LFC HEARING BRIEF

DATE: April 14, 2016

PURPOSE OF HEARING:
Review *2015 Tax Expenditure Report* and address healthcare industry growth and tax expenditures in light of budget affordability issues

WITNESSES: Demesia Padilla, Secretary, Taxation and Revenue Department; Richard Anklam, New Mexico Tax Research Institute

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For the *2015 Tax Expenditure Report*, TRD determined New Mexico's tax expenditures generally fall into five categories: health care, economic development, energy, citizen benefits, and special industries. However, a given tax expenditure may justifiably fit in two or more categories.

BACKGROUND INFORMATION

In the 2016 legislative session, the state faced significant challenges crafting a budget in light of declining revenue projections. These budget affordability issues were prominent in health care, including the state's share of the cost of Medicaid expansion. Making the budget situation more difficult is the magnitude of the state's tax expenditures, many of which have not been reviewed for efficacy or efficiency, and some of which appear no longer necessary.

Revisiting some of the more costly tax expenditures and reducing or eliminating ones that do not offer significant benefits could free up funds to pay for essential state services. The healthcare industry is the fastest growing industry in New Mexico, but it is largely untaxed, impacting state revenues and tying up funds that could be better used elsewhere, including for state-supported health care services. Health care tax expenditures cost the state $344 million in FY15 and represent 28 percent of all revenues lost through tax expenditures.

Tax Policy and Tax Expenditure Reporting

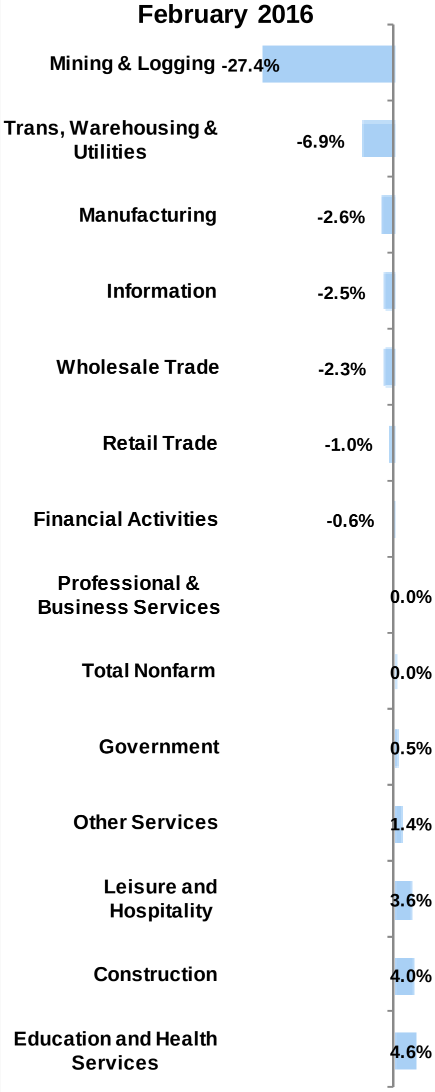
Good tax policy relies on five principles. The first principle, adequacy, states revenue should be adequate to fund needed government services. The second, efficiency, states the tax base should be as broad as possible and avoid excess reliance on one tax. The third, equity, states different taxpayers should be treated fairly. The fourth, simplicity, states collection should be simple and easily understood. Finally, the fifth, accountability, states preferences should be easy to monitor and evaluate.

Tax expenditures can often interfere with these principles and represent revenue losses from a person or corporation's tax liability. They may be used to promote general welfare or incentivize a particular type of behavior, such as promoting economic development overall or encouraging growth in a particular industry like healthcare. However, it is often difficult to verify whether a tax expenditure is resulting in the desired effect, and many tax expenditures have little to no reporting requirement.

Reporting

The Taxation and Revenue Department (TRD) now publishes an annual tax expenditure report, attempting to quantify the cost of tax expenditures. These costs should be viewed as government spending through the tax code and must be taken into consideration when performing revenue projections and building the state budget.

Graph 1. Year-over-Year Job Growth Rates by Industry February 2015 to February 2016



Source: Workforce Solutions Department

Credits

Not all credits, deductions, and exemptions are tax expenditures, as some are intended to define the base being taxed rather than carve out a niche from the base. However, credits most typically represent tax expenditures. Credits are applied after a taxpayer's liability is determined, and the amount is subtracted from what is owed the state. Most credits are reported on returns, but they are not always reported separately, contaminating the data available for analysis.

Deductions and Exemptions

Deductions and exemptions are applied to a base revenue before a taxpayer's liability is determined, reducing a taxpayer's income or payment subject to tax. Deductions, like credits, are typically reported but again are sometimes reported in combination. Exemptions are often not reported, and the resulting costs are sometimes more difficult to ascertain.

Cost of Tax Expenditures and Health Care Industry Growth

Tax expenditures cost the state $1.2 billion in FY15 (see Appendix 1 for a list of tax expenditures sorted by cost). The largest tax expenditure is the food gross receipts tax deduction and related hold harmless payments to counties and municipalities, totaling $239 million. Two of the remaining four most costly tax expenditures are revenue and sales tax exemptions for nonprofit organizations, totaling $156 million. The remaining two most expensive credits are related to health care, totaling $164 million. Combined, health care tax expenditures cost the state $344 million – 28 percent of all tax expenditures.

The health care industry is the fastest growing sector in New Mexico in terms of job growth (see Graph 1), increasing by 4.6 percent year-over-year and adding jobs at a faster rate than at any time since 2002. The industry, fueled by the Affordable Care Act and Medicaid expansion, would likely grow substantially regardless of the tax expenditures in place, resulting in significant costs to the state without a return in beneficial changes in taxpayer behavior.

These expenditures may reasonably be interpreted as rewards rather than incentives, disproportionately favoring some taxpayers over others, violating good tax policy principles.

Tax expenditures for the health care industry are shown in Table 1 on the next page. As evidenced by the enactment dates shown in the table, all but one of the tax expenditures were enacted prior to the enactment of the Affordable Care Act (ACA), and all were enacted prior to the authorization of Medicaid expansion in the state.

Table 1. Health Care Tax Expenditures			
Name of Expenditure	**Statute**	**Enactment Date**	**Amount (in thousands)**
Medical Insurance Pool Credit against Premium Tax Payments	59A-54-10C	1987	$93,520.8
Prescription Drugs and Oxygen Deduction from GRT and GGRT	7-9-73.2	1998	$68,000.0
Medical and Health Care Services Deduction from GRT	7-9-77.1	1998	$55,000.0
Health Care Practitioner Services Deduction from GRT	7-9-93	2004	$38,664.9
DOH-Licensed Hospitals Fifty Percent Deduction from GRT	7-9-73.1	1991	$37,150.0
Health Care Hold Harmless Distribution	7-1-6.46 & .47	2004	$31,430.7
DOH-Licensed Hospitals Credit against GRT	7-9-96.1	2005	$13,700.4
Rural Health Care Practitioner Credit against PIT	7-2-18.22	2007	$6,376.8
Tax Stamps Rate Differential in Cigarette Tax	7-12-7D	1943	$260.7
Construction Equipment and Materials Used in the Construction of Sole Community Provider Hospitals Deduction from GRT	7-9-100	2004	$0.0
Construction of Sole Community Provider Hospitals Deduction from GRT	7-9-99	2006	$0.0
Hearing and Vision Aids Deduction from GRT	7-9-111	2007	$0.0
Physician Participating in Cancer Treatment Clinical Trials Credit against PIT	7-2-18.27	2011	$0.0
Total Health Care Expenditures:			**$344,104.3**

Sources: Taxation and Revenue Department - 2015 Tax Expenditure Report, Office of Superintendent of Insurance

The impacts of these two programs were dramatic on the industry, and all related tax expenditures should be evaluated in light of today's health care environment. For example, one of the primary reasons for enacting the health care practitioner services deduction was to offset uncompensated care for those without insurance or means of payment – an issue largely eliminated by the ACA and Medicaid expansion. However, despite the resolution of this issue, the tax expenditure remains.

At the same time the state is foregoing significant revenues through health care tax expenditures, the industry is urging more state spending, and the Human Services Department projects substantial additional costs related to Medicaid expansion (see Appendix 2 for the FY15-FY20 general fund impact).

Medical Insurance Pool Credit

The largest health care tax expenditure, the New Mexico Medical Insurance Pool (NMMIP) credit, does not appear in TRD's tax expenditure report because the credit appears in the Insurance Code rather than in the traditional set of tax statutes, and TRD does not administer the credit or collect premium tax revenues.

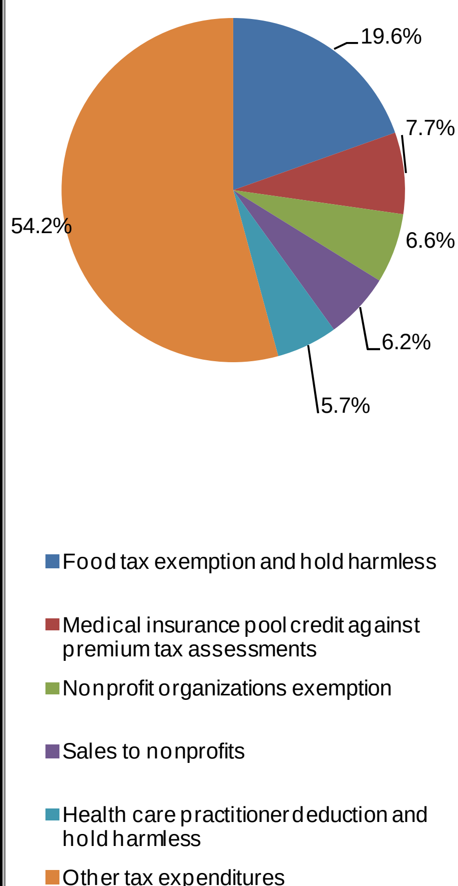
The pool was created to provide state-supported insurance coverage for the uninsurable or to cover gaps in coverage timelines, and funding for the pool is provided in part by New Mexico's health insurance companies, which then receive a credit against their premium taxes. However, the ACA and Medicaid expansion make NMMIP mostly unnecessary, because the substantial majority of remaining pool members now have other options, primarily the health care exchange.

Tax Rate Differentials

Tax rate differentials are similar to tax expenditures because they give preferential tax treatment to a particular type of revenue or taxpayer class; however, they do not appear in TRD's tax expenditure report. For example, the motor vehicle excise tax at 3 percent is less than half the state and local gross receipts tax rate charged for other retail purchases.

Additionally, New Mexico's motor vehicle excise tax rate is significantly lower than surrounding states. Increasing the tax by 1 percent would raise approximately $44 million and leave New Mexico's tax rate 2.3 percent below Texas, 1.6 percent below Arizona, and 3.6 percent below Denver, Colorado.

Chart 1. Five Most Costly Tax Expenditures in FY15 Compared with All Others



The state lost $93 million in direct revenues from the NMMIP credit in FY15, and while this annual loss is shrinking through attrition of pool members, the cost is projected to remain in the range of tens of millions of dollars through at least FY19. The cost may be greater than necessary due to a decision by the board of directors to implement a three-year drawdown in pool membership, delayed by one year, instead of using a one-year timeframe.

Additionally, the superintendent of insurance and board chair expects about 1,000 people to remain in the pool after the drawdown. The savings from shutting down the pool sooner or reducing or eliminating the credit could help offset rapidly rising Medicaid costs or fund other health care services.

Revisit Tax Expenditures to Address Funding Issues

The calls for additional state health care spending and the revenues lost to health care tax expenditures are at odds, but revisiting these tax expenditures and reducing or eliminating those that are no longer needed could free up significant funding to address the industry's concerns. This could improve health care services and related outcomes in the state. It could also incrementally improve tax policy in New Mexico, as many tax expenditures do not adhere to the principles of good tax policy and the healthcare tax expenditures appear to violate at least the first principle, adequacy.

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