FY19 Appropriation Request Budget Guidelines

NEW MEXICO LEGISLATIVE FINANCE COMMITTEE

The Legislative Finance Committee will focus on developing a balanced fiscal year 2019 budget that supports legislative strategic priorities and addresses the structural imbalance between recurring revenue and recurring expenditure levels. The LFC recommendation will support an appropriate level of reserve balances to ensure the state maintains prudent financial resources to protect itself against future economic downturns. Detailed guidelines are attached.

Budget Request Guidance

Flat or nearly flat agency general fund appropriations, strengthened financial reserves, and an expanded focus on legislating for results are among the goals of the LFC's *FY19 Appropriation Request Budget Guidelines*. The committee will consider any growth in base general fund appropriations on a case-by-case basis to address changes in program caseload, workload, waiting lists, and medical and per diem inflationary costs. The committee will focus on funding programs that are supported with evidence of success. These policies are to serve as a guide for improved financial management and heightened accountability, with more focus on making sure today's decisions are sustainable in the future and will strengthen New Mexico's financial future and ranking among states.

Committee Priorities

Public Education
Early Childhood Development
Medicaid
Economic Growth
Public Safety
Protection of Vulnerable Citizens

Priorities

Available general fund will be targeted for growth in the Medicaid program, kindergarten through 12th grade education, early childhood initiatives, substance abuse, and behavioral health. Within agency base budgets, the need for initiatives outside of an agency's core responsibilities will be reviewed for possible reallocation to adequately fund core functions.

Legislating for Results

The committee will focus on funding programs with demonstrated results in improving lives and effective design and strong planning and management. The committee will emphasize the goals and practices of the Accountability in Government Act (AGA) that provide for more cost-effective and responsive government services by using, within the state budget process, defined outcomes, outputs, and performance data and annual evaluations of state government programs. Performance information, routinely provided to the Legislature and the public, provides a major accountability tool by identifying what taxpayers get for their tax dollars.

Legislating For Results

Identify Priority Areas and Performance
Review Program Inventory and Effectiveness
Budget Development
Implementation Oversight
Outcome Monitoring

Managing For Results

Measuring the Right Things
Improving Performance Reporting
Incorporating Benchmarking
Implementing Corrective Action Plans

Managing for Results

The development of the budget will also consider agency efforts to effectively use performance indicators and tools, such as cost-benefit analysis, to ensure limited resources are put to good use. Incorporating performance results in management discussions and decisions, assigning to staff specific responsibilities, and following up is the path toward success.

GUIDELINES FOR FY19
LFC APPROPRIATION
RECOMMENDATION

I. PURPOSE

The Legislative Finance Committee (LFC) budget guidelines provide analysts with committee directions on performance-based budgeting, the preparation of the budget narrative, the development of FY19 recommendations on recurring appropriations and, priority capital spending and other one-time investments. The guidelines also serve to inform state agencies and the general public about LFC new priorities and the committee's approach to budget recommendations for FY19.

II. REVENUE OUTLOOK

The August 2017 consensus revenue estimate projects FY18 recurring general fund revenue will be $5.9 billion, and FY19 recurring revenue will be $6.1 billion. Preliminary FY17 ending reserve balances are estimated at $329 million, or 5.4 percent of recurring appropriations. Preliminary estimates for FY18 ending reserve balances are $206 million, or 3.5 percent of recurring appropriations. “New money” in FY19, defined as FY19 projected recurring revenue less FY18 recurring appropriations, is estimated at $25 million, or 0.4 percent of recurring appropriations, marking the first time in the last several forecast periods when new money was a positive figure.

III. FY19 PRIORITY AND APPROACH

The goal of the committee is to propose a balanced budget for the operations of government that improves service levels, increases accountability, and ensures an adequate general fund reserve. The August consensus revenue estimate identified significant downside risks to reserve levels heading into the 2019 budget cycle which will challenge the committee’s efforts to boost reserves to the longstanding goal of 10 percent. Many of the budget balancing and reserve building tools deployed during the state’s solvency crisis, identified in the attached stress-test memo, were largely exhausted; however, low reserve levels may require the committee to consider use of these tools again.

The committee will recommend a balanced budget focused on improved education, early childhood investment, public health, workforce development, improved public safety outcomes, the protection of vulnerable citizens, and increased economic growth.

Overall, the committee will emphasize flat general fund appropriation levels in most state agency budgets. Any growth in base general fund appropriations will be considered on a case-by-case basis to address changes in program caseload, workload, waiting lists, and medical and per diem inflationary costs. In order to fund prioritized programs, the committee will consider targeted cost savings, focusing on duplicated services, non-critical or ineffective initiatives, areas where efficiencies have been created, or where there is no evidence a program is working.

Further, LFC analysts shall:
- Identify opportunities for consolidating or streamlining duplicate or unnecessary programs and activities, eliminating earmarks, and enhancing efficiency;
- Federal funds to largely support the program are being phased out;
- Identify agencies or programs that exhibit mission drift, have demonstrated limited success in fulfilling their mission, are unfocused, ineffective, high cost, are not cost beneficial, could be funded by user fees or alternative sources, or are no longer needed because goals or other conditions have been met or changed, so that funding can be utilized elsewhere;
- Use cost-saving opportunities and evidence-based analysis to prioritize agency funding and improve performance outcomes; and
- Consider whether funding supports existing service levels and caseloads.

IV. PERFORMANCE AND ACOUNTABILITY

The Legislature and the public have improved access to performance information through updated key agency report cards. In July 2017, at the start of the 2019 budget cycle, LFC staff worked with the Department of Finance and Administration to update the list of key agencies and schedule of reporting frequency for each agency. Only three notable changes, to match the availability of data, removed the Department of Information Technology from the list of key agencies and switched Public School Support and Higher Education Institutional reporting to semi-annual reporting.

Analysts shall integrate agency performance results into their budget analysis and, whenever possible, align budget recommendations with program achievement. Consideration for continued base funding should be given to those programs that demonstrate results, effective design, and strong planning and management. Analysts should follow these guidelines in reviewing agency performance:

- Agency strategic plans should ensure: 1) the stated mission, goals, and objectives are consistent with statute and state policies; 2) overarching programs are coordinated among divisions and, where applicable, across agencies; 3) programs are consistent with current resources and conditions; and 4) resources are aligned with the agency's strategic direction and performance results.
- Performance targets should be benchmarked for priority programs whenever possible. Suggested resources for benchmarking include federal standards, best practice standards set by other agencies and states, historical data, and desired results. Analysts should recommend new or alternative performance measures that better gauge program outcomes as necessary.
- Performance data and results from recent LFC program evaluations should be used to identify programs that are ineffective or producing marginal results or, conversely, are achieving desired outcomes.

Analysts shall use Results First cost benefit analysis where available, notably in the areas of public safety, early childhood, child welfare, and behavioral health programs.

The committee will also focus on Managing for Results. Performance accountability has matured and agencies need to more effectively use performance indicators and tools, such as cost-benefit analysis, to ensure limited resources are used to cut ineffective programs and bolster effective ones.

In select cases, analysts may recommend additional performance measures, from what DFA approved during the interim for agencies to include in their FY19 budget request, to hold agencies accountable for achieving program results. Additionally, the committee may recommend less budget flexibility for agencies that report with less frequency and do not report on a robust set of performance measures.

V. BUDGET GUIDELINES

The following budget guidelines apply to all agencies.

Compensation, FTE, and Vacancy Rates. Even though state employment in New Mexico remains significantly below peak employment levels seen prior to the Great Recession of 2008, out-of-cycle increases, targeted salary adjustments, and increased benefit costs have increased personal services and employee benefits (PS&EB) spending. Also, elevated vacancy rates have resulted in large amounts of PS&EB funding transferred to other areas of the budget.

According to the State Personnel office, the state's salary structure is 19.5 percent below market. The committee may consider the need for targeted compensation increases to address poor recruitment and retention issues impacting public safety, health care, and other positions that serve vulnerable citizens. Additionally, the committee may consider general salary increases for state employees to offset inflation and increases for benefits

Expenditures and Contractual Services. Analysts are directed to analyze requested expenditures for professional services and other contracts to ensure contracts address legislative priorities, and adhere to performance criteria. Analysts shall use the monthly Contracts Report provided by DFA information in the New Mexico Sunshine Portal and postings on the USD website to analyze an agency's historical use of contractual services. Analysts should note shifts of workload from FTE to contractors and ensure the cost of performing the work is not double funded.

Revenues and Cash Balances. Use of other state funds and federal funds shall be maximized based on grants, awards, agreements, budget adjustment request (BAR) activity, and program history. To reduce the need for revenue from the general fund, cash balances shall be used in the FY19 budget recommendation. Governing statutes shall be reviewed to ensure that if funds are budgeted appropriately and if they can be used for other purposes. Analysts shall scrutinize expenditures where an earmarked revenue or federal funds are in decline or potentially unavailable.

Federal Funds. Federal funds should be leveraged to the extent possible in keeping with the committee's policy priorities to ensure these funds are accurately reflected in the budget recommendation. Analysts are directed to compare information on revenue forms provided in the budget requests with deviations from appropriations, the database provided by the Federal Funds Information for States (FFIS) service, and other sources of information on federal funds. Analysts shall also use historical budget adjustment request (BAR) information to determine if the level of federal funds is accurately reflected in the agency request.

Expansion. Given revenue projections, expansions will be limited to committee priorities that are evidence-based or tied to enhanced service delivery. Workload growth is not considered an expansion. Analysts shall avoid financing expansions with nonrecurring revenue. Generally, expansions not identified as a committee priority must be financed within current appropriation levels through reprioritization. All expansions must be tied to enhanced performance and explained in the budget document accordingly. Expansion FTE should be budgeted for a partial year if it is unlikely they will be filled by July 1, 2017.

Capital Outlay, Building Use Costs, and Space Allocation. To achieve greater efficiency with the state's limited resources, analysts should evaluate capital projects based on critical public health and safety, other initiatives in progress, and state and federal code compliance. Analysts shall evaluate the effectiveness of agency owned and leased space and operating budget implications, including maintenance and renewal costs in future years, space utilization standards adopted by the Capitol Buildings Planning Commission, lease costs, and square feet per employee, when reviewing requests for new facility construction, renovation, expansion, demolition, or leased space. Analysts shall review agency Infrastructure Capital Improvement Plans (ICIP), agency compliance with Executive Order 2012-023 (Facility Master Planning Guidelines) and Executive Order 2013-006 (Uniform Funding Criteria, Grant Management, and Oversight), LFC quarterly reports, and the progress and project outcome of significant capital appropriations included in the $1 Million or Greater Report authorized in previous years and progress toward completion of local projects funded between $300,000 to $999,999.

Information Technology Request. Given revenue projections, a limited number of the state's most critical IT projects will be considered for funding. Funding recommendations will be based on conformance with stated agency priorities, agency and statewide IT plans, the quality of the specific business case, and available funding. Analysts shall consider operating budget implications, such as ongoing maintenance, training, and impacts on operations, when reviewing requests for new or extended information technology (IT) projects. Staff shall review IT appropriations from previous years and monitor the progress and outcome of ongoing IT projects. Analysts must ensure all IT funding requests are submitted through established protocol (i.e. requests are submitted directly to DFA, LFC, and DoIT using the "C2" request form separate from the agency's annual budget request) to ensure these requests receive the appropriate level of analysis prior to approval.

Agency Audit Reports. Analysts shall use the agency's financial audit reports in preparing the FY19 budget recommendation paying close attention to general fund reversions, unreserved/undesignated fund balances, and any long-term outstanding debt. Significant deficiencies and material weaknesses identified in the audit shall be reported to the LFC. Additionally, analysts shall identify significant, long-existing fund balances, barriers to expenditure, and potential reprioritization of accumulated balances.

VI. TAX EXPENDITURES

In the 2017 legislative session, an appropriation was made to fund a tax study to assess the adequacy and stability of the state's tax system, particularly with respect to the gross receipts tax and income taxes. A review of tax expenditure estimates will be included as part of this study. The committee staff shall review the results of the tax study and the use of tax expenditures and earmarked revenues to identify uses of state funds that do not meet the intended purpose, are not cost effective, or are no longer necessary and can be redirected to higher priority uses.

The state faced significant challenges crafting a budget in the last two legislative sessions due to declining revenue projections. While the economy appears on track for modest growth in FY18 and beyond, the state will likely continue to face budget challenges in the 2018 legislative session, as recurring revenues continue to fall short of recurring appropriations. Making the budget situation more difficult is the magnitude of the state's tax expenditures, many of which have not been reviewed for efficacy or efficiency, and some of which appear no longer necessary. Revisiting some of the more costly tax expenditures and reducing or eliminating ones that do not offer significant benefits could free up funds to pay for essential state services.

VII. OTHER FINANCIAL ISSUES

In addition to agency operating budgets and revenues, analysts should consider other financial issues.

Medicaid. By the end of FY18, an estimated 956,259 New Mexicans will be enrolled in Medicaid, 278,935 of whom became eligible pursuant to the federal Patient Protection and Affordable Care Act (ACA), which expanded Medicaid eligibility for adults with incomes up to 138 percent of the federal poverty level beginning January 1, 2014. While early projected shortfalls for FY17 were largely avoided due to initial cost containment efforts and a moratorium on a federal insurers' tax, the outlook for FY18 and FY19 remains a significant concern. In May, the Human Services Department estimated an additional $32 million to $80 million in new appropriations from the general fund will be needed in FY18 for enrollment, utilization, and reduced federal support for the expansion population, which is decreasing to a maximum of 90 percent by calendar year 2020. The changing federal outlook adds further volatility to health care.

Analysts should evaluate cost-saving initiatives such as administrative cost ratios, payment and delivery system improvement initiatives, appropriateness of various rate structures, changes in federal requirements, and consider ways the state can leverage Medicaid dollars for services that improve outcomes, such as Medicaid financed home visiting. Additionally, analysts should evaluate programs initiated or expanded with ACA such as care coordination, pay-for-performance and Centennial Rewards to ensure cost effectiveness and expected performance outcomes.

Public School Funding Issues. The $2.7 billion investment in public education continues to show slow progress in improving student achievement. Certain components of the formula are not aligned with improving student achievement for at-risk populations. Accountability for both formula funding and PED flow-through grant funding continues to be a concern, and districts are not able to compete with neighboring states when it comes to teacher pay. Additionally, resolutions for the education sufficiency lawsuits and federal special education maintenance of effort requirement shortfalls remain on the table. Priorities of the committee include adjusting the funding formula to better support struggling students and close the achievement gap, investing in programs that improve student achievement, ensuring accountability for public education appropriations, and increasing school employee compensation to recruit and retain the highest quality employees. Early childhood programs that promote literacy will again be prioritized, including Prekindergarten and K-3 Plus – both of which have demonstrated improved outcomes for participants.

Economic Growth and Workforce Development. New Mexico's economy has not yet recovered from the Great Recession and has not grown much for most of the past year. The state's workforce training and development programs are coming under increasing pressure to prepare and retrain citizens for current and prospective job opportunities, especially in light of underemployment and regional unemployment levels in New Mexico. Many economic development programs and tax incentives focus on short-term results, ignoring long-term structural issues such as infrastructure and workforce education and readiness. However, nearly every survey of business executives and site selection consultants ranks these two issues as the most important for expanding and relocating businesses. Analysts shall review existing and proposed programs related to economic development and workforce training to address these concerns, improve accountability for recently approved funding, calculate the cost per job created when possible, and identify evidence based investments to improve agency coordination and reporting, reduce fragmentation, improve labor force quality, assist job growth, and promote increasing personal income levels.

Child Welfare. Although funding for early childhood initiatives have continued to increase over the previous few years, early childhood programs are under increasing pressure to improve statewide quality standards which typically increase costs. Priorities for FY19 include targeting existing services to children birth to age 3. Additionally, funding must be invested in a deliberate manner so that communities can grow local capacity and infrastructure responsibly. Enrollment in childcare assistance increased significantly in FY17, over 5 percent, and is projected to continue growing in FY18, FY19, and FY20. This coupled with increasing provider rates to fund the highest levels of quality will considerably raise the need for additional childcare assistance funding in FY19 and FY20. Conservative estimates project an additional $20 million in both FY19 and FY20 and will be necessary to maintain caseloads and reduce the chances of growing waitlists. New Mexico continues to struggle to meet quality childhood program standards, such as the providers' level of technical skills, education, and stability among caregivers; workforce development for providers will be crucial to improving child welfare.

Behavioral Health. Concerns remain that the state has not fully recovered from disruptions to the behavioral health system which exacerbated the already existing challenges to access and quality care. Over the interim, the state's Legislative Finance Committee (LFC) and the Legislative Health and Human Services Interim Committee (LHHS) jointly requested additional information about the Human Services Department's efforts to ensure the behavioral health network is sufficient to meet the needs of the state's most vulnerable populations. Working together with HSD, analysts will analyze access, costs and expenditures, outcomes, and services available to best address gaps and improve outcomes with limited resources.

For non-Medicaid behavioral health administered by HSD’s Behavioral Health Services Division, analysts will assess changes as clients move from state-funded services to Medicaid-funded services and determine the best use for any additional savings realized. Additionally, analysts should assess the department’s plan for and anticipated costs and savings for the department to assume the administrative services functions from OptumHealth.

DATE: August 17, 2017
TO: Patricia A. Lundstrom, Chair, LFC
FROM: Jon Clark, Chief Economist, LFC; Dawn Iglesias, Economist, LFC
SUBJECT: Simple Fiscal Stress Test

Several states perform occasional fiscal stress tests to estimate the impact to state revenues from a downturn in economic conditions or other factors, such as energy prices. These tests can involve expensive software, customized economic forecasts by external organizations, and significant staff time. LFC staff economists performed a simple, mini stress test to provide ballpark figures for the impact to state revenues of another decline in oil prices. This is not intended to be a complete, dynamic stress test.

Due to the state's recent efforts to maintain solvency after the impacts of the oil price shocks in 2015 and 2016, the state's ability to deal with another significant revenue shock without swift and substantial budget cuts or tax and fee increases is limited. As a result, the state should begin planning for how, and over what period of time, to bring reserves back up to 10 percent or more.

Recent Oil Price Shock: A Historical Stress Test

Over the last two years, New Mexico underwent a downturn in revenues in line with an adverse stress test and managed to end FY17 with projections of positive reserve levels at the end of FY17 and FY18. Below are some key points to understand about this real world stress test.

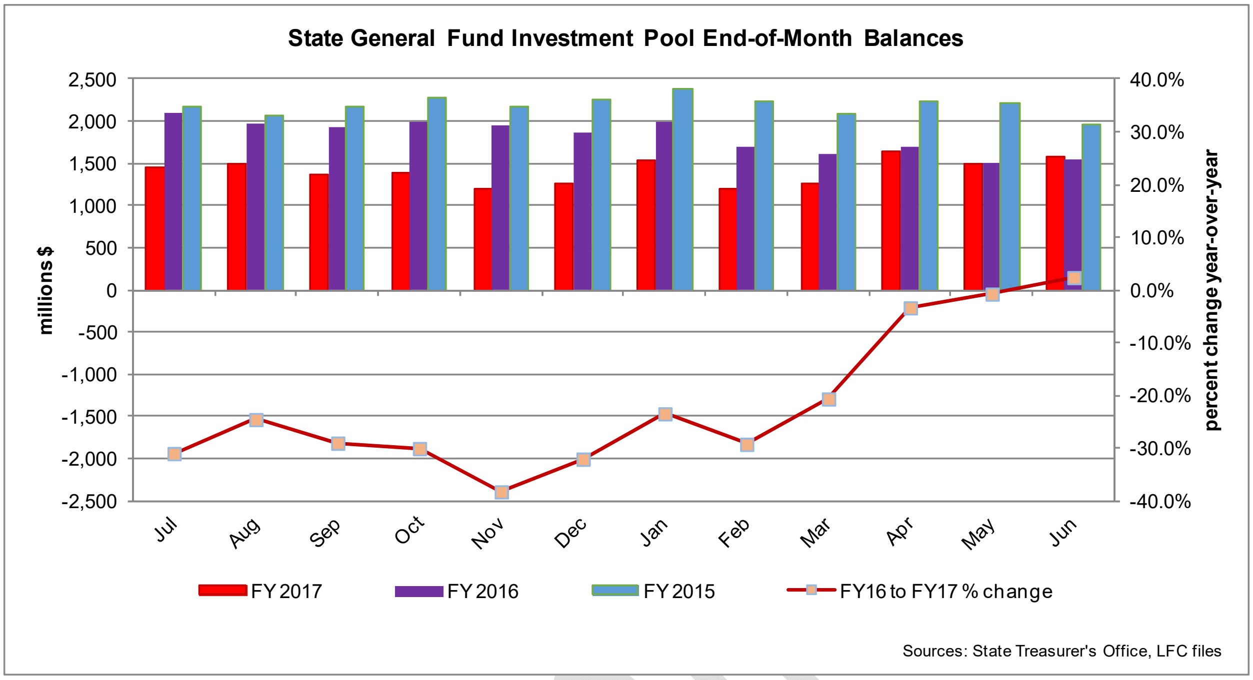
What Caused the Impact?

- New Mexico was in a weak economic position with a "lost decade" of job growth and wage growth.
- Oil and gas prices fell significantly.
    - The prices directly impacted severance tax revenues tied to production values and rents and royalties, such as federal mineral leasing.
    - The prices indirectly impacted revenues due to:
        - A reduction in gross receipts tax revenue from the decline in drilling activity;
        - A reduction in personal income tax revenue from associated job losses;
        - A reduction in corporate income tax revenue, partly due to reduced profitability for oil and gas companies and related businesses; and
        - Other related impacts.
- Tax expenditures cost more than expected (e.g. high-wage jobs tax credit and health care practitioners tax credit), and combined with tax cuts (e.g. corporate income tax changes) led to significant revenue reductions.

Magnitude of the Impact

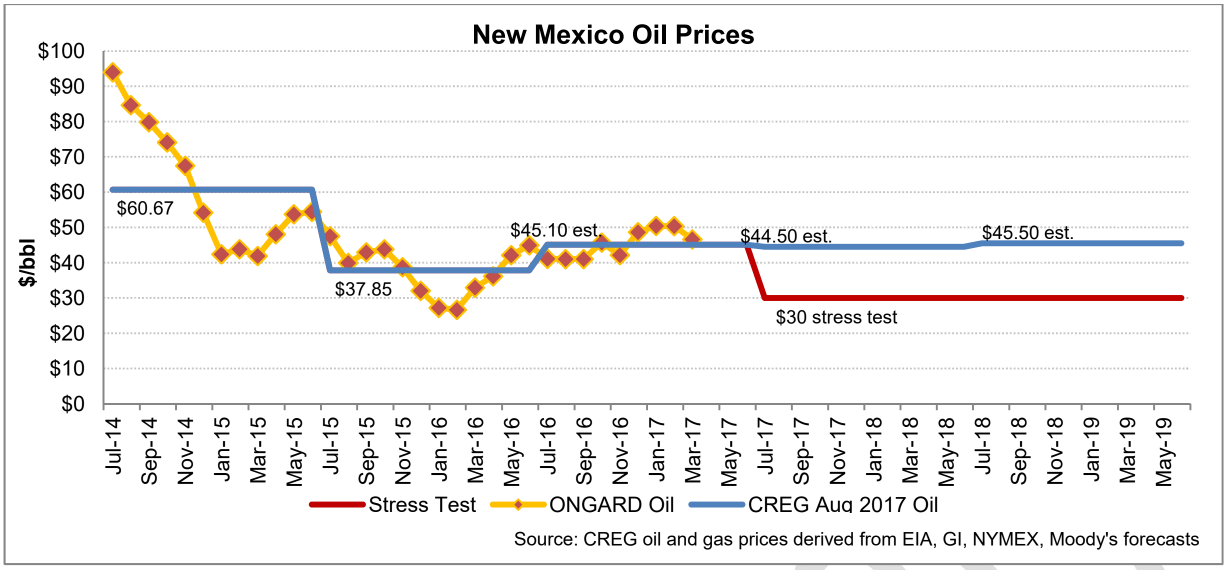
- The consensus revenue estimates for FY17 and FY18 were reduced by $866 million for each of the two years from the December 2015 forecast to the December 2016 forecast.

- General fund balances held by the treasurer fell from an end-of-month peak of $2.4 billion in January 2015 to a low of $1.2 billion in February 2017 before rising to $1.6 billion in June 2017.



Looking Forward: Simple Stress Test Results

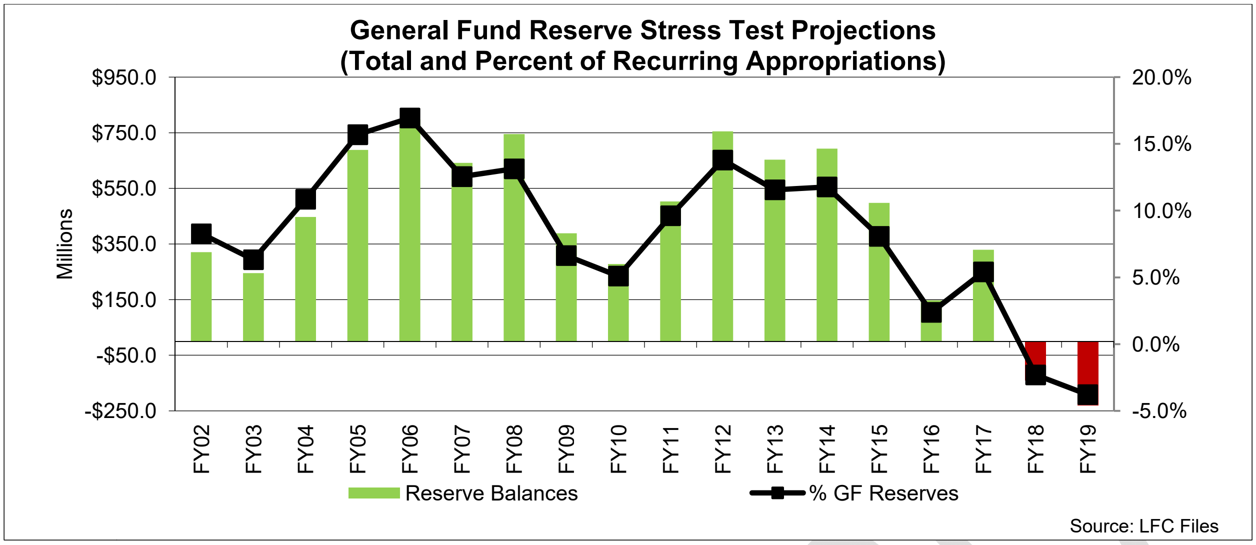
LFC economists performed a simple, mini stress test to illustrate the potential impact to general fund revenues if oil prices fell to $30 per barrel and gas prices fell to $2.90 per million cubic feet throughout FY18 and FY19. A comprehensive stress test would use detailed economic forecasts designed in coordination with the chosen stress test scenario and would ideally use dynamic modelling software to capture indirect and induced effects. This is a static test using only changes in prices and is not designed to accurately forecast total revenue losses under this scenario. The purpose was to supply a ballpark estimate of potential losses to determine what steps the state might need to take in such a situation.



Gross receipts tax (GRT) revenues are affected by multiple variables impacted by low oil prices in addition to the prices themselves (such as mining industry employment levels); however, this stress test modeling kept other variables constant, resulting in an estimated impact that does not truly reflect the impact of a large drop in oil prices. Therefore, the scenario also includes the impact of the reversal of abnormal "other credits" impacts from June 2016 through May 2017, increasing the general fund losses by $84 million. While not related, adding this known downside risk changes the GRT losses to more realistic ballpark figures given the magnitude of the losses sustained in FY16 and FY17.

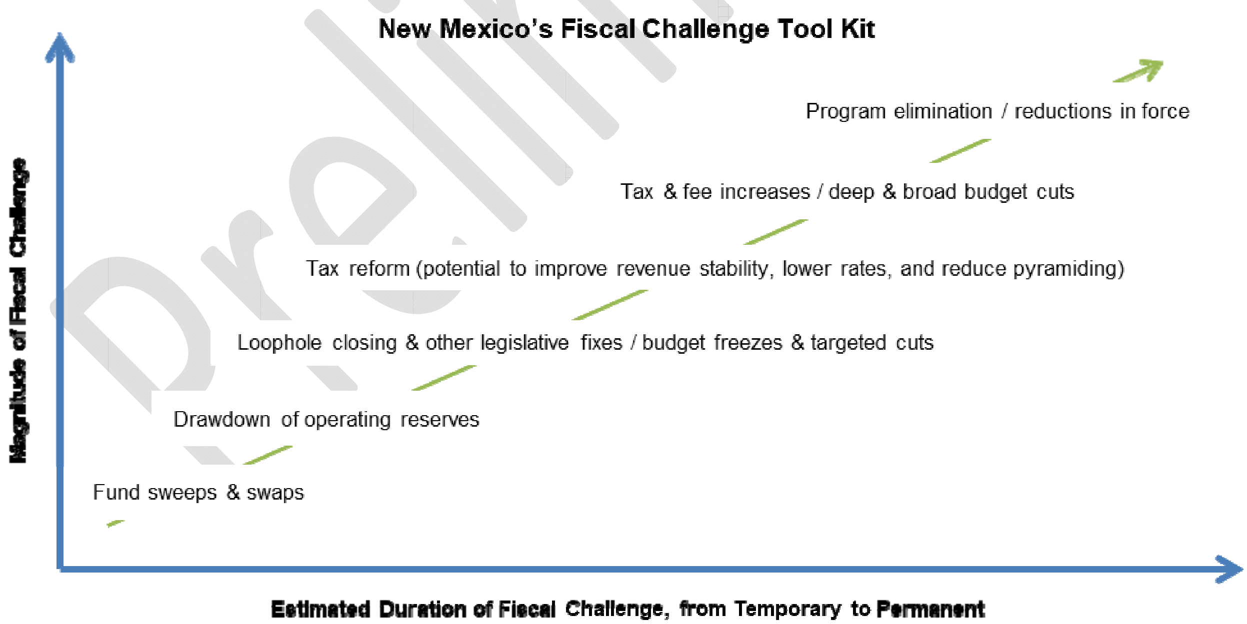
- GRT losses, including the $84 million credits reversal in FY18, would total about $119 million in FY18 and $64 million in FY19.
- Severance tax losses would total about $95 million in FY18 and $100 million in FY19.
- Federal mineral leasing revenue losses would total about $75 million in FY18 and $100 million in FY19.
- Personal income tax losses would total about $55 million each for FY18 and FY19.
- Total general fund losses from these sources would be about $344 million in FY18 and $319 million in FY19, approximately 5 percent to 6 percent of annual recurring revenue.

The August 2017 consensus revenue forecast estimates ending FY18 reserves at a little over $200 million. This stress test would result in a shortfall of about $140 million for FY18 and, assuming flat appropriations, a cumulative shortfall of nearly $230 million for FY19.



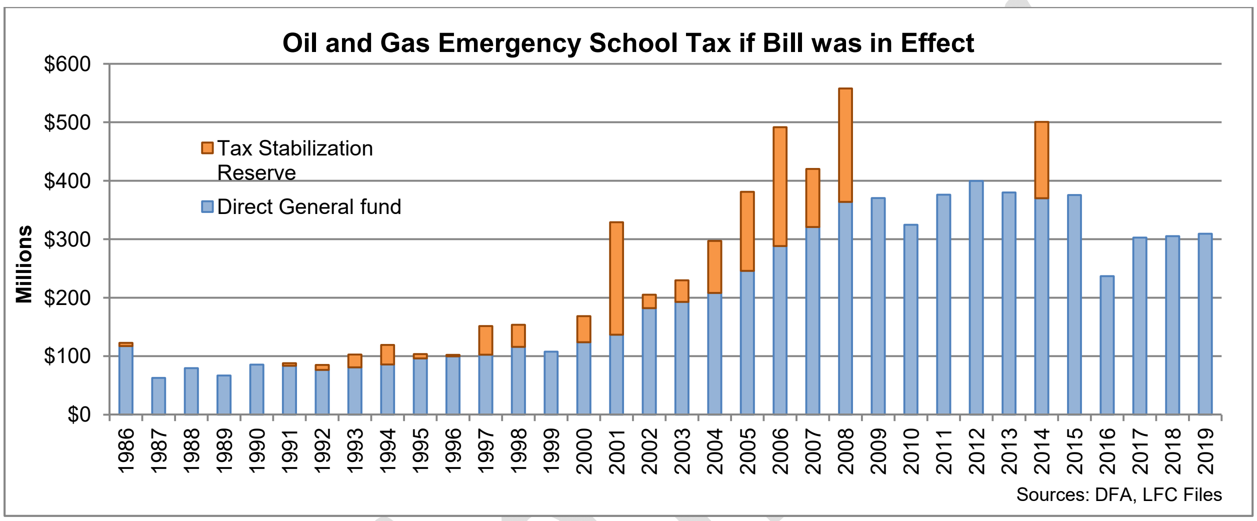
Tools to Address Fiscal Challenges

To address the fiscal challenge posed by this stress test and future actual revenue declines, the state should plan for ways to enhance and replenish its fiscal management tools. Below is the committee's guidelines for a potential set of options the state can use to address fiscal challenges, organized by the magnitude of the fiscal challenge and the estimated temporary or permanent nature of the problem. However, the ease and speed with which each tool can be used must also be considered.



Certain tools the state used to address solvency are no longer immediately available if New Mexico enters another fiscal crisis. For example, no money is left in the tax stabilization reserve. Also, changes in accounting to get a nonrecurring revenue bump by speeding up receipt of certain funds can only be made once for those revenue sources. Many "other state funds" balances are partially or completely depleted, making it more difficult to "sweep" additional fund balances to a significant degree. Finally, agency budgets were cut significantly over the last two years, making additional cuts difficult to absorb without substantially impacting core agency missions. However, in addition to the tools New Mexico used during the recent fiscal crisis, the state has two additional tools: closing tax loopholes and tax and fee increases.

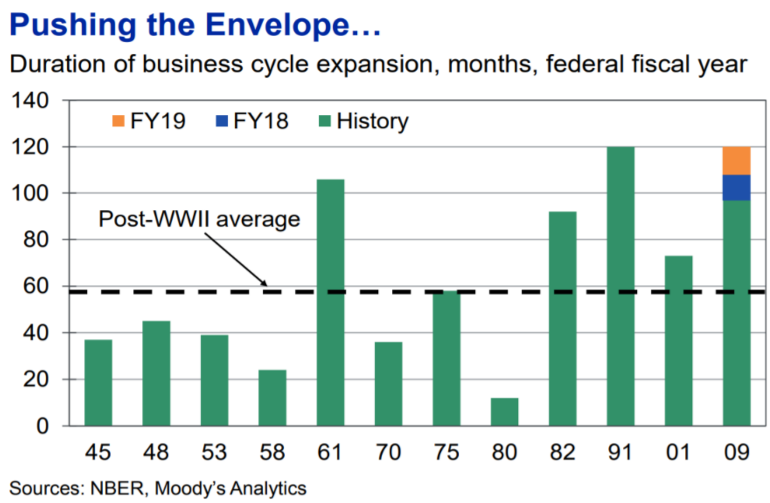
Following the 2017 special session, the state has a new tool: a true rainy day fund (the restructured tax stabilization reserve) with a portion of excess revenues from the volatile oil and gas emergency school tax deposited in the fund. The graph below shows amounts that would have been distributed to the fund if the tool were in place years ago.



Outlook and Next Steps

In order to perform a comprehensive, dynamic stress test, additional resources (such as customized economic forecasts and possibly software such as REMI), and significant time would be required. However, this simple, mini stress test shows that even without many indirect and induced impacts taken into account, the state does not have reserves capable of covering revenue losses from another oil price shock. Fund sweeps and swaps might not be sufficient, leaving the state with the choice of either increasing revenues by closing tax loopholes or increasing taxes and fees or reducing expenditures by making targeted cuts or deep and broad cuts if the fiscal challenge were severe.

Some of the fiscal management tools the state used in the 2016 – 2017 sessions are no longer available or are temporarily depleted. For example, the state spent down reserves to zero, necessitating legislative action to address the shortfall, bringing projected reserves at the end of FY18 to 3.4 percent, still one of the lowest reserve levels in more than two decades. The state should begin planning for how to bring reserves back up to 10 percent or more. The state could consider using some of the items in the fiscal challenge tool kit best suited for longer-term issues in order to build up reserves. How to do this and over what period of time will be the challenges for policymakers, but one thing to consider is the possible timing of the next recession.



Recessions do not follow a schedule, so an assertion the country is due for another recession would be erroneous; however, as time passes, the opportunity for conditions to arise that could cause a recession increase. Although the likelihood of another recession occurring in the next year or two appears high given historical cycles, with no signs of an overheating economy or substantial impending shocks, policymakers may have time to use fiscal challenge tools that require more time to implement, such as tax and fee increases. However, if FY20 begins with no national recession, this will become the longest expansion in modern U.S. history. Therefore, this might be a good target date for the state to use to return to 10 percent or greater reserves. However, another oil price shock could occur at any time, creating a need to begin this planning and implementation process quickly.