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## FISCAL IMPACT REPORT

ORIGINAL DATE 02/17/13  
 SPONSOR HAFC LAST UPDATED 03/12/13 HJR CS/13/aHF1#1  
 SHORT TITLE Minimum Land Grant Fund Balance, CA SB \_\_\_\_\_  
 ANALYST van Moorsel

### REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY16	FY17	FY18	FY19	FY20		
\$95,304.0	\$151,118.0	\$157,970.7	\$162,803.3	\$165,600.2	Recurring	General Fund
\$19,106.6	\$30,296.2	\$31,670.0	\$32,638.8	\$33,199.6	Recurring	Other LGPF Beneficiaries
(\$114,410.6)	(\$181,414.1)	(\$189,640.7)	(\$195,442.1)	(\$198,799.8)	Recurring	LGPF

(Parenthesis ( ) Indicate Revenue Decreases)

Conflicts with HJR 1, HJR 10, SJR3

### SOURCES OF INFORMATION

LFC Files

Responses Received From

State Investment Council (SIC)

State Land Office (SLO)

### SUMMARY

#### Synopsis of HF1 #1 Amendment

The House Floor #1 amendment to the House Appropriations and Finance Committee substitute for House Joint Resolution 13 requires that the \$10 billion floor for the five-year average of year-ending market values below which the additional distributions may not be made be adjusted annually for inflation.

The IHS-Global Insight forecast for the annual percentage change in the Consumer Price Index-All-Urban shows the projected inflation rate at approximately 2 percent in out years. At this rate of inflation, the projections for the additional LGPF distribution indicate that through 2035, the 5-year average of the LGPF balance will not fall below the constitutional floor, and the additional distributions would not be suspended.

Synopsis of Original Bill

The House Appropriations and Finance Committee substitute for House Joint Resolution 13 (HJR 13) proposes an amendment to Article, XII, Section 7 of the Constitution of New Mexico, which governs the distributions from the land grant permanent fund (LGPF). If approved by voters, the amendments to the constitution would make permanent the additional distribution of 0.5 percent of the five-year average of the year-end market value of the fund (currently scheduled to expire after FY16).

The amendments would also create an additional distribution of 1.0 percent of the five-year average of the year-end market value of the fund to begin in FY16. This additional distribution must be used for early childhood education nonsectarian services administered by the state for the benefit of children before they are eligible to attend kindergarten, as provided by law. The bill defines "early childhood education nonsectarian services" as nonsectarian services for children until eligible for kindergarten. Such services may be provided by a school district, a state contractor, a pueblo or tribal entity, the New Mexico School for the Blind and Visually Impaired (NMSBVI) or the New Mexico School for the Deaf (NMSD); provided that early childhood education nonsectarian services available from NMSBVI or NMSD shall not be delivered by a state contractor.

The total distribution rate proposed in HJR 13, compared with the current distribution rate, is as follows:

Land Grant Permanent Fund Distribution Rate			
FY	Current Rate	HAFC/HJR 13	Difference
2013	5.5%	5.5%	0.0%
2014	5.5%	5.5%	0.0%
2015	5.5%	5.5%	0.0%
2016	5.5%	6.5%	1.0%
2017	5.0%	6.5%	1.5%
2018	5.0%	6.5%	1.5%
2019	5.0%	6.5%	1.5%
2020	5.0%	6.5%	1.5%

HJR 13 would also amend the constitution to provide that no additional distributions above 5 percent may be made from the LGPF if the five-year average of the year-end market value of the fund is less than \$10 billion. The additional distributions not directed toward early childhood education be used to implement and maintain educational programs, rather than reforms, as provided by law.

The joint resolution requires that the proposed amendments be submitted to the people for their approval or rejection at the next general election or at any special election prior to that date that may be called for that purpose. The resolution also provides that the amendments proposed shall not become effective without the consent of the U.S. Congress.

**FISCAL IMPLICATIONS**

The impact of HJR 13 was estimated by assuming annual contributions into the fund of \$438 million, the four-year average for calendar years 2008-2011. Investment returns are assumed to

be the State Investment Council’s (SIC) long-term target of 7.5 percent, less 50 basis points for management fees. Holding these inputs constant, the effect of the increased distribution can be estimated, as shown in the revenue table above. It is noteworthy that, beginning in FY17, the additional distribution pursuant to HJR 13 is 1.5 percent over the distribution currently provided for in the constitution.

In the short term, additional contributions from the LGPF will produce more revenue to the general fund and other LGPF constitutional beneficiaries, primarily public education (83.3 percent). In the long term, and taking into consideration fund contributions from the oil and gas revenues, as well as expectations for general inflation and fluctuations in investment income, this proposal greatly increases the risk that the LGPF will not be able to continue to deliver the same benefits to the general fund and other beneficiaries as the Fund does today.

**This increased distribution will undoubtedly deplete the fund over time.** The additional distributions (estimated to total \$880 million for FY16-FY20) would reduce the balance in the fund available for investment, and (assuming positive returns on investment) reduce further growth in the fund. By 2020, the corpus of the fund is diminished by \$1.1 billion, and ten years after that, the negative impact has grown to almost \$4.7 billion. Further, beginning in FY20, the size of the excess distribution proposed in HJR 13 over the current distribution begins to diminish.

The SIC notes, as a point of reference, that HJR 13 would reduce the corpus of the LGPF on a greater scale than the most recent temporary additional distributions for educational reforms approved by the Legislature and public in 2003. Those additional distributions have reduced the LGPF corpus \$647 million for the 10 years they have been in place (FY05-FY14). This impact does not consider foregone investment earnings as a result of lower balances in the LGPF.

### SIGNIFICANT ISSUES

The decision to deplete an endowment is a policy decision rather than a financial dictum or “best practice”. The real question is whether the benefits of the expenditures will outweigh the benefits of greater income tomorrow.

The SIC provides a history of LGPF investment returns as of December 31, 2012. Below is a preliminary investment performance summary for the LGPF for the calendar year ending December 31, 2012. The drastic effects of financial market volatility during the 2008/2009 crisis continue to impact return averages, with the LGPF not achieving its 7.5 percent annualized return target for any long-term time period.

	<u>1-year</u>	<u>3-year</u>	<u>5-year</u>	<u>7-year</u>	<u>10-year</u>	<u>15-year</u>	<u>20-year</u>
<b>LGPF Return %</b>	<b>14.49</b>	<b>9.11</b>	<b>2.35</b>	<b>4.85</b>	<b>7.30</b>	<b>5.78</b>	<b>7.39</b>

The SIC adds it undertook an asset allocation study in 2011, concluding that without taking excessive risk, it could not achieve its previous annual target of 8.5 percent, and lowered the return target to 7.5 percent. Other institutional investors, including ERB and PERA in NM have also taken similar steps by lowering targets in recent years, with some peer funds around the country reducing long-term expectations to 7 percent, 6 percent or even lower.

When determining an appropriate asset allocation mix, the SIC in 2011 built a portfolio and investment strategy seeking to return 7.5 percent to the corpus of the fund, a number which on a conservative basis should be sufficient to cover 5 percent-5.5 percent annual distributions, protect against inflation, and provide a small measure of real fund growth. The growth is intended to be both a cushion for when inflation exceeds expected rates, as well as for years when investment returns or contributions from the Land Office fall short of expectations, and more importantly, the growth must serve to increase the fund's long-term purchasing power in preparation for the eventual day when natural resource contributions plateau, and then begin their inevitable decline.

## **RELATIONSHIP, CONFLICT**

Relates to SJR 1, which would require the SIC to invest and manage the LGPF in accordance with the Uniform Prudent Investor Act.

Conflicts with HJR 10 and SJR 3, which make similar changes to the LGPF distribution rate.

## **TECHNICAL ISSUES**

HJR 13 calls for 1.0 percent of the additional distributions to "...be used for early childhood education nonsectarian services administered by the state for the benefit of children before they are eligible to attend kindergarten, as provided by law."

While the LGPF is often referred to as the state's permanent educational endowment and has also been known as the "Permanent School Fund", it is not entirely composed of educational interests. In fact, more than 16 percent of the LGPF annual distributions go to beneficiaries outside the scope of "common schools".

This non-public school beneficiary pool is composed of: state universities at 5.9 percent (UNM, NMSU, ENMU, WNMU, NM Tech, Northern NM school, NM Highlands); 3.8 percent for specialty schools (NMMI, School for the Blind and Visually Handicapped, New Mexico School for the Deaf); 1.3 percent for health/hospitals; and 5.4 percent for "other" LGPF beneficiaries which include funding for public buildings, the state penitentiary, and water needs.

It is unclear how these beneficiaries would use the additional distributions to "...for early childhood education nonsectarian services administered by the state for the benefit of children before they are eligible to attend kindergarten, as provided by law."

## **ALTERNATIVES**

In reviewing how other top endowments around the country establish their spending and distribution policies, the SIC analyzed several of the largest university funds in the country. These are a few of those endowments with their respective spending policies:

- **University of Texas:** base of 4.5 percent, minimum of 3.5 percent, maximum of 5.5 percent
- **Yale:** 5 percent with a smoothing variable
- **Stanford:** target rate of 5.25 percent weighted with prior year's payout rate
- **Emory University:** floor of 4 percent, ceiling of 6 percent

- **Columbia University:** 4.5 percent of average market value
- **Texas A&M:** no more than 5 percent of the last 12 quarter rolling average of market values
- **Washington University:** 3 percent to 5.5 percent based on a five-year moving average
- **University of Pennsylvania:** 4.7 percent of a 3-year moving average
- **Vanderbilt University:** 5.2 percent of a 5-year moving average

Other sovereign wealth funds, like the Alaska permanent funds, have varying approaches. Alaska distributes a dividend to its residents annually based on income earned by its funds, but is seeking a change which would limit annual spending to 5 percent of its permanent fund market value.

Wyoming, which also benefits from a multi-billion dollar permanent fund created through its natural resources and extractive industries, currently distributes 5 percent of its 5-year-rolling average, similar to New Mexico.

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