NEW MEXICO VOICES FOR CHILDREN

Fiscal Policy Project

The 2 Percent Disaster

Tax System "Reboot" Would Harm New Mexico's Low-Income Families

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December 2013

During the 2013 legislative session, a pair of bills was introduced to "reboot" the state's tax system. The bills would have eliminated income taxes, while lowering the state's consumption tax to 2 percent and broadening its base. While such a system seems fair, it would actually make the state's tax system—which already leans more heavily on those with the lowest incomes—much more unfair. While this legislation did not pass in 2013, it is almost guaranteed to make an appearance in subsequent sessions. It should be stopped again.

The duplicate bills—HB-369 and SB-368—were sponsored by Representative Tom Taylor and Senator William Sharer. The bills would have eliminated state income taxes for both individuals and corporations, lowered the state's gross receipts tax (or GRT; a sales tax on most goods and services) from 5.125 percent to 2 percent, and broadened the GRT base by applying it to wages and salaries. The bill sponsors referred to their bills as an 'overhaul' or 'reboot' of the state tax system, but for all intents and purposes, it represents a flat tax, which is how we will refer to it here.

On the face of it, there is a great deal to like about a flat tax. It removes the various credits and deductions that income tax filers must wade through when filling out their tax returns. It calls for one low tax rate, so it also appears to be fair. Upon closer inspection, however, it becomes clear that a flat tax would be highly unfair—extracting more from the incomes of low-wage families while releasing high-income filers from much of their current tax responsibility and allowing profitable corporations to get off scot-free.

In addition, it is unknown whether HB-369/SB-368 would bring in the amount of revenue needed in order for the state to fund the many necessary programs and services—such as education, health care, and public safety—at the levels it funds them now. This assessment, while important to a more complete discussion of this sort of tax system, is beyond the scope of this report.

Given that New Mexico already has the highest rate of income inequality in the nation, the highest percentage of working families that are low-income, and the lowest

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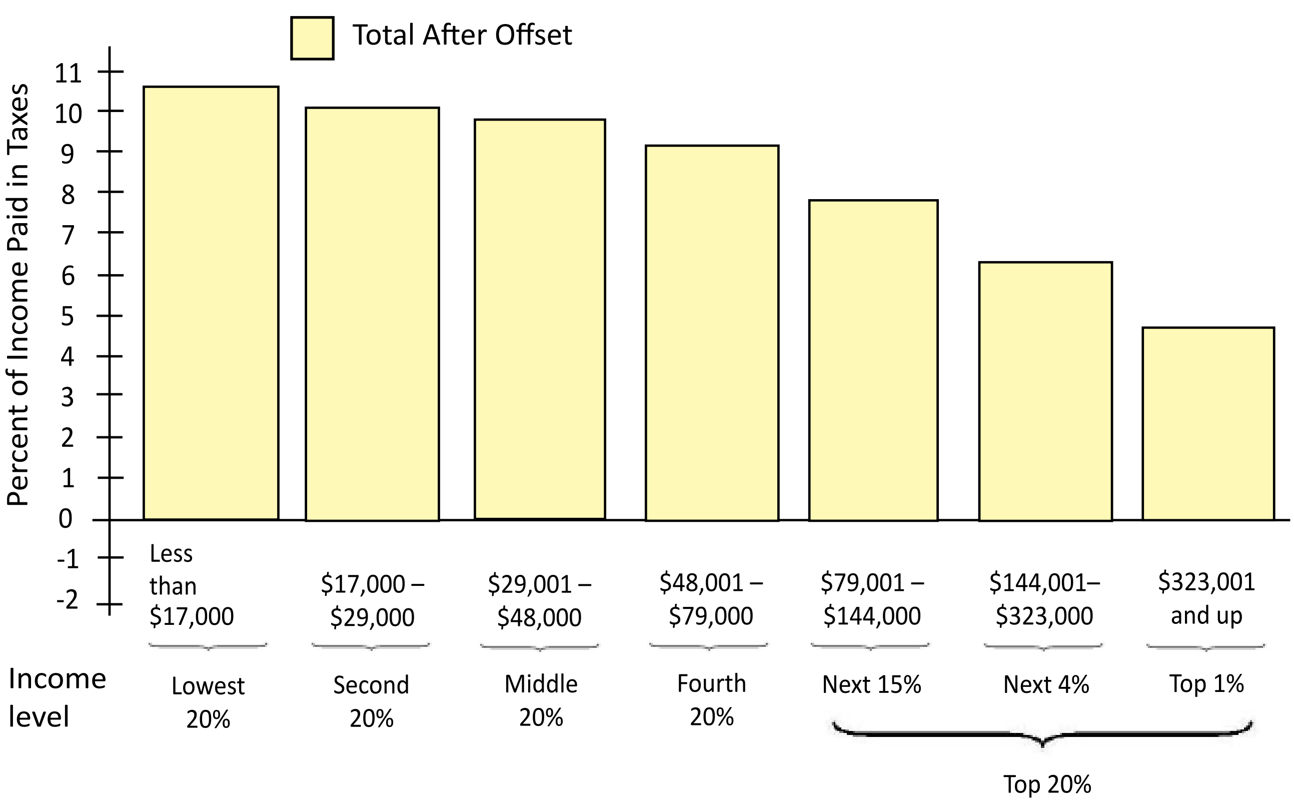
rank for child well-being, HB-369/SB-368 and bills like it would represent a disaster for New Mexico's most vulnerable families and the children they support.

This report assesses the impact that a flat tax like HB-369/SB-368 would have on New Mexico families by income group. Assumptions about tax incidence are based on the 2013 edition of *Who Pays?: A Distributional Analysis of the Tax Systems in All Fifty States*, a report by the Institute for Taxation and Economic Policy (ITEP) that assesses the fairness of state and local tax systems. The ITEP report analyses how state and local taxes impact taxpayers by income level. Using the ITEP analysis as the basis for comparison, we can estimate the direction of change in the tax system given the new variables. This report will not attempt to provide numerical estimates of the impact of a flat tax on the fairness of the state's tax system, but will indicate the direction of change and possible order of magnitude of the various tax changes. The discussion will be mostly qualitative, not quantitative.

Three Types of Tax Systems

Tax systems can be either regressive, proportional, or progressive. A **regressive** system is one in which those at the bottom of the income scale pay a higher share of their income in taxes than those with higher incomes. Sales taxes are a good example of a regressive tax. A **proportional** tax requires every tax payer to pay the same percentage (or proportion) of their income in taxes. Payroll taxes are proportional up to a point. The same percentage is taken out of every paycheck, regardless of income level—up to the first $106,000 of income. All wages earned above that level are exempt from the payroll tax. In a **progressive** tax system, those at the top of the income scale pay at

Graph I
Share of Income Paid in State and Local Taxes by Non-Elderly* New Mexicans (2013)



Source for Graphs I through V: The Institute on Taxation and Economic Policy's 2013 *Who Pays?* report.
Note: Table shows permanent law in New Mexico enacted through January 2, 2013 at 2010 income levels.
*The ITEP analysis covers the tax incidence for taxpayers who are under the age of 65. This is because state tax structures are notorious for treating elderly families very differently from other families and those differences cloud the incidence of state tax structures.

the highest rate. Personal income taxes with graduated rates are progressive.

The federal income tax system is progressive—meaning those in the very lowest income brackets pay no (or very little) federal income taxes, while those at the highest end pay the highest rate, with the top rate being 33 percent. Changes in tax law during the George W. Bush Administration have made the federal tax system much less progressive, mainly by lowering the top tax rates and by significantly reducing the amount paid on capital gains income (which is why hedge fund managers like Warren Buffet—whose income comes from capital gains instead of wages or a salary—can pay a lower income tax rate than their secretaries). Capital gains is income from investment and the sale of goods like real estate.

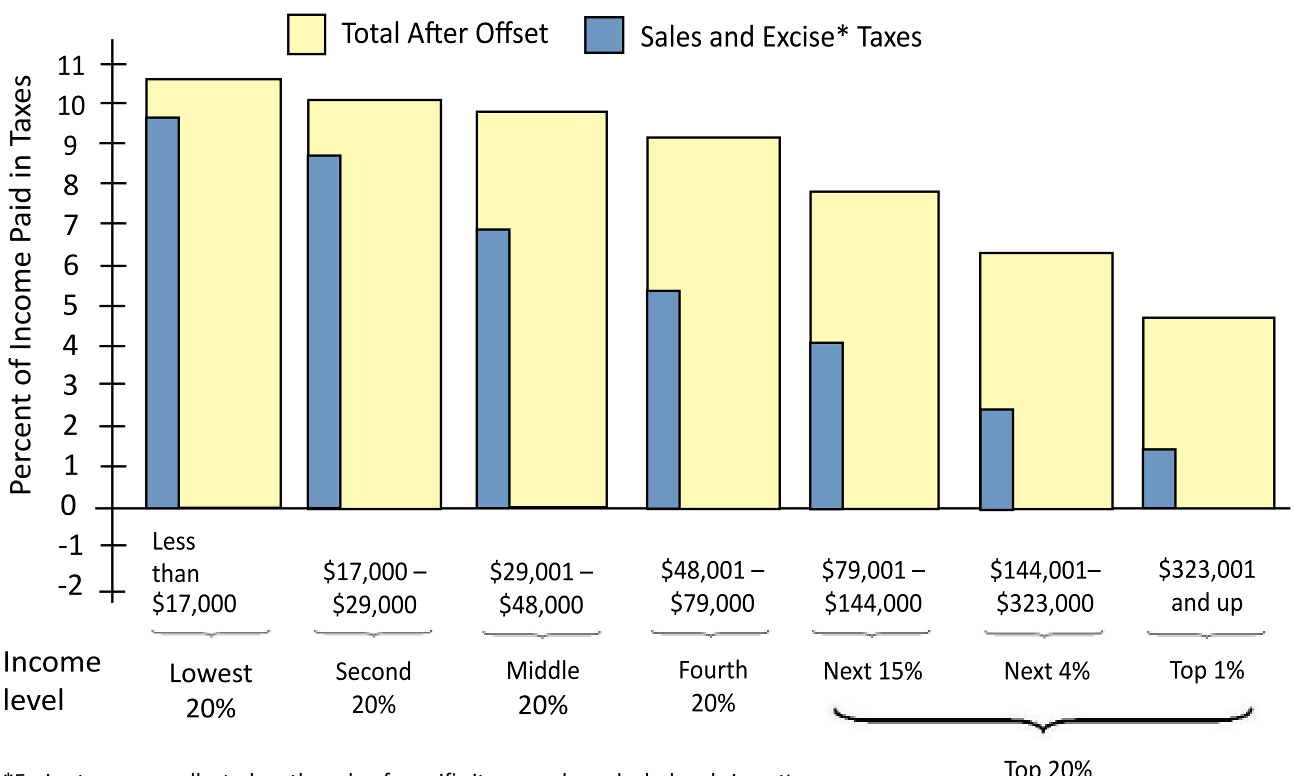
Federal income taxes are designed to be progressive, in part, to help offset the regressive nature of most state tax systems.

New Mexico's Tax System

New Mexico's overall tax system is quite regressive. The only progressive aspect is the income tax—both on personal income and corporate profits—although it has become considerably less progressive over the last decade. In 2003, Governor Bill Richardson asked for and received an income tax cut for those on the high end of the income scale. The top rate was cut nearly in half (from 8.2 percent to 4.9 percent), and taxpayers with capital gains incomes were allowed to deduct half of that money from their taxable income. The vast majority of capital gains income goes to those with the highest incomes. Although the state's income tax structure is slightly progressive, the overall tax system is regressive because of the impact of the GRT and property taxes.

As Graph I (page 2) shows, New Mexicans in the lowest earning bracket paid more than 10 percent of their income in state and local taxes in 2012, while those at the very top paid less than 5 percent. The reasons for this become apparent when we look at each tax individually.

Graph II
Share of Income Paid in Sales and Excise Taxes by Non-Elderly New Mexicans (2013)



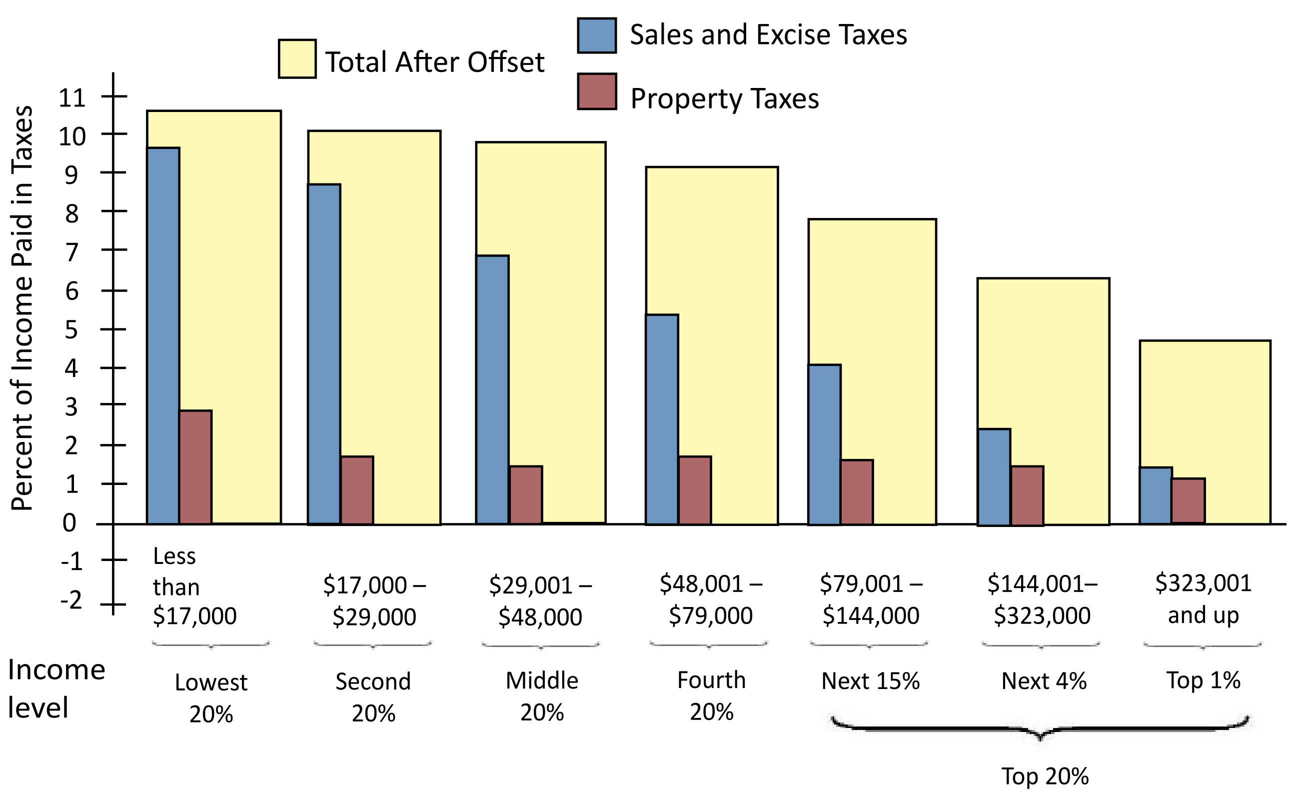
*Excise taxes are collected on the sale of specific items such as alcohol and cigarettes.

Because everyone buys goods that are taxed, people often think of sales taxes as the most "fair" tax. But as Graph II (page 3) shows, **sales and excise taxes** (the blue bars) make up the largest share of taxes for those in middle- and low-incomes brackets. The lowest 20 percent of New Mexico families—those with incomes below $17,000—pay almost 10 percent of their income in sales taxes alone while the highest 20 percent of families—those with incomes of $79,000 and up—pay as little as 4 percent. Sales and excise taxes are taxes on consumption, and are regressive because low-income people must consume virtually all of their income just to get by, while upper-income earners can save or invest some of their income. The majority of the GRT is collected by the state, but cities and counties also tack on a small amount—the highest being 3.5 percent (for a total GRT rate of 8.625 percent when added to the state's 5.125)—although it varies by municipality.

People generally associate **property taxes** with homeowners, but rental property is also taxed and that tax is passed along to the tenant as part of their rent. Property taxes (the red bars in Graph III, below), which are based on the value of the property, are considered a tax on wealth. Property taxes are mildly regressive because there is no hard-and-fast connection between property ownership and family income level. Families may own valuable property—meaning they pay a high property tax—but still have a modest income, especially in places where property values have been elevated by the arrival of higher-income families. What happened in Santa Fe, when high-end newcomers began to purchase real estate, is a good example of how rising property values can drive property taxes beyond what a family with a moderate income can afford. Property taxes are collected by counties but a small portion goes to the state.

Graph IV (page 5) shows the progressive character of **income taxes** (the purple bars). The top rate for state income tax is 4.9 percent. After credits and deductions are taken, the 20 percent of New Mexico taxpayers with the highest incomes pay around 3 percent. Income earners in the lowest 20 percent make too little money to pay state income taxes. In

Graph III
Share of Income Paid in Property Taxes by Non-Elderly New Mexicans (2013)



fact, many in the bottom 40 percent actually receive a check from the state if they qualify for the Working Families Tax Credit (shown by the bars that go below the 0 percent line). This tax credit, a state version of the federal Earned Income Tax Credit, is refundable. Tax credits are deducted from the amount of money the taxpayer owes in income tax, but if the credit amount is higher than the taxpayer's income tax bill, the balance of a refundable credit is sent to the taxpayer. Refundable tax credits like the WFTC and the Low-Income Comprehensive Tax Rebate (LICTR) were enacted to help offset the overall regressivity of the state's tax system. They do offset it somewhat, but they don't make the overall system progressive or even proportional.

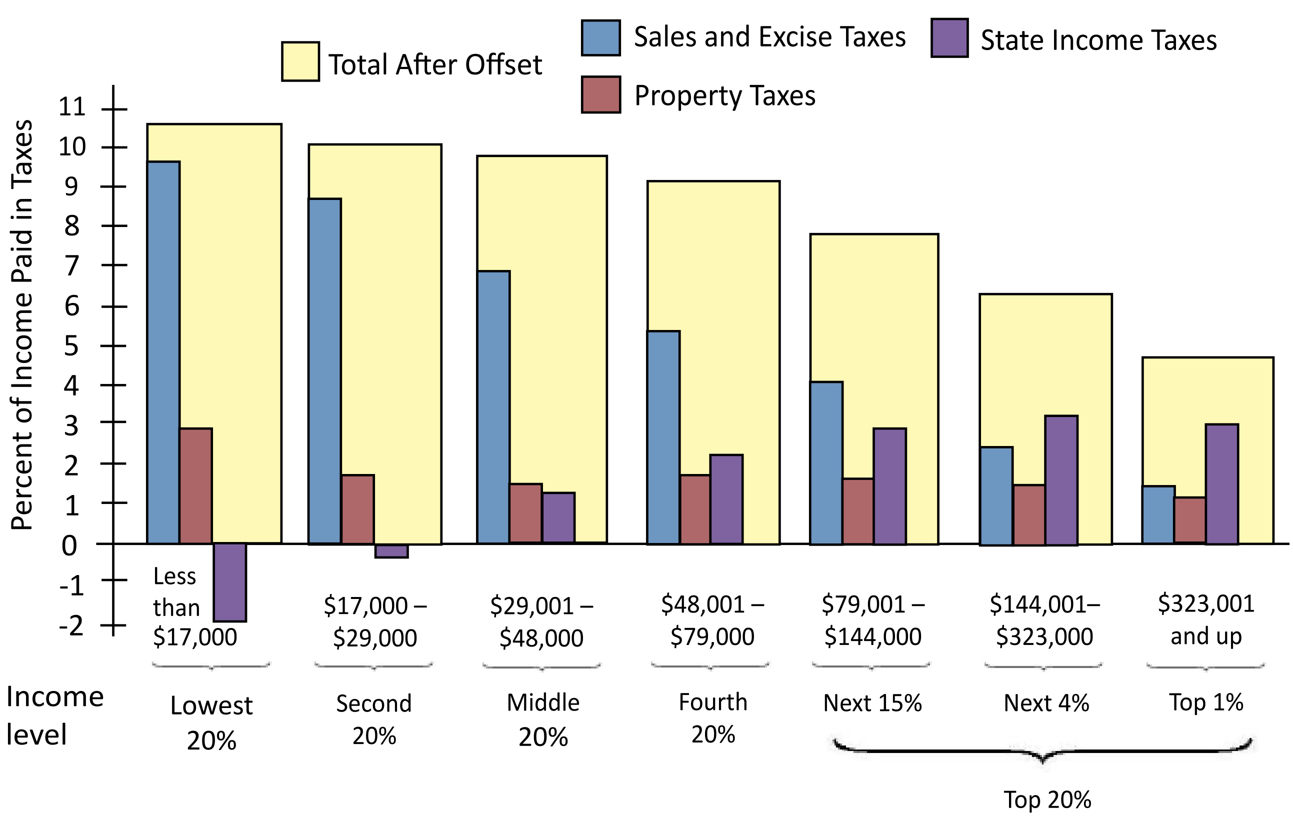
Unlike tax credits, which can and do benefit low-income New Mexicans, deductions from taxable income—such as the deduction for state and local taxes from federal taxes—benefit higher-income taxpayers more than taxpayers with lower incomes. Lower-income people simply have less income for deductions to be taken against.

Graph V (page 6) illustrates the regressivity of the **federal offset** (the green bars), which is the deduction of state and local taxes from taxable income for federal tax purposes. The bars in this graph all dip below the 0 percent line because this deduction reduces a taxpayer's federal tax liability. This offset is regressive because the higher the taxpayer's income, the larger the offset.

Flat-Lining the Tax System

The intent of a flat tax proposal like HB-369/SB-368 seems to be to implement a proportional tax system—with everyone paying 2 percent—which sounds fair. But that's not what would happen. In fact HB-369/SB-368 would make the state's tax system more regressive than it is now. The bills would eliminate New Mexico's only progressive taxes—personal and corporate income taxes, and the estate tax—and add a proportional gross receipts tax on wages and salaries. While HB-369/SB-369 would lower the gross receipts tax on consumer goods and services from 5.125

Graph IV
Share of Income Paid in State Income Taxes by Non-Elderly New Mexicans (2013)



percent to 2 percent (and allow cities and counties to tack on a maximum of .5 percent each, for a total of 3 percent), it would add a 2 percent tax on all wages and salaries, regardless of the person's income level. Capital gains income would not be subject to the 2 percent GRT. Because the vast majority (87 percent) of capital gains income in New Mexico goes to those earning more than $100,000 annually—or more than twice the median income—this would represent a huge tax break for a very small percentage of people (see Graph VI, page 7). In addition, several other types of income that go mostly to higher-income households, such as rents, royalties, and partnership income, would no longer be taxed under HB-369/SB-368.

Taxing Poverty

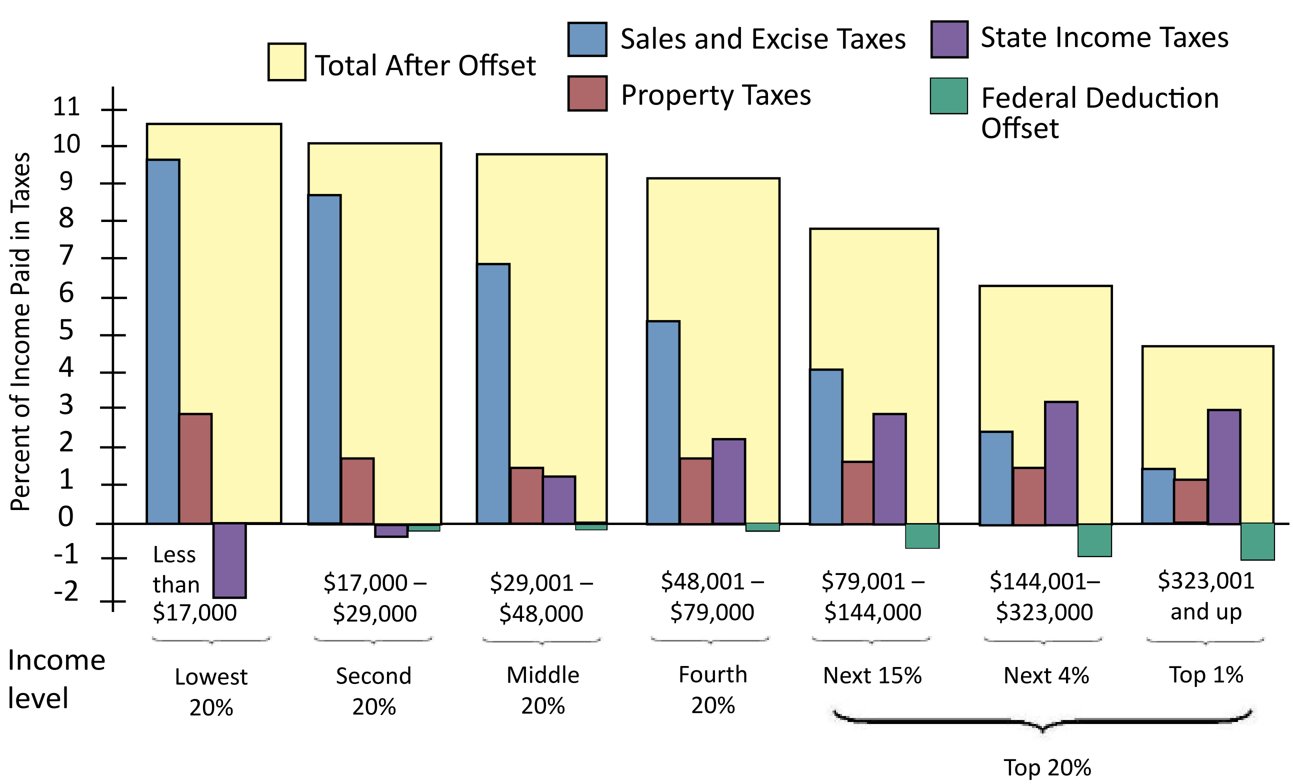
Normally, a reduction in a consumption tax, such as the GRT, makes a tax system more progressive because sales taxes are regressive. However, HB-369/SB-368 would neutralize that impact with the addition of the 2 percent across-the-board GRT on wages and salaries. By eliminating the income tax, HB-369/SB-368 would also eliminate all credits and deductions that taxpayers take—including the Working Families Tax Credit. HB-369/SB-368 did include a circuit breaker that reduced tax liability for very low-income taxpayers—allowing them to take a credit of 1.5 percent of the GRT they paid on wages and salaries, but low-income filers would receive less under this system than the WFTC is worth (see Graph VII, page 7).

At current rates, the ratio of GRT on goods and services as a share of income is 3.6 times between the highest- and the lowest-income brackets. That ratio would not change because the GRT changes. Even with a GRT at 2 percent (or up to 3 percent once the cities and counties add in their share), the lowest-income New Mexicans would still pay nearly four times as much of their income in GRT on goods and services as would the highest-income New Mexicans.

In addition, the bill repeals dozens of tax expenditures (credits, exemptions and deductions), some of which will directly impact the consumer. Most notably, the bill would repeal the GRT deduction for groceries—

Graph V

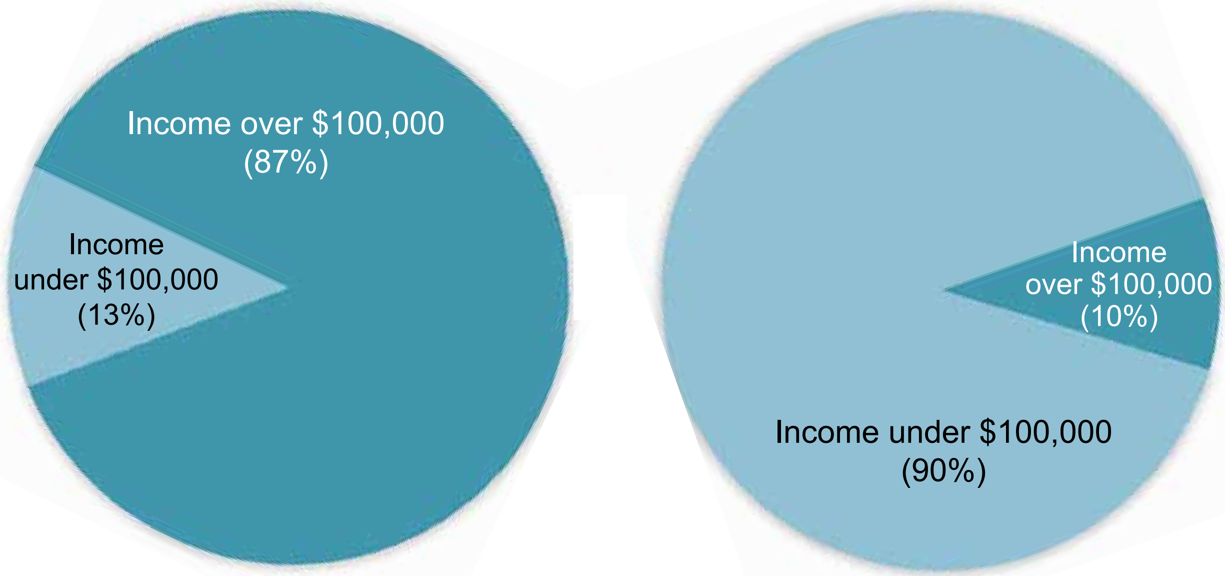
Federal Deduction Offset as Share of Income for Non-Elderly New Mexicans (2013)



even those purchased with food stamps—and some health care services. This would add significantly to the regressivity of the tax system.

The corporate income tax is progressive because it is paid by the owners or shareholders of a corporation, who are typically high-income individuals. The fact

Graph VI
Almost 90% of Capital Gains Income Goes to 10% of New Mexico Tax Filers



Share of Capital Gains Income by Tax Filer Income Level

Share of Tax Filers by Income Level

Source: Statistics of Income publication, IRS, 2011 (most recent year available)

Graph VII
Working Families Tax Credit is Worth More Than Low-Income Tax Credit under HB-369/SB-368

Family size	2	3
Income (at poverty level)	$15,530	$19,530
GRT paid on wages and salaries under HB-369/SB-368	$466	$586
Low-income credit under HB-369/SB-368	$699	$879
Difference (reimbursed to taxpayer)	**$233**	**$293**
Average income taxes paid under current tax system	$0	$0
Working Families Tax Credit amount (reimbursed to taxpayer)	**$524**	**$589**
Difference between two tax systems	**$291**	**$296**

that net corporate profits would no longer be taxed is clearly a move toward greater regressivity. Eliminating the taxation of corporate profits would cost the state about $300 to $400 million annually.

HB-369/SB-368 would also not repeal or change property tax rates, because those taxes are collected by the counties. So that source of regressivity would be preserved.

Conclusion

The sweeping changes to New Mexico's tax system proposed by HB-369/SB-368 would make it even more regressive than it already is. This flat tax model involves a vastly augmented gross receipts tax and the repeal of the state's personal and corporate income taxes. The repeal of the corporate income tax would leave corporate profits completely untaxed in the state of New Mexico. By taxing salaries and wages under the GRT, capital gains taxes would also be completely untaxed. In addition, HB-369/SB-368 would repeal most gross receipts tax deductions, including the deduction for purchasing groceries—even with food stamps—and for some health care services. HB-369/SB-368 would repeal the Working Families Tax Credit and the Low-Income Comprehensive Tax Rebate. The credit for low-income taxpayers proposed by HB-369/SB-368 would not offset the impact of the repeal of the WFTC.

On the whole, HB-369/SB-368 would be a step in the direction of a more unfair tax system and should not be passed by the Legislature.

Other Tax Expenditures Eliminated Under HB-369/SB-368

Four tax credits that would be repealed by HB-369/SB-368 are the Rural Jobs Tax Credits, the Film Production Tax Credit, the High Wage Jobs Tax Credit, and the Advanced Energy Tax Credit. The bill then goes on to repeal 15 exemptions and several dozen deductions—among them are several deductions intended to ameliorate the so-called 'pyramiding' problem.

The Taxation and Revenue Department made no attempt to cost out the repeal of these myriad exemptions and deductions in the fiscal impact report for HB-369/SB-368. Exemptions are not reported to the Taxation and Revenue Department at all. Costing out deductions is difficult because the Taxation and Revenue Department does not separate out deductions on the combined reporting system (CRS) form, with one exception. That exception is the deduction for food and some medical services. When that legislation was passed it included a requirement to separate that deduction on the tax form so that policy makers would be able to keep track of the cost.

The Fiscal Policy Project, a program of New Mexico Voices for Children, is made possible by grants from the Annie E. Casey Foundation, the McCune Charitable Foundation, and the W.K. Kellogg Foundation.

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