The Oil and Gas Industry and New Mexico's Fiscal Future:
Finding a Path Forward and the Need to Act

Presentation to the Revenue Stabilization and Tax Policy Committee

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December 19, 2022

Overview

Introduction and Project Overview

Prior PFM 2020 Report: State of New Mexico Tax Structure

- PFM's December 2020 report, "State of New Mexico Tax Structure: Key Issues and Alternatives," highlighted New Mexico's reliance on revenue from the oil and gas industry and detailed a series of steps that the State could take to achieve a more diversified, more equitable, and increasingly stable revenue base.
- The study included a review of financial and budget documents and prior studies and was informed by 23 interviews with New Mexico tax subject matter experts and key stakeholders. The project team also compared New Mexico with peer states (benchmarking) and conducted best practices research.
- Since the report's release, there have been major shifts in the domestic and global macroeconomic situation – particularly as it relates to the oil and gas sector – and changes to the New Mexico tax code.

Current PFM Study: Why This Study is Needed Now

- **Recent "windfall" revenues from the oil and gas sector have contributed to a structural imbalance** between the State's reliable, recurring sources of general revenue – primarily personal income taxes and gross receipts taxes – and recurring State spending.

- **The reliance on the oil and gas sector for revenue may also have a negative economic impact.** New Mexico's recent lackluster economic performance and population stagnation, particularly when compared to neighboring states, may be the result of a "resource curse" – an economic term describing when reliance on extractive industries leads to underinvestment in policies needed for long term growth.

- **If the oil and gas sector declines in the near term, it will create a significant revenue shortfall and further exacerbate the gap** between recurring revenue and State appropriations. The State's revenue estimates generally reflect an expectation that New Mexico's oil and gas sector will remain robust for many years. Given market shifts and historic trends, this assumption is risky.

Current PFM Study: Three Questions for New Mexico's Fiscal and Economic Future

- For the last eight months, PFM has been working on a new study that builds and expands upon our prior work and focuses on three critical questions:
  - How will changes in the oil and gas sector affect State revenues over the next 15 years?
  - If there is a long-term decline in the oil and gas sector, how can the State help offset the revenue impact through its tax structure?
  - What role can economic diversification play to increase revenue, promote growth, and improve equity for New Mexico residents?

Summary of Findings

Summary of Findings

- The recent surge in oil and gas revenue is due to a once-in-a-generation confluence of supply and demand factors that are unlikely to be sustained over time.
- Independent analysts suggest that the peak in oil and gas production in New Mexico could potentially come within the decade.
- Recent State revenue trend projections suggest assumptions of continued oil and gas revenue growth that are inconsistent with historical growth trends and with alternative scenarios of how price and production relate to changes in State revenue.
- If oil and gas revenue projections aren't achieved, it will worsen the structural recurring revenue deficit resulting in potentially significant outyear budget gaps.
- Closing the potential gaps would require unprecedented growth in the State's two other main sources of revenue – the gross receipts tax and the personal income tax.
- **Therefore, utilizing non-recurring revenue to offset cuts to recurring revenue sources now would leave New Mexico even more vulnerable to the potentially catastrophic consequences of the next inevitable downturn.**

New Mexico’s Slow Growth and High Poverty Economy

- New Mexico has lagged in economic and population growth for more than a decade and remains one of the poorest states in the nation.
  - Between 2000 and 2010, New Mexico gained just over 95,000 jobs and total jobs grew by 10 percent. But between 2010 and 2019 (pre-COVID), New Mexico’s jobs and total population growth decelerated. Jobs were up by just 5 percent, and New Mexico was fourth from the bottom in jobs growth – behind only Alaska, West Virginia, and Vermont.
  - In addition, between 2010 and 2020, New Mexico’s population only grew by 2.8 percent – tied for the 11th slowest rate of growth. It was only the second decade since its founding that the State did not experience a double-digit growth rate.
  - Despite the perception that remote workers have been moving into the State during the pandemic, the population of the State declined between 2020 and 2021, as did net in-migration. This is in stark contrast to neighboring states, especially Arizona.

New Mexico's Slow Growth and High Poverty Economy

- New Mexico has persistently high poverty. Based on three-year data, New Mexico has the third highest state poverty rate – trailing only Mississippi and Louisiana. Relatedly, Arkansas, Mississippi, Oklahoma, and West Virginia were the only states with lower average weekly wages as of December 2021.
  - In addition, poverty is concentrated in certain places – for example, Cibola, Socorro, Sierra, and McKinley Counties – and among certain groups of people, especially Latino households (21.3 percent), Black households (22.2 percent), and Native American households (30.0 percent).
  - As of May 2022, New Mexico was tied with Arkansas for the third lowest civilian labor force participation rate – only West Virginia and Mississippi had lower rates of participation. And, New Mexico has the 13th lowest college attainment rate at just 30.1 percent.

The Economic and Fiscal Impact of the Oil & Gas Sector

- Absent robust economic and population growth, State revenue has become more dependent on the oil and gas sector.
  - Employment in the mining, quarrying, and oil and gas extraction sector represented less than 2.5 percent of direct employment in the State for 2021, ranking 14th out of the 20 sectors examined by the U.S. Bureau of Labor Statistics.
  - Other sectors actually drive employment in New Mexico, with nearly 40 percent of jobs contributed by the top three sectors: 17.8 percent in health care & social assistance, 11.4 percent in retail trade, and 10.3 percent in accommodation & food services.
- New Mexico's State Budget depends on oil and gas for approximately one-third of its general revenue, meaning State policymakers must ride the "roller-coaster" of the ups and downs of oil and gas prices and production.
- The recent surge in oil and gas revenue is largely the result of the timing of two once-in-a-generation events – a rebound in demand as the COVID-19 pandemic eases and a restriction in supply due to the Russian invasion of the Ukraine.

Risks Related to the Reliance on the Oil and Gas Sector

- Multiple sources currently estimate that peak production of oil and natural gas will occur by or before the mid-2030s.
  - Projections used by the State for revenue forecasting, from analytical firms that include Moody's Analytics, Rystad Energy, and IHS Markit, estimate that the final turning point for oil production could occur as soon as 2028 and shortly thereafter for natural gas.
  - Similarly, entities like the International Energy Agency predict peak demand will occur by the mid-2030s, and a survey of institutional investors in the oil and gas industry found that two-thirds of investors believed that demand would peak by 2030.

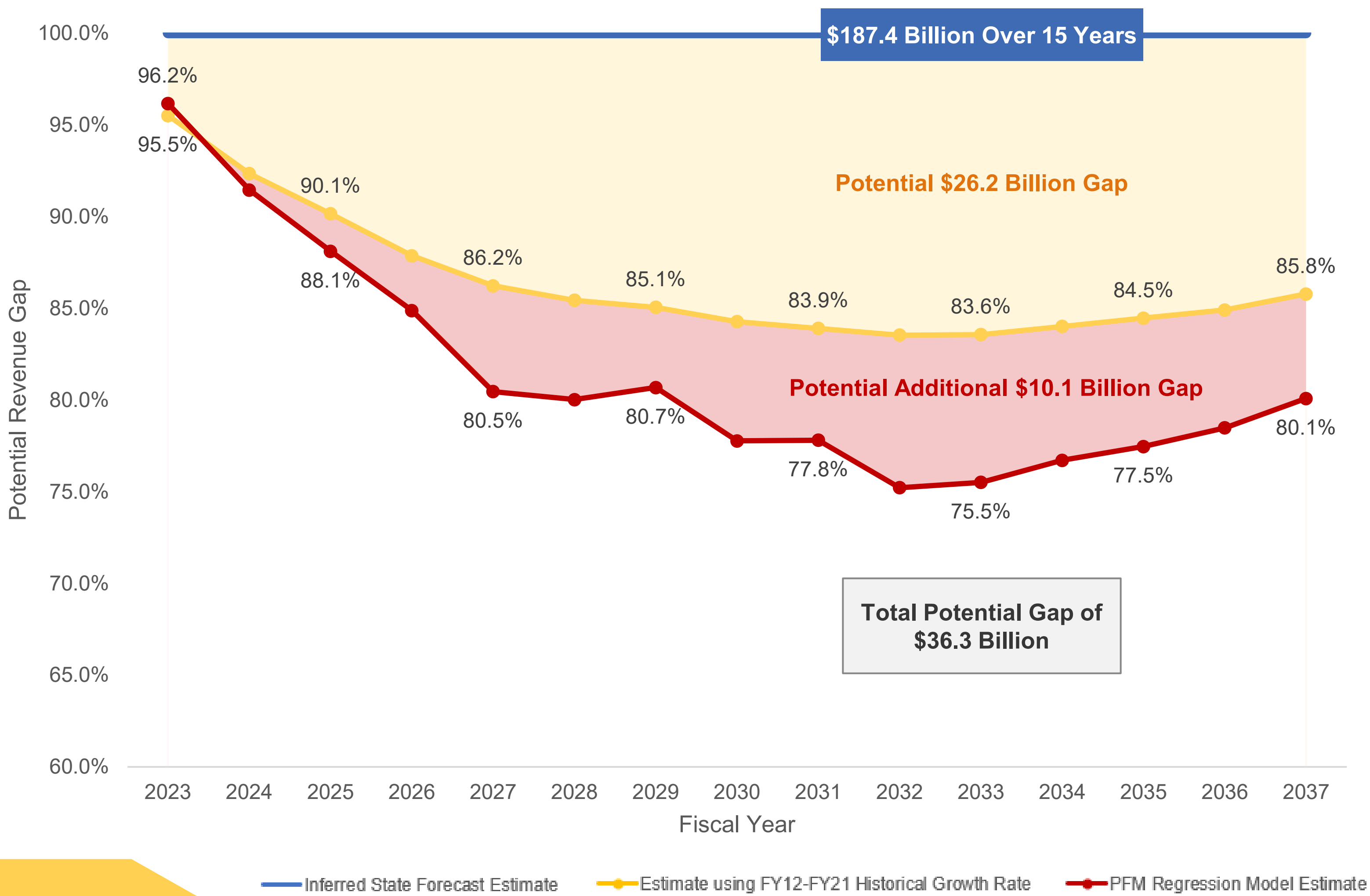
Recent Estimates Show Continued Reliance on Oil and Gas Revenues

- The New Mexico Legislative Finance Committee (LFC) staff and Consensus Revenue Estimating Group (CREG) conducted the State's first formal long-term analysis of the General Fund in July 2022, with a heavy focus on severance tax revenues.
  - In a review of mid- to long-term revenue options, LFC staff projected that strong oil production will be maintained at least through the next 10 to 15 years. While LFC analyzed long-term trends, they did not create a projection of actual revenues beyond FY 2026.
  - However, the recent spike in State revenues is "baked in" to the State's short-term baseline forecasts. Thus, growth that is slower than trend in the out years still results in substantially increased aggregate net revenues over a medium-term horizon.
  - The group did, however, conclude that at some point before FY 2050, revenue growth will dip below the ten-year historical trend and encouraged careful consideration of spending of recurring funds so that appropriations don't exceed revenue in the long-term.

Alternative Scenarios Suggest Long Term Risk in Reliance on Oil and Gas

- In order to extrapolate a 15-year State baseline forecast, PFM inferred a State projection from the various growth rates embedded in the committee presentation's charts and tables from the summer meeting.
- Then, PFM conducted a systematic regression analysis of dozens of available oil and gas historical data points and tested their predictive relationship to New Mexico's General Fund revenues, applying a line that statistically "fit" the data to a forward-looking estimate of the portion of future revenues anticipated to be derived from oil and gas.
- When PFM modeled various price and production scenarios, we found that the inferred State forecast may be overstating aggregate revenues **by $26 billion to $36 billion over the next 15 years** – or up to $3 billion annually at the end of the projection period (For more discussion of methodology, see Appendix A).

Potential New Mexico Revenue Gap Over the Next 15 Years of $26 Billion to $36 Billion



Potential New Mexico Revenue Gap Over the Next 15 Years of $26 Billion to $36 Billion

15-Year General Fund Projected Revenues (millions)		FY2037	Total (FY2023-FY2037)
(A)	Inferred State Forecast Estimate	$15,331	$187,429
(B)	Estimate using FY12-FY21 Historical Growth Rate	$13,150	$161,250
(B - A)	*Difference to Inferred State Forecast Estimate*	*($2,181)*	***($26,180)***
(C)	PFM Regression Model Estimate	$12,277	$151,097
(C - B)	*Difference to Historical Growth Rate Estimate*	*($873)*	***($10,153)***
(C - A)	*Difference to Inferred State Forecast Estimate*	*($3,054)*	***($36,333)***

The Eventual Decline in Oil and Gas Revenue

- While predictions of the specific timing of industry peaks are just that – predictions – at some point, State oil and gas revenues will begin to decline permanently.
  - The State's Consensus Revenue Estimating Group estimates that oil and gas revenue will decline to 10 percent of General Fund revenue by 2050.
- Given historical volatility and long-term trends, a decline in revenue could begin much sooner, and there is no guarantee that it will occur in a linear fashion.
  - The CREG and LFC staff acknowledge that many factors could contribute to a future shock to the industry, including recessions, environmental or geopolitical crises, changes to federal regulatory policy, or technological innovations.
- **In other words, no matter which scenario one looks at, there is a significant risk in the continued reliance on oil and gas revenue.** Doing so could lead to outyear revenue gaps that worsen the State's recurring revenue structural deficit.

Other Taxes Would Need to Grow at Unprecedented Rates to Close Gaps

- Other than revenue from the oil and gas sector, New Mexico primarily relies on GRT and PIT collections. Without changes to the State's overall tax structure and economy, there would need to be unprecedented growth in both to offset potential revenue gaps. Over the 15-year period examined by PFM:
  - Gross Receipts Tax (GRT) aggregate collections by FY2037 would need to increase more than 60 percent over what the historical growth rate would predict to cover the revenue gap from the PFM scenario outlined earlier, at $95.7 billion over the projection period versus a baseline of $59.4 billion using the historical growth rate of the GRT.
  - Personal Income Tax (PIT) aggregate collections by FY2037 would need to increase by more than double to fill the same revenue gap – $71.4 billion over the projection period versus a baseline of $35.0 billion using the historical growth rate of the PIT.
  - Under a combined scenario, aggregate GRT and PIT collections would need to increase by nearly 40 percent over the amount predicted by historical growth rates.

Unprecedented Increases in Collections Needed to Cover Potential Revenue Gap Absent Reform

Estimated Collections Needed to Cover Revenue Gap (millions)	FY2037	Total (FY2023-FY2037)
Potential Revenue Gap	**($3,054)**	**($36,333)**
Scenario 1: Closing the Gap with GRT Revenue Only		
GRT Revenue Using Historical Growth Rate	$5,192	$59,363
GRT Needed for Potential Revenue Gap	$8,246	$95,696
Difference to Historical GRT Growth Rate Estimate	59%	61%
Scenario 2: Closing the Gap with PIT Revenue Only		
Net PIT Revenue Using Historical Growth Rate	$2,554	$35,031
PIT Needed for Potential Revenue Gap	$5,608	$71,364
Difference to Historical PIT Growth Rate Estimate	120%	104%
Scenario 3: Closing the Gap with Both GRT and PIT Revenue		
Combined GRT and PIT Revenue Using Historical Growth Rate	$7,746	$94,394
GRT and PIT Needed for Potential Revenue Gap	$10,800	$130,727
Difference to Combined Historical Growth Rate Estimate	39%	39%

Recommendations

Summary of Recommendations: Take Opportunity to Act Now

- **To reduce the risk and uncertainty related to the potential significant outyear budget gaps, New Mexico needs to act now** to both reform its existing tax structure and expand efforts to grow a more equitable and sustainable state economy. Tax reform and economic expansion are both essential to fiscal health and economic prosperity.
- The State should consider a series of tax policy changes including:
  - Reforming the PIT rate structure and eliminating the capital gains PIT deduction
  - Reinstituting an estate tax
  - Increasing the motor fuel tax rate
  - Broadening the GRT tax base
  - Continuing to expand excise taxes
- The State should better align tax policy and economic development strategy by examining the efficacy of current tax incentives.
- The State should build on its efforts at economic diversification by increasing investments in people and places, focusing on innovation, and explicitly considering likely revenue impacts of economic development initiatives.

The State Should Pursue Tax Policy Changes to Improve Equity, Reduce Volatility, and Better Position New Mexico to Meet Future Needs

- The State should consider a series of tax reforms consistent with the LFC's tax principles, defined as follows:
  - Adequacy – the tax or tax system generates enough revenue to pay for public services without continuous changes
  - Efficiency – the tax or tax system minimizes economic distortion and avoids excessive reliance on any single tax
  - Equity – the tax or tax system fairly distributes the tax burden among all taxpayers
  - Simplicity – taxes are simple to understand and collect
  - Accountability/Transparency – tax collection/administration is easy to monitor and evaluate and subject to periodic review

The State Should Pursue Tax Policy Changes to Improve Equity, Reduce Volatility, and Better Position New Mexico to Meet Future Needs

- **Reforming the PIT rate structure.** Reinstituting a rate structure with higher marginal PIT rates at higher income levels can make New Mexico's tax structure more progressive and equitable, significantly increase General Fund revenue, and reduce reliance on other revenue sources.
- **Eliminating the capital gains PIT deductions.** Lower capital gains rates or deductions significantly reduce progressivity in State income taxes specifically and the State tax structure in general. The exemption also undermines revenue sufficiency in the State tax structure, reducing State tax revenue collection by tens of millions of dollars per year.
- **Reinstituting an estate tax.** Implementing an estate tax with exemptions for estates below a certain threshold will make New Mexico's tax structure more equitable, given that the current tax treatment overwhelmingly favors very wealthy individuals.

The State Should Pursue Tax Policy Changes to Improve Equity, Reduce Volatility, and Better Position New Mexico to Meet Future Needs

- **Broadening the GRT tax base.** Broadening the GRT tax base can improve tax revenue adequacy and stability by providing targeted tax relief to low-income earners while returning hundreds of millions of dollars in lost revenue to the State.
- **Increasing the motor fuel tax rate.** Increasing the motor fuel tax rate to align with national trends (raising rates to adjust to long-term trends of increasing automobile fuel efficiency) can support greater tax base adequacy.
- **Continuing to expand excise taxes.** The State should continue to align its excise taxes with new forms of goods or services that gain traction in the market; the typical regressivity of excise taxes can be offset by or coupled with a more progressive PIT.

The State Should Align Tax Policy and Economic Development Policy

- The State should also revisit and examine its tax incentive structure. New Mexico has literally hundreds of tax credits; most are rarely used, while many of the more popular ones may result in a net loss in revenue to the State.
- The State should focus on fewer, more effective tax credits, including an effort to streamline and market all tax credits relevant to the State’s nine existing “target industries.”
- A more progressive PIT tax structure can be designed to retain the tax benefits of living in New Mexico for high income earners while generating more revenue to invest in the health, education, outdoor, cultural, and quality of life programs and services that can help support relocation to New Mexico.

Build on Current Efforts at Diversification by Investing in People and Place

- The State's plan for economic diversification is centered on sector-specific strategies with a focus on retaining and attracting high wage earners. New Mexico's tax expenditure programs are also largely industry specific.
- In addition to sector specific strategies, New Mexico also needs to focus more on economic development initiatives centered on certain areas and communities – both to ensure multi-sector growth and to reduce economic inequity.
- The State has made strides in this area – including growing investment in childcare and access to higher education as well as expanding tax credits for low-income families – but more needs to be done to drive economic expansion and poverty reduction.

Strategic Investment in Places and People

- **The State should continue to prioritize equity and reducing barriers to employment in its workforce development strategy** – such as the cost of education, needs for childcare, structural racism, and criminal history – to better link workforce development with economic development and expand the economic power of New Mexico's tax base.
  - The State already has programs that are focused on certain communities, but they largely provide project- or employer-specific funding.
  - Using a data-driven approach, the State should concentrate its resources in geographic areas with both high poverty and high unemployment that are experiencing population decline, as well as in areas in the Permian Basin that are most dependent on the oil and gas industry for employment.
- **The State should develop and formalize a stronger framework – including adding State capacity where needed** – to help connect local governments with third-party grants and technical assistance, encourage greater collaboration with regional organizations, and align local needs with State economic development priorities.

Strategic Investment in Places and People

- **New Mexico should work with communities to understand what they see for their future** in order to address the fact that it is the only Western state that does not have substantial population growth that can help fill newly created high-wage jobs.
  - Specifically, **the State should increase funding for both early and ongoing education for current residents**, as well as pursue an active strategy to incentivize and attract domestic in-migrants who can join the labor force in the short- to medium-term to avoid constraining economic growth due to a lack of skilled labor.
  - These initiatives can both help support current residents and better position the State to benefit from its current efforts in the innovation space.
  - The National Labs play a very significant role in the State's high-wage jobs strategy, but the State is too dependent on third-party efforts in the innovation sector.
- **The State should continue to bolster New Mexico Tech, UNM Rainforest, and other innovation** efforts that seek to spin off technology in order to increase private sector activity, especially in the biosciences. These programs have the potential to significantly increase high-wage jobs and provide a path of opportunity for more New Mexicans.

The State Should Explicitly Consider the Revenue Impacts of its Economic Development Initiatives and Programs

- **The State needs to address economic inequities as part of its overall revenue strategy, too.** A shift in strategy is important for New Mexico's people as well for its State Budget.
  - When New Mexicans earn more, their standard of living increases, and they pay more in taxes and may have less need for State services.
  - The State should focus its economic development strategy on State revenue in addition to employment. As noted earlier, this requires a focus not only on people who have been left behind but also places that suffer from significant and persistent poverty.
  - The State's evaluation of its economic development efforts currently focuses mostly on job creation.
- But if economic diversification is going to help offset potential oil and gas revenue losses, the State should pay more attention to the revenue consequences of the State's economic development strategy, through strategic coordination on the front-end and regular evaluation on an ongoing basis.

Conclusion

The Bottom Line and the Need to Act

- Despite current budget surpluses, **New Mexico faces a series of interrelated challenges** that stem from the State government's disproportionate reliance on revenue from the oil and gas industry.
- **Over-reliance on taxes and royalties generated by oil and gas production** subjects critical State services, including public education, public health, and public safety to the unpredictable "boom and bust" cycles of an increasingly volatile fossil fuel industry. Since 2020, New Mexico has experienced an accelerated version of the historical cycle of boom and bust, with crude oil prices fluctuating from $115 per barrel to negative $38 per barrel.
- While no one can credibly claim to predict the future with total accuracy, and current State forecasted growth trends represent one plausible scenario, **the range of potential outcomes over the long-term is far more variable than State policymakers may assume.**
- If the structural revenue gap is of sufficient magnitude, **the State will require unprecedented gains in other economic sectors and other sources of revenu**e to offset the potential losses in oil and gas revenue. Such gains may be extremely difficult to achieve given the current structure of New Mexico's tax code and economy.

The Bottom Line and the Need to Act

- However, **recent windfall oil and gas revenues create an unprecedented opportunity** for the State to reduce the likelihood of a future revenue slump by investing in economic and revenue resilience through:
  - Restructuring the State tax system
  - Diversifying the economy
  - Equalizing opportunity for all New Mexicans
  - Making the State more attractive for both residents and new investors
- New Mexico's policymakers have taken steps to segregate and invest some surplus revenue when circumstances allow.
- **But alongside the many opportunities created by New Mexico's current revenue surplus is an equally potent threat that policymakers will utilize non-recurring revenue to offset cuts to recurring revenue sources**, leaving New Mexico even more vulnerable to the potentially catastrophic consequences of the next inevitable downturn – and the risk that next time, there might not ever be a full recovery back to trend.

Questions

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Appendix A: About PFM and Methodology

Background

- Founded in 1975, PFM is a national firm with 33 offices, including five offices throughout the West.
- PFM offers a wide range of services, including financial advisory, alternative finance, financial modeling, consulting, and other specialized services.
- PFM's Management and Budget Consulting (MBC) practice is leading our engagement in New Mexico.
- In just the last three years, our MBC practice has worked with over 80 state and local governments on a variety of engagements.
- PFM has undertaken numerous studies related to tax and revenue structures, revenue estimates, and tax collection practices, including for the States of Kansas, Oklahoma, Delaware, Hawaii, and Pennsylvania.

PFM Project Team

David Eichenthal, Engagement Manager

David Eichenthal joined PFM in 2011 and became a Managing Director in the firm's Management and Budget Consulting practice in 2014. He served as the Engagement Manager for PFM's 2020 study of the State of New Mexico tax structure. Both as a consultant and as a former local government CFO, Mr. Eichenthal has led a variety of projects related to revenue and economic development.

Ryan McNeely, Project Manager

Ryan McNeely is a Director in the Management and Budget Consulting practice in PFM's New Orleans office. He has led multi-year financial planning and operational reviews for local governments around the country and previously served as an analyst with the New Jersey Office of Management & Budget.

William Fulton, Senior Advisor

Bill Fulton is a former director of Rice University's Kinder Institute for Urban Research. He previously served as mayor of Ventura, California and director of planning & economic development for the city of San Diego – and has written multiple books and articles on economic development.

Economist Dr. Kelly O'Donnell served as an independent advisor to the project team.

Methodology for Current PFM Study

- The project team conducted policy and data analysis for this study using a combination of national and state sources, including the U.S. Census Bureau, U.S. Energy Information Administration, New Mexico Legislative Finance Committee, and New Mexico Consensus Revenue Estimating Group.

- The project team also consulted with a range of subject matter experts and other stakeholders through 26 interviews to develop a better understanding of important issues related to the oil and gas industry and energy sector, current economic diversification efforts, and the overall economics and demographics of New Mexico.

- Interviewees included members of the legislative and executive branches and their staff, experts based in higher education, and representatives of other research and advocacy institutions. These interviews were not for attribution but provided additional background and context for the project team.

- As noted earlier, the State does not publish long-term revenue forecasts beyond five fiscal years. To infer a baseline State revenue forecast, PFM substantially relied on the CREG “Long-Term Outlook” presentation to the Legislative Finance Committee on July 20, 2022.

Methodology for Current PFM Study

- PFM first used the December 2021 consensus revenue estimates, the most recently published short-term revenue estimates at the time of the presentation, which projected State revenues through FY 2026.

- A PFM analysis of historical CREG December revenue estimates compared to actual revenues collected in the subsequent fiscal year shows that the CREG is generally accurate or even conservative in their short-term forecasts.

  - The short-term consensus revenue estimates have since been updated twice, in August 2022 and December 2022, but there has been no corresponding update to the long-term outlook, which may become an annual exercise.

- Then, for the years FY 2027 through FY 2037, PFM applied various growth rates embedded in the “Long-Term Outlook” presentation to the short-term revenue estimates to infer a 15-year baseline, accounting for a CREG analysis of the decline in direct severance revenue as a percentage of General Fund revenues through FY 2050.