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Labor supply and government programs: A cross-country analysis

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A B S T R A C T

There are substantial cross-country differences in labor supply late in the life cycle (age 50+). A theory of labor supply and retirement decisions is developed to quantitatively assess the role of social security, disability insurance, and taxation for understanding differences in labor supply late in the life cycle across European countries and the United States. The findings support the view that government policies can go a long way towards accounting for the low labor supply late in the life cycle in the European countries relative to the United States, with social security rules accounting for the bulk of these effects.

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1. Introduction

There are substantial differences in labor supply and in the design of tax and transfer programs across countries. The cross-country differences in labor supply increase dramatically late in the life cycle: using data from the Survey of Health, Ageing, and Retirement in Europe (SHARE), Fig. 1 documents that while differences in employment rates among eight European countries are in the order of 15 percentage points for the 50–54 age group, they increase to 35 percentage points for the 55–59 age group and to more than 50 percentage points for the 60–64 age group. In this paper we quantitatively assess the role of social security, disability insurance, and taxation for understanding differences in labor supply late in the life cycle (age 50+) across European countries and the United States. The paper makes three contributions to the recent literature in macroeconomics studying government policies and labor supply across countries.[1] First, we use the newly released Survey of Health, Ageing, and Retirement in Europe (SHARE), as well as the US Health and Retirement Study (HRS), to consistently document the facts on labor supply late in the life cycle (after the age of 50) across

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[1] See for example Prescott (2002, 2004), Ljungqvist and Sargent (2006), Ohanian et al. (2008), and Rogerson and Wallenius (2009).

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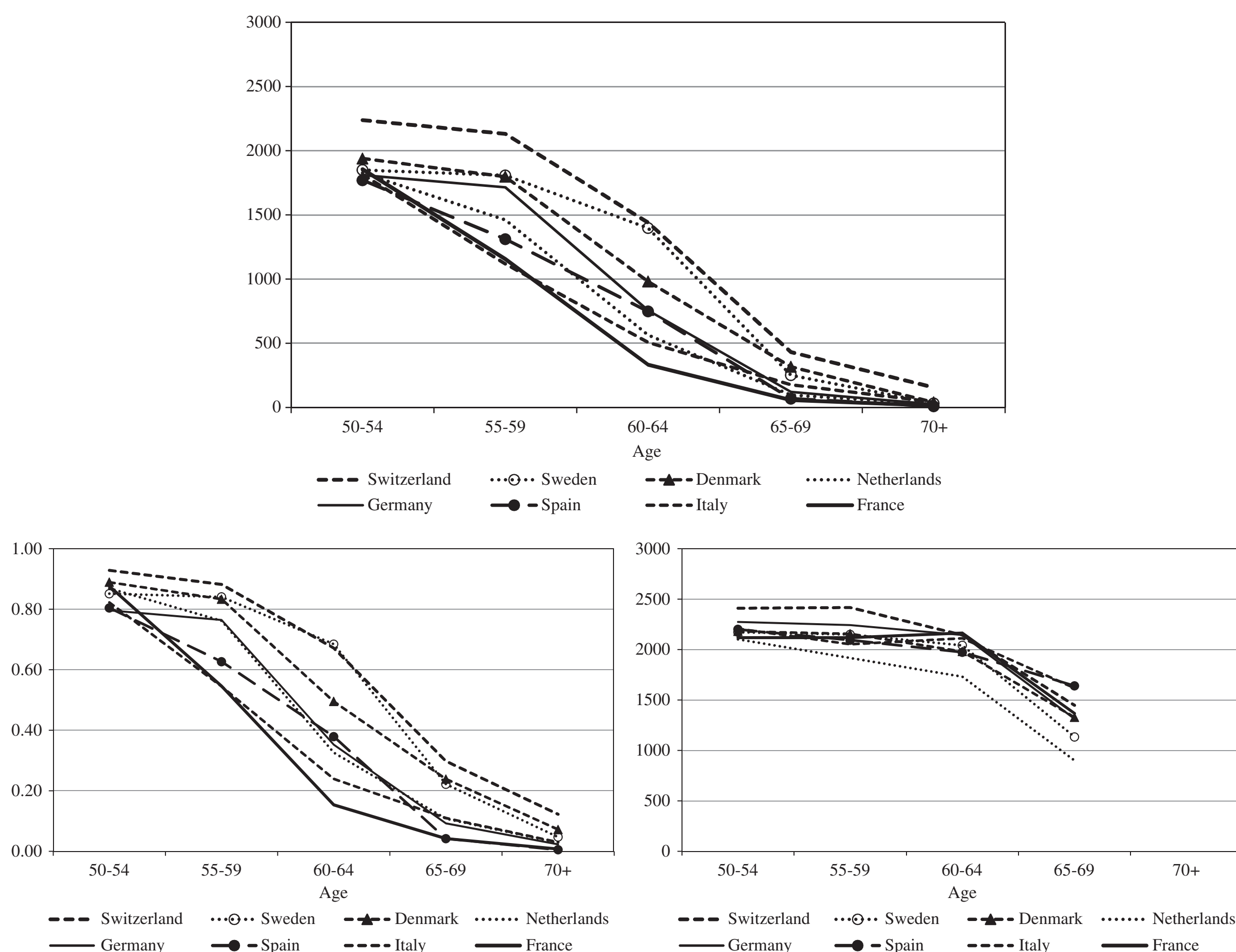

Fig. 1. Mean annual hours worked, SHARE 2006, men: all, extensive, and intensive margin.

many European countries and the US. Second, we document how the social security, disability, and taxation institutions vary across the countries in our empirical analysis. Third, we build a structural life-cycle model of labor supply and retirement decisions that explicitly models the key institutional differences across countries and use the model to assess the role of government policy in accounting for the micro-level observations documented in the empirical analysis.

While it is well known that the tax and transfer programs vary substantially across countries, there is substantial debate about their impact on labor supply decisions. A recent literature in macroeconomics has shown that tax differences can account for cross-country differences in labor supply, both in the context of the representative agent model (Prescott, 2002, 2004; Ohanian et al., 2008) and the life-cycle framework (Rogerson and Wallenius, 2009). This research has often been criticized for assuming a labor supply elasticity larger than the one typically estimated in empirical micro studies. When there is an active extensive margin on labor supply decisions and heterogeneous agents, however, aggregate labor supply responses are not driven by the preference parameter determining labor supply responses along the intensive margin (e.g., the parameter estimated in micro data as discussed in Rogerson and Wallenius, 2009; Erosa et al., 2011). The mass of agents that are close to being indifferent between working or not becomes crucial for labor supply responses (Chang and Kim, 2006). Building on these insights, we develop a theory of heterogeneous agents in which labor supply varies both along the intensive and extensive margins. Another important lesson from the literature is that aggregate labor supply responses to tax changes depend crucially on how tax revenue is spent (Prescott, 2002, 2004). Thus, we model in detail the social security system, which is arguably the most important transfer program in the OECD countries. Moreover, using data from national surveys, Gruber and Wise (2004) and Blondal and Scarpetta (1999) provide empirical evidence on the importance of social security rules in affecting retirement incentives for many countries. In addition, we model the disability insurance system since several empirical studies (Gruber and Wise, 2004) have also emphasized the potential importance of the so-called "early retirement programs" in Europe such as disability insurance. The SHARE with its harmonized cross-country methodology, allows us to document the facts on employment and participation on transfer programs consistently across several European countries.

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