International Journal of Accounting and Economics Studies, 12 (SI-1) (2025) 259-263

International Journal of Accounting and Economics Studies

Website: www.sciencepubco.com/index.php/IJAES
https://doi.org/10.14419/xmnf6h26
Research paper

Tax Compliance and Economic Growth: Empirical Investigation of Developing Economies

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Received: May 28, 2025, Accepted: June 4, 2025, Published: August 28, 2025

Abstract

In today's world, everyone feels the impact of the tax policies set by their government, whether they realize it or not. Tax policy is a sensitive and vital topic for both the government and its citizens. When it comes to political and economic matters, few issues spark as much debate and reflection as taxation and how it's enforced. Back in the day, the role of a state or government was pretty limited, mainly focused on protecting its borders and maintaining law and order. Nowadays, however, governments have taken on a much broader role, needing to implement various development projects and welfare programs for their citizens. The responsibilities of modern governments have expanded significantly. Naturally, this means they require substantial funds and resources to support their public spending and transfer initiatives. Effective resource mobilization, particularly through a solid tax policy and its successful execution, has become essential for every government. Recently, many governments have adopted new strategies and policy measures to address this need, and it's clear that tax collections have surged in numerous countries. There's a prevailing belief among many economists and researchers that the expansion of government roles and the increase in tax revenue have led to a tax revolt, higher rates of tax evasion, a rise in the underground economy, and a backlash against welfare programs.

Keywords*: Tax; Economic Growth; Developing Economies; Empirical; Government.*

1. Introduction

In many parts of the world, tax evasion and its related activities have become so noticeable and widespread that they're starting to threaten the normal functioning of our systems (Alagumuthukrishnan et al., 2015). It's no surprise that this issue has recently made headlines and captured the attention of scholars and government officials alike (Torgler, 2007). When we talk about taxation on income, we generally consider two main aspects: individual income tax and corporate income tax. In many developing countries, before income tax was introduced, export taxes were imposed on the profits of foreign companies, which was seen as a straightforward way to tax those profits. Corporation tax, which used to be called the super tax, is a direct tax that hits a company's total taxable income (Pandey & Gupta, 2024). Typically, this tax is applied at a flat rate across various types of corporate entities, but there are often different rebates and exemptions based on the specific activities, income types, profits, and investments involved. It's interesting to note that companies are classified by their size, ownership (whether they're widely or closely held), and nationality (Indian or foreign) (Umar et al., 2019). Over the years, many committees, experts, and thinkers have suggested using corporate tax as a tool to reach different economic goals. Typically, this involves setting up incentives and penalties, but the ever-changing tax regulations have turned the corporate tax system into quite a complex maze. Tax breaks for corporations have changed over time, with some key ones being depreciation allowances, development rebates, investment allowances, and tax holidays (Mannan et al., 2020). However, some economists believe that these breaks have unintentionally led to tax evasion, as many corporations find ways to exploit them as loopholes (Gacanja, 2012; Al-Zarkoshi & Razzaq, 2022).

Tax collection varies from state to state, influenced by their unique tax bases, taxable capacities, and the efficiency of their tax efforts. discusses the concept of tax capacity, which is all about how well a government can bring in tax revenue (Jelena & Srđan, 2023). This ability hinges on various structural factors, including the level of economic development, the number of available 'tax handles,' and how much the population can afford to pay in taxes. On the flip side, it measures how effectively a country utilizes its taxable capacity. This essentially looks at the ratio of actual tax revenue to that capacity (Basanta Kumar & Sunil, 2024). Tax effort indices are quite handy for comparing how different countries or local governments leverage their potential tax bases (Seidgar et al., 2024). These indices can also guide policy decisions regarding budget deficits; for instance, countries with a high tax effort index might consider cutting spending instead of increasing taxes. Beyond just the size of the economy, states also differ in their economic structures and the socio-economic status of their residents, which not only shapes the tax base but also influences taxpayer compliance behavior. Unfortunately, the existing literature on this topic is limited and often fails to accurately reflect the tax efforts of various states. In addition to the quality of institutions and tax regulations, tax effort is also influenced by the administrative capabilities and infrastructure available within tax departments (Nkundaban-yanga et al., 2017). The analysis draws on the Endogenous Growth Theory, which posits that tax revenues, when effectively allocated to productive public expenditure, can enhance economic performance. We also incorporate the Tax Compliance Model by Allingham and Sandmo (1972), which examines compliance behaviour based on audit probabilities and penalties. Furthermore, the Fiscal Effort Index is used conceptually to assess the gap between a government's actual tax revenue and its potential, providing a framework to evaluate tax performance across states.

Definition of Key Concepts:

- Tax Effort: The ratio of actual tax revenue to the taxable capacity of a government.
- Compliance Cost: The monetary and time burden on taxpayers to meet tax requirements, including paperwork, legal fees, and indirect productivity loss.

2. Role of the Budget in a Developing Economy

For these countries, fiscal policy plays a key role in gathering resources and channeling them into productive endeavors. The government has taken on the responsibility of enhancing the well-being of its citizens through proactive measures. Budgeting is one of the primary ways the government plans and manages public resources to achieve specific goals in a developing economy. The budget has become an essential part of government policy, acting as a key tool for rolling out programs that greatly affect both the public and private sectors of our national economy. In simple terms, a budget is a strong instrument that enables the government to influence how national income is generated, shared, and utilized through its decisions on taxes, public spending, and borrowing (Gacanja, 2012; Biswakarma, 2014). The relationship between taxation and growth has been extensively debated in public finance literature. Tanzi and Zee (2000) emphasize how tax structures in emerging economies can create distortions that impact productivity and investment. In contrast, Gupta (2007) demonstrates that higher revenue mobilization enhances macroeconomic stability and reduces fiscal deficits. Additionally, Pessino and Fenochietto (2013) propose a cross-country tax effort index to estimate the gap between actual tax collections and a country's tax capacity. These foundational studies guide the present work in empirically assessing the relationship between tax-to-GDP ratios and economic performance across developing nations.

3. Tax Revenue and Economic Growth

A solid tax system is essential for driving economic growth in developing countries. Although a heavy tax burden can hinder a nation's economic advancement in several ways, it's vital to unpack this issue further. For one, high taxes can scare off investors and shrink the overall capital available, which ultimately slows down economic efficiency. Additionally, taxes can lessen the motivation to work, leading to lower labor productivity as people might choose to work fewer hours (Akintoye, 2013). Taxes can also impact the marginal productivity of capital by driving investments away from high-tax sectors—where productivity tends to be higher—toward low-tax sectors that are less efficient. However, there's also some evidence that suggests taxes can have a positive impact on economic growth, showing that they can indeed play a role in a country's development. So, taxes are essential for generating revenue and promoting economic growth. When tax revenue falls short, it can throw off resource allocation and impede overall economic welfare and growth. That's why having a well-functioning tax system is vital for balancing resource allocation with stable economic growth. Yet, it's crucial to understand that an ideal tax system often involves a trade-off between government revenue and the country's economic development.

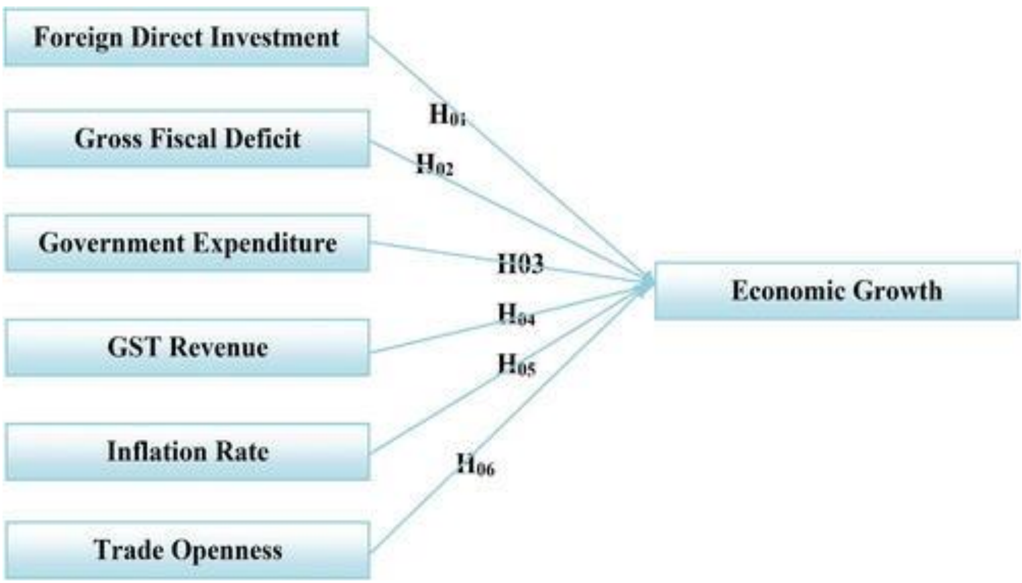

Fig. 1: Conceptual Framework Linking Fiscal and Economic Variables to Economic Growth

4. Results and discussion

The need for government spending is on the rise across Indian states, driven by population growth and urbanization. Unfortunately, the annual revenue collected by the government often doesn't keep up with these expenditures, leading many states to grapple with both revenue and fiscal deficits. Public infrastructure investment is falling short across all Indian states, and any improvements in this area are expected to drive economic growth and create jobs over time. While the Constitution grants states certain taxation powers, they have limited avenues to expand their tax base. Moreover, their natural resources—such as forests, fossil fuels, and minerals—further constrain their ability to boost non-tax revenue. As a result, states need to seek out alternative methods to enhance revenue generation to keep up with the increasing demand for government spending. Some viable options might include bolstering state tax administration and pursuing tax reforms in areas that fall outside the GST system (Ameyaw et al., 2016).

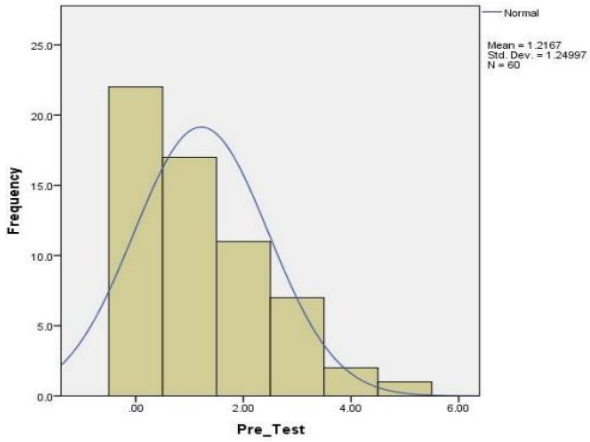

Fig. 2: Distribution of Pre-test Scores for Total Sample

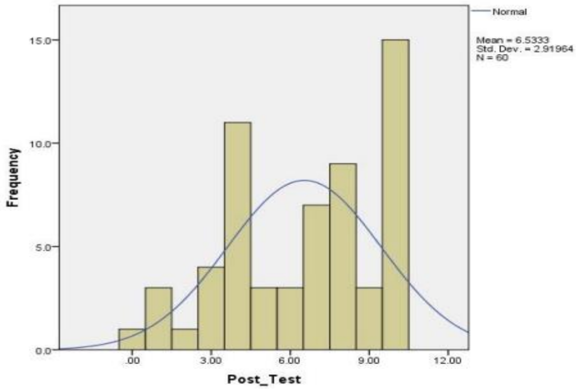

Fig. 3: Distribution of Post-test Scores for Total Sample

There really wasn't much to prevent State governments from stepping in and overriding the decisions of elected local governments. Plus, there was no obligation for them to hold regular elections for these local bodies. The financial powers given to local governments just didn't generate enough revenue, which meant they often had to depend on grants from the State government to deliver services. As a result, the effectiveness of these institutions could vary quite a bit from one State to another, largely based on the efforts each puts in. Every state government was tasked with setting up a State Finance Commission. This commission would oversee how taxes and fees are allocated to local governments and offer suggestions on sharing taxes and distributing grants (Musimenta et al., 2017).

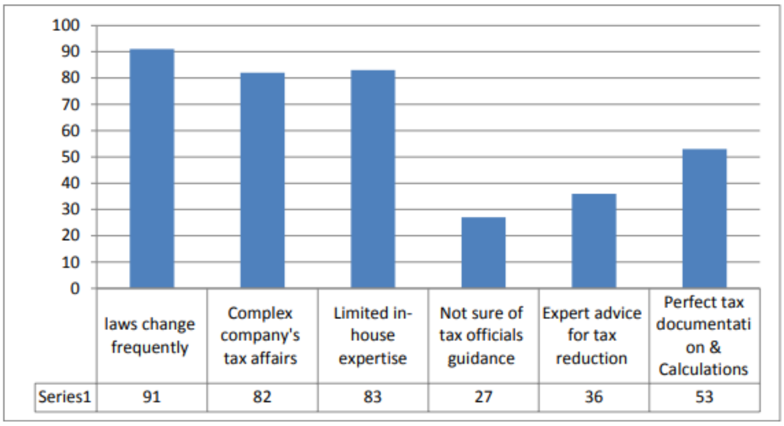

Fig. 4: Tax Compliance Requirements

The States have established a system to distribute their revenues and offer grants to local entities, regardless of whether they're in urban or rural settings. Every state government needs to set up a State Finance Commission. This commission will take a close look at the finances of local bodies, determine their share of taxes, and distribute grants as necessary (Adem et al., 2024).

Table 1: Benefits of Income Tax Compliance Requirements

	No of Positive responses	Total Responses	% of Positive Responses
Better Preparation of Income Statement & B/S	109	116	94.0
Improved Asset Management & Stock & Inventory Control	46	116	40.0
Improved Asset and Stock Valuation	39	116	34.0
Better Control on Companies' Borrowings & Repayment.	4	116	3. 4
Company Earns Interest between TDS & Remittance	2	116	1.7
Able to detect employee malfeasance	14	116	12.1
Other Advantages.	12	116	10.3

You know, a lot of key areas and centrally sponsored programs are managed by local governments. The money allocated for these projects is sent to them from the state governments to get things rolling. This study employs a panel data analysis approach using secondary data from the World Bank and the Indian Ministry of Finance for the years 2001–2021. The empirical model estimates the effect of the tax-to-GDP ratio (independent variable) on GDP growth (dependent variable), controlling for inflation, public debt, and fiscal deficit. Statistical techniques used include correlation analysis, unit root testing (ADF), and multiple linear regression using SPSS. The robustness of the regression was assessed through multicollinearity checks and residual diagnostics.

Policy Implications

To enhance tax compliance and fiscal sustainability, developing economies should:

1. Digitize Tax Administration: Implement real-time data matching, e-filing platforms, and AI-driven audit systems to improve transparency and efficiency.
2. Simplify Tax Codes: Reduce the number of exemptions and streamline procedures to lower compliance costs and confusion.
3. Use Behavioural Nudges: Send personalized reminders, deadline prompts, and public recognition for compliant taxpayers to increase voluntary compliance.
4. Promote Subnational Tax Effort Transparency: States should regularly publish tax effort scores and link performance to fiscal devolution frameworks.

5. Conclusion

Tax revenue is essentially the money that individuals and businesses pay to the government to help support public services. It's worth mentioning that this doesn't include certain mandatory payments like fines, penalties, or most social security contributions. The government gathers this tax revenue through both direct and indirect taxes. Direct taxes encompass things like income tax, estate duty, wealth tax, gift tax, land revenue, hotel receipts tax, and expenditure tax. On the other hand, indirect taxes include customs duties, union excise duties, service tax, state excise duty, value-added tax, vehicle taxes, electricity taxes, and taxes on goods and passengers. Taxation plays a crucial role in fiscal policy and is a primary source of revenue for the government. By adjusting taxation and spending policies, the government can work towards reducing class distinctions and inequalities. Moreover, policies aimed at expenditure and production seek to address issues like poverty and unemployment, while also encouraging wealth distribution and stimulating economic growth. Public borrowing strategies are crafted to boost savings and mobilize resources, ultimately driving rapid economic development.

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