

UNDERSTANDING ARIZONA'S PROPOSITIONS: 2012 SERIES

Prop 118 – Permanent Funds Amendment

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Proposition 118, also known as the Permanent Funds Amendment, would amend the Arizona Constitution to allow the state to change the formula for distributing money from the state land trust “permanent fund” to public institutions, primarily schools. The new formula would be employed from fiscal years 2013 through 2021.¹

Experience since 2004 has demonstrated that the current formula can result in years with little or no payout due to economic fluctuations or downturns. Prop 118 would guarantee annual payouts but likely at smaller average distributions over time.

State trust land refers to approximately 10.9 million acres of land granted to Arizona in 1910 by Congress prior to statehood. Although there are 13 beneficiaries of the permanent fund, K-12 schools are the largest in receiving about 90 percent of the overall payout. The fund is currently valued at \$3.5 billion.² Monies are distributed annually.

The permanent fund receives revenue from natural product leasing or sales, royalties from mineral materials, and land sales. In 1998 voters passed Proposition 102, which amended the Arizona Constitution to allow revenues to be invested in equities (or stocks). It also established the current distribution formula. Fund investments are managed by the State Treasurer.³

The current distribution is determined by the average total rate of return on the previous five fiscal years. This figure is then adjusted for inflation by subtracting the average of the annual percentage change in the GDP price deflator (a measure of price levels for goods and services) for the previous five fiscal years. That inflation-adjusted rate of return is then multiplied by the average market value over the previous five years. The formula, first implemented in 2004, was designed to protect the permanent fund from the vagaries of the equities market where nearly 60 percent of the fund is now invested.⁴

To stabilize annual payouts to state beneficiaries, Prop 118 would re-write the formula so that distribution is based on a simple 2.5 percent of the fund's average of market value over the last five years. The formula would revert to the existing calculus after 2021.⁵

Advocates say Prop 118 simplifies the distribution formula and guarantees an annual payout to permanent fund beneficiaries.

Critics argue that the new formula would reduce average distribution amounts to the detriment of public schools.

Economics 101

Average market value is a measure of the overall price level of a given market, as defined by a specified group of stocks or other securities.

Inflation is an average index used to measure the rise in the general level of prices of goods and services in an economy over a period of time.

GDP stands for gross domestic product, the total value of goods and services produced during a specified period.

GDP deflator is a measure of price levels for all domestically produced goods and services in an economy.

Rate of Return is the ratio of money gained or lost on an investment relative to the amount of money invested.

Source: *The Economist*

Although the ballot measure passed the Legislature in a largely bipartisan fashion, some Republicans opposed it and Democrats were split in their support.⁶

Yes on Proposition 118

Proponents argue that Prop 118 simplifies the distribution formula, requires no new taxes or spending from the state's General Fund, and guarantees an annual payout to permanent fund beneficiaries.

"We're removing about 200 words from the Constitution and adding about 20. We're basically taking about the last five years average of the permanent land endowment times 2.5 percent and distributing that annually to K-12 education," Arizona State Treasurer Doug Ducey told the *Arizona Capitol Times*.⁷

Citing a Joint Legislative Budget Committee (JLBC) study as evidence, Prop 118 supporters say the current formula is flawed because it produces unpredictable distribution results. "Schools, which are the primary beneficiary of the fund, have gotten inconsistent swings in money from the fund over the years under the current formula," State Treasurer spokesman Kevin Donnellan argued.⁸

Indeed, the JLBC concedes that distributions have varied widely from year to year given the inherently volatile equities market (where nearly 60 percent of the permanent fund is invested). According to JLBC, the FY 2010 distribution of \$1,799 was the smallest amount distributed to all beneficiaries, while \$84 million in FY 2012 was the largest. Arizona K-12 schools received \$0 and \$78 million in those years, respectively.⁹

Prop 118 supporters also buttress their arguments with the findings of an independent consultant – the Meketa Investment Group – hired by the State Treasurer to examine the current distribution formula.¹⁰

Meketa compared projected 19-year distributions of the current formula to the proposed formula (2.5 percent of the average five-year market value of the fund). The distribution patterns depend on the economic conditions assumed by the consultant, which includes negative GDP growth in four of the next 20 years, as well as inflation rates ranging from 1 percent to 12 percent. Their model also assumes that the average annual rate of return on investment over the 20-year period would be 7.5 percent.¹¹

Meketa’s analysis shows that the current formula would yield six years of no distributions between FY 2014 and FY 2032, while reaching an annual high of \$728 million in FY 2032. Alternatively, the formula proposed by Prop 118 would increase incrementally, beginning with a \$74 million distribution in FY 2014 and reach \$164 million in FY 2032.¹²

No on Proposition 118

Opponents of Prop 118 say that while the new formula would provide more stable revenues, it would also produce a lower average distribution to the detriment of K-12 schools, where spending per pupil is already among the lowest in the nation. There is worry, too, about the inherent unreliability of long-term economic forecasts to which the projected performance of Prop 118 is tied.

Permanent Endowment Trust Fund

The Permanent Endowment Trust Fund, now valued at \$3.52 billion, was established in the Arizona Constitution to invest proceeds from the state trust land permanent fund.

As of June 30, 2012, endowment assets are invested as follows:

- 41.5% is allocated among fixed income securities (bonds, variable-interest rate notes, etc.)
- 35.2% is allocated among Standard & Poor 500 equity stocks.
- 14.7% is allocated among S&P 400 MidCap stocks.
- 8.6% is allocated among S&P 600 SmallCap stocks

Source: Arizona State Treasurer

According to JLBC, the current formula was designed to smooth out distributions as a hedge against the volatility of the equities market. It was also intended to protect the market value of the fund from inflation. The formula proposed by Prop 118 sidesteps these built-in safeguards by trading potentially higher investment yields for lower but guaranteed payouts annually.¹³

JLBC agrees that the current formula is likely to result in years with no beneficiary distribution. Although Prop 118 would guarantee payouts, JLBC cautions that much – perhaps too much – depends on assumptions about the timing of the broader economic cycle and its resulting effect on investment performance.

As an alternative to Meketa’s economic cycle analysis, JLBC estimated the impact using average growth in every year. Assuming a long-term average rate of return of about 6 percent and a long-term average inflation rate of about 2 percent, the total distributions over the 19-year period would be higher under the current formula, approximately \$3.5 billion compared to \$2.2 billion under the proposed formula.¹⁴

The current formula would also produce higher payouts in the first nine years. This growth scenario is based on historic averages for both investment returns and inflation. While the JLBC analysis assumed average returns each year, it admits such a scenario is highly unlikely. This alternative, however, demonstrates the sensitivity of the projected distributions to the underlying economic conditions.

Therefore, any distribution formula estimates based on long-term economic forecasts should be “viewed with considerable skepticism,” noted JLBC.¹⁵

Impact of the measure

A “yes” vote would amend the Arizona Constitution to change the distribution formula from the state’s trust land permanent fund to 2.5 percent of the fund's average market value over the last five years. Although Prop 118 would guarantee annual payouts, analysts agree that the proposed distribution would most likely result in smaller deposits to the permanent fund.¹⁶

¹ House Concurrent Resolution 2056, 4/30/12. Also see: Legislative Council Analysis of HCR 2056.

² Investments, State Land Permanent Endowment Funds, Arizona State Treasurer. www.aztreasury.gov

³ Ibid., Endowment

⁴ Fiscal Note for HCR 2056, Joint Legislative Budget Committee (JLBC), Prepared by Brett Searle, 4/9/12

⁵ HCR 2056, Legislative Council Analysis

⁶ Voting Record, Legislation On Line Arizona, Arizona Capital Reports. www.azcapitolreports.com

⁷ Samantha Valtierra Bush, "Ducey says keys to economy are simplified tax code, getting government out of the way," *Arizona Capitol Times*, 4/13/2012

⁸ Gary Grado, "Arizona votes on seven ballot measures in 2012," *Arizona Capitol Times*, 5/25/12

⁹ Fiscal Note for HCR 2056, Searle. Also see “Endowment Asset Allocation as of June 30, 2012,” State Treasurer.

¹⁰ Stephen P. McCourt and Laura B. Wirick, Asset Allocation Review for Arizona Permanent State Land Fund, Meketa Investment Group, January 2012.

www.aztreasury.gov/presentations/2012/Asset_Allocation_Review.pdf

¹¹ Ibid.

¹² Fiscal Note for HCR 2056, Searle

¹³ Ibid., Analysis

¹⁴ Ibid.

¹⁵ Ibid.

¹⁶ Ibid., Local Government Impact

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