

Comment on Bruce Meyer: The Earned Income Tax Credit -- A Swedish Perspective
(Ekonomiska Rådets konferens den 7 maj "From Welfare to Work")

Ann-Sofie Kolm

This paper discusses in a very balanced way the effects of the U.S. Earned Income Tax Credit (EITC) on labor supply, poverty and income distribution. Considering the author's own very careful work on the effects of the EITC, it is difficult to find a person more suited for this task than Bruce Meyer. Thus it has been a pure pleasure to read this paper.

The expansions of the EITC in the U.S. have provided researchers with extensive opportunities to evaluate the effects of the program. Although different time periods have been studied and different empirical methods and identifying strategies have been used, the results are rather robust. The EITC seems to stimulate labor supply and reduce poverty. Moreover, the potentially negative effects from the EITC on, for example, work hours of those already working, and participation among the second income earners in the family, seem to be a non issue.

Considering the rather strong empirical support for the EITC, it comes as no surprise that this type of policy have become increasingly popular as a means to reduce poverty and improve work incentives across the western world. The U.K. followed the U.S. more than 25 years ago and implemented a version of tax relieves conditioned on work. Other countries that have recently followed the U.S. and U.K. are Belgium, Canada, Denmark, Finland, France, Ireland, The Netherlands, New Zealand, and in fact, since a year ago, also Sweden.

Taking a Swedish perspective, I guess it would be fair to say that Sweden both have a different aim with such reform and different preconditions for how well such reform would function in comparison to the U.S. The aim of reducing poverty is less of an issue in Sweden, although decision makers certainly care about the income distribution. To affect work incentives is more of an argument in favor of an EITC-type of policy in Sweden.

This view is also supported by a study by Boone and Bovenberg (2006) who show that the relationship between in-work benefits and welfare payment are *U*-shaped. Generous in-work benefits are called for both in countries with low welfare benefits and in countries with high welfare benefits, although for different reasons. In countries such as the U.S. where the social benefits are low and the incentives to work are fairly good, the EITC aims at alleviating poverty. Many countries in Europe, on the other hand, deal with poverty through generous social benefits. Generous social benefits, however, creates disincentives to work which induces a demand for implementing an EITC-type of policy in order to maintain work incentives.

I mainly want to stress two things in this comment on the U.S. Earned Income Tax Credit. First, the expansion of the EITC in the U.S. makes it increasingly important to account for the general equilibrium effects in order to trace out the employment effect of the program. Thus, a better understanding of the wage adjustments is needed in order to evaluate the full effects of the EITC in comparison to that of alternative policies. Secondly, in order to analyze the likely effect on an EITC-type of policy in a less market oriented country, such as Sweden, it is important to account for the country's particular institutional settings. A valid question to ask is if we can expect such a reform to be equally successful when implemented in Sweden and other less market oriented economies as it has been in the U.S. After all, the institutional framework is far from the same in Sweden and the U.S. Finally, I like to parallel to a different type of policy which has had a long history in Sweden, namely subsidized day care.

1. Institutional differences

Two potentially important aspects of the Swedish institutional framework when considering the effects of an EITC-type of policy are the *compressed wage distribution* and the *imperfectly competitive labor market*.

The fact that Sweden has a compressed wage distribution is often viewed as problematic for any design of an EITC-type of policy that involves a phase-out region. With a compressed wage distribution, many people will be located on the phase-out region of the credit schedule. This is a concern as the phase-out of the tax credit is associated with negative incentive effects on work hours.¹

In addition, a recent study by Immervol et al. (2007) that looks at the design of optimal in-work benefits suggests that countries with a wider income distribution have more to gain on in-work benefits. The reason is that the efficiency loss for a given improvement in the redistribution is higher when wages are compressed.

Considering the particular Swedish institutional framework, perhaps even more important is that the Swedish labor market can be viewed as less market oriented than the U.S. labor market. Wages are set in bargains where workers or worker representatives have the power to push for high wages. This makes involuntary unemployment a concern in Sweden. Considering that the impact of an EITC-type of policy will likely have different effects on employment in countries like Sweden and the U.S. due to institutional differences, accounting for those differences in an analysis seem important.

2. Expected effects of an EITC-type of policy in Sweden

Since no EITC-type of policy in a less market oriented setting such as Sweden have been at place long enough to make empirical evaluation possible, one must rely on theoretical models and simulations to trace out the likely effects. Let's take a very simple model featuring involuntary unemployment as an outcome variable such as the standard search and matching model of Pissarides (see Pissarides, 2000). Then account both for an endogenous choice of labor force participation (as that has turned out to be a very important margin) and endogenous search effort among the unemployed. Moreover, assume that wages are set in wage bargains, and that firms will open vacancies as long as it is profitable to do so.

It is then straightforward to trace out the general equilibrium effects of a tax credit on wages, unemployment, search effort, labor force participation, and employment. In such a simple framework it can be shown that the effect of a tax credit conditioned on work likely will increase search effort, labor force participation and employment, while reducing wages and the unemployment rate. The effects, however, does not mainly work through increased incentive to work because the take home pay increases. Rather the effect works through job creation. In fact, this simple framework can easily be used to show that the take home pay may actually fall with the reform due to rather strong wage moderation. However, the shorter expected unemployment spells due to that more vacancies are posted when gross wages are lower increases labor force participation and search effort. Thus employment increases both because the labor force participation increases and because the equilibrium unemployment rate falls. See Kolm and Tonin (2006) for details.

A tax credit conditioned on work is thus likely to be good for employment also in an imperfectly competitive labor market setting where wages are allowed to respond to policy changes, although for different reasons than what is usually stressed in the literature. The traditional story is that employment increases as labor supply increases with a higher

¹ Here one can note that the recently implemented tax credit in Sweden is not phased out. Negative incentive effects due to the substitution effect in the phase-out region are thus not a problem. However, the negative incentive effects due to the income effect remain.

take-home pay. One could potentially argue that the labor supply story may be more accurate in the U.S. economy where the EITC is targeted to low income earners where the minimum wage operate. This may stop the gross wage from falling inducing the take home pay to increase and consequently reward work in terms of a higher consumer wage.

3. Child care subsidy as in-work benefit?

I finally want to end this comment with a parallel to a different type of policy which has had a long history in Sweden. It is true that Sweden only recently implemented a tax credit conditioned on work. However, how about viewing the Swedish child care subsidy as an in-work benefit? The child care subsidy in Sweden resembles the U.S. system of EITC in a number of ways. First, it is an in-work benefit as it is conditioned on work (recently, in 2002, unemployed got limited access to subsidized child care). Second, it is directed towards families with children (although in the Swedish case, small children). Third, it is more generous to families with more children. Fourth, it is based on family income rather than individual income (which is unusual for the Swedish tax and transfer systems). It is also more generous towards single mothers (however this is only symbolic as the differences are very small). There are clearly also differences between the Swedish child care subsidy scheme and the U.S. EITC system. Most importantly, the Swedish childcare subsidy is in kind as it can only be used for child-care service consumption. However, it is very generous. The subsidy is about 90,000 SEK (\$12,800) a year/child. This adds up to total payments of 34 billion SEK (\$4.8 billion), which constitutes about 1.3 percent of GDP in Sweden. To get a perspective of the size of this program, the EITC constitute about 0.3 percent of GDP in the U.S.

It is difficult to empirically evaluate the impact of the subsidized child care on, in particular, female employment. A lot of things happened at the same time as the childcare subsidy was introduced. But in my view the childcare subsidies most likely have had a large impact on female labor supply.

4. Conclusions

Considering some of the particular Swedish institutional settings and earlier programs of similar type, there are thus reasons to believe that an EITC-type of policy will be good for employment also in a country like Sweden. However, it may be difficult to empirically evaluate the effects of the reform in the future as no consideration of how to evaluate the reform was taken at the time of implementation.

References

- Boone J., and Bovenberg, L. (2006), Optimal welfare and in-work benefits with search unemployment and observable abilities, *Journal of Economic Theory*, 126, 165-193.
- Immervol, H., Kleven, H. Kreiner, C.T. and Saez, E. (2007), Welfare reform and European countries; A micro simulation analysis, *Economic Journal*, 117, 1-44.
- Kolm, A-S., and Tonin, M. (2006), In-work benefits in search equilibrium, Working Paper 2006:12, Department of Economics, Stockholm University.
- Pissarides, C. (2000), *Equilibrium unemployment theory*, MIT Press, Boston, MA.