

General Fund Reserves – Relationship, Triggers, and Targets

New Mexico’s revenues are increasingly dependent on natural resource extraction that, in general, is highly volatile – changes in prices and production can significantly increase or decrease some of the state’s largest revenue sources. Revenue swings in either direction confound efforts to keep a balanced budget; therefore, one of the most important mechanisms for managing revenue volatility and protecting against revenue shortfalls is by maintaining adequate levels of general fund reserves.

Stress-testing of the revenue estimates indicate oil market shocks could create revenue shortfalls in excess of \$1 billion in a given fiscal year, and oil market downturns can span multiple fiscal years. The regular inclusion of stress-testing in the general fund consensus forecast led policymakers to adopt higher general fund reserve targets to prevent more painful budget-balancing mechanisms in the event of revenue declines, like tax hikes and budget cuts.

However, due to the current relationship of the state’s general fund reserves, higher reserve targets create a potential risk of growing more restrictive reserve accounts at the expense of less restrictive ones. This interaction potentially limits lawmakers’ flexibility in addressing important state needs.

Reserve Targets

The Need for a High Reserve Target

While the state does not have an official reserve target set by statute or rule, historically, the state maintained a reserve of about 10 percent of recurring appropriations – a target equal to Moody’s Analytics general recommendation for state reserve balances necessary to withstand a moderate recession. However, in light of the oil price crash of 2014-2015, the state found this reserve target to be inadequate. The effect the oil market crash on the state was greater than effects of a moderate recession, plunging revenues a combined \$1.3 billion in FY16 and FY17 below the forecast on which those fiscal years’ budgets were set.

Without the federal assistance that typically accompanies a national recession, the state was forced to weather the storm alone. General fund reserves heading into the 2015 legislative session were just \$693 million, well below the amount of revenue declines. Without enough reserves to cover spending, the state enacted a series of solvency measures in 2015-2017 regular and special sessions, including using reserves, cutting budgets, raising revenues, sweeping cash balances, and swapping general fund expenditures for bonding capacity. By FY16, the state had emptied the operating reserve and tax stabilization reserve and pulled from the tobacco settlement permanent fund, ending the fiscal year with just \$169 million in reserve balances.

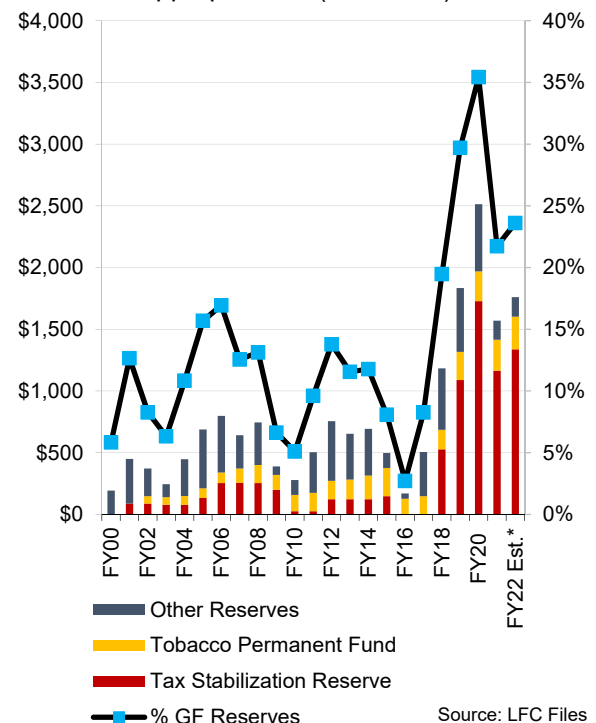
Because the New Mexico Constitution requires a balanced budget, state government maintains general fund reserves to cover any shortfalls if revenues are unexpectedly low or expenses are unexpectedly high.

General Fund reserves are made up of several distinct accounts:

- Operating reserve,
- Tax stabilization reserve,
- Appropriation contingency fund,
- Tobacco settlement permanent fund, and
- State support reserve fund.

Attachment A – General Fund Reserve Finance Facts – contains a detailed description of the state’s reserve accounts.

General Fund Reserve History
Total and Percent of Recurring Appropriations (in millions)



Source: LFC Files

Low Oil Price Stress Test Scenario - Revenue Difference from Baseline Forecast				
Forecast	Current FY	Budget FY	Following FY	Total
Feb 21 CREG	\$ (378)	\$ (1,009)	\$ (1,255)	\$ (2,642)
Dec 20 CREG	\$ (236)	\$ (473)	\$ (353)	\$ (1,062)
Jun 20 CREG	\$ (517)	\$ (2,433)	\$ (2,475)	\$ (5,425)
Dec 19 CREG	\$ (365)	\$ (940)	\$ (1,160)	\$ (2,465)
Aug 19 CREG	\$ (470)	\$ (1,205)	\$ (1,415)	\$ (3,090)
Dec 18 CREG	\$ (475)	\$ (1,275)	\$ (1,350)	\$ (3,100)
Aug 18 CREG	\$ (525)	\$ (1,250)	\$ (1,150)	\$ (2,925)
Average	\$ (424)	\$ (1,226)	\$ (1,308)	\$ (2,958)

Note: dollars in millions

Low Oil Price Scenario Revenue Decline as a Percentage of Current Fiscal Year Recurring Appropriations						
Forecast	Fiscal Year	Current FY Approp.	Budget FY Only	Current FY & Budget FY	Budget FY & Following FY	Current FY, Budget FY, & Following FY
Feb 21 CREG	FY21	\$ 8,768.9	14%	16%	26%	30%
Dec 20 CREG	FY21	\$ 8,768.9	7%	8%	9%	12%
Jun 20 CREG	FY20	\$ 7,933.8	33%	37%	62%	68%
Dec 19 CREG	FY20	\$ 7,933.8	12%	16%	26%	31%
Aug 19 CREG	FY20	\$ 7,933.8	15%	21%	33%	39%
Dec 18 CREG	FY19	\$ 7,560.7	17%	23%	35%	41%
Aug 18 CREG	FY19	\$ 7,560.7	17%	23%	32%	39%
Average			16%	21%	32%	37%

Source: Consensus Revenue Estimates, LFC Files

Recognizing the severe effects an oil market crash could have on general fund state revenues, the consensus revenue estimating group began incorporating stress-testing into its revenue forecasts – projecting the potential changes in estimated revenues in the event of a moderate recession or another oil market collapse. Generally, the stress-tests found the state would need on average about 20 percent of recurring appropriations in reserves to support budgets for the current fiscal year and budget year (the upcoming fiscal year budget that will be set in the next legislative session) in the event of an oil price crash, and even higher to support budgets for the following fiscal year.

Using the stress test results, both the executive and Legislature set reserve targets of 20 percent to 25 percent in the 2020 and 2021 sessions. In the wake of the Covid-19 pandemic, and the severe economic recession and oil price collapse that ensued, high reserve balances put the state on good

In the event of an extended oil price collapse, stress-tests found the state would need, on average, reserves of about 20 percent of recurring appropriations to support budgets for the current and budget fiscal years. Even higher reserves would be needed to also support budgets for the following fiscal year.

footing to deal with falling revenue projections. Extremely low oil prices and the bleak economic outlook at the onset of the pandemic led revenue estimators in June 2020 to project a potential FY21 revenue decline of nearly \$2 billion below the prior forecast. Although the state paired back planned spending increases for FY21 in a June 2020 special session, healthy reserves enabled the state to prevent budget cuts below FY20 levels and avoid damaging tax increases. As the economic picture improved and oil prices rebounded, high reserves enabled the state to enact a series of pandemic-relief and economic stimulus measures in the November 2020 special session and 2021 regular session.

Reserve Relationships and Triggering Mechanisms for Transfers Between Reserve Accounts

Relationship Between the Operating Reserve and the Tax Stabilization Reserve.

Under current statute, when the balance of the operating reserve exceeds 8 percent of the prior fiscal year’s recurring appropriations, the excess is transferred to the tax stabilization reserve (TSR). For example, in FY21, the balance of the operating reserve would be capped at \$567 million – meaning if revenues transferred at the end of the year would push the balance of the fund above this amount, the excess would be transferred to the TSR.

The operating reserve cap is most responsible for the large transfers to the TSR in recent years. In 2017, the tax stabilization

reserve balance was zero after it was emptied to shore up the FY16 budget during the oil price bust. From FY18 to FY20, the TSR received \$1.6 billion in transfers, 85 percent of which came from distributions from the operating reserve in excess of the 8 percent cap (see sidebar chart).

Potential to Grow a More Restrictive Reserve Account at the Expense of Less Restrictive Accounts.

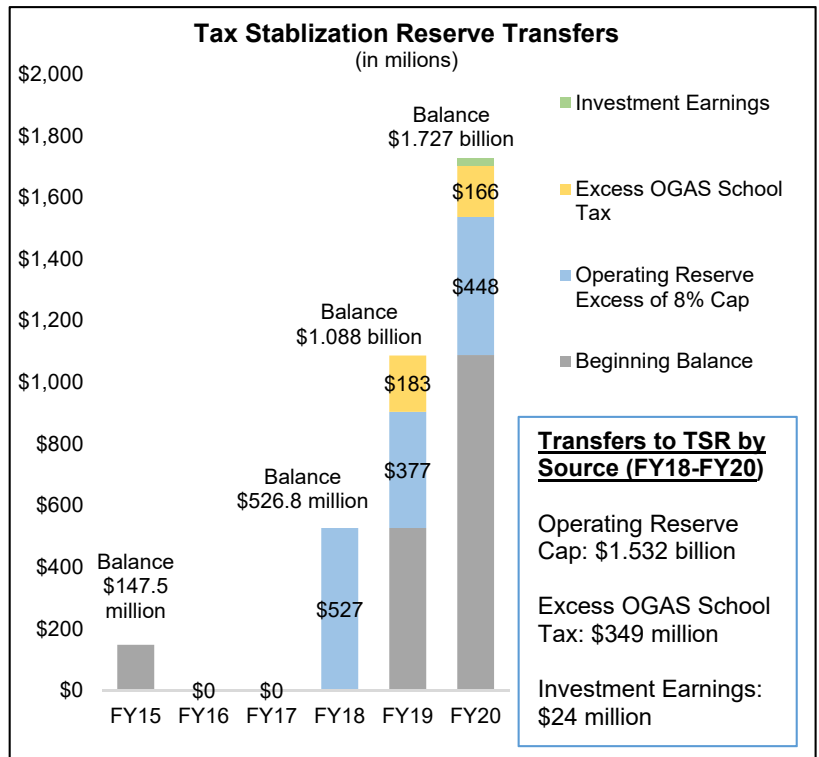
Legislation passed in the 2017 session removed prior caps on the tax stabilization reserve, transforming the account into a true “rainy day fund” – a fund that can only be accessed through a simple majority vote if revenues fall short of appropriations, or for necessary expenditures that receive a two-thirds vote of both the House and Senate. Additionally, the legislation provided a revenue stabilization mechanism that automatically transfers revenues above the five-year average from the oil and gas emergency school tax to the TSR – a process that both simplifies the general fund revenue estimating process and helps mitigate oil and gas market swings.

In the 2020 session, lawmakers took similar steps to manage the volatility of federal royalty revenue – which on average experiences revenue swings of 25 percent or more – by sending revenue in excess of the five-year average to the newly created early childhood trust fund. Additionally, if general fund reserves are greater than 25 percent, any excess oil and gas school tax revenue would be sent to the early childhood trust fund rather than the tax stabilization reserve.

Given the volatile nature of energy-dependent revenues, these stabilization mechanisms help to prevent unsustainable revenue growth – like the 15.8 percent and 17.5 percent growth in FY18 and FY19, respectively – from being baked into recurring budgets.

However, when these changes to the TSR were made, the existing operating reserve cap was not revisited. Because the operating reserve balance is capped but the TSR is not, distributions to the TSR continued regardless of the size of the fund or the state’s total reserves. To the extent the legislature has a target level for reserves, there is a risk of growing the more restrictive TSR at the expense of the less restrictive operating reserve. For example, if the Legislature sets a reserve target of 25 percent of recurring appropriations, but the TSR holds a balance of 30 percent of recurring appropriations, then the Legislature would be unable to spend the additional funds through a simple majority vote to meet the state’s needs.

In this example, it would also be possible to exhaust the funds in the operating reserve, leaving the more-liquid reserve account empty while having a large



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Options for Enhancing the Rainy Day Fund

- Establish formulas directing when and how reserves can be tapped.
- Enact rules that require offsetting budget action in conjunction with rainy day fund withdrawals over certain amounts.
- Require a supermajority vote of the legislature if money is to be withdrawn for purposes other than an economic downturn, health or safety emergency, or unexpected revenue shortfall.
- Enact measures that reserve funds be repaid after being tapped.
- Establish a reasonable and reliable schedule for replenishing rainy day funds after withdrawals.
- Specify a revenue source or sources to provide money automatically for rainy day funds.
- When the economy is expanding and revenues are surging, deposit any resulting surpluses into the rainy day fund.
- Consider the volatility of tax revenues when calculating the adequacy of reserves.
- Deposit excess cash into the rainy day fund when revenues exceed a predetermined amount.
- Use data on historical revenue trends to help stock the rainy day fund.

Note: Checkmarks indicate current practices for the tax stabilization reserve.

Source: Barrett & Greene (2019), *Rainy Day Fund Strategies*, prepared for the Volcker Alliance

less-liquid TSR. This issue was the primary reason for the passage of HB341 in the 2020 session, which set a “floor” for the operating reserve equal to 1 percent of appropriations. Still, this legislation did not address the above issue of having a potentially ever-growing TSR and a near-empty operating reserve.

Potential Solutions

Increasing the Operating Reserve Cap. Senate Bill 59 of the 2021 session contemplated increasing the operating reserve from its current 8 percent limit to 15 percent of recurring appropriations. This approach has both benefits and drawbacks.

By increasing the operating reserve cap to 15 percent, it would effectively increase the threshold at which transfers are made to TSR. This would allow the operating reserve to hold a larger balance before making distributions to a more restrictive reserve account, effectively making those funds more accessible for nonrecurring initiatives. If the TSR balance is already high, this approach would grant more flexibility to future Legislatures.

However, if the TSR balance is low, this approach would make it harder for windfall revenues to reach the rainy day fund. Capturing and saving windfall revenues for use in future downturns is one of the rainy day fund’s primary functions, enabling the relative success of the state’s budget to endure the severe projected revenue declines following the Covid-19 pandemic.

Changing the Oil and Gas Emergency School Tax Distribution.

Senate Bill 59 would have also sent the distributions of excess oil and gas school tax revenue to the operating reserve. Two distributions from the excess oil and gas school tax transfer have occurred since the enactment of that provision – \$183 million in FY19 and \$166 million in FY20. This mechanism serves an important role in reducing general fund volatility and makes up less than a quarter of the recent TSR distributions.

Notably, the bill continued to send the distribution of excess oil and gas school tax revenue to reserves, but proposed sending the excess to the operating reserve instead of the tax stabilization reserve. This would maintain the general fund stabilization features of the excess school tax distribution while making some of the reserve balances more accessible by the Legislature. Also, because of the cap on the operating reserve, it would still be possible for excess school tax funds to end up in the TSR if those distributions would push the operating reserve above the 15 percent limit.

Although the bill maintained the stabilization mechanism of distributing windfall oil and gas general fund revenue to reserves, when paired with the increase of the operating reserve cap, the bill made it more difficult for the TSR to receive new inflows other than investment gains. This may not be a problem when the TSR balance is already high, but it would make it harder to later regrow the TSR if those funds are used for solvency.

Place a Condition on Operating Reserve Transfers to the Tax Stabilization Reserve.

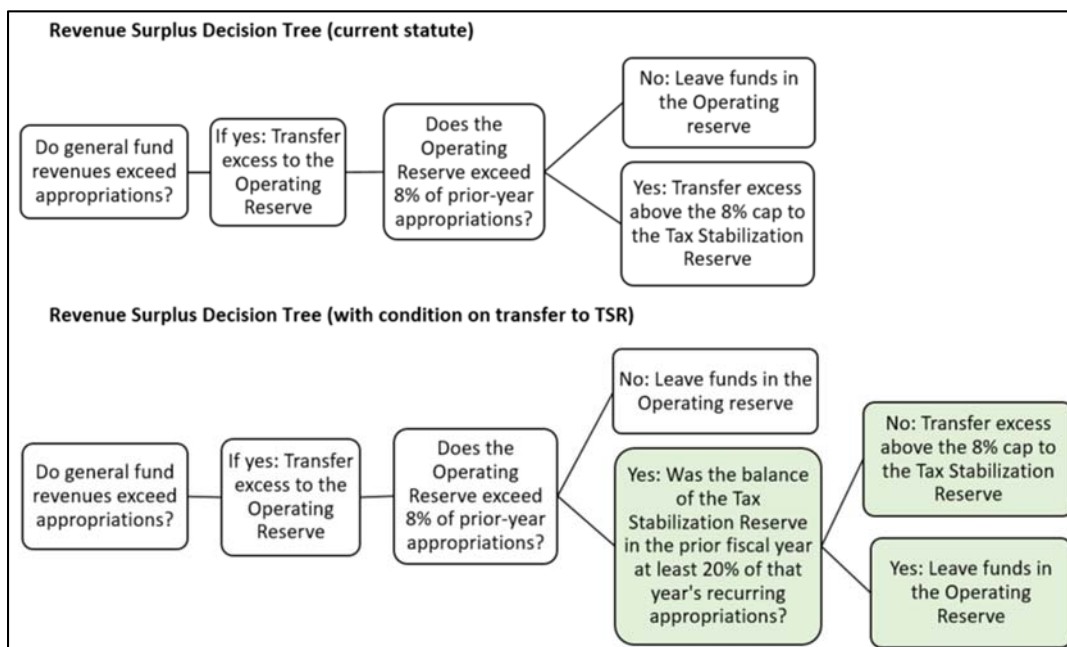
A separate option would be leave in place the transfer of operating reserve funds above 8 percent of prior year appropriations to the TSR, but set a new condition that the transfer be made depending on the size of the TSR.

The Legislature could, for example, set a lookback threshold of some percentage for the TSR. If the balance of the TSR in the prior fiscal year was at least that percentage of recurring appropriations, then the transfer from the operating reserve to the TSR would not occur. If the TSR balance was less than that percentage of recurring appropriations, then transfers from the operating reserve would continue. This approach would have the benefit of allowing the operating reserve balance to grow when TSR balances are high, without the drawback of permanently making it more difficult to regrow the TSR after those funds are used to shore up budgets in a downturn. This would ensure the TSR has measures to repay the funds after being tapped – a recommended feature for state rainy day funds (see sidebar on page 4).

If this approach were used, lawmakers would need to choose the appropriate percentage that would trigger a transfer from the operating reserve to the TSR. Using stress-testing to inform the decision would be a research-based approach to managing the state’s reserves. For example, because the stress-tests have found that, on average, the state would need at least 20 percent in reserves to withstand an oil market downturn for the current fiscal year and budget year, a 20 percent lookback threshold could be chosen. If the balance of the TSR in the prior fiscal year is at least 20 percent of that year’s recurring appropriations, then future transfers from the operating reserve would halt until the TSR balance dropped below that threshold. Alternatively, since the TSR is just one of the state’s five general fund reserve accounts, lawmakers could choose a slightly lower threshold, such as 15 percent, which is the average percentage stress-testing has shown the state would need to cover one fiscal year of budget needs in event of an oil price shock.

Additionally, using this approach, investment earnings and excess oil and gas school tax transfers to the TSR could continue, maintaining the ability of the state’s rainy day fund to grow through means other than transfers from the operating reserve. This would preserve the intent of saving money from volatile revenue sources during periods of growth for use during periods of revenue decline. Furthermore, this approach would establish a way to increase the operating reserve when TSR balances are high, enhance the fund’s functionality and provide more liquidity to legislative budget-making.

Placing a condition on the transfer of funds from the operating reserve to the TSR would have the benefit of allowing the operating reserve balance to grow when TSR balances are high, without the drawback of permanently making it more difficult to regrow the TSR after those funds are used to shore up budgets in a downturn.





Legislative Finance Committee **FINANCE FACTS**

Understanding State Financial Policy

General Fund Reserves

Because the New Mexico Constitution requires a balanced budget, state government maintains general fund reserves to cover any shortfalls if revenues are unexpectedly low or expenses are unexpectedly high. The general fund reserves are measured as a percentage of recurring appropriations – planned ongoing spending. They are made up of several distinct accounts: the operating reserve, tax stabilization reserve, appropriation contingency fund, and state support reserve fund.

Operating Reserve

Revenues left at the end of the fiscal year are transferred to the operating reserve. If revenues come up short, the governor may transfer money from the operating reserve to cover authorized expenses. The amount the governor can transfer is capped by the Legislature each year in the General Appropriation Act. Once the operating reserve fund hits 8 percent of the prior budget year's recurring appropriations, the excess must be transferred to the tax stabilization reserve by law.

Tax Stabilization Reserve

Money in the tax stabilization reserve may only be appropriated if (1) the governor declares it necessary because of a shortfall and the House and Senate approve it with a simple majority vote, or (2) two-thirds of both the House and Senate vote for it.

Additional funds are deposited into the tax stabilization reserve from the oil and gas emergency tax if annual revenue exceeds the five-year average income. This allows the state to capture windfall revenue from the oil and gas industry and moderate the volatility of that revenue source. Other state revenue that also spikes when the energy industry booms – including federal mineral leasing payments, trust land distributions, and gross receipts tax collections – are not captured.

Until 2017, revenue in the tax stabilization reserve in excess of a specified threshold was transferred to another fund for possible distribution to taxpayers. However, several years of depleted reserves prompted lawmakers to transform the tax stabilization into a true “rainy day” fund.

Appropriation Contingency Fund

The Legislature authorizes revenue going in and out of the appropriation contingency fund. A limited amount of the rev-

enue in the fund can also be spent when the governor declares an emergency. The fund is mostly used to set aside money for use if certain circumstances come into play, such as the start-up of a new program moving faster than funded.

State Support Fund

On the first day of each fiscal year, any balance in the public school district general obligation bonds loan fund over \$1 million is transferred state support reserve fund and can only be used to augment certain appropriations to the public schools.

Tobacco Settlement Fund

The tobacco settlement permanent fund was created to hold payments to New Mexico from cigarette companies under the master settlement agreement of 1998. Under the enabling legislation, the settlement payments are split, with half going to the permanent fund and half spent directly on health and education programs. However, during economic hard times, the Legislature has temporarily suspended deposits into the permanent fund and put the entire amount into direct spending.

Money in the tobacco settlement permanent fund is invested by the State Investment Council and interest is credited to the fund. The Legislature may authorize spending from the fund for a budget shortfall only after balances in all other reserve accounts have been exhausted.



For More Information:

- The status of the New Mexico's reserve accounts can be found in the state's general fund financial summary, published on the State Board of Finance's website: http://nmdfa.state.nm.us/Board_of_Finance.aspx
- Statutes governing New Mexico's general fund reserves include 6-4-2.1, 6-4-2.2, 6-4-2.3, 6-4-4, 6-4-9, 7-1-6.61, 12-11-24, 22-8-31 NMSA 1978.