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Tax Structure and Economic Growth in Nigeria

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Abstract
The development of endogenous growth theory has opened an avenue through which the effects of taxation on economic growth can be explored. Taxes are the importance aspects of government revenue and they also act as means of transferring resources from the private sector to the public sector. Explicit modeling of the individual decisions that contribute to growth allows the analysis of tax incidence and the prediction of growth effects. This paper reviews the theoretical and empirical evidence to assess whether a consensus arises as to how taxation affects the rate of economy growth. It is shown that the theoretical models isolate a number of channels through which taxation can affect growth and that these effects may be very substantial. Although there are empirical difficulties, the empirical evidences point very strongly to the conclusion that the tax effect is very weak.
Keywords: Tax, Structure, Growth, Economic, Nigeria.

Introduction

Economic growth is the basis of increased prosperity. Investment in new capital [both human and physical], the implementation of new production techniques and the introduction of new products are the fundamentals of the growth process. Though its effect on the return to investment of the expected profitability of research and development, taxation can affect what choices are made and, ultimately, the rate of growth. In most developing countries like Nigeria, the Level of taxes has risen steadily over the course of the last century. An increase from about 5 to 10 percent of GDP at the return of the century to 20 to 30 percent at present is typical. Such significant increases in taxation raise serious questions about the effect they have had upon economic growth (Gareth, 2000).

Until recently, economic models that could offer insight into this question were lacking much of the growth literature focused on the steady state where output per head was constant, whilst those that did have sustained growth introduced this through a process exogenous to the model. By definition, such exogenous growth could not be affected by taxation. It is only since the development of endogenous growth theory that a tool has existed for investigating how taxation affects growth. These new models explicitly model the process through which is generated and, by doing so, can trace the effects of taxation upon the individual decision making that lies behind them. Thus, tax incidence can be understood and predictions made about growth effects.

In more recent times, analysis has to be made using Solow (1970) model and the endogenous growth model to explain the effect of tax structure on the growth rate of the economy. Reflecting on the short term output on the increase in tax of percentage and long term persistent effect of taxes on output growth rate, it may pose a negative effect on the economy due to inefficiency of measuring government expenditure against revenue. It entrepreneurial activity is an important source of economic growth, as argued by Schumpeter (1942), then these same characteristics of the tax law should also generate a higher growth rate. Having taking interest in the happiness in recent time on Nigeria tax system and current economy trend in the country, this paper is focused on the significance of Direct and Indirect tax on Nigeria economy and its effect on economic growth.

Theoretical Background

In a neoclassical setting, growth simply depends on the accumulation of physical and human capital. In the long-run, any given tax structure generates an equilibrium capital labor ratio and an equilibrium level of education per worker. Any further growth in per capital output simply arises from an exogenous rate of technical change. There should be no permanent effects of the tax structure on the growth rate in per capital output, regardless of the size of the misallocation generated by the tax structure. Changes in tax policy, however, can generate changes in these equilibrium values, generating transitory growth effects. An increase in the years of education chosen by new entrants to the labor force, for example, will have fully change the average education for the labor force as a whole only after the first entrants following the policy changes have reached retirement age. Tax effects on the equilibrium capital stock can also take some period of time to be felt, due to adjustment costs to new investment in an open economy or due to the limited elasticity of savings rates in a closed economy.

What changes in tax policy do such increases in investment in physical and human capital generate? Odusola (2003) opines that low current effective tax rates on new investment suggest faster short-run growth, due to an investment boom in response to the temporarily lower tax rates. Our best available proxy for this is periods with a lower corporate income tax rate. The more recent endogenous growth literature provides models forecasting permanent growth, even with a stable tax structure, due to externalities generated through the accumulation of physical or human capital. While effects on growth can be permanent, the key issue remains the current incentives to investment in physical on human capital. During periods of greater incentives, growth rates should be faster. We will not be using a long enough time period to judge whether effects on growth die out after perhaps several decades (as in the neoclassical models), or are permanent as in an endogenous growth setting.

Much earlier than this endogenous growth literature, Schumpeter (1942) emphasizes the role of entrepreneurial activity in generating new ideas that raise productivity. Here rather than investments in physical or human capital per se generating growth, explicit investment by entrepreneurs in the creation of new ideals generates growth.

One of the strongest empirical link taxation and growth was reported in Plosser (1992). Plosser calculates the correlation between the rate of growth of per capital gross domestic product and a range of variable for the OECD countries. The share of income and profit taxes in GDP was found to have a correlation of -0.52 with the growth rate of GDP. A chart plotting average tax rates in OECD countries against GDP growth over 1969-1989 is given to confirm this result. Even so, Plosser warns against taking the correlation as evidence of causality and present several potential explanations for the lack of robustness in regression equations (most polices operate through investment, policies are complex and not easily represented by variables in regression, policies are highly correlated).

Koester and Kormeudi (1989) in an analysis of 63 countries use IMF data to construct measures of the average tax and the marginal tax rate. The average tax rate variable is constructed by using revenue /GDP and the marginal tax rate variable is obtained from a regression of revenue on GDP and a constant. A series of regression of the growth rate on tax variables and income are conducted. The regression results show little evidence of an effect of either average of marginal rate upon the growth rate, but the marginal rate is claimed to have an effect on the level of activity. The tax rates are significant when used as the sole regressor but become insignificant when the level of initial GDP is included. The inclusion of initial GDP raises the explanatory power of the regression, though it still remains small.

Easterly and Rebelo (1993) test the tax rate by their own method of constructing marginal tax rate, plus several other methods of defining the marginal tax rate, in tax regressions, in total 13 different measures of the tax rate are employed. The methodology adopted is to include these measures of the marginal tax rate one at a time within a basic regression equation. The basic equation contained the standard determinants of growth; notably initial income, school enrolments, assassination, revolutions and war casualties. Estimation of this basic equation without the inclusion of rates generated the result with an R of 0.29. They concluded that “the evidence that tax rates matter for economic growth is disturbingly fragile”.

A further analysis of the significance of tax rate variable is undertaken in Mendoza, Milesi-Ferretti and Asea (1997). The clear finding is that when initial GDP is concluded in the regressions, the tax variable is insignificant. Evidence contrary to this is presented in Leibtritz, Thornton and Bibbee (1997). Their regression of average growth rates for OECD countries over the period 1980-1995 against three measures of the tax rate (average tax rate, marginal tax rate and average direct tax rate) showed that a10 percent increase in tax rates would by accompanied by a 0.5 percent point reduction in the rate of growth, with direct taxation reducing growth marginally more than indirect taxation.

Additional work on similar lines has been undertaken by Dowrick (1993) and *de la* Fueute (1997). These papers considered that more marginal issue of how the structure of fiscal policy affects growth. In particular, they investigated how the rate of growth is related to the composition and level of public sectors spending. Dowrick studies a number of OECD countries and showed that personal income taxation and a negative effect on growth but corporate taxes had no effect. The results of *de la* Fueute showed that if public spending (measured as the share of total government expenditure in GDP) increases, growth is reduced (a reduction in government spending of 5 percent of GDP reduces growth by 0.66 percentages point) where an increase in public investment will raise growth. These results confirm the negative coefficient on government consumption expenditure.

Padovano and Galli (2001) also construct marginal tax rates by regressing tax revenue on GDP but improved on Koester and Kormuedi by including level and slop dummies to allow for changes in the tax rate over the sample period. He used government revenue and tax reform dummy variables and the estimated regression equation have an average rate of 0.96 (the value of which suggests there may be spurious regression issues) and almost always have a value that is significant at the one percent level. However, the estimated coefficient shows significant inter temporal variability for individual countries which seems larger than known changes in tax systems would suppose.

It was been noted that some tax regressions employ the average rate of tax, while others attempt to construct a measure of the marginal rate of tax. The consequence of this modeling choice is investigated by Padovano and Galli (2002) for data on 25 industrialized countries over the period 1970-1998. The basic argument is that individual choices are at the heart of endogenous growth theories. The relevant variable for choices is the marginal rate of tax and not the average rate. For this reason, the average rate of tax should not be significant in a growth regression. In addition, the average rate of tax is also related to government expenditure and so may even enter a growth regression with positive sign. The marginal rate of tax, and measures of tax progression, should enter the growth regression with a negative sign.

An approach designed to circumvent the difficulties involved in defining marginal tax rates can be found in Easterly (1993). Rather than looking at tax rates directly, Easterly places the focus on the distortions generated by those tax rates. These distortions are found by using the data of Summers and Heston (1988) on 1980 price data for 15 commodities in 57 countries relative to US: The variance of the prices within countries is then taken as a measure of the relative degree of distortion that exists in those economic due to taxation, quotas, price restrictions and other forms of intervention. After controlling for other determinants of growth (such as initial country income and school enrolment) the reported estimates show that the variance of input prices is a statistically significant variable in the determination of growth. In fact, increasing the variance of prices from the mean by one standard deviation lowers growth by 1.2 percentage points. This is clearly an interesting approach but it does have two deficiencies. First, the variance of prices is not proven to be a good proxy for the degree of distortion in the economy, it is merely assumed to be so. Secondly, there is no immediately obvious way to translate the effect of price variation into the effect of changes in tax rates. To do so would require knowledge of how taxes feed, though market equilibrium, into prices.

Engen and Skinner (1996) focus their discussion around the effect of a 5 percentage point act in marginal tax rate using three methods: (1) By studying the US historical record; (2) By reviewing empirical evidence on cross-section studies for large samples of countries; and (3) Compiling evidence from micro level studies. The review of US history does not suggest any concrete conclusion. Instead, the interest in the exercise lies in the demonstration that a minor change in the period under review can reverse the conclusion. This is a clear warning against making simple inferences from data.

An alternative set of issues are addressed in Kneller and Kormuedi (1999). They note that there are specification problems in the regression because of government budget balance. If the implications of budget balance are not handled correctly the regression equation is actually determining the difference of the effect of tax variables.

Widmalm (2001) investigates the effect of the tax structure on growth using cross-section data on 3 OECD countries from 1965-1990. The methodology follows that of Levine and Renett (1992) but used four basic variables (initial income, investment to GDP ratio, population growth, and average tax rate). The share of different tax instruments in revenue is considered first (corporate income tax, personal income tax, property tax, taxes on goods and services, and taxes on wages). The proportion of tax revenue from taxing personal income has a negative and robust correlation with growth. There is also some evidence that progressivity affects growth.

The theoretical models identify the different routes through which household choice and corporate choices can affect the growth rate. The results suggest that taxation of the household and taxation of the corporation may differ in how they influence the growth rate. This hypothesis is addressed in Lee and Gordon (2005) who conducted a tax regression using the top corporate marginal tax rate and top personal marginal tax rate to capture the effect of taxation. They justify this choice by an appeal to entrepreneurial activity being the driver of growth, and the top marginal rate being the one that is likely to be applicable to successful entrepreneurs, they concluded that it is corporate taxes that are most damaging for growth since they reduce entrepreneurial activities and

lessen the incentive for innovation cutting corporate tax by 10 percent points and can increase annual growth rate by 1.1 percentage point.

Methodology of the Study

Secondary (historical) data of Nigeria's Gross Domestic Product (GDP), Personal Income Tax Rate (PITR), Company Income Tax Rate (CITR), Petroleum Profit Tax Rate (PPTR), Value Added Tax Rate (VATR), Custom and Excise Duties Rate (CEDR), Direct Tax Rate (TDTR), Direct Tax Income Rate (TDYR), Indirect Tax Rate (TIDTR), Indirect Tax-income Rate (TIDYR), Labour force Participation Rate (LPE), and Capital-Income Ratio (KYR) for the period 1980 to 2009 were used for the study. Two research hypotheses were formulated to guide the study:

HO 1: There is no significant relationship between government tax structure and economic growth
HO 2: There is no significant relationship between government tax structure and government revenue
To measure these relationships, co-intergration and error correction modeling (ECM) was used.

Table One: Data Analysis and Interpretaion

YEAR	CED	CIT	K	LEP	PIT	PPT	TD	TID	VAT	GDPGR	GDP	T
1980	1813.5	579.2	11594	41.2	487.5	8564.3	9631	NA	NA	10.68795	43824.38	NA
1981	2325.8	403	18220.59	41	1997.3	6326	8726.3	NA	NA	10.771	47619.66	NA
1982	2336	550	17145.82	40.6	732.5	4847	6129.8	NA	NA	10.80099	49069.28	NA
1983	1984.1	562	13335.33	40.4	710.1	3747	5019.1	NA	NA	10.88007	53107.38	NA
1984	1616	787	9149.76	40.3	580.9	4762	6129.9	NA	NA	10.99579	59622.53s	NA
1985	2183.5	1004	8799.48	40.3	938.9	6711	8653.9	NA	NA	11.12592	67908.55	NA
1986	1728.2	1103	11351.46	40.2	433.7	4811	6347.7	NA	NA	11.14399	69146.99	NA
1987	3540.8	1235	15228.58	40	407.6	12504	14146.6	NA	NA	11.56384	105222.8	NA
1988	5672	1551	17562.21	39.8	540.5	6815	8906.5	NA	NA	11.84284	139085.3	NA
1989	5815.5	1914	26825.51	39.7	938	10598	13450	NA	NA	12.28672	216797.5	NA
1990	8640.9	2997	49121.31	39.5	1724	26909	31630	NA	NA	12.49706	267550	NA
1991	11456.9	3828	45190.23	39.5	3040.4	38616	45484.4	NA	NA	12.65121	312139.7	NA
1992	16054.8	5417	70809.16	39.5	4903.1	51477	61797.1	NA	NA	13.18555	532613.8	NA
1993	15486.4	9554	9691.51	39.3	5626.5	59208	74388.5	NA	NA	13.43552	683869.8	NA
1994	18294.6	12275	105575.5	39.6	3888.2	42803	58966.2	25555.4	7260.0	13.43552	683869.8	84521.6
1995	37364	21878	141920.2	39.6	20436.4	42858	85172.4	58125	20761	13.71	899863.2s	143297.4
1996	55000	22000	204047.6	39.6	3407	7667	102074	86000	31000	14.47469	1933212	188074
1997	63000	26000	242899.8	39.6	8339.9	68574	102913.9	97000	34000	14.84583	2702719	199913.9
1998	57700	33300	242256.3	39.6	11400	68000	112700	96600	38900	14.81188	2708431	209300
1999	87900	46200	231661.7	39.6	20100	164300	230600	135000	47100	14.94015	365600	365600
2000	101500	51100	331056.7	39.3	38100	525100	614300	160000	58500	15..33727	4582127	774300
2001	170600	68700	372135.7	39.8	44400	639200	752300	262400	91800	15.3684	4725086	1014700
2002	181400	89100	499681.5	39.9	68100	392200	549400	290000	108600	15.74882	6912381	839400
2003	195500	114800	865876.5	40	54200	683500	852500	331900	136400	15.95405	8487032	1184400
2004	217200	113000	863072.6	41.1	58900	1183600	1355500	376700	159500	16.25009	11411067	1732200
2005	232800	14030	804400.8	41.8	212100	1904900	2257300	410900	178100	16.49463	14572239	2668200
2006	177700	244900	1546526	41.9	33300	2038300	2316500	399300	221600	16.73677	18564595	2715800
2007	241400	275300	1915349	42.3	268700	1600600	2144600	531000	289600	16.84358	20657318	2675600
2008	310700	316800	2030510	42.5	178500	1837200	2332500	564300	235700s	17.00584	24296329	2896800
2009	353200	391100	2419622	42.7	227900	2391500	3010500	736800	378640	17.02291	24714721	3747300

Source: Field Survey 2013

Results and Discussion

Unit Roots Test: The test of unit root is invariably, the test for stationary. This test is carried out on each variable in the model in order to avoid the estimation of a spurious relationship arising from using two or more non-stationary time series to estimate long run relationship. The Augmented Dickey- Fuller (ADF) method is used for the test of unit roots. The initial set of analysis involves the test on the data series in their level using a non-trended time series format. After this, we test for unit roots on the time series in their first differences.

The result of the unit root test in levels is presented in table 5.2 below from the table, it can be seen that apart from the variable of PITR, PPTR and CITR, the ADF test statistic for all the variables is less than the corresponding 95 percent critical ADF value. This means that the variables are non stationary in levels and that they are time dependent.

Table 2: Unit Root for Variables in Levels

Variable	ADF Test Statistic	95% Critical ADF Value	Rank
GDPGR	-0.668	-3.081	Non-Stationary
CEDR	-1.5145	-2.9678	"
VATR	-1.7806	-2.9678	"
PITR	-5.9536	-2.9678	Stationary
PPTR	-3.9354	-2.9678	Stationary
CITR	-3.6697	-3.081	Stationary
TDTR	-1.0257	-3.5714	Non-Stationary
TDYR	-3.5230	-2.9678	Non-Stationary
TIDYR	-1.0253	-2.9678	Non-Stationary

Source: Field Survey 2013

Moving forward, we take the first difference of the respective variables and perform the unit root test on each of the resultant time series. The rationale behind this procedure is that Box Jenkins (1970) argues that differencing non-stationary time series will make it attain stationarity. The result of the unit root test on these variables in first differences is reported in table 5.3 below. From the result, it is seen that the ADF test statistic for each of the variable is greater than the 95% critical ADF values (in absolute values). With this result, the variables are adjusted to be stationary. This implies that the variables are actually differences-stationary, attaining stationarity after the first difference of the variables. Thus, we would accept the hypothesis that the variables possess unit roots. Indeed, the variables are integrated of order one (ie 1[1]).

Table 3: Unit Root Test for Variables in First Differences

Variable	ADF Test Statistic	95% Critical ADF Value	Rank
GDPGR	-4.2093	-3.081	Stationary
CEDR	-4.2932	-2.9678	"
VATR	-4.6917	-2.9678	"
PITR	-6.9588	-2.9678	Stationary
PPTR	-7.6775	-2.9678	Stationary
CTTR	-6.2152	-2.9678	"
TDTR	-3.5543	-3.081	"
TDYR	-4.5191	-2.9763	"
TIDYR	-5.5688	-2.9678	"

Source: Field Survey 2013

Cointegration Analysis

Having established that the variables are characterized by a unit root process, we proceed to analyse the long run relational properties of the time series. This co-integration test is based on the argument that "given that time series have unit roots, a long run relationship exists between a linear combination of such series. The two-stage method is used for the co-integration test. This method follows a simple procedure: the OLS estimation of the relationship is initially performed and the residual are obtained. Next, unit root test is conducted on the residuals. If the residuals turn out to be stationary, then these variables are accepted as co-integrated. The result of the co-integration test is reported in table 5.3 below. The ADF test statistics value (which is -3.3307) is greater than 95% critical ADF value of -3.081 (in absolute values). This clearly indicates that the residuals are stationary. Indeed, there is co-integration between RGDP and all the other variables. Thus, a long run relationship exists between RGDP and all the other variables.

Table 3 Cointegration Analyses

Variable	ADF Test Statistic	95% Critical ADF Value	Rank
Residual	-3.3307	-3.081	Stationary

Source: Field Survey 2013

The short-run Dynamic Mode:-

The short-run dynamic behaviour of RGDP with respect to temporary changes in the explanatory variables can be analyzed within the context of an error correction model (ECM). The autoregressive distributed lags (ARDL)

approach is used for the estimation of the ECM. The result of the estimation is presented in table 5.4 below. It should be noted that the R-Bar squared criterion was used to select the parsimonious equation. The result shows a very impressive goodness of fit for the model. The R-Squared value of 0.98 is quite high and it indicates that over 98% of the systematic variation in RGDP is explained by short term movements in the explanatory variables including the ECM. Thus, the model possesses a high predictive ability. The overall goodness of fit for the model is observed through the F-Statistic, the F-value of 27.3 easily passes the significance test at the 1% level since it is greater than the 1% critical value of 10.2. Thus, we will accept the hypothesis i.e. there is significant linear relationship between RGDP and the explanatory variables combined.

A close examination of the estimated coefficients for each of the explanatory variables reveals that the coefficients of some of the variables are negative while others are positive. Many of the other coefficients possess signs that are in line with a priori determination signs. More importantly, the significance of each of the coefficients is considered using the 1% test statistic; the result reveals that the coefficients of all the individual tax variables pass the significance test, except that of CITR which fails the significance test at the 5% level. This implies that short term economic growth may be predicted by these temporary changes in these variables. The result therefore shows that changes in the indirect tax component do not have any short-run impact on the economy. The coefficient of tax ratio in terms of total tax revenue is significant, but exhibits a negative sign. Thus, increasing direct tax share in total taxes tends to depress economic growth in the long run.

The coefficient of the ECM is significant at the 5% level. However, this coefficient has a pervasive positive sign, which suggests instability in the system. This indicates that any short run deviation from equilibrium will not be restored in the long run

Table 4: The short-run Dynamic Model

Variable	Coefficient	T-ration
DGDPGR	0.126416	7.705854
DCETR	-24.70194	-8.375729
DVATR	20.02828	-8.025067
DPITR	10.26605	7.895401
DPPTR	8.861891	7.608366
DCITR	13.53333	0.751481
DTDTR	-5.860504	-4.991610
DTDYR	1.000341	0.593218
DTIDYR	-11.66169	-1.372631
RESIDAL (-1)	0.489251	2.839779

R^2 = 0.980 F=27.3 D.W. Statistics = 2.15

Source: Field Survey 2013

Conclusion

The mobilization of tax revenue is an important policy objective. While government can do little in the short run to changes in structural determinant of the tax revenue (such as composition of value added), they can alter factor that influence tax revenue, such as economic policies, the level of corruption, and the quality of tax administration. The wide divergence between the effective and statutory tax rates in Nigeria indicates that there is scope for raising tax revenue without increasing tax rates by enforcing tax and customs administration, reducing tax exemptions (especially in the areas of manufacturing), fighting fraud and corruption. Nevertheless, one must be realistic in terms of improvement in revenue ratios that can be reasonably expected to be achieved in Nigeria, given the low level of development and the heavily agricultural and informal character of the economy. Indeed, optimizing tax mobilization and carrying out reforms can be achieved only when there is a strong political will and leadership to adopt the necessary measure.

Recommendations

The outcomes of the empirical investigation are far reaching and useful for policy directions. In this context, the following policy recommendations are made:

1. The efficiency of the Nigeria tax must be improved
2. A combination of royalties and profit-sensitive taxes should be considered as appropriate, with close attention to detail and implementation also required.

3. The perceived links between paying tax and enjoying the benefits of public spending should be strengthened by increasing awareness of this relationship which can be clearly constructive for the economy as a whole.
4. Simple and transparent tax laws should be enacted to regulate the tax regimes in Nigeria
5. The sharing of the proceeds of the value added tax (VAT) should be attractive enough to prevent re-introduction of sales tax, which may constitute double taxation. Value Added Tax, if well handled can be very useful in transferring resources from the rich to the poor.
6. Involvement of the wider community in tax issues should be pursued. Timely interaction between the tax authorities and tax payers should educate both sides, foster trust, and can lead to measures that are both better designed and more widely accepted.

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