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I Z A
World of Labor
Evidence-based policy making

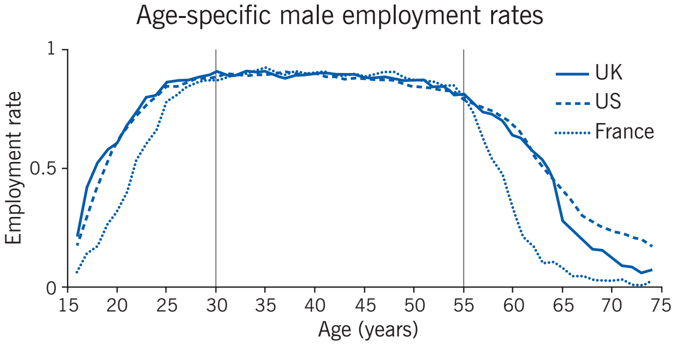
How responsive is the labor market to tax policy?

When applied to the most responsive segments of the labor market, tax policy can increase lifetime earnings and employment

Keywords: work, employment, tax incentives, human capital

ELEVATOR PITCH

With aging populations and increased demands on government revenue, countries need to boost employment and earnings. 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.



Source: Own calculations based on [1].

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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.

AUTHOR'S MAIN MESSAGE

Even before the financial crisis of 2008–2009 many developed economies were struggling to maintain employment and earnings. 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.

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