Lost jobs, new jobs and optimal tax-tranfers reforms

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Optimal labor income taxation

- Conceptually, optimal labor income taxation problem (Mirrlees (1971), Saez (2001), Saez (2002)) is government maximizes SWF subect to:
  - Government budget constraint
  - Individual consumption-leisure optimal trade-off
- With respect to such a problem from the traditional literature:
  - Microsimulation tools are used
  - Additional constraint in the model: labor market equilibrium ("reduced form" labor demand function with constant elasticity)

This paper

- This paper finds that the optimal tax and transfer rule is close to an affine function of income (demogrant + linear tax).
  - No negative marginal tax rates at the bottom (no EITC)
  - Limited tax progressivity
  - No very high marginal tax rate at the top

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- In this discussion I will focus on:
  1. What elements of the model are driving the results?
  2. How do these conclusions compare to the traditional optimal tax literature? What could be reasons for divergence from the literature?

EITC vs NIT

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- It seems that flexible wages (finite elasticity labor demand) key:
  - Authors show if wages not flexible in this model EITC better than NIT
  - Aaberge and Colombino (2013) with no labor demand find EITC-like policy optimal
- Literature on the topic?

EITC vs NIT

- Historical literature:
  - Saez (2002) model with ext margin labor supply (but no labor demand/involuntary unemployment), finds that EITC can be optimal if extensive margin labor supply responses more significant than intensive margin ones
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- More recently, jury seems still out:
  - Empirical papers that question the relative importance of extensive and intensive margin responses (Chetty, Friedman, and Saez (2013), Kleven (2024), Kleven, Kreiner, Larsen, and Søgaard (2024)). If so, even within Saez (2002) framework NIT could be optimal
  - Papers that question Saez (2002) framework by introducing labor demand and involuntary unemployment: Kroft, Kucko, Lehmann, and Schmieder (2020), Ferey (2022), Hummel (2025). Mixed results with respect to the NIT vs EITC debate
- This paper fits the more recent literature

Progressivity

- Saez (2001) finds more progressivity in contrast to earlier numerical simulation of the model in Mirrlees (1971)
- Mankiw, Weinzierl, and Yagan (2009) argue the importance for the Saez (2001) result of the shape of the earnings distribution
  - Does the shape of the earnings distribution matter? Different scenarios, similar results (some difference for Luxembourg but MTRs do not rise much)
  - Surveys struggle to estimate right tail. Does this matter? Thin tails reduce the benefit of increasing marginal tax rates

Progressivity

- SWF and U:
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  - Utility function. Does MU become quickly flat ? Does the result change with a different functional form?

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- SWF and U:
  - With k large enough can span all SWFs until Rawlsian. How much is $k = 0.5$ (max in the paper)?
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- Are labor supply elasticities increasing in income? Does that drive the result?

Top tax rate

	US	Denmark	IT
Pareto parameter	1.5	3.3	?
Standard e	0.2	0.2	0.2
Dynamic e	0.5	0.5	0.5
Top rate Rawlsian (standard e)	0.77	0.60	?
Top rate Rawlsian (dynamic e)	0.57	0.38	?
Top rate this paper			≈ 0.45

Adapted from Kleven, Kreiner, Larsen, and Søgaard (2024)

- Does not look very different conditional on SWF: if same SWF (Rawlsian), top tax rate higher in this paper (or viceversa others would be lower with no Rawlsian)
- Other potential differences include: implied elasticity at the top, estimated thickness right tail (does it matter in this model, potential issue with survey data) ?

Concluding remarks

- Congratulations on an interesting paper about an important topic!!!
- It argues that moving to a system with a NIT + a linear tax could boost social welfare by increasing output and reducing poverty, despite some additional inequality
- It would be interesting to unpack a bit more what is behind the limited tax progressivity in the results

Literature I

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