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INTRODUCTION

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NEED/IMPORTANCE OF THE STUDY

STATEMENT OF THE PROBLEM

OBJECTIVES

HYPOTHESIS (ES)

RESEARCH METHODOLOGY

RESULTS & DISCUSSION

FINDINGS

RECOMMENDATIONS/SUGGESTIONS

CONCLUSIONS

LIMITATIONS

SCOPE FOR FURTHER RESEARCH

REFERENCES

APPENDIX/ANNEXURE

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TAX REVENUE AND ITS IMPACT ON ECONOMIC GROWTH OF INDIA: AN EMPIRICAL STUDY

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ABSTRACT

Tax has always been the driving fuel of the economy ever since the history of mankind. The same holds true yet for all the developed and developing economies including India. India has got some major taxes in the form of Corporation tax, Customs Duty, Excise Duty, Income and Services tax which form the major source of its revenue. This study was conducted to find the relationship between different kinds of taxes and GDP of India for years 1994-2014 using time series data. Statistical techniques used in analysis include Regression analysis, Unit root test, co-integration test, Breusch-Pagan-Godfrey, and so other tests for reliability of the study. The study shows that there is significant positive impact of taxation on economic growth of India with income tax being least effective. Services tax apart from other taxes was found to be one of most productive in such a shorter span of time since its imposition (in 1994).

KEYWORDS

Corporation Tax, Custom Duty, GDP, Excise Duties, Income Tax, Service Tax, India.

INTRODUCTION

Tax is a compulsory contribution to the state revenue, levied by the government on people who in turn enjoy returns from it. It is the driving fuel of the economy and keeps the economy alive and enables the government to practice numerous economic and non-economic activities which lead to development. It makes possible for the government to provide public, social and merit goods and holds the increase in debt to GDP ratio in balancing budget deficit to control the rate of inflation and practice fiscal stabilization. Indian economy is one of the emerging developing economies with a good but unutilized resource base. The government has to implement strong fiscal and international trade policies to cope with widening gap between public revenue and expenditures. In this case tax GDP ratio of India is 17.7 percent which is a bit higher from the similar developing neighbour economies like Pakistan (10.2 percent), Nepal (10.9 percent), Bangladesh (8.5 percent) and Bhutan (10.7 percent). The authority to levy a tax in India is derived from the Constitution of India which allocates the power to levy various taxes between the Centre and the State. Article 246 of the Indian Constitution, distributes legislative powers including taxation, between the Parliament of India and the State Legislature. Schedule VII enumerates these subject matters with the use of three lists as: the areas on which only the parliament is competent to make laws; the areas on which only the state legislature can make laws, and the areas on which both the Parliament and the State Legislature can make laws upon concurrently. In India, taxes are imposed on individuals and legal entities in the form of income tax, corporate tax, sales tax, custom duties, excise duties, services tax etc. There are some twenty different taxes imposed in India. Tax collection is the major tool of fiscal policy and a source of revenue collection for government in both developed and developing economies. Effective tax system is crucial and indispensable for economic growth in developing economies, where large portion of income is utilized in unproductive channels. Taxation diverts the conspicuous and wasteful expenditures into the acceleration of investment and formation of socio-economic overheads. However there is a difference of opinion among the economists on the impact of taxation on economic growth in the economy. Policies regarding tax considerably differ between poor and rich countries. In rich countries the contribution of tariffs in total taxation is lower than other taxes like income and consumption taxes. While in poor countries, tariffs and excise taxes play a vital role in tax revenues of the country (Gordon and Li, 2005). Taxes are important for expenditure of government to manage, redistribute income among people and different sectors of the economy, market regulation, inflation control, and so forth. India has collection of direct taxes as a big contribution of total tax revenues at centre, while indirect taxes have low level of revenues for government as it has failed to collect taxes from every sector calling forth for the need of increasing the tax base. However, there is a good amount of indirect tax being collected at the state level. According to P. Chidambaram (June 6, 2013) only 2.89 percent of the Indians (near about 36 million people) pay income tax. Most of the evasion occurs because of corruption, bribes and false assessments by the tax collectors as Income Tax Department lists among the most corrupt departments of the country. The tax to GDP ratio in India is even somewhat low at 17.7 % in FY 2013-2014 which is 30 % for developed economies.

THEORETICAL RELATIONSHIP

Theoretically we know that the burden of tax may have worse effects on economic growth of a country through different ways. First, the tax burden may lead to fall in investment and stock of capital or it may discourage the level of investment, which lowers the efficiency of economy. Second, tax policy may depress the productivity growth of research and development (R and D) which is the only way to improve the productivity of labor and capital. Third, taxes can also lead to fall in intensive to work which lead to fall in the contribution of labor productivity by reducing their hours of work. Fourth, tax may lead to fall in marginal productivity of capital as it forces capital to leave high taxed sector which is more productive to low taxed sector which has low productivity . There are also some evidences that show a positive impact of taxes on economic growth which conclude that taxes can lead to economic growth.

LITERATURE REVIEW

There are a lot of studies done by researchers on tax and GDP relations in the world, and in India as well. Two of the early studies by Hinrichs (1966) and Musgrave (1969) examined the relationship between the ratio of tax revenue to GDP (TAX/GDP) and found it was relatively low in the developing countries. M. Govinda Rao (2000) analyzed the evolution of the tax system in India since the early 1990’s. The paper describes and assesses the introduction of new forms of direct and indirect taxes, their revenue and equity implications and the successes achieved in their implementation. The author comes to the conclusion that instead of increase in tax gdp ratio there is a decline in it and further the tax system is yet to reach the levels of efficiency and productivity it was prior to reforms. Lutfunnahar (2007) identified the determinants of tax share and revenue performance for Bangladesh along with 10 other developing countries for the 15 years through a panel data analysis. The results suggested international trade, external debt and higher population growth are significant determinants of tax efforts. The study concluded low tax to GDP ratio for Bangladesh and other economies by not utilizing their tax revenue at full capacity which results in...
budgetary imbalance. Taufik and Imbarine (2012) found statistical evidence suggesting that the total tax revenue to GDP ratio is higher in the high income countries compared with the low and middle countries. Increase in total tax revenue (ITR) will encourage gross saving to increase in a country caused by increase in goods and services tax (GST) or sales tax that reduces consumption. However, taxes on international trade (ITT) has negative impact to gross saving, in which increase in ITT will increase the price of imported goods and relatively expensive than domestic goods that will encourage consumption and reduce gross saving. A research by (Rosaiza et al. 2011) was about the relationship of economic growth and taxation revenue. This study included the annual data from 1970 to 2009 of Malaysia. They used the GDP as measure of economic growth. All the variables were converted in constant price using 2000 as base year. ADF and PP test used by researchers as Unit Root test for stationary in time series data. For co-integrated time series they used Vector Error Correction Model (VECM). They concluded that changes in taxes have no effect on economic growth.

NEED AND IMPORTANCE OF THE STUDY
In economy like India, the poor are suffering more from the burden of taxes as indirect taxes (sales tax) on basic necessities is rising because of inelastic demand compared to tax rate on luxury goods, which shows regressive, where rich are paying less than poor as compare to their tax to income ratio. The tax system is designed by the elite class including the politicians and bureaucrats who are part of policy formulation to have a clear way for tax evasion and corruption. This has shifted the tax burden from rich onto the poor which results in utilization of their income on hoardings, jewelry and demonstration effect. Optimal tax rate is necessary in both direct and indirect taxation to reduce market distortions and inefficiency along with high revenues for public expenditures. This will decrease burden on both the consumers and producers. Empirically there is lot of the controversies about the impact of taxes on economic growth among authors, that their empirical study shows some differences about the impact. Many of the authors concluded that there is positive relationship overall between taxes and economic growth, some concluded this relationship as negative. Few study results state that there is no relationship between taxes and economic growth. The motive of this present empirical study is to seek the answer for the same question of relationship between tax and economic growth. This way the relation between the GDP growth rate and the major taxes of India is studied from the period 1994-95 to 2013-14. The study would have been extended much below to 1994 but since one of the major important taxes i.e. Service tax was imposed for the first time in 1994. So, there was no option other than to start the analysis from 1994 and further revised estimates of various taxes were taken into consideration for the period of 2014.

OBJECTIVES OF THE STUDY
1. To study the impact of taxation on the growth rate of GDP in India.
2. To study the contribution of some major taxes individually on the growth rate of GDP.

DATA AND METHODOLOGY
SAMPLE DESIGN AND DATA DESCRIPTION
MODEL SPECIFICATION
Multi Linear Regression Model (MLR) is used on time series data to estimate the model and find out the relationship between GDP and five kinds of major taxes of India. The dependant variable is GDP of India and independent variables included are Income Tax (IT), Sales Tax (ST), Custom Duties (CD), Excise Duties (ED), and Services Tax (ST). A unit root test is used for stationarity of the data and Co-integration test for long-run association. The general equation of the model is:

\[ Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 + \epsilon \]

Where,
\[ Y = \text{GDP of India} \]
\[ X_1 = \text{Income Tax (IT)} \]
\[ X_2 = \text{Corporation Tax (CT)} \]
\[ X_3 = \text{Custom Duty (CD)} \]
\[ X_4 = \text{Excise Duty (ED)} \]
\[ X_5 = \text{Services Tax} \]

DATA ANALYSIS AND RESULTS INTERPRETATION
REGRESSION
Dependent Variable: GDP
Method: Least Squares
Date: 05/01/15  Time: 16:31
Sample: 1994 2014
Included observations: 21

| Variable | Coefficients | Std. Error | t-Statistics | Prob. |
|----------|--------------|------------|--------------|-------|
| C        | 223682.9     | 407349.8   | 0.549118     | 0.5910|
| IT       | 8.44474      | 8.962943   | 2.615741     | 0.0395|
| CT       | 25.25627     | 2.469089   | 10.14599     | 0.0001|
| ED       | 17.54544     | 4.531809   | 3.650958     | 0.0024|
| CD       | 19.17761     | 10.43596   | 2.283926     | 0.0374|
| ST       | 14.78217     | 5.964455   | 3.316677     | 0.0047|
| R-squared| 0.986439     | Mean dependent var | 4246106. |
| Adjusted R-squared| 0.985252 | S.D. dependent var | 3124480. |
| S.E. of regression| 215296.2 | Akaike info criterion | 27.63237 |
| Sum squared resid. | 6.95+11 | Schwarz criterion | 27.93081 |
| Log likelihood | -284.1399 | Hannan-Quinn criter. | 27.59714 |
| F-statistic | 839.4470 | Durbin-Watson stat | 1.746960 |
| Prob(F-statistic) | 0.000000 |                       |       |

Interpretation
The regression analysis shows the impact of different variables on GDP which are included in the model. Coefficients show the direction and degree of the variable with which they are affecting the dependant variable. The predictor variables IT, CT, CD, ED and ST have significant positive impact on GDP with p-values are less than 5 % significance level and significant t-statistic values showing that all the variables are individually enough significant to explain the dependant variable. And it is seen that the Corporation tax, Excise duty and Custom duties are the taxes with maximum impacting or contribution in the growth rate of the GDP. The Income tax coefficient is seen with the minimum regression coefficient means affecting least to the growth of GDP in the economy. F-statistic shows the overall significance of the model and it is 839.447 with p-value less than significance level and R-square as 0.986 which in econometric sense means that independent variables are explaining 98.5% variation in the dependant variable GDP. The R-square sounds too high in the model which may be due to time series analysis and so due to Multicollinearity, but the model don’t has the problem of Multicollinearity which we will soon defend with tests.
UNIT ROOT TEST FOR GDP
Null Hypothesis: D(GDP,2) has a unit root
Exogenous: Constant, Linear Trend
Lag Length: 2 (Automatic - based on SIC, maxlag=4)

| t-Statistic | Prob.* |
|-------------|--------|
| Augmented Dickey-Fuller test statistic | -5.229806 | 0.0038 |
| Test critical values: | | |
| 1% level | -4.667883 |
| 5% level | -3.733200 |
| 10% level | -3.310349 |

*Mackinnon (1996) one-sided p-values.

Interpretation
The series of GDP is not stationary at the level, that's why we take the first difference of the series and tested it again using Augmented Dickey-Fuller test for unit root. The test statistic of (-5.229) of the test in absolute sense is greater than the critical values -4.667, -3.733 and -3.310 at 1%, 5% and 10% confidence levels respectively, and the p-value is less than 0.05, which conclude that there is no unit root or the data is stationary at 1st difference.

UNIT ROOT TEST FOR INCOME TAX (IT)
Null Hypothesis: D(IT,2) has a unit root
Exogenous: Constant
Lag Length: 1 (Automatic - based on SIC, maxlag=3)

| t-Statistic | Prob.* |
|-------------|--------|
| Augmented Dickey-Fuller test statistic | -4.803378 | 0.0034 |
| Test critical values: | | |
| 1% level | -3.886751 |
| 5% level | -3.052169 |
| 10% level | -2.666593 |

*Mackinnon (1996) one-sided p-values.

Interpretation
The series of Income tax (IT) is not stationary at the level and neither at ist difference that's why we took the second difference of the series and tested it again using Augmented Dickey-Fuller test for unit root. The test statistic of (-4.803) of the test in absolute sense is greater than the critical values of -3.886, -3.052, -2.666 at 1%, 5% and 10% confidence levels respectively, and the p-value is less than 0.05, which conclude that there is no unit root or the data is stationary at second difference.

UNIT ROOT TEST FOR CORPORATION TAX
Null Hypothesis: D(CT,2) has a unit root
Exogenous: Constant
Lag Length: 0 (Automatic - based on SIC, maxlag=4)

| t-Statistic | Prob.* |
|-------------|--------|
| Augmented Dickey-Fuller test statistic | -6.207333 | 0.0001 |
| Test critical values: | | |
| 1% level | -3.886751 |
| 5% level | -3.052169 |
| 10% level | -2.666593 |

*Mackinnon (1996) one-sided p-values.

Interpretation
The data series of Corporation tax is not stationary at the level as well as first difference that's why we again had to take second difference of the series and test it again using Augmented Dickey-Fuller test for unit root. The test statistic of (-6.207) of the test in absolute sense is greater than the critical values of -3.857, -3.040 and -2.660 at 1%, 5% and 10% confidence levels respectively, and the p-value is less than 0.05, which conclude that there is no unit root or the data is stationary at second difference.

UNIT ROOT TEST FOR CUSTOM DUTY
Null Hypothesis: D(CD,2) has a unit root
Exogenous: Constant
Lag Length: 0 (Automatic - based on SIC, maxlag=4)

| t-Statistic | Prob.* |
|-------------|--------|
| Augmented Dickey-Fuller test statistic | -6.14379 | 0.0000 |
| Test critical values: | | |
| 1% level | -3.757386 |
| 5% level | -3.040391 |
| 10% level | -2.980551 |

*Mackinnon (1996) one-sided p-values.

Interpretation
The data series of Custom Duty is not stationary at the level as well as first difference that's why we again had to take second difference of the series and test it again using Augmented Dickey-Fuller test for unit root. The test statistic of (-6.143) of the test in absolute sense is greater than the critical values of -3.757, -3.040 and -2.980 at 1%, 5% and 10% confidence levels respectively, and the p-value is less than 0.05, which conclude that there is no unit root or the data is stationary at second difference.

UNIT ROOT TEST FOR EXCISE DUTY
Null Hypothesis: D(ED,) has a unit root
Exogenous: Constant, Linear Trend
Lag Length: 0 (Automatic - based on SIC, maxlag=2)

| t-Statistic | Prob.* |
|-------------|--------|
| Augmented Dickey-Fuller test statistic | -4.975702 | 0.0112 |
| Test critical values: | | |
| 1% level | -4.332598 |
| 5% level | -3.673616 |
| 10% level | -3.277364 |

*Mackinnon (1996) one-sided p-values.
The data series of Excise Duty is not stationary at the level and so we had to take the first difference of the series and test it again using Augmented Dickey-Fuller test for unit root. The test statistic of (-4.975) of the test in absolute sense is greater than the critical values -4053, -3.67 and -2.71 at 1%, 5% and 10% confidence levels respectively, and the p-value is less than 0.05, which conclude that there is no unit root or the data is stationary at first difference.

UNIT ROOT TEST FOR SERVICES TAX
Null Hypothesis: D(ST,) has a unit root
Exogenous: Constant, Linear Trend
Lag Length: 2 (Automatic - based on SIC, maxlag=2)

| t-Statistic | Prob.* |
|-------------|--------|
| Augmented Dickey-Fuller test statistic | -3.877338 | 0.0374 |
| Test critical values: | | |
| 1% level | -4.616209 |
| 5% level | -3.710482 |
| 10% level | -3.297799 |

*MacKinnon (1996) one-sided p-values.

INTERPRETATION
The data series of Service tax is not stationary at the level and so again we had to resort to the first difference of the series and test it again using Augmented Dickey-Fuller test for unit root. The test statistic of (-3.873) of the test in absolute sense is greater than the critical values -3.71, and -3.29 at 5% and 10% confidence levels respectively, and the p-value is less than 0.05, which conclude that there is no unit root or the data is stationary at first difference.

CHECKING FOR MULTICOLLINEARITY
Using multicollinearity matrix

|          | GDP   | ED    | CT    | CD    | IT    | ST    |
|----------|-------|-------|-------|-------|-------|-------|
| GDP      | 1.000000 |       |       |       |       |       |
| ED       | 0.697735 | 1.000000 |       |       |       |       |
| CT       | 0.555134 | 0.189932 | 1.000000 |       |       |       |
| CD       | 0.721244 | 0.121008 | 0.712966 | 1.000000 |       |       |
| IT       | 0.732249 | 0.699487 | 0.687739 | 0.271791 | 1.000000 |       |
| ST       | 0.563215 | 0.616588 | 0.743266 | 0.723659 | 0.686479 | 1.000000 |

Interpretation
The correlation coefficients among different independent variables of the regression model can be seen as very high but still in the feasible region within the zone of acceptance. None of the coefficients in the correlation matrix falls in the rejection zone. But however high degree correlation is due to the nature of the time series data, where the variables seem to be increasing with the passage of time. Utilizing correlation matrix was much appropriate than going for auxiliary regression function as the the R-square of the original regression function was already high to be compared with the auxiliary regression function’s R-square.

TESTING REGRESSION MODEL FOR THE HETEROSKEDASTICITY

Heteroskedasticity Test: Breusch-Pagan-Godfrey

| F-statistic | Prob. F(5,15) | Prob. Chi-Square(5) |
|-------------|---------------|---------------------|
| 1.110104    | 0.3960        | 0.3395              |

Test Equation:
Dependent Variable: RESID*2
Method: Least Squares
Date: 05/02/15  Time: 17:56
Sample: 1994 2014
Included observations: 21

Interpretation
Checking data for the heteroskedasticity by the method of Breusch-Pagan-Godfrey Test. Here the null (Ho) shows absence of heteroskedasticity or the presence of homosedasticity in the variance of residuals which is desirable. The test shows the probability chi-sq value of 33.95 which is greater than 5% level. And thus we accept the null as per the prescribed guideline and conclude with no heteroskedasticity in the residuals.

JOHANSEN CO-INTEGRATION TEST
Finally looking for the co integration (long run relation) between the variables by way of Johansen Co integration test. This gives us the reliability that the relation derived by regression model between the variables and their coefficients is a long run phenomenon.

| Hypothesized No. of CE (s) | Eigenvalue | Trace Statistic | 0.05 Critical Value | Prob.** |
|-----------------------------|------------|-----------------|---------------------|--------|
| None*                       | 0.999979   | 424.2733        | 95.75366            | 0.0001 |
| At most 1 *                 | 0.992605   | 219.5959        | 69.81189            | 0.0000 |
| At most 2 *                 | 0.977063   | 126.3639        | 47.85613            | 0.0000 |
| At most 3 *                 | 0.809654   | 54.63916        | 29.79707            | 0.0000 |
| At most 4 *                 | 0.683039   | 23.1193         | 15.49471            | 0.0029 |
| At most 5                   | 0.065605   | 1.289270        | 3.841466            | 0.2562 |

Trace test indicates 5 cointegrating eqn(s) at the 0.05 level
* denotes rejection of the hypothesis at the 0.05 level
**MacKinnon-Haug-Michels (1999) p-values

Interpretation
The test suggests that the p-value which is at 0.0001 less than 5% showing no co integration among any variable with trace statistic above the critical value is rejected. And further the co integration among at least 5 variables is accepted with p-value above 5% and trace statistic above critical value (3.81>1.28) is accepted. Showing that the co integration or long run relation does occur among all the variables of the regression model.
CONCLUSIONS AND RECOMMENDATIONS

This study focuses on the relationship and significance of different taxes with GDP of India. The study concluded that there is overall positive impact of taxes on GDP with high regression coefficients. However, the most minimum of these coefficients is of the income tax, which states that taxes on income is adversely affecting the productivity of the people and so to GDP. The coefficient of Corporation Tax (CT), Custom Duty (CD) and Excise Duty (ED) is very high and significant, which shows that these taxes play a dominant role in improvement of GDP growth, as they can generate greater revenues with a unit rise because of highly consumption society and lack of tax evasion which is evident from the higher coefficients of ST, CD and ED. The Services Tax imposed in 1994 has shown much progress so far and is the one of the emerging taxes in India. The low beta coefficient of Income tax is however on the basis of excessive income tax evasion. Income tax rates in India are one of the highest which is also responsible for massive tax evasion. Further higher income tax rates decreases the incentive to work more and hence cause a deteriorating effect on GDP growth rate. Percentage of people paying income tax is also too low mainly the people working in the government sector or the organized sector and the corporates having no scope for evasion for one reason or the other, pay income tax. Apart from excessive evasion and inefficient collection it still ranks second after the Corporation Tax in terms of amount of collection. Overall citizens of the society are subject to indirect taxation with its burden being most imposed on the poor and middle class by way of its regressive character. The effect of lowering of the Corporation tax rate from 30% to 25% during the present (2015-16) budget is yet to be seen by way of its impact on the tax collection. It is to be seen whether India will lose some of its revenue with time or ‘laffer’ curve approach will follow, which states increase in tax revenue with a decrease in its rate at certain point of time.

POLICY RECOMMENDATIONS

For an effective fiscal consolidation and a good GDP growth India needs strong and vibrant fiscal reforms. On the basis of this study following are some of the recommendations.

1. There is no need to increase tax rates in India; rather there is a need to increase the tax base, so that most of the professions should contribute to the tax revenue and growth rate of the economy. We ought to gain from buoyancy rather than from elasticity.
2. There is a need to bring the black money, tax evasion and foreign unaccounted deposits under the scanner rather than only make tall promises for vote bank politics.
3. Rates of the taxes like Income Tax, Gift Tax or tax on Capital Transactions is required to be brought down on the grounds of breeding inefficiency in the system being economically less viable, creating scope for evasion and corruption.
4. Custom duties and Excise duties should be increased on luxury goods to restrict their imports as compared to basic need goods. It will help in diverting private consumption into productive investment.
5. There is a need to hold proper scrutiny on the expenditures of the various government departments and ministries in order to check the wastage of hard earned tax money of the country to be prevented from being wasted on unproductive activities and scams.

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