Optimal Nonlinear Income Taxation with Learning-by-Doing

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Abstract
This paper examines a two-period model of optimal nonlinear income taxation with learning-by-doing, in which second-period wages are an increasing function of first-period labour supply. We consider the cases when the government can and cannot commit to its second-period tax policy. In both cases, the canonical Mirrlees/Stiglitz results regarding optimal marginal tax rates no longer apply. In particular, if the government cannot commit and each consumer's skill-type is revealed, it is optimal to distort the high-skill type's labour supply downwards through a positive marginal tax rate to relax an incentive-compatibility constraint. Our analysis therefore identifies a setting in which a positive marginal tax rate on the highest-skill individual can be justified, despite its depressing effect on labour supply and wages.