DOI: https://doi.org/10.3126/pragyaratna.v6i2.70592

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Contents lists available at NepJol

Pragyaratna

A Peer-Reviewed, Open Access Journal

Nexus Between Tax Revenue and Economic Growth in Nepal

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Article Info **Abstract**

Received: August 7, 2024

Accepted: September 13, 2024

Published: October 22, 2024

This study examines the relationship between Nepal's economic growth and tax revenue from the country's fiscal years 2002–2003 to 2022–2023. Relevant time series secondary data were gathered from the World Bank, Nepal Rastra Bank, Ministry of Finance, Inland Revenue Department, and other sources in order to achieve the objectives. Scholarly publications from the past were also consulted. The linear regression model has been used to examine the gathered data. The outcome demonstrates that overall revenue, including tax revenue, significantly increases GDP. Although tax collection has shown encouraging trends, it is still insufficient to cover Nepal's government's expenses.

Keywords: *Taxation system, tax revenue, total tax revenue, economic growth, GDP*

Introduction

A tax is a compulsory financial obligation imposed by the government on individuals or corporations to contribute to public revenue. It serves as a consistent mechanism for generating funds, crucial for economic development. In developed nations, taxes form a significant portion of government income, and they are increasingly becoming an important source of revenue in developing countries as well.

Taxes are collected from earnings or profits according to legal frameworks, and individuals or businesses are required to pay them without expecting direct, immediate benefits in return, such as goods or services. These contributions help fund the government's operations and meet the needs of the public.

In developing nations, economic development is often a key focus. Governments aim to achieve financial growth, reduce income inequalities, and improve living standards. As a result, taxes play a central role in supporting these broader economic and social objectives.

Adhikari (2003) defined that tax simply means a liability to pay an amount to the government. It is a compulsory contribution to the national revenue from the taxpayers according to the law. Tax payers gets no direct and quid pro quo for the payment of tax. The tax fulfills the required expenditure of the government for public welfare. Its objectives are social justice and equal distribution of income. The tax is classified based on its structure, nature, merits, quantity, volume or form and procedure, etc. However, taxes are direct and indirect.

According to Macek (2014), economic growth is a conventional means of achieving well-ordered socio-economic transformation or gains in life quality. Based on empirical research, the majority of tax systems were determined to be highly significant and correlated with a nation's economic growth. Economic planning may be impacted by changes in tax laws (Marsden, 1983). Gober and Burns (1997) assert that modifications to any one tax component may have varying effects on a nation's economy. According to Mahdavi (2008), increases in overall tax income have the effect of slowing down the rate of growth in emerging nations. Studying the relationship between taxes and growth helps us create appropriate policy measures for more equitable and inclusive growth in a budget-constant economy like Nepal.

Generally speaking, the budget problem is caused by either a decrease in public spending or an increase in tax collection (Macek 2014). Prompt tax increases or spending cuts have a negative impact on long-term growth performance. Therefore, the government's main issue is how difficult it will be to balance budgetary austerity with appropriate growth, for which tax policy is essential.

Theoretical Framework and Empirical Literature

Taxation plays a part in the process of economic growth, according to recent growth literature. Boom tendencies were more fundamentally based on external shifts and the steady state approach until recently. From a theoretical standpoint, taxes no longer affect boom (Myles 2000). The field of fiscal policy, particularly tax policy, is opened up by the development of endogenous boom models in identifying ways to improve performance. In this sense, the pioneers have been Barro (1990), King and Rebelo (1990), and Jones et al. (1993). Tax intensity and tax structure affect household saving behavior and human capital investment. However, the company also adjusts its funding choices and enhancements in accordance with tax legislation (Johansson et al. 2008). These choices and rewards in the accumulation of bodily and human capital create the 'Growth' disparities amongst the nations and state economies.

Many researchers, academics, and scholars have explored various theories and frameworks to understand the relationship between taxation and economic growth. Numerous studies have been conducted to examine how tax policies influence economic expansion. Some research suggests that taxes contribute to improving the overall functioning of the economic system, while others indicate that taxes can have a negative effect on economic growth and output, particularly in developing nations. Solow (1956), stated that, the policies affect economic growth by requiring workers to put in a lot of labor and develop their skills. In essence, an economy's GDP is a measure of its output, which is based on its financial resources.

Adhikari (2024), found that a positive relationship between income tax revenue and GDP progression, implying that an increase in income tax revenues correlate with corresponding rise in Nepal's economic growth.

Huang et. al (2022), explored the relationship between taxes and economic growth in China. Researchers concluded that there is a positive correlation relationship between tax and economic growth. Value Added Tax, Business Tax can impact on GDP significantly, while tariff, corporate tax would not significantly impact on GDP.

Kharel (2021) studied the relationship between Nepal's economic growth and tax income between 2000 and 2015. In order to determine the relationship between tax revenue and economic growth, the study employed linear regression analysis. The analysis demonstrated a distinct and significant relationship between tax revenue and total tax revenue and GDP. Tax income has a considerable beneficial effect on GDP. The amount of tax income affects how quickly the economy grows. He discovered that a rise in overall revenue leads to a rise in GDP.

Tsaurai (2021) used panel data spanning from 2008 to 2018 to examine the effects of taxation on economic growth in emerging markets using the dynamic generalized methods of moments (GMM), fixed effects, pooled ordinary least squares (OLS), and random effects approaches. Under dynamic GMM and random effects, tax revenue was found to have a strong beneficial impact on economic growth, whereas financial development was validated under fixed and random effects approaches. Using the dynamic GMM and pooled OLS econometric estimate methodologies, the study also discovered that the complementarity between taxes and financial development has a considerable positive impact on economic growth in emerging markets.

Neog and Gaur (2020) investigated the relationship between tax structure and state-level growth performance in India, both in the short and long terms. Based on linear regression analysis, it was found that whereas property taxes promote growth, commodities and service taxes had the opposite effect. The results of property taxes, which show that high property taxes promote growth, are supported by the non-linear regression. Lowering the overall tax burden and switching from income and commodity taxes to property taxes as a source of revenue generation is the most promising course of action for long-term growth performance in India's states, according to the report.

Stoilova and Patonov (2020) used data from Bulgaria to study the relationship between growth and fiscal policy in small emerging economies. The empirical data demonstrates that Bulgaria's government spending significantly raises the country's annual GDP growth rate. This makes taxes one of the most dependable tools for implementing fiscal policy, which is consistent with the circumstances of a small, open developing market economy. The significant negative current account balance that has been maintained for a long time is most likely the reason behind the diluting of public spending efforts.

Hakim (2019) examined the impact of direct and indirect taxes on overall tax collection and economic growth in a sample of 51 nations from 1992 to 2016. The dynamic panel generalized method of moments (GMM) estimation was used to estimate the data. The findings show that whereas indirect taxes appear to have a small but beneficial effect on the dependent variables, direct taxes have a large and negative correlation with economic growth. The research verified that while direct taxes, such income, profit, and capital gains taxes, are more effective in raising national revenue, they are detrimental to economic growth.

Egbunike et. al. (2018) looked into how taxes affected Ghana's and Nigeria's economic expansion. Multiple regressions were employed in the study as analytic techniques. According to the study, tax income had a favorable effect on Ghana's and Nigeria's GDP, supporting earlier findings.

Iswahyudi (2018) combined the frameworks of endogenous growth models and neoclassical growth models to examine the relationship between tax structure and economic growth for the case of Indonesia, covering the years 1984–2015. Panel growth regressions that take into consideration human capital and tax structure indicators are used to analyze the growth effects of the combination of consumption and income taxes. According to empirical findings, consumption taxes have a positive and statistically significant impact on economic growth, but income taxes have no discernible effect on growth.

Pokharel (2018) investigated the connection between SAARC countries' economic growth and tax reforms. The research has revealed an imbalance in factors resulting from nations that grant exemptions or credits for earnings repatriated; hence, the incentives for tax competitiveness ought to be contingent upon the make-up of the investing nations. According to empirical evidence, tax rate increases have a long-lasting negative impact on the growth of GDP per capita. According to the study's conclusion, the GDP growth rate of SAARC countries will increase if tax rates are lowered.

Stoilova (2017) used regressions on pooled panel data to examine the effect of taxes on economic development in EU-28 member states between 1996 and 2013. According to her research, taxes on consumption, personal income, and real estate have a greater positive impact on economic growth than value-added taxation, which has a negative impact on the economies of the EU-28.

Zeng et.al (2013) found that economic growth not only has a significant impact on the total tax revenue and structure changes but also has a long-term stability relationship with total tax revenue. Researcher's also concludes that every tax reform shows a clear impact on the tax structure, while the impact of changes in the total tax revenue diminishing over the time.

Stoilova & Patonov (2013) examined the fundamental patterns in the allocation of the overall tax burden across the 27 EU member states between 1995 and 2010. To determine whether their forecast is valid, regression analysis is employed. The empirical findings made the effect of direct taxes on economic growth evident and firmly stated. This is because wealth taxes generate income more efficiently. Regarding fostering economic growth in the EU member states, the direct tax system is a more effective system.

Myles (2000) examined the empirical and theoretical data to determine whether there is agreement on how taxes impact the pace of economic expansion. As demonstrated, there are several pathways through which taxes might impact growth, and these effects may be rather significant, according to the theoretical models.

Research Problem

Economic growth is the gradual increase in the production of goods and services. Given that the government provides public goods and services, it would seem that its role aligns with this. To fulfill its obligations, the government collects taxes. Thus, it would seem that taxes affect economic expansion (Riba 2016). Consequently, the study's precise research question is as follows:

i. How do tax revenue and GDP revenue exhibit a discernible tendency toward positive or negative values?
ii. How does Nepal's economic progress correlate with tax revenue?

Research Hypothesis

The following is the proper research hypothesis for this study, which is based on the aforementioned research objective:

H_1: Taxation and economic growth in Nepal are significantly positively correlated.

Data and Research Method

This study used a descriptive and analytical research design to investigate secondary data published by various governmental and organizations. The Statistical Year Book, information from the Tax Revenue Department, a Ministry of Finance economic research and other publications, the Central Bureau of Statistics, the Quarterly Economic Report from Nepal Rastra Bank, etc. The relationship between tax revenue, total tax revenue, and government spending and GDP has been studied using a basic linear regression model. It has been predicted that tax revenue, overall revenue, and spending will have an impact on GDP and economic growth in Nepal. In light of this, the following model is designed to investigate how tax revenue, overall revenue, and government spending affect GDP.

The impact of tax revenue (T×R) on GDP is estimated by:

$GDP_{t=}\alpha_0+\beta_1+T\times R_t+\epsilon_t$ ……………………………………(i)

Where, GDP is the gross domestic product. The α_0 is constant; β_1 is coefficient parameter and ϵ_t is the error term. The GDP is expected to be increase due to increase in tax revenue.

The impact of total revenue (TR) on GDP is estimated by:

$GDP_{t=}\alpha_0+\beta_1+TR_t+\epsilon_t$ ……………………………………(ii)

Where, GDP is the gross domestic product. The α_0 is constant; β_1 is coefficient parameter and ϵ_t is the error term. The GDP is expected to be increase due to increase in total revenue.

Results and Discussion

Taxation trend in Nepal

Nepal accounted for more than 80% of the government's overall tax revenue. There are slight variations in the tax revenue contribution during the study periods. Both the total amount of taxes and their percentage of GDP have been continuously increasing. There seems to be fluctuations in the growth rate of GDM over the periods under study.

Table 1: *Trends of ratio of tax revenue and total revenue to GDP and growth rate of GDP from 2002/03-2022/23*

Fiscal Year	Total Revenue to GDP	Tax Revenue to GDP	GDP Growth Rate
2002.03	11.40%	8.70%	3.95%
2003.04	11.60%	9.00%	4.68%
2004.05	11.90%	9.20%	3.48%
2005.06	11.10%	8.80%	3.36%
2006.07	12.10%	9.80%	3.41%
2007.08	13.20%	10.40%	6.10%
2008.09	14.70%	12.00%	4.53%
2009.10	15.30%	13.30%	4.82%
2010.11	14.60%	12.60%	3.42%
2011.12	15.70%	13.20%	4.67%
2012.13	17.50%	15.30%	3.53%
2013.14	18.50%	16.10%	6.01%
2014.15	19.10%	16.75%	3.98%
2015.16	18.48%	16.15%	0.43%
2016.17	19.80%	18.00%	8.98%
2017.18	21.03%	19.08%	7.62%
2018.19	21.50%	19.14%	6.67%
2019.20	20.41%	18.00%	-2.37%
2020.21	21.50%	19.99%	4.25%

2021.22	21.61%	19.95%	5.80%
2022.23	17.89%	16.18%	4.35%

Source: Economic Surveys of Fiscal of Various Years and macrotrends.net/countries/NPL/Nepal/gdp-growthrate

Table 1 illustrates the trends in the ratio of total revenue, tax revenue to GDP, and the GDP growth rate of Nepal from FY 2002/03 to 2022/23. In 2002/03, the ratio of total revenue to GDP was 11.40%, rising to 21.61% in 2021/22 before declining to 17.89% in 2022/23. Similarly, the ratio of tax revenue to GDP increased from 8.70% in 2002/03 to 19.99% in 2020/21.

The GDP growth rate, however, has shown a more fluctuating pattern. It was 3.95% in 2002/03 and increased slightly to 4.35% in 2022/23, though the growth rate experienced variations over the years. While the ratios of total revenue and tax revenue to GDP have significantly increased, the GDP growth rate has exhibited an inconsistent trend during the study period.

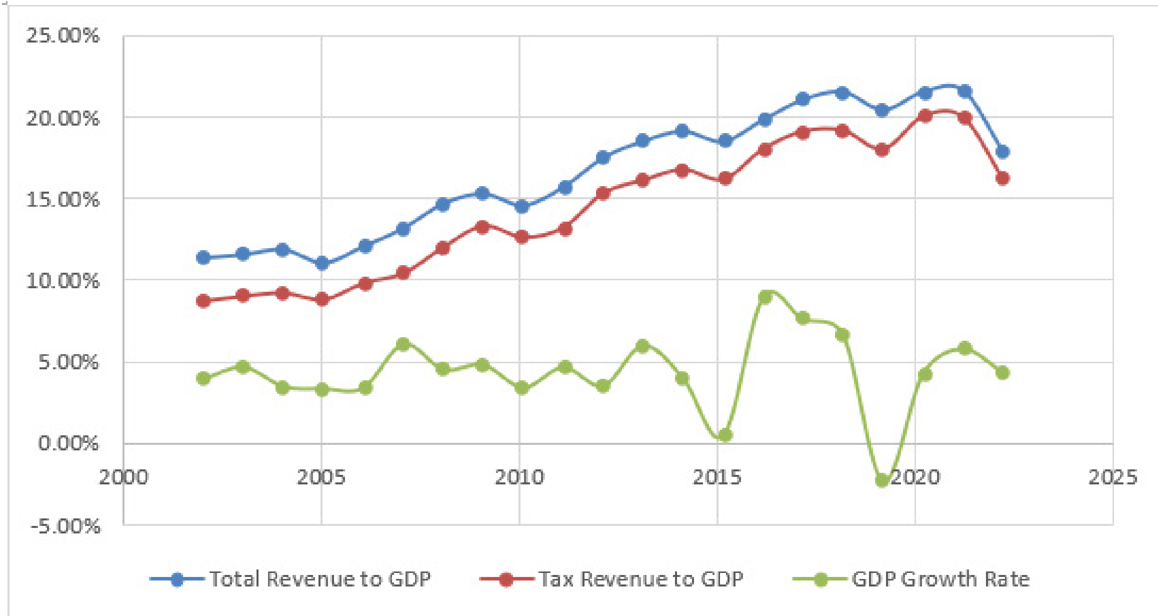

Figure:1 Trends of Ratio of Tax Revenue and Total Revenue to GDP and Growth Rate of GDP from 2002/03-2022/23

This figure shows the trends of ration of the tax and total revenue to GDP and GDP Growth rate of the Nepal. It is clear that the trend of total revenue and tax revenues are in increasing trend till 2020/21 but not in satisfactory level. But the GDP growth rate are ups and downs trends during the study period.

Table 2: *Trends of GDP, total revenue and tax revenue from 2002/03 to 2022/23* *(Rs. in billions)*

Fiscal Year	GDP	Total Revenue	Tax Revenue
2002.03	492.23	67.57	40.89
2003.04	536.75	73.61	48.17
2004.05	589.41	84.51	54.10
2005.06	654.08	86.11	57.43
2006.07	727.83	103.51	71.13
2007.08	815.66	127.94	85.16
2008.09	988.05	169.86	117.05
2009.10	1,171.90	218.35	156.29
2010.11	1,366.95	198.35	177.19
2011.12	1,527.34	244.37	211.72
2012.13	1,692.64	296.02	259.22
2013.14	2,232.50	356.62	312.44
2014.15	2,423.60	405.87	355.96

2015.16	2,608.20	481.96	421.10
2016.17	3,077.10	609.18	553.87
2017.18	3,455.90	726.49	659.49
2018.19	3,858.90	829.63	738.60
2019.20	3,888.70	793.74	700.06
2020.21	4,352.70	939.32	870.11
2021.22	4,933.70	1,067.96	984.16
2022.23	5,348.30	957.15	865.62

Source: Economic Surveys of Fiscal of Various Years and annual report of ird

Table 2 highlights the growth in Nepal's GDP, total revenue, and tax revenue from the fiscal year (FY) 2002/03 to FY 2022/23. In 2002/03, Nepal's GDP was approximately Rs. 492.23 billion. Over the two-decade period, this figure saw substantial growth, reaching around Rs. 5,348.30 billion by 2022/23, reflecting significant economic expansion.

Similarly, tax revenue also showed remarkable growth. In 2002/03, Nepal generated Rs. 67.57 billion in tax revenue, which surged to Rs. 957.15 billion by 2022/23. This increase indicates that tax collection efforts have grown in parallel with the country's expanding economy, likely due to improved taxation policies and more efficient collection mechanisms.

Additionally, the total tax revenue, which includes both direct and indirect taxes, grew from Rs. 40.89 billion in 2002/03 to Rs. 865.62 billion in 2022/23. This substantial increase demonstrates that tax revenues have become a much larger component of the national budget, allowing the government to support public services and infrastructure.

Overall, the steady rise in GDP, total revenue, and tax revenue over the study period points to Nepal's economic progress and an increasingly effective tax system, which has played a crucial role in supporting national development.

Economic impact

Governments use fiscal policy as a controlling tool, so is a relationship between total revenues, tax revenues, government spending, and economic growth.

Impact of tax revenue on GDP

There is a strong positive correlation between tax revenue and GDP, as demonstrated by SPSS calculations examining the impact of tax revenue on economic growth. To quantify this relationship, a regression analysis was performed with GDP as the dependent variable and tax revenue as the independent variable. The results indicate that the overall model is statistically significant, with an R-squared value of 0.980 ($p<0.05$). This suggests that an increase in GDP is closely associated with a corresponding increase in tax revenue.

The R-squared value of 0.980 means that 98% of the variation in GDP can be explained by changes in tax revenue, highlighting the substantial influence that tax revenue has on economic growth. This large impact underscores the critical role that tax revenue plays as a predictor of GDP growth.

Overall, the results of the regression analysis, as summarized in Table 3, confirm that tax revenue is a key determinant of GDP, showing that a robust tax system can significantly contribute to economic development.

Table 3: *Regression between tax revenue and GDP*

Model Summary					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.990[a]	.980	.979	225.84082	1.378

a. Predictors: (Constant), Tax Revenue
b. Dependent Variable: GDP Amount

Coefficients						
		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	t	Sig.
1	(Constant)	424.890	76.704		5.539	.000
	Tax Revenue	4.886	.159	.990	30.640	.000

a. Dependent Variable: GDP Amount

Impact of total revenue on GDP

This study also analyzed the impact of total revenue on GDP, finding that an increase in total revenue leads to an increase in GDP. To test this relationship, a regression analysis was conducted, regressing GDP on total revenue using data from 2002/03 to 2022/23. The results showed that the regression model had an R-squared value of 0.546, indicating that 54.6% of the variation in GDP can be explained by changes in total revenue. The overall relationship is statistically significant at the 5% level.

These findings suggest that total revenue plays a significant role in influencing GDP growth, although its effect is less pronounced compared to tax revenue. The regression results, summarized in Table 4, reinforce the conclusion that total revenue is an important predictor of GDP and contributes to the broader economic development of the country.

Table 4: *Regression between total revenue and GDP*

Model Summary					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.739[a]	.546	.523	1079.93285	.790

a. Predictors: (Constant), Total Revenue
b. Dependent Variable: GDP Amount

Coefficients						
		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	t	Sig.
1	(Constant)	888.126	365.672		2.429	.025
	Total Revenue	3.557	.744	.739	4.784	.000

a. Dependent Variable: GDP Amount

Discussion

This study employed a linear regression model to examine the impact of tax revenue on Nepal's economic growth, using time series data from 2002/03 to 2022/23. The analysis includes both descriptive statistics and an investigation of the long- and short-term relationships between tax revenue and economic growth. Additionally, diagnostic tests were conducted to ensure the reliability of the model parameters.

The primary objective of this study was to determine how tax revenue influences Nepal's economic growth, focusing on total tax revenue and total revenue to understand their broader implications for the economy. The findings support previous research by providing evidence from Nepal that tax revenue plays a crucial role in economic development.

This study aligns with earlier research by Myles (2000), Stoilova and Patonov (2012), Stoilova (2017), Iswahyudi (2018), Egbunike et al. (2018), Neog and Gaur (2020), Stoilova and Patonov (2020), Tsaurai (2021), Kharel (2021), Huang et al. (2022), and Adhikari (2024), all of which demonstrate that a higher proportion of income taxes significantly boosts economic growth. Conversely, studies by Pokharel (2018), Pokharel (2019), and Hakim (2019) argue that income taxes can hinder economic growth, highlighting a nuanced relationship between tax policies and economic outcomes.

Conclusion

The goal of this study was to examine the impact of tax revenue, overall revenue, and government spending on Nepal's GDP. It explored how changes in tax policy and income distribution can influence economic activity. The analysis revealed that both total revenue and tax revenue have a distinct and significant influence on GDP. In particular, tax revenue was found to have a strong positive effect on GDP, highlighting its crucial role in driving economic growth.

Additionally, the study investigated the effect of overall revenue on GDP and found that an increase in overall revenue is associated with GDP growth. While well-designed tax policies have the potential to stimulate economic development, numerous challenges remain, and there is no certainty that changes in the tax system will automatically lead to improved economic outcomes.

A key finding is that government revenue is consistently less than its expenditures. Over 80% of government revenue comes from taxes, while the remaining 20% is derived from non-tax sources. To cover budget deficits, Nepal relies on foreign assistance and borrowing. However, the level of public debt in Nepal is increasing each year. To reduce this growing debt, governments must focus on increasing tax revenues while creating a tax-friendly environment for taxpayers.

The Government of Nepal must strengthen the management of both tax administration and overall revenue administration to effectively achieve sustainable economic growth. By improving the efficiency of tax collection and revenue management, the government can increase its resources, reduce fiscal deficits, and support public services and infrastructure development. Additionally, fostering a tax-friendly environment and enhancing compliance can help boost revenue without overburdening taxpayers, ultimately contributing to stronger economic growth and reduced public debt.

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