

# Optimal Fiscal Policies Along the Development Spectrum

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## Abstract

I study the optimal fiscal policies over the whole development spectrum including low-income countries where subsistent self-employment is prevalent. If self-employment work is untaxed due to limited enforcement, income taxation that helps redistribution hinders reallocation from a traditional self-employment sector to a modern wage-employment sector. In a simple two-sector heterogeneous-agent framework, I analytically characterize the optimal fiscal policies. I show that optimal income taxes increase and become more distributive with development. I develop a quantitative model with nonlinear income tax and transfers, private insurance, and flexible labor supply along intensive and extensive margins.

**Keywords:** Optimal income taxation; Tax progressivity; Development

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