Capital taxation in a life cycle economy with firm heterogeneity

Chung Tran
The Australian National University

Abstract

Capital incomes are taxed at different sources at different rates. In this paper, we study the effects of different types of capital taxes levied on corporate incomes, dividends and capital gains in a incomplete market model with life-cycle households and heterogeneous firms which undergo idiosyncratic productivity shocks. Our results, based on a marginal excess burden analysis, indicate that taxing capital incomes at different sources results in different marginal distortions. Firm heterogeneity and life-cycle structure are important for evaluating which capital tax should be used. In our heterogeneous firms framework, shifting tax burdens from corporate income taxes to household income taxes is not always favorable. Dividend tax can be more distorting than corporate income tax as it reduces the investment incentive of small, highly productive firms which amplifies allocative inefficiency of capital.