

**REVIEW OF UPDATED REVENUE OUTLOOK FOR NEW MEXICO****Thomas Clifford, Ph.D., Research Director****Introduction**

For the past 10 months, Dr. Clifford has served as Research Director for the NM Tax Research Institute, a non-profit, non-partisan, member-supported organization dedicated to promoting good tax policy in New Mexico. A description of the “Principles of Good Tax Policy”, as adopted by the members of the NMTRI, is attached to this presentation. Dr. Clifford is the former Director of Tax Research for the NM Taxation and Revenue Department (“TRD”), and former Chief Economist for the NM Department of Finance and Administration (“DFA”). In these roles he played a key part in forecasting the State’s revenue for 13 years. Prior to moving to New Mexico, Dr. Clifford spent 10 years in Washington, DC, conducting economic analysis for the U.S. Congress, first at the General Accounting Office and later at the Joint Committee on Taxation. Dr. Clifford has a Ph.D. in Economics from the University of California at Santa Barbara.

**Consensus Revenue Estimating Process***Background:*

The Consensus Revenue Estimating Group – composed of economists from TRD, DFA, the Legislative Finance Committee (“LFC”) and the NM Dept. of Transportation (“NMDOT”) – recently presented an updated outlook for General Fund revenue to the LFC. A copy of their presentation is attached to this presentation. This group meets on roughly a quarterly basis to update their projections. By a long-standing agreement between the executive and legislative branches<sup>1</sup>, their work is almost entirely insulated from direct political influence.

The estimators consider each revenue source separately, and agree as a group on the best point estimate for each revenue. The total revenue forecast is simply the sum of these individual revenue forecasts. They typically prepare a forecast that encompasses the current fiscal year and the next four fiscal years.

An often-considered question is how to handle unusually high levels of risk in the forecast. The estimators have generally opted to avoid explicitly adjusting their forecast for risk. This leaves the task of managing risk primarily in the hands of the Legislative appropriating and tax-writing committees.

A related issue is the classification of revenue as “recurring” vs. “non-recurring.” Although the distinction appears obvious in some cases – for example a lawsuit that brings a one-time windfall – problems arise when there is a temporary increase in a recurring revenue. The obvious example is high oil and gas prices, although there have been temporary run-ups in other revenues as well. Although it might seem prudent to treat a portion of the revenue as non-recurring, it would be difficult in practice

---

<sup>1</sup> The Consensus group is not created by any statutory provision. Statutes assign to DFA the task of preparing a budget, which is required to include a description of expected revenues to support the budget.

to identify the non-recurring component of the revenue on a month-to-month basis. With regard to energy prices in particular, estimators have been unwilling to make a distinction that may appear arbitrary when there is so much uncertainty and the consequences of the uncertainty are so significant. Again, the usual procedure is to prepare a forecast that reflects the economists' best judgment, and to leave the problem of managing the risk inherent in the forecast to the Legislature.

*Estimating methods:*

Estimators rely on a variety of modeling techniques and data sources. As a foundation for the broad-based revenues like the Gross Receipts Tax ("GRT") and the Personal Income Tax ("PIT"), they rely on a forecast of the U.S. economy by the Global Insight economic forecasting service, and on the FOR-UNM forecast of the New Mexico economy prepared by the Bureau of Business and Economic Research at UNM. Forecast of oil and gas production-related revenues (royalties from public lands production as well as taxes) depends primarily on product price forecasts. These are usually a blended average of several different forecasts, including the latest futures market quotes, and forecasts from energy consulting groups like Global Insight and the PIRA Group in N.Y.

Individual revenue models vary from econometric regression analysis to spreadsheet-based trend analysis to expert-judgment forecasts like energy prices and interest rates. Econometric modeling is limited to revenues with the highest periodicity of tax payments, like the Gross Receipts Tax ("GRT"), the vehicle excise tax and a few others. Income tax trends have been dramatically altered by state and federal tax law changes, so that consideration of these has assumed a predominant role in recent years. Since the state "piggybacks" on federal law for both the personal and corporate income taxes, federal changes in income definitions and deductions -- but not in tax credits or tax rates -- will directly impact New Mexico revenues.

Two unusual components of the General Fund have offsetting effects on predictability of total revenue. Taxes and royalties on crude oil and natural gas contribute over 20% of recurring General Fund revenue. This figure is at its historical high and is subject to extreme unpredictability. As recently as 2002, this revenue source fell by 50% in one year. Investment earnings on the State's two large permanent funds -- the Land Grant Permanent Fund and the Severance Tax Permanent Fund -- contribute roughly 10% of total revenue. This source can be predicted with near certainty because it is based on a formula that uses a fixed percentage of the market value of the funds averaged over the preceding 5 years. Although the investment earnings offset some volatility, the importance of oil and gas production revenues means the General Fund forecast is often subject to a high degree of risk.

**July 2008 Economic Outlook As Seen by the Consensus Estimators**

Global Insight predicts that the U.S. economy will come close enough to a recession this year that the term is appropriate, regardless of how it is defined. The combination of job losses with resurgent inflation means the country faces "stagflation." The fact that this has not yet generated significant wage inflation, though good news for financial markets, means that consumers are being hit hard. Sensitivity to their pain will prevent the Federal Reserve from tightening until sometime next year. Sustainable recovery will wait until then.

Although New Mexico may avoid the negative employment growth being seen in the country as a whole, it too will see slower growth over the coming year. Construction and manufacturing, although they comprise only about 10% of the employment base, have been losing jobs for a year and are expected to continue to do so for the coming year. Most job growth will be in the services and in retail trade.

The following table summarizes the key economic parameters influencing the revenue outlook, as agreed to by the consensus group. The detailed assumptions are contained in Appendix Table 1 of the DFA/TRD presentation.

**Table 1**

**Summary of Key Economic Indicators as Forecast by Consensus Revenue Group**

	FY 2008		FY 2009		FY 2010	
	Dec. 2007 Estimate	July 2008 Estimate	Dec. 2007 Estimate	July 2008 Estimate	Dec. 2007 Estimate	July 2008 Estimate
US Real GDP Growth	1.9%	2.1%	2.9%	0.4%	2.9%	3.7%
US Inflation Rate	1.9%	4.2%	1.6%	4.6%	1.9%	0.6%
NM Employment Growth	1.7%	0.9%	1.7%	1.1%	1.6%	1.5%
NM Personal Income Growth	6.5%	5.8%	5.2%	4.3%	4.8%	4.9%
Oil Price	\$80.00	\$91.80	\$75.00	\$134.00	\$75.00	\$125.00
Natural Gas Price	\$6.40	\$8.20	\$6.60	\$11.50	\$6.57	\$9.50

*Economic growth:*

Although U.S. GDP growth in 2008 was in line with previous expectations, the slowdown is clear in the revisions to 2009. In New Mexico, employment growth has decelerated sharply, along with personal income growth.

*Inflation and state revenue:*

One of the most important figures in forecasting revenue is the inflation rate, since the broad-based revenues tend to increase in line with general inflation. The sharp uptick in 2008 and 2009 should therefore translate into higher revenue growth. Obviously this increase comes with higher costs for goods and services purchased by the government, so the revenue growth figure represents less in real purchasing power than it would with lower inflation. Note the implication of negative real personal income growth in 2009.

*Crude oil and natural gas prices:*

Crude oil and natural gas prices at these levels imply substantial risks to this forecast. The natural gas price is the more important in state revenue impacts since about 2/3 of the combined revenue from oil and gas comes from gas. Every \$0.10 change in the price of gas changes General Fund revenue by almost \$11 million. Each \$1 change in the price of oil changes General Fund revenue almost \$4 million.

In a dramatic illustration of this sensitivity, natural gas prices on the futures market have come down by \$4 since the beginning of July when the consensus forecast was prepared (Figure 1). Oil is down \$20.

**Figure 1: Natural Gas Futures Price for the Next Month's Contract as of 7/25/2008**



### Revenue Outlook:

Like many other states, New Mexico has seen weakness in its broad-based revenues over the last year. Unlike most states, we have strong revenue growth from oil and gas production to offset that weakness. The following table summarizes the General Fund outlook as presented in detail in Appendix Table 2 of the DFA/TRD presentation.

**Table 2**  
**Summary of Revenue Forecast by Consensus Estimating Group**  
 (Millions of dollars)

	2008		2009		2010	
	July 2008 Estimate	Change from Prior Year	July 2008 Estimate	Change from Prior Year	July 2008 Estimate	Change from Prior Year
Gross Receipts Tax	1,861	1.1%	1,937	4.1%	2,014	4.0%
Personal Income Tax	1,120	(5.1%)	1,140	1.8%	1,193	4.6%
Corporate Income Tax	411	(11%)	399	(2.9%)	411	3.0%
Oil and gas revenue	1,224	17.9%	1,647	34.6%	1,399	(15.0%)
Investment Income	623	3.4%	652	4.7%	703	7.8%
Other	658	0.6%	669	1.7%	699	4.5%
<b>Total Recurring Revenue</b>	<b>5,897</b>	<b>2.1%</b>	<b>6,444</b>	<b>8.4%</b>	<b>6,419</b>	<b>(0.4%)</b>

*Gross Receipts Tax:*

The single largest revenue source and a broad-based indicator of economic activity in the state, the GRT has not been immune to the housing market implosion. The construction sector, which makes up about 13% of the tax base, began declining last winter. Weakness is expected to spread to the rest of the tax base, with widespread weakness in the spring of 2008. Growth is expected to recover next year, however. A clear indication of the weakness of the state's broad based revenues like the GRT and PIT is that their growth in FY 2008 was so weak (1.1% and -5%) despite inflation of 4.2%.

*Personal Income Tax:*

The trend in 2008 and 2009 is affected by the final year of phasing in tax rate reductions. Altogether those reductions have reduced the base by about 25%, over \$300 million per year. In addition, the state is implementing a new refundable income tax credit based on the federal Earned Income Tax Credit this year, a change that is expected to reduce revenue by about \$30 million annually. These changes are not the only factors reducing revenue in 2008 and 2009, however. The economic slowdown appears to have already hit tax liabilities, perhaps due to the impact on asset prices and business income. The declines are significant, which is not unusual at a time of economic change for this relatively volatile revenue stream.

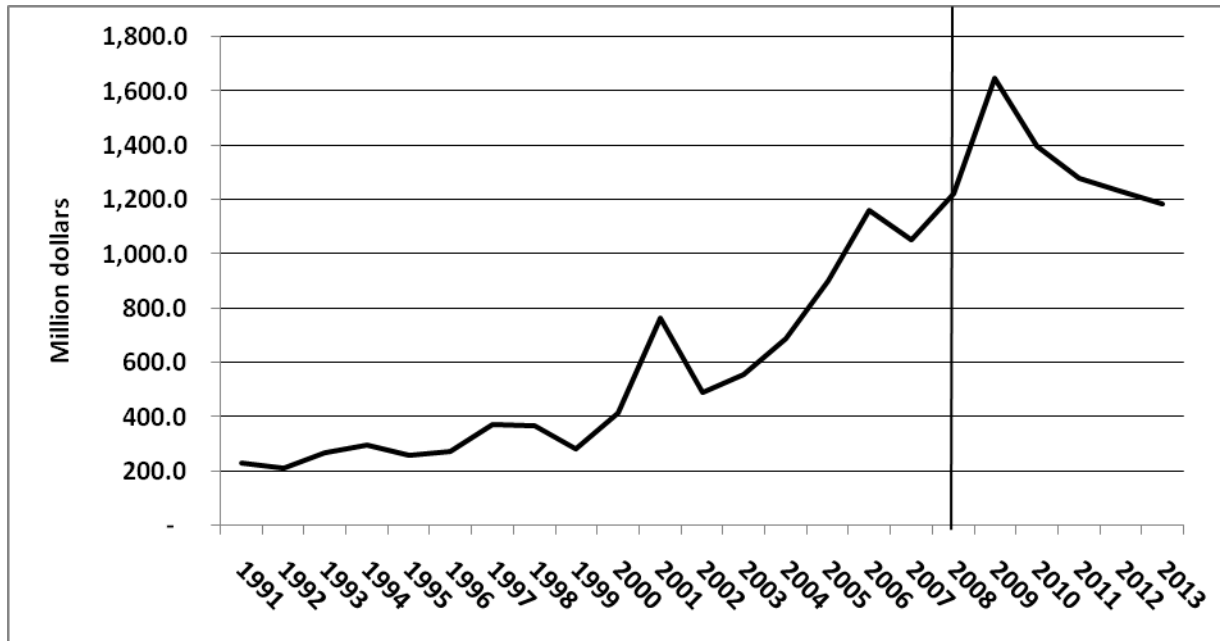
*Corporate Income Tax:*

This revenue is highly sensitive to the business cycle, and appears to have hit a plateau after a dramatic run-up in recent years. The oil and gas industry contributes about half of the tax base. A new factor reducing net revenues is the application of over \$46 million in film production tax credits in FY 2008, an increase from \$18 million the year before.

*Oil and gas revenues:*

These include the state's 50 percent share of federal land mineral royalties as well as some of the taxes imposed by the state. As discussed earlier, the dramatic increase of product prices accounts for sharply higher revenue forecasts. From an already high level in 2008, revenues are forecast to rise by more than \$400 million in 2009 and to fall off thereafter.

Figure 2: Oil and Gas Revenue to the State General Fund



### General Fund Financial Summary:

The last page of the DFA/TRD presentation contains the General Fund Financial Summary updated for the revised revenue outlook. Important points to note in the Summary:

- The State will end FY 2008 with General Fund reserves of \$606 million, or 10.7% of recurring appropriations. Although 10% is considered a large reserve in some states, it is probably a prudent minimum in New Mexico given the state's reliance on volatile revenues.
- FY 2009 revenue will exceed appropriations by almost \$404 million. Most of this amount will likely be treated as available for non-recurring appropriations and perhaps one-time tax relief since reserves are already at a healthy level.
- "New money", the excess of FY 2010 revenue over FY 2009 recurring appropriations, is estimated at \$392 million. If all appropriated, it would constitute a 6.5% increase.

### Bonding Capacity

Bonding capacity estimates have been prepared based on the revised revenue outlook and are attached to the end of the testimony document.

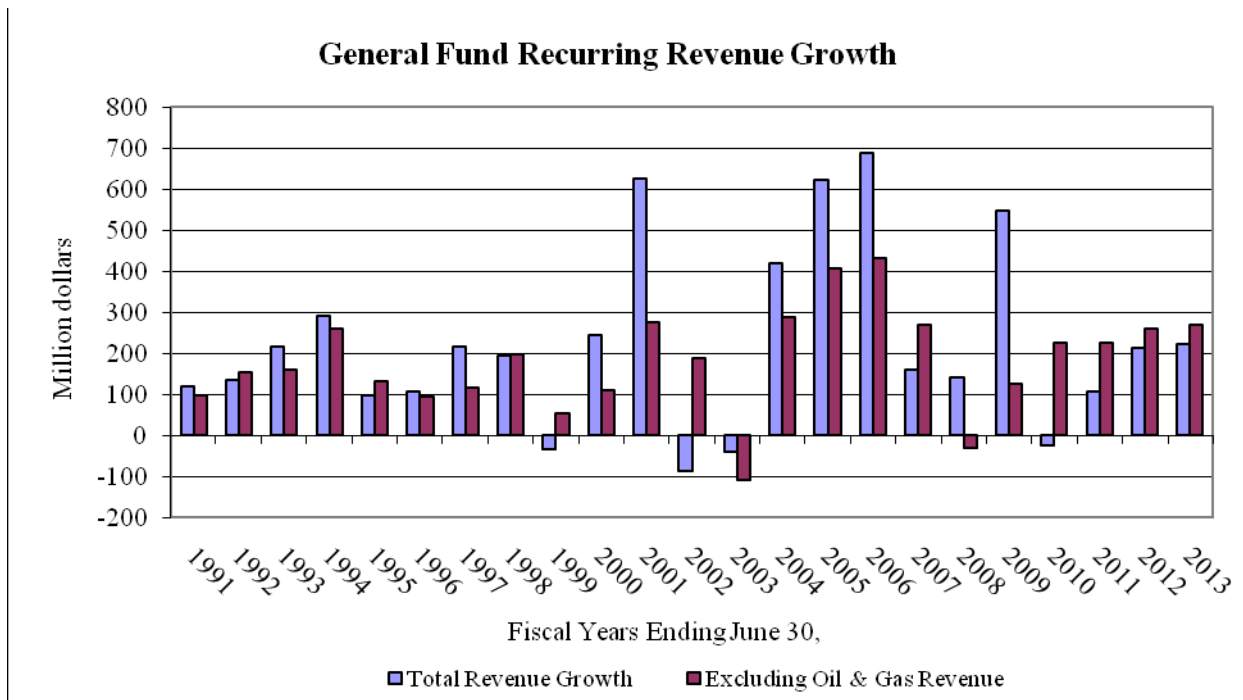
- FY 2009 General Obligation Bond capacity is estimated at \$224 million.

- Severance Tax Bond capacity is estimated at \$389 million. About \$152 million in statewide capital projects have already been approved, reducing the money available for new projects to \$236 million.
- Supplemental Severance Tax Bonds, earmarked for public school capital, are \$240 million.

**Historical context:**

Figure 3 provides some historical context for the current revenue projections. After a pronounced increase in the early 1990’s, perhaps generated by construction and employment gains related to the expanded Intel plant in Rio Rancho, the state experienced several years of low revenue growth, interrupted only by a spike in natural gas prices during the California “energy crisis” in 2001. Low growth in the late 1990’s was partly influenced by significant cutbacks at the state’s national labs. The state experienced large revenue increases in 2004 through 2007, with annual revenues growing by almost \$2 billion, about one-third of which amount is oil and gas revenue. Although legislative changes are included in these figures, legislated revenue decreases were slightly larger than increases. Growth slowed dramatically in 2008, with broad-based revenues actually declining. The forecast calls for increased oil and gas revenue – from an already-elevated base – as well as historically strong growth in the broad-based revenues.

**Figure 3**



The historical record suggests several inferences:

- Growth of other revenues is amplified – in either direction – by sharp movements in oil and gas revenue. This phenomenon may be limited in the future if high prices do not lead to additional hiring in the mining sector.
- Following four years of strong revenue growth, the forecast anticipates a “soft landing” in FY 2008-2009, and a resumption of relatively strong growth in 2010.
- In addition to the risk of lower oil and gas prices, a major question is how vulnerable the state’s economy is to budget cutbacks at the national labs. When these occurred in the mid-1990’s, they lead to several years of minimal revenue growth for the state.