LEGISLATIVE EDUCATION STUDY COMMITTEE
BILL ANALYSIS

Bill Number: **SJR 12** **51st Legislature, 2nd Session, 2014**

Tracking Number: **.195592.2**

Short Title: **Land Grant Fund Balance & Education, CA**

Sponsor(s): **Senators Michael S. Sanchez and Michael Padilla**

Analyst: **Kevin Force** **Date:** **February 5, 2014**

Bill Summary:

SJR 12 proposes to amend Article XII, Section 7 of the Constitution of New Mexico to change the annual distribution from the Land Grant Permanent Fund (LGPF). Specifically, SJR 12 would:

- make permanent an additional 0.5 percent distribution of the year-end market value of the fund to implement and maintain educational reforms;
- establish an additional 1.5 percent distribution beginning in FY 17 for nonsectarian early childhood education programs administered by the state for children prior to kindergarten eligibility;
- defines "nonsectarian early childhood education programs as:

> "[N]onsectarian 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 or the New Mexico school for the deaf; provided that nonsectarian early childhood education services available from the New Mexico school for the blind and visually impaired or the New Mexico school for the deaf shall not be delivered by a state contractor;"

- increase the LGPF "failsafe value" that would suspend increased distributions to $ 10.0 billion from $5.8 billion; and
- add a contingent effective date, stipulating that the constitutional amendment proposed in SJR 12 will not become effective without the consent of the US Congress.

For FY 17 and thereafter, SJR 12 proposes an additional 1.5 percent distribution to be made to the beneficiaries of the LGPF (see "Background," below), with specific earmarks that the additional 1.5 percent "be used for nonsectarian early childhood education programs administered by the state."

Thus, the total distribution rate proposed in SJR 12, compared with the current distribution rate, is as follows:

Land Grant Permanent Fund Distribution Rate			
Fiscal Year	**Current Rate**	**SJR 12**	**Difference**
2014	**5.5 percent**	**5.5 percent**	**0.0 percent**
2015	**5.5 percent**	**5.5 percent**	**0.0 percent**
2016	**5.5 percent**	**5.5 percent**	**0.0 percent**
2017	**5.0 percent**	**7.0 percent**	**2.0 percent**
2018	**5.0 percent**	**7.0 percent**	**2.0 percent**
2019	**5.0 percent**	**7.0 percent**	**2.0 percent**
2020	**5.0 percent**	**7.0 percent**	**2.0 percent**
2021	**5.0 percent**	**7.0 percent**	**2.0 percent**
2022	**5.0 percent**	**7.0 percent**	**2.0 percent**
2023	**5.0 percent**	**7.0 percent**	**2.0 percent**

As a joint resolution proposing to amend the constitution, SJR 12 must not only be passed by the Legislature, but also approved by the voters.

Fiscal Impact:

SJR 12 does not contain an appropriation.

According to the Fiscal Impact Report (FIR), offered by the Legislative Finance Committee (LFC), fiscal impact would be as projected in the following table:[1]

Estimated Revenue					**Recurring or Nonrecurring**	**Fund Affected**
FY15	**FY16**	**FY17**	**FY18**	**FY19**		
0.0	0.0	$53,434.6	$58,133.3	$61,698.2	Recurring	General Fund (Ed. Reforms)
0.0	0.0	$10,944.4	$11,906.8	$12,637.0	Recurring	Other Beneficiaries (Ed. Reforms)
0.0	0.0	$160,303.7	$174,399.8	$185,094.5	Recurring	General Fund (Early Childhood)
0.0	0.0	$32,833.3	$35,720.4	$37,910.9	Recurring	Other Beneficiaries (Early Childhood)
0.0	**0.0**	**$213,738.2**	**$232,533.0**	**$246,792.7**	**Recurring**	**Total General Fund**
0.0	**0.0**	**$43,777.7**	**$47,627.2**	**$50,547.9**	**Recurring**	**Total Other Beneficiaries**

(Parenthesis ( ) Indicate Revenue Decreases)

[1] Assuming 7.5 percent investment returns, less 0.50 percent fund management fees, and based on three-year rolling average, updated annually.

Fiscal Issues:

According to the FIR, the increased distributions proposed by SJR 12 would deplete the fund over time:

- the additional distributions (estimated to total $835 million for FY 17 through FY 19) would reduce the balance in the fund available for investment;
- assuming positive returns on investment, the distribution would reduce further growth in the fund;
- by 2020, the corpus of the fund will have been diminished by $1.46 billion;
- by 2030, the negative impact will have grown to almost $6.8 billion; and
- beginning in FY 22, the size of the excess distribution proposed in SJR 12 over the current distribution begins to diminish.

Further, LFC staff also note:

- The majority of the additional 1.5 percent distribution is intended to fund early childhood education programs.
- Combined state and federal funding for early childhood programs to the Public Education Department (PED), the Children, Youth and Families Department, the Human Services Department, and the Department of Health has steadily increased in recent years:

  - FY 12 funding for these programs totaled $137 million;
  - $165.9 million in FY 13;
  - $205.2 million in FY 14; and
  - the LFC recommendation for FY 15 funding is $239.7 million.

According to the State Investment Council (SIC):

- In the short term, additional contributions from the LGPF will produce more revenue to the General Fund and other LGPF beneficiaries, primarily public education.
- In the long term, however, considering fund contributions from the oil and gas revenues, as well as expectations for general inflation and fluctuations in investment income, SJR 12 would increase the risk that the LGPF may fail to deliver the same benefits to the General Fund and other beneficiaries as it does today.
- Assuming the achievement of the SIC's targeted annual rates of return of 7.5 percent, and average inflows from the State Land Office (SLO), the Land Grant Fund will grow to approximately $15.2 billion at the end of calendar year 2015.
- Under current constitutional mandate, the LGPF will distribute approximately $624 million.
- Under the proposed amendment:

  - the distribution would grow to $930 million, an increase of $258 million in the first year (FY 17) of the increased distribution alone;
  - in FY 18, the *additional* distribution would be approximately $258 million, above the anticipated $700 million in LGPF transfers;
  - in FY 19, distributions would reach the $1.0 billion mark for the first time, providing an additional $298 million to the fund and beneficiaries; and

- in the first three years, SJR 12 would result in the additional distribution of $837 million of LGPF corpus, not including the $2.1 billion currently estimated to be distributed from the fund over those three years, pursuant to the current mandated rate of 5.0 percent distribution.

- The table below illustrates the performance summary of the LGPF as of November 30, 2013:

Returns as of 11/30/13	**1 Year**	**3 Years**	**5 Years**	**10 Years**	**15 Years**
Land Grant Total Fund Composite – Gross	**16.27**	**10.68**	**12.40**	**6.98**	**5.76**

Regarding the implications of these figures, the SIC indicates that:

- In addition to extremely strong investment returns over the last five years relative performance has improved among peer-funds as well, climbing from the low 4th quartile to the top third, and above the median for 1, 2, 3, 4, and 5 year time periods.
- While last year's returns were more than double the annual investment target, such performance is not something the SIC anticipates with consistency moving forward.
- Even with the recovery from the 2008 recession, the LGPF's annualized returns for longer time periods of 10 and 15 years show returns far below the annual target of 7.5 percent.
- Depending on LGPF inflows from the SLO, the rate of inflation, which is anticipated to grow, and investment returns, it is reasonable to assume that, under the 7.0 percent distribution rate contemplated by SJR 12, the LGPF would have suffered damage to its corpus over many of the previous 10 or 15 years.
- The fiscal crisis of 2008 illustrated the impact of a market downturn when combined with an aggressive spending policy or an impaired funding matrix. The differences in the LGPF and Severance Tax Permanent Fund (STPF) offer a prime example of this:

  - Today, the LGPF has recovered from 2008 and its balance is more than 17 percent better than its 2007 high water mark.
  - The STPF, however, with a less aggressive spending policy at 4.7 percent, remains more than 10 percent *below* its all-time highs, five years after the crisis.
  - The primary reason for this difference in the funds lies in the fact that the LGPF receives monthly inflows which are reinvested steadily over time, while the STPF receives inconsistent and minimal infusions once or twice a year, of 0.0 to 5.0 percent of the state's hundreds of millions in annual severance taxes.
  - Changes to the STPF's funding formula during the 1990s and 2000s have resulted in a fund which is currently unable to grow long-term, even under a very fruitful investment environment.

- In recent years, the SIC has taken a less aggressive investment approach than was previously the case, reducing its annual return target to a more conservative and realistic 7.5 percent return, from the previous 8.5 percent:

- ➢ The decision to increase diversification and lower investment risk (and reduce the risk-adjusted return target) was based on an extensive asset allocation study and guidance of investment consultants, and mirrored many institutional investors around the country.
- ➢ Assuming current distributions, average market returns, low to mild inflation rates, and continued strong contributions from oil and gas, the SIC believes it can continue to maintain or slightly grow the inflation-adjusted value of the LGPF over time, providing equal or greater benefit to tomorrow's generations of New Mexicans than it does to those today. Changes to any of those variables (returns, inflation, inflows or distributions) increases the risk that the LGPF will not be able to perform as a permanent endowment should.

Substantive Issues:

Although focused not on SJR 12, but on the similar HJR 15 (2012), Attorney General Opinion No. 12-03, dated February 1, 2012, directly addresses some of the issues raised by SJR 12. According to the Attorney General (AG):

- In 1996, New Mexico voters adopted amendments to Article XII, Section 7 of the constitution, which were approved by Congress with amendments to the act, stating, "distributions from the trust fund shall be made according to Article XII, Section 7."[2]
- Thus, it appears that changes to how the funds are distributed may be made as long as it is accomplished by amendments to Section 7 and the funds are used for purposes permitted by the *Enabling Act*.
- The use of any increased distribution for early childhood learning programs is limited to programs *provided by the public schools*.

Additionally, the Legislative Council Service appears to agree with the opinion expressed by the AG:

- Sections 6 through 9 of the federal *Enabling Act of 1910* "require that any change in the use of the trust must be consented to by Congress."[3]
- Prior to 1997, this was indeed the case; however, as noted above, Congress approved amendments to several sections[4] of the *Enabling Act* in 1997, one of which specified that future *distributions* "shall be made as provided in Article XII, Section 7 of the Constitution of the State of New Mexico" (emphasis added).
- While these amendments to the *Enabling Act* do permit changes to the distributions of the LGPF, Congress did not amend Section 8 of the *Enabling Act*, which states that:

[2] See Public Law 105-37, 105th Congress, August 7, 1997.
[3] *Piecemeal Amendment of the Constitution of New Mexico, 1911-2006*, Richard H. Folmer (Seventeenth Revision (January 2007)), for the New Mexico Legislative Council Service.
[4] The sections of the *Enabling Act* amended in 1997 were:

- Sec. 7. University and internal improvement land grants; school fund;
- Sec. 9. Common school fund; and
- Sec. 10. Grants of public lands held in trust; sale or lease; price; restrictions; water power reservations; lieu sections; national forests.

> "The schools, colleges, and universities provided for in this act shall forever remain under the exclusive control of the said state, and no part of the proceeds arising from the sale or disposal of any lands granted herein for educational purposes shall be used for the support of any sectarian or denominational school, college or university."

Given these provisions of the Constitution of New Mexico and the *Enabling Act of 1910*, it is unlikely that amendments that include changes to the beneficiaries of the LGPF, or specific allocations to those beneficiaries or to the programs within their purview, would fall within those distributions approved by Congress in the 1997 amendments to the *Enabling Act*, particularly those changes that potentially benefit private or sectarian institutions not under the exclusive control of the state.

The AG has addressed issues similar to those raised by SJR 12 previously. In an advisory letter dated March 6, 2003, the AG expressed serious reservations about any proposed amendment to the New Mexico constitution that seeks to increase the distribution rate of the LGPF without Congressional approval:

- The Supremacy Clause in Article VI of the US Constitution provides that federal law prevails over conflicting state law.
- Any federal law that appears to conflict with New Mexico law may give rise to expensive, lengthy litigation, with no guarantee of a favorable outcome.
- Without Congressional consent, the *Enabling Act* may conflict with proposed elevated distribution levels on several grounds:
  - Congress approved the 1996 amendments to the Constitution of New Mexico, which did not appear to endanger the Permanent School Fund;
  - Congress may withhold its approval of higher distribution rates, however, because the rates may conflict with existing safeguards for trust funds in the act;
  - the Congressional law enacted to approve the 1996 amendments was explicitly intended to "protect the permanent trust funds of the State of New Mexico from erosion"; and
  - this express purpose weighs against any theory that New Mexico now has plenary power to expend trust money without seeking Congressional approval.
- The most prudent course is to seek Congressional approval, by requiring that any joint resolution proposing to alter current distribution rates be made contingent upon approval of the US Congress.

As noted by the SIC:

- SJR 12 includes a "safety valve" intended to protect the fund from additional distributions during times of financial duress should the five-year average of the fund drop below $10.0 billion at the end of any calendar year.
- This valve has an inflationary slide that will increase its value over time in line with the Consumer Price Index (CPI).
- The fund's five-year average only met the $10.0 billion threshold for the first time, as of December 31, 2013, when the five-year mark rose to $10.8 billion. However, the previously depressed five-year calculation jumped significantly this year due to the removal of the 2008 figure from the rolling average.

- Should the LGPF balance experience a historic drop as it did between 2007 and 2008, the safeguard would not be triggered:

  - If the LGPF lost 50 percent of its value year over year, the safety net would still not deploy, and additional distributions would continue.
  - It would require an estimated year-over-year loss of approximately $9.0 billion, or almost two-thirds of the LGPF, to invoke the suspension and terminate the additional 2.0 percent distribution for just a single year.
  - Moreover, intra-year valuation drops would also not trigger the safeguard, because the five-year average is only determined by asset values as of December 31 of the calendar year.

According to the SLO:

- if all variables other than the distribution rate were held constant, the proposed increase in distribution levels would result in the beneficiaries receiving approximately $2.0 billion more in total distributions during the next 10 years, and approximately $6.7 billion less in total distributions over the next 50 years.
- The joint resolution proposes to increase the floor for distribution from the fund to $10.0 billion, and would increase this threshold based on the CPI, which would partly address issues about protecting the corpus of the fund, from the effects of inflation.
- Inflation protection was the primary purpose of the 1996 constitutional amendment, and subsequent *Enabling Act* amendment, which ended the practice of distributing *all* LGPF investment income, and instead established the 5.0 percent distribution level.
- Assuming an inflation adjustment to the $10.0 billion floor of 3.0 percent per year, the ending market value of the fund would fall below the inflation adjusted floor in about 33 years, or FY 47.
- New Mexico ranks 50th in the nation in terms of child well-being, with about 30 percent of the state's children living below the poverty line. Adequate investment in early childhood education and other important educational initiatives is a critical component in reversing this trend.
- About 94 percent of the revenues earned by SLO go to support education, and although the SLO has earned record levels of revenue over the last several years to contribute to the growth of the LGPF, these levels are unlikely to be sustainable in the long term, as much of this revenue is derived from the depletion of non-renewable resources. Thus, it is important to ensure that the value of LGPF is maintained at a level that provides distributions to existing beneficiaries while preserving the ability of the LGPF to support future beneficiaries.
- The fund derives from the *Enabling Act* grant made specifically to support "common schools," with permanent school fund income historically being used to support schools falling within the traditional definition of "common schools" (*i.e.*, compulsory and universal primary and secondary education). Thus, by directing that the additional distributions be used for early childhood education, the amendment would significantly expand the range of programs to be supported by the original grant.

Technical Issues:

According to the SIC:

- SJR 12 specifies that 1.5 percent of the additional annual LGPF distributions shall be used for early childhood education programs, yet more than half of the LGPF beneficiaries listed in the table below are either not educational facilities or have a mission completely unrelated to early childhood education.

Institutions	LGPF Ownership	ECE Focus
Public schools	83.95%	Y
NM Military Institute	3.29%	N
NM School for the Deaf	1.99%	?
School for Blind & Visually Impaired	1.99%	?
NM State Penitentiary	1.98%	N
University of New Mexico	1.45%	?
Public buildings	1.10%	N
Water reservoir	1.08%	N
DHI Miners Hospital	0.95%	N
Penal reform	0.86%	N
NM State University	0.46%	?
NM State Hospital	0.25%	N
Improvement of the Rio Grande	0.24%	N
NM Institute of Mining & Technology	0.20%	N
Eastern NM University	0.08%	?
UNM Saline Lands	0.04%	N
Western NM University	0.03%	?
NM Highlands University	0.03%	?
Northern NM Community College	0.02%	?
NM Boys School	0.01%	?
Carrie Tingley Hospital	0.00%	N

- Given the wording of SJR 12, it is possible that these beneficiaries would not be able to access legally the additional distribution amount, and the mandate might also present significant challenges for those beneficiaries outside the core "common schools" scope, which today "own" 16 percent of the LGPF.
- While SJR 12 is silent regarding who would be responsible for regulating the additional disbursements, if measures enforcing early childhood education-only spending are adopted, or additional funding is denied to some beneficiaries, there is a possibility that legal actions would ensue.
- However, if these beneficiaries are allowed to share the additional distribution without limitation to early childhood education, as they currently do with the ongoing 0.5 percent distribution for "educational reforms," this, too, would appear to violate both the letter and spirit of the New Mexico constitution.

Background:

According to the SIC:

- Nationally, permanent endowments such as the LGPF follow generally accepted distribution and spending policies, the most widely followed of which allows for annual distributions of between 3.0 and 5.0 percent of the corpus of the fund.

- Some state funds prohibit increased distributions altogether; others only allow increases for extreme emergency situations for which other funding is not available.
- As the principal of the LGPF grows, annual distributions will automatically increase – even if the percent distributed remains the same, allowing educational institutions and early childhood programs will benefit from those increased amounts, and share in a much greater benefit as time goes on.
- The principal of the fund must increase in order to offset potential inflationary impact.
- The principal of the fund must increase in anticipation of inevitable (in the LGPF's case) diminished contributions due to the finite nature of our state natural resources.
- Even if the investment returns plus annual contributions to the fund increase, invading the principal arguably is not prudent. As noted, the fund was established in order to assure intergenerational equity, yet contributions from New Mexico's public lands and their underlying resources will likely decrease over time, as minerals are depleting resources, and the revenues they generate must become part of the principal of the endowment so earnings from those revenues can continue to provide funding for education and other needs in the years after the resources are themselves exhausted.
- If distributions from the permanent funds were increased to the suggested level, the SIC, as fiduciaries for the fund, would be required to accept increased investment risk in order to achieve the returns necessary to permit that level of payout, possibly exposing council members and staff to personal liability.

According to the SLO:

- As originally conceived, the LGPF was to be invested only in interest-bearing securities, and *all* of the interest earned (and only the interest earned) was distributed. Thus, the LGPF was truly "permanent" because none of the corpus of the fund was distributed, except when due to the effect of inflation eroding the true value of the fund.
- When the *Enabling Act* and the New Mexico constitution were amended in the mid-1990s to allow investment of the LGPF in other kinds of securities, and set the annual distribution at 5.0 percent, the primary goal was to protect the corpus of the LGPF against inflation.[5]
- Increases in the distribution percentage such as those proposed by SJR 12 raise questions about whether the LGPF is still truly a "permanent" fund where the corpus is being preserved and only income distributed.

As noted above, the last changes to Article XII, Section 7 occurred in 2003, when voters approved a constitutional amendment to:

- increase the annual distribution from the LGPF to the fund's beneficiaries (including public schools) from 4.7 percent to 5.0 percent of the average of the year-end market values of the fund for the immediately preceding five years;
- provide an additional 0.8 percent annual distribution from FY 05 to FY 12 (for a total distribution of 5.8 percent) and an additional 0.5 percent annual distribution from FY 13 to FY 16 (for a total distribution of 5.5 percent) to be used for education reform as provided by law;

[5] *See* Pub. L. No. 105-37, 111 Stat. 1113 (*Enabling Act* amendment "to protect the permanent trust funds of the State of New Mexico from erosion due to inflation and modify the basis on which distributions are made from those funds").

- provide that the above additional distributions shall not be made in any fiscal year if the average of the year-end market values of the fund for the immediately preceding five calendar years is less than $5.8 billion;
- authorize the Legislature, by a three-fifths' vote of the members of each house, to suspend any of the above additional distributions; and
- revert the distribution to 5.0 percent in FY 17.

At that time, the increased distribution was considered conservative, and it was not expected to erode the corpus of the fund.[6]

The LGPF beneficiaries and their respective percent ownership are shown below:

Institutions	**Percentage LGPF ownership**
Common Schools	83.20
NMMI	3.38
NM School for the Deaf	2.07
School for the Visually Handicapped	2.06
NM State Penitentiary	2.02
UNM	1.60
Public Bldgs. Cap., Inc.	1.17
Water Reservoir	1.15
DHI Miners Hospital	1.04
Char. Penal and Reform	0.91
NMSU	0.50
Improve Rio Grande	0.27
NM State Hospital	0.24
NM Inst. Mining and Technology	0.21
ENMU	0.08
WNMU	0.03
NM Highlands	0.03
Northern NM College	0.02
NM Boys School	0.01
UNM Saline Lands	0.01
Carrie Tingley Hospital	0.00
Total	100.00

Committee Referrals:

SRC/SJC/SFC

Related Bills:

HJR 3 *Land Grant Fund for Education Reforms, CA*
SJR 4 *Land Grant Fund Care & Investments, CA*

[6] *CONSTITUTIONAL AMENDMENTS PROPOSED BY THE LEGISLATURE IN 2003, 0.03 APPEARING ON THE SEPTEMBER 23, 2003 SPECIAL ELECTION BALLOT, Brief Analysis and Arguments For And Against*, New Mexico Legislative Council Service, June 2003