A Look at the:

Tax Foundation 2008 Business Tax 'Climate' Index

Why the Findings DON'T Add Up

THE FULL REPORT

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A classic episode of the *The Bob Newhart Show* begins with Bob in a struggle against an attack of insomnia. Maybe, a snack might help. Bob fixes a bowl of cereal and returns with it to the bedroom. The audience then watches a darkened screen to the sound of Bob crunching through a spoonful of cereal. Bob's wife, Emily, awakens and expresses some frustration with his noisy eating. With perfect deadpan earnestness, Bob explains that his mother taught him to chew each bite of cereal twenty-eight times because well-chewed food aids digestion and promotes health. As spoonful succeeds spoonful, the comic effect grows. Bob obsessively chews each one the requisite twenty-eight times, and Emily is driven to distraction in the process.

The humor of the scene rests on three kinds of exaggeration. First, the obsession with one principle – chew food thoroughly – takes a piece of reasonable advice and drives it to an extreme. Second, the use of a totally arbitrary benchmark adds to the humor. Why chew twenty-eight times? Why not twenty-six? Or thirty? Third, the selection of one value – chewing thoroughly – over other values heightens the absurdity of Bob's behavior. Is it not likely that Bob's mother also told him not to eat in bed? Is it not even more likely that she told him to show consideration for other people? Of course, Bob's eating habits *do* have a kernel of truth behind them. That morsel of validity actually increases the comic effect because the audience sees the contrast between his serious pursuit of one minor value even as he ignores other more important values.

The Tax Foundation's Tax Climate Report has all of the same elements of humor. It takes some principles of tax policy with a kernel of validity and rides them obsessively to absurd lengths. It employs wholly arbitrary benchmarks in the process of quantifying its definition of "tax climate." It values some aspects of state tax systems and ignores others. Finally, it provides a perfect hint about what is coming when it advances the use of anecdotes as method for "reinforcing" knowledge about taxes. Well, everybody loves an amusing story, and the Foundation does not disappoint. Of course, tax professionals will insist that research protocols demand the use of data rather than anecdotal yarns about businesses and taxes, but what fun is that?

This paper provides a brief summary of the Tax Foundation report followed by a few examples of its more ridiculous judgments and contentions.

Overview of the Report

The Tax Foundation released its 2008 business tax climate index in the Fall of 2007. Ohio ranked 46th out of 50 states where the ranking proceeds from #1 as best to #50 as worst.

The Tax Foundation report assigns a score to each state. The report claims that the score quantifies the State's business tax climate. Each state's final score results from the creation of scores from five areas of tax policy – corporate tax, personal income tax, sales and excise tax, property tax, and unemployment compensation tax. A separate "index" for each of these tax types results from two scores developed from the sub-indexes of rate structure and tax base for each of the five areas.

The report makes clear that it does *not* compare tax burdens. Unlike other generally respected comparisons of state and local tax systems, the report makes no comprehensive attempt to estimate per capita taxes or taxes per thousand dollars of income. Instead, it takes various features of tax systems and assigns to them a relative score. The sum of the scores for all of the features yields the total upon which the ultimate ranking rests. While tables in the report show the results in the five tax indexes, and while the text describes the assignment of values in each sub-index in varying degrees of specificity, the Report does not show the actual background computations by which it arrived at each score.

Special Note for Readers with a Serious Interest in State and Local Tax Comparisons

Some readers may not appreciate the humorous view of taxes proffered by the Tax Foundation in its Tax Climate Index. For those who take tax analysis more seriously, reports by the Ohio Department of Taxation, the Ohio Public Expenditure Council (OPEC), and the Committee on State Taxation (COST) provide a drier but more data-driven perspective. Generally, these organizations attempt to present comparative information about taxes without the subjective weighting schemes used by the Tax Foundation. In the process, of course, much of the humor disappears.

Reduction of a Principle to Absurdity

The Tax Foundation relies on the generally accepted economic principle that the best tax system employs a broad base and low rate. In applying this principle to the personal income tax, the Foundation's indexing system evaluates states' rate structures on two equally weighted areas: the top rate in the system, and the structure of the rate brackets. The top rate analysis uses only one variable based on the highest marginal rate used by each state to tax personal income. The other area uses three variables to evaluate the rate structure. These variables

include the level of income where the top bracket starts, the number of brackets, and the width of brackets. Generally, the Foundation's scoring system rewards states where the highest bracket applies at a low income level because those systems approximate a flat rate tax. At the same time, the scoring rewards states where the top rate starts in a very high bracket because those highest rates only affect a few taxpayers. The system rewards states for having few brackets and penalizes those with many brackets. It also rewards states for using narrow brackets, i.e., brackets covering a small range of income, and penalizes states with wide brackets.

Ohio's top marginal rate in 2007 equals 6.24% on income over $200,000. The Foundation claims that Ohio has ten brackets by treating the zero tax on the personal exemption amount as a separate bracket. To compute Ohio's highest marginal rate, the Foundation adds the top State marginal rate to the average municipal income tax rate. As a result, Ohio receives a poor score on the top rate variable for its combined state and local rate of 8.05%. The Report also does not address the fact that much of the income received by persons in the top State income tax bracket would not be taxed under the Ohio municipal income tax which exempts investment income. This overstates the true impact of Ohio's highest marginal tax rate.

Ohio also receives a poor score on the variable for the income level where the top rate starts. The Foundation considers that Ohio starts its top rate bracket in the middle income range and the scoring system penalizes the state accordingly. In contrast, Vermont is rewarded with a better score on the top rate start-up score for initiating its top rate (9.5%) on incomes over $336,550. The scoring also apparently rewards Oregon for starting its top rate (9.36%) at $14,600, a relatively low level. No objective justification separates the determination that Vermont's $336,550 bracket deserves the characterization of "high" any more than Ohio's $200,000 bracket.

The Foundation's scoring system also penalizes Ohio for its high number of wide brackets and apparently rewards Oregon for using only three brackets with an average width of about $3,400 for the first two brackets.

Table 1 shows a comparison of the Ohio and Oregon tax bracket systems. See next page for table.

Table 1:
Comparison of Ohio and Oregon Personal Income Tax Rate Structures as Applied to Taxable Income – 2007

Ohio - 2008				Oregon - 2008		
Income Greater than:	Income Up to:	State + Local Tax Rate		Income Greater than:	Income Up to:	State + Local Tax Rate
$0	$5,000	2.43%		$0	$5,800	5.36%
$5,000	$10,000	3.05%		$5,800	$14,600	7.36%
$10,000	$15,000	4.28%		$14,600	All	9.36%
$15,000	$20,000	4.90%				
$20,000	$40,000	5.52%				
$40,000	$80,000	6.14%				
$80,000	$100,000	6.75%				
$100,000	$200,000	7.55%				
$200,000	All	8.05%				

Notes: Ohio tax rates include average local rates of 1.81% in all brackets. Oregon tax rates relate to married couples filing jointly and include average local rates of 0.36% in all brackets.

The Foundation also assigns a tax base score. Its supplementary information shows 14 variables from which it derives a tax base rating, but the actual values assigned to each state's data do not appear. Ohio and Oregon agree in the treatment of 10 of 15 variables.

Differences include the following items:

1) Oregon is rated as having no "marriage penalty," but Ohio does have a "marriage penalty."
2) Oregon indexes its brackets for inflation. The Tax Foundation treats Ohio as not indexing its brackets, although that conclusion in itself involves a value judgment. Ohio has scheduled tax rate reductions through 2009. After those reductions finish, an indexing law takes effect. For 2008 and 2009, scheduled tax reductions will provide a significantly better deal for taxpayers than indexing would provide, but the Foundation chooses to ignore the future when it includes scheduled reductions and to recognize the future when it includes indexing.
3) Oregon offers a standard deduction ($3,650 on a joint return for 2007),

but Ohio does not allow a standard deduction.

4) Oregon is rated as recognizing LLC status, but Ohio is rated as providing only partial recognition. The meaning of the "partial" rating for Ohio is not explained.

5) Oregon allows a deduction for federal taxes and Ohio does not.

What about the bottom line?

A comparison of married taxpayers filing a joint return in Oregon and Ohio reveals a surprising result. Both couples start with $80,000 in wages. The Oregon couple would pay about $5,900 in personal income taxes on that amount after accounting for the differences in taxable income allowed by standard deductions, exemptions, and federal tax deductibility. The Ohio couple would pay about $4,000.

Nevertheless, the Foundation ranks Oregon's personal income tax 35th and Ohio's income tax 48th. (In this ranking system, a higher rank is worse.) Each part of the Foundation's ranking system has a kernel of logic for a justification. In the end, the Oregon system taxes this middle income couple almost half again (49%) more heavily than an Ohio couple with the same income.

Table 2 extends the comparison of two married couples in Ohio and Oregon with $80,000 in combined income to four other couples with income at $40,000 to $120,000.

Table 2:
Approximate Comparison of Ohio Income Tax to Oregon Income Tax For Married Taxpayers Filing Jointly With Five Different Levels of Gross Income

Gross Income	Ohio	Oregon	Difference	Ratio of Oregon Tax to Ohio Tax
40,000	1,541	2,444	903	159%
60,000	2,713	4,055	1,341	149%
80,000	3,988	5,927	1,939	149%
100,000	5,272	7,799	2,527	148%
120,000	6,702	9,671	2,969	144%

The first column in Table 2 shows the couples' gross income. The second and third columns estimate Ohio and Oregon income taxes, respectively. The third column shows the difference by which the Oregon tax exceeds the Ohio tax. The

final column shows the ratio obtained when the Oregon tax is compared to Ohio. In each instance the Oregon couple pays substantially more. (These estimates use average local rates as computed by the Tax Foundation. They allow standard deductions and exemptions based on 2007 amounts, but they use the 2008 rate structures for both states. In the case of the Oregon couple, only the standard deductions or exemptions were allowed in computing the federal income tax. This assumption tends to make the Oregon deduction for federal taxes larger and the Oregon tax less. All income is assumed to be wages and fully taxable under the Ohio municipal income tax.)

Any competent elementary school student could examine the figures in Tables 1 or 2 and identify that Oregon has higher, and therefore less business friendly, income taxes. The conclusion that the Oregon system's approximation to a flat rate tax makes its income tax structure better for the business climate there compared to the effects of the Ohio income tax throws a pie in the face of common sense.

This simple example clearly shows the fundamental flaw of the Tax Foundation approach. The report properly cites Charles Tiebout as the author of the seminal article on the role of taxes and public services in location decisions. However, the Foundation completely misses Tiebout's fundamental point - that it is the *level of taxes* that influences behavior. Rather than measuring the level of taxes, the Tax Foundation has chosen to create a scoring system of state tax structure that is based entirely on subjective judgments. While the report makes frequent references to "economic theory," by virtue of its single-minded focus on tax structure the Tax Foundation Tax Climate index ignores the most fundamental tenet of economics: behavior is influenced by relative price (which in this case is the level of taxes not their structure).

Finally, public finance experts do analyze tax systems in terms other than the quantitative burden of taxes. However, such analyses recognize tradeoffs among the various features of a tax system. The pursuit of "fairness" taken to an extreme leads to intolerable complexity and imposes unreasonable administrative or compliance burdens. The pursuit of streamlined administration to the opposite extreme can result in systems where persons with lower incomes bear a relatively higher share of government costs. The Foundation ignores all such considerations and the tradeoffs implicit in them in favor of its own one-dimensional and subjective version of the ideal tax structure.

Arbitrary Benchmarks

As mentioned above, the Foundation's tax climate computation uses five areas of taxation with two sub-indexes for each area – one for tax rates and one for tax base. Overall, the rating process uses 113 variables in the various indexes. These

variables fit together based on the Foundation's *arbitrary* assignment of a relative weight for each one.

The property tax index provides an example of how arbitrary the variable weights can get.

The Foundation divides the property tax index into two parts or sub-indexes. One sub-index considers property tax burden. It uses two measures of property tax burden: property taxes per capita and property taxes per $1,000 of personal income. The Report claims that these two variables each account for half of the property tax rate sub-index. However, the property tax rate sub-index also includes three variables related to states' usage of capital stock taxes. These variables account for another 20% of the property tax rate sub-index. For those who have not kept score, this means that the property tax rate sub-index is weighted at 120%.

The property tax base sub-index considers whether a state levies any of seven different kinds of taxes. These taxes include: intangible property taxes, inventory taxes, real property transfer taxes, estate taxes, inheritance taxes, gift taxes, and generation-skipping transfer taxes. A state is penalized for each of these seven taxes that it levies, and each tax weights equally in the computation of the property tax base sub-index.

Now, the catch is that the two sub-indexes receive equal weights. The tax rate sub-index, based on taxes per capita, taxes relative to personal income, and capital stock taxes equals 50% of the total property tax score. The tax base sub-index score, based on whether or not a state levies any of the other seven taxes listed above, accounts for the other 50% of the total property tax score.

In Ohio, the taxes in the property tax rate sub-index computation have an annual value of about $13 billion. The taxes in the property tax base sub-index have an annual value of a little over $1 billion. Therefore, in evaluating Ohio taxes, the Foundation's system of sub-indexes weights a sub-index worth about $13 billion equally with a sub-index worth about $1 billion. Because Ohio still charges an intangible property tax along with only two or three other states, it apparently scores poorly on the property tax base sub-index. However, the Ohio intangible property tax only applies narrowly to one type of business entity – dealers in intangibles. Moreover, it applies in lieu of the other forms of corporate taxation. And still moreover, it continues to exist because the dealers who pay the tax prefer it to the payment of other forms of corporate taxation under which they would pay more than the $30 million that they paid in intangibles taxes in 2006. Thus, the weight applied to penalize Ohio for continuing to use an intangibles tax exists out of all proportion to the importance of the tax itself.

The Foundation also serves up a delicious irony with its treatment of the inventory tax. The tax base sub-index penalizes Ohio for continuing to employ the inventory tax at the same time that the property tax rate sub-index includes taxes on inventory property as part of the measure of per capita and per $1,000 of income measures. If the State of Ohio used such a double accounting trick in its computation of business' taxes, the Foundation no doubt would claim a "double taxation" foul.

That the Foundation can deliver its double inventory penalty with a straight face enhances its comedic style.

The closer examination of the property tax sub-indexes illustrates how the Foundation's assignment of value to the 113 variables in its five tax index comparisons really has no grounding in common sense or public finance theory. Each item included as a variable may have some value as an indicator of states' tax climates, but the process of fitting the variables together rests entirely upon the arbitrary judgment about the relative importance of each variable.

A final point about the assignment of weights to variables in the Foundations indexes deserves emphasis. The five tax indexes do not receive equal weight. Their weights are assigned as follows:

Individual income tax – 29.53%
Sales tax index – 22.23%
Corporate tax index – 20.31%
Property tax index – 14.82%
Unemployment insurance tax index – 13.11%

The assignment of these weights does not depend on the relative value of the tax burden associated with each tax, as might be reasonably expected in a study that purports to assess tax "climate." Rather, it depends on the degree of variability among states in each index. Greater variance among the states resulted in a heavier weight. The justification for weighting the indexes by the degree of variation among the states relies on the notion that greater variability in an index shows more room for a state to adjust its tax in that index, and that the failure to adjust a tax where other states have done so penalizes its tax climate. For example, Ohio ranks 11th best according to the Tax Foundation ranking system on the unemployment tax index. However, the comparatively low weight applied to the unemployment tax diminishes the effect of the state's relatively better unemployment tax system.

At least three problems appear in the weighting method.

First, as with the property index, the Foundation again uses a kind of double accounting in its weighting system. A state's poor performance on any index has the effect of penalizing it. To the extent that its poor performance departs unusually far from the performance of other states the penalty becomes relatively worse. That effect occurs without the weighting system. The addition of the weighting system based on variance within each index has the effect of compounding the raw score to the extent that the weight for an index exceeds 20%. (If each of five indexes received an equal weight, that weight would equal 20%.). In effect, states receive a penalty for poor performance, and then they receive a second weighting penalty for poor performance. Of course, states with a good score on an index receive a reward and then the reward is compounded if the weight attached to the index exceeds 20%. On the other hand, where the weight falls short of 20%, good and bad performances are discounted.

Second, the weighting itself does not reflect the relative burden imposed directly on business. Individual income taxes paid directly by businesses account for the relatively small part of the income tax related to profits of sole proprietorships, partnerships, and some small corporations. Businesses pay well under half of sales taxes. Also, taxes on business property account for less than half of all property taxes. Corporate taxes and unemployment taxes are paid entirely by business, but the weights for these taxes rank third and fifth, respectively. While income withholding taxes or sales tax collections by merchants might affect businesses indirectly by changing the cost of labor or requiring retailers to face competitive pressures in the form of net price plus tax amounts, the Foundation's Report never makes distinctions between direct and indirect taxes or between taxes that primarily impact businesses and those that do not. For this reason, its weighting system has no direct relationship to business tax climate. It only has the relationship to that climate arbitrarily devised for it by the Foundation's weighting method.

Third, the weighting of the five tax indexes applies to the results of the weight assigned within each tax index to 113 variables in ten sub-indexes. From where did those weights come? The answer is that the Foundation assigned them according to its opinion about the relative importance of those variables. In other words, while each variable may have some objective justification for appearing as a part of the comparison in each sub-index, the ultimate process of assigning the relative importance to each variable was subjective.

The quirkiness of the Foundation's weighting system at both the index and sub-index levels appears even more bizarre when considered in light of the fact that tax comparisons have a built-in weighting mechanism: the amount of tax paid by taxpayers. For that reason, other comparisons of state and local taxes

relate taxes paid to population to obtain per capita tax burdens or taxes paid per $1,000 of income to impute a net tax burden on income. The Foundation substitutes its own wacky 113 variable system as a substitute for the bases of comparison inherent in population and income data as used by the less playful and stuffy tax analysts like the Department of Taxation.

Another technique of good comedy uses an humorous concept and then brings it back again in intensified fashion. The first use of a gag gets a laugh, and then the comic returns to the gag later to reinforce the original laugh. The Foundation report employs the same technique. First, it uses an arbitrary weighting system to distribute the effect of its 113 variables among the sub-indexes. Second, it weights the weights when it prioritizes among the five indexes. Finally, to cap the effect of the second round of weights, it advances a pseudo-scientific rationale for the five index weights to obscure the fact that no rationale underlies the 113 variable weights. It is a comic tour-de-force, and masterful piece of sleight of hand.

Emphasis on Some Principles While Ignoring Others

The Foundation takes great care to show that research supports the view that taxes affect business decisions. It also asserts that the best tax includes the characteristics of a broad base and a low rate.

"Good state tax systems levy low, flat rates on the broadest bases possible, and they treat all taxpayers the same." 2008 State Business Tax Climate Index, p.4.

Public finance experts probably would endorse this conclusion in the Foundation's Report. However, public finance experts also value state tax systems with a balance among the three kinds of taxation. Generally, taxes can apply to income, consumption (sales and excise taxes), or wealth (property and estate taxes). This principle actually represents an extension of the broad base/ low rate principle to the whole revenue system. While the Foundation adopts the broad base/low rate view *as applied to individual taxes*, it does not apply that view to state revenue systems. Consequently, the states with worse balance receive the best scores because they levy no tax in one of the major tax areas.

In this way, the Foundation ranking method penalizes states who follow the broader principle that a revenue system spread over income, wealth, and consumption actualizes the broad base/low rate principle systematically rather than in one tax only. Thus, the Foundation emphasizes the broad base/ low rate value by assigning perfect scores on the appropriate index to states without a sales tax or an income tax. This is a narrow application of the principle, and it ignores the broader applications favored by other tax experts.

The Foundation also pursues some principles with single-minded intensity to absurd results in other areas. For example, the sales tax index penalizes states for excluding food from the sales tax base. The argument here is that the inclusion of food would widen the base and eliminate discrimination between different kinds of products and retailers. At the same time, the Foundation also would lower excise taxes on commodities like cigarettes because of the effect of higher taxes on these items on business locations on state borders.
The application of both values to Ohio results in a double penalty. First, the Foundation penalizes Ohio because the sales tax exempts groceries (as well as other food for off-premises consumption). Ohio receives a second penalty because it taxes cigarettes at a higher rate than some neighboring states. This treatment leads to the curious scenario that the cross-border incentive for Ohioans to buy cigarettes in West Virginia (a state with lower cigarette taxes) receives the Foundation's criticism. At the same time, the incentive for West Virginians to buy their groceries tax free at Ohio supermarkets again results in criticism of Ohio. (Obviously, the cross border sales here would occur only in border areas). This example finally leads to the bizarre notion that Ohio's tax climate would improve if it lowered taxes on cigarettes and started to tax groceries.

The cigarette/grocery issue becomes even more absurd when it is considered in the context of the state's entire "business climate." The Foundation Report takes great pains to show by way of a literature review that taxes matter when businesses make location decisions.

Different businesses care about different aspects of the tax climate. Does anyone really believe that Honda's decision about the location of a new automobile plant will depend on whether Ohio taxes groceries or cuts the cigarette tax down to West Virginia's fifty-five cents per pack? Of course not. Does it matter to a potential investor in a grocery or convenience store whether Ohio taxes cigarettes at the current rate or continues to exempt food from the sales tax? It might. Of those two potential business investments, which one places more demands upon Ohio's ability to offer a congenial "tax climate?" The Report does not distinguish between types of investment or types of competition.

On page 4, the Foundation states, "States do not enact tax changes in a vacuum." However, their analysis of this issue acts as if businesses do assess relative taxes in various states in a vacuum. No consideration is given to the role played by other factors in location, such as climate or the education level of the workforce. The Tax Foundation openly states that its expertise is in taxes. However, ignorance of (or disinterest in) other influences is insufficient grounds for assuming them to be zero.

The Foundation also penalizes Ohio for excluding the sales of motor fuel from the

sales tax. Again, the theory is that the broadest base is best. From the consumers' viewpoint, the final price of gasoline is all that matters. At the current cost of gasoline, the addition of sales tax to the amount paid for a gallon of gas would add another 15 cents or so per gallon to the final price. It is difficult to understand how tax climate improves by taxing an item such as gasoline in a manner where the tax due will increase when the prices is highest (and consumers can least afford it) than by using an excise tax where the tax is fixed regardless of the price of gas.

Obviously, a favorable tax climate means different things to different kinds of businesses. The Foundation's Report mixes all of these different features of a climate into one overall rating without any regard for whether the final aggregate rating really makes sense.

The tax climate ratings mix other concepts as well. When other organizations compute objective comparisons of tax burdens such as those based on per capita taxes or taxes per $1,000 of income, they have no choice but to use historical data. This necessarily means that such comparisons take a snapshot of the states' tax systems in the recent past. Because such comparisons must rely on historical data, they cannot anticipate changes in states' taxes even if those changes have occurred already.

In contrast, the Foundation insists that it does not measure tax burdens. Rather, it attempts to show the relative competitiveness of state tax systems. Its orientation points toward the future. It attempts to highlight the features that businesses consider when they make investment and location decisions. The very title of the Report emphasizes this point by calling itself the *2008 State Business Tax Climate Index* even though 2008 was several months in the future at the publication of the Report.

In spite of its orientation toward the future, the Report acknowledges only historical tax provisions. For this reason, it only gives Ohio partial credit for the repeal of the inventory tax as that repeal stood on July 1, 2007, although it notes that tax is repealed by 2009. If the repeal of a tax has been enacted for the near future, why does that repeal not more accurately reflect a state's tax climate?

In fact, in 2005, Ohio enacted sweeping business tax reforms. It repealed two business taxes – the corporate franchise tax and the tangible personal property tax – and replaced them with one tax – the Commercial Activity Tax. The details of these changes guarantee that the net result will equal roughly a billion dollars in lower business taxes by 2010.

Thus, the historical record for 2007 does not accurately reflect what the Ohio tax climate will look like in the future. Presumably, many potential business investors

would use a "2008" tax climate report to inform themselves about tax consequences of investment *in the future*. The Foundation does not provide such a perspective, although it has no reason not to do so.

By following some principles stringently while ignoring others completely, the Foundation keeps the laughs coming. It shows how Ohio can lure more business investment by cutting cigarette taxes, repealing the sales tax exemption for groceries, and by piling the sales tax on top of the motor fuel tax. In the course of making these recommendations, it ignores the largest business tax reform in the state's history. All of these features fit perfectly with the Foundation's principles. The fact that the audience knows that other principles should trump these "policy implications" makes the humor work.

Recent Changes in the Tax Foundation Methodology

A final note on the arbitrariness of the Foundation's tax climate index will focus the preceding discussion in the true spirit of a funhouse mirror.

In 2004, the Foundation released a Tax Climate report in which Ohio scored 29th on the overall index. (Remember the scale goes from 1 as best to 50 as worst). The ranking system in that report used five equally weighted measures: corporate income tax, individual income tax, sales and excise tax, unemployment tax, and fiscal balance. The last measure included total state tax burden and features of a state's tax system related to tax and expenditure controls. Ohio ranked 21st on that index.

In 2006, the Foundation changed the measures used in its climate index. A wealth tax measure replaced the fiscal balance measure, and the Report introduced the system of weighting the five indexes. In the process of revising its 2006 methodology, the Foundation also retrofitted the new methodology to the previous report year – 2004. As a result, Ohio's 2004 overall rank dropped 19 places from 29th to 48th. In 2006, the overall measure ranked Ohio at 47th.

Therefore, Ohio's 2004 rank changed by 19 places *for the same year* because the Foundation changed its methodology. The Ohio tax system did not change. The two measurements applied to the same year. The fact that the two methodologies could produce such a dramatic difference when applied to the same data underscores the arbitrariness of the Foundation's tax climate. Of course, the Foundation would argue that its later method is better. Both methods rely upon a long series of value judgments with which the various indexes and sub-indexes are constructed followed by the weighting of the indexes by one formula from among many possible formulas. The "science" behind the two methods does not change. Only the specific implementation differs.

A good comic changes his or her routine to keep up with changing times while simultaneously preserving the schtick that put him or her in the limelight in the first place. That principle makes the Tax Foundation humor work year after year. The gimmicks that they use might change, but the underlying arbitrariness of their ranking system remains constant.

Conclusion

The 2008 Business Tax Climate Index purports to provide a ranking of the 50 states and the relative attractiveness to business of their state and local tax systems. The validity of this index is fundamentally flawed, however, as result of the following problems in its construction:

1). The index focuses on tax structure rather than actual tax burdens.

A state with a more attractive tax structure (at least in the eyes of the Tax Foundation) but higher actual taxes can receive a more favorable ranking than a state with a less attractive structure but lower taxes. This is completely contradictory to universally accepted economic theory regarding consumer and producer behavior. While the Foundation proudly proclaims that they are not attempting to compare tax burdens across states, this admission is the study's fatal flaw, as this is the only valid comparison to be made.

2). The actual construction of the tax climate index is based wholly on subjective judgments made by the Tax Foundation regarding the relative role of different factors.

In some cases different factors are weighted equally in a simple "check-off" fashion, creating a bias against states with more balanced tax systems. In other cases factors are weighted on the basis of the variability across states rather than the actual revenue importance, as would be the case in a more standard interstate tax analysis. This can lead to the result that a state which performs unfavorably on a low revenue tax with a wide variance can score lower than a state which performs unfavorably on a high revenue tax with lower variance. In dollar terms, which are the only terms that influence consumer and producer behavior, the second state truly has the less favorable tax climate though the Tax Foundation methodology would lead to the opposite result.

3). The methodology is inconsistent, and arguably irresponsible, in the extent to which it takes future tax changes *which have already been enacted* into account in its rankings.

The Tax Foundation intentionally used the year 2008 in the title of this report, implying that readers should use the findings as they think ahead to future decisions. In light of this, the choice to not incorporate all known information about future tax changes which have already been enacted is both incomprehensible and indefensible.

4). Modification of the Tax Foundation Methodology shows great fluctuation in state rankings.

The Tax Foundation has, perhaps inadvertently, performed a type of sensitivity analysis of its state ranking methodology. By modifying the methodology used to construct the rankings and then retrofitting the results to prior versions of the study the Tax Foundation has showed that the old method and the new method lead to very different assessments of the same state tax systems. While the Foundation might argue that the new methodology is now superior to the old, the reality is that both the old and new methodologies are based upon subjective, though differing, judgments about what is important and how it should be weighted. Close scrutiny, however, shows that neither methodology provides a reliable or useful measure of relative state tax climate.

Based upon the above considerations, policymakers would be well-advised to rely upon more traditional methods for assessing comparative state taxes provided by analysts driven by objective motives rather than ideological beliefs.

On the other hand, the Tax Foundation's 2008 State Business Tax Climate Index has all of the earmarks of comedic exaggeration. It runs with one principle of taxation far beyond the border of absurdity with its one-dimensional focus on broad-based and low rate taxes. It uses arbitrary benchmarks to create a topsy-turvy rating system where Ohio can improve its business tax climate with higher taxes on food and gasoline and lower taxes on cigarettes. Finally, it remains entranced with one connection between economic development and taxation, while other considerations such as fairness, ease of compliance, and other influences on business location decisions fall by the wayside. Whatever the details, it takes a sense of humor to read Tax Foundation reports. ##