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

LAST UPDATED

SPONSOR Brown/Armstrong **ORIGINAL DATE** 2/8/23

SHORT TITLE Index Social Security Income for Taxes **BILL NUMBER** House Bill 193

ANALYST Faubion

REVENUE*
(dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY23	FY24	FY25	FY26	FY27		
--	--	(minimal but negative)	(minimal but negative)	(minimal but negative)	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases
*Amounts reflect most recent version of this legislation.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT*
(dollars in thousands)

	FY23	FY24	FY25	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
	$5.6	$5.6	$5.6	$16.8	Recurring	TRD/ITD
Total	**$5.6**	**$5.6**	**$5.6**	**$16.8**		

Parentheses ( ) indicate expenditure decreases.
*Amounts reflect most recent version of this legislation.

Conflicts with HB192.

Sources of Information
LFC Files

Responses Received From
Aging and Long-Term Services Department (ALTSD)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of House Bill 193

House Bill 193 annually adjusts the income caps on the income tax exemption for social security income to account for inflation.

The provisions in this bill apply to taxable years beginning on or after January 1, 2023.

FISCAL IMPLICATIONS

Currently, social security income is exempt from state income tax for individuals with income of less than $75 thousand for married filers filing separately, $150 thousand for heads of household, surviving spouses, and married filers filing jointly, and $100 thousand for single filers. This bill will annually adjust the income caps by a ratio of the consumer price index, increasing the income levels by the inflation rate, except in instances where the inflation rate would result in a downward revision.

The current social security exemption estimate in the Consensus Revenue Estimating Group (CREG) December 2022 forecast for Personal Income Tax (PIT) is based on modeling the impact at the current adjusted gross income (AGI) levels. To scale the impact of this exemption to tax year 2022 and into the forecast horizon, the Taxation and Revenue Department (TRD) utilized a combination of a) the growth in Social Security outlays forecasted by the Congressional Budget Office (CBO)[1], b) the growth rate of the population 65 years and older in New Mexico relative to the United States[2], and c) the cost-of-living-adjustment (COLA) to Social Security and Supplemental Security Income (SSI) benefits for calendar year 2022[3,4]. Thus, a portion of the indexing of the AGI thresholds will be captured in the growth rates currently assumed for this population because it captures inflationary increases to social security benefits which then roll-into increases in overall AGI. But, if the AGI thresholds are not indexed, over time fewer taxpayers will be eligible for the exemption as their AGI increases with inflation (see *Significant Issues*). Thus, the bill proposal will reverse the slow increase in revenue to the general fund as taxpayers lose the exemption qualification, by indexing the income thresholds to inflation. This has a minimum impact year over year but in aggregate would build up more year after year with no indexing.

This bill creates or expands a tax expenditure with a cost that is difficult to determine but likely significant. LFC has serious concerns about the significant risk to state revenues from tax expenditures and the increase in revenue volatility from erosion of the revenue base. The committee recommends the bill adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting or action be postponed until the implications can be more fully studied.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

SIGNIFICANT ISSUES

This bill requires the income caps that determine eligibility for the social security exemption to index to inflation, allowing incomes to naturally rise with inflation without "graduating" people off the exemption. Without adjusting the income eligibility for inflation, the exemption will slowly "phase out" as people's incomes rise above the static eligibility income thresholds. Allowing tax expenditures to phase out with inflation acts like a gradual sunset and allows future

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[1] https://www.cbo.gov/publication/57342

[2] Population Projections, United States, 2004 - 2030, by state, age and sex, on CDC WONDER Online Database, Sept. 2005.

[3] https://www.ssa.gov/cola/

[4] 2022 COLA adjustment at 5.9% was significantly higher than the average in the last five years of 1.6%. An adjustment was, therefore made to CBO's projected outlays to account for this higher than expected adjustment as well as to account for the current high inflationary expectations in FY2022 and FY2023.

legislatures to decide whether the exemption should be continued and at what level. Indexing the income thresholds creates permanence to this exemption, requiring statutory changes to eliminate or reduce the benefit.

TRD notes the following policy issues:

> Over time, if the adjusted gross income (AGI) levels are not indexed to inflation, recipients of social security income will no longer qualify for the exemption. Slowly, fewer taxpayers will be eligible for the exemption as their AGI increases with inflation. In 1984, when the federal government subjected a portion of social security benefits to federal income taxes, they did not index the combined income thresholds at which point social security benefits are taxable. Since 1984, wage and retirement income have increased and therefore the proportion of beneficiaries paying federal tax on their benefits and the amount of taxable social security benefits is rising over time. The new proposed indexing of the AGI ranges will thus maintain the proportion of taxpayers eligible for the exemption relative to their real inflation adjusted-income. This will maintain progressivity in the income tax structure to preserve this exemption among low and middle-income recipients of social security where progressivity being where higher-earning taxpayers pay a larger share of their income in tax compared to lower-earning taxpayers.

In current statute, there is a "cliff effect" at the income caps where those with incomes just under the cap do not pay income tax on their social security income, while those with incomes just over the cap do pay income tax on their social security income. This erodes horizontal equity at those income levels near the exemption caps as those with similar incomes are not treated equally.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met since TRD is <u>not</u> required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the exemption and other information to determine whether the exemption is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

By annually indexing the AGI level for the Social Security income exemption, this may increase the number of suspended PIT returns among paper filers who have not calculated correctly. This will increase PIT return processing in the Revenue Processing Division of TRD. Updates to forms, instructions and publications will be incorporated into annual tax year implementation. These changes will cost $5,554 in recurring workload costs for TRD's Information Technology Division (ITD).

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

House Bill 193 conflicts with House Bill 192, which removes the income caps for the social security income tax exemption.

TECHNICAL ISSUES

The 'consumer price index' referenced in the proposed sub-section B, is not defined. TRD suggests using the following definition currently in law for the indexing of the Low-Income Comprehensive Tax Rebate, Section 7-2-14 NMSA 1978. "Consumer price index" means the consumer price index for all urban consumers published by the United States department of labor for the month ending September 30.

On page 2, line 13, the formula refers to multiplying each amount of "modified gross income." TRD suggests the amount referenced should be changed to "adjusted gross income."

OTHER SUBSTANTIVE ISSUES

At the federal level, if a taxpayer's adjusted gross income (AGI) including half of social security benefits totals less than $32 thousand for married couples filing jointly or $25 thousand for single filers, none of the benefit amount is included in gross income. Accordingly, none of it is subject to federal income tax or state income tax. For AGI including half of social security benefits that exceeds $44 thousand for married joint and $34 thousand for single, then 50 percent to 85 percent of social security income is taxable.

Reducing or eliminating income tax on social security benefits is often viewed as a mechanism for attracting or retaining retirees in the state. A 2018 publication by New Mexico State University included the following discussion:

> Because New Mexico is listed as one of the "10 Least Tax Friendly" states for retirees (Kiplinger, 2017), additional research should be conducted on the impacts of reducing or eliminating taxes on retirement. However, it should be noted that while tax friendliness is often listed as a top criteria on "best places to retire" lists, other research has shown that tax policy changes have done nothing to attract retirees (Conway and Rork, 2012).[5]

The consideration of exempting social security and eroding horizontal equity must be placed in context of the federal and state tax structure, in its entirety. As far as attracting more retirees to the state is concerned, exempting social security from income taxation may not necessarily help in achieving that goal. For example, Texas does not tax any income, social security or otherwise, at all. Yet, the state features as one of the least tax friendly states for retirees in the country because of its high property and sales taxes. Notably, New Mexico's property taxes are among the lowest in the nation. It is, therefore, necessary to take a holistic look at New Mexico's tax code, and attempts should be made to make the tax structure more simple, broad based, and equitable, without being punitive to any segment of the population.

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.

[5] Potential Fiscal Impacts of a New Mexico Retiree Attraction Campaign, December 2018 https://aces.nmsu.edu/pubs/_circulars/CR691.pdf

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

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted**: The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted**: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent**: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable**: The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective**: The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions "but for" the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LFC Tax Expenditure Policy Principle	Met?	Comments
Vetted	?	The issue has not been discussed at an interim committee recently. The issue was discussed during the 2022 legislative session.
Targeted Clearly stated purpose Long-term goals Measurable targets	 ✗ ✗ ✗	No purpose, targets, or goals established.
Transparent	?	TRD will likely publish a cost estimate in its annual Tax Expenditure Report; however, no specific reporting on this exemption to interim committees is required.
Accountable Public analysis Expiration date	 ✗ ✗	 The bill contains no provisions for reporting. The bill does not include an expiration date.
Effective Fulfills stated purpose Passes "but for" test	 ? ?	Without a purpose statement or required reporting, it is not possible to determine if the exemption fulfills intended outcomes.
Efficient	✗	Without a purpose statement or required reporting, it is not possible to determine if the exemption is the most efficient means of achieving desired outcomes.
Key: ✓ Met ✗ Not Met ? Unclear		

JF/al/ne/rl