



State Revenue Volatility and Enhancing Fiscal Stability

In the first Legislative Finance Committee study of New Mexico revenue volatility five years ago, revenues were exhibiting the highest levels of volatility in decades. Since then, revenues have only become more volatile, with the most recent five-year period exhibiting the most volatility in 40 years and the most continuous volatility in state history. Rising revenue volatility has complicated state revenue forecasting and challenged state budgetary planning, threatening the stability of essential public services. Because positive and negative revenue swings hinder efforts to maintain a balanced budget, policymakers should adopt practices that stabilize state finances. Such policies can reduce the need for difficult budget choices, such as spending cuts and tax increases during periods of decline, or help determine the best use of surplus funds when tax collections are high.

Understanding long-term trends can also help state leaders judge whether budgets are on a sustainable path and support better-informed fiscal planning and policy formulation. Policymakers should assess the factors behind tax revenue deviations and ensure the state’s fiscal sustainability and stability through policy actions.

Research from the Pew Charitable Trusts finds that states can manage uncertainty by regularly studying the causes of revenue volatility and developing budget policies that save money during growth periods for use during downturns. This brief discusses the sources of New Mexico’s general fund revenue volatility, identifies steps lawmakers have taken to reduce volatility, provides examples of how other states manage revenue surpluses, and discusses additional stabilization options for consideration.

Historical Volatility, State Comparisons, and Emerging Trends

A volatility score mathematically represents revenue volatility and allows comparisons across revenue sources. The score is calculated using the standard deviation of the revenue’s annual percent change. Pew found that tax revenue in most states and nationwide has become more volatile in recent years compared with historical volatility. During the five years ending in fiscal year 2022, federal tax policy changes and multiple pandemic-era factors fueled historic annual increases and decreases in collections.

Using a similar method, LFC economists calculated the volatility score of general fund revenue sources in five-year increments from FY00 to FY24 to identify changes in revenue volatility.

THIS REPORT provides an overview of New Mexico’s revenue volatility, including how New Mexico compares to other states, state revenue volatility over time, and a discussion of how revenue volatility can be mitigated to improve strategic budgeting and delivery of state services.

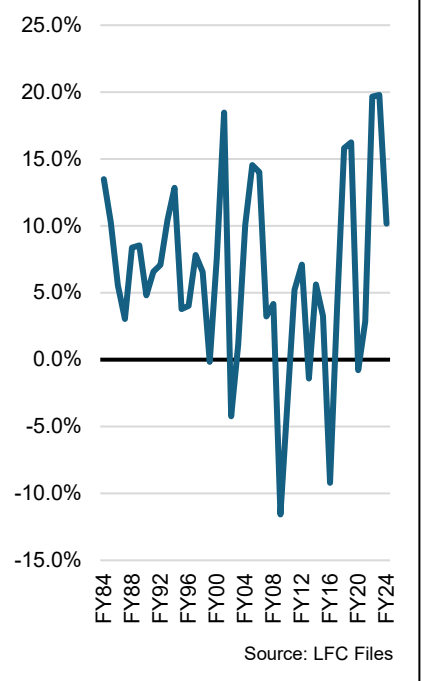
Prepared By: Ismael Torres

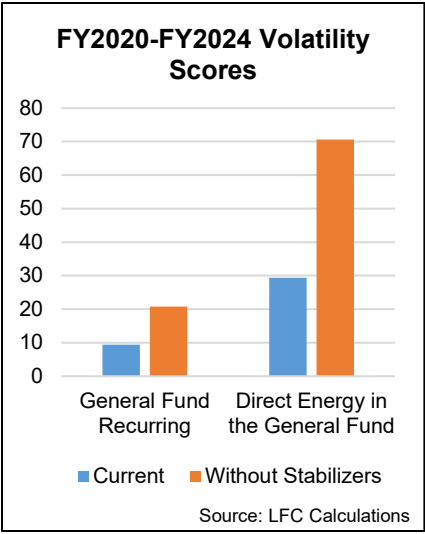
New Mexico Revenue Volatility
(10-Year, General Fund)

| | 2017 | 2022 |
|--|-------|-------|
| US Ranking (50 is most volatile) | 45 | 44 |
| State Volatility Score | 8.4 | 11.9 |
| Volatility Compared to National Median | 1.68x | 1.68x |

Source: Pew, LFC Calculations

General Fund Revenue Change

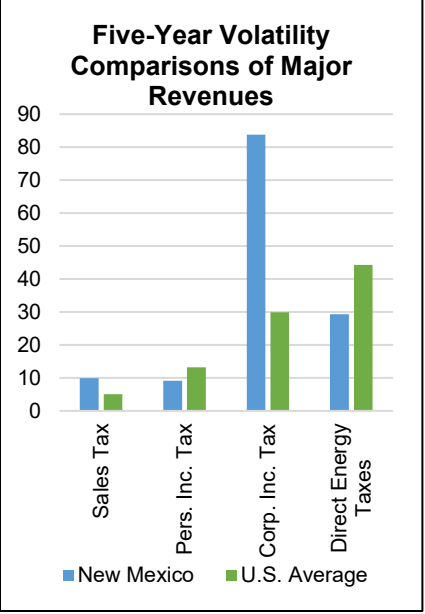




Stabilizing Actions Taken

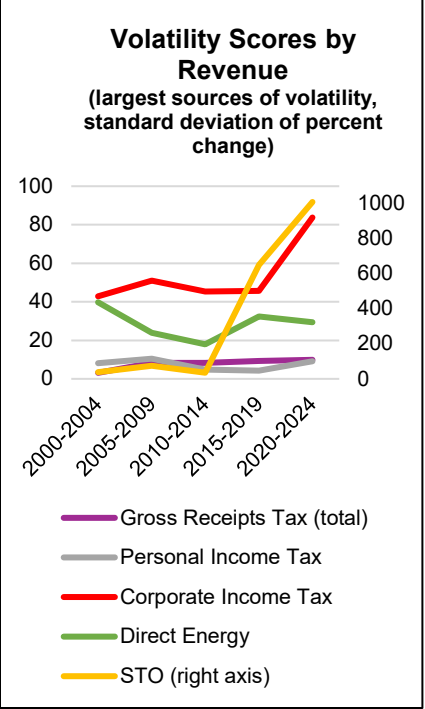
Following the first study on state revenue volatility in 2019, the Legislature expanded its efforts to stabilize state revenues by creating distributions of some windfall oil and gas revenues to the early childhood education and care trust fund (ECTF). Despite record levels of volatility, these distributions of above-trend revenue tamped down New Mexico’s revenue volatility by 37 percent in the five-year period following enactment. These reductions in volatility prevented New Mexico from becoming the third most volatile state in the country, behind Alaska and North Dakota, for general fund revenue collections.

In 2023, the Legislature took another step to improve revenue stability by capping some oil- and gas-related revenues in the general fund and investing any excess revenues into permanent funds for stable and sustainable general fund revenue growth in the future. Because those distributions do not begin until FY25, the impact of these most recent reforms has yet to affect New Mexico’s rankings. However, estimates show that volatility could be reduced by 55 percent over the next five years.



Tax Changes and Impacts on Volatility

Improvements in revenue stability have been somewhat offset by reductions in stable sources of revenue, such as the personal income tax and gross receipts tax. Among the major sources of tax revenue in the general fund, the personal income tax is the most stable, with a 10-year average change of less than 7 percent. The gross receipts tax follows, with an average volatility of nearly 10 percent. Since 2019, however, recurring personal income and gross receipts tax cuts have totaled nearly \$1 billion. Reductions in insurance tax revenues from the general fund has similarly contributed to volatility, highlighting the unintended negative impacts of earmarking stable revenues to non-general fund sources. These earmarks and tax reductions in stable revenue sources, have increased budgetary reliance on more volatile revenues by 5 percent.



Emerging Issues

As the Legislature has reduced oil and gas revenue volatility in the general fund by more than half, new sources of revenue volatility have emerged. As tax reductions in the most stable revenue sources take effect, the instability of these new sources and their impacts on the budget are also growing.

In New Mexico, as in most states, corporate income tax (CIT) revenues are among the most volatile. Revenues in a given fiscal year are affected by economic conditions, industry-specific factors, corporate financial strategies, and international operations. Despite corporate income tax revenues being the most volatile revenue source for most states, New Mexico’s corporate income tax revenue is almost three times as unstable as the national average. In most states, an average swing of 30 percent in corporate income tax revenues is considered the most volatile, while in New Mexico, that average swing is over 80 percent in a single year. New Mexico’s added instability stems in part from a more volatile industry makeup, with a higher concentration of oil and gas corporations, which tend to have more volatile profits subject to commodity price swings.

In addition to corporate income tax revenues, investments in the state general fund investment pool have become a major source of volatility. Over the last two five-year periods, earnings on general fund balances managed by the State Treasurer’s Office (STO) have become the most volatile source of revenue in the general fund. The State Treasurer’s Office invests what is known as the state general fund investment pool (SGFIP), with earnings attributed to the general fund. As balances in that pool have risen to exceed \$10 billion, interest rates have fluctuated dramatically, and investor expectations for interest rates have been even more volatile, the market-valued holdings in the SGFIP have fluctuated wildly. The value of the SGFIP holdings has grown or shrunk by over 1,000 percent on average in the last five years. This has led to inaccurate forecasts of this revenue and introduced extreme volatility to budget development. Although corporate income tax receipts and treasury earnings are on track to represent only 7 percent of revenues in FY24, volatility from these sources could contribute to doubling revenue growth or result in revenue declines with little to no warning, especially when considering general fund revenue growth is estimated to be nominal.

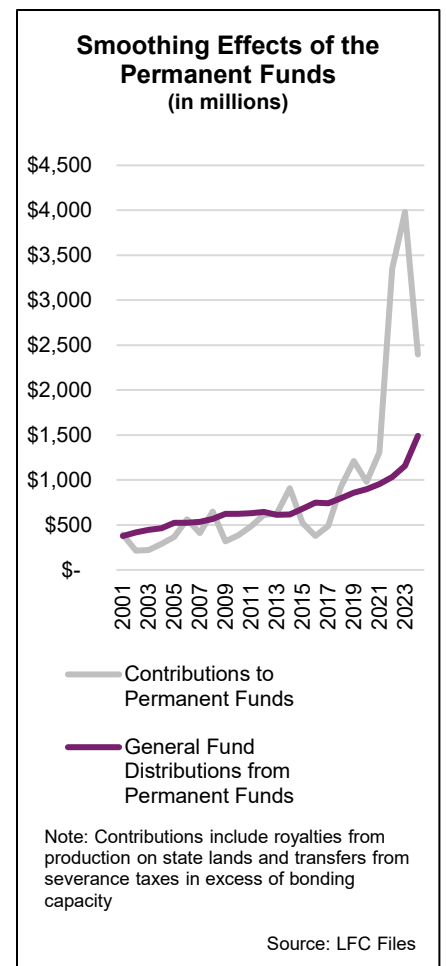
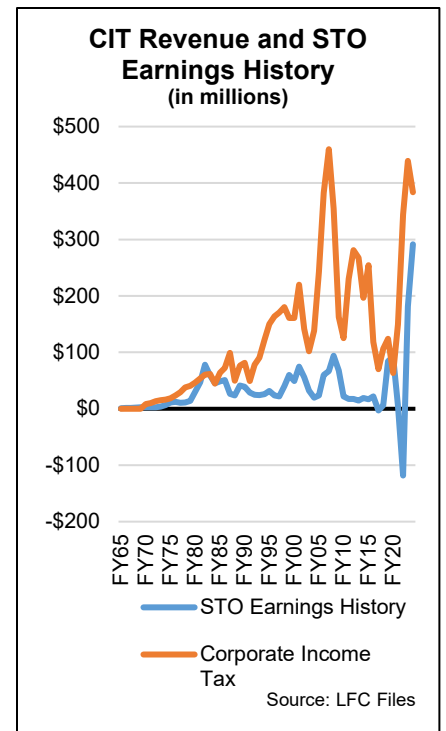
Additionally, volatility in gross receipts tax (GRT) revenue is rising, largely due to wider variances in receipts from Eddy and Lea counties in the oil-rich Permian Basin. Drilling and other oil and gas production activities drive receipts in these counties, leading to large gains and losses during price or production booms and declines. However, recent corporate discipline in capital investments is changing the responsiveness of drilling rigs to oil prices, creating more certainty in GRT revenue projections and helping to stabilize receipts comparable to the recent production stability in New Mexico.

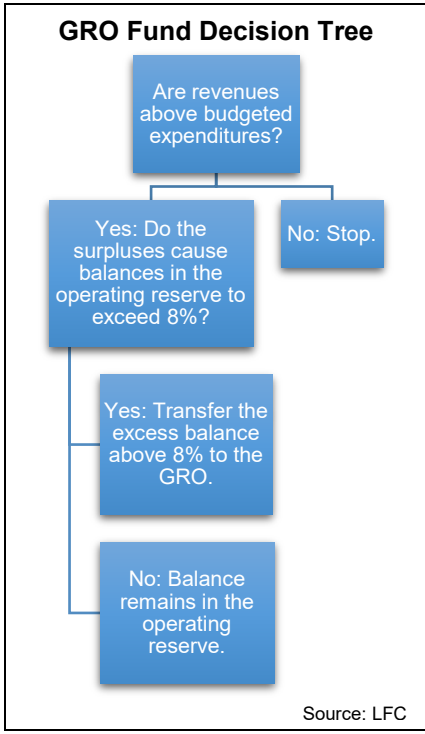
Notably, personal income tax revenues have grown more volatile in recent years. As oil and gas production has increased dramatically, so have the withholding payments for oil and gas proceeds in the personal income tax program. As the value of production has grown, so have these payments, which depend on production and prices, resulting in high levels of volatility. These payments now represent nearly 5 percent of total estimated revenues and almost one-quarter of estimated personal income tax payments. Representing about 20 percent of total revenues, personal income taxes were the most stable major tax in the general fund for the previous decade. However, with oil and gas proceeds withholding taxes growing as a share of personal income, the tax has become as volatile as the gross receipts tax, with similar shares of each revenue source dependent on the oil and gas industry.

Reducing Uncertainty

One key way states can reduce revenue volatility is by investing volatile revenue sources into budget stabilization funds. These funds transform volatile revenues into steady sources of income for the general fund, allowing for more efficient budget decisions and reducing the need for tax increases, painful program cuts, or deferred infrastructure maintenance. Budget stabilization funds with well-crafted rules for deposits and withdrawals mitigate business cycle fluctuations in receipts and support counter-cyclical policymaking, which fosters economic growth.

Permanent Fund Distributions Enhance Stability. Distributions from the permanent school fund and severance tax permanent fund (STPF) are among the most stable and reliable revenue streams for the general fund. The distribution formula, calculated as a percent of the five-year average of the

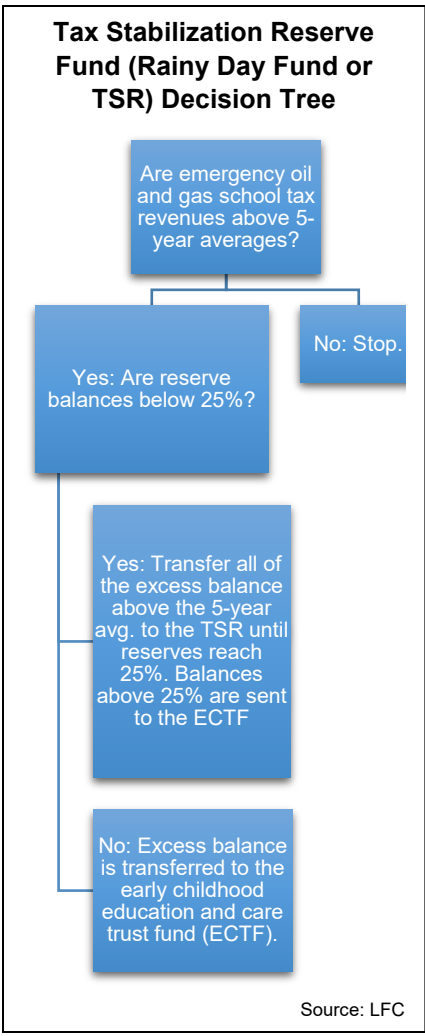




year-end balance of the fund, makes this revenue source easily predictable for the upcoming budget year. The actual distribution amounts for the next fiscal year are known prior to the legislative session. This formula also smooths fluctuations in market activity and oil and gas revenues, partially insulating the general fund from sudden shocks. Additionally, the permanent funds provide an intergenerational revenue stream, allowing current resource extraction to benefit future New Mexicans. Finally, permanent fund distributions have become the fastest-growing part of the general fund, driving revenue and budget growth from a stable source.

Identify Volatile Revenues for One-Time Use. The newly created government results and opportunity (GRO) fund is structured to allow excess cash to flow into the fund when revenues significantly exceed budgeted amounts. The GRO fund is used to pilot and evaluate newly proposed projects requiring multi-year funding on a one-time basis using one-time funds. Once pilot projects are completed, their performance can be evaluated and considered for recurring funding, supporting the allocation of limited recurring resources to their highest use.

The GRO fund receives revenues when the operating reserve—the state’s buffer for minor annual declines from the forecast—reaches 8 percent of the prior year’s recurring appropriations. Any excess balance above 8 percent is deposited into the GRO. Originally, these funds flowed to the tax stabilization reserve fund (the state’s rainy day fund) and proved successful in mitigating volatility. For example, surging oil- and gas-related revenue in FY23 resulted in a \$723.9 million transfer to the rainy day fund due to this rule.



Despite no longer receiving inflows from excess operating reserve balances, the rainy day fund can still receive excess revenue from the oil and gas emergency school tax when reserves are below 25 percent and those tax revenues exceed their five-year averages. The tax stabilization reserve follows best practices for rainy day funds by establishing specific revenue sources to make automatic deposits into the fund, making deposits during periods of surging revenues, and setting stringent limitations on withdrawals supporting its emergency use.

These transfers of excess funds described above help to identify one-time revenues more appropriately used for nonrecurring expenses. As demonstrated over the past 10 years of volatility, spikes in revenues above the revenue trend growth are, by definition, nonrecurring as revenues fall back to or below the trend. By identifying above-trend revenues for distribution to the GRO for nonrecurring spending or to the rainy day fund for use during short-lived downturns in revenues, the state ensures sustainable and stable budgeting and provision of services. To the extent these practices can be applied to new sources of volatile revenues, like the corporate income tax or general fund investment earnings, these strategies would greatly benefit general fund revenue and budget stability.

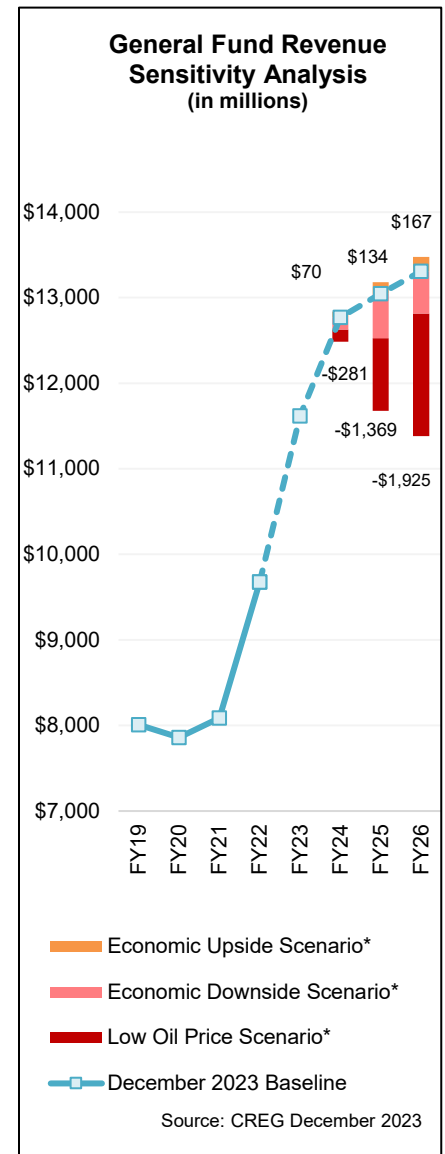
Some states set rules for how to use identified nonrecurring revenues. For example, Louisiana requires nonrecurring revenues be spent on retiring bonds in advance, making payments against the unfunded liability of the public retirement systems, funding capital outlay projects, making deposits into the budget stabilization fund, making deposits into its coastal protection and restoration fund, or funding new highway construction for which federal matching funds are available.

Exercise Fiscal Restraint. The most recent Consensus Revenue Estimating Group (CREG) trend analysis shows that, after stabilizing measures are taken into account, the variation in general fund revenues for the next three fiscal years remains significantly above the most recent 10-year trend. Revenues are estimated to exceed the 10-year trend by \$2.128 billion in FY24, by \$1.853 billion in FY25, and by \$1.557 billion in FY26. These significantly above-trend revenues may not be sustainable over time. The current above-trend forecast and the increasing budgetary dependence on volatile revenues indicate that policymakers should proceed cautiously when allocating the current revenue surge to recurring expenditures.

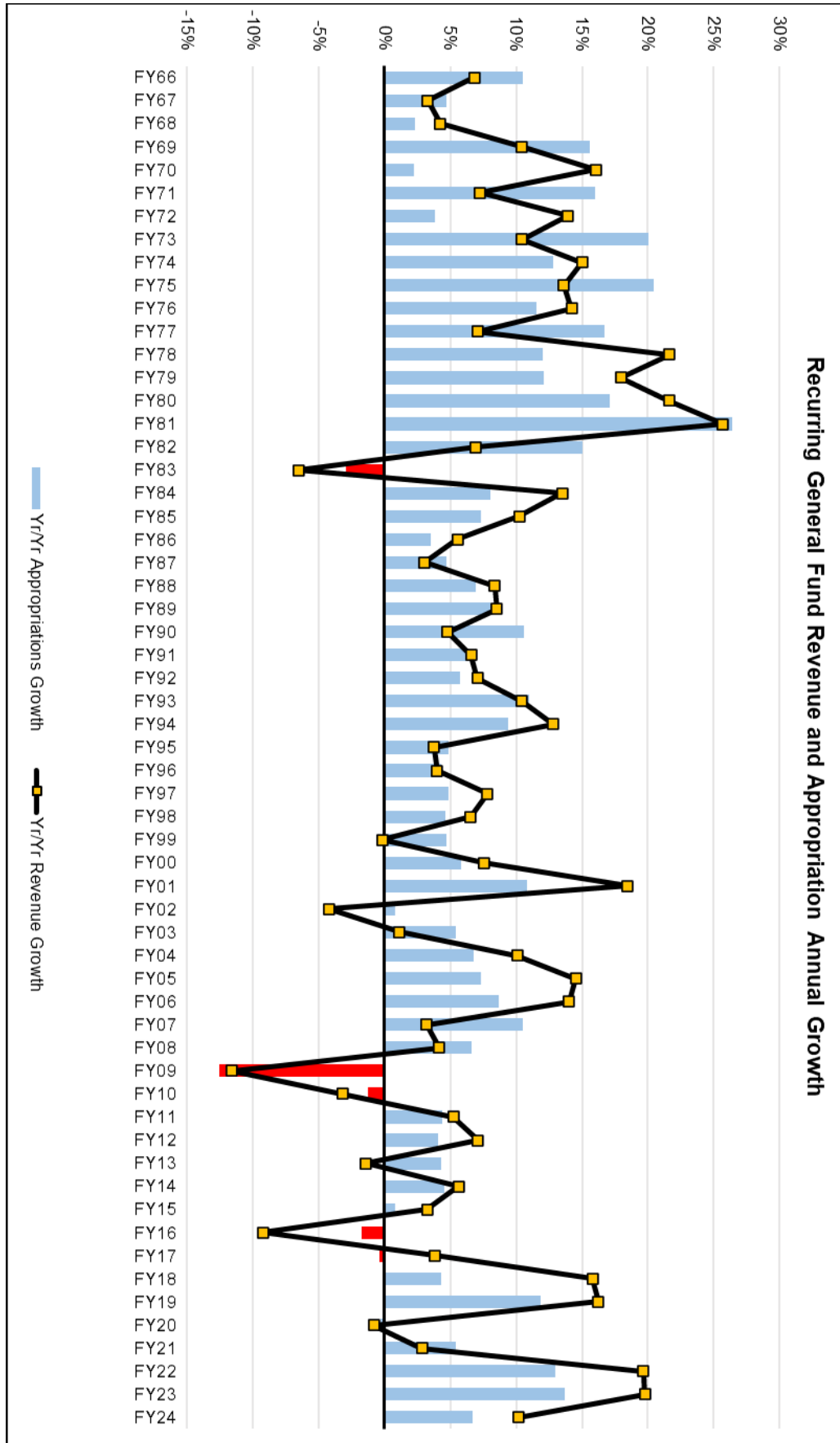
Budget best practices recommended by Pew, the Volcker Alliance, and others include budget mechanisms like those in Virginia, Utah, and Louisiana, which use above-trend revenue only for nonrecurring uses to prevent volatility in budget-making. Some states use these strategies to manage long-term revenue fluctuations, avoid committing short-term gains to long-term obligations, and ensure adequate and justifiable resources in reserve. For example, when revenue estimates are above the 15-year trend, Utah requires some of the surplus to be used to restore specified fund withdrawals and maintain reserves. Virginia sets a threshold for above-normal general fund revenue that exceeds the prior six-year average growth rate and deposits half into the state’s rainy day funds. Each of these policies is intended to prevent the state from becoming overly dependent on revenue growth that is one-time, unexpected, or unsustainable over time.

Limit Recurring Appropriations Below Recurring Revenues. Maintaining a gap between a state’s budget for recurring expenses and recurring revenues is critical to avoid emergency budgeting when volatile revenues fall short of expectations. When recurring budgets are set at levels too close to recurring revenues, even normal swings in volatile revenues could result in an unconstitutional budget deficit and require lawmakers to reconvene to address the shortfall. To maintain the provision of state services and improve services through stability and uninterrupted strategic planning, policymakers should determine an appropriate gap between recurring spending and recurring revenues. By aligning recurring expenditures with recurring revenues, the state ensures financial stability and sustainability by mitigating the risk of sudden budget shortfalls which can have negative economic and social impacts. The cushion between recurring revenues and recurring expenditures should represent the risk tolerance of policymakers and could be set to cover declines as estimated in stress-test scenarios only for the current budget year, so lawmakers will not be required to convene a special session to address revenue shortfalls and can instead dedicate an interim to planning and budgeting to address revenue declines, should declines continue.

Maintain Adequate Reserves. Stress testing of the December 2023 consensus revenue estimate indicates general fund revenues could fall by \$1.4 billion in FY25 and \$1.9 billion in FY26 due to an oil price shock and production decline—equivalent to about 32 percent of FY25 recurring appropriations. However, with the recent accumulation of funds beyond reserves and within agency budgets, and the recurring expenditure commitments below recurring revenues, more analysis is needed to develop reserve balance recommendations. Reserve threshold recommendations could be developed following the August 2024 revenue estimate based on the recurring revenue and expenditure gap and analysis of other available funds.



Appendix A: Historical Revenue and Budget Volatility

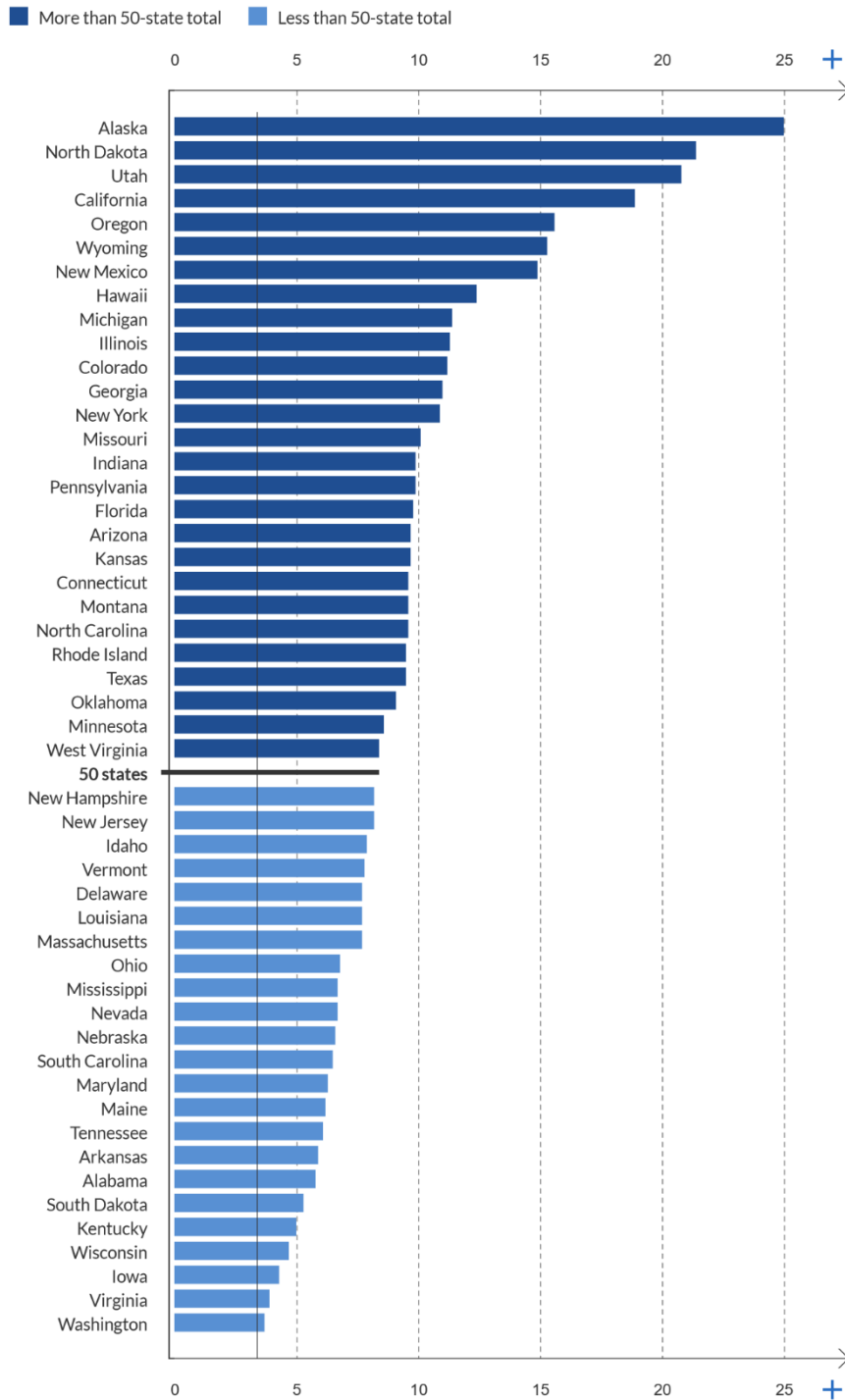


Appendix B: Pew Charitable Trusts State Volatility Ratings (1 of 2)

Fiscal 50: State Trends And Analysis

Tax Revenue Volatility by State

Volatility scores based on collections during 5 years ending fiscal year 2022, adjusted for tax policy changes



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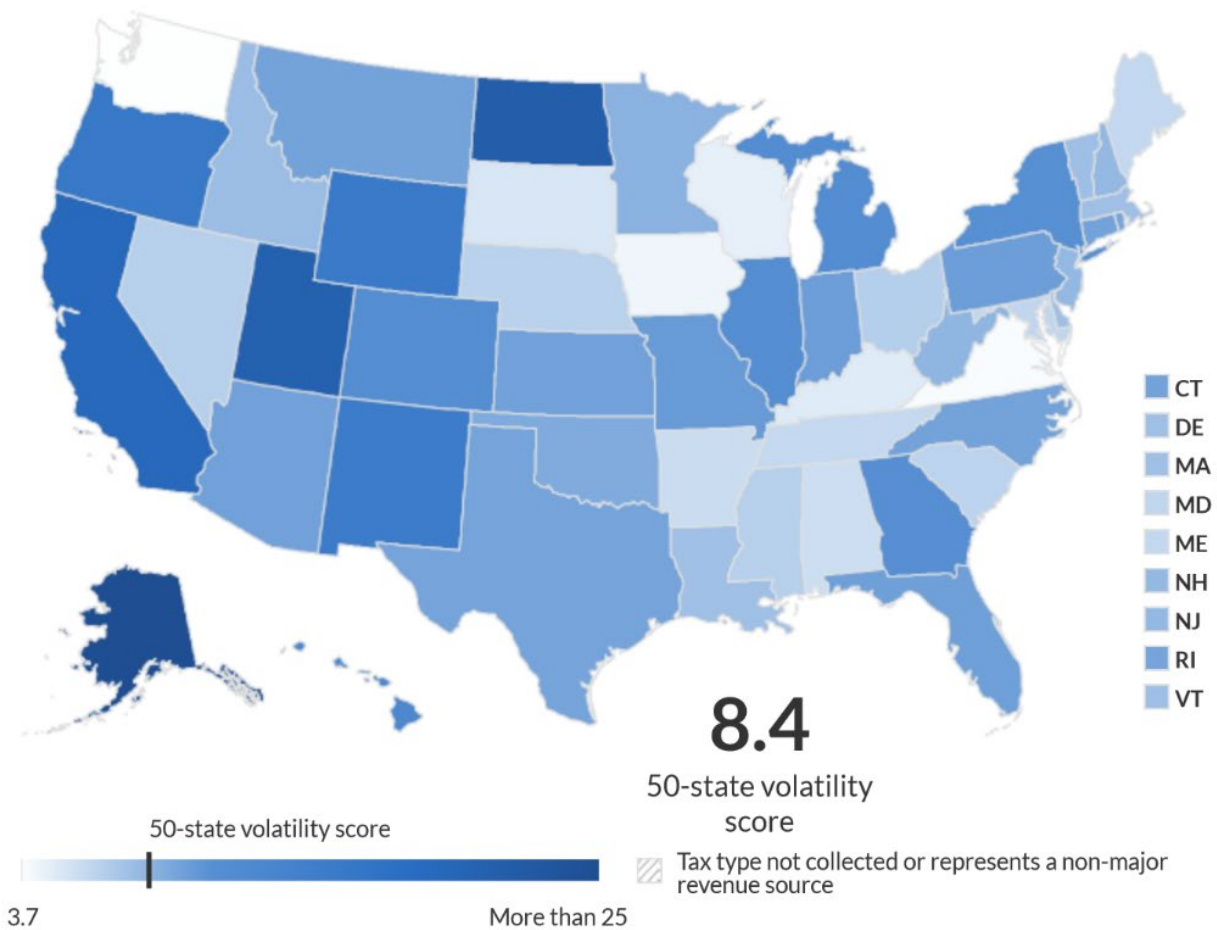
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Appendix B: Pew Charitable Trusts State Volatility Ratings (2 of 2)

Fiscal 50: State Trends And Analysis

Tax Revenue Volatility by State

Volatility scores based on collections during 5 years ending fiscal year 2022, adjusted for tax policy changes



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Appendix C: Corporate Income Tax Volatility

Corporate income tax volatility is primarily driven by the inherent variability in corporate profits, which are influenced by economic conditions, industry-specific factors, corporate financial strategies, and international operations. This volatility poses challenges for governments in forecasting and managing corporate tax revenues, necessitating robust fiscal policies and diversification of revenue sources to mitigate the impact of such fluctuations. Here are the primary reasons why corporate income tax is volatile:

1. Economic Cycles

- **Economic Conditions:** Corporate profits are highly sensitive to changes in the economy. During economic expansions, corporate profits tend to rise, leading to higher corporate tax revenues. Conversely, during recessions, profits decline, resulting in lower tax revenues.

2. Industry-Specific Factors

- **Sector Performance:** Certain industries, such as technology or energy, can experience significant profit swings due to factors like technological advancements, commodity price changes, and regulatory shifts.
- **Market Volatility:** Financial markets can be unpredictable, and companies heavily involved in trading, investment, or speculative activities may see substantial fluctuations in taxable income.

3. Corporate Profit Margins

- **Profit Margins:** The profitability of corporations can vary widely from year to year based on operational efficiency, competition, and cost management. High volatility in profit margins leads to corresponding volatility in corporate tax revenues.
- **Price Setting:** Companies with significant pricing power can adjust prices in response to market conditions, affecting their revenues and taxable profits.

4. Tax Planning and Avoidance

- **Tax Strategies:** Corporations often engage in tax planning to minimize tax liabilities. These strategies can include timing income and deductions, shifting profits to lower-tax jurisdictions, and using credits.
- **Changes in Tax Laws:** Frequent changes in tax legislation, including rates, deductions, and credits, can create uncertainty and volatility in corporate tax collections as businesses adjust strategies in response.

5. Globalization and International Factors

- **Global Operations:** Many corporations operate globally, and profits can be affected by international economic conditions, exchange rates, and geopolitical events.

6. Investment and Capital Expenditures

- **Capital, Research, and Development Investments:** Significant capital expenditures, such as purchasing new equipment, expanding operations, or investing in research and development can fluctuate taxable income due to depreciation and investment-related tax deductions.

7. One-Time Events and Corporate Actions

- **Mergers and Acquisitions:** Corporate restructurings, mergers, and acquisitions can result in significant changes to a company's taxable income.

Appendix D: State General Fund Investment Pool (SGFIP) Volatility

The SGFIP holds bonds which have experienced significant volatility in valuation in recent years due to various key factors. This volatility poses challenges for revenue forecasting and budget management, necessitating robust investment strategies and diversification to mitigate the impact of such fluctuations. Here are the primary reasons why bond investment funds have been volatile:

1. Interest Rate Fluctuations

- Bond valuations are highly sensitive to changes in interest rates. When interest rates rise, the value of existing bonds typically falls because newer bonds are issued with higher yields, making older bonds less attractive. Conversely, when interest rates fall, the value of existing bonds increases.

2. Other Federal Reserve Policies

- The Federal Reserve's actions, such as quantitative easing (QE), in addition to interest rate adjustments, have a significant impact on bond markets. For instance, during the pandemic, the Federal Reserve implemented aggressive QE measures, purchasing large amounts of government and corporate bonds, which initially boosted bond prices. However, as the economy began to recover and inflationary pressures emerged, the Federal Reserve signaled tapering of asset purchases and potential rate hikes, leading to increased volatility in bond pricing.

3. Economic Uncertainty

- Economic conditions such as inflation, recession fears, and global economic events (e.g., trade tensions, geopolitical conflicts, and the COVID-19 pandemic) contribute to uncertainty in the bond market. These factors can lead to rapid changes in investor sentiment and increased market volatility.

4. Inflation Expectations

- Inflation expectations directly affect bond yields and prices. Higher inflation erodes the purchasing power of future bond payments, leading to higher yields and lower bond prices. Recent years have seen periods of both low inflation and sudden spikes in high inflation contributing to valuation swings.

5. Supply and Demand Dynamics

- Supply of new bonds and the demand from investors can cause price volatility. For example, increased issuance of government bonds to finance fiscal deficits can lead to higher yields and lower prices if demand does not keep pace with supply.

6. Credit Risk

- Changes in the perceived creditworthiness of bond issuers, whether sovereign or corporate, can impact bond valuations. Economic downturns or company-specific issues can increase credit risk, leading to wider credit spreads and lower bond prices.

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