

State Income Taxes and Corporate Liquidity Management

Abstract

We investigate the direct effect of corporate income tax changes on the liquidity management of firms. Using the staggered corporate income tax rate changes across states as an identification strategy, we find that tax increases cause firms to hold more cash. This effect is more pronounced for firms with low and risky cash flows, more growth opportunities, more financial constraints and low repatriation costs of foreign earnings. These findings suggest that corporate income tax increases have a first-order impact on firm cash holdings, and firms conserve more cash to mitigate tax-induced frictions, consistent with the precautionary motive of cash holdings.

Key words: cash holdings, liquidity management, corporate taxes, financial constraints