

## THE IMPACT OF TAX EVASION ON A NATION'S ECONOMIC GROWTH<sup>1</sup>

### ABSTRACT

*Economic stability and nation-wide growth experience significant negative effects when residents evade their taxes. Tax evasion impacts public financial measures such as GDP and fiscal deficits and public expenditure by studying distinct economic examples according to the research findings. The investigation of tax evasion explores the intricate nature of its relationship to economic expansion which shows how it undermines state budget planning and prevents funding of public welfare programs. Tax evasion has distinct impact patterns between developed and developing nations because developed countries face challenges from corporate tax dodging and profit migration but developing nations must confront poor tax enforcement in addition to their large informal market. This paper analyses methods which technology along with international tax partnerships help minimize evasion occurrences. A comprehensive examination is employed between Indian and historical tax standards as well as new legislative approaches to aid in better understanding the tax system weaknesses which promote tax noncompliance. The combination of qualitative policy assessment for legislative materials merges with quantitative evaluations of economic reports forms the research methodology.*

Keywords: tax evasion, economic growth, fiscal deficits, global taxation.

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## CHAPTER I: INTRODUCTION

### 1.1. Introduction

The backbone of a country's economic structure is its taxation, which allows governments to raise the revenue required for economic growth and public spending. In order to achieve equitable growth and stability in the economy, a strong tax system is essential. During the past few decades, the complexity of both local and international tax systems but has in turn made it simpler for individuals or companies to intentionally underreport their income, inflate their deductions, or conceal activities in order to avoid paying taxes. Tax evasion impacts developed and developing nations in a different manner. It worsens fiscal deficits, lowers public investment, and increases income inequality in developing nations, while developed countries struggle with tax evasion strategies, frequently involving cross-border transactions and tax havens.

A landmark reform was introduced for the Indian economy, through the implementation of the Goods and Services Tax (GST) in 2017, with the goal of improving public compliance with the nation's tax system and eliminating indirect taxation. However, due to a large informal sector, intricate rules and regulations, and inadequate enforcement tools, tax evasion persists.

Moreover, globalization has introduced new dimensions to tax evasion, with multinational corporations exploiting loopholes in international taxation frameworks to minimize liabilities. India has responded with measures like the General Anti-Avoidance Rule and participation in global initiatives like the OECD's Base Erosion and Profit Shifting framework. The effectiveness of these measures, however, is debatable. In light of these challenges, this paper aims to explore the intricate relationship between tax evasion and a country's economic growth. By analysing the causes consequences and potential solutions to tax evasion, this paper aims to contribute to the discourse surrounding the relation between tax compliance and economic growth.

## 1.2. Literature Review

- i. Dr S M Alagappan, *Indian Tax Structure – An Analytical Perspective*, International Journal of Management, Volume 10, Issue 3, pp. 36-43 (May-June 2019).

The author defines and explores tax evasion alongside various economic theories underpinning it. Some of these theories include the Allingham-Sandmo model, which illustrates that the taxpayer's decision-making process is clouded in uncertainty, and models from behavioral economics that highlight the influence of social norms and cultural influence upon a person's compliance with tax payment. Tax evasion is said to occur due to high tax rates, systemic inequality, development of large informal sectors and inefficient enforcement mechanisms.

- ii. Dr. Sanjay B Bagde, *An Analytical Study of Indian Tax: A Study*, Cosmos Multidisciplinary Research E-Journal, ISSN No. 2456-1665.

This paper integrates classical theories with a modern framework to propose an outlook upon tax evasion through a complex interplay of economic, institutional, and individual factors. One is assumed to weigh the cost and benefits before evading tax, i.e., the risk and reward, in addition to psychological and cultural factors of society. The paper also identifies several determinants to tax evasion, adding to the list lack of awareness and corruption, while suggesting policy reforms that may curb the same.

- iii. Nishant Gauge and Katdare, *Indian Tax Structure – An Analytical Perspective*, International Journal in Management and Social Science, ISSN: 2321-1784, Vol. 03, Issue 09, Sep. 2015.

This paper provides a detailed analysis of the Indian tax regime, tracing its way back to the origin and evolution of the same. It highlights the dual nature of taxation in India, with direct and indirect taxes, and their significance upon Indian economic growth, public welfare and resource allocation. Several challenges of this system have also been highlighted, with a comparison drawn from other global tax structures.

- iv. Michael G Allingham and Agnar Sandmo, *Income tax Evasion: A Theoretical Analysis*, Journal of Public Economics 1 (1972) 323-338.

This paper employs a more economic standpoint of analysis of tax evasion. A model is proposed wherein individuals weigh their benefits of tax evasion with the risk of detection. This study revealed that stricter penalties deter evasion and there is no set

behaviour of taxpayers with respect to tax rates, meaning it is based upon individual preference. Reporting of tax also changes overtime, depending upon the 'short-sightedness' of people. In conclusion, they state that tax enforcement efficiency is primarily dependent upon optimising penalties and audit probabilities to minimise evasion.

### 1.3. Research Problem

Due to a plethora of issues, including but not limited to, administrative inefficiency, high tax rates, complex tax system and lack of knowledge, evasion of tax is a crime committed by citizens with and without the intention to do so. Therefore, there is a gap in revenue generation, which in turn impacts the economic stability of the nation and further curbs a practice of progressive taxation to reduce income inequalities in the country.

### 1.4. Research Objectives

- Identify the reasons for tax evasion by citizens
- Analyze the impact of tax evasion on economic growth of a nation

### 1.5. Research Questions

- i. How did the system of taxation come into being and evolve with changing needs of society?
- ii. What are the primary causes for tax evasion in developing and developed countries, and how do they differ?
- iii. How does tax evasion impact key economic indicators such as GDP growth and income inequality?
- iv. What are recent legislative changes undertaken to tackle tax evasion?
- v. What strategies can policymakers adopt to address tax evasion with the needs of the country's tax regime?

### 1.6. Hypothesis

It is hypothesized that tax evasion is an unfortunate practice that negatively impacts a nation's economic growth. The quality of governance and the stringent nature of enforcement mechanisms put in place to curb this act significantly impact tax evasion. While recent policy reforms in India, such as the introduction and implementation of

GST have aimed at simplifying the tax structure to reduce tax evasion, it is hypothesised that a practice of underreporting, among others, still persists.

#### 1.7. Scope and Limitation

This study aims to analyse the economic impact of tax evasion from a macroeconomic perspective, focusing on its impact upon revenue generation, income inequality and economic growth. While the scope is limited to India, comparative analyses with other developing and developed economies is done to provide a global perspective and suggest policy amendments. Due to limited availability of data and the complex interplay between tax evasion, policy effectiveness and other factors differing from region to region, it may be hard to generalise and state under one umbrella the findings. The study also focuses upon the economic and sociological dimensions.

#### 1.8. Research Methodology

This paper adopts a mixture of quantitative and qualitative research. There is a comparative analysis of tax systems in developing and developed nations from newspaper articles and data from the reports of their respective governments. There is also heavy reliance upon other secondary sources such as international agencies, academic journals and thoughts of prominent scholars in this area.

## CHAPTER II: TAX EVASION IN THE INDIAN CONTEXT

### 2.1. Historical Evolution of Taxation in India

This is a complex narrative, whose origin can be traced back to the Indus Valley civilization. While information from retrieved archaeological evidence is limited, historians state that such evidence is suggestive of the fact that some form of taxation existed at the time. About a thousand years later, taxes were predominantly collected through means of agricultural produce and cattle. A 'bail system' was employed, wherein a portion of a person's harvest was to be contributed towards a collective contribution to sustain rulers, priests and other administrative functions.<sup>2</sup> The following periods of Mauryan Empire and the Gupta Empire marked the origin and evolution of a more organised system of taxation. Kautilya's work 'Arthashastra' provided comprehensive guidelines for the same, outlining the interplay between effective governance and the importance of taxation in the same regard.<sup>3</sup> Through the establishment of the Mughal empire, Emperor Akbar introduced the concept of 'Zabt', which was a more stringent form of taxation based on crop productivity which formed the backbone of Mughal monetary policies.<sup>4</sup>

The British empire is credited with the formal introduction of income tax in India, through Sir James Wilson, wherein income tax was divided into four initial dissections. They also introduced land revenue systems, which unfortunately led to exploitation of peasants.<sup>5</sup> The Indian Income Tax Act was passed in 1886, which has seen numerous amendments and renovations to adapt with changing needs of Indian society. In 1918, a novel Income Tax Act was passed, which consolidated all the prior amendments alongside necessary changes into a new legislation.<sup>6</sup> Post-independence, the Income Tax Act of 1961 came into effect, which paved the way towards the modern taxation system involving a wide range of taxes such as the Goods and Services Tax, custom duty, and local body taxes among others.<sup>7</sup>

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<sup>2</sup> "Dr. Bagashree P. Bangera Bandekar, Ms. Aksha Memon, The Evolution of Taxation in India: From Ancient Civilizations to Modern Systems, International Journal of Research Publication and Reviews, Vol 4, no 9, pp. 2578-2581, September 2023."

<sup>3</sup> "History of Direct Taxation, Income Tax Department, Ministry of Finance, Government of India, Available at: <https://incometaxindia.gov.in/pages/about-us/history-of-direct-taxation.aspx>."

<sup>4</sup> "Manu Sharma, Indian Tax System Before Independence: Here's the History for You, Taxscan, (Aug. 15, 2024, 12:43 PM), Available at: <https://www.taxscan.in/indian-tax-system-before-independence-heres-the-history-for-you/428679/>."

<sup>5</sup> "History of Taxation in India, Knowledge Base, Levare Consultants Pvt. Ltd., Available at: <https://www.levare.co.in/articles/history-taxation-india>."

<sup>6</sup> "Taxation System in India: Understanding the Indian Tax Structure, pnb MetLife, (Oct. 21, 2021), Available at: <https://www.pnbmetlife.com/articles/taxation/evolution-of-taxation-system-in-india.html>."

<sup>7</sup> "supra note 4."

## 2.2. Key Legislative Reforms in India's Tax Regime

The Wealth Tax Act of 1957, which was repealed in 2015, was enacted to tax individuals and Hindu Undivided Families (HUFs) whose net income was above a certain set limit. The practice of surcharge was introduced after its repeal upon high-earning individuals to replace the same.<sup>8</sup> The Income Tax Act of 1961 is the cornerstone of India's income tax system post the British introduction of statutory taxes.<sup>9</sup> It provided for various types of income, such as salaries, business, income from profession, and capital gains among other sources. It also provided for deductions and exemptions of income tax, as provided under Section 80C.<sup>10</sup> It was amended numerous times to adapt to the economic changes required by society and to cater to policy objectives.<sup>11</sup>

The Benami Property Transactions Act created a barrier against animals through which property ownership remains hidden under a third-party name since its 2016 amendment strengthened its prohibited aspects.<sup>12</sup> Additional Acts were created to address the changing fiscal policy matters in India.<sup>13</sup> The Goods and Services Act arrived in 2017 as a national unified tax system that substituted various indirect taxes. This system helps Indian subcontinent tax compliance by merging complex rules into simpler approaches while minimizing the tax chain effects.<sup>14</sup>

## 2.3. Trends in Tax Evasion

Tax evasion trends are a reflection of evolving economic policies, technological advancements, and international cooperation. Reports state that globally, countries across the world have faced approximately \$492 billion annually due to tax evasion. This evasion was specific towards multinational corporations (MNCs in short) and wealthy members of society through tax havens.<sup>15</sup> A significant number of leading global actors including Australia, Canada, Israel, Japan, New Zealand, South Korea, United States, and United Kingdom enabled widespread

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<sup>8</sup> "Renu Suresh, Tax Concepts in India, India Filings, (Feb. 20, 2025), Available at: <https://www.indiafilings.com/learn/tax-concepts-in-india/>."

<sup>9</sup> "Income Tax Act, 1961 (Act 43 of 1961)."

<sup>10</sup> "Id., §80C."

<sup>11</sup> "Mohammed S Chokhawala, Income Tax Act 1961: Chapters, Objectives, Features, Provisions, cleartax, (Mar. 7, 2025), Available at: <https://cleartax.in/s/income-tax-act-1961>."

<sup>12</sup> "Benami Property Transactions (Prohibition) Amendment Act, 2016 (Act 43 of 2016)."

<sup>13</sup> "Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 (Act 22 of 2015)."

<sup>14</sup> "The Central Goods and Services Tax Act, 2017 (Act 12 of 2017)."

<sup>15</sup> "The State of Tax Justice 2024, Tax Justice Reports, Tax Justice Network, Available at: <https://taxjustice.net/reports/the-state-of-tax-justice-2024/>."

global tax evasion at the same time that they were experiencing economic losses.<sup>16</sup> The United Nations along with the Organisation for Economic Cooperation and Development implemented specific reforms for nation-wide tax system improvement to combat worldwide tax-related obstacles. The acceptance level and critique of GloBE Rules together with the UN's tax convention have shown different reactions from interested parties.<sup>17</sup>

It is to be noted that there are varying reasons and 'levels' of tax evasion between developed and developing economies.<sup>18</sup> Advanced economies have stronger mechanisms of administering tax and third-party reporting, while developing countries reportedly had inadequate audit mechanisms with weak enforcement, allowing for widespread evasion. Developing countries, due to a large informal sector in their economy, also causes tax evasion to be more common due to dominance of small businesses and cash-based transactions. Developing countries also, reportedly, have higher trust in governmental institutions, but there is also employment of aggressive tax avoidance strategies and legal loopholes by wealthy individuals and co-operations.<sup>19</sup>

There was an attempt made towards reducing corporate tax cuts as it was theorised that doing so might reduce the amount of tax evasion that occurred. This, however, had the opposite effect, and led to multinational corporations further shifting their profits into tax havens. This was in complete opposition to the 'tax appeasement' strategy, which suggested that lowering tax rates would cause reduced tax evasion.<sup>20</sup> Further, as technology advanced, it was increasingly used to detect and prevent tax evasion, with AI being used in more recent times.<sup>21</sup> One of the few measures employed in modern times towards preventing, or at least reducing, the amount of tax evasion in the Automatic Exchange of Information (AEOI in short) as per the Common

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<sup>16</sup> "Mark Bou Mansour, World losing half a trillion to tax abuse, largely due to 8 countries blocking UN tax reform, annual report finds, Tax Justice Network, (Nov. 19, 2024), Available at: <https://taxjustice.net/press/world-losing-half-a-trillion-to-tax-abuse-largely-due-to-8-countries-blocking-un-tax-reform-annual-report-finds/>."

<sup>17</sup> "OECD, Tax Challenges Arising from the Digitalisation of the Economy – GloBE Information Return (January 2025), Publications, (Jan. 15, 2025), Available at: [https://www.oecd.org/en/publications/tax-challenges-arising-from-the-digitalisation-of-the-economy-globe-information-return-january-2025\\_a05ec99a-en.html](https://www.oecd.org/en/publications/tax-challenges-arising-from-the-digitalisation-of-the-economy-globe-information-return-january-2025_a05ec99a-en.html)."

<sup>18</sup> "Hichem Khelif, Imen Achek, The determinants of tax evasion: a literature review, International Journal of Law and Management, Volume 57 Issue 5, ISSN: 1754-243X, Published on: September 14, 2015."

<sup>19</sup> "Joel Slemrod, Cheating Ourselves: The Economics of Tax Evasion, Journal of Economic Perspectives, Volume 21, Number 1, Winter 2007, pp. 25-48."

<sup>20</sup> "Id."

<sup>21</sup> "Julie Watson, Top 11 Technology Trends Shaping the Future of Tax, Ace Cloud Hosting, (Mar. 6, 2025), Available at: <https://www.acecloudhosting.com/blog/technology-trends-in-tax/>."

Reporting Standard. AEol helped reduce offshore tax evasion by wealthy individuals but the amount of wealth so 'reduced' remains unknown.<sup>22</sup>

## CHAPTER III: ECONOMIC IMPACT OF TAX EVASION

### 3.1. Revenue Loss and Fiscal Deficits

Tax has evolved into a system that the government is significantly reliant upon for its finances. Approximately ₹9.6 trillion are lost annually in India through tax evasion, which in extension limits the aid and development the government can do in infrastructure, healthcare and educational sectors of the economy.<sup>23</sup> During the COVID-19 pandemic, a whopping ₹971 billion were lost in April of 2020 alone due to the drastic drop in tax compliance and economic slowdown due to the nationwide lockdown.<sup>24</sup> In the United States of America, the IRS reported a \$450 billion tax gap as early as 2006 due to misuse of law by shell companies and underreporting of income by small businesses in the nation.<sup>25</sup>

Unreported income that arises due to evasion directly increases a country's budget deficits. In the United States, a 1% increase in deficit is correlated with a 0.3% increase in tax evasion, which is observed as an anticipation on the taxpayers' end for future tax hikes.<sup>26</sup> To offset this loss of revenue, the borrowings of a government increase, therefore raising public debt. In 2020-2021, India's fiscal deficit increased to 6.9% of its GDP, which is partially accredited to losses caused by the pandemic.<sup>27</sup> In addition to the same, these deficits are likely to lead into higher tax rates, prompting further evasion from the population. Studies report that systems with higher tax rates and complex taxation law, such as those present in Bangladesh, correlate with increased avoidance by taxpayers.<sup>28</sup>

<sup>22</sup> "supra note 16."

<sup>23</sup> "Mrs. Chhaya Rai, Tax Evasion and its Consequences, International Journal of Advanced Research in Science, Communication and Technology, Volume 2, Issue 6, ISSN (Online) 2581-9429, January 2022."

<sup>24</sup> "Yeesha Shriyan, Impact and Incidence of tax evasion, Vidhi Centre for Legal Policy, Available at: [https://vidhilegalpolicy.in/wp-content/uploads/2023/03/Impact-and-Incidence-of-Tax-evasion\\_VCLP.pdf](https://vidhilegalpolicy.in/wp-content/uploads/2023/03/Impact-and-Incidence-of-Tax-evasion_VCLP.pdf)."

<sup>25</sup> "Mary Cowx, Felipe Bastos G. Silva, Kelvin Yeung, Government Deficits and Corporate Tax Avoidance, S&P Global Market Intelligence, Available at: <https://ssrn.com/abstract=4060416> (2023)."

<sup>26</sup> "Richard Cebula, An Empirical Analysis of Determinants of Recent Federal Personal Income Tax Evasion in the U.S., MPRA Paper No. 53205, Available at: <https://mpra.ub.uni-muenchen.de/53205/> (2014)."

<sup>27</sup> "supra note 23."

<sup>28</sup> "Md Shamim Hossain, Md. Sobhan Ali, Chui Ching Ling, Chorong Yuan Fung, Tax avoidance and tax evasion: current insights and future research directions from an emerging economy, Asian Journal of Accounting Research, Volume 9, Issue 3, ISSN: 2459-9700 (2024)."

### 3.2. Effect on GDP Growth and Developmental Expenditure

As aforementioned, tax evasion in India has caused significant losses for the government, in extension reducing funds for further development in various required sectors of the economy.<sup>29</sup> Similar trends were observed in Nigeria, where tax evasion has limited grassroot infrastructure development.<sup>30</sup> This tax evasion further discourages foreign investments due to perceived instability in the community, further creating a barrier around GDP growth.

Furthering upon Africa's case study, it was realised that Nigeria face under developed utilities and roadways due to tax evasion and lack of funds from the same.<sup>31</sup> This forces governments to limit or entirely do away with any welfare programs or schemes they have employed to aid certain marginalised communities of the nation. In South Africa, it was noted that pandemic relief measures were substantially delayed due to fiscal constraints, primarily arising out of a lack of funds due to tax evasion. South Africa's paradox is completely in contrast with India's economic environment, where a 2024 study found that when tax rates were raised there was minimal impact upon the nation's GDP from tax evasion.<sup>32</sup>

### 3.3. Policy Recommendations

It is suggested that tax laws are regularly updated to address emerging tactics of tax evasion, such as cryptocurrency. For some economic systems, more stringent punishments might prove to deter non-compliance. Simplification of tax regimes also aids in better understanding of tax to 'laymen', making it feasible for tax payment and lowering incentives for evasion. Artificial Intelligence may be used to detect anomalies in tax filing, such as its current use in India to match invoices. However, this usage must be limited and overseen appropriately. Creating e-filing platforms for income tax returns can help further ease such filing. Having a transparent database of usage of revenue also may help improve the taxpayer morale. Initiating whistleblower initiatives, equipped with financial rewards, concessions and anonymity protection, to

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<sup>29</sup> "Dr. Yazhini Kuppusamy, Impact of Tax Avoidance on Indian Economy, International Journal of Legal Science and Innovation, Volume 7, Issue 1, ISSN 2581-9453 (2025)."

<sup>30</sup> "Asomba Ifeyinwa U, Owa John T, Chime Jessie Onyinye, Effect of Tax Evasion and Avoidance on Economic Development of Grassroots in Nigeria, Journal of Policy and Development Studies, Volume 14, Issue 2, ISSN (p) 0189-5958 (2023)."

<sup>31</sup> "Id."

<sup>32</sup> "Jean Damascene Mvunabandi, Bomi Nomala, Ferina Marimuthu, The Effect of Tax Avoidance and Tax Evasion on the Performance of South African Economy, International journal of Economics and Financial Issues, Volume 14 No. 1 (2024)."

encourage reporting of tax evasion. Some studies suggest risk-based or targeted audits towards high net-worth individuals, MNCs and sectors prone to cash transactions.<sup>33</sup>

## CHAPTER IV: CONCLUSION

Tax evasion continues to be a formidable challenge in a nation's economic stability and fiscal integrity. This paper has explored the historical evolution of the taxation system in India, alongside its formal evolution into statutory authorities. These statutes have, with changing needs of society and emergence of new issues, been amended, repealed and re-introduced to better cater to such needs. Depending upon a nation's system, a variety of measures may be employed to curb tax evasion or at least ensure that such evasion does not drastically impact the nation's fiscal strength. Tax evasion also further exacerbates income inequality in economic systems, specifically isolated towards high net worth individuals and corporations who exploit legal loopholes. A comparative analysis was employed to analyse the differing challenges and trends between developing and developed nations, alongside the diaspora of measures that could be employed to curb the same. Addressing tax evasion requires a multifaceted approach, with stricter enforcement mechanisms, simplified taxation authorities and responsible use of technology.

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<sup>33</sup> "John Cassey, Tax evasion - minimising risks, ACCA, Available at: <https://www.accaglobal.com/in/en/member/sectors/internal-audit/our-publications/tax-evasion-minimising-risks.html>."

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