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Relation between tax wedge and employment rate: The case of OECD countries

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Abstract: *The paper investigates the relationship between tax wedge and employment rate in thirty-six OECD countries for the period 2000-2020. The aim of this paper is to identify how tax wedge indicators affect the employment level in these economies. The empirical research includes correlation analysis and panel regression to determine character and intensity of nexus among observed variables. The results of Hausman represent that a random effects model is adequate for estimating the effect of tax wedge on the employment rate in selected countries. The model results show a negative correlation between these variables, as well as, that tax wedge indicators have a negative impact on the employment rate in OECD countries for the observed period. The empirical findings manifest that a 1% increase in the average tax wedge leads to a lower employment rate of 0.33% in OECD economies.*

Keywords: *tax wedge, employment, correlation, random effects model, OECD countries*

Relacija poreskog klina i stope zaposlenosti: Slučaj OECD zemalja

Apstrakt: *Rad ispituje odnos između poreskog klina i stope zaposlenosti u trideset šest zemalja OECD-a za period 2000-2020. godine. Cilj ovog rada je*

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da utvrdi kako indikatori poreskog klina utiču na nivo zaposlenosti u ovim ekonomijama. Empirijsko istraživanje uključuje korelacionu analizu i panel regresiju, kako bi se utvrdili karakter i intenzitet veze između posmatranih varijabli. Rezultati Hausman testa prikazuju da je model slučajnih efekata adekvatan za procenu efekta poreskog klina na stopu zaposlenosti u odabranim zemljama. Rezultati modela pokazuju negativnu korelaciju između ovih varijabli, kao i da indikatori poreskog klina imaju negativan uticaj na stopu zaposlenosti u OECD zemljama za posmatrani period. Empirijski nalazi pokazuju da povećanje prosečnog poreskog klina od 1% dovodi do niže stope zaposlenosti za 0.33% u OECD ekonomijama.

Ključne reči: *poreski kiln, zaposlenost, korelacija, model slučajnih efekata, OECD zemlje*

1. Introduction

Taxes should have an essential role in economic policy, where tax structure must be adequately determined so taxes would be in function of growth (Đurović-Todorović et al. 2019). Individual income taxes, payroll taxes, value added taxes and sales taxes generate a generous allocation of many economies' tax revenue (Bunn and Fornwalt, 2018), where these taxes combined make up the tax burden on labor (Asen, 2019). After the Great Crisis, many OECD countries are faced with the necessity of coordination between fiscal measures and policies to reduce unemployment. An improved understanding of the impact of labour income taxes on the operation of the market is essential to determine the mechanisms that may mitigate unemployment without conflicting public finances (Lehman et al. 2015). Hodge and Hickman (2018) indicate that many countries try to make international competitive tax systems, where the issue of tax wedge is a relevant topic for the tax authorities. Calculation of tax burden is the primary tool used in the literature to identify the impact of taxation (Celikay, 2020). Some taxes, especially labour taxes, can have a considerable impact on income distribution (Akgun et al. 2017). Large labour taxes are usually cursed for impeding employment conception (Zarkovic-Rakic, 2015). A great tax rate on labour is generally harmful to growth and employment (Myles, 2009; Arnold et al. 2011). The field for moving taxes to more beneficial revenue sources is not sufficiently used (Paetzold and Tiefenbacher, 2018). Tax wedge can be decreased by lowering taxes on labour and covering the revenue loss with higher indirect taxes and recurrent taxes on personal immovable property (André and Hwang, 2018). Namely, a lower tax wedge on labour leads to a relevant growth in labour performance (Annicchiarico et al. 2017).

This paper highlights the importance of the tax wedge and its relation to the employment rate. Tax wedge can be analyzed as the most essential tax, aside from some sectors that are faced with special duties (Pelagidis and Mitsopoulos, 2021). The definition of tax wedge can be expressed as the ratio between the amount of taxes paid by an average single employee and total labour cost for the employer. This index is evaluated in the relative value of labour cost, where the average tax wedge value indicates the effect of tax on labour income on employment (OECD, 2022). Precisely, tax wedge represents the difference between the real net wage paid to workers and the real gross wage paid by the employers. Gross wages are greater than net wages by the volume of total direct taxation, while the variation in price level arrives from indirect taxes (Deskar-Škrbić et al. 2018).

The structure of the research includes five parts. The first and second part implies an introduction and literature review that have analyzed tax wedge based on previous theoretical and empirical studies. The third part includes a methodological framework that explains variable and sample selection, as well as, hypotheses development. The next part shows descriptive and empirical statistics with obtained findings to precisely determine the relationship between tax wedge indicators and employment rate in OECD countries. Finally, there is a conclusion which summarizes the given results with recommendations for policymakers and other interesting factors in tax areas in selected economies.

2. Literature review

Many empirical studies illustrated that high labour costs are significant factor for a greater unemployment rate (Azemar and Desbordes, 2009; Dolenc and Laporšek, 2010; Radu et al. 2018). For example, Radu et al. (2018) highlighted that many countries should introduce fiscal measures to reduce labour taxes and transfer from labour tax to other taxes. The results of this activity may have decisive implications for employment, enhancing demand and labour supply. Accordingly, Stähler (2019) determined that construction in labour taxation has an affirmative effect on employment, demand and output.

In terms of upgrading economic performance, many empirical studies (Stähler and Thomas, 2012; Bosca et al. 2013; Langot et al. 2014; Gomes et al. 2016; Engler et al. 2017; Jacquinet et al. 2018; confirmed lucrative results based on a continual shift from labour taxes to consumption taxation. Precisely, Fahri et al. (2014) found that lower labour taxes financed by higher value added tax can be economically beneficial. Daveri and Tabellini (2000) investigated the effect of labour taxes on employment and growth in fourteen OECD countries from 1965 to 1991. Their findings revealed that an increase in labour taxes by 10%

enables a lower unemployment rate of 4%. Analyzing the impact of labour taxes on employment and unemployment in twenty-one OECD countries for the period 1983 – 2003, Bassanini and Duval (2006) confirmed that the reduction of tax wedge for 10% leads to a lower unemployment rate by 2.8%, as well as, higher employment rate by 3.7%. Similarly, Dolenc and Laporšek (2010) investigated the tax wedge-employment rate in twenty – seven EU members from 1999 to 2008. The findings confirmed the negative relationship between these variables, and specifically 1% growth of tax wedge declines employment in these economies by around 0.04%. In their analysis Đurović Todorović et al. (2018) point out that the tax burden creates a tax wedge that determines the unemployment rate and negatively affects economic growth, making the markets uncompetitive. Their research included Serbia and OECD countries for the period 2015 – 2017 and determined that high tax rates inefficiently impact redistribution and wealth. Kalaš et al. (2021) verified that OECD countries should reduce personal income tax due to negative implications for investment share in these economies.

3. Methodology and data

The empirical research includes annual data given from OECD Revenue Statistics for thirty-four countries in the Organisation for Economic Cooperation and Development (OECD). This paper introduces multivariate analysis of variance (MANOVA), as well as, panel models that estimate the effects of TW on the employment rate for the period 2000 – 2020. The applied panel models in the research are pooled least squares model (POLS), random effects model (RE) and fixed effects model (FE). Further, the EU variable is a dummy variable involved in panel models with moderation to provide information about the effects of the European Union. The empirical analysis was done by using the software package STATA13.

Table 1. Variable selection

Variable	Notation	Calculation	Source
Employment rate	EMP	Annual rate	OECD
Average tax wedge	ATW – 100	% of labour costs	OECD
Average tax wedge	ATW – 67	% of labour costs	OECD
Average tax wedge	ATW – 167	% of labour costs	OECD

Source: Authors' illustration

The tax burden on labour is referred to as the tax wedge, which implies the difference between the employer's cost of an employee and the employee's net

disposable income (Enache, 2021). Hodge and Hickman (2018) defined tax wedge as:

$$\text{Tax wedge} = \frac{\text{Average Total Labor Costs} - \text{Net Take-Home Pay}}{\text{Average Total Labor Costs}}$$

Based on previous papers examining the relationship between tax wedge and employment, the following hypotheses are developed:

H₁: There is a statistically significant difference in tax wedge level in OECD countries.

H₂: There is a significant correlation between tax wedge and employment rate in OECD countries.

H₃: Tax wedge indicators negatively affect the employment rate in OECD countries.

4. Results and Discussion

In this section of research, we introduce descriptive analysis and panel regression models that measure the impact of tax wedge variables on the employment rate in OECD economies. After analyzing their trend it is available to determine the potential impact of tax wedge indicators on employment level.

Table 2. Descriptive statistics

Variable	Obs.	Mean	Std. Dev.	Min.	Max.
EMP	756	66.84	7.65	47.03	82.77
ATW-67	756	32.87	10.42	7	51.41
ATW-100	756	36.79	10.60	7	57.10
ATW-167	756	40.79	10.69	7.49	62.61

Source: Authors' calculation

The average employment rate in OECD countries was 66.84, where Turkey recorded a minimum value of 43.8%, while Iceland had a maximum employment rate of 82.77% for the observed period. Looking at the tax wedge indicators, the mean value of ATW-67 was 32.87%, where the minimum value is identified in Chile. Contrary, Belgium recorded the maximum value of this indicator for the observed period. Similarly, the mean value of ATW-100 and ATW-167 were 36.79 or 40.79, where minimum values were in Chile and maximum values were in Belgium.

Table 3. Panel unit root tests

Variable	IPS test	P-value	Fisher test	P-value
EMP	2.887	0.997	2.968	0.998
Δ EMP	-6.739	0.000	-8.553	0.000
ATW – 67	2.903	0.996	2.899	0.997
Δ ATW – 67	-11.069	0.000	-16.284	0.000
ATW – 100	0.610	0.729	-0.459	0.674
Δ ATW – 100	-12.091	0.000	-18.799	0.000
ATW – 167	-0.341	0.367	-0.855	0.196
Δ ATW – 167	-11.601	0.000	-18.134	0.000

Source: Authors' calculation

After presenting descriptive values of selected variables, there are testing panel unit root tests by IPS test and Fisher test. These tests are included because panel data has unbalanced character, as well as, are not restrictive as the other test such as LLC test (Das, 2019). It can confirm that panels do not contain unit roots in terms of the first difference of all variables.

Table 4. Test difference of tax wedge level

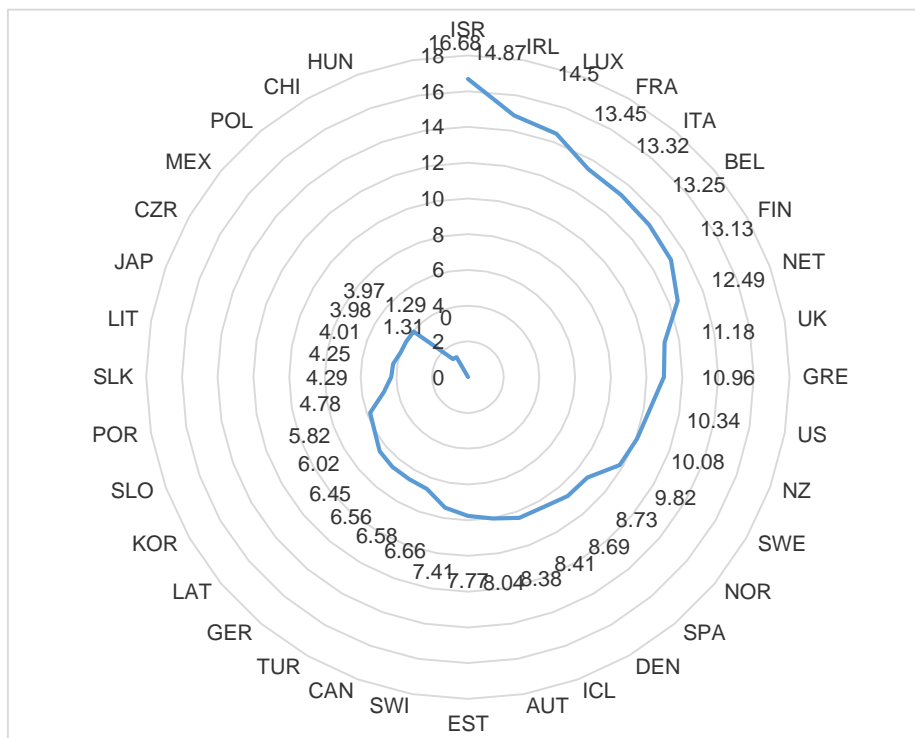
Dummy - panel	W = Wilks' lambda		L = Lawley-Hotelling trace		
	P = Pillai's trace		R = Roy's largest root		
Source	Statistic	F(df1)	F(df2)	F	Prob > F
W	0.026	35.0	720	774.38	0.000
P	0.974	35.0	720	774.38	0.000
L	37.64	35.0	720	774.38	0.000
R	37.64	35.0	720	774.38	0.000
Residual	720				
Total	755				
Dummy – EU membership	W = Wilks' lambda		L = Lawley-Hotelling trace		
	P = Pillai's trace		R = Roy's largest root		
Source	Statistic	F(df1)	F(df2)	F	Prob > F
W	0.443	1.0	754	950.06	0.000
P	0.557	1.0	754	950.06	0.000
L	1.26	1.0	754	950.06	0.000
R	1.26	1.0	754	950.06	0.000
Residual	754				
Total	755				
Number of obs.	756				

Source: Authors' calculation

The obtained findings indicate that there are significant differences in the tax wedge level of OECD economies for the period 2000 – 2020. The values of the multivariate analysis of variance test are less than 0.05 which confirms the

presence of a significant difference in the observed indicator of tax wedge. Furthermore, there is a significant difference in the tax wedge level between countries that are EU members with countries that are not in the EU (the values are less than 0.05).

Figure 1. Progressivity level in OECD countries for 2020



Source: Authors' calculation

To calculate potential progressivity in tax systems of OECD countries, we have analyzed the difference between AW – 167 and AW -67 for 2020 year. Positive values of calculated indicator imply progressivity in taxation. As we can see, Hungary is the only economy whose income tax system can be characterized as a proportional income tax system. Similarly, Chile and Poland had mild progressivity, while Mexico, Czech Republic, Japan, Lithuania, Slovakia and Portugal ranged between values of 3 and 5. The highest tax progressivity is identified in Israel (16.68), Ireland (14.87), and Luxembourg (14.5), while

Table 5. Correlation coefficients between EMP and ATW – 100

Countries	AUS	AUT	BEL	CAN	CHI	CZR
Cor. coeff	-0.32	0.15	-0.85	-0.08	-0.18	-0.55
Sig	0.161	0.513	0.000	0.711	0.431	0.001
Countries	DEN	EST	FIN	FRA	GER	GRE
Cor. coeff	-0.74	-0.84	-0.44	-0.84	-0.91	-0.11
Sig	0.000	0.000	0.046	0.000	0.000	0.615
Countries	HUN	ICL	IRL	ISR	ITA	JAP
Cor. coeff	-0.83	-0.12	-0.44	-0.33	-0.16	-0.83
Sig	0.000	0.602	0.043	0.138	0.490	0.000
Countries	KOR	LAT	LIT	LUX	MEX	NET
Cor. coeff	-0.87	-0.42	-0.53	-0.82	-0.70	-0.52
Sig	0.000	0.059	0.014	0.000	0.000	0.015
Countries	NZ	NOR	POL	POR	SLK	SLO
Cor. coeff	-0.17	-0.71	-0.63	-0.18	-0.08	-0.31
Sig	0.463	0.000	0.002	0.441	0.712	0.175
Countries	SPA	SWE	SWI	TUR	UK	US
Cor. coeff	-0.57	-0.37	-0.57	-0.61	-0.45	-0.12
Sig	0.006	0.095	0.008	0.004	0.036	0.607

Source: Authors' calculation

There was a negative correlation between employment rate and ATW – 100 is confirmed in every observed country. However, the significant relationship between these variables is determined in twenty-one countries. The highest correlation level is identified in Germany (-0.91), Korea (-0.87), Belgium (-0.85), Estonia and France (-0.84), Hungary and Japan (-0.83) and Luxembourg (-0.82). Conversely, the smallest correlation coefficient is determined in Finland and Ireland (-0.44), the United Kingdom (-0.45), Netherlands (-0.52), Lithuania (-0.53), Czech Republic (-0.55) and Spain (-0.57). Finally, there is no correlation between employment rate and ATW – 100 in economies such as Australia, Austria, Canada, Chile, Greece, Iceland, Israel, Italy, Latvia, New Zealand, Portugal, Slovakia, Slovenia, Sweden and the United States.

Table 6. Different panel models

Variable	Pooled Ordinary Least Squares	Random effects model	Fixed effect model
AW – 67	-0.75 (0.000)	-0.22 (0.000)	-0.24 (0.000)
AW – 100	-1.92 (0.000)	-0.33 (0.000)	-0.40 (0.000)
AW – 167	-1.13 (0.000)	-0.27 (0.000)	-0.25 (0.000)
R-squared	0.583	0.598	0.474
Hausman test	3.09 (0.3787)		

Source: Authors' calculation

After identifying the correlation between tax wedge and employment rate, there are panel regression models with the aim to determining the effects of tax wedge indicators (ATW-67, ATW-100 and ATW-167) on employment rate. All three models show a significant and negative impact of tax wedge indicators on employment rate. It implies that increasing tax wedge leads to lower employment level. The results of Hausman test confirmed that a random effects model is appropriate for measuring and estimating the impact of explanatory variables. To provide accurate reactions of the variables on the employment rate, we developed three scenarios that include the growth of tax wedge by 1%, 5% and 10%.

Table 7. Different scenarios and effects on employment

Variables	Scenario 1	Scenario 2	Scenario 3
	↑ 1%	↑ 5%	↑ 10%
AW – 67	↓ 0.22	↓ 1.10	↓ 2.20
AW – 100	↓ 0.33	↓ 1.50	↓ 3.33
AW - 167	↓ 0.27	↓ 1.35	↓ 2.70

Source: Authors' calculation

Table 7 shows various scenarios with potential growth of 1%, 5% and 10% selected tax wedge indicators and their effects on employment rate. The first scenario implies that a higher level of AW for 1% causes a lower employment rate for 0.22% (67% of average labour cost), 0.33% (100% of average labour cost) and 0.27% (167% of average labour cost). The second scenario shows that a greater level of AW for 5% implies a lower employment rate for 1.10% (67% of average labour cost), 1.50% (100% of average labour cost) and 1.35%

(167% of average labour cost). Finally, the third scenario reflects that a higher level of AW for 10% leads to a lower employment rate of 2.20% (67% of average labour cost), 3.33% (100% of average labour cost) and 2.70% (167% of average labour cost).

5. Conclusion

The conducted research has examined the relationship between tax wedge and employment rate in thirty-six OECD countries for the period 2000 – 2020. Being aware of existing theoretical and empirical studies related to tax wedge, especially in OECD countries, this research was constructed to identify and give results to the main issue of employment rate. It implies that empirical analysis was aimed at estimating differences in tax wedge level, measuring the correlation intensity with employment, as well as, determining the effect of tax wedge indicators on employment rate. The findings of multivariate analysis of variance (MANOVA) have manifested statistically significant differences in tax wedge level in OECD economies. This implies that H_1 can be accepted. Within this analysis, we have shown that there are also significant differences in tax wedge level in terms of EU membership. The results have shown that countries which are EU members have smaller tax wedge level compared to countries that are not in European Union. Namely, the ATW-100 was 42.69% of EU members which is far more than ATW-100 in OECD countries that are not EU members (26.46%). Likewise, empirical analysis has shown the presence of tax progressivity in all countries, except Hungary, where it is identified the proportionality. The highest tax progressivity is determined in Israel, Ireland and Luxembourg, while mild progressivity was in Chile and Poland. Additionally, progressivity increased in twenty-three countries, where the greatest growth rate was in Turkey and Netherlands. On the other hand, Hungary, Iceland and Mexico reduced progressivity in their tax systems.

Empirical findings of correlation have shown a negative correlation between employment rate and ATW – 100 is in every observed country for the selected period. This implies that H_2 can be accepted. The highest correlation is determined in Belgium, Estonia, Germany, Hungary, Japan, Korea and Luxembourg. On the other hand, the smallest correlation is identified in the Czech Republic, Finland, Ireland, Lithuania, Netherlands and Spain and the United Kingdom. Lastly, there is no confirmed correlation between employment rate and ATW – 100 in countries such as Australia, Austria, Canada, Chile, Greece, Iceland, Israel, Italy, Latvia, New Zealand, Portugal, Slovakia, Slovenia, Sweden and the United States for the observed period. Empirical findings of regression have reflected that tax wedge indicators negatively affect

the employment rate, which implies that their growth declines employment level in these countries. The results of the chosen panel model have manifested that a 1% increase in ATW-100 leads to a lower employment rate of 0.33%. This means that H_3 can be accepted.

According to obtained results, the study has given a certain direction to tax policymakers in profiling tax wedge level in selected countries. This means that OECD countries should continue to reduce tax wedge level to provide positive effects on employment rate. Higher employment can enable greater consumption which can have a favourable impact on revenue generosity from the aspect of indirect taxation. Reducing the tax wedge is not decent to significantly improve employment, but it is a good precondition to relaxing and stimulating labour market in these economies.

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