Contemporary Issues in Social Sciences and Management Practices (CISSMP)
ISSN: 2959-1023
Volume 4, Issue 2, June 2025, Pages 44-58
Journal DOI: 10.61503
Journal Homepage: https://www.cissmp.com

Role of Tax Policy, Regulatory Quality, and Public Trust in Enhancing Tax Compliance: Evidence from Pakistan's Informal Sector

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Article History:

Received:	Feb	20, 2025
Revised:	March	12, 2025
Accepted:	March	19, 2025
Available Online:	June	30, 2025

Keywords: Tax Policy, Regulatory Quality, and Public Trust in Enhancing Tax Compliance

Funding:
This research received no specific grant from any funding agency in the public, commercial, or not-for-profit sectors.

ABSTRACT

This study examines the impact of tax policy clarity, regulatory quality, and public trust in institutions on tax compliance behavior within Pakistan's informal sector. A sample of 300 micro and small informal business owners was surveyed to explore how these institutional factors shape tax-related decisions. Partial Least Squares Structural Equation Modeling (PLS-SEM) was conducted using SmartPLS 4.0 to assess the reliability, validity, and predictive strength of the proposed model. The structural equation model analysis revealed that all three explanatory variables Public Trust, Regulatory Quality, and Tax Policy have a significant and positive effect on Tax Compliance. These relationships were statistically significant, as indicated by uniformly low p-values (all < 0.001), confirming the robustness of the model. The novelty of this study lies in its application of SmartPLS-SEM to investigate institutional drivers of tax compliance within the informal economy of a developing country—an area that has received limited empirical attention. By integrating governance-related variables into the tax compliance framework, this study provides empirical evidence that strengthening institutional trust and improving policy clarity can significantly boost voluntary compliance. The findings offer valuable insights for public economics and inform strategies for fiscal reform and informal sector integration.

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DOI: https://doi.org/10.61503/cissmp.v4i2.292
Citation: Rasheed, A., Idrees, F., & Rashid, A. (2025). Role of Tax Policy, Regulatory Quality, and Public Trust in Enhancing Tax Compliance: Evidence from Pakistan's Informal Sector. *Contemporary Issues in Social Sciences and Management Practices*, 4(2), 44-58.

1.0 Introduction

Tax compliance has long been recognized as a fundamental determinant of fiscal sustainability, governance legitimacy, and public service provision, particularly in developing economies where tax-to-GDP ratios remain significantly below global benchmarks. In countries like Pakistan, a sizable proportion of economic activity occurs outside the formal sector, thereby limiting the state's ability to mobilize adequate domestic resources (Umair, 2023). The informal sector, which includes micro- and small businesses that are often not registered and supervised, is both a source of livelihood through employment and a major taxation blind spot in countries. The voluntary tax compliance of informal business operators continues to fall behind in spite of regular reforms to expand the tax base, which is an obstacle to fiscal equity and inclusivity (Chongvilaivan & Chooi, 2021). The mainstream theories of tax compliance have focused much on deterrence-based enforcement strategies like audits and penalties but the emerging body of evidence highlights the importance of institutional factors, e.g. policy clarity, regulatory efficacy and public trust, in determining tax compliance, particularly in low-governance contexts.

This has seen a shift in the academic discourse of the punitive to behavioral/institutional approach that depicts a more sophisticated view of taxpayer engagement. In the informal sector, where there is little formal contracting, record keeping and legal protection, institutional integrity and the transparency of tax obligations become key factors of compliance. Pakistan presents a very good example: its informal economy estimated to be over 35 % of GDP is a good place to study the interaction between institutional quality and taxpayer psychology. Despite the existence of an abundance of small business tax plans and simplified regimes, anecdotal and empirical evidence suggest that the lack of trust in government institutions, regulatory inconsistency, and the obscurity of policy design discourage informal enterprises to join the formal tax net (Bourguignon & Wangwe, 2023). In a bid to solve this policy dilemma, the current research paper empirically examines the joint effects of tax policy clarity, regulatory quality, and the level of trust on the tax compliance behavior of the informal business operators in Pakistan thus providing a multi-dimensional view on voluntary compliance in weak institutional environments. Tax policy clarity refers to the degree to which tax rules, rates, obligations and filing procedures are understandable and available. It includes such features as the plain language, uniformity of application, the availability of guidance, and predictability of interpretation. On the other hand, opacity, discrepancy, and technicality in the design of policies increase confusion and fear of non-compliance among taxpayers, especially those with low financial literacy or professional assistance (McBride, 2022).

The results show that the general tax compliance rate in the informal sector is low and 70 % of the respondents are fully out of the formal tax system. Multivariate results indicate that clarity of tax rules and regulations is positively associated with informal tax compliance, but perceptions of corruption and institutional opacity have negative impact on informal tax compliance. These effects are also compounded by regulatory efficiency implying that the formalization of informal businesses into the official tax net depends on a multilateral intervention that seeks to increase

policy clarity, regulatory efficiency, and institutional trust. Regulatory quality, on the other hand, reflects the government's ability to design and implement policies that are coherent, transparent, and supportive of private sector development. High regulatory quality entails efficient enforcement mechanisms, consistent application of rules, low bureaucratic burdens, and minimal opportunities for discretion or corruption. Public trust in institutions, as a third pillar, captures the extent to which individuals believe that public institutions, including tax authorities, operate fairly, effectively, and in the public interest (Wibowo et al., 2025). Trust serves as a psychological contract that bridges the informational and enforcement asymmetries between the state and its citizens, and it has been empirically associated with higher compliance in both developed and developing contexts.

The relationship between these constructs is theoretically grounded in the extended slippery slope framework which posits that both power (e.g., enforcement capacity) and trust (e.g., legitimacy and fairness) are necessary for effective tax compliance. Within this framework, policy clarity and regulatory quality can be viewed as institutional expressions of power and competence, while public trust embodies the normative alignment between taxpayers and the state (Ndukwe et al., 2022). When tax policies are clearly articulated and regulatory frameworks function predictably, taxpayers are more likely to view the state as capable and legitimate. This perception, in turn, fosters trust, which mediates the relationship between institutional quality and compliance behavior. Empirical studies have validated parts of this theoretical chain, indicating that in environments with low trust, even strong enforcement fails to produce sustainable compliance, whereas in high-trust settings, taxpayers often comply voluntarily, even in the absence of stringent oversight (Chung, 2024). However, there is a paucity of research that simultaneously tests these institutional antecedents and the mediating role of trust within informal economies, particularly in South Asian contexts.

The present study identifies a critical gap in the literature concerning the dynamics of tax compliance in informal sectors of developing countries, where state capacity is limited, and institutional arrangements are often in flux. Much of the existing empirical work on tax compliance in Pakistan has focused on formal firms, salaried individuals, or macro-level determinants such as tax-to-GDP ratios and audit intensities (Karnowski & Rzońca, 2021). Few studies have examined the micro-level behavioral and institutional determinants that affect informal business owners, who constitute a significant portion of the potential tax base but are systematically underrepresented in both policy debates and academic research. Moreover, while the role of public trust has been increasingly acknowledged in developed economies, its mediating function in the interplay between regulatory structures and tax behavior remains underexplored in Pakistan's informal sector (Zahoor et al., 2025). The informal business environment is characterized by low regulatory visibility, weak legal protections, and limited interactions with formal institutions, making it a unique and under-theorized context for testing institutional models of compliance.

Given these empirical and theoretical lacunae, the central research problem addressed by this study is: how do tax policy clarity, regulatory quality, and public trust in institutions jointly influence tax compliance behavior in Pakistan's informal sector? The study further interrogates the mediating role of institutional trust in these relationships, hypothesizing that clarity and quality of tax governance enhance compliance primarily by strengthening taxpayer confidence in public institutions. This research problem is not only analytically significant but also policy-relevant, as it sheds light on non-coercive pathways to increasing tax compliance among economically marginalized yet dynamically productive segments of society (Bobarykina, 2025). The current study can provide a micro-level view of the institutional design-to-compliance incentive translation when the traditional enforcement mechanisms are either too costly or unsatisfactory by investigating the case of informal business owners. The contribution of the study is twofold: on the one hand, it contributes to the body of knowledge on institutional determinants of taxpayer behavior by testing and improving the slippery-slope framework in a relatively little studied setting. Unlike most of the previous literature, where one or the other angle has been pursued separately, the current study has combined the two approaches into a single model. The addition of policy clarity and regulatory quality as structural antecedents, and psychologically mediated trust as a mediating variable, provides a more differentiated representation of compliance mechanisms. The analysis is empirical and is based on Partial Least Squares Structural Equation Modeling (PLS-SEM) with SmartPLS 4.0, which is appropriate when the model is complex in terms of latent-constructs and the sample size is moderate. Such methodological tightness secures the strength of the results and their transferability to other similar research situations. The study is based on a primary data that includes 300 micro and small-scale informal businesses, and thus fills a long-standing gap in data on tax conduct in the underground economy in Pakistan.

Policy-wise, the results provide practical recommendations to governments, tax agencies, and development agencies that want to increase fiscal revenue without exacerbating enforcement expenses and social injustices. Findings show that institutional trust can be fostered by enhancing the clarity and quality of policy and encouraging voluntary compliance through strengthening the quality of regulatory enforcement even without widespread auditing or sanctioning. This fact is particularly relevant to Pakistan where tax bases need to be expanded due to fiscal deficits and donor conditions. The research provides a strategic blueprint on how to design inclusive and sustainable tax reforms by shedding light on psychological and institutional channels that promote compliance (at the expense of coercion, clarity, and fairness).

The heterogeneity of the taxpayers population and the associated necessity of policy differentiation is also acknowledged in the analysis of informal business owners. Broad-brush enforcement approaches usually pay little attention to the limitations and incentives of informal entrepreneurs, including informational shortages, institutional distrust, or bureaucratic complexity. The study also provides an opportunity to reach out specifically to this segment and build capacity and design participatory policies by identifying factors that increase compliance readiness among this segment. In addition, the results resonate beyond informal-enterprise research to inform digital tax administration, financial inclusion programs, and taxpayer-education programs, which all work better when guided by an empirical appreciation of taxpayers and their institutional environments.

Overall, the study is of a burning and topical research problem that lies at the intersection of tax policy, regulatory governance, and institutional trust in Pakistan informal economy. It adds to the theoretical rigor, empirical strength, and policy relevance of a theoretically coherent and empirically well-founded explanation of the influence of institutional arrangements on the tax compliance behavior of a segment of economic importance. By so doing, it contributes to scholarly discussion on the topic of public finance and informal-sector dynamics and gives a practical guide to strengthening fiscal legitimacy and socioeconomic equity in developing nations.

2.0 Literature Review

The theoretical frame of reference in understanding tax compliance has transformed to include a broad-based perspective to include integrated frameworks that give prominence to institutional environments, the quality of governance, and psychological contracts between the state and its citizens. In this larger context, the slippery slope approach provides an all-embracing perspective: it states that tax compliance is not only a matter of coercive measures, such as audits, penalties, and legal sanctions, but also a matter of perceived legitimacy, fairness, and trustworthiness of the tax authority. By making the taxpayers feel that the state is trustworthy and the tax system is fair, the willingness to comply with the taxes is created not due to fear but due to moral alignment and social duty. Compliance in this case is not forced.

The view is particularly relevant in developing nations where the weakness of institutions and informal markets restrict the effectiveness of coercive enforcement. It implies that the development of institutional trust and policy clarity are viable alternatives to aggressive policing that are strategic. In this case, the quality of the tax policy formulation and regulatory enforcement directly influences the level of trust in institutions and consequently compliance. On this basis, tax compliance is theorized as the result of rational calculations of clarity and consistency as well as relational judgments of fairness and legitimacy.

Empirical studies which appeal to this theoretical framework have become more comprehensive and multifaceted, especially with regard to persistent low levels of compliance in low- and middle-income countries. A large literature has now begun to examine the relationship between the clarity of tax policy and taxpayer behavior and found that clear, unambiguous statements of obligation tend to increase compliance. Clarity decreases informational loads, decreases the perceived risk of making a mistake, and increases the perceived fairness, which is particularly strong in informal contexts, where the educational level can be limited and financial literacy is restricted. The findings of many developing nations show that the easier it is to file, and the more the taxation requirements are made to be understood by the locals through their languages, the better the compliance. Certainty also limits rent-seeking of corrupt officials who use ambiguity to their advantage. Fragmented, technical, and often amended tax codes are a good example of obstacles to policy clarity and informal sector participation in the tax regime in the Pakistani context.

In line with policy clarity, regulatory quality has come out as a critical factor in determining tax compliance. Regulatory quality includes the ability of state institutions to formulate and implement rules that are transparent, predictable and conducive to the development of the private enterprise. Procedural justice is created by effective regulation and compliance is rewarded by it, whereas arbitrary, inconsistent, or corrupt regulation destroys compliance incentives. Empirical evidence shows that effective regulatory bodies increase the tax morale and reduce compliance cost in jurisdictions where there is low enforcement. Regulatory quality in informal economies indicates the effectiveness of the state in governance, which defines the expectations of the taxpayers on the costs and advantages of compliance. Overlapping jurisdictions, administrative inefficiency, and discretionary interpretation of the rules have been long barriers to registration and engagement, especially amongst informal businesses with small margins and limited interaction with formal institutions in Pakistan.

Another dimension that empirical studies find appealing is the mediating role of trust in institutions in the tax compliance behavior. Trust refers to the confidence that the government is using revenues wisely, is in the interest of the citizens and is fair to the citizens. The presence of high institutional trust pushes individuals to perceive tax compliance as a civic duty instead of being a forced duty. The research in both developed and developing settings demonstrates that the institutional trust is strongly related to compliance attitudes narrowing or softening the effects of policy clarity and the quality of regulations. In Pakistan, where the level of trust in the tax authorities is low because of corruption, unequal treatment, and fears of misappropriation of the public funds, distrust in the informal sector discourages the efforts to expand the tax net.

Empirical efforts in the recent past have attempted to combine these institutional dimensions into unified models that better forecast the results of compliance. The models that combine structural factors (clarity, enforcement, administration) with behavioral factors (trust, social norms) are always more successful than deterrence-only models. Findings show that the regulatory quality and institutional trust interaction may enhance or reduce the effects of policy reforms. Well-designed policies can come to a halt when taxpayers do not trust implementing institutions, and high trust can generate large payoffs to small advances in transparency or control. These results confirm the need of a multidimensional tax reform agenda that should not only deal with the content of regulation, but also with institutional credibility and legitimacy.

The literature on the subject matter explains the influence of institutional variables in determining the tax compliance behavior within formal economies. Nonetheless, there exists a large literature gap in explaining their effects in informal economies whereby the state is less present and formal accountability is undermined. One of the most complex case studies is the informal sector in Pakistan, which is made up of unregistered micro and small businesses. Such enterprises are generally not subject to legal and administrative systems, they incorporate informal capital and labor networks and are characterized by low record-keeping (Gholipour et al., 2023). As a result, their chances of complying with tax laws do not depend as much on enforcement as they depend on the perceived fairness, clarity, and trustworthiness of the state. However, the current research in Pakistan has been biased towards salaried taxpayers, formal businesses, or macro-level indicators and informal businesses have been under-researched analytically (Hashmi, 2025). In addition, despite the fact that policy documents often recognize the need to integrate informal actors into the tax net, they rarely use empirical evidence to demonstrate the behavioral and institutional factors that moderate this integration.

This study responds to these gaps by empirically testing a structural model in which tax policy clarity and regulatory quality are posited as predictors of tax compliance behavior, with public trust in institutions serving as a mediating variable. It hypothesizes that clear and well-enforced tax policies enhance compliance primarily by increasing institutional trust among informal business owners. In doing so, the study contributes to a growing literature on governance and tax compliance by operationalizing institutional variables in a context where coercive capacity is limited. The underlying assumption is that informal enterprises, despite their marginal legal status, are embedded in broader institutional frameworks that shape their perceptions, decisions, and behavioral patterns. As such, their engagement with the tax system is mediated not only by direct costs and benefits but also by the broader political and institutional environment in which they operate.

Based on the theoretical foundations and empirical patterns outlined above, the following hypotheses are developed to guide the empirical analysis. First, it is hypothesized that tax policy clarity has a significant positive effect on tax compliance behavior. This is grounded in the proposition that clear, accessible tax rules reduce informational barriers and enhance perceived fairness, thereby motivating informal businesses to comply. Second, it is posited that regulatory quality exerts a positive influence on tax compliance. Effective, predictable, and transparent regulation signals state capacity and fairness, thereby enhancing the legitimacy of the tax system (Anjarwi, 2025). Third, it is hypothesized that public trust in institutions is positively associated with tax compliance behavior. Trust is a normative principle and a psychological device that rewards voluntary compliance with tax obligations. In addition, the institutional legitimacy is said to moderate the relationship between tax policy clarity and tax compliance: that is, when tax policies are clear and consistent, there is an increase in the institutional legitimacy, thus enhancing tax compliance. Similarly, it is proposed that the connection between the quality of regulations and tax compliance is mediated by the trust of people in institutions. Quality regulation enhances institutional legitimacy that further contributes to the confidence of taxpayers and compliance. All these hypotheses outline a holistic picture of tax compliance, which integrates both structural and behavioral aspects of the picture in the context of institutional weakness and informality.

3.0 Methodology

This research paper uses quantitative research methodology to explore the interconnection between the clarity of tax policy, the quality of regulation, and the level of trust in institutions and the tax-compliant behaviour of the business community in the informal sector of Pakistan. The quantitative design is desirable since it allows the gathering of standardized data of a large population, thus facilitating the testing of hypothesized relationships in a systematic and replicable manner through statistical methods. The philosophy of research underlying this project is post-positivist, which emphasizes the application of empirical data and objective measurement but considers that reality cannot be observed with full precision and depends on the contextual influences. The research thus falls in line with its objective of testing theoretical propositions with observable indicators and quantitative data to generate insight that can be generalized to the informal sector behaviour in developing-country settings.

The population includes the informal business operators in various parts of Pakistan, mainly the micro and small businesses owners who are not registered with the government taxation authorities. This is a segment that should be considered since it forms a big percentage of the national economy but is mostly outside the formal tax net. The informal sector is diverse and geographically spread and is found in urban and semi-urban centers in the retail trade, services, small-scale manufacturing and construction sectors. With no centralized list of informal enterprises, a non-probabilistic purposive sampling method was used to determine the participants who fit the inclusion criteria. The respondents had to be unregistered commercial actors whose operations are continuing and hence relevant to the research objectives.

The sample size of 300 informal business owners was chosen as per the demands of Partial Least Squares Structural Equation Modeling (PLS-SEM) that is resistant to small or moderate sample sizes. The sampling frame included large cities and the peri-urban regions in which informal economic activity is especially concentrated. The sample is not statistically representative of the whole informal sector, but provides a varied cross-section of informal entrepreneurs in different sectors and regions, which increases external validity within the limitations of a non-probabilistic design.

The survey questionnaire was developed to collect data on this project. The sections collected demographic data and measured constructs of interest with validated scales. The questions on tax policy clarity, regulatory quality, level of public trust in institutions and tax-compliant behaviour were customized and based on the existing instruments, but modified to fit the Pakistani informal-sector setting. The responses were captured using a five-point likert scale which ranged between strongly disagree and strongly agree. The questionnaire was translated to English and Urdu to suit the linguistic and education backgrounds of the participants. The face-to-face administration with trained enumerators provided clarity, accuracy and completeness of responses and was deemed important due to the sensitive nature of the questions asked with regards to taxation.

Data analysis was performed based on Partial Least Squares Structural Equation Modeling (PLS-SEM) framework in SmartPLS 4.0 software. The PLS-SEM was chosen as it can be used in complicated models involving many latent variables, it is resistant to non-normal distributions, and it can be used in predictive and exploratory modelling. The process of analysis was carried out in two phases: the measurement model was estimated to determine reliability and validity using factor loadings, composite reliability and average variance extracted (AVE); the structural model was then used to test the hypothesised relationships, both direct and indirect. Path coefficients were determined to be significant through bootstrapping of 5000 resamples, which increased the strength of the estimates.

Ethical issues were well addressed during the study to safeguard the rights and dignity of the participants. Data collection was preceded by an informed consent, and the respondents were promised that their answers will be kept anonymous and confidential. The participation was voluntary and people could opt out without penalty. Questions sensitive in nature were treated with care and all the information was kept in a secure place, so that no unauthorized person could access it. The ethical permission was gained in the corresponding academic institution and all the actions were performed according to the international ethical norms related to the research on human subjects, which is especially significant in the case of informal participants who can be suspicious about the taxation and the governmental power.

Finally, the methodological design of the present study was intended to provide rigorous and ethically acceptable data collection and analysis that would be required to explain the tax compliance behaviour in the informal sector in Pakistan. Combining a well-designed survey tool with a solid analytical framework, the project aims at producing credible and actionable knowledge on how institutional factors shape voluntary tax behaviour among informal entrepreneurs. Every choice, whether in the approach to sampling or analytical methods, indicates a dedication to methodological soundness, situational relevance and high academic standards.

4.0 Findings and Results

4.1 Measurement Model

Table 4.1: Reliability Analysis

	Cronbach's Alpha	rho_A	Composite Reliability	Average Variance Extracted (AVE)
Public Trust	0.7679	0.7837	0.8367	0.5007
Regulatory Quality	0.7765	0.8233	0.8354	0.5082
Tax Compliance	0.71	0.7753	0.7963	0.5045
Tax Policy	0.786	0.7824	0.8446	0.5133

The reliability analysis of Table 4.1 shows that the internal consistency and convergent validity of all constructs are acceptable, including Public Trust, Regulatory Quality, Tax Compliance, and Tax Policy. The values of the Cronbach Alpha of these constructs are 0.71 to 0.79, which exceed the minimal level of 0.70, and, therefore, prove their reliability. Also, the values of rho_A and Composite Reliability of all constructs are higher than 0.70 and 0.80 respectively, which also proves the consistency of the measurement model. Besides, all constructs attained Average Variance Extracted (AVE) values greater than 0.50, which implies that the indicators capture more than 50 % of the variance. The findings thus affirm that these constructs have been measured reliably and are appropriate to be analyzed further.

4.2 Validity Analysis

Table 4.2: Discriminant Validity (HTMT)

	Public Trust	Regulatory Quality	Tax Compliance	Tax Policy
Public Trust				
Regulatory Quality	0.4489			
Tax Compliance	0.636	0.7564		
Tax Policy	0.6876	0.4241	0.5767	

The heterotrait-monotrait (HTMT) ratios suggest that discriminant validity has been achieved within the four constructs-Public Trust, Regulatory Quality, Tax Compliance and Tax Policy. All HTMT values are significantly below the conservative limit of 0.85 indicating that all constructs are empirically unique. The highest values of HTMT between Public Trust and Tax Policy (0.6876) and between Regulatory Quality and Tax Compliance (0.7564) are not in the acceptable range; however, they are not very high. These results prove that there is no problem of multicollinearity or conceptual redundancy and the constructs exhibit adequate discriminant validity in the measurement model**.**

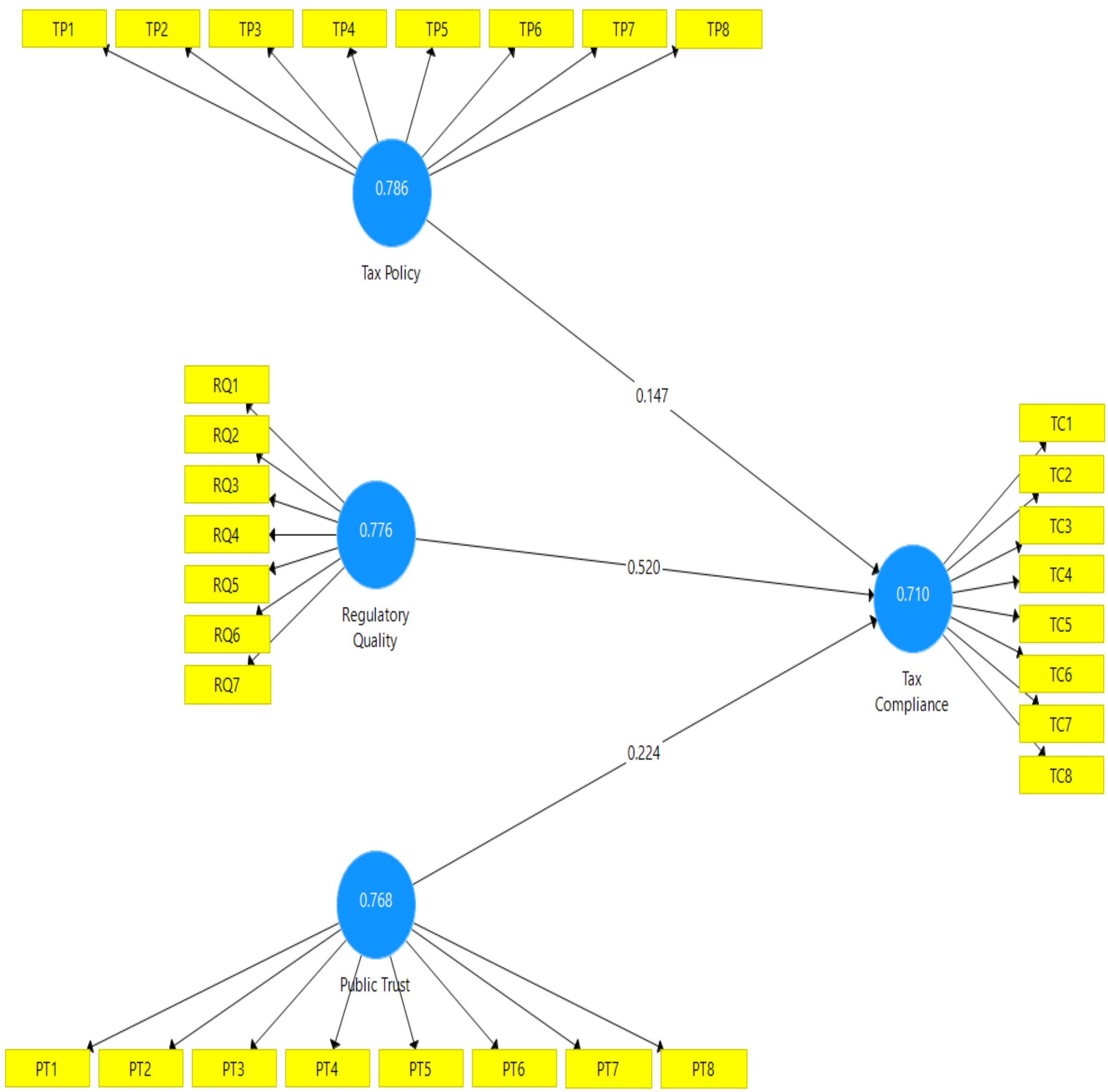

Figure 4.1: Measurement Model

4.3 Structural Equational Model

Table 4.3: Structural Equational Model

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (|O/STDEV|)	P Values
Public Trust -> Tax Compliance	0.2236	0.2255	0.0311	7.1975	0.000
Regulatory Quality -> Tax Compliance	0.5204	0.5205	0.0333	15.6111	0.000
Tax Policy -> Tax Compliance	0.1469	0.1469	0.0335	4.3824	0.000

The structural equation model (SEM) analysis shows that all the explanatory variables Public Trust, Regulatory Quality, and Tax Policy have a significant positive impact on Tax Compliance in the tax system under analysis. Among the three predictors, the Regulatory Quality has the greatest impact with a path coefficient of 0.5204 and a t-statistic of 15.6111 ($p < 0.001$), denoting an especially strong and highly significant relationship. There is also a significant positive correlation between Tax Compliance and Public Trust, with the coefficient of 0.2236 and t-statistic of 7.1975 ($p < 0.001$). The Tax Policy also has an effect on the Tax Compliance, albeit minor as indicated by a path coefficient of 0.1469 and a t-statistic of 4.3824 ($p < 0.001$). These relationships are statistically significant as evidenced by the uniformly low p-values of the model (all < 0.001).

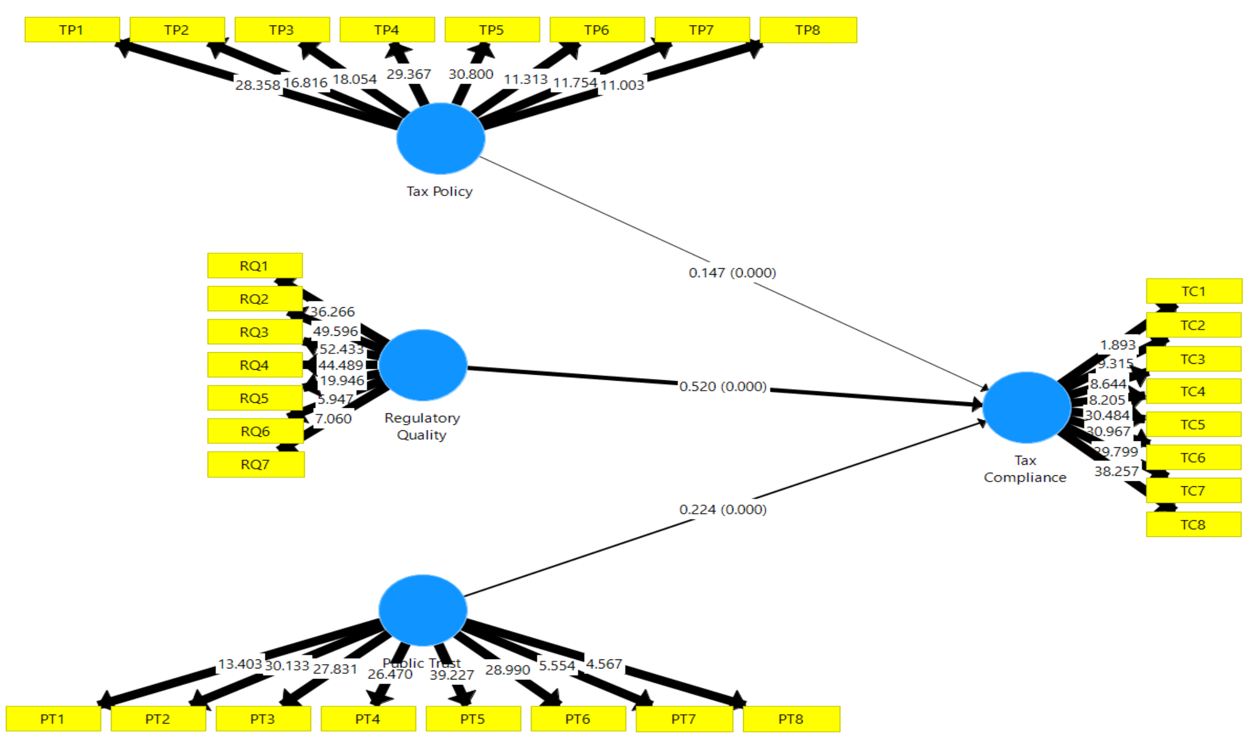

Figure 4.2 Structural Equational Model

5.0 Discussion and Conclusion

The current research provides a solid empirical support to the theoretical hypotheses that institutional factors breed tax compliance in Pakistan informal sector. The results reveal that the clarity of tax policy and the quality of regulations have significant positive effects on the tax-compliant attitude of the informal entrepreneurs. These findings are in line with the slippery slope model that assumes that voluntary tax compliance is raised when taxpayers feel that the rules are clear, consistent and applied fairly. Institutional cues take on greater significance in those situations where formal enforcement is weak or sporadic. Clarity of tax policy decreases cognitive loads, lowers ambiguity, and supports the sense of fairness, all of which leads to more compliant attitudes. The quality of regulation, as evidenced by transparent procedures, low levels of corruption, and enforceability predictability, is a sign of competence of the state, and reinforces the belief that the tax system is fair and trustworthy.

Another notable addition of the research is the mediating effect of the trust in institutions. The findings show that the relationships between both clarity of tax policy and quality of regulation and the tax compliance behavior are largely mediated by public trust. Institutional trust therefore provides a psychological pathway through which structural and administrative characteristics of governance become behavioral. Tax policies or regulations of high quality will lead to more compliance only in case they also increase the trust in the state. When the informal business owners feel that the tax laws are being enforced in a fair manner, the revenue is being spent wisely and the government institutions are acting in the best interest of the people, they will tend to pay tax voluntarily. Trust therefore does not appear as a side effect or an epiphenomenon but as a core process through which institutional credibility is transformed into behavioral change.

The relevance of the study in the Pakistani contexts is enhanced by the ubiquitous experience of tax evasion and the often-week relationships between the government and the people. The positive correlation between the quality of the institutions and the tax compliance behavior is a more sustainable solution to the purely punitive measures that have failed in the past to bring the informal sector into the tax net. It becomes clear that the most effective and less confrontational way to increased compliance is to enhance trust and communication between the state and its citizens. Instead of enforcing tax using enforcement mechanisms, i.e. audits and penalties, which is in most cases impossible in informal contexts, governments can do better by streamlining tax policies, guaranteeing regulatory consistency and building trust through accountability and transparency.

The literature is also enhanced by the study as it empirically tests a structural model that combines both structural and behavioral aspects of tax compliance in a developing country. It builds upon prior studies by addressing the informal enterprises, a group that is perennially underserved by research although it contributes to an economy. The application of PLS-SEM allows a subtle analysis of direct and indirect correlations between variables. The results validate the fact that institutional context plays an important role in determining the behavior of taxpayers and that voluntary compliance cannot be separated with the quality of governance. They also point out the interactional character of the institutional variables: clarity and quality will determine trust;

trust will then strengthen or weaken the effects of the institutional variables on compliance.

Considering these findings, a number of conclusions can be made. Institutional design and administrative behavior are first in the list of issues when it comes to enhancing the tax compliance in informal economies. Making tax law simpler, making it understandable, and keeping it applied in the same manner can result in significant increases in compliance rates. Second, the trust in institutions is not simply a product of good governance but a mediator that influences the reaction of citizens to policy actions. Third, any approach to the integration of the informal sector into the tax system should be more than coercive and punitive, including behavioral insights and institutional reforms that enhance legitimacy, equity, and procedural justice. Not only is this a more effective method but it is also more in line with democratic governance and the aims of sustainable development.

In line with this, some suggestions to the policymakers and tax authorities in Pakistan are provided. The government must focus on the simplification and communication of tax policies that are specifically designed to the informal sector- translating tax guidelines into local languages, using culturally appropriate channels of communication and making advisory services to micro and small businesses cheap or free. It should also be aimed at enhancing the quality of regulation through eliminating bureaucracy, increasing transparency in the application of rules, and limiting discretionary authority that usually encourages rent-seeking behavior. Government accountability such as participatory budgeting, tracking of government spending and transparent reporting of tax revenue should be visible and consistent to show the citizens that their taxes are being utilized effectively and thus building trust and encouraging voluntary compliance.

In practice, the paper provides strong reasons to reconsider the tax administration approaches in the situations of informality and low trust in institutions. It questions the hegemony of the models of deterrence by introducing a model based on the institutional theory and behavioral economics. In the eyes of international development agencies and fiscal reform activists, the results point to the significance of institutional capacity-building and civic participation in tax reform efforts. They also suggest that taxation, which is commonly considered a technical or administrative field, is relational and political in its nature and the dynamics of trust, legitimacy, and reciprocity are complex. Tax reforms in the future should thus be comprehensive, combining legal, administrative and social measures that will promote a culture of taxation based on cooperation and not confrontation.

The study is academically relevant to an emerging literature that aims to comprehend taxpayer behavior that is not limited by the enforcement and evasion perspectives. Focusing on informal entrepreneurs in Pakistan expands the study of tax compliance to a broader context and lays an empirical basis of study in similar developing countries context, which encourages interdisciplinary research between public finance, governance, behavioral science, and development studies. With nations like Pakistan trying to increase fiscal capacity and decrease reliance on foreign debt, the understanding of the institutional and psychological triggers of tax compliance becomes not just an academic pursuit, but a matter of urgent policy concern as well.

Asim Rasheed: Problem Identification and Theoretical Framework
Amad Rashid: Data Analysis, Supervision and Drafting

Fahmeed Idrees: Methodology and Revision

Conflict of Interests/Disclosures

The authors declared no potential conflicts of interest in this article's research, authorship,and publication.

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