Do State Business Climate Indicators Explain Relative Economic Growth at State Borders?

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Abstract

Numerous organizations produce rankings of states and localities on relative business climate. State and localities tout the indexes on which they rank highly in their efforts to attract new or expanding businesses. Politicians use them to demonstrate the success of their policies or to denigrate the policies of incumbents. Indexes are widely disseminated in print and electronic media, often treated as accurate measures of actual economic performance. However, few of the indexes are subject to systematic tests of their predictive power.

This study submits eleven indexes to tests of their ability to predict relative economic performance on either side of state borders. On the presumption that an area’s comparative advantage is unlikely to differ on either side of a state boundary, it is reasonable to assume that firms would be equally successful in either state, other things equal. This presumption is reinforced by the fact that ease of migration of capital and labor from one side of the border to the other should equalize the marginal products of capital and labor so that productivity shocks in one state would be transmitted quickly to the other. However, states can dampen the forces that would tend to equalize growth to the extent that capital or labor flows respond to state policies. For example, states differ dramatically in the types of taxes imposed, marginal tax rates, training programs, government regulations, support for infrastructure, investments in the arts or education, recreational amenities, or any number of policies that have been alleged to affect business climate. If these differences affect incentives to invest or live in one state relative to another, they can disrupt the free flow of labor and capital across the borders and create gaps in economic performance. As aggregators of the presumed positive and negative effects of these policies, business climate indicators should signal which side of the border should have the more favorable prospects for growth.

The borders are the most logical place to test the performance of these business climate indicators because the differences in state policies will have their largest effects on competitors that are in the same area. Firms located in the interior of the state will have the benefit of distance to moderate the adverse consequences of more favorable policies afforded their competitors in other states. In addition, almost all states have multiple borders which means that the same business climate can be tested against the variety of competing business climates of their neighboring states.

We impose several tests. The first examines the ability of each index to predict relative economic growth at the border over the next five years relative to its ability to explain relative growth over the past five years. This will tell us whether the index is more focused on prediction or simply ranking based on past performance. The second examines whether an index has predictive power in any five year period between 1970 and 2010 regardless of when the index was published. If business climate persists, then we may find that predictive power persists as well. Finally, we allow the various business climate indexes to compete against one another in predicting relative economic growth over the 2005-2010 period regardless of when the index was published. Various measures of growth were employed including changes in aggregate income, per capita income, labor productivity, employment, wages, and population.

Preliminary results show that most business climate indexes have no ability to predict relative economic growth regardless of how that growth is measured. Some are negatively correlated with relative growth. Many are better at reporting past growth than at predicting the future. In the end, the most predictive business climate index is the Grant Thornton Index which was discontinued in 1989.