Tax Structure and Developing Countries

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Abstract

The main source of public revenue compared to other sources are Taxes, as in developed countries and developing countries, therefore the tax system has an extraordinary role in sustainable economic development and employment growth. Also, tax policy that acts in a complementary way to monetary policy is of vital importance also due to the preservation of economic stability by limiting the level of inflation and balancing the equilibrium on the market. The main purpose of this paper is to explore the tax structure in developing countries and their comparison with developed countries. In this paper some tax theory will be discussed. It will also be shown for impractical research and their effects on economic development and the growth of social welfare. Although there is no consensus among researchers, most empirical studies show a negative link between public spending and economic growth. However, in order for the tax effects to be the highest in the economy in developing countries, the international trade tax and the VAT should be replaced rather within the country.

Keywords. Structure of taxes, direct taxes, indirect taxes, developing countries, economic development.

1. Introduction

The purpose of taxing efficiently is to make the looked-for fiscal policy goals (delivery, redistribution and stabilization) in the most efficient way, thus reducing undesired distortions, reducing the cost of collecting taxes and promoting economic growth. Tax efficiency and especially the tax structure explained role in achieving economic growth and fiscal consolidation (Stoilov, Patonov 2012). Direct and indirect taxes should be countered by balancing each other. However, in developing countries, direct taxes have a limited space and thus indirect taxes have more important role. A well- structured system of systems requires the combination of direct and indirect taxes of different proportions. Taxes in pursuing the principle of equality. direct taxes are progressive in sort, also some indirect taxes, such as taxes on extra goods are also progressive in sort. This means that the well-off class has to maintain the highest incidence of taxes, while the low-income group is either exempt from tax (indirect tax) or should pay lesser charges (indirect tax) for goods consumed by the masses. Thus, taxes help to reduce income and capital inequality (Rahul, 2015).

Tax policies in practice vary dramatically among the poorest and richest countries (Gordon, Li). In order to increase revenue, low-income countries have historically supported more international trade taxes, while richer countries use more taxes on consumption and revenues (McNabb, LeMay -Boucher, 2014, Gordon, Li). Between 2000 and 2002, small states collected around 36 percent of tax revenues in international trade compared to 1.1 percent collected from the same source in the OECD (Borg, 2006). In this process, however, the poorest countries collect much less revenue as a share of GDP than they gather in the richest countries (Gordon, Li). Currently, personal income taxes are relatively small in developing countries, while taxes such as the VAT have become central to mobilizing domestic revenue (Newbery and Stern, 1987) cited in (Lauren, Tiffany, Stephanie, 2008). Property and land taxes are relatively effective domestic taxes, but tend to be weak in developing countries. Property taxes represent about 6.7% of total OECD revenue, compared to 2.4% in developing and transition countries (Bird, 1999). Corporate income tax increases 17% of total tax in developing countries, compared to 10% (pre-crisis) in the OECD. While personal income taxes from a significant percentage of tax revenues in high-income countries (around 9-11% of GDP), developing countries increase only about 1-3% of GDP by Personal Income Tax (Peter, Buttrick, Duncan, 2010) cited in (Velde, 2013).

There some reasons why developing countries are less able to use the tax system to redistribute income. First, income and wealth taxes show a relatively small role in the tax structure of developing countries, as opposed to developed countries. Second, individual income tax in developing countries is often merely on a wage withholding tax. In many countries, labor sector fees account for more than 90% of total personal income tax revenues. In some countries, tax law has allowed tax administration restrictions to effectively exclude some types of tax revenues (for example, income from foreign assets held abroad). Third, it is certainly politically difficult to set effective tax on income and pelf tax in many countries. It may be appropriate to pass tax legislation that is progressive but in practice does not impose significant tax liabilities in the upper classes (Bird, Zolt, 2003).

A well- functioning revenue system is a necessary condition for sustainable and inclusive economic development. However, revenue systems in some developing countries have substantial shortcomings. Revenue funded on public spending on physical, social and administrative infrastructure that enables businesses to start or expand. The revenue system is also a central element in supporting a strong citizen-state relationship that supports effective, accountable and sustainable governments. These elements contribute to stronger economic results and employment growth (Easter, 2002). Tax changes often appear to improve the efficiency of the tax system. That is, under the new tax system the cost (administrative, compliance and economic) of revenue growth will be lower. This may be the case in the medium and long term. However, in the short route, there will be future administrative and compliance costs associated with the transition of a new regime. Dynamic gains associated with the redistribution of production factors or goods and services in higher value uses also occur over time and are more skeptically seen by non-economists, cited in (Carnahan, 2015).

In developing countries, there is no magical tax strategy to encourage economic growth. Some countries with high tax burdens have high growth rates and some countries with low tax burdens have low growth rates. Despite many theoretical and empirical research, as well as policy and policy polemics, there is no simple answer to taxation on economic growth in developing countries. Theoretical literature suggests that the tax has a negative effect on economic growth. Thus, high tax rates reduce economic growth. The reason for this is that higher rates may be more distorted and thus negatively affect growth, while lower rates may generate productive income. However, empirical literature suggests direct and reverse relationships between tax burden and growth rates. Of course, the highest tax burden may lower or increase economic growth rates. Thus, future economic output may be higher than the optimal tax rate and thus future tax revenues would be higher at a lower tax rate (Nantob, 2014).

The rest of the paper will be organized as follows: Chapter 2 will outline the importance of taxes in developing countries. Chapter 3 will summarize the theoretical aspect of taxation. Chapter 4 presents a review of empirical literature on the impact of taxes on economic development. The final chapter will present the conclusions and recommendations.

Importance of taxes in developing countries

The financial crisis in 2008 comes to uncover the debate about the size of fiscal multipliers. In recent years, the slowdown in economic activity caused waves of fiscal stimulus, implemented by developed and emerging economies to unequivocally support fiscal policy in stabilizing economic fluctuations. There is limited discussion in the literature on the evaluation method and the value of the fiscal multipliers. Evidence suggests that they depend on time in the business cycle and across countries. They may also depend on other factors, as shown by Espinoza and Senhadji (2011) in broad empirical evidence for developed economies, but less for developing countries. Fiscal multipliers may be higher in developing countries, due to frequent occurrences of significant economic shortages, as reflected in the negative production gaps and high levels of unemployment (Blanchard and Leigh 2013), cited in (Abaida, Abdeljabbar).

According to Fjeldstad (2013) challenges for many developing countries is not only the largest tax (egg increase of the tax on GDP), but the taxation of a larger number of citizens and enterprises more consensual and to encourage engagement constructive of state-citizens about taxes. This is not easy for various reasons, by erasing the economic structure and history. Nevertheless, historical and contemporary experiences show that taxpayer behavior can be transformed by reforming the tax and expenditure system, bringing as a greater willingness to pay. And a greater tendency to mobilize the demand for better public services.

General advice of international institutions such as the IMF and World Bank to emerging economies over the last decades has been the replacement of international trade taxes with local consumption tax, particularly value added tax (VAT) and maintaining relatively high rates of corporate income tax. Unlike developed countries where personal income tax and social security contributions increase by two-thirds of total taxes, a tight tax base and high implementation costs make direct impractical taxation for developing countries. The income tax base consists mainly of the income of employees in the public sector, because all other taxpayers are self-employed or small businesses that avoid paying all or most of the income tax. In addition, personal income tax is easily avoided (Avi-Yonah, Margalioth, 2006). The VAT was recommended or endorsed by the IMF in 90% of the overall sample, the percentage of which was identical (90) both low-income and lower-middle income country group. However, simplification of tax administration was consulted at 50% and 20% of low and lower-middle-income countries, respectively. Expanding the tax base, it is recommended in 80% of the total sample or 100% of the low-income group and 60% of the lower-middle income group (Lauren, Tiffany, Stephanie, 2008).

According to Bernardi (2009), the role of political variables and the evolution of institutions in the process of increasing fiscal pressure typically characterized by shifting from planned economies to a market structure and a democratic government cannot be forgotten. This result is not a specific feature for a single site as the analysis was conducted for a large number of locations in different areas of the world. However, the empirical analysis shows that the structure of the tax system (direct and indirect taxation) should not be related to the evolution of democratic institutions. As stated above, the political reasons justify this result and in addition, the greatest administrative difficulties in direct tax administration have to be taken into account, especially in the case of personal income tax which requires the assessment of total income and allowances allowed for a large number of taxpayers.

Gordon, Li (2005) explored how the predicted change policies dropped if the firm can successfully avoid taxes by conducting all business in cash, in order to avoid any use of the financial sector. The main hypothesis of this paper is that governments must be based on available information from bank records to identify taxable entities and to measure the amount of their taxable activity. Firms then undergo tax if they choose to use the financial sector. When tax rates are high enough, firms may give up economic benefits from using banks to avoid these taxes. This threat of non-mediation may be small in rich countries, where the value of financial intermediation is considerable. However, in poor countries, this threat to non-mediation can be a key factor that limits the government's ability to collect tax revenues and shape government policy more. The size of the informal economy estimates is on average more than two times higher in poor countries than in rich countries. Developing countries have an informal sector representing an average of about 40%, perhaps up to 60% in some countries (Scheider, Buehn and Montenegro, 2010). Non-formal sectors represent many small informal traders that cannot be efficiently brought into the tax network (the cost of collection is high and the income potential is limited), cited in (Velde, 2013).

Bird, Martinez-Vazquez (2008) using cross-section data from 1990-1999 argue that a more legitimate and responsible state is a key factor for a more appropriate taxation effort in developing and high-income countries. Thus, these empirical results strongly suggest that corruption as well as say, and accountability play an important role in determining the level of tax efforts of developing and transition countries. The results show that demand side determinants are very important in explaining tax performance. The authors also observed a strong relationship between the quality of government and tax efforts in high-income countries. Also, the authors observed that demand side determinants are very important in explaining tax performance to high-income countries. The two variables, control of corruption and voice and accountability are statistically significant comparable or even higher than the traditional supply factors. The study also shows that high-income countries have the potential to improve their tax performance by improving their institutions. Improving corruption, voice and accountability may not last longer or be necessarily more difficult than changing opportunities for tax projects and economic structure.

According to Besley, Persson (2014) ultimately, closer scrutiny is the underlying fact that developing countries today are not so different - with regard to the share of tax on GDP and taxation structure - from modern income countries high at a similar stage of development. This model suggests that low taxation may reflect a range of factors that also help explain why low tax countries are poor. From this perspective, the most important challenge is undertaking the steps that encourage development, instead of specific measures focused exclusively on improving the tax system.

Tax can be used as a means of controlling inflation in developing countries in order to achieve economic and financial stability. Through taxation, the government can control the following inflation: if inflation is due to higher prices of key items, then the government may reduce the indirect tax rate. If inflation is due to increased demand, the government can lower the demand effectively by increasing its rate. Increasing the tax rate may limit consumption, which can reduce demand and then inflation may be contracted (Rahul, 2015).

In literature, it is generally assumed that the promotion of economic growth and social justice are shared by developed and developing countries. However, a number of major differences between developed and emerging economies, such as the differences in the type of industries (mainly the relatively high share of agriculture and small businesses in developing countries), the size of administrative costs and compliance, the level of corruption, monetization in the economy, polity restrictions and the relative size of the informal economy may require different tax designs (Avi-Yonah, Margalioth, 2006).

Theoretical aspects

In terms of taxation, many financial theorists have been taken into account, since taxes are the essential part of the budget revenue, which means that taxes are one of the main instruments in redistributing national income to finance state spending. Different theories are presented with regard to taxation, so some of them will be presented in this paper.

The neoclassical growth model - (inter Alios Swam 1956; Solow 1956) does not provide scope for assessing the potential for fiscal policy to affect the long-run steady-state growth rate; in this model a change in the tax rate may lead to a shift to a shift in the steady-state growth path, but not in its slope. Endogenous growth models provide a sound theoretical basis to examine the effects of different tax categories on economic growth (or at least investment decisions affecting economic growth). Mendoza's work et al. (1997) is particularly illustrative of the various distortions of growth arising from the choice of the tax rate. However, an important issue lies in the fact that their model deals with the marginal tax rates, cited in (McNabb, LeMay-Bucher, 2014).

Altruism - Is altruism a reasonable theory of bequests? At the very least, we know that it is not the full theory of bequests: the tests of its economic implications are routinely rejected. The best well-known example of such a test is based on the observation that altruistic bequests should be compensatory: a parent with two children should make bigger transfers to a child who is worse off. However, in practice, bequests are predominantly split equally between children. Some support for the desire for compensating children is provided by work of McGarry (1999) who finds evidence suggesting that inter vivos gift may be compensatory even though bequests are not, and by Light and McGarry (2004) show that a fair number of individuals show intention of behaving in a compensatory manner. Bernheim and Severinov (2003) suggest that bequests may serve as a signal of parental altruism and show that in thas context equal splitting may arise, cited in (Kopczuk, 2010).

Bequest Motives **-** While there are usually many parties that are either directly or indirectly affected by any particular tax, this is particularly starkly visible in the context of transfer taxation. There are two sides to every bequest: donor's and donee's. The action of the donor (the choice of bequest) directly affects welfare of the donee. Because bequests are usually not bought and sold, there is a possible externality here. The presence of an externality has important implications for the economic analysis of efficient policies, because it is well-known that optimal policy involves the correcting of externalities. We know in a reasonably well how the presence of a simple externality affects the structure of optimal policy (Sandmo, 1975, Kopcuk, 2003a, Micheletto, 2008) when the externality can be directed directly: he dies by modifying the formula for the tax imposed on the sole source of externality, cited in (Kopczuk, 2010).

The Standard Theory of Optimal Taxation posits that a tax system should be chosen to maximize a social welfare function subject to a set of constraints. The literature on optimal taxation typically treats the social planner as a utilitarian: that is, the social welfare function is based on the utilities of individuals in the society. The primary focus of modern optimum tax research has been the schedule of marginal tax rates on labor income. A well-know early of the Mirrlees (1971) model optimality of a zero-top marginal tax rate. In the Mirrlees model, the schedule of marginal tax rates is the main battleground in the tradeoff between equality and efficiency. Consider an increase in the marginal tax rate at a given level of income. This tax increase has a cost of efficiency because it discourages the individuals who earn that income from exerting effort. Recent work has undermined the practical significance of this finding, but its intuition may still have important implications for high-income taxation, cited in (Mankiw, Weinzierl, Yagan).

The optimal taxation literature also recommends equal tax rates on all forms of consumption, as seen, for example, in Atkinson - Stiglitz (1976). Developing countries have over time been replacing excises taxes, where rates often varied dramatically by good, with a VAT one or at least only a few rates. The effective rates, though, are low due to a combination of exempt (or zero-rated) goods and evasion. One other standard result from the optimal tax literature is that a small open economy should take full advantage of any gains from trade, and not distort trade patterns. With evasion such a dominant issue, countries face additional to lower tax rates, in order to draw firms into the formal economy and to reduce the incentives on those who are already in the formal economy to underreport their income or value-added (Gordon, 2009).

(Creedy) has considered, within a limited bus, the extent to which economic theory can provide specific policy advice with regard to income tax structures. According to the author, many of the results are negative or too broad to provide direct policy guidance. In fact, most of the theories have been clarified instead just because it is very difficult to produce clear arguments. In giving policy advice, inevitably it turns out that the role of the economist is to explore implications of adopting alternative value estimates - and there are few results that do not depend in any way on the final objectives of a tax system. Wide-ranging tax literature does not provide and refuse to provide clear guidance but instead clarifies: the exact way in which the optimal tax system depends on a wide range of factors, some of which relate to court judgments value, while others relate to behavioral response or basic conditions, such as skills, which exhibit considerable heterogeneity in practice.

Review of the literature.

Taxes are needed to finance public goods, to control other market imperfections; and achieve social justice through redistribution. Economic growth (efficiency) is promoted through the first set of goals; while social justice (equality) is promoted through redistribution and delivery of public goods and merit, especially health and education (Avi-Yonah, Margalioth, 2006). This paper will present a review of empirical literature on the impact of taxes on economic growth in developing countries.

This study looked at the effects of VAT on the economic growth of the 19 developing countries for the period from 1995 to 2010. For the data analysis, the GMM panel was used. Subsequently, the effect of VAT through the savings channel on accumulation and capital productivity and finally the impact of VAT on economic growth was examined. The results derived from VAT have a negative effect on increasing capital accumulation at the level; the positive effect of VAT on the level of economic growth seems to be imposed through other channels than the increase in savings, and its effects on capital accumulation. Results of the GMM system evaluator showed a statistically significant relationship between VAT and productivity growth (Kolahi, Noor, 2015).

According to (Alegana, 2014) the purpose of the study was to determine the effect of tax incentives on economic growth in Kenya. In the research, secondary data were used, using descriptive analysis, correlation analysis and regression analysis. The findings showed that it was a reverse ratio between GDP growth rate and tax incentives and GDP growth and development stage, while having a positive relationship between GDP growth rate and investment levels, rate of GDP growth and the level of productive population and the rate of GDP growth and literacy levels.

Eugene, Abigail (2016) examined the effect of tax policy on economic growth in Nigeria. The study uses 20-year time series data (1994 - 2013), OLS regression analysis was used to investigate relationships that exist between dependent and independent variables. Findings found that taxes have a significant effect on Nigeria's economic growth. It showed that the percentage of indirect taxes to the total has increased over the years. Different components have different effect on economic growth, the result showed that indirect taxation has a strong positive relationship with the level of economic growth in Nigeria. The result of direct tax analysis showed a weak relationship between economic growth and direct tax policy.

Lumbantobing, Ichihashi, (2012) investigated how the tax system, in fact, affects the country's economic growth rate and the distribution of income through the use of a panel data of cross-national data composed of 65 countries during the 1970s - 2006. For the evaluation analysis, OLS was applied, case effect and fixed effect estimates. This document concludes that corporate income tax rates are highly related to economic growth and income inequality. However, the personal income tax rate does not have an impact on economic growth and inequality of income.

McNabb, LeMay-Bucher (2014) investigated the relationship between tax structure and economic growth in developed and developing countries from 1980 to 2010. Results from Common Correlated Effects Mean Group (CMG) estimator (Pearson 2006) conclude that tax increases of income (especially personal income tax) offset by the reduction of trade or consumer taxes have had a negative impact on the GDP growth rate. We also emphasize the fact that trade liberalization has not had any significant positive effect on economic growth. Net income increases in personal income taxes are found to be particularly damaging in middle and low-income countries.

Nantob (2014) explore effects of tax increases on economic growth in 47 developing countries, analyzing the effects of four kinds of taxes, namely income tax, taxes on goods and services, taxes on income, profits, capital gains and taxes on international trade to economic growth. Using a dynamic panel data over the period 2000 - 2012 and using the GMM estimator to address issues of endogeneity, econometric results show that: (1) there is a relationship not linear between tax revenues and economic growth. (2) there is a relationship not linear between taxes on income, profits and capital gains, taxes on international trade and economic growth in particular. These taxes reduce economic growth in the short term and then these effects diminish over time when these taxes rise.

Gordon, Li (2005), characterized the way tax revenues related to tax rates. Regression analysis was used to determine the ratio of tax revenue / GDP, compared to the maximum rate of VAT and minimum personal tax rates and corporate focusing separately on data from poor countries and rich. In rich countries (18 observations), the results look quite sensitive; if the average basis of consumption tax was about two thirds of GDP, it means that the rate the effective tax rate is 87. The coefficient of .46 at the level of the minimum tax income also seems acceptable, given the frequent use of a progressive rate structure under the personal income tax, resulting in an average tax rate too lower than the maximum legal rate. In poor countries (25 observations), in contrast, the results are dramatically different: the coefficient is lower than the rate the average VAT is far below the maximum level of legal tax, perhaps because the informal economy is often much greater in poorer countries. negative coefficient on the rate of tax on income, however, suggests the opposite causes; when incomes are very low due to a large informal economy, the statutory tax rates become higher to collect more of the few firms that remain part of the taxable sector.

Borg (2006) empirically analyzed in small countries the link between international trade income, GDP per capita, GDP size of and open trade level, using Two-Stage Least Square method (TSLS) in 130 countries from 1999 to 2004. The regression results show that the rate of international trade taxes in total revenue is negatively related to GDP per capita. While the rate of tax on international trade is positively related to economic opening. Also, results show that small States totaling HDI tend to collect more of their tax revenues from taxes on income, profits and profitability of capital, while small states with low HDI tend to increase most tax revenues from taxes on international trade.

Empirical literature in developed countries shows that there is a negative relationship taxes on GDP. Dackehag, Hansson (2012) studied how tax rates on corporate income and personal income affect economic growth using panel data from 1975 to 2010 by 25 rich countries of the OECD. The results showed that the taxation of corporate income and personal income negatively affects economic growth. However, the correlation between the tax on corporate earnings and economic growth is strong.

Stoilov, Patonov (2012) explored the basic trend in the distribution of the overall tax burden in the EU member states during the period from 1995 to 2010, using regression analysis. Comparative analysis is focused on the differences between countries in terms of the overall tax burden as measured by the GDP ratio of the tax and the determination of the tax structure, presented by dividing the total on standard components such as direct taxes, indirect taxes and social contributions. The regression coefficient expresses the impact of public spending on GDP growth. It has a negative sign and statistically significant at 1 percent. Consequently, this the result is a reliable empirical evidence about the negative impact of budget expenditures on economic growth. Tax structure based on direct taxes is the most effective in terms of supporting the economic growth in the EU countries.

Conclusions and recommendations

The main objective of this study was to investigate the tax structure in developing countries. Tax policy of these countries consists of a tax structure, where the share of revenues collected from more budget tax revenues from taxes on international trade and much less from direct taxes. Based on the review of the empirical literature, it was found that most of the research tax impact on economic growth had a negative relationship. Also, according to the theoretical literature taxes do not affect economic growth.

Since the tax impact on the economy is at a high intensity and attracting foreign investors to be a high turnout, developing countries need to apply a more effective tax policy through the use of more direct taxes and the gradual reduction of tax revenues from international trade taxes in order to encourage taxpayers to increase their participation in production, trade and investment growth. Substantial additional income can grow in many developing countries through established methods, tailored and unique circumstances of countries rankings. Approval and making clear ready laws and regulations that include a strong defense of taxpayers - the main problem is often the application (IMF, 2011).

Also, it is important even in these countries the permanent extension of the tax base, so that the tax burden on existing taxpayers to be lower, because it would affect in reducing tax evasion and increasing GDP.

In developing countries, it is very important the growth number of enterprises in conducting payment operations through the banking system - namely the creation of powerful taxpayer's relations - the bank, because this would affect their attraction in the formal sector, and as a result this also increase public revenues. But that this increase cooperation, provision of services by banks should be convenient for enterprises. With regard to the role of banks in tax enforcement, the authors have derived the following projections for countries where banks provide only a modest added value: 1. Tax revenues as a share of GDP will be lower, limited by the threat the not mediation. 2. The tax base will be tight, sealed in intensive equity firms particularly value the use of financial intermediation. 3. Optimal tax structure would impose a significant burden on the income taxes of the capital, in order to concentrate the tax burden on those firms are less willing to give up the use of the financial sector. 4. Fees will used to protect the taxed sector. 5. Inflation will be used as a means of indirectly to taxation of non-taxed economy (cash). 6. The entry of foreign firms may be limited to those sectors which are subject to tax, but should be encouraged in various sectors of non-taxed. 7. There is likely to be limited to red border duty-free sectors (Gordon, Li, 2005).

Because taxes are a source of important public revenues in developing countries, future research should be intensified on the need to reform tax policy, so that their impact is greater in economic growth and increased social welfare. Also, because developing countries are characterized by their specificity in economic and tax structure, future research should focus on the country level.

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