Presentation to

Interim Revenue Stabilization and Tax Policy Committee

At its First Meeting
June 6, 2014

Proposal for Reforming New Mexico's General Excise Tax

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1. The Problem: New Mexico's general excise tax—called the "gross receipts tax"—does not fit our economy today. Worse, it may be a real hindrance to economic development.

a. The gross receipts tax started life in 1966 as a broad-based tax on business receipts from selling goods or providing services in New Mexico.

It has never been a true gross receipts, or "turnover", tax. From its inception the tax's structure allowed exceptions for the bulk of business-to-business sales of tangible products and also for some inter-business services. Paraphrasing Franklin Jones, the tax was intended to fall on the transaction in which the good or service left the stream of commerce. Unfortunately however useful as a guiding principle, identifying that transaction can be more art than science.

Neither is the gross receipts tax is a sales tax as generally conceived. Its broad taxation of services extends its reach well beyond the typical sales-to-consumers base. A few years ago, the New Mexico Tax Research Institute estimated that approximately one-third of the tax's revenue derives from pyramiding, that is, taxation of business-to-business transactions. Taxing business inputs has long been known to be economically inefficient. Practically, it puts New Mexico businesses at a disadvantage with out-of-state competitors who are not faced with such taxes.

A second unwritten but foundational concept was taxing (indirectly) the federal government. Why? At least since the 1950s the federal government has been one of the biggest "industries" in New Mexico. States can tax only what they have. Taxing the federal government directly of course is unconstitutional. So the tax was designed to apply to federal contractors and suppliers. This is the reason vendors, not buyers, are taxpayers under the gross receipts tax. The revenue stream derived from the federal sector is still a major component of gross receipts tax collected.

b. Over the past half century, New Mexico has become much more integrated with both the national and international economies. New Mexico businesses, especially those performing services, face much more intense competition now than they did in the mid-1960's.

c. New Mexico has responded to pressures on taxpayers on a piece-meal basis, compounding the problem (literally). We've caused tax rates to rise significantly over the last decade or so as we've chipped away at the consumption tax—making the system even less competitive for business and more regressive on poor households than it would otherwise be.

Business: Some enactments responded to the underlying pyramiding problem by selectively removing some business-to-business transactions, such as 7-9-46B (consumables sold to manufacturers), 7-9-52.1 (leasing equipment to construction contractors) and 7-9-56.1 (internet services to ISPs). More commonly the tax breaks are for economic development reasons, whether up front as a gross receipts exemption or deduction or indirectly as a tax credit. In this case, only favored businesses/industries get relief, creating systematic equity issues.

Consumer: In the last twenty years or so, the political popularity of un-taxing transactions with consumers has proven irresistible. A prohibition on enforcing compensating tax on imports of household goods passed in 1993. Since then the several deductions for health care, drugs and prosthetic devices, 7-9-92 (food, as defined by the federal SNAP), 7-9-95 (annual back-to-school tax holiday) and 7-9-107 (professional boxing/wrestling) have been enacted, removing not insignificant segments of the tax base.

Government: New Mexico has noticeably moved away from taxing federal contractors—7-9-54.1 (aerospace services to "organizations" associated with the US Air Force), 7-9-54.2D (research, development, testing and evaluation services provided for the US Air Force's operationally responsive space program), 7-9-62.1 (maintenance/remodeling services on certain commercial or military aircraft), 7-9-94 (military transformational acquisition programs) and the now-expired 7-9-106 (military construction services at Cannon AFB). Several others have been offered in recent sessions. This reacts to budgetary pressures on federal agencies, who now need to shop seriously.

d. The result is a shrunken tax base having no unifying principle but still differing from every other state's and constantly changing. We all know that businesses desire certainty in the tax arena. The gross receipts tax's quirky nature and the steady upward creep of its rates do not provide that necessary sense of solidity or fairness to either in-state businesses or those looking to locate here.

2. Possible Solutions: The gross receipts tax system is broken. Can it be fixed in any meaningful sense? We argue an emphatic NO! The fundamental problem is the tax's design.

Gross receipts tax issues have been thoroughly studied over the years. Consult the work of the 1996 Professional Tax Study Committee chaired by Dean Robert Desiderio, the 1997 New Mexico Business Tax Competitiveness Study by the Barents Group LLC (of KPMG Peat Marwick) and the 2003 Blue Ribbon Tax Reform Commission, among others. The follow-up (or rather, the lack thereof) to these studies suggests that New Mexico cannot nudge, fiddle or tweak its way to fundamentally sound tax policy.

a. **Now is the time to replace the gross receipts tax**.

b. Two general paths for accomplishing this feat beckon.

- **Turnover tax**--expand the tax base and dramatically drop the rate. This is the approach of the Sharer-Taylor proposition, embodied in 2013's HB 369 and SB 368. Essentially all business-to-business transactions are subject to tax, as well as business-to-consumer transactions.

- **Consumption tax**--reduce the tax base and increase the rate. Pull all or most of the remaining pyramiding from the tax base, perhaps adding back some or all of the consumption items currently deductible. This generates a tax on retail sales or consumption, similar to that in most other states.

3. Our proposal: Charge a group, under general Revenue Stabilization and Tax Policy Committee supervision, with examining the two general alternatives, creating detailed designs, estimating tax base size and requisite rates and potential revenue offsets, outlining their pros and cons, preparing alternatives and, if so instructed by the Committee, draft legislation to enact one or more alternatives. This task is large enough that it cannot be accomplished realistically before the 2015 legislative session. We propose that it be split into two major chunks: preparing the ground (2014) and then resolving the policy/design issues (2015).

a. For 2014, the main job would be getting the data and putting it into usable form.

Even Taxation and Revenue Department does not have all the data necessary to scope out the size of a turnover tax base. The four corners of such a tax have to be thoughtfully considered first. Then the base needs to be estimated, relying on federal data and possibly information from other states, input-output tables and the like.

Establishing the consumption (retail sales) tax base is also not straight-forward. For example, are sales to governments or non-profits "consumption"? Although it would be economically pure to pull out all pyramiding from this tax base, pragmatically this is not necessary (and perhaps not possible). All state sales taxes contain a level of pyramiding. Since New Mexico would not be at a competitive disadvantage by including commonly-taxed business-to-business transactions (i.e. tangible property or construction materials), it could include them and thereby lower the ultimate tax rate commensurately.

Because any single base likely will be controversial, alternative bases should be constructed for consideration. Estimates of some of the individual items may also serve as the basis for creating separate user taxes.

Keep in mind that the new tax, turnover or consumption, must serve not only the state but also the municipalities and counties. Revenue effects on individual local governments could be sizable and must be well analyzed and understood.

b. Other 2014 tasks:

- List the possible policy goals. For example, does New Mexico want to qualify for joining the streamlined sales tax system (or any similar regime that may be authorized by federal law)? It would really help to know where we're headed before we move very far down the road. <u>We assume as an initial standard that the new system must generate the same revenue as the current one</u>.

- Decide how imports and exports are to be treated for tax purposes. Under the gross receipts tax, there is a difference between case law and statutory/regulatory law. Is the state in which the customer is located the state with authority to tax, or is some other regime to be followed? The choice could have significant revenue effects, particularly for local governments.