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

SPONSOR Padilla
ORIGINAL DATE 2/01/17
LAST UPDATED 2/24/17
HB

SHORT TITLE Permanent Funds for Early Childhood, CA
SJR 3

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
$0.0	$0.0	$0.0	($230,059.1)	($237,379.6)	Recurring	LGPF
$0.0	$0.0	$0.0	$195,269.6	$201,483.0	Recurring	General Fund (Early Childhood)
$0.0	$0.0	$0.0	$34,789.5	$35,896.6	Recurring	Other LGPF beneficiaries

Parenthesis ( ) indicate revenue decreases

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY17	FY18	FY19	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	$0.0	$50.0	$0.0	$50.0	Nonrecurring	General Fund

Parenthesis ( ) indicate expenditure decreases

Related to HJR1, HJR2, and SB182.

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
Department of Finance and Administration (DFA)
Children, Youth and Families Department (CYFD)
Attorney General Office (AGO)
Public Education Department (PED)

SUMMARY

Synopsis of Bill

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), to provide additional yearly distributions of 1.5 percent from the LGPF, which would raise the overall LGPF distribution to 6.5 percent per year. The resolution requires additional distributions from the permanent school fund be used purpose of funding early childhood educational (ECE) services.

Early childhood education services are defined in the resolution as "nonsectarian services provided, for the benefit of children not yet eligible for kindergarten, through a state agency; an Indian nation, tribe or pueblo; the New Mexico school for the blind and visually impaired; or the New Mexico school for the deaf."

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 five-year LGPF average drop below $10 billion.

The 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, and would not take effect unless the amendment were approved by the US Congress.

FISCAL IMPLICATIONS

The State Investment Council takes no official position regarding this joint resolution, but has identified various legal and performance-related concerns, which the legislature may wish to consider when evaluating the bill's impact.

SIC indicates that in the short term under this joint resolution, additional distributions from the LGPF will produce significantly more revenue to the general fund and other LGPF constitutional beneficiaries. However, the additional distribution will lessen future earnings and reduce the benefits that a larger fund would produce in the long-term even at a lower distribution rate.

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.

SIC's expectation over the next 7-10 years is for both lower-than-historical investment returns (targeting 7.0 percent), and oil/gas prices substantially below the high-water marks seen over the previous decade. Today's LGPF inflows are currently about half or less of where they were in 2014.

SIC provides the following table, which shows projected values and fund distributions for fiscal years 2020-2031 at the current 5.0 percent distribution and the 6.5 percent rate proposed under SJR3. The table also uses a side-by side comparison between increased LGPF distributions over 12 years and the corresponding, greater fall of LGPF corpus value over the same time period.

The projection assumes annual inflows of $400M and investment returns of 7.0 percent, with additional distributions of 1.5 percent beginning in FY2020. Both are consistent with SIC expectations during this time frame. The starting value of $16.68B is projected for the end of 2018, which determines the distribution for FY2020.

Calendar Year	Corres-ponding Fiscal Year	($B) LGPF Value Current (5%)	($M) LGPF Distrib. @ 5%	($B) LGPF Value w/SJR3 (6.5%)	($M) LGPF Distrib. @ 6.5%	($M) Rolling Difference in LGPF Distrib.	($M) Rolling Difference in LGPF Value
2018	**2020**	16.68	$766.9	16.68	$996.9	$230.1	($115.0)
2019	**2021**	17.45	$796.2	17.33	$1,033.6	$467.4	($356.5)
2020	**2022**	18.23	$834.6	17.88	$1,078.8	$711.7	($621.1)
2021	**2023**	19.04	$873.3	18.42	$1,121.0	$959.5	($908.8)
2022	**2024**	19.86	$912.6	18.95	$1,160.4	$1,207.2	($1,217.4)
2023	**2025**	20.70	$952.8	19.48	$1,196.8	$1,451.2	($1,544.9)
2024	**2026**	21.55	$993.9	20.01	$1,231.7	$1,689.0	($1,889.3)
2025	**2027**	22.43	$1,035.8	20.54	$1,266.2	$1,919.4	($2,250.0)
2026	**2028**	23.31	$1,078.5	21.06	$1,300.6	$2,141.4	($2,626.9)
2027	**2029**	24.22	$1,122.1	21.59	$1,334.9	$2,354.2	($3,020.3)
2028	**2030**	25.14	$1,166.5	22.12	$1,369.1	$2,556.8	($3,430.3)
2029	**2031**	26.08	$1,211.7	22.65	$1,403.5	$2,748.5	($3,857.3)
2030	**2032**	27.04		23.18			

The model shows that at the higher distribution rate, after a dozen years, additional dollars will be taken from the LGPF for beneficiaries, resulting in a significantly lower fund corpus value in 2030.

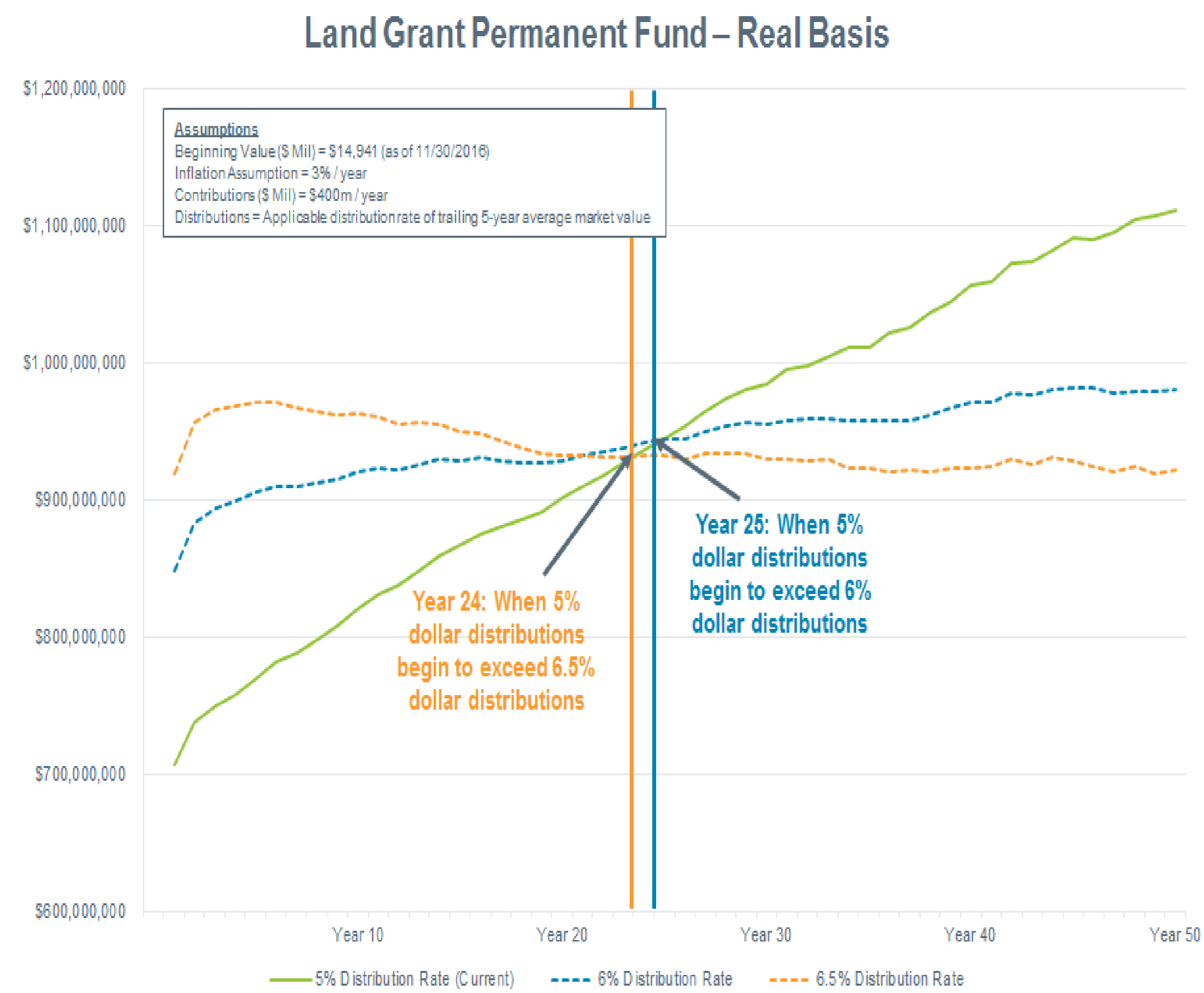
SIC offers the following key observations:

- After a dozen years, the LGPF is expected to distribute a total of $11.75 billion through 2031 at the 5.0 percent rate.
- At the 6.5 percent rate, the LGPF would distribute an estimated $14.49 billion for the same time period.
- This total at the 6.5 percent rate would draw-down $2.75 billion more than the base rate, or on average, $229 million more per year.
- At the end of a dozen years at the 6.5 percent rate, the LGPF value would be a projected $3.86 billion less than it would have been at the 5.0 percent rate.
- Projected average annual earnings on $3.86 billion are more than $258 million per year.
- This $258 million per year in potentially lost earnings would grow with every subsequent year, with the lower corpus value and opportunity costs compounding over each year of positive market returns.
- That $258 million represents an opportunity cost in recurring lost earnings and would continue to grow annually at an accelerated rate.

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. It also does not consider the impacts of possible major market events or a severely compromised inflow model to the LGPF. Such variables could greatly increase risk to the fund's long-term earning ability.

RVK, which acts as an independent fiduciary and investment advisor to the SIC, has projected a long-term impact on the LGPF, based on a 5 percent, 6 percent, and 6.5 percent distribution (SJR3). Visually, this highlights what has previously been referred to as the "tipping point", where the fund with the higher-spending policy is eventually caught and overtaken by the fund with a lower spending rate. At 6 percent, RVK predicts the short-term benefit, or tipping point, to be 25 years out. At 6.5 percent, the additional benefit is eclipsed in year 24, as highlighted in the graphic on the following page.

Based on these projections, it could be argued that while increasing LGPF distributions certainly would benefit one generation, those additional dollars would be delivered at the expense of subsequent generations, who may face equal or greater challenges and uncertain needs.

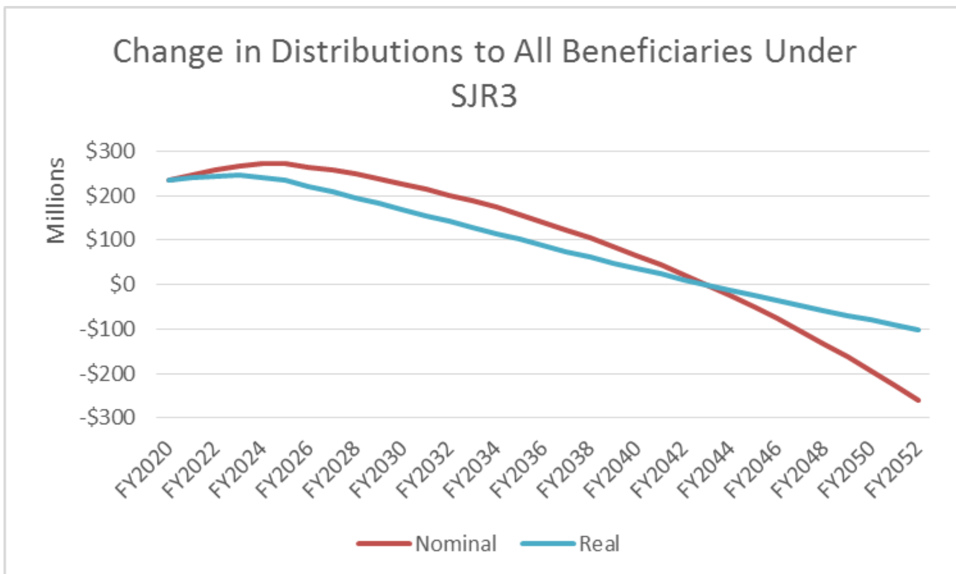


Monte Carlo Simulations assume Land Grant Permanent Fund is invested at the Long-Term Target Allocation.
All annual distribution amounts shown represent the 50th percentile result.

RVK

Similarly, the Department of Finance and Administration (DFA) projects that by FY2042, the fund will have distributed a cumulative additional $4.3 billion to beneficiaries at the cost of over $8 billion in market value. It is around this time that DFA projects the tipping point will occur. After this point, the amount distributed by the LGPF under the 6.5 percent distribution no longer exceeds the amount that would have been distributed at the 5.0 percent level had the corpus not been disturbed. From this point forward, the effect on the fund is increasingly negative. The result is that although the fund would distribute additional money in the short and medium term, it eventually would distribute less money to the beneficiaries and result in a much smaller corpus.

DFA provides the following graph to illustrate the change in the 5-year market value of the fund under the resolution relative to current law:



SIC also notes that the 6.5 percent distribution rate would deliver an additional $2.8 billion to beneficiaries over the next dozen years, an amount that is almost 3.7-times larger on a dollar-basis than the additional amount drawn down from the permanent fund by the previous constitutional amendment of 2003 ($747M) over the same time period.

SIC adds that by mandating these dollars be spent solely on early childhood programs, the resolution in effect reduces the pool of dollars to be deployed for primary public school education in exchange for ECE programs.

Additionally, Section 1-16-13 NMSA 1978 requires the Secretary of State (SOS) to print the full text of each proposed constitutional amendment, in both Spanish and English, in an amount equal to 10 percent of the registered voters in the state. The SOS is also constitutionally required to publish the full text of each proposed constitutional amendment once a week for four weeks preceding the election in newspapers in every county in the state. LFC staff estimate each constitutional amendment may cost up to fifty thousand dollars ($50,000) in printing and advertising costs based on 2016 actual expenditures.

SIGNIFICANT ISSUES

Distribution 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 1.5 percent distribution permanent.

CYFD points out opinion No. 12-03 issued on February 1, 2012 by the Attorney General's office on the use of the LGPF for private early childhood programs, finds that the New Mexico Constitution and Enabling Act do not support the use of land grant permanent funds for private or sectarian schools, but does support the use of land grant permanent funds for early childhood services exclusively under the control of the state.

Investment Issues. SIC provides the below investment performance data for the LGPF, as of 12/31/16:

	1 Year	3 years	5 years	10 years	15 years	20 years
Land Grant Permanent Fund Returns - % net of fees	7.37	4.63	8.73	4.90	5.87	6.70

According to SIC, while the one-year and five-year annualized investment returns slightly exceed SIC's annual return target of 7 percent, the council anticipates the next decade may be one of both volatility and depressed investment returns. Longer-term returns, which include one or both of the major global investment crises experienced this century, are still struggling to achieve SIC's long-term target of 7 percent. Like many institutional investors, SIC has reduced its return expectations in the past few years.

Early Childhood Issues. Volume I of the LFC Report for Fiscal Year 2018 discusses in detail the increased funding commitment to early childhood education. New Mexico continues to show leadership in increased investment in early care and education. Despite significant focus on early childhood programs, New Mexico is among the three lowest-ranked states in the Annie E. Casey Foundation's annual *Kids Count Data Book*, which ranks states according to 16 child well-being measures, primarily because of the large number of children in need of services.

Early childhood funding has grown by more than 80 percent since FY12. However, improved leadership, coordination, and oversight are needed. By investing in early childhood programs, taxpayers may save more over time through decreased juvenile delinquency, criminal activity and educational remediation. Strategic investments, along with careful attention to implementation and monitoring performance, could improve the social and cognitive skills of children, with benefits extending throughout a child's life.

The Public Education Department (PED) states that while the resolution provides for a major influx of new money into early childhood programs, it is unclear whether those funds could immediately be put to use toward those programs. Prior to this year's budget shortfall, New Mexico PreK programs had relatively small waiting lists across the state. Additionally, only 54 of 89 school districts participate in the program.

PERFORMANCE IMPLICATIONS

CYFD states it has performance measures related to early childhood services which may be affected by the amendment.

PED states the New Mexico PreK Program (Children's Code, 32A-23-1-8) provides *voluntary* pre-kindergarten services to four-year-old children in the state. The program shall address the total developmental needs of preschool children including physical, cognitive, social and emotional needs and, also, health care, nutrition, safety and multicultural sensitivity.

In FY2017, $22.9 million was allocated to 54 school districts, 14 of which are served through two regional education cooperatives, and 6 state charter schools to serve 5,248 four-year olds in 233 classrooms at 144 school sites, with 1,348 children receiving extended-day services. In FY17, districts and charters were allowed to adjust the number of children served at particular school sites, and the number of children served in extended-day classrooms to address community need.

ADMINISTRATIVE IMPLICATIONS

PED states, if the agency charged with ensuring the deployment of the additional funds meet the qualifications and true intent of the legislation, the department would require additional personnel in the Literacy and Early Childhood, Procurement, and Fiscal Grants Management bureaus to support, monitor and fund additional early childhood programs.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Relates to HJR1, which seeks to increase the base distribution rate of the LGPF to 6.0 percent.

Relates to HJR2, which seeks to withdraw $7B for infrastructure, renewable energy and early childhood programs.

Relates to SB182, which seeks to create a new permanent fund from federal disposal land assets with ECE being the sole beneficiary.

TECHNICAL ISSUES

Distribution. SIC points out the resolution seeks additional distributions for early childhood education programs, though many of the beneficiaries have no connection to ECE measures. However, language in SJR3 requires the additional 1.5 percent distributed to the permanent school fund be used for early childhood education services. It appears the other beneficiaries will receive their additional 1.5 percent and would not be obligated to use it for early childhood services.

The Office of the Attorney General (OAG) references the Attorney General Opinion No. 12-03, dated February 1, 2012, which directly addresses many of the issues raised by this resolution. OAG provides the following statements below:

- *An examination of the potential barrier posed by the anti-donation clause of the state constitution to direct or indirect assistance to sectarian or private schools is not required* *in light of SRJ 3, because the Enabling Act of 1910 and the corresponding provisions of the constitution directly prohibit the state from using money from the LGPF for private or sectarian entities.*

- *Unless Congress amends the Enabling Act, the Legislature has no authority to propose amendments to the constitution or enact laws that add a private or sectarian entity to the roster of designated land grant beneficiaries.*
- *<u>Any proposed constitutional amendment to increase distributions from the Land Grant Permanent Fund for early childhood learning programs would only be permissible if the increased distributions were limited to those programs provided by the public schools.</u>*
- *The land grant permanent funds are derived from the lands granted to the state by Congress in the Enabling Act and are therefore subject to the terms of the act.*
- *The prohibitions of the Enabling Act and the constitution apply to indirect as well as direct land fund grant distributions:*
  - *<u>These prohibitions cannot be avoided by appropriating the funds to a state agency for the purpose of disbursing funds to, or executing contracts with, sectarian or private schools not under the exclusive control of the state</u>.*
  - *Such a scheme would be "an artificial attempt to circumvent the prohibitions of the act and the state constitution. Regardless of the number of intervening entities, the transaction would still amount to the use of permanent fund money or the support of private or sectarian schools contrary to the prohibitions of the Enabling Act and the constitution."*
- *<u>The distribution of LGPF funds to a private or sectarian entity would require amendments to both the Enabling Act and the state constitution, after which both the act and the constitution would have to be amended to allow for an additional beneficiary</u>.*
- *In 1996, New Mexico voters adopted amendments to Article XII, Section 7 of the constitution, which were approved by Congress with amendments to the act, stating, "distributions from the trust fund shall be made according to Article XII, Section 7."*
- *<u>Thus, it appears that changes to how the funds are distributed may be made as long as it is accomplished by amendments to Section 7 and the funds are used for purposes permitted by the Enabling Act</u>.*

It could be interpreted that Section 8 of the Enabling Act of 1910 and Article XII, Section 3 of the New Mexico Constitution prohibit use of land grant permanent funds for any sectarian or private school and require that schools receiving such funds must remain under the exclusive control of the state. <u>While the legislation authorizes only "nonsectarian" early childhood educational services, it also appears to permit the allocation of land grant permanent funds to "contractors" which would provide those services</u>.

On this point, CYFD states:

"… any distribution made pursuant to the amendment must be used by the Public Education Department for early childhood programs exclusively under the control of the State. As the majority of the Public Education Department's early childhood education services is provided through Pre-Kindergarten programs, the majority of the appropriations made through the distributions provided by the proposed amendment would logically fund Pre-

Kindergarten programs run by the Public Education Department. However, NMSA 1978 §32A-23-9 requires that any money appropriated for Pre-Kindergarten programs be divided equally between the Public Education Department and the Children Youth and Families Department."

Section 1.H.4 of NMSA 1978, §32A-23-9 sets forth school district preference requirements for contractors. CYFD administers a significant part of the State's early childhood services that are delivered through private contractors. It is unclear how this joint resolution would affect CYFD's current structure for delivery of early childhood services considering opinion No. 12-03 issued on February 1, 2012 by the Attorney General's office, as stated above.

Due to distribution issues, the resolution requires the consent of the U.S. Congress prior to enactment. However, SIC points out the 2003 constitutional amendment requiring additional distributions to be put toward education reform was never approved by the US Congress, despite an opinion from the New Mexico attorney general at the time, indicating such changes would require congressional blessing.

Further, CYFD believes it is unclear whether congressional approval is required, stating:

"Section 3 of this joint resolution states that an amendment to the distribution rate provided in N.M. Const. Art. 12, Sect. 7 by the New Mexico Legislature and voters shall not take effect without consent of the United States Congress. This provision may be unnecessary, as the New Mexico's Enabling Act was amended by Congress in 1997 to provide that "[d]istributions from the trust funds shall be made as provided in Article 12, Section 7 of the Constitution of the State of New Mexico." New Mexico Statehood and Enabling Act Amendments of 1997, S. 430, Public Law 105-37 (Aug. 7, 1997). The New Mexico legislature and voters have previously approved two constitutional amendments to Article 12, Section 7, without congressional approval, based on Public Law 105-37 (Senate Joint Resolution 6 (2003), House Joint Resolution 16 (2014))."

Safety Valve. This resolution includes an asset value "safety valve" intended to protect the fund from the burden of additional distributions during times of financial stress. The valve is designed to stop the additional 1.5 percent distribution should the five-year average of the fund drop below $10 billion at calendar end of any given year.

The construction of the LGPF distributions are based on a five-year fund average with the goal of steadying pay-outs in a smooth, consistent manner, to better accommodate legislative advance planning. However, the safety valve sought to protect the fund in this joint resolution does not account for that, as the LGPF could technically go to $0 in 2017, and the five-year average would still not fall below the $10 billion trigger. An alternate technical safety-valve might better be tripped when the current LGPF corpus value itself drops below $10 billion or some similar appropriate value.

OTHER SUBSTANTIVE ISSUES

According to DFA:

"The LGPF was established and is required by law to benefit public schools and other beneficiaries indefinitely. It is not and was never intended to be a "rainy day" fund. It is

> *funded by income from non-renewable natural resources and was designed to provide a steady revenue source for future generations of New Mexicans even after those resources are exhausted. As a result, the fund was established with a 4.7 percent distribution rate, a rate that would allow the LGPF corpus to grow at a pace that would exceed distributions and inflation."*

DFA adds that a higher distribution rate from the LGPF will increase the pressure on the State Investment Council to achieve higher returns on investment, a potentially challenging goal during periods of national or global economic decline, which may lead SIC to take on greater investment risk in hopes of achieving higher returns.

The LGPF is a permanent endowment fund. SIC indicates that, nationally, peer endowments follow generally accepted distribution policies/spending policies. The most widely followed policy allows annual distributions of between 3-5 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 & early childhood programs will benefit from those increased amounts, and share in a much greater benefit as time goes on.
This is what happened between FY17 and FY18, when the LGPF distribution rose from $638 million, to $689 million, a $50+ million increase year over year, with both years at the 5 percent rate.

Further, DFA states Bond ratings agencies have recently identified the permanent funds as a credit strength for the State, not as a potential revenue source, but for the ability to leverage the earnings for general fund spending.[1] An increase in distributions from the LGPF could cause the ratings agencies additional concern at a time when the ratings are already at risk of a downgrade due to the insolvency of the general fund. The structuring of permanent fund distributions to the general fund on a five-year average market value was an innovative way to transform a volatile revenue stream (energy related taxes) into a stable source of long-term revenue.

ALTERNATIVES

SIC indicates 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: statutory formula, approximately 5 percent; principal may not be spent
    - Arizona: 2.5 percent
    - Idaho: 4 percent
    - Montana: 2.2 percent
    - North Dakota Legacy Fund: distributions may begin in June 2017
    - Wyoming: 5 percent
    - Texas Permanent School Fund: 3.3 percent;
    - Utah: interest & dividends only

NACUBO reported the average spending policy/distribution rate of more than 700 US universities was 4.2 percent.

DI/jle/al

[1] http://nmdfa.state.nm.us/uploads/files/Board%20of%20Finance/Current%20Bond%20Rating/(First)%20S%26P%20Nov%202016%20Update.pdf