

Pyramiding in New Mexico's Gross Receipts Tax

Presented to the Legislative Finance Committee

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LFC Principles of Good Tax Policy

Adequacy: revenue should be adequate to fund government services

Efficiency: broad base with low rates; minimize distortion; avoid reliance on one tax

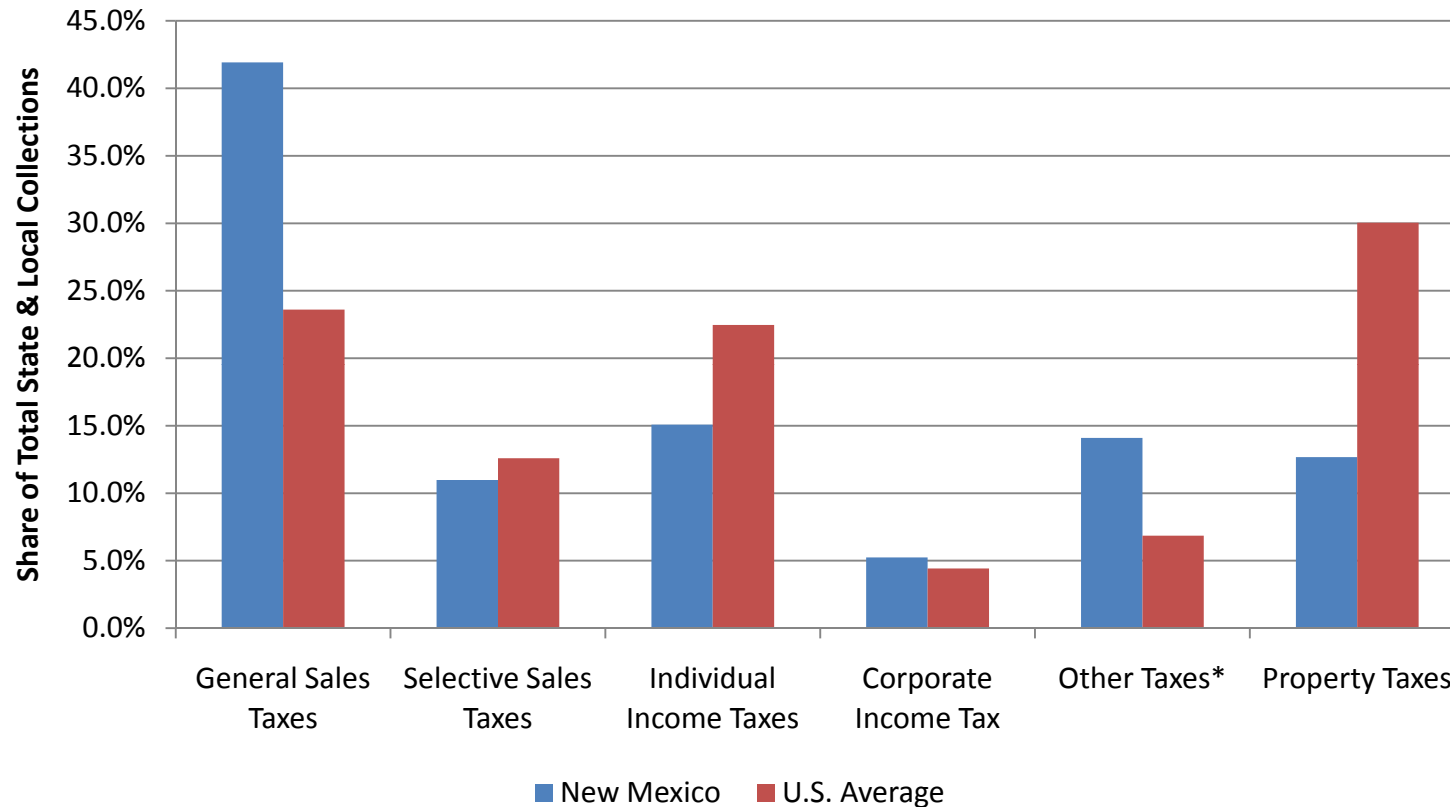
Equity: fairness to taxpayers in similar circumstances; fairness to taxpayers with different incomes

Simplicity: encourage compliance and minimize administrative costs

Accountability: tax preferences should be easy to monitor and should be reviewed periodically

Implementing principles requires trade-offs

GRT's Role in New Mexico's Tax System

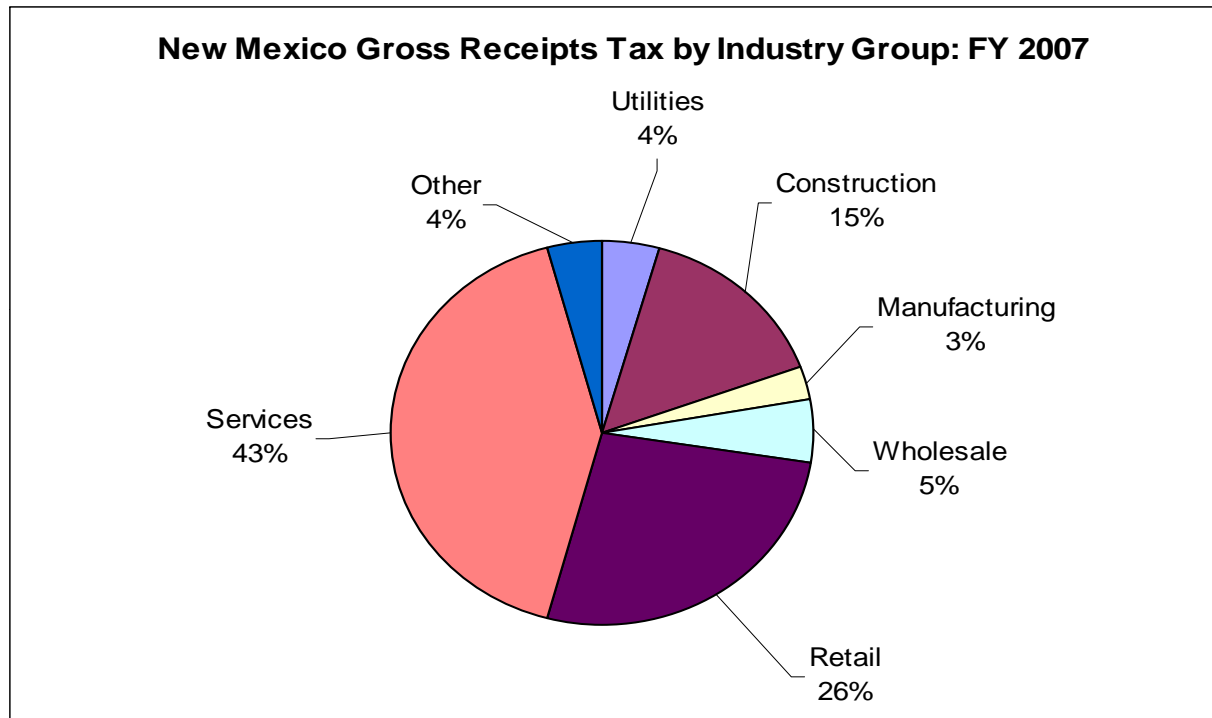


- *GRT comprises over 40% of all tax collections in New Mexico*
- *Higher NM Sales Tax offsets lower Property Tax than U.S. Average.*
- *NM lower Individual Income Tax is offset by Oil & Gas production taxes.*

GRT Role in New Mexico's Economy

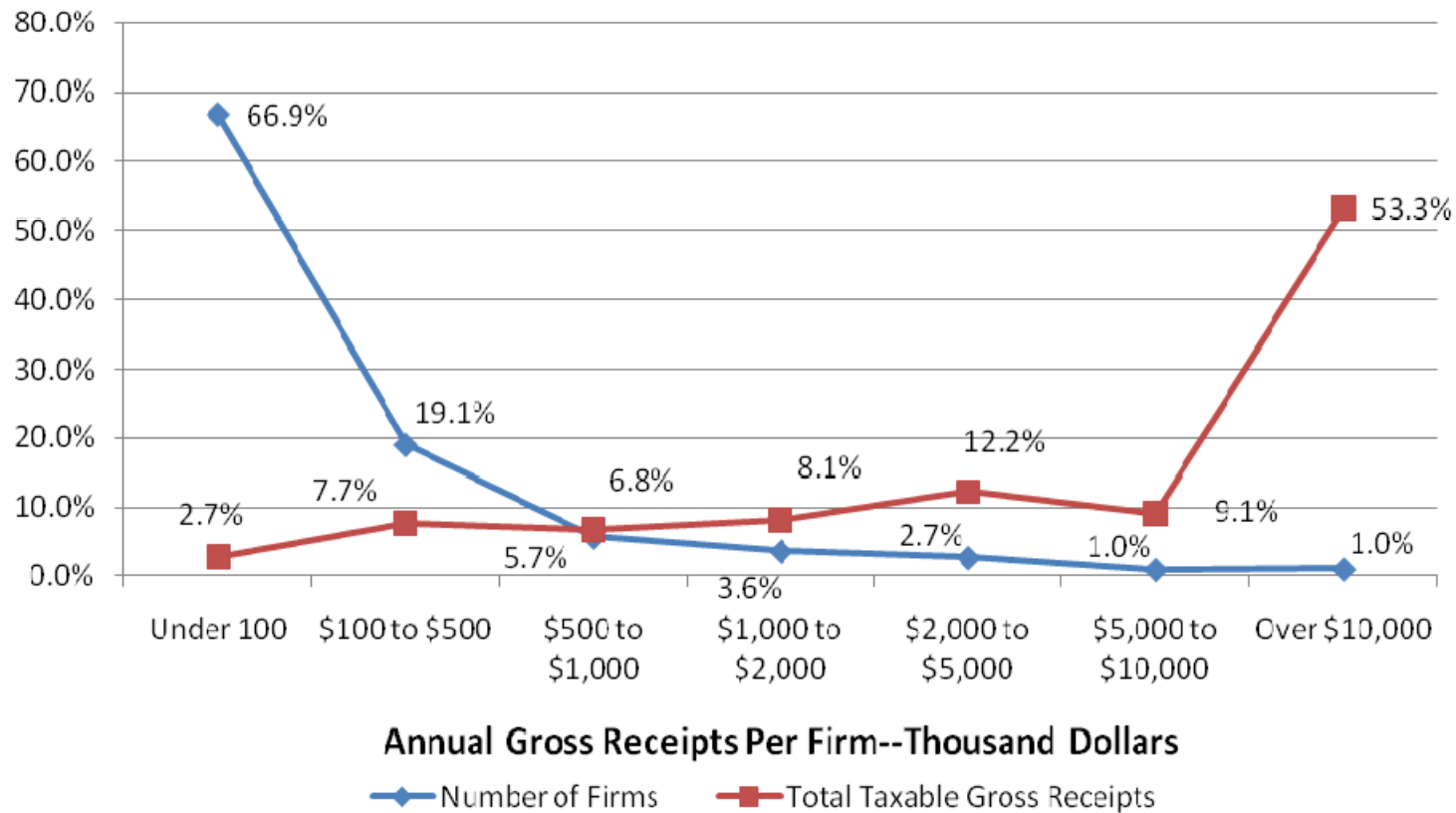
- Limited role of cross-border transactions so little tax competition at retail level (changing with e-commerce).
- Large role of government facilities: Seller-imposed GRT brings government contractors into tax base.
- Large role of resource extraction industries: GRT on services brings their contractors into the base.
- Relative isolation of N.M. economy is changing. Newly-locating businesses are putting pressure on the GRT, seeking relief on inputs and outputs.

GRT Tax Base by Industry



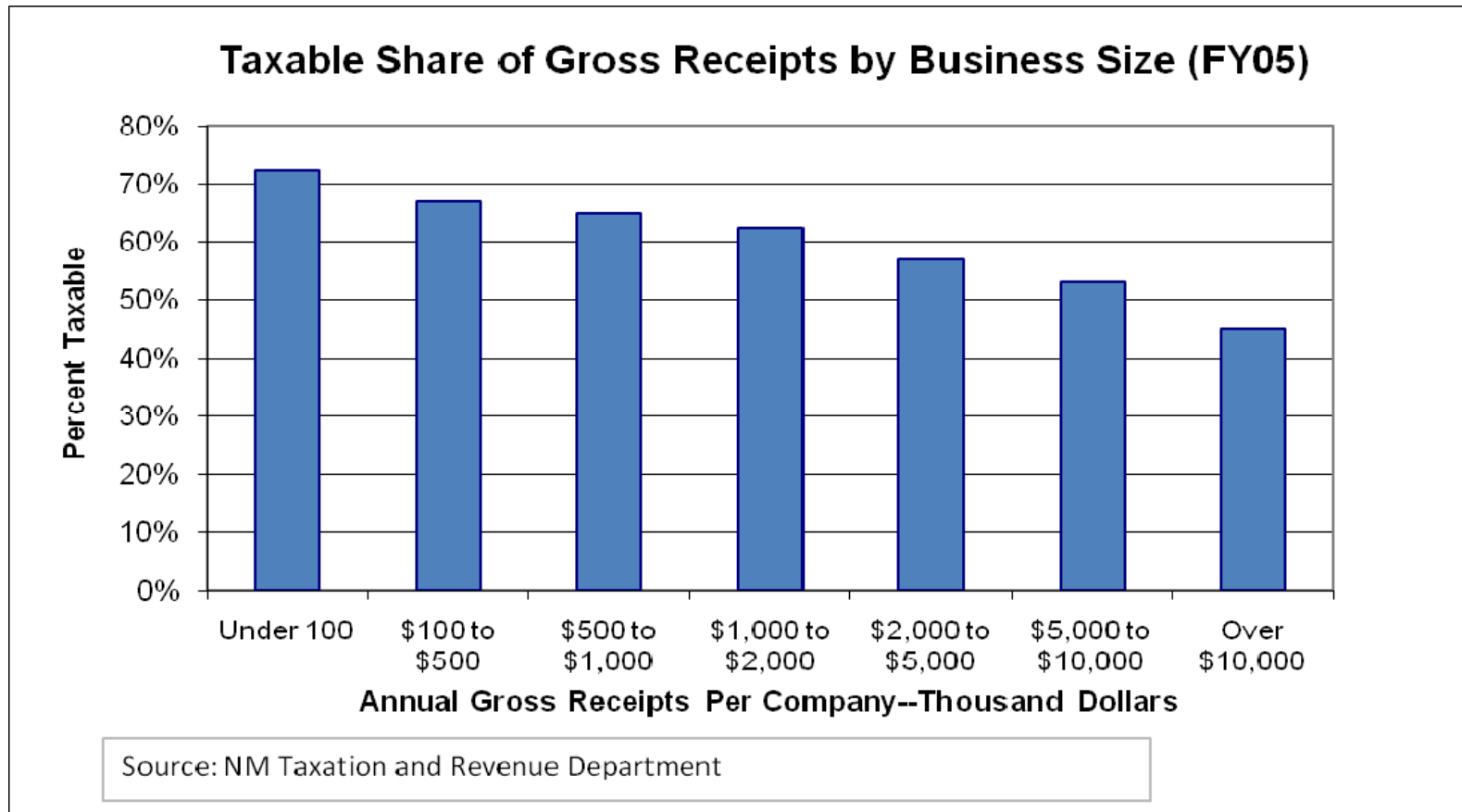
- *Services + Construction almost 60% of tax base*
- *Retail sales only 26%*
- *65% of average household spending is non-taxable*

Taxable Gross Receipts by Firm Size--FY05



Source: NM Taxation and Revenue Department

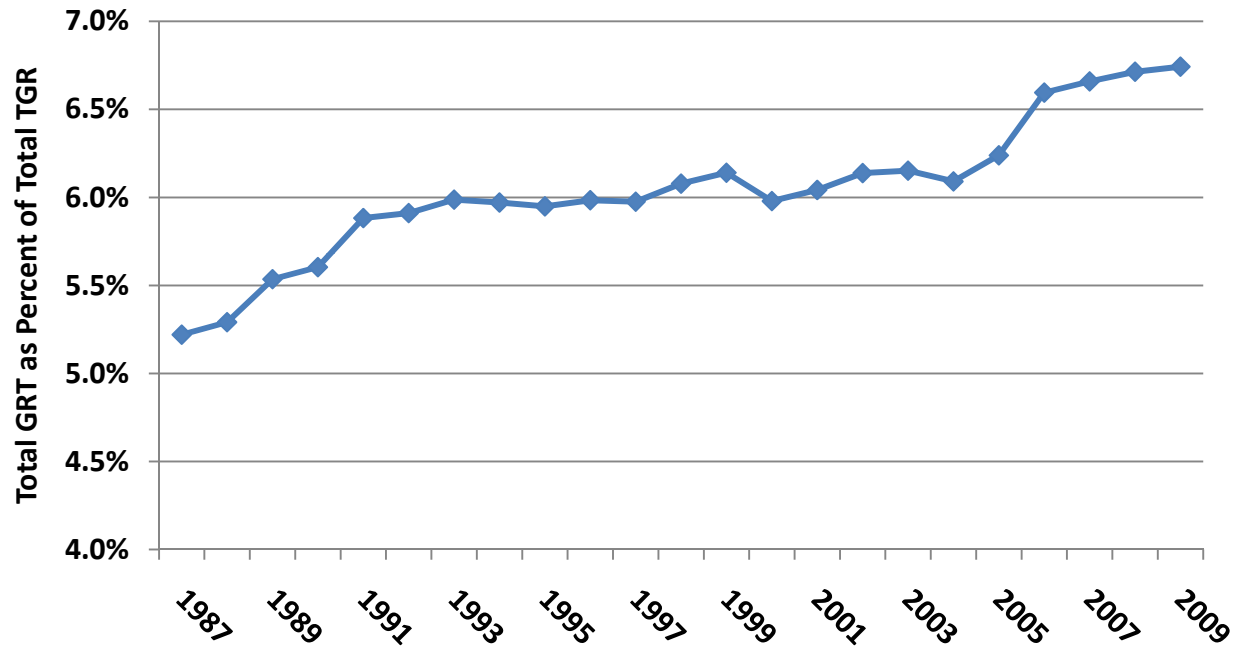
- *Largest 1% of firms contribute over half of GRT base*
- *Smallest two-thirds of businesses contribute less than 3%*



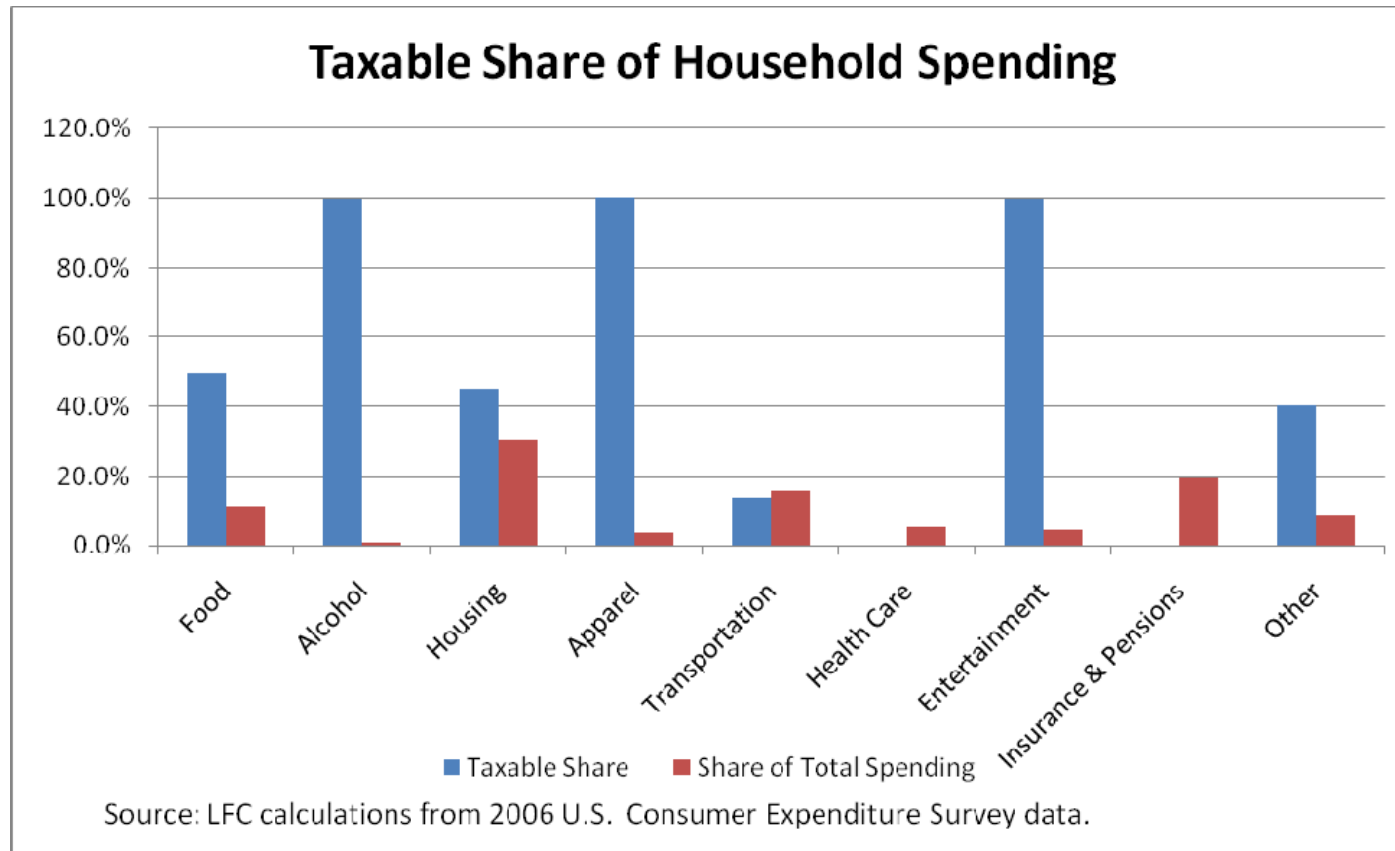
- *Taxable share of sales decreases as firm size increases*
- *Larger firms are more likely to have exports or other deductions*

GRT Rate History

Trends in Average Combined GRT Tax Rate



- *State rate increased due to 0.5% municipal credit repeal in 2005*
- *Another 0.125% increase took effect July 2010*
- *Local option rates have been increasing gradually over time*



- *LFC estimates two-thirds of household spending is non-taxable*
- *Household exemptions/deductions reduce tax base by 50%*
- *Uneven taxation of purchases distorts economic behavior*

Pyramiding Illustration

	Sales	GRT
Drilling contractor	\$100	\$7.40
Natural gas producer	\$200	\$14.80
Electric Utility	\$400	\$29.60
Commercial power consumer	\$800	\$59.20
Total final value/Tax	\$800	\$111.00
Effective tax rate		13.88%

Pyramiding can raise effective tax rates sharply, creating strong incentives to avoid tax by importing, or bringing operations in-house.

Pyramiding in Other States*

- Most states – including NM -- exempt goods that are to be re-sold or to become ingredients in a final product.
- About half of states exempt equipment used in manufacturing (NM does not). Another 1/3 provide lower tax rates or partial exemption.
- About half of states exempt materials that do not become components (e.g. fuels) – NM does not.
- Most states – including NM -- tax goods sold to non-taxable entities.
- NM taxes a much broader spectrum of services than most states. Few deductions are allowed for sales to businesses.

*Source: R.C. Fisher, *State & Local Public Finance*, Chapter 15.

Multi-state Business Tax Comparison

Tax	New Mexico Percent of Gross State Product	U.S. Average Percent of Gross State Product	NM – U.S. Average Annual Revenue
Property Tax	0.8%	1.7%	(\$600 million)
Sales Tax on Inputs	1.9%	1.1%	\$520 million
Excise Tax on Purchases	0.5%	0.6%	(\$60 million)
Corporate Income Tax	0.5%	0.5%	--
Unemployment Insurance Tax	0.2%	0.3%	(\$70 million)
Income Tax on Business Profits	0.1%	0.2%	(\$45 million)
Other	2.1%	0.5%	\$955 million
Total	6.0%	4.9%	\$700 million
Total Excluding Severance Taxes*	4.6%	4.7%	(\$63 million)

Source: "Total State & Local Business Taxes," Ernst & Young, Council on State Taxation, January 2009

- *NM business tax burden about average on non-severance industries*
- *Sales tax on business inputs almost twice national average*
- *Businesses buying within state face high overhead*

Concerns Raised by Pyramiding

- Pyramiding places a heavier tax burden on businesses and individuals who make a lot of purchases from in-state vendors. This creates incentives to buy from out-of-state vendors: 2.5% advantage if the seller has nexus, 7.5% if not.
- Small companies face a larger tax burden – and are placed at a disadvantage to larger businesses – because they purchase more inputs rather than providing them in-house.
- The effective tax rate is greater than the nominal rate, increasing with the number of taxable stages of production.
- The likelihood is high that most of the ultimate burden of this tax is borne by New Mexico households, a hidden tax with regressive implications.

Policy Recommendations

- “First, do no harm”
 - Inefficiency (i.e. lost economic output) increases with the square of the tax rate – i.e. exponentially – holding down the GRT tax rate is essential
 - New exemptions targeted at consumer purchases should be kept to a minimum, they shift the tax base to businesses
 - Use of tax incentives should be strictly limited – they reduce the base and put upward pressure on tax rates
- Sales tax reform should focus on final sales, exclude intermediate sales
- GRT could be split into two taxes:
 - Retail sales tax with fewer exemptions and
 - Business privilege tax at much lower rate – e.g. TX Margin Tax