BUSINESS TAX CREDIT ANALYSIS

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I. Overview: Credit Evaluation

There are several key issues or questions that should be addressed for all credits.

A. **Purpose.** Any evaluation of a credit necessarily rests on some concept of its purpose.

1. Purpose falls into three broad categories
   a. Shift production from less valuable to more valuable uses
      i. In this case, the credit increases the total value of products and services produced in the state and national economies
   b. Shift production from one location (state) to another
      i. In this case, the credit shifts location of production, e.g. from AZ to NM, but does not increase the total value of production.
      ii. Such credits are a "beggar thy neighbor" policy.
   c. Improve distribution of income, for example by increasing skills and/or wages of low-wage workers, often in rural areas.
2. Those who advocate a credit have the responsibility of explaining
   a. why non-governmental mechanisms (businesses acting through market processes and private non-market entities, such as non-profits) are failing to allocate resources appropriately and
   b. why the credit will improve on the existing situation.
3. When stating the purpose of a credit we need to identify the private-sector resource allocation failure the credit is intended to offset. Two fairly straight-forward examples:
   a. The Cultural Properties Preservation credit is plausibly justified by the possibility that the value of cultural properties to future generations may be underestimated by persons living today. The credit is a "stand-in" for and should be commensurate with the value of preservation to future residents of New Mexico <u>that would otherwise be ignored</u>.
   b. The Solar market Development and Renewable Energy Production credits may be based on the fact that the benefits of switching from fossil fuels to solar and renewable energy production are in part cleaner air and water. Such "external" benefits cannot be sold by energy producers and do not add to their bottom line. So energy producers will not take these external benefits into account when choosing among alternative means of generating power. A credit can be a "stand-in" for external benefits, allowing the value of the cleaner air or water to show up in the bottom line of energy producers.
4. **In short, in determining the purpose of each credit, we need to identify the external benefit for which the credit is a "stand-in."**

5. Another rationale for credits is to **subsidize** NM businesses so that they can be more competitive with producers in other states. In this case, the credit is not a stand-in for external benefits. It is simply a subsidy of qualifying NM businesses.
    a. Such a credit cannot significantly increase the demand for products and services produced by businesses; it can only shift production among businesses.
        i. If successful, the credit necessarily results in **given** demands for products and services being filled by the subsidized businesses instead of other businesses.
        ii. It is not creating more value of production; it is only changing the businesses that create that value.
        iii. Policymakers may say "That's o.k. because the credit is shifting production from out-of-state businesses to NM businesses."
    b. There are three problems with this view.
        i. Increased production by the subsidized, credit-receiving businesses may come in part at the expense of other NM businesses – those that produce competing products and services but do not qualify for the credit.
        ii. The credits mean either higher taxes or lower public services for other NM businesses and residents. So help for one category of NM business may come at the expense of other NM businesses and persons. **State government in this case is picking winners and losers, which raises the question of how it determines which businesses are to win and which are to lose.**
        iii. Other states may match or exceed New Mexico's credit so it is no longer effective in attracting business to NM.
6. The purpose of a credit should not be stated as "job creation" because credits cannot "create" jobs.
    a. Jobs are created by the demand for products and services expressed by the buyers of products and services.
    b. Credits can influence how **given** demands for products and services are met
        i. By which businesses
        ii. With which technologies
        iii. In which location (state)
    c. Credits can shift employment toward businesses that benefit from (are subsidized by) the credit. But the increase in taxes and/or decrease in government spending required to offset the revenue loss due to the credits will reduce demand for products and services of unsubsidized businesses and reduce employment by those businesses.
        i. There can be a net gain in employment only if the subsidized businesses are **more labor-intensive** than other businesses. Any "labor-intensity" effect is likely to be small. And it will be in the direction of **reducing employment** if, as is typically the case, the credit subsidizes capital-intensive and high-technology businesses.

B. **Reporting and oversight.** What provisions does authorizing legislation make for reporting and oversight? At present we have little information about credits, apart from their budgetary cost. We do not have the information needed to even begin evaluation of credits.

1. What information is needed to evaluate credits?
2. Are credit recipients required to report such information?
3. Have credit recipients met reporting requirements?
4. Are oversight agencies identified? Are their responsibilities defined?
    a. What data are they to collect and report (e.g. annual reports)?
    b. Do they have resources needed for effective oversight?

C. **Effects and effectiveness of credits.** Although we cannot make conclusive statements about effects of credits, perhaps we should highlight for the RSTP committee several of problems that arise in any effort to evaluate. (These problems are discussed in more detail in my report, *Evaluating Tax Expenditures: The Case of Business Tax Credits,* June 2010.) Some of the more important problems are:

1. Purpose of the credit may not be clear and may not be stated so that progress toward achieving purpose can be measured.
2. Legislation may not indicate whether and how revenue losses due to credit are to be measured and offset. Maintaining budget balance should be the preferred policy.
3. Data reported by businesses using credits gives at best only a partial, and perhaps biased, view of a credit's effects.
4. Evaluating a credit requires information about what would have happened absent the credit, but we generally do not have such "what-would-have-happened" data.
    a. In particular, the increase in employment due to a credit cannot be measured by the current-year increase in employment over a benchmark such as employment in a period preceding the credit. The reason is that we do not know how current-year employment would have changed had there been no credit.
        i. Also, many of the workers added by businesses receiving credits would have been employed elsewhere, absent the credits. So the additional employment by a credit recipient cannot be taken as measure of the increase in employment due to the credit.
    b. The same "what-would-have-happened" issue arises when assessing the effects of a credit on other variables, such as tax revenue and workers' incomes.
5. Effects of credits, whether positive or negative, will likely be small. These small changes are difficult to separate from changes due to other factors, and consequently difficult to observe in measures such as gross state product, total employment and total income accruing to New Mexico's residents.

II. Review of Specific Credits

Following are short descriptions and evaluations of four credits: investment, laboratory partnership with small business, high-wage jobs, and biodiesel blending facility credits.

Investment credit (7-9A)

Stated purpose: Provide favorable tax climate for manufacturing businesses and promote increased employment in New Mexico.

Amount: Compensating tax rate times value of qualified equipment, which is broadly defined to include equipment placed into service under the Industrial Revenue Bond Act and the County Industrial Revenue Bond Act. In any given year, credit cannot exceed 85% of combined compensating, gross receipts and withholding taxes.

Employment requirement: For each $500,000 up to $30,000,000 of qualified equipment, one FTE in addition to the number of FTEs one year prior to day on which taxpayer applies for credit. For qualified equipment over $30,000,000, one FTE is required for each $1,000,000. (Same employment requirement as Alternative Energy Product Manufacturers Credit)

Reporting: none except requirement for a 2005 review of the use and effectiveness by interim RSTP committee. (7-9A-2.1).

Recapture: None

Refundable: Under specified conditions – see 7-9A-8.

Carry forward. Unlimited.

Overall cap. None

Control for overlap with other credits, incentives and assistance: Definition of qualified equipment is broad enough to include equipment on which Alternative Energy Product Manufacturers Credit can be claimed; claiming both credits is not prohibited. Cannot claim investment credit if any amount of Research and Development Small Business Tax Credit has been claimed (7-9H-5).

Evaluation:

Since only a small number of businesses claim the credit, its economic effects are likely small. Also, the credit provides only a small offset to equipment costs – at most the amount of the gross receipts and compensating tax due on purchase of the equipment. One possible justification for the credit, independent of its effect on manufacturing production and employment, is that taxing inputs to production leads to pyramiding of the gross receipts and compensating tax.

Because of the overlap with the Alternative Energy Product Manufacturers Credit, an explicit decision is needed on whether to continue both credits, and if both are continued whether to allow taxpayers to claim both.

If both credits are continued, impose the same recapture requirements as Alternative Energy Product Manufacturers Credit and Technology Jobs Tax Credit: recapture if business ceases operations for 180+ days within 2 years after claiming credit.

Consider removing the employment requirement. Replacing worn out or obsolete equipment may not increase employment, but it is necessary to maintain existing manufacturing employment and production. Therefore, if the objective is to encourage manufacturing, all purchases of new equipment should qualify. The employment requirement also complicates tax administration and compliance.

To get data for gauging effects of this credit, TRD could work with taxpayers to prepare reports that include amounts of all credits, deductions, exemptions used by the businesses and the time paths of their employment and production. The aim is to provide a picture of *combined* effect of taxes on the businesses.

Laboratory partnership with small business tax credit (7-9E)

Stated purpose: Bring the technology and expertise of the national laboratories to small businesses in New Mexico to promote economic development of the state, with an emphasis on rural areas.

Amount: Qualified expenditures incurred by a national laboratory in assisting small businesses, not to exceed $10,000 per calendar year per small business located outside a rural area and $20,000 per calendar year per small business located in a rural area. Credit is against state gross receipts tax.

Reporting: Annual report for previous calendar year by Oct. 15 to Trd, Edd and appropriate interim legislative committee. Report is to include an economic impact study of jobs created, jobs retained, cost savings and increased sales generated by small businesses for which assistance was provided.

Recapture: None

Carry forward. None

Overall cap. Total credits for a laboratory not to exceed $2,400,000 per calendar year.

Evaluation:

An annual report provides a fairly informative overview of the uses of the credits. The report should explain how the metrics in the table on page 17 – return on investment, jobs created or retained, etc. – are calculated.

Small amounts of assistance are provided to a large number of businesses. Assistance is widely dispersed, both among types of businesses aided and areas within the state. Given its limited and low annual cost and wide dispersion of assistance, this is a credit that should be continued in the short run. But continuing evaluation is needed based on more transparent metrics.

High wage jobs tax credit (7-9G-1)

Stated purpose: None

Amount: 10 percent of wages and benefits of an eligible employee up to $12,000 for up to 4 years. Credit against all CRS except local GRT.

Eligibility: Credit applies only for increases in employees. An employee is eligible if total number of employees on last day of qualifying period is at least one more than the number on date prior to the date the employee's job was created. Employee must work at least 48 weeks of the 12 month qualifying period. Wages must be $40,000+ in municipalities of 40,000 or more and $28,000+ in all other areas. Business must have made more than 50 percent of sales outside New Mexico or be eligible for development training program assistance pursuant to section 21-19-7 NMSA 1978.

Reporting: EDD is to report annually by Nov. 1 to the legislature the cost of the credit and its impact on company recruitment and job retention

Recapture: None

Refundable: Fully refundable if credit exceeds tax liability.

Carry forward. None

Overall cap. None

Control for overlap with other credits, incentives and assistance: none

Evaluation:

Like many other credits, the question of why this credit is needed is left unanswered. What failures in decision making by New Mexico businesses generate the need for this, and related, tax credits? When this and other business incentive tax credits are looked at as a whole, we see State government intervening in labor, capital and product markets in a variety of overlapping, offsetting and uncoordinated ways. How this intervention affects the New Mexico economy on balance is unknown. Continuation of this credit should be conditional on a systematic review of the rationales for and effects of it and related credits.

The credit is a wage subsidy paid to recipient businesses. Some fraction of the credit may accrue to workers as higher wages than they would otherwise receive; the remainder accrues to the businesses. Division of the dollar amount of the credit between workers and businesses will vary from business to business.

Although the credit is an incentive to increase high wage jobs, we cannot gauge its effect by the observed increase in high wage jobs. That increase may be due only in part or not at all to the credit. The number of high wage jobs created by the credit cannot be determined without knowing what the number of high wage jobs would have been without the credit. Yet the observed increase in high wage jobs is commonly attributed in full to the credit.

An important modification would be recapture if a recipient business ceases operations for 180+ days within 2 years after claiming credit.

The out-of-state sales requirement is an unnecessary complication; production for export is no more valuable to the New Mexico economy than other production.

A new high wage job is eligible for the credit only if it results in an increase in total high wage jobs; credit is paid on only the increase in high wage jobs. The credit provides no support for firms that must eliminate high wage jobs because of a declining market for their products; it does nothing to help retain existing high wage jobs.

Biodiesel blending facility tax credit (7-9-79.2)

Stated purpose: None.

Amount: Thirty percent of purchase cost of biodiesel blending equipment plus 30 percent of the cost of installing that equipment. Credit not to exceed $50,000 for the equipment installed at any one facility. Credit applies against gross receipts and compensating tax liabilities, and is neither transferable nor refundable.

Pre-certification. Upon application from the taxpayer, the Energy, Minerals and Natural Resources Department (ENMRD) must determine whether the equipment to be installed meets requirements of this section. If it does meet requirements, ENMRD issues a certificate of eligibility which is to be provided to TRD to obtain the credit.

Reporting: None.

Recapture: Full recapture of credit if facility ceases blending without completing at least 180 days of availability of facility within the first 365 days after issuance of certificate of eligibility.

Carry forward. Credit can be carried forward up to 4 years from date of certification of eligibility.

Control for overlap with other credits, incentives and assistance: Need to determine whether definition of qualified equipment is broad enough to include equipment on which Alternative Energy Product Manufacturers Credit can be claimed.

Overall cap. No credits available once credits from all taxpayers reach a total of $1,000,000.

Evaluation:

The first step in evaluating a credit is to determine whether and why it is needed. Why is there need to subsidize use of biodiesel fuel? Why is there need to encourage use of biodiesel as a vehicle fuel but not as a fuel for stationary engines? One possible reason for the subsidy is that biodiesel is a renewable energy source that is less environmentally damaging. That is, there is an “external benefit” from using biodiesel that buyers and sellers of fuel do not take into account; the credit is a “stand-in” for this external benefit. Whether such is in fact the case is still debated by energy and environmental scientists. Also, if this is the rationale, there is no need to limit qualifying use to vehicles.

To qualify for the credit, the fuel need contain only 2 percent biodiesel, so it seems unlikely that the credit will greatly expand use of biodiesel.

Given the $1,000,000 overall limit on claims, this credit will not have a significant budgetary cost. However, the questions raised in the preceding paragraph should be answered before increasing the limit on total payout from the credit.

The limit of $50,000 per facility means that the credit can be applied to at least 20 facilities. The credit can be effective in encouraging installation of at least 20 facilities, which does not seem an excessive number for the entire state.

Since nothing in the authorizing legislation explains why the credit is needed or what it is intended to accomplish, it would be useful and appropriate to have a report from EMNRD that explains the rationale for the credit and gives details on credits claimed – amount, location and capacities of facilities.