
[Download](#)

Keep in mind

The series Working Papers on Economics is published by the Office for Economic Studies at the *Banco de la República* (Central Bank of *Colombia*). The works published are provisional, and their authors are fully responsible for the opinions expressed in them, as well as for possible mistakes. The opinions expressed herein are those of the authors and do not necessarily reflect the views of Banco de la República or its Board of Directors.

AUTHOR OR EDITOR

Andrés Felipe García-Suaza

Fernando Jaramillo

Marlon Salazar

The series [Borradores de Economía \(Working Papers on Economics\)](#) contributes to the dissemination and promotion of the work by researchers from the institution. On multiple occasions, these works have been the result of collaborative work with individuals from other national or international institutions. This series is indexed at Research Papers in Economics (RePEc). The opinions contained in this document

are the sole responsibility of the author and do not commit Banco de la República or its Board of Directors.

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.