the level of taxpayer compliance has been very low. For these reasons, despite the extensive and frequent manipulation of the tax system, the Korean government has not depended heavily on these tools in a practical sense. Rather, financial policy has been employed more effectively.

Politically and economically, Korea is now at a crossroads. Many new problems threaten to hinder Korea's economic growth. Korea's successful export-led growth, producing substantial balance-of-payments surpluses, has

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elicited friction and growing protectionism from its trading partners. In addition, imbalances in regional, sectoral, and urban and rural development have been exacerbated, which has resulted in increasing income disparities, a major source of discontent and social conflict. With the process of democratization, the pent-up discontent of the past decades has emerged in the form of social conflicts and disorder, thus posing a major obstacle to further development.

Tax policy, as part of the growth-oriented strategies of the past, has been partially responsible for bringing about these problems. In the future, Korea's tax policy should aim not only for sustained economic growth but also for correction of disparities that exist among various economic and social sectors. To redress such imbalances, which arose from the government's long neglect of social development, there is a strong need for redirection of tax policy.

This paper presents an overview of some of the current tax reform issues in Korea. We first briefly review the historical changes in Korean tax policy and the tax structure. Next, we outline the current tax system and structure and identify a few important structural problems with the system. Finally, we discuss current tax reform issues and the tax reforms to be carried out in the coming years.

5.2 A Historical Overview of Korean Tax Policy and Reform

Almost every year since the establishment of the government in 1948, the tax system has changed. The reforms of 1961, 1967, 1971, 1976, and 1982 were carried out on a larger scale than other reforms and were directly linked to Korea's five-year economic development plans. In other words, Korean tax policy has been an integral part of the country's economic development policy. Therefore, in spite of the repeated citation of equity objectives, efficiency objectives have dominated in practically all these reforms. As noted above, only recently have equity issues been seriously discussed in relation to tax reform.

5.2.1 The Preindustrialization Period (1948–61)

The Republic of Korea was formed in 1948, and a set of tax laws were enacted that same year. Previously, the U.S. military regime used a partially revised version of a wartime tax system that had been taken over from the Japanese colonial government. The new system, which was embodied in eighteen tax laws, included income tax, corporate tax, liquor tax, inheritance tax, commodity taxes, and other minor taxes. It was the first modern and democratic tax system introduced in Korea. One of its notable characteristics was the shift in the taxation target from the rural landlord class to the wealthy urban class.

The new system was completely disrupted by the Korean War during 1950–53. By that time, policymakers had also become aware of administrative difficulties in the system. Postwar tax reforms in the 1950s, especially in 1956,

can be characterized as reflecting these administrative considerations and as attempting to replace the wartime emergency system with a normalized one. Around the end of the 1950s, the government's policy emphasis partially shifted from rehabilitation and reconstruction to industrialization and economic growth. Tax policy, accordingly, began to emphasize incentive measures to promote capital formation and exports.

5.2.2 The Period of Export-oriented Industrialization (1961–70)

Rapid economic growth in Korea began in the early 1960s, when the military government that came to power in 1961 launched an organized and single-minded policy on industrialization. The new government had to solve several problems before it could promote its ambitious plan to push the economy out of the quagmire of poverty. First, fiscal difficulties arose from the drastic reduction of foreign aid, which had formerly served to meet a considerable portion of the government's fiscal budget. Other financial sources for investment in the Korean economy had to be found. The economy faced the typical problem of a lack of domestic savings to finance investment and a lack of foreign exchange to import capital goods. In addition, the government wanted to carry out its investment projects directly, in order to combat the severe deficiency of social overhead capital. Naturally, the goal of a new tax policy would be to maximize revenue and to encourage savings and foreign exchange earnings.

To maximize revenue, a crucial administrative reform was implemented, the establishment of the Office of National Tax Administration (ONTA) in 1966. The military government diagnosed correctly that the problem was not in the system of taxation as legally defined but in the implementation of the system. Before the establishment of ONTA, some measures were taken to ensure the enforcement of tax laws. These measures included simplifying tax administration, intensifying the punishment for tax delinquency, and providing incentives for bookkeeping and voluntary compliance.¹

To promote private saving and investment, capital taxation was drastically reduced. In particular, interest income was almost untaxed, a law guaranteeing the anonymity of bank accounts was passed in the early 1960s, and official interest rates for deposits were raised dramatically in the mid-1960s. On the investment side, the definition of "key and strategic industries" in which firms were eligible for quite liberal tax holidays was expanded.

During this period, income generated from foreign exchange-earning activity was taxed at a preferential rate, that is, 50 percent of the normal rate. Previously, the preferential reduction rates were 30 percent for exports and 20

1. For example, ONTA introduced a new "green-return system" (so named for the color of the return form) under which firms and individuals file their tax returns on a self-assessment basis rather than having tax officials prepare returns. Taxpayers who kept satisfactory accounting records were selected and brought into the system through certain incentives.

percent for other foreign exchange earnings, such as tourism and sales of goods and services to the foreign military forces stationed in Korea.

Most of the above reforms were made in 1961. In 1967, the urgency of securing tax revenue somewhat relaxed. Hence, more or less “sophisticated” goals were set. A global income tax system with progressive rates was partially introduced, and the exemption level for wage and salary earners increased. An important change in the corporate tax system was the introduction of rates that discriminated between “open” corporations and closely held corporations, to encourage the opening of corporations and to foster the domestic capital market.

5.2.3 The Period of Heavy Industrialization (1971–79)

The first phase of economic development through export-oriented industrialization was extremely successful, and the government ambitiously planned to proceed to the second phase, in which the self-reliance of the economy was to be emphasized. The term “self-reliance” can mean many things. In this case, it meant national security and specifically included self-sufficient production of the main staple crop (rice) and a more balanced and developed industrial structure. Reaching a better balance in the industrial structure required an expansion of the heavy and chemical industries. This expansion was pursued excessively, however, and created many problems toward the end of the 1970s.

From the early 1970s onward, tax reforms reflected an increasing concern for redistribution. This change in tax policy direction seems to have reflected in part the increased capacity of the economy to pursue equity goals and in part a political calculation aimed at pacifying the public, which was growing increasingly restive under the prolonged dictatorship.

Two very important tax reforms were carried out in the mid-1970s. By then, the tax system was in tatters, perhaps due to frequent ad hoc revisions geared to many specific objectives. The dual structure of the personal income tax system, for example, was administratively inefficient and promoted neither horizontal nor vertical equity in distributing the tax burden. The system of indirect taxes was even more complicated. Korea had both excise and turnover taxes with more than fifty rates, ranging from 0.5 to 300 percent. This background led to a strong desire to streamline and simplify the overall tax structure, not only for administrative efficiency but also for greater tax burden equity and neutrality with respect to resource allocation. Specifically, an almost global personal income tax was introduced by the reform in 1974 (implemented in 1975), and a consumption-type value-added tax (VAT) and set of special excise taxes replaced the business tax (a turnover tax) and seven other indirect taxes as a result of the 1976 tax reform (effective in 1977).² To compensate for the possible adverse effects of the newly introduced VAT and to

2. The seven taxes included commodities, textile products, petroleum products, electricity and gas, transportation, admission, and entertainment.

soothe political tension due to its introduction, the government introduced additional income tax relief for low- to middle-income workers, certain concessions for taxes on inheritance and land sales, and more generous depreciation allowances. In short, the reforms of 1974 and 1976 determined the basic structure of the current tax system in Korea.

Another significant change in the tax system in the seventies was the introduction of the defense tax, surcharged on various taxes at rates of 0.2 to 30 percent. This tax was introduced as a temporary earmarked levy with an expiry date of 1980, but its expiration was postponed twice, until 1990. It generated a considerable amount of revenue, at the cost of adding a fair number of complications to the tax system.

The essential part of the tax policy in this period, as noted earlier, was unreserved support for heavy and chemical industries. Various types of generous tax incentives were legislated, mainly through the Tax Exemption and Reduction Control Law enacted in 1965. The so-called key industries, which included shipbuilding, machinery, basic metals, petrochemicals, automotive products, electronics, and chemical fertilizers, were extremely favorably treated in terms of corporate or proprietors' income taxation.

From the early 1970s, incentives for heavy industrialization were reinforced, while incentives for export industries were drastically reduced.³ In 1974, all major incentives for promoting key industries were unified and rearranged under "special tax treatment for key industries" in the Tax Exemption and Reduction Control Law. This "special treatment" included three optional sets of incentives—tax holidays, investment tax credit, and special depreciation—to qualified firms in selected heavy and chemical industries.⁴

A quantitative summary of the incentives extended to key industries during the period from 1963 to 1985 is presented in table 5.1. According to these estimates, during the second half of the 1970s as much as 37 percent of investment at margin was given to investors in eligible key industries in the form of tax privileges.

5.2.4 The Structural Adjustment and Liberalization Period (1980–87)

Dramatic changes in the economic and political environment led to a drastic readjustment of development policy objectives in the early 1980s. The role of the market mechanism in resource allocation was emphasized in order to combat some of the conspicuous structural difficulties in those heavy and chemical industries that had been carefully tended by the government. Hence, liberalization in various areas, such as foreign trade, foreign and overseas investment, and financial markets, was sought. On the other hand, to overcome the macroeconomic crisis of 1980, a series of strong stabilization policy measures

3. The 50 percent reduced rate of corporate or proprietors' tax on income from foreign exchange-earning activity was discontinued in 1973 and a couple of tax-free reserve systems, whose incentive effects were much smaller compared with the previous system's, were introduced. See Kwack (1986) for a discussion of the incentive effects of this change.

4. See Choi et al. (1985) for a detailed discussion on the tax incentives for key industries.

Table 5.1 Benefits from Tax Incentives for Investment in Machinery by Firms in Typical Key Industries (Manufacturing) for Selected Years (%)^a

Year ^b	Discount Rate ^c	Statutory Tax Rate ^d	20% (80%) Spec. Deprec. ^e	Incentives for Key Industries				Total ^f
				T.H.	Spec. Deprec.	I.R.	I.T.C.	
1963	52.5	20	0.8	18.5	—	—	—	18.6
1968	56.0	45	1.7	—	—	—	6.0	7.7
1970	49.8	45	1.8	—	—	—	6.0	7.8
1973	33.3	40	5.6	—	—	—	6.0 (10.0)	11.6 (15.6)
1976	40.5	40	1.7 (5.5)	36.7	6.5	—	8.0 (10.0)	36.9 (37.4)
1982	30.5	38	1.6 (5.3)	—	6.2	3.4	6.0 (10.0)	9.6 (9.6)
1983	25.8	33	1.4	—	5.2	—	3.0 (5.0)	5.2 (5.2)
1985	24.1	33	2.0	—	5.0	—	3.0 (5.0)	5.0 (5.2)

Source: Kwack (1986, 82).

Notes: Figures in parentheses represent the benefit of investment made on domestically produced machinery. Incentives for export promotion are not considered. I.R. = investment reserves; I.T.C. = investment tax credit; Spec. Deprec. = special depreciation; T.H. = tax holidays.

^aRatio of tax reduction amount to gross investment. All incentives are converted to investment tax credit equivalent ratio. For example, the total benefit in 1963 is equivalent to having a 18.6 percent investment tax credit. For further details of computation, see Kwack (1986).

^bThe selected years are when major tax reforms were effected.

^cCurb market interest rate is used as a proxy for discount rate. This rate may be interpreted as an upper limit.

^dSurtaxes to the corporate tax are not considered.

^eAssumed asset lifetime for tax purposes is 11 years, and assumed economic depreciation rate is 11 percent.

Interaction and overlapping (some pairs of incentives cannot be adopted at the same time) of incentives were taken into account when the figures in the total column were calculated.

was adopted.⁵ Finally, the social aspects of development began to attract public attention, with equity and balance stressed as values to be pursued with a higher priority.

The most significant tax reform in the early 1980s took place in 1982. Though this measure did not involve a major overhaul as did reforms in the mid-1970s, it is particularly important. The reform lowered personal and corporate income tax rates, streamlined the industrial tax incentive system, and moved partway toward the "real-name system" (see sec. 5.4.2) for financial transactions. The intent of these changes was to bring the Korean tax system one step closer to an ideal system of fairness and efficiency. In a practical sense, however, the streamlining of tax incentives was the most significant result of the reform.

Under the announced principle of low taxes and low exemption, the 1982

5. In 1980, for the first time in Korea, a negative growth rate of -4.8 percent was recorded. The wholesale price index jumped by as much as 42 percent, and the current account balance recorded a deficit of U.S \$5.3 billion (30.3 percent of the total amount of annual exports).

tax reform revamped the incentive system drastically. Specifically, the liberal tax privileges of key industries were almost completely removed. The effects of this measure can be observed in table 5.1. Incentives for research and development, and investment in small and medium firms were reinforced. In other words, the government adopted a “functional” or “indirect” approach, in contrast to the previous industry-specific or “direct” approach, in providing industrial incentives.

The economy quickly stabilized and showed steady growth through the mid-1980s. Other reform measures for liberalization and structural adjustment were consistently implemented. Tax policy remained largely unchanged during the mid-1980s, however, although the demand for a fundamental tax reform in response to drastically changing internal and external conditions was very strong throughout the 1980s. This increasing demand led the government to establish the Commission on Tax Reform in 1984. The first proposal of the commission was submitted in 1985 and was allegedly reflected in the tax reform of 1988. That reform, however, was not a full embodiment of the commission’s proposals but a first response to the rapidly changing political and social environment and its needs. Subsequent tax reform was mainly geared to coping with social and economic needs stemming from the extreme political changes of the past two to three years. Since such reforms are still in progress, we will discuss them separately in section 5.4.

5.3 An Outline of the Current Tax System

5.3.1 The Structure and Characteristics

Currently, Korea has twenty-nine taxes, of which fifteen are national (see the appendix). In terms of revenue, the VAT is the most important national tax, generating more than 20 percent of total tax revenue. Other major taxes are defense tax, personal income tax, corporate tax, and customs duties. Specialized excise taxes (special excise, liquor, and telephone) are also important revenue generators. The revenue from local taxes is only 10 percent of total tax revenue, whereas the taxes on tobacco and on real estate acquisition and registration are significant.⁶

The tax structure in Korea can be characterized by its heavy reliance on indirect taxes. As presented in table 5.2, about 60 percent of total tax revenue is from indirect taxes. The dependence on indirect taxes has been criticized as

6. The distinction between central and local government has relatively little meaning in Korea. Although the country is administratively divided into six special cities and nine provinces, the heads at all levels of local government are directly appointed by the central government. Local autonomy was briefly in effect before the military coup d'état in 1961 but has not been reintroduced. Thus, Korea's local governments have acted merely as agents carrying out the decisions of the central government. They have neither their own kinds of tax nor the power to change tax rates in response to the needs of local residents.

Table 5.2 Direct and Indirect Tax Ratio (% of all taxes)

	Direct	Indirect
1965	42.9	57.1
1970	43.5	56.5
1975	39.5	60.5
1980	36.9	63.1
1985	39.3	60.7
1988	44.9	55.1

Sources: Office of National Tax Administration 1982; Ministry of Finance 1990.

the major source of the regressive nature of the overall tax burden in Korea. This "inequitable" feature of the tax system may be more clearly demonstrated by the relatively insignificant role of the personal income tax (table 5.3). As of 1987, less than 2 percent of GDP was collected as personal income tax, while in most Western countries the level (as of 1985) was around 10 percent. With such a low percentage, it is impossible to significantly affect the distribution of income through tax policies.

There are a few reasons for the poor performance of personal income tax in Korea. First, though the marginal tax rate is very high and progressive, the exemption level is also very high, and only about 40 percent of workers pay income tax. Second, most interest income and about half of dividend income is taxed separately, at a low flat rate (10 percent, plus surcharges and 5 percent education tax). Third, capital gains from financial asset transactions are completely untaxed and those from real asset transactions are undertaxed. Probably most important, the level of income tax compliance and administration is very low. Proprietors' income is especially notorious for escaping taxation.⁷

Revenue from taxes on wealth as a percentage of the total tax revenue of all governments at all levels is about 8.1 percent, which is quite low by international standards.

5.3.2 Taxation on Income

The individual income tax system in Korea is a mixture of global and schedular systems. Not all incomes are included in the global income calcu-

7. It is difficult to construct a statistical proof for this assertion. However, this idea is generally accepted among Koreans, based on their personal experience. Another important indirect argument for the assertion can be found in the following facts: An unincorporated firm whose annual sales are below 36 million won is eligible for the "special taxation" program of the VAT. A firm eligible for this program is not required to keep books, and its VAT liability is 2 percent of total sales. This sales information is also used in estimating the firm's income tax base, by applying the "standard income ratio." If the ratio is 10 percent, monthly taxable income of such a business owner is only 300,000 won, which is even lower than the starting salary of a typical high school-graduate worker. About 70 percent of the unincorporated firms in Korea are covered under the special tax program. As a result, about 65 percent of proprietors belong to the zero bracket even though the personal exemption level for proprietors' income is smaller than that for labor income.

Table 5.3 Tax Revenue Structure by Type of Taxes, 1985 (% of GDP)

	Income		Consumption			Social Security	Total
	All	Personal	All	General	Property		
Canada	15.0	12.0	10.7	4.5	3.2	4.5	33.9
West Germany	13.1	10.8	9.7	6.0	1.1	13.8	37.8
Sweden	21.2	19.5	13.3	7.0	1.2	14.7*	50.5
United Kingdom	14.8	9.9	12.0	6.0	4.6	6.7*	38.1
United States	12.3	10.3	5.1	2.1	2.9	8.4	28.7
Japan	13.0	7.0	4.0	—	2.7	8.5	23.3
Korea (1987)	3.6	1.9	12.8	4.0	1.6	0.3	18.0

Sources: OECD 1987; Bank of Korea 1989.

*Includes taxes on payroll and work force.

lation. Global income comprises interest, dividends, real estate income, business income, and wages and salary and is taxed at a highly progressive rate, ranging from 5 to 50 percent, exclusive of surcharges.⁸ There are eight brackets, and the bracket for the top marginal rate is over 50 million won. Currently, almost 100 percent of interest income and more than half of dividend income is taxed separately at 10 percent. (Inclusive of surcharges and 5 percent education tax, the effective rate ranges from 16.75 to 17.75 percent.)⁹

Retirement income, capital gains from sales of real assets, and timber income are taxed under independent schedules. Tax rates for real capital gain from real assets range from 40 to 60 percent according to the size of the capital gain. Capital gains from the financial asset market are simply untaxed. Income from agricultural land is taxed by local governments at progressive rates. As noted previously, liberal deductions and exemptions are stipulated in the income tax law, and, as a result, about 60 percent of workers and 65 percent of proprietors belong to the zero bracket.

Corporate incomes are taxed under the corporate tax. On up to 80 million won, the low rate of 20 percent is applied, and the excess is taxed at 30 percent.¹⁰ For large closed corporations, the high (marginal) rate is 33 percent. Capital gains from real property sales are uniquely treated. First they are taxed as normal corporate income, and then an "additional tax" of 25 to 35 percent is charged. This makes corporate capital gains taxes consistent with the high tax rate on capital gains of individuals.

As previously mentioned, these taxes have been heavily used as policy tools

8. The effective top marginal rate inclusive of defense tax (10–20 percent) and inhabitant tax (7.5 percent) is 63.75 percent.

9. As a means to promote financial savings, income from major financial savings had been almost untaxed until the mid-1970s. The current system of separate taxation of financial income provides incentives for saving and reflects the inability to identify taxable financial income under the system in which fictitious-name financial transactions are allowed.

10. Defense tax (20–25 percent) and inhabitant tax (7.5 percent) are surcharged on the corporate tax amount.

for a variety of purposes. The exemptions and deductions of the personal income and the corporation taxes were considerably reduced by the reform of 1982, but various incentive measures such as accelerated depreciation, investment tax credit, and tax-free reserves are still liberally used in promoting research and development investment, investment in small and medium industries, and relocation of industries away from large metropolitan areas.

The Korean tax system has not yet incorporated serious measures such as the imputation method to handle the problem of double taxation at corporate and personal dividend income levels. A tax credit for dividend income has been adopted for this purpose. More than 50 percent of dividend income, however, is taxed separately at a low rate, and therefore the double taxation problem has not been too serious.

5.3.3 Consumption Taxes

The current structure of the consumption tax system was completed in 1977 when the VAT was introduced. The VAT is the largest consumption tax in Korea. Other consumption taxes are the special excise, liquor, telephone, stamp, and tobacco sales. In terms of revenue, the tobacco sales tax, which is the only local tax among consumption taxes, the special excise tax, and the liquor tax are particularly important.

The Korean VAT is a typical European Community type with a flat rate of 10 percent and zero rating. To the small firms that have difficulty in bookkeeping, the "special taxation" system is applied. Under this system, eligible firms are taxed on a turnover basis; they pay 2 percent of their gross sales amount rather than 10 percent of their value-added amount. Because more than 70 percent of VAT payers are under the special taxation system, the merits of the VAT are not fully exploited.

The special excise tax was first introduced to mitigate the presumed regressivity of the single-rated VAT. Currently thirty-six items (single commodity, groups of similar commodity, or services) are taxed at rates ranging from 10 to 100 percent.¹¹ Incidence of this tax is estimated to be significantly less regressive, compared with the VAT.¹² Liquor taxes are ad valorem in Korea, ranging from 10 to 300 percent. Tobacco production and sales were monopolized by the government until very recently, when the business unit was changed to a public corporation. Previously, the profit from the government monopoly was included as an indirect tax revenue of the central government, but currently, similar revenue is generated by local government taxation of tobacco consumption.

5.3.4 Taxation on Property Ownership and Transfers

At the national level, the inheritance and gift tax has been the most important tax on property transfers, though the revenue from it has been negligible.

11. Only gasoline and Turkish baths are taxed at 100 percent. Most items are taxed at 10 to 25 percent, and a few items are taxed at 30, 40, or 60 percent.

12. See Lee and Bae (1987) for a comprehensive incidence study of indirect taxes in Korea.

Taxes on capital gains from real property transactions can also be categorized as taxes on property transfers. Capital gains taxes were created to control real estate speculation in the mid-1960s but now are incorporated in the income tax law and corporate tax law as discussed above.¹³ Recently, a tax on excess profit from land was introduced. This tax is a selective capital gains tax levied on an accrual basis. We will discuss this tax and related recent legislation in section 5.4.

The inheritance tax in Korea is not a true inheritance tax but an estate tax.¹⁴ Gifts or inter vivos transfers are taxed separately unless such transfers take place within a three-year period before the death of the donor. In such a case, the gift amount is added to the estate tax base. The gift tax base is calculated by accumulating the inter vivos transfers from a donor for three consecutive years. Both taxes have highly progressive rate schemes, ranging from 5 to 55 percent for the inheritance tax and 5 to 60 percent for the gift tax. In addition, a 20 percent defense tax is surcharged on both taxes. Exemption levels are not very high.

These taxes, in spite of such high rates and strictness in other aspects, have generated insignificant revenue. This fact is the most obvious evidence that they have not contributed significantly to redistributing wealth. The most notable reason for such poor performance has been, among other things, the unrealistically low assessment of assets.

Local governments tax property holdings, acquisition, and registration. Currently, the property tax is applied to buildings and construction, mining lots, aircraft, and vessels; the landholdings are taxed under the global landholding tax, which came into effect in 1990. We will discuss this tax in some detail in section 5.4. The acquisition tax and the registration tax have been important revenue sources for local governments.

5.4 Current Tax Reform Issues

5.4.1 Recent Sociopolitical Changes and Emphasis on Equity and Balance

The late 1980s may be considered one of the most important turning points in Korea's modernization. In spite of economic success in the 1980s, the Ko-

13. It is not clear why tax measures have been preferred in coping with land speculation in Korea. We guess the following reasons are important. First, Korean financial markets were not working efficiently. Second, land speculation in Korea has been looked at as a social sin, and the policymakers seem to have thought that those who speculate on land deserve a heavy tax as a penalty. Third, as a short term emergency measure to scare away speculators from the overheated real estate market, tax measures sound more powerful than financial measures. Fourth, a financial squeeze not only affects the real estate market but also hampers industrial investment. Policymakers wanted to redirect loanable funds from unproductive real estate speculation to productive industrial investment. In other words, some selective measures were preferred.

14. The legal description of this tax is not perfectly clear, and, indeed, a few scholars claim that the Inheritance and Gift Tax Law is an inheritance tax. But the majority of scholars in this field agree that it is an estate tax as described in the law, which is the official interpretation. For a detailed discussion on this matter, see Choi (1990).

rean citizens' resentment against Chun's dictatorial regime grew rapidly, and in early 1987 it burst out in violent protests. The "June 29 Declaration" of the ruling party, which promised a drastic "democratization" including a direct election of the next president, calmed the protest. The abrupt removal of various controls, however, resulted in social disruption and difficulties of different kinds. Extremely extensive and violent labor unrest hit the economy from the second half of 1987 on. Not only workers but farmers, street vendors, the urban poor, and other groups marched the streets to make their voices heard.

Fortunately, the economy of the country was extremely healthy, with double-digit growth rates, large and unprecedented trade surpluses, and perfect price stability. The Korean public, who had believed that they were personally indebted when the national debt was an economic issue in earlier years, naturally believed that they deserved shares in the large trade surpluses.¹⁵ Specifically, the relatively underprivileged classes began to cry out for equity and balance. They asked the government to secure the awarding of their due shares, which had been suspended until "the pie grew large enough." The presidential election and the general election for representatives of the National Assembly were carried out with severe and confusing competition among four major parties. All the parties and candidates offered fantastic promises, inflating the expectations of the public. Under the new constitution, President Roh Tae Woo was elected and inaugurated in 1988, but the ruling party failed to secure the majority in the National Assembly.

5.4.2 Tax Reform Experiments under a "Democratized" Environment

These social and political changes exercised enormous influence both on policy-making processes and policy objectives themselves. First, popular voices and various interest groups gained much power, whereas the influence of the technocrats and specialists weakened. Public hearings and opinion surveys about policy-making became much more frequent. Second, equity in income and wealth distribution and balance in development among regions and sectors became the prime policy objectives. Recent tax reforms reflect these changes vividly.

Income Taxation and Equity

Income taxation in Korea, in spite of its highly progressive rate structure, has not contributed significantly to distributive equity. Reducing the tax burden of low-income workers, however, seems to make a powerful and attractive political catchphrase at any time. Such tax reform was promised by all competing parties in the elections and was implemented in the 1988 tax reform. Though officially it was the first major reform carried out in response to the proposals that the tax reform committee made in 1985, in effect most of

15. Various policy forums had active debates during 1987-88 on how to use the "trade surpluses" to improve social welfare.

the changes were administrative or technical, and few were major. One of the important features of the reform was an increase in the personal exemption level of the income tax. Other major changes were reduction in the number of brackets and the marginal tax rates of the income tax and the inheritance tax, downward adjustment in many excise tax rates, a large-scale upward adjustment of the limit below which the special taxation system of the VAT is applicable, and reduction of some incentives for exports and inducement of foreign capital.

Income tax reform in 1988, ostensibly to help the poor working class, actually undermined the already narrow base of the income tax system and might negatively affect distributive equity in the long run. The majority of the workers were not paying any income tax, and the reform increased the size of this group. By reducing the tax rate without any other compensating measures, the income tax burden of the upper-bracket families was visibly reduced. The tax revenue in general was expected to be reduced, limiting the expansion of welfare-related programs for low-income families.

Ironically, the income tax revenue in 1989 substantially exceeded the budget and the figure predicted by the government.¹⁶ In the event, most newspapers in Seoul printed editorials and columns saying that the "excessive" collected revenue should be refunded. Very hot debates on this matter followed, subsiding after a while without any clear-cut conclusions. Since the "real-name system" is officially suspended, a further reduction of the income tax is being considered by the policy authorities.¹⁷ The income tax base in Korea is thus continually pared down by political motives.

"Public Concept" of Landownership and Land Use

The centerpiece of the recent tax reform issues in Korea is how to control land speculation through tax measures. Land speculation has been a serious economic and social problem in Korea almost from the beginning of industrialization. In the mid-1960s, the land-speculation-control tax was introduced, but land speculation caused various problems throughout the 1970s. After a series of strong stabilization measures in the early 1980s, asset market inflation seemed to be held under control. In recent years, however, speculation in real assets has resumed all over the country. One important reason for this drastic increase is an excessive increase in liquidity supply, due to balance of payment surpluses. Another factor is the elections; they not only contributed to the increase in the liquidity supply but also actively stimulated land

16. There are a few reasons for this excess. The business conditions were extremely good. Nominal wage level increased dramatically as a result of good business conditions and extensive labor unrest. And the budget officers seem to have been too conservative in estimating the revenue implications of the reform.

17. We will say more about the "real-name system" later. Introduction of this system has been associated with a heavier taxation of income from financial assets of high-income-class households. Therefore, to balance the suspension of the introduction of the system, many argued, labor income tax should be further reduced.

speculation when politicians announced blueprints for numerous development projects to be carried out when elected. In addition, industrial investment became extremely unattractive mainly because of the skyrocketing cost of labor, including the psychic cost of violence by workers. As a result, capital owners began to seek a safe and easy way of making money or at least of safely hoarding their wealth. The public, losing confidence in the stability of the value of money, began to escape from financial assets. The real demand for housing was also increasing because of the rapidly rising income level of middle-class workers. The real estate market simply exploded.

Even before this explosion, the government was seriously concerned about the concentration of the distribution of real assets and the severe shortage of urban land for housing and business. Since inflation in the real estate market has been far exceeding that in the commodity markets, the skewed distribution of land and buildings is the single most important source of the ever-widening gap between the haves and the have-nots. The rapidly rising cost of housing, when the supply of urban housing is far short of the desired level, could cause serious social instability. Under these conditions, the government planned to introduce a strong system to fight real estate speculation. In September 1988, an ad hoc committee to study the "public concept" of the ownership of land was established to draft a proposal on various measures to deal with pending land problems. At the same time, the government announced that it would introduce a global landholding tax. The global landholding tax and three other measures proposed by the "public concept" committee were enacted in 1990.

As part of the effort to control land speculation, the government announced a schedule to raise the landholding tax assessment to 60 percent of the actual market price by 1992. One of the major reasons for poor performance of property-related taxes was unrealistically low and extremely uneven assessment of real assets for tax purposes. A survey by the Ministry of Home Affairs reported that the average assessment for property tax was 23 percent of the actual value in Seoul and 46.2 percent in Kyungbuk province as of 1988. The assessment ratio varied among different regions and among different uses or types of land (Lee 1988, 37-39). In addition, several "official" prices of land were assessed by different organizations for different public policy purposes.

As a practical measure to provide a unified and realistic assessment of land to be used for various policy purposes, a new system for assessing land and announcing the results to the public was introduced in 1989. It is expected that the administration of the property-related taxes will be improved and strengthened substantially as a result.

The introduction of the new assessment system and the plan for the upward adjustment of the assessment ratio may be considered complementary measures of the new system on landholding enacted in 1990. A global land tax, under which the property tax operates as a personal tax with a progressive rate system, was introduced.

As early as 1973, a tax measure to deal with speculative holding of real property was introduced. Penalty rates on luxurious real properties and on unused urban land were introduced in the property tax system. A progressive property tax rate scheme ranging from 0.3 to 5 percent (raised to 7 percent later) on houses was introduced in 1974. This system became a partially global personal property tax system in 1988. As an excessive-landholding tax, the system applied progressive tax rates of 1 to 5 percent on the value of a person's local holding of unused urban land. This measure was felt inadequate to control the ever-increasing demand for landholding and to satisfy public demand for equity and social reform. Opinions claiming that public control over landholding and use must be reinforced seemed to gain public support.¹⁸ As a result, a full-fledged global landholding tax and other rather extreme measures to control speculative landholding were introduced.

Under the global landholding tax (the aggregate land tax) system, all land owned by individuals and corporations is classified in three ways: (1) properties to be taxed under the main global scheme, (2) properties to be taxed under the secondary global scheme, and (3) properties to be taxed separately at flat rates.

The first group includes most of the properties previously taxed under the excessive-landholding tax at progressive rates ranging from 0.2 percent for the base which is less than 5 million won, to 5 percent for more than 5 billion won. The second group is mainly composed of commercially used land. In this case, the highest marginal tax rate is 2 percent, and the tax bases are much wider, the maximum base being above 30 billion won. The third group includes properties, owned by a single individual or a corporation, to be taxed at low flat rates (0.1 to 0.3 percent) or at a very high rate (5 percent) depending on the type of use, regardless of the size.

This tax, though a personal tax, is administered as a local tax. The tax liability of each taxpayer is calculated by the Ministry of Home Affairs, but collection is the responsibility of local governments, each of which collects a proportional share from a single individual in case a taxpayer owns land in multiple jurisdictions. This unique feature of the tax may cause significant administrative difficulties in the future. In addition, this tax depends critically on the judgment of the tax administrator in classifying specific properties.

Another important tax measure enacted in 1990 to deal with land speculation is the excessive-land-profit tax. This tax is levied on "excessive" capital gains accrued to landholdings.¹⁹ Under this system, accrued net capital gains (net of capital expenditure on the land) in excess of normal gains, that is, in excess of the national average rate of land price increase, is taxed at a 50

18. Possible reasons for the bias toward tax measures in coping with land speculation are mentioned in footnote 13. Even the "public concept" committee did not propose any financial measure to fight real asset inflation.

19. A similar tax system had been introduced in Korea in the 1967 tax reform but was immediately repealed, mainly because of administrative difficulties.

percent rate every three years. Different percentages (40–80 percent) of the tax may be credited to the existing capital gains tax, depending on the length of time between the levy of the excessive-land-profit tax and the sale of the land. This system critically depends on the accuracy and fairness of the assessment of all land as well as on the judgment of the tax authority about the utilization of each piece of land.

Although not exactly a tax issue, the most debated “public concept” issue during the past couple of years was whether a ceiling should be established on the holding of residential land. Those who opposed the introduction of the ceiling emphasized the constitutional right of property ownership and disposal as well as the market system of resource allocation, while those for the ceiling emphasized the public sentiment on land issues, the shortage of housing, and the extreme concentration of landholding. According to the latter group, by sacrificing a handful of large landholders, social justice could be greatly enhanced, benefiting the majority. A few polls confirmed the public sentiment in favor of the ceiling. The National Assembly eventually passed a bill to establish a ceiling on the holding of residential land in city areas, which was partially enacted in 1990.²⁰

The third system proposed by the “public concept” committee and adopted by the National Assembly was the system to retake development profits. According to this system, a land developer pays 50 percent of the evaluated profit from the project to the government.

“Real-Name System” of Financial Transactions

Another pillar of the reform debates during recent years has been the so-called real-name system of financial transactions. In fact, it is an “old” issue. In 1961, the capital-hungry military government introduced a system in which financial transactions under fictitious names were allowed, to encourage financial saving. The anonymity system had long been criticized for generating inequities in the tax burden and providing a safe harbor for curb market activities, the most typical underground economic activity in Korea. It had not been an urgent issue, however, until a national financial scandal was disclosed in 1982. A number of leading corporations were involved in a combination of fraud and curb market financial transactions. The shock of the incident gave strength to the cry for introduction of a forced real-name system. In the same year, the law disallowing fictitious-name financial transactions was passed by the National Assembly, with a proviso that the implementation of the system would be suspended until the economy had gained sufficient strength and the administration was prepared. The authority to implement the system was given to the president.

20. Under this system, a household unit cannot hold residential land in excess of 660 square meters in six major city areas. Those who want to hold in excess of the limit must pay annually 7 to 11 percent of the value of the excess land.

Over the past several years, however, the government has failed to launch the system. In the presidential election in 1987, all candidates promised to activate the system when elected. In due course, the government announced the schedule to implement the system and established a working group in the Ministry of Finance. From the second half of 1989 on, in spite of the scheduled introduction of the "public concept" systems, real asset prices skyrocketed and the stock market slid steeply down. In particular, price increases in the housing market were formidable. In addition, the real economy was performing very poorly in 1989 and did not improve in 1990. Facing such conditions, the government cancelled the scheduled activation of the system early in 1990 and instead is concentrating on the fight against real asset inflation.

5.5 Pending Issues and Prospects

A number of important issues are oppressing the Korean economy. The industrial sector is in the midst of a drastic structural adjustment. The leading export sectors are rapidly losing their competitiveness in international markets, due mainly to dramatically increasing labor cost. The agricultural sector, which includes about one-fifth of the population, cannot be easily restructured. At the same time, the public's inflated expectations must be taken care of somehow. Macroeconomic stability is very seriously threatened.

All these problems are important and urgent, but politically the public demand for justice and equity or a "social reform" seems to be the top policy concern. The government and the ruling party try to show their willingness to "reform" by proposing tax reforms. There is little likelihood of achieving this goal through reform of income taxation unless the real-name system is implemented in the near future. Even if the system is enacted successfully, however, it is clear that it will not immediately bring equitable income taxation.

Equity and balance may be pursued by increasing transfer expenditures and other social programs. This approach, however, requires increased government revenue. Over the past several years, government plans to raise the tax/GNP ratio moderately have not been successful. It is not likely that the government will reform the tax system to raise revenue substantially in the near future, mainly because it is not politically rewarding. To the contrary, outspoken political pressure is forcing the government to further cut taxes on labor income. In addition, industries are demanding tax cuts to facilitate smooth structural adjustment.

The demand for reform can be satisfied in large part by stabilizing the real estate market and eliminating speculation. Currently, the government is both persuading and threatening large corporations to dispose of their excessive real properties. This is only a stopgap, and permanent and truly effective policies should be introduced. As noted above, radical tax measures have already been introduced in recent years. The real problem is that land and housing

prices increased even more rapidly after strong antispeculation measures were announced. It is quite clear that the public either do not believe in the consistency of the government in pursuing certain policy goals or do not understand the effects of the new systems.

The most challenging and important issues in the area of tax policy in the coming years, we believe, will be to operate the property-related tax systems effectively and smoothly and to reinforce them, rather than introducing new systems.

Appendix

Table 5A.1 The Tax Structure in Korea (%)

	1980	1985	1990 (budget)
NATIONAL TAXES	88.3	87.7	82.2
Domestic	855.6	54.8	60.9
Personal income	10.2	11.1	11.3
Corporate	7.5	8.5	11.7
Inheritance and gift	0.1	0.3	0.5
Assets revaluation	0.3	0.1	0.2
Excess profit	0.0	0.0	0.0
Value-added	22.7	21.8	26.2
Special excise	8.9	7.4	4.7
Liquor	4.6	3.8	3.1
Telephone	0.8	1.3	0.8
Stamp	0.5	0.6	0.6
Securities transaction	0.0	0.1	1.8
Customs duties	11.8	11.8	7.1
Surcharges	13.1	14.9	14.2
Defense tax	13.1	12.5	12.5
Education tax	—	2.4	1.7
Monopoly profits	7.8	6.2	—
LOCAL TAXES	11.7	12.3	17.8
Ordinary taxes	10.2	10.6	16.3
Acquisition	2.4	2.6	2.6
Registration	1.9	2.7	3.3
License	0.3	0.2	0.2
Inhabitant	1.8	1.5	1.8
Property	1.8	1.8	0.7
Automobile	0.9	0.9	1.3
Global land	—	—	1.2
Farmland income	1.0	0.1	0.0
Butchery	0.1	0.1	0.1
Horse race	0.0	0.1	0.1
Tobacco	—	0.6	5.0
Earmarked taxes	1.5	1.7	1.5
City planning	0.8	0.9	0.7
Fire service facilities	0.2	0.3	0.3
Workshop	0.5	0.5	0.5
TOTAL	100.0	100.0	100.0

Sources: Economic Planning Board 1989, 1990.

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