Rio Grande Foundation

P.O. Box 2015
Tijeras, NM 87059
505 286-2030
www.riograndefoundation.org

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Reform This!

Coherent Tax Strategies for New Mexico

By Harry Messenheimer, Ph.D.
President, Rio Grande Foundation

What Constitutes Meaningful “Tax Reform” for New Mexico?

The verb “reform,” according to *Webster’s New World Dictionary,* means: “to make better by removing faults and defects.” Exactly what are the faults and defects that New Mexico’s tax reformers are trying to remove? What faults and defects should they be trying to remove?

Let’s begin with the premise that tax reform ought to remove faults and defects that impede our prosperity. Given that premise, three major faults and defects now exist with New Mexico’s tax system. The first is the problem of overspending. Spending drives the need for tax revenue. The second is our gross receipts tax. Its application to services puts New Mexico at a significant disadvantage compared to other states. The problem of overspending coupled with the problem of the gross receipts tax on services must be corrected if New Mexico is to change to a prosperous economy. The third fault and defect is the wishful thinking that our tax-transfer programs actually help the poor. The reality is that these programs are counterproductive.

Unfortunately we are now poised to make things worse under the guise of “reform.” Rather than providing for “maximum economic development benefits,” which was the charter of the recent “Blue Ribbon Tax Reform Commission,” most of the “reform” proposals will do just the opposite. Moreover, nowhere has the Commission justified what tax revenue is necessary to “maintain necessary government services at an appropriate level” (another charge of the Commission). All we have gotten on the spending side is need for more revenue without justification of how well revenue is being spent for benefit of New Mexico’s citizens. “Tax reform” has become code for net tax increases.

We need to change our mindset about the proper scope and funding of government in New Mexico. Until we do, we will continue to be ranked near the bottom for everything good and near the top for everything bad.

This report proceeds as follows:

1. It documents the faults and defects of excessive spending. It justifies spending restraint as a needed reform. It does so by looking at empirical evidence of the benefits of reduced spending. Recommendations are to achieve spending discipline by means of tax and spending limitations.

2. It looks at the sources of tax harms, documenting New Mexico’s adverse positions with respect to its citizens’ ability-to-pay taxes out of income. It follows with an assessment of the major fault and defect of our current tax system: the gross receipts tax on services.

3. Perhaps the major contribution of this report is that of bringing overall tax and welfare incentives into the light of day. As part and parcel of New Mexico’s problem of excessive spending is the welfare system. “Tax reformers” have erred

by looking only at individual taxes and transfers. But the state's tax and transfer policies are inextricably intertwined with those of the federal government. The ineffectiveness of the spending itself cannot be understood without benefit of this bigger picture. Once we have benefit of this bigger picture we can see clearly how proposals currently being advanced as "tax reform" will make matters worse. And we see that conventional wisdom about who pays taxes is complete nonsense.

This report contains two background appendices the reader may want to read first in order to understand the main arguments in the text. The first (Appendix A: NM Income Tax Compared to its Neighbors) contains extensive detail about New Mexico's personal income tax. It documents the wisdom of the 2003 income tax reductions; and it provides background and perspective for the bigger picture tax-transfer assessment found in the main text. The second (Appendix B: The Distressing Arithmetic of Trying to Help the Poor) provides the reader with background on how to think of incentives associated with means-tested transfers. It, too, is helpful for understanding the bigger picture tax-transfer assessment found in the main text (The big picture: taxes and transfers).

Change in Mindset Needed

As has been well documented, New Mexico has one of the worst economic climates in the nation[1]. Over the long haul we have tried to make ourselves prosperous by increasing government programs. As a result we are overly taxed and regulated. Government overspending and high taxes and regulations have actually *reduced* our prosperity. If claims about all the magic of economic multipliers from increased government spending were true, we would be one of the most prosperous states in the nation.

But these claims are not true. Messenheimer (2000) provides statistical evidence of the relationship between smaller, less intrusive governments and greater prosperity across the states. Professor Richard Vedder (2002) and Karabegovic, *et. al*. (2002) independently confirm the same statistical relationship, including comparable economic benefits of smaller, less intrusive government.

Why is our state government not getting the picture? Assuming that we really would like to have a prosperous state, the recent failure to reform Medicaid coupled with initiatives to increase government are counterproductive. They are mostly the result of what economists call "concentrated benefits and widely dispersed costs." Those who receive the concentrated benefits are clearly defined, and they are grateful when politicians show up for ribbon cutting ceremonies, call press conferences or otherwise take credit. The result is excessive government spending.

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[1] See, for example, the Foundation's piece "Lack of Economic Freedom Means Anemic Growth for New Mexico!". It documents New Mexico's 15-year rate of growth compared to other states. Similar documentation of 20-year rates of growth may be found in *New Mexico 2000: a Study of its Policies and Economic Health*. Both studies may be found on our website at www.riograndefoundation.org under "economic development."

For example, Medicaid has its government beneficiaries in the form of administrators, "advocates" for the poor and health care providers; education "reform" has its beneficiaries in the form of union leaders; and recipients of corporate welfare are numerous. They receive well-defined "concentrated benefits." In each case we hear politicians and the press trumpet the wondrous things state government is doing for the economy, the poor, the heretofore uneducated[2] and the creation of high-paying jobs.

Unfortunately those who pay for all this in terms of <u>much larger lost income</u> are unseen and unheard, since the effects on them are for the most part <u>individually</u> imperceptible. This is the problem of widely dispersed costs[3] that, when coupled with the problem of concentrated benefits, leads to excessive government spending.

Next we look at estimates of the harms caused by New Mexico's inability to control spending and thereby implement meaningful tax reform.

Estimated Magnitude of New Mexico's Losses

Some of the stark contrasts we see internationally[4] are not present when it comes to demonstrating the link between smaller, less intrusive government and prosperity across states in the United States. Nevertheless, empirical research points overwhelmingly to smaller, less intrusive government leading to increased prosperity.

For example, the findings from Messenheimer (2000) may be summarized by what might have been for New Mexico: *If New Mexico now had state and local governments that were only slightly more coercive than the lower 48 average, then the median income for 4-person families is predicted to be $9,797 higher and per capita income $6,462 higher than they are today in today's dollars*[5].

Similarly, a new study by the National Center for Policy Analysis and Canada's Fraser Institute found that *if New Mexico had average economic freedom,*[6] *then its per capita gross state product would be $2,329 higher than it is today.* And Professor Richard Vedder (2002) finds that *if New Mexico only took average amount of taxes as a*

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[2] This time they are going to get it right. Right? Yeah, right.

[3] The Foundation has estimated these costs in terms of the effects of tax reductions forgone because of excessive spending. See *See What Big Government Costs in New Mexico* available on our website in the "taxes" section: www.riograndefoundation.org.

[4] The link seems quite clear (without the aid of econometrics) when we see the stark contrasts between culturally and geographically similar entities such as North Korea and South Korea, the former East Germany and West Germany, Hong Kong and Guangzhou (Canton). In each case it is clear that the entity with substantially greater economic freedom (South Korea, West Germany, Hong Kong) has much greater prosperity than its culturally and geographically similar counterpart.

[5] Both were easily statistically significant at the one percent level of significance. This result assumes that New Mexico would be 20 percent less coercive than it is now.

[6] More "economic freedom" means less intrusive government in the form of reduced taxes, less regulation and less litigation.

percentage of income, then its per capita income would be roughly $1,500 higher than it is today.

These results suggest that New Mexico's economic health would improve markedly with less government. This obviously begs the questions of exactly how to reduce government: Where to reduce spending? Which taxes to lower? Which regulations to eliminate or modify? How to balance litigation so that marginal costs of engaging in litigation equal marginal benefits of reduced harm from fraud or unsafe practices?

One way to reduce New Mexico's proclivity for excessive spending and taxing is to implement rules that impose fiscal discipline on the legislature.

Needed Reform: Constitutional Limit on Spending and Taxing

Imposing fiscal discipline by rule has so far not been on the tax reform agenda. It should be. The bias toward excessive spending is likely to undermine the only growth-oriented piece of legislation yet passed—the five-year phase-in of reductions in income tax rates. Without fiscal discipline, it is all but inevitable that these cuts will be rescinded; or they will be replaced by other tax increases. If so, New Mexico will continue to be mired in a sluggish economy caused by its high taxes relative to those in neighboring states. Therefore, meaningful tax reform must be passed with rules that make its undoing quite difficult (Brown 2003).

Colorado sets a magnificent example that New Mexico would do well to follow. In 1992, Colorado voters passed the Taxpayer's Bill of Rights (TABOR), a *constitutional amendment that limits state government spending* to population growth plus inflation. And it allows only those tax-rate increases that are approved by voters. Notice that spending is allowed to grow, but it is not allowed to grow at an excessive rate.

TABOR has worked wonders for Colorado. In the previous decade, spending grew twice as fast as population-plus-inflation, while in the ten years after the amendment's passage the two were about equal. This helped private sector employment to grow twice as fast as government jobs. Moreover, the surplus rebate mechanism returned about $3,200 to an average family of four between 1997 and 2001. Colorado now faces a budget deficit, but it's solving the problem with spending cuts, not big tax increases, thanks to its TABOR.

Once spending is no longer excessive, New Mexico will be able to implement real tax reforms and thereby increase its prosperity. Assuming that we can somehow impose the spending discipline needed, we must understand the economic harm caused by taxes in more detail. Then we will know where to place our tax reform emphasis.

Taxes Cause Economic Harm

Most people understand intuitively that taxes cause some kind of economic harm. But beyond that they have not given our tax system much thought. The harm caused deserves emphasis, because it is our free enterprise system that produces prosperity via individual initiative and exchange. Unfortunately the harm caused by taxes has gotten short shrift in policy forums. Most recently, for example, some three and a half months into their charge, New Mexico's Blue Ribbon Tax Commissioners have heard from scores of speakers. With much of the time spent familiarizing the Commissioners with the nuts and bolts of the state's Byzantine revenue structure, little attention has been given to the basic principles of efficient (harm reducing) taxation.

The exception was a fine presentation in late May by Commissioner and economist Brian McDonald. Dr. McDonald presented his fellow Commissioners with a list of what he considered "Principles of a High-Quality State Revenue System."[7] Along with such concepts as equity, adequacy and ease of administration, he listed efficiency as an essential ingredient of a quality revenue system. Efficiency, in fact, is perhaps *the* indispensable component of a quality revenue system. In a crowded presentation, however, Dr. McDonald only spoke for a few minutes about efficiency. His written testimony, furthermore, devoted only a couple of paragraphs to the topic. Other than this short presentation, no testimony has focused exclusively on the harm reducing properties of an efficient tax system. From our perspective, this is an alarming and dangerous lacuna. Once we understand the source of tax harms we know how to reduce them; and priorities for tax reform become much clearer.

The basics of taxation and its harm:

In order to collect tax revenue the government must tax something. Each something taxed (be it income, property, goods or services) results in a tax rate induced wedge being driven between the incremental cost of production and the price buyers are willing to pay. Because of the tax wedge, sellers and buyers will not trade as much as they would absent the tax. The voluntary exchange and individual initiative that is stifled because of the tax is the economic harm caused. The harm shows up as reduced economic activity. Of course, we cannot actually see what might have been. The harm manifests itself, however, by New Mexico's anemic job and income growth over the long haul compared to states with lower tax rates.

The main contributing factor to this harm is comparatively high rates of tax in New Mexico. *The harm due to taxes increases exponentially as tax rates increase*, and even more so when people have untaxed or lower-taxed alternatives from which to choose[8]. This is the case for New Mexico, as we shall see in more detail below. Obviously the harm may be offset somewhat if differentially good government services are provided (e.g. infrastructure, crime control, education, enforcement of contracts) relative to other states. Good government services would tend to lower business costs and increase economic activity. After all, good government services are why we are willing to

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[7]McDonald, Brian. *Principles of a High-Quality State Revenue System*. Testimony before the Blue Ribbon Tax Reform Commission. Santa Fe, New Mexico, May 22, 2003.

[8] See, for example, a leading textbook in public finance: Browning, Edgar K. and Jacquelene M. Browning: *Public Finance and the Price System*, 4th edition, Macmillan, New York, 1994, pp. 324-34.

undergo tax harm in the first place. Unfortunately, we do not seem to get comparatively good government services in New Mexico[9]

New Mexico's High Tax Burden Compared to Other States

States have tax policies that are quite different. And the bewildering array of things taxed, rates at which they are taxed, exemptions from tax and economic development tax incentives make interstate policy comparisons difficult. Nevertheless, we can finesse our way around that difficulty to make reasonable interstate comparisons. We shall see where New Mexico's tax policy causes differential harm to its economy. First, we look at New Mexico's main sources of tax revenue based on its citizens ability-to-pay out of personal income. Then we get into the nitty gritty of taxing efficiently by focusing on different rates of taxation state-to-state.

Taxes Paid as a Percentage of Personal Income

How does New Mexico stack up compared to other states when it comes to citizens' ability-to-pay taxes? We begin our discussion of tax harms with an interstate comparison of how difficult it is for our people to pay their taxes out of the income they have.

We compare fiscal year 2000 state and local taxes collected as a percentage of personal income among states in our region and the national average. By measuring taxes as a percentage of personal income, we get a good initial indicator of ability-to-pay tax: the lower the estimate, the greater the ability-to-pay. Likewise the higher the estimate the lesser is the ability to pay and the greater is the tax burden. Personal income gives us a particularly good measure of ability-to-pay, because it is what the taxpayer has available to pay taxes from all sources of income.

Overall New Mexico's citizens are less able to pay their tax. Figure 1 compares New Mexico's overall state and local tax burden to the nation and region. State government in Santa Fe and local jurisdictions throughout the state appropriate a higher percentage of personal income than do competing state and local jurisdictions (nearly $20 more per thousand dollars of income on average).

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[9] My study of October 2000 compared educational output (K-12) across states as an example. New Mexico was in the bottom 10 percent. The study may be found on our website at www.riograndefoundation.org. Click on "economic development" and find *New Mexico 2000: a Study of its Policies and Economic Health.*

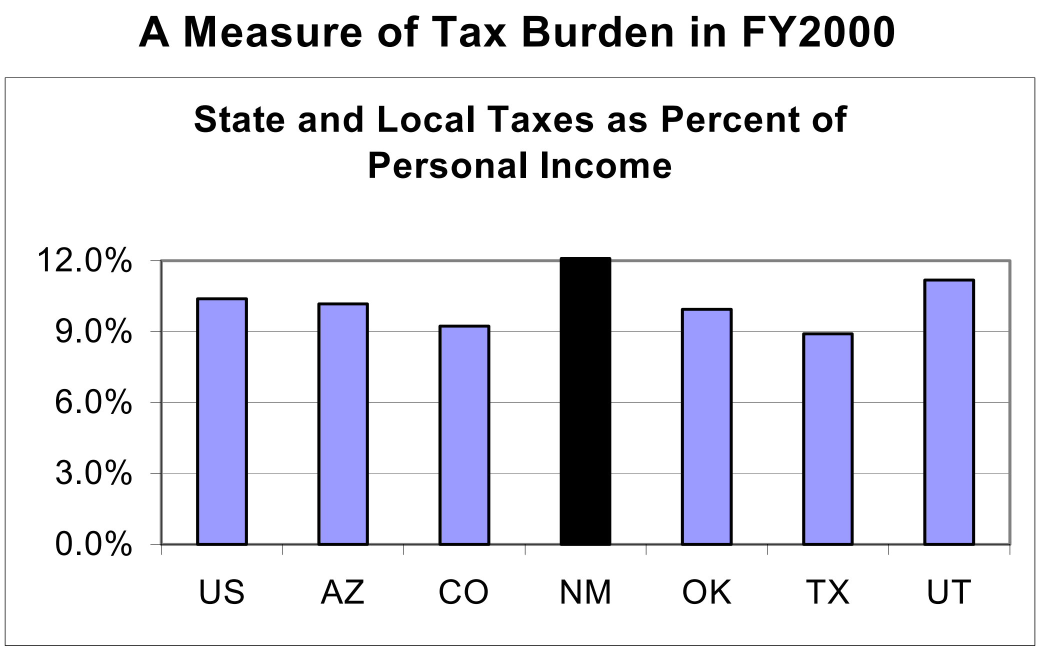

Figure 1: Comparison of state and local taxes collected as a percentage of personal income[10]

It is enlightening to break down these totals into their major component parts, so that we may see what is doing the most damage. The three major sources of tax revenue for state and local jurisdictions are sales and gross receipts taxes (GRT), individual income taxes and property taxes. Total taxes collected from these major sources are pictured in Figure 2 below, again using the ability-to-pay approach (taxes collected as a percentage of personal income from each source)[11].

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[10] Source: Census Bureau, Bureau of Economic Analysis, author's calculations.

[11] *ibid*.

Major Taxes as Percent of Personal Income

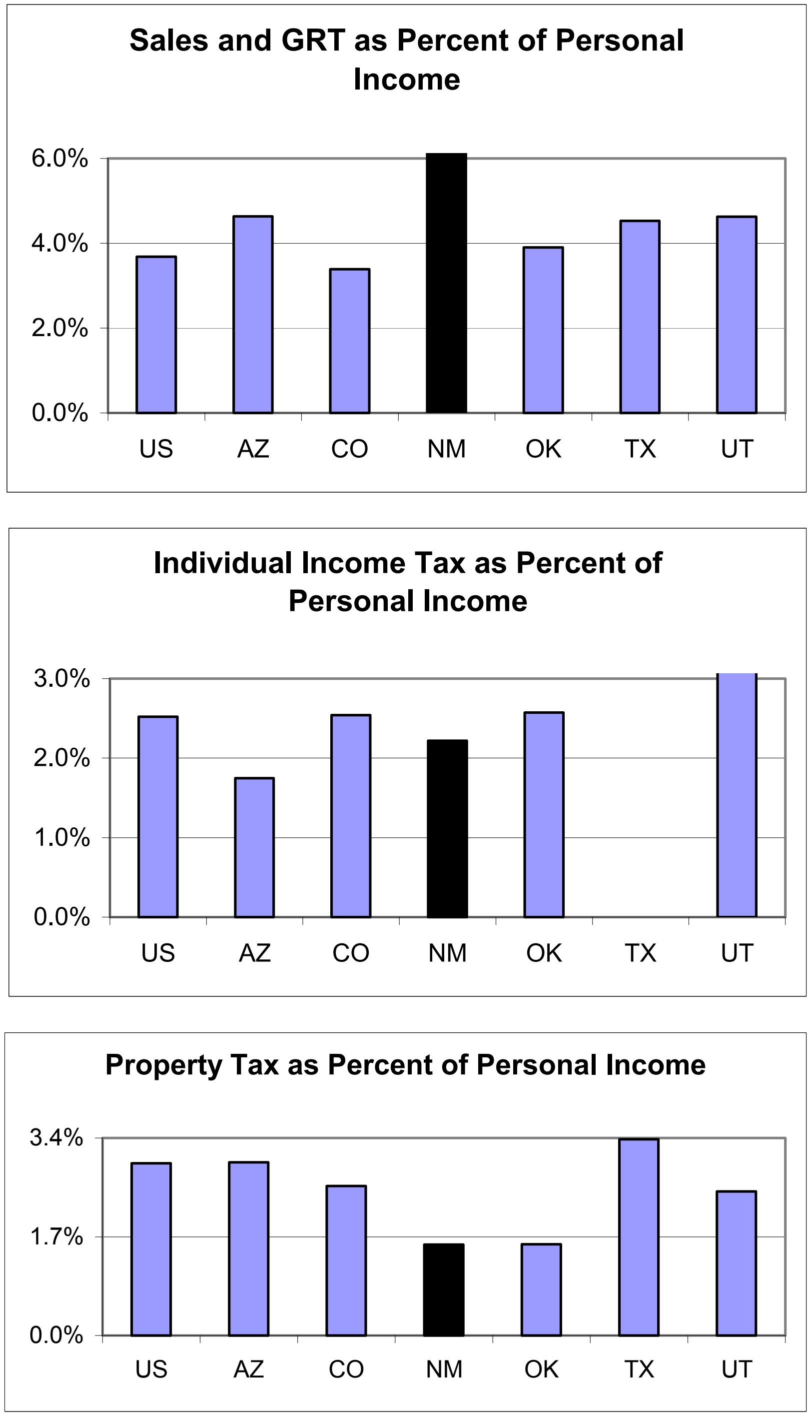


Figure 2: Major taxes as a percentage of personal income 2000

This measure of burden emphasizes differences between New Mexico and other states from Figure 2:

- New Mexico's gross receipts tax burden is much higher than the nation and region (see top panel).

- New Mexico collects slightly less than the average amount of revenue as a percentage of personal income from the individual income tax (see middle panel). Its individual income tax burden is a little less than average by this measure.

- New Mexico collects *far less* than average as a percentage of personal income from the property tax (see lower panel). Its property tax burden is far less than average by this measure, although recent increases are eroding this advantage.

The bottom line: We have looked at an overall measure of ability-to-pay taxes out of personal income. On average *New Mexico's tax burden from all taxes is much higher than other states.* On average *New Mexico's tax burden from GRT is much higher than other states. New Mexico's average burden from individual income tax is slightly less than that for other states, and its average tax burden from property tax is much less than other states.*

Efficient (Harm Reducing) Tax Policy

Of course, average ability-to-pay taxes out of personal income does not tell all about New Mexico's adverse position. It may mask important differences in tax rates. And it is tax rates, not averages, which directly affect the efficiency of our tax system. **Tax margins matter most**: higher tax rates reduce economic activity as individuals and firms adjust to them by moving sales, income and/or assets to jurisdictions with lower tax rates.

Usually this adjusting is somewhat subtle and imperceptible since firms and people make such choices individually. But one clearly visible example is how taxes are causing an exodus of medical doctors. Doctors must pay the gross receipts tax on all receipts, including those that cover expenses for office and equipment. If a doctor's personal compensation is one-third of total receipts, then she is faced with a de facto tax rate of roughly 18 percent on that compensation. Taking the deductibility of GRT paid and then adding New Mexico's top tax rate on income, the doctor is subject to a New Mexico marginal tax rate of roughly 24 percent of her income! Is it any wonder that doctors are leaving New Mexico?

The following two sections get into the nitty gritty of tax efficiency by addressing the two major sources of harm to New Mexico's economy. First, we focus on interstate comparisons of sales and gross receipts tax rates. Then we will look at incentives at the lower rungs of the income ladder to see how means-tested transfers influence effective income tax rates. These effective income tax rates should be taken into account in reforming taxes.

Source of Harm from Gross Receipts Tax

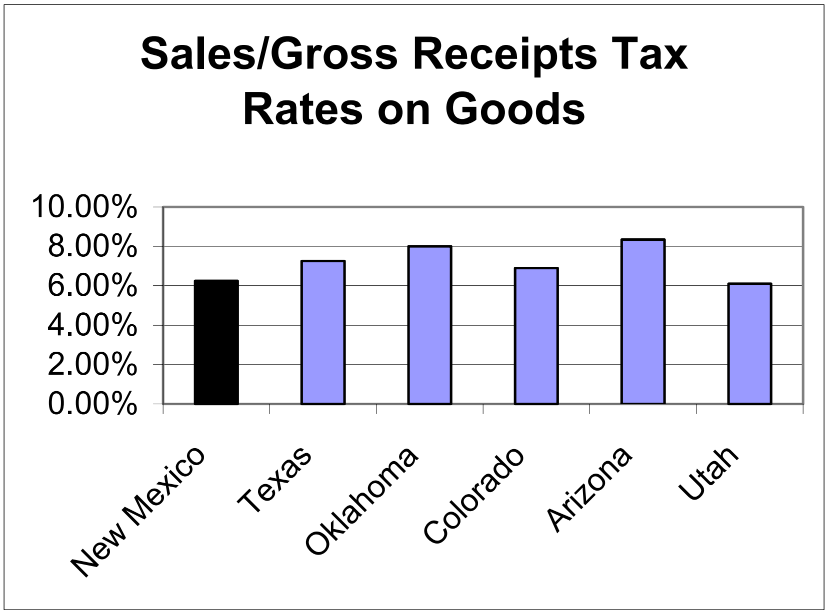
The GRT in New Mexico is in essence two taxes: a tax on goods and a tax on services. In addition, New Mexico and other states impose selective excise taxes on some goods. The top panel in Figure 3 below displays median state plus local **tax rates** among states in the region for sales and gross receipts taxes for goods[12]. Notice that New Mexico's median state plus local tax rate of 6.25% compares favorably to other states in the region (only Utah at 6.1% is lower, Arizona is highest at 8.35%). New Mexico taxes goods at a rate almost one percentage point below average for the region (New Mexico's tax rate is roughly 13% lower than the average in the region). In terms of the efficiency (harm reducing) benefits of low tax rates discussed above, the comparatively low tax rate on goods is a real plus for New Mexico.

The main problem is that New Mexico taxes services and other states do not. Texas, for example, is often cited as having a very high sales tax rate compared to New Mexico. Notice that is not really true: Texas may exceed New Mexico for its median tax on goods (7.25% to 6.25%), but New Mexico far exceeds Texas for its median tax on services (6.25% to **zero**).

The relevant tax rate shown in the lower panel of Figure 3 is 6.25% for New Mexico and **zero** for all others. This is the main source of tax harm done to New Mexico: Goods producing businesses are also harmed by this tax, since many of them must procure taxed services (legal, accounting, roof repair and so on) as part of their business activity. These taxes raise their costs compared to comparable businesses in other states. *Businesses and consumers have alternatives in other states where services are not taxed! Many adjust away from New Mexico as a result.*

In addition, New Mexico generally has higher selective excise taxes than do other states. Figure 4 shows how New Mexico's excise taxes differ from the nationwide median in percentage difference terms. Notice that the state gasoline tax is a little lower, but all the "sin" taxes are substantially higher than the nationwide median. Once again, New Mexico's higher taxes reduce its economic activity. Excise taxes are not trivial; they represented over 23 percent of revenue collected from the Sales/GRT category in 2000.

[12] There are some differences among states in what goods are taxed. For example, New Mexico and Utah tax groceries purchased for home consumption; but Texas, Colorado and Arizona do not. Oklahoma and New Mexico provide for an income tax credit for food taxes paid.



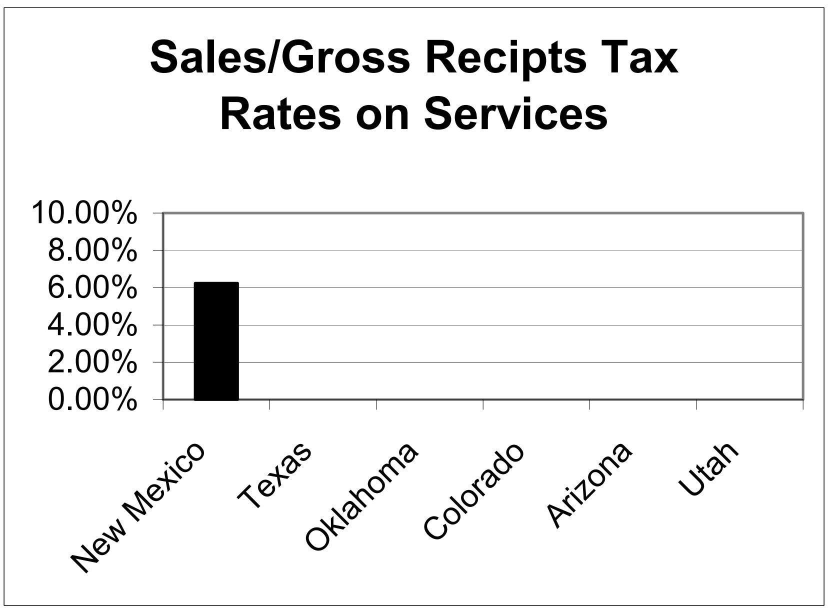


Figure 3: Comparison of Combined State and Local Sales/GRT Tax Rates for Goods and Services

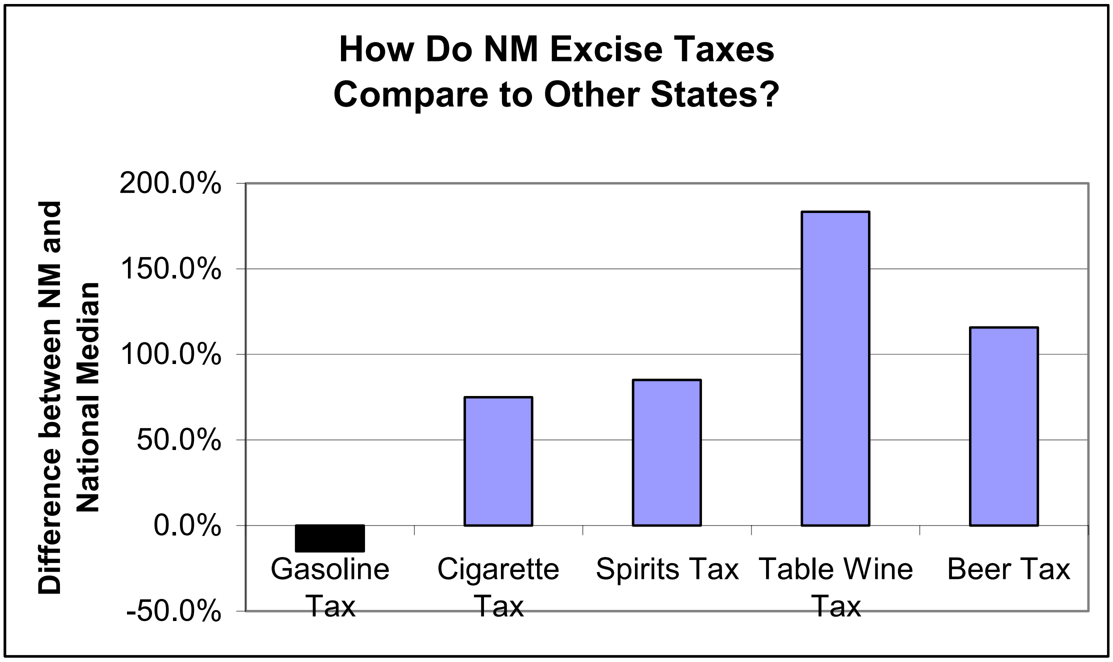


Figure 4: How New Mexico's Excise Taxes Compare to Other States (measured in percentage difference from the nationwide median at end of 2002)[13]

The bottom line: We have compared state and local sales/GRT tax rates across states. We see that New Mexico compares favorably for its tax rate on goods. But its tax rate on services has particularly bad economic consequences, since services are not taxed elsewhere. New Mexico's sin taxes are much higher than elsewhere, further dampening economic activity.

Lowering its growth retarding gross receipts tax rate should be a high priority for New Mexico tax reform. Likewise sin taxes should be lowered so that they are more in line with other states.

The big picture: taxes and transfers

We now show how the big picture of overall state and federal taxes and transfers gives insights into effective tax margins and regressive versus progressive arguments. The insights produced are contrary to conventional wisdom. We find that *effective marginal rates of tax on income are quite high for low-income families*. Yet we also find that our *overall tax-transfer structure is highly progressive*.

State taxes and transfer programs and federal taxes and transfer programs are inextricably intertwined. The effects of New Mexico's tax and transfer policies cannot be understood

[13] Source: Tax Foundation. Includes New Mexico's 2003 new excise tax of 91 cents per pack of cigarettes.

without benefit of this bigger picture. Each tax and transfer program tends to be misunderstood when viewed in isolation.

For example, the big picture reduces confusion about who pays the tax. We find that the tax structure is progressive, not regressive; and bad effects on the poor actually involve adverse incentives to use their productive energy and creativity. The big picture reduces confusion about the need either to eliminate the tax on groceries or to increase the low income tax credit. We find that alternative tax reductions would be much more effective at helping the poor and everyone else as well. By looking at the big picture, we can clearly see incentives for erosion of the rule of law and the work ethic. We begin our big picture perspective by taking a look at the total state and federal income taxes paid by a representative family of four.

Total income taxes

Table 1 displays the total *federal and state* income tax liabilities for a New Mexico family of four[14] by adjusted gross income in increments of $5,000 from zero to $50,000. Notice that the family does not incur a positive tax liability[15] until income of $25k and that taxes increase quite rapidly thereafter.

Table 1: New Mexico Taxes Paid by AGI

AGI*	State Tax	Federal	FICA/Medicare	Total
$ -	$ (240)	$ -	$ -	$ (240)
$ 5,000	$ (305)	$(2,010)	$ 765	$ (1,550)
$10,000	$ (145)	$(4,010)	$ 1,530	$ (2,625)
$15,000	$ (90)	$(4,499)	$ 2,295	$ (2,294)
$20,000	$ (47)	$(3,946)	$ 3,060	$ (933)
$25,000	$ 88	$(2,610)	$ 3,825	$ 1,303
$30,000	$ 205	$(1,057)	$ 4,590	$ 3,738
$35,000	$ 365	$ 476	$ 5,355	$ 6,196
$40,000	$ 587	$ 1,226	$ 6,120	$ 7,933
$45,000	$ 837	$ 1,976	$ 6,885	$ 9,698
$50,000	$ 1,137	$ 2,726	$ 7,650	$ 11,513

Assumptions

1. Family of four: husband 30 yrs old, wife 29 yrs old, first child 8 yrs old, second child 4 yrs old
2. Income comes only from labor.
3. Family takes standard deduction for tax purposes.

*AGI is "adjusted gross income"

[14] Detailed assumptions concerning this representative family may be found in Appendix A: NM Income Tax Compared to its Neighbors.

[15] Negative taxes are result of the federal earned income tax credit (EITC) and the state's low income comprehensive tax rebate (LICTR).

To complete the big picture we need to estimate means-tested transfers (negative taxes) received by low-income earners. What is important for behavior is how these low-income earners themselves actually value these transfers.

Total transfers (negative taxes based on income)

Table 2 displays the typical value (as valued by the family itself) of cash and in-kind transfers received by the family via means-tested welfare programs by the same increments in adjusted gross income[16]. The Medicaid estimates are educated guesses provided by me[17]. For this I make no apologies. It is curious that no "experts" or authorities are willing to venture such guesses. By the way, doesn't anyone ever wonder about the absurdity of providing a health care benefit that costs taxpayers about four times more than the value placed on that benefit by the receiving family? It is hard to imagine a more poorly designed and politicized program than the current and emerging Medicaid disaster.[18].

Table 2: Approximate Family's Value of New Mexico Transfers by AGI

AGI*	Food Stamps	LIHEAP	TANF	School Lunch	Child Care	Medicaid
$ -	$ (5,580)	$ (140)	$ (5,628)	$ (500)	$ -	$ (2,000)
$ 5,000	$ (5,184)	$ (120)	$ (5,460)	$ (500)	$ -	$ (2,000)
$ 10,000	$ (3,660)	$ (100)	$ (2,964)	$ (500)	$ (100)	$ (2,000)
$ 15,000	$ (2,460)	$ (100)		$ (300)	$ (200)	$ (1,000)
$ 20,000	$ (1,260)	$ (80)		$ (300)	$ (400)	$ (1,000)
$ 25,000		$ (80)		$ (300)	$ (500)	$ (1,000)
$ 30,000				$ (300)	$ (700)	$ (1,000)
$ 35,000					$ (700)	$ (1,000)
$ 40,000					$ (700)	$ (1,000)
$ 45,000					$ (700)	$ -
$ 50,000					$ (700)	$ -

(values in parentheses are negative taxes: transfers)
LIHEAP is the low income energy assistance program, TANF is the Temporary Aid To Needy Families Program. Housing

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[16] Values except for Medicaid obtained from state's Income Support Division. The TANF benefit supposedly has some "workfare" requirements along with a 5-year time limit, so the overall assessment that follows includes the cases where the family is eligible and ineligible for TANF transfers.

[17] We can put some bounds on the estimates by observing what families are actually willing to pay for health insurance in the insurance marketplace. Families earning more than the Medicaid threshold are unwilling to buy such generous insurance packages. Assuming that health insurance is a normal good (people are willing to buy more as their income increases), we can deduce that low-income earners value comparable insurance packages less than higher income earners. And no health insurance company has so far been so foolish as to provide a package of benefits as generous as that available to New Mexico Medicaid recipients. Of course, there is likely to be substantial variance in how particular families value Medicaid.

[18] If you are interested in ending the disaster, see the Foundation's study *Solutions to the Medicaid Crisis in New Mexico* by Kenneth M. Brown and Harry Messenheimer available on our website at www.riograndefoundation.org.

subsidy programs are not included.

Notice the generosity of these programs for low levels of income, and see how the value of welfare benefits is lost as income increases.

Implications of the big picture

Now we are in a position to look at the big picture. What is the overall effect of the tax-transfer programs? And how do these programs affect the poor? Overall government tax and transfer policies actually exacerbate the problem of poverty that they are attempting to solve! By previously focusing attention only on isolated taxes (such as the GRT) or on isolated transfer programs (such as LICTR), "reformers" have been deceived into thinking they may actually be helping the poor.

Implications for Alleviating Poverty

The following two tables lay out the overall effects of the mishmash of tax and transfer programs for our example family of four. Table 3 displays the overall valuation of taxes and transfers by our family of four when it is not eligible for the TANF program. Recall that the family's valuation of transfers is treated like a negative tax. Likewise, Table 4 illustrates the overall effect when the family is eligible for TANF.

Notice from Table 3 *and* Table 4 *that the effective tax margins for the poor are quite high above $10,000 of earned income.* And this is true even if TANF is excluded. On average federal and state governments take 50 cents out of each additional dollar earned for incomes over $10,000. That is how we are really hurting the poor. A poor worker making $10 per hour only gets to keep $5 of it.

Table 3: Tax Effects With Transfers Except TANF

*AGI**	*Sum of Transfers and Taxes by AGI*	
$ -	($8,460)	***Tax Margin excluding TANF***
$ 5,000	($9,354)	Zero to $5,000: –17.9%
$10,000	($8,985)	$5,000 to $10,000: 7.4%
$15,000	($6,354)	$10,000 to $15,000: 52.6%
$20,000	($3,973)	$15,000 to $20,000: 47.6%
$25,000	($577)	$20,000 to $25,000: 67.9%
$30,000	$1,738	$25,000 to $30,000: 46.3%
$35,000	$4,496	$30,000 to $35,000: 55.2%
$40,000	$6,233	$35,000 to $40,000: 34.7%
$45,000	$8,998	$40,000 to $45,000: 55.3%
$50,000	$10,813	$45,000 to $50,000: 36.3%

Tax margins are computed for each $5k income increment. For example, in going from $5k to $10k AGI the family has its overall negative tax (in-kind and cash transfers) reduced by $369 [($8,985) minus ($9,354) equals $369] yielding an effective marginal tax rate of 7.4% [$369 divided by $5,000 equals 7.4%].

Table 4: Tax Effects With Transfers Including TANF

*AGI**	*Sum of Transfers and Taxes by AGI*	*Tax Margin incl. TANF*
$ -	($14,088)	
$ 5,000	($14,814)	Zero to $5,000: —14.5%
$10,000	($11,949)	$5,000 to $10,000: 57.3%
$15,000	($6,354)	$10,000 to $15,000: 111.9%
$20,000	($3,973)	$15,000 to $20,000: 47.6%
$25,000	($577)	$20,000 to $25,000: 67.9%
$30,000	$1,738	$25,000 to $30,000: 46.3%
$35,000	$4,496	$30,000 to $35,000: 55.2%
$40,000	$6,233	$35,000 to $40,000: 34.7%
$45,000	$8,998	$40,000 to $45,000: 55.3%
$50,000	$10,813	$45,000 to $50,000: 36.3%

Tax margins are computed for each $5k income increment. For example, in going from $5k to $10k AGI the family has its overall negative tax (in-kind and cash transfers) reduced by $2,865 [($11,949) minus ($14,814) equals $2,865] yielding an effective marginal tax rate of 57.3% [$2,865 divided by $5,000 equals 57.3%].

Implications for who pays taxes (regressive or progressive?)

Assertions that our tax system is regressive are pure nonsense. Only if our gross receipts tax was our only tax would that be true. But we cannot look at gross receipts tax in isolation (Hayek, p. 307).

For example, let's compare the situation for annual income earners of $10,000, $50,000 and $100,000 for a family of four. Assume that the poorest family[19] consumes a disproportionate amount of high-taxed cigarettes and booze while the higher income families are a bit more astute about avoiding some gross receipts tax – the higher the income, the greater the ability to avoid some tax. Table 5 lays out such a scenario:

Table 5: Progressivity of Overall Tax-Transfer Structure

Income Earned	Effective Excise/GRT Tax Rate	Effective Excise/GRT Tax Paid	Sum of Income Tax and Transfers[20]	Sum of Income and Sales Taxes	**Taxes as a percent of income**
$10,000	10%	$1,000	$ (8,985)	($7,985)	**—80%**
$50,000	6%	$3,000	$ 10,813	$13,813	**28%**
$100,000	4%	$4,000	$ 30,161	$34,161	**34%**

[19] We also assume that this family is not eligible for Temporary Assistance to Needy Families (TANF).

[20] This sum excludes TANF. It is the sum of earned income plus net of taxes and transfers in Table 3 above.

Notice that when all taxes are considered our tax structure is really quite progressive, even in an example like this where it is assumed that the poor family pays a disproportionately higher effective rate of excise/GRT. In fact, the poor actually "pay" negative taxes because of the cash and in-kind transfers they receive from the government[21].

Implications for the gross receipts tax on groceries[22].

We can see immediately the piddling effect of either eliminating the tax on groceries or providing additional transfers to offset the tax on groceries. The poor already receive large net transfers (negative taxes). Providing them with piddling additional transfers will further erode their incentives to become productive workers. What we need to do is reduce the effective marginal tax rates at all levels of income. There are much better reform opportunities available for helping the poor and everyone else. For example, we could reduce the overall rate the gross receipts tax. Or we could really reform New Mexico Medicaid.

Implications for the Rule of Law

High effective marginal tax rates lower the relative price of engaging in activities that are inimical to the rule of law. When governments extract roughly 50 cents of each extra legitimate dollar earned, prospective workers are more encouraged to engage in crime or off market transactions.

Crime

Say our low-income worker can deal drugs or rob banks at the rate of $20 per hour or earn a legitimate $10 per hour. There is obviously some risk that the worker, by engaging in criminal activity, may get caught and be penalized by doing time. But notice that the potential criminal "earns" his or her $20 per hour *tax-free*. The potential criminal does not compare $20 per hour to $10 per hour. Rather he or she compares $20 per hour to $5 per hour (the amount he or she receives net of taxes for legitimate work). Because of the 50 percent effective marginal tax rate on earned income, there is an extra $5 per hour reward for being a criminal.

Black Markets

Similarly, our worker has an incentive to engage in off-market transactions. These are usually done on a cash only basis, so they are hard to track. One wonders how large the

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[21] The poor will also be subject to some taxes not considered in this illustration. For example, the poor may have to pay some property tax. But such taxes are more than likely proportional to income earning ability, and therefore will not change our conclusion about the progressivity of the overall tax structure.

[22] The Rio Grande Foundation has previously considered eliminating the gross receipts tax on groceries in context of other potential tax reductions forgone. The bottom line is that other tax reductions would be much more effective at helping the poor and everyone else as well. See "Lower Taxes Period: the Right Way to End the Food Tax," by Harry Messenheimer, June 2002. The paper may be found on our website www.riograndefoundation.org.

underground economy really is. To the extent that high effective marginal tax rates have driven low-income workers off-economy, lower effective rates would help bring them back (and increase tax revenues for the state). The adverse incentive to engage in off-economy transactions is exacerbated by New Mexico's gross receipts tax on services.

Implications for Erosion of Work Ethic

When the poor are penalized at an effective marginal tax rate of 50 percent on their earned income it should be obvious that their incentive to work and earn income is eroded. Beyond that, however, there is a welfare state mentality that develops. That mentality is in the form of reduced work ethic; and it manifests itself in the form of "advocates," state welfare bureaucrats and the poor themselves thinking they are entitled to the productive rewards of those who pay positive taxes. Moreover, the erosion of the work ethic tends to get transmitted to children of those who are adversely affected by the high effective marginal tax rates on the poor.

Of course, the story does not end with the poor. Those who actually pay taxes via high marginal tax rates to support the welfare state abomination also have less incentive to work and earn income. And their work ethic is eroded commensurately[23].

What Should Constitute "Tax Reform" in New Mexico?

What can reform do to help New Mexico? While we are hampered a great deal by the intertwining of the federal and state tax-transfer systems, there is a great deal that can be done to reduce our tax-transfer system's faults and defects at the margin.

1. Constitutionally implement tax and spending limitations

We have documented excessive spending in New Mexico. One way to control it is to prevent the legislature from spending more than the constitution allows. New Mexico should copy the good limits that Colorado enacted over 10 years ago.

2. Do something to reduce New Mexico's gross handicap due to its gross receipts tax on services

Once spending is under control we have many options to improve the gross receipts tax situation. We can reduce the overall statewide rate of tax. Or we can reduce the rate of tax on services. Either option would greatly improve New Mexico's economy by making our tax structure much more friendly compared to other states.

3. Eliminate wishful thinking when it comes to the bigger tax-transfer picture

Our welfare system is an abomination. We clearly show that in our assessment of the bigger picture. Since incentives faced by the poor are all wrong and conventional

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[23] Amplification of these points may be found in Buchanan, James M., *The Political Economy of the Welfare State*, the Industrial Institute for Economic and Social Research, Stockholm, 1988. Buchanan also elaborates on the difficulty of achieving sensible transfer policies due to incentives in political process.

wisdom about taxes and transfers is all wrong, we can easily see that the usual proposals purported to help the poor (higher taxes on the "rich" to fund additional transfers to the "poor") amount to wishful thinking. What we need to do is lower effective tax margins at all levels of earned income. Medicaid reform would be a good place to start.

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About the Author

Harold C. "Harry" Messenheimer holds a Ph.D. in economics from George Mason University. He is currently President of the Rio Grande Foundation. He has taught at George Mason University, Troy State University and the University of Richmond.

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Appendix A: NM Income Tax Compared to its Neighbors

Here we look at the personal income tax, comparing New Mexico's current position relative to other states and its future position (should it actually implement its 5-year phased-in income tax reductions). We show in detail how NM's income tax compares to its neighbors with respect to effective marginal tax rates on earned income. The bottom line is that we look pretty good by 2007 if our recent tax reductions stick.

Details of the Personal Income Tax

How does our personal income tax stack up compared to our neighbors? Does it tend to stifle economic activity compared to them? How do low income families fare in the comparison? How about middle class families?

We cannot answer these questions simply by looking at published tax rates because those rates do not include state-unique transfers, credits or deductions. But answers may easily be understood by way of a fairly detailed example. The example is for a family of four: 30 year old husband, 29 year old wife, one child age 8, and one child age 4. We will see how this family fares for levels of income from zero to $100,000 in increments of $5,000 state-to-state. More importantly, we will see how *effective marginal rates of tax* differ state-to-state. It is the effective marginal rates of tax that slow down economic activity, and they do so exponentially as margins increase.

Before we calculate income tax liabilities we need some specific assumptions. First, to keep things simple, we assume that all income is derived from labor. Second, since most families at or below the $50,000 threshold of income take the standard deduction, that is the assumption we make here. Finally, families earning more than $50,000 are assumed to itemize deductions based on IRS averages (we will discuss the sensitivity of our results to the assumed pattern of deductions). Armed with these assumptions we can compute the 2002 tax liabilities for our family in New Mexico, Colorado, Oklahoma, Arizona and Utah (Texas has no income tax). Moreover, we can compare the *effective marginal rates of tax* in each state so as to get insights into the relative tax harms in each.

Table 6 below displays the 2002 tax liabilities for the family for each state for each level of income. The grayed area of the table indicates that our family took the standard deduction. Levels of income (AGI, or adjusted gross income) are listed in the first column. Tax liabilities for each state can be found in the state's column for each level of income. For example, the liability for our family in New Mexico at $25,000 of income is $88. Dollar amounts in parentheses indicate net negative taxes: When the tax due is negative the government sends money to the taxpayer by way of a tax credit that outweighs any tax liability. For example, New Mexico has a Low Income Comprehensive Tax Rebate that results in a net transfer of money from the state to the family when incomes are in the range of zero to $20,000.

Table 7 details the deductions taken by our family when it earns more than $50,000. Notice that total deductions start at $14,000 for income level of $55,000; and deductions increase by $600 for each income increment of $5,000.

Total Income Tax Liabilities from Zero to 100 Thousand Dollars of Income

Examination of Table 6 yields the following conclusions about total income tax liabilities:

- For incomes $15,000 or less New Mexico and Oklahoma transfer the most money to the family. Arizona transfers somewhat less. Utah and Colorado make no transfers. No family has a positive tax liability in any state.

- For incomes in the range of 20 to 50 thousand dollars an Oklahoma family generally has the largest tax liability followed by Utah, Colorado, New Mexico and Arizona in that order.

- For incomes in the range of 55 to 75 thousand dollars Oklahoma and Utah families have the largest tax liability followed by Colorado, New Mexico and Arizona in that order.

- For incomes in the range of 80 to 100 thousand dollars an Oklahoma family has the largest tax liability followed by Utah, New Mexico, Colorado and Arizona in that order.

Table 6: 2002 State income tax comparisons for a family of four[24]

AGI*	NM	CO	OK	AZ	UT
$ -	$ (240)	$ -	$ -	$ (100)	$ -
$ 5,000	$ (305)	$ -	$ (261)	$ (100)	$ -
$ 10,000	$ (145)	$ -	$ (326)	$ (100)	$ -
$ 15,000	$ (90)	$ -	$ (226)	$ (100)	$ -
$ 20,000	$ (47)	$ -	$ 37	$ (100)	$ 87
$ 25,000	$ 88	$ 164	$ 381	$ 62	$ 334
$ 30,000	$ 205	$ 396	$ 763	$ 306	$ 679
$ 35,000	$ 365	$ 627	$ 1,317	$ 449	$ 1,012
$ 40,000	$ 587	$ 859	$ 1,667	$ 596	$ 1,336
$ 45,000	$ 837	$ 1,090	$ 2,017	$ 756	$ 1,660
$ 50,000	$ 1,137	$ 1,322	$ 2,367	$ 916	$ 1,983
$ 55,000	$ 1,066	$ 1,409	$ 1,877	$ 887	$ 1,909
$ 60,000	$ 1,334	$ 1,618	$ 2,185	$ 1,028	$ 2,194
$ 65,000	$ 1,595	$ 1,827	$ 2,493	$ 1,169	$ 2,479
$ 70,000	$ 1,887	$ 2,035	$ 2,799	$ 1,309	$ 2,763
$ 75,000	$ 2,198	$ 2,243	$ 3,107	$ 1,450	$ 3,048
$ 80,000	$ 2,506	$ 2,454	$ 3,415	$ 1,591	$ 3,315
$ 85,000	$ 2,820	$ 2,663	$ 3,723	$ 1,756	$ 3,582
$ 90,000	$ 3,135	$ 2,872	$ 4,032	$ 1,920	$ 3,849
$ 95,000	$ 3,444	$ 3,080	$ 4,339	$ 2,085	$ 4,114
$ 100,000	$ 3,795	$ 3,289	$ 4,647	$ 2,249	$ 4,381

Assumptions

1. Family of four: husband 30 yrs old, wife 29 yrs old, first child 8 yrs old, second child 4 yrs old
2. Income comes only from labor.
3. Family takes standard deduction for tax purposes at income levels of $50,000 or less (grayed cells in Table 6).

*AGI is "adjusted gross income"

Table 7: Itemized Deductions Assumed for Incomes greater than $50,000

AGI	Total Deductions	Taxes	Interest	Charity
$ 55,000	$ 14,000	$ 2,974	$ 8,423	$ 2,603
$ 60,000	$ 14,600	$ 3,184	$ 8,721	$ 2,695
$ 65,000	$ 15,200	$ 3,394	$ 9,019	$ 2,788
$ 70,000	$ 15,800	$ 3,604	$ 9,317	$ 2,880
$ 75,000	$ 16,400	$ 3,814	$ 9,614	$ 2,972
$ 80,000	$ 17,000	$ 4,024	$ 9,912	$ 3,064
$ 85,000	$ 17,600	$ 4,234	$ 10,210	$ 3,156
$ 90,000	$ 18,200	$ 4,444	$ 10,508	$ 3,248
$ 95,000	$ 18,800	$ 4,653	$ 10,806	$ 3,340
$ 100,000	$ 19,400	$ 4,863	$ 11,104	$ 3,432

[24] The author thanks Don Kamin, Accounting Associates, Inc., in Albuquerque for his help in compiling this example.

Effective Marginal Tax Rates 2002

Table 8 displays the effective marginal rates of tax for tax year 2002 for New Mexico and each of its neighbors. Effective marginal rates are computed for increments of five thousand dollars (zero to $5,000, $5,000 to $10,000 and so on to $100,000). Again the grayed cells indicate margins for those taking the standard deduction (incomes at or below $50,000)[25].

How New Mexico's Effective Marginal Tax Rates Differ from its Neighbors

Table 9 shows how New Mexico differs from its neighbors with respect to these effective marginal rates of tax. Positive percentages mean that New Mexico's tax margin is higher than the neighboring state. For example, the column labeled "NM – CO" shows how computed marginal rates differ between New Mexico and Colorado. When the family's income increases from $55,000 to $60,000 you can see that New Mexico's effective tax rate on the extra $5,000 earned is 1.2 percentage points higher than Colorado's. In other words, New Mexico takes 1.2% more of earned income ($60 more) than does Colorado when the worker earns the extra $5,000.

Examination of Table 9 yields the following conclusions about the differences in marginal tax rates between New Mexico and its neighbors:

- For incomes in the range of zero to $50,000 New Mexico effective marginal tax rates are about equal to Colorado, much less than Oklahoma, greater than Arizona, less than Utah, and much greater than Texas.

- For incomes in the range of $55,000 to $100,000 New Mexico effective marginal tax rates are greater than Colorado, about equal to Oklahoma, much greater than Arizona, a little greater than Utah, and much greater than Texas. <u>New Mexico is not competitive with its neighbors based on its 2002 tax code</u> (before the recent tax reduction). The higher tax rates in New Mexico drive a larger wedge between workers and firms that hire them, reducing voluntary exchange and individual initiative and encouraging relocation to more favorable tax climates. The harm from these high marginal rates shows up as reduced economic activity in the form of fewer jobs and reduced income.

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[25] Margins are not directly comparable for those taking the standard deduction and those itemizing. The reason is that those itemizing spend money on goods and services favored by tax policy. These are known as "tax expenditures," and they tend to make effective tax rates look somewhat lower than they really would be if taxes were neutral. Since the margins are not directly comparable, no margin is calculated for the increment in which our family goes from taking the standard deduction to itemizing ($50k to $55k).

Table 8: Effective 2002 State Income Tax Margins

AGI	NM	CO	OK	AZ	UT
Zero to $5,000	-1.3%	0.0%	-5.2%	0.0%	0.0%
$5,000 to $10,000	3.2%	0.0%	-1.3%	0.0%	0.0%
$10,000 to $15,000	1.1%	0.0%	2.0%	0.0%	0.0%
$15,000 to $20,000	0.9%	0.0%	5.3%	0.0%	1.7%
$20,000 to $25,000	2.7%	3.3%	6.9%	3.2%	4.9%
$25,000 to $30,000	2.3%	4.6%	7.6%	4.9%	6.9%
$30,000 to $35,000	3.2%	4.6%	11.1%	2.9%	6.7%
$35,000 to $40,000	4.4%	4.6%	7.0%	2.9%	6.5%
$40,000 to $45,000	5.0%	4.6%	7.0%	3.2%	6.5%
$45,000 to $50,000	6.0%	4.6%	7.0%	3.2%	6.5%
	NM	CO	OK	AZ	UT
$55,000 to $60,000	5.3%	4.2%	6.2%	2.8%	5.7%
$60,000 to $65,000	5.2%	4.2%	6.2%	2.8%	5.7%
$65,000 to $70,000	5.8%	4.2%	6.1%	2.8%	5.7%
$70,000 to $75,000	6.2%	4.2%	6.2%	2.8%	5.7%
$75,000 to $80,000	6.2%	4.2%	6.2%	2.8%	5.3%
$80,000 to $85,000	6.3%	4.2%	6.2%	3.3%	5.3%
$85,000 to $90,000	6.3%	4.2%	6.2%	3.3%	5.3%
$90,000 to $95,000	6.2%	4.2%	6.1%	3.3%	5.3%
$95,000 to $100,000	7.0%	4.2%	6.2%	3.3%	5.3%

Effective marginal rates of tax are in 5 thousand dollar increments rounded to the nearest one-tenth of one percent. Grayed cells indicate family took standard deduction.

Table 9: 2002 State Income Tax Margin Differentials compared to NM (including Texas which has no income tax)

AGI	Differentials				
	NM - CO	NM - OK	NM - AZ	NM - UT	NM - TX
Zero to $5,000	-1.3%	3.9%	-1.3%	-1.3%	-1.3%
$5,000 to $10,000	3.2%	4.5%	3.2%	3.2%	3.2%
$10,000 to $15,000	1.1%	-0.9%	1.1%	1.1%	1.1%
$15,000 to $20,000	0.9%	-4.4%	0.9%	-0.9%	0.9%
$20,000 to $25,000	-0.6%	-4.2%	-0.5%	-2.2%	2.7%
$25,000 to $30,000	-2.3%	-5.3%	-2.5%	-4.6%	2.3%
$30,000 to $35,000	-1.4%	-7.9%	0.3%	-3.5%	3.2%
$35,000 to $40,000	-0.2%	-2.6%	1.5%	-2.0%	4.4%
$40,000 to $45,000	0.4%	-2.0%	1.8%	-1.5%	5.0%
$45,000 to $50,000	1.4%	-1.0%	2.8%	-0.5%	6.0%
	NM - CO	NM - OK	NM - AZ	NM - UT	NM - TX
$55,000 to $60,000	1.2%	-0.8%	2.5%	-0.4%	5.3%
$60,000 to $65,000	1.1%	-0.9%	2.4%	-0.5%	5.2%
$65,000 to $70,000	1.7%	-0.3%	3.0%	0.2%	5.8%
$70,000 to $75,000	2.1%	0.1%	3.4%	0.5%	6.2%
$75,000 to $80,000	1.9%	0.0%	3.3%	0.8%	6.2%
$80,000 to $85,000	2.1%	0.1%	3.0%	1.0%	6.3%
$85,000 to $90,000	2.1%	0.1%	3.0%	1.0%	6.3%
$90,000 to $95,000	2.0%	0.0%	2.9%	0.9%	6.2%
$95,000 to $100,000	2.9%	0.9%	3.7%	1.7%	7.0%

Positive (negative) percentages indicate that New Mexico's effective marginal tax rate is higher (lower) than the neighbor indicated for each $5k income range indicated.

How New Mexico's Effective Marginal Tax Rates Will Differ from its Neighbors in 2007

New Mexico's position relative to its neighbors will improve dramatically by 2007 (assuming no change in states' tax law between now and then). Table 10 shows how New Mexico's relevant tax liabilities will change for affected income ranges between years 2002 to 2007. More important, we can see how the relative effective tax margins will change. Table 11 displays the effective tax margins in 2007, and Table 12 shows how New Mexico' effective tax margins will differ from its neighboring states in 2007. Examination of Table 12 yields the following conclusions:

- For incomes in the range of zero to $50,000 New Mexico effective marginal tax rates will be about equal to Colorado, much less than Oklahoma, greater than Arizona, less than Utah, and much greater than Texas. These conclusions are unchanged from 2002.

- For incomes in the range of $55,000 to $100,000 New Mexico effective marginal tax rates will be a little greater than Colorado, less than Oklahoma, greater than

Arizona, less than Utah, and much greater than Texas. Overall, New Mexico is positioned to be much more competitive with its neighbors when we reach 2007.

Table 10: Effect of New Tax Reduction Law in NM for Family of Four

AGI	2002 Tax	2007 Tax
$ 50,000	$ 1,137	$ 1,082
$ 55,000	$ 1,066	$ 963
$ 60,000	$ 1,334	$ 1,178
$ 65,000	$ 1,595	$ 1,394
$ 70,000	$ 1,887	$ 1,609
$ 75,000	$ 2,198	$ 1,825
$ 80,000	$ 2,506	$ 2,041
$ 85,000	$ 2,820	$ 2,256
$ 90,000	$ 3,135	$ 2,472
$ 95,000	$ 3,444	$ 2,687
$ 100,000	$ 3,795	$ 2,903

Table 11: Effective 2007 State Income Tax Margins

AGI	NM	CO	OK	AZ	UT
Zero to $5,000	-1.3%	0.0%	-5.2%	0.0%	0.0%
$5,000 to $10,000	3.2%	0.0%	-1.3%	0.0%	0.0%
$10,000 to $15,000	1.1%	0.0%	2.0%	0.0%	0.0%
$15,000 to $20,000	0.9%	0.0%	5.3%	0.0%	1.7%
$20,000 to $25,000	2.7%	3.3%	6.9%	3.2%	4.9%
$25,000 to $30,000	2.3%	4.6%	7.6%	4.9%	6.9%
$30,000 to $35,000	3.2%	4.6%	11.1%	2.9%	6.7%
$35,000 to $40,000	4.4%	4.6%	7.0%	2.9%	6.5%
$40,000 to $45,000	5.0%	4.6%	7.0%	3.2%	6.5%
$45,000 to $50,000	4.9%	4.6%	7.0%	3.2%	6.5%
	NM	**CO**	**OK**	**AZ**	**UT**
$55,000 to $60,000	4.3%	4.2%	6.2%	2.8%	5.7%
$60,000 to $65,000	4.3%	4.2%	6.2%	2.8%	5.7%
$65,000 to $70,000	4.3%	4.2%	6.1%	2.8%	5.7%
$70,000 to $75,000	4.3%	4.2%	6.2%	2.8%	5.7%
$75,000 to $80,000	4.3%	4.2%	6.2%	2.8%	5.3%
$80,000 to $85,000	4.3%	4.2%	6.2%	3.3%	5.3%
$85,000 to $90,000	4.3%	4.2%	6.2%	3.3%	5.3%
$90,000 to $95,000	4.3%	4.2%	6.1%	3.3%	5.3%
$95,000 to $100,000	4.3%	4.2%	6.2%	3.3%	5.3%

Table 12: 2007 State Income Tax Margin Differentials compared to NM (including Texas which has no income tax)

AGI	NM - CO	NM - OK	NM - AZ	NM – UT	NM - TX
Zero to $5,000	-1.3%	3.9%	-1.3%	-1.3%	-1.3%
$5,000 to $10,000	3.2%	4.5%	3.2%	3.2%	3.2%
$10,000 to $15,000	1.1%	-0.9%	1.1%	1.1%	1.1%
$15,000 to $20,000	0.9%	-4.4%	0.9%	-0.9%	0.9%
$20,000 to $25,000	-0.6%	-4.2%	-0.5%	-2.2%	2.7%
$25,000 to $30,000	-2.3%	-5.3%	-2.5%	-4.6%	2.3%
$30,000 to $35,000	-1.4%	-7.9%	0.3%	-3.5%	3.2%
$35,000 to $40,000	-0.2%	-2.6%	1.5%	-2.0%	4.4%
$40,000 to $45,000	0.4%	-2.0%	1.8%	-1.5%	5.0%
$45,000 to $50,000	0.3%	-2.1%	1.7%	-1.6%	4.9%
	NM - CO	NM - OK	NM - AZ	NM - UT	NM - TX
$55,000 to $60,000	0.1%	-1.8%	1.5%	-1.4%	4.3%
$60,000 to $65,000	0.1%	-1.8%	1.5%	-1.4%	4.3%
$65,000 to $70,000	0.1%	-1.8%	1.5%	-1.4%	4.3%
$70,000 to $75,000	0.2%	-1.8%	1.5%	-1.4%	4.3%
$75,000 to $80,000	0.1%	-1.8%	1.5%	-1.0%	4.3%
$80,000 to $85,000	0.1%	-1.8%	1.0%	-1.0%	4.3%
$85,000 to $90,000	0.1%	-1.9%	1.0%	-1.0%	4.3%
$90,000 to $95,000	0.2%	-1.8%	1.0%	-1.0%	4.3%
$95,000 to $100,000	0.1%	-1.8%	1.0%	-1.0%	4.3%

Positive (negative) percentages indicate that New Mexico's effective marginal tax rate is higher (lower) than the neighbor indicated for each $5k income range.

Sensitivity of Conclusions to Assumptions

Medical deductions in lieu of other kinds of deductions make a substantial difference for Arizona and a minor difference for New Mexico. In Arizona there is no limitation on the deductibility of medical expenses (federal deductible expenses are allowed only to the extent that they exceed 7.5 percent of adjusted gross income). New Mexico allows deduction of 15 percent of medical expenses not allowed on federal returns up to adjusted gross income of $70,000. Above $70,000 AGI New Mexico allows deduction of 10 percent of federally ineligible medical expenses.

Say, for example, that we replaced some of the interest and charity deductions by a $5,500 federal medical expense deduction for incomes above $50,000. That would have the effect of lowering Arizona's effective marginal tax rate by approximately one-quarter of one percent. And it would have the effect of lowering New Mexico's effective marginal tax rate by approximately six-hundredths of one percent.

Appendix B: The Distressing Arithmetic of Trying to Help the Poor

Public policy designed to help the poor almost never explicitly assesses the trade-offs between the helping part of the policy and the incentive effects of the policy[26]. The trade-offs are the same whether the transfers designed to help the poor are in-kind (such as food stamps and MEDICAID) or are in cash. In an attempt to bring the trade-off issue to the forefront for policy makers, two simple examples of a cash transfer are offered to illustrate the problem. The examples are for cash transfers only; they do not include the personal income tax or the Social Security and Medicare tax.

Assume we want to give a poor person an income guarantee of $10,000. To qualify for the guarantee, the poor person must have earned income less than $10,000. Example 1 shows how this would work absent any attempt to give the poor person any incentive to become a productive worker. If the poor person earns no income she receives a government transfer of $10,000. But if she earns $4,000 she only receives a transfer of $6,000. In essence the whole $4,000 earned has been taxed away – and the effective tax rate is 100% -- as you can see in the right-hand column. The remainder of the schedule shows that each increment of income earned up to $10,000 results in an offsetting reduction in the transfer. All income earned below the $10,000 qualification threshold gets taxed away.

[26] One of the most insightful discussion I have seen on these trade-offs is: Browning, Edgar K., *The Economics of Welfare Reform*, prepared for the Twelfth Annual Lecture in Virginia Political Economy Series, Center for Study of Public Choice, Fairfax, Virginia, 1996.

Example 1 (amounts in dollars):

Income Guarantee	Income Earned	Transfer to the Poor Person	Total Income of the Poor Person	Effective Tax Rate on Income Earned
10,000	0	10,000	10,000	
10,000	4,000	6,000	10,000	100%
10,000	8,000	2,000	10,000	100%
10,000	10,000	0	10,000	100%
10,000	12,000	0	12,000	0%

Recognizing that taxing earned income at a rate of 100% does not do much to encourage the poor person to acquire skills and go to work, the government might try an alternative welfare program such as shown in example 2. Now when the poor person earns $4,000, she gets to keep $2,000 of what she earned. The effective tax rate on her earned income is now 50% rather than 100%. The remainder of the schedule shows that for each increment of income earned up to $20,000 results in a 50% reduction in the transfer. Half of all income earned below the $20,000 qualification threshold gets taxed away. Her incentive to be engaged in responsible behavior has improved compared to example 1. But, in order to improve that incentive the government must now transfer money to those who did not qualify in example 1. Everyone now earning income in the range of 10 to 20 thousand dollars would qualify for transfers.

Example 2 (amounts in dollars):

Income Guarantee	Income Earned	Transfer to the Poor person	Total Income of the Poor Person	Effective Tax Rate on Income Earned
10,000	0	10,000	10,000	
10,000	4,000	8,000	12,000	50%
10,000	8,000	6,000	14,000	50%
10,000	10,000	5,000	15,000	50%
10,000	12,000	4,000	16,000	50%
10,000	16,000	2,000	18,000	50%
10,000	20,000	0	20,000	50%
10,000	24,000	0	24,000	0%

When earned income in example 2 is $20,000 the transfer to the poor person goes to zero. It is called the "break-even level of earned income." By increasing the break-even level of earned income, policy makers lower the tax rate and increase incentives for the poor to work. But while doing so they also increase the number of people who qualify for transfers and reduce their incentive to work.

The point of the examples is to illustrate the distressing arithmetic associated with transfers to the poor. The more money (the higher the income guarantee in cash or in kind) that we try to transfer to them, the higher is the effective tax rate on their earned income as long as the break even level of income earned is held constant. And if we try to lower the effective rate of tax on their earned income, we can only do so by making higher income earners eligible for transfers, e.g. by raising the break even level of income. There is no way around these difficult trade-offs.

You can see there is a lot more to helping the poor than just giving them government-sponsored aid. And when the individual income tax system is added into the calculus, matters are further complicated. We cannot arrive at effectively designed policy for helping the poor until we consider the tax and transfer incentives together.[27]

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[27] Browning and Browning (1994, p. 297) give an illustrative example of the difficulty of augmenting the income of the poor via transfers. Raising the income of the lowest quintile of the income distribution by two or three percent would require increasing marginal tax rates on everyone by 15 to 20 percentage points. Their example assumes no dynamic effects. Once adjustments to the higher marginal tax rates kick in, the difficulty would be compounded.