



NATION'S SEVENTH-BEST BUSINESS CLIMATE?

BRIEFLY

The Tax Foundation has ranked Washington as having the seventh-best business tax climate in the U.S. Our state generally does well in the Tax Foundation's rankings, in large part because we don't impose an income tax. On the non-income tax portions of the rankings, Washington doesn't fare as well.

The methodology weighs heavily against income tax states.

The Tax Foundation, a respected national tax policy research group, recently ranked Washington as having the seventh-best business tax climate in the 50 states. Last year, Washington ranked eighth. Our state generally does well in the Tax Foundation's rankings, in large part because we don't impose an income tax, which receives extraordinary weight in the Foundation's methodology. On the non-income tax portions of the Tax Foundation's ranking, Washington fares rather poorly.

The study provides an abundance of good information about state tax policy and its impact on business. Some would argue, as we have, that it is not possible to rank states fairly on a single business tax climate index. There's simply too much variation in how states apply incentives and how industrial sectors respond to tax policies for the rankings to be clear-cut.

There can be no argument, however, regarding the important role of tax policy in interstate competitiveness, and rankings like this can help clarify differences among the states. The Tax Foundation states it clearly:

... even in our global economy, states' stiffest and most direct competition often comes from other states. The Department of Labor reports that most mass job relocations are from one U.S. state to another ...

As we have noted, the Foundation's rankings reflect its policy preferences—preferences informed by an extensive review of the economic literature. The top 10 states in this year's ranking are Wyoming, South Dakota, Nevada, Alaska, Florida, New Hampshire, Washington, Montana, Texas and Utah. In the report, the Tax Foundation observes:

It is obvious that the absence of a major tax is a dominant factor in vaulting many of these 10 states to the top of the

rankings. Property taxes and unemployment insurance taxes are levied in every state, but there are several states that do without one or more of the major taxes: the corporate tax, the individual income tax, or the sales tax.

In particular, the methodology weighs heavily against income tax states. The index consists of five components, each of which is weighted differently. The individual income tax receives a weighting of 33.1 percent; followed by the sales tax, 24.1 percent; corporate tax, 20.3 percent; property tax, 14.1 percent; and unemployment insurance tax, 11.1 percent. Overall, the study uses 118 variables to create the comprehensive index.

Individual Income Tax. On this measure, which accounts for nearly one-third of the overall index score, Washington ties Alaska, Florida, Nevada, South Dakota, and Wyoming for No. 1. The individual income tax is important to business for two reasons, according to the Tax Foundation. First, "a significant number of businesses, including sole proprietorships, partnerships and S-corporations, report their income through the individual income tax code" (a point made in our analysis of the Initiative 1098 income tax proposal). Second, individual income taxes affect labor costs.

Indeed, as noted in our analysis of Initiative 1098, states with steep progressive income tax rates have been substantial losers in the competition for jobs and investment.

Corporate Tax. Washington's business and occupation (B&O) tax is treated as a corporate tax for purposes of the ranking. On the corporate tax component, which accounts for 20.3 percent of the overall index score, Washington ranks No. 30.

The Tax Foundation points out that the number of states with gross receipts taxes (like our B&O tax) is growing. Such taxes have a pyramiding problem. As the Foundation notes, "Since gross receipts taxes are

levied many times in the production process, the effective tax rate on a product is much higher than the statutory rate would suggest.”

In *Clarifying Tax Preferences*, a WRC policy brief published last spring, we noted that many of Washington’s tax exemptions are designed to minimize the pyramiding associated with taxing business inputs in the manner described by the Tax Foundation. In that brief, we noted the similar conclusion reached by the Washington Tax Structure Study Committee (the Gates Committee) that

Our B&O tax is a dramatic violator of the principle of neutrality among like businesses. The pyramiding of this tax on goods as they move through the production chain is a fundamental problem that requires correction.

Sales Tax. Washington comes in near the bottom, No. 48, in the sales tax component, which accounts for 21.4 percent of the overall index. In its discussion of sales taxes, the Tax Foundation again cites the pyramiding problem in Washington and a handful of other states: “Hawaii, New Mexico, Washington and South Dakota are examples of states that tax many business inputs.” The problem, of course, would be many times worse were it not for the exemptions currently in place for machinery and equipment and other intensive capital inputs.

Property Tax. On the property tax component, which accounts for 14.1 percent of the index score, Washington ranks near the middle, No. 22.

Unemployment Insurance (UI). Last year’s unemployment insurance reforms may, over time, improve Washington’s ranking on the UI index, which represents just 11.1 percent of the overall index score. For this year, the Tax Foundation ranks Washington No. 18, but dings the state for having the nation’s highest taxable wage base.

Discussion

It’s important to read the Tax Foundation report as one useful barometer of the business tax climate. A complementary approach is taken by the Council on State Taxation (COST).

Each year, COST engages the accounting firm Ernst & Young to prepare a report comparing state and local taxation of businesses across the 50 states. In the most recent analysis, published in July 2011, Ernst & Young reported that state and local business taxes in Washington amount to 5.4 percent of Gross State Product (GSP). This is significantly

higher than the U.S. average of 5.0 percent, and much higher than the burden imposed by neighboring states. In Oregon, the business tax share of GSP is 3.8 percent; in Idaho, 4.3 percent.

A number of factors come into play in achieving and maintaining a competitive business climate. Tax policy is one of the most critical; and, as the Tax Foundation emphasizes, it can be manipulated quickly. Education and infrastructure improvements, conversely, though vitally important, may take years to yield benefits.

In the first month of the legislative session, lawmakers have proposed new personal and business income taxes, a capital gains tax, and an extension of the sales tax to personal and professional services. Each of these proposals would increase the share of taxes paid by businesses, increase employer costs, and lower our ranking on the Tax Foundation index, making Washington less competitive for job creation and investment.