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TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: KOREA

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TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: KOREA

by

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Abstract
This paper is part of a wider research on South and East Asia countries' taxation, carried on at the Department of Public and Environmental Economics of the University of Pavia, under the direction of L.Bernardi, A.Fraschini and P.Shome and the supervision of. V. Tanzi. Korean tax system is characterized by a comparatively low overall tax pressure: total general government revenue amounts only to 27 percent of GDP. This feature comes from narrow tax bases and relatively low marginal effective tax rates. It mainly reflects the social safety net still being at an early stage of development. During the past decade, and especially after the 1998 financial crisis, the government started reform measures to address the weaknesses of the tax system. However the program includes generous allowances for individuals, large-scale and wide-ranging tax preferences for enterprises. Furthermore the, taxation of property remains inappropriate, and a strong and uniform tax enforcement is still lacking. This chapter of the research first discusses the current structure of Korean tax system, and gives an overview of its development during the last two decades, highlighting how it was connected to trend of overall economy. Then, institutional features of Korean taxation are presented. This section is followed by discussing some indicators about redistribution and efficiency effects of Korean fiscal system. The final section outlines some feasible policies to strengthening neutrality, equity and efficiency of the current tax system.

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1. Introduction, contents and main conclusions

This chapter is devoted to the analysis of the Korean Tax System. The study has been elaborated using the more recent statistics accessible from different sources, from international institutions to Korean sources.

The rapid growth beginning in the 1960s has transformed Korea from one of the poorest countries in the world to an industrialized nation with a per capita income more than half of the OECD average. This study is particularly interesting because permits to investigate the character of the fiscal system of a country that experimented such a rapid change and that is still growing fast.

The first chapter, after a brief analysis of the Korea's economic and political environment, is dedicated to the description of the current structure and the development of the tax system from the beginning of the 1980. Korea is characterized by a relatively heavy dependence on indirect taxation. Among the indirect taxes, the most important is the value added tax (VAT), while earmarked taxes reach together a sum that is the 4 percent of the gross domestic product.

The second chapter describes the framework of the main Korean taxes, focusing on personal income tax, corporate tax and VAT.

After that, there is a section that analyze, according to the avaible data, the distribution of fiscal burden, giving particular stress to tax wedges on labor, capital and consumption, and to the distributional effects from taxes and transfer. The most striking positive features of the Korean tax system are the low overall tax burden and the limited labour market distortions. The tax system is also relatively neutral with respect to income distribution, leaving almost unaffected the fairly even pre-tax income distribution.

The last chapter begins with an outlook over the future trend of the main economic indicators. After a sharp downturn experienced by Korea in the first half of 2003, the economy, according to the OECD estimates, should grow to around 4¾ percent in 2004 and 5½ percent in 2005. The main problem that Korea will must face is the ageing of population that will increase public expenditures significantly. Other major weaknesses include the narrow bases, the excessive complexity of the system and the perceived unfairness of tax enforcement. The chapter then analyses some of the main challenges in tax reforms, in particular: improving the budgeting and expenditure management system; enhancing the efficiency and accountability of public service delivery; securing tax base.

Reform is strongly needed in a number of areas of the tax system in order to improve its revenue- raising capacity, equity, efficiency and simplicity. Tax reform should preferably cover a broad range of measures to make all groups contribute to the future increase in the tax burden and to reap the full economic benefits of the various potential improvements and their mutual interactions. Moreover, reforms should be implemented in a transparent and timely fashion, allowing the private sector time to adjust. By broadening the tax bases, simplifying the system and making the structure and enforcement more equitable, the tax system in Korea could become substantially more neutral across different types of income and less distortionary to economic activity.

2. A broad view of tax system and its developments from the early 1980s

2.1 A short reminder of Korean economy and public sector outline[1]

As one of the Four Tigers of East Asia, since the early 1960s, South Korea has achieved an incredible record of growth and integration into the high-tech modern world economy. Four decades ago GDP per capita was comparable with the levels of the poorer countries of Africa and Asia. Today its GDP per capita is 18 times North Korea's and equal to the lesser economies of the European Union.

Growth plunged to a negative 6.6 percent in 1998, then strongly recovered to 10.8 percent in 1999 and 9.2 percent in 2000. Growth fell back to 3.3 percent in 2001 because of the slowing global economy, falling exports, and the perception that much-needed corporate and financial reforms had stalled. Led by consumer spending and exports, growth in 2002 was an impressive 6.2 percent, despite anemic global growth, followed by moderate recession (2.8 percent growth) in 2003. In 2003 the six-day work week was reduced to five days.

The composition of GDP by sector shows at the first place the services (58 percent) followed by industry, mostly electronics, telecommunications, automobile production, chemicals, shipbuilding, and steel (37.6 percent) and agriculture (4.4 percent).

The unemployment rate, 3.4 percent in the first quarter of 2004 is about the same as the average of the past three years, while core inflation (which excludes petroleum-based fuels and non-grain farm products) has remained around the midpoint of the medium-term target

[1] The main source is OECD Economic Surveys - Korea (2003)

range of 2.5 to 3.5 percent, despite the economic downturn.

The general government spending as share of GDP amounts to 23 percent of GDP and its main categories are Consumption (10.1 percent) and Net Capital Outlays (8.3), while Income Transfers are only the 3.6 percent, compared with the 10 percent of Japan and the 12.4 percent of the OECD area.

The population of the Republic of Korea as of 2003 was 47.9 million. Fast population growth was once a serious social problem in the Republic, as in most other developing countries. Due to successful family planning campaigns and changing attitudes, however, population growth has been curbed remarkably in recent years. The annual growth rate was 0.6 percent in 2003. A notable trend in the population structure is that it is getting increasingly older. The 2003 population estimate revealed that 8.2 percent of the total population was 65 years old or over. The number of people in the age of 15-64 years accounted for 71.4 percent. The life expectancy at the bird is 75.6 on the total of population. The distribution of family income (calculated as Gini index) is a low 31.6 and the 4 percent of the population is below the poverty line

2.2 The tax system

2.2.1 The current structure

The tax pressure in Korea is among the lowest in OECD. Total tax revenue amounts to only 27 percent of GDP. The low tax burden mainly reflects a relatively small government sector, as well as the lack of a social safety net, comparable to those existing in many other OECD countries and despite a recent significant expansion. However, compared with the other low-income OECD countries, though, the tax burden in Korea is about near the average.

The tax-to-GDP ratio has risen slightly over the past 20 years. Most of the increase of the tax burden took place during the 1990s, reflecting high growth rates of personal incomes, increasing social contributions and higher property taxes. Over the past two decades, Korea's tax system developed itself along lines similar to the other OECD countries. In particular, tax-bases have been broadened and rates lowered, thereby reducing the distortionary cost of taxation. But a number of features still continue to hamper equity, efficiency and redistribution, in addition to making the system excessively complex.

Korea is characterized by a relatively heavy dependence on indirect taxation. During the 1970s and 1980s the share of indirect taxes to total taxes was recorded as about 60 percent. Although this share gradually decreased in the 1990s, it stays still high, when compared to that of other OECD member countries: in 2001 indirect taxes amount to 39.6 percent of the total tax revenue, while the direct taxes only to 26.4. Among the indirect taxes, the most important is the value added tax, that represents the biggest proceeds for the government, standing for 5.4 percent of the gross domestic product (GDP).

The second most important tax is the income tax: its revenue is about 15 percent of the total. The yield collected from transportation tax and custom duties is also significantly high: these make up for roughly the same revenue gathered from corporation tax.

A unique factor of the Korean tax system is the importance of earmarked taxes, among which the most important are education tax, transportation tax and rural development tax. Combined with some minor local earmarked taxes, total revenue from earmarked taxes amounts to nearly a fifth of total general government tax revenue, or almost 4 percent of GDP.

2.2.2 Developments of the system from 1975 to 2002

The trend of fiscal revenue in Korea was affected by the tax reforms that continuously succeeded between 1974 and 2000: during this period tax reforms occurred almost once a year.

In December 1976, the government carried out a large scale tax reform and introduced the Value Added Tax (VAT) and the Special Excise Tax. Eighteen new tax laws were enacted or amended under the reform as well. This tax reform was mainly aimed at modernize the tax system and to create a better social environment. By this reform, the traditional indirect tax system, which included a cascade-type business tax, was replaced by a consumption-type VAT and supplementary special excise taxes. This was primarily to simplify tax administration and promote exports and capital investments. General consumption taxes on good and services, in fact, enhanced of two points percent between 1975 and 1980.

There was a dramatic economic policy change in the 1980s. Following the second oil crisis in 1979 and the political turmoil of 1979 and 1980, the Korean economy was plunged into a deep recession and total tax revenue lowered by 0.8 percent. Under these new circumstances, the Korean government fundamentally switched its economic policy directions: from protection to international competition and openness, and from regulation to liberalization and bold privatization. In this regard, the government began to reduce its intervention in the private sector. As a result, not many new functions were demanded from taxation. Therefore there were no relevant tax charges during the 1980s.

The major contents of tax reforms introduced from 1989 to 1992 were principally the reduction of the burden on wage and salary earners and an enhancement in tax equity. In order to achieve these results, the government lowered the fiscal rates on wage and salary income, increased the limits on tax credits for wage and salary earners and strengthened taxation on property. In fact, social security contributions over the three years here considered grew 0.5 percent points faster for employers than for employees, and there was also a rise of rates on financial assets and on inheritance and gift taxes.

The 1993 tax reform aimed at reaching the following purposes. First, tax rates of corporation tax and individual tax were lowered: this strategy had the consequence of the reduction of yield due to income and corporate taxation. Then the taxation method on capital gains was modified. A tax credit system on VAT was introduced, and there was an adjustment of the rates of excise duties and the liquor tax: this resulted in the lowering of the revenue from indirect taxation. Finally a transportation tax for social overhead capital investments was introduced.

The 1994 tax reform was designed to establish a tax system characterized by lower tax rates and broader tax bases. The Korean government planned to set up a fair tax system in terms of horizontal equity. The Korean government finally introduced the inclusion of the financial income in excess of 40 million won into the global income tax base..

The Korean government also hoped to improve the efficiency of the economy by mitigating distortions caused by government intervention and by encouraging market competition. In order to strengthen the international competitiveness of domestic industries, corporation tax rates were reduced again. To overcome inequities in the fiscal charge on different goods, indirect taxes were redefined, by simplifying tax rates and structure.

The decrease of corporate tax experimented from the second half of the 1990s is a consequence of the 1995 tax reform. In order to strengthen the competitiveness of Korean firms, the government alleviated the tax burden, adjusting downwards the corporation tax rate by 2 percentage points. During the same years a decrease of income tax was recorded: this was the effect of the broadening of individual income tax brackets.

The economic crisis of Korea in late 1997 has forced the government to start a series of comprehensive economic reforms to overhaul the economy. In such a troublesome time, it was essential that no tax liability should neither discourage nor prevent companies and financial institutions from undergoing necessary restructuring. Above all, the Korean government introduced tax measures to restructuring of banking and business sector. Taxes on asset transaction for the purpose of corporate and financial reorganization were called out or reduced. Tax incentives to encourage and accelerate restructuring were mostly granted to transaction-related taxes such as capital gain tax: they were intended to encourage sales of business assets and corporate mergers and acquisitions.

Tax revenue declined significantly since the beginning of 1998: among all, the slowdown of income-elastic tax bases was particularly pronounced. Therefore, the government choose to increase taxes on income-inelastic goods.. To broaden tax bases, the government curtailed tax exemptions and reductions: a notable example was the abolition of the VAT exemption on some services. Another example of the government effort to broaden tax bases was the significant increase of the transportation tax, that reached its top value of 1.9 percent of the GDP in 2001.

[Table1 here]

3. Some quantitative and institutional features of the main taxes

3.1 Direct taxes

3.1.1 Personal Income Tax

Korean citizen and individuals considered as residents for tax purposes are subject to Korean income tax on worldwide income. Korea's income tax is a global tax, under which most incomes are aggregated and taxed at progressive rates. The income tax is collected either by withholding at the source or by filing a tax return based on voluntary self-assessment for the income during a calendar year. Personal income are classified into the following ten categories for the purposes of tax computation:

interest; dividends; real-estate income; business income; wage and salary income; temporary property income; retirement income; timber income; capital gains; other income (such as prize winnings, royalties, rewards, etc).

Tax is withheld at the source of income for the following items: interest, original issue discount premiums of non-interest-bearing bonds, dividends, employment and retirement payments, remuneration or fees for professional services, and fees for public performances. Tax on wages and salaries is withheld at the source, and adjustments between withheld amounts and final tax liability are made at the first payment of such wages and salaries in the next calendar year.

For income from the lease of real estate and income from business activities, gross receipts minus all necessary expenses are taxable.

Capital gains are added to the aggregate income to be taxed at progressive rates. There is a separate tax for capital gains on land or buildings for which the rate varies, depending on weather ownership has been long or short term.

All income, except retirement income and timber income which are taxed separately, is added together. Subtracted from this total income are 1 million won for each exemption: the basic exemption; the exemption for spouse; and the exemption for each dependent. When a taxpayer, spouse or dependent is handicapped, an aged person (65 years or older), a widow/widower, or a working student, an additional exemption is available.

The basic exemption is one million won times the number of person in the taxpayer's family, plus an other million if the family is formed by one person alone, or plus 500.000 won if family is formed by two person.

A person who is 65 years or older, a handicapped person, a female worker or a single male worker who has a lineal descendant under 6 years of age are eligible for an additional exemption and may deduct one million won (plus 500.000 won if person belongs to the third group) per year.

Casualty losses, medical expenses, life insurance premiums, fire and casualty insurance premiums, social insurance contributions, and donations may be deducted from taxable income, subject to certain limitations. Particularly, wage and salary income earners may deduct an amount equal to the sum of the following from their wage and salary income.

a. Insurance premiums paid, up to 700.000 won and total medical care insurance contribution.
b. Medical expenses in excess of 3 percent of the taxpayer's annual salary, up to one million won.
c. Domestically incurred educational expenses up to 700.000 won annually per student for kindergarten and nursery school expenses and up to 2.3 million won for college education expenses.
d. 40 percent of the loan interest (for a total up to 720.000 won per year) allotted to the purchase or lease of a house of appropriate size.
e. Interest of a mortgage loan with the duration of more than ten years.
f. Amounts donated to qualified institutions: up to 5 percent of the taxpayer's salary and wage income of the year. This limit may be raised by an additional 5 percent of the salary and wage income in cases of donations made to privately operated schools.

A tax payer may elect to choose an annual standard deduction if he fails to claim deductions in question or accrues only global income without wages or salaries earned.

A tax payer may deduct finally the total amount of the pension contribution up to 2.4 million won.

Recently, the amount of expenditure used by credit card was added a deduction item, which was intended to promote the use of credit card. Recent surge in the use of credit card by this type of incentive is believed to have contributed to make the business income more exposed to tax authority. A tax payer may deduct the 20 percent of amount of payment by credit card, exceeding 10 percent of income, up to 5 million won.

Effective from January 1, 2002, individual income tax rates on global income range from 9 percent to 36 percent.

[Table 2 here]

3.1.2 Inheritance and Gift taxes

The inheritance tax is imposed on the recipient of assets from the decedent by inheritance, bequest, or devise.

If any heir or legatee has received property by gift from the decedent within ten years from death, the value of such property is added to the total taxable assets. Life and personal accident insurance payments and retirement allowances received by heirs up to a certain amount are also added to the total taxable assets.

From the value of the properties, 200 million won as the basic exemption and 30 million won for each statutory heir are subtracted to obtain taxable value. The value thus obtained is divided among the statutory heirs in accordance with the shares provided by the Civil Code.

The tax rates are progressive, beginning at 10 percent for a taxable estate of 100 million won or less; the maximum rate is 50 percent for taxable assets over 3 billion won. The tax rates are applied to the total share.

[Table 3 here]

Some allowances are granted for inheritance and gifts, varying according to the category of beneficiaries or donees. Besides a general basic deduction of 200 million won, in fact, there are also additional deductions for inherited family businesses (up to 100 million won), inherited farms, fisheries, and forestry (up to 200 million won), deductions for dependents amounting to 30 million won per person, deductions for minors (an annual deduction of 5 million won is granted to the minor until he or she becomes 20 years old) and deductions for the elderly (a deduction of 30 million Won is
granted to the inheritor or legatee, or a member of the inheritor or legatee's family when he is over 60 years old).

Effective from 1st January 1997, gift tax rates are the same as those for inheritance tax.

3.1.3 Corporation Tax

Companies that are subject to corporation tax in Korea can be classified into two types: domestic or foreign, and for-profit or non-profit. For taxation purpose, a company with its head or main office in Korea is deemed a domestic company and is liable to tax on its worldwide income. Otherwise, it is considered to be a foreign company, and the tax liabilities of foreign companies in Korea are limited to Korean –source income.

The income of a domestic corporation during each business year is the amount remaining after deducting the gross amount of losses from the gross amount gains during each year. To derive the tax base, the deficits carried over from the previous five years should be deducted from this income. Other deductibles specified in the law may apply.

The Korean corporation tax rates were gradually reduced in the last ten years: from 34 percent to 32 percent in 1994, to 30 percent in 1995, and further to 28 percent in 1996. For corporations with income of less than 100 million won, the tax rate on profits has been 16 percent since 1996 and that rate is also applied for non-profit organizations. Both rates were reduced by 1 percent in 2001.

[Table 4 here]

3.2 Indirect taxes

3.2.1 The Value added tax

In its 1976 tax reform, Korea adopted the Value Added Tax (VAT) on the delivery of goods, the rendering of services and importation. The tax replaced the following taxes as of 1st July 1977: business tax, commodity tax, textile products tax, petroleum products tax, electricity and gas tax, travel tax, admission tax and the entertainment and food tax.

VAT is imposed at the uniform rate of 10 percent on a wide range of goods and services. The tax is levied at each stage of sale on domestically produced or imported goods and services by business entities. The consumption tax paid to suppliers is credited against the tax on sale by the business entities in order to avoid tax cascading

Exports are exempted from tax (zero rate), and daily necessities such as unprocessed foodstuffs and tap water, financial services and so on are exempt.

In addition to the zero rating and other exemptions, there was, until July 2000, a special treatment, called simplified taxation. A trader whose turnover (or proceeds including VAT) of the supply of goods or services during the immediate preceding year is less than 48 million won falls under that category. If a trader is eligible for simplified taxation, the tax amount payable is calculated as follows: aggregate amount of supply during the concerned taxable period × average rate of value added as prescribed by the Presidential Decree for each category of business (raging from 20 percent through 40 percent) × 10 percent. This simplified taxation tended to be abused because small business such as self-employed are prone to under-report their turnover .

The elimination of this scheme implies that 0.5 million taxpayers will be included in the ordinary VAT regime, increasing the ordinary tax payers by 40 percent. However, the taxable turnover in the ordinary regime will only increase by about 1 percent, making the immediate effect on total VAT revenue quite small.

3.2.2 Excise Taxes

As in most other countries, a number of excise taxes are imposed on consumption. In Korea are those on transportation, liquor, telephone service and the special consumption tax, which imposes excise taxes on 27 luxury goods. Tax rates differ according to the type of commodity. Percentage rates vary from 10 percent to 20 percent except for the rate applying to horse race admissions. Taxable objects and tax rates are classified into four classes, each of which is subdivided into groups. The first class of goods includes slot machines, golf requisites, movie projectors, and so on. Class 2 includes jewellery worth over two million won, luxury cameras, watches, carpets and furniture, etc. Tax rate applied on these first two classes is 20 percent. Cars are classified in class 3. Tax rates of class 3 depend on the size of engine and currently are in the range of 7-14 percent. Class 4 includes fuels such as gasoline, diesel, LPG, LNG, etc. A fixed amount of tax is applied to those items.

Together, these excise taxes raise revenue equivalent to 2.5 percent of GDP. Compared with many other OECD countries, where excise taxes tend to be concentrated on a few items in three product groups (mineral oils, tobacco and alcoholic beverages), the Korean excise tax system is much more widespread and complex.

4. The fiscal burden

4.1 The general distribution of taxation charge

The tax mix in Korea relies more heavily on property and consumption taxes than in most other OECD countries. The share of consumption taxes (40 percent on total revenue) is significantly above the level of countries such as Japan, the United States and the EU's ones , though this share has strongly fallen during recent years and is now closer to the OECD average. VAT revenue constitutes under half of total consumption tax revenue, a relatively low share compared with other OECD countries. This is not fine since the VAT tends to be less distortive than other kinds of consumption taxes. Social security contributions are still fairly low, but have risen substantially, primarily because of the introduction of the National Pension Scheme in 1988. The share of individual income taxes has also increased, in line with the government's long-term objective of raising the ratio of direct to indirect taxes. However, the share of individual income taxes is still somewhat lower than in many other OECD countries (Dalsgaard 2000).

Measured by average *ex post* effective (= implicit) tax rates, taxation of labour is much lower in Korea than elsewhere in the OECD, while average taxation of consumption and capital appears to be close to the OECD average. Taxation of capital has risen sharply over the past 20 years, mainly as a consequence of soaring property tax revenue because of land and property prices increases, but also a declining trend in the economy-wide operating surplus. When measured against the net operating surplus, the increase is even larger since depreciation of fixed capital, as measured in the national accounts, has increased more than proportionately with income (Dalsgaard, 2000). Although these average tax rates should be interpreted with caution, they indicate that the rise in the average effective tax burden on labour relative to that on capital which took place over the past couple of decades in most other OECD countries did not occur in Korea. The rising trend in the OECD area is thought olso to reflect the fact that capital taxation tends to be more prone to base erosion than labour and consumption taxes. However, since a significant share of Korea's capital taxes are based on property, erosion of the tax base is less of a problem.

Commento: Sicuro? Dovrebbe essere l'opposto

Commento: E' tutto poco chiaro: gli ammortamenti sono deducibili!

[Table 5 here]

Commento: Spostare a fine testo e adeguare l'editing, come già indicato.

4. 2 Distributional effects from taxes and transfer

The tax and transfer system has only a marginal influence on income distribution in Korea. Income taxes slightly reduce income inequalities whereas social security contributions and the value added tax draw in the other direction. The special consumption tax, which was introduced along with the VAT to counterbalance expected adverse distributional effects of the VAT itself, has only a negligible effect on the income distribution. The low overall redistributional effects from the tax system mainly reflect the low tax burden in Korea. Progressivity of the personal income tax system is roughly similar to that in other OECD countries. The distance between the marginal tax rate for an average production worker (APW) and for a top income earner is higher in Korea than elsewhere. However, since the top marginal tax rate, unlike in many other OECD countries, is only applied at very high income levels, according to Dasgaard (2000), this is not representative of the potential increase in tax burdens facing the average income earner. When measured at the margin, the income tax system in Korea appears to be no more progressive than other OECD countries, including Japan and the United States.

[Table 6 here]

5. Tax reforms

5.1 A quick glance at macro economic and budget outlook

According to the latest OECD Economic Survey of Korea (OECD, June 2004), Korea has been one of the fastest growing economies in the OECD area over the past five years, with an annual growth rate of about 6 percent. This excellent performance has sustained the convergence process, lifting per capita income to two-thirds of the OECD average.

Korea has made a stunning recovery from the Asian crisis. Within one and half years, output had already regained its pre-crisis level; within five years, the economy was one-quarter larger than before. Korea's performance has been better than any other Asian country affected by the crisis.

The return of high growth rates corrected some of the weaknesses that made it vulnerable to the Asian crisis. Rapid growth also reflects the country's underlying economic dynamism, particularly in the information and communications technology sector. Korea has also beneficiated from strong demand from China, which has emerged as its biggest trading partner. Korean outstanding performance is underpinned by large impulse of labour and capital, reflecting still-rapid population growth, rising labour force participation rates and high level of investments.

Indeed, remaining weaknesses in the economic framework contributed to the economic recession in the first half of 2003, which slowed growth for the year to around 3 percent. Private consumption was negatively affected by the liquidity and solvency problems of the credit card companies. The instability in financial markets, resulting from the problems of the credit card companies, had a negative impact on business investments. This negative impact was magnified by the deterioration in already difficult industrial relations and labour strikes at major firms. In addition to these structural weaknesses, Korea was hit by a series of external shocks, notably SARS and the North Korea nuclear issue, which weakened confidence.

Public expenditure as a share of GDP is relatively low in Korea: using national accounts data, total public spending of the general government amounts to 22.5 percent of GDP (OECD 2003), the lowest level among the OECD countries. The major factor that underlies the comparatively low spending level in Korea is that income transfer are limited by the lack of a well-developed social safety net. This low level is partially offset by a relatively high level of privately funded social expenditure, both mandatory and voluntary. This is largely due to the retirement allowance that firms are legally required to pay and voluntary social benefits, such as family allowance - paid by many employers. Even so, total social expenditure, public and private, is still only 8 percent of GDP, compared with 15 percent of Japan, and 20 percent or more in all other OECD countries.

Government consumption is well below the OECD average, reflecting the small size of the public sector in Korea. Upward pressure on spending is likely to gain further momentum in Korea. One factor is the 157 trillion won (27 percent of GDP) programme on financial-sector restructuring. Pressure to increase spending will also arise from the expansion of the social safety net. Social welfare spending increased as a result of the financial crisis in 1997 in order to cope with the sharp rise in unemployment and to expand the safety net.

Over the longer term, spending pressure will likely accelerate as a result of population ageing and the consequent demands that this implies on social spending, notably on pensions, healthcare and associated personal services. After Mexico and Turkey, Korea has the youngest population among OECD members, but its population will age more rapidly.

According to the Social Expenditure Database of OECD (2000), around 2030 the portion of pension and security expenditure will take the largest part of the total social welfare expenditure (about 48.4 percent). That is, pension and security expenditure will take about 10 percent of GDP in 2030, which is larger than the OECD average in 1995.

Expenditures related to health, including health insurance, will take the second largest part of the social welfare expenditure in 2030 (6.4 percent of GDP). In sum, expenditures related to pensions and health will take 60~65 percent of welfare expenditure in 2030 and give considerable burden on government budget.

5.2 Tax reforms of last years, under way and planned

Commento: In linea generale questo paragrafo mi sembra poco chiaro perchè non si capisce bene quail sono le riforme già attuate e quelle programmate (al momento in cui lei scrive…)

The direction of tax reforms was lending support to mid and low income classes in 1999, bringing energy tax regime in line with international standards in 2000, reducing tax incentives and lowering tax rates in 2001. The direction of tax reforms in 2002 was supporting mid and low income classes, giving stimulus to local economy, enhancing corporate competitiveness and transforming Korea into a regional hub of business.

Commento: Un po' lungo e senza citazioni

The main pillars of international tax reforms during this period have been regulated by the Foreign Exchange Transaction Act (1999) and its subsequent Revision (2000), following three main directions. First, by allowing an exchange of financial transactions with other countries; second, by subjecting all international transactions under transfer pricing rules; and finally by revising rules on thin capitalization and controlled foreign corporations (CFC rules). With respect to exchanging information on financial transactions with other countries, the Ministry of Finance and Economy plans to provide the information on a reciprocal basis and upon request from foreign revenue authorities on a condition that the released information is strictly limited for the purpose of imposing tax. And non-residents living in Korea as well as foreign companies and branches operating in Korea will come under the scope of the new measure. As for subjecting international transactions to transfer pricing rules, some international transactions between related enterprises (or associated enterprises) falling under the corporate income tax law and not covered by the international tax law used to be subject to "the rules on denying deductibility of improper transactions" in the past. This rule has been changed and all international transactions was be subject to transfer pricing rules, effective from 2003.

Korea expanded the scope of major foreign shareholders by adding brother company of a domestic company as subject to thin capitalization rules. As of April 2003, foreigners owning more than 50 percent of shares of domestic corporations and those foreign shareholders effectively determining the course of the domestic company are classified as major foreign shareholders subject to thin cap rules. Korea has also expanded the scope of major foreign shareholders of domestic permanent establishments subject to thin capitalization rules. Foreign shareholders owing more than 50 percent of brother company of the firm concerned are now subject to thin capitalization rules.

Another revision the country is going to introduce into the rules on thin capitalization is about deemed foreign loan. In the past, only loans either issued by foreign shareholders or by the third party and guaranteed by the shareholder used to be subject to thin capitalization rules. Now other legal documents such as comfort letter, effectively guaranteeing payment of the issued loan shall be deemed as falling under the scope of foreign loans subject to thin cap rules. Thin cap rules prevail over other tax laws or transfer pricing rules in case of divergence of interpretations.

The CFC rules also have undergone some changes. The purpose of CFC rules is to impose tax on unreasonably retained profits of subsidiaries located in “tax havens” by treating them as notional dividends paid to the Korean parent. The concept of “tax havens” under the Korean tax law refers to jurisdictions with no tax or those exempting 50 percent or more of income from tax or with less than 15 percent of tax rate. The companies falling under the scope of CFC rules are subsidiaries located in low-tax jurisdictions whose share capital is at least 20 percent, either directly or indirectly owned by a Korean parent.

The Korean tax law provides for some exemptions to CFC rules, where a subsidiary carries on *bona fide* operations in the low tax jurisdictions through a fixed place of business, such as an office, sales outlet or factory. However, even if these conditions (*bona fide* operations, through a fixed place of business) are met, CFC rules still used to apply to wholesaling, retailing, repair of consumer goods, transport, warehousing, communications, banking, insurance and real estate leasing or services.

There also have been some major revisions of the foreign investment regime in Korea. The Korean government recognizes the fact that foreign direct investments play an important role in the economy and plans to designate special economic zones to facilitate an inflow of foreign investments. In designated special economic zones, qualified foreign investments on a

Commento: non si capisce se ciò che lei descrive è già in vigore oppure no….

large scale shall be granted the same benefits as in foreign investment zones. In the foreign investment zones, companies are exempt from tax for seven years and enjoy 50 percent reduction for the next three years. In designated special economic zones, qualified foreign investments on a medium scale shall be granted the same benefits as in Jeju Free International City. In Jeju, companies are exempt from tax for three years and enjoy 50 percent reduction for the next two years.

What is noteworthy about new measures to promote foreign direct investments is that the proposed measures will expand tax incentives to advanced technologies.

5.3 Suggestions for further improvements

One basic goal of mid to long-term tax reforms is securing tax base. The basic thrust of income taxation reform must be ensuring an adequate and equitable distribution of tax burdens through a continuous broadening of tax base.

The reintroduction of the Comprehensive Financial Income Taxation (CFIT) in the fiscal year 2001 will probably contribute to improvement of equity of tax burden in the long run. However, in order to improve effectiveness of this policy, some complementary measures should be prepared. First of all, it is necessary to extend the scope of financial income subject to this policy. Under the current system, a wide scope of tax-exempt and tax-favored savings is still taxed separately and their withholding tax rate is 10 percent, which is lower than the rate allowed under the system of the CFIT (Jae Jin Kim 2002)

Commento: Non può usare il futuro riferendosi al 2001…che è già passato

Commento: Voglio dire che gli effetti non sono ancora evidenti, ma che potranno rivelarsi nel lungo periodo.

Commento: frase poco chiara…

According to Chun and Lee (1999), the proportion of the stock of tax-exempt and tax-favored savings out of total financial assets was over 25 percent as of 1998. In addition, there are other means to avoid the CFIT. Long-term treasury bonds and public bonds are not subject to the CFIT. Allowance for tax-exemption, favored taxation and separate taxation will restrict the effectiveness of the CFIT in improving the equity of tax burden.

Individual trading in stock market has increased significantly but taxation in this area is still in early stage of development: Therefore, for a more equitable tax burden, capital gains taxation on securities has to be steadily expanded. To accomplish this, small shareholders must bear the tax burden on the capital gains from listed stocks and it is necessary to gradually expand capital gains taxation to derivatives and bonds (Dae Hee Song 2002).

At the root of problems in Korea's tax system it is the wide variation in average effective taxation across various sources of income. While this is partly due to the statutory design of the system, it also reflects an inequitable administrative enforcement of taxation. A number of measures have been implemented since the mid-1990s to enhance tax administration. These include the introduction of the real name system for ownership of financial assets, the adoption of self-assessment as a ruling principle and the implementation of an automated taxpayer database system called the Tax Integrated System. Although these changes are steps in the right direction, a number of deficiencies are still in place in the tax administration and require a coomprehensive intervention to improve the effectiveness and transparency of the system.

Transparency is one of the most important goals in tax administration, since Korean administration does not depend on evidence-based taxation. Effectiveness is another important goal, since tax administration should be organized with economic judgement. Transparent tax administration can be achieved by evidence-based taxation, which refers to, for example, book-keeping, invoices, etc. Effective tax administration can be organised by reducing the work burden in tax information processing, and by emphasizing tax inspection and audits by tax officers (Jin Kwon Hyun 2002).

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Commento: Cos'è?

Table 1 Structure and developments of consolidated General Government revenue - 1975-2001 - Percentage of GDP

	1975	*1980*	*1985*	*1990*	*1995*	*1998*	*1999*	*2000*	*2001*
Direct taxes of which:	*3.7*	*4.5*	*4.5*	*6.2*	*6.5*	*7*	*5.8*	*7.5*	*7.3*
personal income	1.3	2	2.3	3.5	3.9	4.3	3.7	3.8	-
corporation income	1.4	2	1.9	2.7	2.5	2.6	2.1	3.7	-
Taxes on property:	*1.5*	*1.4*	*1.5*	*2.5*	*3*	*2.5*	*3.2*	*3.2*	*3.1*
Taxes on goods and services:	*9.3*	*11.1*	*10.1*	*9.2*	*8.8*	*8.7*	*9.5*	*10*	*10.9*
general consumption	1.9	3.9	3.6	3.9	3.9	3.5	4.2	4.4	-
specific consumption	7.2	7	6.3	5.1	4.5	4.6	4.8	5.1	-
Others	*0.7*	*0.5*	*0.6*	*0.2*	*0.8*	*0.9*	*1*	*1.1*	*1.1*
TOTAL TAX REVENUE:	15.2	17.5	16.7	18.1	19.1	19.1	19.5	21.8	22.4
Social contributions:	*0.1*	*0.2*	*0.3*	*1*	*1.4*	*3.8*	*4.1*	*4.4*	*5*
employees	0	0	0	0.3	0.4	1.7	2	2.4	-
employers	0.1	0.2	0.2	0.7	1	2.1	2.1	1.9	-
TOTAL FISCAL REVENUE:	15.3	17.7	17	19.1	20.5	22.9	23.6	26.2	27.4
Administrative level:									
Central government	89	-	-	-	-	-	-	68.2	-
Local government	10.1	-	-	-	-	-	-	15.1	-
Social security funds	0.9	-	-	-	-	-	-	16.7	-

Source: OECD (2002): "*Revenue Statistics*".

Table 3 Inheritance and Gift tax rates

Tax Base (millions won)	*Tax Rate (percent)*
up to 100	10
100- 500	20
500-1.000	30
1.000- 3.000	40
over 3.000	50

Table 4 Corporation tax rates

Tax Base (millions won)	*Tax Rate (percent)*
up to 100	15
over 100[4]	27

Table 5 Average effective tax rates on capital, labour and consumption

	Capital based on gross operating surplus			*Labour*			*Consumption*		
	1980-85	*1986-90*	*1991-97*	*1980-85*	*1986-90*	*1991-97*	*1980-85*	*1986-90*	*1991-97*
United States	28.3	29.2	31.1	21.6	22.1	22.6	6.3	5.9	6.1
Japan	39.1	42.4	32.6	20.1	23.1	24	6.4	6.2	6.7
Korea	*13.4*	*16.2*	*26.8*	*3.5*	*5*	*7.7*	*17.2*	*17.1*	*16*
OECD average	25.1	26.7	26.6	30	32.2	33.4	16.1	17.2	17.1

Source: OECD (2000).

[4] For corporations with income of more than 100 million won, the tax amount is computed as follows: 15 million won plus 27 percent of tax base.

Table 6. Distributional effects of taxes and social security contributions percent, 1998

	Distribution of income					
Decile	*Gross income*	*Gross income after income tax*	*Gross income after SSC*	*Gross income after VAT*	*Gross income after SCT*	*Net income after all taxes and SSC*
1.	2.64	2.69	2.63	2.57	2.63	2.59
2.	4.71	4.81	4.70	4.68	4.71	4.76
3.	5.89	5.99	5.88	5.86	5.88	5.96
4.	6.95	7.04	6.93	6.93	6.94	7.01
5.	7.99	8.08	7.96	7.96	7.99	8.03
6.	9.15	9.24	9.14	9.13	9.15	9.22
7.	10.56	10.59	10.53	10.58	10.57	10.60
8.	12.32	12.30	12.32	12.33	12.33	12.29
9.	14.97	14.83	14.97	15.02	14.99	14.89
10.	24.83	24.43	24.94	24.95	24.82	24.66
Total	*100*	*100*	*100*	*100*	*100*	*100*
Gini index	*0.3157*	*0.3092*	*0.3169*	*0.3182*	*0.3160*	*0.3131*

Note: SSC = Social security contributions; SCT = Special consumption tax.
Source: National Statistical Office, Monthly Income and Expenditure per Household by Income Decile for Salary and Wage Earners Households of All Cities (1998); Sung (1999); OECD calculations.