

Considering the Relationship between Business Applications and State Tax Rank: Effect of Tax Cuts and Jobs Act of 2017

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This research measures the relationship between state-level taxes and per capita business applications. State-level taxes used in the analysis are based on the tax rank of each state from 1 to 50, with a lower number rank associated with lower tax burden for that category and a higher number rank with higher tax burden for that category. Tax categories used as independent variables in the model are the following: corporate tax rank, individual income tax rank, sales tax rank, property tax rank, and unemployment insurance tax rank. Five-time periods were measured from 2015-2016, 2016-2017, 2017-2018, 2018-2019, and 2019-2020. The research question for the model considers how the 2017 Tax Cuts and Jobs Act (TCJA) legislation affects business applications within each state as measured through state-level variables. Sales taxes are found to inversely affect business applications two years before TCJA passage and during the year of passage, but to have a positive relationship one year after passage. Income tax is positively correlated in that immediate year following passage, while corporate tax inversely impacts two years following passage.

Keywords: Business development, Taxes

Introduction

Prior research addresses the issue of cause-and-effect relationships between state tax policy and business activity within a state. The prior studies used a time-series analysis so data from multiple years were combined in the model. These prior studies found conflicting results in terms of the specific taxes that affected business activity as well as the relationship to business activity. Since factors beyond state taxes, including federal taxes paid, impact business activity these additional factors could impact

the relationship between state tax policy and business activity (Shuai & Chmura, 2013). These differences across time are likely responsible for the varying results in prior research. This paper will address the issue by using five annual models for the third quarter of 2015 to the second quarter of 2020 to examine the relationship between state business activity and state tax policy.

This paper uses total business applications per capita for each year to measure business activity. The establishment of new businesses relative to other states provides a good indication of the level of business activity in the state. One weakness of this measure is that a sole proprietorship and a one-member LLC are not required to file for a taxpayer identification number so they will not be included in the analysis. For state tax policy five state taxes are ranked from most favorable (lower taxes) to least favorable (higher taxes) for all 50 states. The taxes included in the model are corporate income taxes, individual income taxes, sales taxes, property taxes, and unemployment insurance taxes. Using the ranking for each state by year will help to control for any changes in the state taxes across time as the changes will be incorporated into the state tax rank. Economic theory argues that states with lower taxes, decreasing the cost of operating a business, would lead to increased business activity. The majority of businesses generate business income that is taxed at the individual rates and business location decisions are frequently made based on this criterion (Russell, 2011). Specific sales taxes on equipment and the level of property taxes were found to have a negative relationship to new businesses started (Bartik, 1989). The enforcement of taxes on online sales is an emerging issue in the impact of taxes on entrepreneurial activity (Conroy, Cutler, & Weller, 2016).

Unemployment levels have traditionally been considered as a function of macroeconomic effects in measuring economic activity. Barron and Westley (1981) consider unemployment insurance taxes paid and the level of unemployment. To the extent that business activity may or may not be affected, Murray (2018) found that the unemployment tax burden does not have a significant impact on the formation of benefit corporations in the United States, suggesting no effect for this variable. However, our data runs through the second quarter of 2020 which will include two or three months impacted by the pandemic which could have a major impact on the significance of this variable.

Although this paper focuses on the impact of state taxes on business activity businesses must also pay federal taxes. Changes in the federal tax laws can impact the relationship between state taxes and business activity (Huffer, Iselin, Sammartino, & Weiner (2019). This is relevant to our study as the Tax Cuts and Job Creation Act (TCJA) was passed in 2017, implemented in 2018, and made substantial changes to the federal tax laws. One direct impact of this act related to state taxes was that it limited the deduction for state and local taxes paid (property, sales, or income) to \$10,000 where before all of these taxes could be deducted on the federal tax return. This change would have a negative impact on high tax states as their citizens would see a decrease in their deductions on their federal tax Hines (2017). Since the limit applied to all state and local taxes and not just specific taxes states could not help their residents avoid the limit by shifting from one source of tax revenue to another. To address this issue New Jersey set up a fund where taxpayers could donate money to the fund and claim a charitable contribution. Then, any amount contributed to the fund could be taken as a credit to reduce their state taxes, allowing them to reduce their state taxes below the \$10,000 and transfer the excess into a charitable contribution which can be deducted on the federal tax return. However, the federal government amended the law so that any contributions to these funds would then reduce the \$10,000 limit on the federal return to prevent this practice in the states.

The other major impact of the TCJA was that it substantially reduced the taxes paid on business income (Tax Foundation, 2018). For corporations, the tax rate on business income was reduced from 35% to 21%, with the 14% reduction in the tax rate representing a 40% decrease in the federal tax on corporate income. The corporate income tax rates at the state level range from 2.5% in North Carolina to a maximum of 12% in Iowa; two states - South Dakota and Wyoming - have no corporate income tax. The decrease in the federal corporate tax rate is larger than even the highest

state corporate income tax rate which represents a substantial decrease in the taxes paid on corporate income.

The other types of businesses have their income taxed at the individual tax rates which range from 10% for low-income taxpayers to a high of 37% for high-income taxpayers. The TCJA added a 20% qualified business income deduction for these firms to reduce the taxes paid on the business income. For taxpayers in the 37% bracket, the deduction reduces the rate on their business income from 37% to 29.6% ($80\% \text{ of income} \times 37\% \text{ tax rate}$) which is a reduction of 7.4%. At the state level, individual income tax rates range from 2.9% in North Dakota to a high of 13.3% in California; nine states have no individual income tax. Across the 41 states with an individual income tax, 31 states have a tax rate of 7% or less, which is smaller than the savings at the federal level. The significant reduction in the federal taxes on income could result in states being more willing to open new operations in high tax states as their overall tax liability could still be lower than before the TCJA was passed.

For this paper, models are run for the second quarter of 2015 to the second quarter of 2016 and the second quarter of 2016 to the second quarter of 2017 to examine the relationship between state tax policy and business activity for the two years before the passage and implementation of the TCJA. The model for the second quarter of 2017 to the second quarter of 2018 was used to examine the impact of the passage of the act and the initial application of the new rules. The last two models, quarter 2 2018 to quarter 2 2019 and quarter 2 2019 to quarter 2 2020 examine the relationship for two years after the passage of the TCJA. This methodology will illustrate the impact of the TCJA on the relationship between state tax policy and business activity.

What follows is a review of prior literature, research methodology, results, analysis of results, conclusion and future research, and bibliography.

Review of Prior Literature

There are two competing theories as to what drives economic growth in a city or a region. The first relates to the climate for business in terms of tax policies and regulation as locations with lower taxes and less regulation would lead to increased economic growth. The 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. The local educational system, public transportation, and the quality of public services will also impact business decisions. The argument is tied to the idea that cities in the same state facing similar tax and regulatory environments have substantially different levels of economic growth. Nashville and Memphis, both in Tennessee, are two cities facing similar tax and regulatory environments where Nashville has had substantial economic growth as compared to Memphis (Renn, 2018). While both theories have been supported in the research, the large increase in employees working remotely could potentially increase the importance of local and regional tax policies on business location decisions.

The high corporate income tax rate in the United States has often been mentioned as a reason why many businesses choose to operate in foreign countries as opposed to the United States to lower their tax burden. Since it is easier to move a business across states as opposed to across countries state tax structures should also have a major impact on business location decisions (Russell 2011). A Small Business and Entrepreneurial Council study argues that personal income tax rates impact business location decisions as over 92% of businesses have business income taxed on individual tax returns at the individual tax rates. They also argue that high state unemployment tax rates increase the cost of labor so labor-intensive firms should avoid these states (Russell, 2011). Barron and Wesley (1981) found significant differences in the unemployment rates across states with the highest rates in the northeastern states and lowest rates in many southern states. The highest unemployment rate for taxes paid was in California at 2.1% of total wages paid while in Texas, the state with the lowest rate, it was only 0.3%. However, McClure Jr. (1981) argues that the objectives of state tax policy should focus on

allocation neutrality and not the redistribution of wealth so it should not impact business location decisions. He also argues that state corporate income taxes can impact business location decisions if they are different across the states.

Prior research has specifically addressed the impact of state or local tax policies on business location decisions. Lower entrepreneurial rates have been found in states with higher individual tax rates, the existence of state-level estate and inheritance taxes beyond the federal tax, and a higher weight on the sales factor in the state corporate income tax apportionment formula. Higher entrepreneurial rates were found in states with more progressive personal income tax structures and having aggressive corporate income tax structures with a combined reporting requirement (Bruce & Deskins, 2012). They also found that the composition of the state tax portfolio was not a significant factor in entrepreneurial activity for states. Cline (2006) argued that the state and local tax burden in the United States includes much more than direct business taxes like income and franchise taxes, as firms also pay property and sales taxes.

Higher state corporate income taxes and higher state minimum wage rates were found to result in a reduced rate of entrepreneurial activity (Garrett & Wall, 2006). Kreft and Sobel (2003) found that the existence of a state inheritance tax led to a lower level of growth in the number of sole proprietorships formed. Carlton (1979) found no evidence that local taxes influence the number of firm births. Bartik (1989) found that higher property taxes, corporate taxes, and sales taxes on equipment negatively impact the number of small business startups. However, he also found that personal income taxes and general sales taxes had no significant impact. Summarizing the impact of state tax policy on business location decisions finds that state tax policies can influence the decision but the results on the magnitude and direction of the impact have been inconclusive (Bruce & Deskins, 2012).

The Tax Cuts and Job Creation Act (TCJA) of 2017 will likely have a significant impact on state tax policy as it makes substantial changes in the federal income tax laws. Forty-one of the fifty states have state-level broad-based income taxes while two states only tax unearned income and seven states have no income tax. Of the forty-one states, thirty start their calculation of state taxable income with the adjusted gross income from the federal return. Five states start the calculation of state taxable income with federal taxable income. The last six states do not directly tie their taxable income calculation to a number from the federal tax return but use many of the same rules for measuring income and deductions. Since the majority of states tie their taxable income to numbers reported on the federal tax return any changes in the federal tax laws will also impact state income taxes (Huffer, et al, 2019).

The major changes in the TCJA are summarized below. The basic standard deduction was nearly doubled for each filing status which reduces taxable income. Several states tie their standard deduction to the federal standard deduction which would have the same impact at the state level. The TJCA also eliminated the personal exemption, \$4,150 per taxpayer on the return, as well as the deduction for dependency exemptions which increases taxable income. To offset the impact of the loss of the dependency deductions the child credit for qualifying children was increased from \$1,000 to \$2,000 and a dependent credit of \$500 was created for all other dependents. Since the corporate income tax rate was reduced from 35% to 21% in the TCJA they also adopted the Qualified Business Income (QBI) deduction of up to 20% of business income for firms not operating as a corporation, reducing taxable income.

Another significant change was limiting the itemized deduction for taxes paid to \$10,000 per year. While the increase in the standard deduction will significantly decrease the number of taxpayers claiming the standard deduction taxpayers in states with high property values, such as New York, New Jersey, and California, are home to many taxpayers whose combined state property and income taxes exceed the \$10,000 and still itemize and will face an increase in taxable income. Huffer et al (2019)

examined the impact of the TCJA on state income taxes. They found that the two largest impacts were from the increase in the standard deduction and the elimination of the personal and dependency exemptions which offset each other with a slightly larger impact from the elimination of the personal and dependency exemptions. The changes in the federal tax laws will potentially result in states examining their tax policies to adapt to the new rules.

Research Methodology

This research measures, as the dependent variable, per capita changes in the number of business applications submitted for each U.S. state. Five independent variables are employed in the model: corporate tax rank; individual income tax rank; sales tax rank; property tax rank; and unemployment insurance tax rank. The rank for each category is within a range of 1 to 50, inclusive, representing the rank within each of the 50 U.S. states. A higher rank (i.e. 50) denotes higher taxes for that category within that state relative to other states; a lower rank (i.e. 1) indicates less tax imposed within that category. Rank is not mutually exclusive between and among states; if a state does not tax income at the state level, then the rank for each of those states for that tax category would be 1. Population estimates are provided from the U.S. Census Bureau and the number of business applications and rank for each tax category from the 2020 State Business Tax climate index that is published by the Tax Foundation.

The model examines five distinct periods in years from Q2 to Q2: 2015 to 2016; 2016 to 2017; 2017 to 2018; 2018 to 2019; and 2019 to 2020. The TCJA was passed in 2017 and implemented in 2018. Effects are analyzed for two years before the legislation, 2015 to 2016 and 2016 to 2017, during the contemporaneous year of 2017 to 2018, and two years after enactment, 2018 to 2019 and 2019 to 2020.

Using ordinary least squares (OLS) regression analysis, changes in per capita business applications were analyzed. Five separate regressions were run to reflect how state tax activity within each tax category affects business applications within each of those five time periods. Data are standardized to reflect differences in size and scope of input variables. Business applications are measured as per capita change from year to year, while predictor variables are expressed by state rank from one to 50. To standardize, each predictor variable is multiplied by 1/100,000. Thus, the interpretability of output coefficient values is enhanced (Sweet & Grace-Martin, 2012).

Results

The model for this analysis is structured within two time periods: before the enactment of 2017 TCJA, during the enactment of 2017 TCJA, and two years after the enactment of 2017 TCJA. Calculations are grouped and results are presented accordingly. Each table identified the variables, coefficient, t-statistic, *p*-values, and adjusted R square for each regression output.

Table 1 presents results for before 2017 TCJA enactment for 2015 to 2016 and 2016 to 2017 measured from Q3 to Q2 for each period. For this iteration of the model barely 5 percent of changes in business applications are explained by predictor variables. Constant or intercept variable is statistically significant, with sales tax showing an inverse relationship, although only at a level of $p < .10$. For the 2016 to 2017 time period, the constant continues to be statistically significant with a strong, positive association. Although higher taxes for each category are generally associated with lower levels of business application submission, the association is not statistically significant and is likely the result of chance.

Table 1 – Results before 2017 TCJA

Q2 2015 to Q2 2016				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Business Applications Change				0.05297
Constant	42.6408	2.99736	.00446**	
Corporate Tax	-0.3719	-1.33778	.18784	
Individual Income Tax	-0.2931	-1.09168	.28092	
Sales Tax	-0.5100	-1.87530	.06740	
Property Tax	0.2530	0.84655	.40183	
Unemployment Insurance Tax	-0.3191	-1.08468	.28397	
Q2 2016 to Q2 2017				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Business Applications Change				-0.01805
Constant	49.1374	4.59654	.00004***	
Corporate Tax	-0.1987	-0.98585	.32960	
Individual Income Tax	-0.1875	-0.95414	.34523	
Sales Tax	-0.1965	-0.98339	.33079	
Property Tax	0.0187	0.08754	.93064	
Unemployment Insurance Tax	-0.2222	-1.04685	.30088	

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

Table 2 lists regression output for the model during the coeval period of 2017 to 2018 that TCJA was enacted. The model shows a much stronger fit with an adjusted R-square indicating more than 17 percent of the data fit the regression model. Results find that sales tax shows a strong inverse relationship (t-statistic = -3.239) with changes in business application submissions for the period. While an inverse association existed from 2015 to 2016, during this time the association is stronger with a higher level of statistical significance (p -value = .002 compared to p -value = .067).

Table 2 – Results for the model during 2017 - 2018

2017 TCJA Enacted				
Q2 2017 to Q2 2018				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Business Applications Change				0.17077
Constant	85.9425	5.14356	.00001***	
Corporate Tax	-0.2490	-0.78020	.43945	
Individual Income Tax	-0.4780	-1.56463	.12483	
Sales Tax	-1.0174	-3.23918	.00228**	
Property Tax	0.1636	0.48877	.62743	
Unemployment Insurance Tax	-0.3801	-1.15199	.25555	

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

Table 3 presents regression output for two years after the enactment of the 2017 TCJA. For the 2018 to 2019 time period the model explains over 17 percent of changes in business application submissions. Two variables, individual income tax, and sales tax are statistically significant in addition to the intercept. What is interesting is that sales tax is strongly positively associated in this iteration, unlike strong inverse associations during two prior periods in this analysis.

With an adjusted R-square of 0.132, the fit of the model in 2019 to 2020 is not as robust as the immediately prior year. However, corporate tax is strongly statistically significant (p -value = .009) in this regression output, unlike the output for any of the prior four years, with an inverse correlation (t-statistic = - 2.719). Property tax and unemployment insurance tax would be predictors in the model at a level of $p < .10$ but are otherwise subject to chance. The directional impact of property tax is positive, while unemployment insurance tax is negative or inverse.

Table 3 – Results for the model after the 2017 TCJA

After 2017 TCJA				
Q2 2018 to Q2 2019				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Business Applications Change				0.17460
Constant	-69.2490	-3.99191	.00025***	
Corporate Tax	0.2536	0.73226	.46789	
Individual Income Tax	0.6422	1.93271	.05972*	
Sales Tax	0.9345	2.84319	.00675**	
Property Tax	-0.0690	-0.19824	.84377	
Unemployment Insurance Tax	0.1516	0.44001	.66208	
Q2 2019 to Q2 2020				
Variable	Coefficient	t-statistic	p-value	Adjusted R-square
Business Applications Change				0.13242
Constant	38.0140	1.76409	.08466	
Corporate Tax	-1.1319	-2.71856	.00935**	
Individual Income Tax	-0.2356	-0.59020	.55808	
Sales Tax	0.0706	0.17515	.86176	
Property Tax	0.7973	1.91242	.06235	
Unemployment Insurance Tax	-0.6816	-1.64343	.10742	

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

Analysis of Results

Unlike the majority of prior research which used time-series data this analysis examining the impact of a state's tax policies on economic activity is conducted yearly, analyzing the impact on business applications from July 1 to June 30 for each year. For the 2015-2016 year the ranking for corporate income taxes, individual income taxes, sales taxes, and unemployment taxes are negatively related to business applications while property taxes are positively related. However, the only significant relationship is for sales taxes with a p -value of .067. For the 2016-2017 year the direction of the relationships remains the same with no significant relationships. These are the two years right before the Tax Cuts and Job Creation Act of 2017 took effect making significant changes in the federal

tax laws. Since most states tie their tax systems to the federal laws it also had a significant impact on state taxes as well. One key difference between the two years is that a Republican administration was elected in November 2016 and took office in January 2017. For the 2016-2017 year almost all of the states had significant increases in business applications making it more difficult to find significant relationships. This could have resulted from having an administration focused on reducing regulations to encourage business activity. The 2017-2018 year was the transition year as the new tax law was in place for half of the year covered during this period. The results for this year mirror the results for 2015-2016 as only sales taxes had a significant (p -value = 0.002) negative relationship with business applications. The results from the first three years, before the new tax law took full effect, indicate that all taxes except property taxes have a negative relationship with business applications with sales taxes representing the only significant relationship.

The 2018-2019 year is the first year after the new tax law took effect, which had a significant impact on the results. For the 2018-2019 year the relationship between the different taxes and business applications completely reversed from the prior three years as corporate income taxes, individual income taxes, sales taxes, and unemployment taxes were positively related to business applications, and property taxes were negatively related. Also, individual income taxes (p -value = .060) and sales taxes (p -value = .007) had a significant positive impact on business applications. The new tax law significantly reduced the income taxes paid on business income which would encourage business activity and reduce the negative impact of higher tax rates across states as less income was subject to tax. The most surprising result is having sales taxes go from a significant negative relationship for two of the prior three years to having a significant positive relationship. One potential explanation is if the decrease in the income taxes paid reduced the negative impact of paying higher sales taxes. The 2019-2020 year is the second full year under the new tax law but also includes a few months that were impacted by the coronavirus pandemic which shut down substantial segments of the economy. For the 2019-2020 year corporate income taxes, individual income taxes, and unemployment taxes were negatively related to business applications while sales taxes and property taxes had a positive relationship. Thus, all taxes except sales taxes reverted to the same relationship as the three years before the 2018-2019 year. However, the significant relationships are now corporate income taxes (p -value = .009) with a significant negative relationship and property taxes (p -value = .062) with a significant positive relationship. The increased risk in the economy may have encouraged economic activity in states who collect substantial amounts in property taxes as it represents a more stable source of tax revenue. One other significant finding for 2019-2020 is that unemployment taxes (p -value = .107) are approaching being significant as the coronavirus substantially increased the number of people on unemployment. Since the year only included one quarter that was impacted by the virus, it is very possible that its significance will increase until the virus is controlled.

Prior research has found that the tax climates of the states did impact business activity, but the magnitude and direction of the impact varied across different studies. One factor frequently mentioned to explain the differences is that different measures were used to measure economic activity and different measures were used to measure the business and tax climate of the different states. This paper addresses this issue as the same measures were used to examine five separate years. The results again indicate that the magnitude and the direction of the impact of the different taxes vary across the years even when using the same measure for economic activity and the business climate. While the tax structure of the states can have a significant impact on economic activity in the state, the actual impact is tied to other events happening in the economy. For our analysis, the main factors were the new tax law and the coronavirus which had major impacts on the economy.

Conclusion and Future Research

The analysis indicates that federal tax legislation creates disruptions in state-level taxation through intricate relationships between each variable. That higher taxes generally thwart entrepreneurial activity as a result of higher costs is to be expected. With this analysis using the 2017 TCJA as the focal point around which incentives and disincentives are created by extension at the state level, results indicate that effects are measurable but positive directional impacts were unexpected in 2018 to 2019, for example.

With the implementation of the TCJA in early 2018, additional observational time periods may further explain each phenomenon, or otherwise find changes to be an aberration. Further, future research in this area is expected to be very robust as a result of COVID-19 pandemic conditions. To what extent has the pandemic shifted tax incentives at the corporate level or individual level in explaining an area of economic development? Remote working is a research area opportunity as physical location domiciles are replaced by a more fluid movement of workers away from traditional settings. How will tax legislation and incentives approach these changes in supporting economic development?

Including a measure of a state's minimum wage to the federal minimum wage is also a variable to consider (Garrett & Wall, 2006). Do higher state minimum wage levels continue to adversely impact entrepreneurial activity after an overall reduction in the tax burden in 2017? Linking those interactions with higher percentages of remote work could identify shifts in the flow of capital.

Finally, while this study considered business applications to reflect any business structure (sole proprietorship, partnership, Limited Liability Company, and corporate structures), exploring if these relationships hold when considering corporate forms, for example, could add another component to the research for analysis. Fewer observations, however, may reduce data validity in explaining those relationships.

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