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

ORIGINAL DATE 02/03/12
SPONSOR SFC **LAST UPDATED** 02/15/12 **HB**

SHORT TITLE Manufacturing Property Gross Receipts **SB** 276/SFCS

ANALYST Walker-Moran

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY12	**FY13**	**FY14**	**FY15**	**FY16**		
Manufacturing GRT Deduction						
	~20%	**~40%**	**~60%**	**~80%**	**100% deduction after FY17**	
$0.0	($2,370.0)	($7,450.0)	($12,900.0)	($18,620.0)	Recurring	General Fund***
$0.0	($1,420.0)	($4,430.0)	($7,830.0)	($11,730.0)	Recurring	Local Governments
$0.0	($35.0)	($60.0)	($100.0)	($150.0)	Recurring	Small Counties Assistance
$0.0	($30.0)	($50.0)	($80.0)	($125.0)	Recurring	Small Cities Assistance
$0.0	($10.)	($17.0)	($30.0)	($40.0)	Recurring	Muni Equivalent Distribution
Construction-Related GRT Deduction *This estimate is the lower bound. The impact could be much higher*						
	Half-year	**Full-year**	**Full-year**	**Full-year**		
	($6,830.0)	($14,290.0)	($14,930.0)	($15,570.0)	Recurring	General Fund***
	($3,430.0)	($7,180.0)	($7,500.0)	($7,820.0)	Recurring	Local Governments
Small Cities Assistance & Small Counties Assistance						
	Half-year	**Full-year**	**Full-year**	**Full-year**		
		($5,060.0)	($5,150.0)	($5,190.0)	Recurring	General Fund (Cities)***
		($860.0)	($1,110.0)	($1,370.0)	Recurring	General Fund (Counties)***
		$5,060.0	$5,150.0	$5,190.0	Recurring	Small Cities Assistance
		$860.0	$1,110.0	$1,370.0	Recurring	Small Counties Assistance

(Parenthesis ( ) Indicate Revenue Decreases)

Duplicate of HB184 & HB 256 Substitute

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenues Department (TRD)
joint analysis with Department of Finance and Administration (DFA)
Economic Development Department (EDD)

SUMMARY

Synopsis of Senate Finance Committee Substitute Bill

Small Cities Assistance Fund: 1) The Senate Finance Committee substitute for Senate Bill 276 modifies the minimum amount distributed from $35,000 to $90,000. The effective date of the small cities distribution minimum is January 1, 2014. 2) The bill also modifies the formula for the Small Cities Distribution. The distribution increases to fifteen percent from the existing ten percent of the net receipts attributable to the compensating tax. Effective date is January 1, 2013.

Small Counties Assistance Fund: Senate Bill 276 proposed substitute changes the distribution formula to increase the amounts distributed.

The effective date of the small cities and counties assistance fund formula is July 1, 2013.

Manufacturers Gross Receipts Deduction: Senate Bill 276 amends section 7-9-46 NMSA 1978 to expand the existing deduction for tangible personal property to include the property consumed in the manufacturing process; provided that the tangible personal property is not a tool or equipment used to create the manufactured product.

The existing deduction extends only to tangible personal property incorporated as an ingredient or component part of the products that the buyer is in the business of manufacturing. Because utilities are defined as “tangible property” for GRT purposes, the proposed deduction would cover utilities.

The bill provides for an increasing deduction each year. Prior to CY14, twenty percent of receipts may be deducted; in CY14 forty percent of receipts may be deducted; in CY15 sixty percent of receipts may be deducted; in CY16 eighty percent of receipts may be deducted; and in CY17 and beyond, one hundred percent of receipts may be deducted. The full impact of the deduction will not be until FY18.

The purpose of the deduction is to encourage manufacturing businesses to locate in New Mexico and to reduce the tax burden, including reducing pyramiding, on the tangible personal property that is consumed in the manufacturing process and that is purchased by manufacturing business in New Mexico.

Construction Gross Receipts Deduction: Senate Bill 276 substitute amends section 7-9-52 NMSA 1978 to identify the definition of “construction-related services” in the Gross Receipts Tax deduction for construction services to persons engaged in the construction business. The bill also adds a new section to allow a deduction for receipts from leasing construction equipment if it is leased to a person engaged in the construction business who delivers a nontaxable transaction certificate to the person leasing the construction equipment. The service deduction and the equipment leasing deduction would be available only for sales to a construction business for use in a taxable construction project.

The effective date of the manufacturing and construction GRT deductions is January 1, 2013.

There is no sunset date. The LFC recommends adding a sunset date.

FISCAL IMPLICATIONS

This bill may be counter to the LFC tax policy principle of adequacy. According to the LFC staff General Fund Recurring Appropriation Outlook for FY14 and FY15, December 2011 forecasted revenues will be insufficient to cover growing recurring appropriations.

***<u>Full Implementation</u>: When fully implemented the total impact on the general fund of the measures in this bill in FY17 is at least $50 million.

Historically the Small Cities and Small Counties Funds have not reverted large amounts to the general fund therefore the impact to the general fund from the distribution change will be significant. Currently, the formula for Small County Assistance does not distribute the full amount of compensating tax distributed to the program. The remainder reverts to the General Fund. The proposed changes would increase the amount of the current earmark of compensating tax that is distributed each year thus reducing the General Fund reversion. The fiscal impact applies to distributions beginning in FY14. The increase in the distribution amount from ten percent to fifteen percent going to the Small Cities Assistance Fund decreases the amount going to the general fund starting on January 1, 2013. The calculation uses the compensating tax estimate in the December 2011 Consensus Revenue Estimate.

Per DFA, the small cities and small counties assistance changes were computed using 1) the consensus forecast of total compensating tax revenue, (2) worksheets used by the Taxation and Revenue Department (TRD) and the DFA to make annual distributions under each program. The small cities assistance changes were calculated using 2010 U.S. Census population totals and FY11 taxable gross receipts data provided by TRD.

<u>Manufacturing Deduction</u>: The negative impact to the general fund in FY13 for half a year is $2.4 million; $7.5 million in FY14; $12.9 million in FY15; and $18.6 million in FY16. There is also a negative impact on the local governments, the small cities assistance fund, the small counties assistance fund and the municipal equivalent distribution. The estimate above uses data from the U.S. Bureau of Economic Analysis, the U.S. Census Bureau's Economic Census, and the Taxation and Revenue Department (TRD) to calculate the gross receipts tax (GRT) base. The impact uses the average state gross receipts rate of 7 percent and a 60/40 split of GRT between general fund and local governments to estimate the impacts. The estimate applies the consensus revenue growth rate for GRT and compensating tax to determine the fiscal impact in the out years. The first year impact is ½ of an annual total, as the legislation takes effect halfway through FY13. The estimates represent 20% of receipts in CY2013, 40% in CY2014, 60% in CY2015, 80% in CY2016 and 100% in CY2017 and thereafter.

The revised manufacturing GRT deduction estimate includes oil and gas extraction, 50% of mining support activities, and power-generation. "Manufacturing" as determined by the GRT statute includes natural gas processing and refining, but does not include production. The inclusion of these sectors increases the estimated impact by about 16%. Since this figure includes production, the total fiscal impact is likely smaller.

Construction-Related Deduction: Recognizing that the estimate may be underestimated due to the uncertainty in the data that is available, the estimate could be a lower bound of the actual deduction. The lower bound impact to the general fund in FY13 for half a year is $6.8 million; $14.3 million in FY14; $14.9 million in FY15; and $15.6 million in FY16. These impacts could increase by up to 20 percent. There is also a negative impact on the local governments.

Per TRD and DFA, the construction GRT estimate is highly uncertain. Input-output data from the U.S. Census Bureau were used to determine the total amount of business-to-business sales in the construction industry in New Mexico. Roughly 50% of professional services provided to the construction industry were assumed to be eligible for the proposed new deduction. The estimate also assumes 80% of construction-related leasing services would be eligible for the deduction. The combined state and local average GRT rate was applied to calculate the fiscal impact.

The revised construction GRT deduction estimate takes into account oil and gas drilling, which is included in the Taxation and Revenue Department's regulated definition of "construction." This inclusion increases the total fiscal impact by about 20 percent. Due to the language in Section 5, Subsection B, which limits the deduction to projects subject to GRT upon completion, the total impact of oil and gas drilling will likely be small.

SIGNIFICANT ISSUES

According to the TRD, this proposal could reduce the incidence of "pyramiding" or multiple points of taxation of manufactured goods. With total gross receipts tax rates close to 7 percent statewide, the economic impacts of "pyramiding" in the GRT have increased significantly. Pyramiding occurs when inputs sold by one business to another in a multi-stage manufacturing process are not deductible. Under present law, the final price of a manufactured product, for example, includes the gross receipts tax at least twice, once on each input billed to the business that is manufacturing a product, and once on the final sale of the product.

According to EDD, GRT relief for manufacturing entities will encourage greater capital investment and employment growth in New Mexico.

There is a question on how many new jobs if any the construction deduction will create. This analysis does not estimate the economic impact of either one of the deductions.

A recent study by Ernst & Young ranked New Mexico last in terms of tax competiveness on new investment. Gross receipts tax imposed on business inputs was largely to blame for the low ranking. In contrast, Oregon, which was ranked second best, imposes no sales tax on business inputs. According to a new Ernst & Young study released January 23, 2012 after incentives are included New Mexico still ranks first in some industries compared to 8 other states but its rank improves for other industries when incentives are included. [1]

---

[1] For more detail please refer to "New Mexico Business Tax Competitiveness and Simulations of Selected Tax Policy Changes" by Ernst & Young, January 23, 2012.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is met since TRD is required in the bill to report annually to the Revenue Stabilization and Tax Policy committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose. The taxpayer is also required to report the amount deducted separately for each deduction.

ADMINISTRATIVE IMPLICATIONS

Per TRD, developing a list of construction services and leased equipment that will be deductible pursuant to this bill may be difficult. The Department's role will be to approve the request of a contractor to issue construction services non-taxable transaction certificates. (CS-NTTC). In the past, the Audit and Compliance Division of TRD has enforced this restricted interpretation by auditing architects and construction-related services providers. The architect or other service provider cannot accept the Type-6 NTTC in good faith to prove a deduction. The estimate reported above assumes that construction-related service providers are compliant. However, if there is an increase in non-compliance as a result of the bill, the fiscal impacts could be higher than those shown. One effect of this bill would be to bring construction-related service providers into compliance with the law.

TECHNICAL ISSUES

"Consumed in the manufacturing process" needs to be defined through regulation. A definition of tool or equipment would be beneficial and regulations would need to be promulgated. The definition and instructions should make clear the types of tangible personal property that would be considered as eligible.

ALTERNATIVES

The EDD recommends that in order to stimulate the New Mexico economy, the manufacturing sector should be reviewed for any impediments to growth; a reduction in the cost of doing business will create jobs for the state and all options should be considered.

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:amm