

Effect of Tax Revenue and Foreign Grants on Government Activities: A Study in Nepalese Perspective

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ABSTRACT

This study aims to examine the impact of previous years' government expenditure, tax revenue, and foreign grants on determining Nepal's government activities or expenditures. The secondary data from used in the analysis. It includes 48 data points from 1974/75 to 2021/22, collected from the publication of Nepal Rastra Bank and economic surveys of Nepal. The descriptive and exploratory research designs are used in this study. Some statistical and econometric tools like descriptive statistics, Kolmogorov-Smirnov test, multiple regression analysis, analysis of variance (ANOVA), and residual analysis are used in this study. The previous expenditure determines the present government activities. Tax revenue, foreign grants, and previous years' government expenditures are individually and jointly significant in determining the government expenditure. One unit increase in tax revenue and foreign grants resulted in a 0.177 and 0.046 unit increase in government expenditure in Nepal, respectively. 86.5 percent variation in government activities is determined by the previous year's government expenditure, tax revenue, and foreign grants. The positive impact of tax revenue is more than foreign grants on spending government activities. So, the policymakers must prioritize measures that increase domestic tax revenue.

1. INTRODUCTION

Government expenditure and government activities are closely connected, as government expenditure represents the financial resources the government allocates to fund various activities and functions (Musgrave & Musgrave, 1989). Government expenditure is the total money the government spends in a given period. In contrast, government activities encompass

various functions and services the government provides its citizens. The government activities depend upon government expenditure.

Government expenditure is the financial commitment made by the government to fund its various programs, services, and functions (Stiglitz, 2000). This includes spending on education, healthcare, defense, infrastructure, social welfare, and

other public services. Government activities often involve providing public goods and services that benefit society. These may include law enforcement, national defense, public education, healthcare, and infrastructure development. Government expenditure is the financial means by which these activities are carried out (Adegbelemi et al., 2017).

Governments allocate funds for emergency response and disaster management. This includes resources for natural disaster relief, public health emergencies, and other unforeseen events. Government expenditure is often used to redistribute wealth and address income inequality. Social welfare programs, progressive taxation, and other fiscal policies are tools governments use to ensure a more equitable distribution of resources and opportunities.

The relationship between tax revenue and government spending is a crucial aspect of fiscal policy. Tax revenue is a primary source of funding for government activities, directly influencing the government's ability to carry out its functions and programs (Alesina & Perotti, 1999). Tax revenue provides the financial resources to fund various government programs and services, such as healthcare, education, defense, infrastructure, and social welfare. Higher tax revenues generally allow the government to allocate more funds to these programs. An increased budget size indicates the expansion of government activities and vice versa.

The level of tax revenue directly affects the government's budgetary capacity. Governments can allocate funds to different sectors when tax revenue is high and respond flexibly to emerging needs. Conversely, lower tax revenue may lead to budget constraints, requiring the government to prioritize spending or explore alternative funding sources. Tax revenue plays a crucial role in managing government debt. Higher tax revenues can be used to reduce budget deficits and pay down existing debt, while lower tax revenues may contribute to deficits and

increase the need for borrowing (Reinhart & Rogoff, 2010).

This study explores the impact of tax revenue and foreign aid on government activities or public spending. It also compares the effects of tax revenue and foreign aid on government activities.

Six sections make up this study. The remainder of the paper is broken up into sections. The theoretical and empirical literature is presented in part two. The study materials and methodologies are described in the third segment. The data are given and examined in section four. Part five discusses the findings and makes comparisons with other scholars' earlier study projects. The study's shortcomings, policy implications, and conclusion are covered in section six.

1.2 LITERATURE REVIEW

The Tax-Spend Hypothesis (TSH) establishes a positive relationship between government spending and tax. The size of the government expenditure budget increases with tax revenue (Friedman, 1978). Buchanan and Wagner (1977) and Niskanen (2006) presented an alternative tax-spending hypothesis. They suggest that higher taxes reduce spending; a negative relationship exists between federal expenditure and tax revenue.

The Spend-Tax Hypothesis (STH) believes that the government first spends, and then tax policies and revenue are adjusted to accommodate the desired level of spending. According to this hypothesis, causality runs from spending to revenue (Peacock & Wiseman, 1979). The fiscal synchronization hypothesis believes that the government decides to tax and spend simultaneously, and causality runs in both directions (Metzer & Richard, 1981). Musgrave (1966) argues that the expenditure and tax sides of the budget must be decided jointly to maximize the society's intertemporal welfare function. The Institutional Separation Hypothesis (ISH) believes that different institutions have independent decisions regarding expenditure. There is no intertemporal

causality between public spending and revenue (Hoover & Shreffrin, 1992).

Tagem (2020) observed the impact of foreign aid and taxes on government spending in sixty-seven developing countries from 1980 to 2013. He found that spending, foreign aid, and tax ratios cointegrated in the short and long run. The aid coefficients have a less positive impact on public spending than tax revenue. Ho et al. (2023) found the positive effects of tax revenue and government incentives. They further observed that tax revenue impacts economic growth, possibly through increased government activities or spending. Researchers such as Macek (2014), Stoilova and Patonov (2012), and Brebler (2012) supported taxation's positive impact on economic activities and growth.

Aworinde and Onokoya (2016) observed foreign aid's positive and significant impact on expanding government activities. Morrissey (2015) found the positive effects of tax revenue on government spending. Gomancee et al. (2005) found that aid increased welfare directly through its impact on growth, and there was no evidence that aid operated through public spending. Kaya and Kaya (2020), Mascagni and Timmis (2017), Marc (2017), and Remmer (2004) found a positive link between foreign aid and government activities or public spending.

These literatures present distinct perspectives on the relationship between government spending, taxation, and foreign aid. Most of the studies focus on the impact of tax and aid on economic growth. However, this study explores the effect of tax revenue and foreign aid on the economic activities of the central government. This study provides a comprehensive exploration of the channels through which foreign aid and taxation jointly influence government spending, shedding light on the intricate interdependencies in the fiscal policies of developing countries.

2. MATERIALS AND METHODS

This study is based on the descriptive and exploratory research design. Secondary

data was used in this study. It covers 48 data points from 1974/75 to 2021/22 collected from the various publications of Nepal Rastra Bank and the Ministry of Finance of Nepal's government. Jamovi 2.4.11 and SPSS 27 are used to process and analyze the data. Some statistical and econometric tools like graphs, descriptive statistics, one-way Kolmogorov-Smirnov test, multiple regression analysis, standardized and unstandardized regression analysis, analysis of variance (ANOVA), and residual analysis are used to explore the impact of tax revenue and foreign aid on the government activities.

Three variables, tax revenue, foreign aid, previous year's government spending, and government expenditure, are used in this study; the government expenditure is taken as the dependent variable, and the rest are taken as independent variables. The government activities depend upon government expenditure. The previous years' government expenditure, tax revenue, and foreign aid are the main determinants of government expenditure. In this sense,

Government Expenditure = f (Previous years' expenditure, tax revenue, foreign aid) (1)

In symbol, EXP = f (PEXP, TTR, FGNT) (2)
After converting the variables into logarithmic forms:

LNTEXP = f (LAGEXP, LNTTR, LNFGNT) (3)

A multiple regression model is used to explore the relation and impact of independent variables on dependent variables. Multiple Linear regression (MLR) uses several explanatory variables to predict the outcomes of a response variable. The stepwise regression equation is used in this analysis. The stepwise multiple regression model is a step-by-step process that begins by developing a regression model with a single predictor variable and adding and deleting the predictor variable one step at a time (Kutner et al., 2004). The general form of multiple regression (Syazali et al., 2019) is as follows:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \dots + \beta_k X_k + \mu \quad (4)$$

Where Y is the dependent variable. β_0 is the Y intercept, $\beta_1, \beta_2, \beta_k$ are the regression coefficients for the independent variables X_1, X_2 and X_3 respectively and μ is the error term. Introducing the study variables in equation (4) can be formed as:

$$\text{LNTEXP} = \beta_0 + \beta_1 \text{LAGEXP} + \beta_2 \text{LNTTR} + \beta_3 \text{LNFGNT} + \mu \quad (5)$$

Stepwise multiple regression models are developed as given below:

$$\text{LNTEXP} = \beta_0 + \beta_1 \text{LAGEXP} + \mu \quad (6)$$

$$\text{LNTEXP} = \beta_0 + \beta_1 \text{LAGEXP} + \beta_2 \text{LNTTR} + \mu \quad (7)$$

The general form of the standardized multiple regression model is specified as given below:

$$\text{LNTEXP} = \beta_1 \text{LAGEXP} + \beta_2 \text{LNTTR} + \beta_3 \text{LNFGNT} + \mu \quad (8)$$

Standardized regression coefficients allow for comparing the relative importance of predictors by expressing their effects in terms of standard deviations. In contrast, unstandardized coefficients represent the change in the dependent variable per one-unit change in the predictor.

2.1 PRESENTATION AND ANALYSIS

2.1.1 CONDITION OF VARIABLES

The condition of variables is presented through graphical representation and key statistics of concerned variables. Figure 1 shows the condition of dependent (total government expenditure) and independent variables (total tax revenue and foreign grants). The government expenditure and tax revenue gradually increase with slight variations in some fiscal years. Minor fluctuations of variables are noticed during the COVID-19 pandemic periods, such as fiscal years 2019/20 and 2020/21.

Figure 1: Condition of dependent and independent Variables

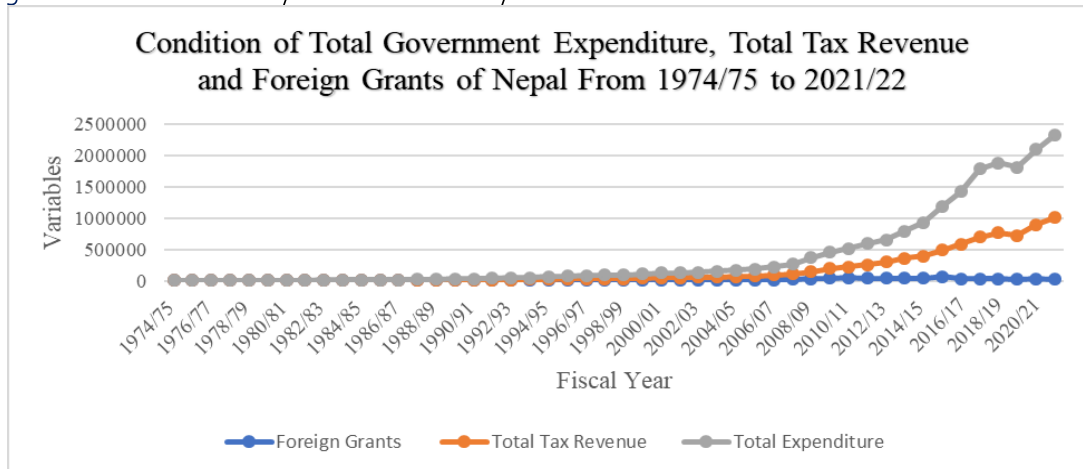


Table 1 summarizes Nepal's financial profile based on various economic indicators. These statistics provide a comprehensive overview of the distribution and characteristics of the financial data, including central tendency, variability, skewness, and kurtosis. The mean values of total expenditure are 232,660, total tax revenue is 149,903, and foreign grants are 13691. The spread of the data is illustrated

by standard deviations, which are considerably high, especially in total expenditure and tax revenue. Skewness values are positive and indicate a right-skewed or positively skewed distribution. The value of kurtosis is more than 0.263. So, all distributions are platykurtic. The standard error of skewness measures the uncertainty or precision associated with the skewness estimate. It indicates how much

the skewness estimate might vary in repeated sampling. A more minor standard error suggests a more reliable skewness estimate. The standard error of kurtosis is a measure that indicates the amount of variability or uncertainty associated with

the forecast of kurtosis. A more standard minor mistake suggests a more reliable estimate, while a more significant standard error indicates more variability or uncertainty in the kurtosis estimate.

Table 1: Descriptive statistics of dependent and independent variables

Base	Total Expenditure	Total Tax Revenue	Foreign Grants
N	48	48	48
Mean	232660	149903	13691
Median	57849	27340	5557
Standard deviation	368527	254189	16189
Minimum	1514	841	283
Maximum	1.31e+6	984332	67080
Skewness	1.85	2.00	1.31
Std. error skewness	0.343	0.343	0.343
Kurtosis	2.21	3.05	1.14
Std. error kurtosis	0.674	0.674	0.674

Source: Authors calculation by using Jamovi 2.4.11

2.1.2 NORMALITY CHECK OF DEPENDENT VARIABLE

The Kolmogorov-Smirnov Test is used to check the normality of the dependent variable. Table 2 indicates mean and standard deviation values of 10.8873 and 1.96851, respectively. The test statistic was 0.060, with an asymptotic significance of 0.200 (2-tailed). The Monte Carlo significance was calculated as 0.943, and the 99 percent confidence interval ranged

from 0.937 to 0.949. Based on these results, we fail to reject the null hypothesis of normality for the dependent variable LNTEXP at a conventional significance level, indicating that the data is reasonably consistent with a normal distribution. There is no evidence to suggest a problem of normality in the dependent variable total expenditure (LNTEXP).

Table 2: One-Sample Kolmogorov-Smirnov Test

		LNTEXP	
Normal Parameters	Mean	10.887	
	Std. Deviation	1.969	
Most Extreme Differences	Absolute	0.060	
	Positive	0.056	
	Negative	-0.060	
Test Statistic		0.060	
Asymp. Sig. (2-tailed)		0.200	
Monte Carlo Sig. (2-tailed)	Sig.	0.943	
	99% Confidence Interval	Lower Bound	0.937
		Upper Bound	0.949

Source: Authors' calculation using SPSS, 27

2.1.3 MULTIPLE REGRESSION TEST

Multiple regression analyzes the relationship between a dependent variable and two or more independent variables,

allowing for the assessment of the combined impact of these variables on the dependent variable. Various multiple regression models are developed based on

included independent variables. The results of multiple regression are presented in Table 3. Top of Form

Table 3: Multiple regression analysis between LAGEXP, LNTTR, and LNFGRT concerning LNTEXP

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Model Summary		
		B	Std. Error	Beta			R2	Adjusted R2	SEE
1	Constant	0.232	0.061	-	3.769	0.00	0.856	0.866	0.073
	LAGEXP	0.892	0.006	0.899	177.28	0.00			
2	Constant	0.555	0.107	-	5.193	0.00	0.869	0.857	0.066
	LAGEXP	0.748	0.069	0.754	10.797	0.00			
	LNTTR	0.225	0.064	0.246	3.526	0.001			
3	Constant	0.469	0.112	-	4.203	0.00	0.865	0.855	0.063
	LAGEXP	0.766	0.067	0.772	11.355	0.000			
	LNTTR	0.177	0.066	0.193	2.669	0.011			
	LNFGRT	0.046	0.022	0.037	2.052	0.046			

Dependent variable: LNTEXPN

The results of three different multiple regression models are presented in Table 3. In model 1, the lag value of government expenditure is statistically significant. LAGEXP has a coefficient of 0.892, a standard error of 0.006, and a very high t-value of 177.28. It is highly statistically significant ($p < 0.001$). This means the previous government expenditure affects the present year's government expenditure. The regression equation based on the model 1 is developed as given below:

$$LNTEXPN = 0.232 + 0.892 * LAGEXP$$

In model 2, the lag value of government expenditure (LAGEXP) and total tax revenue are included in determining the government activities in Nepal. Both LAGEXP and LNTTR are significant predictors of government expenditure (LNTEXPN). LAGEXP has a higher impact than LNTTR, as reflected by the higher coefficient and t-value. Based on model 2, the regression model is developed as given below:

$$LNTEXPN = 0.555 + 0.748 * LAGEXP + 0.225 * LNTTR$$

The standardized regression equation is developed as given below:

$$LNTEXPN = 0.754 * LAGEXP + 0.246 * LNTTR$$

Model 3 includes all independent variables like LAGEXP, LNTTR, and LNFGRT. In addition to LAGEXP, LNTTR, and LNFGRT are significant predictors of LNTEXPN. LAGEXP remains the most influential variable. One unit increase in the previous value of government spending results in 0.766 units in the present year's government spending. Likewise, one-unit increase in total tax revenue and foreign grants results in a 0.177 and 0.046 unit increase in government spending in the Nepalese economy. Based on the outcomes of model three, the regression model is developed as follows:

$$LNTEXPN = 0.469 + 0.766 * LAGEXP + 0.177 * LNTTR + 0.046 * LNFGRT$$

The standardized regression is found:

$$LNTEXPN = 0.772 * LAGEXP + 0.193 * LNTTR + 0.037 * LNFGRT$$

All models show that LAGEXP is a highly significant predictor of LNTEXPN. Model 3, with additional variables LNTR and LNFGRT, suggests that these variables also contribute significantly to explaining the variance in LNTEXPN.

Analysis of Variance (ANOVA) is used to analyze the differences among group means in a sample. It assesses whether the means of different groups are statistically significant and provides insight into the sources of variation within a dataset. ANOVA is beneficial when comparing three or more groups. In model one, the F-

statistic is exceptionally high at 31428.41, indicating a highly significant relationship between the predictor (LAGEXP) and the dependent variable (LNTEXPN). In model 2, the F-statistic remains highly significant at 19713.727, suggesting that adding LNTR to the model significantly contributes to explaining the variation in LNTEXPN. In model 3, the F-statistic remains highly significant at 14102.83, indicating that including LNFGRT further enhances the model's ability to explain the variation in LNTEXPN.

Table 4: Analysis of variance (ANOVA)

	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	168.905	1	168.905	31428.41	0.000b
	Residual	0.242	45	0.005		
	Total	169.146	46			
2	Regression	168.958	2	84.479	19713.727	0.000c
	Residual	0.189	44	0.004		
	Total	169.146	46			
3	Regression	168.975	3	56.325	14102.83	0.000d
	Residual	0.172	43	0.004		
	Total	169.146	46			
a. Dependent Variable: LNTEXPN						
b. Predictors: (Constant), LAGEXP						
c. Predictors: (Constant), LAGEXP, LNTR						
d. Predictors: (Constant), LAGEXP, LNTR, LNFGRT						

Each model shows a highly significant F-statistic, indicating that the respective predictors contribute significantly to explaining the variance in LNTEXPN. As the number of predictors increases in subsequent models, the F-statistic remains significant, suggesting that each additional variable adds explanatory power to the model. The overall conclusion is that the models are well-fit, and the predictors (LAGEXP, LNTR, LNFGRT) are statistically significant in explaining the variation in LNTEXPN.

In Table 5, the residual model of the regression model is displayed. The provided residuals statistics table shows that the regression model appears reasonably well-fit. The predicted values range from 7.5481 to 14.087, suggesting the model captures

variability in the dependent variable. The residuals have a mean of 0.000, indicating that, on average, the model does not systematically over- or under-predict the dependent variable. The standard deviation of the residuals is 0.061, indicating relatively low variability in prediction errors. The standardized and studentized residuals have means close to 0 and standard deviations close to 1, suggesting that the residuals are reasonably well-behaved. Cook's distance and Mahalabinus distance is a measure of influential points and leverage, and the low values (Cook's distance ranging from 0.000 to 0.146) suggest that no highly influential outliers affect the model significantly. The centered leverage values are relatively low, indicating

that individual data points are not excessively influencing the model.

Table 5: Residual Analysis of the model

Residuals Statistics					
	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	7.5481	14.087	10.963	1.9166	47
Std. Predicted Value	-1.782	1.630	0.000	1.000	47
Standard Error of Predicted Value	0.009	0.031	0.018	0.005	47
Adjusted Predicted Value	7.5459	14.087	10.963	1.916	47
Residual	-0.1128	0.1399	.0000	0.061	47
Std. Residual	-1.785	2.214	0.000	0.967	47
Stud. Residual	-1.847	2.330	-0.003	1.007	47
Deleted Residual	-0.1208	0.1549	-0.0004	0.066	47
Stud. Deleted Residual	-1.902	2.463	0.003	1.028	47
Mahal. Distance	0.025	9.743	2.936	2.346	47
Cook's Distance	0.000	0.146	0.022	0.030	47
Centered Leverage Value	0.001	0.212	0.064	0.051	47

Dependent Variable: LNTEXPN

The histogram of residuals provides a visual representation of the distribution of the residuals. Residuals are the differences between the observed values of the dependent variable and the values predicted by the regression model. A histogram can show whether the residuals

approximate a normal distribution. A roughly bell-shaped histogram suggests that the residuals are approximately normally distributed, a common assumption in many statistical analyses. Figure 2 proved that the residual of this model is normally distributed.

Figure 2: Histogram of residuals of the model

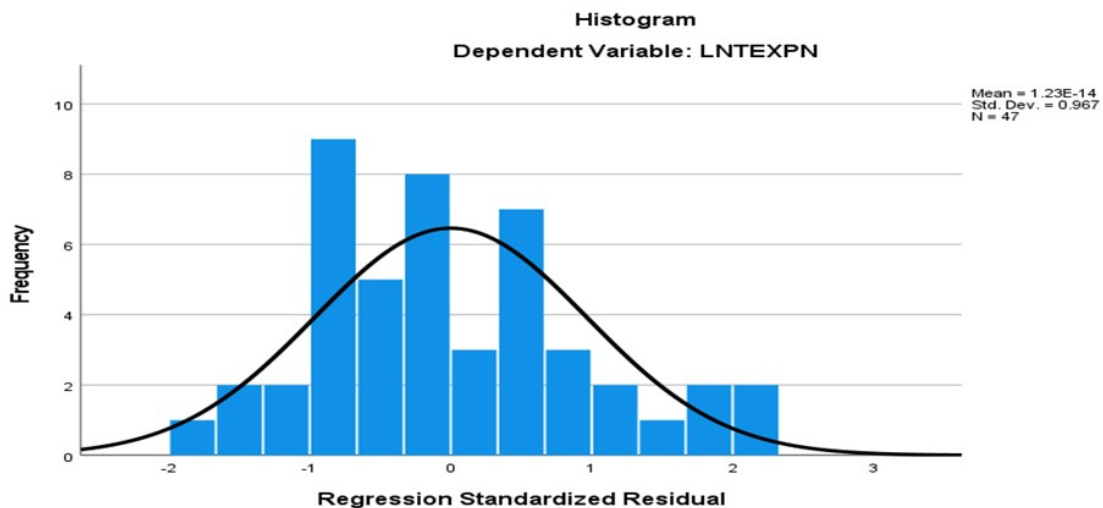


Figure 3 represents the normality test of residuals. The normal probability plot shows the data spread around the diagonal

line, and the distribution follows the direction of the diagonal line. Therefore, the multiple regression model satisfies the assumption of normality.

Figure 3: *Normality test of residuals*

3. RESULTS AND DISCUSSION

This study has found the relationship between tax revenue and foreign aid on government spending in Nepal. The previous government spending affects the government activities and current years' government expenditure. Previous years' government expenditure can impact the current years' spending through factors like budgetary commitments, ongoing projects, and long-term obligations, creating a carryover effect on financial allocations and priorities. Additionally, economic conditions and policy decisions made in prior years can influence budgetary decisions, shaping the trajectory of current government expenditures.

The tax revenue and foreign aid were individually and jointly significant in determining government spending. These findings align with Tagem's research findings (2020). The tax revenue and government activities are positively related. One unit increase in tax revenue results in a 0.177-unit rise in government spending in Nepal. These findings align with the research findings of Ho et al. (2023), Macek (2014), and Brebler (2012). The foreign aid affects the government spending. One unit increase in foreign aid results in a 0.046 unit increase in government spending. The research findings of Aworinde and Onokoya (2016), Morrissey (2015), and Kaya and

Kaya (2020) also support the finding of the positive impact of foreign aid on government annual activities. The positive relationship between foreign aid and government spending may be attributed to the recipient government's ability to use external funds to finance and expand various domestic programs and initiatives (Heller, 2005).

The impact of tax revenue on determining government spending is more than foreign aid ($0.193 > 0.037$). Tax revenue has a more significant effect on government spending than foreign aid due to its sustained and reliable nature, providing a stable source of funds for consistent budget planning. Subject to fluctuations and donor priorities, foreign aid may offer additional resources but lacks tax revenue's consistent and predictable nature.

86.5 percent variation in government activities or public spending depends upon tax revenue and foreign aid. A significant portion of the variation in government spending depends on tax revenue and foreign aid, as these primary funding sources directly influence a government's financial capacity and policy choices (Barro & Redick, 2011).

4. CONCLUSIONS, POLICY IMPLICATIONS, AND LIMITATIONS

The impact of total tax revenue and foreign grants on government activities is observed in this study. The total expenditure and tax revenue fluctuate highly. The previous year's government expenditure is also an influencing factor of current expenditure. 85.6 percent variation in government expenditure is determined by the previous year's government expenditure. The tax revenue from the previous year's government expenditure and foreign grants are individually and jointly significant in determining the government activities. One unit increase in total tax revenue and foreign grants results from a 0.177 and 0.046 unit increase in government expenditure in Nepal, respectively. One unit increase in government expenditure in the previous year results in a 0.766 unit increase in the present government expenditure. The impact of tax revenue is more on determining government activities than foreign grants. 86.5 percent variation in government activities is determined by the previous years' government expenditure, tax revenue, and foreign grants.

Since foreign grants, tax revenue, and the previous year's expenditures all impact government spending, policymakers must prioritize measures that increase domestic tax collection. This implies that efficient tax reforms, such as streamlining tax structures, enhancing tax administration, and encouraging compliance, are required. Relying on foreign grants will not have the same significant influence on government annual activities as focusing on increasing tax collection. Therefore, policies that support a robust and steady domestic tax base should be given top priority by policymakers. This would allow the government to sustain fiscal stability and efficiently finance development and public services.

The present study searches the influence of tax revenue and foreign grants on government activities in Nepal. It is assumed that the size of the budget or expenditure determines the government

activities. The government activities increase with the increase in government expenditure. This study includes 34 annual data points from 1975/75 to 2021/22. Multiple regression is used to explore the impact of independent variables on dependent variables. The SPSS 27 and Jamovi 2.4.11 are used to explore the results. Therefore, further study is necessary using more data, variables, methods, processes, and tools for a comprehensive and reliable result.

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