Tax Administration Reform in Korea and Its Implications*

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* Prepared for World Bank and KDI School Conference on Fiscal Policy and Management on November 14-18, 2011.

I. Introduction

As we see it, the standard explanations of Korea's rapid and sustained economic growth leaves much to be desired. Korea's economic growth is typically explained by two models: state-led and market-led. Focusing on export-led industrialization, both models attribute favorable macroeconomic conditions and heavy investments in physical and human capital as fundamental to Korea's economic growth. Where the models diverge is the role government played in mediating the efficient allocation of resources, or not.[1] Korea's industrial policy of targeting certain sectors for investment like the heavy and chemical industries during the 1970s has been used to illustrate the efficient or inefficient allocation of resources at the hands of the government.

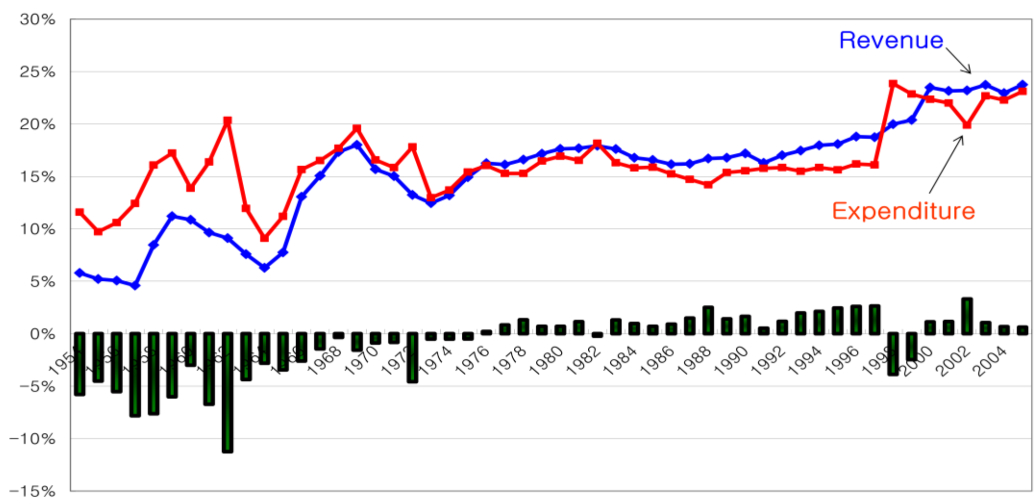
In both models, the burning question of how Korea was able to ensure macroeconomic stability and make necessary investments in the first place remains largely unanswered, if at all. Here, we posit that Korea's capacity to mobilize tax revenue, often taken for granted, was crucial in providing sufficient fiscal resources - government savings - to maintain an economic environment conducive to growth, not to mention allow the government to take an active role in economic development. Fiscal soundness allowed Korea not only to manage inflation and induce foreign capital but also to make huge investments in education and infrastructure.[2] It also allowed the government to provide subsidized credit and tax benefits for industrialization and to promote socio-economic policies (*Saemaul Movement*) for broad based development. Indeed, Korea's capacity to mobilize tax revenues, and its fiscal implications, cannot be emphasized enough.

Besley and Persson (2007) put it more simply: "Economists generally assume the

[1] See Rodrik (1995) and Sakong & Koh (2010).
[2] The massive investments during 1945 to 1965 funded by foreign aid were also critical in raising Korea's physical and human capital stock.

existence of sufficient institutions to sustain a market economy and tax the citizens." In other words, market supporting institutions like private property rights, rule of law to enforce contracts, and the capacity to tax, cannot be assumed to function well, let alone exist, especially in a development setting. Besides having market supporting institutions, Korea had the capacity in taxation to run a surplus in government savings, which was critical early in its development when private income and savings were inadequate.

<Figure 1> Government Revenue, Expenditure, and Fiscal Balance in Korea (% of GDP)



To redress the interpretations of Korea's development, this paper argues that the capacity to raise tax revenues as a result of the efforts to improve tax administration and to stamp out corruption in government in the 1960s was central to Korea's economic development. These efforts could not have come at a more crucial time, as Korea had become dependent on foreign aid, which not only accounted for nearly 53% of total government revenue but also began to decrease by the end of the 1950s. Moreover, government bureaucracy suffered from corruption and inefficiencies, which became an obstacle to economic reform and progress. After 1966, tax revenues grew rapidly, doubling to average about 17% as a share of GNP in 1975, after fluctuating at about 8% and experiencing a declining trend in the early 1960s. The rapid expansion of tax revenues due to the efforts in tax administration reform and anti-corruption under Park Chung Hee was, as we argue, a critical turning point in Korea's development; Korea went from being aid dependent to taking ownership of its development process, which as defined under the DAC principles means "Developing countries set their own development strategies, improve their institutions and tackle corruption."

The paper begins by briefly discussing the importance and implications of tax revenue mobilization or the capacity in taxation in the context of development. It surveys the literature on the topic of taxation and draws some useful insights by applying them in the context of Korea. The next section discusses Korea's experience in tax administration reform where efforts to improve taxation and root out corruption in government went hand-in-hand. The final section concludes by drawing some general lessons from Korea's experience in reforming tax administration and addressing corruption.

This paper makes no pretense on generalizing the lessons drawn from the subtleties of Korea's experience. The impact of foreign aid in Korea is extremely context specific. Nonetheless, it is to be hoped that the paper provides some useful insights and lessons to contribute in shaping future research and development policies.

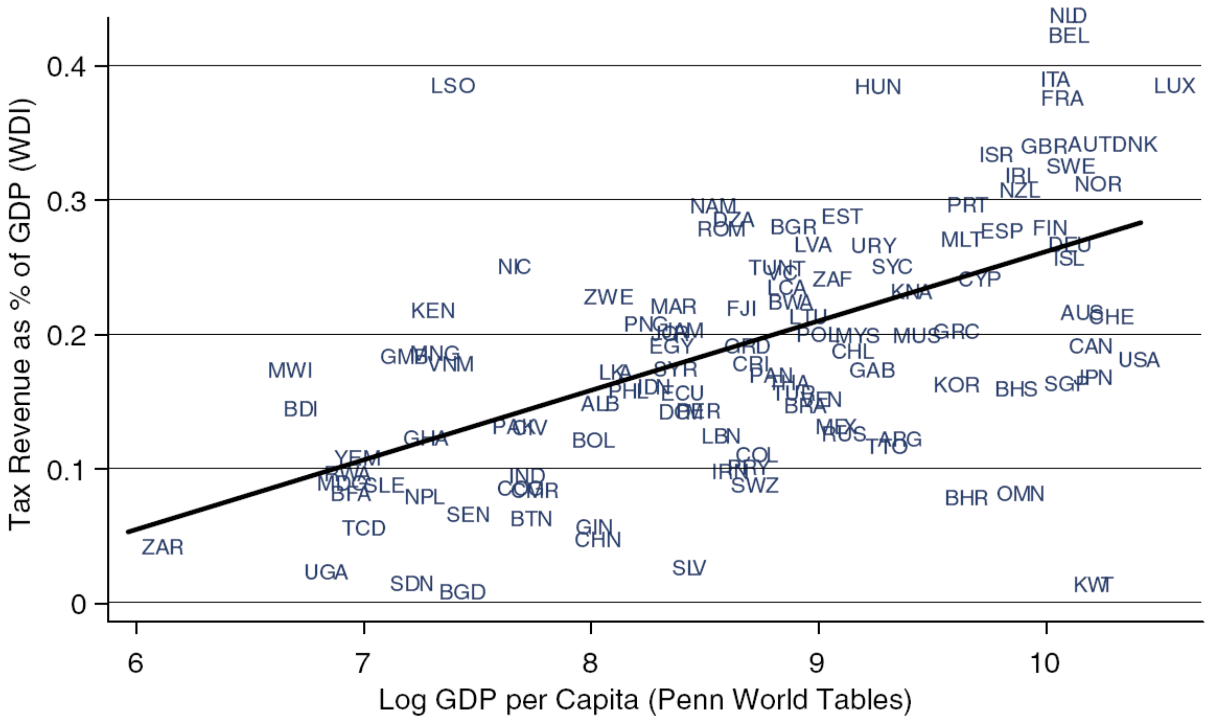
II. Role of the State (Government) and Its Capacity to Tax

Historians, and the historical figures they study, have long propounded that the power of the state - the capacity to govern - rested on its power to tax. The demise of China's Han and successor dynasties tell a similar story of corruption and inefficiency of the political bureaucracy weakening the capacity of the state to tax and manage its affairs, which often led to conflict and in-fighting among the self-interested ruling elite. Already weakened, the state's urgent need to raise revenues to fight off nomadic invaders from the north only worsened Han China's fiscal crisis. [3] The added pressure to collect taxes for the state's coffers resulted in excessive taxation of peasant farmers, who often had to sell their land to local warlords to pay taxes. As more farmers sold their land to warlords, it led to the concentration of economic and political power among competing warlords that sought to challenge the state/emperor. Besides paying more taxes, peasant farmers were forced to serve in the military. The result was destabilizing. It led to a significant decline in agricultural production and increased factional in-fighting among the ruling elite, both of which fueled social and economic instability. Recent empirical studies confirm what has always been plainly observed; that, advanced countries also seem to raise higher tax revenues. Indeed, studies have shown that higher GDP per income positively correlates with higher tax revenues as a share of GDP.[4] (The same correlations can be found between higher income/tax revenues and financial development.)

[3] In studying the origins of state capacity, Besley and Persson (2009) investigate how the capacity in taxation and other market supporting institutions can influence economic development, and argue that the capacity to tax is a key element of building state capacity. The study cites historical evidence of how the introduction of a tax system was a response to finance wars, which can be seen as a "common interest public good," in countries like the Britain and US. It was only later that tax revenues were collected for the purposes of investing in public goods.

[4] See Acemoglu (2005)

<Figure 2> Tax Revenue and Income: 1990-2000



Source: Acemolgu (2005)
Note: Log GDP per capita is the average log GDP based on Penn World Tables, and tax revenue is the average as a share of GDP based on World Bank Data.

If the ability to tax (and to govern) is a measure of a state's capacity, then the capacity of a state can be defined as the "power to tax and regulate the economy and to withstand political and social challenges from non-state actors." (Acemoglu, 2005) Those that lack the capacity are deemed to be "weak states," both economically and politically. Acemoglu (2005) shows that weak states tend to have lower tax revenue as a share of GDP and invest less in public goods. Besides investing little in public goods, it can be also argued that states with limited capacity also tend not to implement policies that redistribute resources to the poor, and that allocate resources inefficiently.

The model used in Acemoglu (2005) predicts that "both weak and strong states create distortions in the allocation of resources, and consequently, both excessively weak and excessively strong states are likely to act as impediments to economic development." As such, it is necessary to have a “balance structure of economic and political power” where the state is strong enough to raise sufficient taxes but not able to wield too much political power and go unchecked. The same balance has to be achieved in the level of taxes where taxes are high enough to create a surplus for the state to invest in public goods but not to stifle economic activity.

There has been a long line of literature studying the relationship between state capacity and economic growth. The capacity of the state, or lack thereof, has been used to explain differences in cross-country growth patterns; in that countries unable to achieve economic development suffer from corrupt and inefficient states. In an extension of the relationship between the state and development, many economists have gone further by advocating the important role a state can play in economic development. Within the large, growing body of literature that study market supporting institutions i.e. property rights and contract enforcement that are conducive to growth, there is growing recognition of the importance of fiscal institutions, the capacity both to collect tax revenues and to facilitate more efficient redistribution and allocation of resources. (Acemoglu 2010, Besley and Persson 2010)

In many poor developing countries, the state is not able to raise adequate tax revenues, let alone play a role in economic development. Aside tax policy considerations, the issues and challenges of tax administration in developing countries stem from several factors including a narrow tax base, poor governance or corruption, lack of tax administrative capacity, and low taxpayer compliance. Indeed, tax revenue as a share of GDP is often found to be well below 15%, a key indicator for measuring the adequacy of tax revenues, in many poor developing countries. Developing countries often lack a broad basis for taxes i.e. income taxation, and therefore, tend to rely on a system of tariffs, or “border taxes” to generate tax revenue. Moreover, many countries suffer from weak tax administration capacity due to complex tax laws and procedures, lack of technical capacity and adequate human resources, weak administrative systems, and poor organizational structures.

The challenge of improving tax administration is made more difficult since economies of developing countries are often informal, cash-based economies operated by small businesses and merchants, which are "hard-to-tax." Tax evasion may be a problem among qualified taxpayers, but lack of bookkeeping and records make assessing taxes a bigger problem in implementation. But the biggest challenge in building a more effective and equitable tax system remains corruption in tax administration. The lack of tax administrative capacity and corruption often results in the arbitrary and uncertain nature of tax assessment and collection, if not outright expropriation. Since it is difficult to assess tax, it presents much rent seeking opportunities, and could distort incentives similar to a regressive tax. This only worsens the deep seeded mistrust taxpayers may have of the government, making the challenge of promoting taxpayer compliance more difficult. An ineffective and corrupt tax administration system can result in inequity in taxation and worsen income distribution.

It is often the case that weak tax administration, poor governance or corruption, and low taxpayer compliance, are often found to be strongly associated to each other and with low tax revenues. As we will see, the symptoms of weak tax administration suffered by Korea early in its development are not all that different from the conditions apparent in developing countries today, which lead to the conclusion that the policy remedies may not be different as well.

III. Anti-Corruption and Tax Administration Reform: Korean Case

The turning point in Korea's development history came in 1966. After Park Chung Hee took power, the government's Herculean efforts to improve tax administration and root out corruption were critical in raising tax revenues. It not only required the full commitment of the political leadership, but a massive collective and human effort on the part of tax officials. In 1966, the year the NTS was established, the organization collected 70 billion won in tax revenues, which was an increase of 67 percent from 42 billion won in 1965. In 1967, 1968, and 1969 tax revenues increased by 48 percent, 51 percent, and 39 percent, respectively, compared to the previous years, bringing up the tax burden ratio from 7.3 percent in 1964 to 14.6 percent in 1969, as seen in Figure 1.

Before 1966, Korea's economy suffered massive structural problems: growth was largely driven by aid-induced consumption and high inflation was persistent, making any efforts at promoting economic development difficult. The government suffered chronic budget deficits, relying on money financing to plug budgetary gaps. Making matters worse, the inflow of foreign aid, which had accounted for more than 50 percent of government revenue, began to decrease gradually (Table 1).

<Table 1> Share of Domestic and Foreign Sources of Government Revenue

(Mil Won, %)

	1957		**1965**		**1966**		**1970**		**1974**	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Total	42,459	100	105,481	100	153,777	100	445,856	100	1,046,386	100
Domestic Tax revenue	20,008	47.1	69,391	65.8	115,362	75.0	422,158	94.7	1,046,386	100
Foreign source	22,451	52.9	36,090	34.2	38,415	25.0	23,658	5.3	0	0

Source: 30 year History of Korea's National Tax Service (1996), p126

Korea's tax system and laws were assessed to be "fairly comprehensive and adequate" relative to international standards after sweeping reforms in 1950 (Brown 1973, pg 63). In fact, previous governments including the military government under Park Chung Hee undertook comprehensive reforms of tax laws to establish a favorable tax regime to stimulate private savings and investment since economic development took top priority. Many of the changes to the tax laws and structure were made by the new military government to spur economic development. The tax reforms of 1960s included additional tax benefits and exemptions specifically aimed at stimulating private savings and investment. The tax laws were further simplified and streamlined with a more favorable treatment of income in 1962. Income taxes were assessed to be unequal, particularly among employers of large corporations who had to bear a greater tax burden since their income was withheld by the employer to pay taxes. This fueled the perception that honest taxpayers were rewarded with less income while dishonest taxpayers could have more income. Besides a more favorable tax regime, one of the goals of the tax reforms was to reduce tax inequality by improving tax administration and taxpayer compliance. Indeed, the objectives of the reform were to establish "a just, equitable, and simplified tax system based on taxpayer record keeping and compliance rather than arbitrary assessment…" (Brown 1973, pg 69)

But the efforts to reform tax policy and administration did not produce the expected increase in tax revenues; in fact they had the opposite effect of reducing revenues. During 1963-1964, the tax revenue growth rate was lower than the economic growth rate, causing the tax burden rate (tax revenue/GNP) to decrease from 10.6 percent in 1962 to 7.3 percent in 1964. As Brown (1973, pg 63) concluded: "Korea's central tax problems have been those of administration rather than legislation, particularly lack of taxpayer records, arbitrariness of tax collector assessments, and corruption." It was only after President Park had put the full weight of the government behind efforts to establish a more effective basis for the assessment and collection of taxes based on voluntary compliance and to root out corruption in government bureaucracy did Korea's capacity to mobilize revenues improve.

III. 1. Anti-Corruption Campaign

Entering the 1960s, Korea was by all intents and purposes dependent on aid while the failures of the government gave way to rent seeking and corruption within government and business. The failures of the state gave way to the authoritarian leadership of Park Chung Hee who had taken power through a bloodless coup after the previous regime was forced out of power. In 1961, the military government initiated major tax reforms "to sweep out deep-rooted and misconduct in tax administration … and to build an effective tax system which could support the First Five Year Economic Development Plan."[5] After the military government had transitioned to a civilian government in 1963, President Park initiated a major campaign to root out corruption and rent seeking within Korea government bureaucracy at all levels of government. To this end, an Office of Civil Affairs was established in the Blue House for the first time to collect and review petitions made by the public in regards to the affairs of the government. The office was not only symbolic but was also the nerve center of President Park's anti-corruption program. The office was led by Mr. Nak-Sun Lee, a close lieutenant of Park Chung Hee in the army (who would later become the first Commissioner of the National Tax Service). The main objective of the Civil Affairs Office was to monitor public sentiment of public services and investigated serious complaints by the public. The office was not merely for improving public relations but sought to "identify, understand, and address civic problems." (Bae 2002) If a complaint was found to be true after it was investigated and verified, any

[5] See *An Outline of Korean Taxation by Korean* National Tax Services *(*1967).

misconduct and inappropriate behavior on the part of the government were swiftly reported to President Park. Then, the responsible government agency was identified and appropriate corrective actions were taken.

The actions of the Civil Affairs Office quickly spread among Korea's government bureaucracy, the public, and the media.[6] Once news of the office spread in the media, it had a ripple effect in Korean government, sending shivers down the spine of many bureaucrats who were afraid that they too would be the target of investigations. This also led to an increase in the number of petitions, as the public was more willing to come forward. Among the complaints of public service, a growing number complained of unfair and dishonest tax officials and tax collection practices. (Bae, 2002) Indeed, reports of corrupt tax officials taking bribes and abusing their power surfaced in the news media.[7] When complaints of corrupt and abusive tax officials began to surface, the government's anti-corruption campaign had been proceeding for three years, led by the Office of Civil Affairs. As the news reports stoked the flames of public outrage, President Park used the opportunity to put the full weight of the government behind efforts to root out corruption in tax administration.

To dismantle the network of corruption, a member of the Civil Affairs Office was sent to a tax administration sub-office in Youngsan District, in Seoul, as the new head of the office in August 1965. As part of cleaning house, the existing head of the tax office was demoted and kicked out of Seoul district. To establish a new way of doing things, the new appointee also

[6] Bae (2002) wrote that members of the office became known as a kind of Secret Royal Inspectors. The Korean news media had quoted President Park as saying: "Right now at this moment, a Special Team from the Office of Civil Affairs is carrying out its mission inch by inch in all parts of Korea to address societal demands."

[7] In early 1965, reports of rampant corruption among tax officials appeared in a newspaper, which wrote: "The positions of tax officers were up sale. The higher the position was, the higher the price was. The tax officers were backed by the rich and the powerful. In return for their backing tax officers had to bribe them to get promoted. Tax officers were bribed and lavishly entertained by businessmen, and lived a very extravagant life style, throwing around money like it was water."

acted as a role model for other tax office heads.[8] The threat of relocation, demotion, or dismal kept the other existing tax officers on their toes. (Bae 2002) Indeed, the message that corruptive behavior would no longer be tolerated was sent and well received.

In September 1965, a year before the NTS was established, President Park formed a Special Task Force to Inspect Tax Administration, appointing the Presidential Secretary of Civil Affairs to lead the investigation. The task force consisted of three teams with twelve members each from different governmental branches including the Blue House, the Board of Audit and Inspection of Korea (BAI), and the Prosecutors' Office. The investigating committee was given broad authority to carry out tax investigations and inspections to the extent that other government offices were required to cooperate fully. The Blue House team took the lead of the special task force and provided administrative support. The Board of Audit and Inspection team conducted the investigations and the assessment of tax administration. The Prosecutor's Office was in charge of investigating any criminal acts of tax evasion.

After six months of inquiry, the collective efforts of the Office of Civil Affairs were successful results in uncovering many cases of tax evasions. Encouraged by the success, President Park established a central revenue authority, the Korea National Tax Service (NTS), to improve the effectiveness of tax administration and taxpayer compliance. (Kim 2011)

Soon after the organizational structure of Korea's tax system was restructured, which led to the establishment of the NTS in March 1966, the government began to clean house by reorganizing tax personnel.[9] First, all personnel decisions were transferred to the NTS, which

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[8] At that time, the tax bureau was in the Ministry of Finance. Under the Tax Bureau, there were four regional main tax offices in Seoul, Daejeon, Gwangju and Busan. There were 77 tax offices and 2 branch offices in four regions. One of the Civil Affairs staff was Do Bae who would later be a founding member of the NTS. He was first put in charge personnel management and then later would serve as a Deputy Commissioner at the NTS.

[9] Before the NTS was established, the Ministry of Finance was in charge of tax policy and tax administration within the Tax Bureau.

were previously made at the regional offices. In June 1966, the managers and the subordinates of all the tax offices in six major cities were reorganized almost overnight. Many existing senior managers were either demoted, relocated or chose to quit. (Bae 2002) Moreover, a merit-based approach to personnel management was instituted where personnel decisions were made based on fairness and performance but above all on character rather than capacity or background of candidates. High priority was placed on promoting integrity and honesty among tax officials. Moreover, tax officials were subject to a performance-based system of awards and penalties depending on if they met targets.

III. 2 Tax Administration Reform

As the government proceeded to dismantle the corruption network within the revenue authority, it also focused on improving the administrative basis for enforcement based on voluntary compliance of tax laws and self-assessment of taxes among taxpayers. But the basis for tax administration such as accounting and bookkeeping for both tax collectors and taxpayers was woefully inadequate; in that the tax revenue authority and taxpayers did not maintain and rely on accurate books and records for tax assessments. The lack of accurate books and records meant that tax assessments could only be arbitrary, allowing abusive tax officials the opportunity to extort bribes and gifts and to meet their tax collection quota, resulting in excessive and unequal taxation. Essentially, tax collectors would call on businesses and calculate the tax liability based on an arbitrary figure pulled out of thin air. Tax collectors would impose an excessive assessment to gain bargaining leverage with the taxpayer. The arbitrariness and uncertain nature of tax assessments left many taxpayers feeling victimized and abused by a system that was known to be inequitable and reward non-compliance among taxpayers and corruption among tax officials. This made promoting taxpayer compliance much more difficult in a society where paying taxes to the government was not the social norm. The sense of civic duty or responsibility to pay taxes to the government was not engrained in Korean society at the time. So tax evasion was not seen as immoral or criminal by many.[10] Deep public mistrust of tax officials and the system discouraged taxpayer compliance, resulting in a high rate of unreported income and unpaid taxes. Indeed, "the real core of the tax problem lay in implementation and administration."[11]

As such, the mission statement of the NTS was to increase tax revenues by enforcing the tax laws, improving administration, and promoting self-compliance among taxpayers.[12] This mandate fell on the first commissioner of the NTS appointed by President Park, Naksun Lee, who also led the anti-corruption efforts of the Civil Affairs Office. At the NTS, he made sure the message of zero tolerance for corruption was not only heard but also seen by the tax officers. Mr. Lee had the words "do not fall prey to greed" inscribed on green neckties worn by the tax officers.[13] He also had the number 700 (Seven Hundred Ock Won or Seven Billon Won), the tax revenue target for 1966, engraved on his car license plate (See Figure 4).

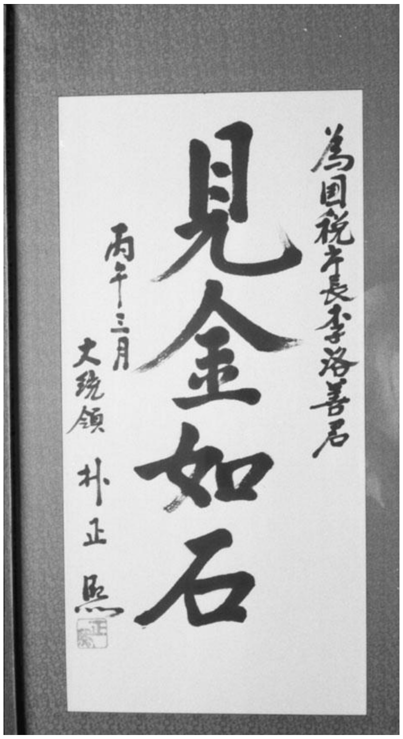
[10] In some cases, not paying taxes was seen as a virtue. As a legacy of Japanese colonization of Korea, taxpayers were looked down upon since taxes were collected by the Japanese colonial government.

[11] Sang Soo Kwak (1965), *Tax Policy and Tax Administration in a Developing Economy: The Korean Experiment.*

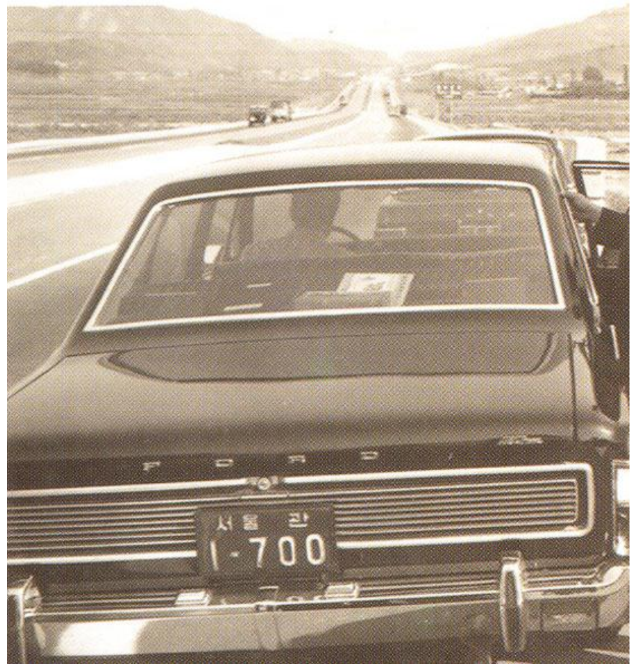
[12] In 1961, military government enacted a special law on Punishment of Tax Violators to enforce the tax code and reduced tax evasion.

[13]Upon his appointment, Naksun Lee was reminded by the President Park the importance of maintain integrity due to the rampant corruption in tax administration. The President handwrote his own words in Chinese scripture which said "to see gold as a stone" (見金如石) meaning do not fall prey to greed (Figure 3).

<Figure 3> Handwritten Words of Park Chung Hee to NTS Commissioner: "See gold as a stone"



<Figure 4> 1966 Tax Revenue Target of 70 billion Won engraved on the Car License Plate of the NTS Commissioner



A top priority of Mr. Lee and the newly founded NTS was to tackle underreporting of income and tax evasion. As such, an integrated investigation (tax fraud) unit within the NTS was created in 1966.[14] This consolidated the investigatory functions which were previously divided among several law enforcement agencies. Since all the tax investigatory functions were in the NTS, all tax evasion cases from other law enforcement organizations were reported to, and investigated by the NTS.[15] Reorganization of the unit also meant that the investigatory results of the NTS were subject to audits by the Board of Inspectors (BOI). This helped to increase the

[14] Before this, the function of tax investigation was divided among several agencies including the prosecutor's office and the police which conducted inspections on an ad-hoc base (arbitrarily) and did not have a systemic approach. For instance, tax inspectors or prosecutors or policemen would visit taxpayers randomly and would collect taxes arbitrarily.

[15] Major tax evasion cases were subject to a Special Law on Aggravation Punishment and fell under the jurisdiction of the Prosecutor General.

efficiency of investigating tax evasions, to reduce bureaucratic red tape for businesses, and to change the image of tax investigations which was tarnished after years of tax officials abusing their investigatory authority.

The investigation unit of the NTS was vital in addressing underreporting of income and tax evasion. First, the NTS offered a series of grace periods where taxpayers in breach of tax codes were given immunity if they disclosed their past tax violations and paid back taxes. Moreover, new measures were instituted to address and deter future unreported income and tax evasion. Second, a system of collecting and processing data and information on taxpayers and businesses was established. The information was then disseminated and used by the investigation unit and local tax offices. To check if all the businesses and residences were on tax rolls and paying the appropriate amount of taxes, teams of tax officials canvassed specific areas to conduct "saturation compliance."

As seen in Table 2, the focus on uncovering unreported income and unpaid taxes led to a sharp rise in the number of tax inspection cases during 1966-70. This period also saw a high number of tax evasion cases, which targeted large firms, state-owned enterprises, SMEs, the wealthy class, essentially any group that could and should pay taxes. As the number of investigations increased, taxpayers were more willing to step forward voluntarily and pay taxes, instead of having their tax liabilities assessed by the NTS. After 1970, nearly four years since the establishment of NTS, the high number of tax inspection cases fell dramatically and continued to decline through the 1970s into the 1990s.

<Table 2> Result of Tax Inspection: 1966-1995

	No. of Tax Inspection (Cases)	Tax collection from inspection (Mil Won)			Results of Inspection (Cases)		
		Total	Collection of Uncollected Taxes	Tax Fine	Number of Cases Resolved	Number of Criminal Cases	Number of Cases with No Irregularities
1966-70	5,662	5,941	3,919	2,022	3,969	50	1,643
1971-75	2,186	20,582	17,467	3,115	1,670	152	364
1976-80	1.611	75,149	66.535	8,614	1,256	250	105
1981-85	784	85,342	79,905	5,437	565	118	101
1986-90	98	76,467	75,919	548	33	64	1
1991-95	57	136,382	136,163	219	5	52	-

Source: 30 year History of Korea's National Tax Service (1996), p1266

Until the mid 1960s, the basis of tax administration – accounting, bookkeeping, and recordkeeping - was as foreign as the idea of paying taxes.[16] The lack of accurate information available on the sources and size of income made it impossible to make tax assessments. Even if taxpayers had the administrative capacity for accounting and bookkeeping, the books and records were highly unreliable. In the beginning, a great deal of physical effort went into improving the capacity to make tax assessments based on taxpayer records and available information to the extent possible.

The improvement in the compliance of tax laws and assessment of taxes was a result of a massive human effort by tax officials which was often physical and laborious.[17] Tax officials were often required to make hundreds of site visits and kick the tires. Due to the lack of bookkeeping or refusal of taxpayers to produce records at first, tax assessments had to be based on estimates of gross sales volume, which was then multiplied with standard income ratios

[16] Mission statement of US tax authority (Internal Revenue Services) states: the Congress passes tax laws and requires taxpayers to comply; The taxpayer's role is to understand and meet his or her tax obligations; The IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.

[17] See Brown (1973) for detailed description of the efforts by the revenue authority to improve tax administration, and An Outline of Korean Taxation (1967) and An Introduction of Korean Taxation (1968) published by the Korea NTS for more on the history of Korea's tax system.

determined by tax officials to derive income and tax liabilities. The problem with this method is that the standard ratios could overstate, or in Korea's case, underestimate actual income. Indeed, tax officials deemed the ratios to be generally too low while it encouraged taxpayers to understate income since it was lower than their actual income. The revenue authority's efforts to revise up the ratios were met with much resistance from businesses. But businesses agreed to pay the assessed taxes, when the revenue authority threatened or actually did have tax officers visit and observe their business to determine the actual value and receipt of sales. Other efforts by tax officials to better assess actual sales and income including installing turnstiles in theaters to record the number of admissions, and periodically counting the number of passengers on buses.

A formal system of tax self-assessment was introduced for the first time. The NTS gave taxpayers the option to voluntarily prepare a tax self-assessment or be subject to normal tax assessment procedures, which was on-site assessment. The voluntary self-assessment option was called *code green*. Moreover, taxpayers were given additional tax reductions and exempt from tax audits to promote the timely and voluntary filing of tax assessments. To qualify for self-assessment, taxpayers had to keep record books for past two years. Also, code green taxpayers were allowed to pay taxes in installments over a period rather than in lump-sum, and allowed to amortize depreciation cost.

The introduction of self-assessment helped to promote voluntary compliance of taxpayers and to encourage book-keeping practice. If voluntary tax assessments were later found to have been falsified or underreported income, then taxpayers were subject to much more severe penalties. Furthermore, the NTS targeted the small businesses and self-employed workers that did not have book-keeping by promoting voluntary compliance, and required corporations to keep accounting records.

<Table 3> Personal Income Tax Base

(Billion won, %)

	Non-agricultural income (A)	Tax base (B)	B/A
1957	102.9	18.7	18
1958	113.3	23.5	21
1959	130.5	33.5	26
1960	138.6	35.6	26
1961	159.9	40.4	25
1962	193.9	50.1	26
1963	250.2	66.0	26
1964	351.9	87.5	26
1965	448.1	118.3	26
1966	594.9	181.2	31
1967	766.4	263.6	34
1968	963.2	376.2	39
1969	1,276.5	560.5	44
1970	1,566.2	815.6	52
1971	1,896.8	998.1	53
1972	2,312.8	1,220.4	53
1973	3,058.9	1,440.8	47
1974	4,248.0	1,947.2	46

Source: (Mason et. al., 1980)

Efforts to strengthen tax administration within the revenue authority included instituting internal tax audits and stronger supervision of tax officials. An internal audit department was established to monitor tax officials and to investigate cases of misconduct. Staff of the NTS was subject to performance based evaluations which kept permanent records of employee conduct and performance. As a check against abuse by tax officials, records of how much tax officials collected were maintained and tracked against collection quotas based on past amounts and expected increase. Previously, quotas were abused by tax officials who imposed high tax assessments to meet quotas or receive bribes.

Aside improving the government's capacity for tax administration, a lot of energy and time was spent on improving taxpayer services. There was a great deal of effort to change the public image of tax officials and to raise awareness and education on tax assessment and filing on part of taxpayers. The government attempted to educate the public in the importance of tax revenues needed to fund public goods and development. Training seminars were held for businesses, accountants, attorneys, and taxpayers. Also, the NTS focused on improving taxpayer services including establishing a claims and appeals system so that taxpayers could formally dispute tax matters. As a check on both tax officials and taxpayers, businesses were required to display a tax certificate in their place of business for tax officials, other businesses, and taxpayers. The certificates had various types of information about the business. It recorded the amount of taxes paid, the signature of the tax assessor, and so on.

IV. Conclusion and Implications for Developing Countries

Though it is difficult to exactly separate the effects of income growth, the dramatic rise in tax revenues in Korea can be largely attributed to improved and more effective tax administration rather than tax laws and policies. Despite having a reasonably developed tax system and policies favorable to private savings and investment, the government could not raise tax revenues due to ineffective basis for tax administration and corrupt tax officials, which resulted in tax inequity, widespread mistrust of the tax system, and non-compliance among taxpayers who believed that it was not rewarding to comply with tax laws. It was only after the political leadership put top priority on rooting out corruption, which made the "tax office immune from normal political influence," (Brown 1973, pg 65) and improving tax administration was the government able to significantly mobilize tax revenues.

The general lesson is that while the level and quality of taxes are important, their benefits cannot be realized without effective tax administration that promotes fair, equitable taxation based on voluntary taxpayer compliance and a sufficiently broad tax base that includes income tax for countries in the early stages of development. A more effective and efficient system of tax administration on its own can result in a more equitable distribution of income. Above all, any efforts at tax administration reform need to be backed by a strong commitment of the political leadership and competent government bureaucrats.

Korea's experience presents a unique perspective on the role of weak and strong states in economic development. Despite numerous accounts of failed states under control of self-interested rulers or ruling elite, Acemoglu (2005) writes: "In South Korea, General Park ran a highly authoritarian regime, with few formal checks on state power, and used the resources of the state to help industrialization in alliance with the large *Chaebols* (as long as they did not pose a threat to his political power).” As excessively weak and strong states can impede growth and lead to misallocation of resources, Acemoglu (2010) cautions that the benefits of greater fiscal capacity cannot be realized unless an increase in a state’s fiscal capacity is accompanied by “an increase in the political accountability of rulers and politicians.” Otherwise, greater fiscal capacity may increase the benefits of controlling state power, resulting in a power grab and political instability.

Early in its development, Korea was a weak state when judged by its capacity to mobilize tax revenues. This made it dependent on aid resources and unable to secure macroeconomic stability needed for growth, let alone undertake investments in public goods. Moreover, corruption and inefficient bureaucracy had become impediments to economic progress and reform. By being able to remove these obstructions and promote development, the Korean government demonstrated that it had taken ownership of its development process.

But what allowed the government to reform and insulate itself from pressure groups was Korea’s initial condition of a relatively equitable distribution of income and wealth.[18] This meant that economic and political power would not be monopolized in the hands of self-interested individuals or ruling elite. Soon after he took power, President Park had the top industrialists jailed, and many government bureaucrats relocated or demoted as part of the anti-corruption campaign. Under these conditions, the government under Park Chung Hee was able to strike a balance between being a weak and strong state by raising enough tax revenues to make investments in public goods necessary for economic development including the construction of expressways, infrastructure to support industrialization, and rural development. Ultimately, a state’s capacity may be measured by its capacity to tax; but what truly defines a state – whether it

[18] Land reform and war had conspired to bring about a relatively equitable distribution of income and wealth. The fact that everyone was poor ensured a level playing field.

redistributes and allocates resources more efficiently - may be the way tax revenues are used. The defining feature may be the kinds of investments in public goods that the state undertakes or not.

In concluding, the importance and the development of market economy supporting institutions, especially the capacity to tax, cannot be overlooked. The implications of a government's ability to mobilize tax revenues may be magnified as the growth prospects of developing countries are deteriorating amid lower expected global growth. The economic situation of the least developing countries may be even worse as studies on aid flow suggest that total foreign assistance will likely fall as donor countries reduce aid outflows due to economic uncertainty, especially in advanced countries that are in crisis and addressing fiscal sustainability issues. Against this background, the development prospects of poor countries may depend on their capacity to tax. As in Korea, the path to sustainable economic development for developing countries may begin with improving tax administration capacity and rooting out corruption in government.

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