MERCATUS CENTER
George Mason University
BRIDGING THE GAP BETWEEN ACADEMIC IDEAS AND REAL WORLD PROBLEMS
MERCATUS RESEARCH

A Comparison of Indices that Rank State Economic Competitiveness

Emily Washington
Associate Director of State Outreach

In the last few years, several free-market organizations have ranked the states on the basis of their economic and social policies. The organizations have designed these indices to help individuals select states with the fiscal, and sometimes the social, climates that most closely match their ideals as well as to provide state policy makers with ways to compare their states' legal and economic climates. As each of these indices surveys the states through a particular lens—business, taxes, individuals—they rank states in different orders. But the ranking systems are similar enough that comparing the indices side-by-side allows the reader to receive an overview of state economic freedom.

All three systems look at state policy from the perspective of Tiebout Competition.[1] Charles Tiebout first explained in the 1950s that people "vote with their feet," so that if people become sufficiently dissatisfied with public policy in their state, they will move to another state where policies align more closely with their preferences. These indices provide individuals and businesses with a transparent way to select states where the fiscal (and social) climates most closely match their ideal. They also provide a metric for policymakers to improve their states' climates for economic growth relative to their neighbors. This paper will provide a brief description of each of the three indices and then analyze their similarities to find areas where these three studies are in agreement on potential policy improvements.

State Business Tax Climate Index by Kail M. Padgitt, The Tax Foundation[2]

The Tax Foundation's *State Business Tax Climate Index* (*SBTCI*) is the most narrowly focused of the three, looking only at the tax policies that influence where entrepreneurs locate their businesses. Padgitt explains that the Tax Foundation chooses this lens because, "unlike changes to a state's health care, transportation, or education system—which can take decades to implement—changes to the tax code can bring almost instantaneous benefits to a state's business climate."

The *SBTCI* heavily emphasizes the impact that tax policy has on domestic migration. Businesses will choose to relocate if taxes become too burdensome in their current state. Furthermore, Padgitt asserts that the effect of Tiebout Competition is even more important for businesses than individuals because they can often relocate more easily, and in some cases, moving from one state to another could be the difference between making profits and making losses.

In general, states that have eliminated one of the major taxes—the corporate tax, individual income tax, or sales tax—do very well in this index.[3] The ten top-ranked states are South Dakota, Alaska, Wyoming, Nevada, Florida, Montana, New Hampshire, Delaware, Utah, and Indiana, all of which refrain from taxing at least one of these areas.

Table 1: States that Ranked in the Bottom Ten of at Least Two Indices

	Rich States Poor States	Freedom in the 50 States	State Business Tax Climate Index
California	47	48	49
Hawaii	46	46	22
New Jersey	45	47	48
New York	50	50	50
Rhode Island	42	42	42
Vermont	49	44	38

Table 2: States that Ranked in the Top Ten of at Least Two Indices

	Rich States Poor States	Freedom in the 50 States	State Business Tax Climate Index
Colorado	6	10	15
Florida	10	14	5
Idaho	5	4	18
North Dakota	7	3	20
South Dakota	2	1	1
Tennessee	8	6	27
Utah	1	20	9
Virginia	3	5	12
Wyoming	4	23	3

New York ranks last on the *SBTCI* because it does poorly in all three of the major tax categories. Padgitt explains that New Jersey had scored last for the past four years but moved up to 48th this year by eliminating its two top income tax brackets. He writes, "The states in the bottom ten suffer from the same afflictions: complex, non-neutral taxes with comparatively high rates."

Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index by Arthur B. Laffer, Stephen Moore, and Jonathan Williams, American Legislative Exchange Council[4]

Compared to the other indices , *Rich States, Poor States* places greater emphasis on the quantifiable effect that state policies have on migration. It even has a State Economic Performance Ranking, which is based on personal income per capita, absolute domestic migration, and non-farm payroll employment, rather than on measures of policy.

The ranking that is the most similar to those of the other indices, however, is the Economic Outlook Ranking, which weighs 15 fiscal and labor policy variables equally to determine which state has the freest economic policy. As the result of being a right-to-work state, not having a state minimum wage above the federal floor, not having an estate tax, and having a flat personal income tax, Utah earns the top spot, followed by South Dakota, Virginia, Wyoming, Idaho, Colorado, North Dakota, Tennessee, and Missouri.

The states that fared the worst in ALEC's Economic Outlook Ranking include New York at number fifty, preceded by Vermont, Maine, California, Hawaii, New Jersey, Illinois, Oregon, Rhode Island, and

Pennsylvania. Four of these states that ranked at the bottom of the Economic Outlook Ranking, New York, New Jersey, California, and Illinois are also among the worst states on the Economic Performance Ranking, demonstrating the importance of fiscal policy for growth in state income and population.

Freedom in the Fifty States: An Index of Personal and Economic Freedom by William P. Ruger and Jason Sorens, Mercatus Center at George Mason University.[5]

Unlike the other indices that focus exclusively on state economic competitiveness, *Freedom in the 50 States* also evaluates policies that affect personal freedom. In Ruger and Sorens's index, "Regulatory Policy" and "Fiscal Policy" each comprise 25% of the "Overall Freedom Ranking" and "Personal Freedom" accounts for the other 50%.
Ruger and Sorens also give an "Economic Freedom" ranking, which, as it is made up equally of the fiscal and regulatory policy areas, is comparable to the other studies. State and local spending, tax revenues, and debt burden are some of the variables that they weight most heavily.[6]

The raw data used in *Freedom in the 50 States* is available online, and readers can use it to compile rankings based on their personal definitions of freedom. Relative to the other ranking systems analyzed here, *Freedom in the 50 States* includes fewer factors related to taxes and expenditures, choosing to focus less on how taxes are generated than the overall tax burden. It also looks in greater detail at each state's regulatory and legal environment, including labor regulation, health insurance mandates, and eminent domain.[7]

The authors provide specific policy recommendations to states. For example, for New York, the last state in the Economic Freedom Ranking, the authors recommend cutting spending in all areas [including public welfare, hospitals, electric power, transit, and employee retirement], and cutting taxes across the board.

Comparing the Indices

While each of these indices is derived from somewhat subjective measures of the policies that create a favorable climate for economic growth, looking at the three together provides a more general perspective on state policies. The states that ranked in the top ten or bottom ten on at least two of the three indices are shown in Table 1. There are many similarities between the indices rankings, especially at the bottom. New York, for example, ranked dead last on each list. California and New Jersey both scored very poorly on each list, and Rhode Island ranked 42nd on each.

The top ten states on each list show more variety. Only South Dakota ranked in the top ten of each of the three rankings. Virginia ranked in the top five in *Rich States, Poor States* and *Freedom in the Fifty States*, but came in eleventh on the *State Business Tax Climate Index*.

Two states in particular bring out the differences across the three indices, demonstrating how the differences in the authors' objectives affects states' ranking. One of the greatest variances between the rankings is Alaska, which scored 49th on *Freedom in the Fifty States*, 29th on *Rich States, Poor States* and 2nd on the *State Business Tax Climate Index*. Alaska fares well in the *State Business Tax Climate Index* primarily because the state has no individual income tax and no statewide sales tax.[8] By contrast, *Freedom in the 50 States* ranks Alaska very poorly because of its debt and share of its employees who are government employees, two variables the Tax Foundation does not consider.[9] In *Rich States, Poor States*, Alaska ranks in the middle of the pack because of its high number of public employees and labor laws that discourage hiring alongside its avoidance of state individual income and sales taxes.

Likewise, the studies ranked Oregon very differently. Oregon ranked 14th in the *SBTCI*, 25th in *Freedom in the 50 States,* and 43rd in *Rich States, Poor States*. This variation comes from *Rich States, Poor States* placing a heavy importance on the top marginal personal income tax and the top marginal corporate income tax (11% and 11.25% respectively in Oregon) as well as on restrictive labor policies and an inheritance tax. Oregon's minimum wage and pro-union policies do not affect its standing in *SBTCI,* but its lack of a state sales tax boosts its standing.

The similarities across the states ranked at the bottom of these indices represent the broadest agreement across the three studies and also serve as the most important result from this comparison. The burdensome tax and regulatory regimes in these states are driving citizens and businesses to vote with their feet and move to other states. The dissemination of these indices provides citizens and businesses with transparent metrics for finding states that fit their preferences. For policymakers in poor-performing states, these rankings should serve as a wake up call; other states should see these states as outcomes to avoid and work to improve business climates in their own states to remain competitive in this marketplace.

ENDNOTES

1. Charles Tiebout, "A Pure Theory of Local Public Expenditures," *Journal of Political Economy* 64 (1956).
2. Kail M. Padgitt, "2011 State Business Tax Climate Index," Tax Foundation Background Paper 60 (October 2010).
3. Ibid., 5.
4. Arthur B. Laffer, Stephen Moore and Jonathan Williams, *Rich States, Poor States* 4 (2011).
5. William P. Ruger and Jason Sorens, "Freedom in the 50 States: An Index of Personal and Economic Freedom," Mercatus Center at George Mason University (June 2011).
6. Ibid., 11.
7. Ibid., 7.
8. Padgitt, SBTCI, 4.
9. Ruger and Sorens, "Freedom in the 50 States," 25.

For more information, contact
Emily Washington, Associate Director of State Outreach, (703) 993-4886, ewashin1@gmu.edu
Mercatus Center at George Mason University 3351 North Fairfax Drive, 4th Floor Arlington, VA 22201