NEW MEXICO TAX RESEARCH INSTITUTE

Tax Policy, Trends, and New Mexico (Good, Bad, and Ugly)

Presented to the Legislative Finance Committee

September 24, 2014

Richard L. Anklam, President & Executive Director

NMTRI Principles of Good Tax Policy

N.M. Tax Research Institute is a non-profit, non-partisan member-supported organization dedicated to advancing the following principles of good tax policy in New Mexico:

- ***Adequacy***
  - Revenues should be sufficient to fund needed services
- ***Efficiency***
  - Interference with the private economy should be minimized
- ***Equity***
  - Taxpayers should be treated fairly
- ***Simplicity***
  - Laws, regulations, forms and procedures should be as simple as possible
- ***Comprehensiveness***
  - All taxes should be considered when evaluating the system
- ***Accountability***
  - Exceptions should be rare and should be carefully evaluated and justified

LFC 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

Trends in State Taxation

- Recession Spurs State Tax Reform Efforts
  - Lots of activity - some success and lots of failures
  - Economic development a large driver
    - "Tax Reform" a common theme
    - Tesla ring a bell?
  - Economic conditions improving and state revenues rising providing the financial opportunity for most states to spend more or tax less

Trends in State Taxation

2014 Notable Tax Changes

- Lawmakers in Missouri and Oklahoma passed personal income tax rate reductions that are contingent upon each state meeting future revenue growth targets.
- Indiana enacted legislation that phases down the corporate income and financial institutions tax rates. The corporate income tax rate will be reduced from 6.5 percent in fiscal year (FY) 2016 to 4.9 percent beginning in FY 2022; and the financial institutions tax rate will be reduced from 6.5 percent in calendar year (CY) 2018 to 4.9 percent beginning in CY 2023.
- Lawmakers in New York included several tax changes in the enacted budget, including a 20 percent property tax credit for manufacturers.
- Arizona lawmakers added a sales tax exemption for manufacturers' electricity purchases.

Source:NCSL

Trends in State Taxation

2014 Notable Tax Changes Under Consideration

- California lawmakers are considering a proposal to increase the motion picture tax credit and to make the credit permanent.
- Numerous tax changes are under discussion in Illinois as temporary tax increases are set to expire in 2015.
- Michigan is considering several bills that would reduce the income tax as well as reinstate a variety of credits, exemptions and deductions that were repealed in a 2011 tax reform package.
- Nevada did not have a regular legislative session in 2014, however, voters will decide on a ballot measure that would create a new business tax at a rate of 2 percent of the taxable margin for businesses with more than $1 million in total revenue. If approved by voters, it becomes effective in 2015.

Source:NCSL

Trends in State Taxation

2013 Notable Tax Changes

- Alaska lowered oil and gas production taxes, which is expected to reduce state revenues by about $500 million per year.
- New Mexico made changes to the corporate income tax, reducing the rate over five years and moving to combined reporting requirements and a single sales factor apportionment formula for certain corporations.
- Virginia adopted wide-ranging changes to the sales tax, gas tax and some local taxes and fees to address how state transportation is funded.

Source:NCSL

Trends in State Taxation

2013 Notable Tax Changes

- Alaska lowered oil and gas production taxes, which is expected to reduce state revenues by about $500 million per year.
- New Mexico made changes to the corporate income tax, reducing the rate over five years and moving to combined reporting requirements and a single sales factor apportionment formula for certain corporations.
- Virginia adopted wide-ranging changes to the sales tax, gas tax and some local taxes and fees to address how state transportation is funded.

Source:NCSL

Trends in State Taxation – Federal

Congress may not be capable of fixing their own taxes, but…

They have no problem messing with yours…

- The Internet Tax Freedom Act (ITFA) has been extended through December 11, but that law and the Marketplace Fairness Act (MFA) face an uncertain future in what is likely to be a contentious lame-duck session after the midterm congressional elections. Many think the MFA and ITFA will be tied together. Opponents of MFA don't want to see that happen.
- Some proponents want ITFA to become PITFA (P=permanent). That proposal strips the grandfather clause that states like New Mexico enjoy – further narrowing the tax base and placing upward pressure on rates.
- States are often wedded to changes in income tax rules.

Trends in New Mexico State Taxation

Significant/broad changes to personal and corporate income taxes relatively infrequent

- Personal income tax reductions of 2003
- Add-back of itemized deductions of 2008
- Corporate income tax rate reductions of 2013
- Net operating loss carryover expansion of 2014

Significant changes to other tax programs infrequent

- Cigarette tax increase of 2004

Except...

Trends in New Mexico State Taxation

HUGE EXCEPTION – GROSS RECEIPTS TAX

- Changes passed every year for over a decade
  - Last year was fairly quiet with only 4 new GRT deduction pass
- Consumption base erosion is particularly expensive and troublesome
  - And a full –employment act for lobbyists
- As the tax base erodes, the rates go up… and up
  - Rate increases make everything bad about the Gross Receipts Tax worse
    - It becomes more regressive
    - Pyramiding is exacerbated
      - Renders local business uncompetitive
      - Further aggravates regressivity
      - Hides tax in price/reduced wages and hiring, and profitability

Pyramiding - Example

- A construction company buys engineering services on which tax is charged.
  - Part of the cost of the engineering services includes accounting services on which tax is charged.
    - Part of the cost of the accounting services includes printing services on which tax is charged.
      - Part of the cots of the printing services includes business supplies on which tax is charged.
        - » Etc.

Pyramiding is a common problem.

Pyramiding of taxation in state transaction taxes like the GRT occurs when the tax is imposed on both the purchases and sales made by businesses. Economists have argued for years that, ideally, the GRT should be applied only to final consumption and not to business inputs. This ideal state of no taxation of business inputs is not achieved completely by any state's transaction taxes today. Intuitively it seems clear that a broad tax base, which is often a very desirable policy and which we have in New Mexico, will result in greater pyramiding of tax simply because more goods and services are subject to tax, including goods and services purchased by business.

Concerns Raised by Too Much Pyramiding in a State's Tax

- Pyramiding is very rate-sensitive in that the problem is much worse with higher rates because the rate will apply to each transaction in the chain of commerce.
- Pyramiding on services is a bigger problem for small businesses because they often purchase business services rather than hiring in-house providers.
- Pyramiding places a heavier tax burden on businesses and individuals who make a lot of purchases from in-state vendors. This creates incentives to buy from out-of-state vendors.
- The likelihood is high that most of the ultimate burden of this tax is borne by in-state households, a hidden tax with regressive implications.
- In-state companies face a direct impact on their bottom line, reducing their ability to invest and add laborers, and compete with out-of-state businesses.
- The tax becomes less transparent (rather than paying 6% tax on the final purchase, a greater amount of tax is "embedded" in the price of goods and services).

Comparison With Similar Taxes

	New Mexico GRT	Washington B&O	OHIO CAT	Retail Sales Tax
Taxable transactions	*All except listed exemptions & deductions*	*All except listed exemptions & deductions*	*All except listed exemptions & deductions*	Specifically listed transactions. Usually sales at retail for use or transfer of tangible personal property
Taxation of Services	*Most taxable*	*All taxable*	*All taxable*	Most not taxable. Taxed services specifically enumerated
Consumer deductions	*Health care; Food;*	None	None	*Food; Medicine; Clothing*
Business deductions	*Resale; Exports; Manufacturing ingredients;*	Wholesale	Small business	*Resale; Exports; Manufacturing equipment and ingredients;*
Average Tax Rate	*7.26%*	0.1% to 1.5%	0.26%	*2.9% - 9.0+%*

Summary of GRT Tax Base

- GRT is an imperfect hybrid of a Retail Sales Tax and a Business Privilege Tax
- Tax rate and deductions for resale are similar to a retail sales tax.
- Comprehensive taxation of sales to businesses are similar to a business privilege tax.
- GRT on services sold to non-profits, government is more like BPT, broader than most RST's.
- B-to-B sales extend the GRT base well beyond consumption, but large parts of the consumption base are excluded.*

*Thomas F. Pogue, *"Tax Expenditure Budget: Defining the Benchmark GRT Base,"* Prepared under contract to the New Mexico Taxation and Revenue Department, April 2008.

Pyramiding and Regressivity

- The GRT is a consumption tax and the tax on business purchases will be passed on to the ultimate customer (or may sometimes result in less business spending on things like wages).
  - Taking the tax off of one consumer good and raising the rate on business purchases simply results in taxes "embedded" in other products.
  - The regressive effect of a hidden or embedded tax is harder to evaluate and control.
- The only way to contain regressivity is to <u>not raise rates</u>.

GRT - Is it Broken?

Yes, at least it's trending that way…

- As a sales tax, GRT is over-broad
  - Economic interference
  - Inefficient
- As a true gross receipts tax – it's too narrow and the rate is too high
- No single focus
  - A hybrid – the worst of both worlds
- High and rising rates and shrinking base
  - Increasingly a high rate business inputs tax
- Over-reliance on ad hoc measures, like credits, to patch the system

Possible Solutions and Recommendations

- Since 1/3 to 1/2 of the GRT revenue comes from pyramiding, the problem will be expensive to address.
- "First, do no harm"
  - Inefficiency (i.e. lost economic output) increases with the square of the tax rate – i.e. exponentially – holding down the GRT tax rate is essential
  - No exemptions targeted at consumer purchases if offset by rate increases since this simply shifts the tax to business purchases and results in greater pyramiding of tax (eventually paid for by consumers as a hidden tax)
  - Use of tax incentives should be strictly limited – they reduce the base and put upward pressure on tax rates (you need them less without the pyramiding).
- Sales tax reform should focus on final sales, exclude intermediate sales
  - Specific deductions for business inputs
- Expansion of the anti-pyramiding credit (an incremental solution)
  - Scalable and targeted
  - Has to be large enough to make a difference
- GRT could be constructed as:
  - Retail sales tax (only on consumption) – would likely require offsets
  - Business privilege tax (true gross receipts tax – i.e. Sharer/Taylor)
  - Or both – split into two like Washington, Ohio and Texas

Tax Reform, Trends, and New Mexico

- Large scale reform largely unsuccessful
  - Professional Tax Study Committee
  - Blue Ribbon tax Reform Commission
  - Governor's Budget Balancing Task Force

- Smaller targeted efforts have been more successful
  - Manufacturing and to a lesser extent, construction

- Last successful large scale reform in the 60's
  - Franklin Jones Commission

- Conversations Ongoing
  - Sharer/Taylor inspire conversation
  - LCS begins preliminary steps to study tax base

GRACIAS!