Reforming the Gross Receipts Tax

Before the

Revenue Stabilization and Tax Policy Committee

of the

New Mexico Legislature

September 14, 2016

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

The 3-legged stool – typical state profile.

Consumption taxes

- This is the tax that is the most within the control of state governments.
- Most states have room to expand – (services, intangibles, etc.)
  - That is not as true for New Mexico
- Typically imposed at both state and local (municipal) rates
- Problems with consumption taxes
  - They are regressive
  - Enforcement difficulties – remote sellers may not have to collect the tax
  - Pyramiding - tax on business inputs (embedded tax)
  - Risk to businesses
    - If they should charge it but they don't – it will come out of their own pockets (profits).
    - If they should NOT charge it but they do – they will be at a competitive disadvantage.
    - So complexity is not good.

History of the GRT

Emergency School Tax

- First enacted in 1934 and permanently in 1935
- States had to enact new taxes during the recession
- Base was broad – including taxation of services
  - Kept the rate low – 2%
- Everybody gets to pay something

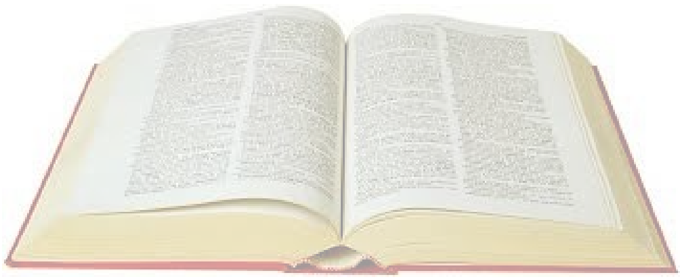
Formation of GRT in 1966

- Tax on the seller (collected from the buyer in most cases)
- Tax federal government through its contractors
- Maintained spirit of taxing everyone
- In the mean time
  - Property taxes recovered
  - Income taxes were in place
  - It was no longer necessary for the GRT to function as the whole tax system
  - Tax on business-to-business transactions began to be a problem

History of the GRT

Early 1990s forward

- Erosion of the tax base
  - The political pressure is to grant taxpayers exceptions (deductions) from the tax
  - Because New Mexico taxed things other states did not – this pressure was increased
  - There were policy reasons for some carve-outs – but they weren't always done in a way that benefitted everyone
- Increasing difference from other state tax systems
  - In 1999 – states began the streamlined sales tax effort
  - NM's GRT does not really fit the streamlined template
  - Being a small state with an odd tax system does not help NM's economic development



The GRT System Includes

- Compensating Tax
  - Companion tax ("use" tax) – imposed on purchaser
  - In New Mexico – GRT rate differs from comp tax rate
- Municipal and county gross receipts taxes
  - Local revenues tightly controlled by Legislature
  - Local option taxes
  - Munis also receive 1.225% of the state rate (5.125%)
  - GRT provides 75% of municipal general revenue
  - Bases are identical – so locals piggyback on state base
- Tribal taxes
  - Tribal governments are sovereign with respect to the state. They have taxing power of their own.
  - They do not have to align their general excise tax with New Mexico's. It is a matter of mutual convenience that they do.
  - Currently 15 tribal entities impose a gross receipts tax administered by the state under cooperative agreements.

The GRT System Includes

- “Special” state taxes
  - Governmental GRT
    - Justified by competition between governments and businesses
    - Bucks used for capital outlay projects of select local govts & state agencies
    - Could be folded into regular GRT
  - Interstate telecommunications GRT
    - Long-distance service was taxed under the gross receipts tax until 1992
    - This separate tax was created, mainly as a convenience to the long-distance companies
    - The FCC would not permit passing on the tax unless local rates were part of a special tax.
    - ITGRT’s rate of 4.25% determined as an average of the actual effective gross receipts tax rate.
  - Lease vehicle GRT & surtax
    - At the behest of auto rental companies, this 5% tax on top regular GRT replaced the motor vehicle excise tax on the same vehicles.
    - Effectively reduced interest paid on financed vehicle purchases.
    - Tax is targeted at tourists.
  - Telecommunications relay service surcharge
    - Rate = 0.33% - charged on receipts from intrastate telephone services.
    - It funds TTY/TDD services.
    - It is a special excise tax that happens to be collected through the gross receipts tax system.

The GRT System Includes

- Tax credits
  - Investment
  - Lab partnership
  - Technology jobs
  - High-wage
  - Advanced energy
  - R&D small business
  - Affordable housing
  - Alternative energy manufacturing

Is it broken? (If so, what's the problem?)

Yes.

- 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

Is it broken? (If so, what's the problem?)

What do we want our tax to be when it grows up?

- "Normal" sales tax? Easy:
  - Restore "retail" or consumption to the tax base
  - Eliminate business to business service taxation
    - This is what distinguishes – negatively – the GRT from others
  - Leave legal imposition the same, but "rebrand"
  - Other base issues
    - Taxation of Federal Activity
    - Healthcare, Digital Goods, etc.
    - Harmonize GRT and compensating tax bases
    - Rationalize taxation of services (inside/outside) and sourcing
  - SSTP/MFA Conformity
    - Why not be like everyone else?
    - One disadvantage of the GRT is reputation: it's weird and no one understands it

Is it broken? (If so, what's the problem?)

What do we want our tax to be when it grows up?

- True Gross Receipts Tax?
  - Eliminate most exemptions and deductions
  - Reduce rates (below 2%)
  - Note: every state that has one uses it as a general business tax in lieu of corporate income tax (broader non-shrinking base)
    - Every state that has a GRT like tax also imposes a general sales tax
- Regardless, there are other critical considerations
  - Local government finance
    - Municipalities more reliant on GRT than state
  - Household burden/regressivity
  - Fiscal Impact (general fund)

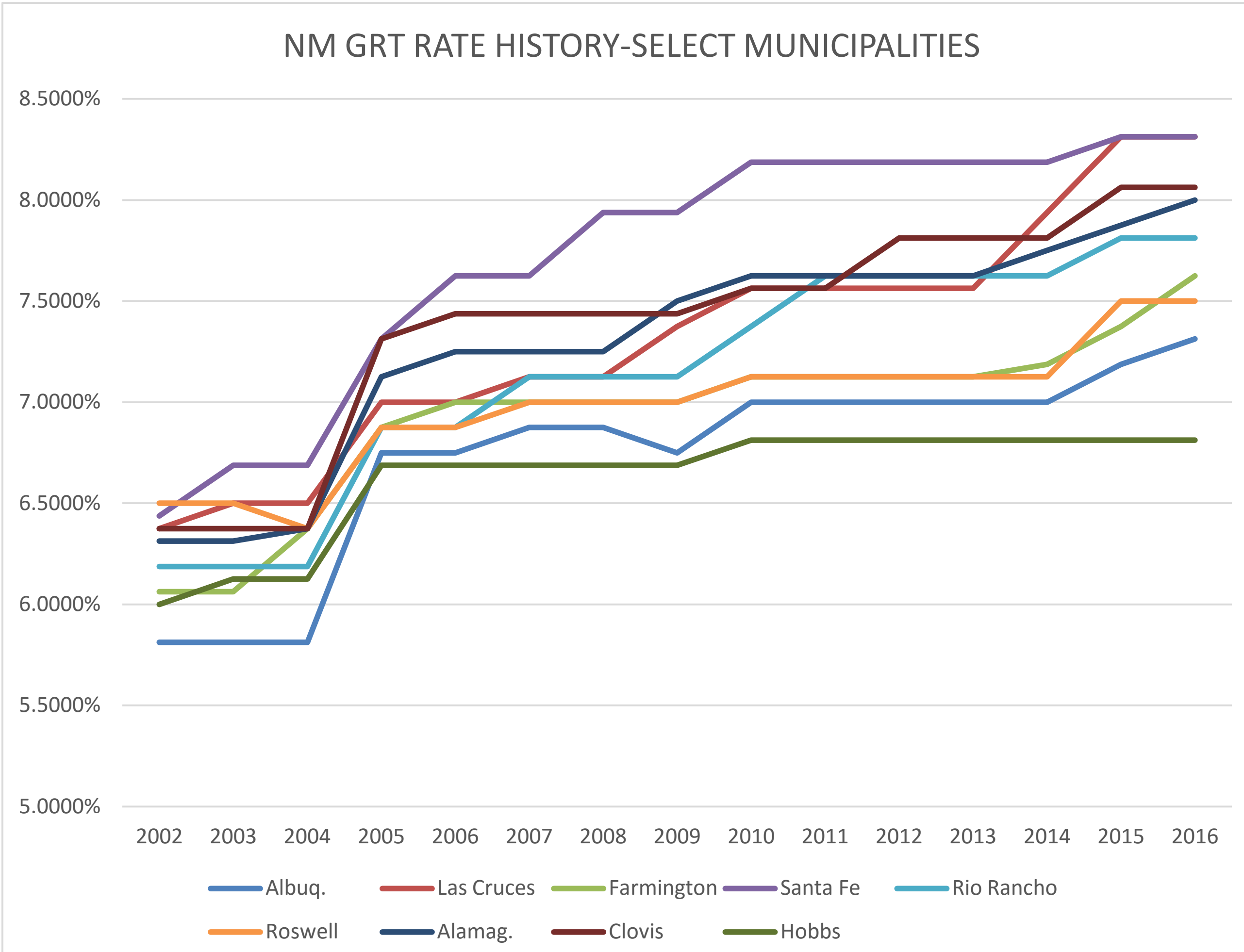
More problems with the GRT.

Most comparisons do not take into consideration the impacts of pyramiding when comparing sales tax burdens.

- What is pyramiding?
  - Pyramiding is when a consumption or transaction tax (including the NM GRT) is charged on business inputs (business-to-business sales) and becomes embedded in the cost of the ultimate goods or services sold to the consumer.

	Sales	GRT
Drilling contractor	$100	$7.40
Natural gas producer	$200	$14.80
Electric Utility	$400	$29.60
Commercial power consumer	$800	$59.20
Total final value/Tax	$800	$111.00
Effective tax rate		13.88%

General Fund Revenue Sources – Gross Receipts and Compensating Tax – Rate Trends



More problems with the GRT.

- GRT is also regressive
  - Hit's poorer households harder relative to income
  - Carving out food and medical services didn't help. Why?
    - To make up for lost revenue, the rates were raised on everything else.
    - Food stamp recipients were especially hurt since they didn't pay tax on food purchased with food stamps in the first place.
- State, muni's, counties and others in competition for tax base
- Counties increasingly dependent on GRT – some now receiving more revenue from GRT than property tax.

What other states are doing.

Attempts to expand the tax base

- Taxing services and digital goods
  - Progress by other states has been slow
  - States don’t want to increase tax on business inputs
  - Policy makers consider NM “lucky” in that its base has always been broad
    - But as discussed, this creates many other problems
- Replacing other taxes with expanded sales tax
  - Maine, Missouri, other attempts – typically focus on reducing or eliminating income tax and expanding the sales tax or raising rates.

Streamlined sales tax effort

- Progress to date
  - Substantial progress on the big issues – still lots of little issues
  - Slightly more than half the states are members (but not the biggest states)
- Outlook
  - Depends on what Congress ultimately does

What other states are doing.

Congressional efforts

- Marketplace Fairness Act –
  - Passed the Senate (S. 698) – pending in the House
  - Unlikely to pass unchanged
- Digital Goods and Services Tax Fairness Act (S. 851 H.R. 1643)
  - Would set out rules for when states can tax digital goods and services
  - Has been endorsed by the National Conference of State Legislatures
- Online Sales Simplification Act
  - Rep. Goodlatte proposal (origin sourcing)

State Activity (challenges to Quill, reform efforts, and other changes)

Taxpayer issues

- Trying to reduce tax on business inputs (pyramiding

State reform efforts

How to fix the GRT.

Who thinks we have a problem?

- Everyone (but agreement ends at 100,000 ft)

What Hasn't Worked?

- Most broad legislative efforts since the Franklin Jones Commission
- Lack of effort otherwise
- Piecemeal efforts (lot of them) for narrow interests, followed by
- Rate increases…

* that's not to say that no good has been done or that all exemptions/deductions/credits are created equally

How to fix the GRT.

Too far gone for tweaks a la Blue Ribbon

- Limiting efforts to changes to relieve political pressure (more random carve-outs) is not useful
- Basic problem is the design flaw in the GRT – it tries to do too much.
- We need a basic consumption tax that fits within the overall system

Need to address current issues like-

- Digital goods
  - Computer programming, music files, video files, etc.)
  - Cloud computing – where does it happen
- Importation of services - currently not taxed
- Export/import rules – what rule governs the application of tax rates –
  - Origin? Destination? Hybrid?

Clean slate

- Broaden scope to focus on general approach to taxing businesses – think about simultaneously replacing the corporate income tax

How to fix the GRT.

Decide:

- Who/what do we want to tax?
- Consumption tax? Business activities tax? Both?
- Separate taxes for certain industries?

Recommendations:

- Build state capacity to analyze alternatives timely
- Use small-ish working group to develop plan
- Phase-in if possible – delayed effective date
- Public debate only on complete proposal(s)
- Include Administrative Issues

*incremental reform shouldn't be discouraged but sweeping reform in that manner requires long term legislative discipline

How to fix the GRT.

Resources –

- A true reform effort requires extraordinary data analysis
- Need to make sure that data and capacity to evaluate it is in place

Past reform efforts –

- Franklin Jones
  - Small private group created the plan
- Legislative committees
  - Operated within the committee process – public
- Academic-led efforts
  - Public, but only sparsely attended
  - No major legislative results
- Blue ribbon
  - Only minor changes

Best approach

- Small group – adequate resources – clear instructions – private deliberations until the basic plan is designed
- Need an implementation plan for any major reform