Tax Foundation's Business Climate Rankings a Poor Guide for Lawmakers

By Wesley Tharpe, Policy Analyst

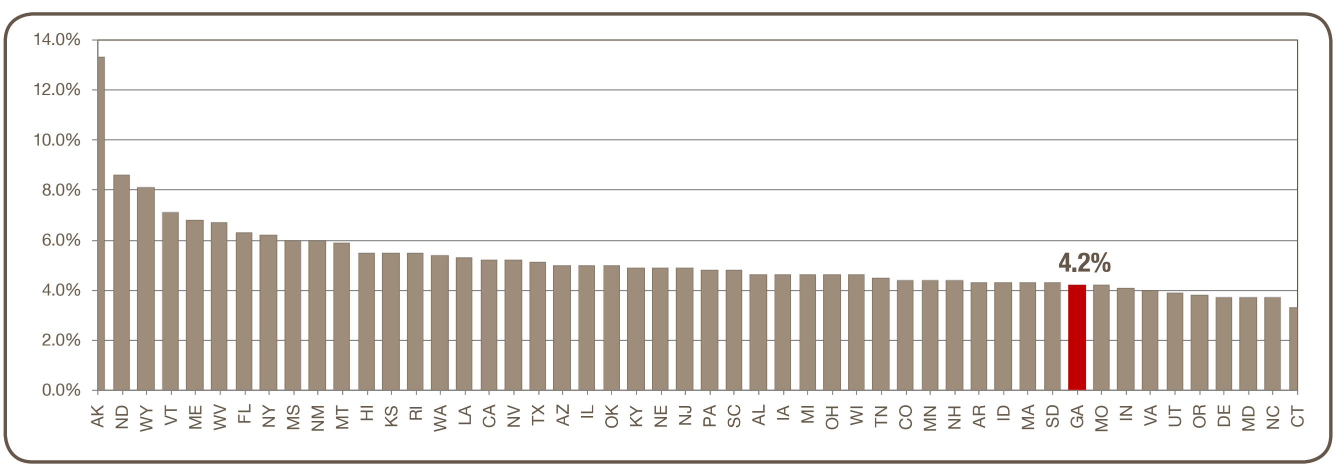
By essentially any measure, Georgia is a low-tax, low-regulation, business-friendly state. So, why does Georgia's business tax climate rank 34th in the nation in the Tax Foundation's latest report?

The Tax Foundation's 2012 *State Business Tax Climate Index* depicts Georgia's tax system as a greater hindrance to business than tax climates in other states; but, there are serious problems with the report. Most importantly, its rankings do not provide an accurate measure of Georgia's true business tax burden, which is actually quite low. There should be no greater priority for Georgia policymakers than to take actions that create jobs, protect the middle class, and build a strong economy for all. The Tax Foundation's rankings present a detour from where the state should go and Georgia lawmakers should disregard them as guideposts for sound tax policy.

True Picture of Georgia's Business Tax Climate

In FY 2010 Georgia collected less revenue per capita than all other states except South Carolina, according to analysis by Georgia State University's Fiscal Research Center.[1] Meanwhile, a 2011 report by Forbes Magazine identified Georgia as having the 11th best business environment and the 3rd best regulatory environment.[2] For decades, lawmakers have worked to keep Georgia's business costs low via the relatively-low income tax rates and assortment of business tax credits and deductions. In fact, the level of taxes that Georgia businesses pay relative to the state's economy is 41st in the nation, as shown by a 2011 report from the nonpartisan Council on State Taxation (COST).

Georgia Business Taxes Rank Low as % of Gross State Product



Source: Council on State Taxation (COST), "Total State & Local Business Taxes Paid: July 2011"

Tax Foundation Rankings Based on Flawed, Subjective Methods

Since Georgia's business tax burden is relatively low, why does the state rank poorly in the Tax Foundation's eyes? The reason is essentially that **the Tax Foundation does not measure how much taxes businesses *actually* pay**. Instead, the rankings use a complicated index of 118 variables to subjectively evaluate a state's tax structure, looking at aspects like the level of corporate and personal income tax rates, the number of brackets in the code, and the degree to which states offer credits and incentives. The organization describes this clearly in the report, noting that "The [index] does not measure business tax burdens. While it is unquestionably important how much revenue states collect in business taxes, the manner in which they extract tax revenue is also important… The [index] does not allow states with poor business tax regimes to hide behind low business tax burdens."

There are three main problems with this approach:

1. **The rankings seem to arbitrarily value certain areas of tax policy over others.**
   For example, states are penalized based on the number of brackets they employ, despite a complete lack of evidence that multiple brackets are an "economic drag" (as the Tax Foundation describes them) on businesses or growth. The rankings also ignore such key questions as the deductibility of federal taxes or the type of apportionment formula used, which arguably have a much higher impact on business costs than small differences in marginal tax rates or bracket structure.[3] Additionally, the index includes penalties for "top income tax rates that kick in at high income levels" and the "throwback rule" for taxing interstate sales, both of which are viewed as key components of sound tax policy by nonpartisan groups like the Institute on Taxation and Economic Policy and Center on Budget and Policy Priorities.

2. **The rankings appear to confuse their stated goal of tax "neutrality" with the idea that lower tax rates are inherently better.**
   A widely accepted tenet of good tax policy is tax neutrality, which occurs when governments avoid incentives that alter business or personal behavior, such as locating a company in one place versus another. The Tax Foundation's rankings wrongly equate neutrality with the philosophy that lower (or nonexistent) state taxes are always better. As a result, the rankings elevate states with low, flat tax structures while penalizing those with relatively higher, graduated ones. States that have abolished their income taxes entirely, such as Florida and Nevada, rank highly in the report, while those like New York and Wisconsin with more traditional, graduated systems rank poorly. As described in the report, the "dominant factor vaulting many" states is the absence of a major tax (such as individual income or corporate income tax). However this focus on replacing or eliminating major taxes runs contrary to the National Conference on State Legislatures, which includes among its core revenue principles that "a high-quality revenue system relies on a balanced variety of revenue sources."[4]

3. **The rankings rely on unsupported economic dogma about the importance of business taxes.**
   As the Tax Foundation describes it, states "with lower tax costs will be more attractive to business investment, and more likely to experience economic growth." However, the idea that taxes are the primary driver of business decision-making or a state's economic health is poorly supported by the evidence. State economies rely on numerous factors including the availability of skilled labor, the quality of education, and the presence of well-maintained infrastructure—all of which business leaders take into account when deciding where to invest. A state with low taxes might enjoy an edge in one area while being dragged down by low investments in another (e.g. minimal spending on amenities and services leading to a poor quality of life). One of the scholars cited frequently in the Tax Foundation report, Michael Wasylenko, stated: "Taxes do not appear to have a substantial effect on economic activity among states." [5]

Conclusion

The Tax Foundation's business climate rankings are not a meaningful measure of a state's overall business friendliness. The rankings do not actually measure how much businesses pay; they reward and penalize states along arbitrary and subjective lines; and, they rest upon an unproven foundation of economic assumptions. Perhaps most important, even if the rankings were devoid of flaws in their methodology, they would still reinforce the misguided view that small differences in state tax levels are the primary concern for businesses.

The 2010 Special Council on Tax Reform and Fairness for Georgians report stated: "Research on business firm location finds that while taxes matter, other factors seem to play a larger role. Factors such as functioning transportation systems, availability of water, and the quality of public education are more important components of the decision making process." Corporations, small businesses and entrepreneurs look at many factors when determining when and where to invest, and taxes are only a small part. An educated workforce, well-maintained infrastructure, and an attractive quality of life are essential, and states must invest in them in order to attract and maintain the businesses of the future. Rather than embracing a flawed ranking to push for further cuts to Georgia's already-low taxes, lawmakers should take a balanced approach by keeping Georgia's taxes competitive while also investing in important drivers of job creation and economic growth.

Endnotes

[1] "Comparing Georgia's Revenue Portfolio to Regional and National Peers," Georgia State University Fiscal Research Center. January 2011.

[2] "The Best State for Business and Careers," Forbes Magazine. 2011.

[3] Each state's income tax law includes an apportionment formula that determines how much tax can be collected from multistate corporations. In most states, the formula is based on how much property, payroll and sales a company has in that state. But Georgia is one of 17 states with a system known as single-sales-factor apportionment, which means that companies are only taxed based on their in-state sales. This is generally considered a sizable tax benefit to businesses.

[4] "Principles of a High Quality Revenue System," National Conference of State Legislatures (NCSL).Accessed January 31, 2012.

[5] "Total State and Local Business Taxes Paid: July 2011," Council on State Taxation.

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