Optimal Taxation in an Informal Economy

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Economics of Informality - Universidad del Rosario

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Introduction

Goals:

- Identify optimal tax policy with imperfect enforcement (informality).
  - Develop occupational choice model
  - Two dimensions of informality: informal workers and profit evasion
- Quantify welfare gains from implementing such a policy.
  - Solve decentralized version of model and calibrate it to the Peruvian economy with actual tax system.
  - Solve planner's problem to identify maximum welfare gains from optimal tax policy.

Outline

1. Data & Institutional Framework of Peru
2. Model
3. Next steps

Data & Institutional Framework of Peru

- SUNAT (Tax administration) administrative records.
  - Tax reports of all formal firms (2010-2017).
  - Revenue, costs, profits, employees, taxes payed.
- Economic Census (2008).
  - Information of all (formal and informal) establishments.
  - All sectors except agriculture, mining, public administration, defense, and economic activities not performed in fixed establishments.
  - Taxes payed, prices and quantities sold, payroll, financial statements, among others.
- Household Survey (ENAHO).
  - Standard household survey. Demographics, income and expenses, education.
  - Work characteristcs. (in)formal job, characteristics of work place (number of workers, formal firm).

Data & Institutional Framework of Peru

- Peruvian economy is characterized by high levels of informality
  - 70% of workers are informal (ENAHO)
  - 40% of businesses are not registered (Economic Census, 2008)
- Five different tax regimes for businesses
  - RUS: 2 categories (5 until 2017). Monthly fixed payments of (6USD-19USD), for firms with annual sales under (19,000USD).
  - RER: Revenue tax of 1.5% for firms with annual sales under (165,000USD).
  - MYPE (Since 2017): Firms with annual sales under 200,000USD $\rightarrow$ Progressive marginal tax rates on profits up to 29.5%.
  - General regime
    - Corporate profit tax rate 29.5%.
    - 20+ employees $\rightarrow$ distribute between 5%-10% of after tax profits with workers.

Data & Institutional Framework - Peru

We restrict our sample to Lima Metropolitan region to have a homogenous urban sample.

Table: Share of establishments/workers/capital/Value Added/taxes/informality by firm size (Economic Census)

Employees	Establishments	Employees	Capital	Value Added	Taxes	Informal
$[0-5]$	0.9	0.3	0.06	0.11	0.16	0.97
$[6-10]$	0.05	0.07	0.04	0.05	0.01	0.02
$[11-50]$	0.04	0.13	0.13	0.17	0.09	0.01
[50+],	0.01	0.5	0.77	0.68	0.75	0

- Most firms are small and informal.
- Large firms are less prevalent. Explain large proportin of tax payment, value added, capital and employment.

Data & Institutional Framework - Peru

Table: Distribution of occupational categories and informality (ENAHO-2008)

	% in labor force	% who are informal
Employee	59.38	53.46
Employer	5.81	75.91
Non-remunerated	6.30	100.00
Other	0.14	100.00
Self-employed	28.36	92.38
Total	100.00	68.80

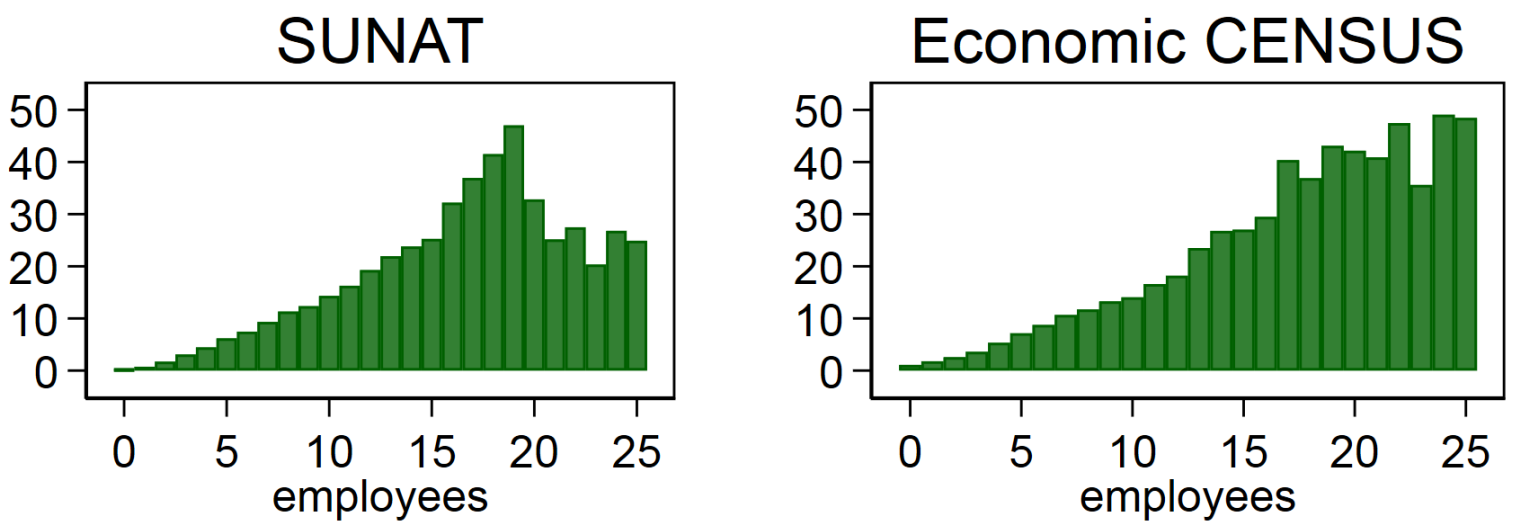
- Majority of workers are employees. $\approx$ evenly distributed between informality and formality.
- Other occupational categories are largely informal.

Data & Institutional Framework - Peru

Tax regulation reveals firm behavior revealing information to identify parameters of the economic model.

- Firms with 20+ employees distribute 5%-10% of profits with workers.

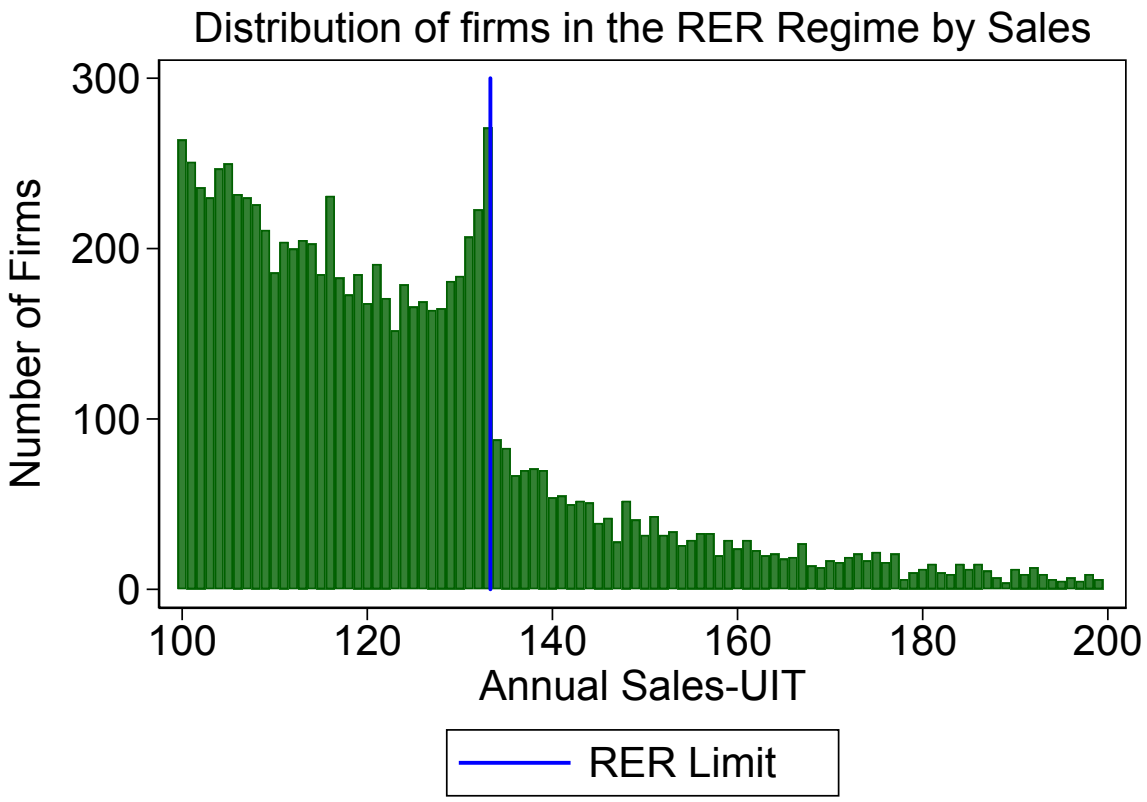
  Median annual profits by number of employees (thousands of USD)



- Discontinuity in reported profits to tax administration but not in Census. Evidence suggestive of tax evasion. Distribution by size

Data & Institutional Framework - Peru

- Firms with annual sales under 133 UIT ($525,000 S/; $ US160,000) are eligible for the RER scheme.
- Firms pay 1.5% tax on revenue rather than 29% on profits



Data & Institutional Framework - Peru

- Firms can adapt to changes in tax rates by constraining size or evading.
- Smaller firms are more prevalent, more likely to be informal (evade taxes), less productive.
- Majority of self-employed or employers are informal.
- Employees $\approx$ evenly distributed between informality and formality. In large firms, less likely to be informal.

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Primitives

- Continuum of individuals characterized by entrepreneurial and working skills $\Theta = [\theta_e, \theta_w]$ and a government
- Individuals choose work for a wage or become entrepreneurs
- Workers: Maximize consumption subject to budget constraint
  - Chose working in formal and informal market (no personal income taxes).
  - Costly to provide work, costlier if informal
- Entrepreneurs: Maximize profits chosing number of formal and informal workers, and evasion levels.
  - Informal workers $\rightarrow$ no payroll taxes. Convex hiring costs.
  - Evasion $\rightarrow$ no corporate profit taxes. Convex costs of evasion.
- Government: raise taxes to pay for transfers and expenses.
  - Trades off efficiency and redistribution
  - Information frictions: informality and tax evasion

Worker's problem

$$V(\theta_w \mid w_f, w_l) = \max_{l_f, l_i} \theta_w \left(w_f l_f + w_i l_i\right) - \chi \frac{\left(l_f + l_i\right)^{1+\psi}}{1+\psi} - \frac{\kappa \left(\theta_w l_i\right)^{1+\rho}}{1+\rho} - T\left(\theta_w w_f l_f\right)$$

- Formal and informal labor income
- Disutility from working
- Penalty from informal income
- Personal Income tax

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Entrepreneurs

Operating profits $\pi(\theta_e, n_i, n_f)$:

$$\pi(\theta_e, n_i, n_f) = \theta_e(n_i + n_f)^{\alpha} - w_i n_i - w_f n_f - T_n(n_f)$$

Total Profits

$$\Pi(\theta_e) = \max_{n_f, n_i, z} \pi(\theta_e, n_i, n_f) - T_c\big(\pi(\theta_e, n_i, n_f) - z\big)$$

$$- \frac{\delta}{1+\gamma} n_i^{1+\gamma} - \frac{\beta}{1+\sigma} z^{1+\sigma}$$

- Total production
- Formal and informal labor cost
- Payroll taxes
- Corporate profit taxes
- Reported profits. Z $\rightarrow$ evasion
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Allocations

An alloation in this economy is defined by:

$$\{c(\theta), i(\theta), l_f(\theta), l_i(\theta), n_f(\theta), n_i(\theta), z(\theta)\}_{\theta \in \Theta}.$$

- Consumption
- Entreprenurial decision
- Formal and informal labor supply
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- Evasion levels

Allocation is feasible if clears the three markets. Details

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Equilibrium

An equilibrium with taxes consist of an allocation and wagea w_f, w_i such that

- $i(\theta) = 1$ whenever $\Pi(\theta_e) > W(\theta_w)$
- If $i(\theta) = 1$, the allocation for θ solves entrepreneur's problem, given taxes and prices.
- If $i(\theta) = 0$, the allocation for θ solves worker's problem, given taxes and prices.
- The allocation is feasible.
- The government budget is balanced

$$G = \int_{\Theta} \left\{ \left(T_c\left(\pi(\theta_e)\right) + T_n\left(w n_f(\theta_e)\right) \right) i(\theta) + T_p\left(w\theta_w l\left(\theta\right)\right)\left(1 - i\left(\theta\right)\right) \right\} dF\left(\theta\right)$$

Planner's problem

Find **implementable** allocations to maximize a social welfare function:

$$\int_{\Theta} W\big(U(\theta)\big) f(\theta) d\theta$$

$$U(\theta) = c(\theta) - (1 - i(\theta)) \frac{\chi}{1+\psi} (l_i + l_f)^{1+\psi}$$

- **Implementable**: If there exists set of $T_n(.)$, $T_c()$, $T_p()$, w_f, w_i such that allocations + tax functions + wages $\rightarrow$ equilibrium.
- Planner proposes allocation but does not observe informality n_i, l_i nor tax evasion z_i. Should satisfy incentive compatibility constraint.
- Once optimal allocations found, back-up tax functions to solve for optimal tax policy. Details

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1 Data & Institutional Framework of Peru

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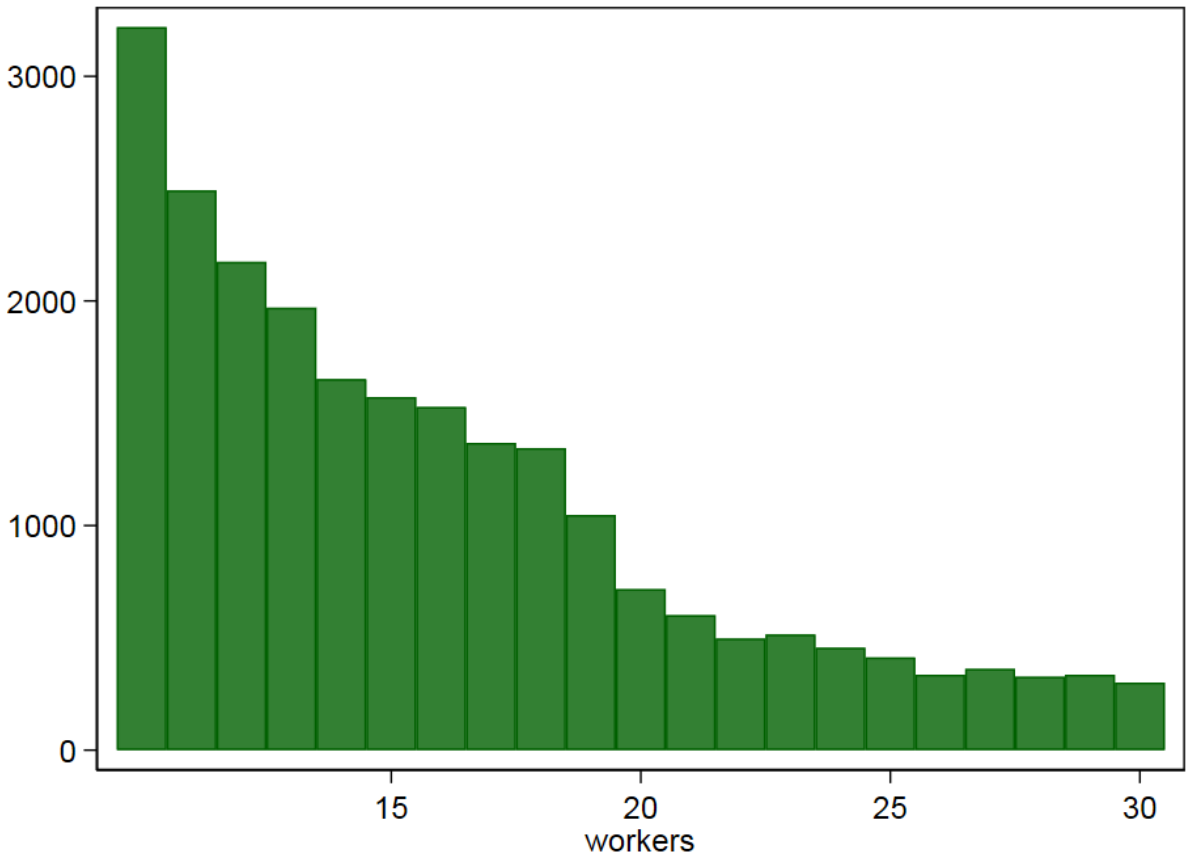
Next steps

- Find set of parameters ϕ to minimize distance between empirical and theoretical moments in the descentralized economy.
  - Find $\hat{\phi} \in \arg\min_{\phi} Q(m - \hat{m}(\phi))$
  - m Vector of empirical moments
  - $\hat{m}(\phi)$ vector of model-moments
  - Informality costs: distribution of informal workers.
  - Discontinuities in reported profits and differences in reports to tax administration and economic census.
- With $\hat{\phi}$ compare welfare in descentralized economy and optimal tax policy.
- Characterization of optimal policy and quantify how much can be gained from implementing it.

Appendix

Distribution of firms by size



Back

Feasible allocation

$$\int_{\Theta} c(\theta)\, dF(\theta) + G =$$

$$\int_{\Theta} \left\{ \left[\theta_e q\left(n\left(\theta_e\right)\right) - k_n\left(n_i(\theta_e)\right) - k_c\left(z(\theta_e)\right) \right] i(\theta) - k_l\left(\theta_w l_i(\theta_w)\right)\left(1 - i(\theta)\right) \right\} dF(\theta) \quad (1)$$

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- Goods (G: Government expenses)
- Formal labor
- Informa labor

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Details of Planner problem

- Planner's proposed allocation constitutes a direct mechanism
- Individual of type θ must weakly prefer proposed allocation to any alternative
- Information frictions: observable choices are formal labor supply, demand, and reported profits.
- Workers hide informal labor, entrepreneurs evade profits and hide part of their labor force.
- Mechanism prescribing $\hat{l}_i, \hat{l}_f$ to individual who is worker of type θ must satisfy

$$\hat{l}_i \in \arg max_{l_i} w_i \theta_w l_i - \frac{\chi}{1+\psi}\left(\hat{l}_f + l_i\right)^{1+\psi} - \kappa\frac{(\theta_w l_i)^{1+\rho}}{1+\rho}$$

- Similarly, prescribing $\hat{n}_f, \hat{n}_i, \hat{z}$ for type θ, should satisfy that $\hat{n}_i, \hat{z}$ solve entrepreneur's problem given $\hat{n}_f$

Back

- Prescribe $n_f(\theta'), n_i(\theta'), z(\theta')$.
- Planner observes formal labor demand $n_f(\theta')$ and reported sales $\theta_e \left(n_f(\theta') + n_i(\theta')\right)^{\alpha} - z(\theta')$
- For a given level of informal labor demand $\check{n}_i$, the corresponding level of profit hiding ins

$$\check{z}(\check{n}_i, \theta'; \theta) = z(\theta') - \theta_e \left(n_f(\theta') + n_i(\theta')\right)^{\alpha} + \theta_e \left(n_f(\theta') + \check{n}_i\right)^{\alpha}$$

- Problem of agent type θ pretending to be type θ' is

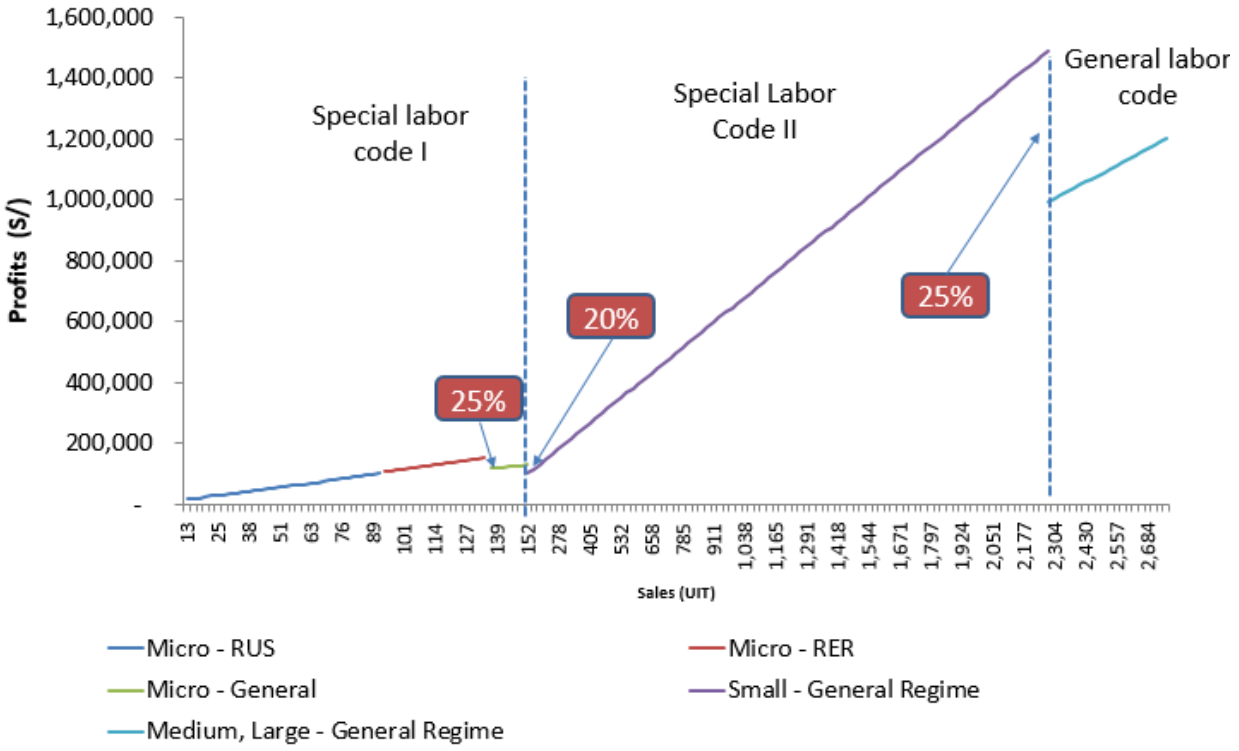
$$\check{\Pi}(\theta'; \theta) = \max_{\check{n}_i} \theta \left(n_f(\theta') + \check{n}_i\right)^{\alpha} - w_i \check{n}_i - \frac{\delta \check{n}_i^{1+\gamma}}{1+\gamma} - \beta \frac{\check{z}(\check{n}_i, \theta'; \theta)^{1+\sigma}}{1+\sigma}$$

- Informal labor demand prescribed to type θ should solve this problem.

Back

Data Analysis – Some evidence from Peru

Predicted Profits of Firm according to Labor and Tax Regime



1 UIT=3,950 S/. 1 S/=0.31 US$

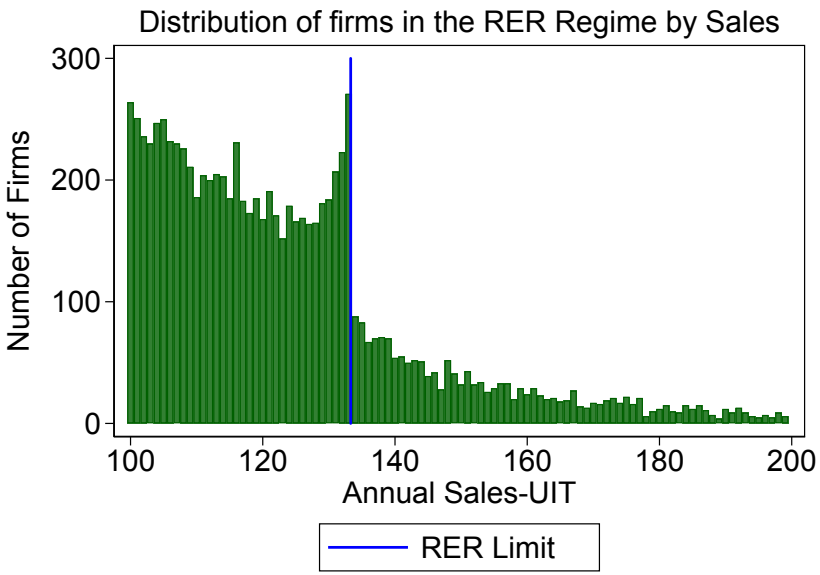
Firms with ≥ 20 workers distribute between 5%-10% of profits with workers.

Elegibility for RER regime also includes having < 10 workers

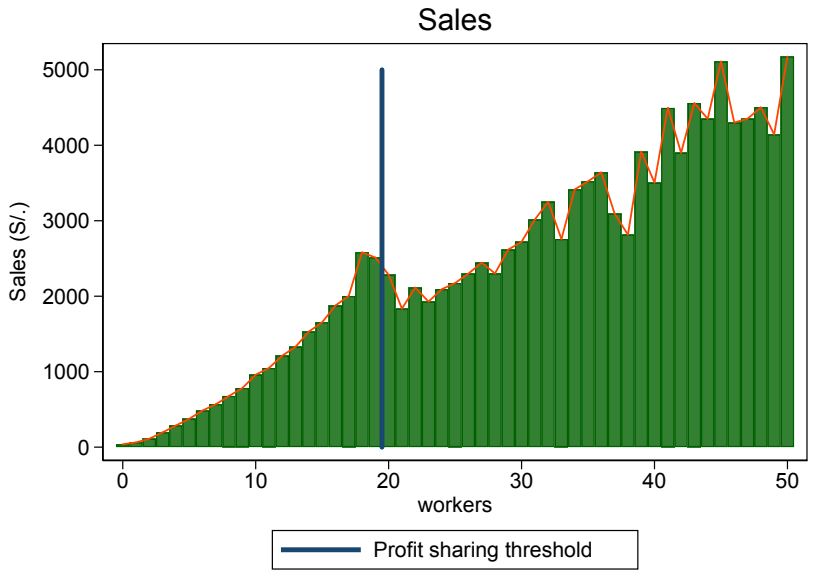
Details MYPE regime Back

Data Analysis – Some Evidence from Peru

Transition from "Régimen Especial de Impuesto a la Renta" (RER) to Régimen General (RG)



Firms with more than 20 are required to distribute between 5% to 10% of profits with their workers



RER: 1.5% tax rate on net income

General Regime: Tax rate of 28% on profits

Source: LMK, FMM joint work with SUNAT (2017) data

Distribution of Firms by sales
Distribution of Firms within RUS
Distribution of Firms by workers

MYPE regime

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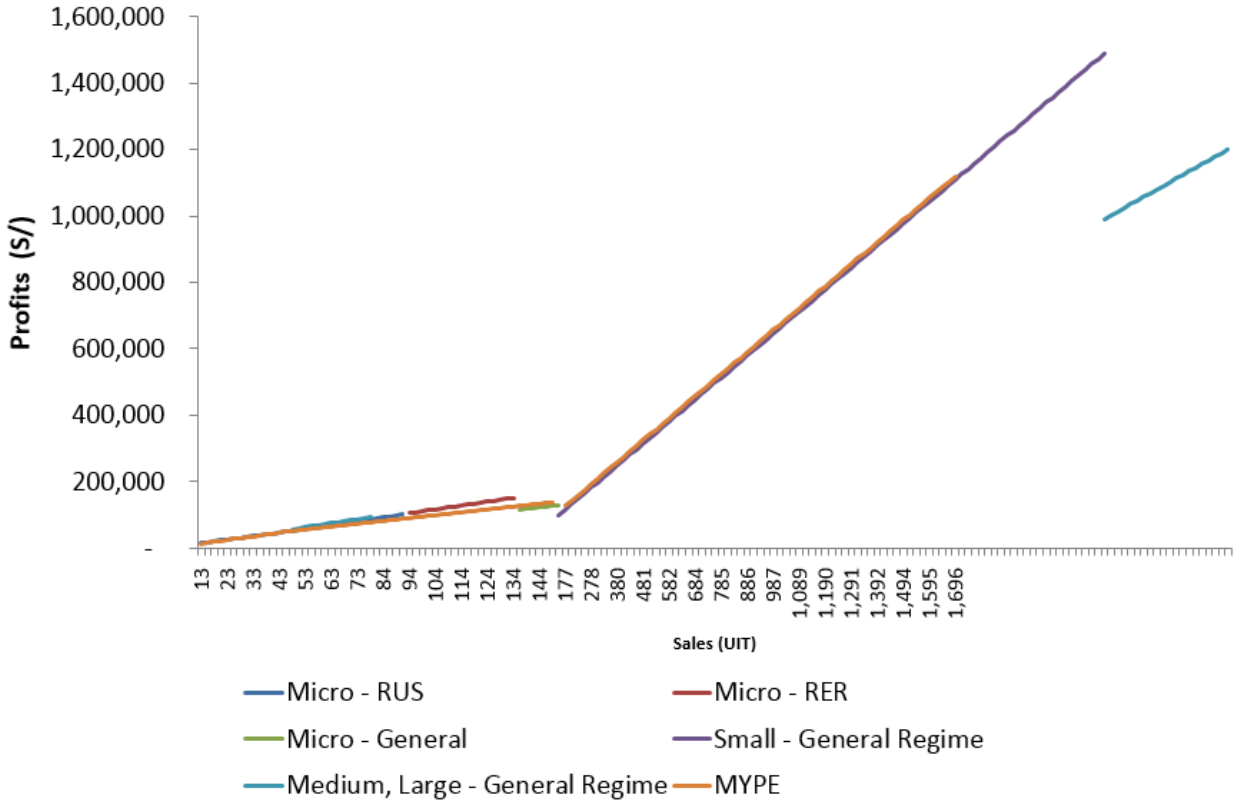

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MYPE: 10% corporate tax on first 15 UIT. 29% for each additional UIT beyond 15.

Back

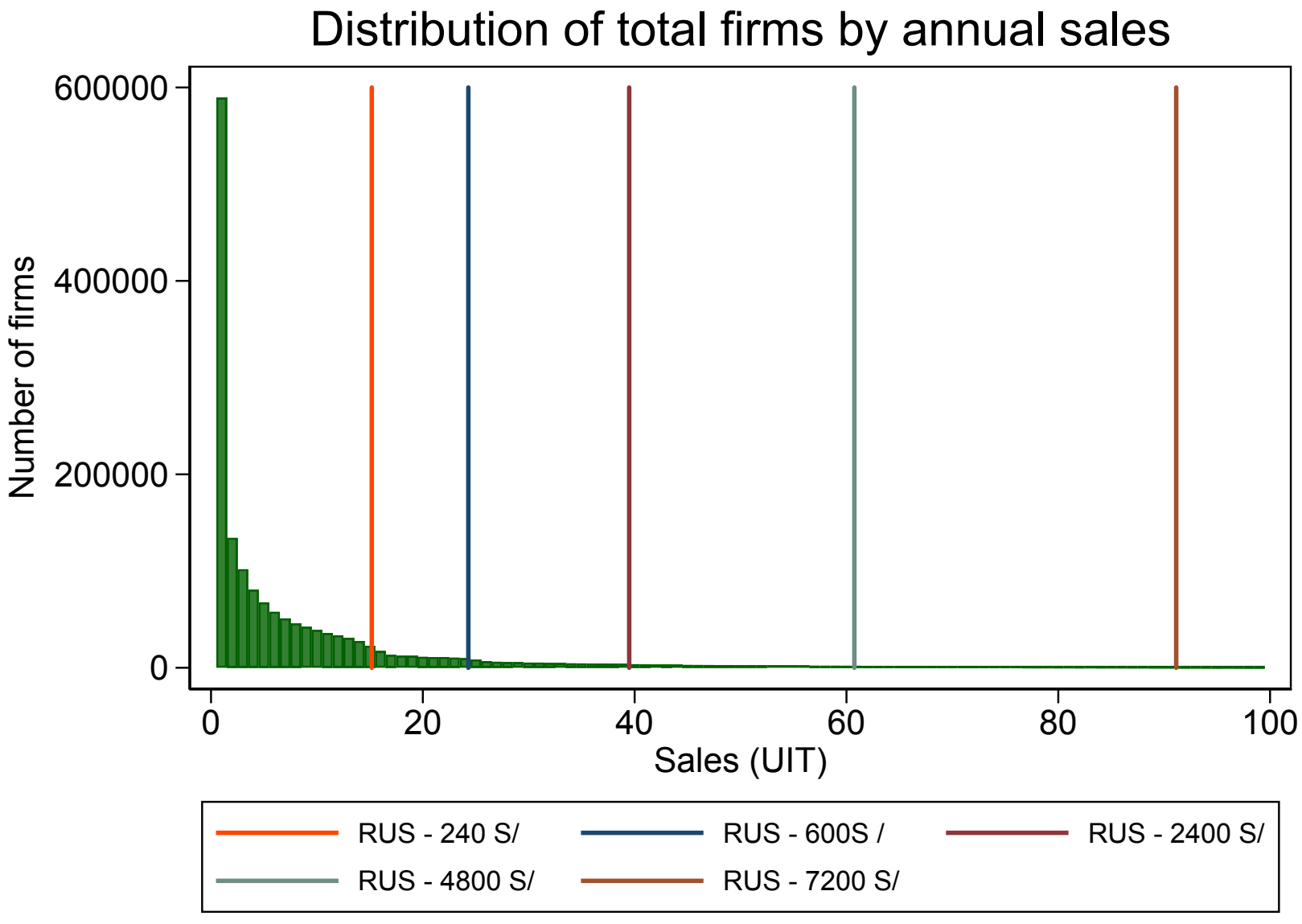
Special Tax Regime	Requirements	Income or Profit Tax
Régimen Único Simplificado (RUS)	Gross annual income < S/360,000 All activities should be done in only one establishment Assets value < S/. 70,000 Acquisitions of goods and services < S/. 360,000	Monthly payment depending on value of sales. From S./20 until S./600.
Régimen Especial Impuesto a la Renta (RER)	Net annual income < S/. 525,000 Assets </.s 126,000 Workers < 10	1.5% over net monthly incomes
Régimen General		29.5% tax rate over profits
Régimen MYPE*	Annual sales < 6'885,000	Profit tax rate of 10% until 10 UIT** Profit tax rate of 29.5% for each UIT exceeding 10 UIT**

*Regime introduced in 2017
** 1 UIT=4,050 in 2017

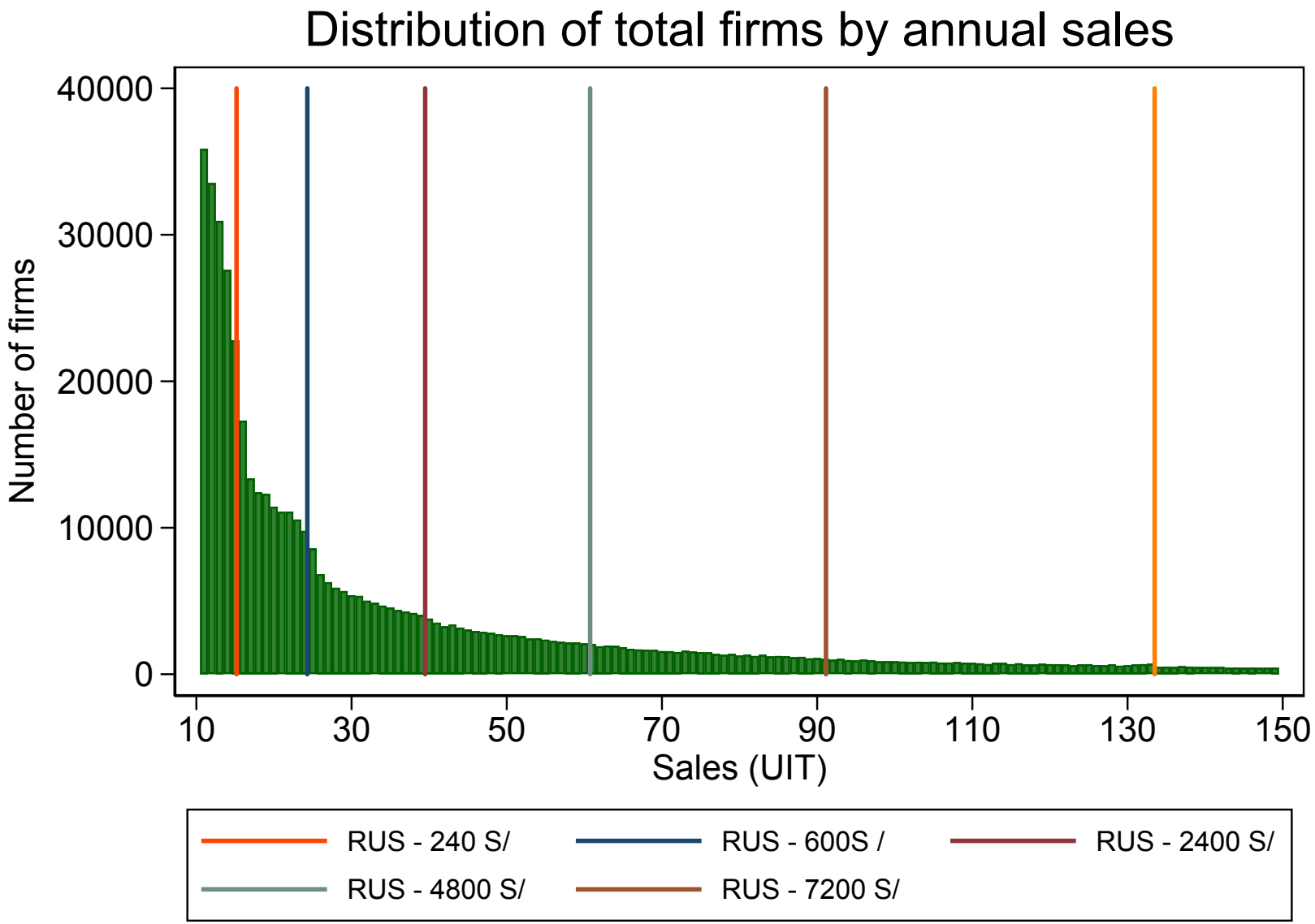
Back Details of Labor regimes

Concept / Regime	General	Pequeña	Micro
Holidays	30 calendar days	15 calendar days	15 calendar days
Extra-hours	Extra 35% 10:00pm - 6:00am	Extra 35% 10:00pm - 6:00am	No
Gratificaciones	Two extra wages a year	Two extra wages a year	No
Health Insurance	9% payed by employer	9% payed by employer	No
Firing cost	Up to one year of compensation	Up to 0.5 years of compensation	Up to 90 days of compensation
Asignacion Familiar	Yes	No	No

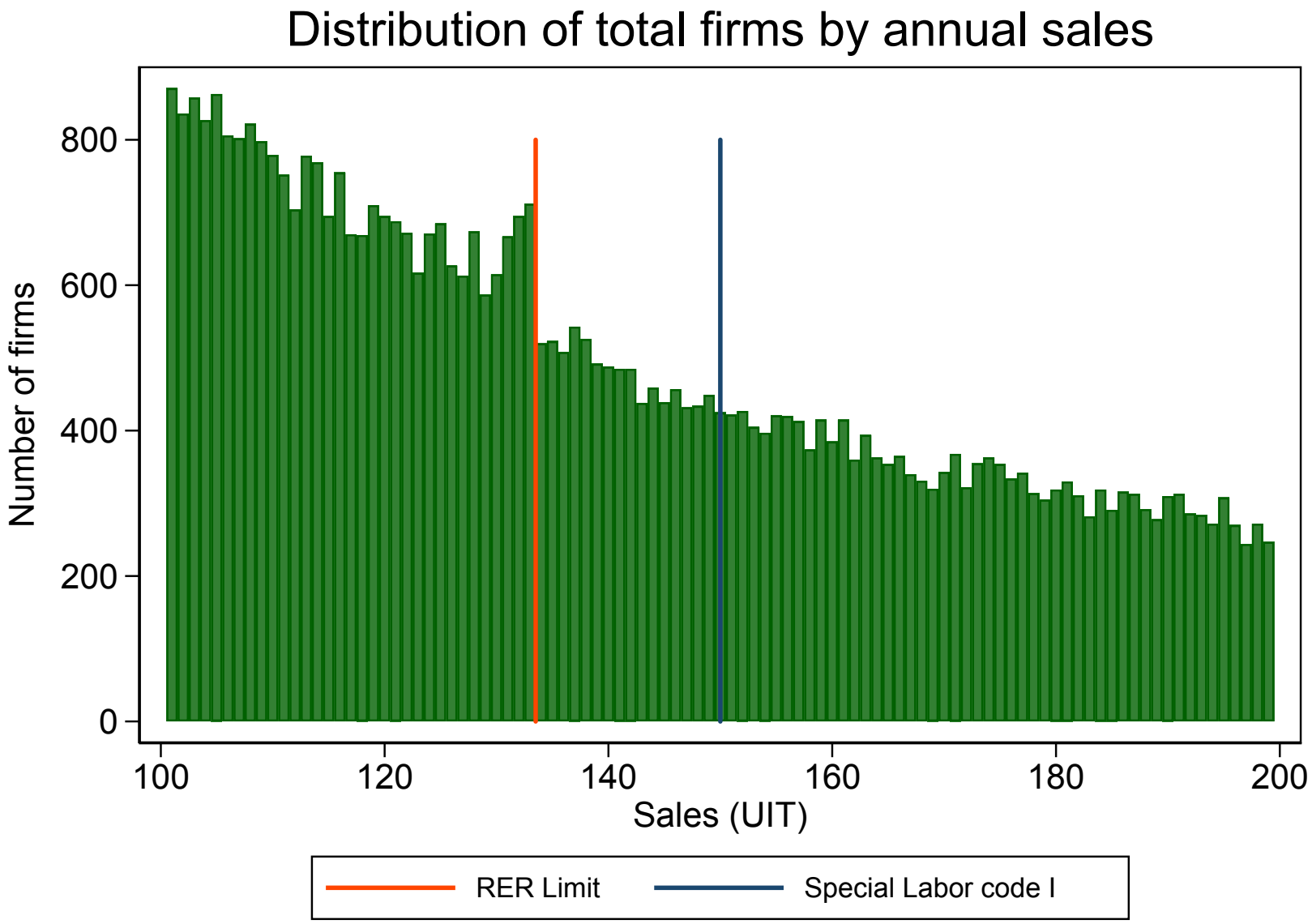
Back


Distribution of total firms by annual sales
Number of firms
600000
400000
200000
0
0
20
40
60
80
100
Sales (UIT)
RUS - 240 S/
RUS - 600S /
RUS - 2400 S/
RUS - 4800 S/
RUS - 7200 S/

Back


Distribution of total firms by annual sales
Number of firms
40000
30000
20000
10000
0
10
30
50
70
90
110
130
150
Sales (UIT)
RUS - 240 S/
RUS - 600S /
RUS - 2400 S/
RUS - 4800 S/
RUS - 7200 S/

Back


Distribution of total firms by annual sales
Number of firms
0
200
400
600
800
100
120
140
160
180
200
Sales (UIT)
RER Limit
Special Labor code I

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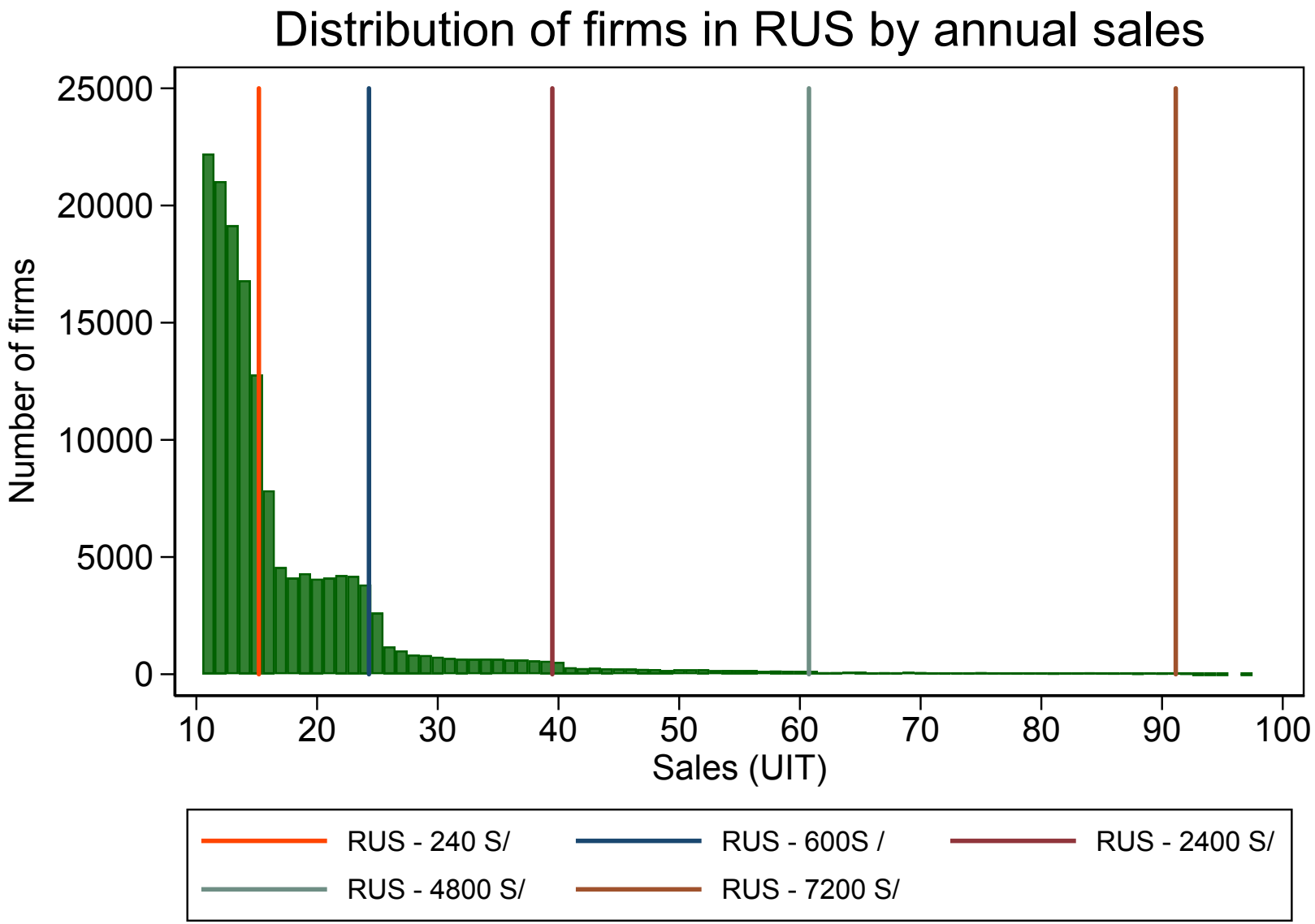
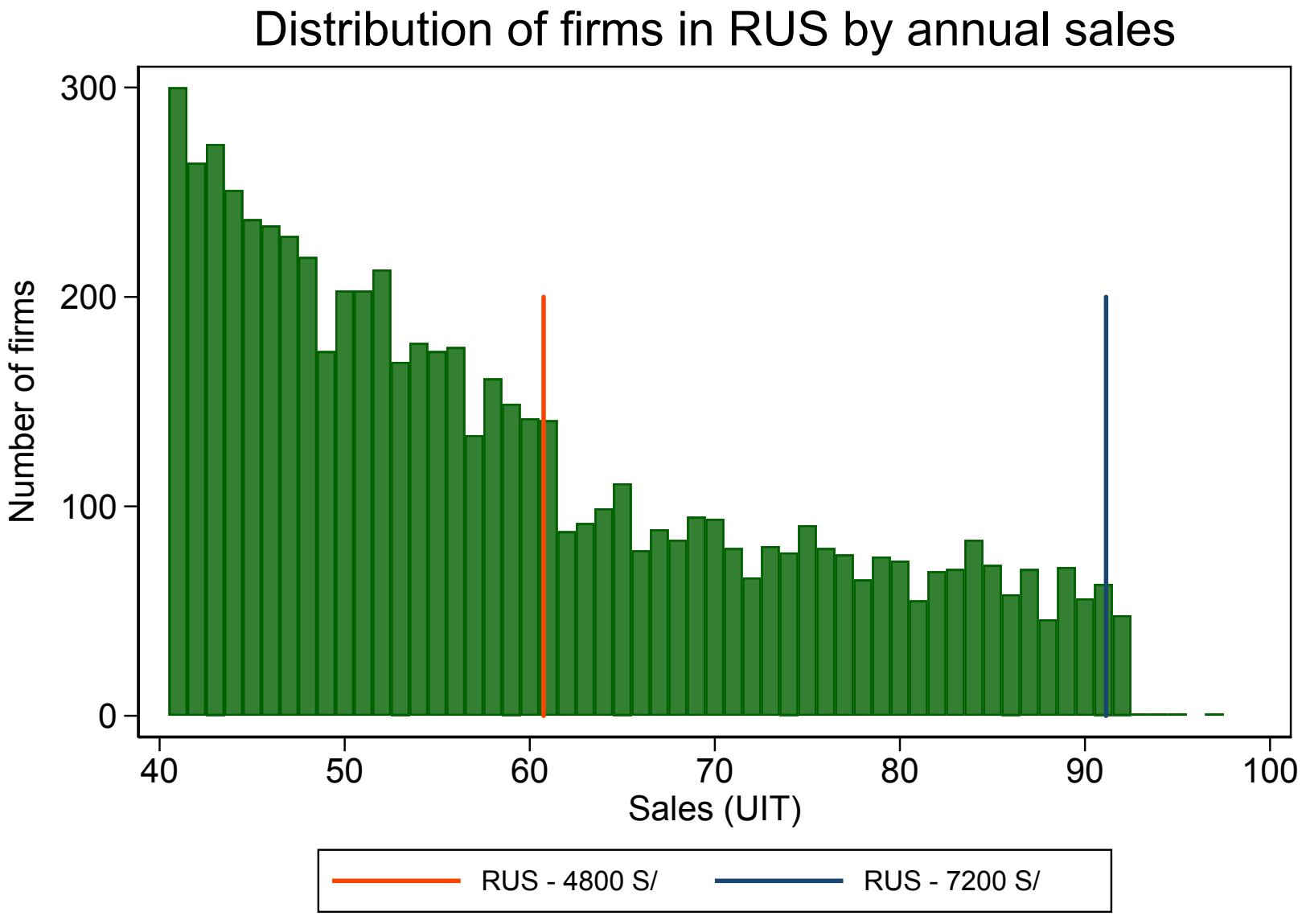

Distribution of firms in RUS by annual sales
Number of firms
25000
20000
15000
10000
5000
0
10
20
30
40
50
60
70
80
90
100
Sales (UIT)
RUS - 240 S/
RUS - 600S /
RUS - 2400 S/
RUS - 4800 S/
RUS - 7200 S/

Back


Distribution of firms in RUS by annual sales
Number of firms
300
200
100
0
40
50
60
70
80
90
100
Sales (UIT)
RUS - 4800 S/
RUS - 7200 S/

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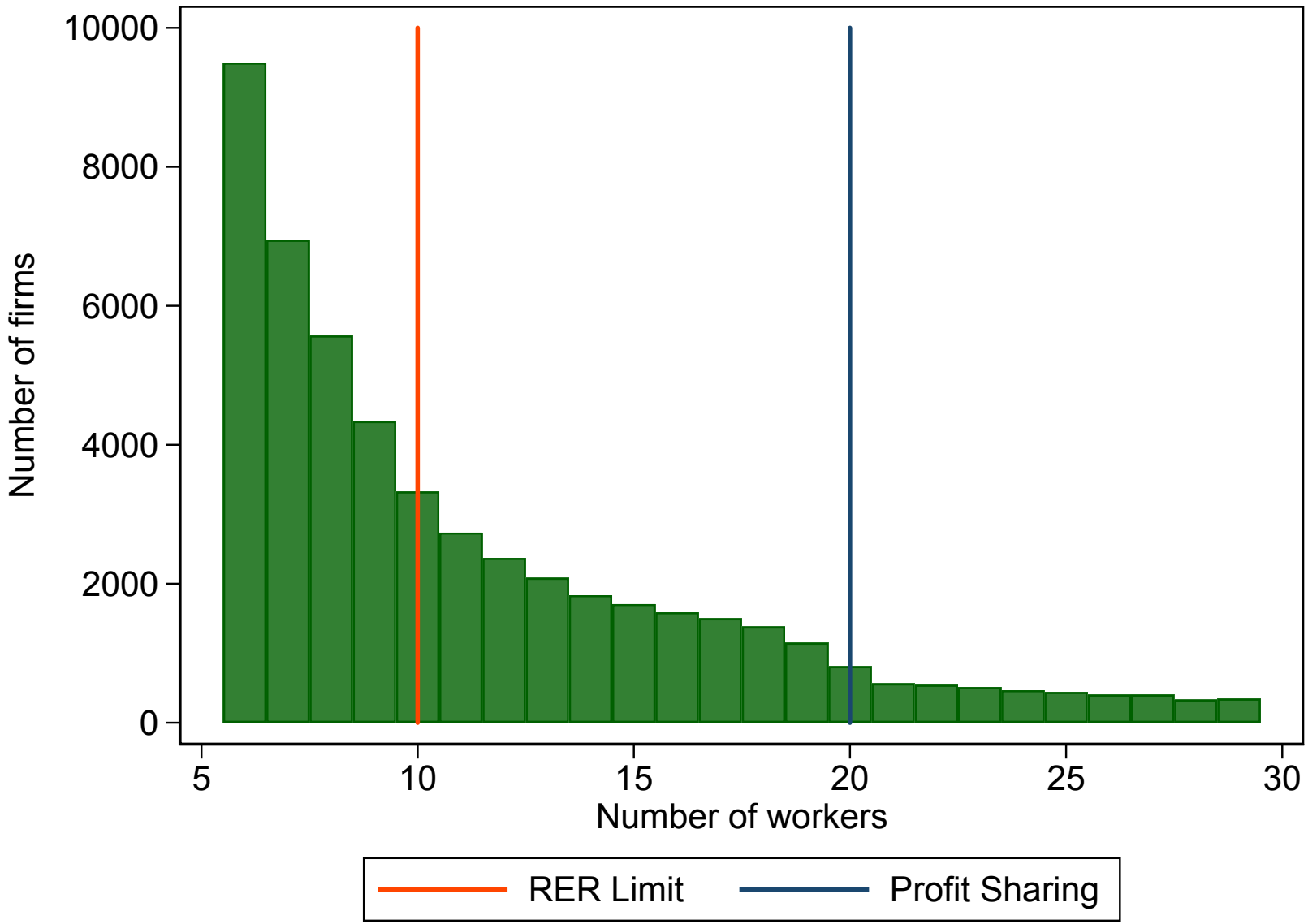
10000
8000
6000
4000
2000
0
Number of firms
5
10
15
20
25
30
Number of workers
RER Limit
Profit Sharing

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