

# Tax Reform to Combat Land Speculation in Korea

DONG-KUN KIM

*Professor of Economics, Seoul National University Seoul, Korea*

## I. Introduction

Korean economy experienced the rapid changes in various aspect during the 1980s. Particularly the late 1980s may be considered to be one of the most important turning points in Korea's modernization history. In spite of general economic success in the 1980's, the Korean people resented against the military dictatorial regime and their resentment bursted out as violent protest in early 1987.

On June 29th of that year, the ruling party declared publicly a direct election of the next President and promised a drastic "democratization" by removing various controls. This so-called "June 29 Declaration," however, resulted in various social disruption and difficulties. Extremely extensive labor unrest hit the economy from the second half of 1987 and so on.

Fortunately the Korean economy was doing well during 1986-89, with duple digit growth rates (except 1989), unprecedented trade surpluses, and reasonable price stability. On the other land, the Korean public began to believe that they deserved shares in the economic prosperity. Specifically the relatively underprivileged classed began to cry out for equity and balance. The presidential election was carried out in 1987. President Rho was elected and inaugurated in 1988, promising to achieve the equity among income groups and regions.

The equity issue, however, is extremely difficult to be resolved. The large foreign trade surpluses between 1986 and 1989 cause a huge amount of foreign currency to flow suddenly into the country, thereby causing excessively large liquidity in the Korean money market. This excessive liquidity triggered especially land speculation which was also accelerated by the government's extensive plan for regional development. The rate of increase in land prices in urban areas was 30 percent in both 1988 and 1989. The land speculation boom continued until 1990.

The government tried to show its willingness to combat land speculation and took land tax reform in 1990. The counterpiece of this tax reform was how to control land ownership and speculation and thus how to achieve the primary policy goal of social equity. This paper attempts to review the recent land tax reform in Korea. In order to do so, we must first provide general overview of the current tax system. After the Korean land taxes which were enacted in 1990 are closely examined, some related issues to improve their performance are discussed. Finally, some concluding remarks are followed.

## II. The Current Korean Tax System

The current Korean tax system consists of 14 national taxes and 14 local taxes. In the former, there are internal taxes, import duties, defense tax and education tax. In the latter, there are property tax, registration tax, acquisition tax, comprehensive land tax, tobacco tax, etc. Internal taxes are classified into direct taxes and indirect taxes. Details of the current Korean tax structure are shown in Table 1.

The Korean tax structure may be characterized by its heavy dependence on domestic indirect taxes, as shown in Table 1. Income taxes, consisting principally of personal and corporate income taxes, accounted for about 23% of total tax revenues in 1990, or about 4.3% of GNP (2.1% for personal income tax and 2.2% of corporate income tax). Compared with those of the OECD countries, the income taxes, particularly the personal income tax, do not occupy the central position in Korea's revenue structure.

There are a few reasons why the personal income tax does not play the central role in the Korean tax system.<sup>1)</sup> First, though the marginal tax rate is very high and progressive, the exemption level is also very high and only about 40 per cent of workers pay income tax. Second, some of incomes such as interest income and dividend income are taxed separately at a low flat rate (10 per cent rate plus surcharges). Third, capital gains from financial asset transactions are completely untaxed and those from real asset transactions are known to be undertaxed and those from real asset transactions are known to be completely untaxed and those from real asset transactions are known to be undertaxed even though its nominal tax rates are very high (50 per cent rate plus surcharges).

The global income tax was introduced only in 1975. Since then, the personal income tax system has been modernized quite rapidly. The current tax rates range from 5 per cent to 50 per cent, covering 5 bracket.<sup>2)</sup> For the sake of equity, however, it is essential to broaden the personal income tax base. Capital gains and all kinds of income should be consolidated with global income. A variety of sources of income should be brought under the tax net. More importantly, the income tax compliance and administration should be efficiently improved.

The current structure of the consumption tax system was completed in 1977

〈Table 1〉 The Current Tax Structure in Korea

(unit: %)

	1990 (budget)
I. National Taxes	82.2
1. Internal Taxes	60.9
1) Direct Tax	23.7
Personal Income Tax	11.3
Corporate Income Tax	11.7
Inheritance Gift Tax	0.5
Assets Revaluation Tax	0.2
Excess Land Profits Tax*	—
2) Indirect Tax	37.2
Value-Added Tax	26.2
Special Consumption Tax	4.7
Liquor Tax	3.1
Telephone Tax	0.8
Stamp Tax	0.6
Securities Transaction Tax	1.8
2. Customs Duties	7.1
3. Defense Tax (Surcharges)**	12.5
4. Education Tax (Surcharges)	1.7
II. Local Taxes	17.8
1. Property Tax	0.7
2. Registration Tax	3.3
3. Acquisition Tax	2.6
4. Comprehensive land Tax*	1.2
5. Automobile Tax	1.3
6. Tobacco Tax	5.0
7. Inhabitant Tax	1.8
8. Others	1.9
Total	100.0

Notes: \*enacted in 1990

\*\*abolished officially at the end of 1990, but will be collected until 1991.

Source: Economic Planning Board, *Summary of Budget for Fiscal year 1991*.

when the value-added tax (VAT) was introduced. The VAT is now the major source of revenue in Korea, as shown in table 1. The Korean VAT is a typical EC type with a flat rate of 10 per cent and zero rating. Because of a uniform tax rate of 10%, the effect of the VAT on equity has been a crucial question since its introduction. A single tax rate is considered regressive since lower-income tax payers consume a higher proportion of their income than do middle and upper

income tax payers. It is for this reason, to correct partially the regressivity of the VAT burden, that basic necessities such as unprocessed foodstuffs, medical and health services, and educational materials are exempted from the VAT liabilities.

The major problem associated with the VAT is how to treat the small firms which have difficulty in bookkeeping. To cope with this problem, the special treatment for the small firms are designed and eligible firms are taxed on turnover basis (i.e., 2% of their gross sales amount rather than 10% of their value-added amount). Currently more than 70 per cent of VAT payers are taxed under this special treatment.

The concurrent introduction of the special consumption tax with the VAT in 1977 was originally designed to inject some progressivity into the indirect tax system through high taxes on luxury items and expensive durable goods. However, while some studies indicate the significantly less regressivity of the special consumption tax compared with the VAT<sup>3)</sup>, its contribution to the intended equity objective is questionable because major emphasis on this tax has been put on revenue-raising objective rather than moderation of the VAT regressivity.

Taxes on wealth in Korea, such as inheritance and gift taxes, are hardly significant in terms of their revenue yield. In view of unusually low revenue yield from wealth, it is quite obvious that there is ample room for rectifying some major weaknesses in the existing taxation of wealth. But various Korean wealth taxes are closely related to counter-speculation policy. For example, capital gains tax was originally created to control real estate speculation. But now it has incorporated in the income tax law and has proved ineffective in discouraging land speculation. In 1990, two new taxes, excess land profits tax and comprehensive land tax were introduced to combat land speculation. We now discuss these two taxes in the following section.

### **III. Recent Tax Reform to combat Land Speculation**

#### **1. The Establishment of the Committee of "Public Concept of Land Ownership".**

As mentioned earlier, the Korean economy enjoyed th unprecedented trade surpluses and the rapid economic growth during 1986-89, even though the trade deficit began again in 1990. The good performance of the economy and the movement toward democratization during these years have led the whole social and political sturcture of Korea to be under stress.

At a fundamental level, there have been some concerns about changes in the values, outlook, and attitude of the Korean people in general. The continued rise in consumption on luxury goods is viewed as a singn that frugal habits of Ko-

reans are disappearing. The increased preference of young workers for service jobs over manufacturing jobs is seen as evidence of a changed work attitude that shuns hard work. The rapid increase in crime is regarded as a reflection of loosing social discipline. The generally accepted view is that these social changes have something to do with the increased opportunities for making easy money and the initially undesirable effect of expanded individual freedom following the democratization of society.<sup>4)</sup> Similar views were also expressed outside the country. An American newspaper remarked that Koreans had popped their champagne cork too early.

Under these circumstances, the Korean government had to pursue the austerity campaign, saying that we Koreans might lose all that we toiled for at the entrance to advanced industrial nationhood. This concern has come to be held by an increasingly large number of people, as easy money is being made through real estate or land speculation and is widening disparity in income and wealth.

In 1989, the government set up a strange-named committee, the "Public Concept of Land Ownership"<sup>5)</sup>, to formulate new policy measures which would solve the problem of land speculation. This committee introduced four measures which were accepted by the government and the congress and took place in effect in 1990. They were: i) a ceiling on the holding of residential land; ii) the introduction of the comprehensive land tax; and iv) the introduction of the excessive land profits tax. At the same time, a new system of land assessment, reinforced regulations on land transactions, and the compulsory registration of land transactions have been also enacted.

Skepticism about their effectiveness remains, because land speculations in Korea has been a serious economic and social problem almost from the beginning of the industrialization more than two decades ago.

## **2. Land Price Increase and Market Failure.**

The national rate of land price increase is not easy to be calculated. Table 2 shows the simple mean of the rates of increase of various types of land and locations. During the sixteen year period since 1974, the land price has increased by 14.3 times for the nation. It is much higher for Seoul, the Capital City of Korea, where the corresponding figure is 29 times. In the same period, the consumer price index has increased by 4.8 times, wholesale price index by 3.7 times and real gross national product by 4.0 times. Evidently land price has increased swiftly indeed compared to most other economic indicators.

Industrialization and the consequent urbanization in Korea created a disproportionate demand for different types of land in various locations. Demand for potential sites for housing, manufacturing, service, and recreational facilities expanded rapidly while that for agricultural and forest land did not increase at all.

〈Table 2〉 Indices for Land Price (with 1974 = 100)

Year	Land Price (1)		Price Level		Real GNP
	National	Seoul	CPI	WPI	
1974	100	100	100	100	100
1976	161	153	142	140	119
1978	320	474	182	173	145
1980	414	599	284	291	160
1982	444	656	350	348	177
1984	596	1,276	368	353	224
1986	685	1,431	384	345	271
1988	968	1,878	429	359	352
1990	1,431	2,901	480	373	404

Note: 1) Based on October price each year except 1990.

The 1990 figure is based on April price.

Sources: Ministry of Construction, *Land Price Statistics* (every year)

Bank of Korea, *Year book of Economic Statistics* (every year)

However, supply of the land with good accessibility and desirable environment is limited in the short-run. Korea is indeed one of heavily densified countries in the world.

Land price increase due to such an imbalance between demand and supply encourages more development, but these are restricted by regulations on land use and development. Such regulation is a necessary complement to the functioning of the market, since the way in which a parcel of land is used has an external effect on adjacent parcels. If such regulation is inflexible, however, it may prevent the market from satisfying excess demand by development.

In theory, speculation has its role in a well-functioning market. When rapid land price increases have caused distributional problems, many people agree that the idle holding of valuable land, particularly in newly developing urban fringe, is harmful to the economy. They frequently refer to Henry George<sup>(6)</sup> to describe, analyse, and remedy the problem. However, speculation pushes up land price, which in turn invites more speculation, until finally the real sector can no longer support the elevated land price. If this is so, the market is failing and government intervention is necessary to reinstate efficiency and equity.

### 3. Two Newly Introduced Land Taxes

Table 3 shows the structure of Korean land taxes. Since Table 3 explains itself, we describe only two newly introduced land taxes in 1991, i.e., excess land

〈Table 3〉 Korean Land Taxes

Classification	National Tax	Local Tax
Acquisition	Inheritance Tax Gift Tax	Acquisition Tax Registration Tax
Holding	Personal & Corporate Income Taxes <sup>1)</sup>  Excess Land Profits Tax	City Planning Tax Property Tax  Comprehensive Land Tax
Transaction	Personal & Corporate Income Taxes <sup>2)</sup>	

Notes: 1) impose on rental income

2) means the capital gains tax on land transactions.

profits tax and comprehensive land tax.

#### (1) Excess Land Profits Tax

It intends to recapture excess windfall gains accrued to the holdings of "idle" land. Under this system, accrued net windfall gains in excess of normal gains, that is national average rate of land price increase, is taxed at 50% rate in every three years. To avoid double taxation with the existing capital gains tax, different percentages of tax may be credited to the capital gains tax by the length of time between the excessive land profits tax levy and the sale of the land. This system critically depends on the accuracy and fairness of the assessment of all land as well as on the judgement of the tax authority with regard to the utilization state of each piece of land.

#### (2) Comprehensive Land Tax

It sums up value of all land holdings nationwide of a individual or a corporation and applies progressive tax rates. Under this system, land is classified into three groups: 1) land to be taxed under the main global scheme; 2) land to be taxed under the secondary global scheme; and 3) land to be taxed separately at flat rates.

Table 4 shows the tax rate structure. The first progressive rate, which applies to speculative land as well as to residential land, ranges from 0.2% to 5% in 9 brackets. But it only reaches 1% rate when the assessed value is as high as 500 million won (about 700 thousand US dollars).

The second progressive rate ranging from 0.3% to 2% in 9 brackets applies to commercial land. Again, its progressivity is very mild; the rate reaches 1% for land assessed at 10 billion won (about 14 million US dollars). The third category

**(Table 4)** Rate Structure of Comprehensive Land Tax

Classification	Land Type	No. of Brackets	Tax Rate (%)
Progressive Rates	I. Speculative Land and Residential Land	9	0.2-5.0
	II. Commercial Land	9	0.3-2.0
Fixed Rates	Factory Site	—	0.3
	Farmland titled by owner	—	0.1
	Luxury Property	—	5.0

is applied to various types of land such as farmland, factory site and luxury land with a fixed rate ranging from 0.1% to 5%.

This tax, though a personal tax, is administered as a local tax. The tax liability of each tax payer is computed by the Ministry of Home Affairs (central government), but the collection is the responsibility of local governments. Each local government collects its proportional share from a single individual in the case that a tax payer owns land over multiple jurisdictions. This unique feature of the tax may cause significant administrative difficulties in the future. In addition, this tax depends critically on the judgement of the tax administer on the classification of specific lands.

#### **IV. Issues uelated to Land Tax Reform**

The public demand for equity or social reform seems to be the top priority policy concern that the government must deal with. The enactment of the new land taxed represents considerable progress in the tax system, especially in view of the fact that most of the total landholdings are in the hands of a few wealthy persons. Many tax specialists argue, however, that the current land tax system has a plenty of possible loopholes as well as unrealistic stipulations.

The excess land profits tax, the comprehensive land tax, and the other land-related taxed all make distinction between speculative and nonspeculative land in providing exemptions and reductions of tax rates. These taxes are designed to be anti-speculation measure, based on the belief that the distinction between speculative and non-speculative holdings of land is possible and that discrimination against speculative holding is desirable. The success of such discrimination depends on the ability to sort out which land is held speculatively and which is not. This job is extremely difficult considering the diversity of land user's activities, and any codified classification rules are bound to be arbitrary. There would be several problems involved in this aspects.<sup>7)</sup>

First, one can question whether any discrimination against supposedly speculative holding promotes efficiency in the long-run. Second, if the distinction can be



successfully made, it is not clear why a progressive rate structure should be applied instead of a uniformly high rate, or why taxes should be used at all instead of an outright ban on such holding. Third, administration costs are too high to effectively apply the classification rules and to contain all the information necessary to determine the excess land holdings defined by the local tax law. Last, as the tax codes get complicated, greater personal judgement is required of tax official, raising the possibility of corruption and the failure of the policy objective.

Another crucial issue is related to the ability to assess the actual value of land. Local government officials are supposed to assess the unit value of each land parcel every year. But there is a tendency that local governments are not bothered with finding an accurate assessment. The major part of the local government budget does, after all, come from the central government. When land price increases rapidly, the official standard value of land for taxation is raised only slightly.<sup>8)</sup>

A new law for the improvement of land assessment was passed in 1989. Under this law, a sample of about 300,000 parcels is evaluated by licensed assessors each year, and the rest of 24 million parcels subject to holding taxes nationwide are assessed by using the land price table. Each land price table is formulated on the base of multiple regression analysis for a particular land market.

Assessment must correctly reflect the market price of land. Currently, local governments and local branch of the National Tax Bureau have separation of power of assessment; the former for local taxes and the latter for national taxes. One or both of the assessment records sometimes contain incorrect information and they may conflict each other. Therefore, it may be desirable to set up a new institution responsible for the appraisal and assessment of all land. This institution may also manage all land related information and make land registration record public and legally binding.<sup>9)</sup>

A great deal of efforts should be devoted to improve the land-related record system. Issues to be considered include not only synthesis of the various records into a single system representing correct information, but also nation-wide computerization of all related information with broader scope (linked to the national identification card number, etc.) and periodical land census.

As far as the tax rate structure is concerned, tax on land holding should be raised, while tax on land transaction be rather reduced.<sup>10)</sup> Korea's capital gains tax rate on real estate transaction is very high (50 per cent rate plus surcharges on capital gains). In reality, however, this tax is simply a "paper tiger", since the tax base has been eroded seriously due to wide loopholes. The higher tax rates are likely to stimulate efforts for evasion. This may lead to a shift in the focus of speculators toward types of land and buildings for which evasion is easier.

On the other hand, the current tax rate on land holding are quite low, as

mentioned earlier. Therefore the discrepancy between the market and the assessed value of land makes the tax on land holding insignificant to land owners, and renders land taxation ineffective to any policy objectives. In addition to strengthening the tax rate structure, the variety of exemptions and reductions should be limited and the tax base should cover all of owner's land indiscriminately.

## V. Concluding Remarks

It has been argued that land speculation has resulted in market failure, both in efficiency and equity. The basic reasons for rapid increases in land prices in Korea are the rapidity with which both the liquidity of money and the demand for urban uses have grown, while the supply of land is limited by the government regulation. To dampen the speculative demand for land and to appropriate socially the increases in the value of land, the effective tax rate of the comprehensive land tax as well as the excess land profits tax should be raised, and all loopholes in the real estate capital gains tax should be closed.

There is no unified land speculation theory.<sup>11)</sup> A theoretical model should be developed to explore the nature and effects of land speculation on the working of the economy. A more rigorous investigation is needed to find out which types of tax (land holding or land transaction) is the more effective means of curbing land speculation. According to Henry George, the land holding tax is considered to be the better policy instrument. the Georgian view, however, is not fully supported by other taxation theories.

If tax reform almost invariably means tax increase, it is critical that such reform must be accompanied by expenditure reform.<sup>12)</sup> More attention should be paid to the benefit principle of finance, both in the sense of charging for public services and in the sense of matching expenditure and tax responsibilities in at least the richer urban areas. And, finally, it must be emphasized that any tax reform will produce undersired results if it is administered poorly. So, tax administration is fundamentally important. None of these aspects is easy to implement. We can only hope that the government is strong enough, and wise enough, to carry out proper actions for such improvements.

## Notes

- 1) Tae-Won Kwack and Kye-Sik Lee, *Tax Reform in Korea*, KDI Working Paper No. 9103 (Seoul: KDI, 1991), pp. 15.
- 2) It was only the 1990 tax reform that the number of income brackets was reduced from eight brackets to five brackets.
- 3) Kye-Sik Lee, "Incidence of Indirect Taxes in Korea," *Korean Journal of Public Finance* (March 1987), pp. 111-146.
- 4) Soon Cho, *Consolidating the Past and Building the Future: U.S.-Korea Trade Relations*

- (Seoul: KDI, 1990), pp. 4-5.
- 5) The "Public Concept of Land Wonership" (Land Gongkaenyum) is translated as public control of land, meaning that society has rights to restrict ownership, use and disposition of land held by individuals.
  - 60 Henry George, *Progress and Poverty*, 5th ed. (New York: Rober Schalkenback Foundation, 1946).
  - 7) Jae-Yong Son, *Analysis of and Reform Proposals for "The Land Problem" in Korea*, KDI Working Paper No. 9013 (Seoul: KDI, 1990), pp. 47-48.
  - 8) For this reason, the official standard value of land for taxation is not more than 40% of the actual market price of land. The government wishes the official standard value of land to be as much as 60% of the actual market price of land.
  - 9) Jae-Yong Son, *op. cit.*, p. 51.
  - 10) Lee tried to unify a sort of land speculation theories. See Jin-Soon Lee, "Land Speculation in Korea: Causes, Economic Impact and a Proposal for Institutional Reforms", paper presented at the 4th International Korean Economists Conference, Korean Economic Association, Seoul, August 16-17, 1991.
  - 12) Richard M. Bird, "Expenditures, Administration and Tax Reform in Developing Countries", paper presented at the 45th Congress of International Institute of Public Finance, Buenos Aires, August 28-31, 1989.

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