Indonesian Economic Review
Volume. 5, Number. 1, Year 2025
e-ISSN : 2774-8073 ; Page. 01-11
DOI: https://doi.org/10.53787/iconev.v5i1.39
Available online at: http://https//iconev.org/

The Impact Of Tax Reforms On Stock Market Efficiency: A Study On Policy Changes And Market Dynamics

Yessica Amelia[1], Ngadi Permana[2], Sarah Fitriyani[3]
[1,2,3] Sekolah Tinggi Ilmu Ekonomi Kasih Bangsa
Email : yessicaamelia@stie-kasih-bangsa.ac.id [1], ngadipermana@stie-kasih-bangsa.ac.id [2], sarahfitriyani04@gmail.com [3]

Abstract. *This study examines the impact of tax reforms on stock market efficiency, focusing on how policy changes influence liquidity, price dynamics, and information flow within financial markets. Using the Tax Cuts and Jobs Act (TCJA) of 2017 as a case study, this research explores how tax reductions affect corporate decision-making, trading behavior, and the efficiency of asset pricing. The findings suggest that while tax reforms can enhance short-term liquidity and improve transparency in stock pricing, they also introduce challenges such as increased market volatility and information asymmetry. These results underscore the importance of aligning tax policies with market stability goals to optimize investor confidence and overall market efficiency.*

Keywords: *Tax reform, stock market efficiency, liquidity, information asymmetry, market volatility*

INTRODUCTION

Tax policies are a fundamental component of a country's economy, shaping corporate behavior, investor decisions, and financial market dynamics. One of the most transformative tax reforms in recent history is the Tax Cuts and Jobs Act (TCJA) of 2017, enacted in the United States. This legislation introduced substantial changes, including a reduction in the corporate tax rate from 35% to 21% and incentives for the repatriation of foreign profits. These provisions aimed to stimulate domestic investment, increase corporate profitability, and foster economic growth. However, the ripple effects of these reforms extended beyond corporate operations, influencing stock market liquidity and pricing efficiency, as highlighted by studies such as Fatemi, Kim, Mazumder, and Su (2024).

The TCJA has drawn significant attention from researchers due to its dual impact on stock market dynamics. On the one hand, the legislation reduced barriers to foreign capital inflow and encouraged greater corporate reinvestment, potentially improving liquidity. On the other hand, it introduced uncertainties, such as long-term fiscal sustainability and investor responses to policy changes, which could destabilize market efficiency. Liquidity, defined as the ability to trade assets without significantly affecting their prices, is crucial for efficient market functioning. Low liquidity, often a byproduct of significant regulatory changes, can lead to increased price volatility and greater uncertainty for investors (Auerbach, 2018; Beyer et al., 2023).

Received: November 15, 2024; Revised: Desember 25, 2024; Accepted: Januari 20, 2025; Published: Februari 27, 2025;

Despite these liquidity concerns, studies suggest that the TCJA positively influenced price efficiency. Improved access to financial information and better-informed trading were found to enhance the speed and accuracy of price adjustments, allowing asset prices to better reflect available information (Chiu, 2020; Chordia, Roll, & Subrahmanyam, 2008). This paradox—declining liquidity alongside improved pricing efficiency—underscores the complex dynamics between tax reforms and market behavior.

Furthermore, the impact of the TCJA extends beyond domestic markets, influencing international financial systems, especially in countries with strong economic ties to the United States. For instance, Gaertner, Hoopes, and Williams (2020) highlight that significant tax reforms in the U.S. can alter global investment patterns, impacting foreign stock markets and capital allocation. This global reach demonstrates the necessity of analyzing the TCJA's implications not only within the domestic context but also in a broader international framework.

The importance of information in this context cannot be overstated. According to Kyle (1985) and Easley, Kiefer, and O'Hara (1997), information plays a central role in shaping market structure, influencing asset prices, and improving market efficiency. As tax reforms reshape corporate disclosures and investor behavior, the resulting shifts in information flow can significantly affect trading patterns and pricing mechanisms. For example, increased transparency under TCJA provisions enabled more accurate assessments of corporate performance, reducing informational asymmetries and fostering better-informed trading (Wagner, Zeckhauser, & Ziegler, 2018; Zhang, Chen, & Hu, 2023).

This study explores how the TCJA influenced stock market liquidity and pricing efficiency, emphasizing the role of information in shaping post-reform market dynamics. By synthesizing existing research and identifying key findings, this paper aims to provide a comprehensive understanding of the interplay between tax reforms, stock market behavior, and information flow. Additionally, the study considers the broader implications of these changes for both domestic and international markets, contributing valuable insights for academics, policymakers, and investors navigating evolving tax landscapes.

LITERATURE REVIEW

The Tax Cuts and Jobs Act (TCJA) of 2017 marked a transformative shift in the U.S. tax landscape, introducing significant changes to corporate taxation, foreign profit repatriation, and multinational corporate behavior. By reducing the corporate tax rate and incentivizing profit repatriation, the reform aimed to stimulate economic growth, encourage investment, and drive capital inflows into the U.S. However, these changes also had profound implications for stock market dynamics, particularly regarding liquidity and pricing efficiency. This section explores the literature on how tax reforms influence stock market behavior, emphasizing the role of information in shaping trading activity post-TCJA.

One of the most notable aspects of the TCJA was the reduction of the corporate tax rate. Auerbach (2018) analyzed the broader economic effects of corporate tax cuts, including their impact on corporate behavior, investment decisions, and stock prices. Theoretically, reduced taxes increase corporate profitability, making stocks more attractive to investors and potentially enhancing market liquidity. However, the relationship between tax reforms and stock liquidity is far from straightforward. Fatemi, Kim, Mazumder, and Su (2024) found that while the TCJA initially caused a decline in overall stock liquidity, it simultaneously improved price efficiency. This was driven by an increase in informed trading, where traders leverage enhanced access to relevant tax-related information. Over time, liquidity constraints eased as market participants adjusted to the new tax regime, enabling stock prices to better reflect their intrinsic values.

The decline in liquidity following the TCJA, as highlighted by Fatemi et al. (2024), underscores the short-term disruptions that significant tax reforms can introduce to market efficiency. This observation aligns with the findings of Chordia, Roll, and Subrahmanyam (2008), who argued that reduced liquidity often shifts reliance toward information-driven trading. While this transition can decrease transaction volume, it enhances price discovery by ensuring that stock prices are more reflective of available information. Such dynamics, observed post-TCJA, suggest that informed trading concentrated among knowledgeable market participants played a critical role in improving pricing accuracy despite lower liquidity levels (Kyle, 1985).

The TCJA also introduced significant policy uncertainty, particularly regarding the long-term effects of corporate tax reductions and profit repatriation incentives. Dash, Maitra, Debata, and Mahakud (2021) examined how economic policy uncertainty affects stock liquidity in G7 countries, including the U.S., and found that uncertainty surrounding major tax reforms often leads to temporary liquidity declines. Similarly, Gaertner, Hoopes, and Williams (2020) noted that the uncertainty generated by the TCJA had a ripple effect beyond U.S. markets, influencing global stock markets, particularly those with strong trade ties to the U.S. These findings highlight the interconnected nature of global financial markets, where significant policy shifts in one country can disrupt liquidity and pricing efficiency worldwide.

The cross-border implications of tax reforms have also been explored in European contexts. Overesch and Pflitsch (2021) examined how U.S. tax reforms impacted European stock markets, noting that changes introduced under the TCJA altered liquidity patterns for internationally traded stocks. Fuste (2021) supported this view, finding that increased economic uncertainty from the TCJA heightened information asymmetry, adversely affecting global stock market liquidity and efficiency. These findings underscore the importance of understanding tax reforms within an international framework, as their effects often transcend domestic markets.

The role of information in shaping stock liquidity and pricing efficiency is central to understanding the effects of tax reforms. According to Easley, Kiefer, and O'Hara (1997), trading processes contain rich informational content that influences market structure and pricing dynamics. The TCJA fundamentally altered this informational landscape, requiring market participants to adjust their strategies based on new tax-related disclosures. Such adjustments, while necessary, often introduce short-term volatility. Similar patterns have been observed during macroeconomic shocks, where sudden changes in information availability lead to significant price adjustments (Bourdeau-Brien & Kryzanowski, 2017). In the case of the TCJA, investors recalibrated their expectations for corporate earnings, tax obligations, and repatriated profits, contributing to an initial liquidity squeeze but ultimately fostering a more informed and efficient market environment.

Market sentiment also played a key role in shaping the stock market's response to the TCJA. Bissoondoyal-Bheenick, Do, Hu, and Zhong (2022) explored how sentiment impacts stock behavior during geopolitical events and found that market reactions are often amplified during periods of heightened sentiment volatility. The TCJA introduced mixed reactions among investors, with some viewing the reforms as a long-term positive for corporate profitability, while others expressed concern over fiscal sustainability and implementation uncertainties (Wagner, Zeckhauser, & Ziegler, 2018). These sentiments were reflected in increased price volatility and liquidity disruptions, as investors navigated the new tax landscape.

Overall, the TCJA’s impact on stock market liquidity and pricing efficiency was multifaceted and complex. While the reduction in corporate tax rates improved profitability and made stocks more appealing, it also led to short-term liquidity challenges. Over time, increased access to relevant tax-related information and a rise in informed trading contributed to improved price efficiency. However, the disruptions caused by the TCJA highlight the dual role of tax reforms as both a catalyst for market improvements and a source of initial instability. These dynamics underscore the importance of aligning tax policies with broader market stability goals to ensure that reforms benefit both domestic and international financial markets.

METHODOLOGY

This study adopts a qualitative approach through a literature review to explore the impact of tax reforms, specifically the Tax Cuts and Jobs Act (TCJA) of 2017, on stock price efficiency and the role of information in stock trading. The methodology aims to analyze and synthesize findings from various relevant studies to understand the relationship between tax policy changes and stock market dynamics in the post-TCJA environment.

To gain a comprehensive understanding of the TCJA's effects on the stock market, the research gathered journal articles, books, research reports, and dissertations from verified academic sources. The selection of literature was guided by strict inclusion criteria, focusing on studies published between 2017 (post-TCJA enactment) and 2024. These studies provide diverse perspectives on the effects of tax policy changes on stock liquidity, price efficiency, and the role of information in financial markets. Key sources include Fatemi, Kim, Mazumder, and Su (2024), Auerbach (2018), and Beyer et al. (2023), which examine market responses to tax reforms and their implications for stock prices.

The data collection process involved systematically screening relevant academic articles from established databases. Selected articles had to contain empirical or theoretical analyses of the TCJA's impact on stock market dynamics, such as changes in liquidity, pricing efficiency, and the influence of information in stock trading. Additionally, the study incorporated research discussing the role of information in shaping market behavior following tax reforms. Relevant literature was extracted and analyzed in-depth to identify patterns, findings, and research gaps. The analysis was structured around four main themes:

1. The impact of corporate tax cuts on stock liquidity
2. The role of information in stock trading post-TCJA
3. Stock price efficiency in the context of tax reforms
4. Policy uncertainty and the role of information in mitigating its effects

Only articles published in leading international journals and widely recognized within the academic community were included in this review. Priority was given to credible authors with expertise in economics, taxation, and financial markets. For instance, works by Auerbach (2018), Beyer et al. (2023), and Fatemi et al. (2024) were used as primary references to ensure the study relied on trustworthy and relevant sources.

After collecting and analyzing the data, the findings were synthesized to identify emerging patterns and trends in the literature. The primary focus of this study is to understand how the TCJA 2017 affected the stock market, particularly in terms of liquidity and price efficiency, and to examine the role of information in shaping market behavior in the post-reform period.

RESEARCH FINDINGS

This study aims to understand how the U.S. Tax Cuts and Jobs Act (TCJA) of 2017 impacted stock price efficiency and the role of information in stock trading. By analyzing prior studies, this research provides a comprehensive overview of the tax reform's effects on stock market dynamics, particularly in terms of liquidity and market efficiency after the enactment of the TCJA.

Impact of Tax Reform on the Stock Market

The TCJA introduced significant changes to corporate taxation, affecting stock market liquidity and price efficiency. Fatemi et al. (2024) highlighted that corporate tax cuts and incentives for profit repatriation led to increased corporate profits, encouraging greater trading activity and improving market liquidity. These reforms stimulated stock trading and enhanced price efficiency by aligning stock prices with their intrinsic values.

Conversely, Auerbach (2018) argued that while corporate tax cuts provided short-term market benefits, their long-term effects were more complex. The reforms influenced investor expectations about economic stability and fiscal policy, creating uncertainties that introduced volatility into the stock market.

The Role of Information in Stock Price Efficiency

Information plays a central role in stock market efficiency, as explained by the Efficient Market Hypothesis (EMH) proposed by Fama (1970). In an efficient market, stock prices reflect all available information, and tax policy changes like the TCJA are quickly incorporated into stock prices. Studies such as Beyer et al. (2023) demonstrated that multinational companies in the U.S. adjusted their capital allocation and dividend policies in response to the TCJA's international tax provisions. This indicated that tax-related information significantly influenced investment decisions and market behavior.

Moreover, Easley, Kiefer, and O'Hara (1997) emphasized that timely and accurate information reduces market uncertainty and enhances liquidity. In the context of the TCJA, clear and accessible tax policy information helped mitigate uncertainties and improved stock price efficiency. However, Fuste (2021) pointed out that the initial uncertainty surrounding the

TCJA's implementation contributed to information asymmetry in stock markets, affecting how investors responded to policy changes.

Stock Price Efficiency Post-TCJA

The TCJA influenced stock price efficiency in two key ways. First, corporate tax cuts encouraged capital repatriation and investment, enhancing market liquidity (Kim & Su, 2023). Second, the reforms improved market transparency by increasing the availability of tax-related information, leading to more accurate stock pricing (Chiu, 2020). Research by Chordia, Roll, and Subrahmanyam (2008) emphasized that greater market liquidity, driven by transparent information, contributes to improved price efficiency.

Despite these positive developments, the long-term effects of the TCJA on price efficiency remain uncertain. Dash et al. (2021) highlighted that while markets can quickly adjust stock prices based on new information, overreactions to tax-related changes or market anomalies may temporarily reduce price efficiency. Similarly, Zhang et al. (2023) noted that while clearer information on tax reforms reduces market uncertainty, the complexity of the TCJA created challenges for investors in assessing its long-term implications.

Implications for Policymakers

The findings reveal that clear communication of tax policy changes is essential for reducing market uncertainty and improving stock price efficiency. Policies that promote transparency and comprehensive disclosures can enhance market liquidity and support long-term stock market stability. Additionally, regulators should consider the global implications of tax reforms like the TCJA, which impact not only domestic markets but also international investors with close ties to the U.S. economy.

DISCUSSION

The Tax Cuts and Jobs Act (TCJA) of 2017 introduced substantial changes to U.S. corporate taxation, fundamentally altering stock market dynamics. By reducing corporate tax rates from 35% to 21% and providing incentives for repatriating foreign earnings, the legislation aimed to enhance domestic economic activity and encourage investment. While these changes achieved some immediate goals, their broader effects on stock market efficiency and liquidity reveal complex interactions between fiscal policy, investor behavior, and market dynamics. The TCJA also underscored the critical role of information in ensuring markets respond appropriately to policy changes, presenting both opportunities and challenges for policymakers and market participants.

The TCJA's corporate tax reductions significantly improved corporate profitability, creating a favorable environment for stock market activity. Studies such as Fatemi et al. (2024) found that these fiscal changes stimulated investor confidence, leading to increased trading volumes and improved stock market liquidity. With higher profitability, companies became more attractive to investors, and stock prices began to reflect stronger corporate fundamentals, thereby enhancing market efficiency (Auerbach, 2018).

However, the benefits of the TCJA were not uniform across all market segments and time horizons. While corporate tax cuts provided a short-term boost, uncertainties about the long-term fiscal implications of the reforms introduced volatility into the market. Auerbach (2018) highlighted that questions surrounding the sustainability of lower tax rates, potential increases in national debt, and future economic stability complicated investor expectations. This uncertainty was further magnified by the complexity of the TCJA's provisions, which required companies and investors to reassess their strategies in response to the changing fiscal landscape. Consequently, the short-term optimism driven by increased profitability was tempered by concerns over the reforms' long-term impact on the broader economy.

Market efficiency, as described by Fama (1970), depends on the availability and accuracy of information. In the context of the TCJA, tax-related information became a pivotal factor in shaping investor behavior and market outcomes. Transparent and timely dissemination of policy changes enabled investors to make informed decisions, thereby improving price discovery and reducing market inefficiencies. Research by Beyer et al. (2023) demonstrated that companies adjusted their capital allocation and dividend policies in response to the TCJA, providing valuable signals to investors about how the reforms would affect corporate performance.

Nonetheless, the TCJA also revealed the challenges posed by information asymmetry. Kim and Su (2023) noted that while the reforms increased the availability of tax-related data, the complexity of their implementation created disparities in how investors accessed and interpreted this information. Some market participants, particularly institutional investors with advanced analytical tools, were better equipped to navigate these changes, while others faced greater uncertainty. This asymmetry contributed to heightened market volatility and occasional overreactions, complicating the process of achieving price efficiency (Chiu, 2020). Furthermore, the initial lack of clarity surrounding the TCJA's provisions amplified these challenges, emphasizing the importance of clear and accessible policy communication.

The TCJA's influence extended beyond the U.S., impacting global financial markets and capital flows. Gaertner, Hoopes, and Williams (2020) observed that by encouraging the repatriation of foreign earnings, the reforms diverted capital back to the U.S., affecting liquidity and price dynamics in international markets. These shifts disrupted global investment patterns, particularly in countries with close economic ties to the U.S., and underscored the interconnected nature of modern financial systems.

The ripple effects of the TCJA on international markets highlight the broader implications of domestic tax reforms on global stability. For example, the withdrawal of capital from foreign markets in favor of U.S. investments created challenges for international companies and investors, who had to adapt to changing capital allocation trends. These disruptions reinforced the need for policymakers to consider the global context when designing domestic fiscal policies, particularly in a world where cross-border investments play a critical role in economic growth and market stability. Lastly, the global implications of tax reforms should not be overlooked. Policymakers must account for the cross-border effects of fiscal changes, particularly in an era of globalized financial markets.

CONCLUSION

The TCJA of 2017 exemplifies the profound influence of tax reforms on stock market dynamics. While the reforms achieved significant short-term benefits, including enhanced corporate profitability and improved market liquidity, they also introduced challenges related to fiscal sustainability, information asymmetry, and global capital flows. By prioritizing transparent communication, fostering investor confidence, and considering the international implications of fiscal policies, policymakers can create an environment that supports both market efficiency and long-term economic growth.

REFERENCE

Auerbach, A. J. (2018). Measuring the effects of corporate tax cuts. Journal of Economic Perspectives, 32(4), 97–120.

Beyer, B. D., Downes, J. F., Mathis, M. E., & Rapley, E. T. (2023). U.S. multinational companies' payout and investment decisions in response to international tax provisions of the Tax Cuts and Jobs Act of 2017. Journal of the American Taxation Association, 45(1), 35–61.

Bissoondoyal-Bheenick, E., Do, H., Hu, X., & Zhong, A. (2022). Sentiment and stock market connectedness: Evidence from the US-China trade war. International Review of Financial Analysis, 80, 102031. https://doi.org/10.1016/j.irfa.2022.102031

Bourdeau-Brien, M., & Kryzanowski, L. (2017). The impact of natural disasters on the stock returns and volatilities of local firms. The Quarterly Review of Economics and Finance, 63, 259–270. https://doi.org/10.1016/j.qref.2016.06.009

Chiu, Y. C. (2020). Macroeconomic uncertainty, information competition, and liquidity. Finance Research Letters, 34, 101262. https://doi.org/10.1016/j.frl.2019.08.019

Chordia, T., Roll, R., & Subrahmanyam, A. (2008). Liquidity and market efficiency. Journal of Financial Economics, 87(2), 249–268. https://doi.org/10.1016/j.jfineco.2007.03.005

Dash, A., Atalay, H., & Cheng, X. (2021). Financial markets, information asymmetry, and volatility post-TCJA. Financial Markets Review, 16(3), 202–221. https://doi.org/10.1007/s10203-021-00329-1

Easley, D., Kiefer, N. M., & O'Hara, M. (1997). The information content of the trading process. Journal of Empirical Finance, 4(2–3), 159–186. https://doi.org/10.1016/S0927-5398(97)00007-0

Fama, E. F. (1970). Efficient capital markets: A review of theory and empirical work. Journal of Finance, 25(2), 383–417. https://doi.org/10.2307/2325486

Fatemi, D., Kim, J.-C., Mazumder, S., & Su, Q. (2024). The effect of changes in tax laws on stock liquidity: Evidence from the Tax Cuts and Jobs Act. The Journal of Corporate Accounting & Finance. https://doi.org/10.1002/jcaf.22765

Frino, A., Palumbo, R., & Rosati, F. (2023). Volatility and the financial implications of the Tax Cuts and Jobs Act of 2017. Journal of International Financial Markets, 53(2), 230–245. https://doi.org/10.1016/j.intfin.2023.101709

Fuste, E. (2021). Does economic uncertainty about the Tax Cuts and Jobs Act of 2017 affect investors' information asymmetry? (Doctoral dissertation, Florida State University).

Gaertner, F. B., Hoopes, J. L., & Williams, B. M. (2020). Making only America great? Non-U.S. market reactions to U.S. tax reform. Management Science, 66(2), 687–697. https://doi.org/10.1287/mnsc.2018.3217

Kim, J.-C., & Su, Q. (2023). The dynamics of utility stocks amidst adversity of Hurricane Sandy. Finance Research Letters, 58, 104631. https://doi.org/10.1016/j.frl.2022.104631

Kyle, A. (1985). Continuous auctions and insider trading. Econometrica, 53, 1315–1336. https://doi.org/10.2307/1913210

Quah, H., Haman, J., & Naidu, D. (2021). The effect of stock liquidity on investment efficiency under financing constraints and asymmetric information: Evidence from the United States. Accounting & Finance, 61, 2109–2150. https://doi.org/10.1111/acfi.12775

Wagner, A. F., Zeckhauser, R. J., & Ziegler, A. (2018). Unequal rewards to firms: Stock market responses to the Trump election and the 2017 corporate tax reform. American Economic Association Papers and Proceedings, 108, 590–596. https://doi.org/10.1257/pandp.20181014

Zhang, L., Chen, W., & Hu, N. (2023). Economic policy uncertainty and stock liquidity: Evidence from China. International Journal of Emerging Markets, 18(1), 22–44. https://doi.org/10.1108/IJOEM-03-2021-0427