Job-to-Job Transition Responses to Personal Income Taxes

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How do workers respond to changes in income taxation? Following a change in their tax schedule, a worker may prefer a different bundle of wages, hours, and other job characteristics to the one they chose prior to the change. But in a real world labor market, most workers wishing to change their chosen bundle must either renegotiate the terms of their employment with their current employer, switch to a new job, or exit the labor market. In this project, we are particularly interested in examining the behavior of those workers who choose to remain in the labor market following a tax change. Insofar as these workers exhibit some behavioral response to income tax reforms (in terms of their chosen bundle of job characteristics), how important are job-to-job (J2J) transitions in mediating these responses? Using the US Census Bureau's Job-to-Job Flows dataset, we provide empirical evidence on this question by examining how J2J transition rates are influenced by state income tax reforms in the US between 2000 and 2014.

If J2J transitions are an important component of workers responses to taxation, one might expect to observe an increase in the J2J transition rate following a tax reform. However, we note that there may also be reason to expect that changes in income taxation will have permanent effects on equilibrium J2J transition rates. For example, in a model with job ladder effects, we might expect that higher marginal rates would reduce the equilbrium rate of J2J transitions, as the potential gains to job search are reduced. Thus, the observed behavior of the J2J rate following a tax reform reflects two simultaneous effects: (i) the gradual adjustment to a new equilibrium J2J transition rate; and, (ii) J2J transitions that reflect workers altering their chosen bundle of job characteristics. We will call the former the *equilibrium adjustment* effects and the latter the *behavioral response* effects.

We propose a strategy for separately identifying both these effects in an event-study framework. Across a wide range of labor market models, we should expect to see such asymmetries because while the sign and magnitude of equilibrium adjustment effects should depend on both the sign and magnitude of marginal tax rate changes, behavioral response effects should increase J2J transition rates in the case of both positive and negative tax changes. Furthermore, while equilibrium adjustment effects should be present in the long-run, behavioral response effects should be temporary in nature. These simple insights suggest that we should observe asymmetries in the patterns of dynamic treatment effects in response to positive and negative marginal rate changes in the presence of behavioral response effects. These asymmetries form the basis of our identification strategy.

Our results provide evidence consistent with the existence of significant behavioral response effects follow tax reforms, as well as a long-run negative impact of marginal tax rates on the equilibrium J2J transition rates. Our estimated dynamic treatment effects for positive and negative marginal rate changes exhibit the kind of assymetry our theoretical framework predicts. We discuss several challenges to our identification strategy and present a variety of robustness checks.