Tax Heterogeneity and Misallocation*

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Abstract

Companies face different effective marginal tax rates on their income. This can be detrimental to allocative efficiency unless taxes offset other distortions in the economy. This paper develops a methodology to estimate the effect of tax rate heterogeneity on aggregate productivity in distorted economies with multiple frictions. Using firm-level balance sheet data and estimates of marginal tax rates, we find that tax heterogeneity *reduces* total factor productivity by 3 to 5%. Our findings highlight the positive correlation between marginal tax rates and other distortions to capital and especially labor. This implies that tax rate heterogeneity exacerbates the distortionary effects of other frictions in the economy. If such correlation is causal, TFP gains from removing tax heterogeneity is around 7 percent instead.

*The views expressed here are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Cleveland or the Federal Reserve System.

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