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

SPONSOR Tallman | **ORIGINAL DATE** 02/05/21 | **LAST UPDATED** | **HB**

SHORT TITLE Amend Personal Income Tax Brackets | **SB** 89

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	FY22	FY23	FY24	FY25		
	$51,000.0	$104,000.0	$106,000.0	$109,000.0	Recurring	General Fund (PIT)

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY21	FY22	FY23	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		$2.5		$2.5	Nonrecurring	TRD Operating

Parenthesis ( ) indicate expenditure decreases

Conflicts with SB56

SOURCES OF INFORMATION
LFC Files
LFC PIT model updated and calibrated.

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Senate Bill 89

Senate Bill 89 creates a new personal income tax rate structure by repealing and reenacting 7-2-7 NMSA 1978. The number of brackets for each filing group is increased from five to seven, adding middle brackets that increase the rate of tax and a highest bracket more incrementally. The rate of tax is also higher for middle- and upper-income earners. For married individuals filing separately (SEP) new brackets added include for income amounts between $17.5 thousand and $37.5 thousand, and between $37.5 thousand and $75 thousand, with the highest bracket for income over $150 thousand. For heads of household (HOH), surviving spouses, and married individuals filing jointly, new brackets added include for income amounts between $35 thousand and $75 thousand

and between $75 thousand and $150 thousand, with the highest bracket for incomes over $300 thousand. For single individuals (SNGL) and for estates and trusts new brackets added include for income amounts between $23.5 thousand and $50 thousand and between $50 thousand and $100 thousand, with the highest bracket for incomes over $200 thousand.

The effective date of Section 1 of this act is January 1, 2022, making the changes applicable to taxable years beginning on or after January 1, 2022. The effective date of the repeal in Section 2 is not specified, indicating the repeal would be effective 90 days following adjournment (June 18, 2021). However, language in the Section 1 of the bill repeals the previous version of 7-2-7 NMSA 1978 effective January 1, 2022.

FISCAL IMPLICATIONS

In a description of its methodology for its estimated revenue impact, TRD states:

> 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 higher tax rate effective for Tax Year 2021. The growth rates from the Consensus Revenue Estimating Group (CREG) December 2020 estimate were applied.

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY21	**FY22**	**FY23**	**FY24**	**FY25**		
	51,000.0	104,000.0	106,000.0	109,000.0	R	General Fund (PIT)

LFC staff also used the newly calibrated and updated LFC/PIT model to estimate the impacts of this bill:

FY21	FY22	FY23	FY24	FY25	Recurring or Nonrecurring	Fund Affected
0.0	37,750.0	77,920.0	84,980.0	88,030.0	R	General Fund (PIT)

Note the TRD methodology, which uses direct data, may be superior. However, the LFC PIT model simultaneously exhibits burden charts and shows the percentage of the tax change that would be borne by Schedule B filers. These are primarily out-of-state residents with New Mexico source business income, such as oil and gas royalties or dividends from oil and gas interests. As shown in the burden chart below, 25 percent of the revenue derived from the rates and brackets proposed in the bill are "exported" to residents of other states. Another observation from the burden charts is that taxpayers in the lowest four deciles of gross income would have a very small reduction in taxes. Middle income single filers would have no change in tax burden from this proposal.

6.5% Top Rate

Summary Tables

Residents Only\AGI\2021 Impacts	0-20%	20%-40%	40% to 60%	60% to 80%	80% to 100%	All Returns

Effect of Changes						
Single - AGI -- Base amt	$15,707	$25,229	$33,923	$46,304	$87,953	$41,819
- Avg Tax	-$1	$1	$9	$33	$169	$42
-# Rtns w/ impact	6,842	18,846	33,743	0	55,039	166,240
- ATR/TI	2.9%	3.4%	3.6%	4.1%	4.7%	4.4%
MFJ - AGI - base amt	$47,562	$70,113	$90,383	$117,498	$222,097	$109,514
- Avg Tax	-$9	$5	$49	$173	$854	$214
-# Rtns w/ impact	18,820	41,151	42,552	42,540	42,540	187,603
- ATR/TI	3.2%	3.8%	4.3%	4.6%	5.2%	4.8%
MFS - AGI - base amt	$21,475	$34,067	$44,890	$59,211	$122,183	$67,775
- Avg Tax	-$7	$0	$31	$98	$498	$122
-# Rtns w/ impact	816	1,294	1,320	1,311	1,280	6,021
- ATR/TI	2.9%	3.9%	4.3%	4.7%	5.3%	4.6%
HH - AGI -- base amt	$27,335	$35,491	$43,023	$53,738	$92,403	$50,372
- Avg Tax	-$3	-$4	-$12	-$8	$120	$18
-# Rtns w/ impact	1,764	2,940	8,682	13,362	13,341	40,089
- ATR/TI	1.9%	2.8%	3.0%	3.4%	4.4%	4.6%

	Fiscal Impact	TP's Affected	Average Impact	
FY23 Impact	$77,920.0			
Resident Filers	$58,100.0	399,953	$152.30	75%
Sch B Filers	$19,800.0	104,934	$188.69	25%

These changes should increase the overall income elasticity of the personal income from near 1.0 for pre-2019 rates and 1.05 after the 2019 increase in the highest tax rate to 5.9 percent to 1.1 for the structure proposed in the bill. Prior to 2005, the income elasticity was about 1.3. Income elasticity measures the growth in personal income tax collections driven by growth in personal income. An elasticity of 1.1 means that personal income tax revenue would increase 11 percent when personal income increased by 10 percent. (See discussion below on the desirability of income elasticity.)

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. Traditionally, TRD has imposed the OGAS/PTE withholding tax at the highest marginal rate. This rate was 4.9 percent from 2008 to 2019. TRD has not increased the rate to reflect the 5.9 percent top marginal rate adopted in 2019 (Chapter 279). The estimates above are not adjusted for an increase in OGA/PTE withholding. It may be that no adjustment would be necessary if TRD retains the 4.9 percent withholding rate.

SIGNIFICANT ISSUES

In 2003, legislation was passed that gradually decreased New Mexico's personal income tax rate structure over several years. Prior to that legislation, the top marginal personal income tax rate in New Mexico was 8.2 percent.

TRD discusses whether an increase in income elasticity in the personal income tax is appropriate:

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 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 go against the simplicity aspect of tax policy. A simpler tax system helps taxpayers better understand the system and reduces the costs of compliance.

Increased progressivity in income tax structure affects the objective of fairness and vertical equity. Vertical equity means that tax burden should be based on the taxpayer's ability to pay, meaning that higher income earners pay more in taxes. Vertical equity can be achieved under a proportional income tax structure where all taxpayers can 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

[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

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].

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.

However, the personal income tax is only one tax in a complicated mix of consumption and gross receipts taxes, income taxes, specific excises, property taxes, and severance taxes. Even with an increase in the income elasticity of the personal income tax component, the overall tax structure is probably quite regressive – largely because of the state's heavy reliance on the gross receipts and compensating tax.

ADMINISTRATIVE IMPLICATIONS

TRD 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 to the Information and Technology Division (ITD).

Estimated Additional Operating Budget Impact*				**R or NR****	**Fund(s) or Agency Affected**
FY2021	**FY2022**	**FY2023**	**3 Year Total Cost**		
--	$5.2	--	$5.2	NR	ITD – workload costs

* In thousands of dollars. Parentheses ( ) indicate a cost saving. ** Recurring (R) or Non-Recurring (NR).

[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

[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

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB56 proposes a different rate and bracket structure than proposed in this bill.

LG/al