

Abstract: I study the optimal taxation of families in an environment in which (i) characteristics of a family, labor productivity and desire for children, are only observable by the family, and (ii) child-rearing requires both goods and parental time. Potential parents simultaneously decide labor income and number of children. The government uses information on family income and family size to construct an optimal tax system via a combination of an income tax schedule with child tax credits. I observe that the parental time and the cost of goods involved in child-rearing have distinct impacts on the shape of optimal child tax credits. As a quantitative analysis, I calibrate my model to the US data and show that child-rearing costs translate into a pattern of optimal credits that is U-shaped in income. In particular, the credits are decreasing in the first three quarters of the income distribution and increasing afterwards. In addition, the credits are decreasing by family size owing to economies of scale in the impact of child-rearing costs. For median-income families, the credit for the second child equals 64% of the credit for the first child. I find that the optimal tax schedule generates a welfare gain equal to 1.3% of aggregate consumption.