

**A Look at the:**



*Tax Foundation  
2008 Business Tax  
'Climate' Index*

**Why the Findings  
DON'T Add Up**

**EXECUTIVE SUMMARY**

William Driscoll and Howard Fleeter  
Education Tax Policy Institute

---

**A Look at the: "Tax Foundation 2008 Business Tax 'Climate' Index:"  
Why the Findings DON'T Add Up - EXECUTIVE SUMMARY**

---

**The Tax Foundation released its 2008 business tax climate index in the Fall of 2007. Ohio ranked 46<sup>th</sup> out of 50 states where the ranking proceeds from #1 as best to #50 as worst.**

The Tax Foundation report assigns a score to each state. The report claims that the score quantifies the State's business tax climate. Each state's final score results from the creation of scores from five areas of tax policy – corporate tax, personal income tax, sales and excise tax, property tax, and unemployment compensation tax. A separate "index" for each of these tax types results from two scores developed from the sub-indexes of rate structure and tax base for each of the five areas.

**The deeply flawed nature of the "research" behind the index appears in many ways.**

- 1)** The ranking system involves a process of assigning arbitrary weights to different aspects of each state's tax system. Not only does no research support the assignment of these weights, but the report does not even show the full distribution of those weights among the various parts of each tax system. As a result, readers have no opportunity to assess the details underlying the index.
- 2)** The Tax Foundation explicitly endorses anecdotal "evidence" as a sound basis for tax research.
- 3)** The ranking system intentionally excludes the one method of comparison used by other assessments of tax climates: relative per capita or per income tax burdens. Such comparisons of tax burdens rely upon objective measures of taxes rather than a subjective scoring system with its opportunities for manipulation.
- 4)** Four faults characterize the Tax Foundation index:

**A) Reduction of a Principle to Absurdity**

The business climate index rests upon the principle that the best taxes have a broad base and a low rate. In fact, most tax experts agree with this principle, but the Tax Foundation takes this general guideline to extreme lengths. For example, its comparison of State income taxes emphasizes rate structures. The comparison method rewards states

## **A Look at the: "Tax Foundation 2008 Business Tax 'Climate' Index:" Why the Findings DON'T Add Up - EXECUTIVE SUMMARY**

---

with flat rates and penalizes those with graduated rate structures. This rating method scores Oregon as a better tax climate state than Ohio because Oregon has fewer rate brackets and its highest rate engages at a much lower level of income compared to Ohio. The absurdity of Oregon's higher score appears in a comparison of the actual tax burdens imposed in the two states. At every income level, Oregon taxpayers pay higher income taxes than Ohioans. At incomes between \$40,000 and \$120,000, about one and one-half times the amount of Ohio income tax burdens. A simple rate structure has value. However, the amount of actual taxes paid is unquestionably the most important aspect of tax climate. To its detriment, the Tax Foundation index relies on the rate structure principles and ignores actual tax burdens.

### **B) Arbitrary Benchmarks**

The method used to rank state tax climates assigns different percentage weights to different parts of each tax system - corporate taxes, income taxes, sales taxes, property taxes, and unemployment taxes. Each of these parts of the tax system is divided into a tax rate division and a tax base division. The two divisions weigh equally. However, the application of this method to Ohio's property tax system shows how arbitrarily the method works. The "rate" division of the property tax actually compares per capita property taxes and property taxes as a percent of income. The property tax base division assigns a score based on whether a state does or does not levy seven specific kinds of taxes, such as intangible property taxes, inventory taxes, or estate taxes. The ranking index punishes a state for imposition of one or more of these taxes. Ohio does impose some of these taxes, but their total burden equals about \$1 billion. In contrast, the taxes considered in the property tax rate division raise \$13 billion. Yet, the Tax Foundation ranking method assigns equal weight to both divisions.

### **C) Emphasis on Some Principles While Ignoring Others**

The business climate index claims to follow the principle that taxes should employ low rates on the broadest possible base. However, the ranking method does not extend this principle beyond each individual tax to the whole tax structure of a state. Instead, it does the opposite. The ranking method rewards states for avoiding the use of a particular tax. For example, Oregon gets the highest possible sales tax score because it does not have a sales tax. Washington gets the highest possible income tax score because it does not have an income tax. Both states have relatively unbalanced systems in which the omission of one tax from the tax structure tends to require over-reliance on

## **A Look at the: "Tax Foundation 2008 Business Tax 'Climate' Index:" Why the Findings DON'T Add Up - EXECUTIVE SUMMARY**

---

another tax. Washington has relatively high sales taxes, and Oregon has relatively high income taxes. In fact, public finance experts recommend revenue systems in which a state balances reliance on different sources of revenue: consumption (sales and excise taxes), income, and wealth (property and estate taxes). Ohio's tax structure follows this principle. Indeed, the principle amounts to an extension of the notion that taxes should apply at low rates to a broad base. However, the Tax Foundation index punishes states like Ohio for following this principle.

### **D) Subjectivity of the Tax Climate Index**

In 2004, the Tax Foundation ranked Ohio 29th in its tax climate index. For 2006, the organization changed its method by dropping a sub-index based on a state's fiscal balance in favor of a wealth tax sub-index. The change dropped Ohio's rank from 29th to 49th although no change had occurred in the Ohio tax structure itself. The changes in the ranking method from 2004 to 2006 show the extent to which the Foundation's subjective selection of categories for comparisons and the weights used in them can be manipulated to make dramatic changes in states' rankings without any changes in the underlying reality of state tax structures.

## **CONCLUSION**

**The Tax Foundation business tax climate index provides a poor indication of Ohio's true tax situation.**

### **1) The index focuses on tax structure rather than actual tax burdens**

A state with a more attractive tax structure (at least in the eyes of the Tax Foundation) but higher actual taxes can receive a more favorable ranking than a state with a less attractive structure but lower taxes. This is completely contradictory to universally accepted economic theory regarding consumer and producer behavior. While the Foundation proudly proclaims that they are not attempting to compare tax burdens across states, this admission is the study's fatal flaw, as this is the only valid comparison to be made.

### **2) The actual construction of the tax climate index is based wholly on subjective judgments made by the Tax Foundation regarding the relative role of different factors**

---

## **A Look at the: "Tax Foundation 2008 Business Tax 'Climate' Index:" Why the Findings DON'T Add Up - EXECUTIVE SUMMARY**

---

In some cases different factors are weighted equally in a simple "check-off" fashion, creating a bias against states with more balanced tax systems. In other cases factors are weighted on the basis of the variability across states rather than the actual revenue importance, as would be the case in a more standard interstate tax analysis. This can lead to the result that a state which performs unfavorably on a low revenue tax with a wide variance can score lower than a state which performs unfavorably on a high revenue tax with lower variance. In dollar terms, which are the only terms that influence consumer and producer behavior, the second state truly has the less favorable tax climate though the Tax Foundation methodology would lead to the opposite result.

### **3) The methodology is inconsistent, and arguably irresponsible, in the extent to which it takes future tax changes *which have already been enacted* into account in its rankings.**

The Tax Foundation intentionally used the year 2008 in the title of this report, implying that readers should use the findings as they think ahead to future decisions. In light of this, the choice to not incorporate all known information about future tax changes which have already been enacted is both incomprehensible and indefensible.

### **4) Modification of the Tax Foundation Methodology shows great fluctuation in state rankings.**

The Tax Foundation has, perhaps inadvertently, performed a type of sensitivity analysis of its state ranking methodology. By modifying the methodology used to construct the rankings and then retrofitting the results to prior versions of the study the Tax Foundation has showed that the old method and the new method lead to very different assessments of the same state tax systems. While the Foundation might argue that the new methodology is now superior to the old, the reality is that both the old and new methodologies are based upon subjective, though differing, judgments about what is important and how it should be weighted. Close scrutiny, however, shows that neither methodology provides a reliable or useful measure of relative state tax climate.

**Based upon the above considerations, policymakers would be well-advised to rely upon more traditional methods for assessing comparative state taxes provided by analysts driven by objective motives rather than by ideological beliefs.**