



Legislative Finance Committee **FINANCE FACTS**

Understanding State Financial Policy

Consensus Revenue Estimate

Unlike many states, New Mexico executive and legislative staff work together to develop a revenue forecast that provides a common starting point for the Legislature and the executive to build separate budget recommendations. The staff-driven, analytical process is intended to be isolated from political influence.

Process

Only staff economists of LFC and the executive departments of Finance and Administration, Taxation and Revenue, and Transportation are members of the consensus revenue estimating group, or CREG; agency directors and political officials are excluded to protect the process from partisan pressure. In addition to providing a common basis for planning the budget, the use of economists across agencies allows as many of the limited number of professional economists in state government as possible to review revenues, trends, and economic models. Further, it allows staff economists to share information and techniques.

Although no state law requires a consensus estimate, the longstanding practice is for CREG to present forecasts, typically for the next five years of general fund revenues, in August and December. CREG also provides an update at the midpoint of the legislative session.

Legislative and executive staff economists spend months preparing the estimates, updating financial databases, reviewing legislative changes that impact revenues, studying economic and industry forecasts and literature, and testing and updating economic models.

Risks

Economic models often struggle to account for the full impact of significant rises or declines in the oil and gas industry, an industry with an outsized impact on state revenues and New Mexico's economy. The struggle, in large part, is because forecasts of oil prices are often incorrect. Additionally, even when price forecasts are accurate, other changes in the energy industry can significantly impact energy revenues and the state's dependence on the industry fluctuates depending on the strength of other economic sectors.

The estimates produced by the revenue models can also be overwhelmed by sudden shifts in taxpayer behavior, significant revenue losses from exploitation of tax loopholes, and other factors.

Revenue models are also dependent on the underlying state and national economic forecasts provided by outside orga-

nizations under contract with the CREG agencies. If the economic forecasts are wrong, the revenue forecasts are almost certain to be wrong as well.

Goals

The obvious goal of any economic forecast is to be as accurate as possible; however, risks, even when identified, cannot always be quantified, especially five years in advance. The LFC goal for the estimate prepared 18 months ahead of a forecasted period is to have no more than a 3 percent difference between estimated and actual revenue.

In assessing the positive and negative risks to the forecast, some economists aim for the midpoint between the most and least revenue the state could actually receive. However, budget risks are asymmetrical. While an underestimate of revenue might result in some reduced spending, an overestimated can force substantial cuts. Generally, the first opportunity to cut spending comes halfway through the fiscal year and must be absorbed in the second half of the year, doubling the impact. Further, excess funds, if revenues come in stronger than expected, can be used to increase general fund reserves. Many economists consider a strong reserve for New Mexico highly desirable given the state's volatile revenues.

Another consideration is the impact of the estimate on the link between state spending and state revenue. State spending flows into the state economy, increasing tax revenue. Cuts in state spending not only depress economic activity but also cause state revenues to decline further. Underestimating the state's ability to spend because of a low forecast can put money in the reserves that could be used to stimulate economic activity.

For More Information:

- LFC staff briefs with the revenue forecasts and accompanying graphs and narrative can be found on the LFC website at: www.nmlegis.gov/Entity/LFC/Revenue_Reports. The annual revenue estimating error graph can be found in the appendices of each revenue forecast brief.