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Caterina Mendicino, Mauricio Prado

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Heterogeneous Firms and the Impact of Government Policy on Welfare and Informality*

Caterina Mendicino† Mauricio Prado‡

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Abstract

We analyze the formality benefits through productivity-enhancing public goods. We document that: benefits from formality matter for firms' optimal decisions; there is a disconnect between the objectives of maximizing formality versus welfare; this disconnect is mitigated under higher formality benefits.

Keywords: firm heterogeneity, production complementarity, taxation, enforcement, regulation.
JEL Classification codes: E26,E62,H32,O17

1 Introduction

Informality is defined as "unreported income from the production of legal goods and services, either from monetary or barter transactions, hence all economic activities that would generally be taxable were they reported to the tax authorities" (Schneider and Enste, 2000). The size of the informal sector therefore measures the value of the production under informality, which is both a widespread phenomenon and a significant part of the economy across countries. Previous literature finds that higher taxation and regulation are associated with larger informal sectors, whereas higher enforcement is associated with lower informality (see, among others, D'Erasmo and Moscoso Boedob, 2012; Leal Ordóñez, 2013; Prado, 2011).

We present a model of firms which are heterogenous in productivity. They optimally choose in which sector (formal or informal) to operate given government policies on taxation, enforcement, and regulation. The government collects taxes on formal activities and revenues from enforcement on informal firms, and spends on costs associated with enforcement and government consumption. We consider the case in which all or part of government consumption can be used as an input for public investment that increases the productivity of firms (e.g. transportation and telecommunication infrastructures, security, rule-of-law, etc.). We compare the case in which public investment benefits formal and informal firms equally against the case in which public investment benefits more formal firms than informal ones. We show that the benefits of formality through productivity-enhancing public goods affect the firms' optimal decision of whether to operate in the formal or informal sector.

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†Corresponding author: Banco de Portugal, Department of Economic Studies, Av. Almirante Reis 71, 1150-012 Lisboa, Portugal. e-mail: caterina.mendicino@bportugal.pt

‡Copenhagen Business School, Department of Economics. e-mail: mp.eco@cbs.dk