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Discussion Paper Series

The “Business Climate” and Economic Inequality*

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December 2013

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Downloadable copy available online

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The “Business Climate” and Economic Inequality

While a fundamental goal of government policy is to encourage economic growth, the distribution of the resulting economic resources is also important, and policymakers must grapple with the potential tradeoff between promoting economic growth and promoting equity. States use a variety of policies to achieve these goals, and it is therefore obviously important to understand which policies promote equity and growth, and the tradeoffs they present.

There is a cottage industry that tries to capture or summarize state economic policies in “business climate indexes.” These indexes arise commonly in arguments for lowering taxes and relaxing regulations in states that do poorly on indexes that emphasize these policies. Conversely, states that do well on such indexes – presumably because taxes, for example, are low – often tout these indexes or rankings in trying to attract businesses.

Prior analysis of these business climate indexes led to three main findings that motivate the present paper:

- First, business climate indexes largely fall into two clusters – indexes that capture policies related to productivity or quality of life, and indexes that capture policies related to taxes and other costs of doing business. States that rank highly on one tax-and-cost index tend to rank highly on all tax-and-cost indexes, and states that rank highly on one productivity/quality of life index tend to rank highly on all productivity/quality of life indexes. In contrast, state rankings on tax-and-cost indexes are often uncorrelated with rankings on the productivity indexes.
- Second, business climate indexes that emphasize taxes and costs predict economic growth; in particular, lower taxes and costs of doing business result in higher rankings, and higher rankings on the tax-and-cost indexes are associated with faster growth. Indexes that focus on productivity measures do not predict growth in employment, wages, or Gross State Product (GSP).
- Third, examination of sub-indexes of the tax-and-cost indexes suggests that an especially important factor that is associated with higher growth is lower welfare and transfer payments.

In this paper, David Neumark and Jennifer Muz turn to evidence on business climate indexes and the promotion of income equality. Examination of the components of the productivity-related indexes suggests that some of the policies captured in these indexes – such as education and health insurance coverage – may promote equality. Thus, the prior research may have found no role for the productivity-related indexes because of its narrow focus on economic growth. Thus, a state that tries to improve its ranking on the tax-and-cost indexes and discounts the policies captured in the productivity-related indexes may unwittingly end up prioritizing or over-emphasizing economic growth over equity.

Alternatively, the same tax-and-cost indexes that are associated with faster economic growth may be associated either with the promotion of economic equality or with increased inequality. This is also potentially significant, as the direction of these relationships could reveal the potential consequences of pursuing policies that are associated with faster economic growth.

Their analysis leads to two main findings:

- There is no consistent evidence that a high ranking on a productivity-related index is associated with reduced income inequality.
- There is evidence of a tradeoff between income equality and growth: those states that rank highly on the tax-and-cost indexes, and thus experience faster economic growth, also tend to experience faster growth in income inequality.

Analysis

Using data drawn from the Current Population Survey Annual Social and Economic supplement, the analysis documents the relationships between business climate indexes and changes in income inequality. Data are also used from ten business climate indexes – five tax-and-cost and five productivity/quality of life indexes – for all available years from 1992 through 2008. The categories that are given the most weight in each type of business climate index are listed in Table 1.

Table 1. Categories given the most weight in each type of business climate index

<i>Taxes and costs of doing business</i>	<i>Productivity/quality of life</i>
<ul style="list-style-type: none"> • Cost of doing business (excluding taxes) • Size of government • Tax rates and tax burden • Regulation and litigation • Welfare and transfer payments 	<ul style="list-style-type: none"> • Quality of life • Equity • Employment, earnings, and job quality • Business incubation • Human capital • Infrastructure • Technology, knowledge, jobs, and digital economy

In the analysis, the authors employ regression models that relate scores on the business climate indexes to percentage point changes in the poverty rate, percent changes in the size of the income gap between high-income and poor families (90-10 differential), high-income and middle-income families (90-50 differential), and middle-income and poor families (50-10 differential), and percent changes in income for poor (10th percentile), middle-income (50th percentile), and high-income (90th percentile) families. If, for example, the relationship between changes in the poverty rate and the index score is negative, this indicates that a higher ranking is associated with slower growth in poverty.

Results

Productivity/Quality of Life Indexes and Inequality

Regression results using scores from the productivity/quality of life business climate indexes are displayed in Table 2. Results that are considered statistically significant are marked by asterisks. Note that none of the indexes show an association between higher scores and slower growth in poverty. However, higher scores on the SNEI and DRCS-P indexes are associated with slower growth in the income differential between middle- and low-income families (50-10 differential).

To interpret the magnitudes, for example, the -1.046 estimate for the SNEI index implies that moving from the 10th to 40th in the state rankings is associated with a rate of growth in the 50-10 differential that is lower by 2.0 percentage points per year. This is large relative to the average growth rate of .305.

However, looking further down the table, we see that the lower growth in the 50-10 differential is not generally attributable to low-income families doing better. For the SNEI index, the relationship between income growth for poor families (10th percentile) and higher scores is positive, but not statistically significant. Higher scores on the DRCS-P index are negatively associated with income growth for middle-income families (50th percentile), and the estimate for poor families is negative as well.

Looking at the other income differentials (90-50 and 90-10), there is no evidence suggesting that the productivity/quality indexes are associated with less growth in inequality. None of the estimates are statistically significant, the signs vary, and many of the estimates are quite small.

Taken as a whole, the results in Table 2 do not show a clear indication that a higher ranking on the productivity/quality of life indexes is associated with slower growth in inequality.

Table 2: Results from Regressions for Productivity/Quality of Life Indexes

	Productivity/Quality of Life Indexes				
	State New Economy Index (SNEI)	Development Report Card for the States - Performance (DRCS-P)	Development Report Card for the States - Development Capacity (DRCS-DC)	Development Report Card for the States - Business Vitality (DRCS-BV)	State Competitiveness Index (SCI)
	(1)	(3)	(3)	(4)	(5)
Poverty	-0.071	0.054	0.045	-0.077	0.052
50-10 differential	-1.046**	-0.493*	-0.293	-0.236	-0.242
90 -50 differential	0.567	0.074	0.202	-0.19	-0.09
90-10 differential	0.033	-0.117	0.031	-0.209	-0.149
10 th percentile	1.356	-0.333	-0.79	-0.18	-0.565
50 th percentile	-0.431	-0.432*	-0.407*	-0.207	-0.297
90 th percentile	0.143	-0.134	-0.047	-0.196	-0.18

**Statistically significant at 5% level, *Statistically significant at 10% level

Tax-and-Cost Indexes and Inequality

Although the starting point for this study was asking whether the productivity/quality of life indexes were associated with less growth of inequality, it is also of interest to examine the relationship between the tax-and-cost indexes and changes in inequality. Recall that these indexes are generally associated with faster economic growth.

Regression results using scores from tax-and-cost indexes are displayed in Table 3. The strongest evidence in Table 3 emerges for the EFI index. Higher scores on the EFI index are positively associated with growth in the income differential between middle- and low-income families (50-10 differential) and high- and low-income families (90-10 differential).

To interpret the magnitudes, the 1.132 estimate for the 50-10 differential of the EFI index implies that moving from the 40th to 10th in state rankings is associated with a rate of growth in inequality that is 1.95 percentage points higher. This is large relative to the average growth rate of 0.305 percentage points per year. The 0.915 estimate for the 90-10 differential of the EFI index implies that moving from the 40th to 10th in state rankings is associated with a rate of growth in inequality that is 1.58 percentage points higher. The average growth rate here is 1.13 percentage points per year. Moreover, as the bottom panel of Table 3 shows, there is a positive and significant relationship between higher scores on the EFI index and income growth for high-income families (90th percentile). These estimates suggest that the EFI index could potentially account for large increases in the income gap between poor and high-income families (the 90-10 differential).

The evidence presented in Table 3 suggests that high scores on the tax-and-cost indexes are strongly associated with rising inequality.

Table 3: Results from Regressions for Tax-and-Cost Indexes

	Tax-and-Cost Indexes				
	State Business Tax Climate Index (SBTC)	Small Business Survival Index (SBSI)	Cost of Doing Business Index (CDBI)	Economic Freedom Index (EFI)	Economic Freedom Index of North America (EFINA)
	(1)	(2)	(3)	(4)	(5)
Poverty	-0.112	-0.015	-0.095	0.017	0.021
50-10 differential	0.364	0.107	0.14	1.132*	0.046
90 -50 differential	0.243	-0.005	-0.078	0.902	0.069
90-10 differential	0.272	0.037	0.013	0.915*	0.057
10 th percentile	0.253	-0.026	0.619	-1.073	-0.074
50 th percentile	0.314	0.084	0.244	0.568	0.037
90 th percentile	0.269	0.034	0.058	0.708*	0.046

*Statistically significant at 10% level

Policy Implications

The authors conclude by stating that they find little consistent evidence that the policies captured by the productivity/quality of life indexes are associated with more moderate growth in inequality. While this might be viewed as discouraging for those who value the policies emphasized in these indexes, it should be kept in mind that these results do *not* imply that none of the policies captured in these indexes moderate the growth in inequality. Rather, the evidence presented here suggests that the agglomeration of the policies captured in these indexes are not associated with declining inequality. Nonetheless, this kind of evidence can inform policy debate about business climate indexes. Touting a state's high ranking on the productivity/quality of life indexes to argue that such a state might, for example, be spared from some of the rising inequality the United States has experienced is not warranted, but instead requires more explicit evidence on specific policies.

The authors do find, however, more direct and, in their view, more easily interpretable evidence of a policy tradeoff between promoting growth and promoting equity. Specifically, the same tax-and-cost related policies that are emphasized in the tax-and-cost indexes are associated with

faster economic growth *and* larger increases in inequality. These results suggest that policymakers – and society at large – have to make some tradeoffs when choosing policies affecting taxes and the costs of doing business; the policies that enhance growth are also associated with more rapidly increasing inequality.

In summary, the evidence implies that when tax-and-cost-related business climate indexes are touted as demonstrating a strong business climate in a state – as they often are – policymakers and voters should be aware that there is another side to the coin: although these business climate indexes are in fact associated with higher economic growth, they are also associated with rising inequality. This perspective should influence the way policymakers and the public think about the tax-and-cost-related business climate indexes that feature prominently in policy debate.