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# INFLUENCE OF INSTITUTIONAL QUALITY ON TAX FRAUD MANAGEMENT IN SOUTH WEST NIGERIA STATE

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## ABSTRACT

Tax revenue is to be the surest way for the government to finance its budget but institutional deficiency is one of the factors militating against effective tax revenue in Nigeria. This study examined the influence of institutional quality on tax fraud management in South West Nigeria. This study used a quantitative method of data collection with a population of 504,263; the sample size was 400. The inferential statistics of the Partial Least Square Structural Equation Model (PLS-SEM) were used to analyze the data collected. The result of the finding indicated that in the context of control of corruption ($\beta$ = -0.817, t = -22.043, p=0.000 < 0.05), rules of law ($\beta$ = -0.116, t = -2.392, p=0.000 < 0.05) and quality of regulatory ($\beta$ = -0.204, t = -2.169, p =0.043 < 0.05); there was a significant negative relationship between the variables of interest (control of corruption, rule of law and quality of regulatory) and tax fraud management in South West Nigeria. This study concluded that control of corruption, rule of law, and quality of tax regulation by the government reduce the tendency by which taxpayers will engage in tax fraud in South West Nigeria. It is also concluded that the taxpayers' low rating on control of corruption and adherence to the rule of tax laws by the government and its agency contributed to the high rate of tax fraud among the taxpayers in South West Nigeria. This study, therefore, recommended that government live up to the expectation of taxpayers to block corruption, enhance adherence to the rule of law and maintain the high quality of tax regulatory agencies (FIRS) for better performance of tax revenue generation.

## 1.0 INTRODUCTION

The countries of the world impose taxes on their citizens and businesses as a means of raising revenue internally which is used to fiancé government budget as well as to improve economic development. OECD (2008a) stated that tax is a catalyst for governments that are more responsive and accountable to their citizens, and for expanding state capacity. Tax is a compulsory levy and surest source of revenue to the government; it is levy on personal income such as salaries, business profit, interest income, dividends and royalties, and others such as company income, petroleum profits, and capital gains (Ishola, 2016). However, the issues of tax fraud is a major concern to government as it hinder effective tax collection of the required revenue in order to have enough funds for provision of basic infrastructure for the people. Tax fraud is as a menace that has been impending economic development of a nation. The scenario of tax fraud continues go down across the nations worldwide. It is a universal constraint as no countries is immune, although emerging countries such as Nigeria and the various states suffered of this economic pandemic in the past and this is being seen as a factor that has negatively affected Nigeria's capital expenditure performance.

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Tax revenue is to be the surest way for government to finance its budget but lack of accountability by the government and tax officials has not been seen to be encouraging. According to Onoja and Ewarere (2015), an average Nigeria has no trust in government and it is discouraged them to pay taxes and pay correctly, hence, they involved in tax fraud. Nigeria taxpayers believe that tax revenues are used to cater for the needs of government functionaries and their close associates rather than the needs of tax payers (Dauda & Saidu, 2014; Nwocha, 2017). Tax fraud is pertinent with the non-compliance by the taxpayers either as an individuals or firms. In between the payment of taxes and the issuance of tax certificate by the tax authorities, exchange of money as bribe may take place and therefore exposing the government to lose tax revenue into the private hands thereby affects tax revenue negative. Ademikanra, (2019) stated that the state government of Osun charged three of his officials to court for collecting tax revenue  with a cloned tax receipts thereby exposes the state government to tax revenue loss.

Hence, this postulates that when revenue is lost from taxes, it may affect the government in meeting their primary responsibility of providing social amenities for the citizen and consequently which may impact negatively on the development of South West Nigeria. One of the probable ways by which the tax fraud could be prevented is to strengthen institutional quality variables (control of corruption, rule of law, voice and accountability, regulatory quality and government effectiveness). Oyedele (2015) supported that non-transparency, non-accountability, and high rate of corruption discouraged tax payers to comply with the payment of taxes.

Ashrat and Sarwar (2016) observed that poor tax revenue collection is not mainly due to low income or education rather it is because of many institutional hindrances which create loopholes for effective tax payment. Klomp and Hean (2015) alluded that the institutional environment in Nigeria is seen to be characterized with a weak legal system and poor governance as a result of inept law enforcement and government ineptitude. While tax fraud has contributed to revenue loss to the government in Nigeria, there has been a paucity of empirical studies on the impact of institutional quality on tax fraud management in South West Nigeria. Hence, this study is designed to close the gap with the objective to examine the impact of institutional quality on tax fraud management in South West Nigeria.

Hypothesis: H0:1: Institutional quality has no significant influence of tax fraud prevention in South West Nigeria.

## 2.0 LITERATURE REVIEW

### 2.1 Conceptual Clarification

#### 2.1.1 Institutional Quality

The quality of institution is crucial in the promoting economic growth of a nation. It is a crucial matter in the determination of a country's economic performance. It is assumed that countries with the weak legal system, corruption, lack of accountability and low quality regulatory mechanisms might have weaker infrastructural development. These might be as a result of inept law enforcement and bad governance. Nigerian Independent Corrupt Practices and Other Related Offences Commission (ICPC), (2015) stated that corruption can be described as


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"Corumpere" meaning, destroy, falsify, seduce, bribe, ruin, mar, and draw to evil. Also, Okoduwa (2009) defined corruption as the abuse of privileged positions for personal gain and disruption of a system for accomplishing unmerited advantages.

Corruption is the usage of public or entrust power for private gain or benefit (Picur and Riahi-Belkaoui, 2006). Tsikas, (2017) opined that people feel more concern to pay tax when there is a high institutional quality in terms of trustworthy, otherwise individual tax payers will refuse to pay voluntarily. The institutional quality according to World Bank Governance Indicator has voice and accountability, political instability and absence of violence, government effectiveness, and regulatory quality, rule of law and control of corruption as its variables. These variables have played a significant role in taxpayers' compliance decision on tax payment (Alabede, 2014)

The high level of tax fraud may be influenced by loss of confidence in the government and tax system by the tax payers. This may be as result of lack of accountability and transparency in the management of tax revenue which has become a major problem in many developing countries like Nigeria. Fadjar (2013) stated that transparency in government provides the opportunity for the enhancement of taxpayers' compliance levels while lack of transparency will probably lead to tax fraud.

However, tax fraud can be managed through an effective and efficient tax laws that will enhance revenue from taxes. Tax laws are consequently to be obeyed and complied with by individual taxpayers but in event of tax non-compliance (tax fraud), the tax laws enforcements will be carried out by the government through the relevant tax authority and other agencies in order to minimize cases of individual's involved in tax fraud.

### 2.2 Control of Corruption

Corruption is the usage of public or entrust power for private gain or benefit (Picur & Riahi-Belkaoui (2006). Corruption in tax administration captured tax collectors who solicit for gratification from the tax payers. It is the misuse of public fund for private gain accruable to individual, parties or group. The effects of corruption in Nigeria are severe and profound; the country is ranked 146 out of 180 countries as one of the most corrupt countries in the world, most especially in the African region (Ajide & Olayiwola, 2020). It has been established in the literature that corruption cannot be eradicated but can be controlled (Uche & Banymu, 2020)

### 2.3 Rule of Law

This is the mechanism, process, institution, practice, ideas that backs the equality of all taxpayers before the law, as a guide against the misuse of power. Middle and low-income taxpayers tend to be tax evasive when theses taxpayers perceive that that the tax laws are unfair and inequitable (Akinyomi & Okpata, 2021)

### 2.3 Accountability

Accountability in tax administration is a quality in which a person shows a willingness to accept responsibility, a desirable trait in public officials, government agencies, or organization. It is a means of evaluating the effectiveness of government or tax officials and the level of confidence

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reposed in them by the taxpayers. Ljungbolm (2015) stated that accountability play significant roles in minimizing corruption as well as enhancing taxpayers' contentment with public services.

### 2.4 Quality of Regulatory

Quality of regulatory emphasizes the need to promote conducive and enabling tax payment /collection environments' for both the taxpayers and tax collectors and take measurement of perception of existing government policies to encourage or discourage a certain types of business (Torgler & Schneider, 2009). It is the perception of the ability of the government to formulate and implement sound tax policies and regulations that allow and promote taxpayers to voluntarily comply with the tax payments.

### 2.5 Government Effectiveness

This is the quality of public/civil services, the quality of the civil services and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies (Kaufmann, Kraay, & Mastruzzi, 2006).

## 3.0 EMPIRICAL REVIEW

Acconnia (2003) stated that the level of corruption and tax fraud depends on such factors as the taxpayer and the wage of the tax officer. Further works on the wages model was identified to examine the optimal wage at which tax officer should be remunerated (Maclearn, 1996). The study further argued that government face the dilemma of identifying a salary level which will ensure that its tax officers are not enticed to bribery, as there is a link between tax fraud and salary level of tax officers through the bribery and corruption.

Pashev (2005) also provided that the failure of the government to provide basic needs for the taxpayers, lack of transparency and accountability in the management of tax revenue has the effect of building distrust both in the tax system as well as the government. He concluded that this is believed to increase the level of tax fraud.

Christie and Holzener (2006) examined what explains the tax evasion with the introduction of a corruption variable as well as the quality of judicial system in their analysis. The study revealed that either corruption or quality of the judicial system influences tax evasion significantly for valued-added taxation, personal income tax and excise taxation. They specifically find that the higher the level of corruption and/or poorer the judicial and administrative, the higher is also the tax fraud. The study concluded that the corruption index, as well as the quality of judicial system, plays a significant role in the perception of fairness of the tax system.

Chong and Gradstein (2007) conducted study on the institutional quality and government efficiency in Inter-American Development Bank using simple model; the study employs firm level perception on the quality of public services and on the tax burden to test some of the model's predictions. The finding shows that the growth and welfare effects of taxation are mediated through institutional quality; consequently, optimal tax levels increase with improved

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Volume: 06, Issue: 02 March - April 2023

ISSN 2582-0176

institutional quality. Finding shows that with these predictions, a higher level of institutional quality bolsters positive perceptions of the quality of public services while at the same time moderating the view of taxes as a stumbling block to growth.

In related work, Levin and Widell (2007) alluded that an estimated amount of tax fraud in customs authorities in Kenya and Tanzania by calculating measurement errors with tax rates through evidence from missing imports. The findings concluded that coefficient on tax is higher in Tanzania as compared to Kenya, implying that tax fraud on imported goods is more pronounced in Tanzania than Kenya which shows that tax fraud in Tanzania is invariably higher in Kenya. Ultimately, corruption among tax officials and lack of transparency in tax revenue are motivational factors for the unfavorable comparison.

Ajaz and Ahmad (2010) looked at the developing countries on their inability to generate enough income through their taxes. The studies discovered that these countries face a lot of institutional problems in income generation process. They analyses the effect of institutional and structural variables on tax revenue using a panel of 25 developing countries over the period 1990- 2005, using the generalized moment method (GMM). Their study found that institutional variables have a negative effect on tax collection while good governance contributes to better tax revenue collection performance.

Bird (2015) stated that revenue collections in emerging economy of the world are generally being hindered by high forms of fraud, evasion, coercion, and corruption which indicates that corruption might lead to tax system inefficiency, reduction in tax revenue collection and minimizes the individual willingness to pay legitimate taxes that might lead to reduction in tax revenue generation.

Augustine and Enyi (2020) examined the influence of institutional factors on tax payer’s compliance behavior in South West, Nigeria. The study used survey research design with the total population of 5,216,422 individual tax payers. Sample size of 1,200 was used with the administered questionnaire to the respondents. Descriptive and inferential statistics were used to analyze data collected with validated questionnaire. The study revealed that institutional factors positively influenced tax payers’ compliance behavior and the fairness in the application of tax laws should also be entrenched while stiff measures should be put in place to control corruption in tax revenue.

Hoijat, Ydollah and Pouria (2021) examined the simultaneous impact of institutional quality and tax evasion on the performance of the tax system in selected MENA countries in the period of 2002 – 2017; panel data method was used. The results indicated that government efficiency and accountability, structural transformation in the economy, the share of imports of goods and services in GDP have a positive effect and the share of value added in agriculture in GDP have a negative effect on the ratio of tax revenues to GDP. The study recommended that increasing the efficiency and accountability of the government provides the ground for greater public participation in financing government expenditures and increases government tax revenues while reducing tax fraud.

Mahdieh and Amirhosein (2021) investigated the nexus between institutional quality and tax evasion in Iran during the period of 1978 – 2018. The study employed the Multiple Indicators – Multiple Causes (MIMIC) to estimate the time series of relative and absolute size of tax

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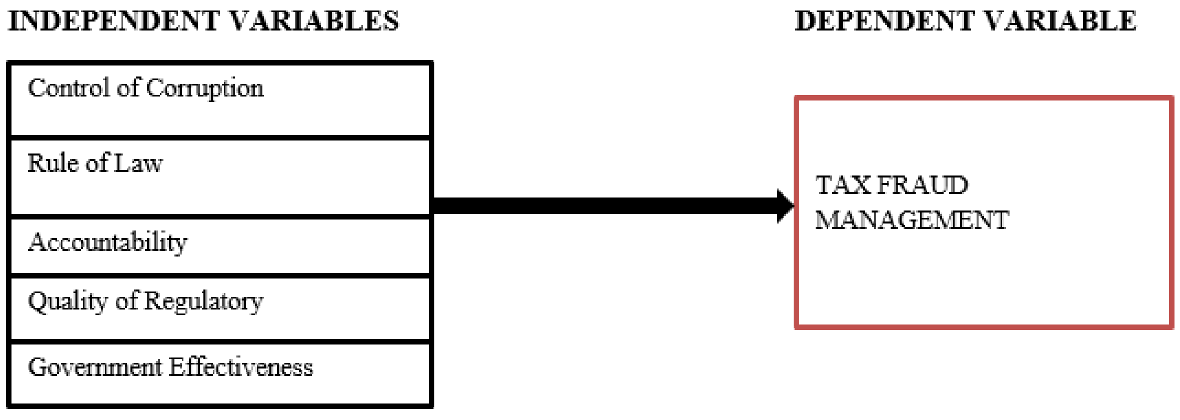
evasion in Iran and looked at the cause and effects using Amos software and with maximum likelihood method. The outcomes of calculating the relative size of tax fraud show that although the trend of tax fraud fluctuates in the desired period, but in general it has had an increasing trend over a period of 38 years. The second sage of their study empirically analyze the long – term and short- term impact of institutional quality and other related variable (inflation and GDP) on tax evasion in the Iranian economy in Time series, ARDL Bounding test method was used. The result shows that institutional quality is negative and significant both in the short and long term.

### 3.1 The Fiscal Exchange Theory

The fiscal exchange theory is one of the institutional theories founded in 1963 by Lazarsfeld P. F and Morgenstern. O. It was developed from the economic deterrence and the social psychology models (Mckercher & Evans, 2009). The theory looks at the presence of government expenditures that may encourage and change the behaviors of the taxpayer to comply with payment of taxes. According to Togler, 2003; Fjeldstad, Schulz-Herzenberg & Sjursen, 2012, the fiscal exchange theory is founded on the existence of social, rational, or psychological contract between the government and the taxpayers. Moore (2004) stated that taxation and provision of public goods and services are interpreted as a contractual relationship between the taxpayers and the government.

The payment of tax is based on the reciprocity between the state and the government which goes to imply that the taxpayer comply with the tax laws when they are satisfied with the quality of public goods and services they enjoy from the government. Furthermore, it also provides a good links between the taxpayers’ behavior on tax payment and the government.

The Fiscal Exchange Theory further adopts an exchange relationship between the institution (government) and the taxpayers in the sense that governments collect taxes for the purpose of providing basic amenities such as water, housing, education, health care services among others (Omodero & Dandago, 2019). The government has the obligation to provide basic facilities to the populace while the public is expected to respond by paying taxes that are commensurate with the benefits derived (Bhartia, 2009)




**Conceptual Framework Figure 1**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Volume: 06, Issue: 02 March - April 2023

ISSN 2582-0176

## 4.0 METHODOLOGY

The study adopts survey research design to source the relevant primary data required for the study. The study covered only registered taxpayers with Federal Inland Revenue Services (companies/businesses) and tax officials of FIRS (tax audit, investigation and compliance) in South West Nigeria. The population for the study was 504,263 for the taxpayers. The study sample size is 400 for taxpayers while the Taro Yamane (1967) was used to determine sample size with the error term of 5%. The study used random sampling techniques for data collection.

### 4.1 Model Specification

This objective determined the influence of institutional quality on tax fraud management in South West Nigeria. Deriving from the theoretical framework for study, the equation 3.2 is specified in a functional form to capture the relationship between institutional quality (control of corruption, rule of law, accountability, quality of regulatory and government effectiveness) and tax fraud management. The model stated below:

〖TFM_i=β_0+β_1 〖CC_i+ 〖β_2 〖RL_i+β_3 〖ACB_ (i) β_4 〖QR_i+β_5 〖GEF〗 _i+e_i Eqn.(i)

Where,

FFM = Tax Fraud Management

CC = Control of Corruption

RL = Rule of Law

ACB = Accountability

QR = Quality of Regulatory

GEF = Government Effectiveness

$\beta$ 0 = Intercept

$\beta$ 1 – β5 = Parameters of the estimate

ei = error term

a-priori expectation: The a-priori expectation of this objective is β1, β2, β3, β4, β5 θ < 0

The stated model in equation 3.2 indicated the influence of institutional quality on tax fraud management as it was indicated in the research question two and the intention of all the variable of institutional quality as stated in this study. It was expected to have negative relationship with tax fraud management. The model as stated in equation 3.2 was for the argument and prediction of theory of fiscal exchange theory. Accordingly, the fiscal exchange theory explains that payment of tax is a bargaining exchange between government and tax payers while the

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Volume: 06, Issue: 02 March - April 2023

ISSN 2582-0176

prediction of this theory was specifically relating to the expected negative relationship between institutional quality and tax fraud management. The theory postulated that if the government or its agencies (tax authorities) could be accountable to the taxpayer, maintain rule of laws in administration of tax, control widespread of corruption, be more effective in the administration of tax revenue collected, tax fraud could be managed very well.

Test of Hypothesis: Institutional quality (Control of corruption, Rule of law, Accountability, Quality of regulatory and Government effectiveness) has no significant influence on Tax Fraud Management in South West Nigeria

Answers were also provided to second research questions emanating from second research objective through five sub-hypotheses on the relationship between institutional qualities in context of: control of corruption, rule of law, accountability and quality of regulation as well as government effectiveness; and tax fraud management.

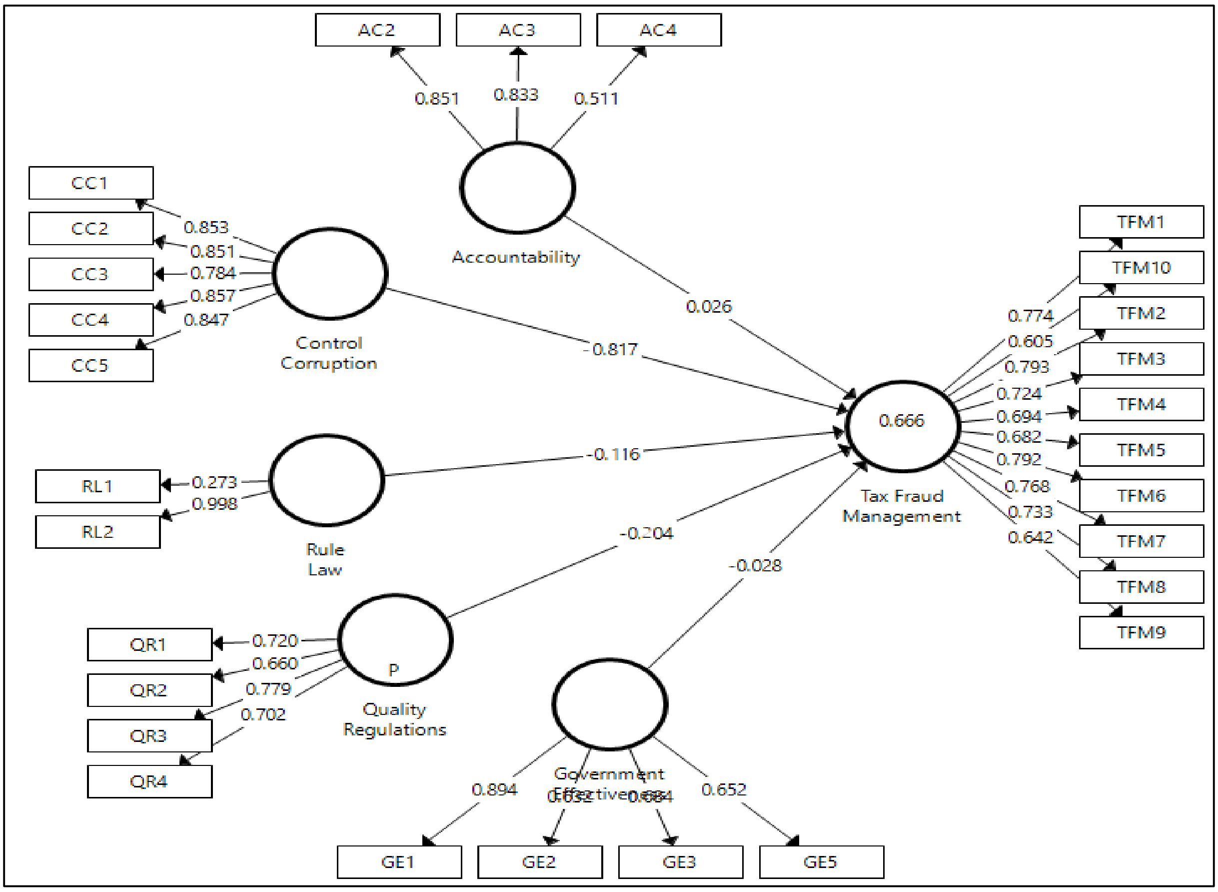


**Figure 2: Measurement Model Result (@Algorithm for Institutional Quality and Tax Fraud Management**

Thus, assessment of significance of path coefficient through 5000 bootstrap samples and 388 cases show the results in Figure 2 and 3 along with Table 1

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Volume: 06, Issue: 02 March - April 2023

ISSN 2582-0176

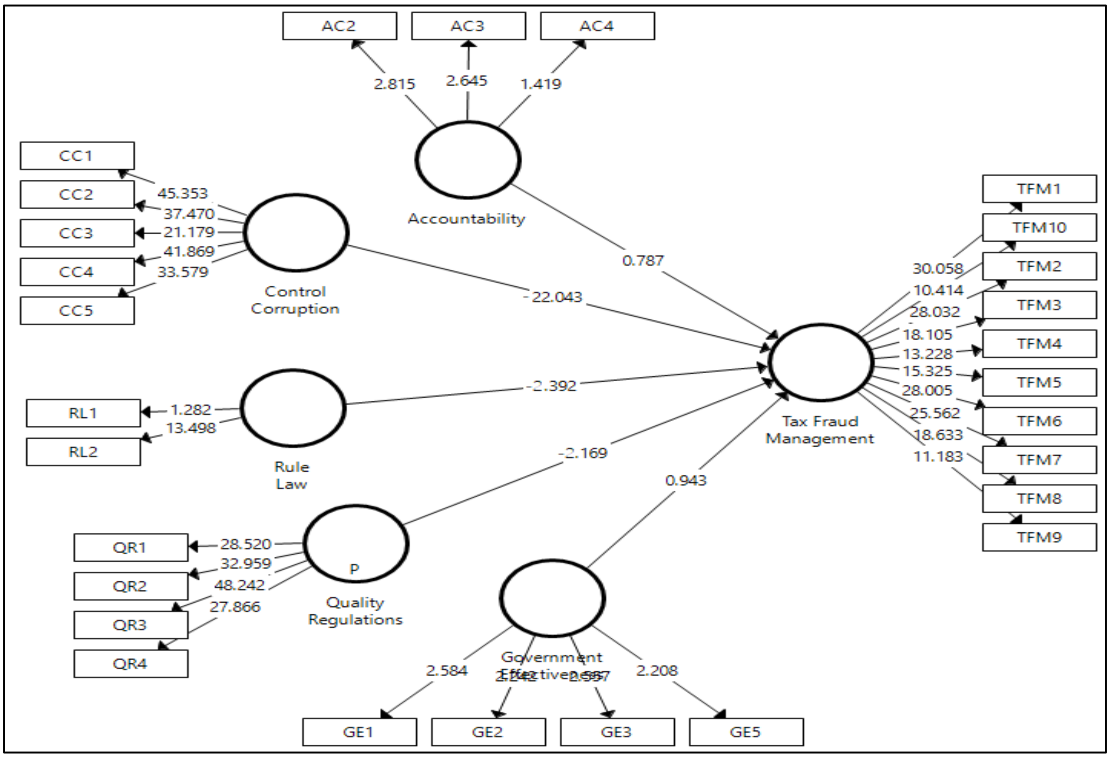


**Figure 3: Structural Model (Bootstrapping @5000 Institutional Quality and Tax Fraud Management**

**Table 1: Structural Model (Bootstrapping @ 5000)**

| Hypotheses | Beta | Se | T-value | P-value | Decision | BCI-LL 5% | BCI-UP 95% |
|---|---|---|---|---|---|---|---|
| CC -> Tax Fraud Management | -0.817 | 0.039 | -22.043 | 0.000 | Reject Null | -0.643 | -0.891 |
| RL -> Tax Fraud Management | -0.116 | 0.396 | -2.392 | 0.009 | Reject Null | -0.121 | -0.162 |
| Acc -> Tax Fraud Management | 0.026 | 0.345 | 0.787 | 0.216 | Not Reject Null | -0.132 | 0.120 |
| QR -> Tax Fraud Management | -0.204 | 0.026 | -2.169 | 0.043 | Reject Null | -0.046 | -0.142 |
| GE -> Tax Fraud Management | -0.028 | 0.030 | 0.943 | 0.173 | Not Reject Null | -0.071 | 0.024 |

**Researcher's Computation, 2022**

Based on the depicted results, sub- null hypothesis (1a) predicted that no significant relationship between control of corruption (β = -0.817, t = -22.043, p = 0.000 < 0.05) on tax fraud management in South West Nigeria was rejected, given the enough evidence that perceived low control of corruption, the higher the tendency for tax payer to involve in tax fraud management.

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Volume: 06, Issue: 02 March - April 2023

ISSN 2582-0176

Similar result was also observed on the hypothesized relationship between the rule of law and tax fraud management in South West Nigeria. The sub- null hypothesis (1b) predicted no significant relationship between rules of law and tax fraud management in South West Nigeria. Accordingly, the result indicated that rule of law have negative significant impact on tax fraud management ($\beta = -0.116$, $t = -2.392$ $p = 0.000 < 0.05$). This implies that taxpayers' perceived low quality of rule of law may encourage tax payers to engage in tax fraud.

However, there was no enough evidence to fail to reject hypothesized relationship between accountability and tax fraud management (sub-null hypothesis 1c). As shown in Table 1, an insignificant positive relationship between accountability and tax fraud management ($\beta = 0.026$, $t = .787$, $p = 0.216 > 0.05$) was reported.

Meanwhile, the sub- null hypothesis (1d) that predicted no significant relationship between quality of regulation and tax fraud management in South West Nigeria was rejected based on these indicators: $\beta = -0.204$, $t = -2.169$, $p = 0.043 < 0.05$. In essence, observed evidence shows strong enough to affirm that taxpayers perceived quality of regulatory authorities influence tax fraud management in South West, Nigeria.

With regards to the sub- null hypothesis (1e) it predicted no significant relationship between government effectiveness and tax fraud management, the results in Figure 2 and 3 along with Table 1 also reflect insignificant r negative relationship between government effectiveness and tax fraud management ($\beta = -0.028$, $t = 0.943$, $p = 0.173 > 0.5$), indicating no enough evidence to reject null hypothesis (1e).

In summary, the second main hypothesis that institutional quality (control of corruption, rule of law, accountability, quality of regulatory and government effectiveness) has no influence on tax fraud management in South West Nigeria is safely rejected since the path coefficient for the three (3) of the five (5) sub-hypotheses is statistically and negatively significant. With the rule of number, it signifies rejection of the hypothesis. The path coefficient is significant for each of the control of corruption, rule of law and quality of regulatory, but not significant for accountability and government effectiveness. This implies that institutional quality has influence on tax fraud management on the area of control of corruption, rule of law and quality of regulatory.

## 5.0 DISCUSSION OF THE FINDINGS

With the observed evidence in relation to the degree of influence the taxpayers perceived quality of institutional factors has on the level of tax fraud management, it can be argued that the tax payers' propensity to involve in tax fraud is related to the how they rate quality of each institutional factor. In context of control of corruption, a significant negative relationship ($\beta = -0.817$, $t = -22.043$, $p=0.000 < 0.05$) suggest as long as taxpayers rate government effort to be low in controlling corruption in all areas of governance, particularly as related to tax issue, tax payer will see no crime in perpetrating tax fraud.

Since the observed result on the relationship between rules of law and tax fraud management in South West Nigeria was also significant negatively ($\beta = -0.116$, $t = -2.392$, $p=0.000 < 0.05$), it implies that taxpayers' perceived low quality of rule of law also contributed to degree at which tax payers may involve in tax fraud and of course seen as no crime. For instance, where

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taxpayers expect constituted authority to punish tax defaulter or defend innocent citizen in a manner suggestive of adherence to the rule of law but takes contrary action, such tax payers is expected to perpetrate unethical tax practice to see that no criminal offence is committed. The same argument is applicable for the relationship between rule of law and tax fraud management in South West Nigeria, that is if the tax payers perceive or rate the quality of various regulations affecting different strata of society, particularly as it relates to business environment to be low, there is the tendency that tax fraud management on the part of tax payers may be on the increase.

More so, the finding revealed that quality of tax regulatory is a determinant to the tax fraud management since the observed result on the relationship between quality of regulatory and tax fraud management in South West Nigeria was significantly negative $\beta = -0.204$, $t = -2.169$, $p = 0.043 < 0.05$. This implies that taxpayers perceived low quality of tax regulatory which shows that the tax regulatory is too bureaucratic in its day-to-day activities. For instance, if the taxpayer sees the tax regulatory authorities as being reliable in the collection of tax revenue and being friendly to the taxpayers, the propensity to engage in tax fraud will be reduced.

The finding of the study conforms to the a priori expectation that institutional quality would have negative influence on tax fraud management in South West Nigeria and also collaborates with the previous empirical works and findings of Bird and Martinez-Vazquez (2008); Ajaz and Ahmad (2010); Ashraf and Sarwar (2016); Augustine and Enyi (2020) and as well confirm the prediction of fiscal exchange theory that if the government or its agencies (tax authority) could be accountable to the taxpayer, maintain rule of laws in tax administration, control the widespread of corruption, be more effective in the administration of tax revenue collected, tax fraud could be managed very well as well as reduced.

## 6.0 CONCLUSION AND RECOMMENDATIONS

The study aims to identify institutional variables that created to motivate taxpayers to engage in tax fraud and closing such gap. This result indicated that control of corruption, rule of law and quality of tax regulatory by the government reduce the tendency by which taxpayers will engage in tax fraud in South West Nigeria. It is also concluded that the taxpayers' low rating on control of corruption and adherence to the rule of tax laws by government and its agency contributed to high rate of tax fraud among the taxpayers in South West Nigeria

The payment of tax is based on the reciprocity between the state and the government which goes to imply that the taxpayer comply with the tax laws when they are satisfied with the quality of public goods and services they enjoy from the government. It is therefore recommended that government to live up to the expectation of taxpayers so as to block corruption, enhance adherence to the rule of law and maintain high quality of tax regulatory agencies (FIRS) for better performance of tax revenue generation.

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