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Tax Policy Briefing: Why Does New Mexico's Economy Underperform Compared To Its Neighbors?

"It's your taxes. They're the highest in the region and everyone knows it¹."

Governor Bill Owens of Colorado

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September 24, 2002

¹ On July 31, 2002 we asked Gov. Bill Owens of Colorado what he thought was the main factor in New Mexico's lagging economy. He replied without hesitation.

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Introduction

Taxes are being featured prominently in this year's gubernatorial campaign. While *promising lower taxes* for New Mexico, major party candidates appear to be taking positions that outdo one another. What wonderful news!

New Mexico needs lower taxes. We have an anemic economy, and high taxes are one of the main reasons. This study begins by documenting just how anemic our economy is. Then we present evidence that too much government interference in the economy, including too high taxes, is the reason for our malaise.

Next we go to discussion of specific taxes and their harms. New Mexico is compared to other states, with emphasis on the region, for each of the major tax bases. In this section we also discuss the harm imposed by the somewhat disguised tax on welfare recipients.

Finally, in the context of interstate comparison of tax harms, we discuss specific tax reduction proposals and estimate their effects on job creation, wealth creation and tax revenues. Also, in the context of recommended reform we assess specific proposals to exempt groceries and medical services from the gross receipts tax, lower the capital gains tax and lower the corporate income tax.

How Anemic Is New Mexico's Economy?

The growth of per capita income over the past 15 years and median income over 20 years paint a dismal picture of our economy. Look first at per capita income:

15-Year Growth Picture Using Per Capita Income

As a consequence of its differentially high tax rates and excessive regulation and government spending compared to other states², New Mexico has underperformed the lower 48 states in growth of one important indicator of economic health: *per capita income*. Over the past 15 years (1986-2001) we have fallen behind the U.S. average by 25.4 percent. That means we have grown at an annual average rate of 1.5 percent *less than* the nation as a whole. In 1986 the U.S. average for per capita income was 14.0 percent higher than NM. In 2001 it is 39.4 percent higher than New Mexico. Had New Mexico grown at the same rate as the national average our average income would be \$6000 per person higher today (\$29,600 versus \$23,600) as of 2001!

Our comparatively slow rate of growth means we are being caught by states usually considered poor. Mississippi, which has long been last in annual per capita income rankings, was 17.6 percent behind us in 1986. Today Mississippi is only 0.9 percent behind us. Our average annual income would be \$3,700 per person higher today had we grown as fast as Mississippi over the past 15 years. Alabama, a state that had roughly the same per capita income as NM in 1986, has outpaced us by \$1,900 per person.

²Evidence supporting this assertion is documented below.

As shown in Table 1, we do not fare any better over the past 15 years when compared to states in our region:

Table 1

Where NM's *per capita income* would be in 2001 had we kept pace with each of these states in our region:

If we had kept pace with AZ	Our income would be \$ 1,698 higher
If we had kept pace with CO	Our income would be \$ 5,448 higher
If we had kept pace with OK	Our income would be \$ 637 higher
If we had kept pace with TX	Our income would be \$ 3,561 higher
If we had kept pace with UT	Our income would be \$ 3,514 higher

20-Year Growth Picture Using Median Income

There is yet another income measure that is an appealing proxy for economic health. That measure is *median income*. The reason that median income is appealing is that it better reflects economic activity in the private sector. And it is the private sector that generates economic health.

The reason median income better reflects private sector economic activity is that it is robust to unknown influence of data points at each end of the income distribution.³ For per capita income measures discussed above, New Mexico is under the unknown influence of such extreme data points. At the high end of the income distribution we see a comparatively large number of Ph.D.'s who are employed by government or quasi-government organizations. At the low end of the income distribution we see a comparatively large number of poor native-Americans who (unfortunately) are largely subject to the lesser economic freedom on Indian reservations. Because these extreme data points have very little influence on median income, the median income measure is more likely (than per capita income) to capture what is going on among firms and consumers in private economic activity.

Data are readily available from the Census Bureau for *median income for 4-person families* from 1979 to 1999. Since the data are for 4-person families only, the reader is cautioned that they are not directly comparable to the per capita income results summarized above. Looking first at state rankings for 1999 in Table 2 below, we see that New Mexico is next to last among the lower 48 states, and it is worst in the region. New Mexico and regional states are highlighted in the table for ease of comparison.

³ The importance of using robust measures of central tendencies in the presence of potentially influential "outliers," specifically the median, is emphasized in Mosteller and Tukey (1977).

Table 2: Ranking of Lower 48 States by Median Income for 4-person families in FY 1999 (low to high)

Arkansas	\$ 36,828	Vermont	\$ 49,401
New Mexico	\$ 38,143	Missouri	\$ 50,015
Mississippi	\$ 38,748	Nevada	\$ 50,946
West Virginia	\$ 41,293	United States	\$ 51,518
Montana	\$ 41,462	Ohio	\$ 51,835
Louisiana	\$ 41,851	New York	\$ 52,799
Oklahoma	\$ 43,138	Indiana	\$ 52,962
Idaho	\$ 44,133	Wisconsin	\$ 52,986
Florida	\$ 44,829	Washington	\$ 53,153
Alabama	\$ 44,897	Virginia	\$ 53,394
Kentucky	\$ 44,932	Colorado	\$ 53,632
Arizona	\$ 45,032	California	\$ 53,807
South Dakota	\$ 45,043	Pennsylvania	\$ 53,814
Tennessee	\$ 45,245	Rhode Island	\$ 53,967
North Dakota	\$ 45,480	Illinois	\$ 55,372
Utah	\$ 45,775	Michigan	\$ 56,174
Oregon	\$ 46,245	Minnesota	\$ 56,200
Nebraska	\$ 46,726	New Hampshire	\$ 56,497
Texas	\$ 46,757	Delaware	\$ 56,662
Wyoming	\$ 46,830	Maryland	\$ 61,860
South Carolina	\$ 46,973	Massachusetts	\$ 62,385
Iowa	\$ 48,167	New Jersey	\$ 65,586
Maine	\$ 48,632	Connecticut	\$ 67,380
Georgia	\$ 48,920		
Kansas	\$ 49,034		
North Carolina	\$ 49,272		

Worse yet, New Mexico is last among the lower 48 when we look at the growth of median income over the last 20 years (see **Table 3** below). Again, New Mexico and regional states are highlighted in the table for ease of comparison, and the reader can visually see how New Mexico stacks up relative to states in the region. *When ranked against the lower 48 states by this indicator, New Mexico's economic health is poor and getting poorer.*

Where would New Mexico be had it kept pace with the region and nation during the period 1979 to 1999? If we had kept pace with the region, then median income of 4-person families in New Mexico would be \$6,594 higher in today's dollars. If we had kept pace with the nation, then median income of 4-person families in New Mexico would be \$14,989 higher in today's dollars.

Table 3: Ranking of 20-year growth of median income for 4-person families (1979-1999) in lower 48 states (low to high)

New Mexico	146%	Ohio	196%
Wyoming	157%	Virginia	197%
Oregon	160%	United States	198%
Arizona	163%	Kentucky	200%
West Virginia	165%	Michigan	202%
Montana	167%	Tennessee	204%
Texas	168%	South Carolina	205%
Arkansas	169%	Indiana	206%
Louisiana	173%	New York	207%
Utah	175%	Nebraska	207%
Florida	175%	Missouri	209%
Idaho	176%	Georgia	210%
Oklahoma	176%	Minnesota	213%
Nevada	179%	Pennsylvania	216%
California	184%	Rhode Island	218%
Iowa	185%	Vermont	218%
Illinois	186%	Maryland	220%
Mississippi	188%	North Carolina	224%
Washington	190%	South Dakota	229%
Kansas	191%	New Jersey	230%
Alabama	193%	New Hampshire	234%
Colorado	194%	Delaware	236%
North Dakota	194%	Maine	237%
Wisconsin	196%	Massachusetts	250%
		Connecticut	259%

Conclusion: We have looked at two income indicators of the economic health of New Mexico. They tell a dismal story⁴. New Mexico is in poor economic health whether we use recent per capita income comparisons, per capita income growth comparisons, median income comparisons or median income growth comparisons. New Mexico is nearly the poorest state in the nation; it is the poorest in the region; and it is falling farther and farther behind.

20-year Empirical Evidence that Economic Freedom, Including Lower Taxes, Matters:

While this is a study of taxes, taxes are but one component of restraints on economic activity. Others are excessive regulation and litigation⁵. The goal of this section is to test empirically the link between prosperity and economic freedom. Ideally, we would have data for economic freedom and data for prosperity for all states, and we would conduct a cross-section econometric test of the link. In other words, we would expect to find statistical evidence that increased economic freedom leads to increased prosperity when making interstate comparisons of their differences. Practically, however, the problem is much more difficult.

Some of the stark contrasts we see internationally⁶ are not present when it comes to demonstrating the link between economic freedom and prosperity across states in the United States. Margins of difference in taxes, regulation, litigation and welfare spending are much smaller state-to-state. Moreover, the bewildering array of differing tax rates and bases, regulations and their enforcement, litigation practices, and welfare spending criteria substantially reduce the “degrees of freedom” available to the economist in search of the empirical link.

Fortunately there is a good way around the difficulty. While we do not have detailed data for economic freedom, we can find a good estimate of its converse: economic coercion (where higher taxes indicate more coercion). Increased economic coercion reduces economic freedom, and if our theory is correct, we should find statistical evidence linking high coercion to low prosperity.

Gross state product (GSP) is a good measure of resources forgone in each sector of the economy. Private sector resources are forgone as a cost of providing resources to state and local governments. The more resources forgone by the private sector, the greater are the constraints on economic freedom and the greater is economic coercion. Can we find a variable that gives a clear picture of the relative resources forgone, state-by-state, by the private sector to provide for the government sector? Yes, economic coercion is estimated to be the proportion of total state and local government GSP per year relative to the total quantity of state and local government GSP

⁴ Internal domestic migration (where people within the U.S. decide to live over time) is not quite so dismal an indicator. While NM’s internal domestic migration does not measure up well relative to states in our region, we do better compared to all states. The reason may be that our delightful climate and scenery attracts retirees.

⁵ Also, quality and quantity of government services actually produced affect economic activity. An example is the quality of K-12 education.

⁶ The link seems quite clear (without the aid of econometrics) when we see the stark contrasts between culturally 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 similar counterpart.

per year plus private GSP per year. And data are readily available for state and local government GSP and private sector GSP as well as federal government GSP.

Two regressions were run using data for the lower 48 states over the period 1977 to 1997. The first tests the 20-year growth of median income of 4-person families (one measure of prosperity) as a function of total state and local government GSP per year relative to the total quantity of state and local government GSP per year plus private GSP per year (our measure of economic coercion). The second tests the 20-year growth of per capita income as a function of the same variable for economic coercion. Both regressions showed strong evidence that economic coercion reduces prosperity as predicted.

The findings can 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*⁷.

The regressions also test for the possible effect of federal government activity on state prosperity. No effect is found. The regressions actually lose explanatory power when the effect of the federal government is included⁸, although state policy influence on prosperity is unaffected.

These results suggest that New Mexico's economic health would improve markedly if its economic freedom increased markedly. This obviously begs the questions of exactly how to increase economic freedom: Which taxes to lower? Which regulations to eliminate or modify? Which constitutional rules to change? The purpose of inquiry here is to suggest which taxes to lower. To that end we need to understand exactly how taxes cause economic harm.

Tax Policy Indicators

The purpose of this section is to introduce the reader to the harm caused by taxes and compare New Mexico to other states with respect to that harm.

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. Let's take a brief look at the basics of taxation: In order to collect tax revenue the government must tax something. Each something taxed (be it income, property, goods or services) results in a wedge being driven between the 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 that is stifled because of the tax is the economic harm caused. We see the harm show up as reduced economic activity. That harm shows up as New Mexico's anemic job and income growth.

⁷ 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.

⁸ Adjusted R² falls when the federal effect is included.

Even worse, this harm increases exponentially as tax rates increase, particularly when people have untaxed or lower-taxed alternatives from which to choose outside New Mexico. *They can often mitigate the local effects of the tax wedge by taking advantage of those alternatives.* 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 undergo tax harm in the first place. Unfortunately, we do not seem to get comparatively good government services in New Mexico⁹

New Mexico's High Taxes 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 quite difficult. Nevertheless, we can finesse our way around that difficulty to make reasonable interstate comparisons. Then we shall see that New Mexico's flawed tax policy may be causing differential harm to its economy. Take a look at the evidence:

Figure 1 below compares 1998 total state and local taxes collected per \$1,000 of income among states in our region and the national average. By measuring taxes as a percent of income, we get a good first-cut estimate of ability-to-pay tax: the lower the estimate, the greater the ability-to-pay. Notice that New Mexico's citizens are less able to pay their tax. State government in Santa Fe and local jurisdictions throughout the state confiscate a higher percentage of income than do competing state and local jurisdictions (over \$10 more per thousand dollars of income on average).

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 issue papers and find *New Mexico 2000: a Study of its Policies and Economic Health*. Much of the data presented herein is derived from that study.

1998 State and Local Taxes per \$1,000 of Income

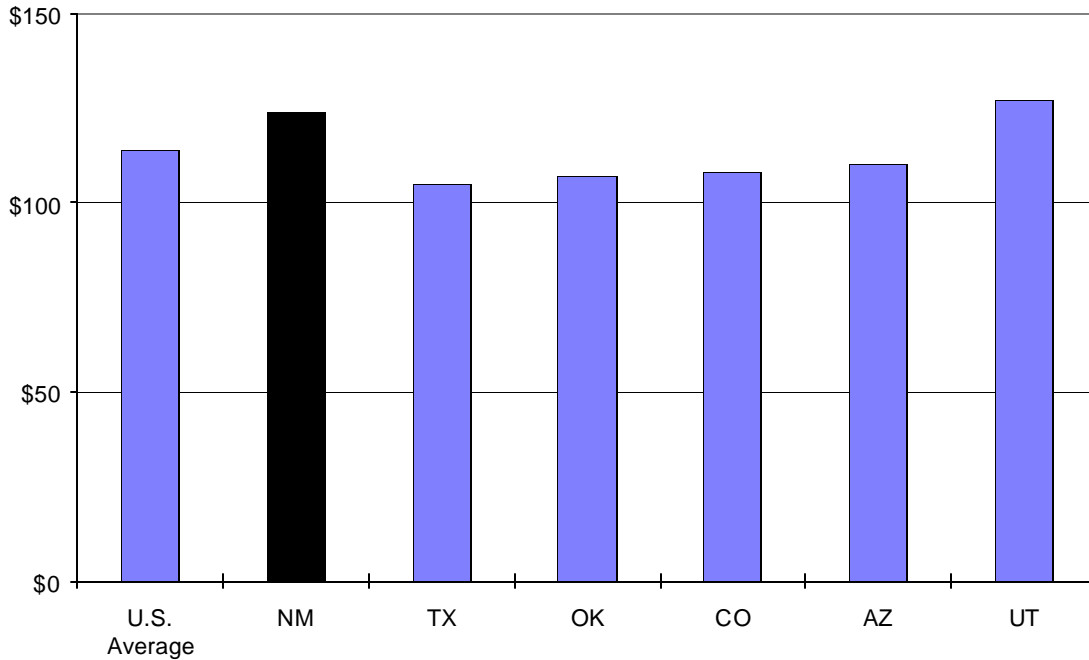


Figure 1: Comparison of state and local taxes collected per \$1000 of income¹⁰

It is enlightening to break down these totals into their important component parts, so that we may see what is doing the most damage. The four major sources of tax revenue for state and local jurisdictions are sales and gross receipts taxes (GRT), individual income taxes, corporate 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 per \$1,000 of income from each source)¹¹.

¹⁰ Source: Moody (1999).

¹¹ Source: Bureau of Economic Analysis, 1995 data.

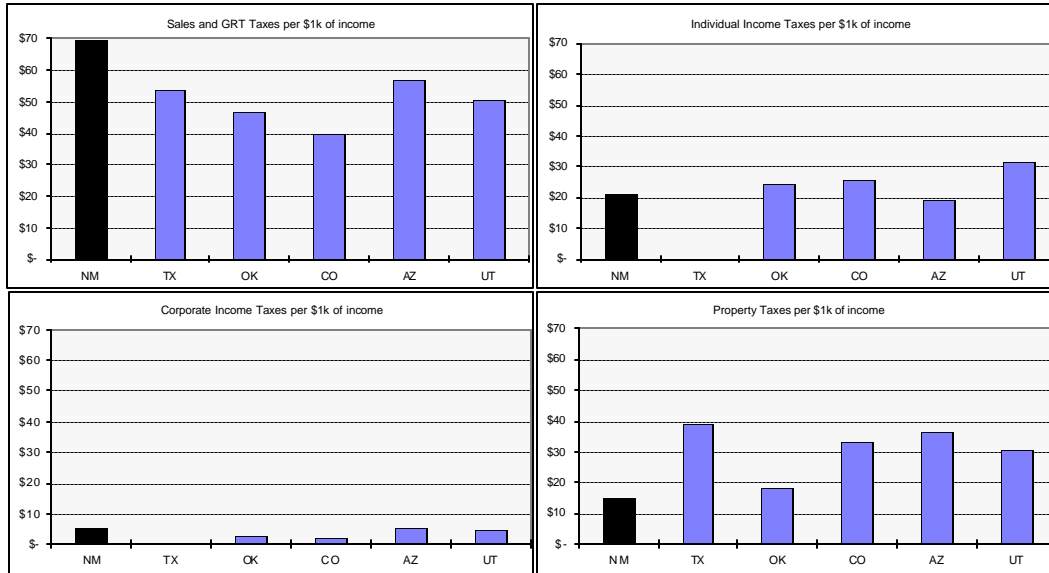


Figure 2: 1995 Interstate comparisons of important tax bases by revenue collected per \$1000 of income

The components are pictured to scale, so that you may readily compare the relative revenue shares of each. Notice the following from Figure 2:

- Sales and GRT constitute the largest source of tax revenue, and New Mexico taxes much more heavily than competing states as a percentage of income (see upper left panel).
- New Mexico collects slightly more than the average amount of revenue as a percentage of income from the individual income tax (see upper right panel).
- New Mexico collects above average revenue as a percentage of income from the corporate income tax. The corporate income tax is the smallest revenue source among the four major sources displayed (see lower left panel). Texas has no corporate income tax as such, but it has a franchise fee that is essentially the same thing, collecting about four and one-half percent of corporate earnings.
- New Mexico collects *far less* than average as a percentage of income from the property tax (see lower right panel). The property tax is a little larger revenue source in the region than is the individual income tax (mainly because Texas has no income tax).

The bottom line: *New Mexico's adverse position in ability-to-pay taxes from GRT, individual income tax and corporate income tax far outweighs its advantage from property taxes.*

Critics will correctly point out that the average ability-to-pay taxes out of income does not tell all about New Mexico's adverse position. People adjust at the margin, and in that regard

the averages displayed above may be somewhat misleading. **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 away is somewhat subtle and imperceptible since firms and people make such choices individually. But one clearly visible example is tax effects causing an exodus of medical doctors. Doctors must pay the gross receipts tax on all receipts, including those that cover expenses of 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 15 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 22 percent of her income! Is it any wonder that doctors are leaving New Mexico?

The effects of that adjustment process may be seen by comparisons of revenue actually collected in the presence of higher tax rates¹². If this seems confusing, Figure 3 should help clarify by example for comparisons of sales and gross receipts taxes in the region. The GRT in New Mexico is in essence two taxes: a tax on services and a tax on goods. The top two panels of Figure 3 display alternative **tax rates** among states in the region for the sales and gross receipts taxes for these two categories. New Mexico taxes services, and other states do not; so, the relevant tax rate shown in the upper left panel is 5% for New Mexico and **zero** for all others. This is the main source of tax harm done to New Mexico: *Businesses and consumers have alternatives in other states where services are not taxed! Many will adjust away from New Mexico as a result.*

¹² Sales and GRT across states differ by categories of goods that are exempt. I have made no effort to sort out these minutiae. Also, I have not attempted to account for local jurisdictions' add-ons to the statewide rates shown. Even so, this comparison is much closer to making an apples-to-apples approach than you will usually see in legislative tax reports from Santa Fe.

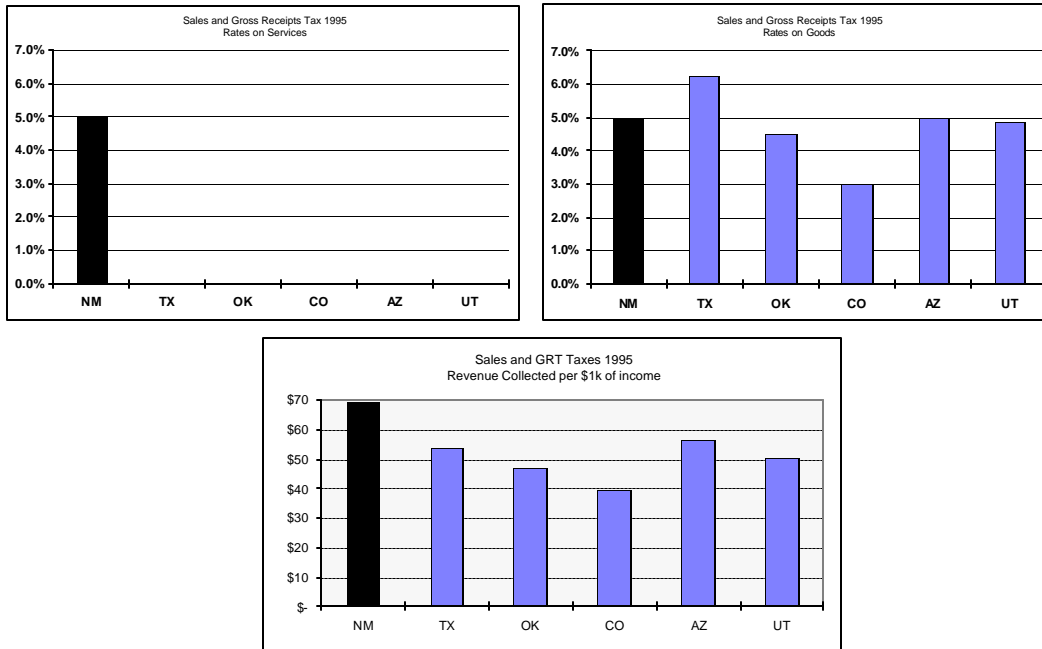


Figure 3: Regional comparison of tax rates and revenue collected for sales and gross receipts taxes: 1995

New Mexico and the other states tax goods¹³, so the relevant tax rate shown in the upper right panel is 5% for New Mexico and ranges from **3 to 6.2%** for the others. New Mexico taxes goods at a rate a little above average for the region. Texas 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 the state-wide-tax on goods (6.2% to 5%), but New Mexico far exceeds Texas for the tax on services (5% to **zero**).

Now look at the lower panel in Figure 3 to see the revenue results of these taxes on services and goods. New Mexico collects about 38% more revenue as a percentage of income, *even though its taxation of services increases the tax base by some 80% compared to other states*. The amount of revenue generated is nowhere near in proportion to the larger tax base in New Mexico. We see evidence (based on revenue actually collected) of big adjustments *away* from New Mexico. These adjustments result from New Mexico's grossly higher tax rate on services and slightly higher tax rate on goods. Trade is stifled in New Mexico as a result of the GRT, and that is an important reason for our anemic economy.

Now take a look at the **individual income tax**. The upper panel in Figure 4 displays top tax rates on individual income among states in the region. Notice who is highest: New Mexico. Does New Mexico collect more revenue as a result of having the highest tax rate? No. Look at

¹³ 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 provides for an income tax credit for food taxes paid.

the lower panel to compare revenue collections as a percent of income¹⁴. Among states that have an income tax (Texas does not), only Arizona collects less revenue than New Mexico. This is further evidence that margins matter: This is the source of the tax harm to New Mexico: *Employers and employees have alternatives in other states where income is taxed less! Many will adjust away from New Mexico as a result.* Trade is stifled in New Mexico between employers and employees as a result of the individual income tax, and that is another important reason for our anemic economy.

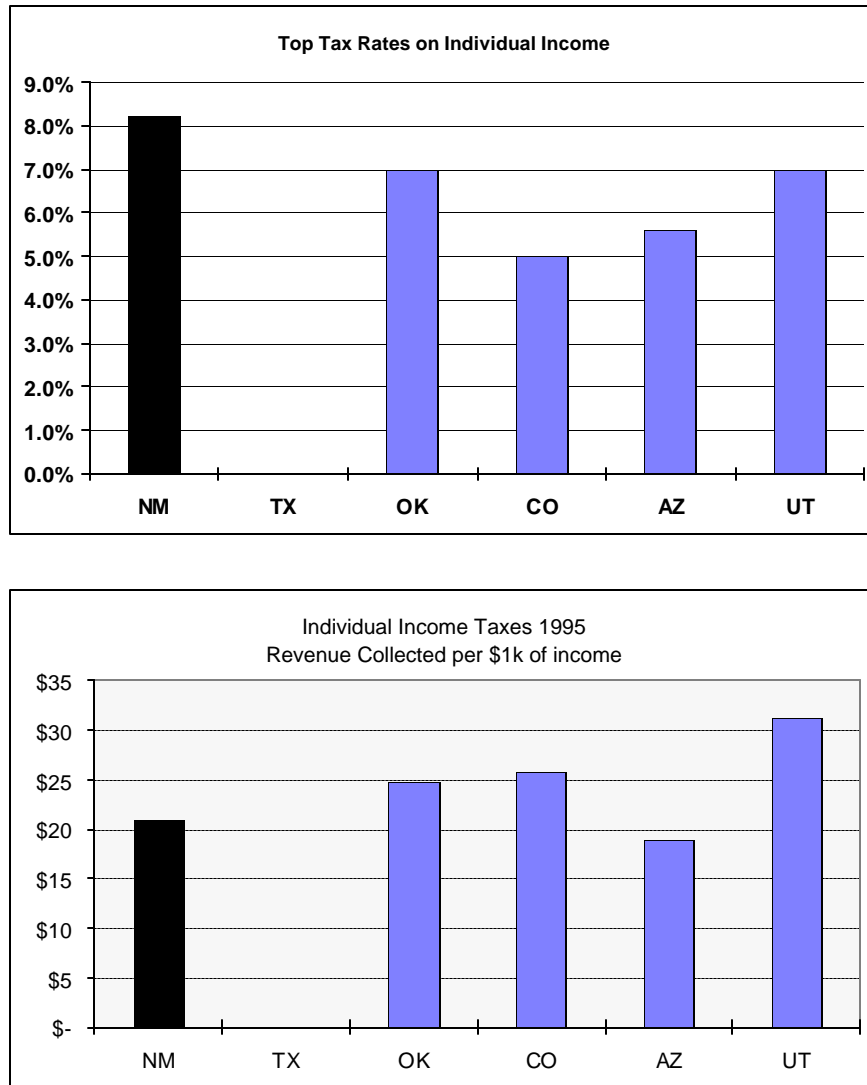


Figure 4: Regional comparison of income tax margins and revenue collected: 1995

¹⁴ The number and placement of lower tax brackets (not shown) will affect revenue estimates. These effects may be important, but it is the highest rate that goes farthest in stifling economic activity.

Table 4 below summarizes New Mexico’s comparative position for sales and gross receipts tax and income tax margins in 2002:

Table 4

Sales/GRT and Individual Income Tax Rates

	Tax on Goods	Tax on Services	Top Rate on Individual Income
New Mexico	5.00%	5.00%	8.20%
Texas	6.25%	0.00%	0.00%
Oklahoma	4.50%	0.00%	7.00%
Colorado	2.90%	0.00%	4.63%
Utah	4.75%	0.00%	7.00%
Arizona	5.60%	0.00%	5.04%

Source: *Tax Foundation 2002* (Statewide rates do not include add-ons by local jurisdictions.)

Transfers to the poor in kind or in cash (our welfare programs) also result in high marginal tax rates on the poor

This is a fact that is not well known. The more generous the welfare programs, the higher is the tax on the poor. There is no getting around this trade-off, and it needs to be kept in mind in reforming taxes. The intuition behind this tax on the poor is explained in Appendix A by way of numerical examples.

Summary of New Mexico’s Tax Policy

We have discussed the harmful effects of taxes in New Mexico relative to our neighbors and posited that dismal performance may be the consequence of the differentially high constraints on economic freedom compared to neighboring states. Differentially harmful effects are generated by tax rates that are higher on particular bases than our neighbors. Specifically, our tax on services (5% versus **zero** in neighboring states) and our differentially high tax on individual income (top rate 8.2% versus 0% to 7% in neighboring states) have caused New Mexico substantial harm. We see evidence of the harm in our anemic economic health and in comparative revenue generated by these taxes. So far we have not separated out estimates of the benefits of reducing particular taxes in New Mexico. Nor have we estimated the revenue effects of proposals to lower taxes. We next turn our attention to estimating these benefits and revenue effects.

Dynamic Estimates of the Benefits and Revenue Effects of Lowering Taxes and their Estimated Risk

Recognizing that particular reforms will not take place without more concrete estimates of their benefits and revenue effects, Rio Grande Foundation last year contracted with the Beacon Hill Institute in Boston to estimate those effects¹⁵.

The problem with estimating a model of the economy is that policy makers would like more precision than economists can possibly deliver. That being said, Beacon Hill did a superb job of formulating the model and gathering relevant data for New Mexico. It is unlikely much improvement could be made in either estimating technique or quality of estimates.

Due to a predetermined precision criterion¹⁶ Beacon Hill did not include estimated wage effects of tax policy changes in its policy simulations. That is the same as assuming wage effects of zero, even though the model's estimates indicated otherwise. The tax reform proposals assessed below relax the precision criterion, bringing the wage effects back into the assessment of each. Based *only* on statistical estimates derived from the Beacon Hill study there is substantial downside and upside potential associated with each one¹⁷. However, those estimates must be assessed in combination with other evidence and not looked at in isolation.

In large part, then, implementation of any of the proposed tax reform schemes will require that policy makers be persuaded by all of the evidence. They will need to be persuaded that more economic freedom works well in creating jobs and improving compensation. Dovetailing with other evidence contained herein as it does, such persuasion should be a slam-dunk.

The following three proposals are presented in order of priority we give them for implementation. The first implements tax reduction in one fell swoop. That is the best way to go from an economics standpoint. People will understand immediately that tax reduction is serious, and that New Mexico has a great economic environment.

Delaying tax cuts through phase-ins may even retard economic growth in the short term. When people think that tax cuts are coming, they often wait until incentives are more salubrious before they take economic risks. With this said, political considerations may make phase-ins necessary. Phase-ins will be most effective when market participants really believe that the phase-in plan will be fully carried out. In other words as long as they *know* that tax rates will

¹⁵ The study may be found on our website at www.riograndefoundation.org. If you would like a printed copy please contact Rio Grande Foundation, P.O. Box 2015, Tijeras, NM 87059.

¹⁶ The “statistical significance” criterion had to be less than 0.2 in order to be included in the simulation. Only the jobs’ effect estimation satisfied that criterion, and it was the basis for the estimates found in Beacon Hill’s tax reform scenarios.

¹⁷ Unfortunately, it is the possible downside that makes policy makers nervous. Indeed, economists’ inability to use statistics to provide precise estimates is one reason that big-government apologists are able to escape reality.

continue to go down, they will not be so inclined to wait until incentives improve. We offer the other two proposals with this in mind.

Keeping in mind our caveats about the precision of the statistical estimates, here are predictions of each proposal (assuming that tax reductions start in 2003):

Scenario A: Immediately lower the statewide gross receipts tax by one percentage point and lower the top rate on individual income to four percent.

- Predicted Benefits: **Jobs** gradually increase until there are 16 percent more jobs (138,000 more) by 2006. **Wages** gradually increase until they are 29 percent higher (average compensation increases by \$10,000 per year) by 2006. **Tax revenues received by local jurisdictions** are predicted to increase gradually over the four-year period until they are \$227 million higher relative to the baseline.
- Predicted Costs: **Tax revenue shortfalls** are 14 percent and 7 percent during the first two years (total for those two years of roughly \$873 million). Beyond that economic activity increases revenues so that roughly \$222 million is estimated to be available in the last year to offset the first two years' shortfalls.

Here is how New Mexico would compare to states in the region under Scenario A:

	Tax on Goods	Tax on Services	Top Rate on Individual Income
New Mexico	4.00%	4.00%	4.00%
Texas	6.25%	0.00%	0.00%
Oklahoma	4.50%	0.00%	7.00%
Colorado	2.90%	0.00%	5.00%
Utah	4.75%	0.00%	7.00%
Arizona	5.60%	0.00%	5.04%

Source: Tax Foundation 1996

The following table lays out the statistical estimates of Scenario A's costs and benefits in more detail.

Scenario A: Immediately lower the statewide gross receipts tax by one percentage point and lower the top rate on individual income to four percent:

	Current Rates	Proposed Rates			
		2003	2004	2005	2006
State GRT Rate	5.0%	4.00%	4.00%	4.00%	4.00%
Personal Income Tax					
< 8,000	1.7%	0.0%	0.0%	0.0%	0.0%
8,000 - 16,000	3.2%	2.0%	2.0%	2.0%	2.0%
16,000 - 24,000	4.7%	2.0%	2.0%	2.0%	2.0%
24,000 - 40,000	6.0%	4.0%	4.0%	4.0%	4.0%
40,000 - 64,000	7.1%	4.0%	4.0%	4.0%	4.0%
64,000 - 100,000	7.9%	4.0%	4.0%	4.0%	4.0%
> 100,000	8.2%	4.0%	4.0%	4.0%	4.0%

Predicted Change	-13.59%	-7.02%	-0.71%	5.47%
Predicted Change (Tax revenue, \$million)	(\$568)	(\$305)	(\$32)	\$257
Predicted Standard Error	7.03%	13.58%	19.71%	25.46%
Predicted Change in Local GRT revenue	12.16%	23.70%	34.72%	45.25%
Predicted Change in Local GRT revenue (Tax revenue, \$million)	\$53	\$109	\$166	\$227

Dynamic Effect on Jobs:

Predicted Change	4.16%	8.28%	12.34%	16.35%
Predicted Change (Number employed)	33,439	67,755	102,795	138,651
Predicted Standard Error	1.58%	3.15%	4.69%	6.22%

Dynamic Effect on Wages:

Predicted Change	9.64%	17.56%	24.05%	29.38%
Predicted Change (Wage rate, \$/person/year)	\$2,916	\$5,524	\$7,868	\$9,996
Predicted Standard Error	13.25%	24.12%	33.04%	40.36%

Numbers in parentheses are negative.

This proposal has the greatest impact on job creation and improved compensation. It also has the smallest predicted overall revenue impact, although revenue losses are greatest in the first two years.

Scenario B: Over four years lower the statewide gross receipts tax by one percentage point and lower the top rate on individual income to 3.8 percent.

- Predicted Benefits: **Jobs** gradually increase until there are 11 percent more jobs (89,800 more) by 2006. **Wages** gradually increase until they are 21 percent higher (average compensation increases by \$7,000 per year) by 2006. **Tax revenues received by local jurisdictions** are predicted to increase gradually over the four-year period until they are \$151 million higher relative to the baseline.
- Predicted Costs: **Tax revenue shortfalls** are 3.2 percent, 5.0 percent, 5.3 percent and 4.3 percent during the four-year phase-in (total for those four years of roughly \$795 million).

Here is how New Mexico would compare to states in the region when Scenario B is fully phased-in:

	Tax on Goods	Tax on Services	Top Rate on Individual Income
New Mexico	4.00%	4.00%	3.80%
Texas	6.25%	0.00%	0.00%
Oklahoma	4.50%	0.00%	7.00%
Colorado	3.00%	0.00%	5.00%
Utah	4.75%	0.00%	7.00%
Arizona	5.00%	0.00%	5.10%

Source: Tax Foundation 1998

The following table lays out the statistical estimates of Scenario B's costs and benefits in more detail.

Scenario B: Gradually over a 4-year period lower the statewide gross receipts tax rate to 4% and lower the top rate on individual income to 3.8%:

	Current Rates	Proposed Rates			
		2003	2004	2005	2006
State GRT Rate	5.0%	4.00%	4.00%	4.00%	4.00%
Personal Income Tax					
< 8,000	1.7%	1.2%	0.8%	0.4%	0.0%
8,000 - 16,000	3.2%	2.9%	2.6%	2.3%	2.0%
16,000 - 24,000	4.7%	4.1%	3.4%	2.7%	2.0%
24,000 - 40,000	6.0%	5.5%	4.9%	4.3%	3.8%
40,000 - 64,000	7.1%	6.3%	5.5%	4.6%	3.8%
64,000 - 100,000	7.9%	6.9%	5.8%	4.8%	3.8%
> 100,000	8.2%	7.1%	6.0%	4.9%	3.8%

Dynamic Effect on Revenues:

Predicted Change	-3.24%	-4.97%	-5.33%	-4.31%
Predicted Change (Tax revenue, \$million)	(\$135)	(\$216)	(\$241)	(\$203)
Predicted Standard Error	2.03%	5.67%	10.72%	16.92%
Predicted Change in Local GRT revenue	3.51%	10.02%	19.11%	30.22%
Predicted Change in Local GRT revenue (Tax revenue, \$million)	\$15	\$46	\$92	\$151

Dynamic Effect on Jobs:

Predicted Change	1.05%	3.17%	6.36%	10.59%
Predicted Change (Number employed)	8,440	25,940	52,980	89,805
Predicted Standard Error	0.40%	1.20%	2.42%	4.04%

Dynamic Effect on Wages:

Predicted Change	2.25%	6.59%	12.82%	20.66%
Predicted Change (Wage rate, \$/person/year)	\$681	\$2,073	\$4,194	\$7,029
Predicted Standard Error	3.23%	9.30%	17.86%	28.46%

Numbers in parentheses are negative

Notice that overall benefits are not as great as for Scenario A. One practical advantage of Scenario B is that revenue losses are predicted to be spread more evenly over the entire 4-year period.

Scenario C: Over four years lower the statewide gross receipts tax by one percentage point and lower the top rate on individual income to 4.5 percent.

- Predicted Benefits: **Jobs** gradually increase until there are 10 percent more jobs (84,700 more) by 2006. **Wages** gradually increase until they are 19 percent higher (average compensation increases by \$6,500 per year) by 2006. **Tax revenues received by local jurisdictions** are predicted to increase gradually over the four-year period until they are \$140 million higher relative to the baseline.
- Predicted Costs: **Tax revenue shortfalls** are 3.2 percent, 4.9 percent, 5.4 percent and 4.6 percent during the four-year phase-in (total for those four years of roughly \$802 million).

Here is how New Mexico would compare to states in the region when Scenario C is fully phased-in:

	Tax on Goods	Tax on Services	Top Rate on Individual Income
New Mexico	4.00%	4.00%	4.50%
Texas	6.25%	0.00%	0.00%
Oklahoma	4.50%	0.00%	7.00%
Colorado	3.00%	0.00%	5.00%
Utah	4.75%	0.00%	7.00%
Arizona	5.00%	0.00%	5.10%

Source: Tax Foundation 1998

The following table lays out the statistical estimates of Scenario C's costs and benefits in more detail.

Scenario C: Gradually over a 4-year period lower the statewide gross receipts tax rate to

	Current Rates	Proposed Rates			
		2003	2004	2005	2006
State GRT Rate	5.0%	4.75%	4.50%	4.25%	4.00%
Personal Income Tax					
< 8,000	1.7%	1.2%	0.8%	0.4%	0.0%
8,000 - 16,000	3.2%	2.9%	2.6%	2.3%	2.0%
16,000 - 24,000	4.7%	4.1%	3.4%	2.7%	2.0%
24,000 - 40,000	6.0%	5.5%	4.9%	4.3%	3.8%
40,000 - 64,000	7.1%	6.3%	5.5%	4.6%	3.8%
64,000 - 100,000	7.9%	7.0%	6.2%	5.4%	4.5%
> 100,000	8.2%	7.3%	6.4%	5.4%	4.5%

Dynamic Effect on Revenues:

Predicted Change	-3.15%	-4.85%	-5.39%	-4.57%
Predicted Change (Tax revenue, \$million)	(\$132)	(\$211)	(\$244)	(\$215)
Predicted Standard Error	1.89%	5.29%	10.02%	15.82%
Predicted Change in Local GRT revenue	3.28%	9.26%	17.68%	27.97%
Predicted Change in Local GRT revenue (Tax revenue, \$million)	\$14	\$42	\$85	\$140

Dynamic Effect on Jobs:

Predicted Change	0.99%	2.98%	5.99%	9.99%
Predicted Change (Number employed)	7,958	24,385	49,898	84,717
Predicted Standard Error	0.37%	1.12%	2.26%	3.78%

Dynamic Effect on Wages:

Predicted Change	2.09%	6.03%	11.77%	18.97%
Predicted Change (Wage rate, \$/person/year)	\$632	\$1,897	\$3,851	\$6,454
Predicted Standard Error	3.03%	8.66%	16.66%	26.54%

4% and lower the top rate on individual income to 4.5%:

Numbers in parentheses are negative

Notice that overall benefits are not as great as for Scenarios A and B. Like Scenario B a practical advantage of Scenario C is that estimated revenue losses are spread more evenly over the entire 4-year period. Revenue loss is predicted to be about the same under Scenario C as under Scenario B.

Tax Reductions Must be Credible

Whether tax reduction is accomplished in one fell swoop or phased-in it must be credible. Market participants must be comfortable that the risk of having the tax reduction rug pulled out from under them is minimal. Therefore, reduction must be passed with rules that make its undoing quite difficult. For example, Colorado has achieved success with its constitutional tax and spending limitations. Colorado's success is documented above in Table 1.

One way to make phase-in reductions credible is to require a supermajority of both houses of the legislature to overturn them. For example, the phase-ins could be combined with a rule that requires a 60% majority of both houses to undo them. Such a rule could be further offered as a constitutional amendment to additionally hinder the legislature from undoing tax reduction.

Other Tax Reduction Proposals in Context of Major Tax Reduction

Major tax reduction of the kind recommended above greatly reduces the need for some other reductions recently proposed. We round out our tax briefing with a discussion of how these other proposals fit into the big picture¹⁸. One recent proposal is to **eliminate the tax on groceries** purchased for home consumption¹⁹. Eliminating this tax will not be as effective in helping the poor as major tax reduction. It would do practically nothing to improve their nutrition or promote the kind of economic activity that leads to increases in income. This proposal should be considered in the event that major tax reduction is politically impossible.

Another proposal frequently mentioned is **eliminating the gross receipts tax on doctors**. Note that the kind of major tax reduction proposed above would effectively lower the tax rate on doctors' income by 6.5%. Rather than facing an effective rate of 22%, they would face a rate of 15.5%. This would amount to substantial tax reduction without having to single out one group for favored tax treatment. Absent major tax reduction we must give this proposal high priority, however. It would then become a quality-of-life issue because of shortages in medical services. In that case favored tax treatment for doctors may literally be the only way to stop the bleeding.

Capital gains tax reduction is another proposal often mentioned. In New Mexico capital gains are taxed as ordinary income. Since a large capital gains tax can be avoided by moving to a no/low tax jurisdiction, New Mexico tends to lose the economic activity and tax revenue generated by the kind of success that brings about large capital gains. The issue becomes much less significant, however, if we are able to accomplish major income tax reduction. Rather than

¹⁸ The Beacon Hill study was not able to tease out separate estimates of costs and benefits of these more narrowly targeted proposals.

¹⁹ See Messenheimer, Harry, *Lower Taxes Period: The Right Way to End the Food Tax*, Rio Grande Foundation, June 2002 for a complete analysis of this proposal in the context of "offsetting" increases in the cigarette tax.

being taxed at a rate of 8.2%, capital gains would be taxed at 4%. Absent major tax reduction we should give this proposal high priority, however.

Lastly, we often hear calls for **lowering the tax rate on corporate income**. New Mexico's top rate on corporate income is 7.6%, and, not surprisingly, it is the highest rate in the region. It should be reduced to something on the order of six percent to put New Mexico more on par with other states in the region. Since the corporate income tax is small as a revenue raiser, such a reduction would reduce state revenue by only one percent as a *static* estimate. Obviously there would be some unestimated dynamic offset to this estimate.

In Sum

In sum we have seen that New Mexico's economy performs much worse than the nation and region. One major contributing factor is our high taxes compared to other states. If we achieve major tax reduction as proposed above, New Mexico would become an economic environment to be envied for its job and income growth. No longer would we tend to be toward the top in everything bad and the bottom in everything good.

The **Rio Grande Foundation** is an independent, nonpartisan research and educational organization dedicated to the study of public policy. The Foundation promotes prosperity for New Mexico based on principles of limited government, economic freedom and individual responsibility. The Foundation neither seeks nor accepts government funding. It relies solely on the generosity of private individuals and institutions to fund its activities. Tax-deductible contributions may be mailed to Rio Grande Foundation, P.O. Box 2015, Tijeras, NM 87059.

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Appendix A 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 policy²⁰. 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 and one of an in-kind transfer are offered to illustrate the problem. The examples are for welfare transfers only; *they do not include personal income tax or 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 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.

²⁰ 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:

Income Guarantee	Income Earned	Transfer to the Poor person	Total Income	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 an offsetting 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:

Income Guarantee	Income Earned	Transfer to the Poor person	Total Income	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%

Earned income in example 2 of \$20,000 is where 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.

A third example occurs for some in-kind transfers like Medicaid, where the entire transferred benefit is taken away at some income threshold. Say the Medicaid recipient values the Medicaid insurance package at \$2,000 and it is taken away if the recipient earns more than \$10,000. In that case the tax rate on earned income schedule might look as follows:

Example 3:

Value of Medicaid Insurance	Income Earned	Transfer to the Poor person	Total Income	Tax Rate on Income Earned
2,000	0	2,000	2,000	
2,000	4,000	2,000	6,000	0%
2,000	8,000	2,000	10,000	0%
2,000	10,000	2,000	12,000	0%
0	12,000	0	12,000	100%

When the recipient loses her Medicaid benefit as income goes over \$10,000 her effective tax rate goes to 100% (higher if you consider earned income in smaller increments).

When you consider these 3 examples 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. But we cannot arrive at effectively designed policy for helping the poor until we consider the tax and transfer incentives together. That means not just looking at the tax on groceries or looking at Medicaid transfers in isolation. Whether our system is regressive or progressive depends on all the taxes and transfer programs that exist.

Moreover, actually helping the poor involves more than giving them increased transfers. It also involves their incentives to become responsible workers. And perhaps just as important it involves the incentives of those at the higher ends of the income distribution to work and pay taxes in New Mexico or go elsewhere. The **Rio Grande Foundation** will endeavor to able help policy makers understand and face these trade-offs.