Taxation of Earnings and the Impact on Labor Supply and Human Capital

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MARGINS OF EARNINGS RESPONSE

- Education before entry into labor market
- Time of entry into labor market
- Earnings decisions in labor market
  - Intensive margin: hours, earnings, taxable income
  - Extensive margin: whether to work, migration
- Time of retirement from labor market
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  – Intensive margin: hours, earnings, taxable income
  – Extensive margin: whether to work, migration (e.g. Kleven, Landais, Saez & Schultz 2013)

• Time of retirement from labor market
INTEGRATED VIEW OF TAXES & BENEFITS

• Getting the *effective tax wedge* right is important for
  – Estimating earnings elasticities
  – Calculating welfare given the elasticities

• Why stop at taxes and benefits? Public spending also important:
  – Child care, elderly care, public transport, etc.
  – These are subsidies to work complements (fixed cost of work)

• Mirrlees vs Ramsey (or Atkinson-Stiglitz):
  – Information argument against Ramsey is problematic
  – Ignoring Ramsey differentiation ⇒ strong stand on Slutsky matrix
CHILD CARE SUBSIDIES & EITC

• Child care subsidies (even if universal) have an EITC element through complementarity in utility
  – With child care subsidies, we do not necessarily need an EITC

• Cross-country correlation does not line up with the EITC argument
  – Countries with the largest participation taxes (e.g. Scandinavia) have the largest labor force participation rates
  – But those countries also have the most generous child care policies

• We need more (micro-based) evidence on this
DEVELOP THEORY & EVIDENCE TOGETHER

• Recent success of PF rests on a transparent link between the two

• **Analytical results** based on estimable entities
  – Sufficient statistics (Ramsey (...) Feldstein, Saez, Chetty, etc)
  – Elasticities, shape of income distribution, social welfare weights
  – BUT: social welfare weights present a problem

• **Estimate sufficient statistics** based on clear identification
  – Quasi-experimental variation and administrative data
  – BUT: dynamics and human capital effects not well-captured
    (short-term comparisons around tax reforms, bunching)
OPTIMAL LINEAR INCOME TAX

Classic formula:

\[
\frac{\tau}{1 - \tau} = \frac{1 - g}{e},
\]

where \( g \in [0, 1] \) captures social preferences and \( e \) is the \textit{elasticity of aggregate earnings with respect to} \( 1 - \tau \).

The formula is very general in terms of the income-generating process (intensive, extensive, human capital, etc.)

It also holds with endogenous human capital (Best and Kleven 2013), but the issue is \textit{how to estimate the long-run aggregate elasticity?}
BEYOND THE BASIC LINEAR INCOME TAX

• Blundell bottom line: “Focus tax policy on improving incentives around points in the lifetime when labor supply responses, especially at the extensive margin, are found to be strongest. Largely for parents with young children and for older workers.”

• This boils down to two things
  – Child-dependent taxes
  – Age-dependent taxes

• Recent work on age-dependent taxation leads to contrasting views
AGE-DEPENDENT TAXATION

- **Exogenous human capital**
  - Taxes *increase* with age
  - Weinzierl effect: Pareto parameter declines with age

- **Endogenous human capital**
  Best and Kleven (2013): career effects of work effort
  - Taxes *decrease* with age
  - **Efficiency:** old workers are relatively elastic wrt. current tax and young workers are elastic wrt. future tax (*aspiration effect*)
  - **Equity:** negative age-ability correlation, conditional on earnings
AGE-ABILITY CORRELATION EFFECT:
AGE-WAGE PROFILES BY EDUCATION (ABILITY)

Source: Blundell, Costa-Dias, Meghir and Shaw (2013)
SOME LOOSE ENDS

• **Macro studies** on taxes and labor supply (Prescott, Rogerson, etc)
  – Redo in the light of Blundell, Bozio & Laroque

• **Labor supply decision of young adults**
  – Education vs time of entry given education?
  – Scandinavian narrative; Israeli kibbutz (Abramitzky & Lavy 2013)

• **Optimization frictions** (information, adjustment costs)
  – Observed short-run elasticities vs structural long-run elasticities
    (Chetty 2012, Kleven & Waseem 2013, Chetty et al. 2013)