

Education and Optimal Taxation: Loosening Incentive Constraints

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Abstract

As in Mirrlees (1971), I consider a situation where the government imposes an income tax without observing a taxpayer's productivity. The novelty in this paper is that, before taxation, taxpayers can choose a lottery over productivity levels in the form of education, at a cost. Can this education be socially beneficial, even when private costs exceed private benefits? Here I examine the second-best context of optimal income taxation. The government imposes an optimal tax without observing the productivity, resulting from the lottery. Since taxpayers of a given initial type make the same education choices, some initial types become vacant after the choice of education, which loosens incentive constraints and improves welfare.

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