# Reforming the Gross Receipts Tax

Before the

Legislative Finance Committee

of the

New Mexico Legislature

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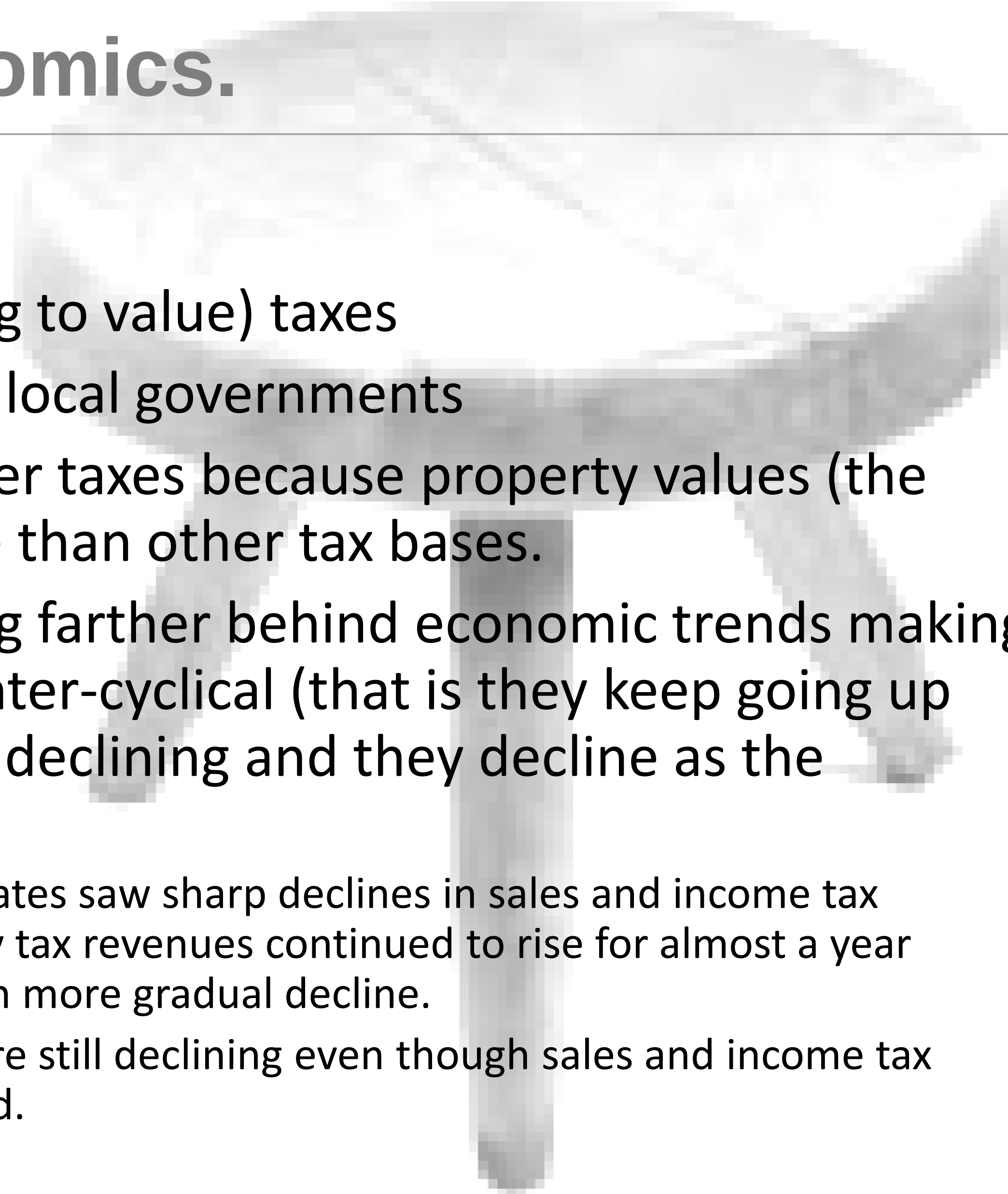
# REFORMING THE GROSS RECEIPTS TAX

# General structure of modern tax systems

The “3-Legged-Stool”

- Defining the three legs in economic, policy and administrative terms:
  - Property Taxes
  - Income Taxes
  - Consumption Taxes
- Because taxpayers have different economic profiles, a taxation strategy that uses multiple approaches—
  - gets “more feathers with less squawking;”
  - may make it easier to ensure everyone pays a “fair share.”

# The 3 legs - economics.



Property taxes

- Ad valorem (according to value) taxes
- Imposed primarily by local governments
- More stable than other taxes because property values (the base) are more stable than other tax bases.
- Property taxes also lag farther behind economic trends making them somewhat counter-cyclical (that is they keep going up while the economy is declining and they decline as the economy picks up)
  - For example, in 2010, states saw sharp declines in sales and income tax collections, but property tax revenues continued to rise for almost a year before beginning a much more gradual decline.
  - Property tax revenues are still declining even though sales and income tax revenues have recovered.

# The 3 legs - economics

## Income taxes

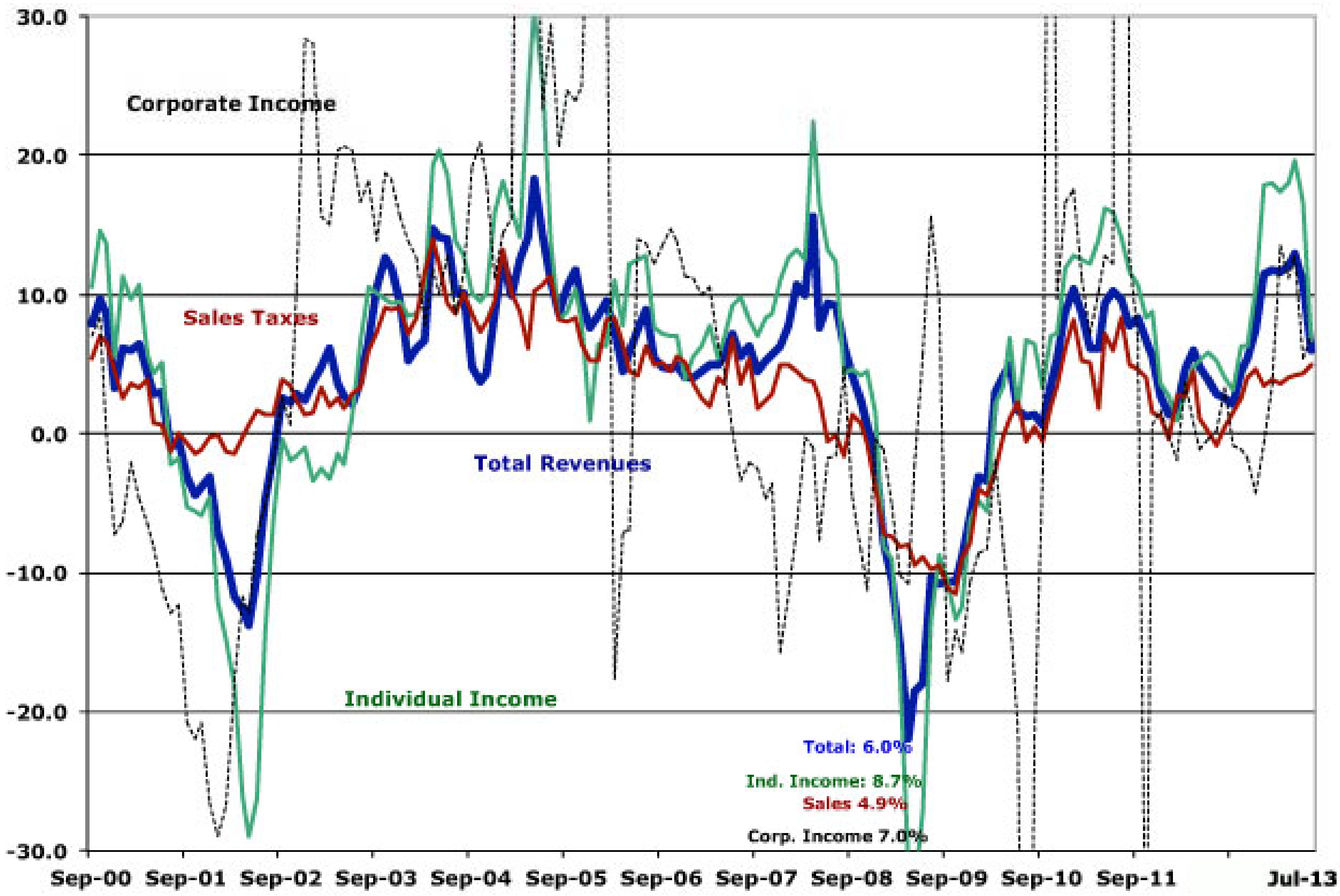
- Tax on wages, earned income, investment returns and profits (not necessarily wealth)
- Imposed primarily by federal and state governments
- Least stable, most volatile of the 3 legs
  - In the second quarter of 2009 – state income taxes shrunk by 28% on average
  - In the first quarter of 2013 – they grew by 18%.
  - Corporate income taxes are the most volatile of all state taxes
  - Not only do income taxes decline sharply during economic downturns—they decline at the very time that governments may need to provide additional services

# The 3 legs – economics.

## Consumption taxes

- Includes not only general sales taxes but also excise taxes (vehicles, fuel, insurance premiums, etc.)
- Legal incidence may fall on purchaser or seller—but economic incidence is intended to fall predominantly on the consumer
- Consumption taxes are susceptible to pyramiding (a problem discussed in more length later)
  - Example: Manufacturer pays some tax when buying supplies or services, wholesaler pays some additional tax when buying consumables or other inputs, retailer pays some additional tax on consumables and all of this is embedded in the cost of the product, which is then taxed again when sold to the consumer.
- Consumption taxes are more volatile than property taxes, but less volatile than income taxes.
- Only tax that ecompasses the “underground economy”

# Volatility in Income and Sales Taxes.



# The 3 legs – administration.


Property taxes

- Relatively simple for the government, compared with other taxes.
- No filing typically required for real property taxes
- Annual filing for tangible personal property
- Value doesn't change significantly from year to year
- Value is generally based on accepted academic and economic principles (rather than on statutory formulas)
- Collection can be difficult if the owner doesn't have sufficient funds to pay the tax assessed.
- Administration is generally handled at the local level.
    - Local administration presents its own challenges

# The 3 legs – administration.

Income taxes

- Most states, including New Mexico, piggyback on federal law which determines the tax base
  - This greatly simplifies the state level administration, requiring little effort on the part of the state to ensure a reasonable level of compliance.
  - It also creates a substantial amount of uniformity—although states can and do make adjustments to the federal base.
- Most of the filing is done by households with relatively simple returns (wages)
  - Withholding on wages guarantees that tax is collected on a substantial amount of that income
- Pass-through entities are generally not taxed at the entity level, although a few states have imposed taxes directly on pass-throughs' (e.g. Business Activity Taxes)
- Corporations have more complex filing requirements
- The big issue generally is tracking the source state of income (i.e. residency issues and business income sourcing).

# The 3 legs – administration.

## Consumption taxes

- In every case, the seller is required to collect and report the tax.
  - The seller collects the money for the transaction so this works well (just as withholding works for collecting the income tax on wages).
  - Also, the seller maintains records of the transactions which the purchaser is not required to maintain.
- Administration is complicated for multistate businesses because every state’s general sales tax rules are slightly different—and what is taxed or not tax varies.
- Sourcing (that is deciding what state should tax the sale) can be an issue for some types of sales (e.g. services, digital goods, etc.)
- Under U.S. Supreme Court holdings, states cannot collect the tax from certain remote sellers—so collecting on Internet and mail order sales can be very difficult, if not impossible.

# The 3-legged stool in other places.

Internationally –

- Consumption taxes
  - OECD reports that in 2012 – consumption taxes were 31% of total government tax revenues on average.
  - 150 countries have a VAT. Of the 34 OECD countries, 33 have VAT taxes. (The US is the only OECD country without a national or sub-national VAT).
  - 2/3 of consumption taxes are VAT taxes.
  - 1/3 is other excise taxes (vehicles, fuel, tobacco, etc.)

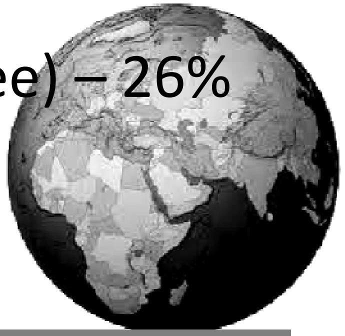
# The 3-legged stool in other places.

Internationally –

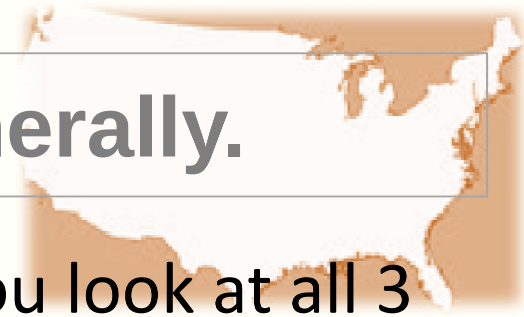
- Income taxes
  - OECD reports that in 2012 – individual and corporate income taxes (not including social security type taxes) were 33% of total government tax revenues on average.
    - 24% for personal income tax
    - 9% for corporate income taxes
- Property taxes – now account for only about 5% of total government tax revenues for the OECD countries.

What makes up the balance of total government tax revenues?

- Social security contributions (employer and employee) – 26%
- Other – 3%



# The 3-legged stool in the US generally.



In the United States you only get 3 legs if you look at all 3 levels

- The government and the tax system is effectively split between federal, state and local.
  - The federal government relies almost entirely on income and payroll taxes.
    - About 91% total – with about 92% of that coming from personal and payroll taxes
    - There is no federal level consumption tax – only minor excise taxes.
  - The states rely almost entirely on sales taxes and income taxes.
  - The local governments rely primarily on property taxes.
    - On average about 75%
- In the U.S. - of the total federal, state and local government tax revenues:
  - About 60% goes to the federal government
  - About 21% goes to states
  - About 19% goes to local governments

# The 3-legged stool – state and local level.

Property taxes – 33%

- 1% of this goes to states
- (States also impose severance taxes – which amount to about 2% on average and about 15% of NM's total tax revenue)

Income taxes – 25%

- Broken down between PIT (21% of total) and CIT (4% of total)

Consumption taxes – 34%

- This includes general sales taxes and excise taxes (vehicles, fuel, tobacco, alcohol, insurance premiums, telecom and other public utilities, etc.)

# The consumption tax.

True or false – some states have no consumption tax.

- FALSE
- Some states have no general sales tax (NH, OR, MT, AL, DE)– but they all have *some* type of consumption tax.
  - For example, Oregon has no general sales tax but it imposes $1.4 billion in other consumption taxes.
  - Montana has no general sales tax but 22% of its total tax revenues comes from consumption taxes.

# The 3-legged stool – typical state profile.

Income taxes

- No state imposes the level of taxes on personal and corporate income that the federal government does
- Federal taxes on income, to some extent, “crowd out” state and local taxes.
- States also “piggy-back” on federal income tax rules, so that almost all of what goes into the base is determined by the federal government

Property taxes

- States typically do not try to derive much revenue themselves from the property tax—leaving it for the locals to collect.
- If states were to impose a state-level tax, it would likely crowd out local revenue.

# 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.

# How do the states stack up?

| STATE | PERCAPITA $ | RANK |
|---|---|---|
| Arizona | 1,980 | 39 |
| California | 2,954 | 12 |
| Colorado | 1,976 | 40 |
| Idaho | 2,115 | 37 |
| Montana | 2,447 | 25 |
| **New Mexico** | **2,440** | **26** |
| Oklahoma | 2,314 | 33 |
| Oregon | 2,231 | 35 |
| Texas | 1,865 | 43 |
| Utah | 2,035 | 38 |
| Wyoming | 4,426 | 3 |
| | | |
| U.S. Total | 2,536 | |
| Median | 2,443 | |

Revenue per capita and national rank (with 1 being the most revenue collected per capita and 50 being the least).

Source: Federation of Tax Administrators – 2012.

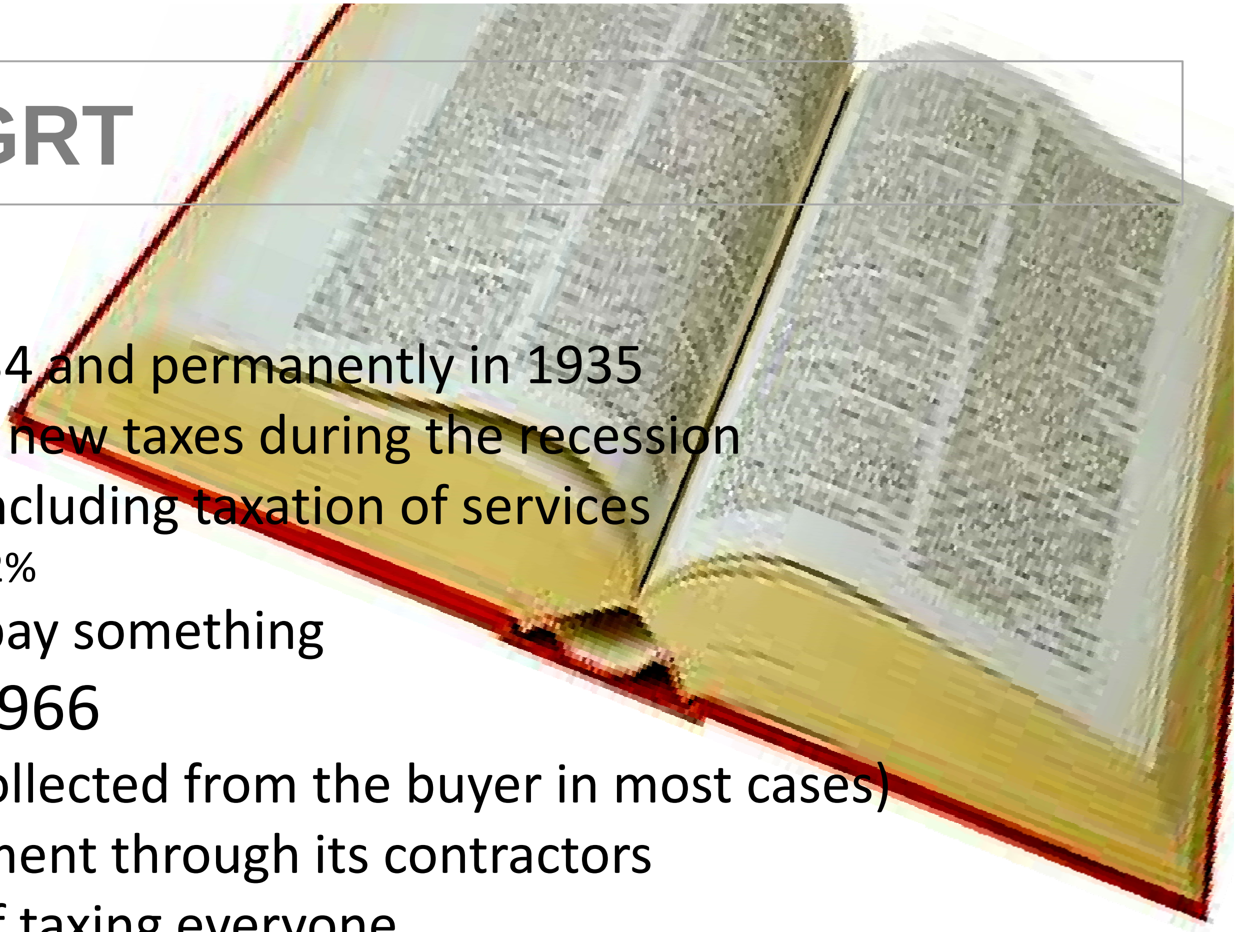
# How do the states stack up?

| 2011 | Property | Sales | Excise | Personal | Corporate | Other |
|---|---|---|---|---|---|---|
| Arizona | 33 | 38 | 10 | 13 | 3 | 4 |
| California | 29 | 22 | 10 | 27 | 5 | 7 |
| Colorado | 38 | 24 | 9 | 21 | 2 | 6 |
| Idaho | 29 | 25 | 10 | 25 | 4 | 8 |
| Montana | 39 | N/A | 16 | 24 | 4 | 18 |
| **New Mexico** | **19** | **39** | **11** | **15** | **3** | **13** |
| Oklahoma | 19 | 33 | 11 | 20 | 3 | 16 |
| Oregon | 36 | N/A | 10 | 39 | 4 | 11 |
| Texas | 44 | 30 | 15 | N/A | N/A | 11 |
| Utah | 28 | 27 | 12 | 25 | 3 | 5 |
| Washington | 31 | 46 | 16 | N/A | N/A | 8 |
| Wyoming | 34 | 29 | 4 | N/A | N/A | 34 |
| U.S Total | 33 | 23 | 12 | 21 | 4 | 8 |

Percentage share of total tax revenues.

Source: Federation of Tax Administrators – 2011.

# 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

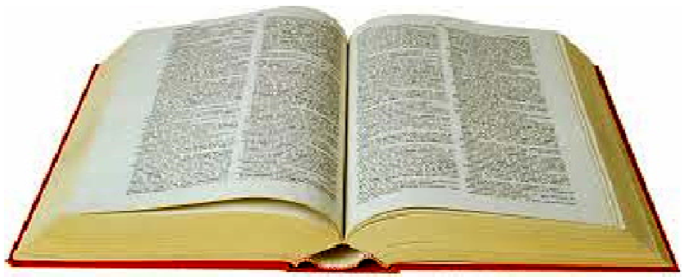
Formation of GRT in 1966

- 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 t RT is ove
  - Economi erence
  - Ineffici
- As a tru ss receipts it's too narrow and the rate is too high
- No ocus
  - the worst oth worlds
- risi nd shrinking bas
  - easingly a high rate business inputs tax
- relianc n ad hoc measures, edits, to the

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

What do we wa... ur tax to ... ws ...?

- "Normal" s... ax? Eas...
  - Restore ... or consu... ase
  - Elimina... ness to busi... vi... on
    - Th... at distinguishes ... tively – ... GRT from others
  - Lea... mpositio... ut "rebrand"
  - Ot... e issues
    - ...tion of Federa... ctivity
    - ...thcare, Digita... ods, etc.
    - ...rmoni... mpensating tax bases
    - ...ationa... ze taxation of services (inside/outside... g
  - ...P Conform... ty
    - Why no... ke everyone else?
    - ...tage of the GRT is reputation: it's weird and ... ds it

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

What do we wa ur tax to ows ?

- True Gross ipts Tax?
  - Eliminate exempti
  - Reduce below 1%)
  - Note tate that has o es it as a general business tax in lieu of corp come ta n-shrinking base)
    - state that G also imposes a gen les tax
- Re , there a other critical consid ns
  - vernment fi e
    - unicip liant on GRT than state
  - sehold rden/regressivity
  - scal Impact ely negative)

# More problems with the GRT.

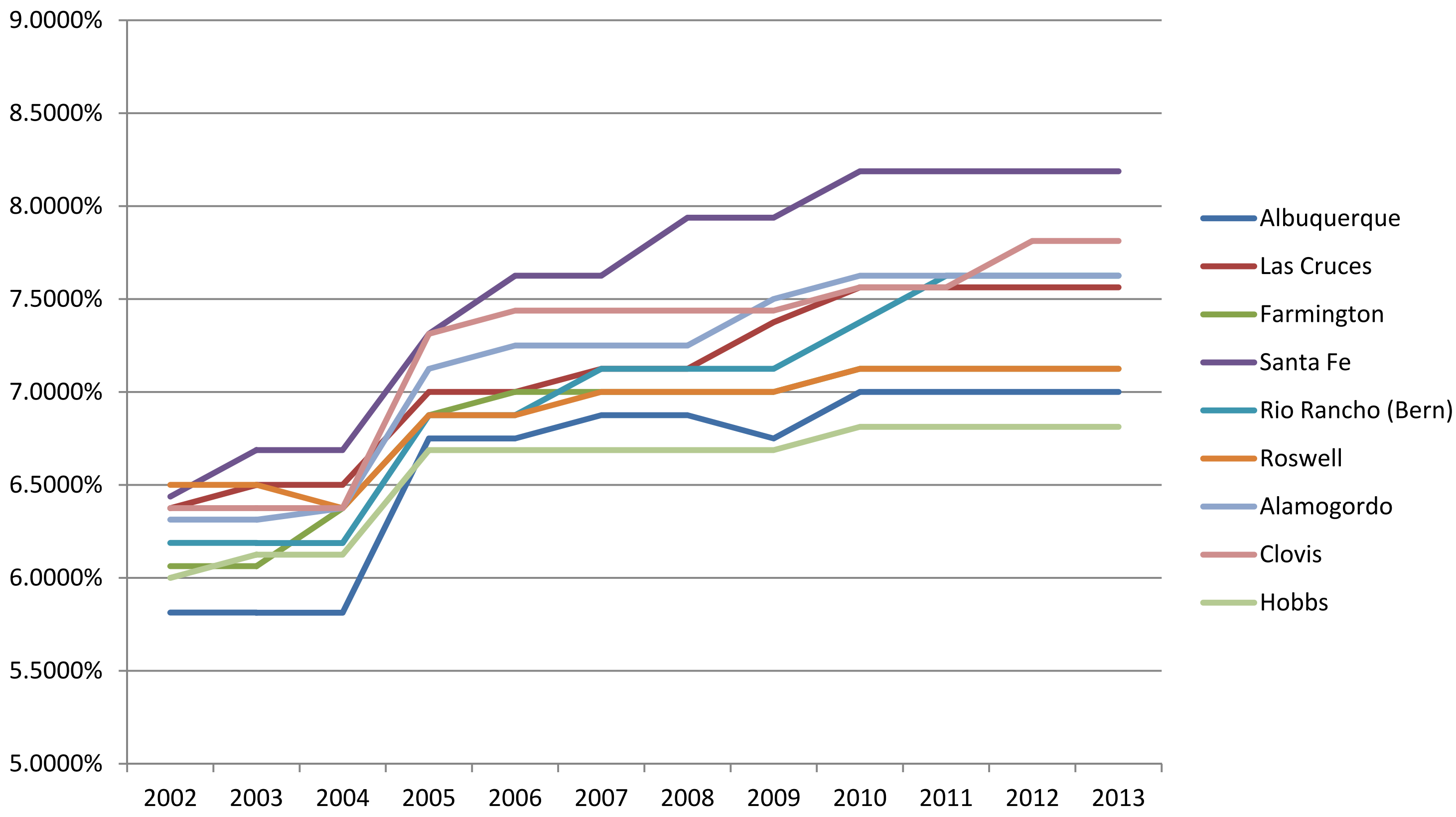
Most comparisons do not take into consideration the impacts of pyramiding when comparing sales tax burdens.

- 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% |

# More problems with the GRT.

Rising rates makes the pyramiding problem worse . . .



# 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.

## Congregational efforts

- Marketplace Fairness Act –
  - Passed the Senate (S. 743) – pending in the House
  - Unlikely to pass unchanged
- Digital Goods and Services Tax Fairness Act (S. 1364)
  - Would set out rules for when states can tax digital goods and services
  - Has been endorsed by the National Conference of State Legislatures

## Taxpayer issues

- Trying to reduce tax on business inputs (pyramiding problem)

## State reform efforts

# 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?
- 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 plan

# 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