GRT Policy Issues: Economic Aspects

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Overview of the Presentation

Our focus is the *economic* aspects of GRT policy issues

We will present these economic aspects in two parts:

1. **The design of the GRT and its conceptual base (Jim Nunns), and**

2. **Issues in enacted GRT law and practice, and past efforts to address these issues (Richard Anklam)**

We will then jointly present:

3. A suggested framework for improving the GRT

The Design of the GRT and Its Conceptual Base

Design of the GRT:

- **The GRT is New Mexico's tax on retail sales**

- **We consider "GRT" to include the compensating, governmental gross receipts, interstate telecommunications, local option, and tribal GRTs**

- **All but 5 states impose a tax on retail sales (RST)**

- **Like the RSTs of other states, the GRT applies to sales of *goods* at retail to households**

The Design of the GRT and Its Conceptual Base – Cont.

- **But unlike the RSTs of most other states, the GRT also applies to sales of most *services* to households.**
  - **Services were included in the GRT base when it was originally enacted as the Emergency School Tax in 1935**
- **Recently, many states have added some services to the bases of their RSTs as an increasing share of household purchases shifts from goods to services**
- **However, the share of services in most state's RSTs is still far below the share in New Mexico.**
  - **Only Hawaii's RST base is broader than the GRT base.**

The Design of the GRT and Its Conceptual Base – Cont.

- **The State GRT rate is lower than the state rate of most RSTs, but local GRT rates are higher**
  - **As of July 1, 2022, only 7 of the 46 states plus DC with a sales tax had a lower RST rate than the 5.0% (now 4.875%) rate of the GRT**
  - **But the average local option GRT rate in New Mexico is higher than the average local RST rate in all but 11 states (only 37 states allow local option RSTs)**
- **The administrative design of the GRT also differs substantially from the design of most RSTs**

The Design of the GRT and Its Conceptual Base – Cont.

- **Generally, only businesses that sell taxable items at retail are required to register with the state tax agency for RST purposes and file periodic (generally monthly) RST returns along with remittances of RST due**

- **In contrast, nearly all businesses with receipts from sales in New Mexico must register with TRD and periodically file GRT returns along with remittances of any GRT due**

- **GRT returns generally must be filed even if a business does not have any GRT liability either because it made no sales in New Mexico during the period, or its sales were not taxable due to one or more exemptions, deductions, or credits**

- **The GRT now uses the *purchaser's* location to determine the GRT rate that applies to the sale, rather than the *seller's* location**

The Design of the GRT and Its Conceptual Base – Cont.

- **This relatively recent change, also adopted in some state's RSTs, facilitates the application of local GRT rates to purchases from remote sellers (e.g., internet sites) that do not have a sufficient economic presence ("nexus") in New Mexico**

- **Previously, only the compensating tax rate (which is set at the State GRT rate) applied to remote sellers**

  - **This change also affected the location of some sales by some New Mexico businesses, so changed local jurisdictions' GRT revenues**

- **The broad registration and reporting requirements of the GRT have the important administrative advantage of reducing the amount of revenue lost due to noncompliance by retail businesses**

The Design of the GRT and Its Conceptual Base – Cont.

The conceptual base of the GRT:

<u>Spending on all goods and services</u>,

<u>in New Mexico</u>,

<u>by households in New Mexico</u>

- **Household spending is part of "consumption", the largest component of GDP**
  - **Consumption includes household's *out-of-pocket spending* on items such as food, shelter and medical care**
  - **Consumption also includes *spending on behalf of households by governments and nonprofits* on food (e.g., SNAP, WIC), housing (e.g.,**

The Design of the GRT and Its Conceptual Base – Cont.

- **Consumption also includes *spending on behalf of households by governments and nonprofits* on food (e.g., SNAP, WIC), housing (e.g., Section 8, rental assistance), and health care (e.g., Medicare, Medicaid)**

- **In addition, other spending on goods and services by governments and nonprofits is included in consumption;**

  - **Cash transfer payments (such as Social Security benefits) and net interest paid are *not* included**

The Design of the GRT and Its Conceptual Base – Cont.

- **Spending <u>not</u> included in the conceptual base of the GRT includes:**
  - **Spending on *nondurables* outside of New Mexico by *NM* households;**
  - **Spending on *durables* in New Mexico by *non-NM* households; and**
  - **Spending by businesses for business purposes, i.e., sales between businesses**
    - **An undesirable feature of the GRT, which Richard will discuss in detail, is that GRT does apply to business-to-business sales in many circumstances**
  - **Note that where a good or service is produced has no bearing on whether the item is included in NM consumption**

The Design of the GRT and Its Conceptual Base – Cont.

What are the principles of tax policy that apply to all taxes, including the GRT and proposed amendments to it?

<u>Equity</u> – How fairly does the tax apply to households at different income levels ("vertical equity") and how fairly does it apply to households that have similar incomes and are similar in other ways ("horizontal equity");

<u>Economic Neutrality</u> – Does the tax distort economic decisions (e.g., whether to make an investment in plant or equipment, whether to enter the labor force or remain unemployed);

<u>Simplicity</u> – How much time and money do taxpayers need to spend to comply with the tax law, and how much does the government need to spend to administer the law both fully and even handily; and

<u>Adequacy</u> – Does the tax, along with other revenue sources, raise sufficient revenue to fund the budgeted amount of government spending

The Design of the GRT and Its Conceptual Base – Cont.

- **Economists have developed analytical tools intended to objectively measure the application of these principles, such as:**
  - **Distribution tables**
  - **Cost of capital calculators**
  - **Compliance burden models**
- **These tools can help inform policy decisions, but policy makers often need additional information to judge the desirability of a tax or amendment to it**

A Suggested Framework for Improving the GRT

Objectives

- **Remove business-to-business (BTB) sales ("pyramiding") from the GRT base;**
- **Broaden the GRT base (or rate) to include items of consumption not currently taxed;**
- **Reduce rate differentials between inside and outside of cities, instate and out-of-state sellers, and items of consumption subject to reduced rates;**
- **Retain the broad administrative structure of the GRT;**

A Suggested Framework for Improving the GRT – Cont.

Objectives – Cont.:

- **Use the personal income tax (PIT) to address fairness issues that depend on the specific circumstances of families (e.g., income, presence of children); and**

- **Consider using some of the surplus to reduce the average GRT rate**

A Suggested Framework for Improving the GRT – Cont.

<u>Remove Pyramiding</u>

- **All pyramiding could be removed from the GRT base by allowing *all* businesses to deduct *all* purchases of items from other businesses**

- **To protect against reporting of sales to other businesses as sales to households, invoices documenting the seller and purchaser would be required to be retained by all businesses for all transactions**

- **Pyramiding distorts the relative prices of consumption and export items, so removing pyramiding improves fairness and economic neutrality**

A Suggested Framework for Improving the GRT – Cont.

<u>Broaden the GRT base (or rate)</u>

- **This improvement could be addressed by:**
    - **Including currently excluded items in the GRT base, and**
    - **For items currently subject to separate excise taxes, raising the rates of these excises to the State GRT rate plus, for motor vehicles and motor fuels, the applicable local option rate(s)**
- **Note that if food were included in the GRT base the "hold harmless" distributions to local governments would effectively be repealed**
- **Including currently excluded items in the base would improve the fairness, economic neutrality, and administrative simplicity of the GRT**

A Suggested Framework for Improving the GRT – Cont.

Reduce rate differentials

- **Inside/outside city rate differentials could be reduced by reinstating the credit (up to a cap) against State GRT for municipal local option rates**
  - **Rate differentials are currently much larger than when the 0.5% cap was enacted in 2005**
    - **The *average* inside/outside (remainder of county) differential is now 1.75 percentage points;**
    - **The *maximum* differential is 2.61 percentage points (Lincoln County);**
    - **And the *minimum* differential is 1.00 percentage points (Mora County)**

A Suggested Framework for Improving the GRT – Cont.

Reduce rate differentials – Cont.

- **Reducing rate differentials is economically similar in some respects to reducing pyramiding and also to broadening the base**
  - **Fairness and economic neutrality would be improved,**
  - **Incentives for tax planning and evasion would be reduced, and**
  - **The administration of the GRT would be simplified**

A Suggested Framework for Improving the GRT – Cont.

Retain the broad administrative structure of the GRT

- **Retaining the broad registration and filing requirements for all businesses with receipts from sales in New Mexico is critical to many improvements**
  - **GRT tax liability is based on the taxability of each sale to each purchaser – it is a *transactions*-based tax**
  - **In contrast, income tax liability is based on the taxability of income received over a period of time (generally, a year); it is *income* based**
  - **Although RSTs in the US are generally based only on retail transactions, the broad-based consumption taxes levied in nearly every other country in the World are transactions based**

A Suggested Framework for Improving the GRT – Cont.

Retain the broad administrative structure of the GRT – Cont.

- **The broad-based consumption taxes levied by other countries are typically called Value-Added Taxes (VATs), but in English-speaking countries are called Goods and Services Taxes (GSTs), and in a few countries (e.g., India) sales taxes**

- **Most countries have only a national-level broad-based consumption tax, but some (e.g., Canada, India) also have subnational-level taxes**

- **The GRT is also *destination* based, as are all VATs and GSTs**

- **The broad registration and filing requirements of transactions-based taxes help minimize revenue losses due to noncompliance**

A Suggested Framework for Improving the GRT – Cont.

<u>Use the personal income tax (PIT) to address household fairness issues</u>

- **One dimension of the fairness of the GRT and amendments to it is how much of the burden falls on specific types of households (e.g., low-income households, households with children)**

- **The personal income tax applies on an annual basis to each household (PIT filing unit)**

    - **PIT liability is based on the annual income, deductions, credits, and other characteristics of each filing unit (household) resident in, or with income in, New Mexico in the prior year**

    - **A household has PIT liability if it has taxable income**

A Suggested Framework for Improving the GRT – Cont.

Use the personal income tax (PIT) to address household fairness issues – Cont.

- **One approach to addressing concerns about the regressivity of the GRT would be to increase the standard deduction amounts**
  - **New Mexico's standard deduction amounts could be increased by simply adding amounts to the federal amounts**
  - **Higher standard deductions would remove PIT liability from affected households, reducing their overall tax burden and simplifying their filing**
  - **A sufficiently large increase in the standard deductions could replace the Low- and Middle-Income Tax Exemption, further simplifying filing**

A Suggested Framework for Improving the GRT – Cont.

Use the personal income tax (PIT) to address household fairness issues – Cont.

  - **Note that the federal standard deduction amounts will be reduced starting in 2026 due to the expiration of the temporary increases enacted in 2017**

- **PIT has also long been used to administer credits designed to:**

  - **Mitigate the overall regressivity of New Mexico's tax system (the Low-Income Comprehensive Tax Credit -- LICTR);**

  - **Provide work incentives (the Working Families Tax Credit, which is modeled largely on the Federal EITC); and**

  - **Provide support for children (the New Mexico Child Tax Credit, which is modeled largely on the Federal CTC).**

A Suggested Framework for Improving the GRT – Cont.

<u>Use the personal income tax (PIT) to address household fairness issues – Cont.</u>

- **PIT credits are based on certain specific characteristics of households, such as income, household size, and the number and age of children**

- **Some of these credits are also *refundable*, so taxpayers receive a direct deposit (or check) from the State if the amount of these credits exceeds their PIT liability (net of nonrefundable credits)**

- **One or more refundable PIT credits could be designed to address concerns about the how the burden of the GRT and amendments to it affects specific types of households**

A Suggested Framework for Improving the GRT – Cont.

Use the personal income tax (PIT) to address household fairness issues – Cont.

- **PIT credits can be well targeted, so be much more cost effective in addressing fairness concerns than GRT deductions, exemptions, or credits**
- **PIT credits can also be designed to require little or no reporting by targeted households, and to be paid out in installments over the year**
  - **Information returns received by TRD could be used to determine the credit eligibility of most households with no, or little, reporting**
    - **Many current filers would no longer need to file a PIT return, and this number could be even higher with higher standard deduction amounts**
  - **Larger credit amounts could be paid out in installments (e.g., monthly)**

A Suggested Framework for Improving the GRT – Cont.

<u>Consider using some of the surplus to reduce the average GRT rate</u>

- **NM currently has a huge surplus, but many of us have experienced the boom-and-bust cycle of State finances more than once, so the Legislature is on very solid ground in being cautious about how the surplus is used**

- **We believe that using some of the surplus to reduce the average GRT rate would be a cautious use of the surplus, for several reasons**

  - **Historically, the GRT has been the "go to" revenue source to provide tax relief in surplus times and to raise revenue when deficits loom**

    - **So, reducing the GRT rate now can be seen as a form of precautionary saving against a future economic downturn**

A Suggested Framework for Improving the GRT – Cont.

<u>Consider using some of the surplus to reduce the average GRT rate – Cont.</u>

- **Reducing the average rate would reduce any remaining economic distortions in the GRT once improvements are made**
- **Reducing the average GRT rate would also reduce any losses of households and businesses due to base expansions and replacement of special rates**
- **A further consideration is that improvements made to the GRT might help insure against the side effects of the adoption of a federal VAT**
    - **Several recent and forthcoming federal tax reform proposals have the adoption of a federal VAT (or similar broad-based consumption tax) as a key element**

A Suggested Framework for Improving the GRT – Cont.

<u>Consider using some of the surplus to reduce the average GRT rate – Cont.</u>

- **Beyond widespread dissatisfaction with the federal tax system, these proposals are meant to address concerns over the growing federal deficits**

- **Having an improved GRT in place could provide some insurance that New Mexico could retain its design of the GRT, rather than having that design preempted by the design of the federal VAT**