DOES THE HIGHER CORPORATE INCOME TAX HURT THE ECONOMY?

Deergha Raj Adhikari, Professor, University of Louisiana at Lafayette, U.S.A.
S. P. Uma Rao, Professor, University of Louisiana at Lafayette, U.S.A.
Denis Boudreau, Associate Professor, University of Louisiana at Lafayette, U.S.A.

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ABSTRACT

The trickledown economics claims that if corporate income tax is lowered it will leads to higher level of investment, real output, and employment. Those who support the trickledown theory argue that lowering corporate income tax raises the profit encouraging businesses to increase investment leading to the increase in real output. Increasing real output not only requires more investment but also more labor and larger amount of raw materials and other inputs. The rise in demand for labor causes raises the wage rate putting more money in workers' hand thereby improving their standard of living. Thus, cutting corporate income tax spurs economic growth and improves workers' standard of living.

This paper tests the validity of the theory of trickledown economics using US data over the period, 1990-2020. The paper applies the VAR (vector autoregressive) model with two endogenous variables, RGDP (real gross domestic product) and HCIT (highest rate of corporate income tax). The study finds that, in the equation in which RGDP is the dependent variable, the coefficient associated with the independent variable $HCIT_{t-2}$ *to be positive and statistically significant. So, we concluded that any rise in the highest rate of corporate income tax would in fact raise the real GDP with two-period lag. This finding invalidates the claim made by the supporters of trickledown economics particularly in US context.*

Keywords: *Trickledown economics, Corporate income tax, Real GDP, VAR, etc.*

1. INTRODUCTION

The proponents of trickledown economics claim that cutting corporate income tax leads to increased investment thereby increased real output and employment and a better life for the workers. The economic argument they forward is that cutting corporate income tax raises per-unit profit encouraging businesses to increase investment leading to the increase in real output. But increase in real output can only be achieved through a higher level of spending on plant, equipment, labor, raw materials, and other inputs at the current state of technology. The rise in the demand for labor, then raises the wage rate putting more money in workers' and raising their standard of living. Thus, lowering corporate income tax will ultimately raise the real output (GDP) and the standard of living of workers. It is this argument that president Donald Trump used to propose a corporate income tax from its highest level of 39% to 21% in 2018. This study attempts to empirically examine the validity of the trickledown economics using US data. A tentative observation of Figure-1 indicates no association between U.S. real GDP (RGDAP) and the highest U.S. corporate income tax (HCIT). However, the study conducts an in-depth statistical analysis to examine any possible association between the two variables.

Some studies have tried to examine the issue. For example, a study by Hungerford (2013) finds no evidence of lowering corporate income tax rate spurring economic growth.

Liu and Altshuler (2013) examine the effect of corporate income tax under the condition of imperfect competition. Their findings suggest that it is the labor that bears a significant portion of the burden of the corporate income tax. Their findings suggest that a $1.00 increase in corporate income tax lowers the wages by approximately $0.60.