

Comment on Bruce Meyer: The earned income tax credit—a Swedish perspective

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This paper discusses in a very balanced way the effects of the US. 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 US 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 has become increasingly popular as a means to reduce poverty and improve work incentives across the western world. The UK followed the US more than 25 years ago and implemented a version of tax reliefs conditioned on work. Other countries that have recently followed the US and UK 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 has a different aim with such a reform and different preconditions for how well such a reform would function in comparison to the US. The aim of reducing poverty is less of an issue in Sweden, although decision makers certainly care about the income distribution. Affecting 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) which shows that the relationship between in-work benefits

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and welfare payment is *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 US, 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, create 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 US. Earned Income Tax Credit. First, the expansion of the EITC in the US 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. Second, 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 US. After all, the institutional framework is far from the same in Sweden and the US. Finally, I would like to draw a parallel to a different type of policy which has 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 in 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

¹ Here, one can note that the recently implemented tax credit in Sweden is not being 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.

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 from 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, it might be even more important that the Swedish labor market can be viewed as less market oriented than the US 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 be likely to have different effects on employment in countries like Sweden and the US due to institutional differences, accounting for those differences in an analysis seems 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 has been in place long enough to make empirical evaluations possible, one must rely on theoretical models and simulations to trace out the likely effects. Let us 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 an 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 is likely to increase search effort, labor force participation and employment, while reducing wages and the unemployment rate. The effects, however, do not mainly work through increased incentives 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 un-

employment spells due to more vacancies being posted when gross wages are lower increase labor force participation and search effort. Thus, employment increases both because 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 take-home pay. One could potentially argue that the labor supply story may be more accurate in the US economy where the EITC is targeted to low income earners where the minimum wage operates. This may stop the gross wage from falling, thus 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, what about viewing the Swedish child care subsidy as an in-work benefit? The child care subsidy in Sweden resembles the US 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 US 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 SEK 90,000 (USD 12,800) a year/child. This adds up to total payments of SEK 34 billion (USD 4.8 billion), which constitutes about 1.3 percent of GDP in Sweden. To get a per-

spective of the size of this program, the EITC constitutes about 0.3 percent of GDP in the US.

It is difficult to empirically evaluate the impact of subsidized child care on, in particular, female employment. Many things happened at the same time as the childcare subsidy was introduced. But in my view, childcare subsidies have most likely 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 since no consideration of how to evaluate the reform was taken at the time of implementation.

References

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