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# Factor Income Taxation in a Horizontal Innovation Model\*

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## Abstract

We consider the optimal factor income taxation in a standard  $R\&D$  model with technical change represented by an increase in the variety of intermediate goods. In the model there are externalities both to working and to saving, due to market power by firms, incomplete appropriability of the benefits of inventions and the cost of economic activity in terms of public expenditures. Redistributing the tax burden from labor to capital will increase employment but, in most cases, reduce the rate of growth, with conflicting effects on the deadweight loss from the externalities. Under plausible calibrations of the model, the optimal tax rate on capital will be sizable.

**Keywords:** *Capital Income Taxes, R&D, Growth Effect, Welfare Effect.*

**JEL classification:** *E62, H21, O41*

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