F I S C A L   I M P A C T   R E P O R T

		ORIGINAL DATE	01/26/10		
SPONSOR	Chavez, El	**LAST UPDATED**	02/06/10	**HB**	82/aHTRC/aHAFC
SHORT TITLE	Develop Tax Expenditure Budget			**SB**	
				ANALYST	Lucero

APPROPRIATION (dollars in thousands)

Appropriation		Recurring or Non-Rec	Fund Affected
FY10	**FY11**		
	None		

(Parenthesis ( ) Indicate Expenditure Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY10	FY11	FY12	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		$150.0		$150.0	Recurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION

LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)
Economic Development Department (EDD)

SUMMARY

Synopsis of HAFC Amendment

House Appropriations and Finance Committee Amendment to House Bill 82 would require the tax expenditure budget include enhanced revenue sources, whether significant General fund revenue sources or revenue for funds from sources other than General Fund from increased taxes, fees or other new or enhanced state revenues, and tax credits or other tax incentives that directly or indirectly provide new revenue to the state.

Synopsis of HTRC Amendment

House Taxation and Revenue Committee Amendment to House Bill 82 changes the month and frequency the tax expenditure budget would be due. The amendment would require the tax expenditure budget to be due November 15, on even numbered years.

Synopsis of Original Bill

House Bill 82 proposes to enact a new section of the Tax Administration Act (Chapter 7, Article 1 NMSA 1978) to require the Taxation and Revenue Department (TRD) to compile a tax expenditure budget each year no latter than October 15 for the upcoming fiscal year and present the report to the governor, the interim legislative Revenue Stabilization and Tax Policy Committee and to the Legislative Finance Committee. The tax expenditure budget shall report on tax expenditures with revenue impacts in excess of $5 million in aggregate for specific tax expenditures.

The tax expenditure budget would provide approximate costs in foregone revenue from tax expenditures including:

- A projection of the costs of tax expenditures for all significant general fund revenue sources;
- Identify each tax expenditure and its statutory basis, purpose, year of enactment and date of repeal, if any;
- Quantify the revenue lost to the state from each tax expenditure;
- Identify to the extent possible the beneficiaries of each tax expenditure, including the number of business that used the tax expenditure and number of businesses that potentially qualified for but failed to use the tax expenditure;
- Identify unintended consequences of the tax expenditure that have come to the attention of the department; and
- Provide a total of all of the costs in each fiscal year for all tax expenditures.

The bill authorizes TRD to request the necessary information from a state agency or local government to complete the tax expenditure budget and mandates compliance with the request.

The bill identifies significant general fund revenue sources as gross receipts tax, compensating tax, corporate income tax, personal income tax, tobacco excise tax, liquor excise tax, severance taxes, motor vehicle excise tax, gaming excise tax, and other revenue sources including insurance revenues, fire protection fund reversion, leased vehicle surcharge, rents and royalties, and tribal gaming revenue.

Tax expenditure is defined as a deduction, credit, exemption, exclusion, rebate, offsets, preferential tax rate, subtraction, or allowance that reduces a tax liability.

FISCAL IMPLICATIONS

As amended, TRD did not clarify whether the administrative costs would change. However, less frequent reporting may ease the administrative burden on the department. Presumably, the first tax expenditure budget would be due November 15, 2010.

TRD estimates that the first report would require three full-time equivalent professional staff over a two-year period, and each subsequent report 1 ½ such staff. The department reports that with current vacancies and little prospect of filling those vacancies in the next two years, it would not be feasible for TRD to complete these reports.

Like programs (or entitlements) on the spending side of the budget, most tax expenditures do not go through a direct appropriations process each year. They continue and often expand; for example, the value of charitable deductions rises with an expanding economy.

Tax expenditures operate essentially like direct expenditures, even though they appear as tax breaks. They benefit many different types of activities and individuals and account for a significant benefit to the public.

SIGNIFICANT ISSUES

Tax expenditures are amendments to the state's tax system that reduce revenue collections from what they would otherwise be. They include deductions, exemptions, credits, preferential tax rates, and any other means by which tax collections are reduced from the normal base amount. A tax expenditure budget is a document that provides information about individual tax expenditures, including estimates of the amount of revenue lost to the state due to each one.

Tax expenditures give preferential tax treatment to a specific group to encourage certain types of economic activity. From a tax policy standpoint, these mechanisms by which the revenue base is eroded should be evaluated as rigorously as appropriations.

According to a 2006 report by the American Federation of State, County and Municipal Employees (AFSCME), 30 states regularly prepare a tax expenditure budget. The nonprofit organization Good Jobs First reports that 35 states currently publish a tax expenditure budget. According to recent tax expenditure budgets, the amount of state tax revenue forgone due to tax expenditures is 53 percent in Michigan, 22 percent in Illinois, and 20 percent in Louisiana.

Uncovering the degree of erosion in a state's tax base is important for several reasons. Without knowing the amount of revenue forgone due to tax expenditures, policymakers and the public cannot know how much tax relief is being granted and to whom the benefits are accruing. Also, a narrower tax base requires that a higher tax rate be charged on everything that remains taxable to provide enough revenue to meet the state's spending needs. Finally, a narrower tax base leads to increased revenue volatility, which makes fiscal planning more difficult.

Currently, the cost of New Mexico's tax expenditures are only estimated when they are first enacted in Fiscal Impact Reports. However, the costs of tax expenditures are rarely revisited to assess whether they cost more or less than expected, whether costs are growing as anticipated, or whether tax expenditures are effective.

Like most states, New Mexico's tax code contains hundreds of tax expenditures. The gross receipts and compensating tax code (Chapter 7, Article 9 NMSA 1978) includes about 100 exemptions, deductions, and credits. The personal and corporate income tax codes (Chapter 7, Articles 2 and 2A NMSA 1978) also include dozens of tax expenditures. While many of New Mexico's tax expenditures have very small costs, they cumulatively represent a significant erosion of the state's revenue base.

According to TRD, the bill appears to require the tax expenditure budget to cover non-tax revenues, which is inconsistent with the definition of "tax expenditure". The bill also apparently includes in "tax expenditures" provisions in the federal internal revenue code that flow through to New Mexico taxes, which would be very difficult to estimate and might be of limited value since the State cannot amend the internal revenue code. The requirement that State and local agencies provide information to the Department that is "necessary to complete the tax expenditure budget" is problematic in several respects.

Although TRD prepared, published, and reported a multi-year, comprehensive review and analysis of tax expenditures including business incentive credits, the report was not as comprehensive as would be required under this bill. TRD's reports and others can be found on the Departments website at http://tax.state.nm.us/pubs/taxpolicy.htm.

PERFORMANCE IMPLICATIONS

Periodic review of tax expenditures adds transparency, fiscal discipline, and political accountability to the budget process. By uncovering the cost of New Mexico's tax expenditures, a tax expenditure budget will allow the state's policymakers to tailor tax incentives and appropriations to better achieve the state's goals.

ADMINISTRATIVE IMPLICATIONS

A significant effort by the economic and legal staffs in TRD would be required to prepare the initial report and to update it annually. A conservative estimate to prepare the first report would require three full time equivalent professional staff over a two-year period, and each subsequent report 1 ½ such staff. With current vacancies and little prospect of filling those vacancies in the next two years, it would not be feasible for TRD to complete these reports.

TECHNICAL ISSUES

TRD notes that the bill defines "tax expenditure" as special tax provisions, but requires the tax expenditure budget to cover non-tax revenues such as rents and royalties, tribal revenue sharing, and fire protection fund reversions. Since non-tax revenues cannot (by definition) generate tax expenditures, it is not clear how the bill intends the tax expenditure budget to cover these items.

The definition of "tax expenditures" would apparently include deductions, etc. in the federal internal revenue code that flow through to New Mexico taxes through our adoption of federal tax bases (primarily for the personal and corporate income taxes). So, as drafted, the bill would require that the tax expenditure budget cover any federal tax expenditure that reduced State revenues by $5 million or more. For nearly all of these federal flow-through tax expenditures, there is no information on State tax returns and little or no information from available federal tax returns that would be required in order for the Department to estimate the amount of such tax expenditures. It is also unclear how useful this information would be to the Governor or to the Revenue Stabilization and Tax Policy and Legislative Finance Committees, since the State cannot amend the internal revenue code.

Section C of the bill requires State and local agencies to provide information to the Department that is "necessary to complete the tax expenditure budget". The bill provides no sanction to an agency that does not comply. Conversely, the bill is silent on how an agency that is bound by confidentiality or other non-disclosure statutes is supposed to reconcile those restrictions with the demands of this section.

OTHER SUBSTANTIVE ISSUES

The Massachusetts governor's budget for FY10 provides an example of an expenditure budget.

FY2010 H1 - Tax Expenditure Budget Introduction

Tax expenditure budget revenue estimates only quantify the direct effects of tax expenditures and do not attempt to include dynamic revenue effects that may result if tax expenditures result in job creation or increased economic activity. For this reason, tax expenditure estimates may overstate the true costs of some successful tax incentives.

The ease of estimating the cost of tax expenditures depends on tax reporting requirements. Tax credits must be explicitly reported on tax forms, which makes calculating their cost straightforward. However, deductions and exemptions are not reported explicitly, with the important exceptions of the food and medical services gross receipts tax deductions enacted in 2004, which were expected to be revenue neutral but are resulting in a revenue loss of about $30 million per year. Without explicit reporting, the costs associated with deductions and exemptions must be estimated. These estimates are time consuming and contain some degree of uncertainty.

One of the most difficult challenges in creating a tax expenditure budget is defining the revenue base against which tax expenditures should be measured. Much has been written about defining the base of income and excise taxes in other states and at the federal level, but New Mexico's gross receipts tax is unlike most sales taxes and will be more difficult to model.

TRD notes that without any statutory mandate, the department has undertaken a multi-year, comprehensive review and analysis of tax expenditures. The first report prepared as part of this effort has been completed and released. The second report is near completion. The department also recently released detailed information on tax expenditures in the form of business incentive credits in a joint report with the Economic Development Department to the Legislative Finance Committee and the interim Revenue Stabilization and Tax Policy Committee. The department believes that this comprehensive, multi-year plan will allow the department to provide the Governor and the Legislature a carefully prepared and highly useful series of reports that will help inform policy debates and policy decisions well into the future.

TRD's multi-year, comprehensive review and analysis of tax expenditure report includes an in depth description of the concept and framework for analysis of tax expenditures, major taxes, including the gross receipts and compensating taxes; the gasoline, alcohol, cigarette and motor vehicle excises, the personal and corporate income taxes, taxes related to severance of oil, gas, coal, uranium, and minerals; the insurance premiums tax; gaming taxes; and the property tax. In addition, the department reports on manufacturing tax incentives. The reports were reported to legislative committees most recently during the 2009 interim.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The amount of New Mexico's general fund revenue eroded due to tax expenditures will continue to be unknown. Policymakers will continue to be unable to decide whether the benefits of tax expenditures are great enough to justify their costs.

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