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

SPONSOR Trujillo, J **ORIGINAL DATE / LAST UPDATED** 02/03/14 **HJR** 3

SHORT TITLE Land Grant Fund Distribution, CA **SB**

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	$58,213.4	$62,031.0	Recurring	General Fund
$0.0	$0.0	$10,944.4	$11,923.2	$12,705.1	Recurring	Other LGPF Beneficiaries
$0.0	$0.0	$64,379.0	$70,136.6	$74,736.1	**Recurring**	**Total**

(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				

(Parenthesis ( ) Indicate Expenditure Decreases)

Relates to SJR4 Land Grant Fund Care & Investments, CA. Conflicts with SJR 12 – Land Grant Fund Balance & Education, CA.

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council

SUMMARY

Synopsis of Bill

House Joint Resolution 3 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 "increase educational performance as provided by law." The additional distribution would result in a permanent 5.5 percent annual distribution from the LGPF.

HJR 3 would amend the constitution to suspend the additional 0.5 percent distribution from the LGPF if the five-year average of the year-end market value of the fund is less than $10 billion. The amendments would permit the Legislature, by a three-fifths' vote of the members of each house, to suspend the additional 0.5 percent distribution.

The constitution currently provides for a 5.5 percent distribution through FY16. The additional distributions pursuant to HJR 3, depicted in the chart below, would take effect FY17 and onward.

House Joint Resolution 3			
Fiscal Year	Current Rate	HJR 3	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%	5.5%	0.5%
2018	5.0%	5.5%	0.5%
2019	5.0%	5.5%	0.5%
2020	5.0%	5.5%	0.5%
2021	5.0%	5.5%	0.5%
2022	5.0%	5.5%	0.5%
2023	5.0%	5.5%	0.5%

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.

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, there 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 HJR 3 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, primarily public education, the largest of the beneficiaries accounting 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 $209 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 $368 million, and ten years after that, the negative impact has grown to nearly $1.81 billion. Further, beginning in FY24, the size of the excess distribution proposed in HJR 3 over the current distribution begins to diminish.

The five-year average of the year-end market value of the balance in the fund is not estimated to fall below the minimum $10.0 billion level, thus suspending the additional distribution.

SIGNIFICANT ISSUES

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 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, 2013. The financial market volatility during the 2008-09 crisis continues 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 extremely 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 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 2008/2009 has vividly shown the impact of a market downturn when combined with an aggressive spending policy and/or impaired funding matrix. The differences in the LGPF and Severance Tax Permanent Fund (STPF) offer a prime example of this:

The SIC notes Institutional funds with broken or substandard endowment models not only have a far greater challenge in meeting long-term maintenance and growth goals, they are also 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 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 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 three to five 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.</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) to assure intergenerational equity. Contributions from New Mexico's public lands and their resources will decrease over time; minerals are depleting resources and the revenues they generate must become part of the principal of the endowment so investment earnings 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

HJR 3 calls for the additional distributions to "increase educational performance as provided by law." While the LGPF is often referred to as the state's permanent educational endowment and has is known as the "Permanent School Fund", it is not entirely composed of educational interests. More than 16 percent of LGPF distributions go to other beneficiaries.

The 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 special 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 "increase educational performance as provided by law."

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 funds have varying approaches. Alaska distributes an annual dividend to its residents based on income earned by its funds, but is seeking to limit annual spending to five percent of fund market value. Wyoming, also benefits from a multi-billion dollar permanent fund created through its natural resources, and currently distributes 5 percent of its 5-year-rolling average.

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/jl