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

ORIGINAL DATE 1/30/07
SPONSOR Moore **LAST UPDATED** 2/1/07 **HB** 235/aHHGAC

SHORT TITLE Require Tax Expenditure Budget **SB**

ANALYST Schardin

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY07	FY08	FY09	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total		$100.0		$100.0	Non-Recurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Department of Finance and Administration (DFA)
Economic Development Department (EDD)

SUMMARY

Synopsis of HHGAC Amendment

The House Health and Government Affairs Committee amendment to House Bill 235 addresses concerns raised by TRD. The amendment will require state agencies and local governments to provide TRD with information necessary to complete the tax expenditure budget.

The amendment also changes the definition of a “tax expenditure” to give TRD greater flexibility in defining the normal tax base against which tax expenditures will be measured. This change ensures that the total tax expenditure calculation is meaningful and will eliminate unnecessary efforts on the part of TRD.

Synopsis of Original Bill

House Bill 235 creates a new section of the Tax Administration Act (Chapter 7, Article 1 NMSA 1978) to require the Taxation and Revenue Department (TRD) to compile a tax expenditure budget (TEB) by October 15 of each year. The TEB will include information on the three preceding fiscal years, the current fiscal year, and the upcoming fiscal year.

Tax expenditures to be included in the TEB will be of all major general fund revenues including gross receipts tax, compensating tax, corporate income tax, personal income tax, tobacco excise tax, liquor excise tax, severance taxes, motor vehicle excise tax, gaming excise tax, insurance revenues, fire protection fund reversion, leased vehicle surcharge, rents and royalties, and tribal gaming revenue.

In addition to estimated revenue forgone due to each tax expenditure, the TEB will include each tax expenditure's year of enactment, purpose, and repeal date (if applicable).

FISCAL IMPLICATIONS

Creation of a TEB is a difficult but achievable task that requires specialized knowledge of New Mexico's tax system. The first time the report is published TRD estimates needing a nonrecurring appropriation of $100 thousand to pay a contractor to help with legal and economic analysis. After the first year, TRD reports the TEB can be updated using existing resources. This estimated cost is similar to the $95 thousand Minnesota's Department of Revenue reports as the recurring cost of producing Minnesota's TEB.

SIGNIFICANT ISSUES

Tax expenditures are amendments to the state's tax system that reduce revenue collections from what they would otherwise be. They include deductions, exemptions, credits, preferential tax rates, and any other means by which tax collections are reduced from the normal base amount. A TEB is a document that provides information about individual tax expenditures, including estimates of the amount of revenue lost due to each one.

Tax expenditures give preferential tax treatment to a specific group to encourage certain types of economic activity. From a tax policy standpoint, these mechanisms by which the revenue base is eroded should be evaluated as rigorously as appropriations.

According to a 2006 report by the American Federation of State, County and Municipal Employees (AFSCME), 30 states regularly prepare a TEB. The nonprofit organization Good Jobs First reports that 35 states currently publish a TEB. According to recent TEBs, the amount of state tax revenue forgone due to tax expenditures is 53 percent in Michigan, 22 percent in Illinois, and 20 percent in Louisiana.

Like most states, New Mexico's tax code contains hundreds of tax expenditures. The gross receipts and compensating tax code (Chapter 7, Article 9 NMSA 1978) includes about 100 exemptions, deductions, and credits. The personal and corporate income tax codes (Chapter 7, Articles 2 and 2A NMSA 1978) also include dozens of tax expenditures. While many of New Mexico's tax expenditures have very small costs, they cumulatively represent a significant erosion of the state's revenue base.

Uncovering the degree of erosion in a state's tax base is important for several reasons. Without knowing the amount of revenue forgone due to tax expenditures, policymakers and the public cannot know how much tax relief is being granted and to whom the benefits are accruing. Also, a narrower tax base requires that a higher tax rate be charged on everything that remains taxable to provide enough revenue to meet the state's spending needs. Finally, a narrower tax base leads to increased revenue volatility, which makes fiscal planning more difficult.

Currently, the cost of New Mexico's tax expenditures are only estimated when they are first enacted in Fiscal Impact Reports. However, the costs of tax expenditures are rarely revisited to assess whether they cost more or less than expected, whether costs are growing as anticipated, or whether tax expenditures are effective.

PERFORMANCE IMPLICATIONS

Periodic review of tax expenditures adds transparency, fiscal discipline, and political accountability to the budget process. By uncovering the cost of New Mexico's tax expenditures, a TEB will allow the state's policymakers to tailor tax incentives and appropriations to better achieve the state's goals.

ADMINISTRATIVE IMPLICATIONS

TRD will incur significant administrative costs in publishing a TEB, especially in the first year. These costs are detailed in the Fiscal Implications section.

OTHER SUBSTANTIVE ISSUES

TEB revenue estimates only quantify the direct effects of tax expenditures and do not attempt to include dynamic revenue effects that may result if tax expenditures result in job creation or increased economic activity. For this reason, tax expenditure estimates may overstate the true costs of some successful tax incentives.

The ease of estimating the cost of tax expenditures depends on tax reporting requirements. Tax credits must be explicitly reported on tax forms, which makes calculating their cost straightforward. However, deductions and exemptions are not reported explicitly, with the important exceptions of the food and medical services gross receipts tax deductions enacted in 2004, which were expected to be revenue neutral but are resulting in a revenue loss of about $30 million per year. Without explicit reporting, the costs associated with deductions and exemptions must be estimated. These estimates are time consuming and contain some degree of uncertainty.

One of the most difficult challenges in creating a TEB is defining the revenue base against which tax expenditures should be measured. Much has been written about defining the base of income and excise taxes in other states and at the federal level, but New Mexico's gross receipts tax is unlike most sales taxes and will be more difficult to model.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

The amount of New Mexico's general fund revenue eroded due to tax expenditures will continue to be unknown. Policymakers will continue to be unable to decide whether the benefits of tax expenditures are great enough to justify their costs.

SS/nt