M7: According to the World Bank, tax revenues above 15% of a country's GDP are a key ingredient for economic growth and, ultimately, poverty reduction. Discuss.

(Answer in 250 words) : 15 Marks

Subtopic M7: Taxation

Topic P1 : Economy II

M7 :According to the World Bank, tax revenues above 15% of a country's GDP are a key ingredient for economic growth and, ultimately, poverty reduction. Discuss.

$$\boxed{\text{Tax to GDP ratio} = \frac{\text{Tax revenue}}{\text{GDP of economy}}}$$

↳ shows where a Govt directs its economic resources.

More tax revenue translates into higher social & public spending by Govt.

↳ so high tax to GDP ratio may indicate higher social spending.

↳ Developed countries generally do have high tax to GDP ratio

↳ For OECD countries it is ~34%.

India's Tax to GDP ratio –

- 9.9% in FY20
- 10.2% in FY21
- With record GST collections in FY22
  ↳ the ratio will rise.

The World Bank has recommended a level of 15% for poverty reduction & eco. growth.

Reasons for low Tax to GDP ratio of India

- Narrow tax base
- Tax evasion
- Weakness in Tax administration.

It is generally held that a higher tax to GDP ratio
↳ gives the Govt ability to spend on infrastructure & social sector
↳ meet fiscal deficit targets.
↳ boosts economic growth.
↳ and helps in poverty reduction.

But Nepal's Tax to GDP ratio is ~25%.
↳ in the range of developed economies
↳ but financially, Nepal cannot justify such high levels of tax to GDP ratio
↳ This is due to high tax burden on the people.
↳ A high tax burden discourages private investment & hence cannot boost growth.

Conclusion

- Tax to GDP ratio is not an indicator of economic development
- Higher GDP translates into high tax revenue but more taxation may not yield a growth in GDP.
- World Bank's recommended level of 15% of tax to GDP ratio –
  - ↳ China was able to have double digit growth & poverty reduction even when its ratio was at 9-10% levels.
  - ↳ Govts can generate revenue from sources other than taxation.
  - ↳ This can be used to finance the infra and social spends.

Detailed Synopsis:

A tax-to-GDP ratio is a gauge of a nation's tax revenue relative to the size of its economy as measured by (GDP). The ratio provides a useful look at a country's tax revenue because it reveals potential taxation relative to the economy.

KEY TAKEAWAYS

- The tax-to-GDP ratio is a measure of a nation's tax revenue relative to the size of its economy.
- This ratio is used with other metrics to determine how well a nation's government directs its economic resources via taxation.
- Developed nations typically have higher tax-to-GDP ratios than developing nations.
- Higher tax revenues mean a country is able to spend more on improving infrastructure, health, and education—keys to the long-term prospects for a country’s economy and people.
- According to the World Bank, tax revenues above 15% of a country’s gross domestic product (GDP) are a key ingredient for economic growth and, ultimately, poverty reduction.

Understanding the Tax-to-GDP Ratio

Taxes are a critical measure of a nation’s development and governance. The tax-to-GDP ratio is used to determine how well a nation's government directs its economic resources. Higher tax revenues mean a country is able to spend more on improving infrastructure, health, and education—keys to the long-term prospects for a country’s economy and people.

Tax Policy and Economic Development

According to the World Bank, tax revenues above 15% of a country's gross domestic product (GDP) are a key ingredient for economic growth and, ultimately, poverty reduction.

This level of taxation ensures that countries have the money necessary to invest in the future and achieve sustainable economic growth.
Developed countries generally have a far higher ratio.
The average among members of the OECD was 33.8% in 2019.
According to one theory, as economies become more developed and incomes rise, people generally begin to demand more services from the government, whether in healthcare, public transportation, or education.

This would explain, for example, why the tax-to-GDP ratio in 2019 in the European Union, at an average of 41.4%, is so much higher than in Asia-Pacific, where tax-to-GDP ratios ranged from 11.9% in Indonesia to 35.4% in Nauru (and the majority of countries did not have a ratio as high as the OECD average of 33.8%).

What should be the ideal tax -GDP ratio?

The government should get adequate revenues to finance its expenditure. Hence tax GDP ratio should be enough to meet government expenditure.
In Western countries, the tax GDP ratio is higher. At the same time, government expenditure there is also very high as those Government makes expenditure on hospital expenditure, free

schooling etc.
In India, compared to several other countries, tax-GDP ratio is lower. The combined tax-GDP ratio for the center and states is estimated to be around 16.5% as per 2016-17 budget.
For the center, the tax GDP ratio was 11.3% as per 2016-17 budget and the 2017-18 budget also makes the same estimate.

Reasons for low tax-GDP ratio:

Tax GDP ratio is lower because of narrow tax base. Only 3% of the country's population pay income tax. There is large scale tax evasion. Similarly, corporate have tendency to avoid taxes. Weaknesses in tax administration is another factor.

What are the measures for the improvement of tax-GDP ratio in India?

Over the last one decade the government has made several steps to raise tax -GDP ratio. The main hurdle is the prevalence of black economy. The demonetization programme and the follow up steps have added strength to the fight against black money.

Tax -GDP enhancement steps are broadly two:
1. Refining tax structure
2. Improving tax administration

Recent trends in Tax to gdp ratio-

India's gross tax-to-GDP fell from 11% in FY19 to 9.9% in FY20. Owing to a decline in the overall GDP marred by Covid-19 troubles, the ratio improved to 10.2% in FY21.
For years, India has struggled to increase its tax-to-gdp ratio, a marker of how well the government controls a country's economic resources.

A low tax-to-GDP ratio poses significant challenges for the government to spend money on creating necessary infrastructure in the economy and raise investment.

Slowing economic growth in the current fiscal has raised questions on meeting the tax collection target. This could further hurt India's tax-to-GDP ratio.

Why is it important?

A higher tax to GDP ratio means that an economy's tax buoyancy is strong as the share of tax revenue rises in sync with the rise in the country's GDP. India, despite seeing higher growth rates, has struggled to widen the tax base. Lower tax-to-GDP ratio constrains the government to spend on infrastructure and puts pressure on the government to meet its fiscal deficit targets.

Where does India stand among global peers?

Although India has improved its tax-to-GDP ratio in the last six years, it is still far lower than the average OECD ratio which is 34 per cent. India's tax-to-GDP ratio is lower than some of its peers in the developing world. Developed countries tend to have higher tax-to-GDP ratio.

World Bank recommended level

Tax revenues above 15 percent of a country's gross domestic product (GDP) are a key ingredient for economic growth and, ultimately, poverty reduction.

Many developing countries have a low tax-to-GDP ratio. The most recent data indicate that about 60 countries fall below the 15 percent threshold.

Tax-to-GDP Ratio of Different Countries

Countries	India	China	Japan	America	UK	Russia	Bhutan	Canada	Nepal
Tax-to-GDP ratio	10.9	9.21	34.3	24.3	33.5	11.7	12.03	33.0	25.29

Source: World Bank Report, 2019

It compares the tax-to- GDP ratio with the neighboring and the most developed countries of the world.

The tax-to- GDP ratio of china is at the lowest point, followed by India. The tax-to-GDP ratio of Japan is at the highest point among the sampled countries.

Critical Analysis:

- It is commonly assumed that a more tax-to-GDP rate shows a better financial position and can finance its expenditure.
- On the other hand, the lower tax-to-GDP ratio reduces the tax burden to the general public and investors that encourage private investment.
- An increase in private investment induces increased personal profit and employment and ultimately improves its economic growth.
- For eg Nepal's tax-to-GDP ratio seems much higher in comparison to its overall financial condition.
- The tax-to- GDP is not only one indicator of economic growth. If tax revenues rise less than GDP or fall further, the tax-to-GDP ratio will go down.
- Therefore, the tax-to-GDP ratio does not necessarily mean that the amount of tax revenues has increased in nominal or real terms.
- The high tax-to-GDP ratio discouraged investors from increasing their business.
- Only a tax increase- to- GDP ratio is not the panacea to the economy's financial problems. Many socialistic economists assume that increased rate hampers economic growth.

Conclusion

- The tax- to- GDP ratio of Nepal is expanding and near the level of most developed countries. The tax- to- GDP ratio of Nepal (25.29%) is more than the tax-to- GDP ratio of India (10.9%), China (9.21%)., America (24.4%), and Russia (11.7%) but less than the tax to GDP ratio of Japan (34.4%) and the United Kingdom (33.3%).
- It means that the tax-to-GDP ratio is not a single and powerful indicator of economic development.
- The Tax-to-GDP ratio cannot ensure economic development or the fulfillment of financial resources.
- There is a positive relationship between tax revenue and GDP.
- Therefore, it is necessary to increase GDP for the increment of tax revenue. More tax rate in comparison to the increment of GDP may hamper the economic growth of the nation.
- It is proved from Nepal's economic condition that the higher tax-to-GDP ratio alone cannot ensure its high economic growth.
- It is necessary to advise the government to expand the tax net rather than solely focusing on custom revenue and income tax. The government effort has to put in tax diversification.
- The maximization of tax revenue is possible at the maximizing condition of GDP. A very high tax-to-GDP ratio discourages investment. So, it is necessary to decrease the tax rate to allow investors to expand their investment.