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

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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

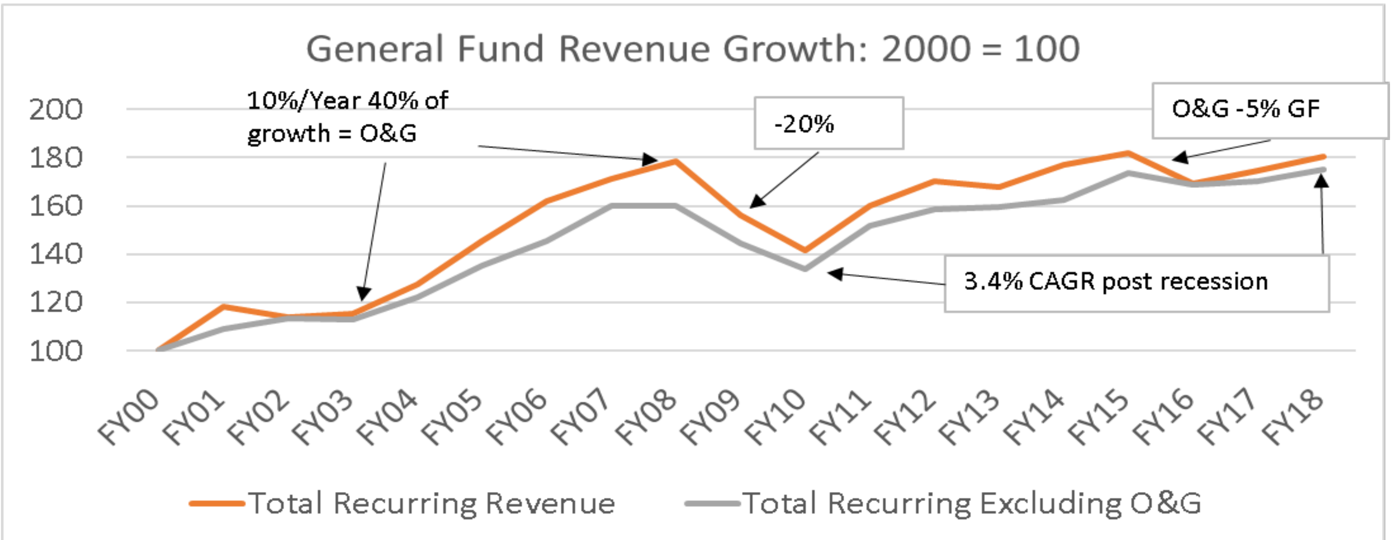
Adequacy: NM v US Average

	New Mexico as Percent of U.S. Average
Median Household Income	82%
State & Local Taxes Per Capita	85%
State & Local Taxes Percent of Personal Income	107%
State & Local Direct General Spending Percent of Personal Income	134%
State & Local General Expenditures Per Capita	115%

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

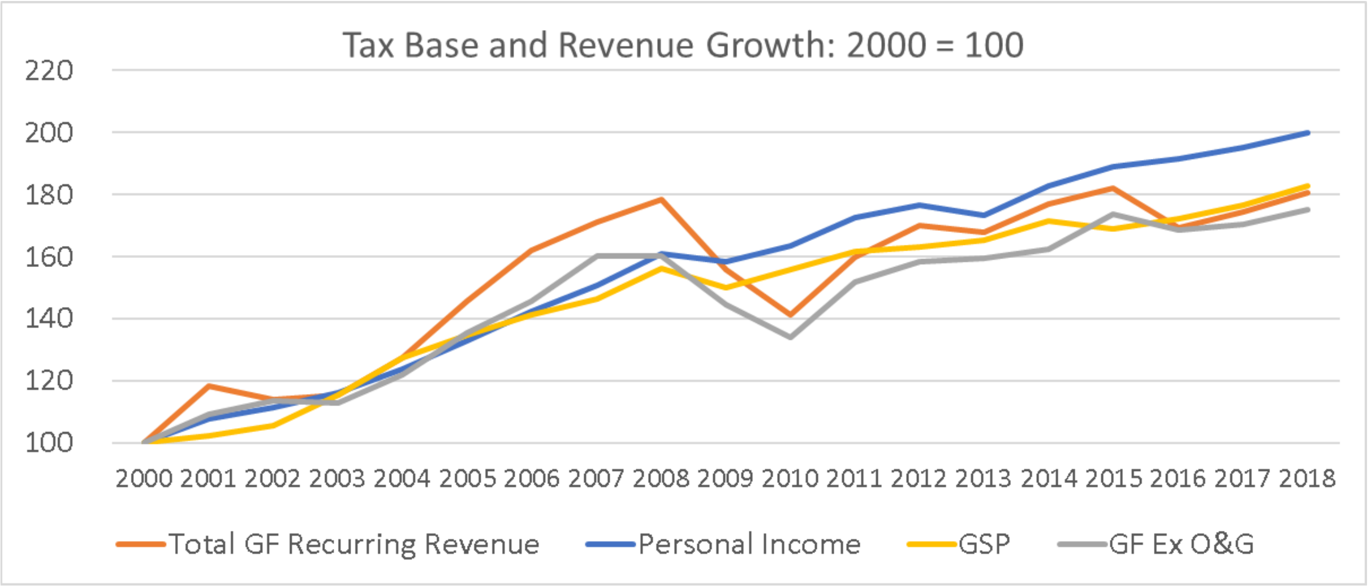
Adequacy Over Time



Source: NM DFA, General Fund Report

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

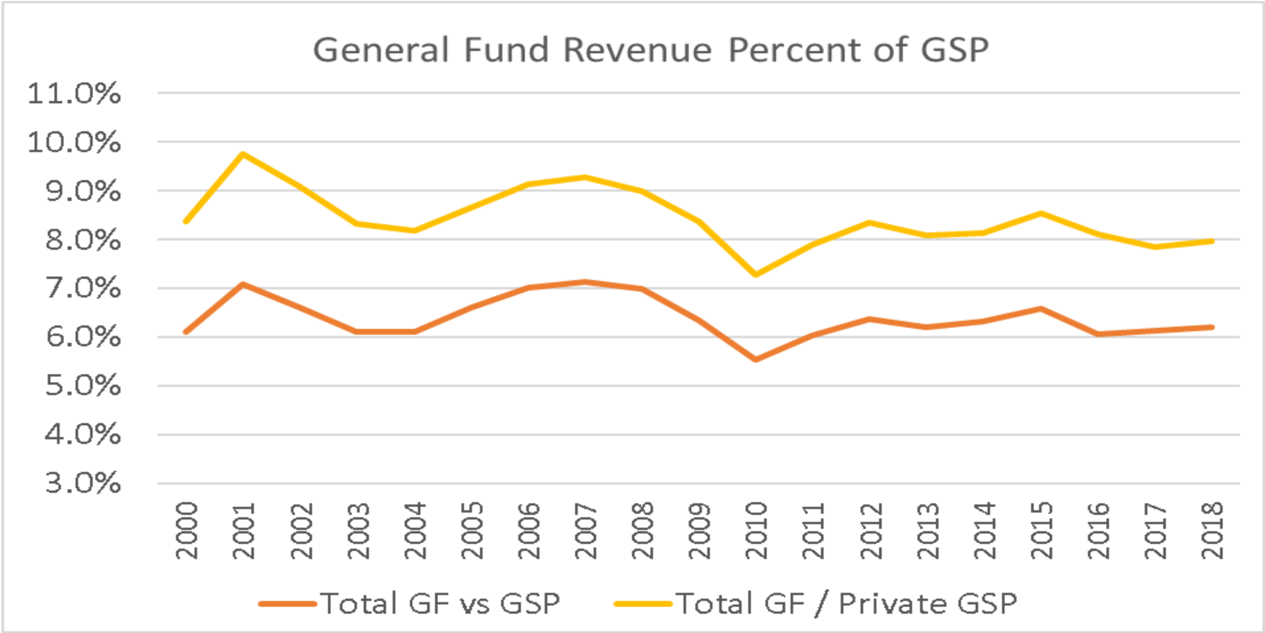
Revenue growth vs the economy



Sources: NM DFA, U.S. Bureau of Economic Analysis; Author's calculations

- 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

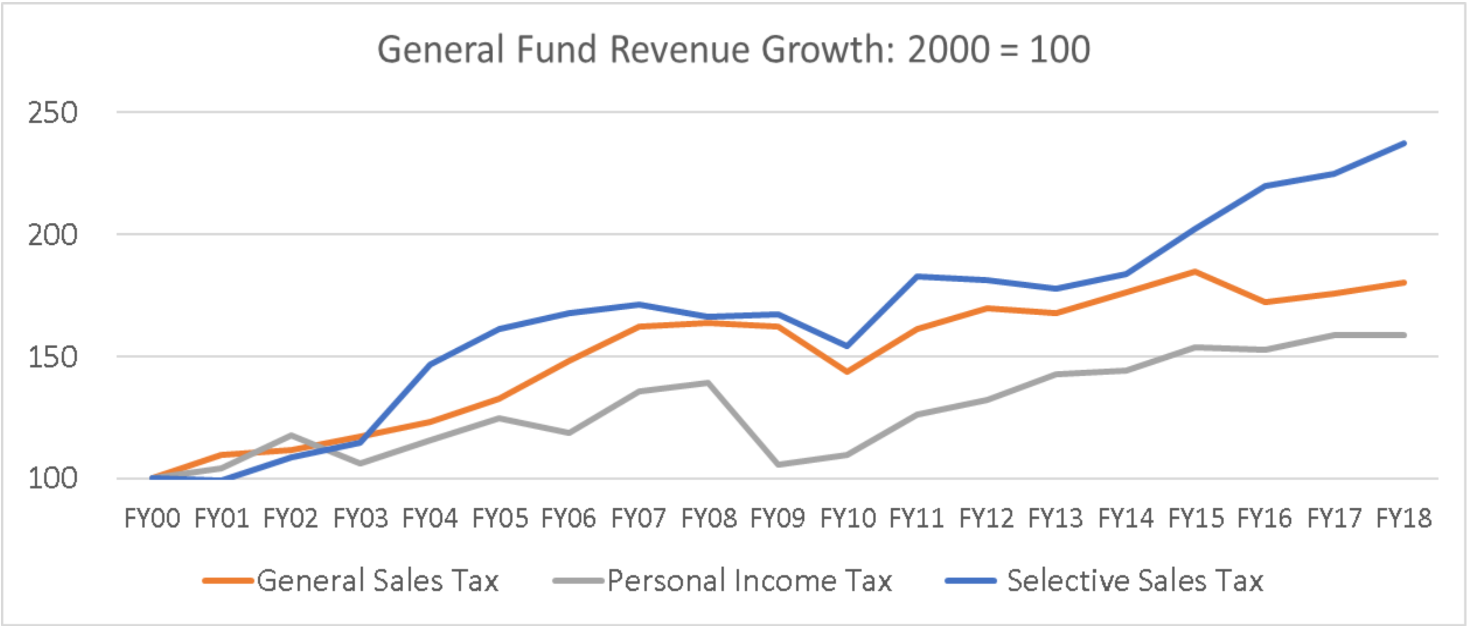
Revenue adequacy vs tax base



Source: NM DFA, U.S. BEA; Author's calculations

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

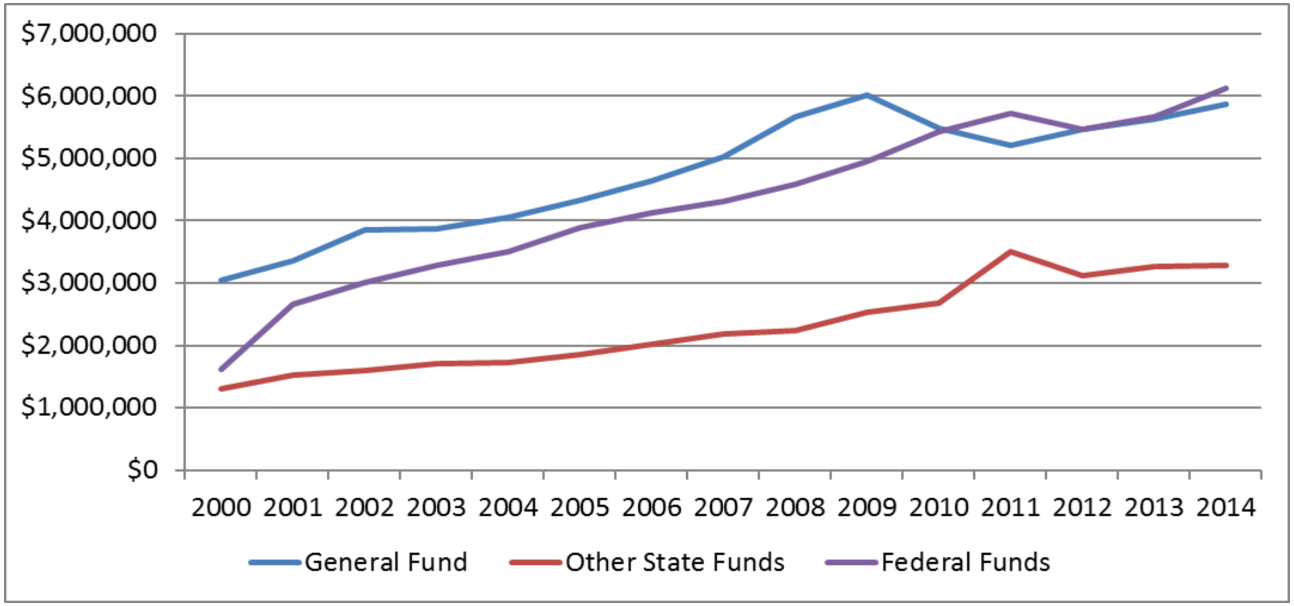
Revenue growth of major GF taxes



Source: NM DFA General Fund Report; Consensus Forecast

- 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

Adequacy: All operating funds



Source: NM DFA

- 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%

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

- 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

2016 State & Local Business Tax Collections by Source – E&Y COST					
	Property	Sales	PIT	Other	Total
NM % of GSP	1.3%	2.6%	0.7%	1.0%	6.4%
US Average % of GSP	1.7%	1.0%	0.6%	0.3%	4.5%
Difference	(0.4%)	1.6%	0.1%	0.7%	1.9%
Annual Revenue Impact (Million Dollars)	($290)	$1,150	$70	$500	$1,370

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 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 rate of return on investment

Effects of Taxing Consumption (cont.)

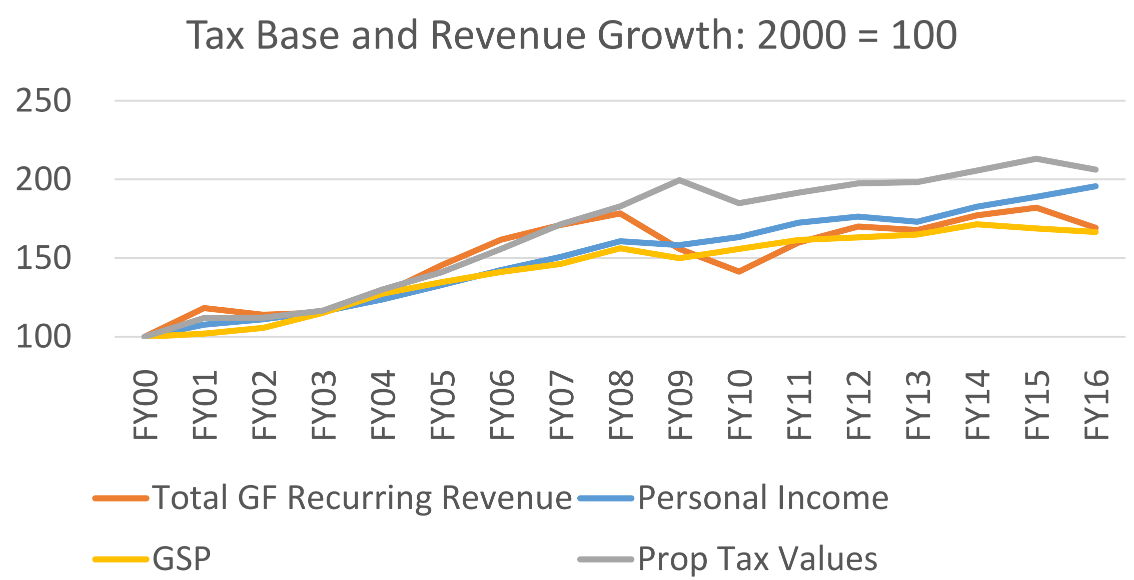
- Although sales taxes may be simpler to enforce than some other taxes, there are important qualifications to this assumption:
    - Federal income tax is more complex, but state-level tax doesn't add much to that complexity
    - Taxing remote commerce, intangibles and services increases complexity

- 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