# FINANCIAL SYSTEM AND TAXATION: THE ROLE IN THE ECONOMY

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DOCTOR OF PHILOSOPHY

2012

CM: 7990

1100085734

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tesis
HG 187 .A2 R6 2012

1100085734
Financial system and taxation : the role in the economy / Roshaiza Taha.

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# Financial System and Taxation: The Role in the Economy

**A thesis submitted**
**to fulfil the requirements of the degree**
**Doctor of Philosophy**

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**2012**

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# DECLARATION

This thesis contains no material that has been accepted for the award of any other degree or diploma in any university or other institution. To the best of my knowledge, the thesis contains no material previously published or written by any other person, except where due reference is made in the text of the thesis, and a list of references is given in the bibliography.

Signed: .....

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# ABSTRACT

The relationship between the financial system (specifically stock market development) and economic growth has been an important issue of debate. A well-functioning financial system can affect economic growth through the improvement of capital productivity and the efficient allocation of resources. The role of taxation as a major determinant of an active financial system and strong economic growth also becomes of interest to the researcher. Taxation through policy and revenue collection seems to play a pivotal role in fostering economic growth and promoting the financial system. However, both taxation and the financial system jointly affect economic growth performance. In this respect, not many empirical studies have been devoted to observing this issue and none exist for Asian economies.

Thus, the main objective of this study is to empirically examine the impact of both the financial system and taxation on economic growth performance in the Malaysian context for the period of 1980-2008. As an introduction, **Chapter 1** provides the background, motivation and outline of this thesis. **Chapter 2** then provides an overview of the Malaysian economy throughout the study period. In this chapter, the performance of all the key macroeconomic indicators that have been used in this study are highlighted. **Chapter 3** provides a survey of the relevant literature and discusses the motivations behind the development of the key research questions addressed in Chapters 4 through 6.

**Chapter 4** focuses on the examination of the nexus between taxation revenue and the financial system. The main objective here is to identify the nature of the relationship between taxation revenue and the financial system – does taxation matter for financial system activities or does the financial system contribute to high revenue collection. In this chapter, we analyse the relationship in the multivariate model applying Autoregressive Distributed Lag utilising the monthly data for direct taxation, the Kuala Lumpur Composite Index (stock market proxy), investment bank loans to the private sector, commercial bank loans to the private sector, and the outstanding private sector bond market for the period of 1997 to 2008. From the analysis conducted, no significant results are reported for the stock market variable,

however, investment bank credit negatively affects the revenue collection. While chapter 4 provides novel evidence on the nexus between the financial system and taxation in Malaysia, our empirical work can also be viewed as addressing the issue of whether the existing government policy is capable of explaining the influence on the financial system performance in Malaysia.

**Chapter 5** employs the Vector Error Correction model and variance decomposition analysis to explain the impact of both the stock market and taxation on the economic growth performance of Malaysia over the common sample period of 1980 to 2008. Consistent with Levine's (1991) endogenous growth model, we found that taxation and the stock market jointly affect the growth rate. However, these results were only found in the short-run while in the long-rung we failed to identify any significant results concerning the impact of the financial system and taxation on economic growth.

While in Chapter 5 we found that the financial system and taxation does matter for economic growth in the Malaysian context in the short-run, in **Chapter 6** we then expand our analysis to cover ten developing Asia countries – Bangladesh, China, India, Indonesia, Malaysia, Pakistan, the Philippines, Sri Lanka, Taiwan, and Thailand – utilizing monthly data from 1990 to 2008. In this analysis we conduct panel unit roots, panel cointegration, and panel Granger causality tests to see the nature of the relationship. The panel analysis results reveal that while tax revenue does not matter for economic growth, the stock market does play a pivotal role in determining short-run growth performance in the Asian region.

**Chapter 7** summarizes the key findings of this thesis along with some recommendations for future research. We finally conclude this thesis by offering some general guidelines, which might be useful for future empirical research on the nexus between the financial system, taxation and economic growth.