To: CFED

From: Doug Hoffer

Date: 15 July 2007

Re: Comments on the Forbes business climate rankings

I would like to offer some comments about the Forbes magazine article with the business climate rankings that has been added to the members' packets for Monday July 16.

Rankings of this nature assume that there are a significant number of businesses moving (or interested in moving) from state to state. In fact, there is no public data on the interstate movement of businesses. Furthermore, such rankings assume that the job impacts of interstate business moves are substantial. Again, there is no public data to support this.[1]

Second, Forbes gave a very brief summary of the items included in each ranked category but did not provide the methodology. That is, exactly what measures were used and how were they weighted? Without such transparency, there is no way to evaluate these rankings. So how can anyone comment on them (favorably or otherwise) without knowing the answers to these questions?

In addition, the sources listed include at least two entities that have a decided bias. The Tax Foundation publishes the Small Business Tax Climate Index (SBTCI) and "tax burden" rankings. The former was examined in depth by a professor at the University of Iowa (to my knowledge, the only academic review of these types of rankings). In conclusion, he stated that

> *"There is no point, really, in trying to assess whether the SBTCI successfully predicts which states will do better in attracting business investment, creating jobs, or the like. If it does, it is purely by accident, for the index does not even measure the effect of a state's tax system on a firm's cost of doing business. Even if the index appeared to be correlated with growth, one could not conclude, as the Tax Foundation would like us to, that lower taxes cause growth. The index does not measure tax rates to begin with, or even correlate with relative business tax levels. As a tool for assessing public policy, it is fatally flawed, notwithstanding its carefully groomed appearance of plausibility and academic credentials (however spurious)."* [2]

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[1] A good deal of interstate business movement occurred in the `70s and `80s. However, most job losses are now due to shifts overseas. Thus, minor differences in business costs between states are now dwarfed by the labor cost advantages overseas.

[2] Fisher, Peter, "*Grading Places: What Do The Business Climate Rankings Really Tell Us*", Economic Policy Institute, 2005, pp.27-28. Fisher teaches at the Univ. of Iowa and is the part-time research director for the Iowa Policy Project. He is the co-author, with Alan Peters, of *Industrial Incentives: Competition Among American States and Cities* and *State Enterprise Zone Programs: Have they Worked?* (W.E. Upjohn Institute for Employment Research).

The Tax Foundation's tax burden rankings are also flawed because they measure only total taxes as a percent of total income. This ignores the distribution of the so-called "burden" and fails to capture the many variations in tax policy between states and the impact on different families and businesses.

Another Forbes source is the Pacific Research Institute (PRI), which is a well known "free market" advocate that believes government is the problem.

> *"PRI strives to change the perception of lawmakers and the public so that the starting point for any policy solution is a private, voluntary action, rather than unnecessary, and even harmful, government intervention."* [3]

Prof. Fisher also reviewed PRI's "Economic Freedom Index" in *Grading Places* and found that

> *Taxes represent "a government infringement on free markets," according to PRI. Even when taxes "correct inefficient prices" they "distort markets by changing the relative prices of goods and services." This will come as a surprise to economists, who have spent a great deal of effort developing the theory of market failure, which lays out the conditions under which markets fail to produce efficient outcomes and how government intervention to correct distorted prices improves economic efficiency. But in the world of PRI, there is no such thing as a good tax or, apparently, an inefficient unregulated market; the only thing that can render a market inefficient is government. Monopoly, market power, predatory pricing, collusion, price fixing, false advertising, insider trading—all these habits of unregulated capitalism are absent in PRI's free world.* [4]

Furthermore, PRI goes so far as to suggest that <u>any</u> type of transfer payments is suspect. In the "Welfare Spending Sector",

> *"PRI singles out welfare spending as the only component of state budgets (other than the judiciary) worthy of its own sector. It says it is not concerned about the purpose or merit of welfare programs, by which it means any transfer program (including food stamps, Medicare, and Social Security). Instead, PRI is concerned that "they are financed by an involuntary transfer of private assets; therefore, they reduce economic freedom."* [5]

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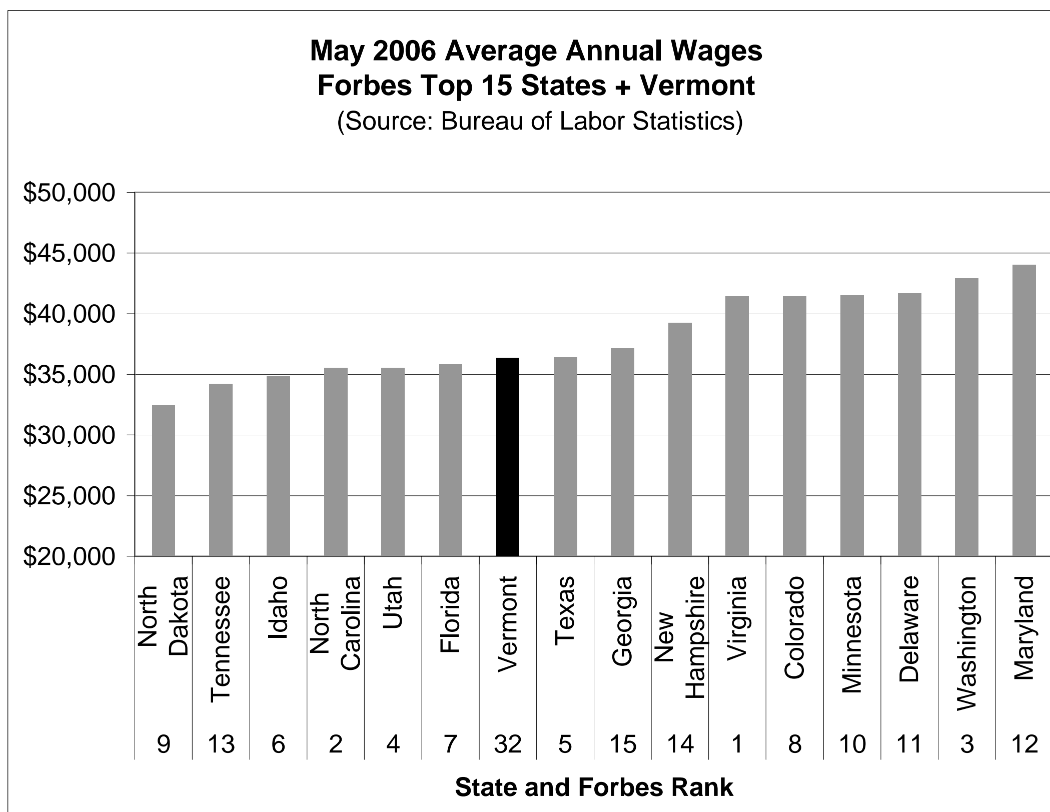
[3] Pacific Research Institute web site http://liberty.pacificresearch.org/about/id.81,type.1/default.asp
[4] Op cit., "Grading Places", pp.50-51.
[5] Op cit., "Grading Places", p.54

The point is that the Tax Foundation and the PRI have a clear agenda and the methodologies and data selected are intended to reach a preconceived outcome. This is not scholarship; it is advocacy. Indeed, that's why their work does not appear in peer reviewed publications. So while Forbes is certainly free to rely on such sources, it tells us a great deal about the biases inherent in these rankings.

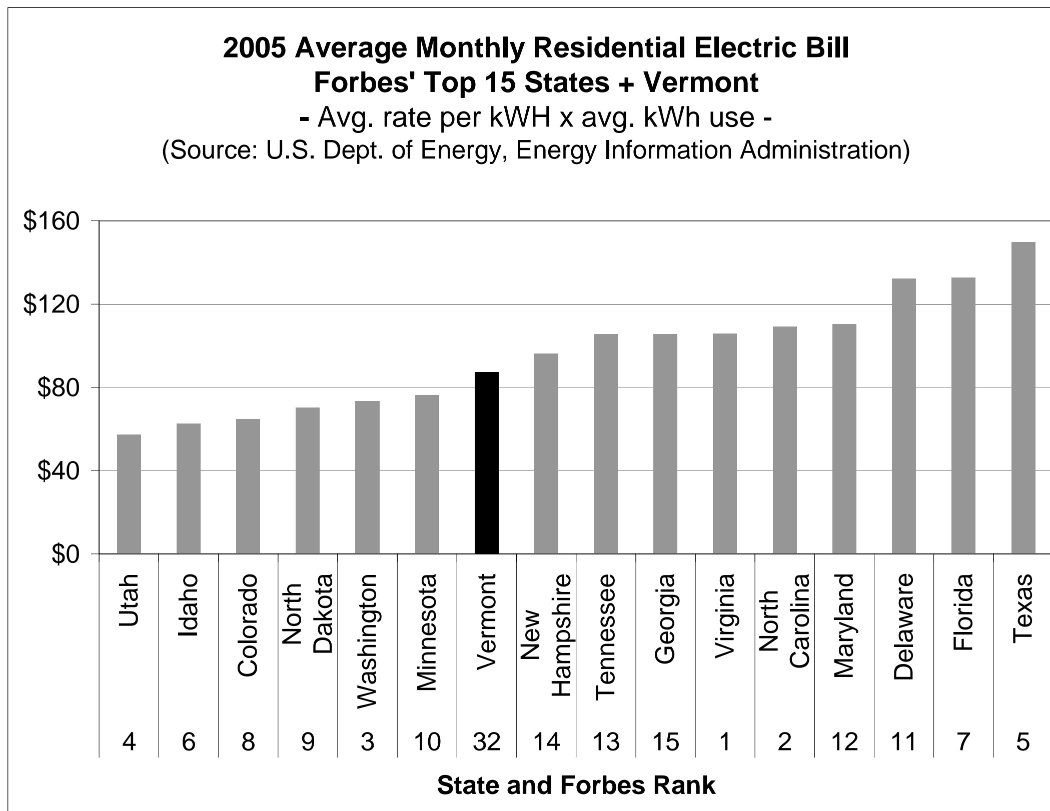
As for the Forbes rankings, one presumes that a good place to do business is a good place to work. Forbes assumes that lower labor costs are a good thing for business. But this is at odds with the premise of the "Labor" category, which rewards states for higher educational attainment in the workforce. But if businesses need a well educated workforce, why is it considered advantageous to pay them less? While this may benefit employers, it is hardly a good outcome for workers.

Another component of the "Labor" category is net migration (more is better). But why would highly educated workers choose to move to low wage states? If - as in Vermont - it's because of the great quality of life, this presents an internal contradiction. The elements of the "Quality of Life" category include (among others) schools, health, and crime, all of which are influenced by government spending. But government spending requires taxes; and taxes are bad. You can't have it both ways.

As noted above, the weighting of the elements in each category is unknown. This is evident in "Business Costs", which includes the costs of labor, energy, and taxes. Vermont's average wage is lower than the national average, which should be good for businesses. Indeed, our average wage is lower than 9 of the top 15 states in Forbes' rankings.



So why are we ranked 45th in "Business Costs"? Evidently, energy and taxes (however they're measured) are weighted heavily. If so, this presents a problem. For while Vermont's electric rates are comparatively high, our average consumption is low (due in part to our successful efficiency programs). This is important because residents and businesses don't pay rates; they pay bills; and bills are a function of rates times' usage. As it happens, Vermont's average residential usage is considerably lower than many other states. [Note: There is no way to determine average use for commercial and industrial customers.] As a result, Vermont's average residential bills are actually quite competitive.



Furthermore, many of the states ranked ahead of Vermont for "business costs" (which includes energy costs) get their electricity from coal, nuclear power, and federally subsidized hydro. Since Vermonters don't want coal (however cheap); have no interest in more nuclear power; and have no access to subsidized hydro, there is little we can do about the comparative advantage enjoyed by those states that have made different choices and have different natural endowments.

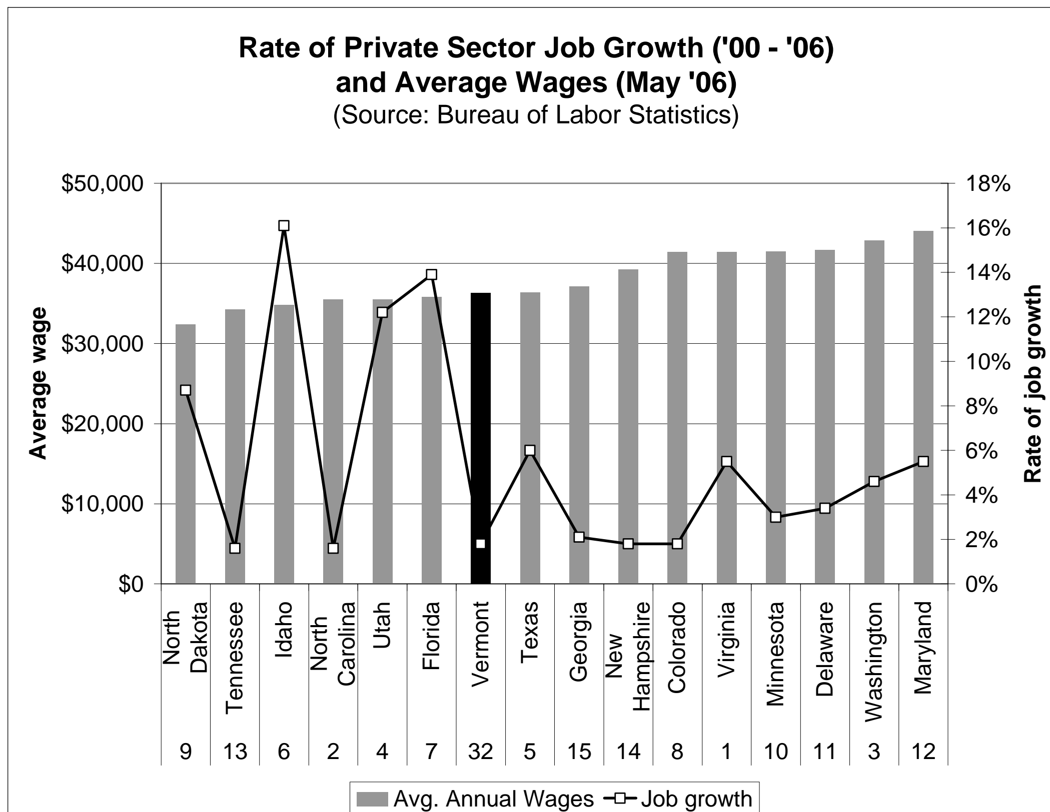
The decision to include energy in the "business costs" ranking is troubling for another reason. According to the Census Bureau, the average cost of purchased fuels and electric energy for all manufacturers is 2.1% of the total value of shipments (electricity was only 1%).[6] Thus, even if Vermont businesses could save 20% of their energy costs (to be more in line with low cost states); it

6 Census Bureau, Annual Survey of Manufactures, 2005, Statistics for Industry Groups and Industries, Table 2 (p.2) and Table 4 (p.72).

would represent a savings of about four tenths of 1% of revenues. And since most service industries use much less energy than manufacturers, the costs of energy (and potential savings from lower prices) are even less for them. So why does Forbes include energy prices in the business costs category?[7]

As for taxes (the third leg of "business costs"), there is ample evidence that simplistic rankings based on top marginal rates are deceptive. For example, the recent JFO Tax Study found that 46% of the largest multi-state and multi-national C corporations operating in Vermont paid only $250 in state taxes in 2003.[8] So while Vermont has one of the highest top marginal corporate rates, state taxes are not much of a "burden" for large businesses.[9] But if you consider only tax rates, Vermont looks bad.

The category "Economic climate" "reflects job, income and gross state product growth as well as unemployment and presence of big companies".[10] Job growth and income are important, but we don't know which measures are used or how they're weighted. For example, of the top 15 states in the Forbes rankings, Idaho, Florida, Utah, and North Dakota (ranked 6, 7, 4, and 9 respectively) have by far the highest rates of private sector job growth. But their average wages are all lower than Vermont (which Forbes ranked 32nd). It should matter what type of jobs are being created.



[7] My guess is that - like taxes - it is a cost that can be reduced or shifted through lobbying legislatures (i.e., rate redesign, resistance to renewables and publicly funded efficiency programs, etc.).

[8] Vermont Tax Study, Joint Fiscal Office, January 16, 2007, p.58.

[9] C corporations are no longer the majority of businesses in Vermont since S corps, partnerships, and LLCs represent over 60% of all incorporated businesses. No doubt one reason is that they offer certain tax advantages, so it's likely that the "burden" for those firms is no worse than for C corps.

[10] See http://www.forbes.com/2007/07/10/washington-virginia-utah-biz-cz_kb_0711bizstates-table.html.

In addition, it's likely that Forbes used the rate of personal income growth. If so, this presents a problem too because (not surprisingly) there is a very strong correlation between population growth and personal income growth (more people = more income).[11] In contrast, there is almost no correlation between the rate of personal income growth and median household income.[12] For example, while Vermont's rate of personal income growth was lower than all but 3 of the top 15 in the Forbes rankings, our median household income is right in the middle.

In the end, the Forbes rankings suffer from many of the same problems identified by Professor Fisher. For the most part, they use measures that are not necessarily correlated with successful business activity (unproven assumptions abound); they ignore the distribution of costs and benefits; they contain internal contradictions; and they are not transparent. So why should we care what they say?

[11] The correlation coefficient between these two variables for the Forbes top 15 plus Vermont = 0.81.

[12] The correlation coefficient between these two variables for the Forbes top 15 plus Vermont = -0.17.