Chapter 1 : CESifo Group Munich - Tax Policy and Labor Market Performance

The effect of tax policies and welfare state incentives on the performance of the labor market: theoretical and empirical analyses by leading European and American economists. The effect of tax policies and welfare state incentives on the performance of the labor market: theoretical and empirical.

Tax policy should focus on labor market entry and retirement. Those are the points where labor supply is most responsive to tax incentives, which can enhance the flow into work of people leaving school and women with young children and can prolong employment among older workers. Human capital policy has a complementary role in improving the payoff to work and ensuring that earnings hold up longer over a lifetime. Key findings Pros Employment and hours worked are responsive to tax incentives at key points in the life cycle, particularly the early and late stages. Employment and hours worked are also responsive to tax incentives for mothers with young children. Human capital investments extend incentives for lifetime labor supply by boosting wages and keeping them higher longer into old age. Cons Longer-term payoff to employment is small for people with only basic school qualifications. Part-time work experience seems to have little long-term payoff. Tax and welfare policy is limited without a focus on human capital investments. These problems become even more severe as populations age. The key to extending employment and earnings is to focus policy on improving the flows into work for people leaving school and for mothers with young children, and on expanding work among people in their 50s and 60s. These are the margins where labor supply is most sensitive to tax incentives, and a policy redesign can enhance earnings throughout the working life. Motivation Three key trends explain the recent history of variation in employment and hours worked [1]: These are also the three key margins most likely to respond positively to tax reform. Despite large overall differences in the level of work in France, the UK, and the US, for example, average annual hours worked by people aged 19â€”74 in the 20 years preceding the â€” financial crisis grew very little see Figure 1. Performance was mediocre despite the strong increase in female employment and hours worked. While there are only minor differences in employment rates across countries for some age groups, differences are stark for others see Figure 1. Thus, in normal economic times employment rates vary little across countries for people aged 30â€” This was the case for both men and women in , the last buoyant year before the great recession. In contrast, differences in employment across countries are considerable at younger and older ages. At young ages the decision whether to leave school, to start work, or to combine work and college comes into play. These decisions vary widely across countries [1]. At later ages, most of the wider differences in employment rates across countries cannot be explained simply by differences in the health of workers or the technology of employers [2]. The much lower labor supply of women of childbearing age is also noteworthy, as reflected by wide differences in average annual hours worked see Figure 2. It is not just employment and hours worked that matter, though. Overall earnings are the key to income levels and to sustaining an aging population. And when it comes to wage differentials, differences in human capital investments really matter. Hourly wages grow faster and for a longer time among people with more education. Looking at the average hourly wages in log units for women in the UK over their working life by education level reveals a clear story: The higher the education level, the longer wages continue to grow and the higher they peak see Figure 3. Discussion of pros and cons The story behind these trends is revealing. It suggests that the key to improving employment levels in the long run is to enhance human capital investments and focus on the entry and retirement margins of labor supply. Policies should be guided by what is known about the size of the responses of labor supply and human capital investment to tax reform. Empirical studies yield lessons about taking a life-cycle approach and considering policy interactions The responsiveness of employment and earnings to tax policy incentives has received enormous empirical attention at both micro and macro levels [4] [5]. Increased access to administrative data on individual tax returns has added precision to empirical analysis, reducing measurement error and enabling studies of responses by specific groups and at specific points on the tax schedule. Tax return information has also provided direct evidence on taxable income elasticities. Five clear messages emerge from these empirical studies: It is important to view employment and earnings over a lifetime, because

there are points in the life cycle when responses to tax incentives are most effective. Work incentives are also influenced by decisions on human capital investment. Investments in formal schooling boost wages over the working life, and on-the-job training adds a dynamic incentive to any tax reform. Because tax, tax credit, and welfare systems interact, incentives in the tax credit and welfare systems can influence work decisions as much as incentives in the personal income tax system do. Intended incentives in reforms of a particular tax, tax credit, or welfare benefit can be muted or neutralized by these interactions. Fixed costs and information costs of work also affect work incentives. The fixed costs of work mean that decisions at the extensive margin whether to work and at the intensive margin how much and when to work will respond differently to incentives. Additionally, information costs mean that the incentives facing individuals and families may not be precisely as written in the tax and welfare law. Consequently, large reforms that are well understood are more likely to have the desired impact on work incentives and net incomes. Opportunities for tax avoidance and tax shifting can induce responses of taxable income to tax reform in addition to the induced changes in gross earnings. A life-cycle perspective Many recent studies emphasize a life-cycle perspective, noting that although responses may appear small at certain points in the life cycle, they are large at other points. Viewed over the whole life cycle, labor supply can be quite responsive to taxes even for those who appear not to respond to changes in incentives early in their working career. In a life-cycle analysis, tax reforms can substantively alter the input of hours and effort over a lifetime. A micro-data-based model of retirement choices, which allows for disincentives in social security and medical insurance at the individual level, has been developed to explore these lifetime responses. Weakening these disincentives is found to have much larger impacts for older workers than for younger ones. At older ages there are more workers who are close to their labor market participation margin and who are more likely to respond to incentives. These workers provide more convincing micro-evidence on the potential of supply-side responses through the extension of the working life. Interactions between human capital investments and labor supply Added to this life-cycle view is a greater focus on the interaction between human capital investments and labor supply. A lifetime framework accounts for responses in investments in education and on-the-job training alongside labor supply. Human capital investments increase the payoff to work and augment earnings over the working life. Micro-based studies increasingly acknowledge features of both labor supply and human capital behavior in tax policy analysis. A recent study noted that the payoff to human capital investments may be greater among workers with higher initial education investments [3]. In turn, education investments depend on perceived returns that can be clearly influenced by redistributive taxation. A long line of research relating experience capital and future wages convincingly supports the argument that allowing for human capital increases the responsiveness of labor supply to tax changes and that these effects differ over the life cycle. Interactions of tax and welfare systems While hardly new, this life cycleâ€”human capital setting for analyzing labor supply responses deserves more attention and better integration in the general analysis of supply-side reforms of tax, welfare, and social insurance systems. Assessing the effective incentive, or disincentive, to work induced by the tax and welfare systems requires careful analysis of how tax rates, tax credits, and welfare benefits overlap. Benefits change incentives to work, first by providing income to those who are out of work and then by withdrawing those benefits as income is earned in work. When considered together with tax credits, employer taxes, and income tax rates, effective tax rates can be extremely high, especially for low-wage workers. Fixed costs and information costs The distinction between whether to work and how much to work seems a natural one to make in a study of work incentives. Yet it is not as simple as it seems. Should the unit of analysis of the decision on whether to work be a day, a week, a month, a year, a job, or a lifetime? Potentially important aspects of fixed costs include child care, travel to work, and work clothing. Even then, the strength of the responses at the extensive and intensive margins can have a large effect on where work incentives are placed and where they are likely to be most effective. At the extensive margin, responses are strongest for younger workers, parents of young children, and older workers. If the information requirements are too complex, some people will be unwilling, unable, or too uninformed to access all the benefits and tax credits for which they are eligible. Tax avoidance and shifting The focus here on hours, employment, and human capital is not meant to ignore other key ways that earnings respond to taxes, such as taxation of top income earners and the

self-employed. In that context concerns about the tax base come back into play. For example, a convincing case can be made for looking directly at taxable income. The more opportunities for tax exemptions and deductions and for tax shifting to lower tax jurisdictions, the more difficult it is to raise revenue from the top income earners. Analysis requires a general elasticity measure that captures these other avenues of response. The taxable income elasticity does just that. A higher tax rate on a smaller base will raise less revenue and will probably be harder to sustain. The responsiveness of taxable income to the tax rate is a key parameter for setting top tax rates see Higher tax rates on a smaller base. This elasticity captures additional avoidance and tax-shifting responses and can be expected to fall as the tax base broadens. For a given tax base a simple formula can give an idea of the revenue maximizing rate for the top tax bracketâ€"the Laffer rate [7]. Estimated responses vary at different points in the life cycle From a life-cyle perspective, the various estimated response elasticities reported in the literature form a much more coherent pattern. The points at which many key lifetime decisions are being made are also the points at which incentives, including those in the tax and welfare systems, have the greatest effect. Younger, low-education workers and workers with young families The evidence suggests that younger workers with little formal education are likely to experience a low payoff from investments in on-the-job training, whether through passive learning by doing or active investment, because of the complementarities between human capital investments [8]. Consequently, at least in buoyant economic times, low-education workers have little dynamic incentive to stay in work over and above the current-period incentives modeled in standard labor supply analyses. Typically, they face important complexities in the tax and welfare benefit systems through the interaction and overlap of the tax, tax credit, and welfare systems, especially if they have children. To understand their responses, it is important to model these nonlinear budget constraints and to account for awareness and take-up of welfare and tax credit entitlements. The distribution of younger, low-education workers is likely to be closer to the participation margin than the distribution of their more educated counterparts, making the low-education workers particularly sensitive to incentives at the extensive margin. For these workers it becomes important to allow for fixed costs of work, including child-care costs. There is evidence that once these details are accounted for, standard static models of labor supply behavior that account for demographic differences and differences at the extensive and intensive margins, as well as program take-up, can provide a reasonably good guide to the behavioral responses to tax and welfare reform [3]. The literature on labor supply responses for low-education workers suggests moderately high extensive margin elasticities, especially for women with young children, and somewhat lower intensive margin elasticities often also pointing to important income effects for such groups [4]. This combination of elasticities can be used to argue for the introduction or expansion of earned income tax credit-style subsidy programs for certain groups of low-wage workers [7]. Perhaps the most responsive segment of labor supply is low-education mothers returning to work after having a child. Well documented in the empirical literature, this phenomenon deserves to be a key part of the design of work incentives for low-wage workers. Children play a key role. Even if fertility decisions are exogenous to the tax system which may be an assumption worth relaxing , the reforms that follow from these Mirrlees-style arguments often make a case for targeted wage subsidies that encourage work among young low-education women. There are of course other arguments to justify these policies. But if early childhood investments by parents through time spent interacting with and reading to their children, for example are key to child development, subsidizing work for low-education mothers with younger children might seem counterproductive.

Chapter 2 : Tax Policy and Labor Market Performance - CORE

The impact of tax policy on labor market performance depends importantly on various other labor-market institutions, such as minimum wage laws, wage bargaining, and unemployment benefits. In non-competitive labor markets, employment declines if a higher tax burden makes the outside option (i.e. unemployment) relatively more attractive.

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Chapter 6 : Faculty Template

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Chapter 7 : Tax Policy and the Labour Market Performance. Edited by JONAS AGELL and PETER BIRCH

Abstract: In exploring the impact of tax policy on labor-market performance, the paper first investigates how tax reform impacts labor supply and equilibrium unemployment in representative agent blog.quintoapp.com impact of tax policy on labor market performance depends importantly on various other labor.