Spring, 2002

NEW MEXICO ADVOCATES FOR CHILDREN AND FAMILIES

Campaign to Reduce Child Poverty

Policy Brief #7

Taxation of Low Income Families in New Mexico

Introduction

New Mexico relies heavily on consumption taxes, most notably the state's unusually broad-based gross receipts tax (GRT). Virtually everything sold for final consumption in New Mexico is subject to tax under the state's gross receipts or selective excise tax statutes. They are levied on all income not saved, invested, or spent on housing and thus they consume a larger percentage of the income of lower income households, and are thus "regressive."

Consumption taxes exacerbate poverty; but the most obvious solution to the problem of disproportionate tax burden – selective exemptions for food and other necessities – is probably not the best one, particularly for a poor, sparsely populated state like New Mexico.

This policy brief investigates the extent to which consumption taxes exacerbate poverty in New Mexico and the relative effectiveness of policies aimed at reducing their impact on low income families. It examines personal income tax rebates, gross receipts tax exemptions for necessities such as food and healthcare services, and the effect of these policies on the poor and working poor.

Background: The New Mexico General Fund

In New Mexico, funding for state government and public education derives from the state general fund, which provides the operating budgets of all state agencies including the Department of Health, the Children, Youth, and Families Department, the Human Services Department, and the Department of Corrections. With money from the general fund, state agencies provide services to New Mexico citizens: public health clinics, community centers, prisons, services for children who have been abused or neglected and job training, to name a few. For fiscal year 2001 the New Mexico General Fund totaled $4 billion. The vast majority of general fund revenue derives directly from taxes.

The **gross receipts tax** is the single largest source of the general fund revenue. In fiscal year 2001, the state collected roughly $1.99 billion in gross receipts tax, and approximately 63%, or $1.25 billion, was allocated to the state general fund. The remaining $749 million was allocated to local governments. The gross receipts tax is the primary revenue source for both counties and municipalities.

New Mexico levies the gross receipts tax in lieu of a state sales tax. Unlike a conventional sales tax, the New Mexico gross receipts tax is levied

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Tax Terminology

Tax policy can seem dauntingly complex, but tax talk isn't as complicated as it sounds. Knowing accurate definitions of a few basic terms can make tax policy much easier to understand.

Tax base *– the total amount of property, assets, sales or income that taxes can be calculated on. For income taxes, the base is taxable income, which includes wages, salaries, rents, interest, and dividends. The base for the gross receipts tax is all gross receipts taxable sales.* ***Exemptions****, like removing the gross receipts tax on prescription drugs, and* ***deductions****, for example, allowing the subtraction of mortgage interest payments from taxable income, reduce the tax base.*

Tax rate *– the percentage of the tax base that is paid in taxes.*

Tax expenditures *— deviations from normal tax policy that are functionally equivalent to spending programs because they seek to accomplish specific policy goals that are unrelated to equitable or efficient taxation. For example, the mortgage interest deduction is a* ***tax expenditure*** *because it is intended to subsidize homeownership, not enhance the equity or efficiency of the tax system. The gross receipts tax exemption for prescription drugs is a* ***tax expenditure*** *because it is intended to make prescription drugs more affordable, not improve the functioning of the tax system.*

Regressive – *a tax that consumes a larger percentage of income as income level falls. The gross receipts tax is regressive because low income households spend a larger percentage of their income on gross receipts taxable goods and services than do upper income households. As a result, they spend a greater percentage of their income on the gross receipts tax.*

Progressive *– a tax that consumes a larger percentage of income as income level rises. The personal income tax is a progressive tax because the rate at which income is taxed increases with income level. Therefore, upper income households pay a larger percentage of their income in personal income taxes than do lower income households.*

on the seller rather than the buyer. In most instances, the seller passes the gross receipts tax through to the buyer as an explicit addition to price. Therefore, to the final consumer, the gross receipts tax is essentially a sales tax.

The New Mexico GRT has a broader base than most sales taxes. The GRT is imposed upon total construction receipts, including labor, the sale of business, health, and professional services, and goods such as food, natural gas, and electricity consumed in the home. The small handful of goods and services exempt from the GRT – insurance premiums, gasoline, oil, gas, and some mineral extraction and processing — are subject to other, similar, taxes. In general, broader tax bases allow states to charge lower tax rates. The statewide effective gross receipts tax rate averages about 5.9%[1].

The **personal income tax**, which generated revenue of $902 million in FY 2001, is the second largest source of general fund revenue. New Mexico's personal income tax is as progressive as its GRT is regressive. In New Mexico, a two parent family of four does not incur income tax liability until its annual income exceeds $21,300, or 118% of the federal poverty threshold. Twenty six of the forty two other states that levy an income tax have a liability threshold lower than New Mexico's[2]. In those states, the same family of four would pay income tax even though they had annual income of less than $21,300

Much of the progressivity in the New Mexico personal income tax is attributable to the Low Income Comprehensive Tax Rebate (LICTR). LICTR returns cash in the form of a personal income tax rebate to low-income New Mexicans. All non-institutionalized low-income state residents, even those with no tax liability and no earned income, are eligible for LICTR. The intent of LICTR is to refund poor people a portion of the state consumption taxes they pay in order to equalize the state tax burden across income classes. LICTR benefits are based on income and household size. Households with annual income (taxable and non-taxable) less than $22,000 may receive up to $450 in LICTR each year. Households with annual income less than $5,000 and six or more exemptions receive the maximum benefit, while a single person making $22,000 per year in income gets just $10 in LICTR. In 1998 (the last year for which reliable data exists), New Mexico spent roughly $25.3 million on LICTR.

All States Tax the Poor

Of all the United States, New Mexico consistently ranks worst or second worst in terms of poverty. Roughly one in five New Mexicans is poor, and over a quarter of New Mexico's children are poor.

Myth: *Poor people don't pay taxes.*

Reality: *New Mexico's heavy reliance on the gross receipts tax ensures that low-income households contribute at least their fair share of general fund revenue. In addition, low income households pay property taxes that are passed through in rent, gas taxes, and motor vehicle fees. Even undocumented workers pay New Mexico's gross receipts tax every time they purchase food or goods.*

How Does New Mexico Rank in its Tax Treatment of Working Poor Families?		
	Rank	How Do Other States Compare?
2001 income tax liability threshold for single parent families of 3: **$18,400**	17th highest [i]	In California, the state with the highest theshold, single parent families of 3 don't start payming state income taxes until their annual income exceeds $36,800.
2001 income tax paid by family of 3 with minimum wage earnings: **$100 refund**	11th lowest [i]	Alabama levies the highest tax on minimum wage earners. There, a single parent making minimum wage pays $218 in state income taxes. In Vermont, the same worker receives a $1,283 refund.
Percent of personal income spent on state income taxes [ii]: **2.25%**	34th highest	Residents of Oregon, which ranks first in this indicator, spend an average of 4.33% of income on state income taxes. The US average is 2.43%
Percent of state and local tax revenue from sales and excise taxes [ii]: **62.98%**	5th highest	Nevada ranks first in this indicator deriving 75% of total tax revenue from state and local sales taxes.
Percent of personal income spent on sales taxes [ii]: **6.52%**	4th highest	Residents of Washington state, which ranks first in this indicator, spend an average of 7% of their incomes on sales taxes.
i Of 42 states with personal income taxes. Source: Center on Budget and Policy Priorities www.cbpp.org ii Source: National Conference of State Legislatures http://204.131.235.67/programs/fiscal/spr19n06a.htm		

Consumption taxes exacerbate poverty by contributing to the cost of virtually all goods purchased. A family of three with income just below the poverty level ($15,020) pays around $450 per year in gross receipts taxes on necessities such as food, medical care, clothing, and gas and electric utilities. As noted earlier, 68% of the gross receipts tax flows into the general fund and the general fund is the primary source of state funding for programs such as Medicaid and child care assistance that directly benefit low income families. It seems illogical to tax low income households in order to provide them with services; but virtually all states do, and this is because few politically or administratively viable alternatives exist.

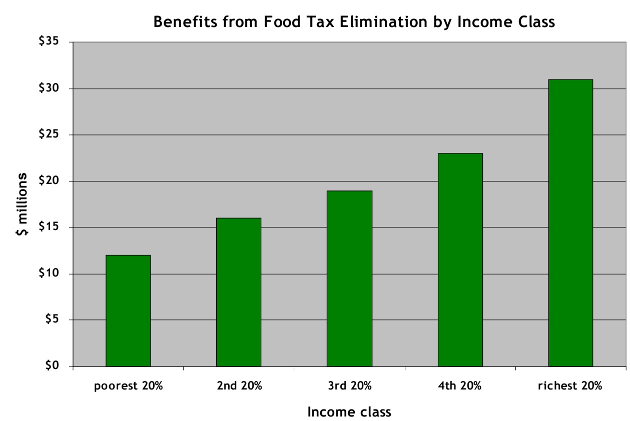
In New Mexico, more equitable alternatives to taxing necessities include increasing property and/or personal income taxes. Neither of these approaches is likely to be popular with politicians. Exempting low income households from the gross receipts tax would make the tax system more equitable, but such an exemption would be impossible to administer. Exempting necessary goods and services from the gross receipts tax is yet another impractical solution.

In New Mexico, over one third of the benefits of exempting groceries from the gross receipts tax would accrue to the richest 20% of households. Less than 20% of the benefits would go to the poor.

Why Selective Exemptions Don't Work

The gross receipts tax is regressive because opportunities for avoiding the tax -- through saving, investment, e-commerce, and out-of-state travel -- increase with income. On the other hand, to light one's home one must pay the gross receipts tax on electricity and to buy groceries without food stamps one must pay the gross receipts tax on food. Why not then simply remedy regressivity by exempting necessities such as food and electricity from the gross receipts tax? The answer to this question comes in three parts:

1. ***Selective exemptions are inefficient***. Most of the benefits of selective exemptions accrue to upper and middle income households that have more rooms to light and more expensive taste in food. Thus, remedying regressivity with selective gross receipts tax exemptions means spending a great deal of money on tax relief for households that don't need it. The benefits to a four-person household from eliminating the gross receipts taxes on necessities (including retail food, physicians services, hospitals, drug stores, apparel and accessories, gas, electric and sanitation utilities) are 2.5 times greater for households making over $50,000 than they are for poor households. Eliminating the gross receipts tax on food alone would require a tax expenditure of over $100 million. Such a large tax expenditure potentially undermines the ability of the general fund to support public programs that benefit low income households.



2. ***Narrowing the tax base through selective exemptions may necessitate imposing new taxes or raising the rate on everything that continues to be taxed***. Low-income households will bear the burden of a rate increase whenever they purchase goods or services not exempted. For fiscal year 1998 gross receipts tax exemptions for the necessities listed in paragraph (1) above would have decreased the statewide gross

receipts *tax base* (ie. the total amount of property, sales, or income that taxes can be calculated on) by $5.6 billion or 18.7%. Exemptions from the gross receipts tax obviously narrow the tax base. Fiscal year 1998 gross receipts tax *revenue* was $1.76 billion. To maintain this level of revenue with a narrowed base would have required increasing the average gross receipts tax rate from 5.9% to 7.25%. In addition, the gross receipts tax, particularly on business, legal, and research and development services, is already a competitive disadvantage to New Mexico business. Higher rates would almost certainly stifle economic development, which means fewer jobs and less income for ***all*** working New Mexicans.

3. ***Selective exemptions for necessities would be disproportionately burdensome to local governments.*** In addition to providing state revenue, the gross receipts tax is the principle revenue source for local governments. Exemptions for the necessities listed in paragraph (1) above would have decreased the municipal gross receipts tax base by $1.2 billion or roughly 21.7%. To recoup this profound revenue loss, municipalities would have to increase local taxes beyond the level permissible under current law.

Tax Burden Solutions: Entitlement Programs and Refundable Credits

Food purchased with food stamps is exempt from the gross receipts tax. Families receiving the maximum food stamp benefit ($356 per month for a family of three) therefore pay little, if any, food tax. Because the food stamp program is 100% federally funded, this potent form of tax relief comes at virtually no cost to the state. In 2001, New Mexico families received over $140 million in food stamps, avoiding approximately $8 million in gross receipts tax they would have paid had all the groceries they bought with food stamps been paid for with cash[3].

Unfortunately, fewer than one third of families potentially eligible for food stamps are actually enrolled in the program. Exempting groceries from the gross receipts tax would cost state and local governments over $100 million annually. Investing a small fraction of this sum in food stamp outreach and enrollment could substantially reduce the tax burden on low income households while at the same time stimulating New Mexico's economy with additional federal dollars.

Myth: *Entitlement programs and refundable tax credits don't stimulate the economy; but personal income tax breaks for the wealthy do.*

Reality: *Low income New Mexicans spend all their money in New Mexico, generating tax revenue and jobs. Higher income New Mexicans may save, invest in the stock market, or spend their tax savings outside the state.*

A $10,000 increase in income for a three person household making $7,500 per year generates two thirds more gross receipts tax revenue than a $10,000 increase in income for a three person household making $40,000 per year. ($163 vs $98).

In 1999, the food stamp program alone brought almost $182 million federal dollars into New Mexico. Although food stamps aren't subject to the gross receipts tax they generate significant general fund revenue by enabling low income households to spend their cash income on other gross receipts taxable commodities such as clothing, utilities, and healthcare. The same year, the federal Earned Income Tax Credit brought roughly $280 million into New Mexico, generating at least $8 million in gross receipts tax revenue*.
**** Some expenditures, like housing and gasoline, are not subject to the gross receipts tax***

Another approach to equalizing tax burden is to use one tax program to offset the burden of another. Such an approach may be considerably less expensive than attempting to make each tax program more equitable in its own right, and is not as novel as it may sound. The Earned Income Tax Credit, a federal personal income tax rebate with broad, bipartisan political and popular support, was conceived as a way to offset the regressiveness of the social security tax. Refundable personal income tax credits, such as New Mexico's Low Income Comprehensive Tax Rebate offset gross receipts tax burden at minimal cost.

Take, for example, the gross receipts tax on food. Eliminating it would cost over $100 million annually and most of the benefits would go to upper income households. Poor New Mexicans pay approximately $12 million in food tax a year. Most file a personal income tax return in order to receive LICTR and refunded withholding. **Offsetting the burden of the food tax on poor people could be as simple and inexpensive as refunding the $12 million to poor families through LICTR. Such a policy would have the additional benefit of lifting at least 500 children out of poverty.** The state would continue to receive over $78 million in food tax, including all the food tax paid by tourists and other non-residents, while completely offsetting the burden of the food tax on poor New Mexicans.

> ***Myth:*** *Selective gross receipts tax exemptions for necessities such as food equalize tax burden more efficiently than refundable tax credits.*
>
> ***Reality:*** *Gross receipts tax breaks are most beneficial to households that spend the most money. Refundable tax credits such as LICTR are more efficient because they specifically target the low income households most in need of tax relief.*
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> ***Piecemeal tax policy doesn't work because tax systems are more than the sum of their parts. Using one tax program to offset the burden of another may be much less expensive than attempting to make each tax program more equitable in its own right.***

Conclusion

A tax on commodities like food, utilities, healthcare, and clothing is regressive. However, as this analysis has demonstrated, refundable tax credits such as LICTR and in-kind transfers such as food stamps can dramatically diminish the burden consumption taxes place on the poor at minimal cost to state and local governments. New Mexico's tax system is far from perfect. Nevertheless, in the absence of comprehensive tax reform, combining a broad-based gross receipts tax with a strongly progressive personal income tax remains the most efficient way for New Mexico to maintain tax system equity.

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[1] The state gross receipts tax is 5% less a credit of .5% for receipts within municipal boundaries. 1.225% of the remaining 4.5% state base is returned to each municipality based on transactions within that municipality. There is no equivalent credit or distribution to counties. A state rate of 5% is imposed in unincorporated areas. Local governments can and do impose local option gross receipts taxes as increments (usually 1/8 of a cent) to the state base. Local option gross receipts taxes are administered in the same fashion as the state gross receipts tax and distributed to the local jurisdictions by the state taxation and revenue department.

[2] Johnson, Carey, Mazerov, McNichol, Tenny, and Zahradnik ***State Income Tax Burdens on Low-Income Families in 2001: Assessing the Burden and Opportunities for Relief***. February 2002 Center for Budget and Policy Priorities

[3] Of course, without food stamps many low income households would purchase a lot less food. Research indicates that for each dollar of food stamps they receive, low income households increase their food purchases by between $.20 and $.45. Source: Fraker, T. 1990. The Effects of Food Stamps on Food Consumption: A Review of the Literature. Mathematica Policy Research. Prepared for United States Department of Agriculture. Washington, D.C.

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