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## FISCAL IMPACT REPORT

SPONSOR Varela ORIGINAL DATE 02/10/09  
LAST UPDATED \_\_\_\_\_ HB 320  
SHORT TITLE Require Tax Expenditure Budget SB \_\_\_\_\_  
ANALYST Lucero

### ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY09	FY10	FY11	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
<b>Total</b>		\$150.0	\$125.0	\$275.0	Recurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to Appropriation in the General Appropriation Act

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Economic Development Department (EDD)

Taxation and Revenue Department (TRD)

### SUMMARY

#### Synopsis of Bill

House Bill 320 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) for the upcoming fiscal year by October 15 of each year. TRD would be required to present the TEB, including an analysis of tax expenditures and revenues greater than \$1 million, to the governor and Legislative Finance Committee.

The bill authorizes the department to request information and requires compliance from other state agencies and local governments in order to complete the TEB.

The TEB shall include information on the three preceding fiscal years, the current fiscal year, and the upcoming fiscal year.

The TEB shall include the approximate costs in foregone revenue from tax expenditures and including:

1. a projection of the costs of tax expenditures for all significant general fund revenue sources;

2. identify each tax expenditure and its statutory basis, purpose, year of enactment, and date repeal (if any);
3. quantify the revenue lost to the state from each tax expenditure;
4. identify the beneficiaries of each tax expenditure, including the number of businesses that used the tax expenditure, and the number of business that potentially qualified for but failed to the use the tax expenditure;
5. identify unintended consequences of the tax expenditure that have come to the attention of the department; and
6. provide a total of all the costs in each fiscal year for all tax expenditures.

The bill identifies significant general fund revenue sources as 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, and other revenue sources including insurance revenues, fire protection fund reversion, leased vehicle surcharge, rents and royalties, and tribal gaming revenue.

Tax expenditure is defined as a deduction, credit, exemption, exclusion, preferential tax rate, subtraction, or allowance that reduces a tax liability.

### **FISCAL IMPLICATIONS**

According to the December 2008 revenue estimate, FY10 recurring revenue will only support a base expenditure level that is \$293 million, or 2.6 percent, less than the FY09 appropriation. All appropriations outside of the general appropriation act will be viewed in this declining revenue context.

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 \$150 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**

A significant effort by the economic and legal staffs in TRD would be required to prepare the initial report and to update it annually. A conservative estimate of to prepare the first report would require three full time equivalent professional staff over a two-year period, and each subsequent report 1 ½ such staff. With current vacancies and little prospect of filling those vacancies in the next two years, it would not be feasible for TRD to complete these reports.

### **TECHNICAL ISSUES**

According to TRD, the bill requires the TEB to cover non-tax revenues, which is inconsistent with the definition of "tax expenditure". The bill defines "tax expenditure" as "a deduction, credit, exemption, exclusion, preferential tax rate, subtraction or allowance that reduces tax liability when compared with a normal tax system as determined by the secretary", but requires the tax expenditure budget to cover non-tax revenues such as rents and royalties, tribal revenue sharing, and fire protection fund reversions. Since non-tax revenues cannot (by definition) generate tax expenditures, it is not clear how the bill intends the tax expenditure budget to cover these items

The bill also apparently includes in "tax expenditures" provisions in the federal internal revenue code that flow through to New Mexico taxes, which would be very difficult to estimate and might be of limited value since the State cannot amend the internal revenue code. The definition of "tax expenditures" would apparently include deductions, etc. in the federal internal revenue

code that flow through to New Mexico taxes through our adoption of federal tax bases (primarily for the personal and corporate income taxes). So, as drafted, the bill would require that the tax expenditure budget cover any federal tax expenditure that reduced State revenues by \$1 million or more. For nearly all of these federal flow-through tax expenditures, there is no information on State tax returns and little or no information on available federal tax return information that would be required in order for the Department to estimate the amount of the tax expenditure. It is also unclear how useful this information would be to the Governor or the Legislative Finance Committee, since the State cannot amend the internal revenue code.

The requirement that State and local agencies provide information to the Department that is “necessary to complete the tax expenditure budget” is problematic in several respects. The bill provides no sanction to an agency that does not comply. Conversely, the bill is silent on how an agency that is bound by confidentiality or other non-disclosure statutes is supposed to reconcile those restrictions with the demands of this section.

Completing the first tax expenditure budget by October 15, 2009, as the bill requires, is not feasible.

#### **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.

TRD notes that without any statutory mandate, the department has undertaken a multi-year, comprehensive review and analysis of tax expenditures. The first report prepared as part of this effort has been completed and released. The second report is near completion. The department also recently released detailed information on tax expenditures in the form of business incentive credits in a joint report with the Economic Development Department to the Legislative Finance Committee and the interim Revenue Stabilization and Tax Policy Committee. The department believes that this comprehensive, multi-year plan will allow the department to provide the Governor and the Legislature a carefully prepared and highly useful series of reports that will help inform policy debates and policy decisions well into the future.

**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.

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