DIRECT TAXES AND ECONOMIC GROWTH: CASE OF REPUBLIC OF KOSOVO

Donat Rexha
AAB College, Kosovo donat.rexha@universitetiaab.com
Liza Alili Sulejmani
International Balkan University, Struga, Macedonia liza.a.sulejmani@gmail.com

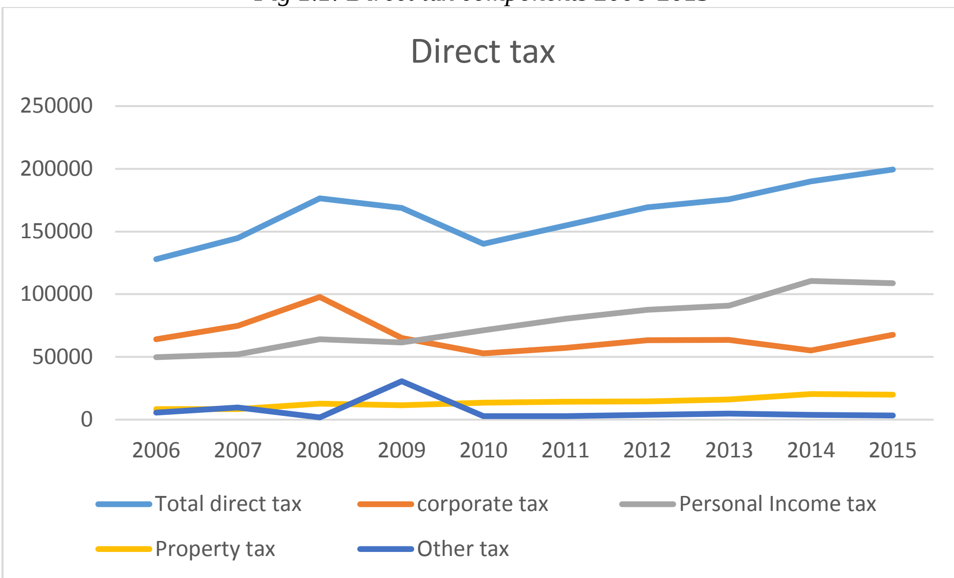
Abstract: Main purpose of this paper is to analyze the relationship between direct taxes and economic growth in Republic of Kosovo, thus the effects of Personal Income tax and Corporate Income Tax on real GDP, for the time-period 2006 – 2016, by utilizing quartile time series data. Further, the Solow model of economic growth is taken into consideration when précising the empirical model, thus Gross Fixed Capital Formation and Labor Force participation rate are included as independent variable as well. Moreover, data are investigated regarding their stationarity by employing Augmented Dickey Fuller and Phillips Perron test, revealing data are non-stationary in their level and stationary in their first difference. Based on the results of Johansen Jusilius test for co-integration to exist one rank. Findings reveal positive and significant effect of Personal Income tax on Real GDP, and negative and insignificant for the Corporate Income Tax.
Such results imply that even though tax rate cuts encourage savings, employment and investment; if not accompanied by spending cuts, result with budget deficit raise, thus reducing positive direct impact on economic growth due to the savings reduction and interest rates raise in the long term.
Moreover, such findings can contribute to the government for the following needed steps to be taken in the future regarding the tax policies in Kosovo.
Keywords: Personal Income Tax, Corporate Tax, Unit Root, co-integration, regression.

1. INTRODUCTION

Countries in transition have applied different tax forms when it comes to selecting their tax structure. Major source of government revenue for most countries in the world is tax. The tax structure is commonly composed of direct and indirect taxes. Direct taxes are assumed to be paid by the factors that produce incomes whereas indirect taxes are assumed to be paid by the house hold that consume taxed items. Direct taxes mainly include corporate tax, income tax, withholding tax, rental income tax and presumptive income tax among others. Indirect taxes are taxes on domestic goods and services like the Value added Tax (VAT), and tax on imported goods.
Indirect taxes contribute a greater share of overall tax revenues. Regarding Kosovo case in 2016, the highest tax contribution came from VAT around 38%, followed by excise duties at 22%, customs duties around 8% and Personal Income tax around 7% to the total tax revenue of this period.
Tax is a compulsory payment that citizens of any state should pay to the authorities to allow their governments to provide public goods, deliver merit goods and services such as education and healthcare, promote economic growth and broad-based development, and to stabilize the economy. Indeed, as observed by Musgrave (1997), every country imposes taxes on its citizens and institutions for three strategic objectives: the allocation function, the distributive function and the stabilization function. It is therefore important to state that, tax is an important component that allows the government to promote various development activities, provide for both public and merit goods and services, and at least stabilize the economy through various fiscal policies, of which the tax system is the most significant.
Tax and country's output linkages do exist, and fiscal authorities have relied on this to spur economic growth and development. Two forms of taxes namely direct and indirect taxes have been used to realize this goal. The former forms the backbone of this study. Direct taxes have been in existence in Kenya since pre-independence. However, there have been various reforms to improve productivity of various types of direct taxes. Although direct tax revenue has a direct relation to economic growth, mixed thoughts exist to this proposition. Some proponents argue that an objective to raise sufficient tax revenues will bolster the much needed economic growth and development. Contrary to this, some argue that tax is a burden on their well earned fortunes, while to others; tax is seen as a necessary evil, to support the state and its activities. Depending on the side one is, this all depends on the benefit one derives from the tax system that is the net of tax payments over the respective benefits earned from the taxes they pay.
Kosovo is known as a county with lowest direct taxes in the Balkan region. Since after the war Kosovo has made few changes regarding the tax system and norms. Kosovo now possess 10% tax on corporate income (known as

corporate income tax) which is the lowest in Balkan and in the region, regarding the personal income tax Kosovo has progressive tax system which is based on the income level like: 0-80 Euros income per month is 0% tax, 81-250 Euro income per month is 4% tax, 251-450 Euro income per month and 451 Euro income per month and above is 10% tax on income.

Fig 1.1: Direct tax components 2006-2015



Based on the Ministry of Finance of Kosovo and Statistical Agency of Kosovo

As we can see in the Fig1.1 the Corporate Tax was the highest until 2009 and from 2009 until now Personal Income Tax is the highest. Why personal income tax is higher now? Personal income tax is higher for the reasons that during this time wages have been increased and number of the employees is increased as well. Another reason is that until 2009 rate of corporate income tax was 20% and it changed to 10% from 2009 and this have had impact in the corporate income tax. However, Kosovo as we mentioned above has the lowest rate of the direct tax in the region and still we do not see this as an advantage with regard to the other countries.

2. LITERATURE REVIEW

There are many authors that wrote regarding the direct tax revenue and specialty for corporate tax revenue and income tax revenue in this paper we will try to find articles that talk more regarding these two as in our empirical study we will consider the impact of direct tax revenue and economic growth of Kosovo.

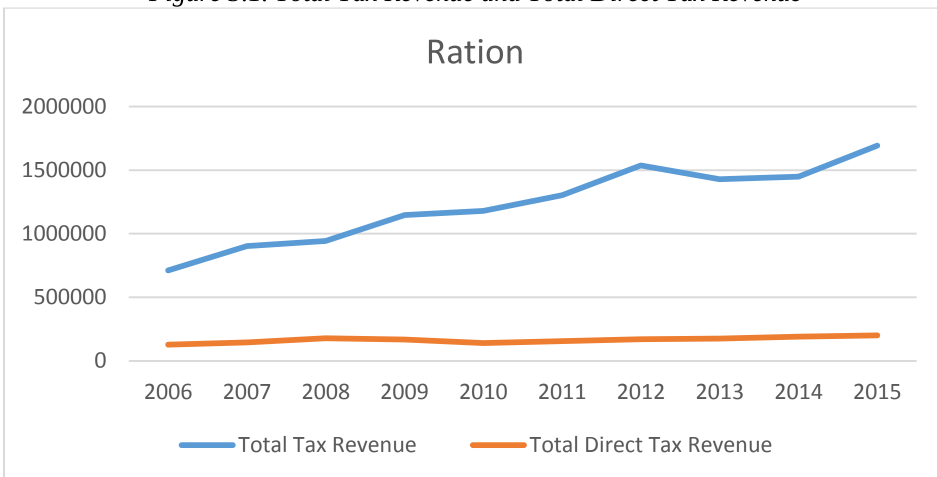
Zilcha and Eldor (2004) argued that corporate tax schedules in most countries are characterized by an asymmetric treatment of profits and losses: profits are taxed at a higher rate than losses are compensated. In such a context, firms pay the statutory corporate tax rate in the event that the risky project is successful, but is only partly compensated in the event that it is unsuccessful. Corporate taxes and tax incentives have the potential to discourage productivity growth by 17 attenuating research and development (R&D) activities whose spillover effects can potentially enhance the productivity of existing production factors. Vartia (2008) highlights three specific channels through which taxation affect productivity, namely distortions in factor prices and factor allocation, entrepreneurship and research and development activity. High corporate taxes reduce the firms' incentives to invest in technology and other productivity-enhancing innovations by reducing the potential profits by them thus reducing productivity in the formal sector, hurting the overall long-term economic growth. High corporate taxes reduce incentives for risk taking by firms with negative consequences for productivity. Ormaechea and Yoo (2012) stated that increasing income taxes while reducing consumption and property taxes is associated with slower growth over the long run. They also found that among income taxes, social security contributions and personal income taxes have a stronger negative association with growth than corporate income taxes; a shift from income taxes to property taxes has a strong positive association with growth; and a reduction in income taxes while increasing value added and sales taxes is also associated with faster growth. Worlu and Emeka (2012) examined the impact of tax revenue on the economic growth of Nigeria, judging from its impact on infrastructural development from 1980 to 2007. The results showed that tax revenue stimulates economic growth through infrastructural development. T

3. FINDINGS

This analysis gives an empirical view of the performance of different variables regarding the direct tax and economic growth.

Based on the figure 2.1 we can see that trend in direct tax components has not changed and most of the time is same and it did not have any big impact in the total revenue. This is because Kosovo has low rate of revenue of corporate income and also low rate of personal income. Kosovo has around 70% of the income from customs tax and direct taxes are very low comer to indirect taxes. Therefore, this tell us that Kosovo has low level of domestic products and because of this it has very high import compare to export of goods.

Figure 3.1. Total Tax Revenue and Total Direct Tax Revenue



4. EMPIRICAL RESULTS BY USING REGRESSION ANALYSIS

Purpose of this paper is to analyze the relationship between direct taxes and economic growth in Republic of Kosovo, thus the effects of Personal Income tax and Corporate Income Tax on real GDP, for the time-period 2006 – 2016, by utilizing quartile time series data. Further, the Solow model of economic growth is taken into consideration when précising the empirical model, thus Gross Fixed Capital Formation and Labor Force participation rate are included as independent variable as well. Moreover, data are investigated regarding their stationarity by employing Augmented Dickey Fuller and Phillips Perron test, revealing data are non-stationary in their level and stationary in their first difference.

Such results imply that even though tax rate cuts encourage savings, employment and investment; if not accompanied by spending cuts, result with budget deficit raise, thus reducing positive direct impact on economic growth due to the savings reduction and interest rates raise in the long term. **Findings reveal positive and significant effect of Personal Income tax on Real GDP, and negative and insignificant for the Corporate Income Tax.**

Moreover, such findings can contribute to the government for the following needed steps to be taken in the future regarding the tax policies in Kosovo.

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. regress rgdp gfcf laborforce corporateincometax personalincometax

      Source |       SS       df       MS              Number of obs =      44
-------------+------------------------------           F(  4,    39) =   38.07
       Model |  2508558.83     4  627139.708           Prob > F      =  0.0000
    Residual |  642442.713    39  16472.8901           R-squared     =  0.7961
-------------+------------------------------           Adj R-squared =  0.7752
       Total |  3151001.55    43  73279.1057           Root MSE      =  128.35

------------------------------------------------------------------------------
        rgdp |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
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gfcf	1.086221	.4511476	2.41	0.021	.1736893	1.998753
laborforce	.0404377	.1580077	0.26	0.799	-.2791629	.3600384
corporateincometax	-.0031781	.0033103	-0.96	0.343	-.0098738	.0035176
personalincometax	.0306992	.0042948	7.15	0.000	.0220121	.0393863
_cons	444.9362	164.9183	2.70	0.010	111.3574	778.5149

Based on the information provided form the table above, R-squared of the analysis is 0.7961 which means that 79.61% of GDP is explained by independent variables. Therefore, there is space for other variables not included in the analysis to expand information about GDP behavior.

An 1% increase of Gross Fixed Capital Formation would lead to 108% increase of GDP. If Labor Force increases by 1%, GDP will increase by 40%. An 1% increase of Corporate Income would lead to 3.1% decrease of GDP, and finally GDP would increase for 30% due to an 1% Personal Income increase.

To know if the variables are significant for this analysis, one must look at the coefficients. There are two significant variables: Gross Fixed Capital Formation and Personal Income, this is because their coefficients are lower than 0.05; 0.021 and 0.000 respectively. Furthermore, Labor Force and Corporate Income are not significant for this analysis because their coefficients are higher than 0.05.

CONCLUSION

From the research findings, results imply that even though tax rate cuts encourage savings, employment and investment; if not accompanied by spending cuts, result with budget deficit raise, thus reducing positive direct impact on economic growth due to the savings reduction and interest rates raise in the long term. Findings reveal positive and significant effect of Personal Income tax on Real GDP, and negative and insignificant for the Corporate Income Tax.

Investment has the biggest impact on the level of direct taxes in the economy, with private investment having a positive effect while public investment having a negative impact. This trend of events calls for better and continued coordination and administration of the private sector and private investment in particular while complete reform may be necessary as far as the public sector is concerned, especially in the management and administration of public investments. It however remains questionable over what particular reasons public investment did not have a statistically significant effect on direct taxes. The tax system of any economy is used to achieve a wide range of aims which are not always consistent and which vary from time to time. A good tax system therefore should be efficient in that it does not distort economic decision-making. To initiate improvements in her fiscal systems that would lead to increased direct tax revenue, Kosovo should particularly adopt the following recommendations: Improve international tax cooperation and introduce systems for automatic information exchange with other tax authorities to combat harmful tax practices. Improve transparency by reforming accounting systems for expenditures along functional lines, using international standards as a guide, so that amounts spent on public investment needs can be clearly determined and assessed. Improving the allocation of public expenditure on education so that more productive labour force is produced.

Moreover, such findings can contribute to the government for the following needed steps to be taken in the future regarding the tax policies in Kosovo

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