Role of taxation in development strategy

D. D. M. Waidyasekera

Tax system: The Role of taxation and fiscal policy in the development strategy has to be viewed in the background of the functions which a taxation system performs. Its main functions in relation to economic development are as follows.

A development project in progress

01. Functions of Taxation in Relation to Economic Development

01. The primary function of a tax system is to raise revenue for the government for its public expenditure. So the first goal in the development strategy as regards taxation policy is to ensure that this function is discharged adequately.

02. To reduce inequalities through a policy of redistribution of income and wealth. Higher rates of income taxes, capital transfer taxes and wealth taxes are some means adopted for achieving these ends.

03. For social proposes such as discouraging certain activities which are considered undesirable. The excise taxes on liquor and tobacco, the special excise duties on luxury goods, betting and Gaming Levy are examples of such taxes, which apart from being lucrative revenue sources have also goals.

04. To ensure economic goals through the ability of the taxation system to influence the allocation of resources. This includes.

a) transferring resources from the private sector to the government to finance the public investment program;

b) the direction of private investment into desired channels through such measures as regulation of tax rates and the grant of tax incentives etc. This includes investment incentives to attract foreign direct investment (FDI) into the country;

c) Influencing relative factor prices for enhanced use of labour and economising the use of capital and foreign exchange.

05. To increase the level of savings and capital formation in the private sector partly for borrowing by the government and partly for enhancing investment resources within the private sector for economic development.

06. To protect local industries from foreign competition through the use of import duties, turnover taxes/VAT and excises. This has the effect of transferring a certain amount of demand from imported goods to domestically produced goods.

07. To stabilise national income by using taxation as an instrument of demand management. Taxation reduces the effect of the multiplier and so can be used to dampen cyclical fluctuations on the economy.

02. Principles of taxation

A tax system is based on certain basic principles. They are equity, progressivity, simplicity and efficiency.

Equity - The equity principle implies that taxation must be imposed in accordance with the ability to pay principle. Equity has two dimensions, horizontal equity and vertical equity.

Progressivity - A tax system can either be progressive or regressive. Direct taxes for example, income tax is generally progressive in character with an exemption tax free threshold for the smaller income receivers and a graduated rate schedule.

In Sri Lanka for example, the current tax free threshold for individual is Rs. 300,000 a year and rates of tax range from 5% progressively to 35%.

The indirect taxes like the VAT, import duties excises and other consumption taxes are generally regressive in character nevertheless the regressivity can be minimised to a certain extent through exemptions on basic consumption commodities and a differential rate system.

The VAT for example has a list of exemptions for the supply of basic commodities and a differential rate system of a standard rate of 15% together with a zero rate, a concessionary rate of 5% and a 20% rate for luxuries.

Simplicity - A taxation system must be as simple as possible with a few taxes and uncomplicated legislation. However often tax systems are complex with a large number of taxes and levies imposed for revenue considerations and tax legislation is necessarily complex in character.

Efficiency - Finally a tax system must be efficient. No amount of sound fiscal policy is effective if the tax administration system is inefficient or corrupt.

03. Tax factors that affect development and growth

Taxes affect growth in two ways. First, by influencing the aggregate supply of the main factors of production by raising or lowering their net (after tax) returns; and second, by influencing the efficiency of resource utilisation factor (total productivity). Some of the main factors in this process are given below.

01. Tax revenue ratio to GDP: Since an adequate volume of government revenue is essential for public expenditure and economic growth, the ratio of tax revenue to GDP has

been used regularly to measure and judge the success of a country's fiscal management. Generally the revenue ratio to GDP in developed countries have been high and the less developed countries low.

In this context the Mahinda Chinthana: government's ten year Horizon Development Framework aims to reverse this trend and increase revenue to around 19% of GDP by 2010. This is to be accomplished mainly by broadening the tax base and strengthening the tax administration.

The main reasons for the decline include

* Unplanned and ad hoc tax holidays and incentives.

* Narrow tax base and inadequate coverage.

* Lack of elasticity and buoyancy in the tax system.

* Periodic tax amnesties.

* Administrative weaknesses.

2. Tax rates, saving and capital formation: It is difficult to establish a direct and precise statistical correlation between tax rates and private capital formation due to many factors and the time lag, changes in the tax base and other externalities determining investment. Nevertheless historical and statistical trends tend to suggest that savings and private capital formation have been sensitive to effective tax incidence.

3. Tax elasticity and buoyancy in development: A principal fiscal in any development strategy is to increase the elasticity and buoyancy of the revenue systems. Elasticity reflects the built-in responsiveness of tax revenue to movements in national income or GDP.

Buoyancy reflects the total response of tax revenue to changes in national income or GDP including the effects of discretionary changes in tax policies over time.

4. Taxation and demand management: Taxation has been often used in many countries as a tool in countering inflationary and deflationary pressures on the economy.

Such pressures affect development through a lack of external balances and/or in a spiral of changing prices and employment.

In mitigating the effects of cyclical pressures monetary policy, through traditionally more effective is often limited by the structural nature of the economy and therefore tax policy assumes major importance.

5. Tax incentives in the development strategy: Tax and investment incentives have in recent times become a favourite tool in development strategy both for domestic investors and for attracting foreign direct investment (FDI). The rationale for their use is that they constitute an important, if not a major, element in determining investment behaviour.

Incentives increase the net of tax rates of returns and thereby reduce the need for large initial capital investment and also reduce risk. The availability of incentives tends to make otherwise unpromising and risky ventures more profitable. They are also valuable as an indirect stimulus to investment because they publicize and enhance the country's investment climate.

The role of tax incentives in determining investment behaviour has however been controversial. According to current studies, incentives by themselves do not play a major role in determining investment vis-a-vis other factors such as economic and political stability, infrastructure facilities, cheap and easy credit, access to markets, reliable and skilled labour force.

Nevertheless tax incentives schemes are in place in a large number of developing countries and form a significant part of the development strategy being adopted.

6. Taxation, black money and the informal economy: A sound development strategy seeks to reduce the size of the informal economy and bring into the open economic resources that lie untapped in the form of black money.

Apart from such mechanisms as tax and foreign exchange amnesties and demonetisation, taxation has been used as a tool to tap the resources inherent in these areas.

Large scale tax evasion and the existence of a large black economy while resulting in loss of revenue to the state, tends to reduce the built-in elasticity of a fiscal system and to the extent that the tax evaded income is spent on goods and services, help to generate inflationary pressures and raise the prises of real property.

7. Customs duties in the development strategy: Import and export duties have been traditionally used not only as a means of deriving substantial government revenue but also as a tool in the development strategy.

Export duties have been used as an instrument of siphoning off excess demand in times of inflation and stimulating them in times of depression. In the use of export duties however, there is clearly a conflict between the objectives of revenue and export development.

Hence in many countries the use of export duties have gradually diminished and tailed off altogether. In Sri Lanka for example there are no export duties at present (except for scrap iron).

8. Role of the tax administration in development: Finally, development policy requires the existence and functioning of a sound and effective tax administrative machinery. No amount of development planning would have the intended effect if the required stability and level of a administrative resources are not invested in their implementation.

9. Summary: The above sections dealt with some of the main components in the relationship between taxation and development. While there is often no direct perceptivable correlation between tax policy and actual development performance due to the prevalence of a variety of variables, the links between fiscal policy and economic

growth are there. Often this is mostly indirect, operating through the capital, labour and product markets.

Finally, another important reason why taxation is essential in getting macro economic policies right is that alternative ways of financing government expenditure such as money creation, mandating larger required reserves, domestic borrowing and foreign loans can have very harmful effects on the economy.

The writer is a former Commissioner of Inland Revenue, Secretary of the 1990 Taxation Commission and presently attached to the Institute of Policy Studies of Sri Lanka.