

## **Tax Foundation's "Tax Policy Podcast"**

**Episode No. 12**

**October 24, 2006**

**Scott Hodge:** Welcome. I'm Scott Hodge, President of the Tax Foundation.

I am pleased to have with me today the authors of the Tax Foundation's 2007 State Business Tax Climate Index, Chris Atkins and Curtis Dubay. Chris is our staff attorney and analyzes federal, state, and international tax policy from a legal and economic perspective. Curtis is our staff economist and has written extensively on how states can improve their competitiveness. Curtis is also the lead author of our annual Tax Freedom Day Report.

Thank you both for joining us today.

**Chris:** Thank you, Scott.

**Scott:** Curtis, let me start with you. First tell us, what is the Business Tax Climate Index? What are you trying to measure? And then how do you rank the states?

**Curtis:** Sure. The State Business Tax Climate Index is an objective measure of the friendliness of each state's business tax climate. We rank each state based on its competitiveness compared to other states by looking at five areas of each state's tax system.

We look at the corporate tax. Generally the corporate income tax, the individual income tax, the sales tax, unemployment insurance tax and the property tax system.

We utilize 113 different categories of tax rates, laws and statutes. We score each state based on their scores in each of these five component indexes. We then compose each state's overall scores and rank based on these five components.

Because the Index is so broad and at the same time detailed, it is able to provide a roadmap for lawmakers, the media and the public alike to pinpoint those exact areas where each state's tax system is lacking. It also provides a comparison for all states to see where they rank nationally compared to every other state on their business tax climate.

**Scott:** Once you have crunched all the numbers and you have taken all that input, which states do well and which don't do so well? Why do they do well and why don't they do so well?

**Curtis:** Sure. States that score in the top ten of our Index will generally have broad-based taxes. That means that there are not a lot of loopholes or credits, deductions, exemptions or even targeted tax incentives in their tax base. Those broad bases will generally have low-rate taxes levied on them.

The states that score well that have these types of taxes are: Number one, Wyoming--number two; South Dakota--number three; Alaska--number four; Nevada--number five; Florida--number six; Texas--number seven; New Hampshire--number eight; Montana--number nine; and Delaware--number ten Oregon. It is important to point out one factor that catapults these ten states to the top of our ranks.

Each of these states goes without imposing one of the three major tax categories. Those are either the corporate income tax, the individual income tax or the sales tax. In fact, Wyoming, Nevada and South Dakota go without taxing corporate or individual income at all. By not taxing one of these three major categories, these states have put themselves in an extremely competitive situation compared to every other state in the country.

**Scott:** Who is at the other end of the spectrum and the states that have the worst tax systems for business?

**Curtis:** States that do the opposite of these top ten states. That is, states that levy all of these taxes and at the same time levy very narrow-based taxes with high rates.

These include Rhode Island at number 50, Ohio at number 49, New Jersey at number 48, New York at number 47, Vermont at number 46, California at 45, Nebraska at 44, Iowa at 43, Maine at 42 and Minnesota at 41.

**Scott:** Just listening to you read off the good states and the bad states, a couple of things come to mind. Number one, the good states all seem to be states that are prosperous and healthy and growing and seem to be attracting business. Many in the Sunbelt I guess you would call them. The states that do poorly seem to be kind of old-line, rust-belt states and ones that do not seem to be growing or are losing jobs.

What sort of linkage are you seeing between economic performance and the Index rankings?

**Curtis:** We have seen that states that score in the top ten of our Index are experiencing faster rates of economic growth than states that score in the bottom ten.

It is true that certain areas of the country--the Northeast--is often plagued with bad tax policy, such as New York, New Jersey, Rhode Island and Vermont. But there is New Hampshire in the middle of that tax boondoggle that scores number seven. They go without a sales tax and they have a very limited individual income tax. States can differentiate themselves and stand out from the pack by having a particularly advantageous business tax climate.

States should really strive to advance toward the top of the ranks. I really think they will experience faster rates of economic growth.

**Scott:** The bottom line is taxes matter?

**Curtis:** Absolutely. Taxes certainly matter. Aside from them really mattering they are really the one thing that legislators and lawmakers can do to immediately help business and taxpayers in the state. It might take years for increased education spending to really impact a state's business climate. It might take years to build a road and to see that road really help the business climate. By going in and making the state fairer, simpler and more economically efficient, a state can see real improvements immediately.

**Scott:** I want to have Chris pick up on some of those points. You have been working with a number of state legislators across the country. Let's say you get a legislator that comes to you and says, "Well Chris, this ranking is all well and good, but how do we get there? What do we do? What specific roadmap can you give my state? Or blueprint to improve our tax structure?" What are you telling them today?

**Chris:** Scott, I think there are a couple of things that lawmakers need to focus on. First, ideally, to get in the top ten or top fifteen of our rankings you would need to eliminate one of your major taxes. You would need to eliminate your corporate income tax, individual income tax or the sale tax because our top 10 states managed to go without one of those taxes. Now of course that may be politically difficult in some states although they are going to at least attempt it next year in Michigan with eliminating their single business tax. So if you cannot eliminate a major tax then you really need to look at some of the states that rank in the teens like Colorado, Virginia and Indiana. These are states that levy all of the major taxes: corporate income, individual income, and sales. But they do so at low rates and at a relatively broad base. That is they do not exempt a lot of consumer goods and services. From their sales tax they do not have a lot of special credits or deductions on their income taxes.

And then finally I know that, I expect at least ten states to take a look at major tax reform next year to make their systems more business competitive. But you really need to avoid this new phenomenon--which is really an old phenomenon--of gross receipts taxes. I thought these things had been dead and buried with a stake in their heart, but it seems like more states are considering them now as they make changes in their tax system and they are considering it because they are levied on a broad base and at a low rate and they seem to be a good options for those to support such policies. But as we are going to point out in the future, and as we are pointing out now in fact; gross receipt taxes have a lot of economic problems associated with them. They cause what is called tax pyramiding, which is layers of taxes as good or services makes it way through the production process. So I would say ideally eliminate a major tax. If not, try to lower your tax rate by broadening your tax base, and third, avoid gross receipts taxes at all cost.

**Scott:** Well, but if I am a legislator and I am looking at gross receipts tax, this looks like a pretty good attractive deal here. I get to essentially broaden our tax base by taxing people out of the state. So I am shifting some of our tax burden on out-of- state taxpayers. Why shouldn't that be a good thing if I am a legislator?

**Chris:** Well there is no free lunch, Scott, and taxpayers who located out of state may pay the bills but in-state taxpayers are the ones that have to live with the goods and services that are provided and if you tax out-of-staters or relying on them too heavily you are

creating a situation where you think you are getting more government than what you are paying for. That puts an upward pressure on government and leads to too much government and not enough pressure on the government to keep things running efficiently, and second, it gets Congress' attention. Congress does not like it when states try to tax out-of-staters, and indeed currently there are some protections in federal law for the taxation of out-of-state businesses and there is currently a debate in Congress about even adding to those or expanding those protections. So adopting these gross receipts taxes to open outsiders invites Congressional regulation and oversight of state tax policy.

**Scott:** Well, now some have criticized the business climate Index by saying that the Index penalizes states for trying to attract business through various tax incentive and abatement programs and a lot of legislators are probably saying, "Hey, that is how we do it here. This is how we are trying to reach out to the larger business and make ourselves attractive by using these kinds of incentive programs." And yet the Tax Foundation is saying that this is bad. What do you tell them?

**Chris:** Well Scott tax incentives are often about job announcements rather than job creation. There is a wealth of economic evidence that shows there is no correlation between tax incentives and job growth or job creation in a state and then there is a wealth showing the contrary that low-rate, broad-based tax systems are the best bet for a state that wants to grow, that wants to increase its personal income, that wants to increase employment, that wants to increase its gross state product in a more efficient way. And unfortunately lawmakers are not very good at picking winners and losers. I think we should trust the market to allocate resources and tax incentives are often just a means that lawmakers use to cover up a bad tax climate.

**Scott:** A lot of people may look at the Index and say, "Well, New York may not have a great business climate, but who would want to live in Wyoming?" There are a lot of other things that go into a business climate than just tax policy. There is education and roads and all of these other things that go into certainly some businesses' site location process so why is tax so important in your mind?

**Chris:** Scott, we certainly do not claim that taxes are the only thing that matter. Business like to have highly skilled employees, they like to have a good transportation infrastructure, network. The Index just measures the overall tax climate. But we know because the economic studies tell us that taxes do play an important role and indeed businesses will often choose sites based on a number of factors but taxes will often be the deciding factor, one of the last factors that can make or break a state's laying a new investment. Taxes are also easier to change than roads or transportation or education policy. Lawmakers in the coming sessions in 2007 can immediately give themselves a much better competitive business tax climate. But educating our children, fixing and building our roads--those are much longer-term public policy choices that some states may need to make, but taxes are the only ones that give you the immediate bang for your buck and immediately put the country on notice that you are going to compete for jobs and investment.

**Scott:** Thank you, Chris, for speaking with me today, and Curtis as well. I appreciate the work that you have done on this. It is a very important study and one which I hope lawmakers pay attention to.

**Chris:** Thank you, Scott.

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