MINUTES
of the
FIRST MEETING IN 2016
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

June 20, 2016
Room 322, State Capitol
Santa Fe, New Mexico

The first meeting of the Revenue Stabilization and Tax Policy Committee for the 2016 interim was called to order by Representative Jason C. Harper, chair, on Monday, June 20, 2016, at 10:02 a.m. in Room 322 of the State Capitol in Santa Fe.

Present	**Absent**
Rep. Jason C. Harper, Chair	Sen. Ted Barela
Sen. Carlos R. Cisneros, Vice Chair	Sen. Sue Wilson Beffort
Rep. Tim D. Lewis	Rep. David M. Gallegos
Rep. Antonio Maestas	Sen. Mark Moores
Rep. Rod Montoya	Sen. George K. Munoz
Rep. Debbie A. Rodella	
Sen. Clemente Sanchez	
Sen. William E. Sharer	
Sen. John Arthur Smith	
Rep. James R.J. Strickler	
Rep. Carl Trujillo	
Rep. Jim R. Trujillo	
Sen. Peter Wirth	

Designees	
Sen. Lee S. Cotter	Rep. David E. Adkins
Rep. Conrad James	Sen. William F. Burt
Sen. Nancy Rodriguez	Sen. Jacob R. Candelaria
	Rep. Sharon Clahchischilliage
	Rep. Randal S. Crowder
	Rep. Brian Egolf
	Rep. Miguel P. Garcia
	Rep. Stephanie Garcia Richard
	Rep. Bealquin Bill Gomez
	Sen. Stuart Ingle
	Sen. Gay G. Kernan
	Rep. Idalia Lechuga-Tena
	Rep. Javier Martínez

Rep. Bill McCamley
Rep. Tomás E. Salazar
Sen. John M. Sapien
Rep. Jeff Steinborn
Rep. James G. Townsend
Sen. Pat Woods

Staff
Pam Stokes, Staff Attorney, Legislative Council Service (LCS)
Tessa Ryan, Staff Attorney, LCS
Ric Gaudet, LCS

Handouts
Handouts and other written testimony are in the meeting file.

Guests
The guest list is in the meeting file.

<u>Monday, June 20</u>

Post-Session Fiscal Review
David Abbey, director, Legislative Finance Committee (LFC), presented the committee with an analysis of the state's finances since the end of the 2016 regular legislative session. The legislative session ended with very slim margins for general fund reserves, with the operating reserve expected to be at one percent of recurring appropriations by the end of fiscal year (FY) 2016. Mr. Abbey said that the fiscal outlook is challenging, with little margin for additional declines in revenue. New Mexico has a revenue problem and a spending problem. The state has seen eight years of mostly flat budgets, with the exception of Medicaid spending, and revenues are not keeping pace with population growth. Revenues in the current fiscal year showed a cumulative 10 percent drop from the same period in FY 2015.

The base state budget is expected to run at a deficit for several years, requiring more reserves to be used to balance the budget. In FY 2018, most of that deficit can be attributed to an expected $94 million increase in Medicaid and other health spending. The state's main revenue source, gross receipts tax (GRT) revenue, has declined more than five percent since FY 2015. In the oil and gas sector, Mr. Abbey reported that production levels are flat and drilling activity has declined. However, the recent increases in the price of oil are one of the few positive factors in the financial forecast for the state. The health care and tourism sectors are the only industries that are performing well.

Mr. Abbey reviewed some appropriation highlights from the legislative session, including public school support, higher education and Medicaid. Public school funding increased only .2 percent from the FY 2016 budget. Higher education funding decreased by $15 million, a reduction of 1.8 percent from FY 2016. Medicaid funding increased $21 million from FY 2016, but the Human Services Department had still anticipated an $85 million shortfall during FY 2017. However, the department recently reported that cost-containment measures and federal rulings will reduce the shortfall to $24.5 million for the upcoming fiscal year. The department anticipates a need to increase Medicaid funding by $60 million to $80 million for FY 2018. Mr. Abbey said that health-care-related tax expenditures total more than $300 million annually. He suggested that the legislature consider changing some of those expenditures in order to pay for expected Medicaid appropriation increases.

Questions and comments from committee members included the following.

- Will the state's reserves being at such a low level affect the state's bond ratings? Mr. Abbey said that severance tax bonds were downgraded a bit recently, but that the oil and gas sector's expected recovery should mean that severance tax bonds should maintain good ratings. General obligation bonds, however, may be downgraded significantly if the state is unable to maintain sufficient reserves. He said that general obligation bonds will be issued in April or May 2017, after the legislature will have had a chance to enact a budget with adequate reserve levels. Even if general obligation bonds are downgraded, there should be sufficient capacity in the enacted law to cover the additional costs.

- Will the low reserve levels affect the ability of state agencies to receive supplemental and deficiency appropriations during the next budget cycle? Mr. Abbey said that the prospects for getting supplemental or deficiency appropriations are not good. Agencies need to live within their appropriated budgets during FY 2017. The LFC and the Department of Finance and Administration may need to develop a set of contingencies in order to keep the state's reserve levels adequate, including enacting more special fund reversions and revisiting the one percent agency budget reduction language that was vetoed by the governor.

- The legislature may need to meet in a special session to enact further reductions in agency budgets for FY 2017. New Mexico is actually in a better position financially than other states such as Oklahoma, Kansas and Alaska.

- The committee has a responsibility to look at potential revenue increases and not be locked into a dogmatic rejection of all revenue-increasing measures. For example, the legislature could enact a hospital provider fee to generate large amounts of money to provide Medicaid matching funds. This is a fee that New Mexico hospitals are actually advocating for, since the revenue generated will enable them to provide more services, but the current administration has categorically rejected any form of tax increase.

- San Juan County has recently lost 6,000 jobs, and more than 11,000 people have left the area because of the economic situation. In addition, a coal mine in the area just laid off 85 people. This kind of demographic shift will require that state and local governments further cut their expenses, since there will not be enough revenues to cover budgets.

- The administration has been unwilling to endorse legislation to increase revenue for several years, but at the same time is also unwilling to cut the number of full-time-equivalent positions in state budgets, which results in constant deficiencies in state agency budgets.

- One area in which the state should be willing to increase taxes is in the renewable energy sector. While the oil and gas and mining sectors are losing jobs, the renewable energy sector is greatly subsidized. The legislature may need to enact some kind of "tax in lieu of severance taxes" in order to offset the inevitable decline of revenues received from the extraction industries.

Gross Receipts Tax Base Study: Phase II Results

Dr. Lee A. Reynis, research professor of economics, Bureau of Business and Economic Research, University of New Mexico, presented the committee with findings of her research on the gross receipts tax base and possible alternatives to the tax. New Mexico has consistently ranked near the top in states that tax business inputs. A 2011 study found that New Mexico had the second-highest percentage of state and local sales taxes imposed on business input purchases, with about 55 percent of those purchases being taxed. The state has since improved its ranking slightly by enacting legislation to reduce GRT taxation on manufacturing consumables and construction inputs. Excessive taxation of business inputs has many negative impacts, including increasing tax pyramiding, making goods and services more expensive in export markets, reducing business profits, incentivizing the sourcing of inputs from out of state, reducing the economic multiplier of business activity and inducing businesses to locate production operations elsewhere. Taxation of business inputs is aggravated when rates are high. Since 2000, New Mexico GRT rates have slowly increased to an average rate of 7.2 percent, with some locations having a GRT rate as high as 8.9375 percent.

Dr. Reynis used the economic modeling software IMPLAN to analyze New Mexico's GRT base. The study was complicated by several factors, including the myriad exemptions and deductions from the GRT, many of which target only specific activities of a particular industry; many manufacturers do not report their export production to the state, which results in inaccurate data; much of the data being studied by businesses is self-reported and not audited; IMPLAN activity is not always correctly classified in its state databases; and data on business inputs used is not always available for each stage of production, making estimating tax pyramiding much more difficult.

Dr. Reynis provided the committee with an analysis of the GRT base and business inputs of the health care services industry. The analysis examined the role of the public sector and nonprofit entities, itemized the various kinds of business inputs made by the industry and evaluated the impact of health-care-related tax expenditures. Of the approximately $13.5 billion in total health care expenditures in the state in 2015, about 20 percent of the total is provided by public agencies. Of the remaining amount, nearly 45 percent of health care providers are nonprofit entities, which can deduct from gross receipts their business inputs and are exempt from paying the tax for their services. This can provide a large competitive advantage over for-profit entities engaged in the same industry. Finally, Dr. Reynis listed health-care-related tax expenditures allowed in statute, primarily for for-profit entities, which in 2014 totaled more than $269 million in foregone state revenue.

Questions and comments from committee members included the following.

- Senator Sharer discussed his idea from 2015 to completely restructure the GRT system by eliminating most exemptions, credits and deductions and then applying a much lower tax rate to the suddenly much larger GRT base. He had initially divided the state gross domestic product by current tax revenue and came up with a base GRT rate of 1.87 percent. The study performed by Dr. Reynis was intended to better model that idea, so that legislators could come up with a simplified tax system that was understandable and had a low rate, while keeping revenues the same. If every business paid a two percent GRT, the tax pyramiding issue would be much less of a problem than it is today. Health care, which is a huge and growing industry in the state, is largely untaxed. Applying a two percent GRT to all health care services would raise a tremendous amount of money.

- The biggest problem about reforming the tax system is that legislators do not have the political will to fix the problem. Most legislators are worried about their reelection.

- If all of the GRT credits, exemptions and deductions were repealed, what would the GRT tax rate need to be in order to stay revenue neutral? Dr. Reynis said that question is still unanswered. However, many of the exemptions would need to remain in statute, because of constitutional and federal preemption issues.

- Reforming the entire GRT system is probably not possible. But the legislature should examine the top five or 10 most expensive tax expenditures to determine if any should be modified or discontinued. The 10 costliest tax expenditures account for 75 percent of all the foregone revenue from tax expenditures.

Tax Deviation Report

Ms. Stokes presented the committee with a Tax Deviation Report, which attempts to list all of the credits, deductions, exemptions and other deviations from New Mexico's taxes. It is somewhat of a summary of the Taxation and Revenue Department's (TRD's) Tax Expenditure

Report, with some differences, including the categorization of tax expenditures and descriptions of deviations that have not been defined by the TRD. There are 313 tax deviations, of which 145 are currently identified as tax expenditures, 105 are not tax expenditures, 26 could be classified either way and 37 are still undefined. The Tax Deviation Report categorizes tax expenditures into seven general categories: citizen benefit; economic development; environment, conservation and renewable energy; extractive industries; health care industry; nonprofits; and other. The Tax Deviation Report uses the estimates reported in the Tax Expenditure Report for the costs associated with each expenditure. The total cost for all tax expenditures in FY 2014 was nearly $1.2 billion.

Discussion of Work Plan and Meeting Schedule

Representative Harper discussed with the committee his idea of how the committee could be run in the 2016 interim. Rather than hearing endless lectures about tax issues, coupled with requests from various interest groups for specific tax relief, he envisioned having educational sessions about certain tax topics, followed by roundtable discussions to identify specific problems and possible solutions to those problems. At the end of the interim, the committee would have a series of tax policy proposals that it would present to the legislature. Instead of being merely a tax loophole committee, the committee could actually come to a consensus on various tax policy issues. New Mexico needs to have a fair tax policy that does not pick winners and losers, which will in turn attract more business investment to the state. Republicans and Democrats in the New Mexico Legislature probably agree on 90 percent of tax policy issues, so the committee should work to find those agreements that can create consensus tax legislation to improve the economic climate of the state.

Ms. Stokes reviewed the proposed work plan and meeting schedule for the committee. She said that the committee would need approval from the New Mexico Legislative Council for an extra meeting day in December and to meet outside of the State Capitol for its November meeting. The committee would also request $30,000 to contract with subject matter experts during the interim.

The proposed work plan and meeting schedule for the committee during the 2016 interim were adopted by the committee unanimously.

Adjournment

There being no further business, the committee adjourned at 12:30 p.m.