Grading Places: What Do the Business Climate Rankings Really Tell Us?

by Peter Fisher

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Newspapers love rankings. Their readers have an apparently insatiable interest in how a particular state or city compares with others. Recognizing this, several advocacy think tanks have accommodated the press in recent years by creating and publicizing rankings that purport to show which states or cities have the best business climate, the most competitive tax and regulatory environment, or the conditions most conducive to small-business growth and entrepreneurialism.

These rankings are based on each organization's version of an index that is supposed to summarize the various factors that make a place more competitive or conducive to economic growth. The purpose of this report is to dissect those various indexes to see what really drives them. Are they based on science? Do they have biases? Do they in fact work as predictors of economic activity?

> ***Do rankings of business climate have biases? Do they in fact work as predictors of economic activity?***

Competitiveness rankings date back to the 1970s, when a so-called economic war between the states was heating up. In 1979 the accounting firm Grant Thornton began to produce an annual ranking of the states based on their business climates. In the following decade, the Grant Thornton Index gained considerable publicity and was widely cited by public officials and businesses to make the case for changing public policy to enhance a state's prospects for growth. But in 1986 it was harshly criticized in a report by the Corporation for Enterprise Development for its methods and its bias in favor of certain kinds of policies. In the face of that and other criticism, the index was abandoned a few years later.

It didn't take long for the void to be filled: At least eight groups now produce rankings of states or cities on a regular basis. In this report we critique in detail five rankings that claim to measure the *capacity* or *potential* for economic growth. The indexes analyzed vary widely in the factors that underlie them, but they have one thing in common: They claim that places with lower taxes and fewer government regulations are better. The reports based on those rankings then draw explicit policy recommendations: Cut taxes, shrink government, and reduce regulations, and your state or city will experience more business investment, more job creation, or more small-business development.

These policy recommendations are valid, of course, only if the index is a valid measure of the state's or city's growth climate. That is the issue investigated here. For each index, we ask a series of questions to assess the validity of its components and the way they are combined.

The indexes of competitiveness described and critiqued in detail in this report are:

1. the "Small Business Survival Index," produced annually by the Small Business and Entrepreneurship Council;
2. the "State Business Tax Climate Index," produced annually by the Tax Foundation;
3. the "Metro Area and State Competitiveness Report," produced annually by the Beacon Hill Institute;
4. the "Fiscal Policy Report Card on America's Governors," prepared biennially by the Cato Institute; and
5. the "Economic Freedom Index," first published by the Pacific Research Institute in 2004.

We also briefly review three other rankings or indexes of competitiveness for which there is less information available. These rankings are produced by business-oriented magazines or think tanks that view their methods as proprietary, making it difficult to critique their approaches in depth.

The Small Business Survival Index

The Small Business Survival Index (SBSI) is produced annually by a group called the Small Business and Entrepreneurship Council (SBEC) in Washington, D.C. While the index purports to be a measure of how well state government supports and nurtures entrepreneurship and small-business development, the authors apparently believe that there are in fact no government programs or policies that are supportive. The index consists of 23 measures that are described as "government-imposed or government-related costs impacting small-businesses and entrepreneurs." The index, in other words, is largely a measure of how heavily a state taxes or regulates business. State spending on infrastructure, the quality of the education system, small-business development centers or entrepreneurial programs at public universities, technology transfer or business extension programs, business-university partnerships, small-business incubators, state venture capital funding — none of those public activities are considered.

Our analysis of the SBSI leads us to conclude that it is an ideologically driven construct that is at best a crude measure of the level of a state's progressive taxes. The SBEC uses the index to argue for lower and less-progressive taxes, and for less government in general, on the grounds that those policies will stimulate small-business development and the state economy. There is no real-world connection, however, between scoring well on the index and doing well economically. A rough attempt to identify a relationship between the SBSI and a variety of measures of small-business growth and vitality finds little or no relation. In fact, many of the "best" states on the SBSI do quite poorly compared with their peers on objective measures, and some of the "worst" states on the SBSI do quite well. Whatever the merits of the SBEC economic development philosophy, the SBSI fails dramatically as a guide to state policy toward small business.

The State Business Tax Climate Index

The Tax Foundation has been producing an annual State Business Tax Climate Index (SBTCI) since 2003. The SBTCI is, in some ways, at the opposite end of the spectrum from the Small Business Survival Index. It has an aura of respectability and objectivity and avoids the blatantly ideological arguments for smaller government and lower taxes. Instead, it relies heavily on an argument for tax neutrality, which has the effect of making the analysis itself appear neutral.

The Tax Foundation, it turns out, in fact treats quite favorably in its index many tax features that actually harm tax neutrality. The index ends up being largely a measure not of tax neutrality but merely of tax burden, and a very poor measure even of that. There are better measures of the level of taxation on businesses by state, and the SBTCI is negatively correlated with those measures. In other words, states that show up with lower taxes according to the Tax Foundation actually, on average, have higher taxes on business according to more accurate measures.

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There are five main components of the SBTCI: the corporate income tax index, the individual income tax index, the sales and gross receipts tax index, the unemployment tax index, and the fiscal balance index. A major deficiency in the SBTCI is that it considers only state taxes, despite the fact that local taxes are on average comparable in size to state taxes. Another reason for the index's poor ability to track actual tax levels is that it gives heavy weight to rates and very little weight to significant aspects of the tax base that can have very large effects on actual taxes paid.

There is no point 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 what it purports to measure — the effect of a state's tax system on the 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 conclude, that lower taxes cause growth. The index does not measure tax rates to begin with, or even correlate with relative business tax burdens. As a tool for assessing public policy, it is fatally flawed, despite its carefully groomed appearance of plausibility and academic credentials.

The Metro Area And State Competitiveness Report

The Beacon Hill Institute (BHI) at Suffolk University in Boston produces an annual ranking of the 50 states and the 50 largest metropolitan areas in terms of competitiveness. The ranking is based on an index, which in turn is derived from 42 measures for the states (39 for metro areas) in each of eight areas that BHI describes as: government and fiscal policies, security, infrastructure, human resources, technology, business incubation, openness, and environment.

The most serious problem with BHI's indexes of competitiveness is that they indiscriminately mix causal and outcome variables. The institute claims that its index measures how effectively a state or metro area can compete for economic growth. Yet nine of its index variables are in fact measures of the *outcomes* or *components* of economic growth, not the causes of it. Similarly, five other of the variables are simply correlates of high income, or measure the results of slow growth or low income. The confusion of causal and outcome variables renders the meaning of the index incomprehensible.

Another flaw in the index is that there are many missing variables. The index actually measures different things for different states or cites, depending on what data are available for that place.

BHI does subject its index to a statistical test by measuring how well it predicts increases in per capita income. It wouldn't be surprising if the overall index "predicted" which states grow or have higher incomes, since in fact that is what about a third of the index variables are measuring in the first place. But the test used is highly dubious. Other tests show that the index in fact fails to predict growth in per capita incomes at all, despite the biases inherent in the measures.

Because BHI's overall Competitiveness Index is an odd collection of potential causal variables, outcome variables, components of growth, correlates of income, and other unjustified measures, it is of no use as a guide to public policy.

Fiscal Policy Report Card On America's Governors

The Cato Institute released its seventh biennial fiscal report card in 2005. One might surmise from the title that this is an assessment of how well America's governors manage state finances. In fact, the "grades" are based only on "an index of fiscal restraint" for each state. Put quite simply: "Governors who cut taxes and spending the most receive the highest grades" (p. 2).

Cato's overall fiscal policy score is based on 15 variables, organized in three categories: expenditures, revenues, and tax rates. Clearly, the report card is little more than a measure of how aggressively governors push the Cato Institute's agenda of limited government by cutting spending and taxes. There is not much pretense that it is about anything else. Whatever the level of government spending in a state, whatever the quality of public services, there is too much government. All spending cuts are equally good, whether it be cutting a wasteful economic development subsidy or cutting child healthcare. All spending increases are equally bad, whether to subsidize an indoor rain forest in Iowa or raise teachers' salaries up from the bottom in Alabama.

The Cato Institute does not directly subject its index to a test. Instead, it selectively cites research that supports its argument that fiscal stringency produces economic growth. However, the index impact fails to predict which states will grow faster, either in the growth period of the mid-1990s or in the recessionary period of 2001-03. While Cato's Fiscal Policy Report Card may provide some summary indication of how states and governors performed relative to one another in terms of increasing or decreasing tax rates, revenues, and spending, there is no evidence that this tells us anything about state economic performance. The policy conclusions that Cato would like to draw from this report are simply not supported.

U.S. Economic Freedom Index

The Pacific Research Institute (PRI) in 2004 released its first U.S. Economic Freedom Index. According to the PRI report: "Economic Freedom is the right of individuals to pursue their interests through voluntary exchange of private property under a rule of law. This freedom forms the foundation of market economies" (p. 12). The index is purported to measure "how friendly (or unfriendly) each state government is toward free enterprise and consumer choice." And economic freedom, in turn, is supposed to attract firms and individuals, producing economic growth.

The overall Economic Freedom Index (EFI) is composed of scores or index numbers in each of five sectors: fiscal, regulatory, judicial, government size, and welfare spending. The PRI claims that the EFI actually predicts which states will experience greater growth in income (though its method is highly questionable). The PRI then calculates an "oppression tax" for each state. That is the percent reduction in per capita income suffered by the state's residents as a result of their state failing to be like the No. 1 state in "economic freedom."

To appreciate the kinds of data included in the index and the conclusions that the PRI would have us draw, consider the state that has the highest "oppression tax" at 13 percent: Rhode Island. The PRI would have us believe that if the citizens of Rhode Island simply cut benefits to women, infants, and children; quit requiring nurses and accountants to have licenses or further their education, lowered income tax rates on the rich, lowered the price of a fishing license, exempted pesticides from the sales tax, got the federal government to cede them all federal land, quit buying recycled oil, started buying more foam cups and plates, fired half the staff of the Public Utilities Commission, lowered the minimum age for a driver's license, got rid of half their attorneys, paid their judges more, sent more children to private schools, provided easier access to handguns, and a few other things, the state's per capita income would rise $3,600!

Other Competitiveness Rankings

Three additional rankings that attempt to identify a city's or state's economic competitiveness or business climate are also reviewed. Unlike with the others, the method behind these rankings is viewed as proprietary and is not described in detail. As a result, we could not critique these indexes in depth. The three rankings discussed here are:

1. Economy.com's "North American Business Cost Review" for states and metro areas;
2. *Forbes* magazine's "Best Places" ranking of metro areas; and
3. *Expansion Management* magazine's six "quotients" for states, cities, or school districts.

Two of the three rankings are produced by business-oriented magazines appealing to site location consultants and corporate site location managers. This gives them a decidedly different flavor from the indexes produced by think tanks with a pronounced ideological position that are trying to influence public policy. The remaining ranking was produced by a private consulting firm.

In comparing these three rankings with the five reviewed earlier, a striking difference stands out: These indexes are for the most part based on a much broader set of factors that are defensible as significant determinants of business investment or state growth. Also, there are far fewer instances of extraneous variables with little theoretical or empirical justification. Still, these indexes are not without their flaws and, since the method is viewed as proprietary, independent verification is precluded.

Conclusions

The five principal indexes reviewed produce widely different rankings of the states, despite the fact that all of the organizations creating them assert that they are measuring something of critical importance to a state's economic future and its potential for growth. Thirty-four of the 50 states can brag that they are in the top 10 in terms of business climate or competitiveness; they just have to pick which of the five indexes they want to point to. The average state's best ranking is 26 positions above its worst. Perhaps more importantly, business interests in just about any state can find at least one ranking to support an argument for cutting business taxes to make the state more competitive. In all but eight states, one can find at least one index that puts the state in the bottom half of all states.

The underlying problem with the five indexes, of course, is twofold: None of them actually do a very good job of measuring what it is they claim to measure, and they do not, for the most part, set out to measure the right things to begin with. The SBSI is in fact almost entirely about tax burdens on upper-income residents rather than about state programs or policies to assist entrepreneurship or small-business growth. The SBTCI is a large and complex undertaking but ends up generating a number that has little relation to the actual taxes falling on new business investment in a state. The Beacon Hill Competitiveness Index is a hopeless mishmash of causal and performance variables that render it useless as an overall predictor of anything. The Cato Institute's Fiscal Policy Report Card is little more than a rating of governors on their aggressiveness in promoting an agenda of limited government. And the EFI is a sometimes bizarre collection of policies and laws libertarians love — or love to hate — but few have any plausible connection to a state's economic potential.

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Do the businesses making investment and location decisions pay any attention to these state rankings? Here it is instructive to look at the publications aimed at corporate location executives and site location consultants. A striking difference is that the business magazine rankings are much broader in scope. The two that are aimed at creating an index of growth potential or competitiveness look at the whole range of factors that are important to business or employees, including labor costs, cultural and recreational amenities, climate, energy costs, transportation, educational attainment, school quality, and healthcare. Tax levels are part of the equation, but only a small part.

It is precisely because the competitiveness indexes produced by ideological think tanks are aimed at promoting particular kinds of legislation that they do a poor job of predicting state economic growth. The measures used must pass their ideology screen, so the validity and relevance criteria go by the wayside. That is also why they are probably ignored by the business folks actually making the decisions. They should be ignored by policymakers for the same reasons.

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