

Optimal Income Taxation across Sectors with Different Tax Avoidance Opportunities

Abstract

This paper studies optimal sector-dependent income taxation in an economy where one sector is subject to strict third-party reporting while another allows tax avoidance through underreporting. Individuals differ in skill levels and entry costs, and choose between the two sectors while determining labor supply, income reporting, and avoidance behavior.

The paper develops a two-sector Mirrlees-type framework in which the government maximizes social welfare under asymmetric information. The analysis derives optimal marginal tax formulas that account not only for redistributive motives and behavioral elasticities but also for fiscal externalities arising from endogenous sectoral choice. In particular, tax differentials affect individuals' incentives to move across sectors, thereby influencing the tax base.

The model is further reformulated using observed income distributions and virtual densities to improve empirical tractability. Numerical simulations show that optimal tax schedules differ across sectors, especially at the top of the income distribution. While marginal tax rates generally decline with income, the sector allowing tax avoidance tends to face lower optimal tax rates among top earners.

Overall, the paper provides a unified framework for analyzing optimal taxation in economies with heterogeneous reporting environments and highlights the importance of accounting for both tax avoidance and sectoral mobility in tax design.