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Insurance and Taxation over the Life Cycle

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Abstract

We consider a dynamic Mirrlees economy in a life-cycle context and study the optimal insurance arrangement. Individual productivity evolves as a Markov process and is private information. We use a first-order approach in discrete and continuous time and obtain novel theoretical and numerical results. Our main contribution is a formula describing the dynamics for the labour-income tax rate. When productivity is an AR(1) our formula resembles an AR(1) with a trend where: (i) the auto-regressive coefficient equals that of productivity; (ii) the trend term equals the covariance productivity with consumption growth divided by the Frisch elasticity of labour; and (iii) the innovations in the tax rate are the negative of consumption growth. The last property implies a form of short-run regressivity. Our simulations illustrate these results and deliver some novel insights. The average labour tax rises from 0%

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to 37% over 40 years, whereas the average tax on savings falls from 12% to 0% at retirement. We compare the second best solution to simple history-independent tax systems, calibrated to mimic these average tax rates. We find that age-dependent taxes capture a sizable fraction of the welfare gains. In this way, our theoretical results provide insights into simple tax systems.

Key words

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JEL codes

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