

# Selective reductions in labor taxation: Labor market adjustments and macroeconomic performance<sup>☆</sup>

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## Abstract

We use a calibrated general equilibrium model with heterogeneous labor and search to evaluate the quantitative effects of various labor tax cut scenarios. The focus is on skill heterogeneity combined with downward wage rigidities at the low end of the skill ladder. Workers can take jobs for which they are overeducated. We compare targeted and non-targeted tax cuts, both with or without over-education effects. Introducing over-education changes substantially the employment, productivity and welfare effects of a tax cut, although tax cuts targeted on the least skilled workers always have larger effects.

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## 1. Introduction

Many European countries, including the largest ones, are characterized by high labor taxes and high unemployment rates (Nickell, 2004). Although the causal relationship between labor taxes and unemployment remains a much debated issue, there are strong social and political pressures

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favorable to payroll tax cuts. The aim of this paper is to evaluate the quantitative effects of various labor tax cut scenarios on employment, productivity and welfare. To that end, we develop a calibrated general equilibrium model with heterogeneous labor and search.

The main implications of a labor tax cut in a standard aggregate model are well-known. With an inelastic labor supply curve (or wage-setting curve in an imperfect competition setup), tax cuts lead to higher net wages and have little impact on employment. By definition, such aggregate models fail to take into account the heterogeneity observed on actual labor markets. Accounting for this heterogeneity may be crucial, especially if payroll tax cuts are targeted on specific groups of workers. We focus in this paper on skill heterogeneity. This choice is motivated by the fact that the unemployment rise has been especially strong for low-skill workers. Several mechanisms may have contributed to this outcome. One possible mechanism is the rigidity of relative wages resulting, for instance, from minimum wage regulations in the face of asymmetric productivity shocks (see [Greenaway & Winchester, 2007](#)) who emphasize the role of embodied technological change and capital-skill complementarities). Tax cuts targeted on low-skill workers may in this context be seen as a means to decrease their relative wage cost and stimulate low-skill employment without changing relative net wages. An alternative mechanism has also attracted attention. Low-skill unemployment can be the result of job competition between high- and low-skill workers in a depressed labor market. If high-skill job seekers react to a demand slack by searching on both the high- and the low-skill segments of the labor market and by accepting jobs for which they are over-qualified, they will “crowd out” some low-skill workers. If wages are downward rigid at the bottom of the skill ladder, this crowding-out effect will lead to more low-skill unemployment. [Dolado, Felgueroso, and Jimeno \(2000\)](#) examine Spanish labor market and find symptoms of over-education. Similar conclusions are drawn for instance by [Mavromaras, McGuinness, O’Leary, Sloane, and Fok \(2007\)](#) for Britain and Australia.

To examine the implications of payroll tax cuts in such contexts, we set up a general equilibrium model including the government budget constraint and a representation of the labor market à la [Mortensen and Pissarides \(1994\)](#), with job competition effects as in [Albrecht and Vroman \(2002\)](#) and [Blazquez and Jansen \(2008\)](#), and on-the-job search as in [Dolado, Jansen, and Jimeno \(2002\)](#) and [Gautier \(2002\)](#). We distinguish three types of jobs and three types of workers. We first neglect job competition effects and evaluate the implications of targeted and non-targeted tax cuts. We next re-examine the same tax cut scenarios when there is job competition and overeducated workers hold low-skill jobs. The model is calibrated on Belgian data, but the comparisons across scenarios are valid for other countries sharing similar features in terms of low-skill unemployment and downward wage rigidities at the low end of the skill ladder. Our paper is closest to [Pierrard \(2005\)](#). This paper distinguishes only two types of jobs and workers but has an endogenous job destruction rate. It suggests, by comparison with previous general equilibrium models, that the effects of a tax cut targeted on minimum wages can be very large and come through the job destruction rather than the job creation channel.<sup>1</sup> This result is in line with the empirical results obtained for instance by [Laroque and Salanié \(2000\)](#), [Crépon and Desplatz \(2001, 2002\)](#) and [Kramarz and Philippon \(2001\)](#) on French data. The relative importance of the job destruction channel (as opposed to the job creation channel) may however be overemphasized in the [Pierrard \(2005\)](#) setup as, by construction, the direct impact of minimum wage changes is on the job destruction rate. In our paper, we reintroduce a direct link between job creation and minimum

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<sup>1</sup> [Mortensen and Pissarides \(1998\)](#) also emphasize the role of the job destruction channel, in a setup with linear production functions (rather than Cobb–Douglas), no minimum wage regulation and no job competition effects.

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