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

ORIGINAL DATE 02/25/13

SPONSOR Sapien **LAST UPDATED** **HB**

SHORT TITLE Gross Receipts Manufacturing Definitions **SB** 561

ANALYST Walker-Moran

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY13	**FY14**	**FY15**	**FY16**	**FY17**		
$0.0	$3,717.0	$6,596.0	$9,480.0	$12,764.0	Recurring	General Fund
$0.0	$2,400.0	$4,267.0	$6,133.0	$8,267.0	Recurring	Local Government
$0.0	$17.0	$28.0	$40.0	$52.0	Recurring	Small County Assistance Fund
$0.0	$25.0	$42.0	$60.0	$78.0	Recurring	Small City Assistance Fund
$0.0	$8.0	$14.0	$20.0	$26.0	Recurring	Municipal Equiv. Dis.
$0.0	$6,167.0	$10,947.0	$15,733.0	$21,187.0	Recurring	**TOTAL**

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Economic Development Department (EDD)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 561 provides definitions of “consumed,” “manufacturing,” “qualified business,” and “tangible personal property” for the purpose of the gross receipts tax deduction for sales to manufacturers. Section 1.B. replaces “person engaged in the business of manufacturing” with “qualified business” engaged in manufacturing

- “consumed” means incorporated into, utilized, depleted, destroyed or transferred in the process of manufacturing a product,”
- “manufacturing” means the process of combining, processing or converting raw material, substances or components into new products through mechanical, physical or chemical transformation,”

- "qualified business" means a business classified within the manufacturing sector as described in the official 2012 North American Industry Classification System," and
- "tangible personal property" includes chemicals, dyes, electricity, fuels, gases, jigs, manufacturing aids and supplies, repair parts, spares and water."

The effective date of this bill is July 1, 2013.

FISCAL IMPLICATIONS

The manufacturing tax credit was revised during the interim. In August 2012, gross receipts were reduced $16 million in FY13 and $32 million in FY14 to account for the increasing cost of the manufacturing and construction tax credit. Several committees have heard testimony that the impact of this credit was underestimated during the 2012 legislative session. The current FY13 and FY14 estimate is roughly double and triple the amounts estimated in the final session fiscal impact report for the two fiscal years, respectively.

Cost of the Manufacturing Tax Credit
(in thousands of dollars)

	FY13	FY14	FY15	FY16	FY17	FY18
General Fund	$ (9,723)	$ (18,229)	$ (31,585)	$ (46,098)	$ (61,741)	$ (71,459)
Local Government	$ (6,822)	$ (12,519)	$ (21,719)	$ (31,748)	$ (42,583)	$ (49,362)
TOTAL	**$ (16,545)**	**$ (30,748)**	**$ (53,304)**	**$ (77,846)**	**$ (104,324)**	**$ (120,821)**

This bill clarifies the definition of "consumed," "manufacturing," "qualified business," and "tangible personal property." These are not clearly defined in the New Mexico tax code. Proper definition narrows the tax credit's intended target. Unintended use of the credit by those not defined will reduce the cost of the tax credit by about 20 percent.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

As reported by the Taxation and Revenue Department (TRD):

This bill would narrow the scope of businesses that would qualify as manufacturers. However, as written there could be some significant unintended consequences. NAICS codes would be a more precise and establish way to define manufacturers without requiring the TRD staff to make a judgment call, given companies are properly classified (See Administrative & Compliance Impact). The definition of a qualified business should account for the majority of the impact.

There has been significant policy discussion recently regarding whether this deduction has expanded beyond its original intent. Much of the discussion is directly related to the type of business that may be eligible for the deduction, especially under Subsection B: The current definition of manufacturing could arguably include businesses such as restaurants. The proposed legislation is intended to clean up the language defining eligible firms and refocus the deduction on the sector it is intended for. If the technical issues are not addressed, however, it could end up having mixed results, narrowing the applicability for Subsection B, while broadening Subsection A in a way that the TRD does not believe is intentional.

The estimates for this analysis include a high degree of uncertainty. There are several reasons for this. First, the deduction is not separately stated, and so the historical size of the deduction is not known. Second, to compound this, the law was changed in the past year, which is expected to greatly increase the size of the deduction, but the changes have simply not been effective long enough to get a true picture of their impact. Third, given the current and proposed definitions of manufacturing, it is very hard to identify with any certainty the pool of firms that will be eligible for the credit. Fourth, the data does not exist to directly analyze the percentage of New Mexico production that is sold outside of New Mexico, at the aggregate or individual firm level. In combination, these factors make it difficult to estimate the baseline "status quo" level of the deduction, much less the impacts from the proposed changes. The analysis that follows is the Department's best effort at such an estimate.

To establish a baseline level of the manufacturers' consumables deduction, the Department has relied on the Department of Finance and Administration revised analysis (i.e., October 2012) of an REMI Input-Output model of manufacturer consumption. This model estimates the size of the deduction under current law.

With the baseline established, the Department identified the proposed changes that are expected to have a significant revenue impact. The definition of a qualified business as being classified within the manufacturing sector as described in NAICS 2012 is more restrictive than the current broad definition of manufacturing activity.

The current broadly interpreted definition of manufacturing leaves the door open to many types of firms qualifying that do not necessarily fit the mold of what is conventionally considered a manufacturer. The proposed legislation would significantly reduce the number of firms that could potentially qualify for the credit by restricting qualifying firms to those classified as manufacturers under NAICS 2012.

To estimate the proportion of proposed qualifying firms to current potential qualifying firms, the Department utilized 2012 Implan Institution Industry Demand table data. Using this data, the Department estimates a reduction in claims from changing to the NAICS 2012 definition of manufacturing sector of approximately 21 percent. The table below shows the estimated impacts to gross receipts tax and compensating tax.

	FY13	**FY14**	**FY15**	**FY16**	**FY17**
General Fund (GRT)	$0.0	$3,600.0	$6,400.0	$9,200.0	$12,400.0
Local Governments	$0.0	2,400.0	$4,267.0	$6,133.0	$8,267.0
Net Gross Receipts Tax Impact	**$0.0**	**6,000.0**	**$10,667.0**	**$15,333.0**	**$20,667.0**
General Fund (Comp)	$0.0	117.0	$196.0	$280.0	$364.0
Small County Assistance Fund	$0.0	17.0	$28.0	$40.0	$52.0
Small City Assistance Fund	$0.0	25.0	$42.0	$60.0	$78.0
Municipal Equivalent Distrib.	$0.0	8.0	$14.0	$20.0	$26.0
Net Compensating Tax Impact	**$0.0**	**167.0**	**$280.0**	**$400.0**	**$520.0**
Total Impact	$0.0	6,167.0	$10,947.0	$15,733.0	$21,187.0

SIGNIFICANT ISSUES

Per the Economic Development Department (EDD), clarification of intent is critical to the equitable use of the incentive and removes room for interpretation that may impact its effectiveness. The North American Industry Classification System (NAICS) is published by the federal government and used by its agencies for the purpose of setting the standard for business classification.

PERFORMANCE IMPLICATIONS

Per the EDD, manufacturing is an economic-base industry that has the highest “multiplier affect” meaning that it generates the highest ratio of indirect jobs and new dollars brought into the economy where the goods are produced. In New Mexico the manufacturing sector is experiencing a small increase in job growth which is very important to economic recovery and growth, and should be encouraged.

TECHNICAL IMPLICATIONS

As reported by the TRD, the definition of manufacturing would supersede, for this section, the definition of manufacturing in Section 7-9-3(H) NMSA 1978 which excludes construction. Under this proposal, Section 7-9-46(B) would require that a firm be a “qualified business” to be eligible for the deduction. This would limit firms to those classified as manufacturers under the NAICS 2012 system. Subsection A, however, does not have the qualified business requirement, and could potentially open up the deduction under that subsection to the construction industry. This could have a significant negative revenue impact that seems to be counter to the intent of this bill. The proposed language also creates inconsistency in the gross receipts tax code with respect to defining manufacturing.

ADMINISTRATIVE IMPLICATIONS

The TRD is currently in the process of converting from NAICS 2002 to NAICS 2012 coding. In the process, it has become apparent that not all businesses are accurately or adequately coded (e.g. many businesses are categorized in catch-all or “other” categories that should rightly be coded more precisely.) Some businesses that should actually be coded as manufacturers under NAICS may not be. This would increase administrative burden slightly, to get the coding cleaned up on a case by case basis. The Department would need to modify the manufacturer consumable NTTC application at a cost of $3,000.

OTHER ISSUES

Page 3, Subsection (F)(1), under the definition of consumed, the term “incorporated into” is used. The tangible property “incorporated into” can also be deducted under subsection A which calls for the tangible personal property to become an ingredient or component part of the product. This will be a problem since the two subsection deductions have to be reported separately and there will be some cross over on some of the items.

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

EWM/svb