F I S C A L   I M P A C T   R E P O R T

ORIGINAL DATE 2/19/15
SPONSOR Ryan **LAST UPDATED** **HB**

SHORT TITLE Permanent Fund to Ec. Development Dept **SB** 544

ANALYST van Moorsel

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY15	**FY16**	**FY17**	**FY18**	**FY19**		
$0.0	$0.0	Negative – see "Fiscal Implications."			Recurring	STPF Earnings
$0.0	$0.0	$0.0	Negative – see "Fiscal Implications"		Recurring	General Fund (STPF Distribution)

Parenthesis ( ) indicate revenue decreases

Relates to SB 533 – Severance Tax Fund in NM Credit Union; HB 66 – Investment in NM Tech Collaborative Companies; HB 179 - Severance Fund Investment in Renewable Energy.

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
Economic Development Department (EDD)

SUMMARY

Synopsis of Bill

Senate Bill 544 amends the Severance Tax Bonding Act to create minimum percentages of the market value of the Severance Tax Permanent Fund that must be:

- invested indirectly or indirectly in New Mexico Businesses, subject to SIC approval; or
- transferred to the Economic Development Department for investment in businesses.

The minimum investment percentage is increased in phases up to seven percent as follows:
- 4 percent in FY15;
- 5 percent in FY16;
- 6 percent in FY17; and
- 7 percent in FY18 and thereafter.

The bill creates a new section of the act that governs EDD investments in qualified businesses. This section:

- Authorizes EDD to make investments in qualified businesses to create new job opportunities and to support new, emerging or expanding businesses if each investment is made:
    - contemporaneously with and on substantially the same terms as one or more qualified investments in the qualified business; and
    - per qualified business, no less than $500 thousand and no more than 50 percent of the aggregate amount of contemporaneous qualified investments in the qualified business.
- Requires EDD to:
    - invest no more than $1 million in any 12-month period in a single qualified business;
    - not evaluate a proposed investment other than to the extent necessary to determine compliance with this section; and
    - transfer proceeds from investments to the state investment officer for deposit in the STPF.

By September 1, 2016 and each subsequent year, EDD must report to the LFC about investments made and proceeds transferred for deposit in the preceding fiscal year, including the total number of investments made, money invested, and earnings. For each investment, EDD must report the name and a description of the business; the amount of the investment; the amount of earnings from the investment; and an analysis of the efficacy of the investment in fostering business growth in the state, financial viability of the business; and earnings projections for the business.

The bill defines qualified business as a business that maintains its principal place of business in New Mexico, engages in high-technology research or manufacturing activities in New Mexico, and limits the types of businesses that may qualify. A qualified business must have 100 or fewer full-time equivalent employees; and may not have had gross revenues in excess of $5 million in any fiscal year ending on or before the date of the investment.

The bill defines "qualified investment as a cash investment in a qualified business for equity, not including an investment by a taxpayer if the taxpayer receives compensation from the qualified business in exchange for services provided to the qualified business within one year of investment in the qualified business.

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends.

FISCAL IMPLICATIONS

As with other permissive differential-rate investments, the investments required in this bill are not targeted solely at delivering returns. The reduced levels of expected financial return from such investments are typically justified by the expected economic development benefits that the investment is expected to deliver.

The negative impact shown in the revenue table reflects the fact that these investments typically perform below-market. As the bill increases the percentage of the market value of the STPF that must be invested in such differential-rate investments increases, the lower returns of such investments place downward pressure on the net return of the entire portfolio. SIC echoes this interpretation in its analysis of the bill, reporting a negative yet indeterminate fiscal impact due to the expected lower than market-rate financial returns the council has seen historically from this strategy. SIC adds that transfers of funds for investment by EDD present more downside risk to STPF investment returns as these investments pose more significant risk for investment write-offs. Further, in order to maintain its 7.5 percent long-term return target, the council may need to consider ore risky investments with a higher expected return to offset the lower returns of investments proposed in this bill.

SIC notes that the fiscal impact to STPF returns will likely not be seen until FY17, when the minimum investment level exceeds the 5 percent long-term allocation target level the SIC currently invests in differential-rate investments. The SIC analysis adds that it considers a 5 percent level of such investments the limit to what it can invest prudently while maintaining target returns.

SIC approximates the opportunity cost of such differential-rate investments by applying the portfolio's long-term target return of 7.5 percent to the marginal investment (in excess of the current 5 percent) it would have to make pursuant to the provisions of the bill. Increasing these investments by 1 percent in FY17 would, based on the current STPF market value, require an additional $47 million investment. The 2 percent investment in FY18 would require a $94 million investment with lower expected returns. Assuming 7.5 percent returns, the FY18 opportunity cost can be approximated at $7 million. Lower investment returns place additional downward pressure on the corpus of the STPF, which has not seen the growth of the larger Land Grant Permanent Fund because it does not enjoy consistently large contributions.

Finally, a lower STPF corpus would result in reduced general fund revenues, as 4.7 percent of the five-year average of the year-ending STPF market values is distributed to the general fund each year.

The economic impact of the legislation is difficult to determine. However, SIC provides anecdotes of previous "direct investments" made by SIC in three New Mexico companies in 2003-2004 that were sourced and completed in part through "Invest New Mexico," an economically-focused investment partnership between SIC and EDD. According to SIC, these investments in Eclipse Aviation, Earthstone International, and TCI Medical, resulted in STPF equity losses of more than $36 million, while only Eclipse created a significant number of jobs and economic development benefits to the state.

SIGNIFICANT ISSUES

Both the SIC and EDD analyses of the legislation identify issues with the provisions that allow EDD to make investments of STPF funds:

- Both EDD and SIC emphasize EDD does not make investments. EDD notes it does not have the staff expertise to make the sort of investments the bill contemplates, adding that any staff the department were to hire would not have the expertise, experience, and institutional knowledge of SIC's investment staff. EDD supports companies through incentives, resources, and job training, but its the lack of specific investment experience could place returns at risk.

- Both agencies express concerns about the provision of the bill requiring EDD not to evaluate a proposed investment other than to the extent necessary to determine compliance the section outlining basic qualifications. The agencies are concerned about whether necessary investment decisions consider the potential for returns, quality of company management, competitive market analysis, and other important investment-related analysis. SIC worries without this analysis the investment process will not be driven by sound investment criteria.

  To this point, SIC questions whether, as fiduciaries, the "SIC and members of the Council can responsibly waive their duty and loyalty to the funds under the Uniform Prudent Investment Act, placing it with others, while knowing in advance that those others are not bound by the same responsibilities, and who in fact are statutorily instructed to ignore any type of financial assessment about the overall viability of the investments they approve."

- Finally, both agencies are concerned the qualifying criteria in the bill may limit the pool of potential companies that could receive an investment. EDD investments would be limited to manufacturing or high-technology research companies with fewer than 100 employees and less than $5 million in gross revenues. Further, the bill provides for many exceptions, and it is unclear whether the investment floor can be reached given potentially limited qualifying investments.

OTHER SUBSTANTIVE ISSUES

The SIC analysis iterates its concern that it finds five percent of the STPF to be the limit of what it can prudently invest in this type of investment. SIC emphasizes that only ideas with commercial application, a sound business plan, and the ability to implement that plan ultimately succeed. SIC discusses the strategy of Sun Mountain Capital, SIC's professional consultant and fiduciary, is crucial to ensuring that the council fund only the best and most likely to succeed ideas. Even so, SIC admits, many companies fail. SIC points out Sun Mountain Capital has not indicated it currently requires a larger allocation of permanent fund balance to prudently invest. SIC adds that a process is currently in place to for Sun Mountain to recommend to the SIC to invest more, as is currently permitted in law. SIC reviews the pacing study concerning this investment strategy each year.

ALTERNATIVES

The SIC analysis provides one alternative that it reports could improve access to venture capital in New Mexico. According to SIC:

> One of the more challenging aspects of current statute governing NMPEIP investments is the restrictive statutory requirement that regional venture funds which receive a commitment from the SIC must have a NM office and at least one professional on the ground full time. Many top venture funds have been reluctant to make that financial & personnel commitment, despite having interest in making investments in NM, and having a person here part-time (when their main offices are in Phoenix, Salt Lake City, Austin, etc). Loosening that restriction would likely result in better quality venture managers focusing resources here, who in turn would source additional deals and improve the entrepreneurial IQ and diversification of the state.

These managers, as they do today, would be required to invest or cause to be invested in NM companies an amount equal or greater than the SIC's commitment to their fund ($10M SIC commitment requires $10M in NM company investments).

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

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