Taxation and Informality

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Abstract

This paper studies an optimal non-linear tax problem in the presence of informality. Empirical evidence suggests that informality is costly and this cost increases in the worker’s skill. I show that, in this case, it is possible to improve welfare by limiting access to the formal sector. I also consider a framework in which workers of the same skill may face different costs. I derive a modified Mirrlees Formula for an optimal non-linear income tax schedule in the presence of informality that accounts for the effects of this additional heterogeneity. I prove that, in this richer model, the second best requires positive sales taxes. This demonstrates that Atkinson-Stiglitz theorem fails when workers can become informal.

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