

Taxation Base in Developing Countries*

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Abstract: One of the principal challenges of tax reform in developing countries is to enlarge the taxation base. Major inroad could be made if currently informal enterprises could be encouraged to join the formal economy. Unlike in rich countries where informality is largely a result of the tax burden, the informal economy in developing countries is largely a result of high fixed costs of entry into the formal sector. The tax burden is lower in developing countries and the barriers to entry into the formal economy are higher. We show that raising barriers to entry is consistent with a deliberate government policy which aims to maximize state revenue. Barriers to entry into the formal sector generate market power, and hence profits, for the permitted entrants. These profits can be readily confiscated by the government through entry fees and taxes. The relevance of the theory is assessed with a sample of 65 countries. Empirical analysis supports the results of the paper.

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