

Abstract

This paper studies the effects of progressive income taxes and education finance in a dynamic heterogeneous agent economy. Such redistributive policies entail distortions to labor supply and savings, but also serve as partial substitutes for missing credit and insurance markets. The resulting tradeoffs for growth and efficiency are explored, both theoretically and quantitatively, in a model which yields complete analytical solutions. Progressive education finance always leads to higher income growth than taxes and transfers, but at the cost of lower insurance. Overall efficiency is assessed using a new measure which properly reflects aggregate resources and idiosyncratic risks but, unlike a standard social welfare function, does not reward equality per se. Simulations using empirical parameter estimates show that the efficiency costs and benefits of redistribution are generally of the same order of magnitude, resulting in reasonable values for the optimal rates. Aggregate income and aggregate welfare provide only very crude lower and upper bounds around the true efficiency tradeoff.

Keywords: Income Distribution, Heterogenous Agents, Inequality, Growth, Redistribution, Education Finance.

JEL classification: D31, E62, I22, D63.