POLICY brief

Washington Research Council

PB 03-11 ***November 4, 2003***

The Bad News Is The Good News Is Wrong

BRIEFLY

Two recent national studies of state business tax climates fixate on income taxes and miss much of the real story.

In recent months two national studies have given high marks to Washington's business climate. The Washington D.C.-based Small Business Survival Committee's Small Business Survival Index ranks Washington as the 8th "most entrepreneur-friendly" state. Focusing more narrowly, the Tax Foundation's State Business Tax Climate Index, ranks Washington's tax system the 8th best. These results are surprising. And they are wrong.

As we show below, the Small Business Survival Committee and the Tax Foundation indexes both see income taxes as the predominant factors undermining state business climates. Washington ranks favorably in both indexes because the state has neither a personal nor a corporate income tax.

Income taxes, however, account for only 15 percent of state and local taxes on business. A paper by Ernst and Young prepared for The Council on State Taxation estimates that state and local governments altogether collected taxes totaling $428.3 billion from businesses in fiscal year 2003. Property taxes represented 36 percent of the total; general sales taxes, 18 percent; excise and gross receipts taxes (including Washington's B&O), 17 percent; corporate income taxes, 8 percent; personal income taxes, 7 percent. (See Chart 1.)

Thus, analysts who fixate on income taxes miss much of the real story.

Moreover, state business climates encompass many dimensions beyond tax systems. Over the past three years, the Research Council has interviewed a large number of Washington State business leaders to gauge how they believe the state stacks up against other states as a place to do business. The general opinion: Washington does not stack up well. They identify transportation, regulation and education in addition to taxation as major business climate issues for the state.

With regard to taxes, the Research Council has long believed that the overall level of state and local taxes on business is a key indicator of the tax climate, independent of the particular mix of taxes imposed.

In the course of our interviews, many multi-state businesses reported paying higher taxes on operations in Washington State than on comparable operations in other states. Studies comparing burdens across states confirm that businesses pay higher state and local taxes in Washington than in most states, largely because of our business and

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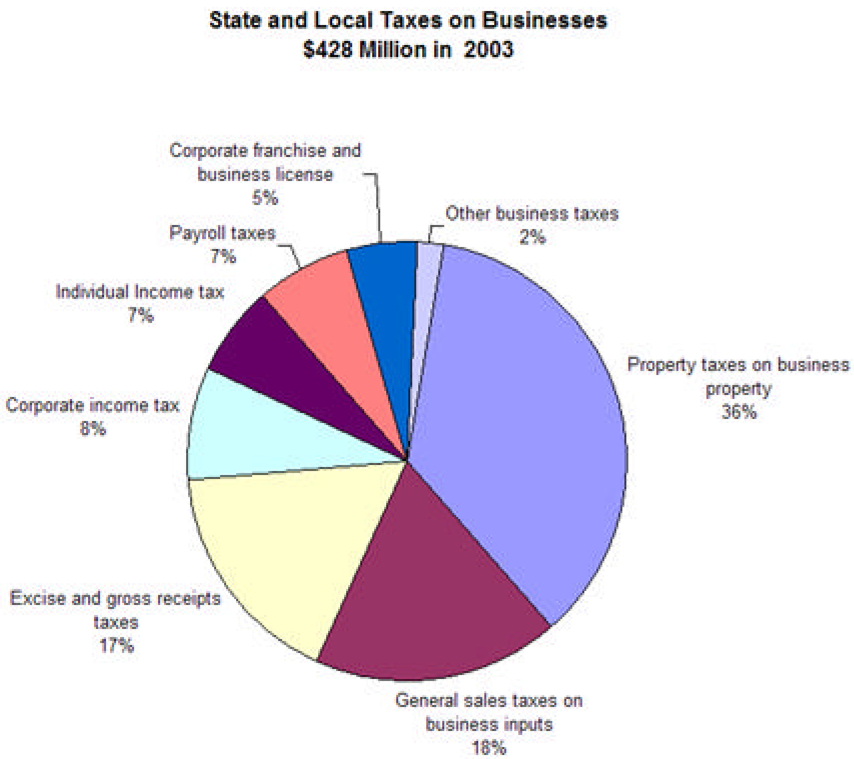
Chart 1:



Source: The Council on State Taxation

occupation tax. For example, a 1997 study by the Institute on Taxation and Economic Policy (prepared for a number of Oregon labor unions) ranked Washington 4th highest in the share of taxes paid by business. The Utah State Tax Commission's tax burden studies (which focus on western states) tell essentially the same story. Neither the Tax Foundation nor the Small Business Survival Committee considers business's share of the state and local tax burden as a factor in assessing state business tax climates, and both indexes are weaker for this omission.

The State Business Tax Climate Index

The Tax Foundation's State Business Tax Climate Index (BTCI) is constructed as the average of five "major" indexes:

- The Corporate Income Tax Index
- The Individual Income Tax Index
- The Sales and Gross Receipts Tax Index
- The Fiscal Balance Index
- The Tax Base Conformity Index

Each of these major indexes is in turn the average of two to six sub-indexes. And each sub-index in turn is the average of one to five variables. The variables are constructed so that in each case the best state gets a value of ten and the worst state gets a value of zero. Scaling in this way assures that each variable has roughly the same degree of variation, which is important when the variables are averaged to create an index.

One striking omission is the property tax. Although the property tax is the largest single tax imposed on business by state and local government, it does not enter into the BTCI. The taxation of business property at a higher rate than residential property (the issue of the "split roll") has long been a major concern to the business community and a comprehensive index of state business tax climate should capture the taxation of business property. Washington's constitutional requirement for tax uniformity would doubtless earn the state a more favorable tax ranking were the property tax to be included.

Besides the omission of the property tax, the most obvious problem with the BTCI from a Washington state perspective relates to income taxation. Although the corporate and individual income taxes represent less than 20 percent of the business tax burden, they account for 60 percent of the BTCI. Three of the five major indexes are based on the income tax: the corporate and individual income tax indexes, obviously, and the tax base conformity index, which measures how well a state's corporate and individual income taxes conform to other state's and the federal systems. A state with neither a personal nor a corporate income tax (like Washington) gets a perfect "10" on each of these three major indexes.

The BTCI captures Washington's major business tax, the business and occupation tax, within the sales and gross receipts tax index. With the inclusion of the B&O, Washington ranks 50th in the sales and gross receipts tax index, with a score of 2.37. Still, it's three against one. The state's "best in the nation" scores on the three income tax related major indexes swamp the "worst in the nation" score on the sales tax index.

Most Washington businesses view the B&O as a form of business income tax, albeit one that does not allow the deduction of the basic costs of doing business. As an income tax it lacks the one virtue of the typical state income tax: B&O liability does not go to zero in years when a business fails to earn a profit.

The Research Council estimates that the burden of the B&O tax is comparable to an 11 percent corporate income tax and an 11 percent individual income tax applied to non-corporate business profits. (It would take a 15 percent corporate income tax to replace the revenue the state gets from the B&O, which applies to both corporate and non-corporate businesses.)

Aside from this over-weighting issue, the corporate income tax index and the index themselves are seriously flawed.

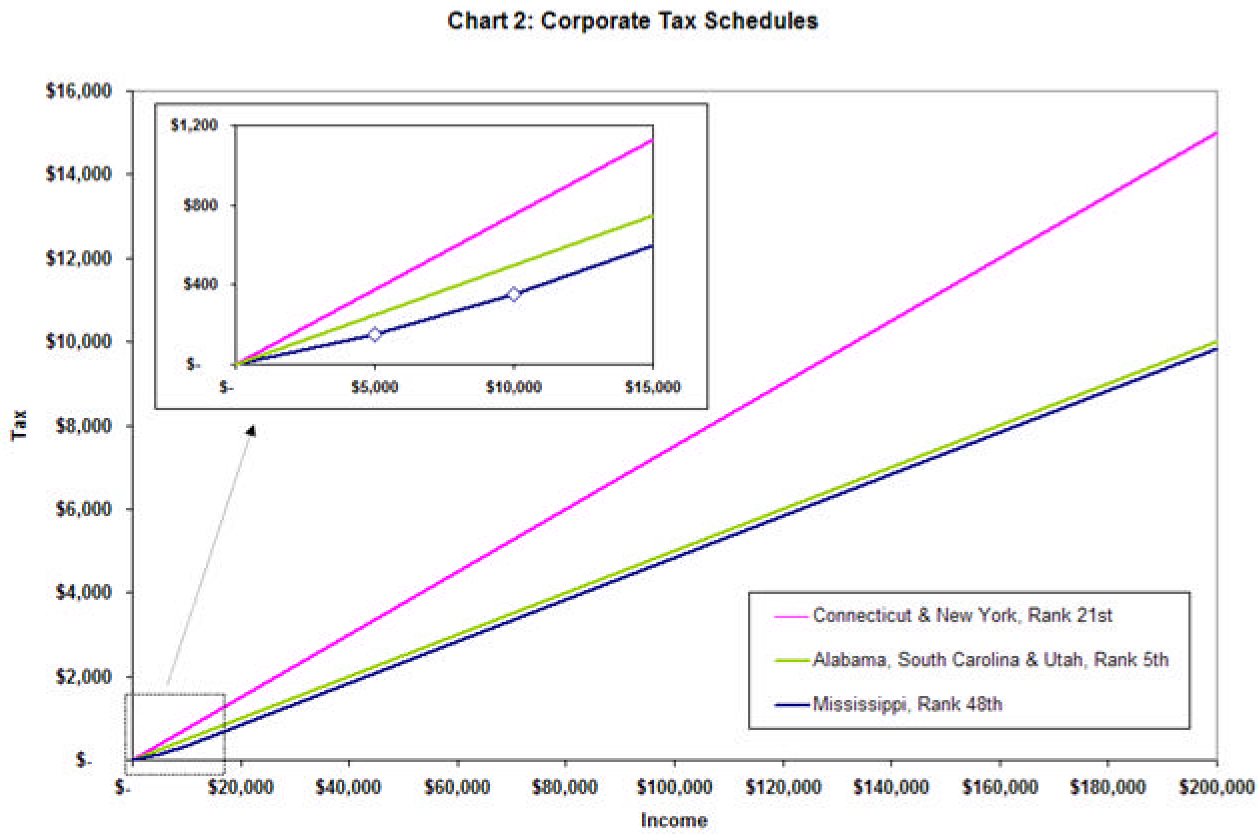
<u>Corporate Income Tax Index:</u>

The corporate income tax index is the average of four sub-indexes related to states' schedules of corporate income tax rates:

- The top rate
- The income level at which the top rate kicks in
- The number of brackets
- The average width of the brackets

The top corporate rate, which is by far the most significant of these four factors, accounts for only a quarter of the corporate tax rate index. This relatively low weight placed on the top marginal rates results in some perverse results, well illustrated by the treatment of Mississippi.

The corporate income tax index ranks Mississippi 48th among the 50 states, with a score of 3.79. In Mississippi, the first $5,000 of income is taxed at a 3 percent rate. The second $5,000 is taxed at 4 percent, and all additional income is taxed at 5 percent. Mississippi's 5 percent top rate is less than the top rates of 37 other states. The state is marked down because it has multiple rates, because the top



Source: The Tax Foundation

rate kicks in at a relatively low income-threshold, and because the average width of its tax brackets is relatively small.

Mississippi's extremely low ranking is silly.

This is demonstrated by Chart 2, on which we have plotted state corporate taxes due as a function of income for Mississippi and five other states: Alabama, Connecticut, New York, South Carolina and Utah. Alabama, South Carolina, and Utah tax corporate income at a flat 5 percent rate. The states tie for 5th best in the corporate income tax index with a score of 9. However, at every level of income Mississippi's tax schedule imposes a smaller tax than the flat 5 percent schedule does and is clearly better for business.

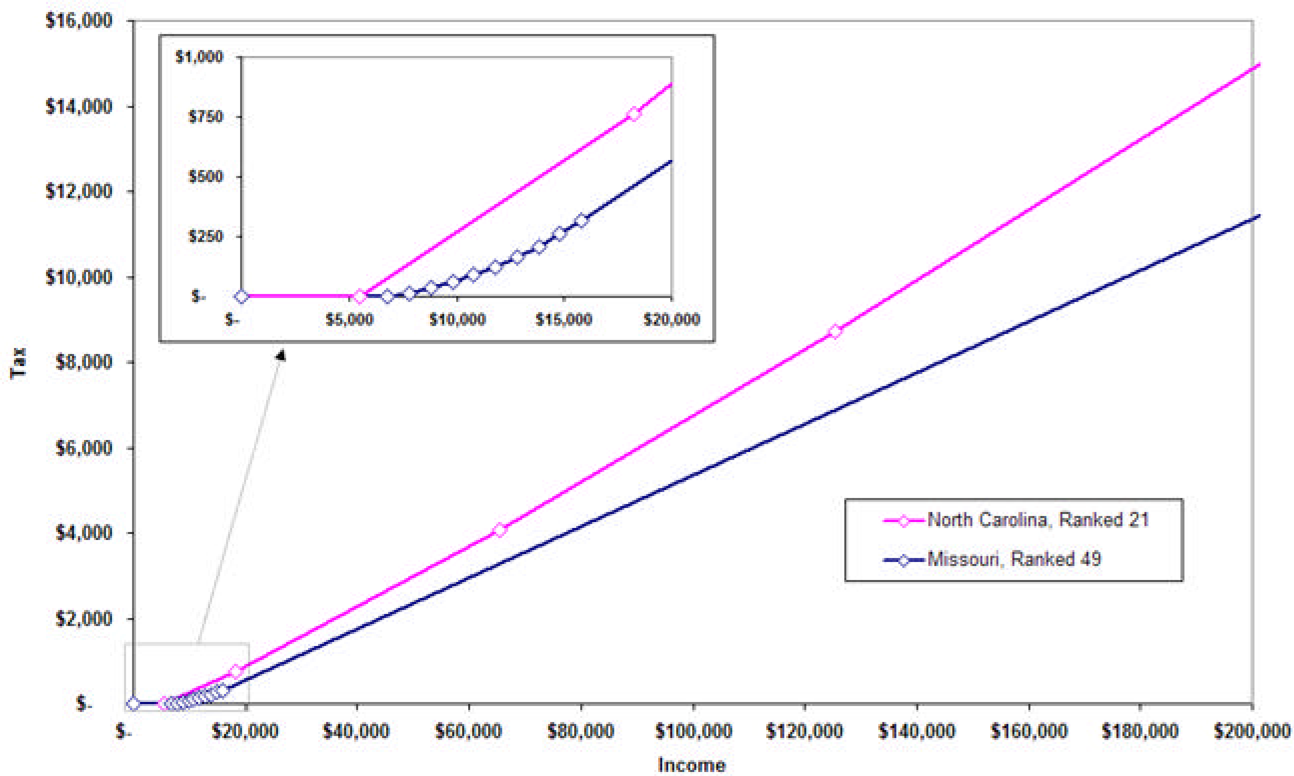
Connecticut and New York impose flat 7.5 percent corporate income taxes. The Tax Foundation corporate income tax index ranks these states 21st with a score of 8.63. At all income levels the burden in these states exceeds the Mississippi burden by more than 50 percent.

Personal Income Tax Index

Like the corporate income tax index, the personal income tax index is built up from 4 sub-indexes:

- The top rate
- The income level at which the top rate kicks in

Chart 3: Individual Income Tax



Source: The Tax Foundation

- The number of brackets
- The average width of the brackets

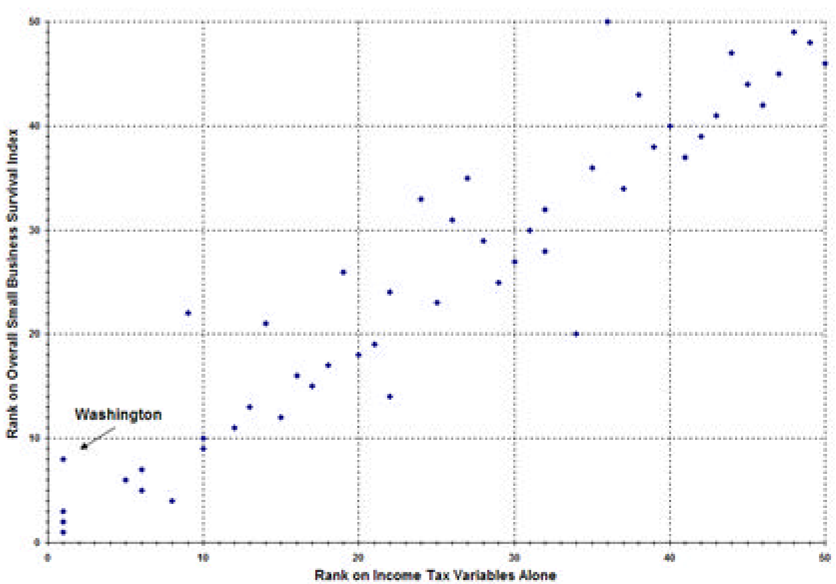
Again, the top rate accounts for only one-quarter of the index and the underweighting of the top rate results in perverse state rankings. Compare, for example Missouri, which scores 1.39 on the individual income tax index, ranking 49th with North Carolina, scoring 4.40 and ranking 21st.

We have graphed taxes against income for these two states in Chart 3. A Missouri taxpayer taking one personal exemption (this is the taxpayer that the Tax Foundation uses when comparing schedules) pays no taxes on the first $6,800 of income. The marginal rate is 1.5 percent for income from $6,800 to $7,800, 2.0 percent from $7,800 to $8,800, 2.5 percent from $8,800 to $9,800, and so on until the marginal rate reaches 6.0 percent for income greater that $15,800, from which point the rate remains constant.

A North Carolina taxpayer pays no tax on the first $5,500 of income. From $5,500 to $18,250 the marginal rate is 6 percent; from $18,250 to $65,500 the marginal rate is 7.0 percent; from $65,500 to $125,500 the marginal rate is 7.75 percent; above $125,500 the marginal rate is 8.25 percent.

Missouri's top rate is less than North Carolina's. However, the Tax Foundation ranks Missouri's individual income tax below North Carolina's because that state's top rate kicks in at a higher income level; it has fewer

Chart 5: Overall Ranking vs. Ranking on the Income Tax Sub-Index



Source: Small Business Survival Committee, WRC Calculations

brackets; and its average bracket is wider. This is silly. For every possible income, the Missouri tax schedule imposes a smaller tax bill (and a smaller marginal tax rate) than the North Carolina schedule.

The Small Business Survival Index

The Small Business Survival Committee constructs the Small Business Survival Index (SBSI) by summing together 21 separate variables, intended to capture "some of the major government-imposed or government-related costs impacting investment, entrepreneurship, and business." These 21 variables are listed in the appendix.

The Committee makes no explicit attempt to weight the variables when aggregating them into SBSI. Rather, as they note, the variables "are simply added together . . . into one index number."

Of the 21 variables, 13 are tax related. These include 6 income tax variables and single variables relating to property taxes, sales and gross receipts taxes, inheritance taxes, unemployment insurance taxes, Internet taxes, gas taxes and whether a supermajority vote is required to raise taxes. The index thus is primarily a tax climate index.

As indicated in Chart 4, the average (mean) value of the index across the 50 states is 43.24. The maximum value is 57.60; the minimum is 22.99. (Lower is better.) The standard deviation, which is a measure of the amount that the typical state's value for the index varies from the average, is 8.24. Washington's SBSI value is 33.21, which ranks 8th best.

With six of its 21 variables related to the income tax, the SBBI is clearly income-tax-centric. The income tax variables, however, drive the state rankings by even more than the 6 of 21 proportion suggests. To understand how this is so, it is useful to decompose the overall SBSI into two sub-indexes: an *income tax sub-index* (ITSI), which sums the six SBSI variables related to income taxation, and an *everything-else sub-index* (EESI), which sums the other 15 variables.

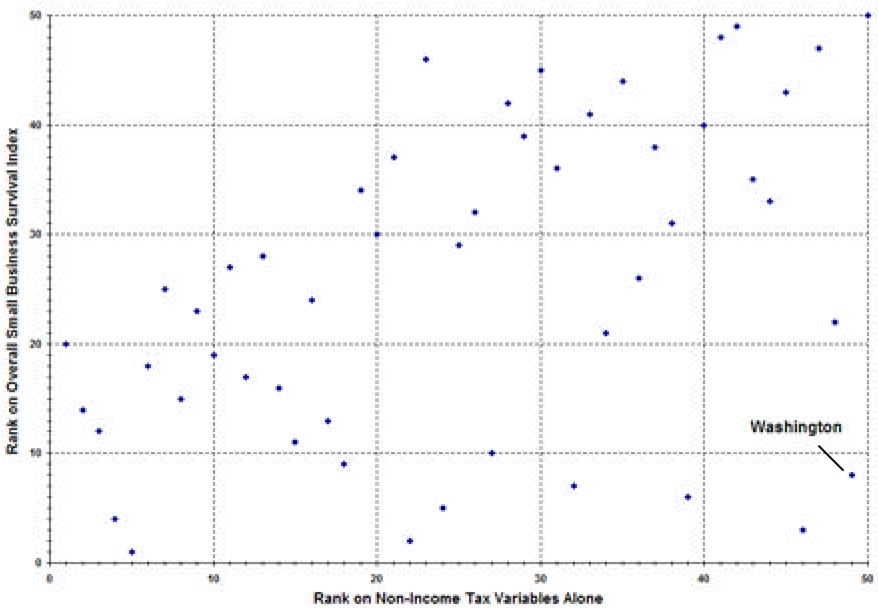
Chart 4: Summary Statistics

	Small Business Survival Index	Income Tax Sub-Index	Everything Else Sub-Index
Mean	43.42	17.63	25.78
Sandard Deviation	8.24	7.76	2.84
Maximum	57.60	29.44	34.70
Minimum	22.99	0.00	20.05

Source: Small Business Survival Committee, WRC Calculations

Chart 4 provides summary statistics on the two sub-indexes. The ITSI has an average value of 17.6; it ranges from 0 to 29.4 and has a standard deviation of 7.8. The EESI has a higher average value, 25.8, but shows much less variation ranging from 20.05 to 34.70, and a standard deviation of 2.84. As Washington has no individual or corporate income tax, the state's ITSI value is 0, ranking first, in a tie with three other

Chart 6: Overall Rankings vs. Ranking on the Everything Else Sub-Index



Source: Small Business Survival Committee, WRC Calculations

states. Washington's value for the EESI is 33.21, which ranks 49th among the 50 states.

The variation among states in the ITSI is much greater than the variation in EESI. Because of this, the ranking of states by the income tax sub-index substantially determines the ranking by the overall SBSI. Charts 5 and 6 illustrate this. On Chart 5 we have plotted each state's rank on the SBSI index against its rank on the ITSI, while on Chart 6 we have plotted the overall rank against the EESI rank. The points on Chart 6 are tightly bunched along the diagonal, indicating a tight relationship between a state's rank on the overall SBSI and its rank on the income tax sub-index. In contrast, the points on Charts 6 are more broadly scattered. The correlation between the ITSI ranking and the SBSI ranking is very high, 0.946. The correlation between the EESI and the SBSI is much lower, 0.447.

The dominance of the income tax in determining the overall ranking is confirmed by the way Washington is ranked: 1st in the income tax sub-index and 49th in the everything-else sub-index combine to 8th in the overall SBSI.

Comment

With our economy still suffering from the effects of recession, we would welcome the opportunity to celebrate good news about the business climate. Indeed, Washington policymakers have made progress in a number of areas, including transportation, fiscal policy, unemployment insurance, and regulation. The recent Washington Alliance for a Competitive Economy report, "Accelerating Out of the Turn" (posted on the Research Council's website, (www.researchcouncil.org) identifies some specific policy changes made by the administration and legislature over the past year.

But it's a mistake to manufacture good news from faulty data. Improvement begins with honest assessment, and the two reports discussed here misrepresent our state tax structure. The reports represent an unfortunate lapse by two business-friendly research groups, one we hope will not be repeated.

Both the Small Business Survival Committee and the Tax Foundation have well-deserved reputations for producing quality work. It is therefore frustrating that these two indexes fall so far short of the mark. Both organizations intend to update their indexes in 2004. We hope that the criticisms offered here will contribute to their improvement. A good index of business tax climate would be very valuable to those of us struggling to improve state business conditions.

Still, interstate comparisons are hard to do right. The broader the scope of the comparison the greater the difficulty becomes. Tax systems are particularly idiosyncratic, and the devil truly is in the details. Witness the difficulty out-of-state analysts have with Washington's unique business and occupation tax.

Both the Small Business Survival Committee and the Tax Foundation try to derive a single number that will serve as the index of state business climate. This may be an impossible goal. A set of policies that is ideal for one industry can be bad for another industry. A better approach, then, would be to offer a range of indicators rather than a single index.

Sources

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Keating, Raymond J., *Small Business Survival Index 2003: Ranking the Policy Environment for Entrepreneurship Across the Nation*, Small Business Survival Committee, September 2003. (http://www.sbsc.org/Media/pdf/SBSI2003.pdf)

Appendix: Variables Included in the Small Business Survival Index

1 Top personal income tax rate
2 Top capital gains tax rate
3 Top corporate income tax rate
4 Has individual alternative minimum tax*
5 Has corporate alternative minimum tax*
6 Personal income tax rates Indexed for inflation*
7 Property taxes as a share of personal income
8 Sales and gross receipts taxes as a share of personal income
9 Has estate tax beyond the federal pick-up tax*
10 Unemployment tax rate
11 Health care cost index
12 Electricity cost index
13 Workers' compensation benefits per $100 of covered wages
14 Crime rate
15 Has no right-to-work law*
16 Full-time equivalent government employees per 100 residents
17 Supermajority required to increase taxes*
18 Has internet access tax*
19 Gas tax rate
20 State minimum wage
21 Legal liability system index

*1 if true, 0 otherwise
For a more complete description of the variables see: http://www.sbsc.org/Media/pdf/SBSI2003.pdf

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