Labour Taxes and Work Hours in Australia

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Abstract

In the 1970s, work hours in Europe were similar to work hours in the United States, but today Europeans work less than Americans. Prescott (2004) attributes the decline in European work hours to an increase in the effective marginal tax rate on labour income. Applying Prescott's dynamic general equilibrium model to Australian labour market data confirms that the taxation of labour income is an important determinant of the decision to work. In this paper it is found that a temporary increase in taxes reduced Australian work hours in the 1980s, while taxes and work hours did not change much in the long-run. The resilience of Australian work hours in the 1990s suggests that a return to the tax rates of the 1970s would restore the European labour supply.

1. Introduction

As recently as in the 1970s, work hours in Europe exceeded work hours in the United States, yet today Europeans spend less time at work than Americans. The reversal of European and American work hours in the last quarter of the twentieth century provides an opportunity to study the effect of labour market institutions on national labour supplies. Institutional factors that are commonly thought to influence the decision to work include the tax system, unemployment benefits, the degree of unionisation and other labour market conditions.

Table 1 illustrates the dramatic shift that occurred in weekly work hours in Europe and America. In the early 1970s, work hours per person aged 15 to 65 years averaged 24.4 hours in France and 24.6 hours in Germany, whereas Americans worked 23.5 hours. By the mid-1990s, average work hours had fallen to 17.5 hours in France and 19.3 hours in Germany, while American work hours had risen to 25.9 hours. This amounts to a decrease in labour supply of 28 per cent in France and 22 per cent in Germany, and an increase of ten per cent in America. Between the 1970s and the 1990s, weekly work hours fell in all G-7 countries, except in America and Canada. Prescott (2004) specifies a labour market model that highlights the relationship between weekly work hours and taxes on labour income. He concludes that ‘virtually all of the large differences between the United States labour supply and those of Germany and

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France are due to the differences in the tax system. Surprisingly, national differences in labour market institutions, including the system of unemployment benefits and the degree of unionisation, matter little. Prescott finds that the distortionary effect of the high European taxes on labour income produces a substantial welfare loss. If France were to reduce its taxes on labour income to the United States level, the welfare of French workers as measured by lifetime consumption equivalents would increase by 19 per cent.

Table 1 - Work Hours Per Week for the G-7 Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>1970-74</th>
<th>1993-96</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>22.2</td>
<td>22.9</td>
</tr>
<tr>
<td>France</td>
<td>24.4</td>
<td>17.5</td>
</tr>
<tr>
<td>Germany</td>
<td>24.6</td>
<td>19.3</td>
</tr>
<tr>
<td>Italy</td>
<td>19.2</td>
<td>16.5</td>
</tr>
<tr>
<td>Japan</td>
<td>29.8</td>
<td>27.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>25.9</td>
<td>22.8</td>
</tr>
<tr>
<td>United States</td>
<td>23.5</td>
<td>25.9</td>
</tr>
</tbody>
</table>

Notes: Weekly work hours per person aged 15 to 65 years. The figures are from Prescott (2004).

Davis and Henrekson (2005) conduct a cross country analysis of the effect of taxes on work effort. They concur with Prescott that tax rate differences among rich countries explain much of the international variation in work activity outcomes. Still, the findings of Prescott (2004) and Davis and Henrekson (2005) remain controversial. Olovsson (2004) shows that work hours in Sweden exceed work hours in France and Germany, although Sweden has the highest tax rate in the world. Nickell (2004), who considers a bargaining model of wage determination, estimates that the tax wedge explains about one quarter of the difference in employment between Europe and the United States. The remainder is being accounted for by differences in national social security systems and other labour market institutions.

Alesina, Glaeser and Sacerdote (2006) also reject Prescott’s claim that taxes explain most of the low work hours in Europe. They argue that a regression of work hours on taxes that omits the degree of unionisation overestimates the effect of taxes because tax rates are positively correlated with the degree of unionisation. Once the degree of unionisation and employment protection is included among the explanatory variables, the tax effect becomes insignificant. Rogerson (2006), however, finds no relationship between work hours and the degree of unionisation and employment protection. He also points out that country and time dummy variables account for most of the explanatory power in the regressions conducted by Alesina, Glaeser and Sacerdote (2006).

Ljungqvist and Sargent (2007) hold that generous government transfers, which are conditional on recipients not working, account for low European work hours. Prescott (2007) rejects their model because, unlike his own, it does not provide ‘a quantitative general equilibrium analysis … that is restricted to be consistent with the national account statistics’. Yet, Prescott recognises that Ljungqvist and Sargent’s
approach sheds light on the implications of labour indivisibility. Employed Europeans work similar hours per day and week as Americans. In Europe average weekly work hours of the working age population are low because people take longer vacations, more sick days and there are more public holidays. In addition, Europeans start to work later in life and they retire earlier than Americans.

In this paper, the dynamic general equilibrium model of Prescott (2004) is used to analyse the relationship between taxes on labour income and work hours in Australia. Prescott’s macroeconomic approach complements microeconomic studies of taxes and labour supply in Australia, such as Kalb (2002) and Breunig et al. (2008).\(^1\)

Both macroeconomic and microeconomic models apply an optimizing framework to labour supply. Section 2 presents Prescott’s labour market model. Section 3 details how Australian national accounts data were transformed to fit the labour market model and how the effective marginal tax rate on labour income was calculated. Section 4 compares actual and predicted work hours in Australia with work hours in the G-7 countries. As in the United States, in Australia taxes on labour income and work hours did not change much in the long-run, but a short-lived increase in Australian taxes temporarily reduced work hours in the 1980s. Section 5 considers whether other factors besides labour taxes affected work hours. Section 6 concludes with some remarks on taxation and labour supply in Australia.

2. Labour Market Model

Prescott (2004) presents a labour market model that explains how a person allocates time between work and leisure. The distinction between work and leisure depends upon whether an activity is taxed or not. Market work is subject to taxation, whereas leisure comprises all tax-free non-market work, in particular home work and work in the shadow economy, together with ordinary leisure activities. The available time for work and leisure is 100 hours per week, the remaining time being used for sleep and other necessities of life. In period \(t\), the preferences of the representative worker are:

\[
\log c_t + \alpha \log(100 - h_t) \tag{1}
\]

where \(c\) is weekly consumption, \(h\) represents weekly work hours, and \((100-h)\) measures leisure time. The parameter \(\alpha\) is a weight that determines the subjective value of leisure. The logarithmic utility function implies that the elasticity of substitution between leisure in two time periods equals one.\(^2\)

The worker allocates time between market work and leisure subject to the budget constraint:

\[
(1+\tau_c)c_t + (1+\tau_x)x_t = (1-\tau_k)w_t h_t + (1-\tau_x)(r_t - \delta)k_t + \delta k_t + T_t \tag{2}
\]

\(^1\)See also Creedy and Kalb (2006) and Buddelmeyer et al. (2007).
\(^2\)See Romer (2006, 183-184) for the implications of logarithmic preferences. Harding and Negara (2008) calibrate a real business cycle model for Australia with a utility function that is logarithmic in consumption. Kam et al. (2009) estimate that the coefficient of relative risk aversion is close to one in Australia, implying logarithmic preferences for consumption.
$x$ denotes gross investment, $w$ the real wage, $k$ the capital stock, $r$ the real interest rate, $\delta$ the depreciation rate and $T$ government transfers. The taxes are: $\tau_c$ consumption tax rate, $\tau_i$ investment tax rate, $\tau_h$ marginal labour tax rate and $\tau_k$ capital income tax rate. The budget equation states that the sum of wage income, capital income, depreciation allowances and government transfers must equal expenses for consumption and gross investment, with all items being adjusted by the pertinent tax rate. The government uses taxes to finance public services, which, except for military expenses, are assumed to be perfect substitutes for private consumption. Any excess of taxes over expenses for public services is returned to households as lump-sum transfer payments.

Output $y_t$ is produced with a Cobb-Douglas technology:

$$y_t = A_t k_t^{\theta} h_t^{1-\theta}$$  \hfill (3)

Assuming workers are paid the marginal product, the parameter $\theta$ is the capital share in income. $A_t$ is a productivity parameter. Since it is assumed that the Cobb-Douglas production function has constant returns to scale, the size of the productive unit does not matter; it may be a single worker or a firm.

The effective marginal tax rate on labour income captures the combined effect of labour and consumption taxes on the work decision. To calculate the effective marginal tax rate, differentiate the budget equation with regard to consumption and labour income, holding all other variables constant.

$$\Delta c_t = \frac{1 - \tau_h}{1 + \tau_c} \Delta (w_t h_t)$$ \hfill (4)

In this expression the fraction $(1-\tau_h)/(1+\tau_c)$ represents the effective marginal increase in labour income, unencumbered by labour and consumption taxes. Setting $(1-\tau) = (1-\tau_h)/(1+\tau_c)$, the effective marginal tax rate $\tau$ is:

$$\tau = \frac{\tau_h + \tau_c}{1 + \tau_c}$$ \hfill (5)

The first optimum condition requires that the marginal rate of substitution between consumption and leisure is equal to the after-tax real wage, using the effective marginal tax rate on labour income.

$$\frac{\alpha/(100 - h_t)}{1/c_t} = (1 - \tau_c) w_t$$ \hfill (6)

The marginal rate of substitution, which is shown on the left-hand side of the optimum condition, can be derived from equation 1. The second optimum condition states that the real wage must equal the marginal product of labour.

$$w_t = (1-\theta) y_t / h_t$$ \hfill (7)
Substituting equation 7 into equation 6 yields the key equilibrium relationship between work hours, the effective marginal tax rate on labour income and the consumption-income ratio.

\[ h_t = \frac{1 - \theta}{1 - \theta + \frac{c_t}{y_t} \frac{\alpha}{1 - \tau_t}} \]  

(8)

This equilibrium relationship contains two endogenous variables, work hours \( h \) and the consumption-income ratio \( c/y \), whose values depend on the effective marginal tax rate \( \tau \) and all other factors that determine the path of the economy in a dynamic macroeconomic model. The equation splits the effect of a change in the tax rate into a present-time substitution effect and an intertemporal substitution effect. An increase in \( \tau \) lowers the incentive to work because the after-tax wage falls, reducing the relative price of leisure in the first optimum condition. If the increase in \( \tau \) is expected to be temporary, the \( c/y \) ratio rises because people work less and, maintaining consumption, save less as long as the higher taxes persist. Consequently, a temporary increase in \( \tau \) reduces \( h \) both because \((1 - \tau)\) falls and the intertemporal substitution effect increases the \( c/y \) ratio. A permanent tax increase cannot be avoided by postponing work effort. As there is no intertemporal substitution effect, a permanent tax increase reduces \( h \) only by lowering \((1 - \tau)\), without affecting the \( c/y \) ratio. Since extra tax revenues are returned to households through lump-sum transfer payments, there are no wealth effects in this analysis. Prescott (2004) uses equation 8 to measure the effect of taxes on work hours.

3. Australian Taxes

Prescott (2004) calculates the effective marginal tax rate on labour income for the G-7 countries, using United Nations System of National Accounts data (SNA). The following calculations for Australia follow Prescott’s method as far as possible. Since SNA data are unavailable for Australia after 1998, OECD data have been used for the period from 2001 to 2003.

Most indirect taxes are consumption taxes, although some indirect taxes are levied on investment goods, for example in the transport sector and in the building industry. Prescott assumes that in the G-7 countries two thirds of total indirect taxes net of subsidies are consumption taxes, and the other third falls evenly on consumption and investment goods. Then, net indirect consumption taxes are:

\[ IT_c = \left[ \frac{2}{3} + \frac{1}{3} \frac{C}{C + I} \right] IT. \]  

(9)

\( IT \) and \( IT_c \) denote total indirect taxes and indirect consumption taxes net of subsidies, and \( C \) and \( I \) are consumption and investment from the national accounts. Capital letters indicate national accounts data.

Indirect taxes are computed on final products in the budget equation because they are assigned to households in the model. Therefore, indirect taxes must be removed as a cost component of GDP and consumption. The model variables for aggregate output \( y \) and consumption \( c \) are:
\[ y = GDP - IT \] 

\[ c = C + G - G_{\text{military}} - IT_c \] 

\[(G - G_{\text{military}})\] stands for the government’s civilian public services. Aggregate consumption is composed of private consumption and civilian public services, which are assumed to be perfect substitutes.

The consumption tax rate \( \tau_c \) is calculated as:

\[ \tau_c = \frac{IT_c}{C - IT_c} \] 

The model considers two tax rates associated with labour income, the marginal social security tax rate \( \tau_{ss} \) and the income tax rate \( \tau_{inc} \). The estimate for \( \tau_{ss} \) is:

\[ \tau_{ss} = \frac{\text{Social Security Taxes}}{(1 - \theta)y} \] 

The social security taxes in the SNA database include contributions for pension funds, unemployment insurance, health insurance and a number of other provisions. In Australia pension funds and unemployment insurance are not funded by social security taxes. \((1-\theta)\) is the labour share of income in the Cobb-Douglas production function if workers earn the marginal product in a competitive labour market. The average income tax rate is:

\[ \bar{\tau}_{inc} = \frac{\text{Direct Household Taxes}}{GDP - IT - Depreciation} \] 

The average income tax rate is transformed into the marginal tax rate by the formula

\[ \tau_h = \tau_{ss} + 1.6 \bar{\tau}_{inc} \] 

The average tax rate is multiplied by the factor 1.6 because the marginal tax rate exceeds the average tax rate in a progressive income tax system. Prescott (2004) derives this figure from a study by Feenberg and Coutts (1993), who use a sample of United States tax records to determine the marginal tax rate on labour income. The effective marginal tax rate on labour income \( \tau \) (equation 5) combines the consumption tax rate \( \tau_c \) (equation 12) with the marginal income tax rate \( \tau_h \) (equation 15).

\[^3\]The discussion paper version of this paper (available on SSRN) includes spreadsheets with the Australian data and calculations. The consumption tax rate is comparable with those of Creedy (1999, table 1), who provides estimates for various commodity groups for 1993. For that year, our estimate is \( \tau_c = 0.141 \), which is close to Creedy’s estimates (0.129 for food and beverages, and an unweighted average of 0.137 for all commodity groups, excluding spirits, beer, wine and tobacco).
Besides the Feenberg-Coutts parameter, the capital share of income $\theta$ and the weight of leisure $\alpha$ must be specified. Prescott (2004) keeps all three parameters constant across the G-7 countries. The capital share $\theta = 0.3224$ is the average for all G-7 countries, and the weight of leisure $\alpha = 1.54$ brings the predicted work hours near the actual value for most countries. He treats the weight of leisure as a residual parameter because there exists no empirical literature on it. In this study, Prescott’s parameter values for the G-7 countries are applied to Australia. The capital share in income, measured as the ratio of gross operating surplus divided by gross national income, fluctuated between 0.300 and 0.317 in Australia in the 1990s (ABS 5204.0, table 7). Hallam (2006, 54-56) conducts a sensitivity analysis, which shows that the Feenberg-Coutts parameter is the least influential parameter in the labour market model. A ten per cent change in the Feenberg-Coutts parameter results in a 1.5-2.0 per cent change in predicted work hours. The responses in work hours are about 3.5 per cent and 7.0 per cent if $\theta$ and $\alpha$ change by ten per cent.

Using equation 5, the effective marginal tax rate on labour income is low in Australia compared to most G-7 nations (table 2). In the 1970s and 1990s, taxes in Australia absorbed close to one third of an extra dollar of labour income. In the G-7 countries, marginal tax rates between 40 and 50 per cent were common in the 1970s, and above 50 per cent in the 1990s. The only exception is Japan with a marginal tax rate of 25 per cent in the 1970s and 37 per cent in the 1990s. The effective taxation of labour income is less onerous in Australia than abroad because both the marginal labour tax rate and indirect consumption taxes are low. Australians did not pay a general consumption tax until the introduction of the goods and services tax (GST), which became operational on July 1, 2000. Even after the introduction of the GST, the effective marginal tax rate remained low because the GST, which is set at ten per cent, replaced a host of indirect taxes, and basic food items as well as some other goods and services are exempted.

Table 2 - Effective Marginal Tax Rates for Australia and the G-7 Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>1970-74</th>
<th>1993-96</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>0.32</td>
<td>0.34</td>
</tr>
<tr>
<td>Canada</td>
<td>0.44</td>
<td>0.52</td>
</tr>
<tr>
<td>France</td>
<td>0.49</td>
<td>0.59</td>
</tr>
<tr>
<td>Germany</td>
<td>0.52</td>
<td>0.59</td>
</tr>
<tr>
<td>Italy</td>
<td>0.41</td>
<td>0.64</td>
</tr>
<tr>
<td>Japan</td>
<td>0.25</td>
<td>0.37</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.45</td>
<td>0.44</td>
</tr>
<tr>
<td>United States</td>
<td>0.40</td>
<td>0.40</td>
</tr>
</tbody>
</table>

Notes: G-7 countries (Prescott 2004), Australia (see text).

Table 2 documents the increase in taxes in continental European countries from the early 1970s to the early 1990s. The effective marginal tax rate on labour income rose from 49 per cent to 59 per cent in France and from 52 per cent to 59 per

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4 Earlier, this measure of the capital share was lower because of the high share of “mixed income” (the income of unincorporated firms).
cent in Germany. Meanwhile, tax rates remained virtually unchanged in Australia and the United States. This substantial increase in the tax wedge forms the basis of Prescott’s explanation of the labour supply divide that has occurred between America and Europe since the 1970s. The American labour supply remained stable because the tax rate did not change, whereas in Europe rising taxes provided a disincentive for work.

4. Actual and Predicted Work Hours

In this section equation 8 is used to predict work hours for Australia during the past four decades. The predicted work hours are compared with actual values, which are calculated from labour market data of the Groningen Growth and Development Centre and the OECD Database on labour force statistics. If Prescott’s hypothesis on the importance of taxes in determining labour supply is correct, then Australian work hours should be similar to those in other countries with comparable tax rates, the predicted number of work hours should match actual work hours, and actual and predicted work hours should move in the opposite direction of the tax rate from one period to the next.

In the early 1970s, actual work hours were similar in Australia, America, France and Germany. In all four countries, 15 to 65 year olds on average worked about 24 hours per week (tables 1 and 3). From the 1970s to the 1990s, tax rates and actual work hours remained stable in Australia and the United States, while taxes increased and work hours fell below twenty hours in France and Germany (tables 1, 2 and 3). This observation supports Prescott’s hypothesis that the labour taxes determine work hours. Work hours remained stable in Australia and the United States where taxes did not change, while the increase in European taxes accounts for the decline in European work hours. But the model fails to explain initial work hours in the 1970s. Actual work hours were similar in Australia, America, France and Germany, although the effective marginal tax rate on labour income was considerably less in the first two countries.

Table 3 - Actual and Predicted Labour Supply for Australia

<table>
<thead>
<tr>
<th>Period</th>
<th>Tax Rate</th>
<th>c/y Ratio</th>
<th>Predicted Work Hours (h)</th>
<th>Actual Work Hours</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-74</td>
<td>0.32</td>
<td>0.68</td>
<td>30.3</td>
<td>24.2</td>
<td>6.1</td>
</tr>
<tr>
<td>1986-88</td>
<td>0.39</td>
<td>0.72</td>
<td>27.0</td>
<td>22.9</td>
<td>4.1</td>
</tr>
<tr>
<td>1993-96</td>
<td>0.34</td>
<td>0.76</td>
<td>27.6</td>
<td>23.5</td>
<td>4.1</td>
</tr>
<tr>
<td>2001-03</td>
<td>0.33</td>
<td>0.74</td>
<td>28.6</td>
<td>24.0</td>
<td>4.6</td>
</tr>
</tbody>
</table>

In table 3 predicted Australian work hours exceed actual work hours by about four to six hours. These errors lie within the range of errors for the G-7 countries in Prescott’s study. The model accurately predicts work hours in Germany in the 1970s and in the United Kingdom in the 1990s, and it over predicts work hours in Italy and Japan by six and nine hours in the 1970s. One explanation for the divergence between predicted and actual work hours in Australia is that actual (measured) work hours may be too low. Since OECD data are unavailable until 1978, Australian work hours were
calculated using data from the Groningen Growth and Development Centre. After 1978, actual work hours increase between 0.7 and one hour if OECD data is used instead of the Groningen data.\(^5\) Prescott (2004) also suggests that the model over predicts work hours for countries with a low tax rate because the curvature of the logarithmic utility function with respect to leisure may be too low. Since the Australian tax rate was low, a more strongly curved utility function would reduce predicted work hours.

In table 3 predicted and actual work hours always move in the same direction, reflecting changes in the Australian tax rate. Between the early 1970s and the late 1980s, the Australian tax rate increased from 32 per cent to 39 per cent, leading to a decline in predicted work hours from 30.3 to 27.0 hours and in actual work hours from 24.2 to 22.9 hours. Between the late 1980s and the early 1990s, the movement in the tax rate reversed and work hours rebounded. The tax rate dropped to 34 per cent in the early 1990s and stayed at that level afterwards. The lower tax rate accounted for an increase in predicted work hours from 27.0 to 28.6 hours and in actual work hours from 22.9 to 24.0 hours. After high taxes in the 1980s, the tax rate returned to a level that was only one percentage point higher than thirty years earlier, and actual work hours differed by only 0.2 hours from the previous level. Thus, the Australian experience supports Prescott’s policy recommendation that if France and Germany reversed the increase in their tax rates since the 1970s, then they would move toward their previous labour supply outcomes. In Australia the reversal of the tax rate after a period of high taxes indeed restored the original labour supply.

5. The Consumption-income Ratio

Of course, the taxation of labour income is not the only factor that determines labour supply. Equation 8 contains two endogenous variables, work hours \(h\) and the consumption-income ratio \(c/y\), which depend on the effective marginal tax rate on labour income and on all other factors that are relevant in a dynamic macroeconomic model. These other factors include the current capital stock, expected future tax rates and productivity shocks. It is possible that movements in these other factors cause simultaneous changes in work hours and the \(c/y\) ratio, without a change in the marginal tax rate. For example, a temporary increase in the marginal product of labour provides an incentive to work more and to save, raising work hours and reducing the \(c/y\) ratio. Ljungqvist (2006) shows that the tax rate explains about two thirds of the change in work hours in France and Germany between the 1970s and 1990s, the remaining third being accounted for by productivity shocks and other factors that affect the \(c/y\) ratio.

Ljungqvist (2006) measures the effect of a change in the effective marginal tax rate on work hours by holding the \(c/y\) ratio constant in equation 8. This yields the effect of a permanent tax change on work hours that does not produce an intertemporal substitution effect, providing the minimum effect of a tax change on work hours. Table 4 compares the predicted work hours for Australia, using the actual \(c/y\) ratio in each period and holding the \(c/y\) ratio constant at the level of the preceding period; the \(c/y\) ratio is given in table 3. Between the 1970s and 1980s, predicted work hours fell by 10.9 per cent, but they would have fallen by 7.3 per cent if the \(c/y\) ratio had been

\(^5\) Baker and Roberts (2007), however, find that the OECD data overestimate Australian work hours. The Groningen data are close to Baker and Roberts’s estimates.
constant. Thus, the increase in the tax rate from 32 per cent to 39 per cent accounted for two thirds of the reduction in labour supply, and maybe more if people perceived the tax hike to be temporary, as it indeed turned out to be. Between the 1980s and 1990s, predicted work hours increased by 2.0 per cent, but they would have increased by 5.9 per cent if the c/y ratio had been constant. In this interval, an increase in the c/y ratio dampened the positive effect of the fall in the tax rate on work hours. Between the 1990s and the early 2000s, the tax rate accounted for one third of the increase in predicted work hours. In the last interval, the effect of the tax rate was modest because it did not change much. These calculations confirm that the Australian labour supply responds strongly to changes in the effective marginal tax rate on labour income.

Table 4 - Decomposition of Predicted Work Hours for Various Periods

<table>
<thead>
<tr>
<th>Period</th>
<th>Predicted Work Hours</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-74</td>
<td>30.3</td>
<td></td>
</tr>
<tr>
<td>1986-88 (86-88 c/y ratio)</td>
<td>27.0</td>
<td>-10.9</td>
</tr>
<tr>
<td>1986-88 (70-74 c/y ratio)</td>
<td>28.1</td>
<td>-7.3</td>
</tr>
<tr>
<td>1986-88</td>
<td>27.0</td>
<td></td>
</tr>
<tr>
<td>1993-96 (93-96 c/y ratio)</td>
<td>27.6</td>
<td>2.0</td>
</tr>
<tr>
<td>1993-96 (86-88 c/y ratio)</td>
<td>28.6</td>
<td>5.9</td>
</tr>
<tr>
<td>1993-96</td>
<td>27.6</td>
<td></td>
</tr>
<tr>
<td>2001-03 (01-03 c/y ratio)</td>
<td>28.6</td>
<td>3.6</td>
</tr>
<tr>
<td>2001-03 (93-96 c/y ratio)</td>
<td>27.9</td>
<td>1.2</td>
</tr>
</tbody>
</table>

6. Conclusion

The taxation of labour income is crucial for labour market outcomes in the G-7 countries and Australia. Thirty years ago, average work hours were similar in Australia, America and continental Europe. Prescott (2004) attributes the subsequent decline in European work hours to an increase in the effective marginal tax rate on labour income. The Australian labour market experience fits the pattern observed among the G-7 countries. As in America, Australian taxes and work hours did not change much in the long-run, but a short-lived increase in taxes temporarily reduced work hours in the 1980s. The resilience of the Australian labour supply suggests that Prescott is right that a return to the tax rates of the 1970s would restore the European labour supply.

Prescott’s calibration of the model for the G-7 countries was used to predict aggregate labour supply in Australia. This produced estimates of work hours that were too high but, since the model overestimates Australian work hours in all sub periods, actual and predicted work hours always move in the same direction. Thus, Prescott’s calibration of the model, which is also inaccurate in Japan and Italy, is not universally applicable. The calibration of a dynamic general equilibrium model of the Australian labour market provides an area for future research. Since effective marginal labour taxes are lower in Australia than in most G-7 countries, particular attention should be paid to the curvature of the utility function. In addition, the progression of income taxes almost certainly differs across countries. Therefore, using a distinct value for the Feenberg-Coutts parameter that takes account of the unique features of the Australian tax system would improve the model fit.
This model can be used to ascertain the sensitivity of labour supply to changes in the effective marginal tax rate on labour income. In Australia, an increase in the tax rate from 32 per cent to 39 per cent reduced predicted work hours by 10.9 per cent between the 1970s and 1980s. Thus, work hours fell by 1.6 per cent for a one percentage point increase in the tax rate. The increase in European taxes had a somewhat stronger effect on work hours. Using Prescott’s figures, predicted work hours fell by 2.3 per cent in France and by 3.0 per cent in Germany for every one percentage point increase in the tax rate between the 1970s and 1990s. This information is useful in a tax reform that affects the effective marginal tax on labour income, either by changing the marginal labour tax rate or the consumption tax rate (GST). Using 2001-03 figures, a revenue-neutral increase in the GST from 10 per cent to 12 per cent would increase the effective marginal tax rate by 1.1 percentage points, reducing Australian work hours by 1.2 per cent. If Australia adopted the German consumption tax rate of 19 per cent, work hours would fall by 5.3 per cent.

References