Automatic Stabilization and Labor Supply

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Abstract

This paper estimates the stabilizing effects of tax and transfers systems through a marginal incentives channel. When income taxes are progressive, the tax rate that a household faces will fall following an income decline in a recession, thereby increasing work incentives and hence labor supply. This effect offsets part of the initial income decline, stabilizing aggregate income and output. The magnitude of the effect depends on the change in the marginal tax rate after a change in gross income, as well as the elasticity of labor supply with respect to a change in the after-tax wage.
We estimate a structural discrete choice labor supply model and individual tax rates for households in the EU28 using the microsimulation model EUROMOD and EU-SILC household data. Our estimations show that up to ten percent of a fall in household income is offset by an increase in labor supply. The EU average is roughly two percent. The results reveal a large heterogeneity across countries, which is mainly due to differences in the progressivity of the tax systems across Europe: the incentive effect is large in countries with a highly progressive tax schedule, while it is zero for countries with a flat tax, where the marginal tax rate is constant. Differences in labor supply elasticities also play a significant role.

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