

1 Korea

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1.1 Introduction

The Republic of Korea is located in the Korea Peninsula extends southward from the northeastern part of the Asian continent, spanning 1,000 km north to south. It shares most of its northern border with China and touches Russia, neighboring Japan. The entire size of Korea is 222,154 square kilometers. About 70 % of the territory is mountainous. The western and southern slopes are very gentle, forming plains. The peninsula has an indented and irregular shoreline with many inlets and over 3,000 islands. Considering the size of its territory, Korea has a relatively large number of rivers and streams. The Korea Peninsula has hot, humid summers and long, dry, cold winters. Spring and autumn are rather short. The temperatures range from a low of -15°C (5F) in winter to a high of 34.7°C (94.5F) in summer. The Republic of Korea (South Korea) is about 46.9 millions (1999); North Korea is about 22.1 millions (1999). Average population density is 463 persons (1997) per square km making Korea (South) one of the most crowded nations around the world. The birth rate of the year is 14.6 persons (1997) per 1,000 people, and the death rate of the year is 5.3 persons (1997) per 1,000 people. A notable trend in the population structure is that it is getting increasingly older. The 1994 statistics showed that 42.8 % of the population was under 25 years old. Another distinct phenomenon is the continuing migration of rural residents to cities resulting in heavy population concentrations. Monetary unit is won.

The name of 'Korea' derived from 'Koryo' dynasty (AD 918 – 1392) in which Buddhism was the state religion. Korean language, the Korean Alphabet, is the official language of Korea, which was invented in 1443. Korea was annexed by Japan in 1910, and was independent from Japan in 1945. As a result of the territorial division in 1945, the Republic of Korea (the capitalist South) and the Democratic People's Republic of Korea (the communist North) were inaugurated respectively in 1948. The Korea War occurred in 1950, and after a three-year war a cease- fire was signed in 1953 without a peace treaty. In 1991, both South Korea and North joined the UN simultaneously. The Republic of Korea declared its new government in 1948, from then the Republic of Korea almost has been presidential system in the political structure, and always has adopted the market economy system in the aspect of economic structure. The present government formed in 1998, as a result of a direct presidential election held in December 1997. The president of Korea is the head of the executive and nation. A single chamber parliament – the National assembly, which consists of 299 members, is vested only in the highest legislative power of the Republic of Korea.

Education system is six-year primary schools, three-year middle schools, three-year high schools, two-year colleges or four-year universities. Primary and middle school have been compulsory. The number of student over colleges and universities is 5,581 persons (1996) per 100,000 people, which makes Korea well-developed in the base of human resources.

Many of the world's major religions are active in the Republic of Korea; Shamanism, Buddhism, Confucianism, Catholicism, Protestantism, and others. Korea's most ancient religions are shamanism, Buddhism and Confucianism. All these played an important role in the country's early cultural development and have greatly influenced thought and behavior.

The Korean government launched a Five-Year Economic Development Plan in 1962. Extensive export promotion measures were taken. The government focused on the efficient mobilization and allocation of investment resources. Considering the poor endowment of

natural resources and the limited domestic market, the economic development was remarkable. Especially, based on rapid development, Korea emerged on the world stage as one of the front runners among the newly industrializing economies so that it was able to become a member of the OECD in 1996. But, it also has forced structural weaknesses accumulated in the process of concentrated growth. In the course of grow-oriented industrialization, the government usually induced industrial restricting by promoting heavy and chemical industries. So, exports product mainly includes such as electric and electronic products, shipbuilding, iron and steel, automobiles, machinery and petrochemicals; and also imported raw material such as crude oil, chemical products, steel products, raw materials for light industry, and capital goods. Consequently, the portion of trade in the economy is so large, and the Korean economy has a close relation with the situation of foreign economy and international environment. At the end of 1997, Korea suffered a financial crisis with a rapid depreciation of the currency and drop in the securities market. In the response to the crisis, the Korean government is implementing the reform program that involves far-reaching structural and institutional change.

1.2 Overview of Macroeconomic Activity and Fiscal Position

Korea was an underdeveloped, largely agrarian country until the turn of the 1960s. However, thanks to the success of export-oriented industrialization, it was transformed into a modern industrialized country. Helped by the rapid growth, which averaged over 8 percent per annum for more than thirty years, its GDP volume soared from only 2.1 billion U.S. dollars in 1961 to 484.4 billion U.S. dollars by 1996, while its per capita GNP also leapt from 82 dollars to 10,543 dollars over the same period.

1.2.1 Economic Performance during the 1960s and the 1970s

a. Launch of Economic Development Plans & Industrialization in the 1960s

In the early 1960s, the Korean economy remained locked into what was literally “a vicious circle of poverty”. The government launched an ambitious five-year Economic Development Plan. In the early stage of economic development, the government fostered import-substitution industries, which produced such basic intermediate materials as cements and fertilizers. After that, it promoted labor-intensive export industries such as textiles and plywood, which had international competitiveness because of cheap labor costs and were capable of absorbing the unemployed and underemployed human resources. In order to support export industries, extensive export promotion measures were taken. Low-interest rate policy loans were granted to help export firms facing financial difficulties. Various forms of preferential tax treatment, such as tax exemptions and tariff rebates, were given to export industries. The government also focused on the efficient mobilization and allocation of investment resources. Several specialized banks were established to finance such underdeveloped strategic sectors as small and medium-sized enterprises (SMEs) and housing construction. Together with this, to encourage foreign capital inflow, the Foreign Capital Inducement Act was passed in 1966 and foreign banks were allowed to open branches from 1967. Throughout the 1960s, the Korean economy, in a process of industrialization under the firm guiding hand of the government, exhibited impressive performance. Exports, the engine of growth, expanded by almost 40 percent annually. With this backing, Korea was able to register high average growth rates of above 8.5 percent a year. Per capita GNP increased from 87 U.S. dollars in 1962, when the first economic development plan commenced, to 210 U.S. dollars in 1969.

In the course of growth-oriented industrialization, a large amount of foreign capital had to be induced since domestic savings were insufficient to finance the enormous investment demand. Together with this, the money supply was increased to finance various government projects. As a result, there was chronic inflation throughout the decade. The annual average inflation rate in terms of consumer prices was above 11 percent during the period from 1966 to 1969.

b. Promotion of Heavy and Chemical Industries & Emergence as a Newly Industrializing Economy in the 1970s

In the early 1970s, Korea experienced dramatic changes and challenges both at home and abroad. Internationally, a new climate of protectionism spread rapidly, along with the world-wide stagflation caused by the first oil crisis. Labor-intensive light industries, whose competitiveness was gradually weakening as a result of rapid wage increases, faced fierce competition from other developing countries. These circumstances forced the Korean economy to modify its strategic objectives. The government induced industrial restructuring by promoting heavy and chemical industries such as shipbuilding, iron and steel, automobiles, machinery and petrochemicals. Investments in these sectors were encouraged by tax and financial incentives. As a result, the share of heavy and chemical products in exports expanded from 13 percent in 1970 to 39 percent in 1979.

In parallel with industrial restructuring, Korea expanded construction and manufacturing exports to the oil producing countries of the Middle East, whose import demand had increased due to abundant oil revenues. The construction boom in the Middle East contributed to an improvement in the domestic employment situation and served as an important source of foreign exchange. By virtue of the transformation of heavy and chemical industries into new export sectors, Korea was able to retain a strong pace of growth throughout the 1970s. Exports increased rapidly at the rate of 40 percent per annum. The amount of exports sectors, Korea was able to retain a strong pace of growth throughout the 1970s. Exports increased rapidly at the rate of 40 percent per annum. The amount of exports, which was well below 1 billion U.S. dollars in 1970, crossed the 10 billion dollar mark in 1977, and reached 15 billion U.S. dollars in 1979. The Korean economy grew at a high average rate verging on 9 percent a year, and per capita GNP rose from 253 U.S. dollars in 1970 to 1,647 U.S. dollars in 1979. This progress allowed Korea to emerge as one of the Asian newly industrializing economies (NIEs).

However, in carrying out economic development plans with an insufficient rate of domestic savings, the economy was handicapped by a serious lack of funds. This investment-savings gap was bridged by inducing inflows of foreign capital or by expanding the money supply, despite recognition of the importance of prudent monetary management in avoiding inflationary pressures in the process of economic development. In consequence, foreign debt kept piling up and chronic inflation lingered on.

1.2.2 Economic Performance during the 1980s and the 1990s

a. Strengthening of Economic Stabilization Efforts and Shift to Current Account Surplus in the 1980s

At the outset of the 1980s, the side effects of growth-oriented economic management became conspicuous. The second oil crisis and domestic political turmoil also took a heavy toll. By 1980, consequently, the nation faced difficulties throughout the entire economy. These included its first ever negative growth since planned development was launched, and a huge current account deficit. To cope with these difficulties, the government undertook a series of

structural adjustment measures to enhance economic efficiency. Firstly, it shifted the priority in its economic policy from growth to stability, and actively encouraged the adjustment of duplicated investment and liquidation of troubled enterprises. Together with these policies, the opening up of the economy and deregulation were pursued on a stage-by-stage basis, as part of the move to private-initiative in economic management. Efforts for both deregulation and opening-up at that time did not make great progress owing to the immaturity of the political and economic environment. However, tight monetary and fiscal policies contributed greatly to the construction of a stable foundation for the Korean economy, as did the renewed stability of international oil prices. Consumer price inflation, which had risen by 29 percent in 1980, dropped to single digits from 1982, and the current account deficit narrowed significantly. At the same time, GDP growth, which had registered negative figures in 1980, turned positive again. Especially from 1986 onward, GDP growth accelerated swiftly and the current account balance, chronically in deficit, moved into substantial surplus.

However, the continued high economic growth led to renewed price instability. In consequence, consumer prices, which had shown only a 2-3% increase in the middle of the 1980s, rose by 7.1 percent in 1988. Together with this rekindling of consumer price inflation, wages rose sharply with the emergence of a strong labor movement amid the democratic reform of Korean politics and society.

b. Weakening of Economic Constitution during the 1990s

As the Korean economy moved into the 1990s, the structural fault-lines of its “high-cost, low-efficiency” industrial structure deepened amid a sharp increase in competitive pressures. High costs had become endemic with high wages, high land prices and high interest rates, due to repeated waves of price instability and the inflexible adherence to firms’ management strategies of external expansion. The financial and real sectors became markedly less efficient, because market principles could not operate in a socio-economic environment characterized by over-regulation and government meddling in the financial and corporate sectors. Efforts to improve productivity, such as through technological development, were likewise inadequate. Moreover, Korean companies faced intense competition with foreign companies in both domestic and international markets, owing to the rapid catch-up growth of late-starter developing countries, the launch of the WTO, and the acceleration of market opening to meet OECD entry criteria.

Coping effectively with these tough new domestic and overseas economic environments required a strong drive for economic stability and structural reform. Policies along these lines were pursued only half-heartedly, however, and the previous growth-oriented strategies tended to persist. As a result, economic growth raced ahead, while the current account balance shifted deeply into the red and price instability continued GDP.

However, structural weaknesses accumulated in the process of concentrated growth. These underlying fractures were revealed toward the end of 1997 with the transformation of the internal and external economic environment. The Korean economy experienced a currency crisis and face difficulties. To cure the weaknesses Korean is pressing ahead with the thoroughgoing structural reform of its overall economy.

Table 1.1 Economic Performance Indicators in The Past Three Decades

	1962	1969	Annual change (%) 1962-69	1970	1979	Annual change (%) 1970-79	1980	1989	Annual change (%) 1980-89
Per capita GNP (US\$)	87	210	12.5	253	1,647	22.9	1,597	5,210	12.2
Real GDP growth rate (%)	2.1	13.8	8.7	8.8	7.1	8.8	-2.7	6.4	7.8
Gross domestic investment ratio (%)	11.8	27.9	---	24.3	35.8	---	31.9	33.8	---
Gross savings ratio	11.0	21.4	---	18.1	28.5	---	23.2	36.2	---

Source: *Key Economic Indicators of The Korean Economy*, The Bank of Korea, 1999.

1.3 Macroeconomic Activity

Since the mid-1960s, the country's gross domestic product grew at rapid speed annually. Per capita income exceeded US\$ 10,500. Between 1991 and 1995, the economy expanded at about 7.5 percent a year and unemployment was less than 2.5 percent. In the same period, Korea maintained a budget surplus in all but two years and inflation remained in the single-digit range. At the end of 1995, Korea's external debt was about US\$ 120 billion and the debt-GDP ratio was a comfortable 17 percent. Banks were weakened by substantial problems in their portfolios, and from high maturity and foreign exchange risks.

Consequently, a full year under the stewardship of the International Monetary Fund in 1998 meant tumultuous and often painful changes for the Korean people. For a nation that thrived on expansion and growth over the past thirty years, estimated contraction of the economy by 5.5 percent in 1998 was a tribulation. Actually, the World Bank's first financial assistance to Korea in 1962, in the form of an International Development Assistance credit, and in the early 1980s the Bank extended a structural adjustment loan. With a membership in the World Bank, Korea begun contributing to International Development Assistance as a donor country in 1977, and graduated from Bank lending in 1994.

The more imminent cause of economic difficulties that erupted lately was the near depletion of foreign currency reserves. The latent structure of the crisis owes to factors that are more fundamental. Domestic origin of the crisis can be traced back to long-standing structural weakness of the economy, although one could acknowledge the effect of the environment of the international economy. And, also failure to keep up with the rapid pace of globalization was one main reason that Korea eventually invited the recent economic difficulty. Korea was ill-prepared for the changes in the global economic environment over the past years. The economy has long been plagued by pervasive moral hazard problems. Under the umbrella of government protection, financial institutions in questionable lending practices. Nonetheless for every reckless lender, there has also been a reckless borrower.

Chaebols (family-owned conglomerates) pursued excessively leveraged expansion based on the so-called "too-large-to-fail" theory. The corporate sector was consequently weighed down by heavy debt burdens and substantial investment losses. This resulted in staggering

accumulation of non-performing loans in the financial sector and the erosion of capital base at financial institutions.

Korea's economic overhaul that got off to a roaring start in 1998 will be accelerated for the time being. Ever since, the government has been accelerating its reform agenda under the following banners: 1) swift and prudent reforms, 2) coordinated, multi-faceted approach, 3) prevention of moral hazard, 4) maintenance of social stability. This is because restructuring is not just meant to provide a quick fix to the crisis. Rather, the changes are to shape and mold the future of the economy, as the country undergoes a dynamic process of establishing a new economic paradigm commensurate with global standards.

Table 1.2 Selected Macroeconomic Indicators (1989-1998)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Gross Domestic Product US\$ hundred million)	2,204	2,518	2,920	3,057	3,457	4,024	4,894	5,200	4,766	3,213
Per Capita GNP (US\$)	5,210	5,883	6,757	6,988	7,811	8,998	10,823	11,380	10,307	6,823
GDP Growth rate (%)	6.4	9.5	9.2	5.4	5.5	8.3	8.9	6.8	5.0	-5.8
GDP Deflator Indexes Growth rate (%)	5.3	9.9	10.8	7.7	7.0	7.6	7.2	3.9	3.2	5.3
Producer Price Index	1.5	4.2	4.8	2.1	1.5	2.7	4.7	3.2	3.9	12.2
Consumer Price Index	5.7	8.5	9.3	6.3	4.8	6.2	4.5	4.9	4.5	7.5
Export (FOB, US\$ hundred million)	624	650	719	766	822	960	1,250	1,297	1,361	1,323
Import (CIF, US\$ hundred million)	615	698	815	818	838	1,023	1,351	1,503	1,446	933
Growth rate by kind of economic activity (%)										
- Manufacturing	4.2	9.7	9.5	5.3	5.4	10.8	11.3	6.8	6.6	-7.2
Agriculture, forestry & fishery	-1.0	-4.6	2.9	9.6	-4.5	0.2	6.6	3.3	4.6	-6.3
Increase rate by kind of expenditure (%)										
- Final consumption expenditure	10.4	10.1	7.9	5.6	5.4	7.1	8.2	7.2	3.2	-8.2
- Gross fixed capital formation	15.9	25.9	13.7	-0.7	6.3	10.7	11.9	7.3	-2.2	-21.1
- Ratio of tax amount to GDP (%)	17.7	18.6	17.9	18.7	18.9	19.8	20.5	21.1	21.0	19.8

Source: *The Ministry of Finance and Economy*, Government of Korea, and The Bank of Korea, 1999.

Table 1.3 GDP by Kind of Economic Activity (1997)

GDP	(Billion Korean Won)			
	Industry (A+B+C)	Agriculture, Forestry and Fishery (A)	Mining and Manufacturing (B)	Construction and Services (C)
290,888	268,979	18,103	88,846	162,030
100 %	92.6%	6.2%	30.5%	55.7%

Source: *National Accounts*, Bank of Korea.

Table 1.4 Composition Structure of Expenditure on GDP (At 1990 constant Prices)

(Billion Korean Won)

Period	GDP	Total Consumption	Private Consumption	Government Consumption	Gross Fix. Investment	Increase in Stocks
1991	195,936	125,251	105,526	19,725	74,973	1,147
1992	205,860	133,724	112,501	21,223	74,376	153
1993	217,699	140,752	118,884	21,868	78,279	-1,891
1994	236,375	150,653	127,865	22,788	87,484	1,190
1995	257,501	161,485	138,461	23,024	97,717	95
1996	275,691	172,697	147,869	24,828	104,641	3,244
1997	290,888	178,729	152,480	26,249	100,947	-6,922
1998						
I p	62,620	38,075	32,608	5,467	17,453	-9,754
II p	65,912	38,464	33,039	5,425	18,176	-7,460
III p	68,615	40,789	34,879	5,910	18,955	-6,943

Note: p) Preliminary

Source: *National Accounts*, Bank of Korea.

1.3.1 International Environment

a. Current Account Balance and Exports & Imports

Before 1997, the current account and exports & imports of Korea had relatively been reasonable in the aspects of its economic situation. However, Imports recently have too much reduced than that of exports by the influence of the decreasing domestic consumption. In 1998, the volume of goods imports is reduced into 93.2 US\$ billion from 144.6 US\$ billion of the previous year - that is, 35.5 percent decline from corresponding period of the previous year. On the other hand, the volume of goods exports is reduced into 132.6 US\$ billion from 136.2 US\$ billion of the previous year. As a result, trade surplus of goods was about 40 US\$ billion 1998.

In 1999, it is expected that exports will remain stagnant, while imports will rise substantially because of economic recovery in domestic market. Lately, in March 1999 exports decreased 1.9 percent, while imports grew 10.5 percent compared to the same month of last year. Despite deteriorating export conditions, the decrease in exports has weakened from the previous month. Imports rose 10.5 percent due to increased capital goods imports. In the current account, in February 1999 current account recorded a 2.34 US\$ billion surplus, recording substantially increased surplus from previous month. Capital account balance recorded a 660 US\$ million net inflow due to increased foreign direct and portfolio investment, and domestic financial institutions' collection of loans made in foreign currencies.

As a whole, Export volume is expected to decrease sharply, while import volume is expected to increase, due to appreciation of the won and global economic growth. Due to decreasing prices for imported goods as a result of the appreciating won and improving domestic economy, import volume is expected to record a two-digit increase. As a result, net exports are expected to record about 5 to 6 percent decrease. In 1999, the current account surplus is expected to decrease to 20 US\$ billion from 40 US\$ billion in 1998, by the influence of weak export performances and sharply expanding imports.

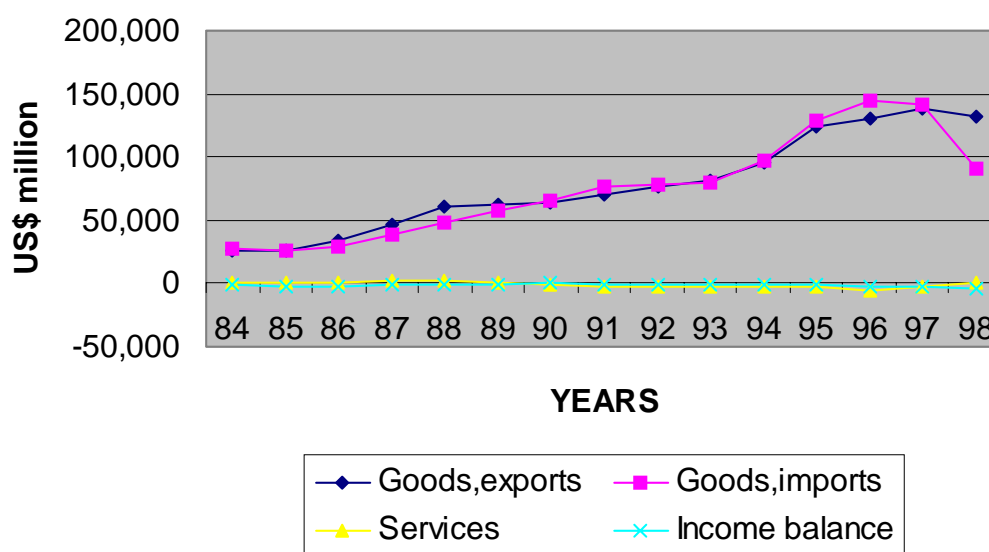
Table 1.5 Balance of Payments

(Unit: US\$ million)

	1994	1995	1996	1997	1998					1999
					Jul.	Aug.	Oct.	Nov.	Dec.	Jan.
Current Balance	-3,867	-8,508	-23,005	-8,167	3,814	2,105	3,697	3,041	3,094	1,909
Goods	-2,860	-4,444	-14,965	-3,179	3,879	2,774	3,696	3,192	3,364	1,867
Exports	94,964	124,632	129,968	138,619	10,734	9,725	10,722	11,270	11,711	10,127
Imports	97,824	129,076	144,933	141,798	6,855	6,950	7,026	8,078	8,347	8,260
Services	-1,801	-2,979	-6,179	-3,200	-91	-308	255	70	-110	-42
Income balance	-487	-1,303	-1,815	-2,454	-137	-521	-455	-448	-420	-180
Unrequited Transfers (NET)	1,280	218	-46	667	162	159	201	227	259	265

Source: *The Ministry of finance and Economy, Government of Korea, 1999.*

Figure 1.1. Trends of Balance of Payments (1984-1998)



The Korean government will be continued to make its utmost efforts to increase exports, since the nation is short of natural resources and has so many people comparatively. To do this end, motivating in export industries will be expedited in order to strengthen Korea's export competitiveness, with the priority oriented to high value-added business and capital goods industries. In 1998, the volume of exports was 132,313 US\$ million and it was the twelfth in the world. The volume of imports was 93,282 US\$ billion and it was the fifteenth. The Korea's main export products are heavy and chemical products such as electric & electronic products including semiconductor products & info-communications products, machinery & precision equipment, steel & metal products, chemical products, and automobiles. The principal import goods are capital goods, and raw materials – i.e. crude oil, chemical products, raw materials for light industry. Other importation is durable consumer

goods, direct consumer goods and grain product. Major goods of export and import are mainly related with U.S., Japan, and EU. In the case of U.S. in 1997 the volume of exports was 21.6 US\$ billion, and the percentage to total exports was 15.9 percent. The volume of imports was 30.1 US\$ billion, and the percentage to total imports was 20.8 percent. In the case of Japan, in 1997 the volume of exports was 14.8 US\$ billion, and the percentage to total exports was 10.8 percent. The volume of imports was 27.9 US\$ billion, and the percentage to total imports was 19.3 percent.

Table 1.6 Exports by Product

(Unit: Customs clearance base, US\$100 mil., % change over-the same month of last year)

	Feb. 1998	Jan.-Feb. 1998	Feb. 1999
Total Exports	112.2(19.9)	202.2(9.9)	94.2(-16.0)
Heavy & chemical products	69.6(12.1)	127.3(5.7)	66.7(-4.2)
- Electric & electronic products	28.2(11.1)	54.5(2.3)	30.6(8.4)
(Semiconductor products)	13.3(24.0)	26.3(12.2)	14.6(9.6)
(Info-communications products)	7.2(4.5)	14.2(-0.6)	8.8(22.0)
- Machinery & precision equipment	7.3(17.1)	13.8(11.6)	8.0(9.6)
- Steel & metal products	9.2(17.9)	16.5(9.2)	7.3(-20.5)
- Chemical Products	7.8(12.7)	15.0(11.0)	6.7(-14.7)
- Automobiles	4.8(-6.8)	7.8(-0.5)	4.8(1.2)
Light industrial products	32.0(36.1)	55.0(16.1)	21.0(-34.2)
- Textile	1.6(9.2)	3.0(5.9)	1.0(-39.1)
- Fabric	6.3(-5.9)	11.6(-12.6)	4.9(-22.4)
- Gold	11.3(184.7)	16.9(115.5)	3.7(-67.6)
- Clothing	2.8(10.1)	5.5(5.6)	2.9(4.1)
- Paper products	1.4(33.0)	2.5(20.4)	1.3(-8.8)
- Tire & tube	1.2(21.7)	2.2(13.7)	1.0(-12.7)

Source: *The Ministry of finance and Economy*, Government of Korea, 1999.

Table 1.7 Imports by Product

(Unit: Customs clearance base, US\$100 mil., % change over-the same month of last year)

	Feb. 1998	Jan.-Feb. 1998	Feb. 1999
Total imports	78.8(-31.3)	153.71(-36.0)	76.4(-3.1)
Raw materials	41.1(-30.6)	83.3(-32.2)	35.7(-13.2)
- Crude oil	10.1(-41.4)	23.4(-33.2)	7.9(-21.9)
- Chemical products	7.1(-22.4)	13.3(-28.4)	6.6(-7.8)
- Steel products	3.4(-26.2)	7.0(-26.7)	3.4(-0.7)
- Raw materials for light industry	3.2(-25.4)	6.2(-35.4)	2.6(-19.3)
Capital goods	29.7(-26.6)	54.7(-35.9)	30.5(2.9)
- Electric & electronic goods	17.3(-15.7)	32.5(-25.9)	21.3(22.9)
(Semiconductor products)	9.7(8.9)	17.7(-6.1)	12.1(25.2)
(Info-communications products)	2.6(-41.3)	5.3(-47.4)	4.1(55.8)
- Machinery & precision equipment	9.1(-43.6)	17.3(-46.8)	7.4(-17.9)
Consumer goods	8.1(46.8)	15.6(-5.8)	10.2(26.5)
- Durable consumer goods	3.0(-59.3)	5.7(-62.9)	5.4(79.9)
- Direct consumer goods	1.7(-44.2)	3.3(-49.9)	2.3(33.5)
- Grain products	2.3(-1.0)	4.5(-4.7)	1.6(-30.6)
- Non-durable consumer goods	1.0(-56.3)	2.0(-58.4)	0.9(-14.2)

Source: *The Ministry of finance and Economy*, Government of Korea, 1999.**Table 1.8 Main Destination and Origins**

(Unit: US\$ hundred million)

	1994	1995	1996	1997	1998						1999
					Jun.	Jul.	Aug.	Oct.	Nov.	Dec.	Jan.
U.S.A											
Exports	205.5	241.3	216.7	216.3	18.5	19.4	18.2	19.9	19.4	21.7	18.3
(Percent change)	(13.3)	(17.4)	(-10.2)	(-0.2)	(-7.2)	(-1.5)	(1.7)	(4.6)	(5.0)	(7.1)	(18.9)
Percent to total exports	21.4	19.3	16.7	15.9	16.1	19.4	18.8	18.7	16.6	17.5	19.7
Imports	215.8	304.2	333.1	301.2	18.3	15.7	15.9	17.3	17.1	19.2	19.4
(Percent change)	(20.4)	(41.0)	(9.5)	-9.6	(-30.9)	(-43.6)	(-31.9)	(-31.3)	(-23.6)	(-0.9)	33.9
Percent to total imports	21.1	22.5	22.2	20.8	23.6	22.2	22.3	23.7	20.5	22.2	22.5
Trade Balance	-10.3	-62.9	-116.4	-84.9	0.3	3.7	2.3	2.5	2.3	2.5	-1.2
Japan											
Exports	135.2	170.5	157.7	147.7	9.4	9.3	8.4	11.3	11.3	11.0	9.7
(Percent change)	(16.9)	(26.1)	(-7.5)	(-6.3)	(-28.2)	(-29.2)	(-30.4)	(-11.6)	(-5.8)	(-11.3)	3.6
Percent to total exports	14.1	13.6	12.2	10.8	8.2	9.2	8.6	10.7	9.7	8.9	10.4
Imports	253.9	326.2	314.5	279.1	13.3	13.0	12.0	14.6	14.7	16.2	14.6
(Percent change)	(26.9)	(28.5)	(-3.6)	(-11.3)	(-46.5)	(-47.1)	(-44.7)	(-42.8)	(-32.8)	(-14.1)	22.0
Percent to total imports	24.8	24.1	20.9	19.3	17.1	18.3	16.8	19.0	17.7	18.8	16.9
Trade Balance	-118.7	-155.7	-156.8	-131.4	-3.9	-3.7	-3.6	-3.2	-3.4	-5.2	-5.0

Notes: 1) Reference dates are based on the customs clearance dates.

2) Exports are valued at FOB, imports at CIF.

Source: *Trade Balance by Major Country*, *The ministry of Finance and Economy*, Government of Korea, 1999.*b. Foreign Exchange Rate and Exchange System.*

The Korean won is mainly floating linked to the US dollar, and was depreciated by about 40 percent between August 1997 and February 1998. The US dollar was used as the intervening currency to fix the exchange rate. Especially, in the end of 1997, the large mismatch between demand and supply in the domestic foreign exchange market was attributable to the heavy external debt taken on to finance the current account deficit, and to the excessive reliance on short-term external borrowings. The building of expectations of a massive depreciation of the Korean won played a substantial part in the worsening of the foreign exchange situation. Eventually foreign currency conditions of Korea was the cause of the economic crisis. At present, the exchange rate of won against the US dollar is determined by market forces, namely, foreign exchange demand and supply in the domestic market.

The Ministry of Finance and Economy is responsible for the formulating and implementing policies on foreign exchange. To deal with the foreign exchange crisis, the Ministry has gone through its policy well, and that was available for stabilizing the crisis. The Bank of Korea is managing official foreign exchange reserves. Its principal objectives in its management are to safeguard the value of the reserves and to meet the nation's demand for foreign exchange. The size of the reserve is tending to increase as the scale of trade and the economy grows larger. The Bank of Korea conducts certain foreign currency operations. Their main aim is generally to counter disorderly market conditions. Market forces determine the exchange rate of won. Exceptionally however, if there is a large discrepancy between demand and supply that disrupts the regular operation of the foreign exchange market, the Bank participates in it as a buyer or seller. In addition, the Bank of Korea act as agent for the government in managing the Foreign Exchange Equalization Fund, which was founded in 1967 with the object of stabilizing the foreign exchange market. The Bank is also represents the government in all dealings and transactions with international financial institutions of which the Republic of Korea is a member.

Lately, the won/dollar exchange rate has stabilized to around 1,200 level, despite the volatile conditions of the international financial market. The stabilization was helped by the upgrading of Korea's sovereign ratings, inflows of foreign investments, continuation of current account surplus, and the rise in international reserves.

Exchange rate policy of government is managing flexibly to accommodate changes in fundamental market conditions, including capital flows and current account balance fluctuations. The government's direct intervention in the exchange market would be avoided. And the government builds up foreign currency reserves continuously and repays external debts as planned. The exchange rate is not an economic variable that can be arbitrarily decided by the government, which would provide incentives for each economic entity to hedge the exchange risks. Against uncertainties in the international financial market, the government will increase its usable foreign exchange reserves to more than 55 US\$ billion in 1999. Associated efforts will be made to improve its external debt structure. And, included is the development of foreign exchange market in Korea. For this purpose, a launch of the won/euro market is envisaged, and the won/dollar market will be activated.

Table 9. Foreign Exchange Rates

(Unit: won in terms of foreign currency 1 unit)

	1998					1999		
	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
USD	1,357.30	1,390.00	1,317.00	1,250.70	1,189.00	1,175.10	1,225.00	1,227.00
Euro	---	---	---	---	---	1,340.20	1,352.40	1,316.88
GBP	2,281.96	2,360.08	2,211.05	2,067.06	1,973.98	1,937.15	1,957.86	1,978.48
DEM	777.15	833.01	796.49	730.44	706.94	685.23	691.47	673.31
CAD	869.51	908.35	850.23	815.59	767.59	774.62	817.10	812.58
FRF	230.21	248.49	237.45	217.72	211.15	204.31	206.17	200.76
ITL(100)	78.46	84.24	80.50	73.74	71.54	69.22	69.85	68.01
CHF	945.69	1,007.90	978.60	885.89	858.17	831.34	847.16	824.13
HKD	175.14	179.38	169.99	161.53	153.46	151.64	158.10	158.34
SER	169.39	176.93	168.96	152.93	146.27	151.45	150.83	147.04
AUD	771.01	825.03	820.69	792.88	727.01	737.32	775.49	768.78
DKK	202.59	219.12	209.50	192.07	186.01	180.48	181.31	177.03
BEF	37.65	40.35	38.61	35.39	34.54	33.22	33.53	32.64
ATS	110.32	118.20	113.24	103.71	100.59	97.40	98.28	95.70
NOK	172.68	188.18	178.05	165.33	156.77	166.53	155.27	157.40
NLG	683.80	738.15	706.07	647.56	628.55	608.16	613.69	597.57
SAR	360.74	370.58	351.15	333.46	316.94	313.32	326.54	327.16
KWD	4,413.98	4,589.28	4,368.88	4,124.32	3,940.35	3,881.42	4,044.51	4,002.95
BHD	3,600.74	3,687.49	3,493.83	3,317.95	3,154.26	3,117.39	3,249.77	3,255.07
UAED	369.58	378.49	358.61	340.56	323.76	319.97	333.56	334.10
JPY(100)	959.56	1,019.44	1,131.44	1,011.08	1,037.07	1,009.97	1,014.91	1,017.83
SGD	765.11	823.46	811.21	758.92	717.45	695.33	709.73	707.73
ESP(100)	909.11	980.50	936.90	857.82	832.69	805.48	812.81	791.46
FIM	251.94	273.72	261.79	240.14	233.99	225.41	227.46	221.48
NZD	670.85	694.37	695.57	662.06	626.54	630.50	651.76	651.97
USD T/T Selling Rate	1,377.60	1,410.80	1,349.92	1,269.40	1,206.80	1,192.70	1,243.30	1,245.40
JPY T/T Selling Rate	973.95	1,034.73	1,159.72	1,026.24	1,052.62	1,025.11	1,030.13	1,033.09

Note: Figures are the rates at the end of the month.

Source: Korea Exchange Bank, 1998-1999.

c. Foreign Direct Investment

Korea needs foreign capital in order to overcome the current economic crisis, and so the government has “The Foreign Investment Promotion Act” which intends to make more business-friendly environment for foreign investors. The inflows of foreign investment rose to 7.0 US\$ billion in 1997, and 8.9 US\$ billion. More recently, the inflows have increased significantly. According to the Ministry of Finance and Economy, in April 1999, the amount of foreign investment posted 8.1 US\$ billion, up 43.3 percent compare to the same month of last year, recording 4 straight months increase since January 1999. For January 1999 to April 1999 period, the total of foreign investment reached 2.8 US\$ billion, up 147.4 percent from the same period of last year. The foreign investments from EU regions soar to 1.2 US\$ billion during January 1999 to April 1999 period, up 331.3 percent from the

corresponding period of last year. The investments from the U.S. rose 77.3 percent, while the investment from Japan fell 28.1 percent from the same period of last year. By the industry, the foreign investments to service sector rose sharply. During January 1999 to April 1999 period, the investment to service sector rose to 1.9 US\$ billion, taking up 67.2 percent of total foreign investments.

The foreign investments to communications industry and other services took up the highest portion reaching 6.1 US\$ billion. The foreign investment using mergers and acquisition of corporations' existing shares shown declining trend, while the foreign investment April period, the foreign investment using M&A took up 16.8 percent.

Table 1.10 Foreign Investment Trends

(Unit: US\$ mil., % change from the same period of previous year)

	1994	1995	1996	1997	1998
Amount	1,317	1,941	3,203	6,971	8,852
(percent change)	(26.1)	(47.4)	(65.0)	(117.6)	(27.0)

Source: *The ministry of Finance and Economy*, Government of Korea, 1999.

d. Borrowing from Abroad

Korea has been relying on foreign debt to fill the gap between domestic savings and investment gap, and also to implement its development program ever since 1960s. Korea's total external liabilities grew at an average of 46.4 percent while net external debt grew at the average of 25.9 percent between the period 1990 and 1998. The main sources of external was from U.S., Japan, and EU countries as well as the IBRD, the IMF.

In 1996, Korea's total external debt was 104.7 US\$ billion (based on the IBRD standard), total external liabilities was 157.5 US\$ billion (based on the definition agreed on between the Korean government and the IMF), and the usable foreign exchange reserves was 29.4 US\$ billion. By November 1997, Korea was almost defaulted on its debts. Total external debt was over 120 US\$ billion, but the usable foreign exchange reserves was only 8.9 US\$ billion. Consequently, the government had to turn to the IMF to request stand-by funds. Thanks to the consolidation of the basis for economic stability, and to reform of the economic structure in line with the agreements with the IMF, foreign exchange market conditions have improved significantly. Usable foreign exchange reserves had increased to 43 US\$ billion by the end of 1998.

Lately, according to the Bank of Korea's announcement, as of end of March 1999, Korea's total external liabilities posted 145.52 US\$ billion. And the ratio of short-term external liabilities to total liabilities recorded 21.9 percent, up 0.9 percent from February 1999. Usable foreign currency reserves recorded 57.38 US\$ billions as of May 15, 1999. The increase was mainly attributed to the inflow of 1 US\$ billion Second Structure Adjustment Loan from the IBRD.

Table 1.11 Korea's External Liabilities

(Unit: US\$ hundred million)

	End 1997	End 1998	End-Feb. 1999 ¹⁾	End-Mar. 1999 ¹⁾

Long-term liabilities	948.4	1,185.2	1,149.1	1,136.6
Public sector	222.6	365.0	340.6	342.2
Financial sector (A+B)	472.4	529.8	517.6	502.6
A. Domestic financial institutions	428.9	472.9	547.4	444.0
(Resident domestic financial institutions)	266.3	286.8	280.2	274.6
(Offshore banking of domestic financial institutions)	110.0	107.0	101.2	93.8
(Foreign branches of domestic financial institutions)	52.6	79.1	76.0	75.6
B. Domestic branches of foreign banks	43.5	56.9	60.2	58.6
Private sector	253.4	290.4	290.9	291.8
Short-term liabilities (I+II)	632.2	308.3	305.2	318.6
I. Financial sector (A+B)	423.6	188.9	182.5	192.0
A. Domestic financial institutions	271.5	106.0	111.2	116.6
(Resident domestic financial institutions)	121.6	64.6	64.9	68.3
(Offshore banking of domestic financial institutions)	55.7	13.6	15.1	17.3
(Foreign branches of domestic financial institutions)	94.2	27.8	31.2	30.9
B. Domestic branches of foreign banks	152.1	82.9	71.2	75.4
II. Private sector	208.6	119.4	122.7	126.6
Total external liabilities	1,580.6	1,493.5	1,454.3	1,455.2

Notes: 1) Preliminary figures.

2) Amount change from the same month of last year.

Source: *The Ministry of Finance and Economy, Government of Korea, 1999.*

Table 1.12 Foreign Currency Reserve Balance

(Unit: US\$ hundred million)

	End 1997	End-Mar. 1998	End-Jun. 1998	End-Sep. 1998	End-Dec. 1998	End-Jan. 1999	End-Feb. 1999	End-Mar. 1999	End-Apr. 1999
Foreign currency Reserve balance (A)	204.1	297.5	409.0	469.8	520.4	536.0	554.6	574.5	592.6
Holdings of Korean Bank's overseas branches (B)	113.3	54.0	36.6	34.0	33.3	33.0	32.9	28.1	26.9
Others(C)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Usable foreign Currency reserve A-(B+C)	88.7	241.5	370.4	433.7	485.1	500.9	519.6	544.6	563.8

Source: The Bank of Korea, 1999.

1.3.2 Domestic Environment

a. Economic Growth Rate

Before 1997, Korea's gross domestic product (GDP) grew at an average rate of 8.2 percent annually for more than thirty years. In the 1960s, exports expanded by 40 percent

annually, and so Korea could get high average growth rates of above 8.5 percent a year. As a whole, the Korean economy had laid the bases for industrial development, and was ready for take-off. Throughout the 1970s, Korea could register a rapid pace of growth. The amount of exports crossed the 10 billion dollar mark in 1977, and accomplished 15 US\$ billion in 1979. The average growth rate was 9 percent a year, and per capita GNP increased from 253 US\$ in 1970 to 1,647 US\$ in 1979. In the 1980s, Korea has confrontations with difficulties in the economy. In 1980, the nation had experienced its first negative growth rate since 1962. In 1982, GDP growth rate turned into positive. From 1986, GDP growth accelerated rapidly and the current account balance moved into substantial surplus. This was owing to the so-called “three lows”; namely, low oil prices, low international interest rates and the low values of the U.S. dollar in terms of the Japanese yen, as well as the greater degree of price stability attained in the first half of the 1980s. In the 1990s, while the current account balance moved into the red and price instability continued, GDP growth went ahead at the average of 7.5 percent annually from 1990 to 1996.

In 1999, a large part of the economic recovery witnessed in recent periods can be viewed as a result of temporary factors, such as the government’s expansionary macroeconomic policies. Economic growth is expected to be led by domestic demand including consumption and facility investment as opposed to an increase in net exports. The Korean economy is expected to grow over 4 percent. According to the Bank of Korea, Korea’s gross domestic product grew by a higher-than-expected 7.3 percent year-on-year during the first half. This growth is largely attributable to both a combination of a fast recovery in private consumption and facility investment and a rapid expansion of exports.

Table 1.13 Growth Rates of Real GDP and Economic Activity
(Percent change from the same period of the previous year)

Period	GDP	Industry	Agriculture	Mining and Manufacture	Construction and Services
1989	6.4	6.6	-1.0	4.0	10.0
1990	9.5	10.3	-4.6	9.3	13.9
1991	9.1	9.6	0.4	8.9	11.5
1992	5.1	5.7	6.0	4.8	6.2
1993	5.8	6.4	-2.9	4.9	8.6
1994	8.6	8.8	1.6	10.4	8.9
1995	8.9	9.1	3.7	10.6	8.9
1996	7.1	7.2	4.0	7.3	7.5
1997	5.5	6.1	2.5	6.2	6.4
1998 III p	-6.8	-6.0	-5.6	-8.0	-5.0

Note: p: Preliminary

Source: *National Accounts*, The Bank of Korea, 1999.

b. Inflation Rate

In 1960s and 1970s, in the process of the growth-oriented industrialization, foreign capital had induced because domestic savings were not sufficient to meet the investment demand. With this, the money supply was increased to finance economic projects. Consequently, there was high inflation. For example, from 1966 to 1969, the annual average inflation rate in terms of consumer prices was above 11 percent. At the outset of the 1980s, because of the second oil crisis and political problems, the consumer price inflation had risen by 29 percent in 1980.

But, strict monetary and fiscal policies contributed to the construction of a stable basis for price inflation, as did the stability of international oil prices. Consumer price rate dropped to single digits in 1982. In the middle of the 1980s, consumer prices had shown 2 of 3 percent increase, and rose by 7.1 percent in 1988. During the 1990s, Korea was coped with new domestic environment, which required a strong drive for economic reform. As a result, consumer prices rose at a rate of 6.4 percent annually during the period from 1990 to 1996, much faster than that of major competing countries.

In 1999, despite the decreasing aggregate demand gap(the difference between aggregate supply capacity and aggregate demand resulting from recovering business environment), consumer prices are expected to increased by about 2 percent, due to declining prices for imported goods caused by appreciation of the Korean won. On a monthly basis, consumer prices rose 0.3 percent, and producer prices fell 0.29 percent in July 1999.

Table 1.14 Percent Change in Price Indices

	Producer prices		Consumer prices		Export prices (Won basis)		Import prices (Won basis)	
	1995 =100	Change (%)	1995 =100	Change (%)	1995 =100	Change (%)	1995 =100	Change (%)
1982	78.24	4.7	52.5	7.1	68.2	3.3	76.5	1.9
1983	78.37	0.2	54.3	3.4	70.3	3.1	77.6	1.4
1984	78.95	0.7	55.5	2.2	74.4	5.8	80.7	4.0
1985	79.64	0.9	56.8	2.3	78.3	5.2	83.6	3.6
1986	78.48	-1.5	58.4	2.8	80.4	2.7	80.0	-4.3
1987	78.84	0.5	60.2	3.1	83.9	4.4	85.8	7.3
1988	80.99	2.7	64.5	7.1	87.5	4.3	90.8	5.8
1989	82.17	1.5	68.2	5.7	85.9	-1.8	87.5	-3.6
1990	85.6	4.2	74.0	8.5	87.9	2.3	86.6	-1.0
1991	89.7	4.8	80.9	9.3	91.2	3.8	86.6	0.0
1992	91.6	2.1	86.0	6.3	93.7	2.7	87.9	1.5
1993	93.0	1.5	90.1	4.8	96.0	2.5	91.0	3.5
1994	95.5	2.7	95.7	6.2	98.7	2.8	94.6	4.0
1995	100.0	4.7	100.0	4.5	100.0	1.3	100.0	5.7
1996	103.2	3.2	104.9	4.9	95.8	-4.2	100.7	0.7
1997	107.2	3.9	109.6	4.5	102.1	6.6	110.3	9.5
1998	120.3	12.2	117.8	7.5	134.1	31.3	141.4	28.2
1999.1	117.2	-1.8	117.9	1.5	108.0	-35.6	117.9	-29.7
1999.2	117.0	-4.3	118.4	0.2	106.3	-34.1	115.1	-29.9
1999.3	116.8	-4.3	118.6	0.5	110.1	-28.6	118.8	-24.6
1999.4	117.1	-4.1	118.9	0.4	110.0	-19.2	121.2	-15.4
1999.5	117.6	-2.6	118.7	0.8	107.8	-18.8	121.2	-14.0
1999.6	116.8	-3.2	118.0	0.6	105.7	-19.8	119.5	-14.3
1999.7	116.6	-2.9	117.6	0.3	105.1	-16.1	120.6	-9.9

Source: The Bank of Korea, 1999.

c. Consumption

Private final consumption expenditure in Korea has exceeded government final consumption expenditure. The consumption ratios of government consumption to GDP has ranged from 9 percent to 12 percent, and those of private consumption are fluctuating about from 50 percent to 60 percent, recently. The 1960s and 1970s was Korea's period of high economic growth, which magnifies the importance of increasing private consumption to foster economic growth. At that time private consumption was about seven times as large as

government consumption. The absolute volume of government and private consumption was increased rapidly in accordance with the economic expansion. During the last two decades the proportion of private consumption vis-a-vis government consumption has reduced to about six times. Recently, Korea has shrunk the total ratio to GDP of consumption into about 60 percent. It is expected to reflect the expansion of the economy.

In 1999, consumption is anticipated to grow 4 to 5 percent as a result of increasing real incomes and asset values, appreciation of the Korean won, and the effects of a sharp decrease in consumption. In February 1999, wholesale and retail sales rose 7.3 percent from a year earlier, recording two straight months increase. Wholesale sales rose 3.8 percent, and retail sales rose 5.9 percent from the same month of 1998. And, domestic consumer goods shipment rose 11.9 percent. Domestic consumer goods shipment for durable goods increased 37.7 percent, and nondurable consumer goods shipment increased 2.2 percent.

Table 1.15 Korea's Consumption Trends (1971-1997)

(Year December ending)

	Government Consumption			Private Consumption		
	Billion won	Change (%)	The ratio to GDP	Billion won	Change (%)	The ratio to GDP
1971	333	27.1	10.1	2,586	25.0	75.5
1972	426	27.9	8.4	3,104	20.0	73.7
1973	457	7.3	9.7	3,770	21.5	69.5
1974	741	62.1	11.0	5,392	43.0	70.4
1975	1,134	53.0	10.9	7,264	34.7	70.6
1976	1,537	35.5	10.8	9,221	26.9	65.5
1977	1,945	26.5	10.4	11,250	22.0	62.2
1978	2,542	30.7	10.0	14,786	31.4	60.6
1979	3,130	23.1	11.6	19,367	31.0	61.6
1980	4,416	41.1	11.6	24,585	26.9	64.4
1981	5,556	25.8	11.7	30,649	24.7	64.3
1982	6,313	13.6	11.5	34,629	13.0	63.3
1983	6,935	9.9	10.8	38,892	12.3	60.6
1984	7,354	6.0	10.0	43,443	11.7	59.0
1985	8,304	12.9	10.1	48,027	10.6	58.5
1986	9,575	15.3	10.0	52,822	10.0	55.2
1987	10,843	13.2	9.7	59,031	11.8	52.6
1988	12,660	16.8	9.5	67,963	15.1	51.0
1989	15,237	20.4	10.2	79,424	16.9	53.2
1990	18,187	19.4	10.1	96,388	21.4	53.7
1991	19,725	8.5	10.1	105,526	9.5	53.9
1992	21,223	7.6	10.3	112,501	6.6	54.6
1993	21,868	3.0	10.0	118,884	5.7	54.6
1994	22,788	4.2	9.6	127,864	7.6	54.1
1995	23,023	1.0	8.9	138,461	8.3	53.8
1996	24,828	7.8	9.0	147,869	6.8	53.6
1997	26,249	5.7	9.0	152,480	3.1	52.4

Notes: Percent change from the same period of the previous year.

Source: *National Accounts*, The Bank of Korea, 1999.

d. Investment & Capital Stock

Korea's investment as a share of GDP is relatively high as compared with the other countries. Private saving supported a substantial portion of the investment during the last two decades. The high investment rate resulted in the same growth and industrialization in the nation. The gross saving ratio has maintained over 33 percent (at current prices) since 1986 owing to the increase of private saving, and the private saving rate was about four times as large as general government saving. At that time, the gross saving ratios of general government was always below 9 percent. Gross domestic fixed investment ratio reached 32.1 percent in 1989, and since then the ratios of gross domestic fixed investment ratios has continued over 35 percent. Gross domestic investment ratio was 30.0 percent in 1987, marked 39.1 percent at the peak in 1991, and the ratios have kept on going around 35 percent. In 1997, the ratio to GDP of gross fixed capital formation was 34.7 percent, resulting from the fall in private investment and general government investment, and the increase in stocks recorded minus 6,922 billion won.

In February 1999, domestic machinery orders fell 1.0 percent on a yearly basis, and machinery shipment for domestic use fell 8.1 percent by the influence of recent economic crisis. The total value of construction orders received by 292 large domestic construction companies also plunged 52.2 percent compared to the same month of last year. But, in 1999 facility investment is expected to record about 10 percent increase thanks to expectations for economic recovery and decreasing investment costs led by stabilization interest rates and won/dollar exchange rates.

Table 1.16 Trends of Investment (1994-1998)

(Percent change from the same period of the previous year)

	1994	1995	1996	1997	1998	1998				
						Jul.	Aug.	Oct.	Nov.	Dec.
Building Construction Permits	-1.3	1.0	-3.0	-0.4	-55.0	-63.5	-70.0	-79.9	-57.7	-61.6
Residential use	-8.5	-1.2	-2.5	2.6	-50.3	-61.8	-68.7	-81.3	-47.8	-61.2
Industrial use	16.8	3.3	-13.2	-26.2	-68.2	-72.0	-73.2	-74.2	-50.5	-51.0
Domestic construction orders	18.5	24.4	21.4	5.4	-42.5	-41.0	-41.3	-52.2	-35.7	-45.2
Public	17.0	14.2	44.7	7.6	-21.4	14.1	-16.6	-12.1	-29.4	-49.1
Private	19.4	29.7	9.1	-5.9	-57.6	-66.8	-54.1	-79.9	-51.2	-18.7
(Manufacturing)	(59.6)	(94.6)	(-9.4)	(-26.0)	(-76.7)	(-85.9)	(-50.5)	(-74.2)	(-85.3)	(-63.1)
Machinery orders	25.5	19.0	15.5	15.6	-17.9	-24.5	-17.7	-18.1	-11.0	-5.3
Foreign	18.5	16.3	0.5	64.1	24.8	-10.3	35.6	21.6	-13.0	-16.0
Domestic	26.9	15.8	16.5	3.3	-30.5	-26.6	-25.3	-25.4	-5.1	0.9
(Manufacturing)	(24.0)	(20.8)	(13.7)	(0.7)	(-28.1)	(-35.7)	(-38.3)	(-23.9)	(-12.1)	(-13.6)

Source: *The Ministry of Finance and Economy, Government of Korea, 1999.*

Table 1.17 Trends of Gross Fixed Capital Formation (1971-1997)

(at 1990 constant prices)

	Gross capital formation (A+B)	Gross fixed capital formation (A)			Increase in stocks (B)
		Billion won	Change (%) ¹⁾	The ratio to GDP	Billion won
1971	8,033	6,683	3.0	22.4	1,450
1972	7,404	6,670	1.3	20.7	734
1973	9,575	8,514	27.6	23.9	1,061
1974	12,532	9,775	14.8	27.0	2,757
1975	12,018	10,523	7.7	26.7	1,495
1976	14,209	12,732	21.0	25.5	1,477
1977	17,846	16,381	28.7	28.3	1,465
1978	23,227	22,009	34.4	32.5	1,218
1979	27,016	24,141	9.7	33.7	2,875
1980	24,437	21,562	-10.7	32.1	47
1981	21,966	20,757	-3.7	28.0	1,209
1982	24,259	23,050	11.0	28.5	790
1983	27,114	27,029	17.3	29.5	85
1984	31,019	29,726	10.0	29.0	1,293
1985	32,231	31,018	4.3	28.6	1,213
1986	34,861	34,316	10.6	28.2	545
1987	40,807	40,142	17.0	29.1	665
1988	47,673	45,646	13.7	29.6	2,027
1989	55,779	52,885	15.9	31.9	2,894
1990	66,299	66,569	25.9	37.1	-270
1991	76,120	74,973	13.3 ²⁾	38.3	1,147
1992	74,529	74,376	-0.7	36.1	153
1993	76,389	78,279	6.3	36.0	-1,890
1994	88,674	87,484	10.7	37.0	1,190
1995	97,812	97,717	11.9	37.9	95
1996	107,885	104,641	7.3	38.0	3,244
1997	94,025	100,947	-2.2	34.7	-6,922

Notes:

1) Percent change from the same period of the previous year.

2) Percent change from 1991 to 1997 are based on 1995 prices.

Source: *National Accounts*, The Bank of Korea, 1999.*e. Money Supply*

Korea has a systematic banking structure of commercial banks, specialized banks, the Bank of Korea (BOK), and non-bank financial institutions. Commercial banks consist of nationwide 11 commercial banks, 10 local banks, and 52 foreign bank branches (as of the end of 1998). The total number of domestic branches of nationwide commercial banks amounts to 4,480. Local banks also adopted a branch banking system within a province. Foreign bank branches have tended to specialized in the wholesale banking business. Non-bank financial institutions can be broadly classified into five categories according to their business activities: that is development, savings, investment, insurance, and other institutions. The Bank of Korea

formulates and implements monetary policy in pursuit of its objective of price stability. It sets a price stability target every year in consultation with the government, and formulates and promulgates an operational plan for monetary and credit policies including this target. BOK relied mainly on reserve requirements policy and direct control measures. However, it now employs sales and purchases of government and public bonds under repurchase agreements (RPs) in the market, as instruments in its open market operations. The Monetary Policy Committee of BOK has responsibility for the formulation and execution of monetary policy. It is composed of seven members appointed by the President for four-year terms.

The Governor of BOK serves concurrently as the Chairman of the Monetary Policy Committee. The other six members are recommended by the Ministry of Finance and Economy, the Governor of BOK, the Chairman of the Financial Supervisory Commission, the President of the Korea Chamber of Commerce and Industry, the Chairman of the Korea Federation of Banks, and the Chairman of the Korea Securities Dealers association.

Since 1985, there has been a sharp increase in the outstanding balance of money market instruments. This is chiefly due to product innovation and the expansion in the number of financial institutions handling such instruments. The money market in Korea embraces the call market and a wide range of other financial markets including those for Monetary Stabilization Bonds, negotiable certificates of deposit (CDs), repurchase agreements, corporate bills including commercial paper (CP), and cover bills.

Narrow money (M1) increased by 1.7 percent in 1998 as compared to 1.7 percent decrease in 1997, and monetary assets (M2) has grown rapidly by 27.0 percent in 1998 as compared to 14.1 percent in 1997. The increase in M2 owed to unstable economic situation which accelerated the portion of time & savings deposit and foreign currency deposits at monetary institutions. During 1997, the scale of the repurchase agreement (RP) and call markets expanded to a great extent as a result of consistent deregulatory policies.

In May 1999, M1 decreased by 5.9 percent, and M2 is slowly accelerated by 6.8 percent, and M3 increased by 6.0 percent. Thanks to the economic recovery, Money supply is expected to be retrieved on the normal condition.

Future monetary policies would be designed in a way it can absorb shocks from economic restructuring, with a special watch on possible interest rate overshooting. It is estimated that aggregate demand pressure, which had recorded large minus growth until the third quarter of 1998, is improving at a fast speed. This is evidenced by the increasing velocity of currency circulation and rising equity prices, including share prices.

Table 1.18 Trends of Money Supply (M1, M2, M3)

(December period ending)

	Narrow Money (M1)		Monetary Assets (M2)		Broad Money (M3)	
	Billion won	Change (%)	Billion won	Change (%)	Billion won	Change (%)
1982	5,799	45.6	19,904	27.0	31,257	33.1
1983	6,783	17.0	22,938	15.2	38,032	21.7
1984	6,821	0.5	24,706	7.7	45,726	20.2
1985	7,558	10.8	28,565	15.6	55,450	21.3
1986	8,809	16.6	33,833	18.4	71,594	29.1
1987	10,107	14.7	40,280	19.1	93,638	30.8
1988	12,151	20.2	48,939	21.5	120,359	28.5
1989	14,329	17.9	58,638	19.8	153,927	27.9
1990	15,905	11.0	68,708	17.2	198,124	28.7
1991	21,752	36.8	83,746	21.9	244,837	23.6
1992	24,586	13.0	96,259	14.9	298,277	21.8
1993	29,041	18.1	112,219	16.6	354,933	19.0
1994	32,511	11.9	133,179	18.7	442,663	24.7
1995	38,873	19.6	153,945	15.6	527,017	19.1
1996	39,542	1.7	178,312	15.8	614,962	16.7
1997	35,036	-11.4	203,532	14.1	700,285	13.9
1998	35,583	1.6	258,538	27.0	787,627	12.5
1999 (May)	33,469	-5.9	276,159	6.8	834,532	6.0

Notes:

- 1) M1 = Currency in circulation + Deposit money (demand deposits at monetary institutions.
- 2) M2 = M1 + Quasi-Money (time & savings deposit and resident's foreign currency deposits at monetary institutions).
- 3) M3 = M2 + Debentures issued + Commercial bills sold + CD + RP + Cover Bills.

Source: The Bank of Korea, 1999.

f. Employment

It was necessary that the government's economic reforms should be shifted to the poor class from the jobless. Unemployment rate decreased by 6.8 percent in 1998.

According to National Statistical Office of Korea, in March 1999, the population over the age of 15 grew 1.1 percent (or 401,000 persons) to 35,509,000 persons, and the economically active population fell 0.6 percent (or 127,000 persons) to 21,143,000 persons compared to the same month of the last year. By gender, the economically active male population fell 0.8 percent (or 104,000 persons) to 12,730,000 persons, and the economically active female population fell 0.3 percent (or 23,000 persons) to 8,413,000 persons. The economically non-active population rose 3.8 percent (or 528,000 persons) to 14,366,000 persons. The economic participation ratio declined 1.1 percentage point to 59.5 percent compared to the same month of 1998. The economic participation ratio for male and female workers dropped 1.4 percentage point and 0.7 percentage point respectively to 73.8 percent and 46.1 percent. The number of employed persons dropped 2.3 percent (or 454,000 persons) to 19,438,000 persons. The number of employed male workers fell 2.6 percent (or 310,000 persons), and 1.8 percent (or 143,000 persons) for female workers. By industry, the number of employment in agriculture, forestry & fishery sectors declined 15.3 percent (or 359,000 persons), manufacturing sector 3.4 percent (or 136,000 persons), construction sector 18.4 percent (or

302,000 persons) respectively, while the number of employment in business, personal and public service sectors rose 9.2 percent (or 397,000 persons), wholesale & retail sales, restaurant, and lodging sectors rose 0.4 percent. The unemployment rate fell 0.6 percent point to 8.1 percent. The seasonally adjusted unemployment rate fell 0.4 percentage point compared to previous month to 6.7 percent.

Recently, in June 1999, the unemployment rate marked 6.2 percent. In 1999, the unemployment rate is expected to reach about 7 percent despite a recovering domestic economy, up from 6.8 percent in 1998 (7.5 percent in the second half of 1998) as a result of the continuing economic restructuring and new workers entering into the labor force. The unemployment rate is expected to decrease gradually from the second quarter after reaching its peak in the first quarter (about 8.4 percent).

Table 1.19 Trends of Employment (1983-1999)

	Total employed (1,000 persons)	Manufacturing employed (1,000 persons)	Unemployment rate
1983	14,505	3,266	4.1
1984	14,429	3,348	3.8
1985	14,970	3,504	4.0
1986	15,505	3,826	3.8
1987	16,354	4,416	3.1
1988	16,869	4,667	2.5
1989	17,560	4,882	2.6
1990	18,085	4,911	2.4
1991	18,612	4,994	2.3
1992	18,961	4,828	2.4
1993	19,253	4,652	2.8
1994	19,837	4,695	2.4
1995	20,432	4,797	2.0
1996	20,817	4,692	2.0
1997	21,106	4,482	2.6
1998	19,994	3,898	6.8
1999(June)	20,604	3,952	6.2

Source: The Bank of Korea, 1999.

1.3.3 Fiscal Position

a. Government Expenditure

In the 1960s, with the Five-Year Economic Development Plans, Korea had been relied on external resources for financing its development efforts for a while. With a reduction of external financing, more reliance has been made of finance expenditures on tax revenues and contributions for government enterprise. The budget in current expenditure is classified into General public services, Economic services, National defense, Education, Social welfare, Local government financing, Special account allocation, and Debt payment. Three of the main items that consume expenditures are Economic services, National defense, and Education. Three items consume about two-thirds in total expenditures of central government. In the 1997 budget, the amount of total expenditures was 95,591 Billion won, and it was

equivalent to 32.9 percent of gross domestic product of Korea. The amounts of total expenditures also increased at the average of 23.1 percent from 1991 to 1998, while the government tried to improve the condition of economy, the current expenses for national defense and general expenditures.

In 1998, the component ratio of Economic services in expenditures was 26.1 percent, while National defense was 21.7 percent and Education was 18.1 percent.

The main expenditure sectors of Economic services were Agriculture, forestry & fishery, Roads, General administration & research, Manufacturing & construction, Inland & coastal waterways, and Electricity, gas, steam & water. The budgets reflect that the debt servicing to current expenditure has increased due to the reliance on domestic borrowing, which increased the amount of government bonds issued in 1998.

The government would place emphasis on suppressing increases in government expenditures to regain fiscal soundness, which been weakened substantially in the process of overcoming the economic crisis. Given the increased size of expenditures as a result of approval of the supplementary budget, it is necessary to revise the government's mid-term expenditure growth for the period starting year 2000 downwardly from the planned 6 percent.

Table 1.20 The Component ratio of Expenditures in the Fiscal Year 1998

The Bdget of Expenditure	Ratio (%)
Economic services	26.1
Defense	21.7
Education	18.1
Social welfare	10.6
General public services	10.4
Local government finance	9.9
Debt payment	1.7
Special account support	1.5

Source: *The Ministry of Planning and Budget*, Government of Korea, 1999.

Table 1.21 Central Government Overall Budgetary Positions (1991-1998)

(Unit: Billion won)

Items	1991	1992	1993	1994	1995	1996	1997	1998
Total revenues	39,329	46,267	53,128	54,509	76,917	88,732	95,512	94,277
Tax revenues, total	29,744	34,525	38,332	45,829	54,888	62,384	66,537	64,621
Internal taxes	24,030	30,099	34,178	38,462	44,387	49,188	52,150	51,228
Customs duties	3,435	3,153	2,886	3,449	4,633	5,317	5,798	3,842
Monopoly profit	0	0	0	0	0	0	0	0
Defense surtax	1,462	330	269	79	65	14	-8	1
Education surtax	816	943	999	1,205	1,449	1,969	2,468	2,418
Special tax for rural	0	0	0	186	983	1,073	584	618
Transportation tax	0	0	0	434	3,372	4,824	5,547	6,504
Government enterprise	810	1,042	902	1,079	1,407	2,115	1,444	2,407
Others	8,775	10,699	13,894	7,601	20,622	24,232	27,531	27,250
Total expenditures	41,035	46,955	52,893	52,780	75,205	88,623	95,581	107,496
Expenditure	40,967	46,960	52,870	52,774	75,247	88,544	95,579	107,496
National defense	8,012	8,771	9,308	10,055	11,051	13,217	14,161	13,964
General expenditures	22,319	23,683	26,951	31,118	38,292	43,458	48,273	56,389
Fixed capital formation	2,049	2,821	2,889	2,547	4,045	5,007	7,734	8,274
Others	8,617	11,686	13,721	9,054	21,860	26,862	27,410	28,869
Net lending	38	-5	23	5	-42	79	2	0.1
Net borrowing	-374	0	0	0	-20	0	20	430
Foreign aid	0	0	0	0	0	0	0	0
Use of cash balances	1,876	769	-376	-1031	-459	-115	81	640
Net gov't bonds issued	205	-81	141	-699	-1,233	6	-31	12,149

Source: The Bank of Korea, 1999.

b. Revenues and Borrowings

Korea's revenue base is related with taxes on goods and services as well as net income and profit. National tax and non-tax revenue of 1996 have increased 2.6 times as large as that of 1990, and the amount of current revenue has increased at the average of 27.4 percent from 1990 to 1996. At that time, taxes on good and services increased by 152 percent, taxes on net income & profit was 127 percent, and taxes on property was 118 percent. Relatively, good and services were levied stronger than income, profit, and property. Taxes on individuals showed that the amount of tax rose at the average of 24.5 percent. The increase of individuals owed significantly to the increasing role of withholding taxes on individual income and profit. The government is keen to strengthen its efforts in taxing hidden and under-reported incomes, and implement a comprehensive tax system largely on financial incomes. In 1996, the amount of current revenue was 82,885 Billion won, and it was equivalent to 93.5 percent of total expenditures. Current revenue has met the expenses adequately.

The government is currently running a program called "the Mid-term (1999-2002) Fiscal Plan", the object of which is to recover a balanced budget by 2006 so as to avoid long-term fiscal distress caused by chronic fiscal deficit as observed in a number of advanced countries. According to the Plan, the Korean budget agency needs to set the revenue increasing rates 2 percentage points below the nominal GDP growth rate every year during the period, and tax authorities are supposed to take more positive steps to secure the target revenues from 2000, when the economy is expected to achieve a 5 percent growth rate. To accomplish this, overhauling the tax exemption and deduction system, broadening tax bases, and extensive

taxation of unreported income through tax administration reform will be pursued instead of merely increasing tax rates or introducing special earmarked taxes.

Table 1.22 Trends of Central Government Revenue (1990-1996)

(Unit: Billion won)

Items	1990	1991	1992	1993	1994	1995	1996
Current revenue	31,332	35,947	42,870	49,834	59,725	70,695	82,885
Tax	28,362	31,195	37,751	43,537	51,836	62,210	72,386
Net income & profit	10,643	11,235	14,071	15,647	18,651	22,309	24,137
Company or enterprise	4,657	4,585	5,941	5,862	7,387	8,663	9,356
Individuals	5,986	6,459	8,008	9,462	11,207	13,618	14,767
Others	0	190	121	322	56	28	14
Social security contributions	1,450	1,798	2,417	4,149	4,575	5,435	7,425
Employer's contributions	1,009	1,281	1,782	2,755	2,880	3,276	4,621
Taxes on property	673	521	668	1,072	1,677	1,621	1,473
Inheritance tax	354	326	433	667	907	1,029	967
Taxes on goods and services	10,880	11,955	14,834	17,061	19,965	22,993	27,478
General value added tax	6,964	8,252	10,076	11,687	13,058	14,637	16,790
Selective taxes on goods	3,602	3,391	4,397	4,974	6,448	7,813	10,027
Profits of monopolies	0	0	0	0	0	0	0
Selective taxes on services	313	311	360	399	458	543	661
Inter trade and transaction	3,684	3,294	3,128	2,885	3,452	4,633	5,310
Customs duties	3,684	3,294	3,128	2,885	3,452	4,633	5,310
Other charges	0	0	0	0	0	0	0
Other taxes	1,029	3,390	2,632	2,730	3,514	5,218	6,564
Stamp taxes	193	224	25	242	275	320	356
Non-tax revenue	2,969	3,751	5,119	6,286	7,888	8,485	10,500
Property income	1,708	2,346	2,799	2,935	3,366	3,482	4,514
From N.F.P.E	109	117	134	239	150	163	320
Admin fee & charge	533	600	732	780	886	1,223	1,518
Fine & forfeits	568	571	927	1,254	1,736	3,094	3,502
Other	159	233	659	1,315	1,899	687	965
Capital revenue	756	870	935	916	1,384	1,225	1,302
Sales of assets	19	12	14	5	21	12	4
Sales of land	421	528	567	541	703	656	674
Grants	0	0	0	0	0	0	0

Source: The Bank of Korea, 1999.

Table 1.23 Mid and Long Term Target for Fiscal Balance

	1998	1999	2000	2001	2002	2003
Bond Issued (in Trillion won)	9.7	13.5	13.0	11.7	7.3	-3.0
Deficit/GDP (%)	-5.1	-5.1	-4.5	-3.7	-2.6	0.1

Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.

c. Aggregate Tax Revenue

The aggregate tax revenue has increased gradually at the average of 6.3 percent from 1995 to 1999. Tax collection in Korea has remained constantly. However, internal tax revenue, especially in Income Tax and Corporation Tax, is expected to be decreased in 1999, resulting from the recession of economy. Individual Tax will decline 9.6 percent, and Corporation Tax will reduce 22.6 percent in 1999 as compared to the previous year due to the reduction of wage & salary and the liquidation of many businesses. VAT decreased already 20.9 percent in 1998, and so in 1999, it will increase slowly more than 1998 due to the reflection of economic recovery.

Current tax burden ratio (i.e. ratio of tax amounts to GDP) has been decreasing since 1996, and it is likely that tax revenue will fall short of the government's expenditure needs. The tax burden ratio which is below 20 percent would be raised over 21 percent in the future.

Table 1.24 The Component ratio of Tax Revenue in the Fiscal Year 1998

Tax item	Ratio to Revenue(%)
Individual Tax	25
VAT	23
Corporation Tax	16
Other Tax on External Trade	16
Transportation Tax	10
Customs Duty	6
Excise Tax	3
Inheritance and Gift Tax	1

Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.

Table 1.25 Trends of Principal National Tax Revenue (1995-1999)

(Unit: Billion won, %)

	1995	1996	1997	1998	1999
Total national tax	56,775 (100)	64,960 (100)	69,928 (100)	67,789 (100)	71,202 (100)
Income Tax	13,618 (24.0)	14,767 (22.7)	14,868 (21.3)	17,194 (25.4)	15,548 (21.8)
Corporation Tax	8,663 (15.3)	9,356 (14.4)	9,425 (13.5)	10,776 (15.9)	8,340 (11.7)
Inheritance and Gift tax	1,029 (1.8)	967 (1.5)	1,161 (1.7)	680 (1.0)	940 (1.3)
VAT	14,637 (25.8)	16,790 (25.8)	19,488 (27.9)	15,709 (23.2)	18,617 (26.1)
Excise Tax	2,617 (4.6)	3,119 (4.8)	3,036 (4.3)	2,112 (3.3)	2,116 (3.0)
Transportation Tax	3,372 (5.9)	4,824 (7.4)	5,547 (7.9)	6,504 (9.6)	8,768 (12.3)
Customs duty	4,633 (8.2)	5,310 (8.2)	5,798 (8.3)	3,836 (5.7)	5,387 (7.6)
Other Tax	8,206 (14.5)	9,827 (15.1)	10,605 (15.2)	10,978 (16.2)	11,486 (16.1)

Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.

1.4 Tax Structure

1.4.1 General Tax Structure

a. Organization

National tax policy and administration is under the general jurisdiction of the Ministry of Finance and Economy, which also has the National Tax Administration and the National Tax College as external organization. The Office of Tax and Customs of the Ministry of Finance and Economy is responsible for the planning of the tax policy and the drafting of tax laws, while the National Tax Administration is in charge of tax administration.

b. Tax Administration

The National Tax Administration was established as an external organization of the Ministry of Finance on March 3, 1966. It is mainly in charge of the assessment and collection of internal taxes. The National Tax Administration, which is headed by a Commissioner, is responsible for establishing basic policies and plans for tax administration, and for directing, supervising and controlling the Regional, the District, and the Branch Tax Offices. The Regional Tax Office, under the supervision of the National Tax Administration, is responsible for the direct guidance and control over the activities of the District Tax Offices. In addition, the Regional Tax Office directly handles the assessment of taxes on certain taxpayers in special cases. The District Tax Office is the front-line organization responsible for the assessment, collection, audit, and investigation of all internal taxes.

The National Tax Tribunal was established as an independent organization under the former Ministry of Finance on April 1, 1975. It is composed of a Chief Judge, Judges, Examiners and a General Affairs Division. It is responsible for the examination and judgement of tax appellate cases.

Table 1.26 The Ratio of Tax Amounts to GDP (1994-1999)

	1994	1995	1996	1997	1998	1999
Total Tax(%)	19.8	20.5	21.1	21.0	19.8	19.6
(National Tax)	(15.4)	(16.1)	(16.7)	(16.6)	(16.0)	(15.9)
(Local Tax)	(4.4)	(4.4)	(4.4)	(4.4)	(3.8)	(3.7)

Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.

c. Present tax system

The tax system comprises both national and local taxes. National taxes are divided into internal taxes, customs duties, education tax and special tax for rural development. Internal taxes which are in force at present consist of 5 direct and 7 indirect taxes.

Table 1.27 Present Tax Items

National Tax	Internal Tax	Direct Tax	income tax, corporation tax, inheritance and gift tax, assets revaluation tax, excess profits tax.
		Indirect Tax	VAT, special excise tax, liquor tax, telephone tax, stamp tax, securities transaction tax, transportation tax
	Customs Duties		
	Education Tax		
	Special Tax for Rural Development		
Local tax	Province Tax	Provinces	acquisition tax, registration tax, license tax, race tax, community facility tax, regional development tax
		Metropolitan cities	acquisition tax, registration tax, inhabitant tax, automobile tax, farmland tax, tobacco consumption tax, butchery tax, race tax, city planning tax, community facility tax, regional development tax
	City and County Tax	Inhabitant tax, property tax, aggregate land tax, automobile tax, farmland tax, tobacco consumption tax, butchery tax, city planning tax, workshop tax	
	District Tax	license tax, property tax, aggregate land tax, workshop tax	

d. Tax Laws and Regulations

National Tax

The Constitution specifies that people have obligation to pay taxes in accordance with the provisions of the law and those taxes can be levied only when they are provided for law. Consequently, many tax laws are enacted pursuant to the taxing principles of the Constitution. In order to enforce the tax laws, a Presidential Decrees may be enacted. The minister can also enact ministerial ordinance to enforce the Presidential Decrees and make rulings and authoritative interpretations of laws by tax authorities do not bind courts of justice, which have final authority in interpreting law. The Commissioner of the National Tax Administration issues orders and application rules to ensure the uniform application of laws, enforcement decrees, enforcement ordinances, and ministerial rulings.

Local Tax

The Constitution provides for the principle of local autonomy. Under this principle local government is given the right to assess and collect local taxes. The “Local Tax Law”, the “Enforcement Decree of Local Tax Law”, and “Enforcement Ordinance of Local Tax Law” are enacted under Constitutional provision.

Table 1.28 The Component Ratio of National and Local Tax

(Unit: %)

	1995	1996	1997	1998	1999
National Tax	78.8 (51.3)	78.9 (50.5)	79.0 (49.0)	80.3 (48.4)	81.5 (46.7)
Local Tax	21.2 (48.7)	21.1 (49.5)	21.0 (51.0)	19.7 (51.6)	18.5 (53.3)

Notes: () is the case of including grants and subsidiaries for local government to Local Tax.
Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.

e. Assessment System

Self-assessment system is accepted as usual in tax system, which is calculated by the tax base according to the principle of real taxation. But, it is also admitted to use the official assessment as the determination of tax basis. The excuses are as following;

- 1) The level of tax payer's calculation on tax assets.
- 2) The degree of tax compliance.
- 3) Tax conflict between taxpayers and tax authorities.
- 4) The various irregularities of tax assessors.

Self-assessment:

Final tax liability is fixed by the declaration of taxpayers, so taxpayers determine the taxes paid and accrued by themselves. Taxpayers have to be self-assessed, determined of tax base and tax amount, which is levied by laws (ex. Income Tax, Corporation Tax, and VAT, etc).

The period of return and payment are as following;

- The respective taxable period is required to file a return.
- In case of income tax, it is within the period from May 1 to the end of the May of the following year.
- Taxpayers always submit the filings of return to tax office.

Official-assessment:

Final tax liability is determined by the disposition of administrative authorities, so the government has assessed and fixed the taxes paid and accrued of taxpayers according to his own ability.

- The government determines the tax base and the tax amount of the taxpayers concerned. Director of tax office usually levies it (Ex. Capital gains tax on real estate, Inheritance and Gift Tax, etc).
- The period of return and payment depend on determination and correction of the government, in case that taxpayers are examined and investigated.
- Director of tax office should examine, investigate, determine, and notice a return period by his own purpose.

f. Direct Taxes

Income Tax

Taxpayer

An individual who is domiciled or resident within Korea for one year or longer is liable to income tax on all incomes divided from sources both within and without the country.

Any individual other than a resident individual is liable to income tax only on the income divided from sources within Korea.

Taxable Income

Global income denotes income which is subject to global taxation and includes interest, dividend, real estate, business, wage and salary, temporary property income, and other incomes. Non-global income denotes the income which is separately assessed from the global taxation, and includes retirement, timber income, and capital gains.

Capital gains

Income accruing from the transfer of land, building or rights thereon and other assets specifically enumerated in the Income Tax Law shall be taxed separately from global income. Capital gains may be classified into the three categories:

- a) income accruing from a transfer of land or buildings;
- b) income accruing from a transfer of rights to real estate such as surface rights, lease hold, or a right to acquire real estate; and
- c) income accruing from a transfer of properties as prescribed by Presidential Decree other than those enumerated under(a)and (b) above, such as stocks, lease hold on stores and goodwill.

Tax rates

Income tax amount on global income is the aggregate of amounts calculated by applying each tax rate successively to the income in the relevant tax bracket.

(Unit: thousand won)

Tax Base		Tax Rates		
Over	Not more than	Tax amount + %	of an amount in excess of	--- won
	10,000	10		
10,000	40,000	1,000	20	10,000
40,000	80,000	7,000	30	40,000
80,000		19,000	40	80,000

Tax rates on capital gains are as follows:

- a) Land or building that is held for more than 2years, or other assets
 - i) below 30 mil.won.....20%
 - ii) 30 mil. – 60 mil. won30%
 - iii) over 60mil.won.....40%
- b) Land or building that is held for less than 2years, or other assets.....40%
- c) Assets transferred without registration.....65%

Return and Payment

By the 1994 tax reform, the individual income tax assessment system was changed to a self assessment system, under which each taxpayer is required to file a turn and pay the proper amount of tax at the same time. A resident with a global income is subject to interim prepayment of the global income tax for interim prepayment periods (from January 1 through June 30) in an amount equivalent to half of the global income tax amount paid or payable in the preceding year by the end of November. A resident who had global income, retirement income capital gains or timber income in the respective taxable period is required to file a

return on the respective tax base within the period from May1 to the end of May of the following year.

Taxation on Non-residents

A non-resident is liable to tax only in respect of income derived from sources within Korea. Two kinds of taxing method, global taxation and separate taxation are applied in the case of a non-resident; with respect to the non-resident who had a domestic business place and who has real estate income, the global taxation method is applied on the aggregate domestic source income except for the retirement allowance, capital gains and timber income. The latter three incomes of a non-resident are taxed on the same basis as that applied on a resident. With respect to the income of a non-resident who does not have a domestic business place, the withholding of taxation method is applied on each domestic source of income. A non-resident is required to pay income tax at the domestic business place. In the case of non-resident who has no domestic business place, income tax has to pay at the place where such income is derived.

Table 1.29 Taxation of Individual Income Tax

(Unit: 1,000 persons)

Year	Taxpayer	Wage & salary	Business income
1994	Total	10,530	3,354
	Taxation number	6,479	1,294
	Taxation ratio	61.5%	38.6%
1995	Total	10,935	3,507
	Taxation number	7,022	1,388
	Taxation ratio	64.2%	39.6%
1996	Total	11,246	3,657
	Taxation number	6,894	1,272
	Taxation ratio	61.3%	34.8%
1997	Total	11,338	3,438
	Taxation number	6,915	1,318
	Taxation ratio	61.0%	38.3%

Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.

Corporation Tax

Taxpayer

A corporation with its head office or main office located in Korea is liable to corporation tax. Where a corporation with its head office or main office located in a foreign country earns income from domestic sources, only the income from the domestic source is subject to corporation tax; however, liquidation income of a foreign corporation is not taxable.

Tax rates

The amount of corporation tax on the income of a domestic corporation for each business year shall be an amount calculated by applying the tax rates to the amounts of tax base.

Not over 100 million won.....**16 %** of the amount of tax base

Over 100 million won.....16 million won + **28 %** of an amount in excess of 100 million won

Tax Return and Payment

A corporation tax return must be filed within 15 days from the date of finalization of the settlement of accounts (within 30 days of attaching a taxation adjustment statement prepared by a certified public accountant or a licensed tax accountant). A corporation which has filed a tax return will pay the government, within the period for the tax return in question, the amount remaining after the deduction of the corporation tax under the following from the calculated amount of corporation tax for each business year.

- a) An aggregate of tax credit amounts.
- b) An amount of tax for interim prepayment.
- c) An amount of tax for occasional assessment.
- d) An amount of tax withheld at source.

Table 1.30 Taxation of Corporation Tax

Total	Domestic corporation						Foreign company
	Profit corporation				Non-profit corporation		
	Public limited company	Limited partnership	General partnership	Limited company	Public corporation	General	
179,316 (100%)	153,602 (85.7)	5,030 (2.8)	963 (0.5)	6,242 (3.5)	7,920 (4.4)	4,655 (2.6)	904 (0.5)

Source: *The Ministry of Finance and Economy, Government of Korea, 1999.*

Inheritance and Gift tax

Inheritance Tax

Taxpayer

Inheritors and legatees who acquire property through inheritance or bequest and who have domicile in Korea, are obligated to pay an inheritance tax.

Inheritors and legatees have a joint and several tax obligations for the property that they acquire through inheritance or bequest.

Tax base

From the date of commencement of the inheritance, the following are counted as part of the inheritance property:

- a) bequeathed property.
- b) donated property which is transferred upon the death of the bequeather.
- c) property donated to the inheritor within ten years of the date of commencement of the inheritance.
- d) Property donated to legal persons other than inheritor within five years of the date of commencement of the inheritance

Gift Tax

Taxpayer

Donees who acquire property by gift and who have domicile in Korea are obligated to pay the gift tax. In the case where the donee is a non-resident and he acquires property in Korea by gift, he is obligated to pay a gift tax on that property.

Tax base

The following may serve as a tax base for a donee's gift property:

- a) all gift properties that may be changed to certain monetary or economic forms.
- b) the economic value of legal and actual rights to the gift property.

Tax Rates of Inheritance and Gift Tax

(Unit: Million won)

Tax Base		Tax Rates		
Over	Not more than	Tax amount +	%	Of an amount in excess of ...won
	100		10	
100	500	10	20	100
500	1,000	90	30	500
1,000	5,000	240	40	1,000
5,000		1,840	45	5,000

Assets Revaluation Tax

Taxpayer

An individual or a corporation is subject to Assets Revaluation Tax when the assets belonging to the individual or corporation are revalued.

Tax Base

The tax base is the reappraisal gain minus the amount of losses carried-over as of the revaluation date.

Tax Rates

- 1) 3% of the tax base.
- 2) 1% of the tax base in the case of land permitted new revaluation.

Excess Profits Tax

Taxpayer

Persons who derive excess profits by setting price above the base level specified by the government are liable to excess profits tax.

Tax Base

The tax base is the amount remaining after deducting "the Standard Price" from the actual transaction price. The Office of National Tax Administration determines the standard price.

Tax Rate

The tax rate is 100 % of the excess profits.

Table 1.31 The Ratio of Direct Tax to National Tax (1996)

(Unit: %)

Korea	Japan	U.S.	U.K.	Germany	France	Italy
44.4	65.3	92.1	4.7	46.0	39.2	55.4

Source: *The Ministry of Finance, Japan, Fiscal and Financial Monthly, 1998.4*

g. *Indirect Taxes*

VAT

Taxpayer

A person who engages in the supply of goods or services independently in the course of business, whether or not for profit, is liable to value added tax. Taxpayers include individuals, corporations and any bodies of persons, foundations of any other organizations, which are not incorporated.

Taxable Transactions

VAT is charged on the following transactions:

- a) The supply of goods and services; and
- b) The importation of goods.

Goods means all tangible and intangible objects which have the value of property. Tangible objects include commodities, products, raw materials, machinery, buildings and other objects which have tangible form. Intangible objects include motive power, heat, other controllable forces of nature and rights. Services mean all services and other actions which have the value of property, other than goods.

Zero-Rating

The supply of following goods and services is zero-rated, and the input tax incurred is refundable. Zero-rating is applied only to traders who are residents or domestic corporations.

- a) Goods for exportation;
- b) Services rendered outside Korea;
- c) International transportation by ships and aircraft;
- d) Other goods or services supplied for foreign exchange earning

Tax Rate

The rate of VAT is 10 %.

In the case where the tax rate is applicable on the VAT exclusive price, the 10 % rate applied. However, in the case of application on the VAT inclusive price of the retailers, the tax rate becomes 10/100.

Final Return and Payment

A trader must furnish to the competent tax office a return on the tax base and tax amount payable of refundable in respect of each taxable period within 25 days after the expiration of the taxable period concerned. A trader is required to pay the tax amount payable to the competent tax office at the time of furnishing the return.

Table 32. Taxation of VAT (1997)

(Unit: 1,000 persons)

	Taxpayer	Individual			Corporation
		General taxation	Simplified taxation 1)	Special taxation 2)	
Total	2,930	1,005	490	1,243	192
Business on goods	1,157	566	183	299	109
Business on services	1,773	439	307	944	83

Notes:

- 1) Simplified taxation is charged on a trader whose turnover of goods or services during the immediate preceding year is less than 150 million won.
- 2) Special taxation is charged on a trader whose turnover of goods or services during the immediate preceding year is less than 48 million won.

Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.***Special Excise Tax****Taxpayer*

Any person who comes under one of the items below is liable for special excise tax.

- a) A person who sells Group 1 of Class 4, taxable goods (e.g. jewelry, pearl, ivory etc. and its products, excluding diamonds for industrial use).
- b) A person who manufactures and carries Class 1 to Class 5 taxable goods (e.g. jewelry, pearl, ivory, air conditioner, coffee, fur, furniture, slot machine, carpet or oil products) out of manufactory.
- c) A person who is liable to customs duties and takes taxable goods out of a bonded area under the Customs Law.
- d) Operators of such taxable places as a race course, Turkish bath, golf course, casino.
- e) Operators of such taxable pleasure resorts as a cabaret, night club, saloon etc.

Taxable Goods and Tax Rates

- a) Class 1
A Special Excise Tax of 30 % shall be levied on the price of each following item.
 - 1) Slot machine, pin-ball machine and other similar recreational machines.
 - 2) Golf requisites, hunting guns or rifles.
 - 3) Motorboats, yachts, and their related equipments etc.
- b) Class 2
A special Excise Tax of 15 % shall be levied on the price of each following item.
 - 1) refrigerators and freezers.
 - 2) Electric washing machines for household appliances
 - 3) Color television sets, and related equipments etc.
- c) Class 3
A special Excise Tax of 10% shall be levied on the price of each following item.
 - 1) Soft beverages.
 - 2) Taste beverages.
 - 3) Nutrition preparations and stimulants etc.

- d) Class 4
 - A Special Excise Tax of 30% shall be levied on the price of each of the following items.
 - 1) Group 1: jewelry, pearl, tortoise-shell, coral, amber, ivory and their product etc.
 - 2) Group 2: luxury cameras, luxury watches, luxury fur skin, luxury furniture etc.
- e) Class 5
 - 1) Group 1
 - a. Automobiles with an engine displacement in excess of 2,000cc and cars for camping.....20%
 - b. Automobiles with an engine displacement of 1,500cc~2,000cc.....15%
 - c. Automobiles with an engine displacement of 1,500cc or less, and two wheel motorcycles.....10%
 - 2) Group 2
 - Gasoline(345won/L), Diesel oil(48won/L), Kerosene(60won/L), Petroleum gas(40won/kg), Natural gas(40won/kg)

Liquor Tax

Manufacturers of liquors and persons taking over liquors from a bonded area are liable to pay liquor tax on the liquors carried out of the manufacturing premises or taken out of the bonded area. A person who intends to manufacture or sell liquors must set a manufacturing license or a selling license from the government. The base of liquor tax is the quantity or price of liquors carried out of the brewery or taken out of a bonded area.

Transportation Tax

Taxpayer

Any person who comes under one of the items below is liable for the transportation tax.

- a. A person who manufactures and distributes gasoline and similar substitute oils, and diesel oil.
- b. A person who takes imported gasoline, and similar substitute oils, and diesel oil out of a bonded area.

Tax Base and Rates

- a. Gasoline and similar substitute oils.....455won/L
- b. Diesel oil.....85won/L

h. Local Taxes

Acquisition Tax

Tax payer are persons acquiring real estate, motor vehicles, heavy equipment, trees, boats, aircraft, golf membership, condominium membership, and health club membership through purchase or inheritance. Tax rate is 2 % of the value of the acquired articles or the amount of an annual installments.

Registration Tax

Registration Tax shall be levied on persons who register particular concerning acquisition, creation, transfer, alteration or lapse of property right or other titles in the official book are liable to Registration Tax.

License Tax

Person who have obtained licenses enumerated in the attached table under the Presidential Decree are required to pay License Tax annually for each kind of license.

Inhabitant Tax

Inhabitant tax shall be levied on individuals and corporation.

- a. Per capita:
Individuals with their domiciles and corporation with their offices in a city or country.
- b. Pro rata income:
Individuals and corporation liable for the payment of income tax, corporation tax or farmland tax.

Property Tax

Taxpayer

- a. Buildings: Owners registered in the building taxation book as of the base date of assessment.
- b. Vessels: Owners registered in the ship taxation book as of the base date assessment.

Tax Rates

- a. Buildings

(Unit: Thousand won)

Tax Base		Tax Rates		
Over	Not more than	Tax amount +	%	Of an amount in excess of ---won
	12,000		0.3	
12,000	16,000	36	0.5	12,000
16,000	22,000	56	1	16,000
22,000	30,000	116	3	22,000
30,000	40,000	356	5	30,000
40,000		856	7	40,000

- b. Vessels

- 1) High class vessels.....5%
- 2) Other vessels.....0.3%

1.5 Country – Specific Fiscal Issues

1.5.1 IMF and Economy Crisis

a. Outbreak of Currency Crisis in 1997

From early 1997, foreign currency liquidity conditions continued to worsen, and by November 1997 Korea was on the brink of defaulting on its debts. Consequently, the government had to turn to the IMF to request stand-by funds.

The primary cause of the currency crisis would be the country's loss of creditability. The Southeast Asian currency crisis that started in July 1997 further unsettled foreign investors who had been observing the weakening of both companies and financial institutions

in Korea. Reflecting this, the leading international credit rating agencies such as S & P's and Moody's downgraded Korea's sovereign rating sharply in October 1997. Accordingly, foreign investors repatriated their capital from Korea and the country's usable foreign exchange reserves became depleted.

The mismatch between demand and supply in the domestic foreign exchange market was also attributable to the heavy external debt taken on to finance the current account deficit, and to the excessive reliance on short-term external borrowings. Besides these factors, the building of expectations of a massive depreciation of the Korean won, played a substantial part in the worsening of the foreign exchange situation.

Table 1.33 Trends of Exchange Rate (Won/US\$)

Period	End of period	Average
1994	788.7	803.8
1995	774.7	771.3
1996	844.2	804.4
1997	1415.2	950.0
1998	1195.0	1403.3
1997 I	897.1	865.3
II	888.1	891.7
III	914.8	898.6
IV	1415.2	1149.8
1998 I	1378.8	1613.2
II	1385.2	1394.6
III	1373.6	1325.1
IV	1195.0	1280.2

Source: The Bank of Korea, 1999.

b. Economic Restructuring for Overcome for the Crisis

Recognizing that dilapidation and corruption of lending and borrowing practices were at the core of the structural failure, the government put heaviest emphasis on restructuring the financial and corporate sectors simultaneously. In addition, labor and public sector restructuring has also been pursued to give each sector the flexibility and efficiency necessary to keep up with other sector reform.

Financial Sector Restructuring

1) Banks and Non-bank Financial Institutions

Authorities closed or suspended a number of non-viable financial institutions, including 16 merchant banks, 5 commercial bank, 6 securities brokerages, and 4 insurance companies. As of January 20, 1999, 86 financial institutions have been closed or suspended of operation. The 5 non-viable banks were liquidated through purchases and acquisitions (P & A) in July 1998, and their assets were transferred to acquiring banks selected on the basis of financial soundness. As of January 20, 1999, 43 non-bank financial institutions had their licenses revoked, and 38 were suspended.

2) Public Support for Financial Restructuring

Getting rid of the banking sector of non-performing loans is an important of the financial sector restructuring. Disposing of the non-performing loans (NPLS) is a staggering task. The

strategy is as follows: Korea Asset Management Corporation (KAMCO) modeled after the U.S. Resolution Trust Corporation would purchase the NPL from the bank at market value which is only a fraction of the book value. But, KAMCO does not pay for the purchase in cash, but in kind with its own issuance of bonds. The government guarantees the KAMCO bonds, and agrees to pay for the interest at maturity in cash.

3) Capital Market Liberalization and Foreign Direct Investment (FDI) Promotion

Complete removal of foreign equity ownership ceiling in May 1998, complete freedom for foreign investors to make hostile M & A from May 1998, complete freedom for foreigners to invest in local bonds and short-term money market instruments, complete liberalization of foreign exchange transactions from April 1999. The government renewed zeal for attracting FDI is another case in point. The new Foreign Investment Promotion Act, drafted and legislated after months of intense deliberation, abolishes and replaces the old legal framework on FDI.

4) Liberalization of Foreign Exchange Transactions

Implementing full liberalization measure, the new Foreign Exchange Transaction Act replaces the old Foreign Exchange Management Act. The new law that goes into effect in April 1999, liberalizes corporate overseas borrowing, and establishes futures market.

Corporate Sector Restructuring

The corporate sector restructuring has been led by the creditor banks under the Five Principles of Corporate Restructuring agreed between the government and the business leaders in early 1998. The Five Principles was as following:

(1) Enhancement of Corporate Governance

To reinforce management transparency and accountability, to thirty chaebols (a large conglomerate) and all listed companies were required in February 1998 to organize 'independent audit committee' represented by minority share holders and creditors. To enhance the credibility of corporate accounting, the firms will be required from the fiscal year 1999 to adopt strengthened accounting standards and to publish combined financial statements.

(2) 'large conglomerate' Restructuring

Top 5 chaebols and their creditors reached agreement on debt reduction and other restructuring measures in early 1998, and finalized the agenda for chaebol reform as follows:

- Adoption of combined financial statements from the fiscal year 1999.
- Compliance with international standards of accounting.
- Reinforcement of voting rights of minority shareholders.
- Mandatory appointment of outside directors.
- Establishment of external auditors committee.
- Prohibition of cross-subsidiary debt guarantees.
- Resolution of all existing cross-debt guarantees by 2000.

(3) Exit of No-viable Firms

In May 1998, creditor banks established a formal review committee to assess the viability of 313 client firms showing signs of financial weaknesses. Upon completion of their evaluation, creditor banks listed 55 firms as non-viable, of which 20 are affiliated with top 5 chaebols, and 32 with top 64. Credit banks denied new credit and cross-subsidy bailout to effectively exit these 55 non-viable firms out of the market.

(4) Corporate Work Out Programs

Procedural simplification for market exit also has important implications for corporate workouts, in that the presence of expeditions exit scheme better induces more efficient negotiations for the workouts programs among the creditor, banks, and the firms.

(5) Workout Program for SMEs

Corporate workout is extend to small and medium enterprises as well. Creditor banks have evaluated the financial status of approximately 22,000 SMEs with outstanding loans of one billion won or more. Approximately 13,000 firms listed as viable were selected as candidates for workout programs.

Labor Market Reform

The landmark achievement of labor market flexibility rallied corporate sector restructuring and enhanced corporate competitiveness.

- The labor dispute at Hyundai Motors and its subsequent resolution in August 1998 showcased the social acceptance of the new principle of labor flexibility.
- The same social acceptance of the new labor reality was again ascertained in the subsequent labor disputes between the 9 financially troubled commercial bank and their labor unions.

Social adjustment to the new labor practice is complemented by the government's effort to reinforce the social safety net.

Public Sector Reform

State-owned enterprises (SOEs) require drastic overhaul by means of privatization and /or management reform is necessary.

- Twenty public institutions of the 109 SOEs have already been privatized in 1998.
- The 89 subsidiaries of the 30 parent SOEs are also subject to privatization or management reform.

Downsizing of the government is also an important feature of the public sector reform to raise efficiency. Local autonomies have also streamlined their organizations. Elimination of excessive regulations is another important task in the public sector reform.

- The Regulation Reform Committee abolished 4,465 regulations, some 40 % of the 11,125 total, 23 laws were abolished, and 248 laws revised.

1.5.2 Tax Policy Direction for the future

a. Korea's Technical Needs for Tax Reform

During periods of rapid economic growth tax revenue is collected at higher increased rate than the economic growth rate. In the future, the Korean economy is expected to suffer a low increase in revenue because of structural changes in the economy. But, the demand for expenditures will increase because of the rise in the unemployment rate caused by the on-going restructuring of companies and the increased need for welfare caused by the rapid growth of an aging population.

The Korean government is preparing a "Mid-term plan for Tax Policy", by which it will achieve the goals established in the Mid-term(1999-2002) Fiscal Plan. The government wishes to review the basic policy direction of these plans.

b. Korea's Own Understanding of Its Circumstances

How to Expand Tax Revenue

Because the recent downturn of the economy has caused the ordinary profit rates of Korean companies to decrease rapidly, increasing tax rates at this moment would further discourage business activities in Korea. Moreover, it is highly probable that a rise in individual or corporate income tax rates would drive most financial and industrial capital out of our country, because of the high degree of internalization of economy and severe tax competition among nations. Therefore, efforts to increase the tax revenue needed to regain a balanced budget should be made by broadening tax bases rather than increasing tax rates.

The government has frequently used the tax exemption and deduction system to support the restructuring of financial institutions and companies. As a consequence, the tax base has generally become so narrow that tax revenue may not be able to meet budget expenditure requirements in the future.

Table 1.34 Prospective of Available Resources and Shortage (1999-2002)

(Unit: Trillion won, %)

	1999	2000	2001	2002
Available resources	71.4	77.4	84.1	94.2
General account	66.6	72.1	77.8	87.3
Tax revenue	61.9	67.5	74.7	83.6
Non-tax revenue	4.7	4.6	3.1	3.7
Net revenue of special account	4.8	5.3	6.3	6.9
Scale of expenditures	84.9	90.4	95.8	101.5
(Increase rate)	(5.2)	(6.5)	(6.0)	(6.0)
Shortage amount	13.5	13.9	11.7	7.3

Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.

Analysis of the Equitable Tax Burden among Social Classes

The issue of the equitable tax burden between businessmen and wage & salary income earners has been one of the greatest social concerns in Korea. The income distribution structure became worse, especially in 1998, when a series of bankruptcies and large scale lay-offs took place in the process restructuring financial institutions, government organizations and companies. Since the late 1980s, the government has made strenuous efforts to enhance the direct tax ratio (i.e. direct tax/total tax), but this trend started to reverse in 1996. The recent fall of this ratio indicates that the distribution function of Korea's income tax has weakened. In 1998, the direct tax ratio rose by 4.2 percentage points, but this is considered a temporary phenomenon resulting from the mixed effects of the increased withholding tax rate on interest and a sharp education in VAT.

Complexity and Inefficiency of the Current Tax System

As a easy tool to raise funds, earmarked taxes, the main feature of which is to surcharge on the basis of other taxes, have been frequently used. As a result, the tax system became too complicated to understand quickly and the compliance cost of taxpayers became significant. The ratio of revenue from the earmarked tax is over national tax revenue amount to 21.3 percent, much higher than the average ratio (1 percent) of other advanced countries.

Table 1.35 The Number of Tax Accountants (1998)

(Unit: person)

	Qualification of Tax Account	Registration to government	Current business as Tax Account
Total	15,265	7,447	5,012
Tax Accountant	6,703	3,563	3,563
CPA	4,571	3,687	1,055
Lawyer	3,991	197	394

Source: *The Ministry of Finance and Economy*, Government of Korea, 1999.

1.5.3 The Future Tax Policy Direction

a. *Expansion of the Tax Bases*

A review of the current tax exemption and reduction system across the board including the exemption rates and the ceiling amount of reductions in the respective provisions will be made with a view to simplifying the system, preventing overlapping assistance, and enhancing the effectiveness of tax exemption or reduction measures. Instead of replacing the current individual income tax system with a typical Comprehensive Income Tax System, in which taxable income is defined as consumption plus the increase in value of property during a taxable year, the government will gradually add several types of currently untaxed income to the individual income tax law.

More efforts should be made to find proper vehicles for taxation of products that cause negative externalities, to attain two goals at the same time: namely, increasing tax revenue and discouraging environmental contamination. Therefore, the excise tax or transportation tax needs to cover crude petroleum and electricity, while the difference in the tax rates between gasoline and diesel oil should be removed in order to maintain neutrality between them. Pension income which is not currently taxable should be changed so that such income is subject to tax, and full income deduction should be allowed at the time of deposit into insurance companies, trust funds or other types of pension plans.

b. *Pursuit of Tax Equity*

It needs maintaining the equity among earned income, business profits and financial income. The wide perception is that taxes are unfairly imposed on business and other income. A belief that high income earners are preferentially treated in terms of the tax burden is also wide spread among financial income earners. Methods are sought to improve the level of compliance while simultaneously minimizing the increase of the tax burden for small businesses.

Compared to other countries, Korean tax revenues related to real estates are at a similar level, but transfer taxes are high and taxes for holding real estate are low. It is necessary to impose more tax for holding real estate and less tax on transferring to encourage the real market and improve the tax systems related to real estate. The plan is to strengthen the real estate holding taxes such as the aggregate land tax and property tax, and to lessen the transfer taxes such as the acquisition tax and registration tax. The government plans to have tax payers register the actual transfer price of real estate in a book maintained in the registry office as a first step, and then to convert the current capital gains tax based on the government pre-evaluating value into taxation based on actual transfer prices. Then, the voluntary filing system will be introduced.

c. Simplification of the Tax System

The government plans to emerge the education tax, the special tax for rural development, and the transportation tax into the main taxes. As well, it is expected to integrate the telephone tax into VAT, and abolish the Excess Profits Tax, Assets Revaluation Tax. The Excessively-increased Value of Land Tax was already abolished in the National Assembly in 1998. As a result, the number of National Taxes will decrease about 10 in the near future.

d. Uniformity between National Tax and Local Tax

One alternative to solve the problems is to place the Ministry of Finance and Economy take control over the current local taxes to enhance the effectiveness of macroeconomic policy mixes such as fiscal and financial policies. The other option would be to establish a coordinate body in which policy matters between national and local taxes could be discussed and coordinated.

e. Boosting the Economy through Streamlining the Tax System on Business

Restrictions on the disbursement of improper or excessive expenses incurred by employees, including controlling shareholders and their related parties, will be taken in the areas of labor costs, welfare expenses, traveling expenses. Restrictions on corporate owner's acquisition of personal use assets such as member ships, automobiles , etc, will also be taken. With respect to the dividends between corporations, adjustment for double taxation may gradually be allowed depending on changes in the corporate governance structure.

f. Amending the Tax System to Support Tax Administration

Given Korea's unfavorable fiscal circumstances and the wide spread discontent and distrust of the taxpayers towards the National Tax Administration, the government has no choice but to initiate more drastic reform programs than it has over attempted before. The reform programs the government envisions will focus on minimizing the opportunities for abuse that arise from contact between tax officials and taxpayers. The government is searching for effective ways to ensure that the National Tax Administration had access to tax-related information owned by other government agencies and financial institutions.

1.6 Conclusion

It has been a year and a half since Korea embarked on bold economic the reform and restructuring in the aftermath of the financial crisis of 1997. Despite of the great uncertainty and adversity the government had faced since then, the government has remained committed to the reform measures necessary to overhaul the economy. There are now emerging signs that, overall, the economy is heading in the right direction.

Growth outlook for 1999 is much more positive compared to the estimated contraction of 5.5 percent in 1998. But, environment is still full of uncertainties and instabilities. Nevertheless, the usable foreign exchange reserves were substantially built. Recently, the reserves exceeded 60US\$ billion, a far cry from the near depletion level of 3.9 US\$ billion in mid-December 1997.

Thanks to stabilization and restructuring efforts, Korea can afford an attractive investment destination to investors. Many analysts believe that the Korean economy had already bottomed out in the fourth quarter of 1998. Seventy percent of the budget is earmarked for spending in the first half of the year to maximize the effect of demand-stimulation.

The long-term goal for the new millenium is to build a knowledge-based Korea rich in human creativity. To do this, reform and restructuring can only be accelerated.

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