

# Assessing State Business Climates

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Attracting businesses has always been of interest to state governments, but in the wake of budget hardships and the recessionary slowdown it has taken on even greater importance. Recent decades have seen the rise of a growing number of indexes, ranking states in terms of how favorable they are toward business growth along a number of dimensions. The problem is that all states have favorable (or unfavorable) business climates; it just depends on where you look. For example, California ranks 4th on two indexes that look primarily at business incubation and growth of the digital economy, but 47th on two others that measure the cost of doing business and regulatory burden. In fact, looking at 11 different business climate indexes, 49 states rank in the top 20 in at least one index, and all 50 states rank in the bottom half in at least one other.

*“Public Policy, State Business Climates, and Economic Growth.” Jed Kolko, David Neumark, and Marisol Cuellar Mejia. National Bureau of Economic Research Working Paper No. 16968, April 2011.*

In a recent working paper from the National Bureau of Economic Research, Jed Kolko and Marisol Cuellar Mejia of the Public Policy Institute of California and David Neumark of the University of California at Irvine analyze some of the most widely referenced business climate indexes to determine which aspects of business growth they accurately predict. The authors build on the work of Peter Fisher of the University of Iowa, who in 2005 wrote a critique of business climate indexes published by the Economic Policy Institute. He argued that “none of [the indexes] do a very good job of measuring what it is they claim to measure, and they do not, for the most part, set out to measure the right things to begin with.” Kolko, Cuellar Mejia, and Neumark expand on this analysis, looking at a greater number of indexes and controlling for nonpolicy factors in each state to determine which policy decisions, if any, have the most significant influence on economic growth at the state level.

Through testing, the authors grouped 11 widely referenced indexes into two main clusters: those that measured productivity and quality of life factors and those that measured taxes and costs. They also used data on weather patterns, population density, and existing industry composition for each state in order to create a series of nonpolicy control variables. They then tested the relationships between the factors measured by the indexes and the growth in employment, total wages, and gross state product (GSP) at the state level, and jobs at new businesses.

The authors then narrowed their analysis to the three indexes that demonstrated the most consistent relationships with economic growth — the State Business Tax

Climate Index (SBTC), the Economic Freedom Index (EFI), and the Economic Freedom Index of North America (EFINA) — and explored what proportion of economic growth is determined by the policy factors assessed by these indexes versus the proportion of growth determined by non-policy factors. They found that there is greater variation in employment growth due to nonpolicy factors in each state than due to business climate. This helps to explain why states like California, which scores very low on the tax and cost factors measured by those three indexes, can neverthe-

less continue to attract business growth because of its desirable weather patterns and its central role in industries such as entertainment and technology.

The authors divide the three indexes further by each policy category they measure to determine what drives the correlation with economic growth. The

SBTC index evaluated tax policies, and corporate income tax had the most significant relationship with both wage and GDP growth. In particular, factors such as the simplicity of the corporate tax code and how closely it aligned with federal taxation laws were positively related to growth.

In the EFI and EFINA, welfare spending was related to all measures of growth except wages, and size of government had an effect on employment and wage growth; that is, states that ranked higher on the indexes due to having smaller governments and fewer welfare expenses had higher measures of growth. The authors could not entirely rule out the possibility of the reverse causality: Slower economic climates could prompt greater welfare spending rather than the other way around. However, further testing and the fact that two indexes point to the same conclusion strengthen the authors’ belief that the first explanation is more likely.

In his work, Fisher suggested that while the media and general public might take interest in state business rankings, those studies “are ignored by the business people actually making the decisions.” As Kolko, Nuemark, and Cuellar Mejia’s paper shows, there may be some reason for that: Most of the 11 indexes tested showed little connection with business growth. Furthermore, it seems that a state’s geographic location matters just as much or more than its policy structure. But for policymakers looking to exert some influence over their state’s business climate, this study offers a place to start. The authors write: “At a minimum, the evidence ... implies that concerns that high taxes and costs of doing business slow state economic growth need to be taken seriously.”

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