



Governance Quality and Informal Sector Tax Compliance Behaviour in Oyo State, Nigeria

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Abstract

Original Research Article

This study examines the influence of governance quality on informal sector tax compliance behaviour in Oyo state, Nigeria. Primary data was obtained through the administration of structured questionnaire to 241 respondents out of total population of 610 comprising trading association, petty traders, market traders and tax practitioners. Data obtained was analyzed using descriptive, regression analysis via structural equation model and factor analysis. The results of the analysis obtained revealed that governance quality has a positive and significant influence on tax compliance among informal sector taxpayers in Oyo State ($t=390.73, p<0.05$) which suggests that improved governance builds trust and when taxpayers see transparency and accountability, they are more likely to meet their tax obligations, believing their contributions are used effectively. The study concluded that there is a pathway from governance quality to informal sector tax compliance behaviour in Oyo State. It was recommended that informal taxes collected by the state government be invested in other domestic sectors, such as agriculture and infrastructure.

Keywords: Governance quality, tax compliance behaviour, transparency, accountability.

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INTRODUCTION

The discrepancy between the actual tax income received and the potential tax revenue has raised significant concerns among government authorities and tax practitioners regarding the level of tax compliance in emerging countries. This difference raises serious concerns among government officials and tax professionals regarding tax compliance. Addressing this issue is essential for ensuring fair revenue collection and promoting economic growth in the developing nations of the world.

Individuals and companies are still obligated to pay taxes to the government, which utilizes the collected funds to support the construction of infrastructure and other essential facilities within a country (Alabede, 2014). Adekoya and Olayinka (2023) emphasized that low tax rates in a country can lead to economic decline, deteriorating infrastructure, instability, high levels of tax evasion and avoidance, and turmoil. They also highlighted the need for emerging nations to prioritize tax compliance due to the high cost of governance, population growth, infrastructure needs, and decreased income from



other sources such as crude oil and mineral resources.

Alabede et al. (2011) pointed out that poor governance contributes to a high level of tax evasion or non-compliance, while good governance is likely to improve tax compliance. Similarly, McGee (2006) argued that poor governance, mistrust, or misrule were the main causes of tax evasion and had an adverse effect on tax compliance behaviour. Okwori and Sule (2016) attributed Nigeria's economic decline to poor governance, corruption, and mismanagement. Onyewuchi and Njemanze (2016) argued that these issues have resulted in high levels of tax non-compliance, regressive economic growth, and deteriorating infrastructure.

Robinson (2023) states that mistrust, poor governance, and citizens' refusal to pay taxes are the primary causes of African citizens' lack of access to essential public goods. Additionally, Jimenez and Iyer (2016) and Gobena and Van Dijke (2016) suggested that the perception of openness, trust, and accountability in good governance may influence taxpayer willingness to pay taxes. While tax non-compliance is a global phenomenon, it is more prevalent in developing nations than in developed ones. In Nigeria, despite the importance of taxes and the degree of tax enforcement, the rate of non-compliance with the law is still high, particularly among the informal sectors (Olurankinse & Oloruntoba, 2021). Understanding the essence of this initiative requires an examination of the fundamentals of governance quality and its impact on the tax compliance behaviour of the informal sector. This rationale underpins the investigation into the potential effects of governance quality on tax compliance practices within Osun State's informal sector.

The assessment of tax revenue and related indicators has uncovered a troubling level of tax compliance among the informal sector in Oyo State. This highlights the urgent need to address compliance issues to enhance the state's fiscal health and ensure equitable contribution from all economic segments. Oladipo (2020) argued that tax non-compliance is a significant dysfunction to the tax administration and revenue generating system. It should be viewed

as unacceptable behaviour by Nigerian citizens and it should be regarded as an act of disloyalty which can lead to economic disruption. Cases of fraudulent acts and mismanagement of government resources have created loopholes in the appropriation of budget execution. This has left the state in a position of huge infrastructural and social gaps thereby, creating havoc for a state's economy to develop due to low level of tax compliance among taxpayers (Olugbemi, 2021).

Thus, the government at various levels has the responsibility to spend from IGR to provide good social and other infrastructures to promote economic development thereby improving the welfare and wellbeing of the citizens. Olaniyi and Adams, (2015) and Omodero, (2019) opine that taxpayers evade this type of tax by taking advantage of legal loopholes in the tax code and by filing false returns in order to lower their tax burden.

Low tax compliance is especially apparent in developing countries like Nigeria, as noted by Musimenta et al. (2017) and Nyamapheni and Robinson (2022). This results from ineffective tax systems, poor governance, perceptions of corruption, and the rise of "hard-to-tax" informal sectors. Despite the importance of taxes, low compliance poses a challenge for state governments (Sebele-Mpofu, 2020). Political instability and inefficient tax administration further hinder adequate tax revenue collection (Johnson & Omodero, 2021).

Governance quality is a key predictor of tax collection, with institutional issues often leading to poor tax revenue in less affluent areas. Awa (2022) found that taxes from traders' unions and market vendors significantly contribute to capital growth in Abakaliki. Similarly, Olabisi et al. (2020) noted a strong impact of tax collections on capital development in Lagos Metropolis. Johnson and Omodero (2021) revealed that political instability and corruption positively affect Nigeria's tax revenue. Some researchers conducted studies on taxpayers' perception and tax compliance and some of the above researchers focused on different countries and states as a whole, while other focused in Lagos, Ebonyi state and scanty of them focuses in Oyo State but they did not consider how governance

quality affects the informal sector tax compliance behaviour in the state. Besides no literature amidst the few already written considered the effect of governance quality on informal sector tax compliance behaviour in Oyo State which indicates the existence of gap. The following research question was raised to guide the study. How does governance quality influence the tax compliance of informal sector taxpayers in Oyo State? The study's objective is to evaluate the effect of governance quality, on informal sector tax compliance behaviour in Oyo State.

LITERATURE REVIEW

2.1. Conceptual Review

2.1.1 Tax Compliance

Taxpayers' intrinsic commitment to paying taxes without coercion or threats is the cornerstone of tax compliance. This vital principle encompasses the timely payment of owed taxes, accurate return submissions, meticulous calculation of tax liabilities, and comprehensive reporting of the tax base. According to Twum et al. (2020), tax compliance embodies the ability of taxpayers to uphold both the explicit and implicit intentions of tax laws. This involves not only the preparation and submission of financial reports but also ensuring that payments to tax authorities are made punctually and are formatted correctly.

Additionally, Mianti and Budiwitjaksono (2021) characterised tax compliance as the proactive attitude and actions of taxpayers, who diligently meet their tax obligations by adhering to established procedures and practices. Furthermore, Nurmansyah et al. (2021) and Gantino et al. (2021) highlight that tax compliance necessitates the timely filing of all essential tax returns and accurate reporting of tax liabilities, aligned with the prevailing tax laws at the time of submission. Embracing tax compliance is not just a legal obligation; it reflects a citizen's commitment to their community and country.

Tax compliance is influenced by behavioural phenomena, where the taxpayer's intention shapes their social behaviour. The willingness of the taxpayer to promptly fulfil their tax

obligations in accordance with the relevant tax laws is known as tax compliance. According to Saw (2017), tax compliance entails the timely submission of tax returns and prompt payment to the relevant tax authorities. Adekoya et al. (2020) emphasize that tax compliance is characterized by the timely and complete payment of taxes, rather than through any form of coercion. Jaya (2017) defines tax compliance as the taxpayer's readiness to fulfil their tax obligations in accordance with the applicable laws.

Voluntary tax compliance emphasizes taxpayers' proactive willingness to prepare and file taxes without any form of coercion or intimidation. In today's context, self-evaluation serves as the bedrock of this compliance. Saad (2014) defines self-assessment as the process through which individuals assess and meet their tax obligations independently, free from the imposition of regulations by tax authorities. Similarly, Kirchler (2008) highlights that tax compliance reflects a citizen's responsibility to contribute their fair share, while non-compliance denotes the deliberate failure of a taxpayer to fulfil these crucial obligations. Supporting voluntary tax compliance fosters a cooperative spirit and strengthens the relationship between taxpayers and the government, ultimately benefiting society as a whole.

There are multiple perspectives on the factors influencing tax compliance. The socio-psychological component addresses norms, attitudes, justice, and tax knowledge, and how these factors relate to tax compliance. The political component delves into the complexity of tax law, while economic factors encompass audit thresholds, fines, tax rates, and income, and their impact on tax enforcement behaviour (Oladipo, 2020).

In Olaoye and Ekundayo's (2019) study, low tax compliance among small and medium-sized enterprises could serve as motivation for tax authorities to enhance their investigation of tax payment records and audits. The study focused on the impact of tax auditing on compliance behaviour and the transfer of tax revenue in Ekiti State, Nigeria. The results showed that tax collection—rather than being a component of their business operations—is the primary reason

why businessmen maintain records. Generally speaking, many small and medium-sized businesses will try harder to maintain accurate records as audit enquiries rise.

2.1.2 Informal sector

The "informal sector," often referred to as the "hard to tax group," "shadow economy," or "black market," encompasses small and micro businesses, along with unregistered entrepreneurs engaged in various activities such as professional services, mining, manufacturing, trading, substantial farming, transportation, and entertainment. According to Adekoya et al. (2021), this sector operates outside the framework of established laws and regulations, playing a vital yet unregulated role in the overall economy. These enterprises are highly accessible and operate independently of stringent government oversight. They not only account for a significant share of economic activity but also provide livelihoods for a large segment of the population.

The International Labour Organization (ILO, 2018) characterizes informality through several traits, including small-scale operations, family ownership, low barriers to entry, reliance on local resources, labour-intensive technologies, unregistered competitive markets, and skills that are often utilized outside formal sectors. Understanding the dynamics of the informal sector is essential for devising effective strategies to integrate these players into the formal economy.

The informal sector is characterised by minimal capital and qualification requirements for entrance, small-scale operations, talents obtained outside of formal schooling, labour-intensive industrial processes, and cutting-edge technology. It's a diverse field with a wealth of literature on the activities, job types, income, and employment opportunities that the informal sector can offer. A thorough study is conducted of the literature on perspectives, tax revenue from the informal sector, measuring and overcoming obstacles to economic development, and the state of the informal sector economy today.

The informal sector engages in a wide range of activities, including general trading, the selling of spare parts, domestic animal trade, hair styling, blacksmithing, repair work, shoe services, carpentry, welding artists, microbusinesses, and barbershops, to name a few. Workers paid on a casual, day-rate basis by formal, registered companies are considered to be in the informal employment category, as are subsistent actors like independent contractors. This includes most domestic workers, street sellers, and individuals and business owners who might perform piece labour on their own property.

2.1.3 Governance Quality

The quality of governance is a significant concern for citizens around the world, as it directly affects the benefits they receive from their government. As defined by the World Bank (2006), public governance quality entails the processes of selecting and evaluating leaders, as well as the government's ability to allocate resources in a fair and efficient manner. Good governance highlights the provision of public goods and services, the enactment of sound policies, and the importance of citizen engagement in decision-making. This dynamic is anchored by an implicit social compact: taxpayers have the right to understand how their money is spent and what benefits they receive in return (Dickerson, 2014; Vlachos & Bitzenis, 2018). This transparency fosters trust and strengthens tax compliance.

According to Alabede & Affrin (2011), voluntary compliance will decrease if taxpayers think that the government is not fulfilling its end of the social contract and that taxes are being transformed to political goods at a low rate and scale. It is impossible to overestimate the significance of good governance, even if many factors affect tax revenue collection (Johnson & Omodero, 2021).

Everest-Phillips and Sandall (2009) argue that taxation and governance quality are closely interconnected, with the quality of governance influencing tax system design. A balanced and equitable tax structure emerges from effective governance, while good governance is also

facilitated by a well-structured tax system. Strong governance and efficient tax systems enhance tax revenue generation and compliance. According to their analysis, a robust tax system relies on strong and excellent public governance is contingent upon a reliable tax system.

Through the payment of taxes, citizens help the government carry out its duties by contributing financially. Since they are the ones who pay for the government, taxpayers ought to be concerned about what is happening there. Therefore, governance concerns could influence taxpayer compliance behaviour in a positive or negative way. In order to accomplish the intended goals and targets for the interest, welfare, and prosperity of the citizens, good governance is accomplished through the efficient and effective use of government resources (Sitardja & Dwimulyani, 2016).

Effective planning and income generation depend on high-quality public governance. Since it directly affects the advantages of governance, public governance ensures social order and cohesiveness, making it a topic of general concern for people around the world (Oladejo, 2020). When a nation effectively delivers public goods of the required calibre, which is a sign of strong public governance. Alabede et al. (2011) and Olaniyan (2020) emphasize that good governance is essential for effective power management in the public sector and the efficient organization of resources. They assert that a strong tax system directly results from good governance, while poor governance leads to negative outcomes.

Effective governance and a solid tax system enhance compliance, whereas government failure to provide essential infrastructure drives citizens to disregard tax laws (Olaniyan, 2020). A critical issue in Nigeria's economy is its status as one of the least developed countries in utilizing tax resources prudently, primarily due to inadequate governance standards (Okwori & Sule, 2016).

2.2 Theoretical Framework

The foundation of this study was tax compliance theory, a paradigm with roots in behavioural

economics and public finance that aims to disentangle the complex web of variables influencing people's choices to fulfil their tax obligations. The idea aims to clarify why some taxpayers choose to voluntarily and completely abide by tax regulations, while others engage in tax avoidance or evasion practices. This theory explores the social, psychological, and economic factors that influence people's decisions on tax compliance (Nwokoye et al., 2023). Tax compliance theory highlights that perceptions of fairness, ease of compliance, and fear of detection impact compliance levels. Traditional economic theory suggests that "rational" individuals weigh the financial benefits and costs of evading taxes. Additionally, societal comparisons may lead dissatisfied individuals to comply less to avoid being seen as "suckers" (Quesada et al., 2014). Additionally, by reducing incentives for tax cheating or the pursuit of tax shelters, lowering tax rates can indirectly make tax compliance easier (Joshi et al., 2013).

2.3 Empirical Review

Olaniyi and Adam (2015) investigated the nexus between good governance and tax compliance in Nigeria. The Ordinary Least Square Linear Regression model was used to test secondary data that was taken from the Central Bank of Nigeria Statistical Bulletin. Among other things, the results showed that, with the exception of tax evasion, all of the model's explanatory variables' coefficients are statistically significant to good governance. The study ignored primary data in favour of concentrating primarily on secondary data.

Herman et al. (2019) examined the impact of tax knowledge, tax penalties, and good governance on the compliance of micro, small, and medium-sized businesses in Medan. 170 Medan individual taxpayers participated in this study as respondents. Structural Equation Modelling (SEM) used for data analysis. The results of the hypothesis testing indicate that individual taxpayer compliance is positively and significantly impacted by excellent governance, tax knowledge, and tax penalties.

Baklouti and Boujelbene (2020) looked into how economic development, informality, and

institutional quality interact. The study employed regression analysis. The authors demonstrated that a smaller informal economy is associated with better GDP per capita in countries with high institutional quality, but not in those with low institutional quality. They also found that the extent of the informal economy was positively impacted by the relative volatility of output to consumption.

Sebele-Mpofu (2020) looked at tax compliance, morale, and governance quality in Zimbabwe's unorganised industry. The study examined how the cost-benefit analysis of tax revenue usage, the quality of governance, and the quality of institutions affect tax morale, which in turn affects tax compliance. Although they are frequently the most misinterpreted and disregarded aspects of tax compliance, governance and tax morale are vital to the effectiveness of tax administration and policy.

Nigeria's tax revenue mobilisation and government quality were evaluated by Johnson and Omodero (2021). The study analyses how institutional (corruption), political (political stability), and governance factors affect Nigeria's tax revenue mobilization. Using time series data from 2000 to 2020 and Ordinary Least Squares (OLS) analysis, the findings revealed that political unrest and corruption significantly enhance tax revenue capacity, while poor governance has a positive but negligible effect.

Adekoya et al. (2023) investigated the impact of good governance (GG) on voluntary tax compliance (VTC) among taxpayers in Lagos State, Nigeria. Using a random sampling method, they distributed 750 questionnaires with an 82.8% response rate. The analysis employed descriptive and inferential statistics at a 5% significance level. The study found that GG positively influenced VTC behaviours, significantly correlating with government trust, transparency, and the rule of law. However, accountability did not show a significant correlation with VTC. Notably, government spending was not examined in this research

Adebayo and Okorie (2024) used principal component analysis to create an institutional quality index using ARDL to analyse data in order to investigate the impact of taxes and the

quality of institutions on the Nigerian economy. Regardless of the institution's quality, the data indicate that taxes have a short-term impact on economic growth. Nevertheless, there is little proof that tax income, economic growth, and institutional quality are all co-integrating, which may be the result of inadequate policy coordination to promote synergy.

Long-term individual effects, on the other hand, demonstrated a substantial and significant role for institutions in sustainable economic growth, suggesting that growth-enhancing factors would be useless in the presence of low institutional quality.

3.0 METHODOLOGY

This study was conducted in Oyo State, located in Southwest Nigeria. A survey research design was used in this study to capture the perspectives of a representative sample from the target population without altering any variables. The population of the study is six Hundred and Ten (610) consisting of trading association (artisans), petty traders (street vendors) and market traders (owners of small businesses) registered with the revenue service in the cities considered as well as tax practitioners. The sampling techniques adopted for this study are stratified random sampling methods. Stratified simple sampling techniques were adopted to select respondents on the basis of categories which are, trading association (artisans), petty traders (street vendors) and market traders (owners of small businesses) as well as tax practitioners. This technique was used, because the targeted populations have tax knowledge and aware of the benefits derived from taxes. The researcher derived the sample size of 241 which statistically by using Taro Yamane formulae. The sample size consists of Two Hundred and forty-one (241) comprising trading association (artisans), petty traders (street vendors) and market traders (owners of small businesses) as well as tax practitioners. Samples taken from each of the categories of the informal sector taxpayers are 32 Trading Associations, 111 Market Traders and 69 Petty Traders, while 29 were tax practitioners, registered as consultants with the revenue agency in the State.

The participants from the operators of the informal sector are from different categories in each of the towns considered for the study. The towns considered are Oyo Township, Iseyin and Ogbomoso. The chosen towns had large groups of informal sector operators such as traders, artisans, food vendors, automobile mechanics, hairdressers, fashion designers, electricians, vulcanisers and petty traders. The categories of respondents are: (a) trading association (artisans), (b) petty trading (street vendors), (c) market traders (owners of small businesses) and (d) tax practitioners.

This study employed well-structured questionnaire to gather primary data. The questionnaire was closed-ended with 5 points Likert Scale rating of strongly agreed, agreed, neutral, disagreed and strongly disagreed responses. The questionnaire was self-administered to the respondents. The study employed Partial Least -Structural Equation modelling (PLS-SEM) and factor analysis.

3.1 Model Specification

The models of the study established the relationship between the effect of governance quality on informal sector tax compliance behaviour in Oyo State. The study employed

specified models below: Model specification from the linear function;

Model

$$IST=f(GQ) \text{ ----- (1)}$$

Where GQ= Governance quality proxied by Voice and Accountability, Policy Stability, Government Effectiveness, Rules of Law, Regulatory Effectiveness and Control of Corruption.

$$IST = \beta_0 + \beta_1VA + \beta_2PS + \beta_3GE + \beta_4RL + \beta_5RE + \beta_6CC + \mu \text{..... (2)}$$

IST= informal sector tax compliance

VA= Voice and Accountability

PS = Policy Stability

GE= Government Effectiveness

RL = Rules of Law

RE= Regulatory Effectiveness

CC = Control of Corruption

β_0 , = Autonomous Variables

β_1 - β_6 = Coefficients of parameter for model 1

μ = Error Term

4.0 RESULTS AND DISCUSSION

Figure 1: Effect of Governance Quality on Compliance of Informal Sector Taxpayers in Oyo State.

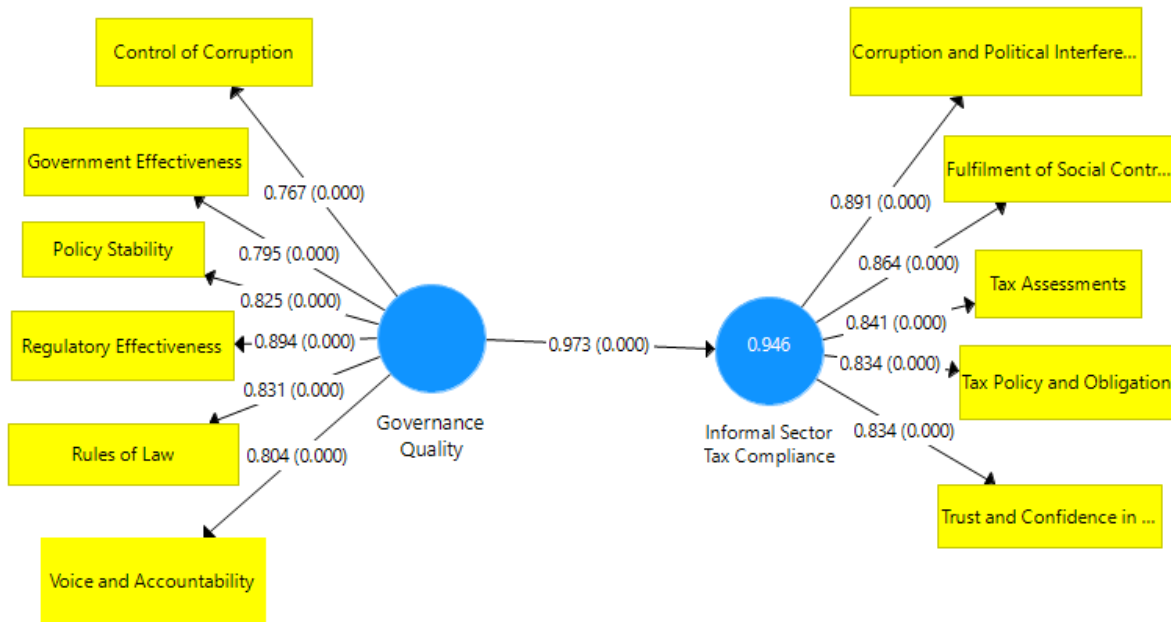


Table 4.1: Path Coefficients of Effect of Governance Quality on Compliance of Informal Sector Taxpayers in Oyo State.

	Coefficient	Standard Deviation	T Statistics	P Values	Decision
Control of Corruption (Governance Quality) -> Informal Sector Tax Compliance	0.767	0.035	22.010	0.000	Supported
Government Effectiveness (Governance Quality) -> Informal Sector Tax Compliance	0.795	0.025	31.187	0.000	Supported
Policy Stability (Governance Quality) -> Informal Sector Tax Compliance	0.825	0.025	32.476	0.000	Supported
Regulatory Effectiveness (Governance Quality) -> Informal Sector Tax Compliance	0.894	0.014	61.953	0.000	Supported
Rules of Law (Governance Quality) -> Informal Sector Tax Compliance	0.831	0.030	27.900	0.000	Supported

Voice and Accountability (Governance Quality) -> Informal Sector Tax Compliance	0.891	0.013	66.886	0.000	Supported
Governance Quality -> Informal Sector Tax Compliance	0.973	0.003	390.73	0.000	Supported

R square = 0.946; F-statistics = 17.665

The analysis of the path coefficients examined the effect of governance quality on compliance among informal sector taxpayers in Oyo State demonstrates strong support for the proposed relationships. Each governance quality aspect exhibits significant positive coefficients, suggesting that improvements in these areas are associated with enhanced compliance. Specifically, the path coefficients indicate that the strongest influence comes from regulatory effectiveness (0.894) followed closely by voice and accountability (0.891), and policy stability (0.825). The associated p-values for all factors are less than 0.01, confirming statistical significance and allowing us to reject the null hypothesis that there is no significant effect of governance quality on tax compliance. The overall model's coefficients indicate a high explanatory power ($R^2 = 0.946$), signifying that governance quality accounts for approximately 94.6% of the variance in compliance behaviour among informal sector taxpayers. These findings underscore the vital role of effective governance in fostering tax compliance, hence, there is positive and significant effect of governance quality on compliance of informal sector taxpayers in Oyo State.

Discussion of Findings

The results of hypothesis indicate a positive and significant effect of governance quality on the compliance behaviour of informal sector taxpayers in Oyo State. This aligns with previous empirical studies that have underscored the significance of governance quality in enhancing tax compliance. For instance, Olaniyi and Adam (2015) found a substantial relationship between

voluntary tax compliance and good governance in Nigeria, demonstrating that the efficiency of governance structures directly influences public accountability and the willingness of individuals to comply with tax obligations. Similarly, Ige et al. (2023) reported a positive correlation between good governance components such as transparency and responsiveness and tax compliance among Small and Medium Enterprises (SMEs) in Nigeria. Their findings highlight the crucial role of effective governance in fostering an environment where taxpayers feel secured and justly treated, thus resulting in higher compliance rates.

Conversely, some studies indicated that the relationship between governance quality and tax compliance is more complex and may vary across different contexts. For example, Sebele-Mpofu (2020) emphasizes the overlooked dimensions of governance quality and tax morale in Zimbabwe, suggesting that high levels of corruption and poor tax administration diminish compliance, irrespective of perceived governance quality. Such findings provoke discussions about the necessary conditions for governance quality to translate into compliance, suggesting that mere existence of good governance measures may not suffice if systemic issues, such as corruption, are rampant.

5.0 CONCLUSION AND RECOMMENDATIONS

The study was motivated by the need to examine the interaction between the effect of governance quality on informal sector tax compliance behaviour in Oyo State. From the analysis and findings, the study deduced that positive

significant relationship existed between governance quality and compliance of informal sector taxpayers in Oyo State

Based on the findings, the study recommends that:

- i. The policymakers should move beyond merely demanding higher tax contributions from the informal sector and ensure accountability and transparency in spending, government should prioritize expenditures on the sector's social and infrastructure needs.
- ii. The policymakers should uphold the rule of law and create democratic spaces for citizens to engage in policy discussions. A strong commitment to fighting corruption should be demonstrated through the prosecution of offenders and reward voluntary compliance.

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