

# Taxation Policy and Economic Development in Underdeveloped Countries (II)

—With Special Reference to Korea—

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## Part-I

### Introduction

- I. The Approach to Taxation Policy in Underdeveloped Countries
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## Part-II

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## IV. Basic Characteristics Economic Structure in Korea

It might be useful to look at the basic features of economic structure in Korea in brief before reviewing the tax structure so as to be able to account the main problems of economic development into taxation policy.

In general, the Korean economy involves the basic characteristics of underdeveloped countries, as pointed out by Prof. *Leibenstein*.<sup>1)</sup> Among them, the most outstanding ones in regard to Korea, are as follows:

Firstly, the level of per capita income is relatively low as compared with even some countries in South East and Far East Asia. It was \$78 in 1959, whereas \$256 in Japan, \$192 in the Philippines, and \$107 in Thailand. However, it has shown a slightly higher level than \$67 in India and \$69 in Pakistan in that year.<sup>2)</sup>

Secondly, the over-population in proportion to the land and capital has resulted in the large number of under-employment and particularly of disguised unemployment in primary and tertiary sector. Moreover, the rate of population growth is exceptionally high with 2.9% as compared with that in other countries in the ECAFE region.

Thirdly, the proportion of the primary sector (agriculture and fishing) is

1) H. Leibenstein, *Economic Backwardness and Economic Growth*, N.Y., 1957, pp. 40-41.

2) L.J. Zimmerman, "The Distribution of World Income 1860-1960", *Essays on Unbalanced Growth*, edited by E. de Vries, Mouton & Co. 1962, p. 53.

overwhelmingly high in relation to other modern industry. Approximately 58.2%<sup>1)</sup> of the total population are engaged in agriculture in 1961.

Fourthly, the balance of payment is steeply unfavourable.

Finally, there are insufficient natural resources, and capital accumulation is small.

These are the major characteristics faced to the Korean economy in the formulating of an economic policy.

#### A. The Characteristics of Industrial Structure:

As far as the structure of the industry in Korea is concerned, we have to indicate three weak spots, namely, the discrepancy between the primitive industry and modern industry, secondly, the imbalance between the productive goods sector and the consumption goods sector within the modern industry and thirdly, the weak condition in exports.

As shown in Table 5, which also contains some advanced countries, the primary sector is predominant in Korea. It shows 38% in relation to G.N.P. in Korea, whereas it is approximately in the region of 10% in advanced countries. On the contrary, the secondary industry which comprises mostly manufacture, remains 20.5% in Korea whereas around 40%—50% in advanced countries. It shows that the Korean economy on the whole has been heavily relying on the primary sector and at the same time, the growth of modern industry has been small. The last striking feature of this Table is expressed in the high proportion of the tertiary sector. This has been due to the huge amount of economic aid from the United States, which led to the expansion of transaction in the economy. (Further the pressure of the rapid increase in population on employment was very heavy.)

TABLE-5<sup>2)</sup>

#### Composition of Industry by Sectional Origin

(Percentage of G.N.P.)

	U.S.A.	U.K.	Germany	Japan	Thailand	Korea
Primary	4.1	4.2	7.2	16.5	41.2	38.0
Secondary	37.2	45.2	54.0	34.4	19.0	20.5
Tertiary	58.7	50.6	38.8	49.1	39.8	41.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

We have seen that the economic structure of Korea is heavily dependent on the primary sector, on the one hand, the secondary sector as a proportion of G.N.P. remains extremely low on the other hand. We now turn to see the structural weakness of industry particularly within the secondary industry. As shown in Table 6, with the exception of Japan, in most countries in the ECAFE region the consumption goods productions as a percentage of total added value of manufactural industry, are approximately in the region of 65%—90% which is very high in comparison to capital goods production which shows around 10%—35%. It is the general tendency that the proportion of consumption goods is high with the view of the need of common necessities, resulting in the growth of food

1) Agricultural Year Book, 1962, The United Agricultural Cooperatives Federation, p.III-1.

2) Source: An Chong Chik, The Direction of Korean Economy, Seoul, 1962, p.5.

TABLE-6 Composition of Manufacturing Industries in ECAFE

	Korea	Vietnam	Pakistan	Taiwan	Philippines	India	Japan
Consumption goods	74.2	94.5	71.9	75.7	66.7	64.4	46.3
food, liquid, tobacco	31.7	39.5	15.0	49.8	44.9	11.0	11.7
textile	17.9	41.2	46.7	17.0	4.5	50.7	16.2
leather, gum, timber, others	24.6	13.8	10.2	8.9	17.3	2.7	18.4
Capital goods	25.8	5.4	18.5	22.5	22.9	35.6	53.7
chemical, medicine, non-metal	14.9	4.1	11.8	12.7	14.6	12.5	19.0
metal	5.5	—	4.1	4.7	4.5	13.3	15.7
machine	5.4	1.3	2.6	5.1	3.8	9.8	19.0
Others	—	—	9.6	1.8	10.3	—	—
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: An Chong Chik, "The Direction of Korean Economy" 1962, Seoul, p.7

and textile industry in the first stage of development in underdeveloped countries. The manufacture of consumption goods especially linked to necessity goods, like food and textile, as a proportion of secondary industry in Korea shows 49.6% which is considerably higher than 27.9% in Japan.

The production of machines which is the most important in capital goods production shows an extremely low percentage of 5.4 in Korea. This means that the Korean economy remains in the first stage of development and calls for the growth of capital goods production for industrialization in accordance with the developmental program.

One of the most striking features of the economic structure of Korea can be seen in the balance of payment. It has been showing a steeply unfavourable condition mainly owing to the low level of productivity in general and lack of sufficient technology in particular. This has resulted in an extremely small amount of export in contrast to the huge amount of imports, and especially the extracted production of export, instead of manufactured production.

The articles of export in Korea in 1960, as shown in Table 7, are mostly

TABLE-7 Exports by Commodity

(Unit: \$ million)

	amount	percentage
food	10.3	31.1
inedible crude materials	16.5	50.0
mineral fuels	1.1	3.5
Animal & vegetable oils & fats	0.2	0.6
chemicals	0.2	0.5
manufactured goods	4.1	12.5
miscellaneous	0.6	1.8

Source: "Summary of the first five year economic plan 1962-1966" 1962, Republic of Korea. p.61.

characterized in the production of agriculture, fishing and mining, that might be called the production of primitive extraction. They occupy 85.2% of the total amount of export whereas the export of manufacture goods, shows 14.8% which is a small proportion of the total export.

#### B. Major Problems for Economic Growth:

Since the ceasing of the Korean war, particularly from 1954 to 1960, the Korean economy has grown up with the average rate of 4.6% per year, as shown in the following Table 8. The rate of 4.6 as such has been much attributed to the rapid development in the secondary sector which has centered the field of mining and manufacturers. During the same period the growth rate of the primary sector was 3.1% per year on average, and of the tertiary sector 3.4%, so that both were below the average growth rate of 4.6% in all sectors of the economy. The growth rate of 12.0% which is much higher than the 4.6% of growth of all sectors, was shown in the sector of the secondary industry. The rate of economic growth, however, has decreased since 1958 after showing 8.7% during the peak year, namely, 1957.

On the whole, the average growth rate of 4.6% was achieved to a large extent by the huge amount of economic aid (which were mostly consumption goods) from the United States and partly by the good climate favourable for crops. This has resulted partly in the fact that the industry has developed inevitably into heavy reliance on consumption goods production as has been mentioned in the foregoing section. Moreover, the raw materials for this industry have been imported from outside. The development of industry of finished consumption goods whose raw materials have been imported, faced three difficulties, with firstly the decrease in economic aid, secondly the narrow scope of domestic market, and finally the lack of sufficient social overhead capital. These phenomena might serve the crucial reason for the decrease in the rate of economic growth which happened since 1958.

TABLE-8

#### The Rate of Economic Growth

(1955=constant price) (Unit: %)

	1954	1955	1956	1957	1958	1959	1960
Primary	6.1	3.0	-5.9	8.7	7.4	1.4	0.9
Secondary	16.0	13.1	12.1	17.0	8.9	13.3	3.7
Tertiary	1.2	2.2	2.1	5.3	5.6	5.3	2.4
G.N.P.	5.2	4.0	0.3	8.7	7.0	5.2	2.1

Source: Economic Survey, 1962, p.52. Economic Planning Board, Republic of Korea.

This has called for a turning point in the direction of economic growth towards the new phase of growth. Therefore, the effort should be placed on the development of intermediary goods industry for supplying the raw materials instead of importing it. In other words, the import substitute industry will have to be expanded. This will lead to the improvement of the unfavourable balance of payments situation. In addition, the vigorous plan has to be set up for enhancing the export industry by technological improvement and government subsidies.

Secondly, one of the serious bottlenecks to progress is the lack of sufficient social overhead capital. This calls for the emphasis to be placed on the development of power, communications, transportation, education and so forth, by which the external economy can be expanded.

Thirdly, the income of the population engaged in agriculture has to be increased to expand the demand for the growing industry by raising the agricultural productivity in view of the large proportion of agricultural population at present.

Fourthly and finally, the shortage of resources for financing the cost of industrialization is an acute problem. Domestically, the increase in saving will have to be brought about by devising tax system incentive to save and invest, and diverting the idle resources which are likely to be hoarded for the purpose of speculation, into desirable directions. Externally, in view of the limited capacity of domestic resources, the foreign investment has to be enhanced by providing favourable conditions inducive to foreign investors.

## V. Description of Tax Structure in Korea

Having presented in the preceding Chapters a brief description of the salient features and major problems of Korean economy, we now proceed to the subject matter proper of this study--the basic features of tax structure of Korea, with presenting the position of taxation in the government revenue, the volume and composition of tax receipts, the pattern of direct and indirect tax, national and local tax and the tax burden to be analysed in this Chapter.

### A. The Position of Taxation in the Government Revenue:

Table 9 shows a breakdown of total revenue of government by the various sources in 1960 and 1961. The most striking feature of revenue structure lies in the fact that 48.4% of the total government revenue relies upon the foreign

**TABLE-9** **FY 1961 Original Budget Revenues** in billion won

	1961		1960	
	Amount	% of total	Amount	% of total
General accounts	26.1	51.6	29.0	68.5
Taxes	18.2	36.0	23.5	55.5
Misc. income except taxes	2.2	4.4	2.0	4.8
National bonds	0.7	1.4	1.0	2.4
Industrial reconstruction bonds	2.2	4.3	0.2	0.4
Monopoly profits	2.3	4.6	2.3	5.4
Borrowings	0.5	0.9	0	—
Counterpart fund special account	24.4	48.4	13.4	31.5
Cash	22.0	43.6	11.4	26.9
Acquisition cost	2.4	4.8	2.0	4.6
Total	50.5	100.0	42.4	100.0

Source: Economic Survey 1962, p.97, Economic Planning Board, Government of the Republic of Korea.

TABLE-10

## Expenditure

In billion won

	1961		1960	
	Amount	% of total	Amount	% of total
General accounts	42.1	83.3	34.3	81.0
General expenditures	22.3	44.1	18.6	43.8
National defense	16.6	32.8	14.9	35.2
National bonds	1.1	2.1	0.7	1.6
Industrial reconstruction bonds	2.2	4.3	0.2	0.4
Counterpart fund and economic reconstruction special account	8.5	16.7	8.1	19.4
Cash	6.0	12.0	6.1	14.4
Acquisition cost	2.4	4.7	1.9	4.6
Total:	50.5	100.0	42.4	100.0

Source: Economic Survey 1962, Economic Planning Board, Government of the Republic of Korea.

source, which represents the counterpart fund accruing from economic aid from the United States, whereas domestic source covers only 51.6% of the total revenues. The reasons for the heavy reliance of the government revenue upon the foreign source as such seems partly that the level of economic development is in a lower stage in general resulting in the meager amount of contribution to the government revenue, and partly that the expenditure of national defense occupies the magnitude proportion of total government expenditure as shown in Table 10, e.g. 32.8 % of total expenditure.

Particularly it would be interesting to look to Table 11 showing the resources of national defense expenditure. It shows that 95% of the total national defense expenditure is covered by foreign aid and the rest 5% is by domestic resources.

TABLE-11 Resources of National Defense Expenditure

In billion won

	1958		1959		1960		1961	
	Amount	% of total	Amount	% of total	Amount	% of total	Amount	% of total
Total	12.7	100	13.9	100	14.7	100	16.8	100
Domestic resources	7.9	62	8.6	62	9.3	64	0.9	5
Foreign aid	4.8	38	5.3	38	5.3	36	16.0	95

Source: Economic Survey 1962, p.101. Economic Planning Board, Republic of Korea.

Now we turn to the position of taxation in the government revenue. Taxes contribute 36.0% to the total government revenue, which amounts to 18.2 billion won.

We have seen already in Chapter II that in many underdeveloped countries the tax revenue in the position of total revenue is very weak owing to several reasons mentioned in that section (such as the subsistence level of living, lack of sufficient monetary sector, the existence of illiteracy and difficulties in tax

administration). In view of the tendency to decrease the economic aid, one of the important tasks in regard to the government revenue, is to mobilize the domestic resources to meet the government expenditure needed to development, by deliberately devising the revenue system particularly in relation to taxation, which can strengthen the taxable capacity thereby yielding an increase in the revenue of the government. However, it would seem that the drastic change in decreasing the heavy reliance of government revenue upon foreign source, will not take place in so far as the country is divided into two parts. This has resulted in the fact that the large proportion of revenue has been paid to the expenditure of national defense instead of to the desirable fields of investment for economic development and a substantial amount of defense expenditure has been covered by foreign source which is economic aid from the United States. This very fact has been pointed out by the Government in 1960 in saying that **the Republic of Korea now maintains the fourth largest military establishment in the world. Even with substantial support from the United States, the maintenance of this military posture places a heavy tax burden on the Korean people. If, for instance, the Korean government could divert the 148 billion Hwan, now budgeted for basic (development) support of the defense forces, to larger scale economic development program, economic progress could be accelerated and the tax burden on the people eased.**<sup>1)</sup>

#### B. The Volume and Composition of Tax Receipts:

In Table 12, the various kinds of taxation are shown during the period from 1957 to 1962.

Over the 6 years, the amount of tax receipts has been slightly increased year by year. It increased from 115897.9 million Hwan in 1957 to 221205 million Hwan in 1962, thus by a rate of 52.3% as shown in Table 13. The amount of taxes in 1962 (budget) is smaller than that in 1961 (actual amount). This is due to the fact that four taxes, namely land tax, entertainment and restaurant tax, parimutuel tax, and automobile tax, have been transferred to the local government.

The outstanding change in the composition of tax receipts over the years can be seen in the fact that the reliance of tax revenue upon the indirect taxes has been considerably increased, particularly since 1961. The indirect taxes occupy 70% of the total tax receipts in 1962, whereas the direct taxes cover merely 26.3% in the same year. This emphasis of indirect taxes, which seem to be a general tendency in the revenue structure of the presently underdeveloped countries, is brought especially by the drastic tax reform by the military government in 1962.

Of the direct taxes, the tax which contributes a major portion to direct taxes is the income tax which is 16% as a proportion of total tax revenue, in 1962. Corporation tax is the next one which is 5.4% in 1962. This percentage has decreased as compared with 7.4% in 1961.

Among indirect taxes, the petroleum tax which is newly introduced by 1962,

1) Outline of the Korean Economy-Progress, Problems and Prospects, June 20, 1960, pp. 11-12. Ministry of Reconstruction, Republic of Korea.

TABLE-12  
Trend in National Tax Revenue

	(Unit: million Hwan)				
	1957 Amount	1958 Amount	1959 Amount	1960 Amount	1961 Amount
Total of Taxation	11,597.9	143,486.9	215,975.7	249,713.2	232,068.1
Personal Income tax	13,994.2	18,099.6	21,986.6	21,391.6	24,555.7
Cooperation income tax	5,243.9	5,139.9	7,196.7	9,190.2	17,072.0
Land tax	—	—	—	—	20,779.3
Inheritance tax	172.9	218.7	241.0	246.1	276.7
Mining tax	2.9	59.7	63.1	71.6	68.6
Travelling tax	1,665.0	2,338.0	2,940.9	3,485.8	3,823.3
Registration tax	1,349.9	1,653.6	2,580.4	2,766.8	2,949.2
Assets revaluation tax	—	109.2	411.0	315.0	283.5
Education tax	—	3,271.6	13,705.7	14,585.9	15,242.9
Special foreign exchange tax	—	14,247.1	47,224.1	50,467.2	2,512.6
Automobile tax	—	—	3,080.0	3,474.0	3,453.5
Temporary land income tax	27,671.8	20,206.0	19,271.6	15,345.9	31.6
1. Total of Direct Taxation	50,100.2	65,343.4	118,700.6	121,341.0	91,048.3
Business tax	7,334.5	8,629.4	10,641.0	10,109.7	10,607.9
Liquor tax	8,087.1	8,429.4	10,259.1	11,563.7	12,511.7
Petroleum tax	—	—	—	—	—
Commodity tax	20,723.9	24,516.6	32,955.5	43,284.0	49,300.0
Entertainment & Restaurant tax	1,169.7	1,376.1	1,700.9	1,284.0	1,314.6
Electricity and gas tax	2,182.7	2,961.4	3,332.5	3,706.8	5,058.8
Admissions tax	1,655.9	1,595.4	1,607.1	2,071.0	1,738.4
Parimutuel tax	31.8	11.1	28.3	17.6	23.3
Customs duties	2,3762.7	29,638.8	35,545.6	51,449.8	53,006.7
Tonnage tax	45.9	52.6	49.2	52.1	52.1
2. Total of indirect Taxation	6,4994.2	77,211.0	96,119.2	123,485.1	133,613.5
3. Stamp duties	—	—	—	3,598.5	4,001.1
4. Carried over from previous FY	803.5	0.7	1,155.9	1,288.6	3,405.0
					2,043.0

Source: Outline of Budget 1962, Economic Planning Board.



TABLE-13                      Trend in National Tax Revenue 1957-1962  
(Percentages)

	1957	1958	1959	1960	1961	1962
Total of Taxation	100.0	100.0	100.0	100.0	100.0	100.0
Personal income tax	12.1	12.6	10.1	8.6	10.6	16.6
Cooperation income tax	4.5	3.6	3.3	3.7	7.4	5.4
Land tax	—	—	—	—	9.0	—
Inheritance tax	0.1	0.1	0.1	0.1	0.1	0.1
Mining tax	0.0	0.0	0.0	0.0	0.0	—
Travelling tax	1.4	1.6	1.4	1.4	1.6	2.6
Registration tax	1.2	1.2	1.2	1.1	1.3	1.6
Assets revaluation tax	—	0.1	0.2	0.2	1.1	—
Education tax	—	2.3	6.3	5.8	6.6	—
Special foreign exchange tax	—	9.9	21.8	20.2	1.1	—
Automobile tax	—	—	1.4	1.4	1.5	—
Temporary land income tax	23.8	14.0	9.0	6.1	0.0	—
1. Total of Direct taxation	43.2	45.5	54.0	48.0	39.2	26.3
Business tax	6.3	6.0	5.0	4.0	4.0	8.0
Liquor tax	6.9	5.8	4.7	4.6	5.4	14.4
Petroleum tax	—	—	—	—	—	17.5
Commodity tax	17.8	17.0	14.3	17.3	21.2	12.2
Entertainment & Restaurant tax	1.0	1.0	0.8	0.5	0.6	—
Electricity and gas tax	1.8	2.0	1.5	1.5	2.2	2.9
Admission tax	1.4	1.1	0.7	0.8	0.7	1.2
Parimutuel tax	0.0	0.0	0.0	0.0	0.0	—
Customs duties	20.5	20.6	16.4	20.6	22.8	13.8
Tonnage tax	0.0	0.0	0.0	0.0	0.0	0.0
2. Total of Indirect Taxation	56.0	53.8	44.5	49.0	57.6	70.0
3. Stamp duties	—	—	—	1.4	1.7	2.8
4. Carried over from previous FY	0.7	0.6	0.5	0.5	1.5	0.9

Source: Outline of Budget 1962, Economic Planning Board.

shows the highest amount, which is 17.5% as a proportion of total tax revenue. The customs duties are the second largest tax in indirect taxes, with the amount of 30600.0 million Hwan which contributes 13.8% to the tax revenue. The commodity tax occupies 12.2% of the total tax revenue with the amount of 26721.0 million Hwan in 1962. The drastic change in tax system towards the indirect tax as such has been brought by the tax reform of 1962, in which the rates on excise duties are increased. The tax reform in 1962 will be discussed hereinafter in further detail.

#### C. The Pattern of Direct and Indirect Tax:

We have seen already in Chapter II that in many underdeveloped countries the infeasibility of direct taxation enforces the government to rely its major revenue on indirect taxation. The tax system in Korea has not been an exception in this respect. As can be seen in Table 14, the proportion of direct taxation in

the government revenue has shown 48.6% (direct taxation) versus 49.5% (indirect taxation) in 1960, and 39.2% versus 57.6% in 1961. In 1962, the drastic change in the reform of tax system has brought the steeply heavy dependence of tax revenue on indirect taxes whose proportion is 70.0% in contrast to 26.3% direct taxes. This fact is the outcome of tax reform, in that year, in which the various exemptions of savings and investment from taxation and the restraining of consumption with high rates on non-necessities and luxuries have been conceived.<sup>1)</sup>

**TABLE-14**                      **Percentage of Direct and Indirect Tax**                      (‰)

Year	Direct Tax	Indirect Tax	Miscellaneous
1949	38.5	61.5	0
1950	59.4	40.6	0
1951	45.7	54.4	0
1952	47.3	51.9	0.8
1953	42.9	56.4	0.7
1954	36.6	62.7	0.7
1955	34.9	64.7	0.4
1957	43.2	56.1	0.7
1958	45.5	53.8	0.7
1959	55.0	44.5	0.5
1960	48.6	49.5	1.9
1961	39.2	57.6	3.2
1962	26.3	70.0	3.7

Source: Economic Survey 1962, p.416. Economic Planning Board, Republic of Korea.

1) Profit of Monopoly (cigarettes and salt) is excluded.

2) 1956 is excluded owing to the change of FY.

3) The period 1949-1961 is excuted budget, and 1962 is budget.

#### D. Tax Burden:

As the amount of tax receipts has increased, the rate of tax burden in proportion to G.N.P. has been increased as shown in Table 15. The rate of tax burden over the last years has been increased from 8.3% in 1958 to 14.1% in 1960. In 1961 it decreased to 10.1% from 14.1% in the previous years. This is due to the fact that the number of taxes accruing from the economic aid has been transferred to the counterpart fund account from the general account in the revenue structure. If we include the amount of transferred source, namely special foreign exchange tax, as a matter of fact, the rate of tax burden in 1961 would be higher than the previous years.

If we compared the rate of tax burden in Korea with that of other countries, as presented in Table 16, Korea has shown 16.5% in 1960, whereas 7.2% in Pakistan, 10.1% in the Philippines, 8.6% in Thailand and 20.5% in Japan. It is clear that the rate of tax burden in Korea is higher than in other countries in ECAFE except Japan.

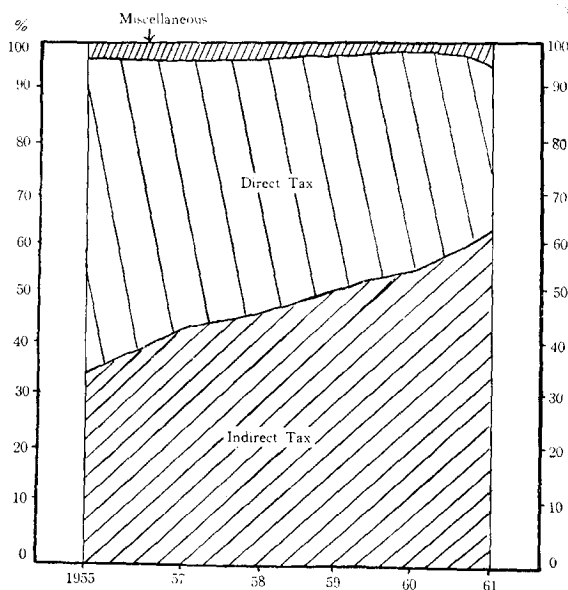
Careful consideration must be taken in the context of tax burden from two

1) "Outline of Tax Reform, 1961", Monthly Economic Research, March-April, 1962, p. 49. Economic Planning Board.

**Graph 1. Composition of Direct and Indirect Tax**

Graph

Composition of Direct and Indirect Tax



Source: Economic Survey, 1962, p. 220  
Economic Planning Board

points of view. Firstly, the increase in tax burden can take place only in the case when rate of economic growth is increased in general. Accordingly, the increase of tax burden rate cannot exceed the rate of economic growth for the reason that otherwise it would offer disincentive to save and invest. Secondly, in contrast to the first point, the effort to increase the tax burden will have to be placed on the seeking of idle resource in kind and in cash, which is so often likely to be kept for the purpose of speculation by mostly well-to-do people like landlords, money-lenders etc.

**TABLE-15****Trend in Tax Burden**

(Unit: billion Hwan)

Total tax burden	1958		1959		1960		1961	
	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
1. National tax burden	164.7	9.6	238.7	12.9	272.7	12.9	212.6	9.2
(i) National tax	143.5	8.3	216.0	11.7	249.7	11.8	186.1	8.0
(ii) Monopoly profits	21.2	1.3	22.7	1.2	23.0	1.1	26.5	1.2
2. Local tax burden	17.1	1.0	22.5	1.2	21.9	1.1	22.9	0.9
(i) Local tax	14.6	0.8	20.7	1.1	20.5	1.0	20.3	0.8
(ii) Education tax	2.5	0.2	1.8	0.1	1.4	0.1	2.6	0.1
G.N.P.	1720.8	100.0	1854.5	100.0	2107.1	100.0	239.6	100.0

Source: Economic Survey, 1962, p.221. Economic Planning Board, Republic of Korea.

**TABLE-16** **Tax Burden of Other Countries** (%)

Year	Korea			U.S.A.	Italy	Japan	Pakistan	Philippines	Thailand
	National Tax	Local Tax	Total						
1958	9.6	1.2	10.8	27.5	24.5	20.5	6.1	8.6	8.6
1959	13.7	1.1	14.8	27.8	24.8	19.9	7.9	8.2	8.9
1960	15.3	1.2	16.5	28.3	24.0	20.5	7.2	10.1	9.9

Source: Economic Survey, 1962, p.221, Economic Planning Board, Republic of Korea.

#### E. National and Local Tax:

There has been a steep disparity between the source of national tax and local tax over the last years. As shown in Table 17, in 1961 national tax shows 91% as a percentage of total tax whereas local tax has remained 8.9%. The reason for this seems that the large number of tax sources have been included in the national tax system; on the contrary, the source of local taxes have been eventually in a weak position with relatively small number of tax resources. In view of the magnitude of expenditures to be covered by the central government in the first stage of economic development, the number of taxes which should be included in the category of local tax system by nature, have been contributed to the source of national tax. The over-emphasis of tax source upon the national tax as such has resulted, consequently, in the fact that the heavy dependency of local finance upon the central government has been increased, receiving large number of various subsidies from the central government; and furthermore, this phenomenon has considerably retarded the independent activities of local government in the area.

The suggestion strongly made by the experts over the years towards the transformation of the local tax sources in character which has been kept in the hands of the central government to the local government, has succeeded its opinion at last in 1961.

In the tax reform of 1961, four taxes that is to say, land tax, entertainment and restaurant tax, parimutuel tax and automobile tax, are rendered to the local government in order to strengthen the source of the local tax so as to keep its sound activities for the development of the local government particularly in various kinds of local industries, education, sanitary facilities, and so forth.

It has been suggested by the government that by rendering these taxes to the

**TABLE-17** **Comparison of National and Local Tax** (In million Hwan)

	1958		1959		1960		1961	
	Amount	%	Amount	%	Amount	%	Amount	%
National Tax	168008	90.7	220737	92.5	265944	92.8	234100	91.1
Local Tax	17091	9.3	17313	7.5	20507	7.2	22800	8.9
Total	185099	100.0	238450	100.0	286451	100.0	256900	100.0

Source: Year Book of Tax Statistics, 1961, pp.266-267. Bureau of Taxation, Ministry of Finance.

local government, 20.8 billion Hwan can be increased in the revenue of local tax in 1962. Table 18 shows the change in the local tax system after the tax reform in 1961.

**TABLE-18**                      **Tax System after Tax Reform**

National Tax	Local Tax
Personal income tax	<u>Independent Tax</u>
Cooperation income tax	Land tax
Business tax	Entertainment & Restaurant tax
Inheritance tax	Automobile tax
Travelling tax	Parimutuel tax
Registration tax	Property tax
Assessment revaluation tax	Acquisition tax
Liquor tax	Slaughter tax
Commodity tax	License tax
Petroleum tax	
Permission tax	<u>Surtax</u>
Electricity & gas tax	Personal income surtax
Customs duties	Cooperation surtax
Tonnage tax	Business surtax

Source: Economic Survey 1962, p.239. Economic Planning Board, Republic of Korea.

## **VI. The Main Trend in Taxation Policy in Korea**

This chapter attempts to review some of the main trends in taxation policy which has been followed by the government of Republic of Korea over the last years, in order to be able to give a suggestion on tax reform appropriate to the process of take-off into self-sustained growth in the economy of Korea.

For the purpose of this chapter, the two different periods for taxation policy are divided from the point of view of the change in the economic and political environment. Those are firstly the period prior to the military regime, May 1961, and secondly the period subsequent to the military regime. The military revolution which took over the former regime on 15th May 1961, has drastically brought a considerable amount of upheavals in the phases of politics, economy and society. Particularly the fact that the tax reform of the military regime in 1961 has initiated the outstanding change in the tax system, gives the reason why the period for reviewing the taxation policy is divided as such in this chapter.

It should be kept in mind at the outset that the objectives of taxation policy in underdeveloped countries are to curtail that part of consumption that is likely to flow to undesirable directions, and channel it into desirable investments in the public and private sectors, by giving incentives to saving and investment. By doing so, the taxable capacity will be strengthened.

### **A. Taxation Policy Prior to Military Regime:**

The Korean war which occurred on the 15th June 1950, has brought a drastic change in the tax system. The enormous amount of expenditure for the war has

enforced the government to establish a number of new devices in the tax system such as the special tax law, temporary land income tax, and temporary tax collection law etc.

In general, it seemed that the taxation policy during the Korean war was mainly concerned with the increase in the revenue of the government but not with the stimulation of economic incentives. One of the most striking points of the tax policy during the Korean war was the temporary land income tax which has contributed a considerable amount of yield to the government revenue.

The temporary land income tax was enacted in September, 1951, especially this tax had been collected in kind rather than in cash. The purpose of the establishment of the temporary land income tax had aimed at three points. First of all, it was motivated by the urgent need to raise a maximum of revenue from every available source particularly from the agricultural sector as the largest and most important in the Korean economy. Secondly, it aimed at the supply of rice for the army, national police, and the sizeable relief population. In addition, government workers and employees in government owned enterprises, including the railroads, utilities, mines and various manufacturing plants, received a rice supplement as part of their wage. Thirdly, it aimed to protect the city population against the increasing food price and recurrent food shortage with the rationing program of rice whose price was at the low official price. Furthermore, it was used as an instrument for anti-inflationary fiscal purposes.<sup>1)</sup>

The temporary land income tax rapidly became the largest single source of government revenue in Korea. In the budget estimates for 1953 to 1954 the tax accounts for about one-fourth of the total receipts as shown in Table 19.

As to the examination of the temporary land income tax collected in kind, the three points that should be taken into consideration in the operation of this tax can be pointed out. Firstly, the severity of the rate schedule and the absence of allowances for size of family appeared not to be acceptable to the government. Moreover, one should not overlook the fact that the tax was designed as **temporary** rather than the long term desirability of the provision for collections in kind.

Secondly, during the period of execution of this tax, the population of the agricultural sector had been severely suffered from the fact that the price of rice that they had to pay in kind was at the low official price which was below the price in the free market.

Thirdly, the fact that the tax served to control over the system of prices and wages was not considered as an advantage for the reason that the price structure could not respond to the inter-play of market forces. For a number of various reasons the temporary land income tax was abolished in 1961 and was substituted by the land tax collected in cash.

Apart from the temporary land income tax which was one of the most characteristics in the tax system during the period, some other defects involved in the tax system, had inhibited the economic growth particularly with regard to the

1) Haskell P. Wald, "Use of tax collections in kind to combat inflation in the Republic of Korea", Public Finance, 1954, pp.180-181.

TABLE-19

## Tax Revenue of Cental Government

(Unit: million Hwan)

	FY 1963-1954
Temporary land income tax	6,178
Personal income tax	3,554
Corporation tax	583
Inheritance tax	17
Business tax	3,276
Commodity tax	1,489
Textile tax	798
Liquor tax	3,077
Monopoly profit of government	4,000
Entertainment & Restaurant tax	663
Admission tax	173
Travelling tax	169
Customs duties	659
Others	656
Total:	24,812

Source: Outline of Budget 1953-1954, Ministry of Finance, Government of Republic of Korea.

incentive to save and invest. Firstly, the exemption of income from tax in the case of savings and investments was rather neglected in general. Especially, the tax has not offered a sufficient allowance for depreciation. Furthermore, the new investments were not given a special treatment in the tax system. It is obvious that this has resulted in the slow-down, or even resulted in retarding economic development in general. In addition, the family allowances were excluded within the personal income tax, and the exemption point for low income level from tax was not at the adequate level in the light of required cost of living in that period.

Secondly, one of the great defects in the tax system has lied in the method of assessment. Over the years, conventionally the assessment of income has been based on unilateral guess by the tax authorities, but not on the book-keeping. This has been due to, in general, a several number of reasons such as the lack of book-keeping system, the incomppliance of the people, dishonesty of people, and inefficient tax service employees, as has been indicated in Chapter III.

Thirdly, there was a steep discrepancy between the source of national tax and that of local tax, which resulted in a weak position in the finance of local government. On the whole, the system during the period seemed not to be conducive to the development, especially with regard to the task of taxation policy in the process of self sustained growth.

#### B. Taxation Policy after the Military Regime, 1961:

The drastic change in the tax system has taken place with the tax reform of 1961 by the Military Regime. As we have seen in the foregoing section, the tax system prior to the Military Regime was not in a conducive

situation for the accomplishment of objectives of taxation policy owing to the existence of such factors as the lack of compliance of the people, lack of correct book-keeping system, the inefficiency in the tax administration and so forth, in the main.

Let us see what are the main points brought in the tax reform of 1961.

(a) The Improvement in Tax Administration:

There has been a considerable amount of defects stemming from the inefficiency in tax administration in the tax system, particularly due to the unilateral assessment by the tax authorities on the basis of presumption, and relatively high tax rates improper to incentive point of view. Above all, the method of unilateral assessment by the tax authorities has been at stake over the years. It would seem that there are two fundamental reasons for choosing the method of unilateral assessment. First of all, it is difficult to assess income without correct book-keeping, which has been mostly lacking in the small business firms and especially in the rural sector, in Korea. There seemed to be no way of assessing the income other than the method of unilateral assessment by tax authorities. Secondly, people do not try to record the book-keeping in a correct and honest way in order to evade from the tax imposition. These two reasons seemed to serve the justification for the method of unilateral assessment.

The unilateral assessment by tax authorities has resulted most of all in the corruption in the tax administration in such a way that the tax payers usually offer the tax collectors or high officials of tax administration various forms of bribery for reducing the amount of their tax burdens. Especially the fact that the tax collectors are paid a low salary has enhanced the corruption in the tax administration as such. Moreover, this has been one of the crucial factors for the poor amount of tax collection.

In rectifying this acute problem in tax administration, the military regime has abolished the method of unilateral assessment and introduced the book-keeping system that the tax-payers of income tax, corporation tax, and business tax have to keep correctly and honestly. In addition, the system of voluntary payment of tax was introduced by rendering a 10% discount of the amount of tax to those whose tax has been paid by the tax day.

As for the tax delinquent, the law of severe punishment is made against the irregular activities or leaking of secret matters by tax officials and also tax payers.

(b) The Emphasis of Indirect Tax in the Tax System:

In view of the need to finance a huge resource for the first five-year economic plan, the reliance of tax revenue has put heavily on the indirect taxes. In the budget of 1962, the indirect tax as a proportion of total tax revenue is 70% as shown in the study of tax structure in Korea-Chapter V.

In this respect, the rate on luxurious consumer goods and entertainment activities is increased sharply. Particularly, the emphasis of indirect taxes can be seen in the several taxes within the indirect tax, such as liquor tax, commodity tax, petroleum tax and admission tax. The overall rate on liquor tax is increased, and high rate on non-necessities is designed within the commodity tax. We can see in Table 20 that the tax rates have been drastically raised on those commodities



**TABLE-20** **Commodity Tax Rates**

Commodity type	Before revision	After revision
Raw wool	36%	45%
Wool top	40%	50%
Impreted woolen yarn	45%	60%
Cotton yarn	10%	10%
Hemp yarn	10%	10%
Commodity	Presently in force	Revision
Staple fibre	10	10
Filament yarn	10	10
Other fibre products	15	15
Tire cord yarn	10	10
Imported textiles	35	40
Saw hides	10	10
Resin	30	40
Raw products	20	20
Cellophane products	2	2
Sheepskin	10	10
Aluminium	5	5
Flat glass	10	10
Plywood	10	10
Molasses	5	5
Raw sugar	10	10
Resh drinks	150 (a kg)	Hw180 (a kg)
Coffee and tea	23 (per liter)	Hw 30 (per liter)
Chemical fibre	20	20

Source: Year book of Tax Statistics 1961, Bureau of Taxation, Ministry of Finance, Republic of Korea.

that are usually for higher income brackets.

The petroleum tax is separated from the commodity tax in order to ensure the sufficient collection of its taxation. The tax rate on gasoline was raised by 50%, whereas the rate on heavy oil and other petroleum used by the essential industries was lowered as can be seen in Table 21.

**TABLE-21** **Rate of Petroleum Tax**

Type of Oil	Before revision	After revision
Gasoline	200%	300%
Kerosene, light oil	20%	20%
Heavy oil	20%	10%
Other petroleum goods	20%	10%

Source: Ibid.

In the admission tax, the overall increase in the rates on the admission into movie houses and billiard halls is made by 10 per cent over the previously applied level, as shown in Table 22.



medium.

Finally, the rate of exemption from the foreign exchange earnings accruing from the exports, service for U.N. forces and sight-seeing business for foreigners is raised from 20%—30% to 50%, thereby stimulating the business of foreign exchange earnings.

(ii) Corporation Tax:

Firstly, the previous classification of public and closed (family) corporations is abolished. The tax rates for corporations which increase the capital stock is reduced by one half for five years from the date of the increase in capital stock.

Secondly, the considerable rate of exemption from the machine industry, fishing manufacture, and dairy are made.

Thirdly, the tax relief measures, applied previously mostly to manufacturing industries, are made applicable even to power, mining and fishing industries.

Fourthly, as in the case of income tax, the tax reduction rate applied to such industries earning foreign exchange is raised from the previous 20 or 30% to 50% in the case of corporation tax. For the tourist industry a new system has been established under the revised tax law.

Fifthly, in expanding industrial facilities the former tax law prescribed to apply the tax relief on newly installed production facilities worth no less than Hw 600 million or on expanded facilities worth no less than Hw 300 million. The tax reform, however, brought that the limited scope is lowered to the level of 50 million for newly installed production facilities.

(d) The Strengthening of the Source of Local Tax:

The four taxes that had been included within the national tax before the revision of tax has been rendered to the local tax. Those are, land income tax, entertainment and horse race tax and auto-tax to strengthen the local finance, as mentioned in Chapter V, the section of discrepancy between the national tax and local tax.

## Conclusion

Taxation has been assigned an increasing significance in the process of economic development in the now underdeveloped countries, in the sense that it has to be utilized as an instrument for increasing the saving ratio and investment. Quite a large number of problems, however, have remained in the accomplishment of the objectives of taxation policy as has been studied in Chapter II.

The most serious antinomy involved in the task of taxation policy in the underdeveloped countries lies between the problem of incentive to save and invest, and that of increasing the government revenue through taxation for the development financing. Nevertheless, this very antinomy could be overcome by giving the incentive features of tax to those who are bound to save and invest, and by imposing heavy rates of tax on the part of income that is likely to flow into undesirable directions such as hoarding of money, storing specific commodities for the purpose of speculation, luxury consumption and so forth.

This assumption brings eventually that the tax structure in the initial stage of economic development in underdeveloped countries has to be shaped to fulfil the above consideration.

What should be the tax system in order to achieve the objectives of taxation policy in underdeveloped countries, seems to be as follows:

The surplus of income in an economy has to be collected through taxation in order to be able to finance the government program as much as possible. On the contrary, the tax system has to have the features of incentive to save, to invest and to take risks for stimulating the entrepreneurial activities by which the industrialization can be enhanced. Our concern in this conclusion is what are the available tax tools in underdeveloped countries under this assumption and how it should be fashioned in the tax system.

First of all, the direct tax in underdeveloped countries could not be an instrument of mass taxes in the short run under the prevailing condition. In the personal income tax, however, it should be based on the principle of progressive rate, in view of the financing contribution to economic development, in spite of the fact that it is covered only by a relatively small proportion of the income earners. That is to say, the higher the income, the greater the capacity to contribute to the financing of economic development through taxation. Particularly as the national income increases, the medium income group especially in the urban area, for instance, a substantial part of salariate, the skilled workers, as the broadest base of taxable income, has to be covered by income tax.

What is more important, however, is the question of the incentive aspects of taxation for saving and investment. The partial exemption of saving from the income tax may be best secured by the imposition of an expenditure tax. But in view of the infeasibility of tax administration, the adoption of expenditure tax would be premature to experiment in underdeveloped countries, as has been discussed in Chapter III. Therefore, it would be better to, for the time being, concentrate on the more effective administration of the income tax and provide for a scheme of exemptions in the structure of the income tax. The exemption of the interest on all savings deposits and postal saving seem to be a quite feasible device in this connection.

As for the company tax the grant of an investment allowance has to be given to a number of concessions for the development of industry. The concessions have to be given to corporated as well as unincorporate enterprise for the expansion of enterprises. However, it must be remembered that in giving the incentive to the enterprise, the concessions have to be given only to those enterprises who otherwise could not increase saving and investment. Furthermore it is desirable to give special rebate on export industry. In general, it would seem that the company tax cannot be a big contributor to the government revenue, in its amount. In most of underdeveloped countries, the majority of the working population is engaged in agriculture. In this regard, the substantial part of tax revenue must be contributed by the population of agriculture. But in reality such taxation of agriculture has been unable to contribute as such, owing to the large number of subsistence cultivators as well as the predominant non-monetized sector

in the rural area. It would be possible, however, that the imposition of taxation on the part of agricultural population may enforce farmers to cultivate the cash crops thereby enhancing the expansion of monetization in rural area. It is desirable also to have gradual adaptation of a separate income tax on agriculture in order to increase the agricultural tax receipts. In addition the larger land owners are to be levied by higher real estate or property taxation.

Secondly, the indirect taxes seem to be the main source of the government tax revenue for many years to come in the now underdeveloped countries.

Tax on commodity has to be shaped in such a way that the growth in the consumption of non-essential or luxury goods can be checked. Commodity taxation is generally regarded as being favourable to saving, because it falls only on that part of income which is spent.

In view of the need of contribution to governmental revenues, from the bulk of population, it may be desirable to levy taxes on certain goods of mass consumption. However, care must be taken in this connection about the basic necessities that are widely consumed by a very large part of the population who are living with the low levels of income. Moreover, it is desirable to increase the production of basic necessities in view of the increasing number of population.

In bringing about the automatic increase in the government revenue with the growth of national income, certain commodities have to be chosen for excise taxation. The favourite choices for this purpose seem to be the commodities liquor and tobacco that are subject to low price-elasticity of demand, thereby providing a good amount of government revenue. Besides, the commodities like radios and electric appliances seem to be adequate for excise taxation as well.

It may be useful that the sales taxation is levied in the form of a general retail sales tax for the sake of simplicity and administrative convenience. This can be more easily shifted to the consumers without taking many steps of shifting its burden. However, the basic necessities have to be excluded in the sales tax.

As for taxation of services in underdeveloped countries, the entertainment and passenger transport are levied. The relatively high rate may be desirable on the luxurious entertainment and special treatment seems to be necessary with regard to the taxation of internal transport of commodities whose activities are of significance in encouraging the expansion of transportation of goods.

Import duties should be designed in the light of development of domestic industry. The exemption of goods from the import tax, that are indispensable for the development of industry, is desirable and on the contrary the high rate or prohibit rate on the non-necessaries or luxuries can be imposed. However, in view of the important role of foreign investment at the initial stage of development, the preferential treatment of tax on the foreign investment has to be elaborated within the tax structure.

The scheme of tax system described above would lead to the proximate road to the task of taxation policy in underdeveloped countries by designing a broad-based, equitable and progressive system within direct taxation which would automatically raise the government revenue as the economic growth takes place, and at the same time promoting the saving and investment with the incentive features of taxation.

On the contrary the large portion of government revenue can be collected through the indirect taxation which is designed to restrain the increase of consumption on non-necessities and luxuries as national income increases, but to exclude in the tax or rather promote the production of basic necessities for the mass population.

This scheme of tax system might be called income elastic in character, which is a very important factor, in not only automatic increase of government revenue but in the principles of progressive contribution to economic development. Under this scheme, however, the government revenue would not increase considerably in the short run, but on a long view it would promise to secure the increase in the government revenue. Therefore, it would seem that in the first stage of economic development in underdeveloped countries, one could not expect much amount from the taxation for the financing of economic development. This fact leads us to eventually the importance of foreign resources for the development.

Finally, one of the most deeply rooted difficulties in the tax system in underdeveloped countries is the problem of tax administration. It is fairly true that the effort of tax scheme towards the economic development would be in vain without the support of effective tax administration that has been lacking in many of underdeveloped countries. The most important factors which have retarded the efficiency in tax administrations are the lack of well trained tax services, the low salaries in tax services, the lack of compliance of the people, and the general lack of a propensity to accept innovations. Thus, considerable effort has to be paid to the training of the tax officials, the improvement of the salaries of tax services, and trying to make people to act in compliance with the government policy. Besides, the correct and honest book-keeping system has to be encouraged for the correct assessment.

We have seen a number of main points in the tax reform of 1961 in the previous section. Our concern in this connection is how far this tax reform could be conducive to the objective of tax policy in Korea. The examination of tax reform will be done and some suggestion on the further consideration of tax system will be given in the light of the objectives of tax policy in underdeveloped countries.

On the whole, it can be said that a certain amount of efforts towards the development have been made in the tax reform in 1961, with several important tax devices as mentioned in Chapter VI. Nevertheless, some points which have been not elaborated in the tax reform can be found in the following.

First of all, we start with the impact of the tax reform as a whole upon the people. The most striking characteristic of the tax reform is represented in the emphasis of indirect tax. As a general rule the incidence of indirect tax is likely to lead to the rise in price in those sectors that are not effected directly by indirect taxes because the entrepreneur will use the general increase in prices, so increase their prices as well. This may have dangerous psychological effect on the prices.

Secondly, as for the question of tax administration, although several devices insisted by the experts over the years have been introduced, for instance the

abolition of unilateral assessment by tax authorities, the further consideration should have been taken in this connection. As we have discussed in Chapters II and III, the factors that retard the modernizing of the tax structure in underdeveloped countries are found in the tax administration. What the tax reform in 1961 should have considered in addition to the abolition of unilateral assessment and discount system of collection, are related to the efforts to improve and to train the government tax services. The next effort is to increase the level of salaries of tax services. It is true that most of tax services have been ill-paid over the last years. Consequently this has resulted in a tremendous amount of corruption, bribery and inefficiency in the tax administration as a whole. Finally, the effort will have to be made considerably in the compliance of people through the interview of tax services with the tax payer and mass education.

Thirdly, the over-all increase in the petroleum tax may inhibit the activities of transportation which is considered important in the process of industrialization. The present preferential rate which is limited only to the important sector of industry, will have to be expanded to other sectors so as to promote the development of transportation. Moreover, the increase of the rate would raise the transportation fee that is likely to effect the increase in other prices.

Fourthly, as to the full exemption of the interest of deposit in the bank from tax, what one doubts is how far this can induce the saving under the prevailing political situation. The ultimate resolution to the increasing of saving lies rather on the political environment favourable to saving, particularly in Korea where the unstable political condition has been going on for a long time now.

Fifthly, the one important device to be taken in income tax is lacking in the tax reform. That is the system of allowance for family. It should be considered in income tax not only from the equity point of view but also from the securing of the basic level of life.

Sixthly, as for the land income tax, the exemptions from the land tax are adapted for a number of years for the new cultivation of the land which is desolated, so as to encourage the reclamation of land. The land tax has been based on the gross produce of land in a given year.

The tax on agricultural income has to be adapted gradually according to the given situation during the transitional period, for modernizing the tax structure, in view of the lack of inadequate records system in rural areas.

Last, but not least, we come to the problem of special tax devices for foreign investment which is one of the most significant questions in the process of economic growth. The special tax incentive for foreign investment is desirable not only to attract the investment, but also to recruit foreign technicians and teachers of know-how.

On the whole, the tax policy at present in Korea, is to be aimed at meeting the increasing government expenditures needed for the development on the one hand, and giving the incentives to saving and investment on the other hand. Increase of revenue should be secured by the revenue yielding activities. This eventually brings us to the heavy contribution of tax on the part of the mass of the people, at the first stage of development. However, on a long view, the

development of the years to come has to be looked upon as a foundation for further development in the future.

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