

# CHAPTER 21: Taxes on Labor Supply

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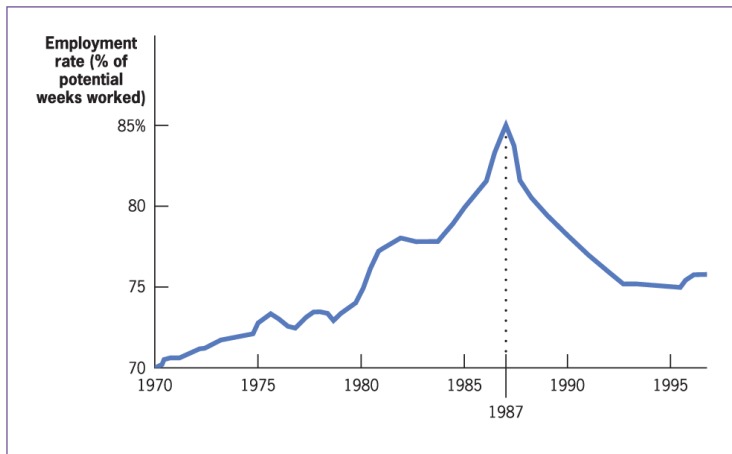
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# CHAPTER 21: Taxes on Labor Supply

- 21.1 Taxation and Labor Supply- Theory
- 21.2 Taxation and Labor Supply- Evidence
- 21.3 Tax Policy to Promote Labor Supply: The Earned Income Tax Credit
- 21.4 The Tax Treatment of Child Care and Its Impact on Labor Supply
- 21.5 Conclusion

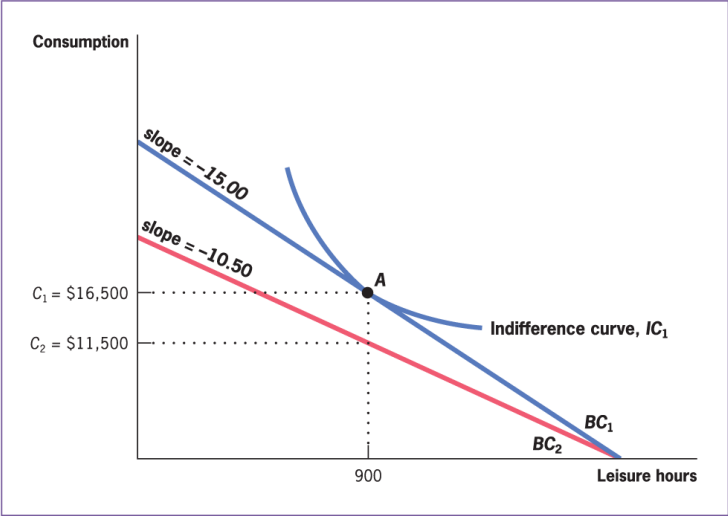
# Introduction: Iceland's Tax Overhaul



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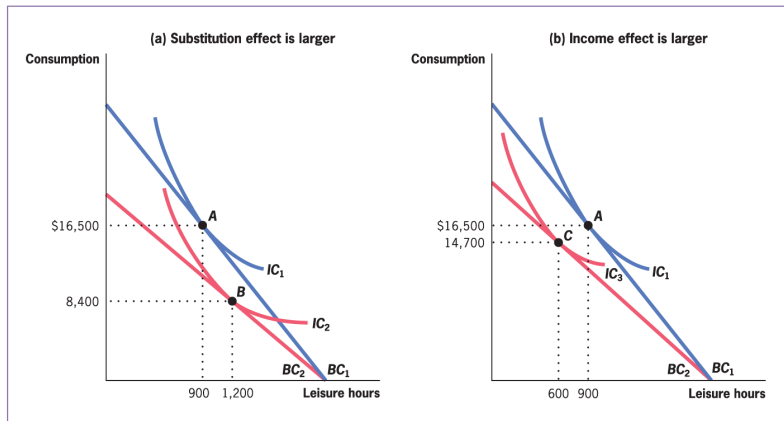
- Overall employment spiked in 1987 from 78 to 85 %.

# Basic Theory



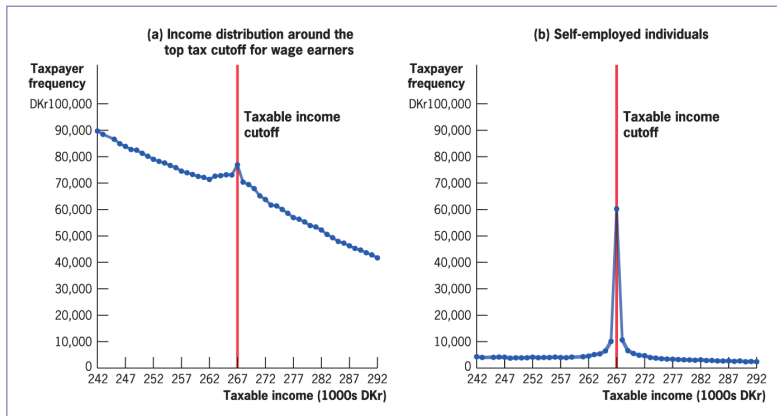
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# Substitution Versus Income Effect



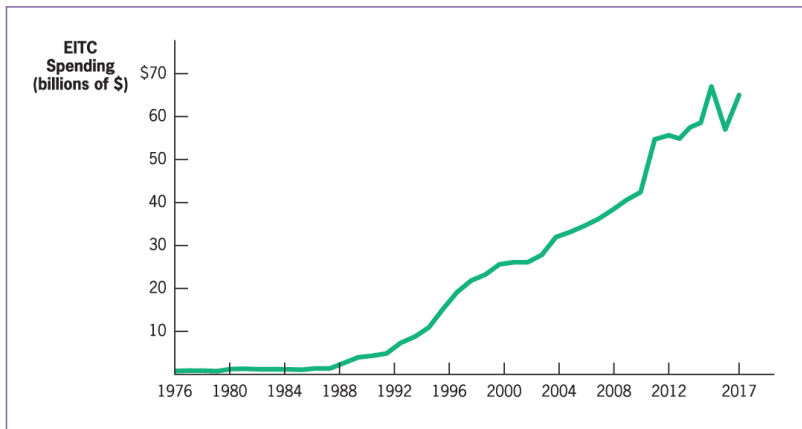
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# EVIDENCE: Estimating the Elasticity of Labor Supply: Graph 1



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# Background on the EITC

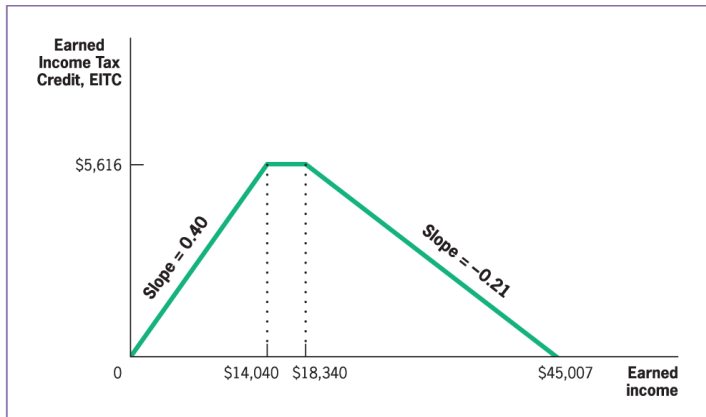


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# Background on the EITC

- The EITC is a refundable tax credit; the exact amount depends on earnings.
- Eligibility depends on the number of children:
  - For families with more than two children, maximum earnings are \$ 53,930.
  - With two children, the maximum is \$50,597.
  - With one child, the maximum is \$ 45,207.
  - With no children, the maximum is \$ 20,600.
  - In all cases, the family must have earnings greater than zero.

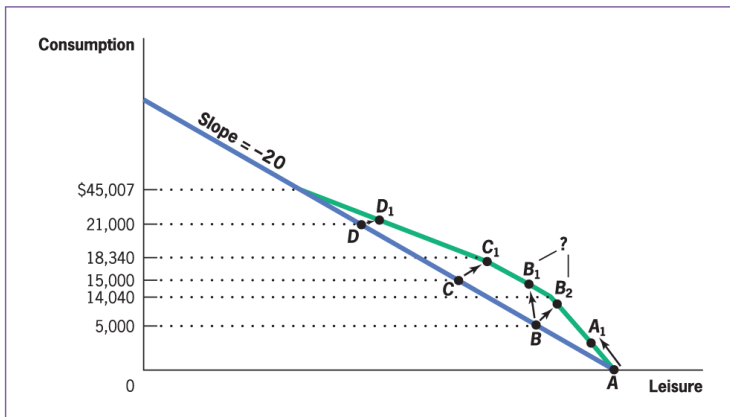
# The EITC Benefit Structure



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- For the first \$14,040 of earned income, Stacey receives an EITC payment of 40c per dollar of earnings, to a maximum of \$5,616. Between \$14,040 and \$18,340 of earnings, the EITC payment is flat at \$5,616. From \$18,340 to \$45,007 of earnings, the EITC payment falls by about 21c per dollar earned, until it reaches zero.

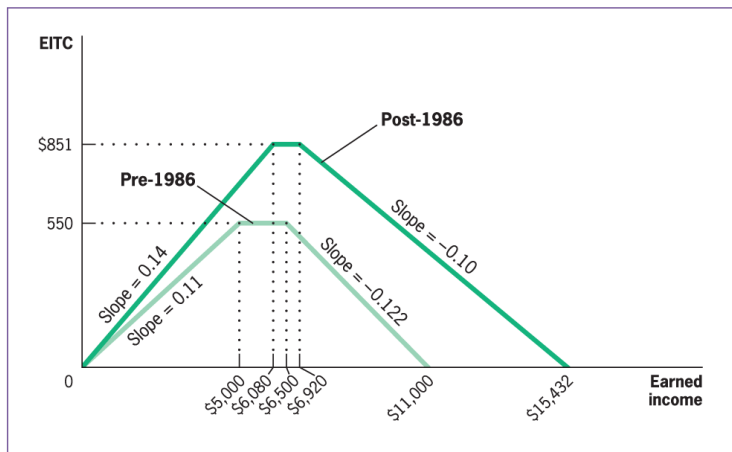
# Impact of EITC on Labor Supply: Theory



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- The theory's prediction about the net impact of the EITC on the total labor supply of low-income populations is ambiguous.

# Impact of EITC on Labor Supply: Evidence



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- The Tax Reform Act of 1986 changed the structure of the EITC so that a wider range of earnings was eligible for the subsidy .

# Options for Resolving Tax Wedges

	Pre-tax, Pre-child-care Earnings	Child Care Costs	Child Care Deduction	Imputed Earnings	Taxes Owed if Work Tax Rate = 50%	Taxes Owed if Home	After-Tax Value of Work	After-Tax Value of Home
Base	\$1,000	\$600	0	0	\$500	0	\$500	\$600
Impute	\$1,000	\$600	0	\$600	\$500	\$300	\$500	\$300
Deduct	\$1,000	\$600	\$600	0	\$200	0	\$800	\$600

# Conclusion

- Optimal tax trades off:
  - The benefits of redistribution.
  - The efficiency cost of taxation, which depends on how peoples' labor supply responds to taxes.
- Primary earners are not very responsive, secondary earners are.
- The EITC is a successful redistribution program designed to encourage labor supply.
- Child care costs are an impediment to the labor supply of secondary earners .