

# BACKGROUND PAPER

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## State Business Tax Climate Index

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### Executive Summary

With this study, the Tax Foundation presents its second annual estimate of each state's "business tax friendliness," the 2004 State Business Tax Climate Index.

Most stories about how states compete for business revolve around the deliberately hyped efforts of politicians and economic development offices to lure high-profile companies to locate there. Usually, the object of their affection is a sports franchise or a famous international company, and the recent competition for the Montreal Expos is a case in point. States and cities routinely assemble generous packages of tax abatements and public spending to lure such firms. But under the media radar, each state's tax system is constantly competing with its neighbors for start-ups and business expansion. In fact, politicians who have to aggressively market their state with huge tax giveaways are often trying to make up for a generally bad business tax climate.

One major element of that competition is the size of each state's tax burden—the

percentage of a state's income taken in taxes. For many years the Tax Foundation has published estimates of each state's combined state-local tax burden as part of its well-known Tax Freedom Day report. The nationwide average in 2004 is 10.0 percent, and state-specific estimates range around that average from 6.3 percent in Alaska to 12.9 percent in New York.

While businesses have always taken note of these tax burden estimates, the structure and complexity of a state's tax system can be as important to businesses as the amount collected. Domestic and even international competition forces businesses to constantly search for more tax-friendly environments. Therefore, the state-local tax burden estimates and the State Business Tax Climate Index are complementary, answering the questions: How much are we paying? and Are we paying it in an economically efficient way?

Business leaders and government policymakers can use the State Business Tax Climate Index as a comparative gauge of state tax systems. Each score that a state

**T**his year's study benefited greatly from reactions by government officials and business leaders to the first edition published in mid-2003. New sub-indexes capture important tax base issues, and the Unemployment Insurance Tax Index has replaced last year's tax conformity index. All of the 2003 and 2004 scores in this report use the new criteria and are not comparable to last year's.

receives on the various measures is determined not only by the state in question but by the competition—the 49 other states. Policymakers can use the index to determine if their state tax system is needlessly hampering either the efforts of local entrepreneurs or the possible entry of new business.

The touchstone of the State Business Tax Climate Index is neutrality. If a state's tax system maintains a "level playing field" for all types of businesses and business transactions, we consider it neutral and rate it highly. An economically neutral tax system benefits and punishes all businesses equally, so this index is a measure of each state's tax friendliness to all business activity, not just small businesses or large businesses, capital-intensive or service-intensive, existing companies or start-ups.

Therefore, if a state's tax burden is relatively low and the state's tax system does not favor some economic activities while penalizing others, we conclude that the state's economy will be comparatively efficient, producing more jobs and yield higher incomes for everyone.

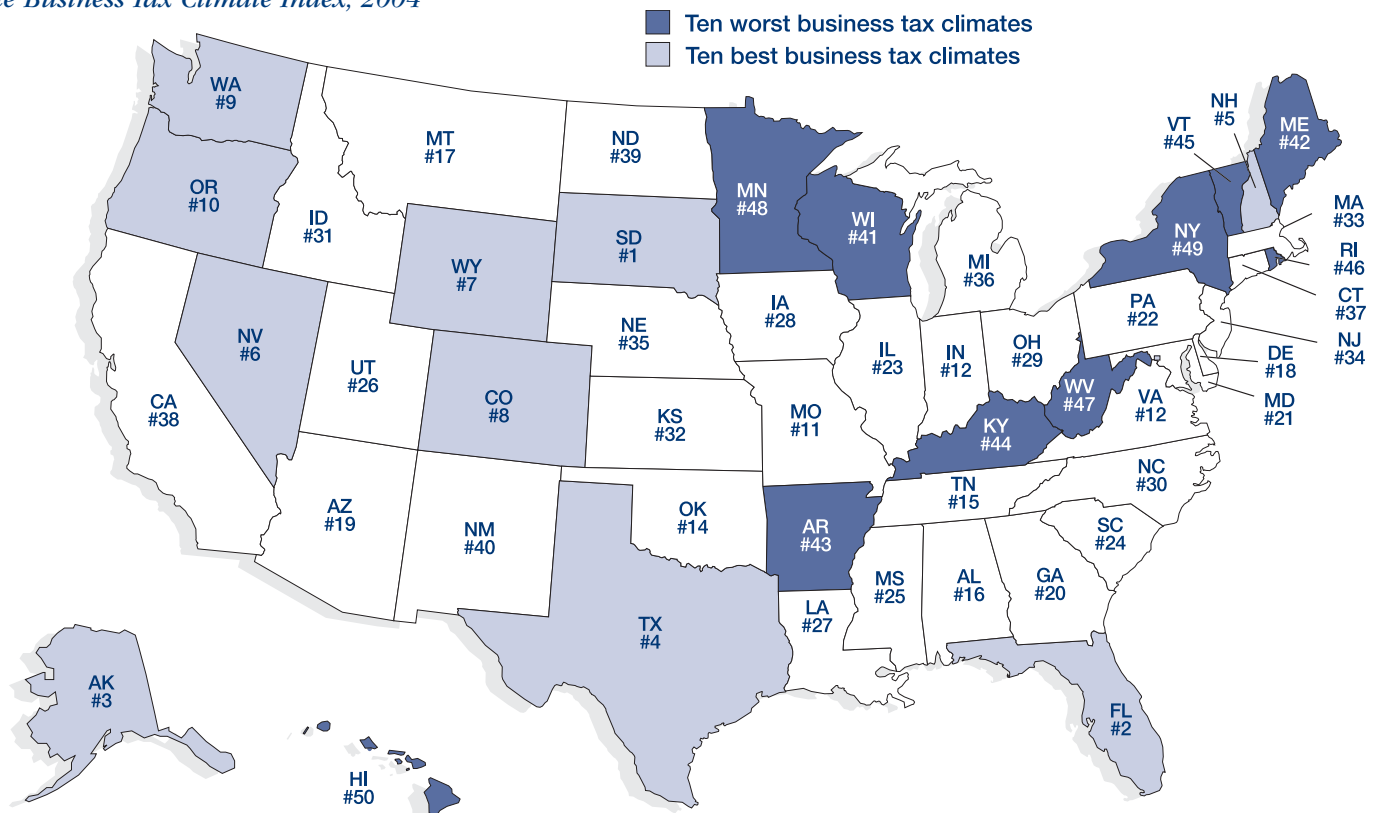
The overall index is a composite of five specific indexes devoted to major features of a state's

tax system, features that definitely influence business decisions or the economy in general: the corporate income tax, the individual income tax, the sales and gross receipts tax, the unemployment insurance tax, and the state's fiscal balance. These five indexes are themselves composites of more than 100 separate variables.

Figure 1 and Table 1 show the overall results for the last two years. In 2004, the ten states that are deemed to have entered 2004 with the most business-friendly tax systems are South Dakota, Florida, Alaska, Texas, New Hampshire, Nevada, Wyoming, Colorado, Washington, and Oregon. On the other end of the spectrum, the ten tax systems least hospitable to business in 2004 are found in Hawaii, New York, Minnesota, West Virginia, Rhode Island, Vermont, Kentucky, Arkansas, Maine and Wisconsin.

Generally speaking, states that rank highly manage without at least one of the major taxes. Indeed, Alaska scores well despite having one of the worst corporate tax systems in the nation because it taxes neither individual income nor sales. Colorado has a "traditional" tax system that imposes all three of the major state-level revenue-raisers—a corporate income tax, an individual

Figure 1  
State Business Tax Climate Index, 2004



Note: Virginia and Indiana were the only states with identical scores. Both rank 12th, and the next state ranks 14th.

income tax and a sales tax—but ranks highly by keeping all of its taxes simple with low, flat rates.

The common characteristics of states that rank poorly are: multiple-rate corporate and individual tax codes that impose above-average tax rates; above-average sales tax rates that exempt few business-to-business transactions; complex unemployment tax systems; and high overall state tax collections with few if any constitutional or statutory restraints on taxing or spending. The 2004 State Business Tax Climate Index is determined by the tax laws in place at the beginning of the year. Therefore, such tax changes as the higher sales and corporate income taxes that Virginia enacted during 2004 are not included.

## Introduction

In July 2004, Florida lawmakers cried foul when a major credit card company announced it would close its Tampa call center, lay off 1,110 workers, and outsource those jobs to another company. The reason for the lawmakers' ire was that the company had been lured to Florida with a generous tax incentive package and had enjoyed nearly \$3 million worth of tax breaks during the past nine years. The company refused to say whether the jobs would be relocated overseas.<sup>1</sup>

As the finances of U.S. states begin to stabilize after the last recession, another issue has grabbed the attention of lawmakers—outsourcing. The outsourcing of jobs to lower-cost nations such as India has made headlines nationwide. But while India's low wages are attracting call centers and back office operations, the types of investment most coveted by American states—manufacturing and production facilities—are being lured away by low-tax countries such as Ireland, Poland, Singapore, and Slovakia. In recent years, these small, emerging countries have aggressively slashed their corporate tax rates in order to attract foreign investment—often from U.S. multinational firms.

While state lawmakers are right to be concerned about how their states rank in the global competition for jobs and capital, the Department of Labor reports that most mass job relocations are from one U.S. state to another rather than to an overseas location.<sup>2</sup> These means that state lawmakers must be aware of how their state's business climate matches up to their immediate neighbors and to other states within their region.

**Table 1**  
*State Business Tax Climate Index, 2003 and 2004*

State	2004 State Business Tax Climate Index		2003 State Business Tax Climate Index		Change from 2003 to 2004	
	Score	Rank	Score	Rank	Score	Rank
U.S.	5.000	-	5.000	-	-	-
Alabama	5.664	16	5.667	16	-0.004	0
Alaska	6.846	3	6.750	5	0.096	2
Arizona	5.491	19	5.503	18	-0.012	-1
Arkansas	4.441	43	4.576	39	-0.135	-4
California	4.607	38	4.621	38	-0.014	0
Colorado	6.352	8	6.294	10	0.058	2
Connecticut	4.699	37	4.748	36	-0.049	-1
Delaware	5.570	18	5.405	19	0.165	1
Florida	6.925	2	7.003	3	-0.078	1
Georgia	5.443	20	5.326	20	0.117	0
Hawaii	3.742	50	3.694	50	0.048	0
Idaho	4.851	31	4.872	34	-0.021	3
Illinois	5.211	23	5.285	23	-0.074	0
Indiana	5.737	12	5.904	11	-0.167	-1
Iowa	5.032	28	4.941	30	0.090	2
Kansas	4.822	32	4.874	33	-0.052	1
Kentucky	4.345	44	4.262	45	0.083	1
Louisiana	5.062	27	5.176	24	-0.115	-3
Maine	4.444	42	4.386	42	0.058	0
Maryland	5.422	21	5.312	21	0.111	0
Massachusetts	4.803	33	4.991	28	-0.188	-5
Michigan	4.703	36	4.713	37	-0.009	1
Minnesota	4.063	48	4.050	48	0.013	0
Mississippi	5.146	25	5.153	25	-0.007	0
Missouri	5.840	11	5.703	14	0.137	3
Montana	5.633	17	5.647	17	-0.014	0
Nebraska	4.767	35	4.936	31	-0.169	-4
Nevada	6.494	6	7.091	2	-0.597	-4
New Hampshire	6.629	5	6.635	6	-0.007	1
New Jersey	4.782	34	4.866	35	-0.084	1
New Mexico	4.502	40	4.358	43	0.144	3
New York	4.043	49	3.948	49	0.095	0
North Carolina	4.861	30	4.881	32	-0.020	2
North Dakota	4.504	39	4.528	40	-0.023	1
Ohio	4.866	29	4.990	29	-0.124	0
Oklahoma	5.682	14	5.682	15	0.000	1
Oregon	6.150	10	6.298	9	-0.148	-1
Pennsylvania	5.311	22	4.995	27	0.317	5
Rhode Island	4.249	46	4.193	47	0.056	1
South Carolina	5.182	24	5.295	22	-0.114	-2
South Dakota	7.365	1	7.288	1	0.077	0
Tennessee	5.668	15	5.890	12	-0.222	-3
Texas	6.798	4	6.781	4	0.017	0
Utah	5.095	26	5.054	26	0.041	0
Vermont	4.310	45	4.355	44	-0.045	-1
Virginia	5.737	12	5.703	13	0.035	1
Washington	6.252	9	6.424	8	-0.171	-1
West Virginia	4.240	47	4.253	46	-0.013	-1
Wisconsin	4.460	41	4.434	41	0.026	0
Wyoming	6.446	7	6.582	7	-0.136	0
District of Columbia	3.702	-	3.709	-	-0.008	-

**Note:** The higher the score, the more favorable a state's tax system is for business. Virginia and Indiana were the only states with identical scores. Both rank 12th, and the next state ranks 14th.

A return to budget surpluses could offer many state lawmakers the opportunity to reform their tax codes in order to make their state more attractive to domestic and foreign investment. The

<sup>1</sup> Dave Wasson, "Florida Lawmakers Slam Capital One's Layoffs After Years of Tax Breaks," *Tax Analysts*, July 27, 2004.

**Table 2**  
**Major Components of the State Business Tax Climate Index, 2004**

State	Overall Rank	Corporate Income Tax Index Rank	Individual Income Tax Index Rank	Sales and Gross Receipts Tax Index Rank	Unemployment Insurance Tax Index Rank	Fiscal Balance Index Rank
Alabama	16	27	19	13	6	14
Alaska	3	49	4	1	38	10
Arizona	19	15	26	41	8	7
Arkansas	42	45	22	39	44	37
California	38	39	44	37	22	30
Colorado	8	5	13	22	25	1
Connecticut	36	19	21	33	24	43
Delaware	18	36	20	3	10	46
Florida	2	9	4	21	1	5
Georgia	20	11	26	7	33	15
Hawaii	50	28	47	45	20	50
Idaho	31	17	35	19	46	22
Illinois	23	23	11	42	41	18
Indiana	12	23	10	10	5	28
Iowa	28	43	30	15	28	17
Kansas	32	46	24	32	17	29
Kentucky	44	44	25	8	47	42
Louisiana	27	34	18	49	21	11
Maine	42	40	34	11	39	40
Maryland	21	6	35	9	14	26
Massachusetts	33	29	15	11	48	38
Michigan	36	50	12	17	41	39
Minnesota	48	31	38	36	32	48
Mississippi	25	32	16	47	2	27
Missouri	11	13	23	29	9	4
Montana	17	30	50	5	23	19
Nebraska	35	42	28	34	16	32
Nevada	6	1	7	46	39	16
New Hampshire	5	37	8	2	43	8
New Jersey	34	33	32	24	26	34
New Mexico	39	18	35	48	15	41
New York	49	14	49	40	50	36
North Carolina	30	22	44	35	7	31
North Dakota	39	48	29	20	37	34
Ohio	29	38	46	38	11	21
Oklahoma	14	12	39	14	3	12
Oregon	10	15	43	4	27	6
Pennsylvania	22	47	13	25	12	25
Rhode Island	46	23	41	28	49	33
South Carolina	24	10	40	16	44	13
South Dakota	1	1	1	43	30	3
Tennessee	15	23	9	44	34	9
Texas	4	20	4	23	13	2
Utah	26	8	42	27	19	24
Vermont	45	35	48	18	4	49
Virginia	12	7	17	6	29	19
Washington	9	1	1	50	36	23
West Virginia	47	41	31	26	35	45
Wisconsin	41	20	32	31	31	44
Wyoming	7	4	1	30	18	47

**Note:** Rankings do not average across to total. States without a given tax rank equally as number 1 and states with identical scores rank equally.

**Source:** Tax Foundation

temptation for many is to craft packages of tax incentives and infrastructure subsidies to lure high-profile businesses or factories from other states. But as Florida's experience shows, these expensive and preferential programs do not always guarantee that the jobs will stay in the state permanently. Moreover, such subsidy packages often paper over deeper flaws in a state's business climate.

State lawmakers would be wise to look to making systemic changes to their business climates that will improve their competitive position for the long-term. As they begin to assess their tax systems, they should keep two rules in mind:

1. Taxes matter to business. Taxes affect business decisions, job creation and retention, plant location, competitiveness, and the long-term health of a state's economy. For businesses, taxes are an input cost, just like the cost of raw materials. If the cost goes up, that cost is passed along to either consumers (through higher prices), workers (through lower wages or fewer jobs), or shareholders (through lower dividends or share value). Thus a state with lower tax costs will be more attractive to business investment.
2. States do not enact tax changes (increases or cuts) in a vacuum. Every tax law will in some way change a state's competitive position relative to its immediate neighbors, its geographic region, and even globally. Ultimately it will affect the state's national standing as a place to live and to do business. Entrepreneurial states can take advantage of the tax increases of their neighbors to lure businesses out of higher-tax states.

Clearly, there are many non-tax factors that affect a state's business climate: its proximity to raw materials or transportation centers, its regulatory or legal structures, the quality of its education system and the skill of its workforce, not to mention the intangible perception of a state's "quality of life."<sup>3</sup>

Some of these factors are, of course, outside of the control of elected officials. Montana law-

<sup>2</sup> U.S. Department of Labor, "Extended Mass Layoffs Associated With Domestic And Overseas Relocations, First Quarter 2004," June 10, 2004, and "Extended Mass Layoffs In The Second Quarter Of 2004," August 26, 2004. In the press release announcing the June 10 study, DOL reported that: "Three out of four [lay-off] events (90 out of 119) associated with movement of work occurred among establishments within the same company. In more than 7 out of 10 cases, the work activities were reassigned to places elsewhere in the U.S. In the 29 events in which work activities were reassigned to another company under contractual arrangements, half of the instances involved relocation of work outside the U.S. and half to companies within the U.S."

makers cannot change the fact that Montana's businesses have no immediate access to deep-water ports. Lawmakers do, however, have direct control over how friendly their tax system is to business. The ideal tax system—whether at the state, federal, or international level—should be neutral to business activity. In such an ideal system, individuals and businesses would base their economic decisions solely on the merits of the transactions, without regard to tax implications. In reality, tax-induced economic distortions are a fact of life, and a more realistic goal is to maximize the occasions when businesses and individuals are guided by economics, and minimize those cases where economic decisions are micro-managed or even dictated by a tax system.

There are two important aspects of state tax neutrality. One is the potential variation in the tax treatment of economic activities within each state. This is frequently referred to as "the unlevel playing field." Taxes should not favor one economic activity or decision over another, or punish one industry at the expense of others. The more riddled a tax system is with politically motivated preferences, the less likely it is that business decisions will be made in response to market forces and the less efficient the state's economy will be. The 2004 State Business Tax Climate Index captures this through such measures as the number of individual income tax rates and the deductibility from sales tax of business inputs. The more level the playing field, the better the ranking.

As difficult and desirable as tax neutrality is to achieve within a state, it is far more difficult to achieve between states. Tax competition is an unpleasant reality for state revenue and budget officials but a godsend to taxpayers, because it is probably the most effective restraint on state and local taxes. The State Business Tax Climate Index captures the impact of tax competition on economic neutrality in several ways. It compares state tax rates in four major areas of special concern to business: individual income taxes, corporate income taxes, sales and gross receipts taxes and unemployment insurance taxes. And it compares the tax base for each of those taxes. Finally, it compares state tax collections and budgetary institutions.

When a state imposes higher taxes than a neighboring state, business will cross the border to some extent. How much states take in taxes is critical, but how they take it can be just as important, so the State Business Tax Climate Index also compares statutory features of each state's tax system, such as the top corporate income tax rate, identifying comparative advantages and disadvantages within each state.

Comparing the relative neutrality of 50 very different tax systems presents many challenges. For example, should Colorado's tax system, which includes a relatively low individual income tax, a relatively low corporate income tax, and a relatively low sales tax be considered more or less neutral than Alaska's tax system which includes a relatively high and complex corporate income tax but no individual income tax or sales tax?

The 2004 State Business Tax Climate Index deals with such questions by comparing the states on five separate aspects of their tax systems and then adding the results up to a final, overall ranking. This approach has the advantage of rewarding states on particularly strong aspects of their tax systems (or penalizing them on particularly weak aspects) while also measuring the general neutrality of their overall tax system. The result is that no matter how neutrality is achieved or violated within a particular state, the business tax climate that results can be compared to the climate in other states. In the end, both Alaska and Colorado are counted among the 10 states with the best business tax climates.

## Factors Measured by the Index

The Tax Foundation's 2004 State Business Tax Climate Index is constructed of five equally weighted component indexes:

- The Corporate Income Tax Index
- The Individual Income Tax Index
- The Sales and Gross Receipts Tax Index
- The Unemployment Tax Index
- The Fiscal Balance Index

<sup>3</sup> A trend in tax literature throughout the 1990s has been the increasing use of indexes to measure a state's general business climate. These include the Center for Policy and Legal Studies' "Economic Freedom in America's 50 States: A 1999 Analysis" and the Beacon Hill Institute's "State Competitiveness Report 2001." Such indexes even exist on the international level, including the Heritage Foundation and Wall Street Journal's "2004 Index of Economic Freedom."

Plaut and Pluta (1983) examined the use of business climate indexes as explanatory variables for business location movements. They found that such general indexes do have a significant explanatory power helping to explain, for example, why businesses have moved from the Northeast and Midwest towards the South and Southwest. In turn, they also found that high taxes have a negative effect on employment growth.

**Table 3**  
*Corporate Income Tax Index and Ranking, 2003 and 2004*

State	2004 Corporate Income Tax Index		2003 Corporate Income Tax Index		Change from 2003 to 2004	
	Score	Rank	Score	Rank	Score	Rank
U.S.	5.00	-	5.00	-	-	-
Alabama	5.07	27	5.40	19	-0.34	-8
Alaska	3.71	49	3.70	49	0.02	0
Arizona	5.53	15	5.51	14	0.02	-1
Arkansas	4.16	45	4.15	45	0.01	0
California	4.53	39	4.52	40	0.02	1
Colorado	6.22	5	6.21	5	0.02	0
Connecticut	5.37	19	5.32	20	0.05	1
Delaware	4.72	36	4.70	36	0.02	0
Florida	5.86	9	5.84	9	0.02	0
Georgia	5.71	11	5.69	11	0.02	0
Hawaii	5.05	28	5.04	28	0.01	0
Idaho	5.49	17	5.47	16	0.02	-1
Illinois	5.08	23	5.06	27	0.02	4
Indiana	5.08	23	5.20	23	-0.12	0
Iowa	4.30	43	4.27	43	0.02	0
Kansas	4.09	46	4.07	46	0.01	0
Kentucky	4.28	44	4.26	44	0.01	0
Louisiana	4.79	34	4.77	34	0.02	0
Maine	4.43	40	4.41	41	0.02	1
Maryland	6.07	6	6.04	6	0.02	0
Massachusetts	5.03	29	5.01	29	0.02	0
Michigan	3.59	50	3.56	50	0.02	0
Minnesota	4.97	31	4.95	31	0.02	0
Mississippi	4.92	32	4.90	32	0.01	0
Missouri	5.57	13	5.55	13	0.02	0
Montana	5.03	30	5.01	29	0.02	-1
Nebraska	4.32	42	4.30	42	0.02	0
Nevada	10.00	1	10.00	1	0.00	0
New Hampshire	4.69	37	4.67	37	0.02	0
New Jersey	4.83	33	4.81	33	0.02	0
New Mexico	5.46	18	5.44	18	0.02	0
New York	5.55	14	5.49	15	0.06	1
North Carolina	5.16	22	5.14	25	0.02	3
North Dakota	3.76	48	3.86	48	-0.10	0
Ohio	4.68	38	4.66	38	0.02	0
Oklahoma	5.65	12	5.63	12	0.02	0
Oregon	5.53	15	5.46	17	0.06	2
Pennsylvania	4.08	47	4.06	47	0.02	0
Rhode Island	5.08	23	5.07	26	0.00	3
South Carolina	5.81	10	5.79	10	0.02	0
South Dakota	10.00	1	10.00	1	0.00	0
Tennessee	5.08	23	5.16	24	-0.09	1
Texas	5.27	20	5.26	21	0.01	1
Utah	5.97	8	5.96	8	0.02	0
Vermont	4.77	35	4.75	35	0.02	0
Virginia	6.05	7	6.03	7	0.02	0
Washington	10.00	1	10.00	1	0.00	0
West Virginia	4.38	41	4.59	39	-0.21	-2
Wisconsin	5.27	20	5.25	22	0.02	2
Wyoming	9.48	4	9.48	4	0.00	0
District of Columbia	4.87	-	4.83	-	0.04	-

**Note:** States without a corporate income tax rank equally as number 1, and states with identical scores rank equally. Territories and possessions excluded from "U.S."

**Source:** Tax Foundation

Using the economic tax literature as our guide, we designed these five indexes to score each state's business tax climate on a scale of zero (worst) to 10 (best). Each of these five component indexes has two equally weighted sub-

indexes, some of which include several categories and variables under them. Overall, there are 10 sub-indexes, 33 categories and 109 variables. These are explained in more detail in the Appendix and Methodology sections. The ranking of the states on each of the five major component indexes is presented in Table 2.

## THE CORPORATE INCOME TAX INDEX

The first of the five major component indexes that comprise the State Business Tax Climate Index measures the impact of each state's corporate income tax. It is well established that the extent of taxation can affect a corporation's level of economic activity within a state. For example, Newman (1982) found that differentials in state corporate income taxes were a major factor influencing the movement of industry to southern states. Two decades later, with global investment greatly expanded, Agostini and Tulayasathien (2001) determined that a state's corporate tax rate is the most relevant tax in the investment decisions of foreign investors.

The differential between a state's corporate and individual tax rates has been found to affect the composition of business activity within the state. Goolsbee (2002) found that "the relative taxation of corporate to personal income plays an important role in the share of firms, employment and sales that are done by corporations versus partnerships and sole proprietorships. Increasing the corporate tax rate by 0.10 reduces the corporate share of firms by 5 to 10 percent and the corporate share of sales and employment by 2 to 6 percent." (p. 17)

To arrive at a measure of this impact, each state's corporate income tax code is examined, and two attributes of the code are assessed, the state's corporate tax rate structure and the corporate tax base. The composite score is the state's corporate income tax index. A state whose corporate income tax is deemed neutral to the economic activities of incorporated businesses receives a high score. A low score indicates that the state's corporate tax code is poorly designed and represents a serious impediment to business activity.

Each state's corporate tax rate sub-index is computed by assessing four key areas: the top corporate tax rate, the level of taxable income at which the top tax rate kicks in, the number of brackets, and the average width of the brackets.

States that do not impose a corporate income tax are clearly achieving a perfectly neutral system in regard to corporate income and so receive a perfect score.<sup>4</sup> States that do impose a corporate income tax generally will score well if they have a flat, low tax rate system. States with complex, multiple-rate systems score poorly.

To compute the parallel sub-index for the corporate tax base, five broad areas are assessed: the differential between the top corporate and individual tax rates, the way the state apportions corporate income for taxation, the treatment of net operating losses, the manner in which capital stock is taxed, and how well the tax code conforms with uniform standards and protects companies from double taxation.

States that score well on the corporate tax base sub-index generally will have a top corporate tax rate that is identical or close to the top individual rate, an apportionment formula that weights sales heavily, generous carry-back and carry-forward deductions for net operating losses, no capital stock tax, and a system that conforms well with uniform standards and avoids double taxation.

The four states with no tax on corporate income, whether or not it is called a corporate income tax, are Nevada, South Dakota, Washington and Wyoming. They receive the highest scores on the corporate tax sub-index. Wyoming is the only one of these states not to receive a perfect score because it does impose a small capital stock tax which, while minimal, is enough to reduce its ranking.

Among those states that do tax corporate income, five states with well-designed corporate income taxes are Colorado, Maryland, Virginia, Utah, and Florida. Each has a relatively low, single-rate system that establishes a comparatively neutral tax climate for business activity.

By contrast, Michigan has the lowest score because it has an effective corporate tax rate of 14.83 percent.<sup>5</sup> The other states rounding out the bottom ten are Alaska, North Dakota, Pennsylvania, Kansas, Arkansas, Kentucky, Iowa, Nebraska and West Virginia. In general, these states have complex, multi-rate systems with high top marginal tax rates. See Table 3 for a ranking of all the states.

## THE INDIVIDUAL INCOME TAX INDEX

The individual income tax code in each state is also a major consideration for business. One important reason is that a significant number of businesses including sole proprietorships, partnerships and S-corporations report their income through the individual income tax code. Indeed, the number of individuals filing federal tax returns with business income has nearly doubled over the past 20 years, from 13.3 million in 1980 to 25.5 million in 2002.

Taxes can have a significant impact on an individual's decision to become self-employed entrepreneurs. Gentry and Hubbard (2004) found, "While the level of the marginal tax rate has a negative effect on entrepreneurial entry, the progressivity of the tax also discourages entrepreneurship, and significantly so for some groups of households." (p. 21)

Using education as a measure of potential for innovation, Gentry and Hubbard found that a progressive tax system "discourages entry into self-employment for people of all educational backgrounds." Moreover, citing Carroll, Holtz-Eakin, Rider and Rosen (2000), Gentry and Hubbard found, "Higher tax rates reduce investment, hiring, and small business income growth." (p. 7) Less neutral individual income tax systems, therefore, hurt entrepreneurship and a state's business tax climate.

Another important reason individual income tax rates are critical for business is the cost of labor. Labor typically constitutes a major business expense, so anything that hurts the labor pool will also affect business decisions and the economy. Complex, poorly designed tax systems that extract an inordinate amount of tax revenue are known to reduce both the quantity and quality of the labor pool. This finding was supported by Wasylenko and McGuire (1985) who found that income taxes affect businesses indirectly by first influencing the location decisions of individuals.

Like the Corporate Income Tax Index, the Individual Income Tax Index is comprised of two complex sub-indexes measuring the states' tax rate structures and tax bases. Tax rate structure is

<sup>4</sup> See Methodology for discussion of how the index scores states that have a given tax along with states that have not enacted one.

<sup>5</sup> Michigan's Single Business Tax (SBT) is the nation's only state-level value-added tax. Fortunately, Michigan's Department of Treasury, Office of Revenue and Tax Analysis has estimated an equivalent corporate income tax rate for the SBT-see "The Michigan Single Business Tax 1999-2000," August 2003 at: [www.michigan.gov/documents/SBTTY1999\\_73989\\_7.pdf](http://www.michigan.gov/documents/SBTTY1999_73989_7.pdf). Because this equivalent rate changes dramatically with the business cycle, this study uses the 20-year average, 14.83 percent, to compare it with other states' fixed corporate income tax rates.

**Table 4**  
*Individual Income Tax Index and Ranking, 2003 and 2004*

State	2004 Individual Income Tax Index		2003 Individual Income Tax Index		Change from 2003 to 2004	
	Score	Rank	Score	Rank	Score	Rank
U.S.	5.00	-	5.00	-	-	-
Alabama	5.14	19	5.20	19	-0.06	0
Alaska	9.72	4	9.72	5	0.00	1
Arizona	4.58	26	4.73	26	-0.15	0
Arkansas	4.99	22	5.04	22	-0.05	0
California	3.69	44	3.73	46	-0.04	2
Colorado	6.47	13	6.50	14	-0.03	1
Connecticut	5.03	21	5.20	19	-0.17	-2
Delaware	5.09	20	5.18	21	-0.09	1
Florida	9.72	4	9.72	5	0.00	1
Georgia	4.58	26	4.63	28	-0.05	2
Hawaii	3.53	47	3.58	49	-0.06	2
Idaho	4.26	35	4.31	37	-0.05	2
Illinois	6.71	11	6.78	11	-0.06	0
Indiana	6.77	10	6.83	10	-0.06	0
Iowa	4.40	30	4.46	30	-0.06	0
Kansas	4.77	24	4.83	24	-0.05	0
Kentucky	4.76	25	4.81	25	-0.05	0
Louisiana	5.23	18	5.30	18	-0.07	0
Maine	4.30	34	4.33	36	-0.03	2
Maryland	4.26	35	4.35	35	-0.09	0
Massachusetts	6.25	15	6.26	15	0.00	0
Michigan	6.67	12	6.70	12	-0.03	0
Minnesota	4.25	38	4.31	37	-0.05	-1
Mississippi	5.54	16	5.60	16	-0.06	0
Missouri	4.94	23	5.00	23	-0.06	0
Montana	2.84	50	2.90	50	-0.06	0
Nebraska	4.52	28	4.61	29	-0.09	1
Nevada	8.28	7	10.00	1	-1.72	-6
New Hampshire	7.81	8	7.90	8	-0.08	0
New Jersey	4.32	32	4.41	34	-0.09	2
New Mexico	4.26	35	4.08	40	0.18	5
New York	3.33	49	3.77	45	-0.44	-4
North Carolina	3.69	44	3.78	44	-0.09	0
North Dakota	4.41	29	4.65	27	-0.24	-2
Ohio	3.64	46	3.82	43	-0.18	-3
Oklahoma	4.21	39	4.43	32	-0.22	-7
Oregon	3.70	43	3.72	47	-0.02	4
Pennsylvania	6.47	13	6.54	13	-0.07	0
Rhode Island	3.97	41	3.82	42	0.15	1
South Carolina	4.05	40	4.10	39	-0.05	-1
South Dakota	10.00	1	10.00	1	0.00	0
Tennessee	7.78	9	7.85	9	-0.08	0
Texas	9.72	4	9.72	5	0.00	1
Utah	3.90	42	3.95	41	-0.04	-1
Vermont	3.50	48	3.70	48	-0.19	0
Virginia	5.37	17	5.43	17	-0.06	0
Washington	10.00	1	10.00	1	0.00	0
West Virginia	4.38	31	4.46	30	-0.08	-1
Wisconsin	4.32	32	4.43	32	-0.11	0
Wyoming	10.00	1	10.00	1	0.00	0
District of Columbia	4.45	-	4.55	-	-0.10	-

**Note:** States without an individual income tax rank equally as number 1, and states with identical scores rank equally. Territories and possessions excluded from "U.S."

**Source:** Tax Foundation

assessed on four key areas: the states' top marginal tax rates, the starting points of their top brackets, the number of brackets and the average width of brackets. States that do not impose an

individual income tax receive a perfect score, and states that do will generally score well if they have a flat, low tax rate. States that score poorly have complex, multiple rate systems.

States' tax bases are assessed on a variety of factors including: how the tax code treats married couples; the lengths a tax code goes to prevent double taxation; whether or not the individual tax rate is higher than the corporate rate; and whether or not the code is indexed for inflation. States that score well will protect married couples from being taxed more severely than if they filed as singles; protect taxpayers from double taxation; recognize LLCs and S-corps under the individual tax code; have identical individual and corporate tax rates; and index their brackets, exemptions and deductions for inflation.

The seven states without an individual income tax are, naturally, the highest scoring states on this sub-index. However, only South Dakota, Washington and Wyoming score a perfect 10. The other four states—Alaska, Florida, Texas and Nevada—each have small deviations that prevent them from achieving a perfect score. For example, Alaska, Florida and Texas all tax LLCs and S-corporations as traditional corporate entities rather than as individually owned businesses. Meanwhile, Nevada enacted a tax on salaries and wages in 2003. While this tax is paid by businesses on their total payrolls, the tax effectively acts as an individual income tax.

New Hampshire and Tennessee also score well because while they do tax individual income in the form of interest and dividends, they do not tax wages and salaries. Of the 41 states that do have a broad-based individual income tax, Indiana, Illinois, Michigan, Colorado, and Pennsylvania score highly because they have a single, low tax rate.

On the other hand, Montana has the lowest score because it has the nation's highest top rate, 11 percent, which sits atop a mountain of nine lower statutory rates plus a zero rate created by its deductions and exemptions. The other states rounding out the bottom ten are New York, Vermont, Hawaii, Ohio, California, North Carolina, Oregon, Utah and Rhode Island. The individual income tax systems in these states are plagued by high tax rates and progressive bracket structures. They generally tax individual business owners at higher rates than traditional corporations, and fail to index their brackets, exemptions and deductions for inflation. See Table 4 for a 50-state ranking.



## THE SALES AND GROSS RECEIPTS TAX INDEX

The type of sales tax familiar to all taxpayers is a tax levied on the purchase price of a good or service at the point of sale, typically about 5 percent. This point-of-sale tax can hurt the business tax climate because as the sales tax rate climbs, more business is lost to lower-tax, causing lost profits, lost jobs and lost tax revenue. On the positive side, sales taxes levied at the final point of sale have at least two virtues. They are "transparent," i.e., the tax is never confused with the price of goods by customers. In addition, taxes levied at the point of sale are less likely than to cause economic distortions than taxes levied at some stage of production.

More detrimental to the business climate are sales taxes levied on business-to-business transactions. When a business must pay sales taxes on manufacturing equipment and raw materials, then that tax becomes part of the price of whatever the business makes with that equipment and with those materials. Of course, it must then collect sales tax on its own products, with the result that a tax is being charged on a tax. This is called "tax pyramiding." Invariably, tax pyramiding results in some industries' being taxed more heavily than others, causing economic distortions.

Gross receipts taxes cause an extreme form of tax pyramiding because they add a layer of taxes at every level. Gross receipts taxes can be especially punitive to businesses during economic downturns because the tax must be paid even if the business fails to earn a profit or suffers a loss.

The negative impact of sales and gross receipts taxes is well documented in the economic literature and through anecdotal evidence. For example, Bartik (1989) found that high sales taxes, especially sales taxes levied on equipment, had a negative effect on small business start-ups. Moreover, companies have been known to avoid locating factories or facilities in certain states because the factory's machinery would be subject to the state's sales tax.<sup>6</sup>

The effect of differential sales tax rates between states or localities is apparent when a traveler crosses the state line from a high-tax state to a neighboring low-tax state. Typically, a vast

*Table 5  
Sales and Gross Receipts Tax Index and Ranking, 2003 and 2004*

State	2004 Sales and Gross Receipts Tax Index		2003 Sales and Gross Receipts Tax Index		Change from 2003 to 2004	
	Score	Rank	Score	Rank	Score	Rank
U.S.	5.00	-	5.00	-	-	-
Alabama	5.77	13	5.71	13	0.05	0
Alaska	9.74	1	9.73	1	0.01	0
Arizona	4.37	41	4.21	43	0.16	2
Arkansas	4.70	39	5.02	32	-0.32	-7
California	4.75	37	4.66	40	0.09	3
Colorado	5.31	22	5.26	22	0.05	0
Connecticut	4.88	33	4.87	37	0.01	4
Delaware	9.58	3	9.64	2	-0.05	-1
Florida	5.41	21	5.38	20	0.03	-1
Georgia	6.19	7	6.13	7	0.06	0
Hawaii	4.10	45	3.92	46	0.18	1
Idaho	5.54	19	5.85	11	-0.31	-8
Illinois	4.32	42	4.86	38	-0.54	-4
Indiana	6.00	10	5.93	9	0.07	-1
Iowa	5.70	15	5.61	16	0.09	1
Kansas	4.89	32	5.04	29	-0.15	-3
Kentucky	6.07	8	5.60	17	0.47	9
Louisiana	3.32	49	3.35	49	-0.03	0
Maine	5.83	11	5.75	12	0.07	1
Maryland	6.05	9	5.94	8	0.11	-1
Massachusetts	5.83	11	5.70	14	0.13	3
Michigan	5.60	17	5.50	19	0.10	2
Minnesota	4.77	36	4.71	39	0.06	3
Mississippi	3.81	47	3.78	47	0.04	0
Missouri	5.06	29	5.03	30	0.03	1
Montana	9.42	5	9.52	4	-0.10	-1
Nebraska	4.82	34	4.94	34	-0.12	0
Nevada	3.91	46	3.99	45	-0.09	-1
New Hampshire	9.61	2	9.61	3	0.00	1
New Jersey	5.23	24	5.14	24	0.09	0
New Mexico	3.75	48	3.77	48	-0.02	0
New York	4.61	40	4.55	41	0.06	1
North Carolina	4.78	35	4.88	36	-0.10	1
North Dakota	5.49	20	5.37	21	0.11	1
Ohio	4.71	38	5.03	30	-0.32	-8
Oklahoma	5.73	14	5.65	15	0.08	1
Oregon	9.45	4	9.43	5	0.01	1
Pennsylvania	5.17	25	5.14	24	0.04	-1
Rhode Island	5.07	28	5.05	27	0.02	-1
South Carolina	5.65	16	5.58	18	0.06	2
South Dakota	4.20	43	4.13	44	0.06	1
Tennessee	4.14	44	4.50	42	-0.36	-2
Texas	5.28	23	5.21	23	0.06	0
Utah	5.10	27	5.05	27	0.06	0
Vermont	5.58	18	5.86	10	-0.29	-8
Virginia	6.68	6	6.59	6	0.09	0
Washington	1.71	50	1.73	50	-0.01	0
West Virginia	5.13	26	5.06	26	0.06	0
Wisconsin	5.00	31	4.94	34	0.05	3
Wyoming	5.02	30	5.02	32	0.01	2
District of Columbia	4.14	-	4.10	-	0.03	-

**Note:** States without a sales or gross receipts tax rank equally as number 1, and states with identical scores rank equally. Territories and possessions excluded from "U.S."

**Source:** Tax Foundation

<sup>6</sup> In the early 1993, Intel Corporation was considering California, New Mexico and four other states as the site of a new billion dollar factory. California was the only one of the six states that levied its sales tax on machinery and equipment, a tax that would have cost Intel roughly \$80 million. As Intel's Bob Perlman put it in testimony before a committee of the California state legislature, "There are two ways California's not going to get the \$80 million, with the factory or without it." California would not repeal the tax on machinery and equipment; New Mexico got the plant.

**Table 6**  
*Unemployment Insurance Tax Index and Ranking, 2003 and 2004*

State	2004 Unemployment Insurance Tax Index		2003 Unemployment Insurance Tax Index		Change from 2003 to 2004	
	Score	Rank	Score	Rank	Score	Rank
U.S.	5.00	-	5.00	-	-	-
Alabama	6.04	6	6.04	7	0.00	1
Alaska	4.30	38	4.25	38	0.06	0
Arizona	6.01	8	6.21	4	-0.20	-4
Arkansas	4.06	44	4.89	30	-0.83	-14
California	5.37	22	5.66	14	-0.29	-8
Colorado	5.16	25	5.32	23	-0.16	-2
Connecticut	5.17	24	5.03	27	0.14	3
Delaware	5.88	10	5.71	12	0.17	2
Florida	6.53	1	6.57	2	-0.04	1
Georgia	4.56	33	4.47	36	0.09	3
Hawaii	5.41	20	5.30	24	0.11	4
Idaho	3.83	46	3.66	47	0.17	1
Illinois	4.18	41	4.25	38	-0.08	-3
Indiana	6.07	5	6.16	5	-0.09	0
Iowa	4.98	28	4.77	31	0.20	3
Kansas	5.62	17	5.55	16	0.07	-1
Kentucky	3.45	47	3.34	48	0.11	1
Louisiana	5.39	21	6.00	8	-0.61	-13
Maine	4.28	39	4.11	42	0.17	3
Maryland	5.75	14	5.37	21	0.37	7
Massachusetts	3.07	48	3.83	46	-0.76	-2
Michigan	4.18	41	4.15	41	0.03	0
Minnesota	4.67	32	4.61	32	0.06	0
Mississippi	6.51	2	6.39	3	0.12	1
Missouri	6.00	9	5.55	16	0.44	7
Montana	5.21	23	5.14	26	0.07	3
Nebraska	5.65	16	5.62	15	0.03	-1
Nevada	4.28	39	5.49	18	-1.21	-21
New Hampshire	4.08	43	3.98	45	0.11	2
New Jersey	5.09	26	4.96	28	0.12	2
New Mexico	5.74	15	5.69	13	0.04	-2
New York	2.34	50	2.45	49	-0.11	-1
North Carolina	6.02	7	5.99	9	0.03	2
North Dakota	4.42	37	4.24	40	0.19	3
Ohio	5.87	11	5.96	10	-0.09	-1
Oklahoma	6.39	3	6.74	1	-0.35	-2
Oregon	4.99	27	5.18	25	-0.18	-2
Pennsylvania	5.83	12	4.04	43	1.79	31
Rhode Island	2.66	49	2.26	50	0.40	1
South Carolina	4.06	44	4.04	43	0.02	-1
South Dakota	4.74	30	4.48	35	0.26	5
Tennessee	4.53	34	4.37	37	0.17	3
Texas	5.81	13	5.85	11	-0.04	-2
Utah	5.42	19	5.45	19	-0.03	0
Vermont	6.24	4	6.09	6	0.15	2
Virginia	4.93	29	4.93	29	0.00	0
Washington	4.44	36	5.37	21	-0.93	-15
West Virginia	4.49	35	4.49	34	0.00	-1
Wisconsin	4.72	31	4.54	33	0.17	2
Wyoming	5.58	18	5.44	20	0.14	2
District of Columbia	5.05	-	5.07	-	-0.02	-

**Note:** States with identical scores rank equally. Territories and possessions excluded from "U.S."  
**Source:** Tax Foundation

expansion of shopping malls has sprung up along the border in the low-tax jurisdiction. Besley and Rosen (1998) found that for many products, the after-tax price of the good increased by the same amount as the tax itself. That means a sales tax increase was passed along to consumers on a

one-for-one basis. For other goods, however, they found that the price of the good rose by twice the amount of the tax, meaning that the tax increase translates into an even larger burden for consumers than is typically thought.

The Sales and Gross Receipts Tax Index is comprised of two complex sub-indexes devoted to the sales tax rate and the tax base. The rate sub-index is calculated using two criteria: how high the state-level rate is, and how high the combined state-local rate is. States will score well if they either do without a sales tax or if the combined state and local sales tax rate is low.

The sales tax base sub-index is computed according to three features of each state's sales tax implementation: (1) the tax may or may not exempt a variety of business-to-business transactions such as agricultural products, services, machinery, computer software, and leased or rented items; (2) the state may or may not levy a gross receipts tax; and (3) the states may levy high or low excise taxes on products such as gasoline, diesel fuel, tobacco and beer.

The five states without a state sales or gross receipts tax—Alaska, New Hampshire, Delaware, Oregon, and Montana—achieve the highest scores on this index. For states with a sales tax, Virginia has the highest score because it does a good job of avoiding tax pyramiding and maintains low excise tax rates. Other states that do well include Georgia, Kentucky, Maryland and Indiana. They tend to have average or below-average tax rates, exempt most business input items from sales tax, and maintain low or moderate excise taxes.

By contrast, Washington has the lowest score because it has both a sales tax and gross receipts tax, thereby creating a high effective sales tax rate of 10.3 percent. Moreover, Washington levies its sales tax on most business inputs—such as services, manufacturing, and leases—and maintains relatively high excise taxes. Joining Washington at the bottom are Louisiana, New Mexico, Mississippi and Nevada. These states levy high sales tax rates that apply to most or all business input items. Like Washington, both New Mexico and Mississippi also impose a gross receipts tax. See Table 5 for state rankings.

## THE UNEMPLOYMENT INSURANCE TAX INDEX

The fourth major index is the Unemployment Insurance Tax (UIT) index. UITs are paid by employers into the Unemployment Insurance

program to finance benefits for workers recently unemployed. Unlike the other major taxes assessed in the State Business Tax Climate Index, UITs are much less well known, every state has one, and there are no perfect or even nearly perfect UIT systems. All are complex, variable-rate systems that impose different rates on different industries and different bases depending upon such factors as the health of the state's UI trust fund.

One of the worst aspects of the UIT system is that financially troubled businesses, where layoffs may be a matter of survival, not only pay more UI taxes, but actually pay higher marginal rates as they are forced into higher tax rate schedules. In fact, the academic literature has long been troubled by the "shut-down effect" of UI taxes. This effect occurs when a failing businesses is forced to layoff workers but at the same time finds its UI taxes climbing as a result. The end result is that failing businesses fail sooner and some teetering on the brink fail instead of barely surviving.

The Unemployment Insurance Tax Index consists of two sub-indexes, one that measures the neutrality of the rate structure and one that focuses on the tax base. Each is weighted to represent half of the total index score. The UIT rates are based on a schedule of rates ranging from a minimum rate to maximum rate. The schedule for any particular business is dependent upon their "experience rating" and other factors in the UIT "base" index. The UIT "base" index scores how states determine how much a business should pay in UIT, which businesses should pay the UIT and other taxes businesses may also be liable for.

Overall, the states with the least damaging UITs are Florida, Mississippi, Oklahoma, Vermont and Indiana. Comparatively speaking, these states have rate structures with lower minimum and maximum rates and a wage base at the federal level. In addition, they have simpler experience formulas and charging methods, and they have not complicated their systems with benefit additions and surtaxes.

On the other hand, the states with the worst UIT are New York, Rhode Island, Massachusetts, Kentucky and Ohio. These states tend to have rate structures with high minimum and maximum rates and wage bases above the federal level. Moreover, they have more complicated experience formulas and charging methods, and they have added benefits and surtaxes to their systems. See Table 6.

**Table 7**  
*Fiscal Balance Index and Ranking, 2003 and 2004*

State	2004 Fiscal Balance Index		2003 Fiscal Balance Index		Change from 2003 to 2004	
	Score	Rank	Score	Rank	Score	Rank
U.S.	5.00	-	5.00	-	-	-
Alabama	6.30	14	5.98	13	0.32	-1
Alaska	6.75	10	6.34	12	0.40	2
Arizona	6.97	7	6.86	10	0.11	3
Arkansas	4.30	37	3.78	37	0.52	0
California	4.69	30	4.54	34	0.15	4
Colorado	8.59	1	8.18	1	0.41	0
Connecticut	3.04	43	3.32	40	-0.28	-3
Delaware	2.58	46	1.80	47	0.78	1
Florida	7.11	5	7.50	6	-0.39	1
Georgia	6.18	15	5.72	16	0.47	1
Hawaii	0.62	50	0.63	50	-0.01	0
Idaho	5.14	22	5.08	26	0.07	4
Illinois	5.76	18	5.47	21	0.29	3
Indiana	4.77	28	5.40	22	-0.63	-6
Iowa	5.78	17	5.59	18	0.19	1
Kansas	4.74	29	4.88	29	-0.14	0
Kentucky	3.16	42	3.29	42	-0.13	0
Louisiana	6.58	11	6.46	11	0.11	0
Maine	3.38	40	3.32	40	0.07	0
Maryland	4.98	26	4.85	31	0.13	5
Massachusetts	3.83	38	4.17	36	-0.34	-2
Michigan	3.47	39	3.65	38	-0.18	-1
Minnesota	1.66	48	1.68	48	-0.02	0
Mississippi	4.95	27	5.09	25	-0.14	-2
Missouri	7.64	4	7.38	7	0.25	3
Montana	5.67	19	5.66	17	0.01	-2
Nebraska	4.52	32	5.21	23	-0.69	-9
Nevada	6.00	16	5.97	14	0.03	-2
New Hampshire	6.95	8	7.03	8	-0.08	0
New Jersey	4.44	34	5.01	28	-0.57	-6
New Mexico	3.30	41	2.80	45	0.49	4
New York	4.39	36	3.49	39	0.90	3
North Carolina	4.66	31	4.61	33	0.06	2
North Dakota	4.44	34	4.52	35	-0.08	1
Ohio	5.43	21	5.48	20	-0.04	-1
Oklahoma	6.43	12	5.96	15	0.46	3
Oregon	7.08	6	7.70	4	-0.62	-2
Pennsylvania	5.00	25	5.20	24	-0.19	-1
Rhode Island	4.47	33	4.75	32	-0.28	-1
South Carolina	6.34	13	6.96	9	-0.62	-4
South Dakota	7.89	3	7.82	3	0.07	0
Tennessee	6.82	9	7.57	5	-0.75	-4
Texas	7.91	2	7.86	2	0.05	0
Utah	5.08	24	4.87	30	0.20	6
Vermont	1.46	49	1.37	49	0.09	0
Virginia	5.67	19	5.54	19	0.12	0
Washington	5.11	23	5.02	27	0.08	4
West Virginia	2.82	45	2.65	46	0.17	1
Wisconsin	2.99	44	3.00	43	-0.01	-1
Wyoming	2.15	47	2.98	44	-0.83	-3
District of Columbia	0.00	-	0.00	-	0.00	-

**Note:** States with identical scores rank equally. Territories and possessions excluded from "U.S."

**Source:** Tax Foundation

## THE STATE FISCAL BALANCE INDEX

Quite apart from the statutory rates and tax bases in a state's tax code, which are measured by the first four indexes, a state's overall fiscal situation is a major concern to business. Papke and Papke (1986), for example, have shown that state tax law changes do change business location decisions by shuffling the ranking of state-local tax burdens. Therefore, the last component of the 2004 State Business Tax Climate Index is the State Fiscal Balance Index, which measures current state tax collections and the rules each state uses to control the growth of spending and tax revenues.

The simplest measure of the fiscal situation is the current size of the tax take within a state, which is defined here as total state tax collections per capita and as a percentage of income. More than just the current status, though, businesses need a sense of whether the fiscal situation is likely to change: will taxes be rising or falling, and what institutional measures are in place to moderate the growth of state spending and tax revenues?

States that score well in this index will have tax collections that are below the national per-capita average of \$1,884 and below the average of 5.62 percent of income. A state will also score well if it has tough tax and expenditure controls. This means that the state requires super-majorities in the legislature to enact tax increases and that it has tax and expenditure limitations written into its constitution or its statutes.

Colorado scores the highest in this index with a 8.59 because the state's tax collections per capita are more than \$400 below the national average, and its taxes are 1.5 percentage points below the national average as a percentage of income. Colorado's success in controlling its tax burden is made possible by its constitutional tax and expenditure measure known as TABOR (Taxpayers Bill of Rights).

Rounding out the best five are Texas, South Dakota, Missouri and Florida. They scored well because their state tax collections are far below average, and with the exception of South Dakota they all have constitutional limits on either expenditures or taxes.

On the other end of the spectrum, Hawaii has the worst overall score on this index. Despite a constitutional expenditure limitation, Hawaii's

tax collections are far above average, nearly \$1,000 per capita above the national average of \$1,884, and measured as a percentage of income, Hawaii collects three full percentage points more, 8.62 percent compared to the national average of 5.62 percent. The states that round out the bottom five are Vermont, Minnesota, Wyoming and Delaware. They all have total tax collections far above the national average and, with the exception of Delaware, have no tax and expenditure controls. See Table 7 for a 50-state ranking.

## The Best and Worst Business Tax Climates

After adding the scores from all the indexes, the ten states with the best business tax climates are:

- |                  |               |
|------------------|---------------|
| 1. South Dakota  | 6. Nevada     |
| 2. Florida       | 7. Wyoming    |
| 3. Alaska        | 8. Colorado   |
| 4. Texas         | 9. Washington |
| 5. New Hampshire | 10. Oregon    |

Looking at the tax systems of these states points to a few key findings:

• **Corporate Income Tax Index:** When measuring state business tax climate, the absence of a corporate income tax is a dominant factor. All four states that manage without a corporate income tax of any kind have one of the top ten business tax climates. The comparatively neutral corporate tax systems of Colorado, Florida and Oregon also help them make the top 10—they each have just one bracket and a moderate tax rate. Texas does not have a traditional income tax but instead levies a 4.5 percent tax on a more broadly defined corporate tax base. The business tax climates in Alaska and New Hampshire rank in the top ten despite poor scores on the Corporate Income Tax Index because high scores on other indexes outweigh it. Alaska ranks as the fifth-best tax system overall, despite having one of the worst corporate tax codes in the nation.

• **Individual Income Tax Index:** All of the seven states with no individual income tax rank in the top ten overall. Colorado has a low, flat rate, and New Hampshire taxes only dividend and interest

income. Oregon is the only state in the top ten with a poor score on the Individual Income Tax Index. It makes up for high top tax rate and multiple brackets with excellent scores on the other component indexes.

• **Sales and Gross Receipts Tax Index:** Of the five states without a general sales tax, three (Alaska, Oregon and New Hampshire) are in the top ten overall. Four of the remaining top-ten states that do levy a sales tax, Florida, Colorado, Texas and Wyoming, score near the middle of the pack on the Sales and Gross Receipts Tax Index. By contrast, Washington, Nevada and South Dakota have some of the worst sales tax systems in the nation. Washington and South Dakota each have both a general sales tax and a gross receipts tax, which compounds the tax pyramiding within their states.

• **Unemployment Tax Index:** All unemployment insurance taxes are designed to violate the principle of tax neutrality, and even the states with the best business tax climates have made little progress in this area. Of the top ranking states, only Florida and Texas have UIT systems good enough to earn top 15 rankings on the UIT Index. In fact, four states in the top ten—Alaska, New Hampshire, Nevada and Washington—score among the worst on the Unemployment Insurance Tax Index. Florida and Texas have reasonably good UIT systems, and the rest of the best 10 states fall somewhere in the middle.

• **Fiscal Balance Index:** Seven of the states with the ten best state business tax climates also scored in the top ten on the Fiscal Balance Index, demonstrating their low tax burden and fiscal discipline. Wyoming is the only top-ten state to rank near the bottom of the fiscal balance index because of its high tax collections and lack of tax or expenditure limitations.

Generally speaking, states in the top ten overall earn that ranking because they raise sufficient tax revenue without one of the three major taxes on corporate income, individual income and sales. Some, such as Alaska, Nevada, South Dakota, Washington and Wyoming, do not impose two of these taxes. Indeed, Alaska is able to overcome one of the worst corporate tax systems in the nation because it does not have either an individual income tax or a state-level sales tax.

Colorado is the only state in the top ten that imposes all three major taxes. Colorado achieves

its high ranking because it (1) keeps all of its taxes simple and at low rates and (2) has one of the most effective tax and expenditure limitation measures in the nation.

By contrast, the states with the worst business tax climates are:

50. Hawaii	45. Vermont
49. New York	44. Kentucky
48. Minnesota	43. Arkansas
47. West Virginia	42. Maine
46. Rhode Island	41. Wisconsin

Here are some of their typical tax problems:

• **Corporate Income Taxes:** The worst-ranking states in the State Business Tax Climate Index are evenly split between a group that has complex, multi-rate corporate tax systems and another that has flat rate systems. The multiple-rate states—Arkansas, Hawaii, Kentucky, Maine and Vermont—compound their business climate problems by levying a capital stock tax or by using apportionment formulas that give businesses the wrong incentives. The flat rate states—Minnesota, New York, Rhode Island, West Virginia and Wisconsin—get credit for having a single-rate system, but their above-average rates combine with other problems to drive down their overall scores. West Virginia compounds its high corporate tax rate by imposing a capital stock tax, while Minnesota adds insult to injury by imposing a 9.8 percent corporate income tax rate and denying companies a deduction for taxes paid to other jurisdictions.

• **Individual Income Taxes:** Nine of the ten poorest-scoring states have multiple brackets and high top tax rates. The top rates in Hawaii, Maine and Vermont are among the highest in the nation. States that have let tax brackets proliferate to the detriment of the business tax climates include Arkansas, Hawaii, Kentucky, New York, Vermont and West Virginia.

• **Sales and Gross Receipt Taxes:** The ten states with the worst overall business tax climate tend to have average to above-average sales tax rates and a greater-than-average level of tax pyramiding. Among the ten states with the worst business tax climates, Kentucky, Maine and Vermont are the only three with good sales tax systems. In Arkansas, Hawaii, Minnesota and New York, a

poor ranking in the Sales and Gross Receipts Tax Index contributes to their finish in the bottom ten overall.

- **Unemployment Tax:** Eight of the 10 states with the worst overall rankings also rank well below average on the Unemployment Tax Index. These states have complex, high-rate UI tax systems with add-on benefits and surtaxes. Vermont is the only state to finish in the bottom ten overall despite a favorable ranking on the Unemployment Insurance Tax Index.

- **Fiscal Balance:** The 10 states with the worst overall business tax climates all scored below the national average on the Fiscal Balance Index. All of these states have per capita tax collections that exceed the national average, and all but New York have above-average tax collections when measured as a percentage of income. Hawaii and Rhode Island are the only states with expenditure limitations that nevertheless finished in the bottom ten overall.

In summary, the common characteristics of states in the bottom ten are: complex, multi-rate corporate and individual tax codes that impose above-average tax rates; above-average sales tax rates that exempt few business-to-business transactions; complex, high-rate unemployment tax systems; and high overall state tax collections with few if any tax or expenditure controls.

## Conclusion

The purpose of the Tax Foundation's State Business Tax Climate Index is to aid business leaders and government policymakers in their determination of whether a state's tax system enhances or harms the competitiveness of a state's business environment. The economic literature clearly shows that taxes do matter a great deal, and the index reduces many complex considerations to an easy-to-use ranking. But businesses must grapple with a wide assortment of other issues: proximity to consumers or raw materials or a highly educated labor pool. These concerns may seem more important than a good tax system, but taxes can positively or negatively affect a business's position with regard to these very resources.

While taxes are a fact of life, not all tax systems are created equal. Ultimately, states must strive for tax systems that are economically neutral—systems that do not favor one economic

activity over another and are reasonable enough not to interfere substantially in business decisions.

## A Review of the Economic Literature—Do Taxes Affect Business Behavior?

Economists have not always agreed on how individuals and businesses react to taxes. As early as 1956, Charles Tiebout postulated that if citizens are faced with an array of communities that offer different types or levels of public goods and services at different costs or tax levels, then each citizen would choose the community that best satisfies his particular demands, revealing their preferences by "voting with their feet."

Tiebout also suggested that citizens with high demands for public goods would concentrate themselves in communities with high levels of public services and high taxes while those with low demands will choose other communities with low levels of public services and low taxes. Competition among jurisdictions results in a variety of communities, each with residents that all value public services similarly.

However, businesses sort out the costs and benefits of taxes differently from individuals. To businesses, which must earn profits to justify their existence, taxes reduce profitability. Theoretically, then, businesses could be expected to be more responsive than individuals to the lure of low-tax jurisdictions.

The economic literature over the past 50 years has slowly cohered around this hypothesis. Ladd (1998) summarizes the post-World War II empirical tax research literature in an excellent survey article, breaking it down into three distinct periods: (1) taxes do not change behavior; (2) taxes may or may not change business behavior depending on the circumstances; (3) taxes definitely change behavior.

Period one included the 1950s, '60s and '70s and is summarized succinctly in three survey articles—Due (1961), Oakland (1978) and Wasylenko (1981). Due's article was less of an academic article than it was a polemic against tax giveaways to businesses. His conclusions were based on crude analysis techniques consisting of simple correlations, interview studies and examining taxes relative to other costs. He found no evidence to support the notion that taxes influence business location.

Oakland was skeptical of the assertion that tax differentials at the local level had no influence at all. However, because econometric analysis was relatively unsophisticated at the time, he found no significant articles to support his intuition. Wasylenko's survey of the literature found some of the first evidence indicating that taxes do influence business location decisions. However, the statistical significance was lower than that of other factors such as labor supply and agglomeration economies. Therefore, he dismissed taxes as a secondary factor at most.

Period two occurred in the early- to mid-1980s. This was a time of great ferment in tax policy as Congress passed major tax bills, including the so-called Reagan tax cut in 1981 and a dramatic reform of the tax code in 1986. Articles revealing the economic significance of tax policy proliferated and became more sophisticated. For example, Wasylenko and McGuire (1985) extended the traditional business location literature to non-manufacturing sectors and found, "Higher wages, utility prices, personal income tax rates, and an increase in the overall level of taxation discourage employment growth in several industries." However, Newman and Sullivan (1988) still found a mixed bag in "their observation that significant tax effects [only] emerged when models were carefully specified." (Ladd, p. 89)

Period three occurred in the late-80s and early-90s when the quantity and quality of articles increased significantly. In all, Bartik (1991) found 57 studies from which to base his literature survey. Ladd succinctly summarizes Bartik's findings:

The large number of studies permitted Bartik to take a different approach from the other authors. Instead of dwelling on the results and limitations of each individual study, he looked at them in the aggregate and in groups. Although he acknowledged potential criticisms of individual studies, he convincingly argued that some systematic flaw would have to cut across all studies for the consensus results to be invalid. In striking contrast to previous reviewers, he concluded that taxes have quite large and significant effects on business activity (p. 92).

A more recent study by Agostini and Tulayasathien (2001) examined the effects of corporate income taxes on the location of foreign direct investment in U.S. states. They determined that for "foreign investors, the corporate tax rate is the most relevant tax in their investment deci-

sion." Therefore, they found that foreign direct investment was quite sensitive to states' corporate tax rates (p. 28).

Other economists have found that taxes on specific products can produce behavioral results similar to those that were found in these general studies. For example, Fleenor (1998) looked at the effect of excise tax differentials between states on cross-border shopping and the smuggling of cigarettes. Moody and Warcholik (2004) examined the cross-border effects of beer excises. Their results, supported by the literature in both cases, showed significant cross-border shopping and smuggling between low-tax states and high-tax states.

Fleenor found that shopping areas sprouted in counties of low-tax states that shared a border with a high-tax state, and that approximately 13.3 percent of the cigarettes consumed in the United States during FY 1997 were procured via some type of cross-border activity. Similarly, Moody and Warcholik found that in 2000, 19.9 million cases of beer, on net, moved from low- to high-tax states. This amounted to some \$40 million in sales and excise tax revenue lost in high-tax states.

In short, the latest word from the tax literature is this: taxes matter a great deal to business.

## Detailed Results of the Major Component Indexes

The Tax Foundation's 2004 State Business Tax Climate Index is constructed of five equally weighted component indexes:

- The Corporate Income Tax Index
- The Individual Income Tax Index
- The Sales and Gross Receipts Tax Index
- The Unemployment Tax Index
- The Fiscal Balance Index

Each of these five component indexes is made up of a series of sub-indexes. Overall, there are 10 sub-indexes, 33 categories and 109 variables.

### CORPORATE INCOME TAX INDEX

The Corporate Income Tax Index consists of two distinct, equally weighted sub-indexes—one that measures the impact of the rate structure and

one that measure the neutrality of the state's definition of taxable corporate income, i.e., the tax base. These two sub-indexes are explained, with notes about which states scored particularly well or poorly on each, and then the scores are averaged, producing the ranking for this major component index of the State Business Tax Climate Index. See Tables 8, 9, 10 and 11 in the appendix.

### **Sub-index #1: The Corporate Income Tax Rate**

This sub-index measures the tax impact of a state's corporate income tax system on the marginal dollar earned by incorporated businesses, that is, the next dollar of income earned (Fleenor and Moody, 1999). The extent of taxation can affect a corporation's level of economic activity within a state (Newman, 1982).

Of course, a state's corporate income tax is levied in addition to the federal corporate tax rate, which varies from 15 percent on the first dollar to a top statutory rate of 35 percent.<sup>7</sup> This top rate is higher than the corporate income tax rate in all but a few industrial nations. In many states, federal and state corporate tax rates combine to levy the highest corporate tax rates in the world.

On the other hand, there are four states with no corporate income tax: Nevada, South Dakota, Washington and Wyoming.<sup>8</sup> These states automatically score a perfect 10 for this sub-index. Texas is often listed as a state with no corporate income tax, but its franchise tax closely resembles a traditional corporate income tax and is treated as one in the index.<sup>9</sup> Therefore, this section ranks the remaining 46 states relative to each other.

Of the states with a corporate income tax, Colorado, South Carolina, Utah, Florida and Texas have the best top scores by virtue of having a low, single rate system.

By contrast, the five states with the worst scores, Michigan, Alaska, North Dakota, Pennsylvania and Kansas, have complex, multi-rate systems with high top marginal tax rates.

The corporate income tax rate sub-index considers two major features of each state's corporate income tax rate structure, the top statutory rate and the graduated rate structure.

### **THE TOP RATE**

Michigan's 14.83 percent corporate tax rate qualifies for the worst ranking in this category.<sup>10</sup> Other states with comparatively high top corporate tax rates are Iowa (12 percent), North Dakota (10.5 percent), Pennsylvania (9.99 percent), the District of Columbia (9.975 percent), Minnesota (9.8 percent), Vermont (9.75 percent), Massachusetts (9.5 percent), Alaska (9.4 percent), New Hampshire<sup>11</sup> (9.25 percent), New Jersey and West Virginia (9 percent).

By contrast, Texas's top tax rate of 4.5 percent qualifies it for the best score among states with a corporate income tax. Other states with comparatively low top corporate income tax rates are Colorado (4.63 percent), Alabama (5 percent), Mississippi (5 percent), South Carolina (5 percent), and Utah (5 percent).

### **THE GRADUATED RATE STRUCTURE**

Three variables are used to measure the economic drag created by multiple-rate tax systems: the top bracket, that is, the level of income at which the highest tax rate is levied; the number of tax brackets and the average width of the brackets.

#### **The Top Tax Bracket**

This variable measures how soon a state's tax system applies its highest corporate income tax rate. If the state's highest corporate income tax rate kicks in at a low level of income, the score is poor; if only the highest earners pay the highest rate, the score is better.

<sup>7</sup> For firms with less than \$50,000 in taxable income, the rate is 15 percent. The rate is 25 percent on the next \$25,000 in income; and for firms with taxable income between \$75,000 and \$10,000,000, the rate is 34 percent. Above that, the effective rate is 35 percent.

<sup>8</sup> Wyoming has a capital stock tax which reduces its score to 9.48.

<sup>9</sup> Texas's 4.5 percent tax on taxable earned surplus is similar to a traditionally defined corporate income tax with the major difference being a larger tax base (federal net taxable income plus compensation paid to officers and directors of the corporation). The 0.25 percent tax on taxable capital—which, if higher, a corporation must pay instead of the tax on earned surplus—is essentially a "wealth tax." For the rate analysis, Texas's Corporate Income Tax Index score is based on the 4.5 percent earned surplus tax. The tax on capital is included in the tax base sub-index.

<sup>10</sup> Michigan Department of Treasury, op. cit.

<sup>11</sup> New Hampshire has a dual corporate income tax with differing tax bases: the Business Profit Tax (BPT) and Business Enterprise Tax (BET). The BPT has a rate of 8.5 percent if gross income is over \$50,000, and the BET has a rate of 0.75 percent if gross income is over \$150,000 or if the base (total compensation, interest and dividends paid) is over \$75,000. As a result, the top tax rate a corporation may face is the BPT rate plus the BET rate for a combined rate of 9.25 percent.



Many states, however, do not have multi-rate corporate tax systems. Indeed, 31 states and the District of Columbia have flat, single-rate systems that tax all corporate income at the same rate beginning with the first dollar of taxable income. While it might seem that single-rate systems are more punitive than multi-rate systems—since they tax all income at the “highest” rate—such systems are also consistent with the sound tax principles of simplicity and neutrality. A flat system does not impact the economic decisions of businesses as they become more successful and earn additional income.

States with multiple-rate tax systems that score poorly on this variable include: North Dakota (the 10.5 percent rate begins at \$50,000); Ohio (8.5 percent over \$50,000); Nebraska (7.81 percent over \$50,000); Alaska (9.4 percent over \$90,000); Arkansas (6.5 percent over \$100,000); and New Hampshire (the 9.25 percent rate begins at \$150,000).

### **The Number of Brackets**

An income tax system creates changes in behavior when the taxpayer's income reaches the end of one tax rate bracket and moves into a higher tax rate bracket. At such a break point, incentives change, and as a result, numerous rate changes are more economically harmful than a single rate structure. This variable is intended to measure the disincentive effects the corporate income tax has on rising incomes.

States that score the best on this variable are the 31 states and the District of Columbia that have a single-rate system. Alaska's 10-bracket system earns the worst score in this category. Other states with multi-bracket systems include Arkansas (6 brackets), North Dakota (6 brackets), Kentucky (5 brackets) and Louisiana (5 brackets).

### **The Average Width of Brackets**

Most states have one flat corporate tax rate. States that place additional, progressively higher rates throughout the income spectrum cause corporations to alter their income-earning and tax planning behavior. This sub-index punishes the latter group of states by measuring the average width of the brackets, rewarding those states where the average width is small.

The 31 states and the District of Columbia with single-rate systems score best on this sub-index. Among states with multiple-bracket systems, Mississippi scores best on this variable with an average bracket width of only \$5,000. Alaska's average bracket width is only \$10,000; North

Dakota's are just \$12,000 wide; and Arkansas's average is just \$20,000. On the other hand, Iowa and Maine score the worst. They each have four brackets spanning \$250,000 in income for an average bracket width of \$83,333.

## **Sub-index #2: The Corporate Income Tax Base**

This sub-index measures the economic impact of each state's definition of corporate taxable income. Four major criteria used to measure the neutrality and efficiency of each state's tax base are given equal weight of 20 percent: the state's apportionment formula, the ability of taxpayers to deduct net operating losses, the presence of a tax on capital stock and the differential between the top corporate and individual income tax rates. A host of smaller tax base issues combine to make up a fifth category that is also weighted 20 percent under this sub-index.

The three states with neither a corporate income tax nor any other kind of similar business activity tax—Nevada, South Dakota and Washington—receive a perfect score for this sub-index. Of the states with only one of these taxes, Wyoming, Maryland, Virginia, Colorado, Iowa and Ohio have the best scores.

By contrast, Pennsylvania has the lowest score because it has the worst capital stock tax and has scores in the average to below-average range in the remaining categories. The other states in the bottom five are West Virginia, Arkansas, California and Kansas. In general, these states follow the pattern set by Pennsylvania. California does not levy a capital stock tax, but it lowered its score significantly by “temporarily” suspending its deduction for net operating losses.

### **APPORTIONMENT FORMULAS**

Businesses that operate across state lines must follow state tax rules that apportion their income to each state they do business in. The climate index uses three criteria to judge the neutrality of how states accomplish this: the apportionment factors used, any alternative factors used, and the implementation of throwback rules.

#### **Apportionment Factors**

All states base their apportionment on one or more of three factors—the locations of property, payroll and sales. The most common apportionment is called the “one-third rule” where each factor is weighted equally.

However, not all the factors are equally neutral from a tax perspective. Since businesses have

control over where they place their capital stock (property factor) and labor force (payroll factor), these factors are non-neutral. In other words, states that use these factors encourage businesses to shop around for the most favorable tax system. The sales factor does not encourage such behavior because a company can not alter the location of its customers. As a result, when states depend more heavily on the sales factor, in some cases completely, the sub-index considers their apportionment formula to be more neutral and gives those states a higher score.

Goolsbee and Maydew (1999) were the first to find that the apportionment formula has a significant effect on a state's economy. In particular, they found that the payroll tax factor effectively acted as a payroll tax and dampened job growth.

The payroll weight is a significant determinant of state employment, although there may be other unobserved policy changes contributing to the result. We find that for the average state, reducing the payroll weight from one-third to one-quarter increases manufacturing employment by approximately 1.1%. (p. 3)

Furthermore, they found that the higher employment levels that can result from a heavily weighted sales factor can generate tax revenue in ways that make up for the corporate tax revenue losses that result from diminishing the property and payroll factors.

These significant employment effects imply that although increasing the sales weight in a state may lead to corporate income tax revenue losses (see Pomp, 1987), the increased employment generates an indirect source of additional personal income tax revenue. The results suggest that this additional revenue reduces and may even exceed the corporate revenue loss for some recently proposed formula changes. (p. 3)

States with the highest score are the five states that have adopted the 100 percent sales factor rule: Illinois, Iowa, Mississippi, Nebraska and Texas. The remaining states are scored based on the proportion the sales factor represents in their apportionment formula.

### **Alternative Factors**

Some states allow for alternative apportionment formulas for specific industries to increase competitiveness via lower tax liabilities. Generally, boosting the sales factor weight does this.<sup>12</sup> The ten states with the highest score allow for alternative factors—Colorado, Connecticut, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, New Mexico, Oklahoma and South Carolina.

### **Throwback Rules**

Among the 50 states, there is little harmony in apportionment formulas. Many follow the one-third rule while others weight the sales factor more heavily. As a result, businesses can end up with “nowhere income,” income that is not taxed by any state. To counter this phenomenon, many states have adopted what are called throwback rules because they identify nowhere income and throw it back into a state where it will be taxed. There are two reasons why this is penalized by the index.

First, all income would be properly apportioned and taxed if every state adopted a universal sales factor rule. From this perspective, nowhere income is simply a transition problem best solved by harmonizing all apportionment formulas. Secondly, throwback rules add yet another layer of tax complexity.

States are almost evenly divided between those with and without throwback rules. Twenty-nine states and The District of Columbia have them; 21 states do not.

States with the best scores in the apportionment formula sub-index include Connecticut, Louisiana, Maryland and South Carolina while those with the worst scores include Alabama, Alaska, Hawaii, Kansas, Montana, North Dakota, Utah and Vermont. The District of Columbia also received one of the worst scores.

### **NET OPERATING LOSSES**

The corporate income tax is designed to tax only the profits of a corporation. However, a yearly profit snapshot may not fully capture a corporation's true profitability. For example, a corporation in a highly cyclical industry may look very profitable during boom years; yet, also look very unprofitable during bust years. However, when examined over the entire business cycle, the corporation may actually have

<sup>12</sup> From a strict tax neutrality perspective, alternative factors are bad tax policy because they single out certain industries for preferential treatment. However, the general direction of alternative factors is to increase the sales factor weight. So from a broader perspective, the sub-index considers this to be a movement in the right direction, however slight, and rewards these states for having alternative factors. Ideally, the benefits of an increased sales factor weighting should be extended to all industries.

an average profit margin.

The deduction for net operating losses (NOL) helps insure that, over time, the corporate income tax is a tax on average profitability. Without the NOL deduction, corporations in cyclical industries pay much higher taxes than those in stable industries, even assuming identical average profits over time. Put simply, the NOL deduction helps level the playing field, especially among cyclical and non-cyclical industries. The federal government currently allows a two-year carry-back and a 20-year carry-forward.

Two variables are taken into account in the assessment of state treatment of net operating losses:

#### **Number of Years Allowed for Carry-Back and Carry-Forward**

This variable measures the number of years allowed on a carry-back or carry-forward of an NOL deduction. The longer the overall time span, the higher the probability that the corporate income tax is being levied on the corporation's average profitability. Generally, states entered 2004 with better treatment of the carry-forward (up to a maximum of 20 years) than the carry-back (up to a maximum of three years).

#### **Caps on the Amount of Carry-Back and Carry-Forward**

This variable measures the amount of NOL deductions allowable for carry-back or carry-forward. Only a handful of states place any limits on these and those that do only put them on carry-backs. They are Delaware, Idaho, New York and West Virginia and they score poorly in this variable.

The state with the best scores on this sub-index is Utah while the states with the worst score are California and New Jersey, both of which have temporarily suspended their NOL deduction.

### **CAPITAL STOCK TAXES**

Capital stock taxes are levied on the wealth of a corporation, usually defined as the corporate stock valuation. Such taxes work counter to corporate income taxes in that they take no account of a corporation's profitability. A corporation must pay the capital stock tax in good times as well as bad times. Naturally, the overriding problem is that corporations who find themselves in financial trouble must use precious cash-flow to pay their capital stock tax. In assessing capital stock taxes, the sub-index accounts for three variables:

#### **Capital Stock Tax Rate**

This variable measures the rate of taxation as levied by the 22 states with a capital stock tax. States with the highest capital stock tax rate include Delaware (9 percent), Pennsylvania (7.24 percent) and West Virginia (7 percent).

#### **Maximum Capital Stock Tax Payment**

Some states mitigate the negative economic impact of the capital stock tax by placing a cap on the maximum capital stock tax payment. These states include Alabama, Connecticut, Delaware, Georgia, Kansas, Oklahoma and Wyoming, and they receive the highest score on this variable.

#### **Capital Stock Tax Versus Corporate Income Tax**

Some states mitigate the negative economic impact of the capital stock by allowing corporations to pay the higher of the two taxes. These states include Connecticut, Rhode Island and Texas, and they receive the highest score on this variable.

States that do not have a capital stock get the best scores in this sub-index while those who scored the lowest include Pennsylvania, West Virginia, Montana, Arkansas and Mississippi.

### **DIFFERENTIAL BETWEEN THE TOP INDIVIDUAL AND CORPORATE RATES**

It is impossible to categorize all relevant and significant tax issues as exclusively a tax base issue or a tax rate issue. As one of the criteria in creating this sub-index, the differential between a state's top corporate and individual tax rates is problematic to categorize. It is a comparison of rates, but its significance is really in how it affects the base.

All corporate forms should be subject to the same level of taxation. Because some businesses pay taxes on individual income tax forms, not corporate income tax forms, this variable of the corporate base sub-index measures how much the top corporate income tax rate exceeds the top individual income tax rate. If the corporate rate is higher, the resulting bias will favor the formation of S-corporations, LLCs, partnerships and sole-proprietorships that file through the individual income tax code.<sup>13</sup> Michigan has the greatest differential of 10.83 percentage points. Other states with large differentials are Pennsylvania (6.92 percentage points), Indiana (5.10 percentage points) and North Dakota (4.96 percentage points).

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## OTHER SIGNIFICANT FEATURES

### Federal Income Used as State Tax Base

States that use federal definitions of income help reduce the tax compliance burden on their taxpayers.<sup>14</sup> Two states do not conform to federal definitions of corporate income, Arkansas and Mississippi, and they score poorly.

### Allow Federal ACRS and MACRS Depreciation

The vast array of federal depreciation schedules is, by itself, a tax complexity nightmare for businesses. The specter of having 50 different schedules would be a disaster from a tax complexity standpoint. This variable measures the degree to which states have adopted the federal ACRS and MACRS depreciation schedules.<sup>15</sup> Six states that add complexity by failing to fully conform to the federal system are California, Michigan, Minnesota (partial conformity), Ohio, Pennsylvania and Tennessee.

### Allow Federal Depletion

The deduction for depletion works similarly to depreciation, but it applies to natural resources. Like depreciation, the tax complexity would be staggering if all 50 states imposed their own depletion schedules. This variable measures the degree to which states have adopted the federal depletion schedules.<sup>16</sup> Eight states are penalized because they do not fully conform to the federal system, Alabama, Alaska (partial conformity), Delaware (partial conformity), Iowa (partial conformity), Minnesota, North Carolina (partial conformity), Oregon and Wisconsin.

### The Alternative Minimum Tax

The Alternative Minimum Tax (AMT) was created to insure that all taxpayers paid some minimum level of taxes every year. Unfortunately, it creates a parallel tax system to the standard corporate

income tax code. Evidence shows that the AMT does not increase efficiency or improve fairness in any meaningful way. It nets little money for the government, imposes compliance costs that in some years are actually larger than collections, and encourages firms to cut back or shift their investments (Chorvat and Knoll, 2002). As such, states that have mimicked the federal AMT put themselves at a competitive disadvantage through needless tax complexity.

Seven states have an AMT on corporations—Alaska, California, Florida, Iowa, Maine, Minnesota and New York—and score poorly. The District of Columbia also has an AMT on corporations.<sup>17</sup>

### Deductibility of Taxes Paid

This variable measures the extent of double taxation on income used to pay foreign, federal and state taxes, i.e., paying a tax on a tax. States can avoid double taxation by allowing the deduction of foreign, federal and state taxes paid to other jurisdictions. Only one state—Louisiana—allows corporations the full deductibility from all three jurisdictions. Twenty-three states and the District of Columbia do not allow any deductions for taxes paid and score poorly. The remaining states fall somewhere in between.

### Indexation of the Tax Code

Indexing the tax code for inflation is critical in order to prevent de facto tax increases on the nominal increase in income due to inflation. Put simply, this “inflation tax” results in higher tax burdens on taxpayers, usually without their knowledge or consent. Seventeen states do not index their corporate income tax brackets<sup>18</sup>: Alaska, Arkansas, Hawaii, Iowa, Kansas, Kentucky, Louisiana, Maine, Michigan,<sup>19</sup> Mississippi, Nebraska, New Hampshire, New Mexico, North Dakota, Ohio, Texas<sup>20</sup> and Vermont.<sup>21</sup>

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<sup>13</sup> All states with an individual income tax follow federal law that taxes business entities such as S-corporations, LLCs, partnerships and sole-proprietorships through the individual income tax code. States without one such as Alaska, Florida and Texas have, to varying degrees, taxed these firms as regular C-corporations. This has the effect of reducing the economic impact of having a top rate differential between the corporate and individual income tax, and the sub-index takes this into account. New Hampshire taxes all businesses through its corporate income tax, nullifying the economic effects of the differential. The same issue applies to Tennessee due to their limited individual income tax.

<sup>14</sup> This is not an endorsement of the economic efficiency of the federal definition of corporate income.

<sup>15</sup> This is not an endorsement of the federal ACRS/MACRS depreciation system. It is well known that federal tax depreciation schedules often bear little resemblance to actual economic depreciation rates.

<sup>16</sup> This is not an endorsement of the economic efficiency of the federal depletion system.

<sup>17</sup> Five of these states impose both a corporate and individual AMT—California, Iowa, Maine, Minnesota and New York. The District of Columbia also imposes both a corporate and individual AMT. An individual AMT sub-index is contained within the Individual Income Tax Major Index.

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## Results of the Corporate Income Tax Index

After tallying up scores on both sub-indexes and all the variables that fall under them, the Corporate Income Tax Index scores four states at or near a perfect 10: Nevada, South Dakota, Washington and Wyoming. Of the states with a corporate income tax, Colorado, Maryland, Virginia, Utah and Florida achieve the best scores by having low, single-rate systems and no capital stock taxes.

The state with the worst score is Michigan because its single business tax rate of 1.9 percent levied on a broad base of corporate revenue is the equivalent of a regular corporate income tax rate of 14.83 percent. This rate naturally creates a large differential between its top corporate and individual tax rates, which also hurts its score. Other states joining Alaska at the bottom include Alaska, North Dakota, Pennsylvania, Kansas and Arkansas.

The Corporate Income Tax Index score for each state counts for 20 percent of the state's overall score in the 2004 State Business Tax Climate Index.

## INDIVIDUAL INCOME TAX INDEX

Similar to the Corporate Income Tax Index, the Individual Income Tax Index consists of two equally weighted sub-indexes—one to measure the impact of the rate structure and one to measure the neutrality of the state's definition of taxable personal income, i.e., the tax base. See Tables 12, 13 and 14 in the appendix.

### Sub-index #1: The Individual Income Tax Rate

The measure of taxation's impact on individual income is important because people make economic decisions based on the value of their time, often measured by economists in monetary terms. This sub-index measures two aspects of this tax impact. First, it gauges the impact of indi-

vidual income taxes on the labor pool available to all businesses. Secondly, it takes into account that many businesses declare their profits on individual income tax forms, gauging the non-neutralities that result.

The extent of taxation can expand or contract the quantity and quality of the labor pool (Wasylenko and McGuire, 1985). For example, suppose a worker has to choose between one hour of additional work worth \$10 and one hour of leisure which to him is worth \$9.50. A rational person would choose to work for another hour. But if a 10-percent income tax rate reduces the after-tax value of his labor to \$9.00, then a rational person would stop working and take the hour to pursue leisure. In the aggregate, the income tax reduces the available labor supply.<sup>22</sup>

From a business perspective, a shrinking labor pool increases the cost of labor which, in most cases, is the single largest business expense. Businesses must either do without the added labor or increase compensation. A progressive, multi-rate income tax exacerbates this problem by systematically ratcheting up the marginal tax rate at higher levels of income. Thus the tax system continually reduces the value of work vis-à-vis the value of leisure.

Aside from measuring the economic impact of each state's individual income tax on wage-earners, the Individual Income Tax Index measures the impact on non-corporate businesses. Because sole proprietorships, partnerships and S-corporations report business income not on corporate tax returns but on individual tax returns, the structure of the individual income tax code is critical to the business climate for these firms. Gentry and Hubbard (2004) found that progressive income tax rates discouraged entry into self-employment and entrepreneurship. Moreover, citing Carroll, Holtz-Eakin, Rider and Rosen (2000), Gentry and Hubbard assert, "Higher tax rates reduce investment, hiring, and small business income growth." (p. 7)

This rate sub-index measures the impact of tax rates on the marginal dollar of individual income using three criteria, the top tax rate and the graduated rate structure. Standard deductions

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<sup>18</sup> This variable only looks at states that have statutory automatic provisions to index for inflation. This does not reflect recent or ongoing legislative activity.

<sup>19</sup> Michigan allows a \$45,000 deduction, in essence creating a two rate system—0 and 1.9 percent. The deduction is not indexed for inflation.

<sup>20</sup> Texas allows a \$150,000 deduction. That effectively creates a two rate system—0 and 4.5 percent. The deduction is not indexed for inflation.

<sup>21</sup> States with a single rate system do not have any brackets to adjust for inflation and are therefore treated as if they were indexation states.

<sup>22</sup> For a more detailed explanation, see Fleenor and Moody (1999).

and exemptions are treated as a zero percent tax rate. The rates and brackets used are for a single taxpayer, not a couple filing a joint return.<sup>23</sup>

The sub-index compares the 44 states that have individual income taxes of any kind, granting a perfect score to the six states that achieve perfect neutrality by levying no individual income tax: Alaska, Florida, South Dakota, Texas, Washington and Wyoming. Among those 44, two equally weighted variables are considered to calculate the rate sub-index: the top tax rate and the graduated rate structure. Nevada, New Hampshire, Tennessee, Indiana and Illinois scored the best.<sup>24</sup> Montana, New York, Vermont, Hawaii and Ohio had the five worst scores.

### THE TOP MARGINAL TAX RATE

Of those states with an income tax, Montana imposes the highest top statutory rate of 11 percent. Other states with high top tax rates include: Vermont (9.5 percent); California (9.3 percent); the District of Columbia (9.3 percent); Oregon (9.0 percent); Iowa (8.98 percent); and Rhode Island (8.75 percent).<sup>25</sup>

Among those states with the lowest rates, Nevada (0.49 percent), New Hampshire (0.9 percent) and Tennessee (1.09 percent) score the best.<sup>26</sup> Other states with relatively low top rates include: Illinois (3.0 percent of federal AGI); Pennsylvania (3.07 percent); Michigan (4.0 percent of federal AGI with modification); Indiana (4.26 percent of federal AGI); Alabama and Connecticut (5 percent).

If only state-level tax rates were considered, Maryland would be in this group of states with the lowest top rates. However, county-level income taxes are also counted by the climate index. As a result, Maryland's average county rate of 2.84 percent is added to its 4.75 percent state-level rate—for a combined rate of 7.59 percent.<sup>27</sup> Similarly, Indiana's local option income tax is incorporated. It adds a more modest 0.86 percent county rate to its state-level rate of 3.4 percent

for a combined 4.26 percent. Municipal income tax rates are not taken into account due to data constraints.

### GRADUATED RATE STRUCTURE

This sub-index measures the impact of a graduated individual income tax structure via three variables.

#### The Top Tax Bracket

New York, North Dakota, Vermont and Rhode Island score the best within this variable because their top income tax rates are not levied until taxpayers have earned substantial amounts: \$507,500 in New York, \$319,750 in North Dakota, \$314,950 in Vermont and \$314,850 in Rhode Island. The states that score the worst within this variable include Alabama and Maryland because their top income tax rates kick in at \$6,500 and \$7,400 of taxable income, respectively.

#### The Number of Brackets

New Hampshire and Tennessee score the highest in this variable by having only one tax bracket. States with only two brackets are Colorado, Illinois, Indiana, Massachusetts and Michigan. On the other end of the spectrum are Missouri and Montana which both score the worst in this variable by having 11 tax brackets. Other low-scoring states with large numbers of brackets include: Hawaii, Iowa and Ohio (all with 10 brackets); and Oklahoma and Idaho (9 brackets).

The number of brackets listed in a state's tax statutes is not always the number used to calculate the climate index. From an economic perspective, standard deductions and exemptions are equivalent to an additional tax bracket with a zero tax rate. As a result, their effects on the income tax have been incorporated into existing sub-indexes.

For example, Kansas has a standard deduction of \$3,000 and a personal exemption of \$2,250 for a combined value of \$5,250.

<sup>23</sup> In many states, tax brackets, deductions and exemptions for joint filers are simply twice that of a single filer's. Therefore, the relative economic impacts are similar. For states where they are not doubled, there exists a "marriage penalty" which is measured in the marriage penalty category of the tax base sub-index.

<sup>24</sup> Often listed as a state with no individual income tax, Nevada recently enacted a 0.7 percent wage tax that mimics an individual income tax.

<sup>25</sup> Rhode Island's top tax rate is computed as 25 percent of the top federal tax rate of 35 percent, or 8.75 percent.

<sup>26</sup> New Hampshire and Tennessee both tax only interest and dividends. To make their top tax rates comparable to other states, the index calculates the rate needed to collect the same revenue of a typical income tax. Nationally, dividends and interest account for 18.09 percent of income. For New Hampshire, its 5 percent rate was multiplied by 18.09 percent yielding the equivalent rate of 0.9 percent. For Tennessee, this calculation yields an equivalent rate of 1.09 percent.

<sup>27</sup> Each county rate was weighted by the share of the respective county's personal income relative to the state total.

Statutorily, Kansas's top rate kicks in at \$30,000 of taxable income, and it has three tax brackets that have an average width of \$15,000. But because of its deduction and exemption, Kansas's top rate actually kicks in at \$35,250 of income, and it has four tax brackets that have an average width of \$11,750.

The size of allowed standard deductions and exemptions varies considerably.<sup>28</sup> Connecticut has the largest standard deduction and exemptions (\$10,026).<sup>29</sup> Mississippi has the second highest (\$8,300) while a number of states tie for third by conforming to the federal system of \$7,800 (in 2003): Idaho, Minnesota, Missouri, New Mexico, North Dakota and South Carolina. On the other hand, Pennsylvania has no standard deduction or personal exemptions while Indiana and New Jersey allow taxpayers only a \$1,000 personal exemption.

### **The Average Width of Brackets**

Many states have several narrow tax brackets close together at the low end of the income scale. Most taxpayers never notice them because they pass so quickly through those brackets and pay the top rate on most of their income. On the other hand, some states continue placing additional, progressively higher rates throughout the income spectrum, causing individuals and non-corporate businesses to alter their income-earning and tax planning behavior. This sub-index punishes the latter group of states by measuring the average width of the brackets, rewarding those states where the average width is small, with the result that the top rate is levied on most income, acting effectively as a flat rate on all income.

The state that scored the best was Missouri which has an average bracket width of only \$1,585. Other states with similar bracket structures include Oklahoma (\$1,625), Utah (\$1,892) and Georgia (\$2,000). North Dakota scored the worst in this variable with an average bracket

width of \$63,950. Other low-scoring states include Vermont (\$62,990) and Rhode Island (\$52,642). As with the counting of the brackets, the "zero bracket" created by a standard deduction or exemption is factored into the calculation of the average width.

## **Sub-index #2: The Individual Income Tax Base**

States have different definitions of taxable income, and some create greater impediments to economic activity. This sub-index gives equal weight, 25 percent, to three major issues in base definition: marriage penalty, double taxation of capital income and the differential between the top individual and corporate tax rates. Then it gives a 25-percent weight to an accumulation of more minor base issues.

The six states with no individual income tax of any kind achieve perfect neutrality. Of the 44 states with an individual income tax, New Hampshire, Tennessee, Indiana, Massachusetts, and Iowa have the best scores. Their top corporate and individual tax rates are approximately the same, and they avoid the marriage penalty and other problems with the definition of taxable income. Meanwhile, states where the tax base is found to cause an unnecessary drag on economic activity are New York, Ohio, Utah, Oregon and North Carolina.

### **MARRIAGE PENALTY**

A marriage penalty exists when a state's standard deduction and tax brackets for married filing jointly are not double those for single filers. As a result, two singles (if combined) can have a lower tax bill than a married couple filing jointly with the same income. This is discriminatory and has serious business ramifications. The top-earning 20 percent of taxpayers is dominated (85 percent) by married couples. This same 20 percent also has the highest concentration of business owners

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<sup>28</sup> Some states offer tax credits in lieu of income exemptions. Rather than excluding a portion of a taxpayer's income from the income tax, tax credits reduce a taxpayer's tax liability. The result is the same: a lower income tax bill. In order to maintain consistency within the sub-index, a tax credit is converted to an equivalent income exemption by dividing the tax credit by the tax rate that corresponds to the estimated 2003 median income of \$29,361. For example, California's \$80 tax credit exemption is the equivalent of an income exemption worth \$1,333 (\$80 divided by 6 percent). Other states with transformed tax credits include Arkansas, Delaware, Iowa, Kentucky, Nebraska and Oregon.

<sup>29</sup> In Connecticut, taxpayers receive a declining exemption and a personal tax credit. The exemption starts at \$12,500 for taxpayers with income less than \$25,000, then declines and reaches \$0 when income exceeds \$37,000. After this calculation, the taxpayer determines his tax liability and deducts a personal tax credit. For taxpayers with income between \$12,500 (beneath which liability is zero) and \$15,600, the personal tax credit reduces tax liability by 75 percent. The percentage reduction declines as income rises, and reaches zero when income exceeds \$54,500. The reported value in the tax climate index assumes a taxpayer with the national estimated 2003 median income of \$29,361. At this income, a taxpayer's exemption is worth \$8,500, leaving tax liability of \$763. The personal tax credit, at this income level, is worth 10 percent of the tax liability or \$76.30. This credit is translated into an income exemption of \$1,526. As a result, the index uses the combined exemption value of \$10,026 (\$8,500 + \$1,526).

(43 percent) of all income groups (Hodge 2003A, Hodge 2003B). Because of these concentrations, marriage penalties affect a large majority of taxable income. States with the largest marriage penalties include New York, Ohio and North Dakota.

Many states get around the marriage penalty problem by allowing married couples to file as if they were singles. While helpful in offsetting the marriage penalty, it comes at the expense of added tax complexity. Despite the complexity, the sub-index rewards states that have this provision.

### **DOUBLE TAXATION OF CAPITAL INCOME**

Since all states with an individual income tax system mimic the federal income tax code, they also possess its greatest flaw—the double-taxation of capital income. Double taxation is brought about by the interaction between the corporate income tax and the individual income tax. The ultimate source of most capital income—interest, dividends and capital gains—is corporate profits. The corporate income tax reduces the level of profits that can eventually be used to generate interest or dividend payments or capital gains.<sup>30</sup> This capital income must then be declared by the receiving individual and taxed. The result is the double-taxation of this capital income—first at the corporate level and again on the individual level.

All states with an individual income tax score poorly by this criterion except Tennessee and New Hampshire which tax individuals on interest and dividends but not capital gains.

### **DIFFERENTIAL BETWEEN THE TOP INDIVIDUAL AND CORPORATE RATES**

Though it does not fit neatly into either the rate or base sub-index, the differential between the top individual and corporate income tax rates has significant implications for a state's tax base. A higher individual tax rate creates a tax bias favoring C-corporations that file through the corporate income tax over S-corporations, LLCs, partnerships and sole-proprietorships that file through the individual income tax code. This variable rewards states where the rates are identical or close, and it punishes states where the individual income tax rate is much higher than the corporate rate. Montana has the greatest differential of 4.25 percentage points. Other states with large

differentials are Oregon (2.4 percentage points), South Carolina and Utah (2 percentage points).

### **OTHER SIGNIFICANT ISSUES**

Tax base issues are almost innumerable. We have identified a half-dozen that significantly affect the neutrality of state individual income tax systems.

#### **Federal Income Used as State Tax Base**

Despite the shortcomings of the federal government's definition of income, states that use it help reduce the tax compliance burden on taxpayers. Seven states do not conform to federal definitions of individual income—Alabama, Arizona, Mississippi, New Hampshire, New Jersey, Pennsylvania and Tennessee—and score poorly.

#### **The Jock Tax**

“Jock tax” is a colloquial expression referring to a state's application of its individual income tax to visiting professional athletes.<sup>31</sup> All of these jock tax states actually enforce the tax on more people than just the athletes. All employees of the sports franchises have to pay, no matter what their income. Some states have extended the tax to visiting entertainers as well, especially popular musicians, while other states are aggressively trying to tax non-residents such as visiting business executives and lawyers.

The jock tax is a blatant attempt to single out a certain class of taxpayers for additional taxation—a clear violation of tax neutrality. Twenty states impose a jock tax.<sup>32</sup> Arizona, California, Colorado, Georgia, Illinois, Indiana, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Utah and Wisconsin (Hoffman, 2004).

#### **The Alternative Minimum Tax**

The Alternative Minimum Tax (AMT) was created to insure that all taxpayers paid some minimum level of taxes every year. Unfortunately, it creates a parallel tax system to the standard individual income tax code. Evidence shows that the AMT is an inefficient way to prevent tax deductions and credits from totally eliminating tax liability. As such, states that have mimicked the federal AMT put themselves at a competitive disadvantage through needless tax complexity.

<sup>30</sup> Equity-related capital gains are not created directly by a corporation. Rather, they are the result of stock appreciations due to corporate activity such as increasing retained earnings, increasing capital investments or issuing dividends. Stock appreciation become taxable realized capital gains when the stock is sold by the holder.

<sup>31</sup> Athletes are considered residents of the jurisdiction where their team is based or headquartered.



Twelve states and the District of Columbia have an AMT on individuals—California, Colorado, Connecticut, Iowa, Maine, Maryland, Minnesota, Nebraska, New York, Rhode Island, West Virginia and Wisconsin—and score poorly.

### **Deductibility of Taxes Paid**

This variable measures the extent of double taxation on income used to pay foreign, federal and state taxes, i.e., paying a tax on a tax. States can avoid double taxation by allowing the deduction of foreign, federal and state taxes paid to other jurisdictions. Only six states allow individuals the full deductibility from all three jurisdictions—Alabama, Iowa, Louisiana, Missouri, Montana and Oklahoma. Most states allow deductions for state and foreign taxes paid, while few allow federal taxes to be deducted.

### **Recognition of Limited Liability**

#### **Corporation and S-Corporation Status**

One important development in the federal tax system is the creation of the limited liability corporation (LLC) and the S-corporation (S-corp). LLCs and S-corps provide businesses some of the benefits of incorporation, such as limited liability, without the overhead of becoming a regular C-corporation. They also are taxed as individuals, which avoids the double-taxation problems that plague the corporate income tax system. Every state with a full individual income tax recognizes LLCs or S-corporations to at least some degree.

### **Indexation of the Tax Code**

Indexing the tax code for inflation is critical in order to prevent de facto tax increases on the nominal increase in income due to inflation. Put simply, this “inflation tax” results in higher tax burdens on taxpayers, usually without their knowledge or consent. Three areas of the individual income tax are commonly indexed for inflation—the standard deduction, personal exemptions and tax brackets. Nineteen states index all three—Arkansas, California, Colorado, Idaho, Illinois, Indiana, Iowa, Maine, Massachusetts, Michigan, Minnesota, Montana, New Hampshire,

North Dakota, Oregon, Pennsylvania, South Carolina, Tennessee, Vermont and Wisconsin.<sup>33</sup>

Twenty-one states and the District of Columbia do not index at all—Alabama, Arizona, Connecticut, Delaware, Georgia, Hawaii, Kansas, Kentucky, Louisiana, Maryland, Mississippi, Missouri, Nebraska, New Mexico, New Jersey, New York, North Carolina, Ohio, Oklahoma, Utah, Virginia and West Virginia.<sup>34</sup>

## **Results of the Individual Income Tax Index**

The six states that do not have an individual income tax score at or near a perfect 10: South Dakota, Washington, Wyoming, Alaska, Florida and Texas. Of the states that tax individual income, Nevada, Tennessee, New Hampshire, Indiana and Illinois achieve the best scores by having low, single-rate systems and relatively neutral tax bases.

The state with the worst score is Montana primarily because it has steeply graduated tax rates and the highest top rate of any state at 11 percent. Montana is also significantly below average on the sub-index devoted to the tax base because it has the largest individual to corporate rate differential and a large marriage penalty. Other states joining Montana at the bottom include Hawaii, Oregon, New York and California. Like all five of the major component indexes, the Individual Income Tax Index makes up 20 percent of the overall score in the 2004 State Business Tax Climate Index.

## **THE SALES AND GROSS RECEIPTS TAX INDEX**

Sales and gross receipts taxes are levies on the purchase price of a good or service. Levying the tax at the final point of sale increases the transparency of the tax and also minimizes economic distortions (Bartik, 1989).<sup>35</sup> Economic distortions occur when the sales tax rate is particularly high and when they are levied on business-to-business transactions. Therefore, the Sales and Gross

<sup>32</sup> In addition to state jock taxes, a few localities have enacted their own jock tax including Cleveland, Columbus, and Cincinnati in Ohio, as well as Philadelphia and Pittsburgh in Pennsylvania. These are not scored in the sub-index.

<sup>33</sup> States with a single rate system that do not have any brackets to adjust for inflation are treated as if they were indexation states. These states include Colorado, Illinois, Indiana, Massachusetts, Michigan, New Hampshire and Tennessee. Taxpayers in Rhode Island calculate their tax liability as a percent of federal tax liability. Since the federal government indexes its brackets for inflation, Rhode Island implicitly does as well and is correspondingly treated as a state that adjusts its brackets for inflation.

<sup>34</sup> This variable only looks at states that have statutory automatic provisions to index the standard deduction, personal exemption or tax brackets to inflation. This does not reflect recent or ongoing legislative activity whose end result may be to adjust these provisions for the effects of inflation.

Receipts Tax Index gives equal weight to these two important traits of state sales and gross receipts taxes: the statutory rate and the extent of taxation on business-to-business transactions.<sup>36</sup> See Tables 15, 16 and 17 in the appendix.

The tax rate itself is important, and a state with a high sales tax rate reduces demand for in-state retail sales. Consumers will turn more frequently to out-of-state purchases, and/or catalog or internet purchases, leaving less business activity in state.

For an example of how business-to-business sales taxes can distort the market, suppose a sales tax were levied on the sale of flour to a bakery. The bakery is not the end-user because the flour will be baked into bread and sold to consumers. Economic theory is not clear as to which party will ultimately bear the burden of the tax. The tax could be “passed forward” onto the customer or “passed backward” onto the bakery.<sup>37</sup> Where the tax burden falls depends on how sensitive the demand for bread is to price changes. If customers tend not to change their bread-buying habits when the price rises, then the tax can be fully passed forward onto consumers. However, if the consumer reacts to higher prices by buying less, then the tax will have to be absorbed by the bakery as an added cost of doing business.

The hypothetical sales tax on all flour sales would distort the market because different businesses that use flour have customers with varying price sensitivity. Suppose the bakery is able to pass the entire tax on flour forward to the consumer, but the pizza shop down the street cannot. The owners of the pizza shop would face a higher cost structure and profits would drop. Since profits are the market signal for opportunity, the tax would tilt the market away from pizza-making. Fewer entrepreneurs would enter the pizza business, and existing businesses would hire fewer people. In both cases, the sales tax charged to purchasers of bread and pizza would be partly a tax on a tax because the tax on flour would be built into the price. Economists call this tax pyramiding.

States that create the most tax pyramiding and economic distortion are states that levy a gross receipts tax. A gross receipts tax is paid by the business on its total receipts, generally allowing no exclusions.

The Sales Tax and Gross Receipts Index consists of two equally weighted sub-indexes, a rate sub-index and a base sub-index that gauges tax pyramiding.

## Sub-index #1: Sales and Gross Receipts Tax Rate

This sub-index measures the highest possible sales tax disincentive to in-state retail shopping and taxable business-to-business transactions. Five states—Alaska, Delaware, Montana, New Hampshire and Oregon—do not have a general state sales tax.

Four states that dispense with sales and gross receipts taxes entirely, at the state and local levels, achieve perfect neutrality in this sub-index. Those are Delaware, Montana, New Hampshire and Oregon. Alaska joins this group of top scorers despite its small local option taxes. Of the states with either a statewide sales or gross receipts tax, Hawaii, South Dakota, Virginia, Georgia and Oklahoma score the best.

The state with the worst score in this sub-index is Louisiana. It combines a high rate of state-local sales taxation, 8.21 percent, with the complexity of local taxes that are levied on differing bases. The other states rounding out the bottom five are Washington, Nevada, Illinois and Tennessee. All have high combined state-local sales tax rates.

Washington is the only state with a gross receipts tax on top of a high statewide general sales tax. Those two taxes combine to bring Washington’s effective rate to 8.75 percent, the highest state-level rate in the nation. Local option sales taxes are layered on top of that. (See note in Table 15.)

At the low end, no state-level rate comes close to Colorado’s 2.9 percent rate. Seven states, however, have a 4 percent state-level sales tax: Alabama, Georgia, Hawaii,<sup>38</sup> Louisiana, New York, South Dakota and Wyoming.

### LOCAL OPTION SALES TAXES

However, state-level sales taxes are only part of the story. Many states authorize the use of local option sales taxes in addition to the state sales tax.<sup>39</sup> Local jurisdictions in Colorado, for example, add a modest 0.69 percent sales tax to the state’s 2.9 percent state sales tax rises, bringing the total sales tax rate to roughly 3.6 percent. In some states, the local option sales tax significantly increases the tax rate faced by consumers. Louisiana not only has the highest local option sales tax (4.21 percent), but it actually exceeds the state sales tax rate of 4 percent. New York has the second highest local option sales tax (3.84 percent) that is nearly equal to the state tax rate of 4 percent. Other states with high local

option sales taxes include Nevada (2.96 percent), North Carolina (2.48 percent) and Tennessee (2.31 percent).

The sub-index adds the state and local sales taxes together and then grades them on the combined rate. States with the highest combined rate are Washington (10.31 percent), Nevada (9.46 percent), Tennessee (9.31 percent), Louisiana (8.21 percent) and New York (7.84 percent).

At the low end are states such as Alaska (0.87 percent—local option sales taxes only), Colorado (3.6 percent), South Dakota (4 percent—no local option sales taxes), Georgia (4.7 percent) and Oklahoma (4.96 percent).

Another difficulty businesses face with some local option sales taxes is that not only do rates differ, but some states also allow localities to define their own sales tax base, multiplying complexity for businesses and consumers. These states include Arizona, Colorado, Illinois, Louisiana and Missouri.

## Sub-index #2: Sales and Gross Receipts Tax Base

This sub-index measures the extent of business-to-business sales taxation. It does so by tallying exemptions for six categories of intermediate goods and services. The top five states on this sub-index are those states without a general sales tax—Alaska, New Hampshire, Delaware, Oregon and Montana. None receives a perfect score because they all levy gasoline, diesel, tobacco and beer excise taxes. For the states that do have a general sales tax, Virginia, Kentucky, Missouri, Georgia and Alabama have the highest scores. These states avoid the problems of tax pyramiding and have low excise tax rates.

On the other hand, the states with the worst scores on the base sub-index are Hawaii, Washington, South Dakota, New Mexico and Mississippi. These states all have a gross receipts tax in addition to the usual retail sales tax. As a result, their tax system is hampering economic growth due to tax pyramiding.

The categories of business purchases tallied by this sub-index are: agricultural inputs, service inputs, manufacturing and machinery inputs, computer and software inputs, leasing and rental inputs, and pollution control equipment. Finally, because excise taxes single out products for extra taxes, essentially the mirror image of a tax exemption, they are tallied in this sub-index as well. Each of these seven categories is weighted equally in the base sub-index.

### AGRICULTURAL INPUTS

- Insecticides and pesticides
- Fertilizer, seed and feed
- Seedlings, plants and shoots

### SERVICE INPUTS

- Cleaning services
- Transportation services
- Repair services
- Professional/personal services
- Other services

These variables are often inputs to other business operations. For example, a manufacturing firm will count the cost of transporting its final goods to retailers as a significant cost of doing business. Most firms, small and large alike, hire accountants, lawyers, and other professional service firms. If these services are taxed, then it is more expensive for every business to operate.

<sup>35</sup> Sales taxes that are levied on stages of production are known as value-added taxes (VAT) and are popular internationally because they attempt to neutralize the negative economic impact of tax pyramiding. The VAT has never gained wide acceptance in the U.S., and only one state has even attempted a VAT-like tax—Michigan's Single Business Tax.

<sup>36</sup> In some cases, transactions that appear to be business-to-business turn out to be business-to-consumer. For example, a hobby farmer needs many of the same business inputs as a commercial farmer. Thus, the hobby farmer is able to take advantage of the same sales tax exclusions as the commercial farmer. Such cases are rare, however, and therefore are not accounted for in this sub-index.

<sup>37</sup> See Besley and Rosen, *op. cit.* For some goods, Besley and Rosen found that in general, sales tax lead to a hike in prices that ranges from the size of the tax to double the size of the tax.

<sup>38</sup> Hawaii is currently in the middle of a seven-year reduction of tax pyramiding in its 4-percent gross receipts tax as passed by Act 71 in 1999. Once Act 71 is fully phased-in after 2004, all business-to-business transactions will be subjected to a lower 0.5 percent rate, while business-to-consumer transactions are taxed at 4 percent. The economic result of this reduction is that the economy-wide effective tax rate will be reduced. The index calculates this effective rate for 2004 at 3.034 percent, a rate that will fall in future years as the phase-in progresses.

<sup>39</sup> The local option sales tax rate is calculated on a weighted average basis. Each county rate is weighted by the share of the county's personal income relative to the state total. However, only a fraction of local option sales taxes is tallied in the 2004 State Business Tax Climate Index. As the local rates charged in counties, municipalities and special districts become more readily available, the index will become more comprehensive.

## **MANUFACTURING AND MACHINERY INPUTS**

- Manufacturing machinery
- Utilities
- Farm machinery
- Raw material
- Office equipment

## **COMPUTER AND SOFTWARE INPUTS**

- Custom software
- Modified canned software
- Downloaded software

## **LEASING AND RENTAL INPUTS**

- Motor vehicles
- Rooms and lodging
- Other tangible property

## **POLLUTION CONTROL EQUIPMENT**

- Air Pollution Control Equipment
- Water Pollution Control Equipment

## **EXCISE TAXES**

From an economic standpoint, excise taxes can be viewed as a single-product sales tax. As a result, they have essentially the same negative effects on businesses such as discouraging in-state retail sales and tax pyramiding. The sub-index tallies:

- Gasoline excise tax
- Diesel excise tax
- Tobacco excise tax
- Beer excise tax

Gasoline and diesel excise taxes (levied on a per gallon basis) are mostly problematic from a tax pyramiding perspective. Gasoline and diesel are major production inputs, yet the excises are part of the purchase price and are not rebated to businesses. States with the highest gasoline tax are New York (33 cents), Wisconsin (30.3 cents), and Rhode Island (30 cents) while states with the lowest gasoline tax are Georgia (7.5 cents), Alaska (8 cents) and New Jersey (10.5 cents). States with the highest diesel taxes are Pennsylvania (32.3 cents), New York (30.4 cents) and Wisconsin (30.3 cents) while states with the lowest diesel taxes are Georgia (7.5 cents), Alaska (8 cents) and Kentucky (12 cents).

Tobacco and beer excise taxes are mostly problematic because they discourage in-state consumption and encourage consumers to seek lower prices in neighboring jurisdictions (Moody and Warcholik, 2004). This impacts a wide swath of retail outlets, such as convenience stores, that move large volumes of tobacco and beer prod-

ucts. The problem is exacerbated for those retailers located near the border with states with lower excise taxes as consumers move their shopping out of state—referred to as cross-border shopping.

In addition to cross-border shopping, there is also the growing problem of cross-border smuggling of products from states that levy low excise taxes on tobacco into states that levy high excise taxes on tobacco. This both increases criminal activity and reduces sales to legitimate retailers (Fleener, 1998).

States with the highest tobacco taxes per pack of 20 cigarettes are New Jersey (\$2.05), Rhode Island (\$1.71) and Connecticut (\$1.51) while states with the lowest tobacco tax are Virginia (\$0.025), North Carolina (\$0.05) and South Carolina (\$0.07). States with the highest beer tax on a per gallon basis are Hawaii (93 cents), South Carolina (77 cents) and Alabama (52 cents) while states with the lowest beer tax are Wyoming (2 cents), Missouri (6 cents) and Wisconsin (7 cents).

## **Results of the Sales and Gross Receipts Tax Index**

The five states with the highest scores are Alaska, Delaware, Montana, New Hampshire and Oregon. Each of these states lacks a general state sales tax, while all levy gasoline, diesel, tobacco and beer excise taxes. For states that have a general sales tax, Virginia has the highest score because it does a good job of avoiding the problem of tax pyramiding. Other states that do well on this index include Georgia, Kentucky, Maryland and Indiana.

States with a gross receipts tax have uniformly poor scores on the Sales and Gross Receipts Tax Index. States whose only consumption tax is a gross receipts tax are Hawaii, New Mexico<sup>40</sup> and South Dakota.<sup>41</sup> Washington is the only state that levies both gross receipts tax with no exemptions and retail sales taxes at the state and local levels and so has the worst score.<sup>42</sup>

Joining Washington at the bottom are Louisiana, New Mexico, Mississippi, Nevada and Hawaii. New Mexico, Mississippi and Hawaii all have a gross receipts tax and thus suffer the most from tax pyramiding. Louisiana and Nevada have the highest combined state and local statutory sales rates, 8.21 and 9.46 percent respectively.

Like the Corporate Income Tax Index and the Individual Income Tax Index, the Sales and Gross Receipts Tax Index makes up 20 percent of the overall score in the 2004 State Business Tax Climate Index.

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## UNEMPLOYMENT INSURANCE TAX INDEX

Unemployment insurance taxes (UITs) are paid by employers into the Unemployment Insurance program to offset income lost by workers who have lost their jobs due to employer cutbacks. Unlike the other major taxes assessed in the 2004 State Business Tax Climate Index, there are no perfect or ideal UIT systems. All of the state UIT systems are complex, variable-rate systems that impose different rates on different industries and different bases depending upon such factors as the health of the state's UI trust fund. In fact UI taxes are non-neutral by design.

Like each of the preceding component indexes of the 2004 State Business Tax Climate Index, the Unemployment Insurance Tax Index consists of two distinct sub-indices—a rate sub-index and a base sub-index. Each is weighted to represent half of the total index score. See Tables 18, 19 and 20 in the appendix.

### Sub-index #1: Unemployment Insurance Tax Rate

UIT rates in each state are based on a schedule of rates ranging from a minimum rate to maximum rate. The schedule for any particular business is dependent upon an "experience rating" (discussed below). The rate is then applied to a taxable wage base (a predetermined fraction of an employee's wage) to determine UIT liability.

Overall, the states with the best score on this sub-index are Nebraska, Mississippi, Florida, Indiana and Missouri. Generally, these states have low minimum and maximum tax rates on each schedule and a wage base at or near the federal level. States with the worst scores are New York,

Massachusetts, Rhode Island, Minnesota and Arkansas.

The sub-index gives equal weight to two factors: the actual rates levied in 2003, and the statutory rate schedules that could be implemented in 2004 depending on the state of the economy and the UI fund.

### ACTUAL RATES

Each state's actual 2003 rates are measured to assess their impact on the 2004 business tax climate. Three variables are considered:

#### Minimum Tax Rate

States with the best scores in this variable are Hawaii, Iowa, Missouri, North Carolina, South Dakota and Wisconsin who all had a minimum rate of zero. On the other hand, the following states had the highest rates and, thus, the worst scores: Connecticut (1.9 percent), Oregon (1.8 percent), Rhode Island (1.69 percent) and Louisiana (1.65 percent).

#### Maximum Tax Rate

Fourteen states receive the highest scores in this variable because they have a relatively low tax rate of 5.4 percent.<sup>43</sup> States with the highest rates and, thus, the worst scores on this variable are Massachusetts (10.96 percent), Minnesota (10.76 percent), Arkansas (10.7 percent) and Michigan (10.3 percent).

#### Taxable Wage Base<sup>44</sup>

Ten states receive the best score in this variable with a taxable wage base of \$7,000—in line with the federal taxable wage base. The states with highest taxable base and, thus, the worst score in this variable are Hawaii (\$31,000), Washington (\$30,200), Idaho (\$27,600), Alaska (\$27,100) and Oregon (\$27,000).

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<sup>40</sup> New Mexico's score is improved by its business exclusion for farmers and ranchers.

<sup>41</sup> South Dakota has a gross receipts tax base, but businesses "have the right" to pass the tax onto the consumer via a complex refund formula. Depending on how many businesses bother to exercise their "right" to pass the tax onto consumers, this could be called either a sales tax or a gross receipts tax. States that use the term "sales tax" may actually have a gross receipts tax and vice-versa. This makes identification difficult, but the structure of the index is designed to reflect the level of tax pyramiding within a state's sales or gross receipts tax.

<sup>42</sup> Many states levy limited gross receipts taxes, often on public utilities.

<sup>43</sup> The Federal government levies its own UIT called the Federal Unemployment Tax Act (FUTA) with a rate of 6.2 percent on wages up to \$7,000. However, the federal government provides a tax credit worth up to 5.4 percent of the 6.2 percent rate. As a result, the lowest state maximum rate is 5.4 percent in order to maximize the use of the federal tax credit. Therefore, the effective federal rate is a much lower 0.8 percent and is used predominantly to offset the administrative costs associated with oversight of the unemployment trust fund.

<sup>44</sup> Eighteen states adjust their taxable wage base. This is often done on an annual basis and is generally based on the growth of previous year(s) wages. The effect in the index for this adjustment is a continual erosion of these state's score as their taxable wage base grows relative to states that have a static taxable wage base. These states include: Arkansas, Hawaii, Idaho, Iowa, Louisiana, Minnesota, Montana, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Utah, Virginia, Washington and Wyoming.

States whose 2003 UIT rates caused the fewest non-neutralities are Nebraska, Arizona, Indiana, Missouri and Florida. They have low minimum and maximum rates and a low taxable wage base. On the other hand, the states with the worst scores are Rhode Island, Massachusetts, Minnesota, Oregon and New York. These states generally have high minimum and maximum rates and a high taxable wage base.

### **POTENTIAL RATES**

The actual UIT rates in any given year are only part of the neutrality story. Due to business and seasonal cycles, all the businesses in each state will probably be forced to change UIT rate schedules at some point during 2004. When UIT trust funds are flush, businesses will trend toward the most favorable rate schedules; however, when UI trust funds are low, businesses will trend toward the least favorable rate schedules. Not only are the rates themselves important from a neutrality perspective, but states with a large differential between the minimum and maximum rates are less neutral than states with smaller differentials. Most Favorable Tax Rate Schedule

#### **Minimum Tax Rate Schedule**

Sixteen states receive the best score in this variable with a minimum tax rate of zero, which they levy when the unemployment is low and the UI fund is flush. The states with the highest minimum tax rate and thus the worst score are New York (2.4 percent), Alaska (1 percent), Massachusetts (0.8 percent), Rhode Island (0.6 percent) and South Carolina (0.54 percent).

#### **Maximum Tax Rate Schedule**

Twenty-four states receive the best score in this variable with a comparatively low maximum tax rate of 5.4 percent. The states with the highest maximum tax rates and thus the worst maximum tax scores are North Dakota (10.09 percent), Tennessee (10 percent), Arkansas (9.9 percent), Kentucky (9 percent) and Wisconsin (8.9 percent).

### **LEAST FAVORABLE TAX RATE SCHEDULE**

#### **Minimum Tax Rate Schedule**

Five states receive the best score in this variable with a minimum tax rate of zero percent. The states with the highest minimum tax rates and, thus, the worst minimum tax score are New York (5.2 percent), Arizona (2.85 percent), New Hampshire (2.8 percent), New Mexico (2.7 percent) and Washington (2.47 percent).

#### **Maximum Tax Rate Schedule**

Twelve states receive the best score in this variable with a comparatively low maximum tax rate of 5.4 percent. The states with the highest maximum tax rates and, thus, the worst maximum tax score are Massachusetts (15.4 percent), Arkansas and Georgia (10.8 percent), Pennsylvania (10.59 percent) and South Dakota (10.5 percent).

Overall, the states with the best scores on their statutory UIT rates are North Carolina, Nebraska, Mississippi, Florida and Nevada. North Carolina gets a perfect 10 with as all of its potential rates at the lowest rates. The other top states follow the same pattern with slight deviations. The states with the worst scores are New York, Massachusetts, Arkansas, Kentucky and Tennessee. Many of these states have double-digit maximum tax rates.

### **Sub-index #2: Unemployment Insurance Tax Base**

The UIT base sub-index scores states on how they determine which businesses should pay the UIT and how much, as well as other UI-related taxes businesses may also be liable for.

The states that receive the best scores on this sub-index are Oklahoma, Delaware, Utah, Vermont and Florida. In general, these states have relatively simple experience formulas, they exclude more factors from the charging method, and they enforce fewer surtaxes.

States that receive the worst scores are New Hampshire, Rhode Island, New York, Idaho and South Carolina. In general, they have more complicated experience formulas, exclude fewer factors from the charging method, and have complicated their systems with add-ons and surtaxes. The three equally weighted factors considered by this sub-index are experience rating formulas, charging methods, and host of smaller factors aggregated into one variable.

#### **EXPERIENCE RATING FORMULA**

A business's experience rating formula determines the rate the firm will be paying—whether they will be leaning towards the minimum rate or maximum rate of the given rate schedule.

There are four basic experience formulas—the reserve ratio formula, the benefit ratio formula, the benefit-wage ratio formula and the payroll variation formula. The reserve ratio formula is used in 33 states.

The first three experience formulas—contribution, benefits and payroll experience—are

based solely on the business's experience and are therefore non-neutral by design. However, the final variable—state experience—is a positive mitigating factor because it is based on statewide experience. In other words, the state experience is not tied to the experience of any one business; therefore, it is a more neutral factor. This sub-index penalizes states that depend on the contribution, benefit and payroll experience variables while rewarding states with the state experience variable.

The thirty-three states that use the reserve ratio formula score the worst because they rely on all three non-neutral experience variables to determine their experience rating. The 17 states that use the benefit-ratio formula score somewhat better.

## **CHARGING METHODS AND BENEFITS EXCLUDED FROM CHARGING**

Before the state can determine what rate a business has to pay, it must first be determined which businesses are going to pay. When a former employee applies for unemployment benefits, the benefits paid to the employee must be charged to a previous employer. There are three basic charging methods:

1. **Charging Most Recent or Principal Employer:** Fourteen states charge all the benefits to the last employer.
2. **Charging Base-Period Employers in Inverse Chronological Order:** Five states charge all base-period employers in inverse chronological order. This means that all employers within a base-period of time (usually the last year, sometimes longer) will have the benefits charged against them with the most recent employer being charged the most.
3. **Charging in Proportion to Base-Period Wages:** Thirty-four states charge in proportion to base-period wages. This means that all employers within a base-period of time (usually the last year, sometimes longer) will have the benefits charged against them in proportion to the wages they paid.

None of these charging methods could be called neutral, but on the margin, charging the most recent or principal employer is the least neutral because the business faced with the

necessity of laying off employees knows that they will bear the full benefit charge. The most neutral of the three is the “charging in proportion to base-period wages” since there is a higher probability of sharing the benefit charges with previous employers.

As a result, the thirty-four states that charge in proportion to base-period wages receive the best score. The fourteen states that charge the most recent or principal employer receive the worst score. The five that charge base-period employers in inverse chronological order receive a median score.

Many states also recognize that certain benefit costs should not be charged to employers especially if the separation is beyond the employer's control. Therefore, this sub-index also accounts for six types of exclusions from benefit charges.

1. Benefit award reversed
2. Reimbursements on combined wage claims
3. Voluntary leaving
4. Discharge for misconduct
5. Refusal of suitable work
6. Continues to work for employer on part-time basis

States are rewarded for each of these exclusions because they nudge a UI system toward neutrality. For instance, if benefit charges were levied by employees that voluntarily quit, then industries with high turnover rates, such as retail, would be hit disproportionately harder. States that receive the best scores in this category are Ohio, Arizona, Delaware, Hawaii and Louisiana. Ohio receives a perfect score by charging in proportion to base-period wages and including all six benefit exclusions. On the other hand, the states that receive the worst scores are Alaska, New Hampshire, Rhode Island, New York and Nevada. All but Alaska charge the most recent or principal employer and forbid nearly all benefit exclusions.<sup>45</sup>

## **OTHER SIGNIFICANT ISSUES**

Five of the eight variables in this catch-all category of the sub-index deal with taxes levied on top

<sup>45</sup> Alaska is the only state not to use benefit payments in its formula but instead the variation in an employer's payroll from quarter to quarter. This is an extreme violation of tax neutrality since any decision by the employer or employee that would affect payroll may trigger higher UIT rates. As a result, Alaska scores the worst of all states in this sub-index.

of the UIT. Not all were triggered during 2003, but states are penalized in this sub-index if they are on the books. Rather, it serves to note that the extent of additional non-neutralities beyond the standard UIT system. As a result, states lose points for having such taxes on the books.

Overall, the states that receive the best scores in this category are Nebraska, New Mexico, North Dakota, Utah and Vermont. Wyoming, New Jersey, Washington and Delaware scored the worst.

### **Solvency Tax**

These taxes are levied on employers when a state's unemployment fund falls below some defined level. Twenty-five states have a solvency tax on the books though they fall under different names such as: Solvency Adjustment Tax (Alaska), Supplemental Assessment Tax (Delaware), Emergency Tax (New Hampshire), Subsidiary Tax (New York), Minimum Safe Level Tax (Ohio) and Fund Building Tax (Virginia).

### **Taxes for Socialized Costs or Negative Balance Employer**

These are levied on employers when the state desires to recover benefit costs above and beyond the UIT collections based on the normal experience rating process. Nine states have these taxes on the books though they fall under different names: Shared Cost Assessment Tax (Alabama), Nonchargeable Benefits Compound Tax (Michigan), Adverse Rating Tax (New Hampshire) and Graduated Social Cost Factor Rate Tax (Washington).

### **Loan and Interest Repayment Surtaxes**

Levied on employers when a loan is taken from the federal government or when bonds are sold to pay for benefit costs, these taxes are of two general types. The first is a tax to pay off the federal loan or bond issue. The second is a tax to pay the interest on the federal loan or bond issue—states are not allowed to pay interest costs directly from the state's unemployment trust fund. Twenty-one states have these taxes on the books though they fall under several names such as: Advance Interest Tax and Bond Assessment Tax (Colorado), Temporary Emergency Assessment Tax (Delaware) and Unemployment Obligation Assessment (Texas) to name a few.

### **Reserve Taxes**

Reserve taxes are levied on employers to be deposited in a reserve fund separate from the unemployment trust fund. Since the fund is sepa-

rate, the interest earned on the fund is often used to create other funds for purposes such as job training and/or paying the costs of the reserve tax's collection. Five states have these taxes on the books: Nebraska (State UI tax), Oregon (Supplemental Employment Department Tax), Texas (Smart Jobs Holding Fund Tax), Idaho (Reserve Tax) and North Carolina (Reserve Fund Tax).

### **Surtaxes for UI Administration or Non-UI Purposes**

Twenty-four states levy surtaxes on employers, usually to fund administration but sometimes for job training or special improvements in technology. They are often deposited in a fund outside of the state's unemployment fund. Some of the names they go by are Job Training Assessment Tax (Arizona), Social Charge Rate Tax (Louisiana), Re-Employment Service Fund Tax (New York), Wage Security Tax (Oregon), Investment South Dakota Future Fee Tax (South Dakota) and Job Skills Fee (Tennessee).

### **Temporary Disability Insurance**

A handful of states—California, New Jersey, Rhode Island, Hawaii and New York—have established a temporary disability insurance (TDI) program that augments the UI program by extending benefits to those unable to work because of sickness or injury. No separate tax funds them; the money comes right out of the state's unemployment fund, and because the balance of the fund triggers various taxes, the TDIs are included as a negative factor in the calculation of this sub-index.

### **Voluntary Contributions**

Twenty-seven states allow businesses to make voluntary contributions to the unemployment trust fund. In most cases, these contributions are rewarded with a lower rate schedule, often saving the business more money in taxes than was paid through the contribution. The index rewards states that allow voluntary contributions because firms are able to pay when they can best afford to instead of when they are struggling. This provision helps to mitigate the non-neutralities of the UI tax.

### **Time-Period to Qualify for Experience Rating**

Newly formed businesses, naturally, do not qualify for an experience rating because they simply have not been around long enough. Federal rules



stipulate that states can levy a “new employer” rate for one to 3 years, but no less than one year. From a neutrality perspective, however, this new employer rate is non-neutral in almost all cases since the rate is lower than the lowest rate schedule. The longer this rate is in effect, the worse the non-neutrality. As such, the index rewards states with the minimum 1 year required to earn an experience rating and penalizes states that permit the full 3 years.

## Results of the Unemployment Insurance Tax Index

Overall, the states with the best UITs are Florida, Mississippi, Oklahoma, Vermont and Indiana. Comparatively speaking, these states have rate structures with lower minimum and maximum rates and a wage base that matches the one at the federal level. In addition, they have simpler experience formulas and charging methods, and they have not complicated their systems with benefit add-ons and surtaxes.

On the other hand, the states with the worst UITs are New York, Rhode Island, Massachusetts, Kentucky and Ohio. These states tend to have rate structures with high minimum and maximum rates and wage bases above the federal level. Moreover, they have more complicated experience formulas and charging methods, and have added benefits and surtaxes to their systems.

Like the three major component indexes discussed already, the Unemployment Insurance Tax Index makes up 20 percent of the overall score of each state’s score in the 2004 State Business Tax Climate Index.

## THE STATE FISCAL BALANCE INDEX

The purpose of the state fiscal balance index is to measure the extent of taxation a business or individual may face in a given state, now and in the future. Any tax law change that shifts the relative state tax differentials among states will in turn affect future business relocations (Papke and Papke, 1986). The Fiscal Balance Index measures two features of state fiscal operations: the current level of tax collections within a state and the budgetary institutions a state may have in place to control the pace of future spending and taxes. See Table 21 in the appendix.

## Sub-index #1: State Tax Collections, Per Capita and as a Percentage of Income

The Census Bureau’s data for state tax collections in FY 2003 is used to gauge an aspect of each state’s business tax climate. This sub-index adjusts state tax collections for population and income to get two different but equally valid perspectives on the extent of taxation. The most extreme differential between these two different measures is in New Jersey where tax collections per capita ranks 43rd highest, but where the rank as a percentage of income is 15th—a difference of 28 places. The sub-index averages the two together, leaving New Jersey with an overall rank of 34th.

States that score well in this sub-index are Texas, South Dakota, Colorado, New Hampshire and Missouri. States that do not are Hawaii, Vermont, Delaware, Minnesota and Wyoming. The District of Columbia ties Hawaii for the worst score.

## Sub-Index #2: Tax and Expenditure Limitations

It is impossible to determine today what the level of state taxation will be in the future. However, all else being equal, states that have enacted a tax or expenditure limitation will have lower tax collections than states that have not. This sub-index measures two important variables that influence the effectiveness of such limitations, supermajority rules to raise taxes, and statutory or constitutional limitations on taxes or expenditures.

Colorado receives the highest score in this sub-index, and other states that score well are Oklahoma, Colorado and Louisiana. Twenty states and the District of Columbia have no limitations at all and score poorly.

### Super-Majority Rule

A super-majority rule requires more than 50 percent of legislators to vote in favor of increasing taxes. Naturally, the greater the percentage, the more difficult it will be to pass such legislation. Arkansas and Oklahoma have the most stringent super-majority provision at 75 percent and score the highest in this variable.

### Type of Limitation

This variable assesses whether the budgetary institution in question is an expenditure limitation, a revenue limitation or both. Having both

yields the best score. In addition, it measures whether or not the provision is statutory, constitutional or both. A constitutional limitation is best because it is generally harder to avoid and/or repeal.

## Results of the State Fiscal Balance Index

Colorado has the highest score in this major component index of the 2004 State Business Tax Climate Index, with the third best state tax collection score and the second best limitation score. Rounding out the top five are Texas, South Dakota, Missouri and Florida.

Hawaii has the worst score in this index because, despite having an expenditure limitation on the books, it has the worst state tax collection score. Rounding out the bottom five are Vermont, Minnesota, Wyoming and Delaware.

## METHODOLOGY

The State Business Tax Climate Index is a hierarchical structure. The first layer consists of the five major indexes devoted to the corporate income tax, the individual income tax, the sales tax, the unemployment insurance tax and the state fiscal balance. These five are all weighted equally.

Within each major index are two sub-indexes, usually devoted to measuring the impact of the tax rates and the tax base. These are weighted equally.

Each sub-index is composed of one or more variables. There are three types of variables, scalar variables, dummy variables and a mix of the two. A scalar variable is one that can have any value between 0 and 10. If a sub-index is composed only of scalar variables, then they are weighted equally.

A dummy variable is one that has only a value of 0 or 1. For example, a state either has a corporate AMT or not—translated as a 1 if there is no AMT and a 0 if there is an AMT. If a sub-index is composed only of dummy variables, then they are weighted equally.

Mixing scalar and dummy variables within a sub-index is problematic because the extreme valuation of a dummy can overly influence the results of the sub-index. To counter this effect, the index weights scalar variables 80 percent and dummy variables 20 percent.

## RELATIVE VS. ABSOLUTE INDEXING

The 2004 State Business Tax Climate Index is designed as a “relative” index rather than an “absolute” or “ideal” index. In other words, each variable is ranked relative to the variable’s range present in other states. The relative scoring scale is from 0 (worst possible) to 10 (best possible).

For example, in states that have a corporate income tax, the top marginal rate ranges from a low of 4.5 percent to a high of 14.83 percent. Massachusetts has top tax rate of 9.5 percent, which is close to the middle of the range, giving Massachusetts a score of 5.16. Iowa has a top rate of 12 percent, yielding a much lower score of 2.74, while Virginia has a top tax rate of 6 percent, yielding a much higher score of 8.55. Since lower top tax rates provide a better business climate, a rate of 4.5 percent receives the highest sub-index score of 10 (Texas), and a rate of 14.83 percent receives the lowest index score of 0 (Michigan).

Many states’ tax rates are so close that an absolute index would not provide enough information about the differences between the states’ tax systems, especially to pragmatic business owners who want to know what states have the best tax system in each region. In such instances, business owners care very little about which states converge toward a perfect tax system.

## Comparing States without a Tax

One problem associated with a relative scale, however, is that it is mathematically impossible to compare states with a given tax to states that do not have the tax. Therefore, states without a given tax receive a perfect 10, and the index measures all the other states against each other.

## “Normalizing” Final Scores

Another problem posed by using a relative scale within the major indexes is that the average score across the five major component indexes can vary. This has the effect of altering the value of not having a given tax across major indexes. For example, the unadjusted average score of the Corporate Income Tax Index is 7.32 while the average score of the Individual Income Tax Index is 5.60. As a result, states with no individual income tax (average gain of 4.60 points) would get a bigger boost than states with no corporate income tax (average gain is 2.68 points).

In order to solve this problem, scores on the five major component indexes scores are “normalized,” which brings the average score for all of

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them to 5.00—excluding states that do not have the given tax. This is accomplished by multiplying every state's score by a constant value. For example, the corporate income tax major index was multiplied by a constant of -29.678 in order to normalize the average score to 5.

**The District of Columbia**

The District of Columbia (DC) is only included as an exhibit. DC does not affect the relative scores between states.

# Appendix

**Table 8**  
*State Corporate Income Tax Rates, As of December 31, 2003*

State	Rates	Brackets	Number of Brackets	Average Width of Brackets	State	Rates	Brackets	Number of Brackets	Average Width of Brackets
Alabama	6.5%		1	-	Maryland	7%		1	-
Alaska	1%	> \$0	10	\$10,000	Massachusetts (g)	9.5%		1	-
	2%	> \$10K			Michigan (h)	1.9%	\$45K	1	-
	3%	> \$20K			Minnesota (i)	9.8%		1	-
	4%	> \$30K			Mississippi	3%	> \$0	3	\$5,000
	5%	> \$40K				4%	> \$5K		
	6%	> \$50K				5%	> \$10K		
	7%	> \$60K			Missouri	6.25%		1	-
	8%	> \$70K			Montana (j)	6.7%		1	-
	9%	> \$80K			Nebraska	5.58%	> \$0	2	\$50,000
	9.4%	> \$90K				7.81%	> \$50K		
Arizona	6.97%		1	-	Nevada		None	0	-
Arkansas	1%	> \$0	6	\$20,000	New Hampshire (k)	8.5%	> \$50K	2	\$100,000
	2%	> \$3K				9.25%	> \$150K		
	3%	> \$6K			New Jersey (l)	9%		1	-
	5%	> \$11K			New Mexico	4.8%	> \$0	3	\$500,000
	6%	> \$25K				6.4%	> \$500K		
	6.5%	> \$100K				7.6%	> \$1 million		
California (a)	8.84%		1	-	New York (m)	7.5%		1	-
Colorado	4.63%		1	-	North Carolina	6.9%		1	-
Connecticut	7.5%		1	-	North Dakota (n)	3%	> \$0	6	\$12,000
Delaware	8.7%		1	-		4.5%	> \$3K		
Florida (b)	5.5%		1	-		6%	> \$8K		
Georgia	6%		1	-		7.5%	> \$20K		
Hawaii (c)	4.4%	> \$0	3	\$50,000		9%	> \$30K		
	5.4%	> \$25K				10.5%	> \$50K		
	6.4%	> \$100K			Ohio (o)	5.1%	> \$0	2	\$50,000
Idaho	7.6%		1	-		8.5%	> \$50K		
Illinois	7.3%		1	-	Oklahoma	6%		1	-
Indiana	8.5%		1	-	Oregon	6.6%		1	-
Iowa (d)	6%	> \$0	4	\$83,333	Pennsylvania (p)	9.99%		1	-
	8%	> \$25K			Rhode Island	9%		1	-
	10%	> \$100K			South Carolina (q)	5%		1	-
	12%	> \$250K			South Dakota (r)		None	0	-
Kansas (e)	4%		1	\$50,000	Tennessee	6.5%		1	-
Kentucky	4%	> \$0	5	\$62,500	Texas		None (u)	0	-
	5%	> \$25K				5%		1	-
	6%	> \$50K			Vermont	7%	> \$0	4	\$33,333
	7%	> \$100K				8.1%	> \$10K		
	8.25%	> \$250K				9.2%	> \$25K		
Louisiana	4%	> \$0	5	\$50,000		9.75%	> \$250K		
	5%	> 25K			Virginia	6%		1	-
	6%	> 50K			Washington (s)		None	0	-
	7%	> 100K			West Virginia (t)	9%		1	-
	8%	> 200K			Wisconsin	7.9%		1	-
Maine (f)	3.5%	> \$0	4	\$83,333	Wyoming		None	0	-
	7.93%	> 25K			District of Columbia	9.98%		1	-
	8.33%	> 75K							
	8.93%	> 250K							

**Note:** Many states have minimum taxes, ranging from \$10 in Oregon to \$800 in California.

(a) 10.84% on financial institutions. AMT rate of 6.65% (2% for financial institutions).

(b) 3.3% alternative minimum rate.

(c) 4% capital gains rate, 7.92% on financial institutions.

(d) 5% on financial institutions; 7.2% alternative minimum rate; 50% federal deductibility.

(e) 3.35% surtax over \$50,000; Banks 2.25% plus 2.125% surtax over \$25,000.

(f) 27% of federal AMT liability.

(g) Rate includes 14% surtax, as does the additional tax of \$7.00 per \$1,000 on taxable tangible property.

(h) Modified VAT applies to gross receipts. Must file if gross receipts over \$250K.

(i) 5.8% AMT rate. A minimum tax is levied based on Minn. property, payroll and sales.

(j) 7% for corporations filing under a water's edge election.

(k) Combined effect of Business Profits Tax and Business Enterprise Tax.

(l) 7.5% if entire net income is less than \$100K.

(m) 2.5% surtax rate.

(n) 5% for financial institutions plus 2% surtax rate; federal deductibility.

(o) For financial institutions, 0.015 times value of stock

(p) Imposes a capital stock and franchise tax of 0.724% on taxable income over \$150K.

(q) 4.5% for banks; 6% for savings and loans.

(r) Rates range from 6% to 0.25% on a bank's net income. Minimum tax is \$200 per location (banks).

(s) Gross receipts tax. The 20 different rates range from 0.011% to 5.029% depending on the type of business activity.

(t) "Business franchise tax" of \$0.70 per \$100 of taxable capital, or a minimum of \$50.

(u) Texas levies a 4.5 percent tax on taxable earned surplus and a 0.25 percent tax on taxable capital. Taxpayers owe the higher of the two. The tax on earned surplus is similar to a traditionally defined corporate income tax with a larger tax base (federal net taxable income plus compensation paid to officers and directors of the corporation).

**Source:** *Tax Foundation Special Report*, No 128, "State Tax Collections and Rates"; State Revenue Departments; Commerce Clearing House; Federation of Tax Administrators.

**Table 9**  
**Corporate Income Tax Base Criteria, 2004**

State	Percentage Points by Which Top Corporate Rate Exceeds Top Individual Rate	Apportionment Formula				
		Property Factor	Payroll Factor	Sales Factor	Alternative Factors	Throwback Rule
Alabama	1.50	33%	33%	33%	No	Yes
Alaska	4.61	33%	33%	33%	No	Yes
Arizona	1.93	25%	25%	50%	No	No
Arkansas	0	25%	25%	50%	No	Yes
California	0	25%	25%	50%	No	Yes
Colorado	0	33%	33%	33%	Yes	Yes
Connecticut	2.50	25%	25%	50%	Yes	No
Delaware	2.75	33%	33%	33%	No	No
Florida	2.69	25%	25%	50%	No	No
Georgia	0	25%	25%	50%	No	No
Hawaii	0	33%	33%	33%	No	Yes
Idaho	0	25%	25%	50%	No	Yes
Illinois	4.30	0%	0%	100%	No	Yes
Indiana	5.10	25%	25%	50%	No	Yes
Iowa	3.02	0%	0%	100%	No	No
Kansas	0.90	33%	33%	33%	No	Yes
Kentucky	2.25	25%	25%	50%	No	No
Louisiana	2.00	25%	25%	50%	Yes	No
Maine	0.43	25%	25%	50%	No	Yes
Maryland	2.25	25%	25%	50%	Yes	No
Massachusetts (a)	2.99	25%	25%	50%	Yes	Yes
Michigan	10.83	5%	5%	90%	No	No
Minnesota	1.95	13%	13%	75%	No	No
Mississippi	0	0%	0%	100%	Yes	Yes
Missouri	0.25	33%	33%	33%	Yes	Yes
Montana	0	33%	33%	33%	No	Yes
Nebraska	1.13	0%	0%	100%	No	No
Nevada	0	0%	0%	0%	No	No
New Hampshire (b)	0	25%	25%	50%	No	Yes
New Jersey	2.63	25%	25%	50%	No	No
New Mexico	0	33%	33%	33%	Yes	Yes
New York	0.65	25%	25%	50%	No	No
North Carolina	0	25%	25%	50%	No	No
North Dakota	4.96	33%	33%	33%	No	Yes
Ohio	1.00	20%	20%	60%	No	No
Oklahoma	0	33%	33%	33%	Yes	Yes
Oregon	0	15%	15%	70%	No	Yes
Pennsylvania	6.92	20%	20%	60%	No	No
Rhode Island	0	33%	33%	33%	No	No
South Carolina	0	25%	25%	50%	Yes	No
South Dakota	0	0%	0%	0%	No	No
Tennessee	2.65	25%	25%	50%	No	No
Texas (c)	2.21	0%	0%	100%	No	Yes
Utah	0	33%	33%	33%	No	Yes
Vermont	0.25	33%	33%	33%	No	Yes
Virginia	0.25	25%	25%	50%	No	No
Washington	0	0%	0%	0%	No	No
West Virginia	2.50	25%	25%	50%	No	Yes
Wisconsin	1.15	25%	25%	50%	No	Yes
Wyoming	0	0%	0%	0%	No	No
District of Columbia	0.67	33%	33%	33%	No	Yes

(a) Massachusetts's 9.5% corporate income tax includes a 14% surtax.

(b) New Hampshire has a dual corporate income tax with differing tax bases--the Business Profit Tax (BPT) and Business Enterprise Tax (BET). The BPT rate is 8.5 percent on gross income over \$50,000, and the BET is 0.75 percent on gross income over \$150,000 or base (total compensation, interest and dividends paid) over \$75,000. As a result, the top tax rate a corporation may face is the BPT rate plus the BET rate for a combined rate of 9.25 percent.

(c) Texas levies a 4.5 percent tax on taxable earned surplus or 0.25 percent tax on taxable capital. Taxpayers owe the higher of the two. The tax on earned surplus is similar to a traditionally defined corporate income tax with a larger tax base (federal net taxable income plus compensation paid to officers and directors of the corporation). The tax on taxable capital is included in the Corporate Income Tax Index under the capital stock variable.

**Table 10**  
**Other Corporate Income Tax Base Criteria, 2004**

State	NOL Deductions				Capital Stock Tax		
	Carry-back (Years)	Carry-forward (Years)	Carry-back Caps	Carry-forward Caps	Capital Stock Tax Rate	Capital Stock Tax Maximum Payment	Payment Options for CST and CIT
Alabama	0	15	Unlimited	Unlimited	1.75%	\$ 15,250	Pay both
Alaska	2	20	Unlimited	Unlimited	None	N.A.	N.A.
Arizona	0	5	Unlimited	Unlimited	None	N.A.	N.A.
Arkansas	0	5	Unlimited	Unlimited	2.70%	\$ 1,075,000	Pay both
California	0	0	Suspended	Suspended	None	N.A.	N.A.
Colorado	0	20	Unlimited	Unlimited	None	N.A.	N.A.
Connecticut	0	20	Unlimited	Unlimited	3.10%	\$ 1,000,000	Pay highest
Delaware	2	20	\$30,000	Unlimited	9.00%	\$ 150,000	Pay both
Florida	0	20	Unlimited	Unlimited	None	N.A.	N.A.
Georgia	2	20	Unlimited	Unlimited	0.23%	\$ 5,000	Pay both
Hawaii	2	20	Unlimited	Unlimited	None	N.A.	N.A.
Idaho	2	20	\$100,000	Unlimited	None	N.A.	N.A.
Illinois	2	20	Unlimited	Unlimited	1.00%	Unlimited	Pay both
Indiana	2	20	Unlimited	Unlimited	None	N.A.	N.A.
Iowa	2	20	Unlimited	Unlimited	None	N.A.	N.A.
Kansas	0	10	Unlimited	Unlimited	2.00%	\$ 5,015	Pay both
Kentucky	2	20	Unlimited	Unlimited	2.10%	Unlimited	Pay both
Louisiana	3	15	Unlimited	Unlimited	3.00%	Unlimited	Pay both
Maine	0	20	Unlimited	Unlimited	None	N.A.	N.A.
Maryland	2	20	Unlimited	Unlimited	None	N.A.	N.A.
Massachusetts (a)	0	5	Unlimited	Unlimited	None	N.A.	N.A.
Michigan	0	10	Unlimited	Unlimited	None	N.A.	N.A.
Minnesota	0	15	Unlimited	Unlimited	None	N.A.	N.A.
Mississippi	2	20	Unlimited	Unlimited	2.50%	Unlimited	Pay both
Missouri	2	20	Unlimited	Unlimited	0.50%	Unlimited	Pay both
Montana	3	7	Unlimited	Unlimited	3.00%	Unlimited	Pay both
Nebraska	0	5	Unlimited	Unlimited	0.20%	Unlimited	Pay both
Nevada	3	20	Unlimited	Unlimited	None	N.A.	N.A.
New Hampshire (b)	0	10	Unlimited	Unlimited	None	N.A.	N.A.
New Jersey	0	0	Suspended	Suspended	None	N.A.	N.A.
New Mexico	0	5	Unlimited	Unlimited	None	N.A.	N.A.
New York	2	20	\$10,000	Unlimited	None	N.A.	N.A.
North Carolina	0	15	Unlimited	Unlimited	1.50%	Unlimited	Pay both
North Dakota	0	20	Unlimited	Unlimited	None	N.A.	N.A.
Ohio	0	20	Unlimited	Unlimited	None	N.A.	N.A.
Oklahoma	2	20	Unlimited	Unlimited	1.25%	\$ 20,000	Pay both
Oregon	0	15	Unlimited	Unlimited	None	N.A.	N.A.
Pennsylvania	0	20	Unlimited	\$2,000,000	7.24%	Unlimited	Pay both
Rhode Island	0	5	Unlimited	Unlimited	0.25%	Unlimited	Pay highest
South Carolina	0	20	Unlimited	Unlimited	1.00%	Unlimited	Pay both
South Dakota	3	20	Unlimited	Unlimited	None	N.A.	N.A.
Tennessee	0	15	Unlimited	Unlimited	2.50%	Unlimited	Pay both
Texas (c)	0	5	Unlimited	Unlimited	2.50%	Unlimited	Pay highest
Utah	3	15	\$1,000,000	Unlimited	None	N.A.	N.A.
Vermont	2	20	Unlimited	Unlimited	None	N.A.	N.A.
Virginia	2	20	Unlimited	Unlimited	None	N.A.	N.A.
Washington	3	20	Unlimited	Unlimited	None	N.A.	N.A.
West Virginia	2	20	\$300,000	Unlimited	7.00%	Unlimited	Pay both
Wisconsin	0	15	Unlimited	Unlimited	None	N.A.	N.A.
Wyoming	3	20	Unlimited	Unlimited	0.50%	\$ 50,000	Pay only CST
District of Columbia	0	20	Unlimited	Unlimited	None	N.A.	N.A.

(a) Massachusetts's 9.5% corporate income tax includes a 14% surtax.

(b) New Hampshire has a dual corporate income tax with differing tax bases--the Business Profit Tax (BPT) and Business Enterprise Tax (BET). The BPT rate is 8.5 percent on gross income over \$50,000, and the BET is 0.75 percent on gross income over \$150,000 or base (total compensation, interest and dividends paid) over \$75,000. As a result, the top tax rate a corporation may face is the BPT rate plus the BET rate for a combined rate of 9.25 percent.

(c) Texas levies a 4.5 percent tax on taxable earned surplus or 0.25 percent tax on taxable capital. Taxpayers owe the higher of the two. The tax on earned surplus is similar to a traditionally defined corporate income tax with a larger tax base (federal net taxable income plus compensation paid to officers and directors of the corporation). The tax on taxable capital is included in the Corporate Income Tax Index under the capital stock variable.

**Table 11**  
**Other Corporate Income Tax Base Criteria, 2004**

State	Federal Income Used as State Tax Base	Allow Federal ACRS or MACRS Depreciation	Allow Federal Depletion	Federal Tax Deductibility	State Tax Deductibility	Foreign Tax Deductibility	Corporate AMT	Rates Indexed for Inflation
Alabama	Yes	Yes	No	Yes	No	No	No	N.A.
Alaska	Yes	Yes	Partial	No	No	No	Yes	No
Arizona	Yes	Yes	Yes	No	No	No	No	N.A.
Arkansas	No	Yes	Yes	No	Yes	Yes	No	No
California	Yes	No	Yes	No	No	No	Yes	N.A.
Colorado	Yes	Yes	Yes	No	Yes	No	No	N.A.
Connecticut	Yes	Yes	Yes	No	No	No	No	N.A.
Delaware	Yes	Yes	Partial	No	No	Yes	No	N.A.
Florida	Yes	Yes	Yes	No	No	Yes	Yes	N.A.
Georgia	Yes	Yes	Yes	No	No	No	No	N.A.
Hawaii	Yes	Yes	Yes	No	Yes	Yes	No	No
Idaho	Yes	Yes	Yes	No	No	Yes	No	N.A.
Illinois	Yes	Yes	Yes	No	Yes	Yes	No	N.A.
Indiana	Yes	Yes	Yes	No	No	No	No	N.A.
Iowa	Yes	Yes	Partial	Partial	Yes	Yes	Yes	No
Kansas	Yes	Yes	Yes	No	No	No	No	No
Kentucky	Yes	Yes	Yes	No	No	No	No	No
Louisiana	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Maine	Yes	Yes	Yes	No	No	Yes	Yes	No
Maryland	Yes	Yes	Yes	No	No	Yes	No	N.A.
Massachusetts (a)	Yes	Yes	Yes	No	No	No	No	N.A.
Michigan	Yes	No	Yes	No	No	No	No	No
Minnesota	Yes	Partial	No	No	No	No	Yes	N.A.
Mississippi	No	Yes	Yes	No	No	No	No	No
Missouri	Yes	Yes	Yes	Partial	No	Yes	No	N.A.
Montana	Yes	Yes	Yes	No	No	No	No	N.A.
Nebraska	Yes	Yes	Yes	No	Yes	Yes	No	No
Nevada	Yes	Yes	Yes	Yes	Yes	Yes	No	N.A.
New Hampshire (b)	Yes	Yes	Yes	No	No	No	No	No
New Jersey	Yes	Yes	Yes	No	No	Yes	No	N.A.
New Mexico	Yes	Yes	Yes	No	Yes	Yes	No	No
New York	Yes	Yes	Yes	No	No	No	Yes	N.A.
North Carolina	Yes	Yes	Partial	No	No	No	No	N.A.
North Dakota	Yes	Yes	Yes	Yes	No	No	No	No
Ohio	Yes	No	Yes	No	Yes	Yes	No	No
Oklahoma	Yes	Yes	Yes	No	No	No	No	N.A.
Oregon	Yes	Yes	No	No	No	No	No	N.A.
Pennsylvania	Yes	No	Yes	No	No	No	No	N.A.
Rhode Island	Yes	Yes	Yes	No	Yes	Yes	No	N.A.
South Carolina	Yes	Yes	Yes	No	No	No	No	N.A.
South Dakota	Yes	Yes	Yes	Yes	Yes	Yes	No	N.A.
Tennessee	Yes	No	Yes	No	Yes	No	No	N.A.
Texas (c)	Yes	Yes	Yes	No	Yes	Yes	No	N.A.
Utah	Yes	Yes	Yes	No	No	No	No	N.A.
Vermont	Yes	Yes	Yes	No	No	Yes	No	No
Virginia	Yes	Yes	Yes	No	No	No	No	N.A.
Washington	Yes	Yes	Yes	Yes	Yes	Yes	No	N.A.
West Virginia	Yes	Yes	Yes	No	No	No	No	N.A.
Wisconsin	Yes	Yes	No	No	No	Yes	No	N.A.
Wyoming	Yes	Yes	Yes	Yes	Yes	Yes	No	N.A.
District of Columbia	Yes	Yes	Yes	No	No	No	Yes	N.A.

(a) Massachusetts's 9.5% corporate income tax includes a 14% surtax.

(b) New Hampshire has a dual corporate income tax with differing tax bases--the Business Profit Tax (BPT) and Business Enterprise Tax (BET). The BPT rate is 8.5 percent on gross income over \$50,000, and the BET is 0.75 percent on gross income over \$150,000 or base (total compensation, interest and dividends paid) over \$75,000. As a result, the top tax rate a corporation may face is the BPT rate plus the BET rate for a combined rate of 9.25 percent.

(c) Texas levies a 4.5 percent tax on taxable earned surplus or 0.25 percent tax on taxable capital. Taxpayers owe the higher of the two. The tax on earned surplus is similar to a traditionally defined corporate income tax with a larger tax base (federal net taxable income plus compensation paid to officers and directors of the corporation). The tax on taxable capital is included in the Corporate Income Tax Index under the capital stock variable.

**Table 12**  
**Individual Income Tax Rates, As of December 31, 2003**

State	Federal Deductibility	Marginal Rates and Tax Brackets for Single Filers (a)	Standard Deduction		Personal Exemptions	
			Single	Joint	Single (b)	Dependents
Alabama	Yes (z)	2% > \$0; 4% > \$500; 5% > \$3K	\$ 2,000	\$ 4,000	\$ 1,500	\$ 300
Alaska	No	None	n.a.	n.a.	n.a.	n.a.
Arizona	No	2.87% > \$0; 3.20% > \$10K; 3.74% > \$25K; 4.72% > \$50K; 5.04% > \$150K	\$ 4,050	\$ 8,100	\$ 2,100	\$ 2,300
Arkansas	No	1% > \$0; 2.5% > \$3,299; 3.5% > \$6,699 4.5% > \$9,999; 6% > \$16,699; 7% > \$27,899 (l)(w)	\$ 2,000	\$ 4,000	\$ 20 (c)	\$ 20 (c)
California	No	1.0% > \$0; 2% > \$5,962; 4% > \$14,133 6% > \$22,306; 8% > \$30,965; 9.3% > \$39,133(w)	\$ 3,070(w)	\$ 6,140(w)	\$ 80(c)(w)	\$ 251 (c)(w)
Colorado	No	4.63% of federal taxable income.	n.a.	n.a.	n.a.	n.a.
Connecticut	No	3.0% > \$0; 5.0% > \$10K	n.a.	n.a.	\$ 12,500 (e)	\$ 0
Delaware	No	2.2% > \$2K; 3.9% > \$5K; 4.8% > \$10K 5.2% > \$20K; 5.55% > \$25K; 5.95% > \$60K	\$ 3,250	\$ 6,500	\$ 110 (c)	\$ 110 (c)
Florida	No	None	n.a.	n.a.	n.a.	n.a.
Georgia	No	1% > \$0; 2% > \$750; 3% > \$2,250 4% > \$3,750; 5% > \$5,250; 6% > \$7K	\$ 2,300	\$ 3,000	\$ 2,700	\$ 2,700
Hawaii	No	1.4% > \$0; 3.2% > \$2K; 5.5% > \$4K 6.4% > \$8K; 6.8% > \$12K; 7.2% > \$16K 7.6% > \$20K; 7.9% > \$30K; 8.25% > \$40K	\$ 1,500	\$ 1,900	\$ 1,040	\$ 1,040
Idaho (x)	No	1.6% > \$0; 3.6% > \$1,086; 4.1% > \$2,172; 5.1% > \$3,259 6.1% > \$4,345; 7.1% > \$5,432; 7.4% > \$8,148; 7.8% > \$21,730	\$ 4,750	\$ 9,500	\$ 3,050	\$ 3,050
Illinois	No	3% of federal adjusted gross income with modification.	n.a.	n.a.	\$ 2,000	\$ 2,000
Indiana	No	3.4% of federal adjusted gross income with modification.	n.a.	n.a.	\$ 1,000	\$ 1,000
Iowa	Yes	0.36% > \$0; 0.72% > \$1,242; 2.43% > \$2,484 4.5% > \$4,968; 6.12% > \$11,178; 6.48% > \$18,630 6.8% > \$24,840; 7.92% > \$37,260; 8.98% > \$55,890	\$ 1,550 (w)	\$ 3,830 (w)	\$ 40 (c)	\$ 40 (c)
Kansas	No	3.5% > \$0; 6.25% > \$15K; 6.45% > \$30K	\$ 3,000	\$ 6,000	\$ 2,250	\$ 2,250
Kentucky	No	2% > \$0; 3% > \$3K; 4% > \$4K; 5% > \$5K; 6% > \$8K	\$ 1,830	\$ 1,830	\$ 20 (c)	\$ 20 (c)
Louisiana	Yes	2% > \$0; 4% > \$10K; 6% > \$50K	n.a.	n.a.	\$ 4,500 (m)	\$ 1,000
Maine	No	2% > \$0; 4.5% > \$4,250; 7% > \$8,450; 8.5% > \$16,950	\$ 4,750	\$ 7,950	\$ 2,850 (w)	\$ 2,850 (w)
Maryland	No	2% > \$0; 3% > \$1K; 4% > \$2K; 4.75% > \$3K	\$ 2,000 (n)	4,000 (n)	\$ 2,400	\$ 2,400
Massachusetts	No	5.3% or 12% (f)	n.a.	n.a.	\$ 3,300	\$ 1,000
Michigan	No	4.0% of federal adjusted gross income with modification.	n.a.	n.a.	\$ 3,100	\$ 3,000
Minnesota	No	5.35% > \$0; 7.05% > \$19,010; 7.85% > \$62,440	\$ 4,750 (y)	\$9,500(y)	\$ 3,000 (y)	\$ 3,000 (y)
Mississippi	No	3% > \$0; 4% > \$5K; 5% > \$10K	\$ 2,300	\$ 4,600	\$ 6,000	\$ 1,500
Missouri	Yes (aa)(z)	1.5% > \$0; 2% > \$1K; 2.5% > \$2K; 3% > \$3K; 3.5% > \$4K 4% > \$5K; 4.5% > \$6K; 5% > \$7K; 5.5% > \$8K; 6% > \$9K	\$ 4,750 (y)	\$ 9,500 (y)	\$ 2,100	\$ 1,200
Montana	Yes (p)	2% > \$0; 3% > \$2,200; 4% > \$4,400; 5% > \$8,900; 6% > \$13,300 7% > \$17,800; 8% > \$22,200; 9% > \$31,100 10% > \$44,500; 11% > \$77,800	\$ 3,330 (p)(w)	\$ 6,660 (p)(w)	\$ 1,780 (w)	\$ 1,780 (w)
Nebraska	No	2.56% > \$0; 3.57% > \$2,400; 5.12% > \$17K; 6.84% > \$26,500	\$ 4,750 (y)	\$ 7,950 (y)	\$99(c)(q)	\$ 99 (c)(q)
Nevada	No	None	n.a.	n.a.	n.a.	n.a.
New Hampshire	No	5% > \$0 (h)	n.a.	n.a.	\$ 2,400	n.a.
New Jersey	No	1.4% > \$0; 1.75% > \$20K; 3.5% > \$35K 5.525% > \$40K; 6.37% > \$75K	n.a.	n.a.	\$ 1,000	\$ 1,500
New Mexico	No	1.7% > \$0; 3.2% > \$5,500; 4.7% > \$11K 6% > \$16K; 7.1% > \$26K; 7.7% > \$42K	\$ 4,750 (y)	\$ 9,500(y)	\$ 3,050(y)	\$ 3,050(y)
New York	No	4% > \$0; 4.5% > \$8K; 5.25% > \$11K 5.9% > \$13K; 6.85% > \$20K	\$ 7,500	\$ 14,600	n.a.	\$ 1,000
North Carolina	No	6% > \$0; 7% > \$12,750 7.75% > \$60K; 8.25% > \$120K	\$ 3,750	\$ 6,100	\$ 1,050 (r)	\$ 1,050 (r)
North Dakota	No	2.1% > \$0; 3.92% > \$28,400; 4.34% > \$68,800 5.04% > \$143,500; 5.54% > \$311,950	\$ 4,750 (y)	\$ 7,950 (y)	\$ 3,050 (y)	\$ 3,050 (y)
Ohio	No	0.743% > \$0; 1.486% > \$5K; 2.972% > \$10K 3.715% > \$15K; 4.457% > \$20K; 5.201% > \$40K 5.943% > \$80K; 6.9% > \$100K; 7.5% > \$200K (u)	n.a.	n.a.	\$ 1,250 (u)	\$ 1,250 (u)



**Table 12 (Continued)**  
**Individual Income Tax Rates, As of December 31, 2003**

State	Federal Deductibility	Marginal Rates and Tax Brackets for Single Filers (a)	Standard Deduction		Personal Exemptions	
			Single	Joint	Single (b)	Dependents
Oklahoma	Yes (d)	0.5% > \$0; 1% > \$1K; 2% > \$2,500; 3% > \$3,750 4% > \$4,900; 5% > \$6,200; 6% > \$7,700; 7% > \$10K	\$ 2,000 (s)	\$ 2,000 (s)	\$ 1,000	\$ 1,000
Oregon	Yes	5% > \$0; 7% > \$2,500; 9% > \$6,300	\$ 1,670	\$ 3,345	\$ 142 (c)(w)	\$ 142 (c)(w)
Pennsylvania	No	2.8% > \$0 (ab)	n.a.	n.a.	n.a.	n.a.
Rhode Island	No	25% of federal income tax liability.	\$ 4,750	\$ 7,950	\$ 3,050	\$ 3,050
South Carolina	No	2.5% > \$0; 3% > \$2,400; 4% > \$4,800 5% > \$7,200; 6% > \$9,600; 7% > \$12,000	\$4,750 (y)	\$ 7,950 (y)	\$ 3,050 (y)	\$ 3,050 (y)
South Dakota	No	None	n.a.	n.a.	n.a.	n.a.
Tennessee	No	6% > \$0 (h)	n.a.	n.a.	\$ 1,250	n.a.
Texas	No	None	n.a.	n.a.	n.a.	n.a.
Utah	Yes	2.3% > \$0; 3.3% > \$863; 4.2% > \$1,726 5.2% > \$2,588; 6% > \$3,450; 7% > \$4,313	\$ 4,750	\$ 9,500	\$ 2288 (v)	\$ 2,288 (v)
Vermont	No	3.6% > \$0; 7.2% > \$28,400; 8.5% > \$68,800 9% > \$143,500; 9.5% > \$311,950	n.a.	n.a.	\$ 3,000	n.a.
Virginia	No	2% > \$0; 3% > \$3K; 5% > \$5K; 5.75% > \$17K	\$ 3,000	\$ 5,000	\$ 800	\$ 800
Washington	No	None	n.a.	n.a.	n.a.	n.a.
West Virginia	No	3% > \$0; 4% > \$10K; 4.5% > \$25K; 6% > \$40K; 6.5% > \$60K	n.a.	n.a.	\$ 2,000	\$ 2,000
Wisconsin	No	4.60% > \$0; 6.15% > \$8,280 6.50% > \$16,560; 6.75% > \$126,420	\$ 7,790 (k)	\$ 14,030 (k)	\$ 700	\$ 700
Wyoming	No	None	n.a.	n.a.	n.a.	n.a.
Dist. of Col.	No	5% > \$0; 7.5% > \$10K; 9.3% > \$30K	\$ 1,000	\$ 2,000	\$ 1,370	\$ 1,370

- (a) Applies to single taxpayers and married people filing separately. Most states double brackets for married filing joint.
- (b) Except for Delaware and Mississippi, married-joint filers receive double the single exemption. Delaware is a flat \$110 tax credit and Mississippi is \$9,500 for joint.
- (c) Tax Credit.
- (d) Rates listed assume that taxpayers opt not to deduct their federal income tax liability. In Oklahoma, if a filer chooses to deduct his federal liability, then he faces a range of rates from 0.5%-10% on income up to \$1,000 and over \$16,000 respectively.
- (e) The single personal exemption will increase to \$12,625 as of the beginning of the 2004 tax year.
- (f) The 12% rate applies to short-term capital gains, long- and short-term capital gains on collectibles and pre-1996 installment sales classified as capital gain income for Massachusetts purposes.
- (h) Applies to interest and dividend income only.
- (k) Deduction phases out to zero for single filers at \$41,000 and joint filers at \$76,000.
- (l) Rates apply to regular tax table. A special tax table is available for low-income taxpayers that reduce their tax payments.
- (m) Standard deduction and personal exemptions are combined: \$4,500 for single and married filing separately; \$9,000 married filing jointly and head of household.
- (n) The standard deduction is 15 percent of income with a minimum of \$1,500 and a cap of \$2,000 for single filers, married filing separately filers and dependent filers earning more than \$13,333. The standard deduction is capped at \$4,000 for married filing jointly filers, head of household filers and qualifying widowers earning more than \$26,667.
- (p) Can claim either the standard deduction or the amount of federal taxes withheld, whichever is greater.
- (q) The \$99 personal exemption credit is phased out for filers with adjusted gross income of \$70,000 or more.
- (r) Exemptions are based on federal standard deductions but are adjusted according to income and filing status.
- (s) The deduction given is applicable to all filers, excluding those married filing separately, with adjusted gross income (AGI) over \$13,333. For those with AGI between \$6,666 and \$13,333 the standard deduction is 15% of AGI and for those with AGI of less than \$6,666 the standard deduction is \$1,000. For married filing separately, the standard deduction is \$500 or 15% of AGI, but not to exceed \$1,000.
- (u) Under Ohio law, when the state ends its fiscal year with a significant budget surplus, that surplus is refunded to taxpayers through a temporary reduction in the income tax rates. Taxpayers receive a \$20 tax credit per exemption in addition to the normal exemption amount. Normal rates and exemptions shown.
- (v) Three-fourths federal exemption.
- (w) Indexed for inflation.
- (x) All filers must pay \$10 for the permanent building fund tax.
- (y) Deductions and exemptions tied to Federal tax system. Federal deductions and exemptions are indexed for inflation.
- (z) Residents should deduct the federal income tax liability as shown on their 2003 federal income tax return, less any federal Advance Child Tax Credit for 2003.
- (aa) If you checked Box A, B, D, E, F, or G on Line 9, your federal tax deduction is limited to \$5,000. If you checked Box C on Line 9, your federal tax deduction is limited to \$10,000.
- (ab) Tax rate changes from 2.8% to 3.07% in 2004.

Sources: State tax forms and instructions, Commerce Clearing House, Federation of Tax Administrators.

*Table 13*  
*Individual Income Tax Base Criteria, 2004*

State	Percentage Points by Which Top Individual Rate Exceeds Top Corporate Rate	Marriage Penalty (e)	Allow Filing Separately on a Single Return	Double Taxation			Indexation		
				Interest	Dividends	Capital Gains	Brackets	Standard Deduction	Exemption
Alabama	0	No	No	Yes	Yes	Yes	No	No	No
Alaska	0	No	Yes	No	No	No	Yes	Yes	Yes
Arizona	0	No	No	Yes	Yes	Yes	No	No	No
Arkansas	0.50	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
California	0.46	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Colorado	0	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Connecticut	0	No	No	Yes	Yes	Yes	No	No	No
Delaware	0	Yes	Yes	Yes	Yes	Yes	No	No	No
Florida	0	No	Yes	No	No	No	Yes	Yes	Yes
Georgia	0	Yes	No	Yes	Yes	Yes	No	No	No
Hawaii	1.85	Yes	No	Yes	Yes	Yes	No	No	No
Idaho	0.20	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Illinois	0	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Indiana	0	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Iowa	0	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Kansas	0	No	No	Yes	Yes	Yes	No	No	No
Kentucky	0	Yes	No	Yes	Yes	Yes	No	No	No
Louisiana	0	Yes	Yes	Yes	Yes	Yes	No	No	No
Maine	0	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
Maryland	0	Yes	No	Yes	Yes	Yes	No	No	No
Massachusetts (a)	0	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Michigan	0	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Minnesota	0	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
Mississippi	0	Yes	Yes	Yes	Yes	Yes	No	No	No
Missouri	0	Yes	Yes	Yes	Yes	Yes	No	No	No
Montana	4.25	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Nebraska	0	Yes	No	Yes	Yes	Yes	No	No	Yes
Nevada (d)	0.49	No	Yes	No	No	No	Yes	Yes	Yes
New Hampshire (b)	0	No	Yes	Yes	Yes	No	Yes	Yes	Yes
New Jersey	0	Yes	No	Yes	Yes	Yes	No	No	No
New Mexico	0.10	Yes	No	Yes	Yes	Yes	No	No	No
New York	0	Yes	No	Yes	Yes	Yes	No	No	No
North Carolina	1.35	Yes	No	Yes	Yes	Yes	No	No	No
North Dakota	0	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
Ohio	0	Yes	No	Yes	Yes	Yes	No	No	Yes
Oklahoma	1.00	Yes	No	Yes	Yes	Yes	No	No	No
Oregon	2.40	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Pennsylvania	0	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Rhode Island	0.65	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
South Carolina	2.00	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
South Dakota	0	No	Yes	No	No	No	Yes	Yes	Yes
Tennessee (c)	0	No	Yes	Yes	Yes	No	Yes	Yes	Yes
Texas	0	No	Yes	No	No	No	Yes	Yes	Yes
Utah	2.00	No	No	Yes	Yes	Yes	No	No	No
Vermont	0	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
Virginia	0	Yes	Yes	Yes	Yes	Yes	No	No	No
Washington	0	No	Yes	No	No	No	Yes	Yes	Yes
West Virginia	0	Yes	No	Yes	Yes	Yes	No	No	No
Wisconsin	0	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
Wyoming	0	No	Yes	No	No	No	Yes	Yes	Yes
District of Columbia	0	Yes	Yes	Yes	Yes	Yes	No	No	No

(e) Many states claim to have eliminated the marriage penalty while actually having done so for low- or middle-income taxpayers only.

**Table 14**  
**Other Individual Income Tax Base Criteria, 2004**

State	Federal Income Used As State Tax Base	Jock Tax	Federal Tax Deductible	State Tax Deductible	Foreign Tax Deductible	AMT Levied	LLCs Recognized	S-corps Recognized
Alabama	No	No	Yes	Yes	Yes	No	Yes	Yes
Alaska	Yes	No	Yes	Yes	Yes	No	No	No
Arizona	No	Yes	No	Yes	Yes	No	Partial	Yes
Arkansas	Yes	No	No	Yes	Yes	No	Yes	Yes
California	Yes	Yes	No	Yes	Yes	Yes	Yes	Partial
Colorado	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Connecticut	Yes	No	No	Yes	Yes	Yes	Yes	Yes
Delaware	Yes	No	No	Yes	Yes	No	Yes	Yes
Florida	Yes	No	Yes	Yes	Yes	No	No	No
Georgia	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Hawaii	Yes	No	No	Yes	Yes	No	Yes	Yes
Idaho	Yes	No	No	Yes	Yes	No	Yes	Yes
Illinois	Yes	Yes	No	No	No	No	Yes	Partial
Indiana	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Iowa	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
Kansas	Yes	No	No	Yes	Yes	No	Yes	Yes
Kentucky	Yes	No	No	Yes	Yes	No	Yes	Yes
Louisiana	Yes	Yes	Yes	Yes	Yes	No	Yes	No
Maine	Yes	No	No	Yes	Yes	Yes	Yes	Yes
Maryland	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Massachusetts	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Michigan	Yes	Yes	No	Yes	Yes	No	Yes	No
Minnesota	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Mississippi	No	No	No	Yes	Yes	No	Yes	Yes
Missouri	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Montana	Yes	No	Yes	Yes	Yes	No	Yes	Yes
Nebraska	Yes	No	No	Yes	Yes	Yes	Yes	Yes
Nevada	Yes	No	No	No	No	No	No	No
New Hampshire	No	No	No	Yes	Yes	No	Yes	No
New Jersey	No	Yes	No	Yes	Yes	No	Partial	Yes
New Mexico	Yes	No	No	Yes	Yes	No	Yes	Yes
New York	Yes	Yes	No	Yes	Yes	Yes	Yes	Partial
North Carolina	Yes	Yes	No	Yes	Yes	No	Yes	Yes
North Dakota	Yes	No	Half	Yes	Yes	No	Yes	Yes
Ohio	Yes	Yes	No	Yes	Yes	No	Yes	Yes
Oklahoma	Yes	No	Yes	Yes	Yes	No	Yes	Yes
Oregon	Yes	Yes	Half	Yes	Yes	No	Yes	Yes
Pennsylvania	No	Yes	No	Yes	Yes	No	Yes	Yes
Rhode Island	Yes	No	No	Yes	Yes	Yes	Yes	Partial
South Carolina	Yes	No	No	Yes	Yes	No	Yes	Yes
South Dakota	Yes	No	Yes	Yes	Yes	No	Yes	Yes
Tennessee	No	No	No	Yes	Yes	No	Yes	No
Texas	Yes	No	Yes	Yes	Yes	No	No	No
Utah	Yes	Yes	Half	Yes	Yes	No	Yes	Yes
Vermont	Yes	No	No	Yes	Yes	No	Yes	Yes
Virginia	Yes	No	No	Yes	Yes	No	Partial	Yes
Washington	Yes	No	Yes	Yes	Yes	No	Yes	Yes
West Virginia	Yes	No	No	Yes	Yes	Yes	Yes	Yes
Wisconsin	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Wyoming	Yes	No	Yes	Yes	Yes	No	Yes	Yes
District of Columbia	Yes	No	No	Yes	Yes	Yes	Yes	No

**Table 15**  
**State Sales, Gross Receipts and Excise Tax Rates, As of December 31, 2003**

	State Sales and Use Tax Rate	Weighted Average of County Rates (b)	Gross Receipts Tax	Gasoline Excise Tax (cents per gallon)	Diesel Excise Tax (cents per gallon)	Tobacco Excise Tax (cents per pack of 20)	Beer Excise Tax (cents per gallon)
Alabama	4%	1.81%	No	16.0¢	19.0¢	16.5¢	52.0¢
Alaska	None	0.87%	No	8.0¢	8.0¢	100.0¢	35.0¢
Arizona	5.6%	0.61%	No	18.0¢	18.0¢	118.0¢	16.0¢
Arkansas	6%	1.16%	No	21.5¢	22.5¢	31.5¢	23.0¢
California	6%	1.29%	No	18.0¢	18.0¢	87.0¢	20.0¢
Colorado	2.9%	0.70%	No	22.0¢	20.5¢	20.0¢	8.0¢
Connecticut	6%	None	No	25.0¢	26.0¢	151.0¢	19.0¢
Delaware	None	None	No	23.0¢	22.0¢	24.0¢	16.0¢
Florida	6%	0.47%	No	14.3¢	27.0¢	33.9¢	48.0¢
Georgia	4%	0.70%	No	7.5¢	7.5¢	37.0¢	48.0¢
Hawaii (a)	4%	None	Yes	16.0¢	16.0¢	130.0¢	93.0¢
Idaho	6%	None	No	25.0¢	25.0¢	57.0¢	15.0¢
Illinois	6.25%	0.81%	No	19.0¢	21.5¢	98.0¢	19.0¢
Indiana	5%	None	No	18.0¢	16.0¢	55.0¢	12.0¢
Iowa	5%	0.58%	No	20.3¢	22.5¢	36.0¢	19.0¢
Kansas	5.3%	0.93%	No	24.0¢	26.0¢	79.0¢	18.0¢
Kentucky	6%	None	No	15.0¢	12.0¢	60.0¢	8.0¢
Louisiana	4%	4.21%	No	20.0¢	20.0¢	36.0¢	32.0¢
Maine	5%	None	No	24.6¢	24.4¢	100.0¢	35.0¢
Maryland	5%	None	No	23.5¢	24.3¢	100.0¢	9.0¢
Massachusetts	5%	None	No	21.0¢	21.0¢	151.0¢	11.0¢
Michigan	6%	None	No	19.0¢	15.0¢	125.0¢	20.0¢
Minnesota	6.5%	None	No	20.0¢	20.0¢	48.0¢	15.0¢
Mississippi	7%	None	Yes	18.0¢	18.0¢	18.0¢	43.0¢
Missouri	4.23%	1.30%	No	17.0¢	17.0¢	17.0¢	6.0¢
Montana	None	None	No	27.0¢	28.5¢	70.0¢	14.0¢
Nebraska	5.5%	None	No	24.6¢	24.8¢	64.0¢	31.0¢
Nevada	6.5%	2.96%	No	23.0¢	27.0¢	80.0¢	16.0¢
New Hampshire	None	None	No	18.0¢	18.0¢	52.0¢	30.0¢
New Jersey	6%	None	No	10.5¢	13.5¢	205.0¢	12.0¢
New Mexico	5%	0.66%	Yes	17.0¢	18.0¢	91.0¢	41.0¢
New York	4%	3.84%	No	33.0¢	30.4¢	150.0¢	11.0¢
North Carolina	4.5%	2.48%	No	22.1¢	22.1¢	5.0¢	48.387¢
North Dakota	5%	0.03%	No	21.0¢	21.0¢	44.0¢	16.0¢
Ohio	6%	1.13%	No	23.0¢	23.0¢	55.0¢	18.0¢
Oklahoma	4.5%	0.46%	No	17.0¢	13.0¢	23.0¢	40.0¢
Oregon	None	None	No	24.0¢	24.0¢	128.0¢	8.0¢
Pennsylvania	6%	0.22%	No	26.6¢	32.3¢	135.0¢	8.0¢
Rhode Island	7%	None	No	30.0¢	30.0¢	171.0¢	10.0¢
South Carolina	5%	0.48%	No	16.0¢	16.0¢	7.0¢	77.0¢
South Dakota	4%	None	Yes	22.0¢	22.0¢	53.0¢	27.0¢
Tennessee	7%	2.31%	No	20.0¢	18.0¢	20.0¢	14.0¢
Texas	6.25%	0.11%	No	20.0¢	20.0¢	41.0¢	20.0¢
Utah	4.75%	1.64%	No	24.5¢	24.5¢	69.5¢	41.0¢
Vermont	6%	None	No	20.0¢	26.0¢	119.0¢	27.0¢
Virginia	3.5%	1.00%	No	17.5¢	16.0¢	2.5¢	26.0¢
Washington (a)	8.75%	1.56%	Yes	25.5¢	25.5¢	142.5¢	26.0¢
West Virginia	6%	None	No	20.5¢	20.5¢	55.0¢	18.0¢
Wisconsin	5%	0.33%	No	30.3¢	30.3¢	77.0¢	7.0¢
Wyoming	4%	1.35%	No	14.0¢	14.0¢	60.0¢	2.0¢
District of Columbia	5.75%	N.A.	No	20.0¢	20.0¢	100.0¢	9.0¢

(a) Hawaii is currently in the middle of a seven-year reduction of pyramiding in its 4-percent gross receipts tax as passed by Act 71 in 1999. Once Act 71 is fully phased-in after 2004, all business-to-business transactions will be subjected to a lower 0.5 percent rate, while business-to-consumer transactions are taxed at 4 percent. The economic result of this reduction is that the economy-wide effective tax rate will be reduced. The index calculates this effective rate for 2004 at 3.034 percent, a rate that will fall in future years as the phase-in progresses.

(b) Washington has the worst top tax rate score because its derived rate is 8.75 percent. The derivation is necessary because Washington has both a sales and gross receipts tax—officially called the Business and Occupation Tax. To calculate the derived rate, the sales tax rate was scaled up to the point where, all things being equal, it would raise the same amount of revenue currently raised by both the sales and gross receipts taxes.

Table 16

Sales and Gross Receipts Tax Index

State Sales Tax Exemptions for Business-to-Business Transactions: Agricultural, Manufacturing and Machinery Inputs, As of December 31, 2003

	Insecticides and Pesticides	Fertilizer, Seed and Feed	Seedlings, Plants and Shoots	Manufacturing Machinery	Utilities	Farm Machinery	Raw Material	Office Equipment	Pollution Control Equipment	
									Air	Water
Alabama	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Exempt
Alaska	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Arizona	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt	Exempt
Arkansas	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt	Exempt	Taxable	Exempt	Exempt
California	Taxable	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Colorado	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Connecticut	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Delaware	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Florida	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable	Exempt	Exempt
Georgia	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt	Exempt
Hawaii (a)	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Exempt	Taxable
Idaho	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Illinois	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable	Taxable
Indiana	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Iowa	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Kansas	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Kentucky	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Louisiana	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Exempt	Exempt
Maine	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt	Exempt
Maryland	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Massachusetts	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Michigan	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Minnesota	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Mississippi	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Exempt	Exempt
Missouri	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Montana	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Nebraska	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Nevada	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable
New Hampshire	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
New Jersey	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable	Taxable
New Mexico	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable
New York	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
North Carolina	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable
North Dakota	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable
Ohio	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Oklahoma	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Oregon	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Pennsylvania	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Rhode Island	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
South Carolina	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
South Dakota	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable
Tennessee	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Texas	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Utah	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Vermont	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Virginia	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Washington (b)	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable
West Virginia	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt
Wisconsin	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable	Taxable
Wyoming	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
District of Columbia	Taxable	Taxable	Taxable	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable

(a) Hawaii is currently in the middle of a seven-year reduction of pyramiding in its 4-percent gross receipts tax as passed by Act 71 in 1999. Once Act 71 is fully phased-in after 2004, all business-to-business transactions will be subjected to a lower 0.5 percent rate, while business-to-consumer transactions are taxed at 4 percent. The economic result of this reduction is that the economy-wide effective tax rate will be reduced. The index calculates this effective rate for 2004 at 3.034 percent, a rate that will fall in future years as the phase-in progresses.

(b) Washington has the worst top tax rate score because its derived rate is 8.75 percent. The derivation is necessary because Washington has both a sales and gross receipts tax – officially called the Business and Occupation Tax. To calculate the derived rate, the sales tax rate was scaled up to the point where, all things being equal, it would raise the same amount of revenue currently raised by both the sales and gross receipts taxes.

Table 17

Sales and Gross Receipts Tax Index

State Sales Tax Exemptions for Business-to-Business Transactions: Services, Software, Leasing and Rental Inputs, As of December 31, 2003

	General Treatment of Services	Cleaning Services	Transportation Services	Repair Services	Professional and Personal Services	Custom Software	Modified Canned Software	Downloaded Software	Motor Vehicles	Tangible Personal Property	Rooms & Lodgings
Alabama	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt
Alaska	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Arizona	Many Taxable	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Arkansas	Many Taxable	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable
California	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt
Colorado	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Connecticut	Many Taxable	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Delaware	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Florida	Many Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Georgia	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Hawaii (a)	Generally Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Idaho	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Illinois	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt
Indiana	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Iowa	Many Taxable	Taxable	Exempt	Taxable	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Kansas	Many Taxable	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Kentucky	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable
Louisiana	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable
Maine	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Maryland	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Massachusetts	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt
Michigan	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Minnesota	Many Taxable	Taxable	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Mississippi	Generally Taxable	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Missouri	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Montana	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Nebraska	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Nevada	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt
New Hampshire	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
New Jersey	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
New Mexico	Generally Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable
New York	Many Taxable	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
North Carolina	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable
North Dakota	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable
Ohio	Many Taxable	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Oklahoma	Many Taxable	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable
Oregon	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Pennsylvania	Many Taxable	Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Rhode Island	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
South Carolina	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
South Dakota	Generally Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Tennessee	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable
Texas	Many Taxable	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Exempt
Utah	Many Taxable	Taxable	Taxable	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Vermont	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt
Virginia	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable
Washington (b)	Many Taxable	Taxable	Taxable	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
West Virginia	Generally Taxable	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Wisconsin	Many Taxable	Taxable	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Wyoming	Exempt	Taxable	Taxable	Taxable	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable
District of Columbia	Many Taxable	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable

(a) Hawaii is currently in the middle of a seven-year reduction of pyramiding in its 4-percent gross receipts tax as passed by Act 71 in 1999. Once Act 71 is fully phased-in after 2004, all business-to-business transactions will be subjected to a lower 0.5 percent rate, while business-to-consumer transactions are taxed at 4 percent. The economic result of this reduction is that the economy-wide effective tax rate will be reduced. The index calculates this effective rate for 2004 at 3.034 percent, a rate that will fall in future years as the phase-in progresses.

(b) Washington has the worst top tax rate score because its derived rate is 8.75 percent. The derivation is necessary because Washington has both a sales and gross receipts tax – officially called the Business and Occupation Tax. To calculate the derived rate, the sales tax rate was scaled up to the point where, all things being equal, it would raise the same amount of revenue currently raised by both the sales and gross receipts taxes.

**Table 18**  
**State Unemployment Insurance Tax Rates, As of 31, 2003**

State	Rates in Effect at the End of 2003			Most Favorable Schedule		Least Favorable Schedule	
	Minimum Rate	Maximum Rate	Taxable Wage Threshold	Minimum Rate	Maximum Rate	Minimum Rate	Maximum Rate
Alabama	0.840%	6.440%	\$ 8,000	0.200%	5.400%	0.650%	6.800%
Alaska	1.060%	5.400%	\$ 27,100	1.000%	5.400%	1.000%	5.400%
Arizona	0.100%	5.400%	\$ 7,000	0.050%	5.400%	2.850%	5.400%
Arkansas	0.900%	10.700%	\$ 10,000	0.000%	9.900%	0.900%	10.800%
California	1.500%	6.200%	\$ 7,000	0.100%	5.400%	1.300%	5.400%
Colorado	0.100%	6.720%	\$ 10,000	0.000%	5.400%	1.000%	5.400%
Connecticut	1.900%	6.900%	\$ 15,000	0.500%	5.400%	1.500%	6.900%
Delaware	0.300%	8.200%	\$ 8,500	0.100%	8.000%	0.100%	9.500%
Florida	0.350%	5.400%	\$ 7,000	0.000%	5.400%	0.001%	6.400%
Georgia	0.030%	7.020%	\$ 8,500	0.013%	5.400%	0.050%	10.800%
Hawaii	0.000%	5.400%	\$ 31,000	0.000%	5.400%	2.400%	5.400%
Idaho	0.200%	5.400%	\$ 27,600	0.100%	5.400%	2.400%	6.800%
Illinois	0.900%	8.600%	\$ 9,800	0.200%	6.400%	0.200%	9.000%
Indiana	0.100%	5.500%	\$ 7,000	0.150%	5.400%	1.100%	5.600%
Iowa	0.000%	8.000%	\$ 19,700	0.000%	7.000%	0.000%	9.000%
Kansas	0.080%	7.400%	\$ 8,000	0.010%	7.400%	0.010%	7.400%
Kentucky	0.300%	10.000%	\$ 8,000	0.300%	9.000%	1.000%	10.000%
Louisiana	1.650%	6.200%	\$ 7,000	0.090%	6.000%	0.300%	6.000%
Maine	0.440%	5.400%	\$ 12,000	0.500%	6.400%	2.400%	7.500%
Maryland	0.300%	7.500%	\$ 8,500	0.100%	5.500%	2.300%	9.500%
Massachusetts	1.120%	10.960%	\$ 14,000	0.800%	7.800%	1.580%	15.400%
Michigan	0.060%	10.300%	\$ 9,000	0.000%	8.000%	1.000%	10.000%
Minnesota	0.440%	10.760%	\$ 22,000	0.100%	9.000%	0.600%	9.500%
Mississippi	0.400%	5.400%	\$ 7,000	0.100%	5.400%	0.100%	5.400%
Missouri	0.000%	6.000%	\$ 8,000	0.000%	5.400%	0.000%	8.700%
Montana	0.130%	6.500%	\$ 20,300	0.000%	6.370%	1.670%	6.370%
Nebraska	0.050%	5.400%	\$ 7,000	0.050%	5.400%	0.050%	5.400%
Nevada	0.250%	5.400%	\$ 22,000	0.250%	5.400%	0.250%	5.400%
New Hampshire	0.010%	6.500%	\$ 8,000	0.050%	6.500%	2.800%	6.500%
New Jersey	0.300%	5.400%	\$ 24,300	0.300%	5.400%	1.200%	7.000%
New Mexico	0.030%	5.400%	\$ 16,800	0.030%	5.400%	2.700%	5.400%
New York	1.500%	9.900%	\$ 8,500	2.400%	5.900%	5.200%	8.900%
North Carolina	0.000%	5.700%	\$ 16,200	0.000%	5.400%	0.000%	5.400%
North Dakota	0.490%	10.090%	\$ 18,500	0.100%	10.090%	0.100%	10.090%
Ohio	0.200%	7.500%	\$ 9,000	0.100%	6.300%	0.100%	6.700%
Oklahoma	0.300%	7.800%	\$ 14,300	0.100%	5.500%	0.500%	5.500%
Oregon	1.800%	5.400%	\$ 27,000	0.500%	5.400%	2.200%	5.400%
Pennsylvania	0.300%	6.189%	\$ 8,000	0.296%	6.189%	1.023%	10.590%
Rhode Island	1.690%	9.790%	\$ 14,000	0.600%	7.000%	1.900%	10.000%
South Carolina	1.240%	6.100%	\$ 7,000	0.540%	5.400%	1.240%	6.100%
South Dakota	0.000%	7.000%	\$ 7,000	0.000%	7.000%	1.500%	10.500%
Tennessee	0.450%	10.000%	\$ 7,000	0.000%	10.000%	0.500%	10.000%
Texas	0.530%	8.260%	\$ 9,000	0.000%	6.000%	0.000%	6.000%
Utah	0.400%	8.400%	\$ 22,700	0.100%	8.100%	0.100%	8.100%
Vermont	0.400%	5.400%	\$ 8,000	0.400%	5.400%	1.300%	8.400%
Virginia	0.440%	6.540%	\$ 8,000	0.000%	5.400%	0.300%	6.400%
Washington	0.970%	5.400%	\$ 30,200	0.470%	5.400%	2.470%	5.400%
West Virginia	1.500%	8.500%	\$ 8,000	0.000%	8.500%	1.500%	8.500%
Wisconsin	0.000%	9.750%	\$ 10,500	0.000%	8.900%	0.270%	8.900%
Wyoming	0.290%	7.600%	\$ 15,900	0.000%	5.400%	0.000%	8.500%
District of Columbia	1.600%	7.000%	\$ 9,000	0.100%	5.400%	1.900%	7.400%

Table 19

State Unemployment Insurance Tax Base Criteria, As of December 31, 2003

State	State Experience Formula	Benefits Are Charged to Employers in Proportion to Base Period Wages	Company Charged for Benefits If					
			Employee's Benefit Award Reversed	Reimbursements on Combined Wage Claims	Employee Left Voluntarily	Employee Discharged for Misconduct	Employee Refused Suitable Work	Employee Continues to Work for Employer Part-time
Alabama	Benefit-Ratio	Yes	No	Yes	No	No	Yes	No
Alaska	Payroll Variation	No (a)	Yes	Yes	Yes	Yes	Yes	Yes
Arizona	Reserve-Ratio	Yes	No	No	No	No	Yes	No
Arkansas	Reserve-Ratio	Yes	Yes	Yes	No	No	Yes	No
California	Reserve-Ratio	Yes	No	Yes	No	No	Yes	No
Colorado	Reserve-Ratio	No (b)	No	No	No	No	Yes	Yes
Connecticut	Benefit-Ratio	Yes	Yes	Yes	No	No	No	Yes
Delaware	Reserve-Ratio	Yes	No	No	No	No	Yes	No
Florida	Benefit-Ratio	Yes	No	Yes	No	No	No	Yes
Georgia	Reserve-Ratio	No (a)	No	No	No	No	No	Yes
Hawaii	Reserve-Ratio	Yes	Yes	No	No	No	No	No
Idaho	Reserve-Ratio	No (a)	No	No	No	No	Yes	Yes
Illinois	Benefit-Ratio	No (a)	Yes	No	No	No	No	Yes
Indiana	Reserve-Ratio	Yes	Yes	No	No	No	Yes	No
Iowa	Benefit-Ratio	No (b)	No	No	No	No	No	Yes
Kansas	Reserve-Ratio	Yes	Yes	Yes	No	No	Yes	No
Kentucky	Reserve-Ratio	No (a)	Yes	No	No	No	Yes	Yes
Louisiana	Reserve-Ratio	Yes	No	Yes	No	No	No	No
Maine	Benefit-Ratio	No (a)	No	No	No	No	No	Yes
Maryland	Reserve-Ratio	Yes	No	Yes	No	No	Yes	No
Massachusetts	Reserve-Ratio	No (b)	No	Yes	No	No	Yes	Yes
Michigan	Benefit-Ratio	No (a)	Yes	Yes	No	No	No	No
Minnesota	Reserve-Ratio	Yes	Yes	No	No	No	Yes	Yes
Mississippi	Reserve-Ratio	Yes	Yes	Yes	No	No	No	No
Missouri	Reserve-Ratio	Yes	No	Yes	No	No	No	Yes
Montana	Reserve-Ratio	Yes	Yes	Yes	No	No	Yes	No
Nebraska	Reserve-Ratio	No (b)	No	Yes	No	No	Yes	Yes
Nevada	Reserve-Ratio	No (a)	Yes	No	No	No	Yes	Yes
New Hampshire	Reserve-Ratio	No (a)	Yes	No	Yes	Yes	Yes	Yes
New Jersey	Reserve-Ratio	Yes	No	Yes	No	No	No	Yes
New Mexico	Reserve-Ratio	Yes	No	Yes	No	No	Yes	Yes
New York	Reserve-Ratio	No (a)	Yes	Yes	No	No	Yes	No
North Carolina	Reserve-Ratio	Yes	No	Yes	No	No	Yes	No
North Dakota	Reserve-Ratio	Yes	No	Yes	No	No	Yes	Yes
Ohio	Reserve-Ratio	Yes	No	No	No	No	No	No
Oklahoma	Reserve-Ratio	Yes	No	Yes	No	No	Yes	No
Oregon	Benefit-Ratio	Yes	No	No	No	No	Yes	No
Pennsylvania	Benefit-Ratio	Yes	Yes	Yes	No	No	Yes	No
Rhode Island	Reserve-Ratio	No (a)	No	Yes	No	No	Yes	Yes
South Carolina	Reserve-Ratio	No (a)	No	Yes	No	No	No	Yes
South Dakota	Reserve-Ratio	No (b)	No	Yes	No	No	Yes	Yes
Tennessee	Reserve-Ratio	Yes	No	Yes	No	No	Yes	No
Texas	Benefit-Ratio	Yes	No	Yes	No	No	Yes	Yes
Utah	Benefit-Ratio	Yes	No	No	No	No	Yes	No
Vermont	Benefit-Ratio	Yes	Yes	No	No	No	No	Yes
Virginia	Benefit-Ratio	No (a)	Yes	No	No	No	No	Yes
Washington	Benefit-Ratio	No (b)	No	Yes	No	No	Yes	No
West Virginia	Reserve-Ratio	Yes	No	Yes	No	No	Yes	Yes
Wisconsin	Reserve-Ratio	Yes	No	Yes	No	Yes	Yes	Yes
Wyoming	Reserve-Ratio	Yes	No	Yes	No	No	Yes	No
District of Columbia	Reserve-Ratio	Yes	Yes	Yes	No	No	Yes	No

(a) Benefits charged to most recent or principal employer  
 (b) Benefits charged to base-period employers, most recent first.



Table 20

Other State Unemployment Insurance Tax Base Criteria, As of December 31, 2003

State	Solvency Tax	Taxes for Socialized Costs or Negative Balance Employer	Loan and Interest Repayment Surtaxes	Reserve Taxes	Surtaxes for UI Administration or Non-UI Purposes	Temporary Disability Insurance	Voluntary Contributions	Time-Period to Qualify for Experience Rating (years)
Alabama	No	Yes	No	No	No	No	No	1.0
Alaska	Yes	No	No	No	No	No	No	1.0
Arizona	No	Yes	No	No	Yes	No	Yes	1.0
Arkansas	Yes	No	Yes	No	Yes	No	Yes	3.0
California	Yes	No	No	No	Yes	Yes	Yes	1.0
Colorado	Yes	No	Yes	No	Yes	No	Yes	1.0
Connecticut	No	No	Yes	No	No	No	No	1.0
Delaware	Yes	No	Yes	No	Yes	No	No	2.0
Florida	No	No	No	No	No	No	No	2.5
Georgia	No	No	No	No	Yes	No	Yes	3.0
Hawaii	No	No	No	No	No	Yes	No	1.0
Idaho	No	No	Yes	Yes	Yes	No	No	1.0
Illinois	Yes	No	No	No	No	No	No	3.0
Indiana	No	No	No	No	Yes	No	Yes	3.0
Iowa	No	No	Yes	No	No	No	No	3.0
Kansas	No	Yes	No	No	No	No	Yes	2.0
Kentucky	No	No	No	No	Yes	No	Yes	3.0
Louisiana	No	No	Yes	No	Yes	No	Yes	3.0
Maine	No	No	Yes	No	No	No	Yes	2.0
Maryland	Yes	No	No	No	No	No	No	2.0
Massachusetts	Yes	No	Yes	No	Yes	No	Yes	1.0
Michigan	No	Yes	No	No	No	No	Yes	2.0
Minnesota	No	No	Yes	No	Yes	No	Yes	1.0
Mississippi	Yes	No	No	No	No	No	No	1.0
Missouri	Yes	No	Yes	No	No	No	Yes	1.0
Montana	No	No	No	No	Yes	No	No	3.0
Nebraska	No	No	No	Yes	No	No	Yes	1.0
Nevada	No	No	No	No	Yes	No	No	2.5
New Hampshire	Yes	Yes	No	No	No	No	No	1.0
New Jersey	Yes	No	Yes	No	Yes	Yes	Yes	3.0
New Mexico	No	No	No	No	No	No	Yes	3.0
New York	Yes	No	Yes	No	Yes	Yes	Yes	1.0
North Carolina	No	No	No	Yes	No	No	Yes	2.0
North Dakota	No	No	No	No	No	No	Yes	3.0
Ohio	Yes	No	No	No	No	No	Yes	2.0
Oklahoma	Yes	No	No	No	No	No	No	1.0
Oregon	No	No	Yes	Yes	Yes	No	No	1.0
Pennsylvania	Yes	No	Yes	No	No	No	Yes	1.5
Rhode Island	Yes	No	No	No	No	Yes	No	3.0
South Carolina	Yes	No	No	No	Yes	No	No	2.0
South Dakota	Yes	No	No	No	Yes	No	Yes	2.0
Tennessee	No	No	Yes	No	Yes	No	No	3.0
Texas	Yes	No	Yes	Yes	No	No	Yes	1.0
Utah	No	No	No	No	No	No	No	1.0
Vermont	No	No	No	No	No	No	No	1.0
Virginia	Yes	Yes	No	No	No	No	No	1.0
Washington	Yes	Yes	Yes	No	Yes	No	Yes	2.0
West Virginia	No	Yes	Yes	No	No	No	Yes	3.0
Wisconsin	Yes	No	Yes	No	Yes	No	Yes	2.5
Wyoming	Yes	Yes	No	No	Yes	No	No	3.0
District of Columbia	No	No	No	No	No	No	No	3.0

*Table 21*  
*State Fiscal Balance Criteria, As of December 31, 2003*

	State Taxes Per Capita	State Taxes As a Percentage of Income	Voting Rule	Tax and Expenditure Limits		
				Expenditure	Revenue	Legal Form
U.S.	\$ 1,880	5.62%	-	-	-	-
Alabama	\$ 1,426	5.18%	50%	No	No	None
Alaska	\$ 1,648	4.73%	50%	Yes	No	Constitutional
Arizona	\$ 1,557	5.50%	67%	Yes	No	Constitutional
Arkansas	\$ 1,888	7.36%	75%	No	No	None
California	\$ 2,232	6.26%	67%	Yes	No	Constitutional
Colorado	\$ 1,458	4.12%	67%	Yes	Yes	Part Constitutional, Part Statutory
Connecticut	\$ 2,730	5.92%	50%	Yes	No	Part Constitutional, Part Statutory
Delaware	\$ 2,600	7.41%	60%	Yes	No	Constitutional
Florida	\$ 1,581	4.95%	60%	No	Yes	Constitutional
Georgia	\$ 1,544	4.97%	50%	No	No	None
Hawaii	\$ 2,839	8.62%	50%	Yes	No	Constitutional
Idaho	\$ 1,716	6.29%	50%	Yes	No	Statutory
Illinois	\$ 1,750	4.87%	50%	No	No	None
Indiana	\$ 1,810	5.90%	50%	No	No	None
Iowa	\$ 1,719	5.50%	50%	Yes	No	Statutory
Kansas	\$ 1,839	5.84%	50%	No	No	None
Kentucky	\$ 2,020	7.23%	50%	No	No	None
Louisiana	\$ 1,656	5.96%	67%	Yes	Yes	Part Constitutional, Part Statutory
Maine	\$ 2,066	6.81%	50%	No	No	None
Maryland	\$ 1,993	5.09%	50%	No	No	None
Massachusetts	\$ 2,427	5.77%	50%	No	Yes	Statutory
Michigan	\$ 2,257	6.90%	50%	No	Yes	Constitutional
Minnesota	\$ 2,649	7.18%	50%	No	No	None
Mississippi	\$ 1,717	6.97%	60%	Yes	No	Statutory
Missouri	\$ 1,512	4.83%	67%	No	Yes	Constitutional
Montana	\$ 1,621	5.93%	50%	Yes	No	Statutory
Nebraska	\$ 1,925	5.86%	50%	No	No	None
Nevada	\$ 1,842	5.64%	67%	Yes	No	Statutory
New Hampshire	\$ 1,521	4.11%	50%	No	No	None
New Jersey	\$ 2,308	5.38%	50%	Yes	No	Statutory
New Mexico	\$ 1,924	7.34%	50%	No	No	None
New York	\$ 2,114	5.45%	50%	No	No	None
North Carolina	\$ 1,885	6.37%	50%	Yes	No	Statutory
North Dakota	\$ 1,858	6.15%	50%	No	No	None
Ohio	\$ 1,806	5.67%	50%	Yes	No	Statutory
Oklahoma	\$ 1,682	6.15%	75%	Yes	No	Constitutional
Oregon	\$ 1,602	5.20%	60%	Yes	Yes	Part Constitutional, Part Statutory
Pennsylvania	\$ 1,875	5.42%	50%	No	No	None
Rhode Island	\$ 2,097	6.16%	50%	Yes	No	Constitutional
South Carolina	\$ 1,532	5.57%	50%	Yes	No	Constitutional
South Dakota	\$ 1,321	4.33%	67%	No	No	None
Tennessee	\$ 1,508	5.07%	50%	Yes	No	Constitutional
Texas	\$ 1,316	4.31%	50%	Yes	No	Constitutional
Utah	\$ 1,680	6.47%	50%	Yes	No	Statutory
Vermont	\$ 2,518	7.81%	50%	No	No	None
Virginia	\$ 1,756	4.97%	50%	No	No	None
Washington	\$ 2,114	5.92%	67%	Yes	No	Statutory
West Virginia	\$ 1,983	7.74%	50%	No	No	None
Wisconsin	\$ 2,227	6.82%	50%	No	No	None
Wyoming	\$ 2,428	7.24%	50%	No	No	None
District of Columbia (a)	\$ 6,217	13.07%	50%	No	No	None

(a) DC estimate based on quarterly data from Census Bureau.

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