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**Discussion of „Taxes, Benefits, Careers, and Markets“
by Lars Ljungqvist and Thomas J Sargent**

Comments on

**Lars Ljungqvist and Thomas Sargent
„Taxes, Benefits, Careers, and Markets “**

By Monika Merz

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What is this paper about?

- wage-elasticities of labor supply at the micro and macro level
- ongoing **tension** between micro and macro evidence: low elasticity at micro level vs. large elasticity in many macro models
- wage-elasticity of labor supply is cornerstone to investigating effect of government policies, e.g., taxes, on employment, or nonemployment
- explore this tension for two alternative aggregation theories (CM vs. IM) in a model with finitely-lived workers who differ in skill and age

Some Backstage Information

- debate between Ed Prescott, LS and others about extent to which government policies explain differences in employment rates between US and Europe
- differing views about appropriate model framework to use for analysis:
 - Prescott favors CM and representative agent, arguing along lines of Krusell and Smith (*JPE* 1998) that CM and IM models with precautionary savings yield similar results (*'harmonious state'*)
 - LS argue in favor of IM models with heterogeneous workers which can yield predictions drastically differing from those of CM-setup if government policies matter. Reason: difference in **tax incidence** between models

- differing views about need for macro models to match microeconomic evidence

Browning, Hansen, Heckman (1999) argue that macro models can only be taken serious if built on microeconomic features consistent with micro evidence

LS basically agree with this, but point out that different microeconomic setups may yield similar aggregate results, “so that failure to match particular micro aspect may not be bothersome”

Key Model Features

workers differ in skills (I, H), age (y, o, r), and employment status

probabilistic transition between skill and age groups

Complete Markets (CM)

(in-)finitely lived representative household (linked dynasties)

indivisible labor model (lotteries)

choice of consumption, savings, employment state for skills/age

Incomplete Markets (IM)

heterog. individuals with finite life

no employment lotteries

choice of consumption, precautionary savings and search intensity s

W continuation value to a worker, due to HC accumulation: $\Omega^y > \Omega^o > 0$

Main Results

- CM and IM model yield similar aggregate reactions of non-employment to labor taxes t_h , but incidence of non-employment drastically differs for particular skill and age groups

Intuition: with CM, efficiency considerations dominate employment adjust.
with IM, workers can avoid paying labor taxes by retiring early if they have accumulated private wealth

- whether CM or IM model render identical or different aggregate responses to non-employment benefits depends on specific policy design

Some Praise

- rigorous quantitative exercise with heterogeneous-agents in a GE-environment to study implications of government policies on (non-) employment
- serious attempt to reconcile tension between micro and macro evidence on labor-supply elasticities
- illustrate that market incompleteness – in addition to heterogeneous agents – may matter for assessing policy implications

Some Criticism

- is result, that specific policy design matters for whether or not IM generate different outcomes than CM, surprising? **NO**, since benefit policy 2 generates **persistence** in labor income for non-employed

Recall: work by D. Lucas and J. Heaton, and Storesletten, Telmer and Yaron show that IM matter with persistent income shocks

- no clear computation / illustration of wage-elasticity of labor supply at micro and macro level, even though these matter for policy evaluation
- role of wages in employment allocation in IM insufficiently illustrated

Criticism cont.

- questionable role of “search intensity s ”: what do workers search for? There are no firms demanding labor in this model
- is model ready for assessing real world differences in employment rates between Europe and US? I doubt it, since model ignores
 - differences in gross-wage distributions between Europe and US
 - huge government debts
 - non-employment of older workers due to lack of jobs / firms

Some Suggestions

- better focus the paper: there are currently too many issues involved
- why not use model to explore importance for cross-country differences in employment rates of gross-wage distribution vs. public policies?
- look at Y. Chang and S.-B. Kim (*IER* 2006): successful illustration of link between labor supply elasticities at micro and macro level when heterogeneity relates to gender, not skill or age