

## **Stimulating New Mexico's Economy by Phasing out its Personal Income Tax**

**Plan Will Spur Immediate, Future Economic Growth**

**By Paul Gessing  
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### **Introduction**

National economic growth has been slowing recently. As a result Congress has passed a so-called "stimulus-package" ostensibly designed to give the economy a boost, most economists believe that putting checks in the mail, without permanent, positive policy changes will do little for the national economic outlook.<sup>1</sup> The stimulus checks people receive will eventually have to be paid back in the form of taxes and they do nothing to improve the economy because they do not change the incentives to work, save, invest, or take risks.

While we may not be able to rely on Washington, New Mexico's policy leaders could stimulate the state's economy in the short-term and improve its long-term economic prospects by phasing out the state's personal income tax over the next four years.

### **Building on Recent Success**

New Mexico's income tax generates a significant portion of the state's General Fund revenue. It is also the case that New Mexico has successfully reduced income tax rates since 2003. Starting that year, income tax rates were reduced from a top rate of 8.2 percent to their current level of 4.9 percent. This occurred despite massive spending increases over that time period.

These reductions in the state's personal income tax have played a major role in New Mexico's relatively strong economic growth of recent years. Personal income per capita is the best single way to measure a state's level of economic prosperity. In 2002, prior to the enactment of any tax reductions and with the personal income tax rate at 8.2 percent, New Mexico's personal income per capita was 47<sup>th</sup> in the nation. By 2007, with the state's top income tax rate at 5.3 percent, New Mexico's average personal income had risen to 43<sup>rd</sup> in the nation.<sup>2</sup>

**Figure 1.**

<b>Calendar Year</b>	2002	2003	2004	2005	2006	2007	2008
<b>Tax Rate</b>	8.20%	7.70%	6.80%	5.70%	5.30%	5.30%	4.90%

<sup>1</sup> Robert Samuelson, "Stimulus Will be Unneeded or Too Little," Robert Samuelson, January 16, 2008, [http://www.realclearpolitics.com/articles/2008/01/stimulus\\_will\\_be\\_unneeded\\_or\\_t.html](http://www.realclearpolitics.com/articles/2008/01/stimulus_will_be_unneeded_or_t.html).

<sup>2</sup> UNM Bureau of Business & Economic Research, "Personal Income by State" April 4, 2008, <http://www.unm.edu/%7Ebber/econ/us-pci.htm>.

In FY 2008, which will end in June of this year, New Mexico expects to collect nearly \$1.18 billion in personal income taxes. At 20 percent of the state's \$5.9 billion FY 2008 General Fund budget, while this is a significant portion of the state budget,<sup>3</sup> it can be eliminated with modest fiscal restraint.

### **Why Eliminate the Personal Income Tax?**

A permanent reduction in the personal income tax rate will expand private entrepreneurial activity, increase employment, and raise wages. Low personal income taxes attract entrepreneurs, who create around 70 percent of U.S. jobs. Clearly then, having taxes low enough to draw in entrepreneurs is important for employment and overall economic well-being. Unlike the so called federal stimulus, reductions in New Mexico's income tax rate will stimulate the economy.

Think about the incentives in New Mexico. If an entrepreneur earns \$50,000, the state takes about \$2,139 in personal income tax (not accounting for New Mexico's economically-destructive gross receipts tax which is charged at rates approaching 8 percent in some places). We need only look to neighboring Texas or slightly more distant Nevada to find out that his income tax there would be \$0.

New Mexico's vast array of incentives and rebates are purportedly designed to improve the state's relatively poor economic standing (43<sup>rd</sup> in the nation in per-capita GDP).<sup>4</sup> Lowering taxes on productive activity has a much longer history of generating economic growth both among the various American states and worldwide.

Temporary economic stimuli such as the one Congress passed earlier this year, on the other hand, will do almost nothing to stimulate either short or long term economic growth. That's because entrepreneurs and consumers make their decisions based on future expectations, not just how much money they have in their pockets at a given moment.

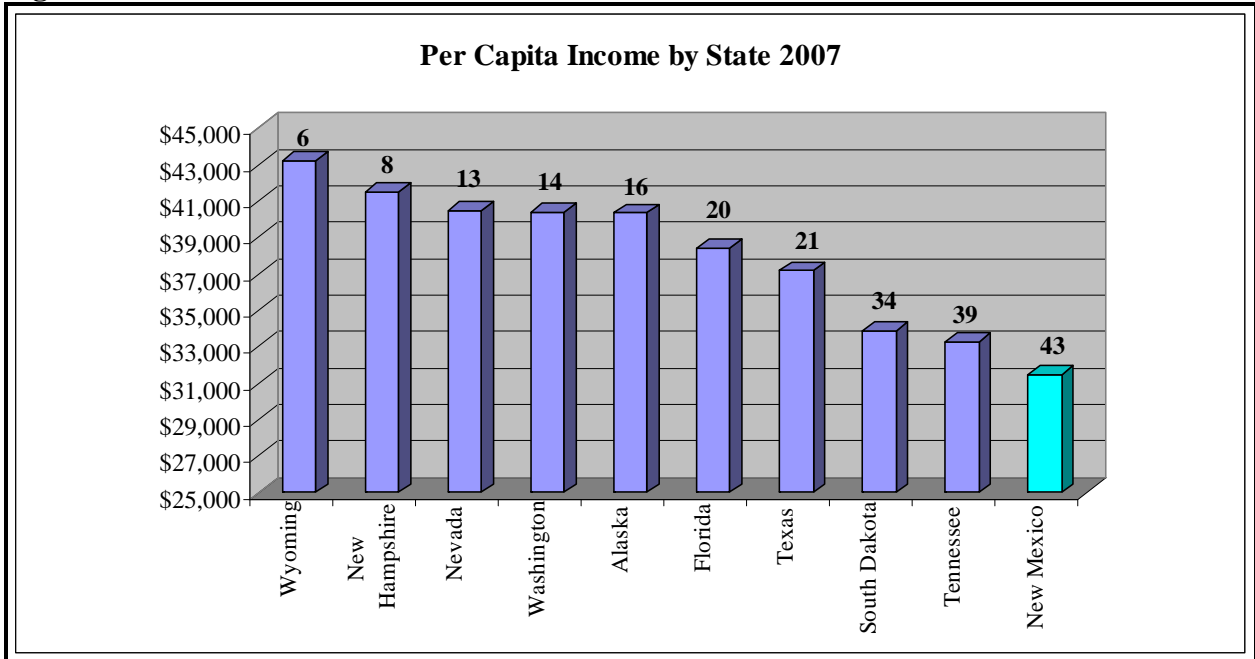
Figure 2, below, shows how New Mexico's personal income level compares with the nine states which charge no personal income tax. Each state's overall personal income ranking (ex. Wyoming has the sixth-highest per capita personal income while New Mexico's personal incomes are 43<sup>rd</sup> highest) is also given.

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<sup>3</sup> Figures taken from Legislative Finance Committee "General Fund Consensus Revenue Estimates" December 11, 2006 and Legislative Finance Committee "Post-Session Review" March 2008, <http://legis.state.nm.us/LCS/lfc/lfcdocs/2008%20Post%20Session%20Review%20Final.pdf>.

<sup>4</sup> UNM Bureau of Business & Economic Research, "Personal Income by State" April 4, 2008, <http://www.unm.edu/%7Ebbber/econ/us-pci.htm>.

**Figure 2.**



UNM Bureau of Business & Economic Research, "Personal Income by State" April 4, 2008

Although diverse, each of these states has one thing in common: far higher personal incomes per resident than New Mexico. In fact, the average personal income of these states is \$38,756 per person, more than \$7,000 per person higher than the income levels of the average New Mexican. What would *you* do with another \$7,000 in *your* pocket?

Eliminating the personal income tax will assure New Mexico's spot on the economic map. Entrepreneur-friendly areas request more patents, spend more on research, start more hi-tech companies, and are more likely to attract the Next Big Thing. Entrepreneurial giants Microsoft (Bill Gates actually started developing the personal computer in Albuquerque) and Dell Computers both started in small garages in states with no personal income tax.

These entrepreneurs generate good for the rest of society by increasing freedom and quality of choice for the rest of us. Due to the nature of competition and the absence of competition, entrepreneurs offer better uses of their dollars than government spending on commuter trains, spaceports, and heavily-subsidized businesses. Taxpayers are *coerced* into paying for these boondoggles.

In Thomas Friedman's "flat world," New Mexico is not only competing against zero income tax states like Nevada, Texas and Washington, but low-cost labor countries like India. By eliminating its personal income tax, New Mexico will attract more entrepreneurs, produce jobs and encourage innovation. That's one investment we can all get behind.

## How to Eliminate the Tax

After a careful review of budget figures from the past seven years and based on future budget estimates, New Mexico could eliminate its income tax within eight years by simply restraining annual General Fund spending increases to 4.5 percent annual growth.

There is no doubt that 4.5 annual budget growth is restrained, particularly compared with recent, rapid spending growth. Nonetheless, it is also reasonable given population and historic inflation rates. New Mexico’s population growth rate since 2000 has averaged just over 1 percent annually.<sup>5</sup> While future inflation rates are impossible to predict, since 2000 the inflation rate has averaged approximately 2.8 percent.<sup>6</sup>

Thus, 4.5 percent is a reasonable estimate of what government needs to grow by in order to remain at the same size in real terms. Certainly there is some fat in the budget to be cut in a pinch.

New Mexico is collecting more money from its personal income tax than ever before despite having reduced rates by more than 40 percent. In fact, in FY 2003, the year in which the first rate cut – from 8.2 percent to 7.7 percent – took effect, New Mexico’s personal income tax generated approximately \$923 million. In FY 2008, the tax is expected to generate \$1.18 billion, an increase of 28 percent in just five years.

Over the same time period, FY 2003 to FY 2008, New Mexico’s overall tax revenues rose from just under \$3.9 billion to \$5.9 billion, an increase of more than 51 percent. So, while rate cuts slowed the growth of personal income tax revenues, economic growth made up for a significant percentage of this “lost” tax revenue.

**Figure 3.**

	2003	2004	2005	2006	2007	2008	Percentage Growth
<b>Personal Income Tax Collections</b>	\$923.1	\$1,007.2	\$1,086	\$1,126.6	\$1,138	\$1,181	28%
<b>General Fund Revenues</b>	\$3,891.1	\$4,283	\$4,906.3	\$5,594	\$5,661.2	\$5,836	50%

(figures in millions)

As this study will show, eliminating New Mexico’s income tax is possible within just four years. Spending restraint is a necessity, but modest, not radical measures can do the job. In fact, based on Rio Grande Foundation analysis of recent revenue growth and personal income tax revenue numbers, New Mexico’s personal income tax could be eliminated simply by restraining annual general fund increases to just 4.5 percent.

First, however, a brief history of New Mexico revenue and spending growth is in order. As shown in Figure 4, New Mexico General Fund tax revenues – of which the personal income tax is one component – have grown rapidly since FY 2003. While the onset of relatively dramatic

<sup>5</sup> U.S. and State Population Estimates, 2000 to 2007, <http://www.unm.edu/~bber/demo/usto2000s.htm>.

<sup>6</sup> Inflationdata.com, “Historical Inflation from 1914 to Present,” [http://inflationdata.com/inflation/Inflation\\_Rate/HistoricalInflation.aspx](http://inflationdata.com/inflation/Inflation_Rate/HistoricalInflation.aspx).

rate cuts in New Mexico’s income tax likely played a role in spurring economic growth and thus driving revenues higher, revenues directly received from the oil and gas industry grew from \$552 million in FY 2003 to \$1.23 billion in FY 2008, a large increase.

**Figure 4.**

Year	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	Average Growth
<b>Actual Revenues</b>	\$3,891.10	\$4,283	\$4,906.30	\$5,594	\$5,661.20	\$5,836	\$6,186.16	
<b>Percent Revenue Increase</b>		10.07%	14.55%	14.02%	1.20%	3.09%	6.00%	8.16%

(figures in millions)

Unfortunately, while revenue increased by a robust 8.16 percent annual average, spending has also grown dramatically. In fact, the six year average spending growth of 7.51 percent is far greater than the state’s historical 6 percent average rate of growth. In order to cut and ultimately eliminate New Mexico’s personal income tax, our elected officials will have to show greater spending restraint than they have in recent years.

**Figure 5.**

Year	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	Average Growth
<b>General Fund Spending</b>	\$3,873.94	\$4,108	\$4,387.10	\$4,707.60	\$5,070.81	\$5,639.12	\$5,977.47	
<b>General Fund Increase</b>		6.04%	6.79%	7.31%	7.72%	11.21%	6.00%	7.51%

(figures in millions)

### The 4.5 Percent Solution

The business of making accurate predictions about future economic growth is a difficult one. In fact, the Legislative Finance Committee’s most recent projections are for revenue growth of 3 percent or less from FY 2009 through FY 2012.<sup>7</sup> Nonetheless, such projections have been wildly inaccurate in the past.

This inaccuracy is not the fault of the Legislative Finance Committee or its analysts; rather it is a simple result of the difficulty in making predictions about future events and how they will impact New Mexico tax revenues. No one predicted the terrorist attacks of 9/11, the Cerro Grande Fire of 2000, or the rapid rise in oil and gas revenues in recent years. Each of these events had significant impacts on New Mexico’s economy and tax collections.<sup>8</sup>

Rather than tailoring our recommendations to LFC expectations of 3 percent average growth over the next few years, this analysis is based on eliminating the personal income tax at a time when revenues grow at 6 percent annually. This 6 percent average is a conservative estimate. According to calculations made by House Minority Leader Tom Taylor, New Mexico’s historical revenue growth has exceeded 7 percent over the past 20+ years.

<sup>7</sup> Stephanie Schardin and Norton Francis, “December 2007 Consensus Revenue Estimate Update,” Legislative Finance Committee, December 3, 2007.

<sup>8</sup> Legislative Finance Committee, “Budget Recommendations FY 2004-FY 2009,” <http://legis.state.nm.us/LCS/lfc/lfcbudget.asp>.

Of course, revenues rarely grow at the average rate two years in a row, much less for five. In fact, as Figure 4 (above) illustrates, over the past six years, New Mexico government has seen annual growth ranging from a high of 14.55 percent to a low of 1.20 percent. Average revenue growth over this time period was 8.16 percent, well above the historical average. Nonetheless, for the purposes of eliminating New Mexico's income tax, we will estimate six percent annual revenue growth.

Given the realities of budget growth which has averaged 7.5 percent over the last six years, thereby eating away at much of the unexpected revenue, any plan to eliminate New Mexico's income tax must slow spending growth. This can be done in a reasonable way by accounting for expected inflation and population growth with an annual growth in government spending of 4.5 percent.

### **How it Would Work**

Happily, our efforts to analyze the fiscal impact of income tax cuts are simplified by the fact that we have recent, accurate budget data on the recently-completed round of tax cuts. As noted above, as of FY 2008, New Mexico has successfully reduced its personal income tax by 40 percent from 8.2 percent to 4.9 percent. Despite these significant cuts, as Figure 3 (found on page three) illustrates, personal income tax revenues nonetheless grew by a robust 28 percent during the six years from FY 2003 to FY 2008.

While 28 percent growth is somewhat lower than the 50 percent growth seen by the General Fund as a whole, a 40 percent tax rate reduction cost the state (at most) 22 percent of the revenue it would have otherwise collected. In the real world, a cut in the personal income tax should only see a loss of 45 percent of revenue that would otherwise have been collected.

For example, for each percentage point of tax levied (up to a 4.9 percent rate currently), the state collects approximately \$230 million in personal income tax. In the most recent round of tax cuts, the state still managed to collect 55 percent of what it would have collected on a per-point basis, despite the new, lower tax rate. Thus, it is estimated that each point reduction in the personal income tax will reduce revenues by \$103.5 million.

Even if we assume a rather generous \$20 million (close to 20% cushion) for each point reduction, that is that each point reduction in the personal income tax costs the state \$123.5, eliminating the tax could be done in as little as five years as the chart below illustrates. This is an extremely generous ratio in light of the fact that income tax cuts will inevitably result in revenue increases in other taxes as entrepreneurial activity is unleashed and attracted to New Mexico.

**Figure 6.**

	FY 2010	FY 2011	FY 2012	FY 2013
<b>Estimated Revenues</b>	\$6,557.33	\$6,950.77	\$7,367.82	\$7,809.88
<b>Estimated Annual Revenue Growth</b>	6%	6%	6%	6%
<b>Spending Increase Limited to 4.5% annually</b>	\$6,246.45	\$6,527.54	\$6,821.28	\$7,128.24
<b>Cumulative Spending Difference</b>	\$310.88	\$423.23	\$546.53	\$681.64
<b>Income Tax Points Eliminated</b>	2.52	3.43	4.43	5.52

(figures in millions)

Estimated revenues are based on a six percent annual expected rate of increase. While this rate is higher than estimates from the Legislative Finance Committee, it is actually below historical averages. Spending restraint of only 4.5 percent is a small price to pay to eliminate one of New Mexico's most growth-stifling taxes.

Eliminating New Mexico's personal income tax entirely may seem like a tall mountain to climb. Fortunately, Governor Richardson moved the state in the right direction by reducing the tax by 40 percent over the span of six years. Eliminating the income tax would put New Mexico on par with fast-growing regional neighbors that lack an income tax including Texas and Nevada.

Reducing the income tax has been an important part of New Mexico's recent economic revival. Eliminating it entirely would truly make New Mexico an attractive place to do business.



### **About the Author**

**Paul Gessing** is president of the Rio Grande Foundation. He holds an MBA from the Smith School at the University of Maryland. His work and more studies on New Mexico's economic policies are available at [www.riograndefoundation.org](http://www.riograndefoundation.org).