

Korean Local Tax System and Local Public Finance

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Abstract

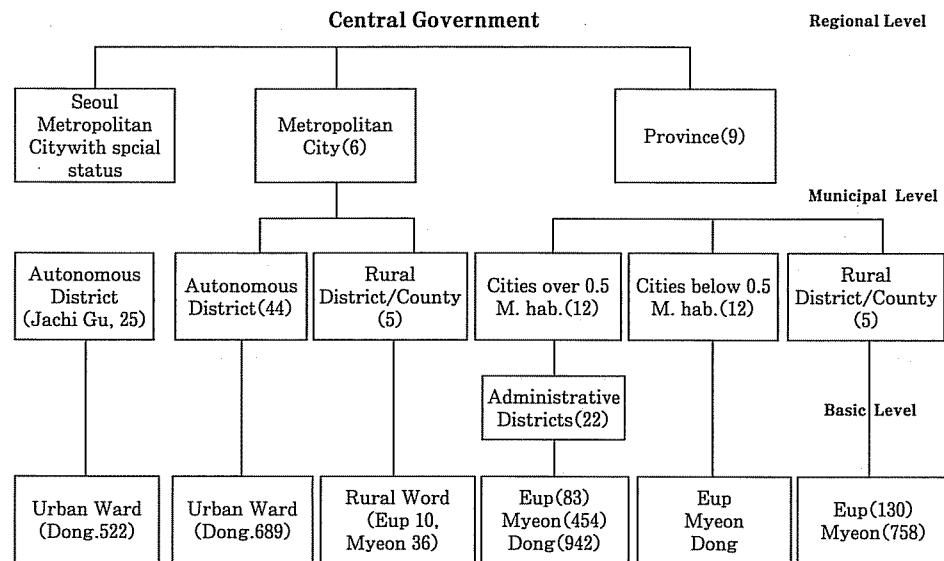
By explaining where Korean local governments get their money, how do they spend it, and why do they spend, this paper empirically painted the dynamics and complexities of local public finance in the Republic of Korea. In navigating the intricacies of Korean local public finance, this paper highlights the passiveness of the local bond market, rising local expenditures, and imbalances between local financing and taxation as the key challenges that needs prompt calibration. In the end, the paper proposes the shifting of fiscal balance principles in favor of the local governments, application of cost-benefit principle to respond to the budget-service disparities, and restructuring of local governments through mergers.

1. Introduction

Through electing officials of local councils, provincial governors, and mayors in 1995, Korea formally revitalized its quest for local autonomy. By instituting local elections, local governments can now employ their own developmental initiatives since elective local government officials will have to be sensitive to the needs of the constituents, especially if they are to run for another re-election. In reality, local expenditures sourced through intergovernmental transfers steadily grown since the last decade. Not until 1995, local representatives were government officers or politicians from the ruling party, hence, suggesting that local government representatives must depend on the central government to win another term. However, in an electoral process, people articulate their demands by their voting preference, likewise, local representatives has to obtain these voters' preferences. The change as brought about by the electoral process has profound effects on the process of political decision-making and the agenda of public administration as shown by the significant relationship between the results of re-election and the size of local expenditure (Kim 2005).

This study explains the overall local public finance and the accompanying current issues. Given the political, global, and fiscal trends ongoing in Korea, as well as other hosts of reason, local government's role has to be expanded alongside the expansion of its fiscal capacity. However, while the fiscal capacity might have been increased, the local government's fiscal *power* has not symmetrically grown. Traditionally, this asymmetric fiscal position limits local governments' responsibility and accountability. With this fundamental problem, fiscal imbalance among jurisdictions is the most severe issue in intergovernmental fiscal relations. The concentration of population in Capital area exacerbated fiscal imbalance. To address this problem, previous administration attempted to urbanized blighted area through creations of 'innovative cities', 'enterprise cities', etc. with employment and education opportunities for the people. These diverse policies aimed to attain balanced

Figure 1 Local government structure in Korea



Source: MOPAS (Ministry of Public Administration and Security, 2008)

regional development are under way. Korean government expects that these policies will contribute to the flat distribution of population.

Overview

Korea is a unitary country with a two-tier local government system. The upper level consists of provinces (*Do*) and metropolitan cities (metropolitan *Si*). The provincial level includes the Special Metropolitan City of Seoul, 6 other metropolitan cities, and 9 provinces of which *Jeju Provincial Government* became *Jeju Special Autonomous Provincial Government and International Free City*. Metropolitan cities are distinguished from provinces being the former are urban areas. Urban areas are separated from the provinces and designated as metropolitan cities once the population reached one million, thus, acquiring the same status as provinces.

The lower tier, functioning as the basic level, is composed of municipalities (*Si*) and rural districts (*Gun*, rural county) and autonomous urban districts (*Gu*). The lower tier has sub-level administrative units such as *Eup* and *Myeon* for rural areas and *Dong* for urban areas. If *Eup*'s population exceeds 50,000, it can become a city. A city with over one million inhabitants becomes a metropolitan city. The upper level and lower level are administratively governed by elected mayors and council members. Authority for education is with the Office of Education in the provincial and metropolitan governments.

Local Autonomy Act concretely defines the legal boundaries explaining the following "autonomous affairs" to be managed by the local authorities: (i) the organization and management of local government; (ii) the promotion of citizen's welfare, including social facilities and assistance for disabled people; (iii) industry

promotion; (iv) local development and management of facilities such as roads and water supply; (v) promotion of education, athletics, culture and the establishment of childcare centers; and (vi) local civil defense and fire fighting (OECD 2005).

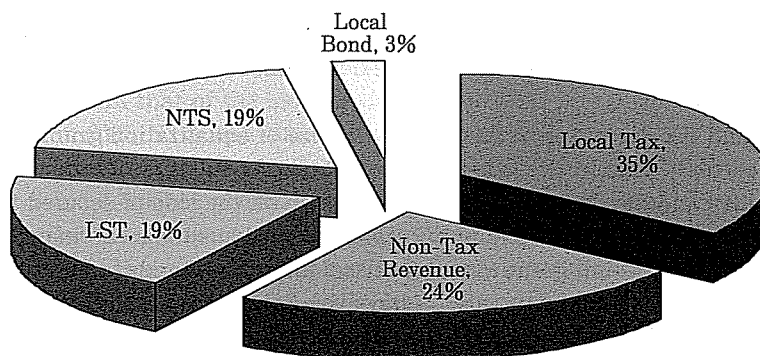
2. Structure of local public finance in Korea

1) Revenue assignment

Steady increase in Local Tax

Own-source revenues, such as local tax (35.0%), non-tax revenue (24.0%), and local bonds (3.0%), and intergovernmental fiscal transfer such as Local Shared Tax (LST) (19.1%), and national subsidy (19.0%), comprise the local revenues. Even though local tax is still the most significant revenue source, local tax covers only a part of local spending and the share has not been rising since the last decade. Furthermore, the ratio of the growth rate of local tax to GDP growth rate is 1.23 from 1996 to 2006. Note that the ratio of the growth rate of national tax to GDP growth rate is 1.17 at the same period. Because of biased composition of local tax bases, the elasticity of local tax is greater than local tax. Recently, bubble price of real estate has been one of the reasons for rise in housing and land acquisition transactions, among others. Speculative transaction stirred-up the trend after 2002. Considerable amount of local tax is related with property transactions such as Acquisition Tax, Registration Tax and surcharge taxes. Consequently, total collected amount of local tax rise in a considerable phase. In a narrow sense, significant relationship between real-estate business cycle and local tax could be considered as an advantage when business is in higher stage. However, revenue buoyancy tends to have higher impact in business lower stage and weak budget conditions. With the current composition of local tax, the ratio of local tax out of total local revenue should be examined in the reformation of the local revenue's structure.

Figure 2 The composition of local revenue in 2006



Source: MOPAS (Ministry of Public Administration and Security, 2008)

Large intergovernmental fiscal transfer

In most countries, transfers appear to have become the main policy instrument in the reduction of fiscal disparities. Reducing differences in tax raising capacity and public service needs across jurisdictions is therefore considered the most important role for intergovernmental grants (Boadway 2007). During the last administration, from 2003 through 2007, social welfare expenditure had been expanded in terms of fiscal size. Local governments used fiscal transfers, such as general and specific grants, as the main tool in welfare expansion. Average annual change of fiscal grants from central government risen 12.1 percent as compared to that of 8.7 percentage rise of local tax. "Tax or grants" debate as a means to raise local revenue is now ongoing in OECD countries (OECD 2008). Like many other countries, reliance on grants increased in Korea due to insufficient tax bases of local governments (OECD 2008) and the central government's preference to intergovernmental grants vis-à-vis expanding the tax bases of local governments. In addition to this vertical imbalance, horizontal imbalance is also a major issue in intergovernmental fiscal relations in Korea. A sizable share of grants is the results of disparities in tax bases or financial needs between jurisdictions that central governments want to correct. Korea has quite a big share of equalization grant as will be shown.

Local Shared Tax

The two main grants sources are Local Shared Tax (LST) and National Treasury Subsidy (NTS). The ratio of intergovernmental fiscal transfer out of local revenue has been stable for the last five years. Notably, dependence on Local Shared Tax (LST) has increased significantly from 13.5% in 2002 to 19.1% in 2006. LST is major fiscal equalization system. In comparison with the 2-4% in OECD countries, the share of LST to GDP in Korea is 6% in 2008. LST is divided into ordinary local shared tax and special local shared tax. The objective of LST is to equalize the fiscal capacities of jurisdictions. The equalization formula used to distribute LST calculates for each local government the standardized fiscal needs, revenue, and their difference. Calculation of the standardized figures and their adjustment for special local circumstances are made based on pre-determined formula for objectivity and transparency.

For sound fiscal position at local level, the size of equalization grants should be investigated first. Due to the tax sharing method of LST, it is often argued on its accountability and fiscal responsibility. Too much on the side of secured financing system characterized by huge amount of transfers weakens the local financing structure. A large equalization grant to correct fiscal disparities tends to make poor local authorities weaker. To prevent this, an incentive mechanism is necessary. In addition, the complicated, non-transparent method of calculation, the selection of the 16 criteria, and the arbitrary setting of adjustment coefficients needs to be reconsidered.

Local Transfer Fund

From 1991 to 2004, Korea had 'Local Transfer Fund' (LTF) as a block grant tool used for five broad local functions: roads, sewage, regional development, rural area development, and juvenile care. The fund was also a kind of tax sharing between the central and local governments since the revenue does not come from the central Government's general revenue collection but from liquor tax and 14.2% of the national transportation tax. The fund was transferred directly to local governments from the designated tax revenue sources without first being accounted for in the central government budget. Around 70% of the LTF was used for local road maintenance, like block grants, to strengthen the local fiscal base and to ensure balanced regional development. In other words, the fund was meant to increase local governments' revenue to prepare for local autonomy (Kim 2003). However, LTF was not qualitatively different with National Treasury Subsidy (NTS) and the money source from 'liquor tax' was vulnerable for revenue stability. These were the background for abolishment of LTF in 2004.

National Treasury Subsidies and Special Account for Balanced National Development

NTS has been the main transfer mechanism for specific grants subsidies. MOPAS classifies the subsidies into three: (i) costs of national services (for administering a general election, military recruitment, etc.); (ii) cost sharing (for recovery from natural disasters, public facilities); and (iii) promotional subsidies (for local governments to undertake certain projects) (Kim 2003). NTS are categorical grants provided by the central governments for specific projects. Political expenditure like social welfare and the increase of fiscal needs after local autonomy are the reasons of expanding NTS. For example, health care and subsidy for low-income households are national programs but delivered by local governments and funded by NTS. The fiscal responsibility of NTS is in the national budget office of the Ministry of Strategy and Finance. In consultation with other ministries, ultimate size and number of projects are determined by the Parliament where representatives exercise significant influence. The share of the subsidies has been rising rapidly since 1995 and was much greater than that of the local shared tax in 1999.

Finally, in 2005, NTS was reformed with drastic increase. In April 2004, the law of Special Account for Balanced National Development (SABND) was enacted. Article 4, 6 and 7 defines planning and evaluation of Enforcement Plans. The purposes of the law's enactment are (i) co-development of metropolitan and rural areas based on cooperation; (ii) correction of imbalance among regions and independent localization through innovation & individual characteristic-based development; (iii) creation of a balanced and individual society where all the people in the nation can enjoy high quality of life. The reasons of reform are that transparency and simplicity for distribution as the first concern and fiscal autonomy in local spending as the second concern. The reform of NTS gave birth to SABND. The Presidential Committee on Government Innovation & Decentralization and the Ministry of Strategy

and Finance rearranged totally the national projects and categorized it into three parts, namely — national projects with NTS, local projects with local tax, and SABND projects. SABND supports projects which are in intermediate stage between local own projects and local delivery for redistribution of national public goods. SABND projects consist of Regional Development Projects (RDP) for infrastructure demand and Regional Innovation Projects (RIP) such as specialized education for human capital investment (NURI; the New University of Regional Innovation). RDP is related with underdeveloped, farming, fishing areas development and the promotion of culture, tourism and IT. RIP covers promotion of local strategic industries, local universities, and regional R&D.

SABND is a block grant using the same distribution formula. Local governments can expect stable amount of transfer while the amount of NTS varies every year and is discretionary after 2005. The formula-based grants covered 87 projects and 8 Ministries. To distinguish the different characteristics of the 15 regions except that of *Jeju*, the formula used regression mainly factoring population, area, the ratio of old aged people, fiscal capacity index, and regional income ratio out of the Inhabitant Tax. The discretionary power of the line ministries in deciding the allocation of funds had been reduced because nearly half of the SABND grants are formula-based (OECD 2005).

To allow local governments to spend these funds in line with their specific priorities, they are given flexibility to shift them to other purposes. At the province level, fiscal flexibility in SABND is achieved by devolving local planning power and allowing the provinces to carry over the grants up to 20% of the total budget during a specific period. When the SABND begun in 2005, it is expected that devolution to local governments of national projects would force local public officials to plan and prioritize their own projects. However, the three-year implementation evaluation did not manifest local efforts to promote high quality of public service delivery. In 2008, BRDG needs improving due to the shrinking of number of projects and the enlargement of the grant size, among other reason. To distinguish SABND, NTS projects should be also defined.

Table 1 Comparison of NTS, BRDG and NTS after reform in 2005

From 2005	Determination Method of Financial Resource	Distribution Method among Regions
Local Shared Tax	Constant Portion of Domestic Tax Revenue	Formula Based
Balanced Regional Development Grant	<ul style="list-style-type: none"> • 100% of Liquor tax • Specific Transfer • Other Fees 	Formula Based
National Treasury Subsidy	Determined Every Year	at discretion

Passive Local Bond Market

Finally, one type of own source revenue is local bonds. The contribution of bond market in local public finance is not considerable since it only amounts to around 2-3% of the total local revenue. According to IMF standard for fiscal rule including local borrowing, local authorities in Korea were one of the most controlled by central government. Until 2005, local bond was under the tight control of the central government. Local authorities were required to satisfy every condition of MOPAS. After the reform, the Local Public Finance Law made the local bond issuances easier. However, even though the issuing environments in local bond market are relaxed, total local revenue's reliance on local bond is still negligible. As is seen in the table, the small increase in 1% is shown after relaxing the permission rule. This implies that local bond is not meaningful revenue resource in Korea. First, local authorities do not want to be burdened by complex financing and debt. With local bond, metropolitan cities planned SOC for infrastructure such as subway, airport, etc several years ago. These financing methods created future fiscal burden for the next generation. Elective local representatives do not want to bear political burden. Debt issuance is not easy politically. Second, public demand changed from economic development, like infrastructures, to social welfare. Relatively, the provision of public services based on their own social welfare plan is very rare. Local bond projects tend to relate with huge land development and infrastructure instead of social welfare and human capital investment. Instead of using bond market,

Table 2 Local bond ratio in 2005 and 2006

(unit: Hundred thousand US \$, %)

Prefecture	2005			2006		
	Local			Local		
	Revenue(A)	Deb(B)	B/A(%)	Revenue(A)	Deb(B)	B/A(%)
Seoul	194,631	7,291	3.75	160,797	5,101	3.17
Busan	67,797	2,962	4.37	55,831	2,806	5.03
Daegu	41,823	1,559	3.73	35,632	1,832	5.14
Incheon	55,217	3,544	6.42	46,691	2,934	6.28
Gwangju	27,079	1,175	4.34	21,796	1,004	4.61
Daejeon	26,007	643	2.47	21,956	525	2.39
Ulsan	22,746	1,025	4.51	16,460	818	4.97
Kyonggi	248,072	8,118	3.27	198,880	7,936	3.99
Gangwon	70,806	1,856	2.62	51,250	1,271	2.48
Chungbuk	53,846	755	1.40	38,346	720	1.88
Chungnam	78,764	1,182	1.50	61,708	910	1.47
Jeonbuk	69,294	863	1.25	53,685	1,779	3.31
Jeonnam	96,157	1,284	1.34	73,827	1,412	1.91
Gyeongbuk	99,278	1,565	1.58	75,128	1,205	1.60
Gyeongnam	110,954	1,779	1.60	81,773	2,387	2.92
Jeju	21,669	430	1.98	19,761	593	3.00
Total	1,284,140	34,760	2.81	1,013,521	33,233	3.28

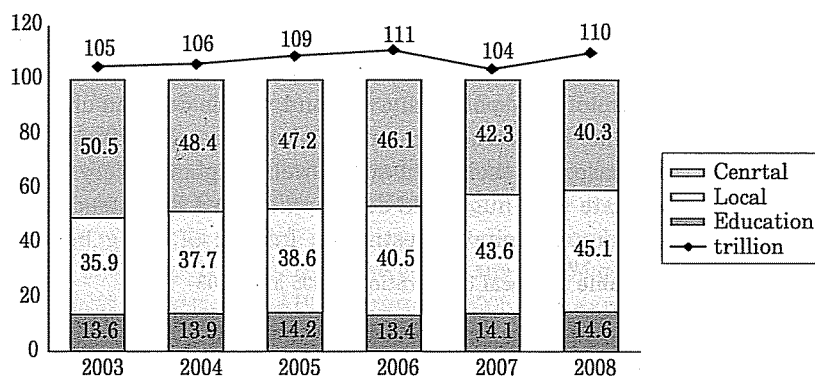
Source: Financial yearbook of local finance planning, MOPAS

private transfer through cash and labor is the main tool for social protection. The above-cited two fiscal and political environmental trends do not allow local bond contribution to the growth of local revenue for the time being.

2) Expenditure assignment

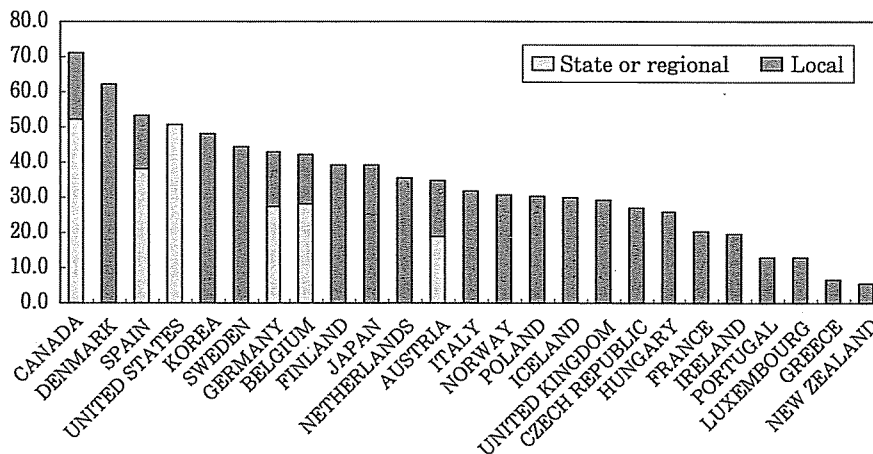
Local share in the total government expenditures has been rising since the last decade. Ratio of sub-central government's expenditures including local education is around 60% in 2008. Local government share in expenditures was 35.9% in 2003 increasing to 45.1% to date hence, local government has the biggest role in the total public expenditures. The average trend of other countries shows that the ratio of sub-central government to total expenditure increased from less than 31 to more than 33 percent in a statistically significant way (OECD 2008). As picture (below)

Figure 3 The size and ratio of local expenditure (unit: %, US \$)



Source: MOPAS homepage (www.mopas.go.kr) (2008)

Figure 4 Expenditure share of sub-national governments in 2005



Source : OECD (2005)

shows, Korea ranked high in local expenditure share level among OECD countries. From 2003, share of central government slowed down to around 10%. With the expanding trend of welfare demand, local expenditure share is projected to get bigger.

To understand the characteristics of expansion of local expenditures in Korea, there is a need to look and analyze the actual effects of decentralization on the overall public sector. Kim (2007) investigated the relationship between fiscal decentralization and regional income in Korea. The empirical results support the findings that the expansion of local expenditure by using intergovernmental fiscal transfer encourages the growth of regional income.

Enlargement of Social Service in Local Expenditure

Local governments are required to follow the annual budget guidelines set by central government stating the unit costs for every detailed expenditure categories. For example, the category of public employee compensation has ten expenditure

Figure 5 Composition of local expenditure between Korea and OECD in 2005

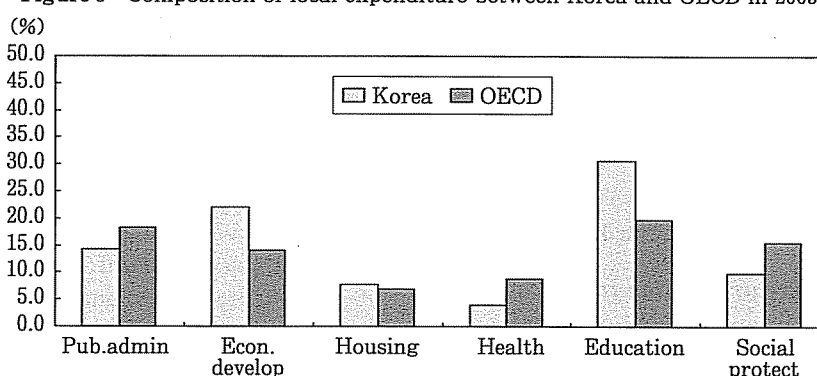
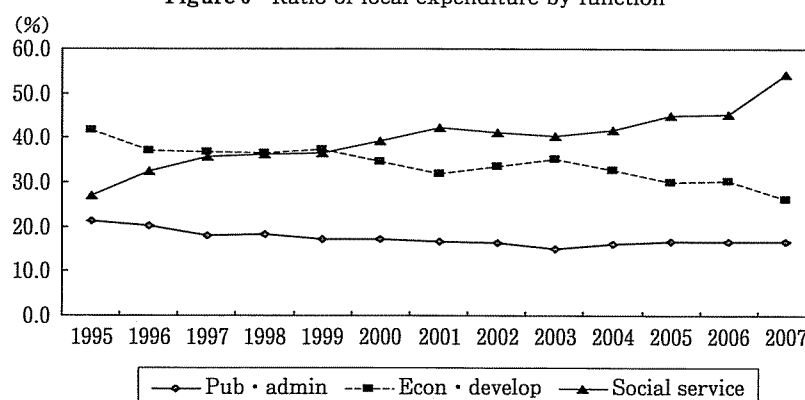


Figure 6 Ratio of local expenditure by function



Source: Financial yearbook of local finance planning, MOPAS

items such as basic salary, bonus, family allowance, meal allowance, transportation allowance, etc. The guidelines were changed to "budget criteria" from 2005, allowing local government to set unit costs for some spending categories. Central government intervention is also exercised through the conditions attached to National Treasury Subsidy (NTS) providing for a wide range of local public services and concentrating in the areas of health, welfare, construction, transport, and agriculture.

Relatively, social service share (health, social protection) is still smaller as compared to other developed countries. Economic development and education has been major items in local government expenditures until 2000. Presently, social service (up to 50%) represents the biggest share of local expenditures. The majority of local fiscal needs are related with people's daily lives such as social protection, public health, and education. Municipal local representatives may increase the ratio of public-service related expenditure such as welfare, health, and sanitation and, in order to be re-elected, expand local welfare projects and lobby for more matching grants earmarked specifically for their voters (Kim 2005).

As explained above, intergovernmental fiscal grants are focused to social service functions. Because of redistribution characteristics, low birth rate, and increase of graying population, the role of central government increased alongside the increasing demand for the transfer of role from higher-level government. Approximately, 60% of national subsidy goes to Ministry for Health, Welfare, and Family Affairs.

3) Fiscal imbalance in Korea

Fiscal Decentralization in Korea

Fiscal decentralization in Korea was the main agenda of the last administration. From 2003 to 2007, many changes occurred in local public finance and local tax system. The severe problem of vertical fiscal imbalance between central and local governments was highlighted. Weak local tax bases and fiscal imbalance within jurisdictions caused the central government to systematic fiscal intervention. In fact, local governments became highly dependent on national subsidies to finance their infrastructure. Revenue capacities are unevenly distributed despite the requirement of the national laws for the local governments to provide public services

Table 3 Vertical fiscal imbalance in 2006

(unit : %)

	Seoul	Metropolitan Cities	Provinces	Cities (> 50,000)	Counties	Wards
Average	85.7	60.5	35.4	40.7	17.2	37.1
Highest		71.2 (Incheon)	66.1 (Kyonggi)	74.0	56.9	86.0
Lowest		47.8 (Gwangju)	11.0 (Jeonnam)	10.8	6.4	13.0

Source: Summary of local budget for fiscal year 2006, MOPAS

Table 4 Local tax concentration of Seoul metro. region

(unit : billion won, %)

	2000	2001	2002	2003	2004	2005	2006
Seoul metro region	11,550.6	15,658.9	18,992.1	19,569.0	19,836.7	20,720.1	23,962.3
Growth Rate (%)	10.2	35.6	21.3	3.0	1.4	4.5	15.6
Noncapital Area	8,810.8	10,980.8	12,591.4	13,493.0	14,322.7	15,256.8	17,319.5
Growth Rate (%)	7.5	24.6	14.7	7.2	6.1	6.5	13.5
Seoul metro Ratio (%)	56.7	58.8	60.1	59.2	58.1	57.6	58.0

Source: Summary of local budget for fiscal year 2006, MOPAS

in accordance with the uniform standard. Nowadays, majority of public services are related with redistribution. These trends of redistribution as it relates to public services exacerbate the fiscal gap between central and local governments.

Moreover, horizontal fiscal disparities made it difficult for local governments to finance local public services. Fiscal independence index (FII) calculates the ratio of own-sourced revenue versus the total revenue. A high value of indicator means high self-financing capacities. As Table 3 shows, the average FII of each government level varies from 6.4% to 86%. Seoul metropolitan city is in solid financial status because of exceptional concentration of population. Most of counties in rural areas seem to be able to finance on their own the residents' needs at only around 17.2% while a Ward in Seoul has FII of 86%. The highest fiscal autonomy ratio in counties is 48% while wards in Seoul are at 92%. To improve the system for reducing fiscal disparities, balanced regional development policy had been implemented by the last administration. Inefficient migration to capital area has sustained for the last 30 years. It might be one of the reasons of reduced GDP productivity and caused the escalation of real-estate prices, fiscal disparities among jurisdictions, among others. The previous administration acknowledged and promoted the policy for even distribution of population in many ways.

3. Local tax issues in Korea

1) Local tax system

There are sixteen local taxes, and they are divided into province, city, and county taxes. At the province level, there are four ordinary taxes and three earmarked taxes. At the city and county level, there are seven ordinary taxes and two earmarked taxes. In the six large specially designated cities that are run as autonomous local administrative units (independent of the provinces that appertain to), the tax composition is slightly different from that of the provinces and cities or counties, although the residents are required to pay the same taxes. Thus, some taxes imposed at the upper level in metropolitan cities, such as the automobile tax, are imposed at the lower level in provinces. In addition, the large number of minor taxes, each generating less than 3% of local tax revenue, reflects reliance on earmarked taxes. Exceptionally, one of the earmarked taxes, the Local Education Tax,

Table 5 Local tax system in Korea

Tax	Revenue in 2007 Billion won	Share of total Percent	Tax imposed by			
			Provinces		Metropolitan cities ¹	
			Upper level	Lower level	Upper level	Lower level
Property registration	7254	16.9	×		×	
Property acquisition	7261	16.9	×		×	
Inhabitants ² , of which	7411	17.3	×		×	
Local education ³	4514	10.5	×			×
Tobacco consumption	2761	6.4	×			×
Automobile	2370	5.5	×			×
Comprehensive land ⁴	5	0.0		×		×
Motor fuel ⁵	3270	7.6	×			×
Urban planning	1883	4.4	×			×
Property holding	3755	8.8		×		×
Leisure	864	2.0	×		×	
Common facilities	543	1.3	×		×	
Business office	731	1.7		×		×
Regional development	100	0.2	×		×	
License	77	0.2		×	×	
Butchery	52	0.1	×			×
Agricultural income	—	—	×			×
Total	42851	100.0	13	4	9	10

1 Including Seoul.

2 The standard rate is 10% of the national personal income tax and corporate income tax.

3 A surtax on five local taxes: Registration, Leisure, Automobile, Tobacco, and Inhabitants.

4 The Comprehensive Land Tax was merged into the Property Holding Tax in 2005, leaving 16 local taxes. Of these, three are levied at the lower level of provincial governments and nine at the lower level of metropolitan cities.

5 A surtax on the national Transportation Tax.

Source: Financial yearbook of local finance planning, MOPAS

is a major revenue source. It was introduced in 2001, as a surcharge on five local taxes. However, this is automatically transferred to local education government, thus, is not fiscal revenue of local governments. Compared to local governments, the local education governments are more dependent on transfers from the central government, which account for 71% of their budget. Contrast to most OECD countries, local governments are primarily responsible for implementing education policies. The rest of local taxes are composed of a kind of fiscal transfer from central government like Tobacco Tax, Local Education Tax, Motor Fuel, and very small portion of

tax items less than 5%. The central government continued to enlarge local tax revenues. For example, a tobacco sales tax became part of the local tax base in 1989. The immediate impact of the tobacco tax on local finances was local governments' tax revenue share to total local revenue increased from 30 percent in 1988 to 39 percent in 1989.

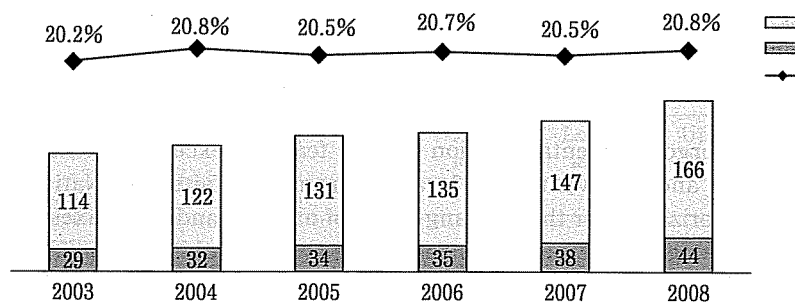
Korean intergovernmental relation mainly features excessive central government authority and intervention in local government affairs. By National Fiscal Law, legal authorization for the rearrangement of national and local taxes belongs to Ministry of Strategy and Finance instead of Ministry of Public Administration and Safety. This central power is often contested due to the limitation of local fiscal power. Local government does not allow changes of tax rate and bases and central government provides Tax exemptions and reliefs. As a result, the local tax system is somewhat rigid, hence, the simplification of local tax regime, streamlining the tax system, and broadening the tax base remains the focus of tax reform agenda.

2) Local tax share and limited taxing power

While the majority of expenditures are done at the local level, local governments have very limited autonomy when it comes to the spending decisions. Twenty percent of local tax share to national tax has been kept since the last two decades. In addition, central government determines local tax rates and bases. However, the Local Tax Act defines the tax bases and standard tax rates for 11 out of 16 local taxes. Legally, local governments and councils can adjust rates as much as 50% above or below the standard rate. In reality, they do not use their own power to change tax rate because of political implications. At the provincial level, only four of 16 jurisdictions, and only ten of the 250 lower level government, changed tax rates from its standard rate as of 2004 (OECD 2005). The active operationalization of flexible tax rate was the only case of *lowering* property tax rate at the capital region after the property taxation reform. In contrast to the limited use of flexible tax rate, tax reduction and exemptions of local governments equals to a considerable amount comprising around 10% of local tax revenue. The asymmetric behavior of local governments is the result of inefficient relations between central and local governments.

Further, local representatives tend to avoid political resistance as maybe brought about by increasing tax rate or bases. Because of these soft budget characteristics, local governments easily financially lean on central government. Higher share of intergovernmental fiscal transfer explains one side of this strategic behavior of local governments. With these aspects, active local taxing power is not operating in Korea as compared with other countries (OECD 2006). From the viewpoint of taxing power at lower level of government, the introduction of Local Consumption Tax (LCT) may not be desirable for properly enhancing autonomy. The most feasible way to introduce LCT in Korea is the method of tax sharing like Japan. Note that tax sharing is not classified as a real local tax as defined in OECD standard.

As a result, inter-jurisdiction tax competition is rarely used in Korea. There are several reasons why taxing power adjustment is absent. First, fiscal responsibility

Figure 7 Figure ratio of local tax to national tax (Unit : 2008-USD 124 Billion)

Source: MOPAS (Ministry of Public Administration and Security, 2008)

is only on the part of central government instead of being shared with local governments. Korea government does not allow bankruptcy of local government. Current budget system allows that central government to play an active role in a local government that is under financial distress. Second, the expanding size of intergovernmental fiscal transfer demands more grants from central government rather than to raise tax rates.

To attain fiscal autonomy, taxing power of local governments should be strengthened. However, there are some evidences that increasing tax share at sub-central level deepens fiscal disparities, thereby jeopardizing equal access to public services across jurisdictions. If tax share at sub-central level is to be increased, more inter-governmental grants will have to be dedicated to equalization in order to avoid disparities (OECD 2008). Therefore, the proper level of taxing power to be granted to local authorities is not easy to determine amidst great fiscal disparities. Fiscal concentration in metropolitan areas distorts even distribution and causes irresponsible behavior as evidenced by the enlargement of intergovernmental fiscal transfer. However, with the low rank in term of taxing power as compared to other OECD countries, institutional change and regulatory relaxation might be needed to at least foster minimum fiscal independence.

3) Heavy dependency of property taxation

Tax bases are distributed in property related taxes such as acquisition tax, registration tax, automobile tax, property tax, urban planning tax, and community facility tax. The large share of property taxes in local tax revenue is attributed to the Acquisition Tax and the Registration Tax that generated 13.1 trillion Won (2% of GDP) in 2006. Total amount of these taxes amounts to around 60% of local taxes (including the Special Tax for Rural Development and the Local Education Tax). In contrast to transaction taxes, taxes on property holdings (the Comprehensive Land Tax and Property Holding Tax) contributed only 2.5 trillion Won. This small amount reflects a tax bases set at approximately 30% of market value resulting in an effective tax rate of 0.12% before 2005. Altogether, property generated revenue was less than 0.5% of GDP in Korea while it is well below the 1.9% average in OECD countries.

Figure 8 Local tax composition in 2006



This skewed property tax bases had been caused by local budget shrinkage during the financial crisis of 1998 to 1999. The number of real estate transactions drastically reduced with more shrinkage impact on local taxes than national taxes. It created under-provision of public services and residents in jurisdictions were vulnerable to keep a minimum standard of life.

Ongoing Arguments about Introducing Local Consumption Tax and Local Income Tax

For balanced composition of local taxes, local government's consumption tax and income tax have been considered since 2005 to present. The ratio of the consumption tax and the income tax is 14.9% and 16.7% respectively. Taxes on consumption, business and personal income, social security, and payroll taxes were relatively insignificant compared to other OECD countries. In order to achieve more tax bases, biased tax composition has been argued to delegate tax bases from central to local governments. Since 2005, local governments along with the Ministry of Public Administration and Safety tried to introduce "Local Consumption Tax (LCT)" and "Local Income Tax (LIT)". For the Local Consumption Tax for example, 20% of total tax rate of VAT goes to local authorities like in Japan. In terms of administration costs, the introduction of Local Income Tax might be somewhat easier since the current Inhabitant Tax is a kind of surcharge of Income Tax, hence, a simple increase of surcharge rate of Income tax could qualify simply as Local Income Tax already. Until 2008, many argued about the way, amount, and the timing of LCT and LIT introduction. To introduce LCT and LIT, the need for additional transfer to Local governments must be confirmed by the national budget office under the Ministry of Strategy and Finance. Political compromise between central and local governments must first be reached. To implement LCT and LIT, technical problem might also arise as secondary issue. There are two main impediments for negotiation among Ministries and levels of governments. The first one is the differentiation from the current tax sharing (Local Shared Tax) and the other one is the validation of the effect of fiscal disparities through simulation. Finally, LCT and LIT are associated with regional based fiscal activity. The direction of local autonomy in Korea

has been rooted in local level governments. Note that conurbation of tax bases in LCT and LIT induces change of political bases.

4) Change in Property Holding Taxes in 2005

As is shown before, property taxation is a main source of local tax. Theoretically, property taxation is more advantageous than other taxes as it is levied on immobile assets, thus limiting the scope for tax evasion. Furthermore, it is based on asset values and conforms with the benefit principle. Even though there are many reasons of keeping property taxation at local government level, Korea have had many problems. OECD (2005) enumerated several problems in property taxation in Korea. The first problem relates to the strong reliance on property taxation at local level hence serving as barrier to liquid property markets and efficient land use as it is largely imposed on transaction rather than on ownership of property. Economic growth in local jurisdiction creates little additional local tax revenue because tax revenue from property transactions is only loosely related to income increases. The revenue depends on real estate market conditions, thus undermining the stability and predictability of local tax revenue. The second problem is tax autonomy issue in property taxation. Even though property taxes were main revenue source of local authorities, tax rates and valuation methods were determined by the central government, which set an "application ratio" that averaged 36% of the "standard market value." The application ratio was not formally binding; most local authorities used it because lowering it would decrease revenue while raising it would cause taxpayer resistance. Moreover, this underestimation of real property value let the holding taxes tended to be regressive as they were adjusted for building size rather than market value. The third one is regional disparities at property values. Since the regional disparity in the property tax bases is larger than that of income taxes, the strong reliance on property taxation aggravates regional disparities. The low rate on property ownership tends to encourage landholding for speculative purposes and does not encourage efficient use of land.

Recognizing the structure of property taxation, the government planned to boost the effective tax rate on property holdings to 0.24% in 2008, 0.5% in 2013, and 1.0% in 2017. For efficient land use and equity, raising the valuation closed to market value is needed. In 2005, the application ratio was raised to 50% of the standard market value while lowering permitted range for the tax rate in order to prevent a sudden rise in tax liabilities. To prohibit speculative transaction on real estate and increase progressiveness, the government introduced in 2005 the "Comprehensive Property Tax" on individuals' nation-wide holdings, at a rate of between 1% and 4% depending on cumulative value. All amount of tax revenue is returned to local governments whose tax revenue declined due to this change or whose financial status is weak. The effect of these reforms is expected to increase revenues from taxes on holdings of land and buildings by 2.6 times between 2003 and 2008. Until 2005, high transaction tax ratio and low holding tax ratio out of property taxation has been treated as the first reformative item. After the introduction of Comprehensive Property Tax, the amount of property holding tax expanded drastically. The

increase in property holding taxes was accompanied by a reduction in the tax rate on property transactions from 5.8% to 4.6% (4% on transactions between individuals). However, the effective rate on transactions was actually increased because the tax base was raised to the standard market value.

5) Remaining policy issues

Soft budget problem

Fiscal power structure in Korea is asymmetric between central and local government. In other words, fiscal power is skewed in favor of central government. Lower fiscal power encourages poor local authorities to lean on higher level of government easily. The fundamental reason of strategic behavior is due to 'soft budget' problem. Since ultimate fiscal responsibility and accountability have been under the central government, local government seemed unwilling to raise local taxes to fund increasing expenditures. Current soft budget system does not force local government to do so. In the aspects of fiscal control, fiscal concentration into central government has bright side. However, excessive central government authority hurts fiscal independency and deteriorate soft budget problem. To strengthen fiscal independency and smooth soft budget problem, fiscal power should be delegated to local governments. Expected side effects are limitation of fiscal autonomy and larger gap of fiscal disparities.

The tight linkage between marginal increase of revenue and their works

However, as expected, symmetric fiscal power will enlarge fiscal gap between rich and poor areas. Moreover, population concentration in metropolitan areas will aggravate fiscal disparities with uneven distribution of tax bases. The benefit principle should be applied. One of the most important deficiencies in the current system is that the cost signal of changing local expenditure is not apparent to local taxpayers. The tight linkage between marginal increase of revenue and their works might be one of the ideas to relieve transfer burden to ultimate fiscal charger. High demand of social welfare would attenuate fiscal capacities of heavy population area. In addition, the surplus of the transfer could go to poor areas instead of being used for rich areas. Therefore, policy maker has to determine what and how much fiscal power should be delivered to local governments within the tolerable impact. More so, in-depth spending reform must be the next tabled agenda.

Rearrange and merge of local district

Current administration is considering the rearrangement of districts' classification. Presidential Council on National Competitiveness (PCNC) declared regulatory reform and public sector innovation for efficiency. With this, the enhancement of competitiveness among 15 provinces and *Jeju* special district may be impeded. Since rearrangement and merger of local districts is being considered at present, restructuring of regional based areas will differentiate fiscal structure between central and local governments. Furthermore, the structure of local administration and financing

method may be designed in accordance thereto. The main difference is the birth of regional based branch of administration. In order to concretize this vision and mission, a financing structure for fiscal transfer may also be introduced.

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