Guide to Comparing Business Tax Policies

Evaluation Report
June 2013

Office of Performance Evaluations
Idaho Legislature

Report 13-06

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Rakesh Mohan, Director
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Guide to Comparing Business Tax Policies

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June 7, 2013

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Members
Joint Legislative Oversight Committee
Idaho Legislature

A key question often faced by legislators is whether a proposed tax policy change will actually affect business activity, and if so, whether the change will occur in the intended way. Various organizations have published national studies that rank states according to how attractive or friendly their tax rates and policies are deemed to be for businesses. However, users of these studies may be disappointed when they find conflicting information that is difficult, if not impossible, to understand.

The purpose of this report, which is based on national tax policy research and best practices, is to help legislators navigate through complex tax policy issues by asking the right kinds of questions early in policy considerations. By asking the right questions, policymakers can enhance their ability to make tax changes that have positive effects and avoid decisions that lead to unintended outcomes.

Accompanying this report, we provide a web-based tool to help policymakers evaluate the link between tax policy proposals and tax policy goals. The tool will allow legislators to experiment with their hypotheses and see relationships that they may not have considered. This interactive tool does not tell users what tax policies should be considered, but instead asks questions to help narrow the information and considerations that are most relevant to the users' goals and policy interests.

We appreciate the formal responses to our study from the Governor, the State Tax Commission Chairman, and the Department of Commerce Director—the responses are included at the end of this report. We hope policymakers and stakeholders will find this report and the tool useful as they deliberate on business tax policies that affect the quality of life for all Idahoans.

Sincerely,

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In March 2012 the Joint Legislative Oversight Committee approved a request from the Senate Local Government and Taxation Committee to study the tax rates in Idaho as compared with those in other states. The committee recognized that comparing one specific tax among states without an independent and objective comparison of the overall tax structure is unfair.

Various organizations publish national studies that compare states' tax rates and policies and rank states according to how attractive or friendly their rates and policies are deemed to be for businesses. However, users of these studies may be disappointed when they find conflicting results and policy implications that are difficult, if not impossible, to understand.

Most multistate tax comparisons include the major features of each state's tax structure but arrive at different rankings of states because they emphasize different factors and weights or capture different aspects of tax policy. As a result, comparisons vary in their perspectives on state tax policy and what constitutes favorable business conditions. None of the studies tell the complete story.

Factors captured by multistate tax comparisons are not the only factors important to business investment. Many interrelated nontax factors determine whether a state is an attractive place for businesses to invest. Nontax factors such as labor costs, climate, education, and infrastructure are often more important to business investment decisions than are tax costs. The effects of tax rate and policy changes cannot be understood or predicted in isolation from nontax factors. Economic performance and business investment hinge on the balance of many, often competing, tax and nontax factors.

Tax policies selected to overcome a particular barrier to economic improvement will likely interact with nontax factors. In some instances, the interaction might be positive while in others it might undermine the policy efforts. The central question to answer is whether a tax policy change will actually affect business activity, and if so, will the change affect activity in the intended way.

Businesses rely on tax-funded government services such as infrastructure development, education, and workforce training. Tax policy changes that affect Idaho's ability to fund such programs might improve Idaho's competitiveness in the short term by reducing business tax burden but decrease Idaho's competitiveness in the long term by eroding the quality of nontax factors.

Considerations for Policymakers

Because tax policies and rates are limited in their ability to influence business investment behavior, policymakers should carefully consider two key relationships:

1. The link between tax policy changes and broader economic goals

2. The balance between Idaho's business tax costs and the revenue necessary to sustain and improve nontax factors that can be influenced directly by government policy

In addition to the information provided in this report, we have developed a web-based tool to help users identify critical questions that should be asked when evaluating tax policy alternatives. The tool will aid users when considering how tax policies can improve Idaho's business investment environment.

Acknowledgements

We appreciate the assistance we received from the State Tax Commission, the Department of Commerce, and the Division of Financial Management (DFM). We would like to thank Derek Santos, chief economist at DFM, along with Mike Ferguson, former chief economist at DFM, and Randy Nelson, former executive director of the Associated Taxpayers of Idaho, for providing technical comments.

Lance McCleve and Tony Grange of the Office of Performance Evaluations conducted this study, and Margaret Campbell copyedited and desktop published the report.

Robert Thomas of Robert C. Thomas & Associates and Brad Foltman, former administrator at DFM, conducted the quality control review. Devin McCleve developed the web-based user interface for the OPE Tax Policy Tool.

Introduction

Legislative Interest

In March 2012 the Joint Legislative Oversight Committee approved a request from the Senate Local Government and Taxation Committee to study the tax rates in Idaho as compared with those in other states. Economic performance is usually a topic of importance for policymakers, and the recent recession has amplified that importance. As part of states' campaigns to improve their economies, policymakers and businesses alike have turned their attention to taxes. In the study request, the committee noted that it hears from many organizations who say Idaho companies cannot be competitive because a particular tax is higher in Idaho than in another state.

The Senate Local Government and Taxation Committee recognized that comparing one specific tax among states without an independent and objective comparison of the overall tax structure is unfair. Although national comparisons of taxes among states exist, the committee noted that it was not aware of any comparisons that used a weighted quantitative analysis.

Study Approach and Methodology

The study requesters asked our office to create a comparison of states' tax structures using a weighted quantitative analysis. We examined the methodologies of multistate tax comparisons and determined that many of them already compare states' taxes using quantitative analysis. However, we found the studies' use of measures and weights can be difficult to find, interpret, and understand.

Through discussions with the study requesters, we determined that repeating the efforts of the national organizations would not add to policymakers' understanding of how Idaho's taxes compare with those in other states. Instead, we determined that a tool for comparing and evaluating tax policy options would be more useful.

Multistate Tax Comparisons

We used four multistate tax comparisons as examples in this report. Our criteria for selecting these studies were that they: (1) consider only tax policies and rates, (2) include well-defined methodologies that allow us to determine what relevant policies these studies capture, and (3) represent common and accepted methods for measuring business taxes.

We analyzed the four studies for the following information:

- Objectives of the comparisons
- Tax burden measures
- Implications for tax policy and economic development
- What the studies tell policymakers about Idaho's business taxes as compared with those in other states

To give policymakers an overall sense of how Idaho compares, we created a composite score for each state by standardizing and averaging the four studies' scores for each state. We also calculated the standard deviation for each state's composite score to determine the variability of states' scores across the four studies.

Existing Research

To help policymakers determine whether a tax policy change will actually affect business activity, and if so, affect it in the intended way, we reviewed existing research to determine what evidence exists for the following:[1]

- A relationship between tax policy and business investment decisions
- The ability of tax-ranking studies to predict or explain economic outcomes
- Factors that affect economic development
- Factors that influence business site selection criteria and patterns

Idaho Context

To better understand Idaho's tax structure and business climate, we talked to agencies and individuals who are familiar with these issues:

- Idaho State Tax Commission
- Idaho Department of Commerce
- Idaho's current and former chief economists
- Former executive director of the Associated Taxpayers of Idaho

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[1] The bibliography at the end of this report is a representative selection of the literature we reviewed.

OPE Tax Policy Tool

We used tax data from the Tax Commission and economic data from the Department of Commerce to develop an interactive tool that stakeholders and policymakers can use to help identify questions when evaluating tax legislation for businesses. As a web-based application, the tool generates a simple logic model that can help users understand the link between business tax policy and anticipated outcomes.

The information in this report and the tax policy tool does not intend to make any statement about the appropriateness or value of policymakers' goals for tax policy. The study was designed to address broad considerations about business tax comparisons and policies, not to answer questions about specific tax policies. We hope this report and the accompanying tax policy tool will aid users in linking policies to their goals and in identifying factors that could potentially limit the success of business tax policies.

Report Organization

We have organized the report into four chapters, an appendix, and a bibliography.

- Chapter 1 introduces a number of challenges that exist in comparing states' tax rates and policies, and describes four common approaches to quantifying differences among states.

- Chapter 2 discusses where Idaho stands in comparison with other states according to four studies that use different methodologies, and includes an analysis of how the cost of taxes on Idaho businesses has changed over time.

- Chapter 3 discusses the importance of nontax factors in business investment decisions and the limitations of tax policy in affecting those decisions.

- Chapter 4 discusses the links between tax policy and economic goals, and looks at a number of considerations that can affect the success of a tax policy. It also introduces our web-based tax policy tool that can assist policymakers in linking policy proposals to policy goals.

- The appendix details the four comparison studies introduced in chapter 2.

- The bibliography is a representative selection of the literature we reviewed for this study.

Chapter 1
Multistate Tax Comparisons

Multistate Tax Comparisons Offer Differing Perspectives on Business Taxes

Various organizations publish national studies that compare states' tax rates and policies and rank states according to how attractive or friendly their rates and policies are deemed to be for businesses. However, users of these multistate tax comparisons may be disappointed when they find conflicting results and policy implications that are difficult, if not impossible, to understand.

Furthermore, although users may find discrepancies among studies, this does not necessarily mean one study is correct and another is incorrect. Discrepancies may indicate that the studies are not answering the same questions. The results of each tax comparison study depend heavily on the specific question it has been designed to answer.

For example, consider this question: How do a state's statutory business taxes and policies rank when compared with those in other states? The answer depends, in part, on the answers to two follow-up questions: (a) Which taxes should be considered business taxes? and (b) What criteria should make one tax rate or policy rank better than another? Although the initial question appears to be a straightforward comparison among states, the answers to the two follow-up questions are not. How the follow-up questions are answered will have a substantial influence on states' rankings and the implication of the rankings on states' tax policies.

Discrepancies among national studies may indicate that the studies are not answering the same questions.

Most multistate tax comparisons include the major features of each state's tax structure but often use different variables to represent how taxes and policies affect businesses. As a result, the studies vary in their perspectives on state tax policy and what constitutes favorable business conditions.

No perfect measure exists for comparing business taxes—all measures are inherently laden with values. Multistate tax comparisons can use measures that indicate the exact amount businesses paid in taxes, but there is no universal measure for whether that amount is

All measures for comparing business taxes are inherently laden with values.

appropriate. The following example is an analogy of a hypothetical homeowner facing a similar challenge.

Example: Homeowner Analogy

A homeowner has listed her home on the market but is unsure how to make the home attractive to potential buyers. She finds a real estate group that ranks the top 100 homes in her area. Each home's overall rank is designed to reflect its marketability as compared with similar properties.

Factors used by the real estate group to determine the marketability of homes include property acreage, square feet of the home, price, age of the home, season placed on the market, garage size, and energy cost per square foot.

The seller's home is ranked near the bottom of the list. She finds the top ranked home is newer than hers, but the second ranked home is older. Her home is larger than three of the top ten homes. Two of the top ten homes have low energy costs per square foot, but the others have high energy costs. The price of her home is about average for the 100 ranked homes.

As weeks go by, she tracks which of the 100 homes sell. Some higher-ranked homes sold after the asking price was reduced, and some lower-ranked homes sold at the asking price. Despite the real estate group's attempt to rank homes using factors that are important to buyers, it did not perfectly predict which homes would sell faster or what the selling price would be. The ranking was subject to how the real estate group believed each factor affected the marketability of the homes but could not account for the preferences of all buyers.

The seller would like to improve her home's marketability by addressing factors that are important to potential buyers in the area. However, the ranking is unclear about how each factor affects a home's rank. Further complicating the ranking's usefulness is the seller's limited ability to address many of the factors on the list. The seller would be able to increase her home's energy efficiency but changing the property acreage or the age of the home would be cost prohibitive if not impossible.

If the seller had looked at another real estate group's ranking that used different factors to rank the same homes or that focused more on the length of time to sell a home rather than the selling price, that group would have certainly ranked the homes differently. Moreover, yet another real estate group might measure different factors of the homes' attractiveness or measure the same factors with different weights. No ranking can capture every factor that might be attractive to every buyer.

Tax Burden Measures Are Commonly Used to Compare States' Tax Rates and Policies

There are many ways to measure the cost of taxes or burden of taxes on businesses, also known as *business tax burden*. We present four tax measures that can provide users of multistate tax comparisons with a sense of the average business tax burden:

- *Business tax as a percentage of gross state product*
- *Average effective tax rate*
- *Total effective tax rate*
- *Marginal effective tax rate*

These four tax measures can be further divided into two groups: (a) measures that use historical data to calculate the business tax burden and (b) measures that calculate tax burden estimates using tax rate and policy information.[1]

Measuring by Historical Data

Business taxes as a percentage of gross state product and the average effective tax rate are two measures of business tax burden that rely on historical data.

Business Tax as a Percentage of Gross State Product

Calculated as the ratio of business tax to gross state product, this measure is a broad representation of the business tax burden.[2] Because the ratio is sensitive to changes in a state's economic output as well as tax policy changes, the business tax to gross state product ratio can change with time and from state to state, even if business tax rates and policies are not changed.[3]

$$\textit{Business tax as a percentage of gross state product} = \frac{\textit{Total business tax collected}}{\textit{Gross state product}}$$

Average Effective Tax Rate

The average effective tax rate is calculated as the ratio of business taxes paid to reported business earnings. It more accurately measures the impact of taxes on business profit than does the business tax as a percentage of gross state product

[1] In chapter 2 and the appendix, we present our analysis of four multistate tax comparisons that use one or more of these measures.

[2] Similar to the national gross domestic product, the gross state product is an annual measure of total economic activity for an individual state.

[3] The Council on State Taxation's study *Total State and Local Business Taxes* uses the ratio of corporate income tax to gross state product. See chapter 2 and the appendix for more information.

because it represents tax burden on business earnings instead of on economic output.

$$\textit{Average effective tax rate} = \frac{\textit{Total business tax collected}}{\textit{Total reported business earnings}}$$

The average effective tax rate and the business tax as a percentage of gross state product are methods based on actual taxes paid and reflect many factors that determine the total tax liability of businesses. Under certain conditions, users can gain insights into a state's average business tax burden with these methods. Users can also compare states' average tax burdens with one another from year to year.

Nevertheless, measures calculated with aggregate historical data cannot be used to assess the implications of tax reforms that are in progress or that are planned for the future because they are dependent on past economic and business conditions which can vary from year to year. To assess current or speculative business tax burdens, users of multistate tax comparisons must look to measures that focus on tax policy and tax rates.

Measuring by Tax Rate and Policy Information

Total effective tax rate and the marginal effective tax rate are two common measures of business tax burden that use tax rate and policy information.

Total Effective Tax Rate

The total effective tax rate is the difference between businesses' profits before and after taxes. Expressed as a percentage of before-tax profits, the total effective tax rate can be calculated using historical data for specific businesses; however, multistate tax comparisons determine the total effective tax rate by applying states' statutory tax rate and policy information to various hypothetical businesses.[4]

$$\textit{Total effective tax rate} = \frac{\textit{Before-tax profits} - \textit{After-tax profits}}{\textit{Before-tax profits}}$$

Marginal Effective Tax Rate

Users of multistate tax comparisons interested in the cost of taxes on new business investment might consider the marginal effective tax rate, which is a measure of the cost of taxes on new investment. Much like the average effective tax rate, the marginal effective tax rate is the difference between businesses'

[4] The Tax Foundation's study *Location Matters: A Comparative Analysis of State Tax Costs on Business* uses a form of the total effective tax rate to compare business taxes on seven hypothetical firms in all states. See chapter 2 and the appendix for detailed information.

before-tax profits and after-tax profits. Expressed as a percentage of before-tax profits, the marginal effective tax rate represents the average effective tax rate on profits from only new investment as opposed to all profits.[5]

$$\textit{Marginal effective tax rate} = \frac{\textit{Before-tax rate of return on new investment} - \textit{After-tax rate of return on new Investment}}{\textit{Before-tax rate of return on new investment}}$$

Both of these measures implicitly include the effect of basic statutory tax policies and can be used to assess a state's tax burden on business income. Unlike measures that rely on historical data, measures that use tax rate and policy information can estimate the tax burden for current and speculative tax rates and policies.

Most Measures of Tax Burden Neglect Important Business Types and Costs

We have just discussed four types of tax measures that can provide users of multistate tax comparisons with a sense of the average cost of taxes on businesses. However, the measures are unable to show the effects of tax compliance costs and do not consistently account for the cost of taxes on noncorporate businesses.

Tax Compliance Costs

Basic tax burden measures often fail to account for businesses' costs of complying with the tax system. These costs generally result from a business's time and expenses to determine its tax liability; they tend to increase with the complexity of the tax system. In our review of literature, we found that tax compliance can be a significant cost to businesses. Consequently, users of multistate tax comparisons should add compliance costs to the statutory tax liability of businesses when calculating the cost of taxes on businesses.

By simplifying the tax system policymakers can, in some circumstances, reduce compliance costs for businesses. In addition, policymakers may identify opportunities to lower the state's average tax burden while maintaining revenue by considering the effects of compliance costs.

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[5] The Council on State Taxation's study *Competitiveness of State and Local Business Taxes on New Investment* uses the marginal effective tax rate to compare business taxes on new capital investment in all states. See chapter 2 and the appendix for detailed information.

Business Types

In Idaho, the State Tax Commission reports that more than 91,000 businesses filed tax returns for 2011. The major structures of businesses are as follows:

- C corporation: Accounting for about 20 percent of Idaho businesses, C corporations are legal entities owned by shareholders. These corporations file a corporate tax return.

- S corporation: Accounting for about 35 percent of Idaho businesses, S corporations are similar to C corporations but have special tax status with the IRS and are considered pass-through entities. Thus, S corporations do not pay taxes at the corporate level; instead, they pay taxes through individual tax returns.

- Partnership: Accounting for about 34 percent of Idaho businesses, partnerships are generally pass-through entities that typically pay business income taxes through individual income tax provisions. These businesses may take the form of a joint venture, and each party would report their income individually.

- Limited liability company (LLC): LLCs may encompass attributes of any one of the previous three structures depending on the number of members and choice of structure: (1) a sole proprietorship single member LLC will report income on a corporate tax return, (2) a single member LLC as a disregarded entity will report income on an individual tax return, and (3) an LLC with two or more members may function as a partnership.

Idaho's mix of business structures makes generalizing the impact of certain tax policies difficult. Policies related to C corporations may not be applicable to businesses filing tax returns under other structures that treat their income as individual tax liabilities. Although major tax policy discussions center on businesses that provide state revenue under corporate income tax provisions, the impact of other business tax policies is much more elusive because of the merging of individual and business income tax paid through regular individual income tax filings.

Conclusion

Although multistate tax comparisons often present conflicting results, each study offers users a different perspective on business taxes and has different implications for tax policy. However, none of the studies tell the complete story. Studies arrive at different rankings of states because they emphasize different factors and weights or capture different aspects of tax policy. Understanding in greater detail the components of each study will help users assess how well the study can address tax policy questions.

Chapter 2
What Multistate Tax Comparisons Say About Idaho

Idaho's Rank on Multistate Tax Comparisons Is Relatively Consistent

To help policymakers get a sense of how Idaho compares with other states, we analyzed the methodologies and results of common multistate tax comparisons. We selected four studies to use as examples in this report using three criteria: (1) they only consider tax policies and rates, (2) they include well-defined methodologies that allow us to determine what relevant policies these studies capture, and (3) they represent common and accepted methods for measuring business taxes.[1]

The multistate tax comparisons we discuss in this chapter underscore that rankings of states are inherently affected by what questions are being asked, what specific tax policy variables are included in the comparisons, and how different areas of policy are weighted. Policymakers' goals and the questions to which they are seeking answers should ultimately determine the appropriate study to consult when considering changes to tax policy in Idaho.

The order of state rankings is less important than the magnitude of the difference between rankings.

Two of the four studies discussed in the following sections use historical data to measure business tax burden, and two use policy and rate information. Measures of tax burden using historical data have the advantage of being based on actual tax payments and therefore reflect not only statutory tax rates, but also effects of the various tax incentives. However, to be useful when making changes to policy, historical tax measures need to be broken down by different types of industry. Consequently, two studies create hypothetical tax burdens for different types of industry using actual tax rate and policy information for the types of taxation in each state. The studies compare states' hypothetical tax burden to judge the business friendliness of states' tax climates.

1 A detailed discussion about each of the four studies is in the appendix.

Total State and Local Business Taxes

The Council on State Taxation, a state tax organization representing taxpayers, in conjunction with Ernst and Young, a professional services organization, developed the study *Total State and Local Business Taxes*. This study, which we refer to as *Total State and Local*, uses a type of measure that employs historical business taxes and income data to determine each state's average tax burden. The following three methods are used to arrive at this measure: (1) the total dollar amount of business taxes paid in each state by major tax type (e.g., corporate, individual income, and unemployment), (2) the percentage of business taxes going to state and local taxes, and (3) business taxes as a percentage of gross state product.[2] Idaho ranked 18 overall in a comparison of business taxes to gross state product. The ratio of corporate taxes to gross state product can serve as a measure for policymakers to understand the cost of taxes on businesses in their state.

Competitiveness of State and Local Business Taxes on New Investment

The Council on State Taxation in conjunction with Ernst and Young developed the study *Competitiveness of State and Local Business Taxes on New Investment*. This study, which we refer to as *Competitiveness*, analyzes the effects of tax policies in different states for five hypothetical business types. *Competitiveness* uses a type of measure that relies on tax rate and policy information to project the tax burden for specific business types. This approach to multistate tax comparisons can be useful in helping policymakers understand how a state's tax structure affects the tax costs faced by different types of businesses, particularly tax costs on new capital investment.

Competitiveness uses two overall measures to compare states: the average rate of return on new capital investment weighted by capital and the average rate of return on new capital investment weighted by jobs. Idaho ranked 30 on both measures.

Location Matters: A Comparative Analysis of State Tax Costs on Business

The Tax Foundation, a nonpartisan tax research group, in conjunction with KPMG, an audit, tax, and advisory services firm, developed the study *Location Matters*. The study applies statutory tax rates to each of seven hypothetical businesses. These hypothetical businesses are designed to represent a range across which different tax structures would vary in competitiveness as measured

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[2] The ranking system used by the four multistate tax comparison studies discussed in this section assign a rank of one to the state with the best score and 50 to the state with the worst score.

by the total effective tax rate. For example, a corporate headquarters represents a business with high salaries, whereas a call center represents a business with a large number of low-wage employees. Each business is modeled as both new (less than three years old) and mature (at least 10 years old) to assess the effect of tax incentives.

In *Location Matters*, Idaho's tax structure was more attractive to new businesses than mature businesses, though by both overall measures Idaho ranked below average when compared with other states (32 for new businesses, 38 for mature businesses). Of the new businesses, Idaho was more attractive to capital-intensive manufacturing and retail stores than to other types. Exhibit 2.1 shows the effective tax rate for each business type by maturity level. Although Idaho ranked above average for mature distribution centers among all states, it ranked last among Idaho's neighboring states.

Exhibit 2.1 Idaho's Effective Tax Rates for Seven Hypothetical Businesses

	Mature businesses		New businesses	
	%	Rank	%	Rank
Corporate headquarters	16.4	34	20.4	43
R&D facility	15.2	39	20.9	41
Retail store	18.1	35	33.5	27
Call center	26.1	41	34.8	43
Distribution center	28.1	23	37.2	32
Capital-intensive manufacturing	15.2	37	9.6	27
Labor-intensive manufacturing	13.5	37	13.4	40
Overall	—	38	—	32

Source: Tax Foundation, *Location Matters: A Comparative Analysis of State Tax Costs on Business*, 2012.

2012 State Business Tax Climate Index

The Tax Foundation publishes the annual study *State Business Tax Climate Index*. This study, which we refer to as the *Climate Index*, represents a comparison method that relies on tax rate and policy information, but unlike *Competitiveness* and *Location Matters*, it does not calculate a tax burden estimate for states. Instead, the *Climate Index* assigns scores to five components of overall business taxes based on 118 individual variables. The five components (tax types) are assigned weights and averages in order to produce a final ranking.

Overall, Idaho ranked slightly above average (21) among the states and similarly on the tax types of corporate, individual income, and sales tax (19, 26, and 23 respectively). In this same study, Idaho ranked 2 in property taxes and 48 in unemployment insurance taxes.

Neighboring States Comparison

Although these four multistate tax comparisons include rankings for all states, they (and others) also allow for comparisons among Idaho's neighboring states. Even though the relative order of ranking does not change, such comparisons give a clearer view of where Idaho stands among relevant states. Exhibit 2.2 shows Idaho's rank for each of the overall measures for each study when compared with Idaho's neighboring states.

Exhibit 2.2 Idaho's and Neighboring States' Rank in Multistate Tax Comparisons

	Location Matters		SBTCI	Competitiveness		TSLBT
	New firm	Mature firm	Climate index	Weighted by capital investment	Weighted by jobs	Business tax (% of GSP)
Idaho	38	32	21	30	30	18
Montana	20	23	8	11	7	40
Nevada	4	38	3	33	28	34
Oregon	28	28	13	2	2	1
Utah	6	10	10	17	17	3
Washington	17	40	7	40	47	36
Wyoming	1	9	1	9	9	48

Sources: Information from four multistate tax comparisons: *Location Matters: A Comparative Analysis of State Tax Costs on Business, State Business Tax Climate Index (SBTCI), Competitiveness of State and Local Business Taxes on New Investment,* and *Total State and Local Business Taxes (TSLBT).*

Idaho's Aggregate Score Among States Is About Average

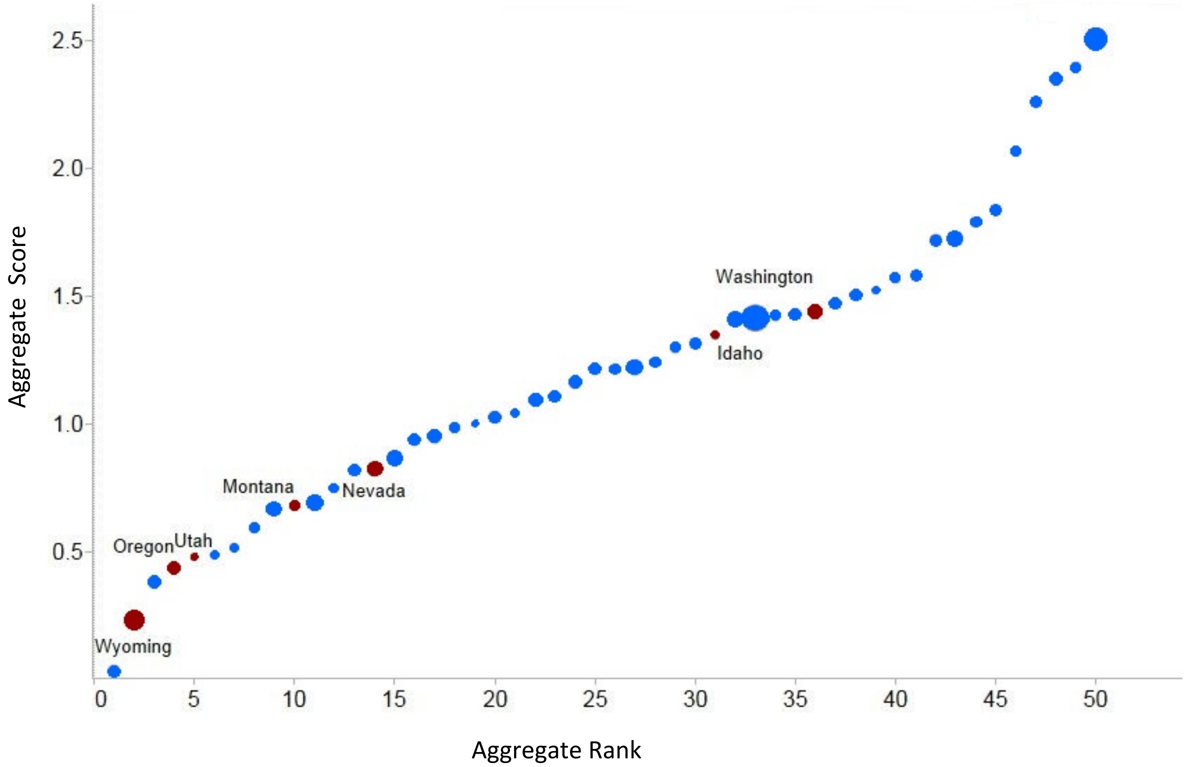
Because each of the four multistate tax comparisons captures different aspects of states' tax policy, we calculated a score for each state that represents its aggregate performance. Exhibit 2.3 shows each state's performance when taking into account the various perspectives of the four studies.

States' relative performance shown by their score is more telling than their rank. For example, although Idaho ranked 31 overall, its aggregate score was close to average. Further, Idaho's performance is relatively consistent across the four studies.

The differences in rankings show three important points about state tax comparisons:

1. The ranking scale does not capture the magnitude of differences among states. A state's score may be very similar to the next higher-ranked

EXHIBIT 2.3 AGGREGATE TAX COMPARISON RANK AND SCORE FOR ALL STATES



Sources: Office of Performance Evaluations' analysis of data from four multistate tax comparisons: *Location Matters: A Comparative Analysis of State Tax Costs on Business, State Business Tax Climate Index, Competitiveness of State and Local Business Taxes on New Investment,* and *Total State and Local Business Taxes.*

Note: The red dots, as labeled, indicate Idaho and its neighboring states.

state, but quite different from the next lower-ranked state. The nonlinear nature of study scores in the graph reflect this variance. Also, several states may have essentially the same score (see the four states between Idaho and Washington) but are still ranked differently.

2. Not all states' performed uniformly among the studies. The size of the marker for each state represents how much that state's performance varied across studies. The larger the state's marker, the more its performance varied by study.

3. Although states differ in tax rates and policies, many states do not differ substantially from each other in overall score. Further, summary scores may mask differences important to a particular decision that policymakers may be considering.

Taken together, the four studies suggest Idaho's tax structure is from slightly above average to slightly below average in business friendliness; however, the meaning of business friendliness depends on the specific assumptions and measures used. The studies measure specific aspects of tax policy and do not necessarily capture all of the factors important for business investment decisions.

The Cost of Taxes on Businesses Should Be Considered Separately from Tax Comparisons

Evaluating business tax policy requires the consideration of the cost of taxes on business. Policymakers have several sources available for determining Idaho's business tax costs, and those sources have varying levels of information. Several studies from one source, multistate tax comparisons, also convey a general sense of the cost of taxes to Idaho businesses.

For example, *Total State and Local* reports the total dollar amount paid annually in various types of taxes by Idaho's businesses.[3] We analyzed the trend in total taxes paid annually by Idaho businesses from fiscal year 2004 to 2011 and found that they have increased on average 8.5 percent each year, rising from $1.4 billion in fiscal year 2004 to $2.2 billion in fiscal year 2011.[4] As a percentage of the gross state product, however, the tax burden has remained between 4.2 percent and 4.7 percent within that same time, as shown in exhibit 2.4. These figures indicate that Idaho's business activity has generally been stable in relation to the overall economy. Further, the overall increase has mainly been a result of increases distributed across the various types of individual taxes.[5]

The measures used in these studies provide only a portion of the information policymakers need to determine the current tax burden on Idaho businesses. For example, *Total State and Local* does not explain that Idaho saw several changes in fiscal years 2004–2011 to the state's tax structure in addition to the effects of the recent recession. The sales tax rate changed twice over this period and the state took on funding for operation and maintenance for public schools in fiscal year 2007, which granted property tax relief to businesses and homeowners.

In addition to statutory tax rates, businesses can also be affected by various incentives, which can apply broadly to industries or be targeted narrowly for specific purposes. Incentives can be advantageous by reducing tax burden, but they also create complexities in a state's tax structure. As mentioned earlier, a complex tax structure creates compliance costs for businesses, which is detrimental to business friendliness. Idaho has a number of incentive and

3 *Total State and Local* reports the total dollar amount paid by businesses in property tax, sales tax, excise tax, corporate income tax, unemployment insurance, license and other taxes, and the portion of individual income tax paid by businesses.

4 The 8.5 percent growth in total taxes paid is calculated as the average underlying rate of increase each year in fiscal years 2004–2011.

5 Property taxes saw a relatively large increase in fiscal years 2004–2006, as well as unemployment insurance taxes in fiscal years 2008–2011.

EXHIBIT 2.4 IDAHO'S TOTAL STATE AND LOCAL TAXES ON BUSINESS AND PERCENTAGE OF GROSS STATE PRODUCT (in billions of dollars), FISCAL YEARS 2004–2011

Type of Taxes	2004	2005	2006	2007	2008	2009	2010	2011
Property	$0.6	$0.7	$0.8	$0.8	$0.8	$0.7	$0.8	$0.8
Sales	$0.3	$0.3	$0.3	$0.4	$0.4	$0.3	$0.3	$0.3
Excise	$0.1	$0.2	$0.2	$0.2	$0.2	$0.2	$0.2	$0.2
Corporate income	$0.1	$0.1	$0.2	$0.2	$0.2	$0.1	$0.1	$0.2
Unemployment	$0.1	$0.1	$0.1	$0.1	$0.1	$0.2	$0.2	$0.3
Individual income	$0.1	$0.1	$0.1	$0.2	$0.2	$0.1	$0.2	$0.2
License	$0.1	$0.1	$0.1	$0.2	$0.2	$0.2	$0.2	$0.2
Total business taxes	$1.4	$1.6	$1.8	$2.0	$2.1	$1.9	$2.0	$2.2
Percentage of GSP	4.2%	4.3%	4.6%	4.6%	4.7%	4.2%	4.3%	4.6%

Source: Council on State Taxation, *Total State and Local Business Taxes*, Fiscal Years 2004–2011.

Note: Totals are not equal to the sum of individual tax types because of rounding errors.

developmental programs, including exemptions for equipment, new manufacturing facilities, and job creation. Without knowing which types of businesses benefit from an exemption and the extent to which they benefit, the success of tax exemptions is difficult to assess.

Conclusion

Multistate tax comparisons can provide a general sense of each state's business tax burdens. However, interpreting tax burden indicators that are assessed on aggregate data can lead to problems. For example, tax burden measures that rely on tax rate and policy information generally ignore the effects of compliance costs. This can result in an underestimation of the effects of business taxes on business profits. A complete picture of the cost of taxes on businesses should include tax rates and policies as well as compliance costs.

Furthermore, the tax factors captured by the four studies are not necessarily important to business investment directly and should be interpreted with a full appreciation of the assumptions made about which factors matter to businesses and which measures best represent those factors.

Although Idaho's performance is about average on these example studies, based on our review of the literature, the relationship between state tax rates and business investment decisions has not been firmly established. Chapter 3 explains that a combination of tax and nontax factors work together to determine how attractive a state is for business investment.

Chapter 3
The Effect of Taxes on Businesses

The Effect of Taxes on Business Investment Decisions Is Difficult to Determine

Advocates for tax policy change frequently claim that their suggested change will help achieve policymakers' goals of increasing jobs, economic competitiveness, or state revenue. The merits of these claims are difficult to assess in the absence of appropriate data and empirical evidence. Even with data and empirical evidence, the merits of many tax policy alternatives can be difficult to evaluate. For example, policymakers can use comparisons of states' taxes to help them determine how to improve their state's ability to attract business investments. However, states' taxes play only a small part in a much larger framework for determining the most effective ways to attract investment.

Taxes play only a small part in determining the most effective ways to attract investment.

Improving a state's economy is a preeminent driver for changing business tax policy. Supporters of business tax cuts argue that when a state has tax policies that result in low business costs and businesses earn a relatively high after-tax rate of return, instate businesses will remain and reinvest in the state. In addition, states with relatively high after-tax rates of return will be more attractive to out-of-state businesses that are expanding or relocating.

Although businesses generally seek to maximize their after-tax rate of return, the link between tax costs and a favorable business environment is not direct. For example, businesses rely on tax-funded government services, such as infrastructure development, education, and workforce training. When these tax-funded government services and other nontax factors are weak, they often become more substantial barriers to achieving policymakers' goals than unfavorable tax rates. Consequently, policymakers must balance the cost of lowering business taxes to incentivize investment while simultaneously adequately funding services that are also valued by businesses.

Although tax policy plays a role in economic performance and business investment decisions, research is unclear about the nature and magnitude of the effects that tax rates and policies have on these decisions. Some research has

The influence of tax policy on business investment decisions is nonlinear.

found that, on average, higher effective tax rates are associated with relatively lower business investment. However, the relationship between taxes and business investment found by such research is generally nonlinear, meaning any degree of alteration to tax rates or policy will not necessarily result in proportional changes to business investment.

Nontax Factors Are Important to Consider When Evaluating Tax Policy Alternatives

The effects of tax rate and policy changes cannot be understood or predicted in isolation from nontax factors. Many interrelated factors determine whether a given state is an attractive place for businesses to invest. Economic performance and business investment hinge on the balance of many, often competing, tax and nontax factors.

Although it is a complex and difficult consideration for policymakers, determining whether tax, nontax, or a combination of tax and nontax factors are impeding or discouraging investment is critically important when evaluating tax policy.

Nontax factors consist of state attributes or conditions other than taxes that vary from state to state and are important to businesses. Although the following factors are not all of the nontax factors important to businesses, they represent the factors that research has shown to be among the most important:

- **Availability of a trained workforce:** All businesses are dependent to some degree on available labor and skills of the workforce.
- **Climate and amenities:** Research has shown that, in many cases, workers are willing to accept lower wages to live in places with mild climates and other amenities. Businesses could potentially lower labor costs by moving to these locations.
- **Education:** A state's education level refers to not only the average level of education of a state's workforce but also the availability of education institutions that are able to prepare the future workforce to meet the needs of businesses.
- **Infrastructure:** A state's infrastructure in this context refers to the quality or extent of a state's transportation systems such as railroads, airports, and road systems. It also includes communications systems such as telecommunications and broadband.

- **Labor costs:** The relative cost of labor consists of nontax factors such as wages but also includes unemployment insurance costs that are considered tax factors and vary from state to state.

- **Location-specific profits (before tax considerations):** Businesses may realize profits in one state that they would not in another because of the state's unique characteristics (aside from taxes). State tax policy is not likely to influence the location choices of businesses that depend on location-specific profits. For example, natural resource extraction is dependent on the presence of natural resources.

- **Market size:** Market size includes the size of a state's consumer market (the number of consumers and per capita income) and the size of a state's producer market (the number and size of other businesses). A larger market size tends to lower business costs by lowering shipping costs.

- **Proximity to waterways:** Depending on the type of business, proximity to waterways can have a substantial impact on a state's desirability.

- **Purchasing power (business cost of living):** Business purchasing power is the relative cost of business inputs for a given location. One of the most significant factors in determining businesses' relative purchasing power is the cost of shipping inputs to the business location and the cost of delivering goods to market.

Unfortunately, not all factors can easily be addressed by policy. However, policymakers can possibly address some factors such as infrastructure, education, labor costs, and the availability of a trained workforce using nontax and tax policies.

Tax Policy May Not Compensate for Weak Performance on Nontax Factors

Can states effectively use a low tax burden to compensate for poor performance on nontax factors? Policymakers typically compare their state's tax rates on business income with other states, relying on multistate tax comparisons. Such comparisons, however, should be used with caution because they generally assume a direct (linear) relationship between tax rates and business investment.[1] National research shows that changes in tax rates or policies range from having little influence on business investment decisions to having dramatic effects in ways that are not predictable. This unpredictability underscores the point that the relationship between tax policy and business investment is nonlinear and the

[1] More detail on state tax comparisons is in the appendix.

response of business investment to past policy changes can be a poor guide to the effect of future policy changes. Even if the measures used in the multistate tax comparisons are capturing factors that matter to businesses, the nonlinear relationship between taxes and investment means that if a state adjusts its tax policy and improves its rank on the studies, it will not necessarily see an increase in business investment.

Strong Nontax Factors and High Effective Tax Rates

Unless a state's nontax factors are particularly strong, high effective tax rates (compared with the national average) can potentially decrease business investment. However, effective tax rates that are relatively high—but still similar to rates in states with similar performance on nontax factors—will likely have only a modest negative effect on investment.

Weak Nontax Factors and Low Effective Tax Rates

Low effective tax rates will unlikely attract investment to a state with relatively weak nontax factors. Further, moderate effective tax rates will not likely discourage investment but will collect tax on profits from business investments that are attracted to a state's nontax factors.

Tax reduction policies can reduce the funds available for improving nontax factors.

For states that lack strong nontax factors, competing for business investment with tax reduction policies can reduce the funds available for improving nontax factors while at the same time failing to increase business investment from instate businesses or out-of-state businesses. On the other hand, tax reduction policies, in some cases, can serve to complement strong nontax factors and, to some degree, rectify negative nontax factors that policymakers cannot address with other policy options.

Conclusion

Research shows that nontax factors are often more important to business investment decisions than are tax costs. However, the importance of nontax factors does not lessen the importance of tax policy decisions. Instead, the important role of nontax factors highlights the importance of tax features that complement policies designed to address nontax factors. Tax policies that reduce the tax burden on businesses but, as a result, decrease state revenues can undermine attempts to improve business investment conditions. For example, reducing a specific tax may be attractive to businesses. However, if the tax reduction affects the state's ability to fund programs designed to improve nontax factors important to businesses, such as educated workforce or infrastructure, businesses may find the state unattractive.

To manage the balance between attractive tax policy and programs that support important nontax factors, policymakers need more information than is provided in multistate tax comparisons. Building upon the content of this chapter and preceding chapters, chapter 4 introduces a tool we have developed to help users identify critical questions that should be asked when evaluating tax policy alternatives. The purpose of the tool is to aide users when considering how tax policies can offset Idaho's business investment environment.

Chapter 4
Balancing Tax Policy and Economic Goals

Identifying Policies and Goals

The information provided in this study is designed to help policymakers use the complex and often conflicting information surrounding business tax policy and more specifically, business tax comparisons. Idaho's modest rankings on the four studies described in chapter 2 are likely cause for policymakers to wonder whether Idaho's rankings would justify changes to tax policy.

Although tax comparisons provide information that can be useful to policymakers, comparisons alone provide insufficient information to drive policy change. The key to developing successful tax policy is linking proposed policies to policymakers' goals—a relationship that is not always clear.

OPE Tax Policy Tool

We have developed a tool to help policymakers evaluate the link between policy proposals and policy goals. Exhibit 4.1 outlines the steps involved in using our web-based tool. Users can load the tool with policy proposal assumptions and anticipated outcomes and use the tool to clarify their relationship.

The tool is not designed to tell users what tax policies should be considered to achieve a particular goal or whether a tax policy can achieve a goal. We designed the tool to help users zero in on the information and considerations most relevant to their goals and policy interests.

The tool does not tell users what tax policies should be considered or whether a tax policy can achieve a particular goal.

A simple but important step when considering tax policy alternatives, and when using our tax policy tool, is to identify the tax under consideration. The tool allows users to select from corporate income tax and sales tax.

After users have selected which tax type is under consideration, they can enter a value for how much they wish to change the tax policy. Users can specify a percentage change, dollar change, or one of the western states as a reference point.

Exhibit 4.1 Steps for Using the OPE Tax Policy Tool

Step 1: The user selects a tax type for a proposed change.

Information concerning the tax is displayed (e.g., current rate, revenue generated)

Step 2: The user selects a policy change and amount from three options.

(1) Rate change

(2) A referenced state to match

(3) A fixed dollar amount (e.g., fiscal impact of an exemption)

If the policy change is not expected to be revenue neutral, a resulting revenue gain or loss is entered.

Step 3: The user selects and weights up to three taxes from which any lost revenue from step 2 will be recouped. Users can also choose that revenue will not be recouped.

Step 4: The tool produces a simple logic model indicating the proposed change and what will be needed for alternative revenue generation. The tool will also provide relevant, additional information that may include the effects of similar changes in other states, cautions about unintended consequences, and safeguards for increasing the likelihood of the desired outcomes.

The direct effect of a tax rate decrease, exemption, deduction, or credit is a decrease in state revenue. Tax policy proposals are frequently presented to policymakers accompanied by claims that by improving economic conditions, increasing jobs, or improving economic competitiveness, the suggested change will offset the revenue forgone because of the policy change. The core purpose of our tax policy tool is to help users evaluate such claims. The tool allows users to input which revenue sources they anticipate will offset the decrease in state revenue from the policy change.

Neither this report nor the tax policy tool is intended to evaluate policymakers' goals but rather to help users consider the links between policies and goals.

More important than the type of tax and policy change being considered are policymakers' goals and the barriers to achieving those goals. Clearly defined goals help identify measurable indicators of whether a policy change is successful. Neither this report nor the tax policy tool is intended to evaluate policymakers' goals but rather to help users carefully consider the links between policies and goals. As explained throughout this report, tax policies and rates are limited in their ability to influence business investment behavior.

Linking Policies to Goals

The link between policy and goals can appear more direct than it actually is. The example in chapter 1 illustrates the challenges faced by a seller trying to improve the marketability of her home. The seller had consulted a real estate ranking that placed her home toward the bottom of ranked homes in the area. She could easily have lowered the asking price of her home to improve its marketability but may have done so unnecessarily. Without identifying and addressing factors that have negatively affected the marketability of her home, lowering the asking price may do little more than decrease her earnings.

Likewise, considering the plausible factors that act as barriers to achieving policymakers' goals is a critical step when evaluating tax policy alternatives. Policymakers should keep in mind that, in isolation, any single barrier might appear to have a direct effect on a desired goal. When considered in light of other relevant barriers, however, the influence of each may become more or less important.

We encourage users to consider a broad array of both tax and nontax barriers to achieve their goals. The following sections identify and discuss three categories of barriers policymakers face when working to achieve economic goals.

What Is the Cost of Taxes on Businesses in Idaho?

The costs Idaho businesses incur from tax policies and rates is one category of barriers that should be considered. Barriers falling under this category are those that, by overcoming, could further policymakers' goals regardless of rates and policies in other states.

For various reasons, tax rates and policies are not applied uniformly to all businesses. Consequently, the effective (actual) tax rate paid by businesses will differ from the statutory tax rate.

Policymakers have various resources available to them that report measures such as average tax rate or business taxes as a percentage of gross state product. These measures can provide an idea of the cost of Idaho's taxes to businesses. However, the measures do not capture important aspects of a state's tax system or all business tax-related costs. Tax compliance efforts can be a considerable cost to businesses and should be accounted for when determining the total cost of taxes on businesses.

What Is the Cost of Idaho's Taxes on Businesses Relative to the Cost in Other States?

Multistate tax comparisons are designed to address the cost of taxes on Idaho businesses relative to those in other states. Although Idaho's tax costs can be a factor in achieving economic goals, consideration should be given to how important these costs are in light of other nontax factors. Two questions can help determine the importance of Idaho's relative tax costs.

How large is the difference between Idaho and other states?

In other words, how much higher or lower are Idaho's business tax costs than other states' tax costs. Although Idaho ranks modestly on some multistate tax comparisons, its scores on the studies are not dramatically different from other states' scores.

How important is the difference between Idaho and other states?

Tax comparison studies and research literature do not definitively answer this question. The discussion on tax and nontax factors in chapter 3, when used in conjunction with an understanding of the measures used in multistate tax comparisons, can help policymakers develop a sense of whether the differences in the tax policies captured by the studies are important.

On average, even when taxes in competing states are substantially different, tax comparison rankings are not strongly predictive of business investment decisions. Small differences among states' taxes are even less likely to affect businesses' investment decisions. Accurately assessing the importance of these differences in tax rates and policies would require substantial research to determine whether the policies underlying Idaho's performance on multistate tax comparisons are having an effect on business investment decisions.

What Are Idaho's Nontax Strengths and Weaknesses?

According to research, nontax factors are generally more important to business investment decisions than are taxes, and they represent a wide array of potential barriers to achieving policymakers' economic goals. Further, favorable tax rates and policies are unlikely able to compensate for relatively weak nontax factors. To determine whether tax policy changes are likely to increase business investment in Idaho, policymakers first need to identify Idaho's nontax strengths and weaknesses and determine how important these strengths and weaknesses are to the businesses that make up Idaho's industry mix.[1]

Interaction of Policy, Barriers, and Goals

Tax policies selected to overcome a particular barrier to economic improvement will likely interact with nontax factors. In some instances the interaction might be positive while in others it might undermine the policy efforts. The central

1 Chapter 3 lists nontax factors that have been shown to influence business investment.

question to answer is whether a tax policy change will actually affect business activity, and if so, will the change affect activity in the intended way. The results of tax policy changes designed to influence business investment decisions fall into five general categories:[2]

- Rates or policies are changed for a specific outcome, but the outcome does not happen.

- Rates or policies are changed for a specific outcome, but the outcome would have happened anyway.

- Rates or policies are changed, and the intended outcome happens as a result of the change.

- Rates or policies are not changed, and the level of investment remains the same or decreases.

- Rates or policies are not changed, but the desired outcome happens anyway.

Multistate tax comparisons generally do not identify which specific areas of tax policy can be changed to improve Idaho's business investment environment. As we have shown throughout this report, the relationship between taxes and investment is nonlinear, meaning any degree of alteration to tax rates or policy will not necessarily result in proportional changes to business investment. Tax policies must be considered in conjunction with nontax policies to determine which are likely to improve business investment.

Businesses rely on tax-funded government services such as infrastructure development, education, and workforce training. Tax policy changes affecting Idaho's ability to fund programs that businesses rely on might improve Idaho's competitiveness in the short term by reducing business tax burden but decrease Idaho's competitiveness in the long term by eroding the quality of nontax factors.

What Are the Unintended Consequences of Business Tax Policy Changes?

Although tax policy changes have the potential to benefit the state, depending on their type and design, they can also lead to unintended and undesirable outcomes. The potential for adverse outcomes deserve careful consideration. The following outcomes can be difficult to foresee and depend on the specific policy alternative under consideration.

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[2] Note that these categories address only the specific policy change considered and its intended effect; they do not consider effects on nontargeted businesses or other entities that could experience repercussions.

- **Bidding wars:** Because states compete with each other for business investment, changes in one state's tax policy can trigger policy changes in competing states. As this behavior escalates, states risk decreased revenue for essential government services and potentially negative effects on nontax factors.

- **Efficiency costs:** Tax policies that increase the complexity of a tax system can result in an increased cost of administering tax policy and a loss of revenue from noncompliance. Complexity can also increase the cost that businesses incur to comply with policies.

- **Tax burden shifts:** The cost of some policies, such as incentives or tax rate reductions, may be passed on to other industries or nonbusiness entities in the state.

- **Tax distortions:** By incentivizing particular business investment decisions, tax policies can lead to market distortions and ultimately instability in the market, which can work against economic improvement goals.

Additional Factors That Affect the Success of Tax Policy

Policymakers can increase the likelihood that a policy will achieve its intended objective by determining what steps can be taken to minimize the potential for unintended, negative consequences resulting from tax incentives, both specific to particular incentives and in general. The following actions are examples that can mitigate unintended, negative consequences:

- *Strengthen the approval process:* Multiple state entities can review the awarding of an incentive to ensure eligibility.

- *Public disclosure and online accountability:* Online transparency can help to ensure businesses are meeting agreed upon expectations. Online accountability can include information about which businesses are taking advantage of incentives and the criteria and requirements used to establish eligibility.

- *Specify detailed qualification criteria for tax incentives:* Clear and specific qualification criteria for tax incentives can potentially reduce the opportunity for nontargeted businesses to take advantage of the incentive. Through an incentive, for example, a business could be required to create a certain number of jobs paying a particular minimum salary.

- *Clawbacks:* Clawbacks refer to specific avenues for recouping lost revenue in case a targeted business fails to meet the agreed upon criteria included in the incentive language.

- *Post-performance awards:* Incentives can be designed to occur after performance criteria have been met, reducing the necessity of recuperation efforts if businesses fail to meet performance criteria.

- *Sunset clauses:* An explicit end date for a tax incentive will encourage a review and assessment of it in terms of benefits to the state, effects on other state entities (both positive and negative), and whether it should be ended.

The Pew Center on the States, in a nationwide study, developed practical steps that state policymakers can take to determine whether tax policy alternatives are achieving their goals. Pew suggests that policymakers who are considering tax policy alternatives should ask this critical question: Can the policy's goals be assessed for achievement? A robust evaluation plan includes steps of review over the entirety of the policy change that would provide evidence of positive outcomes as well as early indications of negative aspects.

Those considering tax policy alternatives should ask this critical question: Can the policy's goals be assessed for achievement?

Policies need to have clearly defined objectives to be monitored and evaluated. In the absence of a clear objective, one may not be able to determine whether a policy is achieving its intended goal. The goal should be framed in measurable terms and should not be limited to the desired, final outcome.

For example, any policy change proposal should include well-informed estimates of the expenditure, expected beneficiaries, the potential affect to other entities, and detailed business-eligibility criteria. Further, a timeline of projected events can facilitate periodic evaluation to determine whether commitments are being met or whether unforeseen negative consequences have arisen.

Conclusion

As explained throughout this report, tax policies and rates are limited in their ability to influence business investment behavior. Tax policies selected to overcome a particular barrier to economic improvement will likely interact with other nontax factors. Policymakers should carefully consider two key relationships:

1. The link between tax policy changes and broader economic goals

2. The balance between Idaho's business tax costs and the revenue necessary to sustain and improve nontax factors that can be influenced by government

Appendix
Examples of Tax Comparison Studies

Four Studies Provide Examples of How to Interpret Multistate Tax Comparisons

As established in the report chapters, tax policy generally plays a limited role in the decisions made by businesses; however, understanding the types of comparison studies and the differing approaches taken in assessing and ranking those policies is helpful for those wanting to understand the implications of tax comparisons. This appendix analyzes four major studies of multistate tax comparisons to (1) demonstrate how to interpret the rankings and (2) illustrate the limitations and strengths of the comparisons.

State Business Tax Climate Index

The *State Business Tax Climate Index* is an annual study produced by the Tax Foundation. The *Climate Index* scores the components of each state's tax law and ranks the states' business tax climates by those scores, resulting in (1) an overall score and rank for each state and (2) a score and rank for each of five major tax components.

The five components are corporate income tax, personal income tax, sales tax, property tax, and unemployment tax. The study weights each component in the overall ranking by the degree of variability among the states on that component—components that vary widely among states are given greater weight than those in which states score more similarly. For example, the individual income tax component ranking makes up 33 percent of the overall ranking, while the unemployment tax makes up only 11 percent.[1]

The *Climate Index* assesses states' business tax climates by how well they score on each of the five components. The Tax Foundation derives scores by assigning values to the states' statutory tax features. Consequently, *Climate Index* users can interpret a state's score as a measure of how close the state's statutory tax features adhere to the *Climate Index*'s definition of a business friendly tax structure. Users can then compare that score with scores of other states.

[1] The methodology section of the *Climate Index* explains the variables used to develop an index for each of the five components.

Climate Index scores do not provide much more information than its rankings. Scores range from 0 to 10, with 0 being the least competitive business tax climate and 10 being the most. The scores describe the relative magnitude of the difference among states' tax structures but do not indicate the significance of those differences. For example, Idaho's overall score is 5.23, indicating that its tax structure is less business friendly than Alabama's score of 5.31 but more business friendly than Kentucky's score of 5.20. However, the scores do not indicate to what degree Idaho is less business friendly than Alabama or more business friendly than Kentucky.

Although the component rankings identify broad policy areas that affect states' overall ranking, they do not indicate what specific policies or tax rates affected the rankings. For example, a poor score on the corporate income tax component does not necessarily indicate that a state's corporate tax rate is too high. Instead, the score could indicate that the state uses corporate tax brackets with several different rate brackets—a policy penalized by the *Climate Index*.

Usefulness for Policymakers

The *Climate Index* does not provide details on the individual variables comprising each of the five components (118 total variables), but it does provide rankings for the components themselves and the weight given to each in the composite ranking. Although the rankings do not indicate the significance of difference between states, components given a lower weight are those in which scores across states are less variable, hence potentially providing a greater opportunity to improve an individual state's rank. Conversely, a low ranking for Idaho on a component given relatively little weight indicates that the real magnitude of difference between it and higher ranked states is not as great as on components given higher weights in the composite.

The *Climate Index* can be useful for policymakers wanting a broad comparison of how well the states' statutory tax rates and policies represent a business friendly tax climate as defined by the *Climate Index*. Especially useful, the appendix in the *Climate Index* presents tables of information about each state's tax features such as tax rates, brackets, credits, deduction, and exemptions.

Total State and Local Business Taxes

The Council on State Taxation and Ernst and Young have produced the *Total State and Local Business Taxes* annually since 2002. The analysis in *Total State and Local* focuses on total state and local taxes paid by businesses in each state. It also includes a measure of each state's total business taxes as a percentage of the private-sector gross state product is included that allows a comparison among states.

Total State and Local reports five results for each state:

- Total state and local business taxes (in dollars) by major tax type
- Major tax type as a percentage of total state and local business taxes
- Total state business taxes
- Total local business taxes
- Total state and local business taxes as a percentage of private-sector gross state product

Because business taxes alone are not useful to compare states' tax systems, *Total State and Local* reports total state and local business taxes as a percentage of the private sector's gross state product. The gross state product is a measure of a state's economic activity, and the percentage represents the average effective tax rate on statewide economic activity.

Users can compare the average effective tax rate among states to see differences in the estimated tax burden relative to gross state product on businesses in each state. However, the average effective tax rate can only provide an overall view of a state's tax structure relative to its economic activity. Because businesses will incur different tax liabilities depending on their business type, this measure does not indicate to users how attractive their state's tax structure is to businesses.

Usefulness for Policymakers

Although *Total State and Local* can help policymakers see how their state's tax burden compares with other states, the policy implications are unclear. The study does not contain the information necessary to determine the weaknesses and strengths of a state's tax system.

Total State and Local is useful in comparing how much state and local governments tax businesses as compared with the private sector's gross state product. In addition, because the developers have been publishing the study for a number of years, policymakers are able to observe a state's change in business taxes over time, both in absolute amounts and as a percentage of the gross state product.

Competitiveness of State and Local Business Taxes on New Investment: Ranking States by Tax Burden on New Investments

In 2011 the Council on State Taxation and Ernst and Young released *Competitiveness of State and Local Business Taxes on New Investment: Ranking States by Tax Burden on New Investments.* The intent of the study is to isolate and compare the impact of state and local business taxes with new capital investments in each state.

Competitiveness applies state and local tax laws to five hypothetical businesses representing new capital investment in each state. It reports two results for each state: (1) the effective tax rate weighted by capital investment level and (2) the effective tax rate weighted by jobs.

Competitiveness isolates differences among states' marginal effective tax rates that are attributable to business tax policies. To isolate differences, the developers hold a constant detailed profile for each of the five hypothetical businesses and apply each state's tax laws to the businesses. The developers have projected financial profiles for 30 years to capture tax features that are reliant on timing, such as sales tax on business investments replaced over time.

The marginal effective tax rate is calculated as the average percentage difference between the before-tax rate of return and the after-tax rate of return for the five hypothetical businesses in each state. For example, if a state's before-tax rate of return is 20 percent and the after-tax rate of return is 19 percent, the state's average effective tax rate would be 5 percent.[2]

Competitiveness users can interpret the marginal effective tax rate as the average impact a state's tax policy has on the rate of return for new capital investment. States with the highest average after-tax rate of return are likely to be the most attractive to businesses. The average effective tax rate for each state is the average rate for the five hypothetical businesses and not a state's actual effective business tax rate.

Usefulness for Policymakers

Competitiveness does not account for the effect of incentives—incentives that often offset less competitive features of a state's tax structure.[3] The study also excludes unemployment insurance taxes, which can represent a significant cost to businesses. *Competitiveness* does not report state-by-state results for each of the five hypothetical businesses in isolation. Further, *Competitiveness* recognizes a substantial limitation in the exclusion of nontax costs and notes that nontax costs are often the most significant variable business cost.

Despite these limitations, the study can help policymakers better gauge how state tax policies affect particular business types. Additionally, the appendix provides tables of basic information about all of the major business taxes in each state.

Location Matters

The Tax Foundation and KPMG LLP produced the newest study we examined, *Location Matters,* first released in spring 2012. The Tax Foundation noted that none of the existing studies provide comparisons of actual business tax burdens and intended for *Location Matters* to fill that gap.

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[2] The calculation is 20 percent (before-tax rate of return) *less* 19 percent (after-tax rate of return) *divided* by 20 percent (before-tax rate of return).

[3] Examples of an incentive are tax abatements, job creation credits, and research and development credits.

Location Matters measures the total cost of taxes for hypothetical new and mature businesses modeled in each state.[4] Individual state sections of the study briefly explain the factors affecting each state's rank. *Location Matters* reports an overall tax cost score and rank for each state, the total effective tax rate by the seven hypothetical businesses in each state, and rankings based on the total effective tax rate for each business type and maturity.

To determine the scores and rankings, *Location Matters* applies each state's tax laws to the seven hypothetical businesses. The Tax Foundation develops characteristics for each of the businesses, such as the number of employees by function, employee salaries, capital investment, revenue and profit, and the amount of property, payroll, and sales in each state.

Using these characteristics, the developer applies a state's tax laws to each hypothetical business and determines the total effective tax rate. Hypothetical businesses are modeled in one of two locations (either a large metropolitan area or a smaller community, depending the typical location of the particular business type) in each state to account for local tax variations. They are also modeled as a new business in operation for less than three years and as a mature business in operation for ten years or more.

The score and rank for each business type are calculated as the ratio of a state's total tax burden to the national average tax burden. States receive scores for each of the seven business types. The scores for each business type are averaged to create an overall score and then ranked from lowest to highest. *Location Matters* notes that industry-specific scores are correctly interpreted as a measure of how much or how little tax a state places on different businesses or industries compared with the national average. Scores are not necessarily a reflection of the quality or efficiency of a state's tax system. Two states could have the same total effective tax rate or score but vastly different tax structures.

Because scores are relative to the national average, they can be interpreted as a percentage of the national average of the total effective tax rate. For example, if the overall score of one state is 112, the average tax burden for businesses in that state is 12 percent higher than the national average

Idaho's overall score for mature businesses is 111.7, indicating that on average Idaho's tax burden for the hypothetical mature businesses is 11.7 percent higher than the national average. Idaho's overall score for new businesses is 116.

Usefulness for Policymakers

Location Matters provides both index scores and rankings for each of the seven hypothetical business at both maturity levels so that policymakers can look at individual industry types in isolation.

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[4] See chapter 1 for an explanation of the various types of studies.

Location Matters presents an approach to multistate tax comparisons that can be useful in helping policymakers understand how states' tax structures affect the tax costs faced by different types of businesses.

Users should be aware of several limitations to *Location Matters*. A state's overall score represents the average total effective tax rate of the seven business types but does not represent the state's actual total effective tax rate. Also, *Location Matters* does not account for the implications of a state's tax policies beyond the total effective tax rate. The study does not account for unintended economic consequences of tax policies or compliance costs to businesses.

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Responses to the Evaluation

C. L. "BUTCH" OTTER
GOVERNOR

May 30, 2013

Rakesh Mohan, Director
Office of Performance Evaluations
954 W. Jefferson St.
Boise, ID 83702

Dear Rakesh,

Thank you for the opportunity to respond to the Guide to Comparing Tax Policies Affecting Businesses report.

I have long been convinced that tax policy in Idaho should represent a public policy expression, hand in hand with our incredible quality of life, to make our state the most desirable place in the nation to live and do business. To this end I have supported lowering marginal rates, eliminating the burden of the business personal property tax, and myriad efforts to simplify and reduce the impact of our tax system on businesses and families.

I am committed to using sound, useful data to drive policy decisions. Your work identifying those factors which may rightly or wrongly be used to compare Idaho with other states should be useful as policy makers continue to address those tax policy issues which will provide the "most bang for our buck" in facilitating new and expanding business in our state.

I appreciate your efforts to collaborate with the Department of Commerce, the Idaho Tax Commission, and the Division of Financial Management in developing this report and the Tax Policy Tool.

As Always – Idaho, "Esto Perpetua"

CLO/rmb

C.L. "Butch" Otter
Governor of Idaho

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State Tax Commission

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May 29, 2013

Rakesh Mohan, Director
Office of Performance Evaluations
954 W. Jefferson Street
Boise, ID 83702

Dear Mr. Mohan:

Thank you for giving us the opportunity to review and respond to the OPE report: "Guide to Comparing Tax Policies Affecting Businesses." We appreciate your consideration of our suggested additions and observations, and we feel the report gives an even-handed assessment of the various studies and rankings in circulation. We concur with your report's conclusion that that "none of these studies tells the complete story." Idaho policymakers are well advised to consider the source and perspective of any given study, and to weigh that against other studies or rankings so as to avoid bias.

We are very encouraged by the new OPE Tax Policy Tool! This tool will provide a quick and easy way for legislators and others to analyze potential changes to tax code and the fiscal impacts of those changes. This will save many hours of work for our staff and the Legislative Services analysts, while getting much more information into the hands of legislators in a timely manner. More and better information can only help the process as policymakers weigh the ins and outs of the inevitable dozens of tax changes contemplated every year. The Tax Policy Tool is a simple and elegant tool to begin the discussion.

The Tax Commission's role is to administer the tax laws of this state, and our desire is to do this as equitably and simply as possible. A fair and thorough reading of your report by policymakers, and the availability of the new Tax Policy Tool, will help ensure that Idaho's tax policy remains as equitable and simple, and that tax burdens remain some of the lowest in the nation.

We appreciate your collaboration and outreach to us in the process of producing this study.

Sincerely,

Richard W. Jackson
Chairman

cc: Roger Brown, Office of the Governor
Commissioners, Idaho State Tax Commission
Randy Tilley, Audit Division Administrator

IDAHO
COMMERCE

C.L. "Butch" Otter, Governor
Jeffery Sayer, Director

June 4, 2013

Mr. Rakesh Mohan
Director
Office of Performance Evaluations
954 W. Jefferson Street
Boise, Idaho 83702

Dear Rakesh,

Thank you for the opportunity to review the "Guide to Comparing Tax Policies Affecting Businesses" report and to offer feedback.

Your statement, "The effects of tax rate and policy changes cannot be understood or predicted in isolation from nontax factors" is one of the most important items in the report, as it highlights a core reality in this analysis and aptly sets the foundation for the complexity of these decisions moving forward.

Understanding the economic impact of Idaho's tax policy and the effect it has on our state's ability to attract and support economic growth will remain an important priority for the state for years to come. We commend OPE's efforts and the foundational analysis it has created with this report. The Department of Commerce is excited about an opportunity to work with OPE.

We are equally encouraged with the OPE Tax Policy Tool. This tool will be a valuable resource for our department as we assist the Governor in evaluating policy opportunities and the strategic impact it may have for our state and economy. We look forward to using this tool and collaborating with others as it is used and developed going forward.

Your efforts are greatly appreciated for teaming up with Commerce, the Idaho Tax Commission, and the Division of Financial Management in the creation of this outstanding report and the Tax Policy Tool.

Sincerely,

Jeffery Sayer
Director

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11-04F	Idaho Transportation Department Performance Audit	March 2011
11-05	Delays in Medicaid Claims Processing	March 2011
11-06	Equity in Higher Education Funding	November 2011
11-07	Idaho's End-Stage Renal Disease Program	November 2011
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