Taxes and labor markets

Tax Policy and Labor Market Performance. By Jonas Agell and Peter Birch Sorensen, eds., Cambridge, MA., The MIT Press, 2006, 340 pp., $42/hardback.

How to improve economic growth rates in developed nations continues to be an area of concern to economists, particularly to Europeans who fret over their ability to compete with lower labor costs in less developed countries. Over the past two decades, European members of the Organisation for Economic Cooperation and Development (OECD) countries have tended to report higher unemployment rates and lower labor force participation rates than the United States, although the reasons for the differences have been matters of dispute among policymakers. Also, even after adjusting for conceptual differences within the European Union (EU), these unemployment rates have varied. For example, in August 2007 the Bureau of Labor Statistics reported that the unemployment rate in the Netherlands stood at 3.4 percent, while the German unemployment rate stood at 8.7 percent. This compares to a 4.6-percent unemployment rate for the United States.

Many economists have pointed to a structurally more rigid European labor market, in comparison to the flexibility of the U.S. labor force, as a continuing obstacle which causes overall higher rates of employment and lower levels of economic growth in the EU. Jonas Agell and Peter Birch Sorensen have compiled a series of essays focused on one aspect of this more rigid structure—the role of taxes in influencing labor markets, both in the U.S. and Europe. Specifically, they have published a volume using papers presented by authors coming from a variety of European and American academic institutions. Their findings were presented at seminars hosted by CESifo, a research group located in Munich, Germany, which looks at topical economic issues from a European perspective and serves as an international network of economists.

The book utilizes essays that search for answers to two questions: How do tax structures affect the working of labor markets? And, how could changes in tax structures affect these markets?

The essays break down into three sections—a broad approach to taxation and labor markets, taxation as it affects wages of both men and women, and taxation and the underground (informal) economy. The issues touch on many of the questions that face economists, such as concerns over economic efficiency and equity trade-offs and whether changing incentives can have a discernable effect on the overall economy.

For the most part, the essays assume that labor markets are affected by rational behavior that can be influenced by monetary policy. As an article of faith, progressively higher tax rates are assumed to produce disincentives which lead to individuals choosing to work fewer hours. Conversely, lower rates are assumed to have the opposite effect. Newer theories of behavioral economics, which might confound these assumptions, are not to be found in this volume.

In fairness, some of the essayists do acknowledge that labor market structures are influenced by non-monetary factors such as culture and beliefs. For example, Frederick van der Ploeg concludes his essay on the relationship between social policy and economic growth by discussing the complications in proposing new tax policies in communities where existing ideologies, such as a belief in poverty as a result of poor luck rather than due to lack of effort, can dramatically affect the acceptance of these policies in a real world filled with complexity. At the same time, much of his essay seems to struggle to reconcile a rational economic approach with a messier real world where outside factors have greater influence than can be expressed by any equation.

The other consistent theme for these essays is their grounding in empirical evidence, both as a supporter of theory and as a means of testing theory. Throughout the book a great deal of work appears in the form of data and data analysis as an underpinning to the ideas expressed by the authors. All eight chapters take a rigorous approach to expressing theories based on the available evidence. Mathematical formulas flow through the chapters showing structural equations and tables showing multivariate statistics.

Being true to the academic origins of these papers, the essays include information not only supporting theories but also providing evidence that weakens the theories. In the name of intellectual honesty, there are few hard answers to the questions being asked by the academicians. For example, the essay by Tranaes, Arnberg, and Holm provides theory, data, and multivariable wage equation on the relationship between progressive taxation and wages, only to summarize by suggesting that their work is incomplete and needs further empirical elaboration before they are ready to present conclusive evidence on the relationship between equity and efficiency. Other authors are equally forthcoming on their degrees of confidence, or lack of it, in their own conclusions which vary from very firm to concluding that the results presented are only preliminary and subject to revision.

In some ways, although the book appears to be filled with complex formulas and theories, it takes a simplified approach to taxation by only considering the role of taxes in reducing income. It is a quirk of economists who study public policy to focus on either public sector revenue or expenditures, but fewer tackle the more complicated issues of the interrelationship between these two sides of the public ledger and the private labor market. For the most part, this book also fails to fully consider the ways that taxation and expenditures interact with private labor markets, for example infrastructure improvements, that can lead to more efficient labor markets.

A warning to potential readers: The volume is not meant for the casual reader or as an introduction to the subject. Individuals already deeply involved in these issues will welcome these essays as stimuli to new perspectives on guiding tax policy to service labor policies, while novices may wish to approach the subject using simpler texts.

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