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State Business Tax Climate Index: An Executive Summary

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The complete study is available at *www.taxfoundation.org/bp45.pdf.*

Abstract

The Tax Foundation's State Business Tax Climate Index measures the "tax-friendliness" to business of each state's tax system at the beginning of 2004.

South Dakota, Florida, Alaska, Texas and New Hampshire are the five states found to have tax systems most conducive to new and expanding businesses, while Hawaii, New York, Minnesota, West Virginia and Rhode Island have the five least hospitable tax systems.

The most competitive tax systems are usually found in states that raise sufficient tax revenue without one of the major taxes on sales, personal income or corporate income. The least competitive are found in states with complex, multi-rate corporate and individual tax codes; above-average sales tax rates that exempt few business-to-business transactions; high state tax collections; and few institutional restraints on taxation or spending.

Introduction

New statistics from the Department of Labor tell us that less than one percent of job relocations in recent years have been outsourced overseas. That leaves 99 percent that have shifted from one U.S. state to another.

Tax systems are one of the principal tools that states use to compete for these jobs. In the newspapers, the story of tax competition is often played out as a courting ritual, with state legislators approving overly generous tax abatements to lure famous companies.

For example, in 1996 Florida lawmakers approved a $4 million tax refund package to persuade a major credit card company to open a call center in Tampa. This year the company moved its call center out of state and laid off 1,100 workers.

Florida's experience shows that the special tax package game is often a futile approach. States are better advised to keep taxes low and simple. It's fair to existing business, it prevents boondoggles, and it works.

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This study highlights areas in each state's tax code that could stand improvement from the perspective of businesses looking to expand. State lawmakers would be wise to make systemic changes to their business climates that will improve their competitive position for the long-term. As state lawmakers assess their tax systems, they should keep two rules in mind:

1. **Taxes matter to business.** Taxes affect business decisions, job creation and retention, plant location, competitiveness, and the long-term health of a state's economy. For businesses, taxes are an input cost, just like the cost of raw materials. When costs rise, they are passed along to consumers (through higher prices), workers (through lower wages or fewer jobs), and shareholders (through lower dividends or share value).
2. **States do not enact tax increases or cuts in a vacuum.** Every tax change will in some way change a state's competitive position compared to states next door or across the country. Ultimately it will affect the state's national standing as a place to live and do business. Entrepreneurial states can take advantage of other states' tax increases to lure businesses, which bring jobs and tax revenue.

The Purpose of the State Business Tax Climate Index

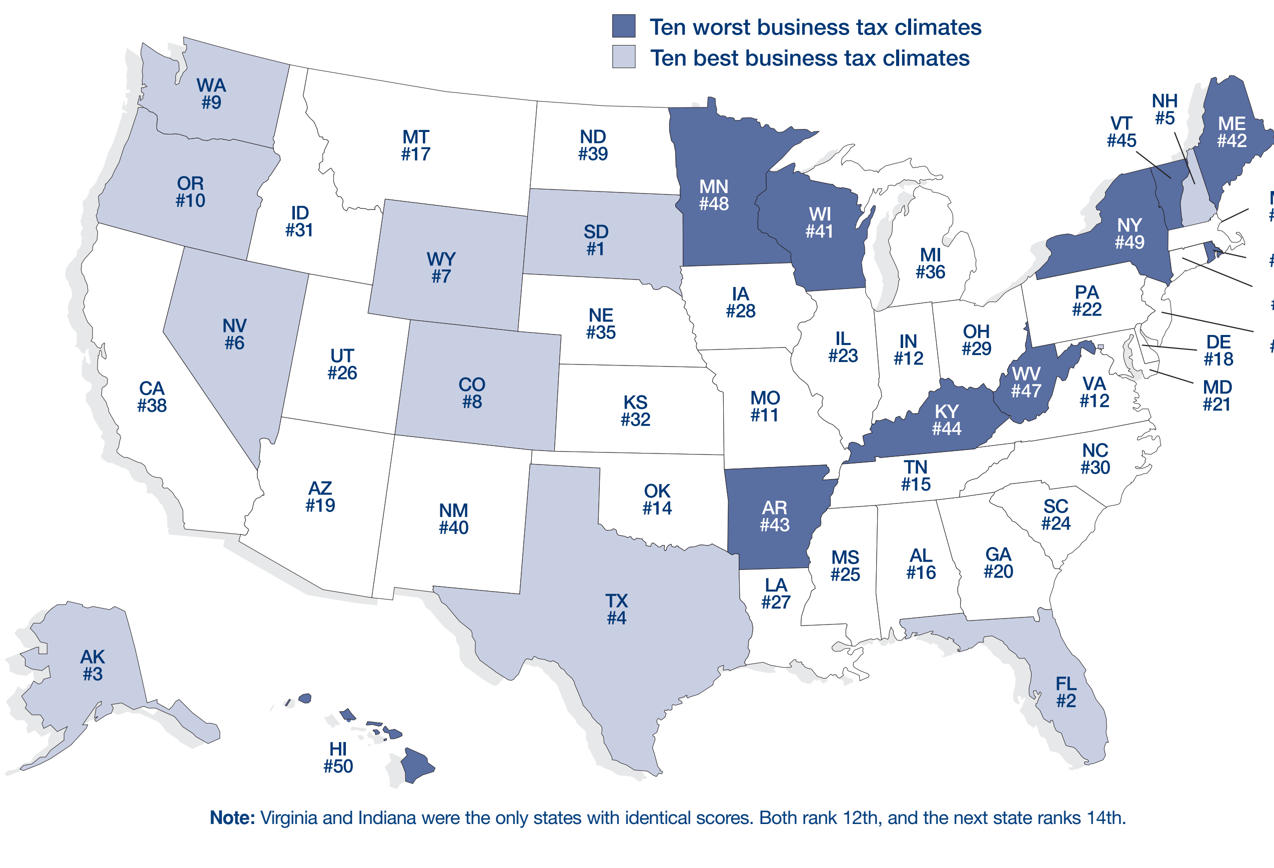
Faced with budget deficits in fiscal years 2002 and 2003, many states raised taxes to close the gaps, although many held the line on taxes by spending less. Some of the tax changes made at a time of fiscal crisis may seem unfortunate now, as lawmakers must consider the long-term damage higher taxes can have on a state's business climate.

The State Business Tax Climate Index provides business leaders and government policymakers a comparative gauge of their state's tax systems, measuring how much each state tax system is hampering either the efforts of local entrepreneurs or the possible entry of new business.

How the State Business Tax Climate Index Is Calculated

The touchstone of the State Business Tax Climate Index is neutrality. If a state's tax system maintains a "level playing field" for all types of businesses and business transactions, we consider it neutral and rate it highly. An economically neutral tax system benefits and punishes all businesses

Figure 1
State Business Tax Climate Index, 2004



Note: Virginia and Indiana were the only states with identical scores. Both rank 12th, and the next state ranks 14th.

equally, so this index is a measure of each state's tax friendliness to all business activity, not just small businesses or large businesses, capital-intensive or service-intensive, existing companies or start-ups.

Therefore, if a state's tax rates are relatively low, and its tax base is defined so as not to favor some economic activities while penalizing others, we conclude that the state's economy will be comparatively efficient and yield broadly higher incomes.

As difficult as tax neutrality is to achieve within a state, it is far more difficult to achieve between states. Tax competition is an unpleasant

Table 1

State Business Tax Climate Index, 2004

State	Score	Rank
U.S.	5.000	-
South Dakota	7.365	1
Florida	6.925	2
Alaska	6.846	3
Texas	6.798	4
New Hampshire	6.629	5
Nevada	6.494	6
Wyoming	6.446	7
Colorado	6.352	8
Washington	6.252	9
Oregon	6.150	10
Missouri	5.840	11
Indiana	5.737	12
Virginia	5.738	12
Oklahoma	5.682	14
Tennessee	5.668	15
Alabama	5.664	16
Montana	5.633	17
Delaware	5.570	18
Arizona	5.491	19
Georgia	5.443	20
Maryland	5.422	21
Pennsylvania	5.311	22
Illinois	5.211	23
South Carolina	5.182	24
Mississippi	5.146	25
Utah	5.095	26
Louisiana	5.062	27
Iowa	5.032	28
Ohio	4.866	29
North Carolina	4.861	30
Idaho	4.851	31
Kansas	4.822	32
Massachusetts	4.803	33
New Jersey	4.782	34
Nebraska	4.767	35
Michigan	4.703	36
Connecticut	4.699	37
California	4.607	38
North Dakota	4.504	39
New Mexico	4.502	40
Wisconsin	4.460	41
Maine	4.444	42
Arkansas	4.441	43
Kentucky	4.345	44
Vermont	4.310	45
Rhode Island	4.249	46
West Virginia	4.240	47
Minnesota	4.063	48
New York	4.043	49
Hawaii	3.742	50
District of Columbia	3.702	-

Note: The State Business Tax Climate Index tallies state and county tax laws in place at the beginning of the year to gauge their effect on economic performance. The higher the score, the better the business tax climate. Virginia and Indiana were the only states with identical scores. Both rank 12th, and the next state ranks 14th.

Source: Tax Foundation

Table 2

State Ranking on the Major Components of the State Business Tax Climate Index, 2004

State	Overall Rank	Corporate Income Tax Index Rank	Individual Income Tax Index Rank	Sales and Gross Receipts Tax Index Rank	Unemployment Insurance Tax Index Rank	Fiscal Balance Index Rank
Alabama	16	27	19	13	6	14
Alaska	3	49	4	1	38	10
Arizona	19	15	26	41	8	7
Arkansas	42	45	22	39	44	37
California	38	39	44	37	22	30
Colorado	8	5	13	22	25	1
Connecticut	36	19	21	33	24	43
Delaware	18	36	20	3	10	46
Florida	2	9	4	21	1	5
Georgia	20	11	26	7	33	15
Hawaii	50	28	47	45	20	50
Idaho	31	17	35	19	46	22
Illinois	23	23	11	42	41	18
Indiana	12	23	10	10	5	28
Iowa	28	43	30	15	28	17
Kansas	32	46	24	32	17	29
Kentucky	44	44	25	8	47	42
Louisiana	27	34	18	49	21	11
Maine	42	40	34	11	39	40
Maryland	21	6	35	9	14	26
Massachusetts	33	29	15	11	48	38
Michigan	36	50	12	17	41	39
Minnesota	48	31	38	36	32	48
Mississippi	25	32	16	47	2	27
Missouri	11	13	23	29	9	4
Montana	17	30	50	5	23	19
Nebraska	35	42	28	34	16	32
Nevada	6	1	7	46	39	16
New Hampshire	5	37	8	2	43	8
New Jersey	34	33	32	24	26	34
New Mexico	39	18	35	48	15	41
New York	49	14	49	40	50	36
North Carolina	30	22	44	35	7	31
North Dakota	39	48	29	20	37	34
Ohio	29	38	46	38	11	21
Oklahoma	14	12	39	14	3	12
Oregon	10	15	43	4	27	6
Pennsylvania	22	47	13	25	12	25
Rhode Island	46	23	41	28	49	33
South Carolina	24	10	40	16	44	13
South Dakota	1	1	1	43	30	3
Tennessee	15	23	9	44	34	9
Texas	4	20	4	23	13	2
Utah	26	8	42	27	19	24
Vermont	45	35	48	18	4	49
Virginia	12	7	17	6	29	19
Washington	9	1	1	50	36	23
West Virginia	47	41	31	26	35	45
Wisconsin	41	20	32	31	31	44
Wyoming	7	4	1	30	18	47

Note: Rankings do not average across to total. States without a given tax rank equally as number 1 and states with identical scores rank equally.

Source: Tax Foundation

reality for state revenue and budget officials but a godsend to taxpayers, because it is probably the most effective restraint on state and local tax burdens.

The State Business Tax Climate Index captures the impact of tax competition on economic neutrality in two ways. The first is a comparison of the states' overall tax collections, and the budgetary institutions they have in place to control taxation or spending. If any state imposes a greater overall tax burden than a neighboring state, business will cross the border to some extent. How much states take in taxes is critical, but how they take it can be just as important, so the State Business Tax Climate Index also compares statutory features of each state's tax system, such as the top corporate income tax rate, identifying comparative advantages within each state.

The overall index is a composite of five specific indexes devoted to major features of a state's tax system, that influence business decisions or the economy in general: the corporate income tax, the individual income tax, the sales and gross receipts tax, the unemployment insurance tax, and the state's fiscal balance. In total, the State Business Tax Index consists of five specific indexes, 10 sub-indexes and 109 variables.

The Results of the State Business Tax Climate Index

Table 1 and Figure 1 show the overall results, and Table 2 shows the state rankings for each of the five major component indexes. The ten states that are deemed to have the most business-friendly tax systems are South Dakota, Florida, Alaska, Texas, New Hampshire, Nevada, Wyoming, Colorado, Washington, and Oregon. On the other end of the spectrum, the ten tax systems least hospitable to business are found in Hawaii, New York, Minnesota, West Virginia, Rhode Island, Vermont, Kentucky, Arkansas, Maine and Wisconsin.

Generally speaking, states that rank highly manage without at least one of the major taxes—the individual income tax, the corporate income tax and the sales tax. Of the 38 states that have all three, Colorado ranks highest by keeping all of its taxes simple with low, flat rates.

The common characteristics of states that rank poorly are: multiple-rate corporate and individual tax codes that impose above-average tax rates; above-average sales tax rates that exempt few business-to-business purchases; complex, punitive unemployment taxes; and high state tax collections with few institutional barriers to taxes and spending.

While the index is comprehensive, it is not exhaustive. From future research into state taxation will emerge new variables and indexes to include in future editions of the State Business Tax Climate Index.

Best known for it's annual calculation of Tax Freedom Day, the Tax Foundation is a nonpartisan, nonprofit organization that has monitored fiscal policy at the federal, state and local levels since 1937.

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