

# *Update on Tax Expenditure Reporting*

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# *Executive Order 2011-071*

Whereas:

- State needs systematic way of evaluating tax expenditures
- Many provisions are not tax expenditures, they are needed to properly define the tax base, e.g. avoid double taxation

Therefore:

- Annual tax expenditure budget will be prepared by executive agencies
- Distinguish tax expenditures from other tax provisions
- Identify fiscal impacts, purpose of provisions
- Evaluate whether purpose is being achieved
- Estimate cost-effectiveness
- Recommend improvements

# *Defining “Tax Expenditures”*

- Congressional Budget Act of 1974:  
*“revenue losses attributable to provisions of the federal tax laws which allow a **special** exclusion, exemption or deduction from gross income or which provide a **special** credit, a preferential rate of tax, or a deferral of tax liability.” (emphasis added)*
- The name refers to the use of the tax code in lieu of direct spending to achieve a public policy purpose. The *purpose* is the basis for defining whether a tax policy is/is not a tax expenditure.
- Tax expenditures must be distinguished from tax exemptions and deductions that are needed to properly define the tax base.
- This is usually done by comparing a provision with a “normal” or “benchmark” tax base. Provisions not included in the benchmark tax base are treated as tax expenditures.

## *Role of Tax Expenditures*

- Tax code can be a powerful tool for targeting public resources to specific needs. Enables the state to target relief to households and businesses. Detailed information can be used in targeting:
  - Income tax data most detailed picture of household finances
  - CRS returns affect all businesses, can target money on a monthly basis, improving cash flows
- Administrative costs can be held down if tax relief is tied to currently collected information.
- Trade-off between moving money easily to private actors vs collecting information for oversight purposes.

## ***Benchmark Tax Base: Personal Income Tax***

- NM “piggybacks” on many federal law tax expenditures, but these are not established as a matter of state policy and are part of the benchmark tax base, e.g. exemption for pensions, health insurance, mortgage interest, etc.
- Exclusions like personal exemptions and standard deductions define a level of non-taxable income needed for minimum consumption and are part of the benchmark base.
- Other exemptions, deductions and credits are tax expenditures: e.g. renewable energy credits, rural practitioners credit, land conservation credit, etc.

## ***Benchmark Tax Base: Corporate Income Tax***

- NM “piggybacks” on many federal law tax expenditures, but these are not established as a matter of state policy and are part of the benchmark tax base, e.g. deduction for charitable contributions, accelerated depreciation, exclusion of pass-through entities, etc.
- NM allows corporations the option to file on a separate entity, unitary combined or federal consolidated basis. Because this election is available to all taxpayers, it is not special treatment and therefore not a tax expenditure.
- Examples of tax expenditures: renewable energy credits, facility rehabilitation credit, sustainable building credit, etc.

## ***Benchmark Tax Base: Gross Receipts Tax***

- Breadth of GRT base means many deductions and exemptions are needed to define the tax base and are not tax expenditures: e.g. wages, dividends, interest, sales for re-sale, etc.
- Some deductions prevent double taxation: e.g. motor fuels, mineral production, motor vehicles, insurance premiums.
- Some provisions reflect federal pre-emption: e.g. sales in interstate commerce. Some streamline administration (isolated sales).
- Examples of tax expenditures: health services, food, renewable energy, jobs credits, etc.

## *Benchmark Tax Base: Compensating Tax*

- Estoppel on collecting tax from households reduces the administrative complexity of the tax and is not a tax expenditure.
- Exclusion from tax for services is not a tax expenditure:
  - Follows common practice among the states
  - Not a special treatment and
  - prevents pyramiding.



## *Benchmark Tax Base: Tribal Issues*

- Federal law preempts state taxation of tribal governments or of tribal members on their own reservation.
- The state can tax tribal member sales to non-tribal members (dual sovereignty).
- Some state law provisions limit state taxes when a pueblo/tribe/nation imposes their own tax. This reduces double taxation, and maintains competitive market opportunities.

## *Tax Rate Differentials*

- No benchmark exists for tax rates.
- States vary widely in rates for any given program.
- Rates depend in part on what role a tax plays in a state's tax system.
- Rate also depends on how base is defined. e.g. GRT rate is similar to retail sales tax, but pyramiding means effective tax rate is much higher.
- Some goods are taxed more than once, complicating the assessment of appropriate rate. e.g., liquor subject both the excise and gross receipts taxes; mineral products are generally taxable at the retail level.

## *Interpreting Tax Expenditure Estimates*

- Tax expenditure estimates cannot be added together because they are based on specific assumptions about the interaction between provisions. For example, an estimate of revenue foregone from non-profit health care providers depends on what is assumed about other deductions for health care.
- Tax expenditure estimates do not reflect the amount that would be raised by repeal of a provision:
  - Timing and behavioral responses are not included
  - If one deduction were to be repealed, taxpayers might be able to use a different deduction to offset the same revenue/income.
  - Actual fiscal impacts depend on how the repeal is drafted.

## *Challenges in Evaluating Tax Expenditures*

- Tax policy criteria may not be relevant if a provision is really a substitute for expenditure policy
- Economic theory provides little guidance for evaluating provisions designed to reduce income inequality
- Economic research provides little help in evaluating positive or negative “externalities” – i.e. effects of behavior on others.
  - Positive examples: education, health care, culture
  - Negative examples: pollution, congestion, negative health impacts

# *Evaluating Economic Development Tax Expenditures*

- Evaluating economic development initiatives presents numerous challenges:
  - Does a company's investment in New Mexico depend on the existence of the incentive?
  - How do incentives for some businesses affect the cost of living and doing business and providing government services for other businesses and households?
  - “Multiplier” estimates should take into account the “Opportunity Cost” of State funds: i.e. the State could make alternative uses of the funds, which would themselves have multiplier effects.
  - **Key: is the incentive effective in increasing the supply of labor and/or capital to the NM economy?**

## *Balancing Accountability With Efficiency*

- In an ideal world, taxpayers benefitting from tax incentives would report to the state every year on the uses to which they have put the money.
- In reality, these reports could be burdensome, they could compromise proprietary information and the results might still not be reliable.
- We must strike a balance between the state's need to know whether its money is being properly used and the taxpayers' need to go about their business with a minimum of red tape.
- Must recognize the potential for significant administrative cost in implementing and managing a tax expenditure program.

## *Other Issues*

- Inclusion or exclusion of a provision from the Tax Expenditure report should not be interpreted as an endorsement or a criticism of the provision.
- There can be such a thing as a “negative” tax expenditure – i.e. a provision that imposes a higher tax burden than would be imposed under the benchmark tax base. An example is the greater-than-normal amount of “pyramiding” in the GRT.