F I S C A L   I M P A C T   R E P O R T

SPONSOR O'Neill **ORIGINAL DATE** 02/1/21 **LAST UPDATED** **HB**

SHORT TITLE New Personal Income Tax Brackets **SB** 56

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	**FY22**	**FY23**	**FY24**	**FY25**		
	$39,000.0	$80,000.0	$82,000.0	$84,000.0	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

Duplicates, Relates to, Conflicts with, Companion to: SB89 also proposes a new high-income bracket at 6.5 percent; HTRCCS/HB98 removes the contingency from 7-2-7 NMSA 1978

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 56 creates a new 8.2 percent marginal tax bracket for the highest income earners for taxable years beginning on or after January 1, 2022. Rates and brackets are shown below. New rate and bracket for each filing status is shaded.

	If Taxable Income is		tax =	plus	times amt over
	over	not over	tax =		
Single					
	$0	$5,500	$0.00	1.70%	$0
	$5,500	$11,000	$93.50	3.20%	$5,500
	$11,000	$16,000	$269.50	4.70%	$11,000
	$16,000	$210,000	$504.50	4.90%	$16,000
	$210,000	$250,000	$10,010.50	5.90%	$210,000

	$250,000	And over	$12,370.50	8.20%	$250,000
Married Joint, Heads of Household, Surviving Spouses					
	$0	$8,000	$0.00	1.70%	$0
	$8,000	$16,000	$136.00	3.20%	$8,000
	$16,000	$24,000	$392.00	4.70%	$16,000
	$24,000	$315,000	$768.00	4.90%	$24,000
	$315,000	$375,000	$15,027.00	5.90%	$315,000
	$375,000	And over	$18,567.00	8.20%	$375,000
Married Separate					
	$0	$4,000	$0.00	1.70%	$0
	$4,000	$8,000	$68.00	3.20%	$4,000
	$8,000	$12,000	$196.00	4.70%	$8,000
	$12,000	$157,500	$384.00	4.90%	$12,000
	$157,500	$187,500	$7,513.50	5.90%	$157,500
	$187,500	And over	$9,283.50	8.20%	$187,500

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends (June 18, 2021). The provisions of the bill are effective for taxable years beginning on or after January 1, 2022. See “TECHNICAL ISSUES for discussion.

FISCAL IMPLICATIONS

TRD has estimated the fiscal impact of this rate and bracket change:

For the Personal Income Tax (PIT) rate changes, the new proposed rate structure was applied to historical data using Tax Year 2019 as the base and taking into account the new 5.9 percent marginal tax rate effective for Tax Year 2021. The growth rates from the Consensus Revenue Estimating Group (CREG) December 2020 estimate were applied.

Using the newly reconstructed LFC PIT model, LFC staff estimated slightly greater fiscal impact, but also created the following burden analysis indicating that 57 percent of the revenue derived from this proposal would be “exported” to out of state taxpayers.

	Fiscal Impact	TP's Affected	Average Impact
FY23 Impact	$81,490.0		
Resident Filers	$34,500.0	2,963	$11,643.60
Sch B Filers	$47,000.0	16,364	$2,872.16

SIGNIFICANT ISSUES

TRD provided the following analysis of the economic consequences of adopting the provisions of this bill.

> PIT represents a fairly consistent source of revenue for many states. While this revenue source is susceptible to economic downturns, it is also positively responsive to economic

expansion. New Mexico is one of forty-two states, along with the District of Columbia, that impose a broad-based PIT. The PIT is an important tax policy tool that has the potential to further both horizontal equity by ensuring the same statutes apply to all taxpayers, and vertical equity by ensuring the tax burden is based on a taxpayer's ability to pay.

The PIT rate and bracket changes in this legislation complicate a mostly flat, 5-tier, income tax structure and at the same time make it more progressive. Four major objectives of optimal tax policy are simplicity, efficiency, fairness, and revenue adequacy. Adding additional tax brackets goes against the simplicity aspect of tax policy. A simple tax system helps taxpayers better understand the system and reduces the costs of compliance.

Increased progressivity in income tax structure effects the objectives of fairness and vertical equity. Vertical equity means that the tax burden should be based on the taxpayer's ability to pay, meaning that higher income earners can pay more in taxes. Vertical equity can be achieved under a proportional income tax structure where all taxpayers pay the same proportion of their income in taxes. Under a progressive income tax structure, higher-income individuals pay a higher share of their income in taxes. This violates the principle of equity in the strictest sense. However, progressivity in income taxes is commonly sought to reduce the tax burden of those with a lower ability to pay and shift the burden increasingly to those with a higher ability to pay, with an intent to reduce the gap between those that are more well off and those that are not as well off. Further, a progressive income tax is also seen as a tool to make the overall tax structure, which includes more regressive taxes such as the gross receipts tax, property tax, and the gasoline tax, fairer. Consumption (of goods, services, gasoline or housing) takes up a larger proportion of income among the lower-income earners compared to higher-income earners. Leaving higher-income earners with more disposable income. Any tax applied on such consumption will take up a larger share of income for lower and middle-income earners compared to the higher income earners, making it regressive.

Because increasing progressivity of a tax structure leads to changes in individual behavior, such a tax policy is seen to be economically distortionary. As for the effect of a more progressive tax structure on inequality, economic literature remains divided on whether such a tax structure is successful in reducing income inequality. Under the optimal tax theory, there is some theoretical evidence that very high earners should be subject to high and rising marginal tax rates on earnings. Also, that the earnings of low-income families should be subsidized to incentivize work, and those subsidies should then be phased out with high implicit marginal tax rates. See, for example, Diamond and Saez (2011)[1].There is also, however, some evidence that increased progressivity may lead to lower human capital investments, output and productivity (via capital and labor mobility towards regions with less progressive or even flat tax structures). See, for example, Caucutt et al. (2003)[2], Li and Sarte (2004)[3], Erosa and Korkeshova (2007)[4], and Heathcote et al. (2010)[5].

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[1] Diamond, Peter, and Emmanuel Saez. 2011. "The Case for a Progressive Tax: From Basic Research to Policy Recommendations." Journal of Economic Perspectives, 25 (4): 165-90

[2] Elizabeth M. Caucutt, Selahattin Imrohoroğlu and Krishna B. Kumar, "Growth and Welfare Analysis of Tax Progressivity in a Heterogeneous-Agent Model," Review of Economic Dynamics 6 (3) (2003): 546-577

[3] Li, W., & Sarte, P. (2004). Progressive Taxation and Long-Run Growth. The American Economic Review, 94(5), 1705-1716

A more progressive tax structure may discourage people from entering higher-paying jobs, reducing the number of people available for those jobs, and consequently further raising the salaries offered in these jobs. The tax then paid on these higher salaries will overstate the tax burden on these individuals. Another way the burden gets shifted is when people must pay a higher price for the goods or services produced by these higher salaried individuals. However, individuals acting in their best interest likely enter higher paying jobs where take home pay and tax liability both rise, and various retirement benefits are maximized.

This bill also invokes the tax principal of revenue adequacy. By increasing a fairly stable source of general fund revenue, the bill would further the goal of ensuring the state collects sufficient revenue to meet the needs of its constituents. Policymakers often discuss the need to decrease volatility in general fund revenue, and PIT is certainly a less volatile source of revenue than energy-related sources.

Given the many facets of the distortionary impact a more progressive income tax structure could potentially have on a society, the true economic impact of a legislation such as this one can only be measured in hindsight; and even then, without exactitude.

ADMINISTRATIVE IMPLICATIONS

TRD notes that it will need to make information system changes and update publications, forms and regulations. These changes will be incorporated into annual tax year implementation and represents $5,164 in workload costs by the Information Technology Division (ITD).

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB89 also proposes a new high-income bracket at 6.5 percent; HB98 removes the contingency from 7-2-7 NMSA 1978.

TECHNICAL ISSUES

LFC staff note that the version of 7-2-7 NMSA 1978 enacted by Laws 2019, Chapter 270, Section 12 (HB6 of the 2019 session) was contingent on FY20 general fund not exceeding FY19 revenues by more than 5 percent. Per compiler's note, "On December 18, 2020, the secretary of finance and administration certified to the New Mexico compilation commission and the director of the legislative council service that fiscal year 2020 recurring general fund revenues are less than five percent above fiscal year 2019 recurring general fund revenues.)

OTHER SUBSTANTIVE ISSUES

TRD notes the following:

Under Section 7-3A NMSA 1978, Oil and Gas Proceeds and Pass-Through Entity Withholding Tax, the department may apply a withholding rate not to exceed the highest income tax rate under 7-2-7 NMSA 1978.

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[4] Erosa, Andres and Tatyana Koreshkova, "Progressive taxation in a dynastic model of human capital," Journal of Monetary Economics, 2007, 54, 667–685. 6

[5] Jonathan Heathcote & Kjetil Storesletten & Giovanni L. Violante, 2010. "The Macroeconomic Implications of Rising Wage Inequality in the United States," Journal of Political Economy, University of Chicago Press, vol. 118(4), pages 681-722, August

In 2003, legislation was passed that gradually decreased New Mexico's PIT rate structure over several years. Prior to that legislation, the top marginal PIT rate in New Mexico was 8.2 percent, the same top rate proposed in this bill.

LG/sb