

State of New Mexico Tax Structure: Key Issues and Alternatives

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Acronyms Used in the Report

CIT:	corporate income tax
COST:	Council on State Taxation
EDD:	Economic Development Department
EIB:	Economic Impact Board
FMAP:	federal medical assistance participation rate
FTA:	Federation of (State) Tax Administrators
FTE:	full-time equivalent
FY:	fiscal year
GDP:	gross domestic product
GRT:	gross receipts tax
ITEP:	Institute of Taxation and Economic Policy
JTIP:	Job Training Incentive Program
LEDA:	Local Economic Development Act
LFC:	Legislative Fiscal Committee
LGPF:	Land Grant Permanent Fund
MMBtu:	one million British thermal units – a measure of heating value
NASBO:	National Association of State Budget Officers
NMTRI:	New Mexico Tax Research Institute
NCSL:	National Conference of State Legislatures
PIT:	personal income tax
PTSC:	Professional Tax Study Committee
RPS:	renewable portfolio standard.
STPF:	Severance Tax Permanent Fund
TRD:	Tax Research Division, New Mexico Taxation and Revenue Dept.
WTI:	West Texas intermediate crude oil

Executive Summary

Introduction

Recent events, including a pandemic-triggered national recession and a cyclical bust in the energy sector, have had significant negative impacts on the New Mexico state economy and its revenue structure. While this confluence of events could not be predicted, there are indications that New Mexico has greater economic and revenue volatility and less ability to ‘bounce back’ from economic and revenue shocks than most other states. For example, New Mexico is one of six states that, by the end of 2019, had not recovered its revenue losses from the Great Recession. Four of these less resilient six states are major energy producers, which suggests that some of the volatility and adequacy concerns may be related to reliance on this economic sector.

There are troubling signals related to the traditional energy producing sector. Most notably, there is unprecedented price volatility – including a major oil benchmark that briefly traded for under \$0 a barrel earlier this year. Major bankruptcies, particularly in the shale oil producing sector, suggest that this isn’t a ‘business as usual’ bust that will soon be followed by a boom. In fact, one Texas state energy official suggested that “this is the worst energy crisis in history. It’s never been worse than this.” As a result, one prominent analyst predicts it is unlikely that oil production will return to its peak of 13 million barrels per day from February 2020. The natural gas industry also experienced a significant contraction, with production declining sharply in the fourth quarter of FY2020, and FY2021 production is projected to decline by 7% to 10% from the previous fiscal year.

New Mexico’s oil and gas industry is the dominant one in the state, measured as a share of GDP, and it also generates a significant portion of state revenue. Given the bust in the industry combined with the pandemic-fueled national recession, it is not surprising that the New Mexico budget shortfall in the summer of 2020 was among the largest of the states as a percentage of the overall state budget. When the New Mexico legislature returned for a special session in June 2020, the primary purpose was to deal with an estimated budget shortfall of between \$1.8 and \$2.8 billion. In July 2020, after the special session, the Legislative Finance Committee (LFC) estimated the deficit for FY2021 at nearly \$1 billion.

In fact, New Mexico finished FY2020 somewhat stronger than had been forecast, with actual revenue collections more than \$300 million above earlier estimates. The latest State economic and revenue forecast (September 30, 2020) was also somewhat improved over the forecast from June 2020. At the same time, the State still faces considerable economic and revenue headwinds, and the current forecast is for current year revenues to decline by 7% to 19% from FY2020.

Project Purpose and Approach

State revenue structures evolve over time and are impacted by internal and external factors. Given the pressures on New Mexico’s current revenue system, it is an opportune time to analyze its structure and alternatives and identify opportunities to improve its outcomes. This study focused on methods to both diversify the current mix of taxes and revenue and to improve the structure in relationship to key tax policy principles.

To accomplish this, the project team analyzed state budget and tax data, conducted in-depth interviews with state tax policymakers and subject matter experts in the public and private sectors, and benchmarked New Mexico with peer states.

In analyzing state tax structures, the project team relied on tax principles developed by the New Mexico LFC. The LFC principles:

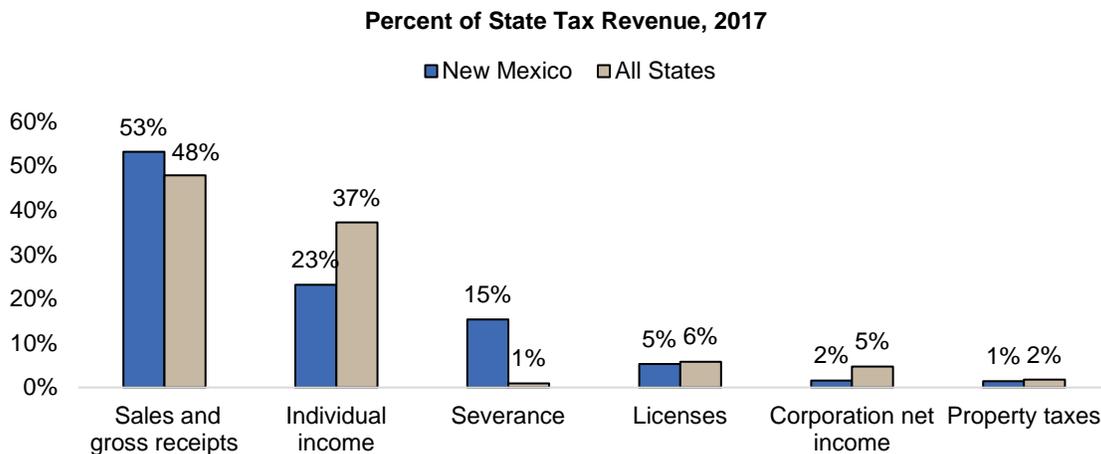
- **Adequacy** – the tax or tax system generates enough revenue to pay for public services without continuous changes;
- **Efficiency** – the tax or tax system minimizes economic distortion and avoids excessive reliance on any single tax;
- **Equity** – the tax or tax system fairly distributes the tax burden among all taxpayers;
- **Simplicity** – taxes are simple to understand and collect;
- **Accountability/Transparency** – tax collection/administration is easy to monitor and evaluate and subject to periodic review.

The project team also reviewed prior studies of the New Mexico state tax system and identified key issues that have led to prior recommendations and changes in the existing state tax structure.

Comparisons of State Revenue Structures

Most states, including New Mexico, rely on a broad-based consumption tax and a personal income tax (PIT) as their two primary revenue sources. While most states rely on a general sales tax, New Mexico’s gross receipts tax (GRT) is a business privilege tax that has a broader base than state sales taxes. Compared to other states, New Mexico raises an above average share of its revenue from its GRT and a below average share from its PIT.

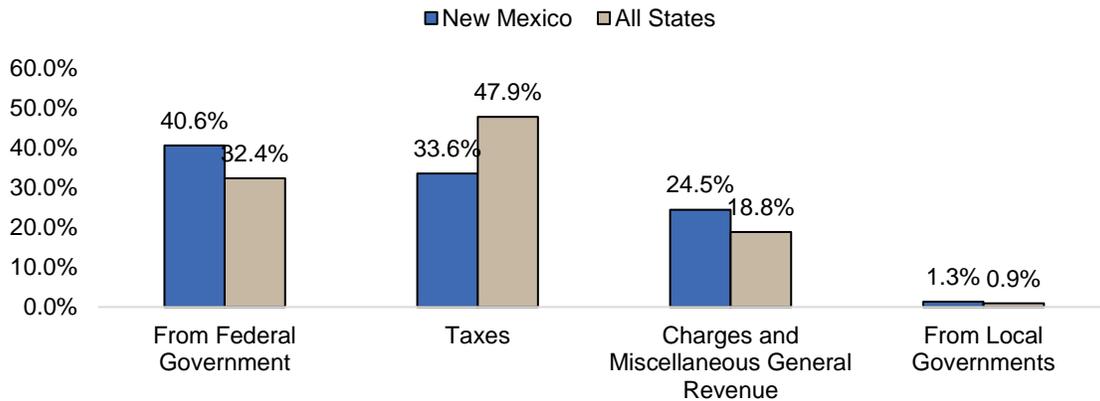
New Mexico is one of a handful of states that obtains a significant share of its tax revenue (15%) from mineral extraction taxes. Above average revenue from extraction taxes compensates, to some degree, for the state’s below average PIT collections.



Source: U.S. Census Bureau, 2017 Annual Survey of State Government Finances

Another notable feature of New Mexico’s revenue structure is its reliance on revenue from the federal government. While a significant portion of this relates to payments for mineral extraction on federal lands, the State also benefits from programs like Medicaid, where the federal match is much higher than for most states, because New Mexico’s per capita personal income is among the lowest in the nation.

Percent of State General Revenue, 2017



Source: U.S. Census Bureau, 2017 Annual Survey of State Government Finances

New Mexico Revenue Structure Components, Characteristics and Challenges

New Mexico's tax and revenue structure has similarities and differences with other states. These create some unique (and similar) challenges related to state revenue structures. The following detail the issues of greatest impact and concern for the state.

Gross Receipts Tax (GRT)

The GRT applies to most business revenue generating activities. This differs from sales taxes, where the base is composed primarily of purchases of tangible goods and excludes many services. This has both advantages and disadvantages:

- **Has a very broad base.** As consumption changes (such as the move to services or new types of consumption), the GRT still applies. This is a strength for adequacy.
- **Taxes lots of business inputs into finished products.** This creates 'pyramiding,' where taxes are applied throughout a process that leads to a finished product – which is also subject to tax. This is a weakness for efficiency.
- **Is regressive.** For most broad-based consumption taxes, low income households devote a far greater percentage of their income to the tax than others. This is a weakness for equity.
- **Can have a high combined rate.** The combined state and local rate for the GRT ranges from 5.1% to 8.9%. At the top end, this is a high rate. Nationally, the average combined rate in New Mexico ranks 15th highest. This is a weakness for efficiency.

Personal Income Tax (PIT)

The PIT has gradually increasing rates at higher levels of income. In the last 20 years, the brackets have been compressed, although there was an increase in the top income bracket that will take effect in 2021. The PIT:

- **Is progressive.** The PIT generally taxes higher income earners at higher effective rates than others. It also uses refundable tax credits to reduce the PIT burden for lower income households. This is a strength for equity.
- **Has reduced collections.** New Mexico has compressed its brackets, which has reduced overall revenue. This is a weakness for adequacy.
- **Has some high income tax breaks.** For example, the capital gains exemption is primarily used by high income households and reduces tax collections. This is a weakness for adequacy and equity.

Other Taxes

New Mexico uses a variety of other taxes and revenue sources. Each of these are important, but none has the overall revenue or economic impact of the GRT and PIT. In particular, the corporate income tax (CIT), which used to be a major tax revenue source for states, is no longer a major revenue contributor. New Mexico has recently adopted a change to corporate taxation, mandatory combined reporting, which may improve collections. Like most other states, New Mexico collects relatively little state property tax revenue; but the state's local governments also collect less property tax revenue, on average, than those in other states. This impacts the state's ability to dedicate resources to services that have traditionally been supported by local property taxes in the US, particularly K-12 education.

Tax Burden

The prominence of the GRT means that New Mexico's tax burden is above average among the states. When local taxes are included, the tax burden rankings improve somewhat. For state tax systems, the PIT is by far the most progressive tax, and greater use of it will improve a state's ranking.

Revenue Concentration and Volatility

In one national comparison, New Mexico's revenue structure is among the most volatile of the states. In that comparison, energy producing states were among the most volatile. In another comparison of states, New Mexico's predominant industry, oil and gas, constituted an above average share of the state's overall economy. Several studies have documented that this translates into the oil and gas industry contributing a significant share of the state's revenue.

This volatility and concentration have an impact on the state's revenue and budget. New Mexico is one of only six states that has not restored the revenue lost from the Great Recession (when adjusted for inflation). During the current recession, New Mexico had a larger budget shortfall than all but a handful of states. These all suggest that the current revenue structure and its reliance on the oil and gas industry are significant concerns.

Recommendations

There is no perfect tax, and every tax will have some negative impact on economic activity. Still, taxes are necessary to ensure that there are resources available to support key government services, including K-12 education, health care and roads. The following recommendations should help ensure that those resources are available while aligning with the State's tax principles.

1. **Reinstitute a PIT rate structure with higher marginal rates at higher income levels.** New Mexico was one of several states that experimented with lowering top rates in the last 20 years to help attract high income households and stimulate economic development. However, there is little evidence from New Mexico or other states that this strategy was successful. Restoring top tax rates would make the overall structure more equitable while raising needed revenue.
2. **Eliminate the capital gains PIT exemption.** Higher income earners obtain nearly all the benefit from this exemption. Eliminating this exemption will improve revenue adequacy and equity.

3. **Reinstitute an Estate Tax.** This tax is paid by high wealth individuals, most of whom have been high income earners. It is one method for dealing with the issue of a ‘stepped up basis’ for assets. This is one of the few existing wealth tax options and will improve revenue adequacy and equity.
4. **Increase the Motor Fuel Tax rate.** Excise taxes are an important component of an overall tax structure, and motor fuel is one of the ‘big three’ (with tobacco products and alcohol) of traditional excise taxes. New Mexico’s state motor fuel tax rate is among the lowest in the country. This will improve revenue adequacy.
5. **Establish a structure for taxing recreational marijuana.** New Mexico has yet to legalize recreational marijuana, but the national trends and significant efforts during recent state legislative sessions suggest this is likely to happen in the near future. Prior to the November 2020 general election, 11 states had legalized recreational marijuana. In the November 2020 election, an additional four states legalized recreational marijuana through voter initiative – Arizona, Montana, New Jersey and South Dakota. Arizona joins Colorado as New Mexico border states that have legalized recreational marijuana. Many states that are now legalizing marijuana are doing so because of its revenue potential – a recognition that its use via the black market is prevalent, and the state would benefit from regulating and taxing it. Current tax structures vary considerably, with tax collections ranging from \$13 to \$67 per capita. Tax collections in the range of \$50 per capita for New Mexico would raise approximately \$100 million a year.
6. **Broaden the GRT tax base to again include food AND couple it with a refundable PIT tax credit for lower income taxpayers.** Besides prescription drugs (which every state exempts) the deduction for food sold at retail is New Mexico’s largest GRT expenditure. The general fund revenue loss is compounded by the ‘hold harmless’ payments the state makes to local governments to compensate them for a portion of their lost GRT revenue as a result of the deduction. This arrangement is unique to the “food and medical” deduction. While the GRT deduction for groceries seems logical from a tax equity standpoint, the exemption applies to all taxpayers – higher income earners purchasing filet mignon get the same benefit as lower income households buying hamburger, and higher income households get the largest share of the benefit. There is a more targeted way – the existing refundable tax credit for low income earners should be expanded to replace the GRT taxes paid by low income New Mexicans. In this way, the GRT base is expanded and those with the ability to pay do so. This would greatly improve revenue adequacy and, when coupled, make the overall structure more progressive.
7. **Resist the temptation to increase the State GRT rate.** The New Mexico combined average state and local rate ranks as the 15th highest among all states (when compared to state and local combined sales tax rates). While this is already above average, the overall GRT taxable base is much broader than nearly every other state sales tax base. As a result, measures that take into consideration both the GRT rate and base rank the New Mexico consumption tax effort among the highest of any state. When considering state and local sales/gross receipts tax collections per capita, New Mexico ranks ninth highest. On sales/gross receipts tax breadth (the ratio of the sales tax base to personal

income), New Mexico ranks third among the states. Given these factors, raising the GRT rate would be a major negative for equity and should not be considered.

8. **Continue to expand excise taxes to align with new goods and forms of services.** The economy continues to evolve and has become more focused on what is referred to as the 'sharing economy.' To date, New Mexico has done a good job of modifying its tax structure to account for this activity. It will need to continue to do so to maintain revenue adequacy in the future.
9. **Shift greater local funding responsibility to the property tax and away from the GRT.** Nationally, the property tax is the predominant local tax revenue source, but in New Mexico, it is the GRT. This heightens some of the negative effects of this tax. While the State's history and reluctance to use the property tax are understandable, there are mechanisms that can be put in place to reduce its negative effects. Broadening the overall tax base would help improve tax adequacy and reduce volatility.

While the focus of the study has been on changes to the overall tax structure, there are non-tax initiatives that can also be a benefit to the State. These include:

10. **Undertake a regular evaluation process for all state business incentives.** The State forgoes significant tax revenue for certain businesses and industries. While this is not unusual among the states, it is also considered a best practice to regularly review and evaluate these specific tax incentives. While New Mexico does a semi-annual tax expenditure report, it does not provide the level of detail necessary to determine the efficacy of these incentives. The Pew Charitable Trust does a regular evaluation of states' incentive evaluation processes and groups them into 'leading, making progress, or trailing' categories. New Mexico is classified as trailing. Developing a regular evaluation process would advance the efficiency tax principle and might lead the state to eliminating or reducing the use of incentives that do not provide a net positive economic or revenue impact for the state.
11. **Incent industry entry for renewable energy technology and processes.** New Mexico enjoys multiple advantages related to renewable energy sources, particularly for wind and solar. These industries also have great job creation potential and will help the state's economy shift from a reliance on oil and gas.
12. **Leverage the State's anchor institutions to capture the benefits of agglomeration economies and industry clusters.** The State greatly benefits from two national research universities and national laboratories. While these are already a key driver for the State economy, they should get greater attention when the State identifies the resources it will dedicate to its economic future.
13. **Expand well-paying, middle-skill manufacturing jobs through targeted job training and workforce intermediaries.** As in the prior recommendation, the State will best benefit and create a more effective tax and revenue structure by targeting resources toward expanding 'middle-skill' jobs. Its current incentive and appropriations-based programs should target these approaches.

1. Introduction

Background

In April 2020, West Texas Intermediate (WTI) crude oil futures were trading on the Chicago Mercantile Exchange at about -\$30 per barrel – the first time in history that domestic crude had fallen below \$0 per barrel. At that price, traders were forced to pay others to take oil contracts off their hands. This marked a 300% drop in the price per barrel of WTI crude oil.

In what some have called the ‘Coronavirus oil bust,’ prices spiraled to previously unheard-of depths due to a combination of factors that simultaneously created a dearth of demand coupled with oversupply – a perfect storm in an industry known for its booms and busts. The reduced demand was largely related to the worldwide COVID-19 pandemic. As nations put their economies into a sort of consumer-driven hibernation, there was far less need for vehicle travel. The use of other forms of transportation – notably air travel – also plummeted. Meanwhile, other product uses were also curtailed, as factories and facilities reduced their operations or shut down completely.

While demand waned, other factors created a market glut for the commodity. Most notably, on March 6, 2020, Saudi Arabia and Russia ended a four-year pact that curbed output. As a result, Saudi Arabia slashed its selling prices and increased production after Russia refused to join its plan to cut output and boost prices. The resulting price war flooded the market and led to the situation where sellers were willing to pay for others to take crude off their hands.

While a truce between the two oil producing giants was negotiated and prices started to return to more tolerable levels, there is evidence that the market will not quickly return to more ‘normal’ prices as it has in previous market setbacks. Figure 1 details the dramatic swings that have occurred within the WTI market in the last five years alone:

**Figure 1: WTI Crude Daily Closing Oil Prices
(price per barrel)**



Source: Federal Reserve Economic Data (FRED)

Industry Outlook

A variety of factors suggest that the industry’s decline is not a temporary swing and the market will not return to ‘business as usual’ anytime soon. First, the rise in prominence of the U.S. as an oil producer was largely driven by the shale boom of the previous decade. However, that boom was built on a highly leveraged foundation, and in recent years (and 2020 in particular), the debt necessary to fuel the boom has proven unsustainable. As an example, when oil was \$35 a barrel,

almost a third of U.S. shale producers were technically insolvent, according to a recent study by Deloitte LLP. More than 100,000 U.S. oil jobs have been lost since the downturn began earlier this year, according to Rystad Energy, an independent energy research company.

While there has been some recovery in the oil market in the last few months (with prices back in the \$37-\$42 per barrel range), production has still not matched previous levels, with New Mexico's rig count declining from 117 at its peak in March 2020 to 49 at the end of July. State economists don't expect oil producers to start adding new rigs in New Mexico anytime soon.¹

As a result of the significant amount of debt already incurred, many producers have been forced out of business – or into bankruptcy. More than 230 North American oil and gas producers, with over \$150 billion in debt, have filed for bankruptcy since the beginning of 2015, according to the law firm Haynes & Boone. In a June 2020 profile of bankrupt shale drillers, Bloomberg noted that “profitability and shareholder returns have been consistently disappointing, and investors had already grown wary of throwing more money into shale before this year's oil crash.” As a result, investor demands have led to cutbacks in oilfield spending, which also hurts the service companies and reduces earnings and employment tied to the industry.

These factors have led many to the conclusion that the 2020 collapse could prove insurmountable for much of the industry. “I believe it is likely to assume that demand will take a long time to recover,” Shell CEO Ben van Beurden noted while announcing an unprecedented \$18.4 billion second quarter 2020 loss, “if it recovers at all.” Earlier this year, Texas Railroad Commissioner Ryan Sitton (one of the elected officials who regulates the Texas oil and gas industry) said “this is the worst energy crisis in history. It's never been worse than this.” Recently, Daniel Yergin, perhaps the world's most prominent oil industry analyst, wrote that “The United States will remain a major producer [of oil] and will likely regain some of the output level lost from the coronavirus crisis; but it will not return to that high point of thirteen million barrels per day hit in February 2020, unless circumstances change significantly.”²

The natural gas industry has also experienced significant decline. In New Mexico, there was a sharp drop in production in the fourth quarter of FY2020, and FY2021 production is projected to decline by 7% to 10% from FY2020. It is also predicted that there will be little to no growth in natural gas production in FY2022.³

Besides the immediate crisis, there are other undercurrents that suggest there will not be an easy return to 'business as usual' for the industry and the states that rely on it as a revenue producer. Carbon-related environmental impacts are one area of concern, as are hazards associated with horizontal drilling. The results of the 2020 federal elections could also change policies emanating out of Washington DC.

Impacts on New Mexico

As with other energy producing states, New Mexico has built its budget around assumptions related to energy prices that have often not met expectations. For 2020, the general assumption was that oil would sell for around \$50 a barrel. In fact, when New Mexico legislators met in a special session

¹“General Fund Recurring Revenue Outlook: Presentation to the Legislative Finance Committee,” September 30, 2020, accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Revenue_Reports/General_Fund_Revenue_Forecast/2021/Consensus%20Revenue%20Estimate%20%20-%20September%202020.pdf

² Daniel Yergin, “The New Map: Energy, Climate, and the Clash of Nations,” September 2020, p. 420.

³ “General Fund Recurring Revenue Outlook: Presentation to the Legislative Finance Committee,” September 30, 2020, accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Revenue_Reports/General_Fund_Revenue_Forecast/2021/Consensus%20Revenue%20Estimate%20%20-%20September%202020.pdf

in June 2020, the primary purpose was to deal with an estimated budget shortfall for the next fiscal year of between \$1.8 billion and \$2.8 billion, as well as a current fiscal year revenue shortfall of between \$368 and \$483 million. In July 2020, after the special session, the LFC estimated the deficit for FY2021 at \$991 million, driven both by the COVID-19 pandemic and lower than expected energy prices.

While oil prices have now rebounded, they are still well below the \$50 a barrel level. The current expectation is that they will range between \$37 and \$40/barrel through FY2021.⁴

This instance of budget and revenue shortfalls tied to the oil and gas industry is not new to New Mexico. New Mexico has faced similar problems in past energy boom and bust cycles. This creates stress on the state budget on a recurring basis. There are concerns that this time may be even more difficult for the industry to recover – an opinion already expressed by energy executives and officials in state government. Time may have run out for some key components of the industry. In a recent commentary, Raoul Nowitz, head of restructuring at SOLIC Capital Advisors opined “unlike the 2014-2016 oil bust, lenders are not making more financing available to producers.” He goes on to predict that up to 60 oil producers will seek protection from creditors this year, and many will not emerge under new owners. Some banks are setting up operations to take over and run failed producers.⁵

By the end of 2019, all but six states had made up the revenue losses from the Great Recession – New Mexico was one of the six that had not.

The boom-and-boost nature of the oil and gas industry and New Mexico’s reliance on it creates multiple levels of instability. For most states, the period from the trough of the Great Recession in 2009 through the end of 2019 was one of steady revenue growth; by the end of 2019, all but six states had (on an inflation-adjusted basis) made up the revenue losses from the Great Recession – but New Mexico was one of the six states that had not. Four of the states that had not reached pre-recession revenue levels (New Mexico, Alaska, Louisiana and Wyoming) are also major oil and gas producing states.⁶

Diversification of Economic and Tax Structures

Based on this set of facts and circumstances, the question presents itself: would New Mexico benefit from an economic (and revenue) structure that was not so tied to the fortunes of a single economic sector? As an investment portfolio carries considerable risk when most of it is tied to the

⁴ “General Fund Recurring Revenue Outlook: Presentation to the Legislative Finance Committee,” September 30, 2020, accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Revenue_Reports/General_Fund_Revenue_Forecast/2021/Consensus%20Revenue%20Estimate%20-%20September%202020.pdf

⁵ Jennifer Hill and Liz Hampton, “Oil in the age of coronavirus: a U.S. shale bust like no other,” Reuters Business News, April 15, 2020, accessed electronically at https://www.reuters.com/article/us-global-oil-shale-bust-insight/oil-in-the-age-of-coronavirus-a-u-s-shale-bust-like-no-other-idUSKCN21X0HC?feedType=RSS&feedName=businessNews&utm_source=dlvr.it&utm_medium=facebook

⁶ Barb Rosewicz, Justin Theal and Alexandre Fall, “COVID-19 Abruptly Ends Decade of State Tax Revenue Growth,” Pew Charitable Trusts State Fiscal Health, September 4, 2020, accessed electronically at [https://www.pewtrusts.org/en/research-and-analysis/articles/2020/09/04/covid-19-abruptly-ends-decade-of-state-tax-revenue-growth?utm_campaign=2020-09-09+Rundown+1+\(CTR\)&utm_medium=email&utm_source=Pew](https://www.pewtrusts.org/en/research-and-analysis/articles/2020/09/04/covid-19-abruptly-ends-decade-of-state-tax-revenue-growth?utm_campaign=2020-09-09+Rundown+1+(CTR)&utm_medium=email&utm_source=Pew)

fortune of a single company or sector, the same is true for states. The National Conference of State Legislators (NCSL) has identified the characteristics of a high-quality state revenue system; one of those characteristics is reliance on a balanced variety of revenue sources.

Other energy producing states are having similar discussions. For example, the State of Wyoming receives between 50 and 60% of its direct revenue from mineral extraction, primarily coal, oil and gas. Both the Wyoming Governor and State Legislature have identified the need to diversify the state revenue structure. In 2018, the Wyoming State Legislature Revenue Committee commissioned a study, by Regional Economic Models, Inc., on economic and fiscal diversification. Governor Mark Gordon has also weighed in on the subject, noting that diversifying “doesn’t mean we’re deemphasizing minerals . . . It just means we’re growing our economy . . . We need to make sure that the tax system is sustainable over time.”⁷ Gordon has highlighted other sectors, including tourism, as well as alternative energy sources like wind and solar and carbon recapture technologies as diversification opportunities for Wyoming.

Other states have also pursued diversification efforts. Both Colorado and Texas have become important high-tech hubs, and Texas and Oklahoma have been the two largest producers of electricity from wind. Oklahoma has also developed a thriving aerospace industry. While all are still heavily dependent on energy, these state economies have grown in other sectors as well.

For New Mexico, this is an opportune time to examine both its economic and revenue structures. One of the ‘lessons learned’ from Wyoming is that pursuing diversification alone will not necessarily improve the state’s budget fortunes – the structure itself can hamper diversification or limit its positive effects.⁸ There are many features of the current New Mexico tax and revenue structure that should be updated or revised to better align with the characteristics of a high quality revenue system.

The following chapters provide an overview of the New Mexico economy and revenue structure. These are examined from a ‘principles of taxation’ perspective and analyzed for their impact on the State and its residents. Finally, high level findings and recommendations will be presented as methods for the State to improve its overall structure and operations.

Report Purpose

While all 50 states have unique revenue and expenditure structures, the State of New Mexico has greater separation from the mean than most states in a variety of revenue and expenditure areas. Some is the result of characteristics related to its economy, natural resources and demographics, and some may result from its political history. Several of the factors that set New Mexico apart from other states existed even prior to statehood.

While New Mexico’s approach to revenue and expenditures has been relatively stable, multiple working groups or task forces have been convened over the past 25 years to consider changes to the existing structure. Many of these have included state policymakers from both the executive and

⁷ “Gordon pushes to diversify revenue through tourism,” Powell Tribune, May 14, 2019, accessed electronically at <https://www.powelltribune.com/stories/gordon-pushes-to-diversify-revenue-through-tourism,18935>

⁸ “Wyoming governor wants state to take ‘realistic’ look at its energy dependent tax system,” Casper Star Tribune, May 18, 2019, accessed electronically at https://trib.com/business/energy/wyoming-governor-wants-state-to-take-realistic-look-at-its-energy-dependent-tax-system/article_2004b29f-6dad-5870-847e-a7395e00f6c0.html

legislative branches as well as external stakeholders and subject matter experts. There have also been notable studies done within and outside of state government. While some of these have resulted in changes to the existing structure, most have been incremental in nature.

The past 20 years have seen significant national economic, technological and demographic changes that have had broad repercussions and implications for how states construct their budgets on both the revenue and expenditure sides. During this time, three national recessions (including the current one that began in February 2020) have put significant pressure on state finances in general, and New Mexico has been impacted by these downturns.

Given these facts and circumstances, now is an appropriate time to examine alternatives or augmentations to the current structure. The current review and this report take into consideration both short-term issues (including the current recession driven in large part by the COVID-19 pandemic) as well as the longer-term challenges related to reliance on a single sector for a significant share of overall state revenues.⁹

There are other factors at play beyond the current recession and the significant reliance on the oil and gas industry contributing to New Mexico's volatile revenue generation. Unlike most states, the primary consumption tax in New Mexico is not a general sales tax; instead, it is a gross receipts tax (GRT) on most business activity conducted in the state. This has ramifications relating to tax incidence, effort and burden, and the GRT has been subject to many modifications in the past. These issues will continue to be important in the current environment and the future. These and other issues are also key topics for discussion.

Research Method

The project team relied on public data and information from a variety of national and state sources. These include comparative data for New Mexico and other states compiled by the U.S. Census Bureau, the National Association of State Budget Officers (NASBO), the NCSL, the Federation of Tax Administrators (FTA) and other sources. It also includes data and information from the State, including its Comprehensive Financial Reports (CAFR), budget documents, revenue estimates and reports from both the legislative and executive branches.

Throughout the study, a set of 'peer states' that included Alaska, Arizona, Colorado, Oklahoma, Utah, and Wyoming was used for benchmarking purposes. These states were selected because they were either close to New Mexico and/or possessed similar economic characteristics, including a substantial oil and gas sector.

While state-to-state comparisons are common, there are no perfect twins for benchmarking purposes. All 50 states have multiple characteristics that combine to make them unique. With that stipulation, states often compete for residents, businesses and capital investment. It can be helpful to understand how differing (or similar) characteristics may distinguish one state from others in ways that make it more or less attractive to residents and businesses. Throughout the benchmarking, the project team was mindful (and will note where important) of specific circumstances that set New Mexico (or other individual states) apart from others.

⁹ Rockefeller Family Fund supported this study as part of its effort to ensure that future state and local transitions away from oil and gas are both fiscally and economically responsible.

The project team also conducted numerous interviews with subject matter experts related to New Mexico finances, budget and taxation. These included current and former members of both the legislative and executive branch, their professional staff and others within higher education and the private sector with significant knowledge and experience in New Mexico's tax policy and economy. These interviews typically lasted between 45 and 90 minutes and were primarily for background purposes. None of the interviews were for attribution, and the resulting study and recommendations are the product of the project team and not the interviewees.

Throughout, the project team was assisted by Dr. Kelly O'Donnell, who provided significant subject matter expertise and insight based on her lengthy experience working in and with New Mexico state government. As an economist, Dr. O'Donnell also provided insight and advice related to the likely impacts and implications of changes to the existing budget and tax structure in New Mexico. While her participation was invaluable for the project, the findings and recommendations are those of the study team and do not necessarily reflect the views of Dr. O'Donnell.

The project team wishes to thank the many individuals from the public and private sector who shared their knowledge and insight related to the history of state and local finance, tax and budget issues related to the State of New Mexico. They contributed much of their time and provided the project team with a far greater understanding of the issues the State has faced and will continue to deal with in the present and future. Of course, the findings and recommendations should not be attributed to any of those individuals, and any errors or omissions are also the sole responsibility of the project team.

Report Organization

After this initial introduction, the remaining sections cover the following topics:

- Section 2 provides background information on New Mexico's geographic, economic and demographic characteristics, including comparisons to a set of peer states and the US as a whole;
- Section 3 provides background information on state tax structures, particularly related to principles of taxation and best practices;
- Section 4 analyzes how New Mexico's state tax and revenue structure differs/is similar to other states;
- Section 5 provides an in-depth look at the key components of New Mexico's tax and revenue structure;
- Section 6 discusses current key topics related to state taxation and revenues, both for New Mexico and the states as a whole;
- Section 7 provides the project team's findings and recommendations;
- The appendices provide a list of those interviewed as well as additional supplementary information to that found in the report.

2. New Mexico Demographics and Economy

Demographics

Population

With an estimated 2019 population of 2,096,829, New Mexico is the 36th most populous U.S. state. After the 2010 census, New Mexico had a population of 2,087,309 and also ranked 36th among the states. Although the state's population has increased, there has been little relative change in its population ranking in the last 50 years.¹⁰

In general, state population growth is positively associated with overall state well-being. A variety of formula-based federal assistance programs use state population as a key input for determining grants to states, and a growing population share will increase federal assistance dollars. Beyond that specific situation, a growing population is often perceived to reflect people 'voting with their feet' as to where they wish to live. It is notable, for example, that states that are experiencing financial or economic difficulty often experience population declines – even when neighboring states or their region are still expanding.¹¹

As shown in the following table, New Mexico has experienced very little population growth since the 2010 Census. In this respect, it trails the peer states.

Table 1: Population Growth by State

	2010	2018	CAGR*
Utah	2,763,885	3,161,105	1.7%
Colorado	5,029,196	5,695,564	1.6%
Arizona	6,392,017	7,171,646	1.4%
United States	308,745,538	326,687,501	0.7%
Oklahoma	3,751,351	3,943,079	0.6%
Alaska	710,231	737,438	0.5%
Wyoming	563,626	577,737	0.3%
New Mexico	2,059,179	2,095,428	0.2%

* Compound Annual Growth Rate (CAGR)

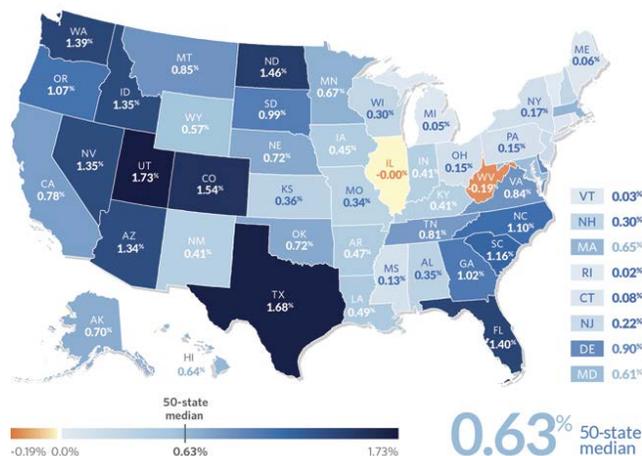
Source: U.S. Census Bureau, 2010 Decennial Census; Population Estimates Program

The national map also illustrates New Mexico's slow growth in comparison to other states in the region:

¹⁰ "The changing population rank of each US state over 100 years," Business Insider, February 8, 2018, accessed electronically at <https://www.businessinsider.com/population-rank-of-each-us-state-over-100-years-2018-2>

¹¹ For a discussion of state population losses tied to employment declines or other issues, see "The States With Declining Populations," Governing Magazine, January 19, 2016, accessed electronically at <https://www.governing.com/topics/mgmt/gov-states-losing-population-census.html>

Figure 2: Population Growth Rate, 2008-2018



Source: The Pew Charitable Trust

New Mexico out-migration is an area for concern. From 2010 to 2018, 62,000 more U.S. citizens moved out of New Mexico than arrived in the state.¹² Over this period, the State’s working age population (defined by the U.S. Census Bureau as ages 16 through 64 years) declined by 30,290.¹³ This may reflect a lack of current economic prospects; it also raises concerns that current and future employers will find it more difficult to recruit qualified workers locally. During this timeframe, New Mexico’s dependent population (younger than 15, and 65 or older) increased by 59,786. The dependent population increase was entirely driven by the 65 and older age group, which increased by 93,093. This growth may lead to higher expenses for state government, as demand for government services and benefits increases with age. The aging population may also depress revenue collections, as these age groups tend to spend less than other age cohorts.

New Mexico is a low population density state. At 121,298 square miles, New Mexico is the 4th largest state.¹⁴ At 17.3 persons per square mile in 2019, New Mexico ranked as the 6th most sparsely populated state. By contrast, New Jersey ranked first in population density (1,207.8 residents per square mile), while Alaska ranked 50th (1.3 residents per square mile). Among the states in the continental US, Wyoming was the most sparsely populated with 6.0 residents per square mile.¹⁵

Although sparsely populated, New Mexico ranks above average in the percent of its population that lives in urban areas. According to the 2010 census, 77.4% of New Mexico residents live in counties classified as urban, which ranks 23rd among the states. According to the 2010 census, the country’s most urban state was California (95%), while Maine was the least urban (38.7%). For the U.S., 80.7% of residents live in urban counties. The trend toward greater urbanization is long-standing,

¹² “New Mexico Lags Behind Neighbors in Population Growth,” Associated Press, December 22, 2018, accessed electronically at <https://apnews.com/8301dac95ce349019dd41b46eab12267>

¹³ US Census Bureau, ACS Demographic and Housing Estimates, 1-Year Estimates 2010 and 2018.

¹⁴ US Census Bureau, “State Area Measurements and Internal Point Coordinates,” accessed electronically at <https://www.census.gov/geographies/reference-files/2010/geo/state-area.html>

¹⁵ “Population density in the U.S. by federal states including the District of Columbia in 2019,” Statista, accessed electronically at <https://www.statista.com/statistics/183588/population-density-in-the-federal-states-of-the-us/>

for both New Mexico and the U.S. For New Mexico, in 1970, the percentage of urban county residents was 69.8%. For the U.S., it was 73.6%.¹⁶

Public Land

A New Mexico defining characteristic is the amount of public land held by the U.S. federal government. In 2018, 31.7% of the land in New Mexico was owned by the federal government, ranking 10th among all states. Nevada had (by far) the highest concentration of federal land (80.7%), while Connecticut and Iowa had the lowest (0.3%).¹⁷ In addition to federally owned land, the State was allocated 9 million surface acres and 13 million mineral acres of land by the federal government under the Ferguson Act of 1898 and the Enabling Act of 1910.¹⁸ This state-owned land accounts for about 11.0% of the total land in New Mexico and is under the direction of the New Mexico State Land Office. These lands (through rents, royalties and taxes on mineral extraction), are an important source of revenue for the State.

Education

An important characteristic of a state's population is its level of educational attainment. It is generally accepted that individuals with bachelors or advanced degrees have higher lifetime earnings. This translates into greater median household income and personal income. A more educated populace may also make the state more attractive to employers requiring a highly skilled workforce.

New Mexico is among the states with the lowest percentage of residents who have obtained a college or university bachelor's degree, at 15.1%. This ranked 45th among the states. However, New Mexico's ranking improves when factoring in advanced degrees. New Mexico is tied for 16th among the states for individuals with an advanced degree, 11.8%. When those with a bachelor's degree and/or an advanced degree are combined, New Mexico ranks 37th at 26.9%. It is likely that the State's two national research universities and three national laboratories contribute to the improved ranking related to advanced degrees.¹⁹

Economy

A common measure of a state or federal economy is Gross Domestic Product (GDP). GDP calculates the sum of private consumption, investment and government spending within a state or nation. GDP is an aggregate measure that includes the value of goods and services produced in an economy. While GDP is a useful measure for assessing the components of an economy, it is not a measure of well-being, and it does not measure positive and negative effects that may occur because of economic activity.

¹⁶ US Census Bureau, decennial census. Data accessed electronically at <https://www.icip.iastate.edu/tables/population/urban-pct-states>

¹⁷ Congressional Research Service, "Federal Land Ownership: Overview and Data, February 21, 2020, p. 7-8. Accessed electronically at <https://fas.org/sgp/crs/misc/R42346.pdf>

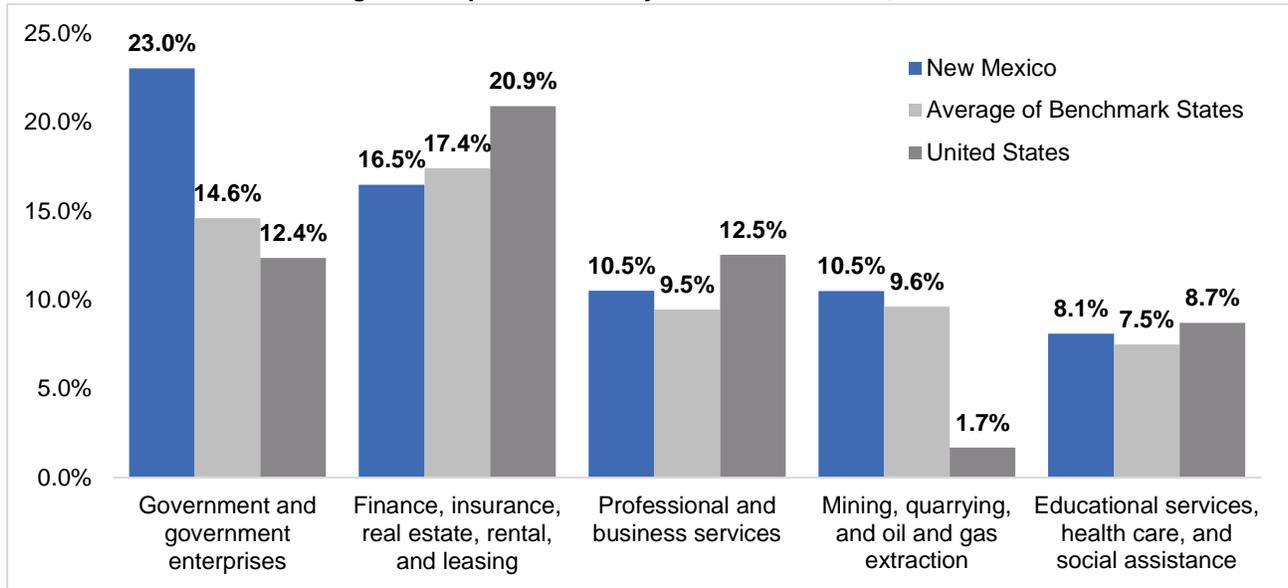
¹⁸ New Mexico State Land Office, "About the New Mexico State Land Office," accessed electronically at <https://www.nmstatelands.org/about/>

¹⁹ US Census Bureau, Table 1. Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2019 (NST-EST2019-01)

Key Sectors

While some measures suggest that New Mexico's economy is defined by mineral extraction (primarily its oil and gas industry), the largest contributor to GDP is the government and government enterprises sector. In this sector, New Mexico's share of GDP significantly exceeds its peer states – and is nearly twice the average of all states.

Figure 3: Top 5 Industries by GDP in New Mexico, 2018²⁰



Source: Bureau of Economic Analysis, Gross Domestic Product by State, Table SAGDP2N

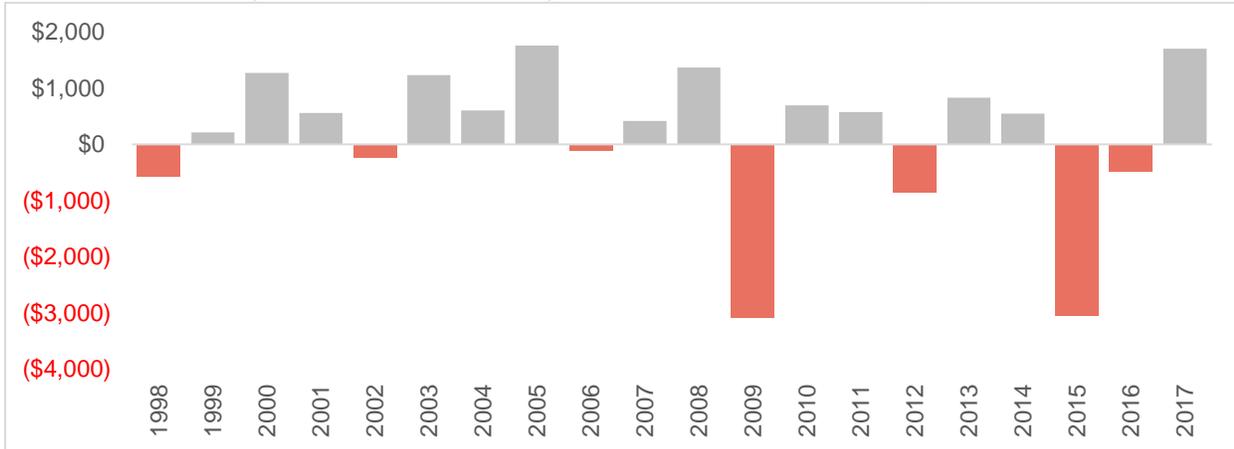
Of course, the government and government enterprises sectors mostly require tax revenue generated by other sectors and state residents to fuel its output. In this respect, it is different than other sectors, where its activity generates revenue for the state.

The five industries in Figure 3 account for nearly 70% of New Mexico's 2018 GDP. The industries that make up the remainder of New Mexico's GDP (such as retail trade and construction), make up a similar share of New Mexico's GDP as they do in the U.S. Some industries represent a much smaller share of New Mexico's GDP than in the benchmark states and the U.S. Manufacturing, for example, represents 4.2% of New Mexico's GDP, but in the benchmark states manufacturing averages 7% of the GDP, and in the U.S., it represents 11% of GDP.

Oil and gas extraction are the driving forces within New Mexico's mining, quarrying, and oil and gas extraction sector. Oil and gas extraction accounted for over two-thirds (67%) of this sector's GDP in 2017 and in the preceding 20 years. During this timeframe, these activities were highly volatile and experienced significant swings in economic activity.

²⁰ The benchmark states are Alaska, Arizona, Colorado, Oklahoma, Utah, and Wyoming.

Figure 4: Year-to-Year Change in Oil and Gas Extraction GDP, 2018 Dollars

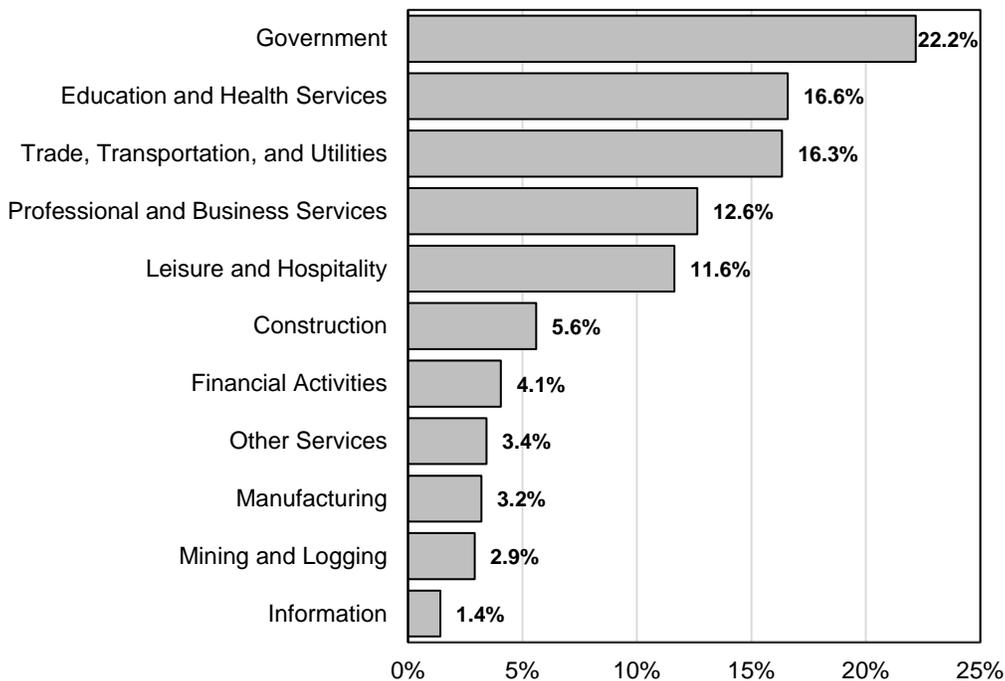


Source: Bureau of Economic Analysis, Gross Domestic Product by State, Table SAGDP2N

Employment

Some industries account for a large share of New Mexico's GDP but a relatively small share of employment. Mining, for example, constitutes 10.5% of New Mexico's GDP but only 2.9% of employment. Education and health services, on the other hand, are 8.1% of the state's GDP but make up 16.6% of the State's total employment.

Figure 5: Percent of Nonfarm Employment by industry in New Mexico, 2018

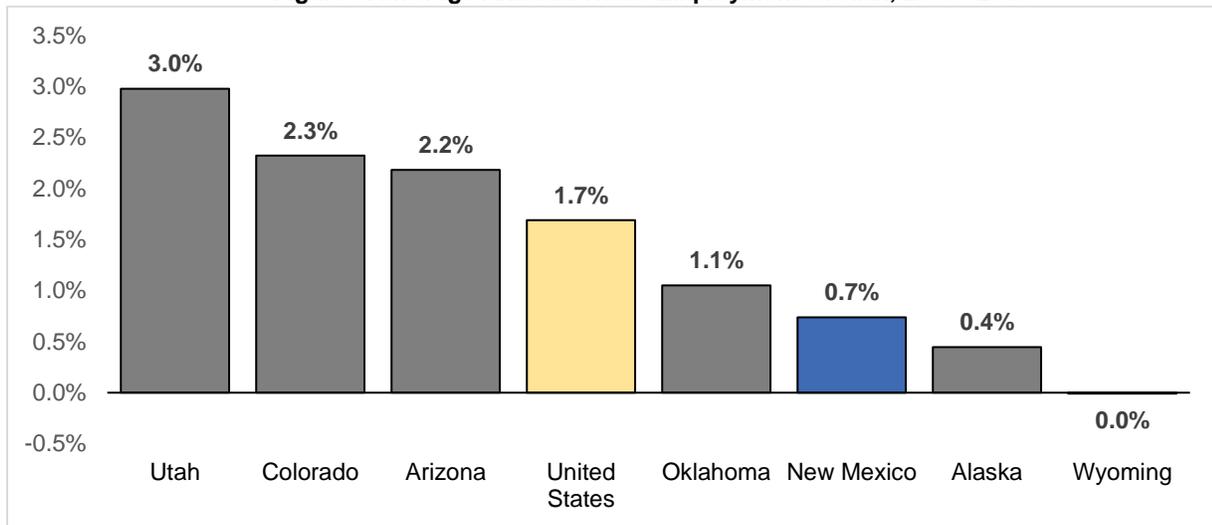


Source: Bureau of Labor Statistics, Current Employment Statistics

For most states, private employment is an important indicator, because it translates into salary and wages that drive personal income. In general, states with higher personal income also score higher on common indexes of well-being. States with strong private employment growth generally experience increases in personal income and median household income.

Figure 6 shows average annual private employment growth over a 10-year period. It suggests that New Mexico is trailing most of the benchmark states and the U.S.

Figure 6: Average Annual Private Employment Growth, 2009 - 2018



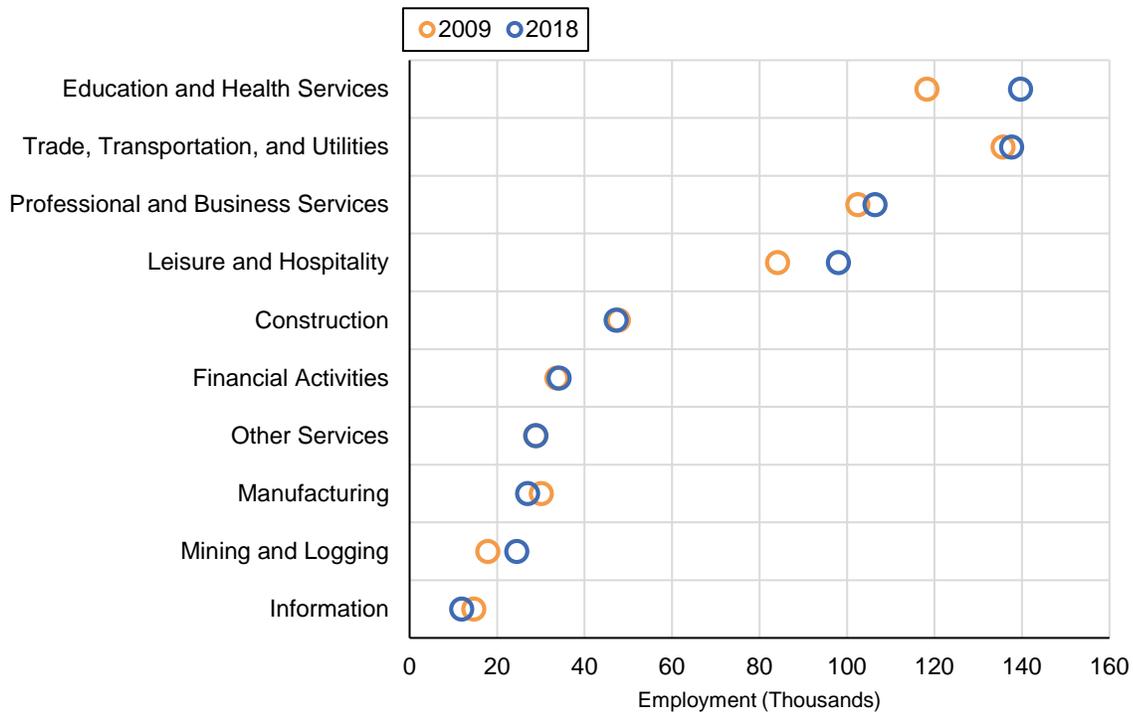
Source: U.S. Bureau of Labor Statistics, Current Employment Statistics

Economies and employment mix evolve over time. When looking at changes in private employment by industry from 2009 to 2018, New Mexico has experienced increases in some services sectors (education and health services, professional and business services, and leisure and hospitality). During that same time period, there was some reduction in employment within the manufacturing and information sectors. For manufacturing, this reflects a national trend. While manufacturing as a share of GDP continues to increase nationally, employment has been declining, primarily due to automation and other efficiencies.²¹ In New Mexico, manufacturing’s share of GDP has also declined significantly – from 20.8% in 1997 to 4.2% in 2018.²²

²¹ See for example, “The Fall of Employment in the Manufacturing Sector,” Bureau of Labor Statistics Monthly Labor Review, August 2018, where it was noted that “Today’s manufacturing output is at least 5% greater than in was in 2000, but it has become much more capital intensive and much less labor intensive...there are far fewer manufacturing workers overall, with about 7.5 million jobs lost since 1980.” Accessed electronically at <https://www.bls.gov/opub/mlr/2018/beyond-bls/the-fall-of-employment-in-the-manufacturing-sector.htm>

²² Federal Reserve Bank of St. Louis, Federal Reserve Economic Data (FRED), accessed electronically at <https://fred.stlouisfed.org/series/NMMANNNGSP>

Figure 7: Change in Private Employment by Industry in New Mexico, 2009 to 2018



Source: U.S. Bureau of Labor Statistics, Current Employment Statistics

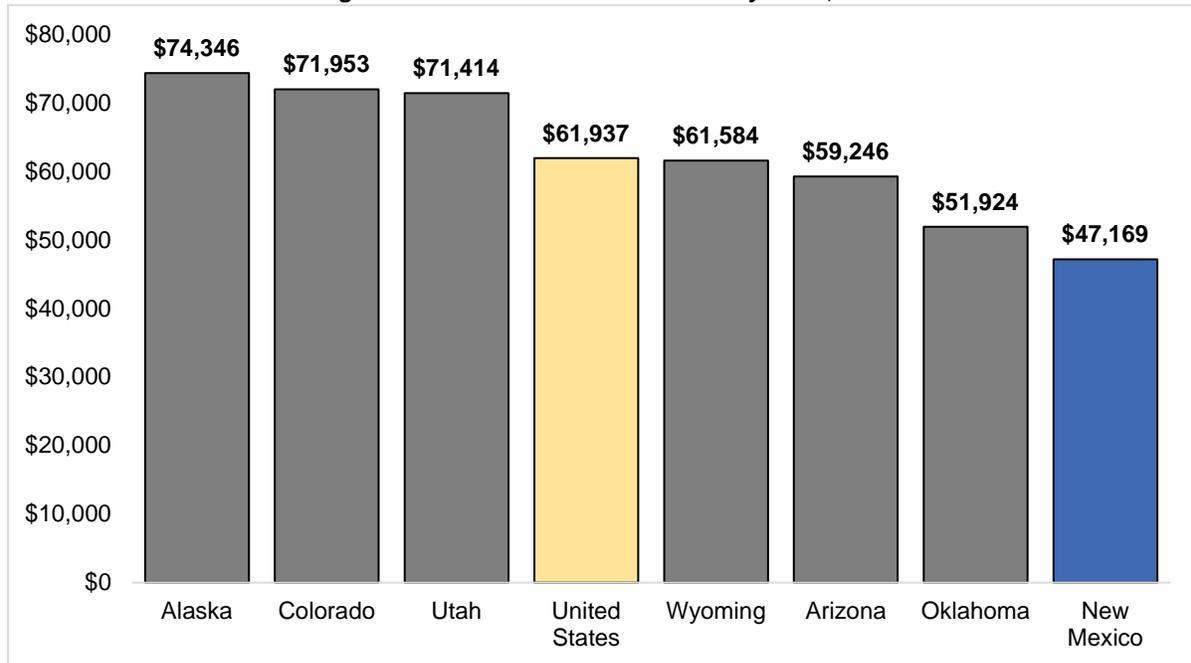
Income and Poverty

Measures of output (like GDP) do not necessarily reflect resident well-being. Likewise, numbers of employed do not provide a full picture on the economic impact of that employment. Some of the industries with strong employment growth in New Mexico tend to be lower-paying jobs (particularly within the leisure and hospitality sector).

Income is an important indicator of well-being, and state personal income and median household income are frequently cited metrics. Median household income, which measures the mid-point of the income distribution, is generally preferred to average household income, which can be skewed by a relatively small number of very wealthy and/or very poor households.

As the following chart shows, New Mexico’s median household income is below that of all the peer states and the U.S.

Figure 8: Median Household Income by State, 2018



Source: U.S. Census Bureau, 2018 ACS 1-Year Estimate

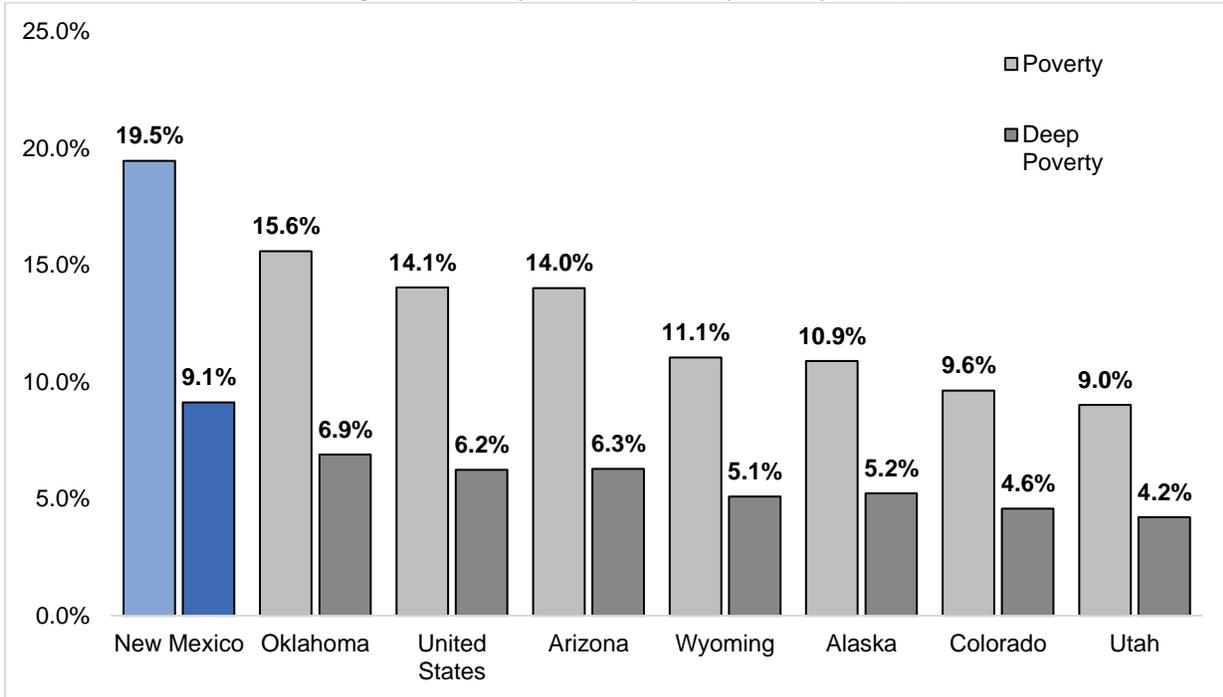
Another common indicator of well-being is the percent of state residents who fall below the federal poverty threshold.²³ The Census Bureau also provides a measure of deep poverty. Deep poverty is defined as living in a household with a total cash income below 50% of the poverty threshold.²⁴

As shown in the following chart, the percentage of New Mexico residents living in poverty and deep poverty is the highest among the peer states.

²³ For purposes of determining who is living in poverty, the U.S. Census Bureau uses a set of money income thresholds that vary by family size and composition. If a family's total income is less than the family's threshold, then that family and every individual in it is considered in poverty. The official poverty thresholds are updated for inflation using the Consumer Price Index (CPI-U). The official poverty definition uses money income before taxes and does not include capital gains or noncash benefits (such as public housing, Medicaid, and food stamps). U.S. Census Bureau, "How the Census Bureau Measures Poverty," April 2019, accessed electronically at <https://www.census.gov/topics/income-poverty/poverty/guidance/poverty-measures.html>

²⁴ US Department of Health and Human Services, "Poverty in the United States: 50-Year Trends and Safety Net Impacts," March 2015, p. 19 accessed electronically at <https://aspe.hhs.gov/system/files/pdf/154286/50YearTrends.pdf>

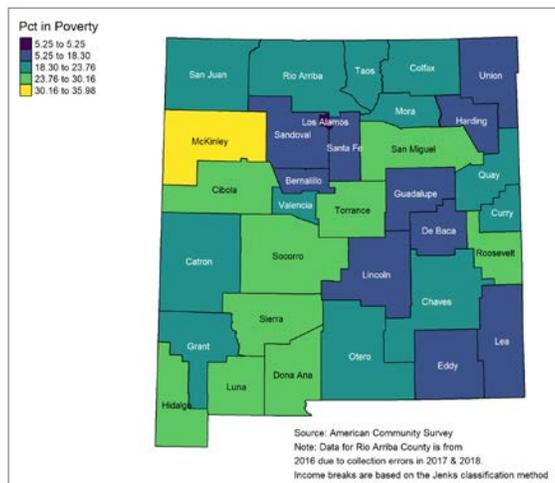
Figure 9: Poverty and Deep Poverty Rate by State, 2018



Source: U.S. Census Bureau, 2018 ACS 1-Year Estimate

Of course, poverty percentages and median household income are aggregate measures. Even the poorest state will have pockets of wealth. For New Mexico, this contrast is most notable in Los Alamos County, which is the only county with a poverty rate below 5.25%. By contrast, McKinley County's poverty rate is over 30%. Los Alamos' income is largely driven by the Los Alamos national laboratories. High regional reliance on national laboratories and federal installations is a notable feature of the New Mexico economy.

Figure 10: Ratio of Income to Poverty by New Mexico County



Livability

Multiple sources provide state livability rankings based on specific or general characteristics. Livability factors often include data on K-12 and higher education attainment, infrastructure, health, economy, business climate, etc.

U.S. News and World Report publishes an annual livability ranking of states that is based on composite scores in eight categories: health care, education, economy, infrastructure, opportunity, fiscal stability, crime and corrections, and natural environment. In 2019, the magazine ranked New Mexico 46th among states, a slight improvement over its 48th place ranking in 2018. The state scored best on infrastructure (17th) and natural environment (23rd) but scored in the bottom four in the categories of education, economy, opportunity, fiscal stability, and crime and corrections.²⁵

Summary

Based on the review of key economic and demographic indicators, New Mexico faces a variety of challenges in the years to come. Some of the economic and demographic challenges can be identified from the benchmarking and national rankings. While New Mexico has strengths to build upon (significant amounts of federal land and federal presence at locations such as the national laboratories, as well as the state's scenic beauty and temperate climate), the state has significant headwinds as well. Issues related to lackluster population growth and educational attainment, coupled with high poverty, will be difficult factors for the State to overcome.

²⁵ U.S. News and World Report, "Best States," 2019, accessed electronically at <https://www.usnews.com/news/best-states/new-mexico>

3. State Tax / Revenue Structures

Overview

Nearly every U.S. state has either a constitutional or a statutory requirement for an annual balanced budget.²⁶ States are generally responsible for a variety of public services, particularly related to K-12 education and health care, which are the largest state expenditure categories.²⁷ Because these and other state expenditures do not lend themselves to user charges, it is necessary to institute taxes to maintain those services. President James Madison noted that “the power of taxing people and their property is essential to the very existence of government.”

There are three primary methods to raise tax revenue. Taxes may be applied on:

- **Consumption.** This is mostly commonly seen when a sales tax is applied to the final purchase of taxable goods and services. In some instances (such as excise taxes on cigarettes, alcohol or motor fuel), the tax is included in the price of the good or service.
- **Income.** The personal income tax and the corporate income tax are the primary forms of taxes on income.
- **Wealth.** Property taxes and estate taxes are examples of taxes on wealth.

Key Principles

Exactly how taxes raise the revenue necessary to maintain public services varies from state to state. In general, states seek to apply taxes without creating undue harm to their residents or economy. As the French finance minister, Jean-Baptiste Colbert, once explained, “The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.”

The New Mexico LFC adopted a set of guiding principles for state tax policy in 2009.²⁸ These principles are:

- Adequacy
- Efficiency
- Equity
- Simplicity
- Accountability/Transparency

These align with basic tax policy principles that have been enumerated by other tax subject matter experts. The following provides a brief explanation of each of the five tax principles adopted by the LFC.

²⁶ “Budget Processes in the States,” National Association of State Budget Officers, 2015, p. 60, accessed electronically at https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/Budget%20Processess/2015_Budget_Processes_-_S.pdf

²⁷ “NASBO Spring 2020 Fiscal Survey of the States,” National Association of State Budget Directors, Spring 2020, p. 1, accessed electronically at <https://www.nasbo.org/reports-data/fiscal-survey-of-states>

²⁸ “Recommendations of the Blue Ribbon Tax Reform Commission and Review of Credits and Exemptions Adopted since 2003.” Clifford, Thoms and Becky Gutierrez. August 13, 2009. Accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Money_Matters/Review%20of%20Findings%20of%202003%20Blue%20Ribbon%20Tax%20Commission%20-%20Review%20of%20Tax%20Credits%20and%20Exemptions%202003%20-%20August%202009.pdf

Adequacy

A high-quality tax system should generate enough revenue to pay for public services without the need for continuous or drastic changes in tax rates or the tax base. Revenue stability is an important consideration for adequacy. The overall tax structure should not be overly reliant on highly volatile revenue sources and should be able to weather changing economic conditions without greatly diminishing the state's ability to pay for key government services.

Efficiency

The LFC defined an efficient tax structure as one that has **a broad tax base and low rates to “minimize economic distortion and avoid excessive reliance on any single tax.”**²⁹ Tax systems that are efficient are also as neutral as possible in market decisions. In other words, the tax system should not influence or significantly alter the economic decisions of people and firms any more than is necessary to raise the appropriate amount of tax revenue.

Equity

A tax system should distribute the tax burden across all taxpayers fairly. Fairness in a tax structure is typically considered related to horizontal and vertical equity:

- **Horizontal equity** requires that taxpayers who are similarly situated pay a comparable amount in taxes. This principle requires that taxes not be arbitrary or disproportionately benefit or harm a particular group relative to their ability to pay or utilization of public services. Of late, this often relates to businesses that deliver similar goods or services in different ways (for example the on-site versus on-line sale of tangible goods).
- **Vertical equity** concerns the relative tax burden across taxpayers at different income levels. Vertically equitable taxes are levied in a manner that is proportional to taxpayers' relative ability to pay or the portion of income that is devoted to a tax.

Simplicity

Taxes should be simple to understand and to collect. Taxpayer compliance has been shown to diminish as taxes become more complex. Higher levels of tax system complexity also correlate with higher administrative costs. To the extent that simplicity increases compliance or reduces administrative costs, it may reduce upward pressure on tax rates.

Accountability/Transparency

As explained by the LFC, deductions, credits, and exemptions “should be easy to monitor and evaluate and be subject to periodic review.”³⁰ Along these lines, the tax burden should be apparent to taxpayers and not hidden. Achieving transparency can be challenging, as illustrated by efforts to gauge and explain the compounding of taxes (known as pyramiding) that occurs in the State's GRT.³¹

²⁹ Ibid, p. 3

³⁰ Ibid., p. 3

³¹ In the GRT, when a business is paying the tax, it may be difficult to determine where the tax incidence ultimately falls, and it may differ by industry or product. A business could shift the tax incidence forward by charging higher prices for their services, shift it backwards on employees by paying lower wages, salaries, or benefits, or absorb the cost by returning a lower profit. In all these cases, the tax incidence has shifted away from the business to the consumer, employee, or owner(s), but it will change based on the market position of the business.

Commentary

While the previously enumerated tax policy principles are widely accepted, other concepts also deserve mention. An important consideration in taxation is tax incidence. Tax incidence relates to who ultimately pays the tax. While this may be easy to determine (such as for personal income taxes), it may be less clear for other taxes. For example, there is a longstanding debate about who pays corporate income tax, and there is considerable debate on how they are allocated amongst shareholders, employees and customers. Likewise, there can be instances where the GRT is ‘pushed forward’ to be paid by customers or ‘carried back’ and borne by business owners and/or employees.

Tax burden is connected to the issue of tax incidence and the equity principle of taxation. Tax burden relates to how much of a person’s income is devoted to taxes. Often, a tax or a tax structure is labeled as “progressive” or “regressive” based on its tax burden: when individuals at higher income levels pay more of their income as taxes than those at lower income levels, the tax or structure is considered progressive. Conversely, if the share of income paid as taxes is higher for lower income individuals than it is for higher income taxpayers, the tax or structure is considered regressive. Most personal income tax structures with multiple tax brackets based on marginal income are considered progressive because rates increase with income, while most broad-based consumption taxes are considered regressive, because the share of income devoted to purchases of taxable goods and services is higher for lower income households.

New Mexico’s reliance on certain types of taxes will create some clear contrasts in the form of how these taxes fit within these tax policy principles. There will also be tension (and interconnection) between types of taxes and tax policy principles. These issues will be addressed in the remainder of the report.

High-Quality Revenue Systems

Every state relies on a mix of taxes to generate revenue. How to devise an overall structure or system – and how to use tax principles as a sort of blueprint - is an important question, and no two states have come up with the same answer. As far back as 1776, the economist Adam Smith identified a high-quality revenue system as one that is equitable, explicit and simple to comply with and administer.³² These qualities are embodied in the principles of taxation previously discussed.

There are many similar discussions of what constitutes a high-quality state revenue system. The NCSL has identified the following nine principles:³³

1. A high-quality revenue system comprises **elements that are complementary**, including the finances of both state and local governments.
2. A high-quality revenue system **produces revenue in a reliable manner**. Reliability involves stability, certainty and sufficiency.
3. A high-quality revenue system relies on a **balanced variety of revenue sources**.

³² Adam Smith, *The Wealth of Nations*, 1776.

³³ National Conference of State Legislatures, “Principles of a High-Quality State Revenue System, June 2007, p.6, accessed electronically at <https://www.ncsl.org/research/fiscal-policy/principles-of-a-high-quality-state-revenue-system.aspx#principles>

4. A high-quality revenue system **treats individuals equitably**. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.
5. A high-quality revenue system **facilitates taxpayer compliance**. It is easy to understand and minimizes compliance costs.
6. A high-quality revenue system **promotes fair, efficient and effective administration**. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.
7. A high-quality revenue system is **responsive to interstate and international economic competition**.
8. A high-quality revenue system **minimizes its involvement in spending decisions** and makes any such involvement explicit.
9. A high-quality revenue system is **accountable to taxpayers**.

Commentary

These principles touch on many of the areas already identified as key principles of taxation by the New Mexico LFC. It is important when discussing the system as a whole to be mindful of some of the principles that encompass the holistic nature of a revenue system, particularly numbers one and three, related to complementary elements of the system (including both state and local government) and reliance on a balanced portfolio of revenue sources.

In the following sections, it will be helpful to keep in mind these high-quality revenue system ideals. As much as possible, these characteristics will be the basis for the foregoing analysis, findings and recommendations for the State of New Mexico.

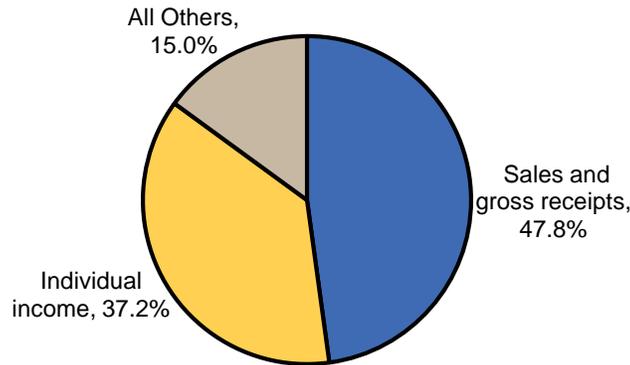
4. Comparisons of State Tax / Revenue Structures

Major State Tax Revenue Sources

Most U.S. states rely on a variety of state taxes and other revenue sources, and New Mexico is no different. Among the 50 states, the two largest revenue sources are the sales tax (or, in New Mexico's case, the gross receipts tax) and the personal income tax. There are notable exceptions, as five states do not impose any sales/gross receipts taxes,³⁴ and nine states do not impose a broad-based personal income tax.³⁵

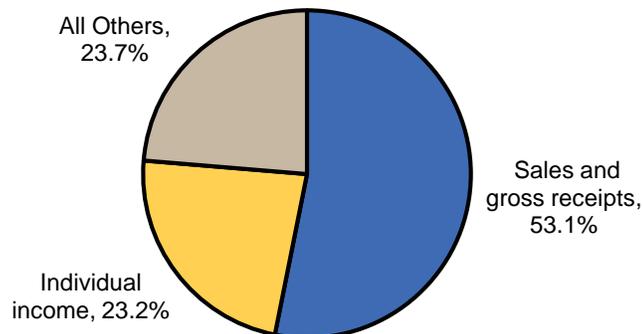
New Mexico obtains a somewhat larger share of its overall state tax revenue from its gross receipts tax than other states. It also derives a significantly smaller revenue share from its personal income tax. **In this respect, New Mexico has less balance between its two key revenue sources than the average state.**

Figure 11: Percent of Total Tax Revenue, All States, 2017



Source: U.S. Census Bureau, 2017 Annual Survey of State Government Finances

Figure 12: Percent of Total Tax Revenue, New Mexico, 2017



Source: U.S. Census Bureau, 2017 Annual Survey of State Government Finances

³⁴ Those states are Alaska, Delaware, Montana, New Hampshire, and Oregon.

³⁵ Those states are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Two others, New Hampshire and Tennessee don't tax wages; Tennessee will impose no individual income tax beginning in 2021.

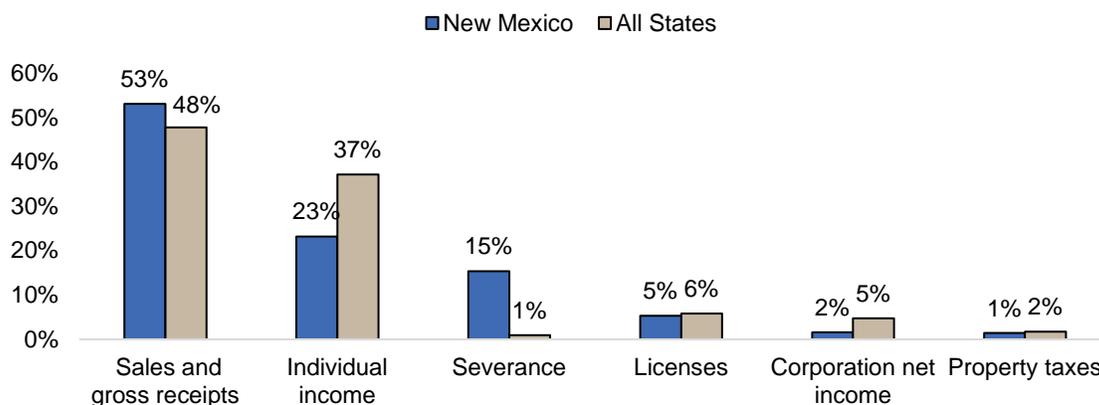
New Mexico’s gross receipts tax is its largest single source of tax revenue, followed by personal income tax and extraction taxes. Personal income tax and severance taxes are two categories that set New Mexico apart from national averages.

Personal income tax (PIT) accounts for less than a quarter of New Mexico tax revenue, while it accounts for 37% on average among all states. New Mexico’s low top marginal rate and low incomes are likely drivers of this difference.

Significant revenue from extraction taxes is rare among states, with only 10 states deriving more than 1% of total tax revenue from extraction taxes in 2017.³⁶ **New Mexico ranked 4th among all states in extraction taxes as a percent of total tax revenue in 2017, with 15%.³⁷**

This smaller portion of New Mexico tax revenue from the personal income tax is largely offset by New Mexico’s share of extraction taxes, primarily on oil and gas.

Figure 13: Percent of State Tax Revenue, 2017



Source: U.S. Census Bureau, 2017 Annual Survey of State Government Finances

One of the emerging issues in state tax structures is the continued decline in the share of tax revenue derived from corporate net income taxes – and this is certainly the case in New Mexico. Some of this is the result of continued growth in pass-through entities that are subject to the personal (rather than corporate) income tax, and some occurs because corporations have developed sophisticated tax avoidance strategies.³⁸ New Mexico has enacted a mandatory calculation method related to apportionment of income among the states, combined reporting, that may limit opportunities for tax avoidance and thus lead to some increase in its CIT collections.³⁹

Another factor for New Mexico corporate income tax collections is the significant use of tax incentives that reduce overall CIT liability. For example, CIT collections for FY2019 were \$172.8

³⁶ Severance taxes, as used here and defined by the Census Bureau, means taxes imposed distinctively on removal of natural products (e.g., oil, gas, other minerals, timber, fish, etc.) from land or water and measured by value or quantity of products removed or sold.

³⁷ U.S. Census Bureau, 2017 Annual Survey of State Government Finances. Accessed electronically at <https://www.census.gov/programs-surveys/state.html>

³⁸For an explanation of these mechanisms, see Edosa Aronmwan and Chinwuba Okafor, “Corporate Tax Avoidance: Review of Measures and Prospects,” International Journal of Accounting and Finance, September 2019. Accessed electronically at <http://research.icanig.org/documents/Corporate-Tax-Avoidance-Article.pdf>

³⁹ For an explanation of the passage of combined reporting in New Mexico, see CCH Tax Group, “New Mexico Adopts Mandatory Combined Corporate Reporting, June 19, 2019, accessed electronically at <http://news.cchgroup.com/2019/06/19/new-mexico-adopts-mandatory-combined-reporting/news/tax-headlines/>

million. However, this was offset by \$50.0 million in refundable credits, for a net amount of \$122.8 million.⁴⁰

State Property Tax Revenue

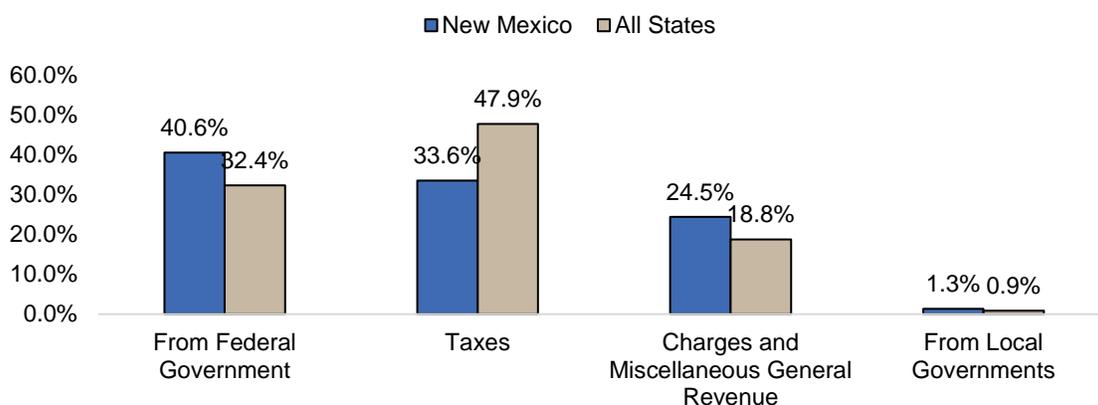
While property taxes are an important local government revenue source, they are generally not a major state government revenue source. Property taxes make up just 1.9% of all tax revenue collected by the states. **New Mexico is similar, as it derives just 1.2% of its state tax revenue from property taxes.**

Most state property taxes are assessed on personal property, for example, on motor vehicles. By contrast, most local property taxes are assessed on real property, primarily residential and commercial real estate. Many states do not tax personal property, instead using vehicle registration or other fees to raise a similar amount of revenue.

Federal Revenue

A factor that impacts overall state revenue collections (and reduces the need for reliance on own-source New Mexico tax revenue) is New Mexico’s share of revenue that comes from the federal government. As the following chart demonstrates, a larger share of the state’s general revenue comes from the federal government than for the states as a whole.

Figure 14: Percent of State General Revenue, 2017



Source: U.S. Census Bureau, 2017 Annual Survey of State Government Finances

Several factors contribute to this. First, many federal grants programs are means- tested (the largest being Medical Assistance, often known as Medicaid), and New Mexico, being a relatively poor state, has a larger share of its residents who qualify for assistance. In fact, the percent of the

⁴⁰ New Mexico Consensus Revenue Estimating Group, June 2020 Special Session Revenue Update, June 10, 2020, accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Revenue_Reports/General_Fund_Revenue_Forecast/2020/Consensus%20Revenue%20Forecast%20Memo%20-%20Special%20Session%202020.pdf

New Mexico population that qualifies for Medicaid, 34%, is the highest among the 50 states.⁴¹ The federal match for Medicaid is also weighted – states with lower personal income have a greater percentage of federal participation. For 2020, the regular federal government contribution rate (known as the Federal Medical Assistance Participation or FMAP) for the Medical Assistance program for New Mexico was 72.71%, which is the third highest contribution rate among the states, trailing only Mississippi and West Virginia.⁴² Subsequent to this calculation, as part of its assistance to states in the wake of the COVID-19 pandemic, Congress increased the FMAP by 6.2% for all States, bringing the New Mexico federal share for 2020 to 78.91%.⁴³ New Mexico also benefits from federal payments related to mineral extraction on federal lands (discussed later in the report).

Commentary

As with all states, New Mexico imposes state taxes that apply to a variety of sources of income and activities. Among major taxes, New Mexico in comparison to all states:

- Does not rely on a general sales and use tax (which is the largest single revenue source for the combined 50 states) and instead applies a GRT on most business activities.
- Raises a smaller share of revenue from its PIT.
- As with a handful of other energy producing states, derives a significant percentage of its revenue from extraction taxes, which is not the case for the combined 50 states.
- Raises very little revenue from its CIT. While CIT has been declining as a share of state tax revenue for decades, it is even more pronounced in New Mexico – at least partly because of tax incentives that reduce CIT collections.

⁴¹ Kaiser Family Foundation, “State Medicaid Fact Sheets,” May 27, 2020, accessed electronically at <https://www.kff.org/interactive/medicaid-state-fact-sheets/#>

⁴² See Kaiser Family Foundation, “Federal Medical Assistance Percentage (FMAP) for Medicaid and Multiplier,” accessed electronically at <https://www.kff.org/medicaid/state-indicator/federal-matching-rate-and-multiplier>

⁴³ The FMAP for the Medicaid expansion under the Affordable Care Act (often referred to as the ACA or Obamacare) does not vary by state. The federal government paid 100% of state Medicaid costs for certain newly eligible individuals through the end of 2016. Starting in 2017, the matching rate declined slightly each year until it reached 90% in 2020 and will remain there. New Mexico was one of the original Medicaid expansion states, which began on January 1, 2014.

5. New Mexico Tax / Revenue Structure

This section describes the key components of New Mexico’s tax and revenue structure. After discussing the system’s individual components, the section considers previous studies of the state’s tax and revenue structure, particularly in relationship to the past and current structure and how those study findings relate to the current discussion.

Gross Receipts Tax

As previously noted, New Mexico does not impose a general sales and use tax. Rather, it is somewhat unique in relying on a business privilege tax, the GRT, which is imposed on businesses engaged in most commercial activity in the state. Because the tax is comprised of a state base rate upon which local governments may impose additional incremental “local option” taxes, the tax rate varies throughout the state, from 5.125% to 8.8675% depending on the location of the business.⁴⁴

Because the GRT is a business privilege tax and imposed on those who do business in New Mexico, all transactions are assumed to be subject to the tax unless specifically exempted. Seven states have gross receipts taxes with a very low rate that solely tax business-to-business transactions;⁴⁵ four of the seven do not impose a CIT.⁴⁶ New Mexico’s gross receipts tax includes many consumer services as well as business-to-business transactions, and it also has a CIT.

Hawaii, North Dakota, and South Dakota are states that have very broad sales taxes that include many services.⁴⁷ An oft-cited rationale for the New Mexico GRT is the significant amount of business activity involving the federal government, primarily at the national laboratories. In a typical sales tax structure, where the tax is imposed on the purchaser of goods or services, sales of goods or services to the federal government are exempt from tax. In New Mexico, when businesses generate revenue from sales of goods or services to the federal government, the business is required to pay tax on that revenue (because the legal responsibility for paying the tax falls on the seller). As a result, the GRT generates revenue from commerce involving the federal government that a sales tax would not.

Table 2: State and Local Sales/Gross Receipts Tax Rates, 2020

	State Rate	Average Local Rate	Average Combined Rate	Max Local Rate	Maximum Combined Rate
New Mexico	5.125%	2.690%	7.815%	4.125%	9.250%
North Dakota	5.000%	1.860%	6.860%	3.500%	8.500%
South Dakota	4.500%	1.900%	6.400%	4.500%	9.000%
Hawaii	4.000%	0.440%	4.440%	0.500%	4.500%

Source: Tax Foundation

⁴⁴ New Mexico Taxation and Revenue Department, Frequently Asked Questions, accessed electronically at <http://www.tax.newmexico.gov/frequently-asked-questions.aspx>. It should be noted that the location-based nature of the tax for tax rate purposes will be changing, and this is discussed later in the report.

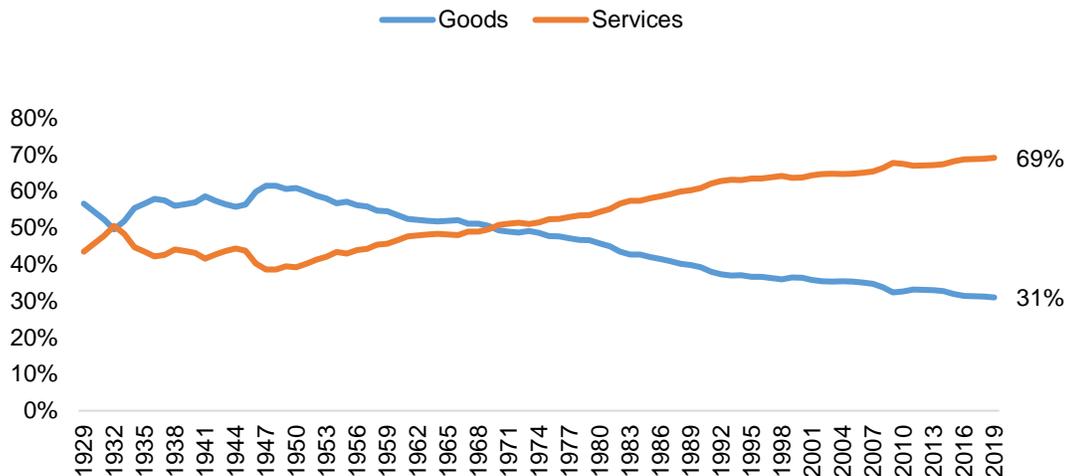
⁴⁵ These states are Delaware, Nevada, Ohio, Oregon, Tennessee, Texas and Washington. Of these, the rates are below 1.0% in all states with the exception of Delaware and Washington, where the top rates are 1.9914% and 3.3% respectively. See “Which States Have a Gross Receipts Tax?” The Tax Foundation, April 22, 2020, accessed electronically at <https://taxfoundation.org/state-gross-receipts-taxes-2020/>

⁴⁶ The four states are Nevada, Ohio, Texas and Washington. See “Range of State Corporate Income Tax Rates, Tax Year 2020, Federation of Tax Administrators, accessed electronically at https://www.taxadmin.org/assets/docs/Research/Rates/corp_inc.pdf

⁴⁷For a discussion of the rationale for a broad-based sales tax that includes consumer services see “Sales Tax Base Broadening: Right-Sizing a State Sales Tax,” Tax Foundation, October 2017, accessed electronically at <https://taxfoundation.org/sales-tax-base-broadening/>

A national survey of state taxation of consumer services identified New Mexico as among those with the highest number of services that are subject to sales/gross receipts tax. The survey, conducted in 2017 by the FTA, identified New Mexico as the state with the third most services subject to tax, 164, trailing only Hawaii and Washington, which both taxed 167.⁴⁸ Taxing services is critical to maintaining a broad consumption tax base, because services are a growing share of overall economic activity. As the following figure shows, consumption has shifted from tangible goods to services, which are not taxed in many state sales tax structures:

Figure 15: Percent of Total U.S. Personal Consumption



Source: Bureau of Economic Analysis

Despite having the highest tax rate among this group, New Mexico has the lowest per capita revenue collections. States with broader tax bases generally collect more revenue per capita, even with lower tax rates.

Table 3: Sales Tax/GRT Revenue, Breadth, and Rates in Comparable States

	Per Capita Sales Tax/GRT Revenue	Sales Tax Breadth ⁴⁹	Average Combined Rate	Maximum Combined Rate
Hawaii	\$3,065	104.0%	4.4%	4.5%
North Dakota	\$1,787	73.0%	6.9%	8.5%
South Dakota	\$1,739	65.0%	6.4%	9.0%
New Mexico	\$1,467	59.0%	7.8%	9.3%
New Mexico Rank	4th	4th	1st	1st

Source: U.S. Census Bureau, Tax Foundation

At least two factors are at play here. First, the state’s lower household income likely translates into less disposable income that can be spent on taxable goods and services. Second, tax exemptions and deductions narrow New Mexico’s GRT base. For example, both Hawaii and South Dakota tax

⁴⁸ Federation of Tax Administrators, “Sales Taxation of Services: 2017 Update,” accessed electronically at <https://www.taxadmin.org/sales-taxation-of-services>

⁴⁹ Tax Breadth calculation is as of FY2015.

food, while New Mexico exempts the revenue from the sale of groceries for home consumption from gross receipts tax.

In fact, New Mexico is among the majority of states that exempt food sales at retail from its consumption tax base.⁵⁰ This exemption was the State's second-largest tax expenditure, foregoing \$149.4 million of revenue in 2018.⁵¹ The State also makes payments to local governments to offset some of the revenue loss caused by the deduction for sales at retail food stores. In 2018, the State made \$101.1 million in 'hold harmless' payments to local governments.⁵² These hold harmless payments to local governments were instituted when food consumption was excluded from the GRT base in 2004.⁵³ In 2013, a phase-out schedule for the hold harmless payments was enacted. Beginning in FY2016, the payments are reduced by 6% each year, which grew to 7% in FY2020. The hold harmless payments will be fully phased out by FY2030. In return, local governments received additional GRT taxing authority of up to three eighths of one percent.⁵⁴ New Mexico also exempts (as do nearly all states⁵⁵) prescription drugs and a significant share of healthcare delivery from its base, which is the largest single tax expenditure, \$170.0 million.⁵⁶

A major concern with gross receipts taxes is pyramiding, which occurs when the tax is applied to business-to-business transactions that are inputs to a finished good or service. The cost of the tax on those transactions becomes a part of the final sales price of a good or service. This results in a higher effective tax rate, because the tax is applied at several stages of the supply chain.

A 2005 study of tax pyramiding in New Mexico found that it added an average of a 1.35% tax on top of the 5.00% state GRT rate in effect at the time.⁵⁷ Estimates suggest one-third to one-half of the State's GRT revenue results from pyramiding.⁵⁸ By contrast, a model maintained by the Hawaii Department of Revenue estimated that the Hawaii general excise tax resulted in pyramiding that added 19.5% to collected revenue.⁵⁹

The GRT raises equity concerns related to horizontal equity. For example, smaller firms may have to absorb the GRT related to services it purchases (if the GRT is passed along to them by the service provider), such as accounting, legal or marketing. Larger firms can bring those services in-house and avoid taxation of these business-to-businesses transactions. The GRT also imposes a

⁵⁰ Of the 45 states with a sales/gross receipts tax, 32 exempt food, while 7 tax it at the general state rate and 6 tax it at a lower rate. See Federation of Tax Administrators, "State Sales Tax Rates and Food and Drug Exemptions (as of January 1, 2020)," accessed electronically at <https://www.taxadmin.org/assets/docs/Research/Rates/sales.pdf>.

⁵¹ The State regularly publishes a report of all State tax expenditures, which the report defines as "deviations from a baseline tax system created by specific tax law provisions. Tax expenditures may reflect an overarching statewide policy, such as to promote the general welfare of all citizens, or may reflect a specific purpose, such as to incentivize a certain type of consumer behavior, economic development, or job creation. The term "tax expenditures" reflects the perspective that foregoing revenue that would normally accrue to the state may be thought of as spending through the tax code." New Mexico Taxation and Revenue Department, "2018 New Mexico Tax Expenditure Report," p. 22, accessed electronically at <https://www.nmlegis.gov/handouts/RSTP%20102319%20Item%201%202018%20NMTRD%20Tax%20Expenditure%20Report.pdf>

⁵² *Ibid.*, p. 150.

⁵³ H.B. 625, 2004.

⁵⁴ Jon Clark and Dawn Iglesias, "Food Tax Deduction," LFC May 2018 Hearing Brief, accessed electronically at https://www.nmlegis.gov/Handouts/ALFC%20052118%20Item%2010%20LFC%20May%202018%20Hearing%20Brief_Food%20Tax%20Deduction_REVISED.pdf

⁵⁵ Illinois is the only state that taxes prescription drugs, albeit at a 1% rate (their general sales tax rate is 6.25%.) Federation of Tax Administrators, "State Sales Tax Rates and Food and Drug Exemptions (as of January 1, 2020)," accessed electronically at <https://www.taxadmin.org/assets/docs/Research/Rates/sales.pdf>.

⁵⁶ New Mexico Taxation and Revenue Department, "2018 New Mexico Tax Expenditure Report," p. 134, accessed electronically at <https://www.nmlegis.gov/handouts/RSTP%20102319%20Item%201%202018%20NMTRD%20Tax%20Expenditure%20Report.pdf>

⁵⁷ New Mexico Tax Research Institute, "Pyramiding Transaction Taxes in New Mexico" 2005. The 5% base was the State base rate at the time. The average GRT rate, with local options, was 7.5%.

⁵⁸ New Mexico Tax Research Institute, "Pyramiding in the New Mexico Gross Receipts Tax" 2010

⁵⁹ Seth Colby, Hawaii Department of Taxation, "Measuring Tax Pyramiding: Modeling the Cascading Effects of Hawaii's General Excise Tax," presentation to the FTA Revenue Estimation Conference, October 9, 2018, accessed electronically at https://taxadmin.memberclicks.net/assets/docs/Meetings/18rev_est/colby.pdf

heavier tax burden on businesses or industries with lower profit margins and high production costs. Finally, many start-up companies have little profit but are still subject to the GRT, which can hamper their ability to remain in business.

A prominent consideration in imposition of sales or gross receipts taxes is whether the imposing state is an origin or destination-based state. In an origin-based state, sales tax is calculated and collected based on the seller's location. In a destination-based state, the buyer's location determines the local rates that apply and where sales tax is collected. Because, as noted earlier, local sales tax rates often vary from community to community, sellers must determine the specific local rate (or rates) that apply to each sale. The number of origin-based states is declining,⁶⁰ and New Mexico, which is currently an origin-based state, will switch to a destination-based system on July 1, 2021.⁶¹

Over the past two decades, the tax treatment of remote (e.g. mail order and internet) sales into a state by sellers that do not have a physical presence (nexus) in the state has been a major issue. Based on a 1992 US Supreme Court decision, state and local governments had been unable to compel remote sellers to collect sales tax on their behalf from in-state customers. In the years following that ruling, many states re-defined nexus in state statute to include sales into the state (defined as economic nexus). In 2018, the U.S. Supreme Court overruled its past precedent and found that economic nexus did not violate the Commerce Clause.⁶²

As a result, nearly every state, including New Mexico, has enacted legislation that defines economic nexus for its state sales and use tax (or, in the case of New Mexico, its GRT). New Mexico defines economic nexus as having annual gross sales of at least \$100,000 into the state. This was one of many modifications made to the state tax code by tax reform legislation adopted in 2019.⁶³

GRT Key Issues:

The following evaluate the GRT based on the tax principles and characteristics of a high quality revenue system.

- Primarily because of its broad base and ability to tax firms that do business with the federal government, it raises a lot of revenue (positive for adequacy);
- Because it taxes business-to-business transactions, there is significant tax pyramiding (negative for transparency);
- Because it taxes business gross receipts, certain types of business structure and sectors are impacted more than others (negative for horizontal equity);
- To the extent it is passed along to consumers, as with most consumption taxes, it is more burdensome to lower income taxpayers (negative for vertical equity).

As the state's largest tax revenue source, the GRT has been subject to much study and change. Once an exemplar of the 'broad base low rate' approach to state taxation, the GRT's ability to generate large amounts of revenue at minimal economic cost has been undermined over the years by numerous exemptions and deductions that have chipped away at the tax base and pushed rates

⁶⁰ The States classified as origin-based are considered to be Alabama, Illinois, Louisiana, New Mexico, Ohio, Tennessee, Texas and, to a certain extent, California and Colorado. See "Origin Sourcing Sales Tax Presents Tricky Issues for Businesses," CPA Practice Advisor, December 2019, accessed electronically at <https://www.cpapracticeadvisor.com/sales-tax-compliance/news/21116470/origin-sourcing-sales-tax-presents-tricky-issues-for-businesses>.

⁶¹ H.B. 6, enacted April 4, 2019. See generally "New Mexico Adopts Significant Tax Changes," Tax Insights, pwc, April 11, 2019, p. 2, accessed electronically at <https://www.pwc.com/us/en/state-local-tax/newsletters/salt-insights/assets/pwc-new-mexico-adopts-significant-tax-changes.pdf>

⁶² The South Dakota v. Wayfair opinion may be read at https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf

⁶³ The full text of H.B. 6 can be found at <https://trackbill.com/bill/new-mexico-house-bill-6-tax-changes/1640062/>

above nine percent in some localities. On the other hand, it has been in place for a long time, and residents and businesses understand it and have factored it into their personal behavior and business models.

Personal Income Tax

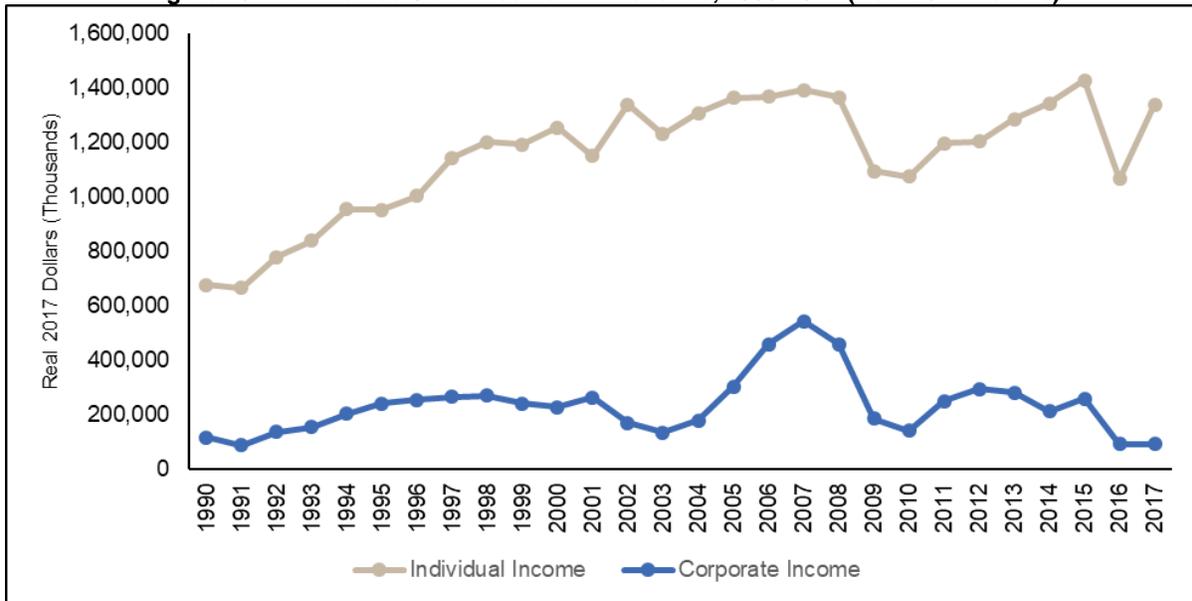
New Mexico’s PIT is the state’s second largest tax revenue source. Because of the income levels where its marginal tax rates take effect, New Mexico has a relatively flat PIT. This, coupled with the fact that New Mexico is not a high income state, constrains PIT collections.

As mentioned earlier, the percent of revenue raised by the PIT is lower in New Mexico than in other states. The PIT accounts for only 14.0% of New Mexico’s own-source general revenue, much lower than the figure for all U.S. states, 26.7%. It is also lower than the share of own-source general revenue of all the benchmark states that have a PIT (Arizona, Colorado, Oklahoma, Utah). The share of PIT of own-source general revenue in these states ranges from 19.7% to 35.0%, and the average is 26.1%.⁶⁴

Historic PIT collections have demonstrated regular growth, which has been interrupted by declines during economic contractions. Even when adjusted for inflation, these collections have trended upward. Of course, recessions will reduce employment, wages and other sources of income (such as realized capital gains) and thus impact PIT collections.

The following charts both personal income and corporate income tax revenue, indexed to 2017 dollars. Using constant dollars adjusts for inflation such that increases reflect growth in personal income and/or population.

Figure 16: New Mexico State Income Tax Revenue, 1990-2017 (Real 2017 Dollars)

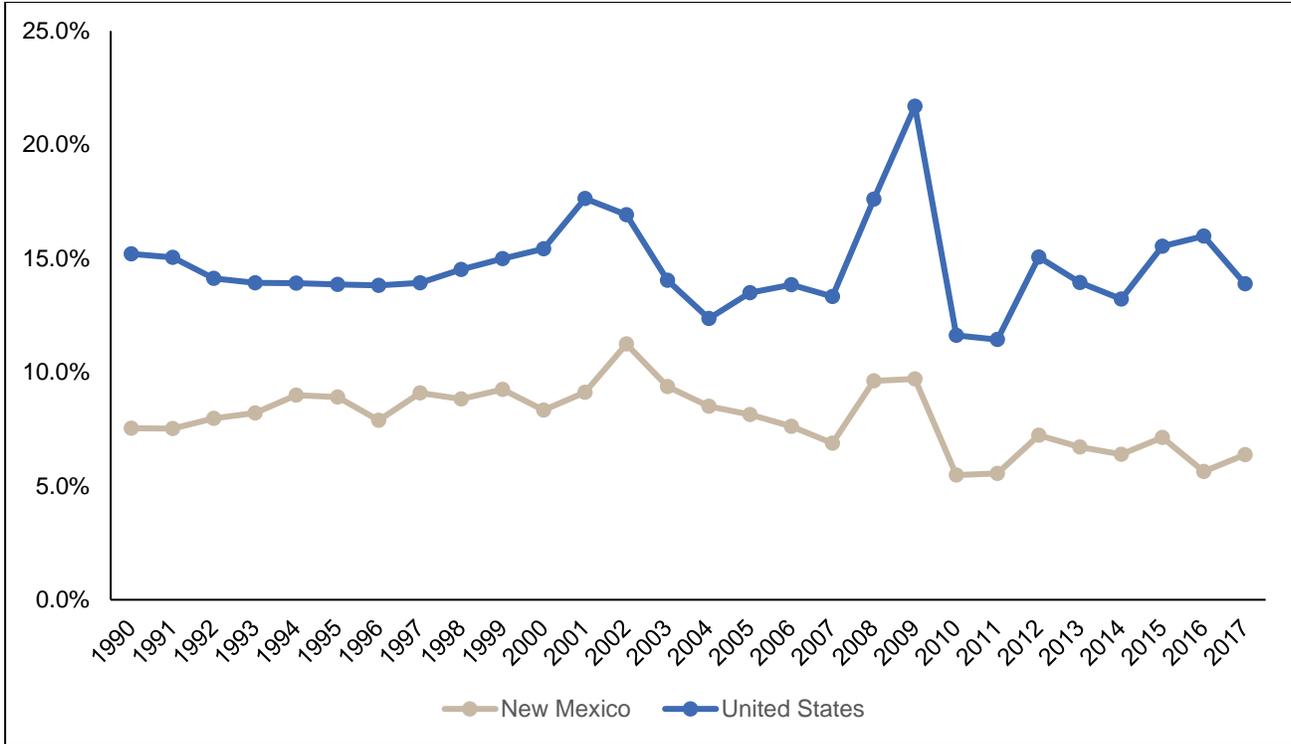


Source: U.S. Census Bureau, Annual Survey of State and Local Finances

⁶⁴ U.S. Census Bureau, 2017 Annual Survey of State and Local Finances.

PIT collections often track with the business cycle and oil prices, increasing rapidly during economic expansions and growing more slowly (or even contracting) during economic recessions. The following figure represents state personal income taxes as a share of state general revenue for both New Mexico and all U.S. states. New Mexico's performance tends to mirror that of the U.S. (albeit at a lower level of total general revenue). The peak PIT revenue in New Mexico was much less steep at the end of the 2007-2009 recession than for all U.S. states. This is likely related to the changes made in 2009 to the PIT brackets and rates.

Figure 17: New Mexico Individual Income Tax as a Percent of State General Revenue 1990-2017



Source: U.S. Census Bureau, Annual Survey of State and Local Finances

Brackets and Rates

Since the year 2000, New Mexico has made several changes to its PIT brackets, mostly to gradually lower the top rate.

Table 4: New Mexico Personal Income Tax Rates and Brackets, 2000 to 2021

Years	Low Rate (%)	Top Rate (%)	Brackets	Low Bracket	High Bracket
2000-2003	1.7	8.2	7	\$5,500	\$65,000
2004	1.7	6.8	5	\$5,500	\$26,000
2005	1.7	5.7	4	\$5,500	\$16,000
2006-2008	1.7	5.3	4	\$5,500	\$16,000
2009-2020	1.7	4.9	4	\$5,500	\$16,000
2021	1.7	5.9	5	\$5,500	\$210,000

Note: Tax rates and brackets are for individuals filing as single.
Source: Federation of Tax Administrators

Effective January 1, 2008, the State compressed its income tax brackets and rates:

Table 5: New Mexico Personal Income Tax Brackets and Rates
Effective January 1, 2008

Single		Married, Filing Jointly	
Taxable Income	Rate/Description	Taxable Income	Rate/Description
Not over \$5,500	1.7% of taxable income	Not over \$8,000	1.7% of taxable income
Over \$5,500 but not over \$11,000	\$93.50 plus 3.2% of excess over \$5,500	Over \$8,000 but not over \$16,000	\$136 plus 3.2% of excess over \$8,000
Over \$11,000 but not over \$16,000	\$269.50 plus 4.7% of excess over \$11,000	Over \$16,000 but not over \$24,000	\$392 plus 4.7% of excess over \$16,000
Over \$16,000	\$504.50 plus 4.9% of excess over \$16,000	Over \$24,000	\$768 plus 4.9% of excess over \$24,000

Source: 7-2-7 NMSA 1978

As part of the tax changes made in 2019, New Mexico added a new 5.9% fifth bracket applicable to income over \$210,000. The new bracket was to be implemented if FY2020 recurring General Fund revenues were less than 5% above the recurring General Fund revenues for the prior fiscal year. Because FY 2020 recurring revenues did not exceed FY 2019 recurring revenue by at least 5%, the bracket will be put in place for tax year 2021.

Table 6: New Mexico Personal Income Tax Brackets and Rates
Effective January 1, 2021

Single		Married, Filing Jointly	
Taxable Income	Rate/Description	Taxable Income	Rate/Description
Not over \$5,500	1.7% of taxable income	Not over \$8,000	1.7% of taxable income
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Over \$11,000 but not over \$16,000	\$269.50 plus 4.7% of excess over \$11,000	Over \$16,000 but not over \$24,000	\$392 plus 4.7% of excess over \$16,000
Over \$16,000 but not over \$210,000	\$504.50 plus 4.9% of excess over \$16,000	Over \$24,000 but not over \$315,000	\$768 plus 4.9% of excess over \$24,000
Over \$210,000	\$10,010.50 plus 5.9% of excess over \$210,000	Over \$315,000	\$15,027 plus 5.9% of excess over \$315,000

Source: 7-2-7 NMSA 1978

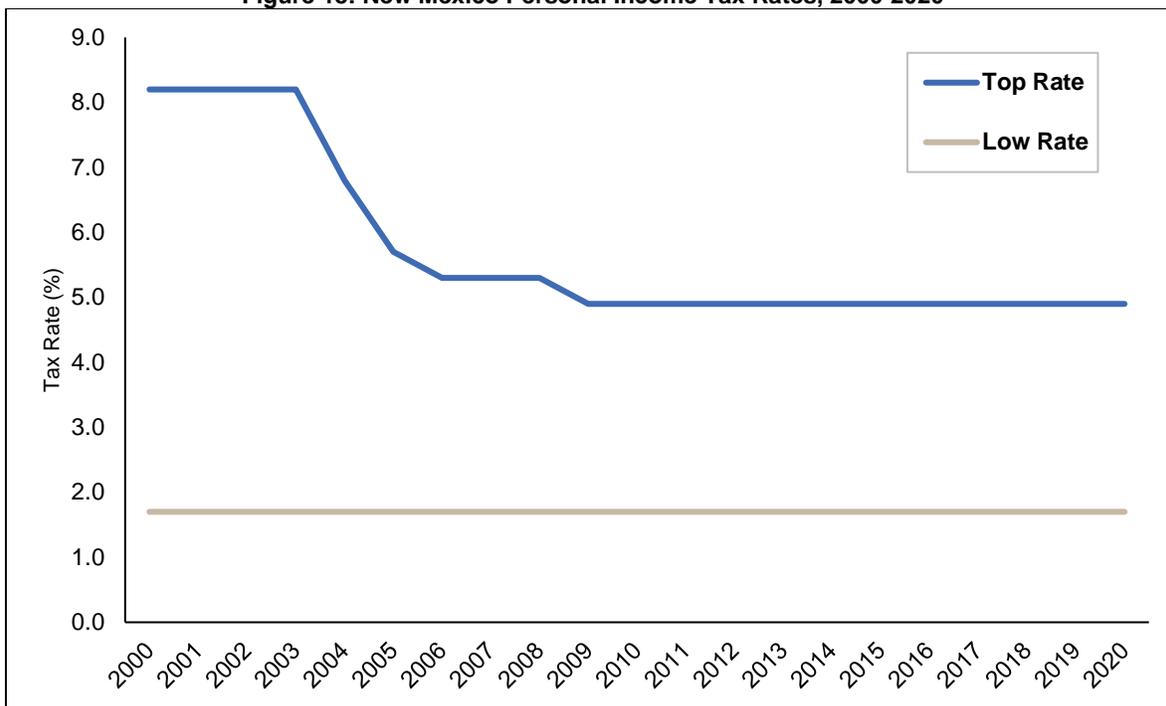
In the FY2021 Executive Budget, prior to COVID-19 revisions, the PIT was estimated to bring in a total of \$1.6 billion.⁶⁵ According to the H.B. 06 Fiscal Impact Report, the new top personal income tax rate and bracket was projected to increase General Fund revenue by \$20 million in FY2021, \$40 million in FY2022, and \$41 million in FY2023. However, these revenue enhancements were also projected to be offset by an increase in the Working Families Tax Credit, which was estimated

⁶⁵ The estimated revenue is based on the December 2019 Consensus Revenue Estimate. State of New Mexico, *Executive Budget Recommendation: Fiscal Year 2021*, January 2020, p. A2-1. Accessed electronically at <https://www.governor.state.nm.us/wp-content/uploads/2020/01/FY21-Executive-Budget-Recommendation-1.pdf>

to cost between \$37 million and \$41 million in FY2020 to FY2023.⁶⁶ These changes would increase overall progressivity of the PIT (and the state tax structure as a whole).

Between 2000 and 2009, New Mexico gradually reduced its top PIT rate, as shown in the following chart. These reductions have moved New Mexico out of the range of top PIT rates amongst the states.

Figure 18: New Mexico Personal Income Tax Rates, 2000-2020



Source: Federation of Tax Administrators, Retrieved from Tax Policy Center

While New Mexico has four brackets and rates, there is very little income difference between the brackets; in essence, New Mexico is very nearly a ‘flat rate’ state.

Table 7: Personal Income Tax Rates in New Mexico and Benchmark States

	Low Rate	Top Rate	Brackets	Low Bracket	High Bracket
New Mexico	1.7	4.9	4	\$5,500	\$16,000
Alaska	No State Income Tax				
Arizona	2.59	4.50	5.00	\$26,500	\$159,000
Colorado	Flat Rate -- 4.63				
Oklahoma	0.5	5	6	\$1,000	\$7,200
Utah	Flat Rate -- 4.95				
Wyoming	No State Income Tax				

Of the benchmark states, two do not have a PIT, and two have a flat rate similar to New Mexico’s top rate (prior to 2021). Arizona is the single benchmark state that has a top bracket similar to the one that New Mexico will implement starting in tax year 2021.

⁶⁶ HB06 Fiscal Impact Report, September 2019, p. 4.

Looking beyond the benchmark states, of the states that have a PIT and do not have a single tax rate, only seven have top brackets that are lower than New Mexico's top bracket (Alabama, Georgia, Oklahoma, Missouri, Mississippi, Idaho, and South Carolina).

Other factors also impact PIT collections and tax burden at differing income levels and other economic and demographic characteristics. Common state PIT deductions, exemptions and credits are important for comparison purposes. However, an analysis of each of these in comparison to other states would be a study in itself.

Exemptions/Credits/Deductions

The New Mexico PIT, like that of many states, uses federal standards and definitions for taxable income. It uses the federal definition of adjusted gross income (AGI) as the base for taxable income in the state. The adoption of federal definitions reduces administrative and compliance burdens for the state and taxpayers respectively. However, it also reduces the state's autonomy and leaves it vulnerable to federal changes.

There are many exemptions, credits, and deductions that are applied to the PIT. The various tax expenditures serve a variety of purposes.

New Mexico's Capital Gains deduction is equal to 40% of the taxpayer's net capital gain income or \$1,000, whichever is less. In FY2017, this deduction resulted in a tax expenditure of \$29 million. In 2019, the deduction was reduced from 50% to 40% of net capital gain income. This change is projected to save the State \$10 million per year.⁶⁷

The state has several credits/exemptions targeted to low- and middle-income families. These most notably include:

- **Working Families Tax Credit (WFTC)** – taxpayers may claim a credit equal to 17% of their federal EITC. In 2017, the WFTC accounted 197,794 claims totaling \$49.6 million.⁶⁸ In 2017, the credit was equal to 10% of the EITC but was increased to 17% in H.B.06 in 2019, in response to the changes in federal tax laws that disadvantaged families with three or more children.⁶⁹
- **Low-Income Comprehensive Tax Rebate (LICTR)** – taxpayers may claim a rebate that varies based on a definition of income unique to New Mexico and the number of household members. The rebate, which ranges from \$10 to \$450 seeks to reduce the disproportionate burden of consumption taxes on low-income families. In 2017, 215,544 claims were filed, and the tax expenditure amounted to \$16.8 million.⁷⁰

Other credit/exemptions/deductions that have expenditures over \$5.0 million include the **Armed Forces salary exemption** (\$9.0 million in 2017), **Low- and Middle-Income Taxpayer Exemption** (\$8.1 million in 2017), **Unreimbursed Medical Care Credit** (\$6.9 million in 2017), and the **Rural Health Care Practitioner Credit** (\$5.6 million in 2017).

Several exemptions/credits seek to incentivize renewable energy development, economic development, and workforce development. In total, the 2018 State Expenditure Report listed 38 credits, exemptions, or deductions that could be applied to the PIT.

⁶⁷ Legislative Finance Committee, HB6 Fiscal Impact Report, 2019.

⁶⁸ 2018 New Mexico Tax Expenditure Report.

⁶⁹ State of New Mexico. Report of the Legislative Finance Committee to the Fifty-fourth Legislature. May 2019. HB06 also reduced the capital gains deduction from 50% to 40%.

⁷⁰ 2018 New Mexico Tax Expenditure Report.

Besides the benchmark states, the following table provides additional detail on state personal income taxes. When looking at other states with median household income below the national average, New Mexico obtains less own-source general revenue from its PIT than any state other than Tennessee (which only taxes dividends and interest and is phasing it out entirely).

Table 8: Comparison of Income Tax to Selected U.S. States

State	Median HH Income	PIT as a Share of General Own-Source Revenue		Income Tax Details		
		State Only	State and Local	Top Marginal Rate (%)	Top Bracket	Local Income Taxes
West Virginia	44,097	23.4%	16.2%	6.5	\$60,000	No
Mississippi	44,717	16.7%	9.9%	5.0	\$10,001	No
Arkansas	47,062	21.0%	15.9%	6.6	\$80,801	No
New Mexico	47,169	14.1%	9.7%	4.9	\$16,001	No
Louisiana	47,905	19.8%	10.1%	6.0	\$50,001	No
Alabama	49,861	21.5%	12.9%	5.0	\$3,001	Yes
Kentucky	50,247	25.9%	23.1%	Flat Rate -- 5.0		Yes
Oklahoma	51,924	22.7%	13.9%	5.0	\$7,200	No
South Carolina	52,306	24.3%	12.6%	7.0	\$15,400	No
Tennessee	52,375	1.4%	0.7%	1% on dividends and interest only		No

Source: U.S. Census Bureau, ACS 1-Year Sample; Federation of Tax Administrators; Tax Policy Center⁷¹

Commentary

Earlier in this century, New Mexico made a concerted effort to lower its top personal income tax rate. Perhaps as a way to compensate for reducing progressivity of the tax, several low income tax credits were also enacted or enhanced. The combined effect has been to reduce the PIT's share of overall state tax revenue. This is one reason that the PIT share of total tax revenue is significantly smaller in New Mexico than for the combined 50 states. The State has added a new top income tax rate (albeit at a lower rate than existed prior to the successive rate reductions) that takes effect in 2021, which will generate revenue and should add a bit more progressivity to the tax.

PIT Key Issues

The following evaluate the PIT based on the tax principles and characteristics of a high quality revenue system.

- The PIT is a progressive tax – rates rise as income rises (positive for vertical equity);
- New Mexico uses refundable credits to reduce (or eliminate) the PIT tax burden for lower income taxpayers (positive for vertical equity);
- Rates have been changed numerous times, with reduced top rates and, most recently, a restoration of a higher top PIT rate (reduced rates were a negative for vertical equity and adequacy but may be a positive for efficiency);
- As will be discussed in a later section on revenue diversification, collections tend to follow trend lines similar to the prices for oil and gas (negative for adequacy).

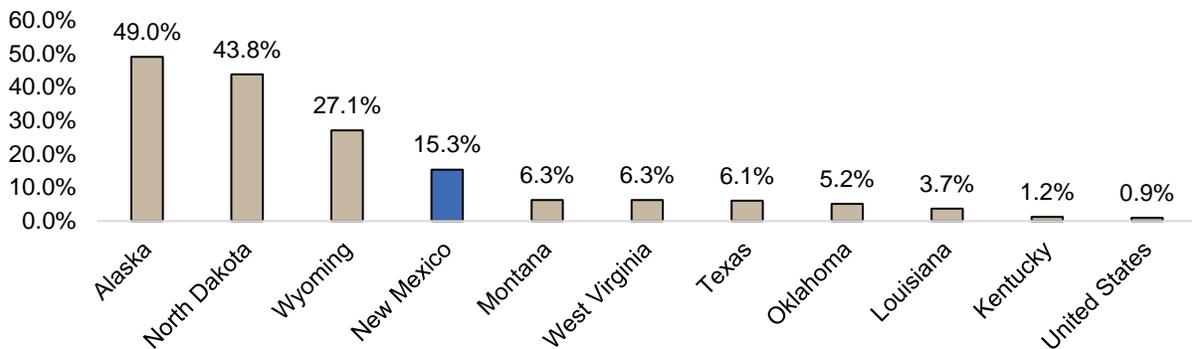
⁷¹ The information about local income taxes is from the Tax Policy Center's Briefing Book on state and local taxes: <https://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-individual-income-taxes-work#:~:text=Local%20governments%20levy%20their%20own,piggybacks%20on%>

Extraction Taxes

As previously noted, New Mexico’s share of tax revenue from extraction taxes is much higher than the combined 50 states. This is not surprising, given the prominence of the state’s oil and gas industry.

New Mexico ranks fourth-highest among states for extraction taxes as a share of state tax revenue, according to the U.S. Census Bureau’s 2017 Annual Survey of State Government Finances. Only Wyoming, North Dakota, and Alaska derive a larger portion of state tax revenue from severance taxes.

Figure 20: Extraction Taxes Share of State Tax Revenue, 2017



Source: U.S. Census Bureau, 2017 Annual Survey of State Government Finances

New Mexico levies several extraction taxes, which provide at least a portion of total revenues directly to the General Fund: Emergency School Tax, Conservation Tax, Resources Excise Tax, and Natural Gas Processor Tax.

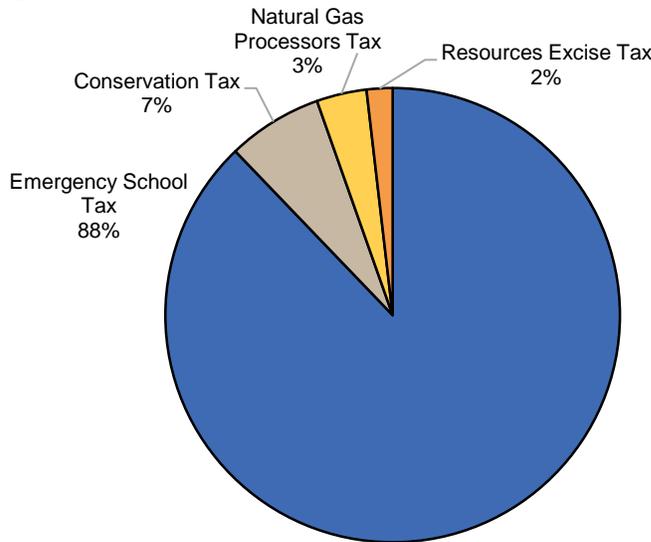
Table 9: New Mexico General Fund Severance Taxes

Tax	Subject of Tax	Tax Rate	Revenue Distribution
Oil and Gas Emergency School Tax	Crude Oil and Natural Gas	3.15% of taxable value of oil 4% of taxable value of natural gas	Deposited in the General Fund
Conservation Tax	Crude Oil and Natural Gas	0.19% of taxable value	Two-nineteenths (10.5%) of total revenue deposited into the Oil and Gas Reclamation Fund with the remainder deposited in the General Fund
Natural Gas Processors Tax	Natural Gas	\$0.116 per MMBtu	Deposited in the General Fund

Tax	Subject of Tax	Tax Rate	Revenue Distribution
Resources Excise Tax	Timber, metalliferous or nonmetalliferous mineral product. Excludes oil, natural gas, liquid hydrocarbon, carbon dioxide, helium, or nonhydrocarbon gas	0.5% of taxable value of potash 0.125% of molybdenum 0.75% of taxable value of all others	Deposited in the General Fund

The Emergency School Tax is by far the largest of these revenue sources, as it accounted for 88% of State extraction tax revenue in FY 2019.

Figure 21: New Mexico General Fund Extraction Tax Revenue, FY 2019

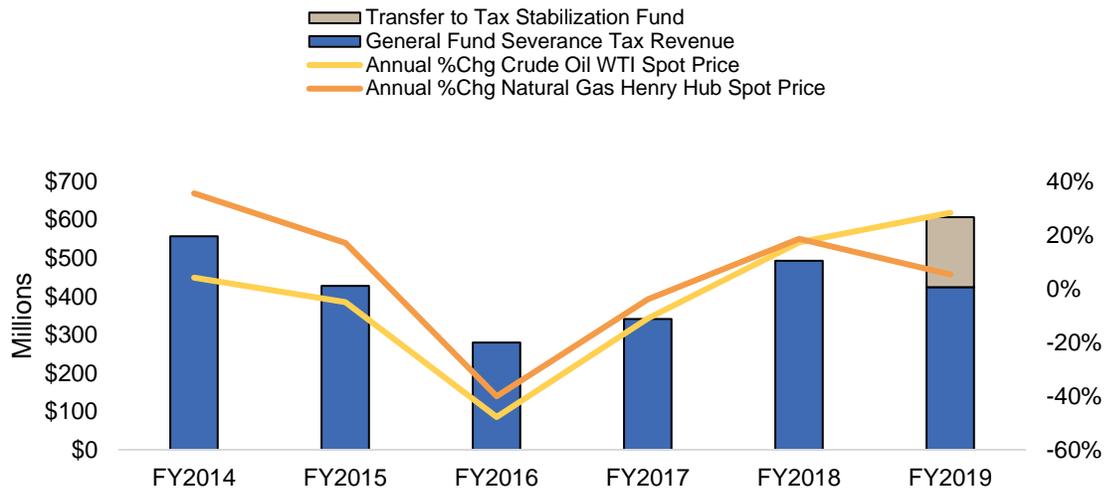


Source: *New Mexico General Fund Consensus Revenue Estimate, 2019 Audited Actuals*

The Emergency School Tax is levied at 3.15% of the taxable value of oil and 4.00% of the taxable value of natural gas.⁷² This revenue is volatile and driven by oil and gas prices. The State manages some of this volatility by transferring revenues in excess of the five-year average to a Tax Stabilization Reserve Fund. The first transfer, equaling \$183 million, was made in FY2019. This allows the State to better manage the volatility of this revenue stream by saving revenue in excess of estimates for low-price periods when revenue support will be needed.

⁷² The Taxation and Revenue Department describes taxable value generally as the actual price of the product at the production unit less royalties paid the United States, the State of New Mexico or an Indian tribe or pueblo, and less the reasonable expense of trucking the product from the production unit to the first place of market.

Figure 22: New Mexico General Fund Severance Tax Revenue and Oil and Natural Gas Price Change



Source: New Mexico General Fund Consensus Revenue Estimate Reports, U.S. Energy Information Administration

The Conservation Tax is applied at 0.19% of taxable value for both Oil and Gas.⁷³ Two-nineteenths of the revenue collected from this tax is deposited into the Oil and Gas Reclamation Fund, which supports the Oil Conservation Division of the Energy, Minerals and Natural Resources Department. An additional Natural Gas Processor Tax is levied on natural gas when it is delivered to a processor. The Taxation and Revenue Department calculates the formula-based rate each year. In FY 2019 the rate was \$0.116 per one million British thermal units (MMBtu).⁷⁴

The Resources Excise Tax is applied to resources other than oil and gas, ranging from 0.125% to 0.75% of the resource’s taxable value. Revenue from the tax is distributed to the General Fund.

In addition to these taxes (which flow directly to the General Fund), the State levies an Oil and Gas Severance Tax at the rate of 3.75% of taxable value on both oil and gas production. Revenues from this tax go to the Severance Tax Bonding Fund, to meet debt obligations supported by the fund. Any excess over the amount necessary for debt service is transferred to the Severance Tax Permanent Fund.

In 2013, Headwaters Economics and the Oklahoma Policy Institute conducted a study comparing effective tax rates on unconventional oil and gas wells among states with the highest production volumes from these wells. Unconventional wells include horizontal drilling and hydraulic fracturing. In 2019, 93% of all active oil and gas rigs in New Mexico used horizontal drilling.⁷⁵ The report compared the effective tax rate over 10 years of production among the top 7 unconventional oil and gas producing states. New Mexico ranked second-highest in effective tax rate on unconventional gas wells and fourth among the seven for unconventional oil wells.⁷⁶

⁷³ When Crude Oil is \$70 per barrel or more, the rate increases to 0.24%

⁷⁴ \$0.0065 per mmbtu * [(annual avg taxable value per mcf of natural gas produced in NM in preceding calendar year / (\$1.33 * mcf)]

⁷⁵ Baker Hughes North America Rotary Rig Count.

⁷⁶ Headwaters Economics and Oklahoma Policy Institute, “Unconventional Oil and Natural Gas Production Tax Rates: How does Oklahoma Compare to Peers?” August 2013. Accessed electronically at https://okpolicy.org/wp-content/uploads/2013/08/State_tax_comparison_study-full-Aug2013.pdf

Figure 23: New Mexico Effective Tax Rate on Unconventional Gas Wells after 10 Years of Production

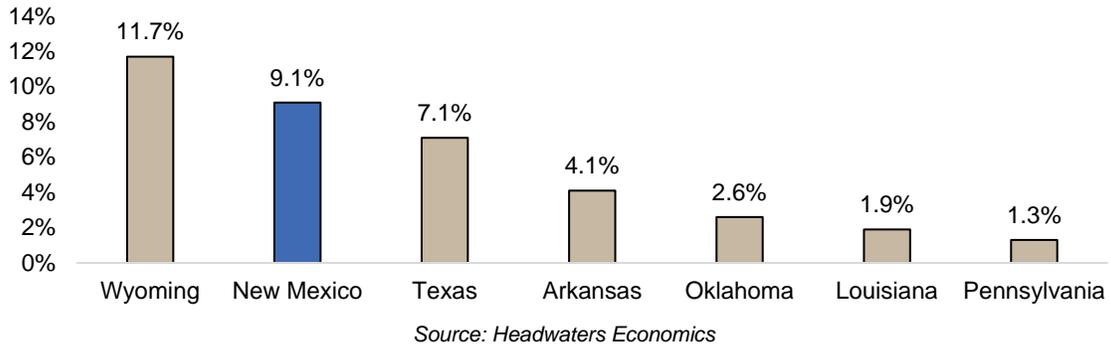
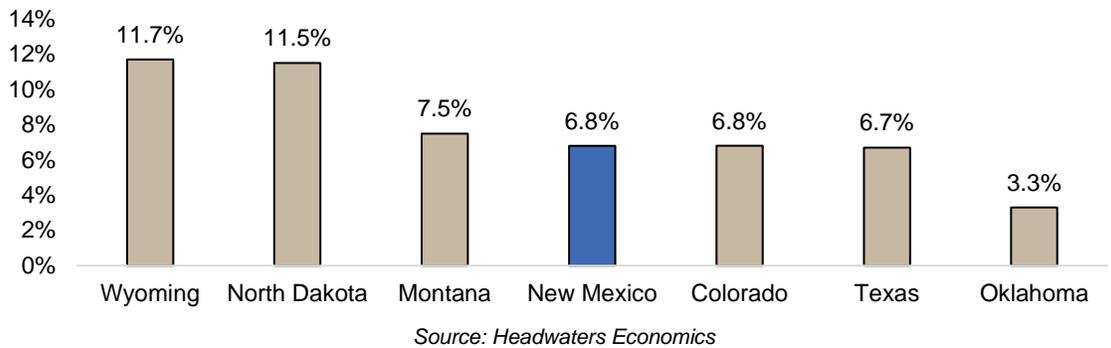


Figure 24: New Mexico Effective Tax Rate on Unconventional Oil Wells after 10 Years of Production

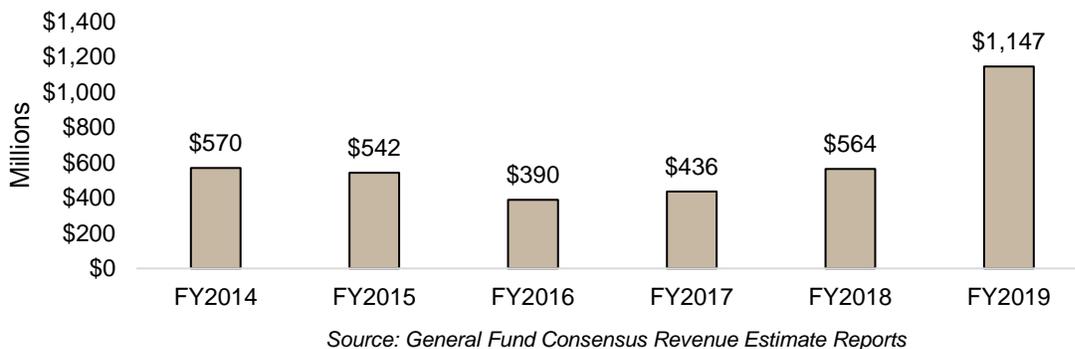


Non-Tax Oil and Gas Revenue

The General Fund also receives several non-tax revenue streams generated by oil and gas production. These include Federal and State mineral royalties and distributions from state funds that invest natural resource royalty and tax revenue.

Companies extracting natural resources on federal land pay royalties, rent and bonuses to the Federal Government. The Federal government, through the Office of Natural Resource Revenue, then returns 49% of the revenue to the states where it was generated. In New Mexico, this revenue is disbursed directly to the General Fund.

Figure 25: New Mexico Federal Land Revenue



This revenue is also generated on state-owned land. Royalty revenue generated on state-owned land is collected by the State Land Office and deposited into the Land Grant Permanent Fund (LGPF). The LGPF is designed to operate in perpetuity, distributing only 5% of its five-year

average value to its beneficiaries each year. This percentage has fluctuated in recent years. Constitutional Amendment No. 2 in 2003 increased the distribution percentage from 4.7% to 5.0% and allowed for an additional distribution of 0.8% in FY 2005 through 2012, declining to 0.5% in FY 2013 through FY 2016 in order to fund educational reforms. The modification of the distribution percentage requires the approval of the legislature and voters. Modifications to the distribution and uses of distributed funds may also require approval of Congress which would need to amend the Enabling Act of 1910 which established the permanent fund.

Beneficiaries of the LGPF were established by the federal Ferguson Act of 1898 and the Enabling Act of 1910. The land granted to New Mexico by the federal government under these acts was designated to provide a benefit to schools, universities, and other public institutions. The state's public schools are the largest single LGPF beneficiary, receiving \$858.8 million in FY 2019.

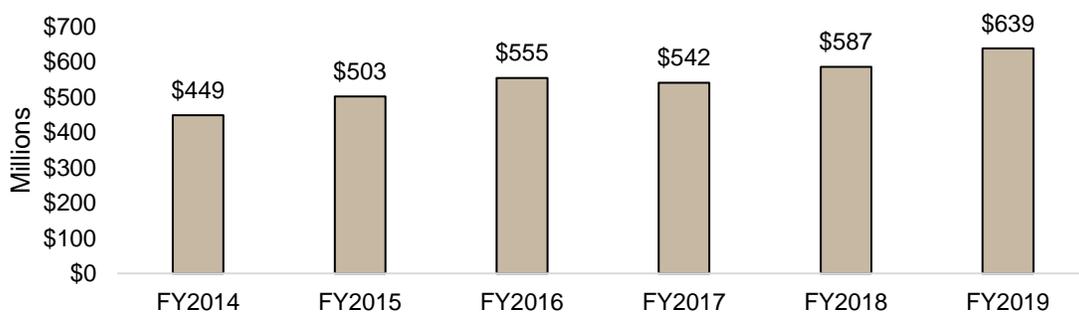
Table 10: Ten Largest New Mexico Land Grant Permanent Fund Transfers to Beneficiaries, FY 2019

Beneficiary	Transfer
Common Schools	\$858.8 million
New Mexico Military Institute	\$13.2 million
Public Buildings	\$12.0 million
School of the Deaf	\$6.1 million
School for the Blind	\$6.1 million
State Penitentiary	\$5.5 million
University of New Mexico	\$3.3 million
Behavioral Health Institute	\$3.0 million
Miners Colfax Medical Center	\$1.1 million
Charitable Penal & Reformatory	\$0.9 million

Source: New Mexico State Land Office 2019 Annual Report

Some of the funds intended for public schools are channeled through the General Fund. In FY 2019, the General Fund received \$639 million from the LGPF to be used for funding public schools.

Figure 26: New Mexico Land Grant Permanent Fund Distributions to the General Fund



Source: General Fund Consensus Revenue Estimate Reports

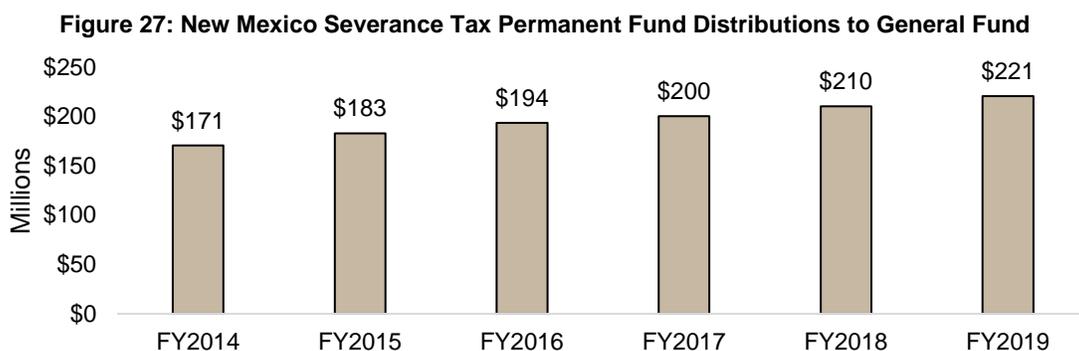
The State Land Office also receives rental revenue that is deposited into its Land Maintenance Fund. The State Land Office distributes nearly all this revenue to beneficiaries in the year that it is received.⁷⁷ In FY 2019, the General Fund received a distribution of \$133 million from this fund.

Oil and gas extraction tax collections are deposited into the Severance Tax Bonding Fund to pay for debt service on severance tax bonds. Severance tax bonds are issued to finance the capital needs

⁷⁷ 91% of receipts were distributed in FY 2019, according to the Commissioner of Public Land's FY 2019 audit.

of state agencies, local governments, and higher education as authorized by the Legislature. These bonds account for most of the State’s capital outlay. Based on December 2019 revenue estimates, the LFC calculated that severance tax bonds accounted for about 70% of the State’s total bonding capacity for 2020.⁷⁸

State statute allows 95% of the previous year’s extraction tax revenue to be used for debt service payments, with the remainder transferred to the Severance Tax Permanent Fund (STPF). Legislation passed in 2015 will gradually decrease this percentage to 86.2% in FY 2022, leaving a greater portion of tax revenue for the STPF. The General Fund receives annual distributions from the STPF equal to 4.7% of its five-year average market value.



Source: General Fund Consensus Revenue Estimate Reports

Commentary

New Mexico has a significant reliance on extraction taxes, primarily on oil and gas. On the plus side, extraction is a revenue source that is not available to many states, so it provides for broader revenue sources. However, heavy reliance on an often-volatile industry creates significant risks as well.

Oil and Gas Tax and Revenue Key Issues

The following evaluate the oil and gas extraction taxes and revenue based on the tax principles and characteristics of a high-quality revenue system.

- The extraction taxes broaden New Mexico’s key sources of revenue (positive for broad sources and adequacy);
- The extraction tax collections tend to rise and fall with what can be a cyclical industry (negative for volatility);
- Extraction non-tax revenue provides an important source of revenue (positive for adequacy).

Corporate Income Tax

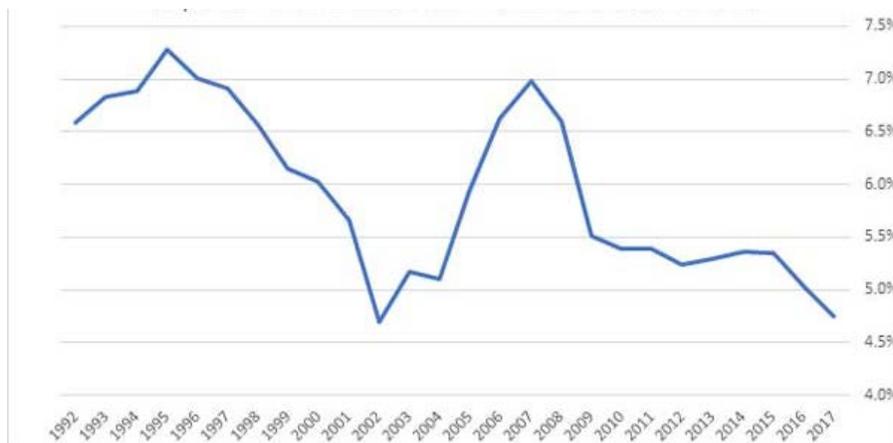
While corporate income taxes have been considered one leg of the traditional ‘three-legged stool’⁷⁹ state tax structure (along with personal income and sales/gross receipts taxes), their influence has

⁷⁸ New Mexico Legislative Finance Committee, Legislating for Results: Policy and Performance Analysis, January 2020. Accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Session_Publications/Budget_Recommendations/2021RecommendVoll.pdf

⁷⁹ The ‘three-legged stool’ concept is based on relative stability. A ‘one legged’ or ‘two legged’ stool would require the person sitting on it to maintain their balance or fall off. By contrast, three legs provides its own balance. State taxation’s three legs (personal income tax, corporate income tax and sales and use or gross receipts tax) is different than what is generally considered the three legs for combined state and local government. In that case, the three legs are personal income, sales and use or gross receipts and property taxes.

waned in the last few decades. The decline in the CIT as a share of total state tax revenue is shown in the following figure:

Figure 28: Corporate Income Tax as a Share of All States' Tax Collections



Source: National Conference of State Legislatures, based on Census Bureau data

Over time, the CIT has contributed well under 10% of total state tax collections, and there is little that suggests this will change in the future. In fact, there is no state that currently receives more than 5% of its total state tax collections from its CIT.⁸⁰

There are a variety of reasons for the decline in CIT revenue. These vary from state to state and include:⁸¹

- **Changes in Apportionment:** Corporations that operate in multiple states must apportion their income for tax purposes among those states. In the past, the most common method was to apportion by a formula based on a corporation's portion of payroll, property and sales within each state. The three-factor formula was based on the federal Uniform Division of Income for Tax Purposes Act (UDITPA) and gave equal weight to the shares of payroll, property, and sales in the state. In recent years, many states have sought to attract multi-state corporations by shifting to formulas based solely on in-state sales ('single sales factor') or that weight sales more heavily than the other factors (i.e. 'double weighted sales factor'). State fiscal estimates generally conclude that apportionment factor incentives reduce overall CIT revenue.⁸²
- **Base Narrowing:** Tax incentives (often in the form of income tax exemptions, deductions, and credits) reduce taxable income or CIT revenue. New Mexico, like every other state, provides various business tax incentives, both against the CIT and other taxes. There are estimates that incentive programs cost state and local governments in the U.S. \$40-\$50 billion a year.

⁸⁰ Urban Institute, State and Local Finances, "Corporate Income Tax," accessed electronically at <https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/corporate-income-taxes>

⁸¹See Jackson Brainerd, "The Decline in State Corporate Income Taxes," National Conference of State Legislatures, September 27, 2018, accessed electronically at <https://www.ncsl.org/blog/2018/09/27/the-decline-in-state-corporate-income-taxes.aspx>

⁸² Part of the argument for a formula that only taxes income within a state is that a corporation may be more likely to locate its facilities and employees in the state; in this case, the state expectation is that other taxes (such as PIT or GRT) will grow by as much or more than the lost CIT revenue.

- **Business vs. Nonbusiness Income:** When reporting taxable income, businesses divide their profits into “business income” and “non-business” income. Business income is taxed based on apportionment formulas previously described, but non-business income is allocated to the one state in which the income-generating asset is located. States will often structure their operations to allow nonbusiness income to be allocated to a lower (or no) CIT state.
- **Tax Planning:** Some businesses have created Passive Investment Companies (PIC) and headquartered them in states that don’t tax income from intangible assets (e.g., copyrights, trademarks), a strategy known as the Delaware loophole. The PICs license these intangible assets to related operating companies. The PICs do not have to pay tax on the payments received, and the operating companies can deduct them in the states where they are located, reducing their overall liability. Tax avoidance through corporate income shifting is estimated to cost states roughly \$20 billion a year.
- **Use of Pass-through Entities:** In the early 1980s, c-corporations produced most of the country’s business income, but this is no longer the case. Pass-through entities (sole proprietorships, partnerships, s-corporations and limited liability companies) are the primary reason for the decline in c-corporation business income. According to the Tax Policy Center, more than 80% of businesses were organized as pass-through entities in 2015—up from 47% in 1980. As a result, pass-through entities accounted for more than 50% of total business net income, up from about 22% in 1980.⁸³ Part of this shift is likely been due to the fact that corporate income is taxed twice (once at the entity level and again when profits are distributed to shareholders) and the effective tax rate on corporate income has been higher than effective rates on pass-throughs.⁸⁴

The New Mexico state CIT uses federal taxable income as its starting point, and the state definition of “net income” is taxed in two brackets. Net income up to \$500,000 is taxed at a rate of 4.8%, and net income over that amount is taxed at a rate of 5.9%. While it is common for there to be multiple tax brackets and rates for state personal income taxes, the justification for a progressive CIT is less clear and most state CITs impose a single rate at all levels of income.⁸⁵

New Mexico CIT revenue mirrors the performance of state CITs as a whole – it is small and declining. Many of the bulleted reasons for national reductions apply to New Mexico as well. New Mexico has sought to mitigate some of the impact of corporate tax planning. In April 2019, New Mexico adopted mandatory combined corporate reporting to begin in tax year 2020. Under the combined reporting approach, a business must report on a combined basis the operations of all related entities involved in a unitary business. The general expectation is that businesses that have used tax planning to exploit state tax differences will have their tax liability increased as a result of mandatory combined reporting.⁸⁶

⁸³ “Briefing Book: Key Elements of the U.S. Tax System, Tax Policy Center, accessed electronically at <https://www.taxpolicycenter.org/briefing-book/what-are-pass-through-businesses#:~:text=Most%20US%20businesses%20are%20taxed,under%20the%20individual%20income%20tax.>

⁸⁴ Of course, pass through entities are still subject to tax, but this shows up as PIT rather than CIT.

⁸⁵ Of states with a corporate net income tax, 31 use a single rate, while 12 have more than one bracket and rate. Alaska has the most brackets/rates (10). “Range of Corporate Income Tax Rates, as of January 1, 2020,” Federation of State Tax Administrators, accessed electronically at https://www.taxadmin.org/assets/docs/Research/Rates/corp_inc.pdf

⁸⁶ See William F. Fox and LeAnn Luna, “Combined Reporting with the Corporate Income Tax: Issues for State Legislatures,” NCSL Task Force on State and Local Taxation of Communications and Interstate Commerce, November 2010, accessed electronically at <https://www.ncsl.org/documents/standcomm/sccomfc/combinedreportingreport.pdf>

Commentary

While a strong argument can be made for a progressive PIT rate structure (on ‘ability to pay’ grounds), the argument is less compelling for the CIT. As one noted tax commentator explains, “Graduated corporate rates are inequitable—that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes.”⁸⁷ In fact, 30 of the 44 states with a CIT use a single rate.⁸⁸

The trend for states that are seeking to stabilize CIT collections has been to mandate combined reporting. With New Mexico adopting it for tax year 2020, 28 states now use that method.⁸⁹ In 2010, just 22 states used combined reporting.⁹⁰

The other major change enacted by many states is to move away from the long-standing three-factor formula for apportioning income among states for CIT purposes. Over the past two decades, states have moved toward formulas that weight more heavily or rely exclusively on sales within the state to apportion income. This has the effect of increasing tax burdens on out-of-state businesses with many sales into a state but reduces burdens on businesses with operations located in-state and more sales out-of-state; it is often justified on the basis of encouraging businesses to locate in a state, as their property and payroll within the state will not be a basis for apportioning income amongst the states. In 2020, only five states used the traditional three-factor formula, while 26 states used only sales in their apportionment formula. The remaining states used a formula that gave greater weight to sales.⁹¹

CIT Key Issues

The following evaluate the CIT based on the tax principles and characteristics of a high-quality revenue system.

- The CIT has become, in New Mexico and among all states, a declining source of tax revenue (negative for revenue diversification and adequacy);
- New Mexico has enacted mandatory combined corporate reporting to counter some of the more common corporate tax planning measures (positive for adequacy and horizontal equity);
- New Mexico uses a two bracket and rate structure (negative for horizontal equity);
- As will be discussed in a later section on tax incentives, a significant share of CIT revenue is foregone by refundable tax credits (negative for adequacy and efficiency).

Excise Taxes

These taxes are levied on specific goods or activities - including motor fuel, cigarettes, alcohol, gambling and hotel room stays. In contrast with sales taxes that are applied as a percentage of a

⁸⁷ Jeffrey L. Kwall, “The Repeal of Graduated Corporate Tax Rates,” Tax Notes, June 27, 2011, p 1395, accessed electronically at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1879329

⁸⁸ Tax Foundation, “State Corporate Income Tax Rates and Brackets for 2020,” January 2020, accessed electronically at <https://files.taxfoundation.org/20200212140256/State-Corporate-Income-Tax-Rates-and-Brackets-for-20201.pdf>.

⁸⁹ The 2020 National Multistate Tax Symposium, “State tax policy: Recent developments in Multistate taxation,” accessed electronically at <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/state-tax-policy-recent-developments-in-multistate-taxation-04.pdf>

⁹⁰ William F. Fox and LeAnn Luna, “Combined Reporting with the Corporate Income Tax: Issues for Legislators,” National Conference of State Legislatures, November 2011, p. ii, accessed electronically at <https://www.ncsl.org/documents/standcomm/sccomfc/CombinedReportingFinalDraft.pdf>

⁹¹ Urban Institute, State and Local Finance Initiative, “Corporate Income Taxes,” accessed electronically at <https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/corporate-income-taxes>

purchase, or gross receipts taxes that are applied as a percentage of receipts of taxable goods or services, excise taxes are typically applied to a specific good or service per unit. Excise taxes may be used to influence consumer behavior or as a 'revenue remedy' for negative externalities (such as health risks) associated with the taxed product. In practice, they are often raised when budget balancing needs arise.

The three longstanding major excise taxes among the states are on motor fuel, alcohol, and tobacco products. Other prominent excise taxes imposed by state and local governments include amusement and admissions, hotel/motel room stays, insurance premiums, marijuana, rental cars, and sugared beverages. Less prominent excise taxes include billboard advertisements, bingo games, boat rentals, cell phones, coin-operated laundromats, dry cleaning solvents, egg containers, electric vehicles, fireworks, fish feed, grocery bags, mobile homes, personal property rentals, snack food, tire sale, tire disposal, and trading stamps, among others.

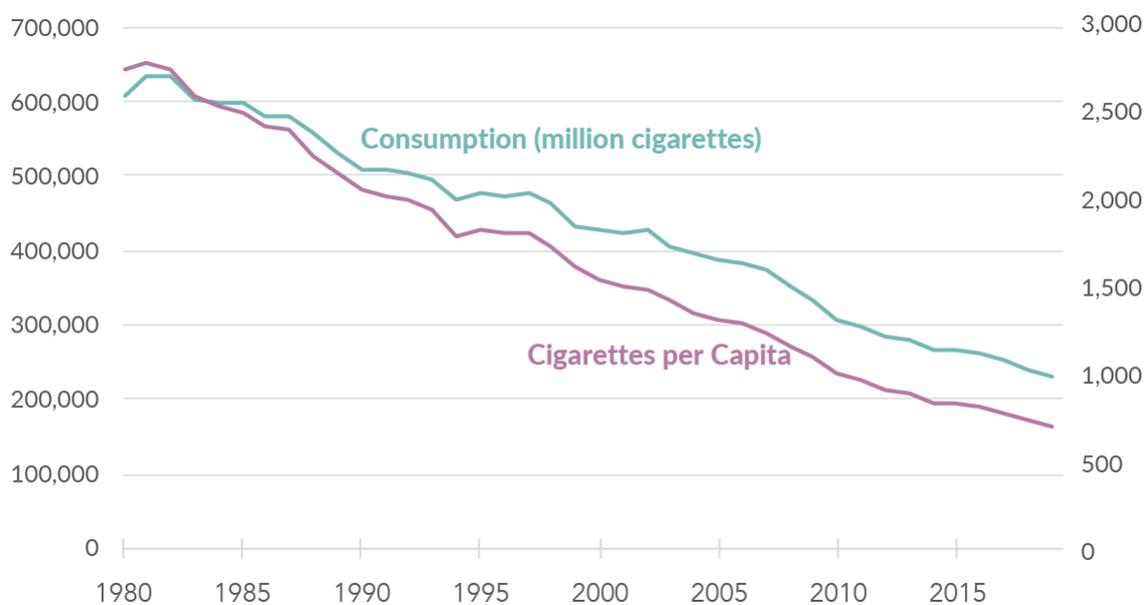
Excise taxes continue to be created and levied on new products and services. For example, e-cigarettes and vapor products and the state-regulated medical and recreational marijuana are products that were not common or legal just five years ago and are now being taxed in several states. In some states, recreational marijuana taxes are rivaling (and surpassing) the 'big three' excise taxes in terms of revenue raised. In FY2019, Colorado raised \$252.8 million from state taxes on recreational marijuana. By contrast, it raised \$189.5 from its cigarette and tobacco taxes and \$47.1 million from its liquor excise taxes.⁹²

New Mexico's major excise taxes are both above and below the national average and/or median. For example, the New Mexico gas tax is 18.875 cents per gallon, which ranks 44th among the states, where the average motor fuel rate for gasoline is 28.6 cents per gallon, and the median rate is 27.65 cents per gallon. Conversely, the New Mexico cigarette tax is \$2.00 per pack, which ranks 17th among the states. The average tax per pack of cigarettes among the states is \$1.76 and the median is \$1.65.

Excise taxes have often been used as a budget balancing tool, and they may bear little resemblance to rates applied to general goods and services under a sales or gross receipts tax. For example, the highest cigarette taxes in the country (the States of New York and Connecticut, at \$4.35 a pack) would equal a sales tax or gross receipts tax rate of over 50%. It is likely that these types of tax rates are impacting consumption - of course, that may well be the expected outcome. As the following chart shows, cigarette consumption has been declining for decades:

⁹² Colorado Department of Revenue, "2019 Annual Report, accessed electronically at https://www.colorado.gov/pacific/sites/default/files/2019_Annual_Report_1.pdf

Figure 29: U.S. Cigarette Consumption (million cigarettes)



Source: Center for Disease Control

Cross-border competition can also reduce sales of items subject to excise tax. This will often occur along densely populated state borders where there are significant tax differentials. In the case of New Mexico and other states, it may also occur where tribal nations have lower tax rates on items, such as tobacco products. This can create another constraint on increasing tax rates or on the revenue gains associated with those rate increases.

There are concerns that some goods and services subject to significant excise taxes are being disproportionately impacted by the COVID-19 pandemic. Excise tax revenue nationally on motor fuel, hotel/motel rooms, and other leisure activities are declining (in some cases precipitously), and it is not clear when that trend will reverse.

Commentary

For many states, excise taxes have become a 'go to' source for balancing budgets, and tax rates can vary considerably. As with sales tax rates, cross border competition can be a concern, as research shows that consumers will travel across state lines to make purchases (such as alcohol, cigarettes and motor fuel) when there is a significant tax differential. However, this is generally more of an issue in densely populated states with major cities on or near a neighboring state and is not as applicable for New Mexico.

It makes sense to maintain some regional comparability on excise taxes. At least as it relates to motor fuel, the New Mexico excise tax rate is significantly below the national average, and, as infrastructure costs continue to increase, the trend has been for states to raise this tax.

Another issue of interest relates to taxes on 'the sharing economy.' As car sharing (such as Uber, Lyft and others), home sharing (such as Airbnb, HomeAway and others) and other services grow in popularity, it makes sense (from the perspective of horizontal equity) to tax them similarly to more

traditional services (taxis and car rentals as well as hotels and motels). Increasingly, states are doing so, and New Mexico should continue to monitor emerging products and services. This also applies to other new technologies that compete with traditional products, such as e-cigarettes/vaping or digital products and services.

Excise Tax Key Issues

The following evaluate New Mexico excise taxes based on the tax principles and characteristics of a high-quality revenue system.

- Excise taxes are an additional revenue source (positive for diversification);
- Excise taxes have much higher tax rates than with general sales taxes or the GRT (negative for horizontal and vertical equity);
- Excise taxes are sometimes used to ameliorate the negative effects of products or services (positive for efficiency).

Tax Incentives

All states provide tax incentives to stimulate economic activity. Incentives are typically provided as credits (such as against PIT or CIT) or exemptions (generally on GRT or excise taxes). Major tax incentives offered by New Mexico include the Film and Television Credit, High Wage Jobs Credit, and the Renewable Energy Production Tax Credit.

Film and Television Credit

The Film and Television Credit can be applied to offset income under the PIT or CIT. The credit is also refundable and equal to 25% of qualifying direct production and postproduction expenditures in New Mexico related to film and television production. Productions may qualify for an additional 5% if it is a pilot of a television series, a television series with an order of at least six episodes spending at least \$50,000 in New Mexico, is filming in a rural area, or is using a qualified production facility as defined by statute. Some expenses may qualify for a 35% credit if, for example, a production is shooting in a rural area and also using a qualified production facility. In 2019, several changes were made to the program.

Prior to 2019, the program operated with an aggregate spending cap of \$50 million, which created a backlog of refundable credits waiting to be paid out. In 2019, one-time spending of \$225 million was authorized to clear this backlog, and the cap was more than doubled to \$110 million. The changes made in 2019 also now allow production companies that make a 10-year commitment to produce films in the State to participate in the program outside of the \$110 million cap. These firms are considered “film partners” by statute. The estimated annual cost of credits to film partners is \$45 million.⁹³ However, without a cap, these credits have the potential to fluctuate significantly from year to year.

The Film and Television Credit cap of \$110 million is among the highest state caps. New York and California are the top states, with caps of \$420 and \$330 million respectively. Louisiana operates with a \$150 million cap. Other states with caps similar to New Mexico are Kentucky and New Jersey, each with \$100 million caps.⁹⁴ There are states without a cap on their programs with

⁹³ Legislative Finance Committee, “Legislating for Results: Policy and Performance Analysis”, 2020.

⁹⁴ “The Guide: An Essential Resource for Global Production Incentives,” Entertainment Partners, 2020, accessed electronically at <https://www.productionincentives.com/wp-content/uploads/pdf/booklet.pdf>

significant expenditures, particularly Georgia, which reported a tax expenditure of \$496 million for its film tax credit in FY2020.⁹⁵ On a per capita basis, New Mexico's cap and program tax expenditures is greater than each of these states.

High-wage Jobs Credit

The high-wage jobs credit is a job creation incentive offering a credit of 8.5% of wages paid to an eligible employee in a high-wage job for a maximum credit of \$12,750 per qualified period. Jobs created must be paid annual wages of at least \$60,000 in urban areas and \$40,000 in rural areas.⁹⁶ The credit resulted in a tax expenditure of \$12.5 million in FY2017.

Job creation tax credits are common.⁹⁷ More recently, states have tailored programs to focus on incenting higher-wage job creation. A similar incentive program in a peer state is the Quality Jobs Program in Oklahoma, which was determined to be cost effective in a recent incentive evaluation.⁹⁸

Renewable Energy Production Tax Credit

The Renewable Energy Production Tax Credit was intended to incent greater use of renewable energy technology. In FY 2016, it generated a tax expenditure of \$15 million. The tax credit is equal to \$0.01 per kilowatt-hour of wind or biomass energy generated and \$0.015 to \$0.04 per kilowatt-hour of solar electricity generated. The credit may be claimed annually over a 10-year period. In order to qualify for the credit, the facility must have generated electricity on or before January 1, 2018. Eligible taxpayers may claim the credit for a period of 10 years.

This is also a common credit for states that generate significant electricity from renewable sources, primarily wind or solar. Most of the states that are significant renewable energy producers have also sunset or capped their per kilowatt-hour tax credit, including Iowa, Minnesota and Oklahoma.⁹⁹

Other Incentives

New Mexico employs a variety of other tax incentives, although none is likely to significantly impact state tax revenue or economic development. These include:

- **Sale of Software Development Services GRT Deduction.** Receipts from the sale of software development services that are performed in a rural area (defined as anywhere except an incorporated municipality with a population of more than 50,000) by an eligible software company are deductible from gross receipts. The deduction is meant to stimulate new business development in rural areas. It was estimated to reduce state GRT receipts by \$2.6 million in FY2018.
- **Manufacturers Investment Credit against GRT, Compensating Tax, or Withholding Tax.** The investment credit is for equipment owned and introduced into New Mexico for use by a taxpayer in a new or expanded manufacturing operation. To be eligible for the credit, until June 30, 2020, the taxpayer must employ one full-time equivalent ("FTE") for

⁹⁵ "Georgia Tax Expenditure Report for FY 2021," Fiscal Research Center, Andrew Young School of Policy Studies, Georgia State University, December 2019, accessed electronically at <https://opb.georgia.gov/tax-expenditure-report-fy-2021>

⁹⁶ "Application for High-Wage Jobs Tax Credit Instructions," State of New Mexico Taxation and Finance Department, revised May 5, 2019, accessed electronically at <https://gonm.biz/uploads/documents/programs/HWJTCapp2020.pdf>

⁹⁷ A 2016 study analyzed broad-based state job creation tax credit programs in 20 states. See Robert Chirinko and Daniel Wilson, "Job Creation Tax Credits, Fiscal Foresight, and Job Growth: Evidence from U.S. States," Federal Reserve Bank of San Francisco, November 2016, accessed electronically at <https://www.frbsf.org/economic-research/files/wp10-25bk.pdf>

⁹⁸ State of Oklahoma Incentive Evaluation Commission, "Quality Jobs Investment Program Evaluation," November 9, 2018, accessed electronically at https://iec.ok.gov/sites/g/files/gmc216/f/Quality%20Jobs%20Investment%20Program_11.09.18_FINAL.PDF

⁹⁹ State of Oklahoma Incentive Evaluation Commission, "Tax Credit for Zero Emission Facilities Program Evaluation," November 28, 2016, accessed electronically at https://iec.ok.gov/sites/g/files/gmc216/f/Zero%20Emission%20Incentive%20Final%20Evaluation_112816.pdf

every \$500,000 of qualified equipment claimed (up to \$30 million) and one FTE for every \$1 million of qualified equipment claimed (over \$30 million). After June 30, 2020, the taxpayer must employ one FTE for every \$100,000 of qualified equipment claimed. The credit reduced state General Fund revenue by \$1.2 million in FY 2018.

- **Rural Job Credit Against GRT, PIT and CIT.** Eligible employers may earn the rural job tax credit for each qualifying job created after July 1, 2000, applying it to GRT (less local option GRT), compensating tax, withholding tax, PIT, or CIT. An eligible employer is one whom the New Mexico Economic Development Department (EDD) has approved for Job Training Incentive Program assistance. A qualifying job means a job filled by an eligible employee for 48 weeks in a 12-month qualifying period. The total credit authorized is between 12.5% and 25% of the first \$16,000 of wages paid depending on its location in New Mexico. The cost of the credit totaled \$1.1 million in FY2018.
- **Technology Jobs and Research and Development Tax Credit against GRT, CIT or PIT.** A taxpayer who conducts qualified research and development at a facility in New Mexico, except at a facility operated for the U.S. government, may claim a basic credit equal to 5% of qualified expenditures (this is doubled to 8% when the qualified facility is in a rural area). The taxpayer may qualify for an additional 4% credit against PIT and CIT liabilities by raising its in-state payroll by \$75,000 for every \$1 million in qualified expenditures claimed. This credit doubles if the qualified facility is in a rural area. The credit reduced revenue by \$0.9 million in FY2018.

Commentary

Every state offers some types of business incentives to spur economic development, and the vast majority provide tax incentives. While there is considerable debate about the efficacy of this approach to business recruitment and retention, it remains a dominant strategy. Supporters of tax incentives argue that the foregone revenue will be made up by the multiplier effect of increased economic activity. However, many studies dispute this.¹⁰⁰

Ultimately, each state determines whether the benefits from incentives exceed the cost. New Mexico has sought to determine the cost of its tax expenditures and incentives, in the form of Tax Expenditure Report issued by the New Mexico Taxation and Revenue Department, which was last issued in 2018. While that report provides much useful information, it is primarily a report on the amount of tax expenditures – rather than an in-depth evaluation of their efficacy.

Tax Incentives Key Issues

The following evaluate New Mexico tax incentives based on the tax principles and characteristics of a high-quality revenue system.

- Tax incentives generally reduce revenue, at least in the short-term (negative for adequacy);
- Tax incentives may provide special benefits to a single company or industry that is not available to its competitors (negative for efficiency and horizontal equity);
- Depending on how they are structured, tax incentives may mask the extent of their use (negative for transparency);
- Tax incentives may be targeted to growth industries that broaden the economic base (positive for diversification).

¹⁰⁰ See, for example, Cailin Slattery and Owen Zidar, "New data on state and local business tax incentives across the U.S.," January 6, 2020, accessed electronically at <https://economics.princeton.edu/2020/01/06/new-data-on-state-and-local-business-tax-incentives-across-the-u-s/>

Past Studies

Over the past 25 years, New Mexico has undertaken multiple major studies of its tax structure. These have included efforts initiated or undertaken by the Governor, the Legislature and other groups. They have often involved academics and state taxation subject matter experts. In some instances, the recommendations have been acted upon, and in other cases they have not. In reviewing these past efforts, the project team focused on the following:

- **Professional Tax Study Committee Report (1996).** The Legislature and the Governor authorized the creation of the committee in 1994 to “examine the manner and purpose of taxation and the foundation and goals of current and recommended tax policy.” The committee gave the gross receipts and compensating taxes lengthy review and did not review either the PIT or the property tax. Recommendations for the GRT were mostly to expand its base, although a few recommendations were to shrink its base, primarily to deal with pyramiding.
- **Blue Ribbon Tax Commission Final Report (2003).** The commission was created by the Legislature in 2003; according to the final report, the commission grew out of a “widespread feeling that New Mexico’s tax system no longer fully meets the state’s diverse needs” and had gotten out of step with the state and national economies. The commission noted that one of the larger concerns expressed to it was the level of pyramiding in the GRT. Other primary issues related to CIT reporting, cuts in the PIT and burdensome administration of the tax code. The commission examined 196 separate tax change proposals and adopted 71 recommendations.
- **Pyramiding Transaction Taxes in New Mexico: A Report on the Gross Receipts Tax (2005).** This study, done by Manuel del Valle, Director of Research at the New Mexico Tax Institute, was done to estimate the extent of pyramiding in the administration of the GRT. It identified the percentage of tax collection that was the result of pyramiding for various sectors of the state economy. It estimated that pyramiding represented approximately 32% of GRT revenues collected. It also determined that if existing pyramiding had been eliminated, the GRT rate would have to be increased by two percentage points to maintain the current levels of revenue.
- **Blue Ribbon Tax Reform Commission and Review of Credits and Exemptions Adopted Since 2003 (2009).** Written as a presentation to the LFC, this reviewed commission recommendations and their status. This was the period of the Great Recession, and the report provided an assessment of the fiscal impact of recommendations that had been enacted. It also identified those recommendations that had not been enacted and provided revenue estimates should the recommendations be adopted. It identified four categories of enacted recommendations – family tax relief, medical services tax changes, economic development tax changes and renewable energy tax credits and GRT reductions.
- **Government Restructuring Task Force: Final Report (2010).** The task force was established by the Legislature “to study the resources of state agencies, programs, services, funding and policies and the public needs served by them, including recommendations of the 2009 Governor’s Committee on Government Efficiency (the Carruthers committee); the need for consolidation of agencies and elimination or reduction of redundant, duplicative or overlapping programs and services; and current and projected revenue estimates for the next three to five years.” This also grew out of concerns about structural budget balance during the Great Recession. While the focus of the task force was improving efficiency and prioritization in service delivery, there was some discussion of additional revenue generation opportunities for the state. Most of its recommendations were targeted at tax and revenue adequacy and sufficiency.

- **New Mexico Tax Competitiveness Study: Updated Results (2014).** Done by Ernst and Young, this was an update of analysis done in 2011-2012. The earlier analysis was a collaborative effort of the State, the City of Albuquerque, Bernalillo County, the New Mexico Municipal League and seven private sponsors. The original study modeled the effective tax rates for a representative business in several industry sectors. There were significant changes in taxes in 2013. It found that most of the business favorable tax policies enacted in the years between the two studies were targeted to the manufacturing sector.
- **New Mexico's Gross Receipts Tax, Compensating Tax, and Personal Income Tax: Considerations and Model Documentation (2019).** This report, done by Ernst and Young and Georgia State University, was commissioned by the New Mexico Legislative Council Services to allow for estimating revenue changes based on changes to the rate or base of the GRT, PIT and CIT. It also provides a brief discussion of the strengths and weaknesses of the GRT and PIT structures.

This is not an exhaustive list, as other studies have touched on tax topics during this timeframe.¹⁰¹ These, however, have the most applicability to the current discussion. For those wishing additional detail on these studies, their background, findings and recommendations, further discussion of their relationship to current events may be found in the appendices.

In reviewing these past efforts, several recurring themes emerge. Key themes addressed in these past studies primarily include:

- **Revenue adequacy.** Budget concerns have been a catalyst for study and/or reform efforts. These have sometimes targeted additional revenue sources or augmenting existing sources.
- **Diversification.** Studies have highlighted the State's reliance on the oil and gas industry, both for direct tax revenue (such as severance tax revenue) and for indirect and induced economic activity (including gross receipts and income tax revenue). Diversification and revenue adequacy or sufficiency are inter-related, and revenue structure volatility can also be a catalyst for some of these discussions and study.
- **Tax equity.** Concerns have been raised that some components of the tax and revenue structure have a disproportionate impact on certain categories of taxpayers (vertical equity) or treat similar taxpayers differently (horizontal equity).
- **Economic Efficiency.** Some studies have focused on the disproportionate impact taxes may play in economic decisions, which may create market distortions and 'pick winners and losers.'
- **Simplification.** Complexity can increase costs and errors and reduce voluntary compliance. Some studies have sought to simplify the tax structure.

¹⁰¹ These include:

Robert Desiderio, "New Mexico Taxes: Taking Another Look," *New Mexico Law Review*, Vol. 32, Issue 3, Summer 2002, accessed electronically at <https://digitalrepository.unm.edu/cgi/viewcontent.cgi?article=1662&context=nmlr>

Amy Williams, "New Mexico's Land Grant and Severance Tax Permanent Funds: Renewable Wealth from Non-renewable Resources," *Natural Resources Journal*, Volume 48, Issue 3, Summer 2008, accessed electronically at

<https://digitalrepository.unm.edu/cgi/viewcontent.cgi?article=1204&context=nri>

Ernst&Young, "New Mexico Business Tax Competitiveness and Simulations of Selected Tax Policy Changes," January 23, 2012, accessed electronically at

<https://cdn.ymaws.com/www.nmtri.org/resource/resmgr/imported/New%20Mexico%20Business%20Tax%20Competitiveness%20Study%202012.pdf>

Melissa Binder, "Providing Leadership for the Livable Economy of the Future: Implementing a Carbon Tax in New Mexico," September 24, 2007, accessed electronically at http://www.emnrd.state.nm.us/ECMD/Multimedia/documents/carbontax8_14.pdf

When viewing the New Mexico studies as a whole, the same features have gotten the lion's share of the attention from both task force and commission work (which is focused on tax policy recommended changes) and more rigorous studies focused on specific aspects of tax policy and its impact on taxpayers and the economy. Without question, the GRT has and continues to capture the greatest attention. Over the years, the GRT has been subject to significant change related to the tax base subject to the tax and its rate. It has been the focus of discussions of major tax principles as well – particularly equity and efficiency.

More broadly, the issue of how best to configure a state tax and revenue structure has often been subsumed by more immediate concerns about budget shortfalls and budget balancing. New Mexico is not alone in this preoccupation. However, given current challenges, based on both a broad-based decline in employment and GDP and a significant drop in oil and gas demand and prices, it is worth considering whether more wholesale changes in the state's approach to its tax and revenue system should be considered.

6. Taxation Key Topics

Revenue Concentration/Diversification

As noted in the NCSL discussion of the characteristics of a high-quality state revenue system on pages 32-33, an effective state tax system relies on a balanced variety of tax and revenue sources. In recent years, a ‘portfolio theory’ of tax and revenue structures has been the subject of significant study and analysis.¹⁰² This theory is similar to the concept of a balanced portfolio of investments, as different types of companies and different types of investment vehicles will perform better (or worse) than the market as a whole based on a variety of circumstances. A balanced portfolio avoids the dangers associated with ‘putting all your eggs in one basket.’ While revenue diversification is not necessarily a panacea for times of serious economic disruption,¹⁰³ there is evidence that it can help a state realize greater fiscal health.¹⁰⁴ A recent study found a positive relationship between revenue diversification and revenue components of fiscal health and suggests that diversification enables states to maintain own source revenues without large tax increases.¹⁰⁵

Economic diversification can be a driver of revenue diversification. A related factor is the relative impact of different industrial sectors on the state economy. A state can establish a varied mix of taxes, but if the economic activity that is to be taxed is negligible, it will not appreciably contribute to overall revenue adequacy. A New Mexico-specific study of economic diversification identified four primary reasons to diversify the state’s economy:¹⁰⁶

- Reduce macroeconomic instability;
- Shield the state from volatility in particular industries;
- Stabilize public revenue streams;
- Increase the size of economic multipliers.

For New Mexico, the oil and gas industry has been dominant according to a variety of economic measures. For example, a 2018 review of each state’s GDP identified the oil and gas industry as New Mexico’s largest, with an 8.2% total share. This is a larger share than the average state’s largest industry, which was generally less than 6%.¹⁰⁷ This analysis found the oil and gas industry to be the largest share of state GDP for several states, including Alaska, Oklahoma and Texas.

According to the New Mexico Tax Research Institute (NMTRI), the oil and gas industry was responsible for an average of 5.5% of the state’s total GRT revenue from FY 2006 through FY

¹⁰² See for example, Thomas A. Garrett, “Evaluating State Tax Revenue Variability: A Portfolio Approach,” Federal Reserve Bank of St. Louis Working Paper Series, February 2006, accessed electronically at <https://s3.amazonaws.com/real.stlouisfed.org/wp/2006/2006-008.pdf>

¹⁰³ One study of states during the Great Recession found little correlation between revenue diversification and fiscal performance during the Great Recession. See Nick Kilby, “Does Tax Revenue Diversification Help States Weather Economic Downturns? Evidence from the Great Recession,” University of Kentucky MPA/MPP Capstone Projects, 2014, accessed electronically at https://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1011&context=mpampp_etds

¹⁰⁴ See Wenli Yan and Douglas A. Carr, “Impacts of Revenue Diversification and Revenue Elasticity on State Fiscal Health,” Public Finance and Management, Vol. 19, No. 2, pp. 151-174, 2019. For revenue diversification, a common determining method is the Hirschman-Herfindahl Index (HHI), which combines five revenue categories (general sales tax, personal income taxes, other taxes, general charges and total miscellaneous revenues and uses the portion of each to calculate a value from zero to one, with increasing values indicating a more diversified revenue structure.

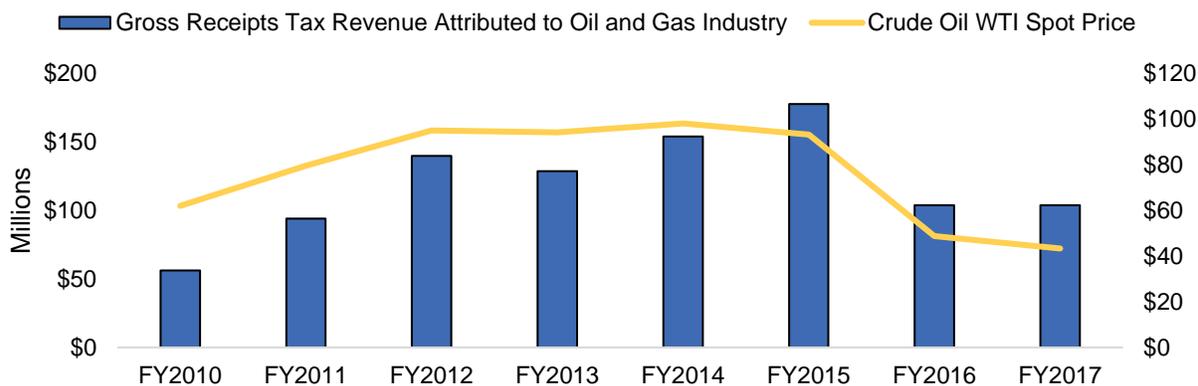
¹⁰⁵ Ibid., p. 163.

¹⁰⁶ Richard V. Adkisson and Sajid Al Noor, “New Mexico’s Industrial Diversity,” December 2018, p.2, accessed electronically at https://www.researchgate.net/publication/330002599_New_Mexico's_Industrial_Diversity_New_Mexico's_Industrial_Diversity

¹⁰⁷ “These are the Largest Industries in Every State,” 24/7 Wall Street, August 31, 2018, access electronically at <https://www.usatoday.com/story/money/economy/2018/08/27/largest-industry-in-each-state/37585051/>

017.¹⁰⁸ This revenue can be volatile due to changes in the price of oil, as shown in the following chart. The industry’s GRT revenue peaked at \$177.4 million while oil was over \$90 per barrel and declined by over \$70 million in FY 2016 as oil prices fell to under \$50 per barrel.

Figure 30: Gross Receipts Tax Revenue and Price of Oil

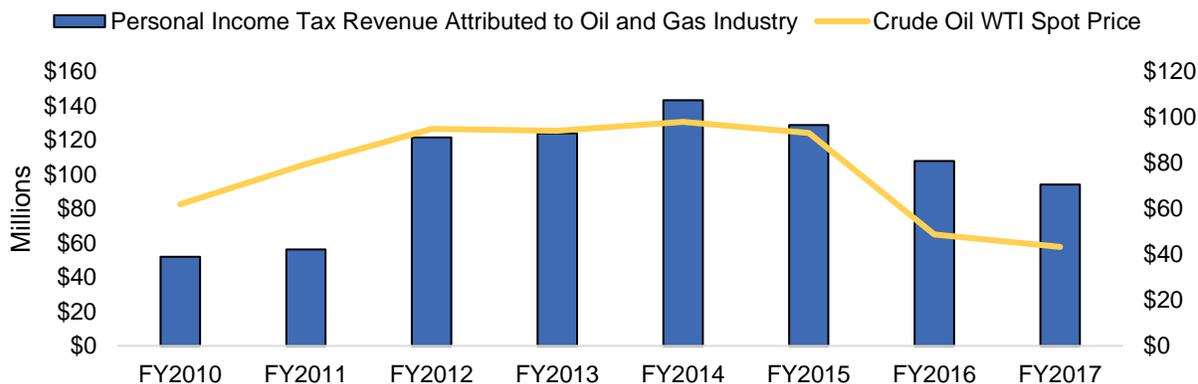


Source: New Mexico Tax Research Institute and U.S. Energy Information Administration

The national economic downturn that occurred in 2016-2017 coincided with a significant downturn in the oil and gas market, and this also occurred in 2020. As the following figures demonstrate, there is evidence that the ebbs and flows of New Mexico’s state tax revenue have aligned with similar ups and downs of the oil and gas industry.

Likewise, the NMTRI found that the oil and gas industry was responsible for an average of 7.5% of annual PIT collections from FY 2006 through FY 2017.¹⁰⁹ This revenue has also increased and decreased alongside the price of oil in recent years. The industry generated \$143.2 million in PIT revenue in FY 2014, its peak during the timeframe, while oil was over \$90 per barrel. As oil declined to under \$50 per barrel for FY 2016, this revenue declined to \$107.8 million.

Figure 31: PIT Revenue and the Price of Oil



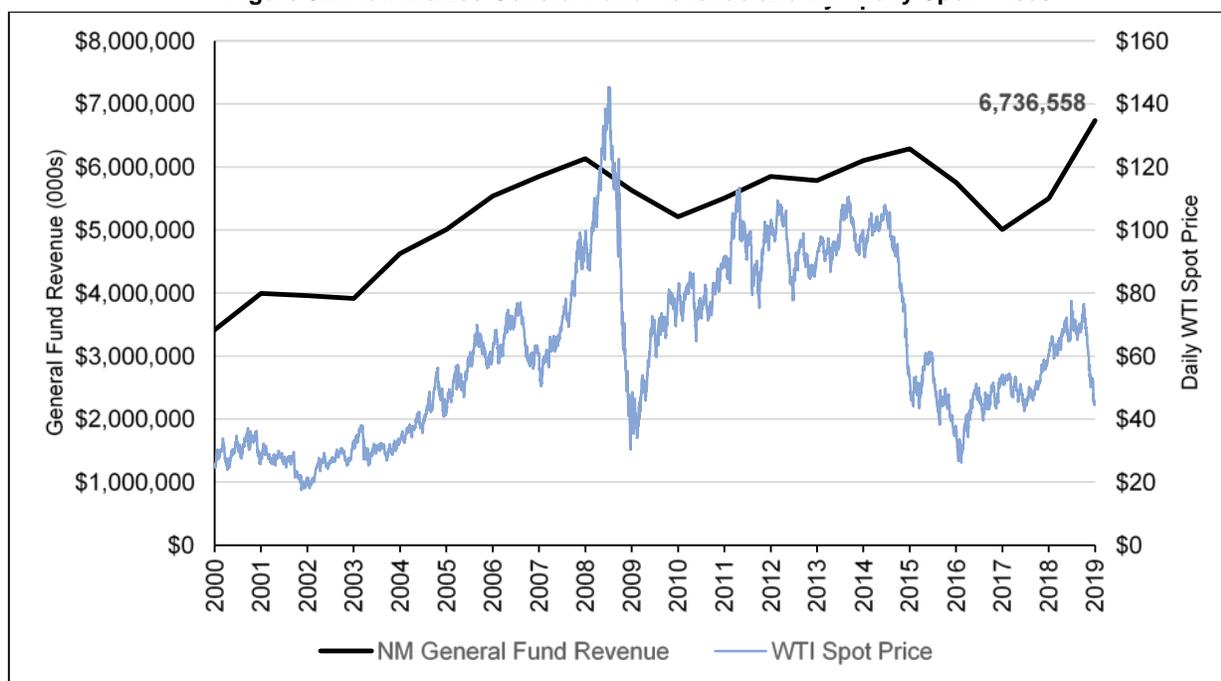
Source: New Mexico Tax Research Institute and U.S. Energy Information Administration

¹⁰⁸ New Mexico Tax Research Institute, Fiscal Impacts of Oil and Natural Gas Production in New Mexico, January 2018. It should be noted that this is smaller than the percentage claimed by the NMOGA study; that study took into consideration not only direct taxes but revenue generated by indirect economic activity. Accessed electronically at https://cdn.ymaws.com/www.nmtri.org/resource/resmgr/Fiscal_Impacts_of_OGAS_in_NM.pdf

¹⁰⁹ Ibid.

It is also useful, for comparison purposes, to look at how New Mexico State General Fund revenue has performed in relationship to energy prices. Figure 32 displays State General Fund revenue and WTI crude oil spot prices respectively.¹¹⁰ As can be seen, the high point in General Fund revenue was reached in 2008, which was also the high point for WTI spot prices. Likewise, the decline in prices in 2015 through 2017 coincided with a decline in General Fund revenue, while gradual improvements in prices in 2017 and 2018 are also reflected in an increase in General Fund revenue. While other factors also come into play, the trend lines are similar.

Figure 32: New Mexico General Fund Revenue and WTI Daily Spot Prices



Source: New Mexico Comprehensive Annual Financial Report, U.S. Energy Information Administration

Revenue Concentration/Diversification Key Issues

The following are key issues for New Mexico’s tax and revenue structure related to revenue concentration and/or diversification:

- New Mexico’s largest industry, oil and gas, constitutes a larger share of state GDP than the largest industry in the average state, and this translates into a significant share of state revenue (negative for diversification).
- New Mexico state revenue peaks and valleys tend to align with cyclical changes in energy prices (negative for adequacy).

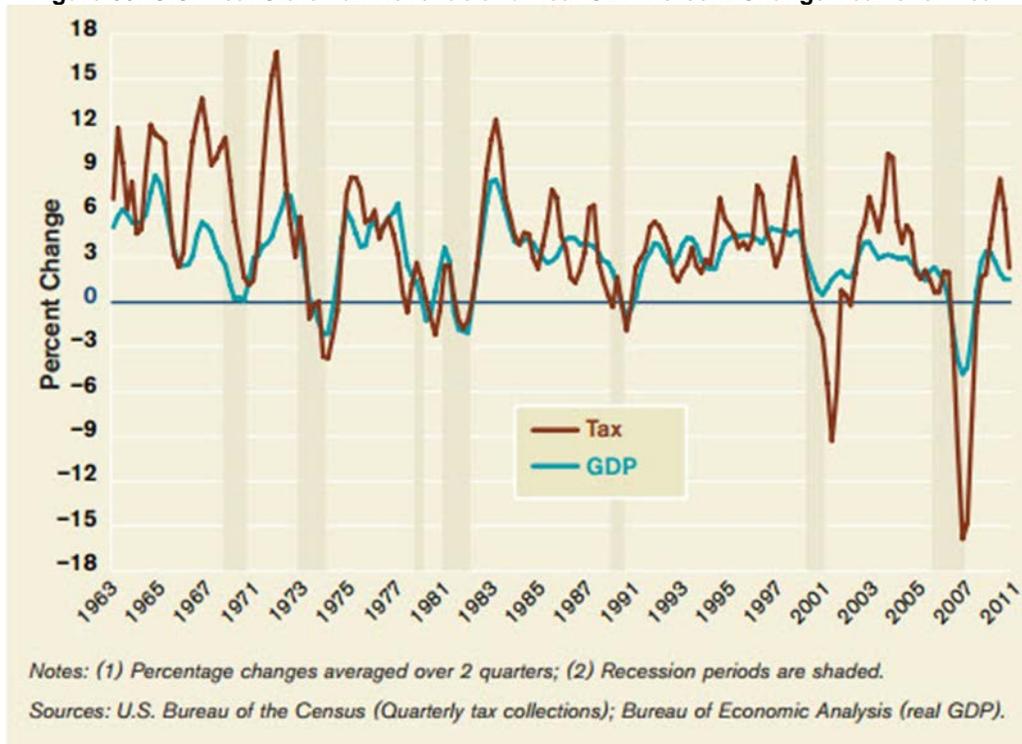
Revenue Volatility

Among the 50 states, there is evidence that tax and revenue structures have become more volatile. Over the last 20 years, state revenue declines during recessions have become deeper and post-

¹¹⁰ West Texas Intermediate (WTI) crude is a common industry benchmark for oil prices.

recession 'bounce backs' have become more pronounced. The following chart reflects this greater variation in state revenue performance at different points in the business cycle through the Great Recession and the beginning of the economic recovery:

Figure 33: U.S. Real State Tax Revenue and Real GDP Percent Change Year-over-Year



There are indications that the current recession is having a disproportionate impact on state revenue collections as a whole.¹¹¹ While some tax sources have held up fairly well (for example, many states have reported strong growth in e-commerce sales tax collections), other sources (such as excise taxes associated with the hospitality industry) have plummeted.

For New Mexico, the consensus revenue forecast provided prior to the June 2020 legislative special session generally aligned with national estimates. In developing two scenarios related to the current recession, the forecast noted that “widespread business closures and associated layoffs lead to significant declines in personal income tax and gross receipts tax (GRT) revenues. Low oil prices and declining production significantly reduce severance tax revenues, federal royalty payments, and GRT collections from drilling activity. Other revenues, including corporate income taxes, motor vehicle excise taxes, gaming receipts, and tribal revenue sharing, are also expected to decline.”¹¹²

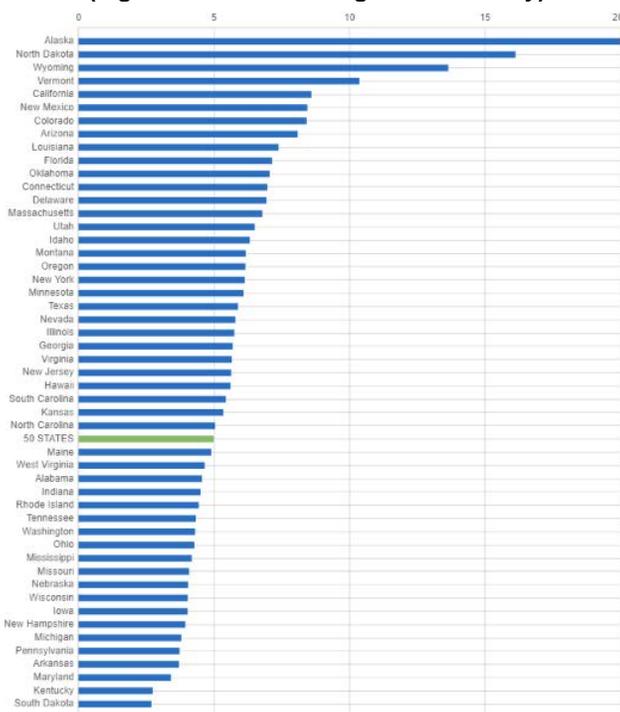
¹¹¹ See, for example, “April Tax Collections Plummet from Tax Deadline Shifts and Fallout of COVID-19,” National Association of State Budget Officers Budget Blog, May 19, 2020, accessed electronically at <http://budgetblog.nasbo.org/blogs/brian-sigritz/2020/05/19/april-tax-collections-plummet-from-tax-deadline-sh?CommunityKey=eca4d2c7-296d-4ab5-aeab-2024a4e7b0b8&tab=>

¹¹² “Consensus Revenue Estimating Group – 2020 Interim Review of Finances,” May 5, 2020, accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Revenue_Reports/General_Fund_Revenue_Forecast/2020/Consensus%20Revenue%20Memo%20-%20May%202020.pdf

“Rising revenue volatility and soaring oil and gas production increased the difficulty of state revenue forecasting. In general, revenues based on natural resource extraction are highly volatile, as changes in prices and volumes can significantly increase or reduce some of the state’s largest revenue sources.”

Measures of tax revenue volatility by state identify certain revenue sources as more volatile than others. In particular, PIT and energy-related taxes are considered more volatile than sales or gross receipts taxes. A Pew Charitable Trusts study of revenue volatility by state found that most of the states with more volatile revenue structures were also major oil and natural gas producing states:¹¹³

Figure 34: Revenue Volatility by State
(higher values indicate greater volatility)



Source: The Pew Charitable Trusts

Revenue volatility has been a concern in New Mexico. A recent hearing brief by the New Mexico LFC noted that “Rising revenue volatility and soaring oil and gas production increased the difficulty of state revenue forecasting. In general, revenues based on natural resource extraction are highly volatile, as changes in prices and volumes can significantly increase or reduce some of the state’s largest revenue sources. Revenue swings in either direction confound efforts to keep a balanced budget.”¹¹⁴ While the use of budget reserves and other stabilization methods are important mechanisms for managing this volatility, fostering alternate revenue sources might be a beneficial

¹¹³ “Tax Revenue Volatility Varies Across States, Revenue Streams,” Pew Charitable Trusts, April 28, 2020, accessed electronically at <https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2014/fiscal-50#ind6>

¹¹⁴ “LFC Hearing Brief: Enhancing Fiscal Stability and Managing Uncertainty,” New Mexico Legislative Finance Committee, August 2019. Accessed electronically at <https://www.nmlegis.gov/Entity/LFC/Documents/Hearing%20Brief%20-%20Fiscal%20Stability.pdf>

part of this overall strategy. This relates not only to the ebbs and flows of a key industry (such as oil and gas) but also its impact on the State's economy and its workforce.

Technological advances in the oil and gas industry have reduced the need for human capital. This may reduce tax revenue that results from this employment. In this respect, other state revenue sources may be impacted even when extraction tax collections are strong.¹¹⁵

In fact, one analysis of state fiscal conditions referred to natural resources as both a 'blessing and a curse,' providing heightened revenue collections when extractive markets are strong and significant revenue reductions when the same markets perform poorly. Unlike other structures that are built on a variety of industries and types of consumption, resource rich states may over-rely on extractive industries.¹¹⁶

Revenue Volatility Key Issues

The following are key issues for New Mexico's tax and revenue structure related to revenue volatility:

- New Mexico has greater revenue volatility than most states (negative for stability);
- Most major oil and gas producing states, including New Mexico, have greater revenue volatility than non-producing states (negative for stability);
- The GRT is considered less volatile than the PIT (positive for stability).

Tax Burden

The term 'tax burden' is generally meant to identify the amount of taxes an individual or business pays as a share of their overall income. A widely cited study on tax burden, by the Office of the Chief Financial Officer of the District of Columbia, defines tax burden as "the dollar amount of taxes owed if the final incidence of each major tax examined is on the individual."¹¹⁷ Tax burden analysis is useful as a way of determining whether a tax (or, preferably, a tax structure) is equitable, particularly relating to vertical equity.

While the analysis may be complicated and the results subject to interpretation, it is important to gain an understanding of who shoulders the responsibility for paying state and local taxes. It is a widely accepted fact that individuals and families at varying income levels pay differing percentages of their income as taxes. It is helpful to understand how the tax burden is shared among the various income cohorts.

Tax burden can also impact economic decision making (the issue of efficiency). The application of taxes will, in nearly all instances, reduce economic activity (what is known as the 'deadweight loss')

¹¹⁵ Adele C. Morris, "The Challenge of State Reliance on Revenue from Fossil Fuel Production," Brookings Institution, August 9, 2016, accessed electronically at <https://www.brookings.edu/wp-content/uploads/2016/08/state-fiscal-implications-of-fossil-fuel-production-0809216-morris.pdf>

¹¹⁶ Olivia Gonzalez, "Natural Resources Can Be a Blessing or a Curse for State Fiscal Conditions," The Bridge, November 5, 2018, accessed electronically at <https://www.mercatus.org/bridge/commentary/natural-resources-can-be-blessing-or-curse-state-fiscal-conditions>.

¹¹⁷ Office of the Chief Financial Officer, District of Columbia, "Tax Rates and Tax Burdens In the District of Columbia - A Nationwide Comparison 2018," March 2020, p. 2, accessed electronically at https://www.nmgcb.org/revenue-sharing.aspxhttps://cfo.dc.gov/sites/default/files/dc/sites/ocfo/publication/attachments/2018%2051City%20Study_June%202020.pdf

related to taxation¹¹⁸). As the level of taxation grows, individuals and businesses are increasingly likely to seek to avoid the tax – even when that may result in sub-optimal decisions from a purely market-based perspective. It is helpful to determine if levels of tax burden may be impacting market decisions.

There are a variety of ways to calculate of tax burden; most have both advantages and disadvantages. In general, it is useful to analyze and discuss tax burden from multiple perspectives to get a balanced view.

State Taxes as a Percent of Income and Per Capita

The FTA has regularly calculated and annually updated two measures of tax burden, state taxes as a percent of personal income, and per capita. These allow a comparison of the tax burden/effort among states based on income or population. The following provides this data for New Mexico and the benchmarked states.

Table 11: State Taxes Per Capita and Percent of Personal Income, 2019

	Total Taxes (Millions)	Per Capita	Rank	% of Personal Income	Rank
Alaska	\$1,781	\$2,434	42	4.1	50
Colorado	\$15,870	\$2,756	36	4.8	44
Arizona	\$18,164	\$2,495	41	5.7	36
Oklahoma	\$10,732	\$2,712	38	5.9	34
Wyoming	\$2,111	\$3,647	14	6.1	31
Utah	\$9,968	\$3,109	27	6.8	14
New Mexico	\$7,428	\$3,542	15	8.5	7

Source: Federation of Tax Administrators

Based on this calculation, New Mexico would be classified as a state with an above average overall tax burden based on either state taxes per capita or as a percent of personal income.

There are some problems with this method of determining tax burden. The first is that it can be distorting to consider state and local taxes independently. Local governments are political subdivisions of the state, and in most states, the local government’s ability to tax relies on a grant of that power by the state. As a result, there is often an intertwining of both taxing authority and spending responsibility between state and local governments. Second, this method assumes that all state taxes are paid by state residents, which is not the case. In many states, a significant portion of taxes are paid by non-residents – often because of tourism or business travel, and, in the case of New Mexico and other states, because of extraction taxes. This exporting of tax burden is an important strategy in many states, and it would be incongruous to suggest that these imported dollars are part of the state’s tax burden on its resident taxpayers.

As it relates to state and local responsibilities, the State of New Mexico funds most K-12 education at the state level, and its property taxes are lower than in most states. As it relates to exporting tax burden, the State of Hawaii is an prominent example of how taxing non-residents reduce the

¹¹⁸ Deadweight loss is defined as the overall economic loss caused by a tax on a product or service. It is the decrease in production and the decline in demand caused by the imposition of a tax. See “Deadweight Loss of Taxation,” Investopedia, accessed electronically at <https://www.investopedia.com/terms/d/deadweight-loss-of-taxation.asp#:~:text=Key%20Takeaways,the%20imposition%20of%20a%20tax>.

residents' tax burden – a 2017 study estimated that approximately one-third of the Hawaii state and local tax burden was paid by visitors to the state.¹¹⁹

A more comprehensive approach to the issue of overall tax burden within a state is to combine the state and local tax burden as a share of personal income. The following table combines state and local taxes and ranks the benchmark states based on tax revenue per capita or as a percent of personal income.

Table 12: State and Local Taxes Per Capita and as a Percent of Personal Income, 2017

	Per Capita	Rank	% of Personal Income	Rank
New Mexico	\$4,052	35	10.2	16
Utah	\$4,063	34	9.4	30
Colorado	\$4,902	20	9.0	33
Arizona	\$3,665	46	8.7	38
Wyoming	\$4,866	23	8.5	43
Oklahoma	\$3,532	48	8.0	48
Alaska	\$4,095	33	7.2	51

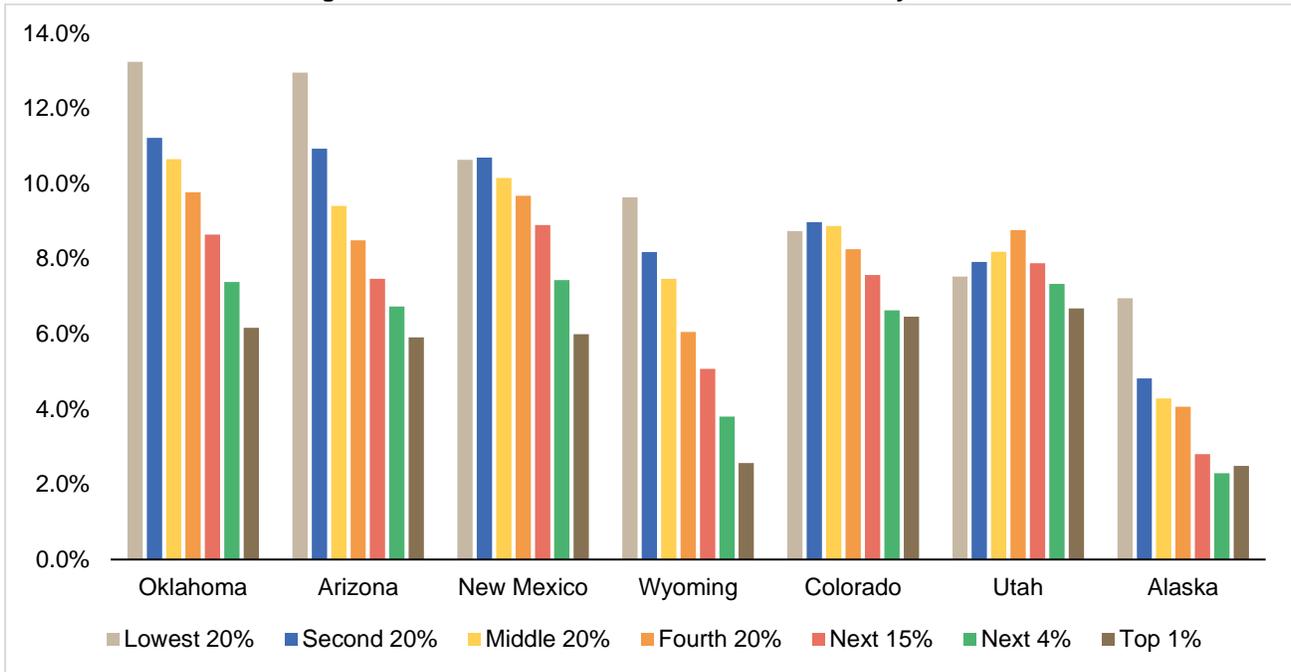
Source: U.S. Census Bureau, 2017 Annual Survey of State Government Finances

When state and local tax collections are combined, New Mexico's ranking improves but remains higher than most states on a percentage of personal income basis.

Estimates of overall tax burden do not capture how that burden is distributed among taxpayers at differing levels of income (an important tax equity consideration). The Institute of Taxation and Economic Policy (ITEP) issues a distributional analysis of state tax structures and tax burden every two years. The following details that analysis for the benchmark states from the most recent (2018) study.

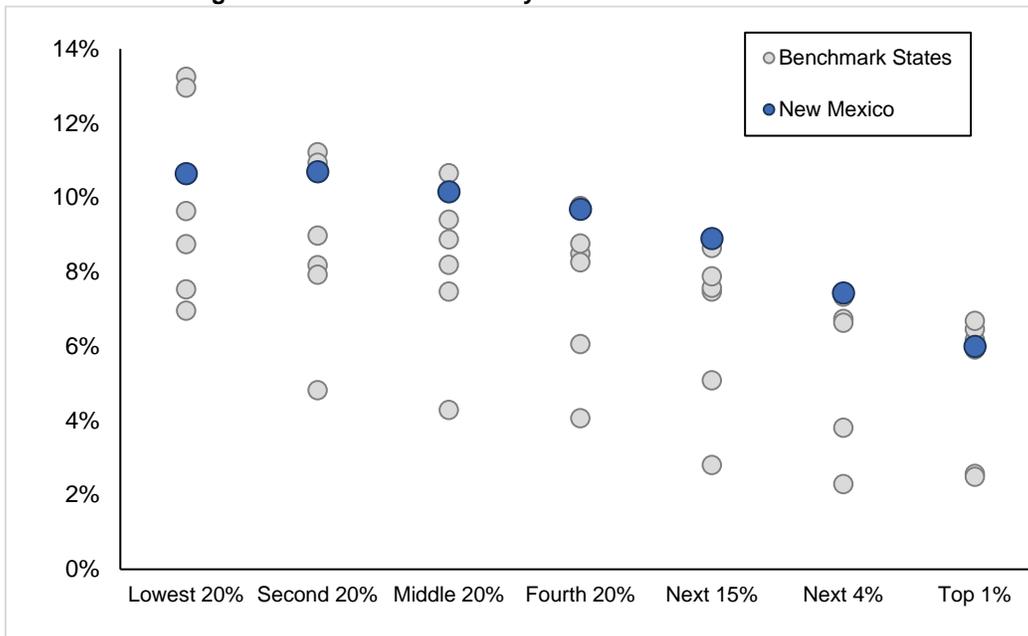
¹¹⁹ PFM Group Consulting, "Study of the Hawaii Tax System," November 14, 2017, p. 50-53, accessed electronically at https://tax.hawaii.gov/stats/a9_2trc_2017/

Figure 37: State and Local Taxes as a Share of Family Income



Source: *Who Pays? 6th Edition*. Institute on Taxation and Economic Policy, 2018

Figure 38: Distributional Analysis of State and Local Taxes

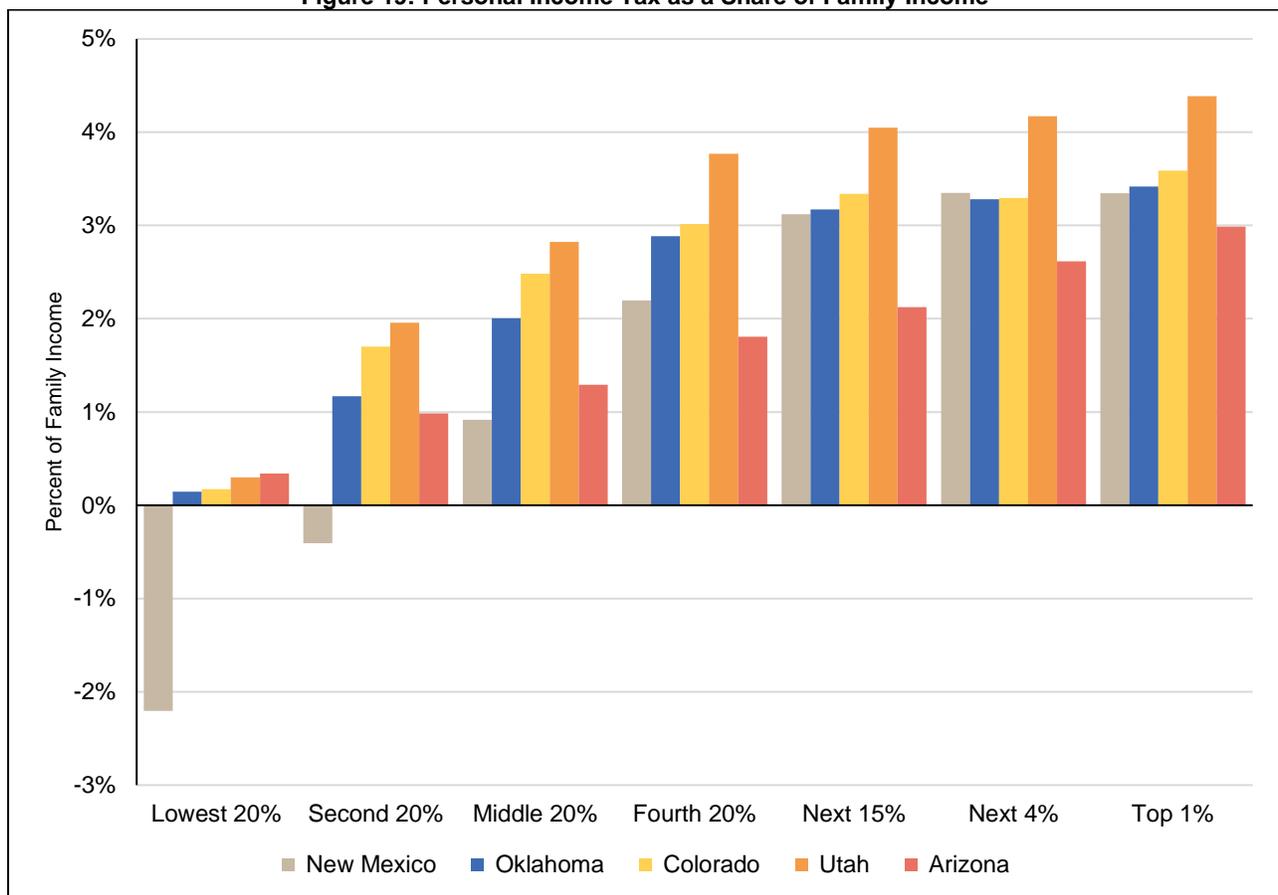


It is notable that in all the benchmarked states, the lowest 40% of taxpayers pay a larger share of their family income in taxes than do the top 20%. Among the benchmarked states, Utah is the only state with a relatively even distribution of state and local taxes as a share of family income. New Mexico has a regressive system, with the share of family income paid as state and local taxes being higher for the lowest 40% than any other income cohort. It is notable that other benchmark states are even worse: the bottom 20% of taxpayers in Oklahoma, Arizona, Wyoming and Alaska all

contribute more than twice as much of their share of income in the form of state and local taxes than the top 1%. In fact, in Wyoming, the share of income paid by the bottom 20% is over three times the share paid by the top 1%.

The New Mexico PIT is progressive, with lower income cohorts receiving refunds and the effective tax rate increasing as income increases. This is primarily because of the long-standing Low Income Comprehensive Tax Rebate¹²⁰ as well as the more recent Working Families Tax Credit (WFTC) and the Child and Dependent Care Tax Credit (CDCTC). The WFTC is a refundable credit equal to 17% of the federal Earned Income Tax Credit (EITC). This credit was increased from 10% of the federal EITC to 17% in 2019. The CDCTC is also refundable, based on an existing federal credit, and equal to 40% of qualifying expenses as defined in the federal Child and Dependent Care Tax Credit, not to exceed \$480 per child or a total of \$1,200 per family. The following figure details PIT as a share of family income for seven cohorts among the benchmark states. In the lower income cohorts (the lowest and second lowest quintiles), New Mexico's PIT burden is the lowest, due to these tax credits that refund more dollars than taxes owed.

Figure 19: Personal Income Tax as a Share of Family Income



Source: *Who Pays? 6th Edition*. Institute on Taxation and Economic Policy. 2018

¹²⁰ According to the New Mexico Taxation and Revenue Department, "The state's low-income comprehensive tax rebate is for resident filers with modified gross incomes of \$22,000 or less (for tax year 2000 and later) who also meet other qualifications. "Modified gross income" is a calculation unique to New Mexico. It means -- for the entire household -- all income and all compensation from other sources regardless of whether the income is taxable by the U.S. Government or the state of New Mexico." Accessed electronically at <http://www.tax.newmexico.gov/frequently-asked-questions/>

The ITEP study also examines how the tax structure varies among income cohorts by tax type. While the New Mexico PIT is progressive, other taxes, such as the GRT and property taxes, are more regressive. Given the smaller overall impact of the PIT on New Mexico revenues (compared to the GRT), while the state's PIT addresses issues of equity and burden, the other features of the State's structure are quite regressive, making the overall tax structure regressive.

Table 13: New Mexico State and Local Taxes as a Share of Family Income by Tax Type

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than \$17,700	\$17,700 to \$32,100	\$32,100 to \$49,500	\$49,500 to \$86,000	\$86,000 to \$165,300	\$165,300 to \$376,500	Over \$376,500
Average Income	\$11,500	\$25,100	\$39,400	\$65,400	\$116,400	\$229,700	\$845,400
Sales & Excise Taxes ¹²¹	9.6%	8.5%	6.9%	5.3%	4.0%	2.4%	1.4%
Property Taxes	3.2%	2.6%	2.3%	2.1%	1.8%	1.7%	1.2%
Income Taxes	-2.2%	-4.0%	9.0%	2.2%	3.2%	3.5%	3.5%
Total	10.6%	10.7%	10.2%	9.7%	8.9%	7.4%	6.0%

Source: *Who Pays? 6th Edition. Institute on Taxation and Economic Policy. 2018*

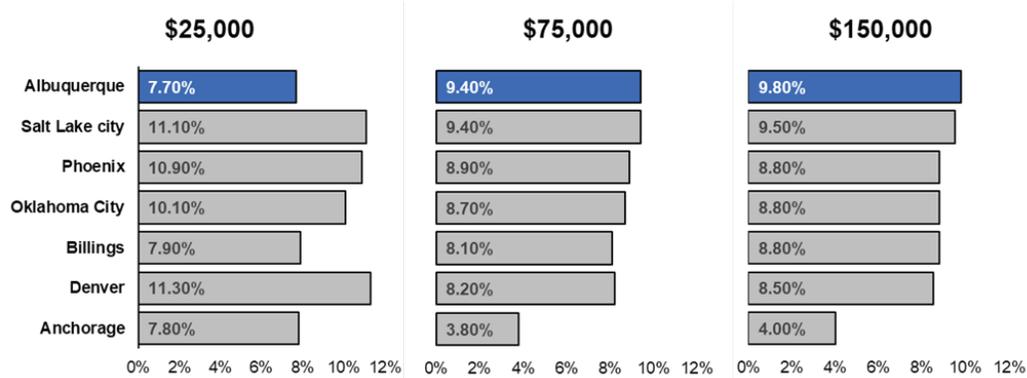
As previously discussed, it is worth examining tax burden inclusive of local taxes. Part of the District of Columbia tax burden analysis compares the tax burden in the District of Columbia to those of the largest cities in each of the 50 states. The study calculates the taxes paid by a family of three at differing income levels (\$25,000; \$50,000; \$75,000; \$100,000; and \$150,000). It only calculates tax burden for families, not businesses, and it uses four major tax groups for its comparison: the personal income tax; the real property tax on residential property; the general sales and use tax/gross receipts and compensating tax; and automobile taxes, including the gasoline tax, registration fees, excise tax, and any applicable personal property taxes.

The most recent DC study, which looks at taxes paid in 2018, was released in March 2020. As it relates to New Mexico state and local taxes, the DC study calculates the tax burden for Albuquerque. For 2018, Albuquerque's population (560,218) represented 26.8% of the state's population (2,093,000). It is notable that Albuquerque makes up the second-largest share of any state's total population within this comparison (New York City makes up 43% of the population for the State of New York). The Albuquerque combined state and local gross receipts tax rate is 7.8750%, which is about halfway between the low (5.5000%) and high (9.2500%) of local gross receipt tax rates within the State of New Mexico. Of course, real property taxes will also vary across the state.¹²² The following reflects the tax burden analysis for the largest cities in the benchmark states.

¹²¹ The ITEP report uses the labels sales and excise taxes. In New Mexico, the gross receipts tax is the equivalent of the sales tax.

¹²² The DC methodology is described in detail in each study and is replicable. PFM has used this methodology for benchmarking and comparison purposes for numerous local governments across the U.S.

Figure 39: State and Local Tax Burden for a Family of 3 by Household income¹²³



Source: *Tax Rates and Tax Burdens in the District of Columbia*, Government of the District of Columbia, 2018

The DC study notes factors that should be taken into consideration when analyzing and comparing tax burdens across localities. These include:

- The DC study measures only household tax burden. Business tax burdens also differ substantially from one city to another. Many cities, because of a large manufacturing base or the presence of a dominant industry, can shift a large portion of the tax burden away from individuals and onto businesses. Cities in natural resource states, for example, may shift a substantial share of the tax burden to industry, thus exporting a portion of their local government tax burden to businesses and consumers in other states. Similarly, convention and tourist activity in cities like Chicago, Washington, DC, New York City, and Las Vegas can help reduce local tax burdens by increasing the share of sales tax, gasoline tax, and parking tax revenues paid by non-residents.
- Service demands in each of the 51 cities will vary. Cold weather services, such as snow removal, may increase costs. Residents of some cities may desire, or be accustomed to, more government services than residents of other cities.
- The costs of providing services may differ substantially from one city to another due to variation in wage levels, work force efficiency, and overhead costs.
- The tax base of each city is different. Cities that have a relatively large percentage of employed residents will typically have a broader tax base than cities with low rates of workforce participation and/or high rates of unemployment. A city with a broad tax base can levy taxes at lower rates than can those with low levels of employment or high levels of exempt property.
- The proportion of publicly-funded versus privatized services may differ from one city to another. Some cities may provide services such as trash collection and public hospitals, while in other cities the private sector performs these services for a fee. As a result, a city in which the private sector performs these functions may have a lower tax burden than one in which these functions are performed by the city. In these instances, the fees charged by the private sector represent payments by individuals for public services that are not reflected in tax burdens.

¹²³ Tax burden is based on income, sales, property, and auto taxes for a family of three at each household income level. Data is sorted from greatest to least by the tax burden for households earning \$150,000.

- Certain taxes that are not discussed in the DC study may affect state and local tax burdens, such as excise taxes on motor fuel, liquor and cigarettes, and taxes on public utility bills.¹²⁴

Commentary

Aspects of New Mexico's tax structure such as the state's low income personal income tax credits are progressive. Other aspects, such as exemption of some groceries from the GRT, seek to reduce overall regressivity of certain taxes. On net, however, the New Mexico's tax structure is more regressive than progressive. The disproportionate burden on the state's lower income households largely stems from the GRT. The GRT has a very broad base and, to the extent it is passed along to consumers, will hit lower income households harder than those with higher incomes.

Including local taxes in the calculation of tax burden may improve New Mexico's overall ranking, primarily because a relatively large share of K-12 education is funded at the state level, and, as a result, local property taxes consume a much smaller share of income than they do in most other states. One of the offsets to higher property taxes, the ability of taxpayers to deduct them from federal taxable income, was limited to \$10,000 per year for all combined state and local taxes in the Tax Cuts and Jobs Act of 2017.¹²⁵ Capping the federal deduction for state and local taxes paid improves New Mexico's standing relative to states with higher property taxes.

Tax Burden Key Issues

The following are key issues for New Mexico's tax and revenue structure related to tax burden:

- Tax burden is generally described in the aggregate or for taxpayers based on income or other characteristics, and this produces differing readings of the New Mexico tax burden;
- Tax structures like New Mexico's that are weighted toward consumption taxes, increase the percentage of income that lower income households must devote to taxes (negative for vertical equity);
- New Mexico offsets some of the GRT regressivity through refundable PIT credits and generally low property taxes (positive for vertical equity);
- Exporting tax revenue (as is the case with taxes on tourism and a portion of extraction taxes) can reduce the resident tax burden (positive for adequacy and equity).

Tax Base Erosion

As previously noted, a key tax principle is to apply the lowest possible tax rate on the broadest possible tax base. Over time, the two major sources of state tax revenue, the PIT and the sales/GRT tax, have experienced significant erosion of their tax base. As a result (particularly related to the sales/GRT tax), most states have resorted to increases in the tax rate.¹²⁶ As a result,

¹²⁴ Government of the District of Columbia, "Tax Rates and Tax Burdens in the District of Columbia – A Nationwide Comparison 2018, March 2020, accessed electronically at <https://cfo.dc.gov/sites/default/files/dc/sites/ocfo/publication/attachments/2018%20Nationwide%20Tax%20Burden%20Study%20033120.pdf>

¹²⁵ H.R. 1, 2017, Section 11042(a)(6)(b). Accessed electronically at <https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf>

¹²⁶ David Wessel and Vivian Lee, "The history and future of the retail sales tax," Brookings Institute, May 16, 2018, accessed electronically at <https://www.brookings.edu/blog/up-front/2018/07/16/the-history-and-future-of-the-retail-sales-tax/>

the preferred approach has been stood on its head: most states are now resorting to ‘the highest politically possible tax rate on a gradually shrinking tax base.’

There are a variety of reasons for the shrinking base. Some are driven by demographic and economic changes. For the sales tax, changes in consumption (from tangible goods to digital goods and services) have had a big impact on the tax base for many states. Likewise, the aging U.S. population has reduced aggregate consumption.

“While other states across the country explore the possibility of expanding the reach of their sales taxes . . . New Mexico’s GRT base has eroded over time.”

A lot of the sales tax/GRT and PIT base erosion is legislated. For New Mexico, the GRT base has been eroded on numerous occasions. The largest of these, removing food consumption and some medical services from the tax base, was done in 2004. Other exemptions have been done in the form of business incentives. The result was noted in an LFC hearing brief from 2018: “While other states across the country explore the possibility of expanding the reach of their sales taxes, often to begin including services, New Mexico’s GRT base has eroded over time.”¹²⁷

Of course, there are logical arguments for these legislated tax exemptions and credits. In some instances, there are tax equity arguments to exclude some types of consumption or income from tax. In other cases, exemptions or credits are expected to increase economic activity or development. In these cases, an argument is often made that the exemptions or credits will spur additional or maintain current economic activity with associated gains in tax revenue. Despite the logic of the arguments or claims, many studies have concluded that the base erosion outweighs the economic activity associated with the credits or exemptions.¹²⁸

21st Century Economy’s Impact on Taxation

The U.S. economy has evolved throughout history, and this has led to modifications in state tax structures. The 19th century agrarian economy focused taxation on the land that generated most commerce and income; when the Great Depression led to plummeting land values, states shifted to taxes on tangible goods and services. As the U.S. federal government introduced personal and corporate income taxes, the states did so as well. As the economy shifted toward consumption of services (including digital services) and away from tangible goods, states began adjusting their sales tax structures to align with these growth areas. At the same time, excise taxes have been imposed on new products and services, including, in recent years, e-cigarettes, legalized marijuana and sports betting.

¹²⁷ Jon Clark and Dawn Iglesias, “Food Tax Deduction,” LFC Hearing Brief, May 2018, accessed electronically at https://www.nmlegis.gov/Handouts/ALFC%20052118%20Item%2010%20LFC%20May%202018%20Hearing%20Brief_Food%20Tax%20Deduction_REVISED.pdf

¹²⁸ Alan Greenblat, “Tax Incentives: The Losing Gamble States and Cities Keep Making,” *Governing*, February 26, 2020, accessed electronically at <https://www.governing.com/finance/Tax-Incentives-The-Losing-Gamble-States-and-Cities-Keep-Making.html>

As the U.S. continues to evolve into an information-based economy, these trends will continue. The following are emerging areas related to products and services and taxes that are being applied by some state and local governments:

- **Medical and recreational marijuana.** Most states have legalized medical and/or recreational marijuana, including New Mexico for medical purposes. Prior to the November 2020 general election, 11 states had legalized recreational marijuana, and each of these applies excise taxes to the wholesale and/or retail (or both) prices. It is notable that an additional four states legalized recreational marijuana in the 2020 general election via voter initiative – Arizona, Montana, New Jersey and South Dakota. Another state, Mississippi, legalized marijuana for medical purposes.

Of the states that have settled on a structure, they rely on some combination of taxes on the manufacturers, the wholesale distribution and/or the retail sales of marijuana. There is broad variation, and determining the best approach depends on a variety of factors. The following identifies the basic tax structure for the states with a revenue history related to recreational marijuana:

- **Alaska** charges a cultivation tax rate of \$15 to \$50 per ounce depending on the portion of the plant being sold. They also impose a 5% sales tax on all sales in Anchorage.
- **California** imposes a 15% excise tax on distributors that is marked up by 80% to match the average market value. It also charges a cultivation tax that varies from \$1.37 to \$965 per ounce.
- **Colorado** imposes a 15% excise tax on distributors and a 15% sales tax on retailers.
- **Illinois** imposes a 7% excise tax on the value of the product at the wholesale level. At the retail level, the state imposes an excise tax of from 10% to 35% on retail sales based on the THC content. Additionally, the state applies its 6.25% general sales tax and allows localities to levy additional tax up to 3%.
- **Maine** imposes an excise tax that varies in price and unit depending on the parts of the plant being sold and a 10% sales tax rate.
- **Massachusetts** imposes a 10.75% excise tax and a 6.25% sales tax, as well as a local option for cities and towns to add an additional 3% tax.
- **Michigan** imposes a 10% excise tax and a 6% sales tax on retail purchases.
- **Nevada** imposes a 15% excise tax on cultivators that is marked up to match the average market value and a 10% excise tax on retailers.
- **Oregon** imposes a 17% excise tax on all retail sales.
- **Vermont** has not settled on a tax structure; one suggestion made to a legislative subcommittee was for a 15% to 25% excise tax on all retail sales.
- **Washington** imposes a 37% excise tax (by far the largest) on retail sales of marijuana, concentrates, usable marijuana and marijuana-infused products.

The amount of revenue raised from recreational marijuana varies considerably, although some states are just beginning their experience. The following provides data for FY 2018 and FY 2019 for states with revenue in those fiscal years:¹²⁹

Recreational Marijuana Tax Revenue (in millions)

State	FY 2018	FY 2019
Alaska	\$11.1	\$19.2
California	\$214.7	\$310.0
Colorado	\$235.1	\$251.8
Massachusetts	NA	\$22.0*
Nevada	\$69.7	\$99.2
Oregon	\$82.0	\$102.0
Washington	\$362.0	\$390.4

* 8 months

Source: Accounting Institute for Success

There are now 34 states that have legalized medical marijuana.¹³⁰ Their methods of taxation also vary. Some states consider it a prescription drug and therefore exempt it from tax. Others apply their general sales and use tax (or in the case of New Mexico, its GRT). Others apply a separate excise tax, sometimes in lieu of - and in other cases in addition to - its general sales or GRT. In New Mexico, the GRT application to medical marijuana was challenged by the marijuana dispenser Sacred Gardens, and in January 2020, the state court of appeals ruled in its favor that the New Mexico GRT exemption for prescription drugs did not allow it to be taxed. The State has appealed the decision to the New Mexico State Supreme Court. Should Sacred Gardens prevail, the state would have to refund about \$24 million in taxes paid and forgo additional revenue.¹³¹

The amount of revenue raised by medical marijuana taxes can be substantial: Colorado now collects more revenue from its combined taxes and fees on marijuana than it does from its taxes on tobacco products.¹³² Figure 35 shows the status of marijuana laws by state, prior to the November 2020 general elections – each of the states in yellow has now joined the states in dark blue where recreational marijuana sales are permitted:¹³³

¹²⁹ Kenneth W. Boyd, “Deep Dive: Recreational Marijuana Tax Revenue in the United States,” Accounting Institute for Success, accessed electronically at <https://www.ais-cpa.com/deep-dive-recreational-marijuana-tax-revenue-in-the-united-states/>

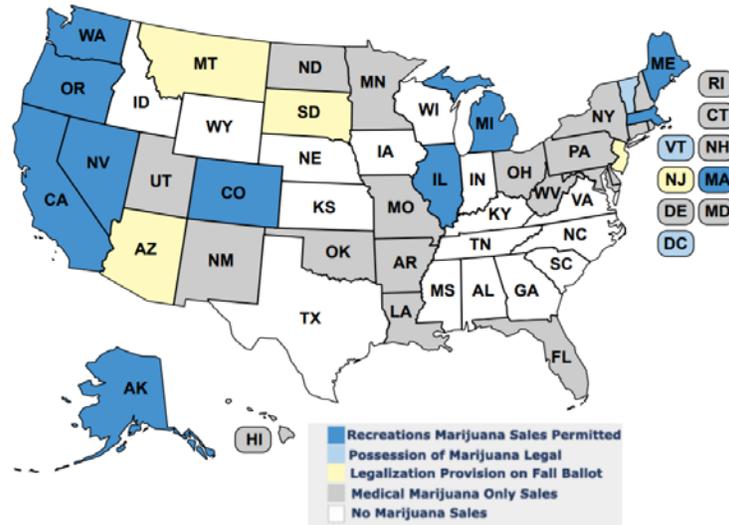
¹³⁰ “State Medical Marijuana Laws,” National Conference of State Legislatures, March 10, 2020, accessed electronically at <https://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx>

¹³¹ Andy Lyman “It could be awhile before the NM Supreme Court decides to rule on cannabis tax case, if at all,” NM Political Report, April 28, 2020, accessed electronically at <https://nmpoliticalreport.com/2020/04/28/it-could-be-awhile-before-the-nm-supreme-court-decides-to-rule-on-cannabis-tax-case-if-at-all/>

¹³² According to the Colorado Department of Revenue’s 2019 Annual Report, marijuana taxes and fees totaled \$274.1 million and taxes on cigarettes and tobacco products totaled \$189.5 million in FY2019. Annual report accessed electronically at https://www.colorado.gov/pacific/sites/default/files/2019_Annual_Report_1.pdf

¹³³ Federation of Tax Administrators, “Status of State Taxation/Sales of Marijuana,” August 26, 2020, accessed electronically at <https://taxadmin.memberclicks.net/assets/docs/Research/Rates/marijuana.pdf>

Figure 35: Status of Marijuana Laws by State



Source: Federation of Tax Administrators, August 2020

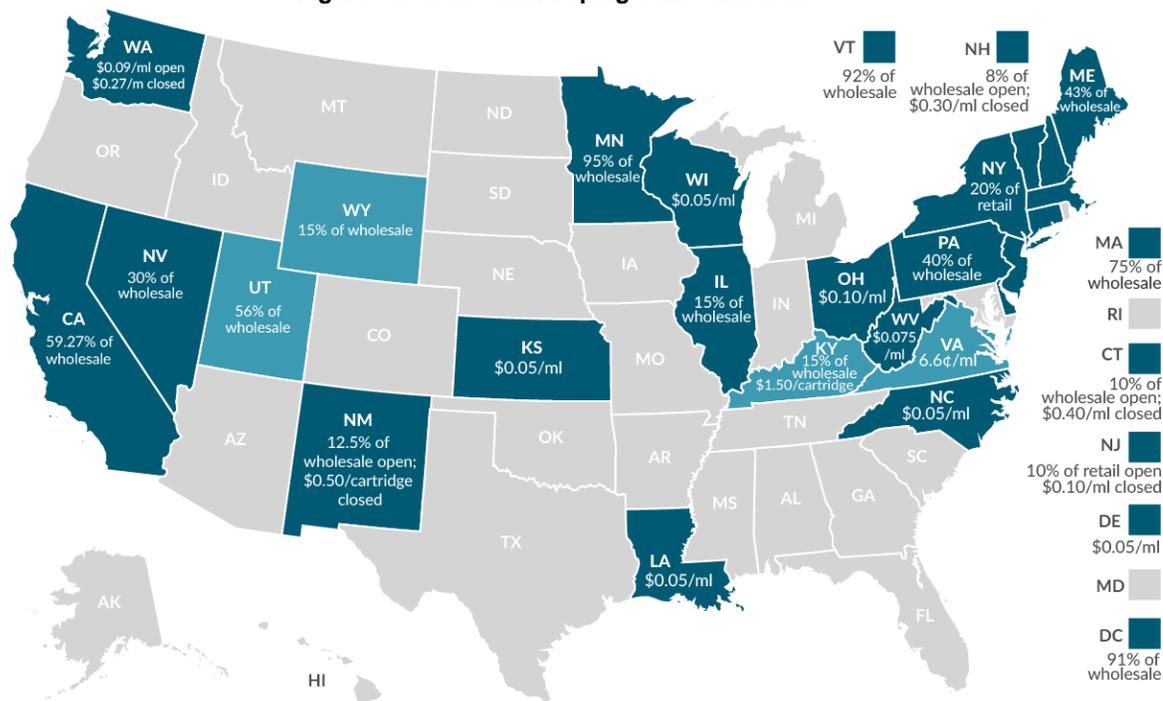
States that have legalized medical marijuana tend to collect less tax revenue than states with recreational marijuana. Most states tax medical marijuana (if at all) at lower rates than for recreational marijuana. That said, some states are collecting significant revenue from their medical marijuana taxes.¹³⁴

- **Vaping and e-cigarettes.** Vapor and e-cigarette products entered the marketplace in 2007, and state and local governments have imposed taxes as the products gained market share. As of June 2020, 25 states imposed vapor taxes, with widely varying tax rates. While New Mexico imposes a tax of 12.5% of the wholesale price, this is at the low end for states that impose a wholesale tax. The following details the states that impose a tax and the rates:¹³⁵

¹³⁴ For example, the State of Oklahoma Medical Marijuana Authority reported that the state received tax revenue of \$30.3 million from its 7% excise tax between January and June 2020, while state and local sales taxes during the same time period totaled about \$39.0 million. Those totals were a 20% and 25% increase in revenues from the prior calendar year. See "Medical marijuana tax revenue in July exceeds \$12 million," Tulsa World, August 10, 2020, accessed electronically at https://tulsaworld.com/news/local/government-and-politics/medical-marijuana-tax-revenue-in-july-exceeds-12-million/article_8fa7392f-bd7e-5c5a-b01e-de00efde8c3d.html

¹³⁵ "How High are Vapor Taxes in Your State?" Tax Foundation, June 3, 2020, accessed electronically at [https://taxfoundation.org/vaping-taxes-by-state-2020/#:~:text=Of%20those%20that%20tax%20wholesale,per%20milliliter%20rate%20\(%240.05\).](https://taxfoundation.org/vaping-taxes-by-state-2020/#:~:text=Of%20those%20that%20tax%20wholesale,per%20milliliter%20rate%20(%240.05).)

Figure 36: States with Vaping Taxes and Rates



Note: Several states levy general sales taxes in addition to the excise tax. Those are not included on the map. CA's rate will change to 56.93% on July 1. Vapor taxes in UT, VA, and WY take effect on July 1. KY's tax goes into effect on August 1.
 Open: An open tank allows the consumer to refill the liquid and allows more freedom in voltage and nicotine levels.
 Closed: Normally sold as pods or cartridges. Closed systems typically have higher nicotine levels to allow for consumption of the desired amount of nicotine in shorter sessions.
 Source: State Statutes & Bloomberg Tax

- Has a Statewide Vapor Excise Tax
- Planned Statewide Vapor Excise Tax
- No Vapor Excise Tax

- **Ride-sharing services.** As Uber, Lyft and other services gain market share, governments are taking note of its impact on existing revenue sources (particularly fees and taxes paid by taxi and other cab services and rental cars). As a result, many cities are now imposing similar taxes and fees. Likewise, many states are including ride-sharing as taxable services within their sales tax statutes.
- **Home-sharing services.** The growing popularity of Airbnb, HomeAway and other home-sharing services has also led governments to seek to replace revenue lost because of decreased hotel-motel and similar taxes. This has become particularly acute in light of the effects of the COVID-19 pandemic. According to one analysis, of the states with a lodging tax, 37 apply it to home-sharing services and 10 do not. Airbnb now collects local lodging tax on reservations within Taos County and the cities of Albuquerque, Ruidoso, Santa Fe, Taos and Taos Ski Valley, New Mexico.¹³⁶
- **On-line sports betting and other gaming.** After the U.S. Supreme Court decision in 2018 that overturned the federal ban on legalized sports betting in most states, several states have taken action to legalize various types of sports betting in their state, including some

¹³⁶ “Occupancy tax collection and remittance by Airbnb in New Mexico,” Airbnb, accessed electronically at <https://www.airbnb.com/help/article/2318/occupancy-tax-collection-and-remittance-by-airbnb-in-new-mexico>

where the state operates the system and others where private operators are licensed and the state taxes either net or gross receipts. To date, New Mexico has not approved legislation to legalize sports betting, but the New Mexico gaming compacts with tribal nations permit any or all forms of Class III Gaming, a category in the federal regulations that includes sports betting and pari-mutuel wagering. The State has entered into revenue sharing agreements with 14 New Mexico Tribes related to their casino operations. In FY 2020, the State received a total of \$80.0 million from these compacts, which is deposited into the State General Fund.¹³⁷

Commentary

For most of the cited examples, the primary method to tax these new types of activity has been via excise taxes. In some instances, states apply both their general sales and use tax or GRT as well as a separate excise tax, and there is no specific rationale for these instances (beyond a desire to raise revenue). An issue with excise taxes is that they are applied to a specific good or service, so that good or service must be defined for an excise tax to apply. As the economy changes and new goods or services are commercialized, states must continually revise their tax codes. An advantage of a broad-based consumption tax that covers goods and services is that it can more readily overcome this timing effect (although at a lower tax rate than many excise taxes).

21st Century Economy Key Issues

The following are key issues for New Mexico's tax and revenue structure related to the 21st Century economy:

- New Mexico has shown a willingness to modify its tax structure as necessary to tax 21st Century economic activity (positive for adequacy);
- New Mexico's GRT has a broader base that may be used to tax much of the 21st Century economic activity (positive for adequacy);
- There is additional opportunity to tax ongoing economic activity, particularly related to marijuana (which would be a positive for adequacy).

Taxes and Negative Externalities

There are legal activities that generate harmful external effects. In economics, a negative externality is defined as a cost associated with an activity that is borne by unrelated third parties and thus not reflected in the final price of a good or service.

Taxes can be applied to these goods or services to reduce the harmful economic activity or to provide revenue that can be used to ameliorate the harmful effects. These are often referred to as Pigouvian taxes, named after the English economist Arthur Pigou, whose book 'The Economics of Welfare' argued that prices could be used to deal with market imperfections. He noted that producers and retailers of alcohol did not have to pay for the police necessary to maintain social order, and he recommended an excise tax on the product. In this case, the proposed tax would both reduce some consumption (because of the additional cost) and provide revenue to deal with the social costs associated with its use.

¹³⁷ State of New Mexico Gaming Control Board, accessed electronically at <https://www.nmgcb.org/revenue-sharing.aspx>

It's not surprising that excise taxes on cigarettes, alcohol, marijuana or gambling are sometimes referred to as 'sin taxes.' Excise taxes on these items are often justified as ways to reduce overall consumption. In the case of cigarettes, there is evidence that elevated tax rates have reduced consumption, particularly among young smokers.¹³⁸

There are a variety of other activities and the taxes associated with them that are meant to reduce consumption of specific goods or services. Of late, major cities have applied congestion taxes to reduce motor vehicle traffic in downtown areas. Excise taxes on sugar-sweetened beverages have been imposed by several major cities including Philadelphia, San Francisco, Seattle, and Washington DC. Several studies suggest that these taxes reduce consumption of sugar sweetened beverages and may lead to substitution of more healthy beverages.¹³⁹ Sweetened beverage taxes are vigorously opposed by the beverage industry with some success. In Cook County, Illinois, one tax was enacted and quickly repealed amidst industry-driven opposition.¹⁴⁰ An argument against sugar taxes is that they are regressive, but sugar sweetened beverages are not necessities, so the hardship associated with these taxes is different than for more nutritious foods.

In recent years, concerns about climate change have led to consideration of methods to reduce carbon emissions. A market-based approach, known as 'cap and trade' has been instituted in other countries and in some U.S. states. In a cap-and-trade system, government sets an emissions cap and issues a quantity of emission allowances consistent with that cap. Those who produce greenhouse gas must obtain allowances for their emissions. Companies may buy and sell allowances, and this market establishes an emissions price. Companies that can reduce their emissions at a lower cost may sell any excess allowances to companies facing higher costs.¹⁴¹

New Mexico has experience with this type of effort. By Executive Order in 2005, Governor Bill Richardson established greenhouse gas emissions reduction goals for New Mexico and created a Climate Change Advisory Group to identify methods to achieve the goals. A 2006 Executive Order also detailed emissions reduction strategies to address climate change. In 2010, the New Mexico Environmental Improvement Board (EIB) adopted a rule to cap greenhouse gas emissions in the state and enable it to participate in a regional cap and trade program under the Western Climate Initiative.¹⁴² However, Governor Susana Martinez was opposed to the program, and a new EIB appointed by Governor Martinez repealed the program in 2011.¹⁴³

¹³⁸ An oft-quoted longitudinal study on cigarette smoking determined that every 10% increase in the price of cigarettes reduces consumption by about 4% among adults and about 7% among youth. John A Tauras, Patrick M. O'Malley and Lloyd D. Johnston, "Effects of Price and Access Laws on Teenage Smoking Initiation: A National Longitudinal Analysis," April 2001, accessed electronically at https://impaceen.uic.edu/generalarea_PDFs/AccessLaws.pdf

¹³⁹ Yujin Lee, Dariush Mozaffarian, Stephen Sy, Junxiu Liu, Parke Wilde, Matti Marklund, Shafika Abrahams-Gessel, Thomas Gaziano, Renata Micha, "Health Impact and Cost-Effectiveness of Volume, Tiered, and Absolute Sugar Content Sugar-Sweetened Beverage Tax Policies in the United States: a microsimulation study," *Circulation*, August 11, 2020, accessed electronically at <https://www.ahajournals.org/doi/10.1161/CIRCULATIONAHA.119.042956#:~:text=Health%20and%20economic%20benefits%20were,1.12%20million%20lifetime%20cardiovascular%20and>

¹⁴⁰ "Why Chicago's soda tax fizzled after two months — and what it means for the anti-soda movement," *Washington Post*, October 10, 2017, accessed electronically at <https://www.washingtonpost.com/news/wnk/wp/2017/10/10/why-chicagos-soda-tax-fizzled-after-two-months-and-what-it-means-for-the-anti-soda-movement/>

¹⁴¹ The embodiment of this concept in the United States is the Regional Greenhouse Gas Initiative (RGGI), which is a consortium of northeast U.S. States. The consortium is discussed in the recommendations chapter. For additional information see <https://rggi.org>.

¹⁴² "New Mexico Adopts a Regional Cap and Trade Program," *Vista, Natural Resources, Energy and Environmental Law Section, State Bar of New Mexico*, Winter 2011, accessed electronically at <https://www.nmbar.org/NmbarDocs/AboutUs/sections/NaturalResources/SONREELWinter11.pdf>

¹⁴³ "NM Regulators Repeal Carbon Cap and Trade Rules," *Associated Press*, February 7, 2011, accessed electronically at <https://insideclimatenews.org/breaking-news/20120207/new-mexico-repeals-cap-and-trade-rules>

Governor Lujan Grisham established the Interagency Climate Change Task Force (Task Force) by executive order in 2019. The Task Force is directed to lead evaluation of policies and regulations that will help achieve the state's renewable energy goals. One policy to be evaluated that is specifically referenced by the Governor's order is the adoption of a comprehensive market-based program that sets emission limits to greenhouse gas pollution across the state. In 2019, the Task Force issued its first report and, though it has not yet fully evaluated and reported on a market-based program, it suggested New Mexico may fall short of its goals without such an approach.

Tax policy has also been suggested as a way to deal with greenhouse gas emission. The thrust of the argument is that the use of carbon emitting processes (such as motor vehicle combustible engines or coal fired electric generating facilities) releases harmful carbon into the atmosphere that is not factored into the cost of these activities. If that is the case, a tax on carbon is one logical way to reduce carbon consumption – or provide resources to deal with its consequences. The State of Washington was the first to attempt a carbon tax, based on a voter initiative in 2016, which was defeated on a 59-41% vote.¹⁴⁴ Additional states have introduced carbon tax legislation, but none have been successful to date.¹⁴⁵

Commentary

New Mexico, like most states, has used 'sin taxes' to reduce consumption or provide revenue to compensate for negative externalities associated with activities like tobacco use, alcohol consumption or gambling. For most of the cited examples, states have applied excise taxes. In some instances, states apply both their general sales and use tax or GRT as well as a separate excise tax, and there is no specific rationale for these instances (beyond a desire to raise revenue). An issue with excise taxes is that they are applied to a specific good or service, so that good or service must be defined for an excise tax to apply. As the economy changes and new goods or services are commercialized, states must continually revise their tax codes. An advantage of a broad-based consumption tax that covers goods and services is the ability to more quickly deal with this timing effect (although at a lower tax rate than many excise taxes).

Taxes and Externalities Key Issues

The following are key issues for New Mexico's tax and revenue structure related to the 21st Century economy:

- New Mexico has enacted the most common forms of taxes that seek to reduce consumption or raise revenue to deal with negative externalities (positive for efficiency);
- As with most states, there has been little done (related to taxation) to deal with carbon and related environmental negative externalities (negative for efficiency).

¹⁴⁴ "The 2016 Washington state carbon tax referendum: what happened" Carbon Tax Center, accessed electronically at https://www.carbontax.org/states--new/#WA_state

¹⁴⁵ Carbon tax legislation has been proposed in Connecticut, HB 6635 (2019), Hawaii, HB 1579 (2019), Maryland HB 1235 (2019), Massachusetts H.2810, (2019), Minnesota SF 4086 and HF 4517 (2018), Montana HB193 (2018), New Hampshire HB 735 (2019), New Mexico SB 393 (2019), New York A3459 (2019), Rhode Island HB5869 2019), Texas HB4599, HB223 (2019), Utah HB 304 (2019), and Vermont H.463 (2019). Accessed electronically at [https://priceoncarbon.org/business-society/state-actions/#:~:text=Carbon%20Tax%20Attempts,\(2019\)%2C%20Massachusetts%20H.](https://priceoncarbon.org/business-society/state-actions/#:~:text=Carbon%20Tax%20Attempts,(2019)%2C%20Massachusetts%20H.)

The Relationship Between State and Local Taxes

As previously noted, there is significant interconnection between state and local taxes. The mix of revenue sources is somewhat different in New Mexico than in most states. The primary tax for local governments in the U.S. is the property tax; for New Mexico local governments, it is the GRT. On a per capita basis, New Mexico's local property tax revenue is among the lowest in the U.S. It is also notable that the state reimburses local governments for a significant amount of foregone revenue related to exempting retail food sales from the GRT and returns 1.225 percentage points of the state's share of the GRT to cities in the form of a municipal credit.¹⁴⁶ While there is a historic aversion to property taxes within the state, the question remains as to whether there should be a rebalancing state and local tax and expenditure policy that reduces the current reliance on the GRT.

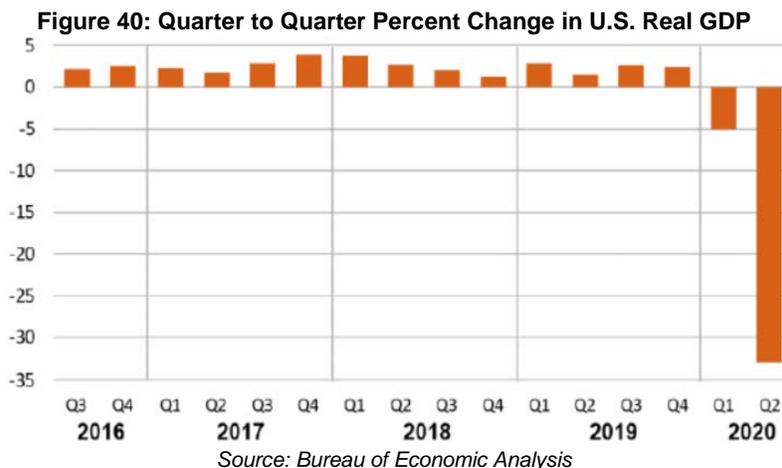
State and Local Taxes Key Issues

The following are key issues for New Mexico's tax and revenue structure related to the relationship between state and local taxes:

- New Mexico replaces a significant amount of local revenue with state revenue (negative for adequacy);
- New Mexico reduces the reliance on a stable form of tax (property tax) in favor of less stable sources (negative for stability).

State Responses to COVID-19 Recession

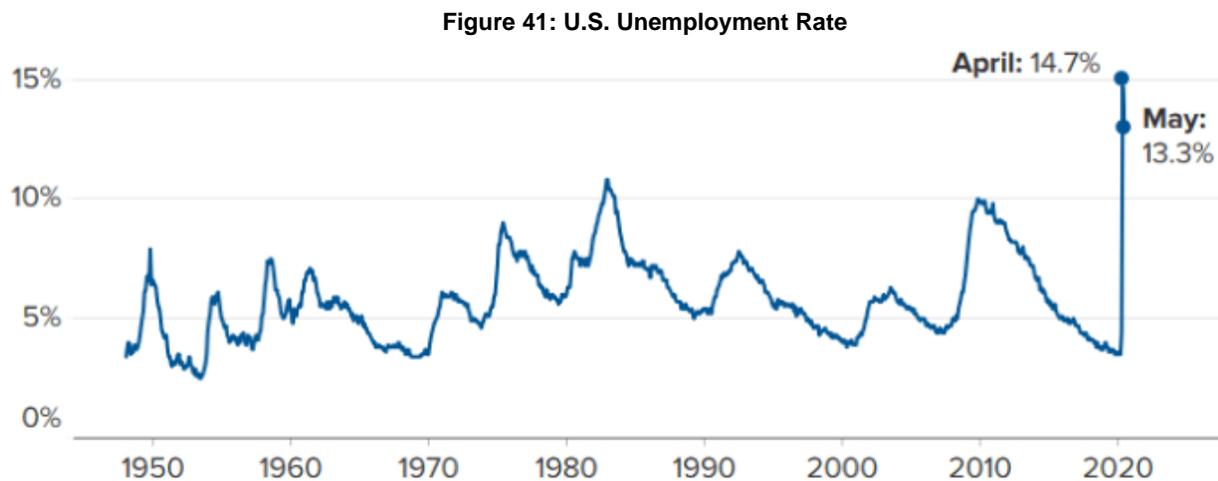
According to the National Bureau of Economic Research, the U.S. economy ended its longest expansion in history in February 2020. While there were already signs that the economic expansion was plateauing, the COVID-19 pandemic dramatically altered the national (and world) economic landscape and drove the economy into an extremely deep downturn. In fact, the 32.9% reduction in GDP in the second quarter of 2020 was the largest on record.¹⁴⁷



¹⁴⁶ [NM Stat § 7-1-6.4 \(2019\)](#)

¹⁴⁷ "Gross Domestic Product, Second Quarter 2020 (Advance Estimate) and Annual Update," Bureau of Economic Analysis, accessed electronically at <https://www.bea.gov/news/blog/2020-07-30/gross-domestic-product-second-quarter-2020-advance-estimate-and-annual-update>

The current recession has largely been driven by a steep decline in demand for services and loss of employment related to the COVID-19 pandemic. The loss of jobs and resulting unemployment has been profound. The following figure illustrates the rapid rise in the U.S. unemployment rate over a two-month period in 2020:



Source: Bureau of Economic Analysis

This service-based recession has caused a very sharp loss of employment and income and devastated restaurants, retail, service, entertainment, tourism and travel related-business and industries. It has also had the greatest impact on relatively small businesses with little capital base and lower paid workers that often lack health insurance coverage or other safety nets and personal savings.

State Revenue Impacts

The Great Recession had a notable negative impact on state revenues, but the 10-year growth period from 2010 to the end of 2019 had been a strong one for states. By the end of 2019, all but six states had fully recovered (on an inflation-adjusted basis) from the revenue losses during the Great Recession.¹⁴⁸

Early indications were that the initial tax revenue declines in this COVID-19 recession were sharper than during the Great Recession. State revenue collection data showed very sharp revenue declines in the months after pandemic-induced economic shutdowns in many regions of the country. The Urban Institute’s report on state revenue collections indicated year-over-year reductions of 49% in March, 21% in May and 13% in June 2020.¹⁴⁹

¹⁴⁸ Barb Rosewicz, Justin Theal and Alexandre Fall, “COVID-19 Abruptly Ends Decade of State Tax Revenue Growth,” Pew Charitable Trusts State Fiscal Health Policy, September 4, 2020, accessed electronically at [https://www.pewtrusts.org/en/research-and-analysis/articles/2020/09/04/covid-19-abruptly-ends-decade-of-state-tax-revenue-growth?utm_campaign=2020-09-09+Run-down+1+\(CTR\)&utm_medium=email&utm_source=Pew](https://www.pewtrusts.org/en/research-and-analysis/articles/2020/09/04/covid-19-abruptly-ends-decade-of-state-tax-revenue-growth?utm_campaign=2020-09-09+Run-down+1+(CTR)&utm_medium=email&utm_source=Pew)

¹⁴⁹ Ibid.

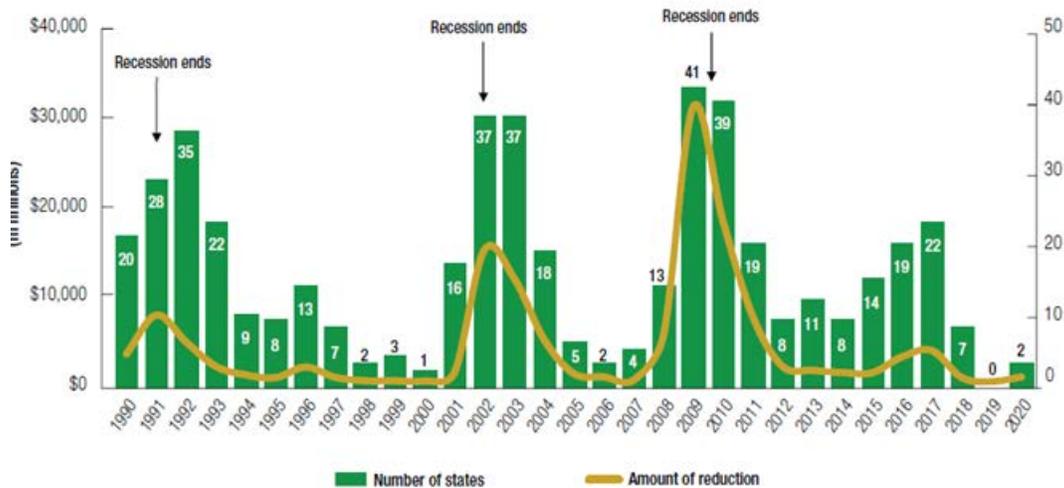
It is notable that the State of New Mexico did not experience as stark a reduction in its GRT revenue as many sales tax dependent states. In fact, GRT distributions in May 2020 were just 1.2% less than May 2019, which was much better performance than in many states.

While some had predicted that this might be a short-lived recession, particularly if stay-at-home orders were lifted in a period of weeks or a few months, this no longer appears to be the case. One commentary on state revenue collections, by the Executive Director of NASBO, suggested that “states are expected to see the impact of COVID-19 on their revenues for years to come.” This commentary suggested that there would be more severe declines in FY2021 than in 2020.¹⁵⁰

Federal and State Responses

While the federal government has provided significant support to workers and the state and local government sectors, the revenue losses have been profound, and many states are dealing with record budget shortfalls for the current fiscal year. While states typically draw down reserves during the early stages of a recession (and have done so already this year), spending reductions are typically the next budget balancing step. Some states have already begun that process, and others are likely to do so when their legislature returns to session after the fall elections in late 2020 or early 2021. The following chart reflects the number of states that made cuts to budgets in prior years (and the dollar amount), which tends to rise during or immediately after a recession:

Figure 44: Budget Cuts Made after the Budget Passed, FY1990 to FY2020

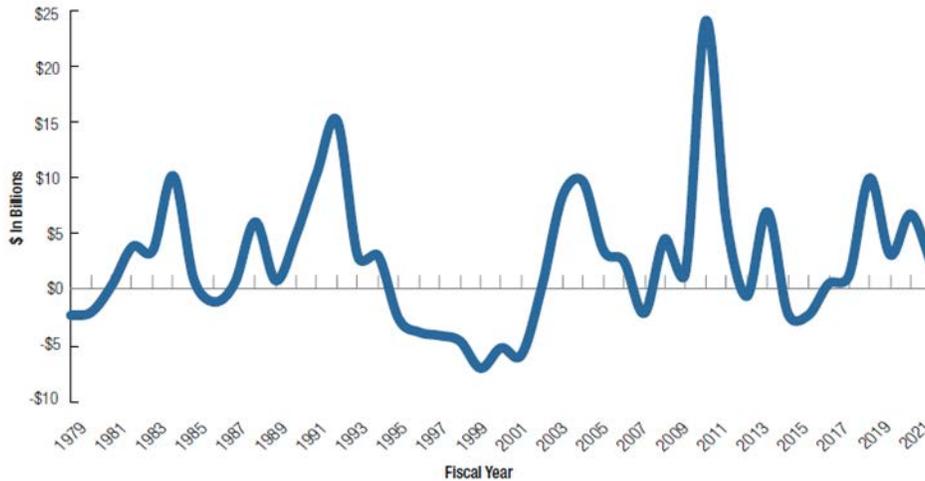


Source: National Association of State Budget Officers

Many states are discussing (and a few have enacted) tax increases. This is generally the third budget balancing approach taken by states during a recession, after drawing down rainy day funds and making spending reductions. The following chart illustrates the amount of new revenue raised by fiscal year since FY1979.

¹⁵⁰ Shelby Kerns, “State Revenue Decline for First Time Since the Great Recession, With the Worst Still to Come,” National Association of State Budget Officers, September 8, 2020, accessed electronically at <https://community.nasbo.org/budgetblogs/blogs/shelby-kerns1/2020/09/08/state-revenues-decline-for-first-time-since-the-gr>

**Figure 45: Enacted State Revenue Changes
FY1979 to FY2020 and Recommended FY2021**



Source: National Association of State Budget Officers

It is notable that the largest revenue increases have been after prior recessions, particularly in Fiscal Years 1992 (recession ended in March 1991), 2003 (recession ended in November 2001) and 2010 (recession ended in June 2009).

If past recessions are any indication, the first taxes to increase will be excise taxes, which have increasingly been utilized as budget balancing tools largely divorced from the efficiency tax principle. In recent months, Georgia legislators have considered their first cigarette tax increase in decades, and Colorado legislators are considering increases on nicotine and vaping products, with projections that the increases could raise \$80 million in new revenue a year.¹⁵¹

If excise tax increases are deemed insufficient, states generally look to larger sources. Earlier this year, California temporarily ended certain tax breaks for medium and large businesses, worth approximately \$4.4 billion as part of the budget for FY2021. New Jersey has enacted a ‘millionaire’s tax’ as part of its budget for FY2021.¹⁵² Currently, both New York and California are considering significant increases to PIT rates for high-income taxpayers.¹⁵³ These can be justified both for the significant amount of revenue they are expected to generate and because high income earners have generally experienced less hardship than lower income earners in the current recession.¹⁵⁴

¹⁵¹ “Governments eye new taxes on cigarettes, homes and tech giants to pay for big budget shortfalls related to the coronavirus,” Washington Post, June 26, 2020, accessed electronically at <https://www.washingtonpost.com/business/2020/06/26/cities-states-taxes-coronavirus/>

¹⁵² “Deal Reached in New Jersey for ‘Millionaire Tax’ to Address Fiscal Crisis,” New York Times, September 17, 2020, accessed electronically at <https://www.nytimes.com/2020/09/17/nyregion/nj-millionaires-tax.html>

¹⁵³ “Tax Hikes in a Pandemic: Some States, Cities Say Yes,” Stateline, July 17, 2020, accessed electronically at <https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2020/07/17/tax-hikes-in-a-pandemic-some-states-cities-say-yes>

¹⁵⁴ An example comes from New York State, where a bill to increase tax rates on millionaire earners is attracting bipartisan support. A Republican co-sponsor, Phil Boyle of Long Island, has been quoted as saying that “In normal times I never would have supported higher taxes. These are not normal times. Asking the ultra-wealthy to pay a bit more during this economic crisis, rather than the constituents of mine who are out of work and suffering financially, is the right thing to do.” Ibid.

State Responses to the COVID-19 Recession Key Issues

- State tax increases generally lag the beginning of economic recessions;
- Often the first taxes to be increased are excise taxes (positive for adequacy; negative for vertical equity);
- When economic downturns persist, states begin to consider more extensive tax increases (positive for adequacy);
- The current recession is unusual in that lower wage earners have shouldered the bulk of the employment and earnings decline (negative for vertical equity), and tax increases focused on higher earners are less likely to negatively impact on the economic recovery (positive for vertical equity and adequacy).

7. Findings and Recommendations

Project Team Findings

The project team has approached the subject matter from a variety of perspectives, using national, peer state and New Mexico-specific data as well as information from past studies and reports augmented by interviews with policymakers and subject matter experts. Throughout, the project team has sought to maintain a neutral and non-ideological focus on issues related to tax and revenue policy and its impact on the New Mexico economy and its residents.

There is no ‘perfect tax’ – all revenue raising measures will have some negative effects on disposable income and economic activity. Of course, these revenue raising measures are also necessary to raise revenue to provide essential services related to education, health care, public safety and other key functions. Recognizing this fundamental tension between the need to raise revenue and taxation’s negative impacts, the project team has sought to identify key findings that may assist with making recommendations. The following lays the groundwork for the recommendations that follow.

Tax and Revenue Sources

Most states rely on a variety of taxes and non-tax revenue sources. This helps to balance out the tax burden among types and classes of taxpayers, and it also provides some buffer against cyclicity and/or volatility of the economy as a whole or specific industries subject to tax. The key findings related to New Mexico tax and non-tax revenue sources:

- **Sales tax and personal income tax are the largest tax revenue sources for all states, and these are similar to New Mexico’s GRT and PIT.** New Mexico’s largest tax revenue source, the GRT on qualified business receipts, has some important differences from a sales tax, both in its broader base and its application to some business inputs that create negative economic effects because of pyramiding. There are clear policy trade-offs, and determining whether characteristics are strengths or weaknesses may depend on which tax principle – adequacy or equity - is deemed paramount.
- **New Mexico’s GRT raises a larger relative share of revenue than most state sales taxes.** The GRT is a regressive tax and is impacted by the business cycle. During a recession, sales tax collections often weaken earlier than personal income tax collections. On the other hand, during the current recession (where individuals are spending more time at home) retail sales tax and GRT collections (particularly online sales) have held up remarkably well.
- **New Mexico’s PIT raises a smaller share of revenue than most state personal income taxes.** The PIT is New Mexico’s most progressive tax. It is also notable that during the current recession, the sectors most impacted are not high-income sectors, so personal income taxes may not be impacted as much as in prior recessions.
- **New Mexico’s extraction taxes raise a much larger share of revenue than most states; and this share is comparable to that of other energy producing states.** On a relative basis, reliance on extraction taxes may offset the share of PIT revenue the state does not

collect in comparison to all states. The prominent role of extractive taxes in New Mexico's revenue mix is indicative of the overall magnitude of the state energy economy.

- **New Mexico applies excise taxes on the 'traditional' major items subject to these taxes but lags somewhat in adopting newer excise tax revenue sources.** New Mexico, like most states, levies the traditional 'big three' excise taxes on alcohol, motor fuel and tobacco products. The state also taxes a variety of other products typically subject to excise taxes, including hotel and motel accommodations, insurance premiums, gaming and wireless phone service. New Mexico lags some other states in taxing emerging products and services, particularly recreational marijuana (which is not yet legal in New Mexico) and sports betting.
- **For the state-local tax relationship, New Mexico collects far less property taxes as a share of revenues than the U.S.** Property taxes are collected by local governments in all 50 states. In nearly every state, property taxes are the largest source of local government revenue. In New Mexico, municipal gross receipts taxes are the primary revenue source (although counties continue to primarily rely on property taxes). A survey of property taxes determined that New Mexico's per capita property tax collections (\$792) ranked 47th of the 50 states, with only Arkansas, Oklahoma and Alabama having lower per capita collections.

Tax Collections and Burden

While the amount a state collects in taxes is readily understood, tax burden is more complicated. Tax burden is a function of who ultimately pays a tax and measures the share of income devoted to paying a tax or taxes by taxpayers at different income levels. While for some taxes it is obvious who pays it (such as a personal income tax), for other taxes, it may be more difficult to ascertain. For example, businesses are responsible for paying the GRT, but it is not evident how much of that tax is ultimately passed through to consumers – in some instances, the extent of the pass through will depend on the elasticity of demand for a particular good or service. Where demand is elastic, the business may not be able to pass all the tax along to customers. Likewise, there is significant debate as to who bears the burden of corporate income taxes, with economists split on the relative share that is borne by consumers, corporate shareholders and employees.

Many studies seek to estimate tax burden, and their utility is subject to debate. For example, a common measure, state tax collections per capita, may overstate the tax burden for a state that collects a large share of its tax revenue from non-residents. Likewise, measures that only consider state tax collections may overstate the tax burden where state taxes pay for a greater share of what in other states are local government costs. In this case, the higher state taxes may be offset by lower local taxes.

With these caveats, the following are key findings for New Mexico state (and where appropriate, state and local) tax collections and tax burden.

- **When looking at state taxes alone, New Mexico total state tax collections are well above the national average, both as a percent of personal income and per capita.** According to FTA data, New Mexico state tax collections ranked 14th highest on a per capita

basis and 6th highest as a share of personal income among the 50 states in 2019. Some suggest that lower income states will have a higher percentage of taxes as a share of personal income (because there isn't a linear relationship between key state services and income); likewise, some argue that less populated states will have a higher percentage of tax revenue per capita (because many costs are fixed rather than variable and are shouldered by a smaller population). However, there are not clear patterns in the rankings. High population states (such as California, New York and New Jersey) have among the highest amounts of tax revenue per capita, and relatively poor states (such as South Dakota and Louisiana) have low tax collections as a share of personal income.

- **When looking at state and local tax collections, New Mexico is above the national average (but not as much as for state taxes alone).** According to the Tax Policy Center, for 2017 (the last year of available comparable data), New Mexico's state and local General Fund tax revenue as a share of personal income was 10.2%, which ranked 14th among the states. For the U.S., the average was 9.8% of personal income. Prior to the Great Recession, in 2006, New Mexico ranked 6th, with state and local taxes consuming 11.6% of personal income, which suggests that the overall burden under this measure has decreased in the past 14 years. Of course, these figures do not necessarily reflect individual or household tax burdens, as a significant share of some state taxes (such as severance taxes) are likely borne by out-of-state taxpayers.
- **When examining tax burden based on income characteristics, many New Mexico taxpayers fare better than by the personal income or per capita metrics.** For example, the District of Columbia's tax burden analysis finds that a hypothetical family of three living in the City of Albuquerque would pay among the lowest amount of taxes of the 51 surveyed cities at the \$25,000 income level and about average at all other income levels (\$50,000 to \$150,000); also, the percent of income devoted to the four major taxes analyzed (income, property, sales and auto) would generally rise from the lowest to the highest income categories. This would be considered a progressive tax structure; in this case, based on these four taxes, the New Mexico structure is progressive (keeping in mind that one of the taxes, property tax, is primarily a local revenue source).

Another income-based study, by ITEP, is more critical of the overall New Mexico tax structure. According to their bi-annual state-by-state comparison, New Mexico has the 19th most regressive tax structure among the 50 states. In general, ITEP gives higher scores to states with a progressive personal income tax and lower scores to states that primarily rely on sales and excise taxes.¹⁵⁵ ITEP identifies both positive (what they call progressive) and negative (what they term regressive) features of the New Mexico tax structure. The positive features include the graduated PIT structure; refundable low income, earned income and dependent-care tax credits; and the exclusion of groceries from the GRT. The negative features include the exclusion of some capital gains from income, the lack of a property tax circuit breaker, and no tax on estates or inheritances.

¹⁵⁵ The latest version of the ITEP analysis ranks the best state tax structures as those of California, Vermont, Delaware, Minnesota and New Jersey. Each of these has a progressive personal income tax, and Delaware has no state sales tax. It ranks the worst state tax structures as those of Washington, Texas, Florida, South Dakota and Nevada – all states without a state personal income tax. "Who Pays," Institute of Taxation and Economic Policy, 2018, accessed electronically at <https://itep.org/fairness-matters-a-chart-book-on-who-pays-state-and-local-taxes-2019/#11>

- **New Mexico’s business tax burden is generally considered about average.** The Tax Foundation does an annual study and rankings of the business tax climate in the 50 states. According to their 2020 version, New Mexico has the 22nd best business climate. According to the study, the state is business friendly on property taxes (1st of 50) and its unemployment insurance tax system (8th), and less business friendly on its sales tax/GRT (41st of 50). New Mexico’s ranking by the Tax Foundation has been relatively stable over the years – each year since 2014, it has ranked between 22nd and 25th among the states. The improved rankings of late may be influenced by business tax changes – according to the Council on State Taxation (COST), New Mexico was one of only three states to have a net reduction in business taxes paid between FY2017 and FY2018. At the same time, COST calculated that New Mexico businesses’ share of total state and local tax revenue was 56.2%, well above the national average of 43.5%.¹⁵⁶
- **New Mexico raises relatively little revenue through property taxes.** National rankings put New Mexico among the lowest states on average property tax collections. As a result, the GRT is a more prominent local revenue source than is the sales tax in other states.

Revenue Adequacy, Volatility and Diversification

Ultimately, a tax and revenue system should provide a reliable method to cover the costs of government services. It is difficult to accomplish this during periods of economic stress, particularly while also accommodating tax policy goals related to equity and efficiency. The issues of revenue adequacy, volatility and diversification are inter-connected, and there is a fair amount of tension that can exist in revenue systems related to the three. That is the case in New Mexico, particularly around the GRT and the large taxpaying oil and gas industry.

- **New Mexico tax and revenue collections are cyclically aligned with oil and gas industry prices.** New Mexico state revenue is correlated with the health of the oil and gas industry. New Mexico is not the only state to have this sort of inter-connection, particularly as it relates to the energy sector. Oklahoma has experienced similar revenue ebbs and flows, as have states dependent on the agricultural industry.
- **State tax structures have become more volatile in recent years.** Several sources have identified increased revenue volatility as a growing issue for the states.¹⁵⁷ Numerous factors drive volatility, including significant fluctuations in energy prices, greater reliance on personal income tax collections and corporate income taxes. One analysis by the Pew Charitable Trusts identified energy taxes as most volatile – and ranked New Mexico’s tax structure as the sixth most volatile of the states. Given New Mexico’s decreased reliance on PIT and CIT, the primary source of volatility is likely to be its reliance on the oil and gas industry.

¹⁵⁶ “Total state and local business taxes: State-by-state estimates for FY18,” Council on State Taxation, October 2019, accessed electronically at <https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/fy18-state-and-local-business-tax-burden-study.pdf>

¹⁵⁷

- **Revenue concentration increases volatility and (in downturns) contributes to lack of revenue sufficiency.** Volatility is closely connected with a lack of revenue diversification. In this case, New Mexico is one of the handful of states with a significant reliance on the oil and gas sector and on extraction taxes, and that is closely associated with revenue volatility. There is also a significantly larger reliance on the GRT than for general sales taxes in other states. While many sources suggest a sales tax or GRT is less volatile in general (not necessarily specific to New Mexico) than the PIT,¹⁵⁸ the degree of reliance on the oil and gas industry is a concern.

The dominance of the oil and gas industry in New Mexico is evident from a variety of metrics, and this has been the case for decades. For example, a 2018 review of each state's GDP identified the oil and gas industry as New Mexico's largest, with an 8.2% total share. This is a larger share than the average state, which had its largest industry GDP share generally less than 6%.¹⁵⁹ This analysis found the oil and gas industry to be the largest share of state GDP for several other states, including Alaska, Oklahoma and Texas.

This share of GDP also translates into a significant share of the state's tax revenue. According to the New Mexico LFC, New Mexico typically receives about \$2 billion in direct revenue from oil and gas production, with additional indirect income of about \$300 million. They estimate that in most years, oil and gas revenue makes up 15% to 25% of total General Fund revenue, depending on economic conditions and the health of the energy industry.¹⁶⁰

- **The current revenue situation suggests this is a continuing problem for New Mexico.** While every state has suffered from revenue shortfalls associated with the current pandemic-induced services sector recession, New Mexico has suffered from a double hit, as the energy sector has also experienced unprecedented declines in prices and demand. Other states have dealt with similar circumstances, but New Mexico has been hit especially hard. One analysis of budget shortfalls among the states for the current fiscal year predicted that New Mexico would face one of the nation's largest shortfalls (25%) and another significant shortfall in the next fiscal year (22%).¹⁶¹

In June 2020, the State of New Mexico's consensus revenue estimating group presented a revised revenue estimate that included a \$1.98 billion reduction in FY2021 General Fund revenue. This would have constituted a 25% reduction from the December 2019 estimate and a 20% reduction from FY2020.¹⁶² At the end of FY2020, actual collections were higher than anticipated, which improved some of the budget prospects for the current fiscal year and set a higher base for the coming fiscal year. Even so, the current fiscal year budget is

¹⁵⁸ Jered Walczak, "Income Taxes Are More Volatile Than Sales Taxes During an Economic Contraction," Tax Foundation, March 17, 2020, accessed electronically at <https://taxfoundation.org/income-taxes-are-more-volatile-than-sales-taxes-during-recession/>

¹⁵⁹ "These are the Largest Industries in Every State," 24/7 Wall Street, August 31, 2018, access electronically at <https://www.usatoday.com/story/money/economy/2018/08/27/largest-industry-in-each-state/37585051/>

¹⁶⁰ "Finance Facts: Oil and Gas Revenue," New Mexico Legislative Finance Committee, May 2018, accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Finance_Facts/finance%20facts%20oil%20and%20gas%20revenue.pdf

¹⁶¹ "States Grappling with Hit to Tax Collections," Center on Budget and Policy Priorities, August 12, 2020, accessed electronically at <https://www.cbpp.org/sites/default/files/atoms/files/4-2-20sfp.pdf>

¹⁶² "2020 Post Special Session Financial Report Including Executive Action," New Mexico Legislative Finance Committee, July 1, 2020, accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Session_Publications/Post_Session_Fiscal_Reviews/2020%20Post%20Special%20Session%20Financial%20Report%20Including%20Exec%20Action.pdf

expected to require additional adjustments to remain in balance when the new legislature convenes in 2021.

There is also considerable concern that the issues facing the oil and gas industry are chronic rather than acute. A prominent oil and gas industry analyst does not expect the U.S. oil and gas industry to return to pre-COVID crisis production output levels. A recent study of the oil and gas industry concludes that issues related to overproduction and lack of profitability create difficult headwinds that would require oil prices in the range of \$80/barrel for several years to restore financial strength to the industry – far above the projected prices for the foreseeable future.¹⁶³

¹⁶³Tom Sanzillo and Suzanne Mattei, "New Mexico's Risky Reliance on Oil Revenue Must Change: Industry Fundamentals Point to Long-Term Decline," Institute for Energy Economics and Financial Analysis, October 2020, accessed electronically at https://ieefa.org/wp-content/uploads/2020/10/New-Mexicos-Risky-Reliance-on-Oil-Revenue_October-2020.pdf

Project Team Recommendations

The New Mexico state and local tax structure is not diametrically different from the average state, and it applies most of the types of taxes that are in common use. In this respect, there is no simple 'silver bullet' in the form of a new tax or changing an existing tax source that will dramatically reverse some of the concerns identified in the findings. Absent this, the project team has identified a series of approaches that, taken together, can move New Mexico in the direction of a more stable, equitable and diversified tax and revenue structure.

While changes to the tax structure can improve the overall functionality of the State revenue system, it will not, by itself, alter the state's economic sector components, particularly related to the oil and gas industry. Strategies that seek to more broadly diversify the state's economy are largely outside the scope of this study. The project team has identified some strategies within the recommendations that may assist with diversification, but state economic development strategies that do not solely rely on offering additional business incentives will likely be more effective in advancing those policy goals.

The following recommendations are categorized by the tax policy principles identified by the New Mexico LFC. As previously noted, these principles can conflict with other tax policy principles, and that interplay has been taken into consideration when making recommendations.

Equity

A tax system should fairly distribute the tax burden across all taxpayers. Equity in a tax structure is often framed in terms of horizontal equity (similar treatment of taxpayers with similar income) and vertical equity (the amount of taxes paid is a function of ability to pay and thus increases with income). The following recommendations should improve equity within the current State tax structure.

1. **Reinstitute a rate structure with higher marginal PIT rates at higher income levels.**

From 2002-2009, New Mexico made a concerted effort to lower its top PIT rate. These changes significantly lowered PIT collections from the state's higher income taxpayers. For example, the District of Columbia's yearly tax burden analysis calculated that for a New Mexico family of three earning \$150,000 a year, the average PIT payment was \$7,268 in tax year 2000 and declined to \$5,764 in 2018, a reduction of 20.7%; in 2018 constant dollars, the decline would be 45.6%. In 2000, the New Mexico tax burden for this income cohort ranked 26th among the states with a PIT and was the median of all states. In 2018, the New Mexico tax burden for this income cohort ranked 35th, and the median was \$7,307. Clearly, New Mexico is now imposing a smaller PIT burden on higher income taxpayers than most states.

In this respect, New Mexico was part of a national trend among states to lower PIT rates. A study by the Urban Institute identified 19 states that reduced the top PIT rate between

“examination of recent state experiences with changing tax structures reveals little evidence of tax cuts driving growth.”

the years 2000 and 2016. Besides New Mexico, this included the neighboring states of Arizona, Colorado, Oklahoma and Utah.¹⁶⁴

The question, of course, is whether there is significant value in this change – which, by any standard, makes the PIT less progressive and increases the regressivity of the state tax structure. In general, those who support reductions in top income tax rates argue that it will increase the attractiveness of the state for higher income individuals or businesses associated with them. While there are studies that support this general theory (and others that do not),¹⁶⁵ the New Mexico economic and demographic data cited earlier in the report does not suggest that there has been a noticeable change in economic activity, migration patterns or other data that would support the economic benefit from the reduction in income tax collections from New Mexico’s highest earning households. This conclusion is supported by studies of other state outcomes with tax cuts. One study, by economists William Gale, Aaron Krupkin, and Kim Rueben, found that “examination of recent state experiences with changing tax structures reveals little evidence of tax cuts driving growth.”¹⁶⁶

Other studies also cast doubt on the traditional argument against what are often referred to as ‘Millionaires Tax’ rates – that those subject to the tax will leave for states with more attractive tax rates. Recent research, based on an analysis of IRS tax records for all individuals who earned over \$1 million a year between the years 1999 to 2011 (over 45 million records) led to the following conclusions:¹⁶⁷

- The overall millionaire tax migration rate is low (2.4%), and only a small portion of those moves (15%) bring a net tax advantage;
- Only 0.3% of the overall millionaire population (15% of 2.4%), on balance, shifted to a lower tax state;
- Tax rate differentials account for a very small percentage of moves undertaken by wealthy households, including for taxpayers making at least \$10 million a year, those who own businesses and those who mostly live off capital gains.

¹⁶⁴ Norton Francis, “Using the Tax Structure for State Economic Development,” The Urban Institute, May 2016, accessed electronically at <https://www.urban.org/research/publication/using-tax-structure-state-economic-development>

¹⁶⁵ For example (albeit a study of national tax structures), a recent study found that “certain segments of the labor market, especially high-income workers and professions with little location-specific human capital, may be quite responsive to taxes in their location decisions.” Henrik Klevin, Camille Landais, Mathilde Munoz and Stefanie Stantcheva, “Taxation and Migration: Evidence and Policy Implications,” National Bureau of Economic Research Working Papers, April 2019.

¹⁶⁶ William Gale, Aaron Krupkin, and Kim Rueben, “The Growth Mirage: State Tax Cuts Do Not Automatically Lead to Economic Growth,” Tax Policy Center, September 8, 2015, accessed electronically at

<https://www.taxpolicycenter.org/sites/default/files/publication/104441/2000377-the-growth-mirage.pdf>

¹⁶⁷ Cristobal Young, “The Myth of Millionaire Tax Flight,” Stanford University Press, 2018, pp. 23-25.

In explaining the low rate of geographic mobility among high income households, many millionaire households have significant social, personal and business connections that make moves problematic. High income earners are also typically late career professionals who are past the age or life-cycle stage in which moving is more likely. The previously cited study concludes that “there is a grain of truth about millionaire tax flight...However, the effect is small and has little impact on a state’s overall stock of millionaires.”¹⁶⁸

It is also worth noting the uneven nature of the current economic recession, which is disproportionately impacting lower income workers and households. Unlike the Great Recession, which was triggered by a steep decline in the housing and banking sectors (and thus impacted many higher income individuals and households), the current recession emanates largely from the services sector, particularly the hospitality and related industries. As a result, some commentators have predicted a ‘K-shaped’ recovery where higher income households begin experiencing a recovery while the economic prospects of lower income households continue to trend downward.¹⁶⁹ If this is the case, income inequality can be expected to further increase. Changes to the PIT that focus on those not as harmed by the current economic turmoil make sense from multiple perspectives.

Several states are making or considering significant changes to income tax brackets at the top end of their PIT. In September 2020, the New Jersey Legislature approved changes that will tax income of between \$1 million and \$5 million a year at a rate of 10.75%, up from 8.97%, on earned income above \$1 million (all income above \$5 million is already taxed at 10.75%). The increased tax rate is expected to bring in at least \$390 million in annual revenue and will take effect during the 2020 tax year.¹⁷⁰ Other states that are considering higher tax rates on high earners include California, Hawaii, Illinois, Maryland, Massachusetts, New York, Oklahoma, Vermont and Wisconsin.

Reversing its past PIT policy decision would make New Mexico’s tax structure more equitable. Increasing top PIT rates would also significantly increase General Fund revenue, and thus aligns with the additional key principle of revenue adequacy. The change would also further diversify the state’s revenue structure by providing greater revenue from its second largest General Fund source, with the additional benefit of reducing reliance on the GRT.

2. **Eliminate the capital gains PIT exemption.**

Prior to 2019, New Mexico personal income taxpayers were able to deduct from net income an amount equal to the lesser of the taxpayer’s net capital gain up to \$1,000 or 50% of the taxpayer’s net capital gain income. In 2019, this deduction was reduced from

¹⁶⁸ Ibid, p. 25.

¹⁶⁹ Christopher Mims, “Covid-19 Is Dividing the American Worker,” Wall Street Journal, August 22, 2020, accessed electronically at <https://www.wsj.com/articles/covid-19-is-dividing-the-american-worker-11598068859>

¹⁷⁰ Kate King, “New Jersey Lawmakers Pass Budget With Heftier Millionaires Tax,” The Wall Street Journal, September 24, 2020, accessed electronically at <https://www.wsj.com/articles/new-jersey-lawmakers-pass-budget-with-heftier-millionaires-tax-11600977779>

50% to 40% of net capital gain income. This change was projected to increase state revenue by \$10 million per year.

While the federal tax code provides lower tax rates for capital gains compared to ordinary income, the tax treatment among the states varies considerably. Most states with a PIT tax capital gains, but some do not. A group of states, including New Mexico, provide varying exemptions, deductions or lower tax rates for capital gains.¹⁷¹

While there are arguments for taxing capital gains at a lower rate than ordinary income,¹⁷² nearly all the benefit from this preferential treatment is enjoyed by a very small percentage of taxpayers. Given that state PIT brackets are more compressed than for the federal income tax, lower capital gains rates or exemptions significantly reduce progressivity in state income taxes specifically and the state tax structure in general.

The capital gains deduction also undermines revenue sufficiency in the state tax structure. It is estimated that this deduction reduces state tax revenue collection by approximately \$40 million a year. Further, capital gains income as a share of personal income continues to grow, which means that the value of the deduction – primarily for high income taxpayers – will continue to grow.

3. Re-institute an Estate Tax.

Before 2001, all 50 states imposed an estate tax, in part because the federal estate tax provided a dollar-for-dollar credit of up to 16% of the estate's value for state estate taxes. This enabled states to impose a 16% estate tax without increasing residents' overall tax burden– the state estate tax reduced the federal estate tax owed by the same amount as the state estate tax collected. In 2001, federal tax changes phased out the federal credit for state estate taxes by 2005. Because state estate taxes were linked to the federal credit, states that wished to retain their estate tax had to enact their own state estate tax. Most did not. At present 11 states have an estate tax (which is owed by the estate); an additional 5 states impose an inheritance tax (which is owed by those who inherit the estate), while Maryland imposes both an estate and an inheritance tax.¹⁷³

Every state with an estate tax provides for an exemption from taxation that applies to most estates. The exemption ranges from a low of \$1 million in Massachusetts and Oregon to a high of \$5.85 million in New York. Most states have a progressive estate tax rate structure with a top 16% tax rate – the same rate that was in place when the federal credit existed.

¹⁷¹ Erica York, "An Overview of Capital Gains Taxes," Tax Foundation, April 2019, accessed electronically at <https://files.taxfoundation.org/20190419110809/An-Overview-of-Capital-Gains-Taxes1.pdf>

¹⁷² "The justification for a lower tax rate on capital gains relative to ordinary income is threefold: it is not indexed for inflation, it is a double tax, and it encourages present consumption over future consumption." David Block, "Why Capital Gains are taxed at a Lower Rate," Tax Foundation, June 27, 2012, accessed electronically at <https://taxfoundation.org/why-capital-gains-are-taxed-lower-rate/#:~:text=The%20justification%20for%20a%20lower,present%20consumption%20over%20future%20consumption.>

¹⁷³ In 2020, states with an estate tax are Connecticut, Hawaii, Illinois, Massachusetts, Maryland, Minnesota, New York, Oregon, Vermont and Washington. States with an inheritance tax are Iowa, Kentucky, Maryland, Nebraska, New Jersey and Pennsylvania. See "Estate and Inheritance Taxes," State and Local Finance Institute, Urban Institute, accessed electronically at <https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/estate-and-inheritance-taxes>

While opponents like to label the estate tax a ‘death tax’ there is a logical public policy rationale for the tax. For starters, the estate tax is one of the few wealth-related taxes that is in use by state and local governments. As income inequality has continued to grow, wealth taxes are one of the logical tools for income redistribution, and the logical place to apply these taxes is at probate of an estate.

Another public policy rationale for the tax relates to how assets that have appreciated in value are treated upon the death of its owner. These held assets (such as real estate, stocks, collectibles or other capital assets) get their original cost basis, for purposes of capital gains taxes, ‘stepped up’ to its current fair market value. This eliminates an heir’s capital gains tax liability on appreciation in the property’s value that occurred during the decedent’s lifetime. Under current state and federal law, people who inherit assets such as stocks, bonds, or real estate pay no taxes on any appreciation of those assets that occurred before they inherited them. As a result, a large share of capital gains are never taxed.

State estate taxes compensate for stepped-up basis by taxing assets at the time they were inherited. As previously noted, this tax treatment overwhelmingly favors very wealthy individuals, and the exemption from the estate tax in every state ensures that most ‘middle class’ estates are still not subject to tax.

Adequacy

A good tax system should generate enough revenue to pay for public services without the need for continuous or drastic changes in tax rates or the tax base. The overall tax structure should be able to weather, as much as possible, changing economic conditions without endangering the state’s ability to pay for key government services.

As is evident from current events and recent history, the New Mexico tax and revenue structure has struggled to maintain adequate state revenues. For example, the current decline in state GDP is outstripped by the decline in state revenues. While every state has struggled during major economic downturns (including the Great Recession and the current, COVID-19 pandemic-driven recession), New Mexico’s woes (and those of several other energy producing states) have been compounded by declines in the extractive industries, even when the national economy was doing well.

As previously noted, excise tax increases are often used by states to balance budgets through increased revenue collection. Excise taxes are applied to specific kinds of consumption, and they may fall disproportionately on lower-income taxpayers. For that reason, the recommendations seek to identify instances where there is also an economic justification for the tax or where the consumption is not a necessary part of daily commerce.

4. Increase the motor fuel tax rate.

Motor fuel taxes are one of the historic ‘big three’ of excise taxes (along with those on tobacco products and alcohol), and they are generally one of the largest sources of state excise tax revenue. They are also described as a sort of ‘user tax’ as the revenue is often

dedicated to the maintenance and construction of public roads. In this respect, motor fuel taxes have been waging a losing battle for years: improvements in fuel economy have eroded the tax base (since it is a gallonage tax), and the rise of non-motor fuel cars (primarily electric vehicles) have also reduced consumption.

Faced with these realities, most states have raised their motor fuel taxes in recent years. Since 2013, 31 states have raised their motor fuel rate, and in some of these states, rate increases have been indexed to inflation.¹⁷⁴ States are also undertaking other changes to their revenue structures to deal with the issue of electric vehicles and other vehicles not subject to motor fuel taxes, such as additional surcharges or registration fees for non-motor fuel powered vehicles. Many states also impose their sales tax (or, in the case of Delaware, a gross receipts tax) on the purchase price of motor fuel.¹⁷⁵

In New Mexico, the gasoline tax is 17 cents per gallon and is imposed on distributors for the privilege of receiving gasoline in the state.¹⁷⁶ It is presumed that this tax, like its federal counterpart, is passed along in the final purchase price to consumers. Among the states, New Mexico has the fifth lowest combined motor fuel tax rate.¹⁷⁷ According to the FTA, the average state gasoline tax rate (as of January 1, 2020) was 28.5 cents a gallon, and the median was 26.9 cents a gallon. New Mexico could raise its gasoline tax by 10 cents a gallon and still be below the national average. It is notable that the current allocation of New Mexico gas tax revenue is to a variety of sources, and most are outside the General Fund.¹⁷⁸ Of course, that allocation could be changed as part of raising the tax; even if it were to stay the same, it would provide needed additional resources to address state and local infrastructure needs.

5. Establish taxation parameters for recreational marijuana.

Currently, 34 states (including New Mexico) allow the purchase and consumption of state-regulated marijuana for medical purposes.¹⁷⁹ Of those 33, 11 states have also established regulated markets for recreational marijuana, and an additional four legalized it during the November 2020 general election. It is expected that the number of states legalizing,

¹⁷⁴ See "Recent Legislative Actions Likely to Change Gas Taxes," National Conference of State Legislatures, August 12, 2020, accessed electronically at <https://www.ncsl.org/research/transportation/2013-and-2014-legislative-actions-likely-to-change-gas-taxes.aspx>

¹⁷⁵ "State Motor Fuel Tax Rates," Federation of Tax Administrators, 2020, accessed electronically at <https://www.taxadmin.org/assets/docs/Research/Rates/mf.pdf>

¹⁷⁶ "Gasoline Tax," New Mexico Department of Revenue and Taxation, accessed electronically at <http://www.tax.newmexico.gov/all-nm-taxes.aspx?9674a2e28c1442ce8b25e81c6d015418blogPostId=3c68e8c324d2447b8692a5054b988666>

¹⁷⁷ Many states impose additional fees or sales taxes on motor fuel. The states with lower rates are Alaska (8.95 cents per gallon), Hawaii (16.0), Mississippi (18.4) and Missouri (17.4). In 2017, Missouri legislators approved a 10 cents per gallon increase over four years, but the general electorate overturned the increase with a 53% no vote in 2018. In 2020 Virginia increased its motor fuel tax by 10 cents a gallon over two years, to 26.2 cents per gallon.

¹⁷⁸ According to the New Mexico Department of Taxation and Revenue website, the current split of gasoline tax revenue is State aviation fund - .26%; Motorboat fuel tax fund - .13%; Counties and municipalities - 10.38%; County government road fund - 5.76%; Road funds of municipalities - 5.76%; Municipal arterial program - 1.44%; General fund \$33,333 per month; Qualified Tribes 40% of the net receipts attributable to the gasoline tax paid to the Department on 2,500,000 gallons of gasoline each month; State road fund – Residual.

¹⁷⁹ An additional 6 states allow the medicinal use of cannabidiol (CBD) oil, the nonpsychoactive marijuana extract. See "States with Legal Cannabidiol (CBD)," Britannica ProCon.Org, accessed electronically at <https://medicalmarijuana.procon.org/states-with-legal-cannabidiol-cbd/>

regulating, and taxing recreational marijuana will continue to grow, as several additional states have advanced legalization bills.¹⁸⁰

One of the notable features of the drive to legalize marijuana is that it is largely happening through the voter initiative or referendum process. The first nine states to legalize recreational marijuana did it through voter initiative or referendum – Vermont was the first state to legalize marijuana through the legislative process. In this respect, the drive to legalization seems likely to continue – the general public (particularly younger voters) are generally supportive of these measures. There are an additional four states that are considering legalized recreational marijuana during the November 2020 general election.

At the same time, the legalization push has gained additional adherents because of its revenue potential. As previously noted, marijuana has become a significant revenue source in several states, and this applies to medicinal as well as recreational use.¹⁸¹ As the current recession reduces traditional revenue sources, there is a natural tendency to look to new sources. In fact, most legalization campaigns identify marijuana as a revenue source that can support key public services.

The primary argument against legalization, from a public policy perspective, is similar to alcohol: there can be significant negative externalities associated with its use, and legalizing its use will make it more difficult to curb abuse. While this is a debatable topic, there is little evidence that criminalization of marijuana has reduced its use, and the black market sales that exist provide little opportunity for the state to regulate the industry and its product. Given the fact that the nation's most populous state (and largest economy) has now legalized recreational marijuana, the genie appears to be out of the bottle; it would be nearly impossible to return to a nation without some legalized recreational marijuana.

Given that set of circumstances – including a border state that has legalized recreational marijuana – the issue may be more when, than if, New Mexico will do the same. If that is the case, it is worthwhile for the state to identify how it would tax this product. In doing so, the state will be able to determine the tax structure that best fits its set of facts and circumstances.

Most states have relied on some combination of taxes on the manufacturers, the wholesale distribution and/or the retail sales of marijuana. There is broad variation, and determining the best approach depends on a variety of factors. The following identifies the basic tax structure for the first 11 states to legalize recreational marijuana:¹⁸²

¹⁸⁰New York Governor Cuomo is once again planning to push for legalization of recreational marijuana when the new General Assembly convenes in 2021. There is speculation that the legalization in New Jersey could spur similar changes in neighboring Connecticut and Pennsylvania.

¹⁸¹Oklahoma is a medicinal marijuana state. Currently, the number of licensed patients is over 8% of the state population. For July 2020, the state collected over \$12 million in revenue from its medicinal marijuana 7% excise tax and its 4.5% state sales tax.

¹⁸²See Kenneth W. Boyd, "Deep Dive: Recreational Marijuana Tax Revenue in the United States," Accounting Institute for Success, accessed electronically at <https://www.ais-cpa.com/deep-dive-recreational-marijuana-tax-revenue-in-the-united-states/> and Ulrik Boesen, "A Road Map to Recreational Marijuana Taxation," Tax Foundation, June 9, 2020, accessed electronically at <https://taxfoundation.org/recreational-marijuana-tax/#CurrentDesign>

- **Alaska** charges a cultivation tax rate of \$15 to \$50 per ounce depending on the portion of the plant being sold. They also impose a 5% sales tax on all sales in Anchorage.
- **California** imposes a 15% excise tax on distributors that is marked up by 80% to match the average market value. It also charges a cultivation tax that varies from \$1.37 to \$965 per ounce.
- **Colorado** imposes a 15% excise tax on distributors and a 15% sales tax on retailers.
- **Illinois** imposes a 7% excise tax on the value of the product at the wholesale level. At the retail level, the state imposes an excise tax of from 10% to 35% on retail sales based on the THC content.¹⁸³ Additionally, the state applies its 6.25% general sales tax and allows localities to levy additional tax up to 3%.
- **Maine** imposes an excise tax that varies in price and unit depending on the parts of the plant being sold and a 10% sales tax rate.
- **Massachusetts** imposes a 10.75% excise tax and a 6.25% sales tax, as well as a local option for cities and towns to add an additional 3% tax.
- **Michigan** imposes a 10% excise tax and a 6% sales tax on retail purchases.
- **Nevada** imposes a 15% excise tax on cultivators that is marked up to match the average market value and a 10% excise tax on retailers.
- **Oregon** imposes a 17% excise tax on all retail sales.
- **Vermont** has not settled on a tax structure; one suggestion made to a legislative subcommittee was for a 15% to 25% excise tax on all retail sales.
- **Washington** imposes a 37% excise tax (by far the largest) on retail sales of marijuana, concentrates, usable marijuana and marijuana-infused products.

There are several considerations and approaches in developing a tax structure for recreational marijuana. First, some consideration should be given to whether the intent of the tax structure is to reduce consumption. The point has been made in several places that many excise taxes are structured to either limit consumption or to provide revenue to ameliorate negative externalities. If that is the case, higher taxes may accomplish that. It is also notable that only one state, Illinois, takes into consideration the amount of THC in the product, with higher THC levels being taxed at higher rates. If there is an intent to limit consumption's ill effects, taxes based on the THC level are logical.

As noted, several states have relied on the promise of additional revenue as a reason to legalize recreational marijuana. It is worth considering whether there is a 'sweet spot' where the taxes are high enough to collect significant revenue but not so high as to encourage black market purchases. In this respect, there are a variety of states that impose retail excise taxes in the range of 10% to 17% either with or without also adding a general sales tax to the purchase price.

The Tax Foundation has used the Colorado tax structure as something of a benchmark and estimated possible tax revenue for each state. Their estimate for New Mexico is annual revenue of approximately \$68 million.¹⁸⁴

¹⁸³ THC is the main psychoactive compound in marijuana that produces the 'high' sensation.

¹⁸⁴

While the State of Washington has the highest state excise tax rate, it has collected the most revenue per capita. Clearly, taxes alone are not the sole factor that will drive consumption. Washington has designed a system that accentuates convenience – including for businesses engaged in the sale of marijuana.¹⁸⁵

The market for recreational marijuana is still evolving. Many state tax structures have changed as well. It is likely that continued state experience will provide additional insight into logical state tax structures for states. In general, there may well be a logic to establishing a relatively simple tax structure in the early stages and modifying it based on experience. Many states have modified their tax structures over time.

For purposes of this discussion, per capita state tax revenue from recreational marijuana sales is a useful guide. In 2019, this varied from a high of \$67 (the State of Washington) to a low of \$13 (the State of Massachusetts). For illustrative purposes, per capita state tax revenue of \$50 for the State of New Mexico would generate over \$100 million in new tax revenue.

6. Broaden the GRT tax base to include food, AND enact a revenue neutral (for lower income taxpayers) refundable PIT food credit.

One of the identified strengths of the GRT is the fact that it has a very large base. However, a large and growing portion of consumption, food, is not included in the economic activity that is subject to the GRT. In this respect, most states exempt food from their sales tax.¹⁸⁶ However, including food in the tax base can improve revenue adequacy and stability, and there are approaches that can ameliorate the impact of the tax on lower-income residents.

First, there is a significant tax revenue loss from this deduction. According to the annual report on New Mexico tax expenditures, for FY 2018 (the latest year for data) this deduction led to a revenue loss of \$149.3 million for the State and an additional expenditure of \$101.1 million provided to local governments to compensate them for lost revenue from this deduction.¹⁸⁷

Second, this deduction applies to all qualifying food sales at retail food stores as defined under the federal food stamp (now referred to as SNAP) program. The purchase of filet mignon is exempt from the GRT to the same extent as the purchase of hamburger. The purchase of lobster is exempt from the GRT to the same extent as the purchase of fish sticks.

It is possible to combine a consumption tax on food with a low-income refundable PIT. Hawaii takes this approach with its refundable food excise tax credit. Households whose federal adjusted gross income does not exceed \$50,000 (for single filers, the limit is \$30,000), may claim the credit, even if they have no personal income tax liability. The credit

¹⁸⁵ Kenneth W. Boyd, "Deep Dive: Recreational Marijuana Tax Revenue in the United States," Accounting Institute for Success, accessed electronically at <https://www.ais-cpa.com/deep-dive-recreational-marijuana-tax-revenue-in-the-united-states/>

¹⁸⁶ Federation of Tax Administrators, State Sales Tax Rates and Food and Drug Exemptions, January 1, 2020, accessed electronically at <https://www.taxadmin.org/assets/docs/Research/Rates/sales.pdf>

¹⁸⁷ 2018 New Mexico Tax Expenditure Report, page 149-150.

is on a sliding scale and starts at \$110 per dependent for those with AGI of \$5,000 or less; at the other end of the scale, the credit is \$35 per dependent for those with household income of between \$40,000 and \$50,000.¹⁸⁸ With a state general excise tax rate of 4%, the \$110 tax credit effectively replaces the GET on \$2,750 of food purchases. On the other end of the spectrum, the \$35 effectively replaces the GET on \$875 of food purchases.

The value of a broad-based grocery tax exemption for all versus a targeted refundable tax credit for low income state residents was explained by ITEP in 2015, related to the State of Idaho's Grocery Credit Refund versus a blanket sales tax exemption for food: "The benefits of grocery tax exemptions are also not very targeted. Visitors from outside the state benefit from grocery exemptions in the same way as residents, and high-income households with large grocery bills tend to receive a disproportionate share of the overall tax benefits." As a result, ITEP concluded that **"Idaho's Grocery Credit Refund is an effective tool for offsetting some of the regressivity of sales taxes on groceries. If grocery tax relief is a priority for Idaho lawmakers, they should consider expanding that refund rather than eliminating it in favor of a less targeted grocery tax exemption."**¹⁸⁹

New Mexico has an existing low- income comprehensive tax rebate that acts as a partial offset for state and local consumption taxes paid by low income taxpayers. It may be claimed by taxpayers with a modified gross income of less than \$22,000. The rebate amount is dependent upon modified gross income as well as the number of exemptions claimed and varies between \$10 and \$450.¹⁹⁰

From a tax policy perspective, this type of targeted refundable tax credit is more efficient than a blanket food exemption, where the largest share of the benefit is going to taxpayers who do not really need it. As previously noted, the food exemption from the GRT was estimated to forego \$149.4 million in FY2018 GRT revenue as well as an additional \$101.1 million in payments to local governments to make up for their lost revenue. By way of comparison, the Hawaii refundable credit reduced state revenue by \$29.9 million in tax year 2017.¹⁹¹

There are two primary arguments against using a refundable credit in lieu of a blanket exemption: some taxpayers will not be aware of the credit and will not take it (particularly if they otherwise have no need to file a personal income tax return), and the refund is delivered as a lump sum after the end of the tax year, while the GRT is paid throughout the year. Both of the concerns are valid; as it relates to awareness of the credit, the State's low income comprehensive tax rebate has been in existence since 1972, so it is already well known. As it relates to timing of payments, the credit can be designed to, in essence, make up the difference in both taxes paid on food and the time value of those payments.

¹⁸⁸ State of Hawaii, Department of Taxation, Form N-311, Refundable Food/Excise Tax Credit for Tax Year 2019. Accessed electronically at https://files.hawaii.gov/tax/forms/2019/n311_i.pdf

¹⁸⁹ "Grocery Tax Exemption is No Improvement for Idaho," Institute on Taxation and Economic Policy, February 2015, accessed electronically at https://itep.sfo2.digitaloceanspaces.com/id_grocerytax_0215.pdf

¹⁹⁰ 2018 New Mexico Tax Expenditure Report, page 104.

¹⁹¹ State of Hawaii Tax Credit Report, Tax Year 2017, accessed electronically at https://tax.hawaii.gov/stats/a5_1annual/a5_4credits/

The U.S. Bureau of Labor Statistics (BLS) publishes annual household consumer expenditure surveys, and from those surveys it is possible to get a reasonably accurate picture of food purchases by income group. In the target income population for this type of credit, food expenditures are generally between 13% and 17% of total income. The credit can be designed, at these income levels to return slightly more of the amount paid in food taxes to make up for the time lag.

These two recommendations must be done in concert with one another. Absent one or the other, alignment with the two key tax principles of vertical equity and adequacy will be lost. If done together, however, the state tax structure will be more balanced and less prone to major revenue swings by expanding the tax base for the GRT to include food for home consumption.

7. Resist the temptation to increase the State GRT rate.

In many cases, the first point of comparison for general consumption taxes (sales taxes in most states and the GRT in New Mexico) is the tax rate. In the case of New Mexico, the state rate is relatively competitive – the 5.125% rate is only 32nd highest among the 50 states and lower than all of the surrounding states except for Colorado and Oklahoma.¹⁹² However, the New Mexico combined average state and local rate ranks as the 15th highest among all states (when compared to state and local combined sales tax rates).¹⁹³

New Mexico local governments have also been given greater GRT taxing authority, and they are increasing rates. In 2013, local governments were given the option to raise GRT rates by up to three-eighths of one percent. By FY2017, these rate increases had generated an additional \$110.7 million in local government tax revenue.¹⁹⁴

While the GRT combined state and average local rate is already above average, the overall impact of the GRT is heightened when it is understood that the New Mexico taxable base is much broader than nearly every other state sales tax base. Measures that take into consideration both the GRT rate and base rank the New Mexico consumption tax effort among the highest of any state. When considering state and local sales/gross receipts tax collections per capita, New Mexico ranks ninth highest among the states.¹⁹⁵ On sales/gross receipts tax breadth (the ratio of the sales tax base to personal income), New Mexico ranks third among the states.¹⁹⁶ Given these factors, raising the GRT rate is not advised at this time.

8. Continue to expand excise taxes to align with new forms of goods or services consumption.

¹⁹² Janelle Cammenga, “State and Local Sales Tax Rates, 2020,” Tax Foundation, accessed electronically at <https://files.taxfoundation.org/20200115132659/State-and-Local-Sales-Tax-Rates-2020.pdf>

¹⁹³ Ibid.

¹⁹⁴ Jon Clark and Dawn Iglesias, “Food Tax Deduction,” LFC Hearing Brief,” May 2018, accessed electronically at https://www.nmlegis.gov/Handouts/ALFC%20052118%20Item%2010%20LFC%20May%202018%20Hearing%20Brief_Food%20Tax%20Deduction_REVISED.pdf

¹⁹⁵ “Facts and Figures: How Does Your State Compare?” Tax Foundation, 2019, access electronically at <https://files.taxfoundation.org/20190715165329/Facts-Figures-2019-How-Does-Your-State-Compare.pdf>

¹⁹⁶ Ibid.

There are additional excise taxes that should be on the State's radar – as new products and services are developed, state excise taxes are often imposed once an established market has developed. An example of this is excise taxes on vapor products. Vapor products generally deliver nicotine, the addictive component in cigarettes, without inhaling the cigarette smoke (or exhaling the second hand smoke) that is associated with carcinogens and other health issues. Currently, New Mexico is one of 21 states that has a vapor tax (or taxes). These taxes vary widely – Minnesota's wholesale tax is the highest with a 95% wholesale rate – by contrast, New Mexico's is relatively low at 12.5%. However, these taxes are not materially impacting state revenue collections.

The same is generally the case for "sharing" features of the 21st century economy. Ride sharing is perhaps the most established industry, and many local governments have sought to revise their tax structures to address lost revenue from taxes and fees imposed on the most established taxi and car rental industries. It is notable that car sharing services are subject to the GRT, and many states have also revised their tax codes to make these services part of their sales tax base.

The same is true for short term rentals, such as those booked through Airbnb and similar services. As states and local governments have seen a decline in collections of lodging taxes from traditional hotels and motels, they have sought to apply these taxes to these newer forms of lodging. Effective January 1, 2020, short-term rental hosts in New Mexico offering fewer than three rooms must collect local lodging taxes.

Vacation rental owners in New Mexico are also required to pay the GRT. While some of the rental platforms will collect lodging taxes, that is not necessarily the case for the GRT, as it is technically a tax on the operator. It is notable that Airbnb now collects the GRT as part of rental reservations within the State of New Mexico.¹⁹⁷

Economic Efficiency

The LFC defined an efficient tax structure as one that has a broad tax base and low rates to "minimize economic distortion and avoid excessive reliance on any single tax." Tax systems that are efficient are also often thought of as being *neutral* in market decisions. In other words, the tax system should not shape or significantly alter the economic decisions of people and firms any more than is necessary to raise the appropriate amount of tax revenue.

As has been described, the New Mexico state tax structure has higher than average reliance on its single largest revenue source, the GRT. Many of the prior recommendations would seek to create greater balance within the mix of taxes. A greater balance would assist in keeping the GRT rate from increasing in the future. There is an oft-quoted rule of thumb that a general sales and use tax rate of over 10% will begin to impact on market decisions. To the extent that recommendations to broaden the tax base take some pressure of the GRT, the recommendations help promote economic efficiency.

¹⁹⁷ "Occupancy tax collection and remittance by Airbnb in New Mexico," accessed electronically at <https://www.airbnb.com/help/article/2318/occupancy-tax-collection-and-remittance-by-airbnb-in-new-mexico>

9. While not recommending its adoption at this time, identify parameters for a carbon tax or market-based approaches.

As previously noted, a carbon tax is imposed on the burning of carbon-based fuels (coal, oil and gas) and is a Pigovian tax, which is intended to correct an inefficient market outcome, either by generating revenue equal to a commodity's social cost or reducing the activity associated with the negative externalities.

As previously discussed, a carbon tax has been attempted unsuccessfully in several states. At this point in time, taxing carbon emissions is probably not a viable revenue alternative for New Mexico. That said, state revenue structures tend to evolve over time, and, for this study's purpose, it is useful to consider how New Mexico might structure this tax should it become a more widely accepted revenue generation strategy.

The point in the chain of commerce where a carbon tax is imposed is important, because it determines who is required to monitor and report emissions and make payments. For example, a state could impose a carbon tax on fuel producers, distributors, or final consumers. At the state level, the point of taxation could be the point of existing Federal Environmental Protection Agency (EPA) data collection for stationary sources. For example, power plants, refineries, and a wide range of industrial facilities must report their greenhouse gas emissions to EPA each year. EPA makes this data publicly available and any state can use this information to identify potentially taxable emissions and estimate their potential revenues under different assumptions about which facilities would be subject to the tax.

In 2019, a carbon tax proposal was introduced to the New Mexico state Legislature.¹⁹⁸ The bill, which did not pass, would have levied a \$0.40 per gallon surtax on gasoline and a \$3.00 per mmBtu surtax on natural gas processors. Revenue generated by the tax would have supported three new funds including a low-income home energy assistance fund (15%), a renewable energy technology fund (15%), and a fossil fuel displacement worker fund (10%). Remaining revenue from the tax would have funded a carbon emission income tax credit for low-to-moderate income taxpayers.

The LFC estimated the natural gas surtax would generate \$405.4 million in revenue by FY 2024, while the gasoline surtax would generate \$356.0 million. Despite these large revenue estimates, many issues with the bill were raised in the LFC's analysis. After distributing revenue to dedicated funds, LFC estimated the revenue provided to the General Fund would be insufficient to cover the increasing cost of the proposed income tax credit. The proposed surtax rate on gasoline would give the state the highest gasoline tax in the nation, leading to concerns about the cost to state residents and businesses. The surtax on natural gas processors would have placed a heavy burden on operators with the tax rate estimated to be 83% of forecasted natural gas value. Furthermore, the natural gas processors tax would be levied on processors, but not on those extracting the natural gas which is seen as an unfair distribution of a tax burden intended to offset the externalities caused by the industry.

Notwithstanding the concerns related to SB 393, a carbon tax has significant potential to generate revenue for the state while assisting in efforts to reduce greenhouse gas emissions. As with SB 393, proposals for a carbon tax should consider the possible tax

¹⁹⁸ SB 393 was sponsored by Senator Bill Soules. Senator Soules also introduced SB 475, which would have appropriated \$250,000 to the Energy, Minerals and Natural Resources Department to draft legislation imposing a carbon tax.

burden on both residents and businesses and how the tax burden is distributed across industries responsible for greenhouse gas emissions.

A common argument against a carbon tax is that it is a regressive tax, and numerous distributional studies have studied those effects. As a starting point, those studies primarily examine the 'use side' impacts. It may well be that a carbon tax would lower some production costs.¹⁹⁹ If returns to capital fall more than wages (because the tax increases the cost of capital), then the carbon tax can be progressive on the 'sources side.'²⁰⁰ In fact, in constructing a general equilibrium model of the economy with a carbon tax, one research team found that various source side effects would fully offset the 'use side' effects, and the carbon tax could be distributionally neutral to slightly progressive.²⁰¹

Of course, how revenue from a carbon tax is used will also have distributional effects. At the national level, the Climate Leadership Council advocates distributing carbon revenue through an equal per capita cash grant, which would be highly progressive. Likewise, using a portion of the revenue to make the tax revenue neutral for lower or middle-income taxpayers (such as through existing New Mexico PIT credits or exemptions) would also be progressive. Several modeling exercises have demonstrated the feasibility of this type of approach.²⁰²

There are also non-tax methods that might be considered. As previously noted, Governor Grisham established the Interagency Climate Change Task Force (Task Force) by executive order in 2019. One policy to be evaluated that is specifically referenced by the Governor's order is the adoption of a comprehensive market-based program that sets emission limits to greenhouse gas pollution across the state.

The most common method of implementing a market-based program is through a 'cap and trade' program. This type of system places a limit on the total amount of greenhouse gases that can be emitted across the state (or region). Permits for each ton of greenhouse gas emissions are sold by the state at auction to large-scale emitters. Emitters that don't utilize their full allotment can sell their permits to emitters that need more. The establishment of a market for the right to emit creates a strong financial incentive for firms to reduce pollution. The state gradually reduces the total emissions cap, reducing the supply of emissions permits, and increasing the cost of using fossil fuels.

In addition to reducing greenhouse gas emissions, cap and trade programs also provide revenue to state governments. For example, the Regional Greenhouse Gas Initiative (RGGI), which includes 10 states in the Northeast, reported \$248 million in revenue from auctions that funded various programs in each member state. Since RGGI started in 2005, member states have used auction revenue to fund energy efficiency programs, investments in clean and renewable energy, greenhouse gas abatement, and direct bill assistance.

It is also reasonable to suggest that some portion of revenue generated through a cap and trade program would be used for general purposes. California's cap and trade auctions generated \$4.4 billion in state revenue from FY 2012 through FY 2017. Revenue generated in FY 2016 or later is restricted by statute so that 60% is used for specific purposes

¹⁹⁹ Factor prices refer to factors of production, which are primarily labor and capital.

²⁰⁰ Gilbert Metcalf, "On the Economics of a Carbon Tax for the United States," Brookings Papers on Economic Activity, Spring 2019, accessed electronically at https://www.brookings.edu/wp-content/uploads/2019/03/Metcalf_web.pdf

²⁰¹ *Ibid.*, p. 440.

²⁰² *Ibid.*, p. 441.

including high-speed rail projects and affordable housing, while the remaining 40% of revenue is available for appropriation.

10. Undertake a regular evaluation process for major state business incentives.

In general, there is tension between industry (or business)-specific incentives and the economic efficiency tax policy principle. Because of this, it is important that a state have a formal process in place to review and evaluate its incentives on a regular basis. Many states have instituted this type of formal process, and New Mexico should as well.

In recent years, New Mexico has made a significant investment in the film production industry, both through broad-based incentives and through additional economic development agreements with specific companies. In 2019, the dollar cap for the Film Production Tax Credit was increased from \$50 million to \$110 million a year, and additional one-time funds (totaling \$98.5 million) were dedicated to this initiative at the end of FY2019. While it is too early to determine the long-term outcome from those efforts, supporters have pointed to renewed film production activity since the cap was increased.²⁰³

Of course, one would expect increased economic activity within an industry that receives a significant state subsidy – the question to be answered is whether there is a positive return on investment from the subsidy. Nearly every independent study of state film tax credits across the country has determined that the credits do not create a positive return on investment. Recently, for example, the Georgia Department of Audits and Accounts, Performance Audits Division, determined that “the economic activity generated by the film tax credit does not generate sufficient additional revenue to offset the credit, even after considering tourism and studio construction. In 2016, the film tax credit resulted in a net revenue loss to the state estimated at \$602 million. The state’s return on investment for the credit was 10 cents for each dollar, though local governments received an additional return of 11 cents in revenue.”²⁰⁴ A study of the Louisiana film credit program commissioned by the state’s Department of Economic Development estimated tax revenue from economic activity associated with the state’s film credit of \$54.4 million in FY2018, at a cost of \$150.5 million associated with the tax credit.²⁰⁵

To its credit, the 2019 expansion of the Film Production Tax Credit also required annual reporting related to the credit and development of an econometric tool to identify the economic impact of the credit.²⁰⁶ While that is an example of specific language added to this credit, the State should broaden that application to include all business incentives. Determining the efficacy of any individual incentive should be an ongoing process that uses data and information to determine the appropriate course of action.

The Pew Charitable Trusts has provided technical support to states related to tax incentive evaluations. In 2017, it provided a detailed review of all 50 states activities for incentive

²⁰³ Alicia B. Keyes, Cabinet Secretary, New Mexico Economic Development Department, “Want results from film incentives? They’re heeere!” Albuquerque Journal, October 6, 2019, accessed electronically at <https://www.abqjournal.com/1374954/want-results-from-film-incentives-theyre-heeere.html>

²⁰⁴ “Impact of the Georgia Film Tax Credit: Credit’s impact on economy, jobs is less than reported,” Georgia Department of Audits and Performance, January 2020, p. 20.

²⁰⁵ “Economic and Fiscal Impact of Louisiana Entertainment Tax Credits,” Camoin Associates, 2019, accessed electronically at <https://louisianaentertainment.gov/docs/default-source/default-library/2019-economic-fiscal-impact-of-louisiana-entertainment-tax-credits.pdf>

²⁰⁶ S.B. 2, Section 5, 2019. Accessed electronically at <https://www.billtrack50.com/BillDetail/1051136>

evaluation.²⁰⁷ In its discussion of New Mexico, they wrote that “In 2011, Governor Susana Martinez signed an executive order requiring the Taxation and Revenue Department to prepare an annual report on tax credits, exemptions, and deductions, including an evaluation of each program. These reports include valuable descriptive information on tax incentives, including their purposes, how they function, and how much they cost. They also include policy recommendations for many incentives, some of which offer ways to improve the design of the programs. However, the evaluation of each program typically consists of only a few paragraphs of discussion, with little or no original economic analysis.”

The Pew analysis also noted that “New Mexico policymakers could consider providing more scrutiny to major tax incentives, such as the High Wage Jobs Credit, which cost \$70 million in fiscal year 2015, than to such expenditures as a tax exemption totaling \$10,000 annually for street vendors with disabilities.”

In that 2017 evaluation, Pew identified 10 states as leading in incentive evaluation, 18 as making progress, and 32 as trailing. New Mexico was identified as one of the trailing states:

Figure 46: State Progress on Tax Incentive Evaluation



Source: The Pew Charitable Trusts

Pew has continued to update its evaluation of states. Its most recent update, from April 2020, now lists Colorado as a leading state, joining Oklahoma among neighboring states. Both Texas and Utah continue to be listed as making progress, while Arizona and New Mexico are trailing.

The mechanics for setting up a regular process vary from state to state, even among the leading states. Some are done by professional staff of the legislative audit committee, which is the case in both Virginia and Washington. Some are done by the State Auditor’s office,

²⁰⁷ The Pew Charitable Trusts, “How States are Improving Tax Incentives for Jobs and Growth: A national assessment of evaluation practices,” May 2017, accessed electronically at https://www.pewtrusts.org/-/media/assets/2017/05/edti_how_states_are_improving_tax_incentives_for_jobs_and_growth.pdf

which is the case in Minnesota. Some are done by an outside contractor, which is the case in Oklahoma.²⁰⁸ In Iowa, they are done by the executive branch Department of Revenue. In each case, however, there is a regular process to identify incentives for evaluation, and the evaluations are in-depth assessments of the particular program, in most instances accompanied by recommendations to improve its overall effectiveness. New Mexico would benefit from establishing a similar formal process for incentive review and evaluation.

Complementary Revenue Structures

It is generally necessary to discuss state and local tax and revenue structures in combination, as the services provided to residents by state and local government vary substantially from state to state. As previously noted, property taxes are the most frequently imposed local-level tax in the U.S., and they have traditionally been the largest single local own-source tax revenue. That is not the case in New Mexico.

Taxes imposed on real property have long been a staple of local taxes for a variety of reasons. They generally have the highest collection rates of all major taxes, they have been more stable than other taxes during economic downturns, and there is a direct connection between the local government services provided within neighborhoods and communities where property taxes are imposed.

Another important feature of the property tax is that it is not generally imposed by either the federal or state government. Within the U.S., the income tax is imposed by both the federal and state governments (and a small but important group of cities and counties). Both states and local governments also impose broad-based consumption taxes. However, there are very few states that impose taxes on real property, and in no case is this a major revenue source. This primacy of local property taxes is important, as local governments are less likely to encounter competition over that tax base.

Without a doubt, there is a unique cultural context and history related to the State of New Mexico and property taxes, which pre-dates statehood. This context was explained in the 2010 Government Restructuring Task Force final report: “New Mexicans have had a deep suspicion of property taxes since Mexican rule, which only deepened during the territorial ‘land grab’ days, so it was natural that the state made the choice not to use property taxes for educational purposes. In addition, because of New Mexico’s historically low property tax rate, large tracts of public and tribal lands and the fact that the railroads did not pay property tax, relying on such a tax for public school funding would not have been beneficial.”

The New Mexico State Constitution (Article 7, Section 2) limits the property tax to 20 mills (one mill equals one one-thousandth of a dollar of assessed property value). The 20 mills are divided between counties (11.85), municipalities (7.65) and school districts (0.50). Property values are to be assessed uniformly across the state, at one-third of market value. Thus the 20 mills represent 2% of one-third of market value, resulting in an effective tax rate of two-thirds of 1%. Among all states, this is a particularly low rate of property taxation.

²⁰⁸ It should be noted that PFM (including members of this study team) has provided business incentive evaluation services to the State of Oklahoma from 2016 through 2020.

11. Amend the New Mexico State Constitution to shift greater local funding responsibility to property taxes and away from the GRT. A major recommendation coming out of the 2010 Government Restructuring Task Force (which is discussed in Appendix A) was to establish a state-wide real property tax levy of 5 mills to help fund K-12 public education. From our perspective, this is a focus on the correct tax but the wrong method for implementation. First, it would create some property tax competition among state and local government in this revenue source. Second, it would not assist with reducing some of the over-reliance on the GRT and the high rates associated with it because of its reliance as a primary revenue source for both the state and its major cities.

From our perspective, a better approach would be to allow use of additional mills for local governments in return for a direct reduction in their GRT rate. This would have several advantages. First, it would reduce the GRT rate imposed on most New Mexico businesses (and generally passed along to consumers). Given that the GRT is considered to be the most regressive of the major taxes imposed in the state, this would help with vertical equity concerns. Second, it would replace the GRT tax with a more stable tax, which would assist with issues of adequacy, particularly during economic downturns, when the demand for services generally increases. Finally, it would improve economic efficiency. It's accepted that over-use of a tax will create 'winners and losers.' It has been observed that consumption decisions are more likely to consider the tax burden when consumption tax rates approach or exceed 10%. That is becoming more of an issue in New Mexico, based on combined state and local GRT rates, and reducing these combined rates should have a positive effect.

At the same time, there are valid concerns related to creating an additional property tax burden, particularly for those on fixed incomes who may have lived in their homes for decades and now see property values (and, thus, real property taxes) increasing faster than their incomes. The best way to deal with this is, once again, through a targeted assistance program – rather than a blanket restriction on taxation that also benefits those with the ability to pay.

An oft-used approach to deal with this problem is through a circuit breaker program. This type of program, which is usually instituted and funded at the state level, limits the percentage or amount of income that can be dedicated to paying property taxes on a primary residence. There are usually income eligibility caps, and it is often done on a sliding scale.²⁰⁹

New Mexico has a form of circuit breaker, but it is a county-funded program and is only in effect in two counties. The low-income property tax PIT rebate is a partial offset for property taxes paid by low income residents with a principal place of residence in a county that has enacted an ordinance authorizing the rebate (to date only Los Alamos and Santa Fe Counties have enacted the required ordinances), and modified gross income²¹⁰ of less than \$24,000. The rebate is calculated as a percentage of the taxpayer's property tax liability and based on the taxpayer's modified gross income. The rebate amount cannot exceed \$350, or \$175 if married filing separately. The State is reimbursed annually by the authorizing county for any low- income property tax rebates granted under this section.

²⁰⁹ "Property Tax Circuit Breakers in 2018, Institute on Taxation and Economic Policy, September 17, 2018, accessed electronically at <https://itep.org/property-tax-circuit-breakers-in-2018/>

²¹⁰ "Modified gross income is a calculation unique to New Mexico. It means -- for the entire household -- all income and all compensation from other sources regardless of whether the income is taxable by the U.S. Government or the state of New Mexico." New Mexico Taxation and Revenue Department, accessed electronically at <http://www.tax.newmexico.gov/frequently-asked-questions.aspx?9674a2e28c1442ce8b25e81c6d015418blogPostId=5061f8b51e134a939af717df9686a3aa>

Many state-funded circuit breaker programs are limited to those ages 65 and older and/or the disabled. An example is Utah, which limits its circuit breaker program to those 65 years of age or older or those who can demonstrate a disability or extreme hardship. The program is indexed; for 2019, the income limit for program eligibility is \$34,167. The benefit is 50% of the total tax for the current year, or a maximum of \$1,043, whichever is less. The dollar limit is also indexed to inflation for successive years.²¹¹

There are states that apply a broader circuit breaker. For example, Wyoming has a circuit breaker that provides up to one-half the homeowner's property tax bill or one-half of the median residential property tax bill within the County of residence, whichever is less. To be eligible, the homeowner's household income must be no more than three-fourths of the median household income in their county of residence or the state as a whole, whichever is higher. Three-fourths of the Wyoming state average for 2020 is \$47,865. There are 9 of the state's 21 counties where the income eligibility would be higher, and they range up to a high of \$71,678 in Teton County.²¹²

Economic Diversification

The current study is primarily focused on recommendations to diversify the tax structure to reduce the State's reliance on a single industry or source of tax revenue. However, economic diversification is also an important strategy to broaden the state's economic base – on which taxes are applied.

As has already been noted, the State's economic reliance on the oil and gas industry translates to a revenue reliance. The State should pursue strategies to diversify its economy in parallel with efforts to reshape the tax structure. The following recommendations should be part of broad-based strategies and local-specific economic and community development plans.

The State already has in place a structure, through its Local Economic Development Act (LEDA), for a community to adopt an ordinance creating an economic development organization and a strategic plan. Currently, 83 communities have developed the necessary structure for use of LEDA. LEDA then empowers communities to embark on economic development projects tailored to their local needs, within the areas of infrastructure, economic development for job creation and retail.²¹³

While every community is different, it is important to understand that many parts of the state with substantial oil and gas industry concentration would benefit from diversification. In some areas, competition within that industry is going to lead to winners and losers, and as drilling and associated activity declines based on market forces, there will, by necessity, be a need to develop alternative industries. There is evidence of this sort of 'shake out' in the industry throughout the country. In 2020, US oil and gas companies announced more than 1.4 million barrels per day of production shut-ins, including for some operations in New Mexico.²¹⁴

²¹¹ "Publication 36 Revised, Property Tax Abatement, Deferral and Exemption Programs for Individuals," State of Utah, accessed electronically at <https://tax.utah.gov/forms/pubs/pub-36.pdf>

²¹² "Current Property Tax Refund/Credit/Deferral Programs in Wyoming," Wyoming Department of Revenue, accessed electronically at <https://sites.google.com/a/wyo.gov/wy-dor/administrative-services/property-tax-refund-program>

²¹³ "Local Economic Development Act, New Mexico Economic Development Department, accessed electronically at <https://gonm.biz/community-development/local-economic-development-act>

²¹⁴ "2020 Mid-year Outlook: Oil and Gas Energy Industry, Deloitte, p.4, accessed electronically at <https://www2.deloitte.com/us/en/pages/energy-and-resources/articles/oil-and-gas-industry-outlook.html>

A recent market survey by McKinsey and company paints an ominous picture of the future of the oil and gas industry. Their June 2020 analysis notes that the oil and gas industry is experiencing its third price collapse in 12 years. While the industry regained its prior business performance after the first two declines, “This time is different. The current context combines a supply shock with an unprecedented demand drop and a global humanitarian crisis. Additionally, the sector’s financial and structural health is worse than in previous crises. The advent of shale, excessive supply, and generous financial markets that overlooked the limited capital discipline have all contributed to poor returns. Today, with prices touching 30-year lows, and accelerating societal pressure, executives sense that change is inevitable.”²¹⁵

Another recent assessment paints a similarly bleak picture for the oil and gas industry. The Institute for Energy Economics and Financial Analysis noted multiple reasons for concern with the long-term health of the industry. These concerns included:²¹⁶

- The major oil producers have experienced declining profits for most of the past 10 years;
- It would require several years of oil prices of \$80/barrel to restore financial strength to the industry;
- By 2050, the domestic energy use associated with each dollar of economic growth will be less than half what it was in 2005;
- Companies are writing down their oil and gas inventories, expecting lower profits and less investment.

Given this type of uncertainty, the State (and its local government partners) would be well advised to take specific action that supports economic alternatives.

12. Incent industry entry for renewable energy technology and processes. New Mexico enjoys multiple advantages related to certain renewable energy sources. It has both strong wind and abundant sunlight, which are necessary for wind and solar energy production. The State currently has credits available for some technology (such as the Alternative Energy Products Manufacturing Tax Credit), but according to the State Tax Expenditure report, it is underutilized – even though the solar production industry in the state includes existing manufacturers, manufacturing facilities, contractor/installers, solar project developers and distributors. According to the Tax Research Division (TRD), the existing employment eligibility investment threshold requirements may be too high for this credit to be useful to small manufacturers.²¹⁷

It is notable that there are additional energy-related credits that can be applied to the GRT and the PIT, but they are also underutilized (with practically no use at all). Again, the TRD suggests that an alternative approach is necessary, and “If a comprehensive energy-related tax program is being considered, then this credit should be repealed. If no comprehensive program is being developed, then at a minimum, consider allowing the credit to expire.”²¹⁸

²¹⁵ Filipe Barbosa, Giorgio Bresciani, Pat Graham, Scott Nyquist, and Kassia Yanosek, “Oil and gas after COVID-19: The day of reckoning or a new age of opportunity?” McKinsey and Company, May 15, 2020, accessed electronically at <https://www.mckinsey.com/industries/oil-and-gas/our-insights/oil-and-gas-after-covid-19-the-day-of-reckoning-or-a-new-age-of-opportunity>

²¹⁶ Tom Sanzillo and Suzanne Mattei, “New Mexico’s Risky Reliance on Oil Revenue Must Change: Industry Fundamentals Point to Long-Term Decline,” Institute for Energy Economics and Financial Analysis, October 2020, accessed electronically at https://ieefa.org/wp-content/uploads/2020/10/New-Mexicos-Risky-Reliance-on-Oil-Revenue_October-2020.pdf

²¹⁷ “New Mexico Tax Expenditure Report,” New Mexico Taxation and Revenue Department, 2018, p. 35

²¹⁸ *Ibid.*, p. 31.

Besides the opportunity to diversify the State's economy, the jobs created by renewable energy sources pay well and are positioned throughout the economy. These include workers involved in production and transmission as well as those who install and maintain equipment, such as solar photovoltaic installers and construction workers who make buildings more energy efficient.²¹⁹

Other states have been able to better use these types of credits to build out their renewable energy industry. For example, Oklahoma has used a refundable credit for wind and solar power generation facilities to create a thriving industry. Prior to its refundable credit, in 2002, no electricity from wind power was generated in Oklahoma, but by 2018 27.3 million megawatt-hours were generated by wind facilities in the State, Oklahoma is now the third-ranked state (behind Texas and Iowa) in electricity generated by wind facilities. In 2002, just 6.7% of the state's electric power was generated by renewable sources; in 2015, that had grown to 30.3%. New Mexico should undertake a similar effort focused on growing its renewable energy industry.

At present New Mexico is largely relying on the Renewable Portfolio Standard (RPS) as the engine for development of the industry. A RPS requires that a specified percentage of the electricity that utilities sell comes from renewable resources. According to the NCSL, roughly half of the growth in U.S. renewable energy generation since the beginning of the 2000's can be attributed to state renewable energy requirements.²²⁰

While most state targets are between 10% and 45%, 14 states (California, Colorado, Hawaii, Maine, Maryland, Massachusetts, Nevada, New Mexico, New Jersey, New York, Oregon, Vermont, Virginia and Washington) have requirements of 50% or greater. In New Mexico, the Energy Transition Act (2019) set statewide standards for renewable energy of 40% by 2025; 80% renewables by 2040; 100% of electricity supplied by zero-carbon resources by 2045.

13. Leverage the State's anchor institutions to capture the benefits of agglomeration economies and industry clusters. New Mexico is home to two U.S. Department of Energy national laboratories – Sandia National Lab and Los Alamos National Lab – as well as the Air Force Research Lab, and several universities and related institutions, such as the University of New Mexico and the University of New Mexico Health Sciences Center, New Mexico Tech, and New Mexico State University. These are just a few examples of regional assets that concentrate highly-educated workers and can be leveraged to generate the agglomeration effects that are essential to economic growth.²²¹

The State is already investing in these anchor institutions through the support of technology parks, such as Sandia Science and Technology Park, and collaborative research efforts, such as the New Mexico Consortium. While the evidence on the efficacy of technology

²¹⁹ Joseph W. Kane and Ranjitha Shivaram, "How Clean Energy Jobs Can Power an Equitable COVID-19 Recovery," Brookings Institution, September 10, 2020, accessed electronically at https://www.brookings.edu/blog/the-avenue/2020/09/10/how-clean-energy-jobs-can-power-an-equitable-covid-19-recovery/?utm_campaign=Brookings%20Brief&utm_medium=email&utm_content=95022469&utm_source=hs_email

²²⁰ "State Renewable Portfolio Standards and Goals," National Conference of State Legislatures, April 17, 2020, accessed electronically at <https://www.ncsl.org/research/energy/renewable-portfolio-standards.aspx>

²²¹ Enrico Moretti, *The New Geography of Jobs* (Boston: Houghton Mifflin Harcourt, 2012).

parks is mixed, the State could look at examples, such as the Research Triangle Park in North Carolina, that have been successful in capitalizing regional anchor institutions into broader economic growth.²²² Further, as the continued increase in urban employment and migration highlight the benefits of spatial agglomeration, the State could reexamine its existing technology parks to assess whether there are opportunities for strategic land-use and development decisions to create the sort of “collisions” and tacit knowledge transfer that drive innovation in high-density locations.²²³

This type of effort is underway in Albuquerque through a public-private partnership involving the City of Albuquerque, the University of New Mexico, Central New Mexico Community College, Bernalillo County and Nusenda Credit Union. As part of a seven-acre Innovate ABQ Campus, the Rainforest was constructed as a \$35 million mixed use building and the anchor of structures that will be built on the campus over several years. Among the facility’s tenants are smaller high-tech start-ups as well as large organizations, including the Air Force Research Laboratory and Sandia National Laboratories. The Innovate ABQ campus is not scheduled for completion until 2025 at the earliest and could cost as much as \$150 million in total.²²⁴

- 14. Expand well-paying, middle-skill manufacturing jobs through targeted job training and workforce intermediaries.** It is important for the State to focus on creating family-sustaining jobs that are available to a broad range of workers, not just those with multiple postgraduate degrees. An emphasis on increasing manufacturing employment in the state was discussed in conversations with state government officials as part of the project process. Manufacturing employment has steadily declined as a share of non-farm employment in New Mexico from 6.5% in 1990 to 3.2% in 2018. The shock to global supply chains caused by COVID-19 may provide an opportunity for the State to encourage the localization of manufacturing as firms may see value in reshoring their production processes to improve the resiliency of their supply chains.²²⁵

One strategy to increase the number of well-paying manufacturing jobs the State could pursue is to create a coordinated job training and workforce intermediation program that supports the production needs of key industries in the State. This program could also help spatially distribute employment across the state so that jobs are not unevenly concentrated in a few metro areas or counties. In North Carolina, the State partnered with its community colleges and life sciences firms to create a training program that prepares students to work as process technicians for biotechnology, pharmaceutical, or chemical manufacturing companies.²²⁶ The program leverages the State’s comparative advantage in the life sciences industry by expanding the types of jobs available in the sector to include production and manufacturing, not just research and development. Research has shown that North Carolina’s training program has been effective in improving employment

²²² Christopher Cirillo, “Birth of an Idea: The Creation of Research Triangle Park and its Sustained Economic Impact on the Research Triangle Area,” April 2018.

²²³ Bruce Katz and Julie Wagner, “The Rise of Innovation Districts: A New Geography of Innovation in America,” *Brookings Metropolitan Policy Program*, May 2014.

²²⁴ “What’s happening at Lobo Rainforest one year in,” Albuquerque Business First, August 27, 2018, accessed electronically at <https://www.bizjournals.com/albuquerque/news/2018/08/27/whats-happening-at-lobo-rainforest-one-year-in.html>

²²⁵ Andrew Fish and Honora Spillane, “Reshoring Advanced Manufacturing Supply Chains to Generate Good Jobs,” *Actionable Ideas for Economic Recovery in American Cities Essay Series*, Brookings Metropolitan Policy Program, July 2020. There is also research that suggests locating production closer to the research and development of products is beneficial for both the manufacturers and researchers. Jennifer Clark, *Working Regions* (London: Routledge, 2013).

²²⁶ <https://www.ncbionetwork.org/biowork>

outcomes for a diverse range of participants, especially less-educated workers, through its targeted curriculum and role as a workforce intermediary.²²⁷

It should be noted that New Mexico has administered the Job Training Incentive Program (JTIP) since 1972 to provide funding for job-training for new positions in New Mexico companies that are expanding or relocating to the State.²²⁸ In 2018, a total of 1,736 workers were trained through JTIP and the average wage of JTIP-funded jobs was \$21.48.²²⁹ However, the JTIP is focused on assisting individual companies as their expansion or relocation needs arise, compared to the North Carolina model which takes a broader, sectoral approach to job training and serves as an active intermediary to match workers and employers.

²²⁷ Nichola Lowe, "Responding to Diversity: Workforce Intermediation in a Transitioning Regional Economy," *Environment and Planning C: Government and Policy*, volume 28, 696-713. Accessed electronically at https://www.researchgate.net/publication/46560048_Responding_to_diversity_Workforce_intermediation_in_a_transitioning_regional_economy. The paper notes that the workforce intermediary role of community colleges is especially valuable for workers as an alternative institutional structure to labor unions as union participation declines. In New Mexico, 7.1% of wage and salary workers were members of a union compared to 10.1% of workers nationally in 2019 (U.S. Bureau of Labor Statistics, Current Population Survey).

²²⁸ <https://gonm.biz/business-development/edd-programs-for-business/job-training-incentive-program>

²²⁹ New Mexico Economic Development Department. "FY18 Annual Report," p. 16. Accessed electronically at https://gonm.biz/uploads/documents/publications/FY18_Annual_Report.pdf

Appendices

Appendix A: List of Interviewees

Name	Organization/Affiliation
Mark Lautman	Independent Economic Development Consultant
Jim O'Neil	O'Neill Consulting LLC
Richard Anklam	New Mexico Tax Research Institute
Jim Peach	New Mexico State University
James Jimenez	New Mexico Voices for Children
Suzanne Bruckner	Sutin, Thayer & Brown
Ben Roybal	Betzer, Roybal, & Eisenerg PC
Laird Graeser	Former Tax Research Director and LFC Economist
Harry Relkin	Relkin Law Firm
Jon Clark	Economic Development Department
Representative Angelica Rubio	House District 35
Janet Peacock	Senate Finance Committee
Helen Hecht	Multistate Tax Commission
Dawn Iglesias	Legislative Finance Committee
David Abbey	Legislative Finance Committee
Senator Clemente Sanchez	District 30
Senator John Arthur Smith	District 35
Representative Jason Harper	District 57
Secretary Sarah Cottrell Propst	Energy, Minerals and Natural Resources Department
AnnaLind Weller	Energy, Minerals and Natural Resources Department
Senator Peter Wirth	District 25
Representative Patricia Lundstrom	District 9
Lieutenant Governor Morales	Office of the Lieutenant Governor

Appendix B: Prior Tax Studies

The following provides brief overviews of prior tax studies (discussed in the New Mexico Tax/Revenue Structure chapter) and the issues they raised. They are presented in chronological order. There are a handful of other studies or reports that are not presented, primarily because they were either very broad or very specific topic discussions that are not as applicable to this project.²³⁰

The recommendations (and any numbers contained within the summary) come directly from the reports or studies. In some instances, these recommendations have been super-ceded by more recent tax law changes. Estimates of revenue changes from the recommendations are also estimated as nominal dollars and have not been adjusted for inflation.

Professional Tax Study Committee Report, 1996

Background

The Legislature and the Governor authorized the creation of a tax study committee in 1994 to “examine the manner and purpose of taxation and the foundation and goals of current and recommended tax policy.” The Professional Tax Study Committee (PTSC) was to report its findings and recommendations to the Legislature prior to the 1996 legislative session. Beginning in May, 1994, the PTSC held regular, monthly meetings that were open to the public. Each meeting was conducted to allow for open discussion between PTSC members, state agency representatives and interested parties representing individual taxpayers, organizations, associations and business.

Even with two years of study, it was not enough time for the Committee to address each New Mexico tax. The resulting report did not address the Personal Income Tax, Severance Taxes and the Property Tax. Because the Committee decided to give the gross receipts and compensating taxes, the crux of New Mexico’s tax base, lengthy review, it did not review these other taxes.

In its deliberations, the PTSC was to review the state’s tax laws from a tax policy perspective, and the Committee used the following tax policy criteria in its assessment:

- Adequacy
 - Equity
 - Efficiency
 - Simplicity
-

The PTSC addressed several key issues, including pyramiding. PTSC categorized it into transactional or direct and indirect pyramiding. “Taxation of the sale of tangible personal property both on the sale by a distributor to a retailer and a retailer to a consumer is an example of the first type of pyramiding. GRT provides mechanisms to avoid most (but not all) pyramiding of this type. Taxation of both the sale of fuel to an electric utility to produce electricity as well as the sale of the electricity to the consumer is an example of the second type of pyramiding. GRT may or may not provide a mechanism to eliminate pyramiding of this type.” They reached several conclusions on pyramiding:

- Virtually every industry segment analyzed suffers from some tax pyramiding under GRT.
- Only a few sectors suffer from material levels of transactional pyramiding, such as government contracting.
- Virtually all industries suffer from some form of indirect tax pyramiding, which, depending on the industry, may or may not be significant.
- The ability of a taxpayer to take advantage of GRT’s provisions eliminating transactional tax pyramiding may depend on the sophistication of the taxpayer.

Recommendations

The Committee considered substantial changes to the GRT, providing, in Appendix B, 25 modifications (one of which had 19 sub-parts). These modifications mostly expanded the tax base, but in three cases would shrink the base (primarily to deal with issues of pyramiding).

The most substantial of the recommendations to expand the GRT base included:

- Repeal GRT exemptions/deductions for agricultural products; storing of crude oil, natural gas and liquid hydrocarbons; aviation fuel; chemicals and reagents.
- Repeal GRT exemption for receipts derived from 501(c)(3) non-profits, including hospitals, engaged in business in New Mexico.
- Repeal the deduction for 50% of receipts of ‘for profit’ hospitals.
- Repeal deduction for sales of tangible personal property to 501(c)(3)’s.
- Repeal the insurance premium tax on MCOs and replace with a GRT.
- Repeal the motor vehicle excise tax and replace with a GRT.
- Impose compensating tax on use of transportation equipment in New Mexico.

Project Team’s Commentary

The members of the PTSC were highly experienced State taxation subject matter experts, and they provided several in-depth recommendations. These touched on equity issues related to the GRT’s application as well as opportunities to expand its base to increase its sufficiency. The PTSC recommendations, in some instances (including replacement of a premium tax and a motor vehicle excise tax) substituted the GRT for other excise taxes. In these cases, the excise tax rates were lower than the GRT rate, and they did not include local options or a municipal credit, which means that the entirety of the revenue flows to the state (a revenue sufficiency measure). The focus placed on the GRT in general is a common thread that runs through many of the studies.

Blue Ribbon Tax Commission Final Report, 2003

Background

The Blue Ribbon Tax Reform Commission (2003 Commission) was created by the state legislature in 2003. According to the introduction of the final report, the Commission grew out of a “widespread feeling that New Mexico's tax system no longer fully meets the state's diverse needs.” The introduction also suggested that the state system had, over time, gotten out of step with the state and national economies. There was also a concern that changes to the state tax structure had been ‘piecemeal’ and there was a need for a fundamental realignment of the tax system to better align with evolving state goals. It was also noted that newly elected Governor Bill Richardson's desire to make the state attractive to the business world and to bring high-paying jobs to the state also provided an impetus for the Commission.

The Commission included 23 members, including 10 members of the legislature and 13 public members. The 2003 Commission goal was to create a tax system that is balanced and maximizes economic development while providing sufficient government revenues. The Commission noted that one of the larger concerns expressed to it was the level of pyramiding in the GRT. Other primary issues related to corporate income tax reporting, cuts in the personal income tax, and burdensome administration of the tax code. The Commission examined 196 separate tax change proposals and adopted 71 recommendations.

According to a later review of the 2003 Commission, it focused on eight key issues when formulating its recommendations:

1. Tax relief for low and middle-income families;
2. Gross receipts tax of medical practitioners and hospitals
3. Gross receipts tax on food for home consumption
4. Tax treatment of commercial active nonprofits
5. Personal income tax rates and capital gains
6. State road fund sources
7. Liquor and other excise taxes
8. Corporate income taxes

It is notable that there were reductions in personal income tax rates and taxes imposed on capital gains during the 2003 regular session, and these changes had significantly reduced state tax revenue. Since the cuts to personal income tax rates and taxes on capital gains primarily benefited higher income taxpayers, the 2003 Commission recommendations included changes to taxes paid by New Mexicans in the remaining income cohorts.

Given the already enacted major revenue reductions, the 2003 Commission also sought to present a revenue package of proposed tax law changes. Some major areas for consideration, such as pyramiding of the gross receipts tax, were not fully addressed, perhaps because of time constraints (the Commission completed its work and issued its final report within a 5-month period) or the lost revenue associated with reducing pyramiding.

As it relates to key tax principles, 2003 Commission recommendations included:

Equity

- Expand the low-income comprehensive tax rebate;
- Restore progressivity in the income tax and cap the capital gains deduction (however, they recommended not capping the deduction for closely held New Mexico companies, to spur economic development);
- add an income tax exemption of up to \$3,000 for families below the median income for their filing status;
- Provide a gross receipts deduction for health practitioners for receipts from managed care contracts or Medicare Part C payments;
- Expand the GRT deduction for for-profit hospitals from 50% to 100% to treat virtually all hospitals similarly;
- Go from a three to a two-bracket CIT with the top rate reduced from 7.6% to 6.4%, to align with the top PIT rate unitary reporting (it was also argued that this would be economically efficient).

Economic Efficiency

- Repeal the “next sale taxable” provision of the GRT, which would reduce pyramiding, except for sales to governments and nonprofits.²³¹

Revenue Sufficiency

- Apply a compensating (in other states known as a use) tax to all services, as opposed to only tangible goods (which would address sufficiency and equity concerns);
- Adopt combined unitary reporting for CIT (this can, for firms only located in New Mexico, be an equity issue);
- Increase gas and special fuel tax rates; increase vehicle registration and other fees.
- Increase the Oil and Gas Emergency School Tax rate on oil to 4% (this is equal to the rate on natural gas so also can be considered an equity issue).

The commission made no recommendations on the following:

- Gross receipts tax on food: commission believed expanding the LICTR and establishing a new personal income exemption was preferable to eliminating gross receipts tax on groceries;
- Personal income tax rates: The commission studied delaying or eliminating the later phases of the income tax rates enacted in 2003 but made no recommendation;
- Liquor excise tax: this is an issue that the full legislature needed to consider because of the larger issue of alcohol abuse in the state.

²³¹ The required taxability of the subsequent resale of a service is known as the “next sale taxable provision”. The provision prevents a service from being resold without tax in two consecutive transactions, which causes multiple incidences of tax when long chains of subcontractors are involved, such as in defense work. Removing the next sale taxable provision is an option to prevent excessive taxation of a service for resale. The Commission noted that striking the “next sale taxable” requirement would reduce tax pyramiding.

Additional Recommendations

As already noted, the 2003 Commission made a total of 71 recommendations. These touched on all major state taxes – GRT, PIT, CIT as well as severance taxes. It also made recommendations related to various excise taxes, property taxes and vehicle registration fees. A listing of additional recommendations can be found in the Appendices.²³²

Project Team's Commentary

This was a wide-ranging and ambitious review of the overall state tax and revenue structure. The Committee formed multiple subcommittees, and they each provided written reports for their areas of interest. In all, it was a comprehensive look at the state tax structure.

As might be expected from this type of review, there was a fair amount of 'give and take' in the final recommendations, with a variety of overall impacts (some positive and some negative) on annual state revenues. As with most of the comprehensive studies, there was significant attention paid to the GRT, particularly the burden it placed on some taxpayers and its distortionary impact on market-based decisions.

The outcomes associated with the 2003 Commission are discussed in more detail in the 2009 presentation to the Legislative Finance Committee by Thomas Clifford and Becky Gutierrez.

Pyramiding Transaction Taxes in New Mexico: A Report on the Gross Receipts Tax, 2005, Manuel del Valle, Ph.D., Director of Research, New Mexico Tax Research Institute

Background

Pyramiding was an issue of concern for both the PTSC and the Blue Ribbon Commission. The study objective was to estimate the extent of pyramiding in the administration of the state GRT. The study did not make recommendations related to its findings, and it acknowledged that pyramiding occurs in all transaction tax systems.

Pyramiding Defined

The study defined pyramiding of taxation in state transaction taxes as when the tax is paid by successive sellers of products and services as those products and services are sold and the subsequent seller is subject to the tax upon its sales (assuming no suspension mechanism exists allowing a deduction, exclusion or exemption on the successive sales). As a result, the tax becomes part of the base for subsequent prices and final purchasers pay a greater amount of tax because prior taxes have become part of the subsequent tax base.

Key Findings (expressed in 2005 dollars)

- A few sectors purchase significant amounts of inputs from other sectors and are more susceptible to pyramiding (absent suspension mechanisms). These are (in terms of

²³² 2003. Final Report of the Blue Ribbon Tax Reform Commission, accessed electronically at <http://www.nmlegis.gov/lcs/fileExists/interimreports/brtrc03.pdf>

business inputs as a percentage of total industrial output) mining (42%), agriculture (41%) and manufacturing (36%).

- Total purchases of business inputs were approximately \$19.6 billion, which means the State could be receiving \$1.175 billion from GRT on these inputs. However, \$426 million in pyramiding relief existed through suspension mechanisms.
- As a result, \$748 million was being collected as a result of pyramiding. This represented about 32% of GRT revenues collected.
- If the existing pyramiding had been eliminated, the GRT rate would have to be increased by two percentage points to maintain current levels of revenue. Because the analysis was static rather than dynamic, it did not account for possible demand reductions due to price elasticity and the impact these might have on the rate increase necessary to maintain then current levels of revenue.

Project Team's Commentary

This study provided a quantitative analysis of the amount of pyramiding in the State GRT, and it is frequently quoted/relied upon by others when discussing or analyzing this subject. The topic of pyramiding is frequently addressed when discussing general sales and gross receipts taxes. It is important to understand the impact of pyramiding on impacted taxpayers and the overall economy.

As has been noted, common principles of taxation recognize the value in equitable treatment of taxpayers. Equity can be difficult to achieve when taxes are levied on inputs into a finished product or service. One common argument against gross receipts taxes is that they benefit vertically integrated companies, as the inputs into the finished product or service are not taxed; thus, a company with its own accounting, legal, advertising, marketing or other services division will not pay tax on those separate inputs, while a (presumably smaller) company that purchases those services will have the gross receipts tax imbedded in the cost of those services, which it will then likely have to pass along as part of the final price of the good or service. Gross receipts taxes may also disproportionately benefit higher valued added industries with fewer inputs into a finished good or service.

Many studies have examined tax pyramiding, particularly around state general sales and use taxes. The Council of State Taxation (COST) and Ernst and Young have conducted regular studies related to the impact of imposing sales taxes on business inputs. According to COST, New Mexico has the highest share of business inputs subject to sales tax (43%). The next highest state was Hawaii (40%). After those two, there is a considerable drop – to South Dakota and Connecticut at 28%.²³³

²³³ Ibid., p.27.

According to an analysis done by the Hawaii Department of Taxation, tax pyramiding from its General Excise Tax (GET) adds 19.4% to its tax collections, which is considerably lower than the findings in this report for New Mexico.²³⁴

COST's most recent study, released in May 2019, found that in FY2017, sales tax systems imposed \$157.4 billion of taxes on business-to-business sales of products, services and equipment. This represented 41.7% of total state and local sales taxes.²³⁵

Blue Ribbon Tax Reform Commission and Review of Credits and Exemptions Adopted Since 2003

Presented to the Legislative Finance Committee, August 13, 2009; Thomas Clifford, PhD, Chief Economist and Becky Gutierrez, Senior Economist.

Background

The Great Recession in the U.S. spanned the period from December 2007 to June 2009, and the impacts of that deep recession were felt for many months (even years) thereafter. It is therefore not surprising that the Legislative Finance Committee was interested in reviewing recently enacted state tax credits and exemptions. In this case, the Committee took as its starting point those enacted since 2003 – the year when the Blue Ribbon Tax Commission issued its report and recommendations, many of which were enacted.

The report identified the following as 2003 Commission recommendations that had been adopted by the Legislature and the Governor in subsequent years:²³⁶

- Income tax credits and exemptions targeted at low- and middle-income households;
- GRT deductions for medical service providers;
- GRT credits for hospitals;
- Consolidate the head of household filing status with married filing joint;
- Provide motor vehicle excise tax relief for fuel-efficient vehicles;
- Provide a small business R&D GRT holiday;
- Create a high-wage jobs credit;
- Expand the Governmental GRT²³⁷ tax base;

²³⁴ While this may be attributed to the structure of Hawaii's general excise tax (for example, a 0.5% rate on wholesaling, manufacturing, producing and wholesale services, while retail and all others are taxed at a 4.0% rate), it also may be due to Hawaii's economy, as it is isolated from other states and its businesses are less likely to be part of interstate supply chains.

²³⁵ "The Impact of Imposing Sales Taxes on Business Inputs," prepared for the State Tax Research Institute and the Council on State Taxation by Ernst and Young, May 2019, p.2. Accessed electronically at https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/news/2019/06/ey-the-impact-of-imposing-sales-taxes-on-business-inputs.pdf

²³⁶ "Recommendations of the Blue Ribbon Tax Reform Commission and Review of Credits and Exemptions Adopted Since 2003," Thomas Clifford and Becky Gutierrez, presented to the Legislative Finance Committee, August 13, 2009, accessed electronically at https://www.nmlegis.gov/Entity/LFC/Documents/Money_Matters/Review%20of%20Findings%20of%202003%20Blue%20Ribbon%20Tax%20Commission%20-%20Review%20of%20Tax%20Credits%20and%20Exemptions%202003%20-%20August%202009.pdf

²³⁷ The state imposes a governmental gross receipts tax of 5.00% on the receipts of New Mexico state and local governments, with the exception of the gross receipts of public school districts and entities licensed by the Department of Health that are principally engaged in providing health care. Governmental gross receipts include the sale of tangible personal property, other than water, from

- Increase GRT authority for counties;
- Tax administration proposals.

The update also identified Commission recommendations that have not been adopted by the Legislature, as well as the estimated fiscal impacts of these recommendations. Among those with the greatest fiscal impact included:

- Phase out capital gains deduction but continue to allow the deduction for closely-held New Mexico businesses, +\$14 million;
- Repeal the 'next sale taxable' requirement for GRT deduction, -\$30 million;
- Reduce the CIT rate and require unitary reporting, -\$2 million;
- Impose the local option compensating tax and apply compensating tax to imported services, +\$15 million;
- Enact property transfer tax on residential property re-sales, +\$12 million;
- Raise motor vehicle excise tax rate to 4.5%, +\$41 million;
- Increase school tax rate on oil to 4% from 3.15%, +\$30 million.

The report concludes by listing the credits and exemptions adopted since the 2003 Commission, while analyzing them in relationship to key tax policy principles. When examining the use of credits and exemptions since the Blue Ribbon Commission, the report divided them into four broad categories. Those categories and the estimated annual General Fund impact (all expressed in FY2005 dollars) are:

- **“Family” Tax Relief (-\$138 million).** Examples include the Working Families Tax Credit and the Low Income Personal Exemption. These focus on maintaining tax equity but create tension with issues of tax adequacy.
- **Medical Services (-\$67 million).** During the period under examination in this report, the state provided a deduction for medical services provided by managed care organizations, a GRT deduction for hospital construction, a GRT credit for uncompensated care, a GRT credit for hospital operations and an income tax credit for rural health practitioners. While the method of taxation has changed for these entities, these created conflicts with tax adequacy and, for the GRT deductions or credits, concerns about equity and simplicity.
- **Economic Development (-\$95 million).** Tax credits approved have included the High-Wage Jobs Tax Credit, the Small Business Research and Development Tax Holiday, the Film Production Tax Credit and others. These also raise issues of adequacy and, because some businesses within an industry (or an industry itself) are treated differently,

facilities open to the general public; refuse collection and/or disposal; sewage services; the sale of water by a utility owned or operated by a county, municipality or other political subdivision of the state, and the renting of parking, docking, or tie-down spaces, or the granting of permission to park vehicles, tie-down aircraft, or dock boats (Section 7-9-3.2 NMSA 1978). The state distributes the governmental gross receipts tax dollars to the Public Project Revolving Fund at the New Mexico Finance Authority, the Energy, Minerals and Natural Resources Department, and the Department of Cultural Affairs. Accessed electronically at <http://www.tax.newmexico.gov/Government/governmental-gross-receipts-tax.asp>

equity concerns. There are also concerns that these favorable tax treatments substitute political decisions for market-based decisions are inefficient.

- **Renewable Energy (-\$11 million).** During the period under study, the state created Solar Market, Renewable Energy Production, Sustainable Building and Renewables Powered Generating Plants tax credits as well as GRT deductions for wind and solar facilities (some with sunsets). These impacted tax adequacy, and the report suggests they be evaluated on a cost-benefit basis related to growth in the renewable energy sector and positive impacts it generates for the State.

The report concludes by noting that the combined credits and exemptions created since 2003 reduced state General Fund revenue by \$345 million. It also concludes that “a piecemeal approach to tax policy has not served the state well. Not only are tax provisions targeting a particular policy goal not well coordinated, the relation between tax policy and expenditure policy in the same areas is seldom addressed. The implication is that the efficiency, equity, simplicity and accountability in the use of state funds may be seriously compromised.”

Project Team’s Commentary

The report introduces the tax policy principles adopted by the Legislative Finance Committee and analyzes tax changes based on those principles. The credits and exemptions enacted since 2003 are significant, and, as the report indicates, they often create conflict among tax policy principles.

Government Restructuring Task Force: Final Report, 2010

Background

The Task Force was established by the Legislature “to study the resources of state agencies, programs, services, funding and policies and the public needs served by them, including recommendations of the 2009 governor’s committee on government efficiency (the Carruthers committee); the need for consolidation of agencies and elimination or reduction of redundant, duplicative or overlapping programs and services; and current and projected revenue estimates for the next three to five years.”

The Task Force was appointed while the State (and the nation as a whole) was dealing with the effects of the Great Recession. While the focus of the Task Force was improving efficiency and prioritization in service delivery, there was also some discussion of additional revenue generation opportunities for the State (which took up just a handful of pages in the 226-page final report). Most of its recommendations were targeted at tax and revenue adequacy and sufficiency.

The key revenue opportunity investigated by the Task Force was to implement a statewide five-mill property tax levy for public education to supplement the General Fund. This was projected, at the time, to generate approximately \$261 million in additional revenue in FY2010 (based on

assessed property values prior to the Great Recession, so that number at that time may have been overstated). It would also have required an amendment to the New Mexico State Constitution.

Beyond the main proposal, the Task Force identified some additional proposals that might also raise additional revenue. These included:²³⁸

- **Increase the property tax valuation from 33.3% to 40%** (also requiring a change to the State Constitution); which would have raised approximately \$177 million in General Fund revenue and \$59 million in direct school district revenue in FY 2010.
- **Increase the distribution of the land grant permanent funds**; because the recession affected the value of the land grant permanent funds, it negatively impacted the income for beneficiaries of the funds, as distributions are based on their five-year average market value. In 2008, at a 6.5% distribution, the increase was projected to total \$103 million for FY 2013. Other percent increases would vary the increase.
- **Equalize the oil and gas emergency school tax at 4% on all products subject to the tax** (oil and carbon dioxide are taxed at lower rates than the 4% tax on natural gas.) To make the revenue applicable to schools, the recommendation would distribute some percentage of the net receipts attributable to the tax to the public school fund. It was estimated that the increased tax would have generated approximately \$29 million in FY2013.
- **Equalize the oil and gas emergency school tax and increase the tax by 1%, and swap out the increase for a decrease in severance tax, which makes it revenue neutral for taxpayers.** This would have generated approximately \$101 million for school funding in FY2013, with a corresponding reduction in severance tax income for the State.
- **Remove yield control on property tax for school districts.**²³⁹ This would have generated an additional approximately \$6 million in General Fund and \$2 million in direct school district revenue in FY 2013.

²³⁸ Government Restructuring Task Force, Final Report, 2010, p. 163-164, accessed electronically at <https://www.innovations.harvard.edu/sites/default/files/opex/documents/New%20Mexico%20Government%20Restructuring%20Task%20Force%20Report.pdf>

²³⁹ States often impose restrictions on the growth in assessed value to limit the growth in property taxes, and yield control is a method that is in place in New Mexico. Section 7-37-7.1 NMSA 1978 ("Additional limitations on property tax rates") is commonly referred to as the "yield control statute" because it limits revenue yields that result when property values are increased due to reassessment. Yield control reduces certain property tax rates from the tax rate as originally imposed ("imposed rates") to the rates actually applied against reassessed property ("yield controlled rates"). In general, yield control does not apply to debt service levies. The result in a district in which reappraisals have increased values is that property tax rates are reduced so that, when applied to the new property values including the reappraised values, they yield only the limited revenue growth allowed. In short, rates are adjusted downward in the same proportion that reappraisals have increased total values. See New Mexico Department of Finance and Administration, Budget & Finance Bureau: Property Taxes & Annual Reports: Yield Control Formula, accessed electronically at [http://www.nmdfa.state.nm.us/Yield_Control_Formula.aspx#:~:text=Yield%20control%20reduces%20certain%20property.%E2%80%9Cyield%20controlled%20rates%E2%80%9D\).&text=The%20percentage%20increase%20in%20property.and%20improvements%20to%20existing%20property.](http://www.nmdfa.state.nm.us/Yield_Control_Formula.aspx#:~:text=Yield%20control%20reduces%20certain%20property.%E2%80%9Cyield%20controlled%20rates%E2%80%9D).&text=The%20percentage%20increase%20in%20property.and%20improvements%20to%20existing%20property.)

- **Revert the school equalization guarantee (SEG) and the public school fund to the state school support reserve and change the law to allow the money to be used for school shortfalls.**

Besides the specific recommendations, the Task Force also highlighted what it considered important short and long-term goals to assist in improving the financial picture for the state. In the short-term (identified as 2011 to 2013), the Task Force identified five fiscal goals, one of which was a “Tax Code review, particularly credits, exemptions, deductions and tax rates.” The Task Force also identified two long-term goals (for 5+ years), one of which was to “broaden tax base and reduce tax burden.”²⁴⁰

Project Team’s Commentary

At the time of the Task Force deliberations, the State was facing significant financial headwinds. As a result, most of the recommendations targeted tax revenue adequacy/sufficiency. It is notable that at least one of the recommendations, related to raising some severance tax rates, used as justification the differing rates paid by natural gas compared to oil and carbon dioxide (an equity argument).

It is notable that, as part of the Task Force work, an online suggestion website was established for the general public to provide its input. According to the Task Force final report, the two most common suggestions from residents on dealing with maintaining adequate program funding levels were to repeal the 2003 tax cuts, or otherwise increase taxes, for the wealthy; and impose the corporate income tax on out-of-state corporations doing business in New Mexico.²⁴¹

New Mexico Business Tax Competitiveness Study: Updated Results, 2014

Ernst & Young

Background

The study was an update of an analysis done in 2011-2012. The analysis done in 2011-2012 was a collaborative effort of the State, the City of Albuquerque, Bernalillo County, the NM Municipal League and seven private sponsors to fund the NM Tax Research Institute (NMTRI) to engage Ernst & Young to expand on a 50 state study they did on effective state tax rates for certain modeled businesses. This was an update to that study.

The benchmarking focuses on the tax implications of a hypothetical \$100 million investment by corporations in nine different industries in nine states. The corporations are assumed to export 95% of their respective goods and services and are subject to the state corporate income tax.

The study compares eight states with New Mexico -- Arizona, California, Colorado, Nevada, Oklahoma, Oregon, Texas, and Utah. The states’ tax rates were compared before and after the inclusion of existing tax credits and incentives offered by each state. For purposes of determining

²⁴⁰ Ibid., p. 7.

²⁴¹ Ibid., p. 58.

local property tax rates, the study assumed the business location would be in Albuquerque. Another set of results was calculated using Deming, to reflect the differing tax and incentive structures presented by rural communities. Industry sectors studied were headquarters, research and development, office and call center, durable manufacturing, non-durable manufacturing, computer and electronic manufacturing, electrical equipment and aerospace products and parts, management scientific and technical consulting, and food processing.

The 2014 update incorporated the most recent state and local tax rates (effective 12/2013). This was important because there were significant changes to tax rates in New Mexico and in the benchmarked states. For instance, New Mexico GRT rate was increased (by 0.125%, to 5.125% before local option taxes are added), and mill levies in Bernalillo and Luna counties increased as well. Accordingly, New Mexico's effective tax rates on the modeled businesses increased without consideration of other more recent legislative changes. Tax rates in the other modeled jurisdictions had also changed.

In New Mexico, 2012 and 2013 tax law changes directly impacted the effective tax rates of the modeled companies. In 2012, the GRT was eliminated on some manufacturing inputs and consumables. That elimination was phased-in over a five-year period in 20% increments, beginning July 1, 2013. That same legislation also reduced some "pyramiding" of the GRT in the construction industry.

The 2011 and 2014 studies did not consider the negative effects of excessive pyramiding in New Mexico's GRT beyond taxation of direct business inputs, so any potential decrease in the effective tax rate (ETR) presented by the changes to construction related GRT were beyond the scope of the study.

The study also identified tax law changes in 2013 that impacted the effective tax rates for the modeled companies. These included:

- Reduced top CIT rate from 7.6% to 5.9%;
- Provided a single sales factor election for manufacturers who apportion business income to New Mexico;
- Both narrowed and expanded the GRT "consumables" deduction passed in the 2012 session (the former not impacting the ETR calculation as the narrowing impacted businesses outside the scope of this study);
- Narrowed the scope and increased qualifying wage thresholds of the HWJTC; and
- Provided authority for municipal and county governments to each increase GRT rates in 1/8 increments up to 3/8% (to offset the phase-out of the food tax hold-harmless payments the State makes to local governments).

Findings

- Most of the business favorable tax policies enacted in the years between the two studies were targeted toward the manufacturing sector, which saw significant decreases in effective tax rate despite increases in gross receipts and property tax rates, as well as a higher threshold for the High Wage Jobs Tax Credit.

- On a comparative basis, New Mexico now had the lowest effective tax rates to three of the four hypothetical company investments in manufacturing sectors, and the second lowest ETR in the fourth.
- Counter to the historic trend, the bulk of the additional effective rate reduction achieved in the manufacturing sectors since the prior study occurred pre-incentive rather than post. (Recall that New Mexico had the highest effective tax rate in all studied sectors before the application of incentives.)
- Non-manufacturing ETR's faced the same headwind as the manufacturing sectors in terms of the increasing GRT and property tax rates, as well as increased wage thresholds for the High Wage Jobs Tax Credit (HWJTC). However, the only change reducing ETR's in the non-manufacturing sectors was the decrease in CIT rates.

Recommendations/Observations

- Any tax reduction or incentive that offsets taxes due will reduce effective tax rates. Any decision on whether to implement these or other similar options, however, will require consideration of general tax policy objectives, as well. For instance, reducing the effective tax rate imposed on a manufacturer of goods for export could be accomplished in one of several ways--using targeted tax credits, eliminating any tax on inputs, reducing corporate or gross receipts tax rates, or changing corporate income apportionment factors (like the single-weighted sales factor), etc. Each of those options presents different broader tax policy implications to the state's overall tax structure, not to mention differing fiscal impacts to state and possibly local government revenue. If the primary concern is the exporter's effective tax rate, a narrowly crafted solution that minimizes the fiscal impact might suffice.
- Alternatively, broader reform can be accomplished with tax rate reduction or broader revisions to the tax code, but this is a more costly way to lower the effective tax rate for a given sector. While narrower options may be less costly, they may also be seen as less certain and less equitable.

Project Team's Commentary

The study highlights a couple of important tax policy issues. First, it is generally not accurate to make judgements about a tax structure based only on statutory tax rates, as effective tax rates take into consideration the variety of exemptions, deductions, credits and other factors not reflected in statutory tax rates. Second, it is generally not accurate to make judgements about a tax structure based on a single tax – rather it is important to identify the variety of taxes that are paid by individual or business taxpayers. As the study notes, that generally requires an understanding of the interaction of and trade-offs that exist between the various taxes.

New Mexico's Gross Receipts Tax, Compensating Tax, and Personal Income Tax: Considerations and Model Documentation, 2019

Ernst & Young, LLP and Georgia State University

Background

The report/model was commissioned by the New Mexico Legislative Council Services to allow for estimating revenue changes based on changes to the rate or base of the GRT, CIT, and PIT. The report does not explicitly offer recommendations but provides a brief discussion of the strengths and weaknesses of the GRT and PIT structures. Compared to most other states' sales taxes, the New Mexico GRT is broader based because it broadly taxes services. However, the numerous exemptions and deductions to reduce pyramiding narrow its base as a business entity tax. The food sales and prescription drugs deduction are two of the largest deductions in absolute dollar amounts in the GRT. But the reported deductions for retail from the GRT are similar as a percentage of total receipts as other industries. The State is less reliant on the PIT, and residents have a lower PIT tax burden than in peer states and the US as a whole. The remainder of the report is focused on detailing model specifications for each tax-specific model.

Strengths and Weaknesses

The study identifies the following key features as strengths or weaknesses:

- GRT
 - Taxation of services makes the base of the tax broader than most sales taxes and allows the state to derive revenue from services, which match trends in general consumption patterns (*strength related to adequacy*).
 - The GRT has a higher rate and more exemptions/deductions than the GRTs in states that have them (*a weakness as it relates to the taxation goal of the broadest possible base and lowest possible rate*).
 - The structure of the GRT can lead some firms to have tax liabilities that exceed their profits. For example, start-up firms with high operating costs, lower sales, and an inability to vertically integrate may have higher tax liabilities with no profits (*weakness related to horizontal equity and economic efficiency*).
 - The CT rate for services acquired from outside of the state is 5%, lower than the GRT rate for services of 5.125% (*weakness related to horizontal equity*).
- PIT
 - The State PIT is linked to the federal system on a rolling basis. This allows for some administrative efficiencies but limits the state's autonomy to change its system.
 - While it is common for states to link their income taxes to federal standards, many states are linked on a static basis, which means that any changes in the federal system have to be adopted by the state. (*In combination these can be both a strength and a weakness. Requires less administrative effort and provides clarity, which are strengths, but it also ties the state to federal changes that may be a weakness related to revenue adequacy*).

Revenue Stability and Yield

- GRT
 - GRT revenue is quite volatile, primarily due to the effect of oil and gas industry revenue in the tax (*weakness related to volatility and, when the market is down, revenue adequacy*).
 - Volatility can increase with more deductions and exemptions and specifically mentions the food tax, saying that including food in the GRT base tends to reduce volatility but is considered regressive. Some states, like Hawaii and Oklahoma, tax food, and Utah taxes it at a lower rate (*has both strengths and weaknesses; greater volatility is a weakness, but exemptions on necessities like food can reduce regressivity and improve vertical equity, which is a strength*).
 - The volatility of the tax is also higher because the base is business receipts, which are more responsive to changes in economic activity. (*As it relates to revenue yield, the broader base is a strength*)

- PIT
 - PIT is less volatile than its peer states due to a lower share of business and capital gains income subject to tax than other states (*reduced volatility is a strength, although it also reduces overall revenue collections, which can be a weakness*).
 - Not including capital gains in the PIT reduces volatility because it makes it less responsive to changes in the stock market. (*reduced volatility is a strength, although it also reduces overall revenue collections, which can be a weakness*).
 - New Mexico is less reliant on the PIT than other states (*given that this means increased reliance on the GRT in particular, this is primarily a weakness*).

Revenue Adequacy

- GRT revenues generally match the trend in economic activity. GRT revenue rises as economic activity rises. However, over the period from 1998-2016 the revenue from the GRT grew at a slower rate than the state GDP (*matching economic activity to tax collections is generally considered a strength; if the GRT is moving in the opposite direction, that is a weakness related to revenue adequacy*).
- The PIT revenue also tracks roughly with growth in the state's personal income. Over the period from 1998-2016, the PIT grew slightly faster than the state's personal income (*matching economic activity to tax collections is generally considered a strength*).

Tax Burdens

- The ratio of state and local taxes to gross state product in New Mexico is 6.4%, higher than the peer states included in the analysis.
- The business taxes per private sector employees in New Mexico was \$7,000, also higher than the peer states, except for Hawaii, which was also \$7,000.

- The PIT tax burden is lower in New Mexico than in the peer states, except Arizona. PIT revenue as a percent of personal income is 1.76% in New Mexico, while the peer average was 2.66%.

Equity and Fairness

- There is an inverse relationship between taxable receipts and gross receipts under the GRT. Roughly 45% of receipts were taxable for firms with over \$10 million in annual receipts; over 70% of receipts were taxable for firms with less than \$100,000 in gross receipts (*this may be considered a weakness related to horizontal and/or vertical equity*).
- The GRT is regressive as lower income taxpayers pay a substantially higher share of their income on the tax than higher-income taxpayers (*this is generally a weakness related to vertical equity*).
- The PIT is moderately progressive due to the tax brackets and increasing rates as incomes rise (*When taking into consideration the tax structure as a whole, progressive PITS are generally considered to align with vertical equity principles*).

Economic Efficiency & Neutrality

- In the GRT, the effective tax rates for the manufacturing and services sectors are higher than most peer states before any credits and deductions are added. However, once credits and deductions are factored in, they become lower than most peer states.
- The value of incentives in New Mexico, measured by the percent of the incentive of value added, is much higher in New Mexico than in the peer states. It is 4.23% in New Mexico compared to 0.73% in the peer states.

Project Team's Commentary

As the latest of the broad-based studies, the Ernst & Young/Georgia State report provides a timely look at the strengths and weaknesses of the current system. Its findings are similar to those of earlier studies – as is the case in many other states, most personal income tax structures have some degree of progressivity and most broad-based consumption taxes are regressive. There are some specific features (particularly pyramiding in the GRT) that may increase the negative effects of the New Mexico primary method of taxing consumption, and its use of incentives also makes it something of an outlier among the benchmark structures.

It is also notable that this project involved creating a model to be used for tax and other decision making by state policymakers. Multi-year projection models can be helpful for estimating the outcomes of tax policy choices, but it was unclear from our discussions with state policymakers as to whether the model is being used for those purposes.