Human Capital Investment and Optimal Income Taxes over the Life Cycle

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Abstract
This paper studies optimal income taxes in a life-cycle model of the dynamic Mirrlees economy with human capital. We make two assumptions regarding human capital. One is that the technology of human capital is the same for different types of agents except for an initial advantage of the high type and the other is that human capital investment is unobservable. Under our settings, the two well-known conditions of zero capital taxation and perfect tax smoothing of labor income taxes no longer hold. We uncover positive capital wedges in every period even without idiosyncratic shocks, as opposed to zero capital taxes, and negative labor wedges in the first period but positive labor wedges in the terminal period, as opposed to perfect labor tax smoothing. To implement the constrained optimal allocation as a competitive equilibrium, we propose a history-dependent tax system. By restricting capital income and labor income to linear taxes on the equilibrium path, we show that intertemporal wedges and intratemporal wedges can be directly implemented as optimal capital income taxes and labor income taxes, respectively, in an equilibrium.

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All are welcome