NEW MEXICO LEGISLATIVE FINANCE COMMITTEE

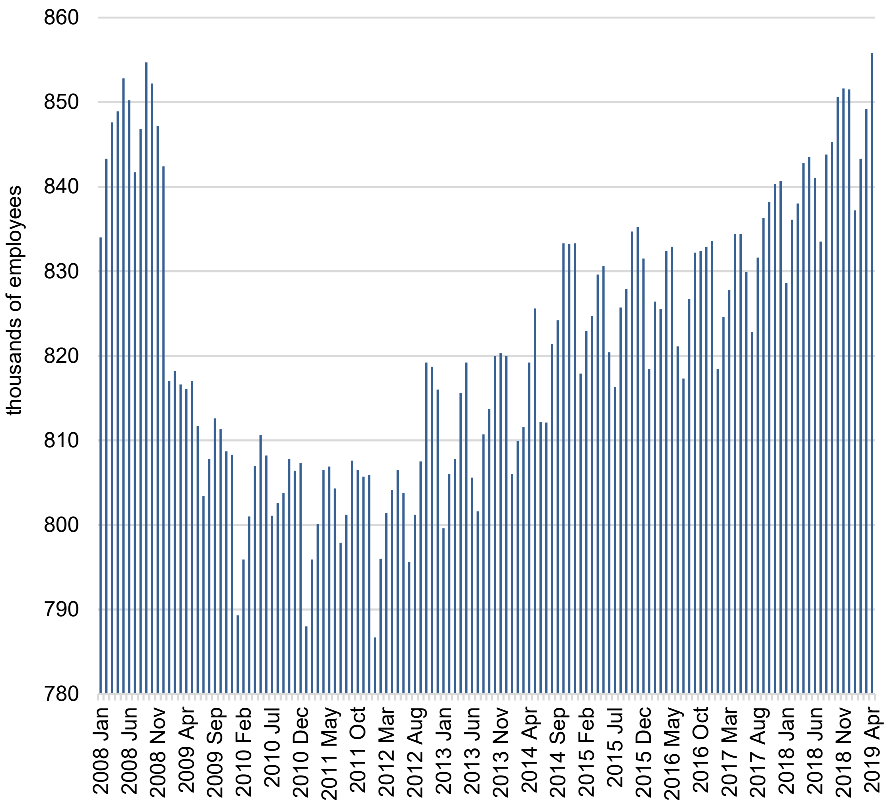
Post-Session Fiscal Report

Dawn Iglesias, Chief Economist, LFC

Presented to the
Revenue Stabilization and Tax Policy Committee
June 11, 2019

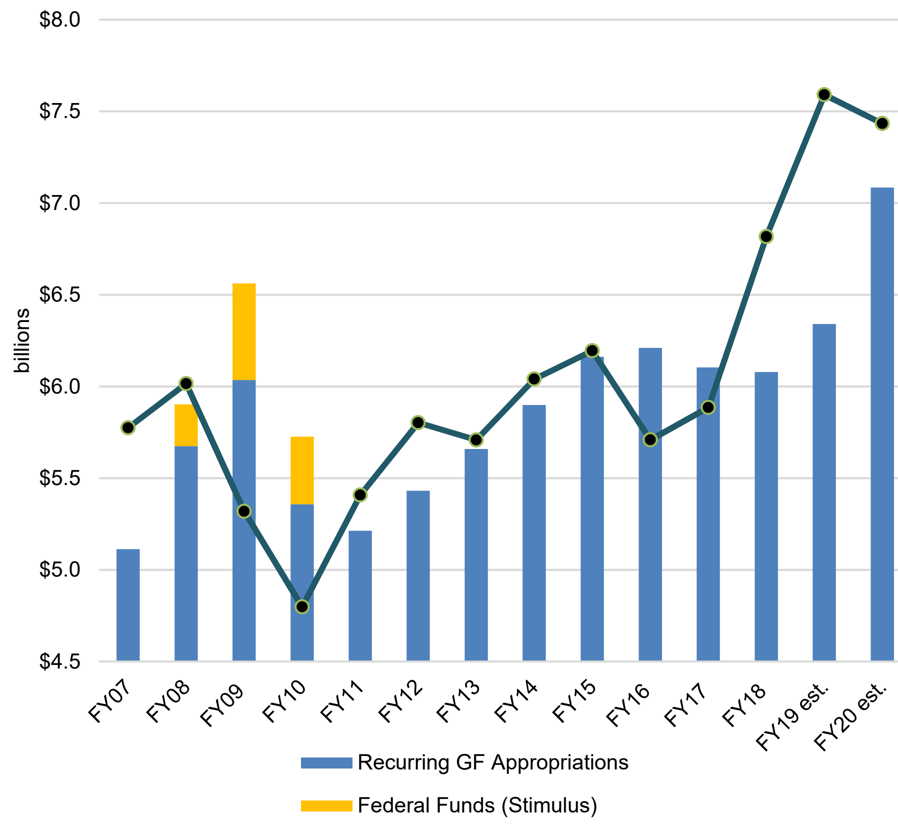
Lost decade of jobs and revenues, but growth rates are rising quickly. Jobs levels reaching pre-recession employment peak.

Lost Decade: New Mexico Monthly Employment Levels



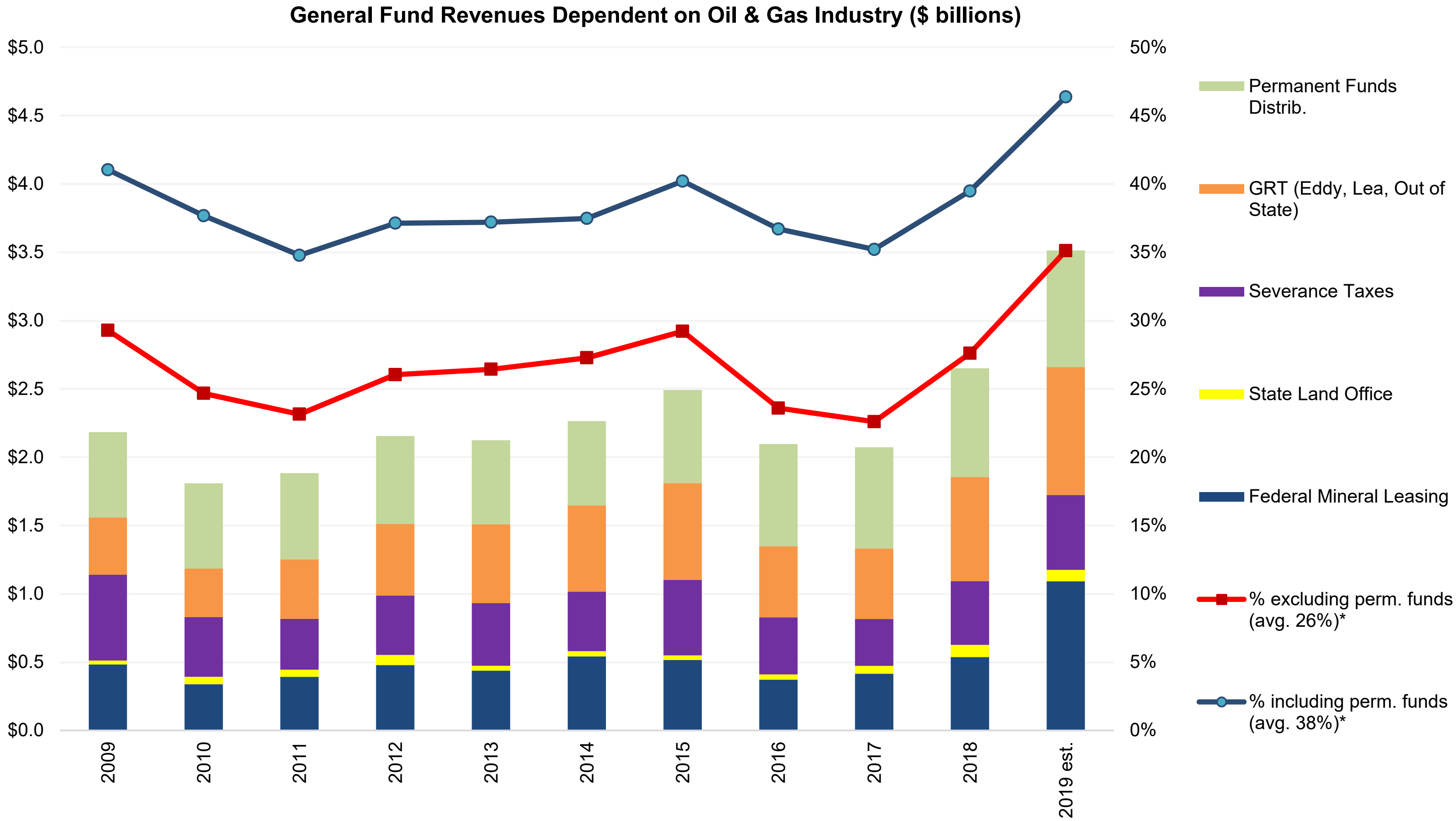
Source: Bureau of Labor Statistics (CES data)

Recurring General Fund Revenues & Appropriations
(including Great Recession federal stimulus offset)



Source: LFC Files

Growing dependence on direct revenues from the oil and gas industry: increased from 26 percent average to 35 percent in FY19

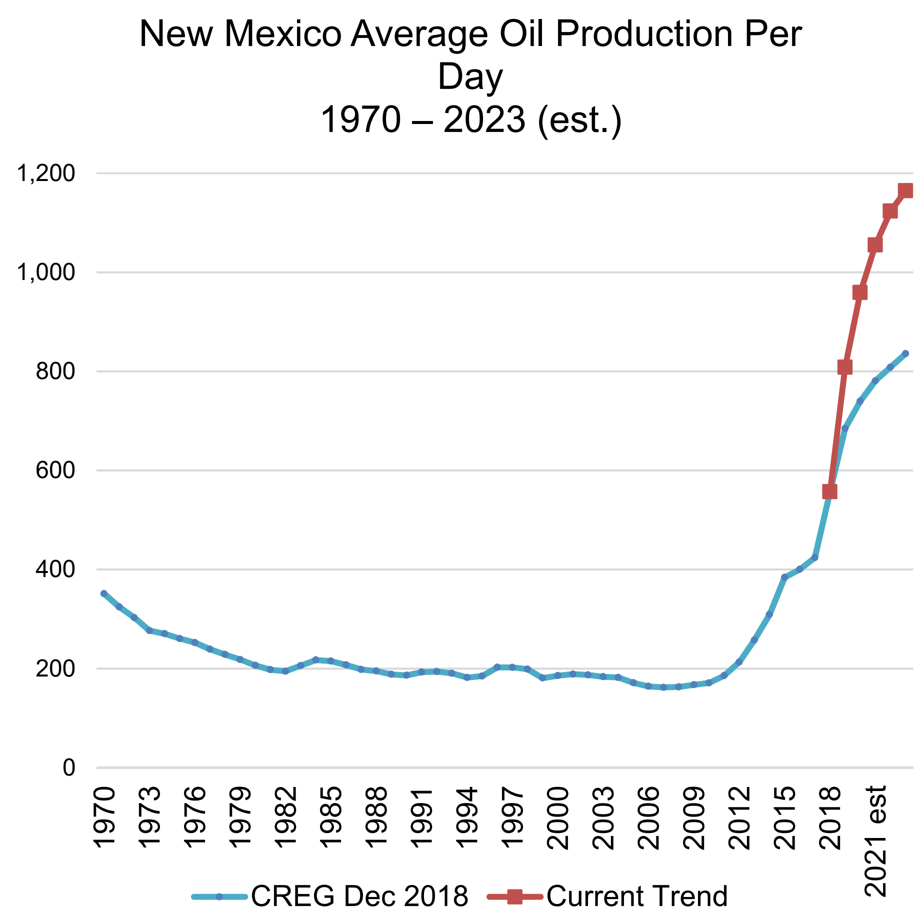


* Average from FY09 – FY18

Source: LFC Files

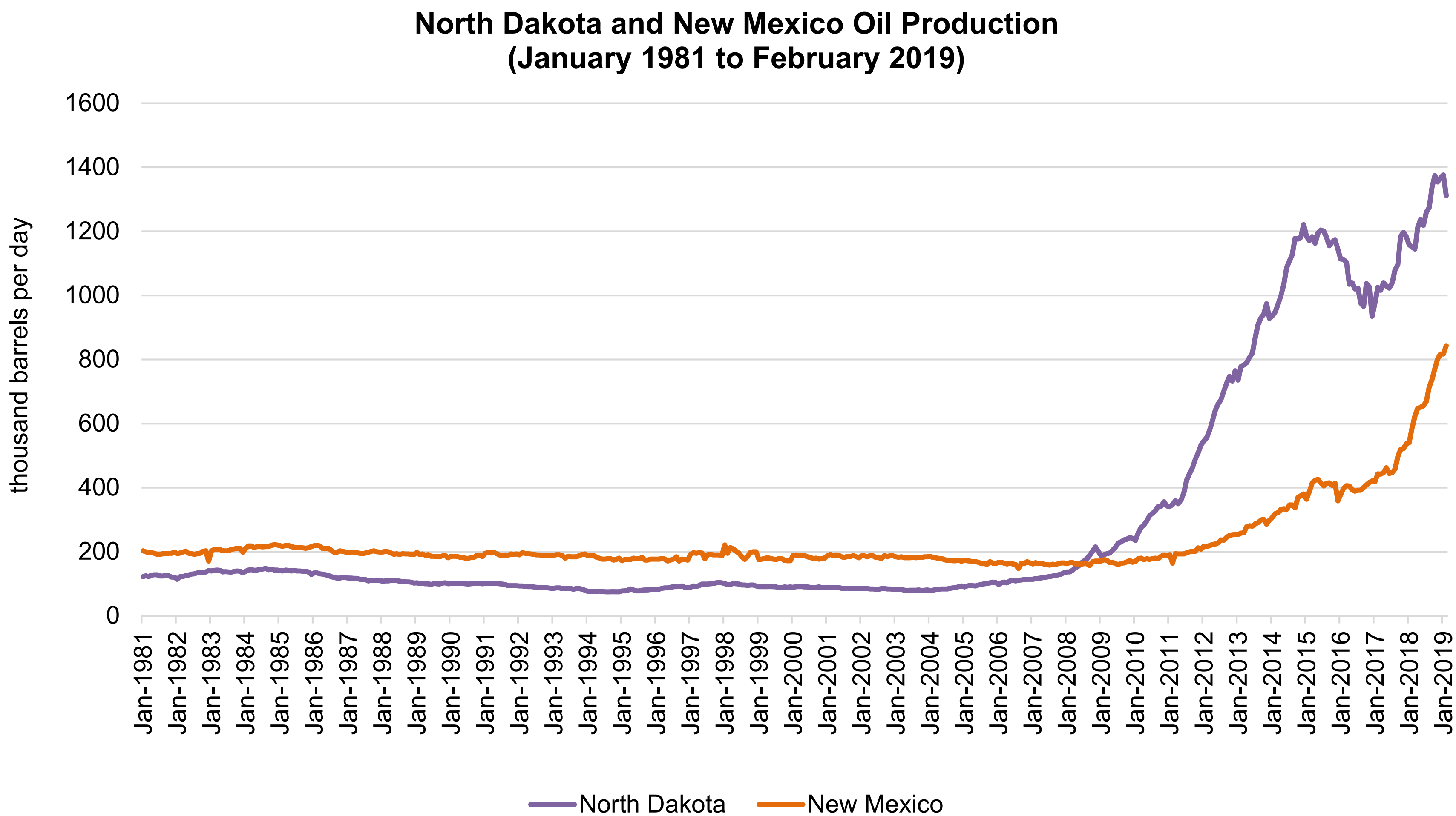
Current trends in oil production are surpassing the previous estimates

- Average oil production in FY18 was 557 thousand barrels per day
- Average oil production for the first quarter of 2019 was about 821 thousand barrels per day
- Compound annual growth rate of about 20 percent from 2012 to 2019
  - Unclear when production will level off
- Macroeconomic forecasts project Permian basin production to double in the next 5 years
  - Could mean annual NM production of over 400 million barrels by 2023



Source: OCD, LFC Files

Where is New Mexico oil production heading?

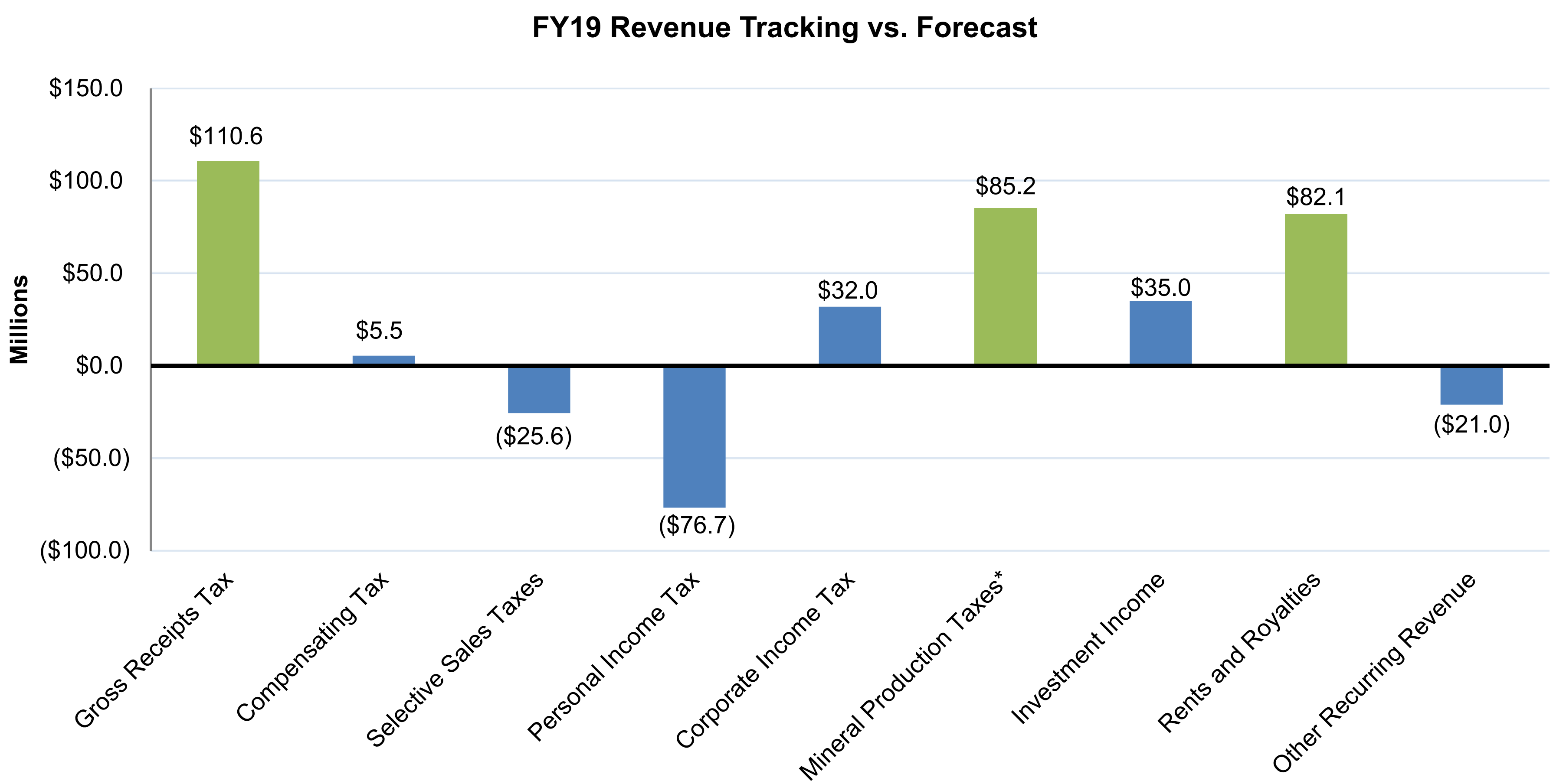


Source: Energy Information Administration

What do changes in production prices mean for New Mexico?

- Based on 2019 direct oil and gas revenues (production taxes and federal royalties),
  - A $1 change in the annual average NM price of oil has about an $18 million impact on the general fund
  - A $0.10 change in the annual average NM price of natural gas has about a $10 million impact on the general fund
  - Each additional million barrels of oil generates about $3 million for the general fund
    - NM is currently on track to produce about 290 million barrels in FY19, 40 million barrels above the December 2018 projection
  - Each additional 10 billion cubic feet of natural gas generates about $2 million for the general fund

FY19 oil and gas related revenues are tracking above the forecast



* Includes Oil and Gas Emergency School Tax revenues going to general fund and to tax stabilization reserve

Source: DFA General Fund Report, LFC Files

Increasing Fiscal Stability

- Projected 21% reserves in FY19 and 20% in FY20
- Backfilling other state funds and fund balances (e.g. Tobacco Settlement Permanent Fund, State Support Reserve, etc.)
- Strengthening the “Rainy Day Fund”
  - Follow-up to 2017 legislation to manage oil and gas revenue volatility and build a true rainy day fund
  - HB393 allowed interest earnings to accumulate in the fund & transferred fund management to State Investment Council for premium returns
  - SB401 (vetoed) transferred federal mineral leasing (oil and gas royalties and bonuses) revenues in excess of the 5-year average to the rainy day fund
- Even with 12 percent growth in recurring appropriations, the session ended with a $332 million FY20 recurring budget surplus

HEADING INTO THE 2019 SESSION…

Last year, Moody's Investor Service flagged the state's challenges…downgraded bond rating

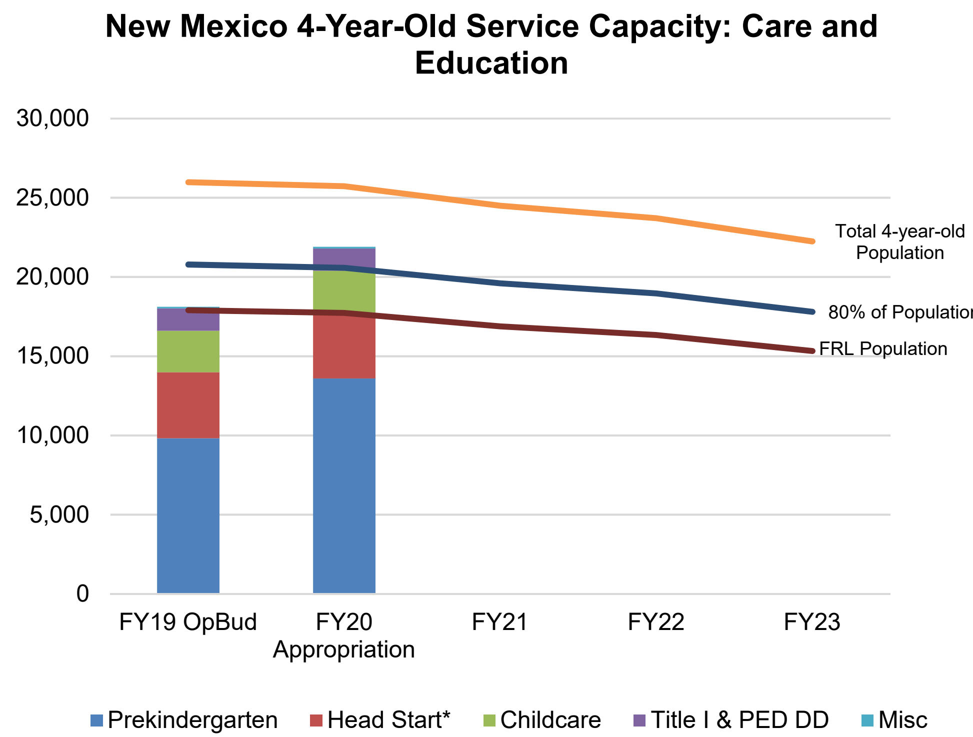
- State general obligation bond rating downgraded twice in last two years. Moody's report flags pressing issues.
  - Fiscal stability
  - Educational outcomes: early childhood to higher education completion rates
  - Medicaid growth: crowding out effect on state responsibilities
  - Total compensation & pension solvency: pay falling behind and benefits cost increasing
  - Tax reform: gross receipts tax rates high with narrowing taxpaying base

Legislative Focus: Public Education

- Recurring budget of $3.2 billion for FY20, an unprecedented $448 million (or 16 percent) increase from the prior year
- Companion legislation significantly responding to Martinez and Yazzie v. New Mexico sufficiency lawsuit
  - Funding for at-risk students, extended learning time (longer school day and school year), bilingual and multicultural education, and rural schools
  - Six percent raises for all school staff and minimum salary increases for teachers and principals
  - Funding for school buses, instructional materials, and professional development
  - Funding to help teacher loan repayment, support adult basic education, and expand career technical education
- LFC studies show evidence these programs improve student outcomes and will be game changers over time

Legislative Focus: Early Childhood Education

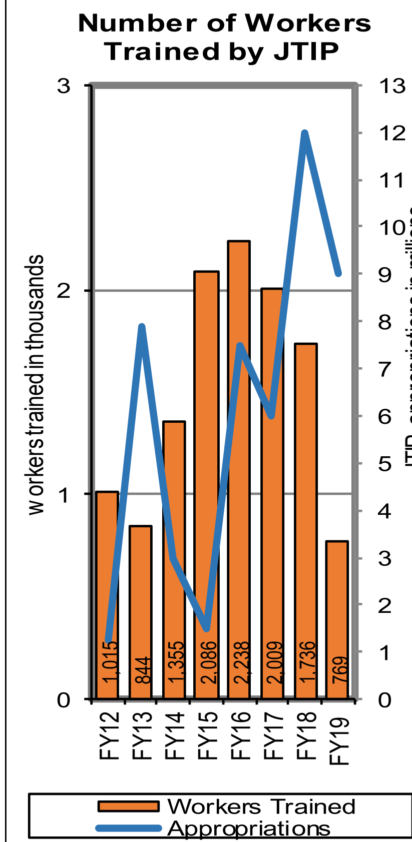
- Over $438 million for early childhood programs, a $125 million (or 40 percent) increase from the prior year
- Excluding the extended school year K-5 Plus initiative, early childhood programs still up $36 million (or 12.6 percent)
- Over 80 percent of 4-year-olds are funded for early childhood education and care services
- Legislation establishing a new early childhood education and care department



Source: LFC Files, DOH
Notes: Repesents funded slots not accounting for children enrolled in multiple services or seasonality. Children accessing more than one service is <1,100.
*Includes American Indian Head State Programs (slots)=685
+Estimated from free and reduced-fee lunch (FRL) participation rates in New Mexico public schools (185 percent of federal poverty level)
Misc = City of Albuquerque and City of Santa Fe funded slots
FY20 appropriation is prior to governor action on HB2

Legislative Focus: Economic Development

- Job Training Incentive Program (JTIP)
  - JTIP grants subsidize wages for employees, with certain restrictions and job requirements
  - JTIP has supported the creation of over 46 thousand jobs since its creation
  - Operating budget increased to $5 million
  - Special appropriation of $5 million
- Local Economic Development Act (LEDA)
  - Authorizes state reimbursement to qualifying local governments for certain infrastructure developments
  - The program has created about 3,850 jobs since FY16 at costs ranging $6,000 to $30,000 per job
  - GAA added $60 million in LEDA funding, with a contingency for $15 million more if revenues exceed the forecast
- Outdoor Recreation Division
  - Created by SB462; intended to increase outdoor based economic development, tourism and ecotourism
  - Economic Development Department received a $200 thousand appropriation to establish the new division in FY20



Sources: EDD, LFC files

Robust Increases for Many Other Priorities

- CYFD Child Protective Services: +$4 million (8.2%)
- Tourism and marketing: +$3 million (26%)
- Oil Conservation Division: +$800 thousand (16%)
- State Parks: +$500 thousand (7%)
- Developmental Disabilities Waiver: +$20 million (13%)
- Corrections Transitional Living: +$2.2 million
- Higher Education Department, Center for Technical Excellence: +$1 million
- State Employee Compensation: +4%

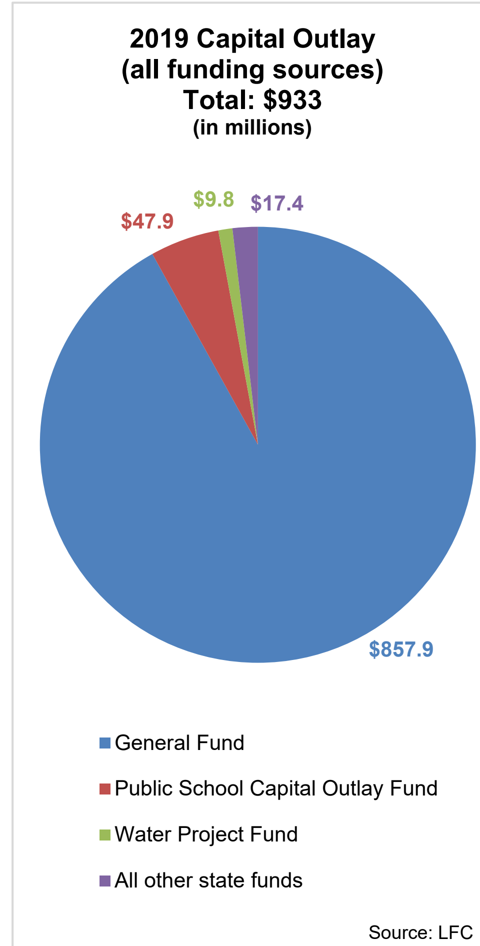
Legislative Focus:
Increasing Fiscal Stability

- Projected 21% reserves in FY19 and 20% in FY20
- Backfilling other state funds and fund balances (e.g. Tobacco Settlement Permanent Fund, State Support Reserve, etc.)
- Strengthening the "Rainy Day Fund"
  - Follow-up to 2017 legislation to manage oil and gas revenue volatility and build a true rainy day fund
  - HB393 allowed interest earnings to accumulate in the fund & transferred fund management to State Investment Council for premium returns
  - SB401 transfers federal mineral leasing (oil and gas royalties and bonuses) revenues in excess of the 5-year average to the rainy day fund
- Even with 12 percent growth in recurring appropriations, the session ended with a $332 million FY20 recurring budget surplus

Legislative Focus: Infrastructure

2019 Capital Outlay

- Appropriations total $933 million for 1,570 projects
- Significant revenues allowed the use of general fund rather than severance tax bonds
- Projects funded include:
  - $34 million for Impact Aid school districts for teacher housing and to build above statewide adequacy standards
  - $33 million for the Department of Public Safety's evidence and crime lab facility
  - $29.3 million for the Children, Youth and Families Department's Child Wellness Center
  - $20 million for renewable energy, energy storage, and energy efficiency system infrastructure improvements at state-owned buildings statewide
  - $16 million for correctional facilities statewide
  - $15 million for public safety radio and communications equipment and infrastructure
  - $10 million for rural broadband infrastructure
  - $9 million for Department of Health facilities statewide
  - $5 million for repairs to state agency buildings statewide
  - $4.5 million museums and historic sites statewide
  - $4.3 million for a student dormitory and cafeteria for the New Mexico School for the Arts



Capital Outlay Concerns

- While $385 million of general and other state funds for “statewide” projects were reviewed and vetted by LFC and DFA, many did not go through a defined project selection procedure
- State agencies currently oversee 1,608 outstanding capital outlay projects with balances of $639.9 million; the significant increase in the number of projects may exceed project management capacity at management and oversight agencies
  - GSD’s Facilities Management Division oversees most state agency projects; currently, two of the division’s seven project manager positions are vacant
  - PED will oversee 267 new projects at traditional public schools and charter schools; PED’s capital outlay bureau only has two FTE
  - DFA’s Local Government Division will oversee 461 new projects for local governments statewide; seven of that division’s 41 positions are vacant
- Efforts to increase capital outlay transparency, including publicizing how elected officials choose to allocate capital funding, were unsuccessful
- Rising construction costs pose a risk to project completion

Road Funding – Another Game Changer

- Significant additional recurring and nonrecurring funding for local governments, state-funded construction projects, and major investment projects
- Again, concerns about capacity of road-building industry when the United States is at full employment

➢ **Nonrecurring (GAA Section 9)**

- $250 million in statewide projects
- $89 million for prioritized statewide transportation improvement program (STIP) project. Additional $11 million if revenues exceed the forecast
- $50 million to new local government transportation project fund (includes up to $5 million for construction of a relief route on U.S. 285 in Carlsbad)

➢ **Recurring**

- HB6 increased motor vehicle excise tax (MVX) from 3 percent to 4 percent

  FY20-FY21: the additional MVX revenues sent to DOT to mitigate emergency road conditions in district 2 (Southeast NM)

  Beginning FY22: the additional MVX revenues plus $26 million of existing MVX revenues to be split equally between state road fund and local government road fund

2019 Session Tax Policy Changes

- Virtually no net change in general fund recurring tax revenues in FY20
- Enacted hospital tax reform to bring nonprofit and government hospitals into the tax base
- Enacted internet tax reform to bring remote sales (including third-party platforms) into the tax base and apply local GRT increments
- Likely personal income tax increase to 5.9 percent of taxable income over $315 thousand for joint filers ($210 thousand for single filers)
  - Effective in FY21, contingent on FY20 revenues being no more than 5 percent above FY19 revenues
- Significant boost to local government revenues beginning in FY22, adding $111 million recurring to local operating funds, not including the additional $40 million for local road funds
  - Largest revenue gains from applying local GRT increments to internet sales, applying local increments to the compensating tax, and hospital GRT revenues

2019 Session Tax Policy Changes, continued

- Revenue gains of the omnibus tax bill (HB6) offset by increase in film credit
  - Film credit changes estimated to cost over $500 million to the general fund over the next five years (in addition to the $250 million that would have been paid out under the existing cap)
  - Likely the most significant state investment ever in a single industry for economic development, despite evidence of about a 40 cent return on the dollar
- Significant tax reform initiatives left undone (e.g. broadening the GRT base and eliminating certain tax expenditures, lowering GRT rates, addressing tax pyramiding issues, etc.)
- Net effect of all 2019 revenue legislation is a recurring general fund loss of about $50 million in FY22 and beyond.

Fiscal Outlook

- FY19 year-to-date revenues running significantly ahead of the forecast
- Oil production soaring
  - About 80 percent of all FY19 revenue growth due to oil and gas activity
  - Stress tests of the December 2018 consensus forecast showed FY20 revenues could come in $1.3 billion above or below projections depending on oil prices and production activity
- Recession outlook
  - Recession signals in the bond markets: recent inversion in the yield curve, meaning very short rates rose above longer 10-year note rates
  - U.S. gross domestic product forecasts transition from above-trend growth in 2018-2019 to below-trend growth in 2020.

Expenditures

- Continued pressure to increase spending on many fronts, notably
  - Public Schools
  - Early Childhood
  - Medicaid
- With U.S. at full employment and N.M. nearing employment peaks, can the state find workers to increase government services and complete construction projects?

- Unfinished Issues
  - Unfunded pension liability
  - Selecting and managing capital outlay projects
  - Gross receipts tax pyramiding, high rates, and narrowing base
  - Fiscal stabilization
    - Worth looking at a state like North Dakota