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

SPONSOR Cervantes
ORIGINAL DATE 02/11/16
LAST UPDATED
HB

SHORT TITLE Funding for Longer School Days & Years, CA
SJR 17

ANALYST Keyes

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**		
($127,614.9)	($137,010.9)	($143,523.3)	Recurring	LGPF
$108,038.8	$115,993.4	$121,506.8	Recurring	General Fund (Early Childhood)
$19,576.1	$21,017.5	$22,016.5	Recurring	Other LGPF beneficiaries

Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
Children Youth and Families Department (CYFD)
Attorney General's Office (AGO)

SUMMARY

Senate Joint Resolution 17 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 require the Land Grant Permanent Fund (LGPF) to distribute to LGPF-defined beneficiaries, in addition to the annual LGPF base distribution of 5 percent, an additional 1.0 percent of its five-year average value to be earmarked for longer school days and years.

A three-fifths majority in both the House and Senate can vote to suspend the additional distributions, and the additional distribution would be suspended should the 5-year LGPF average drop below $10 billion.

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

The State Investment Council takes no official position regarding SJR17, but has identified various legal and performance-related concerns, which the legislature may wish to consider when evaluating the bill's impact. SIC's analysis as follows:

In the short term under SJR17, additional distributions from the LGPF will produce significantly more revenue to the general fund and other LGPF constitutional beneficiaries, primarily public education (84.66 percent LGPF share as of 12/31/15).

In the long term, weighing the impact of SJR17 is more complex, especially taken in tandem with other critical fund variables including investment returns (the Council in 2015 lowered its long-term investment target from 7.5 percent to 7.0 percent) and reduced oil and gas revenue (today's in-flows are approximately half of 2014 levels). It is clear however, that in addition to short-term benefits, removing almost $2 billion from the fund will result in long-term diminishment of fund earning power, and lower annual distributions. It also elevates risk to the fund's health, by lowering its ability to recover from negative market events like the global financial crisis and its recovery in the years following.

The next 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 5.0 percent rate, and the 6.0 percent rate proposed under SJR 17.

Cal.Year	LGPF ($B)Value (5% rate)	LGPF Distribution (5.0%)	LGPF ($B) Value (6.0% rate)	LGPF Distribution (6.0%)	Distr Difference	Fiscal Year
2014	14.508253627	$ 655,785,169	14.508253627	$ 655,785,169		2016
2015	14.402624633	$ 638,074,458	14.402624633	$ 765,689,350	$ 127,614,892	2017
2016	15.140670670	$ 688,882,767	15.076863224	$ 825,893,631	$ 137,010,864	2018
2017	15.911616993	$ 733,468,517	15.711221570	$ 876,991,786	$ 143,523,269	2019
2018	16.686519689	$ 766,496,856	16.332430707	$ 912,376,725	$ 145,879,869	2020
2019	17.474533822	$ 796,159,658	16.952019309	$ 941,701,913	$ 145,542,255	2021
2020	18.283999331	$ 834,973,405	17.580765283	$ 979,839,601	$ 144,866,196	2022
2021	19.113460755	$ 874,701,306	18.217905800	$ 1,017,532,112	$ 142,830,806	2023
2022	19.959225270	$ 915,177,389	18.859819632	$ 1,055,315,289	$ 140,137,900	2024
2023	20.821554015	$ 956,527,732	19.507003847	$ 1,093,410,166	$ 136,882,434	2025
2024	21.700745574	$ 998,789,849	20.159610377	$ 1,131,901,259	$ 133,111,410	2026
2025	22.597036737	$ 1,041,920,224	20.817648560	$ 1,170,743,859	$ 128,823,635	2027
2026	23.510683162	$ 1,085,892,448	21.481108454	$ 1,209,902,290	$ 124,009,842	2028
		$ 10,331,064,609		$ 11,981,297,981	$ 1,650,233,372	

Forward looking assumptions in the data:

- Passage of SJR17, with distributions beginning in second half of FY17 (tied to CY2015 5-year LGPF average), with no sunset.
- Council's targeted rate of return of 7.0 percent (6.7 percent net of fees)

- $420 million annual inflows from oil & gas royalties, (both the 15-year average contribution to the LGPF, & consistent with current inflows, which are around $35 million/month).

This calculation does not take into account potential future growth in state population, or the impact of inflation on the real dollar value and benefits of the LGPF.

The 12-year time frame was chosen for a comparison basis, as the most recent constitutional amendment requiring additional distributions from the LGPF was 12 years in length, 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.

Some observations regarding the impact of SJR17, compared to the current 5 percent base rate:

- Barring market corrections, 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 6.0 percent, the LGPF would deliver an additional $1.65 billion to beneficiaries over the next 12 years.
- That projected $1.65 billion of extra dollars to be deployed is more than two times (2.21x) the additional amount drawn down from the permanent fund ($747 million) from the FY2005-2016 Constitutional Amendment.
- At the 6.0 percent rate, at the end of a dozen years, the LGPF value will be diminished by a projected $2.03 billion, compared to the 5 percent current base rate.
- The net impact to the combined LGPF corpus and its annual distributions amounts to an additional -$379 million in aggregate value (corpus+distributions at each rate) lost.
- In addition, the lower corpus value of -$2.0 billion at the end of the first dozen years will result in the average impact of at least a negative $134 million per year in lost earning power for every year thereafter, due to a reduced corpus value and the expected 7 percent (6.7 percent net) annual return. This annual nine-figure opportunity cost attributable to SJR17 would continue to grow every year.

RVK, which acts as an independent fiduciary and investment advisor to the Council, 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 spending policy of 5 percent, 5.5 percent, 5.8 percent, 6.5 percent, 7.0 percent, and 7.3 percent (a combination of SJR2 & SJR3).

	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 5.0 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.

SIGNIFICANT ISSUES

CYFD has noted that schools operated and facilitated by CYFD, Juvenile Justice, are not directly impacted by this amendment as they have implemented an extended school year and comparable school days as compared with other public schools in the state.

SIC provided the following analysis regarding SJR17:

SJR17 specifies that 1.0 percent of the additional annual LGPF distributions shall be used for early childhood education programs. While one can assume the largest LGPF beneficiary, public education, will be able to effectively deploy the lion's share of an additional $137 million (12-year average) or more every year as intended for statewide early learning programs, nine of the 21 beneficiaries listed below are either not educational facilities, or have a mission completely unrelated to education.

INSTITUTIONS	% OF FUND
COMMON SCHOOLS	84.638561%
UNIVERSITY OF N.M.	1.358980%
UNM SALINE LANDS	0.044485%
NM STATE UNIVERSITY	0.433124%
WESTERN NM UNIV	0.025238%
N.M. HIGHLANDS UNIV	0.025107%
NO. NM COLLEGE	0.020298%
EASTERN NM UNIVERSITY	0.078672%
NM INST. MINING & TECH	0.191261%
N.M. MILITARY INSTITUTE	3.121875%
NM BOYS SCHOOL	0.005417%
DHI MINERS HOSPITAL	0.900607%
N.M. STATE HOSPITAL	0.327613%
NM STATE PENITENTIARY	1.913256%
NM SCHOOL FOR THE DEAF	1.900687%
SCH. FOR VISUALLY HAND.	1.896599%
CHAR. PENAL & REFORM	0.801869%
WATER RESERVOIR	1.011426%
IMPROVE RIO GRANDE	0.226442%
PUBLIC BLDGS. CAP. INC.	1.077062%
CARRIE TINGLEY HOSPITAL	0.001419%

Given the wording of SJR17, there is a possibility these highlighted 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 more than 15 percent of the LGPF.

Should that be the case, these beneficiaries would have little recourse other than to essentially waive a portion of their rightful share of the Land Grant Permanent Fund, or pursue legal remedy.

SJR17 is silent on who or what would be charged with determining whether the additional disbursements would be regulated, or from a practical standpoint, what agency would help ensure qualified deployment of these extra dollars to ensure the intent of the legislation is met.

On the other hand, should these beneficiaries be allowed to share the additional distribution without the requirement that they use the extra 1.0 percent for ECE – as they currently do with the current 0.5 percent distribution for "educational reforms" ending in FY16, this too would appear to violate both the letter and spirit of the Constitution and its amendments as approved by the people of New Mexico (and possibly Congress).

It is noteworthy that the 2003 constitutional amendment requiring additional distributions to be put toward education reforms, was never approved by the US Congress, despite an opinion from the NM Attorney General at the time, indicating such changes would require Congressional blessing.

SJR17 does not contemplate US Congressional approval prior to enactment.

ADMINISTRATIVE IMPLICATIONS

There are 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 percent and 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. Educational institutions & 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 is arguably not prudent. The fund was established (& should be held inviolate) in order to assure intergenerational equity. Contributions from NM's public lands & their underlying resources will decrease over time; our minerals are depleting resources & the revenues they generate must become part of the principal of the endowment so earnings from those revenues can provide funding for education & 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 SJR3, which seeks to increase the base distribution rate of the LGPF to 5.8 percent.

Related to SJR2/a, which seeks to include an additional 1 percent distribution for early childhood education for the next ten years.

Related to HJR10 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.

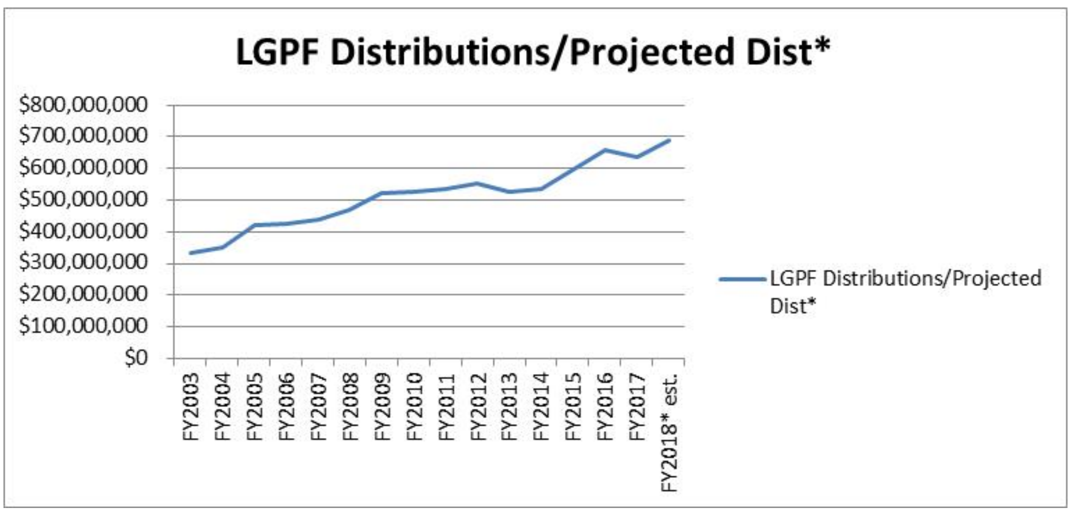
OTHER SUBSTANTIVE ISSUES

The so-called "tipping point" has been identified in previous years as a clear illustration of how a bigger fund can generate much greater benefits over time due to compound investment returns.

Given an assumption of normal investment returns and average contributions, the tipping point will occur approximately 30 years after the first increase, where the fund corpus at 6.0 percent will actually begin to provide lesser benefits every year, compared to what a 5 percent distribution would have produced from a much larger corpus, not saddled with the additional withdrawals.

Recent LGPF distributions help illustrate the argument 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 $17M 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

If passed and subsequently approved by voters, SJR17 will initiate deployment of hundreds of millions of additional dollars from the LGPF to the general fund over the coming decade. It does not outline specifically how those dollars will be spent, or what safeguards might be in place to prevent SJR17 funds from being used to supplant existing education funding, which could then be repurposed in other ways.

From an investor's point of view, any time the Council makes a commitment to a fund manager or investment partner, there is extensive due diligence, typically multiple examples of success in the manager's past, and a well-thought-out and fully articulated business plan for how this investment intends to create wealth through strategic investment.

When it comes to placing capital, the Council believes that there is value to be had by looking at best practices and the actions of our peers.

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 than they had in recent years:

- 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 avg. with adjustments; current rate below 4 percent
    - Wyoming: 5 percent
    - Texas Perm School Fund: 3.3 percent; returns must exceed distributions over 10yrs
    - North Dakota Legacy Fund: distributions may begin in June 2017

Alaska is the largest of the Permanent Funds at $51 billion – they write 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 FY16. Arizona voters in 2012 by a narrow 51-to-49 percent margin, increased their distributions to 2.5 percent for their relatively young $4 billion endowment. And the North Dakota Legacy Fund – created a few years ago with their significant oil/gas windfall, won't distribute any dollars until 2017 at the earliest, following exhaustive study & planning by lawmakers.

International sovereign wealth funds also have varying rates of spending, often predicated on the size of their fund, the amount of natural resources available in their country, and the long-term goals of their government. The largest fund in the world belongs to Norway, which has a 4 percent spending rule. Norway announced in January 2016 that they would not be dipping into their fund or increasing distributions in reaction to plummeting global oil/gas prices, but would instead rely on free cash-flow produced by their 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:
    - 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-yr average
    - Columbia: 4.5 percent of market value average
    - Texas A&M: capped at 5 percent of rolling average
    - Washington: 3 percent-5.5 percent based on 5-year average

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 and their investment returns.

In January 2016 the National Association of College and University Business Officers and Commonfund Institute released their most recent study, aggregating data on hundreds of public and private university endowments and their distribution rates/spending policies. As detailed in the chart below, these endowments largely continued the trend of lowering rates, with averages ranging between 3.8 percent and 4.5 percent. Institutions larger than $1 billion averaged spending rates of 4.3 percent, while public institutions were lower yet at 4.0 percent.

2015 NACUBO-Commonfund Study of Endowments

Average Annual Effective Spending Rates* for U.S. College and University Endowments and Affiliated Foundations, FY2014 to FY2005

Size of Endowment	2015 %	2014 %	2013 %	2012 %	2011 %	2010 %	2009 %	2008 %	2007 %	2006 %
Over $1 Billion	4.3	4.6	4.8	4.7	5.2	5.6	4.6	4.2	4.4	4.6
$501 Million to $1 Billion	4.1	4.3	4.6	4.7	5.2	5.7	4.9	4.5	4.4	4.5
$101 Million to $500 Million	4.1	4.3	4.4	4.3	5.0	4.9	4.4	4.2	4.5	4.6
$51 Million to $100 Million	4.4	4.4	4.4	4.3	4.5	4.6	4.7	4.6	4.8	4.7
$25 Million to $50 Million	4.0	4.2	4.3	3.8	4.0	4.1	4.3	4.3	4.8	4.8
Under $25 Million	4.5	4.6	4.1	3.7	3.7	3.5	3.9	4.1	4.6	4.6
Type of Institution										
All Public Institutions	**4.0**	**4.1**	**4.1**	**4.0**	**4.5**	**4.1**	**4.2**	**4.6**	**4.5**	**4.5**
Public College, University or System	*3.8*	*3.8*	*4.2*	*3.9*	*4.3*	*4.3*	*3.7*	*4.0*	*N/A*	*N/A*
Institution-Related Foundations	*4.2*	*4.3*	*4.0*	*4.0*	*4.1*	*3.9*	*4.3*	*4.1*	*N/A*	*N/A*
Combined Endowment/Foundation	*3.9*	*4.2*	*4.4*	*4.2*	*5.9*	*4.6*	*4.5*	*4.4*	*N/A*	*N/A*
All Private Colleges and Universities	**4.3**	**4.5**	**4.6**	**4.3**	**4.6**	**4.8**	**4.5**	**4.4**	**4.7**	**4.7**
Average (All Institutions)	**4.2**	**4.4**	**4.4**	**4.2**	**4.6**	**4.5**	**4.4**	**4.3**	**4.6**	**4.7**

*The effective spending rate represents the distribution for spending divided by the beginning market value (endowment value on or around the beginning of the fiscal year). The distribution for spending is the dollar amount withdrawn from the endowment to support expenditures on student financial aid, faculty research, maintenance of facilities, and other campus operations, as determined and defined by each institution. The rate is calculated **net** of any investment fees and expenses for managing the endowment.

IN FY2015, NACUBO reports the average spending rate for the 812 participating institutions averaged 4.2 percent, down slightly from 4.4 percent last year.

NACUBO also reports that endowments with assets greater than $1 billion relied on the annual endowment distributions to fund 16.5 percent of operating budgets in FY15. The sometimes overlooked LGPF/STPF distributions of $839 million in FY17 are approximately 13.5 percent of the $6.2 billion projected to be needed for the FY17 New Mexico state budget.

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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