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

**ORIGINAL DATE** 03/04/11
**SPONSOR** Stewart **LAST UPDATED** ______ **HB** 586

**SHORT TITLE** Premium Tax Offset Act **SB** ______

**ANALYST** Graeser and Kleats

## REVENUE (dollars in thousands)

| Estimated Revenue | | | Recurring or Non-Rec | Fund Affected |
|---|---|---|---|---|
| FY11 | FY12 | FY13 | | |
| | $335,000.0 | $0.0 | Nonrecurring | Educational Retirement Fund |
| | ($400,000.0) | $40,000.0 | Recurring until FY22 | General Fund |

(Parenthesis ( ) Indicate Revenue Decreases)

See text as to the proper classification of the financial flows. The table exhibited here records the accrued general fund liability in the year of issue. LFC believes this is the appropriate and correct interpretation of this proposal.

## ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

| | FY11 | FY12 | FY13 | 3 Year Total Cost | Recurring or Non-Rec | Fund Affected |
|---|---|---|---|---|---|---|
| **Total** | | $6.50 | | $6.50 | Nonrecurring | DFA Operating Budget for BOF |

(Parenthesis ( ) Indicate Expenditure Decreases)

## SOURCES OF INFORMATION
LFC Files

Responses Received From
Attorney General's Office (AGO)
Department of Finance and Administration/Board of Finance (DFA/BOF)
Educational Retirement Board (ERB)
General Services Department (GSD)
State Treasurer's Office (STO)

Responses Not Received From
Public Regulation Commission
Taxation and Revenue Department

## SUMMARY

Synopsis of Bill

House Bill 586 (HB 586) creates the Premium Tax Offset Act. The Act authorizes the Board of Finance to sell insurance premium tax offset certificates ("certificates") to investors who can use them as an offset on their future insurance premium taxes and health insurance surtaxes. The proceeds from the sale of these certificates will be deposited into the Educational Retirement Fund to help reduce that fund's unfunded liability.

HB 586 authorizes Board of Finance to determine if the sale of certificates is in the best interest of the state and the members of the Educational Retirement plan. Essentially, the board must determine if reducing the unfunded liability of the ERF is of sufficient benefit to the state as a whole to overcome the detriment of the loss of $400 million in appropriable general funds over a ten-year period. If the board determines certificates should be issued, the Board of Finance will determine the amount not to exceed $400 million. Board of Finance would be authorized to hire a manager for a fee not to exceed 1.5% of the full offset amount, equaling $6 million or less for $400 million in offsets.

HB 586 allows for offset certificates having a maturity date of ten years from the date the certificate is eligible to be utilized. The offset against insurance premium taxes would equal ten percent of the face value of the certificate in each year for ten consecutive years. The investor will be able to apply insurance premium tax offsets each year or use them to reduce the investor's estimated quarterly insurance premium tax payments. Should the value of the offset exceed total insurance premium tax liability in any year, the investor could carry forward the remainder of the offset indefinitely until the investor had sufficient tax liability to offset.

HB 586 also allows investors to transfer the offset received from the certificate to another investor. Investors must submit notice of this transaction to the Superintendent of Insurance within 30 days, and the transferred offset will only apply to insurance premium taxes and health insurance surtaxes.

HB 586 includes a pledge by the state ensuring the irrevocability and legally binding nature of the premium tax offset certificates. Pursuant to this pledge, the state promises not to repeal or amend any law authorizing premium tax offsets or the transfer of such offsets in a manner jeopardizing the offsets or their transferability without the consent of the investors owning the offsets.

HB 586 amends Section 59A-6-2 NMSA 1978 allowing for the reduction in premium taxes owed by the holder of an insurance premium tax offset certificate further solidifying the cash-equivalence of the offset.

HB 586 amends Section 59A-6-5 NMSA 1978 to add a new subsection providing the distribution of premium taxes to the law enforcement protection fund and the fire protection fund shall not be reduced by any offsets taken by certificate holders, but shall be based upon the total value of premium taxes as if the offsets were paid in cash. As a result, all offsets would come out of the general fund.

## FISCAL IMPLICATIONS

The most straightforward means of understanding this proposal is through accounting analysis (T-table). The result of this proposal is linked trial balances (in millions):

| | End of first year (FY12) | | | |
|---|---|---|---|---|
| | G.F. | | Ed. Retirement Fund | |
| | Debit | Credit | Debit | Credit |
| Assets | | | | |
| Treasurer's Balances | 335 | | 335 | |
| | -335 | | -335 | |
| Long-term investments | | | 335 | |
| Liabilities | | | | |
| Long-term liability | | 400 | | |
| Fund Balance | | -400 | | 335 |
| | | | | |
| Revenue | | | | |
| Insurance premiums tax credits | | | | |
| Close books | | | | |
| Expenses | | | | |
| Appropriations account | 335 | | | |
| Time-value-of-money and risk premium | 59 | | | |
| Manager's commission | 6 | | | |
| Close books | -400 | | | |

Note that the fund balance after closing the books at the end of the first year would be -$400 million. This is composed of the long term liability of $400 million balanced by a negative general fund balance composed of distributions and transfers as follows:

| | |
|---|---|
| $59 | million (over ten years, but recorded in the first year) as time-value-of-money and risk premium to be paid over ten years to the investors. |
| $6 | million paid to the manager at the time of the credit sale |
| $335 | million transferred to the Educational Retirement Fund. |

The negative fund balance in the general fund at the end of the first year must be recorded in the total general fund balances after closing of the books. Thus, rather than $270 million in general fund balances (approximately 5% of the $5.4 billion general fund appropriations), recorded the long-term liabilities of $400 million as created by this bill as a subtraction would bring the general fund balances from a prudent 5% to -$130 million or -2.4% of current year appropriations. This would violate other constitutional provisions.

When presented in this form, it is clear that arguments concerning whether this proposal constitutes unconstitutional debt (which, in the opinion of Bond Counsel, it does), the real issue is how much of the long-term liability must be realized in FY12. The answer per the analysis above is the full $400 million of the deferred tax credits.

HB 586 carries no direct appropriation language. This fiscal analysis considers the net proceeds of the sale of tax offset certificates as revenue to the Educational Retirement Fund and future offsets as revenue to the general fund in the year of application. From an accounting perspective, the tax credits would reduce the posted long-term general fund liability. The transaction would be posted as a long-term liability of the general fund, in similar fashion to the way that Severance Tax Bonds are recorded as a long-term liabilities of the Severance Tax Bonding Fund. However, this assumption may not conform to GAAP and provisions of the New Mexico Constitution. Research continues on this point.

This analysis assumes an investor's returns on premium tax offsets must be at least as good as a comparable financial instrument for an open sale to be effective. Board of Finance would have to accept a price for the offset resulting in returns at least equal to an average ten year tax-free municipal bond. The estimated price for a face value of $400 million in offsets would be approximately $341 million. Subtracting the manager fee from this yields a final amount of $335 million deposited into the Educational Retirement Fund.

The offset against premium taxes would equal ten percent of the face value of the certificate in each year for ten consecutive years. HB 586 limits face value to $400 million implying $40 million of offsets from FY13 to FY22. The offset tax revenue would otherwise go to the general fund.

The LFC has concerns when earmarking reduces the ability of the legislature to establish spending priorities. This is a somewhat extreme example of earmarking. Even if the ERF were to become 100 percent solvent due to this proposal, a future legislature would be unable to cancel the $40 million annual loss of general revenue. This revenue might be better spent on other needs, but the legislature would not be able to redirect funding.

## SIGNIFICANT LEGAL ISSUES

There are a number of separate, but linked, legal and accounting issues that this proposal raises:

1. Are the $335 net revenues to the ERF "borrowing" in the constitutional sense? Therefore, does this proposal create general fund debt – prohibited by Article IX, Section 7 of the New Mexico Constitution?
2. If this is constitutional borrowing pursuant to Article IX, Section 7, may the proceeds be used to bolster the corpus of the ERF rather than being expended on a capital asset pursuant to a vote of the people as required in Article IX, Section 8?
3. The constitutionally required "tax" to fund the repayment of the amounts borrowed and interest is the insurance premiums tax which is a general fund revenue source. However, the "deposit" of the proceeds from the sale of the tax credits is to the ERF while the "repayment" of the borrowing comes from the general fund. Does this mismatch create a constitutionally prohibited out-of-balance appropriations act?

On the first question – does this proposal create unconstitutional debt -- the state's bond counsel believes that yes, this proposal does create debt and that debt is prohibited "…the fact an investor gets repaid by not paying taxes is not conceptually different than the state paying the investor out of the general fund. Consequently, HB 586 would create an unconstitutional debt in violation of Article IX, Section 7 of the NM Constitution."

Article IX, Section 7 of the New Mexico Constitution provides as follows:

Article IX, Sec. 7. [State indebtedness; purposes.]
The state may borrow money not exceeding the sum of two hundred thousand dollars [($200,000)] in the aggregate to meet casual deficits or failure in revenue, or for necessary expenses. The state may also contract debts to suppress insurrection and to provide for the public defense.

The proposal may run afoul of article IX, Section 8, since the debt would not be authorized by the electorate and the proceeds would not be used to create a capital asset.

Sec. 8. [State indebtedness; restrictions.]
Statute text
A. No debt other than those specified in the preceding section shall be contracted by or on behalf of this state, unless authorized by law for some specified work or object; which law shall provide for an annual tax levy sufficient to pay the interest and to provide a sinking fund to pay the principal of such debt within fifty years from the time of the contracting thereof. No such law shall take effect until it shall have been submitted to the qualified electors of the state and have received a majority of all the votes cast thereon at a general election; such law shall be published in full in at least one newspaper in each county of the state, if one be published therein, once each week, for four successive weeks next preceding such election. No debt shall be so created if the total indebtedness of the state, exclusive of the debts of the territory, and the several counties thereof, assumed by the state, would thereby be made to exceed one percent of the assessed valuation of all the property subject to taxation in the state as shown by the preceding general assessment.

- According to Bond Counsel, the fact an investor gets repaid by not paying taxes is not conceptually different than the state paying the investor out of the general fund. Consequently, HB 586 would create an unconstitutional debt in violation of Article IX, Sections 7 of the NM Constitution.

- HB 586 requires Board of Finance to determine whether issuance and sale of insurance premium tax certificates is in the best interest of the state and ERA members. Statute already requires the Board of Finance consider only the best interest of the state. The Board of Finance would have to reconcile how a $400 million loss of general fund revenue could be in the state's best interest in order for the sale to proceed.

- The AGO questions whether HB 586 provides the appropriate mechanism for transferring proceeds over to the Educational Retirement Board. The concerns center on whether the revenue must first go to the general fund and be specifically appropriated to the Educational Retirement Fund.

**SIGNIFICANT ISSUES**

As the organization proposed to administer the program, the Board of Finance has a large stake in this bill. BOF has provided an insightful description of HB 586 and the issues surrounding it. An excerpt of this analysis has been included below:

> This bill proposes a partial solution to the underfunding of the State's educational retirement fund. Within 30 days of the bill's effective date, which would be June 17,

2011, the Board of Finance would make a determination whether issuance of premium tax offset certificates ("credits") is in the best interest of the State. If such a determination is made, the Board of Finance would determine an amount up to $400 million to be sold, issue a request for proposals (RFP) to hire a manager to represent the state in marketing, negotiating and selling the credits, oversee the manager, and authorize the manager to proceed with sale of the credits.

This bill, in effect, gives the Educational Retirement Fund a one-time injection of up to $335 million at the cost of up to $40 million in General Fund revenue each year for ten years ($400 million total). That means the transaction costs the state an estimated $65 million. The way the transaction is structured, the State pays a large fee to the hired manager of the transaction and pays the insurance companies who buy the tax credits for the opportunity to secure their cash for the Educational Retirement Fund upfront. The Board of Finance sees no compelling reason why the State should pay an estimated $65 million to the manager and the insurance companies. Instead, the State could ensure that a full $400 million goes to the Educational Retirement Fund by simply appropriating $40 million per year to the Educational Retirement Fund over 10 years.

Section 5 of the bill sets forth requirements that a potential manager of the transaction must meet, which include experience working on insurance premium tax credit sale obligations, experience in the last calendar year in underwriting New Mexico securities, and experience in the last calendar year managing at least 300 financings nationwide. These minimum requirements may be so stringent that only one or possibly two firms would qualify to manage the transaction. The transaction has been proposed to the State by Wells Fargo/Proteus Capital Holdings, and it is inferred that those firms hope to act as manager for the State.

HB 586 provides a mechanism for satisfying part of the unfunded liability of the state educational retirement system, but the proposed mechanism may not be appropriate depending on the cause of this liability. If the unfunded liability has been caused by an underlying structural flaw in the funding streams, the lump sum payment from the sale of tax offsets may not sufficiently solve the problems faced by the Educational Retirement Board; increased contribution rates may be more appropriate in that instance. A lump sum injection would be more appropriate if bad investments caused the unfunded liability even though the funding streams had been structurally sound beforehand.

The legislature has actively increased and redistributed employer and employee contribution rates since 2005. Currently, members with annual salaries exceeding $20,000 contribute at a rate of 9.4 percent with an employer contribution of 10.9 percent, and those members with annual salaries of $20,000 or less contribute at a rate of 7.9 percent with an employer contribution of 12.4 percent. As a result of legislation, in FY 2012, the employer contribution rate for all members employed, regardless of salary, will increase to 13.15 percent and rise again to 13.9 percent beginning in FY 2013.

The market value of Educational Retirement Fund as of September 30, 2010 was $8.8 billion, up from a low of $5.97 billion in February 2009. As of June 30, 2010, the actuarial value of assets of the Educational Retirement Fund was $9.43 billion and the unfunded accrued actuarial liability ("UAAL") was $4.92 billion creating a funded ratio of 65.7 percent. As of June 30, 2010, the UAAL had an amortization period of 62.5 years. As required by Governmental Standards Accounting Board (“GSAB”) Statement 25, the calculation is based on current contribution rates and does not take into account the statutorily scheduled increases described above. If the ERBs investment return is 8 percent per year in the future and if the employer contribution rate increases as scheduled under current law, the UAAL would be amortized in approximately 44 years rather than 62.5.

ERB would like to reach a funding level of 80 percent of accrued pension liabilities in 30 years. Analysis provided by ERB indicates an additional $400 million would enable the ERB to reach a projected 84 percent funding level in 30 years based on current statutory employee and employer contribution rates and an assumed 8 percent rate of return on investments. If the assumed rate of return is 7.75 percent, the projected funding level would be 74.5 percent in 30 years.

HB 586 would allow the 50$^{th}$ legislature, 1$^{st}$ session to require future legislatures to effectively appropriate $40 million each year without the possibility of overturning the law. Working in conjunction with Article II, Section 19 of the NM Constitution, certain sections of HB 586 prohibit a future legislature from enacting a law that would impair the contract establishing the tax credits. Some current contracts, especially for departmental and agency employment, refuse to place such a burden on future legislatures by making the contract conditional on available appropriations.

**ADMINISTRATIVE IMPLICATIONS**

HB 586 places a thirty day time requirement on the Board of Finance to make determination about the insurance premium tax offset certificates. This requirement might be too restrictive given the Board meets only once every month. The LFC estimates the Board would need at least 90 days to present the scheme, prepare an RFP, determine that issuance is in the best interest of the state and perform all of the required notifications.

According to DFA, the bill would have a moderate administrative impact on Board of Finance. BOF would be required to determine when, if and in what amount the credits should be issued. The Board would also need to issue a request for proposals to hire a manager who would represent the State in marketing, negotiating, and selling the tax credits. Finally, the Board may be required to create an Administrative Code rule to carry out the provisions of the bill.

DFA estimates the operating cost of the bill on the Board of Finance to be roughly $6,500, including the cost to conduct a request for proposals, advisory/counsel costs, staff time, and costs associated with promulgating a new NMAC rule.

**OTHER SUBSTANTIVE ISSUES**

The AGO analysis included a State Laws and Provisions Report providing an extensive list of premium tax offset statutes in other states. The taxes offset by all of these statutes support the operation of state guaranty organizations for protection of impaired or insolvent insurers.

None of the AGO-referenced statutes provide for any rate of return to member insurers on initial assessments. Projections show HB 586 would provide a roughly 2.96% rate of return.

None of the AGO-referenced statutes allocate the initial assessment against which future offsets are calculated to any fund except where the offset liabilities would have otherwise gone (i.e. the funds of the guaranty organization). HB 586 would allocate the net proceeds of the initial assessment to a source other than the three statutory distributions for premium taxes: the law enforcement protection fund, the fire protection fund and the general fund.

In 2005, the Legislature amended Section 22-11-21 NMSA 1978 to increase the employer contribution rate by 75 basis points (0.75 percent) for each of the seven years beginning July 1, 2005, and to increase member contribution rates by 7.5 basis points (0.075 percent) for each of the four years beginning July 1, 2005. In the 2009 regular legislative session, the Legislature modified employer and member contribution rates for FY 2010 and 2011 to shift 1.5 percent of the employer contribution rate to members whose annual salary exceeds $20,000, resulting in a member contribution rate of 9.4 percent. For those members whose annual salary is $20,000 or less, the contribution rates remain at 7.9 percent.

In the 2010 regular legislative session, the Legislature again modified employer contribution rates. In Fiscal Years 2010 and 2011, the employer contribution rate for members whose salary is greater than $20,000 is 10.9 percent and the rate for members whose salary is $20,000 or less is 12.4 percent. In Fiscal Year 2012, the employer contribution rate for all members employed, regardless of salary, will increase to 13.15 percent and rise again to 13.9 percent beginning in Fiscal Year 2013.

In addition, New Mexico universities and colleges make an additional contribution of 3 percent of the salary of those employees who elect to participate in the Alternative Retirement Plan ("ARP"), a defined contribution retirement plan available to certain faculty and professional employees, to satisfy the UAAL attributable to participation in the ARP.

Recent estimates of total unfunded pension liabilities for the 50 states exceed $3 trillion. New Mexico's population share of that $3 trillion would be about $20 billion, or far more than our actual unfunded liability.

See, for example **http://www.kellogg.northwestern.edu/News_Articles/2010/municipal-pension-systems.aspx** which reports that cities and counties add $574 billion to the $3 trillion in unfunded liabilities from the states. Prior research by the Kellogg School of Management has found $3 trillion in unfunded legacy liabilities from state-sponsored pension plans. However, new research finds additional liabilities from municipalities that magnify the growing public pension crisis.

The paper, "The Crisis in Local Government Pensions in the United States," is co-authored by **Joshua Rauh** of the Kellogg School and Robert Novy-Marx of the University of Rochester. In this latest study, Rauh and Novy-Marx calculate the aggregate unfunded liabilities and forecast the number of years assets will last for 77 defined pension plans sponsored by 50 major U.S. cities and counties. The sample represented all non-state municipal entities with more than $1 billion in pension assets, covering 2.04 million local public employees and retirees.

**ALTERNATIVES**

- DFA notes as an alternative to the bill, the legislature could enact increases in employer and employee contribution rates to ERB, or could reduce plan benefits.

- Given the relatively small number of firms expected to purchase insurance premium tax offset certificates, the State could act as its own manager for the transactions allowing for an additional $6 million in revenue by removing the cost of a manager. Alternatively, the 1.5 percent manager fee could be reduced to a more reasonable figure.

- Another possibility is for the legislature to annually and directly appropriate premium tax revenue which would otherwise go to the general fund to the Educational Retirement Fund. This option is not only more transparent than the sale of tax offsets, but it also would negate the $6 million cost of a manager and approximately $60 million in forgone revenue.

- The State Treasurer's Office notes state pension funds other than the Educational Retirement Fund have had shortfalls of a similar nature. STO proposes considering methods for reducing unfunded liabilities which could benefit all retirees rather than specifically for retirees from the education community.

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