Informality, tax policy and the business cycle: exploring the links

INTERNATIONAL TAX AND PUBLIC FINANCE
Número:
1
Publicado:
Lunes, 12 Junio 2023
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Clasificación JEL:
E26, E32, E62, H30, O17
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Despite the worldwide prevalence of informality, consensus on a reliable and consistent set of drivers and consequences of this phenomenon has been elusive to both researchers and policymakers. This study partly addresses this shortcoming by exploring the interactions between the informal economy and tax policy and how these are shaped by business cycle fluctuations. To this end, we identify robust determinants of both informality and taxation by means of an econometric analysis that accounts for bi-directional causality. Focusing on two different dimensions of informal activity and three tax policy instruments and employing numerous determinants over dozens of model combinations, we find that the significance of the relationship between informality and taxation depends on the specific tax instrument under consideration. Thus, informal economic activity may particularly affect the design of corporate taxes. Also, the business cycle may have distinctive influences on informality and tax policy, so direct taxes appear to be acyclical or countercyclical while indirect taxes are strongly procyclical. We conclude by noting how the cyclicality of the informal economy and taxation might allow to substantiate evidence on the role of informality in the adoption of potentially destabilizing fiscal policies.