

Rio Grande Foundation



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Lower Taxes – Period: The Right Way to End the Food Tax

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

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EXECUTIVE SUMMARY

Eliminating the tax on groceries is not a bad idea. In fact, any tax reduction is probably a good idea in New Mexico. But we need to be realistic: eliminating the tax on groceries will not “reduce hunger” by any appreciable amount. And when coupled with tax increases meant to recapture lost revenues, ending the tax on groceries does more harm than good.

Two bills were introduced in February 2000 to end the tax on groceries. But coupled with the first bill is an increase in the excise tax on cigarettes by 60 cents per pack. Coupled with the second is an increase in the excise tax on cigarettes by 25 cents per pack and an increase in the overall statewide Gross Receipts Tax rate by one-quarter of one percent.

The intent of the bills was to aid the poor and hungry. But neither would do so. Since a disproportionate number of low-income people smoke, the harm imposed on them would more than offset the benefits from not paying the tax on groceries. The higher taxes on cigarettes would be even more regressive than the existing tax on groceries. In essence, the bills merely transfer wealth from smokers to nonsmokers.

Moreover, the new cigarette taxes would not raise nearly enough revenue to offset revenue lost from ending the tax on groceries. Since cigarettes are readily available in other jurisdictions (Indian land, other states), cigarette consumers would shift a large portion of their purchases to where they would avoid the higher New Mexico tax. Consequently other taxes would have to be increased if the bills are to remain “revenue neutral.”

Supporters of the bills alarmingly assert existence of a serious hunger problem in New Mexico. But they do so by relying on a controversial U.S. Department of Agriculture study and its update. The Department actually surveys a murky concept called “food insecurity,” not hunger. Other studies of hunger itself conclude that nutrition levels, particularly among children, are affected very little by income. Even the data on purchase of groceries supplied by the bills’ supporters implicitly deny a hunger problem: Poor people spend a small portion of their income on

groceries; and as their income increases they tend to spend less and less for groceries out of each extra dollar of income.

There is a small extent to which the bills would induce consumers to purchase more groceries. But the extra groceries purchased would substitute mostly for already prepared food (such as fast food and restaurant food). Consequently there would be no noticeable improvement in nutrition among the poor.

Claimed tangential benefits from increasing the tax on cigarettes will not be realized either. Health care costs will not be lowered, and sin taxes are not an effective way to reduce problems of smoking and alcohol use among our youngsters. Health care costs will not be lowered because the earlier mortality of smokers tends to reduce nursing home and pension costs more than enough to offset smokers' comparatively higher health care costs. To the extent that it is really an issue of public policy (rather than parental guidance), reducing the perceived problem of youth smoking would be better dealt with by directly penalizing youth smoking or the parents of youth smokers.

New Mexico is a poor state compared to others, falling near the bottom of most rankings. Moreover, the past 15 to 20 years have seen New Mexico record the slowest growth of per capita income among the lower 48 states. Bills such as those "ending the tax on groceries" (while quietly *raising* other taxes) come out with great fanfare, claiming that we are doing something to help our poor and make life better.

Yet these bills do not address the real problem and, in fact, would only make matters worse. Too much government interference (in the form of high taxes, regulation and disincentives to work) is the problem. What we need is real tax, regulatory and welfare reform, not just window dressing disguised as lowering taxes. Specifically, if we want to join those states with higher growth rates, we need more economic freedom in the form of lower tax rates, less regulation and smaller government. In that spirit the **Rio Grande Foundation** would embrace ending the tax on groceries *as long as no other taxes are increased*.

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INTRODUCTION

Two bills to increase taxes were introduced in the February 2000 legislative session. The purpose of each bill was to provide enough revenue to eliminate the Gross Receipts Tax on groceries¹ in New Mexico. The worthy goals of the two bills were to help the poor and reduce hunger (particularly among children) in New Mexico. Tax revenue lost from groceries would be replaced either 1) by increasing the tax on cigarettes by 60 cents per pack or 2) by increasing the tax on cigarettes by 25 cents per pack and by increasing the Gross Receipts Tax rate by one-quarter of one percent. By taxing cigarettes the bills also would purportedly reduce the problems of youth smoking and high health care costs. The purpose of this assessment is to examine the bills and their goals: Will the intended goals be achieved should one of the bills become law?

The study is organized as follows:

- First, the regressive nature of the tax on groceries as part of the broad based Gross Receipts Tax is examined.
- Second, reliance on a controversial U.S. Department of Agriculture study of hunger is questioned.
- Third, alternative means of combating hunger—such as food stamps and other food assistance, money transfers to the poor, other in-kind transfers to the poor and the low-income tax credits—are summarized.
- Fourth, the effect of the two bills' on New Mexico tax revenues is assessed.
- Fifth, the effectiveness of sin taxes on reducing health care costs and reducing consumption of cigarettes and alcohol by youth is discussed.
- Finally, this report concludes with a recommendation that would be much more effective in helping the poor than either of the bills.

REGRESSIVITY OF THE FOOD TAX

The rationale behind the bills is that the Gross Receipts Tax on groceries is regressive; consequently its burden falls more heavily on the poor. Clearly the poor spend a higher percentage of their annual income on groceries than do higher income groups. Looking at the Gross Receipts Tax on groceries *in isolation*, however, gives a misleading impression of the Gross Receipts Tax. Also, replacing the food tax with a tax on cigarettes would tax the poor even more.

Groceries as One Element of Broad Tax Base

Groceries are but one category of the many goods and services taxed in New Mexico. Not much in New Mexico escapes the taxman. For each good or service taxed a wedge is driven between buyer and seller – the buyer pays more and the seller receives less than each would without the tax. Because of the tax-induced wedge, voluntary buying and selling ceases sooner than it would without the tax. That reduction in economic activity is the economic loss caused by the tax. The idea behind a broad-based tax such as our Gross Receipts Tax is that everything gets taxed a little, reducing overall economic losses caused by the tax wedge. That was the idea behind the

¹ Groceries are defined as groceries purchased for home consumption. They do not include already prepared food or nonfood items.

legislature's Professional Tax Study Committee four years ago – by bringing more goods and services into the tax base, the committee sought to lower the overall rate of tax.

Like groceries, many goods and services in the tax base will have regressive characteristics when viewed independently. But we could also find many that are highly progressive – those goods and services not usually purchased by the poor. When we start to cherry pick regressive taxes out of the tax base we are in essence making the income tax more progressive (since goods and services are purchased out of income). The more progressive we make it, the more we encourage failure and penalize success. The Gross Receipts Tax as it exists today is more like a flat tax on income when you look at it *in toto*. And we already have a tax that is quite progressive: the state's individual income tax.

The rationale behind the bills is that groceries are not taxed in the vast majority of other states. But many things taxed in New Mexico are not taxed in the vast majority of other states, most particularly services. That being the case, we must be particularly vigilant to guard against increases in the Gross Receipts Tax rate (as one of the bills eliminating the tax on groceries would do). The reasons this would be a job-destroying tax increase are documented in a prior study by **Rio Grande Foundation**². In fact, the Gross Receipts Tax rate should be lowered across the board, not raised.

The Tax on Cigarettes Is Even More Regressive and Is a Wealth Transfer from Smokers to Nonsmokers

Since a disproportionate number of smokers are poor, the tax on cigarettes is even more regressive than the existing tax on groceries. The National Center for Policy Analysis estimated that 47 percent of those who smoke come from families whose income is less than \$30,000 per year³. That evidence is reinforced by Professor Vedder's econometric study, in which he found that purchase of taxed cigarettes tends to decrease as income increases⁴. If the increased tax on cigarettes were implemented, then the poor would pay more tax than they do now. That would hardly help the poor.

What the bills actually do is transfer wealth from smokers to nonsmokers at all levels of income. That the bills have received such widespread political support is not surprising since smokers are in the minority and they are disproportionately poor.

Danger: Opening the Tax Code to More Favor Seeking

The wealth transfer consequence of each of these bills points to a danger lurking should one of them become law. By further opening up the tax code for special treatment of favored buyers or sellers, we invite more unproductive activity to acquire those favors. Interest groups will seek more favors while others, whose taxes would be raised, will resist those interest groups. This favor-seeking activity adds nothing to improve the production and distribution of goods and

² Messenheimer, Harry, "New Mexico 2000: its policies and economic health," Rio Grande Foundation, October 2000, pp. 18-20.

³ National Center for Policy Analysis, "Taxing the Poor," brief analysis No. 269, June 1998.

⁴ Vedder, Richard K., "Bordering on Chaos: Fiscal Federalism and Excise Taxes," in *Taxing Choice: the Predatory Politics of Fiscal Discrimination*, Independent Institute, 1997, p. 279.

services in New Mexico; it only adds to their cost. (In this context it is useful to note that the existing excise tax on cigarettes is not too far out of line compared to other goods, being taxed roughly three percent more than are other goods at current prices.)

A Numerical Example of How the Bills Might Directly Affect Two Poor Families in New Mexico

In order that the reader might better understand the kind of immediate adjustments that are likely to take place should one of the bills become law, the following hypothetical example is offered. The reader is cautioned not to draw overall conclusions about the bills’ effects from this example. This is only a story about two poor families and their immediate adjustments to the bills. It does not constitute an economic analysis of the overall effects of the bills. The examples are fictional, but they are based on actual empirical evidence regarding consumption of groceries and cigarettes.

Consider two 4-person families that have \$10,000 per year to spend. One of the families is nonsmoking and the other contains one or more members who smoke. Neither family has access to food stamps⁵. Each family spends \$2,100 on groceries. Each family spends \$3,000 on untaxed goods such as for rent and prescription drugs. Their expenditures are initially identical except that the smoking family consumes 500 packs of cigarettes taxed in New Mexico among the remaining goods purchased. It is assumed that the average price of a pack of cigarettes in New Mexico today is \$2.60. The remainder of each family’s expenditures is allocated to other taxed goods and services. The following tables summarize each family’s position, including amount of New Mexico Gross Receipts Tax paid, prior to passage of either of the bills under discussion.

Each Family’s Situation Before One of the Bills Becomes Law

Initial Situation for the nonsmoking family:

Category	Proportion of Income Spent	Total Amount Spent	Tax
Groceries	0.21	\$ 2,100	\$ 100
Untaxed Goods	0.3	\$ 3,000	
Other Goods	0.49	\$ 4,900	\$ 233

Initial Situation for the smoking family:

Category	Proportion of Income Spent	Total Amount Spent	Tax
Groceries	0.21	\$ 2,100	\$ 100
Untaxed Goods	0.3	\$ 3,000	
Other Goods	0.36	\$ 3,600	\$ 171
NM Cigarettes	0.13	\$ 1,300	\$ 105

⁵Use of food stamps is not subject to the Gross Receipts Tax, so this example would be irrelevant with respect to groceries if neither family was paying tax on its groceries.

Notice that the total tax paid by the nonsmoking family is \$333 and by the smoking family is \$376 since cigarettes are taxed a little more heavily than are the “other” goods purchased by the nonsmoking family⁶.

Each Family’s Situation After One of the Bills Becomes Law

Before looking at how our hypothetical families are affected by each bill, we need some plausible assumptions about how price changes and tax changes affect their behavior. For the purchase of food the assumption is that the price elasticity of their demand for groceries is one-half. That means that the percentage change in reduced quantity purchased will be equal to one-half the percentage increase in price⁷. In other words, each family will now spend \$2,045 per year on groceries (a five percent reduction in price because of elimination of the tax would be offset partially by a two and one-half percent increase in quantity of groceries purchased). This small increase in quantity of groceries purchased will not lead to a perceptible increase in nutrition, however. The theory and empirical evidence of consumer behavior suggests that groceries will be substituted for those goods that are close substitutes for groceries. For example, economists would predict that consumers would tend to substitute groceries for fast food rather than for socks or pliers. Most of the small increase in groceries purchased will simply substitute for other kinds of food (prepared food and restaurant food).

Assuming that each family will continue to spend \$3,000 on untaxed goods, the nonsmoking family’s expenditure for other goods will increase by \$55 (the amount no longer spent on groceries) as a result of the bill.

⁶ Only taxes relevant to the example are included. There are some federal, state, local and other states’ taxes that wash throughout the example. They can be thought of as being part of the price of purchases.

⁷ This is a generous assumption. The income elasticity of the poor’s response to income increases (estimated at \$10,000 of income from data supplied by proponents of the bills) is only 0.23. On the other hand, the poor’s response to purchase of goods other than food is income elastic (value is 1.2 for income of \$10,000). They tend to spend more of each extra dollar of income on goods other than food. So, although we don’t know the price elasticity of response, it is quite likely to be well below 0.5.

Bill#1: Eliminate Tax on Groceries, Increase Tax on Cigarettes by 60 Cents per Pack and Increase the Gross Receipts Tax by 0.3 percent⁸.

How will the smoking family respond to the new tax on cigarettes? First, there is the question of the total quantity of cigarettes subject to New Mexico tax that the family will purchase subsequent to the tax increase. We assume that the family will reduce its consumption of these taxed cigarettes by half – from 500 packs to 250 packs per year.⁹

The after Bill#1 situation is summarized in the following tables for each family.

Situation for the nonsmoking family after Bill#1 becomes law:

Category	Proportion of Income Spent	Total Amount Spent	Tax
Groceries	0.2045	\$ 2,045	\$ -
Untaxed Goods	0.300	\$ 3,000	
Other Goods	0.4955	\$ 4,955	\$ 249

Situation for the smoking family after Bill#1 becomes law:

Category	Proportion of Income Spent	Total Amount Spent	Tax
Groceries	0.2045	\$ 2,045	\$ -
Untaxed Goods	0.3	\$ 3,000	
Other Goods	0.4155	\$ 4,155	\$ 209
NM Cigarettes	0.08	\$ 800	\$ 203

Notice that the nonsmoking family has improved its tax position by \$84. It now pays \$249 in tax vice \$333 before Bill#1.

The smoking family now pays taxes of \$412 (\$203 plus \$209¹⁰) vice \$376 before Bill#1. So from a tax perspective only, the smoking family is worse off by \$36. In addition the smoking family will undergo some new expenditures to avoid the increased tax on cigarettes. Since these expenditures would not have been necessary before implementation of Bill#1, they represent a loss to that family. For example, more spending for travel to obtain non-New Mexico cigarettes is money the family would not otherwise have spent for such travel. For purposes of this example such expenditures total \$50, so the smoking family is worse off by \$86 as a result of Bill#1.

In summary: as a result of Bill#1 the nonsmoking family improves its position by \$84 and the smoking family’s position deteriorates by the amount of \$86. Each of the two families increases its consumption of groceries by 2.5 percent. But substitution of groceries for prepared or restaurant food constitutes most of the increase, so neither family will experience a noticeable increase in nutrition.

⁸ The bill as written did not include the increase in Gross Receipts Tax. But a tax increase will be necessary, since the tax on cigarettes will not raise nearly enough revenue to offset the loss from eliminating the tax on groceries. See “effects of proposed bills on New Mexico’s tax revenues” below.

⁹ Their other purchases of cigarettes will be from non-New Mexico jurisdictions. These purchases are included in the “other goods” category.

¹⁰ Some of this tax is paid to jurisdictions other than New Mexico since “other goods” now includes purchase of cigarettes outside NM.

Bill#2 Eliminate Tax on Groceries and Increase Tax on Cigarettes by 25 Cents per Pack and Increase the Gross Receipts Tax Rate by 0.35 Percent¹¹

Once again legislation would not result in any noticeable increase in nutrition for the poor. Assumptions about response to the tax changes for the two families are the same as for Bill#1 except for the smoking family’s response to the smaller cigarette tax. We assume that the family will reduce its consumption of these taxed cigarettes by 20 percent – from 500 packs to 400 packs per year.

The after Bill#2 situation is summarized in the following tables for each family.

Situation for the nonsmoking family after Bill#2 becomes law:

Category	Proportion of Income Spent	Total Amount Spent	Tax
Groceries	0.2045	\$ 2,045	\$ -
Untaxed Goods	0.300	\$ 3,000	
Other Goods	0.4955	\$ 4,955	\$ 252

Situation for the smoking family after Bill#2 becomes law:

Category	Proportion of Income Spent	Total Amount Spent	Tax
Groceries	0.2045	\$ 2,045	\$ -
Untaxed Goods	0.3	\$ 3,000	
Other Goods	0.3815	\$ 3,815	\$ 194
NM Cigarettes	0.1140	\$ 1,140	\$ 184

The nonsmoking family has improved its tax position by \$81. It now pays \$252 vice \$333 in tax. The smoking family now pays taxes of \$378 (\$184 plus \$194¹²) vice \$376 before Bill#2. So from a tax perspective only, the smoking family is worse off by \$2. In addition the smoking family will undergo some new expenditures to avoid the increased tax on cigarettes. Since these expenditures would not have been necessary before implementation of Bill#2, they represent a loss to that family. For example, more spending for travel to obtain non-New Mexico cigarettes is money the family would not otherwise have spent for such travel. For purposes of this example such expenditures total \$20, so the smoking family is worse off by \$22 as a result of Bill#2.

In summary: as a result of Bill#2 the nonsmoking family improves its position by \$81 and the smoking family’s position deteriorates by the amount of \$22. As in example one, neither family will experience a noticeable increase in nutrition since their 2.5 percent increase in groceries purchased will mostly substitute for purchases of prepared or restaurant food.

These examples should convince the reader that proposed legislation would not noticeably change nutrition levels among the poor and would make poor smokers worse off. The point of the examples is that, under realistic assumptions, the effects of the legislation would be unimportant or even harmful. And the reader is reminded that the examples do not include the harmful economic effects of the tax increases.

¹¹ The increase shown here is greater by 0.1 percent than that actually proposed in Bill#2 since cigarette tax revenue was underestimated for that bill.

¹² Some of this tax is paid to jurisdictions other than New Mexico since “other goods” now includes purchase of cigarettes outside NM.

THE PROBLEM OF HUNGER IN NEW MEXICO

Supporters of the bills rely on a controversial U.S. Department of Agriculture study and its update¹³, alarmingly suggesting a serious hunger problem in New Mexico. The major source of controversy is that the questions asked in the USDA survey tended to draw responses that overstated the degree of hunger. The 18 questions in the survey asked about “food insecurity” rather than hunger. The basic idea of the survey was to find out if those queried had any difficulty getting “safe, nutritious food at all times in a socially acceptable way” over the past 12 months. Any one affirmative response added to the tally of “hunger.” A couple of questions in the survey were directed toward more “severe” categories of food insecurity. But those questions did not ask whether the person was malnourished or underfed. Rather, they asked whether the person had experienced “an uneasy or painful sensation caused by lack of food” over the past 12 months.

Even the USDA study itself contains the following caveat about its own hunger measure:

The measure of children in food-insecure households with hunger is not, as such, a valid estimate of the number of children directly experiencing hunger, but an upper bound for this figure. In most households, children are shielded from food deprivation until the level of deprivation among adult members is quite severe. Work is currently underway to develop a more accurate estimate of children’s hunger¹⁴.

Rector, *et al.*, provide a clearer picture of the overall hunger problem nationwide¹⁵. They summarize what is known about nutrition and stature of poor children, and the results are far less alarming than the USDA study -- “...the average nutrient consumption among the poor closely resembles that of the upper-middle class¹⁶.” While they do not break down their analysis state-by-state, there is no reason to believe that New Mexico’s incidence of hungry children is nearly as severe as USDA statistics might lead us to believe.

Empirical evidence on purchases of groceries supplied by the legislation’s supporters further undermines their case that a serious hunger problem exists in New Mexico. We see from their own data that the marginal propensity to consume more food out of more dollars of income decreases as income increases. When income increases from \$3,750 per year to \$7,500 per year the poor tend to spend 11.3 cents of every extra dollar of income for food. But when income increases from \$7,500 to \$12,500 per year they reduce their extra expenditure on food to 4.3 cents for each extra dollar of income. Evidently the poor tend to have more pressing needs than additional food – other necessities such as clothing, housing, transportation and so forth.

¹³ United States Department of Agriculture, “Prevalence of Food Insecurity and Hunger, by State; 1996-1998,” September 1999 as updated by “Household Food Security in the United States, 1999,” September 2000. Both studies may be found on the USDA web site: www.ers.usda.gov/publications/fanrr2/ and www.ers.usda.gov/publications/fanrr3/

¹⁴ United States Department of Agriculture, “Household Food Security in the United States, 1999,” September 2000, p.8.

¹⁵ Rector, Robert E., Kirk A. Johnson and Sarah E. Youssef, “the Extent of Material Hardship and Poverty in the United States,” *Review of Social Economy*, Vol. LVII, no. 3, Sept. 1999, pp.351-87.

¹⁶ *Ibid.* p. 366,

Furthermore, the legislation's supporters only cite the proportion of income spent on groceries; they cite no evidence of malnutrition.

Undoubtedly some folks in New Mexico are hungry, including children. But how serious is the situation really? After all, we are not Somalia. Where is the evidence of malnourished children in New Mexico? There probably are a few, but who seriously can believe that ending the tax on groceries is going to help them? I am no expert on hunger, but I conjecture that the problem for these few is probably much more deep-seated than the tax on groceries (for example, irresponsible parents). And if my conjecture is correct, there arises a whole host of sensitive issues for public policy that are beyond the scope of this paper.

Moreover, several programs already exist to help those actually in danger of becoming hungry: food stamps, school lunch, and emergency food assistance. In addition, there are programs to provide cash assistance to the poor.

EXISTING TRANSFERS TO THE POOR

When policy makers consider more help for the poor, it is well that they keep in mind the existing programs that are supposedly designed to provide that help. Many federal, state and local programs exist to transfer money or in-kind goods to the poor. The common element of these programs is that recipients must qualify for the transfers based on an income test. Here is a summary of the main programs

Food Stamps and Other Food Assistance

Food stamps exist to help the poor buy food. Food stamps are not subject to the Gross Receipts Tax. There seems to be some worry that not all who qualify are taking advantage of the transfer. I am quite skeptical of that claim; but even if it is true it does not justify the tax policy change for groceries. If food stamps' access is a problem, then document the problem and find a solution. In addition to food stamps, more direct food help is available from the government via the school lunch program and emergency food assistance program.

Other Transfers Designed to Help the Poor

Other major programs designed to help the poor in New Mexico are outlined in the following box. They are summarized here to give the reader a sense of the overall scope of the safety net for the poor.

SUMMARY OF OTHER TRANSFERS DESIGNED TO HELP THE POOR IN NEW MEXICO

Low Income Comprehensive Tax Rebate Program

This is a money transfer (in the form of a tax rebate) to those filing income tax returns that qualify based on income. It is designed to help the poor make ends meet. In that regard it helps all poor offset the money they had to fork over for Gross Receipts Tax on food and other goods and services. And it helps to give some progressivity to the Gross Receipts Tax.

New Mexico Works

This is a money transfer to those in need under the federal Temporary Assistance to Needy Families (TANF) program. The Income Support Division of the New Mexico Human Services Department administers the program.

General Assistance

This is a money transfer to those in need who do not qualify for the New Mexico Works program. The Income Support Division of the New Mexico Human Services Department administers this state program.

Energy Assistance

Three programs are designed to help the poor with their heating bills: Low Income Home Energy Assistance Program (federal), Emergency Crisis Intervention Assistance Program (federal) and Low Income Utility Assistance Program (state). The Income Support Division of the New Mexico Human Services Department administers these programs.

Medicaid

Medicaid is a combined federal and state program to provide medical care for the poor. It is administered by the Medical Assistance Division of the state Human Services Department. Applications for assistance are made through the Income Support Division. The Medicaid program is complex, containing 39 different categories of persons eligible to obtain medical care. The size and scope of this program were controversial issues during the recently concluded legislative session.

Earned Income Tax Credit

The Earned Income Tax Credit is a federal program designed to encourage work by providing an income tax credit at the lowest levels of income earned. It encourages work by subsidizing incomes from zero to roughly 13 thousand dollars for a family of four. It does so by providing a tax credit for each dollar earned until the threshold is reached. Beyond the maximum threshold, however, the program greatly discourages work as the credit is gradually reduced for each dollar earned; it effectively increases the income tax rate by 20 percent until the credit is reduced to zero at roughly 33 thousand dollars of earned income.

Housing Subsidies for the Poor

The U.S. Department of Housing and Urban Development funds federal housing assistance for low-income families. Public housing for the poor is owned and operated by public housing authorities. Rent subsidies are provided also to tenants in privately owned rental units.

New Mexico encourages construction and purchase of low-income housing units through what is known as the "Low Income Housing Tax Credit." It provides federal tax credits over a 10-year period for qualifying projects. The non-profit, state-authorized New Mexico Mortgage Finance Authority determines eligibility criteria.

EFFECT OF PROPOSED BILLS ON NEW MEXICO’S TAX REVENUES

Revenue estimates from the proposed 60-cents-per-pack tax increase on cigarettes are grossly overstated should Bill#1 become law. Rather than being among the lowest as is the case now, New Mexico would have by far the highest tax on cigarettes among our neighboring states. That means people would change their behavior. Some consumers from neighboring states who now buy cigarettes in New Mexico would switch purchases to their own or some other state. Likewise, some in New Mexico who now buy cigarettes in New Mexico would switch to other states. Or, they would increase their purchase of tax-free cigarettes on Indian land in New Mexico.

According to estimates contained in an interstate econometric study by Professor Richard Vedder of Ohio University, the quantity of taxed cigarettes purchased in New Mexico would decline sufficiently to offset much of the tax increase, resulting in an increase of only \$14.8 million in cigarette tax revenue¹⁷ (compared to the \$50.4 million estimate). Professor Vedder’s study explained interstate differences in taxed cigarettes purchased per capita by the amount of the tax in each state, per capita income in each state, the percentage of each state’s population bordering competing tax jurisdictions (it is easier to purchase cigarettes from another jurisdiction when you live near the border) and the presence or absence of Indian land in the state (it is easier to purchase untaxed cigarettes when Indian land is nearby). Table I presents the cigarette excise tax structure among regional jurisdictions should Bill#1 become law.

Table I: Cigarette Tax after Ending Tax on Groceries and Increasing Cigarette Tax in New Mexico by 60 Cents per Pack

Taxing Jurisdiction	Cigarette Tax (cents per pack)
New Mexico	81 (compared to 21 before tax increase)
Arizona	58
Colorado	20
Oklahoma	23
Texas	41
Utah	51.5
Indian land	None

The alternative Bill#2 would replace revenue lost from the tax on groceries with an increase of 25 cents per pack of cigarettes and an increase in the overall statewide Gross Receipts Tax on all other goods and services by 0.25 percent. Interestingly, the cigarette tax increase would bring in

¹⁷ Vedder, Richard K., “Bordering on Chaos: Fiscal Federalism and Excise Taxes,” in *Taxing Choice: the Predatory Politics of Fiscal Discrimination*, Independent Institute, 1997, pp. 271-85. Using Vedder’s estimates I conclude that the 60-cent increase in tax would reduce cigarette purchases subject to tax in New Mexico tax by 55.4 percent. The estimates contained in Professor Vedder’s study were statistically robust. His estimate for the effect of changes in the excise tax was -0.63, meaning that each one-cent increase in the excise tax would reduce per capita purchases of the state’s taxed cigarettes by 0.63 packs (page 279). If Bill#1 is to remain “revenue neutral” it would necessitate other tax increases.

revenue estimated to be \$14.1 million¹⁸ (only \$0.7 million less than the 60-cents-per-pack tax increase).

This alternative proposal would also do much more harm than good. The 25-cents-per-pack tax increase would fall differentially on the poor once again. The main problem with increasing the Gross Receipts Tax by 0.25% is the loss of jobs. The economic loss of the Gross Receipts Tax tends to increase at an increasing rate, and even more so because services are (for the most part) not taxed in other states¹⁹.

EFFECTIVENESS OF SIN TAXES

Sin taxes generally do not work very well. The commodity taxed usually is not consumed a great deal less as a result of a tax increase. Taxing the commodity itself does not directly get at the sin that it is trying to reduce. Taxing the sin itself would be much more effective. Taxing the direct cause of the harm is a widely accepted principle of public finance.

Sin Taxes as a Way to Reduce Youth Consumption of Cigarettes and Alcohol

Cigarettes are smoked by a wide range of consumers – young, old, men, women, poor, and not-so-poor. We tax them all by an increased excise tax. But we would do little to get directly at the perceived problem – the reduction in youth smoking would be small. While it may not be practical to tax youthful smokers (smoking by minors is already illegal), increasing penalties on parents for their minor’s use of cigarettes would be much more effective. We could implement other forms of taxation such as increased fines for consumption of cigarettes by minors, although I think this is a parental responsibility and not an issue for the rest of us since it does not impose harm on others.

Similar comments apply to irresponsible alcohol consumption. Taxes are an ineffective way to get at those problems. Problems of youth consumption and safety are better dealt with directly. The problem of youth consumption of alcohol may have more relevance as a public policy issue than youth consumption of cigarettes, since it sometimes imposes harm on others because of impaired judgment under the influence of excessive alcohol.

Perhaps the real agenda of the two bills is to use the tax code for social engineering. If that is the case, then it seems to me that the harms imposed on third parties by tobacco and alcohol use by our youth should occupy center stage in the public policy debate about these two bills. Exactly what is the magnitude of the third party harms that should make this an issue for government rather than parents?

¹⁸ Vedder, *op. cit.* As with Bill#1 revenue resulting from the tax increase on cigarettes is vastly overestimated. Therefore other taxes would have to be increased if the bill is to remain “revenue neutral.”

¹⁹ Messenheimer, *op. cit.* pp. 18-20. And the reader is reminded that more tax increase would be necessary if the legislation is to remain “revenue neutral.”

Reducing Health Care Costs by Use of Sin Taxes: A Bogus Argument

Professor W. Kip Viscusi of Harvard University has studied the health care cost related effects of smoking state-by-state²⁰. His findings are quite remarkable and contrary to the public perception of those costs:

The striking economic result is that cigarettes are self-financing when viewed from a variety of insurance cost perspectives. Nursing home cost savings from smokers' early mortality typically exceeded the increase in medical costs. Similarly, pension cost savings associated with smokers' premature mortality exceed the increase in medical costs.

The bottom line for public policy is this: increasing the tax on cigarettes will not reduce health care costs. The existing excise tax is already "self-financing" in an insurance sense. In other words, the existing tax on cigarettes can be thought of as an insurance premium that more than offsets the cost to society of smokers' higher near term health care costs. The results apply specifically to New Mexico (page 604²¹). The reader should be equally skeptical of claims about other sin taxes.

WHAT WILL HELP THE POOR?

New Mexico is a poor state compared to others, falling near the bottom of most rankings. Moreover, the past 15 to 20 years have seen New Mexico record the slowest growth of per capita income in the lower 48 states. Bills such as those ending the tax on groceries come out with great fanfare, claiming that we are doing something to help our poor and make life better. Yet we are not addressing the real problem and, in fact, we would only make matters worse. Too much government interference (in the form of high taxes, regulation and disincentives to work) is the problem. What we need is real tax, regulatory and welfare reform. If we want to join those states with higher growth rates, we need more economic freedom in the form of lower tax rates, smaller government and less regulation. Ending the tax on groceries would at least be a small step in that direction *as long as no other taxes are increased*.

²⁰ Viscusi, W. Kip., "The Governmental Composition of the Insurance Cost of Smoking," *Journal of Law and Economics*, vol. XLII, no. 2, October 1999, pp. 575-609.

²¹ *Ibid.*