New Mexico's Gross Receipts Tax

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Background

- Originated in 1935 as Emergency School Tax, applied to all retail sales and virtually all services
- Emergency School Tax replaced in 1966 by Gross Receipts and Compensating Tax Act
- NM, along with HI and SD, continues to tax more services than other states
- Legal incidence of tax is on seller rather than buyer
- Tax rate varies from 5% to 7+ % among localities due to local option municipal and county taxes
- Compensating tax at rate of 5% imposed on out-of-state purchases that would be subject to GRT if bought in NM, but not fully enforced
- GRT most important source of revenue for NM state and municipal governments, with increasing use by county governments.
    - FY 2007 projected revenue $1.8 billion for state and $1.2 billion for local governments
- Tax does not apply to receipts from sale of products and services that are to be resold, exported, or become integral part of final product
    - The buyer's subsequent sale (the resale) must also be subject to either the gross receipts tax or the governmental gross receipts tax
    - If sold to out-of-state buyers, tax does not apply unless risk of loss or title pass in NM
- GRT applies to
    - receipts of US government contractors
    - receipts from sales of intangibles, services, and leases sold to local governments, non-profits, and some Indian tribes
    - governments' receipts from sales, such as water, sewer, tickets on university athletic events
    - franchise fees
- Although GRT applies to receipts from some sales to non-profits, value added by non-profits is not taxed. The continuing increase in the value of goods and services moving through the non-profit sector therefore eats into the GRT base.

Trends

The very broad base implicit in the 1966 legislation has eroded. Much of this erosion reflects a piecemeal effort to reduce pyramiding on the grounds that taxing business-to-business transactions is unfair and increases the cost of producing in NM. Other deductions from the GRT base are rationalized as making NM more competitive and promoting economic development.

The recently legislated deduction of receipts from sale of food and medical services is aimed at making the GRT tax more equitable. The tax is thus departing from a comprehensive consumption tax, and one of most rapidly growing components of base has been eliminated. A perhaps preferable alternative to removing sales of food and medicine from the tax base would have been expansion of New Mexico's "low income comprehensive tax rebate," which could offset taxes on food and medicine paid by low income persons.

These changes in the GRT base have not been the result of a consistent and comprehensive plan either to reduce pyramiding or to make the tax more equitable. Instead, evolution of the GRT has been dictated by literally scores of *ad hoc* changes, the inescapable consequence of which is a highly complex system. This complexity makes tax administration significantly more difficult. And because the tax is not grounded in well understood principles, it is difficult to argue against further arbitrary and complicating changes.

How serious is pyramiding?

Viewed in isolation, pyramiding is undesirable in that it generates artificial differences in relative prices that can lead to inefficient resource allocation. However, it also generates revenue that must be replaced with other taxes if the pyramiding is eliminated. These alternative taxes will likely also have adverse efficiency effects. So a decision to reduce pyramiding entails a choice among second-best alternatives. In this choice, the inefficiencies associated with pyramiding may be regarded as preferable to those that would follow from increases in other taxes, or decreases in government spending and services. There is a similar trade-off on the equity dimension.

In the case of NM, it is fair to say that legislators are aware of these trade-offs, and have decided to move gradually in eliminating the GRT on business-to-business transactions.
An often expressed view is that the GRT as it existed in 1966 compares favorably to the current GRT because of its greater revenue yield, even though pyramiding was surely more serious in the 1966 version.

Available estimates suggest that 15 to 30 percent of GRT revenue is attributable to taxation of business-to-business sales. With the GRT accounting for about one-third of the state's general fund budget, eliminating pyramiding would entail a major increase in other taxes.

Table 1 presents estimates of how pyramiding increases final product and service prices. To gauge *relative* price changes due to pyramiding, sectoral changes should be compared to the average change. (If all prices increase by the average percentage there is no distortion of relative prices.) Calculated in this way, the largest increases are 1.31 and 1.33 percent for the transportation and manufacturing sectors, respectively. Relative price changes of these magnitudes seem unlikely to generate major distortions of resource allocation. Of course, larger changes could arise in some sub-sectors.

Lessons from the NM experience

NM experience suggests that a broad-based GRT is not stable. Over time, pressures to reduce pyramiding will remove many business-to-business transactions initially included in the tax base. The tax will evolve toward a retail sales tax.

But change will not stop there. Further erosion of the tax base will be driven by the now widely held belief among legislators and other politicians that taxes should be used to promote economic development and gain competitive advantage vis-a-vis other states. Also, because tax breaks have become accepted political currency, base-eroding measures favoring particular economic interests may be enacted regardless of their effect on economic development. These latter two pressures are of course not unique to the GRT; they are at work eroding the bases of other taxes – income, sales and property.

In the case of Illinois, a newly implemented GRT may be less complex than the existing CIT. But the relevant comparison is the existing CIT against the GRT as it is likely to evolve in the years ahead. The forces that have eroded the base and increased the complexity of New Mexico's GRT will likely be a work if a GRT is adopted in IL. So it is possible that the complexity of the CIT will simply be replaced over time by the complexity of the GRT.

Stated differently, when a new tax is imposed legislators should consider the evolutionary pressures that will determine the long-run outcome of their legislation. **What you legislate is not what you get.**

States considering a GRT should recognize that there will be pressures to reduce pyramiding if business-to-business transactions are in the tax base. It will be better to deal with these comprehensively in the initial implementation of the tax rather than leaving the door open to *ad hoc* adjustments that play out over time and generate complexity.

Business-to-business transactions can be removed from the tax base through exemption or deduction of receipts from specified transactions. Alternatively, the tax an be imposed on all receipts from all economic activities, with each taxpayer being allowed a credit for tax paid on any purchases it makes in its business operations.

The first, *exemption-deduction* route requires that sales of goods and services be identified as either *intermediate* or *final*, with receipts from the former being excluded from the tax base. The legislation making these distinctions is likely to be voluminous, complicated, and subject to legal dispute; that has certainly been the case in New Mexico.

The second, *credit* route does not require explicit identification of intermediate goods and business-to-business transactions. Instead, all of each business' receipts are taxed at the GRT rate. But each business also receives a credit for the GRT tax paid on its purchases of products and services when calculating its own GRT liability. With each business' tax determined in this manner, the GRT on business-to-business transactions is eliminated, and the GRT on each product or service is determined only by its final sale value. This end result is achieved without the complicated legislation and administration required if a system of exemptions and deductions is used to remove business-to-business transactions from the GRT base. The end result is also equivalent to a retail sales tax, but one that applies to all services, unlike existing retail sales taxes.

Another advantage of the credit approach is that it achieves neutrality between in-state and out-of-state sources of business inputs. A business buying a product from an out-of-state source pays no GRT on that purchase. If it buys the same product from an in-state source, the seller of the product collects the NM GRT, so at that point the in-state source appears more costly. However, when calculating its own GRT liability, the business receives a credit for the NM GRT paid on its purchase from the in-state source, so the net effect is zero tax on the purchase from the in-state source.

New Mexico attempts to achieve neutrality between in-state and out-of-state sources by imposing a compensating tax on all purchases from out-of-state sources of products and services that would be taxed if purchased in NM. However, collection of this compensating tax is far from complete, so neutrality is not achieved. It should be noted that the credit approach does not achieve neutrality when the purchases are final products, rather than business inputs. In this case, the compensating tax is necessary for neutrality.

Table 1. Estimated Effects of Pyramiding on Revenues and Relative Prices, New Mexico, 2005

Sector	GSP 2005 ($ billion) 1	Business-to-Business Sales ($ billion) 2	Potential Tax on Business Purchases, .06xCol. 2 ($ billion) 3	Pyramiding Relief Under Current Law ($ billion) 4	Revenue Due To Pyramiding, Col. 3 - Col. 4 ($ billion) 5	Pyramiding Tax Rate, Col. 5 as % of Col. 1 (%) 6
All private industries	**55998**	**19588.9**	**1175.3**	**426.7**	**748.6**	**1.35**
Agriculture, forestry, fishing, and hunting	1123	1118.8	67.1	45.0	22.1	2.01
Mining	8781	2557.5	153.5	9.1	144.4	1.67
Utilities	1473	445.0	26.7	0.5	26.2	1.81
Construction	3133	1621.8	97.3	71.6	25.7	0.83
Manufacturing	6487	5307.0	318.4	149.2	169.2	2.68
Wholesale trade	2372	536.0	32.2	2.1	30.1	1.29
Retail trade	4654	1303.0	78.2	1.9	76.3	1.67
Transportation and warehousing, excluding Postal Service	1838	990.0	59.4	11.7	47.7	2.66
Information	1802	686.7	41.2	16.9	24.3	1.37
Finance and insurance	2441	881.4	52.9	26.7	26.2	1.08
Real estate, rental, and leasing	6580	761.0	45.7	12.6	33.1	0.51
Professional and technical services, Management of companies and enterprises, Administrative and waste services	6722	1073.3	64.4	1.0	63.4	0.95
Educational services	320	90.4	5.4	4.4	1.0	0.31
Health care and social assistance	4458	1294.0	77.6	51.0	26.6	0.60
Arts, entertainment, and recreation	420	124.0	7.4	2.0	5.4	1.30
Accommodation and food services	1962	545.0	32.7	13.0	19.7	1.01
Other services, except government	1432	254.0	15.2	8.0	7.2	0.51

Source: "Pyramiding Transactions Taxes in New Mexico." New Mexico Tax Research Institute. September 2005