F I S C A L   I M P A C T   R E P O R T

ORIGINAL DATE 03/02/11
SPONSOR SFC **LAST UPDATED** 03/05/11 **HB**

SHORT TITLE Tax & Rev. Dept. Tax Expenditure Budget **SB** 47/SFCS

ANALYST Burrows

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	FY12	FY13		
	NFI	NFI		

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY11	FY12	FY13	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		$150.0	$150.0	$300.0	Recurring	TRD Operating Budget
		$60.0	$60.0	$120.0	Recurring	EDD Operating Budget

(Parenthesis ( ) Indicate Expenditure Decreases)

Duplicates HB161/aHFL#1
Relates to SB170, HB405, HB166, and SB44

SOURCES OF INFORMATION
LFC Files

Responses Received From
Department of Taxation and Revenue (TRD)
Economic Development Department (EDD)
Department of Finance and Administration (DFA)

SUMMARY

Synopsis of Bill

The Senate Finance Committee substitute for Senate Bill 47 would require the Department of Taxation and Revenue (TRD) in cooperation with the Economic Development Department (EDD) to annually compile a tax expenditure budget for the upcoming fiscal year, including analysis of tax expenditures, for review by the governor, the interim legislative revenue and tax stabilization (RSTP) committee, and the legislative finance committee (LFC). The budget shall report on tax expenditures with revenue impacts exceeding $500 thousand, and should include

- a projection of the costs of tax expenditures for all significant general fund sources;
- the statutory basis, including year of enactment, date of repeal, and purpose;
- quantity of revenue expended by the state for each expenditure;
- the aggregate amount of each expenditure and the business that used the expenditure;
- the total of all the costs of expenditures for each fiscal year
- the estimated number of jobs created and the number of businesses that qualify for but failed to apply the tax expenditure; and
- should identify unexpected effects of the tax expenditures.

Senate Bill 47/SFCS requires EDD to estimate the jobs created and number of businesses that qualified but failed to apply the tax expenditure and report to TRD unless specifically prohibited by law. The bill defines "jobs created" as the net increase of full-time jobs that exceeds the full-time equivalent of jobs that existed at the beginning of the reporting period, provided that the additional jobs can be attributed to the tax expenditure.

The bill defines "tax expenditure" as "a deduction, credit, exemption, exclusion, rebate, offset, preferential tax rate, subtraction or allowance or related tax structure that reduces tax liability when compared with a normal tax system as determined by the secretary," and requires the budget to be completed prior to October 15 of each year.

The bill also requires TRD to annually compile a dedicated revenue budget for the upcoming fiscal year, including analysis of expenditures, for review by the governor, the RSTP committee, and the LFC. The budget shall report on dedicated annual revenues of $500,000 or more in the aggregate for a specific beneficiary, and should include:

- a total of all of the collections and appropriations in each fiscal year for all dedicated revenue;
- statutory basis including year of enactment, date of repeal, and purpose;
- the beneficiaries of the dedicated revenue;
- the outcomes resulting from the expenditure of dedicated revenue; and
- should identify significant unintended effects of the dedicated revenue.

The proposal defines "dedicated revenue" as "an expenditure of a tax or fee that is dedicated to a specific program or purpose, as defined by constitution or statute," and requires the budget to be completed prior to October 15 of each year.

Because no effective date is provided in the bill, its provisions will become effective 90 days after the 2011 legislative session adjourns, on June 17, 2011.

FISCAL IMPLICATIONS

No impacts on state revenues.

SIGNIFICANT ISSUES

DFA notes that the state general fund is eroded each year because of new exemptions, preferences and special tax treatments of certain income and deductions. Depending upon the method of measurement, New Mexico likely forgoes billions in tax collections by perpetuating past practices and creating new preferences each year. Tax expenditures are equivalent to an appropriation of the same magnitude. However, appropriations require reauthorization each year; tax expenditures do not. Tax expenditures cannot be opened to public scrutiny without an annual report as required in this legislation.

Without knowing the amount of revenue foregone due to tax expenditures, policymakers and the public cannot know how much tax relief is being granted and to whom the benefits are accruing. Also, a narrower tax base requires that a higher tax rate be imposed to provide enough revenue to meet the state's spending needs. Moreover, a narrower tax base leads to increased revenue volatility, which makes fiscal planning more difficult. From a tax policy standpoint, these mechanisms by which the revenue base is eroded should be evaluated as rigorously as appropriations.

Currently, the cost of New Mexico's tax expenditures are only estimated when they are first enacted in fiscal impact reports. However, the costs of tax expenditures are rarely revisited to assess whether they cost more or less than expected, whether costs are growing as anticipated, or whether tax expenditures are effective.

Like most states, New Mexico's tax code contains hundreds of tax expenditures. While many of New Mexico's tax expenditures have very small costs, they cumulatively represent a significant erosion of the state's revenue base.

There are many advantages to earmarking revenues for specific programs, such as guaranteed funding, the depoliticization of funding decisions, constrained spending, and more effective targeting of those taxpayers who primarily benefit from the program. However, earmarked revenues can also lead to budget inflexibility, underfunding, and a decrease in accountability. In FY10, approximately $4 billion of tax revenue and fees was earmarked for use by specific agencies and programs, nearly matching the $5 billion distributed to the general fund. Regular reporting could offset some of the inefficiencies and accountability issues associated with earmarks.

TRD notes many states currently prepare tax expenditure budgets as a means of tracking the impacts of special tax provisions that reduce state revenue in order to target certain populations or activities. Three major challenges limit the usefulness of these reports: (1) significant amounts of detailed information are required, much of which is proprietary in nature; (2) reasonable people can disagree on the definition of tax expenditure, thus, a report is unlikely to satisfy all parties to the debate; (3) the state of the art of economic research does not enable reliable estimates of the full economic impacts of tax preferences.

PERFORMANCE IMPLICATIONS

Periodic review of tax expenditures and dedicated revenue adds transparency, fiscal discipline, and political accountability to the budget process. By uncovering the cost of New Mexico's tax expenditures and earmarks, a tax expenditure or dedicated revenue budget will allow the state's policymakers to tailor tax incentives and appropriations to better achieve the state's goals.

ADMINISTRATIVE IMPLICATIONS

The tax expenditure budget mandated by this bill will necessitate additional administrative costs to TRD. Assuming the report would be like those of many other states, essentially a listing of provisions along with their approximate fiscal impacts, one additional FTE would be required with a salary of approximately $30 per hour. The costs in the table include benefits, overhead and some special database software purchases. An alternative approach would be to contract for the report with researchers at an in-state university. The costs of such report would probably be lower than those in the table, but a commitment of TRD resources would be needed to support the contractor's work, yielding a similar overall resource cost. Similar costs would be associated with a dedicated revenue budget.

EDD reports that it does not have the infrastructure to track the information required by this bill. EDD would require additional FTE(s) to track the required data and work in partnership with TRD to complete the report. According to the New Mexico sunshine portal, EDD staff earn an average yearly salary of $60,000. This analysis assumes only one additional FTE will be needed.

Some of the reporting requirements, such as revenue invested and jobs created, may be difficult, if not impossible to determine. EDD notes that reports of the number of eligible businesses that failed to file for the credit would not be an accurate representation.

DUPLICATION

House Bill 161/HFL#1 duplicates the provisions of this bill, but only requires reporting of tax expenditures with revenue impacts of $5 million or more.

House Bill 405 would allow exemption from taxpayer confidentiality for the purpose of tax expenditure reporting.

Senate Bill 170 would require gross receipts and compensating tax deductions to be itemized when filing tax returns for the purpose of tracking the cost of tax expenditures.

House Bill 166 would also require tax expenditure reporting.

Senate Bill 44 would require EDD and TRD to report annually on film production tax expenditures.

OTHER SUBSTANTIVE ISSUES

EDD expresses concerns that the bill may indirectly provide information to business competitors by disclosing private business practices. EDD reports that the tax incentives are used for the purpose of retaining, expanding, and recruiting companies, and this bill could inhibit EDD's ability to provide business incentives and create jobs.

Moreover, EDD is concerned that this proposal does not take into account the administrative implications, privacy issues, and effects on business. New Mexico policy makers should have knowledge of the cost of tax expenditures, but the plan should be developed with all stakeholders in mind.

TRD notes that a significant amount of work has been completed on tax expenditures over the years, including recent legislative testimony describing a comprehensive list of tax expenditures and estimated fiscal impacts. TRD notes a shortage of personnel is the only real obstacle to regular tax expenditure reporting.

The ease of estimating the cost of tax expenditures depends on tax reporting requirements. Tax credits are explicitly reported on tax forms, which makes calculating their cost straightforward. However, deductions and exemptions are not reported explicitly. Without explicit reporting, the costs associated with deductions and exemptions must be estimated. These estimates are time consuming and contain some degree of uncertainty.

One of the most difficult challenges in creating a tax expenditure budget is defining the revenue base against which tax expenditures should be measured. Much has been written about defining the base of income and excise taxes in other states and at the federal level, but New Mexico's gross receipts tax is unlike most sales taxes and will be more difficult to model.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The amount of New Mexico's general fund revenue eroded due to tax expenditures will continue to be unknown, as well as the amount of state revenue earmarked for specific programs or agencies. Policymakers will continue to be unable to decide whether the benefits of tax expenditures or dedicated revenues are great enough to justify their costs.

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