Average Tax Levels Can Be Problematic

Business taxes are either the central or exclusive focus of the state business climate rankings. One might reasonably ask: Why don't we just measure what businesses pay in state and local taxes in each state, rather than creating complex business climate indexes? This is a reasonable question, and there is a standard metric that is commonly used to rank states: total state and local business taxes as a percentage of some measure of total business activity such as state Gross Domestic Product (GDP). This is a rough but reasonable measure of the the average effective tax rate on business income in a state, although it still can't predict the economic competitiveness of states.

There are complications, of course. Determining which taxes are taxes on businesses, as opposed to individuals, is not as straightforward as one might think. The first step is to determine which taxes are at least initially paid by businesses. For example, to measure the impact of sales taxes, the analysis must separate business purchases from consumer purchases. Individual income taxes are applied to wages and salaries, but also on business income from sole proprietorships, partnerships, limited liability companies (LLCs), and subchapter S corporations. A complete analysis should attempt to measure how much of the tax initially paid by business is passed on to consumers, or passed back onto workers in lower wages or property owners in lower prices.

Ernst and Young, in conjunction with the Council on State Taxation (COST), have been producing estimates of the state and local taxes falling on business, by state, for several years.[1] They take the approach of including all taxes where a business has the legal obligation of making the tax payment. They compute business taxes as a percent of state GDP. Similarly, the Anderson Economic Group publishes estimates of state and local taxes as a percentage of pre-tax profits, producing an average effective tax rate for each state.[2]

The point to be made here is that **it is possible to come up with reasonable estimates of the overall, average level of taxation of business by state. There is no need to create arbitrary and complicated scoring systems to rate the "tax climate," which allow much mischief to be hidden in the details of measurements and weighting, when a simple measure of tax levels is available.**

The more important issue, however, is whether even overall measures of the level of business taxation indicate anything about the *competitiveness* of a state for business investment. For a number of reasons detailed here we argue that they do not. Nor do they tell us anything useful about the relative taxes among states for any particular business. A new branch plant manufacturing auto parts, for example, could well face lower taxes in a state that has higher average taxes.

1. Andrew Phillips, Robert Cline, Thomas Neubig, and Hon Ming Quek. *Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2011.* Ernst and Young and the Council on State Taxation. July 2012.

2. Anderson Economic Group. *2015 State Business Tax Burden Rankings.* June 2015.
http://www.andersoneconomicgroup.com/Publications/StateBusinessTaxRankings.aspx