FISCAL IMPACT REPORT

		ORIGINAL DATE	02/09/13		
SPONSOR	Trujillo, J.	**LAST UPDATED**	03/05/13	**HJR**	10/aHVEC
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	$50,579.1	$53,340.1	$55,559.1	Recurring	General Fund
$0.0	$0.0	$10,140.1	$10,693.6	$11,138.5	Recurring	Other LGPF Beneficiaries
$0.0	$0.0	($60,719.3)	($64,033.7)	($66,697.6)	Recurring	LGPF

(Parenthesis ( ) Indicate Revenue Decreases)

Conflicts with HJR 1, SJR 3

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
State Land Office (SLO)
Public Education Department (PED)
Department of Finance and Administration (DFA)

SUMMARY

Synopsis of HVEC Amendment

The House Voters and Elections Committee amendment:

- reduces the size of the additional distribution that the bill would make permanent from 0.8 percent to 0.5 percent.
- requires that the additional distribution be used to “implement and improve educational performance as provided by law,” rather than to “implement and maintain educational reforms as provided by law.”
- Increases the minimum five-year average of the year-end market value of the fund necessary for the additional 0.5 percent distribution to be made to $10 billion from $8 billion.
- The Legislature would still be able to suspend the additional distribution by a three-fifths' vote of the members of each house.

Synopsis of Original Bill

House Joint Resolution 10 (HJR 10) 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 0.8 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." The additional distribution would result in a permanent 5.8 percent annual distribution from the LGPF.

HJR 10 would also amend the constitution to provide that the additional 0.8 percent distribution would not be made from the LGPF if the five-year average of the year-end market value of the fund is less than $8 billion. The amendments permit the Legislature, by a three-fifths' vote of the members of each house, to suspend the additional 0.8 percent distribution.

The short term fiscal implications depend, to some extent, on when the constitutional amendment (if approved) would take effect. 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. If approved at the next general election in November 2014, the additional distribution could be implemented during FY15. This analysis assumes that the additional distributions pursuant to HJR 10, depicted in the chart below, would take effect on January 1, 2015.

Land Grant Permanent Fund Distribution Rate			
FY	Current Rate	HJR 10	Difference
2013	5.5%	5.5%	0.0%
2014	5.5%	5.5%	0.0%
2015	5.5%	5.8%	0.3%
2016	5.5%	5.8%	0.3%
2017	5.0%	5.8%	0.8%
2018	5.0%	5.8%	0.8%
2019	5.0%	5.8%	0.8%
2020	5.0%	5.8%	0.8%
2021	5.0%	5.8%	0.8%
2022	5.0%	5.8%	0.8%

FISCAL IMPLICATIONS

The impact of HJR 10 was assumed 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.

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 83.3 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 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 $191.5 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 $333 million, and ten years after that, the negative impact has grown to nearly $1.6 billion. Further, beginning in FY20, the size of the excess distribution proposed in HJR 10 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 required 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 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.

	1-year	3-year	5-year	7-year	10-year	15-year	20-year
LGPF Returns%	**14.49**	**9.11**	**2.35**	**4.85**	**7.30**	**5.78**	**7.39**

The SIC adds that it undertook an extensive 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 a more modest 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 State Land Office (SLO) 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 SJR 10, which would change the LGPF distribution rate to a different percentage than SJR 3.

TECHNICAL ISSUES

The technical issue described below concerning the implementation and maintenance of educational reforms is addressed in the HVEC amendment to HJR 10. However, the amended language now reads: "implement and improve educational performance as provided by law." It is unclear how the LGPF beneficiaries are to "implement educational performance," and a further amendment to strike the instances of the phrase "implement and" on page 1, line 17, and page three, lines 19-20 may be desirable.

<u>Original Technical Issue:</u>

HJR 10 calls for the additional distributions to "implement and maintain educational reforms 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 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."

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.

PvM/svb:blm