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

SPONSOR Sanchez, M. **ORIGINAL DATE** 02/01/14 **LAST UPDATED** **HB**

SHORT TITLE Land Grant Fund Balance & Education, CA **SJR** 12

ANALYST van Moorsel

REVENUE (dollars in thousands)

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)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY14	FY15	FY16	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		$46.0			Nonrecurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to SJR 3 – Land Grant Fund Care & Investments, CA; HJR 3 – Land Grant Fund for Education Reforms, CA.

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
State Land Office (SLO)
Public Education Department (PED)

SUMMARY

Synopsis of Bill

Senate Joint Resolution 12 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 an additional distribution of 0.5 percent of the five-year average of the year-end market value of the fund to "implement and maintain educational reforms as provided by law"; and
- create an additional 1.5 percent distribution beginning in FY17 to be used for "nonsectarian early childhood education programs administered by the state for the benefit of children before they are eligible to attend kindergarten." These nonsectarian 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

The amendment proposed in the joint resolution provides that the additional distributions would not be made from the LGPF if the five-year average of the year-end market value of the fund is less than $10 billion, adjusted for inflation each July 1.

The constitution currently provides for a 5.5 percent distribution through FY16, and a 5.0 percent distribution beginning in FY17. The additional distributions pursuant to SJR 12, depicted in the chart below, would take effect FY17 and onward.

Senate Joint Resolution 12			
Fiscal Year	Current Rate	SJR 12	Difference
2014	5.5%	5.5%	0.0%
2015	5.5%	5.5%	0.0%
2016	5.5%	5.5%	0.0%
2017	5.0%	7.0%	2.0%
2018	5.0%	7.0%	2.0%
2019	5.0%	7.0%	2.0%
2020	5.0%	7.0%	2.0%
2021	5.0%	7.0%	2.0%
2022	5.0%	7.0%	2.0%
2023	5.0%	7.0%	2.0%

The amendment proposed by this resolution shall 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. To become effective, the amendment would require the consent of the U.S. Congress.

FISCAL IMPLICATIONS

Under Section 1-16-13 NMSA 1978 and the NM constitution, the SOS is required to print samples of the text of each constitutional amendment, in both Spanish and English, in an amount equal to ten percent of the registered voters in the state. The SOS is also required to publish them once a week for four weeks preceding the election in newspapers in every county in the state. In 2012, the cost for the 2012 General Election ballots was $46,000 per constitutional amendment. However, if the ballot size is greater than one page, front and back, it would increase the cost of conduction the general election. In addition to the cost of the ballot here will be added time for processing voters to vote and would mean additional ballot printing systems would be required to avoid having lines at voting convenience centers.

The impact of SJR 12 was estimated by assuming annual contributions into the fund are equal to the three-year average of royalties paid. 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.

In the short term, additional contributions from the LGPF will produce more revenue to the general fund and other LGPF constitutional beneficiaries. Public education, the largest of the beneficiaries, accounts for approximately 83 percent of the distribution from the fund. 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 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 $835 million for FY17-FY19) 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 $1.46 billion, and ten years after that, the negative impact has grown to $6.8 billion. Further, beginning in FY22, the size of the excess distribution proposed in SJR 12 over the current distribution begins to diminish.

Given the assumptions listed above, the five-year average of the year-end market value of the balance in the fund never falls below the minimum $10.0 billion level, thus suspending the additional distribution.

SIGNIFICANT ISSUES

The majority of the additional distribution is intended to fund early childhood education programs. Combined state and federal funding for early childhood programs to PED, the Children, Youth and Families Department, the Human Services Department, and the Department of Health has steadily increased in recent years. FY12 funding for these programs totaled $137 million, increasing to $165.9 million in FY13, and $205.2 million in FY14. The LFC recommendation for FY15 funding is $239.7 million (see attachment).

A 2003 constitutional amendment provided for 0.8 percent additional distribution of the LGPF from FY06 through FY12, and a 0.5 percent additional distribution from FY13 through FY16. The 2003 constitutional amendment required that the additional distribution from the permanent school fund be used to implement educational reforms. The proposed amendment would make the additional 0.5 percent distribution permanent.

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. Below is a preliminary investment performance summary for the LGPF as of November 31, 2013. 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.

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**

In addition to strong investment returns over the last 5 years, the SIC's relative performance has improved among its peers, climbing from low 4th quartile to top third and above median for the one, two, three, four, and five-year periods.

While last year's performance was more than double its annual investment target, such performance is not something the SIC anticipates with consistency moving forward. Even with the bounce back from the 2008 financial meltdown, the LGPF's annualized returns for longer time periods of 10 and 15 years show investment returns far below the annual target of 7.5 percent. Depending on LGPF inflows from the State Land Office, the rate of inflation (anticipated to grow), and investment returns, it is a reasonable assumption that under the 7 percent distribution rate contemplated by SJR12, the LGPF would have suffered damage to its corpus over many of the previous 10 or 15 years.

The fiscal crisis of 2008-09 showed the impact of a market downturn when combined with an aggressive spending policy and/or impaired funding matrix. The SIC notes institutional funds with broken or substandard endowment models have a far greater challenge in meeting long-term growth goal and are far more susceptible to being damaged or even crippled by a market shock incident, which investors have experienced twice in just the past 15 years.

It has been suggested that to counter an increased spending policy, the SIC may have to take an equally aggressive investment approach to be able to maintain the corpus of the fund. The past few years the SIC has taken the opposite approach however, 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 risk-adjusted return target) was based on an extensive asset allocation study, guidance of investment consultants, and also 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, so that it may provide the same or greater dollar for dollar benefit to tomorrow's generations of New Mexicans as it does to those today. Changes to any of those variables (returns, inflation, inflows or distributions), materially increases the risk that the LGPF will not be able to perform as a permanent endowment is intended to.

The State Land Office cautions that while last several years have seen the SLO earn record levels of revenue that have contributed to the significant growth of the LGPF, these contribution levels are likely unsustainable over the long run as much of this revenue is derived from the depletion of a non-renewable resource. SLO adds it is important to ensure that the value of LGPF is maintained at a level that provides distributions that benefit existing beneficiaries while preserving the ability of the LGPF to support our beneficiary institutions in the future. Increases in the distribution percentage raise questions as to whether the LGPF is still truly a "permanent" fund where the corpus is being preserved and only income is being distributed.

The SIC provides other basic issues to consider, relative to the permanency of the LGPF and best practices in deployment and use of such permanent endowments and trust funds:

- The LGPF is a permanent endowment fund. Nationally, permanent endowments follow generally accepted distribution policies/spending policies. The most widely followed policy allows annual distributions of between 3 to 5 percent of the corpus/principal 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. <u>Educational institutions and early childhood programs will benefit from those increased amounts, and share in a much greater benefit as time goes on.</u>
- 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, reducing the principal is arguably not prudent. The fund was established (and should be held inviolate) in order to assure intergenerational equity. Contributions from NM's public lands and their underlying resources will likely decrease over time; minerals are depleting resources and the revenues they generate must become part of the principal of the endowment so earnings from those revenues can provide funding for education and other needs in the years after the resources are 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. Council Members and SIC staff could be exposed to personal liability by accepting such risk. Fund assets/principal could be subject to sub-optimal returns as a result of incurring such risk.

TECHNICAL ISSUES

SJR 12 calls for the additional 0.5 percent and 1.5 percent distributions to be used to "implement and maintain educational reforms as provided by law," and to be used for "nonsectarian early childhood education programs administered by the state for the benefit of children before they are eligible to attend kindergarten," respectively. 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 17 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 Visually Handicapped, 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 "implement and maintain educational reforms as provided by law," or for "nonsectarian early childhood education programs administered by the state for the benefit of children before they are eligible to attend kindergarten."

The SIC notes this same issue, adding the wording of the joint resolution creates a possibility these beneficiaries would not be able to legally access the additional distribution amount, and the mandate might also present significant challenges for all beneficiaries outside the core "common schools" scope, which today "own" approximately 17 percent of the LGPF.

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.

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

PvM/ds:jl

Early Childhood Program Appropriations (in millions)

		FY12 Actuals	FY13 Actuals	FY14 Operating	FY14 LFC Revised[1]	FY14 Executive Revised[2]	FY15 LFC Rec	
1	**Children, Youth, and Families Department - Early Childhood Services Programs**							1
2	**Childcare Assistance**							2
3	General Fund	$26.8	$29.8	$33.3	$33.3	$33.3	$33.3	3
4	Federal Funds	$30.4	$31.6	$31.6	$31.6	$31.6	$33.2	4
5	OSF	$0.8	$1.4	$0.8	$0.8	$0.8	$0.8	5
6	USDA E&T	$0.6	$0.6	$0.6	$0.6	$0.6	-	6
7	TANF	$24.3	$23.8	$27.3	$27.3	$27.3	$30.6	7
8	Tobacco Settlement Fund	-	-	$2.0	$2.0	$2.0	-	8
9	**Total Childcare Assistance**	**$82.9**	**$87.2**	**$95.6**	**$95.6**	**$95.6**	**$97.9**	9
10								10
11	**Home Visiting**							11
12	General Fund	$2.3	$3.2	$5.0	$5.0	$5.0	$7.5	12
13	Federal Funds	-	$2.7	$1.1	$1.1	$1.1	$1.1	13
14	TANF	-	-	-	-	-	$2.0	14
15	Tobacco Settlement Fund	-	-	$2.0	$2.0	$2.0	-	15
16	**Total Home Visiting**	**$2.3**	**$5.9**	**$8.1**	**$8.1**	**$8.1**	**$10.6**	16
17								17
18	**Early Childhood Education**							18
19	General Fund	**$0.5**	**$0.5**	**$0.5**	**$0.5**	**$0.5**	**$1.2**	19
20								20
21	**Prekindergarten**							21
22	General Fund	$8.2	$9.2	$9.2	$9.2	$13.4	$11.2	22
23	General Fund transfer from PED	-	-	-	-	-	-	23
24	TANF			-	$4.6	-	$6.1	24
25	Tobacco Settlement Fund	-	-	$5.8	$1.2	$1.6	-	25
26	**Total PreK**	**$8.2**	**$9.2**	**$15.0**	**$15.0**	**$15.0**	**$17.3**	26
27								27
28	**Planning Grant: High Quality Early Childhood Development Centers**							28
29	General Fund	**-**	**-**	**-**	**-**	**-**	**$0.5**	29
30								30
31	**TOTAL CYFD**	**$93.9**	**$102.8**	**$119.2**	**$119.2**	**$119.2**	**$127.5**	31
32	**Public Education Department - Special Appropriations ***							32
33	**Prekindergarten**							33
34	General Fund	$6.3	$10.0	$15.0	$15.0	$15.0	$22.5	34
35	General Fund transfer to CYFD	-	-	-	-	-	-	35
36	**Total PreK**	**$6.3**	**$10.0**	**$15.0**	**$15.0**	**$15.0**	**$22.5**	36
37								37
38	**Early Childhood Education**							38
39	General Fund	**$0.5**	-	-	-	-	-	39
40								40
41	**K-3 Plus**							41
42	General Fund	**$5.3**	**$11.0**	**$16.0**	**$16.0**	**$16.0**	**$26.0**	42
43								43
44	**Early Literacy**							44
45	General Fund	-	**$8.5**	**$11.5**	**$11.5**	**$11.5**	**$13.5**	45
46								46
47	**TOTAL PED**	**$12.1**	**$29.5**	**$42.5**	**$42.5**	**$42.5**	**$61.9**	47
48	**Department of Health**							48
49	**FIT (birth to 3)**							49
50	General Fund	$14.5	$14.0	$14.5	$14.5	$14.5	$19.7	50
51	all other funds	$16.5	$19.6	$19.6	$19.6	$19.6	$19.6	51
52	**Total FIT**	**$31.0**	**$33.6**	**$34.1**	**$34.1**	**$34.1**	**$39.3**	52
53	**Human Services Department**							53
54	**Evidenced-Based Home Visiting (prenatal to 3)**							54
55	General Fund	-	-	~~**$0.5**~~	~~**$0.5**~~	~~**$0.5**~~	**$0.5**	55
56	Federal Funds	-	-	**-**	**-**	**-**	**$1.1**	56
57	**TOTAL HSD**	-	-	**-**	**-**	**-**	**$1.6**	57
58	**Race to the Top- Early Learning Challenge**							58
59	Federal Funds	-	-	**$9.4**	**$9.4**	**$9.4**	**$9.4**	59
60								60
61	**Early Childhood Programs Grand Total**	**$137.0**	**$165.9**	**$205.2**	**$205.2**	**$205.2**	**$239.7**	61

Source: LFC Files

[1]FY14 Revised reflects replacement of Tobacco Settlement funds with TANF.

[2]FY14 Executive Revised continued $5.2 million from Tobacco Funds. $2.0 million for Childcare Assistance $2.0 million for home visiting $1.6 for PreK. The Executive also recommended a $7.2 million special for FY14 and FY15 funding. Of the Special $4.2 to PreK in FY14, $1 million to homevisiting in FY15 and $2.0 million for PreK in FY15.