

Basic Principles and Current Issues in New Mexico's Tax Policy

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Mr. Chairman and Members of the Committee, thank you for the opportunity to speak on the basic principles that should guide state and local tax policy. In today's testimony we would like to review some of the principles that have been endorsed by our members¹, with particular focus on how these principles relate to issues currently before the legislature.

I. ADEQUACY

"Revenues should be adequate to provide an appropriate level of those goods and services best provided by the public sector."

"How big is government in New Mexico?"

One way to examine the issue of revenue adequacy is to compare the size of the state and local government sector in New Mexico with that in other states. As a relatively poor state, New Mexico faces higher demand for services to low-income residents and a smaller tax base from which to fund these services. The combination presents policymakers with a dilemma, because if the higher demand for services is financed by higher tax burdens on local businesses, the result may be a slower rate of economic growth and reduced opportunities.

Table 1 presents comparisons of New Mexico's tax burdens with those in other states, using data from Fiscal Year 2002. Although New Mexico's total tax burden ranks among the highest in the country, the amount collected is only 7% above the average measured as a percent of personal income. High sales taxes offset low property taxes, while income taxes are slightly below average. Taxes levied directly on households are about average, those levied on businesses are significantly above average.

¹ NMTRI is a member-supported, non-profit, non-partisan educational and advocacy organization. Our members comprise a number of business, individuals and organizations in the state who support the need for an independent voice to address tax policy.

Table 1: Multistate Comparison of Tax Burdens: FY 2002

	<i>Measure:</i>	<i>Rank:</i>	<i>NM as Percent of U.S. Average:</i>
1	State & local general revenue -- % of personal income	3rd	128%
2	State & local taxes as percent of personal income	9 th	107%
3	Property taxes as a percent of personal income	46 th	54%
4	Sales taxes as a percent of personal income	6 th	142%
5	Income taxes as a percent of personal income	36 th	82%
6	Motor fuels taxes as a percent of personal income	22nd	121%
7	Motor vehicle excise tax rate	37th	61%
8	Cigarette tax rate	20th	105%
9	State & local taxes on high-income families (2004)	30th	100%
10	State & local taxes in the largest city (2004)	31st	93%
11	State & local business taxes as a percent of gross state product*	11th	120%

*Sources: Congressional Quarterly, State Fact Finder, except for *Ernst & Young/COST Annual Business Tax Study (adjusted to exclude severance taxes).*

Table 2 presents a comparison of how New Mexico taxes businesses in comparison with the average of other states.² Businesses benefit from the relatively low property tax rate structure in New Mexico, but they are burdened by the high sales tax on business inputs. Altogether, businesses contribute significantly more in state and local taxes than in the average state. Most of the excess New Mexico tax burden is attributable to severance taxes, which are included in the “Other” category. When the latter are excluded, New Mexico’s rate of business taxation is close to the national average. New Mexico tax burdens are heavier for the mineral extraction industry and for businesses that purchase more inputs – especially services – and are lower for those with high property ownership. In summary, it appears that New Mexico businesses as a group are paying a more than adequate share of the costs of state and local government.

² Table 2 uses Gross State Product as the denominator in determining average tax rates, while Table 1 uses Personal Income. These are two distinct but related ways of measuring economic activity. Gross State Product is the value of all the goods and services produced in the state. Personal Income is the total amount of income earned by New Mexico households during the year. Thus, GSP is the “Sales” side of the state’s income ledger, while Personal Income is the “income” side. For most states the two measures end up being relatively close. In New Mexico there are sometimes significant differences because of the large value of mineral production in the state. Since part of the income from this production is owned by non-New Mexico residents, that portion does not appear in the measure of Personal Income.

Table 2: New Mexico vs. U.S. Average Business Taxes

Tax	New Mexico	U.S. Average	NM – U.S. Average
	Percent of Gross State Product	Percent of Gross State Product	Annual Revenue
Property Tax	0.8%	1.7%	(\$600 million)
Sales Tax on Inputs	1.9%	1.1%	\$520 million
Excise Tax on Purchases	0.5%	0.6%	(\$60 million)
Corporate Income Tax	0.5%	0.5%	--
Unemployment Insurance Tax	0.2%	0.3%	(\$70 million)
Income Tax on Business Profits	0.1%	0.2%	(\$45 million)
Other	2.1%	0.5%	\$955 million
Total	6.0%	4.9%	\$700 million
Total Excluding Severance Taxes*	4.6%	4.7%	(\$63 million)

Source: “Total State & Local Business Taxes,” Ernst & Young, Council on State Taxation, January 2009. *Calculated by NMTRI based on E&Y report.

Severance taxes are excluded in the above calculation only to demonstrate their separate influence, and to leave a measure that shows how our taxes on other business types compare with those of other states. *This does not mean to imply that these taxes are borne by persons outside the state or that they are economically insignificant.* The argument that these taxes can be “exported” to residents of other states is based on a set of assumptions about markets that is unlikely to occur in reality. In placing a relatively high tax burden on the mineral extraction industry, the state has made a gamble that the industry is less likely to move out of state than are other industries because of the location-specific nature of mineral resources. Although there is some truth to this logic, there are several reasons the State should be careful not to over-tax the industry. Crude oil and natural gas prices are determined in commodity markets, so our producers cannot increase the price they receive to re-capture tax from buyers. Also, although our natural resources are unusually productive, they are not unique, and technology continues to develop that will make available more alternative sources of supply. Finally, as an export-based industry, the extraction industry is an important part of the economic foundation of the state, serving as the basis for other industries, especially in rural areas with fewer alternative sources of economic development.

“How has the size of government grown over time?”

Figure 1 illustrates trends in collections of the state’s three major tax programs -- Gross Receipts Tax, Personal Income Tax and Property Tax, which together account for about 70% of

annual state and local tax collections. Actual tax collections have been adjusted for population growth and inflation. These adjustments yield a measure of the “real purchasing power” of a tax, i.e. the ability it provides to maintain a consistent level of per capita services after accounting for the increased cost of purchasing the services due to inflation.

The GRT has been on an upward trend, which is partly due to the increased use of local option tax increments over time. The acceleration of the series in 2004 – 2007 was probably due to a combination of strong spending at the national labs, strong construction activity and strong oil and gas development activity. The increase would have been even larger but for the food & medical deductions, which have reduced GRT collections because the repeal of the 0.5% municipal credit was not sufficient to offset the reduced revenue. The PIT was also on an upward trend until the tax rate and capital gains tax cuts that were implemented beginning in Fiscal Year 2004. A second series illustrates the trend in PIT in the absence of the tax cuts of the last several years. Property tax collections have been rising due to increases in assessed value (including new construction) primarily on the residential side. Real per capita collections of GRT are now roughly three times as large as those for either PIT or Property Tax.

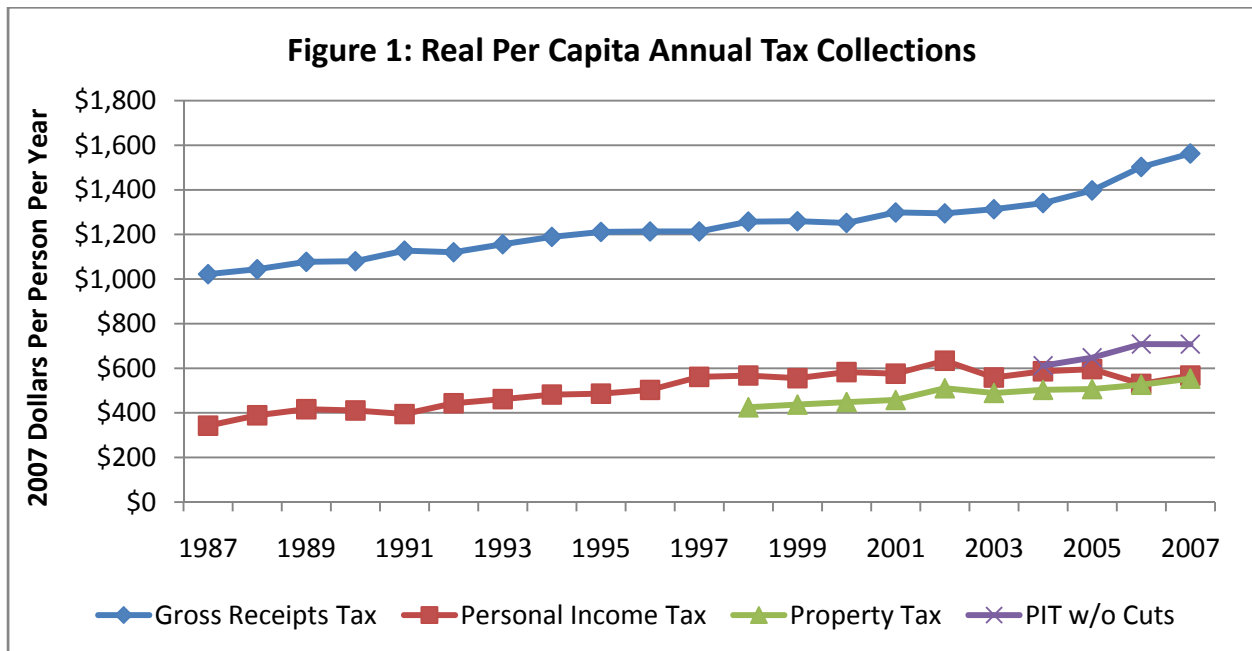
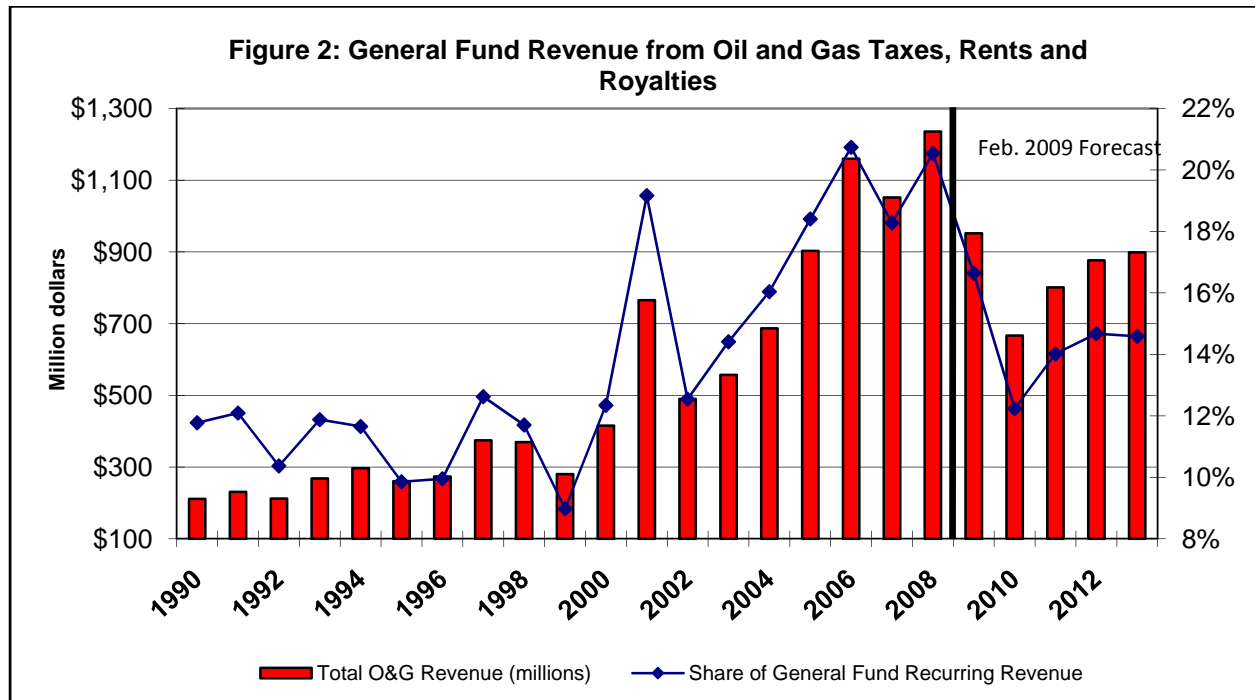


Figure 1 suggests that New Mexico was able to get through the last two national recessions – in 1991 and in 2001-2002 – without seeing a sharp drop in collections from the big three taxes. That may be in part because the oil and gas sector was not experiencing as sharp a drop in income and spending during those cycles. This recession is likely to be different because that situation will be reversed.

“Can we do a better job of managing oil and gas revenue volatility?”

Figure 2 illustrates the extent to which the General Fund relies on oil and gas revenue, and the volatility experienced in that revenue in recent years. Although this is a familiar problem, it has assumed new urgency because energy prices have reached unprecedented levels and also an unprecedented degree of volatility. The State has thus far been able to manage the budget disruption due to revenue volatility, largely by maintaining reserve levels of 10% or more. This strategy should be continued as long as prices remain well above historical levels. In addition, the state might consider adopting other tools to help manage volatility. One option is to designate a portion of the revenue as “non-recurring” whenever prices have reached a level that seems unlikely to be maintained. Another option is to invite a panel of industry experts to provide formal input on their methods of risk management. Finally, the state might provide some guidance to the revenue forecasting group about the degree of conservatism they would like the forecast to contain.



“How should we make decisions about the size of our tax burdens?”

During the last legislative session, a bill was moved that proposed significant tax increases for the purpose of funding increased public education spending. We are not constitutional experts, and cannot advise the Legislature on the “logrolling” issues raised by the bill. However, we found the debate over the bill disappointing because tax policy concerns were overshadowed by debate about the purposes for the additional spending. Specifically, when the bill was amended to increase the rate of the Gross Receipts Tax, we were surprised to hear so little

discussion of the pyramiding problems associated with that tax. We believe that tax policy concerns are distinct from spending concerns and deserve a separate hearing.

II. EFFICIENCY

“State and local taxes should cause the least possible disruption of the private economy.”

“Realistically, what can we do about pyramiding?”

As noted above, New Mexico has become heavily reliant on the Gross Receipts Tax. This raises the question of whether such an imbalanced revenue system is likely to create economic distortions. If we make the simplifying assumption that the GRT is typically shifted forward to buyers in the form of higher prices,³ this structure places a heavier tax burden on businesses and individuals who make a lot of purchases from in-state vendors. Businesses and households who purchase from out-of-state vendors are taxed more lightly. In addition, businesses and households with relatively large property holdings benefit from the current structure.

Although the incidence analysis is exceptionally complicated, the likelihood is high that most of the ultimate burden of this tax is borne by New Mexico households. This is essentially a hidden tax on these households, and is likely to be regressive in its impacts. Another serious economic consequence of the tax is the burden it places on firms competing with out-of-state enterprises that are not subject to the tax. Such in-state companies will see a direct impact on their bottom line, reducing their ability to invest and add laborers, and compete with out-of-state businesses.

The recent proliferation of legislative proposals to enact targeted GRT deductions, suggests that lawmakers are aware that the GRT can be a serious burden. The targeted approach is an arduous way to address the problem, however, and may be easily diverted into creating tax breaks for special interests that are not the parties in most need of relief. A preferable approach is to make relief as broad-based as possible. Although a complete remedy to pyramiding would require a comprehensive tax reform package, with offsetting revenue increases, there are some smaller steps that can be taken. One first step should be to do no more harm by avoiding increasing the rate of tax of the GRT. The burden of the tax increases with the square of the tax rate, compounding the problem even further. Another useful step is to take a skeptical view of proposals to use the tax code to provide incentives. These proposals – regardless of the worthiness of the targeted activity – reduce the tax base, putting upward pressure on tax rates and increasing the burden on local businesses. Although it is tempting to

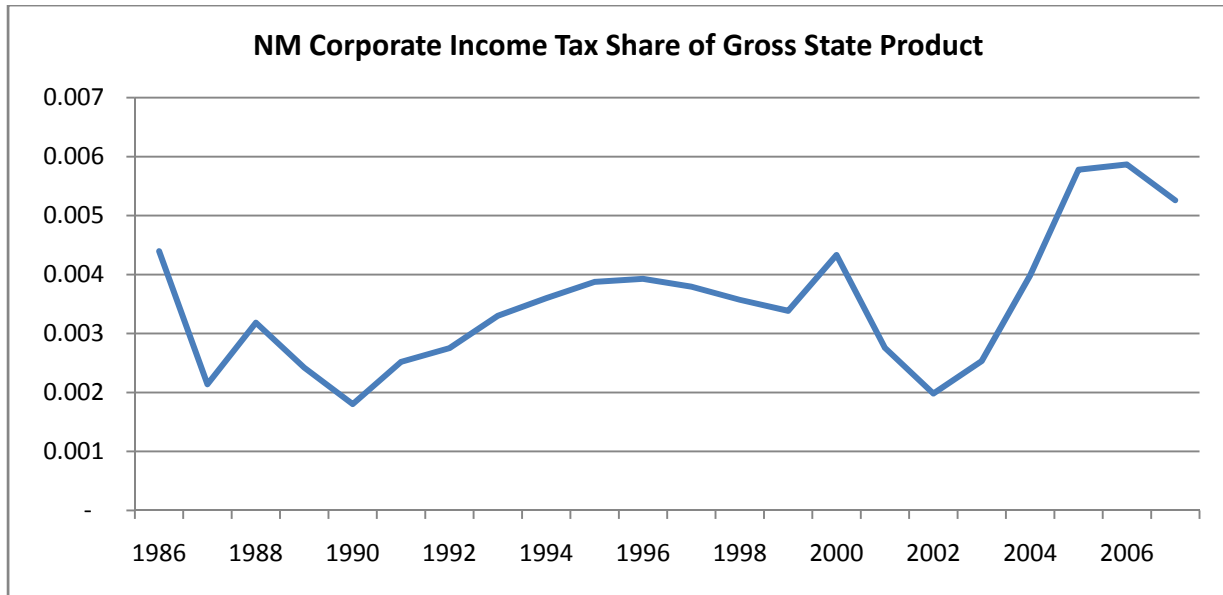
³ This assumption is an example of “incidence analysis,” which attempts to identify who bears the ultimate economic cost of a tax after all of the parties affected by the tax have modified their behavior in response. For example, if local sellers increase their prices in response to the GRT, buyers may shift some of their purchases to out-of-state sellers, reducing sales of local sellers and thereby shifting some of the tax burden back onto them.

believe that businesses newly-attracted to the state will provide growth that will generate net benefits to the economy, the simple truth is that any economic growth brings with it increased demand for government services. If new businesses don't pay the cost of those services, existing businesses and households will have to bear the burden. The state cannot ignore the competition with other states and countries for new investment, but to achieve the goals of efficiency and equity, it should resist the temptation to "micro-manage" the process with targeted incentives.

"Are corporate income taxes too low?"

Proposals have been introduced in recent legislative sessions that would increase the corporate income and franchise tax ("CIT"). These proposals have taken different forms, each of which raises different issues. A common theme has been the argument that corporations conducting business in several states or in different countries have too many opportunities to evade state income tax by shifting income among their separate legal entities through inter-company charges that lack real economic substance. These are valid concerns for state lawmakers, and a number of states have taken legislative action to curtail such activities. However, there is some evidence that these problems may not be seriously eroding the CIT tax base in New Mexico. Also, there are some policy concerns with the CIT that should be kept in mind when reforms are considered.

As evidence of tax avoidance activity, some writers have pointed to the decrease of federal and state CIT collections when compared with total output. However, as the following chart indicates, CIT collections in New Mexico have actually increased relative to gross state product over the last 20 years. This series appears to be dominated by fluctuations due to the business cycle and by trends in revenue from the oil and gas industry, which is a major contributor to New Mexico's CIT base. However, there is no apparent downward trend that might justify the concern that avoidance activity has increased significantly.



The issue of possible CIT avoidance was addressed directly in a recent New Mexico Supreme Court ruling, in the case of N.M. Taxation and Revenue Department vs. Kmart. In that case, the Court ruled in the State’s favor, concluding that payments made by Kmart to a related company for the use of trademarks made the latter subject to CIT in New Mexico. This ruling effectively blocks a type of transaction that has been identified as one of the most abusive tax avoidance schemes. The State’s success in this case suggests that targeting abusive transactions – which may require statutory changes in some cases but not in many – may be a productive way to prevent tax avoidance without making the CIT more complex or onerous for compliant taxpayers.

The main problem with raising CIT is that the tax is hard to justify from the standpoint of good tax policy. CIT was once justified as a tax on the privilege of access to capital markets and also for the privilege of limited liability⁴. Since limited liability is no longer the exclusive province of C-corporations, that justification is no longer appropriate. Another justification is that the tax contributes to the progressivity of the tax system. This argument hinges on who bears the economic burden of the tax. Economic experts have argued that the CIT is effectively a tax on the apportionment factors – in New Mexico payroll, property and sales – used to determine how much income to tax within the state. Since the state already has taxes on each of these factors there seems no justification for an additional tax that only applies to certain businesses. In addition, there are serious concerns about the factor definitions under the CIT. Taxing the sales factor, for example, causes even more pyramiding than the GRT, because the CIT definition lacks deductions to limit pyramiding. Finally, the CIT is sometimes justified as a

⁴ Some writers have argued that limited liability should be encouraged rather than discouraged because it is an efficient way to organize large amounts of capital and to manage risk.

benefits tax, i.e. a payment by the corporate entity for the benefits derived from state and local public services. This argument is weakened because the tax only applies to certain business entities – it excludes limited liability corporations, S-corporations, and partnerships as well as sole proprietorships -- whereas the benefits of public services are presumably derived by all forms of businesses.

III. EQUITY

“Tax policy should be fair and equitable toward similarly-situated taxpayers.”

“Should New Mexico join the Streamlined Sales Tax Agreement?”

One of the more vexing equity issues facing the state is the disparate treatment of in-state and out-of-state vendors under the Gross Receipts and Compensating Tax Act. As things stand today, remote vendors lacking a physical presence in the state are not subject to the GRT. Although the Compensating Tax should apply to purchases from these vendors, there are numerous exceptions to the latter, and the Compensating Tax rate is significantly lower than the GRT rate in many jurisdictions. The Streamlined Sales and Use Tax Agreement (“SSUTA”) is an attempt by a number of states to rectify the disparate treatment of in-state and remote sellers. Other goals of the Agreement include (1) reduce administrative & compliance burdens; (2) encourage voluntary collection of taxes by remote sellers; (3) encourage Congress to allow states to tax remote sellers and (4) prevent sales tax base erosion due to E-commerce. As of last year, 22 states had joined the agreement, including Oklahoma and Utah in this region. Although Congressional action to require sales tax collection by remote vendors does not appear to be imminent, New Mexico may want to consider adopting the agreement to achieve some of the other goals listed above.

What are the hurdles New Mexico would have to clear to participate in the Agreement? One hurdle that has been lowered substantially was the concern that changing our GRT from source-based to destination-based would cause large revenue shifts among our local jurisdictions. At this time however, the Agreement has been modified to reduce this problem. The State would have to develop a database linking addresses to local option tax rates to help remote vendors determine the appropriate local option taxes to collect. Also, we would have to separate our withholding tax from GRT for payment and reporting purposes. Forms and administrative procedures would have to be modified to meet the standards of the agreement. The Agreement requires that some form of vendor compensation be allowed by the state to offset vendors’ costs of collecting and reporting. An amnesty would have to be provided for periods prior to a vendor’s registration with the state. Special reporting of deductions – like our food and medical deductions - would have to be modified. Certain definitions would have to be modified. Arrangements would be needed to allow purchasers to pay sellers’ GRT in some

situations. A significant number of statutory changes will be needed to implement many of these changes.

A large uncertainty hanging over the Agreement is concern among remote sellers that the agreement will not live up to its promise to truly simplify the sales tax. Critics have pointed out that the Agreement relies to a large extent on software that has not yet been developed, that it doesn't streamline compliance requirements sufficiently, definitions are not made completely uniform, and perhaps most importantly, the mechanism to insure that states fulfill their obligations under the agreement is unclear. Prior to undertaking the Agreement, perhaps the State should solicit input from some vendors, to see whether the State's participation is likely to encourage their voluntary compliance.

What is the potential payoff for New Mexico? Estimates vary considerably, from as low as \$15 million to over \$100 million per year. Uncertainty stems from the unknown amount of non-compliance with the sales tax under current law, and also from uncertainty about which sellers would have nexus with the state (Congressional action would be required to force those without nexus to collect the tax). The State's payoff from joining the Agreement is the opportunity to collect GRT on transactions that are currently not subject to tax because of exemptions from the Compensating Tax. In addition, the improved tax equity that would be achieved through this change would be of great importance to local New Mexico vendors. These factors justify the State seriously considering joining the Agreement.

“Can we do anything about ‘property tax lightning’?”

Like a number of other states, New Mexico law limits the rate of growth of assessments of residential property (in our case to no more than 3% annually) as long as the home is not sold or substantially improved. This system is designed to prevent taxpayers from being hit with alarming tax increases due to reappraisal as long as they stay in their homes. An unfortunate side effect of this treatment is that the reappraisal when homes are sold can be substantial, causing the new homeowner to feel they are being treated unfairly. A smaller side effect is that the limit on value increases results in tax rates being pushed up by a small amount, essentially shifting some of the tax burden from existing homeowners to new homeowners.

Over the last several years, as home values in some jurisdictions rose rapidly, these effects were the source of significant anxiety for many new property owners. As we enter a period of slower growing values, we are likely to hear about another potential problem associated with the current system. Since assessments have been limited – in some cases to well below market value – and assessors are required to bring assessments as close to market value as they can subject to the 3% annual growth limit – some property owners will see their assessments rising

by 3% per year even though they may think correctly that property values in their neighborhood are falling.

Can the state do anything about these problems without causing fiscal distress for local governments and/or imposing sharp tax increases on some taxpayers? Since the voters approved the Constitutional Amendment that lead to the 3% limit, it is clear that they are anxious to limit the growth of residential property valuations over time. In order to do this in a way that does not create “winners and losers”, it would be necessary to extend the limit to all properties, i.e. remove the requirement that properties be brought up to market value when they are sold. This type of system is currently in place in Oregon. One consequence is that the assessed value of residential property would gradually fall to a lower percentage of market value. This is not without precedent in state law since the Constitution already requires that property be reduced to one-third of its assessed value for property tax purposes. The existence of the yield control statute and the voters’ ability to impose new debt service obligations means that local government revenues would be largely held harmless for such a change. The biggest remaining concern would be for those taxpayers whose values have been established in the last few years and are therefore substantially above those of their neighbors. These properties’ assessments could be gradually lowered until they were in close conformity with those around them. Again, the yield control and debt service process should help to hold local governments harmless to a significant extent.

Any solution to these problems must address a number of issues, possibly including modifications to Constitutionally-determined debt service limitations. At present, the Legislature does not have all of the information needed to assess these issues. The logical first step is a study, which could be supervised by TRD’s Property Tax Division, and which would require a significant amount of information from the county assessors. A Legislative/Executive Task Force of some kind might be an appropriate body to oversee the conduct of the study.

IV. Tax Incentive Accountability

“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.”

“What is the appropriate role of tax incentives?”

New Mexico has almost 40 different tax statutes providing economic development incentives, with an aggregate “cost” in foregone revenue of over \$80 million annually. Good tax policy suggests both positive and negative aspects to these statutes. On the positive side, incentives can help the state to overcome “disincentives” to investment, such as the pyramiding of the

gross receipts tax on business inputs. On the down side, in addition to being inequitable, incentives often target only new businesses, whereas existing employers contribute far more in total employment to the state's economy. To help strike the appropriate balance, policymakers should ask a number of questions of proposed and existing incentives, including "What are the specific goals and how will we know if they are met? How does the incentive interact with other provisions of the tax code? How much in total state and local incentives is being provided to each business?" Any fiscal evaluation should reflect the fact that foregone state revenue could be put to alternative uses in the state's economy. This "balanced budget" requirement means that most incentives can have only a limited net positive impact on the economy. Finally, the State should consider specific reforms to existing incentives with the goals of making them easier for taxpayers to utilize and also improving accountability for this use of public funds.

Summary/Conclusions:

Although New Mexico ranks relatively high among states in state and local tax burden, that burden is less than 10% higher than the national average. The burden on businesses is relatively high, especially due to severance taxes, while that on households is below average. The real purchasing power of New Mexico's taxes has grown over time, which suggests that the State's tax system is adequate to fund needed government services. However, volatility of oil and gas revenues has become even more important in recent years, and the state should consider additional methods for managing the associated risks. An additional concern about the State's tax structure is the heavy reliance on the Gross Receipts Tax, which is now three times as important as either the individual income tax or the property tax. One downside to heavy reliance on this tax is "pyramiding," the imposition of tax on business-to-business transactions. Although fixing the problem would require comprehensive tax reform, the state can take smaller steps to reduce the problem by avoiding tax rate increases and limiting the number of special exemptions from the tax. Concerns that corporate income taxes are being eroded by tax avoidance seem to be exaggerated, and the appropriate means of addressing avoidance behavior would be targeted legislation or comprehensive business tax reform, rather than a comprehensive re-write of the tax. The State should seriously consider joining the Streamlined Sales Tax Agreement, in order to help reduce the disadvantage experienced by in-state vendors in competition with remote sellers. Perhaps the biggest inequity in the tax code is the disparity in property tax values for new vs. existing homeowners. Experience of some other states suggests ways this problem could be addressed, but a study is needed to clarify the trade-offs and mechanisms to use in any solution. Tax incentives for economic development can play a productive role, but their use should be limited to avoid undermining the system.

Principles of Good Tax Policy as Endorsed by the Members of the NMTRI

Adequacy

State and local taxes should be adequate to provide an appropriate level of those goods and services best provided by the public sector, such as education, public safety, law enforcement, streets and highways and the courts.

Efficiency

State and local taxes should do the least harm to the private economy. Therefore, tax bases should be as broad as possible so that tax rates can be as low as possible in order to raise the necessary revenue.

Equity

State and local tax policy should be fair and equitable towards individuals and businesses similarly situated. Individuals with the same income level should be taxed the same. Businesses engaged in similar commercial activities should be subject to the same level of taxation.

Administrative and Compliance Simplicity

State and local tax policy should not be costly to administer and should be easily understood by taxpayers so as to minimize taxpayer compliance costs.

Comprehensiveness

The state and local tax burden should be evaluated on the basis of the impact of all taxes levied on a given taxpayer, not just a single tax or tax rate.

Accountability

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.