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Tax Progression and the Wage Curve

by

John P Hutton and Anna Ruocco

Department of Economics and Related Studies
University of York
Heslington
York, YO10 5DD

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John P. Hutton

Department of Economics and Related Studies

University of York

Heslington

York

UK.

Anna Ruocco

University of Tübingen

Tübingen

Germany.

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This note derives a model of the wage curve, closely following Phelps (1994) and Campbell and Orszag (1998). Phelps discusses a variety of theoretical bases for a wage curve, the two major competing types being bargaining models and efficiency wage models, though Phelps prefers the term 'incentive wage' models for the latter. The model discussed here is a parametric version of one of Phelps's incentive wage models, developed by Campbell and Orszag. The innovation here is to introduce income taxation into the model, with the effect of modifying the wage curve by introducing a measure of tax progressivity into the equation of the wage curve. This result also provides a link to the bargaining literature.

1 The model

The firm maximises the present value of profits at time t_0,

$$V_{t_0} = \int_{t_0}^{\infty} e^{-\rho t}[f(E_t) - w_t E_t - T(h_t)E_t]dt$$

subject to the dynamic constraint

$$\frac{\dot{E}}{E} = h - q(w^*, w_A^*, R)$$

1

where E is employment, h the hiring rate, $f(E)$ the production function, w the firm's wage rate, w^* the firm's net of tax wage rate, w_A^* the economy-wide net of tax average wage rate, T training costs (time existing workers need to train new workers), and q is the quit rate. The net of tax wage rate is

$$w^* = w(1-a), \text{ where } a = r(w)/w \text{ is the average tax rate}$$
$$\text{and } m = \frac{\partial r(w)}{\partial w} \text{ is the marginal tax rate.}$$

We assume that hours are fixed, so E corresponds to the number of employees as well as the total input of labour, and the tax is therefore levied on labour income rather than just on the wage rate. The quit rate depends on the firm net of tax wage, the economy net of tax average wage, and economy-wide average employment R. L is the labour force, so $(L-R)/L = u$, the unemployment rate. Firms behave in a Nash manner, treating economy-wide averages as given, but in equilibrium wages and employment are equated across firms.

To solve the firm's problem, set up the current value Hamiltonian:

$$H_t = f(E_t) - w_t E_t - T(h_t) E_t + \lambda_t [h_t - q(w_t^*, w_{A,t}^*, R_t)] E_t.$$

The first-order conditions are

$$\frac{\partial T(h_t)}{\partial h_t} = \lambda_t \tag{1}$$

$$-\lambda_t \frac{\partial q}{\partial w_t} = 1$$

$$\text{i.e.} -\lambda_t \frac{\partial q}{\partial w_t^*} \frac{\partial w_t^*}{\partial w_t} = 1$$

$$-\lambda_t \frac{\partial q}{\partial w_t^*}(1-m) = 1 \tag{2}$$

$$\dot{\lambda}_t = \rho \lambda_t - \frac{\partial H_t}{\partial E_t}$$

$$\text{i.e.} \ \dot{\lambda}_t = -[\frac{\partial f(E_t)}{\partial E_t} - w_t - T(h_t)] \tag{3}$$

Equation (1) equates marginal training costs with the shadow value of an additional worker. Equation (2) sets the wage to balance the effect of the wage on replacement costs with the effect of a change in the wage on the total wage bill. Imposing the usual transversality condition, integrating equation (3) expresses the shadow value of an additional worker in terms of the present discounted value of future cash flows from hiring an additional worker:

$$\lambda_t = \int_t^\infty e^{-\rho n} [\frac{\partial f(E_n)}{\partial E_n} - w_n - T(h_n)] dn. \tag{4}$$

2

The next stage is to derive the wage curve, assuming that $q(.)$ and $T(.)$ are, respectively, constant elasticity and quadratic functions. Let

$$q(w^*, w_A^*, R) = B\left[\frac{w^* L}{w_A^* R}\right]^{-\eta}$$

$$\text{i.e. } q(w^*, w_A^*, u) = B\left[\frac{w^*}{w_A^*(1-u)}\right]^{-\eta}. \tag{5}$$

And let

$$T(h) = \frac{A}{2}h^2. \tag{6}$$

The first-order conditions (1) and (2) now become

$$Ah_t = \lambda_t, \tag{7}$$

$$\text{and } -\lambda_t \frac{\partial q_t}{\partial w_t^*}(1-m) = 1$$

$$\text{i.e. } \lambda_t B\eta(w_t^*)^{-\eta-1}(w_{A,t}^*)^{\eta}(1-u_t)^{\eta}(1-m) = 1. \tag{8}$$

In equilibrium, $w = w_A$, and $w^* = w_A^* = w(1-a)$, so equation (8) becomes

$$\lambda B\eta(w(1-a))^{-1}(1-u)^{\eta}(1-m) = 1$$

$$\text{i.e. } w = \frac{1-m}{1-a}\lambda B\eta(1-u)^{\eta}. \tag{9}$$

Substituting equations (5) and (7) into equation (9), and imposing the steady-state condition that $h = q$, yields

$$w = \left(\frac{1-m}{1-a}\right)AB^2\eta(1-u)^{2\eta}. \tag{10}$$

This is the wage curve, the steady-state relationship between the rate of unemployment and the wage rate, where the wage rate has fully adjusted to the unemployment rate. Taking logarithms,

$$\log(w) = \log\left(\frac{1-m}{1-a}\right) + \log(AB^2\eta) + 2\eta\log(1-u). \tag{11}$$

If the unemployment rate is relatively low, $\log(1-u_t) \simeq -u_t$, so the log wage curve simplifies to

$$\log(w) = \log\left(\frac{1-m}{1-a}\right) + \log(AB^2\eta) - 2\eta u.$$

2 Comments

The term $\frac{1-m}{1-a}$ is the well-known index of residual progression, the elasticity of after-tax income to pretax income: see Lambert (1993). It is of interest

to note that the same functional form for the wage curve, complete with the residual progression index, is derived by Lockwood and Manning (1993) using a bargaining model of wage determination, as opposed to our efficiency-wage model. It therefore appears that the index of progression should be included as a matter of course in wage curve studies, since this form of equation is consistent with both of the leading theories of equilibrium unemployment. It should be noted that an increase in progressivity implies a *decrease* in this index: thus a revenue-neutral income tax reform which raised the marginal rate would have the effect of reducing the pretax wage in this model, for any given level of unemployment. Lockwood and Manning summarise recent theoretical bargaining literature thus: "....a very robust result is that increases in the marginal rate of income tax lower the pre-tax real wage, and hence unemployment, whereas an increase in the average tax usually has the opposite effect." These comments can now be extended to include efficiency wage literature.

The introduction of the residual progression index ($RPI = \frac{1-m}{1-a}$) closely parallels the effect demonstrated by Campbell and Orszag of introducing wage and training subsidies: they show that the term

$$\frac{1-\omega}{1-s}$$

appears in the wage curve, in exactly the same way as RPI appears in equation (10) above, where ω is the rate of training subsidy and s the rate of wage subsidy (or negative payroll tax on employers). Thus the introduction of these measures is equivalent (if $s < \omega$) to the introduction of a progressive income tax levied on wage-earners; alternatively, if $s > \omega$, a progessive income tax can perfectly offset the effects of wage and training subsidies.

The other feature of the wage curve in this paper, and those of Lockwood and Manning, and Campbell and Orszag, is that unemployment enters the logarithmic version of the equation through the term $log(1-u)$, whereas the conventional form is that popularised by Blanchflower and Oswald (1994) in which the term is $log(u)$, with an appropriate change of sign. The econometric investigations so far reported (e.g. by Blanchflower and Oswald) have not focussed particularly on these alternative functional forms. This would also seem to merit further investigation. The curves are in fact rather different, as can be seen from the Figure in which the $log(1-u)$ version is clearly more linear, plotting both curves around the point $u = 0.05$.
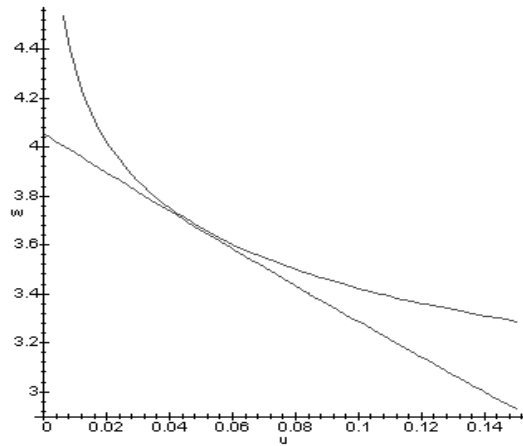
Figure 1: Alternative functional forms of the wage curve

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