Revenue Adequacy and the Role of the Revenue Mix in New Mexico’s Public Finances

Presented to
N.M. Revenue Stabilization and Tax Policy Committee
December 11, 2017
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Periodic Need for Tax Reform

- Laws enacted to address specific conditions become overlapping, complex and contradictory, thwarting primary long-term objectives of tax policy: e.g. food and medical tax deductions; property tax value limitations; Some economic development initiatives

- Economic, demographic, institutional and technological change force reconsideration. E.g. E-commerce; decreased reliance on manufacturing; aging of the population; changing federal budget priorities; interstate competition for economic development; Oil and gas industry fluctuations
Tax Reform Considerations

• If we insist that tax reform be revenue neutral & distributionally neutral: Doesn’t that limit the potential for positive change? (A. Auerbach)
  • One goal of tax reform is to change behavior in positive ways, neutrality means there may not be much of a change in incentives or behavior
  • Tax reform may create winners and losers, which can lead us into a bias in favor of the status quo even if many agree there are currently problems

• What are the major hurdles?
  • Uncertainty: e.g. fiscal impacts; Macroeconomic effects of tax policy;
  • How well do we understand the effects of the current system? E.g. Incidence of the GRT
  • Short run bias: we should try to look beyond the short run to ask whether changes will help build the kind of future we would like to see

• This presentation offers observations on two sets of issues in our current structure:
  • Long run revenue adequacy
  • Imbalance among revenue sources
Revenue Adequacy: Issues

• **Adequacy for budget purposes is the main, but not the only purpose of revenue policy**
  • Taxes enable potential avenues for implementing state policies through incentives/disincentives to private behavior; May compete with adequacy

• **How much spending/revenue growth is appropriate?**
  • Government share of economy in US grew dramatically in the 20th Century, stabilized over the last 20 years;
  • State and Local spending are a zero sum game in terms of economic growth
  • Increased costs of social insurance crowd out traditional functions like education unless the tax burden is increased

• **Why are revenues so unstable?**
  • Is all instability due to reliance on oil and gas?
  • Long run revenue elasticity is difficult to measure due to the changing economy
  • Role of reserves is critical: Could we use them to decouple spending from volatile revenues?
  • Unlike previous recessions, NM has not rebounded quickly since 2009
## Adequacy: NM v US Average

<table>
<thead>
<tr>
<th></th>
<th>New Mexico as Percent of U.S. Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median Household Income</td>
<td>82%</td>
</tr>
<tr>
<td>State &amp; Local Taxes Per Capita</td>
<td>85%</td>
</tr>
<tr>
<td>State &amp; Local Taxes Percent of Personal Income</td>
<td>107%</td>
</tr>
<tr>
<td>State &amp; Local Direct General Spending Percent of Personal Income</td>
<td>134%</td>
</tr>
<tr>
<td>State &amp; Local General Expenditures Per Capita</td>
<td>115%</td>
</tr>
</tbody>
</table>

Source: Tax Foundation “*Facts and Figures: 2013*”

- NM has below-average revenue “capacity”, makes above average revenue “effort”
- Greater spending enabled by federal transfers for health care, education: State match requirement puts pressure on own-source revenues
Adequacy Over Time

Source: NM DFA, General Fund Report

- Population + Inflation up 60%, GF Revenue up 80%
- O&G added volatility and growth
Revenue growth vs the economy

- Revenue is more closely correlated with Gross State Product than Personal Income
- Revenue is significantly more volatile than GSP, Rev Ex O&G tracks GSP

Sources: NM DFA, U.S. Bureau of Economic Analysis; Author’s calculations
Revenue adequacy vs tax base

- GF Revenue as share of economy is similar over time, despite periodic volatility
- GF Revenue share increases in expansions and decrease in recessions

Source: NM DFA, U.S. BEA; Author’s calculations
Revenue growth of major GF taxes

- Selective Sales Tax increased due to Ins. Premiums Tax and MVX
- PIT recovers strongly during expansions, most volatile but also most elastic
- GRT tracks the economy most closely, not recession proof

Source: NM DFA General Fund Report; Consensus Forecast
Adequacy: All operating funds

- GF growth generally strong until latest recession (not shown)
- Very strong growth of Federal Funds – Medicaid expansion (not shown)
- OSF = benefits, tuition, road fund
- Total spending compound growth = 6.6%, inflation 2.5%

Source: NM DFA
Conclusions on adequacy

• Despite turbulent times, and significant statutory reductions of major revenues, NM revenue and spending have increased strongly suggesting the current revenue structure meets the adequacy standard
  • Revenues have kept pace with the economy, and provide increasing resources when adjusted for inflation and population

• Revenue neutrality over the near term is prudent given the current economy

• Some concern about adequacy may be due to some programs being crowded out within the budget: e.g. employee salaries and pension contributions may be crowded out by higher medical costs
## Relative shares of major revenues

### 2013 State & Local Tax Collections by Source – Tax Foundation

<table>
<thead>
<tr>
<th></th>
<th>Property</th>
<th>Sales</th>
<th>PIT</th>
<th>CIT</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>NM % of Total</td>
<td>18.6%</td>
<td>38.2%</td>
<td>16.2%</td>
<td>3.5%</td>
<td>23.5%</td>
</tr>
<tr>
<td>US Average % of Total</td>
<td>31.3%</td>
<td>22.5%</td>
<td>23.3%</td>
<td>3.6%</td>
<td>19.3%</td>
</tr>
<tr>
<td>Difference</td>
<td>(12.7%)</td>
<td>15.7%</td>
<td>(7.1%)</td>
<td>(0.1%)</td>
<td>4.2%</td>
</tr>
<tr>
<td>Annual Revenue Impact (Million Dollars)</td>
<td>($930)</td>
<td>$1,150</td>
<td>($500)</td>
<td>--</td>
<td>$300</td>
</tr>
</tbody>
</table>

- NM much higher on sales tax, lower on Property Tax than most states
- Local share of sales tax is larger than in most states (not shown)
- Policy implications if NM were to decrease Local GRT and increase Property Tax?
Shares of business taxes

<table>
<thead>
<tr>
<th>2016 State &amp; Local Business Tax Collections by Source – E&amp;Y COST</th>
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<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Property</td>
</tr>
<tr>
<td>-----------</td>
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<tr>
<td>NM % of GSP</td>
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<td>US Average % of GSP</td>
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<td>Difference</td>
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<td>Annual Revenue Impact (Million Dollars)</td>
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Source: Ernst & Young, COST State & Local Business Tax Burden, FY 2016.

- **Outsized sales tax burden falls largely on businesses**
- **Roughly one-third of lower property tax burden to businesses**
Economic effects of taxing consumption

• Economists often argue that taxing consumption is better for the economy than taxing income because it encourages saving, which can lead to more investment.

• However, this effect is much weaker in a small open economy like NM because savings and investment easily flow across our state borders.

• Also, the effect is weaker when tax base is narrower, consumers may simply shift to non-taxed forms of consumption rather than saving.

• Also, like income taxes, taxing consumption reduces the reward to labor, reduces growth of output.

• Also, NM GRT on business purchases reduces the rate of return on investment.
Effects of Taxing Consumption (cont.)

• Although sales taxes may be simpler to enforce than some other taxes, there are important qualifications to this assumption:
  • Federal income tax is more complex, but state-level tax doesn’t add much to that complexity
  • Taxing remote commerce, intangibles and services increases complexity

• Sales taxes on consumption are usually deemed to be more regressive than alternatives:
  • However, less regressive when compared with lifetime rather than annual income
  • Not taxing necessities is ineffective means of reducing regressivity
  • Income tax is generally more progressive, but that depends on structure
Policy advantages of property taxes

• Benefits principle supports using this tax to finance local services, i.e. since local services improve the value of property, taxing property to pay for those services approximates a “user fee” structure

• The supply of real property is relatively insensitive to the rate of taxation, thus taxing real property is less distorting of investment decisions

• Adequacy: Property tax contributes both stability and growth compared with most alternatives

• Probably less regressive than alternatives, even without relief mechanisms

• Assessment relief has been poorly targeted and has created inequities

• Other exclusions have narrowed the base creating inequities
Property Tax Values and Taxes Grow More Quickly Than the Economy and Are More Stable Than GF Revenue

- Total Property Tax revenue (not shown) has grown 135% since 2000 – **roughly double the growth of the economy**; Average tax rates are up 14%;

- Prop. Tax revenue shares are similar, though State’s share is down slightly, Schools’ share is up slightly and Munis have shifted from Debt Service to Operating
Conclusions: NM Should consider revisiting the revenue mix

• Heavy reliance on sales taxation is contributing to perceived failings with **no clear solutions within the GRT itself**: e.g. pyramiding, base exclusions to mitigate regressivity.

• Property tax would be a better source of funding for local governments:
  • Funds go to local services that benefit property owners
  • Switch would likely reduce the regressivity of the tax system
  • NM has room to increase property tax without losing competitiveness

• Other reforms of property tax could be considered as part of reform: Transparency of assessments; Better targeting of relief mechanisms; Accountability for use of funds; Rate setting through Yield Control.