Bunching in the presence of deduction possibilities: Real and reporting responses of wage earners to a rigid kink

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Extended Abstract

This project aims to uncover real and reporting responses of wage earners to a large kink point in the Austrian tax schedule. In 2005, an income tax reform created a very large and salient first kink point where marginal tax rates increase by as much as 38.33 percentage points (which translates in a change in the log net-of-tax rate of 47 percent). Since the introduction of the kink, diffuse bunching in (gross) wage earnings as well as sharp bunching in taxable income of the non-self-employed can be observed, both increasing over time. In Austria, wage earnings are strictly third-party reported and before any deductions, indicating a real and reporting response of the non-self-employed to the kink. Furthermore, the availability of (itemized) deductions for wage earners seems to explain most of the difference in the excess masses generated by wage earnings and taxable income bunching.

Exploiting the panel dimension of our tax data, we further examine wether the same individuals bunch at the kink over time. We find a pattern of decreased earnings dynamics around the cutoff point: Wage earners located at the kink have a higher propensity to stay in the same earnings bin over time than individuals further away from the kink. Given that the Austrian income tax schedule is not indexed to inflation, staying at the kink over time causes real earnings losses. By studying the dynamics in wage earnings and taxable income separately, we can distinguish between a real and reporting intertemporal response of wage earners to the rigid kink: We find the propensity to stay at the kink to be more pronounced for taxable income than for wage earnings, mostly due to the use of (itemized) deductions. More precisely, we observe wage earners who stay at the kink over time to have larger increases in deductions than those located further away from the kink. Since filing a tax return in Austria is not mandatory, we can further distinguish between filing and non-filing wage earners. Interestingly, we do not find a pattern of decreased earnings dynamics for non-filers. Moreover, the earnings distribution for non-filers does not display any bunching around the cutoff point. This lack of bunching for non-filers suggests that the overall bunching we observe is not driven by firms tailoring their job offers according to the kink (to

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match workers aggregate tax preferences). In fact, the nominal rigidity of the kink makes its cutoff point not an appropriate yardstick for unions and employer associations when conducting wage negotiations (as it is shown for Denmark by Chetty et al. 2011). Rather, it seems that the pattern we observe is driven by individual bunching.

In sum, we observe real and reporting responses of wage earners to a large and salient kink point, with individuals making use of deductions to target the cutoff point within a given period as well as across periods (both intra- and intertemporal responses). The possibility to observe third-party reported (gross) wage earnings combined with a tax system that allows for a large set of deductions puts us in the position to quantify the proportion of real and reporting responses of the non-self-employed in a way previous studies were not able before. Hence, the Austrian setting represents a promising laboratory to study behavioral responses of wage earners to income taxation.