How Does Tax and Transfer Progressivity Affect Household Consumption Insurance?

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Abstract

Using household survey data for the U.S. and Australia, we quantify the role of taxes and transfers in providing consumption insurance against income risk. While the two countries differ substantially in their degree of tax and transfer progressivity and the extent to which it reduces the variability of disposable income, we find using a semi-structural model of income, net taxes, and consumption that the overall role of taxes and transfers in affecting the elasticity of consumption with respect to permanent income shocks is similar, with an estimated 5.4 percentage point reduction for the U.S. versus 4.8 for Australia. We interpret this result using a stylized life-cycle model with incomplete markets. Counterfactual analysis for a calibrated version of the structural model shows that, while higher progressivity increases the role of taxes in providing consumption insurance, these effects are partially mitigated by less self-insurance given higher marginal tax rates. The level of wealth relative to income also reduces the effects of progressivity on consumption insurance. Thus, higher wealth-to-income ratios in Australia can explain why, despite higher progressivity, the impact of taxes and transfers on consumption insurance is similar to the U.S.

Keywords: Progressive taxes; Redistributive transfers; Consumption insurance; Incomplete markets;

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