Why are Tax Rates High and Procyclical in Developing Economies?

Implications for Growth-Enhancing Tax Reforms

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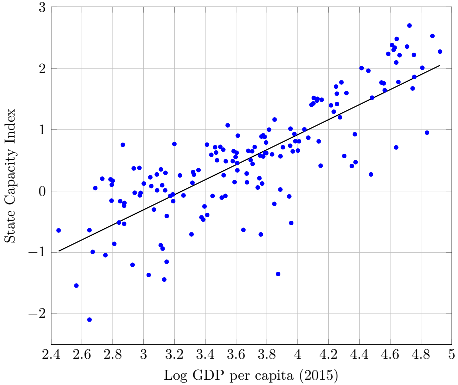
The Tax Policy Paradox in Developing Economies

Two puzzling facts that constrain growth:

1. **Higher tax rates in poorer countries**
   - Low-income countries: 28% corporate tax rate (average 2020-2022)
   - High-income countries: 21% corporate tax rate
   - Opposite of what growth-oriented policy would suggest
2. **Tax rates rise during downturns**
   - Amplifies recessions instead of stabilizing the economy
   - Most severe in countries with weakest administrative capacity

Key insight: Both phenomena stem from limited *state capacity*—the ability to effectively collect taxes. This creates a fiscal trap that hinders growth.

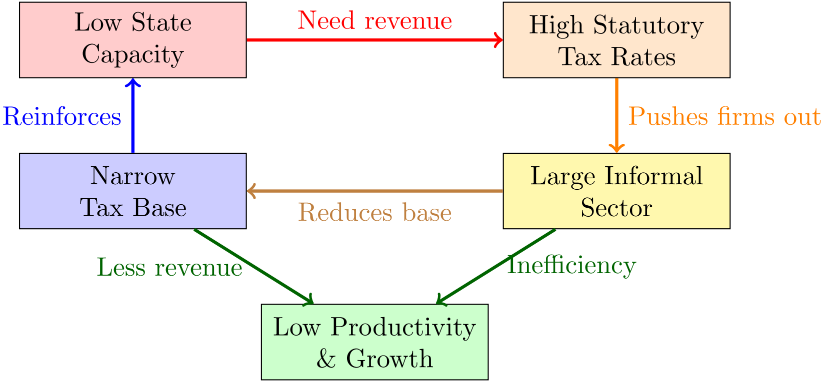
State Capacity: The Missing Link



State capacity encompasses:

- Tax administration technology and information systems
- Ability to identify and monitor taxpayers
- Enforcement capability and technical expertise

How Low Capacity Creates a Growth Trap



Growth impact: Firms operate below their productive potential in informal sector, missing benefits of formality (credit access, contract enforcement, technology adoption).

The Procyclicality Problem: Amplifying Recessions

During economic downturns in low-capacity countries:

1. Economic activity falls → Tax base contracts
2. Government must maintain basic services (debt payments, salaries, essential functions)
3. **Only option:** Raise tax rates to maintain revenue
4. Higher rates push more firms informal → Further base contraction
5. **Result:** Tax policy amplifies the recession instead of stabilizing it

Key Finding

This procyclicality is **more severe** the lower is state capacity. The countries that can least afford procyclical policy are precisely those forced into it.

In contrast: High-capacity countries maintain stable rates through recessions, using debt markets and broader tax bases to smooth fiscal policy.

Policy Implications: Breaking the Trap

The challenge: How to move from a bad equilibrium (high rates, low capacity, low growth) to a good one (moderate rates, high capacity, high growth)?

Three complementary reform pillars:

1. **Invest in state capacity**
    - Short-term costs but long-term gains
    - Requires political commitment beyond electoral cycles
2. **Broaden the tax base**
    - Reduce informality through formalization incentives
    - Brings productive firms into formal sector
3. **Build countercyclical fiscal buffers**
    - Stabilization funds for downturns
    - Reduces need for procyclical tax increases

Critical insight: These reforms must be pursued *jointly*—isolated reforms may fail.

Reform Pillar 1: Investing in State Capacity

Concrete actions:

- **Digitalization and technology:**
  - Electronic invoicing systems (e.g., Chile, Colombia)
  - Integrated tax administration platforms
  - Data analytics for risk assessment and compliance monitoring
- **Human capital development:**
  - Professional training for tax officials
  - Competitive compensation to reduce corruption
  - Institutional memory and expertise accumulation
- **Information infrastructure:**
  - Third-party reporting systems
  - Cross-referencing of tax and financial data
  - Property and asset registries

Challenge: Upfront investment costs and political time horizons—benefits accrue beyond electoral cycles.

Solution: International support (IDB, IMF, OECD) can help finance capacity building and provide technical assistance.

Reform Pillar 2: Broadening the Tax Base

Reducing informality—the dual benefit:

1. **Revenue gains:** More firms paying taxes
2. **Productivity gains:** Firms access formal sector benefits
    - Credit markets and financial services
    - Legal protection and contract enforcement
    - Technology adoption and business partnerships
    - Skilled labor recruitment

Policy instruments:

- Lower marginal tax rates for small businesses
- Reduction of bureaucratic registration barriers
- Improved access to government contracts and programs for formal firms

Key insight from model: As capacity improves and rates fall, formalization becomes self-reinforcing—lower rates attract more firms, expanding the base, enabling even lower rates.

Reform Pillar 3: Building Fiscal Buffers

The procyclicality problem requires fiscal tools:

- **Stabilization funds:**
  - Save during booms to spend during downturns
  - Examples: Chile's copper fund, Norway's sovereign wealth fund
  - Requires fiscal rules and political commitment
- **Contingent credit lines:**
  - Pre-arranged financing for emergencies
  - IMF Flexible Credit Line, regional development banks
  - Provides fiscal space without procyclical adjustments
- **Revenue diversification:**
  - Reduce dependence on volatile revenue sources
  - Balance between consumption, income, and property taxes
  - Natural resource revenues $\rightarrow$ stabilization accounts

Political economy challenge: Governments face pressure to spend windfalls during booms—strong institutions and fiscal rules are essential.

Why Reforms Fail: The Political Economy Trap

Our dynamic model reveals why low-capacity countries stay trapped:

1. **Short political time horizons:**
   - Capacity investments pay off beyond electoral cycles
   - Political instability reduces incentives to invest
   - Immediate costs vs. delayed benefits
2. **High reform costs:**
   - Entrenched interests benefit from weak enforcement
   - Wealthy elites can evade; connected firms get exemptions
   - Corruption within tax administration resists change
3. **Coordination failures:**
   - Need simultaneous reforms (capacity + base + buffers)
   - Partial reforms may fail or be politically unsustainable
   - "Chicken and egg" problem

Breaking the trap requires: External support (technical + financial), broad political coalitions, and credible commitment mechanisms.