MINUTES
of the
FIRST MEETING IN 2011
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

June 21, 2011
Room 322, State Capitol
Santa Fe

The first meeting of the Revenue Stabilization and Tax Policy Committee for 2011 was called to order by Senator Tim Eichenberg, chair, on Tuesday, June 21, 2011, at 10:12 a.m. in Room 322 of the State Capitol in Santa Fe.

Present
Sen. Tim Eichenberg, Chair
Rep. Edward C. Sandoval, Vice Chair
Sen. Mark Boitano
Rep. Donald E. Bratton
Sen. Carlos R. Cisneros
Rep. Anna M. Crook
Sen. Clinton D. Harden, Jr.
Rep. Ben Lujan, Speaker of the House
Rep. Rodolpho "Rudy" S. Martinez
Rep. Henry Kiki Saavedra
Sen. John Arthur Smith
Rep. Jim R. Trujillo

Absent
Sen. Timothy Z. Jennings, Senate President Pro Tempore
Sen. Timothy M. Keller
Sen. Gay G. Kernan
Sen. Howie C. Morales
Rep. Thomas C. Taylor
Rep. Bob Wooley

Designees
Sen. William F. Burt
Sen. Phil A. Griego
Sen. Nancy Rodriguez
Rep. Luciano "Lucky" Varela (attending as a guest)

Sen. Rod Adair
Rep. Ray Begaye
Rep. Zachary J. Cook
Sen. Kent L. Cravens
Rep. Brian F. Egolf, Jr.
Rep. Miguel P. Garcia
Rep. Thomas A. Garcia
Rep. Roberto "Bobby" J. Gonzales
Sen. Eric G. Griego
Rep. Sandra D. Jeff
Rep. Antonio Lujan
Rep. Antonio "Moe" Maestas
Sen. George K. Munoz
Sen. Steven P. Neville
Rep. Debbie A. Rodella
Sen. Bernadette M. Sanchez

Sen. John M. Sapien
Sen. William E. Sharer
Rep. James R.J. Strickler
Rep. Don L. Tripp
Sen. Peter Wirth

Staff
Pamela Ray, Staff Attorney, Legislative Council Service (LCS)
Damian Lara, Staff Attorney, LCS
Pam Stokes, Staff Attorney, LCS
Ric Gaudet, LCS

Guests

The guest list is in the meeting file.

Handouts

Handouts and copies of written testimony are in the meeting file.

<u>Tuesday, June 21</u>

Post-Session Fiscal Review

David Abbey, director, Legislative Finance Committee (LFC), and Charles Sallee, deputy director, LFC, presented an update on New Mexico finances and the 2011 legislative session. The state's recurring general fund revenues dropped significantly since fiscal year 2008, but revenues have begun to rebound since fiscal year 2010. The fiscal year 2012 budget is the lowest total budget since fiscal year 2007 because the one-time federal stimulus money has been mostly spent. However, general fund revenue is expected to continue to grow, and fiscal year 2013 looks promising for revenue growth. The U.S. Bureau of Labor Statistics reported that New Mexico employment growth is still slightly negative, but employment is expected to grow one percent per year for the next five years. Taxable gross receipts in the state have grown five percent from fiscal year 2010's very low receipts.

The December 2010 consensus revenue estimate predicted that fiscal year 2012 would see a four percent increase in recurring revenues but that fiscal year 2008 revenue levels would not be reached again until fiscal year 2015. The fiscal year 2012 budget enacted by the legislature assumed $5.4 billion in recurring revenue, which is $600 million lower than the fiscal year 2009 original operating budget and $140 million lower than fiscal year 2011. Key components of the current budget include the following:

- appropriations prioritized core government services, including education, health care and the judiciary;

- the budget is very close to the executive's recommended spending level;

- the legislature did not make any across-the-board cuts, focusing instead on targeted savings in specific agencies;

- state employees will contribute an additional 1.75 percent of their salary, in addition to the previously enacted 1.5 percent increase, toward retirement benefits;

- $2.5 million was saved from state agency administrative reforms and program efficiencies; and

- $25 million extra was appropriated for Medicaid, public schools and service agencies based on the revenue increase expected from the film production tax credit restructuring.

Public school support in the fiscal year 2012 budget accounts for 44 percent of the general fund budget. Overall, public school support increased 2.6 percent. The appropriations include $88 million to replace federal stimulus money and a reduction of $25 million to account for administrative savings and changes in retirement contributions for retirees who return to work. Higher education funding accounts for 13.5 percent of general fund appropriations. The state is among the top states in funding higher education per capita, but performance outcomes are behind national averages.

Medicaid takes up 16 percent of the general fund budget, and that program saw a 44 percent increase over fiscal year 2011 due to the need to replace $280 million in federal funds. Medicaid enrollment has increased 20 percent since fiscal year 2008, with a total enrollment in programs projected to reach 579,000 individuals this fiscal year.

The budget outlook for fiscal year 2013 projects a bit of breathing room for the next budget cycle. Assuming a flat budget, increased Medicaid spending and one-time replacement funding, state revenues are expected to be $153 million above spending levels.

Questions and comments from committee members included the following:

- New Mexico's typically high reserve levels have allowed the state to replace one-time federal funding during the economic downturn. Mr. Abbey said that although the state has a five percent general fund reserve level, most of that money is in the Tobacco Settlement Permanent Fund and is not necessarily available for appropriation contingencies.

- Has the oil production decline in southeastern New Mexico slowed? Mr. Abbey said that oil production has actually increased one percent. Gas volumes are falling annually by five percent, however. If there are no new wells drilled to replace the natural decline in production, volumes could fall annually by as much as 10 percent.

- Why was there such a large increase in corporate income tax (CIT) revenues? Mr. Abbey said that fiscal year 2010 CIT revenues were very low, so any increase would yield a large percent change.

- What impact will new federal cigarette packaging rules have on tobacco settlement revenue? Tom Clifford, policy and research director, Taxation and Revenue Department (TRD), said that the TRD will study the fiscal implications of the new rules soon. Mr. Abbey said that the state could be at risk of losing $40 million in tobacco settlement revenue because of possible litigation by participating tobacco manufacturers.

- The legislature recently passed a bill that would have closed the loophole that some tobacco manufacturers were taking advantage of to avoid paying into escrow a percentage of cigarette revenue. The bill, vetoed by the governor, was not a tax increase but a method of leveling the playing field for all manufacturers.

- How are the Economic Development Department (EDD) and Public Education Department (PED) managing their recent reductions in staff? Mr. Abbey said that the LFC had recommended that the EDD combine a minor division into another division, which resulted in a reduction of two full-time-equivalent (FTE) positions. The department handled the reduction through attrition. The PED lost 33 FTEs, and those employees who were paid from general fund dollars lost their jobs. The department is hoping to rehire many employees using federal money.

- The PED layoffs are very disturbing and did not need to happen. Employees who were laid off were told on a Friday afternoon not to come back to work the following Monday. Representative Varela said that the PED requested the budget cut from the LFC, which was not made aware that the cuts would result in so many layoffs. He said that 20 people have been rehired using other funding sources.

- How will changes to the film production tax credit, effective July 1, affect existing film productions that already have contracts in place? Secretary of Taxation and Revenue Demesia Padilla said that the TRD is trying to accommodate those film productions that started before the law changed and ensure that the expectations those film production companies had when their contracts were signed are fulfilled. She said that TRD staff is working very closely with those companies to assist them in filing their tax credit documents before June 30. Mr. Abbey said that the speeded-up filing of claims for the film production tax credit could have a negative one-time effect on state revenues.

Work Plan and Meeting Schedule

Ms. Ray and Mr. Lara presented the committee's proposed work plan and meeting schedule for the 2011 interim. Committee members added three items to the proposed work plan, and then the work plan and schedule were approved by the committee. The committee will meet six times during the interim and will:

- examine state taxes and discuss each tax based on sound tax policy principles and the contribution to state revenue made by each tax;

- review the revenue status of the state, examine current revenue streams and discuss the need for further revenue increases or redirection of services;

- continue to review the effectiveness and value to the state of tax incentives; review exemptions, deductions and credits to determine the ability to report and track; review methods to improve the tracking of value, including implementation of Section 9-15-56 NMSA 1978; and review the financial impact of tax increment development districts on state revenue;

- review the effect of the tax amnesty program, identify taxes where amnesty was most heavily used by taxpayers and follow the implementation of the gaming tax credit and the business retention gross receipts tax (GRT);

- review the status of the State Road Fund;

- examine the revenue generation programs in the TRD and other departments in the state that generate revenue to determine if such funds are fully used for the purposes raised;

- identify methods of obtaining data and information on a more timely basis;

- review trends in state investment earnings, including trends in the balances of the Severance Tax Permanent Fund and the land grant permanent funds and review the revenue received by the state from gaming within the state;

- review oversight of and access to data from local GRT collections and distributions;

- receive a report on revenue derived from the State Land Office;

- review the executive branch's tax package for any upcoming legislative session; and

- examine the presence of volume and type of film productions in New Mexico that may be due to changes in the film production tax credit or other incentives available in New Mexico.

Additional ongoing matters that may be addressed by the committee include:

- the relative costs and benefits of holding local governments harmless when the legislature reduces GRTs;

- the use of industrial revenue bonds in the state, including revenue lost and the value of the benefits gained by local communities; and

- the progress of state taxation of internet transactions and the status of the streamlined sales tax efforts.

Tax Legislation Review

Mr. Clifford updated the committee on activities at the TRD and recent tax legislation considered by the legislature. He pointed out that New Mexico's tax system needs to evolve to be compatible with the state's changing industries and with the current global economic climate. The state's tax treatment of businesses has fundamental flaws, including that the major provisions of the GRT are more than 40 years old and that CIT provisions have not been updated in more than 30 years. A recent study by Ernst & Young found that, excluding incentives, New Mexico's tax rate on new investment is the highest in the nation due to the GRT on business inputs, the CIT rate and the three-factor apportionment method for assessing the CIT. Pro-growth tax reform is needed, including reducing the pyramiding of the GRT, updating the CIT, reducing property tax lightning and reforming tax incentives.

Mr. Clifford reported that the TRD has processed eight percent more income tax returns this year than last year. Tax revenue is up 52 percent, mostly due to the state and local tax deduction addback requirements recently enacted. He said that the underlying tax revenue is flat.

Tax-related bills enacted by the legislature in 2011 include:

- film production tax credit reform, including a $50 million annual cap, delayed payments for large credits, tax withholding on performing artists, new disclosure requirements, not allowing interest on refunds and not allowing the credit to be claimed for certain luxury expenditures;

- railroad fuel GRT deduction, which is targeted to new or expanded facilities and overcomes a major competitive disadvantage that New Mexico was previously facing;

- compensating tax cleanup;

- alternative evidence for GRT deductions;

- expansion of alternative energy tax incentives;

- establishing a threshold amount at which penalties for underpayment of tax will be assessed; and

- continuation of the jet fuel GRT deduction.

The TRD is currently considering changes to its rules, including alternative evidence for GRT deductions, film production tax credit changes, the definition for property tax purposes of livestock and hunting licenses, tax credit clarifications, clarification of withholding for oil and gas payments and pass-through entities and loosening up the requirements for e-filing for certain businesses.

The TRD will begin producing tax expenditure reports, but the process will require assistance from many agencies. Mr. Clifford said that the TRD does not have the expertise to evaluate tax incentives from an economic performance perspective. The department is also interested in broad-based tax reform, and stakeholder input will be crucial to the success of the initiative. The combined reporting system (CRS) processing system is out of date and needs to be upgraded soon.

The department is considering several pieces of proposed legislation, including tax credit cleanup and reform, pass-through entity withholding clarification, Tax Administration Act changes, Motor Vehicle Code reorganization and compliance with the federal REAL ID Act of 2005.

Questions and comments from committee members included the following:

- What has been the fiscal impact of recent changes to cigarette tax rates? Mr. Clifford said that the state is receiving more revenue than the predicted additional $35 million annually.

- There have been many changes to the structure of taxes over the past few decades, especially regarding how households are treated. Mr. Clifford agreed, but said that the tax structure on businesses has not changed much.

- Why is property tax lightning reform considered important to the business sector? Mr. Clifford said the business community is concerned that if the issue is not resolved, more property tax burden will shift to the commercial property sector.

- What is the current status of property tax reform in the state? Mr. Clifford said that TRD staff is still discussing solutions to the issue. He said the department will present a package of legislation for the committee's consideration in the near future. The legislation will need to provide equal treatment to taxpayers and protect local revenue.

- How much will it cost to upgrade the CRS processing system? Mr. Clifford said that he estimates it will cost between $5 million and $7 million. An improved system will allow the TRD to collect more tax revenue. The annual contract to maintain the CRS processing system, which costs $1 million, does not include upgrades to the system. A new system will allow the department to process credits, which currently are processed manually.

- TRD staff were requested to give the committee a report on the consequences of California's Proposition 13, which limited property tax valuations.

Financing Small Business Expansion Through Nonprofit and Small Business Administration (SBA) Collaboration

Ronald D. Brown, executive director, Enchantment Land Certified Development Company (ELCDC), briefed the committee on the economic development programs provided by his organization. The ELCDC was formed in 1992 in order to assist established small businesses to expand and hire more employees. It originally received an appropriation to get started, but it is now an entirely self-sufficient operation. The company has 11 staff members, and it has offices in Albuquerque, Santa Fe, Las Cruces and El Paso. Over the past two decades, the ELCDC has assisted more than 700 businesses to expand.

The primary program provided by the company is the SBA 504 loan program, which provides a second mortgage of up to 40 percent of a project's value. Typically, a local bank loans 50 percent, and the business owner puts up 10 percent. Loans are used to purchase commercial real estate into which a business can expand. The SBA-backed second mortgages provide a method for businesses to finance up to 90 percent of a real estate transaction. In the current economic situation, banks have treated commercial real estate loans as nearly worthless, and they are not interested in making those loans. SBA-backed loans, however, are not treated that way and have become a primary means of financing capital for small businesses.

Questions and comments from committee members included the following:

- Could an SBA 504 loan be combined with a small business loan from the New Mexico Finance Authority (NMFA)? Mr. Brown said that the ELCDC has not worked directly with the NMFA because its loans are financed through the SBA. He said that the ELCDC is willing to partner with any entity to finance the first 50 percent of a mortgage.

- What is the typical loan size provided by the ELCDC? Mr. Brown said that the average loan is for $533,000, which corresponds to a property valued at $1.4 million. He said that the company does not usually earn a profit from loans under $100,000, but those loans are an important economic development tool. Larger loans allow the company to offset losses on small loans.

- Does the ELCDC make loans on equipment or loans to start-up businesses? Mr. Brown said that equipment loans are made, but that the SBA 504 program is directed at existing small businesses that want to expand. The SBA has other loan programs for start-up companies.

- Does the ELCDC receive any financial support from the state? Mr. Brown said that other than the initial funding to get the organization started, the ELCDC has been self-sustaining.

- What is the average default rate on SBA 504 loans? Mr. Brown said that there are currently $300 million in outstanding SBA loans, with a loss ratio of 2.35 percent.

- Does the ELCDC provide loans for businesses that need to restructure their existing loans? Mr. Brown said that the SBA does have a refinancing loan program, but it is a short-term loan with very stringent criteria. The SBA 504 loans are primarily designed for businesses to expand and hire new employees. The SBA benchmark is to create one permanent job for every $65,000 loaned.

Mr. Brown concluded the presentation by stating that federal bank regulators do not allow banks to make any new loans if a bank has a 300 percent loan-to-value ratio of commercial property. This new regulation means that it is essentially impossible for companies to refinance commercial loans.

There being no further business, the committee adjourned at 3:15 p.m.