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79-6 Karak-Dong, Songpa-Gu, Seoul, 138-774, Korea

Tel : (82-2) 2186-2114, Fax : (82-2) 2186-2179

<http://www.kipf.re.kr>

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Preface

The Korea Institute of Public Finance(KIPF) was set up in July 1992 with the purpose of conducting policy-oriented research and analysis on all aspects of taxation and public finance, thereby assisting in the formation of national public tax policies and contributing to the national economy.

Since its inception, the KIPF has played a critical role in the development of tax and budget policies and the advancement of tax administration. The KIPF conducts extensive research on tax and fiscal policies and recommends policy alternatives.

The changing economic environment under a globalized and open economy has made tax and fiscal policy an increasingly important tool for making sound economic decisions. The importance of in-depth research and the impact of suggesting various policy alternatives is greater than ever before.

This publication was made to provide a clear picture about studies and researches of KIPF on financial and taxation fields, which serve as the backbone of the national economy.

I sincerely hope this summary book containing research results, which are the product of hard work, will be beneficial and useful to the government, enterprises and ordinary people as well as related researchers.

KIPF President Yong-Sun Choe

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03-01

A Study on Medium Term Budget Outlook of Korea Through Forecasting Revenue and Expenditure

Sung, Myung Jae et al.

This report aims to present macroeconomic and budget outlook for the period 2004~2008, and to analyze economic effects of prospective policy changes on fiscal account budget balance.

We faced severe fiscal deficit after the economic crisis of 1998. It was reversed soon to surplus of 5.4 trillion won again in 2002, even excluding the huge surplus of national pension fund. This seemed a good sign for stabilization of fiscal budget. However, we are still exposed to potentially overwhelming shocks that may deteriorate our fiscal balance, and, so, we need to watch out against those risks.

Korean economy is expected to grow 5.6% in 2004, 4.4% in 2005, and 5% on average in the following years which is about the same as the potential growth rate.

According to the estimates of baseline budget outlook for 2004 through 2008, the consolidated budget of the central government will record surplus of 2 trillion won in 2004, even if we exclude the huge surplus of national pension fund. In 2005, it will be reversed to deficit by about 2 trillion won. However, it, soon, will return to surplus again by about 3 trillion won in 2008. The consolidated budget including local governments will continue

to record small surplus during the next five years.

The national debt of the central government will grow from 126.6 trillion won (21.2% of GDP) in 2002 to 204.2 trillion won (26.0% of GDP) in 2006, and decline to 194.1 trillion won (21.4% of GDP) in 2008.

The net tax burden/GDP ratio will increase from 23.5% in 2003 to 24.1% in 2008, and the gross tax burden/GDP ratio including social security contribution from 27.0% to 27.9% for the same period.

A few scenarios are presented as following, to illuminate their impact on budget outlook in the medium run.

A tax increase in tobacco products by 3.2 trillion won each year is expected to generate direct increase in revenue by 16.0 trillion won in total and indirect decrease in expenditure and net lending by 0.6 trillion won in total for the next five years.

A reduction in tax revenue will generally deteriorate the fiscal stance. If tax revenue is reduced by 3.6 to 4.9 trillion won a year, the consolidated budget will turn out to be deficit of 1.4 to 4.5 trillion won which is about 0.2~0.6% of GDP. This will indirectly increase the expenditure for interest payment by 2.9 trillion won in total for the next five years. Therefore, the revenue decrease will result in deterioration of fiscal balance by 14.2 trillion won in total for the same period. In this case, the national debt level will reach the apex at 210.4 trillion won in 2007 and begin to decrease afterwards.

Introduction of subsidy for infant care of 15.6 trillion won in total for the next five years will enlarge deficit of the consolidated budget by 18.3 trillion won in total including its indirect effect of enlarging fiscal deficit by 2.7 trillion won. The national debt will continue to grow even in 2008.

Expansion of education expenditure to the extent that its ratio to GDP reaches 6% will require additional 6.6~7.9 trillion won every year and 36.4 trillion won in total to the central government alone for the next five years. This will have the consolidated budget of the central government diverge far from being balanced. Fortunately, however, it is expected that the fiscal deficit will begin to decrease again from 2007. The national debt

size will continue to grow, but its ratio to GDP will begin to drop in 2007.

Expenditure cut of 22.8 trillion won in total for the next five years will induce continuous surplus to the consolidated budget of the central government even when excluding the national pension fund with huge surplus. This change will decrease the expenditure for interest payment by 4.5 trillion won and, as a result, it will have a total effect of ameliorating fiscal account budget balance by 27.3 trillion won. The areas to be considered for expenditure cut would be roughly such as housing, transportation, subsidy to agricultural and commercial sectors, and energy and resource development.

Increase in Local Share Tax rate from 15% to 17.6% will require additional transfer of 14.4 trillion to local governments. This will deteriorate the budget balance of the central government and, at the same time it will ameliorate that of local government. Therefore, it will have zero net direct effect. However, it will increase the expenditure of interest payment of the central government by 2.8 trillion won. Unless the local governments use the increased transfer from the central government to reduce local debt, the consolidated fiscal account budget balance will deteriorate by that amount.

03-02

Projecting Changes in the Income Tax Base Arising from Long-term Population Trends

John M. Kim · Myung Jae Sung

This report offers the first instance of income tax revenue projections based on properties of the income distribution which we extract from micro data analysis. It is obvious that the actual distribution of income does matter even when the mean or other aggregate indices of the distribution are the same. This applies both to studies concerned with fiscal revenues such as income tax, and to analyses of fiscal spending in the area of social security policy including social transfers. However, existing research in Korea has relied mainly on aggregate indices. This failure to incorporate distributional information points to a fundamental disagreement between methodology and the objective of income studies. Addressing this issue head on, we suggest a new analytical framework as a useful solution to the problem of projecting income distributions. Using this framework, we also produce specific estimates of parameters that can be used to forecast income distributions.

More specifically, the significance of this report is that it uncovers several stable characteristics, or stylized facts, of the household income distribution using annual data on urban households in Korea from 1982 to 2002. Previously, the salient properties of income distributions in Korea had not been explicitly characterized.

First, we show that the distribution of urban household incomes in Korea can not only be approximated as, but practically are log-normal. We find that log-normality holds in both annual data for all households and also in each age-specific subsample for each year. Log-normality means that the entire income distribution can be represented with only two parameters, and that income distributions can be directly incorporated into policy simulations and analytical models with ease.

Second, in the course of showing that income distributions are log-normal, we find evidence that the Korean economy was already showing serious signs of a system collapse in 1997 well before the foreign exchange crisis erupted at the end of the year. Among the 21 years for which we examined annual income data, the significant exceptions to log-normal income distributions were found to be 1997 and 1998, which roughly coincide with the crisis period. A priori, one would expect the 1997 income distribution would be log-normal or close to log-normal, since the crisis erupted only at the end of the year and since virtually all post mortems of the crisis have been unable to uncover evidence of abnormalities in the economy's macro indices up to the 3rd quarter of that year. However, we show that the distribution of log-income for 1997 is marked left-skewed, similarly to that for 1998. This suggests that structural problems with far more serious consequences than a periodic recession had already progressed to a considerable degree even before the system collapsed upon the crisis at the end of the year, an interpretation that calls for further detailed investigation.

Third, we establish a basis for projecting future changes in income distributions by showing that, expressed as log-income, relative income levels between age groups in cross section are more or less invariant with respect to time. As an example of an application that utilizes this property, we show that full cohort lifetime age-income profiles can be constructed from time series income data of durations much shorter than the typical life span.

Fourth, we give an explicit formulaic exposition of the relation between

income distributions and the Gini index, which is often used to measure income inequality. We also show that this relation can be quantified with considerable precision, a result which we use to project the variance of income distributions indirectly. One limitation of this study is that we were not able to come up with a direct method of forecasting the variance of income distributions, but we believe our simple formula for determining Gini index values given any log-normal income distribution ought to compensate for this deficiency.

As a final exercise that concludes our report, we derive an actual forecast of future income distributions using the newly uncovered stylized facts of income distributions, based on which we attempt several projections of income tax revenues. Our projections up to 2032 show that the effective tax rate will be rising in the long run.

03-03

Reform of Income Tax Allowances and Tax Credits

Byung Mok Jeon · Weon Jong Hak

This study analyzes income tax burden of employees and compares structure of effective tax rates of 4 countries(Korea, the United States, the United Kingdom, Japan). This gives us useful implications on Korean income tax system. For the tax reform, we also analyze economic impacts of two major income allowances, employment income deduction, tax credits for wage and salary income earners. The analysis suggests that Korean income tax system is needed to improve equity that is continuously deteriorate due to increase of minimum taxable income level. And the economic analysis reveals that tax credits for wage and salary workers is superior to general employment income deduction. The results imply that Minimum taxable income of single household is required to set well below of current 50% level of average production worker's income and actual cost of living should be considered in the decision of minimum taxable income of bigger household(4 persons). For the actual reform, we propose no further expansion of employment income deduction for efficiency and equity. Two scenarios that reflect the policy suggestions are analyzed. The results show that there are trade-offs between broadening of tax base and tax burden of low-income earners, supporting low-income earners and tax burden of actual income tax payers.

03-04

Forecasting Local Tax Revenue in Korea

Sung, Myung Jae · No-wook Park

This report aims to forecast local taxes by analyzing revenue or demand equations, depending upon their structures. Local tax revenue forecasting is important especially in forecasting medium-term consolidated budget outlook, revenue distribution among central and local governments, revenue exchange among local autonomies, etc..

We assume that the revenue/demand equations follow log-linear models. In most local taxes, the natural explanatory variables are stock variables, which are in general not easily forecastable. The explanatory variables are selected based on whether their forecasts are easily obtainable and sufficiently reasonable. Otherwise, those variables are excluded from the data sets. Therefore, this report does not focus on the goodness of fit but on the trends of revenue and structural changes of models.

According to our forecasts, the total local tax revenue will record at 34.2 trillion won in 2003; 36.5 trillion won, 40.0 trillion won, 42.4 trillion won, 45.8 trillion won, 49.5 trillion won in 2004~2008, respectively, which are 5.45%, 5.54%, 5.47%, 5.50%, 5.54% of nominal GDP, respectively.

03-05

Corporate Tax Rate Policy: Recent Trends and its Economic Effects

Jin Soo Kim · Hyung-soo Park · Jongseok An

The corporate tax rate in Korea is relatively lower than those in major capital exporting countries but higher than those in East Asian countries. From the beginning of 2005, the corporate tax rate in Korea is scheduled to decrease by 2 percent point. But the total tax rate including local tax is going to be 27.5%, which is still higher than those prevailed in other developing countries in East Asia.

In this research, we investigate recent trends of policies on corporate tax rate not only in advanced countries but also in developing countries, compare the effective tax burden of firms in Korea with that of firms in other East Asian countries, and also analyze the effects of changes in tax burden on investment, economic growth, and government revenue. The results can be summarized as follows.

First, the effective tax burden of firms in Korea is higher than that of firms in other East Asian countries and the decrease in statutory tax rate reduces the effective tax burden.

Second, if the government would like to reduce the effective tax burden to the level prevailed in other East Asian countries, the statutory tax rate should be equal to or lower than 20% under the current depreciation and other corporate tax rules.

Third, the alleviation of tax burden increases investment in the long run

and accelerates economic growth.

Lastly, the fiscal burden followed by the tax cut might be considerably large in the short run.

One of the most important policy implications of the research is that, in order to promote investment and improve economic potentials, there should be a sharp decrease in the corporate tax rate. However, the government should be very cautious in performing tax cut. The tax cut policy should be accompanied by other measures to increase revenue or decrease expenditure maintain the fiscal sustainability. In addition, one should note that tax cut policy might not increase investment unless the investment be elastic with respect to the after-tax rate of return.

03-06

The Economic Effects of International Tax Avoidance and Evasion

Jongseok An · Joonook Choi

We investigate characteristic features as well as economic effects of international tax avoidance and evasion in this report. The results of this research can be summarized as follows.

A tax authority may use a strong investigation as a measure to reduce tax fraud on foreign source income of domestic investors. This measure is supposed not only to reduce taxpayers' incentives to avoid or evade domestic taxes on foreign source income but also to have the effects of promoting domestic investment. This follows because the measure raises expected tax burden on foreign source income while keeping tax burden on domestic source income unchanged.

However, a tax authority should be very careful in investigating domestic source income attributed to foreign investors. The tax investigation may have negative effects on investment inflows from abroad even though it might reduce the incentives for tax fraud.

A cut in tax rate on capital income could be served as a measure for the two purposes at the same time: reducing international tax fraud and inducing domestic investment. This policy is seemed to be effective regardless of the form of tax fraud. A tax cut reduces incentives to avoid or evade taxes on foreign source income of domestic investors. In addition, it also provides domestic investors incentives to invest at home instead of

abroad by giving more benefit to the investment at home than to the investment abroad. A tax cut applied to domestic source income also have the effects of reducing incentives to avoid or evade tax burden on domestic source income while inducing investment inflows from abroad.

03-07

A Study on the Effect of Environmental Tax on Industry and Trade

O-Sung Kwon · Manok Kang

Environmental problems, such as the depletion of natural resources, global warming, and the destruction of ecological system, are among the most serious problems faced by the whole world. Since the early 1990's, many OECD countries have undertaken green tax reforms by introducing new environmental taxes to protect the environment. Environmental tax has been more widely used as an instrument of environmental policy than direct regulation, because an economic instrument has comparative advantage over direct regulation in terms of cost effectiveness and pollution abatement incentive. However, it is indicated that one of the important reasons why green tax reform has no further progress over the world is the fear about the negative effect of environmental tax on international competitiveness in the industry and trade sectors.

The main purpose of this paper is to analyze the effect of environmental tax on industry and trade by using both theoretical and empirical tools. In the theoretical part, we present two different models, and technical change models, to compare the effects of environmental tax between pollution-intensive and energy-saving industries. As for economic growth, sustained growth is possible with the presence of environmental tax in the technical change model, while it is not in the model. Also, it is shown that optimal values of environmental tax and marginal productivity of physical capital

are precisely given for the optimal investment in physical capital in a dynamic model rather than in a static model. This result implies that optimal environmental tax should be determined by dynamic analysis if we take into account both economic growth and the environment. Finally, we investigate the effect of environmental tax on trade, and it shows that the environment-friendly industry has comparative advantage over the pollution-intensive industry in terms of price competitiveness in a trade sector. So, the reconstruction of industrial structure in the direction of a clean and environment-friendly way is important for both protecting the environment and maintaining the international competitiveness in a trade sector.

In the empirical part of this paper, we analyze the effect of the pollution abatement expenditure on R&D, patent, and trade balance, because we cannot analyze the effect of environmental taxes directly, most of which have not yet been established. Empirical results show that the pollution abatement expenditure does not have significant effect on the international competitiveness in industry and trade sectors. These results, however, do not deny the 'Porter Hypothesis' that environmental regulation enhances productivity and competitiveness in the long-term perspective, because of limited data. In order to examine the positive effect of environmental tax on industry and trade, we suggest to use the long-term data in the future for the in-depth analysis in this area.

03-08

Fiscal Implications of Aging and Inter-generational Redistributive Effects of Fiscal Policy

Joonook Choi · Byung Mok Jeon

This report studies (1) fiscal implications of aging, and (2) inter-generational redistributive effects of fiscal policy in Korea. Studies on fiscal implications of aging include long term projections in public pensions, National Health Insurance(NHI), welfare spending on elderly, and education. We also include discussion on fiscal policy implications of a rise in public spending.

Public pensions and NHI, two biggest components of government spending in the future, can cause redistribution of resources across generations. Hence, in this report, by using generational accounting method, potential inter-generational redistributive effects of the two systems are explicitly analysed. The study also includes analysis of how such redistributive effects depend on the method of financing the expenditure.

Korea 's current public pensions can redistribute resources from future generations to the current generation. Since such redistributive potential depends on how the expenditure is financed, this study explicitly compares the tax burden of each cohort under different regimes of financing : financing with consumption tax, financing with income tax, in addition to

the current regime of financing with pension contributions. We also include policy discussion on the reform of public pensions from the perspective of generational justice.

Potential for inter-generational redistribution of NHI depends on demographic changes, future projections of expenditure, spending structure among different age-groups, and method of financing. It turns out that, with most realistic assumptions, NHI redistributes resources from future generations to the current generation. If such effects becomes strong due changes in other factors, replacing the current insurance premium with general consumption tax can mitigate the inter-generational redistributive effects of NHI substantially.

03-09

Net Fiscal Benefit of Local Governments and Balanced Regional Development Policy

Jung hun Kim

Fiscal decentralization and balanced regional development are major reform policies currently undergoing in Korea. The nature of the policies, however, is not clearly understood in the political debate, and sometimes even in the academic debate: the main question is whether fiscal decentralization and balanced regional development can go together. In this paper, it is argued that the design of expenditure assignment in Korea is such that it offers a great incentive for fiscally induced in-migration into a large city such as Seoul. This is because, unlike other countries such as Japan, United Kingdom, and Spain that are surveyed in this paper, local governments in Korea do not provide important publicly provided private goods such as education, police, and welfare programs. For the consistency and success of the two policies, we need to strengthen the link between the fiscal capacity and expenditure responsibilities of local governments. If we focus on transfer of fiscal resources on the one hand, and pursue market-intervening balanced regional development policies on the other hand, we will end up with having less efficient local public finance system with more regional disparity.

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| 03-10 |
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Evolutions of U.S. Transfer Pricing Taxation and its Policy Implications to Korea : Legal analyses of 14 key Cases

Young hoon Ro

As the global economy recovers for the recent years, tax authorities of many governments struggle to tax multinational enterprises which are increasingly outsourcing back office services and moving manufacturing facilities to countries with lighter tax regimes. Especially, Korea suffers from increasing excess of outbound FDI over inbound FDI even in manufacturing industry for the past 4 years.

Each country's transfer pricing rule, which the tax administration establish how multinationals allocate costs and profits between national subsidiaries, tends to be globally harmonized with the need to reciprocity principle.

In this report, fourteen basic Transfer Pricing cases are analysed in the history of how the U.S. IRC Section 482 has been evolved. Especially we examine which economic method (ex. CUP, RPM, CPM, etc.) of determining arm's length price was critical in each key legal cases. We also analyse the formation of OECD Transfer Pricing Guidelines in terms of economic approach to arm's length price.

With the understanding of these U.S. and OECD history of Transfer Pricing practice, we explore the policy suggestion to Korean Transfer

Pricing Taxation.

Major findings of this report is as follows:

- 1) The concept of ALP cannot be perfect competitive equilibrium price in economics sense. The various methods of determining transfer price could be best understood as the reasonable way of deriving hypothetical prices under the specific terms and conditions of transactions.
- 2) U.S. courts tends to settle down with the compromised solution. Especially, the expert opinions based on professional economic analyses in the existing and new transfer pricing methodologies become auxiliary, and courts take the approach of ' Your guess is not better than mine '.
- 3) With the issue of OECD transfer price guidelines in 1995, the arm's length principle was emphasized as the undisputed starting point when dealing with the tax effects of transfer pricing, as was a transactional approaches the preferred application. Especially, the OECD in its concern to match approaches to transfer pricing in different parts of the world went so far as to create a new method called ' the transactional net margin method ' (TNMM) that resulted from the conversion of the US testing approach to a price setting method.

04-01

Redistribution Effect of Government Expenditure

Ki-Baeg Park · Jin Kim · Byung Mok Jeon

This report examines the redistribution effect of government expenditure on household income or consumption by dividing government expenditure into three categories; pure public goods, specific public goods, and public transfers.

We analyze the direct effect through taxes and transfers, the effect through public goods provision, and the effect through the support for housing, education, and health, respectively, by calculating the Gini index with a household survey data set.

The change of Korea's inequality degree in a recent decade could be decomposed into net transfer, pure public goods, and non-pure public goods. Net transfer, which consists of taxes and transfer income, enhances income distribution due to the increase of government transfer. Pure public goods increases the Gini index, which deteriorates the distribution equality. On the other hand, specific public support for housing, education, and health strengthens the distribution equality. The distribution effect of each one dollar spent has the order of education, to housing, to health in 1999~2003.

04-02

Social Security Policy : Long-term Expenditure Projections and Policy Directions

John M. Kim · Myung Jae Sung

We attempt a long-term expenditure projection for the Basic Livelihood Guarantee System, which by itself arguably represents Korea's public policy for low-income household support. The salient findings in this report can be summarized as follows.

First, we confirmed that an important characteristic of urban household incomes in Korea is that they are log-normally distributed. This finding was previously reported by Kim and Sung (2003), but we extend their results using the Household Consumption Survey Data. The latter dataset allows us to verify that household incomes are log-normally distributed not only for urban wage-earning households with 2 or more members, but also for non-single urban proprietors's households. This property holds for subsamples of households partitioned by age of head of household and also by size of the household, as well as for all households regardless of age or size. In particular, we report that incomes of single households can also be decomposed into log-normal distributions by partitioning the households into those aged 35 or less and 36 or over. In summary, we were able to confirm that household income distributions can be characterized as log-normal or as unions of log-normal distributions of households by size or

age of the head.

Second, not satisfied with merely verifying that household income distributions by age of head or household size can be characterized as log-normal, we construct a formal, quantified framework that shows how household income distributions can be combined or partitioned by age of head or household size. Using this framework, we show that it is possible to forecast household income distributions by age of head, given basic assumptions of future GDP growth rates and household projections, in turn derived from population forecasts. We use such a model to produce for the first time a long-term projection of household income distributions for Korea.

Third, we were able to use the forecast household income distribution to produce the first long-term projection of public expenditures for low-income household support. Up to now, this was a task that had remained unaddressed because it required that future income distributions be explicitly incorporated into the analysis. Recalling that the Basic Livelihood Guarantee System (BLGS) has seen its expenditures grow at a faster rate than either the National Pension or the Health Insurance since the financial crisis of 1997, the fact that we were able to provide at least a rough estimate of how BLGS spending will grow over the long-term can be counted as a significant contribution to long-term fiscal planning.

The policy implications that follow from these key results are threefold. First, our projection of long-term BLGS expenditures show that, depending on how fast the Gini index is assumed to rise over the long-term, BLGS expenditure growth will take place at rates that are 2 to 2.5 times higher than nominal GDP growth. As such a forecast exceeds the growth rates currently foreseen for the National Pension or the Health Insurance systems, long-term fiscal planning efforts should take appropriate care to ensure that inter-sectoral resource allocations reflect this newly identified large fiscal burden.

Second, BLGS expenditure growth rates are expected to converge to the level of GDP growth rates over the long-run, if the Gini index remains

constant. However, the past several decades' experiences of other OECD countries show that the Gini index is more likely to show a gradual increase over the long-run than remain at the current level. If so, in the worst case BLGS expenditures will steadily increase at rates that are about 2.5 times that of GDP growth, a prediction that warrants redoubled efforts by public policy to prevent deterioration unfavorable to equity in the household income distribution.

Third, examination of single household incomes show that the poverty rate among single householders aged 36 or above are 2 to 3 times as high as other households, a result that brings to mind the increasing concern over deteriorating incomes among the elderly and those approaching retirement age. In contrast, the poverty rate among single householders aged 35 or less was found to be very low. Current projections show that the number of single households will continue to increase, with most of the increase taking place among single households aged 36 or above and specifically concentrated around those in their 50s or 60s. Support from public policy to this group should thus reflect not only the perspective of policies for supporting low-income households, but should reflect a more diverse set of approaches reflecting other policy perspectives as well, including population aging and support for marginalized groups.

04-03

Income Inequality and Redistribution Policies Based on Sectoral Studies in Korea

Sung, Myung Jae · John M. Kim

Income inequality in Korea, which declined throughout the 1980s and early 1990s and remained quite stable during the mid 1990s, has sharply risen since the economic crisis of 1997 and 1998. The main factors driving this sharp increase were restructuring, a steep rise in the unemployment rate, increasing numbers of part-time workers, aging of the population, etc.

In late 1980s, the share of household heads with high school or better education increased, offsetting a decline in household heads with middle school or lower educational backgrounds. These changes accounted for the drastic decrease in the Gini coefficient in this period. In early 1990s, the distribution of education levels of household heads became quite skewed toward higher education levels, which was reflected in the gradually decline of the Gini coefficient over the same period. However, in 1998, the period of the economic crisis in Korea, the Gini rose sharply, as did income disparities among households of different education backgrounds. Since the economic crisis, the internal income inequality, that is, within-education group inequalities, have risen, although between-education group inequalities have not changed much, and Gini has remained high.

In the past, especially during the 1980s, improved education levels accounted for a large part of the decline in relative income disparities in Korea. However, it is doubtful that policies encouraging higher education

will be able to contribute much more to reducing income gaps, mainly because the distribution of education levels is reaching a saturation point in the sense that it cannot shift as quickly as it did in the past.

We have also found that the increase in the proportion of double-income households has reduced relative income inequality in Korea, at least from the mid 1990s onward. Therefore, a policy of encouraging double income households can contribute to reducing relative income inequality, an example of which would be to subsidize female labor supply, e.g., through child-care subsidies. Our results point up the need for more detailed research for concrete policy measures that support double-incomes.

Another finding of this study is the possibility that a self-employed person may bear a heavier income tax burden than a wage and salary earner, i.e., there is a question of horizontal equity. The effective income tax burden depends on income levels, number of dependents, income sources, and so forth. It is well known that most self-employed under-report their income the tax authority. Under the current income tax law, a smaller income deduction is allowed in business income tax than in wage and salary income tax in Korea. The rationale for the smaller income deduction for business income tax is that it offsets the tax evasion by at least part of the self-employed. Therefore, the justification for lower income deduction in business income tax also depends on the level of tax evasion of the self-employed.

Up to now, only the issues of the tax evasive behavior of the self-employed and the resulting inequity in tax burdens have drawn much attention, whereas only little interest has been given to the whether deduction allowances that presume tax evasion by the self-employed actually achieve equitable results. Our results indicate that this issue warrants further investigation at a more detailed level.

04-04

The Government Policy for Women's Labor Supply and Childcare Costs

Kim, Hyunsook · Weon, Jonghak

We analyze the effects of child care costs on married women's labor supply decision and working hours. For this purpose, we estimate married women's labor supply function including child care costs using Heckman's sample selection model and multi logit model based on control function approach, first and then simulate child care subsidy effects on their labor supply

The main results are ; 1) the child care costs has negative impacts on the labor participation and weekly working hours of married women, 2) the younger her children are, the bigger the labor market participation elasticity of child care cost, 3) the child care costs has larger negative impact on full-time worker rather than part-time working mom, 4) especially, when her child's age is below 5, child care costs decrease labor participation rates and weekly working hours, substantially.

When we analyze the relationship between working mom and her demand for child care facilities, we find that 1) working moms with younger than age 2 prefer nursery school and in-house nanny to kindergarten and private learning academy, 2) working moms who have children with age 3~5 prefer in-house nanny to nursery school, nursery school to kindergarten and private learning academy, 3) Even working moms who have children with younger schoolers (age 6~9) demand nanny

and nursery school for after school program.

The simulation results of child care subsidy are ; 1) the government's child care subsidy stimulates married women's labor supply, 2) the primary target of government policy should be low income married women with a child younger than age 5, 3) after school program is important for maintaining married women's job, 4) working moms prefer nursery and private nanny who provide child care with long hours and relatively cheap price. 5) the government training program for professional nanny will help married women's job participation, but it may replace widespread private nanny system, mainly served by grandparents and relatives living together, which provides very cheap and long child care.

04-05

Subsidizing Colleges and Universities in Non-Capital Regions

Jongseok An

In Korea, economic activities are heavily concentrated in the metropolitan area surrounding Seoul, the capital city. Therefore, the demand for higher education is greater in the capital region than in other regions while there are more supplies in non-capital regions. As a result, the colleges and universities in non-capital regions became to experience shortages of students.

This book investigates the problems the colleges and universities in non-capital regions are facing and examines efforts of the government to solve these problems. In addition, it analyzes the effects of government support to higher education as well as the relationship between higher education and the development of local economy. This book also contains discussions on the reform of financial supporting system for colleges and universities in non-capital regions.

04-06

A study on infrastructure financing scheme for local public services : Development impact fee system

Hyun-A Kim · Sangwon Park · Hyung-Jun Kim

This paper shows the relationship between urban growth-path and infrastructure financing in terms of local public finance. Despite the emergence of a formal urban growth control literature, there has been few analysis of the connection infrastructure financing and urban development. To support such an analysis, this paper investigates two different schemes for financing incremental infrastructure. This approach compares an development impact fee scheme to property tax system for infrastructure financing.

The model confirms the former result that development impact fee is better off property tax system in any conditions. However, under the status of city size, development impact fee may not be the answer for local public finance to provide infrastructure. Development impact fee scheme is more efficient only if the city size can be is relatively big to strength urban control. Numerical exercise ensures the properties of the model. When the city size is small, property tax system would be chosen to encourage urban growth. Main contribution of this paper is to characterize city size explicitly. Difference of discrete time choice with using general equilibrium model is found.

04-07

Political Decentralization and Fiscal Management of Local Governments

Park No-Wook

This paper empirically examines the effects of political decentralization on the fiscal management of local governments. The resumption of Korean local elections in 1995 offers a valuable opportunity to compare the fiscal management of local governments under elected and appointed local officials. By employing panel data of local governments during 1991~1999, this paper finds the following results: (1) fiscal independence rises on average; (2) local governments rely more on non-tax revenues, of which political costs are less than those of local taxes; (3) reliance of intergovernmental grants compared to local borrowings increases slightly; (4) politically competitive electoral districts experience less improvement in fiscal independence and exhibits more dependence on intergovernmental grants. These results suggest that elected local officials raise more internal revenues with an effort to minimize political costs and political characteristics of local governments become important in attracting intergovernmental grants after decentralization.

04-08

Corporate Tax Burdens

Ki-Baeg Park · Jin Kim

This report examines the corporate tax burdens of the Korean business sectors by calculating the average effective tax rates with individual firms' financial data sets. As a micro-data analysis, it uses Income Before Income Taxes (IBIT), the 5-year average of IBIT, or Operating Income, respectively, for an income proxy, and Income Taxes for a tax proxy.

We analyze the difference of the average effective tax rates between the large and the small companies. That difference is increased from 2%p in early 1990s to 6%p in 2000. However, it recently decreases to 5%p or less. The reason would be the current two-tier tax rate system and the increase of tax credits for the small companies. Especially, the difference among the industries reveals that the tax burden of the manufacturing industry is lower than the other sectors. We think the reason would be the large degree of tax credits to that industry.

Based on the analysis of the factors which affects the firms' operating income, we report that the ratio of Depreciation Over Sales increases while the ratio of Personnel Expenses Over Sales remains. Furthermore, we find that the enhancement of Non-operating Balance after the Financial Crisis in 1998, is mainly due to the falling burden of Interest Expenses.

04-09

Demographic changes Fiscal policy (II) : Effects of demographic changes and fiscal rules on tax revenues

Joonook Choi · Byung Mok Jeon · Woocheol Kim

This study is the subject of the second year of continuing project on “Demographic Changes and Tax and Fiscal Policy.” It examines what effects pension taxation system reform would bring about to the individual's life long tax burden and fiscal income flow. As it has led to circumstantial changes, the aging population has raised new challenges in terms of tax policies. As pension taxation is related with the aging population and one of the significant issues in tax policy, there is not sufficient public understanding about what effects any change in pension taxation system would have on the individual's life long tax burden or fiscal income. In particular, Korea drastically reorganized the pension taxation system from the TEE method to the EET method in 2001. Yet there has been almost no analysis on the effect of this transformation.

In spite of its significance, the fact that the pension taxation has not been actively studied much owes to the technical difficulty in reviewing burden on the pension taxation. Examining burden on the pension taxation requires getting grasp of the individual's life long income. Still there is no available long-term panel data for this purpose. Thus this study makes up of a virtual panel with available but limited information. With the use of this panel, the

study utilizes the method to examine the individual's life long income and the burden of income tax on pension. These methods make more realistic analyses possible than simply assumed analysis on the burden of income tax on the individual pension.

This study sets a condition while the current taxation system remains unchanged, and changing economic situations are linked with income tax deduction bracket, eventually expanding the bracket. Under this condition, the study presumes how far the EET method affects the tax burden of the individual and fiscal income. Though deduction on contribution of national pension significantly reduce tax burden, however, future tax revenue from pension income is estimated not to be huge. The study says the individual's life long tax burden will decrease and the extent of decrease of tax burden will differ according to income levels and households. Without considering personal pension or retirement pension, the 2001 reorganization of pension taxation system is highly likely to go beyond the effect of tax deferment and reduce the individual's life long tax burden or fiscal income to some extent.

04-10

Tax Audit and Compliance

Hyungjun Kim · Jin Kwon Hyun

When the tax authority can announce and commit to its tax strategy before taxpayers make their reports, the strategy that maximizes tax revenue typically 'cut-off rules' with proper threshold levels. We consider the economies where there are two types of taxpayers, all taxpayers in a type are identical, and taxpayers in different types differ only in the cost of tax audit. In such economies, 'cut-off rules' are shown to be still best strategies. We show that the threshold level for the taxpayer with low tax audit cost is lower than that for the taxpayer with high tax audit cost. We also show that the audit probability for the taxpayer with low tax audit cost is higher than that for the taxpayer with high tax audit cost. In the vein, the two facts in Korea after 2000 that it costs less than before to audit self-employed taxpayers and that audit probability to self-employed taxpayers decreases less than that to other taxpayers are not controversial but related.

Our experimental result says that, in a certain environment, it has a negative effect on tax compliance to provide information on audit probabilities and the tax compliance level of other taxpayers. Audit probability in our experiment was designed quite low and almost taxpayers did not report truthfully. Hence, our result should be interpreted that it has a negative effect in such an environment but not in general.

04-11

Economic Effects of Aggregate Land Value Taxation in Korea

Ro, Younghoon

Korea's excessively high and escalating land prices always have raised serious concerns among policy makers about the long-term stability of the economy. And their negative impacts of failing to provide a sufficient amount of urban lands for infrastructure, manufacturing, and housing needs have been addressed repeatedly. Furthermore, coupled with the initial concentration of land ownership among the wealthy class, land price inflation could worsen the subsequent income and wealth distribution as a whole.

While those high land prices per se might have truly reflected the extreme scarcity of a non-renewable resource due to the rapid economic development, it is doubtful whether the stabilization of price itself should be considered appropriate as a policy objective. Economists and policy makers in Korea, however, have long been interested in employing tax policies in order to solve these problems. Indeed, many administrations have relied on the change of various real estate taxes as a tool for fiscal stimulus or deterrent in the real estate market. In 1990, the Aggregate Land Value Tax (hereafter 'ALT') was introduced in an effort to stabilize the speculation-driven land price inflation and to lessen the degree of land ownership concentration.

Korea's ALT is levied annually on the individual landholding

assessment across the whole country at the three progressive rate schedules. Since the type of asset subject to taxation is confined only to land asset, it can best be characterized as a particular form of personal wealth tax, with its wealth defined only in terms of land asset holdings. It is defined as an ad valorem- according to the value - tax rather than a unit tax, and is a personal tax, as opposed to in rem- against an object - tax. Valuation becomes very important in terms of the administration and compliance cost. It is reassessed annually upon the capital market value of a land. Even if the ALT is administered by the central government and the same and uniform tax rates are applied in all the local taxing jurisdictions, they belong to local tax. Unlike many other countries, taxes levied annually on property is dichotomized into a land tax (ALT) and a building tax (Property Tax on Buildings).

The purpose of this study is to examine the economic effects of ALT; focusing mainly on change of land ownership distribution across landowners and its land price stabilization effect after the ALT introduction. Major findings are as follows:

First, when we compared the individual ALT taxpayer's land ownership concentration among three cross-sections of 1993, 1996, and 2003, the estimated Gini-coefficient which measure the area between 45 degree line and the Lorenz curve increased from 0.654 in 1993 to 0.671 in 1996 and then reduced back to 0.650 in 2003, which can be interpreted as showing no improvement in land ownership concentration during the whole period. Especially, it is worth noting that the land ownership distribution had not changed in a more equitable way even when the increase of the ALT burden was aggressively sought after by the government during the 1993~1995 period. Since it is always possible to considerably reduce the ALT burden of a household by diversifying the ownership to other members of a household with no or less landholding, we suspect that this loophole in failing to select the household as the unit of the ALT taxation contributed to the loss of effectiveness in affecting real ownership distribution. On top of that the initial tax rates were set much too low to

elicit these desirable behaviors. And political sensitivities, particularly in regard to the cash flow constraints of many middle-class property owners, appeared to preclude ever raising these rates to a level where they might significantly alter major investments and consumption decisions. As for the lessening of land ownership concentration from 1996 to 2003 it appears to result from the large-scale new home ownership increase occurred during the period of 2001 to 2003.

Secondly, according to the Vector Auto Regression (VAR) model of land price, we noticed some land inflation stabilization effect of land-holdings tax increases from 1975~2003 period. But due to the limited number of time series observations we have some reservations in concluding that the increased land holding tax burden caused the land price inflation rate to be less than they otherwise would be.

05-01

A Study on Life-time Poverty and Policy Proposals in Korea through Pseudo-Panel Analyses

Sung, Myung Jae

This report analyzes long-run and, especially, life-time poverties, and proposes policy suggestions for mitigating and stabilizing fiscal welfare expenditure. A life-time income analysis generally requires a panel data set. However, in Korea, we do not have a panel compiled for a sufficiently long period.

This report also proposes a method of constructing pseudo-panel data sets based on the two recently developed statistical properties on income distribution: log-normality of household income distribution and its stability over time. Pseudo-panels are often useful where a panel data set is not available, or where a panel data set does not deliver sufficient information due to severe data attrition over time.

Absolute poverty rate in Korea began to rise around the late 1990s. The upward shift in the poverty rate primarily stemmed from the abrupt changes in income distribution initiated in the economic crisis period, 1997~1998. The poverty rate is generally lower, as the family size is smaller, as the education levels are lower, or as the heads of households are older.

Due to mean-reversing effect embedded in the income transition rule,

household income tends to converge to its mean over time. Differences in family size, age, education level, occupations, industries, experience, productivities, and congenital abilities generally yield persistent income gaps among different household groups.

According to the pseudo-panel analyses, the life-time poverty rate is about the half of the short-run poverty rate. Therefore, some of poor households in the short run are not poor in terms of life-time income, to the extent that their discounted present values of life-time income are greater than those of life-time poverty lines. Direct subsidies may not be necessary for those households, even in the short run, since they can borrow to make up the current shortage in income from the future. This provides a room for reducing fiscal welfare expenditure. A simulation analysis using pseudo-panels shows that life-time poverty is determined almost surely within eight years. Keeping records of household income for at least eight years, we can distinguish life-time poverty from short-run poverty.

Under the current National Basic Livelihood Security System (NBLSS), pecuniary subsidies are distributed on the basis of short-run poverty, regardless of life-time poverty. An alternative is a shift from NBLSS to public loan system: the repayment obligation may be exempt only for those which turn out to be life-time poverty households.

As the mobility of income, i.e. income risk, increases, the life-time poverty rate generally falls, even if the short-run poverty rate remains constant. Therefore, increasing labor market flexibility is helpful to reduce the life-time poverty and, as a result, fiscal welfare expenditure in the long run. A negative income tax may be used to strengthen the welfare program related to poverty.

The above mentioned policy proposals are general directions. Additional rigorous studies are recommended for successful implementation.

05-02

The effect of decentralization on local public finance

Ki-baeg Park · Hyun-A Kim

This paper shows the relationship between local election and local expenditure. The other thing is applied to the growth of regional income by local public finance. From the year 1990 through 2003, the empirical results support the conjecture that local representatives by voters try to expand certain items of local expenditure such as Social Development and Construction & Others.

However, the item of Capital Transfer to Private Sector in local expenditure has been reduced after the third times of local election. And, the significant relationship confirms the connection between the increase of local share out of total expenditure and regional income growth confirms. Especially, these findings indicate the transfer effect of central government may cause the regional economy to municipal level rather than province level. For the province level of governments, the finding explains that tax-benefit ratio may not affect the regional income growth. Local public finance substantially and significantly has been changed for the efficient public provision after local autonomy.

05-03

Causes and Long-term Fiscal Consequences of Unemployment: With Emphasis on Youth Unemployment

Jonghak Weon · John M. Kim · Hyungjun Kim

We examine unemployment patterns in Korea since the Asian financial crisis of 1997, focusing especially on the troubling recent rise in youth unemployment. Our findings are developed in the three main chapters of this report.

Chapter II examines structural changes in unemployment patterns since 1997. We find that unemployment figures have subsided from the sharp peaks that marked the crisis, but have not quite fallen back to pre-crisis levels. While this pattern was found to hold for all age groups and education levels, younger workers aged 15~29 clearly suffered a disproportionately severe loss. We also find that post-crisis shifts in the Beveridge and Phillips curves are consistent with the view that structural changes in the labor market underlie the observed overall increase in unemployment.

Focusing on youth unemployment, Chapter III considers the long-term costs that persist beyond a young person's jobless experience. We argue that since on-the-job learning-by-doing is crucial to a young worker's human capital formation, prolonged unemployment is likely to result in a permanent downward shift of a young unemployed person's lifetime age-

income profile, even should she return to work eventually. We estimate that the present discounted value of the worker's future stream of such income loss comes to roughly 200 million won. From the government's viewpoint, the corresponding loss in tax revenues, reflecting the differences between the potential high and actual low income paths, amounts to 15 million won throughout the person's working lifetime. If this result applies to even 10% of the unemployed youth in Korea, currently estimated to be 400,000, the total loss for the economy would amount to 8 trillion won, or roughly 1% of GDP, which in turn costs the government 600 billion won in lost tax revenues. This makes a strong case for government "investment" in programs designed to facilitate young unemployed persons' return to work; both individual workers and the economy as a whole can reap substantial benefits from such government programs, whose fiscal impact can be neutral or even positive as long as initial program expenditures remain below the anticipated higher future tax revenue stream.

Chapter IV turns to a more analytical inquiry into a possible cause of the structural increase in youth unemployment, focusing on the increasing gap between the salary levels in large and small firms in Korea. We develop a theoretical model that shows a young person may forgo employment in a smaller firm in the presence of wage differentials tied to firm size. Empirical analysis of Korean data supports this hypothesis, and also shows that higher economic growth may also contribute to structural youth unemployment.

On a final note, we wish to emphasize that our investigation into the recent rising youth unemployment in Korea yields results that favor the human capital development approach in unemployment policy over the labor force attachment approach. This is consistent with the labor market policy experience of other developed countries.

05-04

Competition and Efficiency in Government Procurement

Sangwon Park · Jin Kim

This paper studies the relation between competition and efficiency in government procurement by focusing on the three issues, “ Multiple Award Schedule ”, “ Best Price Bidding ” and “ Leniency Program ”.

Under Multiple Award Schedule, several contractors supply the same item with different characteristics and the price is determined not by the competitive bidding but by the negotiation with procurement agent. Among these multiple providers, each consumer of government procurement will choose his favorite one. This form of contract will satisfy the demand for variety but may enforce inefficiency due to low competition and monopolistic standing of different products. This article explains advantage and disadvantage of Multiple Award Schedule with simple models and suggests policy implication on its appropriate usage.

“ Best Price Bidding ” applied to big building projects is based on competitive bidding to obtain cost efficiency. By using the theoretical results of bidding auctions which have similar structural forms to bidding procurements, we could formalize multiple regression models to analyze the impact of reservation values on the award ratio. The determinant variables of construction classes, reservation prices, and competent bidders number are proved to be statistically meaningful. Since the elasticity of the award ratio with respect to reservation values is so small that the critical

value for applying the best price bidding would be lowered on the condition of enhancing the validity of choosing competent bidders. Another possible suggestion would be the introduction of the best value bidding to the construction classes which have complex construction technologies.

The third part in this paper analyzes the effect of leniency program on collusion with focusing on government procurement. Collusion causes inefficiency in procurement by increasing price and making a firm with low technology the provider to the government. To make detection of collusion easy by encouraging a cartel member to confess, the leniency program which had been used since 1997 was revised recently in Korea. The leniency program reduces cartel sanction if a cartel member confesses his behavior and provides hard evidence. The reduction will be applied to a firm who confesses and cooperates either before or after the investigation of authority. It has shown that even though the program can reduce the cost of proving the collusion once investigation has started, it may encourage the collusion *ex ante* by allowing the cartel member to report their behavior after deviation without cost, which can be a credible threat to a collusion breaker. This complicated and doubly effect requires the design of program to be sophisticated and cautionary.

05-05

Labor market impact of income tax and public pension

Byung Mok Jeon · Yong sung Chang

This paper analyzes the effect of income tax, pension, and EITC policies on labor market. In partial equilibrium analysis, we show that expected labor income plays a significant role in person's labor market participation. The change of expected pension asset is also significant on the old's labor market participation decision. But the size of the impact is less than other social factors, such as age, sex etc. In general equilibrium analysis, EITC financed by personal income tax has positive impact on labor market participation ration and economic growth.

05-06

A Study on the Joint Distribution of Income and Housing Wealth in Korea

Ro, Younghoon · Kim, Hyunsook

The economic position of an individual or a household totally depends on her or her household's wealth as well as her or her household's income. The previous studies could not include households' wealth profile to analyze their inequality of income and redistribution issue throughout tax and transfer due to the limit of available wealth data in Korea.

We try to include housing wealth data for households using real estate tax raw data to upgrade the distribution and redistribution of income and wealth research in Korea. We merge two data set ; 1) the year 2003 consumption-income profiles, called the Annual Report on the Household Income and Expenditure Survey from Korea National Statistics Office and 2) the year 2003 taxable housing, building, land value and property taxes for all real estates of Korea from Ministry of Government Administration and Home Affairs to analyze the joint distribution of household income and housing wealth. Based on these joint data of household income-housing wealth of about 8,000 households, we analyze how households determine the ownership of houses and the value of owned houses and the relationship between household income, other characteristics and housing wealth.

The main results are ;

- 1) The inequality of income distribution is mitigated when we calculate more comprehensive income including imputed rent. This implies that high income earners do not always own expensive houses and vice versa, though there is a positive correlation between income and housing wealth. We found more than 10% of top 20% income earners belong to bottom 20% of housing wealth group and about 15% of bottom 20% income earner lines in the top 20% housing wealth group.
- 2) When we compare age profiles for income and housing wealth, we find that the age of most of highest income earners is late 40s. On the contrary, the age of highest housing wealth group is late 50s and early 60s. This imply that people save and accumulate a portion of their incomes during their 30s~40s to buy their houses. When their age reaches 50s, their housing wealth level is relatively high and owns more expensive houses.
- 3) While the income shares of households are proportional to their heads' education level, the housing wealth shares of households are not exactly proportional to their education level. The value of housing wealth of households whose heads have at least master degree is highest, but the value of housing wealth of households whose heads graduate elementary or middle school is higher than that of households whose heads graduate high school or college.
- 4) Based on after-tax Gini and effective tax rates analysis, we found that a self-employed person bears a heavier tax burden than a wage earner. We also found that the progressiveness of tax burden is mitigated when we use comprehensive after-tax income considering imputed rents and property tax rather than common after-tax income.

This paper is important as the first step to analyze the joint distribution of income and (housing) wealth in Korea. Based on these data and basic research, we can show several insights for government tax policy.

First, when we estimate households' income inequality, we may use comprehensive income context including imputed rents and it gives better and comprehensive idea for each household's economic position. For government tax policy, we should consider the progressiveness of property tax as well as income tax as long as we consider property tax as a national tax, not just a local tax.

Second, the levy of property tax and land tax in year 2003 was almost regressive and its role as a redistribution tool of real estates was very limited. If we consider new scheme for property tax in year 2005, we believe the property tax may play a role for redistribution of housing wealth.

Third, We found that there is a difference between income profile and housing wealth profile in terms of tax payers' age and liquidity constraints. Therefore, if we reinforce and increase housing property tax, we need to consider the portfolio of taxpayers' assets and their ability to pay.

05-07

Equity of income tax burdens between employee and self-employed

Byung Mok Jeon · Jong seok An

This paper analyzes income under-report problem of self-employed and optimal labor mix when we include uninsurable risk of self-employed income and a preference for being ones 's own boss as key determinants of participation in self-employment. Using a simple occupational choice model, we show that two factors can cause efficiency losses in a market. Since the optimal employee ratio is lower than the current level, we need to be cautious in further increase of income deduction only for employee. This paper also estimates effective tax burden of urban households in Korea using the data in the Households Income and Expenditure Survey. It shows that the ratio of tax burden of the employed households to general income reported in the survey is much higher than that of the self-employed households. It also estimates the difference between the real income and the reported income of self-employed households under the assumption that the employed households reported their income honestly. It concludes that the reported income of self-employed households amounts to about 70% of real income.

05-08

The Effects of Corporate Tax Burden on Investment Behaviors: an analysis using company panel data

Woocheol Kim

This report, after a brief survey on the effective tax burden of firms, investigates how the corporate income tax affects the investment behaviors of firms in Korea. Using firm-level panel data (Kis-value provided by Korea Credit Evaluation and Information) between 1983 and 2004, we calculate the effective average rates of the corporate tax, which are to be combined with empirical investment equations based on Tobin's Q model and error correction model. Both types of tax-adjusted investment equations are presented in form of an unbalanced dynamic panel data model and estimated by applying the first-difference GMM and system GMM of Arellano and Bond(1991) and Blundell and Bond(1998), respectively. Since the estimated asymptotic standard errors of the efficient two-step GMM estimator can be severely downward biased in small samples, we need to put more emphasis on the statistical inference based on the simple one-step GMM or Windmeijer(2005)'s robust version of two-step GMM. For various choices of instruments, cash flow and sales growth rate turn out to have both statistically and quantitatively significant effects on investment in fixed capital. The coefficients of the tax term, although having a negative sign, are not statistically significant in most cases. Even

in a limited case where statistical significance of the tax effect is confirmed, the tax elasticity is far below the level of economic importance, implying that the tax burden does not play an essential role in the decision of investment.

05-09

The Sectoral Allocation of Government Functional Expenditure

Joonook Choi · Deockhyun Ryu · Hyungsoo Park

This study investigates the determinants of inter-sectoral allocation of government functional expenditures and discusses its future direction. The welfare expenditure is anticipated to increase rapidly as the aging problems intensify.

Hence, the welfare expenditure should be constrained to a reasonable level, with current adjustments in the economic expenditure to avoid huge expansion of overall government spending. Our inquiry into the optimal level of SOC stock shows that reducing economic expenditure is indeed a reasonable course.

We also conclude that there is much uncertainty in future welfare expenditures that hinge on political or environmental factors. The details of each chapter are as follows.

Chapter describes the data used in this study, which are the government expenditures in the most recent OECD SNA data set. Our International Comparison of Government Expenditure(ICGE), based on the regressions of the determinants of functional expenditures, analyze whether the current expenditure structure are appropriate and considers possible changes.

Chapter discusses the effect of functional expenditure on economic growth. Chapters and each analyze the economic effect of economic

and welfare expenditure, respectively. Our analysis encompasses the possibility of future policy changes as they will be crucial factors in the allocation of government expenditures. Chapter discusses other expenditures, focusing their key determinants. We also discuss the size of government expenditure and its inter-sectoral allocation.

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| 05-10 |
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Welfare Effect of Property Transaction Tax

Junghun Kim

Property transaction taxes are important tax policy issues in Korea since their tax revenue is significant, and they have important policy implications on property tax system. In this report, both theoretical and simulation models are employed to analyze the welfare effects of property transaction taxes. In addition, the transaction taxes in other countries are reported in detail. The optimal level of property transaction taxes depends on the factors that affect the relative economic benefits between house-owning and renting. If agency cost that renters pay is high, and a part of property taxes are shifted to renters, the optimal level of property transaction taxes can be high. Also, the effective property transaction tax rate ranging between 2 and 3% is not high by international standards.

03-01

An Analysis on Tax Policies in China and Their Implications for North Korea

Han, Sangkook

In this study we try to derive some fiscal policy implications for North Korea based on Chinese experiences. There are many similar as well as different aspects between North Korea today and China when it started to reform its economy. Therefore, Chinese experiences, successful or not, will certainly be useful for North Korea in its reform process.

We derive our conclusions based on the assumption that North Korea will transform into a market economy gradually after many reform experiments during its transformation process. A new tax system for North Korea should be based on fiscal reform. The essence of fiscal reform is decentralization. Therefore the new tax system should aim to be an equitable, efficient and neutral one.

For a new North Korea tax system, we have derived the following implications based on Chinese experiences. First, North Korea has to introduce a basic law for tax and construct the tax system based on that law. Second, they have to pursue a simple system to enhance transparency. Also in the beginning the tax rate should not be too high so that they can increase tax compliance. Third, they have to encourage entrepreneurship by switching the dividend distributions of national enterprises into tax. That movement can also contribute to securing stable revenue for the

government. Fourth, VAT and other consumption taxes should be the main tax items in the earlier stage. The consumption taxes should be the basis for further tax system development and that will also help to secure the tax revenue. Fifth, they should consider a dual VAT system in which they treat tax imposition on transparent tax bases differently from other tax bases. Sixth, they have to consider the introduction of a dual corporate tax system favoring foreign corporations to induce foreign investments. Seventh, it is desirable to adopt individual income taxes, not comprehensive ones, considering North Korea's embryonic tax environment. Eighth, as tax supports for foreign investment, North Korea should consider tax reductions or exemptions such as tax credit, tax holidays, and investment allowances, etc. Ninth, founding a tax administrative body separate from the policy department should also be considered. A separate tax collecting body will enhance the efficiency of tax administration.

03-02

Taxation on B2C E-commerce under International Harmonization

Beom-Gyo Hong

E-commerce is growing rapidly worldwide. This online transaction poses a good deal of problems to the traditional tax system and administration. Especially retail transactions across borders are hardly being traced, hence, hardly being taxed.

The OECD is the leading international organization where the issue of e-commerce taxation has been actively discussed. As a result, many principles of e-commerce taxation have been derived. Remaining issues are mainly how to implement those principles in the real world. Imposing consumption taxes on B2C transactions in practice is one of the most important remaining issues.

The EU began to impose VAT on the inbound B2C transactions in July 2003. Before that time, while EU suppliers had to collect VAT on their online supplies, outside suppliers who provided online services to EU residents did not have to collect VAT. To correct this inequality using technological development that enabled to collect taxes in a remote way, the EU introduced the registration system.

On the other hand, many US State governments have reached an agreement in November 2002 to simplify and harmonize their tax systems under the Streamlined Sales Tax Project. With that movement big retail chains began to collect sales taxes on interstate sales, even though they do

not have to do that according to the Quill vs North Dakota case.

These changes in the EU and US are indications that the tax authorities are moving toward taxing on B2C transactions. This movement is also in line with the 1998 Ottawa Taxation Framework Conditions that stand against any discrimination in taxation on e-commerce.

Currently, the Korean VAT law does not have a basis for taxation on international B2C transactions that are considered to be services. Considering the tax revenue loss and the inequality between domestic suppliers and foreign suppliers when international transactions are not taxed, the Korean Tax Authority needs to amend the current law. New articles of taxable transactions have to be added and new provisions of the registration system for foreign suppliers have to be written. A simplified registration process for the convenience of foreign e-commerce suppliers shall reduce tax compliance costs. It is not necessary to set a collection threshold level for e-commerce following the example of the EU system. With those preparations the Korean government can stop the loophole in the taxation on international e-commerce.

03-03

A Study for Improvement of Korean Tariff Structure Based on International Comparison and CGE Simulation Analyses

Jaeho Cheung · Myung Jae Sung · Myungheon Lee

Since 1984, Korea has adopted an uniform tariff rate system. Korea still maintains 8% tariff rate on most of its final output and an escalated tariff system with tariff rate varying in accordance with production stage.

Using CGE model, optimal tariff structures that maximizes the representative consumer's utility under three political constraints were calculated. Those political constraints are: (a) the government consumption expenditure in each industry must be held constant in real terms, (b) the share of customs duty in the total government revenue must stay at a current level or other given levels (c) the tariffs for agricultural product and food are determined exogenously in the framework of WTO. The calculation result shows that the tariff structure should be considerably differentiated in comparison to the current one if the theoretical optimality were to be pursued. However, the gain from such optimization was measured to be almost negligible from the practical view. This result suggests that the an attempt for major changes in the tariff structure is not likely to result in a welfare increase which would more than compensate the political and administrative cost that such changes would incur.

A comparative analysis of international tariff structure suggests that Korea should actively introduce non-ad valorem tariffs especially on agricultural product and crude oil. Also, Korea may follow the path of other developed economies by adopting an escalated tariff system with zero tariff on raw materials. Korea considers divide 2 groups of semi-manufactured products according to the value added contribution to economy, and Korea imposes separate two tariff rates; zero rate like raw materials and uniform tariff rate like finished products.

In the Appendix, we estimate transformation and substitution elasticities of production functions in 28 sectors of Korean economy. The regression equations are derived from the first order conditions in optimization process using transcendental logarithmic production frontiers. The parameters are estimated by the maximum likelihood estimation method. The error terms are assumed to follow normal distributions. In so doing, we assume equality, symmetry, normalization, factor augmentation, and group-wise additivity conditions. These conditions are equivalent to assuming CET-CES production functions. We get economically meaningful estimates in 21 sectors; the remaining 7 sectors can not be estimated successfully, either because the production functions are poorly specified or because we do not have sufficient information on data sets.

03-04

Government Debt and its Management

Park, Hyung-soo · Park, Ki-baeg

Since 1997 Economic Crisis, the size of public debt in Korea has risen substantially. There have also been several debates on the size and coverage of public debt. And the empirical tests on fiscal stability conducted in this paper do not provide definite answers.

The concept, scope, and classification of government debt should be clarified to settle the dispute regarding the true size of the debt and to manage the debt effectively. For this purpose, 1) the confirmed financial liabilities of the government to the rest of the economy and the world are the appropriate concept. 2) The scope of the general government should be determined by institution as in IMF and OECD guidelines. However, adjustments of the current consolidated budget to match with the international standard as much as possible is recommended for the time being since it takes time to convert the basis from the account-based consolidated budget to the institution-based. 3) The debt statistics should be classified and reported by definite debts, potential debts, and other debts: Only the definite (confirmed) debt should be used as the official debt statistics. Government guarantees and the debts of public enterprises should be included in the potential debt category. Other statistics such as the debts of the National pension fund and financial public enterprises should be submitted in the appendix of debt statistics.

To maintain the fiscal soundness, it becomes very important to establish

a very effective management system of public debt. This paper reviews the current system of public debt management in Korea. It also compares that with IMF/World Bank's guidelines and those in some advanced countries such as Australia, the United Kingdom, France, the United States.

Base on the finding that the current system is not enough to cope with the rising public debt, this paper provides some suggestions for new management system. It is the most urgent policy agenda to establish a legal framework and organizational structure. This paper proposes a special law for public debt management and a Pan-government board for public debt management. To achieve the policy goal, ensuring analytical capability and risk management is also needed.

03-05

Tax Incentives-Theory, Estimates and Control Methods

Ki-Baeg Park · Jaeho Cheung

The theoretical models indicate that tax incentives should be given when external effects exist and can't be eliminated. The models also show that the tax incentive is superior to government direct spending in the correction of the external effects, while government direct spending is preferable to the tax incentives if strong external effects exist as in national defense and security.

We estimate the change of tax revenue with the input-output table when all VAT exempted goods convert to taxable goods. The foregone revenue is estimated to 3.2 trillion won in 1995 and 6.2 trillion won in 2000, indicating faster growth than GDP. Housing, government service, education, and health and medical service are the major sources of revenue loss when a single good converts from tax exemption to taxable item.

This paper suggests that reinforcement of existing sunset clauses, strengthening of ex ante and ex post control, and introduction of tax expenditure budget for the reduction and efficiency of tax incentive.

03-06

Local Consumption Tax and Local Income Tax in Korea

Hyun-A Kim

The purpose of this paper is to investigate whether local consumption tax(LCT) and local income tax(LIT) could be imposed on and then, if possible, how it should be applied in Korea. There is considerable dispute in both literature and administer in part. The local tax system in Korea is strongly rely on property-based taxes, which means that local governments have a limited revenue-raising capacity compared to that of the central government. In that case, property-based taxes do not easily supplement local tax revenue, because of their non-elastic features of property itself. So, there have been several trials to introduce LCT and LIT in Korea. At the same time, decentralization should be also considered.

This paper attempts to address main issue and theoretical model for LCT. In the respect of efficiency, the model explains LCT provides jurisdiction with local public goods. The intuitive result of this model contributes LCT literature. In addition, simulation analysis shows that 'final consumption expenditure' might be one of the most possible index for local consumption expenditure.

03-07

On the Real estate transfer tax assessment reform : Some Alternatives for taxation based on the real transaction prices.

Ro, Young-Hun

Korean economy suffered from the soaring housing price inflation for the past three years after recovering in 2000 to the pre-1997 economic crisis level. Prices of some condominium type apartments in several districts of Seoul metropolitan area have doubled up due to the exhaustion of available residential urban land and the strict regulations on converting land uses. Also, some macro economic factors like low interest rates and easy monetary policies played the critical role to boost the speculative demand for those types of housing.

Faced with this soaring house prices Korean government resorted to the traditional anti-speculative measures like raising the capital gains tax burden arising from home sales and clamping down on mortgage lendings. Since the Korean tax system involved in the housing market transaction have been fatally flawed in the sense that the seller 's reported sales prices reported to the national administration and the buyer 's reported acquisition prices doesn 't match, the effective tax burdens for those transfer taxes has been quite low. Both sellers and buyers involved in the real estate transaction can safely collaborate to under-report the sales price and reduce their ' Capital gains tax ' and ' Acquisition/Registration tax ' burden respectively.

The prevalence of ' fake sales contract ' limited the effectiveness of policy-oriented tax measures.

This report develops several tax policy suggestions to be taken in combination of relevant tax assessment in order for the real transaction prices to be reported to the taxing authorities by some incentive design mechanism.

First alternative is to have real estate purchasers pay their local Acquisition Tax based on the reported prices and keep these prices as their acquisition prices when they file for the future capital gains tax return after selling this property. Some myoptic purchasers might try to lessen those local Acquisition Tax and Registration Tax when buying, but have to incur heavy capital gains tax burden in future property disposal. Second alternative is to link the reported self- assessment value of Capital Gains Tax and Stamp Duty. Since both taxes belong to the national(central) taxes, the coordination efforts between local and national tax administration become unnecessary. Third alternative is to either change the self-assessment system of Acquisition Tax and Registration Tax, or make those taxes non ' ad-valorem taxes. ' Other alternatives like imposition of reporting the real transaction prices duty toward the real estate brokers have been examined.

Finally, some simulations on the revenue-neutral transfer tax rate adjustments are tried based on the disaggregated province level. This kind of ' rate-cutting-cum-base broadening ' would help the taxpayers compliance by preventing the abrupt tax increase by the above-mentioned alternatives.

03-08

A Study on the Broadening the Tax Base of Self-employed Businessmen

Jae-Jin Kim

So far, the Korean tax authority has problems to be solved: bringing into the open the tax base of self-employed businesses and reconsidering the equity of tax burden and fairness of taxation. To realize the fairness of tax administration, there are many policies that can be chosen and that could be classified with tax systems and tax administration. On the side of the tax system, the tax policy should focus on the global income tax because it has a direct relationship with the self-employed and on modifying the tax code in order to broaden the value-added tax base. The Modification details are as follows: First, tax authority should reduce the portion of simplified-filing tax payers through the expansion of the excluding simplified tax return area in the metropolitan region and reinforcement of tax administration. Secondly, it should expand the tax base by reducing the scope of VAT exemptions. Thirdly, it is necessary to prepare the basic solution for the above problem. The solution should include the policy of bringing down the standard point of global income tax step by step in order to get the effectiveness of the global financial income tax system.

On the side of tax administration, tax authority should first try to minimize the portion of the cash-based transaction in daily trade, and secondly, tax authority should make friendly environments for the enrolled tax agents through education on ethics and responsibility as a mediator

between tax authority and tax payers to make tax payers pay honestly to the tax authority. Lastly, it should prevent intentional and intellectual tax evasions using the systems of suspicious transaction report and currency transaction report. In the details of the administration matter, tax authority should try to eliminate the non-tax administrative area by allowing tax credit on the usage of advance payment cards and expanding the usage of eligible receipts. Secondly, they should try to solve the problems of the personal bad creditor and to vitalize the usage of the cash card for broadening the tax base of small amount transactions; and thirdly, increase the number of mandatory booking businesses by using the rate of additional tax on the non-booking transaction (without evidence) and reconsidering the effectiveness of the standard expenditure system, expansion of mandatory booking system. Fourthly, it should expand the right of accessibility to financial transactions by amending the real name transaction law. Fifth, it should guarantee the effectiveness of the suspicious transaction report system with bringing down the standard amount of suspicious transaction report. Sixth, the currency transaction report system currently used in the USA, Australia, and Canada should be introduced and implemented. Lastly, to secure and reinforce the ethics and responsibility of the enrolled tax agent, it is necessary to implement and complement the rules of fine on tax agents. They should take classes on ethics whenever having professional courses. To make it effective, administration should consider transferring the disciplinary right on faulty tax agents to the national tax service.

03-09

A Study on System of Public Funds in Korea

Tackseung Jun

The report studies the nature and functions of public funds managed by Korea government. First, we develop the framework through which we can analyze and characterize public funds in Korea. This is based on the contract between government and the beneficiaries of public funds. Second, by the framework developed above, each public fund is analyzed. Third, the Korea public funds are compared with trust funds in the United States. The report attempts to guide the future direction for public funds in Korea from the lessons learned from practice of the developed countries. In particular, the report leads us the way in which public funds should be managed and controlled to maximize its benefits from the perspective of public finance.

03-10

Entertainment Expenses and Tax Policy

Wonik Son

There was a significant change in tax policy for entertainment expenses in 1997. Tax deduction limit for entertainment expenses was sharply reduced from 1998 to 2000. This study examines the effect of tax policy changes on firms' entertainment activities. The relationship between the size of entertainment industry and firms' spending on entertainment expenses is also examined.

The Data set used for the analysis are “ Financial Statement Analysis ” published by the Bank of Korea, financial data for the listed companies by “ National Information and Credit Evaluation ”, and “ Report on the census on basic characteristics of establishments ” by the Korean National Statistical Office.

Results from the correlation analysis show that there exists a strong positive relationship with one year lag between firms' spending on entertainment expenses and the ratio of establishments within the industry classified as drinking places to the total number of establishments.

The regression analysis shows that there exists a positive relationship between the rate of changes in entertainment spendings and the rate of changes in tax deduction limits, and the coefficient is statistically significant.

To incorporate the competitive characteristics of entertainment activities the number of firms in the same industry was used as a proxy for entertainment competition. The estimated coefficient implies that as the number of firms within the same industry increases, the rate of changes in entertainment spendings also increases. This result means the existence of entertainment competition among firms within the same industry.

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| 04-01 |
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An Essay on the Attribution of Profits from Global Trading of Financial Instruments to Permanent Establishments

Beom-Gyo Hong

Since the beginning of the 1990s, the 24 hour-based global trading of financial instruments began to flourish over the world. Today it is not difficult to find the presence of those multinational financial enterprises operating in various places of the world. These multinational financial enterprises like investment banks are making a huge sum of financial profits from the global trading of financial derivatives and other financial instruments. Hence the attribution of these profits to permanent establishments has become one of the most important issues to be addressed from the perspective of international taxation.

OECD is currently taking on this issue with taxing authorities of its member countries and international financial powerhouses. Basically functional analysis and factual analysis will be the criteria for the attributions. The role of capital/risk assumption and the function of risk management are emphasized to be the most important factors in their contribution to profit making.

We can derive some policy issues from the OECD discussion on this matter. First, the concept of permanent establishment should be properly defined for these kinds of financial trading. Second, the ways to attribute

profits to dependent agent PE should be clearly harmonized. Third, the way to choose the best method rule for the attribution of profits should be refined. Fourth, the ways to hedge the risks within the financial group should be consistently dealt with. Fifth, when the profit split method is applied, how to share the losses should be addressed. Sixth, we have to reevaluate the unitary taxation as an alternative for the current transfer pricing system.

The emphasis on capital in the attribution of profits is not a favorable factor for less-capitalized countries like Korea. Because Korean financial companies are not yet the equals to international financial powerhouses, nor is Korea yet suitable for a regional financial hub like Hong Kong or Singapore.

Notwithstanding the Korean government should be more specific in providing guidance on transfer pricing by revising the Adjustment of International Taxes Act. Because the discussion at the OECD on the attribution of profits is not concluded, it is not easy to refine the system. But to reduce the uncertainty facing the global players are one of the goals of Korean government to meet the global standard and it also is a desirable policy direction.

Korean tax authorities also had better be prepared for the introduction of unitary taxation system, though it may take some time to be realized. The current system based on Arm's Length Principle shows a lot of problems in actual application. Economically integrated European countries are showing renewed interest on the unitary taxation system. The pros and cons of unitary taxation should be studied and the best strategic road map for the Korean tax authorities should be carefully managed. The minimum effort to achieve those goals is an active participation in international tax fora.

04-02

A Study on Improving the Medium-Term Fiscal Plan System

Park, Hyung-soo et al.

The Korean government adopted MTEF(Medium term expenditure framework) in 2004. This research addresses key policy issues and provides some suggestions for success of this framework in Korea.

First, this paper start analysis of OECD countries' experience. We try to figure out political background of adopting or reinforcing the MTET in Sweden, Canada and U.K. And we evaluate qualitatively and quantitatively its performance in these counties. We also find some problems or difficulties that we have to face in managing the MTET.

On the basis of this study, we addresses one-by-one key policy issues in Korea including macroeconomic projection, planning period, aggregate fiscal target, safety margin, roles of National Assembly and its relationship with the Administration. this paper includes some suggestions related to these policy issues.

In addition, we remind the necessity of cyclical safety margin or budget margin and try to calculate its size in Korea though^r '04~'08 the National Fiscal Management Plan did not consider it clearly.

04-03

A Study on the Tariff and Industrial Structure in Korea

Jaeho Cheung · Deockhyun Ryu

The purpose of this report is to examine the effect of the tariff rate policy on the industrial structure in Korea. To this end, we construct a time series of the effective rate of tariff protection and perform an empirical analysis about the industrial structure with this newly constructed tariff rates.

The empirical results show that the effective rate of tariff protection have influential effects on the trade specialization index and the degree of dependence on import, as desired. Thus, it is advised that we raise the effective rate of tariff protection on the major industries. For example, we can have two-part tariff rates according to the structure of industry: zero rates for lower value-added products like raw materials and uniform tariff rates for higher value-added parts and materials. We can also adjust selectively a uniform tariff rate to solve a lower tariff rate phenomenon in raw and materials than in finished goods.

So far as industrial structure is concerned, the emphasis on tariff policy should be placed on fostering the domestic growth industries like a higher value-added intermediate goods rather than protecting weak industries.

04-04

A Study on Tax System and Implementing Strategies for Development of Logistics System in Korea: Focusing on Transportation Sectors

O-Sung Kwon · Hun-Koo Ha

The major characteristics of Korea's national logistics system are summarized as constant increasing share of freight-trucking and decreasing the share of rail freight transport.

Korea's national logistics cost amounted to 67.4 trillion Won in 2001, and this figure accounted for 12.4% of GDP. Compared to the ratio of total logistics cost to GDP in the US and Japan, that of Korea was high. The primary factors to determine the national logistics cost are related to the freight transport. Those factors are the efficient inter-modal freight transport system, the level of freight transport share balance among transport mode, and the investment in logistics industry and logistics infrastructure including road, railroad, ICD(inland container depot), and warehouse. The outsourcing level in logistics industry such as inventory maintenance and warehousing part, and the logistics industry's accumulation of human capital are also important factors to determine the national logistics cost.

In order to reduce the logistics cost, government should improve the inter-modal transport system, strengthen the competitiveness of rail freight

transport, and increase the share of commercial freight-trucking in the road freight transport. Government should also deregulate the legal and administrative rules in inventory and warehousing sectors, promote the logistics-outsourcing activities of various manufacturing companies to the 3rd party logistics companies.

Also, we focus on studying the logistics and tax system of the transportation sectors, which take the largest portion in the whole logistics system, and we investigate implementing strategies to achieve the important goals of Korean government for building the "Hub Korea in North-East Asia". The transportation sectors in this paper include cargo vehicle transportation, rail container transportation, and domestic marine shipping industry. We hope this paper could make a little contribution for advanced study on reforming the tax scheme to improve the logistics system in Korea.

04-05

Reform Proposal for the Dividend Taxation

Jin Soo Kim

In Korea, the imputation method is used as the relief measure of double taxation for individual shareholders, and the dividend exclusion method is used as the relief measure of double taxation for corporate shareholders. However, if the double taxation of dividend is not fully relieved or the tax system does not maintain neutrality after the relief, it would have an influence on firm's behavior such as the choice of business form, the preference of debt to capital, and the distortion of dividend policy.

This study shows that dividend taxation has several problems as follows. First, the relief of double taxation is not sufficient, because the corporate income tax that was levied at the corporate phase is not fully relieved at the shareholder phase. Second, since the tax burden of high income bracket is not so high as compared with that of low income bracket, this is utterly opposed to the purpose of individual income tax, fair taxation and income redistribution through the progressive rate of tax. Third, there is the discriminative tax treatment of common corporation and holding company in enforcement of the dividend exclusion method. Fourth, taxation is not neutral in choosing the form of business, private business or corporation. Fifth, the dividend taxation does not adhere to neutrality between dividend and reservation of profits, which makes firms prefer reservation of profits to dividend. Sixth, the dividend taxation does not adhere to neutrality between capital and debt, which makes firms prefer debt to capital.

This study suggests the following reform measures to rectify the current problems. First, if the imputation method is still applied, the gross-up ratio that is calculated by effective tax rate should be used, and as a second best the gross-up ratio that is calculated by higher rate of corporate tax rate could be used. For the long term reform, the mixture of the dividend deduction method and the dividend exclusion method could be used in substitute for the imputation method. Second, the same proportion of exclusion of gains must be applied to holding company and common corporation. Third, the problem that the tax burden of low income bracket is not progressive could be solved by lowering the basis amount of global income taxation. Also it must be permitted to choose separate taxation or general taxation even if the financial amount is less than the basis amount of global income taxation. In the long term, global income taxation must be abolished and then every taxpayer must be liable for general taxation by adding up all incomes. Fourth, the rates of withholding income tax on dividend or interest must be lowered down to the lowest rate of income tax. Fifth, since the reservation of profits seems to be dividend indirectly, the income tax on transfer of shares should be imposed whether the firm is listed or not, or whether the shareholder is major or not, and whether the period of possession is long or not.

04-06

Corporate Burden on Quasi-Taxes and Policy Direction

Won-Ik Son · Jaeho Cheung ·
Hyeong-jun Kim · Sang-heon Kim

The scope of quasi-taxes can be broadened when quasi-taxes are defined as firms' involuntary and pecuniary burdens other than production costs. These burdens include both burdens required by Framework Act on the Management of charges, such as charges, fees, dues, public imposts, rental fees and commission, social security related insurance premium (national pension, employment insurance, industrial disaster insurance premium, medical insurance premium), negligence penalty, fine, fine for traffic related offenses, and compulsory performance deposit: and burdens that are not required by any laws, but are in practice almost involuntary, such as certain types of donations and gifts.

With certain benchmarks, quasi-taxes in a broad sense can be slightly narrowed down into ones in a narrow sense. At this point, the pecuniary burden includes 1) charges, contribution, money deposited, dues, surcharges, fund, donation and so on which are not covered by burden of beneficiary or burden of causer, 2) corporate burden on social security related insurance premium, and 3) involuntary donation. Yet, when it comes to rental fee or royalty and commission, they are not regarded as quasi-taxes in a narrow sense since they are just rewards for direct profit in terms of goods and services.

This study tries to grasp the picture of charges/fees system of foreign countries and its current management status. For easy comparison with that of Korea, foreign systems are examined with the basis of judicial grounds, assessors, objects imposed, objective of imposition and usage case by case. This is the first attempt to carry out an analysis on the charges/fees of foreign countries as a whole. It is expected that the results of this study can be utilized as a fundamental outcome for the further study on the charges/fees of Korea.

In addition, the study does a survey on member companies of the Korea Chamber of Commerce & Industry to grasp the degree of corporate voluntary willingness to donate. As of the end of 2003, the proportion of corporate involuntary donation decreased from the 1997 level. It is a desirable result driven by positive consequences of the government's policy to regulate a reckless urge to donation and desirable change of corporate attitude toward social contribution at the same time.

As of the end of 2003, the proportion of quasi-taxes in a broad sense reaches 23.1516 trillion won and that of quasi-taxes in a narrow sense stands at 16.9212 trillion won. Social security related insurance premium (14.830 trillion won) took the biggest slice from the quasi-taxes. Still under the corporate income tax law a variety of quasi-taxes paid by companies are defined as costs, allowing deduction of expenses. Thus with the exclusion of tax amount which are reduced by deduction, the total amount of quasi-taxes in a broad sense is 16.9047 trillion won and that of quasi-taxes in a narrow sense is 12.3565 trillion won. Among them, when the social security related insurance premium (10.4266 trillion won) is excluded, the amount of quasi-taxes in a broad sense is approximately 6.4781 trillion won and that of quasi-taxes in a narrow tax is 1.9299 trillion won. On top of this when involuntary donations are added, the proportion of quasi-taxes in a broad sense records 17.216 trillion won and that of quasi-taxes in a narrow sense records 12,4734 trillion won. The exclusion of social security related insurance premium reduces the amount of quasi-taxes in a broad sense and that of quasi-taxes in a narrow sense to 6.5950

trillion won and 2.468 trillion won, respectively.

This study 's theoretical and empirical grounds illustrate that charges/fees with tax characteristics have generally reduced and charges/fees with non-tax characteristics have grown year by year. Under the current circumstances, it requires consistent attention to the increase in charges/fees with non-tax characteristics to regulate charges/fees among quasi-taxes. In other words, this study suggests policy implication that without control it will be difficult to reduce the amount of charges/fees since charges/fes with non-tax characteristics have continuously grown up.

05-01

The US Tax System on Financial Derivatives : Its Implications to Korea

Beom Gyo Hong

As Korean financial derivative markets are maturing, it is time to reconsider the no capital gains tax policy on financial derivatives. For that purpose, we have reviewed the US tax system on financial derivatives. The US tax system is considered the most sophisticated system in the world as far as financial derivatives are concerned. But at the same time, it is criticized as an inconsistent system that is far from perfect. Main reasons for its inconsistency are the diverse and complex strategies of derivative uses and rapid development of new ones. Despite its shortcomings, the US experiences with its long history of tax imposition provide a good guidance.

Based on our review of the US system and consideration of the basic differences of the tax systems between the two countries, we suggest the Korean tax authorities to pay special attention to the following aspects.

It is important to introduce a new tax system so that taxes are imposed on combined income from both derivatives and its related underlying spot market instruments. If capital gains tax is imposed on capital gains from derivative trading only, then market function will be impaired. Hedging will become imperfect and arbitrage transactions will be difficult to carry out due to the uncertainty caused by such tax system. For example, the current tax exemption on capital gains from stock trading will be a

deterrence to introducing a capital gains tax on KOSPI 200 futures. It is vital to introduce a capital gains tax system that equally applies to both spot and derivative markets.

In that sense, capital losses from one market, either spot or derivative, should be allowed to be deducted fully from the gains of matching trading in the other market. For speculative trading, deduction up to a certain limit had better be allowed, because speculative trading provides liquidity to the market.

Determining income characteristics of capital gains is not so important in Korea because the Korean tax system is not a comprehensive one - only listed incomes are subject to tax - and capital gains are not specially treated as in the US. For the timing of income recognition, we can adopt mark-to-market system for exchange traded derivatives.

In the near future, it is not probable to introduce capital gains tax on stock trading for financial and political considerations. That means it is not desirable to introduce capital gains tax on derivatives in the near future. Then it is conceivable to introduce transaction tax on derivative trading as an interim measure, given the high volume of derivative trading in Korea.

05-02

A Study on the Feasibility of a Profit-and-loss Transfer Model of Group Taxation in Korea

June-Q Lee · Jin Soo Kim

Group taxation regime should be introduced in Korea in order to improve the international competitiveness of corporation, because most of OECD countries have been introduced it. From this point of view, there is few assertions that raise an objection to the introduction of group taxation regime. Most studies have rested their proposals on premises that the consolidated return model of group taxation should be introduced, because it emphasizes the unity of business conglomerate and it is introduced in the major trade partners such as the U.S. and Japan. Although there are several reasons that group taxation regime is not enacted, the most important reason might be the complexity of a consolidated return model of group taxation.

Thus, this study reviewed the feasibility of a profit-and-loss transfer model of group taxation as an alternative proposal of the consolidated return model of group taxation. The consolidated return model of group taxation emphasizes the unity of business conglomerate, and has theoretical advantage because it can handle such concepts as the aggregation of tax benefit, deferral of gain or loss of intercompany transactions, and investment adjustment. On the other hand, the profit-and-loss transfer model of group taxation permits the corporation of conglomerate to offset of loss against profit as the tax incentive system. In terms of the reflection

of the economic substance, the consolidated return model of group taxation has more attraction.

In terms of simplicity, however, the profit-and-loss transfer model of group taxation has more attraction. The provisions of statutes in the U.S., Japan and Australia that introduced the consolidated return model of group taxation are about hundreds of pages and they comprise the complicated provisions of the prevention of tax evasion. On the other hand, the provisions of statutes in U.K. that introduced the profit-and-loss transfer model of group taxation are about thirty pages. A great deal of the provisions are about the consortium group taxation and the schedule system for the classification of income.

In the case of the introduction of the consolidated return model of group taxation, the expansion of tax revenue and the reduction of tax revenue are counterbalanced through deferral of gain or loss of intercompany transactions, investment adjustment, and the aggregation of several bounds except the reduction of tax revenue through the offset of loss against profit. Thus, if the profit-and-loss transfer model of group taxation is introduced and the offset of loss against profit is prescribed, the reduction of tax revenue seems to be not so large as the case of the consolidated return model of group taxation.

In this study, if we admit the fact that the profit-and-loss transfer model of group taxation is not so different from the consolidated return model of group taxation in terms of the tax revenue and is legislated easily, the profit-and-loss transfer model of group taxation might be adopted. In addition, this study reviewed what kind of provisions is necessary when the profit-and-loss transfer model of group taxation is introduced.

05-03

Policy Response to Tax Avoidance Transactions through DFI in Korea

Ro, Younghoon

In 2005, Korean National Tax Service decided to tax the return on the Japanese currency savings account combined with forward exchange contract. It is the first ruling that the fully hedged foreign currency denominated savings account income as a whole can be treated as interest and subject to withholding tax. The decision was made just one month ago even if the product have been sold by the commercial banks more than 3 years ago with the advertisement that the foreign exchange gain guaranteed by the forward contract are tax-exempt. The purpose of the study is to examine the challenges posed by the Derivative Financial Instrument to individual income tax system in Korean setting. Also, it recommends some interim measures like introduction of transfer tax on regulated financial futures and taxing authorities' publishing tax-avoidance scheme notices to public, before the full-scale tax reform on income tax system incorporating mark-to-market valuation and accrual based tax accounting.

05-04

A Study on the Tax Remedy in Korea

Sangkook Han · Hun Park

The Tax Remedy System serves two functions: to correct the errors of tax administration and to correct any infringements of rights which might have occurred as a result of the decision by the tax administration. In this regard, this study reviews the current system of appeal of dissatisfaction and suggests some possible measures for improvement as follows. The measures aim to enable more efficient procedures, quick decisions and a relief of rights by way of simplifying tax remedy structure and specializing the tax relief system.

First, it needs to activate the procedure of the judgment on propriety before tax levying. For this, it is necessary to enlarge the scope of subject to request. In case of the current national tax, requesting the judgement on propriety before tax levying is limited if the taxpayer takes some responsibility or if anticipating tax amount is less than certain amount of money. It is not appropriate to limit the scope of the subject to request except that the case is specified in Article 81, clause 2 of Framework Act on National Taxes. It needs to extend the period of request up to sixty (60) days, which is currently varied as twenty (20) days in case of national tax and customs, and thirty (30) days in case of local tax. The committee which judges the propriety before tax levying needs to become a decision-making one. It is necessary that members from outside outnumber members from inside, and that regulation securing the term of office of the members is

made. The system for raising an objection should be repealed.

Second, it is necessary to consider settling a dispute by reconciliation or mutual consent, however, it is premature to carry out the plan under the current tax law.

Third, although the integration of the request system for examination by the National Tax Service and the adjudgment system by the National Tax Tribunal have some reasonable grounds, it will cause the sharp change of present organizations. It is better that the current selective appeal system of the request for examination or the adjudgment continues, although there are some points to be changed.

Fourth, it would be necessary to establish Tax Tribunal covering national tax, local tax and customs in the long term, and it needs to establish the Local Tax Tribunal covering only local tax for the time being. When Tax Tribunal is established, the branches of it should be located in the every district where the High Courts are. It should be organized not under the Ministry of Finance and Economy or Ministry of Government Administration and Home Affairs but under other organization.

Last, the system of the request for examination by the Board of Audit and Inspection should be abolished. Although it would be abolished, the Board of Audit and Inspection could have a role in supporting for taxpayers' rights with the function of inspection for tax authorities.

05-05

Taxation of Financial Income and Financial Services

Jongseok An · Kwon O Sung

This book examines theories, current systems and practices of taxes affecting the efficiency of financial sector. It investigates optimal tax theories about capital income tax at the individual level. Especially, it focuses on the need of capital income tax and the optimal tax rate if needed. The effect of tax incentives is also examined. In relation to the consumption tax, the book summarizes theoretical studies on whether to impose VAT on financial services and the effective ways to tax. The book also summarizes the current system and practices, the recent trends of taxation on capital income and financial services.

In conclusion, this paper suggests to reconsider the comprehensive income tax rule in Korea and to abolish the tax incentives to the savings of old generations. In addition, it concludes that VAT should not be imposed on financial services. The policy goal of consumption tax on financial services can be by individual income tax on financial income.

05-06

A Study on the Preferential Trade System and its Economic Effect

Jaeho Cheung · Myungheon Lee

Some developed countries maintain special tariff preferences, namely the Generalized System of Preferences (GSP), for imports from developing countries. Korea is granting preferential tariff treatment on imports of 87 products originating in the Least Developed Countries (LDCs).

This paper examines the economic effects of introduction of GSP program on Korea economy. The results suggest that considering the relationship between international trade and poverty reduction in the LDCs, the poverty situation of the LDCs, total volume of import from LDCs to Korea, Korea may grant preferential tariff treatment on all imports from LDCs except some agricultural products and oil. Korea may start GSP scheme to developing countries after conclusion of WTO DDA negotiation and a number of FTA, especially the FTA with China.

05-07

On the introduction of Performance Management into the public sector

Park, No Wook

This report investigates various issues related to the introduction of performance evaluation and incentives into the public sector. Particularly it is centered on the performance budgeting that aims for enhancing links between performance information and budgeting. This paper can be divided into two separated parts. The first part discusses general issues related to the introduction of performance evaluation and incentives into the public sector by utilizing the framework of principal-agent model in economics. It also analyzes actual cases which implemented performance management system. The first part suggests that, in order to introduce effective performance management system, attention should be carefully given to the nature of tasks and environments where tasks are performed. The second part analyzes the results from 2005 Self-Assessment Budgetary Program(SABP) designed after PART of the United States. It provides evidence on the current status of performance information and the utilization of evaluation results in the line ministries. It also discusses future directions for the SABP.

The Current Progress and Future Direction of Fiscal Policy in North Korea

Il-Young Lee · Yeon Chul Kim · Moon-soo Yang ·
Keonbeom Lee · Namju Lee · Byung You Cheon

This study analyzes the changing features and future prospects of North Korea's fiscal policies during the country's economic transition towards marketization. We examine the characteristics of North Korea's current fiscal system in order to formulate a desirable path for future reform.

It is inevitable that North Korea will suffer macro-economic instability during the early stages of marketization. Inflation will likely be a serious concern and if the decline in production and employment continues longer than expected, reform efforts could be delayed by the people's resistance. Therefore, it is desirable that North Korea gradually adopt an expansionary macro-economic policy in the early stages of transition. However, in implementing an expansionary policy, it is necessary to set a target level of inflation and fiscal deficit that do not hinder sustainable growth.

Chapter III studies the objectives of fiscal reform for transition economies. In particular, it focuses on the implementation of a gradual economic reform, without rapid privatization, in order that stable macro-economic conditions can also be sustained. Two particular reform policies are emphasized in this chapter: First, the increase of the local government's role to promote marketization through the decentralization of fiscal system. Second, the severing of financial relationship between the government and state-owned enterprises, and thereby, tightening budgetary constraints.

Chapter IV deals with the role of financial institutions, which is expected to change significantly from being a mere conduit for central planning to a resource allocation and investment selection mechanism. However, banking crises and accumulation of non-performing loans in the banking sector are prevalent in many transition economies. In this chapter, we review the problems of financial sector reform in other transition economies and also take a look at the current status of North Korea's financial system. We recommend a number of key changes for achieving a desirable financial system in a transition economy: a transition from a mono-bank system to a two-tier bank system, privatization of commercial banks to enhance efficiency, defining the role of a central bank, assurance of financial safety, establishment of specialized banks, and a slow and gradual development of securities markets.

In chapter V, we propose an outline for North Korea's enterprise reforms, including the expansion of state-owned firms to become privately held commercial enterprises. The reform of state owned enterprises requires an introduction of new industrial policy and change of priority in investment policy. To promote a more privatized market, a new tax system that can accommodate corporate taxes, personal income taxes and indirect taxes needs to be introduced.

Chapter VI deals with the incentive problems of a transition economy. The socialist economy structure of North Korea consists of a state-controlled resource reallocation system and budgetary system. The incentive structure of North Korea's resource reallocation system should be considered as a very important factor for its reform process. To secure a sound budgetary system in North Korea, it is necessary to impose discipline and economic incentives on both sides of revenue and expenditure. The subsidies to firms and workers and incomes from them should be based on the economic incentives to overcome soft-budget constraints and induce workers' incentives. De-centralization for economic incentives should be controlled by a hierarchical administration with both monitoring and evaluation abilities.

In chapter VII, we analyze an agricultural reform and its relationship with fiscal reform. While agricultural activities have played an important part in economic development and system transformation, public subsidies have largely been attributable to driving the agricultural development. According to the results of some comparative studies, North Korea's financial problem is close to the former USSR's, and the tax structure on producers is similar to China's during the Maoist era. In pursuance of a smooth development and transformation in North Korea's agricultural sector, the shortage of grain has to be relaxed through the increase in purchase prices, in the short to intermediate term. And, from mid to long-run, it is necessary to transform government marketing firms to pure private ones. Finally, in the long-run, to narrow the gap between domestic and foreign prices, structural policies need to be implemented.

Institutional Reform for Improving Public Expenditure Management in Korea

OCK, Dong-Suk

Legal and institutional frameworks of PEM(Public Expenditure Management) in Korea do not have evolved over the decades of the rapid-high economic development. Since the serious economic crisis in 1997, Korean government has begun to focus very ardently at reforming its government systems. Korean government is now facing the challenge of improving fiscal discipline, bringing resource allocation in line with development priorities, creating an enabling environment for public financial managers, and protecting due process.

The study aims to suggest several policy initiatives which guide Korean government in reengineering the institutional arrangements that affect incentives for better budgetary outcomes, including mechanisms that improve aggregate fiscal discipline, strategic prioritization and operational efficiency. The suggestions made in the study are based on new approaches to public sector management which seek to introduce the market mechanism and business-oriented techniques in the name of new public management. The suggestions for increasing transparency, effectiveness and soundness in the PEM process are summarized as follows.

- (1) In order to increase transparency and efficiency in the PEM process it is essential that the coverage of the consolidated public finance should correspond with that of general government sector, and the general

government sector should be defined on the basis of institutional units not of the administrative, legal or accounting types. At present, the consolidated public finance in Korea is understood according to the criteria of accounting units such as general account, special accounts, and the public funds. However, these criteria do not cover the true scope of the consolidated public finance.

- (2) It is important that budget items for appropriation should be reclassified, so as to reinforce administrative classifications and cross-classifications of budgets and to allow the systematic analysis and coordination of individual programs. To modernize the framework of budget items, the various organisational units such as departments, bureaus, directorate, and other major administrative subdivisions should be distinguished, so that individual projects can be allocated to different organisational units and eventually cross-classified.

The structure of budget items currently employed in Korea is not effective in terms of managerial responsibility by organisational unit, cost estimation by project, diversity of cross-classification, or project coordination. After the structure of budget items has been systematically arranged, the individual projects should be classified by objective and function, and then the overlapping projects and project periods should be examined and coordinated properly. To classify objectives and functions of projects systematically, criteria should be provided for classifying departments strategic objectives, their performance plans by year, and their project aims by year.

- (3) One of the prerequisites for effectively preparing a budget is that the Bureau of Budget provides the individual departments of central government as early as possible with a strict budget ceiling which they have to follow. Once the budget ceiling is given, each department and agency can be motivated to make their project plans as tightly as possible with the ceiling in mind.

- (4) In order to increase the practical efficacy of the mid-term fiscal plan, it is essential that it is based on a multi-year framework, so that the multi-year budget amount can be estimated and earmarked by year and by expenditure area. In order for the mid-term fiscal plan to be practical and effective, the mid-term budget ceiling should be defined by ministries and functions.
- (5) The multi-year appropriation should be applied more widely in the projects, whose implementation take more than one year. Under the current one year-budget framework the best way to prepare a budget which will allow contracts between government and private sector to be implemented in a stable way is to apply the multi-year appropriation system.
- (6) Performance contract between the Bureau of Budget and each NDPB(Non-Departmental Public Bodies) should be adopted. That could introduce the output-oriented budget control, competition and benchmarking, pricing and fee concept in the public sector, changing the incentive structures of public employees.

US System of Consolidated Return

Lee, June-Q

This report summarized the evolution and the current system of US consolidated tax return. Also this report analyzed the characteristics of the US system and its implication to the introduction of the consolidated return system into Korea as follows:

First, the US provisions of consolidated return are mostly contained in the Treasury regulations other than Internal Revenue Code. However, considering that US legal system and tradition are quite different from those of Korea, it is required to avoid legislations of comprehensive authorization by the Congress to the government in Korea for the consolidated return.

Second, the US consolidated return system is mainly based on the single entity concept, which is also needed theoretically for Korea to adopt. However considering that the single entity concept requires to cause considerable cost to the taxpayers and taxing authority, it is advisable to minimize the adjustments which should be made on a consolidated basis in consolidated return system of Korea.

Third, as in US system, anti-abusive regulations in Korea could be prescribed comprehensively, but they should be prescribed pattern by pattern.

Fourth, US consolidated return system does not intervene to allocate tax liability among the members of the affiliated group. Considering the difference of legal system, the available methods for the allocation of tax liability should be prescribed in the Commercial Code or the Securities

Transaction Law in order to protect minority shareholders and creditors.

Fifth, among the US tax provisions which are applied for corporations as legal entities other than consolidated groups, the concepts of stock basis, earnings and profits, built-in losses, limitation following an ownership change do not exist or quite different from those of Korea. Before the introduction of such concepts for the consolidated return into Korea, the existing provisions for corporations should be adjusted properly.

Sixth, the US consolidated return system has various anti-avoidance rules against exploiting losses occurred before consolidation such as SRLY and reverse acquisition which are required because the use of common parent's losses are not limited, whereas the use of subsidiaries' losses are limited. For simplifying the system, it is advisable to treat common parent's losses and subsidiaries' losses indifferently in Korea.

Seventh, the US consolidated return system is not regarded as a tax incentive system but the system for tax neutrality. As in the US, it is advisable that the Korean system be optional, but once adopted, applied consistently. Moreover, imposing additional taxes for the consolidated return is not advisable considering that the consolidated return system is not for tax-incentive.

A Study on Economic Systems for Sustainable Development

- Focusing on the Transparency of Financial Transaction & Taxation in the US

Seung-Hun Chun

The aim of this paper is to analyze the rules of economic activities in the US with respect to transparency. To this purpose, interviews were held with people who come from different professions, such as businessman, CPA, licensed real estate agent, and lawyer, who have been working in the US for over 20 years. Then the specific details were supplemented with documents.

It is observed that the basis of systems that discipline the economic activities in US lies on securing transparency. To study the levels of transparency in their process, the economic activities have been analyzed in three aspects: 1) financial transaction, 2) property management, and 3) accounting management of corporation and sole proprietorship.

The transparency of financial transactions is secured by application of the following three mechanisms. First, in principle, the bank obtains the financial records through the personal checks and credit cards transactions that provide both recipient and account holder's information and keeps them as reference. There is no underground private money market in US and almost all the financial transactions are done through financial institutions. Secondly, it is required to report to IRS(Internal Revenue Service) for the financial transactions over a certain amount - the

transactions over \$10,000 or \$5,000 with suspicion. Also, it is required to report to the tax authorities if a wage over \$10(\$600 for a payment of winning from gambling) has been paid to another party. At last, the personal credit history built from financial transactions, such as loans and payments is stored in the database and used for credit rating.

In the property management, on the basis of financial transparency, the real estate trade and price revaluation system secure the transparency and credibility of the real estate value for taxation. The real estate market in US is a perfectly competitive market for the reason that the property profile including value is completely open to the public and that anyone could intermediate the deal. According to the procedure of real estate transactions, lawyers from both seller and buyer sign the written contract that contains the price and conditions of the sale, and the transfer of payment is managed as an escrow account and settled by the lawyers at the closure of the deal. Under this circumstance, a false statement of the deal cannot be achieved in the perfectly competitive market and therefore, the fair taxation is realized. When it comes to assessment of property tax, the fair market value is computed through equalization system of state and local governments that has developed on the basis of the history of real estate sale prices.

On the basis of the transparency in business activities, the US system is analyzed to be consist of additional two subsets which are the autonomy of individual economic activities and ex post corrective mechanisms by government. In the view of guaranteeing the autonomy of individual economic activities, the whole process is under the individual's freedom to earn and spend money, and to file the income and pay the taxes. Individuals and enterprises do not have any relations with tax authorities until they become a selective target of tax audit. This is the reason that business men have no acquaintance with tax officials in daily business. Under these circumstances, individuals and enterprises will be able to be free from the influence of government officials if they do not violate the law. This is very likely that cars are going as they want and the police issues a traffic citation

to only those who violate the regulations.

The ex post corrective mechanisms of the government remedy misbehavior of individuals and enterprises adding to the self-purge function on the transparency. The core of this mechanism is in fairness. One of the characteristics of the ex post corrective mechanisms is that it is applied more strictly to the people of high social status. The higher people in social status are, the more likely they are prosecuted. This is the wisdom of the US cutting off the head of fish before the entire goes rotted.

How does the system of “transparency, autonomy, and ex post corrective mechanism” lead the economic activities of individuals and result in long-term economic performance of the society? As an individual, the only way to enjoy high standards of living in US system is to work hard and pay taxes honestly. In the operation of business, an easy access to a loan with low interest is available only to those with a good credit history.

Socially, this kind of system propels a sustainable economic prosperity with high efficiency and social trust. The transparency of financial transactions and the fair taxation ensure the justness of wealth and the autonomy increases individual creativity and social efficiency. The government's ex post corrective mechanism has a function of filtering the impurities after the transparency has operated. In order for any society to attain economic prosperity, the three conditions must be fulfilled: social justness of wealth should be approved by the society, the autonomy must be enhanced greatly, and mutual trust and harmonization are secured. In the case of the US, the system of “transparency, autonomy, and ex post corrective mechanism” realizes these conditions and leads the country with various races to keep on enjoying high living standards.

This transparency system of the US can be a model to Korea aiming sustainable economic prosperity. In Korea, social justness of wealth is not sufficiently approved. This is because the wealth was built up too rapidly and the transparency was lacked in that process. The same story goes to the autonomy. The autonomy stands on the basis of the transparency and social trust which are lack in Korea. Finally, it is natural that social trust and

harmonization are not realized due to the imperfection of the transparency and fair corrective mechanism. The conflict structure of labor and management is a good example of this. In order for Korea to be on the track of sustainable economic development, the efficiency and social trust must be secured, which will be realized through the autonomy and the fair ex post corrective mechanism based on the transparency of financial transactions and taxation.

Programme Evaluation Case Studies

Ki-Baeg Park et al.

The aim of this study is to evaluate government expenditure programs: evaluation of science and technology related spending, research support to universities, operation of sewage processing facilities, and agricultural products processing center and rice processing complex.

The evaluation method for science and technology related spending was recommended shift from independent evaluation of outside to mixture of inside and outside evaluation. Additional incentives to enhance evaluation quality, development of quantitative indicators, feedback procedure of evaluation results are suggested to improve evaluation.

Government research support to universities is found to assist research performance measured by qualified papers. The support to researchers performs better than that to universities, indicating that the research fund should be given to researchers.

The differences of operating costs among sewage processing facilities are originated from processing capacities. Processing quantity fitting to its capacity should be maintained to reduce operating costs.

The profitability is not affected by joint standardized shipping and connection with distribution organization of producing places. The more the sales and the newer the agricultural processing center, the higher the profitability. The earning rates of rice processing complex depend on the difference between buying and selling price and investment costs. This indicates that purchasing price cut with sales price increase and expansion of the complex are needed to slash the deficit.

Changes in Socioeconomic variables and Health Expenditures that Accompany Population Aging

John M. Kim · Chulhee Lee · Young Jun Chun

This report contains 3 papers that discuss long-term changes in socioeconomic variables that accompany population aging. By theme, the 3 papers touch on: a) long-term forecasts of age-income joint distributions and income dispersions; b) determinants and forecasts of labor force participation among the elderly; and c) the generational incidence of public health insurance costs from a generational accounting viewpoint. These are all timely subjects that are important for diagnosing and prescribing solutions to the aging problem that Korean society faces.

The paper on income distribution shows that the variances of age-specific income distributions can be predicted with some reliability, a result that extends the recent finding by Kim and Sung (2003), which reported that urban household incomes in Korea are log-normally distributed, and further that, of the 2 parameters that define such distributions, the mean (m) of age-specific distributions follow certain regularities. Another contribution of the paper is a clear theoretical exposition of the relationship between the aggregate income distributions for all households (regardless of age) and the age-specific income distributions. Building on the theoretical results, the paper also demonstrates some useful applications. It shows that cohort age-income distribution profiles over the full working life cycle of some 40-odd years can be constructed despite the limitation that only 21 years of income data are available in Korea. Furthermore,

given that the full distributions are known, it is possible to track income levels for any specific income rank. As a result, the fact that peak income age is lower for lower income-rank households in cross section follows directly from the properties of income distributions, whereas the same phenomenon may not be observed longitudinally in cohort age-income profiles. An additional result is that observed measures of inequality of the income distribution, as measured by the variance of log-incomes or by the Gini index, may ostensibly deteriorate as population aging progresses, even when the variances of age-specific income distributions remain constant.

The paper on elderly labor force participation rates analyzes the participation rates of elderly men from 1955 to 2000. It finds a sizable increase in the labor force participation rate among elderly men aged 60 and above, from 40-44% in 1965 to 52-55% in 1995. The paper reports an important finding that virtually all of this rise in elderly labor force participation rates can be explained by the sharp increase in participation rates among elderly men in rural areas. Among the determinants of elderly male labor force participation considered in this paper are such factors as age, education, marital status, household size, home ownership, urban or rural location, and the proportions of aged and rural populations in the administrative district of residence. Regression analysis shows that the proportion of the elderly in the administrative district of residence is the most important determinant of elderly male labor force participation. This result implies that the participation rates among elderly males in Korea are likely to decline over the long-run. Since the participation rates among rural elderly males is already over 70%, it is unlikely that we will see continued increases in their labor force participation rates, which had almost singlehandedly been responsible for the overall increase in elderly male participation in the labor force. Additionally, the declining trend of the rural population also forebodes a fall in the overall elderly male labor force participation rate, given the fact that the participation rate among rural elderly males are currently over twice that among their urban counterparts. All in all, the forecast changes in the factors considered in

this paper, such as education, urban-rural residence, and proportion of non-farming population, indicate that the labor force participation rates of males aged 60-74 will decline by at least 20% between 2000 and 2013.

The paper on generational incidence of the burden of National Health Insurance (NHI) costs analyzes the generational incidence under the current regime, the effects of policy alternatives, and the effects of the recent separation of diagnosis and prescription and the consolidation of public health insurances. The analysis takes into account such factors as the current National Health Insurance finances, changes in the NHI financial structure during the past several years, future changes in the economy's performance, population aging, and the expected rise in demand for health-care expenditures. The analysis shows that increasing demand for health care and weakening tax base, both of which are driven by population aging, together with rising demand for health care driven by better living standards, are likely to increase NHI expenditures sharply, especially for future generations. Additionally, the paper shows that a financially neutral revision that boosts the insurance capacity of the NHI is feasible, in the form of reduced coverage of mild illness offset by greater coverage for serious ones. It was found that such a reallocation of NHI resources can be accomplished without large generational redistributive consequences. The paper also found that expenditures can be considerably curtailed by adopting the DRG system, designed to reduce in-patient treatment costs. Such savings are likely to be amplified should the scope of coverage for in-patient treatments be extended. Finally, the paper notes that NHI expenditures have seen an overall increase following the separation of diagnoses and prescriptions and the financial consolidation of public health insurances in July 2000. These policies were also found to have increased the burden of future generations. The separation policy has raised NHI expenditures by a large amount, mainly in the form of increased coverage for pharmaceuticals, whereas revenue growth from consolidating the NHI finances have been minimal.

A Survey on the Performance Management Systems in Korea and Developed Countries

Tackseung Jun

This study aims at providing comprehensive knowledge at the performance-based public finance reforms at developed countries and Korea. The performance management system(PMS), introduced at 2003, in Korea is benchmarked on the established performance budgeting systems in the United States. and other developed countries. Therefore it is important to understand the performance budgeting system in those countries to further develop the PMS in Korea. Hence this study surveys the performance budgeting systems in developed countries and attempts to draw lessons that will help the Korean system to advance in the future. Especially, the PART in the United State as an alternative to integrate the performance and budgeting, the role of program evaluations, accountability problem, the methodological issues in measuring the performance are discussed in this study. We also examine performance-based public finance system in Korea that come before the PMS in order to find the way to reconcile with the PMS.

An Analysis of Economic Transparency Systems in the US

Seung-Hun Chun et al.

Following the book of *A Study on Economic Systems for Sustainable Development- Focusing on the Transparency of Financial Transaction & Taxation in the US* by Seung-Hun Chun(2003), this paper aims to analyze the cultural basis of economic transparency and more concretely, the individual transparency systems of the US.

Regarding the former, it states that the cultural basis of economic transparency is American 'individualism,' and analyzes that, on the basis of this sense of value, the US has developed a higher standard of economic freedom and transparency than any other country.

In regards to the latter, this paper analyzes economic transparency in four aspects: 1) financial transaction, 2) property management, 3) tax administration, and 4) management of social welfare programs. Firstly, with regard to financial transaction, this paper introduces a detailed operation of rules of the Bank Secrecy Act and Anti-Money Laundering Act used by the Office of the Comptroller of the Currency(OCC). The merit of the US system lies not in its strong regulation but on the effectiveness of its practical operation. The OCC plays a key role in auditing federal banks for the enforcement of the laws. All banks assume the obligation to report to the IRS(Internal Revenue Service) financial transactions exceeding a certain amount, and implement its own program for transparency and anti-money laundering in financial transactions of customers. The OCC supervises banks' activities with detailed rules.

Secondly, this paper analyzes the real estate market in five aspects of ownership, registration, revaluation, taxation, and mortgage. Upon the basis of financial transparency, the real estate market system and price revaluation mechanism both secure transparency and credibility of the real estate revaluation for fair taxation. The real estate market in the US is close to a perfectly competitive market for the reason that the property profile is completely open to the public and the market is very competitive. According to the procedure of real estate transactions, lawyers from both the seller and the buyer sign the written contract which contains the price and conditions of the trade, and the transfer of payment is managed as an escrow account and settled by the lawyers at the closure of the deal. Under such a circumstance, a false statement of the deal cannot be made and fair taxation is achieved.

Thirdly, this work analyzes tax administration under the US income tax system of self-assessment taxation for all the gross income. For this purpose, it traces the development of tax compliance devices and analyzes various current tax compliance activities. Furthermore, it conducts an in-depth study on six institutional arrangements, such as information returns and tax audit, with respect to transparency in taxation. Being true to its name by conducting self-assessment taxation, the US succeeds in protecting the rights and freedom of taxpayers and securing social belief in transparency and fairness of taxation, which is possible because of advanced infrastructure for economic transparency in the US.

Fourthly, this paper analyzes the government's efforts toward guaranteeing that welfare programs do not deteriorate the people's will to work resulting in excessive burden on tax payers. For this purpose, it studies major social welfare programs including the Temporary Assistance for Needy Families(TANF), Medicaid, the Food Stamp program, and Social Security Supplemental Income(SSSI) which is the major welfare program of the Federal Government. In particular, this paper traces the development of the TANF in an effort to prevent lacking motivation to find work. From this analysis, we learn that one of the major tasks for the

welfare authority of the government has been to take measures to prevent cheating, welfare program abuse and poor work motivation.

We may find several implications from the understanding of cultural basis of economic transparency and in-depth knowledge of transparency systems in the US. Firstly, in benchmarking the American transparency system, it is necessary to take into account the cultural or spiritual differences within the US. Secondly, the development of infrastructure for fair taxation is vital for sustained economic development, and the core part of it is a system that ensures transparency in financial and real estate transactions. Thirdly, in managing the welfare system, it is very important to take into account the possibility of the abuse and cheating and effects on work motivation. It is believed that the question that to what level the Korean economy may reach depends upon how Korea may succeed in transforming its economy to a creative and harmonious one under the system of economic freedom and transparency.

Budget Performance Management and Programme Evaluation

Ki-Baeg Park et al.

The aim of this paper is to suggest methods to connect budget performance and budgeting to enhance the existing Korea's performance management system and a practical guideline for programme evaluations applied to specific projects.

For these purposes, the performance management system and the technique for the development of performance indicators using the Logic model were explained first. Programme evaluation guideline and PART chapter suggested PMAT, a revised version of U. S.'s PART which is suitable to Korean situation. It also presented a programme evaluation guideline for more objective and detailed evaluation of projects. The PMAT was constructed to assess a project through objective questions by steps from the planning to performance.

The programme evaluation was conducted for 5 areas. The policy implications are as follows. The study on the effectiveness of the construction of public house for rent indicated the side-effects of the programme to the housing market. The study suggested to reduce the budget of the programme and the house size.

The study on the public guarantee programme pointed the unbalance between the private and the public guarantee for the small and medium sized firms. It stressed to provide incentives to the private financial institutions to expand the ability related to small and medium sized firms. It also recommended that the private financial institutions' management

should be lead by the government not to act as windows of public money supply but to pursue profitability.

The analysis of the investment on the National industrial complex programme revealed that the industrial complex programme had positive impact in stimulation of investment and management of the complex by giving positive effect to the sales of the complex land, employment and production.

The study on the government support to the higher education showed that the BK21 project alleviated the downward trend of research output. It also proved the positive effect of the government support on academic research and colleges.

The final subject is about the measurement of social welfare changes for the programme evaluation. The study briefed the theories and practical tools and presented examples.

Theory and Practice of Corporation Income Tax : A Survey

Taewon Kwack

This monograph was motivated to provide a comprehensive but relatively compact survey of academic and policy researches in the area of corporate income taxation to be used mainly by young scholars interested in the economics of taxation, scholars who have not majored in the area but have to survey the topic rapidly and tax policy developers.

In the first part, we summarized the economic characteristics of the corporation income tax. We also described the major changes of the tax in Korea for the last half century and its major fiscal and economic roles. Corporation tax incentives were heavily utilized in Korea as industrial and macroeconomic policy tools in the 1960s and 1970s and in recent years its revenue generating role is much emphasized. In the following chapter, theoretical and empirical studies on the incidence and excess burden of the corporation taxation were surveyed for the last half century.

Next part is composed of the surveys of studies on the cost of capital and effective tax rates. We have a great number of important literature on this topic. The cost of capital or effective tax rates are tools to analyze the effects of the corporation income tax policies on economic behavior of firms. Our survey was focused on firms' investment behavior and financial behavior. Quite a few empirical researches in Korea were also reviewed in this part.

Finally, researches, experiences and debates on corporation tax reform were reviewed. The traditional integration issue and policy experiences in

several countries were reviewed. Then we described and evaluated more recent reform proposals including Cash-Flow Corporation Tax, CBIT, DIT and ACE. We concluded our work by discussing the future of the corporation income tax in the world as well as in Korea.

Toward Fundamental Reform of Real Estate Taxation in Korea

Jinsoon Lee

Real estate taxation is an ideal way to finance local public services in principle as well as in practice in many countries. Policy makers in Korea, however, have long been interested in employing the real estate taxation for various policy objectives such as curbing real estate price inflation, encouraging use of land, and lessening the degree land ownership concentration etc. As a result, the real estate taxation in Korea become complicated and has serious problems in equity and efficiency. In comparison with other advanced countries, the tax burden on holding a real property is too low, while that on transferring the property, which is the ultimate “anti-market” tax, is too high.

To solve partly these problems, the real estate taxation is reformed in 2005. The taxes on holding a real estate are divided into the Property Tax as a local tax and the Comprehensive Real Estate Tax as a central tax. The tax rate of the registration tax is lowered.

But the reformed taxes on holding a real estate take over the differentiation of land-holding taxes among land classes of the Comprehensive Land Tax (CLT). The CLT in Korea would sum up the value of all land holdings of an individual or corporations and apply progressive tax rates, ranging from 0.2 percent to 5 percent in nine brackets. This principle, however, applies only 37.5 percent of the total land value. The other lands are specially treated in the following two ways (the percentage in parenthesis indicates the share of each category in the

total land value in 2002). Land owned by government($G=12.5\%$) or used for charitable purposes, schools, and public roads etc. is exempt ($E=5.3\%$); Various tax deductions are allowed for various policy purposes($D=1.8\%$). Different tax rates are imposed for different classes of land: commercial building sites are taxed at a low progressive rate between 0.3 percent and 2 percent($LCLT=20.2\%$); farm land and forest land are taxed separately at the flat rate 0.1 percent($o.1ST=13.8\%$); factory sites are taxed separately at the flat rate 0.3%($0.3ST=7.3\%$); luxury lands including golf courses are taxed separately at 5 percent($5ST=0.5\%$).

This study estimates the effect of these special treatments on the tax revenue and equity by simulations based on the computerized CLT DB in 2002 run by the Ministry of Government & Home Affairs. Land owned by government and foreign embassies is excluded from the analysis because it is generally exempt in other countries. The main findings are that these special treatments reduce the tax revenue by 68.2 percent, and reduce the progressivity of CLT by 43.3 percent. Therefore these differentiation of land-holding taxes among land classes should be abolished.

Tax Evasion and Tax Administration

Ilho Yoo

The main purpose of this research is to provide a survey of academic and policy researches on tax evasion. It is also intended that this research could be used as a basic reference for the future research and policy making in this area.

First, early studies on the tax evasion including Allingham & Sandmo is introduced. Researches introduced in this part generally analyze the behavior of individuals when they can evade taxes under the expected utility maximization hypothesis. Also, comparative static analyses such as the effect on the tax evasion by the change in tax rates, audit rate, penalty rate, income level are done in those researches. They are regarded to form a basis for the studies followed, on the tax evasion.

In the next chapter, various expansion of the early studies above are introduced. These researches cover such area as the theory of optimal taxation when the tax evasion is possible, equity issues with the tax evasion, effect of the income tax evasion on the labor supply, the relationship between the tax rate and the size of the tax evasion, the economic effect of the indirect tax evasion. It is also introduced in this chapter that such new theory as the prospect theory is introduced in the analysis of the tax evasion to overcome the limit of the expected utility theory.

Finally, policy researches related with the tax evasion are introduced. First among them are researches on the enforcement measures to deter the tax evasion such as the optimal penalty rate, audit rate. Besides, there are

researches on these measures when the bribery to tax officials are possible. Next, there are many researches on the tax amnesty. Results about its effect on the reduction of the tax evasion and the tax revenue increase vary. They do predict, however, that the repeated use or abuse of the tax amnesty will decrease the tax revenue, contrary to the intention. Related studies with this area are researches on the estimation of the size of the tax evasion. These are introduced as well.

The Future Direction for Consumption Tax Reform

Seong-Lin Na

The aim of this research is to suggest the direction for the future reform of consumption tax in Korea. For this, we survey and analyze the past consumption tax reforms both in Korea and in other advanced countries. We also look at the theoretical arguments for the desirable consumption tax system.

The conclusion is as follows. It would be desirable that Korea for the time being should maintain the current consumption tax system centering around the Value Added Tax and better focus on simplification of consumption tax system. And we also advise to unify various environment-related taxes such as transportation tax and other levies into one environmental tax. Finally, Korean government may consider to increase the tax rate of VAT considering the need to raise tax revenue in order to fund for social welfare expenditure and national debt repayment. This is because it is very difficult to find other revenue sources due to expected tax revolts.

A Reform Proposal on the Filing Status in the Income Tax Code

- Focusing on the Optional split-income procedure -

Wan Souk Kim

Together with tax base and tax rate, the filing status of income tax forms the most basic frame of income tax. Particularly because the income tax adopts the progressive rate structure, the amount of income tax is significantly affected by whether the filing status of income tax will be by the individual unit system or by the consumption unit system. In addition, in case the filing status of income tax is by the consumption unit system, the size of income tax changes according to whether the cumulative income will be divided, how it will be divided, and whether two or more rate schedules will be introduced.

Under the current Income Tax Code, the filing status of income tax is by the individual unit system in principle but, if a joint business is run by family members who do consumption together, the income of the family is assumed to be that of a joint business with a large rate of profit sharing and it is taxed jointly.

In the past, the individual unit system was applied in principle and, for income from assets, the system of cumulative taxation on a married couple was adopted but as the Constitutional Court judged that the application of the system of cumulative taxation on a married couple to income from assets is discriminating against married couples with income from assets to be added up in laying income tax without any good reason and, as a

consequence, it violates Article 36¹ of the Constitution. By the judgment, the individual unit system came to be adopted.

However, in married couples, the individual unit system is unreasonable because it does not consider the joint contribution of the couple to the formation of the income and it is not consistent with the community property system under the civil law. In addition, the individual unit system is criticized for the reason that it does not fit the state of couple's life and is contrary to the principle of real taxation under the tax law. Moreover, the individual unit system causes artificial breakup of income to avoid the application of high progressive rate and violates the equity of taxation.

Therefore, the filing status of income tax concerning couples needs to be improved so that taxpayers can choose between a joint filing with income splitting and a separate filing without income splitting arbitrarily.

However, the system of cumulative taxation on a married couple has diverse types. The most typical and simple form is joint filing under one rate schedule. However, because joint filing lowers excess progressive rate, it is more advantageous to married couples than to single persons or the heads of household. In addition, for married couples, it is more advantageous to one-earner couples than to two-earner couples. Moreover, because joint filing gives a higher benefit of tax reduction to high income earners, it is criticized as an income tax system for high income earners.

In order to complement the defects of joint filing, we can consider the introduction of two or more rate schedules, adjusting taxes by divisor or setting the limit of tax reduction from the application of joint filing.

In conclusion, as for the filing status of income tax on married couples, it is considered desirable to let taxpayers choose between a separate filing without income splitting and a joint filing with income splitting and, in introducing joint filing, to set the upper limit of marriage bonuses for married couples who choose joint filing or the upper limit of excess income tax paid by single persons and the heads of household over the income tax on married couples, to whom joint filing is applied. The upper limit should

be set within the range that does not impair the benefit of joint filing too much.

Next, it is necessary for couples who choose joint filing to bear the joint and several liabilities of income tax. However, if some of income to be filed by a spouse is omitted in joint filing and the other spouse did not or could not know the omission, the innocent spouse must be free from the joint and several liabilities.

Lastly, the preference system for family partnership in calculating income must be abolished. The application of the regulation on family partnership joint taxation to joint business, which cannot be considered to avoid the application of high progressive rate by distributing income, has the possibility of unconstitutionality. In addition, in case a business distributes income by disguising itself as a joint business or manipulating the equity ratio, income tax can be imposed to the actual income earner by applying the substance-over-form principle even if the provision does not exist.

A Comparison between Korean and Japanese Taxation Practices

Younghan Jung

In circumstances of rapid globalization of economic transactions and growth in trade between Korea and Japan, possibilities of taxation conflicts due to transfer pricing are gradually increasing. Transfer pricing rule prescribes how multinational firms should determine normal prices in transactions between foreign related parties. Although, generally the laws do not differ between Korea and Japan, there exist some differences regarding computation rules and application of normal prices.

In case of Korea, according to the Laws for Coordination of International Tax Affairs, which is the basic law of transfer pricing rule, when the basic 3 rules for normal price computation is not applicable, other reasonable methods are suggested to be used, which are listed to be used in the following order: profit split method (“PSM”), transactional net margin method(“TNMM”), other methods. Enacting the Basic Principle in 2004, the practically and frequently used 'Berry Ratio' was expressly stipulated as ‘ other methods’. However, the 'Berry Ratio' being one of the kind of the transactional net margin method, it is constructed as to be used only if the transactional net margin method is not applicable, and so the pliable application of the methods of normal price computation is limited.

In Japan, transfer pricing rule was enacted under the Special Taxation Measures Law(“STM”) during the tax law amendment in 1986. The tax law regulations regarding transfer pricing rule are prescribed in §4of66 of STML, §12of39 of enforcement decree of STML, §10of22 of

administrative regulation of STML, and Transfer Pricing administrative guidelines is provided for the practical applications. According to the transfer pricing rule, price between independent entities is provided to be utilized regarding overseas transactions, and the regulations are classified into 'goods-related' and 'non-goods related' transactions. Additionally, comparable uncontrolled price(“CUP”) method, resale price(“RP”) method, cost plus(“CP”) method and other methods are prescribed as price computation methods for independent entities. According to the enforcement decree of STML, PSM and TNMM are prescribed as other methods. Until the tax law amendment in 2004, since there were no specific rules regarding TNMM, PSM was generally used.

Due to the advance in globalization and the increase of understandings of tax payers, after the introduction of the APA in the Japanese tax law in 1987, the utilization of the rules are tending upwards. By confirming the arm's length price between the taxation office and the tax payers, tax payers may form predictability and reduce taxation risks to a minimum, and so is suggested for examination also from a tax payer's perspective.