

EFFECTS OF GLOBAL TAXATION SYSTEM ON FINANCIAL MARKETS

The Global Taxation System in Effect from 1996

The so-called global taxation system on financial income is scheduled to take effect in early 1996. Under the new scheme, a couple pays a 40 percent progressive tax on their income from financial assets, if their combined income exceeds 40 million won. A 15% withholding tax will be applied to their financial income below the 40 million won limit.

The government, however, will allow some exceptions to this. Investment income from bond and stock transactions will be exempted from the global taxation. Interest income from bonds with maturities longer than 5 years will be taxed separately. Upon the implementation of the global taxation system, we expect several changes in the financial market.

More Flow of Funds into the Stock Market

First, there will be some changes in money flows. Money will flow out from financial institutions due to the following factors; the avoiding of a tax increase once taxes are levied on aggregate income beginning 1996, the phase-out of financial commodities offering tax-saving benefits, and the general public's reluctance to have their income revealed.

But the amount of money which may flow out of financial institutions may not be greater than we forecast. Reasons are as follows; the so-called "big hands" who have huge sums of money prefer safety to liquidity and profitability, and financial asset as much as 40 million won could not be moved around easily. Therefore, actual flow of

fund would be limited to around 15~20 trillion won.

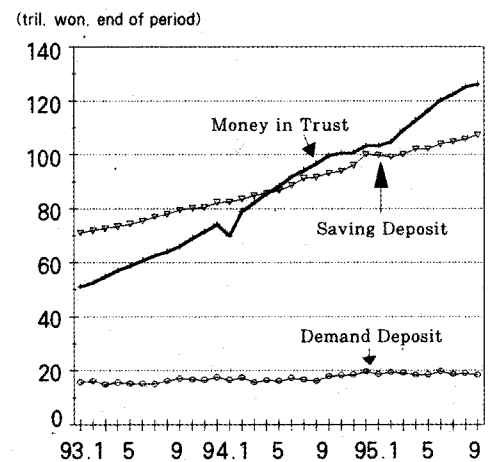
For the time being, the money outflow from financial institutions is likely to be diverted to the bond and stock market. But the volume of shift of fund to the bond market will be limited because long-term bonds are not available in abundance. Also, fund shifting to the stock markets will be limited because stock investment involves risk-taking.

The remainder of money will probably be diverted to the real estate market, durable goods, and private loan market. Some fund will remain in financial institutions under someone else's names.

Banks, Investment and Finance Companies Shocked

Second, the global taxation system will bring about some change in the financial

The Trend of Banks' Deposits



institutions' positions. Due to growing competition, the banks' demand and savings deposits will be gradually reduced. The banks' profitability will also deteriorate. Thus, only a few stable large banks that can withstand low-profit margins will thrive.

Investment and finance companies will negatively be influenced by the global taxation system because they have "black" big savings deposits. As a result, investment and finance companies' competitiveness will erode.

On the other hand, insurance companies will be less affected, because long-term insurance services are exempted from global taxation. It is also difficult to terminate insurance contracts in the middle of contracting period. In relative terms, securities companies as well as investment and trust companies will gain by using their sophisticated managerial skills in bond and stock transactions.

To alleviate the shock caused by the new system, the government should make some adjustments. First, the government needs to increase long-term bond issues and stimulate the demand for them. To this end, the government should diversify financial institutions in charge of bond sales and support them in the development of new services.

The government ought to carefully monitor real estate and durables markets to prevent speculative money from flowing into these markets. In addition, the government has to legalize private loan business to prevent the black market from growing larger. Finally, we need to introduce the banks' deposit insurance system as soon as possible for the stability and safety of the banking system which is threatened by growing competition.

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The Trend of Investment and Finance Companies' Deposits

(tril. won. end of period)

