Behind the Numbers: What Does the Tax Foundation Business Climate Index Really Tell Us?

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The Tax Foundation released its 2011 Business Tax Climate Index this week. According to the report, Pennsylvania ranked 26th in the nation.

Pennsylvania's ranking over the past six years, since 2006, has consistently hovered around the middle of the pack, ranging from 22nd to 30th.

Given the consistent drum beat about Pennsylvania's purported hostility toward business, this ranking should come as good news. But the index has some methodological problems that limit its usefulness.

The Tax Foundation bases its ranking on the statutory rates of five different types of taxes (corporate, individual income, sales, property, and unemployment taxes) and selected other tax features, such as the treatment of net operating losses and certain tax credits. Other types of taxes, such as energy taxes, are ignored completely.

According to this definition, Pennsylvania could enact the highest natural gas severance tax in the nation without slipping a notch in the rankings.

The Foundation also favors states without graduated tax rates. On this measure, Pennsylvania does well because of its flat income tax. But the fact is that states with graduated taxes have some of the highest paying and most desirable jobs, and many of those state have had higher job creation than the Commonwealth despite our low flat personal income tax.

The report argues that state tax decisions are important in the grand competition for jobs and investment, but state actions are pretty predictable through the business cycle. States raise taxes in bad times, as 33 states have done during this recession, and reduce or rollback rates during boom times. When tax policies change in tandem, as they so often do across the states, there is little in the way of advantage or disadvantage for businesses. Moreover, research shows that job creation, particularly in the technology sector, results from "growing your own" businesses, rather than "attracting" businesses from neighbors.

The Tax Foundation agrees that it is bad tax policy to offer special tax breaks or subsidies for specific companies as incentives to relocate. The report cites the case of North Carolina, which gave $240 million in tax breaks and subsidies to Dell Computers to build a facility in the state, only to have it close five years later.

The Council on State Taxation (COST), a tax research group funded by the largest corporations operating in the United States, also produces a state business index, with very different results from that of the Tax Foundation. The COST index ranks states based on state and local business taxes as a share of Gross State Product – in other words, what share state and local taxes are of the total economic pie in each state. The variation between the Tax Foundation and COST indices – and between them and other conservative business tax rankings – raises questions about the validity of each measure.

The table below compares the top 10 states, according to the Tax Foundation report and the COST study.
While the Tax Foundation ranks Alaska, Wyoming and Montana as some of the "best" states in terms of tax climate for business, they are among the worst, according to the COST study. For example, the Tax Foundation's number 5-ranked state – Florida – drops to 36th in the COST calculation. Even as a group, the average ranking of the Tax Foundation "top 10” on the COST index is below average – with an average ranking of 28.

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<th>Council on State Taxation (COST) Ranking of Tax Foundation's &quot;Top Ten&quot; States Ranked by the Tax Foundation State Business Tax Cost Index (SBCTI)</th>
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<td><strong>Average Ranking of Tax Foundation &quot;Top 10&quot;</strong></td>
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Table courtesy of Peter Fisher, Iowa Policy Project

The COST study – which measures actual taxes paid by businesses, rather than tax rates – finds that in Pennsylvania corporate income taxes are 7.5% of total state and local business taxes, which is below the national average of 8.6%. On the other hand, by the Tax Foundation measure, Pennsylvania's corporate taxes do not fare well, as the 9.9% Corporate Net Income (CNI) tax rate is high compared to other states – although, in fact, many corporations don't pay that rate because they use tax loopholes to artificially lower their reported Pennsylvania profits.

In most cases, a library of careful research makes clear, business taxes are not the driving force of decision making as we are led to believe. Access to markets and raw materials, a well developed system of roads and rail, a job-ready workforce, and proximity to academic centers of technological innovation are all factors that matter more than state and local taxes to the overwhelming majority of businesses. Many of these factors are financed through state and local taxes. As with many things in life, you get what you pay for.

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