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Making Sense of The 2007 Tax Foundation *State Business Tax Climate Index*

In February, the release of the Tax Foundation's 2006 *State Business Tax Climate Index* was greeted with considerable enthusiasm in Harrisburg. In particular, Governor Rendell seized upon its ranking of Pennsylvania at 16th among the 50 states to claim that his administration's policies had significantly improved the state's business tax environment. A closer look at the study, however, revealed that the positive features of Pennsylvania's business tax climate cited by the Tax Foundation, such as the rate structure and bases of several key state business taxes, long pre-dated the Rendell Administration. Furthermore, the Tax Foundation's analysis also pointed to several glaring weaknesses in Pennsylvania's business tax system, with the state's corporate and wealth taxes standing out as significant deterrents to business activity.

Last week, the Tax Foundation released the 2007 *Index*, but its findings concerning Pennsylvania received considerably less fanfare than those contained in the previous year's edition. Due to changes in the study's methodology (which were applied to previously published editions as well), the 2007 *Index* ranked Pennsylvania's business tax climate 22nd among the 50 states and revised its 2006 ranking to 22nd—a six-state drop from the February ranking.

The 2007 *Index,* as did the 2006 edition, compares state business tax regimes in five "sub-indexes"—corporate taxes, individual income taxes, sales taxes, unemployment insurance taxes, and property (formerly termed wealth) taxes. As in the 2006 edition of the *Index*, Pennsylvania's primary strengths were, for the most part, related to rankings for the individual income tax (10th), unemployment insurance tax (13th) and sales tax (23rd). Its two weakest business tax areas were the corporate tax ranking (42nd) and property tax ranking (44th). It should also be noted that Pennsylvania's 2007 ranking represents an improvement of six positions over its 28th-place ranking of 2003. An upgrade in the sales tax ranking (from 27th in 2003 to 23rd in 2007) and the unemployment insurance tax ranking (from 43rd in 2003 to 13th in 2007) are the primary reasons for the overall ranking improvement.

The really controversial element in the Tax Foundation ranking scheme (in both the 2006 and 2007 editions of the *Index)* is that the five component indexes are weighted according to the variability of the 50 states' scores from the mean, with the components in which there is greater variability in the states' scores weighted more heavily. In the 2007

edition, the result of this weighting system is that the two highest-weighted sub-indexes (individual income tax and sales tax) comprise slightly more than 50 percent of the total weight, while the remaining three sub-indexes account for slightly less than 50 percent. With regard to Pennsylvania, the design of the Tax Foundation's weighting system has produced a situation in which the state's two weakest business tax areas (corporate and property taxes) are much less heavily weighted than two areas (individual income and sales taxes) on which its ratings are significantly higher.

The Tax Foundation argues that the states' scores are weighted in this manner because businesses give greater emphasis to areas of tax policy in which the differences between the states are large, and that those areas should receive relatively more weight in the *Index*. However, surveys of business people (both inside and outside Pennsylvania) have consistently found that the state's Corporate Net Income Tax (CNIT) and Capital Stock and Franchise Tax (CSFT) do receive greater emphasis as deterrents to business location and expansion than the more positive features of Pennsylvania's business tax climate receive as incentives for growth. In this case, the testimony of those individuals who must operate in Pennsylvania's business tax climate—as well as the state's continuing dismal economic performance—conflicts with the rationale behind the Tax Foundation's weighting system.

This dichotomy illustrates the limitations of the Tax Foundation state tax ranking system. If minor tweaking of the *Index* methodology can drop Pennsylvania's overall ranking from 16th to 22nd place for 2006, how can we be confident that further small improvements in that methodology will not send that ranking down a further 10 spots or raise it by an additional 5 in the future?

While the *Index* is undoubtedly complex and well-intentioned, a more direct approach is needed. In the first place, an overall business tax ranking for a state is not uniformly useful for all businesses. For instance, the needs of a start-up software firm will be different than those of a large, established financial institution. Likewise, a cyclical manufacturing firm with large real estate and fixed capital assets holdings does not have the same concerns as a fast-growing, labor-intensive medical records company.

Therefore, a better approach to understanding the impact of states' tax regimes on businesses would be to use representative examples of firms of various sizes in a variety of industries, with different ages and degrees of profitability, and actually calculate the tax liability for each state for each representative firm. Comparisons of state and local tax bills for the hypothetical firms would give businesses a good place to start estimating what their tax burdens would be in states they might be considering as sites for a new or relocated facility. Indeed, they or their consultants would undoubtedly go through the same calculations before making a decision about where to locate a facility.

Companies that need to worry about property taxes, gross receipts taxes, or other taxes not based on income will shy away from Pennsylvania if they are very low margin firms or expect to incur several years of losses during start-up. To those firms, the state's relatively low personal income tax rate will likely not be enough of an inducement to

compensate for the negative effect that non-income-based tax burdens will have on their operations.

Nevertheless, supporting information in the 2007 *Index* does provide policymakers interested in improving Pennsylvania's business tax climate with some important factors to consider. For instance, it points to Pennsylvania's 9.99 percent Corporate Net Income Tax rate (second only to Iowa among the states with such a tax) and its practice of limiting net loss carryforwards (one of only two states to do so) as real problems for the state. It also points out that the continued presence of the CSFT and the imposition of real estate transfer, intangible personal property, and inheritance taxes put Pennsylvania at a disadvantage (although the ongoing phase-out of the CSFT will likely contribute to future improvements in the state's ranking on this sub-index). These are clearly areas where the state must do better if it hopes to return to the type of economic growth that will keep its people from having to seek opportunities elsewhere.

Ultimately, whether Pennsylvania is 16th or 22nd or 35th on the Tax Foundation's *State Business Tax Climate Index* is largely irrelevant to businesses trying to decide whether or not to move to or remain in the Commonwealth. What matters most are the specific factors that each individual firm must use to gauge how it would actually fare in each state it might be considering as a potential location. Given Pennsylvania's recent paltry economic growth statistics, it is clear that many firms have decided that they would fare better elsewhere.

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