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

ORIGINAL DATE 1/25/2020
SPONSOR Smith/Gallegos, DY **LAST UPDATED** 2/09/2020 **HB**

SHORT TITLE Early Childhood Education & Care Fund **SB** 3/aSEC/aSFC

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY20	**FY21**	**FY22**	**FY23**	**FY24**		
-	-	($75,000.0)	($32,800.0)	($7,600.0)	Recurring	General Fund
-	($173,200.0)*	($119,000.0)*	($91,800.0)*	($77,200.0)*	Recurring	Tax Stabilization Reserve
-	$173,200.0*	$194,000.0*	$124,600.0*	$84,800.0*	Recurring	Early Childhood Education and Care Fund (NEW)
-	-	($20,000.0)	($30,000.0) or more **	($30,000.0) or more **	Recurring	
-	-	$20,000.0	$30,000.0 or more **	$30,000.0 or more **	Recurring	Early Childhood Education and Care Program Fund (NEW)

Parenthesis ( ) indicate revenue decreases
*Note: Estimated impact to tax stabilization reserve conditional on general fund reserves totaling 25 percent of recurring appropriations. See *Fiscal Impact* section for more details.
** Base distribution of $30 million, with potential for more depending on contributions and growth of the endowment fund. See *Fiscal Impact* section for more details.

Duplicates HB83, Conflicts with HB26, Relates to HJR1 and SB18
Relates to Appropriation in the General Appropriation Act

SOURCES OF INFORMATION
LFC Files

Responses Received From
Department of Finance and Administration (DFA)
State Investment Council (SIC)
State Land Office (SLO)
Public Education Department (PED)
Children, Youth and Families Department (CYFD)
Department of Health (DOH)

SUMMARY

Synopsis of SFC Amendment

The Senate Finance Committee Amendment struck the bill's $320 million appropriation in FY21 to the early childhood trust fund. The General Appropriation Act of 2020 as passed from the House Appropriations and Finance Committee contains a $300 million appropriation to the fund.

The amendment creates a new "excess extraction taxes suspense fund" for the Taxation and Revenue Department to transfer oil and gas emergency school tax revenues in excess of the five-year average to be held in suspense until the end of the year. This is a technical amendment necessary for consistency with the Tax Administration Act. It allows for the Department of Finance and Administration to calculate at the end of the fiscal year whether those funds should be transferred to the tax stabilization reserve (if total state reserves are less than 25 percent) or to the early childhood trust fund (if reserves exceed 25 percent).

Lastly, the amendment adds the state support reserve fund to the list of funds on page 3 of the bill to include this fund in the decision-making process on whether the early childhood trust fund could be considered to help shore up a budget downfall if revenues and available funding are insufficient to meet appropriations.

Synopsis of SEC Amendment

The Senate Education Committee amendment changed the start date of the excess federal mineral leasing revenue distribution to the early childhood education and care fund to FY22. The amendment also added the state support reserve fund to the bill's definition of "state reserves", which will include the state support reserve fund in the bill's calculation of 25 percent reserves.

Synopsis of Original Bill

Senate Bill 3 creates the early childhood education and care fund (referred to as the "The Early Childhood Trust Fund" or "ECTF"), endows the fund with $320 million in FY21, and distributes revenue in excess of an annual five-year average for federal mineral leasing payments (FML) to the fund. Additionally, if general fund reserves are 25 percent of recurring appropriations, the bill distributes oil and gas emergency school tax revenue in excess of the five-year average to the ECTF fund that would otherwise flow into the tax stabilization reserve. The ECTF fund will be nonreverting and invested by the State Investment Council (SIC), with interest earnings crediting to the fund. SIC is required to submit an annual report to interim legislative committees on the investment of the ECTF fund.

The bill also creates an early childhood education and care program fund to be administered by the Early Childhood Education and Care Department, from which the legislature may appropriate for early childhood education and care services and programs. In FY22, the bill distributes $20 million from the ECTF fund to the program fund, and then in FY23 and each year thereafter, the bill distributes the greater of $30 million or 5 percent of the three-year average of the ECTF fund to the program fund.

Lastly, in the event general fund balances including reserves are unable to meet appropriations for a fiscal year, the bill provides for appropriation from the ECTF fund to avoid an unconstitutional deficit, but only if the balances of the appropriation contingency fund, tax stabilization reserve, and tobacco settlement permanent fund are exhausted.

The effective date of this bill is July 1, 2020.

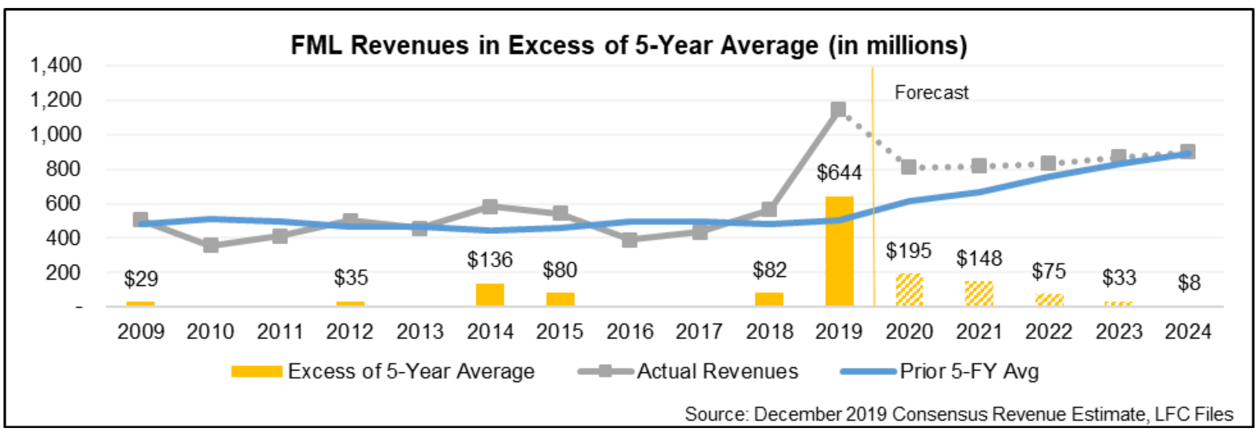
FISCAL IMPLICATIONS

This bill creates two new funds: a trust fund that earns interest and receives contributions from certain above-trend oil- and gas-related revenues, and a program fund that receives annual distributions from the trust fund that can be appropriated for early childhood programs.

The original bill contemplated an initial endowment to the early childhood trust fund of $320 million occurring in FY21. The SFC amendment struck this appropriation; however, the General Appropriation Act (HB2) as passed by the House contains a $300 million appropriation to the fund in FY21 for this purpose.

Distributions of Excess Federal Royalty Revenues. This bill distributes federal mineral leasing revenues in excess of the five-year average to the early childhood trust fund. Federal mineral leasing (FML) revenues are distributions from the federal government to New Mexico for the state's share of royalties for production activities on federal land. Additionally, FML revenue includes the state's share of bonus payments for lease sales of federal land. Oil and gas production activity accounts for over 95 percent of federal royalty payments in New Mexico, making this revenue source particularly sensitive to changes in oil and gas prices and production levels.

The chart below shows the projected FML revenues in excess of the five-year average through FY24 and demonstrates what FML distributions to the early childhood trust fund would have been if similar legislation to capture windfall FML revenues were put in place in FY09.



Oil and Gas Emergency School Tax Distributions. Under current law, if current fiscal year oil and gas emergency school tax revenue exceeds the five-year average, the excess amount is distributed to the tax stabilization reserve (TSR). This bill, if enacted, will distribute the excess revenue to either the early childhood trust fund, the tax stabilization reserve, or a portion to each depending on the state reserve conditions outlined in section five of the bill.

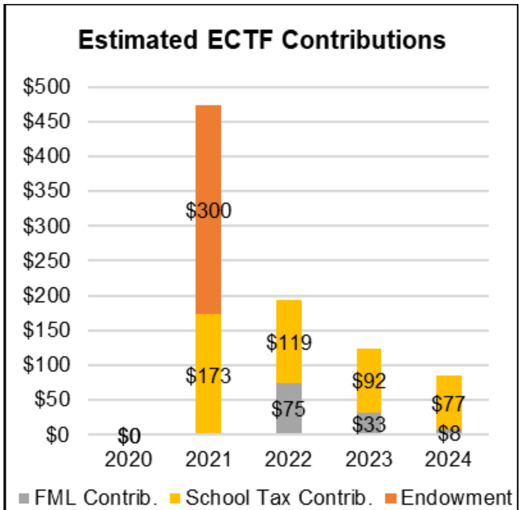
If, prior to any distribution of the excess emergency school tax revenue, state reserves exceed 25 percent of recurring appropriations, then the bill sends excess oil and gas emergency school tax revenue to the ECTF. If state reserves are less than 25 percent, the excess school tax revenue will continue to flow into the TSR until reserves reach 25 percent. Notably, since reserves are a calculated percentage, the total amount needed in reserves to meet the 25 percent threshold grows as recurring appropriations grow.

In FY19, general fund reserves ended the fiscal year at 28.9 percent of recurring appropriations. However, the Department of Finance Administration (DFA) notes both the executive and LFC budget recommendations target reserve levels of 25 percent in FY21; therefore, the DFA analysis assumes no oil and gas emergency school tax revenue distribution will be made to the early childhood trust fund until FY22.

Growth of the Trust Fund. The LFC staff fiscal estimates are based on the December 2019 consensus revenue estimates for FML and emergency school tax revenues. The table below includes all possible emergency school tax distributions to show growth potential for the fund; however, any distributions of school tax revenues to the ECTF are conditional upon state reserves totaling 25 percent.

CY	Beginning Balance	FML Contrib.	School Tax Contrib.	Distrib.	Endow-ment	Interest @ 5.5%	Ending Trust Fund Balance		FY	5% of 3-yr Avg	To Program Fund
2020	-	-	-	-	-	-	-		2021	-	-
2021	-	-	$173	-	$300	-	$473		2022	$12	$20
2022	$473	$75	$119	-$20		$27	$674		2023	$19	$30
2023	$674	$33	$92	-$30		$39	$808		2024	$33	$33
2024	$808	$8	$77	-$33		$46	$906		2025	$40	$40
2025	$906	-	-	-$40		$52	$918		2026	$44	$44
2026	$918	-	-	-$44		$53	$927		2027	$46	$46
2027	$927	-	-	-$46		$54	$935		2028	$46	$46
2028	$935	-	-	-$46		$54	$943		2029	$47	$47
2029	$943	-	-	-$47		$54	$950		2030	$47	$47

Note: Endowment assumes $300 million appropriated in the 2020 General Appropriation Act as passed by the House



Source: December 2019 Consensus Revenue Estimate, LFC Files

Since the December 2019 consensus revenue estimate only extends through FY24, the table above makes no assumptions on potential FML or school tax distributions in FY25 or beyond.

The chart to the right illustrates the total potential contributions to the ECTF fund through FY24, assuming the conditions are met for the emergency school tax distribution.

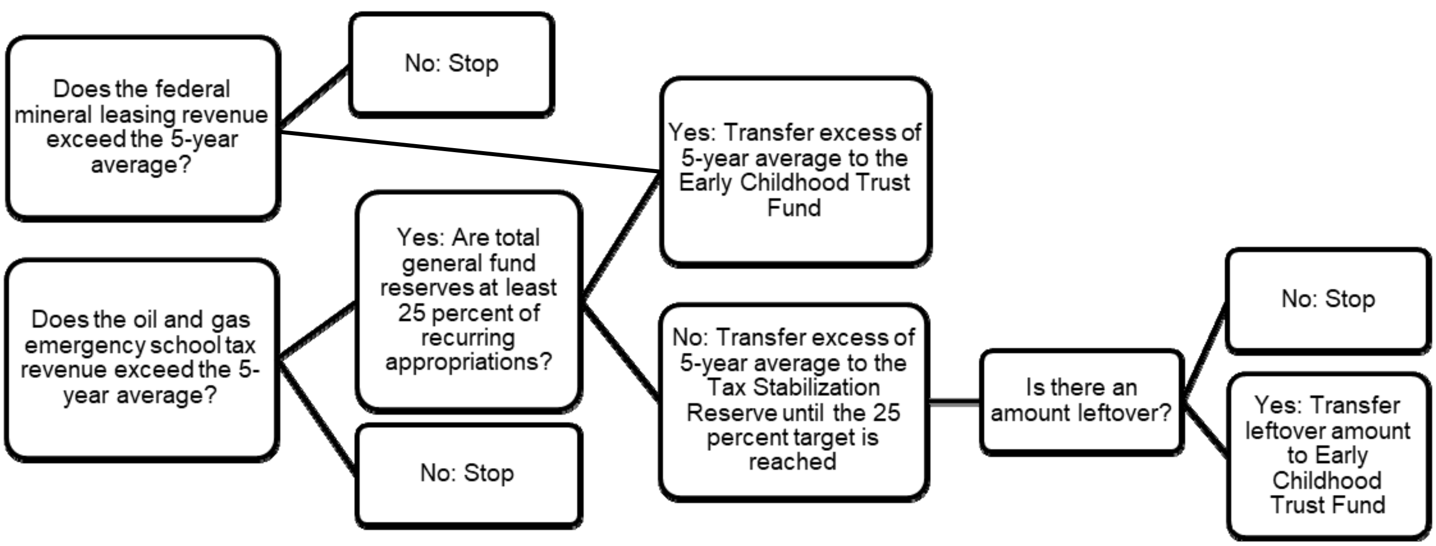
The bill charges the State Investment Council with management of the fund. This allows higher investment earning potential than if managed as part of the state's treasury balances. SIC states it is a fair assumption that the ECTF's asset allocation would be constructed in a manner similar to the Land Grant Permanent Fund.

While the early childhood trust fund will not be part of general fund reserves, the bill provides for appropriations from the ECTF to shore up a budget shortfall if other primary general fund reserve accounts are exhausted (the tax stabilization reserve and the tobacco settlement permanent fund).

Early Childhood Education and Care Program Fund. The bill provides for a continual distribution from the early childhood trust fund to an early childhood program fund beginning FY22. The initial distribution in FY22 is $20 million. Beginning in FY23, the bill provides for at least a $30 million distribution to the program fund. If 5 percent of the three-year average of the fund exceeds $30 million, then that amount will be distributed to the program fund. Based on the above analysis, distributions to the program fund could begin to exceed the $30 million floor in FY24. The above analysis also demonstrates that interest earnings of the ECTF have potential to exceed the annual distributions from the fund, allowing the fund to continue to grow even in years when no FML or emergency school tax contributions are made.

Inflows to the Early Childhood Trust Fund. The following decision tree demonstrates how the early childhood trust fund receives excess oil and gas revenues.

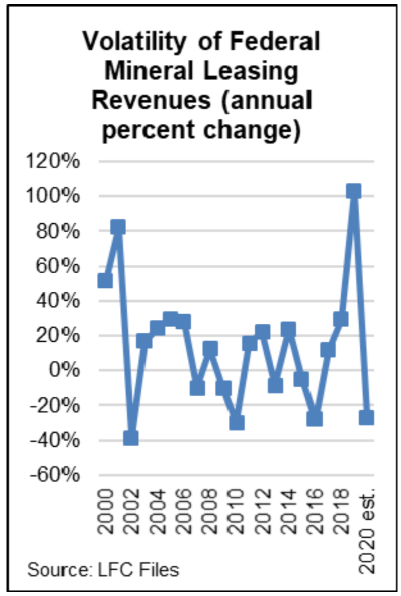
Above-Trend Oil and Gas Revenue Decision Tree



SIGNIFICANT ISSUES

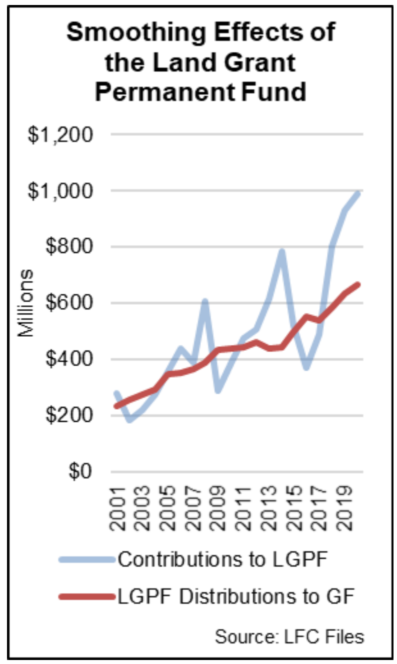
Stabilizing Oil and Gas Royalty Revenues. At the core of New Mexico's fiscal stability problem is the increasing reliance on volatile revenues from the extractives industry. Although corporate income tax revenues are the most volatile, they make up less than 2 percent of general fund revenue. However, severance taxes and federal royalty payments made up 23 percent of general fund revenues in FY19. When including gross receipts taxes from Eddy and Lea Counties and out-of-state receipts, which are also highly dependent on oil and gas activity, energy-related revenues made up 36 percent of general fund revenue in FY19. This is up from a prior 10-year average of 26 percent.

While lawmakers have taken steps to manage the volatility of severance tax revenue to the general fund, more needs to be done to address the considerable variance from royalties and bonus payments. Currently, all federal mineral leasing payments are distributed to the general fund, adding to revenue volatility and forecasting difficulties. For example, a record-breaking federal land lease sale in FY19 generated an unexpected revenue windfall of more than $450 million. Combined with increased oil and gas royalty payments, FML revenues increased 103 percent in FY19 and is projected to decline 29 percent in FY20, as bonus payments will likely return to historical norms.



Royalties from production on state lands are similarly volatile; however, the state mitigates this volatility by contributing those revenues to the interest-earning land grant permanent fund (LGPF). The general fund then receives a distribution from the LGPF based on the five-year average value of the permanent fund, creating a smoothing effect that results in a relatively stable general fund revenue source.

Distributions from the LGPF and severance tax permanent fund (STPF) are some of the most stable and reliable revenue streams to the general fund. The distribution formula – calculated as a percent of the five-year average of the year-end balance of the fund – makes this revenue source easily predictable for the upcoming budget year, as the actual distribution amounts for the next fiscal year are known prior to the legislative session. The formula also smooths fluctuations in market activity and oil and gas royalty contributions, partially insulating the general fund from sudden shocks.



This bill proposes a similar concept as that of the LGPF and STPF, in which volatile oil and gas revenues are deposited into an interest-earning stabilization fund from which distributions are then made to fund important programs. The distribution floor of $30 million to the program fund proposed in this bill provides stability for programming, and the calculated percent of a rolling average of the fund provides opportunity for gradual additional funding as the corpus of the fund grows.

Management of the Early Childhood Trust Fund. According to SIC staff, the council typically does not formally support or oppose legislation it does not originate, but in 2019 seven members of the 11 member council, not including Governor Lujan Grisham (who helped originate the measure), signed a letter of support in favor of the ECTF. Generally, the council has taken a position in favor of the endowment model as a revenue-creating economic and planning tool for the state.

The SIC, which manages the land grant, severance tax and tobacco settlement permanent funds, the water trust fund, the tax stabilization reserve, the rural library endowment fund, and substantial assets of more than 20 government clients, does not foresee any insurmountable problems in taking on the additional responsibility of investing this fund.

PERFORMANCE IMPLICATIONS

SIC's assets are managed in a unitized pool structure, which allows for an efficient cross-fund investment exposure across all of the various investment vehicles and strategies in the SIC portfolio. This allows for investment exposure to appropriate investment strategies, while also preventing inappropriate investments that may be strategy-specific to a particular one of the funds we manage (i.e. the STPF is the only fund with exposure to differential rate investments like NM private equity, which has a specific statutory allowance for the STPF.)

SIC staff states the council would work with the State Treasurer and presumably stakeholders to develop an appropriate long-term strategic asset allocation to achieve a specific plan to achieve optimized risk-adjusted returns.

ADMINISTRATIVE IMPLICATIONS

According to SIC, taking on additional assets with new strategic goals may result in additional resource needs at the SIC, though determining the specific need is challenging. Active management costs more money to invest than passively managed assets, and similarly, advisory services from external experts may or may not require additional compensation above existing contract levels to perform the new services needed for this new fund. The agency states any additional needs could addressed through the normal annual budgeting process.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Relates to House Joint Resolution 1, Permanent Funds for Early Childhood, which seeks to take an additional 1 percent distribution from the LGPF annually to fund early childhood programs.

Relates to Senate Bill 18, Renewable Energy Production Tax, which directs tax dollars from renewable energy producers to fund early childhood programs.

Conflicts with House Bill 26, Highway and Transportation Project Funds, which seeks to distribute federal mineral leasing revenues in excess of the five-year average to fund statewide transportation projects.

Duplicates House Bill 83.

TECHNICAL ISSUES

The original bill began distributing excess federal royalty revenue to the early childhood trust fund in FY21. However, the SEC amendment changes this distribution to begin in FY22.

The original bill defined state reserves as the general fund operating reserve, the appropriation contingency fund, the tax stabilization reserve, and the tobacco settlement permanent fund. However, it did not include the state support reserve fund in its definition, which is typically considered part of general fund reserves. The SFC amendment adds the state support reserve to the bill's definition of state reserves.

Distributions from the ECTF to the program fund use a three-year rolling average of the fund value. This in contrast to the land grant and severance tax permanent funds, which use a five-year rolling average. According to SIC, the five-year average will keep distributions more stable, while the three-year policy may experience a bit more volatility some years.

OTHER SUBSTANTIVE ISSUES

Early Childhood Education. New Mexico's early childhood care and education system begins prenatally and extends through age 8. Benefits of prekindergarten include improved math and reading proficiencies for low-income 4-year-olds, lower special education and retention rates, and lessened negative effects of mobility. According to the LFC *2019 Early Childhood Accountability report*, prekindergarten programs can improve literacy. Additionally, LFC found the achievement gap was nearly eliminated by kindergarten for low-income students who participated in prekindergarten and K-3 Plus.

The LFC report indicates the state has increased its funding to various early childhood programs in recent years, spending more than $500 million in FY20 across childcare assistance, home visiting, pre-K, K-5 Plus, early literacy and head-start programs. This was an increase of more than $100 million, year over year. Despite significant barriers to expansion, New Mexico is close to providing sufficient funding to ensure all low-income 4-year-olds receive at least some type of early education through childcare assistance, prekindergarten, or Head Start.

According to the Public Education Department (PED),

> "Building a stable source of funding for early childhood programs will protect the investment that the state has made in expanding home visiting, PreK, as well as other programs serving New Mexico's young children and their families. Families will benefit as they can count on quality services being available for their children.
>
> Quality early childhood programs, particularly PreK, produce substantial long-term gains that include long-term cognitive effects equivalent in size to one half or more of the achievement gap between minority and white children or low-income and other children through the end of high school as well as gains in social and emotional development, improvements in school success including less grade repetition, less special education placement, and increased high school graduation (National Institute for Early Education Research, 2013). Furthermore, studies that include benefit-cost analyses describe yields that average a $7 to $1 ratio (NIEER, 2013).
>
> [This bill] will support the PED's PreK program and allow for responsible coordinated growth with the goal of universal services, which is defined as 85 percent of all four-year-olds, and 50 percent of all three-year-olds."

According to the State Land Office (SLO), the Commissioner supports expanding early childhood education funding. Early childhood education reduces the deleterious developmental effects of poverty and trauma by providing children with the tools and experiences needed to succeed in school.

According to the Children, Youth and Families Department (CYFD), development of the Early Childhood Trust Fund will enable the Early Childhood Education and Care Department to provide important supports to the early childhood education and care workforce. Supporting the workforce through increased formal education opportunities and compensation is essential to ensure that all children have access to high-quality care and education.

According to the New Mexico Department of Health (DOH), the early childhood funding mechanisms proposed in this bill support goals one and two of DOH's strategic plan for an improved health status for New Mexicans and to expand access to services, respectively.

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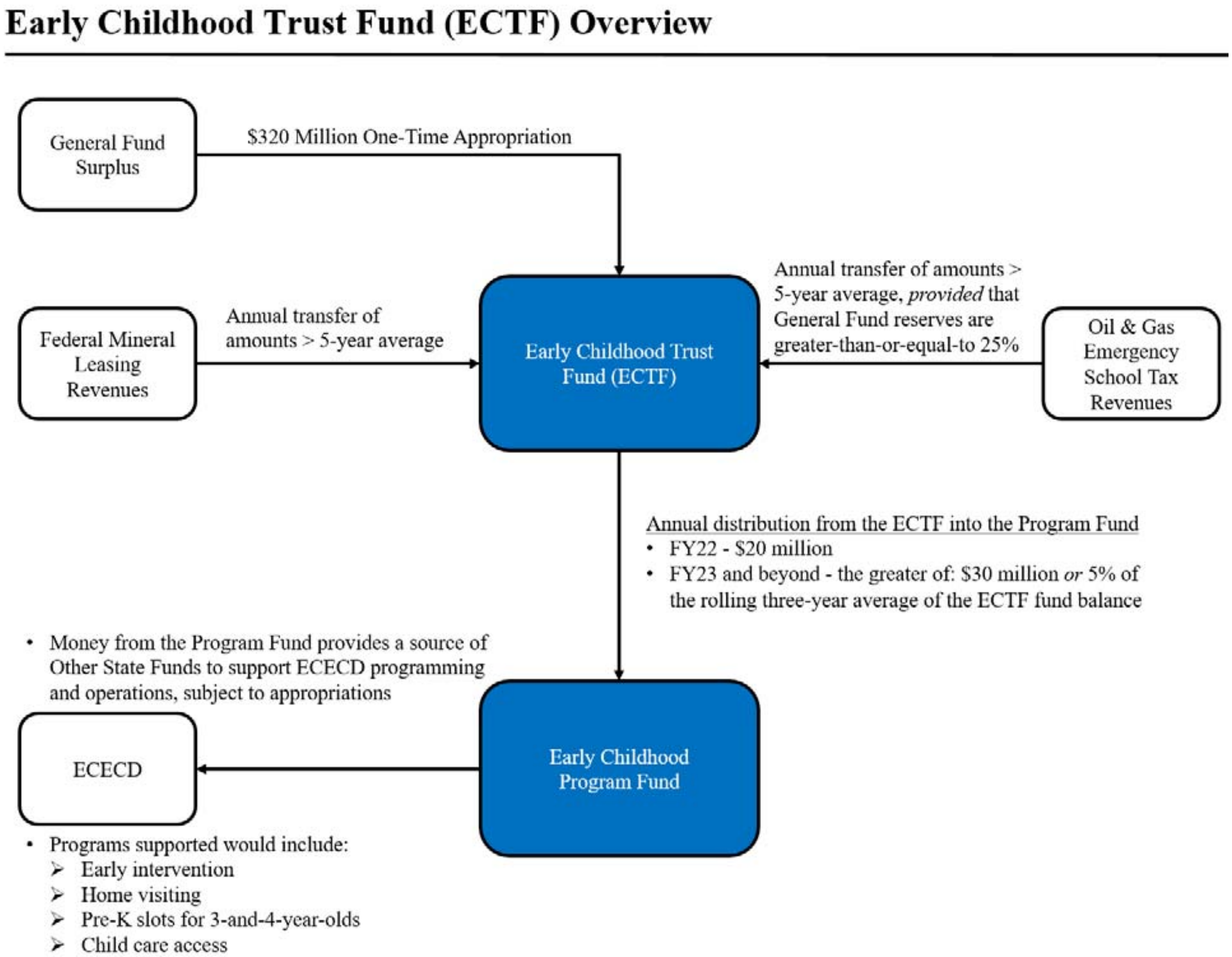
Attachment 1



Source: Department of Finance and Administration