

THE EFFECT OF CORPORATE TAXATION ON INVESTMENT AND WAGES

By

James Apostolico

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Reviewed and approved by:

Philip Sookram

Thesis supervisor

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PREFACE

I would like to thank Philip Sookram, my past professors, and my friends for their support throughout this research. Most importantly, I would like to thank my two brothers (Tommy and Vincent) and my parents for always supporting me.

Abstract

In 2017, President Donald Trump and Republicans in Congress successfully enacted the Tax Cuts and Jobs Act. This legislation slated the federal corporate tax rate to be reduced from 35 percent to 21 percent in addition to having some investments qualifying for immediate deduction as an expense (Auerbach 1). In passing this act, the White House Council of Economic Advisers predicted that reducing the corporate tax rate to 21 percent would lead to an increase in wages and it would “increase average household income in the United States by, very conservatively, \$4,000 annually. ... Moreover, the broad range of results in the literature suggests that over a decade, this effect could be much larger” (1). Some conservatives, such as Trump and the Republicans in Congress in 2017, have long argued that corporate tax rate cuts substantially benefit the economy by increasing investment, wages, and employment. On the other hand, opposers of corporate tax rate cuts have made the argument that these supposed benefits are not the reality of this economic policy and that what happens instead is corporations keep the money they save from these tax rate cuts, and wages and investment are not benefited in any sort of way (Hendricks 1). With my honors thesis, I will examine corporate tax rate cuts and their effects on investment and wages specifically. I will examine whether or not the benefits that Republicans and Donald Trump emphasized of increased investments and wages as a result of corporate tax rate reductions are true.

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Introduction to the Tax Cuts and Jobs Act of 2017

Corporate tax is defined as a tax on the profits of a corporation. These taxes are paid on a company's taxable income, which includes revenues less the cost of goods sold along with general and administrative expenses, depreciation, research, and development, selling and marketing, and other operating costs. Even though individual tax returns are due April 15 each year, U.S. corporate tax returns are due March 15. Corporations can also apply for a six-month extension to file their tax returns in September (Kagan 1). In 2017, Donald Trump signed the Tax Cuts and Jobs Act (TCJA) into law on December 22nd. This act cut the corporate tax rate from 35% to 21%. The 21% corporate tax rate would be the lowest rate since 1939. In addition to this lower corporate tax rate, the Tax Cuts and Jobs Act instituted a 20% deduction on qualified business income for pass-through businesses. Pass-through businesses include sole proprietorships, limited liability companies, S corporations, and partnerships. These businesses are not subject to corporate income tax. Instead, these businesses report their income on the individual tax returns of the owners, and these incomes are taxed at individual income tax rates. The pass-through business deduction enacted by the Tax Cuts and Jobs Act ends after 2025. The TCJA also limits corporations' ability to deduct interest expenses to 30% of income. For the first four full years of the act (2018-2021) income was based on earnings before interest, taxes, depreciation, and amortization (EBITDA). Beginning in 2022, income is based solely on earnings before interest and taxes. Furthermore, the TCJA also allows businesses to deduct the cost of depreciable assets in a single year rather than amortizing them over several years. This does not apply to structures. In order to qualify for this deduction, equipment must be purchased after September 27, 2017, and before January 1, 2023. Next, the TCJA also implemented some changes with regard to carried interest profits. Carried interest is defined as income in an

investment fund that flows directly to a general partner. Instead of being taxed at the top income tax rate, carried interest is taxed at 23.8% under the TCJA. Additionally, the act eliminated the corporate alternative minimum tax. Prior to 2018, the corporate alternative minimum tax had a 20% tax rate that became applicable when tax credits drove a firm's effective tax rate below 20%. And finally, the tax treatment of global corporations was also tweaked under the TCJA. In an effort to encourage global corporations to reinvest in the United States, the TCJA implemented a "territorial" system where global corporations are not taxed on foreign profit. Before the TCJA, global corporations were taxed on foreign income earned. These corporations did not pay tax until profits were brought to the U.S. As a result of this taxation, global corporations reinvested foreign profits earned into those foreign markets overseas. Therefore, many corporations were driven to borrow at the low-interest rates in the U.S. As Kimberly Amadeo of The Balance states, "Corporations became debt-heavy in the U.S. and cash-rich in overseas operations" (1). The main focus of this thesis will be the 21% corporate tax rate implemented by the Tax Cuts and Jobs Act. The White House Council of Economic Advisers predicted that reducing the corporate tax rate to 21 percent would lead to an increase in wages and it would "increase average household income in the United States by, very conservatively, \$4,000 annually. ... Moreover, the broad range of results in the literature suggests that over a decade, this effect could be much larger" (1). Trump and the Republicans in Congress in 2017 argued that corporate tax rate cuts substantially benefit the economy by increasing investment, wages, and employment. Meanwhile, opposers of tax rate cuts argue that these tax cuts are simply a ploy by the wealthy to save more money (Hendricks 1). This thesis will examine the reduced corporate tax rate of 21% set by the Trump administration in 2017 to determine whether

or not a reduced corporate tax rate does lead to higher investments and wages. Not only will data post-2017 be reviewed but so will historical data dating back to World War II.

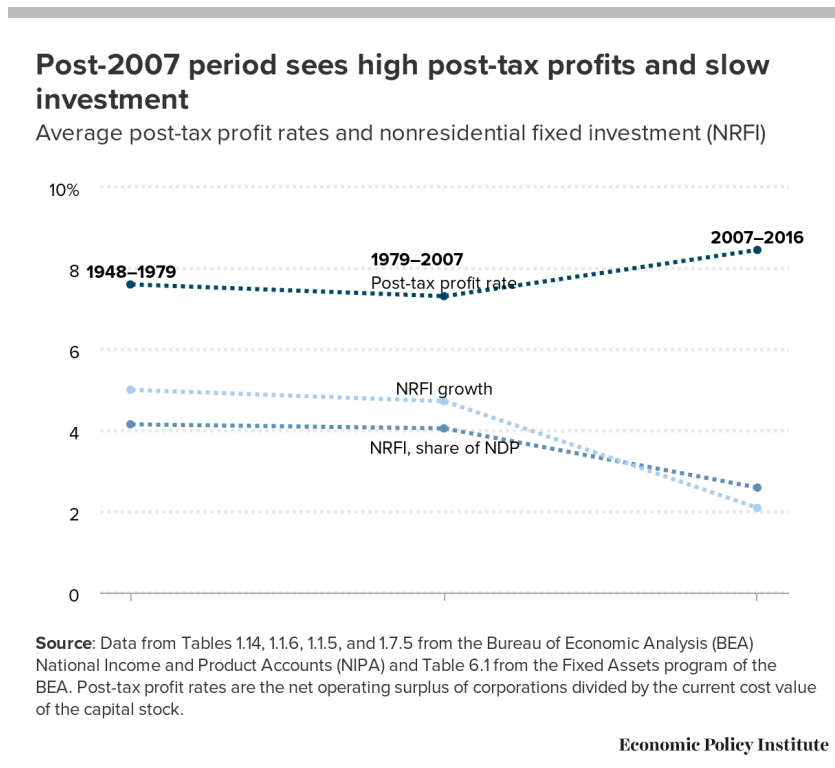
Historical Data and Trends Analysis

The argument that corporate tax rate cuts boost wages entails the idea that at first, corporate tax rate cuts will lead to higher profits for businesses. These higher profits then boost the returns to owning stocks or bonds. In turn, the higher returns will influence households to save more and spend less and so this leads to an increased supply of savings. The increased supply of savings will then translate to lower interest rates and then firms will be driven to borrow more to finance new plants and equipment. Financing new plants and equipment gives workers better tools to work with which will lead to greater productivity. With a competitive labor market, businesses will reward productivity with higher wages for workers (Bivens 1). Josh Bivens of the Economic Policy Institute examined this argument and compared it to historical data. Bivens ultimately put together the following graph of historical data:



Looking at this data, it is evident that as the statutory corporate income tax rate declined, productivity and wage growth did not substantially increase. As Bivens states, “Since 1953,

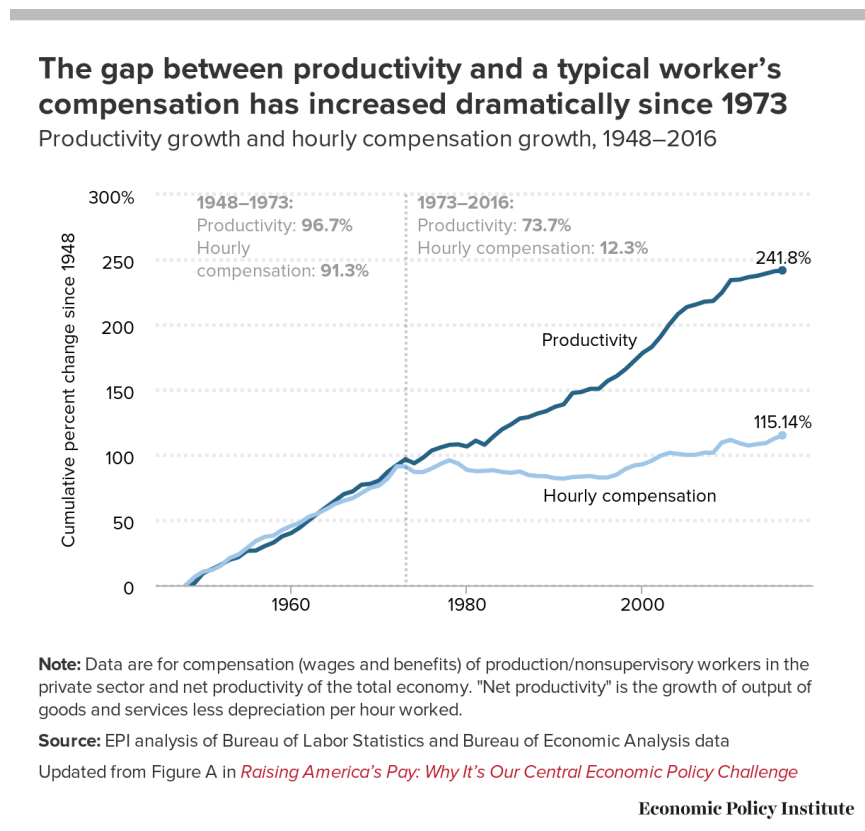
lower corporate rates (the dark line) have not noticeably boosted productivity growth and wage growth (the lighter lines)” (2). It is also evident that productivity and wage growth were strongest when the corporate tax rate was at its highest in the decades following World War II compared to the 1980s, 1990s, and 2000s. In explaining the reasoning behind lower corporate tax rates not leading to higher productivity and wages, Bivens states that there is a weak association between post-tax profit rates and business investment. As Bivens previously noted, the theory behind lower corporate tax rates leading to higher productivity and wages explains that lower corporate tax rates lead to higher private sector savings and this, in turn, results in lower interest rates that drive businesses to invest in property, plant, and equipment. The following figure constructed by Bivens showcases that the link between profit rates and investment is historically weak:



The figure displays the post-tax profit rate, growth in nonresidential fixed investment (NRFI), and net NRFI (NRFI less depreciation) as a share of total net domestic product (NDP) in three

separate periods after 1948. As the figure shows, the post-tax profit rate from 2007-2016 increased significantly and yet the NRFI growth decreased during this period. Thus, this data proves that lower corporate tax rates don't necessarily lead to higher investments which disproves part of the theory explaining that lower corporate tax rates lead to higher profits which eventually result in better productivity and wages.

Furthermore, Bivens builds off of his argument to explain that even if lower corporate tax rates did lead to higher investments and productivity, wages would not necessarily increase as well. Bivens states, "For decades the U.S. economy has seen a growing wedge between productivity growth and wage growth, meaning that pay and productivity used to rise tightly together but they no longer do" (4). The following figure from Bivens illustrates this claim:

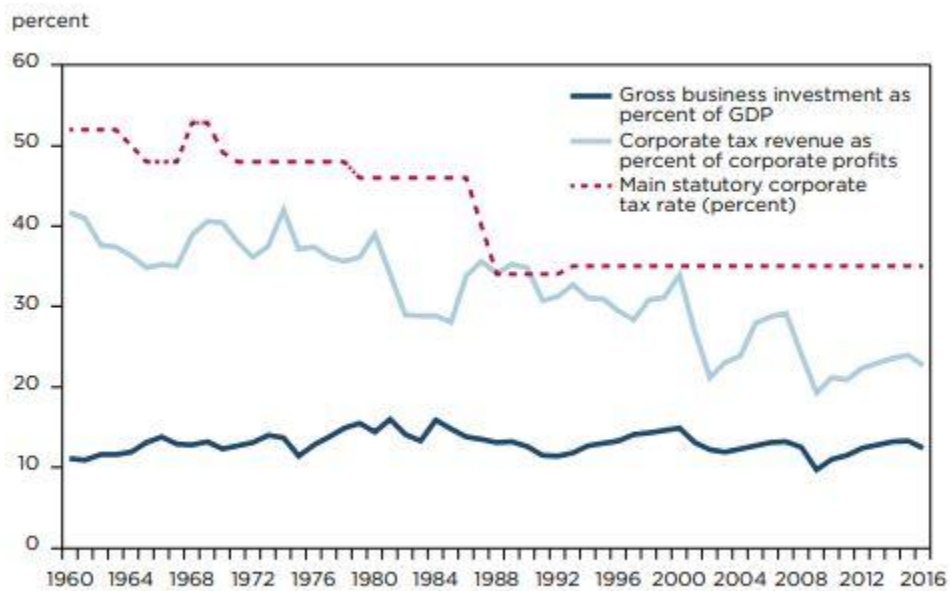


The data in this graph indicates that since the late 1970s, only about 10-15 percent of each 1 percentage-point increase in productivity growth has led to increased hourly pay for typical

American workers. Thus, Bivens effectively refutes the theory supporting lower corporate tax rates by explaining three central ideas: (1) Historically, productivity and wages were strong during times of high corporate tax rates, (2) higher profits do not necessarily lead to higher investments, and (3) recent trends indicate that higher productivity among workers will not lead to higher wages.

Similar to Josh Bivens, William R. Cline of the Peterson Institute for International Economics also examined the historical effects of corporate tax rate cuts in years prior. Specifically, Cline looks at the corporate tax rate cuts in the 1960s, 1970s, and 1980s. Cline constructs the following data that examines the correlation between corporate tax rates, gross business investment, and corporate tax revenue:

Figure 1 Corporate tax rate and gross business investment, 1960-2016

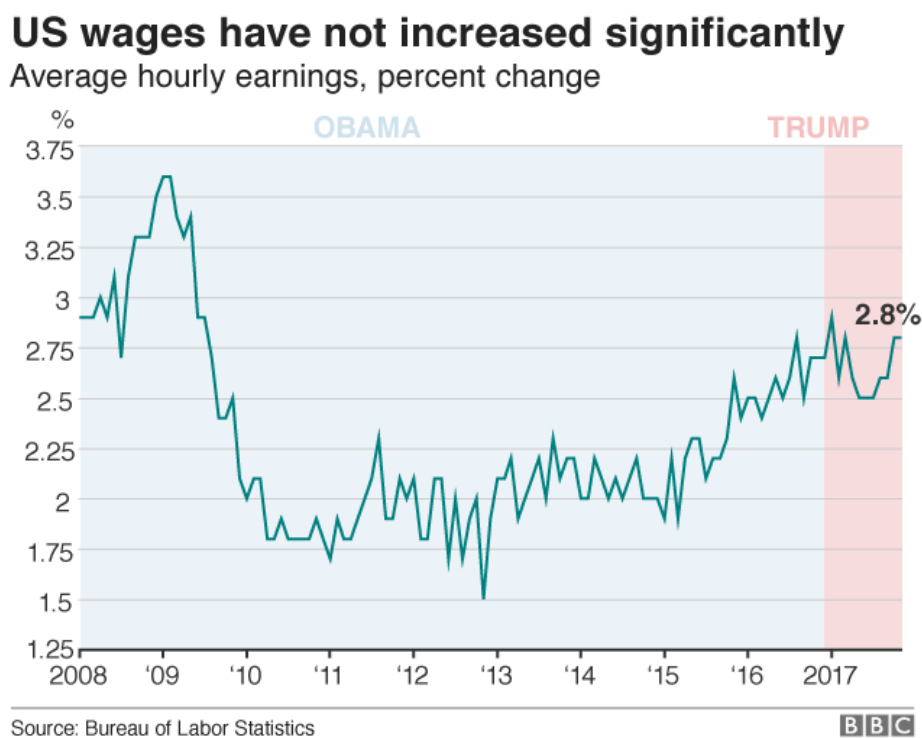


Sources: BEA (2017a, 2017b); Taylor (2002).

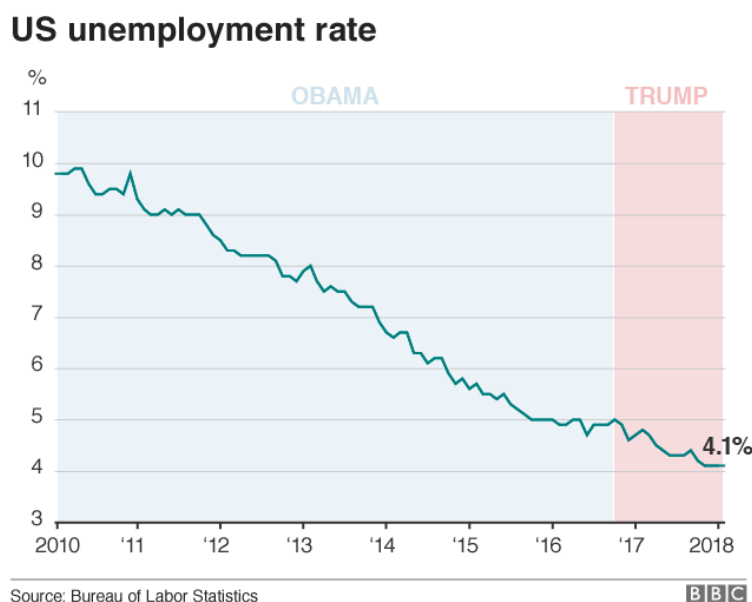
As illustrated by the chart, business investment showed very little response to any changes in corporate tax rates. Even during the period from 1984 to 1988 when the main statutory corporate tax rate substantially decreased, there was no significant change in business investments.

Wages Data and Trends Post 2017

Trump, along with other conservatives, contested that the Tax Cuts and Jobs Act would immensely help workers achieve higher wages. In fact, they predicted that this act would lead to higher investment and, in turn, American workers would experience an increase of \$4,000 in wages (Chupaska 1). In examining the trend of wages since 2017 when the TCJA was enacted, it is evident that wages did not grow as substantially as Trump’s administration predicted. To illustrate this, business reporters Natalie Sherman and Daniele Palumbo of BBC News constructed the following data showing the percentage change of average hourly earnings for American workers:



As seen by the data, wages initially after the Tax Cuts and Jobs Act only grew 2.8%. In examining this data even further, one has to note whether this slight increase in wages is due to these tax cuts or other circumstances. According to Alan Binder, an economics Professor at Princeton University who is also a member of President Clinton’s Council of Economic Advisors, when looking at the state of the economy only a couple of years after a new administration enacts tax laws it is important to note that during this timeframe the state of the economy is more likely to be influenced by what happened before the new administration came into office (Nguyen 1). It’s important to note that before wages increased slightly in 2017 and 2018, the economy was already experiencing improvements during the Obama administration. As stated by Saul Eslake of The Conversation, “It’s worth noting that the improvement in economic conditions in the US started in mid-2016, around 18 months before the tax reform” (1). One of the improvements in economic conditions that led to these slight increases in wages was the decreasing unemployment rate. As shown by the following data from Daniele Palumbo and Natalie Sherman, the unemployment rate in the United States had been decreasing for quite some time before the Trump administration:



As unemployment decreases, the labor market tightens and this itself leads to better wages for workers. This relationship is known as the Phillips Curve. As the unemployment rate decreases along with a tight labor market, businesses are often faced with having to increase wages in order to both retain their own workers and attract outside workers (Marine 1). Proponents of the Tax Cuts and Jobs Act argue that even though firms are looking to increase wages due to the tight labor market, the slashed corporate tax rate pushes this trend even further. John Bremen, a managing director for Willis Towers Watson who advises companies on human capital and benefits, states that despite the fact that companies were raising salaries in the wake of the labor market, the tax law “amplifies it and accelerates it” (Sherman and Palumbo 1). After examining the trends of wages both before and after the Tax Cuts and Jobs Act was enacted, it is apparent that the tax law did not accelerate wages whatsoever. According to Frank Clemente, the Executive Director of Americans for Tax Fairness, under Barack Obama’s last two years of presidency, the yearly wage growth rate was 0.7 percent. In the two years following the enactment of the Tax Cuts and Jobs Act in 2017, the yearly wage growth was only 0.4 percent (1). Other supporters of the tax cuts have argued that there is evidence in the trend of the employment compensation index after 2017 that can be used as proof that the reduced corporate tax rate has led to higher wages. Matthias Cormann, the Secretary-General of the Organisation for Economic Co-operation and Development for Australia, commented on the TCJA and argued that the idea that the TCJA has supported wages is supported by a trend in the Employment Compensation Index in 2018. Cormann highlights data presented in a Bloomberg article which derives data from the Bureau of Labor Statistics and shows that in the second quarter of 2018, the Employment Compensation Index recorded its highest growth since mid-2008 (Eslake 1). While it may be true that this particular index did experience growth for one quarter in 2018, it

must be noted that, as explained by Saul Eslake, this time frame is too soon for one to establish causation between the reduced corporate tax rate and improvements in the economy. In addition, when one looks at other wage data available such as average hourly wages and wages/salaries growth, it is evident that overall there were no significant improvements in the broad scope of wages. Looking at the chart below provided by Saul Eslake, it is evident that the employment cost index did experience growth in 2018 but average hourly wages did not experience similar growth:



The blue line is based on data from the US Bureau of Labor Statistics Employment Cost Index. The red line is also based on data from US Bureau of Labor Statistics, looking at employees average hourly earnings.

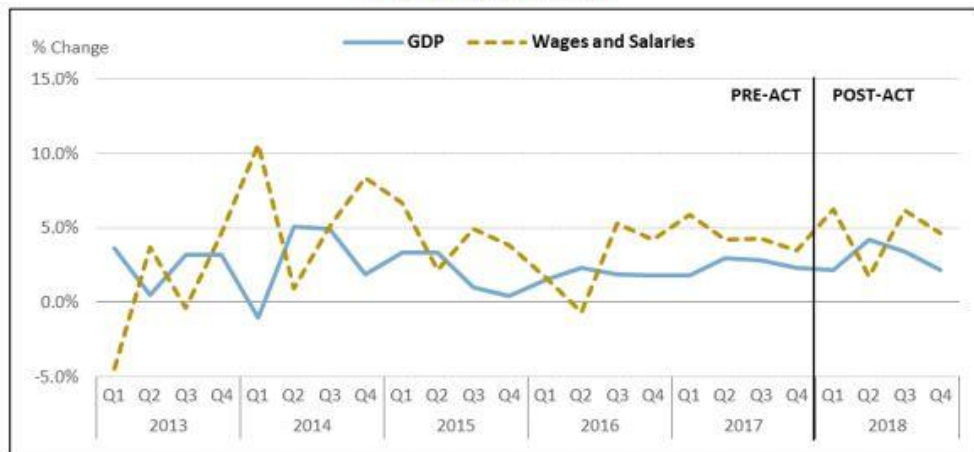
Chart: Fabrizio Carmignani • Source: [US Bureau of Labour and Statistics](#) • [Get the data](#)

Similar to average hourly earnings, U.S. wages and salaries growth did not experience any growth in the same time period (2017-2019) as shown by the following data from the U.S. Bureau of Economic Analysis:



In addition to this data, the Congressional Research Service put together the following data that compares the growth of real wages and salaries to the growth of GDP:

Figure 4. Growth in Real Wages and Real GDP, First Quarter 2013 Through Fourth Quarter 2018



Source: Tables I.1.2, I.1.1, and I.1.4 Bureau of Economic Analysis, National Income and Product Accounts (NIPA).

Notes: Seasonally adjusted at annual rates.

According to the Congressional Research Service, it was reported by the Department of Labor that the average weekly wages of production and nonsupervisory workers were \$742 in 2017 and \$766 in 2018. In addition, wages increased by \$1,248 annually, assuming full-time work. This

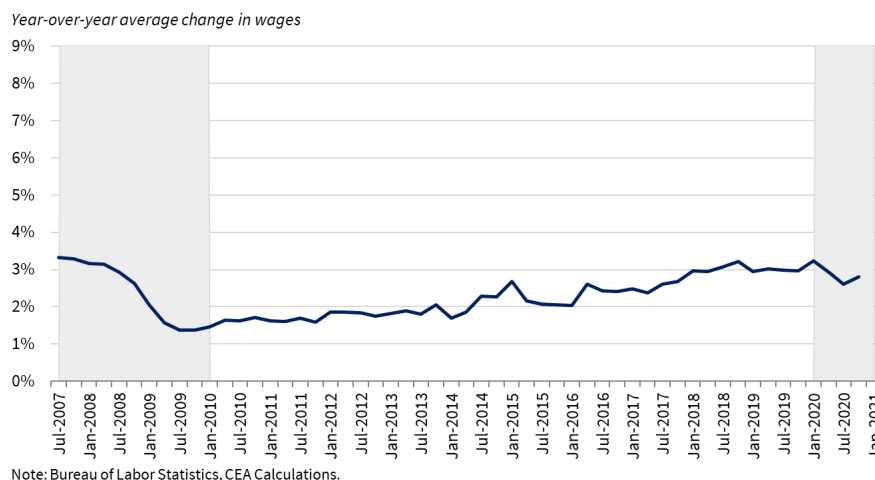
may seem like a modest increase in wages for workers however, as explained by the Congressional Research Service, inflation and growth that would have taken place regardless of the tax change in 2017 must be taken into account. Thus, “The nominal growth rate in wages was 3.2%, but adjusting for the GDP price deflator, real wages increased by 1.2%. This growth is smaller than the overall growth in labor compensation and indicates that ordinary workers had very little growth in wage rates” (Gravelle and Marples 11). In the two years following the enactment of the Tax Cuts and Jobs Act, average hourly earnings and growth of wages and salaries did not experience much growth. Thus, proponents of the TCJA, such as Matthias Cormann, who claim that this act accelerated wage growth simply fail to recognize the data. Even though there may have been an ever so slight increase in wages after the TCJA was enacted (2.8%, as reported by BBC), this growth was not substantial and this trend started to formulate in mid-2016 before the Trump administration came into office.

Wages Data of COVID-19

In examining wages in the U.S. after the Tax Cuts and Jobs Act was enacted in 2017, it is important to note significant changes during the COVID-19 pandemic. In April of 2020, the U.S. economy had lost 21 million jobs and it seemed to have experienced some of the largest wage growth in U.S. history. The Bureau of Labor Statistics reported that year-over-year growth in average hourly wages jumped all the way up to about 8 percent. This was the highest reported growth since the statistic was introduced in 2006. The reasoning behind this spike in wage growth, as explained by Chair Cecilia Rouse and Martha Gimbel of the White House, is that during April of 2020 millions of low-paid workers lost their jobs while high-paid workers remained employed. Rouse and Gimbel state, “When changes in data are driven by a shift in underlying characteristics—like fewer low-wage workers remaining in the

workforce—economists call these composition effects” (1). To illustrate this, say a job market consists of three workers: Worker A makes \$10 an hour; Worker B makes \$20 an hour, and Worker C makes \$60 an hour. The average hourly wage in this job market is \$30. If Worker A becomes unemployed, then the average hourly wage becomes \$40 because the job market only consists of Worker B and Worker C. The \$10 growth in the hourly wage was due to the composition of the workforce changing. Rouse and Gimbel explain that in order to look past these composition effects with regard to wages, one should consider the Employment Cost Index. The Employment Cost Index is a measure of hourly growth that maintains a mix between industry and occupation. As stated by Rouse and Gimbel, “The ECI keeps the mix of employment by industry and occupation constant across time, which prevents it from being affected by shifts between low- and high-wage jobs; that is, the ECI shows the average change in wages within industries and occupations” (1). Rouse and Gimbel showcase the following graph which takes into consideration the Employment Cost Index:

Figure 2: The average change in wages, which adjusts for some composition effects, dipped slightly in the pandemic



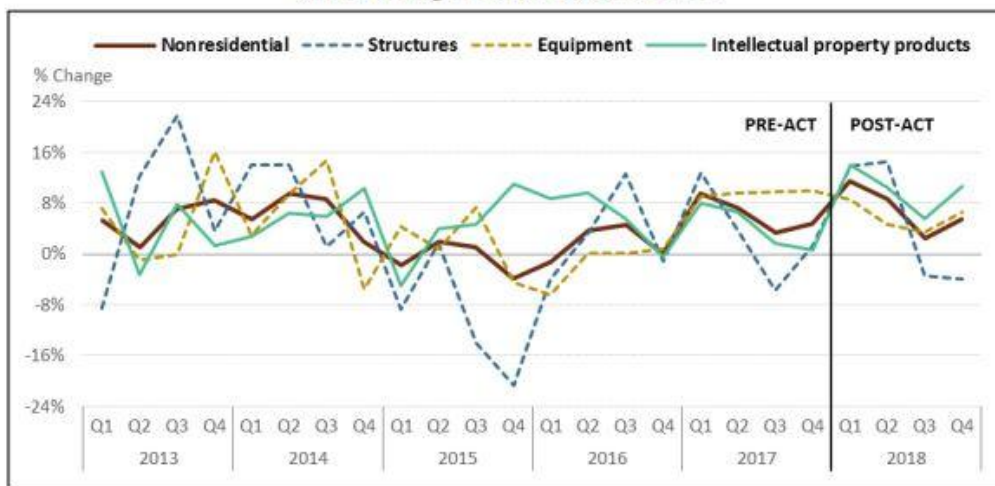
It can be seen that when accounting for composition effects, the average wage growth had actually dipped down to 2.8 percent at the end of 2020. Rouse and Gimbel note that

compositionally-adjusted wage data from the Federal Reserve Bank of Atlanta also do not show an increase in wage growth in 2020.

Investment Data and Trends Post 2017

Looking at business investment after the enactment of the Tax Cuts and Jobs Act, it can be seen that there were no significant improvements in business investments and companies seemed to put more money towards buybacks. According to Eleanor Wilking, an assistant law professor at Cornell University, corporate investment after 2017 remained steady, “as corporations engaged in share buybacks, rather than new projects.” Wilking notes that in 2018, corporations spent \$200 billion more on stock buybacks than on research and development (Nguyen 1). To illustrate the lack of significant improvements in investments after the TCJA, the Congressional Research Service put together the following data:

Figure 3. Growth in Nonresidential Investment and Subcomponents, First Quarter 2013 Through Fourth Quarter 2018



Source: Table I.1.1, Bureau of Economic Analysis, National Income and Product Accounts (NIPA).
Note: Seasonally adjusted at annual rates.

Jane G. Gravelle and Donald J. Marples of the Congressional Research Service explained that in 2018, consumption grew at 2.6% and nonresidential investment grew at 7%. These two numbers could be evidence of a supply-side effect of the tax cuts however, Gravelle and Marples believe

that there are reasons to refute this point. The first reason they give is that the growth rates of investment and its subcomponents are way more volatile than the growth rates of GDP, which makes it harder to draw a correlation between the tax changes and growth rates. The second reason they explain is that the largest effects of these growth rates occurred in the first and second quarters of 2018 and this is simply too soon of a time frame for the growth rates to be a direct result of the tax changes. In addition, the growth rate of structures was negative in the final two quarters of 2018. The final reason they emphasize is that the real growth in the subcategories of equipment, structures, and intellectual property products is inconsistent with the incentive effects of the reduced tax rates. Over the entire year of 2018, structures grew at the slowest rate of 5.0%, equipment grew at a rate of 7.5%, and intellectual property products grew at the fastest rate of 7.7%. Gravelle and Marples explain that in order to correctly assess the incentive effects of the tax changes, one must examine the change in the user cost of capital. They state, “It is the equivalent of the ‘price’ of capital as an input (just as the wage is the price of labor input). It includes two costs of using capital: the opportunity cost of using funds (i.e., the required pretax rate of return on the asset) and depreciation (i.e., the cost of using up the asset)” (6). Gravelle and Marples further explain that the user cost is indicative of the required rate of return at the margin. They estimated that the user cost of capital for equipment declined by 2.7% and the user cost of capital for structures declined by 11.7%. The user cost of research and development happened to actually increase by 3.4%. The reason why the user cost of capital for equipment decreased by less than that of structures is the fact that depreciation makes up more of the cost for equipment. Additionally, the required rate of return for equipment was less for equipment because “it was already favorably treated (eligible for expensing half of the cost)” (7). Lower rates include benefits that are moderated by the use of debt-financed capital, as a lower tax rate reduces the

subsidy that applies to investment that is debt-financed because businesses can deduct the nominal interest. To summarize this data and information, Gravelle and Marples emphasize that even though the possibility exists that the Tax Cuts and Jobs Act increased investment as a result of supply-side effects, “it would be premature to conclude that the higher rate of growth of nonresidential fixed investment was due to the tax changes. Looking at changes in the user cost of capital, the effects of investments in structures would be expected to be the largest, with small (or negative) effects on intellectual property. To date, this pattern has not been observed” (7). A study conducted by the Peter G. Peterson Foundation also found that business investment after the enactment of the TCJA did not live up to the predictions of proponents of the act. The study quotes the Center for American Progress (CAP), which found that in the year after the tax cuts, business investment only experienced very slight growth compared to the predictions of the supporters of the tax law. The CAP also states, “Furthermore, a study by the International Monetary Fund (IMF) concluded that the relatively healthy business investment in 2018 was driven by strong aggregate demand in the economy — not the supply-side factors that tax cut proponents used to justify the tax cut” (1). To further illustrate the lack of business investment following the TCJA and the behavior of corporations using their savings for stock buybacks, Frank Clemente, an Executive Director of Americans for Tax Fairness, explains that in 2018 capital investment experienced just one-quarter of modest growth, and in the second and third quarters of 2019 capital investment declined into negative territory. He goes on to state that U.S. corporations “bought back a record \$800 billion-plus of their own shares in 2018, an increase of more than 50 percent over the \$519 billion in stock buybacks in 2017” (1). The promise from the Trump administration and other conservatives that the TCJA will lead to increased investment among corporations simply did not come to fruition. The drastic increase in stock buybacks that

corporations invested their tax savings towards showcases that these tax cuts benefited shareholders more than the average U.S. employee.

Corporations' Use of Tax Savings

The conservative theory that corporations will use their tax-cut savings to invest in property, plant, and equipment to help boost their workers' wages has not been evident in corporations' behavior since the enactment of the Tax Cuts and Jobs Act in 2017. For example, Erin Marine of the Fordham Journal of Corporate and Financial Law explains that a survey conducted by Morgan Stanley analysts found that, "only 13% of companies' tax cut savings will go to pay raises, bonuses, and employee benefits." At the same time, it is estimated that 43% of companies' tax cut savings will go to stockholders in the form of dividends and buybacks. An example of a corporation that exhibits this behavior is Walmart. As a response to the tax cuts, Walmart announced that it would be increasing its starting wage to \$11 an hour as well as offering a one-time bonus to select employees. Walmart has estimated that the bonuses will cost \$400 million as a one-time cost. At the same time, the annual cost to increase the starting wage to \$11 an hour will be \$300 million. Walmart implemented these changes in 2018 and in that year, the \$700 million costs for these changes makes up about 0.08 percent of Walmart's annual revenue. In addition, the annual cost of the wage increases makes up about only 15 percent of Walmart's estimated \$2 billion annual tax savings. At the same time that Walmart implemented these changes, they made the decision to close 63 Sam's Club locations. In summarizing these changes, Erin Marine states, "A full-time job at Wal-Mart's new minimum wage amounts to approximately \$19,000 annually, below the national poverty rate for a family of three" (1). Thus, while it may seem that a corporation like Walmart is helping its workers by raising their minimum wage, the reality is that only a minuscule amount of Walmart's tax savings are being

used towards improving these wages and a majority of the rest of the savings are going towards buybacks and dividends. In the end, a full-time worker at Walmart is not enjoying any sort of significant improvement in their salary when they can't even make more money than the national poverty rate for a three-individual family. Another example of a corporation that exhibited this type of behavior after the tax cuts is AT&T. Natalie Sherman and Daniele Palumbo of BBC explain that in response to the Tax Cuts and Jobs Act, AT&T announced that it would reward more than 200,000 workers with \$1,000 bonuses and contribute \$1 billion towards U.S. investment in 2018. But just like Walmart, AT&T is putting many of their employees out of work as they negotiated with union workers over roughly 1,000 layoffs (1). Erin Marine summarizes the insignificant improvements in workers' wages after the Tax Cuts and Jobs Act by explaining that, according to the White House, 3.5 million workers benefited from bonuses and wage increases, which is just a minuscule amount of the 125.5 million Americans who work for companies. Marine also states, "And while, for many of those workers, a \$1000 bonus or a \$1 per week raise is certainly a welcome change, it likely doesn't represent a meaningful improvement in their compensation" (1). Simply put, it can be seen that improvements in workers' wages after the Trump tax cuts were not very significant and although wages did improve, the tight labor market and the low unemployment rate in the U.S. were more significant contributing factors to these slight improvements.

Conclusion

The conservative theory that a reduced corporate tax rate would lead to increased investments and wages simply did not come to fruition after the enactment of the Tax Cuts and Jobs Act of 2017. Historically, this theory has proven to be false as a reduced corporate tax rate has not correlated with increased investments. In addition, productivity and wages have actually

been shown to increase during times of higher corporate tax rates. Even though there were some improvements in wages after 2017, these improvements were not very substantial and were most likely a result of the healthy state of the economy leading up to 2017. In the end, corporations often use their tax-cut savings to benefit their stockholders via buybacks and dividends, as showcased by the examples of Walmart and AT&T. The average U.S. employee, both historically and post 2017, has not experienced any sort of significant wage growth as a result of a reduced corporate tax rate.

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