

# The Impact of Taxes and Transfers on Skill Premium

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November 2016

## Abstract

The level of wage inequality has varied across advanced industrial countries. One of the main reasons has been a significant difference in the skill wage premium. This paper analyzes the impact of taxes and transfers on the skill wage premium and social welfare in the context of a heterogeneous-agents incomplete-markets model. The analysis indicates that a significant fraction of the difference in the skill wage premium between the United States and Japan is attributable to differences in the tax system and that the optimal tax rate for capital income lies between the tax rates in the United States and Japan.

**KEYWORDS:** Skill premium; capital-skill complementarity; incomplete markets; capital income taxation.

**JEL CLASSIFICATION:** E13, E24, E62, H21, H24, J31.

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