California economic climate sunnier than thought

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(PhysOrg.com) -- Location, location, location. That's what UC Irvine economics professor David Neumark says is key to understanding how California's economy has managed to stay in line with or surpass the national growth average, despite the Golden State's less-than-favorable rankings in popular business climate indexes.

In a study released last month by the Public Policy Institute of California, Neumark and his co-authors found that non-policy factors such as weather, geography and industry mix more accurately predict a state's economic growth than traditional business index measures, which focus on productivity and tax policy.

"Business climate rankings give a conflicting picture of whether public policy in California is hostile to business, with some placing the state high and others near the bottom," said Neumark.

"As it turns out, the business climate rankings that rate California poorly are the ones that predict economic growth, implying that California's business climate may be problematic. Yet over the past 30 years, the state's economy has managed to grow at roughly the same rate as the nation because its many natural advantages help offset its poor business climate," he said.

The study compared the average results of 11 popular business indexes from 1992 to 2009, including the State Business Tax Climate Index, the Small Business Survival Index, and the Cost-of-Doing-Business Index —

on which California ranked 45th, 46th and 47th, respectively, out of all states. The researchers also collected data on amenities and other geographic or economic conditions that could influence growth, such as average temperature and precipitation.

"Factors like a nice climate may make it easier to attract workers and may also affect productivity directly, providing a boon to businesses that locate here," Neumark said.

He and his colleagues found that, over time, there was no relationship between actual economic growth and business indexes that used productivity or "quality-of-life" measures such as equity or infrastructure in developing rankings.

The indexes that focused on taxes, regulations and fiscal policy — the Small Business Tax Climate Index and the Index of Economic Freedom, for instance — fared better as predictors of economic growth, Neumark said. Study findings, he noted, indicate that a more complex corporate tax structure and higher welfare and transfer payments, in particular, contribute to slower economic growth.

What does this mean for policymakers? "Many business climate indexes do not capture factors that appear to drive state economic growth, and those that do suggest that lowering taxes and the costs of doing business could help," Neumark said.

"But the importance of state differences in policy is often overstated, as these are substantially outweighed by natural advantages or disadvantages that states face, and over which policy has little or no influence."

More information: The full report — co-authored by Jed Kolko, PPIC associate director and research fellow, and Marisol Cuellar Mejia, PPIC research associate — is available online.

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