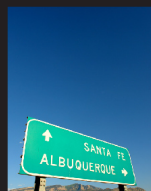


New Mexico Fiscal Policy Project

CITIZEN'S GUIDE TO NEW MEXICO'S TAX SYSTEM

How it works and why it matters



ACKNOWLEDGEMENTS

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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

ABOUT NEW MEXICO VOICES FOR CHILDREN AND THE NEW MEXICO FISCAL POLICY PROJECT

Founded in 1987 by a group of pediatricians, **New Mexico Voices for Children** is a progressive, nonpartisan, statewide advocacy organization. We work to eliminate child poverty and improve the health and well-being of New Mexico's children, families and communities. We do this in two ways: 1.) Using an evidence-based approach of solid research and data, we work to educate the community and policymakers about the unmet needs of New Mexico's children, families and communities and advocate for public policies that address these needs, and 2.) Using tangible issues such as violence prevention, we train New Mexico youth to be the next generation of advocates.

The **Fiscal Policy Project** was created in 2003 as part of the nationwide State Fiscal Analysis Initiative at the Center on Budget and Policy Priorities in Washington, D.C. Organizations in this national network examine state and federal tax and budget issues specific to the needs of the poor.

New Mexico Fiscal Policy Project Staff

Eric Griego, Executive Director

Bill Jordan, Policy Director

Gerry Bradley, Research Director

Anne Stauffer, Policy Analyst

Robert Lucero, Community Partnership Development Director

Felicia Griffin, Development/Operations Director

Sharon Kayne, Communications Director

Lynda Chandler, Publications Director

New Mexico Voices for Children Board of Directors

Nancy Jo Archer, Chairperson ~ Executive Director, Hogares, Inc.

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New Mexico Highlands University / **Danny Lopez** ~ Marketing Director, National Hispanic Cultural Center

Nancy Lopez PhD ~ Professor, University of New Mexico Department of Sociology / **Joe Maestas** ~ Mayor, City of Española / **Robert P. McNeill, JD** ~ The McNeill Law Firm / **Janice D. Paster, JD** ~ Attorney at Law

Dean Wm Rudoy, PhD ~ Clinical Psychologist / **Donald G. Simonson, PhD** ~ Professor Emeritus, UNM Department of Economics / **Antoinette Tellez-Humble** ~ Center for Civic Policy / **Mayra Franco-Vasquez** ~

Doña Ana Community College Student, Amy Biehl Awardee.

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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, travel by airplane, visit the park, deposit money in the bank, 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 watch over 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.

Like creating a spending budget, determining how taxes are collected says a lot about our values and priorities. 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 and the formation process and how advocates can promote their priorities within that process.

HOW THE STATE PAYS FOR SERVICES AND PROGRAMS

Most state services and programs – like public education, public safety and health care – are funded by taxes and fees. Most of the state’s tax revenue comes from income taxes and general sales taxes. The state also receives money from other sources. The federal government helps pay for programs like education and Medicaid.

While the state can borrow money, such funds cannot be used to pay for services. Borrowed money goes into the **capital budget**, which funds things like building schools and community centers. This guide focuses on the **operating budget**, which funds services and programs. The operating budget is funded by state and federal money. Taxes collected by the state are generally deposited into one fund called the **general fund**. This guide discusses the general fund because the state controls the collection and spending of money in this fund.

About 43 percent of the state general fund is spent on public education from kindergarten through high school and another 15 percent on higher education. Health and human services account for 24 percent and public safety for 7 percent.

New Mexico’s tax system is **centralized**, meaning that state government funds many of the government functions that other states pay for at the city and county level. New Mexico funds both K-12 and higher education this way. Most other states fund their schools primarily with property taxes. Hawaii is the only other state that has a public finance system as centralized as New Mexico’s.

Technical Terms:

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

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

Road fund – Money for building and maintaining roads and highways.

Where the Money is Spent

Chart I (NM's \$5.675 Billion General Fund Budget for FY08, page 8) shows how the state spends much of its money. The chart includes only state general fund money. Federal matching dollars for Medicaid, childcare and education are not included. That's because the state has no direct control over these funds.

Education, from public pre-school to graduate school, takes up almost 60 percent of the state budget. Health, hospitals and human services, which includes programs for seniors and the child welfare system, account for about a quarter of the general fund. Public safety spending includes the corrections department and state police.

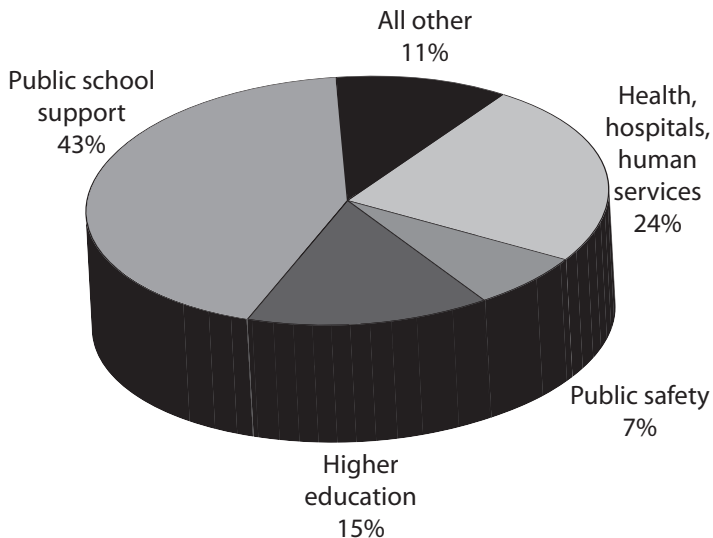
The "all other" slice includes the funding for all remaining agencies and programs of the executive, legislative and judicial branches of state government.

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."

Revenues are discussed by the Legislature in meetings between annual legislative sessions. Revenue policy is the responsibility of the Legislative Finance Committee and the Revenue Stabilization and Tax Policy Committee.



Chart I
New Mexico's \$5.675 Billion General Fund Budget for Fiscal Year 2008
(by percentage)



Source: Estimate from Legislative Finance Committee's 2008 Post Session Review.

Technical Terms:

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

Keeping Up with ‘Current Services’

According to the Legislative Finance Committee’s 2008 Post Session Review, New Mexico’s spending must increase by at least 3.4 percent in the next three years in order to provide the same level of services. A spending level that accomplishes this is called a “baseline level of expenditures.”

The 3.4 percent increase estimate for current services spending is conservative because the actual increase in spending needed tomorrow to meet today’s current levels of service will almost certainly be higher. There are several reasons for this:

- New Mexico’s population increases = about 2 percent a year.
- Inflation = about 3 percent a year.
- Health care costs increase = 4 percent a year.
- New public priorities = expanding pre-K programs, universal health coverage, or making public school funding adequate and fair.



General Fund Revenue Sources

Charts II and III (pages 13 and 14) show where the state gets its tax revenue. The 41 percent **sales tax** piece of the pie includes **gross receipts taxes** on most goods and services, **compensating taxes**. **Excise taxes** on things like tobacco, liquor, motor vehicles, and telecommunications services account for 7 percent. Like many states, New Mexico relies heavily on these sales taxes to fund services. People often suggest raising so-called “sin” taxes – taxes on alcohol and tobacco products – as a way to generate revenue, but these taxes actually make up a very small share of the whole.

Technical Terms:

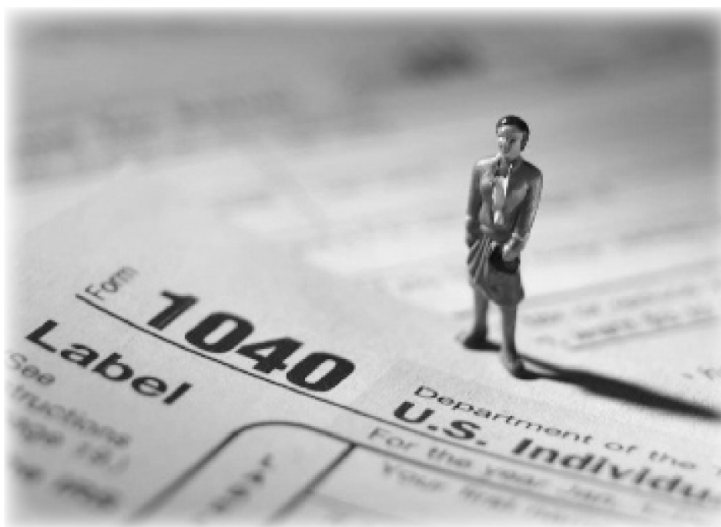
Gross receipts tax (GRT) – Often considered a “sales tax” levied on goods and services, the GRT is not technically a sales tax because it does not have to be passed on to the buyer. However, it usually is.

Compensating tax – A tax on goods brought from out-of-state for use in New Mexico.

Excise tax – A special sales tax on a particular type of product or service, such as alcohol or tobacco.

The state gross receipts tax rate is 5 percent, but many cities and counties tack on a bit more to pay for municipal services. The state then distributes 1.225 percent to cities. 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.

The 27 percent **income tax** piece of the revenue pie includes both personal and corporate income taxes. Corporate income taxes are levied on a corporation's net profits, which can vary widely from year to year.



The 18 percent **severance tax** piece of the revenue pie includes 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 mix, some 90 percent comes from oil and natural gas extraction, with natural gas being the largest revenue producer.

Severance taxes are based on the value of production (e.g., the price of a barrel of oil). 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,”

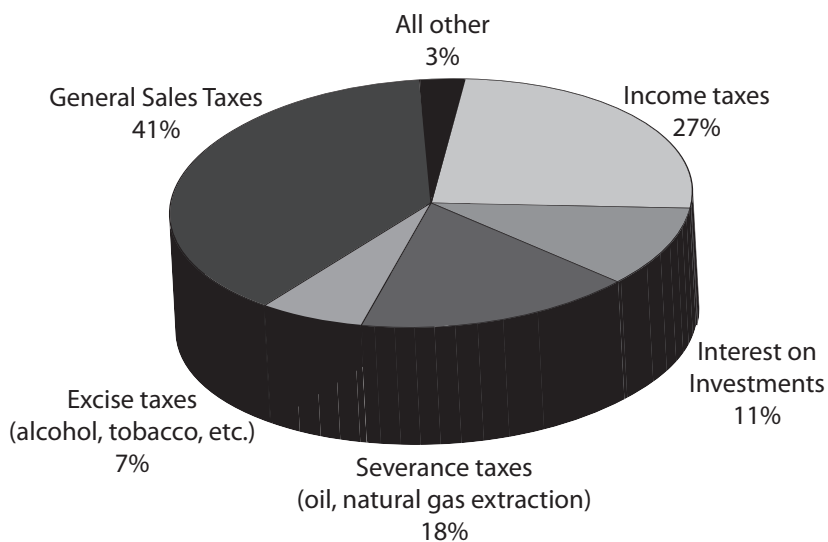
meaning that because New Mexico oil and natural gas companies are owned by people out of state, the costs of these taxes are probably not paid by New Mexicans. In fact, most severance taxes are probably paid by the owners of energy corporations: the stockholders.



The 11 percent **interest on investments** is primarily derived from investments of permanent fund revenue. 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.

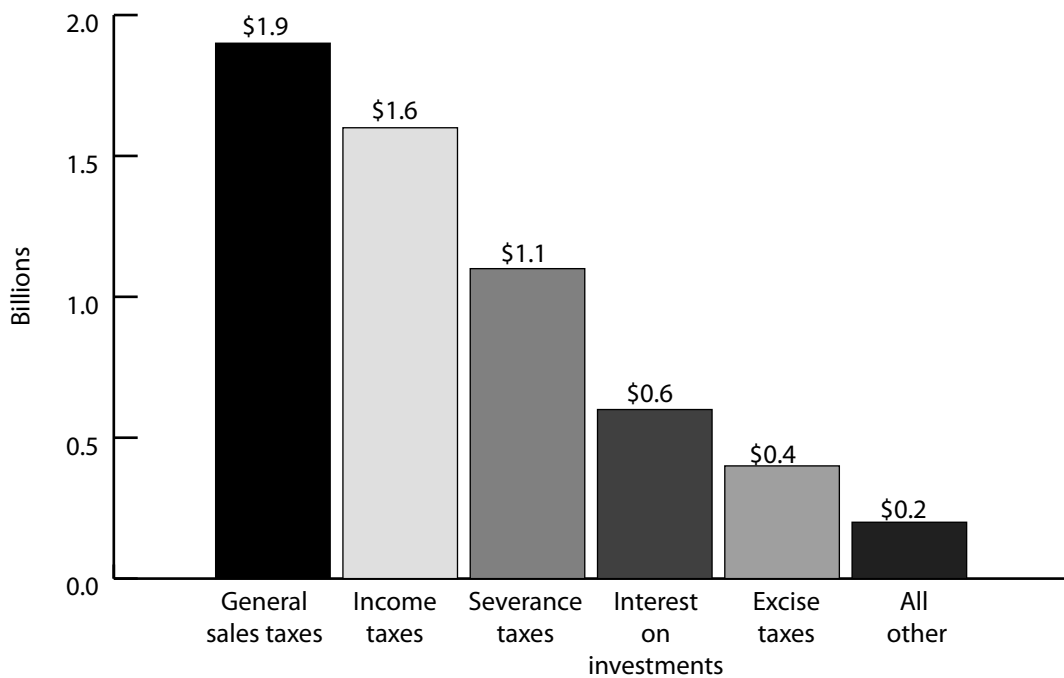
The 3 percent **all “other”** category includes gaming. New Mexico has revenue sharing agreements with tribes and pueblos that operate casinos and other venues under the federal Indian Gaming Regulatory Gambling Act. As negotiated by the state and tribes, tribes and pueblos must pay a percentage of their net revenues in exchange for the right to engage in gambling. While gambling and the revenue-sharing negotiations garner much attention, the revenues account for only 1 percent of the general fund.

Chart II
New Mexico's General Fund Revenue Sources for Fiscal Year 2008
(by percentage)



Source: Estimate from Legislative Finance Committee's 2008 Post Session Review.

Chart III
New Mexico's General Fund Revenue Sources for Fiscal Year 2007
(by amount)



Source: Estimate from Legislative Finance Committee's 2008 Post Session Review. FY2004 revenues are the latest actual revenues.

Some Non-General Fund Revenue Sources

Other revenue sources you may be familiar with that do not go into the general fund are:

Fuel taxes on gasoline and other fuels are specifically designated for the Department of Transportation's use and are deposited in the state road fund. This fund 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 provide another major source of funding for state-delivered services and programs. Federal funds accounted for approximately one third of the state's total budget in FY08. While many agencies receive federal funding, the majority goes to Health and Human Services, the Transportation and the Public Education Departments. Federal funding also goes to higher education institutions.



PRINCIPLES OF A GOOD TAX SYSTEM

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

- Easy to administer
- Transparent
- Balanced
- Fair

An **adequate** tax system is one in which 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. Table I (Structural Budget Forecast with Significant New Spending Initiatives, page 17) is from the 2008 Post Session Review. General revenue growth rates are listed in the first category, "General Fund Recurring Revenues." Spending growth rates necessary to maintain a **baseline budget** (listed under "Baseline General Fund Expenditures") are all higher than the revenue growth rates. The third category, "Significant New State Spending Initiatives," shows increases in a number of education, transportation and health programs that have been brought before the Legislature. Without adequate funds for maintaining even a baseline budget, new initiatives will not be funded unless significant cuts are made in current programs or new sources of revenue are found.

Technical Terms:

Baseline budget – The funding needed to maintain the current level of services and programs.

Table I
Structural Budget Forecast with Significant New Spending Initiatives

	2008 Approp.	Baseline Forecast			
	FY09	FY10	FY11	FY12	
I. General Fund Recurring Revenues (Dec 2007 Estimate adjusted for 2008 legislation)	6,045.4	6,231.1	6,385.3	6,547.1	
General Revenue Growth rate	2.4%	3.1%	2.5%	2.5%	
II. Baseline General Fund Expenditures*					
Health and Human Services	1,533.6	1,619.8	1,710.8	1,808.0	
<i>Medicaid</i>	787.7	850.7	918.8	992.3	
<i>Other</i>	745.9	469.0	792.1	815.7	
Public Safety	410.7	427.1	443.8	462.5	
<i>Corrections</i>	296.1	308.9	322.2	337.2	
<i>Other public safety</i>	114.6	118.1	121.6	125.3	
Higher Education (Includes additional Education Retirement Board contribution)	888.1	915.6	943.0	971.2	
Public Education	2,608.7	2,668.5	2,728.8	2,792.3	
All other (Legislative; Judicial; General Control; Commerce & Industry; Ag, Energy & Natural Resources)	594.3	608.1	621.9	635.9	
Baseline General Fund Expenditures	6,035.3	6,293.1	6,448.4	6,669.8	
Baseline General Fund Spending Increase	559.2	360.4	203.8	221.5	
Baseline General Fund Spending Growth Rate	10.9%	6.4%	3.4%	3.4%	
Annual General Fund Surplus (Deficit)	10.1	(8.0)	(63.0)	(122.7)	
*In FY09, \$19.2 million for compensation is prorated across all agencies; all expenditures inflated using CPI unless otherwise noted.					
III. Significant New State Spending Initiatives:					
Public School Funding Formula Phase-In (1)		118.6	204.0	322.0	
Pre-K Programs (LFC scenario: five-year phase of remaining \$55 million remaining cost to fully implement)		11.0	22.0	33.0	
House Memorial 35 Task Force Recommendations (2) (Highway/Bridge Construction and Maintenance)		115.0	160.0	245.0	
Railrunner Operations (3)		20.0	20.0	20.0	
Medicaid coverage for Children <300% FPL (4)		17.7	35.4	53.1	
Medicaid coverage for Adults <200% FPL (4)		217.9	434.4	651.6	
Medicaid coverage for Adults 200 to 300% (4)		59.0	118.0	177.0	
Retiree Health Care Solvency (5)		13.7	27.3	41.0	
Reduce Developmentally Disabled Waiting List (6)		4.0	8.0	12.0	
New State Spending Initiatives:	-	576.8	1,029.1	1,554.6	
Baseline General Fund plus New Initiatives Expenditures:	6,035.3	6,815.9	7,477.5	8,224.4	
Annual General Fund and New Initiative Surplus (Deficit)	10.1	(584.8)	(1,092.1)	(1,677.3)	

Notes:

1) Public School Funding Formula estimate from American Institutes for Research, School Funding Phase-in Proposal, 1/8/2008

2) HM36 needs forecast from NMDOT and HM35 Task Force study.

3) Railrunner operating cost needs forecast by NMDOT.

4) Cost of covering uninsured through Medicaid based on HSD estimates.

5) RHCA funding assumes that the amount needed to fully fund the annual required construction (ARC), \$136.5 million, will be funded over a five year period with half coming from the general fund. ACR documented on Page 8 of the RHCA Work Group final Report, December 2007.

6) Assumes 160 clients are added per year to eliminated the waiting list of 4,000 over 25 years.

Source: 2008 Post Session Review.

A **stable** tax system is one that relies more on predictable revenue sources than on sources that fluctuate.

Stable Revenue Sources:

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

Gross Receipts Taxes (GRT) – because they also grow with the population and everyone purchases goods and services that are taxed.

Unstable Revenue Sources:

Severance taxes – because they depend on finite resources and on fluctuating global market prices for oil and natural gas.

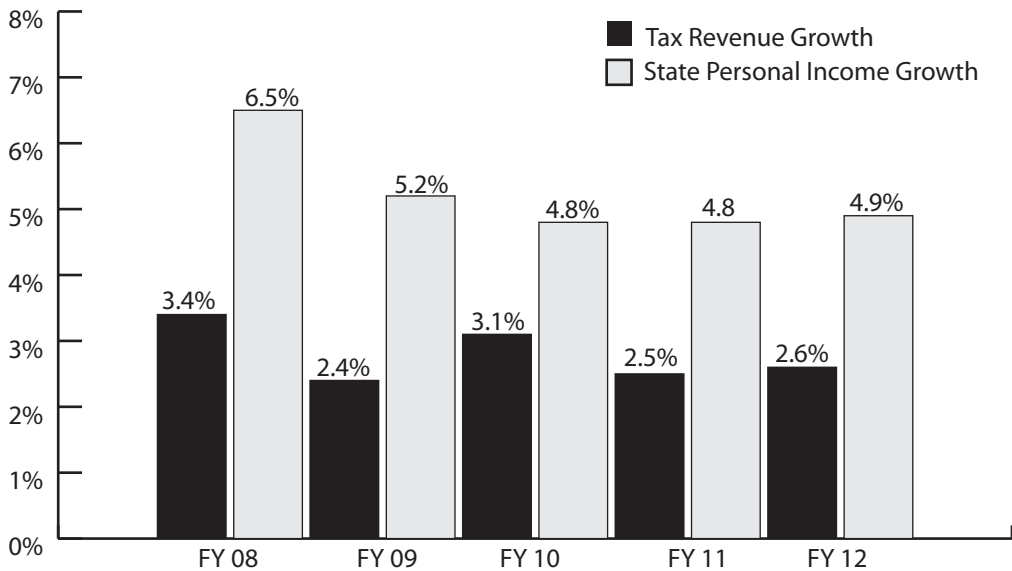
Corporate Income Taxes (CIT) – because, in New Mexico, most of it comes from oil and natural gas companies, whose profits rise and fall as oil and gas prices fluctuate.

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 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 Chart IV: Average Annual Tax Revenue and State PIT Growth Rates, page 19).

New Mexico tax revenues no longer grow at the same rate as the New Mexico economy. The historical growth of state spending was about 6 percent, similar to the long term growth in the state's economy. The general fund growth rate is expected to drop as low as 2.4 percent in FY 09.

A tax system is considered **easy to administer** when the expense of collecting, enforcing and complying with the system is minimal.

Chart IV
Average Annual Tax Revenue and State Personal Income Growth Rates
(by percentage)



Source: 2008 Post Session Review

The gross receipts tax is the state tax with the broadest base. It originally included receipts from the sale of almost all goods and services but it has been changed over the years and now includes numerous **tax expenditures**.

Technical Terms:

Tax Expenditure – An exception to the tax code.

Every time the state makes changes to the tax code in the form of tax expenditures – or **exemptions** and **deductions** – 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.

Technical Terms (Under the gross receipts tax):

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

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

Tax Expenditure – An exception to the tax code.

Exemptions and deductions from the GRT are often put in place as incentives for economic development. While they are supposed to accomplish laudable social goals – such as create new jobs – they often amount to nothing more than gifts to special interest groups. Tax expenditures are really 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.

A **balanced** tax system is one that does not rely too heavily on one 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.

A Flaw: In New Mexico, the state is not required to track tax expenditures. The state has estimated that it loses more than \$5 billion every year to exemptions and deductions. This failure to track exemptions and deductions also makes our tax system less transparent.

A Fix: A **tax expenditure budget** would require that exemptions and deductions be tracked so they could be scrutinized like a spending budget. Legislation to require a tax expenditure budget was passed in 2007 but was vetoed by the governor.

A **fair** tax system is one in which everyone pays according to their ability to pay. 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.
- Include graduated rates.

- Taxes should be based on ability to pay.
- People in similar circumstances should be taxed similarly.
- Taxes on low-income households should be minimized.

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 credits such as New Mexico's Low-Income Comprehensive Tax Rebate (LICTR) benefit low-income tax filers.

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. 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 the ability-to-pay principle. 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** – where the tax rate increases as income increases. This is usually done to help lessen the regressivity of sales taxes on low-income families.

While no single tax can be “fair” to everyone, a tax *system* that is equitable to all is possible.

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

- Income taxes are progressive
- Sales taxes are regressive

Combining the two results in:

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

New Mexico and the Corporate Income Tax

A Flaw: New Mexico’s tax code allows corporations operating in multiple states to minimize the corporate income taxes they pay to New Mexico on the profits they make here. The state loses at least \$80 million a year through this loophole. It also puts corporations that operate only in New Mexico at a competitive disadvantage.

A Fix: Changing this policy with legislation – called **mandatory combined reporting** – has been brought before the state Legislature several times, but never passed. New Mexico is one of the few states west of the Mississippi that does not require combined reporting in its corporate income tax.

How New Mexico Stacked Up

One way to gauge the relative progressivity of our tax structure is to compare it with those of the other 49 states. In a study by the Institute on Taxation and Economic Policy called *Who Pays?*, New Mexico ranked tenth in the top ten states with the highest taxes on the poor. That study was released in January 2003. While the state's income tax was progressive, it did not do enough to offset the regressivity of our broad-based gross receipts tax. Since that time, the state's income tax has been made much less progressive.

Map I
The Ten States with the Highest Taxes on the Poor (2003)



Source: "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States"; Second Edition, pg. 11, 2003, <http://www.itepnet.org/wp2000/text.pdf>.

Taxing Poverty

Most people agree that poor people shouldn't pay more taxes than rich people. But they 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. What confuses many people is the total amount of taxes paid.

The first family paid about \$1,560 in taxes and the second family paid about \$38,430. While the first family paid a lower total amount, it represented a much bigger proportion of their income.

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

Technical Terms:

Adjusted gross income (AGI) – For the income tax, 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. However, the formula to determine the FPL was created in the early 1960s when a family's largest expense was food. The cost of housing has far outpaced the inflation rate on goods such as food, so the formula is outdated.

CHANGING THE CODE

State Income Tax Cuts

In 2003, the state Legislature cut the top marginal personal income tax rate, at the governor's request. These tax cuts were phased in over several years between 2003 and 2008.

For income taxes due on April 15, 2008 (for tax year 2007), the average income tax rate for a single taxpayer started at 1.72 percent (or \$86) on taxable income of \$5,000 and went up to 5.01 percent (\$6,014) on taxable income of \$120,000. For a married couple filing jointly or for a head of household filer, the tax rate started at 1.72 percent on taxable income of \$5,000 to 4.88 percent (\$5,853) on income of \$120,000 (see Graph I, NM Personal Income Taxes Due for Tax Year 07, page 26). As Graph II (page 28) shows, taxes as a percentage of income climb most rapidly in the lowest income brackets, leveling off when incomes hit \$70,000 to \$75,000.

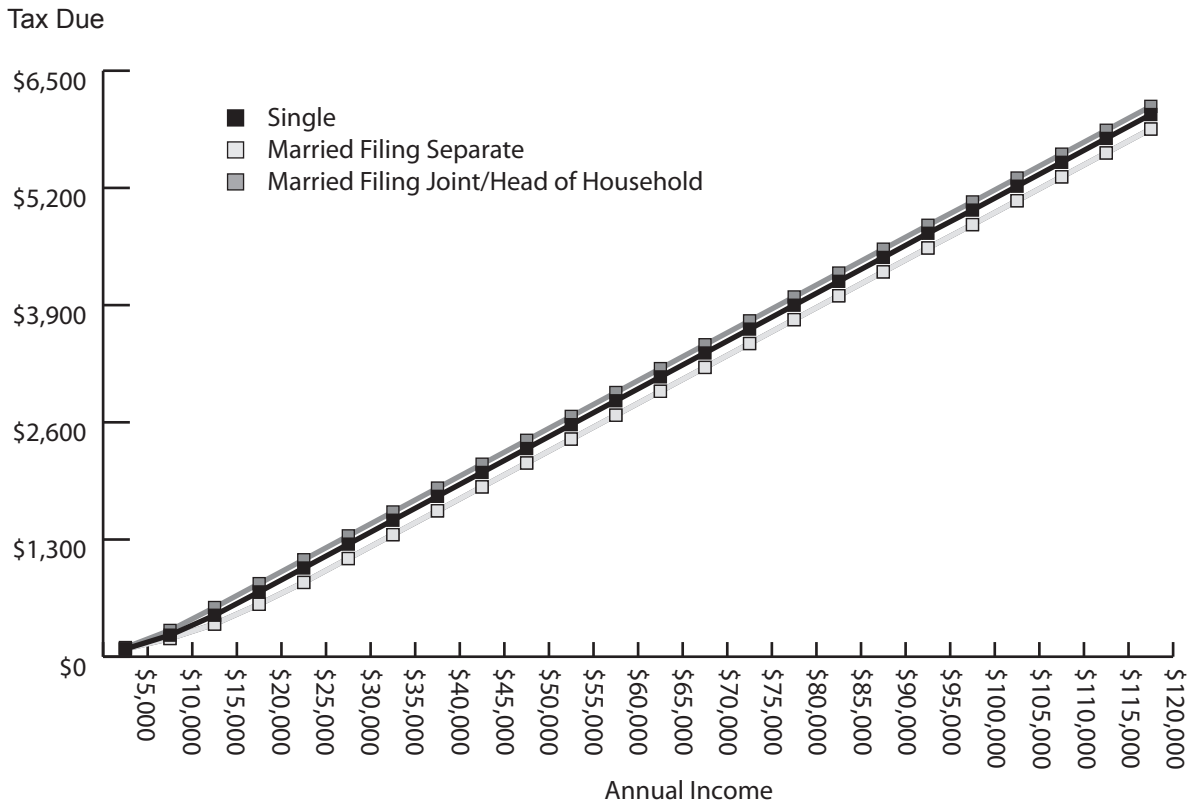
This will change for tax year 2008. The top rate, which was 8.2 percent in 2003, will fall to 4.9 percent, which will further flatten the tax curve as illustrated on page 28. The lowest rate, 1.72 percent in 2003, will not change. Taxable capital gains were also reduced by 50 percent. The combined effect will decrease New Mexico's income tax revenue by one third.

A Flaw: New Mexico's personal income tax (PIT) threshold – the level of earnings at which one begins to pay income taxes – is too low.

According to *The Impact of State Income Taxes on Low-Income Families in 2006* the state income tax threshold for a family of three in New Mexico was \$24,700, about 50 percent higher than the poverty level for that year. That is still not high enough, although the state is improving. (Center on Budget and Policy Priorities, 2006)

A Fix: Raise the PIT threshold to twice the federal poverty level so more low-income families are exempt from paying the PIT.

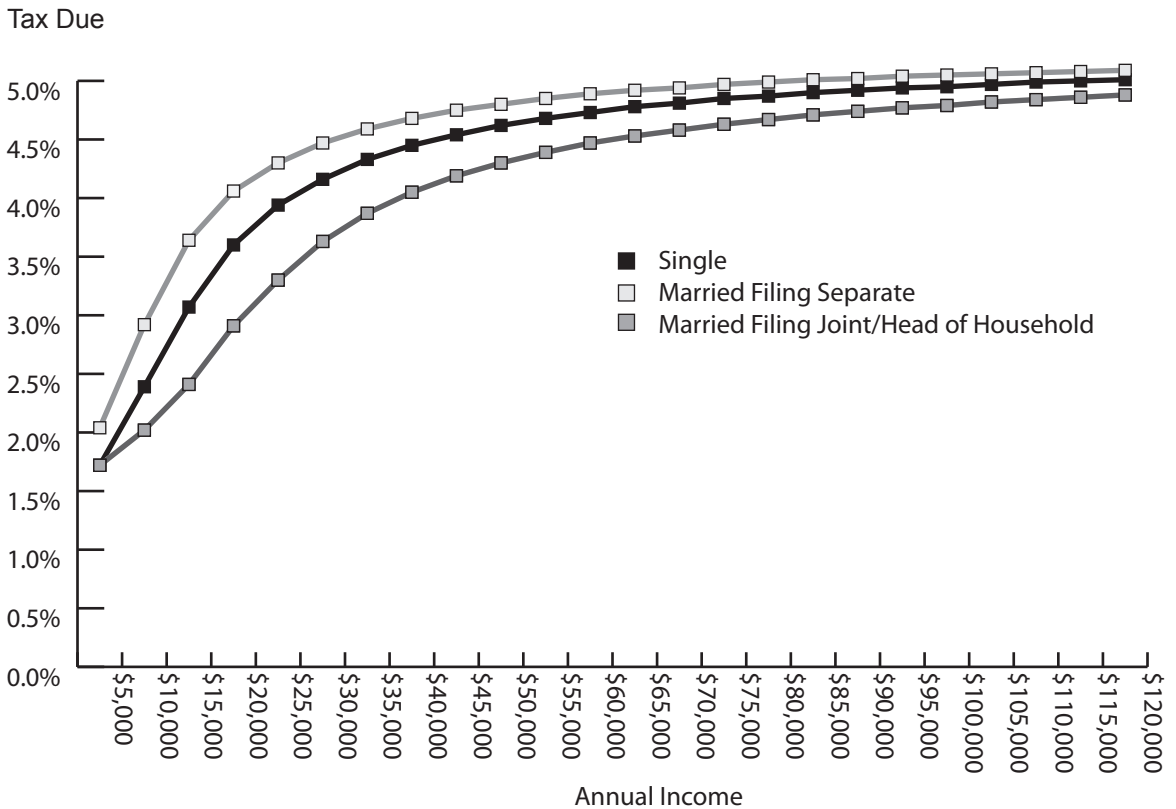
Graph I
New Mexico Personal Income Taxes Due for Tax Year 2007
 (by amount)



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 II
New Mexico Personal Income Taxes Due for Tax Year 2007
 (by percent)

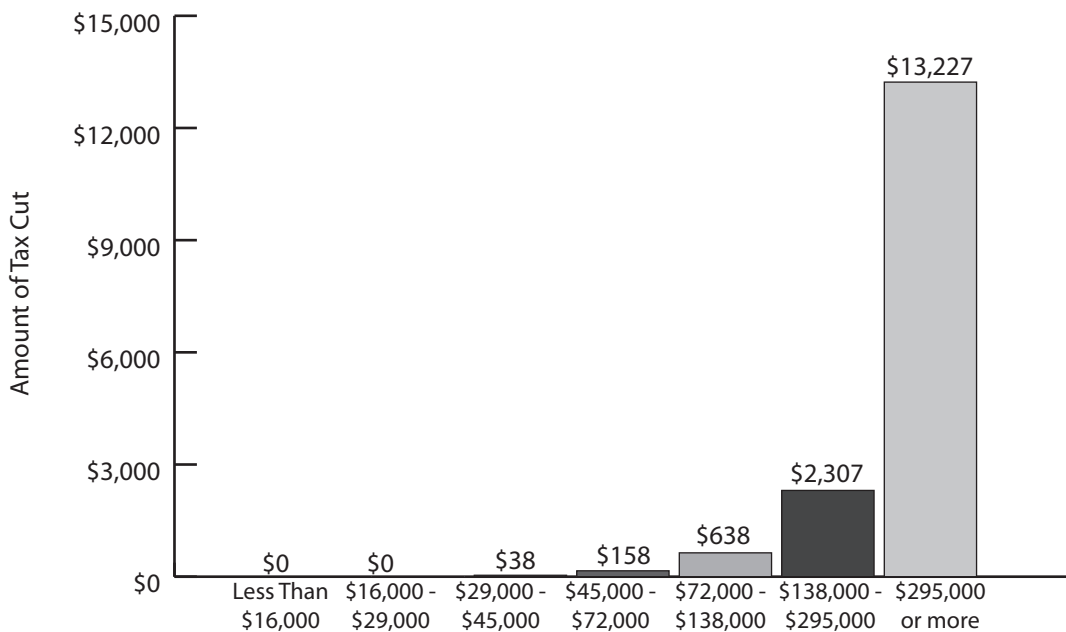


Source: Tax Table for Taxes due April 15, 2008.

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

Chart V (below) shows that those New Mexicans who have the highest income benefited the most from the state income tax cuts enacted in 2003. Those who earn the least did not benefit at all.

Chart V
State Income Tax Cuts When Fully 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

Federal Income Tax Cuts

Federal income taxes have also become much more regressive, thanks to tax cuts called for by the Bush Administration in 2001.

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.

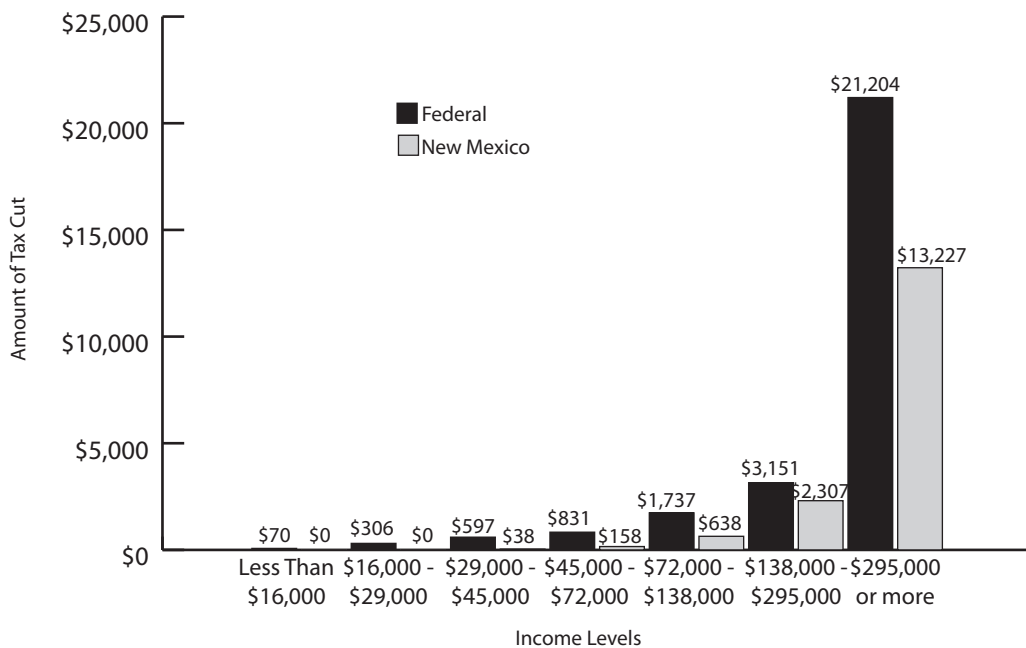
2003 New Mexico State Income Tax Cuts:

- 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.



State income tax cuts mirrored federal cuts in that the greatest benefit went to those with the largest incomes. Both systems are now much less progressive.

Chart VI
Federal and State Income Tax Cuts in 2008
 (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, so do federal itemized deductions.
- Fewer deductions mean higher federal income taxes
- *One third* of the state tax reduction goes straight to the IRS!

Technical Terms:

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.

New Mexico allows an unusual deduction for higher-income tax payers: state and local taxes may be deducted on the New Mexico income tax return.

A Flaw: The federal government allows those who itemize on their income tax return to deduct any income 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.

A Fix: Enact a **PIT-add back** of the state tax deduction to close a loophole that reduces taxes for higher-income taxpayers not as available to low-income New Mexicans because they are less likely to itemize.

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.

- Low-Income Comprehensive Tax Rebate
- Property Tax Rebate for seniors
- Childcare Credit for low-income working parents
- Working Families Tax Credit

The first three credits were in place at the time of the 2003 tax cuts and were not affected by the changes.

During the 2007 regular session, the New Mexico Legislature passed the Working Families Tax Credit, which mirrors the federal Earned Income Tax Credit (a refundable tax credit). Families that qualify for the EITC can get 8 percent of the federal EITC refunded when filing state income taxes.

Unfortunately, millions in federal EITC dollars go unclaimed every year by New Mexicans because they do not file federal tax returns.

Technical Terms:

Refundable tax credit – A tax credit that not only reduces the amount of taxes owed, but if it reduces the amount of taxes owed to less than zero, the government writes a check to the taxpayer for the remaining amount of the credit.

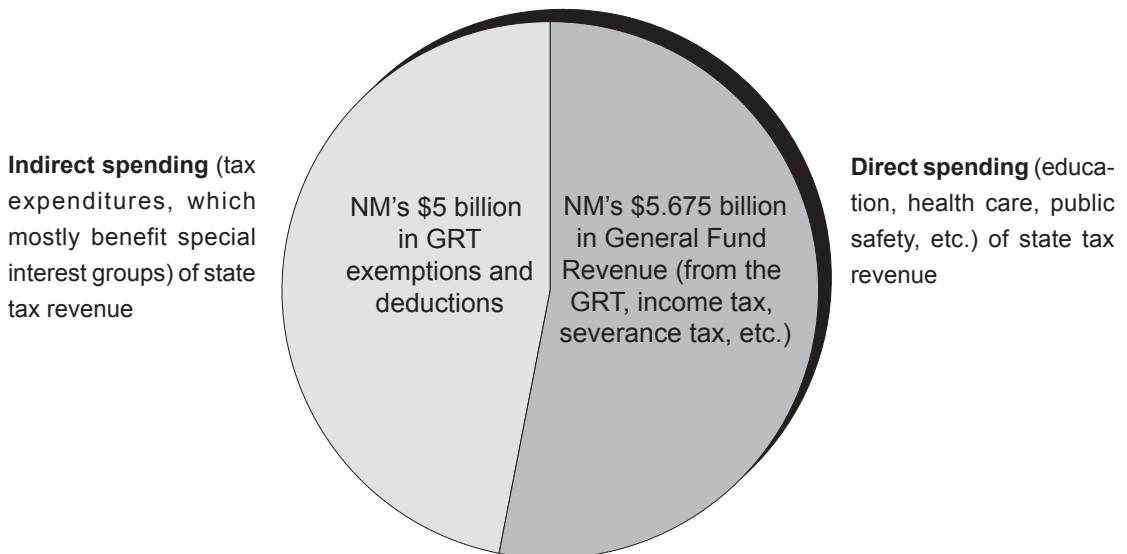
Gross Receipts Tax Deductions

New Mexico's gross receipts tax includes most 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. Because New Mexico's gross receipts tax is so broad, the rate has remained relatively low.

But in 2004, the Legislature enacted a deduction of receipts from the sale of food and most medical services. The state's base gross receipts tax rate had to be increased from 4.5 percent to 5 percent in 2004 to make up for the lost revenue.

Over the years, tax expenditures have cut the tax base almost in half (see Chart VII, below). In other words, without all the exemptions and deductions to the GRT, New Mexico's general fund budget would be double what it is now.

Chart VII
The Complete State General Fund Tax and Revenue Picture



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.

New Mexico has been extremely fortunate in the past few years, however. Global oil and natural gas prices have been 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. Also, oil and natural gas production falls slightly every year.

But natural gas is volatile in more ways than one. Prices fluctuate widely. What's more, the state can neither predict global prices nor control them. When prices drop, the state collects less revenue. If the state has relied too much on this revenue source, the state's budget literally runs out of gas.



Income Tax Cuts, Jobs, and the Economy

State government cannot run a deficit. Tax cuts must be paid for with other tax increases and/or service cuts. The government is New Mexico's single largest employer. When tax cuts result in spending cuts, government jobs are lost. Cities cut back on their police force, states cut back on their educators – even health-care workers can be lost. 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.

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.

Research shows that cutting public-sector jobs in order to pay for private-sector tax breaks does more harm to the economy than good.

Business values a skilled workforce more than tax cuts because:

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

Income Tax Cuts and the State Budget

When the state personal income tax cuts are fully felt in 2009, New Mexico's income tax revenue will be decreased by more than one third – meaning the state will lose about \$360 million every year.

In order to maintain current services in FY12, New Mexico will need at least 3.4 percent – or \$221.5 million – in new revenue, according to the Legislative Finance Committee.

Because of the income tax cuts and a slowing economy the annual general fund deficit will be \$8 million in FY10, \$63 million in FY11 and \$122.7 million in FY12, according to the LFC's 2008 Post-Session Review.



A DAMAGED TAX SYSTEM

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 in the next five years.
- **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 it 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. Cuts to the personal income tax, enacted in 2003, 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 relies heavily on severance and corporate income taxes, which come from the extraction of oil, natural gas, and minerals. But the revenue from these sources is highly unstable, as they rely on factors outside of the state's control. Because gas and oil prices can drop – or production from New Mexico lands can diminish – we may see a decline in the revenue from this sector.

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 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.

Probably, the most significant long-term problem with New Mexico's tax system is shown on Chart IV (Average Annual Tax Revenue and State PIT Growth Rates, page 19): New Mexico's general fund revenues no longer grow with the state's economy. This will pose a fundamental constraint on the state's ability to meet the long-term needs of its residents.



New Mexico Voices for Children
Fiscal Policy Project
2340 Alamo Ave. SE, Suite 120
Albuquerque, New Mexico 87106-3523
505-244-9505
www.nmvoices.org/fiscalpolicyproject.htm