U.S. Tax Reform and Its Implications for Korea

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Introduction

In a globalized economy, resources like labor and capital tend to move their locations across borders in order to reduce their tax burden. As the world economy becomes increasingly integrated, the mobility of resources gradually increases. Increased mobility causes authorities to drive tax reform in each country, so they can prevent internal resources from flowing abroad and, ultimately, secure sovereignty of taxation. Consequently, one country’s tax policy affects the economy of other nations.

Tax policy under a global environment is primarily aimed at helping a country strengthen its competitiveness. Capital outflow hurts competitiveness, since it downsizes the scale of the economy, and eventually counteracts the growth of the domestic economy. Many countries have reduced corporate tax rates in order to hinder corporations from moving abroad and to attract multinational corporations and foreign investment into their territories. In some countries, even the abolition of corporate income tax has been discussed.

The global trend of tax reform is towards reduced tax rates, so that each country that cuts its rates may improve its competitiveness. For the United States, however, even though tax reforms focusing on tax cuts have been carried out since the 1980s, recently it has lagged behind other countries in terms of competitiveness, because its tax system has several structural problems that impede tax competitiveness.

The President’s Advisory Panel on Federal Tax Reform, created by President George W. Bush in 2005, has recommended two options to reform the current taxation system. At this point, it would be appropriate to examine these two options and consider the implications of the U.S. tax reform for the Korean tax system. The reason the implications could be significantly meaningful to Korea is twofold. First, Korea has strong ties in terms of trade volume and capital flow to the United States. It is noted that countries that have close economic ties are expected to respond more sensitively to each other’s tax reforms. Second, the U.S. and Korea have some similarities in their tax structures. The Korean policymaker can take some lessons from the expected shocks to the U.S. economy when the U.S. tax reform is undertaken.

I begin by looking at an overview of the current U.S. tax system. I then introduce the direction of U.S. tax reforms by examining the two options recommended by the President’s Advisory Panel. Next, I focus on the current Korean tax system, and then consider the implications of the U.S. tax reform and the possibility of accommodation in Korea. The purpose of this paper is to provide an overall direction for tax reform in Korea, rather than to give detailed suggestions for the Korean tax system.

Overview of Current U.S. Tax System

The U.S. government and Congress have enacted and modified tax laws several times in the last three decades. The Tax Reform Act of 1986 was followed by several Acts including the Taxpayer Relief Act of 1997, and the Economic Growth and Tax Relief and Reconciliation Act of 2001. However, the current U.S. tax system is still criticized as being complex, unfair, and inefficient.

Complexity

In the past four years, the Bush administration has been successfully cutting tax rates: income tax rates have been reduced, dividend and capital gains taxes have been cut, and tax rules on retirement savings instruments have been liberalized. But there has been no progress toward making the tax code simpler. As a result, the current tax system remains terribly complex. The current federal tax codes have excessively lengthy descriptions.

Complexity imposes high administrative and compliance costs. For example, complexity causes the IRS to make costly errors, and taxpayers to spend a great number of hours annually in filling out tax forms, keeping records, and so on. Those costs
are true costs of the tax system. In other words, the real burden of the tax system on society includes not only the actual tax revenue raised, but also the administrative and compliance costs. Another large problem caused by complexity is that it obstructs efficient decision-making by tax payers, and eventually leads to an inefficient use of resources.

**Unfairness**

There are two notions of fairness: horizontal equity and vertical equity. When similarly-situated people pay a similar amount of tax, the tax system is characterized as having horizontal equity. Under the current U.S. income tax system, some individuals are treated unequally due to various exemptions, deductions, and credits in the tax code. For example, there is a disparity between homeowners and renters with similar incomes. The mortgage interest deduction makes the amount of their tax payments different.

Vertical equity has to do with the idea that different people should pay different amounts of tax. Under vertical equity, higher incomes should mean higher taxes. Vertical equity is usually discussed in terms of the percentage of income that is paid in taxes by people at different income levels, rather than the absolute dollar amount of taxes paid. Some figures indicate that the U.S. income tax is too graduated (progressive) and creates a high degree of inequality.

**Inefficiency: Higher Marginal Tax Rates**

The United States has the second highest corporate tax rate among OECD nations; the corporate tax rate was 39.4 percent in 2003. Table 1 shows the corporate tax rates for the top three and bottom three OECD nations and the average rate for all OECD nations. Even though the average has fallen from 33.6 percent in 2000 to 30.8 percent in 2003, the U.S. has still kept a high rate at approximately 39 percent.

In principle, higher rates lead to distortions by changing behavior, and in turn create economic costs, known as “deadweight loss.” The size of deadweight loss is directly related to marginal tax rates: as marginal tax rates rise, deadweight loss increases more than proportionally. Consequently, inefficiency or deadweight loss associated with higher marginal tax rates may hinder economic growth in the United States.

**Table 1. Corporate Income Tax Rates in the Selected OECD Nations**

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Three</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>40.9</td>
<td>40.9</td>
<td>40.9</td>
<td>40.9</td>
</tr>
<tr>
<td>United States</td>
<td>39.4</td>
<td>39.3</td>
<td>39.3</td>
<td>39.4</td>
</tr>
<tr>
<td>Canada</td>
<td>44.6</td>
<td>42.1</td>
<td>38.6</td>
<td>36.6</td>
</tr>
<tr>
<td>Bottom Three</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td>18.0</td>
<td>18.0</td>
<td>18.0</td>
<td>18.0</td>
</tr>
<tr>
<td>Iceland</td>
<td>30.0</td>
<td>30.0</td>
<td>18.0</td>
<td>18.0</td>
</tr>
<tr>
<td>Ireland</td>
<td>24.0</td>
<td>20.0</td>
<td>16.0</td>
<td>12.5</td>
</tr>
<tr>
<td>OECD Average</td>
<td>33.6</td>
<td>32.5</td>
<td>31.2</td>
<td>30.8</td>
</tr>
</tbody>
</table>


**Inefficiency: Taxation on Savings and Investment**

There is no doubt that saving is one of the fundamental sources for economic growth. Saving provides companies with the investment funds for expanding the business. As businesses increase their investments, productivity rises. Higher productivity in turn leads to higher wages. Higher productivity and wages contribute to economic growth.

Unfortunately, the current U.S. tax code discourages savings and investment. This is another factor to hinder economic growth in the United States. Under the income tax, the returns to savings are taxed. That discourages individuals from saving for the future. Similarly, for business, the current tax code discourages businesses from making long-term investments because they are not allowed to immediately deduct.
The current tax code, of course, already contains many pro-savings elements, such as 401(k)s, IRAs, tax-exempt bonds, and so on. The problem is that rules are very complex, so that complexity may redirect resources into less productive instruments.

Inefficiency: Taxation on Worldwide Income

There are two systems of taxation, both of which deal differently with the tax treatment of foreign-source income: the worldwide system and the territorial system. The United States, like Italy, Japan, and the United Kingdom, taxes on a “worldwide residence basis,” under which the foreign-source income of U.S. citizens, permanent residents, and corporations is subject to tax by the U.S. government. Under the U.S. system, which allows a foreign tax credit, capital export neutrality (CEN) can be achieved, since U.S. investors face the same tax rate on investments in the U.S. and abroad.6

The U.S. international tax system brings four problems. First, it contains excessively complicated rules, such as foreign credit, overall limitation, deferral, separate baskets, source rules, transfer prices, and interest-allocation rules.7 Second, it weakens the competitiveness of U.S. corporations in a global market, and eventually hinders economic growth. Third, it creates a disincentive to locate headquarters of multinational corporations in the United States. Finally, the tax neutrality in terms of CEN is not likely to be achieved as long as many countries follow a territorial system under which CIN can be achieved.

Directions of Tax Reform in the U.S.

Goals of Tax Reform

On January 7, 2005, President George W. Bush announced the establishment of a bipartisan panel to recommend options to reform the tax system to make it simpler, fairer, and more pro-growth. The Presidents’ Advisory Panel on Federal Tax Reform analyzed the current federal tax system, and set goals for tax reform: 1) to simplify the federal tax code to reduce administrative and compliance costs; 2) to share the burdens and benefits of the federal tax structure in an appropriately progressive manner; and 3) to increase efficiency through both promoting long-run economic growth and strengthening global competitiveness.

The President’s Advisory Panel examined the major problems of the current federal tax code and collected options and opinions from various groups. After repeated discussions, the Panel submitted its final report containing two policy options for tax reform to the Secretary of the Treasury on November 1, 2005.

Options Recommended by the President’s Advisory Panel

The two options are the “Simplified Income Tax Plan” and the “Growth and Investment Tax Plan.” The Panel declares that the two options will achieve the goals which were set at the starting point:

Complexity is reduced by:
- Allowing every taxpayer to use a simpler tax form.
- Making three simple saving plans.
- Eliminating a complicated set of phase-outs.
- Allowing seniors to report Social Security income using a simple computation.
- Introducing a simplified cash-based system for small businesses

Fairness is improved by:
- Ensuring that tax benefits are easily accessible.
- Making most tax benefits available to all taxpayers.
- Shifting some tax deductions to tax credits which benefit all taxpayers equally.
- Reducing marriage penalties.
- Making new provisions that are more beneficial to low income taxpayers.
- Eliminating special tax breaks.
- Maintaining the progressive nature of the tax system

Efficiency is increased by:
- Reducing the double-tax on corporate profits.
- Promoting savings throughout the economy.
- Equalizing the tax treatment of several forms of corporate financing.
- Reducing special tax preferences or benefits.
• Lowering the top marginal rates on individuals and large businesses.
• Reducing the paperwork burden for small businesses.
• Updating the international tax system.

The two plans have the following major common features:
• Simplification of streamlined tax filing for both families and businesses.
• Lowering tax rates, while retaining the progressive nature of the current tax system,
• Extension of tax benefits for home ownership and charitable giving to all taxpayers; extension of tax-free health insurance to all taxpayers.
• Removal of impediments to savings and investment.
• Elimination of the Alternative Minimum Tax.

However, the two plans adopt different designs that represent a range of policy choices for simplifying the tax code, removing impediments to savings and investment, and broadening the tax base. Table 2 shows the comparison between the current tax system and the two plans. Although they use different approaches, the plans share the common goals of simplification, fairness, and efficiency.

Table 2.
Comparison between the Current Tax System and the Two Plans

<table>
<thead>
<tr>
<th>The current Tax System</th>
<th>Earned income tax credit</th>
<th>Other Major Credits and Deductions</th>
<th>Individual Savings and Retirement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Households and Families</strong></td>
<td>Provides lower-income taxpayers refundable credit designed to encourage work. Maximum credit for working family with one child: $2,747; with two or more children: $4,536</td>
<td><strong>Home mortgage interest</strong></td>
<td><strong>Defined contribution plans</strong></td>
</tr>
<tr>
<td>Tax rates</td>
<td>Six tax brackets: 10%, 15%, 25%, 28%, 33%, 35%</td>
<td>Deduction available only to itemizers for interest on up to $1.1 million of mortgage debt</td>
<td>Available through 401(k), 403(b), 457, and other employer plans</td>
</tr>
<tr>
<td>AMT</td>
<td>Affects 21 million taxpayers in 2006; 52 million in 2015</td>
<td>Charitable giving</td>
<td>Pension contributions by employers are untaxed</td>
</tr>
<tr>
<td>Personal exemption</td>
<td>$3,200 deduction for each member of a household; phases out with income</td>
<td>Health insurance</td>
<td>IRAs, Roth IRAs, spousal IRAs—subject to contribution and income limits</td>
</tr>
<tr>
<td>Standard deduction</td>
<td>$10,000 deduction for married couples filing jointly, $5,000 deduction for singles, $7,300 deduction for heads of households; limited to taxpayers who do not itemize</td>
<td>State and local taxes</td>
<td>Section 529 and Coverdell accounts</td>
</tr>
<tr>
<td>Child tax credit</td>
<td>$1,000 credit per child; phases out for married couples between $110,000 and $130,000</td>
<td>Education</td>
<td>HOPE Credit, Lifetime Learning Credit, tuition deduction, Student loan interest deduction; all phase out with income</td>
</tr>
<tr>
<td><strong>Small Business</strong></td>
<td><strong>Social security benefits</strong></td>
<td><strong>Defined benefit plans</strong></td>
<td><strong>Retirement savings plans</strong></td>
</tr>
<tr>
<td>Rates</td>
<td>Typically taxed at individual rates</td>
<td><strong>Retirement savings plans</strong></td>
<td>IRAs, Roth IRAs, spousal IRAs—subject to contribution and income limits</td>
</tr>
</tbody>
</table>

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### Recordkeeping
Numerous specialized tax accounting rules for items of income and deductions

### Investment
Accelerated depreciation; special small business expensing rules allow write-off of $102,000 in 2005 (but cut by ¾ in 2008)

### Large Business

<table>
<thead>
<tr>
<th>Rates</th>
<th>Eight brackets: 15%, 25%, 34%, 39%, 34%, 35%, 38%, 35%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>Accelerated depreciation under antiquated rules</td>
</tr>
<tr>
<td>Interest paid</td>
<td>Deductible</td>
</tr>
<tr>
<td>Interest received</td>
<td>Taxable (except for tax-exempt bonds)</td>
</tr>
<tr>
<td>International tax system</td>
<td>Worldwide system with deferral of business profits and foreign tax credits</td>
</tr>
<tr>
<td>Corporate AMT</td>
<td>Applies second tax system to business income</td>
</tr>
</tbody>
</table>

### How the Tax Code Would Change

<table>
<thead>
<tr>
<th>Provisions</th>
<th>Simplified Income Tax Plan</th>
<th>Growth and Investment Tax Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Households and Families</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax rates</td>
<td>Four tax brackets: 15%, 25%, 30%, 33%</td>
<td>Three tax brackets: 15%, 25%, 30%</td>
</tr>
<tr>
<td>AMT</td>
<td>Repealed</td>
<td></td>
</tr>
<tr>
<td>Personal exemption</td>
<td>Replaced with Family Credit available to all taxpayers: $3,300 credit for married couple, $2,800 credit for unmarried with child, $1,650 credit for singles, $1,150 credit for dependent taxpayer; additional $1,500 credit for each child and $500 credit for each other dependent</td>
<td></td>
</tr>
<tr>
<td>Standard deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Child tax credit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earned income tax Credit</td>
<td>Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child: $3,570; with two or more children: $5,800</td>
<td></td>
</tr>
<tr>
<td>Marriage penalty</td>
<td>Reduced; tax brackets and most other tax parameters for couples are double those of individuals</td>
<td></td>
</tr>
<tr>
<td><strong>Other Major Credits and Deductions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home mortgage interest</td>
<td>Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about $227,000 to $412,000)</td>
<td></td>
</tr>
</tbody>
</table>

### Charitable giving
Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses

### Health insurance
All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family)

### State and local taxes
Not deductible

### Education
Taxpayers can claim Family Credit for some full-time students; simplified savings plans

### Individual Savings and Retirement

| Defined contribution plans | Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Growth and Investment Tax Plan would make Save at Work accounts “prepaid” or Roth-syle) |
| Defined benefit plans | No change |
| Retirement savings plans | Replaced with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers |
| Education savings plans | Replaced with Save for Family accounts ($10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver’s Credit available to low-income taxpayers |
| Health savings plans |                               |
| Dividends received | Exclude 100% of dividends of U.S. companies paid out of domestic earnings Taxed at 15% rate |
| Capital gains received | Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary 3.75% to 8.25%) Taxed at 15% rate |
| Interest received (other than tax-exempt municipal bonds) | Taxed at regular income tax rates Taxed at 15% rate |
Social security benefits
Replaces three-tiered structure with simple deduction. Married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation

Small Business
Rates
Taxed at individual rates (top rate has been lowered to 33%)

Solo proprietorships taxed at individual rates (top rate lowered to 30%); Other small business taxed at 30%

Recordkeeping
Simplified cash-basis accounting

Business cash flow tax

Investment
Expensing (exception for land and buildings under the Simplified Income Tax Plan)

Large Business
Rates
31.5% 30%

Investment
Simplified accelerated depreciation

Expensing for all new investment

Interest paid
No change; Deductible

Not deductible (except for financial institutions)

Interest received
No change; taxable

Not taxable (except for financial institutions)

International tax system
Territorial system

Destination-basis (border tax adjustment)

Corporate AMT
Repealed

Table 3.
Tax Collection by Type of Taxes in Korea (2003)
(units: billion won, %)

<table>
<thead>
<tr>
<th>Type</th>
<th>Total</th>
<th>Income Tax</th>
<th>Corporate Tax</th>
<th>Value Added Tax</th>
<th>Earmark Tax</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>107,049</td>
<td>20,787</td>
<td>25,633</td>
<td>33,447</td>
<td>14,817</td>
<td>12,364</td>
</tr>
<tr>
<td>Weight</td>
<td>100</td>
<td>19.42</td>
<td>23.95</td>
<td>31.24</td>
<td>13.84</td>
<td>11.55</td>
</tr>
</tbody>
</table>


Korea taxes on a “worldwide residence basis,” under which the foreign-source income of residents is subject to tax by the Korean government. Non-residents are liable to income tax only if income is derived from sources within Korea. Korea adopted the “global taxation” system, in which real estate rental income, business income, earned income, pension income, temporary property income, and other miscellaneous income is aggregated and progressively taxed as global income. The tax rates range from 8% to 35%.11 The Korean income tax system generally pursues taxation on global comprehensive income, but actually it has many exceptions: numerous income deductions and tax exemptions, separate taxation on interests and dividends, exclusion of financial capital gains from tax base, and so on.12 Wages and salaries are included in comprehensive income, but practically they are taxed separately from the comprehensive income tax.

Domestic corporations are liable to tax from worldwide income whereas foreign corporations are liable to tax only on Korean source income. The corporate income tax rates are 13% for a tax base of 100 million won or less, and 25% for a tax base of over 100 million won.

All the tax incentives are stipulated in the Special Tax Treatment Control Law (STTCL). The major purpose of the STTCL is to significantly rationalize tax deferrals, credits, and exemptions granted to a wide range of taxes, by making all tax province taxes which have four ordinary taxes and three earmarked taxes, and city & county taxes which have seven ordinary taxes and two earmarked taxes.10

Implications for Korean Tax System

Overview of Korean Tax System

Taxes in Korea are comprised of national and local taxes. There are 10 internal taxes, customs duties, and three earmarked taxes within the national taxes.9 The major sources of national tax revenue are income tax, corporation tax, and value-added tax. Table 3 shows that about 75 percent of national tax revenue comes from those three taxes. Local taxes are divided into

incentives covered by the STTCL subject to sunset rules. Most incentives expire automatically within one to five years unless they are extended. The Alternative Minimum Tax (AMT) for corporations and individual taxpayers is stipulated in the STTCL to impose a certain level of tax burden by precluding excessive tax exemption or reduction. Where the tax burden falls short of the AMT, the difference is disallowed from tax exemption or reduction.

A modern tax system was introduced in 1948 after the formation of the Korean government. Since then, a number of major tax reforms have followed: introduction of the comprehensive income tax system in 1975, value-added tax in 1977, comprehensive real estate holding tax in 2004, and so on.

Since 1998, after experiencing financial crisis, Korean tax reform has focused more on supporting business reconstruction rather than pursuing the objectives of fairness. To create a pro-business environment, and eventually stimulate competitiveness, the Korean government lowered both individual and corporate income tax rates, and manipulated income deductions and tax exemptions. As a result, current income tax rates are comparatively lower than those of other OECD countries.

**Simplification of Tax Code**

Both the U.S. and Korean tax code are rated as complex. However, sources of the complexity differ slightly. In the United States, the complexity of the tax code comes from excessively lengthy and detailed description. The complexity of the Korean tax code comes mainly from excessively ambiguous description and a complicated calculation system. This complexity is partly attributed to frequent modification of the code and enactment of temporary provisions, such as the STTCL. The ambiguity and the complicated calculation system bring uncertainty to businesses and individuals, and eventually create huge additional compliance costs.

To simplify reform of the Korean tax code, breaks with similar functions or purposes should fundamentally be consolidated. If tax breaks are simplified and fairer, there would be no need for frequent modification of the code and regulations like the Alternative Minimum Tax (AMT). In addition, the tax code should be modified by easier terms and a simpler calculation system, and be complemented with more detailed descriptions. A cash-flow basis for recording and book-keeping should be introduced for small businesses. By replacing the current complicated accrual basis, small businesses can reduce their compliance costs.

Be it noted that the objectives of the tax system, such as simplicity, fairness, and efficiency, are interrelated. An equity issue is associated with complexity. For example, some of the factors that augment progressivity can create complicated tax codes. When a policymaker makes a decision, the objectives of equity and simplification are competing for priority with each other. However, in the end, simplification tends to be sacrificed. Therefore, it is important to make the tax system simple to avoid huge compliance costs, but make it still complex enough (not extremely simple) to satisfy the objective of equity. The next section will deal with equity issues.

**Perspectives on Equity and Fairness**

Even though the objective of current tax reform under a globalized economy is to focus more on stimulating countries’ competitiveness, the issue of equity should still be considered in the long-term and dynamic perspective. The unfairness in the tax burden between earned income and business income has been an old, but still pending, issue in Korea. Moreover this horizontal inequity results in the deterioration of vertical equity since business income is concentrated more in the upper income classes.

There are two tools for achieving vertical equity: a proportional tax system and a progressive tax system. Most countries, including the United States and Korea, have adopted a progressive system rather than a proportional system. Recently, however, there is a tendency for major developed countries to move closer to a proportional system, while maintaining the nature of progressivity. Many OECD countries have adopted a “Dual Income Tax System” which is less progressive than the current income tax system, and the President’s Advisory Panel in the U.S. also recommended a less progressive system by reducing the number of income brackets and tax rates.
Moving toward a proportional tax system would have several benefits. First, it would improve economic efficiency, since millions would enjoy a marginal tax cut under a proportional system. Second, it would reduce compliance costs by simplifying the tax code. Third, it would increase individuals’ savings, and eventually promote economic growth. Finally, it would reduce the demand for government.16

Table 4 shows the average tax rates classified by income base bracket in Korea. The figures indicate that the income tax system represents some inequality: the average tax rates are too progressive in higher brackets.17 As pointed out in the U.S. case, in higher brackets, the graduated rates create a high degree of inequality. Theoretically, a proportional tax system can resolve an inequality problem. However, in Korea where inequality among the poorest is a more pending issue, it is not likely that the country will move toward a perfect proportional tax system. Nevertheless, the function of income redistribution cannot rely totally upon progressive tax rates, since higher income tax rates in a global era means capital outflow. Considering this circumstance, the combination of a flat rate on capital income and a graduated rate on labor income could be suggested for Korea, since capital income should be taxed at a lower rate to respond to rising global tax competition.

<table>
<thead>
<tr>
<th>Income Bracket</th>
<th>Tax Rate (weight)</th>
<th>No. of People (weight)</th>
<th>Taxable Income (weight)</th>
<th>Tax Amount (weight)</th>
<th>Average Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 mil won or less</td>
<td>9</td>
<td>1,256,703 (64.7)</td>
<td>9,847 (20.3)</td>
<td>396</td>
<td></td>
</tr>
<tr>
<td>10 mil ~40 mil won</td>
<td>1</td>
<td>490,057 (25.2)</td>
<td>13,202 (27.3)</td>
<td>1,311 (16.5)</td>
<td>9.9</td>
</tr>
<tr>
<td>40 mil ~80 mil won</td>
<td>2</td>
<td>118,394 (6.1)</td>
<td>7,674 (15.8)</td>
<td>1,228 (15.5)</td>
<td>16.0</td>
</tr>
<tr>
<td>80 mil won or more</td>
<td>3</td>
<td>77,565 (4.0)</td>
<td>17,711 (36.6)</td>
<td>4,991 (63.0)</td>
<td>28.2</td>
</tr>
<tr>
<td>Total</td>
<td>6</td>
<td>1,942,719 (100)</td>
<td>48,434 (100)</td>
<td>7,926 (100)</td>
<td>16.4</td>
</tr>
</tbody>
</table>

Notes: 1) Taxpayers with taxable income below the tax threshold are excluded. 2) Average tax rates are calculated by the formula, tax amount/taxable income.

Source: Author’s calculations based on National Tax Service, op. cit.

International Tax Competition

In an open economy, higher taxes on domestic capital create capital outflow to foreign countries. Capital outflow downsizes the scale of the economy, and eventually counteracts the growth of the domestic economy. As the world economy becomes increasingly integrated (in other words, as capital mobility increases), higher taxes on capital increasingly slows growth. In this sense, high tax rates on capital, including taxes on business profits and individual dividends, interest, and capital gains, are more difficult to sustain in the new global environment.18

Since the 1980s, when deregulation of financial markets started, the majority of industrial countries have reduced their corporate income tax rates. The average corporate tax rate in OECD countries has fallen by about 10 percent in the last two decades: from 41.6 percent in 1986 to 31.4 percent in 1999. After early 2000, another round of large tax cuts occurred. Between the years 2000 and 2003, the average statutory corporate income tax rate in OECD countries dropped again by almost 3 percent points.19 The general trend has been towards reduced tax rates on capital, and it reflects the need to remain competitive in international capital markets.

Table 5 shows corporate tax rates in Korea for the years 2000-2003. Korea has maintained lower rates than the average
rates of both the OECD and the EU’s 15 countries. However, the gap between the rates in Korea and the average OECD rates has become smaller: about 3 percent in 2000, and about 1 percent in 2003. In terms of the speed of international tax competition, Korea is said to be behind the trend.

Table 5. Corporate Income Tax Rates in Korea

<table>
<thead>
<tr>
<th></th>
<th>Year 2000</th>
<th>Year 2001</th>
<th>Year 2002</th>
<th>Year 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Korea</td>
<td>30.8</td>
<td>30.8</td>
<td>29.7</td>
<td>29.7</td>
</tr>
<tr>
<td>OECD Average</td>
<td>33.6</td>
<td>32.5</td>
<td>31.2</td>
<td>30.8</td>
</tr>
<tr>
<td>EU 15 Average</td>
<td>35.1</td>
<td>33.5</td>
<td>32.4</td>
<td>31.7</td>
</tr>
</tbody>
</table>

Source: OECD, op. cit.

In a globalized economy, the tax policy initiated by one country has an important impact on prices and resource allocation in other countries. The spillovers occur through both terms-of-trade changes and through effects on international capital flows. Countries that have close economic ties will naturally respond more sensitively to another’s tax reforms. A good example is Canada’s response to the 1986 U.S. tax cut. Recently, there is a movement towards lowering the corporate income tax rates in China. The Korean government needs to keep a close watch on China’s movement, since Korea relies more and more on China’s market.

The spillover effects work as an important motive for international tax competition. Many studies argue that international tax competition positively affects worldwide welfare, because if other countries sequentially lower their tax rates, worldwide investment and output increases. This opinion is based on the hypothesis that international tax competition is not a zero-sum game. They illustrate the effect by the round of income tax reductions in the 1980s. At that time, all countries ended up better off as each country pursued its own interests. A study by Ballard & Kang (2003) shows that tax policy changes improve the efficiency of allocation of domestic capital stock, and generate capital inflow, and that, if a capital tax cut in one country leads to retaliation, all regions of the world gain. This study tries to show numerical evidence that international tax competition does not lead to a “race to the bottom,” but actually produces a “race to the top.”

In order to make a tax system more growth-oriented, a territorial taxation system, which taxes only domestic income, is more favorable than a worldwide income taxation system, which taxes foreign-source income as well. A territorial system is superior to a worldwide system in that it would make the home-country an excellent location for headquarters of multinational corporations. Multinational headquarters bring to the home-country highly skilled workers and high income jobs in high-level corporate functions. In this sense, a move to a territorial system would put Korea on the track of the new trend, “global pro-growth tax system.”

Conclusion

A desirable tax system should be simple and efficient, and should back up economic growth. In this sense, the President’s Panel seems to have prepared proper options satisfying these requirements for U.S. tax reform. The options not only address the problems of the U.S. tax system, but also try to move the U.S. tax system one step further toward a pro-growth tax system.

Efficiency and equity have worked as important criteria in public decision-making. But these two values have always been contradictory. Sometimes efficiency has priority, and other times equity is the motivating factor. Today, there is a global trend to put more importance on efficiency than on equity. Korea also has focused more on efficiency issue, since the financial crisis in 1998. In addition to the two options presented by the Panel, more innovative options like the “Dual Income Tax” can be discussed in order to recover the vitality of the Korean economy and to improve structural competitiveness.

To secure vertical equity, most countries have favored progressive tax rates over proportional tax rates. But it is more profitable to use proportional tax rates, because highly progressive tax rates promote resource outflow abroad, and lead to reduced reproduction through distortions of resource allocation. This is based on the idea that, in a globalized economy, dynamic and growth-oriented concepts like how to
enlarge the pie itself is more beneficial than the static concept of how to distribute a fixed pie.

In addition, excessive solicitude to equity makes a tax system complex and inefficient, and finally deteriorates equity itself. To prevent creating a vicious circle, it is very important to design and maintain the tax code to be simple and fair as a whole, instead of making it complex by considering equity in every provision of it.

Under international tax competition, in order to make a competitive tax system, the Korean government and Congress need to take into account the spillover effect of tax reform in major competitive countries, such as China, and have to make strenuous efforts to prepare optimal solutions for coordinating the two values of efficiency and equity in consideration of both domestic tendencies and international trends.

Endnotes

1 I am grateful for helpful comments from anonymous reviewers, and also express special thanks to Hyon-Min Choi, National Tax Service, Korea, and to Susan DeChant, Visiting International Professional Program, Michigan State University.


5 In 2002, under the federal income tax, the average tax rate (tax paid divided by adjusted gross income) on household earnings over $200,000 was 26 percent. By comparison, the average tax rate for those earning between $50,000 and $100,000 was 11 percent. See Chris Edwards, “Options for Tax Reform,” Policy Analysis, no. 536, Cato Institute, (2005).

6 About half of OECD countries, including Belgium, France, the Netherlands, and Norway, adopt a system that is largely a territorial system, under which they do not tax income generated outside their borders. Under this system, capital import neutrality (CIN) can be achieved, since investments in Belgium would face the same tax rate on Belgian investment and French investment. (In other words, Belgian investments in Belgium would pay the same tax as French investments in Belgium do.)


8 Most of this section is quoted from the final report of The President’s Advisory Panel on Federal Tax Reform, Simple, Fair & Pro-growth: Proposal to Fix America’s Tax System, (2005).

9 Internal taxes consist of income tax, corporate tax, inheritance tax, gift tax, comprehensive real estate holding tax, value-added tax, special excise tax, liquor tax, stamp tax, and securities transaction tax. The three earmarked taxes are transportation tax, education tax, and a special tax for rural development.

10 At the province level, ordinary taxes are acquisition tax, registration tax, leisure tax, and license tax; and earmarked taxes are community facility tax, regional development tax, and local education tax. At the city & county level, ordinary taxes are inhabitant tax, property tax, automobile tax, farmland tax, butchery tax, tobacco consumption tax, and motor fuel tax; earmarked taxes are urban planning tax and business place tax.

11 Income tax rates by income brackets: 8% for 10 million won or less; 17% for 10~40 million won; 26% for 40~80 million won; 35% for over 80 million won.
Interest and dividends are subjected to tax withholding, but when the total amount is more than 40 million won, the surplus is subject to global income taxation. Capital gains from real estate are taxed separately at the same tax rate as the global income tax rate, but capital gains from sales of stocks are not taxed.

For individuals, the top rate of income tax was lowered by 4 percentage points (40% → 36%) in 2002, and lowered by 1 percentage point (36% → 35%) again in 2005. The corporate income tax rate was lowered by 1 percentage point (16%, 28% → 15%, 27%) in 2002, and by 2 percentage points (15%, 27% → 13%, 25%) in 2005.

The public is very sensitive to the equity issue, not to the issue of simplification. The majority of compliance costs created by complexity are not tangible, so it has often been disregarded by policymakers.

When an increase in income is associated with an increase in the percentage of income that is paid in tax, it is said that the tax is progressive. When an increase in income is associated with a decrease in the percentage of income paid in tax, it is said that the tax is regressive. If the percentage of income paid in tax is constant across income levels, the tax is said to be proportional.

Under highly graduated system, many people are not aware of their own tax burden created by the government. About 42 percent of U.S. households paid nothing in federal income tax in 2004. Since the price of public goods and services would be zero for those who paid nothing, they likely demand too many goods and services from government. See Edwards, op. cit.

The rates in higher brackets show progressivity: the average rate on household’s earning over 80 million won is 28 percent, whereas the average rate for those earning for 10-40 million won is 10 percent. This is very similar with the U.S. in 2002, which created the problem of inequality as criticized by most economists. In 2002, under the U.S. federal income tax system, the average tax rate on over $200,000 was 26 percent. By comparison, the average tax rate on between $50,000 and $100,000 was 11 percent.


There are two opposing perspectives on the effects of international tax competition. One asserts that international tax competition is efficient. The other, points out the inefficiency of international tax competition. The latter perspective is based on the hypothesis of a zero-sum game. The idea is that the tax system ought to be neutral and the tax system has no effect on investment decisions. As investments flow to low-tax countries, inefficiency occurs because resources may not end up in the highest-valued uses. The EU uses this argument to encourage low-tax member countries to raise their taxes. See Edwards and de Rugy, op. cit.


See Edwards and de Rugy, op. cit. for the superiority of the territorial system. The residency rule also has an impact on individuals. The residence-based worldwide system negatively affects wealthy people living abroad who want to return to their country. A good example is the response of expatriate Indians to the revision of the India’s tax residency rules in 2003. See Financial Times, August 12, (2003), and IAS Global Watch, November 20, (2003).