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The best tax system? That depends on how you measure success

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BY: RICHARD S. DAVIS – OCTOBER 17TH, 2012

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There's a confusing cornucopia of conflicting competitiveness studies. Analysts disagree on which states have performed best in the recovery and why. They define and measure success differently, often to promote favored policy prescriptions. Research I did earlier this year found 20 states placing in the "top five" on at least one of nine popular business climate rankings.

Cato is candid: Governors who "cut taxes and spending the most receive the highest grades." Gregoire lost points for things done and undone. Under her tenure, some taxes increased (cigarettes, gasoline, liquor, estate). But Cato also cites her support for the soda pop tax and income tax (both rejected by the voters) and a half-cent sales tax bump (the Legislature never bought it).

It may appear difficult to reconcile the Cato F with the Tax Foundation's conclusion that Washington has the nation's sixth-best tax climate for business. It's not. The Tax Foundation index looks at the major state taxes – sales, business (including Washington's business and occupation tax), property, unemployment insurance – but assigns the heaviest weight to individual income taxes. The states that fare best don't have them.

That doesn't mean Washington businesses get off lightly. Business taxes here amount to 5.5 percent of gross state product, the 14th-highest average effective business tax rate in the nation.

Scott Drenkard, co-author of the Tax Foundation report, points out that about half of all net business income passes through directly to personal income tax returns.

"For tax competitiveness," he says, "the personal income tax structure and rates matter just as much for businesses as the corporate income tax, sometimes more."

Had recent proposals to introduce income or capital gains taxes been adopted, Washington would be less attractive for business investment and fallen in the rankings.

Taxes are just one of many issues businesses consider in deciding where to grow. Still, as the Tax Foundation notes, tax policy clearly matters on the margins, where most business decisions are made. Unlike other factors, positive business tax reforms can be implemented swiftly. While there's not a perfect correlation between tax competitiveness and economic growth, the evidence is compelling.

Economists Arthur Laffer, Steve Moore and Jonathon Williams created a state economic performance ranking that assesses states on growth in domestic migration, personal income per capita, and nonfarm payroll between 2000 and 2010. I compared their list with the Tax Foundation 2013 business tax climate rankings. Five of the states with the best tax climate finish in the Laffer's top 10 for economic performance. Nine of them finish in the top 20 (Washington ranks No. 14).

The liberal Institute on Taxation and Economic Policy argues that Laffer picks the wrong success measures. ITEP would rather look at median income, unemployment rates and per capita economic output. Substituting their measures, they find states with high income taxes – Oregon, New York, Hawaii, Maryland and California among them – have stronger economies than the non-income tax states.

That's boldly counterintuitive, suggesting flawed measures. Chief Executive magazine's survey of CEOs ranks them among the nation's worst states for business, and most analysts agree. New York and California are at the bottom of the Tax Foundation index.

ITEP is surely mistaken in saying that "the growth of states lacking an income tax is no more than coincidental." The Tax Foundation's study, while not the last word, is persuasive. A lot of Washington small business owners dislike the B&O tax – a tax on gross receipts rather than profits. If the alternative were a highly progressive income tax, however, many would face a heavier burden.

With a new governor and Legislature confronting a sluggish recovery, tax policy will again dominate discussions in Olympia. The Tax Foundation report provides a good starting point. It also reminds us that a good tax system doesn't pick winners and losers. Broad bases, low tax rates, and minimal use of economic development incentives provide stability and avoid distortion.

Like all tax systems, ours is imperfect. But because we've resisted bad ideas in recent years, it's better than many.