

Remarks on Steven Davis,
“Tax Effects On Work Activity,
Industry Mix and Shadow
Economy Size: Evidence From
Rich-Country Comparisons”

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The Paper and the Literature

- Tax and labor supply literature moved away from early Hausman result because of work of Heckman, MaCurdy and others. Elasticity around zero (except for second earners.)
- Cross country differences appear highly correlated with tax rates differences.
- Puzzle

How Can It Happen?

- High taxes move people into shadow production. Everyone still works 40 hours, say, but the tax authority only views 30 of the hours.
- Paper finds strong evidence of this.

Is There Another Link?

- Anne Moore and I are finishing a paper on the possible capital link.
- High capital and labor taxes may be correlated.
- Capital flows that raise labor demand should increase hours.
- Capital has been found to be highly sensitive to tax factors.

Solow Model

$$Y = F(K, L) = K^\alpha (AL)^{1-\alpha}$$

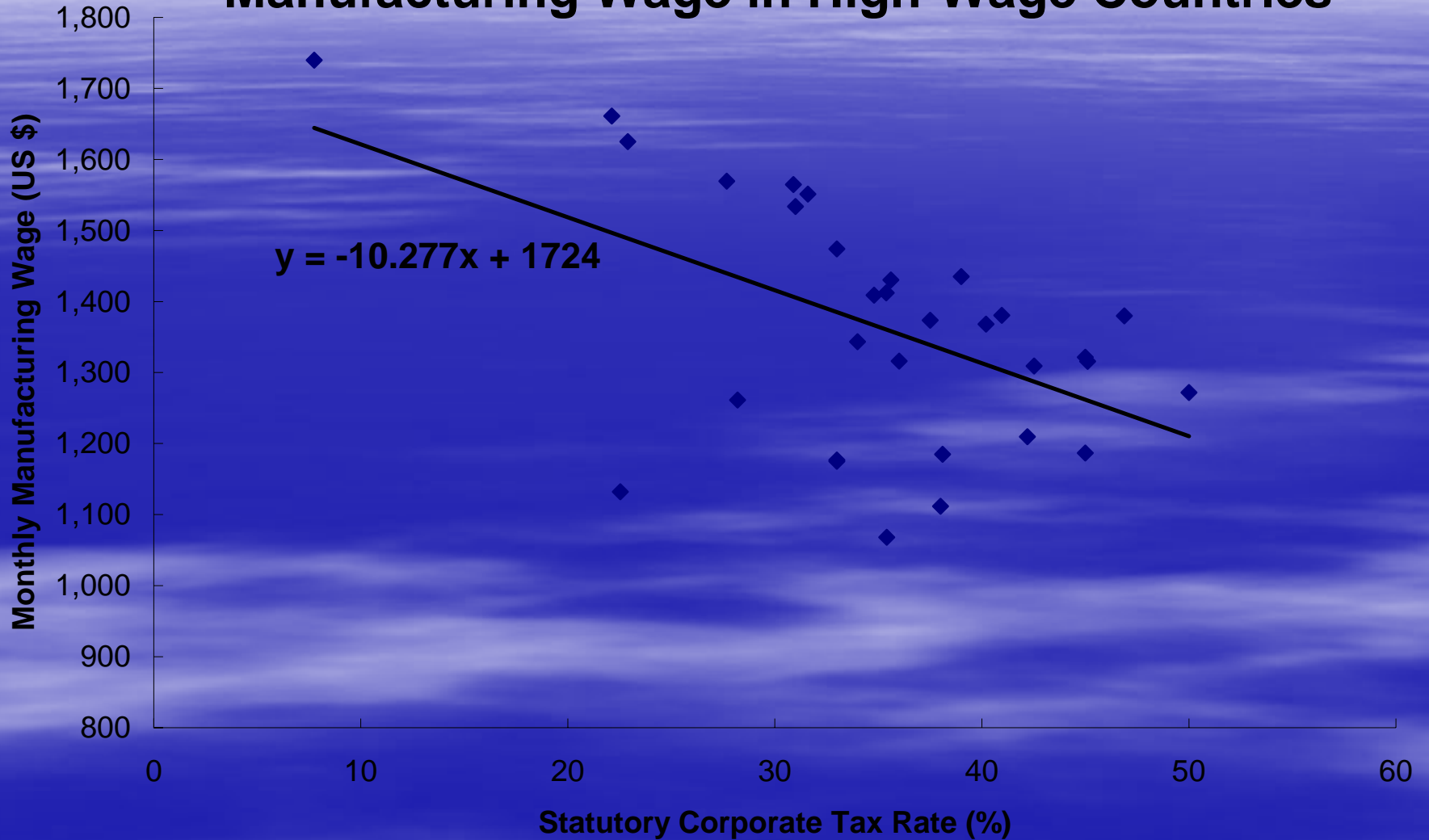
Wage Equation

$$\begin{aligned} w &= \frac{\partial Y}{\partial L} = (1-\alpha) A^{(1-\alpha)} \left(\frac{K}{L} \right)^\alpha \\ &= (1-\alpha) A^{(1-\alpha)} k^\alpha \end{aligned}$$

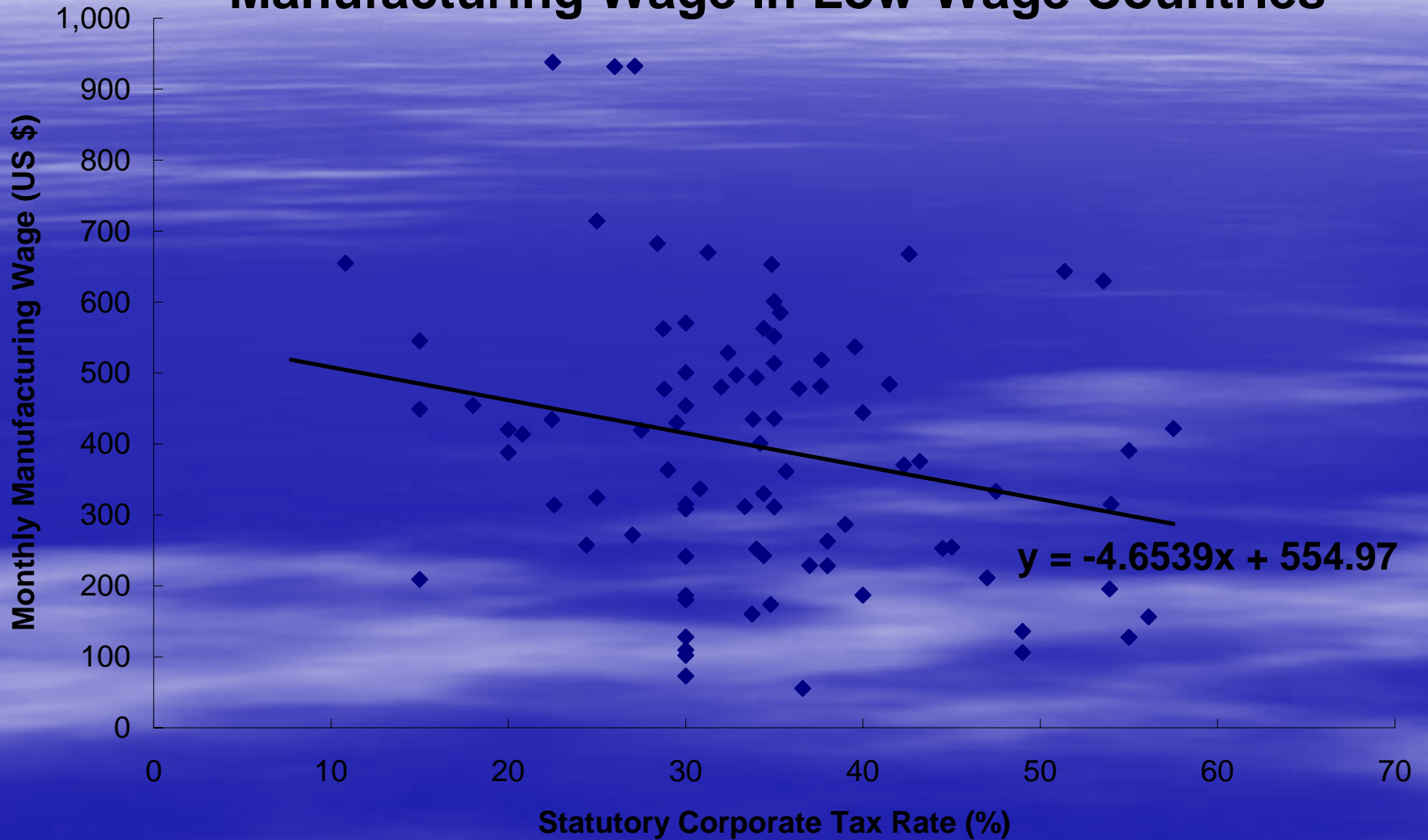
Data

- Summers Heston data and our own tax database.
- To match Steve's analysis, we look at 5-year averages.

Corporate Tax Rate vs. Average Manufacturing Wage in High-Wage Countries



Corporate Tax Rate vs. Average Manufacturing Wage in Low-Wage Countries



Conclusions

- Capital flows may be a big part of the story.
- Evidence also consistent with transition to entrepreneurship lit.
- But...
 - I am troubled by the difficulty of finding effect with time series variation.