Role of Taxation in Developing Countries

Taxation is an important part of fiscal policy which can be used effectively by governments of developing economies.

The role of taxation in developing economies is stated as follows:

1. Resource Mobilisation

Taxation enables the government to mobilise a substantial amount of revenue. The tax revenue is generated by imposing: Direct Taxes such as personal income tax, corporate tax, etc., Indirect Taxes such as customs duty, excise duty, etc.

In 2006-07, it is estimated that the tax revenue of the central government (India) was 81% of the total revenue receipts, whereas, non tax revenue was only 19%.

2. Reduction in Inequalities of Income

Taxation follows the principle of equity. The direct taxes are progressive in nature. Also certain indirect taxes, such as taxes on luxury goods are also progressive in nature. This means the rich class has to bear the higher incidence of taxes, whereas, the lower income group is either exempted from tax (direct taxes) or has to pay lower rate of duty (indirect taxes) on goods consumed by the masses. Thus, taxation helps to reduce inequalities of income and wealth.

3. Social Welfare

Taxation generates social welfare. The social welfare is generated due to certain undesirable products like alcoholic products, tobacco products and such other products are heavily taxed, which restricts their consumption, which in turn facilitates social welfare.

A part of the tax revenue is utilised for social development activities, such as health, education and family welfare, which also improve social welfare as well as social order in the society.

4. Foreign exchange

Taxation encourages exports and restricts imports. Generally, developing countries and even the developed countries do not impose taxes on export items. For instance, in India, exports are exempted from excise duty, VAT, customs duty and other duties.

5. Regional Development

Taxation plays an important role in regional development; Tax incentives such as tax holiday for setting up industries in backward regions, which induces business firms to set up industries in such regions, Tax revenue collected by government is also utilised for development of infrastructure in backward regions.

6. Control of Inflation

Taxation can be used as a tool of controlling inflation. Through taxation, the Government can control inflation as follows :-

1. If inflation is due to high rise in prices of essential items, then the Government may reduce the rate of indirect taxes.
2. If inflation is due to increase in demand, the Government may try to cut down the effective demand by increasing the tax rate. Increase in tax rate may restrict consumption, which may reduce demand, and subsequently inflation may be controlled.

Conclusion

Both direct and indirect taxes are essential to bring adequate revenue to the state for meeting the increasing public expenditure. Both taxes are essential to promote economic growth, fill employment and economic stability. Direct and indirect taxes should side by side & balance each other. However in developing countries, direct taxation has limited scope and hence indirect taxation plays a more significant role. A well oriented system of taxation requires combination of direct & indirect taxes in different proportions.