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

ORIGINAL DATE 1/23/18
SPONSOR Ely **LAST UPDATED** 2/9/18 **HJR** 3

SHORT TITLE Severance Tax Fund for Public Safety, CA **SB**

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY18	**FY19**	**FY20**	**FY21**	**FY22**		
$0.0	$0.0	($24,271.2)	($24,863.0)	($25,508.4)	Recurring	STPF
$0.0	$0.0	$24,271.2	$24,863.0	$25,508.4	Recurring	General Fund

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY18	FY19	FY20	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
	$50.0		$50.0	Nonrecurring	Election Fund

Parenthesis ( ) indicate expenditure decreases

Related to HJR1, HJR2, SJR2, SJR3, SJR7

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
NM Attorney General's Office (NMAG)
State Land Office (SLO)
Administrative Office of the District Attorneys (AODA)
Children, Youth and Families Department (CYFD)

Responses Not Received From
Department of Public Safety (DPS)
New Mexico Corrections Department (NMCD)
Administrative Office of the Courts (AOC)

SUMMARY

Synopsis of Bill

House Joint Resolution 3 proposes to amend Article 10 Section 8 of the state Constitution to provide additional annual distributions from the Severance Tax Permanent Fund (STPF), equal to one-half percent of the fund's five year average value, for the purposes of funding criminal justice and public safety, including education programs, law enforcement, district attorneys, public defenders, courts, correctional facilities and programs, pre-trial and post-trial services, and behavioral health/substance abuse programs. The additional funding will only be deployed from the STPF should the balance of the five-year average of the STPF exceed $5 billion.

The constitutional amendment requires approval by voters in a statewide election, either in the 2018 general election or at a special statewide election held for this purpose.

FISCAL IMPLICATIONS

Severance Tax Permanent Fund. Assuming adoption by voters, this resolution would deliver significant revenue to the general fund from the STPF in coming years, to address a wide-ranging number of budgetary challenges related to crime, the justice system, the corrections system, behavioral health and related societal ills. However, the State Investment Council (SIC) notes the funding comes at a premium, potentially putting the long-term health of the STPF at risk, and at minimum, ultimately reducing the effectiveness of the endowment and reducing the total amount of money the STPF will generate for New Mexicans in the future.

Unlike general fund dollars, permanent fund dollars carry a greater implied value of not only their current dollar denomination, but also the investment earnings that dollar will produce for every subsequent year it is invested. Like most endowment dollars, there is a reasonable expectation that a dollar in the STPF will double in value after about 11 years, assuming average earnings of around 6.75 percent, the return currently targeted. If a STPF dollar is spent rather than being invested, it cannot compound its value over time, and cannot contribute to future generations of NM citizens. This is one of the reasons university endowments, foundations, trusts, permanent funds, sovereign wealth funds and similar entities typically limit their distribution rate, or spending policy, to an annual rate of 5 percent or less.

Though only taking an additional 0.5 percent, the proposal would deliver more than a billion dollars to the state over the first 12 years of enactment, but would also be accompanied by hundreds of millions of dollars in "opportunity cost" that comes from spending those dollars rather than investing them.

SIC provides the following chart, which tracks the first 30 years of additional distributions from the STPF pursuant to this resolution:

Calendar Year	Corresponding Fiscal Year	($B) STPF Value Current (4.7%)	STPF Distribution @4.7	($B) LGPF Value w/HJR3 (5.2%)	STPF Distribution @5.2%	Compounded Difference in 4.7% & 5.2% STPF Distribution	Difference in STPF Value ($B)
2017	2019	5.109	$220,621,474	5.109	$220,621,474		
2018	**2020**	5.261	$228,149,358	5.261	$252,420,566	$24,271,208	**($0.01)**
2019	**2021**	5.414	$234,898,441	5.402	$259,761,426	$49,134,193	**($0.04)**
2020	**2022**	5.570	$244,630,898	5.533	$270,139,276	$74,642,571	**($0.07)**
2021	**2023**	5.728	$254,572,291	5.663	$280,460,815	$100,531,095	**($0.10)**
2022	**2024**	5.887	$261,886,490	5.792	$287,564,034	$126,208,639	**($0.13)**
2023	**2025**	6.047	$269,278,108	5.920	$294,419,980	$151,350,511	**($0.16)**
2024	**2026**	6.211	$276,766,627	6.050	$301,158,492	$175,742,376	**($0.20)**
2025	**2027**	6.378	$284,355,558	6.181	$307,904,715	$199,291,533	**($0.23)**
2026	**2028**	6.548	$292,058,078	6.315	$314,681,171	$221,914,626	**($0.27)**
2027	**2029**	6.721	$299,902,223	6.450	$321,527,158	$243,539,561	**($0.31)**
2028	**2030**	6.899	$307,905,303	6.587	$328,467,003	$264,101,261	**($0.35)**
2029	**2031**	7.080	$316,072,363	6.727	$335,507,756	$283,536,654	**($0.40)**
2030	**2032**	7.264	$324,408,081	6.868	$342,654,017	$301,782,590	**($0.44)**
2031	**2033**	7.453	$332,916,804	7.012	$349,909,045	$318,774,831	**($0.49)**
2032	**2034**	7.645	$341,602,566	7.158	$357,275,397	$334,447,662	**($0.54)**
2033	**2035**	7.842	$350,469,218	7.307	$364,755,169	$348,733,613	**($0.59)**
2034	**2036**	8.042	$359,520,593	7.457	$372,350,277	$361,563,297	**($0.64)**
2035	**2037**	8.247	$368,760,576	7.610	$380,062,584	$372,865,305	**($0.69)**
2036	**2038**	8.456	$378,193,115	7.765	$387,893,942	$382,566,132	**($0.75)**
2037	**2039**	8.670	$387,822,230	7.923	$395,846,208	$390,590,110	**($0.80)**
2038	**2040**	8.888	$397,652,020	8.083	$403,921,258	$396,859,348	**($0.86)**
2039	**2041**	9.110	$407,686,670	8.246	$412,120,992	$401,293,670	**($0.93)**
2040	**2042**	9.337	$417,930,450	8.411	$420,447,337	$403,810,557	**($0.99)**
2041	**2043**	9.569	$428,387,719	8.578	$428,902,249	$404,325,087	**($1.06)**
2042	**2044**	9.805	$439,062,926	8.748	$437,487,714	$402,749,875	**($1.13)**
2043	**2045**	10.047	$449,960,613	8.921	$446,205,747	$398,995,009	**($1.20)**
2044	**2046**	10.293	$461,085,417	9.097	$455,058,397	$392,967,989	**($1.27)**
2045	**2047**	10.545	$472,442,071	9.275	$464,047,742	$384,573,660	**($1.35)**
2046	**2048**	10.802	$484,035,407	9.456	$473,175,892	$373,714,145	**($1.42)**
2047	**2049**	11.064	$495,870,358	9.640	$482,444,990	$360,288,777	**($1.51)**
2048	**2050**	11.332	$507,951,959	9.826	$491,857,214	$344,194,032	**($1.59)**

SIC's projections are based on the following assumptions: The December 31, 2017 value of the STPF of $5.1 billion; investment returns of the SIC's targeted 6.75 percent (6.55 percent net-of-fees); and contributions of $33 million per year, which is the annualized average over the past 15 years.

The projected differences between the 4.7 percent distribution rate and the 5.2 percent distribution rate are significant, even during the first dozen years. Though the bill does not include a sunset provision, we use this time period for comparative purposes, to illustrate the relative size difference between this proposal and the 2003 constitutional amendment which took an additional $747 million from the Land Grant Permanent Fund.

- During the first 12 years under this proposal, the STPF would have delivered an additional $283.5 million to the general fund, with that specific amount going toward criminal justice matters.
- Due to lost earnings on that $283.5 million, the STPF corpus would be $396 million

smaller at that point due to the dozen years of additional distributions. A fund $396 million smaller will on average, lose out on $26 million dollars in earning annually, assuming average investment returns. Looking forward, those estimated revenue losses grow and accelerate.

- The permanent fund under this proposal will provide additional revenue to the general fund for 24 years, in that time delivering an extra $402 million to the state, compared to the fund only producing the base rate distribution of 4.7 percent. However, after 25 years, the 5.2 percent fund is exceeded in distributions by the 4.7 percent fund, due to the additional growth produced by expected investment earnings. At that point, the base fund (at 4.7 percent) with the slower, lower distribution is more than one billion dollars larger than the 5.2 percent proposed fund, and will be producing significantly more for the state than the smaller, faster fund.

This analysis can be affected by other less certain variables, including potential growth of the state population, or potential impact high inflation would have on the real dollar value of the STPF benefits. The analysis also does not consider the real possibility of calamitous investment market events as witnessed in 2008/2009, as well as reduced inflows from the Severance Tax Bonding Fund, as these potential factors are extremely difficult to quantify.

The State Land Office (SLO) provides a similar analysis, in which the proposed additional distributions increase the risk that the corpus of the STPF will be diminished and that less money will be available in future years. SLO's internal financial analysis indicates that if all analytical variables other than the distribution rate were held constant, comparing a 4.7 percent distribution (current law) to a 5.2 percent distribution (proposed), distributions from the STPF would increase by approximately $229 million during the next ten years and distributions would decrease by approximately $595 million over the next fifty years. The analysis indicates that there will be a decrease in distributions from the STPF within 26 years if this resolution is enacted and approved. The internal analysis also indicates that the value of the fund will be approximately $4.1 billion dollars higher in fifty years if current distribution rates remain in place as compared to those proposed in this resolution.

Public Safety. If approved by voters in the next general election, this constitutional amendment will require enabling legislation. The proposed constitutional amendment currently has no master plan or specific details as to how the additional funds will be expended, or how the related benefits of those dollars will be measured and evaluated for effectiveness in either the short or long-term. Additionally, there are no provisions to prevent the use of the funds from simply supplanting current funding for public safety and freeing up general fund dollars for other purposes.

The Administrative Office of District Attorneys (AODA) indicates the resolution itself has no direct fiscal impact on the district attorneys, although if it passes the legislature may provide funding for the district attorneys through use of the severance tax permanent funds. For such funding to occur, the resolution must pass, the constitutional amendment it proposes must pass at the next election, and if the legislature provides by law to use the funds to pay for the criminal justice and public safety purposes listed in this resolution and chooses to include funding for the district attorneys, funds from the land grant permanent funds will reach the district attorneys.

AODA did not provide information how potential additional funding may be utilized. No responses were received from the Corrections Department, the Department of Public Safety, the Administrative Office of the Courts, or the Children, Youth and Families Department indicating how the additional funding may be utilized.

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. According to Secretary of State, the most recent cost to print a constitutional amendment is $47.60 per word.

SIGNIFICANT ISSUES

The State Investment Council notes 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 by 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 eventually help put the STPF on stronger footing long-term, its full implementation is still several 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, SIC states 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, as a result additional sponge bonding in 2017, received a mere $37.77 in CY17 – from the more than $300,000,000 in severance taxes collected by the state), the impact of this proposal could negate or even override any of the measures taken previously to stabilize the STPF and its long-term outlook.

PERFORMANCE IMPLICATIONS

Below is investment performance data for the STPF, as of November 30, 2017:

	1 year	3 years	5 years	10 years	15 years	20 years
Severance Tax Permanent Fund Returns % net of fees	15.25%	6.70%	8.74%	4.67%	7.11%	6.25%

While the one, five and 15 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 the SIC's long-term target of 6.75 percent. Like many institutional investors, the 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.

ADMINISTRATIVE IMPLICATIONS

Article 8, Section 10 currently provides that the frequency and the time of distributions made pursuant to Subsection C (the section allowing the current distribution) shall be as provided by law. The new distribution that would be allowed under the amendment proposed by this resolution is not covered by that provision. Presumably, because the amendment requires the legislature to specifically provide by law to use the distribution to fund some or all of the listed purposes, that law will provide for the frequency and time of distribution.

RELATIONSHIP

Similar to HJR1, which seeks additional annual LGPF distributions by 1 percent for educational programs and early childhood education. Similar to HJR2, which seeks additional annual LGPF distributions by 0.5 percent for public safety. Similar to SJR2, which seeks to increase LGPF distributions by 1.5 percent for early childhood education. Relates to SJR3, which seeks to create the Early Childhood Education Department. Similar to SJR7, which seeks to increase distributions by 0.8 percent from the STPF for early childhood education.

TECHNICAL ISSUES

SIC notes this resolution includes an asset value "safety valve" intended to protect the STPF from the burden of additional distributions during times of financial stress. The valve is designed to stop the additional 0.5 percent distribution should the 5-year average of the fund drop below $5 billion at calendar-end of any given year. The current 5-year average of the STPF as of December 31, 2017 is $4.9 billion, meaning at this time the resolution would not qualify to make additional distributions. Assuming normal, targeted returns of 6.75 percent and inflows of $33 million, the STPF is projected to hit the $5 billion mark for its 5-year rolling average as of the end of CY2020, though it is potentially close at the end of CY2019. Assuming passage by the voters, this resolution may not clear its own restriction for a at least a year, and given the uncertain nature of the investment markets and the extremely sporadic inflows to the fund, it may be many years before the resolution becomes qualified under these terms. Potentially this 'safety valve' could be an important and often visited feature, should the constitutional amendment be enacted.

The State Land Office notes that, in setting a floor value for the additional distribution, the proposed amendment leaves an ambiguity as to what happens when the average year-end value is over $5 billion but the additional distribution would cause the value to go below $5 billion.

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APPENDIX

Quick Facts on the Severance Tax Permanent Fund

What is the Severance Tax Permanent Fund (STPF)?

- Created by the New Mexico Legislature in 1973 as a way to save and invest the severance taxes not being used to bond capital projects [i.e. whatever severance tax funds not used for bonding then flow into the permanent fund].
- Voters approved constitutional protections for the fund restricting the legislature's ability to appropriate from the corpus of the fund. This, coupled with investment earnings, allows the fund to grow.
- Recently, the legislature has used almost all bonding capacity, leaving little for distribution into the permanent fund – 2015 contributions totaled $817 thousand, and 2016 contributions totaled $7.7 million (compared to a historical average of about $40 million). Contributions in 2017 were less than fifty dollars, at just $37.77.
- Corpus of the fund is currently about $5.13 billion.
- General fund distributions are non-earmarked.

Current Distributions

Currently, 4.7 percent of the STPF five-year average is annually distributed to the general fund. In FY18, STPF distributions to the general fund will be about $210 million.

Distribution History

In 1996, voters passed a constitutional amendment to allow for a distribution of 4.7 percent of the five-year average value of the fund.

Important Considerations

STPF was established and is required by law to serve as an endowment fund of the state. It is funded by income from non-renewable resources and were designed to provide for future generations of New Mexicans even when those resources are exhausted.