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

ORIGINAL DATE 01/28/16
SPONSOR Padilla, M. **LAST UPDATED** 02/12/16 **HB**

SHORT TITLE Permanent Fund Annual Distributions **SJR** 3/aSFC

ANALYST Keyes

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**		
($51,045.9)	($109,629.1)	($114,903.0)	Recurring	LGPF
$43,215.5	$92,812.0	$97,276.9	Recurring	General Fund (Public School Funding)
$7,830.5	$16,817.1	$17,626.1	Recurring	Other LGPF beneficiaries

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY16	FY17	FY18	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		$104.0		$104.0	Nonrecurring	General Fund

Parenthesis ( ) indicate expenditure decreases

Relates to SJR 2, which seeks to annually deploy an additional 1.5 percent for early childhood education efforts.

Relates to HJR 10 which seeks to increase the base distribution rate of the LGPF to 5.5 percent, with an additional 1.5 percent distribution earmarked for early childhood funding.

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
State Land Office (SLO)

SUMMARY

Synopsis of Senate Finance Committee amendment to Senate Joint Resolution 3

SFC amendment to SJR 3 changes the title to "A JOINT RESOLUTION PROPOSING AN AMENDMENT TO ARTICLE 12, SECTION 7 OF THE CONSTITUTION OF NEW MEXICO TO PROVIDE FOR AN ADDITIONAL ANNUAL DISTRIBUTION OF THE PERMANENT FUNDS FROM JANUARY 1, 2017 THROUGH DECEMBER 31, 2026 IF THE MINIMUM BALANCE OF THE PERMANENT FUNDS IS AT LEAST TWELVE BILLION DOLLARS ($12,000,000,000).

The amendment requires the year-end market values of the fund for the preceding five calendar years be at least $12 billion for there to be any additional distribution from the permanent funds. It also limits the additional distribution to the period January 1, 2017 through December 31, 2026.

Synopsis of Original Resolution

Senate Joint Resolution 3 proposes an amendment to Article, XII, Section 7 of the New Mexico Constitution, which governs the distributions from the Land Grant Permanent Fund (LGPF).

If approved by voters in a statewide referendum, the state constitution would be amended to increase the annual Land Grant Permanent Fund (LGPF) distributions to beneficiaries from the current 5.0 percent, to a new rate of 5.8 percent of the LGPF's five-year average value as determined on December 31st every year.

As it seeks to establish a new base rate would also remove current language intended to protect against additional distributions over and above the base rate during times of fiscal distress. These protections, which relate to temporary distributions above 5.0 percent which are ending in FY16, include the ability for lawmakers to end extra distributions via a supermajority three fifths' vote by the members of the state senate and house, as well as an LGPF valuation trigger of $12 billion which automatically precludes distributions above the 5.0 percent base rate.

The joint resolution seeks approval of this constitutional amendment by the voters of New Mexico at the next general election or in a special election called for this purpose.

FISCAL IMPLICATIONS

This correction assumes that distributions to the General Fund would begin in January 2017, following the passage by the electorate in November's general election.

SIC indicates that in the short term under SJR3/a, additional distributions from the LGPF will produce significantly more revenue to the general fund and other LGPF constitutional beneficiaries, primarily public education (84.6 percent LGPF share as of 12/31/15).

In the long term however, and taking into consideration the potential for diminished in-flows to the fund due to reduced oil and gas revenue (today's in-flows are approximately half of 2014 levels), and uncertainty related to long-term investment return expectations (the Council in 2015 lowered its long-term investment target from 7.5 percent to 7.0 percent), this proposal increases the risk that the LGPF will be unable to deliver equal or greater benefits to LGPF beneficiaries in the future, according to the SIC.

The following chart shows the end-year values of the LGPF, as well as projections for LGPF values and distributions for the next dozen years, at both the current 5.0% rate and 5.8% rate proposed under SJR3/a.

Cal.Year	LGPF ($B)Value (5% rate)	LGPF Distribution (5.0%)	LGPF ($B) Value (5.8% rate)	LGPF Distribution (5.8%)	Distr Difference	Fiscal Year
2014	14.508253627	$ 655,785,169	14.508253627	$ 655,785,169		**2016**
2015	14.402624633	$ 638,074,458	14.402624633	$740,166,371	$ 102,091,913	**2017**
2016	15.140670670	$ 688,882,767	15.089624713	$798,511,876	$ 109,629,109	**2018**
2017	15.911616993	$ 733,468,517	15.751290445	$848,371,559	$ 114,903,042	**2019**
2018	16.686519689	$ 766,496,856	16.403185188	$883,397,752	$ 116,900,896	**2020**
2019	17.474533822	$ 796,159,658	17.056313940	$912,955,251	$ 116,795,593	**2021**
2020	18.283999331	$ 834,973,405	17.720910473	$951,447,367	$ 116,473,962	**2022**
2021	19.113460755	$ 874,701,306	18.396010165	$989,801,438	$ 115,100,132	**2023**
2022	19.959225270	$ 915,177,389	19.077918443	$1,028,390,323	$ 113,212,934	**2024**
2023	20.821554015	$ 956,527,732	19.767043098	$1,067,411,075	$ 110,883,343	**2025**
2024	21.700745574	$ 998,789,849	20.463534286	$1,106,934,831	$ 108,144,982	**2026**
2025	22.597036737	$ 1,041,920,224	21.167418131	$1,146,914,320	$ 104,994,096	**2027**
2026	23.510683162	$ 1,085,892,448	21.878710570	$1,187,313,645	$ 101,421,197	**2028**

The 12-year time frame was chosen for a comparison basis, as the most recent constitutional amendment requiring additional distributions from the LGPF was also 12 years, from FY2005-2016, and resulted in $747 million of additional pay-outs over and above the base 5 percent, to LGPF beneficiaries during that time.

The State Investment Council has noted certain observations regarding the impact of SJR3/a, compared to the current 5 percent base rate including:

- Barring market corrections, flat or negative return years (like calendar year 2015) or sharp drops in oil/gas revenue like we are seeing today, the LGPF will continue to grow on a nominal basis, though real dollar value may not keep up in a high inflation environment.

- At 5.8 percent, the LGPF would deliver an additional $1.33 billion to beneficiaries over the next dozen years, on average $110 million annually.

- That projected $1.3 billion is almost twice (1.78x) the additional amount drawn down from the permanent fund by the previous constitutional amendment of 2003 ($747M) over the same time period, and unlike the 2003 amendment, SJR3/a does not include a sunset provision for the higher distribution rate.

- At the 5.8 percent rate, at the end of a dozen years, the LGPF value will be diminished by a projected $1.63 billion, compared to the 5 percent current base rate.

- Other variables, including higher than average oil/gas income, or higher than average investment returns – neither of which the SIC believe to be abundantly likely in the coming decade - could mitigate the impact to a degree. However, in the case of lower than expected variables, the impact to the corpus would potentially be amplified.

- Reduced value of the corpus results in diminished capacity to participate in positive investment return environments, increasing volatility overall to the LGPF's yearly benefits. The smaller the fund, the smaller the benefits, and the lesser its ability to recover from negative returns through subsequent positive investment performance.

- To elaborate, at the 5 percent rate, the LGPF is projected to attain a corpus of $23.5 billion, while distributing $10.3 billion (total=$33.8 billion) over 12 years. At the 5.8 percent rate, the projected corpus will be $21.9 billion, with a distribution of $11.7 billion (total=$33.6 billion). The projected net value cost in just the first dozen years of implementation is more than $200 million in combined benefit and corpus value lost, due to diminished investment compounding effects caused by the increased rate.

- In addition, the lower corpus value of -$1.6 billion at the end of the first dozen years will result in the average delivery of $107 million per year in lost earning power starting on year 13, with projected growth every year thereafter, due to a reduced corpus value and the average annual investment return. Given that there is no sunset for SJR3/a, this opportunity cost would continue to grow annually, and at an accelerated rate.

RVK, which acts as an independent fiduciary and investment advisor to the SIC, has developed an Intergenerational Equity Index (IEI) to project estimated value and distributions from the LGPF 50 years from now. The IEI takes reasonable assumptions regarding investment returns, fund inflows, state growth, and inflation, and projects them 50 years forward, to assess whether the LGPF is on track to maintain the benefits provided to New Mexicans in 2016, and deliver the same benefits in 2066. An ideal score on the IEI is a 50, which gives an equal chance that the LGPF benefits in 2066 will be the same as they are in 2016. A lower score means there is less of a chance to deliver equal benefits, while a higher score means there is a better than 50 percent chance the fund will produce greater benefits. The following chart shows the IEI projections at the current LGPF spending policy of 5 percent, as well as at the proposed rates of 5.5 percent, 5.8 percent, 6.5 percent, 7.0 percent, and 7.3 percent (a combination of SJR 2 and SJR3/a).

	Baseline (run as of 3/31/2015)	Updated to 11/30/2015 Market Values
Distribution Policy	Probability of Attaining Full Objective	Probability of Attaining Full Objective
7.30%	11.3%	11.5%
7.00%	14.2%	14.4%
6.50%	21.2%	21.7%
5.80%	34.1%	34.6%
5.50%	39.8%	40.3%
Under Current Policy:	***51.2%***	***51.5%***

While the current 5 percent distribution rate produces a slightly better than average chance the LGPF will deliver equal benefits to beneficiaries in 2066, increases in distributions result in ever- growing statistical challenges to the LGPF's long-term health.

It is estimated that the cost of placing a constitutional amendment on the ballot to be $104 thousand based on 2010 actual expenditures. This includes all necessary printing and publications.

SIGNIFICANT ISSUES

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 to the beneficiaries. Thus, the LGPF was truly "permanent" because none of the corpus of the fund was distributed, except that the effect of inflation in eroding the true value of the LGPF was not taken into account. When the Enabling Act and the New Mexico Constitution were amended in the mid-1990's to allow investment of the LGPF in other kinds of securities and set the annual distribution at 4.7 percent of the value of the LGPF, the primary goal was to protect the corpus of the LGPF against inflation. 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").

In 2003, acting without an additional change in the Enabling Act, the New Mexico Constitution was amended to increase the annual distribution to 5 percent of the average year-end value for the preceding five years and to provide for a temporary additional annual distribution (0.8 percent for FY2005-FY2012, reduced to .5 percent for FY2013-FY2016), with the additional amount from the school fund earmarked to fund "educational reforms." The temporary additional annual distributions are due to expire at the end of FY2016.

Unlike many other current proposals to increase distributions from the LGPF, SJR3/a does not specify how the additional dollars are to be spent. The additional 0.8 percent annual LGPF distributions shall be applied across all LGPF beneficiaries, the largest being public education, which has a LGPF distribution share of 84.6 percent currently.

The 2003 constitutional amendment requiring additional distributions be put toward "education reforms" was never approved by the U.S. Congress, despite an opinion from the New Mexico Attorney General's office at the time indicating such changes would require such an action.

SJR3/a does not require U.S. Congressional approval of the distribution percentage increase it seeks.

PERFORMANCE IMPLICATIONS

Below is investment performance data for the LGPF, as of 12/31/15:

Investment Returns as of 12/31/2015	1 year	3 year	5 year	10 year	15 year	20 year
LGPF - gross returns	0.15%	7.55%	7.13%	5.65%	5.14%	6.98%

While the three-year and five-year annualized investment returns slightly exceed the SIC's annual return target of 7 percent, the SIC does not expect significant excess returns over the coming decade. It is also noteworthy that despite strong returns in the period following the 2008/2009 global financial crisis, the 10, 15 and even 20 year returns for the LGPF continue to be impacted negatively, resulting in below-target investment returns long-term.

The State Investment Council has stated that the typical endowment investment model is structured to achieve balance among its three key components: in-flows, investment returns, and distributions/spending policy. This "three-legged stool" is effective only when it can achieve and maintain balance among the three variables, making the stool stable enough to withstand inevitable short-term volatility in the model. As long as the imbalances are short-term, and not systemic and repetitive, the endowment will create new wealth and added value through long-term compounding of investment returns. It should be noted that just as an endowment can leverage today's assets and create new wealth for tomorrow, actions limiting this compounding ability via policy decisions to "rebalance" the stool's structure, can have the opposite effect, namely unintended and exponential negative impacts when applied over longer time periods.

On this point, the differences between the LGPF and Severance Tax Permanent Fund (STPF) pose a fair example of how an out-of-balance endowment will result in significant challenges. While the LGPF and STPF both have similar investments, and somewhat comparable distribution rates of about 5 percent (STPF distributes 4.7 percent), the STPF's health has been hindered significantly since the legislature increased the amount of severance taxes intercepted prior to deposit in the STPF from 50 percent in the 1990's to a target of 5 percent since the mid-200s.

The result, while the LGPF recovered and grew in the wake of the recovery, the STPF was unable to regain its 2007 value for several years. Today the STPF remains $250 million below the high water mark, and last year received less than a million of the more than $400 million in severance taxes collected by the state. The Legislature passed law in 2015, seeking changes to fix this imbalance in the STPF funding formula, which will be phased in over the next several years.

There are dozens of similar examples of pensions across the US that today find themselves at risk due to massive unfunded liabilities, and of a size inadequate to "invest the fund out of trouble." In nearly all cases, these pensions cite the primary cause of the hole they are in today, as being the overly optimistic return expectations and unrealistic benefit packages provided in the past. When that previous optimism proves unfounded, and benefits are overly aggressive, the financial burden of today is unavoidably shifted onto tomorrow's generations.

ADMINISTRATIVE IMPLICATIONS

SIC provided additional 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 percent-5 percent of the corpus/principal of the fund.

- As the principal of the LGPF grows, annual distributions will automatically increase, even if the percent distributed remains the same. 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, growth of the state's population, and other factors which might diminish its value.

- Even if the investment returns plus annual contributions to the fund increase, invading the principal is arguably not prudent. The fund was established in order to assure intergenerational equity. Contributions from New Mexico's public lands and their underlying resources will decrease over time; our 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, may have to seek increased investment risk, or apply leverage to the LGPF in order to achieve the returns necessary to permit that level of payout. Fund assets/principal could be subject to sub-optimal returns as a result of incurring such additional risk.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Related to SJR 2, which seeks to annually deploy an additional 1.5 percent for early childhood education efforts.

Related to HJR 10 which seeks to increase the base distribution rate of the LGPF to 5.5 percent, with an additional 1.5 percent distribution earmarked for early childhood funding.

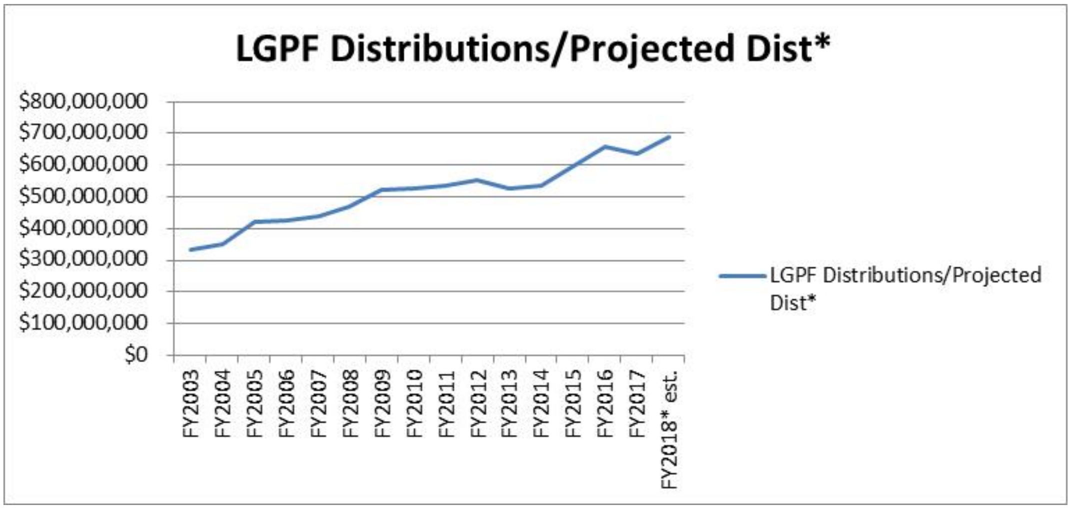
OTHER SUBSTANTIVE ISSUES

The resolution does not contain a provision stating that the constitutional change will not become effective unless and until it is approved by the U.S. Congress. Under the Enabling Act, New Mexico was required to incorporate the Enabling Act's state trust land provisions into its Constitution and was prohibited from changing those provisions without the consent of the U.S. Congress. Enabling Act § 2. When changes in the LGPF provisions in the New Mexico Constitution were proposed in 1996, it was stipulated that those changes would not become effective until the U.S. Congress consented to those changes, which was done through an amendment to the Enabling Act. See SJR 1 (1996) § 6; Pub. L. No. 105-37, 111 Stat. 1113. Enacting further changes in the LGPF without the consent of Congress likely violates federal law.

The SIC illustrated that the bigger the fund, the bigger the benefits, as seen in the LGPF distribution growth over the past several years. While there will be a drop of $17 million from FY16 to FY17, this is simply due to the lowering of the rate from 5.5 percent to the 5.0 percent base rate. Note the negative impact in FY17 is $10 million less than when the distribution rate shifted from 5.8 percent to 5.5 percent in FY13, due to the growth of the corpus.

Fiscal Year	LGPF Distributions/ Projected Dist*	LGPF Dist. Rate
FY2003	$332,784,132	4.7
FY2004	$352,525,968	4.7
FY2005	$422,198,985	5.8
FY2006	$426,443,668	5.8
FY2007	$438,945,139	5.8
FY2008	$469,998,264	5.8
FY2009	$521,520,996	5.8

FY2010	$525,512,604	5.8
FY2011	$535,903,003	5.8
FY2012	$553,418,314	5.8
FY2013	$526,846,546	5.5
FY2014	$535,156,608	5.5
FY2015	$595,993,902	5.5
FY2016	$655,785,169	5.5
FY2017	$638,074,538	5.0
FY2018* est.	$689,000,000	5.0



ALTERNATIVES

SIC indicates that the vast majority of other states with permanent funds, as well as similar university endowments are taking a more conservative approach to fund spending policies:

- Annual distributions by domestic sovereign wealth funds:
  - Alabama: 5 percent of rolling 3-year average;
  - Alaska: seeking 5 percent cap; principal may not be spent;
  - Idaho: 5 percent of 3-year average with adjustments; current rate below 4 percent
  - Wyoming: 5 percent;
  - Texas Perm School Fund: 3.3 percent; returns must exceed distributions over 10 years; and
  - North Dakota Legacy Fund: distributions may begin in June 2017.

Alaska is the largest of the Permanent Funds at $51 billion – the state writes checks to their citizens based on earnings, but are seeking to cap annual distributions at 5 percent or less. Wyoming, which has more than $18 billion in various permanent endowment funds, has a current distribution policy of 5 percent. The Texas Permanent School Fund, with more than $35 billion will only expend 3.3 percent in FY15. Arizona voters in 2012, by a narrow 51-to-49 percent margin, increased their distributions to 2.5 percent for its relatively young $4 billion endowment. And the North Dakota Legacy Fund – created a few years ago with its significant oil/gas windfall, will not distribute any dollars until 2017 at the earliest, following exhaustive study and planning by lawmakers.

International sovereign wealth funds also have varying rates of spending, often predicated on the size of the fund, the amount of natural resources available in their countries, and the long-term goals of their governments. The largest fund in the world belongs to Norway, which has a 4 percent spending rule. Norway announced in January 2016 that it would not be dipping into its fund or increasing distributions in reaction to plummeting global oil/gas prices, but would instead rely on free cash-flow produced by its massive $780 billion fund to prop up budgetary needs. Norway has grown its permanent fund to such a degree that it effectively stabilizes the country's economy and its budgeting process, even during times of fiscal crisis.

University endowments are also similar to the LGPF, as they raise money, are bequeathed gifts, and see significant inflows every year, combining to strike a balance with their distributions. Typically, most endowments average distributions of below 5 percent. Below are a handful of such endowments with recent spending rates:

- University endowments:
    - University of Texas: 3.5 percent-5.5 percent;
    - Yale: 5 percent of market value average;
    - Stanford: 5.25 percent with a previous year adjustment;
    - University Pennsylvania: 4.7 percent of 3-year average;
    - Columbia: 4.5 percent of market value average;
    - Texas A&M: capped at 5 percent of rolling average; and
    - Washington: 3 percent-5.5 percent based on 5-year average.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

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

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