LFC Hearing Brief

NEW MEXICO LEGISLATIVE FINANCE COMMITTEE

The gross receipts tax (GRT) is a hybrid tax that blends traditional sales taxes and pure, transactional gross receipts taxes. The hybrid system creates tax pyramiding for certain industries, although substantial measures were implemented over time to reduce or eliminate some forms of pyramiding. Numerous tax expenditures were also created over the years. Some of these measures might have merit, but they have the effect of narrowing the potential tax base on the business side.

The system also excludes significant portions of final consumption in the state, often because the consumption is taxed through other methods (sometimes at a lower rate), but also often to remove taxation altogether. This also has the effect of narrowing the potential tax base but on the consumer/resident side. While other states across the country explore the possibility of expanding the reach of their sales taxes, often to begin including services, New Mexico's GRT base has eroded over time.

GRT Base Erosion and Revenue Volatility

The food deduction (and associated hold harmless distributions) is the state's single largest tax expenditure, costing over $200 million annually. This is more than double the cost of the next largest tax expenditure – the GRT exemption for receipts of nonprofit organizations, which costs the state about $79 million annually. Excluding food consumption from the tax base removes a relatively stable and predictable revenue stream from state and local government budgets. In frequent discussions about the deduction, proponents cite the good intention of reducing the tax burden on low-income households, but critics often note the dollar benefit of the deduction disproportionately goes to the highest-income households, and there may be ways of reducing the tax burden on low-income households through other means but at a lower cost to state and local governments. The following historical and prospective review can help inform future discussions about the deduction and any role it may play in GRT rate reduction and tax reform.

The erosion of the taxable base results in high and rising GRT rates and also leads to increasingly volatile revenues that are growing in dependency on the sources remaining in the tax base, including GRT revenues related to oil and gas [see matched taxable gross receipts (MTGR) sidebar chart on next page]. Additionally, rising GRT rates amplify tax pyramiding, which occurs when GRT is applied to business inputs creating an extra layer of taxation at each state of production.

Creating the Food Deduction. One of the most significant steps to narrow the tax base occurred in 2004 with Chapter 116 (House Bill 625), which created the GRT deductions for food and certain medical services. As part of this package of deductions, an accompanying provision created "hold harmless" payments from the general fund to local governments to offset the local revenue losses from the deductions.

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PURPOSE OF HEARING: GRT Food Deduction & Hold Harmless Distributions

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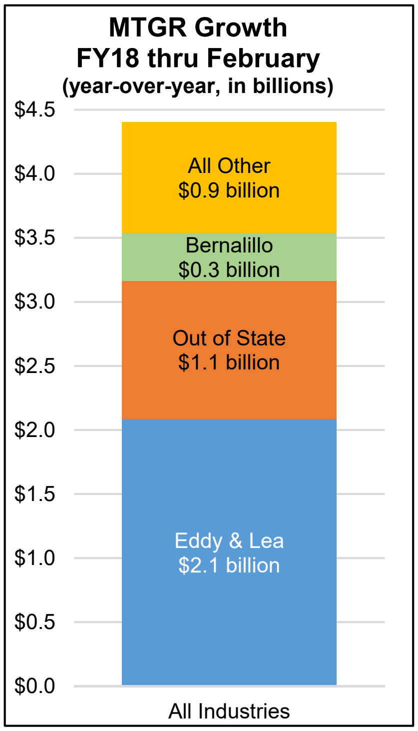
Top Ten State Tax Expenditures and Estimated Costs (in millions)

Tax Expenditure	Five-Year Average Cost
Food GRT Deduction (cost includes hold harmless distributions to local governments)	$227.3
Receipts of Nonprofit Organizations Exemption from GRT	$78.6
Sales to Nonprofit Organizations GRT or GGRT Deduction	$73.8
Health Care Practitioners GRT Deduction (cost includes hold harmless distributions to local governments)	$72.6
Prescription Drugs GRT or GGRT Deduction	$60.6
NMMIP Assessment Credit against Insurance Premium Tax	$57.0
Film Production Tax Credits/Film and Television Tax Credits against PIT or CIT	$50.2
Medical Services GRT Deduction	$49.2
Working Families Tax Credit against PIT	$49.0
Hospitals 50% GRT Deduction	$37.9

Sources: Legislative Council Service *Tax Deviation Report*, Taxation and Revenue Department *Tax Expenditure Report*, LFC files

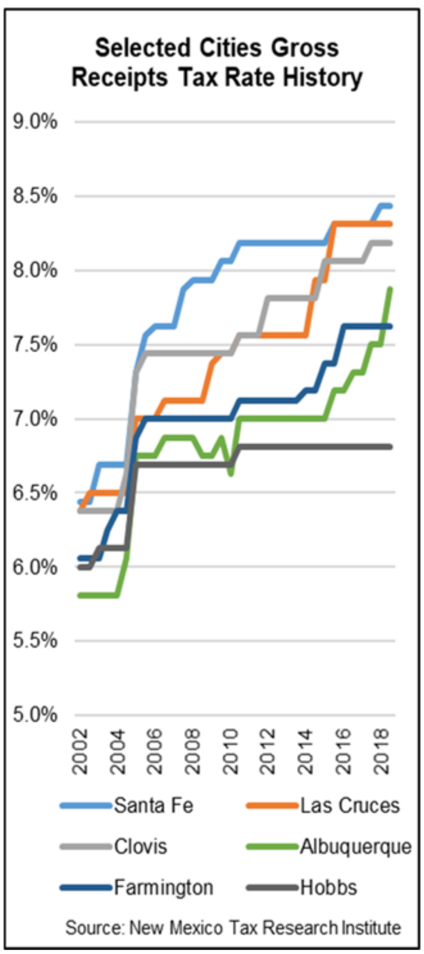
Why Focus on the Food Deduction?

- Single largest tax expenditure
- Ongoing interest from policy-makers and tax experts
- Reduces revenue stability
- Increases reliance on other revenue sources, including the oil and gas industry
- Contributes to rising GRT rates, exacerbating tax pyramiding issues

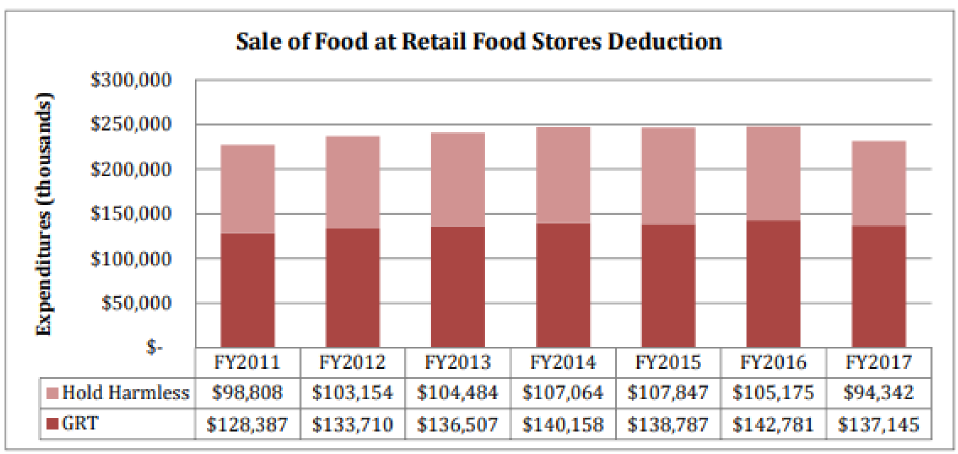


In an attempt to offset general fund losses, another provision in Chapter 116 repealed the 0.5 percent credit allowed against the state's 5 percent (at the time, now 5.125 percent) GRT rate for sellers located in municipal areas. The credit was created in 1986, when the statewide tax rate was increased from 3.75 percent to 4.75 percent. The 1986 credit had the effect of reducing the combined rate of state and local GRT in municipal areas where most taxable transactions occur. The combined fiscal impact of the package adopted in 2004 was estimated at the time to be approximately revenue neutral, and the cost of the food tax deduction, including the related portion of hold harmless payments, was estimated at approximately $107 million for FY06, increasing gradually over time due to inflation. However, the deductions and hold harmless payments reduced revenue by far more than the credit repeal raised revenue because of incorrect estimates of the resulting GRT base erosion.

Rising Costs and Rising Tax Rates. The cost of the food deduction reached $137.1 million in FY17, and the hold harmless payments added another $94.3 million for a total general fund cost of $231.5 million related to the deduction, according to the Taxation and Revenue Department's (TRD) *2017 Tax Expenditure Report* (the report's historical graph is shown below). The hold harmless payments are gradually declining due to the tax package in 2013 – Chapter 160 (House Bill 641). This tax package implemented a phase-out schedule for food and medical hold harmless payments beginning in FY16 with 6 percent annual reductions, accelerating to 7 percent reductions starting in FY20, and fully phasing out by FY30. However, municipalities with populations less than 10 thousand and counties with populations less than 48 thousand are exempt from the phase-out as long as they do not adopt an optional provision of the bill – the three-eighths hold harmless GRT increments.



Source: New Mexico Tax Research Institute



	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Hold Harmless	$98,808	$103,154	$104,484	$107,064	$107,847	$105,175	$94,342
GRT	$128,387	$133,710	$136,507	$140,158	$138,787	$142,781	$137,145

Source: TRD 2017 Tax Expenditure Report

These hold harmless increments may be adopted by the local government's governing body through an ordinance in one-eighth increments up to the maximum three-eighths. Voters do not need to approve these increments, which were intended to offset the gradual phase-out of hold harmless payments from the state. However, more than a third of counties and several cities enacted the full increments by the end of FY17 instead of gradually enacting them as hold harmless payments declined. The imposition of these increments generated an increase in local taxes of $110.7 million in FY17, according to an estimate from the Department of Finance and Administration. That is more than seven times more revenue than the drop in hold harmless payments in FY17 from FY15 – the last year prior to the start of the phase-out. If both a municipality and the surrounding county enact the full three-eighths, the total GRT rate increase due to the 2004 and

2013 legislation is 1.25 percent, including the impact of the repealed muni credit. The size of the food deduction is 3.6 times the size of the medical deduction, so the vast majority of this rate increase is due to the food deduction.

One issue that could be contributing to the cost of the food deduction is the possibility some stores that sell food for home consumption might be reporting items purchased through the Supplemental Nutrition Assistance Program (SNAP, or "food stamps") under this deduction instead of the SNAP exemption. Both reporting methods result in no tax liability for the food sale, so some stores may lump everything together for ease of reporting. However, the deduction results in hold harmless payments from the state, while the SNAP exemption does not, making incorrect reporting significantly more expensive for the general fund. In the 2016 special session, a 20 percent penalty was enacted on taxpayer misreporting that results in erroneously high hold harmless payments, but taxpayers might not be aware of this penalty. TRD should implement an awareness campaign and perform audits of several food sellers to ensure compliance.

Other States' Taxation of Food

As of January 1, 2018, 13 states impose sales taxes on food items. Of these states that tax food, five allow for a rebate or income tax credit to offset the burden on low-income households, and six states tax food at a reduced state rate. Of the states that do not tax food or tax food at reduced rates, five allow food to be taxed at the local level. In about half of all states that do not tax food, items such as candy, confectionery (high sugar items), and soft drinks do not quality as foods eligible for tax exemption (see Appendix).

Many states exclude prepared foods or "meals" from the tax exemption as well; however, the definition of what constitutes a meal varies. For example, Connecticut considers both prepared food and foods packaged for immediate consumption as meals – therefore, most individual, single-serving packages of snacks (e.g. chips, pretzels, or cookies) are subject to the sales tax. New York allows for taxation of food that may be eaten on or near the premises (including convenience stores, concession stands, hot or cold buffets, and coffee shops) and other heated or prepared foods in certain circumstances. Because New Mexico aligns its food definition with SNAP, hot foods and foods intended to be eaten in the store are taxable, while cold prepared items intended for off premises consumption (such as sandwiches, salads, and bakery items) are not taxable.

Other states have more complicated systems for food taxation. For example, Vermont exempts most non-prepared food from the sales tax; however, prepared foods are subject to a meals tax, which is higher than the sales tax. Additionally, candy and soft drinks may be subject to either the sales tax or the meals tax depending on the type of business from which the items are sold (e.g. restaurant, grocery store, convenience store, or some combination). Utah taxes most grocery items at a reduced rate, but if the transaction combines both food and other taxable items, then the entire transaction is subject to the full state tax rate.

Under federal requirements, all states exempt foods purchased with SNAP benefits from the sales tax. Except for clear exclusions – such as alcoholic beverages, tobacco products, vitamins, and food to be eaten in the store – the

STATE SALES TAX RATES
FOOD EXEMPTIONS
(As of January 1, 2018)

STATE	Tax Rate (percentage)	Food Exemption (1)
ALABAMA	4	taxable
ALASKA	none	--
ARIZONA	5.6	*
ARKANSAS	6.5	1.5% (4)
CALIFORNIA (3)	7.25	*
COLORADO	2.9	*
CONNECTICUT	6.35	*
DELAWARE	none	--
FLORIDA	6	*
GEORGIA	4	* (4)
HAWAII	4	taxable
IDAHO	6	taxable
ILLINOIS	6.25	1%
INDIANA	7	*
IOWA	6	*
KANSAS	6.5	taxable
KENTUCKY	6	*
LOUISIANA (6)	5	* (4)
MAINE	5.5	*
MARYLAND	6	*
MASSACHUSETTS	6.25	*
MICHIGAN	6	*
MINNESOTA	6.875	*
MISSISSIPPI	7	taxable
MISSOURI	4.225	1.225%
MONTANA	none	--
NEBRASKA	5.5	*
NEVADA	6.85	*
NEW HAMPSHIRE	none	--
NEW JERSEY	6.625	*
NEW MEXICO	5.125	*
NEW YORK	4	*
NORTH CAROLINA	4.75	* (4)
NORTH DAKOTA	5	*
OHIO	5.75	*
OKLAHOMA	4.5	taxable
OREGON	none	--
PENNSYLVANIA	6	*
RHODE ISLAND	7	*
SOUTH CAROLINA	6	*
SOUTH DAKOTA	4.5	taxable
TENNESSEE	7	5% (4)
TEXAS	6.25	*
UTAH	5.95 (5)	3.0% (5)
VERMONT	6	*
VIRGINIA	5.3 (2)	2.5% (2)
WASHINGTON	6.5	*
WEST VIRGINIA	6	*
WISCONSIN	5	*
WYOMING	4	*
DIST. OF COLUMBIA	5.75	*

** -- indicates exempt from tax*

(1) Some state tax food, but allow a rebate or income tax credit to compensate poor households. They are: HI, ID, KS, OK, and SD.

(2) Includes statewide 1.0% tax levied by local governments in Virginia.

(3) Tax rate may be adjusted annually according to a formula based on balances in the unappropriated general fund and the school foundation fund.

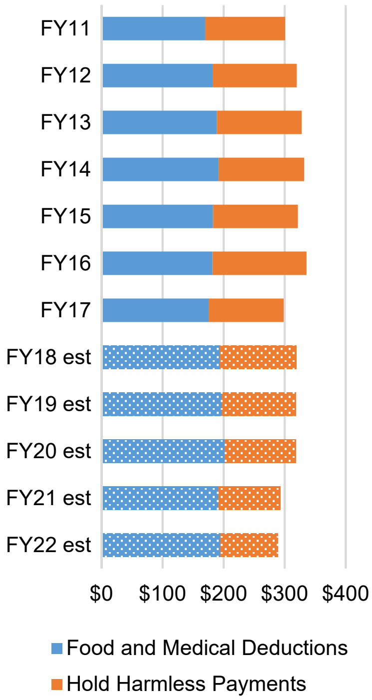
(4) Food sales subject to local taxes.

(5) Includes a statewide 1.25% tax levied by local governments in Utah.

(6) Louisiana tax rate will decrease to 4%, 7/1/18.

Source: Federation of Tax Administrators

Annual Food and Medical General Fund Costs
(in millions)



Sources: TRD 2017 Tax Expenditure Report, January 2018 consensus forecast,

Hold Harmless Phase-Out Schedule	
Fiscal Year	**Phased-Out Rate**
FY15	100%
FY16	94%
FY17	88%
FY18	82%
FY19	76%
FY20	70%
FY21	63%
FY22	56%
FY23	49%
FY24	42%
FY25	35%
FY26	28%
FY27	21%
FY28	14%
FY29	7%
FY30	0%

SNAP approved food list is unrestricted. Therefore, items like candy and carbonated beverages are tax exempt when purchased with SNAP benefits, even in states that otherwise tax those items. Although some states and local governments have attempted to impose restrictions on SNAP purchases, the United States Department of Agriculture has denied all such waivers.

Legislative Proposals to Add Food Back Into Tax Base

Since New Mexico enacted the food tax deduction, there have been various legislative attempts to bring all or some food items back into the taxable base and provide for a full or partial repeal of hold harmless distributions. Some proposals, such as SB 281 (2016), sought to eliminate the food deduction. Other proposals, such as SB 129 (2018) and SB 441 (2017) sought to limit the food deduction to only those food items approved by the U.S. Department of Health for the federal special supplemental nutrition program for women, infants, and children (WIC), as well as unprocessed meat, poultry, and fish. In the 2017 session, SB 416 sought to change the definition of qualifying foods to exclude those with minimal-to-no nutritional value, including sweetened beverages, candy, and certain snack foods.

Other proposals mirrored actions in some states to allow for local food taxes or reduced tax rates for food. SB 274 (2015) sought to apply only municipal and county tax rates on food as part of a larger omnibus package. SB 280 (2018) and SB 476/SFCS (2017) attempted to create a new gross receipts tax on food at a uniform 4 percent statewide rate, from which portions of the revenues would have been distributed to local governments.

Additionally, because the food GRT deduction relies on the SNAP definition of food, attempts to limit items purchasable with SNAP benefits could substantively affect the food tax deduction. For example, SB 5 (2017) sought to change the SNAP definition of food to those qualifying for the WIC program, which subsequently would mean that any food not meeting the WIC food definition would become taxable under GRT.

Important Considerations for Legislative Changes

While proposals to repeal the food deduction and hold harmless distributions are relatively straightforward, other proposals to alter the food deduction introduce various factors that lawmakers need to consider carefully.

One important consideration is the administrative complexity of the proposal. For example, proposals that seek to tie the food deduction to the WIC program's list of approved foods need to be attentive to the nuances of that program. WIC is a grant program and receives a finite budget each year, which is then allocated to states. Because of the budget constraint, the New Mexico WIC program limits the brands and types of food under the major categories, and approved foods may change each year. Various retailers choose not to accept WIC due to these complexities. Fixing the food deduction to WIC food definitions would impose a considerable compliance cost on retailers and would require consistent coordination between TRD and the N.M. Department of Health to maintain the definition of food for this deduction.

Proposals intending to tax unhealthy foods should consider how those foods are defined, which affects any intended outcomes of the proposal (e.g. healthier food choices) as well as the administrative complexity for retailers and TRD. If definitions are open to interpretation, then TRD would likely need to identify those foods by rule and provide a list to retailers that would be updated regularly.

Another important factor is how the proposal affects consumers. Some past attempts to limit the food deduction were criticized for making some food staples non-taxable but applying the GRT to meat and tortillas. Recent proposals have tried to deal with this issue by specifically adding these items to the bill's definitions of food eligible for the deduction. If the intent of the proposal is to incentivize healthier food choices, then the proposal should focus on simplicity and making it relatively easy for consumers to know what food items are taxable. The more difficult it is for consumers to know which food items are taxed, the less likely taxes will play a meaningful role in their food choices.

Because lower income households spend a greater proportion of their income on food, some legislative proposals such as the original HB 412 (2017) paired a repeal of the food deduction with an increase to the state's low-income comprehensive tax rebate (LICTR) in an attempt to offset the additional tax burden on low-income households. The rebate applies to household incomes up to 150 percent of federal poverty guidelines.

Average Annual Expenditures of Food Purchased for Home Consumption

Income	Food at home per household	Potential average tax burden*
Less than $5,000	$2,033	$144
$5,000 to $9,999	$2,420	$171
$10,000 to $14,999	$2,073	$147
$15,000 to $19,999	$2,428	$172
$20,000 to $29,999	$3,079	$218
$30,000 to $39,999	$3,301	$234
$40,000 to $49,999	$3,439	$243
$50,000 to $69,999	$4,301	$305
$70,000 and more	$5,540	$392
Total	$4,052	$287

*calculated using NM state plus local average GRT rate of 7.08%

Source: Consumer Expenditure Survey 2016, Regional Analysis, Bureau of Labor Statistics

Additionally, any legislative changes should consider the impact on local governments. Proposals to partially reinstate the GRT on food but wholly repeal the hold harmless provisions (including hold harmless GRT rate increments) would significantly affect the fiscal condition of municipalities and counties.

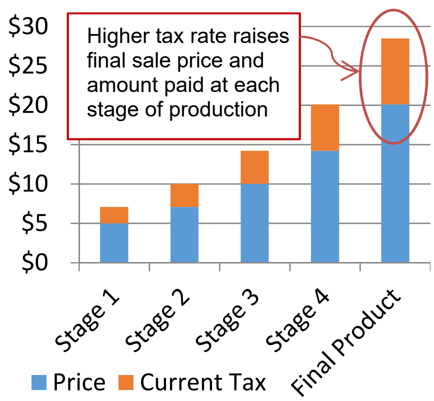
Options for Future Consideration

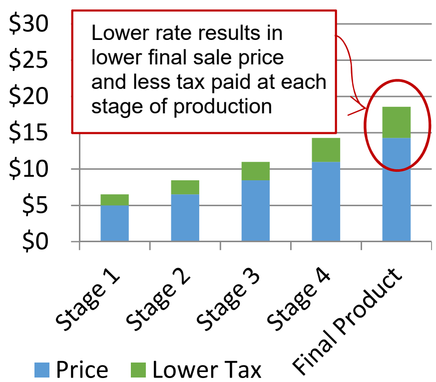
There are several possible options to bring food completely or partially back into the tax base and reduce GRT rates with the savings. However, LFC economists recommend that if the food deduction is mostly or entirely repealed, it be done as part of a more comprehensive tax reform effort to provide additional rate reduction. In order to improve the state's ability to model the impacts of tax reform proposals, the Legislature approved a tax study to be conducted by Ernst and Young (EY). As models and analysis from EY's study become available, LFC economists expect an improved ability to model the impacts of GRT rate reduction and anti-pyramiding provisions, and to determine the household distributional effects of various reform proposals. The models and a comprehensive report from EY are to be delivered by the close of contract, which ends on June 30, 2018.

Preliminary analysis of food and other household expenditures indicates many individuals and families just beyond the caps to qualify for SNAP would incur significant additional tax burdens if the only rate reduction were from food deduction savings. There are also options to offset the impact to low-income families, including increasing LICTR payments, although even without this additional aid, lower income individuals and families using SNAP could see a mix of overall tax increases and decreases depending on spending patterns.

One option is to repeal the food deduction, repeal related hold harmless payments, and reduce the hold harmless GRT increments allowed by local governments. The savings from the deduction could "buy down" the state rate by about 0.25 percent, and the hold harmless savings could be used for additional rate reduction, although this would have a long-term negative revenue impact due to the scheduled phase-out. The local increments could be reduced from three-eighths to one-eighth, reducing the possible local rate increases by up to 0.5 percent for a total possible

Impact of Rate Reduction on Tax Pyramiding





Note: dollar amounts for reference only

rate reduction of 0.75 percent. This would also help local governments that have chosen not to enact these increments.

Another option would be very similar to the first but would reduce the deduction instead of repealing it. Rather than a full, 100 percent deduction, it could be reduced to 75 percent or 50 percent. This would not buy as much rate reduction, but it would mitigate impacts on taxpayers and would be easier to achieve positive overall impacts for low-income and lower-middle income taxpayers if included as part of comprehensive tax reform. This option has the added benefit of likely being the easiest option to administer other than complete repeal.

A third option would be to narrow the food deduction to exclude certain types of sales, and there are a variety of ways to do this. For example, it could be narrowed to include only items available through WIC, or further narrowed to include only those items if sold by an authorized WIC retailer. However, as previously mentioned, use of WIC definitions will increase administrative complexity and likely create a high compliance cost for retailers. Alternatively, the deduction could be narrowed to exclude junk food items, although it would be a difficult, lengthy process to create a comprehensive list, either in statute or in rule, that could withstand possible taxpayer challenges.

If tax reform is considered during the interim or an upcoming legislative session, it would be worthwhile to explore the possibility of including some type of change to the food deduction, which is by far the state's most expensive tax expenditure. It represents such a significant portion of the potential taxable base, and has the greatest opportunity to assist with rate reduction, that it should at least be evaluated as part of a larger proposal while also evaluating options to prevent overall tax increases on low-income households.

Appendix: States with Exclusions to Food Tax Exemptions

State	Taxable items include:
Arizona	hot, cold, and frozen sandwiches
Arkansas	Candy and soft drinks
California	Candy, confectionery, chewing gum, and carbonated beverages
Colorado	carbonated water, chewing gum, candy, soft drinks
Connecticut	soft drinks, candy and confectionery, and food prepared or packaged for immediate consumption (most individual, single-serving packages of snacks including chips, pretzels, or cookies, are considered “meals” and are therefore subject to sales tax)
Florida	soft drinks and candy
Illinois	while grocery items are taxed at a reduced rate, the reduced rate does not apply to candy, soft drinks, carbonated water, mineral water, chewing gum, ice, and food prepared for immediate consumption
Indiana	soft drinks and candy
Iowa	soft drinks and candy
Kentucky	candy, soft drinks, carbonated water, mineral water, ice, chewing gum, and food sold through vending machines
Maine	soft drinks, iced tea, water (includes mineral, bottled, and carbonated), ice, candy, and confectionery
Maryland	soft drinks and candy
Minnesota	vending machine sales
Nebraska	vending machine sales
New Jersey	candy, confectionery, and carbonated soft drinks
New Mexico	vending machine sales
New York	candy, confectionery, fruit drinks containing less than 70 percent natural fruit juice, soft drinks, and soda
North Carolina	soft drinks and candy
North Dakota	candy, gum, carbonated beverages, soft drinks containing less than 70 percent fruit juice, powdered drink mixes, coffee and coffee substitutes, tea, cocoa and cocoa products
Ohio	soft drinks
Rhode Island	soft drinks and candy
Tennessee	candy and chewing gum
Texas	carbonated and noncarbonated packaged soft drinks, diluted juices, ice, and candy
Vermont	candy and soft drinks (in some circumstances these may be exempt from the sales tax but subject to the state’s higher meals tax)
Washington	carbonated beverages, ice, bottled water, and savory bakery items (pizzas, quiche, sandwiches, etc.)
West Virginia	soft drinks
Wisconsin	soda and some snack foods
District of Columbia	soft drinks