

EXAMINING THE IMPACT OF STATE TAX RANK AND THE TCJA OF 2017 ON BUSINESS ACTIVITY: CORPORATE VERSUS OTHER BUSINESS APPLICATIONS

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ABSTRACT

This research considers the impact of various taxes on business activity before, during, and after implementation of the 2017 Tax Cut and Jobs Act (TCJA). Business activity is measured through changes in the level of corporate business applications and other business applications, such as proprietorship, partnership, and Limited Liability Company (LLC). Type of taxes considered are corporate income tax, individual income tax, sales tax, property tax, and unemployment insurance tax. Each tax is measured by rank within each U.S. state. The purpose of the research is to (i) identify to what extent TCJA affects business activity and (ii) if impact varies from type of tax. After enactment of TCJA business activity generally increases in high tax states, with positive correlations between sales taxes and property with business activity suggesting that quality of life issues from school and infrastructure funding initially could be part of a business location decision; results otherwise vary. This research extends the use of prior time series models by using annual models and separating corporate business activity from other business activity in evaluating impact by business type.

Keywords: Business activity, corporations, taxes

INTRODUCTION

The impact of a state's tax policies on the level of business activity within a state is a topic of prior research. Business activity is usually measured as the number of new businesses that open within a state. Tax policy is measured as the level of state taxes paid by residents of each state. The primary taxes collected by states include individual income taxes, corporate income taxes, sales taxes, property taxes, and unemployment taxes. The expectation is that states with higher taxes will have a lower level of business activity as the higher taxes increase the cost of operating a business in the state. Prior research has found significant relationships between the tax policy of a state and the level of business activity. However, the specific taxes that impact business activity as well as the direction of the relationships have varied across the different studies. Most prior research has used a time series analysis to examine the relationship between tax policy and business activity. This approach results in changes in overall economic activity potentially impacting the relationship between business applications and the tax policy of the state. This paper will extend the research by examining the relationship on an annual basis by running yearly models from quarter 2 of 2016 to quarter 2 of 2020. The earlier studies also primarily used total business applications or the change in total business applications as the measure of business activity. This

paper also extends prior research by examining the relationship for corporate business applications and other (LLC, partnership, proprietorship) business applications separately.

For a corporation, the income from operating the business is taxed at the corporate income tax rate in the state. Corporations also pay state unemployment taxes tied to the number of employees in the business. A corporation also pays property taxes on the property owned by the business and sales taxes on purchases made by the business. The corporation will never pay the individual income taxes in the state, but this tax will be paid by their employees, who will also pay state sales and property taxes. Having higher taxes for your employees could force you to pay higher labor costs to attract employees for your business. Income for other types of businesses is taxed at the individual income taxes rates in the states. The owner(s) also pay sales taxes on business purchases and property taxes on any property owned by the business. The owners also pay the state unemployment taxes. These businesses will never pay corporate income taxes. However, states with lower corporate income taxes could attract more corporations into the state which will provide more potential customers for these other types of businesses. The owners and the employees will also personally pay sales and property taxes to the states.

While the focus of this paper is the relationship between state tax policy and business activity, businesses also pay income taxes to the federal government on business income which could impact this relationship. This is very relevant for our analysis as the Tax Cuts and Job Creation Act (TCJA) of 2017 significantly reduced the taxes on business income beginning in 2018. The new tax law reduced the rates on income earned by corporations significantly. There was also a small decrease in the personal income tax rates and the qualified business income deduction was added for these organizations to reduce the taxes owed on their income. Since businesses operate in environments where they can make enough money to justify the investment and risk of operating a business, the significant reduction in federal income taxes could make it more viable for a firm to operate in a state with higher taxes. By using annual models for the five-year time period, the impact of the new tax law can be examined. The purpose of the research is to (i) identify to what extent TCJA affects business activity and (ii) if impact varies by type of tax.

The remaining sections of this research are structured as follows: Review of Prior Literature; Research Methodology, Results, Analysis of Results, and References.

REVIEW OF PRIOR LITERATURE

Competing theories address the factors that drive economic growth in a city or in a region. One theory argues that the business climate in terms of taxes and regulations is a major factor as states with lower taxes and less regulation have higher levels of economic growth. A second theory is that economic growth is driven by factors tied to operating the business and attracting employees like locally available talent, affordable housing, and affordable commercial property. Business location decisions are also impacted by the quality of the local educational system, public transportation, and public services. Proponents of this theory argue that cities operating in the same state facing similar tax and regulatory environments have substantially different levels of economic growth. Renn (2018) finds that Nashville and Memphis, both cities in Tennessee facing similar business environments, have substantially different levels of economic growth as Nashville has substantial growth when compared to Memphis. Both theories have been supported in the

literature suggesting that both the tax burden as well as factors related to operating the business impact business location decisions. As more employees are working remotely across time the importance of the tax burden could increase in these decisions.

Prior research addresses the relationship between state tax policy and business activity. Russell (2011) argues that the income earned by most businesses is taxed at individual income tax rates and business location decisions are often made based on this criterion. Having corporate income tax rates in the United States being higher than in many foreign countries is often mentioned as a reason why firms operate in a foreign country. Since it is easier to move a business from one state to another as opposed to moving from one country to another, state taxation policies should impact business location decisions (Russell, 2011). A study by the Small Business and Entrepreneurial Council finds that over 92 percent of businesses have income that is taxed at individual tax rates so individual tax rates should have a significant impact on business location decisions. They also argue that high unemployment rates increase labor costs so labor-intensive firms should avoid these states. McClure Jr. (1981) argues that state tax policy should focus on allocation neutrality and not the redistribution of wealth, therefore, state tax policy should not impact business location decisions.

However, McClure also argues that if corporate income tax rates are different across states, then tax policy will impact business location decisions; these findings are affirmed by Hines (2017). Not only is foreign investment adversely affected by relatively higher U.S. tax rates (Hebous, Ruf, and Weichenrieder, 2011), but domestic firms are also discouraged from investing (Hines, 1996), with less business formation observed (Bond & Xing, 2015; House, Mocanu, & Shapiro, 2017). There are significant differences in unemployment tax rates across the states with the highest rates in northeastern states and the lowest rates in southern states. In terms of specific rates, the highest unemployment rate of 2.1 percent is in California while Texas had the lowest rate at 0.3 percent (Barron & Wesley, 1981). The unemployment tax burden did not have a discernable impact on the formation of benefit corporations in the United States (Murray, 2018).

The impact of state or local tax policies on business location decisions has been addressed in prior studies. In general, state income tax collection represents a more stable revenue source than sales tax collection (Dye & McGuire, 1991). States with higher individual income tax rates, a state level estate and inheritance tax beyond the federal tax, and a higher weight on the sales factor in the state corporate income tax apportionment formula have lower levels of entrepreneurial activity. However, states with a more progressive individual income tax structure and having aggressive corporate income tax structures resulted in higher levels of business activity (Bruce & Deskins, 2012). Bruce and Deskins (2012) also found that the composition of the state tax portfolio did not have a significant impact on the level of business activity for states. The state and local tax burden on firms in the United States goes beyond direct business taxes like income and franchise taxes as they also pay sales and property taxes (Cline 2006). Specific sales taxes on equipment as well as the level of property taxes were found to be inversely related with business activity as they result in fewer new business applications. However, personal income taxes and general sales taxes had no impact (Bartik, 1989). Enforcing sales tax collections for online sales is an emerging area linking entrepreneurial activity to sales taxes (Conroy, Cutler, & Weiler, 2016). Garrett and Wall (2006) found that higher corporate tax rates as well as a higher state minimum wage rate had an inverse relationship to the level of entrepreneurial activity. The existence of a state level

inheritance tax resulted in a lower level of growth in the number of sole proprietorships formed (Kreft & Sobel, 2003). However, Carlton (1979) found no significant relationship between local tax policies and the formation of new businesses. Bruce and Deskins (2012), in reviewing the prior research, find that state tax policy can influence business location decisions but the results on the magnitude and direction of the impact have been inconclusive. This paper attempts to address this issue by using annual models and also by separating corporate applications from other types of business organizations and analyzing them separately.

The majority of states include federal taxable income as a base in calculating taxable income for the state. Forty one of the fifty states have a broad-based state income tax while two states only tax unearned income. The remaining seven states have no state income tax. Thirty of the forty-one states with a broad-based state income tax start the calculation of state taxable income with federal adjusted gross income while five states start with federal taxable income. Only six of the forty-one states do not use any measure of federal income in determining state taxable income, but they follow many of the same rules used in calculating federal taxable income. Since the large majority of the states tie their rules for measuring state taxable income to federal income changes in the federal tax laws can have a significant impact on state income taxes (Huffer Huffer, E., Iselin, J., Sammartino, F., & Weiner, D., 2019). The TCJA of 2017 made significant changes to the taxation of business income as well as the impact of state taxes paid on federal taxable income which are summarized below.

One major change is that the tax rate on corporate income was reduced from 35 percent to 21 percent. This reduction of 14 percent is larger than the corporate tax rate for all fifty states. For businesses whose income is taxed at individual tax rates, using a progressive system, the rates decreased from 2.6 percent to 4 percent across different income levels with the maximum rate dropping from 39.6 percent to 37 percent. The new law also adopted the qualified business income deduction for these firms where they can deduct up to 20 percent of their business income as a deduction for AGI. This deduction reduces the maximum tax rate on business income from 37 percent to 29.6 percent. The reduction in federal taxes may make it viable for some firms to operate in high tax states as the overall tax liability will be lower. The new law also nearly doubled the standard deduction for all taxpayers. This change has significantly reduced the number of taxpayers claiming the itemized deductions when filing their federal return. Since taxpayers can deduct state and local property taxes and the higher of state and local income or sales taxes as an itemized deduction, having fewer people itemize and receive the benefit of this deduction will hurt high tax states. The TCJA also limited the deduction for state taxes paid to a total of \$10,000 per year, also hurting taxpayers in high tax states. These changes could result in firms avoiding high tax states. Huffer et al (2019) examined the impact of the TCJA on people filing personal state income tax returns finding that the largest impacts were from the increase of the standard deduction and the elimination of the personal and dependency exemptions which basically offset each other.

States may consider making changes to their tax laws to adjust to the new federal law. One example is New Jersey which is a high tax state. Residents of New Jersey were losing substantial tax deductions because of the \$10,000 limit on state taxes paid as an itemized deduction. To address this issue New Jersey established a charitable organization where taxpayers could donate money and then reduce their state taxes owed by the amount contributed to the charitable organization. Doing this could reduce their state taxes paid below \$10,000 and the money contributed to the

charitable organization could also be deducted in full on the federal tax return as an itemized charitable contribution deduction with no limit. This change initially allowed people to deduct all state taxes paid as they could before the new law was enacted. However, the federal government amended the new law so that any amounts contributed to one of these organizations would reduce the \$10,000 limit for state taxes paid, effectively limiting the deduction to \$10,000. Across time it is possible that states will continue examining their tax policies to adjust to the new rules.

RESEARCH METHODOLOGY

The research model measures the extent that tax policy affects various forms of business organization. For this analysis, the model considers corporate business organization and other business organization as two distinct dependent variables. Corporate business organization is a business structure where the firm is incorporated as a C-Corporation. Other business organization represents firms that are not incorporated (sole proprietorship or partnership) or structured as a Limited Liability Company (LLC) or S-Corporation. Independent variables in the model are state sales tax, individual income tax, unemployment tax, property tax, and corporate income tax. Tax variables are measured by rank for each U.S. state. Variables are labeled from one to 50 with identical ranks indicating no differences for that variable for two or more states indicated. Higher rank (lower number) is associated with less burdensome tax policy associated with that variable, while lower rank (higher number) indicates that tax policy for that variable is generally more burdensome within those states.

The data for the number of business applications as well as the state tax ranks for the different taxes were collected from the 2020 State Business Tax Climate Index published by the Tax Foundation. The data for the population of each state came from the U.S. Census Bureau. Data are gathered for three periods before during and after enactment of Tax Cuts and Job Creation Act (TCJA) of 2017. The first period is from quarter 2 2015 to quarter 2 2017 and is titled Before 2017 TCJA; the second period is quarter 2 2017 to quarter 2 2019 and represents the period during 2017 TCJA enactment; and the final period is from quarter 2 2019 to quarter 2 2020 and captures effects post 2017 TCJA implementation. Ordinary Least Squares (OLS) regression is employed, and each set of independent variables measured relative to each dependent variable. Results are presented in the tables to follow.

RESULTS

For this model results are presented in tables 1-5. Each table lists the dependent variable, a constant, and five independent variables in the first column. Successive columns include the coefficient values for changes in mean, the t-statistic of directional impact, *p*-value of level of statistical significance, and explanatory power of independent variables in the model. Tables 1 and 2 summarize changes in corporate business applications before TCJA and during TCJA. The model was not significant for corporate business applications after TCJA enactment. In Table 1 the model shows that 9.19 percent of change in corporate applications is explained by the variables employed for the period quarter 2 2015 to quarter 2 2016. Sales tax and unemployment insurance tax are both statistically significant at $p < .05$ and the directional impact is inverse. For the period quarter 2 2016 to quarter 2 2017 individual income tax is significant in the model at $p < .01$; no

other variable is significant. The explanatory effect of changes in corporate applications for this period is higher relative to the prior period.

Table 1				
Before 2017 TCJA				
Quarter 2 2015 to Quarter 2 2016				
Variable	Coefficient	t-statistic	<i>p</i> -value	Adjusted R-square
Corporate Applications Change				0.0919
Constant	0.0000404	1.3278	0.1911	
Corporate Tax	-0.0000006	-0.9486	0.3480	
Individual Income Tax	0.0000004	0.6472	0.5209	
Sales Tax	-0.0000014	-2.3567	0.0230*	
Property Tax	0.0000009	1.4471	0.1550	
Unemployment Insurance Tax	-0.0000013	-2.0682	0.0445*	
Quarter 2 2016 to Quarter 2 2017				
Variable	Coefficient	t-statistic	<i>p</i> -value	Adjusted R-square
Corporate Applications Change				0.1872
Constant	0.0070930	2.6825	0.0103	
Corporate Tax	-0.0000527	-1.0572	0.2962	
Individual Income Tax	-0.0001443	-2.9698	0.0048**	
Sales Tax	0.0000218	0.4410	0.6614	
Property Tax	-0.0000605	-1.1456	0.2581	
Unemployment Insurance Tax	0.0000407	0.7746	0.4427	

$p < .05^*$; $p < .01^{**}$; and $p < .001^{***}$

Table 2 considers quarter 2 2017 to quarter 2 2019, the periods during which TCJA was enacted. The model is not significant in quarter 2 2017 to quarter 2 2018. For quarter 2 2018 to quarter 2 2019, the model indicates that individual income tax rates ($p < .01$) are positively correlated with more corporate applications filed, while property tax rates ($p < .05$) are inversely related. No other variable in the model for this period is statistically significant. The variables explain approximately 21 percent of the variation in corporate application filings. The model captures one period after the enactment of TCJA; this period is quarter 2 2019 to quarter 2 2020. Results are not statistically significant for corporate business applications.

Table 2				
2017 TCJA Enacted				
Quarter 2 2018 to Quarter 2 2019				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Corporate Applications Change				0.2086
Constant	-0.0000109	-0.7423	0.4619	
Corporate Tax	0.0000004	1.2544	0.2163	
Individual Income Tax	0.0000008	2.8303	0.0070**	
Sales Tax	-0.0000003	-1.0670	0.2918	
Property Tax	-0.0000006	-2.1829	0.0344*	
Unemployment Insurance Tax	-0.0000002	-0.7939	0.4315	

$p < .05^*$; $p < .01^{**}$; and $p < .001^{***}$

Table 3 summarizes changes in other business applications that are not defined as corporate business applications for quarter 2 2015 to quarter 2 2017. For quarter 2 2015 to quarter 2 2016 no variable was significant, although sales tax has a small inverse correlation at $p < .10$ level. The independent variables explain approximately six percent of the variance in the model. For quarter 2 2016 to quarter 2 2017 individual income tax inversely impacts changes in other business applications at a level of significance of $p < .01$.

Table 3				
Before 2017 TCJA				
Quarter 2 2015 to Quarter 2 2016				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Other Applications Change				0.0579
Constant	0.0003860	3.2595	0.0022	
Corporate Tax	-0.0000032	-1.3634	0.1797	
Individual Income Tax	-0.0000033	-1.4774	0.1467	
Sales Tax	-0.0000037	-1.6476	0.1066	
Property Tax	0.0000016	0.6454	0.5220	
Unemployment Insurance Tax	-0.0000019	-0.7720	0.4442	
Quarter 2 2016 to Quarter 2 2017				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Other Applications Change				0.1883
Constant	0.1372694	2.5496	0.0143	
Corporate Tax	-0.0014062	-1.3854	0.1729	
Individual Income Tax	-0.0032043	-3.2383	0.0023**	
Sales Tax	-0.0005014	-0.4981	0.6209	
Property Tax	0.0005571	0.5182	0.6069	
Unemployment Insurance Tax	0.0005738	0.5369	0.5941	

$p < .05^*$; $p < .01^{**}$; and $p < .001^{***}$

Table 4 summarizes changes in other business applications during the period of 2017 TCJA enactment. The period covers quarter 2 2017 to quarter 2 2019. For both quarter 2 2017 to quarter

2 2018 and quarter 2 2018 to quarter 2 2019 sales tax is a statistically significant variable at $p < .01$. Individual income tax is almost significant at $p < .10$. Directional impact, however, is inverse in the first period but positive in the second period. Coefficient of determination for both periods is 16 percent and 18 percent, respectively.

Table 4				
2017 TCJA Enacted				
Quarter 2 2017 to Quarter 2 2018				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Other Applications Change				0.1795
Constant	0.0008709	5.2680	0.0000	
Corporate Tax	-0.0000028	-0.8854	0.3807	
Individual Income Tax	-0.0000049	-1.6240	0.1115	
Sales Tax	-0.0000101	-3.2593	0.0022**	
Property Tax	0.0000015	0.4507	0.6544	
Unemployment Insurance Tax	-0.0000035	-1.0827	0.2848	
Quarter 2 2018 to Quarter 2 2019				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Other Applications Change				0.1614
Constant	-0.0006816	-3.9289	0.0003	
Corporate Tax	0.0000022	0.6261	0.5345	
Individual Income Tax	0.0000056	1.6932	0.0975	
Sales Tax	0.0000096	2.9333	0.0053**	
Property Tax	0.0000000	-0.0136	0.9892	
Unemployment Insurance Tax	0.0000017	0.5071	0.6146	

$p < .05^*$; $p < .01^{**}$; and $p < .001^{***}$

Table 5 summarizes other business applications after 2017 TCJA enactment. Higher corporate taxes produce lower filings of other applications; the level of significance of the relationship is at $p < .01$. Conversely, a higher level of property tax is positively related to other application filings; the relationship between property tax and other applications is significant at $p < .05$.

Table 5				
After 2017 TCJA				
Quarter 2 2019 to Quarter 2 2020				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Other Applications Change				0.1543
Constant	0.0003388	1.7663	0.0843	
Corporate Tax	-0.0000106	-2.8674	0.0063**	
Individual Income Tax	-0.0000015	-0.4232	0.6742	
Sales Tax	0.0000018	0.4921	0.6251	
Property Tax	0.0000081	2.1761	0.0350*	
Unemployment Insurance Tax	-0.0000060	-1.6302	0.1102	

$p < .05^*$; $p < .01^{**}$; and $p < .001^{***}$

ANALYSIS OF THE RESULTS

The analysis included annual models for two years prior to the new federal law, quarter 2 2015 to 2017, the one year where the law was passed and first took effect, quarter 2 2017 to 2018, and then two years after the law had been passed, quarter 2 2018 to quarter 2 2020. For corporations, state sales taxes and unemployment had a significant negative impact on business formations for the 2015-2016 year and individual income taxes had a significant negative impact for the 2016-2017 year. These results indicate that states with higher taxes do have lower levels of economic activity. For the transition year, 2017-2018, none of the tax variables had a significant impact on the number of corporate applications. For the first year after the tax change, 2018-2019, the individual income tax variable had a significant positive relationship with corporate business applications which reversed the significant impact from the last year before the change, 2016-2017. This result suggests that the TCJA had an impact as higher tax states saw an increase in business activity. For the last year, 2019-2020, all five tax variables reverted to the expected negative relationship but none of them were significant. The property tax variable had the expected significant relationship with business activity.

For all other business organizations, whose income is taxed at the individual tax rates, the results are as follows. For the 2015-2016 tax year, none of the tax variables was significant but the corporate income tax, individual income tax, and sales tax variables had the anticipated negative relationship with p -values between .11 and .18. For 2016-2017 the individual income tax variable had a significant negative relationship with business activity. For the transition year, 2017-2018, the sales tax variable and the anticipated significant relation to business applications and the individual income tax variable had the anticipated negative relationship and approached significance with a p -value of .11. For the first year after passage of the TCJA, 2018-2019, the individual income tax and sales tax variables had a significant positive relationship with economic activity. As with corporations, this result suggests that the new federal tax law resulted in more businesses being formed in high-tax states. For the 2019-2020 year the corporate income tax variable had the expected significant negative relationship with economic activity. However, the property tax variable had a significant positive relationship. After passage of the TCJA, the sales tax variable had a significant positive relationship in 2018-2019 and property tax variable had a significant positive relationship in 2019-2020 when examining the formation of new businesses. Since these two taxes fund schools and some of the infrastructure in the states this may indicate that quality schools and quality of life issues become more important factors in business location decisions after the reduction in federal taxation of business income. One last interesting result is that for the 2019-2020 year the unemployment variable approached a significant negative relationship with business activity as the p -value was .11. Since the pandemic was just getting started towards the end of this year it is possible that the significance of unemployment taxes would increase as the pandemic issues spread across the country.

Many prior studies have examined the relationship between state tax policy and the economic activity within a state (Bartik, 1989; Bruce, 2012; McLure, 1981; Russell, 2011). The prior studies have found relationships between the state's tax policy and the formation of new businesses, but the direction and the magnitude of the relationships have varied across studies. This paper extends prior research by using annual models as opposed to a time-series model to control for changes in overall economic activity across time. The use of annual models limits the observations to fifty

per model, making it more difficult to find significant relationships with a small sample. This study also extends prior research by modeling the formation of corporations versus all other types of businesses separately. As with the previous studies our results indicate that state tax policies do impact the formation of new businesses, but the relationship and magnitude vary across the five years studied. Potential explanations for some of these differences through the passage of the TCJA of 2017 and the pandemic, starting in 2020, are offered as factors beyond state tax policy, potentially impacting business location decisions.

One limitation in this paper is the lower overall explanatory power of the annual models which primarily results from two main issues. In examining the impact of the TCJA of 2017 on the relationship between business activity and state tax policy we used annual models before and after the implementation of the act limiting the model to fifty observations. The small number of observations per model allows one outlier to have a major impact on the results which decreases the explanatory power of the model. The second issue is that the paper focuses only on the impact of state tax policy on business activity. Additional issues such as the quality of life for individuals in the state and the different types of industries that operate within a state will have a major impact on business activity. Focusing only on the tax policy limits the explanatory power of the models. Future research can attempt to identify other factors that have a significant impact on business location decisions.

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QUARTERLY REVIEW OF BUSINESS DISCIPLINES

November 2021

Volume 8
Number 3



A JOURNAL OF INTERNATIONAL ACADEMY OF BUSINESS DISCIPLINES
SPONSORED BY UNIVERSITY OF NORTH FLORIDA
ISSN 2334-0169 (print)
ISSN 2329-5163 (online)