Summary for non-specialists
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Do corporate taxes distort capital allocation? Cross-country evidence from industry-level data

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Tax incentives to stimulate investment can distort the allocation of capital in multiple ways. While the corporate income tax rate applies uniformly to all investments, depreciation allowances generally vary across capital asset categories. Different types and durations for depreciation methods, which approximate economic depreciation patterns over time, generate a different effective tax burden for assets depending on their economic life. Likewise, different assets might bear specific taxes other than those falling on the corporate income they generate, e.g. property taxes applicable to commercial and industrial buildings.

This paper provides new evidence on the responsiveness of corporate investment in specific categories of assets to changes in the user cost of capital, using data from the EU KLEMS database. The analysis covers all manufacturing industries in a balanced panel of 11 advanced economies (10 EU countries and the US) over the period 1991-2007.

In addition to the direct effect, the paper identifies the substitution patterns across capital assets in response to changes in the relative user cost. The size and the significance of the estimated elasticities indicate that corporate taxes have non-negligible impacts on the composition of new investment, and, thus, of the capital stock. A counterfactual experiment where marginal effective tax rates are equalised across assets shows that, on average, under-investment in ICT capital and over-investment in other machinery and equipment have occurred over the sample period. The magnitude of the 'misallocated' capital is in the range of 4 percent of the existing aggregate stock.