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

ORIGINAL DATE 2/15/17
SPONSOR Sapien **LAST UPDATED** **HB**

SHORT TITLE Severance Tax Money for Early Childhood, CA **SJR** 18

ANALYST Iglesias/Klundt

REVENUE (dollars in thousands)

Appropriation					R or NR **	Fund Affected
FY18	FY19	FY20	FY21	FY22		
$0.0	$0.0	($37,701.0)	($38,022.1)	($38,389.2)	Recurring	Severance Tax Permanent Fund
$0.0	$0.0	$37,701	$38,022.1	$38,389.2	Recurring	General Fund (Early Childhood Education and Care)

Parenthesis ( ) indicate expenditure decreases. ** R = recurring; NR = non-recurring

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY17	FY18	FY19	3 Year Total Cost	R or NR **	Fund Affected
Total	$0.0	$50.0 - $100.0	$0.0	$50.0 - $100.0	Nonrecurring	Election Fund

Parenthesis ( ) indicate expenditure decreases. ** R = recurring; NR = non-recurring

Relates to HJR1, HJR2, SJR3, SJR14

SOURCES OF INFORMATION
LFC Files

Responses Received From
Office of the Attorney General (OAG)
State Land Office (SLO)
Department of Health (DOH)
State Investment Council (SIC)
Children, Youth and Families Department (CYFD)

SUMMARY

Synopsis of Bill

Senate Joint Resolution 18 is a proposed amendment to the New Mexico Constitution allowing for a portion of the severance tax funds to be put toward early childhood care and education programs. The resolution allows for an additional distribution of eight-tenths percent of the average of the year-end market values of the severance tax permanent fund (STPF) for the immediately preceding five calendar years to be made to the general fund dedicated to early childhood education and care programs as provided by law.

The resolution seeks approval of this constitutional amendment by the voters of New Mexico at the next general election or in a special election called for this purpose.

FISCAL IMPLICATIONS

The following table captures projected STPF values and distributions for a dozen years, at both the current 4.7 percent rate and this resolution's 5.5 percent rate. It assumes net investment returns of 6.45 percent (6.75 percent gross), and inflows to the STPF of $35 million per year, which is the average inflow over the past 15-years. During that time, the contributions from the severance tax bonding fund to the severance tax permanent fund have been incredibly volatile, ranging from annual contributions of under one hundred dollars ($100), to more than $125 million depending on the year. STPF inflows are determined by both the severance taxes collected from oil and gas, and the statutory formula that allocates the percentage of those taxes for bonding capacity. What is not used for bond debt maintenance and new bond issuance capacity then flows into the permanent fund.

Calendar Year	Corresponding Fiscal Year	($B) STPF Value Current (4.7%)	STPF Distribution @4.7%	($B) STPF Value w/SJR18 (5.5%)	STPF Distribution @5.5%	Rolling Difference in STPF Distribution	Difference in STPF Value ($B)
2017	**2019**	4.766515125	$217,404,414	4.766515125	$217,404,414		
2018	**2020**	4.895064321	$221,493,637	4.895064321	$259,194,682	$37,701,045	
2019	**2021**	5.026346944	$224,598,014	5.007496422	$262,620,107	$75,723,138	($0.018850522)
2020	**2022**	5.162500497	$230,498,283	5.104572547	$268,887,470	$114,112,325	($0.057927950)
2021	**2023**	5.30293363	$236,441,589	5.203063687	$274,743,833	$152,414,569	($0.099869943)
2022	**2024**	5.446502913	$242,833,474	5.301845643	$280,632,469	$190,213,564	($0.144657270)
2023	**2025**	5.59316482	$249,395,619	5.401126536	$286,199,153	$227,017,098	($0.192038284)
2024	**2026**	5.742809404	$256,130,366	5.501083387	$291,628,610	$262,515,342	($0.241726017)
2025	**2027**	5.895457618	$263,020,163	5.601989384	$297,100,195	$296,595,374	($0.293468234)
2026	**2028**	6.05113937	$270,053,297	5.703953296	$302,609,981	$329,152,058	($0.347186074)
2027	**2029**	6.20990113	$277,229,240	5.807003196	$308,166,714	$360,089,532	($0.402897934)
2028	**2030**	6.371798484	$284,548,396	5.911166555	$313,777,154	$389,318,290	($0.460631929)
2029	**2031**	6.536890668	$292,012,760	6.016464864	$319,446,350	$416,751,880	($0.520425804)
2030	**2032**	6.705239538	$299,624,710	6.122915096	$325,176,533		($0.582324442)

According to SIC, under this resolution, the STPF would deliver an additional $416 million, or just under an additional $35 million per year to the general fund under SJR18. As a result, the STPF would have a projected $582 million less in its corpus at the end of a dozen years, than had no additional distribution occurred. The difference – or "opportunity cost" is a recurring expense, which grows at an accelerated rate with each passing year, due to diminished earnings and lack of compound interest due to the money being spent instead of reinvested. That opportunity cost over the first dozen years would be approximately $166 million in total, though that number will grow with every subsequent year. Under this resolution, the STPF's diminished value of $582 million will result in lower earnings and compound interest on an annual basis. The annual earnings on $582 million at 6.45 percent (net) is $10.7 million. While the STPF appears to grow under either distribution rate, the benefits provided by the smaller fund are short-term, with the long-term result being diminished benefits for STPF beneficiaries, namely New Mexico taxpayers.

The projection does not account for possible inflation, future growth of the state population, unexpected market events or the potential for less-than-expected investment earnings. Given the high variability of these factors, and the amplifying effects those variables bring, SJR18 unavoidably increases the risk to the STPF's long-term viability, diminishes its current earning ability, and will absolutely result in much lower benefits long-term, should the 5.5% rate be left in place on a permanent basis.

Election Costs. Section 1-16-13 NMSA 1978 requires the Secretary of State (SOS) to print the full text of each proposed constitutional amendment, in both Spanish and English, in an amount equal to 10 percent of the registered voters in the state. The SOS is also constitutionally required to publish the full text of each proposed constitutional amendment once a week for four weeks preceding the election in newspapers in every county in the state. LFC staff estimate each constitutional amendment may cost from $50 thousand to $100 thousand in printing and advertising costs based on 2016 actual expenditures.

SIGNIFICANT ISSUES

According to the Office of the Attorney General (OAG):

> *"Although it is understood that this resolution and potential amendment will be put to a public vote, this bill has the potential to run afoul of the Anti-Donation Clause due to the vague authorization of putting the funds towards "childhood education programs." The wording, on its face, does not authorize impermissible donations. However, legislators must take care to ensure that the funds are only being appropriated to public entities to avoid potential violations the Anti-Donation Clause."* [1]

However, a significant portion of early care and education services are currently provided by contracting with private providers through the Children, Youth and Families Department (CYFD), Department of Health (DOH), the Public Education Department (PED). If this constitutional amendment were passed by the voters then the Legislature could appropriate subsequent funding to state agencies to these expand early childhood programs.

In New Mexico, early childhood programs currently serve children and families prenatally through third grade at a cost of nearly $250 million annually across the Children, Youth and Families, Public Education, and Health departments. These programs, focused on safety, physical care, behavioral health, developmental screening, parental support, and early education, have proven to significantly reduce more expensive and typically less effective remediation later in life. From this significant investment, the state is beginning to realize returns, including increased reading and math competency for low-income children, reduced special education designations, and more consistent utilization of early well-child visits which should improve long-term outcomes for children.

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[1] See, Hutcheson v. Atherton, 99 P.2d 462, 471 (1940) (prohibiting funds to be directed towards private entities, even those that have been deemed "good causes."). See also, State v. Hannah, 63 N.M. 110, 118-119; 314 P.2d 714, 720 (1957) ("When a legislative grant is permissible due to the public nature of the action, it must nonetheless contain sufficient provisions to keep a distribution for a public purpose from ending in a donation to a private individual or corporation.")

LFC and other studies have early care and education services to increase school completion rates producing benefits of $278 thousand for the graduate and $100 thousand for taxpayers and other beneficiaries, compared with a non-graduate.

Despite significant, targeted investments by the Legislature in the state's early childhood programs, New Mexico remains behind most other states in many indicators of child well-being. LFC's Gap Analysis and Spending Plan report (January 2015) examined home-visiting, prekindergarten, child care, and K-3 Plus for gaps in services, barriers to program expansion, and potential funding options.

While home-visiting has achieved successes in some high-risk New Mexico communities, developing community relationships and infrastructure continues to be a barrier to expansion. The majority of at-risk clients remain unserved, and the state lacks sufficient information about whether the program is reaching the targeted population.

LFC estimates remaining statewide funding needs for all early childhood services is close to $190 million. To close service gaps and continue improving early childhood outcomes, targeted interventions are needed, such as focusing state-funded home-visiting services to at-risk, low-income families in high-need communities. Additional funding is needed to grow at a rate to both serve more clients and improve quality.

CYFD points out the importance of funding early childhood education and care services from a consistent revenue source, as an inconsistent revenue stream could adversely impact families and their children, causing disenrollment of families and children from the programs. While distributions from STPF are based on a five-year average, CYFD shows concern over potential fluctuation in the proposed revenue stream.

PERFORMANCE IMPLICATIONS

Below is investment performance data for the STPF, as of 12/31/16:

	1 year	3 years	5 years	10 years	15 years	20 years
Severance Tax Permanent Fund Returns - % net of fees	7.36	4.72	8.49	4.32	5.36	6.32

While the one and five year return metrics surpass the SIC's targeted rate of return for the STPF (6.75 percent), the Council anticipates the next decade may be one of both volatility and depressed investment returns. Longer-term returns, which include one or both of the major global investment crises experienced this century, are still struggling to achieve SIC's long-term target of 6.75 percent. Like many institutional investors, SIC has reduced its return expectations in the past few years, and have emphasized our expectation of potentially muted returns, given that current stock and bond valuations are extremely high on a historic basis.

While this resolution will not directly impact investment performance, it could potentially mean SIC must make strategic decisions about whether to try and take additional investment risk to achieve the additional returns needed to fund distributions at 5.5 percent.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Related to HJR 1 Permanent Funds for Early Childhood, CA; SJR 3 Permanent Funds for Early Childhood, CA; SB 106 Early Childhood Services Department; SB 182 Early Childhood Land Grant Act; and SB 289 Early Childhood Education Department Act.

TECHNICAL ISSUES

For this analysis the SIC assumes additional distributions would not occur until after the next regularly scheduled statewide election, the general election in 2018. Technically, distributions could begin in the middle of FY19, though the overall impact to the STPF would be minimal. The resolution does not contemplate this timing issue, or whether a full or half-year allocation would be distributed assuming approval by the voters. This question has come up previously in regards to related legislation, and also in the 2003 constitutional amendment which impacted the Land Grant Permanent Fund. In that case it appears additional distributions were begun at some point after election results were finalized, though how the ultimate distribution number was calculated is not clear to current SIC or LFC staff.

This bill does not contain a sunset date. LFC recommends adding a sunset date.

OTHER SUBSTANTIVE ISSUES

The STPF currently distributes 4.7 percent of its 5-year average value, as determined by that average amount on the last day of each calendar year. After reaching new fund highs near the end of 2007, the global financial crisis in 2008/2009 affected the STPF dramatically, causing the fund to lose more than a quarter of its value. While the broader financial markets and the STPF's counterpart, the land grant permanent fund (LGPF) essentially recovered from the downturn over the following three years, the STPF's climb back up to 2007 values took much longer, despite the permanent funds having nearly the same investments and the STPF achieving only slightly lower returns than the LGPF, and the LGPF having a considerably higher distribution rate (5.8 percent and 5.5 percent) during this time. The STPF closed calendar year 2016 valued at $4.671 billion, just slightly higher than it closed in 2007, at $4.625 billion.

Both SIC and its independent fiduciary advisor RVK have previously noted the less than healthy outlook of the STPF long-term. Based on Monte Carlo simulations and analysis by RVK, the STPF is projected to have only a 26 percent chance to provide equal or greater benefits to New Mexicans 50 years from now. This would compare to the LGPF, which enjoys a slightly better than 50/50 expectation in this regard.

The STPF has seen major challenges over the past two decades. Before the 90s, the STPF was able to grow, due to both strong investment returns and significant inflows delivered annually from the Severance Tax Bonding Fund, with approximately 50 percent of the state's severance taxes being used for bonding, and the other half being saved for the STPF.

Starting in the late 90's however, the percentages the state saved to the STPF changed due to multiple legislative actions, ultimately resulting in a baseline of only 5 percent of the state's severance taxes being saved to the STPF, with 95 percent being spent on bonding for capital projects.

Concerns over the dramatic restructuring of these funding streams and the associated impact on the long-term viability of the STPF led lawmakers to take action in 2015, passing HB236, which adjusted the spend/save percentage of severance tax revenues from the 95/5 ratio, to a gradual implementation of a new formula that targets saving almost 14 percent (86.2 percent/13.8 percent) of the state's severance tax collections to the STPF by fiscal year 2022.

While there is an expectation that this change will help put the STPF on stronger footing long-term, its full implementation is still more than 5 years away, and the bulk of HB236's impact will not be seen until that time. Further, a critical assessment of the practical impact of these previous legislative changes cannot be developed so early in the implementation process. In short, it is simply not clear at this time whether the efforts of previous legislation will "fix" the STPF to ensure intergenerational equity.

Given the incremental nature of HB236's adjustments over 7 years, combined with state budgetary challenges which have already led to non-standard solutions that impact inflows to the permanent fund (STPF is expected to receive $0 inflows in FY17), SIC states, "the impact of [this resolution] could very easily override any of the measures taken previously to stabilize the STPF and its long-term outlook."

The New Mexico Department of Health (DOH) states this resolution does not define which programs would be included in "early childhood education and care programs as provided by law." Since the resolution does not cite the law or laws that pertain to early childhood education and care, it is not possible to determine if the additional funding from the STPF could be used to fund DOH's early childhood Family Infant Toddler (FIT) Program.

The FIT Program is responsible for the administration of a statewide system of early intervention services in accordance with the Individuals with Disabilities Education Act (IDEA) Part C. The FIT program services children birth to age three with and at risk for developmental delays and disabilities and in FY16 served over 14,000 infants, toddlers and their families. The budget for the FIT Program is approximately $51.3 million, which includes State General Funds of $19.4 million, federal IDEA Part C grant of $1.8 million, private insurance of $1.6 million and federal Medicaid of $28.5 (FY16 expenditures).

The FIT Program is part of New Mexico's early learning system that serves children prenatally through Kindergarten entry and includes: home visiting; Child Care; PreKindergarten; Head Start Collaboration office; infant and early childhood mental health; Preschool Special Education (IDEA Section 619) and the FIT Program (IDEA Part C).[2]

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[2] http://www.earlylearningnm.org/programs