

# BACKGROUND PAPER

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## State Business Tax Climate Index

By

Scott A. Hodge  
J. Scott Moody, M.A.  
Wendy P. Warcholik, Ph.D.

### Executive Summary

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

Most stories about how states compete for business revolve around the location decisions of sports franchises and famous international companies. States and cities routinely assemble and publicize generous packages of tax abatements and public spending to lure a large employer, whether it's the Montreal Expos, or a new auto plant or the corporate headquarters of a major firm. But under the media radar, each state's tax system is constantly competing with its neighbors for start-ups and business expansion.

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 2002 was 9.6 percent, and the state-specific estimates ranged around that average from 5.8 percent in Alaska to 12.8 percent in the

District of Columbia. These estimates include adjustments for the many complex ways that states shift tax burdens to non-residents, making them more significant than raw collection data for individuals and policymakers who are assessing their states' tax burdens.

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.

Business leaders and government policy-makers can use this new ranking of state tax systems, the State Business Tax Climate Index, as a comparative gauge of their state's tax system. Each score that a state receives on the various measures is determined not only by the state in question but by the competition—the other states. Policy-makers 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

*Table 1*  
*State Business Tax Climate Index, 2002*

	Total Score	Rank		Total Score	Rank
U.S.	5.97	–	South Carolina	5.81	26
Wyoming	8.30	1	Oklahoma	5.80	27
New Hampshire	8.05	2	Wisconsin	5.69	28
Nevada	7.91	3	New Mexico	5.58	29
Colorado	7.69	4	Rhode Island	5.55	30
Alaska	7.64	5	Maryland	5.53	31
South Dakota	7.63	6	North Dakota	5.43	32
Florida	7.41	7	Idaho	5.43	33
Washington	7.37	8	Utah	5.40	34
Oregon	7.20	9	Kentucky	5.37	35
Tennessee	7.04	10	Kansas	5.20	36
Indiana	7.04	11	Connecticut	5.11	37
Massachusetts	6.90	12	Iowa	5.10	38
Texas	6.75	13	West Virginia	5.10	39
Illinois	6.71	14	New Jersey	5.09	40
Delaware	6.58	15	Louisiana	4.87	41
Alabama	6.58	16	Minnesota	4.84	42
Arizona	6.46	17	Maine	4.83	43
Michigan	6.39	18	New York	4.80	44
Pennsylvania	6.38	19	Hawaii	4.73	45
Vermont	6.36	20	Nebraska	4.67	46
Virginia	6.36	21	Ohio	4.45	47
Montana	6.33	22	Arkansas	4.43	48
Missouri	5.89	23	California	4.36	49
North Carolina	5.85	24	Mississippi	3.97	50
Georgia	5.83	25	District of Columbia	4.55	–

**Note:** The higher the score, the more favorable the state's tax system is for business.

**Source:** Tax Foundation

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 state’s fiscal balance, and the administrative complexity of the state’s tax system as measured by its conformity with other systems. These five indexes are themselves composites of several sub-indexes.

Table 1 shows the overall results. The ten states that are deemed to have the most business-friendly tax systems are Wyoming, New Hampshire, Nevada, Colorado, Alaska, South Dakota, Florida, Washington, Oregon and Tennessee. On the other end of the spectrum, the ten tax systems least hospitable to business are found in Mississippi, California, Arkansas, Ohio, Nebraska, Hawaii, New York, Maine, Minnesota and Louisiana.

Generally speaking, states that rank highly manage without at least one of the major taxes. Indeed, Alaska scores well despite having the worst corporate tax system in the nation because it does not have either an individual income tax or a sales tax. Colorado has a “traditional” tax system that imposes a corporate income tax, an individual 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 input items; high overall state/local tax burdens that have grown faster than taxpayers’ incomes; and tax codes that impose considerable compliance costs and double-taxation on businesses.

## Introduction

In July 2002, New Jersey lawmakers attempted to close the state’s mounting budget gap by enacting legislation that effectively doubled taxes on corporations. Shortly after the tax increase was enacted, James M. Zimmerman, Chairman of Federated Department Stores (which owns Macy’s and Bloomingdales), wrote New Jersey Governor James E. McGreevey:

“Retailers such as Federated already are dealing with one of the most difficult economies in recent memory, and I can tell you unequivocally that we cannot and will not absorb a \$5.7 million New Jersey tax increase without taking commensurate measures to reduce expenditures there.”

Federated then announced that it would lay off 50 to 60 workers in New Jersey and possibly close a store or a distribution center to cut costs. In response to this news, the head of

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New York's largest business group wrote Zimmerman to encourage the retailer and other affected New Jersey businesses to redirect those jobs and investments to the Empire State, which had been cutting taxes to improve its business climate.

There are two lessons that state lawmakers should draw from this story:

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).
2. States do not enact tax changes (increases or cuts) in a vacuum. Every tax change will in some way change a state's competitive position relative to its immediate neighbors and the region. Ultimately it will affect the state's national standing as a place to live and do business. Entrepreneurial states can take advantage of the tax increases of their neighbors to lure businesses out of higher-tax states.

This year, dozens of states are facing mounting deficits, and the reflex of many lawmakers is to raise taxes in order to close these budget gaps.<sup>1</sup> While raising taxes may solve a state's budget-balancing problems in the short run, lawmakers must consider the long-term damage these actions can have on the state's business climate and economic health.

Clearly, there are many 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>2</sup>

Some of these factors are, of course, outside of the control of elected officials. For example, Montana lawmakers 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 micromanaged 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 less equally economic transactions are treated in the tax system, 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 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

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<sup>1</sup> Routinely mislabeled in the press as "the worst state fiscal crisis in 50 years," the current fiscal problems at the state level have been authoritatively proven by Martin Sullivan in *Tax Notes* to be less severe than those faced during the recession of 1990-91, and far less severe than during the 1981-82 recession.

<sup>2</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 such as the Heritage Foundation and *Wall Street Journal's* "2002 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 significant explanatory power helping to explain, for example, why businesses have moved from the Northeast and Midwest towards the South and West. In turn, they also found that high taxes have a negative effect on employment growth.

is probably the most effective restraint on state and local tax burdens. The State Business Tax Climate Index captures the impact of tax competition on economic neutrality in two ways. The first is a comparison of all the states' overall tax burdens. If any state imposes a greater overall tax burden 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 51 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 State Business Tax Climate Index deals with such questions by comparing the states on each aspect of their tax systems separately and then tiering 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 overall level can be compared to that in other states. In the end, both Alaska and Colorado are counted among the 10 states with the best business tax climates.

## **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, 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 will choose the community that best satisfies his particular demands. Individuals reveal their preferences by "voting with their feet."

Tiebout also suggested that citizens with high demands for public goods will 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. Tiebout maintained that this would lead to "equilibrium," or maximum efficiency, where no individual can be made better off by moving.

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 occurred through 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 give-aways 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

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than that of other factors such as labor supply and agglomeration economies.<sup>3</sup> 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 decision.” 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 and 1999) looked at the effect of excise tax differentials between states on cross-border shopping and smuggling of cigarettes and beer. His results, supported by the literature in both cases, showed significant cross-border shopping and smuggling between low-tax states and high-tax states.

Specifically, 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, “...in 1997, 18.1 million cases of beer, on net, moved from low- to high-tax states.” This amounted to some \$18.8 million in sales and excise taxes moving from high-to low-tax states.

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

## Factors Measured by the Index

The Tax Foundation’s State Business Tax Climate Index is constructed of five major indexes:

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

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 the five is made up of a series of sub-indexes, some of which include several variables. Overall, there are eighteen sub-indexes and thirty-two variables. The ranking of the states on each index is presented in Table 2.

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<sup>3</sup> Agglomeration is the term used by economists to describe a situation where an individual business is able to increase its economic efficiency by locating in an area with similar businesses. Software and computer firms enjoy agglomeration economies in Silicon Valley, for example.

### Major Index #1 – Corporate Income Taxes

The first of the five major 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.

To arrive at a measure of this impact, each state's corporate income tax code is examined, and four attributes of the code are assessed. The

*Table 2*  
*Major Components of the State Business Tax Climate Index, 2002*

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

**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

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.

The four aspects of a corporate income tax measured are: 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.

The four states with no corporate income tax—Nevada, South Dakota, Washington and Wyoming—have relieved businesses of the entire corporate income tax burden, not only of paying the taxes but of fulfilling all the administrative requirements. By doing so, these states greatly improve their business tax climates, and so they receive a perfect score.

Among those states that do tax corporate income, ten states with well-designed corporate income taxes are Alabama, Colorado, Florida, Georgia, Missouri, Oklahoma, South Carolina, Tennessee, Utah and Virginia. Each has a relatively low, single-rate system that establishes a comparatively neutral environment for business activity.

By contrast, Alaska has the lowest score because it has a multi-rate system with a high top rate of 9.4 percent. The other states rounding out the bottom five are North Dakota, Mississippi, Arkansas and Ohio. In general, these states have multi-rate systems with high top marginal tax rates. See Table 3 for other states' ranking.

### **Major Index #2 – Individual Income Taxes**

The individual income tax code in each state is also a major consideration for business. First, labor typically constitutes a majority of a business's total costs, 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 revenues are known to reduce both the quantity and quality of the labor pool. This fact was supported by Wasylenko and McGuire (1985) who found that income taxes affect businesses indirectly by first influencing the location decisions of individuals.

Second, individual income taxes are also an important consideration because a significant

number of businesses, including sole proprietorships, partnerships and S-Corporations report their income through the individual income tax code. Less neutral individual income tax systems, therefore, negatively impact a state's business tax climate.

Like the Corporate Income Tax Index, the Individual Income Tax Index is comprised of four sub-indexes: the states' top marginal tax rates, the starting points of their top brackets, the number of brackets and the average width of brackets.

The seven states without an individual income tax score a perfect 10. They are Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Both New Hampshire and Tennessee score a 9 because while they do tax interest and dividends, they exempt wages and salaries. Of those states that do have a broad-based individual income tax, Illinois, Indiana and Pennsylvania score highly because they have a single low tax rate.

On the other hand, Montana has the lowest score because it has eleven different tax rates

*Table 3  
Corporate Income Tax Index and Ranking, 2002*

State	Corporate Income Tax Index Ranking	Corporate Income Tax Index Score	State	Corporate Income Tax Index Ranking	Corporate Income Tax Index Score
U.S.	–	7.67	Montana	16	8.81
Alabama	5	9.00	Nebraska	45	4.95
Alaska	50	1.68	Nevada	1	10.00
Arizona	17	8.76	New Hampshire	37	6.91
Arkansas	47	3.88	New Jersey	29	8.25
California	28	8.29	New Mexico	34	8.04
Colorado	5	9.00	New York	21	8.63
Connecticut	21	8.63	North Carolina	17	8.78
Delaware	27	8.33	North Dakota	49	2.17
Florida	5	9.00	Ohio	46	4.78
Georgia	5	9.00	Oklahoma	5	9.00
Hawaii	42	5.53	Oregon	15	8.85
Idaho	23	8.60	Pennsylvania	35	8.00
Illinois	20	8.68	Rhode Island	29	8.25
Indiana	24	8.53	South Carolina	5	9.00
Iowa	40	6.23	South Dakota	1	10.00
Kansas	44	5.07	Tennessee	5	9.00
Kentucky	39	6.34	Texas	26	8.38
Louisiana	41	5.57	Utah	5	9.00
Maine	36	7.00	Vermont	43	5.47
Maryland	19	8.75	Virginia	5	9.00
Massachusetts	32	8.13	Washington	1	10.00
Michigan	38	6.49	West Virginia	31	8.25
Minnesota	33	8.05	Wisconsin	24	8.53
Mississippi	48	3.79	Wyoming	1	10.00
Missouri	14	8.94	District of Columbia	–	8.01

**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

**Table 4**  
**Individual Income Tax Index and Ranking, 2002**

State	Individual Income Tax Index Score	Individual Income Tax Index Ranking	State	Individual Income Tax Index Score	Individual Income Tax Index Ranking
U.S.	5.00	–	Montana	0.91	50
Alabama	3.33	28	Nebraska	3.11	33
Alaska	10.00	1	Nevada	10.00	1
Arizona	5.17	19	New Hampshire	9.00	8
Arkansas	2.36	41	New Jersey	3.18	30
California	1.99	44	New Mexico	2.39	38
Colorado	8.41	14	New York	2.67	35
Connecticut	4.14	22	North Carolina	4.40	21
Delaware	2.85	34	North Dakota	7.62	16
Florida	10.00	1	Ohio	3.57	27
Georgia	2.37	40	Oklahoma	1.70	45
Hawaii	1.40	47	Oregon	2.39	38
Idaho	1.62	46	Pennsylvania	9.00	8
Illinois	9.00	8	Rhode Island	5.91	18
Indiana	9.00	8	South Carolina	2.23	42
Iowa	1.40	47	South Dakota	10.00	1
Kansas	3.58	25	Tennessee	9.00	8
Kentucky	2.60	36	Texas	10.00	1
Louisiana	4.11	23	Utah	2.09	43
Maine	2.49	37	Vermont	6.55	17
Maryland	3.13	31	Virginia	3.13	31
Massachusetts	8.08	15	Washington	10.00	1
Michigan	8.82	13	West Virginia	3.31	29
Minnesota	3.96	24	Wisconsin	4.90	20
Mississippi	3.58	25	Wyoming	10.00	1
Missouri	1.39	49	District of Columbia	2.90	–

**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

with the nation’s highest top rate of 11 percent. The other states rounding out the bottom five are Missouri, Iowa, Hawaii and Idaho. See Table 4 for details.

### **Major Index #3 – Sales and Gross Receipts Taxes**

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 jurisdictions, causing lost profits, lost jobs and lost tax revenue. On the positive side, sales taxes levied at the final point of sale are not confused with price of goods by customers. The point-of-sale tax is therefore “transparent,” and it minimizes economic distortions.<sup>4</sup>

More detrimental to the business climate are sales taxes levied on business-to-business trans-

actions. When a business must pay sales taxes on raw materials, and then charge sales taxes when it sells the item those materials went into, 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.

The negative impact of sales and gross receipts taxes is well documented in the economic literature. For example, Bartik (1989) found that high sales taxes, especially sales taxes levied on equipment, had a negative effect on small business start-ups. Although the boost that a low sales tax rate provides to the business climate is effective throughout the state, it is most immediately apparent when a traveler crosses the state line from a neighboring state and sees the large expanses of shopping malls that typically spring up along the border.

The Sales and Gross Receipts Tax Index is comprised of two sub-indexes, the rate itself and five common categories of business-to-business transactions that may or may not be exempted: agricultural products, services, machinery, computer software, and leased or rented items.<sup>5</sup>

The five states without a sales or gross receipts tax—Alaska, Delaware, Montana, New Hampshire and Oregon—score a perfect 10. For states with a sales tax, Virginia has the highest score because it does a good job of avoiding tax pyramiding. Other states that do well on this index include Vermont, Alabama and Massachusetts. Except for Colorado, these states have average or slightly above-average tax rates, but they exempt many business input items from the tax.

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 8.709 percent, and it provides little relief from the problems of tax pyramiding. Joining Washington at the bottom are Mississippi, Connecticut, West Virginia and Minnesota. These states apply the sales tax to

<sup>4</sup> When a sales tax is levied at each stage of production instead of at the point of sale, it is known as a value-added tax (VAT). These are common abroad, but one has never been implemented in the United States at the federal or state level.

<sup>5</sup> Several states allow local governments the option of adding a sales tax to the state levy, the proceeds of which are used to meet local government needs. These local option sales taxes can be substantial and undoubtedly affect an area’s business climate, but they are not included in the State Business Tax Climate Index due to the complexity of accounting for the thousands of U.S. localities.

most or all business input items, and except for South Dakota, they have above-average tax rates. See Table 5 for details.

#### **Major Index #4 – State Fiscal Balance**

Quite apart from the statutory rates and tax bases in a state's tax code, which are measured by the first three 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 fourth component of the State Business Tax Climate Index is the State Fiscal Balance Index, which measures both the current tax burden and the likelihood of future tax law changes.

The simplest measure of the fiscal situation is the current size of the tax burden, which is defined as total state and local taxes paid by the state's citizens as a percentage of their total income. But more than just the current status, businesses need a sense of whether the fiscal situation is likely to change: will taxes be rising or falling? If state tax collections have grown faster than the incomes of its citizens over a period of many years, it is reasonable to assume that powerful forces in the state are pushing the growth of government, that this growth will continue, and that taxes will be rising in the future. Conversely, if income growth has consistently outpaced tax growth, the probability of future tax increases is lower.

New Hampshire scores the highest in this index with a 9.21. New Hampshire had a relatively low state and local tax burden of 6.9 percent of income in 2002, and over a ten-year period, income growth had outstripped tax growth by 3.28 percentage points. Rounding out the top five are Alaska, Oregon, Texas and Tennessee. They scored well because they did a better-than-average job of holding the line on tax growth relative to income growth, and they kept the overall tax burden low compared to the national average.

On the other end of the spectrum, Maine has the worst overall score on this index. The state's tax revenues grew 0.31 percentage points faster than its citizens' income, and its combined state and local tax burden commandeered 11.9 percent of state income in 2002. The states that round out the bottom five are California, Rhode Island, Connecticut and Ohio. These

**Table 5**  
*Sales and Gross Receipts Tax Index and Ranking, 2002*

State	Sales and Gross Receipts Tax Index Score	Sales and Gross Receipts Tax Index Ranking	State	Sales and Gross Receipts Tax Index Score	Sales and Gross Receipts Tax Index Ranking
U.S.	6.27	–	Montana	10.00	1
Alabama	7.45	9	Nebraska	5.79	29
Alaska	10.00	1	Nevada	5.43	35
Arizona	5.31	38	New Hampshire	10.00	1
Arkansas	5.32	37	New Jersey	5.73	30
California	5.73	30	New Mexico	4.73	45
Colorado	8.47	7	New York	7.02	14
Connecticut	4.43	48	North Carolina	6.96	15
Delaware	10.00	1	North Dakota	6.39	19
Florida	5.63	32	Ohio	5.49	34
Georgia	7.12	12	Oklahoma	7.12	12
Hawaii	4.88	43	Oregon	10.00	1
Idaho	6.46	17	Pennsylvania	5.30	39
Illinois	6.38	20	Rhode Island	4.94	42
Indiana	6.33	21	South Carolina	6.13	27
Iowa	6.29	22	South Dakota	5.25	40
Kansas	5.38	36	Tennessee	5.07	41
Kentucky	6.27	23	Texas	4.88	43
Louisiana	6.19	24	Utah	6.17	26
Maine	6.46	17	Vermont	7.66	8
Maryland	6.79	16	Virginia	8.62	6
Massachusetts	7.33	10	Washington	2.37	50
Michigan	5.60	33	West Virginia	4.53	47
Minnesota	4.67	46	Wisconsin	5.96	28
Mississippi	3.17	49	Wyoming	6.19	24
Missouri	7.13	11	District of Columbia	3.45	–

**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

states allowed their taxes to grow faster than their citizens' incomes, and they allowed their total tax burdens to stay high compared to the national average. See Table 6 for details.

#### **Major Index #5 – Tax Base Conformity**

The Tax Base Conformity Index, the fifth major component of the State Business Tax Climate Index, measures the degree to which each state's tax system conforms to other tax systems, especially the federal tax system. Today, a high percentage of the nation's businesses operate in more than one state. Naturally, if each state has its own unique tax rules and definitions, businesses face a much more onerous tax compliance burden than if states follow some standards, which they certainly can do without compromising their sovereign right to design their own tax systems. For example, states can reduce that compliance burden without constitutional problems by adjusting their tax bases to conform with the federal tax system and/or other states. Moody (2002) found that state-level tax compliance costs add to the overall tax burden already

**Table 6**  
*Fiscal Balance Index and Ranking, 2002*

State	Fiscal Balance Index Score	Fiscal Balance Index Ranking	State	Fiscal Balance Index Score	Fiscal Balance Index Ranking
U.S.	3.89	–	Montana	4.00	22
Alabama	4.11	19	Nebraska	3.81	25
Alaska	8.39	2	Nevada	4.10	20
Arizona	4.79	9	New Hampshire	9.21	1
Arkansas	3.44	34	New Jersey	4.54	11
California	1.91	49	New Mexico	3.94	24
Colorado	4.23	17	New York	2.82	41
Connecticut	1.95	47	North Carolina	3.36	36
Delaware	5.68	6	North Dakota	2.24	45
Florida	5.29	8	Ohio	2.09	46
Georgia	3.01	39	Oklahoma	3.48	33
Hawaii	3.61	30	Oregon	6.02	3
Idaho	3.18	37	Pennsylvania	4.04	21
Illinois	3.96	23	Rhode Island	1.92	48
Indiana	3.71	28	South Carolina	4.28	16
Iowa	4.65	10	South Dakota	4.34	15
Kansas	3.51	32	Tennessee	5.70	5
Kentucky	3.81	25	Texas	5.75	4
Louisiana	2.44	43	Utah	2.44	43
Maine	1.14	50	Vermont	4.40	14
Maryland	3.79	27	Virginia	4.22	18
Massachusetts	3.52	31	Washington	4.48	12
Michigan	4.45	13	West Virginia	3.03	38
Minnesota	3.44	34	Wisconsin	3.66	29
Mississippi	2.72	42	Wyoming	5.30	7
Missouri	2.98	40	District of Columbia	1.56	–

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

imposed on businesses, thereby exacerbating existing tax differentials among states.

It is important to note the difference between tax base conformity and tax harmonization. Tax harmonization, as typically understood today, is a convergence of tax rates (or sometimes tax burdens) established by different taxing jurisdictions. Tax harmonization limits tax competition but can be achieved without tax base conformity and therefore does not ensure simplicity in the administration of or compliance with multiple tax systems. Tax base conformity, on the other hand, achieves simplification without limiting tax competition.

Five sub-indexes combine to measure the complexity of each state’s tax code for business filers. One asks whether the state has resorted to an alternative minimum tax (AMT), a major flaw in itself but also a sure sign that the rest of the state’s tax code has reached a Byzantine level of complexity. The other four sub-indexes ask if the states recognize Limited Liability Corporations (LLCs) and S Corporations (S-Corps), if they allow consolidated filings,

if they have incorporated the Internal Revenue Code (IRC), and if they have adopted most of the regulations promulgated under the Uniform Division of Income for Tax Purposes Act (UDITPA) and the Multi-state Tax Commission (MTC).

The three states with neither an individual nor corporate income tax—Nevada, Washington and Wyoming—automatically score a perfect 10.<sup>6</sup> Among the states with one or both taxes, Alabama, Missouri, New Mexico, North Dakota and Oregon have the highest scores because they have generally incorporated the IRC and recognized LLCs and S Corps; they have no AMT, they allow consolidated filings, and they have adopted most of the regulations promulgated under UDITPA and the MTC.

By contrast, New York has the lowest score because it has not incorporated the IRC, only partially recognizes LLCs and S Corps, imposes an AMT, does not allow consolidated filings and has adopted few UDITPA and MTC regulations. Other states scoring poorly on the Tax Base Conformity Index for similar reasons include New Jersey, California, Minnesota and Texas.

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

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

- **Corporate Income Tax Index:** The four states without a corporate income tax are all in the top ten most business-friendly tax systems. Colorado, Florida, Oregon and Tennessee make the top 10, in part because they have single-rate systems with relatively low rates. Alaska and New Hampshire are the only states in the top ten with multiple-rate systems and a high top tax rate. Alaska ranks as the fifth-best tax system overall,

<sup>6</sup> South Dakota has been excluded (see Footnote 8).

despite having the worst corporate tax code in the nation.

- **Individual Income Tax Index:** Of the seven states without an individual income tax, Texas is the only state not in the top ten overall. Colorado has a low, flat rate, and New Hampshire and Tennessee tax only dividend and interest income. Oregon is the only state in the top ten with a poor score on the Individual Income Tax Index.
- **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. Of those states with a sales tax, Colorado received the best score. It has the lowest rate and does a good job of avoiding the problem of tax pyramiding. Washington has both a general sales tax and a gross receipts tax, and therefore receives the lowest score. Despite the poor score on this index, Washington's tax system still gives its businesses the eighth best business tax climate in the nation.
- **Fiscal Balance Index:** Nine of the top ten states kept their total tax burdens below the national average of 9.6 percent of total state income in 2002. Washington's tax burden, at 9.7 percent of income, is slightly above. All states in the top ten kept their tax burdens relatively stable as a percentage of income.
- **Tax Base Conformity Index:** Most of the states in the top ten conformed well to the federal tax code, did not impose an AMT, and recognized LLCs and S-Corps. Of the top ten, only Tennessee and New Hampshire scored below average on the Tax Base Conformity Index.

Generally speaking, states in the top ten 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 having the worst corporate tax system in the nation because it does not have either an individual income tax or a sales tax. By keeping all of its taxes simple and at low rates, Colorado is the only state in the top ten that imposes all three.

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

**Table 7**  
*Tax Base Conformity Index and Ranking, 2002*

State	Tax Base Conformity Index	Rank	State	Tax Base Conformity Index	Rank
U.S.	7.01	–	Montana	7.92	15
Alabama	9.00	4	Nebraska	5.69	40
Alaska	8.13	14	Nevada	10.00	1
Arizona	8.26	12	New Hampshire	5.14	45
Arkansas	7.15	25	New Jersey	3.75	49
California	3.89	48	New Mexico	8.82	6
Colorado	8.33	11	New York	2.85	50
Connecticut	6.39	34	North Carolina	5.76	39
Delaware	6.04	37	North Dakota	8.75	7
Florida	7.15	25	Ohio	6.32	36
Georgia	7.64	19	Oklahoma	7.71	17
Hawaii	8.19	13	Oregon	8.75	7
Idaho	7.29	23	Pennsylvania	5.56	41
Illinois	5.56	41	Rhode Island	6.74	30
Indiana	7.64	19	South Carolina	7.43	21
Iowa	6.94	28	South Dakota	8.54	9
Kansas	8.47	10	Tennessee	6.46	33
Kentucky	7.85	16	Texas	4.72	46
Louisiana	6.04	37	Utah	7.29	23
Maine	7.08	27	Vermont	7.71	17
Maryland	5.21	44	Virginia	6.81	29
Massachusetts	7.43	21	Washington	10.00	1
Michigan	6.60	31	West Virginia	6.39	34
Minnesota	4.10	47	Wisconsin	5.42	43
Mississippi	6.60	31	Wyoming	10.00	1
Missouri	9.00	4	District of Columbia	6.81	–

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

- |                 |               |
|-----------------|---------------|
| 50. Mississippi | 45. Hawaii    |
| 49. California  | 44. New York  |
| 48. Arkansas    | 43. Maine     |
| 47. Ohio        | 42. Minnesota |
| 46. Nebraska    | 41. Louisiana |

Here are some of the typical characteristics of these states' tax systems:

- **Corporate Income Taxes:** The majority of states in the bottom ten have complex, multi-rate tax systems. Three of them—New York, California and Minnesota—get credit for having a single-rate system, but they have above-average rates.
- **Individual Income Taxes:** These states all have multiple brackets and high top tax rates. The top rates in states such as California, Hawaii and Maine are among the highest in the nation. States with an excessive number of tax brackets include: Hawaii, Ohio, Arkansas, California and New York.
- **Sales and Gross Receipt Taxes:** The ten states with the worst overall business tax climate tend to have average to above-average sales

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tax rates and a greater-than-average level of tax pyramiding. Minnesota, Hawaii and Mississippi have the worst scores on the Sales and Gross Receipts Tax Index. New York and Maine are the only bottom-ten states to rank above the average in this category. New York in particular, has a below-average rate (4 percent) that exempts many business inputs.

- **Fiscal Balance:** Of the 10 states with the worst overall business tax climates, four actually grew their incomes faster than their taxes: Hawaii, Minnesota, Nebraska and New York. Of these, Hawaii, Minnesota and New York were weighted down by poor scores on their overall tax burdens. Nebraska's tax burden is moderate but was forced into the bottom ten by poor scores on the other indexes.
- **Tax Base Conformity:** All of the states at the bottom of the State Business Tax Climate Index are marked by below-average conformity with the federal tax code. Most levy an AMT, and few allow consolidated filings or recognize LLCs and S-Corps. Mississippi, New York, Louisiana, Ohio, California and Maine are among the worst on this measure.

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 input items; high overall state tax burdens and revenues that have grown faster than citizens' incomes; and tax codes that impose considerable compliance costs on businesses.

## Conclusion

The purpose of the Tax Foundation's State Business Tax Climate Index is to aid business leaders and government policy-makers in their determination of whether a state's tax system enhances or harms 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.

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# Detailed Results of the Major Tax Indexes

## The Corporate Income Tax Index

The Corporate Income Tax index measures the “tax impact” of a state’s corporate income tax system on the “marginal” dollar earned by incorporated businesses—or, put simply, 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).

Corporations pay many types of taxes, and the most common is the corporate income tax (See Table 8). However, some states levy other taxes on corporations, such as the franchise tax and capital stock tax. Many of these are “wealth taxes” with a tax base consisting of capital assets, stocks and property. This edition of the State Business Tax Climate Index does not take these “wealth taxes” into account unless that tax base closely resembles that of a traditional corporate income tax, as is the case with Texas’s franchise tax.<sup>7</sup>

Of course, a state’s corporate income tax is levied in addition to the federal corporate tax rate of 35 percent, which is already higher than the corporate income tax rate in many industrial nations. In some states, these federal and state corporate tax rates can combine to make the combined corporate tax rate higher than in any nation.

There are four states without a corporate income tax – Nevada, South Dakota,<sup>8</sup>

Washington and Wyoming. These states automatically score a perfect 10 for this major index. Therefore, this section ranks the remaining 46 states relative to each other.

## Sub-Index #1: The Top Rate

This sub-index measures the top statutory rate at which corporate income can be taxed within each state.

Iowa’s 12 percent top corporate tax rate qualifies the state for the worst ranking in this category. Other states with exceptionally high top corporate tax rates include: 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<sup>9</sup> (9.5 percent); Alaska (9.4 percent); New Hampshire<sup>10</sup> (9.25 percent); New Jersey and West Virginia (9 percent); Maine (8.93 percent); and California (8.84 percent).

By contrast, Michigan’s top tax rate of 2 percent qualifies it for the best score among states with a corporate income tax.<sup>11</sup> Other states with relatively low top corporate income tax rates include: Texas (4.5 percent); Colorado (4.63 percent); Alabama (5 percent); Mississippi (5 percent); South Carolina (5 percent); and Utah (5 percent).

## Sub-Index #2: The Top Tax Bracket

This sub-index measures how soon a state’s tax system applies its highest corporate income tax rate. If the top rate (see previous sub-index) 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.

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<sup>7</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” which is currently beyond the scope of the index. As a result, Texas’s Corporate Income Tax Index score is based on the 4.5 percent earned surplus tax.

<sup>8</sup> South Dakota does levy a corporate income tax on financial institutions. While the tax is not expansive enough to be included in the Corporate Income Tax Index, it does affect South Dakota’s score in the Tax Base Conformity Index.

<sup>9</sup> Massachusetts has a corporate excise tax which consists of two parts: a corporate income tax and a corporate franchise tax. The corporate income tax is levied on corporate profits and has a rate of 9.5 percent (including a 14-percent surtax). The corporate franchise tax is levied on taxable Massachusetts property or net worth and has a rate of 0.26 percent. The 0.26 percent corporate franchise tax is essentially a “wealth tax” which is currently beyond the scope of the index. As a result, Massachusetts’s corporate income tax index score is based solely on the 9.5 percent corporate income tax.

<sup>10</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 over 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.

<sup>11</sup> Michigan has a Single Business Tax (SBT) which is levied on gross receipts. Instead of being classified as a gross receipts tax, the index treats the SBT as a corporate income tax since it has an effective income exemption of \$295,000 (only applies to businesses with more than \$250,000 in receipts and has a \$45,000 deductible).

One of the challenges of creating any index is comparing starkly different systems. This sub-index exemplifies this challenge because it compares the top bracket of multiple-rate systems with the “top bracket” of single-rate systems. On the one hand, this sub-index is intended to measure how punitive a state’s tax structure is, assuming that the lower the income level at which a state’s top tax rate kicks in, the worse off taxpayers are because more of their income is subject to that higher rate.

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 income.<sup>12</sup> 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 sub-index include: Alaska (the 9.4 percent top rate begins at \$90,000); Arkansas (the 6.5 percent top rate begins at \$100,000); Nebraska (the 7.81 percent top rate begins at just \$50,000); New Hampshire (the 9.25 percent rate begins at \$150,000); North Dakota (the 10.5 percent rate begins at \$50,000); and Ohio (the 8.5 percent top rate begins at just \$50,000).

### **Sub-Index #3: 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 sub-index is intended to measure the disincentive effects the corporate income tax has on rising incomes.

States that score the best on this index are the 31 states and the District of Columbia that have a single-rate system. Alaska’s 10-bracket system qualifies the state for the worst score in this category. Other states with multi-bracket systems include Arkansas, North Dakota, Kentucky and Louisiana.

### **Sub-Index #4: The Average Width of Brackets**

This sub-index measures the average width of the brackets within the corporate income tax structure of each state. The wider the brackets, the less marginal rates interfere with economic decision-making and the less total income is subject to the higher rates. Therefore, the wider a state’s brackets, the better it scores on this sub-index.

Once again, the 31 states and the District of Columbia with single-rate systems score best on this sub-index. Among states with multiple-bracket systems, states that score well on this sub-index are Iowa and Maine, with four brackets spanning \$250,000 in income for an average bracket width of \$83,333. On the other hand, Mississippi scores worst in this sub-index with an average bracket width of only \$5,000. Alaska also scores poorly with an average bracket width of only \$10,000. North Dakota’s brackets are just \$12,000 wide, and Arkansas’s average just \$20,000.

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

It is well established in the economic literature that businesses locate more readily in jurisdictions with low tax burdens, whether measured by money paid or time spent complying. Therefore, the four states without a corporate income tax—Nevada, South Dakota, Washington and Wyoming—automatically receive a perfect score for this sub-index.

Nine states were “constrained” to a score of 9 (see methodology section): Alabama, Colorado, Florida, Georgia, Oklahoma, South Carolina, Tennessee, Utah and Virginia.

By contrast, Alaska has the lowest score because it has a multiple-rate system that has a high top rate of 9.4 percent that kicks in at a low level of income. The other states rounding out the bottom five are North Dakota, Mississippi, Arkansas and Ohio. In general, these states have steeply progressive tax systems with high top marginal tax rates.

## **The Individual Income Tax Index**

The Individual Income Tax Index measures the economic impact of a state’s tax system in two

<sup>12</sup> Alabama, Arizona, California, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, New Jersey, New York, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Virginia, West Virginia and Wisconsin.

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ways. First, it gauges the impact of individual income taxes on the labor pool available to all businesses. The extent of taxation can expand or contract the quantity and quality of the labor pool (Wasylenko and McGuire, 1985).

The measure of taxation's impact is important because people make economic decisions based on the value—often measured by economists in monetary terms—of their time.

For example, suppose John had to choose between one hour of additional work worth \$10 or one hour of leisure which to him is worth \$9.50. John, being a rational person, would choose to work for another hour. Now suppose there were a 10-percent income tax rate, in which case the after-tax value of labor would fall to \$9. As a result, the additional hour of work (\$9) is now less valuable than the hour of leisure (\$9.50). John would stop working and take the hour to pursue leisure. In the aggregate, the income tax has reduced the available labor supply.<sup>13</sup>

From a business perspective, a shrinking labor pool—due to the decreasing value of work because of income taxes—increases labor costs to businesses 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 is continually reducing 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 file no corporate tax returns, but instead report their business income on individual tax returns, their business climate is directly affected by the individual side of the

code in the same way that C-Corporations are affected by corporate income taxes.

Overall, the Individual Income Tax index is a composite of four sub-indexes that measures the tax impact on the marginal dollar of income: the top rate, the top bracket, the number of brackets, and the average width of brackets. The index treats standard deductions and exemptions as a zero percent tax rate—see Note on Standard Deduction and Exemptions below. The rates and brackets used are for a single taxpayer, not a couple filing a joint return.<sup>14</sup>

The index compares the 43 states that do have individual income taxes. It does not include the seven states that do not have an individual income tax—Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. These states automatically receive a perfect 10 on the Individual Income Tax Index.

#### **Sub-Index #1: 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: Rhode Island<sup>15</sup> (9.65 percent); Vermont (9.5 percent); California (9.3 percent); the District of Columbia (9.3 percent); and Oregon (9.0 percent).

Among those states with the lowest rates, New Hampshire (1 percent) and Tennessee (1.2 percent) score the best.<sup>16</sup> Other states with relatively low top rates include: Alabama (5.0 percent); Connecticut (4.5 percent); Illinois (3.0 percent of federal AGI); Indiana (3.4 percent of federal AGI); and Pennsylvania (2.8 percent).

#### **Sub-Index #2: The Top Tax Bracket**

North Dakota, Rhode Island and Vermont score the best within this category because their top income tax rates begin to kick in at \$314,750. The states that score the worst within this category include Alabama and Maryland because

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<sup>13</sup> For a more detailed explanation, see Fleenor and Moody (1999).

<sup>14</sup> In most 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.

<sup>15</sup> Rhode Island's top tax rate is computed as 25 percent of the top federal tax rate of 38.6 percent, or 9.65 percent.

<sup>16</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 if wages and salaries were also included. Nationally, dividends and interest account for 20 percent of income (wages, salaries, dividends and interest). For New Hampshire, its 5 percent rate was multiplied by 20 percent yielding the equivalent rate of 1 percent. For Tennessee, this calculation yielded an equivalent rate of 1.2 percent.

their top income tax rates kick in at \$6,500 and \$6,850 of taxable income.

### **Sub-Index #3: The Number of Brackets**

New Hampshire and Tennessee score the highest in this category by having only one tax bracket. High-scoring states that effectively have only two brackets are Colorado, Illinois, Indiana, Massachusetts and Michigan (see Note on Standard Deductions and Exemptions below). On the other end of the spectrum are Missouri and Montana which both score the lowest in this category 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 (9 brackets).

### **Sub-Index #4: The Average Width of Brackets**

North Dakota scores the best in this category with an average bracket width of \$62,950. Other high scoring states include Vermont (\$62,010) and Rhode Island (\$52,458). The state that scored the lowest was Oklahoma, which has an average bracket width of only \$1,625. Other low scoring states include Utah (\$1,746) and Georgia (\$2,000).

### **Note on Standard Deductions and Exemptions**

From an economic perspective, the standard deduction 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 previous 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. 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. From an economic perspective, however, Kansas's top rate 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>17</sup> Connecticut has the largest standard deduction and exemptions (\$10,196).<sup>18</sup> Mississippi has the second highest (\$8,300) while a number of states tie for third by conforming to the federal system of \$7,700 (in 2002): 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.

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

The seven states without an individual income tax automatically score a perfect 10—Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Five states were “constrained” to a 9 (see methodology section): Illinois, Indiana, New Hampshire, Pennsylvania and Tennessee. On the other hand, Montana has the lowest score because it has a steep multi-rate system with a high top rate of 11 percent.

## **The Sales and Gross Receipts Tax Index**

The Sales and Gross Receipts Tax Index measures two important traits of state taxes on consumption, the statutory rate and the extent of “tax pyramiding.”

1. The tax rate itself is important. 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. Obviously, fewer consumers would mean less business.

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<sup>17</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, the tax credit is converted to an equivalent income exemption by dividing the tax credit by the tax rate which corresponds to the estimated 2002 median income of \$28,789 in income. For example, California's \$79 tax credit exemption is the equivalent of an income exemption of \$988 (\$79 divided by 6 percent). Other states with transformed tax credits include Arkansas, Delaware, Iowa, Kentucky, Nebraska and Oregon.

<sup>18</sup> In Connecticut, taxpayers receive a declining exemption and a personal tax credit. The exemption starts at \$12,500 for taxpayers with AGI less than \$25,000, then declines and reaches \$0 when AGI exceeds \$37,000. After this calculation, the taxpayer determines his tax liability and deducts a personal tax credit. For taxpayers with AGI between \$12,500 (beneath which liability is zero) and \$15,600, the personal tax credit reduces liability by 75 percent. The percentage reduction declines as income rises, and reaches zero when AGI exceeds \$54,500. The reported value in the tax climate index assumes a taxpayer with the national estimated 2002 median income of \$28,789. At this income, a taxpayer's exemption is worth \$8,500, leaving tax liability of \$763. The personal tax credit at this income is worth 10 percent of the tax liability or \$76.30. Following the methodology discussed in Footnote 17, the tax credit is translated into an income exemption of \$1,696. As a result, the index uses the combined exemption value of \$10,196 (\$8,500 + \$1,696).

2. States that only tax business-to-consumer transactions minimize market distortions. Therefore, this index also measures the extent to which business-to-business sales are subject to the sales tax.<sup>19</sup>

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>20</sup> Economic distortions occur when sales taxes are levied on business-to-business transactions. In economic terms this is called tax pyramiding.

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. 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 were able to pass the entire tax on flour

forward to the consumer, but the pizza shop down the street could not. 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.

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. As a result, states with a gross receipts tax score poorly in the Sales and Gross Receipts Tax Index. States that rely entirely on a gross receipts tax are Hawaii, New Mexico<sup>21</sup> and South Dakota<sup>22</sup>, all of which score poorly. Washington is the only state that levies both gross receipts tax with no exemptions and a sales tax.<sup>23</sup>

### **Sub-Index #1: The Sales Tax Rate**

This sub-index measures the highest possible sales tax disincentive to in-state retail shopping and business-to-business transactions. Five states, Alaska, Delaware, Montana, New Hampshire and Oregon, do not have a general sales tax. For the remaining 45 states, sales taxes range from 2.9 percent in Colorado to 7 percent imposed by Mississippi, Rhode Island and Tennessee. The median sales tax rate is 4.95 percent.

Mississippi, Rhode Island and Tennessee have

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<sup>19</sup> In some cases, transactions that appear to be business-to-business turn out to be business-to-consumer. For example, a hobby farmer will need 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 not accounted for in this sub-index.

<sup>20</sup> Sales taxes that are levied on stages of production are known as value-added taxes (VAT) and are often used abroad, but not in the United States.

<sup>21</sup> New Mexico's score is improved by its exclusion for farmers and ranchers.

<sup>22</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>23</sup> Many states levy limited gross receipts taxes, usually on public utilities.

<sup>24</sup> Washington has the worst top tax rate score because its derived rate is 8.7 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.

the highest statutory rates and two of the worst scores.<sup>24</sup> Minnesota and Nevada are next with a sales tax of 6.5 percent, followed by Illinois and Texas who impose a sales tax of 6.25 percent.

At the low end, no state comes close to Colorado's 2.9 percent rate. Seven states, however, have a 4 percent sales tax – Alabama, Georgia, Hawaii,<sup>25</sup> Louisiana, New York, South Dakota and Wyoming.

#### **Sub-Index #2: Sales Tax Base**

This sub-index measures to what extent states tax business-to-business transactions by examining whether a state exempts certain categories of intermediate goods and services. It consists of five variables: application to agricultural inputs, application to service inputs, application to manufacturing and machinery inputs, application to computer and software inputs and application to leasing and rental inputs. Each variable has two or more components.

##### **Variable #1: Application to Agricultural Inputs**

This variable measures the extent to which the sales tax is applied to products used by agricultural businesses.

- insecticides and pesticides
- fertilizer, seed and feed
- seedlings, plants and shoots

##### **Variable #2: Application to Service Inputs**

This variable measures the extent to which the sales tax is applied to sales made by service-oriented businesses.

- cleaning services
- transportation services
- repair services
- professional/personal services
- other services

These components 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.

##### **Variable #3: Application to Manufacturing and Machinery Inputs**

This variable measures the extent to which the sales tax is applied to products used by manufacturing and machinery businesses.

- manufacturing machinery
- utilities
- farm machinery
- raw material
- office equipment

##### **Variable #4: Application to Computer and Software Inputs**

This variable measures the extent to which the sales tax is applied to products used by computer and software businesses.

- custom software
- modified canned software
- downloaded software

##### **Variable #5: Application to Leasing and Rental Inputs**

This variable measures the extent to which the sales tax is applied to products used by leasing and rental businesses.

- motor vehicles
- rooms and lodging
- other tangible property

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

The five states without a sales or gross receipts tax automatically score a perfect 10: Alaska, Delaware, Montana, New Hampshire and Oregon. For states that tax consumption with one of these taxes, 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 Colorado, Vermont, Alabama and Massachusetts.

Washington has the lowest score because it has both a retail sales tax and gross receipts tax. Joining Washington at the bottom are Mississippi, Connecticut, West Virginia and Minnesota.

<sup>25</sup> 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 2002 at 3.034 percent, a rate that will fall in future years as the phase-in progresses.

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## The State and Local Fiscal Balance Index

The State and Local Fiscal Balance Index<sup>26</sup> measures the fiscal balance within each state, defined as the size of the total tax burden, and the likelihood of future tax hikes. The probability and potential magnitude of future tax changes is determined by comparing the ten-year trends of tax growth and income growth. Any tax law changes would shift the relative state and local tax burden differentials between states, which would in turn affect future business relocations (Papke and Papke, 1986).

### **Sub-Index #1: Tax Growth vs. Income Growth**

This sub-index compares the ten-year average income growth rate with the ten-year average tax growth rate. Where tax growth has exceeded income growth, it is assumed this will continue, indicating the likelihood of future tax increases. Where the rate of income growth has routinely exceeded the rate of tax growth, current tax revenue is presumed to be meeting spending priorities, thereby reducing the probability of future tax increases.

New Hampshire did the best with income outpacing tax revenues by 3.28 percentage points over the ten-year period. During most of the past ten years, tax growth outstripped income growth in the majority of the states. But in 2002, income nationwide grew 0.47 percent faster than state and local tax burdens, and in only 15 states did tax burdens outgrow income. The worst state on this sub-index is Louisiana where income lagged behind tax revenue by 0.74 percentage points over the ten years from 1992 to 2002. Fourteen states saw their tax revenue rise faster than incomes: Alabama, Arkansas, California, Connecticut, Georgia, Maine, Mississippi, Missouri, North Dakota, Ohio, Oklahoma, Rhode Island, Utah and West Virginia.

### **Sub-Index #2: State and Local Tax Burdens as a Percentage of Income**

The specter of a tax increase in any given state could be tempered by the fact that the government itself is a small burden on the state's economy.

This sub-index is based on the Tax Foundation's annual Tax Freedom Day report which has

proven to be a reliable indicator of the combined state and local tax burdens over time.

At the high end of the index, the District of Columbia tops all states with a "state and local" tax burden of 12.8 percent of income in 2002, though the District is not strictly comparable to states since it combines state and local functions in one entirely urban jurisdiction. States that had exceptionally high state and local tax burdens in 2002 include: Maine (11.9 percent), New York (11.9 percent), Rhode Island (10.8 percent), Hawaii (10.6 percent) and Wisconsin (10.6 percent).

At the bottom end of the tax burden index, Alaska is the lowest with a state and local tax burden of 5.8 percent in 2002. Of course, Alaska is able to shift much of its tax burden out of state through the severance taxes it imposes on the extraction of oil. Other states with relatively low tax burdens include: New Hampshire (6.9 percent), Delaware (7.3 percent), Tennessee (7.5 percent), Texas (8.3 percent) and Alabama (8.3 percent).

### **Results of the State and Local Fiscal Balance Index**

New Hampshire has the highest score of 9.21 in this index, with income growth outstripping tax growth by 3.28 percentage points and a low state and local tax burden of 6.9 percent. Other states such as Alaska, Oregon, Texas and Tennessee scored well because they held the line on tax growth relative to income growth and they kept the overall tax burden relatively stable.

On the other hand, Maine has the worst score on the Fiscal Balance Index. The state's tax revenues grew 0.31 percentage points faster than its income over the past ten years, and its state and local tax burden commandeered 11.9 percent of state income in 2002. The states that round out the bottom five are California, Rhode Island, Connecticut and Ohio.

## The Tax Base Conformity Index

The Tax Base Conformity index measures the degree to which a state's tax system conforms to other tax systems, such as the federal tax system or other states' tax systems. In today's economy, business is becoming increasingly multi-state in nature. As a result, businesses are being subject-

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<sup>26</sup> Because localities perform tax and spending functions that are handled at the state level in other states, the State and Local Fiscal Balance Index combines state and local tax burdens to maintain consistency across states.

ed to numerous tax systems. Naturally, if each state has its own unique tax rules and definitions, businesses face a tremendous tax compliance burden. However, states can reduce that compliance burden by amending their tax code to conform to the federal tax system and/or to each other.

### **Sub-Index #1: Incorporation of Internal Revenue Code**

This first component of the Tax Conformity Index determines whether or not the state has adopted the Federal Internal Revenue Code (IRC) as the starting point for its tax system. At least to some degree, most states have adopted the federal IRC as their corporate income tax base. The exceptions are Arkansas and New Jersey who have not incorporated the IRC. These two states score the worst for this sub-index.

The states that have only partially adopted the federal IRC, and thus receive an average score for this sub-index, are California, Hawaii, Mississippi, Montana, New York and Pennsylvania.

### **Sub-Index #2: 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 full blown corporation, which may be beyond the means or needs of the business. They also are taxed as individuals, which avoids the double-taxation problems that plague the corporate income tax system. Every state recognizes LLCs or S-Corporations to at least some degree.

### **Sub-Index #3: 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 both the standard individual and corporate income tax systems. 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.

Thirty-six states have neither an individual nor corporate AMT. Nine states have just one of the two and received a median score. They are Alaska, Colorado, Connecticut, Florida, Maryland, Nebraska, Rhode Island, West Virginia and Wisconsin. The five states that impose both a corporate and an individual AMT, and do most poorly, are California, Iowa, Maine, Minnesota and New York.

### **Sub-Index #4: Consolidated Filings**

Consolidated filings allow a group of affiliated corporations to file a single tax return. Naturally, this reduces the tax compliance burden of having to file different tax forms in multiple jurisdictions. There are 26 states and the District of Columbia that allow consolidated filings.

### **Sub-Index #5: UDITPA and MTC Regulations Adoption**

The Uniform Division of Income for Tax Purposes Act (UDITPA) was designed by the Commissioners on Uniform State Laws and the American Bar Association to encourage states to enact income allocation and apportionment rules that are uniform. The Multi-state Tax Commission (MTC) regulations interpret the UDITPA provisions. The adoption of uniform regulations between states encourages businesses to expand across state lines and facilitates inter-state business transactions.

Of those states with some form of an income tax, Connecticut, New Jersey, Virginia and West Virginia have not adopted UDITPA or MTC regulations. By contrast, Colorado is the only state to have adopted all UDITPA and MTC regulations. All other states have adopted some part of these regulations.

### **Tax Conformity Sub-Index #6: Corporate and Individual Double Taxation**

Double taxation occurs when the same income is taxed twice. This needlessly increases corporate tax burdens and can provide an incentive to reduce economic activity in a double-taxation state. This index measures the extent of double taxation on income used to pay foreign, federal and state taxes. States can avoid double taxation by allowing the deduction of foreign, federal and state taxes paid to other jurisdictions. Only Louisiana allows full deductibility on both the corporate and individual income tax. Most states do little to prevent double-taxation, especially on the corporate side.

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## **Results of the Tax Base Conformity Index**

The three states with neither an individual nor a corporate income tax, Nevada, Washington and Wyoming, automatically score a perfect 10. Two states, Alabama and Missouri, are “constrained” at 9 (see methodology section). New Mexico rounds out the top five. These states have the highest scores because they have generally incorporated the IRC, recognized LLCs and S-Corps, have no AMT, allow consolidated filings, have adopted most of the UDITPA and MTC regulations and provide some relief from double-taxation.

By contrast, New York has the lowest score because it has not incorporated the IRC, only partially recognizes LLCs and S-Corps, imposes an AMT, does not allow consolidated filings, has adopted few UDITPA and MTC regulations and provides little relief from double-taxation. Other states scoring poorly for this sub-index for similar reasons include New Jersey, California, Minnesota and Texas.

## **Methodology**

### **Index Weights**

The State Business Tax Climate Index weights every major index equally, and within each major index, each sub-index is weighted equally.

### **Relative vs. Absolute Indexing**

The 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 sales tax, the rate ranges from a low of 2.9 percent to a high of 8.709 percent. The District of Columbia has tax rate of 5.75 percent, which is close to the middle of the range, giving D.C. a sub-index score of 5.09. Rhode Island has a sales tax rate of 7 percent, yielding a much lower score of 2.94, while Virginia has a sales tax rate of 3.5 percent, yielding a much higher score of 8.97. Since lower sales tax rates provide a better business climate, a rate of 2.9 percent receives the highest sub-index score of 10 (Colorado), and a rate of 8.709 percent receives the lowest index score of 0 (Washington).

Many states’ tax rates and burdens 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 state has the best tax system relative to its neighbors. 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. The index approaches this problem by creating sub-indexes designed to compare the tax systems of states with a given tax. For example, the four corporate sub-indexes compare the corporate income tax systems of the 46 states that have a corporate income tax. States without a corporate income tax system automatically score a perfect 10 in the major index.

Because the sub-indexes use the same 0 to 10 scale as the major index, it is theoretically possible, though unlikely, for a state with a corporate income tax to score a perfect 10, the same score awarded to a state without the tax. Common sense would tell us that no matter how well a state designs a sales or income tax, it will impose a greater burden on economic activity and job creation than a state that dispenses with that tax entirely. As there is no simple mathematical answer to this fundamental problem, we have constrained the top major index score of states with a given tax to a 9. Only states without a given tax are permitted to score a perfect 10 in the major index.

In the Individual Income Tax Index, five states are constrained—Illinois, Indiana, New Hampshire, Pennsylvania and Tennessee. In the Corporate Income Tax Index, nine states are constrained—Alabama, Colorado, Florida, Georgia, Oklahoma, South Carolina, Tennessee, Utah and Virginia. No state is constrained in the Sales and Gross Receipts Tax index. In the Tax Base Conformity Index, two states are constrained, Alabama and Missouri.

# Appendix

**Table 8**  
*State Corporate Income Tax Rates (Effective as of December 31, 2002)*

State	Rates	Brackets	State	Rates	Brackets	State	Rates	Brackets
Alabama	5%	> \$ 0	Kansas	4%	> \$ 0	New York	7.5%	> \$ 0
Alaska	1%	> \$ 0		7.35%	> \$ 50K	North Carolina	6.9%	> \$ 0
	2%	> \$ 10K	Kentucky	4%	> \$ 0	North Dakota	3%	> \$ 0
	3%	> \$ 20K		5%	> \$ 25K		4.5%	> \$ 3K
	4%	> \$ 30K		6%	> \$ 50K		6.0%	> \$ 8K
	5%	> \$ 40K		7%	> \$ 100K		7.5%	> \$ 20K
	6%	> \$ 50K		8.25	> \$ 250K		9%	> \$ 30K
	7%	> \$ 60K	Louisiana	4%	> \$ 0		10.5%	> \$ 50K
	8%	> \$ 70K		5%	> \$ 25K	Ohio	5.1%	> \$ 0
	9%	> \$ 80K		6%	> \$ 50K		8.5%	> \$ 50K
	9.4%	> \$ 90K		7%	> \$ 100K	Oklahoma	6%	> \$ 0
Arizona	6.968%	> \$ 0		8%	> \$ 200K	Oregon	6.6%	> \$ 0
Arkansas	1%	> \$ 0	Maine	3.5%	> \$ 0	Pennsylvania	9.99%	> \$ 0
	2%	> \$ 3K		7.93%	> \$ 25K	Rhode Island	9%	> \$ 0
	3%	> \$ 6K		8.33%	> \$ 75K	South Carolina	5%	> \$ 0
	5%	> \$ 11K		8.93%	> \$ 250K	South Dakota		None
	6%	> \$ 25K	Maryland	7%	> \$ 0	Tennessee	6%	> \$ 0
	6.5%	> \$ 100K	Massachusetts (a)	9.5%	> \$ 0	Texas (c)		None
California	8.84%	> \$ 0	Michigan	1.9%	> \$ 45K	Utah	5%	> \$ 0
Colorado	4.63%	> \$ 0	Minnesota	9.8%	> \$ 0	Vermont	7%	> \$ 0
Connecticut	7.5%	> \$ 0	Mississippi	3%	> \$ 0		8.1%	> \$ 10K
Delaware	8.7%	> \$ 0		4%	> \$ 5K		9.2%	> \$ 25K
Florida	5.5%	> \$ 0		5%	> \$ 10K		9.75%	> \$ 250K
Georgia	6%	> \$ 0	Missouri	6.25%	> \$ 0	Virginia	6%	> \$ 0
Hawaii	4.4%	> \$ 0	Montana	6.75%	> \$ 0	Washington		None
	5.4%	> \$ 25K	Nebraska	5.58%	> \$ 0	West Virginia	9%	> \$ 0
	6.4%	> \$ 100K		7.81%	> \$ 50K	Wisconsin	7.9%	> \$ 0
Idaho	7.6%	> \$ 0	Nevada		None	Wyoming		None
Illinois	4.8%	> \$ 0	New Hampshire (b)	8.5%	> \$ 0	District of Columbia	9.5%	> \$ 0
Indiana	3.4%	> \$ 0	New Jersey	9%	> \$ 0			
Iowa	6%	> \$ 0	New Mexico	4.8%	> \$ 0			
	8%	> \$ 25K		6.4%	> \$ 500K			
	10%	> \$ 100K		7.6%	> \$ 1,000K			
	12%	> \$ 250K						

(a) See Footnote 9.

(b) See Footnote 10.

(c) See Footnote 7.

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

## Notes for Table 9

(a) These brackets, standard deductions and exemptions apply to single taxpayers and married people filing separately. In most states, they are exactly double for married couples filing jointly.

(b) Tax credit (see footnote 17).

(c) Applies to interest and dividend income only.

(d) See footnote 15.

(e) See footnote 18.

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

**Table 9**  
**State Individual Income Tax Rates (Effective as of December 31, 2002)**

State	Tax Rates and Brackets (a)	Standard Deduction (a)	Personal Exemption (a)
Alabama	2% > \$0; 4% > \$500; 5% > \$3K	\$ 2,000	\$ 1,500
Alaska	None	n.a.	n.a.
Arizona	2.87% > \$0; 3.20% > \$10K; 3.74% > \$25K; 4.72% > \$50K; 5.04% > \$150K	\$ 3,600	\$ 2,100
Arkansas	1% > \$0; 2.5% > \$3,199; 3.5% > \$6,399; 4.5% > \$9,599; 6% > \$15,999; 7% > \$26,700	\$ 2,000	\$ 20 (b)
California	1% > \$0; 2% > \$5,834; 4% > \$13,829; 6% > \$21,826; 8% > \$30,298; 9.3% > \$38,291	\$ 3004	\$ 80 (b)
Colorado	4.63% of federal taxable income	n.a.	n.a.
Connecticut	3% > \$0; 4.5% > \$10K	n.a.	\$ 12,500 (e)
Delaware	2.2% > \$2K; 3.9% > \$5K; 4.8% > \$10K; 5.2% > \$20K; 5.55% > \$25K; 5.95% > \$60K	\$ 3,250	\$ 110 (b)
Florida	None	n.a.	n.a.
Georgia	1% > \$0; 2% > \$750; 3% > \$2,250; 4% > \$3,750; 5% > \$5,250; 6% > \$7K	\$ 2,300	\$ 2,700
Hawaii	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	\$ 1,040
Idaho	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	\$ 4,550	\$ 2,900
Illinois	3% of federal adjusted gross income with modification	n.a.	\$ 2,000
Indiana	3.4% of federal adjusted gross income with modification	n.a.	\$ 1,000
Iowa	0.36% > \$0; 0.72% > \$1,211; 2.43% > \$2,422; 4.5% > \$4,844; 6.12% > \$10,899; 6.48% > \$18,165; 6.8% > \$24,220; 7.92% > \$36,330; 8.98% > \$54,495	\$ 1,570	\$ 40 (b)
Kansas	3.5% > \$0; 6.25% > \$15K; 6.45% > \$30K	\$ 3,000	\$ 2,250
Kentucky	2% > \$0; 3% > \$3K; 4% > \$4K; 5% > \$7K; 6% > \$8K	\$ 1,700	\$ 20 (b)
Louisiana	2% > \$0; 4% > \$10K; 6% > \$50K	n.a.	\$ 4,500
Maine	2% > \$0; 4.5% > \$4,200; 7% > \$8,349; 8.5% > \$16,699	\$ 4,700	\$ 2,850
Maryland	2% > \$0; 3% > \$1K; 4% > \$2K; 4.75% > \$3K	\$ 2,000	\$ 1,850
Massachusetts	5.3%/12%	n.a.	\$ 4,400
Michigan	4.1% of federal AGI with modification	n.a.	\$ 2,900
Minnesota	5.35% > \$0; 7.05% > \$18,710; 7.85% > \$61,460	\$ 4,700	\$ 3,000
Mississippi	3% > \$0; 4% > \$5K; 5% > \$10K	\$ 2,300	\$ 6,000
Missouri	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	\$ 4,700	\$ 2,100
Montana	2% > \$0; 3% > \$2,200; 4% > \$4,400; 5% > \$8,700; 6% > \$13,100; 7% > \$17,400; 8% > \$21,800; 9% > \$30,500; 10% > \$43,500; 11% > \$76,200	\$ 3,343	\$ 1,740
Nebraska	2.51% > \$0; 3.49% > \$2,400; 5.01% > \$17K; 6.68% > \$26,500	\$ 4,700	\$ 91 (b)
Nevada	None	n.a.	n.a.
New Hampshire	5% (c)	n.a.	\$ 2,400
New Jersey	1.4% > \$0; 1.75% > \$10K; 2.45% > \$25K; 3.5% > \$35K; 5.525% > \$40K; 6.37% > \$75K	n.a.	\$ 1,000
New Mexico	1.7% > \$0; 3.2% > \$5,500; 4.7% > \$11K; 6% > \$16K; 7.1% > \$26K; 7.9% > \$42K; 8.2% > \$65K	\$ 4,700	\$ 3,000
New York	4% > \$0; 4.5% > \$8K; 5.25% > \$11K; 5.9% > \$13K; 6.85% > \$20K	\$ 7,500	n.a.
North Carolina	6% > \$0; 7% > \$12,750; 7.75% > \$60K; 8.25% > \$120K	\$ 3,000	\$ 2,500
North Dakota	2.1% > \$0; 3.92% > \$27,950; 4.34% > \$67,700; 5.04% > \$141,250; 5.54% > \$307,050	\$ 4,700	\$ 3,000
Ohio	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	n.a.	\$ 1,150
Oklahoma	0.5% > \$0; 1% > \$1K; 2% > \$2,500; 3% > \$3,750; 4% > \$4,900; 5% > \$6,200; 6% > \$7,700; 6.65% > \$10K	\$ 2,000	\$ 1,000
Oregon	5% > \$0; 7% > \$2,500; 9% > \$6,300	\$ 1,800	\$ 142 (b)
Pennsylvania	2.8%	n.a.	n.a.
Rhode Island	25% of federal income tax liability (d)	n.a.	n.a.
South Carolina	2.5% > \$0; 3% > \$2,400; 4% > \$4,800; 5% > \$7,200; 6% > \$9,600; 7% > \$12K	\$ 4,700	\$ 3,000
South Dakota	None	n.a.	n.a.
Tennessee	6% (c)	n.a.	\$ 1,250
Texas	None	n.a.	n.a.
Utah	2.3% > \$0; 3.3% > \$750; 4.2% > \$1,275; 5.2% > \$2,250; 6% > \$3K; 7% > \$3,750	\$ 4,550	\$ 2,175
Vermont	3.6% > \$0; 7.2% > \$27,950; 8.5% > \$67,700; 9% > \$141,250; 9.5% > \$307,050	n.a.	\$ 3,000
Virginia	2% > \$0; 3% > \$3K; 5% > \$5K; 5.75% > \$17K	\$ 3,000	\$ 800
Washington	None	n.a.	n.a.
West Virginia	3% > \$0; 4% > \$10K; 4.5% > \$25K; 6% > \$40K; 6.5% > \$60K	n.a.	\$ 2,000
Wisconsin	4.60% > \$0; 6.15% > \$8,280; 6.50% > \$16,560; 6.75% > \$124,200	\$ 7,440	\$ 700
Wyoming	None	n.a.	n.a.
District of Columbia	5% > \$0; 7% > \$10K; 9% > \$30K	\$ 2,000	\$ 1,370

See notes on page 22.

**Table 10**  
**State Sales Tax Rates and Exemptions for Agricultural, Manufacturing and Machinery Inputs**  
**(Effective as of December 31, 2002)**

State	General Sales and Use Tax	Insecticides and Pesticides	Fertilizer, Seeds and Feed	Seedlings, Plants and Shoots	Manufacturing Machinery	Utilities	Farm Machinery	Raw Material	Office Equipment
Alabama	4%	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable
Alaska	None	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Arizona	5.6%	Taxable	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable
Arkansas	5.125%	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt	Exempt	Taxable
California	7.25%	Taxable	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable
Colorado	2.9%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Connecticut	6%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Delaware	None	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Florida	6%	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable
Georgia	4%	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable
Hawaii	4% (a)	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Idaho	5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Illinois	6.25%	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable
Indiana	6%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Iowa	5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Kansas	5.3%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Kentucky	6%	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable
Louisiana	4%	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Maine	5%	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable
Maryland	5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Massachusetts	5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Michigan	6%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Minnesota	6.5%	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable
Mississippi	7%	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable
Missouri	4.225%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Montana	None	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Nebraska	5.5%	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Exempt	Taxable
Nevada	6.5%	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable
New Hampshire	None	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
New Jersey	6%	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable
New Mexico	5%	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable
New York	4%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
North Carolina	4.5%	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable
North Dakota	5%	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable
Ohio	5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Oklahoma	4.5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Oregon	None	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Pennsylvania	6%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Rhode Island	7%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
South Carolina	5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
South Dakota	4%	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable
Tennessee	7%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Texas	6.25%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Utah	4.75%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Vermont	5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Virginia	3.5%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Washington	6.5% (b)	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt	Taxable
West Virginia	6%	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable
Wisconsin	5%	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Exempt	Taxable
Wyoming	4%	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable
District of Columbia	5.75%	Taxable	Taxable	Taxable	Taxable	Exempt	Taxable	Exempt	Taxable

**Note:** Local government add-ons are not included

(a) Sales and Gross Receipts Tax Index uses a derived rate instead of the statutory rate, see footnote 25.

(b) Sales and Gross Receipts Tax Index uses a derived rate instead of the statutory rate. See footnote 24.

**Source:** State Revenue Departments, Commerce Clearing House, Federation of Tax Administrators.

**Table 11**

*State Sales Tax Exemptions for Services, Software, Leasing and Rental Inputs (Effective as of December 31, 2002)*

State	Cleaning Services	Transportation Services	Repair Services	Professional / Personal Services	Other Services	Custom Software	Modified Canned Software	Downloaded Software	Motor Vehicles	All Other Tangible Personal Property	Rooms and 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	Exempt	Taxable	Exempt	Exempt	Partially Taxable	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Arkansas	Taxable	Exempt	Taxable	Exempt	Partially Taxable	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	Taxable	Exempt	Taxable	Taxable	Partially Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Delaware	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Florida	Exempt	Exempt	Exempt	Exempt	Partially Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Georgia	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Hawaii	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Idaho	Exempt	Taxable	Exempt	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	Taxable	Taxable	Taxable	Taxable	Taxable
Iowa	Taxable	Exempt	Taxable	Taxable	Partially Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Kansas	Taxable	Taxable	Taxable	Exempt	Partially Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Kentucky	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable
Louisiana	Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable
Maine	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Maryland	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
Massachusetts	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt
Michigan	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Minnesota	Taxable	Taxable	Exempt	Exempt	Partially Taxable	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Mississippi	Taxable	Exempt	Taxable	Exempt	Partially Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Missouri	Exempt	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Montana	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Nebraska	Exempt	Exempt	Exempt	Exempt	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	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable
New Mexico	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable
New York	Taxable	Exempt	Taxable	Exempt	Partially Taxable	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
North Carolina	Taxable	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable
North Dakota	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable
Ohio	Taxable	Exempt	Taxable	Exempt	Partially Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Oklahoma	Exempt	Taxable	Exempt	Exempt	Partially Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable
Oregon	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Pennsylvania	Taxable	Exempt	Taxable	Exempt	Partially Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
Rhode Island	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable
South Carolina	Taxable	Exempt	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt	Taxable	Taxable	Taxable
South Dakota	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Tennessee	Taxable	Exempt	Taxable	Exempt	Exempt	Taxable	Taxable	Taxable	Exempt	Taxable	Taxable
Texas	Taxable	Taxable	Taxable	Exempt	Partially Taxable	Taxable	Taxable	Taxable	Exempt	Taxable	Exempt
Utah	Taxable	Taxable	Taxable	Exempt	Partially Taxable	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	Taxable	Taxable	Taxable	Exempt	Partially Taxable	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
West Virginia	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable
Wisconsin	Taxable	Exempt	Taxable	Exempt	Partially Taxable	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable
Wyoming	Taxable	Taxable	Taxable	Exempt	Exempt	Exempt	Taxable	Taxable	Taxable	Taxable	Taxable
District of Columbia	Taxable	Exempt	Taxable	Exempt	Partially Taxable	Taxable	Taxable	Taxable	Taxable	Taxable	Taxable

Source: State Revenue Departments, Commerce Clearing House, Federation of Tax Administrators.

**Table 12**  
**State and Local Fiscal Balance Indicators**  
**2002**

State	Sales & Local Tax Growth vs. Income Growth(a)	State & Local Tax Burdens as Percent of State Income in 2002 (b)
Alabama	0.02%	8.3%
Alaska	-1.99	5.8
Arizona	-1.41	9.8
Arkansas	0.04	9.2
California	0.50	10.5
Colorado	-0.63%	9.2%
Connecticut	0.36	10.7
Delaware	-0.68	7.3
Florida	-1.00	8.4
Georgia	0.03	9.8
Hawaii	-0.91%	10.6%
Idaho	-0.27	10.1
Illinois	-0.46	9.3
Indiana	-0.27	9.3
Iowa	-1.16	9.6
Kansas	-0.22%	9.5%
Kentucky	-0.37	9.4
Louisiana	0.74	9.3
Maine	0.31	11.9
Maryland	-0.37	9.4
Massachusetts	-0.36%	9.7%
Michigan	-0.87	9.3
Minnesota	-0.80	10.6
Mississippi	0.43	9.5
Missouri	0.46	9.1
Montana	-0.34%	9.0%
Nebraska	-0.55	9.7
Nevada	-0.31	8.8
New Hampshire	-3.28	6.9
New Jersey	-1.09	9.6
New Mexico	-0.65%	9.7%
New York	-1.05	11.9
North Carolina	-0.04	9.4
North Dakota	0.70	9.7
Ohio	0.58	10.1
Oklahoma	0.07%	9.0%
Oregon	-1.85	8.9
Pennsylvania	-0.34	9.0
Rhode Island	0.32	10.8
South Carolina	-0.53	9.0
South Dakota	-0.31%	8.5%
Tennessee	-0.84	7.5
Texas	-1.35	8.3
Utah	0.08	10.5
Vermont	-1.34	10.2
Virginia	-0.42%	8.9%
Washington	-1.13	9.7
West Virginia	0.13	9.6
Wisconsin	-0.97	10.6
Wyoming	-1.05	8.5
District of Columbia	-0.52%	12.8%

(a) If tax growth exceeds income growth, the relationship will be positive. If income growth exceeds tax growth, the relationship will be negative.

(b) See Footnote 26.

Source: Tax Foundation

**Table 13**  
**Tax Base Conformity Indicators: Tax Deductibility**  
**2002**

State	Corporate			Individual		
	Federal Tax Deductibility	State Tax Deductibility	Foreign Tax Deductibility	Federal Tax Deductibility	State Tax Deductibility	Foreign Tax Deductibility
Alabama	Yes	No	No	Yes	Yes	Yes
Alaska	No	No	No	N.A.	N.A.	N.A.
Arizona	No	No	No	No	Yes	Yes
Arkansas	No	Yes	Yes	No	Yes	Yes
California	No	No	No	No	Yes	Yes
Colorado	No	Yes	No	No	Yes	Yes
Connecticut	No	No	No	No	Yes	Yes
Delaware	No	No	Yes	No	Yes	Yes
Florida	No	No	Yes	N.A.	N.A.	N.A.
Georgia	No	No	No	No	Yes	Yes
Hawaii	No	Yes	Yes	No	Yes	Yes
Idaho	No	No	Yes	No	Yes	Yes
Illinois	No	Yes	Yes	No	No	No
Indiana	No	No	No	No	Yes	Yes
Iowa	Partial	Yes	Yes	Yes	Yes	Yes
Kansas	No	No	No	No	Yes	Yes
Kentucky	No	No	No	No	Yes	Yes
Louisiana	Yes	Yes	Yes	Yes	Yes	Yes
Maine	No	No	Yes	No	Yes	Yes
Maryland	No	No	Yes	No	Yes	Yes
Massachusetts	No	No	No	No	Yes	Yes
Michigan	No	No	No	No	Yes	Yes
Minnesota	No	No	No	No	Yes	Yes
Mississippi	No	No	No	No	Yes	Yes
Missouri	Partial	No	Yes	Yes	Yes	Yes
Montana	No	No	No	Yes	Yes	Yes
Nebraska	No	Yes	Yes	No	Yes	Yes
Nevada	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
New Hampshire	No	No	No	No	Yes	Yes
New Jersey	No	No	Yes	No	Yes	Yes
New Mexico	No	Yes	Yes	No	Yes	Yes
New York	No	No	No	No	Yes	Yes
North Carolina	No	No	No	No	Yes	Yes
North Dakota	Yes	No	No	No	Yes	Yes
Ohio	No	Yes	Yes	No	Yes	Yes
Oklahoma	No	No	No	Yes	Yes	Yes
Oregon	No	No	No	Yes	Yes	Yes
Pennsylvania	No	No	No	No	Yes	Yes
Rhode Island	No	Yes	Yes	No	Yes	Yes
South Carolina	No	No	No	No	Yes	Yes
South Dakota	Yes	Yes	Yes	N.A.	N.A.	N.A.
Tennessee	No	Yes	No	No	Yes	Yes
Texas	No	Yes	Yes	N.A.	N.A.	N.A.
Utah	No	No	No	Yes	Yes	Yes
Vermont	No	No	No	No	Yes	Yes
Virginia	No	No	No	No	Yes	Yes
Washington	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
West Virginia	No	No	No	No	Yes	Yes
Wisconsin	No	No	Yes	No	Yes	Yes
Wyoming	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
District of Columbia	No	No	No	No	Yes	Yes

Source: Commerce Clearing House.

**Table 14**  
**Other State Tax Base Conformity Indicators, 2002**

State	Incorporates the IRC	Recognizes LLC Status	Recognizes S-Corp Status	Allows Consolidated Filings	UDITPA Adoption	MTC Regs Adoption	AMT Corporate (a)	AMT Individual (a)
Alabama	Yes	Yes	Yes	Yes	Yes	Partial	No	No
Alaska	Yes	Yes	Yes	Yes	Yes	Partial	Yes	No
Arizona	Yes	Partial	Yes	Yes	Yes	Partial	No	No
Arkansas	No	Yes	Yes	Yes	Partial	Partial	No	No
California	Partial	Yes	Partial	No	Partial	Partial	Yes	Yes
Colorado	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
Connecticut	Yes	Yes	Yes	Yes	No	No	No	Yes
Delaware	Yes	Yes	Yes	No	Partial	No	No	No
Florida	Yes	Yes	Yes	Yes	Partial	No	Yes	No
Georgia	Yes	Yes	Yes	Yes	Partial	Partial	No	No
Hawaii	Partial	Yes	Yes	Yes	Partial	Partial	No	No
Idaho	Yes	Yes	Yes	No	Yes	Partial	No	No
Illinois	Yes	Yes	Partial	No	Partial	Partial	No	No
Indiana	Yes	Yes	Yes	Yes	Partial	Partial	No	No
Iowa	Yes	Yes	Yes	Yes	Partial	Partial	Yes	Yes
Kansas	Yes	Yes	Yes	Yes	Partial	Partial	No	No
Kentucky	Yes	Yes	Yes	Yes	Partial	Partial	No	No
Louisiana	Yes	Yes	No	No	Partial	No	No	No
Maine	Yes	Yes	Yes	Yes	Partial	Partial	Yes	Yes
Maryland	Yes	Yes	Yes	No	Partial	No	No	Yes
Massachusetts	Yes	Yes	Yes	Yes	Partial	No	No	No
Michigan	Yes	Yes	No	Yes	Partial	No	No	No
Minnesota	Yes	Yes	Yes	No	No	Partial	Yes	Yes
Mississippi	Partial	Yes	Yes	Yes	Partial	No	No	No
Missouri	Yes	Yes	Yes	Yes	Partial	Partial	No	No
Montana	Partial	Yes	Yes	Yes	Partial	Partial	No	No
Nebraska	Yes	Yes	Yes	No	Partial	Partial	No	Yes
Nevada	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	No	No
New Hampshire	Yes	Yes	No	No	Partial	Partial	No	No
New Jersey	No	Partial	Yes	No	No	No	No	No
New Mexico	Yes	Yes	Yes	Yes	Yes	Partial	No	No
New York	Partial	Yes	Partial	No	No	Partial	Yes	Yes
North Carolina	Yes	Yes	Yes	No	Partial	No	No	No
North Dakota	Yes	Yes	Yes	Yes	Partial	Partial	No	No
Ohio	Yes	Yes	Yes	No	Partial	No	No	No
Oklahoma	Yes	Yes	Yes	Yes	Partial	No	No	No
Oregon	Yes	Yes	Yes	Yes	Partial	Partial	No	No
Pennsylvania	Partial	Yes	Yes	No	Partial	Partial	No	No
Rhode Island	Yes	Yes	Partial	Yes	Partial	No	No	Yes
South Carolina	Yes	Yes	Yes	Yes	No	Partial	No	No
South Dakota	Yes	Yes	Yes	Yes	Partial	No	No	No
Tennessee	Yes	Yes	No	No	Yes	Partial	No	No
Texas	Yes	No	No	No	No	No	No	No
Utah	Yes	Yes	Yes	No	Yes	Partial	No	No
Vermont	Yes	Yes	Yes	Yes	Partial	No	No	No
Virginia	Yes	Partial	Yes	Yes	No	No	No	No
Washington	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	No	No
West Virginia	Yes	Yes	Yes	Yes	No	No	No	Yes
Wisconsin	Yes	Yes	Yes	No	Partial	Partial	No	Yes
Wyoming	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	No	No
District of Columbia	Yes	Yes	No	Yes	Partial	Partial	No	No

(a) Although the federal tax system includes an Individual and corporate alternative minimum tax, states offer no administrative relief to taxpayers by “conforming,” so the index penalizes states that have also adopted an AMT.

**Source:** Commerce Clearing House.

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Editor and Communications Director, Bill Ahern

Tax Foundation  
1900 M Street, NW, Suite 550  
Washington, DC 20036

ph. 202.464.6200  
fx. 202.464.6201

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