



*Improving New Mexico's Tax Incentives:
A Question of Balance*

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Incentives in Present Law

Tax Program	Targeted Economic Development Incentives	Other Incentives
Income Tax	5	13
Corporate Income Tax	4	10
Gross Receipts Tax, Withholding, Compensating Tax	27	8
Other Taxes	3	6

- Attached tables provide one listing of incentives in various tax acts, the number of incentives is summarized in the above table.
- Many incentives target activities other than economic development, e.g. environmental policy.
- Many incentives apply against the GRT & Withholding. In addition to being the largest liabilities for many firms, these are paid monthly.
- Annual cost of economic development tax credits alone is probably over \$80 million per year.

Principles of Good Tax Policy

- Adequacy: Revenues should be sufficient for essential government services
- Equity: Similar taxpayers should be treated similarly
- **Efficiency: Interference in the economy should be minimized**
- Simplicity: Laws should be easy to understand
- Comprehensiveness: All taxes matter when comparing with other states
- *Incentives: “**Deviations from established tax policy in pursuit of economic development, social or other goals should be well-reasoned and pursued only when established tax policies are not significantly undermined and the results of such deviations can subsequently be measured and evaluated.” (Emphasis added)***

Tax Incentives as Economic Development Policy: Pros

- Investors should have the option of selecting the combination of taxes & public spending they prefer.
- Some taxpayers are more likely than others to respond to incentives, targeting the former can attract jobs more cheaply.
- 1997 Business Tax Competitiveness Study found that New Mexico's position was significantly improved by the provision of IRB's.
- Incentives may be decisive under limited circumstances:
 - Some companies have unusual relocation expenses – e.g. service companies with significant severance/training expenses.
 - Some companies face nearly identical locations options with taxes being the only major difference.

Incentives as Economic Development Policy: Cons

- Incentives are inequitable, they reduce support for the tax system and makes it less efficient.
- State & local taxes are a small part of total costs and differences between states are even smaller.
- If all states offer incentives, their competitive position is not improved.
- Relocation incentives do not help existing businesses, the latter contribute far more to employment growth in the long run.
- We can never know the answer to the “but for” question, i.e. would the plant have come here without the incentives?

Incentives vs. Tax Reform

Demand for incentives can often be a sign of the need for more comprehensive tax reform.

- Numerous exemptions and deductions under the GRT are targeted at reducing the impacts of “pyramiding” – i.e. tax on business inputs.
- Targeted relief is politically easier because fiscal impacts are limited, but it is not often clear why one industry deserves relief and others do not.
- Tax laws are a blunt instrument for influencing “industrial policy”:
 - Businesses cannot predict with certainty how many workers they will need, etc. and may find themselves unable to take advantage of promised incentives.
 - Some may benefit without even changing their practices, creating a “windfall” and wasting public funds.
- Taxes should be “broad-based” – i.e. with few exceptions -- with a low rate.

Incentives for Other Policy Goals

Economic theory supports incentives for “public goods”, those that are likely to be under-supplied by the private market. E.g. education, public health, R&D.

- **Advantages:**
 - Tax policy reaches almost every entity in the economy, benefits can be targeted.
 - Benefits needn't be open ended, they can be capped.
- **Disadvantages:**
 - Little evidence on how much subsidy to provide.
 - State has few personnel to provide oversight, sometimes can't track how much is spent.
 - Added complexity for taxpayer and the State.
 - Benefits are limited to tax liability unless made refundable.

Characteristics of “Good” Incentives

- The incentive is needed to reduce an existing tax “disincentive”.
- The proposal includes caps or sunsets to enable evaluation of its cost and/or effectiveness.
- The proposal is not limited to one part of the state. Geographic targeting increases inequities and reduces effectiveness of incentives.
- Proponents provided enough information to enable a thorough evaluation of the need for and design of the incentive.
- The amount of subsidy is limited so that the state is providing a small part of the cost of the targeted activity.

Questions to Ask of Any Tax Incentive

- What are the specific goals? How will we determine if the goals are met?
- How many taxpayers are likely to benefit? Why are these taxpayers deserving of special treatment? Is the total fiscal impact to the state limited?
- How does this incentive interact with other incentives? How much in total State and Local incentives is being provided per job?
- Fiscal and economic analysis – including any “multiplier” estimates -- should reflect alternative uses of public money using balanced budget bookkeeping, i.e. accounting for either a spending reduction or a tax increase on other taxpayers due to the provision of the tax incentive.

Specific Reform Proposals

- Stacking/Anti-Double-Dip:
 - Current language varies, creates confusion
 - When new credits are added often unclear how they interact with existing
 - Suggestion: Group all credits for similar activities and specify their stacking order as well as any limit on the amount of liability that can be offset (e.g. group refundable and non-refundable credits separately).
- Claim process:
 - Process should be clear enough so that taxpayers will know if they are eligible and the amount of incentive for which they are eligible
 - If pre-approval is needed, require other department besides TRD to perform this function, e.g. EDD, NMED, EMNRD
 - Clarify deadlines for claims: which activity periods are eligible? In which accounting periods can claims be made?

Specific Reform Proposals (continued)

- Base/increment measurement:
 - Avoid using limited time period for base – like employment level on the day before a credit application -- use average employment over one year.
 - Base should be measurable and not easily manipulated
 - Amount of incentive should be tied to the level of the targeted activity
 - Incentives should take into account that GRT liability is often passed-on to buyers, so incentives applied against a taxpayer's legal tax liability may not benefit the real taxpayer.
- Cliffs:
 - Avoid abrupt cliffs like the salary limits in the High Wage Jobs Credit. Use phase out over some range.
- More appropriate as a credit, exemption or deduction?
 - Credits tend to be easier to track
 - Deductions may enable the pass-through of the benefit to the entity paying the passed-on tax

Conclusions/Recommendations

- Improving New Mexico's tax incentives requires striking a balance between competing objectives:
 - New vs. existing employers
 - Targeting vs. fairness
 - Social goals vs. economic efficiency
 - Accountability vs. predictability
 - Balanced budgets mean “Encouraging” one activity implies “discouraging” another.
- All incentives – new and existing – should be required to answer the questions identified in this presentation, and to prove their cost-effectiveness – for example, dollars per job created -- to the state's economy, taking into account the state's need to raise other taxes and/or cut spending to finance an incentive.

Conclusions (continued)

- Incentives are not a substitute for comprehensive tax reform.
 - New Mexico should make a serious effort to reduce pyramiding of the GRT.
 - This would provide a broad-based incentive to invest in the state.
 - It would also insure that benefits are received by those paying passed-on tax
- The State should consider streamlining its existing incentives to improve their usefulness, perhaps in a “General Business Credit Act”:
 - Goals of all incentives should be stated in measurable terms.
 - Eligibility criteria should be simplified.
 - Similar incentives might be combined and subjected to collective limits
 - Incentives should include sunsets so they are periodically reviewed.