

STATE TRUST LANDS AND EDUCATION FUNDING

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With the recent passage of Proposition 123, Arizona voters are being asked to weigh in on two significant measures related to state trust land this year. The new proposition relates to how money produced by the sale of trust lands is used to support education. This is headed for a vote on May 17, 2016. A previously referred proposition will also appear on the fall ballot and would allow the State Land Department, which administers trust land, to keep some of its revenue to operate the Department.

These two proposals highlight a relatively obscure part of Arizona's heritage: a huge holding of land by the people of the State, not for recreation or open space, but to make money for schools. The purpose of this paper is not to examine the propositions in depth or make any recommendations about how to vote, but rather to provide perspective on the history and role of state trust land.

The federal government has given new states lands to support education since the Northwest Ordinance of 1787. Arizona was given more than 10 million acres of land by the federal government to be held "in trust" for various beneficiaries, mostly related to education. As Arizona was the last of the lower forty-eight states, the federal government imposed fairly tough restrictions on how it could be sold or leased. Until the 1980's the land was principally used for grazing, timber, and farming. In 1980, the Urban Lands Act created a process for selling or leasing trust land for urban development.

Arizonans have heard more about state trust land in the last few years. Much of northeast Phoenix has been developed on leases or on former state trust land parcels. Attempts to reform the management of the Arizona State Land Department (ASLD) have been on the ballot repeatedly. Reform efforts have focused on trying to increase the revenue ASLD can generate from its operations. Many stakeholders desire reform. Ranchers have sought grazing reform since most of the acreage is used for grazing cattle. Environmental groups have wanted to make it easier to set aside some parcels of trust land for preservation.

Until recently, however, there has been very little focus on what happens to the money from state land and how much actually gets to the intended beneficiaries. Following a proposal by Governor Ducey, the focus has moved squarely to how the "Permanent Fund" created from the disposition of the state trust land should be managed and invested for the future.

I. BRIEF HISTORY OF THE PERMANENT FUND

Early History

Congress enacted the Arizona-New Mexico Enabling Act on June 20, 1910.¹ The first paragraph of § 28 said that all “money proceeds” of trust lands “shall be subject to the same trusts as the lands producing the same.” The state’s fiduciary duty, therefore, extends to financial assets gleaned from the sale of trust lands. Thus, the trust includes both land assets and the cash assets that come from land dispositions. The Permanent Fund is thus a sort of replacement for lands that have been disposed. Although both land and financial assets are subject to the same trust, they are managed by different state agencies—land by ASLD and the Permanent Fund by the State Treasurer.

The seventh paragraph of § 28 specified rules for treatment of the Permanent Fund:

*A separate fund shall be established for each of the several objects for which the said grants are made and confirmed by the said enabling act to the state, and whenever any moneys shall be in any manner derived from any of said lands, the same shall be deposited by the state treasurer in the fund corresponding to the grant under which the particular land producing such moneys was, by said enabling act, conveyed or confirmed. No moneys shall ever be taken from one fund for deposit in any other, or for any object other than that for which the land producing the same was granted or confirmed. The state treasurer shall keep all such moneys invested in safe, interest-bearing securities, which securities shall be approved by the governor and secretary of state, and shall at all times be under a good and sufficient bond or bonds conditioned for the faithful performance of his duties in regard thereto.*²

Arizona’s legislature enacted the State Lands Code in 1915, which created the State Land Department. The Enabling Act contained 13 separate land grants for separate beneficiaries. To this day, Arizona statutes recognize 13 separate funds for universities, penitentiaries, and other minor purposes.³ By far the largest beneficiary (representing 85-90 percent of the acreage and a like percentage of financial assets) are the common schools (*i.e.*, K-12). Generally, everything is lumped together and called “the Permanent Fund.”

In the first decades of statehood Arizona was (like other states) careless in the discharge of its fiduciary obligations towards the Permanent Fund. From the start, the legislature tried to steer trust funds into loans to private landowners. By 1925 approximately two million dollars had been loaned to private agricultural interests. The legislature even tried to forgive many borrowers’ obligation to pay interest on loans from the Permanent Fund. In *Rowlands v. State Loan Board of Arizona*⁴, the Supreme Court held that the Constitution prohibited the forgiveness of interest on the loans. A fundamental legal question, of course, was whether loans to private individuals constituted “safe, interest bearing securities” within the meaning of the Constitution. In 1941 the Arizona Supreme Court said yes.⁵

Six years later, the Supreme Court struck a different and almost apologetic tone regarding the investment of the Permanent Fund. In *Murphy v. State*⁶, the Court decried the “legislative

intermeddling in the duties of the state treasurer” and explained how “pressure groups” had forced the treasurer to invest the Permanent Fund in “questionable investments.”

In 1957 New Mexico wanted to invest some of its Permanent Fund in equities and pressed Congress for an amendment. Congress could have amended the Enabling Act in many ways to permit such investments. Instead Congress simply repealed the entire seventh paragraph of § 28. As a result, after 1957—and until the Enabling Act was amended in 1999—the Enabling Act said almost nothing about the Permanent Fund.

In 1957 New Mexico amended its constitution to permit its Permanent Fund to invest in equities. Arizona did not. As financial matter, Arizona missed a great opportunity by failing to follow New Mexico’s lead because Arizona’s Permanent Fund did not benefit from the appreciation in stocks that occurred from the late 1950’s through the late 1990’s.

Over the course of the 20th century, management of the Permanent Fund gradually became more responsible. It is impossible to pinpoint any single event as marking the change, but in hindsight a good choice would be the U.S. Supreme Court decision in *Lassen v. Arizona Highway Dept.*⁷ Since statehood the Arizona Highway Department had acquired “free” rights of way over trust lands, based on the (probably accurate) justification that the trust land holdings enjoyed a net increase in value due to the new highway frontage. The Arizona Supreme Court held that the highway department need not compensate the State Land Department for the rights of way. The U.S. Supreme Court disagreed and held that the highway department had to pay actual cash value for the right of way. The Court explained that the Enabling Act was designed to allow Arizona “to accumulate funds with which it could support its schools.” *Lassen*’s admonition to treat the trust seriously was echoed in many decisions over the next 25 years.⁸

In the meantime, Arizona’s passage of the Urban Lands Act in 1980 changed the focus from mineral and grazing leases to the sale of more-valuable lands for urban development. Growth in the Permanent Fund accelerated. In 1978, the Permanent Fund stood at a modest \$100 million⁹. In 1984, it had grown to \$170 million. By 1996 the Permanent Fund was \$767 million (Figure 1).

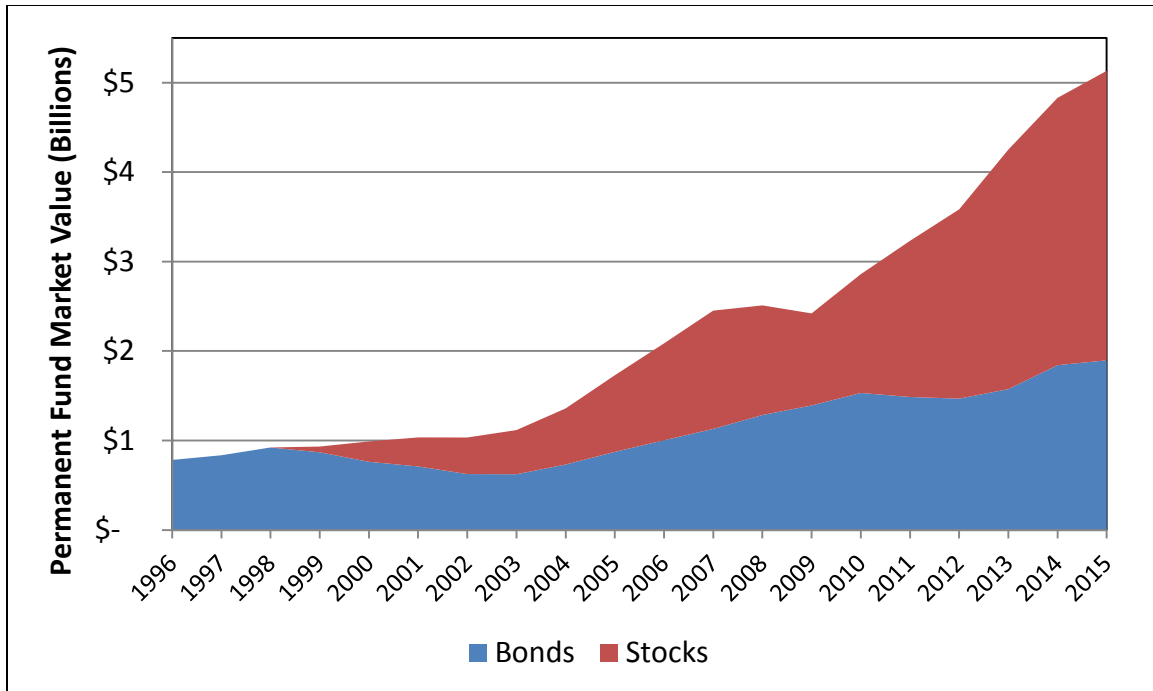


Figure 1: Permanent Fund Value Since 1996.

Reforms in the 1990's

The Permanent Fund is a replacement for permanent dispositions of trust lands, not a general catchment for all revenue from trust lands. The Permanent Fund only receives revenues from non-renewable sources, *i.e.*, land sales and mineral royalties (“Permanent Fund Receipts”). Revenues from renewable resources—including rent on long-term leases, permits, and interest on deferred payments associated with land sales—is distributed directly to the beneficiaries on an annual basis (“Expendable Receipts”). Since the inception of the Trust, Permanent Fund Receipts have totaled \$3.249 billion. The vast majority, \$3.12 billion or 96 percent, has come since the Urban Lands Management Act became law in 1982. Of this, less than 10 percent had been from mineral sales until 2010 when 28 percent of Permanent Fund Receipts came from mineral sales and that percentage grew to as much as 32.67 percent in 2011 before declining slightly. This remains a potential, but finite source of revenue to the Permanent Fund. Expendable Receipts have also grown significantly since the Urban Lands Management Act and since 2002 have averaged approximately \$66 million.

As of the 1990's the Permanent Fund had never invested in equities even though such investments were authorized by Congress in 1957. Bond investments generate income when bonds are held and capital gains or losses when bonds are sold. Arizona's Permanent Fund thus experienced both income and capital gains, but did not grow significantly except from land sales.

In 1995, the legislature asked the Arizona Auditor General to conduct a performance audit of the Land Department. Auditor General Douglas Norton prepared a report that became very influential. The report identified two problems regarding the investment of Permanent Funds.

First was the lack of equity investments. The Auditor General observed that, while equity investments are more volatile, they earn greater long-term returns than bonds. The report advised investing in equities as Congress had authorized 40 years before.

Second, the report criticized the Permanent Fund's payout strategy as being too generous in one respect and too stingy in another. The unwise generosity consisted of paying out *all* interest income earned on the Permanent Fund to the beneficiaries each year, with no allowance for inflation. Instead the Auditor General advised that the Permanent Fund should pay out only post-inflation "real" returns. On the other hand, the Auditor General saw no reason to tie distributions to the type of investment returns—whether they derived from interest income or capital gains—and recommended that they should be treated equivalently. To address all of these issues, the Auditor General suggested tying the amount of distributions to the Permanent Fund's *market value*. To smooth out fluctuations in the market, the report suggested using a 3-year or 5-year look back.

In 1997, the "Growing Smarter" commission proposed statewide reforms to urban planning and growth management, including reform of the State Land Department. One of the commission's proposals became Proposition 102, which amended Arizona's Constitution as proposed in the 1997 Auditor General report. The investment restriction to "interest bearing securities" was removed and investments in "prudent equity securities" were authorized up to a limit of 60 percent.

The critical part of the measure prescribed a formula for making annual distributions. The amount of an annual distribution is determined by multiplying a dollar valuation by a specific rate of return. That is:

$$\text{Amount (in dollars)} \times \text{rate of return (in percent)} = \text{annual distribution.}$$

The amount is easy to calculate: it is the average of the monthly market values of the fund for the immediately-preceding five fiscal years.

The percentage is the average annual total rate of return for the immediately-preceding five calendar years, minus inflation (as measured by a federally-published index called the "GDP price deflator.") The "annual total rate of return" is determined by dividing (i) the amount credited to a fund for each fiscal year, plus unrealized capital gains and losses, by (ii) the average monthly market value of the fund during that year.

Prop 102 was presented on the understanding that its success would require parallel changes to the Enabling Act. Congress did so in 1999 by adding two new sentences to the first paragraph of § 28:

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

This is the last time Congress amended the Enabling Act or otherwise addressed the subject of distributions from the Permanent Fund. These two sentences thus supply the federal framework for future discussion of these issues.

Voters considered two more ballot measures at the 2000 election. Neither bears directly on the current debate over distributions, but they are recent enough to deserve explanation.

Voters approved Prop 301, an initiative measure that included a sales tax dedicated to education and established the classroom site fund. The first \$72 million in earnings subsidizes the legislature's payment to the state funding formula. Earnings above \$72 million are distributed to districts and charter schools on a per pupil basis, primarily for teacher pay.

The voters rejected Prop 100, a constitutional amendment that would have allowed up to 5 percent of auction proceeds to fund specified ASLD operations, including "land use planning" but excluding "personnel expenses."

Fund Distributions Since 2000

The stock market crashed in late 2008 and bottomed out in early 2009. The constitutional formula thus looked back on some very bad returns. For the first time since 1998, the distribution in 2010 was literally zero. The legislature and the education community had both come to rely upon an annual distribution from the Permanent Funds. Separately, during the budget crisis that attended the recession, the legislature revived the idea of using trust fund revenues to partially fund ASLD's operations. In 2009, the Legislature authorized the diversion of up to 10 percent of the proceeds of land sales to fund ASLD operations. The education community sued, alleging that the diversion of trust funds violates the Arizona Constitution.

The legislature responded to the zero distribution by proposing Proposition 118. The measure received bipartisan support at the legislature, as the education community wanted more money for education and the legislature wanted greater predictability in budgeting. Voters narrowly approved the measure in the 2012 election.

Prop 118 did not repeal the variable-payout formula that was enacted in 1998 and used from 1999 through 2012. Rather, Prop 118 temporarily replaced that formula through FY 2020-21. The amount of annual distributions continued to look back to the fund's average market values over the previous five years. But instead of multiplying that market value by the average realized rate of return, that value is multiplied by a flat figure of 2.5 percent.

Prop 118 was advocated as a means to bring more money to education but it has had the opposite effect. Given the surge in stock market values since 2008, distributions would have been higher if they were based upon a five year look-back on actual rates of return.

Comparisons to similar mechanisms for trust distribution show that the current 2.5 percent formula is quite conservative. In North Dakota, distributions have ranged from 3.5 to almost 8 percent in the past 8 years. In New Mexico, the beneficiaries receive a standard 5 percent return on an endowment that is grown largely through oil and gas revenues. University endowments often use either a 4 percent or 5 percent annual payout rate as a stable and safe number to distribute over time. The Internal Revenue Service requires "private foundations" to distribute 5 percent of their net asset value every year to ensure that the foundations are genuinely charitable and not simply an effort at tax exempt hoarding of private assets. The current state treasurer, Jeff DeWit, has stated that a 3.75 percent annual payout would represent a safe and stable distribution amount.

Whatever level of payouts is selected, it is clear that the system of managing payouts should not be constantly changing. Doing so requires public votes to amend the constitution, and creates confusion, inconsistency, and unstable funding. Ideally, the system might authorize the State Board of Investment to manage within a range. But empowering any group with such discretion over public monies would inevitably become politicized. It is probably better to mandate a long term fixed payout—somewhere in the 4-5 percent range. The current system of a temporary 2.5 percent distribution then returning to an old, volatile system is not rational. Proposition 123 would return distributions to 2.5 percent after the 10 year relatively high payout period. This makes it likely that the voters will revisit the distribution yet again at some point in the future.

II. HOW DID THE PERMANENT FUND GROW SO LARGE AND WHAT SHOULD WE DO WITH THE MONEY?

As of 2015, the Permanent Fund has grown to \$5.2 billion, approximately \$1.95 billion, or 38 percent from earnings on the Total Permanent Fund Receipts and \$3.25 billion from land and mineral sales receipts. A recent study by the Center for the Study of Economic Liberty at the W.P. Carey School of Business found that the fund’s extraordinary growth is mostly due to investment gains that were not distributed either under the old formula or the 2.5 percent formula. It seems clear that both the formulaic payout and the flat 2.5 percent payout were flawed. The variable-payout formula was unduly volatile and unpredictable. The flat 2.5 percent payout is unduly conservative.

Exactly how much “extra” has been accumulated in the trust is a subjective determination requiring a number of different assumptions. The Center for Economic Liberty Policy report found that if the 2.5 percent formula had applied back to 2005, an additional \$40 million would have gone to the beneficiaries. If a 4 percent distribution—still considered conservative by most standards—had applied, an additional \$350 million would have been paid by the end of 2014 (Figure 2 and

TABLE I
Arizona Permanent Educational Fund, 2004-2014 (Figures in Millions of 2010 Dollars)

Year (1)	Permanent Fund Value (2)	Receipts Added (3)	Distributions from Permanent Fund (4)	Distributions Minus Receipts [Col 4 minus 3] (5)	Col 5 as % of Col 2 (6)
2004	1,379	171.6	23.1	-148.5	-10.8%
2005	1,793	306	29.7	-276.3	-15.4%
2006	2,041	305.4	36.9	-268.5	-13.2%
2007	2,510	203.8	37.2	-166.6	-6.6%
2008	2,590	255	75.6	-179.4	-6.9%
2009	2,223	144.9	60	-84.9	-3.8%
2010	2,700	94.5	0	-94.5	-3.5%
2011	3,187	117.5	16.9	-100.6	-3.2%
2012	3,325	153.8	79.7	-74.1	-2.2%
2013	3,828	223	62.9	-160.1	-4.2%
2014	4,483	94.6	66.8	-27.8	-6%

Source: Arizona State Treasurer Annual Reports

Table 1). Other estimates have suggested even higher numbers.

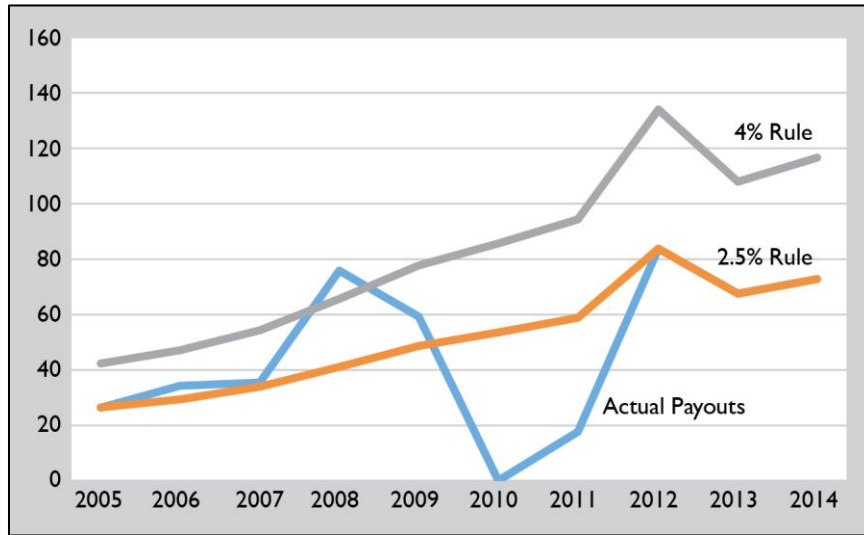


Figure 2: Payouts Under Various Scenarios

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2009	2,223	144.9	60	-84.9	-3.8%
2010	2,700	94.5	0	-94.5	-3.5%
2011	3,187	117.5	16.9	-100.6	-3.2%
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Table 1: Permanent Fund Since 2004.

One recurrent question is how to define the “corpus” of the Permanent Fund and whether it is legal or good policy to invade that corpus at this time. These are not simple questions.

The legal term “corpus” represents the original value of trust assets, usually with an expectation that it will remain intact, though trust provisions often allow invasion for emergencies or other

uses. Modern trust theory would generally hold that the corpus should be managed so as to preserve its original buying power, protecting it against inflation. Thus, if one put \$1 million in trust for designated beneficiaries with typical trust instructions that they are to live off the income, a financial manager would try to invest this \$1 million corpus so that it might earn 6 or 7 percent and would then subtract about 2 percent as a hedge against inflation. The remaining 4-5 percent would be distributed to the beneficiaries.

Aggressive interpretations of what is distributable, coupled with less than robust investment returns could be viewed as reaching into the corpus of the trust. No constitutional or statutory prohibition expressly says that “the state may not invade the corpus.” But various court decisions set up the clear expectation that the “corpus” of the land trust is not to be cavalierly spent. It is not clear whether emergency circumstances would allow such invasion but an express desire to use money from the corpus could easily prompt long and contentious litigation. A desire to increase education funding without raising taxes does not constitute an emergency.

A complex question here, however, is defining the “corpus” of the Permanent Fund. As noted above, the corpus should be viewed as both the land assets and the proceeds from dispositions of non-replaceable assets. If this trust is managed consistent with modern trust management theory, a margin for inflation protection should also be added. So the corpus here would be the value of all the land which has been sold since statehood with some inflation adjustment.

Arizona Republic columnist Bob Robb has suggested that all earnings should be distributed, with the remaining land viewed as the protection against inflation. By this reckoning, somewhere between \$1.5 and \$2 Billion could be regarded as extra accumulation from the past, and should be distributed. At some point, this view would no longer afford inflation protection as most of the valuable urban state land will have been sold or leased.

Most university endowments would reset the value of the corpus every year. That would suggest that, after each annual distribution, the entire remaining balance in the trust becomes the corpus for the next year going forward. This philosophy would grow the corpus quickly in a rising market, by retaining annual returns over the distributed amount.

If the corpus of Arizona’s Permanent Fund were similarly reset each year, there would be no “excess” currently available for distribution. On the other hand, if the “corpus” is regarded as the original value of the land which was sold with some additional amount added as a protection against inflation, there is arguably over \$300 million extra which has been accumulated. The question of how much of the value of the fund should be regarded as excess and might therefore be available for distribution is a question of intergenerational equity. Should that money (whatever the amount) be taken out of the Permanent Fund at this time and be used to make up for current underfunding of education in the state? Or should that money remain in the trust to continue to grow through investment building a bigger endowment for future generations?

This is the context of the current debate. Proposition 123’s proposed 6.9 percent payout can be thought of as simply distributing excess accumulated over the last decade. Returning to the conservative 2.5 percent payout after the high 10 year period can be viewed as a prudent “rebuilding” of the corpus. If the market declines in the next few years the higher payout number could be found to result in an invasion of the “corpus” if the legislature does not lower distributions. The risks of this scenario might give rise to legal challenges. Proposition 123

presents Arizona voters with an important policy choice that is untethered from conventional partisan labels. Some “conservatives” react negatively to using an “endowment” to satisfy current needs—they view the trust like a retirement account, and believe that planning for future needs is inherently conservative. Others feel that the government should not be accumulating money in the first place. Some “liberals” think squandering an endowment because we are unwilling to raise taxes to fund education is inappropriate. Others feel that funding education is the most critically important function of government and needs to be supported however possible.

However voters react to Prop 123, there has been a history of reluctance to reform the operation of the State Land Department, with propositions to do so turned down in the 2000, 2002, 2004, 2006 and 2010 elections.

III. WHAT ABOUT LAND MANAGEMENT?

It is important to consider the land side of the trust since converting land to cash is the main source of growth in the Permanent Fund. The question of how the lands held by the State Trust should be managed is beyond the scope of this paper. Several questions have been debated for a long time. Is it better to lease or to sell? Should the state engage in planning and zoning of the land before it is sold? Should planning money be appropriated by the legislature or should private parties be incentivized to plan state land? Is a state agency capable of administering a complex program of land development and management? Should the Land Department be allowed to keep some of its proceeds in order to manage the department? What is the balance between natural resource protection and land development? Should the State Land Department be insulated from legislative or gubernatorial influence, e.g., should the commissioner serve at the pleasure of the governor?

In recent decades many reforms have been proposed and rejected by the voters. For purposes of discussing the management of the Permanent Fund, one must make assumptions about probable land sales in future years, as well as direct distributions to the beneficiaries from leasing and other annual revenues from the land. When most of the income from state trust land was derived from grazing, agricultural, and mining leases it represented a small but stable income stream to the beneficiaries. Since 1980, when the Department began earning significant money from disposing of land for urban development the additions to the Permanent Fund became much less predictable (Figure 3).

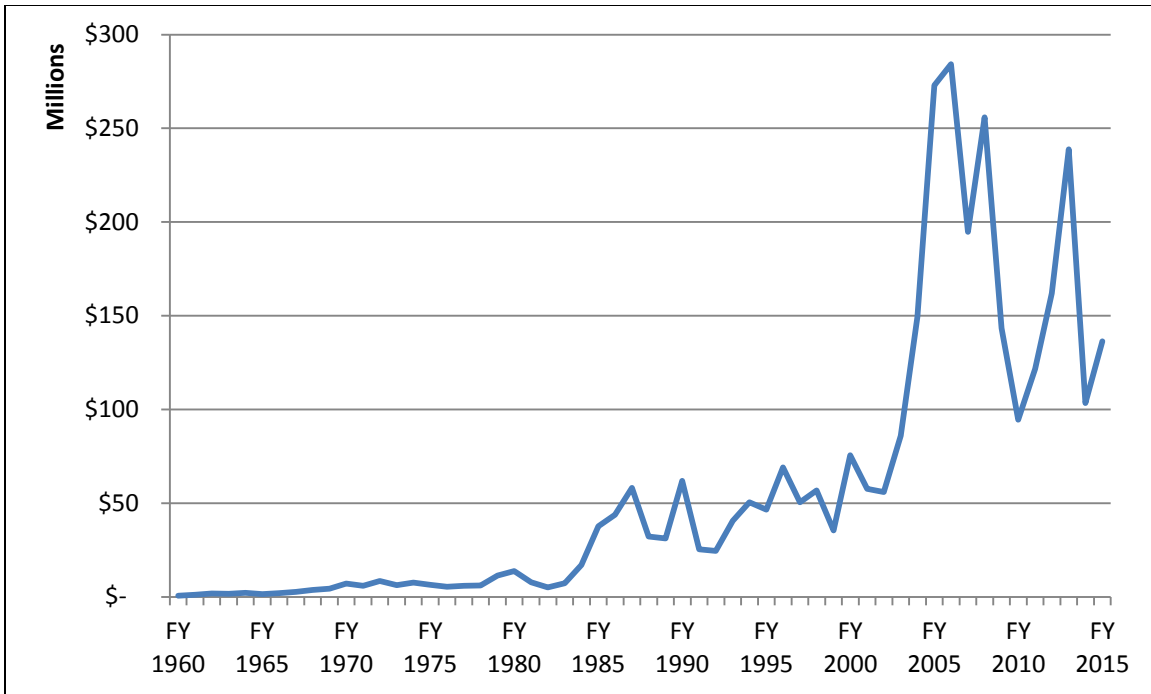


Figure 3: Permanent Fund Receipts Since 1960

Making the assumption that the managers of the Trust can sell a defined amount of land each fiscal year may seem reasonable on the surface, but the odds diminish greatly in light of well-known swings in the real estate market and the constraints placed on disposition of trust lands. Real estate is an inherently volatile and cyclical industry. The reasons it is difficult to make these assumptions with a high degree of certainty are several— location and utility, illiquidity (sale process), and fungibility.

Land in urban areas with excellent access, in the path of growth and in a location where demand persists, is more valuable than inaccessible, rural land. This was the basis for the Urban Land Management Act referenced above. Although there are 9.3 million acres of Trust land remaining, only a small portion of that is in urbanized areas, has excellent access, is not already encumbered by existing leases and is in an area where demand for that land persists. The other factor is utility – its productive capability. This is based on market demand, physical characteristics and legally permissible uses. Not all of the land in and around urban areas is suitable for development. The inventory of developable, marketable land is also finite and, as sales occur, declining. This means that successive years of sales will diminish the ability in future years to generate sales. Since the Urban Lands Management Act, even given 3 notable economic recessions (the Savings and Loan Crises of the 1980s; the tech bubble of the late 1990s and the financial crises beginning in 2008) the Total Permanent Fund Receipts have still grown on average, even during the financial crises. Figure 4 shows receipts from land sales and separately from mineral sales which together equal Total Permanent Fund Receipts since 2003 (Source: Arizona State Land Department).

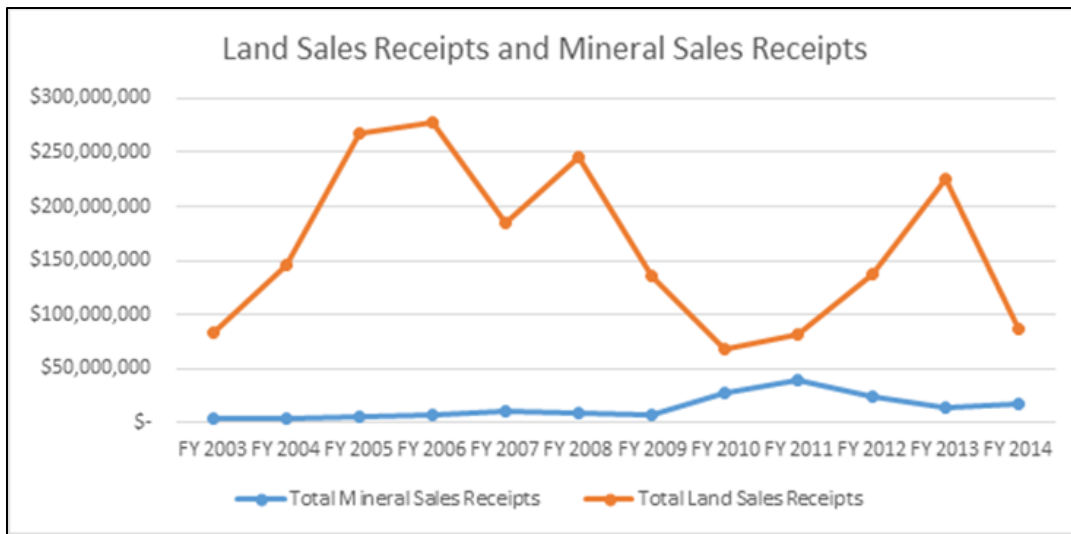


Figure 4: Land and Mineral Sales Receipts

Additionally, real estate is inherently less liquid than other assets. Other assets often trade continuously in an open market that is often global in scope. Real estate, especially raw land, is quite different. The sale process is slow and uncertain because pricing requires local knowledge. This is made considerably more difficult for the managers of the Trust because land sales or leases of more than 10 years must be through a public auction to the highest and best bidder. In addition, disposition is based on minimum values set by appraisal. The auction must be advertised over a long time period and is open to all qualified bidders. Not only does this process result in delay, it increases uncertainty for the buyer. Markets change during the process or appraisals do not fairly represent the market’s perception of value. Sometimes there are zero bids at auction.

Finally, real estate is not fungible: one parcel of land is not the same as all others. It is thus difficult to value and as the size of the asset increases, the per unit value decreases. Selling large quantities of land in a single sale will result in lower per unit prices. The effect may impact the value of all future land sales in a negative way. This is a poor management strategy unless the sole purpose is to liquidate the lands. This strategy will not optimize the value of the Trust.

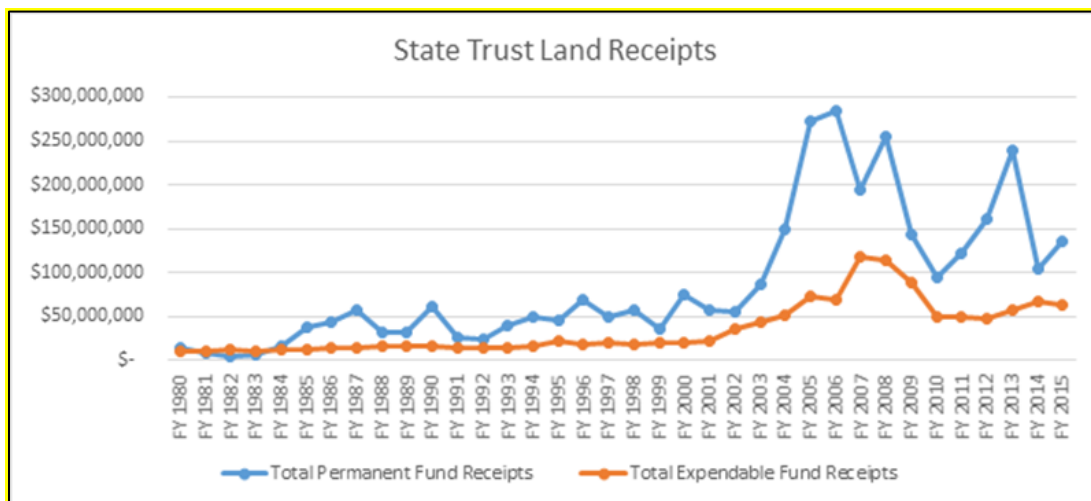


Figure 5: State Trust Land Receipts

The history of ASLD's land sales is one of very slow disposition of land because of the issues raised above and based on the assumption that land values will always go up and that in the context of a permanent trust one can always justify waiting until later. This is a mentality of trade-offs whereby the increase in value of the asset will rise more by waiting than what it can earn in the Permanent Fund. Whether this is actually the case depends on the real estate cycle, the specific land being considered and the rate of return earned in the Permanent Fund. There is no single right answer that can be applied categorically.

There are additional practical issues associated with management of a Trust so diverse. Experienced staff is needed to dispose of land. Another issue is the various encumbrances on Trust land resulting from years of management—grazing and other natural resource uses pose a constraint that is not easily halted. Yet another issue is management of the Trust. To those who work in the Land Department, an important motivating factor is not so much the sales price of land (although that is a critical factor), but the desire to avoid criticism for having sold too early or too cheaply, or to speculators who might then profit “too much”. Establishing a strategy for disposition of such a large inventory of land could sell too much, too quickly which would cause a decrease in value of each additional acre sold – supply well beyond demand will reduce the value of land for all land owners. A measured approach optimizes value. This is easy in theory, but difficult in reality because of all of the exogenous factors impacting value. It is highly probable that a forced policy to sell a defined amount of land will result in less than optimizing the value. The management of Trust land is very complicated. While a full examination of this issue is far beyond the scope of this paper, if the State is to focus more on the land trust as a continuing long term and stable source of educational funding it would be logical to give the Land Department some expectation as to how much money it should seek to add to the trust on average every year and allow it to derive a strategic plan to achieve the goal through approaches that recognize the numerous issues associated with disposing of land in such a way as to optimize its value. This could be done simply as a management directive from the governor to the Land Commissioner and in bad economic times or given particular circumstance of an individual year the Land Department should have the flexibility to say that the presumptive target cannot be met. But based on past performance over the past couple of decades, it would appear reasonable to expect the Land Department to add \$150-200 million to the Permanent Fund every year.

The Land Department is not like other state agencies. In order for the Land Department to have stable successful operations, it must receive stable funding at a level sufficient to attract and retain employees with real estate experience. It should be viewed as an enterprise capable of self-funding. The ballot proposal currently scheduled for vote in 2016 is one way to do this. But its revenue projections, driven by annual sales, could fluctuate widely. In the private sector, a trust manager would charge a percentage of fixed assets. For an endowment of this size, the fee might be .25 percent, which would currently be about \$12 million, could fund most of the Land Department's management expenses. Either a percentage of revenue or of assets going to fund Land Department operations requires a constitutional amendment.

IV. HOW MUCH CAN STATE TRUST LAND AND THE PERMANENT FUND HELP EDUCATION?

Any plan to increase education funding must be put into context to gauge its impact on Arizona's K-12 education system. This context should include consideration of not only the percentage change to Arizona's education expenditures, but also a look at how per-pupil expenditures would change and the change to education expenditures per \$1,000 in personal income. A more accurate picture of the funding situation emerges when these three units of analysis are applied.

Proposition 123 will generate \$3.5 billion over 10 years. The amount directed to K-12 education each year would gradually increase from \$299 million in FY 2016 to \$400 million in FY 2025, with an average payout to education of \$350 million annually. Most of this funding comes from increased distributions from the Permanent Fund, but there is also a small portion of General Fund revenue in the plan. For FY 2016, the legislation passed during the special session of the legislature includes \$172 million from the Permanent Fund, a continuation of the \$74 million General Fund appropriation from the last regular session which, along with an additional \$3 million, will be directed to Basic State Aid for schools. This \$249 million Basic State Aid package will be supplemented by an additional \$50 million that may be used either for maintenance and operations or capital outlay.

Overall Funding Increase

For FY2016, the state's General Fund appropriation to the Department of Education was \$3,889,519,500. Adding \$300 million to this would represent a 7.7 percent increase in state education funding. However, it would be inaccurate to say that the state's schools will receive 7.7 percent more funding in FY2016 under the Governor's plan. State funding is one of three components of school funding. Funding from the state represents 36 percent of total K-12 funding in Arizona, with an additional 49 percent coming from local districts, and 15 percent for the federal government. A \$299 million increase in FY2016 would be an increase of 2.8 percent to Arizona's total K-12 revenue.

It should also be noted that Arizona's K-12 expenditures will necessarily increase as the state's population grows. Historically, student population has grown at a rate of 3 percent per year, but since 2009, K-12 enrollments have grown by just 0.5 percent annually. It is possible, depending upon how final legislation is written, that a portion of the proposed \$350 million increase to education goes to support this increased caseload and not to increased services to the existing student population.

Per-pupil funding

To get perspective on what an extra \$299 million would actually mean to Arizona's school systems and to understand how this would affect the state's education position compared to other states, it is appropriate to look at revenue expenditures per pupil. The most recent data available for national comparison is from 2013. Applying the \$299 million funding increase to the 2013 data provides an estimate of how overall per-pupil funding would be affected and how the state's position in national rankings might change.

Arizona's K-12 funding in FY2013 from all sources, local, state, and federal, was \$8,599 per pupil. This amount ranked 48th among the 50 states, and was 31 percent below the national

average of \$12,380 per pupil. The state's portion of this funding amounted to \$3,116 per pupil which was 45 percent below the national average of \$5,650, ranking Arizona 50th in the nation for state funding per pupil.

Adding \$299 million to the FY2013 figures would raise Arizona's total per-pupil revenue to \$8,917. This would place the state 28 percent below the national average and move the state's ranking up by 2 places to 46th in the nation, ahead of Oklahoma, but lagging behind Tennessee.

Funding per \$1k personal income

While per-pupil funding measures the impact of funding changes on the educational system, another measure is used to gauge impacts on the economy of the state. Expressing K-12 funding in dollars per \$1,000 of total personal income provides insight into the burden that education funding places upon the taxpayers.

In FY2013, Arizona's total education funding amounted to \$33.04 per \$1,000 of personal income. This was 49th in the nation and 22 percent below the national average of \$42.25. The state's share of funding was \$11.97 per \$1,000 of personal income, 38 percent below the national average and ranked 48th in nation.

Note that Arizona's local funding of education, largely from property taxes levied by school districts, is just 15 percent below the national average when measured against personal income, and 24 percent less on a per-pupil basis. Also note that the state receives federal support at levels considerably higher than the nation as a whole, exceeding the average by 25 percent when measured against total personal income and 11 percent by per-pupil spending. These figures suggest that low levels of education financing from at the state level have been somewhat counterbalanced by local and federal funds.

Were \$299 million in additional state revenue added to the FY2013 figures, the total funding per \$1,000 in personal income would rise by \$1.22 to \$34.26. This would place Arizona at 19 percent below the national average at a ranking of 47th place. The state commitment would rise to \$13.19, which is 32 percent below the national average of \$19.29 per \$1,000 of personal income. This change in state funding is insufficient to change the state's ranking, which would remain at 48th place.

Other Implications of Prop 123

In addition to increasing distributions from the Permanent Fund of the State Land Trust, Proposition 123 contains other provisions that may affect education funding. First, there is a provision that the legislature may reduce the distribution from the Permanent Fund to as low as 2.5 percent if the amount of returns to the fund drop. This measure is designed to preserve the corpus of the trust and could reduce education funding to its current level if the market performs poorly.

Second is a provision that reduces the annual inflation funding adjustment in the event of an economic downturn. Had this provision been in place during the Great Recession, the inflation adjustment would have been suspended for four years from 2008-2011. When the next cyclical economic downturn hits this provision will be triggered and schools will receive less funding for the duration of the recession.

Finally, there is a provision that could suspend the inflation adjustment if the General Fund appropriation to the Department of Education (ADE) reaches 49 percent of the total General Fund budget. This suspension would be mandatory if the ADE percentage reaches 50 percent. This trigger effectively puts an upper limit on Arizona's K-12 spending. This limit, using the current budget figures of \$9.2 billion total budget and \$3.8 billion for ADE, would kick in if the ADE appropriation were raised by \$1.4 billion. Although such a large increase seems unlikely to happen, it should be noted that an increase in K-12 funding of \$2.8 billion annually would be needed to bring Arizona's funding up to the national average.

V. CONCLUSION

Several conclusions can be drawn from the history of the state's management of Trust lands and the Permanent Land Endowment Trust Fund ("Permanent Fund").

1. Neither the pre-2012 distribution formula, nor the current temporary 2.5 percent distribution represent sound management of the Permanent Fund:—the former is too volatile; the latter is too low.
2. Arizona should not constantly amend the Constitution to tinker with the management of the Permanent Fund. A long term, stable and sustainable payout to the beneficiaries should be set, similar to what is done for other endowments or foundations. Changes should be made only very rarely.
3. Long history and the practice of other similar institutions suggests that the payout should be fixed at a set percentage of the annual value of the Permanent Fund. The percentage should be in the range of 4 percent to 5 percent annually. The exact number depends on how conservative or "safe" we want to be in protecting the assets.
4. The corpus of the State Trust consists of both the remaining State Trust Land and the money received in exchange for past sales of Trust Land. Protection of the Permanent Fund held as corpus should include some hedge against inflation, which suggests the 4 percent-5 percent distribution range, assuming somewhat higher average returns. Invading the corpus, or even the risk of such invasion, is likely to be met with significant legal challenges.
5. Because of past distribution practices, there are currently potential "excess" funds in the Permanent Fund over what might be regarded as corpus. It is difficult conceptually to determine the exact amount of this excess. The excess in the Permanent Fund could be spent for current educational needs by adding an additional distribution for the next few years. This is the essence of Proposition 123. An alternative would be to keep some or all of the excess to build the Permanent Fund to a more robust level. Choosing between retaining or distributing any excess represents a classic public policy choice: spend now to alleviate a current problem; or save for future generations. This is a legitimate topic for debate.
6. Management of State Trust Lands has been inconsistent and underfunded for decades. The Land Department should be given a clearer mandate and a presumptive target for

production. A realistic target could be average annual sales in the range of \$100 million, with the understanding that the trust has a diminishing portfolio of valuable urban lands and cannot control swings in the real estate market.

7. In order to achieve significant consistent production for education, the State Land Department needs more funding and more stability. Allowing the Department to be funded from its production is a good idea. The proposition expected to be scheduled for vote in the fall of 2016 is one way to do this. Another alternative would be a small percentage of trust assets being used by the Department every year.
8. Even with stable realistic distributions, better funding for the Land Department and more consistent management, it is unlikely that State Trust Lands will ever be able to pay a significant percentage of the cost of education in the State. Prop 123 would increase overall funding by about \$299 million. Arizona would remain near the bottom of states in per pupil funding.

Prop 123 will slightly improve Arizona's overall education finance situation, increasing total K-12 spending by approximately \$278 per student. This would move Arizona up a few places in the national rankings, but would still leave Arizona spending almost 30 percent less than the national average on K-12 education.

¹ 36 Stat. 557 (1910)

² These provisions of the Enabling Act were replicated in Arizona's Constitution. As originally enacted, the first, second, and seventh paragraphs of § 28 of the Enabling Act were repeated, respectively, in sections 1, 2, and 7 of Article X of Arizona's Constitution.

³ A.R.S. § 37-521 *et seq*

⁴ 24 Ariz. 116, 207 P.359 (1922)

⁵ *State ex rel. Conway v. Versluis*, 58 Ariz. 368, 120 P.2d 410 (1941).

⁶ 65 Ariz. 338, 181 P.2d 336 (1947)

⁷ 385 U.S. 458 (1967)

⁸ See, e.g.

⁹ Opinion of the Attorney General I00-028 (2000)