Developmental State and the Political Economy of Taxation in East Asia

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Abstract

A tax structure of a country is affected by its political economic structure. European welfare states tend to have a larger total tax revenue supported by a high personal income tax rate. Anglo-American states have a smaller total tax revenue and relatively higher capital tax burden. East Asian economies with developmental states such as Japan and South Korea have maintained a small-size government dependent upon the tax revenue from corporate sectors. Previous studies point out that there has been a convergence of tax policy to reduce capital tax burden among the industrial democracies due to the neoliberal tax competition since 1980s. Although we observe a convergence of top corporate tax rate among the industrial democracies, the analysis of the tax structure shows the remarkable continuity in East Asian countries. This study argues that the origins of the tax structure in Japan and Korea can be found from the legacies of developmental state. While there was a compromise between capital and labor in European welfare states, East Asian developmental states subsidized the industrial capital and suppressed the organized labor. As a compensation, the tax burden of labor in Japan and Korea has been the lowest among industrial democracies.
Introduction

Recently the political debates about taxation became a major issue in electoral politics in Korea and Japan. Due to the changing economic and social environments, both Korea and Japan need to strengthen their welfare capacities. Although there are consensus that the active government responses to rising inequality and aging society are necessary, it is difficult to figure out how to increase the tax revenue to fund the projects. In this paper, we will clarify the major characteristics of taxation in Japan and Korea by focusing on the political economy of developmental state and explain why the share of corporate tax to the total tax revenue in Japan and Korea is larger than other OECD members.

There are rising concerns about the inequality among many OECD members since the global financial crisis of 2008. Japan and Korea are not exceptions, although they are considered to be relatively equal countries until 1990s. In figure 1-(a), Korea and Japan are not equal societies among OECD members anymore. In addition to the rising inequality between the rich and the poor, they are the most fast aging societies among the OECD members. The share of the elderly population in Japan grow from 17.4% in 2000 to 25.1% in 2013. During the same period, the share in Korea changed from 7.2% to 12.2% (OECD 2016b). Due to the rise of inequality and the increase of elderly population, there are strong demand for the welfare programs in Korea and Japan. However, Korean and Japanese governments are the least effective in terms of government redistribution. According to figure 1-(b), Korea and Japan belong to the group where the effect of the government redistribution on the distribution of disposable income is minimal. They are next to Mexico, Chile, and Turkey.

Japan became one of the largest economy in the world with the economic success after World War 2. Korea also achieved impressive economic growth since 1970s with a set of government-led industrial policies. In spite of the economic success, the development of social welfare in both countries has been less successful. Both countries are facing serious challenges such as rising
inequality and aging society. Among the mainstream parties and voters in general, there is a consensus that active government responses are necessary. However, there are diverging opinions on how to mobilize the resources for active government programs. The expansion of welfare program requires additional tax revenue. There are growing disagreement on the size of additional tax revenue for the active government responses.

Figure 1. Inequality and redistribution in OECD members
(a) Gini coefficient of disposable income inequality in 2014 (or latest year), 2010 and 2007

![Figure 1(a)](image)

From figure 1 (OECD 2016a).

(b) Percentage reduction of market income inequality due to taxes and transfers, 2007 – 2014

![Figure 1(b)](image)

Notes: Redistribution is defined as the difference between market income and disposable income inequality, expressed as a percentage of market income inequality. From figure 5 (OECD 2016a).
After the World War 2, Japan and Korea have maintained the size of the government small compared to other advanced economies. They are typical examples of ‘developmental state’ where the government initiated export-driven economic growth. To promote economic growth, the governments in two countries organized market based on the close linkage between the government and business. The government provided low interest rates, tax exemptions to support strategically important export-industries such as steel, car-making, electronics, etc (Johnson 1982; Amsden 1989; Haggard 1990). Total tax revenue in Japan and Korea is below the OECD average (Table 2). Social safety net in Japan is a mixed system where the welfare contributions from corporations and family members are significant in addition to weak government welfare policies (佐藤滋・古市将人 2014).

Japan established a low-burden small welfare state where the welfare function of the government is limited and the tax burden is low. Korea adopted Japanese model of low-taxation and weak-welfare policy.

However, the mixed welfare system dependent upon the contribution from corporate sector is not sustainable anymore due to the changing labor market and demographic change. Increasing non-standard employees are highly vulnerable to the risk since the corporate welfare is only provided for the standard workers (Kwon 2014). If the portion of non-standard employment increases, then the traditional approach with strong corporate welfare in Japan and Korea will not be effective. Moreover, younger generation nowadays in Korea and Japan is not able to afford to support their retired parents, different from the baby boomers who took care of their parents after their retirement. High level of youth unemployment rate implies that the baby boomers should take care of their child(ren) in addition to themselves after the retirement. Therefore, private welfare provided by family members, usually by their children after their retirement, will not work either.

This paper aims to point out that the low tax regime in Japan and Korea originated from the legacies of developmental state. Kwon (2014) and Yang and Min (2013) already examined the relationship between the developmental state and tax regime in the two countries. According to their
studies, the low tax regime in Japan and Korea can be explained by the dominance of conservative parties and export-oriented production strategy under the developmental state. Different from the previous literature, in this study, we focus on the coordination mechanism of developmental state with a close connection between the government and business excluding organized labor. This relationship contributed to the increase of corporate taxation instead of indirect taxation.

The political economy of taxation

After the beginning of the race-to-the-bottom international tax competition since 1980s, there are growing interests in political determinants of tax policies. Tax competition literature assumes that the government merely responds to the international pressure of tax competition (Zodrow and Mieszkowski 1986; Huber and Stephens 2001a,b; Ross 2000). However, instead of the convergence to low tax rates due to the tax competition, we observe a cross-national variations in terms of the responses to the tax competition. Since the important decisions on the taxation are made through the political process, previous literature tries to identify the domestic political determinants of tax policies. They can be categorized in three different groups.

First, the partisan balance of power between the left and the right explains the patterns of tax policy. Following Hibbs (1977), the application of partisan politics to taxation implies that the leftwing parties, representing the interest of the labor class, are more likely to resist the corporate tax competition which transfers tax burden to labor if the size of the total tax revenue is fixed. However, if the partisan balance of power favors the rightwing parties representing the capital, then the capital tax burden is likely to be transferred to the labor by the capital tax cut and the rise of income tax or regressive consumption tax (Basinger and Hallerberg 2004; Swank 2006). However, Genschel (2002) points out that a leftwing government may pursue a conservative neoliberal
liberalization to promote competition between domestic and foreign capital as a reform against the established domestic capital.

Second, the types of political institutions and the number of veto players affect the structure of taxation. Hays (2003) argues that consociational democracies are likely to adopt moderate level of capital taxation while the labor also contributes through the indirect taxation. In a winner-takes-all politics under the two-party system, the labor tends to form a majority and to increase the capital tax burden. However, in a consociational democracy in a multi-party system, both the capital and the labor have incentive to negotiate. They are likely to end up with an agreement with a moderate distribution of tax burden between the capital and the labor.

Third, there are a group of studies emphasizing the importance of the national system of political economy. Garret (1998) emphasized the interaction between the partisan politics and the national system of political economy. He argue that a leftwing government would maintain a big government in spite of the pressure from globalization when it is combined with corporatism. Summers, Gruber, and Vergara (1993) argue that labor tax burdens are more higher in more corporatist nations, while nonlabor taxes are actually lower. This is consistent with the explanation that the corporatist states in western and nordic Europe adopted regressive consumption tax to enlarge the tax base for the welfare system (Kato 2003; Buggeln et al 2017).

These three factors are useful to explain the experience of the taxation in Korea and Japan. Previous studies on the political economy of taxation in Korea and Japan emphasize the importance of the dominance of the rightwing conservative parties in both countries. During the time of fast economic growth, Japan was dominated by the conservative Liberal Democratic Party from 1955. In Korea, since 1960s, after the military coup by General Park Jung Hee, the conservative parties initiated by the former military officers had ruled until the democratization in 1987. Kwon (2014) emphasizes the significance of the dominance of the conservative parties in both countries to explain how they maintained small-sized government. Both Japan and Korea were governed by the
coalition of conservative party and big businesses. In addition, Kwon also points out that Korea and Japan went through a different path. Korea was able to adopt the value added tax in the late 1970s based upon the powerful authoritarian military government, while Japan did it later in spite of its early plan due to the domestic opposition against the adoption of regressive consumption tax. Kato(2003) makes a similar point indicating that Korea and Taiwan, both are ruled by authoritarian leaders, adopted regressive consumption tax. Due to the dominance of the growth-oriented conservative parties in Korea and Taiwan, they utilized the stable tax revenue from indirect taxation for further economic growth, instead of the expansion of welfare. Although Japan had a similar purpose, due to its democratic political system, the adoption of regressive consumption tax had been delayed many times due to the oppositions. In this sense, the difference in political institutions between Korea and Japan made a difference in terms of the adoption of consumption tax. Yang and Min(2013) argue that the export-oriented developmental state in Korea pursued efficiency and growth through a small state. The national system of political economy in East Asia, defined as a developmental state, was a critical factor to explain the low-tax small-welfare state in East Asia.

From the perspective of the varieties of capitalism proposed by Hall and Soskice(2001), arguably Korea and Japan can be categorized as coordinated market economies. Both Korea and Japan do not have a centralized wage bargaining mechanism, different from the corporatism in western and northern Europe with centralized bargaining mechanism between the business and the labor. Instead of incorporating labor into the centralized wage negotiation, neo-corporatism practiced in Japan does not incorporate the labor(McNamara 1996). Korea also adopted a similar approach. Until 1992, the Democratic Labor Union, one of the union at the national level, had been illegal. Labor had been excluded from the table, while the government and big businesses are closely linked with each other through industrial policies supporting export-oriented big businesses and their political support for the conservative government. Instead of the coordination between the capital and the labor, the government’s export promotion strategy in Japan and Korea maintained
low-income policies to aid the competitiveness in the export market and suppress the consumer price inflation (Kume 1998; Suh 2008).

If we apply the framework of ‘varieties of capitalism’ by Hall and Soskice (2001) to the taxation, East Asian economies can be categorized as an independent group. East Asian economies are similar to liberal market economy in a sense that they also maintain the size of government relatively small. However, East Asian economies are different from the liberal market economy since they adopted non-market mechanism in the labor market. Compared to the coordinated market economy in European corporatist countries, East Asian economies are also different from them because the non-market coordination mechanism excludes labor. The government works as a director for export-led economic growth. To maximize the international trade competitiveness of the domestic producers, the government suppressed the labor wages and reduced the tax burden by making the size of the government small.

<table>
<thead>
<tr>
<th>LME</th>
<th>CME</th>
<th>EAE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size of government</td>
<td>small</td>
<td>large</td>
</tr>
<tr>
<td>labor market coordination</td>
<td>market</td>
<td>non-market</td>
</tr>
<tr>
<td>role of government</td>
<td>regulator</td>
<td>mediator</td>
</tr>
</tbody>
</table>

Table 1. National system of political economy

LME: liberal market economy, CME: coordinated market economy, EAE: East Asian economy

Table 1 shows us the major characteristics of East Asian economy compared to liberal market economy and coordinated market economy. During the period of fast economic growth, East Asian developmental state worked effectively. However, when the governments need to expand their expenditure partly because of the slowdown of economic growth, it is difficult for the government to increase the labor tax burden due to the suppression of the labor in the past. As the developmental state weakened, Korean government and Japanese government are unable to increase
the burden. Sato and Furuich(2014) claimed that the resistance against the tax increase among the middle class is extremely strong compared to other advanced economies. Therefore, the introduction of regressive consumption tax failed several times during 1980s and 1990s. After the Asian Financial Crisis of 1997, with the concentration of wealth to the conglomerates, Korean middle class started to argue that the corporate tax should be increased as a tax on the rich. This legacy of the developmental state partly explain why the portion of corporate tax to the total tax revenue is large in Japan and Korea.

The structure of tax revenue in Japan and Korea

The structure of tax revenue in Japan and Korea is different from the one of other developed economies. As table 2 shows us, compared to many advanced economies, the size of government, total tax revenue to GDP, is relatively small. The size of government in Korea and Japan has been smaller than the OECD average.

<table>
<thead>
<tr>
<th>Year</th>
<th>Japan</th>
<th>Korea</th>
<th>OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>20.1</td>
<td>12.4</td>
<td>26.93</td>
</tr>
<tr>
<td>1982</td>
<td>25.88</td>
<td>16.97</td>
<td>31.14</td>
</tr>
<tr>
<td>1992</td>
<td>26.65</td>
<td>18.45</td>
<td>32.73</td>
</tr>
<tr>
<td>2002</td>
<td>25.76</td>
<td>21.95</td>
<td>33.23</td>
</tr>
<tr>
<td>2012</td>
<td>29.42</td>
<td>24.78</td>
<td>33.44</td>
</tr>
</tbody>
</table>

Revenue Statistics (OECD 2017)

It is evident that both Japanese government and Korean government designed the structure of taxation to mobilize resources for economic growth as a late industrializer. After the World War 2,
the Shoup Mission from the United States recommended to establish a comprehensive tax system in
the *Report on Japanese Taxation by Shoup Mission* published by the General Headquarters
(Brownlee 2009). However, after the San Francisco Treaty in 1952, Japan started make policy
decisions autonomously. To mobilize the resources for rebuilding the economy after the war,
Japanese government revised the tax policy by identifying capital gain as a separate source of
taxation in addition to the adoption of subsidies to encourage savings such as the tax exemptions for
the small-scale savings. During 1950s, Japanese government introduced the reduction of personal
income tax burden and the tax exemptions to reduce corporate tax burden to accumulate and
mobilize capital for economic growth(Kook 2004: 106-108). This framework continued until late
1970s when Japanese government started to suffer from the increasing fiscal deficit.

Korean government also established a tax system to promote economic development. After the
military coup, the new government set up a 5-year plan for economic development. The government
also reformed tax system to promote the economic development with the plan. One of the important
component of the new tax system is to encourage savings and investments for the growth of
national economy(Lee and Jeon 2003). Although Korean government went through yearly tax
reforms, the framework of taxation continued until late 1980s.

Another important component of the structure of taxation in Korea and Japan is a large share of
corporate income tax to total tax ratio, compared to OECD average where the portion of personal
income tax is substantial. Figure 1 shows us the share of major taxation to total tax revenue as a
percentage from 1980 to 2014. The share of corporate tax, personal income tax, and indirect
consumption tax is indicated by blue, red, and yellow line. In the United States, a typical example
of Anglo-American liberal market economy, the share of personal income tax is significant while
the portion of indirect taxation is smaller than Germany, Sweden, and Korea. In fact, the United
States does not adopt value added tax, different from the other 4 countries in the figure 1.
Germany, as a representative of a continental coordinated market economy, shows a similar pattern where the personal income tax is the most important source of tax revenue with its share reaching almost half of the total tax revenue. Compared to the United States, the portion of consumption tax is more significant. In Sweden, a Nordic welfare state, the share of personal income tax is larger than the share of corporation tax and consumption tax, although the portion of direct taxation is smaller compared to the United States and Germany. In Sweden, the significance of indirect consumption tax has been increasing, while relatively large share of corporate taxation declines. Although there are variations among the composition of tax revenue of the three countries, we can find a similarity among them: the personal income tax is the most important source of tax revenue.

However, the composition of taxation in Korea and Japan, typical examples of East Asian developmental state, is significantly different from the three countries in the figure 1. In Japan and Korea, the portion of corporate tax and the share of personal income tax are similar to each other over time, compared to the case of United States, Germany, and Sweden where the revenue from the personal income tax is larger than the corporation tax.

Previous studies interpret this observation by arguing that the personal income tax burden is small in Korea and Japan (Yang and Min 2013; Kwon 2014). However, this study want to focus on the corporate taxation. In case of Japan, compared to the US, Germany, and Sweden, it is more persuasive to argue that the percentage of corporate tax to total tax revenue is significantly higher than other countries rather than the share of personal income tax is small. Since 1980, according to figure 1, the percentage of corporate tax to total tax revenue has been maintained around 40 percent. This number is significantly larger than the share of corporate tax in the United States (around 20%), Germany (around 20%), and Sweden (around 30%-20%). In case of Korea, in spite of the race-to-the-bottom international tax competition for capital investment, the share of corporate tax to total tax revenue is continuously increasing.
It should be pointed out that the discussion here focuses on the composition of the tax revenue. According to table 2, Korea and Japan maintained the size of the government small. Therefore, the nominal corporate tax burden for the corporations in Korea and Japan would be smaller than the nominal tax burden of the firms located in the United States, Germany, and Sweden.
There are a few distinctive characteristics of taxation in Korea and Japan from comparative perspective. First, the total tax revenue as percentage of GDP is small, similar to Anglo-American liberal market economy. Second, the dependency on the corporate taxation is significant. Third, although the two countries show similarities, they are different with respect to the share of the consumption tax. Korea adopted value-added tax since late 1970s. However, Japan adopted the consumption tax much later in 1980s after a few failures to launch it.

**Legacies of developmental state and the taxation in Korea and Japan**

It is natural to argue that the small government with low tax burden in Japan and Korea is originated from the legacies of the developmental state. Although the size of government is rising due to the stronger demand for the active government responses to inequality and aging society, the basic framework is still maintained in both of the countries. In both countries, the small government has been sustainable due to the private welfare contribution from corporate sector and from family members (Yang and Min 2013; Kato 2003; Sato and Furuich 2014).

However, the experience of small welfare state with the significant private welfare contribution became a significant source of powerful resistance against the tax increase. Due to the importance of the private contribution in the past, the voters in Japan and Korea failed to establish the belief that the tax they paid will be used for their welfare. Kato(2003) argues that the voters in European welfare state know that the tax they paid will be compensated by the government welfare program, while Japanese voters do not have a similar perception. This is one of the important foundation for the strong opposition against the tax increase among ordinary voters.

In European coordinated market economy where the corporatist wage bargaining has developed, the labor actively participates in the negotiation with the business for the long-term burden-sharing. As Summers et al(1993) point out, the active participation of the labor in the decision making
process increases the contribution of labor tax. In Japan and Korea, the government and bureaucrats have a strong connection with the big businesses, while they continued to exclude the organized labor from the decision-making processes. However, different from the past, the growth rate of Japanese and Korean economy slowed down. Fast growth allowed the government to suppress the labor since the outcome of the fast economic growth is partly distributed to the labor. This mechanism does not work with the new normal. In addition, the democratic transition in Korea also encouraged the labor to have a voice during the election.

Japanese government continued to request burden sharing to the business community to increase the corporate tax since the proposal to increase the labor tax burden faced strong opposition (Brownlee and Ide 2017). This observation is consistent with the legacies of developmental state where the labor had been excluded and suppressed. This explains the share of corporate tax increases in Japan (figure 1). The case of Korea is different from Japanese case. After the democratization in 1987, the National Assembly, the legislature in Korea, started to increase its influence on the tax policy, different from Japanese case where the Ministry of Finance maintained strong influence on the tax policy. The agenda for tax policy is initiated by the majority in the National Assembly. When the liberal parties acquire the majority, the corporate tax cut has been vetoed by liberal parties in the legislature. If the conservative parties maintain the majority, they initiated corporate tax cut. However, in Korea, the debate on the corporate taxation is dominated by the agenda of taxing the rich (Park 2015). Korean voters believe that the economic achievement of big conglomerates in Korea has been possible with the support and sacrifice of the labor. Therefore, as compensation theory of taxation indicates (Scheve and Stasavage 2016), now it is their turn to contribute for the expansion of government welfare expenditure. The experience of Japan and Korea shows us that the heavier dependency on corporate taxation compared to advanced economies in the United States and Europe can be explained by the legacies of developmental state, although the mechanism is different between Korea and Japan.


