The SBTCI Bears No Relation to Actual Taxes on Business

The Tax Foundation claims the State Business Tax Climate Index (SBTCI) measures state tax competitiveness, but the index misses the mark.

There is little correlation between the SBTCI ranking and what businesses actually pay in state taxes. Consider the chart below. From top to bottom, it shows the states ranked by the 2021 SBTCI, with the states they consider most competitive at the top, least competitive at the bottom. Next to each state is its ranking according to one of the more defensible measures of state taxes actually paid by businesses — the Ernst and Young / Council on State Taxation (COST) annual ranking¹ — and there is little correlation between the two. For example, Connecticut ranks 47th on the SBTCI (fourth “worst” state) but 6th on COST (only 5 states had lower business taxes), and Nevada is 7th best on the SBTCI but 39th on COST.
In fact, of the Tax Foundation’s worst 7 states (those with the least competitive tax systems based on the SBTCI), 4 are among the 15 states with the lowest taxes on business according to COST.

In reality, how much businesses pay in state and local taxes in different states is the
combined result of multiple interacting features of the state, local and federal tax codes, including how the tax base is defined, the structure of tax rates, tax credits, and a myriad of rules. That’s why there is no better way of summarizing the effects of all these tax features than to measure what businesses actually pay, and this can be summarized by considering the total amount of taxes paid by businesses in a state as a percent of state GDP or some other measure of total business activity in the state. This is what COST and others typically do, but the Tax Foundation ignores this standard approach and instead adds together over 100 disparate features of the tax code, weighting them arbitrarily.

The Tax Foundation asserts that they are measuring “tax competitiveness,” and that this is different from business tax levels. But they provide no evidence that the specific tax features that comprise their “competitiveness index” matter to businesses apart from their effect on the bottom line – in other words, the level of taxes they pay. In defending the importance of the business tax climate in determining a state’s competitiveness they make this assertion: “Most importantly, taxes diminish profits…. A state with lower tax costs will be more attractive to business investment.” In other words, what matters is the tax level, which their index — by their own admission — does not measure.

In other places, the Tax Foundation seems to define its index rather differently: “We measure and rank tax structures, and this because the size of a tax is less important than the economic distortions it creates.” But again, their literature review is devoid of research showing that tax structure is important, and instead focuses on tax costs. In that same piece, they say: “Our index is a measure of how well each state conforms to the principles of sound tax policy: simplicity, neutrality, transparency, and stability.” While those are indeed generally accepted principles of good tax policy, along with revenue adequacy and fairness, nowhere does the Tax Foundation show that neutrality, transparency, or stability — however desirable from the perspective of a state’s citizens — have any role in a state’s ability to compete for business investment. Nor does their index measure transparency of state tax systems, which would require, for example, disclosure of the recipients of business tax incentives.

1. Total state and local business taxes: State-by-state estimates for FY19. Ernst and Young, the Council on State Taxation, and the State Tax Research Institute, October, 2020. Their measure is total business taxes as a percent of state GDP. It should be noted that total business taxes includes severance taxes, which are generally assumed to be paid by consumers. Including these as taxes on business inflates the business tax measure for states that rely heavily on severance taxes, notably North Dakota, Wyoming, New Mexico, and Alaska, all of which receive more than 10 percent of their tax revenue from severance taxes, including half or more in Alaska and North Dakota.
