

Tax reform issues in Korea

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Abstract

The relatively simple nature of the tax policy in Korea is changing recently, as widening income gap, unemployment, social expenditures, and decentralization have become important policy issues. In this paper, the tax system in Korea is overviewed, and several important tax reform issues such as economic growth, tax competition, redistribution, tax assignment, and real estate taxes are discussed. The main reform issues are the followings. The tax burden is expected to rise, but the direction of changes in tax mix is not clear since social expenditures can play as important role as direct taxation for redistribution. Taxes related to real estates in Korea are too complicated, and the progressivity is needed to be lessened. The roles of central and local governments with respect to tax policy are not well designed. Redistributive function should be assigned to the central governments, and tax exporting of local governments should be minimized. © 2005 Elsevier Inc. All rights reserved.

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1. Introduction

Taxation and expenditure policies in Korea have been relatively simple issues. The burden of taxation, often a central political issue in developed countries, has not attracted much attention from voters and politicians since political parties in Korea are not clearly divided on the taxation issue. As a matter of fact, all political parties in Korea claim that they are for middle-classes and working classes. Due to rather unsophisticated attitude toward taxes, lowering tax rates of income tax has been generally regarded as a good tax policy even by low income groups.

The fact that the tax burden is not a politically sensitive issue is reflected in the structure of the tax burden. The level of the tax burden in Korea is not only among the lowest in OECD countries,

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but also the burden of income tax is among the lowest. On the other hand, the revenue from the direct taxes such as VAT and gasoline tax occupies more than 50% of the total tax revenue.

As for the expenditure side, the principle of balanced budget was virtually in effect until 1998, the year when financial crisis hit the Korean economy. Before the financial crisis and restructuring process forced the government to have a sizable amount of government debt, the need for raising tax revenue was not a great concern for the government, partly because of the high growth rates of GDP and tax revenue, and partly because the amounts of social expenditures such as welfare programs and health care were limited. Therefore, low tax burden and expenditure within the budget were two main characteristics that defined public finance in Korea until late 1990s.

Taxation also has played a limited role in the process of decentralization. Even if Korea started local autonomy in 1995, few citizens pay attention to the differences between national and local taxes. This is because local governments do not rely on local taxes to raise revenue. It is often argued that local governments in Korea do not have an independent power to tax, but that is not correct since the local tax law, passed by the parliament, allows local governments to set local tax rates within certain boundaries, usually plus minus 50 percent of the standard tax rates set by the parliament. Therefore, the reason why local taxes play a limited role in local decision making should be found in the incentive structure of local public finance in Korea. But more fundamentally, taxes, both central and local, are not the main tools for voters to represent their interests, since politics in Korea are more influenced by other factors than fiscal policies.¹

The relatively simple nature of the fiscal policy environment in Korea seems to be changing recently, however. After the financial crisis in the late 1990s, the nature of Korean economy has changed in many ways. The number of the unemployed increased sharply during the restructuring process, and in response to that, social safety net has been expanded. The public pension program was also significantly extended in 1999 to cover virtually all citizens. The financing structure of companies has changed also. Before the financial crisis, companies heavily depended on debt financing, but the amounts of corporate debt have been significantly reduced since then. The changed financing structure of companies implies that interest expensing has been also reduced, and it has contributed to a record high increase of corporate tax revenue for the past several years.

While it is true that the tax base of the corporate tax has expanded recently, its long-term role as a revenue source seems to be shrinking, rather than expanding. This is because the corporate tax rates have been decreasing, and a further cut of the tax rates is continuously being discussed. The reason why the corporate tax rates are under downward pressure is partly because the corporate tax revenue has been recently increasing very fast. However, another important reason is the possibility of tax competition. The issue of tax competition has not attracted as strong attention in Korea as in the European countries or United States. However, the concern over tax competition is a noticeable element in recent tax policy debates. The international comparison of corporate tax rates, which are generally decreasing, is often used as a policy benchmark in the debates over the level of corporate tax rates in Korea.

If international comparison provides any indication to the tax policy in Korea, it will be the weak role of the individual income tax since its rates are among the lowest in OECD

¹ Recently, there have been exceptional cases. The new government significantly raised the assessed value of properties in order to reflect the rapidly increasing real estate prices. In response to this, the local governments in rich jurisdiction, mostly located in the Seoul metropolitan region, decreased the local tax rates of the property tax. This episode is interesting since it involves the citizens' responsiveness to tax policies, tax and expenditure assignments between the central and local governments. More will be discussed in the later part of this paper.

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