PAYROLL TAXES, SOCIAL INSURANCE AND BUSINESS CYCLES

Michael C. Burda  
Humboldt-Universität zu Berlin

Mark Weder  
The University of Adelaide

Abstract
Payroll taxes represent a major distortionary influence of governments on labor markets. This paper examines the role of time-varying payroll taxes and the social safety net for cyclical fluctuations in a nonmonetary economy with labor market frictions and unemployment insurance, when the latter is only imperfectly related to search effort. A balanced social insurance budget induces countercyclical payroll taxation, renders gross wages more rigid over the cycle and strengthens the model’s endogenous propagation mechanism. For conventional calibrations, the model generates a negatively-sloped Beveridge curve and countercyclical unemployment as well as substantial volatility and persistence of vacancies and unemployment. (JEL: E24, J64, E32)