State of New Mexico Tax Structure: Key Issues and Alternatives

July 2021 Update

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Background

- **The following is an update on findings from PFM's December 2020 study.**
- **The oil and gas industry continues to be the largest component of the New Mexico economy.** As a share of GDP, the industry is larger than the largest industry in most states.
- There was significant disruption within the industry in 2020 – **including an unprecedented period when prices on the West Texas Intermediate (WTI) crude oil futures market went negative**.
- While there has been a recovery, the 'boom and bust' nature of the industry is a concern for the State's revenue structure.
- Reliance on the energy industry in general carries significant risk for states: **one analysis identified New Mexico as among the most volatile state tax structures.**
- The current structure has not kept pace with overall economic growth. An analysis by the Pew Charitable Trusts (Pew) found that (prior to the pandemic) **New Mexico was one of six states that had not recovered its tax revenue since prior to the Great Recession.**
- Federal assistance in 2020 and 2021 has helped New Mexico (and states in general) transition into recovery, but there are still structural issues that should be addressed.

The PFM Group Study

- PFM is a national leader in providing independent financial advice to state and local governments.
- PFM has undertaken numerous studies related to tax and revenue structures, revenue estimates and tax collection practices, including for the States of Delaware, Hawaii, Kansas, New York, Oklahoma and Pennsylvania.
- The project team was led by Randall Bauer, who directs the PFM Group Consulting's state government practice.
- The project team included Dr. Kelly O'Donnell, who provided valuable technical assistance.
- The study included review of hundreds of New Mexico-specific documents and information as well as past Governor's budget recommendations and enacted budgets and changes to state taxes.
- The project team also conducted interviews with New Mexico tax subject matter experts and policymakers.
- The project team benchmarked New Mexico with peer states and conducted best practices research.
- PFM was retained by the Rockefeller Family Fund to identify ways to stabilize and diversify New Mexico's tax and revenue structure.

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New Mexico Tax Policy 'Guiding Principles'

- The study examined New Mexico's tax structure through the lens of the following tax policy principles articulated by the New Mexico Legislative Finance Committee in 2009:

Principal	Definition
Adequacy	The tax or tax system generates enough revenue to pay for public services without continuous changes
Efficiency	The tax or tax system minimizes economic distortion and avoids excessive reliance on any single tax
Equity	The tax or tax system fairly distributes the tax burden among all taxpayers
Simplicity	Taxes are simple to understand and collect
Accountability/ Transparency	Tax collection/administration is easy to monitor and evaluate and subject to periodic review

- These principles align with generally accepted best practices in state tax policy.

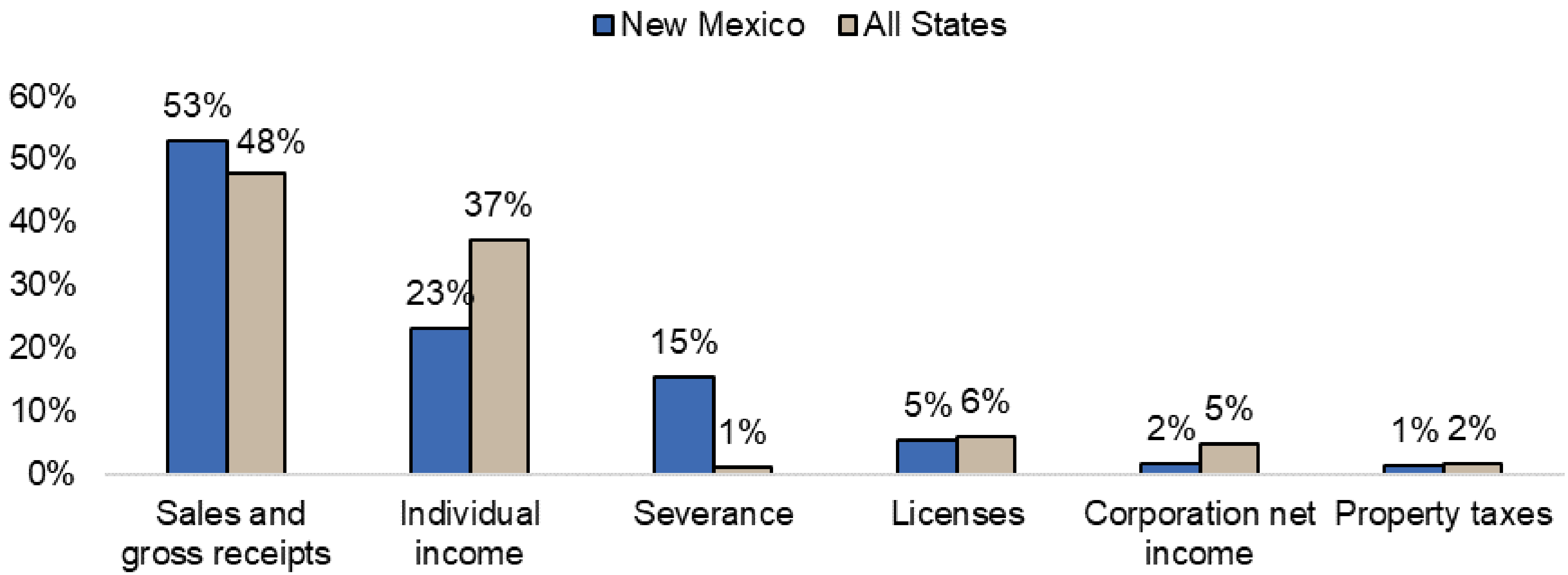
New Mexico Economic and Demographic Features

- **There has been little change in New Mexico's population in recent years**. In fact, its growth is the lowest among the peer and surrounding states.
- **New Mexico has a lot of federal land** as a share of all land in the state – ranking 10th among all states at 32%.
- The largest contributor to state GDP is government and government enterprises. **Among other sectors, the largest concentration is its oil and gas industry.**
- Employment within the mining sector is far smaller than GDP – it represents over 10% of GDP but only 3% of direct employment.
- **Private employment growth in New Mexico trails the US and most of the peer states.**
- New Mexico's percentage of population with a college/university bachelors degree is among the lowest in the nation (15%). It does rank much higher (16th) for those with an advanced degree.
- In comparison to the U.S. as a whole and its peer states, **New Mexico is a relatively low-income state**, based on either median household income or personal income.
- New Mexico's poverty rate is higher than its peer states or the U.S. average.

State Tax Structure Comparisons

- As with most states, New Mexico relies on a tax structure focused on broad-based taxes on income and consumption.
- **New Mexico relies more on its consumption tax and less on its income tax**:

Percent of State Tax Revenue, 2017



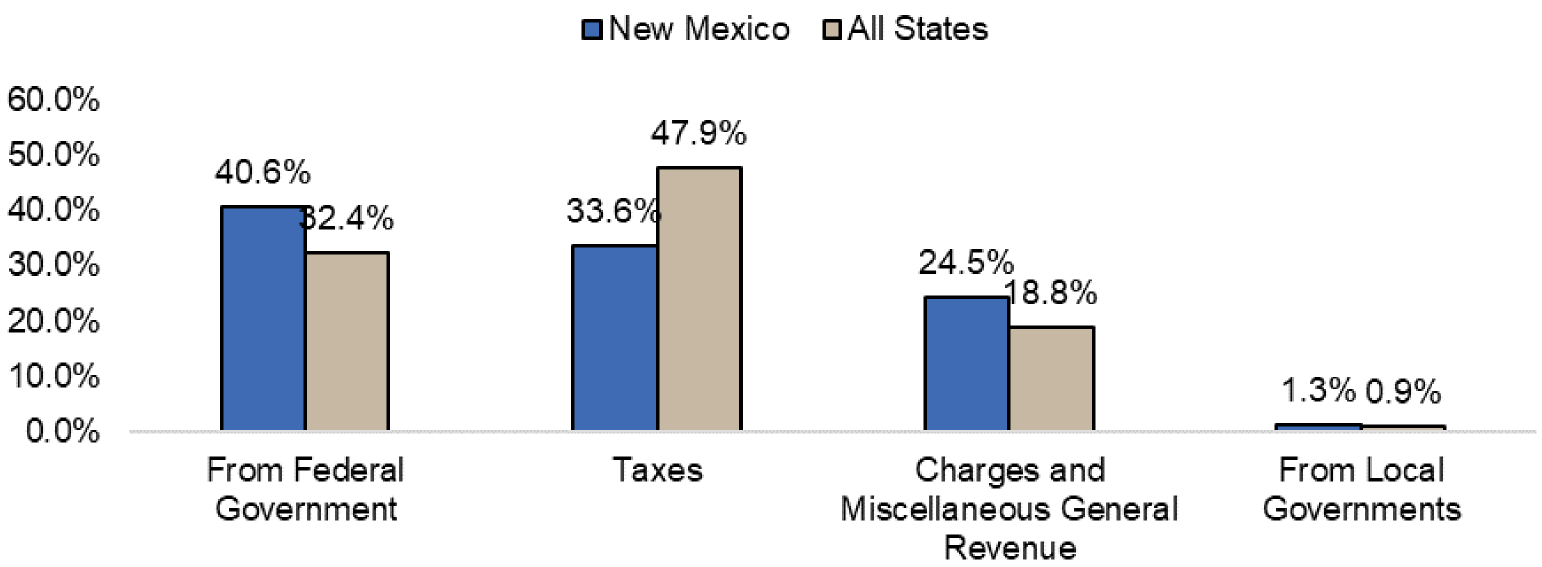
- New Mexico's share of severance tax revenue is similar to other energy producing states and much larger than the average of all states.

Source: U.S. Census Bureau 2017 Survey of State Government Finances

Federal Revenue Impacts on States

- New Mexico benefits from significant federal revenue generated by federal facilities and rents and charges associated with federal lands in New Mexico.

Percent of State General Revenue, 2017



- New Mexico's below average household and personal income also generates greater federal share of program revenue, particularly related to the Medical Assistance (Medicaid) program.

Source: U.S. Census Bureau 2017 Survey of State Government Finances

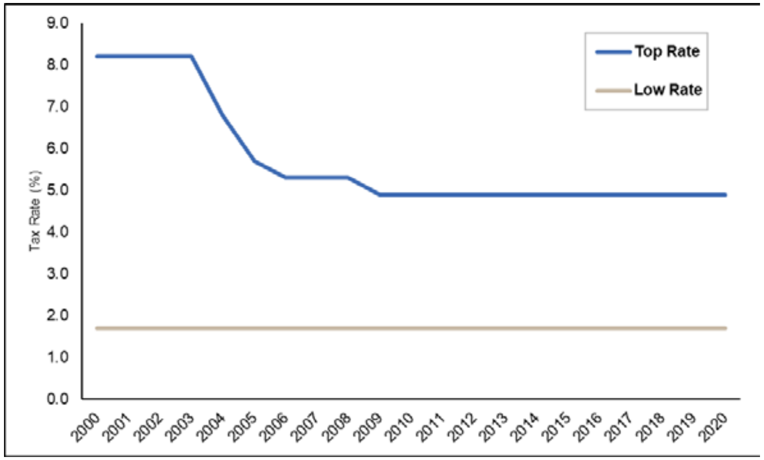
Gross Receipts Tax – SWOT Analysis

- As with many types of tax, there is considerable friction among tax policy principles and the Gross Receipts Tax (GRT).
- **Extremely broad base** captures activity that traditional sales taxes struggle to include (positive for adequacy, some evidence services are used more by higher income households, positive for equity).
- The broad base is subject to **above average combined state and local rates** (negative for efficiency).
- There is a significant amount of **taxing intermediate business inputs**, leading to more tax pyramiding than most general sales taxes (negative for efficiency and transparency, positive for adequacy).
- Tax on business gross receipts can tax activity (such as contractors for the federal government) that would not be subject to a general sales tax (positive for adequacy).
- **The GRT is regressive** – lower income households expend a far greater percentage of their income on taxable consumption than higher income households (negative for equity).

Personal Income Tax – SWOT Analysis

- The recent history of the Personal Income Tax (PIT) has been one of compressing its tax brackets – although a new top bracket will be in effect for 2021 (negative for adequacy).

New Mexico Personal Income Tax Rates, 2000-2020



- New Mexico has refundable credits at lower income levels that ameliorate some of the negative effects of the GRT (positive for equity).
- New Mexico provides various exemptions and incentives that primarily benefit higher income taxpayers, such as capital gains deduction and business incentives (negative for adequacy, equity and efficiency).

Other Tax Issues of Interest

- As with all states, New Mexico has a variety of other taxes and charges, most notably for mineral extraction and excise taxes on motor fuel, tobacco products, alcohol, etc.
- Given that the focus has been on ways to diversify the current revenue mix, the project team did not make recommendations related to changes in **extraction taxes**.
- There are **excise taxes** where New Mexico is significantly below the national average, for example on motor fuel.
- The growth area for states in excise taxes has been on **medical and recreational marijuana**, and this growth is expected to continue.
- While primarily a local tax, it is notable that New Mexico's **property tax** collections are well below the national average, and this impacts on shared state-local issues like funding for K-12 education.
- **Corporate income taxes** (CIT) have declined in signficance in all states – and New Mexico is at the low end of state shares from this revenue source. The shift to mandatory combined reporting for the CIT may lead to some increase in collections in future years.

Key Findings

- **New Mexico tax and revenue collections are cyclically aligned with oil and gas industry prices.** This is the case for both the GRT and the PIT.
- **There are legitimate concerns that the energy industry's recent weak performance is a chronic (rather than acute) condition.**
- **Revenue volatility and energy concentration are linked**. A Pew study on state revenue volatility had Alaska, North Dakota, Wyoming and New Mexico among the six states with the most volatility.
- Even during periods of general economic growth, **the New Mexico tax structure has not created the 'bounce back' experienced in other states.**
- **There is little evidence that the PIT rate compression has changed economic outcomes.** There has been no positive change in New Mexico's standing amongst the states on measures of the economy, population growth or in-migration, and tax policy studies in other states also provide no tangible evidence of positive change.
- The **relatively low reliance on property taxes** increases the reliance on the GRT, which exacerbates its weaknesses.
- The **pandemic-driven recession had the greatest impact on low wage industries**, and this will tend to increase income inequality. There is significant concern that a "K-shaped recovery' will be even more harmful than a typical recession for low-income individuals and families.

Key Recommendations

- **Reinstitute a PIT rate structure with a higher marginal tax rate(s) at higher income levels**. While the trend in the early 2000s was to reduce top rates, more states are revisiting and increasing the top rates. This aligns with research that suggests 'millionaire flight' is more myth than reality.
- **Eliminate the capital gains PIT deduction.** Wealth and income inequality is a major concern, both in today's economy and during the growth period after the Great Recession. This benefit goes almost entirely to higher income individuals. Given the favorable federal tax treatment of capital gains, changes at the state level should not materially impact economic efficiency considerations.
- **Re-institute an Estate Tax.** An estate tax is one of the few wealth taxes in general use. Most states with this tax provide an exemption (between $1 and $6 million) and a progressive rate structure (generally a top rate of 16%). An estate tax is a reasonable way to deal with the fact that, because of a 'stepped up basis,' many inherited assets escape capital gains taxes.
- **Restructure the GRT food exemption to be a refundable PIT credit.** While most states provide these types of exemptions from sales tax, some (including Hawaii and Idaho) tax food and provide refundable income tax credits. Most of the benefit from the food exemption goes to higher income individuals – who, for example, are buying filet mignon and lobster rather than hamburger and tuna fish.

Key Recommendations (continued)

- **Increase the motor vehicle fuel rate.** Among the major existing excise taxes, this one ranks near the bottom of all states (6th lowest). Motor fuel tax receipts are already eroding because of improved vehicle fuel efficiency and an increase in vehicles that do not require motor fuel.
- The recommendation to **establish tax parameters for recreational marijuana** was accomplished with the passage and approval by the Governor of HB 2, the Cannabis Regulation Act.
- **Undertake a regular and rigorous process for evaluating business tax incentives.** A detailed review in 2017 by Pew of the 50 states' efforts around evaluation of business incentives identified New Mexico as a 'trailing state.' Given the significant foregone revenue associated with PIT, CIT and GRT business tax exemptions, the State should institute a regular process for third party evaluations.
- **Broaden efforts to diversify the economy and target key industries.** While not solely an issue of changes to the tax structure, revenue diversification also requires a non-tax policy focus on key industries – through targeted job training, focus at state universities on agglomeration economies and industry clusters.
- Longer-term, pursue a constitutional change to **broaden the use of local property taxes as a mechanism to reduce local gross receipts taxes**.

New Mexico Tax Policy Additional Thoughts

- There are aspects of the State's tax structure that make a lot of sense based on New Mexico's key features. **The GRT, for example, allows taxing some important economic activity in the state that is not taxable in a typical state sales tax struc**ture.
- The project team sought to **identify 'real world' opportunities** rather than those that would be revolutionary changes (such as eliminating the GRT and creating a VAT).
- There are immediate opportunities, **particularly around the PIT structure** and the GRT exemption for food coupled with an increase in PIT refundable credits.
- The issues related to changes in the property tax (which would require a constitutional amendment) are not short-term in nature. We recognize the historic resistance to this form of tax, but it is, by far, the most-used local tax in the U.S. It provides an opportunity to **reduce some of the regressive nature of the existing reliance on the GRT**.
- The longer-range considerations primarily relate to **non-tax changes to the State economy**. These should not be overlooked, as they have perhaps the greatest potential to 'change the shape' of the state tax structure – and there are good examples of other states who have undertaken this effort.

Important Disclosure Information

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Thank You!

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