Importance of Tax Policy for Economic Prosperity

Effective tax policy should generate enough revenue to fund government operations while avoiding harm to business activity in the economy arising from rates stifling growth or perverse incentives creating inefficiencies. Rising gross receipts tax rates, tax pyramiding, and tax revenue volatility compromise these primary functions of New Mexico's tax system.

Revenue stability is accomplished with a broad tax base applied equitably across economic activity.

New Mexico's tax system has relative strengths and weaknesses compared with other states.

In 2018, the Legislative Council Service contracted with Ernst & Young and Georgia State University to analyze New Mexico's tax system and evaluate the strengths and weaknesses of the state's two largest sources of tax revenue – the gross receipts tax (GRT) and personal income tax (PIT). The analysis determined:

- New Mexico's GRT functions as both a business tax and a consumption tax. In its role as a business tax, the GRT raises more revenue (due to its broader base) and is more stable than the state's corporate income tax. As a consumption tax, New Mexico's GRT is applied to most services while many other states struggle to collect revenue on service consumption.
- New Mexico's state GRT rate of 5.125 percent is lower than the regional average sales tax rate of 5.5 percent.[1] New Mexico's state GRT tax rate is lower than the state sales tax rates of its immediate neighbors of Texas and Arizona, but higher than the state rates levied in Colorado, Utah, or Oklahoma.
- Unprofitable firms likely have a positive GRT tax liability, which can be burdensome for startup firms with low sales and high business costs, and firms not vertically integrated in their operations.
- The complexity of the state's GRT can be a competitive disadvantage to businesses in the state.
- New Mexico's PIT structure makes it a less volatile revenue source compared with peer states, though it accounts for a smaller relative share of revenues; in 2016 (the reference year for the study), PIT made up 25 percent of state tax revenue in New Mexico compared with an average of 49 percent in peer states.

LFC Tax Policy Principles

1. **Adequacy:** Revenue should be adequate to fund needed government services.

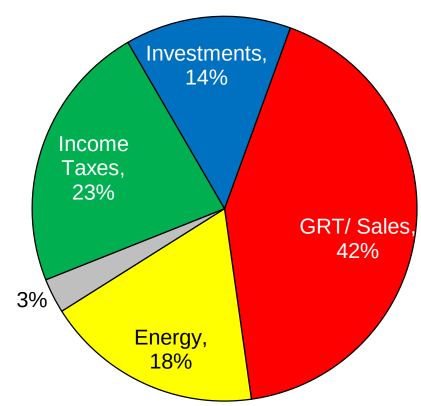
2. **Efficiency:** Tax base should be as broad as possible and avoid excess reliance on one tax.

3. **Equity:** Different taxpayers should be treated fairly.

4. **Simplicity:** Collection should be simple and easily understood.

5. **Accountability:** Preferences should be easy to monitor and evaluate.

General Fund Revenue Sources (FY22)



Source: February 2021 Consensus Revenue Estimate

[1] Comparison states included Arizona, California, Colorado, Hawaii, Nevada, Oklahoma, Oregon, Texas, and Utah. Note, Oregon does not impose a state sales tax.

- The state's PIT is based on income definitions set by the federal tax system, providing the benefit of shared audit and administrative services and increased simplicity for tax filers. However, this can result in a loss of some autonomy over state revenues when faced with changes at the federal level.

Growing tax expenditures are reducing the tax base.

Various tax credits, deductions, and exemptions – also called tax expenditures – have narrowed the tax base such that higher rates are needed to maintain equivalent revenue levels, which also increases revenue volatility. Narrowing of the tax base also often results in inequities in taxation and uneven playing fields for businesses providing the same products or services, and rising GRT rates exacerbate the effects of tax pyramiding.

Despite having over 100 expenditures identified in the Taxation and Revenue Department (TRD) Tax Expenditure Report, ten tax expenditures account for over 75 percent of total tax expenditure costs. Of the ten, the top two – the food deduction and its hold harmless payments plus the prescription drug GRT deduction – account for nearly a third of all tax expenditure costs in New Mexico. Addressing the largest tax expenditures provides the most meaningful opportunities for revenue stability and base-broadening tax reform.

Tax expenditures are expected to continue growing, further whittling the tax base. The United States Federal Reserve estimates inflation will exceed historical trends reaching over 3.1 percent in 2021 and remaining elevated above 2 percent for the following years. Higher inflation will drive up the cost of most GRT deductions and exemptions, at a pace potentially faster than the growth in state revenues. Furthermore, the expansion of the film tax credit and commitments made by current film partners are expected to more than double the cost of the credit in two years, substantially narrowing and vastly outpacing growth in corporate income taxes.

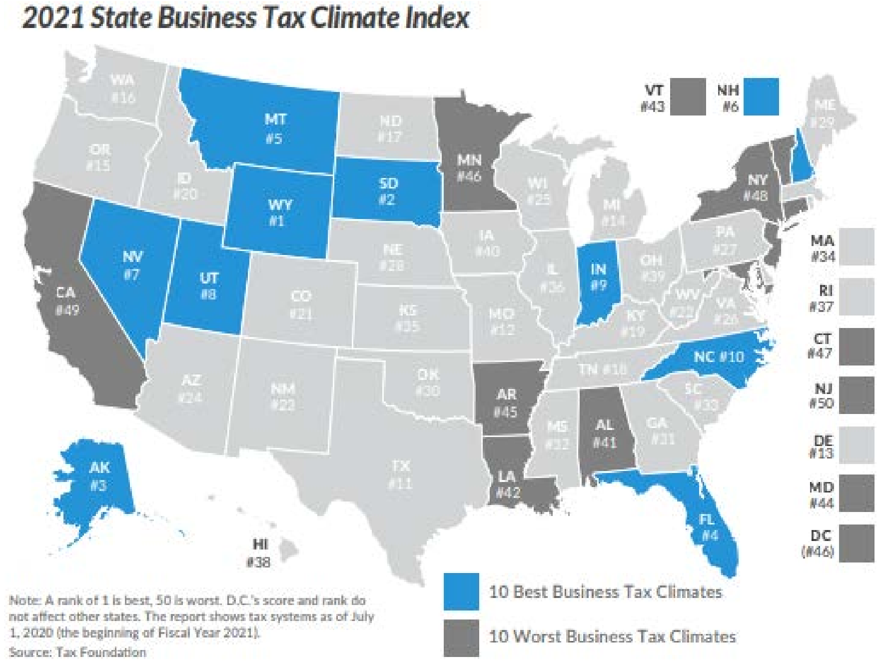
In addition to base tax expenditure growth, recent legislative changes have expanded expenditure costs. Chapter 116 (House Bill 291) increased the working families tax credit to 20 percent of the federal earned income tax credit through tax year 2022 and to 25 percent beginning in tax year 2023, costing an additional $22 million to $49 million a year. Chapter 116 also expanded low-income comprehensive tax rebate to apply to higher incomes, provide for higher rebates, and created an automatic inflation-adjustment to the rebate amounts, with additional costs estimated at $50.9 million a year. These are important poverty reducing measures for low-income individuals; however, they significantly add to the overall cost of tax expenditures. Along with other changes, the combined cost of all tax expenditure expansions in the 2021 Legislative session is estimated at over $105 million a year.

In general, tax expenditures reduce government revenues, and the revenue loss is largely uncapped – most are not subject to annual legislative authorization and factors determining their costs are rarely under government control. Additionally, the only way to control the outflow of revenue by way of tax expenditures is to amend the statutes, but the state typically lacks the information needed to craft the appropriate amendments. Regular reporting on and evaluation of the state tax expenditures could help address this issue; however, tax expenditure reporting varies across state governments. In a

Top Ten Tax Expenditures by Cost	5-Year Avg. Cost
Food GRT Deduction (includes hold harmless distributions to local governments)	$278.5
Prescription Drugs GRT or GGRT Deduction	$93.06*
Health Care Practitioners GRT Deduction (includes hold harmless distributions to local governments)	$71.3
Film Production Tax Credits/Film and Television Tax Credits	$70.5*
Capital Gains Deduction	$60.1
Working Families Tax Credit	$57.9*
NMMIP Assessment Credit	$51.2
Receipts of Nonprofit Organizations Exemption from GRT, except State and Nat'l Labs	$27.8
Low Income Comprehensive Tax Rebate (excluding >65 & blind)	$18.0*
High-Wage Jobs Tax Credit	$16.4

Source: TRD 2020 Tax Expenditure Report
*Prescription drugs GRT deduction does not include medical cannabis which will increase costs by an estimated $14 million a year.
*The film tax credit was expanded in the 2019 session and is estimated to reach a cost of $178 million annually by FY23.
*The working families tax credit was expanded in the 2021 session, increasing in TY22 and TY24, ultimately adding an estimated cost of about $49.2 million per year.
*The low income comprehensive tax rebate was expanded in the 2021 session at an estimated additional cost of $50.9 million per year.

hearing brief presented in October 2020, LFC economists recommended implementing reporting requirements for existing tax expenditures where such requirements are lacking and requiring in-depth evaluations of major tax expenditures to determine their effectiveness.



Well-designed tax policy improves prospects for economic growth.

New Mexico tax policy falls in the median of states for business tax climate.

The Tax Foundation's *2021 State Business Tax Climate Index* compares states on more than 120 variables in five major areas of taxation – corporate taxes, individual income taxes, sales taxes, unemployment insurance taxes, and property taxes. According to the Tax Foundation, states that score well in the index are best suited to generate economic growth.

The benefit of the Tax Foundation's ranking system is that it looks at the state's business tax climate in the context of its overall tax system. For example, New Mexico's tax climate index ranking is relatively low for individual income taxes and sales taxes, ranking 31st and 41st, respectively. However, New Mexico ranks number one for its property tax climate and ranks in the top ten for state corporate income and unemployment insurance taxes. Overall, New Mexico is in the middle of the pack, ranking 23rd in the 2021 state business tax climate index, and the state has ranked between 23rd and 28th in the index since 2014.

Tax policy is one piece of the economic development puzzle.

Tax policy can affect an economy by influencing supply and demand. High marginal tax rates can discourage work, saving, investment, and innovation, while specific tax preferences can positively or negatively affect the allocation of economic resources. But low taxes can also slow long-run economic growth by reducing resources to provide critical government services, increasing government borrowing, and decreasing public infrastructure investments. Furthermore, poorly targeted tax benefits for economic development can lead to narrower tax bases and distort business decisions away from optimal structuring.

According to the Tax Policy Center, a nonpartisan tax-research venture, an economy's productive capacity depends on the size and skills of the workforce, infrastructure quality (machinery, buildings, vehicles, computers, and other physical capital), and the overall stock of knowledge and ideas. These factors tend to influence economic development to a greater degree than tax policy. The Kellogg School of Management at Northwestern agrees, finding taxes affect economic growth on the margins stating "in a service-based economy, companies need to be near customers and close to a wide pool of labor. And

Getting to the Top Ten

According to the Tax Foundation business tax climate report, the absence of a major tax is a common factor among many of the top 10 states. Property taxes and unemployment insurance taxes are levied in every state, but Nevada, South Dakota, and Wyoming have no corporate or individual income tax; Alaska has no individual income or state-level sales tax; Florida has no individual income tax; and New Hampshire and Montana have no sales tax. This does not mean, however, that a state cannot rank in the top 10 while still levying all the major taxes. Indiana, North Carolina, and Utah, for example, levy all of the major tax types, but do so with low rates on broad bases.

New Mexico's lowest rated tax is the GRT, mostly due to high local rates. Below is a ranking of the state's main taxes compared with the rest of the nation.

Source: 2021 State Business Tax Climate Index; Tax Foundation

New Mexico's Tax Rankings	
Overall Rank	23
Corporate Tax	9
Individual Income	31
Sales Tax	41
Property Tax	1
Unemployment Insurance Tax	9

Note: Lower number is better

there's now strong agreement in the field that state and local taxes are not typically an important factor in business decisions."

The Kellogg School also found that the best tax policies for state and local governments seeking to grow their economies are those that (1) offer long-term certainty to businesses and individuals, (2) are coupled with wise public investment, and (3) are designed with the principles of efficiency, simplicity, and equity in mind. An economy benefits from these principles in a state's tax environment by providing the stability businesses need to make informed investment decisions and certainty the government will fund the infrastructure and services that cities and states require.

While poorly designed tax structures can certainly disadvantage state economies and discourage business investment, tax system changes are not a silver bullet for economic growth. Policy makers must also consider the broader context of the state's labor and infrastructure resources and consider other policy changes that maximize the investment of taxpayer dollars.

Combating rising gross receipts tax rates would lower the business and consumer burden.

New Mexico lawmakers implemented several tax reform initiatives in the last three years, many of which were included as part a broad tax package in the 2019 session (Chapter 270, House Bill 6). Those efforts included base-broadening measures to bring previously untaxed goods and services into the state's tax base and equity and fairness improvements in the tax code (see Key Tax Reform Provisions textbox below).

Key Tax Reform Provisions Enacted from 2019 to 2021

Adequacy and Efficiency Improvements through Broadening the Tax Base

- Increased state and local GRT base to include online sales (HB6, 2019)
- Included nonprofit and government hospital receipts in state GRT base (HB6, 2019)
- Created a local option compensating tax (HB6, 2019)
- Brought e-cigarettes into the tobacco product tax base (HB6, 2019)
- Brought recreational cannabis into the GRT tax base and imposed an excise tax (HB 2, 2021SS)

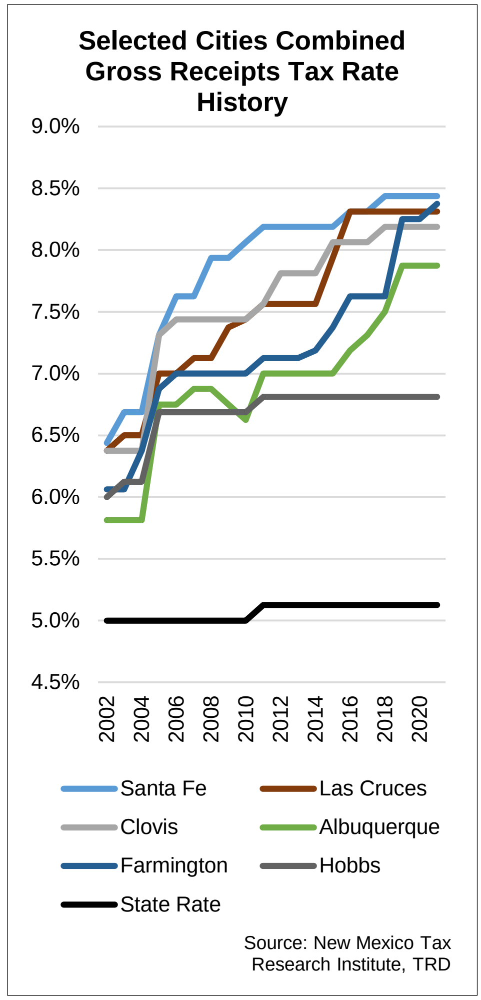
Equity Improvements

- Leveled the playing field for local and out-of-state businesses by moving to destination sourcing for GRT (HB6, 2019)
- Created a more level tax playing field for for-profit, nonprofit, and government hospitals (HB6, 2019)
- Increased the motor vehicle excise tax from 3 percent to 4 percent, bringing the state closer to other states' tax rates (HB6, 2019)
- Aligned state compensating tax rates for services and tangible personal property (HB6, 2019)
- Helped prevent income-shifting in corporate income tax reporting through combined reporting (HB6, 2019)
- Added parity in the sourcing of services and tangible goods for corporate income tax assessments through market-based sourcing (HB6, 2019)
- Added progressivity in personal income taxes with a new 5.9 percent top rate affecting the top 3 percent of filers (HB6, 2019)
- Reduced tax pyramiding for manufacturing services and equipment (HB278, 2021)

However, several significant issues remain unaddressed. Many of the base-broadening, revenue raising efforts were accompanied by increases in various tax expenditures, the largest of which included the working families tax credit, low-income comprehensive tax rebate, and film tax credit. Notably, however, revenue-generating efforts to broaden the GRT base were not accompanied by reductions in state or local GRT rates or measures to significantly alleviate tax pyramiding.

Many of the recent tax reform proposals that attempted GRT rate reduction focused primarily on the state rate, which is currently 5.125 percent. Unfortunately, GRT rate reduction is expensive. A one percent decrease in the state GRT rate would carry a cost of about $615 million as of the last consensus revenue estimate, with the cost increasing as estimated GRT collections increase. Some recent proposals have considered more manageable rate reductions, such as one-quarter or one-eighth percent, which would cost the state roughly $75 million to $155 million. However, small reductions in the state GRT rate may fail to address the issue of New Mexico's high combined state and local GRT rates, which exceeds 9 percent in some areas.

Local rate increases are driving up the total GRT rate. While the state GRT rate has remained relatively stable over time, local government rates continue to rise. Moreover, New Mexico's state GRT rate is relatively low compared with other states, ranking 32nd as of January 2021, but the combined state and local average rate is the 15th highest in the nation (see Attachment A).



In the 2019 session (HB 479), a number of municipal and county restricted-use local option GRT increments were repealed in favor of higher unrestricted local option GRT rates. The provision was intended to provide additional flexibility to local governments; however, it may also make it easier for local governments to raise rates, since those increases would no longer need to be tied to specific, earmarked purposes. Since the passage of that legislation, three counties and eleven municipalities raised their local GRT rates.

The most effective tax reform proposals would incorporate reasonable limits to local rate increases and include base-broadening measures that enhance and stabilize local government revenues to ensure continuity of services.

Reducing GRT pyramiding supports smaller businesses and business competitiveness.

Tax pyramiding occurs when the GRT is applied to business-to-business purchases of goods and services, creating an extra layer of taxation at each stage of production. New Mexico currently has anti-pyramiding provisions for many goods-based inputs, but service-based inputs are still largely taxed, which can be particularly difficult for smaller businesses unable to bring those services in-house and instead contract for services like accountants, attorneys, and human resource functions. The burden of pyramiding is then exacerbated by rising GRT rates. A tax reform package that broadens the GRT base and lowers rates would help mitigate the impact of pyramiding and alleviate the taxpayer burden created by high rates.

Further still, specific anti-pyramiding provisions targeting business-to-business services could make New Mexico more competitive for service-based businesses. As the services proportion of the economy grows and the state faces national and international competition from locations that do not have pyramiding problems, it will become increasingly important for the state to address services-based pyramiding to remain competitive. In a 2016 memo, LFC economists estimated the costs of eliminating all pyramiding of business-to-business services could cost the state nearly $500 million, but the exact cost is unclear due to lack of sufficient data. However, more targeted anti-pyramiding measures could limit the expected costs and provide relief for industries most affected by GRT rate pyramiding.

Personal income tax rates could benefit from larger income bracketing and smaller rate increases.

Well-designed personal income tax rates can encourage work, saving, and investment that contribute to New Mexico's economic growth. Furthermore, as one of the most stable sources of tax revenue, a broad-based income tax helps balance the more volatile GRT and CIT taxes. Tax reform that maintains overall revenue levels by broadening the income tax base and reducing statutory income tax rates, has been found by a study by the Tax Policy Center and the National Bureau of Economic Research (2016) to "raise the overall size of the economy and result in a more efficient allocation of resources."

Currently, New Mexico's personal income tax is highly progressive up until $24 thousand of income (joint filers), but is then essentially flat until reaching $315 thousand of income (joint filers). Recent income tax proposals have considered adding additional intermediate rates at different levels of income, but have not considered a true restructuring of the existing income tax brackets. Future proposals could consider reforming the income tax bracket and rate structure to create an income tax system that expands the current brackets, progresses rates gradually, and could be designed to provide tax relief to low- and middle-income earners to achieve greater economic growth.

Summary of Key Findings and Recommendations

- High marginal tax rates can discourage work, saving, investment, and innovation.
- Other than taxes, an economy's productive capacity depends on the size and skills of the workforce, infrastructure quality, and the overall stock of knowledge and ideas.
- New Mexico's business tax climate ranks in the median of states when evaluating the total tax system – including GRT, personal and corporate income taxes, property taxes, and unemployment insurance taxes.
- High GRT rates are driven by rising local GRT rates, often necessitated by the need to generate sufficient local government revenues from a narrowing tax base.
- Addressing some of the state's largest tax expenditures provides the most meaningful opportunities to expand state and local tax bases.
- Addressing GRT pyramiding for business services inputs could increase business competitiveness in New Mexico.
- Lowering GRT rates reduces the impact of GRT pyramiding.
- Small changes in the state GRT rate may not address the issue of rising local rates – effective proposals would include reasonable limits on local government GRT rates while also expanding tax bases to ensure sufficient revenue generation.
- Income tax reform proposals could consider revisiting the state's current rate and bracket structure to both add progressivity while also providing tax relief to low- and middle-income earners.

Attachment A

State & Local Sales Tax Rates, As of January 1, 2021

State	State Sales Tax Rate	Rank	Avg. Local Sales Tax Rate (a)	Combined Sales Tax Rate	Rank	Max Local Sales Tax Rate
Alabama	4.00%	40	5.22%	9.22%	5	7.50%
Alaska	0.00%	46	1.76%	1.76%	46	7.50%
Arizona	5.60%	28	2.80%	8.40%	11	5.60%
Arkansas	6.50%	9	3.01%	9.51%	3	5.13%
California (b)	7.25%	1	1.43%	8.68%	9	2.50%
Colorado	2.90%	45	4.82%	7.72%	16	8.30%
Connecticut	6.35%	12	0.00%	6.35%	33	0.00%
Delaware	0.00%	46	0.00%	0.00%	47	0.00%
D.C.	6.00%	-17	0.00%	6.00%	-38	0.00%
Florida	6.00%	17	1.08%	7.08%	22	2.50%
Georgia	4.00%	40	3.32%	7.32%	19	4.90%
Hawaii (c)	4.00%	40	0.44%	4.44%	45	0.50%
Idaho	6.00%	17	0.03%	6.03%	37	3.00%
Illinois	6.25%	13	2.57%	8.82%	7	9.75%
Indiana	7.00%	2	0.00%	7.00%	24	0.00%
Iowa	6.00%	17	0.94%	6.94%	28	1.00%
Kansas	6.50%	9	2.19%	8.69%	8	4.00%
Kentucky	6.00%	17	0.00%	6.00%	38	0.00%
Louisiana	4.45%	38	5.07%	9.52%	2	7.00%
Maine	5.50%	29	0.00%	5.50%	42	0.00%
Maryland	6.00%	17	0.00%	6.00%	38	0.00%
Massachusetts	6.25%	13	0.00%	6.25%	35	0.00%
Michigan	6.00%	17	0.00%	6.00%	38	0.00%
Minnesota	6.88%	6	0.59%	7.46%	17	2.00%
Mississippi	7.00%	2	0.07%	7.07%	23	1.00%
Missouri	4.23%	39	4.03%	8.25%	12	5.76%
Montana (d)	0.00%	46	0.00%	0.00%	47	0.00%
Nebraska	5.50%	29	1.44%	6.94%	29	2.50%
Nevada	6.85%	7	1.38%	8.23%	13	1.53%
New Hampshire	0.00%	46	0.00%	0.00%	47	0.00%
New Jersey (e)	6.63%	8	-0.03%	6.60%	30	3.31%
New Mexico (c)	5.13%	32	2.71%	7.83%	15	4.31%
New York	4.00%	40	4.52%	8.52%	10	4.88%
North Carolina	4.75%	35	2.23%	6.98%	26	2.75%
North Dakota	5.00%	33	1.96%	6.96%	27	3.50%
Ohio	5.75%	27	1.48%	7.23%	20	2.25%
Oklahoma	4.50%	36	4.45%	8.95%	6	7.00%
Oregon	0.00%	46	0.00%	0.00%	47	0.00%
Pennsylvania	6.00%	17	0.34%	6.34%	34	2.00%
Rhode Island	7.00%	2	0.00%	7.00%	24	0.00%
South Carolina	6.00%	17	1.46%	7.46%	18	3.00%
South Dakota (c)	4.50%	36	1.90%	6.40%	32	4.50%
Tennessee	7.00%	2	2.55%	9.55%	1	2.75%
Texas	6.25%	13	1.94%	8.19%	14	2.00%
Utah (b)	6.10%	16	1.09%	7.19%	21	2.95%
Vermont	6.00%	17	0.24%	6.24%	36	1.00%
Virginia (b)	5.30%	31	0.43%	5.73%	41	0.70%
Washington	6.50%	9	2.73%	9.23%	4	4.00%
West Virginia	6.00%	17	0.50%	6.50%	31	1.00%
Wisconsin	5.00%	33	0.43%	5.43%	43	1.75%
Wyoming	4.00%	40	1.33%	5.33%	44	2.00%

(a) City, county and municipal rates vary. These rates are weighted by population to compute an average local tax rate.

(b) Three states levy mandatory, statewide, local add-on sales taxes at the state level: California (1%), Utah (1.25%), and Virginia (1%). We include these in their state sales tax.

(c) The sales taxes in Hawaii, New Mexico, and South Dakota have broad bases that include many business-to-business services.

(d) Special taxes in local resort areas are not counted here.

(e) Salem County, N.J., is not subject to the statewide sales tax rate and collects a local rate of 3.3125%. New Jersey's local score is represented as a negative.

Sources: Sales Tax Clearinghouse; Tax Foundation calculations; State Revenue Department websites

https://taxfoundation.org/publications/state-and-local-sales-tax-rates/