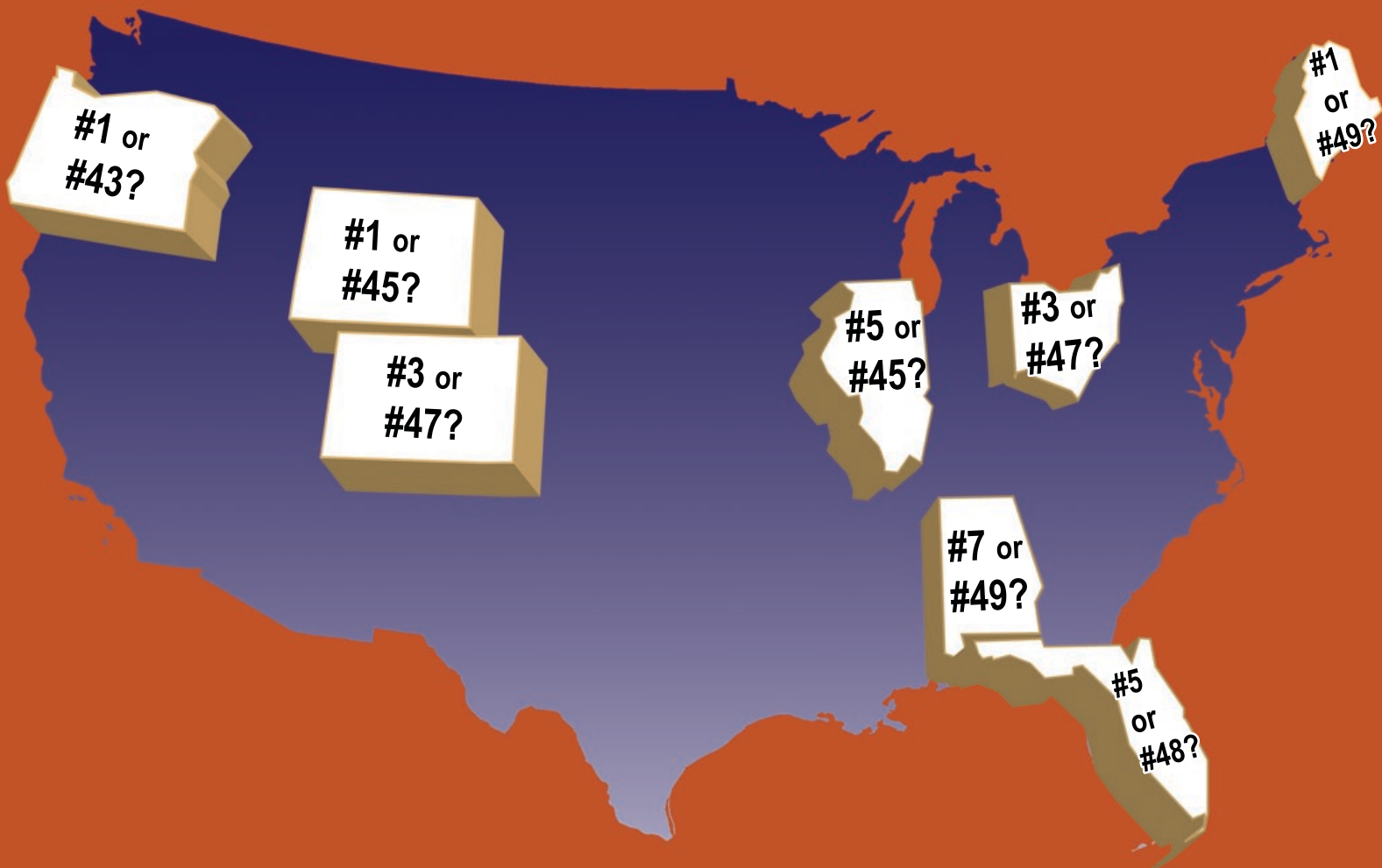


Grading Places

What Do the Business Climate Rankings
Really Tell Us?



GOOD
JOBS
FIRST

May 2013

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**What Do the Business Climate Rankings
Really Tell Us?**

Second Edition

by
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with a preface by Greg LeRoy

Good Jobs First

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Good Jobs First is a non-profit, non-partisan resource center founded in 1998 to promote accountability in economic development and smart growth for working families. It is based in Washington, DC and includes Good Jobs New York in New York City.



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Executive Summary

An examination of the four most prominent “business climate” ratings of state tax systems finds them to be deeply flawed and of no value to informing state policy. They produce state rankings that bear little relation to actual taxes paid in one state versus another. They sometimes include factors that are effects instead of causes of economic growth, or factors that have no empirically proven relationship to growth. They omit significant differences among state corporate tax systems. They display no predictive value about economic growth. They come to highly inconsistent findings among themselves.

Each of these four rankings is constructed by taking widely disparate data points and adding or averaging them to construct an index number. The result is not a useful summary measure of business climate as claimed. It is at best meaningless, and at worst a state ranking manipulated to make the case for policy positions advocated by the organization sponsoring the index.

Two other 50-state ratings that use mathematical models to study typical or representative firms generate more defensible data. However, both are weakened by simplifying assumptions that lead to misleading results. Both generate disaggregated data for different companies but then combine them by state in ways that obscure or dilute their value. And

the two sets of findings are also highly inconsistent with each other.

The Four Business Climate Indexes

The Small Business and Entrepreneurship Council’s *U.S. Business Policy Index* is an amalgam of 46 factors, including 6 on health care regulation, 22 on taxes, 7 on government services, and a potpourri of others on crime, paid leave, renewable energy portfolio standards, electricity rates, eminent domain and tort liability. However, when the 46 variables are disaggregated to reveal which ones actually distinguish one state from another, it is only the 12 factors that bear upon tax progressivity that matter; the other 34 are statistical background noise. Compared to measures of state economic dynamism tracked by the Information Technology and Innovation Foundation, the USBPI does not correlate; that is, it does not apparently measure things that contribute to higher rates of innovation and entrepreneurship.

The Beacon Hill Institute’s *State Competitiveness Report* combines 45 variables that are again extremely diverse: 6 on fiscal policy, 8 on human resources, 7 on technology, and 8 on business incubation. There are some dubious choices such as weekly unemployment benefits, cell phones per 1,000 residents, infant mortality rate,

and the percent of residents born abroad (they are said to be more motivated). The study confuses cause and effect, including various measures that are the *result* of growth, such as labor participation rates, firm births, initial public offerings, exports, and public-budget surpluses.

The Tax Foundation's *State Business Tax Climate* Index combines 35 variables, all having to do with taxes: 11 on the corporate income tax, 7 on the personal income tax, 4 on sales taxes, and 10 on property taxes. The ratings consistently favor regressivity. When compared to the Council on State Taxation's (COST) ranking of actual corporate tax burdens, the Tax Foundation's rankings fail miserably. Of the Foundation's top 10 states, only one actually ranks among the 10 states with the lowest share of state GDP going to business taxes. Its top-rated state, Wyoming, ranks 45th, according to COST.

The American Legislative Exchange Council's *Rich States, Poor States: The ALEC-Laffer Economic Competitiveness Index*, despite its aggressive claims, fails to predict job creation, GDP growth, state and local revenue growth, or rising personal incomes. Empirical evidence does not support its claims that estate taxes or graduated personal income taxes cause rich people to move and thereby retard economic development. No state is anywhere near "Laffer Curve" rates of taxation; the only certain outcome of a tax cut is lower revenues. And the only clear impact of "right to work" laws is lower wages.

The four business climate studies are not about jobs and income, but rather about ideology. We note that each group's findings dovetail with its stated advocacy positions. The one consistent theme that the indexes harp on is regressive taxation, especially lower corporate income taxes, lower or flat or nonexistent personal income taxes, and no estate or inheritance taxes. Even though state tax systems (including income, property, consumption and other taxes) are already quite regressive (and barely offset by the progressivity of the federal income tax), the business climate authors would have states enact even more inequality into their tax codes.

A second recurring theme is wage suppression via recommendations against minimum wages, free union bargaining, health care regulation, paid leave and unemployment insurance. The unspoken subtext seems to be: use public policies to keep your wages down and you will attract investment. This despite the fact that non-managerial wages have stagnated and failed to keep pace with productivity for more than three decades, and consumer spending drives more than two-thirds of the economy.

A third theme is the degradation of the public sector via negative ratings tied to the number of public employees (even if that were to mean smaller school-class size or better public health) and absolute indifference to the condition of a state's infrastructure (the American Society of Civil Engineers' report cards are nowhere to be seen).

A fourth theme is the belief that state and local business taxes are the primary state policy tool for bringing about growth and prosperity. In fact, a review of the extensive academic research in this area reveals that taxes are such a small share of business costs that they have little effect on investment decisions. In fact, the tax-cutting approach can lead to cuts in services that are counterproductive. The rankings are striking in their near total failure to acknowledge the actual sources of rising prosperity and the role of state and local governments in supporting economic development: investments in education, job training, infrastructure, health, and public safety.

Finally, in addition to all of their individual methodological problems, the studies bear no relation to each other. Massachusetts ranks 1st in one index and 38th in another. Alabama is next to last by one ranking and 7th on another. Alaska is ranked 4th and 38th. If a state wants to advertise its friendly business climate, 22 can brag they are in the top 10 (according to someone). If business lobbyists want to demand business tax cuts, in 24 states they can complain about being in the bottom 10. It's all about what a brilliantly malleable term "business climate" has become.

As stated in our Preface, these studies follow in a long line of ideologically charged pseudo-social science published to further the interests of corporations and rich people. They are properly viewed as artifacts of corporate advocacy rather than prescriptions for prosperity.

Representative Firm Models: Promising but Under-realized

We also examined two representative firm models: ***COST's Competitiveness of State and Local Business Taxes on New Investment***, prepared by the accounting firm Ernst & Young; and the ***Tax Foundation's Location Matters***, prepared with the accounting firm KPMG. These mathematical models allow for more complexity and nuance because they acknowledge that different companies and facilities vary greatly in how they interact with tax codes and they are aimed at measuring how tax systems impact plant expansions or relocations.

Unfortunately, both models have serious flaws and fail to take full advantage of the methodology. COST's model excludes pass-through entities such as S corporation or LLCs, very common small-business forms. And even though it models five different kinds of facilities and three kinds of taxes, it hides those disaggregated results and only provides two blended numbers per state (returns weighted by job creation or capital investment). In a huge omission, it fails to account for tax incentives, even though such subsidies can greatly reduce tax liabilities and thereby affect investment returns. The COST model also assumes every facility sells five percent of its output in-state, whether it is located in, say, California or North Dakota. Finally, it uses the property tax rates of each state's largest city, which are often far higher than statewide averages.

The Tax Foundation/KPMG report models seven theoretical facilities. It assumes that six of the seven companies have payroll and property only in the rated state, and distributes sales among the 50 states according to the sizes of their economies, but then admits such a scenario is unrealistic. This assumption artificially penalizes facilities in states with both singles sales factor income tax apportionment and throwback rules. The Foundation does publish its disaggregated seven scores for each state, but then

weights them all equally to derive state scores, a less defensible method than COST's weighted scores (i.e., a clothing store with 25 workers is weighted equally with a corporate headquarters employing 200).

Held against each other, the COST and Tax Foundation numbers show many contradictions. Comparing the five most comparable tax-rate estimates shows an average difference of 57 percent per state.