

The Fiscal Policy Project

New Mexico Tax Basics

New Mexico's Personal Income Tax Cut: What It Means to You

Fairness and revenue adequacy are two important principles of good tax policy. Taxes should generate enough funds to pay for the state's essential services. In addition, taxes should distribute the tax burden equitably - taking a higher percentage of income from higher income households. Unfortunately, with the personal and capital gains income tax cut passed in 2002, New Mexico's tax policy now fails to comply with either of these principles.

Fairness

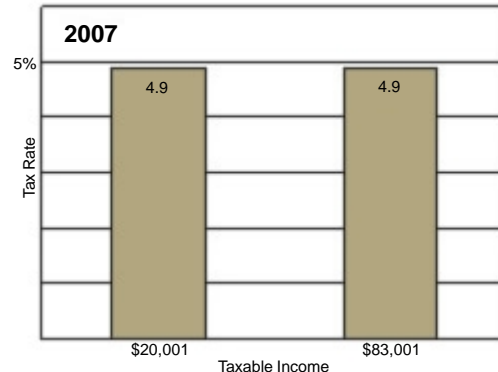
Until the personal income tax cuts were passed, New Mexico had a *progressive* personal income tax system. People with higher incomes paid a higher percentage of their income in taxes. The rates started at 1.7% for a head of household with taxable income (or income after allowable deductions) of \$7,000 and increased to 8.2% for a head of household with taxable income of greater than \$83,000. However, the "effective" tax rate for upper income families was lower than 8.2% because of deductions (such as mortgage interest and health care costs) that are often not available to low income families. Still, the personal income tax system was progressive: rates increased from lower rates for very poor people to higher rates for people with more income.

In 2007, when the income tax cuts are fully phased in, New Mexico will have a *regressive* personal income tax system: high income families will no longer be paying a fair share of taxes. In the new law, the rates for very poor people have not been lowered: they still start at

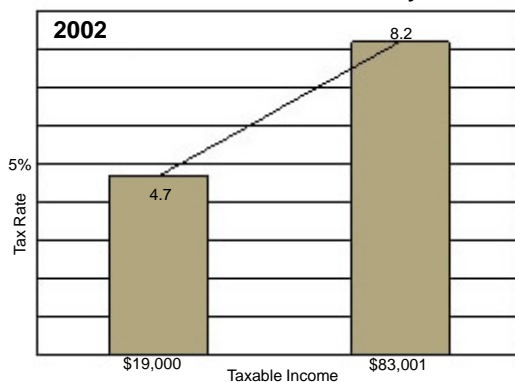
1.7%; but the rates for upper income brackets have been drastically reduced to 4.9%. In 2007, a mother of two children with taxable income of \$20,000 will pay 4.9% in personal income taxes. And a mother of two children with taxable income of \$90,000 will also pay taxes at the same 4.9% rate.

The problem is compounded because the law passed in 2002 also cut capital gains taxes (the taxes paid on the profits from sale of assets, such as stock or commercial buildings.) By 2007, only 50% of capital gains will be subject to tax. This is another windfall for wealthy people who are most likely to derive a large share of income from capital gains.

New Mexico's New Tax Policy



New Mexico's Old Tax Policy

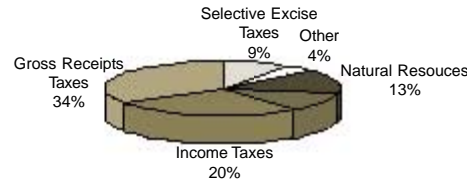


Revenue Adequacy

The Legislative Finance Committee produces fiscal reports throughout the year to inform standing committees of the legislature about important budget and revenue issues. In March, 2004, the *LFC Newsletter* headline was "Personal Income Tax Cut Tempers Revenue Outlook." The report stated, "The second year of a personal tax cut will temper revenue growth in FY05, the LFC-Post Session Fiscal Review report. ...In large part, weak revenue growth can be attributed to two factors: lower energy price assumptions and the second year of the five-year personal income tax reduction." (*LFC Newsletter*, Vol. 04, Issue 09, March 2004).

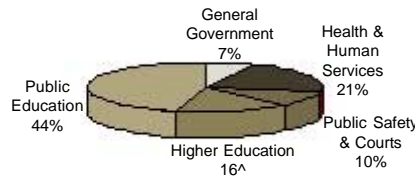
With full implementation of the tax cut, New Mexico's tax policy will fail to meet the 'revenue adequacy' test. **By 2007, the state will collect \$350 million less in taxes each year. Our total budget is only \$4.4 billion.** We felt the first wave of the tax cuts this year: there was **\$83 million less** in income tax-generated revenue available for education, health care, child care and other investments essential to a healthy economy. When fully phased in, there will be \$350 million less to spend *every year*. To understand what that will mean to our budget, and to funding essential programs and services, it is important to understand how the tax system works. Taxes are collected from several sources, and become the General Fund:

Taxes: Sources of the General Fund in FY 2004 (\$4.4 B)



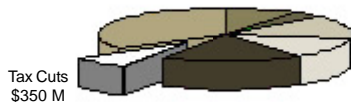
The General Fund, in turn, pays for state programs and services:

Services: What the General Fund Paid for in FY 2003 (\$4.4 B)

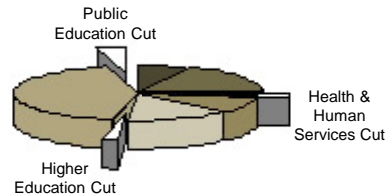


There is a direct relationship between tax policy and funding essential needs. Last year's income tax cuts resulted in \$83 million less in this year's General Fund. Much of the 2004 legislative debate was around the Medicaid budget, and finding sufficient revenue to fully fund Medicaid. With the continued reduction of revenue due to the tax cuts, New Mexico will face drastic spending cuts in education and healthcare in the next year. We cannot afford an annual loss of \$350 million in revenue.

Money Lost From the General Fund (FY 2007)



Cuts in Services Due to Lost Revenue (FY 2007)



Simply put, we will very soon be faced with the choice either to raise taxes or cut services. So far, the debate has been framed as a *spending* crisis. In fact, it is a *revenue* crisis brought on by the personal income and capital income tax cuts of last year. This is a critical distinction. If we understand that the source of our inability to pay for essential services is insufficient revenues (rather than excessive spending) we arrive at different policy solutions. A *revenue* crisis means that we need to examine our tax policy and make sure that it is fair and adequate. A *spending* crisis means that we will reduce funding and the most likely reduction will be in essential services like education, child care, and health care for vulnerable populations.