New Mexico VOICES for Children

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New Mexico Fiscal Policy Project

New Mexico's Revenue Crisis

State Revenues and the Economy: FY08 to FY13

by Gerry Bradley
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The consensus revenue forecast presented earlier this month shows New Mexico in the grip of a crisis. New Mexico's general fund revenues have fallen below the level they were in fiscal year 2008 (FY08), and this trend is expected to continue through FY11. The revenue level of FY08 will not be sufficient to maintain the current level of services, such as health care, public safety, and K-12 educational programs. In fact, the gap between baseline growth – the amount needed to cover increases in inflation and population – and actual growth will be 10 percent of revenues. This is a significant shortfall. Revenue shortfalls of this magnitude are generally dealt with in one of three ways: inefficiencies in government agencies are eliminated while hiring is frozen, services are cut or taxes are raised.

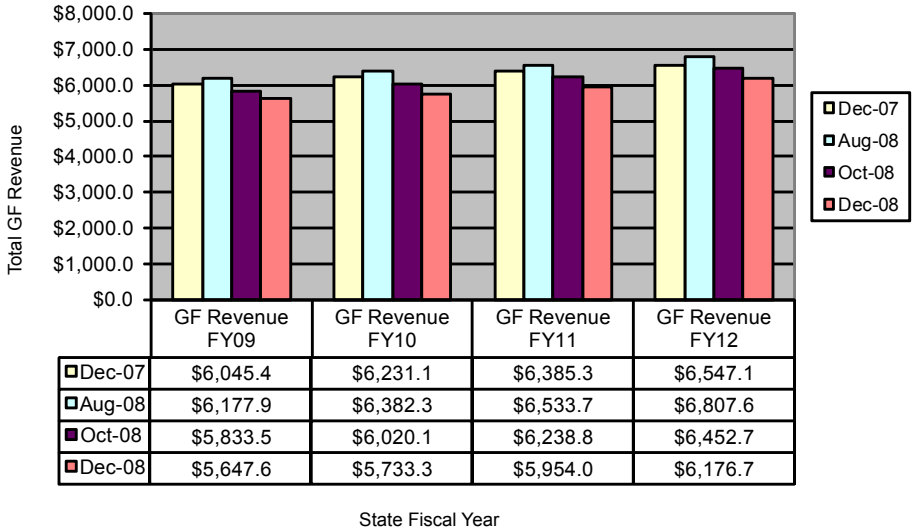
In the December 2008 revenue forecast, which shows inflation rising at a far lower rate in the next two years than previously expected, general fund revenues will fall by 6.5 percent in FY09, the current fiscal year. Growth of 3.5 percent is required in order to maintain current services in FY09. Revenues will then rise by 1.5 percent in FY10, 3.8 percent in FY11, and finally top FY08 levels in FY12.

New Mexico's general fund revenue forecasts for FY09 through FY13 have been on a rollercoaster during the past year.[1] The revenue estimates used by the Legislature to craft the general fund budget for this fiscal year (FY09) were produced in December 2007. Since then, the price of oil has soared – and revenue estimates were raised to accommodate them. The future looked so promising that a special legislative session was held in August 2008 to spend the anticipated revenue surplus. But the oil and natural gas fueled surplus promptly evaporated in late summer.

Before oil prices dropped, the housing bubble began to deflate, the stock market plummeted, and the nation slumped into a recession. The national economic turmoil, along with moderating inflation and a slowing state economy, will continue to affect the state's

[1] The state must create and enact an operating budget for any given fiscal year before the revenues for that year have been collected. In order to create the budget, then, a forecast of future revenues must be made. In New Mexico, forecasts of general fund revenue growth are prepared by a team of career economists from the legislative and executive branches of government. Economists from the Legislative Finance Committee, the Department of Finance and Administration, the Taxation and Revenue Department, and the Department of Transportation are involved. The official estimates are a consensus of the expectations of these agencies.

Chart I
Revenue Estimates by Date



	GF Revenue FY09	GF Revenue FY10	GF Revenue FY11	GF Revenue FY12
Dec-07	$6,045.4	$6,231.1	$6,385.3	$6,547.1
Aug-08	$6,177.9	$6,382.3	$6,533.7	$6,807.6
Oct-08	$5,833.5	$6,020.1	$6,238.8	$6,452.7
Dec-08	$5,647.6	$5,733.3	$5,954.0	$6,176.7

revenue picture. In addition, the phase-in the of state income tax cuts of 2003 was complete in 2008. This has led to a loss of $400 million annually. Unlike the similarly structured federal income tax cuts also enacted in 2003, the state cuts are not scheduled to sunset.

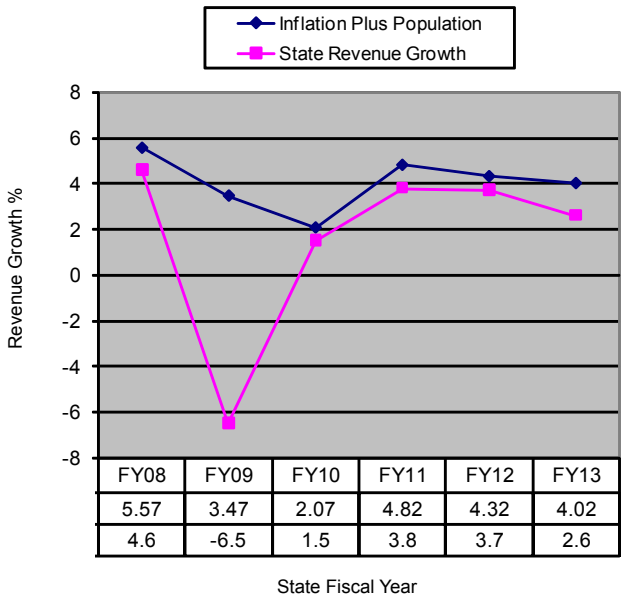
Revenue Growth

State revenue needs to grow in tandem with state population growth – as the state population grows, so does the need for state-supported services. Revenues should match the sum of consumer price index (CPI) inflation and population growth, at a bare minimum. This is called "baseline growth" and is the revenue growth required to fund a "current services" budget in which the current level of services is maintained. The behavior of these two economic indicators sets the minimum requirement for the growth of general fund revenues.

Chart I (Revenue Estimates by Date, above) illustrates the wide fluctuation in revenue estimates for each of the fiscal years from FY09 through FY12, from December 2007 (blue bars) to August 2008 (purple bars), October 2008 (yellow bars) and December 2008 (pink bars).

General fund revenues for FY08 were $6.041 billion, a moderate increase of 4.6 percent over FY07. Even in FY08, revenue growth failed to meet the baseline standard because inflation was 3.7 percent and population growth was 1.87 percent for a total of 5.57 percent (see Graph I, Current Services Revenues, below).[i]

Graph I
Current Services Revenue



FY08	FY09	FY10	FY11	FY12	FY13
5.57	3.47	2.07	4.82	4.32	4.02
4.6	-6.5	1.5	3.8	3.7	2.6

Federal Economic Indicators

The behavior of state revenues depends on both national and state economic performance as measured by several key economic indicators. The state fiscal agencies' testimony on revenues always includes growth rate projections of the US gross domestic product (GDP), CPI inflation, and the federal funds rate, which is a key monetary policy tool used by the Federal Reserve for influencing interest rates.

As Table I (Growth Rates of Federal Funds, the GDP, and Inflation, right) indicates, the federal funds rate was 3.71 percent in FY08. In December 2007, the FY09 federal funds rate was expected to be upwards of 2 percent – but actually it was lowered to near 1 percent due to a far weaker national economy than expected. Since then, it's been lowered again to between 0 and 0.25 percent. The federal funds rate is expected to rise gradually from FY10 to FY13 as the economy begins to recover. The GDP is expected to grow modestly over the forecast period, but inflation will dip to near 0 in FY10, lurch back up to 3.1 percent in FY11, and stay below 3 percent in FY12 and FY13.

Table I
Growth Rates of Federal Funds, GDP, and Inflation

October 08 Forecast

Fiscal Years	2008	2009	2010	2011	2012	2013
US Real GDP Growth	2.4%	-0.4%	0.1%	2.6%	3.4%	3.3%
US CPI Inflation Rate	3.7%	1.6%	0.2%	3.1%	2.6%	2.3%
Federal Funds Rate	3.71%	0.97%	0.62%	2.31%	4.65%	4.75%
NM Pop. Growth Year to Year	1.87%	1.87%	1.87%	1.72%	1.72%	1.72%
General Fund Growth	4.6%	-6.5%	1.5%	3.8%	3.7%	2.6%
CPI plus NM Pop. Growth	5.57%	3.47%	2.07%	4.82%	4.32%	4.02%

State Economic Indicators

Revenue estimators also use economic indicators that are specific to New Mexico in building their projections. The key New Mexico indicators are job growth, personal income growth, and private wage and salary growth. All of these indicators will perform worse than was expected in December 2007.

Revenue estimators see New Mexico job growth on a gradual upward trajectory from its fairly weak growth in FY08 and FY09 to a more typical (although still slow) growth in FY10 and FY11. Growth will fall from 1 percent in FY 08 to -0.1 percent in FY09 before recovering somewhat to 0.6 percent in FY10. Job growth is projected to approach its 1.5 to 2 percent long-term trend at 1.3 percent by FY11 and 1.9 percent in FY13. Personal income growth, too, is expected to fall from FY08 to FY10 before rising and leveling off in FY12 and FY 2013. Private wage and salary growth is expected to show growth in FY08 before falling in FY09 and FY10 (see Graph II, NM Labor Market and Income Growth, right). Wage and salary growth will recover between FY11 and FY13.

Graph II
New Mexico Labor Market and Income Growth

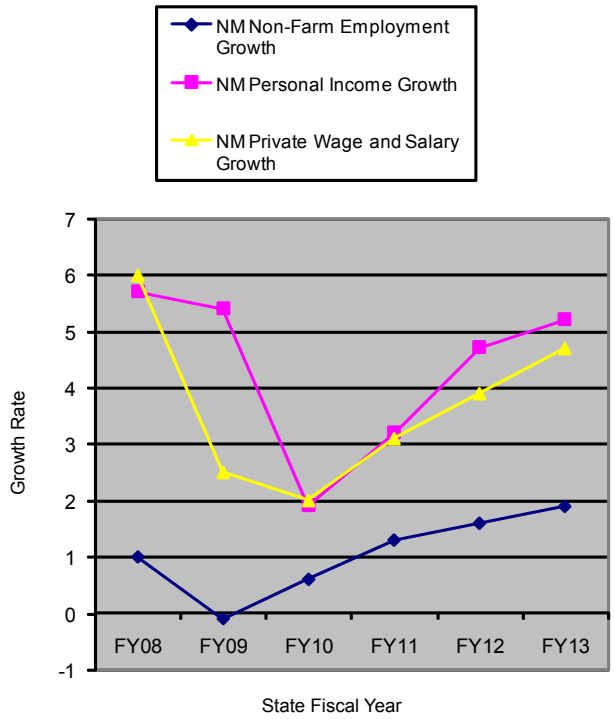
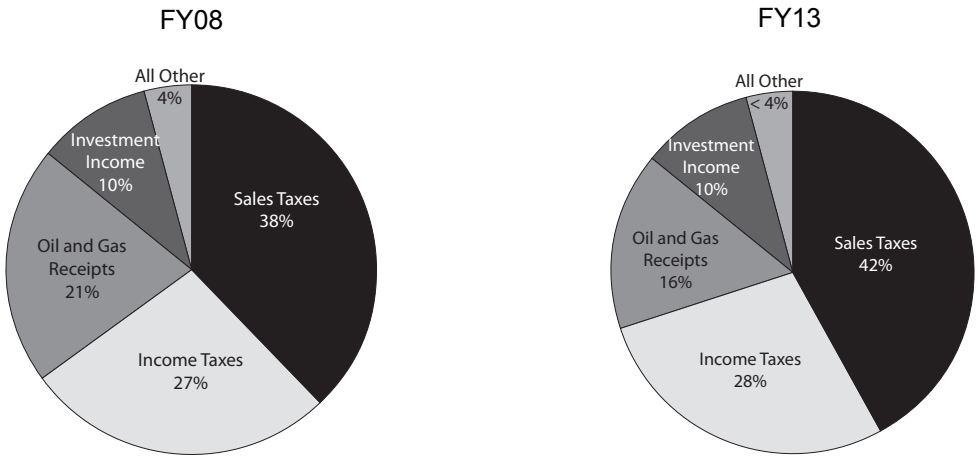


Chart II
General Fund Revenue Shares FY08 and FY13

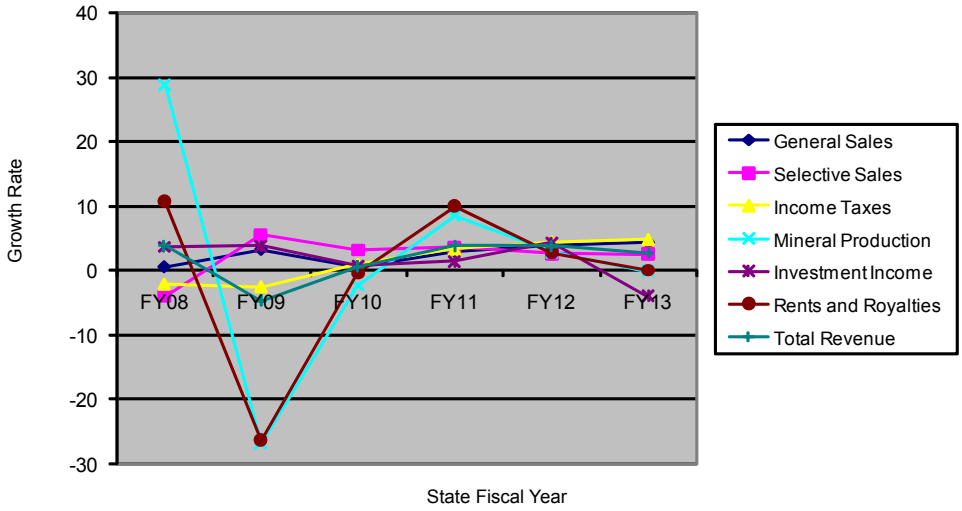


General Fund Revenues

General fund revenues can be divided into four broad categories for ease of analysis: sales taxes, income taxes, oil and gas receipts, and investment income. There are also some smaller revenue sources, such as license fees and revenue sharing from tribal casinos. Each of the revenue categories is influenced by national and state economic developments in specific ways, so the share of each category can fluctuate (see Chart II, General Fund Revenue Shares FY08 and FY13, above). Most notably, oil and gas receipts are expected to fall by FY13.

As Graph III (Revenue Forecast Components, below) shows, by far the most volatile of the revenue components are oil and gas revenue shares (indicated by the light blue 'minerals' line and the brown 'rents and royalties' line). This poses a severe problem for state revenue estimators. In December 2007 the oil and gas share of total revenues for FY09 was expected to be 17.4 percent, but that rose to 23.1 percent in August 2008 and then fell to 14.7 percent in December 2008 as oil and gas prices spiked and then collapsed. The share of oil and natural gas revenues also fell from the August 2008 to the December 2008 revenue forecasts in each of the fiscal years out to FY13.

Graph III
Revenue Forecast Components



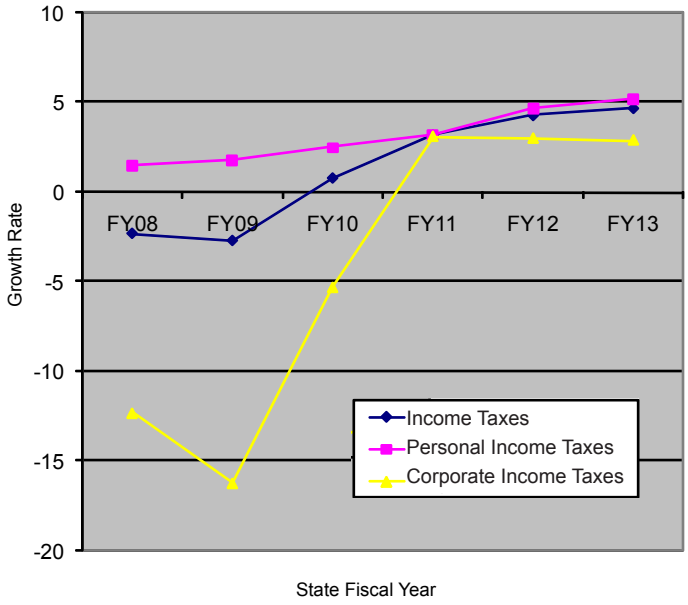
Sales and Income Taxes

Revenue estimators see sales tax receipts as influenced by growth in jobs, and wages and salaries. Both of these indicators are expected to drastically slow in FY09 and FY10 and then recover slightly in FY11 to FY13. Sales taxes are made up of general sales taxes, largely gross receipts taxes on the sale of most goods and services (indicated by the dark blue line on Graph III) and selective (or excise) sales taxes, which include taxes on tobacco and alcohol (indicated by the bright pink line). Growth in revenues from general sales taxes is expected to rise gradually from FY09 through FY13. Selective sales taxes are more volatile and are expected to jump in FY09, dip again in FY10, and continue to rise gradually through FY13.

General sales taxes are expected to be $1.980 billion in FY10, while selective sales taxes will be $431 million. (For context, total revenues will be $5.733 billion in FY10.) In times of scarce revenues, proposals are often made to increase so-called "sin" taxes such as excise taxes on cigarettes and alcohol. Excise taxes of $431 million represent a fairly small share (7.5 percent) of general fund revenues. Alcohol and cigarette taxes are only about $74 million (1.3 percent) of total revenues.

As Graph IV (Income Tax Forecast, below) shows, personal and corporate income taxes have distinct behaviors. This is because they are driven by different economic factors. Personal income taxes (indicated by the bright pink line) are driven by state personal income growth and by policy changes such as the ill-advised cuts in marginal rates enacted in 2003. That cut in marginal rates did not become fully effective until 2008. Personal income tax revenue fell in FY08, and is expected to continue to slide in FY09. They will grow slightly in FY10, strengthening through FY13. Personal income tax revenue is expected to be $1.570 billion in FY10.

Graph IV
Income Tax Forecast



The corporate income tax (indicated by the yellow line) is a tax on net corporate profits, which fluctuate widely. Corporate income tax revenues dropped in FY08 as oil and gas company profits fell, and are expected to fall again in FY09 and FY10. Although corporate income tax revenues will stabilize in FY11 and then begin a slow rise, there will be little growth in this revenue source in the fiscal years out to FY13 where it is expected to be $350 million. As much as 60 percent of the growth in corporate income tax revenues has come from oil and gas companies in recent years. Corporate income tax receipts for FY09 were expected to be $451 million in December 2007 but were revised downward to $338 million in the December 2008 revenue estimates. This is a drop of one quarter in expected corporate income tax revenues for the current year.

Taxes on oil, natural gas, and other minerals are extremely volatile because they depend on prices set in the global energy market. Taxes on the production of oil and gas accounted for about 21 percent of state general fund revenues in FY08 but had fallen to about 15 percent in FY09 and will continue to be close to 16 percent though FY13. Oil prices were expected in December 2007 to rise slightly from $92 per barrel in FY08 to $100 by FY12. The state's problem has been that there was very little in the way of gradual movement in the oil market, as the expected price per barrel in FY09 rose from $75 in December 2007 to $122 in August 2008, and back down to $94 in October 2008. In December 2008, the expected price of oil in FY09 had dropped to $69 per barrel. Natural gas prices are now expected to fall from $8.28 per thousand cubic feet in FY08 to $6.05 in FY09 before rising gradually to $7.20 in FY13

Oil and natural gas production is declining in New Mexico, although this is a fairly predictable process. Oil production will fall from 60 million barrels in FY08 to 57.8 million barrels in FY13. Natural

gas sales are expected to fall from 1,433 billion cubic feet in FY08 to 1,280 in FY13. Given this scenario of prices and production, the share of oil and gas production taxes will fall to about 16 percent by FY13, as compared to 21.2 percent in FY08 (see Chart III, Oil and Gas Shares of Revenue, below).

Investment Income

The final category of general fund revenues is investment income, which is received from interest on the state's investments. Interest income is strongly influenced by the national economy, and US interest rates are strongly influenced by Federal Reserve policies. Monetary policy, as measured by the federal funds rate, is expected to be loose in FY09 and FY10, before tightening slightly between FY11 to FY13. Loose monetary policy (lower interest rates) is necessary during a recession in order to encourage economic growth. However, higher interest rates mean increased revenues on state investments, while lower interest rates reduce investment revenues. Revenues from state investments are expected to be $646.5 million in FY09 and $651.2 million in FY10.

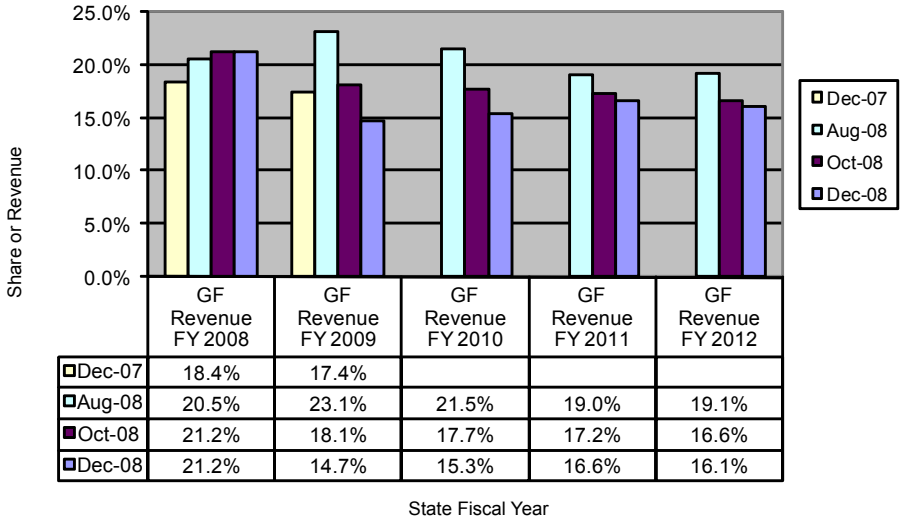
Conclusion

In summary, New Mexico general fund revenues will drop from FY08 to FY09 and be insufficient to meet baseline growth from FY09 through FY12. The onset of a national recession, moderating inflation (especially for gasoline), lower oil and natural gas prices, and a slowing state economy will continue to affect the state's revenue picture.

Endnotes

[i] Population growth rates are estimates from the University of New Mexico Bureau of Business and Economic Research.

Chart III
Oil and Gas Shares of Revenue



	GF Revenue FY 2008	GF Revenue FY 2009	GF Revenue FY 2010	GF Revenue FY 2011	GF Revenue FY 2012
Dec-07	18.4%	17.4%			
Aug-08	20.5%	23.1%	21.5%	19.0%	19.1%
Oct-08	21.2%	18.1%	17.7%	17.2%	16.6%
Dec-08	21.2%	14.7%	15.3%	16.6%	16.1%

Policy Recommendations

A revenue crisis such as the one described in this paper can be dealt with by achieving efficiencies in operations, cutting services, or increasing revenues. While cutting waste in government programs is an attractive solution, it will not yield nearly enough in the way of savings to bridge such a deficit.

Cutting services during an economic downturn means cutting safety net programs at precisely the time when the need for them increases.

When raising new sources of revenue, policymakers should take into consideration New Mexico's regressive tax system and make it more progressive with whatever tax reforms are proposed. Legislators should also revisit whether, in approving some of the tax cuts of the last six years, they may have overreached. Some of those tax cuts could be rolled back, at least temporarily.

We could also safely tap into the state's operating reserve. The so-called rainy day fund is currently 10 percent of the state's general fund budget, which is double what it's been in the past. The state could draw it down to 5 percent without any undue risk.

New Mexico should focus its own economic recovery efforts at creating good jobs, strengthening consumer protections, extending unemployment insurance (UI) benefits, expanding work supports such as childcare assistance and health care, increasing Food Stamp utilization, and increasing the Low Income Home Energy Assistance Program (LIHEAP).

This means, among other things, fully funding Medicaid, where every dollar invested is matched by another $2.90 in federal dollars, and fully funding other essential services like education and public safety.

Consumer protection means enacting strong lending regulations for mortgages, payday and car title lenders, rent-to-own practices and refund anticipation loans (RALs) to prevent the kind of predatory practices that contributed to this economic meltdown.

While investing in infrastructure projects does provide economic stimulus, it primarily helps male workers. Medicaid, on the other hand, creates jobs in the private health care industry, which employs a more diverse workforce. We should also continue to invest in adult basic education and worker training programs, with a special emphasis on incumbent worker training.

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This report and its executive summary are available for download and use with proper citation at www.nmvoices.org/fiscalpolicyproject.htm