

Does the Informal Sector Escape the VAT?

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Abstract

This paper investigates theoretically and empirically the pass-through of taxes to the informal sector in a Value Added Tax (VAT) system. We show that the extent of VAT pass-through to the informal sector depends on (1) the cross-price elasticities of demand between formal and informal varieties of the same product and (2) the degree to which firms switch between the production of each variety. We use establishment-level production data to estimate pass-through of VAT to unregistered firms in India. We find evidence of pass-through at the final stage, suggesting that consumers in the informal sector share in the tax burden. Our results imply that a positive correlation between share of expenditure in the informal sector and income is not sufficient to conclude that a VAT is progressive.