

Technical appendix on Forbes report

Forbes magazine recently ran a report on the “Best States for Business” (Forbes magazine, August 16, 2006). This report ranked Michigan forty-fifth. It might appear that this ranking contradicts the Competitiveness Report’s finding that Michigan is an average business tax state. However, upon further examination, Forbes’s ranking of Michigan is due mostly to Michigan’s slow growth, and to a lesser extent to Michigan’s above-average labor costs, and has little to do with Michigan’s competitiveness on business taxes.

Forbes will not give out the exact data, or the weights, or the exact measures used, but the magazine’s editors do describe what they measure in general terms. Of the six categories in which the magazine publishes a state ranking (business costs, labor, regulatory environment, economic climate, growth prospects, quality of life), only one of them appears to include any measure that is directly related to overall business taxes. The business costs ranking is apparently based on the “cost of labor, energy, and taxes.”

Depending upon what weights the editors use, and how they measure labor costs, energy costs, and taxes, this “business costs” ranking may not have much relationship with business taxes. Most studies suggest that labor costs are probably at least nine times as great as state and local business taxes on average, so if the editors are weighting by share of business costs, their labor costs measure should receive nine times the weight of the business tax measure in calculating their business costs index. According to Fisher (2005, pp. 60, 63), the Forbes business costs index is derived from economy.com and has a 75 percent weight on labor costs, a 15 percent weight on energy costs, and only a 10 percent weight on business taxes. This would mean that labor costs have seven-and-a-half times the importance of business taxes in determining the Forbes ranking on business costs.

We ran a correlation between the Forbes business costs ranking and the measure of average state and local business tax rates used in the Competitiveness Report. The correlation is a negative -0.07 , that is, states with a slightly greater Forbes business cost ranking number (e.g., higher “business costs”) tend to have lower business tax rates as measured by Ernst and Young, although this negative correlation is very slight.

We also compared the Forbes business costs ranking with 2004 figures from the U.S. Bureau of Labor Statistics for average weekly wages in the private sector by state. The correlation between these two variables is 0.60 , that is, states with higher business costs as measured by Forbes tend to have higher average weekly wages.

Taking all these findings together, this suggests that Forbes’s measure of “business costs” probably depends more on a state’s labor costs than on its business tax costs.

The only other Forbes index that has any direct possible relationship with business taxes is the category for regulatory environment. Forbes says that this category includes state incentive programs as well as regulatory and tort environment, transportation, and bond ratings. In any event, Michigan ends up having a No. 2 ranking in the regulatory environment category, so to the extent that this measure reflects business tax incentives, Michigan appears to be doing fine.

As for the other categories in which Forbes does rankings, three of them appear to be strongly related to a state's recent economic growth. Their category of "Labor" includes three measures, "educational attainment, net migration, and projected population growth." Their category of "Economic climate" is said by Forbes to reflect "job, income, and gross state product growth as well as unemployment and presence of big companies." And their category of "Growth prospects" reflects "projected job, income and gross state product growth as well as business openings/closings and venture capital investments."

Tim Bartik's February 2006 testimony to the House Tax Restructuring Committee included a measure for employment growth by state, for all states except Alaska and Hawaii, from the March 2001 business cycle peak to December 2005. This measure of recent growth is highly correlated with the three Forbes categories of Labor, Economic Climate, and Growth Prospects, as well as with the overall Forbes ranking. The calculated correlations are all negative, which means that states that are ranked poorly by Forbes on these measures tend to be states that grew slowly from March 2001 to December 2005. The correlations are: Labor (-0.34); Economic Climate (-0.68); Growth Prospects (-0.35); Overall Forbes Ranking (-0.38).

This result is not surprising. The Economic Climate measure appears to be largely a measure of a state's recent growth. The Labor and Growth Prospects measures appear to be in large part measures of predicted future growth, which in almost any reasonable economic model will be highly correlated with past growth. Finally, because these three categories are half of Forbes's six categories, it is not surprising that the overall Forbes ranking ends up being negatively correlated with employment growth—that is, states that have recently had poor growth tend to do worse on the Forbes ranking.

These results suggest that Michigan's poor overall ranking on the Forbes "Best States for Business Index" is in large part due to the state's poor recent economic growth. The poor overall ranking is probably not directly due to Michigan's business taxes, as it appears that not much of the Forbes index is based on a state's business taxes.