

**Tax Expenditure Budget:
Defining the Benchmark GRT Base**

Thomas F. Pogue

Prepared under contract with the
New Mexico Taxation and Revenue Department
April 2008

Table of Contents

I. Principles of Taxation	page 2
A. Fairness	2
B. Tax Neutrality	3
C. Transparency	3
D. Administration and Compliance Costs	3
II. Benchmark GRT Base Defined as Value of Consumption by NM Residents	4
A. What is Consumption?	4
B. What is Included in the Benchmark Consumption Base?	5
1. Include all receipts from final sales of goods and services	6
2. Do not include business-to-business sales	8
3. Include import but not export sales	9
4. Include goods and services provided by governments and nonprofits	9
5. Adjust benchmark for minimum consumption	11
6. Size of benchmark base	12
C. Summary: Benchmark Consumption Base	12
III. Benchmark GRT Base Defined as Value of Production within NM Borders	12
A. Why Tax Production?	13
B. Implementing a Production Tax	13
C. Summary: Benchmark Production Base	14
IV. A Mixed Consumption/Production Base	14
V. How the Current GRT Base Differs from the Benchmark Bases	16
A. Consumption Base Benchmark	16
1. Add final sales omitted from current base	17
2. Remove business-to-business sales from tax bases	20
3. Adjust taxation related to nonprofits	22
4. Adjust taxation related to governments	24
B. Production Base Benchmark	25
C. Adjusting Other Taxes	25
VI. Summary	27
References	29

Tax Expenditure Budget: Defining the Benchmark GRT Base

Thomas F. Pogue

A tax-expenditure budget lists and provides estimates of the revenue losses attributable to specific departures from “normal” or “benchmark” taxes. The U.S. Treasury first published a list of tax expenditures in 1967, and since 1974 it has been required to publish annually a tax-expenditure budget for the U.S. federal personal and corporate income taxes.¹ Following Treasury’s lead, other countries and some states now publish tax expenditure lists or budgets.

Although tax expenditures have been calculated mainly for income taxes, they can be calculated for other taxes or for tax systems as a whole. This report examines how this might be done for New Mexico’s gross receipts tax (GRT).²

The tax expenditures implicit in New Mexico’s GRT can be defined and measured only with reference to a “normal” or “benchmark” GRT base. This benchmark base is the set of transactions on which the GRT *should* be levied in a properly structured gross receipts tax. It can be defined as the value of all *consumption* by NM residents, or the value of all *production* occurring within NM borders, or some combination of the two. As customarily defined, tax expenditures occur when transactions included in the benchmark base are not taxed, and tax expenditures are measured by the revenues that would be collected if these omitted transactions were in fact taxed. Less commonly recognized are *negative* tax expenditures, which occur when transactions *not included* in the benchmark base are taxed. Negative tax expenditures are measured by the revenue generated by taxing transactions that are not included in the benchmark base.³

Standard tax principles – fairness, economic neutrality, transparency, and low costs of administration, compliance, and enforcement – should be applied in defining the benchmark base. That is, in so far as is possible, the GRT benchmark base should be defined so that the resulting tax 1) is fair, 2) does not distort resource allocation, 3) is easily understood and complied with, and 4) entails low administration and compliance costs.

The next section explains these tax principles more fully.⁴ The following sections define benchmark bases and examine how well each benchmark definition lines up with these principles.

¹ Congress’s Joint Committee on Taxation also publishes an annual tax expenditure budget.

² The exemptions and deductions that give rise to tax expenditures have been a concern of the New Mexico Taxation and Revenue Department for a number of years. See NMTRD (1984; 1997) and Clifford (2006).

³ This paper considers only those tax expenditures due to departures from a defined benchmark base. However, tax expenditures can also arise when credits are given against taxes calculated at the statutory rate(s). New Mexico allows a number of credits against GRT revenues that are intended to encourage a variety of activities. But they also reduce GRT revenues, and they are therefore properly regarded as tax expenditures. Listing and evaluating these credits is beyond the scope of this report.

⁴ For more discussion of these principles, see, for example, Stiglitz (2000, Ch. 17 and 19) and Hyman (2005, Ch. 10-11).

I. Principles of Taxation

A. Fairness

Tax fairness is concerned with how tax burdens – costs of government – are distributed among taxpayers, where a taxpayer can be an individual or a family or other taxpaying unit. Perhaps the most common view is that tax burdens should be distributed according to taxpayers' *ability to pay*. Taxpayers with greater ability to pay should bear an appropriately larger burden than those with a lesser ability to pay (*vertical equity*), and taxpayers with the same ability to pay should bear the same tax burden (*equal-treatment-of-equals* or *horizontal equity*).

Taxes reduce the value of goods and services that a person can acquire through market exchange. A person's tax burden is this forgone value. Persons who are better off in terms of having their needs and wants met are also more able to contribute to the support of government; they have greater ability to pay. A person's ability to pay therefore depends on her income *broadly defined* to include the value of goods and services available to her *from all sources*, and it depends on the goods and services she needs to meet her basic needs. That is, her ability to pay depends on her *monetary* income, but it also depends on the cost of meeting her basic needs and the extent to which she has assistance, from government and other sources, in meeting her needs and wants. Until she has enough income to meet her basic needs, she has no ability to pay; this level of income is often referred to as the tax-free threshold.

A person's ability to pay can also be measured by her consumption – the value of goods and services that she actually uses to meet her needs and wants. Consumption is equal to income if a person actually consumes currently all of the goods and services that are available to her, but no more. In this case she neither saves nor dissaves. Consumption falls short of income when she consumes less than the goods and services available to her, putting some of them aside for future use (future consumption). In this case, she saves. Consumption exceeds income when she consumes more goods and services than are available from her income – when she borrows to buy additional goods and services. In this case, she dissaves. When a person saves, she defers consumption to the future; when she dissaves, she consumes more currently but must consume less in the future when she repays her borrowing. For most people, income and consumption balance out over their lifetimes. So the main difference between consumption and income as measures of ability to pay is in the timing of the measure, and therefore the relationship of tax payments to the measure. The two measures are equivalent over the entire lifetimes of most individuals, but over any shorter period, such as a year, they are likely to differ. Economic theory alone does not indicate whether income or consumption best measures "ability to pay."

An alternative to the ability-to-pay principle is that burdens should be allocated according to taxpayers' *benefits* from government services. Taxpayers who receive greater benefits from government should pay appropriately higher taxes, and those who receive the same

benefits should pay the same taxes. The benefit of a government service can be measured by the cost of providing it or it can be measured by its value to the persons receiving it.

B. Tax Neutrality

As a general rule, tax neutrality, or tax efficiency, requires that all lines of production and all forms of consumption be taxed uniformly, so that relative costs of production and consumption are unchanged. In other words, a tax is not neutral if it provides incentives to reallocate production or consumption among various products and services. For example, a separate tax on synthetic fibers, such as polyesters, would not be neutral. It would increase the cost of clothing made from synthetics relative to the cost of cotton and wool clothing. The price of clothing made from synthetics would increase relative to the price of cotton and wool clothing, and consumers would buy more cotton and wool clothing and less clothing made with synthetics.

The exception to this rule arises when production generates *external costs* – costs that are not taken into account in market-place decisions about what and how much to produce. In this case, taxes can be imposed as *proxies* for costs that would otherwise not be taken into account. Imposing taxes equal in magnitude to external costs *internalizes* those costs, so that buyers and sellers will take them into account when making production and consumption decisions. For example, imposing a tax on heavy, low-mileage vehicles would discourage their use and reduce the external costs (carbon dioxide and other air pollution) they generate.

C. Transparency

Ideally, taxes should be transparent – easily understood by and apparent to taxpayers. Transparency helps taxpayers evaluate government policy. When taxes are hidden – not transparent – taxpayers are less likely to realize the full costs of government and therefore are less able to determine the desirability of government policies by weighing their benefits against their costs.

D. Administration and Compliance Costs

Taxpayers, both individuals and businesses, incur compliance costs as they submit tax returns and keep records required to prepare those returns. New Mexico's state and local governments incur administrative costs as they collect taxes, check on the accuracy of tax returns and tax payments, and deal with taxpayers who underpay or fail to pay.

These costs are inescapable, but their magnitude is affected by how taxes are defined and collected. Generally, as a tax takes more detailed account of individual taxpayers' circumstances, it becomes more costly to administer and comply with. For example, an income tax that takes account of each family's size and medical and childcare expenses is more costly than a tax that depends solely on the family's gross income. Therefore, achieving fairness – taking account of ability to pay – typically introduces complexity into the tax code and increases administration and compliance costs.

An important and growing source of complexity and costs is the use of taxes for purposes other than collection of revenue. For example, New Mexico's income and gross receipts taxes have provisions aimed at assisting low-income families, promoting economic development and creating jobs. These provisions complicate tax returns, increase record keeping costs, increase the costs taxpayers incur in filing tax returns and increase the costs that NM governments incur in administering and enforcing tax laws. Achieving public policies through tax expenditures may be the most cost-effective means of implementing such policies. However, the analysis of the cost effectiveness of current tax expenditures is beyond the scope of this paper.

As we will see below (Part V) the statutes defining New Mexico's gross receipts tax base are complex, and in many instances they conflict with generally accepted principles of taxation. In contrast, the benchmark bases defined in Parts II, III and IV are less complex and more consistent with these principles. But even these benchmark bases do not fully satisfy these principles; tradeoffs have necessarily been made. Further, as a practical matter, there is no ideal tax or tax system that perfectly implements these principles. Tax policy and the design of taxes and tax systems necessarily entails choosing from imperfect or "second-best" alternatives. That fact should not, however, be used as an excuse for forgoing improvements such as would be achieved by implementing one or some combination of the benchmark bases.

II. Benchmark GRT Base Defined as Value of Consumption by NM Residents

This section first defines consumption and then explains which transactions should and should not be included in the consumption benchmark base. At this point, our concern is to identify all of the transactions that should *ideally* be included in the benchmark. The benchmark is therefore defined without considering the cost and political feasibility of taxing its components. Cost and feasibility come into play when considering implementation of a tax based on the benchmark. If, for example, particular transactions are excluded from the base of the implemented tax on grounds that taxing them would be too costly to administer, then revenue forgone because of these excluded transactions is properly included in tax expenditures. So too is the revenue lost when transactions are omitted because of other tradeoffs made in any tax system, including political opposition.

A. What is Consumption?

Consumption by NM residents is the value of all of the goods and services that they use to meet their wants and needs. It is measured over some period of time, most commonly a year. It includes the value of goods and services that New Mexicans 1) purchase in the market place; 2) receive from government, e.g. various educational programs, public safety, services of the court system, use of transportation infrastructure, parks and recreational facilities; 3) receive from charitable and non-profit organizations; and 4) produce for themselves, e.g. home-produced food, clothing, child care. The latter three categories may be termed *non-market* consumption.

As noted above, consumption is related to but not identical to income. Income measures *potential* consumption. A person's income is the value of all goods and services that she

could consume over some specified period without borrowing or reducing her bank accounts or selling her assets (house, land, stocks, bonds).

The difference between income and consumption is *saving*. When a person consumes less than her income she saves; when she consumes more than her income she dissaves, by either dipping into her bank account or selling assets or borrowing.

Consumption differs from *investment*, which is the use of resources to increase *future* consumption or income. Purchases of assets (such as stocks, bonds, farm land) and purchases of capital goods (such as production machinery and equipment and commercial structures) are not consumption. Expenditures incurred in the process of education that will add to future earnings can also be thought of as investment rather than consumption; examples are college textbooks and tuition.

A consumption tax taxes income as it is used to meet needs and wants. In contrast, an income tax is paid as a person receives income. So an essential difference between consumption and income taxes is the timing of tax payments. Under a consumption tax, people can defer their taxes by deferring their consumption – by saving and investing. This deferral is not possible with an income tax because current tax payments are the same whether income is spent on current consumption or saved. A consumption tax is neutral in its effect on the choice between present and future consumption, while an income tax is not.⁵ Further, an income tax may be considered horizontally inequitable because among persons with equal current income, those who decide to save more will pay more present and future taxes than those who decide to save less.

Why tax consumption? When a person pays taxes, she necessarily reduces her use of goods and services to meet her needs and wants, either today or at some future time. That is, she reduces her consumption of goods and services. Taxation thus entails sacrifice of consumption. A person's ability to support government – her ability to pay taxes – is therefore related to her consumption. But ability to pay also depends on a person's consumption needs. Persons who are better off in terms of having their needs and wants met are also more able to contribute to the support of government.

B. What is Included in Benchmark Consumption Base?

Ideally, the benchmark tax base should include all consumption. Of the four categories identified above, all are included except home-produced goods and services. The latter are omitted because, given their small amount, high administrative and compliance costs would make taxing these goods and services impractical.

⁵ In other terms, with an income tax, the *present value* of tax payments will be greater the greater is the share of income saved. In contrast, with a consumption tax, the present value of tax payments does not depend on how much current income is saved.

1. Include all receipts from final sales of goods and services

The benchmark GRT base should include all receipts from *final* sales of goods and services to NM residents.⁶ A final sale is a sale to a buyer who will neither 1) resell the good or service nor 2) use it in further production. For example, sales of computers to households that will use them for record keeping, e-mail, etc. are final sales. But sales of computers by wholesalers to retailers are not final because the computers will be resold, and the tax will be collected at the time of final sale. Also, sales of computers to businesses that will use them for record keeping, product design, etc. are not final because the computers will be used in further production. As a second example, accounting services sold to households to aid in preparation of their tax returns are final sales, but accounting services sold to businesses are not. Sales of vehicles are a third example; vehicles sold for personal use are included in the benchmark base, while vehicles sold to businesses for use in production are not. Although sales of goods and services used in production are not taxed directly, their value is taxed when sales of the goods and services they produce are taxed.

Businesses often provide fringe benefits to their employees. Examples are health and life insurance, health club and country club memberships, cars that can be used for personal as well as business purposes, and subsidized meals in company cafeterias. Fringe benefits reflect purchases of goods or services by businesses on behalf of their employees. Such purchases are properly included in the benchmark consumption base since they would be counted as such if bought directly by employees. Stated differently, fringe benefits are in lieu of wages and salaries. If businesses' outlays on fringe benefits were instead paid directly to employees, that wage and salary income would be used mainly to purchase goods and services purchased that would be included in the benchmark base.

Products – such as computers, vehicles, housing, and financial and other services – that can be either consumption or inputs to production complicate tax administration. Business owners have an incentive to claim purchases of such products as business expenses even when the products are for personal use; or they may use the products both in their business and for personal purposes. Administrative costs are increased by the reporting and audit procedures necessary to discover and discourage such practices. Similarly, tracking businesses' outlays on fringe benefits would add to administrative costs. But such outlays should nevertheless be included in the benchmark base. And if they are not taxed, because of high administrative costs or other reasons, the resulting revenue losses are properly counted as tax expenditures.

The benchmark consumption base includes the value of housing services, whether housing is owner-occupied or rented. Owner-occupied housing may be taxed by including the receipts from sale of newly constructed housing in the base. In this case, the tax collected at the time of sale is essentially prepayment of the GRT on the flow of

⁶ Federal law prohibits taxation of transactions with Indian nations, tribes or pueblos or their agencies or members if the transactions take place on their territory. Receipts from transactions with non-members can be taxed. This prohibition also applies to the GGRT and the compensating tax (7-9-14).

services rendered by the housing over its lifetime. The tax is paid up front for the initial owner and all subsequent owners. So sales of existing (not newly constructed) owner-occupied houses should not be in the base.

The services of rental housing can also be taxed by including the value of newly constructed rental structures in the benchmark base. In this case, the part of rental payments that recovers the opportunity cost of the original structures should not be in the base. However, the part of rental payments that covers maintenance and other services should be in the base. Alternatively, the value of newly constructed rental housing can be omitted from the base (thus treating it as a purchased input), with the full amount of rental payments then being included in the benchmark base. The best approach probably depends on the nature of the rental housing; for single-family units that may alternate between owner-occupied and rental use the first approach may be preferable, whereas for multi-unit housing structures that are likely to always be rental units the second approach may be preferable.

Over its life, a housing unit may sometimes be owner-occupied and sometimes rented, a fact that greatly complicates taxation of housing services. If a unit is initially owner-occupied and converted to rental, then credit must be given for the up-front tax payment made on the sale of the newly constructed unit (or a deduction allowed against rental receipts for unused depreciation). This credit (or the tax value of the deduction) would be a negative entry in the benchmark base equal to the annual amortized value of the up-front tax that was paid on the unit when it initially sold. If the unit is initially rented and then converted to owner-occupied, then the sale price of the unit when it is converted to owner-occupied should be included in the base, so that the homeowner prepays her taxes just as she would if she purchased a new unit. Both of these adjustments would be somewhat complicated to administer.

The benchmark base includes final sales by out-of-state sellers to NM residents. That is, the base includes all consumption goods and services regardless of whether they are bought from in-state or out-of-state sellers. For example, the base includes purchases of food, clothing, household appliances, and automobiles from out-of-state suppliers.

Although the benchmark base should include only final sales to NM residents, as a practical matter it is not possible to restrict the GRT to NM residents. In the case of products such as food and entertainment that are used in NM, it would be very costly to separate sales to nonresidents from sales to residents, taxing only the latter. Some sales to nonresidents will therefore be taxed. However, sales to nonresidents are fairly easily excluded from the base when the products are shipped and used out of state. And that is done under current law. This approach is consistent with other state taxing systems, which generally apply to all sales to consumers in the state. Therefore, as under current law, sales to all consumers, including nonresidents, in New Mexico would be taxed by New Mexico, and consumption by residents (or nonresidents) that occurs outside New Mexico would be taxed by the jurisdiction in which it occurs, but not by New Mexico.

The benchmark base includes, with few exceptions, currently produced goods and services. It does not include sales of financial and real assets – stocks, bonds, land, existing houses and buildings (except as noted above for housing converted from rental to owner-occupied), and natural resources. It also does not include “second-hand” sales of products.

In some cases, final sales include sales that under existing law are subject to other taxes than the GRT, for example, the Motor Vehicle Excise Tax, Insurance Premium Tax and Interstate Telecommunications GRT. Furthermore, the rates of these “in lieu” taxes differ from the GRT rate. As explained below (Part V, section C) these in lieu taxes should either be eliminated (and the sales included in the GRT base), or made fully consistent with the GRT in both rates and definitions of taxable transactions.

Governments and nonprofits typically provide goods and services without charge, in which case the benchmark base includes a proxy for their value (see section B.4 below). But when governments or nonprofits do charge for goods and services, the benchmark base includes their receipts from final sales. Goods and services sold by nonprofit organizations and governments meet individuals’ consumption needs and wants just as surely as goods and services sold by private enterprises. Examples of receipts that should be included in the benchmark base are 1) charges by non-profit medical service suppliers and 2) governmental fees and charges *paid by persons* for sewage collection and treatment, water, parking, recreational facilities, highway use (tolls), and educational programs. Note, however, the benchmark base does not include receipts from charges and sales to businesses, since they are for services used in further production. For example, government receipts from businesses for sewage treatment and water are not included in the benchmark base.

The GRT adds to the cost of producing taxed goods and services. Goods and services that are not taxed therefore have a cost advantage over those that are taxed; they are in effect subsidized. In particular, services produced by governments and nonprofits are subsidized when their sales are not subject to the GRT. In this case, governments and nonprofits enjoy a cost advantage over other producers, primarily private businesses. Such a subsidy violates the principle of economic neutrality because it favors production and consumption of some services at the expense of others. Even if subsidy of services produced by government and nonprofits is thought desirable, exempting their sales from the GRT may not be the best means of doing so.

2. Do not include business-to-business sales

Receipts from sales of market-traded goods and services that are to be used in further production should not be included in the benchmark base. These are termed *business-to-business* or *intermediate* sales. Examples are accounting services; raw materials incorporated into a finished product; machinery, equipment, and other capital goods; and buildings used for office or retail space. However, as explained above, business-to-business sales of goods and services that are employee fringe benefits should be included in the benchmark base.

Section V below identifies numerous business-to-business sales that are currently taxed under the existing GRT but should not be included in the benchmark base. The GRT on business-to-business sales can be eliminated by deducting such sales in calculating taxable transactions or by including such sales in taxable transactions but allowing the purchasing business a deduction for purchases of previously taxed items.

3. Include import but not export sales

Export sales – sales of goods and services to nonresident individuals and businesses – should not be included in the benchmark base because such goods and services do not represent consumption by NM residents.

In contrast, some *import* sales – final sales by out-of-state businesses to NM residents (households) – should be included. But sales by out-of-state businesses to NM businesses should not be included because such goods and services are used in further production.

For the purpose of defining the benchmark base, no distinction is made between sales of consumer goods and services by out-of-state businesses and sales by in-state businesses. But the two types of sales may have to be taxed under different laws. The tax on sales by in-state businesses can be imposed on and collected from sellers, as is the case with the existing GRT. The tax on sales by out-of-state businesses can also be imposed on and collected from the sellers *if* NM nexus can be established. Often, however, nexus cannot be established, and the tax has to be legally imposed on and collected from buyers, as is the case with the existing *compensating tax*.

Although the compensating tax is generally collected from buyers rather than sellers, it should not otherwise differ from the GRT in rate or in goods and services subject to tax. Collecting the compensating tax from buyers is more difficult than collecting the GRT from sellers because there are many more points of collection with the compensating tax. For this reason, compensating taxes, whether in NM or other states, are typically weakly enforced.⁷

4. Include goods and services provided by governments and nonprofits

As explained above, when nonprofits and governments sell their products, receipts from those sales should be included in the benchmark base, but their purchases of inputs should not be included. In this case, governments and nonprofits should be treated just like for-profit businesses.

However, when governments and nonprofits provide products free of charge, proxies for the value of those products must be defined and included in the benchmark base. When

⁷ The New Mexico Taxation and Revenue Department is explicitly barred from taking any action to enforce collection of the compensating tax due on individual, non-business purchases (NMSA 7-9-7.1). If sellers have sufficient “activity” in New Mexico they may be agents for the collection of the compensating tax (7-9-10).

these are *final* products, they help meet needs and wants of individuals; they therefore represent consumption. And they add to individuals' ability-to-pay, since they substitute for products that would otherwise have to be purchased with monetary income. When these are *intermediate* products, they reduce the costs of producers using them and enable such producers to sell at lower prices. The value of such intermediate products will therefore not be reflected in market prices; it must be represented in the benchmark base by the proxies discussed below.

Failing to tax such "free" products violates the principle of economic neutrality. It makes products supplied by governments and nonprofits less costly than taxed products, thereby encouraging their production and consumption. And, to the extent it leads to over-production of intermediate products by governments and nonprofits, it further reduces the relative costs and prices of private-sector products that use relatively large amounts of government and nonprofit inputs, which also distorts private-sector resource allocation.⁸ The implicit message is that free products provided by governments and nonprofits are more valuable to consumers than other products. So too are products that rely relatively heavily on government inputs.

How can products supplied by governments and nonprofits be taxed? When they are not sold, they cannot, of course, be taxed at point of sale. That is, when the *output* of governments and nonprofits is not sold it cannot be taxed. But the value of the *inputs* used to produce that output can be taxed. To do so the benchmark GRT base should include the sales of goods and services, including capital goods, to governments and nonprofits and the payrolls – compensation of labor and skill inputs – of those organizations. Taxing inputs in this manner will tax approximately all of the value of products supplied free of charge by governments and nonprofits.

Some might argue that nonprofits should be exempt from the GRT because they provide valuable services that would not otherwise be available, or would otherwise be too expensive. In this view, exempting nonprofits from the GRT is an appropriate means of subsidizing and encouraging their activities. However, even if we believe that nonprofits should be subsidized, exempting them from the GRT may not be the best means of doing so. *The question of how best to encourage worthwhile activities by nonprofits should be separated from the question of what should be included in the benchmark GRT base.*

More important, exempting nonprofits from the GRT gives rise to a tax expenditure in the amount of the revenue forgone because they are not taxed. Therefore, to calculate the tax expenditure that results when nonprofits are not subject to the GRT either the sales by nonprofits or their purchase of inputs must be included in the benchmark GRT base.

⁸ Providing free intermediate goods and services disproportionately benefits sectors for which such inputs are relatively large. In doing so, it violates the principle of economic neutrality. But this non neutrality cannot be eliminated by taxing government-supplied inputs. Instead, reducing or eliminating this non neutrality requires that government-supplied inputs be sold, at cost, rather than being supplied free of charge, which in most cases is not feasible.

Taxing goods and services that are supplied by government might be opposed on the grounds that it merely shifts funds around within government. But as explained above failure to tax treats consumption of products provided by governments more favorably than consumption of products purchased in the market place, encouraging over production by government. And, consequently, it favors production of private goods that use disproportionately large government inputs. This bias in favor of government-supplied products violates the principle of economic neutrality unless there are valid reasons for such preferential treatment. And, as was the case with nonprofits, exempting governments from the GRT results in a tax expenditure. To calculate this tax expenditure, either government's purchases of inputs (including labor inputs as measured by payrolls) or its sales must be included in the benchmark GRT base.

Another likely objection to including government and nonprofit transactions in the benchmark base is that taxing such transactions would be difficult and costly. But that is not the case; taxing government and nonprofit purchases of inputs (as proxies for the value of their outputs) would not be difficult. Furthermore, the difficulty of taxing specific transactions should not determine whether they are included in the benchmark base. Even if these transactions are not taxed because of the cost of doing so, including them in the benchmark base is necessary for calculation of the resulting revenue loss. This revenue loss is appropriately included in tax expenditures. That is, the feasibility and cost of collecting taxes should be considered when deciding whether specific transactions are in fact taxed, but not whether they are included in the benchmark base.

5. Adjust benchmark for minimum consumption

Some consumption necessarily goes to meet basic needs – for food, clothing, housing, medical care. If all consumption as defined above is included in the benchmark GRT base, then expenditures that meet basic needs will be taxed, which conflicts with the principle of taxing according to ability to pay. Therefore, purchase of some minimum consumption bundle should be free of tax. How might that be done?

Taxation of “basic” goods and services can be avoided by removing them from the GRT base. This is the rationale for exempting sales of food, prescription drugs, and many medical services from the current GRT. But this is at best a rough means of exempting a minimum consumption bundle from taxation. These exemptions reduce the GRT paid by both rich and poor, so low-income persons gain much less than government loses in revenue. An alternative to excluding specific goods and services from the GRT base would be to refund the GRT paid on a minimum consumption bundle with a refundable income tax credit such as LICTR (low income comprehensive tax rebate). The value of the minimum consumption bundle could be defined relative to the poverty threshold currently used to count the number of persons in poverty. Or it could be arrived at by a more detailed calculation of the cost of an identified set of necessities that should be free of tax.

6. Size of benchmark base

The benchmark base could be larger or smaller than the existing GRT base. Removing business-to-business transactions would tend to make the benchmark smaller. Adding final sales of goods and services, including sales by governments and nonprofits, that are currently not taxed would tend to make the benchmark larger. So too would adding the sales to and the payrolls of governments and nonprofits that do not sell their services.

C. Summary: Benchmark Consumption Base

A GRT utilizing the benchmark consumption base would for the most part be consistent with standard principles of taxation. It would be fair in that tax payments would increase with increases in ability to pay as measured by consumption. And it would be fair in that persons with equal ability to pay – equal consumption – would pay equal taxes. It would be economically neutral in that most forms of consumption would be taxed equally, and individuals' tax burdens would not depend on how they choose to allocate their expenditures among alternative goods and services. The tax would be transparent – easily seen and easily understood – in the case of market-traded goods and services. And although taxing governments' and nonprofits' purchases of inputs in lieu of taxing their products requires some explaining, it is, once explained, a fairly transparent practice. Compliance and administration costs would be in line with those for the existing GRT.

However, any definition of a benchmark base, including the consumption base defined above, necessarily reflects tradeoffs among tax principles. Taking more accurate account of ability to pay increases compliance and administration costs. Neutrality requires that sales of final products to New Mexicans be taxed the same whether the seller is in-state or out-of-state. But administration costs are higher when the seller is out-of-state, so achieving strict neutrality between in-state and out-of-state sales increases administration costs. The practical implication of these and other tradeoffs is that no single definition of the benchmark base is ideal. Tax-base definitions can nevertheless be compared and ranked according to their overall consistency with tax principles. That is what we have done above, with the basic point being that the benchmark base is superior to the existing GRT base in its compliance with tax principles.

III. Benchmark GRT Base Defined as Value of Production within NM Borders

An alternative definition of the benchmark GRT base is the total value of all goods and services *produced* in NM. Producers include not only private businesses but governments and nonprofit and charitable entities. Applying this definition, the benchmark GRT base is

- the benchmark consumption base as defined above
- plus receipts from exports of goods and services by NM businesses to out-of-state buyers, both households and businesses
- minus the value of goods and services imported by NM residents and businesses.

Exports include both consumption and intermediate goods and services. Examples: food products such as pecans, milk, chilies, baked goods; agricultural products such as wheat and hay; energy sources such as electricity and natural gas; accounting and other business services. The production base excludes imports of both final and intermediate goods, since neither is produced in NM.

A. Why Tax Production?

The primary reason for basing a GRT on the value of production within NM is that NM governments provide services that facilitate and support production. Producers of goods and services – whether private businesses, nonprofits or governments – use government facilities and services. Examples of government services include the legal system used to define and enforce contracts and property rights, law enforcement and public safety services used to protect property, and transportation facilities. Producers benefit directly from these services as they use them in their own production. They may also benefit indirectly from government services to suppliers of their inputs. For example, a retailer benefits from the transportation services utilized in the shipping of products from factories to stores. In some cases the costs of supplying these services is covered partially or fully by charges and fees. But most of the cost of providing government services is covered by taxes. So, unless a tax commensurate with the value of the government services embedded in products is imposed on producers, product prices will not reflect the value of embedded government services.⁹

Producers benefit from these governmentally supplied services approximately in proportion to the scale of their operations as measured by the value of their production (Oakland and Testa (1996)). Taxing producers according to the value of their production, as would occur with a production-based GRT, is therefore justified by the benefit principle rather than the ability-to-pay principle. This production-based tax should not depend on where final use of NM production takes place – whether products are used within the state or elsewhere.

B. Implementing a Production Tax

The benchmark bases for the consumption and production GRTs are similar, differing only in their treatment of imports and exports. Consequently, some of the concerns about the consumption benchmark noted above – those pertaining to the desirability and feasibility of taxing nonprofits and governments – also apply to the production benchmark. But there are also some differences.

The problems of taxing tax imports do not arise with the production benchmark.

Since the production benchmark is grounded in the benefit principle – the tax is imposed as an offset to the cost of providing services to producers – it would be economically inefficient to reduce or eliminate taxation of goods and services required to meet basic

⁹ See Pogue (2007, 800-807) for discussion of business tax principles and the use of a GRT to tax businesses for the government-provided services they receive.

needs. That is, excluding sales of basics, e.g. food and medical services, from the production benchmark would conflict with the efficiency rationale for taxing production. As was the case with the consumption benchmark, the preferred means of freeing a minimal level of consumption from taxation would be to refund the GRT paid on the minimum consumption bundle with a refundable income tax credit such as LICTR (low income comprehensive tax rebate).

Taxing exports would likely be opposed on the grounds that it puts domestic producers at a competitive disadvantage. Of course, the counter to this view is that exporters in fact benefit from government-supplied services just as do producers who sell in NM. Exempting exporters thus violates the principle of horizontal equity – equal treatment of equals. It favors producers that export over those that sell in NM, even though there is no reason for thinking that the NM economy benefits more from production for export than from production for in-state markets.

But even if it is agreed that exports should not be taxed, export sales should be included in the benchmark base so that the revenue loss from exempting exports can be calculated. This revenue loss is the tax expenditure incurred in the effort to promote competitiveness.

Taxing revenues from providing interstate transportation and communication services is restricted by federal law. And any such taxes will have to be apportioned between NM and other states by formula.

C. Summary: Benchmark Production Base

A GRT utilizing the benchmark production base would promote economic efficiency because it would approximate a charge for the services that governments provide to producers. It would be fair in that tax payments would increase with increases in producers' reliance on government-supplied services, the latter approximated by producers' value added. And it would be both fair and economically neutral in that producers that use approximately equal services – generate equal value added – would pay equal taxes. It would also be neutral in that production for export would be taxed the same as production for in-state use. Of course, this neutrality may be viewed as a shortcoming of the production benchmark by those who wish to use taxes to promote “competitiveness” and “economic development.” Transparency for the production benchmark base would be similar to that of the consumption benchmark discussed above. Compliance and administration costs would be in line with such costs for the consumption benchmark. Differences would arise mainly because of the exemption of imports and the inclusion of exports in the production benchmark base.

IV. A Mixed Consumption/Production Base

A GRT levied on either or both of the benchmark bases defined above is consistent with standard principles of taxation. The consumption base taxes persons according to their ability to pay; the production base taxes producers for the benefits they receive from government. The mixed base is the consumption base as defined above plus exports (NM

businesses' receipts from sales of products and services to out-of-state buyers). It is the value of all final goods and services purchased and consumed in New Mexico, regardless of where produced, plus the value of all goods and services produced in New Mexico but sold to out-of-state buyers.

The consumption and production components of the mixed base may be taxed at different rates. Here is an example of how a GRT using the mixed base would work. Suppose consumption base rate is 7 percent and the production base rate is 2 percent. Then tax rates would be as follows:

- 7 percent rate on receipts of in-state as well as out-of-state businesses from sales of final goods and services to buyers (consumers) in New Mexico. These goods and services would be subject to the 7 percent consumption tax because they are consumed in NM. The tax on final sales by out-of-state sellers (those with no nexus in New Mexico) would generally be implemented as a use or compensating tax
- 2 percent rate on out-of-state sales of goods and services produced by NM businesses. Only the production tax would apply to these export sales because the goods and services are not consumed in New Mexico. This rate would apply to sales to both out-of-state businesses and out-of-state consumers. The production tax would apply only to the extent that the value of export sales represented production in New Mexico.

V. How the Current GRT Base Differs from the Benchmark Bases

This section identifies provisions of the current GRT that cause its base to differ from the benchmark bases defined above. These differences give rise to tax expenditures. Removing these provisions to eliminate or reduce tax expenditures would make New Mexico's GRT base correspond more closely to the benchmark bases. Most of the adjustments either add final products and services that are currently untaxed or under taxed or remove business-to-business transactions. Also, some adjustments incorporate payrolls and purchases to proxy for products and services produced but not sold by nonprofits and governments. NMSA section number and title are given for each exemption or deduction that is to be changed.

A. Consumption Base Benchmark

Adjustments required to make the current GRT base consistent with the consumption base benchmark are listed below. Some adjustments remove or modify an existing exemption or deduction. Others add deductions for sales of business inputs -- sales of goods and services that will be resold or used in further production. Still others add government and nonprofit expenditures (payrolls and purchases of products) to proxy for the value of their products. If existing exemptions and deductions are not listed below, then they are appropriate for the consumption base benchmark. Adjustments are grouped into several categories:

- Add final sales omitted from current base
- Remove business-to-business sales from tax bases
- Adjust taxation related to nonprofits
- Adjust taxation related to governments

These adjustments, explained below, assume that the GRT will continue to be administered as under present law. With this current approach to administration, a NM business's tax base is its total *non exempt receipts* from sales to NM buyers minus *deductible receipts*. The current approach to administration thus requires identification in tax legislation of nontaxable receipts – receipts that are either exempt from taxation or deductible from total receipts in the calculation of taxable receipts.

An alternative administrative approach would be to define a business's New Mexico tax base as its total receipts from sales to NM buyers minus the value of its purchases on which tax has been paid. If this approach were adopted, the adjustments identified in section V.A.1 below would be unnecessary since these receipts would be included in the tax base by definition. The statutes that place the receipts in section V.A.2 into the GRT base would have rescinded.

With either administrative approach, the treatment of governments and nonprofits would have to be modified as explained in sections V.A.3 and V.A.4 below.

1. Add final sales omitted from current base

The following receipts, excluded from the current GRT base by exemptions and deductions, should be included in the benchmark consumption base. Failure to tax these receipts results in tax expenditures.

Receipts of retailers from redemption of food stamps. This exemption is presumably intended to lighten the burdens of poverty by reducing the cost of food. It also makes purchases of food with food stamps the same as purchases with cash. (7-9-18.1)

Premiums received by insurance companies and their agents. Only the part of a premium that represents saving – adds to cash value – should be exempt. The remainder of the premium is for the services of pooling, managing and distributing funds. These services should be taxed the same as other services for individuals. But insurance premiums paid by businesses should be exempt as a cost of doing business. Insurance premiums are presumably exempt from the GRT because they are subject to a separate insurance premium tax. If this separation is continued, the base of the insurance premium tax should be set following the criteria that define the benchmark consumption base. If insurance services for individuals are taxed by the GRT, there should be no separate premium tax. (7-9-24)

Receipts of property bondsmen from security for bail bonds. Only those receipts that are refunded once the bonded person appears in court should be exempted. The receipts that cover the cost of providing the services should be taxed. (7-9-24)

Receipts of disabled street vendors. These are final sales and properly taxable. The motivation for the exemption undoubtedly is to help disabled persons. But this is only a small bit of assistance. It would be better to have some systematic and adequate assistance. (7-9-41.3)

Receipts of commissions by race tracks as their portion of pari-mutuel handle. Betting is an entertainment service; commissions are the fees for that service. Pari-mutuel receipts are subject to a separate pari-mutuel tax at a lower rate than the GRT rate. Either commissions should be added to the GRT base or the pari-mutuel rate should be set equal to the GRT rate. (7-9-40)

Receipts from sale or lease of real property and lease of mobile homes. Receipts from renting housing should be included in the benchmark base, since housing is a consumer good that rental payments are purchasing. But receipts from construction of that housing should not be included. Similarly, receipts should not be included when real property is being used in the production of goods or services that are subsequently sold and subject to the GRT. (7-9-53)

Receipts from charges for loan origination, making or assumption of loans, or handling loan payments. These services should be taxed when they are provided to

individuals rather than businesses, in which case they are final products. When provided to businesses they should be deductible as intermediate services necessary for producing the products that the business sells. (7-9-61.1)

Receipts from sales of newspapers and magazines. Receipts from sales to final users should be taxed, which is currently the case with magazines but not newspapers. Sales to newsstands and other outlets should not be taxed. (7-9-63; 7-9-64)

50% of receipts of hospitals. Fifty percent of hospital receipts are currently deductible from the GRT base. But all of these receipts are from sale of consumer services (health care) and should be included in the benchmark base. However, these receipts should not be taxed if they are paid by health insurance policies on which an insurance premium tax equivalent to the GRT has been paid. More generally, any tax paid on health and medical insurance premiums should be considered as an offset to the GRT on sales of medical products and services that are partially or fully reimbursed by insurance. (7-9-73.1)

Receipts from sales of prescription drug, oxygen and oxygen services. These receipts reflect purchases of consumer products but are currently deductible from both GRT and GGRT. However, as noted above, if these sales are covered by health insurance subject to the insurance premium tax, then the GRT due should be reduced by the amount of insurance premium tax paid on the sales. (7-9-73.2)

Receipts from medicare and tricare. These receipts result from the purchase of consumer services and should be taxed even though they are not paid directly by consumers themselves. (7-9-77.1)

Commissions received by lottery ticket retailers. The commission is part of the price lottery-ticket buyers are paying for the services of the lottery. Ticket buyers are buying a service supplied by the lottery, namely pooling funds and selecting persons to receive payments from the pool. To be consistent, the funds transferred to government from the lotteries should be treated at least in part as a tax (and in part a “profit” created by the legalization of gambling). Lotteries are therefore providing a service that may be taxed more heavily than other services or types of entertainment. (7-9-87)

Receipts from qualifying food sales at retail food stores as defined by federal food stamp program. (7-9-92)

Receipts from sales of agricultural products. Receipts of producers of agricultural products (other than dairies selling at retail) are exempt under current law, but should be taxable if the receipts are from sales to final consumers. (7-9-18)

Receipts of licensed health care practitioners from payments of managed health care providers or health care insurers or medicare part C. These receipts reflect purchases of consumer services. As noted above, the only instance in which they should not be taxed is when the GRT or an equivalent tax has been paid on the premiums paid to the insurer that is making the payments. That is, payments to practitioners are not taxed if

they are paid by health insurance policies on which an insurance premium tax equivalent to the GRT has been paid. More generally, any tax paid on health and medical insurance premiums should be considered as an offset to the GRT on sales of medical products and services that are partially or fully reimbursed by insurance. (7-9-93)

Receipts from sale of specified personal property on tax holiday dates. Tax holiday dates are first Friday in August and following Saturday and Sunday. (7-9-95)

Receipts from payments by or on behalf of Indian Health Service. Allowing this deduction treats consumption by Native Americans differently than consumption by other New Mexicans. The question is whether the GRT should apply to all consumption by all NM residents. If so, these receipts should be in the benchmark consumption base. (7-9-77.1)

Receipts from selling vision aid, hearing aids and related services. These sales should be treated the same as other final sales of consumer products, unless they are paid for by insurance subject to the premium tax (in lieu of the GRT). (7-9-111)

Receipts from producing or staging professional boxing, wrestling, or martial arts contests in NM. These are receipts from the sales of entertainment services that should be taxed the same as final sales of other consumer services. (7-9-107)

Receipts received between July 1, 2007 and June 30, 2012 from admissions to non-athletic special events. These events must be held at a venue that holds at least 10,000 persons on a campus of post secondary school within 50 miles of the NM border. (7-9-104)

Receipts from sale or installation of solar energy systems. Receipts should be excluded from the base only if the systems are exported or used by businesses that sell products and services subject to GRT. (7-9-112)

Receipts from transactions by tribal agencies and individual Indians on tribal territory. Federal preemption prohibits taxing these transactions. So as a practical matter they cannot be taxed. However, they are appropriately included in the benchmark base for the purpose of calculating the tax expenditure attributable to federal preemption.

Receipts from sales of flowers when the order is placed with an out-of-state florist. These receipts are defined as not being “gross receipts”, even though they represent a form of in-state consumption. (7-9-3.6(A)(3)(g))

Individual, non-business purchases from out-of-state sellers. These purchases should be included in the benchmark base and taxed under a compensating or use tax. But the NMTRD is currently prohibited from enforcing collection of the compensating tax on such purchases. (7-9-7.1)

Receipts from isolated and occasional sales. These receipts are exempt under current law, but in principle should be subject to tax if they are from sales to final consumers. (7-9-28)

2. Remove business-to-business sales from tax bases

The following receipts from business-to-business transactions (sales of intermediate products used in further production) are included in the current GRT base, but they should be excluded from the benchmark base. Administratively, as explained more fully above, such sales can be removed from the base by exempting (or deducting) sales to another business (as verified by the issuance of non-taxable transaction certificates (NTTCs)). Alternatively, such sales could be subject to tax, but with the allowance to the purchasing business of a deduction for the amount of the purchase. The two approaches should have identical results if the tax rate on the selling and purchasing businesses are identical.

Business purchases of property from out of state. Such purchases are subject to the compensating tax if they would have been taxed had they occurred in state. But these are purchases of products used in further production and should therefore not be taxed. (7-9-7)

Receipts from supplying R&D services initially used in NM but produced out-of-state. These are business inputs. The likely reason for taxing such services is to prevent out-of-state suppliers from having a cost advantage over in-state suppliers. Note that such receipts are currently exempt if sold between affiliated corporations, sold to the U.S. government by operators of national laboratories (other than 501 (c) 3), or sold to persons operating national laboratories (other than 501 (c) 3). (7-9-13.1)

Receipts from selling tangible personal property to persons engaged in manufacturing. These receipts should be excluded from the benchmark base, but under the current GRT and GGRT they are deductible only if the property is an ingredient or component of manufactured products. (7-9-46)

Receipts from sales of tangible personal property to persons engaged in construction. Under current law these receipts are deductible only if the property by design and intent becomes part of a construction project. But all receipts from selling property to construction businesses should be deductible and therefore excluded from the benchmark base. For example, saws, hammers, and other equipment and tools are intermediate goods used in the production of structures; they are as necessary for construction as the lumber and cement that become part of structures. (7-9-51)

Receipts from sales of indirect services to construction businesses. Receipts from sales of indirect services, such as accounting and architectural services, to persons engaged in construction are not deductible under existing law, but they should be excluded from the benchmark base. (7-9-52)

100%, not just 50%, of receipts from selling aircraft used commercially. (7-9-62)

100% not just 50% of receipts from selling agricultural implements and vehicles. 100% of these receipts should also be deductible from the compensating tax. (7-9-62; 7-9-77)

Receipts from selling advertising space. These receipts are from sales to advertisers. They are currently not deductible, but they should be deductible as the cost of a business input. They should not be included in the benchmark base. However, final sales of magazines and newspapers should be taxable. (7-9-63; 7-9-64)

Receipts from selling explosives, blasting powder, or dynamite. These are intermediate goods used in further production; they should be deductible just as other chemicals and reagents used in production. (7-9-65)

Receipt of real estate commissions on sales or leases of real property or intangible property. These commissions should be taxed unless they are on sales or leases undertaken in the course of business or included in the sales price or lease payment. (7-9-66)

Receipt of real estate commissions on the sale of land. When the land being purchased is to be used in production, commissions should not be taxed. The commissions are part of the cost of inputs to production. (7-9-66.1)

Receipts from selling services to persons engaged in manufacturing. All such receipts should be deductible and excluded from the benchmark base. But under current law, deductibility is restricted to services performed directly on the products being manufactured. (7-9-75)

100%, not just 55%, of receipts from selling jet fuel. 100% of these receipts should be deductible from the gross receipts tax and compensating tax. (7-9-83; 7-9-84)

Receipts from construction of structures that are to be rented or leased. Such construction is an intermediate product that should not be taxed. But the receipts from selling products and services produced with the structures should be taxed. In the case of housing, the GRT should apply to the rental payments received by landlords. In the case of structures rented to businesses, the rents paid by the businesses (the receipts of the owners of the structures) should not be taxed, but the products and services produced with the structure should be taxed if they represent consumption. For example, the receipts from renting a dental office (the rent that a dentist pays on her office building) should not be taxed, but the receipts from selling her dental services should be taxed.¹⁰

¹⁰ In the case of owner-occupied residences, receipts from selling construction services and materials should be included in the benchmark base and taxed. Taxing sales of construction services and materials going into new housing at time of purchase is essentially prepayment of the GRT on the flow of services rendered by the housing over its lifetime. This flow of services is properly included in consumption. The tax is paid up front for the initial owner and all subsequent owners. So sales of existing (not newly constructed) owner-occupied houses should not be taxed.

Receipts from leasing and licensing property used in NM and granting rights to use franchises.¹¹ These can be intermediate inputs necessary for the production or distribution of final products. The GRT should apply only to final products. Franchises and licenses grant rights to use names and processes; production of the products to which the franchises and licenses apply would not be legal without payment of fees required by those who own the rights being franchised or licensed. So these fees are necessary for the production of final products. These fees should only be taxed when the leased property is itself a final product, examples of which are rented housing, furniture, vehicles for personal use, and computer software. Such leases to consumers should be taxed. Note that whether and how income from franchises and licenses should be taxed are separate questions. (7-9-3.5)

Leased vehicles should not be subject to both GRT and Leased Vehicle GRT. Vehicles purchased by lessors should be treated as intermediate goods, with the final good being the services of the leased vehicles. Leased vehicles may also be subject to a \$2 per day surcharge. This surcharge is inappropriate as a supplement to the GRT, but it may be appropriate if earmarked for special purposes.

3. Adjust taxation related to nonprofits

The following receipts of nonprofit organizations, excluded from the current GRT base, should be included in the benchmark base.

Receipts of various nonprofit organizations. Included are receipts of 501(c)(3), 501(c)(4) and 501(c)(6) organizations: providers of accommodations for elderly persons (7-9-16); chambers of commerce, visitor bureaus, and convention bureaus (7-9-29); social, fraternal, political, trade, labor or professional organizations and business leagues (7-9-39); religious organizations (7-9-41); homeowners associations (7-9-20). These organizations provide services that help to meet individuals' wants and needs just as do goods and services bought in the market place. In some cases the value of the services accrues to groups of individuals, but this fact does not prevent the services from meeting individual needs and wants. These services are therefore properly included in consumption as defined above (Section II.A). The activities of community "booster" organizations, such as chambers of commerce, might be thought of as advertising and marketing services that are inputs used but not purchased directly by local businesses. As explained above, the expenditures of these organizations (payrolls and product and service purchases) should be included in the benchmark base as a proxy for the value of the services provided to businesses.

¹¹ Receipts from licenses of copyrights, trademarks and patents are not taxed.

Receipts of 501(c) organizations from two fund raising activities each year. (7-9-85)

Since nonprofits do not sell many of the services they provide, just removing deductions of nonprofits' receipts, as above, will fail to tax many nonprofit services. In this case, nonprofits will be lightly taxed in comparison to for-profit businesses.

When nonprofits do not sell their services, an alternative is to tax the value of the *inputs* they purchase to provide those services, on the presumption that the value of the services provided is at least as great as the value of the inputs used to produce them. As explained above (section II.B.4), nonprofits' payrolls and purchases of goods and services can proxy for the value of services they provide but do not sell. To implement this approach to taxing nonprofits, the following items, currently excluded from the GRT base, should be included in the benchmark base.

Wages and salaries of nonprofits. These are included in the benchmark base for nonprofits to the extent they do not sell their services. (7-9-17)

Receipts from sales of tangible personal property to 501(c)(3) organizations. These receipts are currently excluded from both GRT and GGRT bases. They should be included in the benchmark base as proxies for the value of *final* goods and services supplied free of charge by nonprofits. (7-9-60; 7-9-54.1) However, receipts from sales to 501(c)(3) organizations to the extent they sell their services to consumers should not be included in the benchmark base. For example, sales to nonprofit retirement homes should not be included in the benchmark base if the retirement homes charge fees that cover the cost of their services. Similarly, receipts from sales of services, equipment and materials to foundations or nonprofit organizations for use in new facility construction of hospitals in health professional shortage areas should not be in the base if the hospitals cover their costs by selling services. (7-9-99; 7-9-100)

Receipts from sales of construction materials and metalliferous mineral ore to 501(c)(3) organizations that provide home ownership opportunities for low-income families. These receipts should be included in the benchmark base as part of the payment for owner-occupied housing. As explained in footnote 9 above, taxing the construction materials and services going into owner-occupied housing is a means of taxing the flow of housing services provided by the housing. Further, even if deduction of such receipts is thought to be an effective means of increasing low-income home ownership, the receipts should nevertheless be included in the benchmark base. Forgoing the tax on these receipts is a tax expenditure which can be calculated only if the receipts are included in the benchmark base. (7-9-60, subsection B)

Purchases from out-of-state sellers of property used by nonprofits. These purchases, currently exempt from the compensating tax, should be in the benchmark base. Note: purchases of property used as an ingredient or component part of a construction project are not exempt. (7-9-15)

Value of tangible personal property that is removed from inventory and contributed to 501(c)(3) organizations. The compensating tax does not apply to these contributions. However, if the contributions are in fact inputs used by nonprofits in producing their services, they should be in the benchmark base. They should also be in the base if they are given directly to individuals. (7-9-91)

4. Adjust taxation related to governments

The following receipts of state and local governments and their agencies, excluded from the current GRT or GGRT bases, should be included in the benchmark base.

Receipts of public school districts and hospitals. These receipts are currently exempt from the GGRT, but they should be exempt only if they are from sale of intermediate goods or services. (7-9-4.3)

Receipts of State of NM and its agencies and subdivisions. These receipts should be exempt only if they are from sale of intermediate goods or services, not if they are from selling final products and services such as admission to parks. Receipts from sales of textbooks by bookstores located on campuses of public post secondary educational institutions are exempt. This exemption may be appropriate to the extent textbooks and other educational materials can be regarded as human capital investment outlays rather than consumption. Receipts from bookstores' sales of clothing, souvenirs, etc should always be, and currently are, taxed. (7-9-13; 7-9-13.4)

Receipts from selling property by base exchanges of U.S. armed services. These receipts are excluded from the current GRT base by federal preemption, so as a practical matter they cannot be taxed. But they should nevertheless be included in the benchmark base to allow calculation of the resulting tax expenditure. (7-9-31)

Receipts from sales to diplomats. The receipts are deductible under current law but should be included in the benchmark base. (7-9-89)

Governments and their agencies, like nonprofits, typically provide their services free of charge. A government's payroll plus its purchases of goods and services provides a measure of the value of goods and services it provides but does not sell. To implement this approach to taxing services provided by governments, the following items currently excluded from the GRT base should be included in the benchmark base.

Wages and salaries of governments and their agencies. These are included in the benchmark base to the extent governments do not sell their services. (7-9-17)

Receipts from sales of tangible personal property to NM governments and their agencies. These receipts should be included in the benchmark base unless they are used as inputs to produce government services that are sold at prices that cover their full cost of production. In this case, government production should be treated the same as private production, with the only the value of the final service being taxed. Note that receipts

from some sales to governments are included in the GRT and GGRT bases – materials used in construction (other than certain military construction), or leasing of property or licenses, or the performance of services. (7-9-54; 7-9-54.3; 7-9-97; 7-9-106)

Purchases from out-of-state sellers of property used by NM governments or their agencies or political subdivisions. These purchases, currently exempt from the compensating tax, should be in the benchmark base. Note: purchases of property used as an ingredient or component part of a construction project are not exempt. (7-9-14)

Value of tangible personal property that is removed from inventory and contributed to NM governmental entity. The compensating tax does not apply to these contributions. However, if the contributions are in fact inputs used by governments in producing their services, they should be in the benchmark base. (7-9-91)

B. Production Base Benchmark

The adjustments required to make the existing GRT base consistent with the consumption base benchmark, discussed above, are also applicable for the production base benchmark. Additional adjustments required to implement the production base are those that remove imports from and add exports to the consumption base.

The following receipts, excluded from the current GRT base, should be included in the production benchmark base.

Receipts of trade-support companies located within 20 miles of Mexico port of entry. These are receipts of trade-support companies located in NM. They should not be deductible to the extent they are selling products or services produced in NM. (7-9-56.3)

Receipts from sales in interstate commerce. These receipts, currently excluded from the GGRT and GRT bases, should be in the production benchmark base because they are from exports of goods and services. They include receipts from intrastate transport of persons or property when under a single contract for transportation in interstate or foreign commerce. (7-9-55; 7-9-56)

Receipts from internet sales to persons with billing address outside NM. (7-9-57.1)

Receipts from sales of services to out-of-state buyers. Included are receipts from sales of services that are delivered and initially used out-of-state by out-of-state buyers. (7-9-57)

C. Adjusting Other Taxes

In addition to the above adjustments of the GRT base, the bases on which taxes levied in lieu of the GRT should be included in the consumption and production benchmark bases. If that is not done, then the bases of these taxes should be defined by the same criteria as the benchmark bases. These in lieu taxes include:

- Governmental gross receipts tax
- Leased vehicle gross receipts tax; leased vehicle surcharge
- Motor vehicle excise tax and compensating tax (7-9-22; 7-9-23) and boat excise tax and compensating tax (7-9-22.1; 7-9-23.1)
 - Rates should be same as the GRT rate.
 - Motor vehicle excise tax should not apply to vehicles purchased for use by businesses including agricultural businesses. This result can be obtained by allowing businesses to issue the equivalent of NTTCs to purchase vehicles, or a credit against their GRT liability for the tax paid on vehicle purchases.
- Gasoline, special fuel excise and alternative fuel excise taxes
 - Receipts from sales of these fuels are not included in the current GRT, GGRT and compensating tax bases. (7-9-26; 7-13-3; 7-16a-3; 7-16b-4; 7-9-13.2)
 - These specialized taxes are earmarked to support transportation. To the extent they are a quasi-user fee for transportation services, they are not a substitute for the GRT and compensating tax on sales to final consumers. Sales of these fuels to final consumers should therefore be included in the benchmark bases just as any other final sales. Sales of fuels to businesses should be treated as sales of intermediate goods and therefore should not be in the bases.
- Insurance premium tax (7-9-24)
- Municipal Event Center Funding Act
 - This act allows imposition of an event center surcharge in lieu of the GRT. It exempts receipts from tickets, parking, souvenirs, concessions, programs, advertising, etc and all other products or services sold or related to a municipal event center or related to activities occurring at the event center on which an event center surcharge is imposed. (7-9-13.5)
 - But all receipts from sales of final goods and services should be subject to GRT at regular GRT rates.
 - These receipts should be in the benchmark bases. If omitted, the forgone revenue is a tax expenditure.
- Pari-mutuel Tax
- Minor League Baseball Stadium Funding Act
 - This act allows a stadium surcharge in lieu of the GRT. It exempts all receipts on which stadium surcharge is imposed. (7-9-13.3)
 - However, like the surcharge for funding municipal event centers, these receipts are for final services that should be in the benchmark bases. If omitted, the foregone revenue is a tax expenditure.
- Interstate telecommunications GRT (ITGRT)
 - Receipts from providing interstate telecommunications services should be taxed the same as other services. They should therefore be included in the benchmark bases except when the services are inputs used in further production. The same principles should apply if these receipts are taxed separately. (7-9-38.1)

- Oil and Gas Emergency School Tax, Natural Gas Processors Tax, Resources Excise Tax
 - Receipts from sales of products subject to these taxes are exempt from the GRT if the products are to be resold, used in manufactured products, or shipped out of state. Otherwise the receipts are taxable by the GRT. As a result, when these products are used (in final form) by individuals they are subject to multiple taxes (unless the final product is otherwise exempt, e.g., gasoline). These severance taxes have a separate rationale from the GRT, primarily because severing these nonrenewable products from the earth represents a permanent loss of mineral wealth to the State and the severing and processing of the products may entail environmental and other external costs. The benchmark GRT bases should include final sales of the products to individuals. (7-9-33; 7-9-34; 7-9-35)

VI. Summary

The tax expenditures implicit in the current GRT can be defined and measured only with reference to a benchmark base. This report defines consumption and production benchmarks. The consumption benchmark is the value of all *consumption* by NM residents; the production benchmark is the value of all *production* occurring within NM borders. Tax expenditures, which occur when the actual GRT base departs from a benchmark base, can be defined using either of these bases or some combination of the two.

This report identifies provisions of the current GRT that give rise to tax expenditures; altering these provisions to eliminate or reduce tax expenditures would make New Mexico's GRT base correspond more closely to the benchmark bases. Some current-law provisions generate *negative* tax expenditures because they increase revenue relative to what would be collected on the benchmark bases. Whether a tax levied on a specific benchmark base would yield more or less revenue than the current GRT base and rates is therefore an empirical question, beyond the scope of this report.

Altering the GRT base to make it correspond more closely to a benchmark base, either consumption or production, would make the GRT more equitable and more economically neutral (less distortion of economic decisions). Because of tax pyramiding, the current GRT does not tax all lines of production uniformly, to the disadvantage of producers and consumers of products and services that are taxed at relatively high effective rates. Goods and services provided by the nonprofit and government sectors are typically taxed more lightly than those provided by the private business sector. These disparities in effective tax rates are both unfair and non neutral.

Looked at in isolation, the departures from a benchmark base that give rise to tax expenditures clearly have the efficiency and equity downsides just noted. But proponents of the tax law provisions that create tax expenditures would undoubtedly argue that those provisions are desirable despite the associated revenue losses, non neutralities and inequities. They would argue that tax expenditures are cost-effective means of achieving

public policy objectives – supplementing individual incomes; supporting hospitals, museums, colleges, and various other charitable activities; promoting economic development. Simply identifying the sources of tax expenditures as we have done in this paper therefore leaves open the question of whether they are desirable; but addressing that question is beyond the scope of this report.

The existing GRT base clearly has not been designed with either the consumption or production benchmark as a guide. Instead, it is the result of a long series of changes motivated by a wide range of concerns, such as promoting economic development and competitiveness, encouraging nonprofits, increasing supply of low-income housing, and reducing taxes on certain forms of consumption (food and medical care) or basic levels of consumption.

The resulting complexity of the existing GRT base means that it cannot easily be revised to bring it into line with a benchmark base. Statutes governing the GRT include some transactions that should be in the benchmark base along with others that should not. So converting the existing GRT base to a benchmark base would not be just a matter of eliminating statutes that give rise to tax expenditures. Existing statutes would have to be rewritten both to add transactions that should be in the base and to remove transactions that should not, and perhaps changing some of the administrative provisions of the tax.

References

Clifford, Thomas. "Issues in Tax Expenditure Budgeting." Presentation to Revenue Stabilization and Tax Policy Committee. December 2006.

Eads, Jim. "Tax Expenditure Budgets: A Report to the Revenue Stabilization and Tax Policy Committee." New Mexico tax research Institute. December 4, 2004.

Hyman, David N., *Public Finance: A Contemporary Application of Theory to Policy*, 8th ed. Dryden Press, 2005.

New Mexico Taxation and Revenue Department. "Legislative Summary: 2007." New Mexico Bulletin, B-100.17 2007.

New Mexico Taxation and Revenue Department. "Overview of Gross Receipts and Compensating Taxes. 2007

New Mexico Taxation and Revenue Department. "Exemptions and Deduction in the Gross Receipts and Compensating Taxes." Research Paper #8. October 1984.

New Mexico Taxation and Revenue Department. "Gross Receipts Tax Exemptions and Deductions: Description, Rationale, resource Allocation and Other Issues." Special Report. August 18, 1997.

New Mexico Tax Research Institute. "Pyramiding Transactions Taxes in New Mexico: A Report on the Gross Receipts Tax." Albuquerque, New Mexico, September 2005.

Oakland, William H., and William A. Testa, "State-Local Business Taxation and the Benefits Principle." *Economic Perspectives (Federal Reserve Bank of Chicago)* 20 January/February 1996, pp. 2-19.

Oakland, William H. and William A. Testa, "The Benefit Principle as a Preferred Approach to Taxing Business in the Midwest." *Economic Development Quarterly*, Vol. 14, No. 2 (May 2000), pp. 154-164.

Pogue, Thomas F., "The Gross Receipts Tax: A New Approach to Business Taxation?" *National Tax Journal* 60 No. 4 (December, 2007): 799-819.

Stiglitz, Joseph E., *Economics of the Public Sector*, 3rd ed., W. W. Norton & Company, 2000.