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FISCAL IMPACT REPORT

SPONSOR Sanchez, M.

ORIGINAL DATE 02/01/10
LAST UPDATED 02/01/10

HB

SHORT TITLE Recovery Investment Bonding Act

SB 184

ANALYST White

APPROPRIATION (dollars in thousands)

Appropriation		Recurring or Non-Rec	Fund Affected
FY10	FY11		
	$500,000.0	Nonrecurring	Recovery Investment Note Proceeds

(Parenthesis ( ) Indicate Expenditure Decreases)

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY10	FY11	FY12		
($38,000.0)	($114,000.0)	($114,000.0)	Recurring	General Fund
$0.0	$500,000.0	$0.0	Nonrecurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY10	FY11	FY12	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
Total	$0.0	$0.1	$0.1	$0.1	Recurring	BOF Operating Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to House Bill 2

SOURCES OF INFORMATION
LFC Files

Responses Received From
Attorney General's Office (AGO)
State Investment Council (SIC)
Taxation and Revenue Department (TRD)

<u>Responses Not Received From</u>
Department of Finance and Administration (DFA)

SUMMARY

<u>Synopsis of Bill</u>
Senate Bill 184 authorizes the State Board of Finance (BOF) to issue up to $500 million in refundable "recovery investment notes" by June 30, 2011 with terms of no greater than 6 years supported by a monthly gross receipts tax (GRT) distribution to the newly created "recovery investment bonding fund." Any bonds issued under Senate Bill 184 "shall be sold only at private sale for a negotiated price" as an investment for the Land Grant Permanent Fund (LGPF) or Severance Tax Permanent Fund (STPF).

Senate Bill 184 appropriates up to $500 million of recovery investment note proceeds to the general fund for the purpose of meeting appropriations from that fund.

Senate Bill 184 further appropriates a monthly gross receipts tax distribution of $9.5 million ($114 million annually) to the recovery investment bonding fund for the purpose of paying necessary debt service on the notes authorized per the recovery investment bonding act. On the last day of January and July of each year, the BOF is required to set aside an adequate amount in the fund to make debt service payments, maintain an adequate reserve, and other payments as will be necessary for the subsequent 12 month period. All money in the fund above and beyond that set aside will be transferred to the general fund. The remaining balance of the fund after the retirement of all notes will revert to the general fund.

FISCAL IMPLICATIONS

Senate Bill 184 carries significant fiscal impacts to the state's general fund. While the proposed legislation would provide up to $500 million in FY11 non-recurring general fund revenue, it would cost the general fund $9.5 million each month from the time of enactment until the bonds are retired or FY16 whichever occurs first. This aggregates to a possible net loss to the general fund of up to $222 million in debt service costs over the next six and a half years. This loss is a worst-case estimate based upon the total allowable GRT distributions outlined in the bill. The actual net loss in terms of debt-service to the state would most likely be between $75 million and $150 million depending upon the rate, term, and other specifics of the issuance. This loss has the potential to create even greater budget deficits beginning in FY12. This potential will increase based upon the amount of bond proceeds the legislature chooses to commit to FY11 recurring appropriations as opposed to increasing general fund reserves. Using these non-recurring revenues to maintain recurring spending at unsustainable long-term levels could put the state in even greater financial difficulty in the future.

Due to the high dollar amount related with such an investment, almost 14 percent of the STPF as of December, 2009, for practical reasons the entire issue would most likely be purchased through the LGPF. Requiring the State Investment Officer (SIO) to purchase the notes as investments for the LGPF, in addition to creating possible conflict with the Uniform Prudent Investor Act, could have a potentially negative impact on the performance of the fund. The proposed language states that the notes "<u>shall</u> be sold only at private sale for a negotiated price to the (SIO)…" Therefore the proposed legislative mandate could crowd out other potentially more attractive investment opportunities and negatively effect performance. The LGPF makes annual distributions to the

general fund based upon a fixed percentage of its average market value over the preceding 5 year period. In FY10 this distribution will equal approximately $436.5 million, representing more than 8.5 percent of total recurring general fund revenue. Thus if the fund's performance were negatively affected, Senate Bill 184 would cause an indirect negative impact upon general fund revenue for an extended period.

Senate Bill 184 creates a new fund and provides for continuing appropriations for a period of up to six years. The LFC has concerns with including continuing appropriation language in the statutory provisions for newly created funds, as earmarking reduces the ability of the legislature to establish spending priorities.

SIGNIFICANT ISSUES

The proposed legislation amounts to the issuance of what are essentially known as deficit financing bonds. Legislative bodies in certain other states have recently approved such measures, after a determination that the current economic downturn has hit so hard so quickly that severe budget crises were unavoidable. These approvals were also made on the assumption that the economic turmoil currently experienced by states is a temporary cyclical event, which will soon be replaced by rapid growth and economic expansion. While these types of financings may result in a short-term budget fix, there are potential disadvantages that accompany them as well.

The primary disadvantage of using medium to long-term debt to address a recurring deficit is the forfeiture of future tax revenues for a current one-time situation. The issuance of debt for this purpose amounts to a one-time fix in which no long-term assets are built or improved but future resources are still depleted. This type of proposal usually begs the famous question, "what happens next year?" In order for proposals such as the one outlined in Senate Bill 184 to work properly, "next year" must be accompanied by an economic rebound and strong revenue outlook. This economic rebound must not only be strong enough to solve the existing budgetary deficit, it must also be strong enough to account for the loss of future revenues committed to the one-time fix.

The bond proposals included in Senate Bill 184 are likely to elicit a negative reaction from ratings agencies, because they limit the state's future financial flexibility by committing future tax revenues for current operations. The use of such financing is typically viewed as exposing a major structural problem within a state or municipality's budget. For these reasons the use of any type of medium to long-term debt financing in order to address a state's budget deficit is traditionally frowned upon. The state of California for example, issued deficit financing bonds in the early 2000's based on the assumption that its deficit was a short-term product of an ailing economy. Today the state is still issuing billions of dollars in deficit financing bonds to address a short-term problem that has lasted the better part of a decade. In the meantime its bond rating was downgraded from AA to BBB. Even though the bonds proposed in Senate Bill 184 are state GRT bonds, which currently hold an AAA rating, and not general obligations of the state of New Mexico, the use of deficit financing bonds carries a high probability of a downgrade in the state's overall credit rating. At the very least, the issuance of such bonds would most likely result in the state being put on a negative watch list.

TECHNICAL ISSUES

Both the Attorney General's Office (AGO) and State Investment Council (SIC) voiced concerns in their analyses with regard to the proposed legislation's requirement that the bonds be purchased by the LGPF. The effects of a bond purchase in the range of $500 million would represent more than 5 percent of the total fund and thus have a significant effect on its asset allocation. The SIC analysis states that the SIO "has indicated he could not make such a large investment without violating his duty as a fiduciary" and that such investments "could serve as a downward force on fund performance overall in a period where equity markets were performing well." Furthermore, the New Mexico constitution states that, unlike the severance tax permanent fund (STPF), the legislature cannot establish criteria for investing the LGPF unless such a measure is approved with at least a three-quarter vote in each house.

State Investment Council (SIC):

> "Section 7 of SB 0184 states that the notes shall only be sold at private sale **for a negotiated price** to the state investment officer as an investment for LGPF or STPF, yet there is no indication of the procedure for such a negotiated sale to follow. The large $ amount indicated would be outside the range for any single investment of this type and would likely require an alteration of the existing asset allocation…
>
> It doesn't appear that the wording of SB 0184, particularly as stated in Section 7, covers what happens if the state investment officer is not able to negotiate a desirable price for the notes. Does the negotiation allow for the state investment officer to insist on a favorable rate, considering the size of the investment?"

Attorney General's Office (AGO):

> "Section 4 creates a special bonding fund that is pledged for repayment of bonds, which consists in part of "money appropriated and transferred to the fund". In order to avoid the constitutional requirement of voter approval for general obligations of the state, only non-general revenues (such as certain gross receipts tax receipts, which are expressly appropriated in Section 10) may be appropriated to this fund.
>
> Section 8's authorization of these bonds as legal investments for the land grant permanent fund could raise an argument that the legislature is "establishing criteria for investing the fund", which would require a ¾ vote of each house pursuant to Article XII, Section 7(B) as to the land grant permanent fund, although one could argue in response that it is simply authorizing this form of investment. Additionally, although the bill expressly authorizes such investment, actual investment of either permanent funds in these bonds still would be subject to policies and regulations of the State Investment Council, and must satisfy the Prudent Investor Act. (See NM Const. Art. XII, section 7(B) and Art. VIII, section 10, and NMSA 1978 section 6-8-7(A)."

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

If Senate Bill 184 is not enacted, the BOF will not be permitted to issue "recovery investment notes" supported by state GRT distributions for the purpose of addressing a general fund deficit in FY11. Furthermore the SIO would not be required to purchase the notes as investments for the LGPF.

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