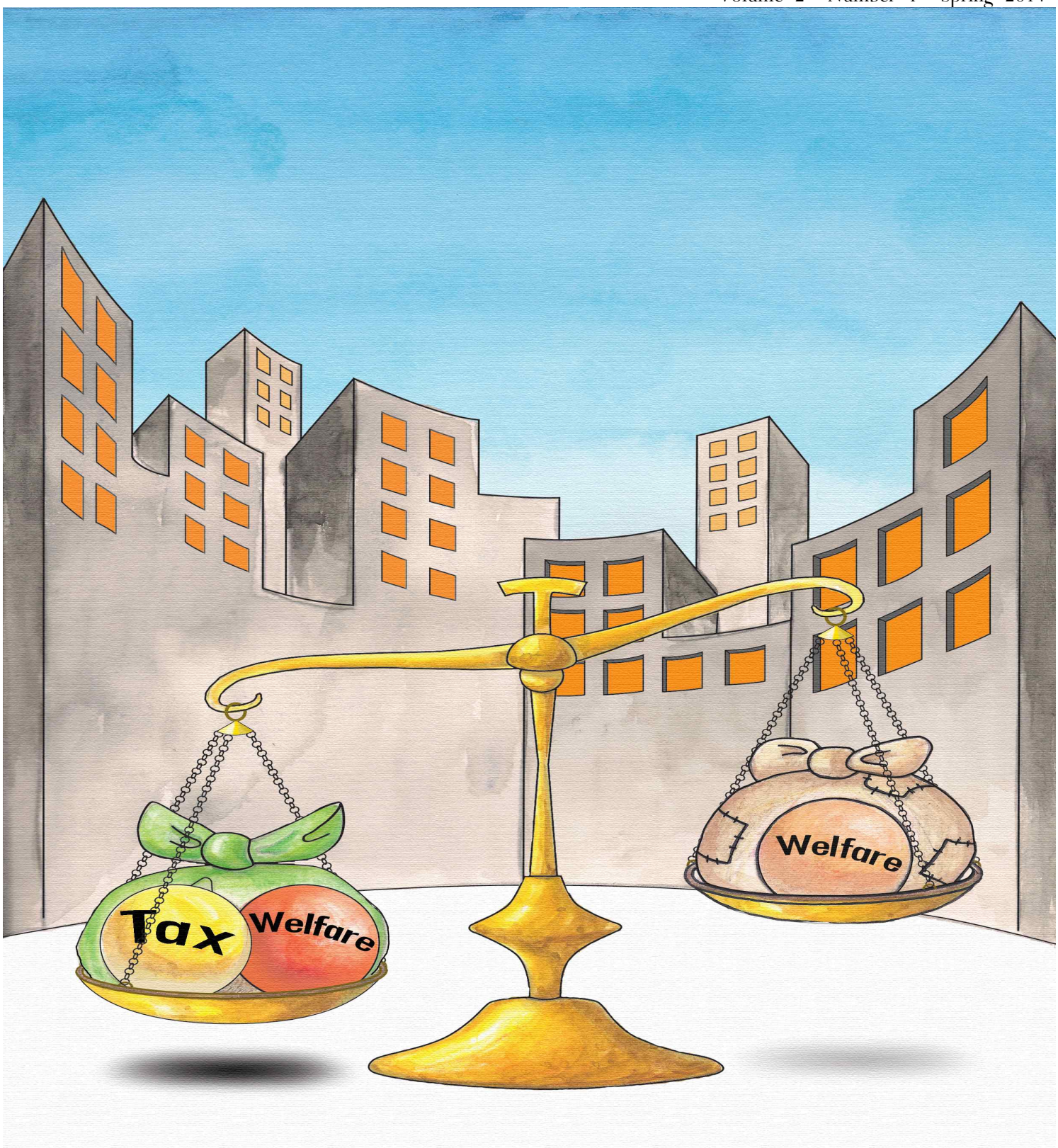
Society in Perspective

Time for a Hard Choice: Tax Issue in the Korean Welfare State

How to Improve Financial Assistance for Low Income Korea

Spring 2014

Volume 2 Number 1 Spring 2014



Contents

Briefings

Where Korea Stands

Society in Perspective

Korea Institute for Health and Social Affairs (KIHASA)
Jinhungro 235, Eunpyeong-gu, Seoul 122-705 Korea
http://www.kihasa.re.kr

Time for a Hard Choice: Tax Issue in the Korean Welfare State

President Park Geun-hye announced her Three Year Plan for Economic Innovation on the first anniversary of her inauguration on February 28, 2014. Her emphasis on economic innovation was an awaited turn by the conservatives, but undoubtedly came as a disappointment to pro-welfare forces in South Korea. Despite her conservative image, Park promised during the 2012 presidential election campaign to realize economic democratization and expand social welfare programs in a sense more proactively than left-leaning opposition party candidate, Moon Jae-in. But, at the same time, she argued that it could be accomplished without increase in tax burden. In short, Park promised welfare expansion without tax increase. This contradictory policy stance has pushed her to oscillate between economy and welfare, in spite of her sincere commitment to new social policy initiatives such as basic pension coverage and free childcare. The Park Government has finally prioritized economy over welfare. Park's policy turn has attested to the historical fact that without tax increase there would be no welfare state development.

Mounting social problems but lagging policy responses trapped in low taxation

Korea is suffering from numerous social problems including one of the lowest fertility rates in the world (1.19 in 2013) and the highest suicide rate among OECD countries. Also, income inequality is higher in Korea than in most of the other OECD countries with 45 percent of Koreans aged over 65 living in poverty. High medical bills are threatening 10.5 percent of households whose medical expenses exceed 40 percent of disposable income. In this context, it can be convincingly argued that expanding social security is not an option in Korea, but rather it is a must - regardless of political ideologies. However, Korea is a welfare state laggard, having inadequately responded to such mounting social problems. As of 2012, it spent only 9.3 percent of GDP on social security while the OECD average was 21.8 percent.

President Park's electoral pledges and commitment to social welfare reflect such urgency, not to mention the underdevelopment of the Korean welfare state. She promised a universal basic pension that would double the pension benefit for all aged over 65, free medical services to patients with four major diseases, and free childcare for children aged five years and younger, to mention a few. Even before her inauguration, worries concerning the massive costs of the new social welfare programs were expressed by the ruling Saenuri Party, conservative media, and economic bureaucrats. These groups pressured Park to readjust her campaign promise to within the budgetary limit. In fact, Korea's taxation capacity is not enough to cover the expected costs as illustrated well by its tax revenue being much lower than most OECD countries. Even if social insurance contributions were included, its total tax revenue accounted for about 25 percent in 2011, while Denmark reached 48.1 percent and the OECD average was 33.8 percent.

President Park's commitment to social security has to be compromised. Basic pension was downsized to cover 70 percent of the aged over 65 with decreasing benefits according to income level. Free medical services were de facto discarded. Nevertheless, still substantial welfare budgets are required to implement the downgraded promises on social welfare. Park's finalized welfare plan, budgeted to cost 135 trillion won (or $130 billion) over the next four years in office, is designed to raise the living standards of low income families and the aged and reconcile births with female employment.

Taxpayers' revolt living in taxpayers' heaven

In order to finance Park's welfare spending plan, the Ministry of Strategy and Finance unveiled a tax reform plan on August 8th 2013 which sought to both reduce tax-exemptions comprehensively across the board and to un-

cover the informal economy. The ministry planned to secure 48 trillion Won ($45 billion) through tax reform. However, the government had to retreat from its original tax reform plan and come up with a new tax plan because of taxpayers' massive backlash against the government plan. This was fueled by the opposition Democratic Party who suggested that a 'tax bomb' would be dropped on the citizenry. President Park herself told the Finance Ministry to devise a new tax plan from scratch. The original plan proposed to collect more taxes from 4.3 million workers with an annual income of 34.5 million Won ($32,0000) or more. Under the new plan, only 2.1 million high-paid workers' with over 55 million Won ($51,000) are subject to tax increase.

As a matter of fact, the original tax plan was a minor reform, which excluded explicit and fundamental tax increases. Neither new tax items nor increases in income tax, corporate tax, or consumption tax were included. Nevertheless, any increase in the tax burden was a tax hike for the taxpayers, especially those who receive no adequate social security from the 'small' welfare state in Korea. Future welfare benefits from the government could not compensate for the immediate income loss of today. Roughly speaking, the taxpayers' revolt against the government's tax plan was triggered by a feeling of breach by the government of an implicit social contract between the state and the citizen formed during the period of rapid industrialization: low tax-low welfare but high disposable income.

By international standard, Korean taxpayers live in a tax heaven. As compared in Table 1, direct taxes on households are particularly low in Korea; only about 50 percent of workers pay low personal income tax due to generous deductions and exemptions. In 2010, state revenue from income tax is only 3.6 percent of GDP in Korea, which is far less than the OECD average of 8.4 percent. By international standard, Korean taxpayers live in a tax heaven. As compared in Table 1, direct taxes on households are particularly low in Korea; only about 50 percent of workers pay low personal income tax due to generous deductions and exemptions. In 2010, state revenue from income tax is only 3.6 percent of GDP in Korea, which is far less than the OECD average of 8.4 percent. Social security contributions (3.8 percent of GDP) are also far below the OECD average (9.3 percent), reflecting low contribution rates and weak compliance with the social insurance schemes.

Table 1. The Tax Mix: Korea in comparison with OECD average

unit:Tax revenue, % of GDP

	2000		2010			Change
	Korea	OECD	Korea	Rank	OECD	2000-2010
Direct taxes on household	3.3	9.3	3.6	30	8.4	0.3
Direct taxes on firms	3.2	3.4	3.5	6	2.9	0.3
Social security and payroll	3.8	9.3	5.8	26	9.5	2.0
Goods and services	8.7	11.3	8.5	29	11.0	-0.2
Property	2.8	1.8	2.9	7	1.8	0.1
Holding taxes	0.6	0.9	0.8	16	1.0	0.2
Taxes on property transaction	2.0	0.6	1.8	1	0.4	-0.2
Estate, inheritance and gift taxes	0.2	0.1	0.3	4	0.1	0.1
Other	0.8	0.2	0.9	3	0.2	0.1
Total	22.6	35.2	25.1	31	33.8	2.5

Source: *Strengthening Social Cohesion in Korea*, OECD (2013)

Therefore, the overall 'tax wedge' on labor, including income tax and social security contributions, was only 20 percent in 2010, the fourth lowest in the OECD area following Chile, New Zealand, Mexico and Israel. Low taxes on labor contribute to high labor inputs in the form of longer working time in Korea, which are 37 percent higher relative to the population than the United States, offsetting much of the productivity gap, according to the OECD's S*trengthening Social Cohesion in Korea* (2013) In short, Koreans work hard for self-help, and the extant tax systems support them.

Export-oriented industrialization and low tax burden

Korea's low tax burden is deeply rooted in its developmental strategy during the authoritarian

period. Korea is an exemplar case of successful export-oriented industrialization (hereafter, EOI). In the 1960s, under the leadership of President Park Jung Hee, the state-led economic development established exporting firms in light manufacturing.

The success of Korean light manufacturing depended on abundant and cheap labor. In critical industries such as apparel, textiles, and footwear labor accounted for as much as 25 percent, 60 percent, and 33 percent of production costs respectively, and fixed capital costs were less than 10 percent. Low wages and long working hours became the norm supporting the competitiveness of Korean exporting firms.

Under such conditions, employers could not afford to appease demands for higher wage. The authoritarian government adopted a repressive labor policy and limited basic labor rights to assist employers who tried to fend off wage increases. This situation did not change throughout the industrialization period even in the 1970s and early 1980s when the Korean economy vigorously caught up with early industrializers with its growing heavy-chemical industry. At that time, price competitiveness in the international market was the primary factor for the success of the Korean economy. In this situation, any measures that would directly or indirectly weaken price competitiveness were shunned by employers and the state. Introduction of social insurance programs was delayed as long as possible and wage increase was allowed strictly below productivity growth rate.

The Park government established the National Tax Agency in 1966 and modernized tax system in 1967. Along with successful economic growth and modernization of tax system, tax revenue grew rapidly at striking annual rates of 66.5 percent in 1966, 48.3 percent in 1967, 50.6 percent in 1968 and 39.4 percent in 1969. The 1971 tax reform was epochal in that the Park government adopted a new tax system tailored to support the EOI. Heavy tax cuts on income and investment were key measures to relieve pressure for wage increase and induce work and investment in the long run. This was quite a unique tax policy for a period when most welfare states in the West had adopted a Keynesian tax-and-spending strategy. The emergency tax reform in 1974 following the first oil shock reinforced tax cuts especially for low-income earners instead of welfare provisions. Korea was, in a sense, a forerunner of supply-side economics, the mainstream economic logic of the neo-conservative era in the 1980s.

Throughout the 1970s income tax continued to decrease in Korea, as illustrated in Table 2. A social contract between the state and the citizen of low income tax-low public welfare emerged and became firmly entrenched during the industrialization period – with a lasting impact on the tax politics even today.

Table 2. Effective income tax rate

unit: % of household income

Income level	1970	1976	1978	1980
lowest 0~10%	2.24	0.00	0.00	0.00
~20%	2.06	0.00	0.00	0.06
~30%	2.40	0.19	0.59	0.74
~40%	2.07	0.71	0.84	1.21
~50%	2.17	1.20	1.25	1.56
~60%	5.29	1.73	1.62	1.90
~70%	6.18	2.40	2.07	2.32
~80%	5.71	3.42	2.69	2.89
~90%	7.50	6.07	3.89	3.79
~100%	7.74	7.30	6.29	5.20
Average	3.90	3.11	2.63	2.49

Source: Jae-jin Yang and Hyo-sang Min (2013) "The political economy of the low tax regime and tax increase in the Korean welfare state" (in Korea), *Journal of Korean Social Trends and Perspectives*. Vol. 88

Time to change: how to escape from the low-low dilemma

In the context of rapid aging and ever-increasing inequality, it is hard to argue that rising social spending is anything but unavoidable. A projection by the Korea Institute for Health and Social Affairs has estimated that even under current policies, social spending will increase from around 9 percent of GDP to 22 percent by 2050. Korea's tax rates need to increase to finance such spending. As seen in Table 1 above, direct taxes on households are particularly low in Korea. Therefore it would be a natural choice for the government to increase income tax. But, as we have seen, this could spell political suicide with the government potentially facing opposition from a massive cohort of 15

million income-earners, or voters, in democratized Korea. The recent tax reform plan of the Park government was a litmus test. The strong backlash from salaried and middle-income earners clearly does not bode well for the future.

If Korea is not to follow the wrong path of 'debt and spending' seen in Japan and Southern European countries, the expected large rise in social spending should be financed through a revenue increase that minimizes the negative effect on growth and pro-welfare politics. Pro-growth tax policies calls for limiting increase in the tax on labor income and keeping a low corporate tax rate: indeed, this is in fact the tax policy Korea has adopted from the 1971 tax reform, and deviation from this route proved politically unfeasible. So, what options remain for Korea?

As suggested in Strengthening Social Cohesion in Korea, "keeping direct taxes low implies that revenue increases should come primarily from indirect tax, notably the value-added tax (VAT), which has a smaller negative effect on labor supply." Moreover, the VAT is deemed to be a relatively easy 'sell' to taxpayers compared to, say, income tax increases. Korea introduced the VAT in 1977, which was the first in Asia and 12 year ahead of Japan. Korea's VAT is still 10 percent (far below the OECD average of 18 percent) and has been the State's biggest revenue source since its introduction. Increasing the tax burden through consumption taxes would have negative implications for equality. Nevertheless, if the increased revenue is accompanied by expanded EITC and other well-targeted social spending, the negative effect will be minimized. Upgrading compliance with social insurance contributions, particularly for non-regular workers and employees at small firms, is also a good candidate for increasing revenue. This is important not only to finance increasing social expenditure but also to play social insurances' intended roles.

President Park and Korea's leading politicians now face an unavoidable hard choice: welfare expansion without tax increase or welfare expansion with tax increase. Although politically tempting, the former can be disastrous for future generations. It is the latter which should be the choice of the political leadership no matter how difficult to persuade voters. Korea's future depends on the choice of today.

How to Improve Financial Assistance for Low Income Koreans

The term "seomin geumyoong"—microcredit finance—has rapidly gained currency in the financial sector since the 2000's. Aimed at helping stabilize the living standards of low-income households, these financial services are in a sense an important part of social protection. However, microcredit finance is not viewed as part of social security, nor is there a clear definition of "financial service for low-income groups." Low income groups have different financial needs compared to the middle and high income group. Therefore, providing financial solutions such as a simple debt adjustment or interest rate adjustment cannot satisfy the needs of the low income group.

Financial system for the low income group started drawing attention since the 2003 credit card crisis. In the early 2000s, many borrowers went delinquent on their credit loans, which had grown rapidly in the wake of the Asian financial crisis. As this has become a social issue, the government has created a rescue program using the Credit Recovery Fund. At the private sector level, interest in micro credit has increased as a way to help rehabilitate low-income groups and many relevant bodies have been created. Microcredit has become a private-public project in the previous administration as 'Smile Microfinance' and has been actively used to support small-business startups or livelihood.

Financial programs for the low income group can be divided into two types: market provided programs and private-public programs. The market-provided programs refer to programs provided by general financial institutions where the low income borrower can borrow money for housing or living expenses. However, as low income groups have low income and bad credit scores, they are at a disadvantage compared to other income groups. There are two types of support provided by the government and the private sector. In addition to the government's direct support through loan programs, Smile Microcredit, Sunshine Loan and New Hope Seed Loan are jointly provided the government and the private sector.

There are a variety of loan programs for low income groups. For instance, there is Mortgage (Chonsae) for Low-income Workers and the Low Income Group Chonsae Loan provided through the National Housing Fund. Student loans for college students and support for start-up businesses by the government (Korea Worker's Compensation & Welfare Service, Regional Credit Guarantee Foundations) are also offered. Apart from these efforts, the current government has created the National Happiness Fund in order to alleviate the excessive debt burden imposed on the defaulted borrowers and low-income households.

In the previous administration, programs such as Smile Microcredit, Sunshine Loan and the New Hope Seed Loan were introduced using the private sector fund to help the low income group and the low credit score group to seek livelihood security. The Smile Microcredit began in July 2008, using the dormant deposits in banks, and contributions from financial institutions and the private sector (2.2 trillion KRW for 10 years). This programs offers loans to the low income group (those with credit levels of 7 and below) for livelihood security and business operation.

In order to operate the Smile Microcredit program, the government has established the Smile Microcredit Bank for the operation and management of Smile Microcredit products. Sunshine Loan was created to supplement the Smile Microcredit to provide loans to the low income group using the fund (10 trillion KRW for 5 years) contributed by the Regional Credit Guarantee Foundations through mutual finance institutions and savings banks. Those with a credit level of 6 or below with an annual income of 40 million KRW or less are eligible for the Sunshine Loan. The New Hope Seed Loan was introduced in the similar timeframe as the Sunshine Loan, Eligibility for the program is

those with a credit level of 5 and below and an annual income of 40 million KW and below and the loan is provided through private commercial banks (Nonghyup, Suhyup and the Korea Federation of Community Credit Cooperatives, to mention just a few.) Designed and put into operation by the previous administration with a view to helping Koreans with low-income and poor credit overcome poverty, these microcredit programs, however, are found to have many limitations. First of all, as these programs are more focused on providing business startup funds, there is a gap in expectations as most people in the low income group need livelihood support. Therefore, the default rate is higher compared to other financial institutions and loan management is difficult. Also, due to lack of professional staff to help with financial management for the Smile Microcredit borrowers and the low income group, linkage with other types of financial assistance, employment support or welfare service is lacking.

A program for the low income group that was introduced in this administration is the Happy Fund, which was designed to help increasing household debt problems. It is aimed at alleviating excessive debt burden and providing linkage with employment opportunities and income generating opportunities to stop the vicious cycle of household debt. The program consists of support for recovery of credit for delinquent borrowers, debt adjustment for student loans and loan conversion from high interest loans to low interest loans. Shortcomings of this program include possibility of moral hazard on the part of the recipients (fairness with the non-delinquent borrows) and the temporariness of the program.

Financial Services for Low Income Koreans

According to Statistics Korea, the asset and finance status of low income Koreans is as follows. Assets and liabilities by income quintile show that the assets for the bottom 20 percent decreased from 108.46 million KRW in 2011 to 98.99 million KRW in 2012 and the liabilities have also decreased from 14.45 million KRW in 2011 to 9.82 million KRW in 2012.

This trend is the opposite of other quintiles where the both assets and liabilities have increased by a small margin between 2011 and 2012. In the case of households that have both assets and liabilities, the assets for the bottom quintile decreased from 108.46 million KRW to 98.99 million KRW and liabilities decreased from 44 million KRW to 30.46 million KRW, respectively. In particular, liabilities have decreased by a large margin compared to the other quintiles.

Table 1. Korean Households' Assets and Debts, by Income Quintile

unit:10 thousand KRW

	All households					
	2011			2012		
	Asset	Debt	Net asset	Asset	Debt	Net asset
Quintile	29,765	5,205	24,560	31,495	5,291	26,203
1st	10,846	1,445	9,401	9,899	982	8,917
2nd	16,130	2,748	13,381	16,619	2,812	13,807
3rd	22,813	3,850	18,963	23,204	3,856	19,348
4th	33,732	5,953	27,779	33,803	5,620	28,183
5th	65,281	12,023	53,258	73,941	13,186	60,756

	Households with Debts and Assets					
	2011			2012		
	Asset	Debt	Net asset	Asset	Debt	Net asset
Quintile	29,765	8,289	21,476	31,495	8,187	23,308
1st	10,846	4,400	6,445	9,899	3,054	6,845
2nd	16,130	4,595	11,535	16,619	4,638	11,982
3rd	22,813	5,637	17,177	23,204	5,289	17,915
4th	33,732	7,879	25,853	33,803	7,349	26,455
5th	65,281	15,530	49,751	73,941	16,279	57,662

Source: Survey of Household Finances and Living Conditions (2012), Statistics Korea

For comparison with ordinary households, the assets, liabilities and the net asset for the vulnerable social group such as the disabled, single-parent households and elderly households were used. Single-parent households had the lowest level of assets with 176.45 million KRW and the disabled and elderly households showed a similar level.

In terms of liabilities, single-parent households showed the highest level at 40 million KRW, disabled households showed 30 million KRW, elderly households showed 17 million KRW and Grandparent-grandchild households had the least amount of debt with 12 million KRW. The assets, liability and net asset size of these types

of households belong to the bottom two quintiles, indicating that these households are vulnerable in terms of assets and liabilities in addition to the low income group.

Table 2. Assets and Debts, by Household Type (2012)

Unit: 10 thousand KRW

Household type	Total asset	Total debt	Net asset	Ordinary income
Disabled-person's households	20,196	2,996	17,200	2,621
Single-parent households	17,645	4,004	13,641	2,939
Elderly households	21,160	1,768	19,392	1,243
Grandparent-grand child housholds	14,327	1,199	13,128	1,738

Source: Survey of Household Finances and Living Conditions (2012), Statistics Korea

The top two reasons for the bottom quintile to rely on debt have shifted from 'others' and 'business fund' in 2011 to 'housing' and 'business fund' in 2012. Compared to other quintiles, debt for living expenses has increased from 11.7 percent in 2011 to 20.0 percent in 2012, which indicates that housing and living expenses are increasing the debt burden for the low income group.

The higher the income, the higher the debt for housing, which was a difference compared to the low income group. The analysis of purpose of debt by type of household shows that housing was the main purpose for debt for disabled households(40.1 percent), single-parent households mostly borrowed for business fund (42.43 percent) and elderly and grandparent-grandchild households borrowed mostly for business fund as well.

Debt for living and medical expenses account for 11 percent for disabled and single-parent households and 10 percent for elderly households, while grandparent-grandchild households showed a high ratio of 17 percent. If the type of household and the income quintile are analyzed together, debt for housing and living expenses will account for a larger portion.

The overall debt mix by income quintile shows a higher percentage in loans compared to rent deposit. In the case of the 1st quintile (bottom 20 percent), not many households had debt for both loans and rent deposit. In the case of loans for the 1st quintile (bottom 20 percent), 12.5 percent of households had secured loans and 10.2 percent had credit loans, which is a lower rate compared to other income groups and only 3.6 percent of households had credit card-related debt. The number of households with credit cards was low in the 1st quintile (bottom 20 percent), however, loans were higher than other quintiles.

Financial soundness has improved in all quintiles between 2011 and 2012

In particular, in the 1st quintile (bottom 20 percent), debt accounted for 279.6 percent of the disposable income in 2011 but improved by a big margin to 144.4 percent in 2012. Debt against asset also improved from 13.3 percent in 2011 to 9.9 percent in 2012. The improvement of financial soundness is mainly due to the decrease of debt in the low income group.

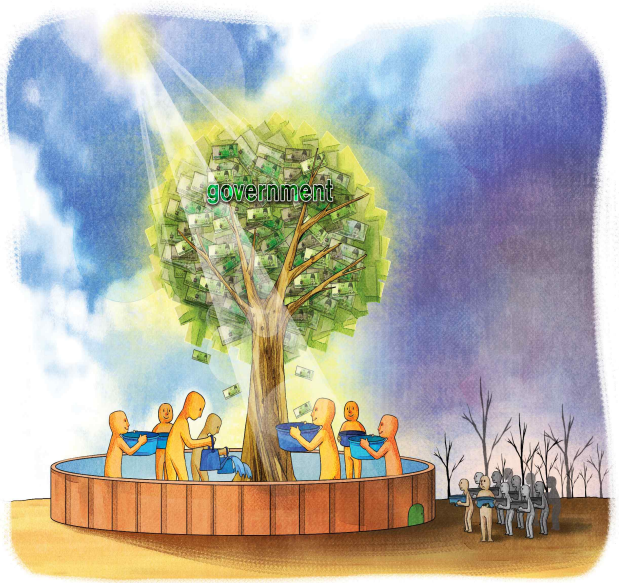
More study is required to identify the main causes behind the debt decrease in the low income group.

Policy Implications

This report reviews the financial assistance programs for the low income group and the current status. More work must be done in order to improve and amplify the financial assistance for the low income group from the social security perspective.

First, a co-op style financial institution needs to be established in order to meet the commercial needs of the institution and assist the low income group from the social welfare perspective at the same time. The existing financial institutions for the low income group (Nonghyup, Suhyup, KFCC, credit unions etc.) were created under the auspices of the government policy in the beginning, however, nowadays; they serve as general financial institutions. As these institutions are commercial entities, they tend to focus more on commercial profit rather than supporting the low income group. With the enactment of the Basic Act on Cooperatives, more co-ops are be-

ing established in Korea, however, the finance sector still faces many limitations in setting up co-ops. Taking into account the characteristics of a cooperative, a co-op style financial institution will be able to satisfy both the profit-seeking aspect as well as supporting the low income group with small-scale loans under the spirit of cooperation and social integration. The current situation shows that the low income group is experiencing an increase in debt for living expenses. The need for microcredit for living expenses, medical expenses and education is discussed. A dualistic approach may be applied where regular business activities can be exercised for the general customers and co-op members and low interest-rate long-term loans can be provided to the low income group. In addition to the financial assistance, co-ops can make use of their networks to provide welfare services provided by private organizations, which otherwise would not be possible.



Second, debt repayment methods must be diversified for the low income group. Currently the most widely used methods are repayment delay or lowering the interest rate

Considering the fact that the amount is small (9.82 million KRW on average), repayment needs to include payment in kind. It must be considered that borrowers or those who receive loans from financial institutions for the low income group (or unemployed youth) do not receive large-scale loans. And even if they wish to repay, it may become difficult due to unemployment or lack of income generating opportunities.

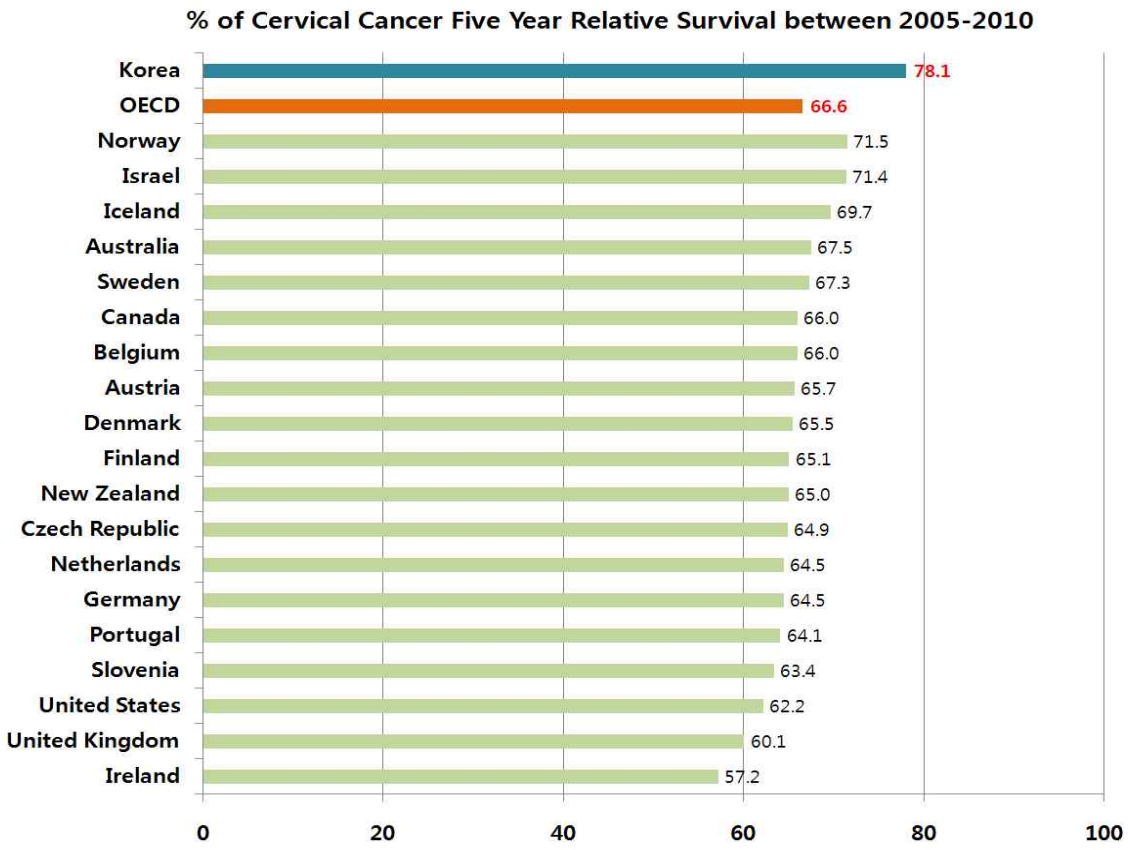
The low income group who has received loans from financial institutions for the low income group must be given priority in the Government-supported job creation projects so that they can repay the debt and maintain a stable livelihood.

Third, professionals for the financial services for the low income group must be fostered. Smile Microcredit is operated by volunteers who have experience working in financial institutions; therefore, there is a limitation in terms of liability and responsibility. The low remuneration discourages young or older people from working. Managers of 'Smile Microcredit' and their employees must receive an appropriate amount of remuneration first; in addition, a professional course must be created to foster professionals, either those who have industry experience or young jobseekers who wish to work in this area. The professionals must provide financial knowledge to the low income group and help them with asset and financial management so that the low income group can maintain stable livelihood.

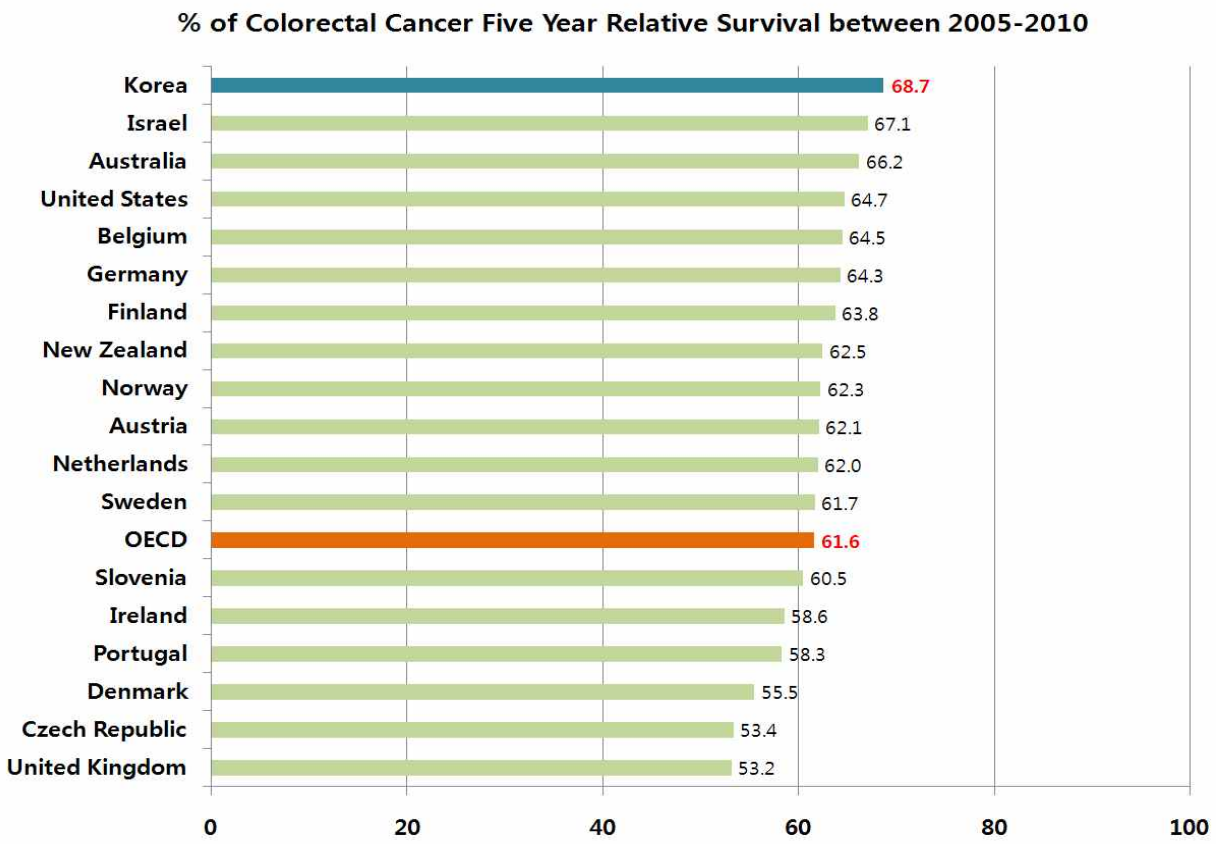
Last, an assessment from the government and the private sector on the current system and an improvement plan are required. In the past couple of administrations, new programs such as Credit Recovery and Smile Microcredit have been created to help the low income group recover credit and resolve household debt issues. Despite the introduction of various programs for the low income group and the low credit group, no proper assessment has been made on the financial and welfare aspects of these programs due to the lack of linkage between these programs. In addition, as these programs were created in different administrations without a long-term plan in mind, there remain sustainability issues. In order to improve support and promote the programs for the low income group, a systematic assessment as well as development plan must be in place for financial system for the low income group and welfare services that include financial support.

Where Korea Stands

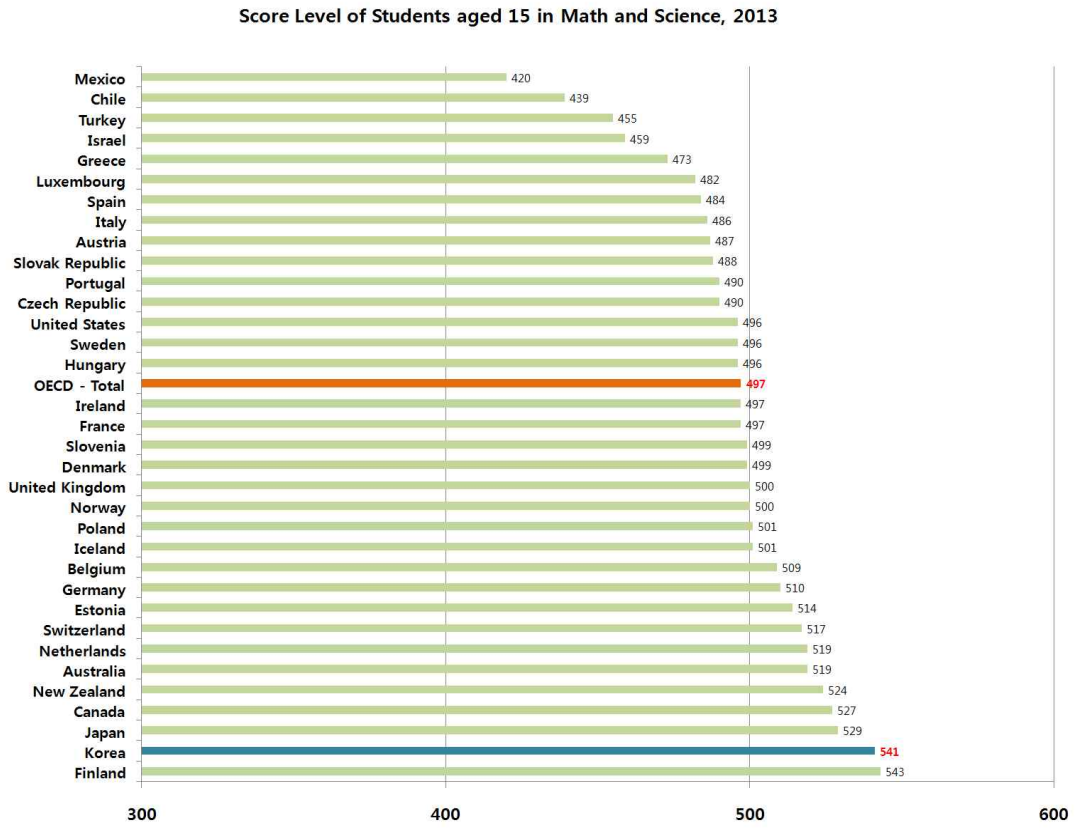
Thumbs up



Source: OECD Health Data 2013

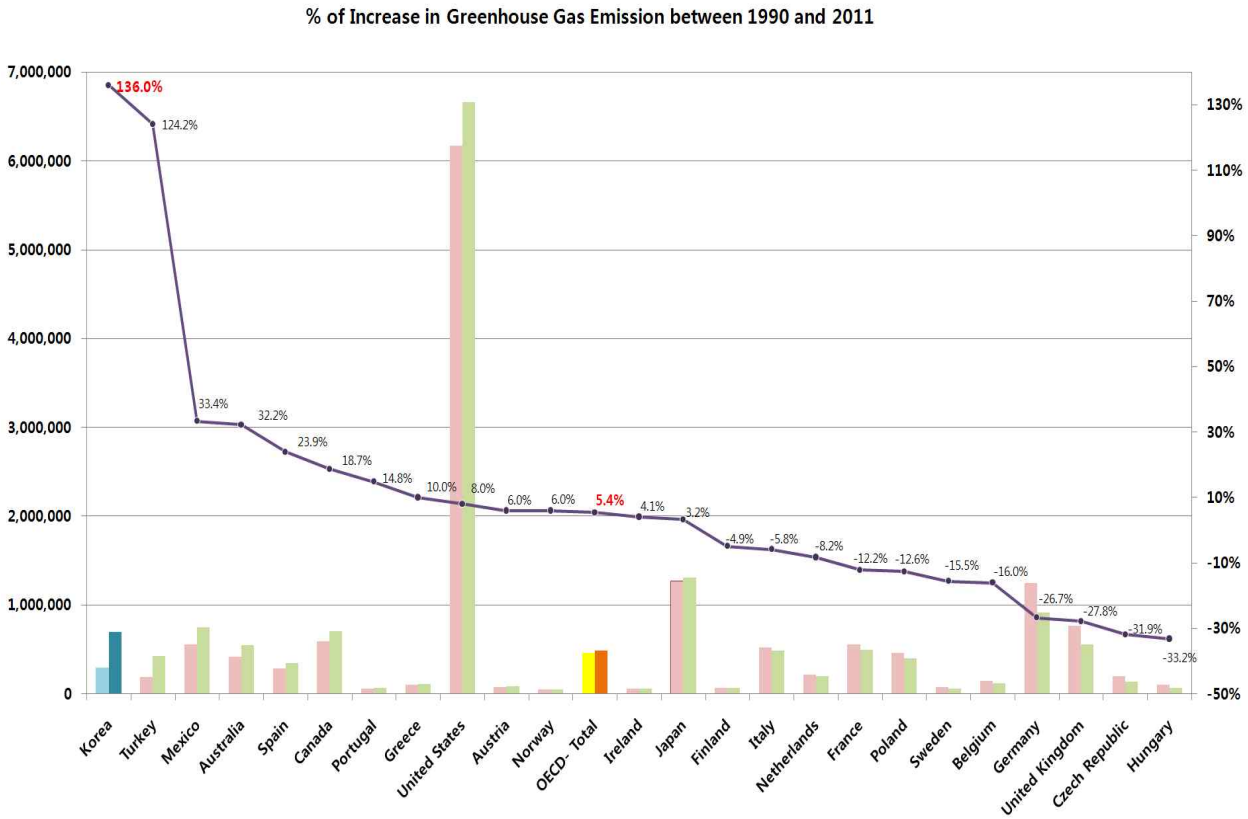


Source: OECD Health Data 2013

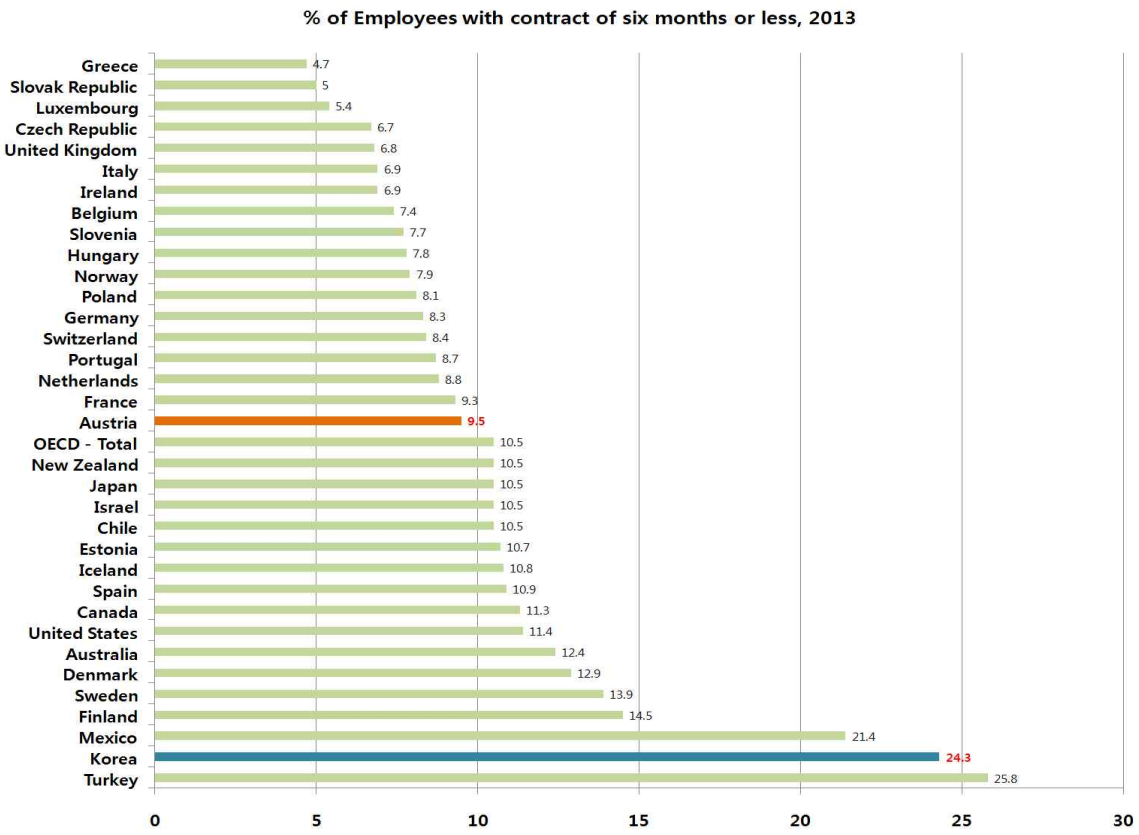


Source: OECD Better Life Index, 2013

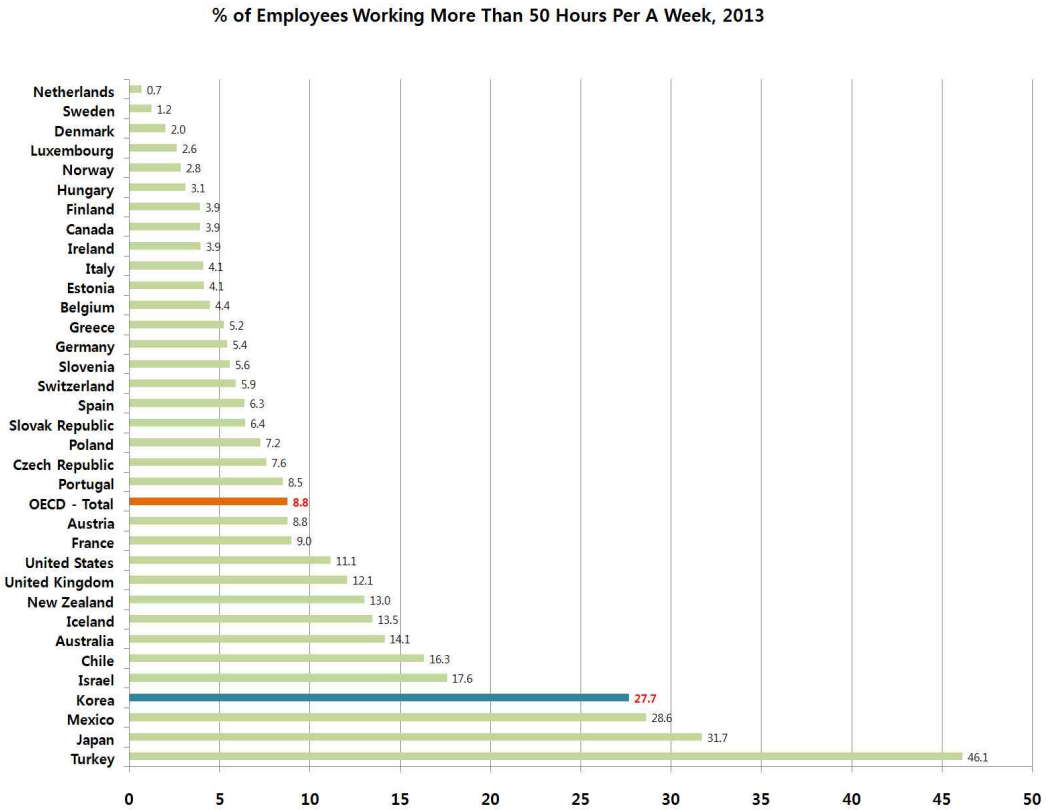
Thumbs down



Source: OECD Environment Data 2013



Source: OECD Better Life Index 2013



Source: OECD Better Life Index 2013