The Speed of Earnings Responses to Taxation and the Role of Firm Labor Demand

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This paper studies the speed at which workers’ pre-tax earnings respond to tax reforms. We do so in the context of Germany, where a large discontinuity — or notch — in the tax schedule induces sharp bunching in the earnings distribution at the expected cutoff. We analyze earnings responses to two policy reforms that increase this cutoff. Following each reform, the entire excess mass of workers at the old notch should dissipate, as workers increase their earnings. While some of these workers indeed adjust rapidly, increasing earnings and often hours, over 40% do not, instead taking several years to adjust. We argue that heterogeneity in firm labor demand plays a key role in generating the observed heterogeneity in the speed of workers’ earnings responses. We propose a framework in which firms can find it optimal to delay increasing their workers’ hours post-reform. Delays will be shortest at growing firms, where both workers and firms benefit from immediate increases in hours. We test and find support for
these demand-side effects in our linked employer-employee data. Our results suggest that labor demand can account for up to 18% of the non-adjustment behavior observed in the first post-reform year.