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MEMORANDUM

TO: Members, Utah State Board of Education

FROM: Brad C. Smith
Chief Executive Officer

DATE: May 7-8, 2015

DISCUSSION: Distribution Formula for Permanent State School Fund

Background: Revenues from school trust lands are deposited into the permanent State School Fund. Each year a distribution comes from the fund to finance the School LAND Trust Program. The Constitution sets the distribution formula as the interest and dividends earned from the fund's investments (Utah Const. Art. X, Sec. 5(2)(b)). Similarly, the Utah Enabling Act states that, as concerns the permanent State School Fund, the "interest of which only shall be expended for the support of" the public school system (Utah Enabling Act § 9). In August 2013, after a rigorous study by the Board's School Trust Investment Task Force, the Board voted in favor of supporting a review of the distribution formula, with the initial recommendation that the formula be based on a percentage of a rolling average of the market value of the fund.

Key Points: The fund is a \$2+ billion endowment for Utah's public schools. All, or nearly all, of the endowments of a comparable size have shifted away from an "interest and dividends" distribution policy and toward one that bases the distribution on the value of the fund. Updating the policy can simultaneously increase funding currently sent to schools, provide for stability in funding across years, and ensure the fund's long-term health. Reform will require, at a minimum, a constitutional amendment and potentially an amendment of Utah's Enabling Act.

Anticipated Action: USOE staff will explain options and be prepared to answer questions concerning options for modernizing the permanent State School Fund's distribution formula and the legislative and political strategy for accomplishing the same, followed by committee discussion.

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Tim Donaldson, 801-538-7709

MEMORANDUM

From: Tim Donaldson, School Children's Trust Director
To: Utah State Board of Education, Finance Committee
CC: Brad Smith, Superintendent; Angela Stallings, Associate Superintendent
Date: May 8, 2015
Re: Distribution Formula Changes and Enabling Act Amendments—Other States

This Memorandum provides factual context for a discussion of a potential change to the distribution formula for Utah's permanent State School Fund, the investment fund for revenues coming off of school trust lands. Part I of this Memorandum discusses the distribution formulas and related enabling act/state constitutional language for some of the states surrounding Utah that have permanent school funds of a similar or greater size than Utah's. Part II summarizes some lessons for Utah's permanent school fund when considering distribution formula changes and Enabling Act amendments.

A discussion of the potential policy changes to Utah's distribution formula is beyond the scope of this Memorandum. A discussion of that topic is included in the *Recommendations on Investment Oversight of the Permanent State School Fund*, from the Board's School Trust Investment Task Force, dated July 22, 2013.

I. Enabling Acts and Distribution Policies of Fellow Land Trust States.

A. Arizona

The Arizona Enabling Act established a "permanent school fund of said State, the income therefrom only to be used for the maintenance of the common schools of said State."¹ The enabling act also mentioned a "permanent inviolable fund, the interest of which only shall be expended for the support of the common schools within said State," into which 5% of all federal land sales were to be deposited.²

In 1998, the voters of Arizona approved a constitutional amendment that established a distribution formula through 2021 that distributes 2.5% of the average of the monthly market values of the fund for the preceding five years. Thereafter, the distribution is determined using a fairly complicated formula that multiplies the average rate of return minus the percentage change in the GDP price deflator for the prior five years by the average monthly market value of the fund for the immediately preceding five fiscal years.³

The Arizona Enabling Act was amended in 1999 to state that:

The trust funds (including all interest, dividends, other income, and appreciation in the market value of assets of the funds) shall be prudently invested on a total rate of return

¹ Arizona Enabling Act, § 25, 36 Stat. 577 (June 20, 1910)

² *Id.* § 27.

³ Ariz. Const. Art. 10, § 7(G)-(H)

basis. Distributions from the trust funds shall be made as provided in Article 10, Section 7 of the Constitution of the State of Arizona.⁴

Conforming amendments were made to Sections 25 and 27 of the Enabling Act to state that “distributions from [the permanent fund] shall be made in accordance with” the language quoted above.⁵ Congress also gave consent to changes enacted by Arizona in 1998 to its constitution.⁶

B. North Dakota

North Dakota’s enabling act passed in 1889, and included Washington, Montana, and South Dakota as well. The enabling act states that the proceeds from trust lands “constitute a permanent school fund, the interest of which only shall be expended in the support of said schools.”⁷ The enabling act also states that the 5% of federal land sales shall be paid to North Dakota “to be used as a permanent fund, the interest of which only shall be expended for the support of common schools”⁸

North Dakota’s voters approved a constitutional amendment in 2006 to change the state’s distribution formula to one that provides a biennial distribution equal to 10% of a 5-year average value of the financial assets in the trust.⁹

After several different failed efforts, North Dakota passed an amendment to the state’s enabling act in 2009.¹⁰ This revision states that “any distributions from trust funds in the State of North Dakota shall be made in accordance with section 2 of article IX of the Constitution of the State of North Dakota. Like Arizona, Idaho, and New Mexico, this amendment wisely gave the state the future control over how its distribution will be worded by tying its enabling act to a section of the Constitution, which can be subsequently amended without Congressional involvement.

C. New Mexico

New Mexico’s Enabling Act states that there shall be a “permanent school fund” and that “the income therefrom [is] only to be used for the maintenance of the common schools of” New Mexico.¹¹ New Mexico’s enabling act similarly says that 5% of the sale of federal lands shall be “used as a permanent inviolable fund, the interest of which only shall be expended for the support of the common schools within” New Mexico.¹²

The voters of New Mexico approved constitutional amendments first in 1996 and then again in 2003 to change the distribution formula for the state’s permanent school fund. The state constitution now provides that “the annual distributions from the fund shall be five percent of the average of the

⁴ Arizona Statehood and Enabling Act Amendments of 1999, § 2(a), H.R. 747, Public Law 106-133 (Dec. 7, 1999).

⁵ *Id.* § 2(b)(1)-(2).

⁶ *Id.* § 4.

⁷ Enabling Act of North Dakota, South Dakota, Montana, and Washington, § 11, 25 Stat. 676 (Feb. 22, 1889).

⁸ *Id.* § 13.

⁹ See North Dakota Const. Art. IX, Sec. 2.

¹⁰ Omnibus Public Land Management Act of 2009, H.R. 146, Public Law 111-11 (March 30, 2009).

¹¹ Enabling Act for New Mexico, § 7, 36 Stat. 557 (June 20, 1910).

¹² *Id.* § 9.

year-end market values of the fund for the immediately preceding five calendar years,”¹³ with an additional half-percent to be distributed through 2016.¹⁴

New Mexico’s enabling act was amended in 1997 to state 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 and retroactively gave Congressional approval to the 1996 amendments to the New Mexico constitution.”¹⁵

D. Idaho

Idaho was admitted to the Union pursuant to the Idaho Admission Act, which granted Idaho two sections out of each township for the purposes of creating a permanent school fund.¹⁶ The Idaho Admission Act contained the similar language to those cited above, stating that the “interest of which” fund “only shall be expended in the support of” the public schools.¹⁷

In 1998, Idaho began a series of changes to the management of its public school fund. In 1998, Idaho passed legislation allowing its investment board to invest in any and all investments available to a prudent investment manager, passed a constitutional amendment to modify how it managed its distribution, and requested a change to the Idaho Admission Act.¹⁸ Congress responded by passing legislation amending the Idaho Admission Act to bring it into conformity with the changes made in Idaho law, specifically: to allow trust land revenues to be put in a land bank to be used to purchase additional lands, and if the funds were not spent within a specific amount of time, to require the funds be placed in the earnings reserve fund, described below.¹⁹ The amendments also allow “the earnings reserve fund to be used for the support of public schools of the state in accordance with State law.”²⁰

In Idaho, earnings (defined in state law essentially as interest and dividends)²¹ off of the permanent fund are placed into an “earnings reserve fund,” out of which a distribution is made at least annually, at the discretion of the land board.²² The current distribution policy is to distribute 5% of the 3-year average value of the permanent fund.²³

E. Texas

Texas was admitted to the Union through the Joint Resolution for Annexing Texas to the United States.²⁴ This resolution had the unique feature of granting all unappropriated lands to the State. It did

¹³ See N.M. Const. Art. XII, Sec. 7(F).

¹⁴ *Id.* Art. XII, Sec. 7(G)(2)

¹⁵ New Mexico Statehood and Enabling Act Amendments of 1997, S. 430, Public Law 105-37 (Aug. 7, 1997).

¹⁶ Idaho Admission Act of 1890, § 5, 26 Stat. L. 215, ch. 656 (July 3, 1890).

¹⁷ *Id.*

¹⁸ See History of the Endowment Fund, Idaho Endowment Fund Investment Board website, <http://efib.idaho.gov/history.htm>, last accessed April 23, 2015.

¹⁹ An Act to Amend the Idaho Admission Act regarding the sale or lease of school land, H.R. 4166, Public Law 105-296 (Oct. 27, 1998).

²⁰ *Id.* At § 5(a)(2)(B).

²¹ Idaho Code 57-724A.

²² Idaho Code 57-723A.

²³ See Idaho Land Board Asset Management Plan at 11 (Dec. 20, 2011).

²⁴ Joint Resolution for Annexing Texas to the United States, 5 Stat. 797, March 1, 1845.

not create any trust lands or require the establishment of a permanent fund. Nonetheless, the Texas Constitution of 1876 set aside half of the remaining lands held in the public domain to support public education and established a permanent school fund.²⁵ The 1876 constitution stated that “only the interest thereon [shall] be used and expended annually.”²⁶ Accordingly, all revisions to the Texas permanent school fund and its distribution policy are a matter of Texas law, not federal law.

Texas also has modernized its distribution formula, albeit without the need to amend the law annexing Texas into the Union. Texas has a biennial distribution of up to 6 percent of the rolling average of the market value of the permanent fund for the prior 16 quarters, excluding real property belonging to the fund, according to a rate adopted by the State Board of Education or the Legislature.²⁷ The General Land Office also has the option of distributing up to \$300 million of current revenue annually.²⁸ The Texas distribution policy was most recently amended in 2011 to change how the market value of the fund is calculated and to add the provision allowing the General Land Office to distribute current revenues.

F. Wyoming

Wyoming was admitted to the Union in 1890 through the Wyoming Admission Act.²⁹ This Act contained the familiar language that the “proceeds” from school trust lands shall “constitute a permanent school fund, the interest of which only shall be expended in the support of said schools.”³⁰ Interestingly, Wyoming’s 1889 Constitution, which the United States accepted as sufficient in its 1890 offer of statehood,³¹ states that the “interest and income of [the permanent school fund] only are to be used” to support Wyoming’s public schools.³² It does not appear that anyone has seen fit to rectify this discrepancy, whereby the state’s constitution allows distribution of interest and income, whereas the Admission Act allows only interest to be distributed. Wyoming currently distributes from its fund “an amount equal to five percent (5%) of the previous five (5) year average market value of the account, calculated from the first day of the fiscal year.”³³

II. Lessons.

Utah’s Enabling Act states that the proceeds from school trust lands “shall constitute a permanent school fund, the interest of which only shall be expended for the support of” Utah’s public school system.³⁴ It also provides that the federal government shall pay to the state five percent of the proceeds from the sale of federal lands, which shall be “used as a permanent fund, the interest of which

²⁵ Constitution of the State of Texas (1876), Art. VII, § 2.

²⁶ *Id.* at Art. VII, § 6.

²⁷ Texas Const. Art. VII, Sec. 5(a)(1).

²⁸ Texas Const. Art. VII, Sec. 5(g).

²⁹ An Act of Admission of the State of Wyoming, 26 Stat. 222 (July 10, 1890).

³⁰ *Id.* § 5; *see also id.* § 7 (stating that the federal government shall give Wyoming 5% of all federal land sales to be deposited in a permanent education fund, “the interest of which only shall be expended for the support of the common schools” of Wyoming).

³¹ *Id.*, preamble.

³² Wyo. Const. Art. VII, § 6 (1889). This section has been subsequently amended twice but retains the same language today. *See* Wyo. Const. Art. VII, § 6. The subsequent amendments gave the Legislature authority to invest and manage the trust fund, which has been delegated to the State Treasurer. Wyo. Stat. Ann. § 9-4-715.

³³ Wyo. Stat. Ann. §9-4-719(h)(v).

³⁴ Utah Enabling Act § 10.

only shall be expended for the support of the common schools within said State.”³⁵ Utah’s original constitution mirrored this language, stating that these funds “shall be and remain a perpetual fund, to be called the State School Fund, the interest of which . . . shall be distributed among the several school districts according to the school population residing therein.”³⁶ An amendment to this language was approved by the voters of Utah to allow the “interest and dividends” earned off of the fund to be distributed annually.³⁷

Arguably, an amendment to Utah’s Enabling Act is required to change the distribution formula from the current “interest and dividends” formula to a formula that uses the rolling average market value of the fund in some way. Many other states, but not all, have seen fit to amend their enabling acts after making constitutional/statutory changes to their distribution formulas. If, after study by the State Board and the School and Institutional Trust Fund Office Board of Trustees, the consensus is that Utah’s Enabling Act must be modified to allow for a change in the distribution formula, the wisest way to amend the Enabling Act would be to revise it to say that the distribution formula will be set “as defined in the Utah Constitution,” or similar language. This will prevent the need to seek future federal changes should the beneficiaries desire further changes to the distribution formula. Any enabling act change should also retroactively approve the prior amendment of Utah’s constitution allowing for the new distribution formula.

³⁵ *Id.* § 9.

³⁶ Utah Const. Art. X, § 3 (1896).

³⁷ See Senate Joint Resolution § 2 (2002). The current language resides at Utah Const. Art. X, § 5(2)(b).