

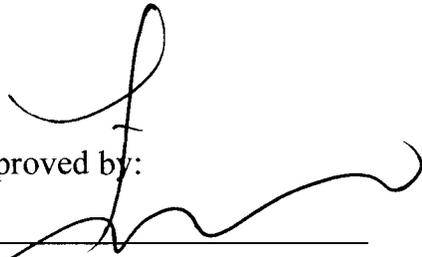
ARE STATES LOSING THEIR LOCAL COMPANIES BECAUSE OF THEIR
TAXES? :
AN EVALUATION OF THE IMPACT OF STATE TAXES ON THE GROWTH
OF A COMPANY
By
ASHLEY MORGAN HUNLEY

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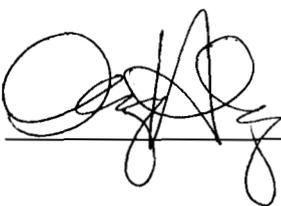
Approved by:



Dr. Oliver Li
Department of Accounting

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Abstract

The goal of this paper is to examine the relationship between the tax environment of the state in which a firm conducts business and the growth of its sales. It is the expectation that firms operating in a low tax environment will experience higher sales growth given the additional cash available to them from tax savings that they can turn around and reinvest. However, based on the results of the data presented in this paper, there is not a correlation between a company in a low tax environment and higher sales growth. The results actually provide evidence for a relationship between a high tax environment and sales growth, which offers support for future research to understand this relationship. This paper offers several explanations for why this could be the case as well as suggestions for future research.

I. Introduction

This paper sets to test the relationship between the growth of a company and the state tax environment in which they conduct business. This study is modeled after the research conducted on companies' use of tax havens to realize substantial tax savings. More often these studies find that these companies and the countries in which they are located are positively affected by their use of tax havens. These positive influences include improving the local economy and providing more opportunities for growth for the specific company. Their results occur because countries observe different tax codes, which permit companies to structure their operations based on their location to realize tax savings. This same situation could also be said of the 50 states. Each state within the United States, like each country around the world, observes a different tax code. As this observed occurrence could be paralleled in the United States, it is expected that companies in a low tax state will experience more growth than a company in a high tax state.

Emerging technology has also allowed companies to realize even more growth by breaking down the barriers of location. Limiting the barriers of location permits companies to widen their customer base and reduce the expenses associated with transportation. The development of faster communication tools, such as websites and email, implies that companies are no longer limited to the customers within their area. They now have the ability to mass advertise and communicate with customers across the country just as easily as those that are within the city they are located. This increases their sales because they are able to increase their clientele. The increased sales would not be realized if there had also not been a decrease in transportation costs. Companies could advertise to new customers continuously, but they would not agree to a sale if it cost more to transport the goods to the customer than the profit they were making from the

sale. Development in transportation mediums has addressed this concern by reducing the repair and maintenance costs associated with the different modes of transportation.

The emergence of new technology and the results of its developments also have implications for the tax liability of a company. As discussed above, reduced barriers of location allow a company to realize more sales, but it also allows the company to organize itself within a low tax state. This allows the company to realize the full potential of the increased sales as they are not paying a substantial portion of the increased sales in taxes. The benefits associated with being located in a low tax state are mitigated if the company establishes nexus in other high tax states. As defined for tax purposes, a company has nexus in a state when it has established a presence enough in that state to be liable to pay taxes to that state. Nexus is most clearly established when a company is headquartered in that state. A company may also establish nexus in a state by having: a substantial percentage of sales made in that state, ownership or a lease of a physical property within that state, or employees within the state that participate in activities exceeding solicitation. State tax codes vary on the definition of a substantial percentage of income when determining a company's nexus.

As long as a company does not meet one of these criteria requirements, they do not establish nexus in the state and therefore are not responsible for paying taxes to that state even if they earn income there. This implies that a company could establish nexus in only a low tax state and earn income across the country but only pay taxes to that low tax state in which they are located. This can yield substantial tax savings for a company, which is similar to a company using a tax haven. If the expected results are proven true, this paper will add to the existing literature by extending the observed effects of tax havens to low tax states.

The paper is outlined in the following manner: Section 2 discusses the prior literature that has been published relating to tax havens, Section 3 outlines the development and the statement of the hypothesis, Section 4 describes the sample to be studied, Section 5 explains the design of the model used to study the hypothesis, Section 6 presents the results, and Section 7 contains a discussion of the possible factors causing the hypothesis to be false as well as the conclusion.

II. Prior Literature

Location is a key decision management must make when relocating their headquarters. The location of the headquarters determines the talent pool of potential employees, the customer base and the proximity of competitors. When announced in the headlines, the previous factors are often discussed as contributing to the decision of the location. What are often missing from the news articles are the taxes the company will be obligated to pay because of their location choice. Companies however do consider the tax environment of the state when making this decision and rely heavily on tax research to be knowledgeable about the tax implications of their decision. Due to the demand for this knowledge, tax research has often considered the impact of a company operating in a low tax country. These low tax havens can substantially reduce the tax expense a company is obligated to pay to the taxing authorities. For this reason, they generate substantial research.

The research of Djankov et. al (2008) illustrates that companies consider the tax impacts of a relocation. Their results find that a 10% point decrease in the tax rate in a country results in a 1.4% increase in the entry rate of firms into that country. Their area of study covered 85 countries across the world therefore providing evidence that companies around the world consider the tax implications of a location decision.

Crabbe and Bruyne (2010) research the impact of taxes on a firm's decision of district location in Belgium. In 2003, the Belgian government reformed the tax code allowing for districts to charge different tax rates. This sparked competition between the various districts to charge fewer taxes to encourage companies to relocate to their district. They found a correlation between the district location choice and the statutory tax rate of the district, only after the tax reform. Their study provides a basis for my research because they were observing the various districts within the country of Belgium. Their area of study is similar to the 50 states within the United State that I plan to study. Their similarities indicate that my research would be expected to parallel their results. Their results however only prove that companies are aware of the tax implications of a location, but they do not seek to study if the company is positively or negatively affected by their choice.

Manas-Anton (1986) printed one of the earlier papers that analyzed the impact of taxes on the growth of a company. While she found results that validate that there is a negative relationship between taxes and the growth of output, she is not confident in the results because of the limitations of her study. The limitations she observes in her study, such as the proximity to human capital and customers, are similar to the limitations I expect to find in my research.

Smith et. al (2010) find that tax rates significantly impact the economic growth of a country. Their measurements of growth in the economy include increase in GDP, decrease of unemployment, and increase in the rate of savings. Specifically, their results indicate that a lower tax country will experience a higher increase in GDP than a higher tax country. The unemployment rate is also found to be more favorable and the rate of savings is higher in a low tax country. Their results indicate that a decrease in tax rates positively impacts the economic growth of a country and has implications for the growth of an individual firm.

Though the research on tax havens has been extensive, tax research however has long overlooked the choice of state location as a means of avoiding tax payments. This paper sets to add to the prior literature by studying this idea.

III. Hypothesis

Low tax environments reduce the tax expense of a company, allowing for their cash outflows to be decreased. Companies are aware of this situation based on the research of Djankov (2008) and attempt to enter into a favorable tax environment to realize these savings. This favorable tax environment could also be a specific area of one country as researched by Crabbe and Bruyne (2010). This background led me to believe that companies would choose more favorable tax states within the United States to realize tax savings.

As evidenced by the research of Smith et.al (2010), reduced taxes also increase the rate of savings so it would be expected that a company would have the ability to increase their savings if they realized a saving in their taxes. As companies generally do not hold cash because it is a low return asset, it is the expectation that a firm experiencing tax savings will reinvest the excess cash back into the company rather than saving it. Reinvestments would be expected in advertising, employment, research and development and capital expenditures. These reinvestments would cause the firm to further its growth. Based on these expectations, it is my hypothesis that an inverse relationship between the tax environment of a state and the potential growth of a company would exist.

My hypothesis is further supported by the research of Manas-Anton (1986) and Smith et. al (2010). The results of Manas-Anton (1986) offer support that there is an inverse relationship between tax rates and the output of a company. Her study focused on the impact of country tax rates, but as state tax rates, similar to countries, also differ between each other it would be

expected that my results would parallel hers. Smith et. al found a correlation between low taxes and the growth of an economy. It is expected that if low taxes positively impact an economy that they would also positively impact an individual firm. This prior literature led me to hypothesize that favorable state tax rates can positively impact a company's growth.

IV. Sample

The overall tax environment of a state, not just the corporate income tax, must be considered by management when researching the state tax environment. Corporations may make the mistake of assuming that they are saving money because the corporate income tax in a state is low, but this savings may be counteracted by other high taxes, such as property taxes or unemployment taxes. Corporations may also not pay the higher tax rate because the high tax state has more lenient tax laws or the presence of more tax loopholes allowing for the corporation to use tax planning in order to avoid these high taxes.

This concept is most clearly illustrated in the state of Delaware. The research of Dyreng et. al (2011) found that even though the corporate income tax in the state of Delaware was one of the highest across the country, companies still realized substantial tax savings because the tax code was more lenient and contained more loopholes. For example, Delaware does not tax income generated by intangible assets, such as a trademark. This permits a company to establish an entity in Delaware that controls their trademark and have entities in other high tax states make payments to the entity in Delaware. This allows the company to claim the payment reducing their tax expense in the high tax state and record the income in Delaware where they will not have to pay taxes on the income.

The accumulation of all of these tax factors as well as the leniency of the tax code determines the overall tax environment of the state. In order to determine if the tax environment

of a state will be defined as low (favorable) or high (unfavorable), I will be using the observations of the Tax Foundation.

The Tax Foundation observes state tax environments and categorizes them into the best and worst tax climates. The Tax Foundation defines the best tax climates as those that result in a low tax expense because they are “simple, transparent, stable, neutral to business activity, and pro-growth”. According to the release of their *2011 State Business Tax Climate Index*, the states with the ten best tax climates are the states of South Dakota, Alaska, Wyoming, Nevada, Florida, Montana, New Hampshire, Delaware, Utah, and Indiana. The ten worst tax climates consist of North Carolina, Rhode Island, Minnesota, Maryland, Iowa, Ohio, Connecticut, New Jersey, California and New York.

The sample was collected using Compustat. Companies in the sample consisted of those whose headquarters are within the best and worst state tax climates using deciles and quintiles based on the 2011 results of the Tax Foundation. This defined search of Compustat resulted in 1,222 companies that are headquartered in low tax states and 7,035 companies that are headquartered in high tax states. Nearly 60% of all the firms located in high tax states and 45% of all the firms located in low tax states are in the manufacturing industry. The second most represented industry in this sample is services, which represents 22% of all the firms headquartered in high tax states and 25% of all the firms headquartered in low tax states.

V. Design

To test this hypothesis, this paper measures the growth of companies in the best and the worst state tax climates for a period of five years. A five year period was chosen because the evaluations of the Tax Foundation were presented for the last five years and the best and worst tax climates remained relatively stable over this time period. Growth, the dependent variable,

will be measured by the percent change in sales from the prior year. The data was first run using the five highest and five lowest tax states and then was repeated using the same model with the ten highest and ten lowest tax states. Low tax states were assigned a 1 and high tax states a 0 so the expectation is that the variable will be positive as it was hypothesized that low tax states and sales growth would have a positive relationship. In order to determine other factors that would explain the sales growth of a company, I consulted prior literature.

Brown et. al (2004) used several factors that attribute to the growth of a firm and several control variables that must be controlled for in their model. First, they found that the acquisition of a firm will give the appearance that a firm is growing because the acquired company's sales are now on the statement of earnings of the acquirer. This does not represent true growth of the firm so it must be controlled for in the growth model. Brown et. al (2004) also included the level of financing a company was able to attain in their growth model. The support for this inclusion being that firms with access to more capital generally have the ability to expand faster as they are not limited by a lack of funds.

The research of Mohnen & Nasev (2005) found several additional factors that contribute to the growth of a firm. First, they found a negative correlation between the age of a firm and its growth. This can be explained by the fact that new firms generally have not completely figured out their market so as they develop strategies, they grow quickly. This can be compared to older firms that have already established themselves so they generally have a low stable growth rate. Mohnen & Nasev (2005) also discovered a positive correlation between employee growth and firm growth. Employee growth is a factor because an increase in the number of employees results in increased promotion of the firm's products and services, which consequently increases production and sales to meet the demand. Mohnen & Nasev (2005) also found that employee

quality not just employee growth contributes to firm growth. Higher quality employees add to the growth of a firm because they generally are more productive because they are better trained and they generate more ideas to improve the firm.

In addition to the factors discussed in prior literature, I had expectations that several other factors would attribute to the growth of a firm. As discussed above I expected firms to reinvest tax savings back into the company through research and development, capital expenditures and advertising. The expectation is that these reinvestments will have a positive relationship with sales as they are expected to increase the growth of the firm.

Following is a discussion of the proxies used to capture the principles discussed in prior literature and my expectations. First, I used a control variable to capture the amount of acquisitions the firms made. This controlled for the amount of growth attributed solely to acquisitions. In order to capture the financing of the firm, I used leverage or long term debt deflated by total assets as a proxy. Age was captured using the reported age of the firm. Employee growth was captured using the percent change in employees from the prior year and a proxy used to identify the labor intensity of a company. This proxy measured the number of employees divided by every million dollars of total assets.

Employee quality was the most difficult principle to find a proxy for given that prior literature often utilized interviews to capture information on the quality of employees at the firm. In order to capture employee quality given the information solely found in Compustat, I used the change in selling, general and administrative expenses. On the statement of earnings, this is the account that captures training costs, which measures employee quality as higher quality employees are generally better trained. This account also generally includes salary expense, which is a measure for employee quality as higher quality employees are usually paid more.

Investment in advertising is also captured in S, G&A expenses so this proxy is capturing multiple determinants of growth. Investment in research and development and capital expenditures is captured using changes in their respective accounts. In addition to the proxies described, industry and year fixed effects were controlled for in all four regressions, while state effects were controlled for in two of the four regressions.

VI. Results

As evidenced by the results presented in Figure 1-A, 1-B and 1-D in the Appendix, there is not a correlation present between the tax environment in which a firm conducts business and the sales growth of the firm. This is illustrated by the t-statistic not exceeding 2 and the p-value exceeding 5% for the low state proxy in the three regressions. This is an indication that that the variable could be 0 meaning the low tax state environment does not explain the variation in sales growth. This offers evidence for the fact that there is not a relationship between the tax environment and the sales growth. It is evident that the lack of relationship between the state tax environment and sales growth is not due to the model not measuring sales growth as several of the other proxies resulted in a high t-statistic and a low p-value. These proxies include the percent change in employees in Figure 1-A and 1-B and the age and the percent change in research and development and capital expenditures in Figure 1-D.

The results found in Figure 1-C (Appendix) however vary from those results described in the other three regressions. The variable for the low state proxy in Figure 1-C has a t-statistic of 2.09 and a p-value of 3.66% indicating a relationship between the tax environment and sales growth. The variable however is negative meaning that firms located in high tax state environments experience more growth than those in low tax states, which is the opposite of what

was expected in the hypothesis. As explained earlier, the variable is expected to be positive as low tax states were assigned a 1.

It is also important to make several additional notations on the results besides those on the low state proxy. First, the model appeared to measure sales growth better when the number of observed states increased to 10. This is a possible indication that using the firms headquartered in the five highest and the five lowest state tax environments produces too small of a sample to have clear results. The second item to note is that the leverage proxy does not explain sales growth of a firm as its t-statistic did not exceed 2 and its p-value was not less than 5% in any of the regressions. This suggests either a better proxy could be used to capture the financing available to a firm or that the financing available to a firm does not explain its sales growth.

The last item to note is that the selling, general and administrative expense proxy similar to the leverage proxy does not explain sales growth of a firm. This suggests that there are possibly too many expenses included in S, G&A not related to employee quality that are clouding its ability to be a measurement for employee quality. Another proxy for employee quality will be difficult to attain as firms generally do not provide more detailed information on their employees than the number of employees.

VII. Conclusion & Discussion

In conclusion, the goal of this paper was to study the relationship between the sales growth of a firm and the low tax state environment in which it conducts business. It is evident given the results presented that there is not a relationship present between a low tax state environment and sales growth. One regression of the four regressions actually presented evidence that firms in a high tax state environment experienced more growth in sales than those in a low tax state environment.

There are several factors that explain the absence of a correlation between the state tax environment and a firm's sales growth and several factors that would cause companies in high tax states to experience more growth than those in low tax states. Those factors that explain a lack of relationship include companies returning tax savings to investors rather than reinvesting it, apportionment taxes, firms' inability to move, and competition generated by firms entering the low tax state. Those factors that explain a firm operating in a high tax state growing faster than one in a low tax state include the ability to recruit high quality staff and access to clientele.

As stated earlier, companies generally do not retain cash as it is a low return asset meaning a company will not save the excess cash it receives from the tax savings it experiences from being in a low tax state. Generally companies follow two responses to having excess cash, first as stated earlier reinvesting it back into the company through advertising, capital expenditures or research and development or second returning it back to its investors. A company choosing to return the excess funds to its investors instead of reinvesting it does not realize the benefit of growth from reinvestment. This would explain the lack of correlation between the tax environment and sales growth as firms in low tax states are not taking advantage of the benefits associated with operating in a low tax state.

Apportionment taxes can also cause there to not be a relationship between the tax environment and sales growth. Because of a high number of sales in the area or employees performing activities other than promotion in the state, a company will non-intentionally develop a nexus in a state they primarily do not conduct business. If nexus is established, the company will have to apportion that income to the state in which they have nexus and pay taxes based on the income earned in that state. This mitigates the benefit of being located in a low tax state as they have to pay taxes to those other higher tax states. Apportionment taxes are not captured by

the Tax Foundation measure so another measure that captures apportionment taxes could be used in future research. Computing an effective tax rate based on the actual taxes a company pays would capture the apportionment taxes. An effective tax rate measure however was not used in this paper as the effective tax rate reflects the company's other tax strategies, such as the benefits of foreign taxes paid to a low tax country.

Another explanation for a non-correlation between the tax environment and sales growth is firms' not relocating to a low tax state because of their inability to move. Firms have substantial investments in their property, plant and equipment, which cannot be so easily relocated to a low tax state. These assets cannot be easily relocated as it is expensive to move them or it is time consuming to sell them. Selling their property, plant and equipment in order to move to a low tax state also may not be beneficial for a company as those states deemed as having a low tax environment change. States leaders facing the issue of not recruiting enough companies into their state lower their taxes to entice companies to relocate to their state. Once they have recruited enough companies, they can increase their taxes meaning they are a low tax state only long enough to entice companies into their state. This implies that companies could have relocated to a low tax state to realize the tax benefits, but no longer receive those benefits as the state is now a high tax state.

An opposite explanation is too many firms relocating to the low tax state resulting in increased competition in that low tax state. As stated earlier, states realize that companies would like to pay as minimal taxes as possible so they will lower their taxes to entice companies into their state. This results in an overwhelming number of firms entering the state to realize the tax savings thereby causing the market to greatly expand. Increased entrance into the market causes competition amongst the firms meaning the demand and consequently prices for input products

will increase. This also results in decreased demand for an individual firm's product as supply has increased meaning with increasing costs and declining sales, a firm will experience low growth. This concept is most clearly illustrated by the investment return of municipal bonds. It is expected that they might provide a high return because they are not taxed, but in reality they provide a low return because individuals compete for those bonds thereby increasing the price. As the price increases, it results in a premium or implicit tax that is paid on the bond, which decreases the return.

The results in Figure 1-C were opposite than expected meaning companies in high tax states were realizing more growth than those in a low tax state. This is possibly because of their access to qualified employees and more clientele. Low tax states usually are those that have a relatively low population per square mile reducing the number of potential employees and customers.

A relatively low population first indicates that those companies will have less potential customers within their area so they will have to sell in other states to increase their sales. This indicates that they will have to compete with companies from the local area. Companies in the local area may have the advantage because customers will want to make purchases locally in order to receive their order quicker and to support the local economy. The companies in the area also may be able to sell at lower prices because the decrease in transportation costs outweighs the extra taxes they pay. The companies that can generally overcome these disadvantages are those that have established economies of scale better than local companies. This generally only applies to those companies that are large enough to spread costs over many products.

A low population also limits the size and quality of the recruiting pool from which they can hire. The size and quality is reduced because the company can only hire individuals who want to live in a low population state. Because they can only select individuals who want to live in a low

population state, the quality of their recruiting pool is diminished due to less competition.

Competition generally entices the best candidates allowing a company to have many choices and to eliminate non-qualified applicants. They also cannot establish locations in other states to improve their recruiting pool by generating competition because they will establish nexus in another state. This implies that in order to maintain the benefits of being in a low tax state, they are limited to the location of the low tax state.

High quality employees improve the quality and speed of the company's goods or services, better advertise the company's products to clients, and can offer solutions for improving the company's business. Because of the discussed benefits of high quality employees, a company with a better recruiting pool in a high tax state may still experience more growth than a company in a low tax state.

Though the results of this paper did not reflect what was expected in the hypothesis, the negative correlation found in Figure 1-C indicates that there is a relationship present between the tax environment in which a firm conducts business and its sales growth. This indicates the need for further research to better understand this relationship. Future research in the use of a low tax state as a tax haven could use better proxies for those that were found to be weak in this model, such as the leverage and S, G & A proxies. Other variables that could explain sales growth could also be tested to improve the accuracy of the model. Additionally a measure other than the use of the Tax Foundation's research could be used to identify which states will be defined as low tax or high tax. This measure could incorporate the amount of apportionment taxes companies pay so that it is better understood if companies are able to take full advantage of the benefit of operating in a low tax state.

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Appendix-Figure 1

Regression A-5 low tax states vs. 5 high tax states, no state effects					Regression B-5 low tax states vs. 5 high tax states, state effects				
Estimated Regression Coefficients					Estimated Regression Coefficients				
Parameter	Estimate	Standard Error	t Value	Pr > t	Parameter	Estimate	Standard Error	t Value	Pr > t
Intercept	-0.0365681	0.04256765	-0.86	0.3904	Intercept	-0.021366	0.04915766	-0.43	0.6639
lowstate5	-0.0204186	0.02150618	-0.95	0.3425	lowstate5	-0.1824121	0.20129551	-0.91	0.3649
age	-0.0009314	0.00060536	-1.54	0.1241	age	-0.0006949	0.00059982	-1.16	0.2468
leverage	0.0729255	0.06058663	1.2	0.2289	leverage	0.0699301	0.0639758	1.09	0.2745
lag_empl_at	-0.0007693	0.00115397	-0.67	0.5051	lag_empl_at	-0.0006847	0.00113651	-0.6	0.547
chg_empl	0.6549734	0.1017641	6.44	<.0001	chg_empl	0.6538142	0.10199372	6.41	<.0001
rd	0.585425	0.2326981	2.52	0.012	rd	0.5698669	0.23357931	2.44	0.0148
sga	0.0878242	0.06115316	1.44	0.1511	sga	0.0923521	0.06222311	1.48	0.1379
capex	0.7523732	0.26425773	2.85	0.0045	capex	0.7866718	0.2772104	2.84	0.0046
acquis	-0.0662483	0.15130578	-0.44	0.6615	acquis	-0.0586974	0.15144836	-0.39	0.6984
Regression C-10 low tax states vs. 10 high tax states, no state effects					Regression D-10 low tax states vs. 10 high tax states, state effects				
Estimated Regression Coefficients					Estimated Regression Coefficients				
Parameter	Estimate	Standard Error	t Value	Pr > t	Parameter	Estimate	Standard Error	t Value	Pr > t
Intercept	-0.0164511	0.02282165	-0.72	0.471	Intercept	0.0170431	0.03543316	0.48	0.6305
lowstate10	-0.0286751	0.01371609	-2.09	0.0366	lowstate10	-0.1960691	0.21624551	-0.91	0.3646
age	-0.00157	0.0003333	-4.71	<.0001	age	-0.0016349	0.00034356	-4.76	<.0001
leverage	0.0526138	0.03590385	1.47	0.1428	leverage	0.0487494	0.03683567	1.32	0.1857
lag_empl_at	-0.0015064	0.00058683	-2.57	0.0103	lag_empl_at	-0.001471	0.00058897	-2.5	0.0125
chg_empl	0.6075968	0.04372065	13.9	<.0001	chg_empl	0.6068586	0.04376789	13.87	<.0001
rd	0.6912085	0.09902794	6.98	<.0001	rd	0.697287	0.10048327	6.94	<.0001
sga	0.0362947	0.03268765	1.11	0.2669	sga	0.0392385	0.03322451	1.18	0.2376
capex	0.8507254	0.16722582	5.09	<.0001	capex	0.8646016	0.16978686	5.09	<.0001
acquis	0.0460084	0.08844924	0.52	0.603	acquis	0.0421051	0.08829978	0.48	0.6335