



TAXATION AND ECONOMIC GROWTH IN INDIA

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The direct tax includes income tax, gift tax, capital gain tax, etc while indirect tax includes value-added tax, service tax, Good and Service tax, customs duty, etc. The Central Government of India imposes taxes such as customs duty, central excise duty, income tax, and service tax. What determines economic growth? This question attracts immense limelight in academic research, and many scholars try to answer it. From the classical theory of economic growth to recent endogenous growth models, all substantiate the ideas of a different aspect of an economy's growth process. The overall trend indicates that employment and agriculture sector has been declined. The government should pay focus to these sectors and try to generate employment in the economy. India has adopted several tax reforms after the 1980s, but still unable to form proper tax base and desired tax revenues. The main reasons were complex tax structure, large tax evasion and improper management. Simplification of tax structure like recent GST and reduction in tax evasion may be helpful for tax generations. Better financial inclusion policies in India will facilitate savings in the economy. Inclusion of more people in the financial system will likely to enhance savings behaviour. Growth tends to be beneficial for trade, thus sustainable and rapid growth rate in India will be favourable for trade and a healthy balance of payments status. Unproductive expenditures should be checked and monitored. The government should adopt input-oriented fiscal strategies to curb the unwanted effects of public expenditures. Agriculture and its allied sector in India are enjoying several exceptions which relief a large part of this sector. Tax evasion also can be seen in the case of this sector as people shifting non-agricultural income to this sector. Thus the government must reexamine the tax exemptions policies for this sector. Trade should be encouraged in India and this will be beneficial for tax collection. With the physical quantity, trade also has several positive externalities which are good for the overall productivity of the economy. Macroeconomic stability becomes very vital for tax performance and hence adequate management of economic policies is necessary. The harmful effect of deficits can be minimized with the domestic resource generation especially tax collection. Resource mobilization through taxation is highly appreciable as India is taxing less than its capacity. Government external liabilities are negatively reducing capital formation. Generation of endogenous resources without progressive distortions to the economy will have a conducive impact on the capital formation which is finally transferred to economic performance. The speed of adjustment in tax to the base is necessary with respect to maintain long-run equilibrium. The government should implement suitable policies to eradicate the tax evasions mainly in direct taxes. Another important aspect of raising revenues is the proper monitoring and transformation of the informal economy to the formal economy. Lower speed of adjustments indicating the increasing gap between revenue collections and expenditures. The current Indian budget system requires cyclically adjusted budget balance i.e. budget balance based on discretionary fiscal policy measures with correspondence to the influence of business cycles on revenues. The potential tax changes at central government level that will have a positive effect on

growth performance in the long-run and short-run are the reduction in corporation tax. Corporation tax policy will bring positive changes in FDI, savings and investment which are growth driver. Custom duty is now under the domain of the Interstate Goods and Service Tax (IGST) and exports are now duty-free. The growth conducive implication of custom duty is anticipated to expand further under IGST. In the case of state-level tax policies, property taxes have shown the promising path to generate revenues and enhancing growth. Policymakers could shift the tax burden from income and commodity taxes to property taxes.

The role of physical capital is highly acknowledged in exogenous growth models (Solow, 1956 & Swan 1956), where endogenous growth models depict the importance of human capital along with physical capital (Romer, 1986; Lucas, 1988; Barro, 1990; King and Rebello, 1990; Jones et al., 1993). With the development of endogenous growth models, the role of economic policies in the economy emerges as a determinant factor for growth performance. However, in a broad area of public policies, the role of taxation in growth is still highly controversial. Elementary state functions like welfare projects, redistributive policy, etc., have been done through public spending, and they are conditioned by sustainable finance in an economy. Tax revenues and non-tax revenues mainly fulfill state finance. As recurrent revenue sources and compulsory payments by citizens, tax always remain a vital part of the government budget. Tax structure, tax policy, and tax relief are the policymakers' main concerns and gain tremendous attention in empirical research. Depending on the national configuration and future objectives, different countries adopt heterogeneous tax policies. The tax has other goals like redistribution, resource mobilization, and poverty reduction with the revenue generation. Tax policy has an inherent effect on labour-leisure trade-off, investment decisions, and labour supply (Johansson et al. 2008). The decision is not only confined to the tax levels but also how tax structure is designed by the authority. Thus, examining how and what structure will be conducive to sustainable growth is a critical policy issue. Most of the tax policy has the main objective of raising the GDP per capita; however, the question remains in the empirical literature as how tax policy affects growth and whether the impact is long-lasting or short-lived?

There is a conventional belief that more taxes increase the economy's economic burden and hence harmful for growth. An increase in tax collection reduces individual and firms income, less trade, and rising inflation in the economy. The detailed investigation of different tax instruments and their possible impact on the economy is highly debatable and needs severe academic research. Empirical literature like Macek (2014) & Vartia (2008) finds high corporate and income taxes are harmful to growth. Where, Dale & Yun (1990) finds a positive association between income tax and growth. Consumption taxes have become growth conducive in the study of Durusu- Ciftci et al. (2018). But the indirect taxes like GST and payroll taxes showing a negative relationship in 24 OECD countries, and personal tax and property taxes are favorable. These are a few examples of how growth reacted differently with different tax instruments in various countries. Therefore, through this study, an attempt has been done to provide empirical evidence as how tax structure affects Indian growth performance at both national and sub-national levels. Investigating the direct impact of tax policy on growth performance is very difficult to assess as a tax influences growth and the other determinant of growth (Johansson et al. 2008). National savings and investments are responsive to tax, and these two are an essential source of economic development (Gober and Burns, 1997). These macroeconomic indicators are highly impacted by the tax structure rather than by the tax level. Most tax reforms are associated with the changes in tax structure in the economy and raise concerns about its possible consequences on the economy. This study uses the tax structure variables rather than tax levels. Tax structure analysis provides the revenue-neutral policy changes and clear impact of each tax instruments on growth. The tax structure is measured through individual tax share to the total tax revenues. Based on the governments' economic and political goal, India also witnessed several tax reforms after the freedom, making changes in the tax structure at the national and sub-national levels.

Theories of Taxation.

In this section, we will discuss the different theories of taxation. Tax theories are mainly divided into three parts-

- (a) **The economic surplus theory:** J.A. Hobson (1857-1940) provided the arguments that tax should be imposed on the excess over which is physical and morally need to secure regular use of production factor.
- (b) **The benefits theory of taxation:** This theory is based on the argument that individuals should pay tax according to the state's cost of providing benefits. In this approach, the tax represents the people's demand for public service. The primary critique of the theory is that the benefits and costs are not adequately measurable.
- (c) **Ability to pay theory:** This theory is based on the ground of equality and expediency. People should contribute to the state based on their means. This means maybe income or expenditure etc. This theory talks about two equity-
 - a. **Horizontal equity:** Equal should be treated equally. Like the same taxes to the people who are in the same economic circumstances.
 - b. **Vertical equity:** Unequal treatment to the people with different circumstances.

Theoretical Linkages between Taxation and Growth.

To begin with the theoretical linkages between tax and growth, we followed Engen & Skinner (1996) work where they adopt Solow (1956) growth model.

$$Y_i = \alpha_i k + \beta_i l + \mu_i$$

+ Here y , k , and l are the real GDP, net investment rate and effective labor. This model allows the following channels for tax-growth nexus- (i) higher taxes of corporation and capital gain tax may reduce investment rate or capital stock (k), (ii) tax may affect labor supply growth (l) by influencing labor-leisure trade-off, occupational choices or acquisition of education and skills, (iii) higher tax may reduce productivity growth (μ) by decreasing research and development, (iv) tax also can shift investment from high tax to low tax sectors where productivity is low, thus reduces marginal productivity and, (iv) labor tax can vanish the efficient use of human capital by distorting workers from employment from high social productivity. Based on the theory and empirical findings, the nexus of tax-growth is manifold. Tax policy may influence growth in following ways-

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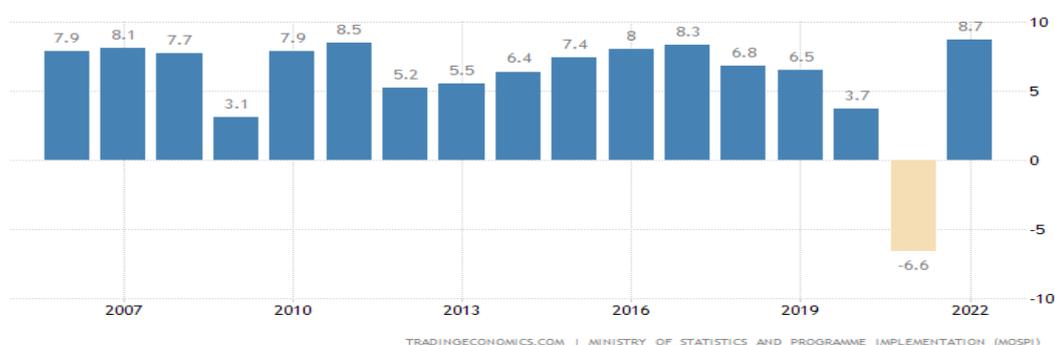
(i) **tax impact accumulation of physical capital:** Daniel & Jefferey (2013) mentioned that high corporate tax reduces the return of invested capital and the structure & age of capital (Pfaffermayr, Stockl & Winners, 2008). FDI is another source of capital formation in the economy, and high corporate taxes reduce the FDI inflow (Feld & Heckemeyer, 2008). Taxation is also playing a role in investment and localization decisions. According to Wong (2011), the clear impact of progressive taxes on localization decision is determined by the tax neutrality. Like other taxes, Labour taxation is another determinant factor for investment decisions as Alesina et al. (1999) mentioned that high labour tax compels workers to decrease in the work supply and consequent decrease in investment due to low profits. Consumption taxes are also an important factor for capital allocation and where the risk is absent, these taxes behave like labor tax (Salanie, 2003).

(ii) **Impact of taxation on human capital:** After physical capital, human capital is another important growth source. According to Lin (2001), if the revenues are used in the formation of human capital, there may be a positive effect of tax reliefs as a motivating factor for an employer to invest in human capital (Jacobs, 2007).

(iii) **Tax influences labour-leisure trade-off:** High-income taxes on labor influence whether to participate in labor markets or not how much they want to work, channelized to labor –leisure trade-off (Mdanat et al. 2017).

(iv) **Taxes finance government spending's:** Tax collection is a handy tool to extract revenues from the economy. These revenues can be utilized for welfare projects and social services.

In light of the above discussion, we select India as a case to investigate the role of taxation on economic growth for the following reasons- (i) India's tax-GDP ratio is far below that of developed nations and even lower among the BRICS economies. The total tax-GDP ratio in the year 2014-15 is only 16.36%, where India's growth performance shows a healthy rise after the economic reform of 1991. The growth rate reached 8% in 2007-08 and declined marginally in recent years. According to Bahl & Bird (2008), underdeveloped countries like India tax less than their capacity, leading to the reduced public sponsored spending. This possible growth conducive tax structure may help to maintain public inputs and sustainable growth performance for an emerging economy like India. (ii) India adopted Goods & Service Tax (GST) in 2017, which has transformed the entire indirect tax structure. Most of the indirect taxes at both the national and sub-national levels are converted into single tax markets. However, it is interesting to see that the crucial and important nexus of 'tax-GDP' is still unclear and debatable in India. India has adopted several tax reforms since independence, and most of the reform was targeted to meet the government's immediate needs rather than long- run goals (Rao & Rao, 2005). Thus we think India provides a fertile ground to investigate the impact of tax on growth using recent data series.



Significance of the Study.

The role of tax policy on growth performance is well established in recent times. India adopted several policy changes in tax after the independence and gone a drastic changes in both central and state levels after the economic reforms of 1991. However, the relationship between tax and growth is still unclear in the case of India. The existing studies on India are mainly cross-country studies where

India belongs to the sample. In that respect, the present study provides important information regarding how various taxes affect economic performance in India, and thereby, prescribes measures of tax reforms that would be conducive to economic growth at both national and sub-national level. Comprehensive literature survey reveals that the empirical studies are mainly related to developed countries and the panel framework, where India only emerged as a sample. However, looking at the single country's perspective, we find very little evidence on the same, especially for India. Recently Sethi et al. (2020) and Muduli & Manik (2020) explore the tax-growth nexus for national and subnational levels, respectively. Venkataraman & Urmi (2017) investigate the impact of central taxes on growth performance. However, this study is mainly focused on tax revenues rather than tax structure. Another important drawback is that these studies do not incorporate revenue- neutral tax changes, which is an important methodological issue in tax regressions.

Our study attempts to fill the gap by examining the effect of tax structure on economic performance in an emerging economy such as India at both the national and sub-national levels. This study will be a contribution to empirical literature in the following way- (i) this will be the first study for both national and sub-national level to examine 'tax-growth' nexus with the use of recent data series, (ii) this work employs 'revenue-neutral' policy change analysis of every tax share which will be a contribution for the literature and (iii) the use of relevant econometric techniques is utmost important in policy research. We employed recent and relevant time series and panel models to examine the dynamics of policy variables.

Objectives.

Based on the above discussion, this study attempts to evaluate the following objectives-

- (1) To examine trend, pattern, and determinants of GDP (its notions) and its components (Agriculture, industry, and services) in India.
- (2) To examine trend, pattern, and determinants of Taxation (direct tax revenues and indirect tax revenues) and its components (Direct tax revenues and Indirect tax revenues) in India.
- (3) To examine the elasticity of tax revenues and GDP with each another.
- (4) To examine the long-run and short-run relationship between tax revenues and economic growth in India.

Hypotheses

In the light of above objectives, the present study attempts to test the following hypothesis-

For objective (1), we have prepared two hypotheses.

- (a) That the GDP in India is rising in terms of average annual growth, especially after the economic reforms of 1991.
- (b) That the structure of GDP in India in terms components has been changing over the study period especially after reforms of 1991.

For the objective (2) we also have prepared another two hypotheses.

- (c) That the tax revenue from its components in India has been rising in terms of per annum growth especially after the reforms of 1991.
- (d) That the share of direct and indirect taxes in total tax revenues in India has been changing especially after 1991.

For the objective (3),

- (e) That the responsiveness of tax revenue and GDP mutually in terms of elasticity is greater than one (1).

And for the objective (4)

- (f) There exists a bi-directional long run as well as short-run causality in between tax revenue and GDP in India.

This study will contribute to the literature as far as we concern; this will be the first study to evaluate the role of taxation in India's growth performance at both the national and subnational level. Following the approach by Acosta Ormaechea and Yoo (2012), we analyze the revenue-neutral tax policy change on economic performance, which will also be a new approach for India.

Methodology and Data Sources.

The study period in each empirical chapter varies per the data availability of the variables. Based on the objectives and sub-objectives, the data period of study in each empirical chapter can be present as follows; for the first empirical chapter- 1970-71 to 2014-15, and 1980-81 to 2014-15, for the second empirical chapter- 1980-81 to 2015-16, 1973 to 2018, 1985 to 2017 and 1981 to 2016, for the third empirical chapter- 1973 to 2017 and for the fourth empirical chapter- 1980 to 2016 and 1991 to 2016. The methodology used in all empirical chapters are; semi-log regression model, dummy variables regression model, Autoregressive Conditional Heteroskedasticity (ARCH) and Generalized Autoregressive Conditional Heteroskedasticity (GARCH) volatility model, Augmented Dickey-Fuller (ADF) and Phillip-Perron (PP) unit root test, dynamic OLS and differenced OLS model, Johansen-Juselius model, Autoregressive Distributive Lag (ARDL) model and panel Pool Mean Group (PMG) model for cointegration analysis, and Toda-Yamamoto and Dumitrescu Hurlin Panel Causality Test for causality analysis.

Limitation of the Study:

There are a few limitations of this study which are mentioned below.

In our second objective, we only use economic determinants of tax revenue performance for India. Due to the lack of time series data on political and institutional variables, we are unable to include these determinants in our study.

This study examines the tax-growth nexus in a macroeconomic perspective, not in microeconomic perspective. Macroeconomic studies are unable to provide the channels through which tax influencing the growth performance. This is another limitation of the study. Dummy variable regression results indicate that every GDP notions are showing an increasing trend. In the case of components, trade sector and manufacturing sector showing an increasing trend in the post-reform period and agriculture sector is in decreasing trend.

- Results from acceleration and deceleration suggest that GDP, Gross Fixed Capital Formation, Consumption of Fixed Capital, Imports, and External Assistance are accelerating in the overall period, i.e. 1981-2015. And employment and gross savings decreased during the same period.
- Dummy variable regression model for determinants of GDP shows that GDP, COFC, Export and import an upward sloping trend. And employment, tax revenue and gross national savings tend to decrease.
- Unit root test results indicate that for the overall period, all the determinants of GDP are stationary at 1st difference. In the post-reform period only GDP, COFC, EXSST, GDFC, inflation, GNS and tax revenue has become stationary 1st difference, whereas employment, export and imports are stationary at 2nd difference.
- Volatility analysis with the use of ARCH & GARCH model indicates that there is no ARCH

(1) effect in the determinant of GDP in India for the overall period. However, GARCH (1 1) effect has been found for GDP and employment for the same period.

- In the post-reform period, ARCH (1) effect has been found in the case of GDP, employment, tax revenue and inflation rate in the post-reform period. The statistical significance of GARCH (1 1) model implies that the volatility effect has been found in the case of GDP, employment, exports, external assistance, tax revenue and inflation rate.
- Johansen-Juselius cointegration test indicates that there is long-run cointegration exist among the explanatory variables and GDP.
- Toda-Yamamoto causality results reveal the fact that there is bi-directional causality among the GDP and COFC. There are also two unidirectional causalities have been found where GDP causes export and import in India.
- In the post-reform period, the downward shift in custom duties is quite obvious. Due to globalization and to attract more foreign investments, India has smoothened the tax structure for custom duties. Rationalization of custom duties is seen in the revenue collections.
- The gradual removal of several tax brackets and a reduction in tax rates in the post-reform era broadening the income tax base. Therefore the growth rate has shown an upward shift.
- The same kind of conclusion is also valid for corporation income tax. From the tax range of 45% - 65% to reduce the rate of 35% help in extension of the tax base. On the other hand, the introduction of tax MAT (Minimum Alternative Tax) in 1996-97 helped in reducing the zero tax companies.
- Indirect tax revenues, income and corporation income tax contributions to the major portion. Therefore rise indirect tax revenues are very much anticipated from the trends of income tax and corporate income tax. Better economic growth, enhance tax administration and improved tax compliances are major factors for growing direct tax revenues.
- Rationalization of excise duties did affect revenue collection temporally. But in long-run analysis, after the reform of 1991, it has grown. Short-run fluctuations in excise duties can be taken as cost of rationalization (See, Aggarwal).
- Indirect tax revenues grow at a rate of 18.21% in the post-reform period with major growth in Union excise duties. The steady expansion of tax base due to the inclusion of more service taxes and increased rates became a helping hand in a rise in indirect tax revenues especially after 2000-01.
- Reduction in excise tax revenues can be found after the financial crisis of 2007-08. In the budget of 2009-10, rates of excise and service taxes are reduced by about 2%. Reduction in tax rates and decelerate manufacturing sector caused a reduction in revenues.
- With rapid growth, globalization and integration of regional economies have proved to be a rising factor for growth in almost all states tax revenues. Pursue the behaviour of central direct income taxes, the state's income taxes are growing at an average rate of 15.92%. Expansion of urbanizations and industrialization pushes the revenues collection form property tax and vehicles tax.
- Overall deceleration of agriculture sector also contributing to the degradation of tax revenues from the agriculture incomes. In our study, agriculture income has to show negative growth.
- Theoretical arguments and empirical results establish that LA3SLS has better predictive power and efficient estimator in comparison to LA2SLSL and OLS.
- Results indicate that GDP growth and trade openness is positively related to tax performance in India, whereas inflation rate, development expenditure and agriculture share to GDP are deteriorating the tax performance.
- In the case of growth determinants, total government expenditure, fiscal deficit and tax revenue share are halting economic development. On the other hand, gross fixed capital formation is a growth-enhancing factor.

- Capital formation is positively responding to tax revenues and GDP growth, whereas central government liabilities are halting it.
- The estimation of long-run elasticities has been done through Dynamic OLS and for short-run elasticities calculation, we develop error correction regression model.
- The unit root of the variables has been checked through ADF & PP tests. Results reveal that all the variables are stationary at 1st difference.
- This study employs Engle-Granger error based cointegration test for checking long-run relationships and results reveal that there is cointegration amongst most of the studied variables.
- More than unit tax base elasticity has been found for the direct, corporation and income tax for the overall period and results are consistent in the post-reform period also.
- The long-run tax-base elasticity is very low for excise duty in both pre and post- reform period.
- The short-run elasticity is very much higher than to long-run elasticity in case of the total tax, direct tax, corporation and excise duty in the post-reform period. Both the long-run and short-run tax-base elasticities are improved in the post- reform period in India. However, the speed of adjustments is not very good in both the overall and post-reform period.
- We have calculated the base to tax elasticities, where more than unit elastic values have been reported for indirect, excise and customs duty in both overall and post-reform period.
- Concerning tax to base elasticities, asymmetric responses exist in case of indirect taxes for both pre and post-reform period. However, the elasticity asymmetry is not found in case of the base to tax elasticities for India.
- All the Time series ARDL model indicate that corporation tax share, income tax share and excise tax share are negatively associated with growth in the long run. In the case of the central government, custom duties have become growth conducive.
- The overall tax burden which is an indicator of the overall tax burden in an economy is negatively related to growth which reveals the distortionary effect of it.
- Again, the capital accumulation variable is positively related to growth in all models and results are per line to the theoretical assumptions.
- The coefficient of population growth substantiates the hypothesis that rapid population growth is bad for economic performance.
- The speed of adjustments measured through the Error Correction Term (ECT) indicates the slow process of adjustments. However, the negative and statistically significant ECT establishes the existence of long-run equilibrium.
- The results for state-level data suggests that the property tax structure has a significant positive relationship with state economic performances. However, commodity & service taxes are becoming a growth hindering factor in our analysis.
- Similar to the national level analysis, the total tax burden is bad for economic performance in case of the sub-national level also.

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