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House-Passed Tax Plan Less Regressive than Senate Plan, But Better Options Are Available

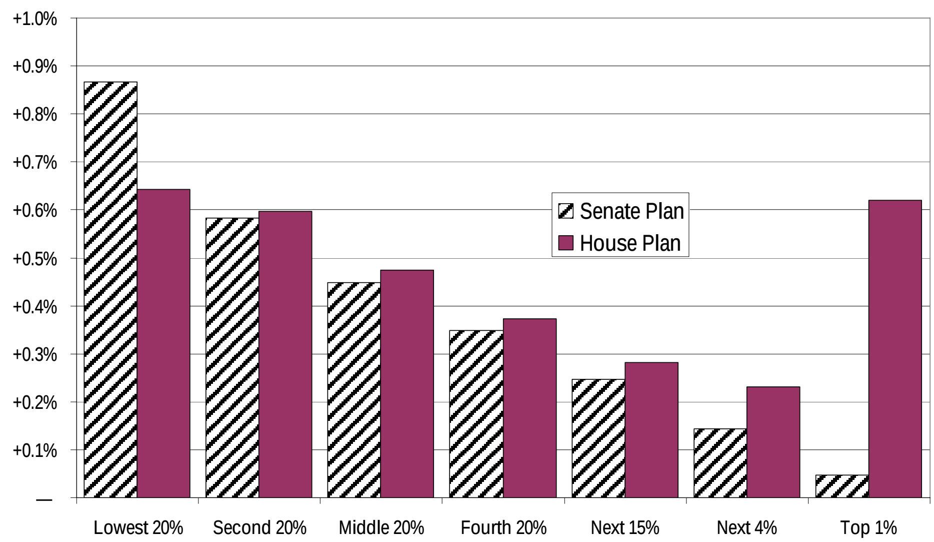
In a special legislative session starting March 1, the New Mexico Legislature will consider a variety of revenue-raising options to close the state's budget deficit. Some of the options under consideration—especially those approved by the state Senate earlier this year—would fall much more heavily on low- and middle-income families than on the best-off New Mexicans. By contrast, the House-approved tax plan includes a small income tax hike on upper income families that makes the House plan less unfair than the Senate plan. But, as this report outlines, both the House and Senate tax changes could be improved on through a variety of more progressive reforms to balance the state's budget without unduly burdening low- and middle-income families.

House and Senate Plans Would Hit Low-Income Families Hardest

The biggest tax hikes under the House and Senate plans would fall on the very poorest families. In particular:

- Under the Senate plan, the poorest twenty percent of New Mexicans would see a tax increase averaging almost 0.9 percent of their incomes, while middle-income families would see a tax hike averaging 0.45 percent of income and the very best off taxpayers would see a tax increase averaging just 0.05 percent of their incomes.
- In other words, the Senate plan would impose tax hikes on low-income families roughly 18 times higher, as a share of income, than those on the wealthiest taxpayers.
- Like the Senate plan, the House plan would also impose the biggest tax increases, as a share of income, on the very poorest families. But the very best-off taxpayers would also see a larger tax hike than most other groups. Middle- and upper-middle-income families would see smaller tax hikes than either the poorest or the richest groups.

Comparing the Senate & House Tax Plans: Tax Change as % of Income
All New Mexico Individuals and Families in 2010



The clearly regressive pattern of the Senate plan, and the somewhat less unfair pattern of the House plan, is due to their mutual reliance on increases in the state's Gross Receipts Tax (GRT) to generate revenue. But the House plan, funded in part by income tax hikes, would raise substantially more revenue without imposing large additional tax hikes on most families.

- The Senate plan, which would raise roughly $175 million a year if implemented in 2011, would be funded primarily by subjecting certain groceries to the GRT, an especially regressive tax hike. The remainder of the Senate plan's revenue would come from increasing the cigarette tax, an even more regressive revenue source.
- Most of the House plan's added revenues would come from a half-cent increase in the GRT rate. Laudably, the House plan also includes an 1.5 percent income tax increase on a small number of the very best-off taxpayers. The poorest ninety five percent of New Mexico families would be virtually unaffected by this provision.
- The House plan would raise more than $100 million more annually than the Senate plan—but most middle-income families would see only slightly higher taxes under the House plan. This is because the upper-income surtax lessens the need to hike taxes on middle- and low-income families.
- But even with the income surtax, the House plan relies disproportionately on regressive revenue sources to address the state's budget deficit—and neither plan offers any offsetting low-income tax relief to mitigate the impact of its GRT increase on low- and middle-income families.

New Mexico's Tax System Already Falls Hardest on Low-Income Families

A November 2009 ITEP analysis found that the current New Mexico tax system imposes much higher taxes on low- and middle-income families than on the best-off taxpayers.[1] In particular, ITEP's analysis showed that the poorest families pay an average of 10.8 percent of their income in New Mexico state and local taxes, more than twice as high as the 5.2 percent of income that the very best-off 1 percent of New Mexicans must pay.

The report identified the state's heavy reliance on regressive sales and excise taxes, and its comparatively low reliance on progressive personal income taxes, as the primary reason for the overall unfairness of the New Mexico tax system. The ITEP report also identified income tax cuts enacted in 2003 as a primary factor making the New Mexico tax system more regressive than those used by most other states.

The unfairness of the House and Senate tax plans is especially disturbing because they would each exacerbate the unfairness of the current tax system, while worsening the imbalance between the state's already-high sales tax and its already-low income tax.

Progressive Alternatives for Revenue Raising

Fortunately, New Mexico lawmakers have a variety of sensible options for restructuring the revenue-raising plans they will evaluate next week.

[1] Institute on Taxation and Economic Policy. "Who Pays: A Distributional Analysis of the Tax Systems in All 50 States." November 18, 2009.

- **<u>Repeal capital gains tax breaks</u>**. New Mexico currently allows a deduction for 50 percent of capital gains. Only a handful of states allow such a deduction, and the New Mexico deduction is among the largest. Virtually all of the benefits from this tax break go to the best-off New Mexicans.
- **<u>Repeal income tax rate reductions.</u>** Legislation enacted in 2003 gradually reduced the top income tax rate from 8.2 to 4.9 percent. The lion's share of the benefits from these tax cuts go to upper-income families.
- **<u>Repeal itemized deductions for state taxes.</u>** Itemized deductions are upside-down tax subsidies, offering the biggest tax breaks to the best-off taxpayers. And New Mexico is one of only a handful of states that bizarrely offer a state income tax deduction for its own income tax. Repealing the itemized deduction for state and local taxes would enhance the fairness of New Mexico's tax system without imposing higher tax rates.
- **<u>Combined Reporting of Corporate Income Taxes.</u>** Strengthening the corporate profits tax by eliminating this unjustified corporate tax giveaway would reduce the pressure on lawmakers to rely more heavily on sales and income tax hikes.
- **<u>Couple regressive tax hikes with low-income tax credits</u>**. New Mexico allows an Earned Income Tax Credit (EITC) based on federal rules that is designed to offset the regressive impact of sales, excise and property taxes. If increases in the GRT are included in the special session's revenue-raising package, increasing the value of the EITC from the current 10 percent rate to 20 percent will be a vital step to help mitigate the impact of these tax hikes on low-income families, at a relatively low cost.

Conclusion

More so than most other states, New Mexico relies primarily on its poorest residents to pay for needed public investments. The very best-off New Mexicans pay effective tax rates that are less than half what the very poorest families must pay. This upside-down tax system is primarily due to New Mexico's heavy reliance on regressive sales taxes, and its below-average reliance on the progressive personal income tax.

The revenue-raising plans approved by the state Senate earlier this year would exacerbate the unfairness—and the imbalance—in the current tax system. And while the House-approved plan's inclusion of a personal income surtax on the very best-off New Mexicans would be an improvement over the Senate plan, even the House plan would not address the underlying regressivity of New Mexico taxes.

Fortunately, state policymakers have a variety of sensible tax reform options to choose from that can help to solve the state's budget dilemma without pushing low-income families further into poverty: paring back the capital gains tax cuts and income tax rate reductions enacted in 2003 would greatly reduce both the unfairness and the imbalance in the state's current fiscal structure. These changes—and the combined reporting and Earned Income Tax Credit changes discussed above—could help make the revenue-raising approach outlined in the House-passed bills fairer and more sustainable.

Appendix: Impact of House-and Senate-Passed Tax Increases

Impact of Various Income/Consumption Tax Reform Options

All New Mexico Individuals and Families, 2011 Income Levels

2011 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $18,000	$18,000 – $32,000	$32,000 – $51,000	$51,000 – $83,000	$83,000 – $162,000	$162,000 – $417,000	$417,000 – Or More
Average Income in Group	$11,000	$25,000	$40,000	$65,000	$111,000	$230,000	$904,000
0.5% Increase in GRT Rate							
Tax as % of Income	+0.6%	+0.6%	+0.5%	+0.4%	+0.3%	+0.2%	+0.1%
Average Tax Change	+72	+149	+190	+242	+313	+386	+924
High-End Surtax on Personal Income (additional 1.5% on TI over $200K married, $133K singles)							
Tax as % of Income	—	—	—	—	+0.0%	+0.1%	+0.5%
Average Tax Change	—	—	—	—	+1	+145	+4,689
House Plan Net Impact							
Tax as % of Income	+0.6%	+0.6%	+0.5%	+0.4%	+0.3%	+0.2%	+0.6%
Average Tax Change	+72	+149	+190	+242	+313	+531	+5,613
Cigarette Tax Hike $1 per pack							
Tax as % of Income	+0.3%	+0.1%	+0.1%	+0.1%	+0.0%	+0.0%	+0.0%
Average Tax Change	+28	+31	+31	+35	+39	+42	+47
Apply State/Local Gross Receipts Tax to Sales of non-WIC groceries							
Tax as % of Income	+0.6%	+0.5%	+0.4%	+0.3%	+0.2%	+0.1%	+0.0%
Average Tax Change	+69	+115	+148	+191	+235	+288	+378
Senate Plan Net Impact							
Tax as % of Income	+0.9%	+0.6%	+0.4%	+0.3%	+0.2%	+0.1%	+0.0%
Average Tax Change	+97	+145	+179	+226	+274	+330	+425

SOURCE: Institute on Taxation and Economic Policy Microsimulation Tax Model, February 2010