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**The Tax System in Korea:
More Fairness and Less
Complexity Required**

Thomas Dalsgaard

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by
Thomas Dalsgaard

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ABSTRACT/RÉSUMÉ

The Tax System in Korea: More Fairness and Less Complexity Required

The tax burden in Korea is among the lowest in the OECD area, mainly reflecting that the social safety net is at an early stage of development. The low tax burden implies limited tax induced economic distortions but as expenditure pressures will mount in the future, neutrality and efficiency of the tax system will have to be substantially improved if more sizeable deadweight losses are to be avoided. Some progress have been made over the past decades in terms of broadening parts of the tax base and lowering rates along the lines followed in many other OECD countries, but a number of weaknesses remain. These include overly generous allowances for individuals, large-scale and wide-ranging tax preferences for enterprises, an inappropriate taxation of property and a lack of strong and uniform tax enforcement. Main directions for reform should include a significant broadening of the bases for personal and corporate taxation as well as in the VAT system; increasing holding taxes on real estate while reducing transaction taxes; aligning the tax treatment of various sources of personal income, in particular between different kinds of capital and pension income; removing earmarked taxes and quasi-taxes; avoiding interventionist approaches; and improving tax administration, especially the enforcement of tax payments of the self-employed.

JEL code: H2

Keywords: Taxation, tax policy, Korea

La charge fiscale en Corée est parmi les plus faibles de la zone de l'OCDE, ce qui s'explique essentiellement par le fait que le filet de protection sociale n'est pas encore très développé. Du fait de la faiblesse de la charge fiscale, les distorsions économiques induites par l'impôt sont limitées mais à mesure que les pressions en faveur d'une augmentation des dépenses se renforceront à l'avenir, il deviendra nécessaire d'améliorer sensiblement la neutralité et l'efficacité du système fiscal si l'on veut éviter des pertes sèches plus importantes. Des progrès ont été réalisés au cours des dernières décennies dans le sens d'un élargissement de certains éléments de la base d'imposition selon des orientations adoptées dans beaucoup d'autres pays de l'OCDE, mais un certain nombre d'insuffisances persistent. Parmi celles-ci, on peut mentionner des abattements excessivement avantageux pour les particuliers, des avantages fiscaux considérables et prenant des formes multiples en faveur des entreprises, une fiscalité immobilière inadaptée et un manque de rigueur et d'uniformité dans la mise en recouvrement de l'impôt. Les principales orientations d'une réforme devraient comporter un élargissement sensible des bases de l'impôt sur le revenu des personnes physiques et des sociétés, ainsi que du système de TVA ; une augmentation des impôts sur la détention de biens immobiliers accompagnée d'une réduction des taxes sur les transactions ; l'alignement du régime fiscal des différentes sources de revenus des particuliers, notamment entre les différentes catégories de revenus du capital et de retraites ; la suppression des impôts affectés et de la parafiscalité ; l'abandon des approches interventionnistes ; enfin, la modernisation de l'administration fiscale, et notamment en ce qui concerne le recouvrement des impôts versés par les travailleurs indépendants.

Code JEL : H2

Mots clés : fiscalité, politique fiscale, Corée

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THE TAX SYSTEM IN KOREA: MORE FAIRNESS AND LESS COMPLEXITY REQUIRED

Thomas Dalsgaard¹

I. Introduction

1. The tax burden in Korea is among the lowest in OECD, with total tax revenues amounting to only 20 per cent of GDP. The low tax burden mainly reflects the lack of a social safety net comparable to those in many other OECD countries, despite a recent significant expansion, as well as a relatively small government sector. Compared with other low-income OECD countries, though, the tax burden in Korea is about average (Figure 1). The tax-to-GDP ratio has risen slightly over the past 20 years, as in many other OECD countries (Panel B). Most of the increase of the tax burden has taken place during the 1990s, reflecting high growth rates of personal incomes (and hence some fiscal drag), increasing social contributions and increased property taxes.

(Figure 1. Tax revenues in selected countries)

2. Over the past two decades, Korea's tax system has developed along lines similar to other OECD countries. In particular, bases have been broadened and rates lowered, thereby reducing the distortionary costs of taxation. More focus has also been placed on the redistributive role of the tax system. However, a number of features, many of which are legacies of the past, continue to hamper equity, efficiency and redistribution, in addition to making the system unduly complex. These include generous allowances and loopholes for individuals, large-scale and wide-ranging tax preferences for enterprises and a lack of strong and uniform tax enforcement. The costs of such deficiencies have so far been manageable as the overall tax burden in Korea is low. In the future, though, these distortions and their effects may rise substantially given the prospects for increased public expenditure and the tendency for tax bases to become increasingly mobile across borders. It is imperative, therefore, to continue the trend towards still more neutrality and to avoid interventionist approaches.

3. This paper first discusses the key forces shaping tax policy in Korea. This is followed by an overview of the main positive features of the tax system and its key weaknesses. The final section outlines specific policy recommendations for strengthening the neutrality, equity and efficiency of the tax system.

1. The author is a staff economist at the OECD. This paper was originally produced for the *OECD Economic Survey* of Korea published in September 2000 under the authority of the Economic and Development Review Committee. The author is indebted to Randall Jones, Rick Imai, Andrew Dean and Michael Feiner for comments and drafting suggestions, and to the Korean authorities for their assistance with obtaining the information and clarifications necessary to prepare the paper. Special thanks go to Chantal Nicq and Brooke Malkin for technical assistance and to Anne Eggimann for secretarial assistance

II. Forces shaping tax policy

The main focus has shifted from growth and industrial policy objectives to equity and efficiency

4. Korea's tax system has been aimed at the dual objectives of raising sufficient revenues to balance the budget and achieving growth and industrial policy objectives. Tax policies have changed direction rapidly and decisively to accommodate wider policy changes consistent with the growth strategies pursued during the post-war period (Box 1).² An undesirable result has been that the tax system has evolved in a rather *ad hoc* and uncoordinated manner rather than as part of an overall reform strategy. Consequently, less emphasis has been placed on raising the required revenues in the most efficient way.

Box 1. Tax incentives to promote growth

The role of the tax system in promoting growth has been most evident in the area of corporate taxation. When policy changed from import substitution to an outward-oriented growth strategy through export promotion in the early 1960s, important incentives were given to exporters, including tax credits, accelerated depreciation schemes and refunds for indirect taxes. In the 1970s, heavy and chemical industries were promoted as the engines of growth and tax incentives were shifted towards these industries. Preferences for these sectors offset the high corporate tax rates, an approach similar to that of Chinese Taipei, but opposite to that of Hong Kong, which relied on low overall rates and few preferences (World Bank, 1993). In the 1980s, economic policy again shifted focus from supporting certain industries to a more functional approach that is still in place today. Subsidies are now mainly given to correct perceived market failures, such as inadequate investment in new technologies and the excessive power of the chaebols.¹ The shift in incentives from industry-specific to a functional base has reduced distortions but not eliminated them.

The extent to which the various tax policies have achieved their objectives remains a subject of debate. In a narrow sense, it is clear that tax preferences generally raised investment and production in the favoured sectors. However, in the context of the whole economy, taking into account the price and tax distortions created in other areas of the economy as well as the potential over-accumulation of capital and excessive rents created in the subsidised sectors, the overall effects on economic growth may be negligible or even negative. While empirical evidence on this issue is scarce, one study using a "general equilibrium" model concluded that tax policies contributed only 6 per cent of Korea's total GDP growth between 1962 and 1982 and only 3 per cent of manufactured export growth (World Bank, 1993).

1. In the publication "Korean Taxation 1999", issued by the Ministry of Finance and Economy, it is explicitly stated that: "The tax incentives provided to SMEs are intended to reduce the concentration of economic wealth by conglomerates and strengthen the economic fundamental".

5. Interest in the role of the tax and transfer system in distributing the fruits of rapid growth increased during the 1980s. This was also encouraged by soaring land prices that led to a massive re-distribution of wealth to land owners. Despite various tax measures, income inequality increased slightly throughout the 1980s before narrowing in the 1990s until the crisis hit. Steps were also taken to increase the efficiency of the tax system. These included the replacement of numerous indirect taxes with a broadly-based value added tax in 1977 and a broadening of the corporate tax base during the 1980s and 1990s by reducing incentives and aligning tax rates across different industries. In addition, the weight of

2. See also Whalley (1994) and Trela and Whalley (1992).

import-related taxes diminished substantially, reflecting more liberal trade policies. The base for more comprehensive taxation of capital income in the future was established by the introduction of the "real name financial transaction system" in 1993. Previously, holders of financial assets could easily evade taxation by registering bonds, stocks and bank accounts under false names. At the same time, however, personal allowances and tax credits were expanded sharply, allowing more than half of all individual income earners to escape the income tax net.³

Alleviating the adverse effects from the economic crisis

6. The policy response to the financial crisis that hit Korea in the fall of 1997 included changes in the area of taxation and social security contributions. The immediate priorities were to raise sufficient revenue to finance soaring social expenditure as well as expenditure related to the governments' purchase of non-performing assets of the financial sector. Other objectives included stabilising the economy *via* expansionary macroeconomic policies and facilitating and promoting corporate and financial restructuring. The most severe barrier to restructuring was high transaction taxes, including capital gains taxes, which implied significant lock-in effects on corporate assets. Tax measures since 1997 have substantially alleviated the tax burden related to asset and equity swaps and the sale of assets for reducing debt. Measures were also taken to promote the inflow of foreign direct investment (FDI) by extending the range and size of tax preferences given to such investment. The emphasis of tax policy shifted in 1999 towards distributional objectives and the equity of the tax system in order to counter the sharp widening of the income distribution and the increase in poverty following the crisis. Several of the tax measures taken in 1998 and 1999, which are summarised in Box 2, are temporary and are thus intended to be repealed as the economy recovers.

The need to reduce the budget deficit

7. The economic downturn in 1998 resulted in a consolidated central government deficit of more than 4 per cent of GDP, a significant departure from Korea's long tradition of balanced budgets. In 1999, the deficit declined to less than 3 per cent of GDP due to the strong economic recovery (see OECD, 2000a). The government's aim to restore a balanced budget by 2003 leaves little room for further discretionary tax cuts. On the other hand, significant tax hikes are unlikely to be strictly necessary to balance the budget since most of the deficit is considered to be cyclical. However, the 1998 crisis triggered an expansion of the social safety net through enhanced unemployment insurance, training opportunities, poverty alleviation and pension coverage (see OECD, 1999a). As some of these programmes are permanent, social expenditures are likely to rise even after unemployment falls from its currently high level. In addition, rising interest expenses will put upward pressure on spending. Such considerations, as well as the longer term fiscal challenges facing Korea (as discussed below), call for immediate improvements in the revenue-raising capacity of the tax system, *i.e.* its ability to raise additional revenue with minimum dead-weight losses.

3. As explained below in more detail, these tax reliefs were targeted mainly at wage and salary earners as a rough compensation for the tax preferences already in place for the self-employed and those earning income from capital.

Box 2. Major changes in the tax system in 1998 and 1999

Tax measures for restructuring

The focus has been on reducing or exempting taxes levied on transactions, including: (i) deferral of taxes on the gains arising from revaluation of corporate assets after mergers and acquisitions until the disposition of the revalued asset; (ii) deferral of income tax on gains from asset and equity swaps for restructuring purposes (does not apply to related parties); (iii) exemption from acquisition, registration and securities transactions taxes on asset and equity swaps; and (iv) 50 per cent reduction of the 15 per cent capital gains surtax when companies sell real estate assets for restructuring purposes.

To accommodate corporate debt restructuring, companies that use the proceeds from the sale of real assets to repay debt to creditor banks are exempt from the capital gains surtax. If owners donate assets or make capital injections in a company, the company is exempted from income tax on the contributions, while the individual owner is exempt from the capital gains tax, and the transaction is exempted from the acquisition and registration taxes. If a shareholder (typically the controlling shareholder) assumes the debt of a corporation prior to its restructuring, sale or liquidation, it is deductible from his or her gross income. The company may then recognise the gain for tax purposes in three equal annual installments after a grace period of three years. This operation is also exempt from the gift tax. The "workout programme" (see OECD, 2000a) gives tax incentives for promoting agreements between financially troubled business and creditor banks that allow the business to continue.

In the financial sector, a key objective has been the closure of non-viable institutions through either merger or termination of their business. Accordingly, income arising from liquidation, merger or sale of assets by financial institutions has been exempted from tax. Financial institutions that acquire under-capitalised institutions under agreement with the Financial Supervisory Commission have also been granted a number of tax exemptions and deductions.

Stimulating investment and consumption

The Foreign Investment Promotion Act (FIPA) of November 1998 aims at attracting inward FDI by creating more favourable business conditions for foreign-owned companies and foreign investors. Foreign investors and companies making high-tech investments in Korea or investing more than \$100 million in areas designated as Foreign Investment Zones are eligible for exemption of individual and corporate income taxes for the first seven years and a 50 per cent reduction for the following three years. Local governments have also been granted discretion to reduce property, acquisition and registration taxes for such companies for up to 15 years. Further stimulus to investment was given through tax exemption of capital gains and stock options in venture capital businesses as well as increased incentives to investment in SMEs and R&D. Revival of the real estate market was promoted through a 10 percentage point reduction in the personal capital gains tax rate, while savings were encouraged by suspending, from 1998 to 2000, the global taxation of dividend and interest income above 40 million won, and replacing it with final withholding rates of 20 and 22 per cent, respectively.

Private consumption was stimulated by reducing the special consumption taxes on electronic goods and automobiles by 30 per cent. In December 1999, the special consumption taxes on electronic goods, beverages and sporting goods were completely eliminated. Private consumption also benefitted from further extensions of tax reliefs for low and middle-income salary earners.

Increasing revenues and reducing inequity

Taxes on diesel and gasoline were increased drastically in 1998 and cigarettes became subject to VAT (on top of the local tobacco tax). The VAT base was broadened in 1999 by the inclusion of professional services, including those by lawyers and accountants, and in 2000 by the elimination of the simplified VAT regime. As of January 2000, the top inheritance and gift tax rate was raised from 45 to 50 per cent and the threshold at which the highest rate applies has been lowered from 5 to 3 billion won. Furthermore, the gains of large shareholders in listed companies became subject to taxation.

Preparing for population ageing and re-unification

8. The ageing of Korea's population during the next few decades will increase public expenditures significantly. According to one estimate (Heller, 1997), demographic changes alone may boost government expenditure on pensions by 4 percentage points of GDP by 2025 and outlays on health care by 1 percentage point.⁴ The prospect of re-unification with North Korea, one of the main reasons motivating Korea's traditionally prudent budgetary policies, also poses a potential significant fiscal challenge, although the costs and timing of re-unification are inherently uncertain. Korea cannot rely on economic growth, expenditure cuts elsewhere in the government budgets and/or borrowing to cover all of the projected increase in expenditure.⁵ Hence a significant increase in the tax burden is likely to be required over the coming decades. It is imperative that this be achieved through exploiting the significant scope for base broadening and increased compliance rather than raising rates. Otherwise, the tax system is bound to cause somewhat larger deadweight losses and hence have a larger negative effect on economic activity in the future.⁶

III. Positive features of the tax system⁷

9. 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. Major weaknesses include the narrow bases, the excessive complexity of the system and the perceived unfairness of tax enforcement. The main positive and negative features are elaborated in the following paragraphs.

Low overall tax burden

10. The low tax burden in Korea reflects a combination of narrow tax bases and relatively low marginal effective tax rates. While statutory rates on most bases are at the same level as in most other OECD countries (Figure 2 and Annex 1), marginal tax rates are generally low when measured in effective terms. Since there is no evidence that elasticities of the bases with respect to changes in effective rates are much higher than in other OECD countries, the overall tax-induced distortion to factor allocation, savings and investment appears to be lower than in most other countries.⁸ This does not rule out, however, that

4. This calculation does not take into account the 1999 extension of the public pension system to include the self-employed and workers of firms with less than five employees.

5. One example of the failure of such a strategy is the Japanese experience of the 1970s when the welfare state was widely expanded without proper financing, as it was generally believed that increased costs could be financed out of continued high economic growth rates. It is noteworthy that Japan's government expenditure (excluding interest and investment spending) was 16 per cent of GDP in 1973 compared to 18 per cent in Korea at present. Spending in Japan increased to around 30 per cent of GDP today.

6. Dalsgaard and Kawagoe (2000) present some historical experiences of OECD Member countries on the economic impact of major tax hikes and discuss recent empirical evidence on the link between taxation and economic growth.

7. Annex 1 describes the main institutional features of the tax system as of January 2000.

8. Empirical estimates of the total deadweight loss (or the excess burden) caused by taxation are mostly based on strong, and sometimes questionable, assumptions. They should generally not be taken too literally, especially if they do not consider dynamic general equilibrium effects (for instance, advancing or postponing certain transactions in anticipation of tax changes can have a major impact on estimates of deadweight losses -- see for instance Slemrod (1998) for an application to the United States). The methodological problems also imply that internationally comparable estimates of deadweight losses are

taxes significantly distort economic choices in specific areas of the economy, especially since effective tax rates differ widely between various sources of income, giving incentives to shift income between sources.⁹

(Figure 2. Highest all-in tax rates for top income earners)

11. The tax mix in Korea relies more heavily on property and consumption taxes than most other OECD countries (Figure 3). The 40 per cent share of consumption taxes in total revenues is significantly above countries such as Japan and the United States, though this share has fallen strongly in recent years and is now closer to the OECD average. VAT revenues constitute under half of total consumption tax revenues, a relatively low share compared with other OECD countries (Table 1). This is problematic 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 due to the introduction of the National Pension Scheme in 1988 (Panel B). The share of individual income taxes has also increased, which is 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.

(Figure 3. Tax mix in selected OECD countries)

(Table 1. The share of VAT in total consumption tax revenues)

12. Measured by *average* effective tax rates, taxation of labour is much lower in Korea than elsewhere in the OECD, while average taxation of consumption and capital appear to be close to the OECD average (Table 2).¹⁰ Taxation of capital has risen sharply over the past 20 years, mainly reflecting soaring property tax revenues as land and property prices increased, but also a declining trend in the economy-wide operating surplus.¹¹ When measured against the net operating surplus, the increase is even

rare and highly fragile. For Korea, Son *et al.* (1999) estimated an overall deadweight loss of 110 per cent (*i.e.* there is an excess burden of 1.1 won per 1 won of tax revenue raised). The distortion is highest for excise taxes and lowest for the VAT, while that of the income tax is in between. However, these estimates are not well documented and appear implausibly high. For instance, estimates for the deadweight loss resulting from the total tax system in the United States normally range between 15 and 50 per cent (see for instance Ballard *et al.*, 1985, and Jorgensen and Yun, 1993). On the other hand, Feldstein and Feenberg (1996) found much higher deadweight losses from the 1993 tax reform in the United States.

9. The personal income tax system is divided into four groups of taxation: (i) global income (including wages and business and rental incomes, as well as (from 2001) interest and dividends above 40 million won); (ii) schedular income (including retirement allowances, capital gains on real estate and timber income); (iii) separate taxation (including interest and dividend income); and (iv) non-taxable income (agriculture; persons in the armed forces). Tax shifting incentives arise since each of these four categories of income are taxed at different effective rates.
10. The average effective tax rates are calculated from the revenues actually collected from various sources and by allocating these revenues to different bases (capital, labour and consumption). Hence, they give an indication of the average tax burden facing each of the three bases that statutory tax rates cannot provide. However, since the results are quite sensitive to a number of critical assumptions as well as data limitations, they should be interpreted cautiously (OECD, 2000*b*). Furthermore, average tax levels are not necessarily good approximations of the incentives created by the tax system, which are determined by the marginal effective tax rates faced by the individual taxpayer and the incidence of the taxes: producers may be able to shift taxes on to consumers (*via* higher prices), depending on product market conditions, or onto labour (*via* lower wage costs), depending on labour market conditions. Conversely, labour may be able to shift taxes on wages and salaries on to producers if labour markets conditions allow the after-tax wage to be held unchanged.
11. In the absence of more accurate measures, the operating surplus, as defined in the national accounts, is used as the base in calculating the effective tax rate on capital. This measure, however, does not reflect increasing prices of land.

larger since depreciation of fixed capital, as measured in the national accounts, has increased more than proportionately with income. 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 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 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. Indeed, as discussed below, there seems to be ample room for further expanding the base for individual capital taxation.

(Table 2. Average effective tax rates on capital, labour and consumption)

Limited tax distortions in the labour market

13. The *marginal* tax wedges on labour income are the lowest in the OECD area for most incomes and family situations (Figure 4). This implies that employment is not unduly constrained from either the demand or the supply side, and that human capital formation is not discouraged by high marginal taxes.¹² Although there is not much empirical evidence on the structural parameters of the labour market, one study (Lee, 1998) found that labour supply elasticities of primary earners are slightly higher than the range of estimates for other countries (Box 3).

(Figure 4. Marginal tax wedges on labour income)

Box 3. Labour market elasticities and wage shifting

Lee (1998) finds a compensated labour supply elasticity for male primary earners of around 0.5 and an income effect of similar magnitude (implying an uncompensated wage elasticity close to zero). This is slightly higher than in most other OECD countries, where male primary earner compensated elasticities are typically estimated at around 0.1 to 0.3 (see for instance Leibfritz *et al.*, 1997, and OECD, 1995).

An increase in the marginal tax rate affects both labour supply and demand by raising the wedge between the product wage for employers and the consumption wage for workers. Empirical analyses suggest that employment normally falls as a result, thereby lowering potential output. The impact is compounded by adverse effects on human capital formation from higher marginal taxes. The extent of the fall in employment depends mainly on the labour market institutions and the wage bargaining framework, although other factors, such as the degree of product market competition, may also have an impact. Even though the Korean labour market is characterised by numerous rigidities, such as fixed hours contracts, limited availability of competing jobs and credit rationing for low income groups (a financial market rigidity with spill-over effects to the labour market), the real wage appears to be relatively flexible. This was demonstrated by the remarkable degree of nominal and real wage flexibility following the 1997 crisis (OECD, 1999a), which not only reflected a focus on preserving employment rather than real wages, but also the large share of total remuneration (up to one-third) that is paid as bonuses and overtime payments. These components can more easily be scaled back under adverse economic circumstances than regular wages. It follows that taxes tend to be shifted back on labour in Korea, reducing the take-home wage while leaving labour demand less affected. In such circumstances, a decline in employment following an increase in taxes could be due primarily to a fall in labour supply, reflecting the drop in consumption wages, rather than reduced labour demand. To what extent such forces are significant in Korea is difficult to gauge, especially since discouraged-worker effects seem to be the dominating factor behind changes in labour market participation.

12. Low marginal tax rates for high incomes imply that the after-tax return to education is high and the relative smoothness of the marginal tax rate curve imply that the tax loss from "bunching" income over a shorter time span and in higher brackets after education is not as significant as in many other countries. The combination of low taxes and massive government support to education may, however, imply a bias toward over-investment in education.

14. The marginal tax wedges for labour income progress relatively smoothly as income increases, hence avoiding large "jumps" in marginal taxation (Figure 4). Since social transfers and unemployment insurance are also limited in terms of coverage and duration, it is unlikely that significant poverty or unemployment traps are created by the combined effects of the tax and transfer system. Moreover, there are virtually no disincentives for the elderly to remain in the labour market. This is unlike the situation in some other OECD countries, where high marginal effective tax rates from extending the working life is caused by a combination of high pension replacement rates, high contribution rates, a low entitlement age and a deficient accrual of pension rights (Table 3).¹³ The main difference between Korea and many other countries is that people may work beyond the normal pension age of 60 years without having to pay pension contributions and at the same time receive part of the public pension entitlement while working (the so-called active old-age pension). The implicit tax from continued work is even lower (and becomes negative, *i.e.* a subsidy) for workers with less than 20 years of contributions since these workers continue to accrue pension rights by staying on in the labour market after the age of 60. The tax and pension systems hence contribute to the fact that participation rates for both elderly men and women in Korea are well above the OECD average.¹⁴ It should be recognized, though, that the low distortions for elderly workers are achieved through substantial budgetary costs.

(Table 3. Average implicit tax rate on continued work due to the old-age pension system)

15. Despite low work disincentives from tax wedges, the overall labour force participation and employment rates are somewhat below the OECD average.¹⁵ Low participation rates are primarily found among young people of both sexes as well as women in the 30 to 50 age range. However, taxation does not seem to discourage second earner participation to any large extent. The tax unit is the individual rather than the household, and -- unlike in other countries, such as Japan, where generous tax allowances for non-working spouses act as a barrier to labour market entry -- the spouse allowance is relatively low and an allowance is also given for working spouses with small children.¹⁶ Hence, the low female participation rate does not seem to be rooted in the tax system.¹⁷

13. The implicit tax rates on continued work basically measure the average annual decrease in pension wealth following from adding more years to the working life. For more detail, see Blöndal and Scarpetta (1997).

14. The participation rate of men (women) aged 55-64 years is 75 (48) per cent against an OECD average of 64 (38) per cent. A main reason for the high elderly participation rates is the existence of a well-developed "second labour" market for people above the normal retirement age of 55. Furthermore, it should be noted that the coverage of public pensions is still relatively low and that most elderly hence rely on family support and their own earnings.

15. The labour force participation rate is 64 per cent against the OECD average of 70 per cent. The employment rate is 60 per cent against an average of 65 per cent (OECD, 1999c).

16. The allowance for a non-working spouse is 1 million won (about 7 per cent of an average production worker's wage). The corresponding figure in Japan is almost 20 per cent. An allowance of 0.5 million won is given for a working spouse with a child below the age of six.

17. One possible explanation is the "dual" labour market, where women with upper secondary education and university degrees are unable to find sufficiently attractive jobs, and are reluctant to take jobs requiring less skills or jobs in SMEs. In addition, the relatively high cost of child care may discourage female labour force participation.

Distributional effects from taxes and transfers are small, but the pre-tax distribution is also fairly even

16. The tax and transfer system has only a marginal influence on income distribution in Korea (Table 4). Income taxes slightly reduce income inequalities whereas social security contributions and the value added tax draw in the other direction.¹⁸ The special consumption tax, which was introduced along with the VAT to counterbalance expected adverse distributional effects of the VAT, only has a negligible effect on the income distribution. The low overall redistributive 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.¹⁹ 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 (Figure 5). However, since the top marginal tax rate, unlike in many other OECD countries, is only applied at very high income levels -- around five times the income of an APW -- this is clearly 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 (Panel B).

**(Table 4. Distributional effects of taxes and social security contributions)
(Figure 5. Progressivity of the tax system in selected OECD countries)**

17. The distributional aspects of tax policy also involve financial and real wealth, which is more unevenly distributed than income or consumption expenditures in most countries. This is certainly the case in Korea, although the decline in property prices throughout the 1990s has reduced the inequality of wealth distribution.²⁰ The tax system also indirectly affects the income distribution through its impact on employment and wage formation, but such influences are likely to be small as discussed above. Other indirect effects, such as incentives provided to SMEs through the corporate tax system, as well as the special VAT regime, may help create job opportunities for low-income workers and people with high poverty risks. These policies may have contributed to narrow the pre-tax income distribution, though the effects are likely to be small, even compared with the direct distributional effects of taxation. Finally, it should be noted that Korea's post-tax and transfer income distribution is close to the OECD average and much more even than that of Turkey and Mexico, the other two low-income, low-tax countries in the OECD (Figure 6).²¹ In summary, it is not evident from an economic point of view that concerns over the distribution of income and wealth alone should trigger tax changes in Korea, in particular since the expansion of the social safety net in recent years will help to further mitigate inequalities in the future.

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18. Income inequality is measured by the Gini coefficient. The lower the Gini coefficient, the more equal is the income distribution. Results similar to those in Table 4 were found by Choi and Hyun (1997), Hyun (1996), and Na and Hyun (1993). The latter study also found that the overall effect of taxation was slightly regressive while the other studies found a small progressive effect overall.
19. The statutory progressivity is based on the OECD's tax equations for production workers, which also include social security contributions. A few limitations of this method should be borne in mind. *First*, take-up rates for deductions and exemptions, which are not included in the tax equations, tend to increase with income, as do fringe benefits, which are also not covered. *Second*, large groups of taxpayers, such as the self-employed, retirees and benefit recipients, do not pay social security contributions in many countries.
20. No recent studies exist, but estimates from the late 1980s show a Gini coefficient on real estate wealth of 0.60 and on financial wealth of 0.77, while that on income was 0.40 (Kwon, 1990). Such estimates are extremely sensitive to valuation assumptions, sampling procedures and the extent of under-reporting.
21. Estimates for the Gini coefficient on disposable incomes in Korea tend to find values of around 0.3 (Hyun, 1993, and Choi and Hyun, 1997), although some studies have found a slightly higher coefficient (Park and Kim, 2000).

Moreover, changing the tax system along the lines suggested below would automatically strengthen its re-distributive features.

(Figure 6. Tax revenues and the distribution of income after tax, 1998)

IV. Major weaknesses of the tax system

Limited coverage of the personal income tax

18. Effective progressivity and horizontal equity in the personal income tax system are undermined by generous allowances and tax credits, as well as a non-negligible scope for tax evasion. Furthermore, the wide range of tax reliefs unduly complicate the tax system, thereby inducing high compliance costs. While actual personal tax payments amount to less than 4 per cent of GDP, the revenue foregone by tax reliefs is almost 5 per cent of GDP at the central government level alone.²² Hence, the revenue foregone by the reliefs outweighs the actual tax payments for all income classes below 50 million won, three times the wage of an APW (Figure 7). The impact of the tax reliefs on effective taxation and progressivity is illustrated by comparing the actual average effective tax rate for each income group with the rate that would apply if all reliefs were eliminated (Panel B). Wage earners with incomes below 20 million won -- 8 million persons or more than half the total number of personal income taxpayers -- effectively pay less than 1 per cent of their income in income tax.²³ In the absence of allowances and tax credits, this group would have to pay average tax rates of 10 to 15 per cent. Tax reliefs also significantly reduce the actual tax rates paid by higher-income workers, although in the case of wage income earners, the subsidy (measured by the distance between the comprehensive and actual tax rate) declines slightly as income increases. The very large tax subsidy provided to those with incomes above 100 million won is mainly due to tax credits on dividends and wages. The tax subsidy to global income earners (excluding pure wage and salary earners), although still substantial, is somewhat smaller than the one provided to persons with only wage income.²⁴ The tax base is also effectively eroded by the non-taxation of fringe benefits (Table 5) and the low effective taxation of retirement and capital income. These tax preferences mainly benefit higher income groups,²⁵ although some of the fringe benefits (such as meals and targeted training) may serve useful social purposes that more than outweigh their harmful effects on tax revenues and horizontal

22. These numbers are for 1997. It covers the reliefs given to global income taxpayers only (including pure wage and salary earners), while tax reliefs on separately-taxed income, including most dividends and interest income, as well as retirement income and capital gains, are not taken into account. The total size of the tax relief for global income earners is much higher than the amount given in the Statistical Yearbook of National Tax (1999) of around 5 trillion won, or 1.1 per cent of GDP in 1997 and 1998. This is mainly because the Yearbook does not include allowances to persons who do not file a tax return (around 6 million pure wage and salary earners), nor does it take into account the substantial relief given through the employment income deduction. Moreover, it does not consider tax credits. Since tax reliefs at the personal level have been increased considerably since 1997, the total revenue loss of 5 per cent of GDP caused by allowances and tax credits is a lower bound estimate. Behavioural effects are not considered, such as the impact of the reliefs on the pre-tax income distribution, labour supply, tax avoidance and tax evasion.

23. The income tax exemption threshold for a household head with spouse and 3 children was 13 million won in 1999. Around 4.2 million persons, or 40 per cent of wage earners, did not pay any income tax at all that year.

24. However, these numbers are not adjusted for under-reporting of income among the self-employed, which is arguably quite significant.

25. According to household surveys of urban workers, income from assets increases from 0.8 to 1.5 per cent of total income in the lowest three deciles to more than 3 per cent in the highest decile.

equity.²⁶ The revenues foregone by these preferences are difficult to estimate due to limited data availability and because tax avoidance and evasion might increase substantially if effective marginal tax rates were higher, especially in the area of capital taxation.²⁷

(Figure 7. Effects of allowances and credits)
(Table 5. Taxation of fringe benefits)

19. Closely linked to the various legal loopholes in the personal income tax system is the low compliance of the self-employed. The large deductions and tax credits given to wage and salary earners are, to a large extent, justified by the need to create a "level playing field" between employees and the self-employed. Consequently, any reduction of the allowances in the personal income tax system would be difficult to carry out without strengthening the effective taxation of the self-employed. Even though the business income of the self-employed is taxed as global income, and hence in principle not treated at preferential terms compared with wage income, there are large *de facto* discrepancies in the effective tax burdens (Box 4).

Box 4. Differences in taxation between the self-employed and wage earners

First, the self-employed are able to split the household income between their family members, thus circumventing the progressivity of the income scale. *Second*, the self-employed can deduct some of their private consumption as business expenses as well as benefit from some of the tax incentives given to corporations. *Third*, the administrative practice of allowing the self-employed within certain turnover limits to be subject to a simplified estimation method implies a substantial under-estimation of tax liabilities.¹ Based on an income-expenditure estimation approach,² Yoo (1997) finds that the actual incomes of the self-employed are on average around 50 per cent higher than their reported incomes. Since the share of individual's operating surpluses to GDP is around 20 per cent, the under-reported income (or the "black economy") can be estimated at around 10 per cent of GDP in 1994. Yoo and Hyun (1998) find a "black economy" equal to 20 per cent of GNP in 1996 using a slightly modified approach. A more recent study found that "black economy" activity has increased sharply in recent years due to the economic crisis, reaching a level of 26 per cent of GDP in 1998 -- the highest level since the 1960s (the Korean Centre for Free Enterprises, quoted in the *Korea Herald* on 14 May 2000). Another study (Hyun, 1996) estimates that the average evaded tax among the self-employed is around 20 per cent of the full-compliance tax. It also finds that tax evasion increases with income: evasion among the highest-income decile is around 75 per cent of the full compliance tax. This is in stark contrast with wage and salary earners, where underreporting is negligible because of the widespread use of withholding taxes. *Finally*, income from agriculture is not subject to national taxation, but is taxed at a progressive scale at the local level. Even though the marginal tax rates are higher than those applied to global income at the national level, and despite the fact that agricultural employment accounts for 11 per cent of the total civilian labour force, total tax revenues from agricultural income are close to zero. This suggests low compliance.

1. Out of 1.2 million self-employed taxpayers in 1998, around 1.1 million were taxed by the estimation method (see Annex 1), while only around 0.1 million kept regular books and were taxed by ordinary self-assessment (National Tax Service, 1999).
2. This approach basically estimates the income from the observed consumption patterns of wage-earners and self-employed (correcting for certain other characteristics such as household size, car ownership, etc.), assuming that the propensity to consume out of actual income is identical for the two groups.

26. A fringe benefit tax is difficult to administer at the level of the individual and could instead be levied at the level of the company. Even though this would not allow taxation to be applied at the individual employees' marginal tax rate, it would still reduce the attractiveness of using fringe benefits for tax avoidance purposes. New Zealand provides a good example of how to implement a comprehensive fringe benefit tax.

27. One indication that the revenue loss from low effective taxation of capital could be significant is that special tax incentives given to small deposits and farmers' savings and to housing and pension savings alone amounted to as much as 0.5 per cent of GDP in 1998.

The overall income tax revenue foregone by the low compliance among the self-employed is difficult to gauge but could amount to around 0.4 per cent of GDP.²⁸ The most damaging effects, however, are not the revenue foregone itself, but the sense of unfairness it induces among wage earners and the indirect revenue losses caused by large deductions and tax credits given to wage earners to compensate for horizontal inequities.

Distortions to investment have been reduced but tax incentives are still large

20. The low overall tax burden in Korea is beneficial to the general investment climate and, since the marginal corporate tax rate is also slightly below the OECD average, the tax system does not appear to act as a major impediment to investment.²⁹ Indeed, the tax incentives given to investment in the corporate tax system may have led at times to over-accumulation of capital, at least within certain sectors such as chemicals and heavy industries (Box 1, and Choi, 1998). Tax incentives include investment tax credits, exemptions, income deductions, low rates for publicly-held companies, accelerated depreciation and tax-free reserves (the latter two are tax deferrals rather than exemptions). These tax incentives are specified in the Special Tax Treatment Control Law. In 1998, a so-called sunset clause system was introduced, under which the exemptions provided by this law automatically expire after a few years. Since the sunset clause system is still new, it is too early to judge to what extent the time constrained exemptions will actually be repealed or whether they will be extended more or less automatically. At present, incentives are mainly given to SMEs, R&D and overall investment (Table 6). Total tax expenditures related to the corporate sector amounted to around 0.6 per cent of GDP in 1998. This is somewhat higher than in many other OECD countries, including Japan, where it was less than 0.2 per cent of GDP (OECD, 1999b).

(Table 6. Tax expenditures in the Special Tax Treatment Control Law)

21. Marginal effective tax rates are negative for all kinds of investment, implying that investment is generally subsidised by the tax system. Tax incentives also create non-neutralities across different kinds of business organisational forms, investment goods and financing sources, thereby distorting resource allocation (Table 7). In particular, investment in machinery and debt financing are favoured relative to other instruments.³⁰ The variation in effective tax rates has declined somewhat since the late 1970s due to a combination of reduced incentives, rate reductions and alignments in the corporate tax system and lower rates of inflation (Choi, 1998). Hence, allocative distortions from the tax system, which once were

28. The amount of income tax evasion can be calculated from an estimated income under-reporting of the self-employed of 50 per cent combined with their share of personal income tax revenues, which is between 20 and 25 per cent. Assuming a tax elasticity of one for income tax revenue to income increases, the evaded tax is between 10 and 12 per cent of total personal income tax revenues (half of 20 to 25 per cent), or around 0.4 per cent of GDP. This number would be higher if tax progressivity were taken into account.

29. The direct tax effects on investment depends on how taxes affect the cost of capital and how investment responds to the cost of capital. Evidence from other countries, such as Japan, suggests that the latter linkage is not very strong. More indirect influences go through labour tax wedges and the overall impact of taxation on savings and growth.

30. The tax distortion toward debt finance stems from the general practice of recognising interest expenditure, but not dividends, as a tax deductible cost. With the introduction of a partial imputation system from 2001 (*cf.* below), Korea will be moving towards more neutrality between debt and equity finance. Tax incentives may have played some role in the building-up of excessive debt positions in the corporate sector in Korea prior to the 1997 crisis, but they are unlikely to have been as important as other factors such as: (i) the *de facto* absence of bankruptcy risks for the chaebols ("too big to fail"); (ii) the links between the conglomerates and their affiliated non-bank financial institutions; (iii) the absence of well-developed capital markets; (iv) the lack of an effective corporate governance system; and (v) debt guarantees between chaebol affiliates.

substantial, no longer appear to be out of line with other OECD countries. Indeed, the marginal effective tax wedges on various investment goods and financing instruments are generally lower in Korea than in many other OECD countries (Table 8). The variance of the rates across financing instruments is also relatively low,³¹ indicating that tax-induced distortions to corporate finance are moderate at least by international standards (which admittedly may not necessarily reflect a satisfactory benchmark). These results, which rely on a number of simplifying assumptions, should be interpreted with some caution.³²

(Table 7. Weighted average of marginal effective tax rates)

(Table 8. Marginal effective tax wedges in manufacturing in selected OECD countries)

Taxation of capital income is low in effective terms and unduly complex

22. The standard statutory rates for taxation of capital income are generally moderate compared with other OECD countries (Table 9). In particular, interest and dividend income is taxed at relatively low final withholding rates and most financial capital gains are tax exempt at the individual level. The marginal rates on interest and dividend income will increase significantly in 2001 when global taxation of capital income above certain limits is re-instated, but the rates will still not be excessive compared with other countries. Taxpayers subject to global taxation are partly relieved from "double" taxation of dividends by a partial imputation system. Moreover, for investors with capital income below the threshold for global taxation, the tax rate on such income will actually be reduced.

(Table 9. Dimensions of capital taxation in selected OECD countries)

23. The moderate taxation of financial income at the personal level implies low distortions to aggregate savings. However, most international studies find little or no empirical evidence that low tax rates significantly influence the overall level of private savings, and even less so the level of national savings (Bernheim, 1999; Leibfritz *et al.*, 1997). This also seems to apply to Korea (Chun, 1999a). On the other hand, the composition of savings is likely to be more significantly influenced by the tax regime since the effective tax rates differ widely between saving vehicles. Depending on the source of income and the type of instrument, capital income in the form of interest, dividends and capital gains can either be exempt, subject to final withholding taxes at varying rates or taxed as global income (Table 10). The broad range of tax preferences results in both intertemporal and contemporaneous distortions of individuals' savings decisions and creates arbitrage opportunities. Hence, the tax base is eroded and the complexity of the system contributes to higher compliance costs and hence lower compliance.

(Table 10. Taxation of personal financial income)

31. A neutral tax system would apply the same marginal tax wedges across all types of financing and investment instruments, leaving the standard deviation of tax wedges equal to zero.

32. The marginal effective tax wedge reflects the pre-tax rate of return an investment has to earn in order to provide a personal investor with the same after-tax return as a bank deposit earning a pre-tax 5 per cent real rate of interest. The estimates shown in Table 8 are based on the King-Fullerton methodology (see Gordon and Tchilinguirian, 1998). The results should be interpreted with caution since for some investment and financing decisions the results generated may not adequately reflect incentives and the effects of taxation on these incentives. The marginal investor, for instance, may not be a fully complying individual (as assumed here) but rather a *de facto* tax-exempt entity. Other simplifying assumptions include perfect competition, a rudimentary treatment of financial structures and the intermediation process, absence of uncertainty, perfect loss offsetting and capital irreversibility. For a discussion of these assumptions and data measurement issues see OECD (2000b).

Intergenerational inequity, low compliance and non-neutralities in the pension system

24. Like most other OECD countries, Korea provides significant tax subsidies to both public and private pension savings through low taxation of pension contributions, earnings of pension funds and the retirement benefits (Box 5). Since the contribution rates in the public scheme (NPS) are far below actuarially fair values, defined as rates that would equalise expected net present values of contributions and benefits for each generation, an issue of intergenerational inequity exists, which will only be partially solved by the announced gradual increase in contribution rates from 9 to 17.7 per cent (starting from 2005). The most pressing concern in relation to NPS, however, is the low level of compliance among the urban self-employed, who were included in the scheme in April 1999. This reflects the lack of stringent enforcement and the redistributive elements of the pension system. The amount of under-declaration of income in the pension contributions of the urban self-employed is likely to be at least 50 per cent,³³ a rate in line with the estimated under-declaration for income taxation. Non-neutralities also exist in contribution

Box 5. Taxation of pension schemes in Korea

Taxation of pensions can take place at each of three steps: when contributions are paid into the schemes; on the earnings derived from the investment of contributions; and when pension benefits are paid out. Most countries in the OECD with fully or partially-funded pension schemes apply a so-called EET system, in which contributions and earnings are largely tax exempt, while benefits are taxed more or less rigorously (see Dilnot, 1992, for a presentation of the terminology, and Dalsgaard and Kawagoe, 2000, for a discussion of its application to pension schemes in the major OECD economies). This implies a subsidy to pension savings since ordinary savings are subject to a TTE system. Korea deviates from most other countries by applying a "partial" TEE system to its *public pension* system, the National Pension Scheme, NPS (taxation of the pension plans for civil servants, private teachers and military personnel is not considered here). Under this approach, the contributions of employees are taxed, but not those of employers, while both the earnings of the pension funds as they accumulate and the benefits are untaxed (Table 11). In a recently implemented and partially-funded system like the NPS, the timing of taxation has important implications for revenues and inter-generational equity. The *second tier* of the pension system is the mandatory separation allowance paid by companies to employees when they leave the company, including for retirement. Large tax preferences are provided to this scheme on both contributions¹ and benefits, while the earnings are taxable -- a pattern that can be characterised as ETT* (where T* means "very low" effective rate of taxation: the average effective tax rate on the benefits received from companies at retirement is around 2 per cent, *cf.* Chun, 1999a). Finally, the *third tier* of the pension system, the Personal Pension Plan, consists of funds managed by banks, investment trusts and life insurance companies. It receives substantial preferential tax treatment, basically EEE, but only within certain limits.² In order to qualify for the tax deduction, the individual must also agree to make a stream of contributions for at least ten years and cannot withdraw the funds until the age of 55.

(Table 11. Tax treatment of retirement income)

1. Up to 40 per cent of the contributions (up to 10 per cent of the wage bill) is tax deductible through the book reserve method, whereby the funds can be kept within the company. Tax deductibility for the remaining contributions is possible if a policy is opened with an outside insurance company to cover the liability. It appears to be a common practice to establish such contracts with the provision that the funds are lent back to the firm. Along with the general problem of insolvency of the insurance sector, this practice has threatened the security of the retirement allowances. An insurance mechanism has recently been instituted to cover at least some of the entitlement of the employees in the case of bankruptcy.
2. Up to 720 000 won per year. Chun (1999b) finds that the introduction of the *Personal Pension Plan* in 1994 raised the personal savings rate, but that the increase was mainly due to the provision of a new financial instrument rather than tax incentives.

33. Estimate by the Korean Institute of Public Finance. Low compliance is also indicated by the fact that the increase in total social security contributions in 1999 was only slightly higher than the increase in wages despite the addition of almost 9 million urban self-employed in the NPS.

rates to the NPS: while wage earners pay 9 per cent of their income in contributions (around 7.5 per cent after tax), the urban self-employed pay only 3 per cent and farmers pay only 2 per cent in contributions. The government intends to gradually eliminate the gap between the urban self-employed and wage earners over the next five years. Finally, contributions are calculated on the basis of standard compensation, excluding fringe benefits. This implies a drag on the contribution base since fringe benefits constitute a non-negligible share of total remuneration -- up to 15 per cent of total remuneration, according to some estimates.

Property taxation acts as a barrier to an efficient use of land

25. Property taxation has been a longstanding and controversial issue, in part because the price of land in urban areas has grown at an average annual rate of more than 20 per cent since the early 1960s, exceeding the average rate of inflation by more than 10 percentage points (see OECD, 2000a). Given the high concentration of land ownership,³⁴ soaring land prices have produced a limited number of wealthy landowners, while preventing many ordinary people from being able to buy a home or to improve the quality of their housing. Even though land prices have declined during most of the 1990s, they are still prohibitively high for a large group of people.³⁵ The main driving forces behind the large increases in land prices appear to have been low controlled interest rates in the past, which made landholding a relatively attractive investment compared to financial investments, as well as excessive regulations that limited the supply of land for development. The government has adopted a number of measures in an attempt to reduce land prices or at least slow the rate of increase, most notably those related to the "public ownership of land" concept, which was introduced in the early 1990s. These measures consisted of central government taxes on accrued and realised gains from "excessive" land value increases and land development, as well as a local tax on large land-holdings.³⁶ However, in 1998, two of these measures were judged to be unconstitutional and were abolished.

26. Property taxes can be divided into taxes on holdings, transaction and capital gains (see Annex 1 for details). Like in most other OECD countries, property tax is mainly administered at the local level.³⁷ The share of property taxes in total tax revenues is higher in Korea than anywhere else in the OECD (Figure 8). However, this is primarily due to transaction taxes since effective taxes on holding real estate are low. Effective holding tax rates are estimated at around 0.10 to 0.15 per cent of the market price for both land and buildings, reflecting the fact that valuation of land for tax purposes is estimated at around one-fifth to one-third of the market price, while that for buildings is around one-third. In comparison, the effective holding tax rate on real estate in Japan is estimated to be about 0.25 per cent. One concern is the

34. As of 1988, 24 per cent of land in Korea was owned by the public sector, 4 per cent by corporations and 66 per cent by individuals. Individual ownership was highly concentrated with 65 (77) per cent of the individually-owned land in the hands of the top 5 (10) per cent of individual landowners.

35. The price of a normal home in one of Korea's large cities was around 30 times the annual average household income in 1996 -- against, for instance, eight times the annual income in Japan's metropolitan areas. See Ro (1996).

36. Even though they helped curb speculation, these measures also gave rise to serious adverse effects, such as disincentives for converting rural land to urban land and for developing residential land as well as incentives for premature development of idle land. Furthermore, trying to tax accrued gains and delineating areas where excessive price increases took place posed serious administrative problems.

37. The provinces and the seven special cities (Seoul, Pusan, Taegu, Incheon, Taejeon, Kwangju and Ulsan) have control over expenditure of the revenues raised by the tax. The Ministry of Government Administration and Home Affairs oversees the local administration of property taxes, while tax rates are determined by the National Assembly. The central government also levies some property-related taxes, notably the capital gains tax on real estate and the surtax on the transactions tax, which is earmarked for education.

potential sharp increase in the landholding tax rate from 0.1 per cent to 0.2 to 5 per cent of the appraised value when land shifts from agriculture to urban residential use, which is compounded by the expected increase in the value of land. However, the expected gains have -- at least historically -- been so large that taxation has not acted as a major barrier for land development. A peculiar feature of the Korean tax system is the relatively high holding tax levied on cars.³⁸ Revenues from this tax amount to two-thirds of the total tax revenues raised from real estate holding.

(Figure 8. Property taxation in OECD countries, 1998)

27. Transaction taxes on real estate raise more revenue in Korea than anywhere else in the OECD, relative to both total tax revenue and GDP. Such taxes include local acquisition and registration taxes, as well as two earmarked surtaxes for education and rural development. The combined effective transaction tax is 4 per cent for land and 1.7 per cent for structures. Given the higher cost of land, the overall transaction tax on total real estate is probably higher than in Japan, where it is 2.6 per cent of the market value.³⁹ Transaction taxes act as an anti-speculative measure, along with the capital gains tax, which is set at 40 per cent if the real estate is held for less than two years and at a progressive scale ranging from 20 to 40 per cent if the holding period is longer. In addition, a reduction of up to 30 per cent is allowed if the real estate is held for more than three years, while principal residences are exempt from the capital gains tax if held for more than 3 years. Whether these taxes have curbed speculation or mainly contributed to higher prices and an inefficient land allocation through lock-in effects is an open question.⁴⁰ The experience of Japan, which shares some of the same property tax features as Korea, suggests that lock-in effects may be significant when capital gains taxes are high and declining over the holding period.

The VAT base is narrow but compliance is high

28. The VAT base has recently been expanded by two measures: removal of the VAT exemption for certain services and the elimination of the "simplified" VAT regime. The inclusion of professional services, such as those provided by lawyers and accountants, will not only broaden the VAT base but possibly also the income tax base, since invoicing of these services will make it more difficult to disguise income. This is also true for the elimination of the simplified regime to the extent that this scheme, together with the "special" regime (see Box 6), has facilitated income tax evasion among the self-employed and small businesses (An, 1997). However, major loopholes continue to erode the VAT base and undermine neutrality. These include the special regime, the extension of zero VAT to some "indirect exporters" and to inputs to agriculture and fisheries as well as the exemption of agricultural products, including unprocessed foodstuffs. These exemptions imply that only 60 per cent of all consumption is taxed under the VAT.

29. While the base is quite narrow, VAT actually due tends to get paid. Input-output based analyses of theoretical VAT payments (assuming full compliance) compared with actual revenues show that VAT compliance is fairly high (Sung, 1999). This is also reflected in a relatively high ratio of the effective-to-actual VAT rate (Figure 9). However, not all private consumption expenditures are properly

38. The holding tax on a standard 2000 cc car is the same as the property tax on a house worth 100 million won (around \$100 000).

39. The 2.6 per cent figure is the combined effective transaction tax rate on property levied by the (national) registration tax and the (prefectural) real property acquisition tax. See OECD (1999b).

40. Lock-in effects are defined as the holding of appreciated assets in order to defer tax on gains already accrued. This leads investors to accept a lower before-tax rate of return than they would require for new investment without such accrued gains, resulting in a distorted allocation of resources and an inefficient portfolio selection.

taken into account either by the tax authorities or in the national accounts. Based on an estimated under-reporting of income of around 10 per cent of GDP, the total VAT revenue foregone by under-reported consumption is estimated at 0.4 per cent of GDP.⁴¹

(Figure 9. Effectiveness of value added taxes, 1997)

Box 6. The special VAT regime

This special scheme applies to businesses with annual turnover of less than 48 million won, while businesses with annual turnover of less than 24 million won are exempt from VAT. The simplified scheme, which was abolished in July 2000, covered businesses with turnover between 48 and 150 million won. The elimination of this scheme implies that 0.5 million taxpayers will be included in the ordinary VAT regime, increasing the number of ordinary taxpayers by 40 per cent (Table 12). However, the taxable turnover in the ordinary regime will only increase by about 1 per cent, making the immediate effect on total VAT revenues quite small. However, second-order effects -- in terms of increased compliance -- could be more substantial.

(Table 12. VAT: number of taxpayers, taxable sales and revenues)

The special scheme applies a value-added ratio, which varies across industries, to the total turnover of the business. Besides alleviating the administrative burden for small businesses, the special scheme contains a *de facto* tax subsidy by imposing value-added ratios that are generally lower than their actual values. It is widely held that the special scheme facilitates tax evasion by SMEs. Since there is no obligation to invoice, firms included in the special scheme can easily disguise their true turnover. The absence of invoicing also facilitates tax evasion by larger firms on the part of their turnover that is supplied to firms in the special scheme. The problem extends beyond VAT evasion since under-reporting of the turnover makes it easier to under-report income as well.

The excise tax structure is too complex

30. As in most other countries, a number of excise taxes are imposed on consumption. The most important in Korea are those on transportation, liquor, telephone service and the special consumption tax, which imposes excise taxes on 27 "luxury" products. Together, these excises taxes raise revenue equivalent to 2.5 per cent of GDP. Tobacco taxes are levied at the local level. 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 wide-ranging. In addition, the education and rural development earmarked taxes levy surtaxes on some of the excise taxes. The excise tax structure appears to be unnecessarily complex and the wide variation in rates distorts consumption choices. There is considerable scope for integrating a number of small excise taxes into the VAT system, in particular the telephone tax and some of the categories under the special consumption tax. The latter, which was introduced along with the VAT to alleviate the distributional consequences, does not have a large impact on distribution and has been significantly scaled back over the past few years.

31. Korea does not yet have a comprehensive strategy for environmental taxes. Levies on fuels and oil products, mainly gasoline and diesel products, are included in the transportation tax, while kerosene, petroleum and natural gas are covered by the special consumption tax. Together, these taxes, amount to 1.5 per cent of GDP or 7 per cent of total taxes. Although this is close to the OECD average for environmental taxes, the structure of excise taxes is based on revenue needs and industrial policy, rather

41. Assuming that the propensity to consume is 0.7 and that the VAT base is 60 per cent of total consumption.

than on environmental considerations. For instance, the excise taxes give much stronger preferences to diesel over gasoline-powered vehicles than in most other OECD countries (Table 13). Consequently, a high proportion of private cars use diesel, which has a detrimental effect on pollution levels, particularly in urbanised areas.

(Table 13. Share of taxes in total energy prices)

Compliance with inheritance and gift taxes has been weak

32. More rigorous enforcement of the inheritance tax is an important issue, in particular since there is a popular perception that wealthy individuals, such as those in the families that control the chaebols, rely on irregular or illegal schemes to transfer wealth to family members without paying due taxes. Tax revenues from inheritance and gifts account for 1.2 per cent of total tax revenues in Korea, as compared to a 0.6 per cent share in the United Kingdom, 1.1 per cent in the United States and 1.7 per cent in Japan. To counteract the perception of unfairness, the top rate for inheritance and gift taxes was raised from 45 to 50 per cent in January 2000 and the threshold above which this rate is paid was lowered from 5 to 3 billion won. To the extent evasion is the problem, such measures are unlikely to have any significant effects on revenue. However, monitoring and enforcement concerning wealthy individuals and their families have also been enhanced, backed by strengthened powers on the administrative side. Moreover, a gift tax will be imposed if majority shareholders donate unlisted stocks to their offspring and list the stocks at a later date to raise their value.⁴² Finally, regulations have been introduced to prevent chaebols and rich individuals from exploiting the non-taxation of donations to non-profit foundations. For instance, non-profit foundations established by the conglomerates will be prohibited from owning stakes of related chaebol affiliates, and individuals donating funds to non-profit foundations will be barred from acting as board members. It is too early to evaluate the impact of the recent strengthening of the inheritance and gift tax, and loopholes may still continue to undermine compliance. However, wealthy individuals and particularly chaebols will find it more difficult to transfer their wealth to family members without paying due taxes.

Widespread use of earmarked taxes and quasi-taxes hampers efficiency and transparency

33. A unique factor of the Korean tax system is the importance of earmarked taxes and so-called quasi-taxes. The most important earmarked taxes are the education tax, the transportation tax and the rural development tax, which are all levied at the national level. 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 per cent of GDP. Earmarking is often used as a political tool to muster public support for tax increases to cover specific expenditures. It also allows -- at least in principle -- a closer link between those who pay the tax and those who benefit. However, the disadvantages of earmarking outweigh these virtues. *First*, earmarking reduces the flexibility of policymakers to adjust spending policies as expenditure needs change over time. *Second*, when earmarked revenues exceed the expenditures for which they are targeted, it can be difficult to reallocate the additional funds to other, more productive purposes. *Third*, earmarked taxes significantly increase the complexity of the tax structure. *Fourth*, they contribute to nurturing vested interests within and outside the government, such as the beneficiaries and those in the ministries responsible for the administration of the taxes. In conclusion, the widespread use of earmarked taxes in Korea is not consistent with an efficient management of public finances.

42. Gift taxes will also be levied on subsidised loans from companies to a majority shareholder's offspring. Furthermore, when stakes of majority shareholders who have management rights are either inherited or donated to their offspring, the majority shareholder will be subject to additional taxes of up to 30 per cent.

34. An even less desirable feature is the so-called quasi-taxes, which are not very well defined but cover a wide range of fees, charges and contributions that are not imposed by the tax laws. Excluding contributions to various social insurance systems, which are similar to regular taxes, the amount of quasi-taxes is estimated at 1.6 trillion won (0.3 per cent of GDP), including involuntary gifts and donations (Son *et al.*, 1998). Most of these are levied on corporations in a discretionary and non-transparent manner for financing off-budget expenditure. In addition to the compulsory quasi-taxes, many corporations also feel obliged by to pay substantial “voluntary” contributions to sports clubs, universities, etc.

Local autonomy is strictly limited

35. Local government taxes in Korea are levied by provinces, counties, districts and cities. Local tax revenues have doubled from 10 per cent of total taxes in the 1970s and early 1980s to currently around 20 per cent. There are three main categories of local taxes: property-related taxes, the tobacco consumption tax and the inhabitants tax (which is basically a surtax on the national income tax). Although local governments collect and administer these taxes, they have very limited discretion in setting tax rates and bases since the Korean Constitution states that tax issues, including rates, must be decided by the National Assembly. In contrast, local autonomy on tax issues is stipulated in the constitutions of many other OECD countries. However, some limited room for manoeuvre is granted to local governments in Korea by the “flexible tax rate system”. This system allows each local government to increase or decrease certain tax rates, including the inhabitants tax, the car tax and the tobacco consumption tax, within a limited range (with the central rates being determined by the National Assembly). Furthermore, local governments are allowed to adjust the centrally-determined valuation of land for tax purposes. Finally, local governments are granted some freedom to exempt foreign companies from property, land acquisition and registration taxes. In practice, most local governments stick to the guidelines issued by the Ministry of Government Administration and Home Affairs in order not to upset the electorate (by raising taxes) or the central government (by lowering taxes when the balance is in deficit, as is the case in the vast majority of local governments in recent years).

36. Local government expenditures are around half the size of those at the central level. The part of local government spending not covered by local taxes is financed by charges, fees, borrowing⁴³ and transfers from the central government. The transfers take the form of revenue sharing, matching grants and subsidies to special activities. *Revenue sharing* allocates a certain share of central government tax revenues -- currently 15 per cent -- as unconditional grants to local governments according to formulas for objective expenditure needs and standard revenues. However, part of the revenue sharing is also given on a discretionary and rather *ad hoc* basis, such as the special local shared tax and the additional grant. *Matching grants* (or “national subsidies”) are provided to specific local projects based on evaluations by the ministries concerned as well as the Ministry of Planning and Budget. Finally, the *subsidies to special activities* (or “local transfer tax”) are transfers of revenues from certain national taxes, such as those on liquor and telephone service, to finance specific local infrastructure and development projects.

43. Local borrowing is restricted to infrastructure projects, disaster relief and certain welfare enhancing projects. There are limits to the amount of debt and the shortfall allowed in tax revenues from the previous year. In any circumstance, the Ministry of Government Administration and Home Affairs has to grant its approval.

Tax administration is still inadequate despite recent reform

37. At the root of problems in Korea's tax system 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. Measures specifically aimed at enhancing taxpayer service, such as the Charter of Taxpayers' Rights, have also been instituted. Finally, the organisation of the National Tax Service (NTS) was completely overhauled in the autumn of 1999 in order to enhance the effectiveness of administration (Box 7).

Box 7. The National Tax Service

In September 1999, the former National Tax Administration changed its name to the National Tax Service. The organisational structure was radically changed, from a tax-specific structure (individual income taxes, corporate taxes, consumption taxes) to a functional structure (assessment, collection, audit, taxpayer service). This follows the approach adopted in most other OECD countries. The changes in tax administration also included a reduction in the number of district offices from 134 to 99. There was also a significant re-allocation of personnel as part of the objective to increase the share of tax auditors in total personnel from 15 to 30 per cent (as generally recommended to ensure adequate and efficient audit coverage, *cf.* Silvani and Baer, 1997) and the share of tax service personnel from 5 to 20 per cent. Management of tax related information as well as personnel management within the National Tax Service are also being reformed. The objective is to improve on the effectiveness and fairness of the tax administration and more firmly establish the right and responsibilities of taxpayers and tax officials alike.

38. Although these changes are steps in the right direction, a number of deficiencies are still in place in the tax administration: (i) the audit coverage is relatively low and declining,⁴⁴ although the projected doubling of auditing personnel may help strengthening audit coverage in the future; (ii) taxpayer services still rely heavily on personal contact between the taxpayer and the tax administrator; (iii) the processing of tax returns is cumbersome and requires an excessive share of resources, leaving insufficient resources for auditing and collection; and (iv) the collection of tax arrears appears to be less than optimal as large and new arrears do not receive the highest priority (Hyun, 1999). These features imply that the self-assessment system, which requires strict enforcement to work properly, as well as the Tax Integrated System, have not yet achieved their full effect in terms of raising compliance and reducing resources needed for tax processing. Probably the most important obstacle to full utilisation of the new information technology has been the lack of sharing of tax-related data between local and national government bodies, as well as the absence of complete and automatised tax information from financial institutions. The Ministry of Finance and Economy has announced that, as of July 2000, local governments are obliged to automatically submit data on high income taxpayers to the NTS -- including data on transactions of cars, villas, luxury houses and yachts. More reporting on financial data will also be required by the KOSDAQ. To the extent these measures are effectuated, they will represent a step forward in the enforcement of tax payments by high-income individuals.

44. The number of audits between 1995 and 1998 fell from 11 000 to 8 000 for individual taxpayers, 20 000 to 12 000 for corporate taxpayers and 9 000 to 8 000 for VAT taxpayers.

V. Improving equity, efficiency and simplicity

39. 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 (a “package approach”) 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. A more piecemeal approach would fail to obtain the full benefit of reform, but would still be better than a no-change policy. 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. Specific policy recommendations are outlined in Box 9 below.

Income and consumption tax bases should be broadened

40. The personal tax base should be broadened by reducing allowances and credits as well as improving the taxation of fringe benefits, capital income and the self-employed. The revenue potential is substantial -- as much as 5 per cent of GDP -- and could be used to lower rates, thus reducing distortions, or finance increasing expenditure without having tax wedges rising accordingly.⁴⁵ However, base broadening is a highly sensitive issue given the vested interests involved and so far the trend has been to narrow the personal tax base rather than the opposite. Possible strategies for base broadening include subjecting all new tax allowances to sunset clauses, as is frequently done in the corporate tax system, and gradually scaling back the effective real value of existing allowances by indexing them to inflation rather than nominal income growth. A politically more viable alternative could be to redesign the personal tax system in a way that keeps a significant share of income earners out of the income tax net, as at present, but in a more simple and less distortive manner.

41. Besides diluting revenues and efficiency, the current system of reliefs in the personal income tax system is an inappropriate mechanism for income redistribution since the tax value of any given allowance increases with the marginal tax rate. Those with income of more than 20 million won a year receive an average income tax relief of 3.5 million won per person, while those with annual incomes below that amount receive less than 1 million won per person. If the objective of tax reliefs is to exempt a certain share of the population from income taxation, this could for instance be achieved at lower efficiency costs by eliminating all or most of the current reliefs and introducing a zero-rated band at the bottom of the income scale (Table 14). As an illustration, one hypothetical revenue-neutral option could be to replace all existing allowances and credits with a zero-rated band for all incomes below 20 million won, while keeping the 20 and 30 per cent tax brackets and eliminating the 40 per cent bracket. This would exclude even more people from the income tax net than at present, while keeping the tax payments from the highest income groups almost unchanged and raising more revenues from people earning 25 to 50 million won (Figure 10).⁴⁶ If instead the zero-rated band was applied for example only to incomes below 10 million

45. Allowances and credits are generally aimed at legitimate social and political purposes such as stimulating family formation, encouraging home ownership and reducing inequalities between wage earners and self-employed. However, it is often unclear whether these objectives are achieved in the most efficient way, if achieved at all, and the benefits should be weighed against the social cost of higher tax rates. Increasing personal allowances and deductions not only make the base smaller thereby necessitating -- all else being equal -- higher rates and thus more distortions; it also contributes to a more complex system and introduces new inequities.

46. An alternative approach would be to expand the earned income tax credit or to introduce targeted transfers for low-income groups. While this would be less costly in budgetary terms than a zero-rated bracket, the

won, additional tax revenue equivalent to about 2½ per cent of GDP could be raised, primarily by significantly increasing the tax burden of people earning 10 to 50 million won. A second revenue-neutral option would be to eliminate the basic global income deduction and extend the 10 per cent tax rate to the first 20 million won of income.

**(Table 14. Illustration of possible effects of various tax-reform scenarios)
(Figure 10. Illustration of possible distributional effects of tax reform)**

42. The problem of taxing self-employed on an equal basis with wage earners is present in almost all OECD countries. The seriousness of the problem depends on the share of the self-employed in the total labour force, the tax rules applied to the self-employed and the enforcement of their income reporting and payment of taxes. Korea's tax base is exposed to this problem on all three accounts: the share of self-employed is high and stable,⁴⁷ several tax incentives are given to the self-employed and the enforcement towards the self-employed has been relatively lax. Hence the magnitude of undertaxing of the self-employed, although difficult to quantify and compare across countries, is presumably above average among OECD countries. Several options exist for strengthening taxation of the self-employed. One obvious possibility is to enhance enforcement through more and better targeted audits as well as higher penalties on the self-employed who are caught under-reporting.⁴⁸ A second option is to promote self-assessment and reliable book-keeping through tax incentives, such as increasing the credits for those who keep proper books. The "blue return" system in Japan has had some success in encouraging the self-employed to keep regular books (OECD, 1999b). Third, the estimation method for tax assessments should be scrapped or at least improved to prevent the tax liability of the small self-employed from being systematically biased downwards. Finally, a more radical solution could be to move from an income tax base to a broader and less easily manipulated base, such as the value added of the self-employed. Among other things, this would eliminate the possibility for the self-employed to spread income among family members to mitigate the progressiveness of personal income taxes.

43. The corporate tax base should be broadened by reducing and streamlining the incentives given to the business sector, which have several negative consequences. *First*, tax incentives distort market signals in determining resource allocation, which leads to sub-optimal outcomes for the economy as a whole. *Second*, incentives complicate tax administration and tax laws, increase compliance costs and pave the way for unintended loopholes, abuse and evasion. *Third*, tax incentives normally favour established firms over new firms, which are more likely to be in a tax loss position and will not be able to take advantage of the incentives. Consequently, tax incentives should be limited to a strict minimum and concentrated in areas where there is evidence that market failures may lead to underinvestment. Such areas may include R&D, environmental protection and development of the social infrastructure. Tax incentives, however, are difficult to target: a poorly targeted tax instrument gives rise to a waste of resources,⁴⁹ while an inadequate dosage may be ineffective in achieving the desired objective.

effective marginal tax rates for persons leaving the targeted income groups may become excessive, depending on the range over which the credit or transfer is abated.

47. The share of self-employed in total working-age population is 17 to 18 per cent, nearly the same as in the early 1980s. In Japan, in contrast, the share was a similar level in the early 1980s but has since fallen to around 13 per cent. In the United States and Germany, for example, the share of self-employed has been stable since the early 1980s at around 6 to 7 per cent of the total labour force.
48. The penalty for under-reporting is typically 10 per cent of the under-reported income plus interest, while the penalty for not reporting (intended fraud) is typically 20 per cent plus interest. However, it is very rarely proven that the under-reporting is intentional.
49. For instance, the incentives to SMEs in Korea do not seem to be particularly well-targeted since the definition of SMEs is very wide (generally firms with less than 300 employees, but sometimes up to

44. Many of the measures introduced during 1998 to facilitate corporate restructuring (Box 2) have been temporary, which has the double advantage of promoting prompt restructuring before the measures expire as well as protecting the corporate tax base against new permanent loopholes. Hence, most of them should not be extended beyond their original time frame. However, those measures contributing to a more neutral tax treatment of corporate restructuring should be incorporated as a permanent feature of the corporate income tax law. This is particularly the case of the tax deferral (until realisation) offered in the case of assets and equity swaps as well as mergers, acquisitions and divisions when appropriate tests for continuation of business and ownership are met. Incentives for corporate restructuring could also be improved by introducing a consolidated tax treatment of holding companies. The expanded preferential tax treatment of foreign companies can to some extent be justified by reason of efficiency and diffusion of knowledge and technology,⁵⁰ but also locks in a package of tax distortions for an extended period of time (Box 2). Taxing foreign companies differently from domestic companies is not usually considered to be neutral and fair and hence could contribute to the propagation of harmful tax practices. It also remains to be seen to what extent local governments will compete in providing tax incentives to foreign companies and how this will effect local government revenues.

45. Priorities for broadening the VAT base should comprise inclusion of agricultural products, such as unprocessed foodstuffs, limiting the zero-rate to exported goods and eliminating the special regime. The 24 million won turnover threshold for VAT exemption is not out of line with practices in other OECD countries as a mechanism to relieve small retailers from the administrative burden of the VAT (Table 15). The special regime, on the other hand, extends the number of ventures not included in the ordinary VAT scheme by 1.2 million (compared with a total of 1.7 million ordinary VAT tax payers), thus contributing to tax avoidance and evasion. It has been argued that the special regime alleviates the tax burden on personal services, such as home services, which typically use low-skilled labour. However, since the tax wedges for low-income earners are already low, it is not likely that taxes are a key factor constraining employment opportunities for this group. Concerns of neutrality and simplicity should, therefore, take precedence over the vested interests of small retailers and the special regime should be ended, perhaps by applying a sunset clause for a gradual phasing out.

(Table 15. Turnover thresholds for VAT exemption)

The tax treatment of savings should be more equitable

46. One of the most important issues for tax reform in Korea is how to achieve a more equitable taxation of capital income. For countries with high marginal tax rates in the personal income tax system, a dual taxation of labour and capital income is often preferred, with a low uniform tax rate on capital income so as to avoid flight of capital. Such a system avoids the complexity and non-neutrality across various kinds of capital income implied by the Korean personal income tax system. However, applying different tax schemes to labour and capital income raises tax-shifting incentives, which require complex administrative countermeasures, and lowers vertical equity (see OECD, 1999*d*). In countries with relatively low personal tax rates, it is usually best to combine the taxation of all income into one comprehensive schedule (the Shantz-Haig-Simons principle). With a top marginal tax rate of 40 per cent on personal income, Korea is in an intermediate position, making it unclear whether comprehensive taxation of capital or a dual system is preferable. If base-broadening efforts in the personal tax system pave the way for lower rates, as recommended above, taxation of capital income could be comprehensive. Otherwise, it may

1 000). Hence 99 per cent of all companies are characterised as SMEs and these companies cover 74 per cent of total employment.

50. According to one estimate, labour productivity in foreign-controlled firms is around 40 per cent higher than that of domestic firms (OECD, 1999*a*).

be a better option to tax *all* interest and dividend income (allowing a few limited incentives to areas such as private pensions and housing) at a low final withholding rate.

47. As part of a more equitable taxation of savings, Korea should consider introducing a tax on financial capital gains, either by including such gains in global income or by taxing them at the same final withholding rate as dividend and interest income. If capital gains were to be included in global income, some averaging provision would be required to mitigate the “bunching problem” due to the fact that a capital gain that has accrued over several years is taxed in one specific year at a high marginal rate.⁵¹ Some countries avoid taxation of financial capital gains because it imposes a double tax on capital, which may adversely influence the development of domestic capital markets. For Korea, however, neutrality *vis-à-vis* the capital gains tax imposed on real estate capital gains should be a more serious concern. Moreover, taxation is probably much less important for the development of Korea’s capital markets than the emergence of well-functioning financial institutions, transparent and consistent regulation and the presence of large institutional investors, including the NPS.

Taxation of pensions should be strengthened

48. Under the current tax regime for retirement income, tax revenues from this increasingly important source of income are likely to remain negligible. This implies that tax revenue has to be raised elsewhere, or expenditure lowered, at potentially higher costs in terms of distortions and inequity. Two issues are important. *First*, to ensure a more uniform tax treatment of the three tiers of the pension system to make the system more neutral and robust *vis-à-vis* tax avoidance. *Second*, to increase the effective taxation of retirement income. This could for instance be achieved by shifting to an EET-system for all three tiers and, at the same time, including all kinds of retirement income as ordinary global income. This would both strengthen revenues and bring Korea in line with most other OECD countries. A transitional arrangement would have to be put in place for those who already paid tax on their contributions to the NPS, so that these people can obtain a credit for taxes paid on contributions at the time of taxation of the retirement income.⁵² There would also have to be a limit on the contributions so as not to undermine the short-term fiscal prospects by excessive deferral of taxes.⁵³ A further option is to start taxing the earnings of the pension funds as they accumulate (an ETT system). Such a treatment is relatively rare in the OECD area because most countries deliberately wish to subsidise long-term private pension savings.

49. Since the current stock of contributors (around 15 million persons) is much higher than the stock of beneficiaries (around half a million persons), a shift from TEE to EET would imply a loss of tax revenue in the short run. However, the loss would be rather limited -- probably about 0.2 to 0.3 per cent of GDP -- and would gradually be offset by higher tax revenues from the fast-growing population of beneficiaries

51. One obvious way is prorating: divide gain by number of years the asset has been held, find the relevant tax rate for this income bracket and multiply the tax amount by number of years.

52. However, full grandfathering provisions (*i.e.* exempting these people from further taxation at the benefit stage) should not necessarily apply since the NPS is far from actuarially fair.

53. A change to EET will also imply other macroeconomic effects: deductions for contributions and imposition of taxes on benefits will cause a deferral of the tax burden from the earlier to later stages of the life cycle. This will temporarily (until the system is fully matured) raise the private savings rate since the marginal propensity to consume is lower at the younger ages than it is at older ages. Since this redistribution of taxation over the life cycle implies a larger element of consumption taxation (tax is not imposed until retirement when income and consumption are more closely linked), there is also an additional welfare gain to be reaped.

(Box 8).⁵⁴ The loss-making period would be prolonged by the projected increase in contribution rates, which would double the tax value of employees' contributions and thus the revenue loss of making contributions deductible. To avoid large leakages of tax revenues, the deductibility of employees' contributions could be phased in over several years, while the taxation of withdrawals should be implemented immediately. Alternatively, the short-term tax loss from allowing deductibility of employees' contribution could be offset by eliminating or substantially reducing some of the exemptions and credits in the personal income tax system or by raising consumption taxes. In any case, there appears to be a window of opportunity for changing the tax treatment of pensions as well as the public pension itself since the NPS is currently running substantial surpluses and the number of beneficiaries is still small. In a decade or two from now, both factors will make reform more difficult.

Box 8. Tax revenue effects from a shift in the taxation of national pensions

Based on the authorities' long-term projections of revenues and expenditures of the NPS, Figure 11 shows two scenarios to illustrate possible tax revenue effects from changing the public pension from TEE to EET. In the first scenario, employee's contributions are deducted from taxable income at an average rate of 20 per cent and pension benefits are taxed at an average rate of 10 per cent. This "conservative scenario" which shows a net revenue loss of around 0.2 per cent of GDP will prevail until around 2025, after which it begins to decline and eventually breaks even in 2050. If the average tax rate on both deductions and benefits is assumed to be 20 per cent, net gains will be realised around 2020 and increase steadily thereafter. Both scenarios are based on the same set of macroeconomic assumptions.

(Figure 11. Revenue effects from a shift in the taxation of national pensions)

Property taxation should be reformed to promote the efficient use of land

50. The taxation of property may serve several purposes aside from raising revenue, such as discouraging speculation; promoting efficient land use; redistributing income and wealth; and capturing part of windfall gains from development. Achieving such objectives requires a careful balancing of holding taxes on the one hand and transaction and capital gains taxes on the other. Since land is such a scarce resource in Korea,⁵⁵ under-utilisation of land is particularly costly. This suggests that holding taxes on land should be sufficiently high so as to deter and penalise non-optimal use. Such taxes are less distortionary than those on buildings and structures since land is not a produced good (at least once it has been converted from rural to urban use). On the other hand, a limited tax on buildings and structures is appropriate in order to discourage premature development. Since the proper allocation of land is facilitated through transactions, capital gains and transfer taxes should be low so as to minimise lock-in effects.⁵⁶ Overall, the current property tax structure in Korea does not seem to promote the most efficient use of land (Table 16).

(Table 16. Property taxes)

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54. The number of beneficiaries is expected to increase by more than 6 million until 2030 while the number of contributors will increase by less than 4 million.
55. The population density is among the highest in OECD and, being a mountainous country, only around 20 per cent of the land is available for urban and agricultural purposes (Ro, 1996).
56. Accrual taxation of capital gains could mitigate lock-in effects, but is politically unpopular, administratively difficult and could have adverse effects if liquidity is constrained. One way to circumvent the liquidity constraint is to charge interest on the amount of tax deferral, but a holding tax may then achieve basically the same effect.

51. To the extent land prices are basically driven by speculation (or “bubbles”) and lock-in effects are primarily due to factors other than taxes, there may be a case for levying high transaction and capital gains taxes to curb speculation and achieve a more equal distribution. However, in this case, raising the effective rate of the capital gains tax should be done by closing loopholes rather than raising statutory rates. The “reduction rate” -- tax expenditure relating to capital gains on real estate as a per cent of total capital gains tax revenues on real estate if all gains were taxable -- is around 40 per cent for corporations and 20 per cent for individuals (Choi, 1998). The loopholes undermine the base, hamper neutrality and complicate administration. Furthermore, the case for high transaction and capital gains taxes to counteract speculation applies mainly in the short term. Even if such taxes may curb speculation arising from policy failures elsewhere in the system, the value of the taxes will be capitalised into prices, leading to a one-off shift in the price level rather than a permanent lower rate of price increase. Furthermore, since land prices in Korea have been stabilised since the early 1990s, property-related taxes should now fulfil a more conventional role with focus on revenue and efficiency and less emphasis on curbing speculation.

52. The overall objective should be to increase holding taxes while reducing transaction taxes. The most important step would be to increase the valuation of land towards its market value, thereby increasing the effective taxation on landholding,⁵⁷ while also reducing the need for other anti-speculation taxes. The holding rate structure could also be flattened to alleviate disincentives for development of rural land. Furthermore, the special and general combined tax under the aggregate land tax should be integrated in order to equalise the tax treatment of residential and commercial land. In order to reduce transaction taxes, the acquisition and registration taxes should be lowered. The base for capital gains taxation of real estate should be broadened and the rate structure made independent of the holding period. The transaction price should be used as the base instead of the appraised value in order to eliminate the incentive for buyer and seller to collude and report a lower-than-actual purchase price in order to reduce transaction taxes. Whether the separate taxation of real estate capital gains should be maintained or not is of less importance. The distributional impact of increasing holding taxes while reducing transaction and capital gains taxes is not obvious. On the one hand, a reduction in the capital gains and transaction taxes is likely to be regressive. On the other hand, the distribution of landholding is so much more uneven than that of income, that even a flat holding tax is highly progressive and would presumably dominate the other effects. The progressivity would be further enforced if the current progressive holding rate structure were maintained.

53. A particular issue arises with the development charge, which was re-introduced in 2000. The development charge levies a 25 per cent charge on “betterment profits” to capture windfall gains arising from development. It can be regarded as a charge on permission to develop rather than a development charge in the traditional sense, where the goal is to recoup some of the benefits gained by landowners from public infrastructure projects. Thus, it is a kind of price for obtaining the right to develop. As the development charge is levied on an accrual basis, it is subject to the usual problems of valuation and liquidity constraints. But the most crucial problem is that of delineating which areas benefit from development, since externalities from development in one zone that affect land prices in bordering zones are not captured. Even though the basic idea behind the development charge makes sense from an economic point of view, the practical difficulties in implementing it appear to be sufficiently large that it should be abandoned, leaving the taxation of windfall gains to the ordinary capital gains tax.

57. The valuation used for the landholding tax is estimated at 30 to 50 per cent on average of the “Official Value of Individual Parcel” (OVIP) price, which is, in turn, only about 70 per cent of the market price.

The consumption tax structure should be simplified and earmarked taxes eliminated

54. There is considerable scope for streamlining the consumption tax structure. Main options include integrating the telephone tax into the VAT system, moving the administration of the tobacco tax to the national level and eliminating the special consumption tax regime and the transport tax, while keeping their energy-related taxes as ordinary excise taxes. Further significant simplification of consumption taxes, as well as of the entire tax system, could be achieved by phasing out the education tax and the rural development tax. Such changes would, of course, require appropriate compensation to local governments for any revenue losses they might suffer, but could conveniently be included with a more thorough reform of local government finances. The system of quasi-taxes should also be abandoned as soon as possible as these taxes add to non-transparency, uncertainty and taxpayer dissatisfaction. With respect to environmental taxes, there appears to be considerable scope for increasing the excise on diesel oil, thereby bringing it more into line with the tax on gasoline.

The autonomy of local governments should be increased

55. Despite some efforts undertaken in recent years to devolve more responsibility to local governments, the central government maintains a tight grip on local government finance. Devolving significantly more autonomy to local authorities, thereby reaping some of the potential benefits from locally-determined and provided public goods and services, would require a thorough change of the local government financing system, as well as in the entire culture of local and central administrators and politicians alike.⁵⁸ One of the most important deficiencies in the current system is that the cost signal of changing local expenditure is not apparent to local taxpayers. Local governments seem unwilling to raise local taxes to fund increasing expenditure, and are not forced to do so by the current arrangements. However, the system of inter-governmental transfers is expected to be reformed over the next few years with the aim of increasing local governments' self-financing and mitigating horizontal inequities between local governments. Simplification of the tax system, as recommended above, would also necessitate a new formula for inter-governmental transfers.

Compliance and equity should be strengthened

56. Despite recent initiatives to improve tax administration, much remains to be done to ensure the overall effectiveness and fairness of the system. Simpler tax forms, higher penetration of user-friendly electronic processing, improved collection of arrears as well as more and better targeted auditing would allow substantial improvements. But the most urgently needed change is to require other government bodies, including property registers and the social security system, to provide tax-related information to the National Tax Service on a comprehensive and automated basis in order to enhance the effectiveness of auditing. A step in this direction has been taken by the announcement of widened information obligations of the local governments to the NTS as of July 2000. How effective this will be remains to be seen, however, especially since the information requirements only seem to apply to high income earners. Moreover, even though financial institutions are required to automatically transfer information on interest and dividend income of all individual accounts to the National Tax Service, it appears not to be the case in practice.

58. See for instance OECD (2000c) for an application of this discussion to the area of locally delivered social assistance in Korea.

57. The low tax compliance among the self-employed points to lax enforcement (low audit coverage) and inadequate penalties.⁵⁹ Only 8 000 audits were carried out among the 1.2 million self-employed taxpayers in 1998, implying a “fiscal presence” (audits per taxpayer) of only 0.7 per cent, compared with for instance 1.2 per cent in Mexico and 1.4 per cent in Spain.⁶⁰ In addition to increased audits, higher and strictly-enforced penalties would help improve compliance among the self-employed. Compliance with the inheritance and gift tax could also be improved. Despite the recent strengthening of the tax, loopholes still exist. For instance, donations to religious, charitable and educational purposes are tax-exempt, which may serve valuable social purposes, but also increases possibilities for evasion and avoidance. As a minimum, there should be strict definitions of such donations and thorough monitoring of the transactions. The measures taken to limit the influence of chaebol and rich individuals on these funds are also not necessarily sufficient to prevent the use of cross holdings or “middlemen”.

59. The penalty for under-reporting is typically 10 per cent of the tax on the under-reported income, while the gain in terms of evaded tax is between 10 per cent and 40 per cent of under-reported income. In order to equalise the expected gain from evading tax with the expected loss from being caught (ignoring any risk aversion of the self-employed and their tax “morale”), the probability of being audited should be around 90 per cent given the current penalty structure. Such a level of audit coverage is of course not obtainable in practice.

60. A standard rule of thumb is that the fiscal presence should be at least in the 1-1.5 per cent range.

Box 9. Options for reform

Tax bases should be broadened in the personal and corporate income tax systems as well as in the VAT system. The personal income tax structure should be considerably simplified and streamlined, for instance by replacing some or all of the existing allowances and credits with a wide zero-rated bracket. Reductions in the level of tax reliefs could be achieved by limiting the degree of indexation. The proceeds could be used to finance part of the future costs of ageing. It is imperative that any reduction in the personal allowances be accompanied by stricter enforcement of tax payments by the self-employed in order to avoid exacerbating the sense of unfairness among wage and salary-earners. The corporate tax base should be broadened by substantially narrowing and reducing the tax incentives given to SMEs, R&D and overall investment. Finally, the VAT base should be expanded by eliminating the special tax regime, leaving only a minimum exemption threshold for very small retailers, as in most other OECD countries.

Equity should be enhanced in several areas. *First*, personal capital income should be taxed more evenly across sources. The most appropriate framework for taxing capital income depends on changes in the rates in the global tax system. If these were lowered, a comprehensive tax would be preferable. Otherwise, a dual tax system could be considered, taxing all kinds of personal capital income, including financial gains, at a moderate flat rate. Incentives to private savings should be limited to a small scale and only to a few targeted areas, such as savings for housing and private pensions. *Second*, a fringe benefit tax should be introduced. Since it is cumbersome to administer at the individual level, it could be levied at the company level. *Third*, social security contribution rates and their tax treatment should be equalised across sources of income. In order to enhance the effective taxation of pension savings and alleviate intergenerational inequities, the taxation of pensions should be changed from TEE to EET (*i.e.* making employees' contributions tax deductible, while taxing pension benefits). Base broadening in the personal income tax system could be used to finance the immediate revenue loss that would arise from such a shift. Retirement income from all three tiers in the pension system should be taxed as ordinary global income.

Efficiency of resource allocation should be promoted. In the area of property taxation, the tax mix should be changed so as to encourage development and a more efficient use of land. This would require higher holding taxes, through raising valuations closer to market prices, and lower transactions taxes. The capital gains tax structure should be independent of the holding period so as to reduce lock-in effects. In the corporate tax system, distortions to financing and investment decisions would be alleviated by reduced incentives. Ongoing restructuring in the corporate sector should be encouraged on a more permanent basis by introducing a consolidated tax treatment of holding companies and by extending the temporary tax deferral offered in the case of assets and equity swaps as well as mergers, acquisitions and divisions, when appropriate tests for continuation of business and ownership are met.

Simplicity should be increased by integrating the special consumption tax and the telephone tax into the VAT system, retaining excises only on energy products, liquor and tobacco. The earmarked taxes and various quasi-taxes should be abolished, perhaps by implementing sunset clauses.

Local autonomy should be strengthened and the incentives for expenditure restraint improved. More freedom should also be given in the area of local taxation, provided that the transfer system from central to local governments is made more transparent and compatible with incentives for fiscal discipline.

The tax administration should urgently improve the enforcement of tax compliance by the self-employed and by recipients of inheritances and gifts by better targeting of audits and more systematic use of information from other government bodies as well as from financial institutions. Penalties may also have to be increased.

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Table 1. The share of VAT in total consumption tax revenues

	1990	1998 ¹
Japan	32	38
Germany	62	64
France	65	62
Italy	52	53
United Kingdom	55	54
Canada	26	28
Austria	66	66
Belgium	60	57
Czech Republic	..	55
Denmark	55	59
Finland	60	58
Greece	55	56
Hungary	..	53
Iceland	56	63
Ireland	49	55
Korea	42	41
Luxembourg	46	47
Mexico	38	38
Netherlands	62	59
New Zealand	67	71
Norway	53	57
Poland	..	59
Portugal	45	55
Spain	55	56
Sweden	60	61
Switzerland	..	54
Turkey	66	63
Average of above OECD countries	53	55

1. 1997 in the case of Canada, Belgium, Ireland, Portugal and Turkey.
Source: OECD, *Revenue Statistics*, 1999.

Table 2. **Average effective tax rates on capital, labour and consumption**¹
Per cent

	Capital based on net operating surplus			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	1980-85	1986-90	1991-97
United States	50.6	48.8	51.0	28.3	29.2	31.1	21.6	22.1	22.6	6.3	5.9	6.1
Japan	108.7	98.8	83.6	39.1	42.4	32.6	20.1	23.1	24.0	6.4	6.2	6.7
Germany	47.6	39.4	36.4	22.9	21.1	19.9	33.1	34.8	35.9	14.8	14.6	15.8
France	53.3	41.5	41.4	24.3	22.9	23.6	35.4	38.5	40.2	18.8	19.0	18.0
Italy	36.0	38.9	49.6	21.7	24.7	31.0	28.6	32.3	36.3	12.2	14.6	16.0
United Kingdom	95.5	90.2	68.6	46.4	47.1	38.4	24.3	22.3	21.0	16.0	16.4	16.9
Canada	53.9	62.4	87.7	29.9	33.6	38.6	22.5	26.3	28.7	16.4	14.9	13.1
Australia	66.2	59.3	56.2	26.1	28.0	28.0	21.4	23.7	22.6	14.0	13.5	11.9
Belgium	52.4	44.5	47.0	32.5	29.9	30.8	38.5	40.1	39.7	16.7	17.5	18.7
Denmark	..	90.1 ²	67.7	..	32.3 ²	29.1 ³	..	40.2 ²	42.8	25.8	27.9	25.7
Greece	..	38.9 ⁴	39.4 ⁵	..	23.5 ⁴	26.8 ⁵	..	20.7 ⁴	24.3	15.7	18.3	18.6
Korea	19.9	25.7	49.0	13.4	16.2	26.8	3.5	5.0	7.7	17.2	17.1	16.0
Netherlands	39.2	38.8	40.7	22.5	23.4	24.7	41.1	42.0	41.0	16.1	18.3	18.7
New Zealand	..	55.4 ⁴	50.1	..	38.2 ⁴	34.9	..	25.7	24.2	11.9	17.9	19.8
Portugal	..	18.2 ⁶	22.2	..	15.4 ⁶	18.3	..	20.0 ⁶	22.7	16.7	21.4	20.5
Spain	24.0	31.4	31.9	12.6	19.7	20.6	24.2	27.7	30.4	8.5	14.1	13.7
Sweden	56.6	80.2	63.5	25.5	35.3	30.5	46.8	51.0	48.5	17.7	20.4	18.7
OECD average	51.7	52.2	52.2	25.1	26.7	26.6	30.0	32.2	33.4	16.1	17.2	17.1

1. Based on a modified version of the Mendoza *et al.* methodology, as described in Carey (2000).

2. 1988-90.

3. 1991-96.

4. 1987-90.

5. 1991-95.

6. 1989-90.

Source: D. Carey (2000).

Table 3. Average implicit tax rate on continued work due to the old-age pension system

1995

	Postponing retirement	
	from 55 to 64	from 55 to 69
Australia	0	6
Austria	34	47
Belgium	23	33
Canada	6	11
Denmark	0	5
Finland	22	33
France	14	42
Germany	14	23
Ireland	14	17
Italy	79	79
Japan	28	26
Korea¹	1	1
Netherlands	13	14
New Zealand	9	15
Norway	15	22
Portugal	4	25
Sweden	18	22
Switzerland	0	10
United Kingdom	5	10
United States	12	17
Average ²	16	24
Standard deviation ²	18	18

1. The Korean rates, which are for 2000, refer to the case where contributions are made to the national pension system for 20 years or more. The average life expectancy at the age of 55 is assumed to be 25 years.
2. Excluding Korea.

Source: Blöndal and Scarpetta (1997) and OECD calculations.

Table 4. Distributional effects of taxes and social security contributions
Per cent, 1998

Decile	Distribution of income					
	Gross income	Gross income after income tax	Gross income after SSC	Gross income after VAT	Gross income after SCT	Gross 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 coefficient	0.3157	0.3092	0.3169	0.3182	0.3160	0.3131

Note: SSC = Social security contributions; SCT = Special consumption tax. The numbers are based on the monthly expenditure surveys for urban workers' households (except for VAT and SCT, which are from Sung (1999)).

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.

Table 5. Taxation of fringe benefits

Classification	Tax assessment
Meals and childcare facilities provided by employer	Fully deductible for the employer. Not taxable for the employee.
Subsidies for employees buying owner-occupied housing or company's own stock	Fully deductible for the employer. Not taxable for the employee.
Low interest loans	Personal income tax will be imposed based on the difference between "market" rate of interest and the employee's contribution.
Lodging owned by employer	Fully deductible for the employer. Not taxable for the employee (except for executives).
Tuition: further education and training	Fully deductible for the employer. Not taxable for the employee. The tuition for government approved schools is also tax-exempt.
Entertainment with customers	Deductible for the company within certain limits. Not taxable for the recipient.
Company cars	Fully deductible for the company. Not taxable for the user.
Share options (including stock options)	Fully deductible for the employer. Taxable at the personal level at market value less contributions (for company's own stock).
Clothing	Fully deductible for the employer. Not taxable for the employee if required and exclusively used.
Gift, discount	Fully deductible for the employer. Value added tax and personal income tax is levied on the recipient.

Source: Ministry of Finance and Economy.

Table 6. Tax expenditures in the Special Tax Treatment Control Law
Billion won, 1998

Incentives for:	Types of taxes			Total	Total (per cent of GDP)
	Personal	Corporation	I&G ¹		
1. SMEs	89	197		286	0.1
2. Investment in facilities	14	349		362	0.1
3. Technology and human resource development	17	354		370	0.1
4. SOC and housing	242	299		541	0.1
5. Balanced development of urban and rural areas	385	62	32	479	0.1
6. Saving and financial institutions	2 621	231		2 852	0.6
7. Social securities	249	302		551	0.1
8. Workers	1 192	14		1 206	0.3
9. Education and culture	156	467	5	629	0.1
10. Other	4	451		455	0.1
Total	4 967	2 726	38	7 731	1.7

1. Inheritance and gift tax.

Source: National Tax Service (1999).

Table 7. **Weighted average of marginal effective tax rates**
Per cent

Year	Corporation size		Capital assets			Investment source		
	Big	Small	Buildings	Machinery	Non-depreciated capital	Loans	Capital raising	Internal holdings
1982	-24.44	-14.47	-14.16	-31.02	-16.08	-51.55	41.55	44.86
1987	-21.80	-19.82	-10.09	-32.76	-9.41	-32.76	27.66	30.17
1992	-25.21	-30.31	-8.47	-43.39	-7.55	-46.46	18.51	22.18
1997	-15.78	-16.56	-2.31	-28.59	-6.04	-32.96	21.75	24.26

Source: Kun Young Yoon and Jong Ung Kim (1997).

Table 8. Marginal effective tax wedges in manufacturing in selected OECD countries¹
 Excluding wealth taxes. Per cent, 1999

	Sources of financing ²			Physical assets ³			Overall weighted average	Standard deviation
	Retained earnings	New equity	Debt	Machinery	Building	Inventories		
United States	1.67	4.90	1.43	1.51	2.54	2.02	1.91	1.20
Japan	2.66	3.88	0.36	0.97	3.14	2.79	1.98	1.23
Germany	1.08	2.21	1.21	0.85	1.40	1.91	1.24	0.48
United Kingdom	2.74	2.24	1.46	1.88	2.21	3.09	2.24	0.53
Korea (in 2000)	0.89	2.22	0.46	0.44	1.33	1.26	0.87	0.61
Korea (in 2001)⁴	0.61	1.41	1.41	0.64	1.34	1.26	0.97	0.35
Mexico	0.77	1.04	1.04	0.73	0.75	1.43	0.89	0.25
Sweden	1.73	2.17	0.68	1.14	1.43	1.99	1.41	0.51
OECD average	1.72	2.59	0.99	1.17	1.71	2.25	1.55	0.56

1. These indicators show the degree to which the personal and corporate tax systems scale up (or down) the real pre-tax rate of return that must be earned on an investment, given that the household can earn a 4 per cent real rate of return on a demand deposit. Wealth taxes are excluded. See OECD (1991) for a discussion of this methodology. Calculations are based on an inflation rate corresponding to the 1998-99 change in CPI.

2. Calculated using the following weights: machinery 50 per cent, buildings 28 per cent and inventories 22 per cent.

3. Calculated using the following weights: retained earnings 55 per cent, new equity 10 per cent and debt 35 per cent.

4. As of 2001, interest and dividend incomes will be taxed as global income if the combined amount exceeds 40 million won. Full imputation of dividends is assumed.

Source: OECD calculations.

Table 9. Dimensions of capital taxation in selected OECD countries
1999

A. Interest profits, dividends and capital gains							
	Highest tax rate on interest income	All-in corporate tax rate		Marginal taxation of dividends ¹		Financial capital gains	
United States	47	40		68		0-20	
Japan	20	41		71		26 ²	
Germany	56	58 ³		50		0	
United Kingdom	40	31		48		0-40	
Korea ⁴	24 (45)	31		46 (45)		0-22	
Mexico	40	32 ³		40		0	
Sweden	30	28		50		30	

B. Inheritance taxes							
	Rate	Spouses		Children			Valuation rules: fair market value unless otherwise noted
		Lower threshold ⁵	Upper threshold ⁶	Rate	Lower threshold ⁵	Upper threshold ⁶	
United States ⁷	18-50	0.7	3.0	18-50	0.7	3.0	Special- valuation for farms and closely-held businesses
Japan	10-70	1.4 or half of the inheritance (whichever the higher)	17.5 ⁸	10-70	0.5	17.5 ⁸	Special valuation for small land plots; residential (up to 200m ²) and business (up to 330m ²)
Germany	7-30	0.3	27.2	7-30	0.2	27.2	First \$0.3 million of business property not assessed
United Kingdom ⁹	0	-	-	40	0.4	-	
Korea	10-50	2.5	5.0	10-50	0.4	3.0	
Mexico	0	-	-	0	-	-	
Sweden	10-30	0.04	0.10	10-30	0.01	0.08	Business capital 30 per cent of substance value

Note: The rates are in per cent and thresholds are in million US\$. Exchange rates used are average daily rates, 1999.

1. Taxation at both corporate and investor level as a percentage of gross distributed profit.
2. Until FY 2001 investors can opt to be taxed by 1.05 per cent of total proceeds instead.
3. Retained profits.
4. As of 1 January 2001, the top marginal tax rates on interest and dividend income will increase to 44.5 per cent, as shown in the parentheses. Financial capital gains are mostly tax exempt, except for gains in unlisted companies and gains of large shareholders, which are taxed at a flat rate of 22 per cent if the shares are held for at least one year.
5. When tax rates above 0 become effective.
6. When the highest rate becomes effective.
7. Federal tax schedule.
8. Applicable to the legal share of inheritance of each inheritor.
9. The rate is 20 per cent for chargeable life-time transfers.

Source: OECD; International Bureau of Fiscal Documentation (1998), *European Tax Handbook 1999*; United States Internal Revenue Service.

Table 10. Taxation of personal financial income
As of 2001¹

	Taxed	Exempt
Interest income	<p>Generally taxed as global income</p> <p>If less than 40 million won (combined with dividends), taxed at separate final withholding rate of 15 per cent plus 1.5 per cent local tax</p> <p>Special low rates apply to special/small savings accounts of less than 40 million won (10 per cent plus 0.5 per cent earmarked tax for rural development)</p>	<p>Life insurance investment and private pension schemes</p> <p>Long-term savings for buying housing</p>
Dividends	<p>Generally taxed as global income</p> <p>If small² shareholders' dividend from listed stock is less than 40 million won (combined with interest income), the dividend income is taxed at separate final withholding tax of 15 per cent plus 1.5 per cent local tax</p> <p>Special low rates apply to special savings accounts (10 per cent plus 0.5 per cent earmarked tax for rural development)</p>	<p>Farmer and fishermen associations</p>
Financial capital gains (after capital gains deductions)	<p>Gains on shares in unlisted companies are taxed at 20 per cent plus 2 per cent local tax</p> <p>Gains on shares in unlisted SMEs are taxed at 10 per cent plus 1 per cent in local tax</p> <p>Gains on large³ shareholders' stock in listed companies are taxed at 20 per cent plus 2 per cent local tax if held more than one year. If held less than one year, a progressive taxation applies at rates ranging from 20 to 40 per cent plus 2 to 4 per cent in local tax</p>	<p>Gains on small shareholders' stock in listed companies are exempt</p>

1. In 2000, dividends and interest income are not included in global income but taxed at final withholding rates of 22 per cent and 24.2 per cent, respectively.
2. Less than 1 per cent of voting shares and book value below 300 million won.
3. More than 3 per cent of voting shares.

Source: Ministry of Finance and Economy.

Table 11. Tax treatment of retirement income

	National Pension Scheme		Corporate severance pay system	Private pension savings
	Employer contribution	Employee contribution		
Contributions	Can be fully expensed	No personal income tax deduction For the self-employed, 40 per cent is deductible with a limit of 720 000 won per year	If set aside as a reserve, 40 per cent can be expensed If invested in a financial institution, 100 per cent can be expensed	For contributions up to 1 million won per month, 40 per cent is deductible with a limit of 720 000 won per year
Fund income	Not taxable	Not taxable	Taxed as if it were income of the corporation	Not taxable
Benefits	Not taxable	Not taxable	Taxable under separate schedule and reduced rates. If taken as a lump-sum payment, 50 per cent is deductible; if taken as an annuity, a 50 per cent tax credit is provided	Not taxable

Source: Data provided by the Korean authorities.

Table 12. VAT: number of taxpayers, taxable sales and revenues
1998

	Number		Taxable sales		Revenue	
	Million	Per cent	Billion won	Per cent	Billion won	Per cent
Total tax revenue	2.9	100.0	105 710	100.0	15 707	100.0
Ordinary	1.2	41.4	103 100	97.5	15 436	98.3
Small business	1.7	58.6	2 610	2.5	271	1.7
Simplified	0.5	18.9	1 260	1.2	215	1.4
Special	1.2	39.6	1 350	1.2	56	0.3

Source: National Tax Service (1999).

Table 13. **Share of taxes in total energy prices**
Per cent, 1999

	Gasoline ¹ (premium unleaded)	Diesel ²
Austria	68	62
Belgium	74	63
Denmark	72	61
Finland	74	63
France	79	73
Germany	74	67
Greece	63	64
Ireland	68	64
Italy	73	70
Korea (1998) ³	48	16
Korea (2000) ⁴	60	34
Luxembourg	64	60
Netherlands	73	65
Portugal	68	63
Spain	67	62
Sweden	73	60
United Kingdom	82	81
Japan	n.a.	44
Mexico	13	13
New Zealand	50	12
United States	28	42
Average of countries listed above	69	59

1. For non-commercial use.

2. 95 RON.

3. First semester 1998. Taxes include the 15 per cent education surtax.

4. March 2000. Taxes include the 15 per cent education surtax.

Source: IEA, *Energy Prices and Taxes* (OECD) and OECD calculations.

Table 14. Illustration of possible effects of various tax-reform scenarios

Tax change	Revenue effect, per cent of GDP	Number of tax payers affected
Eliminate all existing allowances and credits	+4.7	13.1 million (= all taxpayers) will face higher taxes
Eliminate basic income deduction (for taxpayer, spouses, other dependants)	+1.0	13.1 million (= all taxpayers) will face higher taxes
Introduce 0-rated bracket up to 10 million won	-2.1	6.1 million income earners will be exempt from income tax
Introduce 0-rated bracket up to 20 million won	-4.4	9.6 million income earners will be exempt from income tax
Extend 10 per cent tax rate up to 20 million won	-1.1	7.0 million income earners will face lower taxes; 6.1 million will face unchanged taxes (incomes <10 million won)
Eliminate 40 per cent bracket	-0.2	0.06 million income earners will face lower taxes (incomes >80 million won)
Eliminate 30 per cent and 40 per cent brackets	-0.5	0.4 million income earners will face lower taxes (incomes >40 million won)

Source: Sung and Chun (1998), and OECD calculations.

Table 15. **Turnover thresholds for VAT exemption**
1998

	Domestic currency	1998 US\$ PPP
Austria	Sch 300 000	22 023
Belgium	BF 225 000 excluding VAT	5 954
Canada	C\$ 30 000	25 659
Denmark	DKr 20 000	2 332
Finland	Mk 50 000	8 161
France	FF 100 000 excluding VAT	14 917
Germany	DM 32 500	16 202
Greece	Dr 1.8 million	7 451
Iceland	IKr 200 600	2 404
Ireland	Ir£ 40 000	57 552
Italy	L 5 million	2 987
Japan	Y 30 million	182 935
Korea	W 24 million	35 886
Luxembourg	LF 400 000	9 633
Mexico	MN\$ 1 000 000	198 037
Netherlands	Net tax payable up to Gld 4 150	2 026
New Zealand	NZ\$ 30 000	20 250
Norway	NKr 30 000	3 265
Portugal	Esc 2 million	15 986
Spain	Individual retailers	-
Sweden	-	-
Switzerland	SF 75 000	37 707
Turkey	Varies with activity	-
United Kingdom	£50 000	75 757

Note: These thresholds are for "common cases". Various deviations and special cases exist in several countries, *cf.* OECD, *Consumption Tax Trends, 1999*.

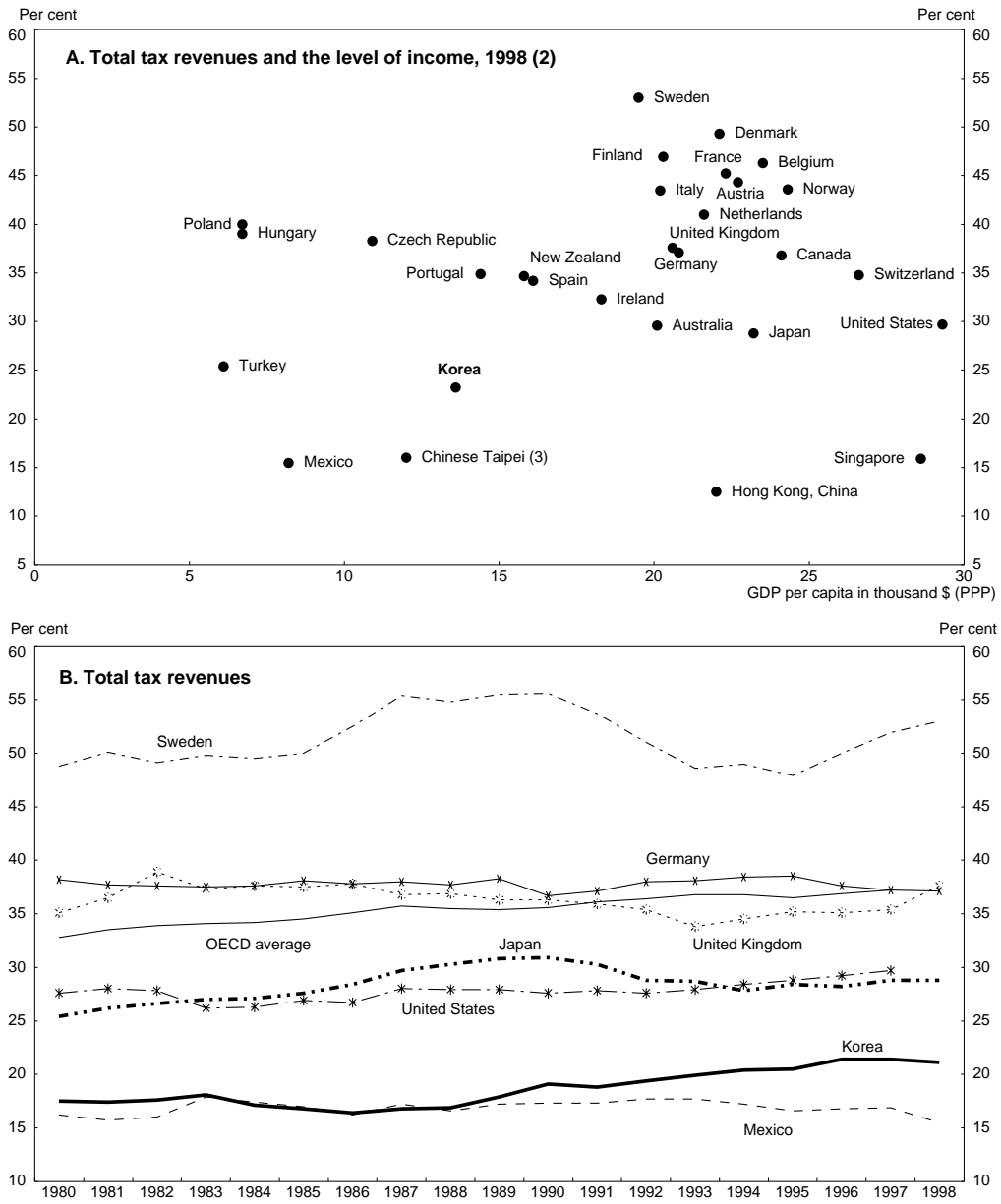
Source: National authorities.

Table 16. **Property taxes**
1998

	Billion won	Per cent of GDP	Share of total property tax, per cent
Holding taxes			
Aggregate land tax	1 199	0.3	10
Property tax	641	0.1	6
Urban planning tax	752	0.2	7
Community facility tax	301	0.1	3
<i>Earmarked taxes:</i>			
Education tax and land development tax	420	0.1	4
Total holding, real estate	3 313	0.7	29
Transaction taxes			
Registration tax and acquisition tax	5 630	1.3	49
Capital gains	963	0.2	8
Inheritance and gift tax	670	0.1	6
<i>Earmarked taxes:</i>			
Education tax and land development tax	900	0.2	8
Total transaction, real estate	8 163	1.8	71
Total real estate taxes	11 476	2.6	100
<i>Memorandum item</i>			
Other property taxes			
Automobile tax	2 175	0.5	..
Securities transactions	242	0.1	..
Stamp tax	303	0.1	..
Total property taxes	14 196	3.2	..

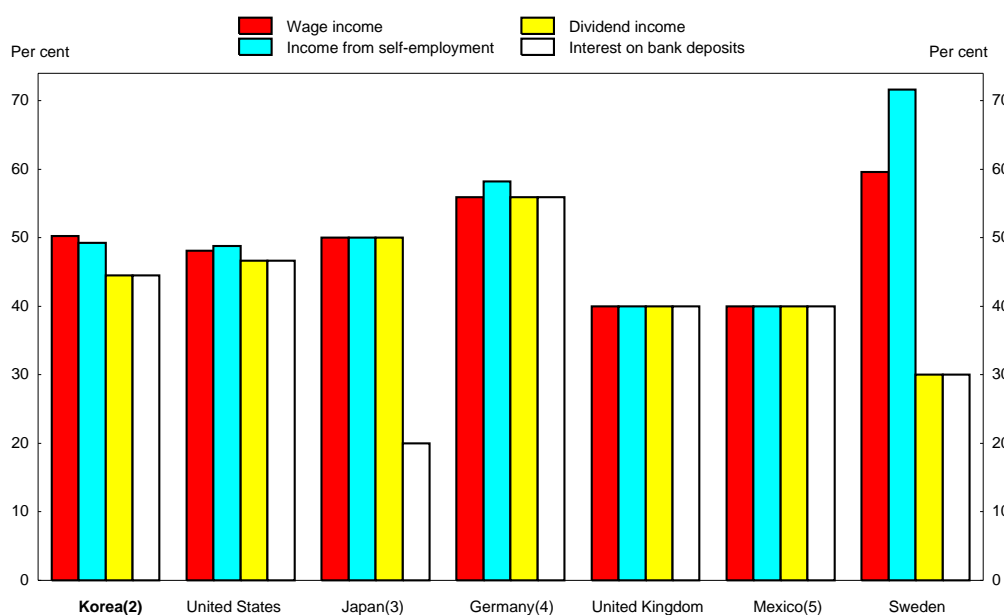
Source: Ministry of Finance and Economy.

Figure 1. Tax revenues in selected countries (1)
Per cent of GDP



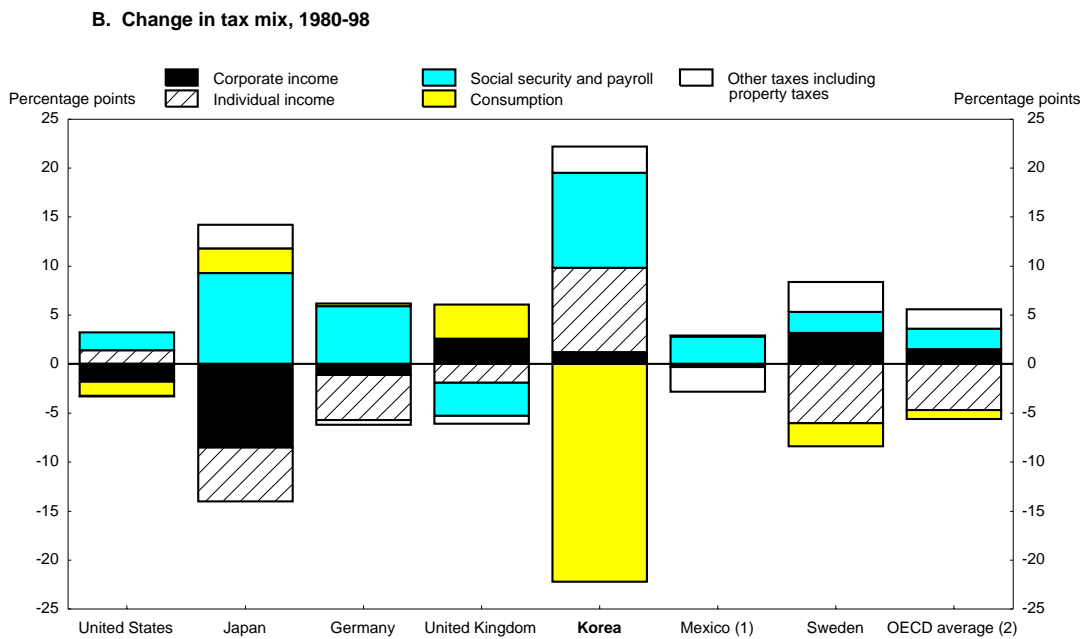
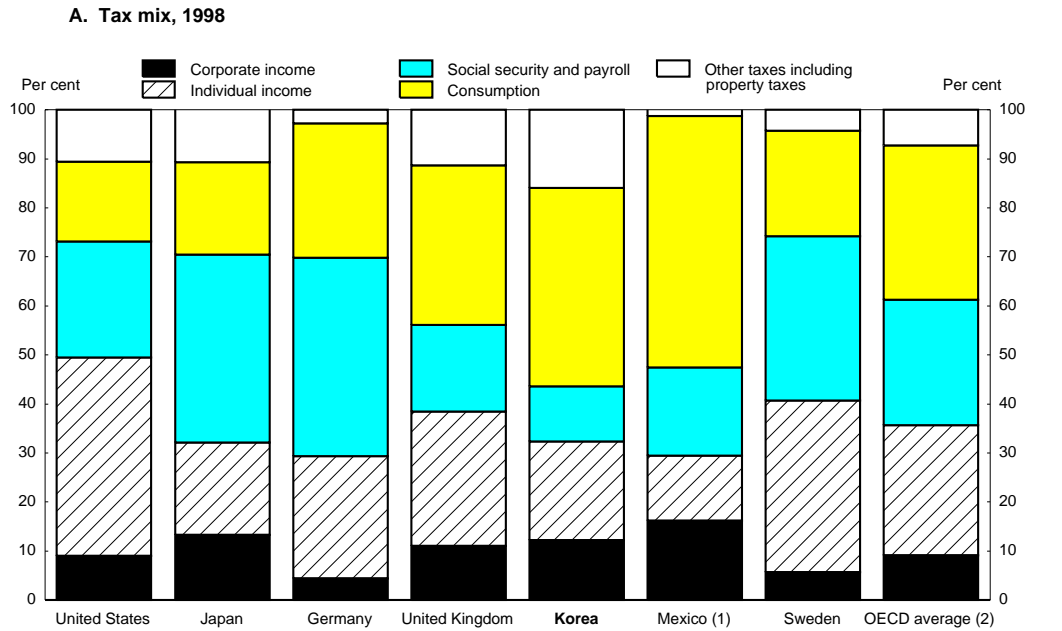
1. General government total tax revenues, including social security contributions. Note that numbers may not be fully comparable across countries and over time due to changes of national accounts from SNA68/ESA79 to SNA93/ESA95.
 2. 1998 or nearest year available.
 3. GDP per capita in thousand dollars (not PPP adjusted).
 Sources: OECD Revenue Statistics, 1999; International Monetary Fund, Government Finance Statistics Yearbook, 1999; World Bank, World Development Report 1999/2000.

Figure 2. Highest all-in tax rates for top income earners(1)
1999



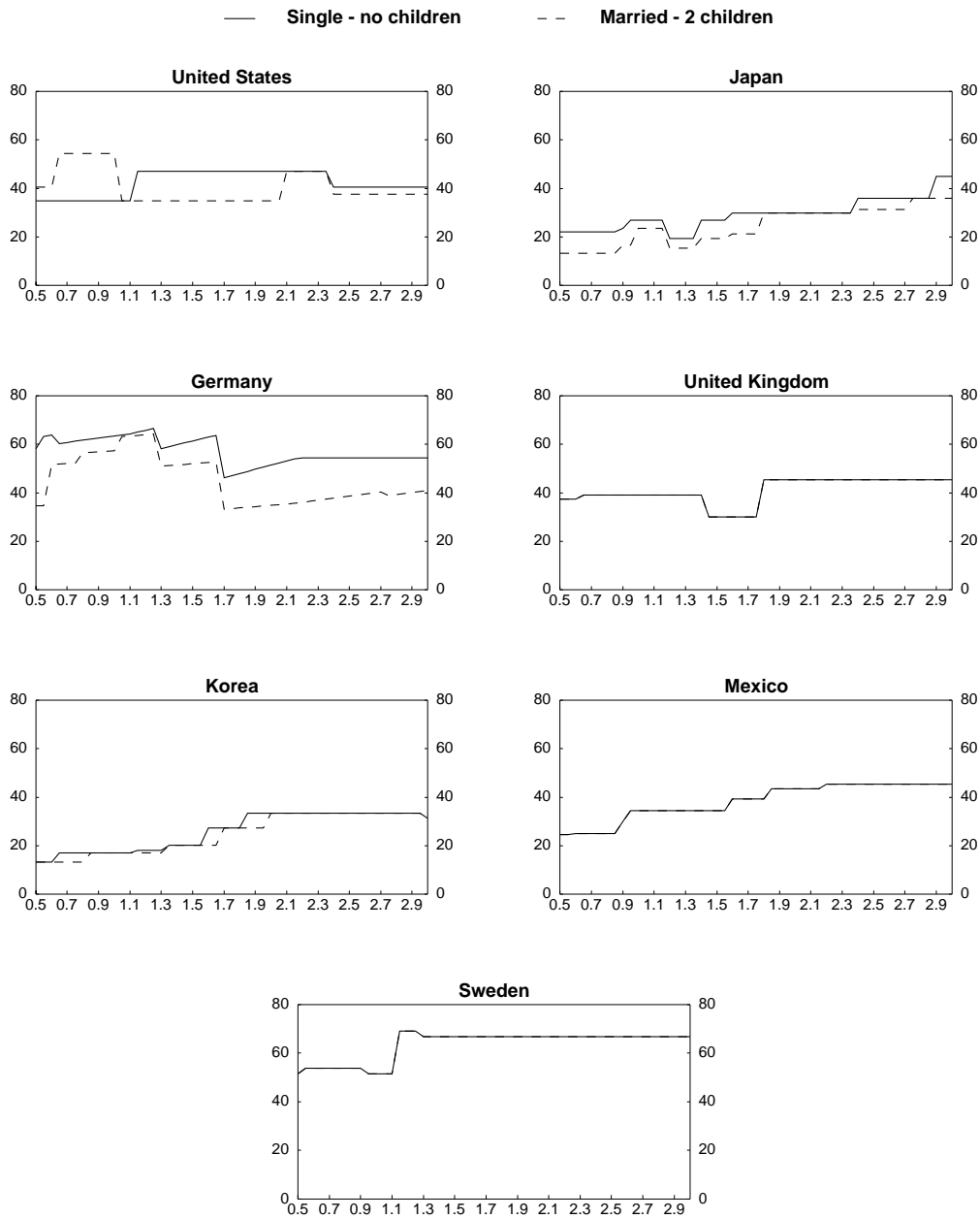
1. The all-in rates include central and sub-central government taxes as well as social security contributions where these are not capped.
 2. The tax rates on dividend and interest income will apply from 2001. In 1999 and 2000, the rates are 22 per cent on dividends and 24.2 per cent on interest income. It is assumed that the marginal wage income is standard income, that the medical insurance premium is 1.7 per cent (deductible), the unemployment insurance premium is 0.5 per cent (deductible) and the national pension contribution is 4.5 per cent (non-deductible).
 3. Tax on dividends depends on the size of payment. Tax credit is not included.
 4. Income from self-employment applies only to business income which is subject to the local business tax ('Gewerbesteuer').
 5. A real interest rate of 5 per cent is assumed.
- Source: Ministry of Finance and Economy and the OECD Tax Database.

Figure 3. Tax mix in selected OECD countries



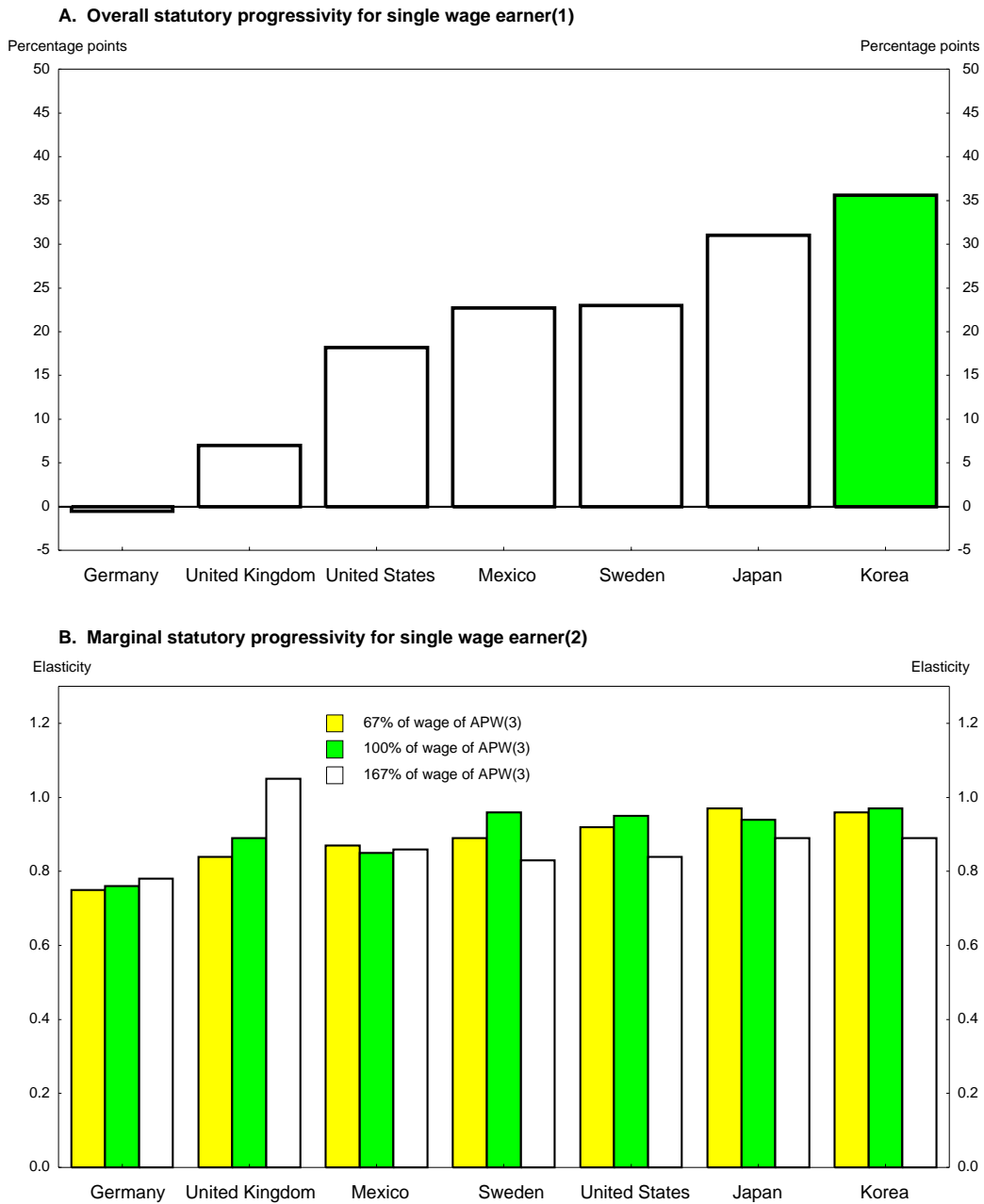
1. Income tax in Mexico was broken down into individual income (45%) and corporate income (55%) taxes.
 2. The OECD average is unweighted.
 Source: OECD, Revenue Statistics, 2000.

Figure 4. Marginal tax wedges on labour income (1)
At multiples of average production worker earnings, 1998



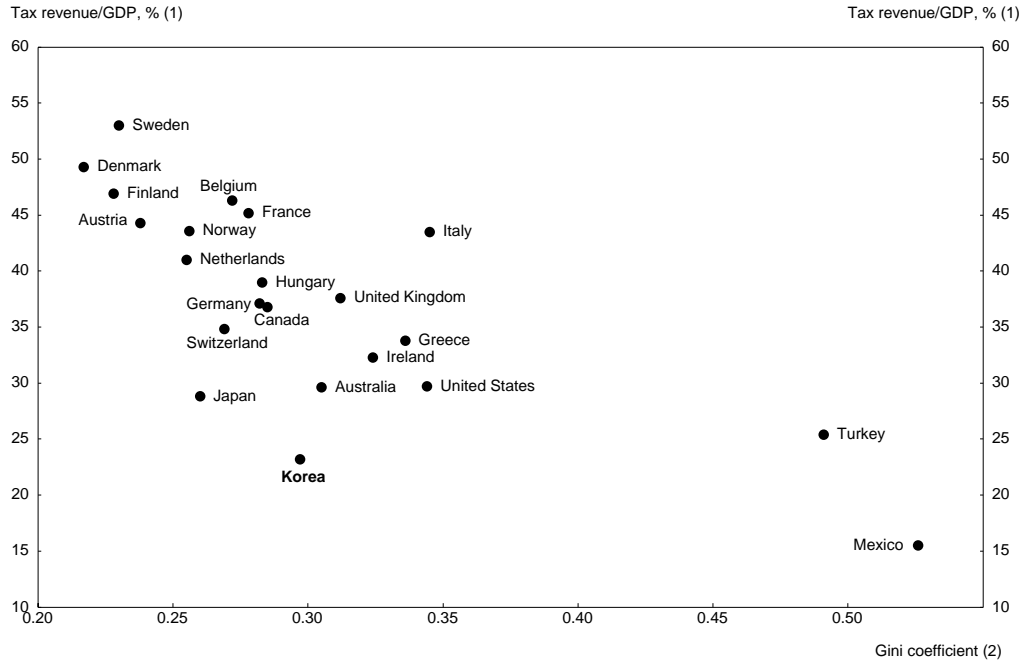
1. Marginal tax rate, covering employees' and employers' social security contributions and personal income tax, with respect to a change in gross labour costs, by family type and wage level, assuming spouse earns no income. Source: OECD Tax equations.

Figure 5. Progressivity of the tax system in selected OECD countries
1999



1. This measure of progressivity is based on the difference between the highest all-in tax rate for wage income earners and the average production worker's marginal tax rate.
 2. Increase in net income after a 1 per cent increase in gross wage. Net income is gross wage minus employees' social security contributions and personal income tax. In a proportional system, the elasticity would equal one. The more progressive the system, the lower the elasticity.
 3. APW: Average production worker in manufacturing.
 Source: OECD, Taxing Wages(1999) and the OECD Tax Database.

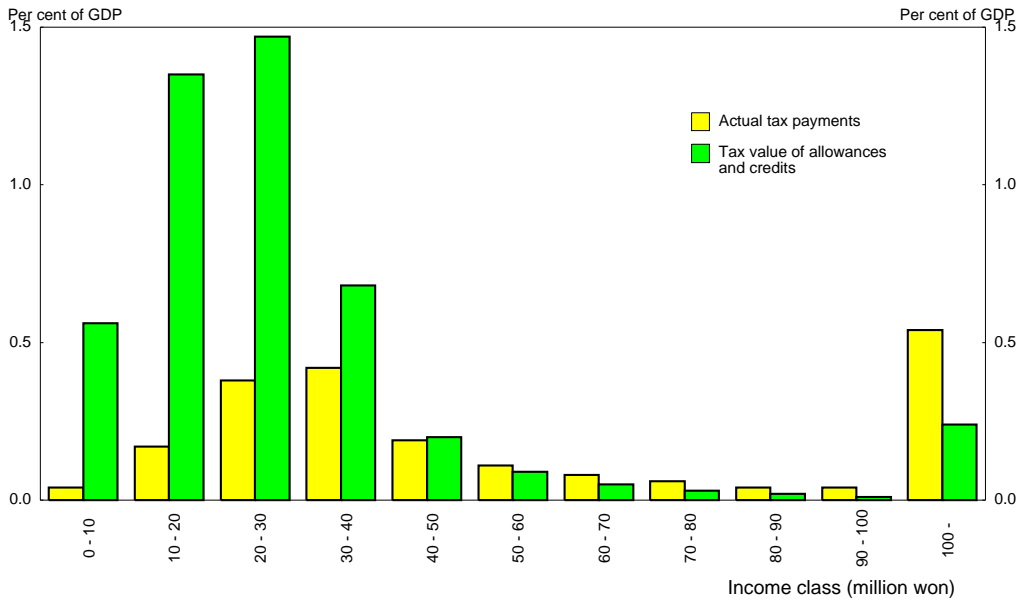
Figure 6. Tax revenues and the distribution of income after tax, 1998



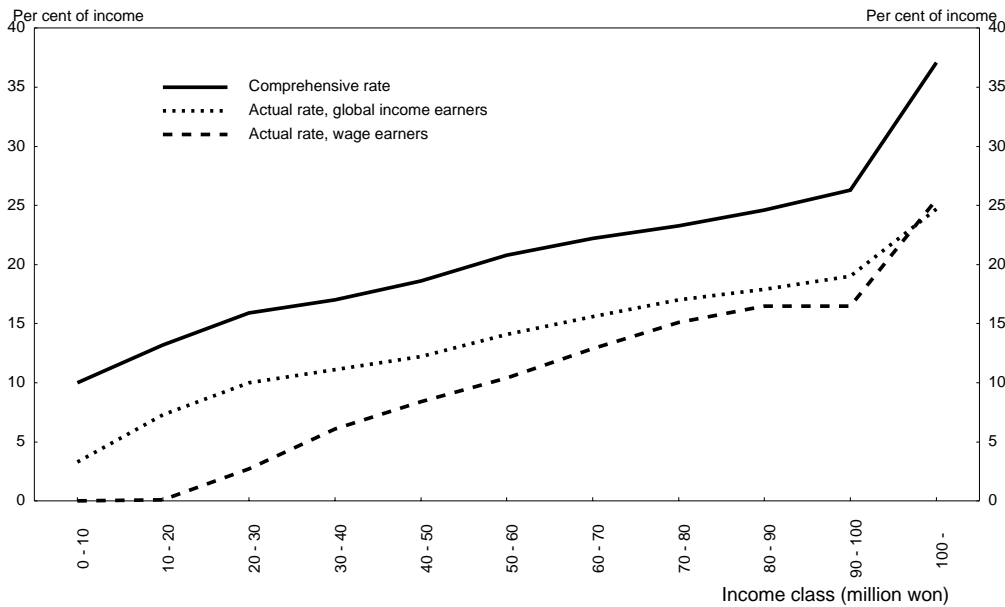
1. General government total tax revenues, including social security contributions, in 1998 or nearest year available.
 2. The Gini coefficient is a measure of income inequality: the higher the coefficient, the wider the income distribution.
 Source: Forster (2000) and OECD, Revenue Statistics, 1999.

Figure 7. Effects of allowances and credits

A. Actual tax payments and tax value of allowances and credits, 1997

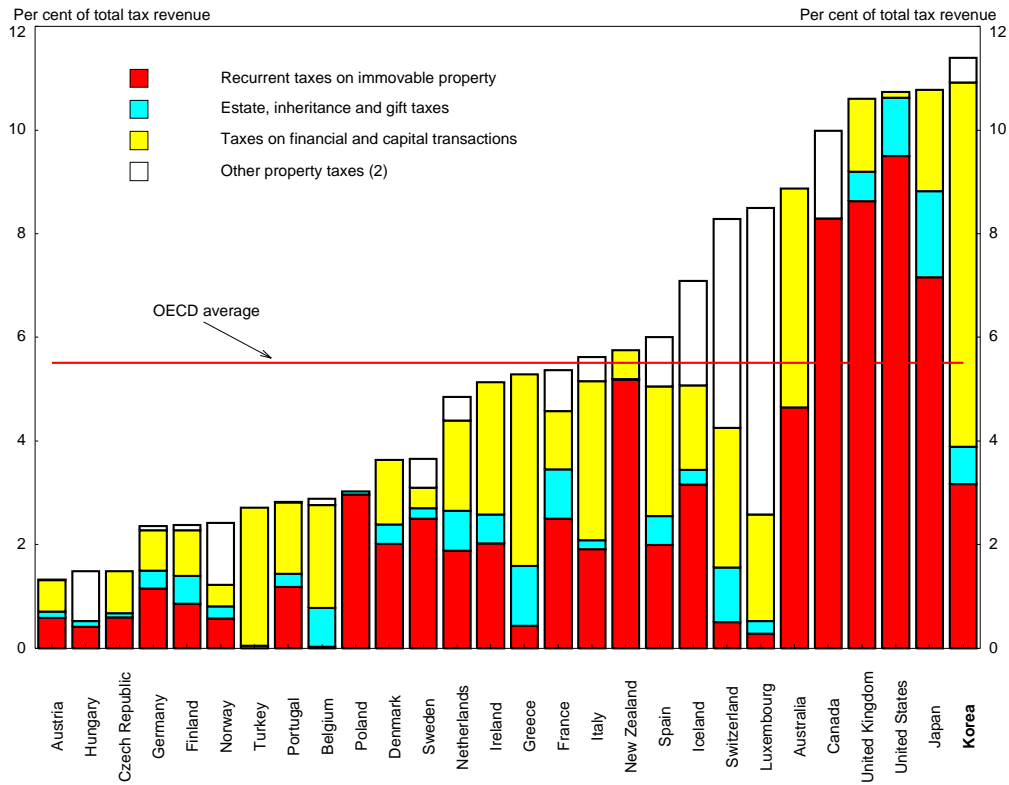


B. Actual versus comprehensive tax rates, 1997



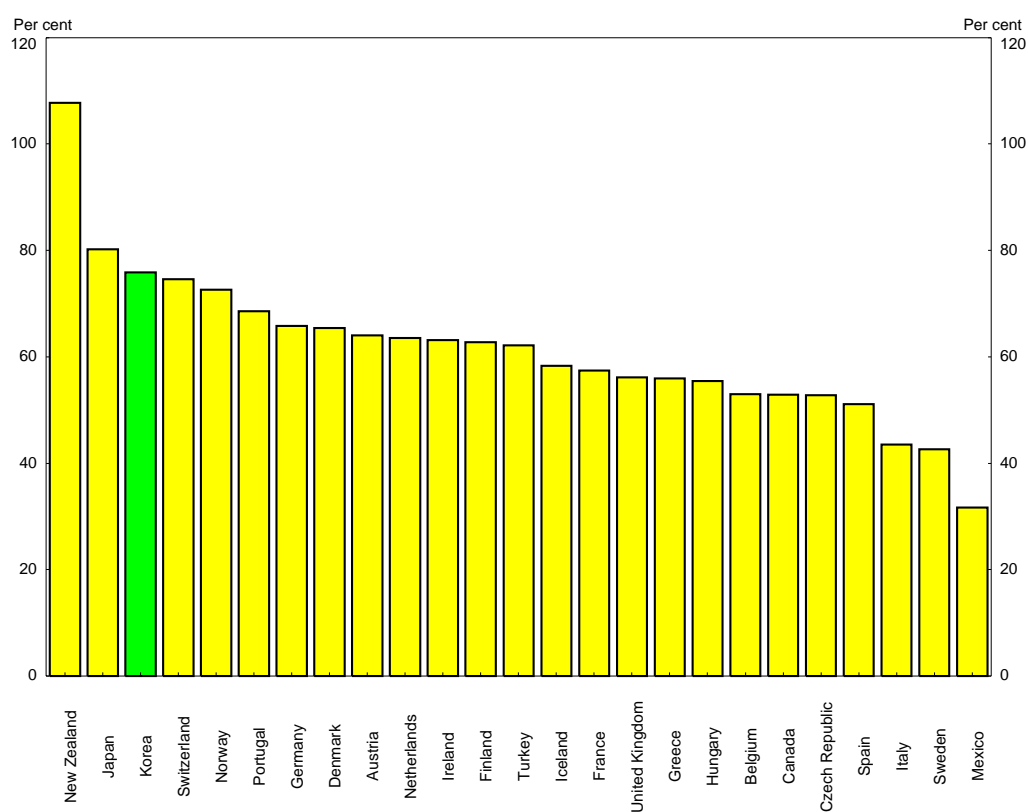
Note: The actual tax rates measure taxes paid in per cent of income whereas the comprehensive rates measure the taxes that would have been paid in the absence of any tax credit or allowance. The comprehensive rates are almost identical between wage earners and global income earners since the average income within each income group only differs slightly. The comprehensive rate shown is for wage earners. Scholarly income, separately-taxed income and local income tax are not included in the calculations.
 Source: Sung and Chun (1998) and OECD calculations.

Figure 8. Property taxation in OECD countries, 1998 (1)



1. 1997 data for the United States, Japan, Canada and Belgium.
 2. Includes recurrent taxes on net wealth and some non-recurrent taxes on property (for instance land development permission charges).
 Source: OECD Revenue Statistics, 1999.

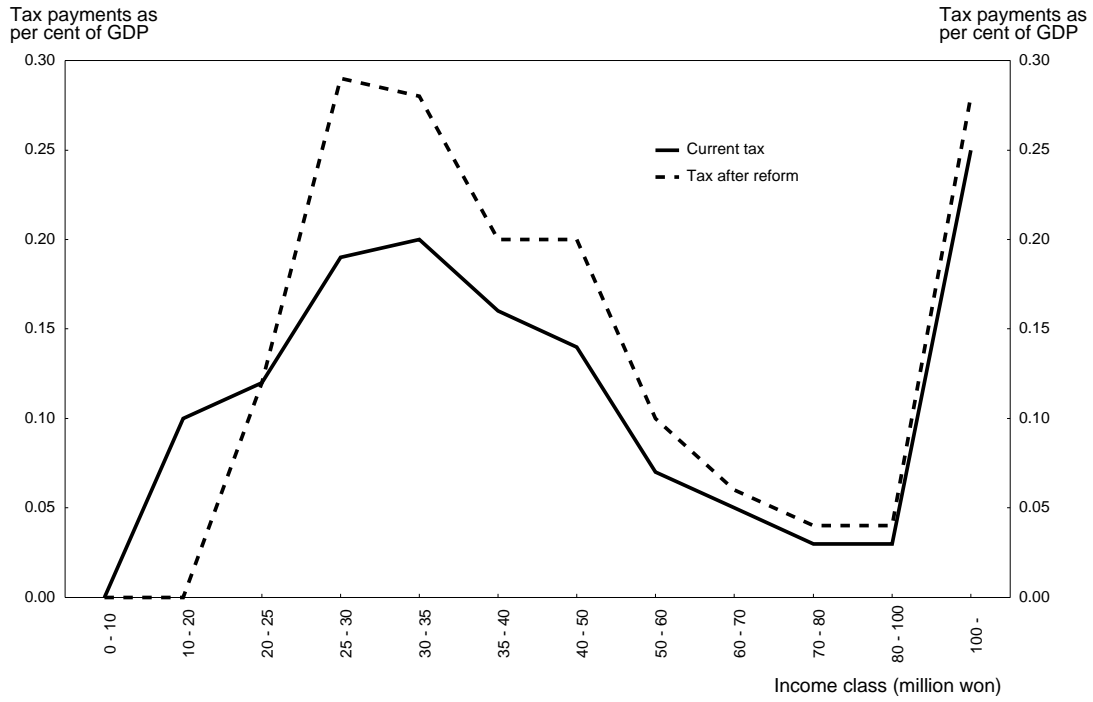
Figure 9. Effectiveness of value added taxes, 1997



Note: Effectiveness of the VAT is measured as the effective VAT rate as a per cent of the standard statutory rate, where the effective rate is VAT revenues divided by the potential VAT base (i.e. consumption minus VAT). The effectiveness of the VAT reflects the broadness of the VAT base and the level of compliance. The VAT-effectiveness for New Zealand exceeds 100 per cent due to differences between the actual VAT base and consumption as measured in the national accounts.

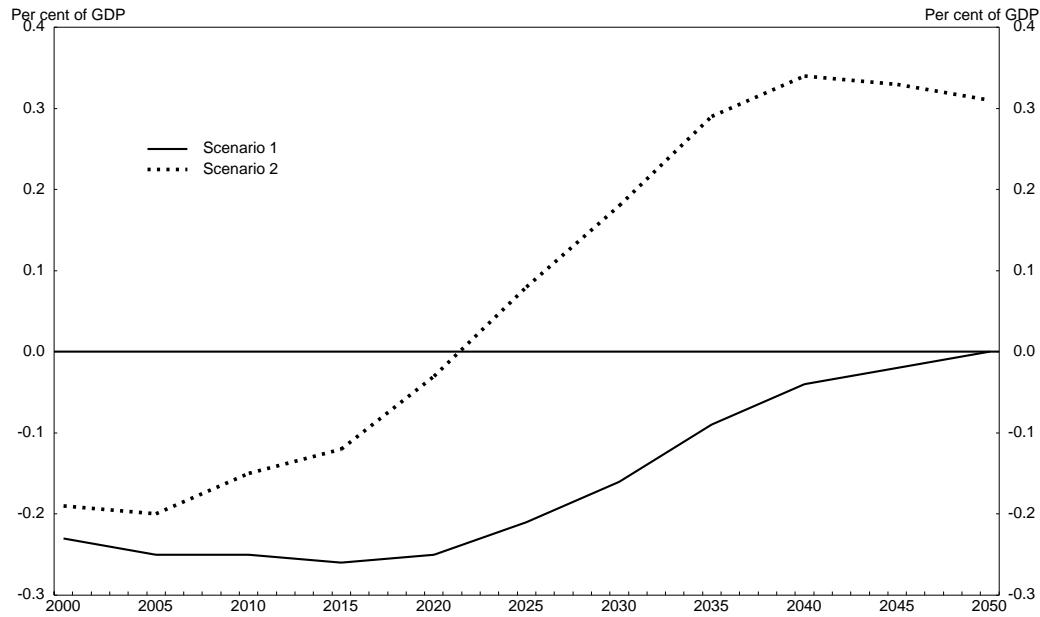
Source: OECD, Revenue Statistics(1999), OECD, Consumption Tax Trends (1999), and OECD calculations. See also Carey(2000).

Figure 10. Illustration of possible distributional effects of tax reform



Note: The figure shows the tax payments by income groups before and after a hypothetical revenue-neutral tax reform that eliminates all existing allowances and credits and replaces them with a 0-rated band for incomes below 20 million won. Furthermore, the top marginal rate is lowered from 40 per cent to 30 per cent. Wage earners only.
 Source: Sung and Chun (1998) and OECD calculations.

Figure 11. Revenue effects from a shift in the taxation of national pensions



Note. Scenario 1: employees' contributions to the National Pension Scheme (NPS) are deducted from taxable income at an average rate of 20 per cent and pension benefits are taxed at an average rate of 10 per cent. Scenario 2: 20 per cent average tax rate on both deductions and benefits. Both scenarios rely on the same set of macroeconomic assumptions: real GDP is assumed to grow at an annual rate of 6.3 per cent until 2010 and 5.0 per cent thereafter. Deflators for GDP and the NPS revenues and expenditures are assumed to grow at identical rates.

Source: Korean authorities' long-term projection for the National Pension Scheme and OECD calculations.

Annex 1
The Tax System (as of 1 January 2000)

I. Personal income tax

Tax unit: the individual. Exception: In the case of a married couple receiving rental income from real estate property or (from 2001) interest and dividend income jointly exceeding 40 million won, the incomes of both spouses are combined to determine taxable income.

Tax base: The individual income tax distinguishes four categories of income:

- *Global income* -- labour income; business income (excluding agricultural income); dividend income deriving from unlisted stock; dividend income of large shareholders of listed stock; real estate rental income; and miscellaneous income. From 2001, interest and dividend income will be included in global income if their sum exceeds 40 million won.
- *Schedular income* -- retirement income; capital gains (excluding listed stock of small shareholders); and timber income.
- *Separately-taxed income* -- interest income and dividends received by small shareholders of listed companies (from 2001: only if the combined amount is below 40 million won); dividends from credit unions, various co-operatives and securities trusts; and other miscellaneous income up to 3 million won (with the option of including it in the global income category).
- *Non-taxable income* -- agricultural income; certain personnel in the armed forces; capital gains from listed stock (small shareholders), transfer of residence, farmland, etc.

Tax rates, global income:

National	Local	Highest all-in marginal rates
0-10 million won: 10 per cent 10-40 million won: 20 per cent 40-80 million won: 30 per cent above 80 million won: 40 per cent	The local inhabitant tax is levied as a surcharge on national tax payments at rates between 3.75 and 11.25 per cent. The typical rate is 10 per cent. This means that the typical combined local and national income tax for an income earner in the top bracket is 44 per cent, and that the highest combined rate is 44.5 per cent. When social security payments are added the highest all-in rate is 50.2 per cent for wage income. Lump-sum per capita taxes are also levied, up to 10 000 won.	Wage income: 50.2 per cent Self-employed: 49.2 per cent Dividends: 22.0 per cent (44.5 per cent from 2001) Interest: 24.2 per cent (44.5 per cent from 2001)

Personal allowances:

- *Employment income deduction:* Up to 5 million won: total amount; between 5 and 15 million won: 5 million won plus 40 per cent of the salary above 5 million won; above 15 million won: 9 million won plus 10 per cent of the salary in excess of 15 million won (limit: 12 million won).
- *Retirement allowance:* 50 per cent of the income amount plus an additional amount according to the years of service (less than 5 years: 0.3 million won per year; 6-10 years: 1.5 million won plus 0.5 million won per year in excess of 5; 11-20 years: 4 million won plus 0.8 million won per year in excess of 10; above 20 years: 12 million won plus 1.2 million won per year in excess of 20).
- *Basic allowance* (applies to global income only) of 1 million won for the taxpayer himself and for each of his dependants:
 - Spouse whose taxable income (excluding interest, dividends and income from real estate) is below 1 million won;
 - other dependants (parents, children, siblings) living in the same household as the taxpayer, whose taxable incomes are below 1 million won each and whose ages are as follows: parents and siblings aged 60 years and over (55 years for females); children and siblings aged 20 years and under.
- *Additional allowance* (applies to global income only): 0.5 million won if the taxpayer himself or one of his dependants is above 65 years of age; is handicapped; is a female worker, or single male worker, with a child below 6 years of age.
- *Extra allowance:* 1 million won for single income earners.
- *Non-standard allowances:* employment income earners may deduct the following items:
 1. Insurance premiums: general insurance premium up to 0.7 million won plus medical insurance premium and employment insurance premium;
 2. medical expenses: up to 2 million won for the taxpayer. Full deduction of medical expenses for the taxpayers' parents if they live in the same household and for handicapped persons;
 3. educational expenses: Tuition fees are fully deductible for the taxpayer, and for dependants as follows: pre-school -- up to 1 million won per child; elementary/middle/high school -- up to 1.5 million won per student; college/university -- up to 3 million won per student;
 4. savings/payments for housing: up to 1.8 million won;
 5. certain charities;
 6. deduction for purchases made by credit cards (10 per cent of the amount of credit card purchases which exceed 10 per cent of the annual salary; limits: 3 million won or 10 per cent of annual salary).

Persons whose total deductible expenses from a), b), c), d), e) and f) do not exceed 0.6 million won may deduct a lump-sum amount of 0.6 million won.

- *Deductions for capital gains* -- the special deduction for long-term possession and the capital gain deduction. The special deduction for long-term possession is as follows: 10 per cent of the capital gain for holding period 3 to 5 years; 15 per cent of capital gain for holding period 5 to 10 years; and 30 per cent of the capital gain if the holding period exceeds 10 years. The capital gain deduction is a fixed 2.5 million won deduction.

Tax credits:

For employment income earners, there is a tax credit of 45 per cent from taxes up to 0.5 million won. For taxes above 0.5 million won the credit is 0.225 million won plus 30 per cent of the tax in excess of 0.5 million won (limit: 0.6 million won).

For retirement income earners, a tax credit of 50 per cent of the tax amount applies (limit: 0.24 million won times years of service).

For dividend income taxed as global income an imputation system applies which allows for partial imputation.

Major income items taxed at preferential terms:

Retirement income is taxed according to the same rate schedule as global income, but with more generous deductions and an averaging method for the calculation of the tax. The averaging provision implies that the tax on retirement income is calculated by dividing the amount of retirement income by the number of years of employment, applying the global income tax rate on this amount and then re-multiplying this amount of tax with number of years of employment.

Timber income is taxed according to the same rate schedule as global income, but with more generous deductions.

Agricultural income is taxed by local governments only and at very low effective rates.

Capital gains from financial assets are untaxed unless they apply to large shareholders or on unlisted stocks. Taxable gains are determined as selling price minus acquisitions price minus special deduction for long-term possession minus the capital gain deduction (*cf.* above).

Dividend income: Low final withholding tax rates on small dividends. Certain kinds of dividend income are either exempt or taxed at a reduced rate (*cf.* Table 10).

Interest income: Low final withholding tax rates on small amounts. Certain kinds of interest income are either exempt or taxed at a reduced rate (*cf.* Table 10).

Fringe benefits: Some kinds of fringe benefits are untaxed, such as cars, drivers and lunches.

Taxation of the self-employed

Individual business income (excluding agriculture) is included in the global personal tax system. Agricultural income is taxed at the local level only. The self-employed are subject to ordinary bookkeeping requirements if last year's turnover exceeds certain thresholds:

- agriculture and wholesale >300 million won,
- manufacturing, hotels and restaurants >150 million won,
- real estate rental offices, education services and other services >75 million won.

If the turnover is below these limits, a simplified method for bookkeeping is allowed according to government regulation. Taxpayers who have neglected a bookkeeping obligation may file a tax return with a simplified income statement (which requires only a statement with revenues and deductions) or may choose to use an industry-wide standard income ratio, but only after paying penalties (20 per cent of non-reported income). The standard income ratio establishes a set of standard assessment guidelines for each major economic activity on the basis of a set of “objective indicators”. The guidelines, which establish the relationship between the indicators and gross sales as well as between gross sales and net income, are based on studies by expert groups comprising tax administrators, tax specialists and representatives from the business community.

A minimum tax of 15 per cent of the business tax liability before tax incentives (*cf.* STTCL, see Annex 2) are considered is applied.

II. Social security contributions

Compulsory contribution to schemes operated within the government sector

	Employers	Employees	Self-employed
National Pension Scheme	4.5 per cent of standard monthly salary, including bonuses and overtime payments Deductible as corporate expenses	4.5 per cent of standard monthly salary, including bonuses and overtime payments Not deductible	3.0 per cent of standard income Up to 40 per cent deductible (limit 720 000 won)
Medical Insurance	1-4 per cent of standard monthly salary, including bonuses. The average rate is 1.7 per cent Deductible as corporate expenses	1-4 per cent of standard monthly salary, including bonuses. The average rate is 1.7 per cent Fully deductible	1-4 per cent of standard income Not deductible
Employment Insurance System	0.9-1.5 per cent of total salary, including bonuses and overtime payments. Deductible as corporate expenses	0.5 per cent of total salary, including bonuses and overtime payments Fully deductible	-
Work Injury Insurance	Total salary insurance rate set by Ministry of Labour. Range 0.5-25.8 per cent. The average rate is 1.65 per cent Deductible as corporate expenses	-	-

Employer's compulsory contributions to retirement allowances:

Korea's Labour Law requires employers to pay every worker who has been employed for one year or more a minimum retirement allowance of no less than 30 days' wage and salary per year of service (8.3 per cent of gross income or more). An employer has the option of contributing to a retirement reserve fund established within the company, or to open a retirement fund with an insurance company. Contributions to retirement allowance reserves are tax-exempt under certain conditions: (a) the annual amount set aside for reserves to retirement allowances may not exceed 10 per cent of the total amount of wages paid to employees who have been in service for one year or more; and (b) the accumulated amount of reserves within the company is limited to no more than 40 per cent of the estimated retirement allowances payable to all employees assuming they retire on the closing date of the business year (hence tax deductibility of the remainder of the liability requires opening of a retirement insurance fund outside the company).

III. Corporate income tax***Tax rates***

National	Local
28 per cent (for income in excess of 100 million won). Income below 100 million won is taxed at 16 per cent	<p>The local inhabitant tax is levied as a surcharge on national tax payments at rates between 3.75 and 11.25 per cent. The typical rate is 10 per cent (will be reduced to 7.5 per cent in 2001). This means that the typical combined local and national income tax for income above 100 million won is 30.8 per cent, and that the highest combined rate is 31.2 per cent</p> <p>Lump-sum taxes are also levied in amounts ranging from 50 000 to 500 000 won</p> <p>Finally, a local business place tax is levied: 0.5 per cent of the total payroll for employers with more than 50 employees plus 250 won per square meter for business places with areas exceeding 330 m²</p>

Other key features of the corporate tax system:

Capital gains are included in ordinary taxable income. A surtax of 15 per cent is levied on income from transfer of real estate (30 per cent if ownership of real estate is not registered). The inhabitant surtax of 10 per cent is imposed in addition to these rates. Capital losses are deductible only at the standard tax rate (exclusive of the 15 per cent surtax).

Dividends received from another corporation are generally included in taxable income.

Additional tax is levied on "excess accumulated earnings" in large unlisted companies. The rate is 15 per cent on the deemed excess accumulations.

Tax credits are allowed for corporate taxes paid to foreign governments (within certain limits).

Losses may be carried forward for 5 years. SMEs may carry back losses one year. Otherwise, no carry-back is allowed.

Consolidated income reporting for groups of companies is not allowed.

Acceptable transfer pricing methods include comparable uncontrolled price method; resale price method; cost-plus method (acquisition costs plus a reasonable margin); profit split method; and transactional net margin method. It is possible to reach transfer-pricing agreements in advance with the tax authorities.

Inventories may be valued at market value, cost value or the lower of the two. Cost values may be applied using LIFO, FIFO, moving or total average, individual costing or retail. If a company fails to notify the tax office, it must use FIFO.

Depreciation: declining balance or straight line (the latter is mandatory for buildings and intangible assets).

Minimum tax: 15 per cent of taxable income before considering tax incentives (*cf.* STTCL, see Annex 2).

Major tax incentives include:

- (a) Public corporations: tax rate of 12 per cent on co-operative associations.
- (b) A broad range of measures included in the Special Tax Treatment Control Law, *cf.* Annex 2.

Tax on foreign corporations

- *With a domestic business operation in Korea*: Same tax rates as those for domestic corporations. The 20 per cent tax reduction for domestic SMEs in manufacturing also applies to subsidiaries, but not branches, of foreign corporations. A Korean branch of a foreign corporation is subject to a branch profits tax (plus a 7.5 per cent surtax) on income that is remitted or deemed to be remitted to the home country if the foreign company is resident in one of the following countries: Australia, Brazil, Canada, France, Indonesia and the Philippines.
- *Without a domestic business operation in Korea*: Leasing and business income is taxed at withholding rates of 2 per cent; personal services income at 20 per cent; interest, dividend and royalty income at 25 per cent; gains from transfer of securities or shares at 10 per cent of gross sales price and 25 per cent of net gain. The local inhabitant tax of 10 per cent is imposed as a surcharge to the above-mentioned rates.

A number of tax measures to attract FDI were introduced by the *Foreign Investment Promotion Act (FIPA)*, *cf.* Annex 2.

IV. Earmarked taxes

National	Local
<p><i>Education tax</i>:</p> <p>a) 0.5 per cent tax on gross receipts (interest, dividends, capital gains, commissions, etc.) received by banks and insurance corporations, plus</p> <p>b) surtaxes of 10-50 per cent on a wide range of other taxes (liquor tax, special excise tax, inhabitant per capita tax, registration tax, property tax, aggregate land tax, automobile tax, tobacco tax, transportation tax, horse race tax)</p>	<p>Community facility tax (provincial): The fire-service facility tax is 0.06-0.16 per cent of the value of house or vessel. For other utilities such as garbage collection and sewage the standard rate is 0.03 per cent (max. 0.1 per cent) of the value of land or house</p>

National	Local
<p><i>Transportation tax</i> (used for social capital spending): Gasoline and other similar products: 691 won per litre Diesel and similar products: 160 won per litre</p>	<p>Regional development tax (provincial): Water for generating electricity: 2 won per 10 m³ Subterranean water: 20-200 won per m³ Underground water: 0.2 per cent of value Containers: 15 000 won per TEU</p>
<p><i>Special tax for rural development:</i> a) surtax on the amount of (some of the) exemptions of corporate tax, individual income tax, customs duty, special excise tax and securities transaction tax as stipulated in the Special Tax Treatment Control Law, the local tax law and the customs law, plus b) surtaxes of 10-15 per cent on the special excise tax, the acquisition tax and the aggregate land tax</p>	<p>Urban planning tax (city and county): standard rate of 0.2 per cent (max. 0.3 per cent) on the value of land or house</p> <p>Business place tax (city and county): 0.5 per cent of the total payroll for employers with more than 50 employees plus 250 won per m² for business places with areas exceeding 330 m²</p>

V. Property, inheritance and gift taxes

	National	Local
1. Holding taxes		
<p>a) <i>Aggregate land tax</i> * General combined tax on residential site and idle land * Special combined tax on building site * Separate flat rate tax</p> <p>Tax base: CSTV (*). Aggregation of all property owned by single taxpayer</p>	-	0.2-5.0 per cent
<p>b) <i>Property tax</i> Tax on buildings and structures, mining lots, vessels, etc. Tax base: replacement cost of raw materials used as benchmark, corrected for age, location and usage. No aggregation of individual pieces of property</p>	-	0.3-7.0 per cent for residential buildings 0.6 per cent for factory buildings 0.3 per cent for other buildings
<p>c) <i>Earmarked taxes on landholding (see also section IV)</i> <i>Education tax</i></p> <p><i>Special tax for rural development</i></p> <p><i>Urban planning tax</i></p> <p><i>Community facility tax</i></p>	20 per cent surtax on the aggregate land tax and the property tax	0.2 per cent (standard rate)
	10-15 per cent surtax on the aggregate land tax	
	-	0.09-0.29 per cent

	National	Local
<i>d) Automobile tax</i>	-	
<i>Business use</i>	-	18-24 won per cc for automobiles 3 300-100 000 won/year for other vehicles
<i>Non-business use</i>	-	80-220 won per cc for automobiles 18 000-157 500 won/year for other vehicles
<i>Education tax (see also section IV)</i>	30 per cent surtax on automobile tax	
2. Capital gains taxes		
<p><i>a) Real estate capital gains tax (realisation basis).</i> Base: sales price-acquisition costs-improvements-deductions. Based on PDVL (*) for land and NTS-assessment (*) for structures rather than the actual transaction prices</p> <p><i>Individuals</i> Exemptions include: most financial assets, principal residence (held more than 3 years), farm land (cultivated by the owner for more than 8 years), newly built houses after renting for 10 years. A 50 per cent reduction or tax deferral applies for factory sites used for more than 5 year by the seller. A 25 per cent reduction in the tax rate applies if the property is sold because of the government's forceful acquisition, for land transferred to the government and for land transferred to a constructor of small homes ("national houses"). A 10/15/30 per cent reduction in the capital gain is allowed if held for 3+/5+/10+ years. A standard deduction of 2.5 million won also applies.</p> <p><i>Corporations</i> Exemptions include: specific gains and transactions defined in the corporate tax law and the special tax treatment control law</p>	<p>Holding period <2 years: 40 per cent (65 per cent if unregistered)</p> <p>Holding period >2 years: 20 per cent (<30 million won) 30 per cent (30-60 million won) 40 per cent (60+ million won)</p> <p>Capital gains are included in taxable income and hence taxed at 16/28 per cent rates. A special additional tax of 15 per cent of sales price minus acquisition cost is levied on capital gains on real estate (**) (30 per cent if ownership of the property is not registered)</p>	<p>Inhabitants tax: 10 per cent surtax</p> <p>Inhabitants tax: 10 per cent surtax</p>
<p><i>b) Land development charge</i> Levied on 30 kinds of development projects: housing construction, residential and industrial land development, etc. The tax paid may be credited against the taxable gain under the capital gains tax. Public developers are exempted or taxed at a reduced rate. Based on OVIP (*). Payable on an accrual basis</p>	<p>A 25 per cent tax on the value of land before and after the project, less development costs, and less the "normal" increase in land price</p>	-

	National	Local
3. Transaction taxes		
<i>a) Acquisition tax</i> Generally based on OVIP (*) and the value used for property tax rather than actual transaction price	-	2 per cent of value (standard rate)
<i>b) Registration tax</i> Generally based on OVIP (*) and the value used for property tax rather than actual transaction price	-	3 per cent of value (standard rate)
<i>c) Security transactions tax</i>	0.15 per cent of sales price for listed stock 0.3 per cent of sales price for KOSDAQ (over the counter) 0.5 per cent of sales price for other securities	-
<i>d) Earmarked taxes on transactions (see also section IV)</i>		
<i>Education tax</i>	20 per cent surtax on the registration tax	-
<i>Special tax on rural development</i>	10 per cent surtax on the acquisition tax and 0.15 per cent surtax on the security transaction tax of listed stock	-
4. Inheritance and gift taxes		
<i>Inheritance and gift tax</i> Based on PDVL (*) for land and NTS-assessment (*) for structures rather than market prices Deductions are at least 500 million won (spouses 3 billion won) for inheritance and 5 million won (spouses 500 million won) for gifts	5 brackets from: 10 per cent (<100 million won) to 50 per cent (>3 billion won)	-
<p>(*) Several land value concepts apply:</p> <ul style="list-style-type: none"> - CSTV = current standard value for taxation (set by local governments as a ratio of OVIP, currently estimated at around 30-50 per cent on average) - PDLV = publicly declared land value system (used by the NTS; consists of OVIP and OVSP) - OVIP = official value of individual parcels (by hedonic pricing), using OVSP as a benchmark - OVSP = official value of standard parcel (announced by central government each year, based on a sample of 450 000 parcels). Currently (early 2000) around 70 per cent of market value - NTS Assessment = valuation carried out by the National Tax Services. <p>(**) The additional capital gains tax for corporations is only levied on the following transfers of securities or shares: (a) transfer of 50 per cent or more of the securities or shares of a corporation whose holdings of real estate amount to 50 per cent or more of its total assets; (b) transfer of securities or shares of a corporation which runs a golf club, a ski club, resort area accommodation or recreation business, and whose holdings of real estate amount to 80 per cent or more of its total assets.</p>		

VI. Consumption taxes

VAT rate: 10 per cent standard rate. A zero VAT rate applies to export of goods and services, including some "indirect exporters"; services supplied by ships and aircraft in international traffic; certain machinery and materials for agriculture, fishery, livestock and forestry; certain equipment for the handicapped.

Exemptions: Besides "standard exemptions"⁶¹ Korea's VAT system exempts certain public transportation services as well as unprocessed foodstuffs and agricultural products. In contrast with the "standard exemptions", Korea levies VAT on rental and supply of commercial buildings.

Special regimes for small taxpayers:

Businesses with taxable annual sales below 48 million won can opt to be taxed at the 10 per cent standard rate on an implied value added ranging from 20 to 40 per cent of the taxable sales (according to sector).

Businesses with annual sales below 24 million won can opt to be exempt from VAT registration.

Excises: There are five permanent excise taxes:

- *Special consumption tax* (national tax): Includes 27 "luxury" items taxed at rates from 10-30 per cent of which the major items are jewellery, automobiles, oil products;
- *liquor tax* (national tax): rates range from 5-115 per cent;
- *telephone tax* (national tax): the rate is 10 per cent on the telephone service charge;
- *stamp tax* (national tax): different amounts up to 350 000 won; and
- *tobacco tax* (local tax): 360 won per pack of cigarettes plus various amounts on other tobacco.

Earmarked taxes on consumption: Education tax, the special tax for rural development and the transport tax (see also section IV).

VII. International comparison

Annex tables A1 to A3 review key features of individual and corporate income taxation as well as VAT systems in selected OECD countries.

61. "Standard exemptions" are the most widely applied exemptions among OECD countries imposing VAT. They are: postal services; transport of sick/injured persons; hospital and medical care; human blood, tissues and organs; dental care; charitable work; education; non-commercial activities of non-profit making organisations; sporting services; cultural services; insurance and re-insurance; letting of immovable property; financial services; betting, lotteries and gambling; supply of land and buildings; certain fund raising events.

Table A1. **Taxation of personal income in selected OECD countries**
1999

	United States	Japan	Germany	United Kingdom	Korea ¹	Mexico	Sweden
Taxes raised by central government							
Range of statutory rates (per cent)	15-39.6	10-37	0-53.0	20-40	10-40	3-40	20-25
Number of tax schedules ²	5	4	4	3	4	10	2
Rates of sub-national taxes (per cent)	0-11.6	5-13	-	-	3.75-11.2	-	25.2-34.7
Marginal tax rate for top income earners ³ (per cent)	48.1	50	55.9	40	50.2	40	59.6
Tax threshold ⁴ (per cent of APW income)	76	90	95	32	84	100	4
Highest rate starts at (ratio of APW income)	9.5	4.3	2.0	1.7	5.3	48.1	1.7

1. Statutory rates also apply for 2000.

2. Excluding zero band or basic allowance.

3. Wage income.

4. For an employee with a non-working spouse and two children (1998 except for Japan (1999) and Korea (2000)). In Japan, one child is between 16 and 22 years of age. In the United States, one child is below 16 years of age. APW = average production worker in manufacturing

Source: OECD Tax Data Base, 1999; OECD, *Taxing Wages*, 1999; Ministry of Finance, Japan (1999).

Table A2. **Taxation of corporations in selected OECD countries**
1999

	Central government basic rate, per cent	Top marginal rate ¹ , per cent	Dividend wedge ² , per cent	Special rates (incl. small profits rate), per cent	Consolidation of losses within a group of companies	General rules of ownership, per cent ³	Loss carry forward, in years	Loss carry back, in years
United States	35	39.5	67.7	15.0	Yes	80	20	2
Japan	30	40.9	70.5	29.3	No	-	7	1
Germany	42.2/30 ⁴	54.0 ⁵	50.2	-	Yes	Several pre-requisites (Organschaft)	Unlimited	1
United Kingdom	31	31.0	48.3	21.0	Yes	75	Unlimited	1
Korea	28	31.2	44.5	16.0	No	-	5	0 (SMEs: 1 year)
Mexico	35/32 ⁴	32.0 ⁵	40.0	17.5/26.3	Yes	50 (but max. 60% of subsidiaries' losses can be consolidated)	10	0
Sweden	28	28.0	49.6	-	No (but income may be distributed within a group of companies)	90	Unlimited	0

1. Including local taxation and surcharges.

2. Differences between the pre-tax profit earned by the distributing company and the net dividend received by the shareholder. The dividend wedge for Korea is for 2001. For 2000, a final withholding tax of 22 per cent applies for dividends, implying a dividend wedge of 46.3 per cent.

3. The ownership rules normally refer to the percentage of ownership of equity (or voting power) that the parent company has over the subsidiary. In some countries the rules may include both direct and indirect ownership. Several countries allow consolidation among resident companies only.

4. Germany and Mexico apply split-rate systems (i.e. different tax rates apply to distribution and retaining of profits).

5. The rates apply to retained profits only.

Source: The OECD Tax Data Base, 1999; Ernst and Young, *The 1999 World Corporate Tax Guide*.

Table A3. Main features of VAT systems in selected OECD countries
1998

	Year VAT introduced	Initial standard rates	Current standard VAT rate ¹	Tax-exempt threshold sales for small traders (in 1998 PPP-US\$)	Departures from standard exemptions ²		Coverage of lower rates	
					Exemptions other than "standard exemptions"	Taxation of "standard exemptions"	Zero rate ³	Lower rates
Japan	1989	3	5	183 000	Social welfare services	Letting of commercial buildings, postal services, non-commercial activities of non-profit making organisations, cultural services, supply of buildings	-	-
Germany	1968	10	16	16 000	-	-	-	Books, food, newspapers, certain cultural events, charitable work if not exempt, transport (applies only to passenger transport by ship and to local public passenger transport). Rate = 7 per cent
United Kingdom	1973	10	17.5	76 000	Burials and cremations, sports competitions, certain luxury hospital care	The freehold sales of new commercial buildings are standard rated for three years from completion date. Furthermore there is an "option to tax" for other supplies of commercial buildings which would ordinarily be exempt from VAT. Gaming machines and certain gambling in licensed clubs	Certain services and goods supplied to charities, children's clothing, food, passenger transport, books, newspapers, domestic sewage and water, prescribed drugs, medicine, certain aids for disabled, new housing, residential and some charity buildings, alterations to listed buildings	Fuel and power for domestic and charity use (5 per cent), certain energy saving materials supplied together with fitting services to recipient of "Passport benefits". Rates = 2.5/5 per cent

Table A3. Main features of VAT systems in selected OECD countries (continued)
1998

	Year VAT introduced	Initial standard rates	Current standard VAT rate ¹	Tax exempt threshold sales for small traders (in 1998 PPP-US\$)	Departures from standard exemptions ²		Coverage of lower rates	
					Exemptions other than "standard exemptions"	Taxation of "standard exemptions"	Zero rate ³	Lower rates
Korea	1976	-	10	36 000	Certain public transportation services. Unprocessed food and agricultural products	Rental and supply of commercial buildings	Services supplied by ships and aircraft in international traffic. Certain machinery and materials for agriculture, fishery, livestock and forestry. Certain equipments for the handicapped. Other goods and services supplied for foreign exchange earnings ("indirect exporters").	-
Mexico	1980	10	15	198 000	The sale of books, newspapers, magazines, gold and silver coins and shares. The exchange of foreign currency, retailing of gold bullions, author's rights. Public transport of passengers by land. Agriculture, forestry and fishing activities	Postal and insurance services except life and agricultural insurance. The letting of commercial buildings and financial services for consumer credits and personal loans	The sale of non-processed animals and vegetables except rubber, patent medicine, milk, water, ice, food except processed food and smoked salmon and caviar, agricultural equipment and machinery and fishing boats. The wholesale of gold, gold bullions and jewellery. Some agricultural and fishing services. The letting of some agricultural machinery and equipment.	The sale of goods and services in the border regions. Rate = 10 per cent.

Table A3. **Main features of VAT systems in selected OECD countries** (continued)
1998

	Year VAT introduced	Initial standard rates	Current standard VAT rate ¹	Tax exempt threshold sales for small traders (in 1998 PPP-US\$)	Departures from standard exemptions ²		Coverage of lower rates	
					Exemptions other than "standard exemptions"	Taxation of "standard exemptions"	Zero rate ³	Lower rates
Sweden	1969	11.1	25	-	Public television and radio, certain memberships. Publications, authors' rights, public cemetery services	Postal services, most cultural services	Commercial aircraft and ships, aircraft fuel, prescribed medicine, printing of certain membership publications	Accommodation, food, passenger transport, ski lifts, newspapers, works of art owned by the originator, import of antiques, collectors' items and works of art. Culture (theatre, cinema, etc.) authors' rights, commercial sports events, commercial museums, etc. Rate = 6/12 per cent

1. As of 1 January 1998. For Germany, this rate is applied as of 1 April 1998; for the United Kingdom, the standard rate is applied to a reduced value on imports of certain works of art, antiques and collectors items, resulting in an effective rate of 2.5 per cent. For Canada, 15 per cent Harmonised Sales Tax (HST) applies in those provinces that have harmonised their provincial retail sales tax with the federal GST (the 15 per cent HST is composed of a provincial component of 8 per cent and a federal component of 7 per cent).
2. Standard exemptions are the following: Postal services, transport of sick/injured persons; hospital and medical care; human blood, tissues and organs; dental care; charitable work; education; non-commercial activities of non-profit making organisations; insurance and reinsurance; letting of immovable property; financial services; betting, lotteries and gambling; supply of land and buildings; certain fund-raising events.
3. All countries apply zero rates to exports.

Source: OECD, *Consumption Tax Trends* (1999).

Sources for Annex 1:

Ernst & Young (1999), *World Wide Corporate Tax Guide*.

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Annex 2
The Special Tax Treatment Control Law⁶²

Tax incentives aimed at achieving specific national economic objectives were mainly provided for under the Tax Exemption and Reduction Control Law (TERCL) and the Foreign Investment Promotion Act (FIPA) until the enactment of the Special Tax Treatment Control Law (STTCL) on 1 January 1999. Tax incentive provisions for FDI in the FIPA were subsumed into the STTCL as of 24 May 1999.

One important aim of the consolidation of the tax incentive systems under the STTCL is to significantly rationalise tax deferrals, credits and exemptions by making all tax incentives covered by the STTCL subject to sunset clauses, under which most incentives expire automatically within one to three years unless their duration is extended (year of expiry is shown in parentheses).

1. Tax incentives on small and medium-sized enterprises⁶³

1. Reserves for investment (2003)
2. Tax credit for investment (2003)
3. Tax incentives for newly established SMEs: 50 per cent reduction of income and property tax payments up to five years and exemption of registration and transaction taxes for two years (2003)
4. Reduction of income tax payment by 20 per cent for SMEs in manufacturing (2003)

2. Tax incentives for technology and human resources development

1. Reserve for technological development (2003)
2. Ordinary and incremental tax credit for technology and human resources development (2003)
3. Tax credit for investment in facilities for technology and human resources development (2003)
4. 50 per cent reduction for income from the transfer of patent right (2003)
5. Non-taxation on capital gains of venture capitals (2003)
6. Tax incentives for stock option (2003)
7. Income deduction for individual investors in start-up SMEs and venture enterprises (2000)
8. Tax exemption of foreign technicians (2003)

62. This annex is based on the publication *Korean Taxation 1999*, published by the Ministry of Finance and Economy.

63. SMEs are mostly defined as businesses with less than 300 full-time equivalent employees, but the definition may vary between industries and sectors and for different applications. Around 99 per cent of all businesses in Korea are SMEs, covering around 74 per cent of total employment.

3. Tax incentives for the international capital transactions

1. Exemption from income tax of some interest and dividend received in foreign currency

4. Tax incentives for the encouragement of investment

1. Tax credit of 5 per cent for investment in facilities for productivity enhancement (2000)
2. Tax credit of 5 per cent for investment in facilities for special purposes -- energy, environment, safety, etc. (2000)
3. Reserve for social overhead capital investment (2000)
4. Reserves for investment in energy-saving facilities (2000)
5. Tax credit of 3 per cent for investment in housing for employees who do not own housing units (2000)
6. Tax credit of 3 per cent for investment in medical equipment (2000)

5. The provisions associated with taxation on re-organisation -- see main text for more details

1. Consolidation between SMEs
2. Conversion from an individual to a corporation
3. Business conversion of SMEs (2000)
4. Alienation of business assets for debt payment (2000)
5. In-kind contributions
6. Shareholder's assumption of debts
7. Contributions by shareholders
8. Transfer of real estate in the process of restructuring (2000)
9. Debt payment by present value
10. Workout agreements
11. Business swaps by exchanging shares (2000)
12. Tax incentives for financial institutions (2000)
13. Purchase and assumption of assets by financial institutions

6. Tax incentives for the balanced development

1. Tax incentives for the relocation of plant facilities or head offices to provincial areas (2000)
2. Tax incentives for acquisition of new plant facilities or head office buildings (2000)
3. Tax incentives for SMEs moving to areas outside the Seoul metropolitan area (2000)
4. Reduction of income tax or corporation tax in designated agricultural areas (2000)
5. Special tax treatment for establishment of hospitals in areas where medical facilities are insufficient (2000)
6. Reduction of corporate tax for farming companies (2003)
7. 50 per cent reduction for the capital gains from farmland transactions (2000)

7. **Tax incentives for the enhancement of social welfare**
8. **Tax incentives on interest and other income**
 1. Non-taxable interest income (private pension savings; long-term savings for housing; wage earners savings; fishermen and farmers savings)
 2. Reduced withholding rates on interest and dividend income
9. **Zero rating of value-added tax for certain goods and services**
10. **Exemption of value-added tax for certain goods and services**
11. **Exemption of special excise tax for certain goods**
12. **Exemption of liquor tax for foreign military personnel and foreign crews**
13. **Foreign direct investment**

The tax incentives granted to FDI are primarily aimed at attracting high-technology and large-scale manufacturing investment. They include partial and full exemptions on individual and corporate income taxes and local taxes. Full exemptions from customs duties, special excise tax, and value-added tax (VAT) may also be granted to imported capital goods.

To be eligible for the tax incentives provided by the STTCL, a foreign investor must either retain at least 10 per cent of the outstanding shares of the company in question (foreign-invested company) or, where the ownership of the outstanding shares is less than 10 per cent, exercise managerial control by an investment agreement or under a similar arrangement with the foreign-invested company.

a) *Tax incentives for FDI*

Prior to the enactment of the FIPA, the government granted tax exemptions and reductions to 265 types of advanced technology FDI. Under the FIPA, the number has been expanded to 436. In addition, 97 new high-technology service businesses that are expected to support the international competitiveness of domestic high-technology industries, *e.g.* software, electronic commerce, etc., are to become eligible for tax exemptions and reductions. As a result, the total of advanced technology FDI that is eligible for tax benefits under the FIPA is now 533.

The FIPA also extended the duration for which these tax exemptions and reductions stay in effect for eligible FDI. The period of time during which tax exemptions and reductions stay in effect for FDI has been extended from eight to ten years for national taxes (individual and corporate income taxes). The FIPA also preserves the full exemptions for capital goods imported for use by foreign-invested companies from customs duties, special excise tax, and value-added tax within three years from the date of the notification of the FDI.

Tax incentives for FDI

Tax	Before FIPA	After FIPA
Individual and corporate income taxes	1. Full exemption for first five years 2. 50% reduction for next three years	1. Full exemption for first seven years 2. 50% reduction for next three years
Local taxes	1. Full exemption for first five year 2. 50% reduction for next three years	1. Full exemption for first five years, 50% reduction for next three years
Acquisition tax		
Property tax		
Aggregate land tax		(Local government can extend the period for tax exemption and reduction from 8 to 15 years)
Registration tax		
Customs duties	Full exemption on imported capital goods by foreign-invested companies	Full exemption on imported capital goods by foreign-invested companies
Special excise tax		
Value added tax		

Foreign businesses and investors making investments in local companies shall also request tax exemptions and/or reductions on individual or corporate income taxes by the end of the fiscal year in which the business begins. Where additional investment is made after the initial investment, further requests shall be made within two years from the date of the notification of the FDI. Tax exemption can also be requested at the time of the notification of the FDI.

As an incentive to potential FDI in Korea, the FIPA also introduced a Tax Exemption and Reduction Checking System, which enables foreign businesses and investors to determine their tax benefit eligibility with the government prior to making any FDI commitments in Korea. Requests for tax exemptions and reductions for FDI are to be decided by the Ministry of Finance and Economy after consultations with relevant government authorities.

b) Foreign investment zone

In an effort to attract large-scale foreign investment, the FIPA also introduced the Foreign Investment Zone (FIZ) system. Unlike in the past, when the national government granted tax incentives to FDI in pre-designated areas, the FIPA grants the local governments the autonomy to designate FIZ for FDI upon request from foreign investors based on the amount of investment and the number of jobs expected to be created from their FDI. Foreign-invested companies that receive the FIZ designation are eligible for government support and tax benefits.

Where an FDI meets any of the following criteria, the governor of the province in which the FDI is to be made can request a FIZ designation to the government. Upon approval of the request, the FDI is eligible for the same tax incentives as those granted to advanced technology FDI and high-technology service business.

Manufacturing	Tourist hotel business
1. FDI over \$100 million	1. FDI exceeding \$30 million in tourist hotel business
2. Investment exceeding 50 per cent of the shares of a company which employs more than 1 000 persons on a regular basis	2. FDI exceeding \$50 million in recreational business
3. FDI exceeding \$50 million and employing more than 500 persons on a regular basis	3. FDI exceeding \$30 million in international convention facilities
4. FDI exceeding \$30 million and employing more than 300 persons on a regular basis if investing in business in established previously-designated industrial park	

With respect to national taxes, FIZ-designated FDI are eligible for full exemption on individual and corporate income taxes for the first seven years and a 50 per cent reduction for the next three years. Full exemptions on local taxes (acquisition tax, property tax, aggregate land tax, and registration tax) are also to be granted for eight to 15 years. Imported capital goods for use by foreign-invested companies in FIZ are exempt from customs duties.

c) *Other business determined by presidential decree*

Business designed to attract foreign investment (its scope determined by presidential decree), such as manufacturing and logistics industries in the Free Trade Zone as well as business registered in the Customs Free Zone. The period as well as reduction and exemption of corporation tax rate shall be the same as applied to FDI in advanced technology and in the Foreign Investment Zone.

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