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The Korean economy and its tax system at a crossroads

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ABSTRACT.
The neo-liberal and export-led growth model has proved to meet its limitations in the past two decades and the Korean model has to change into an alternative model based on wage and welfare-led growth. The goal of this paper is to propose the direction of tax reform which can support that change. In effect, the tax system has been a vehemently debaded issue in the past years since the previous government implemented the smaller government and tax cut policy. In order to propose a desirable tax system, this paper examines the limitation of the current growth model, traces the evolution of the Korean tax system from the industrialization period, and compares it and those of other OECD countries. Based on this work we argue that a reform of the tax system should start by increasing taxes more than social insurance and strengthening the role of direct taxes in a way to increase progressivity and the tax revenue of direct taxes at the same time.

Keywords: Korean economy, welfare-led growth, tax system reform

A. INTRODUCTION

The Korean economy is now at a crossroad between the old export-led model and a new welfare-based one. Good performance in the exporting sector stopped spilling over into other sectors, leading to economic polarization and acute inequality. Being aware of the serious inequality problem, both the conservative and progressive parties put forward "economic democratization" and "welfare expansion" as their main agenda in the past general and presidential elections in 2012. The winning conservative party, however, has been troubling in that it keeping its promise of welfare expansion due to its obstinate belief in the benefit of tax cut policies and the validity of the neo-liberal, export-led growth model. Nonetheless, this growth model has proved to be limited and the wage increase and welfare expansion policy has gained popularity as an alternative focusing on domestic demand.

How should the tax system be reformed to be complementary to the transformation of the Korean economy to a welfare-led growth model? Historically, the Korean tax system has been designed to serve mainly the promotion of economic growth. During the economic take-off of 1960's and 1970's, tax incentives were widely given to businesses and high income earners for the promotion of investment, exports, and capital accumulation. The VAT introduced in 1977 was the main sources of tax revenue for the industrialization period. The role of direct taxes started to increase from the middle of 1980's with political democratization. After the financial crisis of 1997, the Korean fiscal system started to change with rapidly increasing welfare expenditure, which meant a change in the tax system as well. However, the level of welfare expenditure is still very low compared to the OECD average.

The goal of this paper is to propose the direction of tax reform which is supportive of the establishment of a welfare-led economic model. Which tax item is the best candidate? Contrary to the general expectation that a country with a higher welfare expenditure would rely more on progressive tax, recent studies have argued that the regressive tax intensified the country's tax collection capability, contributing to the expansion of the welfare-state (Steinmo, 2003; Kato, 2003). If Korea would like to transform into a welfare-led growth model, should it be financed more by regressive indirect taxes following their experiences? We do not think so. A wage and welfare-led model should be sought together with tax fairness in order to maximize the redistributive impact of the fiscal system at least for the time being.

This paper starts by arguing the need to shift from the neo-liberal and export-led growth model to a wage and welfare led growth model in the following section. Next, the fiscal policy of Korea will be examined from a historical point of view. In the third section, this work will trace the evolution of expenditure and tax systems over a long time and allows for a deeper understanding of the Korean fiscal system. The forth section will be dedicated to the comparison between the tax systems of Korea and those of OECD countries. This work is expected to shed some light on the future direction of tax system reform of Korea. The proposed direction for tax system reform will be given in detail in the fifth section.

B. THE KOREAN ECONOMY AT A CROSSROADS

Under a state system pursuing economic development as its raison d'etre, South Korea achieved rapid industrialization in a brief period of time. After an outstanding achievement, it seemed to transform smoothly into an economy with a more democratic, liberalized, and advanced system up until the year 1997. Yet the financial crisis and subsequent neo-liberal reforms have changed the Korean economy in a drastic way. Prominent features of the Korean economy after the financial crisis have been low growth, polarization, and high inequality. The polarization phenomenon has taken various forms. In industry, the manufacturing sector has enjoyed increasing value while the service sector has not. In business size, the gap between large companies and small and medium-sized businesses has widened in terms of sales, net profit, and even financial soundness such as indebtedness level. In the macro-economy, the export business has exploded but domestic demand has not. This polarization is largely due to the fact that a small number of top Korean *Chaebols* have prospered beyond the domestic market and the rest have shown rapidly deteriorating performances.

Table 1. Polarization between exports and domestic demand after the crisis (Growth rates of macroeconomic expenditure categories)

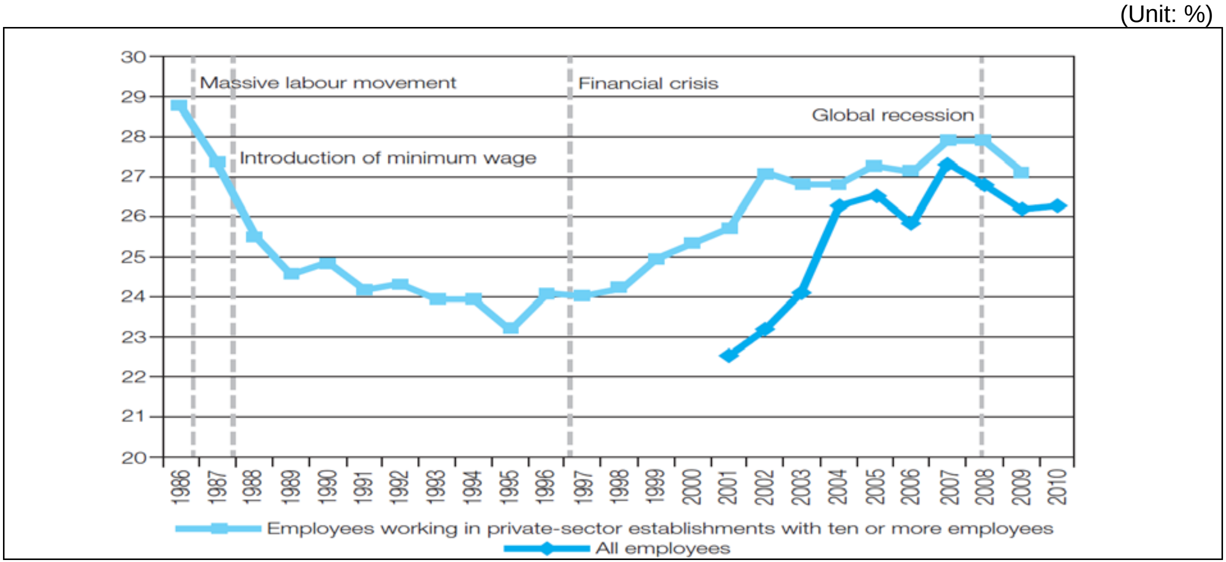
	GDP	Private Consumption	Government Consumption	Investment	Exports	Imports
90-92	8.8	8.5	7.5	13.8	9.9	12.8
93-95	8.8	9.0	4.7	11.7	17.0	20.1
96-98	3.9	1.3	3.6	-4.3	15.4	1.1
99-01	6.9	7.9	4.2	7.1	9.3	11.1
01-03	3.9	1.4	4.3	3.2	14.1	10.2
04-06	4.5	3.7	6.2	2.6	10.8	9.1
07-09	3.6	2.5	3.7	2.2	9.2	8.3
10-12	3.1	1.9	3.1	3.2	3.6	1.9
13-14	3.9	1.4	4.3	3.2	14.1	10.2

Source: *Economic Statistics System, Bank of Korea*

This means that the export-led model driven by the spearheading *Chaebols* targeting overseas markets is no longer viable. The expected trickle-down effect from exporting *Chaebols* to the SMEs and domestic economy has not been observed. Labor flexibilization has been implemented in order to boost the competitiveness of companies, and stimulate investment and employment, but has only resulted in the expansion of low-wage and precarious workers. In particular, the service industries characterized by SMEs and non-unionized workers suffer low-paid employment and a low-productivity problem more severely than manufacturing industries. Manufacturing exporters have increased the outsourcing of service-related works, reducing the employment of their own regular workers.

Figure 1. Trends in the incidence of low pay in the Republic of Korea, 1986–2010

(Unit: %)

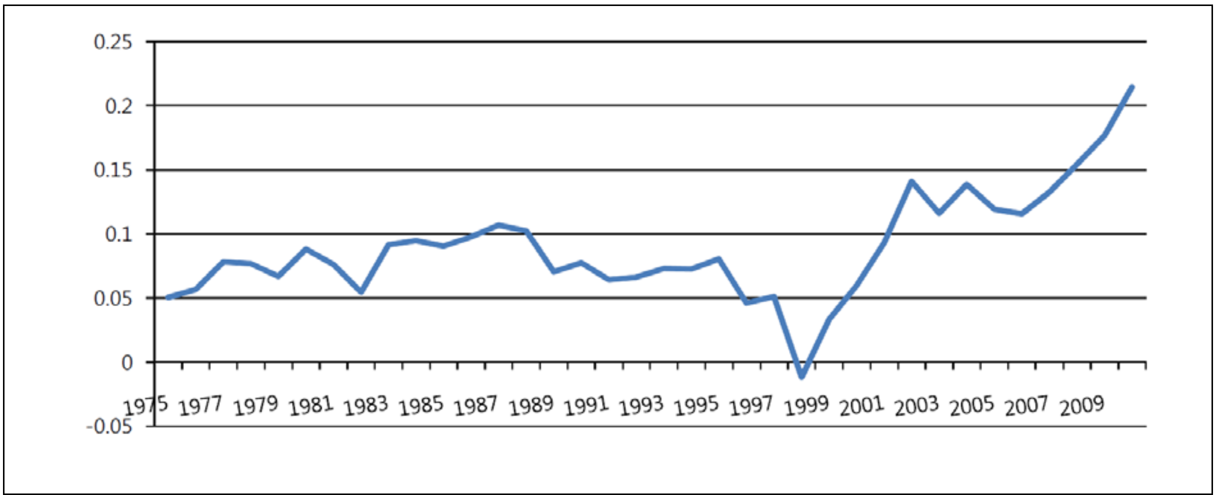


Source: *Hwang and Lee (2012)*

The number of low-paid and precarious workers has been increasing at an alarming speed. The incidence of low-paid workers standing at 29% in 1986 started to rapidly decline in the late 1980's on the backdrop of the country's transition to democracy. The political democracy strengthened workers' bargaining power and led to the widespread adoption of collective bargaining and new policy initiatives such as statutory minimum wages (Hwang and Lee, 2012). However, after the outbreak of financial crisis, the government took a dramatic policy shift towards deregulation and labor flexibility as a part of drastic reform of economic system and the incidence of low pay soared (Figure 1). As a result, the growth in average wages has not kept up with productivity growth.

With the increase in low-paid workers, income distribution has deteriorated, which can be measured by three indicators. The first indicator is the decrease of wage share in the functional income distribution to the advantage of capital. The adjusted wage share in the total income started to decrease after the financial crisis.[1] The second indicator is the decrease of household income share to the advantage of corporations. This is closely related to the first indicator in that the wage is the main component of household income and the profit is the main component of corporate income. However, there are some differences between the two indicators. The total income of the self-employed is counted as a part of household income in this case and the dividend, a distributed profit, belongs to household income also. Figure 2 shows that corporate income had been 5% to 10% for nearly thirty years and began to rise suddenly from the year of 1999 and reached 20% in 2010. The concerning phenomenon regarding this trend is that the investment by the corporate sector has not been active since the financial crisis despite the increase of their income share. The corporate sector has been net lender while the household sector has become a net borrower.[2]

Figure 2. Ratio of Corporate Income to Household Income in Korea (1975 ~ 2010)



Source: *Kang and Lee (2013).*

Note: *Household income means net disposable income of individuals, and corporate income means net disposable income of corporations (financial and non-financial enterprises).*

1 The income of self-employed should be broken down into a labor and capital incomes. This element plays an important role as the proportion of the self-employed in the economic activity in Korea is highly larger than those of other OECD countries, which comprises one of features of Korean economy.

2 It should be notable that cross-company variation in the corporate income is very large. Large corporations show a better performance than SMEs in terms of profitability as well as in stability and growth. In addition, even among large corporations big gap exists between top-tier and lower-tier *Chaebols*. Four *Chaebol* groups, Samsung, Hyundai, LG, and SK came to dominate the Korean economy more strongly than before the crisis. Ok and Yang (2012) diagnosed that the financial and labor market reforms after 1997 were especially negative economic environments to the SMEs.

The third indicator of income distribution is the household income distribution. While the share of household income has dwindled vis-a-vis corporate income, the household income distribution itself has become more unequal. It is mainly because wages have become more polarized, with lower-end wages taking an ever-smaller proportion of earned income[3]. As public welfare expenditures have increased since the financial crisis of 1997, the redistributive impact by fiscal policy has increased as well. However, the deterioration of market income distribution has been too severe to be compensated by redistributive fiscal policy. The Gini coefficient calculated with the household disposable income jumped significantly after the year of 1997. One might argue that the current level of disposable income distribution is not something to be worried about because the official figure of the Gini coefficient is as low as the average of OECD countries. However, Kim and Kim (2013) newly estimated the Gini coefficient using the data of the National Tax Services and found that the Gini coefficient of disposable income was 0.371 higher than the official figure of 0.308 in 2010. Their estimated figure is more reliable because the survey data used for the official figure has the problem of under-collecting or largely omitting high income households. According to the new figure, Korea was the fifth most unequal country in household income distribution.

On this backdrop, the wage-led growth theory has gained its popularity as an alternative growth strategy in Korea.[4] Hong (2014) analyzed the relationship between functional income distribution and economic growth in Korea from 1981 until 2012. He estimated the effects of income distribution on consumption, investment, and net export. Empirical results of the total effect on the aggregate demand show that the demand regime in Korea was weakly wage-led in 1981-1997, and strongly wage-led in 1999-2012. This means that the increase in the wage share can boost the economy by stimulating domestic demand.[5] An increase of the minimum wage can be a good instrument to jump-start the wage-led growth model. However, one problem in this direction is that the Korean corporate sector is extremely polarized and there exists huge informal sectors where government labor inspection has not reached. If the minimum wage is raised substantially at once, the employers in a relatively good condition can comply with it, but struggling marginal employers might have to reduce employment or hide the fact of employment. Due to this problem, the increase of minimum wage should be carried out in a gradual way, giving the time of adaptation to the concerned employers. This means that the welfare expansion will play an important role in the wage-led growth model as it can increase the disposable income of low income household directly. Although the welfare expenditures of Korea have significantly expanded since the crisis of 1997, the level is still very low compared to other OECD countries. Indeed, there is a long way to go.

C. KOREAN FISCAL POLICY FROM A HISTORICAL PERSPECTIVE

The fiscal system of Korea is oriented more towards the pursuit of economic growth compared to other OECD countries. This type of fiscal system was established in the industrialization period and has been maintained despite some minor changes. In 1960's and 1970's, a large part of the budget was poured into national defense and economic programs. On the tax system side, economic development took priority over other goals, such as tax equity or tax fairness. While the tax rate structure of individual and corporate income taxes were highly progressive with

[3] This is not only the phenomenon found in Korea. According to Atkinson, Piketty and Saez (2011) income inequality is worse than at any time in the 20th century.

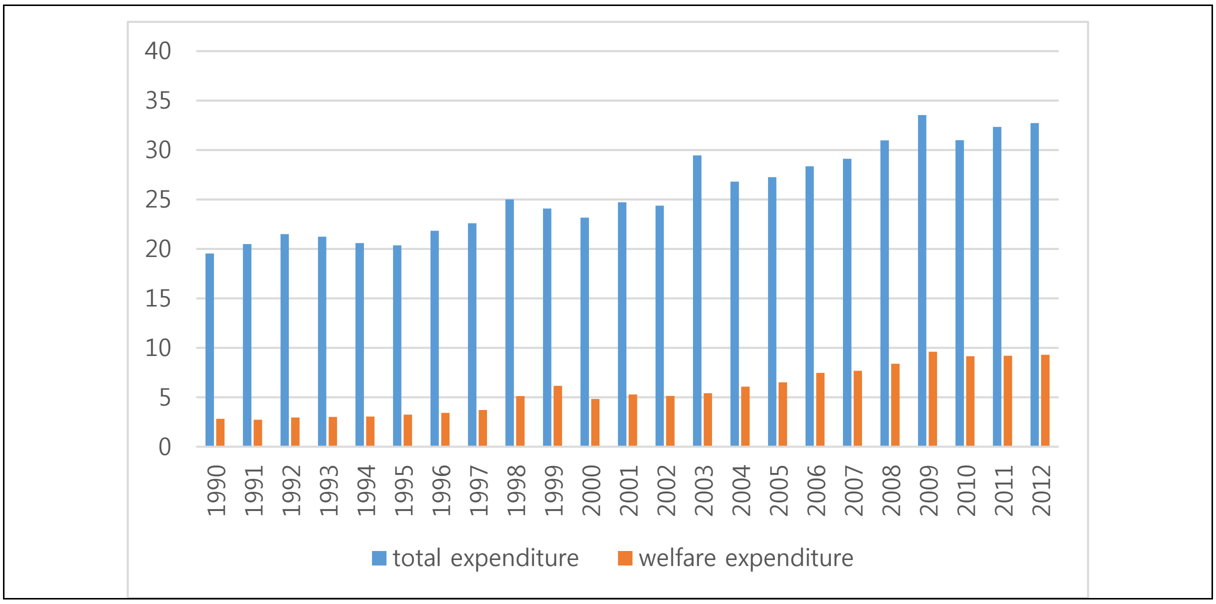
[4] Post-Keynesian scholars considered the decrease in the labor share of income triggered income contraction, which led to the decline of growth of the whole economy. Based on this diagnosis, they proposed wage-led growth model as an alternative to the neo-liberal model (UNCTAD, 2010; Lavoie and Stockhammer, 2010; Stockhammer, 2011; Onaran and Galanis, 2013).

[5] The current government is well aware of the seriousness of the inequality problem, but it tries to push for more of labor flexibility instead of an increase in the minimum wage.

a very high top marginal rate, generous tax exemption measures were provided in order to stimulate longer work hours and more investments and exports. While a comprehensive income tax and capital gains tax were introduced, they were also given favorable treatment with the aim of promoting savings. The amount of tax expenditure reached nearly 40% of total tax revenue in the year of 1970. In addition, tax evasion practices were widespread and the real estate tax was levied on substantially under-assessed property value. The main revenue generating tax was the indirect taxes since the value added tax of 10% was introduced as early as the year of 1977. This type of tax system surely favored the exporting big businesses and wealthy households.

The expenditure and tax structure experienced some changes with the political democratization in 1987. The economic democratization was translated into the expansion of welfare programs and the change of the tax system into a fairer one. On the welfare side, the government launched the National Pension Scheme applied to workplaces with 10 or more full-time employees and accomplished universal health insurance coverage for all of its citizens, introduced in 1977. In that way, social insurances took the central position in the Korean welfare system. In the tax system, the share of direct tax started to increase from the middle of 1980's. Although the statutory income tax rates was gradually lowered, the income tax revenue increased due to the reduction of tax exemption measures and easier enforcement of wage income tax. However, the non-wage income such as financial income and capital gains were not taxed in a fair way compared to wage income. Accordingly, the governments seizing power after the democratization sought to strengthen taxation on these non-wage incomes. New real estate holding taxes and real name financial transaction system were introduced, but these efforts faced a strong resistance and could not win a sensible success[6].

Figure 3. Total and welfare expenditure of the general government of Korea (as percentage of GDP)



Source: www.oecd.org/statistics

Since the financial crisis of 1997, Korean fiscal policy has been characterized by increasing trends in the total expenditure and the welfare program expenditure (Figure 3). The government

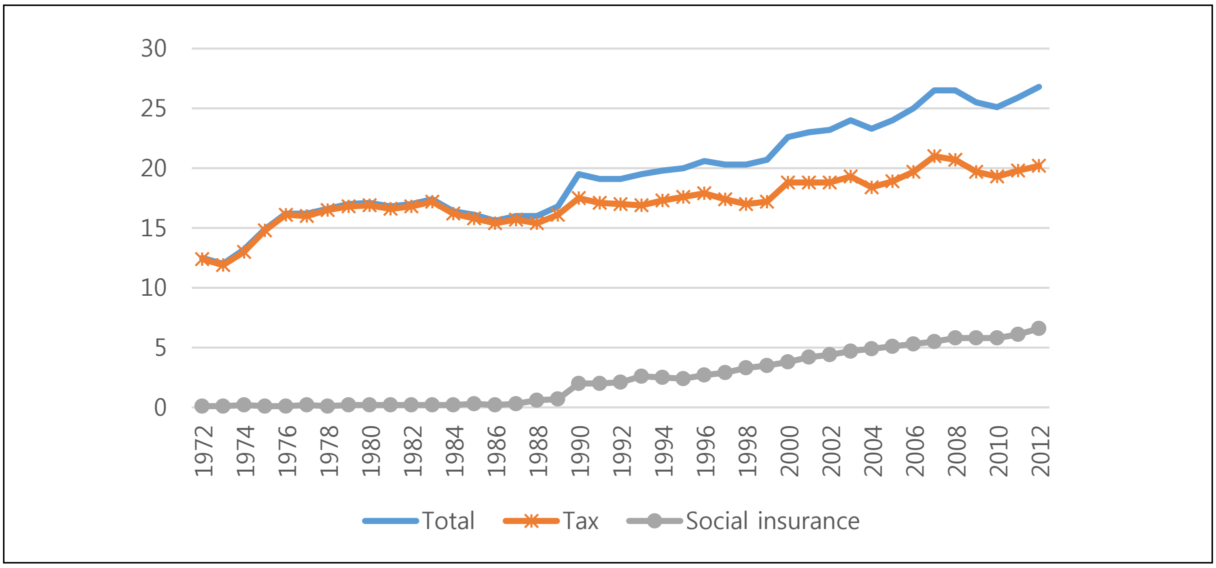
[6] During industrialization period, the Korean government made efforts to limit the size of the fiscal deficit and succeeded in containing the excessive rise of government debt. In the beginning of the years of 1980's, the new military regime officially adopted a rule of keeping fiscal accounts in surplus and a lot of tax exemption measures started to be scrapped with a view to increasing tax revenue. This policy continues to dominate fiscal policy these days.

expenditure itself as a share of GDP has shown the increasing trend since the crisis. In the case of welfare programs, it exceeded economic program expenditures in 2003. The welfare system was improved and expanded during two progressive governments taking power consecutively after the crisis. In the DJ government (1998~2002), the social insurance system and the public assistance system were substantially improved[7]. In the consecutive Rho government (2003~2007), social welfare services for child care, family, women, and the elderly were improved. In addition, the Roh government decided to introduce a Basic Old-Age Pension, Long-Term Care Insurance for the Aged, and an Earned-Income Tax Credit for the working poor at the end of its term. However, the implementation of these new statutory welfare programs were entrusted to the ensuing governments.

Unlike these two progressive governments, the next two conservative governments have been reluctant to expand the welfare programs. The MB government (2008~2012) put forward a principle of "Pragmatism in the favor of ordinary people". However, that principle meant an inactive welfare policy. The MB government argued that the best welfare is to provide jobs though economic growth which would be possible by smaller government and tax cuts. Despite this inactive position, welfare expenditure increased under the MB government as well, mostly because the intensified welfare system by previous governments automatically increased the expenditures. However, the tax cut policy put downward pressure on the taxing capability of government, which led to the contraction of non-statutory welfare programs.

The tax cut and business friendly economic policy of the MB government did not bring the promised growth to Korea. The general and presidential elections held in 2012 were expected to be won by opposition party on the backdrop of socio-economic polarization and global financial crisis. The main campaign agendas of the opposition party were "economic democracy" and "comprehensive welfare". However, the conservative party and its presidential candidate Park also adopted those agendas and modified it into a slogan: "welfare without more taxes". This strategy brought the conservative bloc the victory, but created problems in its realization. The Park government put the promised welfare programs such as the basic pension and the elementary care program program into action but crashed into a financial problem due to the shortage of tax revenue.

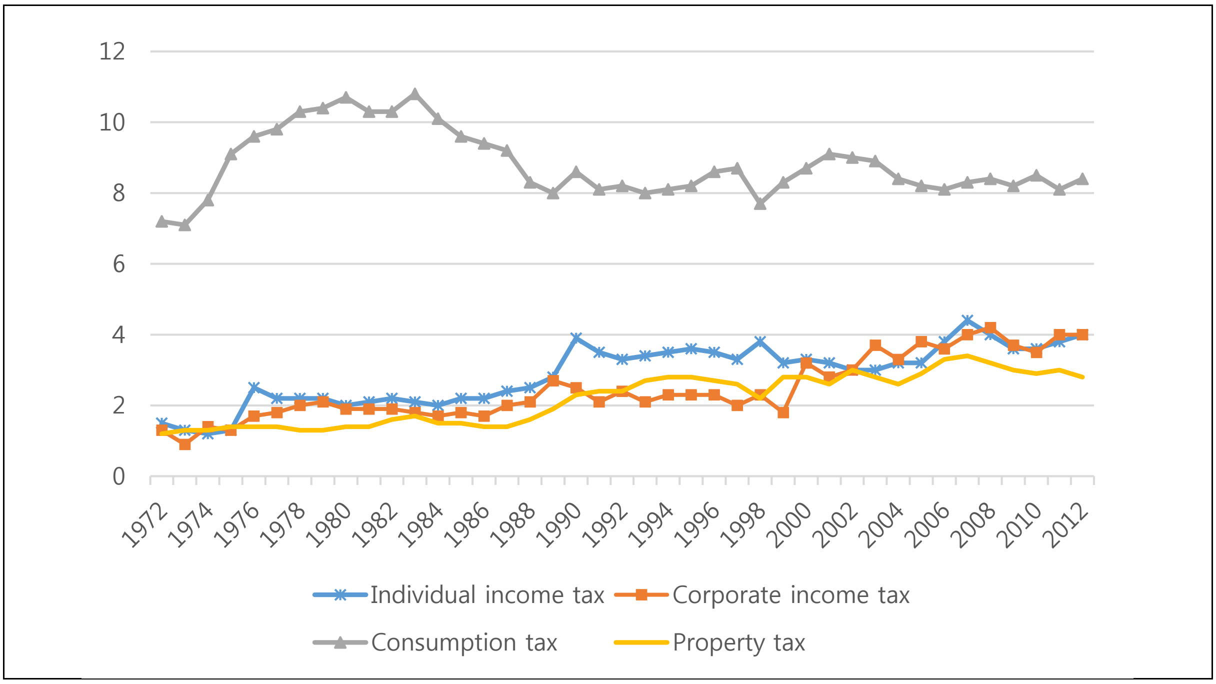
Figure 4. Tax burden with and without social insurance contributions (as percentage of GDP)



Source: www.oecd.org/statistics

[7] The Unemployment Insurance, introduced in 1995, was extended to all workplaces in 1998; the National Pension Scheme was extended to the self-employed living in urban areas in 1999; and the Industrial Accident Compensation Insurance was extended to all workplaces in 1999.

Figure 5. Tax revenue structure excluding social insurance contributions (as percentage of GDP)



Source: www.oecd.org/statistics

How was the evolution of tax system after the crisis of 1997? The years just after the crisis were a propitious period for making the tax system fairer one. The newly established government was expected to implement a long-awaited tax reform, but this expectation was not realized. After the outbreak of the financial crisis, the most immediate concern of tax policy was to alleviate the adverse effects from the crisis and to promote structural adjustments. The DJ government (1998~2002) introduced various tax exemption measures to boost economic activity, facilitate restructuring of the corporate and financial sectors, and encourage foreign direct investment and capital inflows[8]. Comprehensive taxation of capital income was suspended in 1999 and 2000 to prevent negative impacts on the financial markets, and the personal capital gains tax rate were reduced to boost the real estate market. To encourage private consumption, special consumption taxes have been have been reduced or eliminated.

The next Roh government (2003~2008) maintained the same kind of tax policy; that is, the reduction of tax rates and the increase of tax deductions[9]. Instead of the tax cut policy in these taxes, the Roh government intensified the taxation on the real estate[10]. It was based on the diagnosis that the capital income increased faster than wage income, which hampered the efficient operation of the economy of production. The Comprehensive Real Estate Holding Tax, the flagship achievement of the Roh government had an objective of intensifying the taxation on ownership of excessive real estate and allocating tax revenue to local governments for balanced growth in local economies. However, the tax revenue from the comprehensive property tax was not large and was criticized as a tax punishing the rich.

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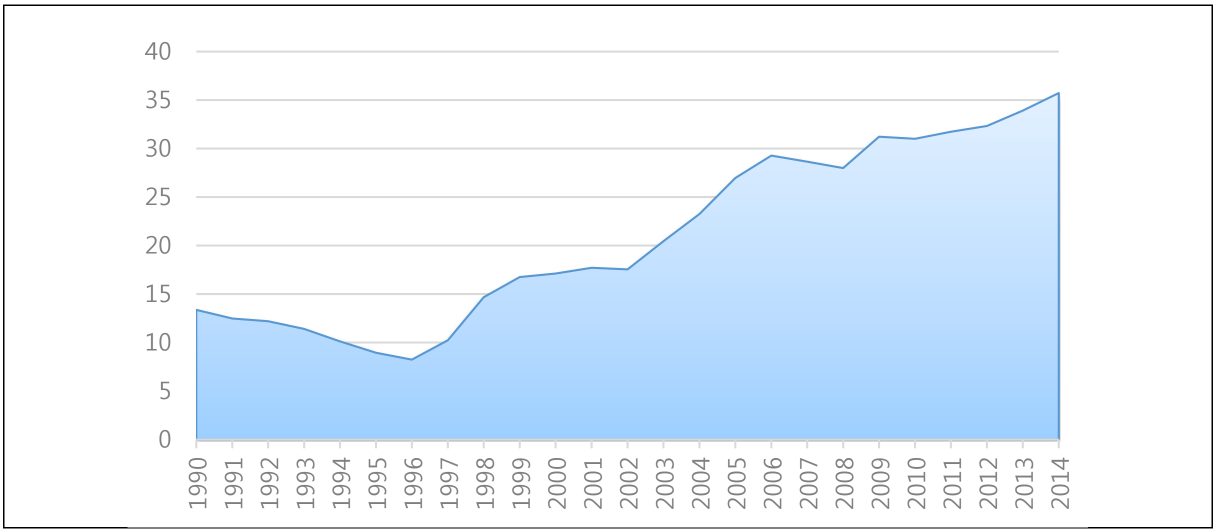
8 Wage and salary earners received tax relief in the form of increased deductions and a cut in the marginal tax rates. The tax burden on the self-employed was reduced by the introduction of a tax credit for formal bookkeeping and expanding the allowances for credit card sales. To stimulate investment, tax incentives were provided to small and medium-sized enterprises, including tax exemptions on capital gains and stock options in venture capital businesses.

9 Sung (2011) examined the redistributive effects of income taxes of the governments from 1992 to 2007 and concluded that they were characterized by decreasing redistributive effects because the provision of generous tax relief was more beneficial to high income households.

10 It introduced the comprehensive property tax, heavier taxation on the capital gains on the real estate, and enforced real price transaction and mandatory registration of ownership of real estate.

The MB government (2008~2012) put forward the idea of "Small Government and Tax Cuts" as a representative policy. The tax rates of the individual income tax and corporate income tax were lowered as in previous governments. In particular, the corporate income tax rates was slashed by 3 percentage point of GDP, more than those of previous governments. In addition, taxation on real estate was loosened. In particular, Comprehensive Real Estate Holding Tax was literally paralyzed. The Park administration (2013~2017) made clear that it would maintain the tax policy of the previous government. With the promise of welfare without more tax, its tax reform has been limited to the reduction of tax expenditure; that is, tax base broadening. In particular, the Park government's tax reform was the reduction of tax deductions given to the individual income tax, which triggered the anger of households struggling due to decreased income. Under the tax cut policy since 2008, the tax burden ratio excluding the social insurance has decreased as the direct taxes have decreased (Figure 4 and 5). The combination of the maintenance of a low tax burden ratio and the welfare expansion trend has deteriorated fiscal soundness in the backdrop of sluggish growth and a tax revenue deficient. The fiscal accounts excluding the social insurance have been in deficit with ever larger size. Government debt as a share of GDP has shown an increasing tendency since the year of 2003. The increase of government debt during 2003 to 2006 was attributable to the failure to recover the public funds poured into the banks in the aftermath of the financial crisis of 1998. Yet the increase since 2008 has been mainly due to the shortage of tax revenue (Figure 6).

Figure 6. Genral government debt of Korea (as percentage of GDP)



Source: Homepage of Ministry of Strategy and Finance of Korea

D. KOREAN FISCAL POLICY COMPARED WITH OTHER OECD COUNTRIES

In order to find a desirable way of reforming the Korean fiscal system, we begin by comparing it to those of other OECD countries[11]. Above all, the Korean system has the features of a very low tax burden and small government expenditure size (table 2). The welfare expenditure is smaller than other groups as well. Scandinavian and Western European countries are two groups with high

[11] In particular, we will distinguish four sub-groups of the eighteen advanced OECD countries and compare them with Korean fiscal system. This is expected to give us more significant implications. The four groups are Scandinavian, West European, Anglo-Saxon, and Southern groups, based on the classification of Castles (2004). The Scandinavian group includes Denmark Finland, Norway and Sweden, Anglo-Saxon groups includes Australia, Canada, Ireland, New-Zealand, U.K. and U.S., Western European group includes Belgium, France, Germany, Netherlands, and Southern group includes Greece, Italy, Portugal and Spain.

burden and high expenditure, but the latter relies more on social security contributions in its tax structure. The Anglo-Saxon group has a lower burden and lower expenditure than the other three groups while the Southern European group has a level of expenditure comparable to those of the Scandinavian and Western European countries but its burden level is lower. The three groups excluding the Northern one have very high government debt. While even the Anglo-Saxon group spends around 50% of its total expenditure on the welfare, Korea spends around 30%. According to the estimation of Torres (2013), the actual tax revenue (excluding social insurance contributions) and government expenditure of Korea are lower than the expected revenue and expenditure which are estimated based on the country's economic and demographic characteristics. The actual tax revenue and government expenditure (as a share of GDP) are lower than expected ones, –3.4 and 9.5 percentage point of GDP respectively. One positive aspect of the Korean fiscal system is that the government debt is quite lower than in other groups. It is the result of implementation of strict fiscal rules by Korean governments.

Table 2. Tax burden ratio, total expenditure and total debt size (2012)

(Unit: as a percentage of GDP)

	Tax burden excluding social insurance contributions	Tax burden including social insurance contributions	Total expenditure of central government	Public social expenditure	Total debt of central government
Scandinavian	35.4	43.7	52.7	27.3	53.0
Anglo-Saxon	25.8	29.3	41.3	20.1	100.1
Western European	25.7	40.5	50.8	27.8	97.3
Southern European	23.9	34.9	50.0	26.5	131.3
Korea	18.7	24.8	32.7	9.6	34.7
OECD average	24.7	33.7	45.0	21.6	83.7

Source: www.oecd.org/statistics

Note: *Social expenditure includes health and social protection programs*

When the expenditure structure is compared in more detail, Korea is observed to spend more on national defense and economic programs and less on welfare programs than OECD averages(as shares of GDP). If Korea was to adjust the expenditure size of each program to the averages of OECD countries, it needs to reduce the economic program expenditure by 2 percentage point of GDP and increase the welfare program expenditure by more than 10 percentage point of GDP. Table 3 shows the size of each expenditure category as a share of GDP. If it is expressed as a share of total expenditure, the Korean government spent 20.1% of total expenditures into economic affairs while OECD countries spent 10.5% on average.

Table 3. Expenditure structure of central government by function (2009)

(Unit: as a percentage of GDP)

	General public services	Defense	Public order and safety	Economic affairs	Environ-mental protection	Recreation, culture and religion	Education	Social expen-diture
Scandinavian	6.7	1.5	1.3	4.2	0.4	1.3	6.6	29.5
Anglo-Saxon	5.3	2.0	1.9	4.6	0.7	0.8	5.6	22.0
Western European	6.5	1.3	1.8	4.8	1.0	1.3	5.6	28.0
Southern European	8.9	1.6	2.0	4.0	0.7	0.9	4.9	25.6
Japan	4.6	0.9	1.3	4.1	1.2	0.4	3.5	25.1
Korea	4.9	2.8	1.3	6.5	0.8	0.7	5.1	9.1
OECD	5.9	1.5	1.7	4.5	0.7	1.2	5.4	21.6

Source: OECD, Statistics Database.

Now let us turn to the tax system side. As Table 4 shows, the OECD countries vary in their tax revenue structures. The Scandinavian group has the highest levels of individual and corporate incomes taxes as well as consumption tax while its social insurance revenue size is slightly below the OECD average while still higher than that of Anglo-Saxon group. The Anglo-Saxon group gathers higher revenue in individual and corporate income taxes but is lower in consumption tax and social insurance contributions than the OECD average. Interestingly, the ratios of individual income tax revenue to consumption tax revenue are same between these two groups and higher than the OECD average. By the way, the Western and Southern European countries are characterized by higher burden ratios of social insurance contributions while Western European group gathers much larger size of revenue from social insurance contributions than the Southern group. In the case of tax categories, the two groups are marked by lower tax revenue in income taxes than the other two groups. Reflecting the lower tax burden ratios, the Korean tax system is characterized by smaller tax revenue in individual income tax, consumption tax, and social insurance while it has higher tax revenues in consumption and property taxes than the OECD average. Among the three tax categories raising smaller revenue, the roles of the individual income tax and employer social insurance contribution are much weaker than the consumption tax and employee social insurance contribution.

Table 4. Tax revenue structure including social insurance contributions (2012)

(Unit: % of GDP)

	Income tax		Consumption tax		Property tax		Social insurance contributions		
	Individual (A)	corporate	revenue (B)	A/B	total	holding tax	total	employee	employer
Scandi-navian	14.6	4.6	13.4	1.1	1.3	0.8	7.9	2.4	5.5
Anglo-Saxon	10.3	3.4	9.2	1.1	2.9	2.2	3.4	1.3	2.1
Western European	9.2	2.3	11.2	0.8	2.2	1.0	12.9	5.3	7.6
Southern European	7.9	2.2	11.4	0.7	2.0	1.1	9.8	3.0	6.8
Korea	3.7	3.7	8.4	0.4	2.8	0.7	5.3	2.6	2.7
OECD average	8.6	2.9	11.0	0.8	1.8	1.1	8.4	3.3	5.1

Source: www.oecd.org/statistics

Note: Property tax incorporates the recurrent taxes on immovable property, recurrent taxes on net wealth, the estate, inheritance and gift taxes and financial transaction taxes.

Table 5. Top marginal tax rates of major countries (2013)

(Unit: % of GDP)

	Individual income tax	Corporate income tax	VAT Standard rate	Social insurance contributions		
				total	employee	employer
Sweden	56.7	22.0	25.0	38.42	7.00	31.42
Denmark	60.4	25.0	25.0	8.00	8.00	0.00
U.S	46.3	39.1	-	21.30	7.65	13.65
U.K	45.0	23.0	22.0	25.80	12.00	13.80
Germany	47.5	30.2	19.0	39.46	20.18	19.28
France	54.5	34.4	19.6	55.53	13.80	41.73
Greece	46.0	26.0	23.0	45.06	16.50	28.56
Italy	48.6	27.5	21.0	42.57	10.49	32.08
Japan	50.8	37.0	5.0	28.36	13.94	14.42
Korea	41.8	24.2	10.0	18.50	8.29	10.23
OECD	43.4	25.3	18.9	26.8	10.43	17.27

Source: www.oecd.org/tax/tax-policy/tax-database.htm

Note: 1) Individual and corporate income taxes are the sum of taxes imposed by the central and local governments' taxes. 2) The U.S. does not levy VAT but rather sales tax at state and local governments 3) In the case of social insurance contribution with flat rate, that flat rate is considered as the top rate.

Are these differences due to the tax rates? The table 5 shows the rate levels of different tax items. When we compare the top marginal tax rates between Korea and the OECD average, the rates of individual and corporate income taxes and employee social insurance contribution rate are not significantly lower than the OECD average while the standard VAT rate and employer social insurance contribution rate are noticeably lower. While the size of social insurance revenues broadly reflect its rate level, other taxes need more explanation.

In the case of individual income tax, tax revenue is quite small compared to other countries not because Korea has a very low statutory rates but because the Korean individual income tax is characterized mainly by excessively large tax relief measures. Generous tax relief measures are offered, which is one of the outstanding characteristics from the industrialization period. As standard tax reliefs, employment income deduction is offered to every households with decreasing rates for the high income households while other numerous allowances based on demographic composition of households, national pension deduction and tax credits are also offered. These tax reliefs are introduced to fully deduct the expenses from their income which households spent while earning income. In addition, non-standard tax reliefs are offered generously as well. Households can deduct from their income expenses such as insurance premiums, medical expenses, educational expenses, etc. The problem with this generous tax relief system is that it lowers the effective tax rates across all households and the value of tax reliefs often increases for higher tax brackets because the income or transaction targeted is most commonly used by higher-income individuals.

Table 6. Tax revenue structure of wage income

(Unit: trillion Korean Won, %)

	Share in the total wage	deductions		share in the total tax revenue	Effective tax rates
		amount (trillion won)	share		
Top 1%	6.4	5.3	2.2	29.0	21.4
10th quantile	27.8	43.2	17.8	65.9	11.2
9th quantile	16.2	37.0	15.2	15.4	4.5
8th quantile	12.8	32.7	13.5	8.1	3.0
7th quantile	10.4	28.2	11.6	4.6	2.1
6th quantile	8.6	24.2	9.9	2.6	1.4
5th quantile	7.1	20.6	8.5	1.5	1.0
4th quantile	5.8	17.7	7.3	0.9	0.8
3rd quantile	4.7	15.5	6.4	0.6	0.6
2nd quantile	3.7	13.4	5.5	0.3	0.4
1st quantile	2.7	10.6	4.4	0.1	0.2
total	100.0	243.1	100.0	100.0	7.0

Source: Kang (2014)

The tax revenue of both corporate income tax and property tax is higher than the OECD average. It is not because Korea imposes heavier taxes on two tax bases than other countries as we have already seen. In the case of corporate income tax, it is because the tax base itself is very large although the tax breaks are offered to corporations generously. Tax revenue has increased rapidly since the year 1999, mainly due to the increase of the tax base; that is, the increase of profit in the corporate sector. The table below shows that the tax base of the corporate tax income was 3.30% of GDP in 1981 but increased tremendously to 18.33% in 2012. The tax base of the corporate sector increased in other major countries, but Korea experienced the largest increase over the period. In the case of property tax, Korea received the property tax revenue much more than the OECD average by 1% of GDP in 2012. However, tax revenue of property holding tax is smaller than the OECD average while the revenue of financial transaction tax is dominant in this tax category.

Table 7. Tax base of corporate income tax of OECD countries

(Unit: percentage of GDP)

	Korea	U.K.	U.S.	Canada	Japan
Tax base of 1981*	3.30	5.63	7.52	8.11	9.45
Tax base of 2012**	18.33	12.08	6.40	13.37	8.79

Source: Kim (2015)

Note: 1982 for Korea, 2011 for the U.S. and Japan

E. TAX SYSTEM REFORM FOR A NEW GROWTH REGIME

The welfare program should be substantially expanded if Korea would like to transform into a wage and welfare-led growth model. Then, how should the tax system be reformed in order to support this transformation? The priority of tax policy for the current government is placed on the containment of the tax burden ratio at the current low level. The tax revenue required to implement the promised meager welfare expansion is intended to be financed mainly by the reduction of tax expenditure. Yet, the insufficient tax revenue has been an obstacle to the implementation of the promised welfare programs in full and even endangered Korea's fiscal soundness. It is evident that the tax burden ratio should be substantially increased.

The first question in designing the tax system reform is how to balance the roles played by each of the two pillars; that is, the tax system and the social insurance system. Currently, Korea relies mainly on the social insurance system for its welfare programs although its level of coverage is still weak compared to other OECD countries. The income replacement ratio of the public pension system is among the lowest in OECD countries. As for this question, the experiences of the advanced countries clearly showed that the social insurance system faced the sustainability problem when the economy entered the stage marked by mass unemployment and the proliferation of irregular workers. France, one of the representative social insurance-based counties has changed from a predominantly Bismarckian system to a dualized system where the taxing state emerged as an important actor with the social insurance system (Palier, 2010). In that Korea is marked by much more severe labor instability, the taxation should take stronger responsibility than so far.

Then, how should the tax system be reformed in a way to raise more revenue without damaging the efficiency and the equity of the system? One option is to rely more on the indirect tax. A group of academics argue that the consumption tax is more efficient and faces less political resistance than the direct tax, being a good candidate for financing expansion of welfare program(Yang, 2015). Although the consumption tax is said to be regressive and could deteriorate the equity of tax system, the increased tax revenue, if it is used only for the expansion of the welfare program, would improve the equity of the whole system. Their argument is based on the fact that the advanced welfare states are highly financed by indirect taxes. One of the outstanding features observed in the changes of tax system of OECD countries from the 1980's has been the rate cut of direct taxes. This change was observed also in the European countries where the leftist parties had taken power for a long time[12]. In addition to a rate cut of direct taxes, the Northern European countries in the grip of social democratic parties discarded the comprehensive income tax and adopted a double income tax system through a number of tax reforms from 1987 to 1993.

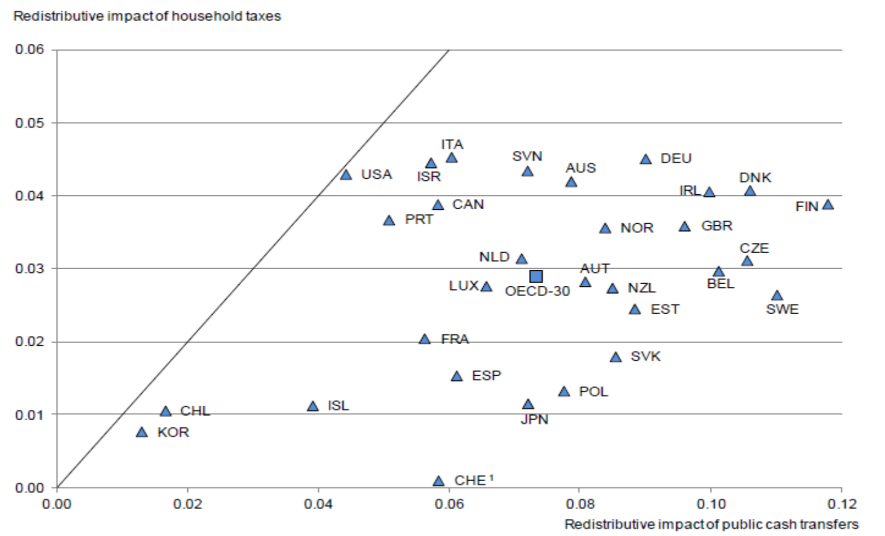
Social-democratic countries that allegedly prioritize equity are expected to rely more on progressive direct taxes while market-based countries that allegedly prioritize efficiency rely on regressive indirect tax. Contrary to this expectation, social democratic countries have relied heavily

[12] Spearheaded by the U.S. which started the tax reform based on the a "Broad Base-Low Rate" approach and low rate in the middle of the 1980's, the advanced countries has competitively reduced the tax rates of the direct taxes.

on consumption tax more than liberal market countries, which is shown in the higher ratio of share in the indirect tax to the share tax in Sweden than in the United States. Recent studies pointed to the fact that the regressive tax amplified the taxing capability of a country and as a result contributed to the development of a welfare state. Steinmo (2003) concluded that the social democratic countries imposed a heavy tax burden on the whole income classes in order to mobilize massive amount of tax revenue and then poured that tax revenue into housing, education, health, and welfare programs. This fiscal policy has been more successful in improving income distribution than a combination of progressive tax systems and mediocre welfare programs. In the same vein, Kato (2003) argued that the countries expanding their funding base though the VAT in the early postwar period could not only develop welfare state earlier than others but also could maintain their high level of welfare in the subsequent period the welfare-state was brought under intensive censure due to the economic depression.

Should Korea increase the role of consumption tax before others following these experiences? The answer should be no. It is true that social democratic countries had increased its dependence on the consumption tax at an early period of welfare state and continued to increase its role steadily at least until the end of 1980's. But the burden of their direct taxes has become already very high when they decided to increase the role of indirect taxes. Accordingly, the share of individual income tax is still the highest among OECD countries and the share of individual income tax is larger than the share of consumption tax. That is, social democratic countries should not give up the progressivity of their tax systems. It is true that the tax rate is high for all brackets; that is, even for low-income households.

Figure 7. Redistributive impacts of household taxes and public cash and transfers Point reduction in the concentration coefficients, in the late 2000's



1. The redistributive impact of household taxes for Switzerland is slightly negative (-0.006), but has been set to zero.

Note: The redistributive impact of public cash transfers is measured as the difference between the concentration coefficient of market income and that of income after transfers. The redistributive impact of household taxes is measured as the difference between the concentration coefficient of post-transfer income and that of disposable income (*i.e.* post-tax and transfers). Data for France and Ireland refer to mid-2000s.

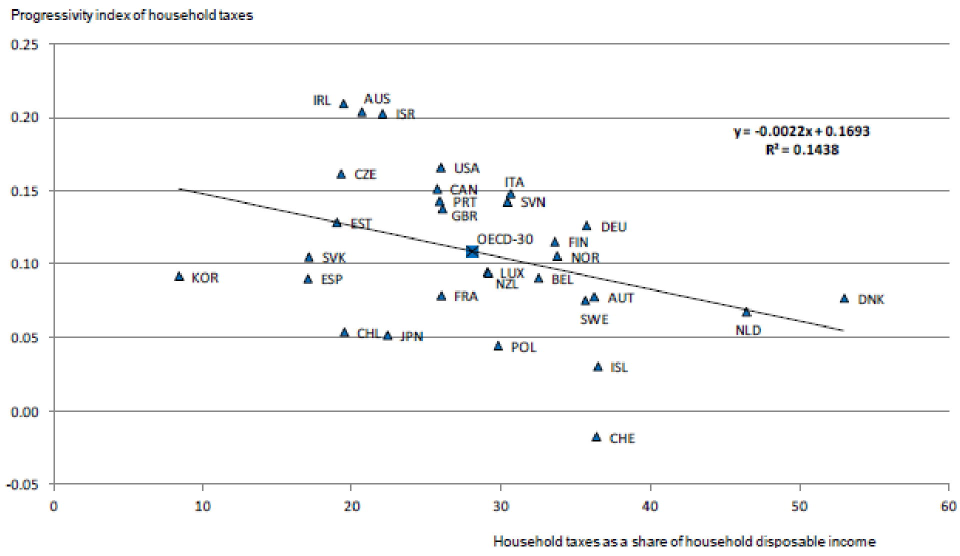
Source: Joumard, Pisu and Bloch (2012)

Figure 7 shows the redistributive impacts of household taxes and public cash transfers of OECD countries[13]. The U.S. has a higher impact of household taxes and a lower impact of public transfer than the average while Sweden has a slightly lower impact of taxes and a higher impact of public cash transfers. However, in terms of combined impact, that of Sweden is higher than the U.S., which serves as evidence of the relevance of the intensified role of the consumption tax. Cash

[13] Household tax includes the personal income tax, social security contributions, and property taxes. Public cash and transfers include the one regarding old age, incapacity, family unemployment, and other social policy areas.

transfers reduce income dispersion more than taxes in most OECD countries. On average, three quarters of the reduction in inequality as between market and disposable income are due to transfers, the rest to taxes. When we look at the impacts shown by other social democratic countries, however, they have as high redistributive impact of taxes as the U.S. does. Incidentally, Korea shows extremely low redistributive impacts in both areas. If Korea would like to improve the redistributive effects of its fiscal system, it should make efforts in both directions. In this situation, if Korea increases the consumption taxes, the improvement of redistributive impact of household taxes would be realized.

Figure 8. Characteristics of household taxes



Note: The redistributive impact of household taxes is measured as the difference between the concentration coefficient of income after transfers but before taxes and that of disposable income (*i.e.* after taxes and transfers). The progressivity index of household taxes is the Kakwani index computed as the concentration coefficient for taxes less the concentration coefficient for income after transfers and before taxes (see Box 3). Data for France and Ireland refer to the mid-2000s. In Panel A, the trend line excludes Chile. Data for Greece, Hungary, Mexico and Turkey are not available.

Source: Joumard, Pisu, and Bloch (2012)

Then how could we increase the redistributive impact of the household tax? The comparison of the features of household taxes in OECD countries gives us some hints. The graph shows that there is a trade-off between two features of the household tax system: the higher progressivity a household tax has, the lower tax revenue it has. It is notable that the countries above the line are broadly the countries characterized by higher redistributive impact of tax in the graph above. It means that if Korea would like to enhance the redistributive impact of taxes, the most reasonable way is to increase both progressivity and tax revenue at the same time.[14] To achieve this goal, the effective tax rates of high income households should be raised and the effective tax rates of low income households should be lowered. Yet the former should be larger than the latter. On the side of high income earners, it can be done by raising the top rate or reducing the tax expenditure for the top income class. Tax expenditures pertaining to personal income tax tend to benefit the well-off, a main exception being in-work tax credits. On the side of low income earners, tax relief can be made more generous so as to reduce the cost of labor of groups at high unemployment risk and earned income tax credit can be raised to make work more attractive for low-income earners.

Another way of pursuing the two goals at the same time is to reform the capital income tax and property tax have long been considered as inequitable and harmful to fair taxation. Capital

[14] . If Korea relies only on the expansion of tax revenue, it would means a drastic incease in the household tax burden.

incomes such as the interest, dividend, and capital gains are still not subject to complete comprehensive taxation. The combined amount of interest and dividend less than 20 million won is subject to a withholding taxation, not to the comprehensive taxation. Capital gains on the stocks of listed companies are exempt from tax in most cases and a handful of cases is subject to taxation. In the case of capital gains on real estate, a generous exemption is provided as well. The tax exemption measures for capital incomes should be eliminated and capital gains should be subject to comprehensive taxation. The same goes for the property holding tax. Generous exemption measures should be reduced. As most beneficiaries of this unequitable taxation are high income households, proposed reform would surely improve the progressivity of the tax and raise revenue. An unfair tax system encourages tax avoidance and causes tax resistance, which creates inefficiency in tax enforcement.

Before the increase in the role of regressive consumption tax, the corporate income tax should be intensified as well. As we already examined, Korean income distribution is highly distorted to the advantage of corporations. Despite this trend, tax payment by corporations has decreased notably, which is evident from the Table 8. Indeed, the effective tax rates of corporate income tax has declined since 2008 due to the drastic tax cut policy. Furthermore, the largest companies that have paid tax at a lower rate in effective terms though the statutory marginal rate have been the highest. It was because they have been the main beneficiary of tax relief offered for R&D activities or investment.

Table 8. Effective tax rates of corporate income tax by corporate size

(Unit: %)

	2008	2009	2010	2011	2012
All	20.5	19.6	16.6	16.6	16.8
Large	21.6	21.0	17.7	17.6	17.8
The 10 largest	18.7	16.3	11.4	13.0	13.0
The 100 largest	20.9	20.4	16.7	16.8	17.5
SMEs	17.2	15.3	13.1	13.2	13.3

Note: *effective tax rates=(corporate tax payment/ tax base)*100.*

10 largest and 100 largest companies are selected by sales size of 2012.

Source: Kang (2015).

Will the intensification of direct taxes mean an increase of inefficiently? Theoretically, the increase of individual and corporate income taxes are said to damage the economic efficiency in that the household would decrease the labor supply and corporations would decrease investment, which reduces the production and employment in turns. However, most empirical studies of the impact of two income taxes on the Korean economy found that efficiency loss is marginal. The studies regards the impact of individual income tax on the labor supply (Kim and Sung, 2007; Nam, 2007; Nam·Chun·Lee·Ki, 2009; Kang and Sung, 2013) showed that after-tax wage rate did not have statically significant impact or if it had, the size is very small. Concerning the impact of the corporate income tax on the investment, the studies have shown broadly comparable results (Lee and Kim, 2004; Kim W.C, 2007; Sung and Kang, 2008).

F. CONCLUSION

Although Korea has increased welfare programs rapidly since 1998, the income redistributive effect through fiscal system is still low compared to the other OECD countries. Considering this, a small-scale welfare expansion cannot be a solution for a Korean economy suffering low growth and severe inequality. On the one hand, welfare expenditures should be significantly amplified if Korea would like to change its economic model to a wage or welfare-led model. In effect, the welfare expenditure size is very small when the economic development and the ageing level are taken into consideration. On the other hand, the tax system marked by an important role of social insurance system and an unfairly structured tax structure should be reformed to increase the revenue of direct taxes in a way to enhance tax fairness.

In the case of the social insurance system, it would be difficult and undesirable to take an essential role in the welfare system when the extremely dualized labor market is considered. In the tax system, the intensification of the consumption tax is not a good option even if it would bring a large amount of revenue probably without strong political resistance. It is because the income redistributive effects are so small that the Korean fiscal system should be reformed to enhance it through both the tax and expenditure system for the time being. The experiences of OECD countries showed that the indirect taxes took a more active role just after the direct taxes had been maximized. The intensification of corporate income tax for large corporations, property holding tax, capital income taxes, and taxation on high income households should be on the tax reform agenda before other options. However, tax fairness itself is not the ultimate goal of tax system reform. Accordingly, this tax reform should be followed sooner or later by the goal of the increase in tax revenue enough to support welfare expansion. Then the intensification of consumption tax will be a good option.

The upcoming presidential election of 2017 will be critical for the future of the Korean economy. The main opposing progressive party recently adopted the slogan of "wage-led growth policy" supported by a medium-welfare and medium-burden fiscal policy. The civil society has been strongly promoting the strategy of the wage and welfare-led growth model and asking for an increase in the tax revenue through adopting a fairer tax system. However, the trade unions have been focused more on the issues related directly to the maintenance of the regular workers' rights because it comprises mostly of insider workers. If this alternative economic model is to be strongly pushed forward, the trade unions have to be involved in this movement. However, an important question remains: will this alternative succeed in appealing to Koreans? Nobody can easily say yes. The traditional economic model is still strongly influencing Koreans' attitudes which argues that the best welfare is to give jobs, which can be attained with more freedom to the enterprises and markets[15]. While Korea is indeed at a crossroads, the progressive bloc has not yet found a break-through toward paradigm change.

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[15] In addition, the rapidly proceeding ageing is an obstacle to welfare expansion. It is feared that without the system modification, the welfare expenditure would approach to the level of OECD average because of the rapid ageing speed sooner or later.

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