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## Tax reform evaluation using non-parametric methods: Sweden 1980–1991

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### Abstract

This paper evaluates the tax reform carried out in Sweden between 1980 and 1991. We use a recently developed non-parametric estimation technique to account for the labor supply responses of married prime aged males. We decompose the tax reform to study how the separate components influence hours of work, tax revenue, and income distribution. We find that the decrease in marginal tax rates stimulated labor supply but that the other parts of the reform counteracted this effect. The net increase in average desired hours of work was approximately 2%. We also find that the reform was under financed and that inequality increased. The non-parametric predictions are compared to the results based on a flexible parametric model. The qualitative results are similar, but the quantitative results are quite different. © 2001 Elsevier Science B.V. All rights reserved.

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### 1. Introduction

The Swedish tax system has during the last couple of decades been transformed in several important ways. Marginal tax rates reached a peak around 1980. However, since this system with very high marginal tax rates was combined with a

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system of fairly liberal rules for deductions of various forms, many economic agents could avoid the high marginal taxes by using the system of deductions in a clever way. During the eighties, there was a series of tax reforms, decreasing marginal tax rates and limiting the scope for various forms of deductions. The series of tax reforms culminated in 1991 with a large change in marginal taxes between 1990 and 1991, several types of base broadening and the introduction of separate taxation of labor and capital income.

Several motivations have been given for implementing the tax reforms. The need to reduce the negative incentive effects of high marginal tax rates on household behavior such as savings and labor supply is probably the single most important one. Another motivation was a concern that the distributional effects of the old tax system were not the ones intended. The use of deductions could in many cases lead to high income earners paying very little in taxes.

The tax reform has been a continuous and gradual process for a long period of time. We therefore have a choice of what part of this process to study. We have chosen to study the effect of the tax reform that took place between 1980 and 1991. This period is of special interest since the tax systems in these two years constitute two extremes. Marginal tax rates reached a historical high in 1980 and a low in 1991.<sup>1</sup> We do not cover all aspects of the tax reform but focus on four changes of large importance for individual behavior; a decrease in marginal tax rates, an increase in the VAT and payroll taxes, a change in the rules for capital income taxation and deductions, and a change in the transfer system.<sup>2</sup>

The major purpose of our paper is to study how the tax reform has affected desired hours of work, tax revenue, and the income distribution. We investigate the net effect of the tax reform, but also perform a decomposition so we can see the effects of its various parts. The evaluation of the reform is performed by simulations. The benchmark of the calculations is the 1980 tax and transfer system coupled with the observed distribution of gross wage rates, capital income and other socio-demographic variables in 1980. In a predefined sequence, we substitute the tax and transfer rules in the 1991 system for the corresponding rules in the 1980 system and calculate the desired hours of work, the tax revenues, and the income distribution.

The paper contains three methodological advances as compared to many earlier studies. First, we decompose the overall set of policy changes into its component effects. This is useful, since if the policy makers would like to do further reforms it is essential to know the effects of the separate instruments that together form the tax system. Second, a novel feature of this study is that we use a non-parametric labor supply function to calculate how hours of work change in response to the tax reform. Since this non-parametric function requires less stringent distributional and

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<sup>1</sup>After 1991 there have been some increases in the marginal tax rates.

<sup>2</sup>There has also been important changes in the corporate taxation, which are not covered in this study.

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