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Taxation a Major Catalyst of growth and development in advanced Nation

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ABSTRACT

Over several decades, taxation has been taken as a veritable medium of engineering the growth or performance of an economy. Taxation is an important fiscal policy instrument at the disposal of governments to mobilize revenue and promote economic growth and development. Governments use tax revenue to carry out their traditional functions such as the provision of public goods and services; maintenance of law and order; defence against external aggression; and regulation of trade and business to ensure social and economic maintenance. The relationship between taxation and economic growth has been widely studied. Some of these studies suggest that tax policies have positive and significant impact on the rate of growth of output, while others have observed that there is an inverse relationship between the two variables, that is, tax policies have a negative and significant impact on growth. Understanding the impact of taxation on economic growth can be viewed from two major schools of thought the traditional economic school and the modern school.

Keywords: Taxation, catalyst, growth, development, advanced, nation.

INTRODUCTION

Taxation is an important fiscal policy instrument at the disposal of governments to mobilise revenue and promote economic growth and development. Governments use tax revenue to carry out their traditional functions such as the provision of public goods and services; maintenance of law and order; defence against external aggression; and regulation of trade and business to ensure social and economic maintenance [1]. A tax from the Latin taxo is a compulsory financial charge or some other type of levy imposed upon a taxpayer by a governmental organization in order to fund various public expenditures [2]. A failure to pay, along with evasion of or resistance to taxation, is punishable by law. Taxes consist of direct or indirect taxes and may be paid in money or as its labour equivalent. The first known taxation took place in Ancient Egypt around 3000–2800 BC. A typical developing economy collects just 15 percent of GDP in taxes, compared with the 40 percent collected by a typical advanced economy [3] [4] [5]. The ability to collect taxes is central to a country's capacity to finance social services such as health and education, critical infrastructure such as electricity and roads, and other public goods. Considering the vast needs of poor countries, this low level of tax collection is putting economic development at risk.

Most countries have a tax system in place to pay for public, common or agreed national needs and government functions. Some levy a flat percentage rate of taxation on personal annual income, but most scale taxes based on annual income amounts. Most countries charge a tax on individual's income as well as on corporate income. Countries or subunits often also impose wealth taxes, inheritance taxes, estate taxes, gift taxes, property taxes, sales taxes, payroll taxes or tariffs. In economic terms, taxation transfers wealth from households or businesses to the government. This has great effects which can increase the economic growth and economic welfare. Consequently, taxation is a highly debated topic.

Effective tax revenue mobilization reduces an economy's dependence on external flows which have been found to be highly volatile.2 Taxation also allows governments' greater flexibility in designing and controlling their development agenda; conditions states to improve their domestic economic policy environment, thus creating a conducive environment for the much-needed foreign direct investments; and strengthens the bonds of accountability between governments and the citizens [6] [7]. The 2008/2009 global financial and economic crisis provided useful lessons for countries on the need to direct more attention to domestic resources mobilization efforts, including through increasing tax revenues, and shift away from over-dependence on external financial flows and export revenues.3

Georgia offers a striking example of successful tax revenue reform. Following the collapse of the Soviet Union, the government struggled to collect tax revenue. By 2003, rampant corruption involving tax evasion, illegal tax credits, and theft of government tax revenue had left public finances in shambles [8]. The government was no longer able to honor its obligations to public servants and pensioners, even though salaries and pensions were very low. Georgia's sweeping tax reform was made possible after the 2003 Rose Revolution, which gave the new government a mandate to reform the economy and fight widespread corruption. The country's new leaders adopted a policy of zero tolerance for corruption, and the culture began to change, along with the laws [9]. A revised tax code, passed in 2004, simplified the tax system, reduced rates, and eliminated a series of minor local taxes that had been generating little revenue (on pollution and gambling, for example). Only 7 of 21 taxes remained, and many of the rates were reduced.

Progressive personal income tax rates (12 to 20 percent) were replaced with a flat rate of 20 percent, and the social security contribution tax rate was first reduced from 33 percent to 20 percent and then eliminated altogether. Corporate income was taxed at a flat rate of 15 percent, and the value-added tax (VAT) was reduced from 20 percent to 18 percent. The revenue lost from lower tax rates was made up through a broader tax base, better compliance, and stricter enforcement. The government also made it easier to pay taxes by introducing measures such as an electronic tax filing system. In this way, technology both improved efficiency and reduced opportunities for corruption [10] [11]. In parallel, the government lowered the minimum capital required to start a business, which also generated more tax revenue. The improvement in the country's ability to mobilize revenue between 2004 and 2011 is all the more impressive given the sharp reduction in tax rates. By 2008, Georgia's tax-revenue-to-GDP ratio had doubled to 25 percent.

Although tax structures vary considerably across countries, the primary objective of any tax structure is to attain maximum revenue and economic growth with minimum distortions. Different countries have different philosophies about taxation and different methods of tax collection. In the same manner, countries have different uses for their revenue which affect growth differently [12]. [13] have argued that the different uses of total government expenditure affect growth differently and a similar applies to way tax revenue is raised. [14] emphasizes factors such as 'spill-over effect and learning by doing' by which firms' specific decisions to invest in capital and research and development, or investment in human capital, can yield positive external effects that benefit the rest of the economy. Solow [15], was the first to examine how taxation affects growth. He argued that steady state growth is not affected by tax policy; that is, tax policy, regardless of distortion, has no impact on long term economic growth rates, even if it reduces the level of economic output in the long term. On his part [16], argued that the different uses of total government expenditure affect growth differently and a similar argument applies to the way tax revenue is raised. The economic growth of Singapore for instance can be attributed to low rates of corporate and personal income taxes. Relatedly [17], argue that there exists a structural difference in taxation in developing countries and developed countries. For developing countries, they established that roughly two-thirds of tax revenue is derived from indirect taxes while for developed countries two-thirds comes from direct taxes. They suggested however, that tax structure can change over time to maximize the economic growth.

LITERATURE REVIEW

The relationship between taxation and economic growth has been widely studied. Some of these studies suggest that tax policies have positive and significant impact on the rate of growth of output, while others have observed that there is an inverse relationship between the two variables, that is, tax policies have a negative and significant impact on growth. [18] examined the impact of tax policies on economic growth using data from Asian economies.

Following [19] research, public finance in developing countries is strongly tied to state capacity and financial development. As state capacity develops, states not only increase the level of taxation but also the pattern of taxation. With the increase of larger tax bases and diminish of the importance of trading tax, while income tax gains more importance. According to [20] argument, state capacity evolves as response to the emergence of war. War is an incentive for states to raise tax and strengthen states capacity. Historically, many taxation breakthroughs took place during the wartime. The introduction of income tax in Britain was due to the Napoleonic War in 1798. US first introduce income tax during Civil War [21]. Taxation is constrained by the fiscal and legal capacities of a country [22]. Fiscal and legal capacities also complement each other. A well-designed tax system can minimize efficiency loss and boost economic growth. With better compliance and better support to financial institutions and individual property, the government will be able to collect more tax. Although wealthier countries have higher tax revenue, economic growth does not always translate to higher tax revenue. For example, in India, increases in exemptions leads to the stagnation of income tax revenue at around 0.5% of GDP since 1986 [23].

Researchers for EPS PEAKS [53] stated that the core purpose of taxation is revenue mobilization, providing resources for National Budgets, and forming an important part of macroeconomic management. They said economic theory has focused on the need to 'optimize' the system through balancing efficiency and equity, understanding the impacts on production, and consumption as well as distribution, redistribution, and welfare.

They state that taxes and tax reliefs have also been used as a tool for behavioural change, to influence investment decisions, labour supply, consumption patterns, and positive and negative economic spill-overs (externalities), and ultimately, the promotion of economic growth and development. The tax system and its administration also play an important role in state-building and governance, as a principal form of 'social contract' between the state and citizens who can, as taxpayers, exert accountability on the state as a consequence.

They established that there is no empirical evidence that tax policies adopted by developing countries in Asia have a permanent effect on the rate of economic growth, a finding that is inconsistent with the endogenous class of growth models. The results of their study suggest that the relationship between aggregate output and the tax rate is best described by the neo-classical growth models because a higher tax rate permanently reduces the level of output but has no permanent effect on the output growth rate. Consequently, they recommended an optimal tax rate to finance the budgets, with debt instrument used in financing transitory expenditure while permanent expenditures are to be financed through taxes.

In a cross-country analysis, [24] used panel data from 65 countries covering the period 1970–2006 to examine the effects of tax structure on economic growth and income inequality and established that company income tax (CIT) rates have a negative impact both on economic growth and income inequality. They also established that personal income tax rate does not significantly affect economic growth and income inequality. The authors therefore, recommended that there is a need to develop a modest design into the tax system since countries which are able to mobilise tax resources through broad-based tax structures, coupled with efficient administration and enforcement of the tax system' are likely to enjoy faster growth rates than countries with narrow tax base and lower efficiency in tax administration [25]. Also, governments should reduce tax evasion, which, they averred, occurs among the highest income group and has potential to distort horizontal and vertical equity in income redistribution. Finally, they recommended that very high earners or the highest income group should be subjected to high and rising marginal tax rates.

THEORETICAL REVIEW

Understanding the impact of taxation on economic growth can be viewed from two major schools of thought the traditional economic school and the modern school. In the traditional economic school, [26], views summarized in the work of [27] is that while holding other determinants of growth constant, low tax rates and low government spending were associated with higher growth. This means that the higher the marginal tax rate, the greater the chances of higher income tax payers diverting extra time from productive operations to leisure activities. On the other hand, the modern school revealed that higher marginal tax rates leads to greater economic development in the long-run because government would secure a greater revenue which when invested in the country's education and infrastructure development will boost the economy.

The differing views of the effects of taxation of growth notwithstanding, important conceptual questions arise however, with respect to the optimal level of taxation for a defined objective function - whether growth or revenue generation; how taxation burden should be allocated among tax payers; the extent of state involvement in taxation; and how tax revenues should be allocated among various public goods and services

From the point of view of economic theory, marginal tax rates are particularly important because they affect the incentives of individuals to earn more income. Consequently, as marginal tax rates increases, individuals to get to keep less of their additional earnings. While economic theory predicts a negative relationship between marginal tax rates and economic growth, it also suggests several factors that will complicate measurement of the linkage. According to [28], such factors includes the following: Firstly, there is the difference between the short-run response to charge in marginal rates so much so that an increase in marginal tax rates reduces the supply of labour and capital which will tend to slow the growth of real gross domestic product (RGDP). As this reaction is expected to take time, short-run response may be a misleading indicator of what will happen in the long-run. In this way, the labour supply response will be smaller in the short-run in the long-run. Secondly, the linkage between marginal tax rates and GDP growth may be weakened because GDP figures often fail to register the negative impact of the price distortions accompanying high marginal tax rates. Essentially, GDP register the expenditures and costs of goods and services produced even if these cost exceeds the value derived by the consumer. Thirdly, the linkage between marginal tax rates and GDP growth may also be weakened by the pattern of government expenditures. In most countries, high marginal tax rates are imposed in order to derive revenues that are utilized to subsidized social safety nets such as child care services, retirement benefits and payment to the unemployed.

Generally, the impact of tax policies is greater in the highest tax brackets where changes in tax rates will exert their largest effect on both labour supply and tax avoidance activities. Furthermore, as the Laffer curve analysis indicates, marginal tax rates can be pushed so high that they will actually reduce the revenues derived from the tax. Obviously, marginal tax rates above the level that generals maximum revenues are highly inefficient and counterproductive as they reduce both aggregate output and the revenue derived by the government. On the other hand, tax rates near the revenue maximum level are also extremely inefficient because as rates increases towards the revenue maximum point, the higher tax rates will squeeze out large quantities of gains from trade relative to the additional revenue generated [11]. Thus, measured in terms of lost output, these additional revenues are very costly because the most severe side effects of taxes will be exerted by the higher marginal tax rates.

Purposes of Taxation

During the 19th century the prevalent idea was that taxes should serve mainly to finance the government. In earlier times, and again today, governments have utilized taxation for other than merely fiscal purposes. One useful way to view the purpose of taxation, attributable to American economist Richard A. Musgrave, is to distinguish between objectives of resource allocation, income redistribution, and economic stability. (Economic growth or development and international competitiveness are sometimes listed as separate goals, but they can generally be subsumed under the other three.) In the absence of a strong reason for interference, such as the need to reduce pollution, the first objective, resource allocation, is furthered if tax policy does not interfere with market-determined allocations. The second objective, income redistribution, is meant to lessen inequalities in the distribution of income and wealth. The objective of stabilization implemented through tax policy, government expenditure policy, monetary policy, and debt management is that of maintaining high employment and price stability [2]. There are likely to be conflicts among these three objectives. For example, resource allocation might require changes in the level or composition (or both) of taxes, but those changes might bear heavily on low-income families—thus upsetting redistributive goals. As another example, taxes that are highly redistributive may conflict with the efficient allocation of resources required to achieve the goal of economic neutrality.

Classes of Taxes

Direct and indirect taxes

In the literature of public finance, taxes have been classified in various ways according to who pays for them, who bears the ultimate burden of them, the extent to which the burden can be shifted, and various other criteria. Taxes are most commonly classified as either direct or indirect, an example of the former type being the income tax and of the latter the sales tax. There is much disagreement among economists as to the criteria for distinguishing between direct and indirect taxes, and it is unclear into which category certain taxes, such as corporate income tax or property tax, should fall. It is usually said that a direct tax is one that cannot be shifted by the taxpayer to someone else, whereas an indirect tax can be.

1. Direct taxes

Direct taxes are primarily taxes on natural persons (e.g., individuals), and they are typically based on the taxpayer's ability to pay as measured by income, consumption, or net wealth. What follows is a description of the main types of direct taxes. Individual income taxes are commonly levied on total personal net income of the taxpayer (which may be an individual, a couple, or a family) in excess of some stipulated minimum. They are also commonly adjusted to take into account the circumstances influencing the ability to pay, such as family status, number and age of children, and financial burdens resulting from illness. The taxes are often levied at graduated rates, meaning that the rates rise as income rises. Personal exemptions for the taxpayer and family can create a range of income that is subject to a tax rate of zero. Taxes on net worth are levied on the total net worth of a person—that is, the value of his assets minus his liabilities. As with the income tax, the personal circumstances of the taxpayer can be taken into consideration.

Personal or direct taxes on consumption (also known as expenditure taxes or spending taxes) are essentially levied on all income that is not channeled into savings [26]. In contrast to indirect taxes on spending, such as the sales tax, a direct consumption tax can be adjusted to an individual's ability to pay by allowing for marital status, age, number of dependents, and so on. Although long attractive to theorists, this form of tax has been used in only two countries, India and Sri Lanka; both instances were brief and unsuccessful. Near the end of the 20th century, the "flat tax" which achieves economic effects similar to those of the direct consumption tax by exempting most income from capital came to be viewed favourably by tax experts. No country has adopted a tax with the base of the flat tax, although many have income taxes with only one rate.

Taxes at death take two forms: the inheritance tax, where the taxable object is the bequest received by the person inheriting, and the estate tax, where the object is the total estate left by the deceased [7]. Inheritance taxes sometimes take into account the personal circumstances of the taxpayer, such as the taxpayer's relationship to the donor and his net worth before receiving the bequest. Estate taxes, however, are generally graduated according to the size of the estate, and in some countries they provide tax-exempt transfers to the spouse and make an allowance for the number of heirs involved. In order to prevent the death duties from being circumvented through an exchange of property prior to death, tax systems may include a tax on gifts above a certain threshold made between living persons (see gift tax). Taxes on transfers do not ordinarily yield much revenue, if only because large tax payments can be easily avoided through estate planning.

2. Indirect taxes

Indirect taxes are levied on the production or consumption of goods and services or on transactions, including imports and exports. Examples include general and selective sales taxes, value-added taxes (VAT), taxes on any aspect of manufacturing or production, taxes on legal transactions, and customs or import duties. General sales taxes are levies that are applied to a substantial portion of consumer expenditures. The same tax rate can be applied to all taxed items, or different items (such as food or clothing) can be subject to different rates. Single-stage taxes can be collected at the retail level, as the U.S. states do, or they can be collected at a pre-retail (i.e., manufacturing or wholesale) level, as occurs in some developing countries. Multistage taxes are applied at each stage in the production-distribution process. The VAT, which increased in popularity during the second half of the 20th century, is commonly collected by allowing the taxpayer to deduct a credit for tax paid on purchases from liability on sales. The VAT has largely replaced the turnover tax—a tax on each stage of the production and distribution chain, with no relief for tax paid at previous stages. The cumulative effect of the turnover tax, commonly known as tax cascading, distorts economic decisions.

Although they are generally applied to a wide range of products, sales taxes sometimes exempt necessities to reduce the tax burden of low-income households. By comparison, excises are levied only on particular commodities or services. While some countries impose excises and customs duties on almost everything from necessities such as bread, meat, and salt, to nonessentials such as cigarettes, wine, liquor, coffee, and tea, to luxuries such as jewels and furs—taxes on a limited group of products alcoholic beverages, tobacco products, and motor fuel—yield the bulk of excise revenues for most countries. In earlier centuries, taxes on consumer durables were applied to luxury commodities such as pianos, saddle horses, carriages, and billiard tables. Today a main luxury tax object is the automobile, largely because registration requirements facilitate administration of the tax. Some countries tax gambling, and state-run lotteries have effects similar to excises, with the government's "take" being, in effect, a tax on gambling. Some countries impose taxes on raw materials, intermediate goods (e.g., mineral oil, alcohol), and machinery.

Some excises and customs duties are specific i.e., they are levied on the basis of number, weight, length, volume, or other specific characteristics of the good or service being taxed. Other excises, like sales taxes, are ad valorem levied on the value of the goods as measured by the price. Taxes on legal transactions are levied on the issue of shares, on the sale (or transfer) of houses and land, and on stock exchange transactions. For administrative reasons, they frequently take the form of stamp duties; that is, the legal or commercial document is stamped to denote payment of the tax. Many tax analysts regard stamp taxes as nuisance taxes; they are most often found in less-developed countries and frequently bog down the transactions to which they are applied [10].

3. Proportional, progressive, and regressive taxes

Taxes can be distinguished by the effect they have on the distribution of income and wealth. A proportional tax is one that imposes the same relative burden on all taxpayers—i.e., where tax liability and income grow in equal proportion. A progressive tax is characterized by a more than proportional rise in the tax liability relative to the increase in income, and a regressive tax is characterized by a less than proportional rise in the relative burden. Thus, progressive taxes are seen as reducing inequalities in income distribution, whereas regressive taxes can have the effect of increasing these inequalities.

Most countries raise resources through a variety of taxes, including direct taxes on wage and property income, contributions to trust funds. The taxes that are generally considered progressive include individual income taxes and estate taxes. Income taxes that are nominally progressive, however, may become less so in the upper-income categories especially if a taxpayer is allowed to reduce his tax base by declaring deductions or by excluding certain income components from his taxable income. Proportional tax rates that are applied to lower-income categories will also be more progressive if personal exemptions are declared.

Income measured over the course of a given year does not necessarily provide the best measure of taxpaying ability. For example, transitory increases in income may be saved, and during temporary declines in income a taxpayer may choose to finance consumption by reducing savings. Thus, if taxation is compared with "permanent income," it will be less regressive (or more progressive) than if it is compared with annual income.

Sales taxes and excises (except those on luxuries) tend to be regressive, because the share of personal income consumed or spent on a specific good declines as the level of personal income rises. Poll taxes (also known as head taxes), levied as a fixed amount per capita, and obviously are regressive [22]. It is difficult to classify corporate income taxes and taxes on business as progressive, regressive, or proportionate, because of uncertainty about the ability of businesses to shift their tax expenses (see below Shifting and incidence). This difficulty of determining who bears the tax burden depends crucially on whether a national or a subnational (that is, provincial or state) tax is being considered.

In considering the economic effects of taxation, it is important to distinguish between several concepts of tax rates. The statutory rates are those specified in the law; commonly these are marginal rates, but sometimes they are average rates. Marginal income tax rates indicate the fraction of incremental income that is taken by taxation when income rises by one dollar. Thus, if tax liability rises by 45 cents when income rises by one dollar, the marginal tax rate is 45 percent. Income tax statutes commonly contain graduated marginal rates i.e., rates that rise as income rises. Careful analysis of marginal tax rates must consider provisions other than the formal statutory rate structure. If, for example, a particular tax credit (reduction in tax) falls by 20 cents for each one-dollar rise in income, the marginal rate is 20 percentage points higher than indicated by the statutory rates. Since marginal rates indicate how after-tax income changes in response to changes in before-tax income, they are the relevant ones for appraising incentive effects of taxation. It is even more difficult to know the marginal effective tax rate applied to income from business and capital, since it may depend on such considerations as the structure of depreciation allowances, the deductibility of interest, and the provisions for inflation adjustment. A basic economic theorem holds that the marginal effective tax rate in income from capital is zero under a consumption-based tax.

Average income tax rates indicate the fraction of total income that is paid in taxation. The pattern of average rates is the one that is relevant for appraising the distributional equity of taxation. Under a progressive income tax the average income tax rate rises with income. Average income tax rates commonly rise with income, both because personal allowances are provided for the taxpayer and dependents and because marginal tax rates are graduated; on the other hand, preferential treatment of income received predominantly by high-income households may swamp these effects, producing regressivity, as indicated by average tax rates that fall as income rises.

CONCLUSION

This paper has tried to explain the terms "tax" and "taxation". Tax has been explained to mean a compulsory levy, which is required to be paid by every citizen, and it is generally considered as a civic duty of every taxable person in a country. Taxation on the other hand has been explained to mean the concept and science or the process of imposing tax on the citizens. Aid interventions in revenue can support revenue mobilization for growth, improve tax system design and administrative effectiveness, and strengthen governance and compliance. [12] found that the best aid modalities for revenue depend on country circumstances, but should aim to align with government interests and facilitate effective planning and implementation of activities under an evidence-based tax reform. Lastly, she found that identifying areas for further reform requires country-specific diagnostic assessment: broad areas for developing countries identified internationally (e.g. IMF) include, for example property taxation for local revenues, strengthening expenditure management, and effective taxation of extractive industries and multinationals. There is no gain saying the fact that tax revenue constitutes a major source of government revenue (pubic revenue). Revenue collected through various taxes is meant to be used for various specific projects to better the lives of citizens in a country. In the light of this, it is strongly advised that cognizance should be taken of the "specific uses" that Lagos State government has been putting its revenue to. These include: re-habilitation of old roads and construction of new ones, canalization and drainage system, construction of pedestrian bridges, provision of BRT buses, to ease the transportation problem in the state, and the beautification of Lagos State to mention just a few.

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