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NEW REPORT: Workers Work More when Earnings are High

A new IZA World of Labor report, shows that workers' effort may be more responsive to wage incentives and therefore the efficiency costs of progressive labor income taxation larger than previously thought.

A fundamental question in economic policy is how labor supply responds to changes in remuneration. The responsiveness of labor supply determines the size of the employment impact and efficiency loss of progressive income taxation for example. The economist Tess Stafford of the University of New South Wales, Australia, summarizes a number of recent studies of independent contractors' labor supply which confirm a key prediction of economic theory: workers work more (in fact, quite a bit more) when earnings are temporarily high.

Standard economic theory predicts two competing responses to the question "do workers work more when wages are high?" On the one hand, higher remuneration makes leisure more costly because one must forgo greater compensation in order to enjoy it. This "substitution effect" induces individuals to work more. On the other hand, higher remuneration generates greater wealth so that one can afford to consume more of everything, including leisure. This "income effect" induces individuals to work less. Previous studies that focus on the annual labor supply behavior of more traditional workers encountered a number of problems when trying to single out the substitution effect.

To address these concerns, a recent and innovative literature has begun using data from industries that exhibit daily variation in both earnings and the quantity of labor supplied, studying workers such as taxicab drivers, bicycle messengers, baseball stadium vendors, and fishermen. The premise of these studies is that observed daily wage variation is small and transitory, so income effects are zero, and workers are autonomous, so they are able to adjust labor supply in response to wage fluctuations.

By and large, as Tess Stafford shows, this new literature reports much larger estimates of the substitution effect, suggesting that workers' effort is quite responsive to short-term variations in earnings. A study of lobster fishermen for example indicated that a 1% increase in hourly earnings leads to a 1.1−1.3% increase in labor supply.

But according to Stafford these figures might still be too low. Another factor that influences workers' behavior needs to be considered: Workers taking into account future higher wages from gaining work experience when deciding how much too work ("returns to work experience"). One US study does this by using data on the labor supply decisions of commercial lobster trap fishermen in Florida. The authors find that a 1% increase in hourly earnings leads to a 2.3−3.1% increase in labor supply for retiring fishermen, for whom the return to work experience effect is negligible.

"These findings" Stafford concludes: "suggest that the substitution effect may be much larger than previously thought." And this would mean that: "the efficiency costs of progressive labor income taxation are greater than previously thought."

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Media Contact:
Please contact Anna von Hahn for more information or for author interviews:
anna@smallspaceagency.com or +44 7852 882 770

Notes for editors:

IZA World of Labor (http://wol.iza.org) is a global, freely available online resource that provides policy makers, academics, journalists, and researchers, with clear, concise and evidencebased knowledge on labor economics issues worldwide.

The site offers relevant and succinct information on topics including diversity, migration, minimum wage, youth unemployment, employment protection, development, education, gender balance, labor mobility and flexibility among others.

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