

Policies for the Long Run (Chapter 18)

Questions

How to raise potential GDP?

Outline

Supply side policies

Product Market Policies

Taxation

Labour Market Policy

Supply Side Policies

Measures designed to raise potential GDP

Competition policy

- ▶ anti monopoly legislation
- ▶ spurring labour market competition

Market failures (*resolutions*)

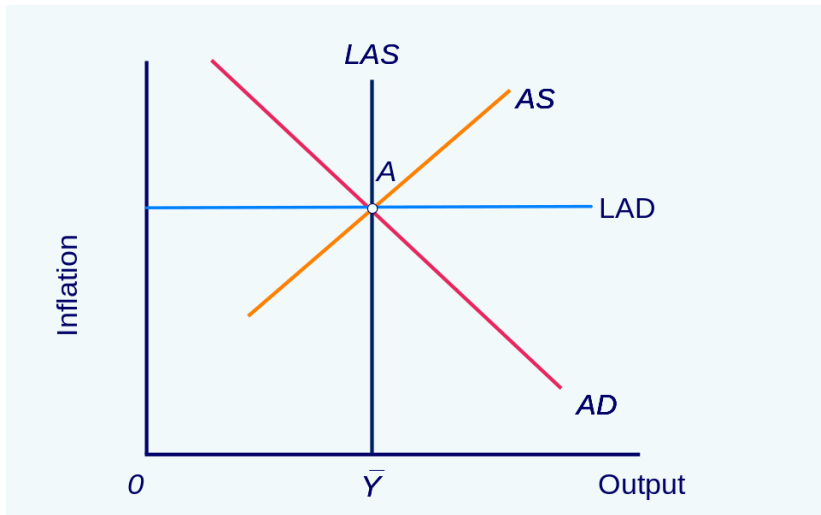
externalities (*property rights*)

pecuniary externalities (*changing wealth distribution*)

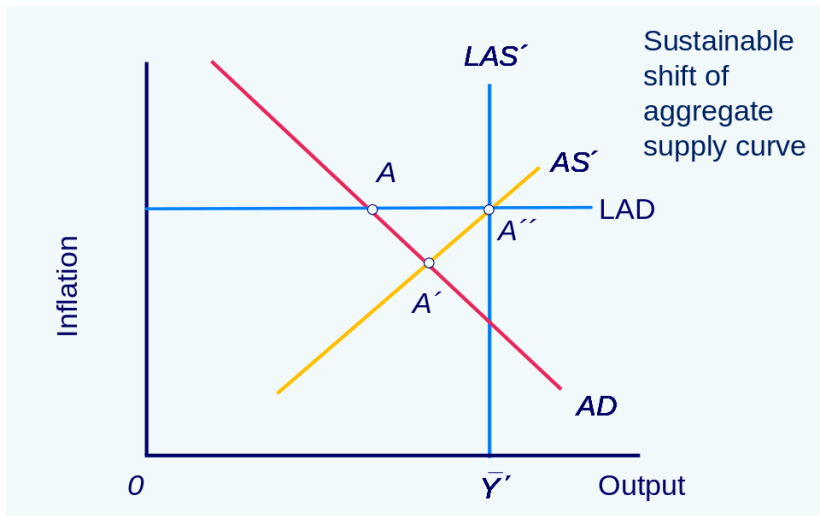
natural monopolies (*regulation*)

information asymmetries (*regulation*)

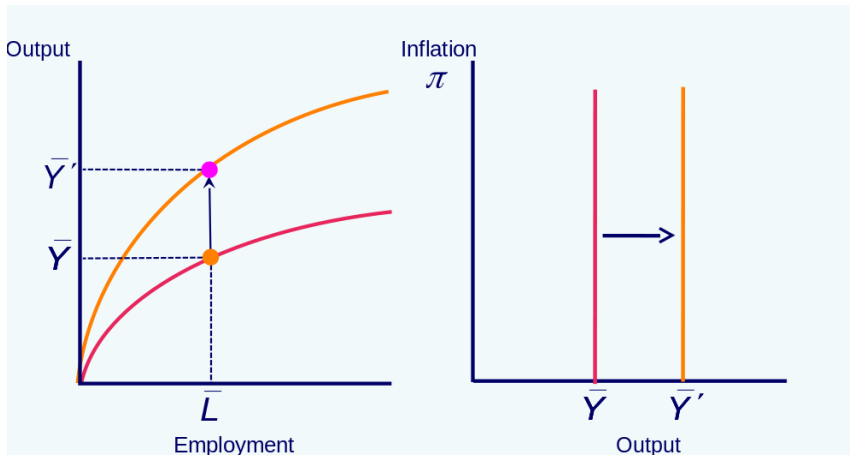
Supply Side Policies



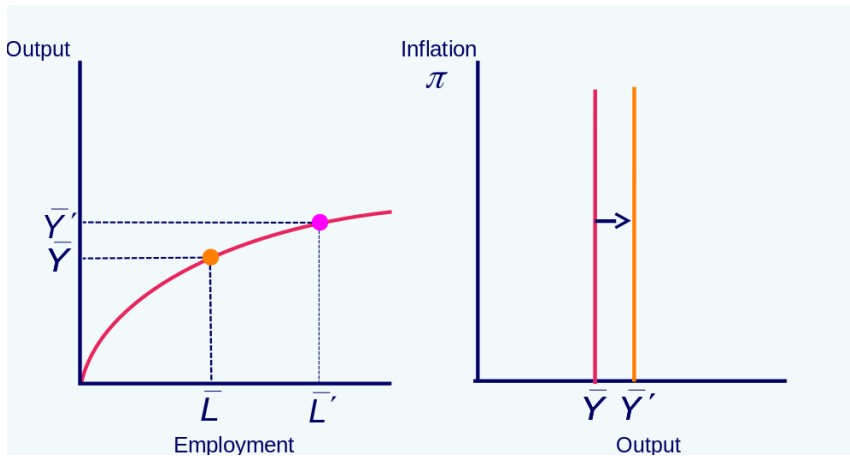
Supply Side Policies



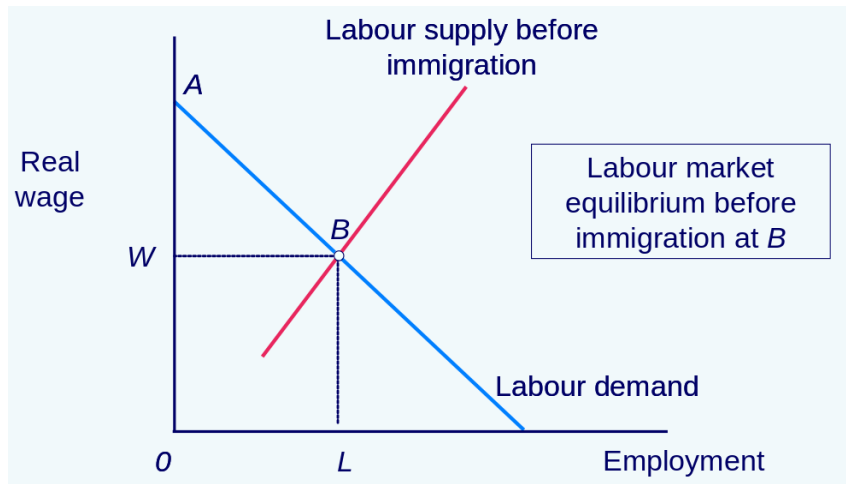
Impact of Supply Side Policies



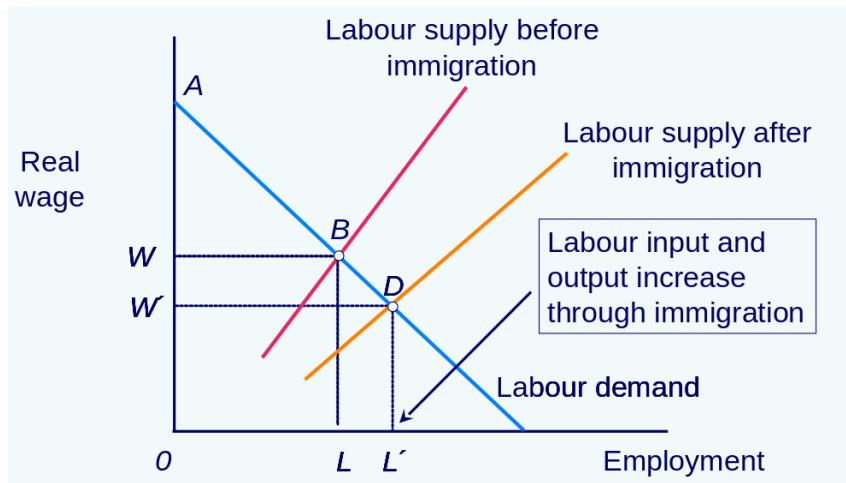
Impact of Supply Side Policies



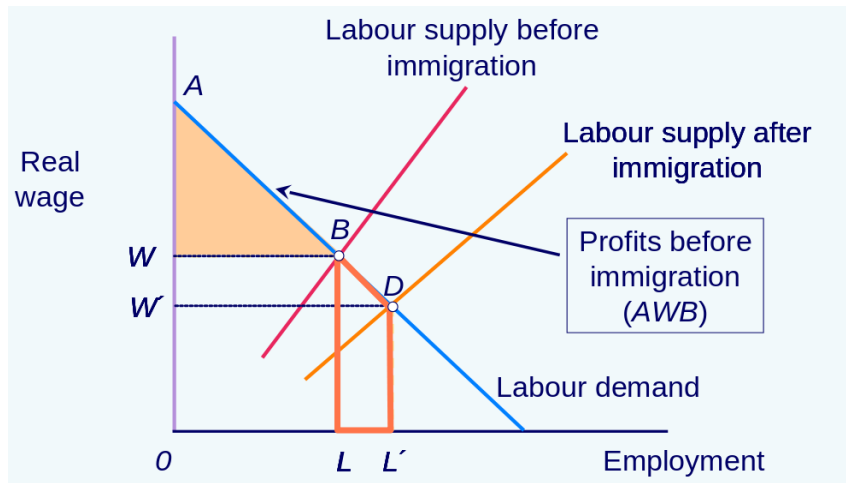
Example: Immigration



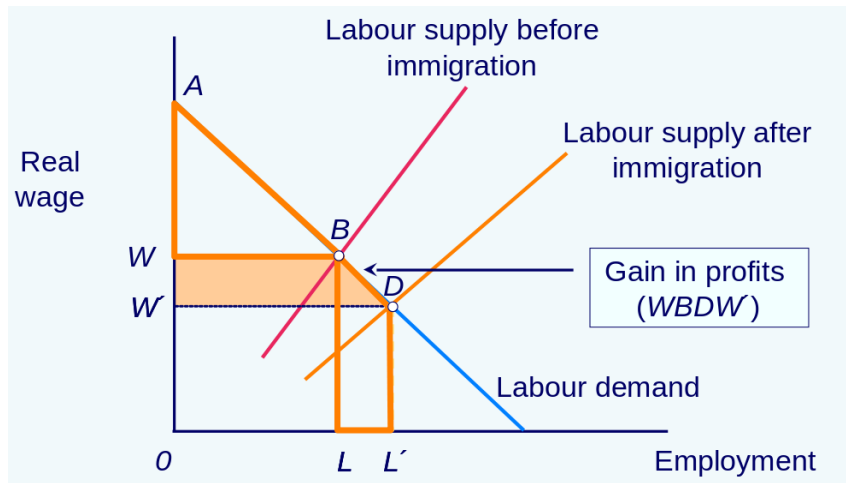
Example: Immigration



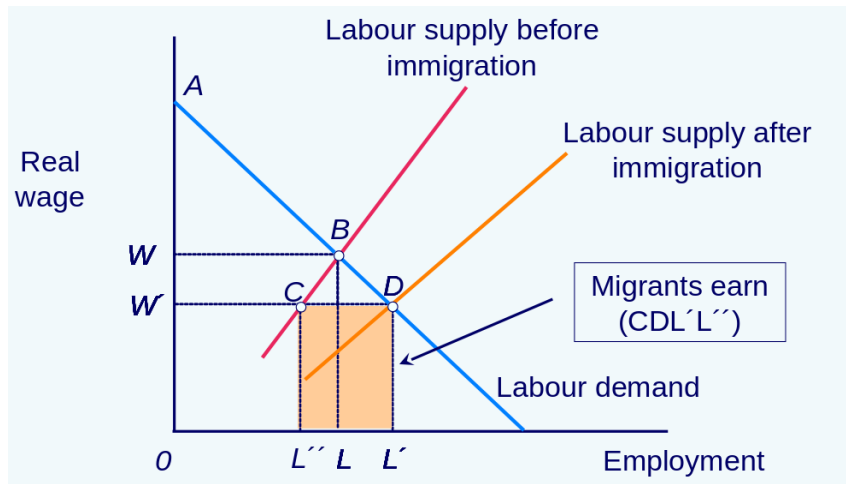
Example: Immigration



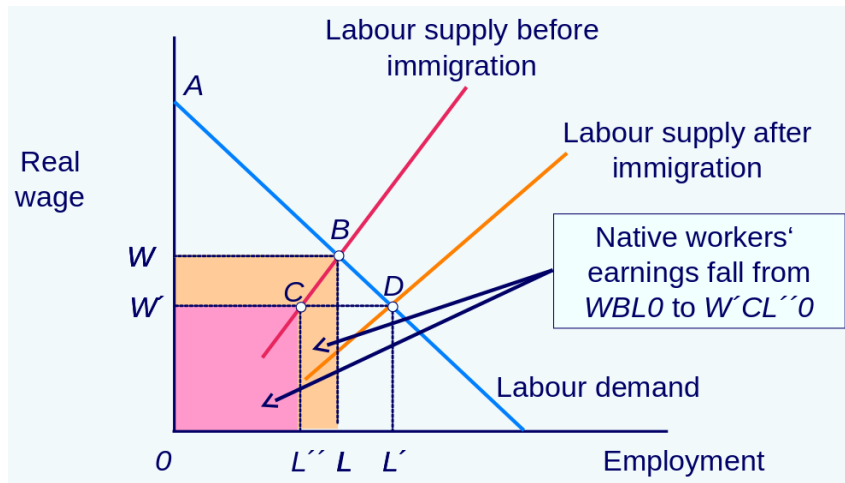
Example: Immigration



Example: Immigration



Example: Immigration



Product Market Policies: Dealing with Externalities

Human capital accumulation

- ▶ education

Law and order

- ▶ no impediments for starting business

Health

Product Market Policies: Dealing with Markets

Privatization

Monopoly regulation

Other market regulation/deregulation

Industrial policy

- ▶ subsidies, state owned companies

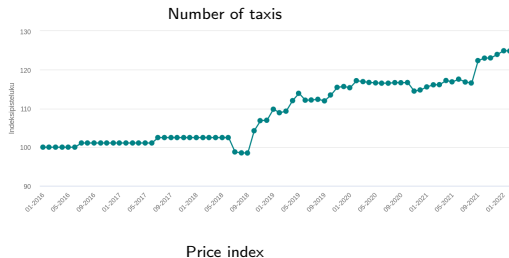
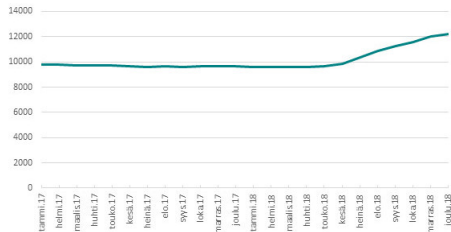
Trade policy

- ▶ tariffs, quotas

Ease of Doing Business Rankings

1. Singapore
2. New Zealand
3. Denmark
4. South Korea
5. Hong Kong
6. UK
7. USA
8. Sweden
9. Norway
10. Finland

Deregulation of Taxi Markets in Finland

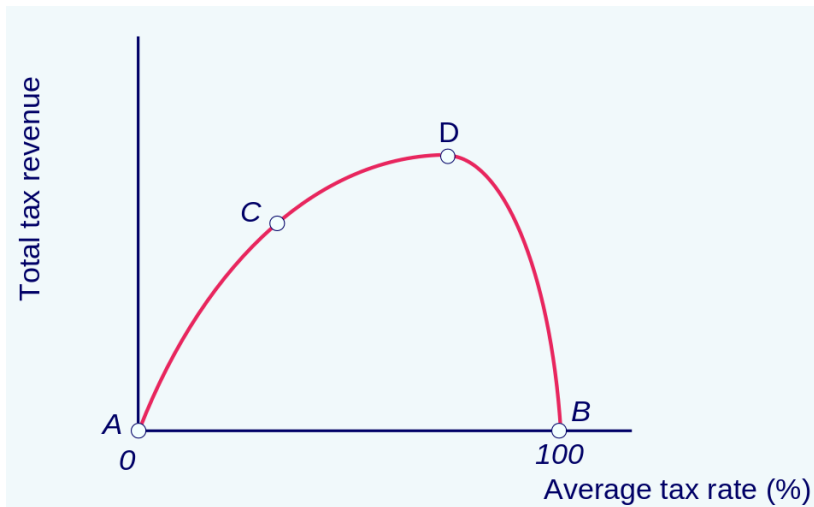


Major market liberalization in Finland in 2000's

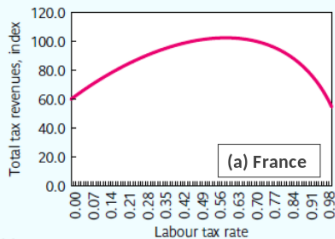
Criticism:

- ▶ demand has decreased
- ▶ quality has dropped
- ▶ less supply in rural areas
- ▶ increase of gray economy

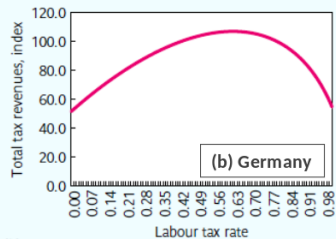
Taxation: Laffer Curve



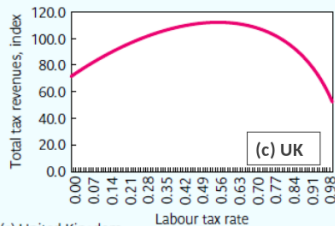
Laffer Curves



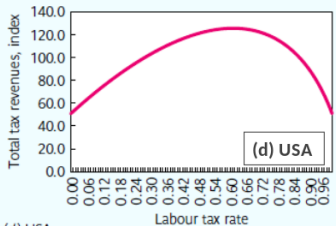
(a) France



(b) Germany



(c) United Kingdom



(d) USA

Labour Tax Wedge

Labour taxes

- ▶ income taxes (τ_ρ), social insurance charges, social security contributions (τ_w)
- ▶ income after taxes $(1 - \tau_\rho)(1 - \tau_w) W$ (take home)

Employer wage tax rate τ_F

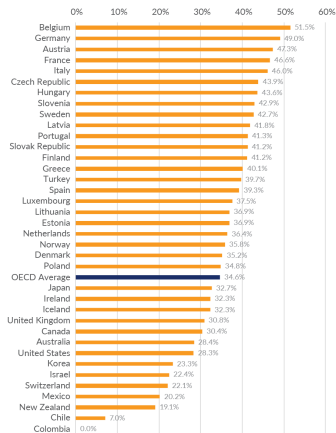
- ▶ total costs $(1 + \tau_F) W$

Effective labour cost: labour tax wedge

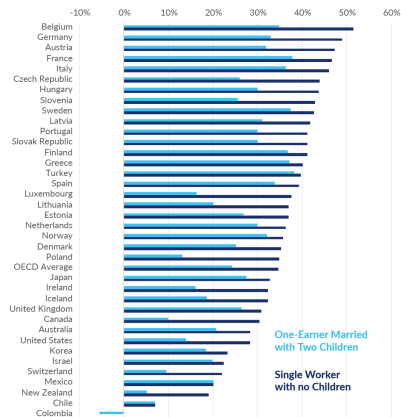
$$(1 + \tau_F) / [(1 - \tau_w)(1 - \tau_\rho)]$$

Tax Burdens

Tax Wedge of a Single Worker with no Children Earning a Nation's Average Wage, 2020



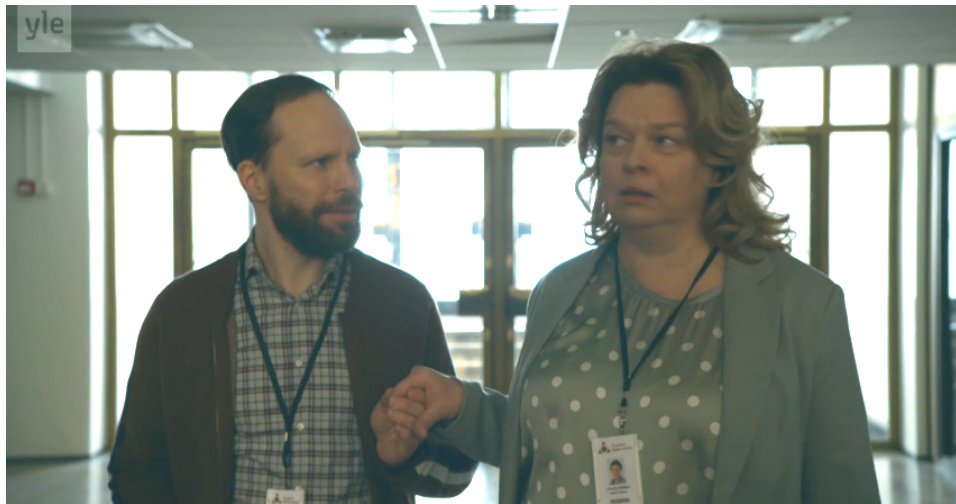
Tax Wedges on Singles and Families at a Nation's Average Wage, 2020



Source: OECD, taxing wages 2021

Wedge=(Tot. labour costs-Net Take Home)/Tot. labour costs

Indoor Air



Juho Milonoff and Elina Knihtilä in TV-series Sisäilmaa (Indoor Air)

Labour Market Policy

Workers and jobs are heterogenous

Incomplete information

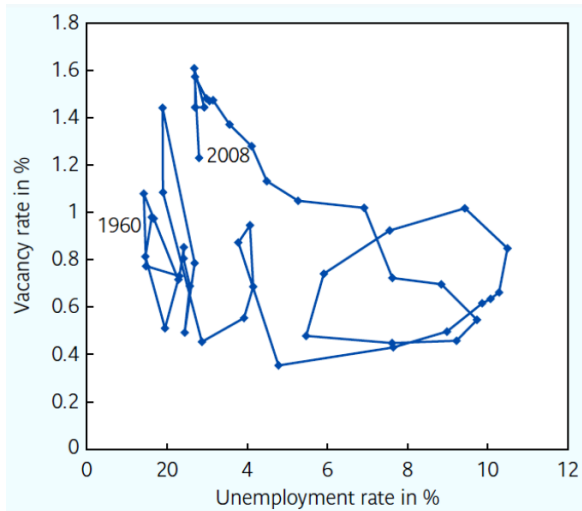
Efficiency of job matching

- ▶ Beveridge curve
- ▶ large number of vacancies and large unemployment (Beveridge curve is up); badly functioning labour market

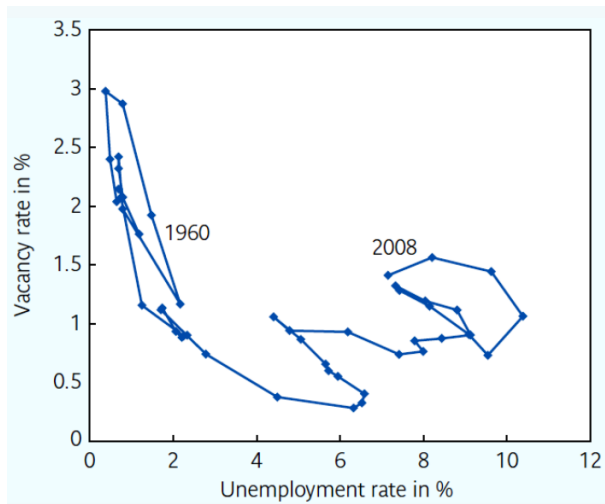
Policy

- ▶ improving firm-worker match; decrease Beveridge curve
- ▶ job agencies, job retraining etc (active labour market policies)
- ▶ regulation related to minimum wages, dismissal
- ▶ social policies and taxation

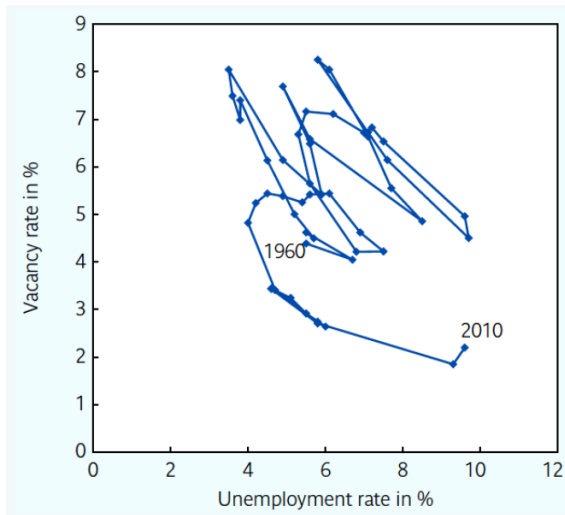
Beveridge Curve UK



Beveridge Curve Germany



Beveridge Curve USA



Search and Matching

Frictional unemployment: only a match of a worker and vacancy leads to a productive job

- ▶ the creation of matches involves frictions

Elements of search and matching theory

- ▶ u unemployment rate, L labor force, vacancy rate v
- ▶ number of newly created jobs (per period) $m(uL, vL)$
- ▶ constant returns to scale matching technology $m(uL, vL)/L = m(u, v)$ (matching rate)
- ▶ instantaneous probability of finding a job: $p(\theta) = m(u, v)/u = m(1, u/v) = m(1, \theta)$, $\theta = v/u$ tightness
- ▶ match destruction rate s

Labor Market Dynamics

What happens to the number of unemployed people over time?

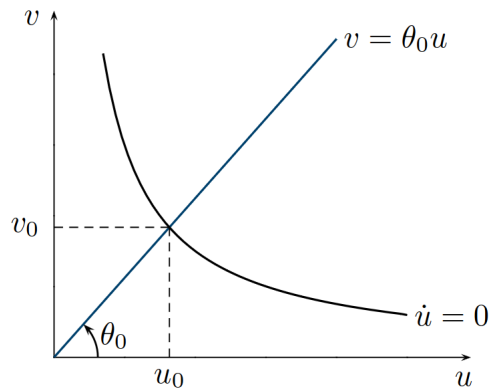
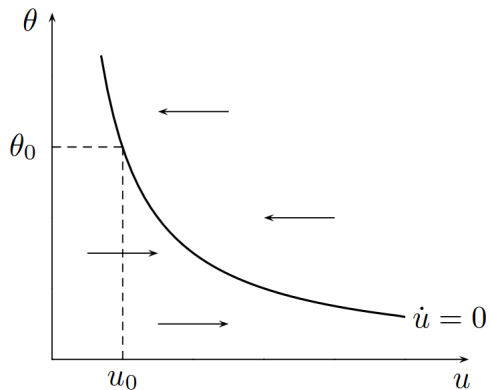
- ▶ $d(uL)/dt = \dot{u}L = s(1 - u)L - p(\theta)uL$, i.e., $\dot{u} = s(1 - u) - p(\theta)u$

Equilibrium unemployment: $\dot{u} = 0$

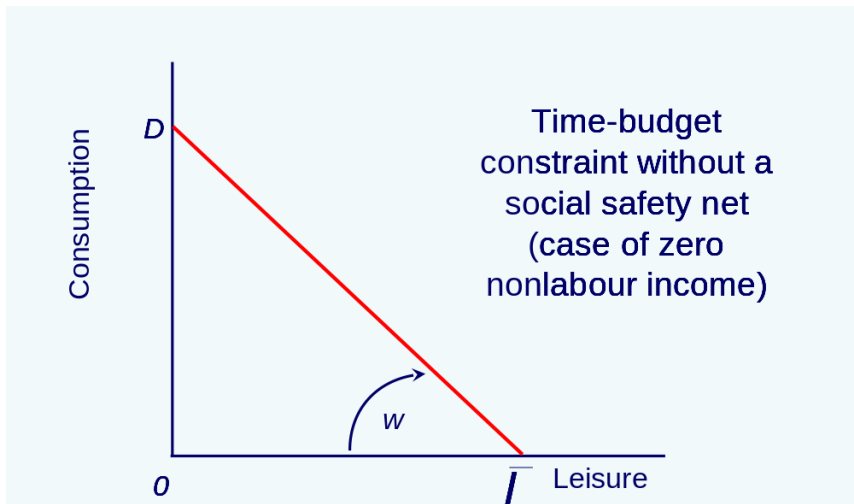
- ▶ $0 = s(1 - u) - p(\theta)u$ from which $u = s/[s + p(\theta)]$

- ▶ Beveridge curve: $u = s/[s + p(v/u)]$

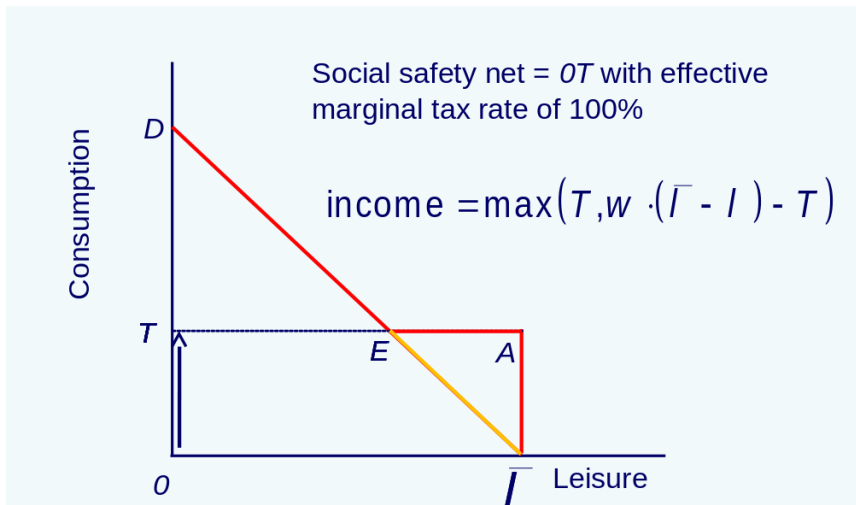
Beveridge Curve Revisited



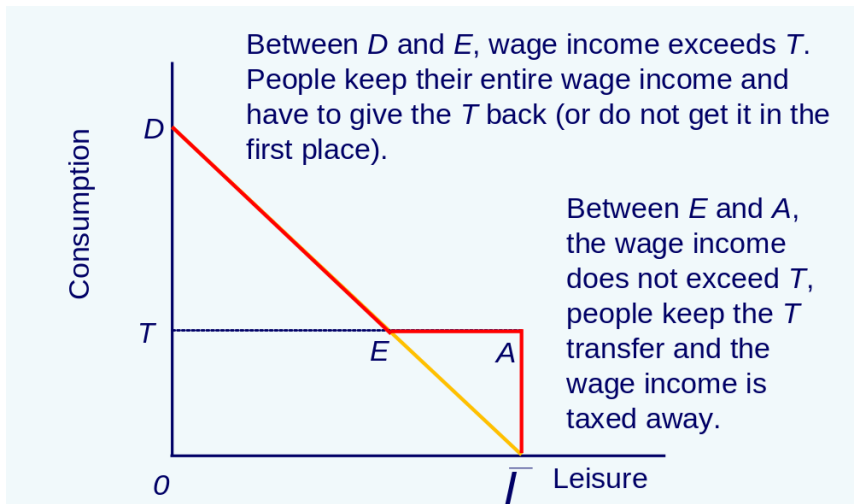
Welfare Trap



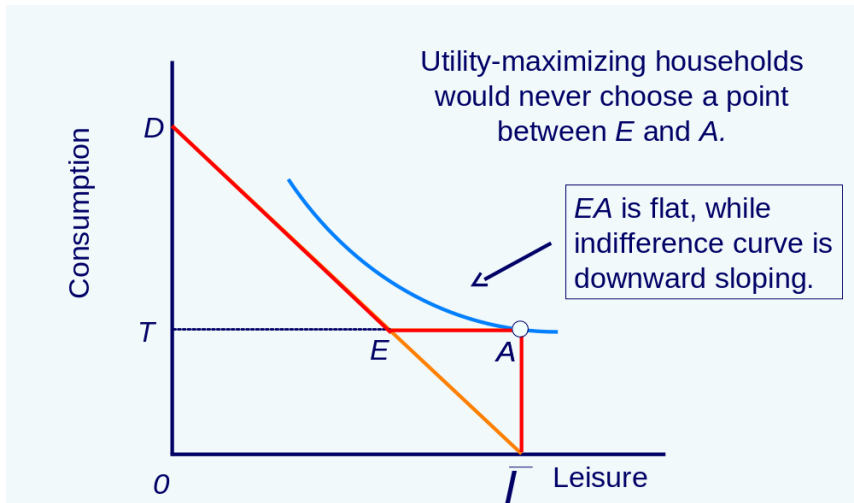
Welfare Trap



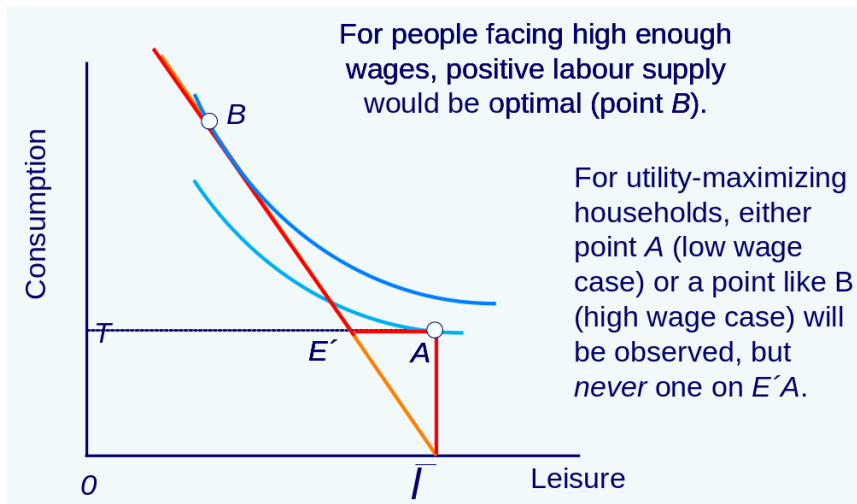
Welfare Trap



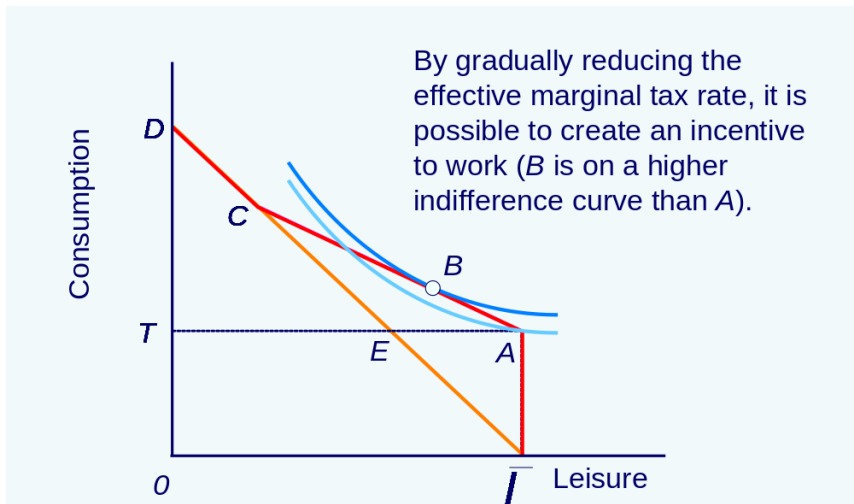
Welfare Trap



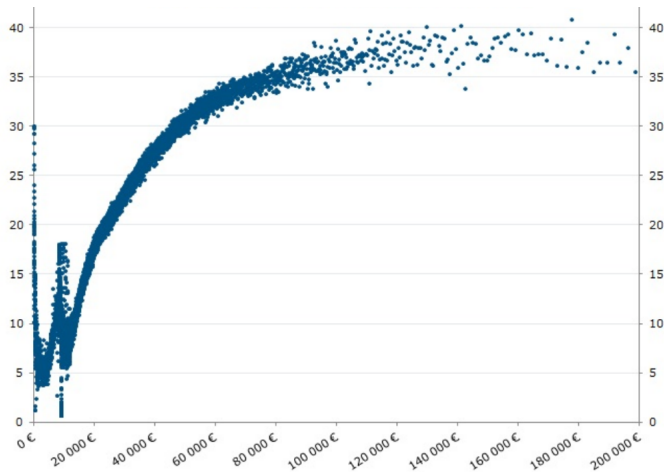
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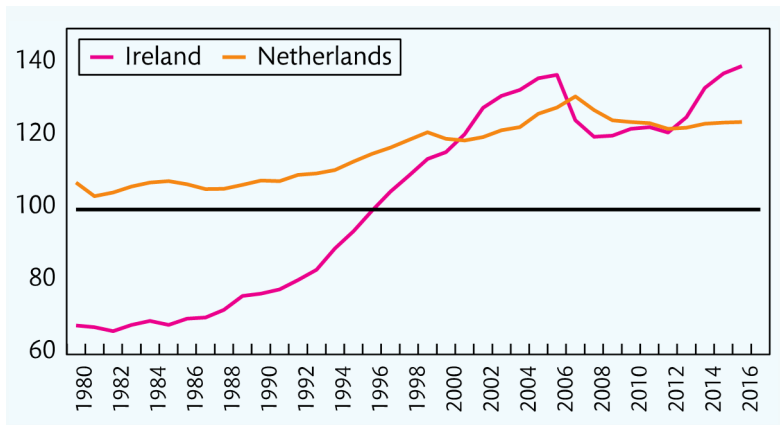


Welfare Traps? Tax Progressivity in Finland

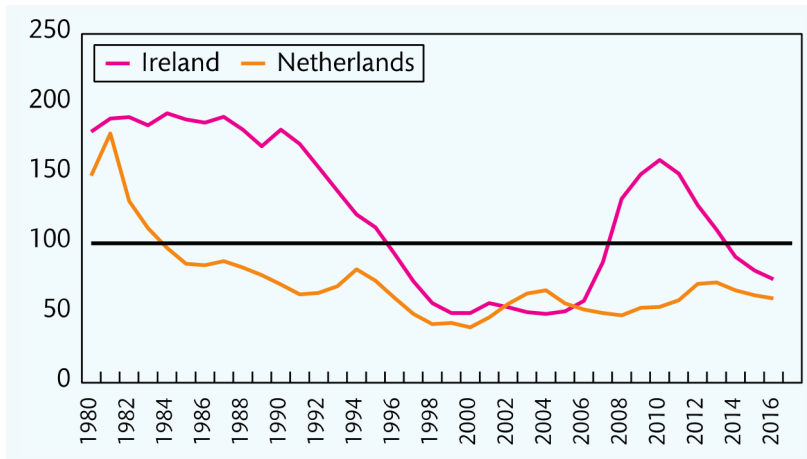


Paid income taxes/Total income, Source: Kärkkäinen 2016

Ireland and the Netherlands: GDP



Ireland and the Netherlands: Unemployment Rate



Ireland and the Netherlands: Employment/Population

