Policy Brief
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Reforming New Mexico's Tax Code

Principles and Options for Success

By D. Dowd Muska and Paul Gessing

Introduction

Most economists agree that the purpose of taxation is to fund public-sector services – such as law enforcement and infrastructure – that the private sector cannot or will not provide. But creating a tax structure that extracts enough revenue to sustain government's duties while minimizing distortions to the market process is a challenge.

Good tax policy avoids altering the natural incentive structure of households and firms. Independent buying and selling, facilitated by the use of accurate market prices, is the best way to allocate a society's resources and ensure a well-balanced, welfare-maximizing economy. That's why tax reform in New Mexico should strive for greater efficiency, equity, and simplicity.

New Mexico in Context

New Mexico's state-and-local tax system can be best understood by comparing it to its counterparts. Three major levies fund the majority of nonfederal expenditures in the United States: sales taxes, income taxes, and property taxes. New Mexico collects all three. Forty-one states tax income, with only a handful of cities, counties, school districts, and transportation districts doing to same. Forty-five states tax retail sales. Property taxes are in place in every state, although some solely occur at the local level.

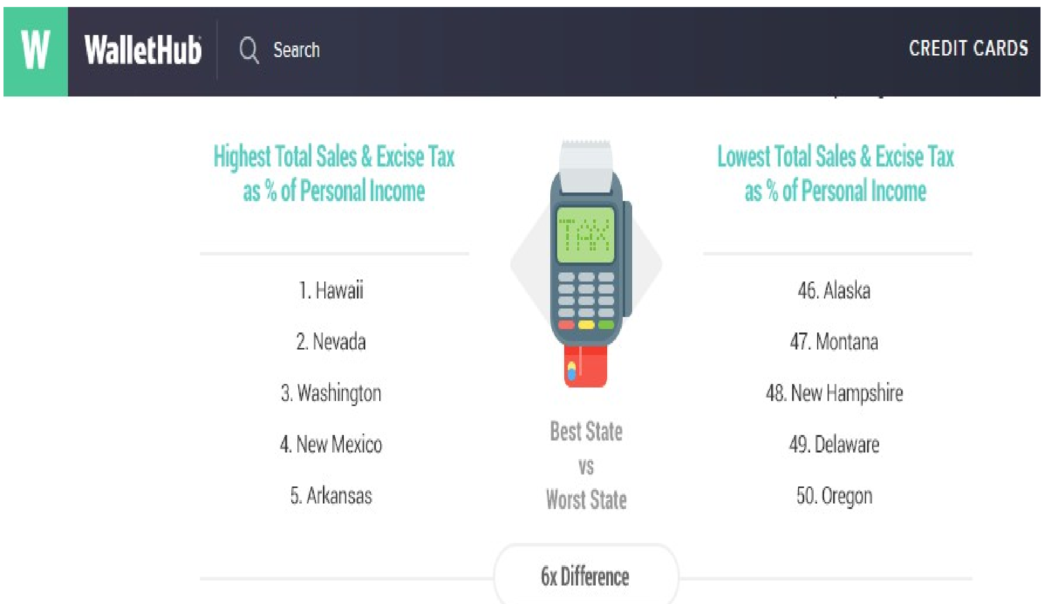
When judged against other states in the American West (and income levels are taken into account), New Mexicans face relatively heavy tax burdens. This information must be considered should calls for "tax reform" turn into calls for tax hikes.

2016 State Total Taxes % of Personal Income

	Total Taxes ($ million)	% of Pers. Income	Rank
California	155,231	7.4	9
New Mexico	5,462	6.9	13
Nevada	8,025	6.6	17
Utah	7,083	6.0	28
Wyoming	1,914	5.8	33
Arizona	14,676	5.5	37
Oklahoma	8,491	4.8	43
Colorado	12,795	4.9	44
Texas	52,133	4.0	49
Median		**6.2**	

https://www.taxadmin.org/2016-state-tax-revenue

As the charts on the following page show, New Mexico's gross receipts tax (GRT), which in today's context resembles a very broad sales tax, is relatively high. But it is important to note that the GRT impacts many business-to-business sales of inputs and services, which further reinforces the levy as the dominant tax in the state.



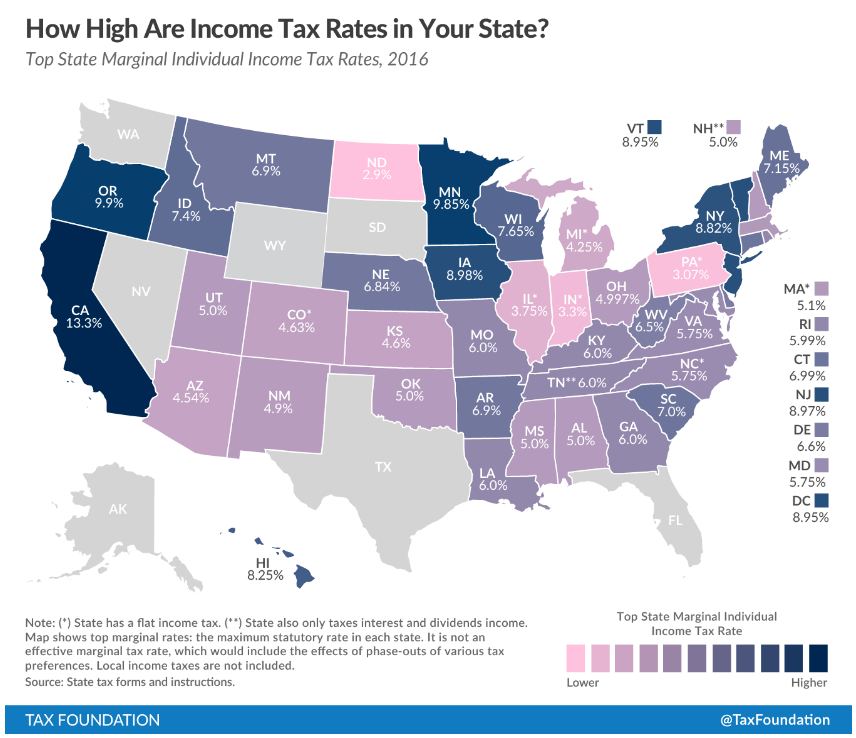
State	Total Sales & Excise Tax Burden (%)	Burden Rank
Hawaii	6.52%	1
Nevada	5.90%	2
Washington	5.47%	3
New Mexico	5.02%	4

Number of Services State Sales/GR Tax Applies To

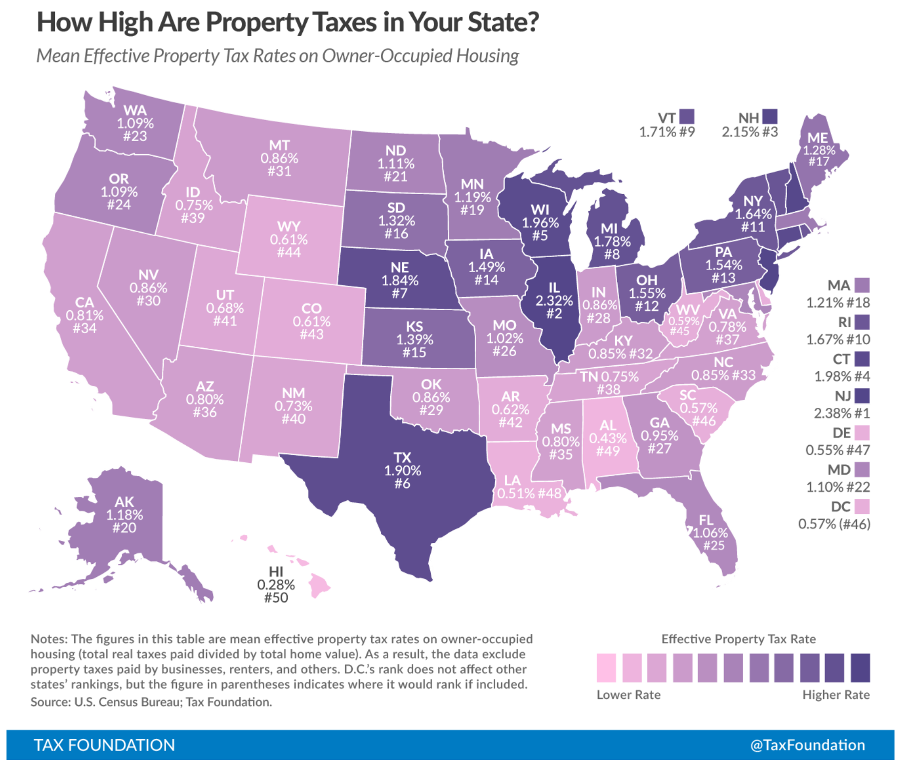
STATE	Services
Alaska	None
Arizona	55
Colorado	15
Florida	63
Nevada	18
New Hampshire	None
New Mexico	**158**
South Dakota	146
Tennessee	67
Texas	83
Utah	58
Washington	158
Wyoming	58

Source: Tax Foundation

New Mexico's income-tax burden could be best described as "moderate," although rates are somewhat higher than its neighbors.

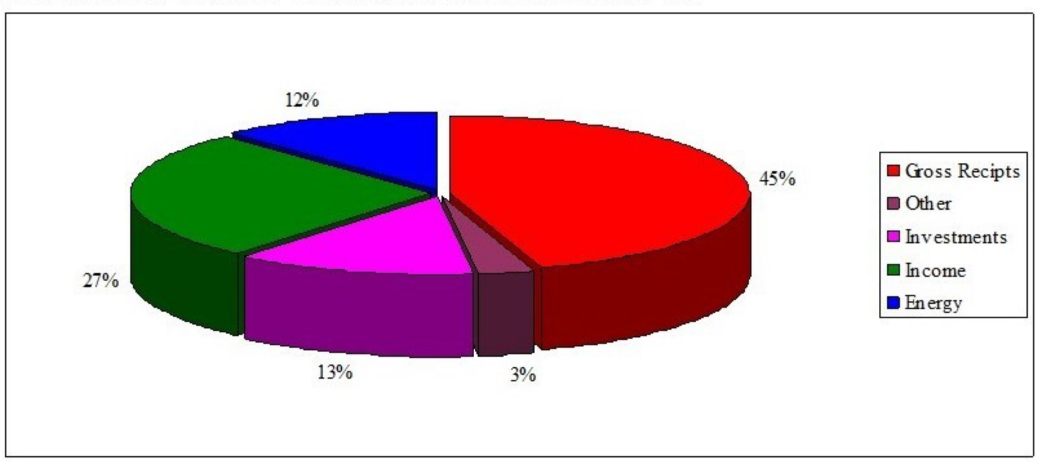


New Mexico's property taxes are relatively low when compared to other states.



As an illustration of the fact that the GRT is the most important and "robust" taxing mechanism in New Mexico, it is worth noting that it generates 45 percent of the state revenue raised within the Land of Enchantment's borders:

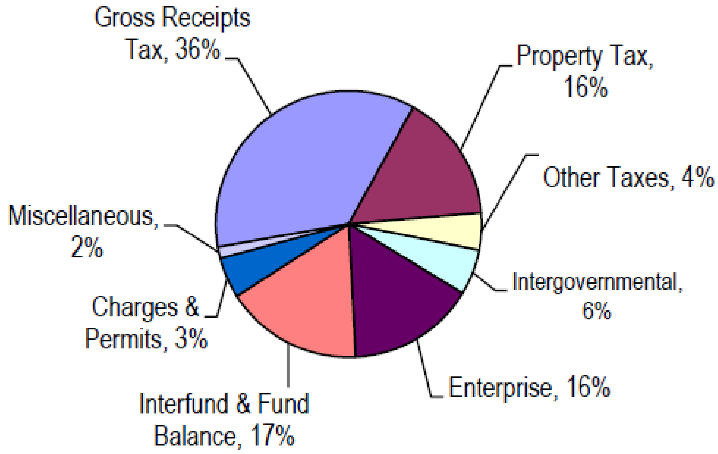
New Mexico Estimated General Revenue Sources FY 2017



Source: Legislative Finance Committee, General Fund Consensus Revenue Estimate: December 2016

In addition, the GRT is the major source of funds for local government in New Mexico. For example, it generates more than a third of Albuquerque's revenue:

FY/17 RESOURCES ALL FUNDS



Source: FY 2017 Approved Budget, City of Albuquerque

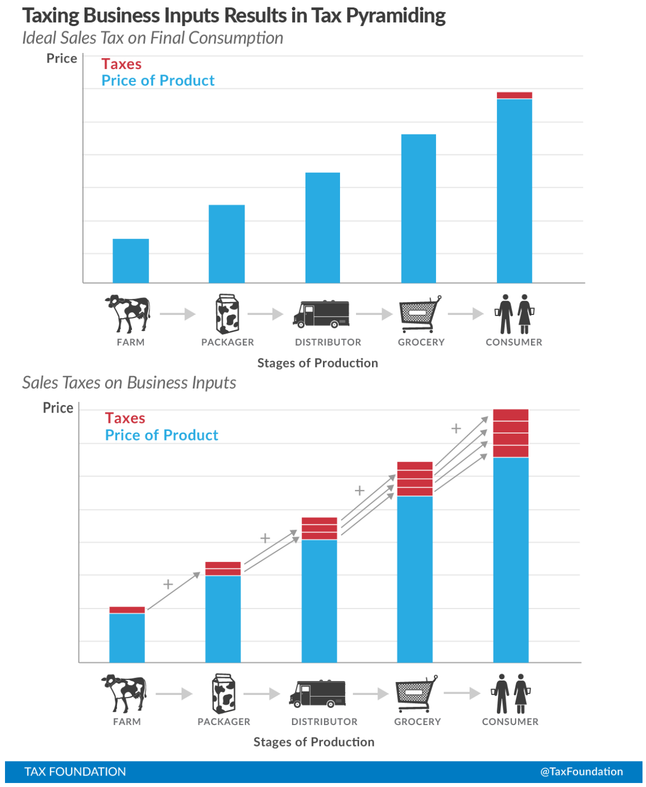
There is widespread agreement that New Mexico's tax structure, especially the GRT, requires dramatic reform. As the major generator of revenue for state and local government, reforms to the levy must be carefully vetted and considered. Significant changes are not to be taken lightly.

An Outdated and Problematic Levy

The GRT was created as a stopgap measure, designed to address a severe drop in property-tax collections induced by the Great Depression. Originally called the "emergency school tax," it essentially brought all business transactions into the fold of taxation – and with such a broad base, the initial rate was a modest 2 percent.[1] With the coming of World War II and a vastly expanded military/nuclear presence in the Land of Enchantment, one "benefit" of the GRT was its ability to indirectly tax federal activity.

But after more than eight decades, there is broad consensus that the GRT is unfair and an impediment to economic development:

• The GRT is meant to apply to *all* transactions, leading to "pyramiding," or taxing final consumption multiple times.[2] When intermediate inputs used to produce goods and services are taxed, the *effective* rate is higher than what is depicted on an invoice or sales receipt. Thus, a significant portion of the GRT's true burden is hidden. The state's rate currently sits at 5.125 percent. With levels of local government added, the total rate can be as high as 9.2500 percent.[3] But as the Tax Foundation notes, when business inputs are taxed, "the costs of those taxes cascade … down the production chain and embed themselves in the final price of the consumer product. Consumers end up paying the tax in the form of higher prices – they just do so in a nontransparent way."[4]

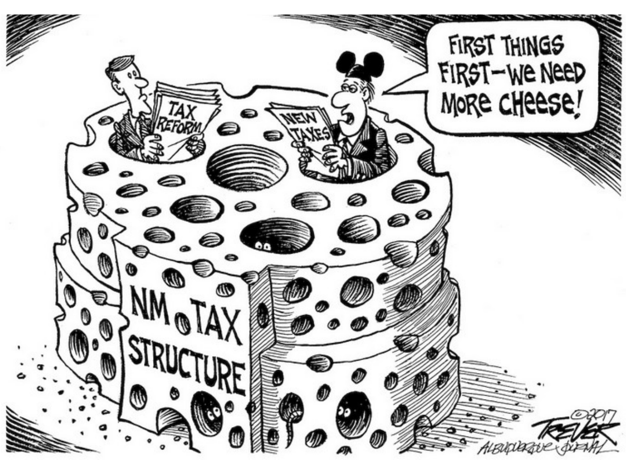


Source: Tax Foundation, "Three Big Problems with Sales Taxes Today – and How to Fix Them"

• The GRT's lack of transparency has helped cause a "carving out" by state legislators, at the behest of powerful or well-organized special interests.[5] Whether large and impactful or just plain unusual, the GRT is "riddled with exemptions and deductions of dubious justification."[6]

• The GRT creates horizontal-equity concerns. The nature of the tax's structure favors firms that are more vertically integrated over enterprises that outsource many of their inputs. Large businesses, which often produce many inputs in-house, obtain a competitive advantage.

• The GRT is regressive, meaning that it takes a larger percentage of income from low-income than high-income earners.



The Need for Reform

Due to the issues outlined above, there is bipartisan agreement that GRT reform is necessary on the grounds of both economic growth and fairness.

State Rep. Bill McCamley (D-Mesilla Park) argued for change in a recent opinion piece: "We should reform the tax code. In our Gross Receipts laws alone, there are over 370 deductions, exemptions and credits. Getting rid of most of them and lowering the overall rate will make things simpler, encouraging businesses to start and move here."[7]

State Rep. Jason Harper (R-Rio Rancho), a leader of the reform community and member of the legislature's Revenue Stabilization & Tax Policy Committee, concurs. For the last several years, he has been crafting a reform package designed to fix "our broken gross receipts tax system and turn it into a broad-based sales tax. The average rate around the state would be about 6 percent."[8]

With over 300 alterations – deductions, exemptions, and credits – now in place, advocates of GRT reform face considerable political obstacles. Picking favored industries and activities has resulted in a higher overall burden on typical taxpayers, but it has benefitted interests that have skilled lobbyists and savvy public relations. But given the condition of the state's economy, it is little wonder that a potentially critical mass of reformists has coalesced. Never a particularly wealthy or prosperous state, today New Mexico faces an unprecedented set of challenges. The old model of relying on federal dollars and oil-and-gas revenues is not working. The state faces considerable economic woes:

• The current unemployment rate is 6.2 percent, second only to Alaska as the highest in the nation. By comparison, neighbors Colorado (2.5 percent), Utah (3.4 percent), and Texas (4.0 percent) have jobless rates *below* the national figure.

• Employment in the state's manufacturing sector has declined by 39 percent since the late 1990s.[9] By contrast, in the leisure-and-hospitality industry, which pays the least of the ten supersectors tracked by the North American Industry Classification System – and suffers from the highest unemployment rate – jobs have grown by 18 percent since the Great Recession.[10]

• A 2014 analysis found that in New Mexico, real, per capita income, adjusted for purchasing-power parity, is $34,577. Only three states fared worse.[11]

The Challenge of Reform

The elimination of the GRT on groceries, implemented more than a decade ago, illustrates both the politicization and negative economic effects of significant tax carve-outs. It was implemented to ease the burden on the poor, but immediately resulted in raising the state GRT on all other goods and services by a half a percentage point. The estimated revenue loss of the deduction for groceries has averaged over $200 million per year during the last five years – about 10 percent of GRT General Fund revenue.

This situation was further complicated in a compromise passed in 2013 that reduced corporate income tax rates, phased out "hold-harmless" compensatory payments made by the state to local government over 15 years, and allowed further increases in the GRT.

Shrinking the GRT base by eliminating the tax for groceries has a second, negative impact: It increased the volatility of revenue. When government taxes fewer items, at higher rates, it forces greater reliance on the smaller group of items that are taxed. Removing groceries, a necessity, from taxation shifted more of the tax's burden to optional goods and services.

Reform Possibilities

In recent years, three options for GRT reform have attained the most attention from lawmakers, activists, and the media. Each tax reform idea as advantages and disadvantages; some have numerous permutations as well.

A. Broaden the Base, Remove Deductions, and Lower Rates

Under this model, the basic structure of New Mexico's GRT would be kept in place, and no changes would be made to the taxes imposed on personal and corporate incomes. Broadly speaking, the plan would:

• Eliminate as many deductions, exemptions, and credits as possible, including the tax on groceries (often mislabeled the "food tax");

• Eliminate pyramiding on many business-to-business transactions;

• Extend taxation to purchases made by the state's nonprofits;

• Reduce the state GRT rate to 3-4 percent, with local option taxes permitted;

• Retain taxation of federal contractors and other activities already taxable under the current GRT.

Pros: This tax reform reduces rates and broadens the base, both of which are good things. It would result in a fairer and simpler system than the existing tax code. It taxes federal activities, but it doesn't discriminate against small businesses and entrepreneurs.

While revenue neutral at the outset, this plan minimizes the impact of taxation on everyday business and consumer decisions, thus making New Mexico a more attractive place to do business. Likely, this would increase economic activity and ultimately generate *more* tax revenue.

Cons: Eliminating *all* GRT breaks in the tax code will be a serious political challenge. Ensuring that the various state and local entities receive revenues at similar rates to what they do now will be a mathematical challenge. In addition, how would the very interests that carved up the current tax code be blocked from again lobbying for special treatment once this reform is passed?

Verdict: This is likely the best option available, in the short term, to New Mexico policymakers.

B. Abandon the GRT and Move to a Traditional Sales Tax

One way to directly and decisively address issues of pyramiding would be to shift to a straight sales tax, similar to those in place in most states. New Mexico would tax goods at the point of final sale, rather than taxing business-to-business transactions. The shift would make the Land of Enchantment much friendlier to entrepreneurs and investors.

Pros: Like ripping the band aid off a wound, this reform is in many ways the most direct and simplest method for improving New Mexico's tax system.

Cons: The most serious objection to making the shift from a GRT to a straight sales tax is the revenue that would be foregone. For example, Sandia National Laboratories and Los Alamos National Laboratory generate $200 million in GRT revenue – most or all of which would be foregone under a straight sales tax.[12] With so much federal spending in the state, it is unclear how much revenue would be lost after the transition.

One possible solution for the revenue-loss problem is to use the Land Grant Permanent Fund and/or Severance Tax Permanent Fund to finance the transition to a sales tax. But doing so would require a constitutional amendment, as well as a massive campaign to educate New Mexico's electorate about the wisdom of the switch.

Verdict: New Mexico could have gone this route during the rise in petroleum prices in the 2000s, when the economy was strong and the Great Recession had yet to strike. However, at the present time, the plan has too many risks. It could, for example, result in consumers facing higher sales tax rates (at least nominally) than they do now. It will be hard to justify amending New Mexico's constitution to tap its permanent funds to address a poorly understood tax issue that could result in significantly higher tax rates.

C. "The 2% Solution," or "Total Reboot"

This plan is championed Sen. Bill Sharer (R-Farmington). It would tax *everything* that is sold, purchased and rented in New Mexico and eliminate the personal income tax, the corporate income tax, the compensating tax and nearly all of the state's special sales taxes, such as the vehicle excise tax and taxes on insurance premiums. The property tax, gasoline tax and severance taxes would remain. Under the plan, local governments will be able to add up to a 1 percent GRT. A rebate will be included in the plan to restore progressivity and reduce the burden for low-income taxpayers.

Pros: Taxing everything at one low, flat rate is in many ways the ideal solution. Eliminating income taxes – or, more particularly, folding them into this new tax code – produces the simplest and "cleanest" tax code imaginable. Sharer would overcome at least some political opposition to his plan by allowing for a rebate that restores a degree of progressivity that would be lost by eliminating the personal income tax.

Cons: Despite its simplicity, such a radical shift in taxation is sure to yield vehement objections. Most notably, in making such a move, how will policymakers make sure they don't "overshoot" or "undershoot" in terms of revenue collected? As with a less-dramatic plan, such as Option A above, there will inevitably be efforts to both introduce deductions and exemptions – and increase rates. The robustness of this tax as a revenue generator could make even a 0.1 percentage-point rate increase both very attractive to policymakers and very impactful economically.

Rather than eliminating pyramiding, this plan *doubles down* on pyramiding – thus making it unlikely that many manufacturing businesses or users of multi-stage business inputs will set up shop in New Mexico.

Verdict: This model for a total reboot is very attractive in many ways, but it is hard to imagine a scenario under which such a dramatic overhaul would make it through the Legislature. Even if it did succeed, we have been down this path before. The GRT began as a low, flat, all-encompassing tax, and was slowly chipped away by favor-seeking interests in Santa Fe. How would this plan survive, absent an additional protection included in the New Mexico constitution? If such protections were introduced and unforeseen economic harms were introduced by this plan, how would policymakers be able to address them?

Conclusion

Fundamentally reforming government revenue-collection systems is never easy, and it will be a challenge in New Mexico. The impetus that gives reformers hope is the fact that the current system is clearly broken beyond repair.

It is time for policymakers to seize the opportunity to make bold, much-needed changes. A sober, sensible reform effort – akin to Option A described above – is the most viable model in the short term. Thoughtful, open-minded discussions of improvements to New Mexico's tax code should continue to be welcomed, as the Land of Enchantment strives to boost opportunity and spread prosperity through a tax code that promotes working, saving, and investing.

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independent, nonpartisan, tax-exempt research and educational organization dedicated to promoting prosperity for New Mexico based on principles of limited government, economic freedom and individual responsibility.

Notes

1. James P. O'Neill, "Gross Receipts Tax: Its Design and Policy Principles," Presentation to the Interim Revenue Stabilization and Tax Policy Committee, New Mexico Legislature, July 16, 2012.

2. Paul Gessing and Harry Messenheimer, "New Mexico's Harmful Gross Receipts Tax: A Warning to Other States," Rio Grande Foundation, January 29, 2007.

3. Gross Receipts Tax Rate Schedule, Effective July 1, 2017 through December 31, 2017, New Mexico Taxation and Revenue Department.

4. Scott Drenkard, "Three Big Problems with Sales Taxes Today – and How to Fix Them," Tax Foundation, February 10, 2017.

5. Paul J. Gessing, "Time for Santa Feans to reject another tax hike," *Santa Fe New Mexican*, September 11, 2017.

6. D. Dowd Muska, "Don't Forget Laser Guns, UFC Bouts, Uranium Hexafluoride," Errors of Enchantment (blog), Rio Grande Foundation, May 25, 2016.

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8. Matt Grubs, "The Tax Man: Reform plan for New Mexico gross receipts tax is DOA for the Legislature's special session," *Santa Fe Reporter*, May 23, 2017.

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10. D. Dowd Muska, "Make New Mexico Poorer – Support Tourism," Errors of Enchantment (blog), Rio Grande Foundation, July 13, 2017.

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12. Tris DeRoma, "NNSA releases draft RFP for LANL contract," *Los Alamos Monitor*, July 14, 2017.

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