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Executive Summary

Achieving a high level of employment is generally considered desirable for a number of economic and social reasons. However, tax systems will generally act to deter employment by reducing the returns to working received by employees, and/or increasing the labour costs faced by employers. This publication examines the effects of taxation on employment, considers the resulting policy challenges, and discusses the ways governments endeavour to address these challenges.

The report provides both a broad overview of the effects of taxation on employment as well as a detailed analysis of selected issues. Chapter 1 of the report provides the overview, examining how taxes on labour income can affect both the size of the labour force and the level of unemployment, and highlighting key areas of concern for tax policy makers. This analysis is then augmented in Chapters 2 to 4 by the more detailed analysis of the effects of taxation on the employment of three groups where empirical research suggests that responses of labour supply to taxation may be relatively large: low-income workers, older workers, and mobile high-skilled workers. As well as highlighting key challenges for tax policy makers, the report places a particular focus on the different measures that have been adopted by countries in response. It discusses, where possible, the main design features, and the advantages and disadvantages of the different approaches that have been adopted. This analysis draws heavily on practical country experiences as reported by Delegates to Working Party No. 2 on Tax Policy Analysis and Tax Statistics of the OECD Committee on Fiscal Affairs.

Overall, employment rates in the OECD area have remained stable at around 65 per cent for the working age population over the 10 years before the financial crisis, though average hours worked per worker have been falling over the same period. However, employment rates are particularly low for three groups: older workers, second earners (who are often women), and low-skilled (generally low-income) workers. The low employment rates of older workers and women are driven predominantly by substantially lower than average labour force participation, while both higher (involuntary) unemployment and lower participation contribute to the low employment rates of low-skilled workers.

Tax burdens on labour income vary significantly depending on income and family characteristics, with substantial variation also across countries. For a single individual earning the average wage in their country, income tax and social security contributions can result in tax wedges ranging from as low as seven per cent to as high as 55 per cent, and marginal tax wedges ranging from seven to 66 per cent. Looking across all OECD countries, the (unweighted) average tax wedge for a single individual earning the average wage is 35 per cent, and the marginal wedge is 44 per cent. In general, taxpayers with children face lower tax wedges than taxpayers without children, while second earners often face higher average and marginal tax wedges than primary earners. Consumption taxes can add as much as 12 percentage points more to these burdens. Furthermore, the interaction of benefit and pension systems with the tax system can lead to even greater effective tax burdens. For example, in a small number of countries the income-based withdrawal of benefit payments can create effective tax rates on entering employment, or on increasing the number of hours worked once in employment, of more than 100 per cent.

These tax burdens can influence the level of employment in an economy through their effect on both labour supply and the level of (involuntary) unemployment. Labour taxes may also result in some individuals working in the informal sector rather than taking formal employment.

The effect of taxation on labour supply decisions will reflect the heterogeneous nature of the potential labour force. That is, different individuals will respond differently to a change in the real consumption wage depending on their individual preferences and family characteristics. In modelling the responsiveness of different demographic groups, labour supply is often assumed in simple models to be homogenous and described in terms of two characteristics – participation, and number of hours worked. However, labour taxes will also affect a number of other labour supply decision margins. In particular, tax will affect the amount of effort an individual is willing to put into his or her work. Longer term labour supply decisions, such as choice of occupation, and whether to undertake further education, may also be tax influenced.

Empirical evidence suggests that low-income workers, single parents, second earners and older workers are relatively responsive to changes in labour income taxation, particularly at the participation margin. In addition, taxable income elasticities suggest that higher-income individuals are more responsive to taxes than middle- and lower-income workers. The variation in empirical estimates highlights the need for tax policy makers to be aware of the groups likely to be affected by a tax change, and their likely response to the change, in order to understand the overall impact of the reform on employment, tax revenue and the income distribution.

Tax will also affect a number of margins that may not generally be considered as affecting employment, *per se*, but that still carry with them significant efficiency consequences – the decision to engage in tax avoidance or evasion (including working in the informal sector) is clearly tax motivated. Tax may also influence the form in which compensation is taken (biasing towards tax-favoured forms such as pensions, or fringe benefits, including less obvious forms such as improved working conditions), and create a bias towards tax-favoured forms of consumption (for example, charitable giving and housing).

While labour taxes will, in general, reduce the level of employment in (the formal sector of) an economy, whether they affect (involuntary) unemployment is slightly less clear. Nevertheless, the weight of both theoretical and empirical evidence tends to suggest that labour taxes may interact with other labour market institutions – such as unionised bargaining and minimum wage laws – to push wages above market clearing levels, thereby increasing long-run "equilibrium" unemployment. In particular, strong but decentralised (*i.e.* sectorial) unions may push for higher wages to compensate for a tax increase without fully accounting for any unemployment that may result. Meanwhile, generous minimum wage laws in combination with substantial payroll taxes and/or employer social security contributions may price some low-skilled workers out of employment. As institutional settings vary significantly across OECD countries, the effect of taxation on long-run unemployment is likely to be highly country specific.

While taxes on labour income have the clearest and most direct impact on employment, almost all taxes can have some effect on employment, indirectly, by distorting economic decisions, and thus leading to an inefficient allocation of resources and reduced labour demand. Perhaps the most significant indirect effect on employment is likely to come from the corporate income tax, which may be borne by capital, labour, consumers, or (more likely) some combination of the three. While empirical evidence on the incidence of the CIT is limited, it does suggest that at least some of the burden is borne by labour (through, for example, lower investment leading to lower capital/labour ratios, and hence lower wages).

Drawing together the analysis in the report, a number of key employment-related tax policy challenges can be identified. These arise, in general, where high tax burdens are imposed on groups whose labour supply is relatively responsive to economic incentives. Such cases provide significant scope for tax reforms to increase employment. These areas of concern are briefly outlined below, along with potential reform options drawn from the country examples discussed in this report.

- *Low-income workers*. Effective tax burdens on low-income workers are often very high due to the combined impact of taxation and benefit withdrawal on entering employment, or on increasing hours worked once in employment. Furthermore, empirical evidence highlights the high responsiveness of low-income workers to these disincentives, particularly at the participation margin. Possible options to improve work incentives include: reducing personal income tax and social security contribution burdens on low-income workers (*e.g.* by raising personal allowances), and introducing in-work tax credits (or equivalent benefit schemes). The latter have become an increasingly popular tool to both increase work incentives and alleviate in-work poverty. However, the fiscal costs of such tax reliefs and credits limit their affordability; and in the latter case this often leads governments to impose high marginal effective tax rates as credits are withdrawn as income rises (or to provide less generous credits or benefits).
- *Older workers*. Tax and pension systems often combine to create significant incentives for older workers to retire and empirical evidence suggest that the retirement decision of older workers is highly responsive to such incentives. Where work disincentives are extremely strong, they tend to be driven by pension systems – in which case pension reforms will be the most appropriate means of addressing the problem. While the contribution of tax factors to these employment disincentives is often subsidiary, in many countries there is substantial scope for tax reform to improve work incentives for older workers. Possible options to improve work incentives include: providing age-based rather than pension-specific tax concessions; reducing social security contribution burdens on older workers to match those due on pension income; and providing in-work tax credits targeted at older workers.
- *Mobile high-skilled workers*. Tax systems often impose high tax burdens on high-skilled workers, and estimates of taxable income elasticities suggest that high income recipients are more responsive than most taxpayers to tax rates. Migration does not appear to be a significant driver of these elasticities and the limited empirical evidence does not suggest migration decisions are highly responsive to tax. Nevertheless, international mobility may still be a concern for governments as high-skilled workers can add significant value to an economy. As such, there may be merit, in certain cases, in introducing tax concessions targeted at mobile high-skilled workers. This may

particularly be the case in countries with higher than average taxation of labour income, and high and/or complex taxation of foreign sourced capital income. Such schemes have become increasingly popular in OECD countries. However, scheme design can become complex, imposing substantial compliance and administrative costs relative to the potential gains in employment.

- *Second earners.* Tax systems often create significant work disincentives for second earners, while empirical evidence highlights the higher responsiveness of second earners to these disincentives. Possible options to improve second earner work incentives include: moving from family-based towards individual based taxation; increasing individual allowances; and removing dependent spouse allowances. Where equity-based objectives do not allow a shift away from family-based taxation, the introduction (or increase in value) of an independent allowance for second earners will increase second earner work incentives.
- *Pricing low-skilled workers out of employment.* As well as reducing the supply of low-income workers, the high taxes imposed on low-income workers in many countries may also reduce labour demand. This may cause some low-skilled workers to be "priced out" of employment by high employer social security contributions, generous minimum wage laws, or a combination of both. Possible options to improve demand for low-skilled workers include: reducing employer social security contributions and providing employer tax credits targeted at low-skilled workers.

A number of the reforms discussed above would involve a revenue cost and therefore would require either a reduction in public expenditure, or an increase in taxes – either on other tax bases or on different workers. In many cases, reductions in expenditure may conflict with other government goals. Meanwhile, shifting the tax burden towards another base requires a trade-off to be made between the employment gains from reducing the taxation of labour income, and the distributional and efficiency consequences of increasing the tax burden on the other base. A detailed country-specific analysis of the pros and cons of such a shift would be necessary before implementing any such reform.

However, even where reducing the overall tax burden on labour is not feasible, increases in employment may still be possible through a redistribution of the labour tax burden. Employment gains may be made by reducing marginal and/or average tax burdens faced by more responsive groups, such as those highlighted above, at the expense of less responsive groups. In doing so, the distributional consequences of such reforms must also be considered.