Statement of Jim Peach
Legislative Finance Committee
Red River, NM , August 28, 2019

Thank you for this opportunity to speak to you about the challenge of achieving fiscal stability in New Mexico without relying so heavily on the oil and gas industry. The comments and suggestions I will make are my own and do not represent the views of any organization or anyone else. I will try not to repeat too much of what the other panelists have been saying.

For as long as anyone in this room can remember (and some of us can remember a long time), the most important tax issue facing New Mexico has been to provide a stable and dependable revenue stream for the state to perform its essential functions that is not dependent on the oil and gas industry. In1982, Tom Clifford stated before the Legislative Finance Committee that New Mexico faced two issues regarding the oil and gas industry and the tax revenue stream from that industry: “a long-term production decline and price volatility.” Given the dramatic increases in oil production in recent years, so-called peak oil is no longer a critical issue. Price volatility and the subsequent volatility in state revenue remains a critical issue. The current budget surplus could disappear in an instant.

We can all celebrate the projected revenue stream for FY19 and FY20. The new money for FY20 is a welcome relief. In real (inflation adjusted) terms, however, $7.4 billion translates into just about the same expected revenue as in FY08 or FY09 ($6.2 billion). In the meantime, of course, we have seen the expansion of Medicaid, which is now the second largest expenditure in the state budget. The Medicaid expansion has squeezed appropriations for all other essential functions of government.

In general, states need to increase their spending in nominal terms by the rates of growth of population and inflation just to continue providing the same level of services. Assuming an optimistic 1 percent increase in population and 2 percent inflation, this means about 3 percent a year with no new programs. A 3 percent stay even budget means the need for about $200 million in new money each year. So, what the state needs is not just a stable and dependable revenue stream. The state needs to increase revenue over the next several years by substantial amounts. Now is not the time to cut taxes.

Other tax issues are also long-standing and will not surprise anyone. Tax pyramiding, the truly amazing number of exemptions and exceptions to GRT, the relationship of the tax system to economic development, fairness and equity, how the state tax system relates to the Federal Tax code, and how we finance capital projects.

The urgency of addressing the fiscal stability issue is obvious. During FY 19 (and probably FY20), at least 40 percent of state revenue can be directly tied to the oil and gas industry. This is just under $3 Billion per year. Any disruption to the oil and gas industry would be a major fiscal issue. While all estimates suggest ample reserves of oil in the Permian, there is little reason to think that this will be a three or four decade period of smooth sailing as some have suggested.

Historically, oil price volatility has been an important characteristic of the industry. Since 2010, the inflation adjusted price of oil (WTI) has had annual fluctuations as large as 50 % in both directions. The monthly, weekly, and daily oil price changes can and often do look like a roller coaster. We should all be surprised by oil price stability, not volatility.

Threats to oil price stability are numerous and obvious. How long will Russia and Saudi Arabia cooperate in limiting production and exports? How long will the embargo on Iranian oil last? Can Venezuelan production resume? How long will the US-China trade dispute last and what will that do to oil demand? Will there be a national or global recession? Of course, there will be a recession. The questions concern timing, severity and duration. During the next national recession, no one should expect the federal government to provide meaningful aid to the states as it did during the Great Recession.

In the long-run, oil demand will be constrained by the growth of electric vehicles (EVs). This is not a short run problem that will be evident this year or next or even in five years. In ten or 12 years, EV sales of light vehicles will surpass the sales of internal combustion engine (ICE) vehicles. Without a new use for crude oil, there will be trouble in the Permian and other oil producing areas.

There are troubling signs in the Permian already. Even top producing exploration and production firms (E&Ps) are experiencing cash flow problems. Oilfield service companies are in financial trouble and are seeking merger opportunities or hard-to-find external financing. Weatherford recently filed for Chapter 11 bankruptcy. Haliburton laid off 8 percent of its North American workforce. It is a difficult environment for many firms. In the Texas portion of the Permian, rigs counts are down compared to a year ago and production is soon to follow this trend.

Is Growth the Answer?

New Mexico is unlikely to grow its way out of this problem. For the last five years (2014 to 2018) New Mexico has ranked 49th among the fifty states and District of Columbia in terms of per capita income (Bureau of Economic Analysis). Fifty years ago (1969), New Mexico ranked 42nd among the fifty states and its per capita income was 79.1 percent of the national average or about 3 percentage points higher than it was in 2018.

During 2018 employment in New Mexico increased by 11,333 jobs—an increase of 1.4 percent. (QCEW data). During the same time period, 6,108 or 53.9 percent of the increase in jobs occurred in Eddy and Lea Counties. Without the addition of the Eddy and Lea County jobs, the state increase would have amounted to only 0.64 percent, a less than enviable record. While the state has witnessed broad based employment increases, the growth in non-oil industry employment has not been enough to solve the fiscal stability problem.

According to an LFC presentation in July, 57% of the increase in matched GRT revenue through April is from Eddy and Lea Counties.

Income and employment are highly correlated (0.81 since 1998). Since 2010, New Mexico Total Personal Income has been growing at an average annual rate of 2.93 percent, while state GDP has been growing at 1.77 percent per year. New Mexico's population has grown at an annual rate of 0.32 percent per year since 2010.

The point of this discussion is very simple. There is nothing in the historical record to indicate that New Mexico is growing fast enough to withstand a serious downturn in the oil and gas industry or the next recession.

Will economic diversification solve the fiscal stability problem?

Probably not. .It is not obvious that diversification leads to faster economic growth. First, economic theory strongly suggests that specialization not diversification is the path to increasing the output, income, and employment of national or sub-national areas. The logic behind the assertion of specialization is simple: do the things that you do the best compared to others. This is the principle of comparative advantage. Sadly, I am not likely to become a closer for the Chicago Cubs and New Mexico is unlikely to become a major manufacturer of automobiles

Second, measuring diversification is a very technical process that can lead to contradictory conclusions. There are numerous statistical measures of diversification including the Shannon-Weaver diversity index, Theil's entropy index, the index of dissimilarity, the Gini Coefficient, and many more. None of these measures are entirely satisfactory and they can produce different answers to the diversification question. By some of these measures, New Mexico already has a diversified economy. Other measures suggest that New Mexico's economy is not very diverse ranking in the mid 40s among the fifty states. An excellent study of New Mexico's economic diversity was conducted in 2018 by Richard Adkisson and Sajid Noor. That study is available at: https://arrowheadcenter.nmsu.edu/wp-content/uploads/2019/05/New-Mexico-Industrial-Diversity-Dec-2018.pdf

Measures of diversification compare the industrial structure of one area to the industrial structure of another area or to some hypothetical industrial structure. For example, we can compare the industrial structure of New Mexico to that of the national economy, which by general consensus is highly diversified We could also compare the state's industrial structure to a hypothetical distribution that we consider diversified. Consider a hypothetical economy with ten industries each of which has 10 percent of employment or output. We could easily compare the structure of industry in New Mexico to this hypothetical standard of diversification.

A simple way to examine diversity is to look at location quotients (LQs): the percent of employment in a given industry in NM divided by the percent of employment in the US in the same industry. An LQ greater than 1 indicates relative specialization in that industry. Tabl1 displays LQs for major sectors of the New Mexico economy. Most of the LQs are greater than one. Notable exceptions include manufacturing, wholesale trade, transportation and warehousing, information, and finance.

Third, if the New Mexico economy had exactly the same industrial structure as the nation, we could expect growth of the economy to be approximately the same as national growth. New Mexico needs to grow faster than that. If the state is interested in diversity as a strategy, it might take a look at industries that are less sensitive to the business cycle or are inherently less volatile than other industries.

Geographic diversification is, well worth a closer look. For the most part, economic activity in the state is concentrated in only a few counties: the four MSAs plus Eddy and Lea Counties. This is reflected in demographic data.

According to the latest estimates from the Census Bureau, New Mexico's population increased by only 1.5 percent between 2010 and 2018 and during two years the state had absolute declines. Between 2010 and 2018, 23 of the state's 33 counties lost population and seven New Mexico counties had a smaller population in 2018 than in 1930.

New Revenue Streams:

With a little imagination and a good sense of humor, there are several possible sources of new revenue for the state. Some of these are described below. Any tax proposal that can get through the legislature and secure the governor's signature is possible.

An obvious place to start is to eliminate many, if not all, of the exemptions and deductions from the GRT. These exemptions and deductions are tax expenditures. The food tax exemption, for example, was intended to help the poor but it also subsidizes well-off New Mexicans. There are more efficient ways to help the poor. Eliminating this exemption alone would save the state more than $200 million per year. The same can be said for many other exemptions.

There have been numerous proposals to legalize recreational cannabis and impose an appropriate tax. This has already been done in several states including our neighbor to the north. While this would no doubt generate some additional state revenue, the results are likely to be disappointing. A recent Pew Foundation report indicates that marijuana tax revenue is volatile, hard to predict, and often disappointing in the ten states that have legalized recreational use. (

An expert on the hemp industry told me that it is all about CBD oil. Forget fiber, the money is in CBD. There is a lot of confusion nation-wide about tax rules on hemp and CBD. And, since hemp has only been recently legalized at the state and federal level, it is too soon to know how large this potential revenue stream might be.

The state could place a tax on electric vehicles (EVs) to partially offset the loss of revenue from the gasoline tax. Seventeen states have already done so and rumor has it that legislation to do this will be introduced in the next session. Georgia has the highest EV tax at $300 per vehicle per year. California, which can't quite decide what it wants to do, subsidizes the initial purchase of EVs but also imposes an annual tax on them. In the near future, an EV tax would not generate a lot of revenue for New Mexico but as sales of EVs increase over the years, this could be a significant source of revenue.

Along the same lines, an increase in both the gasoline tax and the special fuels tax is long overdue. Each penny increase in the gasoline tax would probably generate an additional $10 to $12 million in state revenue per year and a substantial but unknown portion of this would be paid for by out-of-state visitors. Twelve states implemented a gasoline tax on July 1, 2019 and the increases ranged from 0.5 cents per gallon to 19 cents per gallon (https://itep.org/gas-taxes-rise-in-a-dozen-states-including-an-historic-increase-in-illinois/).

New Mexico could also tax plastic water bottles, plastic straws and plastic utensils along with Styrofoam cups and food containers. Such a tax could generate substantial revenue, reduce landfill and recycling costs, and have positive environmental effects. Based on national averages, New Mexicans consume about 800,000 plastic water bottles per day. A ten- cent tax per bottle would generate about $80,000 per day or about $29 million per year –unless of course, the tax caused a change in behavior. And this calculation is for water bottles alone.

Several cities, but no states, have passed a soda tax –a tax on sugary drinks. Cities imposing such a tax include Philadelphia, Boulder, Seattle, San Francisco, Oakland and others. Generally, the tax is 2 cents per ounce on sugary drinks. The purpose of this tax is to reduce consumption of sugary drinks (a sin tax) and not to raise revenue, but such a tax would raise some revenue.

A special excise tax on college sports betting might generate a small amount of revenue.

Traditionally, New Mexico has not relied heavily on the property tax. Other states (e.g., Texas) obtain a substantial portion of their revenue from a property tax. Historical and cultural opposition to the property tax is understandable and probably remains a barrier to the property tax, but an increase in property taxes has the potential to increase state revenue significantly.

Tax triggers are another possibility. Given FY19 reserve balances that are projected to total 25 percent or more of general fund revenue, the state can probably withstand a severe oil and gas industry downturn for at least a year, but probably not two years. The last major oil price downturn which occurred in June 2014 lasted two years and it was longer before state revenues began to recover. Tax triggers could be designed to automatically increase tax rates on some or all major state revenue sources if reserve funds fell below some specified percent of the general fund. Triggers could also be set to reduce tax rates when reserve balances exceeded some specified level. Tax triggers could be imposed on the existing system without the agonizing process of major tax reform.

The list of new revenue streams above is not intended to be complete. Rather, the list is intended to illustrate the many options available to raise revenue in the event of an oil industry downturn or other threats to the state's revenue.

What else can be done?

Marginal changes in tax rates and minor sources of new revenue are unlikely to fix the problem. We have been doing that for as long as anyone can remember.

Why not try something new? My former boss, dean, governor, president, chancellor, Garrey Carruthers spends a lot of time and money in his garage attempting to make a 1955 Crown Victoria run like it was new. Governor Carruthers is smart enough not to do the work himself and also smart enough to know that the 1955 Crown Vic will never be as good as new or run like a 2019 vintage car. It just can't be done. Nevertheless, minor improvements and small victories seem to please him.

Governor Carruthers was neither the first governor or the last to try to find solutions to New Mexico's fiscal issues. In 1986 he created a Blue Ribbon Tax Commission which did a lot of good work and patiently listened to all of the usual suspects, experts, and lobbyists. Yes, I plead guilty to having testified before this commission and a nearly empty room. While there were a number of good ideas presented to the Blue Ribbon Commission, the basic problems were not solved during his administration or later. The state continued to drive a 1955 Crown Victoria.

Over the years, the Legislature has also spent an uncountable number of hours in genuine efforts to fix the problem. Several committees including Senate Finance, the Legislative Finance Committee, and the Revenue Stabilization and Tax Policy Committee devote much of their time to tax issues. In recent sessions, the number of tax reform proposals seems to have accelerated.

These tax reform proposals have originated from both sides of the aisle and occasionally have been co-sponsored by Legislators in different parties. The efforts at tax reform have been sincere and many of the proposals embody sound principles of taxation. Yet, here we are discussing issues that have plagued the state for decades.

A value added tax (VAT) is not a new idea, but it would be a very new policy in New Mexico. It is worth considering. For New Mexico, a VAT could:

- Eliminate tax pyramiding
- Eliminate the problem of exemptions and exceptions from GRT
- Easily replace GRT and CIT
- Possibly replace PIT
- Be implemented at a relatively low tax rate
- Provide a more stable revenue source
- Treat all businesses in the same fashion and
- Reduce the amount of time this committee and others spend on tax issues

The disadvantages of a VAT are also well-known. A VAT is said to be:

- Regressive, but so is NM's GRT even with exemptions such as the food tax exemption.
- Sensitive to the business cycle, but so are all of New Mexico's revenue streams and a VAT is based on value added which varies less over the cycle than other variables
- A barrier to exports, but this can be addressed as it is in many nations
- Difficult to administer, but so is our current tax system, particularly the GRT
- Difficult to set an initial tax rate, but this problem is probably over-stated. A lot of data on value added is available and economic models including the EY model delivered to the state last year can be used to estimate the rate

Michigan was the first state to implement a value added tax (1975). Michigan named this tax the Single Business Tax (SBT) and claimed that it eliminated seven forms of business taxation. The initial SBT tax rate was 2.25% but it has since been raised to 4.95 percent. In 2007, Michigan renamed the SBT to Michigan Business Tax (MBT) and implemented a 0.8% gross receipts tax. The MBT is still a VAT. Michigan also has a flat rate (4.25%) individual income tax. Michigan claims on its tax website to be the 11th most business-s friendly tax system in the nation. New Hampshire has a very small VAT (0.25%) and several other states have considered implementing a VAT.

In New Mexico, a VAT could be implemented gradually while simultaneously beginning the process of eliminating GRT and perhaps other taxes.

Concluding Remarks

The time to act on fiscal stability issues is now. Waiting for the next fiscal crisis to occur is not an attractive option. Fiscal stability would contribute to efforts to attract in-migrants and new businesses from other areas. Who wants to move to a state in which fiscal instability threatens the provision of essential services.

Waiting for economic growth or economic diversity to solve the problem is at best, a very long-term solution. Hoping that there will not be a downturn in the oil and gas industry or that there will not be another national recession is a pipedream.

The state has many options including some combination of revenue enhancing policies. No one likes to increase taxes but many of the options are better described as tax reform. The obstacles to achieving fiscal stability in New Mexico are political, not economic.

I appreciate your time and patience. I will be happy to answer questions.

Table 3. Location Quotients for New Mexico (2013-2017)					
US Based	**2013**	**2014**	**2015**	**2016**	**2017**
By type					
Wage and salary employment	1.01	1.01	1.02	1.02	1.01
Proprietors employment	0.96	0.96	0.95	0.94	0.95
Farm proprietors employment	1.97	2.00	2.04	2.07	2.11
Nonfarm proprietors employment	0.91	0.91	0.90	0.89	0.90
By industry					
Farm employment	1.87	1.84	1.90	1.99	1.94
Nonfarm employment	0.99	0.99	0.99	0.99	0.99
Private nonfarm employment	0.91	0.91	0.91	0.91	0.91
Forestry, fishing, and related activities	0.98	1.04	1.05	1.10	1.09
Mining	3.89	4.11	4.11	3.88	3.99
Utilities	1.36	1.36	1.37	1.39	1.37
Construction	1.09	1.07	1.06	1.03	1.05
Manufacturing	0.47	0.45	0.46	0.45	0.45
Wholesale trade	0.71	0.74	0.73	0.69	0.69
Retail trade	1.04	1.05	1.05	1.05	1.04
Transportation and warehousing	0.72	0.71	0.69	0.64	0.63
Information	0.83	0.81	0.82	0.84	0.81
Finance and insurance	0.60	0.62	0.61	0.62	0.62
Real estate and rental and leasing	0.81	0.80	0.80	0.80	0.80
Professional, scientific, and technical services	1.03	1.02	1.01	1.02	1.04
Management of companies and enterprises	0.41	0.41	0.42	0.43	0.43
Administrative and waste management services	0.81	0.80	0.78	0.79	0.82
Educational services	0.64	0.64	0.64	0.65	0.65
Health care and social assistance	1.02	1.03	1.06	1.09	1.08
Arts, entertainment, and recreation	1.00	0.99	1.00	0.98	1.00
Accommodation and food services	1.11	1.12	1.12	1.14	1.13
Other services, except public administration	0.87	0.87	0.87	0.88	0.89
Government and government enterprises	1.49	1.50	1.51	1.52	1.51
Federal, civilian	1.82	1.81	1.81	1.83	1.83
Military	1.53	1.52	1.51	1.58	1.61
State and local	1.43	1.45	1.46	1.47	1.45
State government	1.85	1.89	1.92	1.94	1.92
Local government	1.27	1.28	1.29	1.29	1.28
Total employment	1.00	1.00	1.00	1.00	1.00
Source: Author's Calculations based on Table 1 and 2					