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

SPONSOR Trujillo, J **ORIGINAL DATE** 01/23/14 **LAST UPDATED** **HB** 78

SHORT TITLE Transfer Funds To Tobacco Settlement Fund **SB**

ANALYST Geisler/Van Morsel

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY14	**FY15**	**FY16**		
$100,000.0			Nonrecurring	Tobacco Settlement Permanent Fund
($100,000.0)			Nonrecurring	General Fund Operating Reserve

(Parenthesis ( ) Indicate Revenue Decreases)

SOURCES OF INFORMATION
LFC Files

Responses Received From

State Investment Council (SIC)
Department of Health (DOH)

SUMMARY

Synopsis of Bill

House Bill 78 would transfer $100 million from the general fund operating reserve to the tobacco settlement permanent fund on the effective date of the act.

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

State Investment Council (SIC) notes it would invest the $100 million along with current assets in the Tobacco Settlement Permanent Fund (TSPF), which is allocated with an investment strategy bias toward liquidity. This is primarily due to the TSPF's status as a state reserve fund, and the legislature's ability to expend and appropriate this reserve fund if the need arises.

The $100 million transfer would reduce the operating reserve and would increase the tobacco settlement permanent fund by $100 million, respectively. Because both accounts are components of general fund reserves, there is no net change to the reserve balance, projected to be $559.5 million (9.5 percent of recurring appropriations) at the end of FY14. However, funds in the tobacco settlement permanent fund are not as liquid as funds in the general fund operating reserve and legislative action would be required to transfer the funds out of the tobacco settlement permanent fund back into the general fund operating reserve.

According to Section 6-4-9, NMSA 1978, the tobacco settlement permanent fund shall be considered a reserve fund of the state and, as a reserve fund, may be expended in the event that general fund balances, including all authorized revenues and transfers to the general fund and balances in the general fund operating reserve, the appropriation contingency fund and the tax stabilization reserve, will not meet the level of appropriations authorized from the general fund for a fiscal year. In that event, in order to avoid an unconstitutional deficit, the legislature may authorize a transfer from the tobacco settlement permanent fund to the general fund but only in an amount necessary to meet general fund appropriations.

SIGNIFICANT ISSUES

According to the bill, the purpose of the transfer is to restore funds diverted from the tobacco settlement permanent fund to meet prior-year state fiscal solvency requirements. The current balance in the permanent fund is approximately $169 million.

SIC notes the current investment return target for this fund is approximately 6.25 percent per year, slightly below fund targets for the Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF), which seek risk adjusted returns of 7.5 percent. The main reason the larger permanent funds can achieve higher long-term investment returns is due to the illiquidity premium they take on, namely through private market investments in real estate, private equity and similar long-term investment-horizon assets which trade low liquidity and longer lock-up periods in exchange for higher returns. The long-term investment target for the TSPF is higher than the returns realized by the earnings on investment of operating reserve balances by the State Treasurer, whose investments follow three fundamental principles: safety, liquidity, and yield, prioritized in that order.

SIC actually did a TSPF asset allocation study in 2013, which recommended shifting to an allocation similar to the LGPF, and vetted this strategic shift with the Tobacco Settlement Revenue Committee during interim hearings. The Committee agreed with the Council's assessment that shifting investment strategy to include less-liquid assets was a prudent step, as concerns the TSPF would have to be deployed to solve state fiscal problems grew less likely since the fiscal crisis.

However, prior to the Council deploying this strategy, the state received an adverse ruling by the arbitrators examining New Mexico's 2003 enforcement of the tobacco master settlement agreement. As a result, it is likely that the 2014 distribution projected at approximately $40 million will be reduced from $12 million to $24 million. In response, the Legislative Finance Committee has proposed using funds from the TSPF to partially offset potential shortfalls in tobacco appropriations in 2014. Because additional arbitration hearings are possible, it appears that New Mexico is moving into a period of uncertainty over future tobacco settlement distributions. As a result the SCI shelved its plans to re-allocate TSPF assets towards a more aggressive long-term growth strategy.

Department of Health (DOH) notes that allowing for additional growth of the TSPF would sustain tobacco use prevention and control, and other health programs for future years. Some states have significantly improved the health of their citizens by reducing smoking rates, thereby decreasing smoking-related diseases, deaths, and health care costs. Even in economically challenging times, states can make a significant difference in public health by employing high-impact, cost-effective tobacco control and prevention strategies.

PERFORMANCE IMPLICATIONS

There would be no immediate change in investment performance due to $100M contribution to the TSPF. The Council would likely require additional assurances of the fund's "permanent" status before it could take formal action which might improve the targeted investment return.

A larger corpus – barring some future appropriation against it – would greatly accelerate the anticipated date on which this fund could achieve self-sustainability while also providing an annual benefit equal to what the state receives today (as originally envisioned by the legislature). Current estimates given zero inflows and sub-optimal investment returns due a strategy dependent on high liquidity, SIC estimates that would not happen for 25-30 years. A $100 million one-time infusion would shorten that estimate by approximately a decade.

OTHER SUBSTANTIVE ISSUES

SIC notes that when created, the TSPF was envisioned as a permanent endowment fund that, once reaching a reasonable size, would mimic the construction of the STPF and LGPF by providing an annual percentage of its corpus for distribution to appropriate beneficiaries, acting as a perpetual state endowment. Based on historic average annual distributions of the TSPF ($40M), the TSPF would have to reach $850M to distribute 4.7 percent of the fund per year for an annual distribution comparable to that historic average.

Current language governing the TSPF calls for a 50/50 split of new revenue received from the Tobacco Master Settlement, between tobacco-related legislative programs and the TSPF. Since inception in 2000, the TSPF has only received a 50 percent contribution on three occasions. In comparison, the legislature has "swept" 100 percent of new tobacco settlement funding to general fund needs for 8 other fiscal years (the remaining years took other inconsistent percentages).

According to SIC records, since the fund was originally created with a $49M contribution in 2000, $539M in tobacco settlement revenue has flowed to New Mexico. Only $56M of that more than half billion has gone to the TSPF, with the vast majority being legislatively allocated for anti-tobacco programs and other general fund needs (lottery scholarships, early childhood education). HB 78 seeks to partially replenish the TSPF corpus which has previously been diverted.

CC/jl:ds