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

ORIGINAL DATE 2/3/18
SPONSOR Sapien **LAST UPDATED** ____ **HB** ____

SHORT TITLE Severance Tax Fund For Early Childhood, CA **SJR** 7

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY18	**FY19**	**FY20**	**FY21**	**FY22**		
--	--	**($38,834.0)**	**($39,769.0)**	**($40,766.0)**	Recurring	STPF
--	--	$38,834.0	$39,769.0	$40,766.0	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

Similar to SJR2, SJR11, HJR1, HJR2, HJR3

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
State Land Office (SLO)
Children, Youth and Families Department (CYFD)

Responses Not Received From
Public Education Department (PED)

SUMMARY

Senate Joint Resolution 7 proposes to amend Article 8 Section 10 of the state Constitution to provide additional annual distributions from the Severance Tax Permanent Fund (STPF), equal to 0.8 percent of the fund's five-year average value, for the purposes of funding "early childhood education and care programs as provided by law." This would bring the total annual distribution from the fund to 5.5 percent of the rolling five-year average.

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

Early Childhood. If approved by voters in the next general election, this constitutional amendment will require enabling legislation to be used for early childhood education and care. Currently there is no specific plan as to how the additional funds for early childhood 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. The bill does not contain any 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 Children, Youth and Families Department (CYFD) indicated a concern with potential unreliable funding sources making maintenance of expanded early childhood programs difficult. However, this bill proposes making the additional 0.8 percent distribution permanent (e.g. has no expiration date). The current distributions have fluctuated some over time; however, the nature of the calculation for the distribution makes it possible to determine the likely distribution amount in advance of approval of operating budgets.

CYFD and the Public Education Department (PED) have not indicated how the additional funding provided by this bill will be utilized.

Severance Tax Permanent Fund. Currently, distributions from the STPF are made to the general fund in the amount of 4.7 percent of the five-year average of year-end market value of the fund. This amounted to $200 million in FY17. The distributions are not earmarked, instead they contribute to the overall general fund and are appropriated as needed by the Legislature just as other non-earmarked revenues. This proposal would earmark the 0.8 percent additional distribution for early childhood education (ECE) and care programs.

Assuming adoption by voters, this resolution would deliver significant revenue to the general fund from the STPF in coming years to fund early childhood education and care programs. However, the State Investment Council (SIC) states 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. 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. SIC states 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.

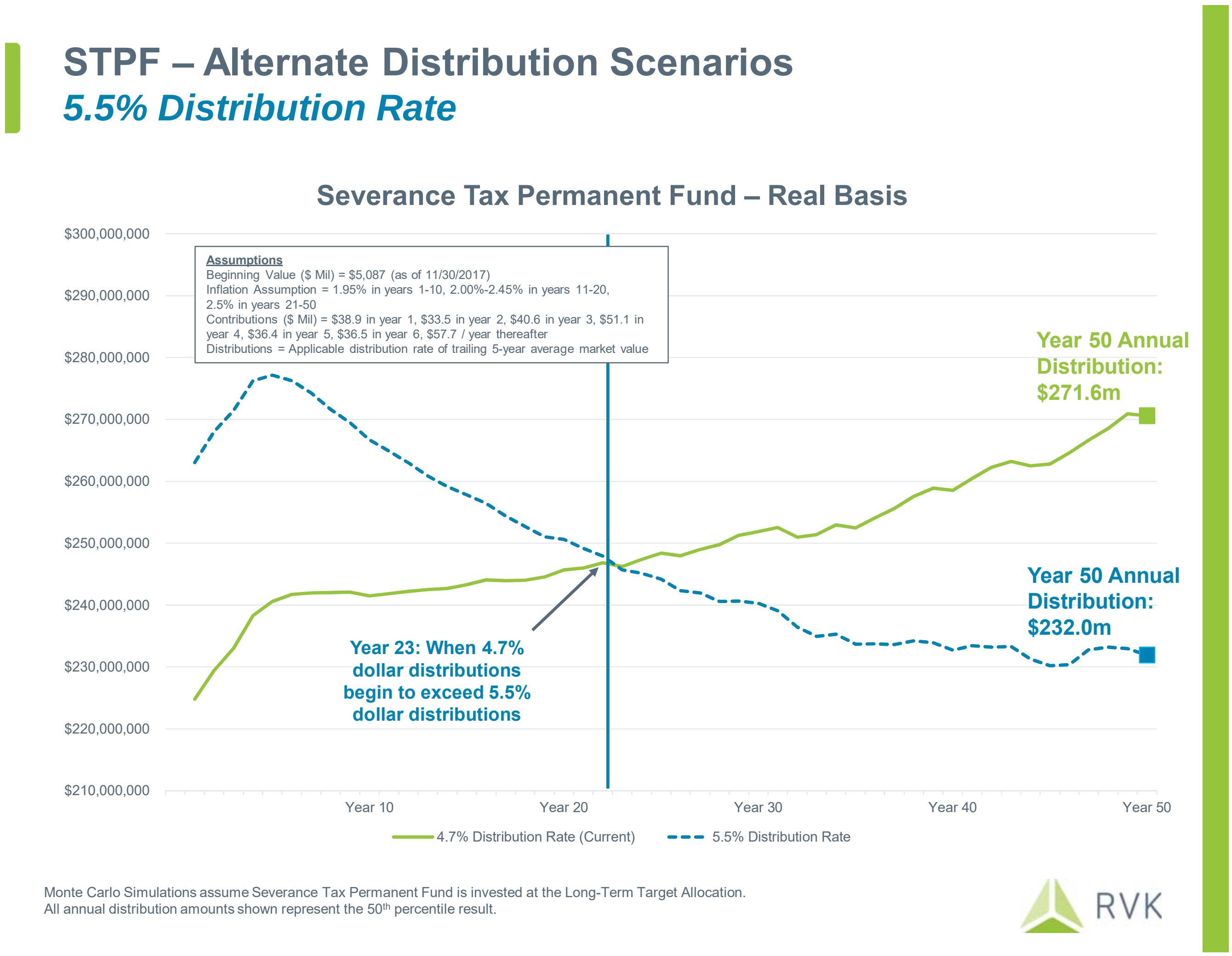
The additional 0.8 percent distribution would deliver a projected additional $448 million in excess distributions to the state over the next 12 years, and $619 million in excess distributions over the first 24 years. After 24 years, SIC projects the STPF will reach a "tipping point" in which the distributions from the 5.5 percent will be smaller than if the fund had been able to grow under the 4.7 percent distribution.

The following chart was provided by SIC, which tracks the first 30 years of additional distributions from the STPF pursuant to this bill. The projections are based on the following assumptions: December 31, 2017 value of the STPF at $5.109 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.

Calendar Year	Corresponding Fiscal Year	($B) STPF Value Current (4.7%)	STPF Distribution @4.7	($B) LGPF Value w/SJR7 (5.5%)	STPF Distribution @5.5%	Compounded Difference in 4.7% & 5.5% 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	$266,983,291	$38,833,933	**($0.02)**
2019	**2021**	5.414	$234,898,441	5.395	$274,667,567	$78,603,059	**($0.06)**
2020	**2022**	5.570	$244,630,898	5.510	$285,396,719	$119,368,880	**($0.10)**
2021	**2023**	5.728	$254,572,291	5.624	$295,884,206	$160,680,795	**($0.15)**
2022	**2024**	5.887	$261,886,490	5.735	$302,770,822	$201,565,127	**($0.20)**
2023	**2025**	6.047	$269,278,108	5.844	$309,186,404	$241,473,423	**($0.26)**
2024	**2026**	6.211	$276,766,627	5.954	$315,338,267	$280,045,063	**($0.31)**
2025	**2027**	6.378	$284,355,558	6.065	$321,437,272	$317,126,777	**($0.37)**
2026	**2028**	6.548	$292,058,078	6.176	$327,513,850	$352,582,549	**($0.43)**
2027	**2029**	6.721	$299,902,223	6.290	$333,616,257	$386,296,583	**($0.49)**
2028	**2030**	6.899	$307,905,303	6.404	$339,774,759	$418,166,039	**($0.56)**
2029	**2031**	7.080	$316,072,363	6.520	$345,998,758	$448,092,434	**($0.63)**
2030	**2032**	7.264	$324,408,081	6.637	$352,293,559	$475,977,912	**($0.70)**
2031	**2033**	7.453	$332,916,804	6.755	$358,662,328	$501,723,436	**($0.77)**
2032	**2034**	7.645	$341,602,566	6.875	$365,107,225	$525,228,095	**($0.84)**
2033	**2035**	7.842	$350,469,218	6.997	$371,629,745	$546,388,622	**($0.92)**
2034	**2036**	8.042	$359,520,593	7.120	$378,231,088	$565,099,117	**($1.00)**
2035	**2037**	8.247	$368,760,576	7.244	$384,912,339	$581,250,880	**($1.09)**
2036	**2038**	8.456	$378,193,115	7.370	$391,674,531	$594,732,296	**($1.17)**
2037	**2039**	8.670	$387,822,230	7.498	$398,518,675	$605,428,741	**($1.26)**
2038	**2040**	8.888	$397,652,020	7.627	$405,445,781	$613,222,502	**($1.35)**
2039	**2041**	9.110	$407,686,670	7.757	$412,456,862	$617,992,694	**($1.45)**
2040	**2042**	9.337	$417,930,450	7.889	$419,552,938	$619,615,182	**($1.55)**
2041	**2043**	9.569	$428,387,719	8.023	$426,735,042	$617,962,505	**($1.65)**
2042	**2044**	9.805	$439,062,926	8.159	$434,004,217	$612,903,796	**($1.75)**
2043	**2045**	10.047	$449,960,613	8.296	$441,361,521	$604,304,704	**($1.86)**
2044	**2046**	10.293	$461,085,417	8.434	$448,808,021	$592,027,308	**($1.97)**
2045	**2047**	10.545	$472,442,071	8.575	$456,344,798	$575,930,035	**($2.09)**
2046	**2048**	10.802	$484,035,407	8.717	$463,972,948	$555,867,576	**($2.20)**
2047	**2049**	11.064	$495,870,358	8.860	$471,693,578	$531,690,796	**($2.33)**
2048	**2050**	11.332	$507,951,959	9.006	$479,507,810	$503,246,647	**($2.45)**

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 SIC's fiduciary consultant RVK has provided the following graph to illustrate this "tipping point" concept, using inflation-adjusted dollar valuations. RVK's conclusion, which includes an inflation rider as well as more robust inflows based on projections from the State Board of Finance, is that the distributions of 4.7 percent catches up to the 5.5 percent distribution in year 23.



SIGNIFICANT ISSUES

Early Childhood Issues. New Mexico's early childhood care and education system begins prenatally and extends through age 8. Services for improving the health, safety, stability, and education of New Mexico's children span several state agencies, including the Children, Youth and Families Department (CYFD), the Department of Health (DOH), the Human Services Department (HSD), and the Public Education Department (PED).

Benefits of early childhood education include increased reading and math competency for low-income children, reduced special education designations, and more consistent utilization of early well-child visits, which should improve long-term outcomes for children. LFC's *2017 Early Childhood Accountability Report* found students who participated in New Mexico's prekindergarten program improved attendance and performance through the 5th grade. LFC has also found prekindergarten programs deliver a positive return on investment for New Mexico taxpayers based on improvement in test scores. Low-income students who participated in both prekindergarten and K-3 Plus closed the achievement gap by kindergarten entry.

In the last decade, appropriations for the Public Education Department's (PED) early childhood education programs have increased over tenfold, from about $5 million in FY07 for prekindergarten and K-3 Plus to $58.7 million for these two programs and an early reading initiative. For FY17, PED and the Children, Youth and Families Department (CYFD) were budgeted to serve 8,496 four-year-olds in state-funded prekindergarten. PED serves 5,273 children and CYFD serves 3,248. This does not include 997 three-year-olds served by CYFD in early prekindergarten.

K-3 Plus has been scientifically shown to improve student performance relative to peers when programs are executed correctly. However, there is concern the K-3 Plus program may not be implemented effectively at all schools. For increased gains, students should stay with the same teacher they had during the K-3 Plus program; however, this is not often the case. Further, more programs are now only making available 20 days of instruction rather than 25. LFC's *2017 Early Childhood Accountability Report* notes the intent of the program is not being followed and should raise concerns for policymakers that K-3 Plus is turning into summer school rather than a scientifically proven program to extend the school year for students from low-income families that need additional time-on-task to catch up to more affluent peers academically.

Additionally, the LFC report notes that currently, 3-year-old prekindergarten is only implemented by CYFD-funded private child care programs, and PED has raised concerns regarding the infrastructure and capacity of schools to expand prekindergarten to earlier ages and instead chose to focus on expansion of extended-day prekindergarten for 4-year-olds.

LFC estimates remaining statewide funding needs for all early childhood services is close to $190 million. To close service gaps and continue improving early childhood outcomes, targeted interventions are needed, such as focusing state-funded home-visiting services to at-risk, low-income families in high-need communities. Additional funding is needed to grow at a rate to both serve more clients and improve quality.

Despite a clear funding need, there are currently no specific details as to how the additional funds made available through this legislation 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. Accountability, program effectiveness and a standard evaluation process should be important considerations when establishing long-term public policy.

Severance Tax Permanent Fund. 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.

SIC notes that concerns over the 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 2015's HB236 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 million in severance taxes collected by the state), SIC indicates 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.

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 HJR 3, which seeks additional annual STPF 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 SJR11, which seeks to increase distributions by 1 percent to lengthen the school say and school year.

TECHNICAL ISSUES

Unlike previous constitutional amendments both passed and proposed regarding the state's permanent funds, SJR7 does not include any safeguards to suspend the additional distribution should the fund's balance drop below a specific value, or through a two-thirds vote by the legislature. Should market events precipitate a significant drop in the value of the fund, such a "safety valve" could be critical in protecting the corpus from additional damage at its most stressful time, where additional distributions could both amplify fund losses, and prevent fund recovery during a market rebound. The only alternative, lacking such a safety provision, would be to pass another constitutional amendment, which can be a very time-consuming and challenging process.

ALTERNATIVES

The State Land Office (SLO) indicates an alternative way to fund early childhood education without increasing permanent fund distributions would be to add additional land to the trust (i.e., increase the corpus of the trust). SLO states, “this is precisely the concept driving the proposal to transfer unleased federal mineral estate to the state land office for the purpose of funding early childhood education.”

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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 $5.11 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.

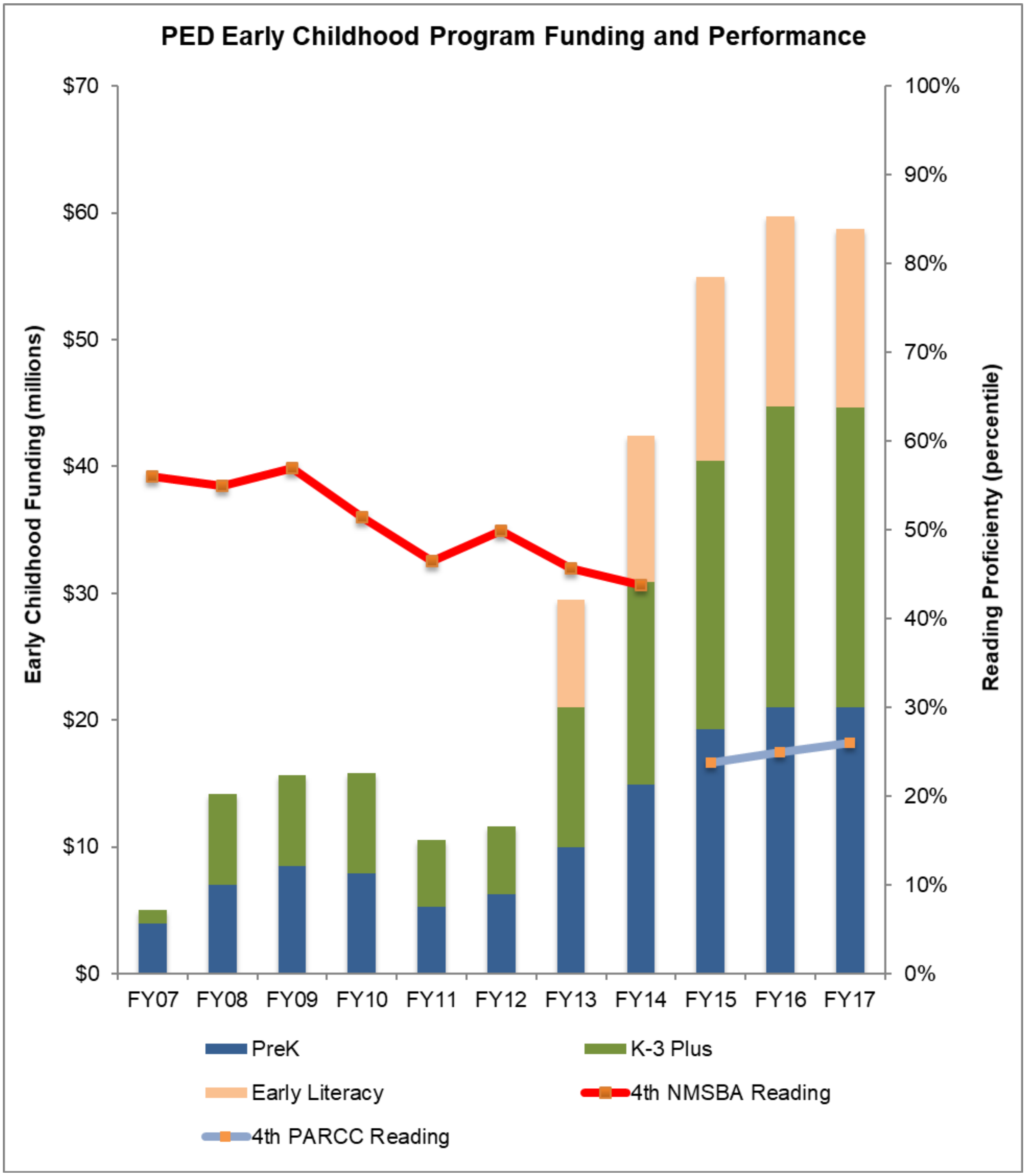
Distribution History

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.

APPENDIX B


PED Early Childhood Program Funding and Performance
Early Childhood Funding (millions)
$0
$10
$20
$30
$40
$50
$60
$70
Reading Proficienty (percentile)
0%
10%
20%
30%
40%
50%
60%
70%
80%
90%
100%
FY07
FY08
FY09
FY10
FY11
FY12
FY13
FY14
FY15
FY16
FY17
PreK
K-3 Plus
Early Literacy
4th NMSBA Reading
4th PARCC Reading