



# A Study of Social Security Financing

Seong-eun Choi



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Chapter

01

# Introduction







## Chapter 1

# Introduction

Korea's social welfare spending, including that of the national health insurance, reached approximately 12.2 trillion won in 2011. The size, which accounts for 36% of the government's total spending, tops its list of public expenditures.<sup>1)</sup> The government's welfare spending breaks down into different categories: 31% for the national health insurance, 26% for the public pension schemes, and 5% and 4% for the unemployment insurance and the industrial accident compensation insurance, which, taken together, represent the country's four key public insurance programs and account for 66% of the nation's total social spending. Public assistance, which includes national basic livelihood security program and other programs for the underprivileged, and social

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1) The Ministry of Strategy and Finance's list of social welfare expenditure covers the following functional categories: health, welfare, veteran, labor, housing and national pension programs. However, it should be noted that the list includes all public expenses related to housing, even those of housing-related surveys, which do not have any relevance to social welfare. Meanwhile, out of the nation's public pension programs, the list only counts the national pension program, excluding multiple pension schemes for groups of people of government-designated public areas. To make matters more complicated, public expenditure on the national health insurance system is not included in the Ministry's statistics, which only captures government subsidies for this category. As a whole, the Ministry's function-based social welfare expenditure statistics is not believed to represent Korea's real size of welfare spending. Therefore, in this article, the estimated volume of social welfare spending does not include housing survey-related expenses, which are hardly regarded as welfare spending, and instead includes expenses for national pension schemes for the government-designated public occupations, and expenses for national health insurance, which is not counted in the national statistics of public expenditures.

services and job creation altogether take up 13%. Child support and family-related programs takes up 2%, and health and medical expenses account for 1%.

Korea's welfare expenditure has increased at a fast pace as the coverage of public insurance programs has been rapidly expanded over a relatively short period of time. In the wake of the fiscal crisis in 1998, the Korean government implemented the national basic livelihood security program to help ease the difficulty of people meeting the minimum standard of living, and started to put more investment on the stabilization of employment and subsidies for the unemployed to strengthen the country's social safety net. In addition, with its declining childbirth rate and the population's aging, Korea began to increase its spending on child care and launched the basic old-age pension program and the elderly long-term care insurance programs, placing more pressure on its social welfare finance. The changes to the nation's demographics, spurred by the rapid progress of an aging society, indicates that the country's public spending on medical services and income coverage for senior citizens will remarkably grow in the near future.

All of the above will push up not only the payment of social insurance benefits, including those of the national health insurance and the national pension programs, but also social insurance premiums and the extension of the government's funds. At present, the social insurance programs for which relevant laws endorse government financing are as follows: 14% for the public health insurance and compensation for any loss in the government employees pension fund and the military pension fund, leaving

no legal protection for any loss in the teachers pension fund and the national pension system. The teachers pension fund is expected to dry up by 2020, and the national pension system also reviews its fiscal status every five years to estimate the timing when the fund runs out, raising people's concern about fiscal deficit and the need for a further increase in premiums of the two funds. The national health insurance, which has experienced a very speedy rise in its benefit payment, adds to the demand for premium increase and expanded government support of financial sources.

The expected hike in expenditure of social welfare programs, including the national health insurance, the national pension scheme and the elderly long-term care insurance, mainly covered by social insurance premiums, will inevitably lead to increase in tax sources as well as in premium rates. Especially, child rearing, family life and social services are the areas that will put more financial burden on state coffers as well as on citizens in the form of premium. A social debate on the need for expanded social welfare, which is considered as populism, and another continued discussion on the need for the government's active involvement in child rearing and various forms of family support, have intensified along with scheduled general elections and change of political leadership in power. The discussion on the government's increased engagement in child care has built a social consensus and even led to the extension of the government's full subsidy for daycare center fees to all middle-class families with child aged 0 to 2 and 5. As even a universal child allowance is under review, the pressure on government spending on child

care and family issues is expected to grow significantly. Given all the aspects discussed above, this article will offer recommendations on sustainable ways to finance growing social welfare needs.



Chapter

02

# **Current Status and Projections of Korea's Social Welfare Finances**



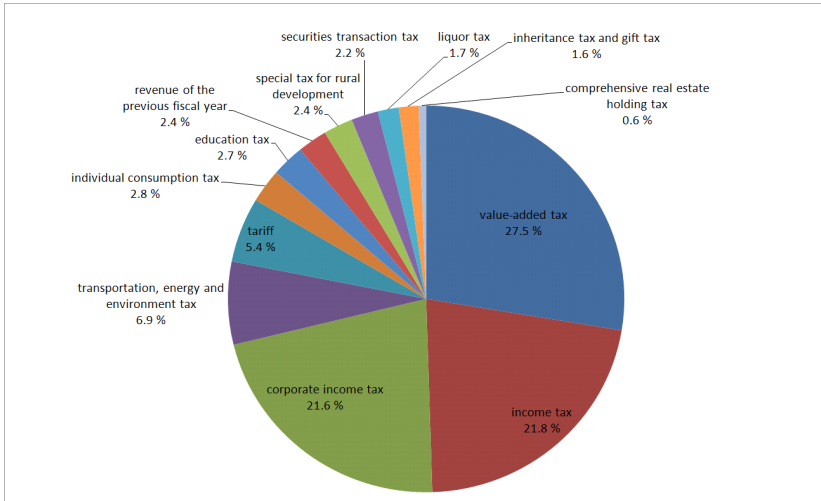


## Chapter 2

# Current Status and Projections of Korea's Social Welfare Finances

The total tax revenue of the central government's budget and public funds amounted to 290 trillion won, accounting for 27.2% of the nation's gross domestic product (GDP), as of 2009. Out of the total revenue, the budget revenue is 194.8 trillion won (67.1%), consisting of national tax revenue of 170.5 trillion won (58.7%) and non-national tax revenue of 24.3 trillion won (8.3%). The revenue of public funds is 96.0 trillion won (32.9%), of which 35.6 trillion won (12.2%) is covered by public insurance premiums, including that of the national pension program. A tax item-based breakdown of the total revenue is as follows: value added tax of 27.5%, income tax of 21.8%, and corporate income tax of 21.6%. Tax revenue sources of the special account are as follows: transportation, energy and environment tax of 6.9%, education tax of 2.7% and liquor tax of 1.7%.

[Figure 2-1] Tax Revenue Break-down (as of 2010)



Source: Digital Budget & Accounting System ([www.dbrain.com](http://www.dbrain.com))

The revenue sources of social insurance funds, such as public pension programs, national health insurance, unemployment insurance and industrial accident insurance, are insurance premiums and income from taxes belonging to the general account, except for income from properties and various other income sources. National health insurance has multiple fund sources: premium, a part of general account tax income allocated to cover 14% of national health benefits, and about 65% of an expected revenue of the public health promotion levy, imposed on cigarettes. The national pension program is mainly covered by premium, with a part of general account tax revenue designated to cover administrative costs and childbirth credit, which adds premium to eligible parents' pension account. As for the public employees



pension fund, the public employees pension levy comes from general tax revenue and the rest from the following sources: taxes of other special accounts, such as taxes of registration, construction of multi-functional administrative city, environment improvement and transportation facilities; taxes of the corporate special account, such as taxes of postal service and procurement; and proceeds of performance-based public organizations, such as science museums, hospitals, public medical centers and police hospitals. The premiums of both Korea teachers' pension and military personnel pension are covered by tax revenue of the general account. For the military personnel pension and the government employees pension, the use of government funds to make up any loss is specified by relevant laws. Tax revenue of the general account also covers the expenses of unemployment insurance, specifically those of management of unemployment insurance, and various projects including maternity protection programs, and those of the industrial accident insurance as well.

The government's expenditure on public assistance and social services, other than social insurance programs, is also paid by general account tax revenue. As for public health and medical care spending, the revenue from the public health promotion levy imposed on cigarettes is used to pay for the projects of the national health promotion fund. Meanwhile, the special accounts financed by earmarked taxes allocate a certain portion of the funds to supporting public health and welfare; the special account for the rural area structural improvement fund, mainly covered by the diversion of farmland levy; the special account for the energy and resource project, financed by relevant levies;

the special account for balanced development, covered by liquor tax; and the special account for performance-based public organizations, covered by their own business proceeds.

〈Table 2-1〉 Social Welfare Spending of Special Accounts (as of 2011)

(unit: Million won)

Special Account	Project	Amount
Rural area structural improvement		68,121
The underprivileged	House remodeling for the disabled in rural areas	1,900
The elderly	Expansion of welfare facilities for the elderly with mobility problems in rural areas	0
Labor	Vocational training for the unemployed in rural areas	907
Health and medical services	Improvement of medical services in rural areas	65,314
Energy and resource projects		88,452
The underprivileged	Provision of LPG voucher for the disabled with cars	0
Labor	Prevention of industrial accidents	54,272
Veteran	Subsidy for LPG car purchase by men of national merit	34,180
Innovation city construction		3,478
Labor	Relocation of a call center for innovation city in the Ministry of Labor	3,478
Metropolitan and local development		64,265
The elderly	Finding jobs for the elderly	1,944
The young	Expansion of facilities dedicated to young people	49,417
Labor	Development of vocational capabilities and labor-management policies	6,892
Housing	Improvement of housing environment	0
Veteran	Operational cost of regional offices of patriots and veterans affairs	1,286
KFDA (Korea Food and Drug Administration)	Monitoring of food safety and follow-up actions	4,726
Performance-based public organizations		102,121
Health and medical care	Operational cost of National Rehabilitation Center and national hospitals	102,121

More than 50% of welfare spending for the youth is primarily covered by proceeds from projects of relevant public funds: money transferred from the lottery fund, formed with sales proceeds of lottery, and legal levies. As for labor-related welfare expenditure, the sources of the wage claim guarantee fund are levy on employers and general tax revenue, while the sources of the fund for employment promotion and vocational rehabilitation for the disabled are the disabled employment levy, general tax income and money transferred from the lottery fund. The lottery fund is used to cover some projects to support the underprivileged, and to finance the labor welfare promotion fund and the development fund for women.

〈Table 2-2〉 Lottery Fund's Social Welfare Projects for the Disadvantaged

(unit: Million won)

Category	Project Title	Run by	Plan for 2010 (A)	Plan for 2011 (B)	Increase /Decrease (B-A)	
Public service	Subtotal		471,936	481,375	9,439	
	Provision of housing					
	Purchase and rent of multi-family housing	Ministry of Land, Transport and Marine Affairs	374,850	374,850	-	
	Subleasing of housing	Ministry of Land, Transport and Marine Affairs	80,826	90,265	9,439	
	Housing support for residents living in flop houses	Ministry of Land, Transport and Marine Affairs	16,260	16,260	-	
	Subtotal		153,394	290,074	136,680	
	Support for assistive technology devices	Employers	8,000	8,000	-	
	Operation of a job training and job arranging center for released prisoners	Ministry of Justice	2,750	1,410	△1,340	
	Support for dormitories for the disadvantaged youth	Ministry of Justice	2,120	714	△1,406	
	Legal support for credit restoration of the financially disadvantaged	Ministry of Justice	2,800	2,800	-	
	Subtotal of the lottery fund's transfer to the development fund for women		104,560	126,724	22,164	
	• Control of reoccurrence of domestic and sexual violence	Ministry of Gender Equality and Family	6,289	2,902	△3,387	
	• Support for child care and education expenses of single-parent families	Ministry of Gender Equality and Family	55,934	65,468	9,534	
	• Support for multicultural families	Ministry of Gender Equality and Family	42,337	58,354	16,017	
	Building of a dedicated treatment and rehabilitation center for children and young people	Ministry of Gender Equality and Family	2,964	4,318	1,354	
	Improvement of energy efficiency of low-income households	Ministry of Knowledge Economy	29,200	19,450	△9,750	
	Consumer education and a consumer damage relief system for the underprivileged	Fair Trade Commission	1,000	600	△400	
	Promotion of microfinance	Small Medium Business Administration	-	120,000	120,000	
	Building of an incubator for customized business start-up of the low-income disabled	Small and Medium Business Administration	-	3,000	3,000	
	Provision of shelters for elderly people experiencing abuse	Ministry of Health and Welfare	-	2,458	2,458	
	Employment of janitors for correctional facilities	Ministry of Justice	-	600	600	
	Subtotal		17,649	16,471	△1,178	
	Veterans' welfare	Enhancement of welfare facilities for men of national merit	Ministry of patriots and veterans affairs	17,649	16,471	△1,178

Category	Project Title	Run by	Plan for 2010 (A)	Plan for 2011 (B)	Increase /Decrease (B-A)
Legally designated projects	Support for local governments; construction of medical and rehabilitation facilities for the disabled, expansion of public and private child care centers and support for children of low-income families	Local governments	40,266	62,362	22,096
	Support for special account of Jeju Provinces' development projects, support for child care expenses of infants and provision of basic old-age pension program	Jeju Province	43,266	62,362	19,096
	Fund transfer to the labor welfare promotion fund; lending of low-rate fund to the underprivileged to cover their living expenses	Korea Workers' Compensation & Welfare Service	13,305	19,178	5,873
	Support for the Korea Veterans Health Service; support for the project to advance medical services	Korea Veterans Health Service	16,108	23,216	7,108
	Support for the Community Chest of Korea; a project to take care of children and adolescents without guardians at night time	Community Chest of Korea	10,739	15,479	4,740

Source: 2011 Lottery Fund Management Plan

As about 89% of the health and welfare spending is legally specified expenditure, it will continue to rise even without the expansion of beneficiaries or the introduction of a new welfare program. In addition, the demographic changes led by an aging society and a declining birth rate are expected to bring up medical and income security expenses for the elderly. Those changes will also rapidly increase the expenditure of national health insurance, basic old-age pension, elderly long-term care insurance and national pension programs. Studies on a future trend of the percentage of health and welfare expenditure of the nation's GDP show that the rate, which ranged from 8.9% to 10.9% in 2010, will grow to 15.2% to 20.6% by 2030.

〈Table 2-3〉 Outlook for Government's Social Welfare Expenditure

(unit: Percentage against GDP)

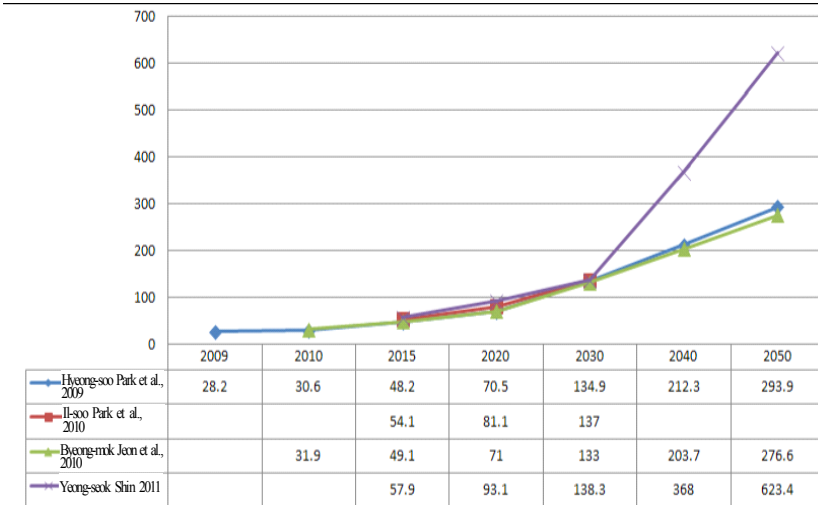
		2009	2010	2015	2020	2030
I <sup>1)</sup>			10.1	11.3	12.9	17.5
II <sup>2)</sup>	Minimum	8.6	8.9	10.2	12.0	17.0
	Maximum	8.8	9.1	10.6	13.2	20.1
Model III <sup>3)</sup>		9.5	9.8	10.6	12.0	15.2
Model IV <sup>4)</sup>			10.9		15.3	20.6

- Note: 1) Model I KDI, 2005. Mid- and Long-term Priorities of Policies and Direction of Finance Management  
 2) Model II Korea Institute of Public Finance, 2004. Changes and Forecast of Social Welfare Spending Status  
 3) Model III Hyeong-soo Park et al, 2009. Study on Development of Mid- and Long-term Financial Estimation Model for Analysis of Social Welfare Finance  
 4) Model IV Vision 2030

National health insurance spending, which amounts to 38 trillion won in 2011, is expected to reach 133 to 138.3 trillion won by 2030 (source: Hyeong-soo Park et al., 2009; Byeong-mok Jeon et al., 2010; Il-soo Park et al., 2010; Korea Institute for Health and Social Affairs (KIHSA), 2011). When it comes to the long-term forecast of the spending by 2050, different research studies present significant gaps in their estimation, which range from 293.9 trillion won to 623.4 trillion won.

[Figure 2-2] Outlook for Government Spending on National Health Insurance

(unit: Trillion won)

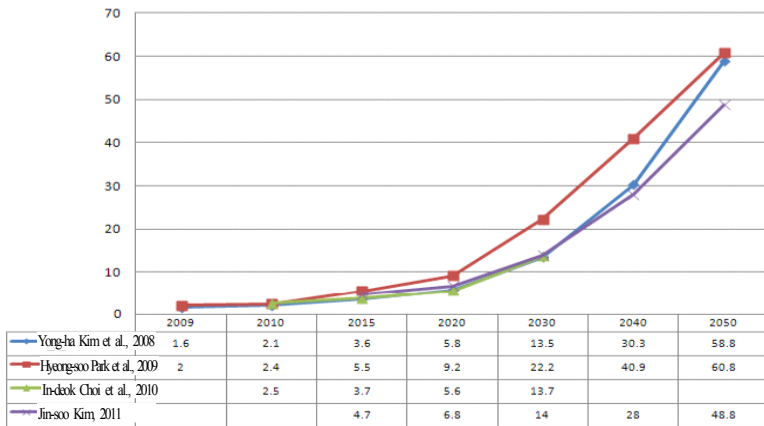


Source: Hyeong-soo Park et al., 2009. Study on Development of Mid- and Long-term Financial Estimation Model for Analysis of Social Welfare Finance  
 Il-soo Park et al. 2010. Study on Mid- and Long-term Financial Outlook for National Health Insurance  
 Byeong-mok Jeon et al., 2010. Financial Forecast and Policy Issues on Social Insurance  
 Yeong-seok Shin, 2011. Seminar on Future Strategy for Life Expectancy of 100

Elderly long-term care insurance expenditure, which was about 1.9 trillion won in 2009, is estimated to grow to about 13.5 trillion won to 22.2 trillion won by 2030 (Yong-ha Kim et al., 2008; Hyeong-soo Park et al., 2009; Korea Institute for Health and Social Affairs (KIHSA), 2011). Studies show that the expenditure will reach about 48.8 trillion won to 60.8 trillion won by 2050. Since a debate continues on the eligibility standards of the beneficiaries, the chances are that the coverage of the insurance will be expanded, pushing upward the relevant spending at an alarming pace. Now only 5.1% of the population aged 65

or over is eligible for this insurance. If the eligibility standards are eased and the coverage is expanded to 10% of the elderly population, out of the total budget, the estimated government fund support alone would be 420 billion won, which will inevitably lead to an increase in premium (National Assembly Budget Office, 2011).

[Figure 2-3] Outlook for Government Spending on Elderly Long-term Care Insurance



Source: Yong-ha Kim et al., 2008. Study on Development of Financial Estimation Model for the Elderly Long-term Care Insurance  
 Hyeong-soo Park et al., 2009. Study on Development of Mid- and Long-term Financial Estimation Model for Analysis of Social Welfare Finance  
 In-deok Choi et al., 2010. Forecast of Mid- and Long-term Finance Management of the Elderly Long-term Care Insurance  
 Jin-soo Kim, 2011. Seminar on Future Strategy for Life Expectancy of 100

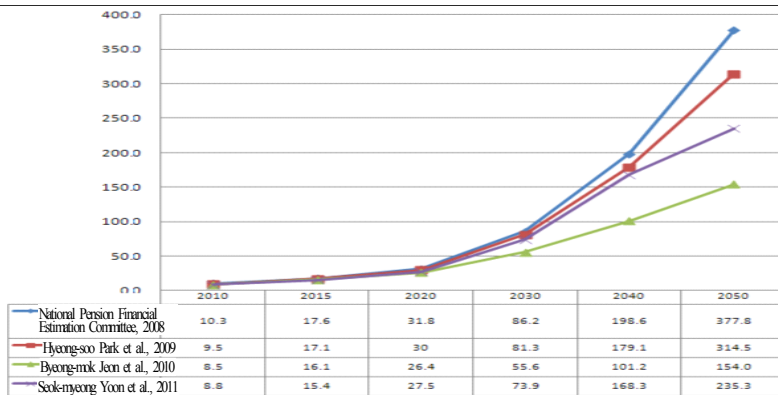
With the start of a large-scale pension benefit payment, the national pension expenditure has sharply increased recently, contributing most to a jump in the government's budget for health and welfare services, along with the expenditure for national



health insurance. While the size of national pension expenditure is about 10 trillion won as of 2011, analysis of pension finance in 2008 estimates that the fund will turn into a loss by 2044 and dry up by 2060. The Korea teachers' pension is expected to be exhausted by 2020. Many studies forecasting the expenditure of the national pension scheme estimate that it will grow to 55.6 trillion won to 86 trillion won by 2030, and even further jump to 154 trillion won to 383.8 trillion won by 2050 (The National Pension Financial Estimation Committee, 2008; Hyeong-soo Park et al., 2009; Byeong-mok Jeon et al., 2010).

[Figure 2-4] Outlook for Government Spending on National Pension System

(unit: Trillion won)



Source: National Pension Financial Estimation Committee, 2008. Financial Estimation of the National Pension System

Hyeong-soo Park et al., 2009. Study on Development of Mid- and Long-term Financial Estimation Model for Analysis of Social Welfare Finance

Byeong-mok Jeon et al., 2010. Financial Outlook and Policy Issues on Social Insurance

Seok-yeong Yoon et al., 2011. Seminar on Future Strategy for Life Expectancy of 100





Chapter

03

# **International Comparison of Social Welfare Expenditure Level**





## Chapter 3

# International Comparison of Social Welfare Expenditure Level

Korea's social expenditure, which accounts for 7.5% of the nation's GDP as of 2007, is only equivalent to 38% of the OECD average, 19.3%. However, this simple comparison cannot provide a proper and reasonable solution to the question of what should be the appropriate level for social welfare spending. That is because there are big differences among countries in their social and cultural backgrounds and development history of national welfare systems. Individual countries' level of welfare spending depends on various factors: maturity of national pension system, a level of population aging and national income, a rate of citizens' contribution to social welfare programs and the size of government. While it is relatively easy to compare figures of economic indicators among nations, it is much more difficult to measure a country's social, cultural and ideological factors against those of other countries. It is also true, however, that the latter qualitative factors can have a significant impact on determining an individual nation's appropriate level of social expenditure. Many studies indicate that social and cultural factors can make notable differences in people's perception of welfare and redistribution propensity among different groups (Luttmer et al, 2010; Benabu et al, 2006).

〈Table 3-1〉 Social Expenditure and Economic Status of OECD Countries (2007)

(unit: \$, %)

Country	Social welfare spending	Citizens' contribution %	Per capita GDP	Fiscal balance	Women employment rate	Unemployment rate	General government spending	% of elderly population
France	28.4	43.2	32,495	-2.7	59.4	8.3	52.6	16.5
Sweden	27.3	46.3	36,785	3.8	73.2	6.1	51	17.4
Austria	26.4	42.7	36,839	-0.7	64.4	4.4	49	17
Belgium	26.3	44.2	34,665	-0.2	54.9	7.5	48.4	17.1
Denmark	26.1	48.2	36,326	4.5	73.3	3.8	50.8	15.5
Germany	25.2	37	34,683	0.2	63.2	8.4	43.6	19.9
Finland	24.9	43.1	35,346	5.2	68.5	6.9	47.2	16.5
Italy	24.9	43.3	30,990	-1.5	46.6	6.1	47.9	20
Hungary	23.1	40.2	18,763	-5	50.9	7.4	50	16.1
Portugal	22.5	35.3	22,638	-2.7	61.9	8.1	44.4	17.3
Spain	21.6	33.3	31,469	1.9	55.5	8.3	39.2	16.6
Greece	21.3	32.6	27,793	-4	48.1	8.3	46.6	18.6
Norway	20.8	42.6	53,802	17.7	74	2.6	41.1	14.6
Luxembourg	20.6	35.6	82,456	3.7	54.5	4.2	36.2	14
UK	20.5	35.7	34,957	-2.7	66.3	5.3	44	16
the Netherlands	20.1	39.1	39,594	0.2	68.5	3.2	45.3	14.6
Poland	20	34.3	16,312	-1.9	50.6	9.6	42.2	13.4
OECD average	19.3	35.4	33,077	-1.3	57.5	5.7	41.2	14.2
The Czech Republic	18.8	36	23,995	-0.7	57.3	5.3	42.5	14.5
Japan	18.7	28.2	33,635	-2.5	59.5	3.9	35.9	21.5
Switzerland	18.5	29.1	41,800	1.6	71.6	3.6	32.3	16.3
New Zealand	18.4	33.7	27,020	5	69	3.7	38.8	12.5
Canada	16.9	32.3	38,448	1.6	70.1	6	39.4	13.4
Ireland	16.3	28.8	44,381	0.2	60.3	4.6	36.7	10.8
USA	16.2	26.1	46,434	-2.8	65.9	4.6	36.8	12.6
Australia	16	27.1	37,616	1.8	66.1	4.4	33.4	13.2
The Slovak Republic	15.7	29.3	20,270	-1.9	53	11.2	34.3	11.9
Iceland	14.6	36.8	36,325	5.4	81.7	2.3	42.3	11.5
Turkey	10.5	24.2	13,362	-	22.8	8.6	34.5	6
South Korea	7.5	26.5	26,574	4.7	53.2	3.2	28.7	9.9
Mexico	7.2	21	14,128	-	43.6	3.7	20.5	5.5

Note: The above figures of fiscal balance, general government spending, citizens' contribution % and social welfare spending represent their percentage of the nation's GDP.

Source: OECD Stats. National Accounts, Social and Welfare Statistics, Taxation and Market Regulation

Despite its relatively low level of social welfare expenditure, Korea's welfare spending has made much faster growth than its OECD counterparts. Since the 1990s, the OECD members' average annual growth rate of social expenditure has been 0.52%, but Korea has recorded a much higher rate of 5.93%. We have to understand that Korea achieved a remarkable economic growth for a very short period of time under its government leadership, focusing its spending on economic development, and it is in a different situation from its European counterparts that experienced the benefits and problems of economic growth attributed to the industrialization during the early 1990s.

〈Table 3-2〉 Average Annual Growth Rate of Public Social Welfare Expenditure (since 1980)

	Average annual growth rate since 1990	Average annual growth rate		
		the 1980s	the 1990s	the 2000s
South Korea	5.93%	..	8.95%	6.64%
Mexico	4.78%	..	5.50%	4.49%
Turkey	3.67%	4.37%	6.21%	..
Portugal	3.52%	0.88%	3.91%	2.56%
Japan	3.02%	0.75%	4.05%	1.78%
Switzerland	1.90%	0.70%	3.63%	0.53%
Poland	1.74%	..	4.33%	-0.52%
Greece	1.53%	4.69%	1.69%	1.55%
Italy	1.30%	1.85%	1.75%	0.94%
UK	1.21%	0.26%	1.14%	1.43%
Australia	1.18%	1.38%	2.56%	-1.11%
USA	1.10%	-0.06%	0.83%	1.64%
The Czech Republic	0.94%	..	2.18%	-0.74%
Germany	0.86%	-0.10%	2.29%	-0.77%
France	0.78%	1.99%	1.66%	0.35%
Austria	0.63%	..	1.45%	-0.16%
Ireland	0.52%	0.75%	-0.65%	2.99%
OECD average	0.52%	1.12%	0.98%	0.27%
Spain	0.46%	1.67%	0.26%	0.78%
Luxembourg	0.45%	-0.95%	0.71%	0.61%

	Average annual growth rate since 1990	Average annual growth rate		
		the 1980s	the 1990s	the 2000s
Iceland	0.36%	..	1.24%	-0.63%
Belgium	0.34%	0.50%	0.45%	0.52%
Chile	0.23%	..	2.82%	-3.11%
Denmark	0.22%	0.24%	0.56%	0.23%
Finland	0.15%	2.56%	0.68%	0.34%
Norway	-0.41%	2.94%	0.63%	-0.34%
Canada	-0.42%	2.29%	-0.87%	0.31%
Sweden	-0.60%	0.86%	-0.22%	-0.58%
New Zealand	-0.92%	2.42%	-1.16%	-0.57%
The Netherlands	-1.41%	-0.36%	-2.42%	0.21%

Source: OECD Stats. Social and Welfare Statistics

Another point that we have to note is that Korea is in a unique situation of national division, which requires the country to set aside a certain portion of its budget for national defense purposes. This difference is well explained in budget allocation of the OECD member countries. In the case of Korea, national defense represents 8.9% of the nation's total budget, the third highest number following Israel and USA, and its spending on economic items even accounts for 21.8% of its total expenditure, the second highest following Iceland. However, the nation's social welfare expenditure percentage of its general governmental spending (a combination of the central and local governments) stands at 25.4%, which is a mere 53% level of the OECD average rate of 48.2%. The fact that Korea's total government spending itself, compared with its level of national income, is very low, the second lowest following Mexico among OECD nations, explains why its percentage of welfare spending to its GDP is even lower than those of other OECD countries.



〈Table 3-3〉 Breakdown of Total General Government Expenditure (2009)

(Percentages against the nation's GDP. ( ) percentages of total general government expenditure)

	General	National defense	Public order	Economy	Environmental protection	Housing	Health	Cultural and local issues	Education	Social protection	Total general government expenditure
Denmark	7.5 (12.9)	1.5 (2.5)	1.2 (2.0)	3.1 (5.3)	0.5 (0.9)	0.6 (1.0)	8.8 (15.1)	1.7 (3.0)	8.0 (13.7)	25.4 (43.5)	58.4 (100.0)
France	7.2 (12.8)	1.9 (3.3)	1.3 (2.4)	3.1 (5.5)	0.9 (1.6)	2.1 (3.7)	8.4 (14.8)	1.7 (3.0)	6.2 (11.0)	23.7 (42.0)	56.5 (100.0)
Finland	7.4 (13.2)	1.7 (3.0)	1.5 (2.7)	5.1 (9.0)	0.4 (0.6)	0.5 (0.9)	8.0 (14.2)	1.2 (2.2)	6.6 (11.8)	23.9 (42.5)	56.3 (100.0)
Sweden	7.5 (13.6)	1.5 (2.7)	1.4 (2.6)	4.7 (8.5)	0.4 (0.6)	0.8 (1.4)	7.4 (13.5)	1.2 (2.2)	7.3 (13.2)	23.0 (41.6)	55.2 (100.0)
Belgium	9.2 (17.0)	1.1 (1.9)	1.9 (3.4)	5.9 (11.0)	0.6 (1.2)	0.3 (0.6)	8.0 (14.8)	1.3 (2.4)	6.3 (11.7)	19.5 (36.0)	54.2 (100.0)
Greece	10.7 (20.1)	3.6 (6.7)	1.9 (3.6)	5.3 (9.9)	0.7 (1.2)	0.4 (0.7)	6.0 (11.3)	0.6 (1.1)	4.5 (8.5)	19.5 (36.7)	53.2 (100.0)
Austria	6.9 (13.1)	0.8 (1.6)	1.6 (3.0)	5.0 (9.5)	0.5 (1.0)	0.7 (1.4)	8.2 (15.7)	1.1 (2.0)	5.8 (11.1)	21.8 (41.7)	52.3 (100.0)
Italy	8.7 (16.7)	1.6 (3.0)	2.0 (3.8)	4.4 (8.5)	0.9 (1.8)	0.8 (1.6)	7.5 (14.4)	0.9 (1.7)	4.8 (9.2)	20.4 (39.2)	51.9 (100.0)
UK	4.5 (8.6)	2.7 (5.3)	2.8 (5.4)	4.3 (8.4)	1.1 (2.1)	1.5 (2.9)	8.5 (16.4)	1.2 (2.3)	6.9 (13.5)	18.0 (35.0)	51.5 (100.0)
The Netherlands	7.7 (15.1)	1.5 (2.9)	2.0 (3.9)	5.8 (11.2)	0.9 (1.8)	1.1 (2.1)	6.8 (13.3)	1.5 (2.9)	6.0 (11.7)	18.1 (35.3)	51.4 (100.0)
Iceland	10.2 (20.0)	0.0 (0.1)	1.6 (3.2)	6.0 (11.8)	0.7 (1.3)	0.5 (1.0)	8.4 (16.4)	3.7 (7.3)	8.6 (16.8)	11.3 (22.2)	51.0 (100.0)
Hungary	10.3 (20.5)	0.8 (1.6)	2.0 (3.9)	5.5 (10.9)	0.7 (1.3)	1.2 (2.4)	5.0 (9.9)	1.4 (2.8)	5.3 (10.4)	18.3 (36.2)	50.5 (100.0)
Slovenia	5.8 (11.8)	1.5 (3.0)	1.7 (3.5)	5.0 (10.1)	0.9 (1.9)	0.9 (1.8)	6.9 (14.0)	1.8 (3.7)	6.7 (13.6)	18.0 (36.5)	49.1 (100.0)
Ireland	3.8 (7.7)	0.5 (1.1)	2.0 (4.1)	7.4 (15.0)	1.3 (2.8)	2.1 (4.2)	8.9 (18.1)	0.9 (1.7)	5.6 (11.4)	16.5 (33.8)	48.9 (100.0)
Portugal	6.9 (14.4)	1.4 (3.0)	2.2 (4.6)	3.9 (8.0)	0.7 (1.5)	0.6 (1.3)	7.1 (14.7)	1.1 (2.4)	6.7 (13.9)	17.4 (36.1)	48.0 (100.0)
Germany	6.1 (12.9)	1.2 (2.4)	1.7 (3.5)	3.6 (7.6)	0.7 (1.4)	0.7 (1.6)	6.9 (14.5)	0.7 (1.4)	4.4 (9.2)	21.6 (45.6)	47.5 (100.0)
Norway	4.9 (10.4)	1.8 (3.7)	1.0 (2.2)	4.5 (9.4)	0.7 (1.4)	0.7 (1.5)	7.9 (16.6)	1.4 (3.0)	6.2 (13.0)	18.3 (38.7)	47.3 (100.0)
The Czech Republic	4.7 (10.3)	1.1 (2.4)	2.2 (4.7)	7.6 (16.4)	0.7 (1.6)	1.2 (2.6)	8.0 (17.4)	1.5 (3.2)	5.0 (10.9)	14.0 (30.5)	45.9 (100.0)
Spain	5.2 (11.3)	1.0 (2.3)	2.1 (4.7)	5.6 (12.3)	1.0 (2.1)	1.2 (2.6)	6.7 (14.7)	1.8 (3.8)	5.0 (10.9)	16.1 (35.2)	45.8 (100.0)
Poland	5.7 (12.8)	1.1 (2.4)	2.0 (4.4)	5.3 (12.0)	0.7 (1.5)	1.2 (2.6)	5.1 (11.6)	1.3 (3.0)	5.6 (12.6)	16.5 (37.1)	44.4 (100.0)

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	General	National defense	Public order	Economy	Environmental protection	Housing	Health	Cultural and local issues	Education	Social protection	Total general government expenditure
Japan	5.2 (12.3)	1.0 (2.3)	1.5 (3.6)	4.8 (11.3)	1.5 (3.6)	0.8 (1.8)	8.5 (19.9)	0.1 (0.3)	4.3 (10.0)	14.9 (34.9)	42.5 (100.0)
Luxembourg	4.4 (10.3)	0.3 (0.7)	1.0 (2.3)	4.8 (11.4)	1.1 (2.7)	0.8 (1.9)	5.0 (12.0)	1.9 (4.4)	5.0 (11.8)	17.9 (42.5)	42.2 (100.0)
USA	4.9 (11.5)	4.9 (11.7)	2.3 (5.4)	4.2 (10.1)	.. ..	1.3 (3.1)	8.7 (20.5)	0.3 (0.7)	6.7 (15.8)	8.9 (21.1)	42.2 (100.0)
The Slovak Republic	5.4 (13.1)	1.5 (3.6)	2.6 (6.2)	5.2 (12.5)	0.7 (1.6)	0.8 (1.8)	7.8 (18.7)	1.1 (2.6)	4.3 (10.4)	12.2 (29.5)	41.5 (100.0)
Switzerland	3.8 (11.4)	0.9 (2.7)	1.7 (5.1)	4.2 (12.4)	0.5 (1.6)	0.2 (0.6)	1.9 (5.6)	0.9 (2.7)	5.7 (16.9)	13.8 (41.0)	33.7 (100.0)
South Korea	4.6 (14.1)	2.8 (8.5)	1.4 (4.1)	7.3 (22.1)	1.0 (3.2)	1.4 (4.2)	4.3 (13.1)	0.8 (2.5)	5.2 (15.8)	4.1 (12.4)	33.1 (100.0)

Source: OECD Stats.

Additionally, when maturity of national pension, levels of the population's aging and national income, and level of people's contribution to the national pension system are factored in, the gap in the level of social welfare spending against GDP between Korea and the other OECD countries would be much narrowed. Assuming that Korea's national pension system will reach its maturity stage by 2030 and its maturity level will be 4%, we can conclude that the percentage of the nation's social welfare spending of its GDP would be 11.5%, equivalent to about 60% of the OECD average. The gap would also decrease if the nation's aging rate and its income level are put into consideration. With the aging rate of 10%, the nation's social expenditure would be 45% to 68% of those of the advanced countries'. When per capital GDP is assumed to be US\$20,000, the above figure would further drop to 38% of the OECD average.

〈Table 3-4〉 Social Welfare Spending and Economic Status at the Point of Countries' Per Capital GDP of \$20,000 Achieved

(unit: \$, %)

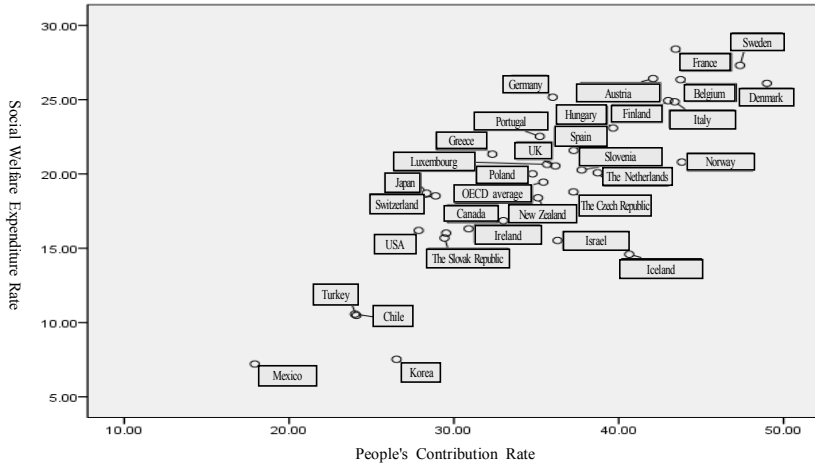
Country	Social welfare spending	People's contribution	Point of \$20,000 achieved	Fiscal balance	Women employment rate	Unemployment rate	% of elderly population
Sweden	30	51.4	1988	3.3	80.1	1.8	17.8
Belgium	25.8	41.7	1992	-8.2	44.6	7.1	15.3
The Netherlands	25.5	45.1	1991	-2.7	49.3	5.5	12.9
France	24.9	42	1990	-2.4	50.3	8.4	14
Norway	24.2	40.3	1992	-1.9	66.7	6.5	16.2
Austria	23.8	39.7	1990	-2.5	-	4	14.9
Denmark	23.8	48.9	1987	3	71	5	15.4
Hungary	23.1	40.2	2007	-5	50.9	7.4	16.1
Finland	23	42.7	1988	5.2	69.6	4.2	13
Portugal	22.5	35.3	2007	-2.7	61.9	8.1	17.3
Germany	21.7	34.8	1990	-2.8	52.2	4.2	14.9
Spain	21	34.2	2003	-0.2	46.8	11.1	16.9
Italy	20.8	40.2	1994	-9.1	35.4	10.6	16.3
Poland	20	34.3	2007	-1.9	50.6	9.6	13.4
Greece	19.9	31.1	2004	-7.4	45.5	10.5	18
Luxembourg	19.6	36.1	1988	4.3	40.6	2	13.4
UK	19.6	33.8	1996	-4.2	62.5	7.9	15.9
The Czech Republic	19.5	37.5	2005	-3.6	68.3	7.9	14.1
OECD(26)	19.5	36.3	-	-1.5	59	6.3	14
New Zealand	18	33.8	2003	4	65.7	4.8	11.8
Canada	16.7	34.8	1989	-4.6	62.4	7.5	11.1
Australia	16.2	28.1	1995	-3.7	59	8.2	11.9
the Slovak Republic	15.7	29.3	2007	-1.9	53	11.2	11.9
Switzerland	15	36.4	1987	-0.1	66.5	3.1	14.4
Ireland	14.8	32.5	1996	-0.1	76.5	11.7	11.4
Iceland	13.7	31.4	1989	-4.4	74.5	2.5	10.5
USA	13.1	28.4	1988	-3.7	63	5.5	12.3
Japan	11.5	28.6	1991	1.8	56.6	2.1	12.6
Turkey	10.5	24.2	2007	-	22.8	8.6	6
South Korea	7.5	26.5	2007	4.7	53.2	3.2	9.9
Mexico	7.2	21	2007	-	43.6	3.7	5.3

Note: As none of Hungary, Mexico, Poland and Turkey reached per capital GDP of \$20,000, the year 2007 is applied to the point of \$20,000 achieved. But these countries were not counted in the calculation of the OECD average.

- When a measured figure was not available for a specific year, it was replaced with that of the nearest year.
- Fiscal balance: Germany ('91), Luxembourg ('90),
- Women employment rate: Iceland ('91), Switzerland ('90)
- Unemployment rate: Germany ('91), Switzerland ('90). But if the nearest year is more than three years distant from the year of no measured value, the field is left empty.
- The figures of fiscal balance, people's contribution and social welfare spending represent percentages of those spendings of the countries' GDP.
- As for women employment rate, Austria was not included in the OECD average (26).

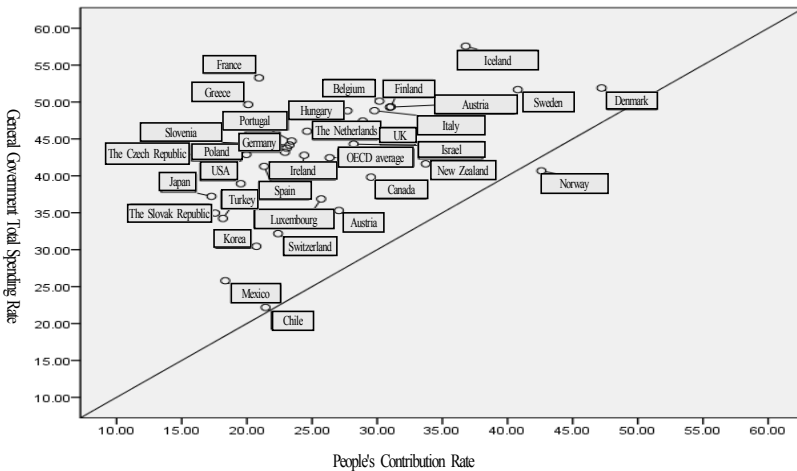
Source: OECD Stats. National Accounts, Social and Welfare Statistics

[Figure 3-1] People's Contribution Rate and Social Welfare Expenditure Rate (2007)



Source: OECD Stats.

[Figure 3-2] People's Contribution Rate and Total General Government Spending Rate (2008)



Source: OECD Stats.

When compared with key countries' allocation of social welfare budget, Korea's percentage of expenditures in the areas of the elderly, family and active labor market, are far much lower than those of the major OECD countries, while its spending levels on health and unemployment are higher than those of its OECD counterparts.

The percentage of the nation's elderly-related spending rate of its GDP stands at a mere 1.61% and 21.41% of its total welfare spending, and both of them are lower than those of other OECD members. This is partly because Korea's elderly population rate of 9.9% is still lower than the OECD average of 14.2%, but it also explains why the country's poverty rate for senior citizens is higher than those of the developed countries. With the rapid growth of the aged population, the government's spending on this group is expected to increase, which will require premium increase of relevant social insurance programs and additional tax revenues to cover rising demands for the government's fund support as well as increasing needs for financial sources for elderly-related welfare programs, including the basic old-age pension scheme. What is more important, however, is the government's efforts to cut down on the required funds by moderating the speed of an aging society and improving the current system to guarantee the elderly a certain level of income.

Korea's level of expenditure on child care and child rearing, which accounts for 0.46% of its GDP (26.9% of its total social welfare expenditure), is far behind those of key developed countries. Once a consensus is formed about the government's increased engagement in supporting child raising and universal

welfare programs are put into place to support it, the government's spending on family-issues will soar, which will require a much larger scale of tax increase. Therefore, to reduce the increased burden on taxpayers, it is necessary to develop systems to make the public spending on child raising encourage more women to work, and to reform the existing inefficient government system to cover child care expenses. Given the country's unique situation of child rearing, cooperation among the government, businesses and individuals is required to address the rising social expense of child raising. In this regard, we can refer to the examples of the advanced countries in terms of welfare, which are more actively involved in child rearing and spend more funds on this area, and employers contribute to a significant portion of the fund needs.

Korea's spending on the active labor market policies, which is only 0.13% of its GDP (1.73% of its total welfare spending), is still a lower level than those of major developed nations. Given the experiences of the exemplary welfare states, the success or failure of being a welfare state heavily relies on a virtuous cycle of economic growth and wealth distribution. In this regard, the field of active labor market polices deserves intensive investment and will require more of the government's spending and expanded fund source.

〈Table 3-5〉 OECD Countries' Allocation of Social Welfare Fund S (2007)

(Percentages against the nation's GDP. ( ) percentages of total general government expenditure)

	The elderly	Family of the bereaved	The disabled	Health	Family	Active labor market	Unemployment	Housing	Others	Total
France	11.1 (38.9)	1.7 (6.2)	1.8 (6.2)	7.5 (26.4)	3.0 (10.5)	0.9 (3.2)	1.4 (4.8)	0.8 (2.7)	0.3 (1.2)	28.4 (100.0)
Sweden	9.0 (32.9)	0.5 (2.0)	5.0 (18.4)	6.6 (24.1)	3.4 (12.3)	1.1 (4.0)	0.7 (2.4)	0.5 (1.7)	0.6 (2.2)	27.3 (100.0)
Austria	10.7 (40.7)	2.0 (7.4)	2.3 (8.8)	6.8 (25.7)	2.6 (9.9)	0.7 (2.6)	0.9 (3.5)	0.1 (0.4)	0.3 (1.1)	26.4 (100.0)
Belgium	7.1 (26.9)	1.9 (7.2)	2.3 (8.9)	7.3 (27.8)	2.6 (9.7)	1.2 (4.6)	3.1 (11.9)	0.1 (0.6)	0.7 (2.5)	26.3 (100.0)
Denmark	7.3 (27.9)	0.0 (0.0)	4.4 (16.7)	6.5 (25.0)	3.3 (12.6)	1.3 (5.0)	1.9 (7.4)	0.7 (2.7)	0.7 (2.8)	26.1 (100.0)
Germany	8.7 (34.4)	2.1 (8.2)	1.9 (7.5)	7.8 (31.2)	1.8 (7.3)	0.7 (2.9)	1.4 (5.5)	0.6 (2.4)	0.2 (0.7)	25.2 (100.0)
Finland	8.4 (33.7)	0.8 (3.3)	3.6 (14.3)	6.0 (24.1)	2.8 (11.3)	0.9 (3.5)	1.5 (6.2)	0.2 (1.0)	0.5 (2.2)	24.9 (100.0)
Italy	11.7 (47.2)	2.4 (9.7)	1.7 (7.0)	6.6 (26.7)	1.4 (5.6)	0.5 (1.8)	0.4 (1.8)	0.0 (0.1)	0.0 (0.1)	24.9 (100.0)
Hungary	8.3 (36.0)	1.3 (5.8)	2.7 (11.5)	5.2 (22.7)	3.5 (15.1)	0.3 (1.4)	0.7 (2.9)	0.9 (3.9)	0.1 (0.6)	23.1 (100.0)
Portugal	9.2 (41.0)	1.6 (7.1)	2.1 (9.5)	6.6 (29.5)	1.2 (5.1)	0.5 (2.3)	1.0 (4.4)	0.0 (0.0)	0.3 (1.1)	22.5 (100.0)
Spain	6.5 (30.3)	1.9 (8.9)	2.5 (11.7)	6.1 (28.1)	1.2 (5.7)	0.7 (3.4)	2.1 (9.8)	0.2 (0.9)	0.3 (1.2)	21.6 (100.0)
Greece	10.0 (47.0)	2.0 (9.4)	0.9 (4.2)	5.9 (27.5)	1.1 (5.1)	0.2 (0.8)	0.5 (2.2)	0.5 (2.2)	0.4 (1.8)	21.3 (100.0)
Norway	6.2 (29.9)	0.3 (1.2)	4.3 (20.6)	5.7 (27.4)	2.8 (13.5)	0.6 (2.7)	0.2 (1.0)	0.1 (0.7)	0.6 (2.9)	20.8 (100.0)
Luxembourg	4.8 (23.5)	1.7 (8.3)	2.7 (13.2)	6.4 (30.8)	3.1 (15.2)	0.5 (2.3)	0.9 (4.1)	0.1 (0.7)	0.4 (2.0)	20.6 (100.0)
UK	5.8 (28.1)	0.1 (0.7)	2.4 (11.9)	6.8 (33.3)	3.2 (15.8)	0.3 (1.5)	0.2 (1.0)	1.4 (7.0)	0.2 (0.8)	20.5 (100.0)
The Netherlands	5.3 (26.2)	0.2 (1.2)	2.9 (14.6)	6.0 (29.6)	2.0 (9.9)	1.1 (5.4)	1.1 (5.7)	0.4 (1.9)	1.1 (5.5)	20.1 (100.0)
Poland	8.7 (43.6)	2.0 (9.9)	2.4 (11.9)	4.6 (22.8)	1.3 (6.5)	0.5 (2.5)	0.3 (1.6)	0.1 (0.4)	0.2 (0.8)	20.0 (100.0)
OECD average	6.4 (33.5)	1.0 (5.0)	2.1 (11.1)	5.8 (30.2)	2.0 (10.1)	0.5 (2.4)	.. (..)	.. (..)	0.7 (3.6)	19.3 (100.0)

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	The elderly	Family of the bereaved	The disabled	Health	Family	Active labor market	Unemployment	Housing	Others	Total
The Czech Republic	6.9 (36.8)	0.7 (4.0)	2.3 (12.5)	5.8 (30.6)	2.0 (10.6)	0.3 (1.4)	0.6 (3.1)	0.1 (0.3)	0.1 (0.8)	18.8 (100.0)
Japan	8.8 (47.0)	1.3 (6.9)	0.8 (4.2)	6.3 (33.7)	0.8 (4.2)	0.2 (0.9)	0.3 (1.7)	..	0.3 (1.4)	18.7 (100.0)
Switzerland	6.3 (34.0)	0.4 (1.9)	3.0 (16.2)	5.6 (30.2)	1.3 (6.8)	0.6 (3.2)	0.6 (3.4)	0.1 (0.6)	0.7 (3.7)	18.5 (100.0)
New Zealand	4.2 (22.7)	0.1 (0.7)	2.5 (13.4)	7.1 (38.5)	3.0 (16.6)	0.4 (1.9)	0.2 (1.2)	0.8 (4.1)	0.1 (0.8)	18.4 (100.0)
Canada	3.8 (22.6)	0.4 (2.3)	0.9 (5.3)	7.0 (41.6)	1.0 (5.7)	0.3 (1.7)	0.6 (3.3)	0.4 (2.3)	2.6 (15.2)	16.9 (100.0)
Ireland	3.1 (19.1)	0.8 (4.9)	1.8 (10.7)	5.8 (35.6)	2.6 (15.9)	0.6 (3.9)	1.0 (6.0)	0.3 (1.7)	0.4 (2.2)	16.3 (100.0)
USA	5.3 (32.7)	0.7 (4.3)	1.3 (8.1)	7.2 (44.7)	0.7 (4.1)	0.1 (0.7)	0.3 (2.1)	..	0.5 (3.4)	16.2 (100.0)
Australia	4.3 (26.9)	0.2 (1.1)	2.2 (14.0)	5.7 (35.9)	2.4 (15.3)	0.3 (1.9)	0.4 (2.5)	0.3 (1.8)	0.1 (0.5)	16.0 (100.0)
The Slovak Republic	5.4 (34.2)	0.8 (5.3)	1.5 (9.4)	5.2 (33.0)	1.8 (11.4)	0.2 (1.4)	0.4 (2.4)	0.0 (0.0)	0.5 (3.0)	15.7 (100.0)
Iceland	2.3 (15.8)	0.0 (0.1)	2.2 (15.3)	5.7 (39.4)	2.9 (19.6)	0.0 (0.3)	0.2 (1.3)	0.6 (4.2)	0.6 (4.0)	14.6 (100.0)
Turkey	5.0 (48.0)	1.2 (11.5)	0.1 (1.3)	4.1 (39.1)	0.0 (0.1)	0.0 (0.0)	0.0 (0.0)	..	..	10.5 (100.0)
South Korea	1.6 (21.4)	0.3 (3.4)	0.6 (7.3)	3.5 (46.5)	0.5 (6.1)	0.1 (1.7)	0.3 (3.3)	..	0.8 (10.3)	7.5 (100.0)
Mexico	1.1 (15.9)	0.2 (3.4)	0.1 (0.8)	2.7 (36.8)	1.0 (13.8)	0.0 (0.3)	..	1.3 (17.4)	0.8 (11.7)	7.2 (100.0)

Source: OECD Stats.





Chapter

04

# **How to Fund Social Welfare Services**





## Chapter 4

# How to Fund Social Welfare Services

For the issue of how to finance social welfare services, we can think of several options: restructuring of the existing tax expenditure system, increase of tax revenue, issuance of treasury bonds, raising of social insurance premium, and involvement of the private sector. However, the restructuring of tax expenditures has inherent limitations and the issuance of government bonds also has restrictions given the current atmosphere in which fiscal soundness and a tight control of national finance are necessary, and in this chapter we will focus on how we can raise more tax revenue. Overhauling of state expenditures refers to reorganizing of expenditures' structure, restructuring the government budget and funds, and working for a more efficient budget management, all of which need be considered before implementing measures to raise more tax revenue. To increase the government's tax revenue, it is recommended to properly combine various options: restructuring of taxation system, abolishment of inefficient tax reduction and exemption rules, raising of tax rates, and expanding of tax sources and creation of new taxes. Securing more tax revenue should be carried out under the principle of lower rates and wider sources. As for tax revenue, we should focus more on identifying more sources and maximizing economic impact rather than on the function of income redistribution, while making income

redistribution a focal point of the expenditure side.

When selecting options to increase tax revenue, we have to consider which class of the society should undertake the burden of providing additional government funds: wage workers, people with income from property, employers, corporations or specific group of consumers. We also need to determine if the central government or a relevant local government should be responsible for securing more fund sources.

## **1. Restructuring Tax Reduction and Exemption System**

Since the tax reduction and exemption system provides indirect tax incentives, it is more difficult to identify its size and beneficiaries than in the case of direct incentives made through government expenditure. These indirect incentives have advantages of easy enforcement and execution as well as lower administrative costs, compared with direct incentives. However, Korea's tax incentive system has been a target of reform because many programs, which were created for temporary purposes and had pre-defined expiration dates, have continued to exist, and their size has significantly grown every year. As of 2009, the combined total amount of tax reduction and exemption was estimated at 28.6 trillion won.

Out of many tax incentive programs, <Table 4-1> captures the programs that are widely agreed to deserve assessment. Temporary deduction of investment from tax liability (1.9188 trillion won in 2009) was originally introduced to be effective

temporarily in order to facilitate investment during an economic recession, but it has become permanent and is now subject to restructuring. The following rules also need be reviewed for reduction or discontinuance because they no longer have any justification: temporary deduction of fixed asset investment, deduction of investment in facilities designed to enhance productivity (28.5 billion won in 2009), deduction of expenses of logistics service by third party (23.5 billion won in 2009), taxation deferment for establishment of holding company with investment or exchange of securities (24.5 trillion won in 2009), deduction of investment in facilities for welfare of workers (12.1 billion won in 2009), and deduction of investment in facilities intended to improve quality control process of medicine (9.9 billion won in 2009).

〈Table 4-1〉 Tax Incentive Items to be Reduced or Abolished

(unit: Hundred million won)

Item	2009 (forecast)
Temporary deduction of fixed asset investment	19,188
Deduction of investment in facilities to enhance productivity	285
Deduction of expenses of logistics service by 3rd party	235
Taxation deferment for establishment of holding company with investment or exchange of securities	245
Deduction of investment in facilities to enhance welfare of workers	121
Deduction of investment in facilities to improve quality control process of medicine	99
Total	20,298

Source: Ministry of Strategy and Finance, 「Tax Expenditure Report」

## 2. Income Tax

The GDP elasticity of Korea's income tax revenue is around 1.3 (from 2000 to 2009), indicating that the growth rate of income tax revenue exceeds that of GDP and it will be relatively easy to increase tax revenue even without creating the highest tax bracket. In Korea, where updating of tax brackets has failed to catch up with inflation rates, the chances are high that GDP growth will result in a higher tax revenue. If a 2% decrease in income tax rate is deferred and a new tax rate of 40% is adopted for the tax base amount of 150 million won or over, their impact on tax revenue increase would be about 1.4 trillion won to 1.6 trillion won (Jong-seok Ahn et al., 2010; National Assembly Budget Office, 2010).

As for income tax, before raising tax rates, more efforts should be made to expand the tax base by encouraging taxpayers to reveal their real income level with the introduction of measures to allow taxable income deductions for sole proprietors on a more practical level. More active measures are recommended to find out tax evasion cases and expose more taxable income of high-income professionals and sole proprietors in order to expand the tax base. In addition, tax incentives provided in the form of different types of deductions for wage earners, which strengthens regressive tax effects of income tax, should be controlled to prevent a decrease in tax revenue.

〈Table 4-2〉 Tax Revenue Effect of Highest Tax Rate (as of 2008)

(unit: Number of people, Billion won)

		No. of taxpayers	Tax base	Final tax liability	Tax liability with tax rate decrease	Decrease in tax revenue
Decrease of highest tax rate by 2%	Global income tax	126,714	30,999	7,891	7,540	351
	Earned income tax	79,718	14,799	3,947	3,795	152
	Total	206,432	45,798	11,839	11,335	504
Tax rate of 40% applied to tax base of 150 million won or over	Global income tax	70,610	24,246	6,458	7,057	599
	Earned income tax	37,341	9,994	2,863	3,080	216
	Total	107,951	34,241	9,321	10,136	816

Source: Jong-seok Ahn et al., 2010

### 3. Capital Gains Tax

#### A. Tax on Gains from Transfer of Listed Stock

According to Korea's current tax system of gains from transfer of stocks, individuals' gains from transfer of non-listed and non-registered stocks and corporations' gains from stock transactions have been subject to income tax and corporate income tax, respectively. However, individuals' gains from transfer of listed stocks and registered stocks have been free from taxation to promote the local stock market, and transaction tax instead of capital gains tax has been imposed. The fact, however, that individuals' interest and dividend income is subject to tax while leaving any gain from transfer of listed stocks tax-free has created controversy over taxation equity and encouraging of speculative

stock investment. Experts agree that the local stock market has matured enough to sustain even without tax incentive on capital gains, and the current tax exemption is not much required.

Major developed nations impose income tax on individuals' capital gains on transfer of listed stocks; many of them even include this gain on their global income for taxation, offer incentives for long-term ownership of stocks, or allow offsetting gains against losses, and deduction carried-forward of losses. Japan is one of the success cases of gradually shifting from a transaction tax system to an income tax system. Korea has to follow the suit of those advanced countries. This transformation is expected to strengthen the tax base, enhance the equity of taxation and control speculative investment in the stock market. Once capital gains tax is imposed, at an interest income tax rate of 14%, on the gains from the transactions of stocks in the marketable securities market and KOSDAQ (Korea Securities Dealers Automated Quotation) market, based on the market capitalization of 2009, the additional tax revenue would be 19 trillion won (Beom-gyo Hong et al., 2010). This amount represents 15.5 trillion won higher tax revenue than the total transaction tax revenue of 3.5339 trillion won collected from securities transactions in 2009.

## **B. Tax on Gains from Transactions of Financial Derivatives**

In Korea, since 1996 when futures transaction was introduced, no tax, even transaction tax, has been imposed in order to help develop the local financial derivatives market. However, the local financial derivatives market, including futures and options, has



so significantly grown that its transaction volume can be comparable to other world-scale markets, and diverse investment strategies linking derivatives to spot products are actively adopted, all of which support the popular opinion that gains from financial derivatives transactions should be subject to taxation. As for the introduction of tax on financial derivatives, given that individuals' gains from transactions of listed stocks are tax exempt for now, some experts suggest that securities transaction tax be introduced first to control speculative transactions and increase tax revenue at the same time. There is one example of such an initiative: a bill pending in the National Assembly proposes that a basic tax rate of 0.01% and an elasticity tax rate of 0% be applied on contracted amount for futures and transaction amount for options.

#### **4. Value Added Tax (VAT)**

Korea's current VAT rate is 10%, much lower than the OECD average of 18.1% (2010). Out of OECD countries, only Canada (7%) and Japan (5%) have lower VAT rates than Korea's. As the same rate of VAT is applied to both low-income and high-income classes, Korea's current VAT system has an issue of regressive tax, by which the higher the income you earn, the lower tax burden you would get. Some people show their disagreement with the idea of making this regressive tax a new source for social welfare services as well as their concern that it would add to inflation rate. But the proponents of the idea argue that the issue of regressive tax could be offset with enhanced income redistribution efforts with tax expenditure, and zero tax rate can

be applied to necessities for the daily lives of ordinary citizens, all of which would address many issues involved. While we have a lower VAT rate, indirect taxes, including VAT, make up a larger portion of the nation's entire tax system than in major countries, and increasing VAT rate is feared to bring up inflation further since a rapidly increasing inflation rate is already putting much pressure on citizens and the national economy.

Therefore, before raising the VAT rate, it is recommended to reduce the range of VAT exemptions, a widely criticized issue, so that it will expand the tax base of VAT and provide the government with more tax source. The current VAT exemption system has a fundamental problem: as tax credit on purchase amount is not allowed, which precedes VAT exemption, excessive VAT exemption could increase VAT amount in the following stages of tax calculation, hindering the essence and effectiveness of the VAT system. The study done by Jong-seok et al. (2010) suggests reducing the VAT exemption for financial insurance, medical care and educational service.

〈Table 4-3〉 Characteristics of Tax-exempt Industries and Taxation Impact on Tax Revenue of Those Industries

(unit: Billion won, as of 2003)

Tax-exempt industry	Sales	Added value	Intermediate demand	Total spending	% of Sales <sup>1)</sup>	% of VAT of GDP <sup>2)</sup>	VAT rate	Taxation's impact on tax revenue
Agricultural products	22,204	16,521	16,090	10,091	0.0127	0.0215	0.7440	800.48
Livestock products	8,930	2,123	7,982	730	0.0051	0.0028	0.2377	-50.13
Marine products	4,771	2,125	3,257	1,931	0.027	0.0028	0.4453	147.49
Raw food products	12,715	1,257	5,964	6,733	0.0073	0.0016	0.0988	111.86

Tax-exempt industry	Sales	Added value	Intermediate demand	Total spending	% of Sales <sup>1)</sup>	% of VAT of GDP <sup>2)</sup>	VAT rate	Taxation's impact on tax revenue
(agricultural)								
Raw food products (livestock)	6,825	578	5,335	4,392	0.0039	0.0008	0.0848	209.66
Raw food products (marine)	3,546	490	1,429	2,800	0.0020	0.0006	0.1382	308.62
Deposit with banks	26,944	21,594	19,853	7,215	0.0154	0.0282	0.8015	-83.60
Deposit with non-bank institutions	7,668	4,751	5,302	2,385	0.0044	0.0062	0.6196	-104.42
Other financial intermediary services	11,699	8,129	8,433	3,295	0.0067	0.0106	0.6948	-249.94
Related services	9,299	6,717	6,562	1,776	0.0053	0.0088	0.7224	-108.50
Life insurance	13,233	7,740	82	11,709	0.0076	0.0101	0.5849	1,157.86
Non-life insurance	11,606	3,915	5,367	2,619	0.0066	0.0051	0.3373	-145.88
Medical care (public)	1,267	765	89	247	0.0007	0.0010	0.6038	20.93
Medical care (non-profit)	8,029	4,470	204	7,827	0.0046	0.0058	0.5567	765.19
Medical care (industrial)	27,336	13,305	1,178	26,148	0.0156	0.0173	0.4867	2,495.65
Sanitation (public)	1,837	942	407	585	0.0011	0.0012	0.5130	33.34
Sanitation (private)	3,295	2,259	2,955	321	0.0019	0.0029	0.6854	-174.89q
Cleaning and disinfection	3,732	2,702	2,944	765	0.0021	0.0035	0.7240	-127.49
Education (public)	24,060	19,760	0	4,890	0.0138	0.0258	0.8213	534.08
Education (private)	15,735	13,405	0	16,662	0.0090	0.0175	0.859	1,760.75
Education (industrial)	8,234	5,227	1,007	7,293	0.0047	0.0068	0.6349	654.91
Railroad passenger transportation	2,419	1,267	962	1,515	0.0014	0.0017	0.5240	94.50
Railroad freight transportation	347	106	337	4	0.0002	0.0001	0.3067	-9.81
Road passenger transportation	14,049	7,759	3,217	10,716	0.0080	0.0101	0.552	925.19
Coastal inland transport	1,039	366	852	176	0.0006	0.0005	0.3520	-30.24

Tax-exempt industry	Sales	Added value	Intermediate demand	Total spending	% of Sales <sup>1)</sup>	% of VAT of GDP <sup>2)</sup>	VAT rate	Taxation's impact on tax revenue
Outer port transport	11,239	1,148	3	72	0.0064	0.0015	0.1021	8.59
Newspaper	2,947	757	2,397	555	0.0017	0.0010	0.2571	-163.80
Publication	5,090	1,659	2,689	2,608	0.0029	0.0022	0.3258	100.03
Other media	448	116	343	107	0.0003	0.0002	0.2594	11.94
Mail	3,307	2,222	3,507	128	0.0019	0.0029	0.6719	-128.48
Terrestrial broadcasting	3,140	1,529	2,880	341	0.0018	0.0020	0.4869	-202.53
Cable broadcasting	1,887	624	1,169	720	0.0011	0.0008	0.3307	-65.60
Cultural service (public)	1,497	819	262	770	0.0009	0.0011	0.5469	120.90
Cultural service (others)	296	129	44	316	0.0002	0.0002	0.4349	38.16
Home ownership	53,906	40,427	0	54,339	0.0308	0.0527	0.7500	5,517.41
Leaf tobacco	230	175	393	0	0.0001	0.0002	0.7590	16.57
Hygiene paper	1,336	330	472	550	0.0008	0.0004	0.2472	20.89
Anthracite	226	93	494	0	0.0001	0.0001	0.4122	21.29
Coal briquette	448	116	37	29	0.0003	0.0002	0.2594	1.06
Crude salt	55	36	109	38	0.0000	0.0000	0.6616	1.40

Note: 1) Percentage of each industry's sales of the total combined sales of all industries

2) Percentage of each industry's VAT of Korea's GDP; Added value ratio

Source: Jong-seok Ahn et al., 2010

## 5. Introduction of Carbon Tax

Carbon tax is one of the environment-related taxes specifically targeting the reduction of green house gas. It has been discussed that carbon tax be imposed on energy use to have economic players share the social and economic costs incurred by CO<sub>2</sub> emission. The estimated social cost of CO<sub>2</sub> emission in two main areas, energy and electric power, is 20.4928 trillion won as of 2004 (Korea Environment Institute, 2007). Assuming that

the average carbon credit price per ton during 2008 and 2012 is €25, the estimated revenue from carbon tax would be 1% of the nation's GDP (Seung-rae Kim et al., 2009).

In European countries, when introducing a new carbon tax, governments lowered income tax and social security contribution amount, shifting citizens' burden of tax payment from the two old taxes to the new one. In Denmark, when adopting taxes on natural gas and sulfuric acid gas, the government decreased the social security contribution. Germany also lowered the contribution by employers and employees to the employee pension scheme by 1.7% after introducing a new energy tax (2003). In the Netherlands as well, increased tax revenue from taxation on energy, CO<sub>2</sub> emission and waste disposal resulted in a decrease of employers' contribution to the social security system by 0.19% (1996). UK also used additional tax revenue made by energy and CO<sub>2</sub> emission taxes to cut down on employers' share of the social security program by 0.3% (2001). Given these examples and to add environment tax functions to the current energy-related taxes such as oil tax, transportation tax and environment levy, we should adopt a carbon tax and reform the existing energy tax system step by step, and utilize the increased tax income as social insurance premium or a fund for welfare services.

## 6. Increasing Taxes on External Diseconomy Items: Cigarettes, Soft Drinks and Gambling

### A. Raising Tax on Cigarettes

As smoking is a demerit good, it is necessary to raise the prices of cigarettes to reduce the smoking rate. Due to the externality of smoking, increased cigarette prices make smokers bear the burden of social expense. The estimated total social and economic cost of smoking amounted to 2.8358 trillion won (2001) (Korea Institute for Health and Social Affairs (KIHSA), 2005). While Korea raised tobacco prices seven times during 1994 and 2002, they are still considered low, compared with those of other countries.

〈Table 4-4〉 International Comparison of Cigarette Prices (as of Feb. 2007)

Country	Retail price	Unit-based duty	Add valorem duty <sup>2)</sup>	VAT	Total tax	Tax/Price %
Austria	2.36	0.33	1.01	0.39	1.73	73.6%
Belgium	2.69	0.22	1.41	0.47	2.09	77.7%
Bulgaria	0.90	0.10	0.43	0.15	2.09	76.2%
Cyprus	1.92	0.28	0.86	0.25	1.39	72.1%
The Czech Republic	1.08	0.36	0.27	0.17	0.80	74.2%
Denmark	2.85	1.15	0.39	0.57	2.11	74.0%
Estonia	0.84	0.24	0.22	0.13	0.58	69.5%
Finland	2.76	0.20	1.38	0.50	2.08	75.4%
France	3.37	0.20	1.95	0.55	2.71	80.4%
Germany	3.17	1.11	0.80	0.51	2.42	76.4%
Greece	1.89	0.07	1.02	0.30	0.39	73.5%
Hungary	1.26	0.39	0.35	0.21	0.94	75.0%
Ireland	4.75	2.04	0.84	0.82	3.71	78.1%
Italy	2.22	0.08	1.22	0.37	1.67	75.1%
Latvia	0.42	0.16	0.08	0.07	0.31	72.6%

Country	Retail price	Unit-based duty	Add valorem duty <sup>2)</sup>	VAT	Total tax	Tax/Price %
Lithuania	0.73	0.19	0.11	0.11	0.41	55.6%
Luxembourg	2.05	0.21	0.97	0.27	1.45	70.6%
Malta	2.43	0.23	1.25	0.37	1.85	76.1%
The Netherlands	2.69	0.98	0.55	0.43	1.97	73.0%
Poland	0.99	0.26	0.31	0.18	0.75	76.2%
Portugal	2.02	0.79	0.47	0.35	1.60	79.2%
Romania	0.88	0.23	0.25	0.14	0.63	71.4%
The Slovak Republic	1.61	0.43	0.37	0.26	1.06	65.8%
Slovenia	1.35	0.20	0.59	0.22	1.01	75.2%
Spain	1.62	0.11	0.92	0.22	1.26	77.6%
Sweden	3.28	0.42	1.29	0.66	2.36	71.9%
UK	5.23	2.10	1.15	0.78	4.03	77.1%
South Korea <sup>1)</sup>	1.42	0.76	-	0.13	0.89	62.7%

Note: 1) The price of 2,500 won, average retail price of cigarettes, is multiplied by the exchange rate of 1,759 won per £.

2) Different types of levies are included.

Source: UK Tobacco Manufacturers Association (<http://the-tma.org.uk>), "EU Cigarette Price and Tax Breakdown", 2007. Quoted from Eun-jeong Kang et al., 2009.

Taxes account for 62% of tobacco price, which is lower than the OECD average of 72% (2011). In Korea, the public health promotion levy and the tobacco excise tax, a local tax, are charged on tobacco, with local education tax, waste disposal tax and VAT added. As tobacco tax increase is expected to control smoking and be implemented easily, disagreement with or opposition to the idea will be relatively low, but the Korean government's attempt to raise the tobacco tax failed once due to a strong objection to the name of the tax, 'sin tax'. Yet, it will be inevitable to raise the cigarette tax as a part of the government's cigarette price policy so as to bring down the smoking rate.

〈Table 4-5〉 Size of National Health Promotion Fund

(unit: Hundred million won, %)

Before '01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	Annual growth rate
445	5,109	7,020	8,064	13,185	15,143	15,025	15,721	15,788	16,355	16,355	16,355	38.7

Source: Ministry for Health, Welfare and Family Affairs 「2006 National Health Promotion Fund Management Report」  
 Ministry for Health, Welfare and Family Affairs 「Reference Materials of 2008 Key Businesses of Ministry for Health, Welfare and Family Affairs」  
 Ministry of Health and Welfare 「Overview of Yearly Budget and Fund Management Plan of Ministry of Health and Welfare」  
 Ministry of Health and Welfare 「2012 Budget and Fund Management Plan of Ministry of Health and Welfare (draft)」

〈Table 4-6〉 Trend of Tobacco Excise Tax

(unit: Hundred million won, %)

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Annual growth rate
25,086	22,378	23,847	27,223	24,479	27,027	27,610	29,204	30,107	28,748	1.5

Source: Statistics Annal of Ministry of Public Administration and Security, 2011

When the cigarette price was increased by 500 won in 2004, a total of 409 won, except for 41 won of VAT and distribution margin of 50 won, was allocated to the health promotion fund and local tax on a 50:50 basis. More specific allocation details are as follows: 204 won to the health promotion fund, 131 won to the tobacco excise tax, 66 won to local education tax, 5 won to the leaf tobacco stabilization fund and 3 won to the waste levy. If the tobacco price is further increased by 500 won and the 2004 allocation rule is still followed, the portion to be



distributed to the health promotion fund will jump from 354 won to 558 won, and the total health promotion fund revenue will rise by 550 billion won (Young Lee et al., 2007). It will also increase the total revenue of local taxes, including tobacco excise tax and local education tax, by 550 billion won and VAT revenue by 110.5 billion won, generating the total additional tax revenue of 1.2 trillion won.

### **B. Raising Taxes on Speculative Businesses: Horse Racing, Cycle Racing, Motorboat Racing, Casino and Lottery**

The sales of speculative industries, such as horse racing, cycle racing, motorboat racing, casino and lottery, have remarkably grown in recent years. Those speculative businesses recorded sales growth even in an economic slowdown of 2009, and their combined sales reached 16.6 trillion won in 2010. As the total revenue of the industries, which was 4 trillion won in 1997, soared four times to 16 trillion won by 2008, they created social problems, including gambling addiction, which can be so serious that it draws the people's concern. As these types of speculative businesses make people lose control and become deeply involve in them, only to regret later what they have done, it is recommended to leverage a tax increase to control citizens' spending on those businesses.

〈Table 4-7〉 Trend of Sales of Speculative Industries

(unit: Hundred million won, %)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Annual growth rate
Total sales	62,761	89,336	126,516	142,355	123,927	118,888	121,320	145,815	160,014	165,337	173,270	11.9
Nest sales	21,149	31,849	39,356	36,026	51,489	49,880	51,167	60,469	66,151	68,112	73,629	14.8

Source: National Gaming Control Communication

As for horse racing, 10% of leisure tax, and local education tax and special tax for rural development, all of which are surtaxes, are imposed on the sales of pari-mutuel tickets. The sales of admission tickets to the horse racetrack and velodrome/motorboat racing park are 500 won and 200 won of individual consumption tax per person imposed, with education tax and VAT added. For casinos, individual consumption tax of 50,000 won is charged on each person for one location, and in the casino established in an abandoned mine area, local visitors are charged 3,500 won and foreigners are tax-free.

While a part of the profits from horse racing are used for the livestock development fund and welfare projects for agricultural and marine villages, the profits from cycle racing and motorboat racing are partly distributed to multiple public funds: the sports promotion fund, the youth fostering fund, the small and medium business promotion and industrial foundation-building funds, and local governments. As for casinos, a maximum of 10% of casino sales goes to the abandoned mine area development fund and 20% of the earning before tax is allocated to the tourism promotion and development fund. A

part of Sports Toto profits is contributed to the national sports promotion fund. As for lotteries, 30% of the profits serves as revenue source for the legally specified funds: the special account of the Jeju province development project, the technology and science promotion fund, and the national sports promotion fund, while the rest 70% is used for different public projects, including the national housing fund.

[Figure 4-1] Revenue and Expenditure Structure of Speculative Industries

Horse Racing		Cycle Racing/Motorboat Racing		Casino	Lottery	Sports Toto
Payoff to bettors (73%)		Payoff to bettors (72%)		Total payoff to bettors (82~83% of drop amount) Machine game dividend rate (92~93%)	Payoff to bettors (50~60%)	Payoff to bettors (50~70%)
Total taxes (16%) - Leisure tax(10%) - Local education tax (4%) - Special tax for rural development (2%)		Total taxes (16%) - Leisure tax(10%) - Local education tax (4%) - Special tax for rural development (2%)		Abandoned mine area development fund and project expenses (16~17%)	Operational costs (about 10%)	Operational costs (about 19%)
Charge income (11%)	Cost of holding races	Charge income (12%)	Cost of holding races	Corporate income tax (10%)	Profit (38~39%)	Profit (15~30%)
	Profit		Profit	Tourism promotion and development fund (10%)		
↓		↓		↓	↓	↓
Profit reserve (10%)		National sports promotion fund (40%)		Dividend (about 43~45%)	Legally specified projects (30%)	Contribution to the national sports promotion fund (80%)
Reserve for expanding horse racing business (30%)		Youth fostering fund (30%)				
Livestock industry promotion fund (48%)		Small and medium business promotion and industrial foundation-building funds (17.5%)		Reserve for business expansion and other purposes (about 55%)	Public projects (70%)	Support for sports games organizing entities (10%)
Welfare projects in rural areas (12%)		Support for local governments (10%)				
		Support for public projects (2.5%)				Projects designated by the Minister of Culture, Sports and Tourism (10%)

Note: The allocation of casino sales to the tourism promotion fund is limited to 10% of the casino sales, and different allocation percentage is applied in accordance with Paragraphs 1, 2 and 3, Article 2, Section 30 of the Enforcement Decree of the Tourism Promotion Act. For the abandoned mine area development fund, 20% of the earning before income tax is allocated.

Source: National Gaming Control Commission, 2009.

Leisure tax, one of the local taxes, recorded the combined total of 989 billion won from horse, cycle and motorboat racing in 2008, and 60% of the races were concentrated in Seoul and Gyeonggi Province, raising the issue of significant gap of tax income among different regions. The annual leisure tax revenue continued to drop from 1.770 trillion won in 2002, but bounced back to 864.3 billion won in 2007 and 989 billion won in 2008. It can be an option to make leisure tax a national tax and utilize it as another source of social welfare. To compensate for decreased local government's tax revenues and ease their burden of social welfare expenditure, creating a social welfare grant tax for local government can be considered.

〈Table 4-8〉 Annual Leisure Tax Amount Collected

(unit: Million won)

2002	2003	2004	2005	2006	2007	2008	2009	2010
1,077,663	895,907	771,921	691,875	687,825	864,332	989,019	1,002,264	1,067,457

Source: Korea Statistical Information Service, Local Tax Administration Yearbook

### C. Tax on Unhealthy Foods: Soft Drink and Fast Food

Like Western countries, Korea is suffering from the obesity of its children and youth and experiencing upward trends in obesity-related diseases. The economic cost of obesity is estimated to be 1.8 trillion won (as of 2005, Health Insurance Institute, 2010). Tax on unhealthy food such as soft drinks and fast food, which may cause obesity, can be justified in that it can help lower the obesity rate and the occurrence rates of obesity-related

diseases. If health-endangering foods are left to increase obesity-induced diseases, it is tantamount to transferring a part of the national health insurance premium to those who do not consume those unhealthy foods.

In the US, 19 states impose tax on unhealthy foods such as soft drinks, snacks, candy and syrup. Most of them have adopted ad valorem duties, while five states, including Washington, have introduced unit-based taxes. Mostly due to objection and lobbying by affected businesses, 12 states abolished taxes on several unhealthy foods. Tax on health-risking foods, which can cause health problems such as obesity, can be imposed in accordance with food classification based on nutritional factors of definition of unhealthy foods based on ingredients of soft drinks.

## **7. Introduction of Social Security Tax**

Social security tax (provisional title) can be introduced as a new revenue source, which will explicitly specify the relationship between tax revenue and social welfare expenditure. Assuming that Korea's welfare system is classified as low burden and low benefit, once we are certain that the country is shifting to medium burden and medium benefit, even to high burden and high benefit, the introduction of social security tax will be required in an effort to build a public consensus to accommodate the change. Social security tax can be implemented in different forms. In France, to make up for the fiscal deficit created by the treasury bonds, issued to cover increasing welfare expenditure, the country added social security tax on income tax, tobacco and car insurance

premiums. If social security tax, an earmarked tax, is imposed on the appropriate tax items that have justifications, such as addressing of external diseconomy, we can effectively link tax revenue sources to expenditures. We can primarily impose social security tax on the items of external diseconomy to control gambling-encouraging speculative businesses, smoking and alcohol addiction, and even use income tax as a tax source, depending on the size of the tax revenue. In one possible scenario, if tax on speculative businesses, tobacco tax, leisure tax and alcohol tax are all incorporated into the national treasury and are allocated for welfare purposes, the state budget could be flexibly maintained. The existing taxes for speculative businesses, tobacco and alcohol include various surtaxes, such as local education tax, which makes it difficult to flexibly operate the taxes and utilize possible additional tax revenue for social welfare and other purposes. In a long-term strategy, we need to simplify the existing inefficient structure of surtaxes, improve the current system to increase education funds with local education tax and local grant tax, and also enhance ways of managing the health promotion fund and national health insurance, which are covered by the health promotion levy. Meanwhile, we also have to note that the incorporation of those tax sources into the state coffers and their redistribution would negatively affect the sustainability and stable operation of the social welfare services.

There was a proposal that social security tax be charged on income tax, corporate income tax, inheritance/gift tax and comprehensive real estate holding tax. The key idea of the proposal was to impose social security tax on the top 5% of high income

earners and the top 1% of large corporations, which would raise 15 trillion won in tax revenue every year. However, we have to understand that putting a tax burden only on the high income bracket in the form of progressive tax will not bring in as much practical impact as its symbolic impact.

## **8. Utilization of Social Insurance**

### **A. Increasing Social Insurance Premium**

Increasing social insurance premium can be another option to finance the country's social welfare spending. There have been the following discussions: the required fund to cover the projects of the elderly's health, including restructuring of health and medical care systems for senior citizens, could be met by increased national health insurance premium, and the capital needs to cover childbirth and child care support could be satisfied by raised national pension premium.

### **B. Utilization of Extra Portion of National Pension Fund**

Some recommend that an extra portion of the national pension fund be used as a source for social welfare services. Their logic is that some extra portion of the public pension fund is used for policy measures to encourage women to have babies and the childbirth rate finally will rise, which will produce more of the productive population, which will increase the pension premium in turn and expand the tax base. In addition, if this



fund is invested into infrastructure such as elderly care facilities, it will help guarantee the population a financially stable life after retirement by providing them with required goods as well as pension income, and also reduce additional social burden increased by the poverty of senior citizens. However, this extra part of the pension fund cannot fully cover increasing expenditure of social welfare. All we can consider is to utilize the pension fund only to cover some businesses that are regarded necessary for a certain period of time.

### **C. Introduction of a New Social Insurance**

At the bottom of the latest debates on social welfare lies a rising demand for child rearing-related social welfare. The government's expenditure to make it take more responsibility in child care will be able to grow fast, along with the planned expansion of full compensation for child care center expenses, depending on the future social consensus on this issue. It is also believed to be a starting point for Korea to enter into a European-style system of high level of welfare. Once the social consensus is reached on the issue, we can think of introducing new social systems in the form of social insurance. More specifically, new social insurance systems can be created to promote childbirth and support child care so that necessary funds can be raised to cover income loss of women during and after pregnancy. For example, the parental insurance in Sweden covers 80% of income loss from maternity leave or leave for disease of a child or a guardian during a child raising period, and its

fund source is employers' contribution of premium. Implementing new social insurances will help form a social consensus on the need for promoting childbirth and avoid the difficult task of selecting beneficiaries. It will also help integrate welfare programs, separately managed by different government agencies and different systems, and develop and implement consistent policies for childbirth promotion and child care supporting.



Chapter

05

# **Conclusion and Policy Recommendation**





## Chapter 5

# Conclusion and Policy Recommendation

The government's proper redistribution policies, based on the assumption of the nation's continued economic growth, will help ease the deepening polarization of wealth and facilitate social integration by improving the nation's income distribution structure and lowering poverty rate. They can also serve as a main engine for a virtuous cycle of economic growth and welfare spending. In other words, a successful social welfare system can realize social integration through a proper distribution of benefits from an economic growth and build a virtuous cycle in which economic growth and welfare expenditure continue to lead each other. Korea's social welfare system made remarkable progress for a much shorter period of time than the developed countries in the West, and the nation's social safety net, which is built upon social insurance programs, has significantly developed as well.

Despite this quantitative growth and the introduction of various social welfare programs, the status of Korea's wealth distribution has deteriorated since the financial crisis during 1997 and 1998. Gini's coefficient of Korea, measured by disposable income, which was 0.26 in 1990, was slightly improving until the Asian financial crisis, but has been worsening since the crisis. Korea's Gini coefficient rapidly aggravated, rising to 0.29 in 1999, and improved to the level of 1990 in 2000, but from this point continued to deteriorate, even to the level of the financial crisis of the late

1990s in 2010. Measured by another indicator of relative poverty rate, which represents the households with income less than 50% of the median household income level, Korea's status of wealth distribution is much worse. Its relative poverty rate, which stood at 7.1% in 1990, temporarily dropped after a rapid increase during the Asian financial meltdown, but continued to increase, even to 12.5% in 2010. These indicators show that Korea's social welfare system and related government spending have failed to have a meaningful effect on the alleviation of poverty and status of income redistribution.

At the bottom of the failures lie various issues: structural weakness of the national social welfare system, including the poor class not covered by the welfare system and unresolved issues of labor market; inefficiency of the process to deliver the benefits of social welfare programs; and the current welfare system's inherent issues of creating inefficiency by increasing the poor population's dependency on the welfare programs and lowering beneficiaries' will to work. As welfare programs, in the form of public assistance, tend to lead the beneficiaries to rely more on them and not on work, thereby rendering the programs inefficient, we need to develop the incentives to encourage the beneficiaries to actively find work to exit the programs. In fact, however, the current national basic livelihood security program provides the beneficiary households only with the gap between the minimum cost of living and their income, which discourages their will to work. In addition to this living cost benefit, those financially challenged households are also eligible for medical, educational and housing benefits all together, which give them

more incentives to stay on the program. Even though the national basic livelihood security program has a clause that require the beneficiaries with the capability to work to fulfill their labor duty, it is hardly followed. This reality raises the issue of reforming the social security program to strengthen the incentives to push the beneficiary households to work. Another important issue of the social security program is that the benefits of the government's public assistance programs are concentrated on those households living with less than the minimum fund for living, which attracts many qualified families to opt not to work. It is also pointed out that another poor class categorized just above the group eligible for the livelihood security program or the working poor families are left out from public assistance systems.

Another source of inefficiency of Korea's social welfare system is the lack of coordination of work among different government agencies and their duplicate roles. There are many overlapping roles among the following government organizations: Ministry of Health and Welfare, Ministry of Employment and Labor, Ministry of Gender Equality and Family, Ministry of Land, Transport and Marine Affairs, Ministry of Education, Science and Technology, Ministry of Public Administration and Security and Ministry of Patriots and Veterans Affairs. As for employment and welfare-related projects, Ministry of Employment and Labor and Ministry of Health and Welfare implement related projects with different policy objectives, which hampered the efforts to build an organic relationship between employment and welfare. When it comes to child care businesses, not to mention the fact that the primary responsibility shifted from Ministry of Gender

Equality and Family to Ministry of Health and Welfare, both of the agencies are still involved in the same businesses regarding children and the youth, which requires the coordination of their respective roles. There also have been duplicate projects of child rearing and child support, conducted in two agencies, Ministry of Health and Welfare and Ministry of Education, Science and Technology. As for housing-related welfare expenditure, since Ministry of Land, Transport and Marine Affairs has the ownership and its range of work even covers the provision of houses and vouchers for low-income households, the agency applies its own rules to old tasks such as means test, causing inefficiency. Over the areas for which different agencies have duplicate roles, relevant organizations tend to lose momentum to push ahead with required projects due to overlapping tasks and the unclear definition of roles and responsibilities.

To create a virtuous cycle of social welfare expenditure and economic growth, the nation's social spending should prove that it can strengthen social integration by improving wealth distribution, specifically relieving the polarization of wealth and lowering poverty rate. Various indicators of income distribution, however, show disappointing results of the effect of Korea's social welfare expenditure. To enhance the effectiveness of the nation's social spending, we need to restructure the existing public assistance systems not to raise the beneficiaries' dependency on the systems or encourage them not to work. For the national basic livelihood security program, it is necessary to convert the existing system of combined benefits to that of individual benefit, to pressure more beneficiaries not to rely on the program any



longer. Additionally, instead of providing medical care, educational and housing benefits all together with the livelihood benefit, we should develop separate systems to manage the qualifications of medical benefit and education benefit, provided in kind. At the same time, a more consolidated management of various social welfare systems should be put in place to prevent different public agencies from providing duplicate benefits for the population living below the minimum standard of living.

Over the areas for which different agencies have similar roles, we should coordinate responsibilities and create organic business flows among them. It is urgent to clearly define roles and responsibilities and promote effective cooperation between Ministry of Health and Welfare and Ministry of Employment and Labor over elderly job arrangement, social service-related job creation and self-reliance support projects in order to carry out the essential task of connecting labor and welfare. It is also necessary to ensure that related projects that different government organizations are carrying out with different policy objectives be implemented in a unified manner under consistent policy goals. Related projects and budgets should also be prepared according to more concise and clear objectives of social welfare policies. As for budget preparation, performance-based budget appropriation should be firmly established. Other urgent tasks are to develop welfare expenditures to enable a virtuous cycle of growth and distribution and to determine the direction of welfare spending based on the priority of the government's financial investment. The government's investment should be made to fulfill real welfare needs, excluding populist elements,

for the following areas: connecting labor and welfare, providing job opportunities, allowing every class of the needy access to welfare benefits, and increasing investment to improve and streamline the delivery process of welfare services.

While local governments are responsible for the administrative affairs of social welfare businesses, the burden of securing financial resources is shared by the central and local governments, which often puts them in sharply conflicting positions. To resolve the issue, it is necessary to fully implement the performance-based budget allocation system for the central government and enhance the local governments' systems to properly manage budget execution performance and successfully adopt the merit-based budget distribution system. Korea's fiscal expenditure to GDP rate is just a half of the OECD average, but the recent demographic changes, such as rapid progress of aging and low birthrate, signals the future expansion of the nation's overall spending on welfare. The population's aging represents a fundamental shift of a society's economic structure, and it needs an increased fiscal expenditure to cover rising social cost of supporting the elderly and address related economic and social issues. Along with this challenge, the growing demand for the government's active involvement in offering support for child care and child rearing raises the question of how the government will be able to secure stable and sustainable supply of required funds.

Other countries' examples of utilization of welfare resources show that their individual welfare systems and combination of different fund sources have changed depending on the individual country's development history of social safety nets and changes

in economic and social environments. Korea, which experienced a relatively rapid expansion of social welfare system and establishment of a social safety net in recent years, is required to put in place a management mechanism of welfare funds to enable the nation to flexibly respond to future changes in its economic and social conditions. Increasing payment of social security benefits represents an additional financial burden on the nation as a whole, and we need to build a public consensus on a Korean-style welfare model and how to share burdens among stakeholders in advance. The most urgent short-term strategy to raise funds to cover growing welfare expenditure should be the restructure of the fiscal expenditure system or expansion of the tax revenue sources. The following mid- and long-term strategies require a paradigm shift: reform of the tax system to effectively respond to rising welfare needs and changes of the nation's economic conditions; a public agreement on appropriate sources of tax revenue; consideration of earmarked taxes or new social insurance programs; more active involvement of the private sector; and securing new fund sources with expanded contribution by employers.

Expanding fund sources should be implemented step by step. Before discussing increasing the citizens' share of the growing fiscal burden, the following efforts should be made: improving the delivery mechanism of welfare services; coordinating roles and responsibilities among related government agencies and improving the existing spending structure to be more efficient and effective; restructuring the relevant budgets and funds; and making fund administration more efficient. In the short-term,

the tax reduction and exemption system should be reorganized and reduced in a way to secure more sources. In the mid- and long-term, we need to review whether we can raise more funds by taking advantage of the special accounts, including earmarked taxes and levies, and eliminating the inefficiency of fiscal administration through restructuring of tax items of local and national tax items. On the key goods of external diseconomy, such as cigarettes, alcohol, horse racing and lottery, are various types of taxes, such as levies, local taxes and earmarked taxes, imposed for each tax source, and they serve as primary sources of the special accounts or the public funds, or used as local taxes. Given this nature, even though the taxes are charged in the form of earmarked tax, there is no clear relationship between tax revenue and expenditure, and tax revenue cannot be flexibly utilized. Therefore, the relevant tax system is to be revisited in the mid- and long-term. As for the use of budget among different government agencies, it is necessary to allow them to share each other's budget for projects of similar characteristics. As the mid- and long-term strategies, we suggest a comprehensive restructuring of the financial sources, such as various funds and special accounts as well as earmarked taxes and levies to achieve an efficient budget allocation and management and secure additional fund sources.

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