ABSTRACT:

Since the 1980’s, wage inequality has been systematically higher in the US and UK than in most continental European countries. Moreover, since the 1980’s, wage inequality has increased substantially in the U.S. and U.K while changing little in most of continental European countries (CEU). This paper studies the effects of different labor income tax policies for explaining these trends. We begin by documenting two new empirical facts that link these trends to tax policies. First, we show that countries with a more progressive labor income tax schedule have significantly lower before-tax wage inequality at a point in time. Second, progressivity is also negatively correlated with the rise of wage inequality over time. We next construct a life-cycle model in which individuals decide each period whether to go to school, to work, or to be unemployed. Individuals can accumulate skills either in school or while working. Wage inequality arises from differences across individuals in their ability to learn new skills. Progressive taxation compresses the wage structure, thereby distorting the incentives to accumulate human capital, in turn reducing the cross-sectional dispersion of wages. Furthermore, these effects of progressivity are compounded by differences in average labor income tax rates: the higher taxes in the CEU reduces labor supply (and the benefit of human capital investments), further muting wage dispersion. When this economy experiences skill-biased technical change, progressivity dampens the rise in wage dispersion over time. We find that differences in tax policies can account for 2/3 of the difference in the level of, and 60% of the rise in, wage inequality between US-UK and the CEU since 1980.