Short-run and Long-run Effects of Capital Taxation on Innovation and Economic Growth

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Abstract

In this study, we examine the effects of capital taxation on innovation and economic growth in an R&D-based growth model. We find that capital taxation has drastically different effects in the short run and in the long run. An increase in the capital income tax rate has both a consumption effect and a tax-shifting effect on the equilibrium growth rates of technology and output. In the short run, the consumption effect dominates the tax-shifting effect causing an initial negative effect of capital taxation on the equilibrium growth rates. However, in the long run, the tax-shifting effect becomes the dominant force yielding an overall positive effect of capital taxation on steady-state economic growth. These contrasting effects of capital taxation at different time horizons may provide a theoretical explanation for the mixed evidence in the empirical literature on capital taxation and economic growth.

Keywords: Capital taxation, economic growth, R&D, transition dynamics

JEL classification: H20, O30, O40