FISCAL IMPACT REPORT

		LAST UPDATED	
SPONSOR	Tallman/Herndon	**ORIGINAL DATE**	2/17/23
SHORT TITLE	Increase Standard Income Tax Deduction	**BILL NUMBER**	Senate Bill 105
		ANALYST	Faubion

REVENUE*
(dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY23	FY24	FY25	FY26	FY27		
	($55,000.0)	($56,000.0)	($57,000.0)	($58,000.0)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases
*Amounts reflect most recent version of this legislation.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT*
(dollars in thousands)

	FY23	FY24	FY25	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
	--	$5.5	--	$5.5	Nonrecurring	TRD/ITD

Parentheses ( ) indicate expenditure decreases.
*Amounts reflect most recent version of this legislation.

Sources of Information
LFC Files
IRS Statistics of Income for New Mexico

<u>Responses Received From</u>
Office of the Attorney General (NMAG)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Senate Bill 105

Senate Bill 105 increases the standard deduction for income tax purposes to 110 percent of the standard deduction allowed by the federal government instead of the current 100 percent.

This bill does not contain an effective date, and as a result, would go into effect June 16, 2023, (90 days after the Legislature adjourns) if signed. The provisions of this bill apply to taxable years beginning on or after January 1, 2023.

FISCAL IMPLICATIONS

The Taxation and Revenue Department (TRD) estimated the impact of the proposed changes to the standard deduction by using tax year 2021 tax return data for New Mexico taxpayers. The IRS annually adjusts all standard deductions and other federal tax provisions for inflation. The IRS published standard deduction amounts for tax years 2022 and 2023 were used to apply a growth rate to the estimate for tax year 2023, the first effective tax year. Using IHS Markit's January 2023 forecast, TRD grew the estimate annually by IHS Markit's forecast for the Consumer Price Index. This results in a $55 million to $58 million general fund revenue decrease through the forecast period.

This bill creates or expands a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the significant risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base. The committee recommends the bill adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting or action be postponed until the implications can be more fully studied.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

SIGNIFICANT ISSUES

Defined by the IRS, the standard deduction is a specific dollar amount that reduces the amount of income on which one is federally taxed. The standard deduction consists of the sum of the basic standard deduction and any additional standard deduction amounts for age and/or blindness. The standard deduction for married couples filing jointly for tax year 2022 was $25,900. For single taxpayers and married individuals filing separately, the standard deduction was $12,950. For heads of households, the standard deduction was $19,400. The federal standard deduction is adjusted for inflation each tax year. According to tax year 2020 Statistics of Income data from the IRS, 892,230 New Mexico tax returns claimed the federal standard deduction totaling $15.6 billion dollars of deducted income. In contrast, itemized deductions totaled only $2 billion.

New Mexico has its own standard deduction for state income taxes, which is statutorily equal to the federal standard deduction. This means that income is not subject to the state personal income tax. This bill would increase the New Mexico standard deduction to 110 percent of the federal income tax, increasing the amount of income not subject to the income tax by 10 percent. This policy would result in a tax cut for all taxpayers who claim the standard deduction, the majority of New Mexicans.

TRD notes the following policy issues:

> Personal income tax (PIT) represents a consistent source of revenue for many states. While this revenue source is susceptible to economic downturns, it is also positively responsive to economic expansions. New Mexico is one of 42 states, along with the District of Columbia, that impose a broad-based PIT. The PIT is an important tax policy

tool that has the potential to further both horizontal equity, by ensuring the same statutes apply to all taxpayers, and vertical equity, by ensuring the tax burden is based on taxpayers' ability to pay.

The 10 percent increase to the federal standard deductions will be applied equally across all taxpayers who take the standard deduction on their state tax returns. Thus, the change promotes both horizontal and vertical equity. While every taxpayer claiming the standard deduction will see a lower tax liability, most of the financial benefit is realized by taxpayers with a marginal tax rate of 4.9 percent or 5.9 percent. Of the fiscal impact, approximately 80 percent goes to those in the higher marginal tax brackets.

New Mexico, like many states with PIT, conforms to the federal definitions of federal income tax such as taxable income and applies the federal standard deduction. When the federal government alters these definitions, as was the case under the Tax, Cuts and Jobs Act (TCJA) whereby the standard deductions were increased while personal exemptions were removed, New Mexico automatically changed alongside the federal government. In the event the federal government alters the standard deductions in the future, the proposal in this bill may have unintended consequences.

Conformity with federal income tax reduces New Mexico taxpayer burden to file their state tax returns. The modification to the standard deductions which would normally mirror federal standard deductions may be missed by those filing on paper returns and result in return adjustments and possible overpayments of tax. Further, by having a higher state standard deduction than federal deduction, there will be taxpayers whose best option is to itemize deductions for federal purposes, but to take the higher standard deduction for their state return purposes; this adds complexity and taxpayer burden.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met since TRD is <u>not</u> required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

TRD will need to make information system changes and update forms and publications. These changes will be incorporated into annual tax year implementation and represent $5,554 in workload costs for the TRD's Information Technology Division (ITD).

Does the bill meet the Legislative Finance Committee tax policy principles?

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

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted**: The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted**: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent**: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable**: The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective**: The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions "but for" the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LFC Tax Expenditure Policy Principle	**Met?**	**Comments**
Vetted	?	The issue has not been discussed at an interim committee recently.
Targeted		
Clearly stated purpose	✗	No purpose, targets, or goals established.
Long-term goals	✗	
Measurable targets	✗	
Transparent	?	TRD will likely publish a cost estimate in its annual Tax Expenditure Report; however, no specific reporting on this exemption to interim committees is required.
Accountable		
Public analysis	✗	The bill contains no provisions for reporting.
Expiration date	✗	The bill does not include an expiration date.
Effective		
Fulfills stated purpose	?	Without a purpose statement or required reporting, it is not possible to determine if the exemption fulfills intended outcomes.
Passes "but for" test	?	
Efficient	?	Without a purpose statement or required reporting, it is not possible to determine if the exemption is the most efficient means of achieving desired outcomes.
Key: ✓ Met ✗ Not Met ? Unclear		

JF/al/ne