AUTHOR OR EDITOR
Andrés Felipe García-Suaza
Fernando Jaramillo
Marlon Salazar

Publication Date:
Tuesday, 04 July 2023

Abstract

Developing countries have a vast informal sector generally associated with low productivity levels. The response of informal employment to tax policies might depend on labor market rigidities. This paper proposes a theoretical framework consisting of a search and matching model with segmentation in the labor market to understand how tax policies and enforcement interact to determine the size of the formal sector. The analytical results show that decreasing payroll taxes increases formal employment demand, and enforcement expenditure decreases informal employment offers. The model suggests that a tax policy combination leads to a significant impact on informality reduction. Moreover, the magnitude of the effect of tax policies depends on real wage rigidities, i.e., when the economy faces high real wage rigidities, the tax policies have a higher effect on informality reduction.