NEW MEXICO VOICES FOR CHILDREN

Fiscal Policy Project

# Citizen's Guide to New Mexico's Tax System

## How the State Collects Money and Why it Matters

2014



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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 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 much of what 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 property tax bill, the taxes are passed on 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. Your trash is hauled 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 direct 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 more or 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*

**CIT** – Corporate Income Tax
**EITC** – Earned Income Tax Credit
**FIR** – Fiscal Impact Report
**FPL** – Federal Poverty Level
**FY** – Fiscal Year
**GRT** – Gross Receipts Tax
**LFC** – Legislative Finance Committee
**LICTR** – Low Income Comprehensive Tax Rebate
**PIT** – Personal Income Tax
**TRD** – Taxation and Revenue Department
**WFTC** – Working Families Tax Credit

# How the State Collects Money

## General Fund Revenue Sources

This guide focuses on revenues that are deposited in the state General Fund, which is the state's main pot of money for operating expenses. The pie chart on page 6 shows where the state gets its tax revenue, and how much is expected to be generated for **fiscal year** 2014 (FY14). The largest slice of the pie (34.6 percent) comes from *general sales taxes*. This includes **gross receipts taxes** (GRT) and **compensating taxes**. GRT is levied on most goods and services. Including services in the tax base is good because services constitute an increasing share of economic activity while goods constitute a decreasing share. More states are beginning to tax services. Many cities and counties in New Mexico also collect GRT to pay for municipal services, so the amount you pay will vary depending where you are in the state.

**Excise taxes** on the sales of tobacco, liquor, motor vehicles, and telecommunications services account for 8.2 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 significant share of revenues.

**Personal income taxes** (PIT) make up a much larger percentage (20.5 percent) of revenue than **corporate income taxes** (5.4 percent).

### *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 2014 (which began July 1, 2013) ends on June 30, 2014. Fiscal year 2014 is abbreviated as FY14.

### *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.

Corporate income taxes are levied on a corporation's net profits, which can fluctuate widely from year to year. Also, the Legislature has enacted many tax breaks and lowered the overall CIT rate in recent years.

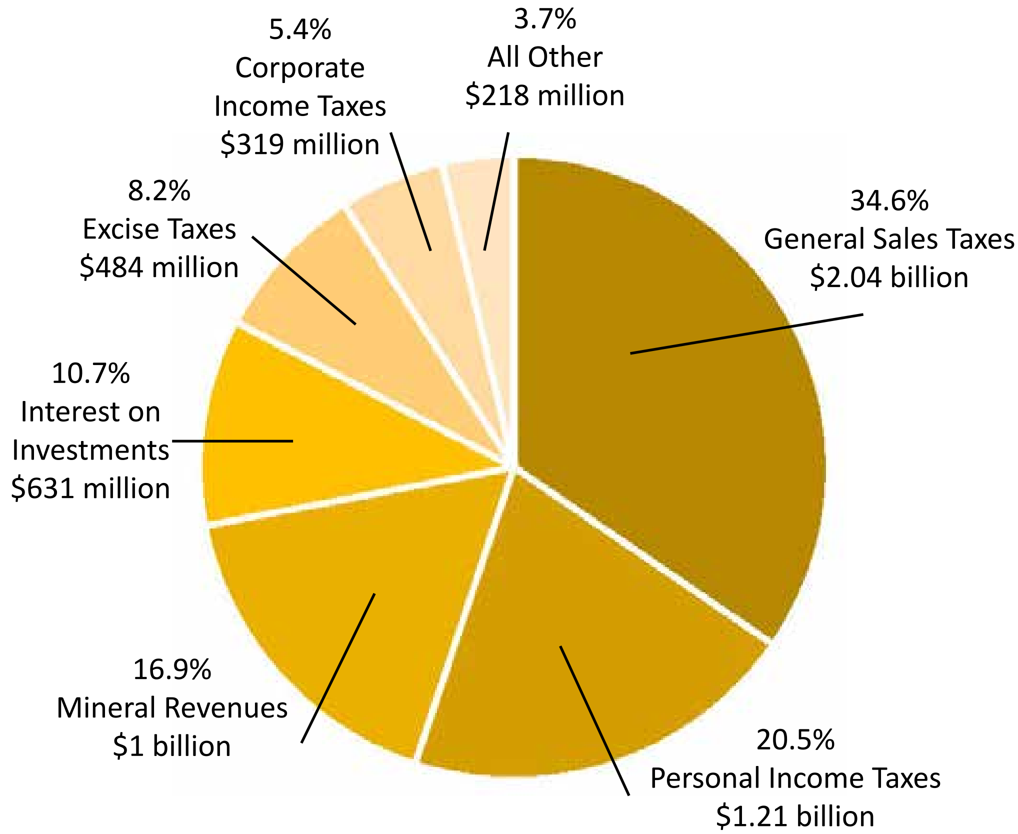
The 16.9 percent *mineral revenues* piece of the revenue pie includes **severance taxes** on crude oil, natural gas, coal, copper, and other hard minerals that are extracted from the ground, as well as rents and royalties from the sale or lease of mineral-producing land. Out of this mineral mix, some 90 percent of revenue comes from taxes collected on oil and natural gas extraction.

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 most New Mexico oil and natural gas producers are owned by out-of-state companies, these taxes are likely not paid by New Mexicans.

The 10.7 percent *interest on investments* is primarily derived from investing permanent fund revenue in the stock and bond markets.

**Figure I**

**New Mexico's General Fund Revenue Sources for FY14**




Source: Legislative Finance Committee, 2013 Post Session Review

New Mexico derives an unusually large share of revenue from investments, but this revenue also rises and falls with the stock market.

The 3.7 percent *all other* category includes gaming. New Mexico has revenue-sharing agreements under the federal Indian Gaming Regulatory Act with Native-American nations that operate casinos. While gambling and the revenue-sharing negotiations often receive media 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 spending in FY12. While many agencies receive federal funding, the majority goes to Health, Human Services, Transportation, and Public Education. Federal funding also goes to higher education institutions.

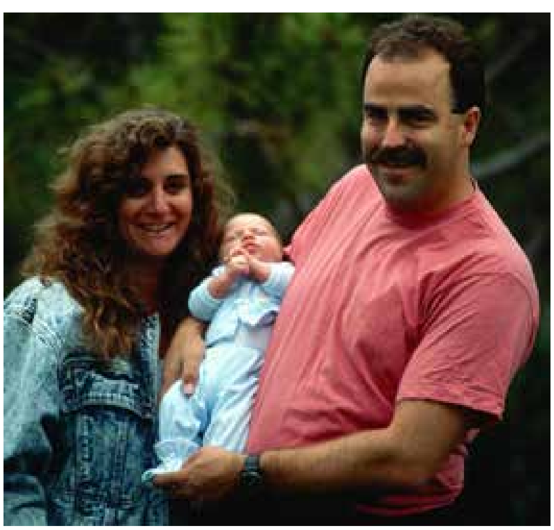
**Property Taxes** do not support the operations of state government but are used for public infrastructure. County and city governments receive over 46 percent of taxes imposed on property. The public schools receive about 30 percent, mostly for school construction, and the remainder goes to two-year colleges, health facilities, and special districts.

# Why it Matters

People often ask why a child advocacy organization like New Mexico Voices for Children works on tax and budget issues. Wouldn't it make more sense to advocate on issues that directly affect kids—like better nutrition in schools, higher quality foster care, and more anti-gang programs?

The state and federal tax systems also directly impact kids. The vast majority of the money the state or federal governments have to spend on services like schools, health care, and public safety comes from taxes. Every time the government cuts taxes for one group of people or businesses, it either has to raise taxes elsewhere or it has to cut spending. Spending cuts generally lead to a lack of services, which can have detrimental impacts on children. Cuts can lead to more crowded classrooms, fewer caseworkers for investigating child abuse or recovering child support payments from deadbeat parents.

Tax systems also directly impact working families and that impacts kids. The more money a working family spends on taxes, the less money they have for necessities like nutritious food, health care, and books that help their children succeed. It's a common myth that low-income people pay the lowest percentage of their income on taxes, but that is most often not the case—especially when it comes to state and local taxes.



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.[1] 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.[2] The nation's personal income tax practices of the past 40 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.[3]

# Spending Through the Tax Code

The state spends money both directly and indirectly. Direct spending takes the form of annual budgeting for programs such as education, social services, transportation, and public safety. Direct state spending is covered in the companion publication *Citizen's Guide to the New Mexico State Budget*. The state also spends money indirectly by choosing to forego collecting certain tax revenues. While direct spending is done through the budgeting process, indirect spending is handled by changing the tax code.

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 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.[4]

One sure 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 tries to estimate how much it will cost. These estimates are released in a fiscal impact report (FIR) prepared by the Legislative Finance Committee (LFC). 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 or the Executive.

Most states (and the federal government) review their tax expenditures annually in much the same way that direct spending is reconsidered.[5] New Mexico does not look at the cumulative cost of tax breaks or whether the breaks had the desired effect. Over the years, New Mexico's Legislature has passed bills that would have required the state to produce an annual **tax expenditure report**, but the bills were vetoed. Instead, the governors issued executive orders, but the resulting reports were grossly incomplete and flawed.

## *Technical Terms*

**Tax Expenditure** – A way the state spends money indirectly by foregoing collecting certain taxes through tax exemptions, deductions, and credits.

**Tax Expenditure Report** – An accounting (usually annually) of the cumulative cost of all tax expenditures. Such a report may also determine whether the tax expenditure had the intended economic effect.

# Principles of a Good Tax System

New Mexico's Legislative Finance Committee evaluates tax policy on five principles:

- **Adequacy**
- **Efficiency**
- **Equity**
- **Simplicity**
- **Accountability**

Adequacy means that tax revenue meets state spending needs and keeps pace with inflation and population growth.

An efficient tax system, by the LFC's definition, is one that has a broad base to avoid excess reliance on one tax. Most states rely on three sources to create balance: income, sales, and property taxes. New Mexico also collects severance taxes, so the state has four main sources of revenue, giving it a broad base.

Equity in a tax system means that everyone pays according to their ability to pay. This means 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 credits for some family expenses like child care and health care;
- Can include low-income wage subsidies such as the federal Earned Income Tax Credit and New Mexico's Working Families Tax Credit (for more on tax credits, see page 13.); and
- Include graduated rates.

A tax system is simple when the effort that goes into collection is minimal and it is easily understood. Every time the state enacts a tax exemption, deduction or credit, the system becomes more and more difficult to administer.

Accountability means that tax credits, exemptions, and deductions are easy to monitor and evaluate.

These five principles cover most aspects of a good tax system. However, we would add three more: stability, consistency, and transparency.

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.

***Technical Terms*** *(as applied to the gross receipts tax)*

**Tax Exemptions** – Receipts from the sale of goods and services that are not reported on a business' gross receipts form.

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

A tax system is consistent 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).

Transparency is what makes accountability possible. A tax system is transparent when citizens have enough information about the tax code to hold government accountable. New Mexico's lack of a tax expenditure budget is a serious problem for transparency and accountability.

## Measuring Tax Fairness

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

Sales and excise taxes tend to be **regressive** because low-income people must spend all of their earnings on day-to-day necessities—most of which are taxed, such as gas, utilities, and non-food groceries. 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.

### *Tax Facts*

**Regressive Taxes** – Those with lower incomes pay a higher percentage of their income in tax than do those with higher incomes.

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

**Progressive Taxes** – Those with lower incomes pay a smaller percentage of their income in tax than do those with higher incomes.

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 income tax system is somewhat **progressive**, because it relies heavily on income taxes, the rates of which increase as income increases. It is designed this way to help make up for the fact that state and local taxes tend to be regressive.

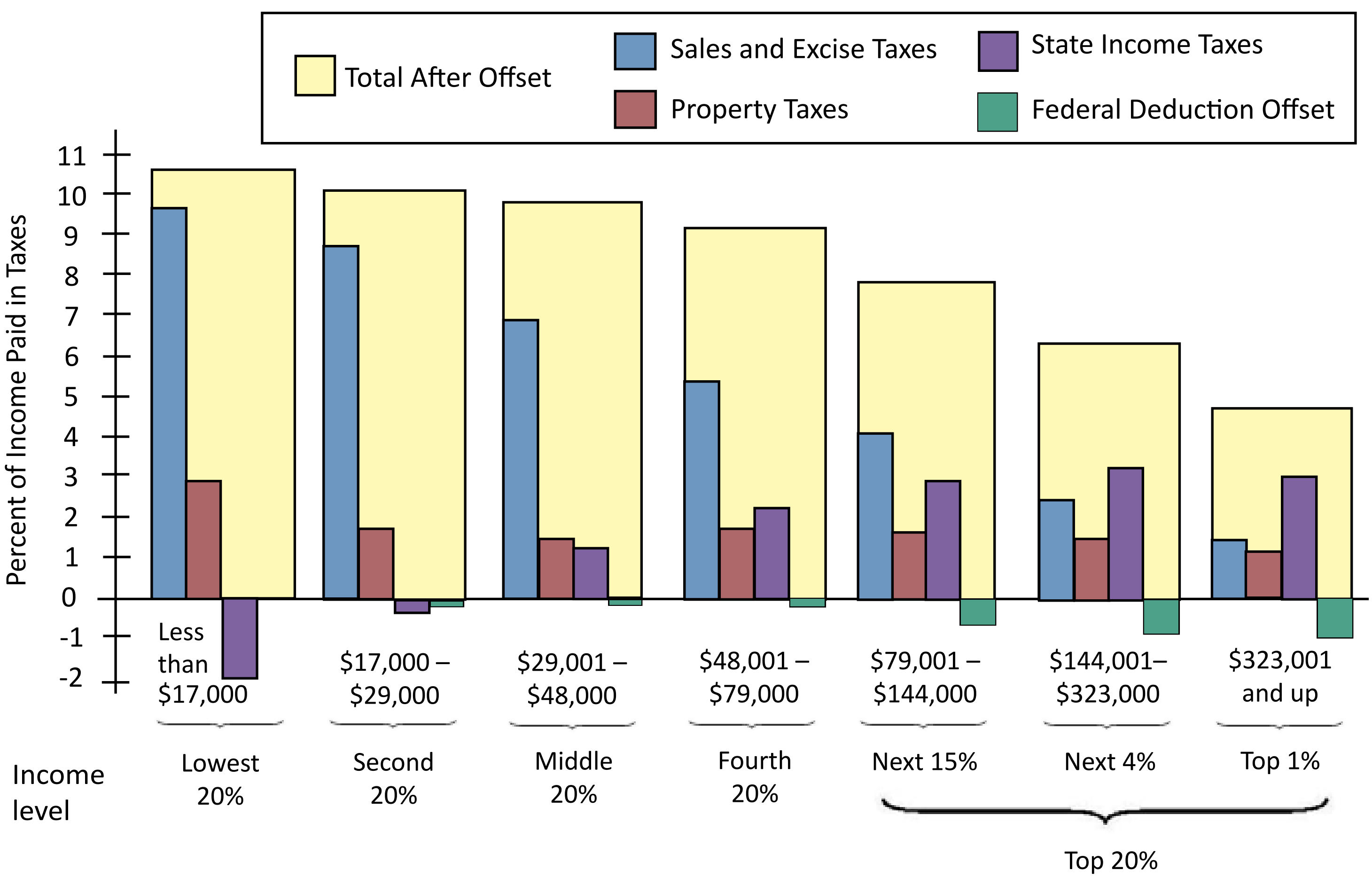
### Taxing Poverty

Most people agree that the poor shouldn't pay a higher tax rate than the rich. However, the truth is that poor people not only pay a higher rate, they pay a much higher rate.

When we look at taxes as a share of income, the ideas of regressivity and progressivity become more clear. Figure II (below) 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.

The yellow bars show the total share of income paid in state and local taxes—and they decrease as income increases. As the blue bars indicate, sales and excise taxes are the most regressive—hitting the lowest 20 percent the hardest. The opposite trend can be observed for income taxes (the purple bars) because these taxes are progressive. The lowest 20 percent of earners receive an income tax credit (shown by the purple bars that dip below the 0 percent line) and as the amount earned increases the percentage paid to income taxes also increases (except for the top 1 percent, where it decreases slightly).

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




Source: The Institute on Taxation and Economic Policy 2013 *Who Pays?* report
Note: Table shows permanent law in New Mexico enacted through January 2, 2013 at 2010 income levels. Top figure represents total state and local taxes as a share of personal income, post-federal offset.

In addition, there is a federal offset (the green bars). State income taxes are deducted from the amount owed in federal income taxes, thereby decreasing the amount of federal income taxes due. The higher the income group, the more valuable the offset.

Overall, Figure II shows that income earners in the lowest 20 percent pay nearly 11 percent of their income in taxes, while the top 1 percent pays less than 5 percent—meaning the tax rate paid by the poorest New Mexicans is more than twice the tax rate paid by the richest. To make matters worse, big corporate tax cuts enacted in 2013 will likely be paid for, in part, by higher gross receipts taxes, which are regressive.

## Refundable Tax Credits

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

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

**Refundable tax credits** help low-income families by reducing their overall tax bill if they owe taxes or refunding them money they've already spent (for example, on child care) if they do not owe taxes. The WFTC, a state-level Earned Income Tax Credit (EITC), rewards work because the credit amount is based on income earned. Unfortunately, millions of dollars in federal and state refundable tax credits go unclaimed every year by New Mexicans[6] because they either do not file tax returns or they (or their tax preparer) are unaware of the credits.

### *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 child care 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 credit is deducted from one's income tax bill if they owe taxes. If they do not owe taxes—or if the credit amount exceeds the owed amount—they receive a check for the amount of the credit or the difference.

## State Income Tax Cuts

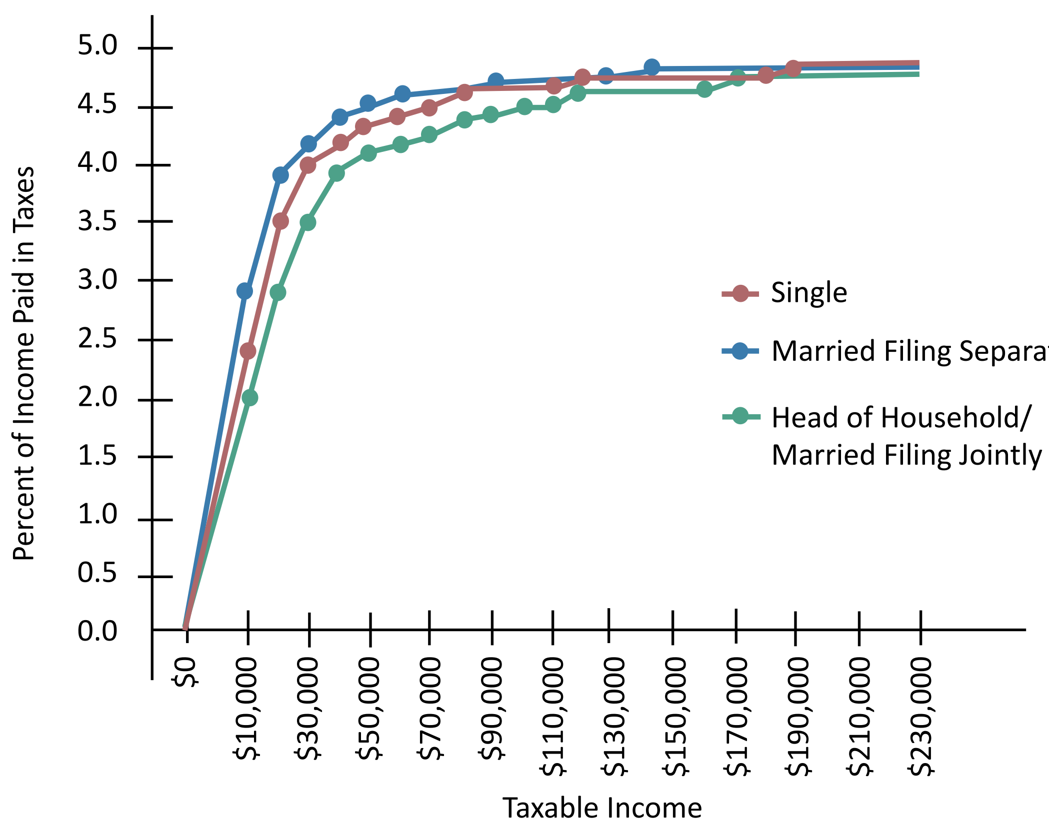
In 2003, at Governor Richardson's request, the New Mexico Legislature cut the personal income tax rate for the top income earners by almost half—from 8.2 percent to 4.9 percent.[7] New Mexicans earning the median income ($29,001–$45,000) received a small cut. Those earning the least—the bottom 40 percent of tax filers—received no benefit at all.

As Figure III (below) shows, this has made state income taxes considerably less progressive. The tax rate climbs rapidly in the lower-income brackets ($0 to $30,000), 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, not at the lowest. In other words, the curve below should start out flat and rise most rapidly at the end of the income scale instead of the beginning.

**Figure III**

**New Mexico Personal Income Taxes Due for Tax Year 2011**

(by percent)




Source: Tax Table for Taxes due April 17, 2012

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

In 2003, those receiving **capital gains** income were given a large deduction on their state and federal taxes. Capital gains is income realized when something of value—stocks, bonds, real estate, etc.—is sold at a profit. Because it does not come from wages or salaries, capital gains is called unearned income by economists. The state allows those with capital gains to deduct half of that income from their state taxes. This deduction also overwhelmingly went to the highest-income earners.

**2003 New Mexico Income Tax Cuts**

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

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.

## *Technical Terms*

**Taxable Income** – The income amount that is taxed after all deductions and credits have been applied.

**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. State law allows them to deduct half of their capital gains from their taxable 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.

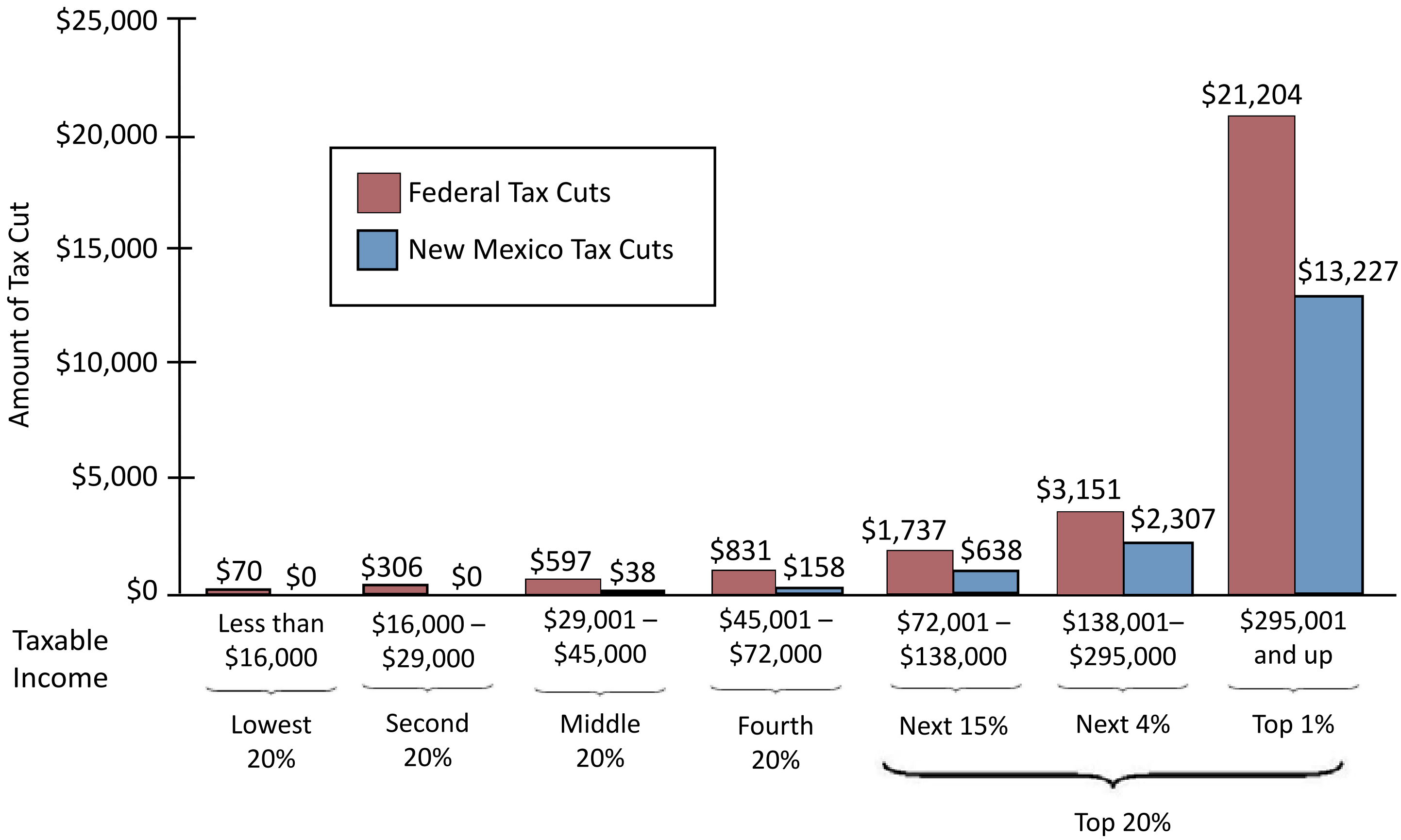
## Federal Income Tax Cuts

Federal income taxes have also become much less progressive due to hefty tax cuts enacted by the Bush Administration in 2001 and 2003. As with state income tax cuts, the greatest benefit went to those with the largest incomes, as shown on Figure IV (below).

### 2001, 2003 Federal Income Tax Cuts

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

**Figure IV**
**Federal and State Income Tax Cuts of 2001 and 2003 when Completely Phased In (2008)** (by income class)




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

## Those Elusive 'Job Creators'

Over the past 40 years, Americans have been told that tax cuts for the wealthy will create jobs. We were also told that the new jobs created by these tax cuts would generate enough new tax revenue that the cuts would "pay for themselves." While tax cuts for the so-called "job creators" can spur job growth, they have not been proven to pay for themselves.[8] In fact, the Bush tax cuts had a tremendous impact on the growth of the national debt.[9] Job growth during the Bush Administration, meanwhile, had more to do with the housing bubble than the tax cuts.

While the federal government can finance tax cuts with deficit spending, the states cannot. So whenever the states reduce taxes for one group they must either increase taxes somewhere else or reduce services by cutting spending.

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

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.[10]

Tax cuts for businesses are also said to encourage job growth by luring new companies to the state. While no company will turn down a tax incentive, research shows that business owners weigh a very broad range of factors—such as the quality of the public education system and the local workforce, proximity to highway, rail and airline routes, and even the weather—when considering new business locations.

In the last decade, New Mexico has cut personal income taxes and corporate taxes by billions of dollars in an attempt the lure companies to the state. Our job growth rate, however, continues to be sluggish.

Business values a skilled workforce more than tax cuts because:

- Labor = 40% of business costs.
- State taxes = 1% of business costs.

## The Great Recession

An economic downturn puts great strain on the budget. The state collects less tax revenue because business is sluggish, people's salaries are frozen, their work hours are cut back, or they become unemployed altogether. As more people lose their jobs, 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.

"A million dollars spent providing education or health care creates far more jobs than a million dollars sent back to shareholders or high-income consumers in the form of tax cuts."

The Great Recession that began in late 2007 hit New Mexico much harder than previous recessions because the state had benefitted more from the preceding boom.

Historically, state spending has grown by about 6 percent, which was close to the long-term growth rate in the state's economy. During the recession, however, tax revenues ceased to grow at the same rate as the economy, dropping to negative 11.6 percent in FY09.

This loss of economic activity sent state revenues plunging in FY09, bottoming out in FY10. While revenues began to recover in FY11, revenue forecasters have determined that it will take several more years until the state budget returns to its pre-recession level.

New Mexico cannot run a deficit[11] the way the federal government can, so losses in revenue must lead to either cuts in spending or tax increases. New Mexico's lawmakers raised very little new revenue during the recession, relying instead on draconian cuts to the very programs New Mexicans were in greater need of.

Had it not been for the recession, the general fund would have been increasing during those years. The fact that it will take 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 to avoid suffering this decline directly, changes must be made to the tax system to increase revenue and New Mexicans must send a signal to Santa Fe that spending should be safeguarded for programs that are vital for their well-being.

## Conclusion

Most government services and programs are paid for by taxes, as is the infrastructure that makes our way of life and modern economy possible. How we collect taxes says a great deal about our values and priorities—whether we want a progressive tax system that allows low-income families to pay less, or whether 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 low-income families. The income tax cuts of 2003 and corporate tax cuts of 2013 made our system even less progressive. These changes also made our tax system:

- **Less stable** – a heavier reliance on oil and natural gas revenues makes the state more vulnerable to global price fluctuations;
- **Less consistent** – revenues no longer grow with the state's economy;
- **Less balanced** – the scales have tipped from stable revenue sources to less stable sources; and
- **Much less equitable** – 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.

The 2003 income tax cuts and 2013 corporate tax cuts also significantly decreased the state's revenue. On top of that, the recession caused the state's revenue to plummet by $600 million in FY09. The general fund loses revenue every time the Legislature passes another tax exemption or deduction—and neither the cost nor the value of these expenditures are tracked. These events continue to make our tax system:

- **Less adequate** – budget constraints are likely to continue until FY15;
- **More difficult to administer** – exemptions and deductions from the gross receipts tax make the tax code more complex; and
- **Less transparent** – the state lacks a statute requiring a tax expenditure report.

## Endnotes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