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

ORIGINAL DATE 3/2/15
SPONSOR Harper **LAST UPDATED** **HB** 491

SHORT TITLE Reduce Multiple Tax Rates **SB**

ANALYST van Moorsel

APPROPRIATION (dollars in thousands)

Appropriation						Recurring or Nonrecurring	Fund Affected
To Fund	**FY15**	**FY16**	**FY17**	**FY18**	**FY19**		
State Road Fund	$0.0	$243,333.3	$243,333.3	$243,333.3	$0.0	Recurring	General Fund
Local Road Projects	$0.0	$30,000.0	$30,000.0	$30,000.0	$0.0	Recurring	General Fund

Parenthesis ( ) indicate expenditure decreases

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY15	**FY16**	**FY17**	**FY18**	**FY19**		
Indeterminate – See “Fiscal Implications”						

(Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY15	FY16	FY17	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	High Impact – See “Administrative Implications”				Recurring	TRD

Parenthesis ( ) indicate expenditure decreases

Conflicts with SB 346 – Tax Reform

SOURCES OF INFORMATION
LFC Files

Responses Received From
This FIR will be amended pending submission of Taxation and Revenue Department’s response.

SUMMARY

Synopsis of Bill

House Bill 491 implements wide ranging changes to New Mexico's tax structure by significantly broadening the Gross Receipts Tax (GRT) base and reducing the tax rate. The bill reduces several other taxes, repeals exemptions and deductions, makes appropriations, and changes distribution of certain tax tax revenues.

The bill approporiates $850 million from the general fund to the state road fund for expenditure in FY16-FY18. Unexpended or unencumbered balances at the end of each fiscal year revert to the general fund.

- $243.3 million is appropriated in each of the three years for maintenance, construction and improvement of state transportation projects; and
- $30 million is appropriated in each of the three years for local road projects.

The bill reduces the following tax rates:

- Corporate Income Tax (CIT) is reduced to 4.7 percent on the first $500 thousand of net income and 4.9 percent of income over $500 thousand;
  - The nonprofit exemption from CIT is repealed;
  - The bill creates a credit against CIT liability for GRT and compensating tax paid on uranium enrichment and sales of uranium hexafluoride.
  - The bill creates a credit against CIT liability for GRT and compensating tax paid on locomotive engine fuel.
- Gross Receipts Tax (GRT) is reduced from 5.125 percent to 2.0725 percent;
  - exemption from GRT is created for receipts of donations to 501(c)(3) organizations.
- Municipal Gross Receipts Tax is limited to an imposition of 1.24 percent;
- County Gross Receipts Tax is limited to 0.4375 percent;
- Governmental Gross Receipts Tax (GGRT) is reduced from 5 percent to 2.0725 percent;
- Compensating Tax is reduced from 5.125 percent to 2.0725 percent;
  - The percentage of the comp tax distribution to municipalities is adjusted;
  - The credit against compensating tax for amounts previously paid on materials that became a component of real property, the receipts of whose sale are subject to GRT;
- Motor Vehicle Excise Tax (MVEX) is reduced from 3 percent to 2.0725 percent;
  - MVEX revenue is transferred to the state road fund rather than the general fund;
- Leased Vehicle Gross Receipts Tax is reduced from 5 percent to 2.0725 percent; and
- the Tax on Boats is reduced from 5 percent to 2.0725 percent.

The bill repeals:

- the Estate Tax Act;
- certain local option gross receipts taxes;
- the Supplemental Municipal Gross Receipts Tax Act;
- the Local Hospital Gross Receipts Tax Act;
- the County Correctional Facility Gross Receipts Tax Act;
- the Special County Hospital Gasoline Tax Act; and

- the second distribution of GRT revenue to the state aviation fund.

The bill also:

- amends the Income Tax Act to exclude gifts from "modified gross income;" increase the Working Families Tax Credit (WFTC) from ten percent to 15 percent of the federal Earned Income Tax Credit; and create an exemption from personal income tax for donations received by 501(c)(3) organizations;
- amends, repeals, and enacts certain credits, deductions and exemptions pursuant to the Income Tax Act, the Corporate Income and Franchise Tax Act, and the Gross Receipts and Compensating Tax Act, including the film production tax credit;
- amends percentages of local tax effort in the Small Cities and Small Counties Assistance Acts; adjusts the county equalization distribution percentage;
- strikes additional distributions from the small counties assistance fund as the county GRT impositions are repealed.
- replaces the county obligations to the county-supported Medicaid fund and the safety net care pool (SNCP) with the following state obligations of GRT:
  - 0.014 percent to the Medicaid Fund; and
  - 0.018 percent to the Safety Net Care Pool Fund; provides temporary amnesty from penalties and interest on taxes not paid;
- provides the repeal of certain taxes shall not impair outstanding bonds or loan guarantees.
- creates new definition sections for statutes governing municipal and county revenue bonds.
- replaces references to specific local government GRT increments with reference to local option GRT revenue.

Amendments to and repeals of sections in the Income Tax and Corporate Income and Franchise Tax Act apply to tax years beginning on or after January 1, 2016.

The effective date of most provisions of the act is January 1, 2016. The effective date of the "additional repeals" section is January 1, 2017.

FISCAL IMPLICATIONS

Because this bill makes significant and wide-ranging changes to the tax code estimating the bill's fiscal impact is extremely difficult and subject to a high degree of certainty. As such, the revenue table states the impact as indeterminate. The Taxation and Revenue Department also reports it did not estimate the fiscal impact of the bill.

During the 2014 interim the Legislative Council Service contracted with UNM's Bureau of Business and Economic Research to perform a study of the gross receipts tax base. Dr. Lee Reynis, Research Professor of Economics and Director of the Institute for Applied Research Services at UNM, presented the results of the study to the Revenue Stabilization and Tax Policy Committee in December 2014 (See other Substantive Issues for more detail).

Modeling the impact of a proposed transaction tax, Dr. Reynis reported first that the model estimated a transactions tax base of $248.7 billion. Applying a 2.125 percent transaction tax would yield revenues of $5.3 billion. These revenues would need to replace the following general fund revenues:

General sales taxes:	~$2.00 billion
Certain excise taxes:	~$0.12 billion
Income taxes:	~$1.51 billion.
Total	~$3.63 billion

BBER estimated the revenue balance would be a positive $1.66 billion, but added the state gross receipts tax is shared with municipalities thru a 1.225 percent distribution. Keeping local governments whole in 2012 would require a distribution of $418 million, leaving $1.24 billion.

Although the transaction tax modeled by BBER projected a surplus, it is unclear whether the tax reform proposed in this bill, which limits the lower rates to sales and use taxes, would generate sufficient revenue to maintain state government and local government services. The bill imposes the lower state and local GRT rates, reduces exemptions and deductions, and reduces the CIT top rate to the top PIT rate.

It appears the bill is intended to generate a surplus above the amount needed to maintain state spending. The bill would spend that surplus through:

- an increase in the Working Families Tax Credit (WFTC), estimated to cost the general fund approximately $30 million per year,
- channeling the reduced motor vehicle excise tax revenue to the state road fund (general fund impact – loss of $145-$150 million; road fund gain - approximately $100-$105 million); and
- appropriating $850 million in additional general fund money to the state road fund for state and local projects in FY16-FY18.

Perhaps the biggest risk to such a proposal is the broad nature of the changes. The bill makes many significant changes whose fiscal impact would be difficult to model in isolation. Making these changes at the same time as other equally significant tax policy changes introduces uncertainty that makes estimating the fiscal impact impossible given the short timeframe and limited resources available.

Revenue Adequacy. A concern arising from such uncertainty is whether the tax code, after such large changes, would generate sufficient revenues to maintain the services provided by state government. The LFC tax policy principle of adequacy states that revenue should be adequate to fund needed government services. Should the rates proposed in this bill generate insufficient revenue, the state would be forced to cut services pending further legislation to adjust tax rates to generate additional revenue. Uncertainty about state revenue sufficiency could contribute to uncertainty about the state's ability to provide basic services such as public safety and education or pay its debt obligations, which could in turn discourage investment in New Mexico. The uncertainty concerning revenue adequacy also applies to local governments – it is unclear whether the lower local option GRT rate limit would provide counties and municipalities with sufficient revenue to operate.

On the other hand, generating too much revenue could have negative effects as well. A sharply increased tax burden could discourage investment in New Mexico while placing additional financial pressure on low-income taxpayers. The increased revenues could also take a large amount of money out of the economy, slowing economic growth.

SIGNIFICANT ISSUES

The intent of the legislation to reform New Mexico's tax system by reducing the GRT rate and significantly broadening its base while reducing other tax rates to the same level. This supports LFC's tax policy principle of efficiency which states the tax base should be as broad as possible.

Pyramiding. GRT base erosion has contributed to increased GRT rates at the state and local levels. Increased rates also exacerbated tax pyramiding, which occurs when GRT is applied to business-to-business purchases of supplies, raw materials, and equipment, taxed at each stage of production. This is a critical issue for New Mexico because GRT taxes professional services not taxed in other states, such as legal services, accounting services, and transportation. Pyramiding can force price increases and make New Mexico industries less competitive compared with other states. The 2011 NMTRI/Ernst & Young business competitiveness study estimated effective New Mexico tax rates for business support services, electrical equipment manufacturing and aerospace products and parts were in over 20 percent before tax incentives. After incentives, business support services and electrical equipment manufacturing sectors had effective tax rates over 10 percent. In all these sectors, GRT pyramiding contributed to the high effective rate.

The bill eliminates several tax preferences intended to minimize the effects of tax pyramiding. The intent appears to impose a rate low enough to minimize the anticompetitive effects of pyramiding even without anti-pyramiding tax preferences. It remains unclear whether the rate can be set low enough to minimize the effects of pyramiding, however, particularly in industries with many business-to-business transactions.

Legislation in 2012 to address pyramiding in the manufacturing and construction sectors was onerous to administer and more open-ended than intended, doubling its estimated fiscal impact and requiring legislation to reduce the revenue losses. Future anti-pyramiding legislation should be carefully constructed to avoid ambiguity and uncertainty.

In its analysis of the similar SB 346, TRD notes there may be instances where a taxpayer was enticed to locate a business in New Mexico in response to the availability of certain credits, deductions, or exemptions, and in which a taxpayer could conceivably, though not necessarily successfully, challenge the repeal on equitable estoppel grounds. This bill creates credits for two such repealed incentives – the uranium enrichment and locomotive fuel tax credits against GRT.

ADMINISTRATIVE IMPLICATIONS

TRD reports the bill provides for the comprehensive amendments to numerous tax programs. These changes, particularly the changes to the state and local government gross receipts tax, would necessitate significant changes in reporting requirements by taxpayers, significant reformation and/or repeal of the NMAC's tax-related provisions, and significant changes in tax administration, including, changes in monitoring software, forms, and publications.

For instance, TRD projects the bill will have a high impact on the Information Technology Division, noting it would need to change GenTax & Taxpayer Access Point documents and combined reporting system (CRS) and personal income tax returns; CRS Rate structure and rates for all rate types on each location; Business Objects for CRS return pre-popping, daily and monthly distribution in revenue accounting model; and multiple CRS reports and letters.

OTHER SUBSTANTIVE ISSUES

Dr. Reynis stated BBER developed a modeling tool using an IMPLAN model and proprietary data bases for 2012. Dr. Reynis explained IMPLAN is a widely used regional economic model that is based on Input-Output analysis. She added the model databases that were used provide aggregates that can be used in estimating the gross receipts tax base as well as the tax base for alternative broad-based taxes, such as a tax on transactions. Data series include data on sales, on interbusiness purchases, on exports abroad and within US.

Dr. Reynis reported the effort to develop the model demonstrated the promise of I-O models like IMPLAN. However, she added:

- Activity was not always correctly classified;
- Misclassification creates problems if occurring in specific exemptions or deductions as they can exhaust tax base in a particular industry.
- Difficulty exists in aligning exemptions and deductions with specific industries, particularly in the case of deductions for manufacturing and construction.
- The lack of 2012 economic census data was a major issue, particularly for treatment of wholesale and retail trade.

Dr. Reynis also noted:

- The IO model is not a dynamic model, and IO model estimates of inter-business sales are not the same as capturing individual business transactions and having the tax pyramid as purchases move up the stages of production.
- The analysis only deals with the state's general fund. No analysis was done concerning the adequacy of revenues to municipalities and counties or concerning governmental gross receipts tax revenues.
- The analysis did not address the federal tax deductibility of receipts from this transaction tax.

ALTERNATIVES

The large amount of uncertainty surrounding the bill indicates implementation of the tax reform proposed within would come with considerable risk. An alternative would be to attempt to study the issue further. The General Appropriation Act of 2014 included an appropriation to perform such a study, but the appropriation was vetoed. Such a study may help to develop a tax reform proposal with safeguards against revenue insufficiency while also protecting against a sharp increase in the tax burden, particularly for low-income taxpayers.

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

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