

LEGACY FUND EARNINGS COMMITTEE

Section 32 of Senate Bill No. 2015 (2019), created a legacy fund earnings committee to study the potential uses of legacy fund earnings. The committee consists of the Majority and Minority Leaders of the House and Senate, the chairmen of the House and Senate Finance and Taxation Committees, the chairmen of the House and Senate Appropriations Committees, two members of the Legacy and Budget Stabilization Fund Advisory Board appointed by their respective Majority Leaders, and the chairman of the Legislative Management. The study must include consideration of using the legacy fund earnings for tax relief, reinvestment, research and technological advancements, economic growth and diversification, workforce development, and career and technical education initiatives. The committee may review the operation of similar funds and may consider public input on the use of legacy fund earnings.

Committee members were Representatives Chet Pollert (Chairman), Josh Boschee, Jeff Delzer, Craig Headland, Keith Kempenich, and Don Vigesaa and Senators Joan Heckaman, Ray Holmberg, Jerry Klein, Jessica Unruh-Bell, and Rich Wardner.

LEGACY FUND History

In 2010, the voters of North Dakota approved a constitutional amendment to create the legacy fund (Section 26 of Article X of the Constitution of North Dakota). Pursuant to the measure, 30 percent of oil and gas gross production and oil extraction taxes are deposited in the legacy fund. The measure restricted the expenditure of principal and earnings until after June 30, 2017. Up to 15 percent of the principal balance of the legacy fund may be spent during a biennium upon approval of at least two-thirds of the members elected to each house of the Legislative Assembly. The Legislative Assembly may transfer funds from any source to the legacy fund, which become part of the principal of the fund. Interest earnings accruing after June 30, 2017, are transferred to the general fund at the end of each biennium. Pursuant to North Dakota Century Code Section 21-10-12, earnings include interest, dividends, and realized gains and losses, but exclude unrealized gains and losses.

The State Investment Board is responsible for investing the principal of the legacy fund. The 2011 Legislative Assembly established a Legacy and Budget Stabilization Fund Advisory Board to develop recommendations for the investment of the legacy fund and the budget stabilization fund. The goal of the investment strategy is principal preservation while maximizing total returns. The advisory board regularly reviews and approves investment policies.

For the 2011-13 and 2013-15 bienniums, 25 percent of any revenues deposited in the strategic investment and improvements fund were transferred to the legacy fund if the balance of the strategic investment and improvements fund exceeded \$300 million at the end of any month. In House Bill No. 1377 (2015), the Legislative Assembly removed the requirement to transfer additional funding from the strategic investment and improvements fund to the legacy fund.

Status

During the budgeting process for the 2017-19 biennium, the 2017 Legislative Assembly included \$200 million of estimated legacy fund earnings in the general fund revenue forecast. The 2019 Legislative Assembly increased the estimate by \$100 million to reflect total earnings of \$300 million. The 2017-19 biennium earnings transferred to the general fund at the end of the biennium were \$455.26 million, \$155.26 more than the revised estimate.

The balance of the legacy fund was \$6.12 billion on July 1, 2019. As of July 31, 2020, the legacy fund had a value of \$7.25 billion, and the earnings available to transfer to the general fund at the end of the 2019-21 biennium totaled \$339 million. In March 2020, the fiscal year-to-date net investment returns for the legacy fund decreased to a loss of 7.21 percent due to the market effects of the Coronavirus (COVID-19) pandemic. Investment performance recovered in the spring and summer of 2020 resulting in a gain of 4.23 percent for fiscal year 2020.

The 2019 Legislative Assembly budgeted for \$100 million of legacy fund earnings in the 2019-21 biennium as a part of a plan to transition from spending the earnings in the current biennium to spending the earnings in the subsequent biennium. Senate Bill No. 2362 (2019) included a contingent transfer of \$64.37 million from the general fund to the common schools trust fund if the legacy fund earnings are at least \$164.37 million for the 2019-21 biennium. The 2019 Legislative Assembly approved the contingent transfer to correct a shortfall of oil extraction tax allocations to the common schools trust fund in prior bienniums.

The Office of Management and Budget's September 2020 revised revenue forecast included \$300 million of legacy fund earnings for the 2019-21 biennium. Any excess legacy fund earnings in the 2019-21 biennium may be needed to offset a potential general fund revenue shortfall resulting from decreased state revenues due to the COVID-19 pandemic.

BUDGET INFORMATION

The committee received information from the Legislative Council regarding North Dakota's budget process since the 1980s. The oil boom and bust cycle during the 1980s created budgetary challenges that lasted until the mid-1990s and affected the way the state budgets today. The Legislative Assembly responded to the budget challenges by implementing the following changes:

- Created a permanent oil tax trust fund to reduce the general fund's direct reliance on oil and gas tax revenues;
- Established a budget stabilization fund; and
- Provided separate constitutional allocations of oil and gas tax revenue for a K-12 education stabilization fund.

State revenues increased significantly during the oil boom that began in 2008. The increase in oil and gas development activity also prompted increased state spending for property tax relief programs, infrastructure development, public safety, and human service programs. The Legislative Assembly changed the oil and gas tax revenue allocation formulas to allocate revenue to various state funds as a way to set aside money for the next biennium and provide volatility protection. The decline in oil prices during the 2015-17 biennium resulted in a 50 percent decrease in oil and gas tax revenues and nearly a 30 percent decrease in general fund revenues. The Legislative Assembly's policy of setting aside oil and gas tax revenues for the next biennium helped to lessen the impact of the budgetary challenges during the 2015-17 biennium.

Ongoing general fund revenues have been less than ongoing general fund spending since the 2015-17 biennium. Approximately 8 percent (\$400 million), of the general fund budget for the 2019-21 biennium is directly related to oil and gas tax revenues received during the biennium. The general fund budget also includes \$947 million of indirect oil and gas tax revenue as transfers from other funds. Of the \$5,071 million ongoing "general fund equivalent" 2019-21 biennium budget, \$1,347 million, or 27 percent, is related to oil and gas tax revenues. Ongoing general fund appropriations exceed ongoing general fund revenues by \$840 million for the 2019-21 biennium after excluding the estimated transfer of \$100 million of legacy fund earnings. Options to address the gap between ongoing revenues and ongoing appropriations include growing general fund revenue exceeding projections, increasing general fund taxes, reducing general fund spending, using additional oil and gas tax revenues, and using additional legacy fund earnings.

SOVEREIGN WEALTH FUNDS

The committee received information from the Retirement and Investment Office regarding sovereign wealth funds in the United States, including the Alaska permanent fund, Texas permanent school fund, Wyoming permanent mineral trust fund, and Alabama trust fund. Based on a 2019 survey, the distributions from 6 of the 10 funds analyzed use a percent of market value calculation while the distributions from the remaining 4 funds use investment income. Investment performance varied significantly between the funds, which was likely a result of differences in asset allocations. For 8 of the 10 funds, the principal is restricted permanently, but the principal may be spent from the other 2 funds.

A representative of the Alaska Division of Legislative Finance provided information regarding the Alaska state budget and use of Alaska's permanent fund. The Alaska permanent fund is a constitutionally protected fund that receives a portion of the state's oil and gas revenues and is intended to provide an intergenerational benefit to Alaska's residents. Alaska deposited additional revenue in the permanent fund to offset inflation and created an earnings reserve account to address the volatility of earnings. Some income from the fund pays annual dividends to Alaska's citizens, which began in 1982. In recent years, the dividend payments to citizens have been less than the calculated amount because the permanent fund's earnings were insufficient to meet the state's budgetary needs.

Based on Alaska's experience with the permanent fund over the past 40 years, the Alaska representative posed the following questions for the committee's consideration:

- Is the legacy fund intended to benefit the state's residents while the oil is being produced or when the oil resources are depleted?
- Should the earnings of the legacy fund be reinvested to increase the balance of the fund and future earnings?
- What procedures or methods should be used to reduce the volatility of legacy fund earnings?
- When will the legacy fund earnings be needed to replace declining oil and gas tax revenues in the state budget?

PROPOSED USES OF LEGACY FUND EARNINGS **Comments Submitted to the Committee**

The committee received comments from 121 individuals including 2 at the August 15, 2019, meeting in Bismarck; 36 at the November 12-13, 2019, meeting in Fargo; 82 at the February 19-20, 2020, meeting in Watford City; and 1 at

the July 8, 2020, meeting in Bismarck. The comments were categorized into K-12 education programs, health and human service programs, economic development, infrastructure projects, tax relief programs, or miscellaneous items. Some of the comments included multiple proposals resulting in a total of 176 proposals.

The schedule below summarizes the comments submitted to the Legacy Fund Earnings Committee regarding proposed uses of legacy fund earnings.

Category	Number of Proposals	Examples
K-12 education programs	20 proposals, including: <ul style="list-style-type: none"> • 7 proposals (November 12-13, 2019) • 13 proposals (February 19-20, 2020) 	The proposals include: <ul style="list-style-type: none"> • Free hot lunch to all public school students; • Support for education programs; • Supplemental salary payments for teachers; and • Funding for afterschool programs.
Health and human services programs	19 proposals, including: <ul style="list-style-type: none"> • 12 proposals (November 12-13, 2019) • 6 proposals (February 19-20, 2020) • 1 proposal (July 8, 2020) 	The proposals include: <ul style="list-style-type: none"> • Health insurance for all North Dakota residents; • Matching grants to charitable organizations; • Issue bonds to support health programs; and • Support for affordable housing.
Economic development	23 proposals, including: <ul style="list-style-type: none"> • 10 proposals (November 12-13, 2019) • 13 proposals (February 19-20, 2020) 	The proposals include: <ul style="list-style-type: none"> • Matching grants for visitor attractions; • Funding for university research projects; • Funding for workforce development; and • Support for child care programs.
Infrastructure projects	70 proposals, including: <ul style="list-style-type: none"> • 17 proposals (November 12-13, 2019) • 53 proposals (February 19-20, 2020) 	The proposals include: <ul style="list-style-type: none"> • Capital assistance for school construction; • Grants for school construction projects; • Low-interest rate loans for water projects; • Funding for transportation infrastructure; and • Support for health care infrastructure.
Tax relief programs	15 proposals, including: <ul style="list-style-type: none"> • 1 proposal (August 15, 2019) • 5 proposals (November 12-13, 2019) • 9 proposals (February 19-20, 2020) 	The proposals include: <ul style="list-style-type: none"> • Elimination of state income taxes; • Funding for property tax relief; and • Not providing tax reductions.
Miscellaneous items	29 proposals, including: <ul style="list-style-type: none"> • 2 proposals (August 15, 2019) • 7 proposals (November 12-13, 2019) • 20 proposals (February 19-20, 2020) 	The proposals include: <ul style="list-style-type: none"> • Dividend payments to North Dakota residents; • Returning the earnings to the legacy fund; • Expanded services to Native Americans; and • Interest rate buydowns on student loans.

Committee Member Proposals

Committee members also submitted proposals regarding uses of legacy fund earnings. One proposal included allocating 25 percent of the legacy fund earnings to the state highway fund to support road maintenance and road projects. Another proposal returned 25 percent of the legacy fund earnings to the legacy fund and designated the remaining earnings for the following:

- Road projects (40 percent);
- The infrastructure revolving loan fund (20 percent until the fund balance is \$500 million);

- Income tax rate reductions (20 percent); and
- Other purposes designated by the Legislative Assembly (any remaining amount).

The committee also received a proposal to return 20 percent of the earnings to the legacy fund and to allocate the remaining earnings for the following:

- The highway tax distribution fund (25 percent);
- A research and innovation fund (15 percent);
- A human service and public health stabilization fund (15 percent);
- A workforce development and lifelong education fund (10 percent);
- A regional economic development infrastructure fund (15 percent);
- An arts and culture endowment fund (10 percent); and
- A student lunch support fund (10 percent).

ADMINISTRATION OF LEGACY FUND EARNINGS

Current Process

The committee reviewed the process of administering legacy fund earnings. Under the current process, the State Treasurer transfers the earnings of the legacy fund to the general fund at the end of each biennium pursuant to Section 26 of Article X of the Constitution of North Dakota. The earnings of the legacy fund include interest, dividends, and realized gains and losses as defined in Section 21-10-12. The current administrative process is based on transferring all the biennial earnings of the legacy fund to the general fund in accordance with these constitutional and statutory provisions.

The committee reviewed the process of administering earnings of the common schools trust fund. In contrast to the legacy fund, the administration of common schools trust fund earnings reflects a distribution method separate from the earnings of the fund. The earnings of the common schools trust fund are reported in the annual financial statements published by the Department of Trust Lands. The method of distributing earnings from the common schools trust fund is based on 10 percent of the 5-year average of the fund's assets pursuant to Section 2 of Article IX of the Constitution of North Dakota.

Potential Concerns

The committee discussed the following potential concerns associated with the current process of administering the legacy fund earnings:

- **Cashflow** - Even though the earnings are transferred to the general fund on the last day of the biennium, the funding associated with the earnings is included in the current biennial budget as revenue; therefore, the earnings may be appropriated and spent up to 24 months before the cash from the earnings is available to pay the expenditures. This could result in the general fund having insufficient cash to pay for the expenditures. This issue will become more of a concern as the earnings become a greater share of state revenues.
- **Budgeting** - Under the current process, the Legislative Assembly must finalize the revised revenue forecast for the current biennium as well as develop the state budget for the next biennium prior to the earnings amount being known. Because the earnings are generated from the performance of investments, the earnings can be volatile making it difficult to determine a reasonable and reliable estimate. Any significant variance in the earnings affects the budgets of both bienniums.
- **General fund balance** - Because the earnings are recognized as part of the current general fund budget in which the earnings are transferred on the last day, if the investments experience losses in the last couple months of the biennium, the final general fund balance could become negative which would require the governor to direct agencies to reduce budgets in the final days of the biennium. Alternatively, the general fund could have a large surplus if the investments of the legacy fund experience gains in the last couple months of the biennium.
- **Replacing oil revenues** - The primary purpose of the fund is to replace oil and gas tax revenues when oil and gas development activity decreases. Legacy fund earnings may not be sufficient to replace declining oil and gas tax revenues if the earnings are fully committed to supporting ongoing spending items before oil production declines.

COMMITTEE CONSIDERATIONS

Percent of Market Value and Legacy Earnings Fund Bill Draft

The committee considered a bill draft relating to the establishment of a percent of market value method for determining the amount of legacy fund earnings available to be spent each biennium and to the creation of a legacy earnings fund. The bill draft requires the State Investment Board to manage the investment of a newly created legacy earnings fund, establishes the legacy earnings fund, requires the legacy fund earnings to be transferred to the fund, designates a reserve balance, and provides for the calculation of the amount available for appropriation or transfer based on the percent of market value.

In the bill draft, the percent of market value calculation is based on 6 percent of the 5-year average value of the legacy fund assets. The reserve balance in the legacy fund would be invested in the same manner as the legacy fund and would be available only to cover shortfalls that occur when the legacy fund earnings transferred to the fund are less than the calculated amount available for appropriation or transfer. The bill draft would become effective August 1, 2021, with the first transfer of legacy fund earnings to the newly created fund at the end of the 2021-23 biennium.

The committee received information from the Legislative Council regarding the implementation of the percent of market value calculation. Changing the definition of legacy fund earnings in statute to implement the percent of market value as a distribution method would conflict with the constitutional provisions requiring the biennial earnings of the legacy fund to be transferred to the general fund. Applying the percent of market value directly to the legacy fund earnings would require a constitutional change similar to the way the common schools trust fund was changed. The bill draft allows the legacy fund earnings to be distributed using the percent of market value without a constitutional amendment by transferring the earnings from the general fund to a special fund. The constitution does not limit the purposes for using legacy fund earnings after the earnings are transferred to the general fund. As a result, the legacy fund earnings may be transferred to a special fund after being deposited in the general fund without a constitutional conflict. In addition, transferring the earnings to a special fund increases transparency by allowing the Legislative Assembly to separately identify the spending of legacy fund earnings, which ensures the spending is appropriate and balanced with the need to replace declining oil and gas tax revenues.

The committee received information from the Retirement and Investment Office regarding the State Investment Board's support for the implementation of the percent of market value method.

Legacy Fund Earnings Committee Bill Draft

The committee considered a bill draft relating to a legacy fund earnings committee. The bill draft continues the legacy fund earnings committee for the 2021-22 interim with the same committee membership and study purpose.

Recommendations

The committee recommends a bill draft [21.0111.02000] relating to the establishment of a percent of market value method for determining the amount of legacy fund earnings available to be spent each biennium and the creation of a legacy earnings fund.

The committee recommends a bill draft [21.0178.01000] relating to a legacy fund earnings committee.