

New Mexico



VOICES
for Children

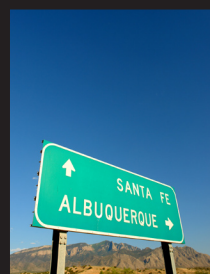


Taking a closer look at tax and budget policies affecting New Mexico's quality of life

New Mexico Fiscal Policy Project

CITIZEN'S GUIDE TO NEW MEXICO'S TAX SYSTEM

HOW THE STATE COLLECTS MONEY AND WHY IT MATTERS



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Other Citizen's Guides

Citizen's Guide to the New Mexico State Budget

Advocate's Guide to the New Mexico State Budget

Citizen's Guide to Legislative Advocacy in New Mexico

A New Mexico Citizen's Guide to Children's Issues



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INTRODUCTION

When we think about paying taxes, what usually comes to mind is that frantic day in mid-April when we file our income tax returns. But the truth is, we pay taxes much more often than that. In fact, most New Mexicans pay some tax almost every day. This is because New Mexico, like most states, levies a lot of different taxes—sales taxes, income taxes, property taxes, gasoline taxes—so many taxes, in fact, that virtually everything you buy has at least one tax on it. Even things that don't seem to be taxed—like rent—are taxed. Even though you may not get the bill, the taxes are usually passed along to you.

Now consider how often you directly benefit from the buildings, roads and services that are paid for with your tax money. Again, it's almost every day. Every time you drive on a road or highway, visit the park, borrow a library book, or send your kids off to school you benefit from some service or infrastructure that was funded, at least in part, by taxes. But even if you never leave the house, you benefit from this common network. Police and firefighters protect you. Garbage collectors take your trash away. Even the grids of pipes and wires that bring water and electricity into your home were paid for in part by your taxes.

Determining how taxes are collected says a lot about our values and priorities, in much the same way that deciding how to spend that money is a reflection of our values. While the

budget determines who will receive the most benefit from government spending, the tax code determines who will pay for these services and how much. A tax code can spread the payments evenly among taxpayers or it can allow some citizens to pay less than others.

This guide describes the basics of New Mexico's tax system. Two companion publications, *Citizen's Guide to the New Mexico State Budget* and *Advocate's Guide to the New Mexico State Budget*, explain the basics of the state's general fund budget, the budget formation process, and how citizens can promote their priorities within that process.

Some Tips for Using This Guide

Words that appear in boldface are defined in the *Technical Terms* and *Tax Facts* boxes. All of the acronyms used in this guide are written out in the box below.

Acronyms

AGI – Adjusted gross income
CIT – Corporate Income Tax
EITC – Earned Income Tax Credit
FIR – Fiscal Impact Report
FPL – Federal Poverty Level
GRT – Gross Receipts Tax
LICTR – Low Income Comprehensive Tax Rebate
PIT – Personal Income Tax
TRD – Taxation and Revenue Department
WFTC – Working Families Tax Credit

WHERE THE STATE SPENDS MONEY

Direct Spending

The state spends money both directly and indirectly. We'll get to indirect spending in a moment. The biggest direct expenditure for New Mexico is public education (K–12 schools plus public colleges and universities).

The state also spends money on health, hospitals, and human services (Medicaid, other public health services, childcare, and child welfare), public safety (state police, prisons, and crime labs), the court and judicial systems, staffing the legislative and executive branches, and building and maintaining public infrastructure such as roads, bridges and public buildings.

Most programs and services are paid for out of the **operating budget**, which is supported by the **general fund**. Money for capital projects (such as building new schools and community centers) and road construction come from different funds. While the state can borrow

money, such funds generally cannot be used to pay for services. Borrowed money goes into the **capital fund**. This guide focuses on the general fund, which is comprised of taxes and fees.

Chart I (page 6) shows how the general fund is spent. This fund does not include federal matching dollars for Medicaid, childcare, and education, even though they go into the operating budget, because the state has no direct control over how these funds are spent. As the pie chart illustrates, education takes up the biggest slice of the state budget. Health, hospitals, and human services account for about a quarter of the general fund, and public safety spending is just 7 percent of general fund spending. The “all other” slice includes funding for all remaining agencies and programs of the executive, legislative and judicial branches of state government.

Technical Terms

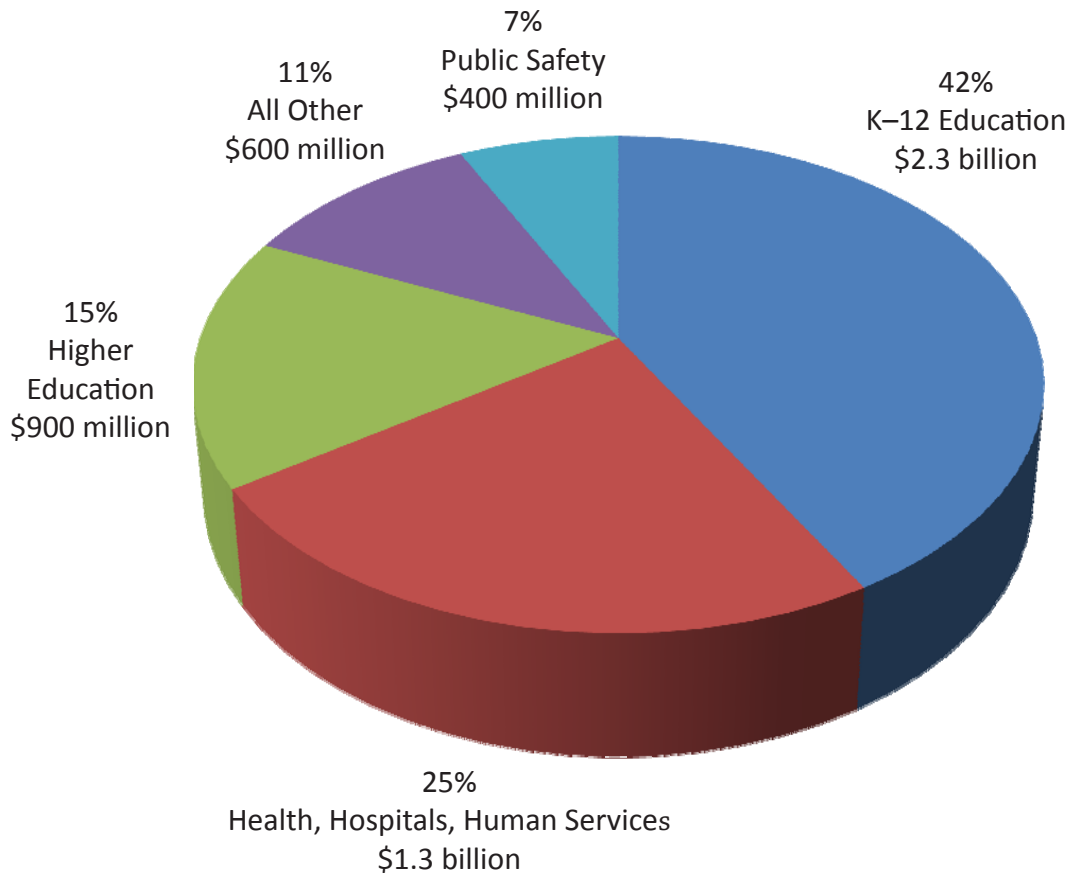
Capital fund – Money for things like building schools and community centers. This spending is referred to as “capital outlay.”

General fund – Money that the state has collected that supports the operating budget.

Operating budget – Money for operating ongoing programs and services, such as public school education.

Road Fund – Money for building and maintaining roads and highways from revenue sources such as gasoline taxes and car registration fees.

Chart I
New Mexico's \$5.5 Billion General Fund Operating Budget for FY10
(by percentage and amount)



Source: Legislative Finance Committee, 2009 Post-Session Review, Appendix D

Technical Terms

Fiscal year – The revenue and budget year for the state. New Mexico's fiscal year starts on July 1 and ends the following June 30. The fiscal year is named for the calendar year in which the fiscal year ends. For example, fiscal year 2008 (which began July 1, 2007) ends on June 30, 2008. Fiscal year 2008 is abbreviated as FY08.

General fund spending is determined annually by the state Legislature with input from the governor and state agencies. For a more complete picture of how the budget is created, see the companion publication *Citizen's Guide to the New Mexico State Budget*.

Indirect Spending

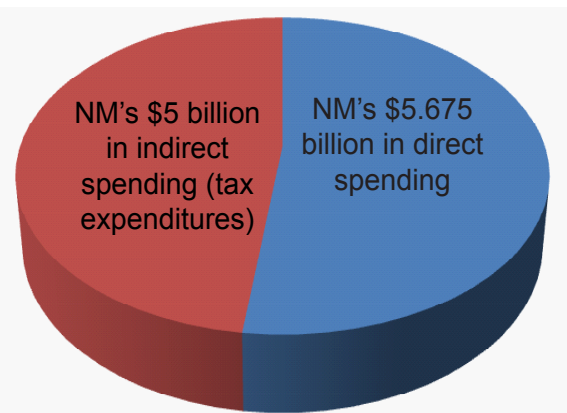
The state spends money indirectly by choosing to forego collecting certain tax revenues. Over the years, the Legislature has enacted tax exemptions, deductions and credits, which are called tax expenditures. Many tax expenditures are touted as necessary for economic development because they can provide a subsidy or incentive for specific businesses. Tax credits for the film industry are a good example. Other expenditures are intended to help working families, for example when the Legislature exempted most food from the gross receipts tax.¹ As a result, when you go to the grocery store to buy bananas, bread, and other food you are no longer charged tax on them.

Another result of enacting tax expenditures is that the state collects less revenue. That means the state will either have to cut its direct spending or it will have to raise other taxes or fees to make up the difference. Before any legislation to enact a tax expenditure is passed, however, the state researches how much the tax cut or deduction will cost. These estimates are released in a fiscal impact report (FIR). Unfortunately, the fiscal

impact of a tax expenditure—not to mention the cumulative cost of many expenditures over many years—is seldom revisited by the Legislature. In fiscal year 2008, tax expenditures cost the state some \$5 billion in lost revenue—or almost as much as the state's direct spending (see Chart II, below). And yet, the Legislature does not consider whether these expenditures have had the desired effect. Tax expenditures enacted as economic development incentives that do not grow the economy are simply tax giveaways.

Most states (and the federal government) have tax expenditure reports,² which enable them to scrutinize this indirect spending in much the same way that direct spending is reconsidered every year. New Mexico's Legislature passed a bill in 2007³ that would have required the state to produce an annual tax expenditure report, but it was vetoed by the governor.

Chart II
The Whole Budget Picture, FY08



Source: Calculation by NM Voices for Children from estimates from NM TRD Tax Research Unit

Tax Facts

The Trouble with TIDDs

Another way the government can spend money indirectly is through tax increment financing (TIF). In most states, TIF is used as an incentive to get developers to rehabilitate an urban area that has fallen on hard times. Here's how it works: Typically, in addition to commercial buildings, the developer is also responsible for providing much of the public infrastructure—the roads, sidewalks, and such. Because the redevelopment of an existing area is usually more of a financial risk than creating a brand-new development, the city and county offer to use future tax revenue to help pay for the public infrastructure. The amount that's paid is determined by how much economic activity increases within the area after it's been redeveloped. That amount is called the 'increment.'

Many cities and counties see TIF as a win-win situation. It helps them bring needed redevelopment to an area that has lost much of its former economic activity—along with the tax revenue that activity generated. Even though some of the taxes from the new economic activity will go to the developer, the city or county will still collect more tax revenue too if the redevelopment is a success.

In 2006, the state Legislature enacted a bill that allows for state tax revenues to be used in financing development projects—even when they are planned for previously undeveloped areas.⁴ The project that would receive the TIF is called a tax increment development district (TIDD).

Advocacy groups like New Mexico Voices for Children have grave concerns about TIDDs and the disastrous consequences they could have on the state's general fund. Those concerns include:

- State tax revenue that would normally go to fund programs that benefit the whole state—such as education, health care and public safety—will be diverted so that it only benefits the TIDD.
- Rural areas are likely to be left out because they are less able to attract big developments.
- The developer decides how the tax money is spent, which circumvents both the Legislature's authority to appropriate state tax dollars and the state's procurement policies and procedures.
- Building on previously undeveloped land is less risky and occurs anyway without these kinds of incentives.
- There are no mechanisms in place to track whether TIDDs actually pay for themselves.

Some arguments in favor of TIDDs have revolved around the promise of good, sustainable communities with high-wage jobs and affordable housing. But they are just that—promises.

Keeping Up with Current Services

In order to continue to provide the same level of programs and services as the year before, the state must increase spending every year by at least 5 percent. This is because of inflation (which is at 3 percent) and population growth (2 percent).



Tax Facts **A Centralized System**

New Mexico's tax system is centralized, meaning that state government funds many of the programs that are paid for at the city and county level in most other states. For example, New Mexico funds both K–12 and higher education through the state government. Most other states fund their schools primarily with city and county property taxes. Hawaii is the only other state that has a public finance system as centralized as New Mexico's.

An economic downturn puts great strain on the state budget. The state collects less money in the way of taxes because business is sluggish, unemployment goes up, and people's salaries are frozen or their work hours are cut back. As more people lose their income, more come to need the very social services that those declining tax revenues are funding. State universities and colleges also experience higher enrollment as people seek to develop new skills or earn a degree. Unlike the federal government, however New Mexico, like most states, cannot run a deficit.⁵

“The expenses of government, having for their object the interest of all, should be borne by everyone, and the more a man enjoys the advantages of society, the more he ought to hold himself honored in contributing to those expenses.”

—*Anne Robert Jacques Turgot, French economist*

HOW THE STATE COLLECTS MONEY

General Fund Revenue Sources

Chart III (page 11) shows where the state gets its tax revenue, and how much is expected to be generated for FY10. The largest slice of the pie (36 percent) comes from *general sales taxes*. This includes **compensating taxes** as well as the **gross receipts tax** (GRT), which is levied on goods and services. This is good because services constitute an increasing share of economic activity while goods constitute a decreasing share. Many states are now scrambling to increase their taxation of services.

Excise taxes on things like tobacco, liquor, motor vehicles, and telecommunications services account for 8 percent. People often suggest raising so-called “sin” taxes—taxes on alcohol and tobacco products—as a way to generate revenue, but as the pie chart indicates, such taxes do not amount to a very significant share of the whole.

Personal income taxes make up a much larger percentage (23 percent) of revenue than **corporate income taxes** (5 percent). Corporate income taxes are levied on a corporation’s net profits, which can vary widely from year to year. Also, our tax code allows corporations that do business in New Mexico, but are based in another state, to avoid paying taxes on the profits they make here (see the *Tax Facts* box below).



Tax Facts

New Mexico and the Corporate Income Tax

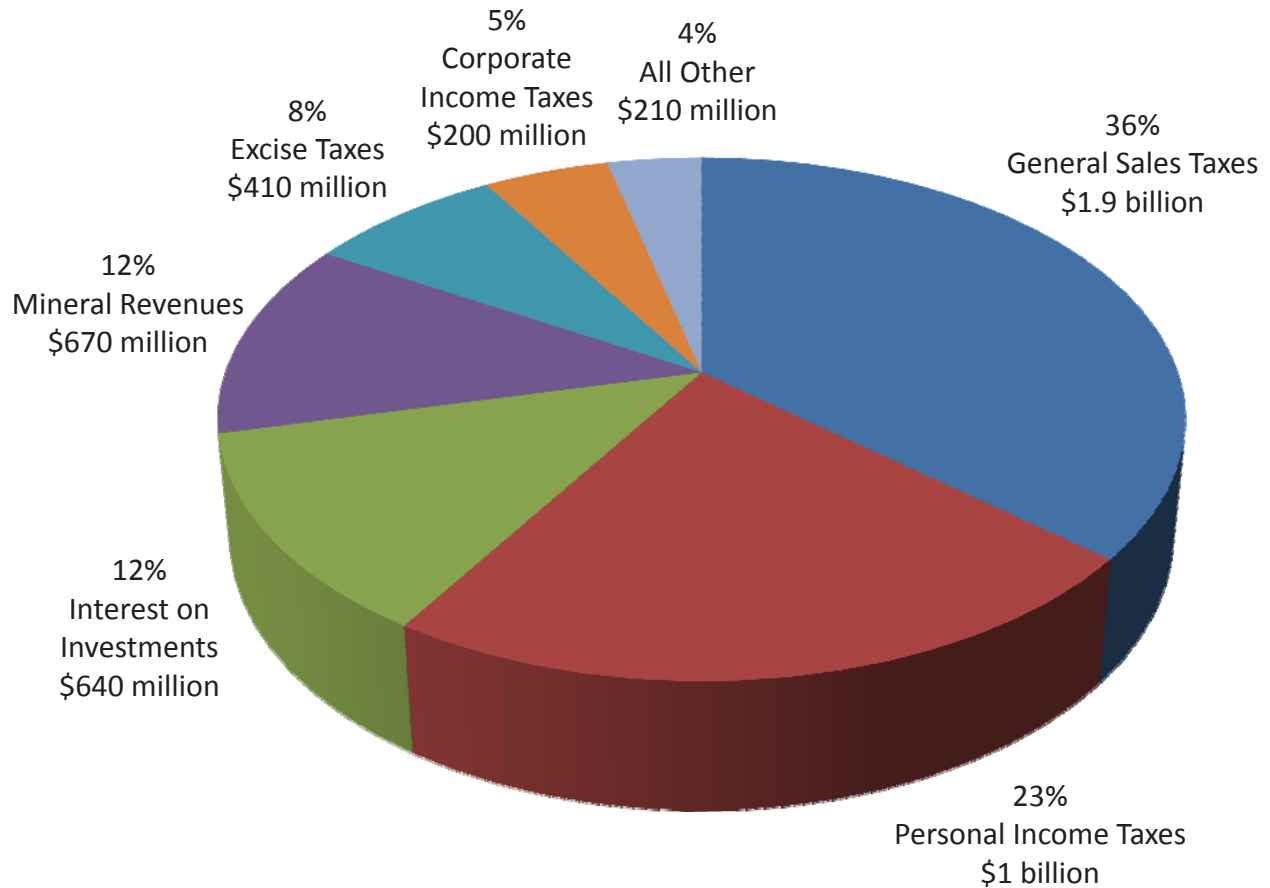
New Mexico’s tax code is written in such a way that it allows multi-state corporations to minimize the corporate income taxes (CIT) they pay to New Mexico on the profits they make here. There are a number of ways they do this, but the most common is for the companies to shift their New Mexico income to a state that does not charge CIT, such as Delaware. This costs the state tens of millions of dollars every year⁶ and puts corporations that operate only in New Mexico at a competitive disadvantage.

Changing this policy with legislation—called “unitary combined reporting”—has been brought before the state Legislature several times, but has never passed. New Mexico is the only state west of the Rockies that does not require unitary combined reporting.

Chart III

New Mexico's General Fund Revenue Sources for Fiscal Year 2010

(by percentage and amount)



Source: Legislative Finance Committee's 2009 Post Session Review, Appendix H

Technical Terms

Gross Receipts Taxes (GRT) – Taxes collected on the sale of most goods and services.

Compensating tax – A tax on goods that are bought out-of-state for use in New Mexico.

Excise Taxes – Taxes levied on specific goods, such as cigarettes, alcohol and gasoline.

Income Taxes – Taxes paid on a resident's personal income and a company's profits.

Severance Taxes – Taxes paid on natural resources such as crude oil and natural gas, so named because these resources are 'severed' from the ground.

The 12 percent *mineral revenues* piece of the revenue pie includes **severance taxes** on crude oil, natural gas, coal, copper, and other hard minerals that are extracted from the ground, as well as rents and royalties from the sale or lease of mineral-producing land. Out of this mineral mix, some 90 percent of revenue comes from taxes collected on oil and natural gas extraction specifically, natural gas being the largest mineral revenue producer.

Severance taxes are based on the value of production (e.g., the price of a barrel of oil), so changes in the market prices of these commodities can have a significant effect on the amount of revenue collected by the state. These taxes are a desirable revenue source because they are “exported,” meaning that because New Mexico oil and natural gas



companies are owned by out-of-state people, these taxes are likely not passed on to New Mexicans. Instead, most severance taxes are likely paid by the owners of energy corporations, that is, the stockholders.

The 12 percent *interest on investments* is primarily derived from investing permanent fund revenue in the stock and bond markets. New Mexico derives an unusually large share of revenue from investments. As interest rates rise and fall, interest on investments will also rise and fall.

The 4 percent *all other* category includes gaming (among other sources). New Mexico has revenue sharing agreements with tribes and pueblos that operate casinos and other venues under the federal Indian Gaming Regulatory Gambling Act.⁷ This requires tribes





and pueblos to pay a percentage of their net revenues in exchange for the right to engage in gambling. While gambling and the revenue-sharing negotiations garner much attention, gaming revenues account for a mere 1 percent of the general fund.

Tax Facts

Other Revenue Sources

Some other revenue sources you may be familiar with that *do not* go into the state general fund are:

Fuel taxes on gasoline and other fuels. These are specifically designated for the Department of Transportation's use and are deposited in the state road fund, which is used to finance operating costs, highway construction and maintenance, as well as debt payments for highway capital improvement bonds.

Fees are collected for services such as licensing a car or to enter a state park.

Federal funds accounted for approximately one-third of the state's total budget in FY09. While many agencies receive federal funding, the majority goes to Health and Human Services, and the Transportation and Public Education Departments. Federal funding also goes to higher education institutions.

Property taxes go largely to fund local government in New Mexico. County and city governments combined get almost half (46.3 percent). Another large share goes to school districts (30 percent), with the remainder going toward higher education, health facilities, the state debt, and conservancy districts.

WHY IT MATTERS

People often ask why a child advocacy organization like New Mexico Voices for Children works on tax issues. Wouldn't it make more sense for us to advocate on issues that directly affect kids—issues like better nutrition in schools, higher quality foster care, and more anti-gang programs? We do advocate for those kinds of things, but they are not the only public policies that directly impact kids.

The state and federal tax systems also impact working families, which directly affects their children. For example, tax systems can—and often do—favor those who have the most money not those who have the greatest need. As you will see later in this guide, low-income families actually pay a much higher percentage of their income in state and local taxes than high-income people do. The more money a low-income family spends on taxes, the less money they have for necessities like nutritious food, health care, and books that help their children succeed.

Low-income families do tend to benefit from much of the state's spending, but, then, so do profitable businesses. The state spends a great deal of money on what are called "economic development incentives." These incentives, which range from direct subsidies to tax breaks, aim to get businesses to come to New Mexico. This is not necessarily a bad practice—especially if the businesses bring or

retain good-paying jobs. However, the return on investment of these incentives is seldom measured in New Mexico. If these incentives are not creating good jobs, they may simply be shorting the state's general fund, which pays for programs—like education—that benefit the whole state.

Another reason state tax practices are so important to the well-being of children is that the federal tax system has become less child-friendly over the past several decades. Almost

every year since the 1960s, the share of federal spending on children's programs has become a smaller and smaller slice of the budget pie.⁸ This includes programs like education, nutrition,

and health care—all of them essential if our children are to grow up healthy and reach their potential.

This has shifted more of the responsibility for child well-being to the states, which have fewer resources than the federal government.

Meanwhile, the federal budget has relied less on income taxes from corporations and more on income taxes from working families.⁹ The nation's personal income tax practices of the past 30 years have also resulted in a shift of wealth upward and, for the first time since World War II, parents cannot be certain that their children will have more opportunity and a better standard of living than they had.¹⁰

"Taxes, after all, are dues that we pay for the privileges of membership in an organized society."

—Franklin D. Roosevelt

PRINCIPLES OF A GOOD TAX SYSTEM

A good tax system provides **adequate, stable** revenue to **consistently** fund state services in a manner that is:

- **Easy to administer**
- **Transparent**
- **Balanced**
- **Fair**

A tax system is **adequate** when tax revenue meets state spending needs and keeps pace with inflation and population growth.

Revenue forecasters have determined that New Mexico's state budget will become less adequate in the coming years. As the bar graph on page 16 illustrates, the amount of revenue available dropped significantly from FY08 to FY09 and has fallen to even less for FY10. This dramatic downturn is due in part to the present economic recession. As economic activity slows, revenue decreases—especially from sales- and energy-related taxes. Also, less revenue is being collected due to new tax incentives.

In the past, it was appropriate to increase the budget

annually to meet the demands of inflation and population growth. However, as Graph I (page 16) shows, New Mexico won't return to FY08 revenue levels until FY14.

Given that the general fund would have normally been *increasing* during that time, the fact that it will take six years before we are back to pre-recession funding levels highlights the seriousness of the impact of the economic recession on state-funded programs. In order for citizens not to suffer this decline directly, changes must be made to the tax system that increase revenue and citizens must advocate to keep those aid programs that are vital for their well-being.

Tax Facts **Tacking on to the GRT**

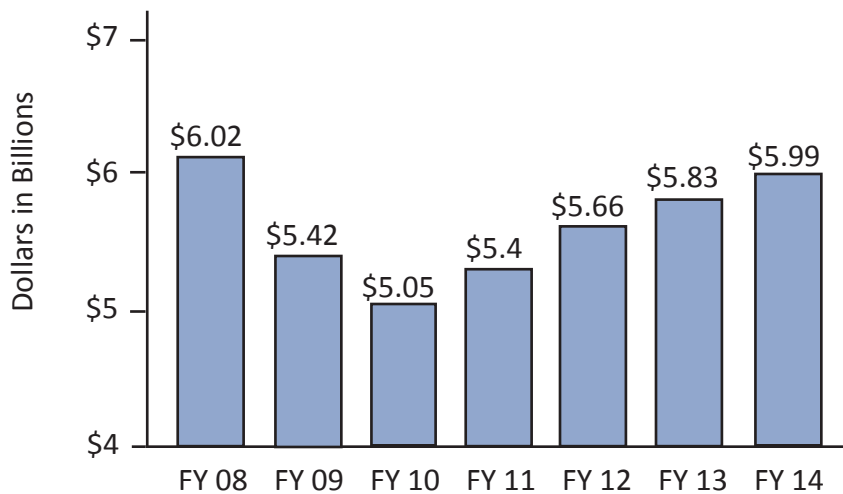
Because New Mexico's gross receipts tax is levied on both goods and services, it is broad-based. This has kept the rate relatively low. However, in 2004 the Legislature enacted a deduction of GRT from the sale of food and most medical services. To make up for lost revenue, the overall GRT rate had to be raised from 4.5 percent to 5 percent.

On top of that, many cities and counties tack extra onto the GRT to pay for municipal services. This is the largest source of municipal revenues in New Mexico. The highest gross receipts tax rate in the state (7.875 percent) is levied by the cities of Española, Santa Fe, Santa Rosa, and Red River.

A **stable** tax system is one that relies more on predictable revenue sources than on sources that fluctuate. Personal income taxes are stable because they grow with personal income. The

PIT cuts of 2003 made New Mexico's tax system far less stable because it has had to rely more on severance taxes, which fluctuate with global prices.

Graph I
New Mexico's General Fund Recurring Revenue Forecast
(by amount)



Source: Legislative Finance Committee, August 2009 Consensus Forecast

Stable Revenue Sources:

Personal Income Taxes (PIT) are stable because they grow with personal income.

Gross Receipts Taxes (GRT) are stable because they grow with the population.

Unstable Revenue Sources:

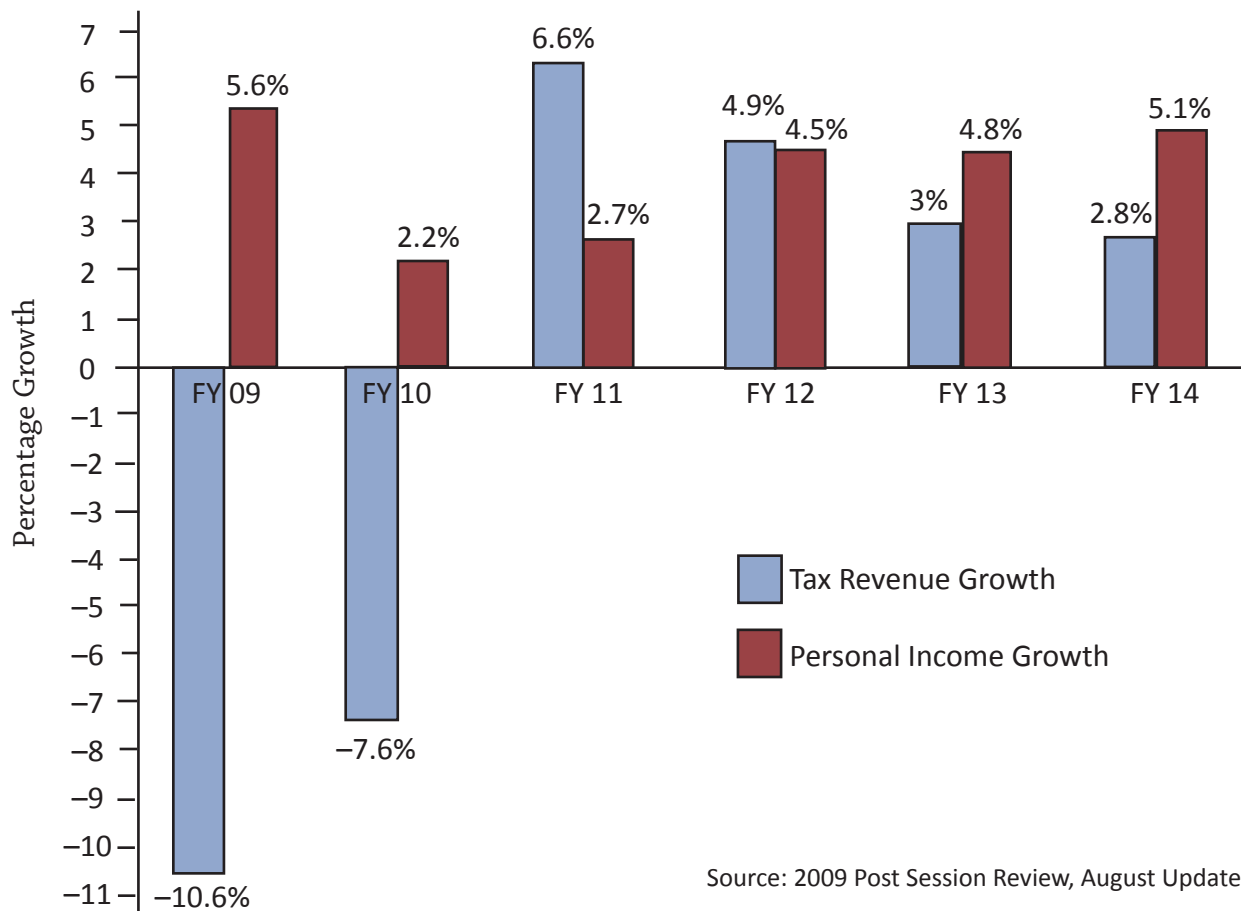
Severance Taxes are unstable because they depend on finite resources and on fluctuating global market prices for oil and natural gas.

Corporate Income Taxes (CIT) are unstable because, in New Mexico, most of them come from oil and natural gas companies, whose profits rise and fall as oil and gas prices fluctuate.

A tax system is **consistent** with the state’s economy when tax revenues grow at the same rate as state personal income. Gross receipts tax growth is the most consistent because it closely follows population growth (which also impacts the need for state services). Sales taxes tend to grow at a faster rate than state spending grows, and excise taxes tend to grow at a slower rate. See Graph II (below) for a comparison of revenue and personal income growth.

Historically, state spending has grown about 6 percent, similar to the long-term growth in the state’s economy. However, tax revenues have ceased to grow at the same rate as the economy. As the bar graph illustrates, revenue growth has hit an all time low—dropping to *negative* 10.6 percent in FY09.

Graph II
Average Annual Tax Revenue and State Personal Income Growth Rates
 (by percentage)



Source: 2009 Post Session Review, August Update

Finally, a tax system is considered **easy to administer** when the expense of collecting, enforcing, and complying with the system is minimal. Every time the state makes changes to the tax code (for example, **tax expenditures** like **exemptions** and **deductions** to the gross receipts tax, and **tax credits**) the system becomes more and more difficult to administer. Exemptions and deductions also shrink the tax base and whenever that happens either we all pay higher taxes to make up for the lost revenue or the state must cut services.

Exemptions and deductions from the GRT are often intended as incentives for economic development. However, tax expenditures are a form of indirect spending, but the state is not required to keep track of the cumulative cost of these expenditures.

A tax system is **transparent** when citizens have enough information about the tax code to keep government accountable. New Mexico's lack of a tax expenditure budget is a transparency problem. Many incentives have no expiration or review date.

A **balanced** tax system is one that does not rely too heavily on one revenue source. Most states rely on three sources to create balance: income, sales, and property taxes. New Mexico also collects severance taxes, so New Mexico has four main sources of revenues. The property tax is mostly used to fund county government in New Mexico.



Technical Terms (as applied to the gross receipts tax)

Tax expenditure – An exception to the tax code (also called ‘indirect spending’).

Tax exemptions – Receipts from the sale of goods and services that don't have to be reported on a business's tax form.

Tax deductions – Expenses that, when deducted from gross receipts, lower taxable receipts.

A **fair** tax system is one in which everyone pays according to their ability to pay. People in similar circumstances should be taxed similarly, and taxes on low-income households should be minimized. Personal income taxes usually incorporate this ability-to-pay principle because they:

- Adjust for family size and family type;
- Allow deductions and tax credits

for some childcare and health care expenses;

- Can include low-income wage subsidies such as the federal Earned Income Credit and New Mexico's Working Families Tax Credit (For more on tax credits, see page 31.); and
- Include graduated rates.

MEASURING TAX FAIRNESS

A state tax system can either be regressive, proportional or progressive.

Technical Terms

Regressive taxes – Lower-income people pay a higher percentage of their income in tax than do higher-income people.

Proportional taxes – Everyone pays the same percentage of their income in tax.

Progressive taxes – Lower-income people pay a smaller percentage of their income in tax than do higher-income people.

Sales and excise taxes tend to be **regressive** because low-income people spend all of their income on day-to-day necessities like gas and utilities. This means they spend a greater proportion of their income on sales taxes than do upper-income people, who can save or invest some of their earnings.

While a **proportional** system may sound like the most equitable tax system, it does not take into account one's ability to pay. Nor does it minimize taxes on low-income households.

The federal tax system is somewhat **progressive**, because it relies heavily on the income tax. Income taxes tend to be progressive because the tax rate increases as income increases. This is usually done to help

Taxing Poverty

lessen the regressivity of sales taxes on low-income families.

Most states, New Mexico included, have both a sales tax and an income tax because:

- Income taxes are progressive; and
- Sales taxes are regressive.

Combining the two results in:

- A somewhat fairer system;
- Lower rates overall; and
- Adequate, stable, consistent revenue.

Technical Terms

Adjusted gross income (AGI) – The income amount that is taxed after all deductions and credits have been applied.

Federal poverty level (FPL) – The income level at which a person or family is considered to be in poverty. The formula to determine the FPL was created in the early 1960s when a family's largest expense was food. Housing, childcare and health insurance take up the lion's share of a typical working family's budget today, so the formula is outdated.¹¹

Most people agree that poor people shouldn't pay more taxes than rich people. However, the truth is that poor people often do.

Before the tax changes enacted in 2003, a New Mexico family with an income of less than \$13,000 paid about 12 percent of their household income in state and local sales taxes, while a family with an income above \$610,000 paid only 6 percent. In sum, the first family paid about \$1,560 in taxes and the second family paid about \$38,430. What confuses many people is the amounts paid by each family—while the first family paid a lower total amount, it represented a much bigger proportion of their income, and thus had a bigger impact on their lives.

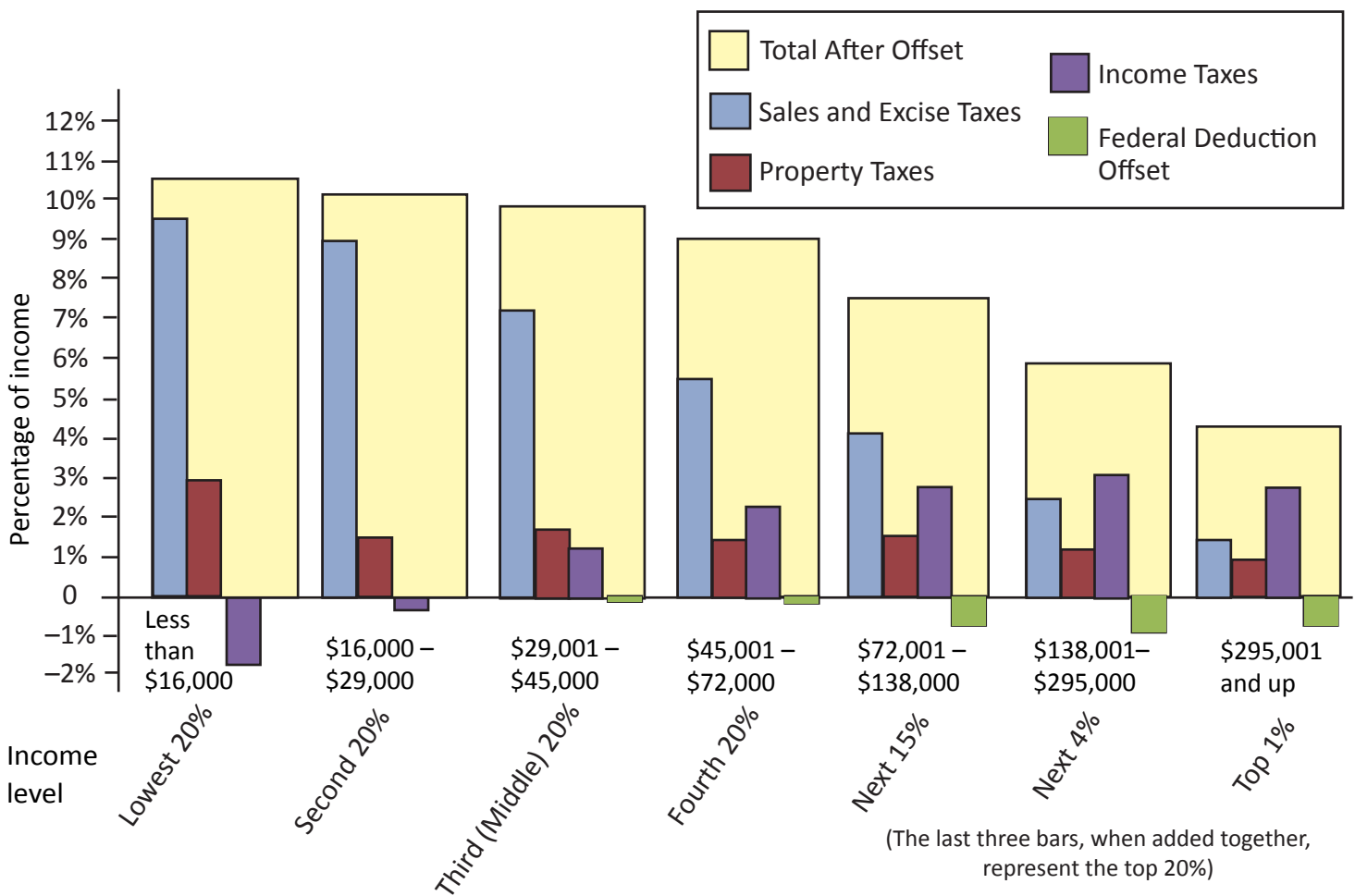
Look at it this way—\$1,500 is a lot of money to a family scraping by on \$13,000 a year while, for the family with an annual income of \$610,000, \$38,000 wouldn't make the difference between paying rent or putting food on the table.

When we look at taxes as a share of income, the ideas of regressivity and progressivity become more clear. Graph III (page 21) illustrates what percentage of their income non-elderly New Mexicans pay in taxes. The chart is organized by income levels, from the lowest 20 percent to the highest 1 percent, in order to show how the impact of taxes varies depending on how much one makes.

As the blue bars indicate, the percentage of income non-elderly New Mexicans spend on sales and excise taxes *decreases* as income increases: the lowest 20 percent of earners spend 9.7 percent of their income on sales taxes and the top 1 percent spends only 1.4 percent.

The opposite trend can be observed for income taxes (the third bars, shown in purple) because these taxes are progressive. The lowest 20 percent of earners receive an income tax credit (shown by a negative percentage of income tax) and as the amount earned increases the percentage paid to income taxes also increases. However, notice the richest top 1 percent actu-

Graph III
Share of Income Paid in State and Local Taxes by Non-Elderly New Mexicans (2007)
 (by percentage)



Source: The Institute on Taxation and Economic Policy 2009 *Who Pays?* report

Note: Table shows 2007 tax law updated to reflect permanent changes in law enacted through October 2009.

ally pays a *smaller* share to income taxes than the previous income group (2.5 percent for the top 1 percent versus 2.9 percent for the previous income category). In addition, there is a federal offset (shown in green) through which state income taxes are deducted from the amount owed in federal income taxes, thereby decreasing the amount of federal income taxes due. This federal offset becomes more valuable in higher income groups.

Overall, Graph III shows that lower-income groups pay a significantly larger portion of their income to taxes. The net percentage is shown by the yellow boxes behind the bars; the lowest 20 percent of earners pays 10.9 percent of their income in taxes, the middle 20 percent pays 9.8 percent, and the top 1 percent pays only 4.6 percent.

CHANGING THE CODE

State Income Tax Cuts

In 2003, at the governor's request, the New Mexico state Legislature cut the personal income tax rate for the top income margin.¹² By the time these tax cuts were phased in (2008), the top rate was down to 4.9 percent from its original 8.2 percent.

When you look at these tax cuts by amount, as shown in Graph IV (page 23), the system still appears to be progressive, because the amount paid increases as income increases.

But when you look at the tax cuts by percentage of income, as shown on Graph V (page 24), it looks considerably less progressive.

Tax Facts

Needed: A Higher Threshold

New Mexico's personal income tax (PIT) threshold—the level of earnings at which one begins to pay income taxes—is too low.¹³ The state income tax threshold for a single-parent family of three in New Mexico in 2008 was \$32,700—which is less than 200 percent of the federal poverty level (FPL) for that year (\$17,165). Because the FPL is so outdated, a family is still considered low-income when they're earning double the FPL. As we saw on page 21, this family pays more than 10 percent of their income in state and local taxes because many taxes (sales, etc.) are regressive. New Mexico needs to raise the PIT threshold to at least twice the FPL so more low-income families are exempt from paying income taxes.

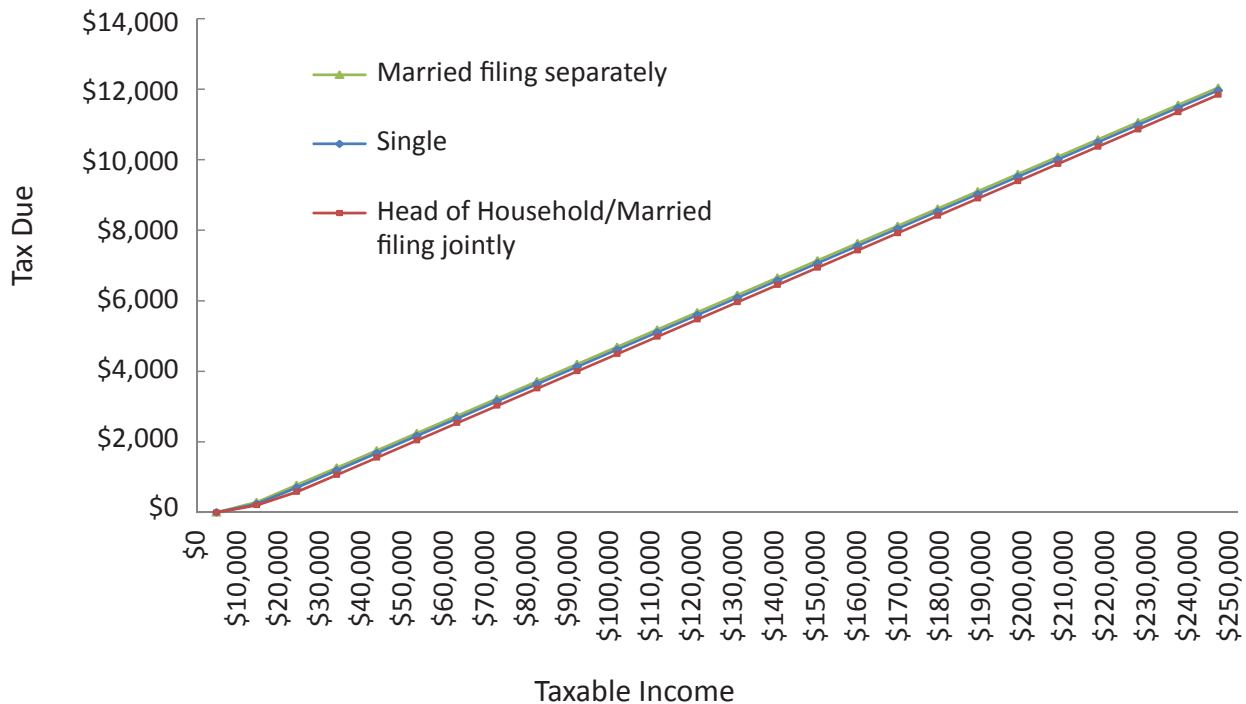
The tax rate climbs very rapidly in the lower-income brackets, then begins to level out at about \$70,000, and is completely flat by the time it reaches \$250,000. To be truly progressive, tax rates should climb more rapidly in the highest income levels.

The PIT cuts of 2003 did not change the bottom income tax rate of 1.72 percent, meaning the bottom 40 percent of tax filers received no benefit at all. Those New Mexicans who have

the highest income benefited the most from the state income tax cuts. New Mexicans earning the median wage (\$29,001–\$45,000) got back just \$138 a year. Those who earn the least did not benefit at all.

In 2003, taxable **capital gains** were also reduced by 50 percent. These tax cuts also overwhelmingly went to the highest income earners.

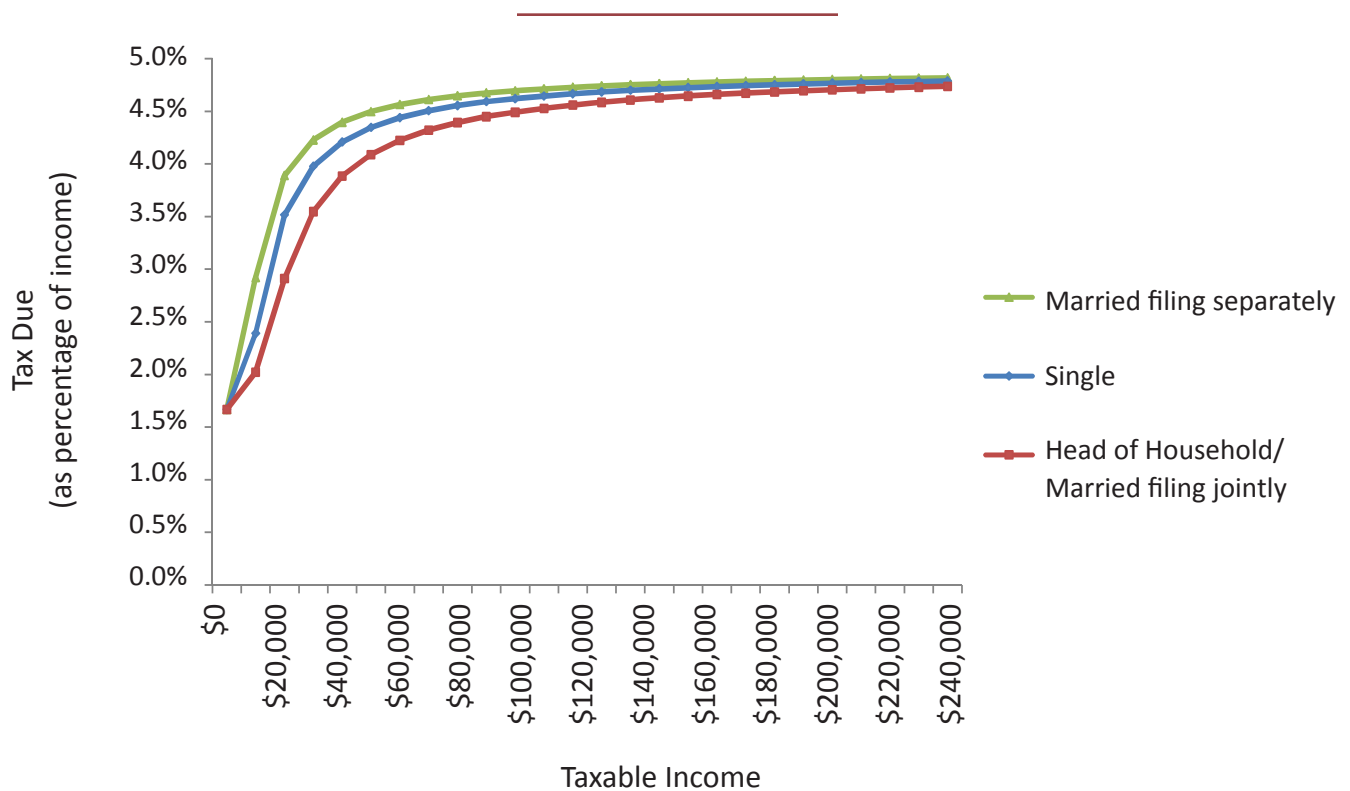
Graph IV
New Mexico Personal Income Taxes Due for Tax Year 2008
 (by amount)



Source: Tax Table for Taxes due April 15, 2008

Note: Taxable income is after the Low and Medium Income Exemption but before the Working Families Tax Credit.

Graph V
New Mexico Personal Income Taxes Due for Tax Year 2008
 (by percent)



Source: Tax Table for Taxes due April 15, 2008

Note: Taxable Income is after the Low and Medium Income Exemption but before the Working Families Tax Credit.

Technical Terms

Capital gains – Income realized from the sale of assets such as stocks, bonds, real estate or antiques. Only the wealthiest New Mexicans have a significant amount of taxable capital gains income.

Itemize – To list deductions and exemptions separately on one’s income tax return form instead of taking the “standard” deduction. Most people who own their home itemize because they can deduct the interest on their mortgage.

Federal Income Tax Cuts

Federal income taxes have also become much less progressive due to hefty tax cuts called for by the Bush Administration in 2001. State income tax cuts mirrored federal cuts in that the greatest benefit went to those with the largest incomes. This made the state's tax system much less progressive.

2001 Federal Income Tax Cuts

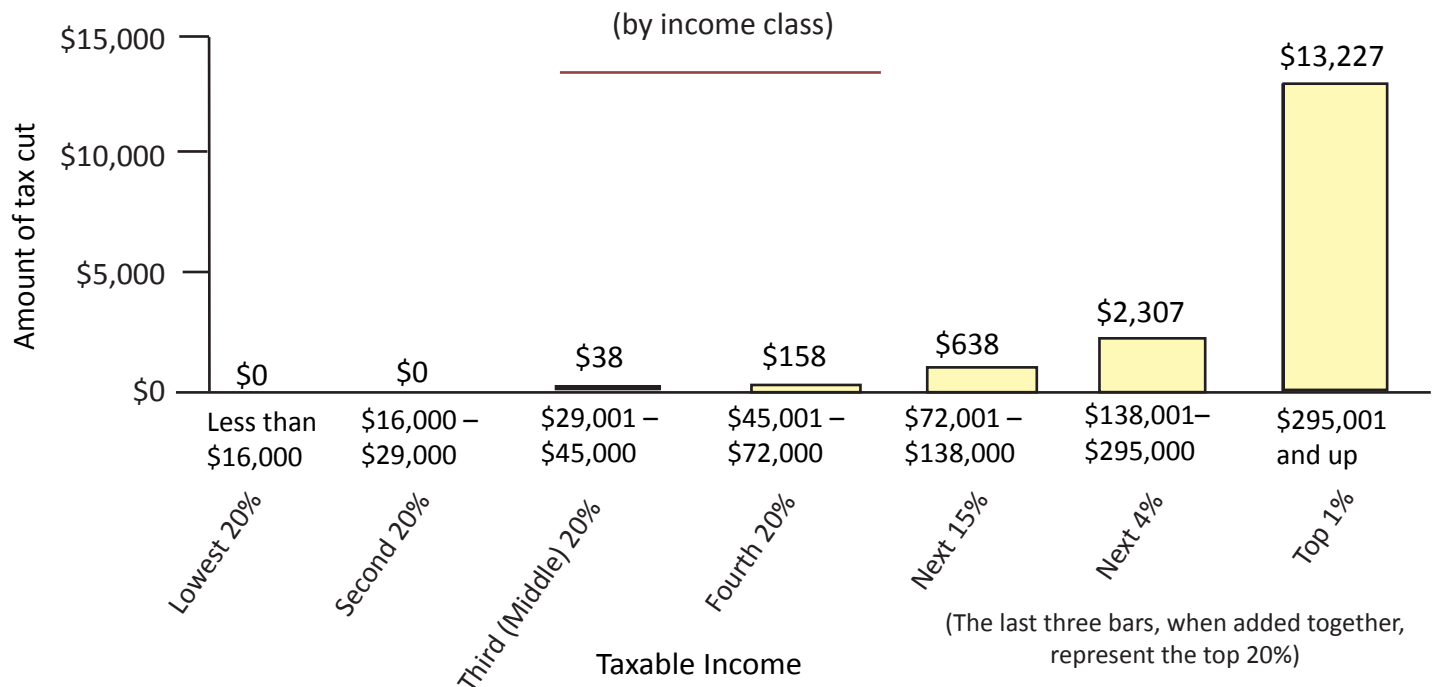
- Reduced the overall tax responsibility of the *richest 1 percent* of Americans by more than 12 percent.
- Provided the bottom 20 percent of Americans with *only a 3 percent tax reduction*.

2003 New Mexico Income Tax Cuts

- Reduced state income taxes for New Mexicans in the top tax bracket by *more than 30 percent*.
- Provided the bottom 40 percent of New Mexico taxpayers with *no tax reduction*.

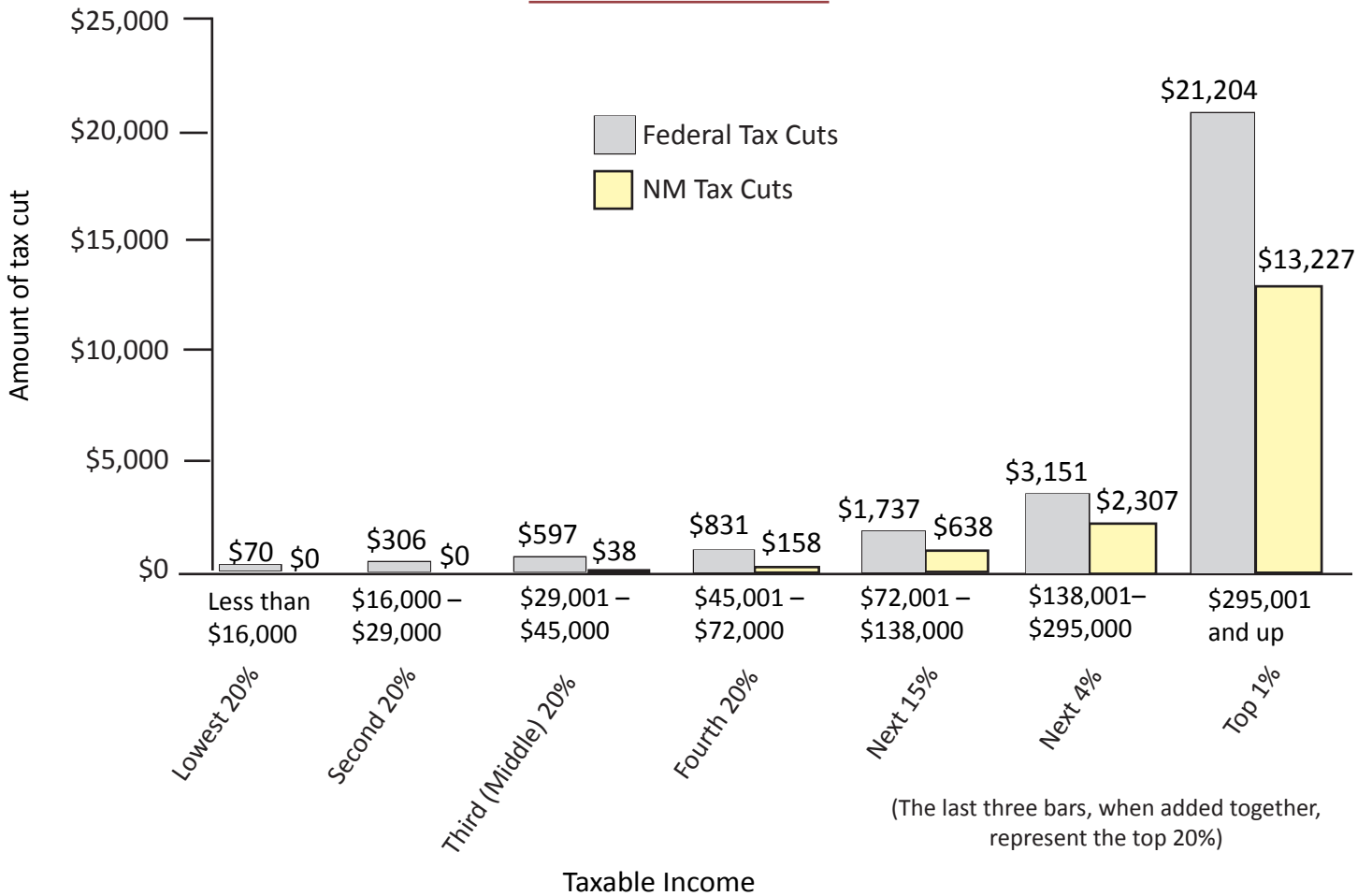
Graph VI

State Income Tax Cuts (Fully Phased in, 2008)



Source: Citizens for Tax Justice, Institute for Taxation and Economic Policy, custom analysis for New Mexico Voices for Children

Graph VII
Federal and State Income Tax Cuts
 (by income class)



Source: Citizens for Tax Justice, Institute for Taxation and Economic Policy, custom analysis for New Mexico Voices for Children



Ironically, *reduced* state income taxes mean *increased* federal income taxes for those taxpayers who **itemize**. This is because:

- State income taxes are deductible from federal income taxes.
- When state taxes go down, federal itemized deductions go down.
 - Fewer deductions mean higher federal income taxes.
 - *One third* of the state tax reduction goes straight to the IRS!



“No government can exist without taxation. This money must necessarily be levied on the people; and the grand art consists of levying so as not to oppress.”

— *Frederick the Great, 18th century Prussian king*

Tax Facts

A Deduction That’s the “PITs”

New Mexico allows an unusual deduction for higher-income tax payers: state and local taxes. The federal government allows those who itemize on their income tax return to deduct any income tax and property tax paid to the state. The federal income tax amount is then based on this lower level of income. Most states require that these deductions be added back on the state income tax return. New Mexico does not.

New Mexico should enact a “PIT-add back” of the state tax deduction. This would close a loophole that reduces taxes for higher-income taxpayers that is not as available to low-income New Mexicans because they are much less likely to itemize. The state loses some \$70 million through this loophole.¹⁴

Giving Credit Where Credit is Due

One progressive aspect of New Mexico's income tax is the existence of four **refundable tax credits** for very low-income New Mexicans. These include:

- Low-Income Comprehensive Tax Rebate (LICTR);
- Property Tax Rebate for seniors;
- Childcare Credit for low-income working parents; and
- Working Families Tax Credit (WFTC).

The first three credits were in place at the time of the 2003 tax cuts and were not affected by them. The Working Families Tax Credit was passed by the Legislature in 2007 and is worth 10 percent of the federal Earned Income

Tax Credit (EITC). The EITC lifts thousand of people out of poverty every year, while rewarding work by returning a small percentage of a family's income via a refundable tax credit. The LICTR is meant to help make up for the regressivity of sales taxes, and can go to those who do not work, such as very low-income seniors.

Under these credits, families that qualify can have their taxes lowered or even get money back from the government. Unfortunately, millions in federal EITC dollars go unclaimed every year by New Mexicans¹⁵ because they either do not file federal tax returns or they (or their tax preparer) are unaware of the credit.

Technical Terms

Tax credit – A set amount of money that lowers one's income tax bill as a way of compensating that taxpayer for specific expenses, such as childcare and some medical expenses. Tax credits can be either refundable or non-refundable.

Refundable tax credit – A tax credit that is available to filers even if they do not owe income taxes. The government simply writes a check to the taxpayer for the amount of the credit.

Making Up the Difference

Whenever the state reduces taxes, it must either increase taxes somewhere else or reduce services. Neither of these solutions tends to be popular.

In the early 2000s, global oil and natural gas prices were unusually high. While this is tough on consumers, it is good for the state piggy bank. Higher oil and gas prices mean higher revenues in the form of severance taxes, corporate income taxes, and rents and royalties on the land leased to energy companies.

But gas is volatile in more ways than one. Prices fluctuate widely and what's more, the state can neither predict global prices nor control them. When prices drop, the state collects less revenue. Also, oil and natural gas production falls slightly every year as natural supplies diminish. The fact is that if the state relies too much on this revenue source, the state budget could suffer considerably.

Tax Facts

What Business Wants

Business values a skilled workforce more than tax cuts because:

- Labor = 40 percent of business costs
- State taxes = 1 percent of business costs

Tax Cuts, Jobs, and the Economy

When tax cuts result in spending cuts, both public- and private-sector jobs are lost. Cities and states not only cut back on their employees, they also cut back on contracts with private businesses, vendors, and non-profits that provide services. Even health care workers can be lost. In short, a million dollars spent providing education or health care creates far more jobs than a million dollars sent back to high-income consumers in the form of tax cuts.

“Here is my principle: Taxes shall be levied according to ability to pay. That is the only American principle.”

—*Franklin D. Roosevelt*

Leading economists say that cutting public-sector jobs in order to pay for private-sector tax breaks does more harm to the economy than good.¹⁶

A Blue Ribbon Tax Reform Committee was formed in 2003 to study the effects of New Mexico's income tax cuts before they were enacted. The committee found that the jobs created in the private sector as a result of an income tax cut would not make up for the education and health care jobs that would be lost if the tax cuts were paid for by spending cuts.¹⁷

A DAMAGED TAX SYSTEM

When the state personal income tax cuts were fully felt in 2009, New Mexico's income tax revenue was decreased by more than one third—meaning the state loses some \$400 million every year. That, along with the national recession, made New Mexico's revenues plummet in FY10 far below what had been budgeted for spending that year.

The outlook for the next three or four years is bleak, as well, with revenues not returning to FY08 levels until FY14.

In order to prevent drastic cuts in spending, the Legislature will need to find ways to raise new revenue. Economists agree that cutting spending during a recession only makes a bad situation worse. Raising revenue on the highest income earners makes the most sense and will help the state balance its budget without breaking working families.



Changes in the state tax system since 2003 have done great damage.

New Mexico's tax system is now:

- **Less adequate** – Budget shortfalls are likely to continue until FY14.
- **Less stable** – A heavier reliance on oil and natural gas revenues makes the state more vulnerable to global markets and price fluctuations.
- **Less consistent** – Revenues no longer grow with the state's economy.
- **Less easy to administer** – Exemptions and deductions from the gross receipts tax make the tax code more complex.
- **No more transparent** – Tax expenditures are still not tracked.
- **Less balanced** – The scales have tipped from stable revenue sources to less stable sources.
- **Much less fair** – Personal income tax cuts did not benefit the New Mexicans who need help the most. Coupled with a broad-based regressive sales tax, New Mexico over-taxes its lowest-income residents and under-taxes its richest.

CONCLUSION

Taxes pay for most government services and programs, and the infrastructure that makes our modern way of life possible. How we collect taxes says a great deal about our values and priorities. Do we want a progressive tax system that allows low-income families to pay less, or do we think everyone should pay the same rate no matter their income level?

Because of our broad-based gross receipts tax, New Mexico's tax system has always leaned rather heavily on our lowest-income families. Furthermore, the 2003 cuts to the personal income tax benefited those with the highest incomes. Almost every year, the state Legislature allows for more deductions and exemptions from our gross receipts tax, but they are not tracked over time to see if they are producing any economic benefits. Every exemption and deduction whittles away our tax base.

New Mexico's tax system needs to be more progressive. Those who can afford to pay—including multi-state corporations—should pay their fair share, and the tax burden on those who are struggling to pay their daily bills should be reduced. Exemptions and deductions need to be tracked and analyzed so the system is more transparent. Over-reliance on unstable severance taxes should be reduced. Returning to a greater reliance on stable revenue sources and a more progressive tax structure will ensure that the state will be able to provide services that benefit all of us.

"I like to pay taxes. With them I buy civilization."

—*Oliver Wendell Holmes, Jr.*

Re-evaluating how much and from whom we collect taxes is especially important now, more than ever. FY10 has seen a severe drop in revenue and this poses a fundamental constraint on the state's ability to meet the needs of its residents. Eliminating tax cuts for the highest income earners and industries is absolutely necessary in order to maintain critical services.

One way or another, changes will be made this year. Citizens should take the opportunity to realign the tax system so it is balanced, fair, and serves New Mexicans in the long term.

Policy Recommendations

Some potential ways to generate new revenue and restore more fairness to the state's tax system include:

- Restore progressivity to the state's income tax system by rolling back the 2003 PIT cuts for the highest earners.
- Enact a tax expenditure report.
- Mandate unitary combined reporting for all corporations doing business in New Mexico.
- Lower the PIT threshold so those living in poverty do not have to pay PIT.
- Require that filers who itemize on their federal forms add back New Mexico taxes to their state form.

Endnotes

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- 6 SB389, 2009; <http://legis.state.nm.us/Sessions/09%20Regular/firs/SB0389.pdf>
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- 16 *The Ultimate Burden Of The Tax Cuts: Once the Tax Cuts are Paid for, Low- and Middle-Income Households Likely To Be Net Losers, on Average*, William G. Gale, Peter R. Orszag, and Isaac Shapiro, Center on Budget and Policy Priorities, Washington, DC, 2004; <http://www.cbpp.org/cms/index.cfm?fa=view&id=1971>
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