

**Title:** Optimal Policies with an Informal Sector

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**Research Question:**

This paper characterizes optimal policies in the presence of tax evasion and undocumented workers.

**Importance:**

The informal economy affects not only the size and scale of productive output but also optimal government policy. This sector arises for a variety of reasons: perhaps primarily, as a source of employment for undocumented workers and as a method of evading taxes for employers. These two motivations have been studied independently; in this paper, we look at them jointly and find that illegal immigration has a large impact on the nature of optimal tax and enforcement policy, and interacts with standard tax evasion incentives, playing an important role not only in the determination of equilibrium wages but also in the organization of production across the formal and informal sectors.

**Research Findings:**

In equilibrium, domestic workers may work exclusively in the formal sector or in both the formal and informal sectors. Surprisingly, in equilibrium, wages are always equalized between domestic and undocumented workers, even if they do not work in the same sectors of the economy. This is driven by the interaction of firm-level decisions with optimal government policy. We also find that enforcement may not always be decreasing in its cost and that governments will optimally enforce labour market segmentation if enforcement costs are not too high.

**Implications:**

We find that optimal policies play a crucial role in the wage determination process and lead wages to be equalized even when domestic and undocumented workers are not competing against each other in the same sector. This result does not arise in previous papers that have considered illegal immigration. We also find that enforcement may not always be decreasing in its cost and that governments will optimally enforce market segmentation if enforcement costs are not too high. We consider several extensions. First, we consider the consequences of a marginal amnesty. Second, we introduce a minimum wage as a means of breaking the wage arbitrage condition and altering agents' responsiveness to enforcement policy. Finally, we make the amount of illegal migration endogenous and find a novel role for the public good. The public good can be used to depress wages in the informal sector and thereby redistribute income from undocumented workers to entrepreneurs. In this environment as well, we see that firm level enforcement is socially more desirable than border controls.