Optimal Taxation with Risky Human Capital*

Marek Kapička
U.C. Santa Barbara and CERGE-EI†

Julian Neira
University of Exeter

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Abstract

We study optimal tax policies in a life-cycle economy with risky human capital and permanent ability differences. The optimal policies balance redistribution across agents, insurance against human capital shocks, and incentives to learn and work. In the optimum, i) if utility is separable in labor and learning effort, the inverse labor wedge follows a random walk, ii) if the utility is not separable then the “no distortion at the top” result does not apply, and iii) quantitatively, high-ability agents face very risky consumption while low-ability agents are insured. The welfare gains from switching to an optimal tax system are large.

J.E.L. Codes: E6, H2

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†CERGE-EI, a joint workplace of Charles University in Prague and the Economics Institute of the Czech Academy of Sciences, Politických veznu 7, 111 21 Prague, Czech Republic.