Pyramiding in New Mexico’s Gross Receipts Tax

Presented to the Legislative Finance Committee

Thomas Clifford, Ph.D.
Chief Economist
New Mexico Legislative Finance Committee
tom.clifford@nmlegis.gov
Adequacy: revenue should be adequate to fund government services

Efficiency: broad base with low rates; minimize distortion; avoid reliance on one tax

Equity: fairness to taxpayers in similar circumstances; fairness to taxpayers with different incomes

Simplicity: encourage compliance and minimize administrative costs

Accountability: tax preferences should be easy to monitor and should be reviewed periodically

Implementing principles requires trade-offs
**GRT’s Role in New Mexico’s Tax System**

- **GRT comprises over 40% of all tax collections in New Mexico.**
- **Higher NM Sales Tax offsets lower Property Tax than U.S. Average.**
- **NM lower Individual Income Tax is offset by Oil & Gas production taxes.**
GRT Role in New Mexico’s Economy

• Limited role of cross-border transactions so little tax competition at retail level (changing with e-commerce).

• Large role of government facilities: Seller-imposed GRT brings government contractors into tax base.

• Large role of resource extraction industries: GRT on services brings their contractors into the base.

• Relative isolation of N.M. economy is changing. Newly-locating businesses are putting pressure on the GRT, seeking relief on inputs and outputs.
**GRT Tax Base by Industry**

- **Services + Construction almost 60% of tax base**
- **Retail sales only 26%**
- **65% of average household spending is non-taxable**
• **Largest 1% of firms contribute over half of GRT base**

• **Smallest two-thirds of businesses contribute less than 3%**
Taxable share of sales decreases as firm size increases

Larger firms are more likely to have exports or other deductions
GRT Rate History

Trends in Average Combined GRT Tax Rate

- State rate increased due to 0.5% municipal credit repeal in 2005
- Another 0.125% increase took effect July 2010
- Local option rates have been increasing gradually over time
• **LFC estimates two-thirds of household spending is non-taxable**

• **Household exemptions/deductions reduce tax base by 50%**

• **Uneven taxation of purchases distorts economic behavior**
**Pyramiding Illustration**

<table>
<thead>
<tr>
<th></th>
<th>Sales</th>
<th>GRT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drilling contractor</td>
<td>$100</td>
<td>$7.40</td>
</tr>
<tr>
<td>Natural gas producer</td>
<td>$200</td>
<td>$14.80</td>
</tr>
<tr>
<td>Electric Utility</td>
<td>$400</td>
<td>$29.60</td>
</tr>
<tr>
<td>Commercial power consumer</td>
<td>$800</td>
<td>$59.20</td>
</tr>
<tr>
<td>Total final value/Tax</td>
<td>$800</td>
<td>$111.00</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td></td>
<td>13.88%</td>
</tr>
</tbody>
</table>

Pyramiding can raise effective tax rates sharply, creating strong incentives to avoid tax by importing, or bringing operations in-house.
Pyramiding in Other States*

- Most states – including NM -- exempt goods that are to be re-sold or to become ingredients in a final product.

- About half of states exempt equipment used in manufacturing (NM does not). Another 1/3 provide lower tax rates or partial exemption.

- About half of states exempt materials that do not become components (e.g. fuels) – NM does not.

- Most states – including NM -- tax goods sold to non-taxable entities.

- NM taxes a much broader spectrum of services than most states. Few deductions are allowed for sales to businesses.

## Multi-state Business Tax Comparison

<table>
<thead>
<tr>
<th>Tax</th>
<th>New Mexico Percent of Gross State Product</th>
<th>U.S. Average Percent of Gross State Product</th>
<th>NM – U.S. Average Annual Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Tax</td>
<td>0.8%</td>
<td>1.7%</td>
<td>($600 million)</td>
</tr>
<tr>
<td>Sales Tax on Inputs</td>
<td>1.9%</td>
<td>1.1%</td>
<td>$520 million</td>
</tr>
<tr>
<td>Excise Tax on Purchases</td>
<td>0.5%</td>
<td>0.6%</td>
<td>($60 million)</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>0.5%</td>
<td>0.5%</td>
<td>--</td>
</tr>
<tr>
<td>Unemployment Insurance Tax</td>
<td>0.2%</td>
<td>0.3%</td>
<td>($70 million)</td>
</tr>
<tr>
<td>Income Tax on Business Profits</td>
<td>0.1%</td>
<td>0.2%</td>
<td>($45 million)</td>
</tr>
<tr>
<td>Other</td>
<td>2.1%</td>
<td>0.5%</td>
<td>$955 million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>6.0%</strong></td>
<td><strong>4.9%</strong></td>
<td><strong>$700 million</strong></td>
</tr>
<tr>
<td><strong>Total Excluding Severance</strong></td>
<td><strong>4.6%</strong></td>
<td><strong>4.7%</strong></td>
<td><strong>($63 million)</strong></td>
</tr>
</tbody>
</table>

Source: “Total State & Local Business Taxes,” Ernst & Young, Council on State Taxation, January 2009

- NM business tax burden about average on non-severance industries
- Sales tax on business inputs almost twice national average
- Businesses buying within state face high overhead
Concerns Raised by Pyramiding

• Pyramiding places a heavier tax burden on businesses and individuals who make a lot of purchases from in-state vendors. This creates incentives to buy from out-of-state vendors: 2.5% advantage if the seller has nexus, 7.5% if not.

• Small companies face a larger tax burden – and are placed at a disadvantage to larger businesses – because they purchase more inputs rather than providing them in-house.

• The effective tax rate is greater than the nominal rate, increasing with the number of taxable stages of production.

• The likelihood is high that most of the ultimate burden of this tax is borne by New Mexico households, a hidden tax with regressive implications.
Policy Recommendations

• “First, do no harm”
  – Inefficiency (i.e. lost economic output) increases with the square of the tax rate – i.e. exponentially – holding down the GRT tax rate is essential
  – New exemptions targeted at consumer purchases should be kept to a minimum, they shift the tax base to businesses
  – Use of tax incentives should be strictly limited – they reduce the base and put upward pressure on tax rates

• Sales tax reform should focus on final sales, exclude intermediate sales

• GRT could be split into two taxes:
  – Retail sales tax with fewer exemptions and
  – Business privilege tax at much lower rate – e.g. TX Margin Tax