Tax Policy Options to Improve Economic Prospects

- The tax policy options summarized below are based on the LFC's tax policy principles, and generally share three common goals: 1) to broaden the tax base, 2) to lower the tax rate, and 3) to address concerns that New Mexico's tax structure provides a disincentive to economic investment.

- Generally, the options adopt a principle that New Mexico tax rates should be in line with neighboring states and not an "outlier."

- Many of the state's current tax inefficiencies, such as business-to-business pyramiding, are magnified by high tax rates and many economic goals can be advanced by tax restructuring. A lower tax rate should make the state more competitive and business friendly, and a broader base preserve revenue in the face of rate reductions. In addition, narrowly based tax incentives are inefficient and difficult to administer, rate reductions have positive symbolic value.

- The Legislative Finance Committee tax policy principles are:

    - Adequacy: Revenue should be adequate to fund needed government services.
    - Efficiency: Tax base should be as broad as possible and avoid excess reliance on one tax.
    - Equity: Different taxpayers should be treated fairly.
    - Simplicity: Collection should be simple and easily understood.
    - Accountability: Preferences should be easy to monitor and evaluate.

- The options are grouped by their status as tax reductions/revenue reducers or tax increases/revenue offsets that could offset revenue losses to maintain revenue neutrality.

- Preliminary fiscal-impact estimates are included in the attached table.

Revenue Reducers.

- **1 - Eliminate the Corporate Income Tax**

Recent statutory changes have made both reporting and enforcing the CIT more complicated. The rate change and the optional single-sales factor apportioning are both phased in over five years, creating a reporting and an administrative burden. This revenue source has been erratic and difficult to estimate, and represents only a small portion of total state revenues. However, appetite for further CIT reductions may be limited after the 2013 legislative session as such a change may be vulnerable to criticism that policymakers are further favoring large corporations.

CIT State Comparison						
NM	**AZ**	**TX**	**CO**	**OK**	**UT**	**National Average**
7.60%	6.97%	N/A	4.63%	6.00%	5.00%	7.36%

- **2 - Reduce the Gross Receipts Tax (GRT) Rate**

The GRT total burden is high, at a rate approaching 10 percent when applying a broad base and local rates. The state GRT rate is 5.125 percent. Recently enacted legislation provides rate authority for municipalities and counties to each impose an additional 3/8 percent local option GRT increase to offset the phase out of food and medical hold harmless payments from the state. The impact of a lower rate could be offset by a concurrent broadening of the base through the repeal of certain tax preferences, which are addressed below. Reducing the GRT rate would alleviate the effect of pyramiding. During the 2013 legislative session, the TRD estimated a one percent decrease in the GRT would reduce revenue approximately $302 million in FY15. The same decrease in the compensating tax would reduce general fund revenue approximately $13 million.

GRT State Comparison				
	GRT/GST Rate	**Local Option**	**Food**	**Prescription Drugs**
New Mexico	5.13%	0.375 - 3.5%	Exempt	Exempt
Arizona	6.60%	0.0 - 7.125%	Exempt	Exempt
Texas	6.25%	0.0 - 2.0%	Exempt	Exempt
Colorado	2.90%	0.0 - 7.5%	Exempt	Exempt
Oklahoma	4.50%	0.25 - 6.5%	Taxable	Exempt
Utah	5.95%	0.0 - 2.0%	1.75%	Exempt
National Average	5.60%			

- **3 - Enhance the New Mexico Working Families Tax Credit**

The tax credit was last increased in 2008, 25 percent from eight percent to ten percent of the federal earned income tax credit (EITC). A 20 percent increase (from 10 percent to 12 percent of the EITC) would reduce personal income tax revenue approximately $11 million. The increase in this credit would increase the progressivity of the personal income tax, while reducing revenue. This provision has merit if the GRT on food and medical services is reimposed.

- **4 - Anti-GRT Pyramiding**

The GRT applies to all transactions, including intermediate business-to-business purchases of supplies, raw materials, and equipment. As a result, gross receipts taxes create an extra layer of taxation at each stage of production that sales and other taxes do not – an effect termed “tax pyramiding”. A 2005 New Mexico Tax Research Institute (NMTRI) study estimated that, on average, the effective GRT rate is 1.35 percent higher than the statutory rate due to pyramiding, and that up to 32 percent of GRT revenue results from pyramiding. Estimating the fiscal impact of pyramiding is difficult, and estimates vary widely, ranging from 15 percent to 50 percent, depending on the industry. The total current GRT revenue estimate is $2,071 million in FY15 and $2,192 million in FY16.

2012 Legislation attempted to address tax pyramiding in the manufacturing and construction sectors. The manufacturing deduction allows firms to deduct tangible property consumed in the manufacturing process. The manufacturing deduction proved to be onerous to administer, and more open-ended than originally intended, more than doubling its estimated impact. The construction service and equipment leasing deductions would be available only for sales to a construction business for use in a taxable construction project. Future attempts at reducing the effects of pyramiding in other industries should be carefully constructed to avoid such ambiguity and uncertainty.

The table below, from NMTRI's 2005 study, shows the magnitude of pyramiding varies among industries. Anti-pyramiding provisions would be most effective if crafted for specific industries. However, this carries the possibility of making the tax code overly complex and difficult to administer, defeating the purpose of a simplified GRT. An alternative solution is a value-added tax, which taxes only the additional economic value at each step of production.

Economic Sectors	Value of Business Purchases (1)	Potential Tax from All Business Purchases (2)	Pyramiding Relief Under Current Law (3)	Tax Collected from Pyramiding (4=2-3)	Percentage of Pyramiding "Solved" by Current GRT Law (5=3/2)
Agriculture	$1,118.8	$67.1	$45.0	$22.1	67.0%
Mining	$2,557.5	$153.5	$9.1	$144.4	5.9%
Utilities	$445.0	$26.7	$0.5	$26.2	1.9%
Construction	$1,621.8	$97.3	$71.6	$25.7	73.6%
Manufacturing	$5,307.0	$318.4	$149.2	$169.2	46.9%
Wholesale	$536.0	$32.2	$2.1	$30.2	6.5%
Retail	$1,303.0	$78.2	$1.9	$76.2	2.4%
Transportation	$990.0	$59.4	$11.7	$47.7	19.7%
Information	$686.7	$41.2	$16.9	$24.3	41.0%
Finance	$881.4	$52.9	$26.7	$26.2	50.5%
Real Estate	$761.0	$45.7	$12.6	$33.1	27.6%
Professional, Mgmt, Admin	$1,073.3	$64.4	$1.0	$63.4	1.6%
Education	$90.4	$5.4	$4.4	$1.0	81.1%
Health	$1,294.0	$77.6	$51.0	$26.6	65.7%
Arts	$124.0	$7.4	$2.0	$5.4	26.9%
Accom and Hotels	$545.0	$32.7	$13.0	$19.7	39.8%
Other Services	$254.0	$15.2	$8.0	$7.2	52.5%
Total	**$19,588.9**	**$1,175.3**	**$426.7**	**$748.6**	**36.3%**

Source: *Del Valle:"Pyramiding Transaction Taxes in New Mexico" (2005)*

- **5 - MVX Distribution to the State Road Fund**

The funding issues of the state road fund are well documented. Capital improvements to roads have traditionally been funded through the state road fund, most notably through the massive Governor Richardson's Investment Partnership (GRIP) bond program. The state road fund experiences a high degree of pressure due to the large geographical size of New Mexico and because growth in state and federal transportation-related revenues to the fund have not kept pace with inflation.

It may prove difficult to build support for a tax increase on motor vehicle sales (see below), but dedicating a portion (in this case, 50 percent) of the increased revenue to the state road fund could make the increase more palatable.

Revenue Increases.

- **6 - Increase top Personal Income Tax (PIT) Rate to 5.5 percent (from 4.9 percent)**

Laws of 2003 eliminated the top 8.2 percent rate on incomes as an economic development tool. While the previous top rate and brackets were too high, the phased-in reduction to a 4.9 percent rate has yet to yield discernible economic benefits. The reduction has, however, added to the regressivity of the tax system and an increase in New Mexico income inequality that the Census Bureau noted in their latest report. The increase in the top rate to 5.5 percent would place PIT rates more in line with the recently-reduced corporate income tax rate (5.9 percent when fully phased in). This increase would raise general fund revenue an estimated $138 million in FY15.

PIT State Comparison						
NM	**AZ**	**TX**	**CO**	**OK**	**UT**	**National Average**
4.90%	4.54%	N/A	4.63%	5.25%	5.00%	6.61%

- **7 - Remove 50 Percent Capital Gains Deduction**

This provision was part of the 2003 PIT rate reduction bill and in part was intended to induce company relocation by reducing the tax burden on their chief executives. Research has not shown the deduction has helped induce companies to relocate to New Mexico. Further, the concurrent PIT rate relief arguably made the capital gains deduction redundant.

- **8 - Phase Out Selected Healthcare Related GRT Deductions**

With the implementation of the Affordable Care Act and expanded healthcare coverage to over 100,000 uninsured adults the need to subsidize healthcare costs is not needed. Some common themes permeate both the healthcare tax expenditure programs and the locally-financed healthcare programs. These programs are somewhat disjointed with insufficient accountability, unclearly defined goals and, in some cases, a diminished ongoing necessity after the implementation of national healthcare reform. In general, New Mexico needs to re-evaluate the use of local taxes to see if they are adequately addressing healthcare goals or if they need to be repurposed to better leverage federal matching funds.

Health care has been the only sector to grow robustly over the last 15 years and it is too large a part of the economy to be exempt from taxation. For example, healthcare will account for 24 percent of New Mexico's employment growth through 2020. These expenditures shift the burden to those sectors currently paying taxes and contribute to New Mexico's "unfriendly" business climate.

One concern raised by health care tax expenditures is that they deprive the state of funds that could be spent on health care and generate matching federal funds. Thus, the health care sector may not even be a net beneficiary from the tax breaks. Meanwhile, a "patchwork" of varying tax treatment has been created in which some providers and payments are given preferred treatment, and the fairness of the tax system is called into question.

Laws of 2003 exempted of all managed care organizations (in addition to Medicare and TRICARE) from gross receipts taxes. This deduction applies to providers who receive payments from any of the organized plan networks. Currently, the state only taxes receipts from Medicaid. There is no rational basis for discriminating among these payers.

The gross receipts tax deduction for medical service providers, coupled with a corresponding hold harmless for local governments, represented a double impact where the state lost revenue through a tax expenditure and also a direct general fund expenditure to localities. However, 2013 legislation scheduled a phase-out of the hold harmless payments. Further, the health care practitioners' deduction is escalating at more than 5.2 percent per year. TRD's current estimate for this deduction is $70 million. The latest estimate for the Medicare deduction is $47 million; TRICARE is estimated to cost less than $10 million. Policymakers might also wish to examine the deduction for the gross receipts of hospitals, worth roughly $41 million annually.

- **9 - Eliminate the GRT Food Deduction**

Laws 2004, Chapter 116 (House Bill 625) enacted a deduction for food and certain health care services from the gross receipts tax base. It created new distributions to cities and counties to offset revenue losses from removing those taxes, it adjusted the county equalization formula, and it repealed the 0.5 percent credit against the state tax rate for taxpayers reporting to municipal locations. The food and medical deductions have become much more costly than estimated in 2004. Legislation enacted in 2007 froze the local option rates for large municipalities and counties at their January 1, 2007 levels for hold harmless distributions. 2013 legislation phases out the hold harmless payments to local governments.

Beginning January 1, 2005 food meeting the qualifications for the federal Supplemental Nutritional Assistance Program (SNAP) became deductible. Excluded are alcoholic beverages, tobacco, and prepared hot foods sold for immediate consumption. Unlike almost all other exemptions and deduction the food deduction must be separately stated in order to calculate hold harmless distributions to counties and municipalities.

The net benefits of the food GRT deduction are difficult to determine. Benefits to low income families are limited, because their food purchases using food stamps were already exempt. Thus, most of the benefits of the measure go to middle class and upper class households. In addition, because the entire cost is funded by the state general fund, the forgone revenue is not available for education, health care, public safety and other state needs. If the goal of the program is to lower the costs of meeting basic needs of New Mexico households, it would seem a more targeted approach would be through some kind of income tax relief such as the Working Families Tax Credit mentioned earlier in this brief.

- **10 - Implementation of Internet Sales Tax**

The Senate passed the Marketplace Fairness Act in May, but the bill faces conservative opposition in the House that could slow or stop its passage. Anticipating the bill's eventual passage, several states have begun to act with conforming legislation, and New Mexico may wish to do the same. If the bill passes, New Mexico will need to implement conforming language in statute. To be able to begin collecting tax on remote sales, New Mexico would need to specify the tax (gross-receipts or compensating tax) that would be applied to remote sales. New Mexico would also need to implement minimum simplification requirements, including a single entity for administration of the tax, a single tax return for use by remote sellers, and provide software to online sellers to facilitate reporting. Major retailers are already collecting tax on internet purchases, in anticipation of the legislation, and New Mexico is already seeing some of the revenue increases as a result. The NMTRI estimated (roughly) that taxation of all internet sales could capture an additional $40 million in revenue per year.

- **11 - Increase Motor Vehicle Excise (MVX) tax to 5.5 percent**

New Mexico imposes a much lower MVX tax rate than neighboring states, and the national average is closer to 5.75 percent. A 2.5 percent increase would raise this revenue by $108 million in FY15. Dividing the additional revenue between the general fund and the road fund could offset other general fund revenue reductions while improving the adequacy of revenues to the state road fund, better enabling the state to address critical infrastructure needs.

MVX State Comparison					
NM	**AZ**	**TX**	**CO**	**OK**	**UT**
3.00%	2.80%	6.25%	2.9%+RTD+local	3.25%	5.95%+local

Tax Policy Options to Improve Economic Prospects **July 1, 2013**

	Tax Policy Option	Fiscal Impact (decrease in parentheses)	
		FY15	**FY16**
	Revenue Reducers		
1	**Eliminate the Corporate Income Tax**	($343,218.0)	($322,407.0)
2	**Reduce State Gross Receipts Tax (GRT) Rate by 1%**	($302,400.0)	($320,000.0)
3	**Enhance Working Families' Tax Credit**	($10,600.0)	($10,800.0)
4	**GRT Anti - Pyramiding**	Inadequate Information	
5	**MVX Distribution to State Road Fund**	($54,037.5)	($56,100.0)
	Revenue Offsets		
6	**Increase top Personal Income Tax (PIT) Rate to 5.5 percent (from 4.9%)**	$137,099.8	$143,543.5
7	**Remove 50% Cap Gains Deduction**	$45,000.0	$47,200.0
8	**Phase Out Selected GRT Healthcare Deductions**		
8a	Section 7-9-16 - certain nonprofit facilities that provide accomodations for retired elderly persons.	$975.0	$985.0
8b	Section 7-9-73 – Sales of prosthetic devices deduction	Inadequate Information	
8c	Section 7-9-73.1 – 50 percent hospital deduction - licensed by DOH.	$44,128.0	$44,871.0
8d	Section 7-9-73.2 – Sales of prescription drugs; oxygen deduction provided by a medicare durable medical equipment provider	$74,379.0	$78,061.0
8e	Section 7-9-77.1 – Certain medical and health care services deduction on payments by the US government of other agency for medicare beneficiaries (alternative healthcare services)	$60,137.0	$63,923.0
8f	Section 7-9-93 – Health care practitioner deduction on payments by a managed health care provided or health care insurer for commercial contract services	$90,878.0	$96,865.0
8g	Section 7-9-96.1 – Up to 5% of receipts of DOH licensed hospitals credit	$10,703.0	$10,898.0
8h	Section 7-9-96.2 – 100% credit for unpaid qualified health care services provided by a licensed medical doctor or osteopathic physician in a hospital	$1,710.0	$1,805.0
8i	Section 7-9-99 – New facility construction service for certain public health care facilities deduction - sole communicty provider hospitals	Inadequate Information	
8j	Section 7-9-100 – Sole community provider hospital deduction for sale of construction equipment and materials used in new facility construction of the hospital	Inadequate Information	
9	**Eliminate the GRT Food Deduction**	$131,430.0	$133,264.0
10	**Implementation of Internet Sales Tax**	$40,000.0	$40,000.0
11	**Increase MVX to 5.5% (2.5% increase)**	$108,075.0	$112,200.0