Optimal Taxation with Risky Human Capital*

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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.

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