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

SPONSOR SCORC **ORIGINAL DATE** 2/10/17 **LAST UPDATED** 3/06/17 **HB**

SHORT TITLE Income Tax Rates & Pre-K Funding **SB** CS/344/SCORCS

ANALYST Clark

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
$0.0	$20,000.0	$49,500.0 - $78,800.0	$11,100.0	$11,400.0	Recurring	General Fund
$0.0	$0.0	$0.0	$11,300.0	$23,300.0	Recurring	Public Pre-K Fund
$0.0	$0.0	$0.0	$11,300.0	$23,300.0	Recurring	CYFD Pre-K Fund
$0.0	$0.0	$0.0	$67,500.0	$46,500.0	Recurring	Public School Fund for SEG Distrib.

Parenthesis ( ) indicate expenditure decreases.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY17	FY18	FY19	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	Minimal	Minimal	Minimal	Minimal	Recurring	TRD operating

Parenthesis ( ) indicate expenditure decreases.

Conflicts with other bills affecting personal income tax rates, including: HB-117, HB-169, HB-201, HB-310, HB-311, and SB-50

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Public Education Department (PED)

SUMMARY

Synopsis of Bill

Senate Corporations and Transportation Committee Substitute for Senate Bill 344 adds a new upper bracket for personal income taxes (PIT), changes the capital gains deduction, and adds new distributions from PIT revenues. It also makes changes to the statutes for the public pre-kindergarten fund and the Children, Youth and Families Department (CYFD) pre-kindergarten fund to provide that these additional distributions shall be used for early childhood care and education services provided for prenatal care through third grade. The changes to the fund statutes are effective January 1, 2019.

Prior to FY20, the bill makes no changes to distributions, and all new PIT revenue flows to the general fund. For FY20, the bill distributes 4.5 percent of PIT revenues to the public school fund for state equalization guarantee (SEG) funding and 0.75 percent each of PIT revenues to the public pre-k and CYFD pre-k funds.

In FY21 and subsequent years, the bill distributes 3 percent of PIT revenues for SEG funding and 1.5 percent each to the public pre-k and CYFD pre-k funds.

The bill makes two changes affecting PIT revenues prior to distribution. It adds a top bracket with a 6.4 percent marginal tax rate to each filing status for personal income tax. It also reduces the net capital gains deduction to $1,000 from the current maximum of $1,000 or 50 percent of the capital gains included on a federal tax return. The PIT rate and capital gains deduction changes are applicable to tax years beginning January 1, 2018.

The floor amount for the higher 6.4 percent rate is as follows:

	Taxable income is
Married Filing Separate	Over $125,000
Heads of Household, Married Filing Joint and Surviving Spouse	Over $250,000
Single and estates and trusts	Over $166,667

Finally, the bill repeals an old version of PIT rate statutes as clean-up.

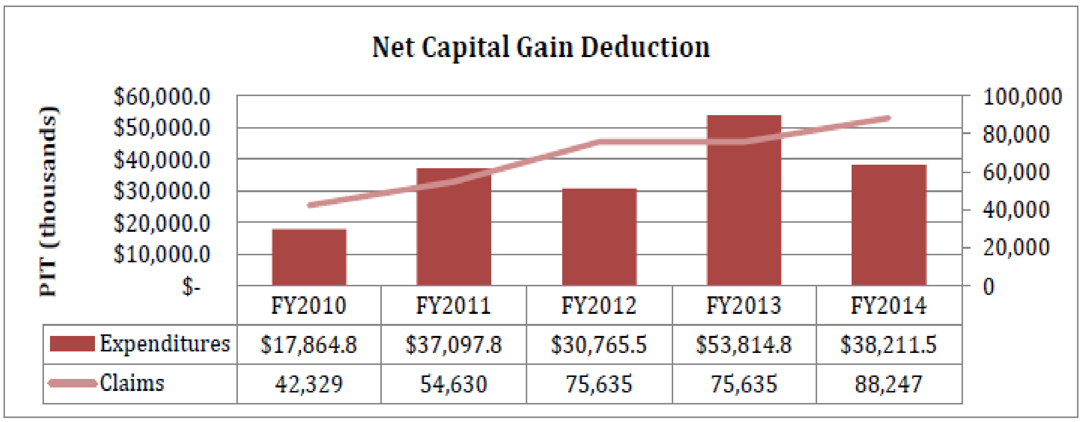
FISCAL IMPLICATIONS

Capital Gains Deduction Reduction:

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	FY18	FY19	FY20	FY21		
$0.0	minimal	$19,100.0 - $38,200.0	$39,000.0	$40,300.0	Recurring	General Fund

(Note: the minimal amount for FY18 is caused by timing, not liability. The capital gains reduction is applicable for tax year 2018 and beyond. Few higher-income taxpayers will adjust their estimated payments for the April and June 2018 payments because of the existence of the so-called “safe-harbor” feature. If higher-income taxpayers pay as much in total estimated payments for TY18 as they owed for TY17, there would be no penalty. The extra amount would be paid primarily as a final settlement in April 2019. Some taxpayers adjust withholding from salaried employment to account for the additional taxes accruing to capital gains. The range shown for FY19 demonstrates the uncertainty in the proportion of taxpayers who would file extensions and submit final settlements in the following fiscal year.

LFC staff estimated the fiscal impact based on 2014 New Mexico federal taxpayer data and New Mexico tax expenditure data reported in the TRD 2015 Tax Expenditure Report (TER). The consensus revenue estimating group revenue projections show increasing personal income tax revenues over time, but the increases are dwarfed by historic swings in the cost of this tax expenditure. Market volatility could cause individual years to be higher or lower than the given estimates.



2015 New Mexico Tax Expenditure Report Page 117

As reported in the 2015 TER, the cost of the deduction has varied; during the five-year period from FY10 - FY14, the expenditure was as low as $17.9 million (FY10) and peaked at $53.8 million (FY13). The five-year average expenditure for this period is $35.6 million, but there is also an upward trend as the country exited the recession and markets began to recover.

Of further note, there is a loose correlation between the year-ending stock market price and the value of capital gains reported for a particular year. In January 2017, the Dow-Jones industrial average exceeded 20,000 for the first time in history, and many observers are expecting President Trump to continue to execute policies favorable to job growth and growth in the economy and, concomitantly, the stock prices.

The savings from this portion of the bill would be nearly as great as if the deduction were eliminated altogether. Using the highest number of claims reported in the five-year period shown in the 2015 TER, and using an average tax rate for all filers of 4.3 percent, if all claimants qualified for the $1,000 maximum deduction in the bill, the cost to the state would be $3.8 million annually – an order of magnitude less than the current cost of the deduction.

New PIT 6.4 Percent Bracket

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
$0.0	$20,000.0	$30,400.0 - $40,600.0	$62,100.0	$64,200.0	Recurring	General Fund

A note here similar to the note on the receipt of revenues occasioned by the reduction of capital gains: in the case of the new top bracket at 6.4 percent, the withholding tables would be adjusted for January 2018. Thus, the state would receive a portion of the revenue from salaried taxpayers beginning with FY18. However, non-salaried or employed higher-income taxpayers affected by the new rate would probably not adjust their estimated payments and pay off the additional liability as a final settlement in April 2019, with some using extensions to make final payments in FY20. The range shown for FY19 demonstrates the uncertainty in the proportion of taxpayers who would file extensions. There is also the possibility of business owners paying through PIT who have a business fiscal year that starts on a date other than January 1 and whose final settlements might occur in the following fiscal year.

New PIT Distributions

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
$0.0	$0.0	$0.0	($90,000.0)	($93,100.0)	Recurring	General Fund
$0.0	$0.0	$0.0	$11,300.0	$23,300.0	Recurring	Public Pre-K Fund
$0.0	$0.0	$0.0	$11,300.0	$23,300.0	Recurring	CYFD Pre-K Fund
$0.0	$0.0	$0.0	$67,500.0	$46,500.0	Recurring	SEG Funding Formula

These impacts have been derived from the December 2016 consensus revenue estimating group update.

This bill provides for continuing appropriations. LFC has concerns with including continuing appropriation language as earmarking reduces the ability of the legislature to establish funding priorities.

SIGNIFICANT ISSUES

In response to a similar bill, TRD noted on the capital gains portion, "…although 100 percent of New Mexico taxpayers are eligible to claim the net capital gains deduction (NCGD), a taxpayer must have qualifying income to apply it. Over 65 percent of the NCGD claimants have taxable incomes less than $100 thousand. These claimants account for approximately 30 percent of the total deduction amounts claimed. In contrast, the top 10 percent of wage earners claiming a NCGD account for over 66 percent of net capital gain income earned. To maximize this deduction, a taxpayer must have net capital gain income greater than $25 thousand. During tax year 2013, federal income tax data indicates that the average amount of net capital gain income earned by New Mexico taxpayers was $13.7 thousand, indicating that many New Mexico taxpayers are using this deduction based on small amounts of capital gain income, such as from the sale of a residence or from interim withdrawals from a retirement account. From a revenue adequacy perspective, this bill has the positive effect of increasing state revenues. However, [reducing] the deduction will have an adverse effect on a large segment of claimants whose income is under $100 thousand and may result in outward emigration of high wage earners."

LFC staff note that this bill clearly proposes a tax increase. On the other hand, it can be seen as partially restoring a previous (2003) PIT rate cut. The 2003 cut was enacted in an attempt to make the state more attractive to businesses seeking to relocate or expand.

The Pre-Kindergarten Act, Sections 32A-23 through 32A-23-9 NMSA 1978, provides "Any money appropriated for pre-kindergarten programs shall be divided equally between the public education department and the children, youth and families department." The equal distribution requirement may result in the inability of the Public Education Department (PED) to expand services as quickly as the Children, Youth and Families Department (CYFD) due to capital infrastructure needs for additional classrooms in public schools. However, school districts may look at contracting for additional capacity growth.

In addition, the Pre-Kindergarten Act provided services for four-year-olds; however, in recent fiscal years, CYFD began piloting early prekindergarten for three-year-olds. As the bill reads now, these funds would not be eligible for early prekindergarten. A suggested amendment would be to expand the language to allow these funds for early prekindergarten.

For FY17, CYFD and PED are budgeted to serve 8,496 four-year-old children in state-funded prekindergarten. This includes 5,248 children budgeted for PED and 3,248 children budgeted for CYFD. The CYFD number does not include 997 three-year-old children served in early prekindergarten programs. The overall number of children served has decreased as more children are served in extended-day programs. In FY16, PED served 1,104 children in extended-day programs. PED is serving 1,346 children in extended-day programs in FY17.

The FY18 LFC recommendation for public school support includes $21 million in general fund appropriations and $3.5 million of TANF funds for the public pre-kindergarten fund. Balances in the fund do not revert, and recurring appropriation recommendations for prekindergarten have remained flat since FY16.

ADMINISTRATIVE IMPLICATIONS

There would be a minimal administrative impact.

CONFLICT

This bill conflicts with other bills amending the personal income tax act. These include at this point: HB-48, HB-76, HB-117, HB-169, HB-196, HB-201, HB-310, HB-310, HB-311, and SB-50.

JC/sb