Perspectives on Pyramiding

Presentation to the New Mexico Legislative Revenue Stabilization and Tax Policy Committee

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Contrary to Common Descriptions, Pyramiding Is Not Just "Imposing Tax on a Tax"

- "Pyramiding of taxation in state transaction taxes, like the [NM GRT], occurs when the tax is paid by successive sellers of products and services as those . . . are sold and resold and the subsequent seller is subject to the tax on its sales. . . . In the process, the tax becomes part of the base for subsequent prices and final purchasers pay a greater amount of tax because prior taxes have become part of the subsequent tax base." (NMTRI, "Pyramiding Transaction Taxes in New Mexico, 9/05; emphasis added)

- "[C]ertain items may be taxed at a higher effective tax rate . . . due to taxes collected at prior stages of production which are embedded in input prices." (E&Y, "New Mexico's Gross Receipts Tax, Compensating Tax, and Personal Income Tax: Considerations and Model Documentation," updated 9/6/18; emphasis added)

Most Pyramiding Results from Multiple Taxation of Business Purchases

- "Pyramiding, or multiple taxation of the same value of a good, occurs when the GRT is levied on the receipts from a sale of a business input used to produce a good that is subsequently subject to tax. For example, . . . the GRT levied on receipts from sales of inputs to restaurants selling taxable meals would generally result in pyramiding since the value of the input would effectively be taxed twice <u>and</u> there would be some amount of tax on a tax."

(E&Y, "New Mexico's Gross Receipts Tax, Compensating Tax, and Personal Income Tax: Considerations and Model Documentation," updated 9/6/18; emphasis added)

Pyramiding Example

- Assume sales tax rate is 10%
- Business buys $500 of taxable services
- Has $50 sales tax expense ($500 * 10%)
- Has $350 in internal labor costs
- Business charges $1000 for its service to:
  - recover $50 in sales tax costs
  - recover $850 in service purchases and labor expenses
  - obtain $100 profit
- Customers charged $100 tax on invoices ($1000*10%) plus $50 in hidden tax on services, i.e. 15% sales tax, not 10%
- Of $100 tax on customer invoice, $5 (10% of $50) is “tax on tax”; much lower than the $50 hidden tax on inputs

Taxing Business Inputs Comes with Problems (1)

- Conceptually, broad-based transaction taxes like general sales taxes are supposed to be a tax only on final consumption

- Sales taxes hidden in price make it politically easier to raise more revenue from them; if voters/taxpayers knew how much they were really paying, they might push for more reliance on progressive taxes like personal and corporate income taxes

- Taxes should be fully transparent on good govt. principles alone

- Hidden taxes on business inputs may well be more regressive than taxes on final consumption, since they may be passed through into the cost of goods and services like food and health care that have been exempted to mitigate sale tax regressivity

Taxing Business Inputs Comes with Problems (2)

- Taxing business inputs complicates compliance and enforcement: e.g., businesses selling to other businesses must collect NTTCs; inevitable exclusions of some business purchases require complicated line-drawing

- Taxing business inputs can incentivize vertical integration to avoid the tax; e.g. companies in-source janitorial and accounting

- May unlevel the playing field for small businesses, which are less likely to have resources to engage in vertical integration

- Can place in-state businesses at competitive disadvantage in competing for both in-state and out-of-state sales with out-of-state businesses that don't have to pay tax on their inputs to the same extent

- Taxes on business inputs <u>may</u> pyramid.

All Sales Tax States Tax Business Inputs to a Significant Extent

- Despite these possible pitfalls, all states that levy sales taxes impose them on business inputs to a significant extent.
- E&Y 2019 study for Council on State Taxation claims NM is highest at 60% of (state plus local) sales tax revenue, but SD and WY at 58% and TX not far behind at 52%. (This measure is not apples to apples comparison since there are no local sales taxes in some states.)
- E&Y: in 29 states, taxes on inputs 40% or more of total
- Business share of state GRT only is 51.5% in the E&Y's NM-specific study (E&Y presentation to RSTP Committee, June 25, 2018, slide 50)
- Even lower 46% share can be calculated from same report. Business share of $894 million (slide 55) of $1,929 million total (slide 43)

Higher Taxation of Business Inputs in NM Is A Side-Affect of Positive Tax Code Feature

- NM's somewhat higher level of taxation of business inputs is largely a side-effect of a very exemplary feature of its GRT: its broad coverage of services

- Taxation of household services enhances the fairness of a state consumption tax; the tax shouldn't be higher on people who prefer to spend their money on goods rather than services

- Taxing household services raises substantial revenue to finance critical public services and allows rates to be significantly lower, reducing incentives for GRT evasion/avoidance

- Taxing household services broadly ensures that GRT revenue yield keeps up with public service costs as household consumption shifts from goods to services over time

- Fact that this broad service coverage tends to rope in B2B sales of services arguably is a price worth paying

Taxing Business Inputs ≠ Pyramiding (1)

- "At a 6% GRT tax rate and if anti-pyramiding laws had not been enacted in New Mexico, total collections from these business inputs (pyramiding) would be approximately $1.175 billion. . . ." (NMTRI, "Pyramiding Transaction Taxes in New Mexico, 9/05)

- Above sentence implies that taxing business inputs is synonymous with pyramiding. This is incorrect.

- "Pyramiding, or multiple taxation of the same value of a good, occurs when the GRT is levied on the receipts from a sale of a business input used to produce a good that is subsequently subject to tax. For example, the GRT levied on sales of inputs to hospitals would generally not result in pyramiding because hospital receipts are generally not subject to tax . . . ."

(E&Y, "New Mexico's Gross Receipts Tax, Compensating Tax, and Personal Income Tax: Considerations and Model Documentation," updated 9/6/18; emphasis added)

Taxing Business Inputs ≠ Pyramiding (2)

- Hospital example is outdated given subsequent change in law that began subjecting non-profit hospital charges to GRT, but fundamental point is valid: if final sales aren't subject to GRT, taxation of inputs to produce them doesn't create pyramiding. (There may be some pyramiding embedded in those inputs.)

- In such scenarios, there is a transparency issue and likely a regressivity issue, but not a pyramiding issue.

- And, if the tax on inputs is passed through into the price of the final sale, that tax is an appropriate tax on final consumption (with transparency again being a separate issue).

- In fact, majority of final household spending in NM is GRT exempt -- estimated 65% as of 2010 ("Pyramiding in New Mexico's Gross Receipts Tax," presentation of Thomas Clifford to Legislative Finance Committee, undated)

Taxing Business Inputs ≠ Pyramiding (3)

- Widely-cited estimates of the $ amount of GRT paid by businesses on their purchases after factoring in various anti-pyramiding exemptions and deductions are exaggerated estimates of the scale of pyramiding, because they don't take account of the exempt status of most household purchases

- E.g., estimate in 2005 NMTRI report ($749 million) explicitly mislabels it as total "Tax Collected from Pyramiding" when it is actually total tax on business inputs

- E&Y estimate of $894 million (FY16) labels it "Estimated Business Tax," but estimate follows a slide titled "Pyramiding in a tax system" and makes no effort to distinguish this estimate from an estimate of pyramiding (E&Y presentation to RSTP Committee, June 25, 2018, slides 53,55)

New Mexico Has Already Taken Substantial Steps to Mitigate Taxation of Inputs/Pyramiding

	Taxable Gross Receipts	Deductions	Share of Taxable Gross Receipts Offset by Deductions
Ag., Forestry, Fishing	$359	$261	73%
Mining, Oil & Gas Extraction	$3,721	$1,468	39%
Utilities	$3,768	$1,279	34%
Construction	$8,903	$2,885	32%
Manufacturing	$6,339	$4,930	78%
Wholesale Trade	$13,505	$11,636	86%
Retail Trade	$22,973	$11,683	51%
Transportation	$1,871	$1,293	69%
Warehousing	$91	$46	51%
Information	$2,573	$190	7%
Finance and Insurance	$474	$201	42%
Real Estate, Rental, Leasing	$1,902	$691	36%
Prof., Scient., Technical Svcs	$10,343	$4,377	42%
Management of Companies	$112	$109	97%
Admin, Waste Mgmt & Remediation Svcs	$1,637	$368	22%
Educational Services	$253	$36	14%
Health Care & Social Assistance	$5,352	$2,830	53%
Arts, Entertainment & Recreation	$355	$109	31%
Accommodation and Food Services	$3,943	$202	5%
Other Services	$6,618	$2,578	39%
Public Administration	$719	$117	16%
Unclassified Establishments	$538	$163	30%

Source: E&Y presentation to RSTP Committee, June 25, 2018, slide 26

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Debatable that Additional Deductions for Business Inputs Are Warranted (1)

- To repeat: not all remaining taxes on business inputs create pyramiding; they may be being passed through into the very large share of exempt household spending.

- Existing exemptions and deductions have already introduced enormous complexity and cost into enforcing and complying with the GRT. Enactment of new ones will increase complexity and inspire lobbying for even more.

- Predicting the revenue loss from targeted tax reductions on business inputs is extremely difficult; there is a history in NM of underestimating these losses.

- Same market power that leads to passing through of business input taxes to final purchasers likely ensures that reduction of these taxes will provide a windfall to sellers rather than lead to price reductions for purchasers.

Debatable that Additional Deductions for Business Inputs Are Warranted (2)

- No evidence presented (that I'm aware of) that remaining level of taxation of business inputs is, in fact, leading to competitive disadvantage for in-state firms.
  - 78% of taxable manufacturing gross receipts, 73% of agriculture receipts, and 86% of wholesaling receipts offset by deductions; aside from mining, these are the sectors most likely competing with non-NM sellers for out-of-state sales
  - Lower shares of gross receipts offset with deductions are mostly in "non-traded" sectors like retailing and construction where out-of-state firms less likely to be competing with in-state firms and where compensating tax significantly offsets any advantage to out-of-state competitors.
- Need hard evidence that small businesses are, in fact, more likely to outsource (e.g., legal and accounting) services before such services are even considered for new deductions.

Debatable that Additional Deductions for Business Inputs Are Warranted (3)

- Major problem in expanding deductions for additional goods and services based on categorization of seller's industry is risk of substantial tax evasion by increasingly large number of self-employed. (E.g., is storage locker being rented for business or personal use? Ditto cell phone, hotel room rental, auto lease, cable TV subscription, etc.)

- Expansion of LICTR arguably a more efficient mechanism than new GRT deductions for offsetting increased GRT regressivity resulting from passthrough of taxes on inputs to exempt items like food and health care

- To address concerns about transparency, additional research and modeling is advisable to illuminate how much GRT on business inputs is being hidden in prices charged to in-state final consumers

Debatable that Additional Deductions for Business Inputs Are Warranted (4)

- GRT on B2B sales is generating in neighborhood of $1B annually

- NM has many critical unmet needs for investments in childcare, education, health care, economic development, etc., and it seems questionable that additional GRT deductions should have a high priority claim on limited state revenues.

- To the extent that state policymakers do believe that additional reductions in GRT taxes are desirable to offset effects of taxing business inputs and affordable, that may best be achieved through modest GRT rate reductions, the revenue loss from which can be estimated more accurately and the savings from which are likely to be more broadly distributed.

Debatable that Additional Deductions for Business Inputs Are Warranted (5)

- Notwithstanding however much GRT pyramiding is happening, NM already has a reasonably competitive business tax structure.
- Tax Foundation's "Location Matters" finds that NM largely in "middle of the pack" of states nationally in S/L taxes on new business facilities; often imposes lower taxes than neighbors.
- NM imposes lower taxes than TX on 7 of 8 business types
- NM imposes lower taxes than all neighbors on new computer programming/data processing businesses, and lower taxes than all except OK on new corporate HQs and R&D facilities
- NM imposes lower taxes than 3 of its 5 neighbors on back-office support facilities, distribution centers, and labor-intensive manufacturing plants

Pyramiding Reflects Over-Reliance on GRT

- If GRT rates were lower, there would be less tax on business inputs and less pyramiding.
- Rates are as high as they are because the state has made unwise, regressive, and economically ineffective policy choices to deeply cut personal income, corporate income, and capital gains taxes (notwithstanding some commendable partial walk-backs in recent years).
- Reversal of the corporate rate cuts could finance GRT rate reductions or new deductions, but, although the business community rails against taxation of business inputs, when push comes to shove it seems to always choose lower income taxes (personal and corporate) over lower sales taxes
- The business community's reconsideration of this stance could lead to better state business tax policy.

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