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Today or Tomorrow?

A Pending \$300 million General Fund Commitment & The Reauthorization of Prop 123

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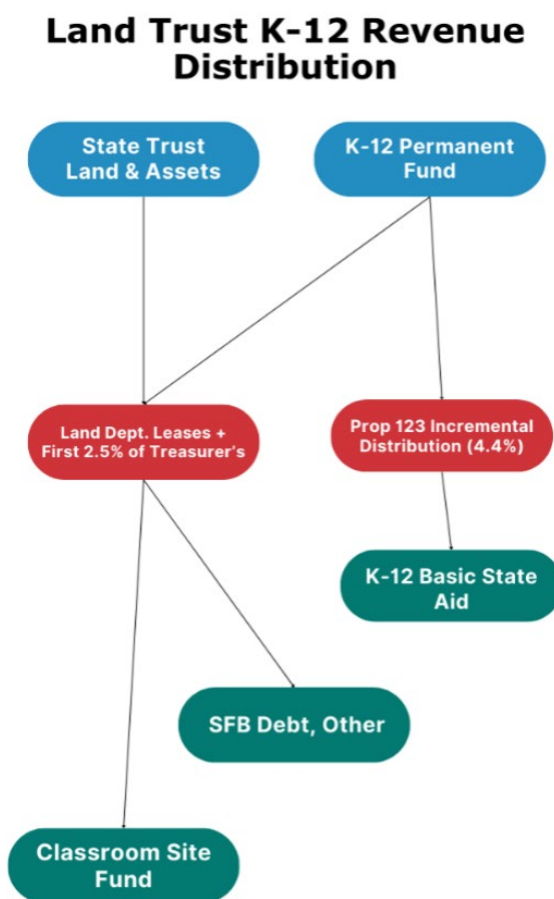
Introduction

The state of Arizona holds 9.2 million acres of land in trust to benefit Arizona’s public schools, universities, and state agencies. Money earned from the sale or use of this land is held in Trust – the Permanent Land Endowment Trust Fund – for distribution to the beneficiaries. While the historical formula for distributions was complicated and varied from year-to-year, in practice, actual distributions were relatively small and far below earnings. In 2012 then-Treasurer Doug Ducey successfully changed that practice: the distribution rate was simplified to a fixed 2.5% of the funds 5-year average balance; last year Arizona’s K-12 public schools received over 92% of the distribution.

Enacted in 2016, after being devised and championed by newly-sworn-in Gov. Ducey, Proposition 123 increased distributions from the Permanent Land Endowment Trust Fund to State Land Trust beneficiaries (principally K-12 education). Intended to resolve longstanding disagreements about the treatment of K-12 funding during the Great Recession, this voter-approved Constitutional measure increased distributions from the Land Trust Fund by 4.4% (to 6.9%) for 10 years¹. Unlike past distributions, additional K-12 funding goes into the per-pupil equalization formula as Basic State Aid (effectively acting as General Fund offset).

The expiration of Prop. 123 in FY 2026 would shift the growing costs of Arizona’s public K-12 system back onto taxpayers and the State General Fund, precisely when the General Fund is least able to shoulder these new burdens and despite the proven capacity of the Land Trust Funds to continue meeting these needs.

Figure 1



The State of Arizona's General Fund

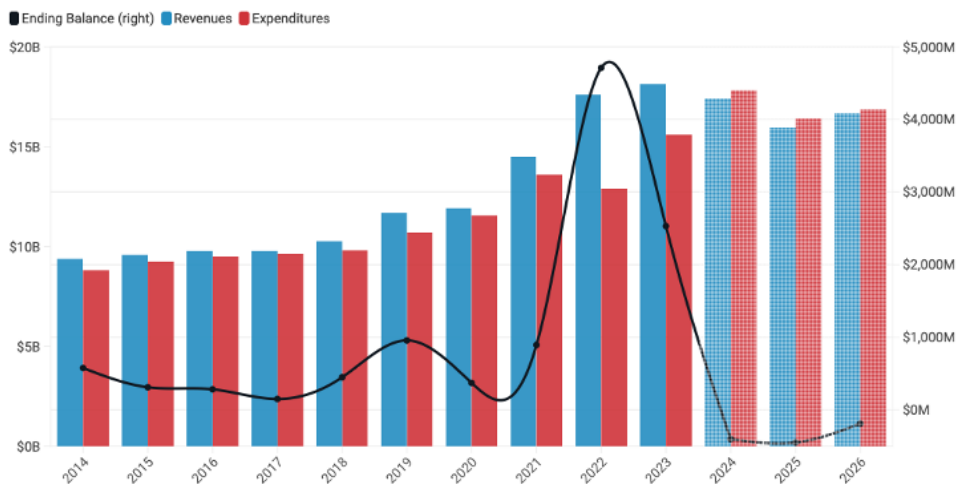
On October 11, 2023, the Joint Legislative Budget Committee announced the State's first expected fiscal deficit since 2016 – a cumulative \$1.0 billion over the next three fiscal yearsⁱⁱ. At the same time, the expiration of the 10-year Proposition 123 Land Trust Fund distribution increases in FY 2026 will increase ongoing General Fund costs by an expected \$300 million (and growing) annuallyⁱⁱⁱ.

- Although Arizona's General Fund revenues have increased 90% since 2014, spending has increased 102%. The fiscal gap thus far has been covered by a record cash surplus of \$4.7 billion in FY 2022. However, the FY 2023 and FY 2024 enacted budgets exhausted this surplus – reducing projected cash reserves to just \$10 million^{iv}.
- Revised projections in October reduced the expected cash balance this year to -\$400 million, the state's first persistent deficit projection since 2016.
- Because the enacted budget assumes Prop 123 expires, a clean extension – without new spending commitments – would alleviate some of this new fiscal pressure.
- **The expiration of Prop 123 in 2026 could increase ongoing General Fund expenses by approximately \$300 million per year, shifting this burden to the taxpayers.**

Figure 2

State General Fund Balance

The enacted State Budget assumes that Prop. 123 expires in FY 2026 and General Fund spending will increase nearly \$300 million to cover lost K-12 formula funding. Over the past two years total General Fund spending has already increased nearly 40% (+\$4.9 billion), resulting in projected cash deficits.



Source: JLBC FY 2023 Appropriations Report, Financial Advisory Committee

Who Benefits from Proposition 123 & Arizona’s Permanent Land Endowment Trust Fund?

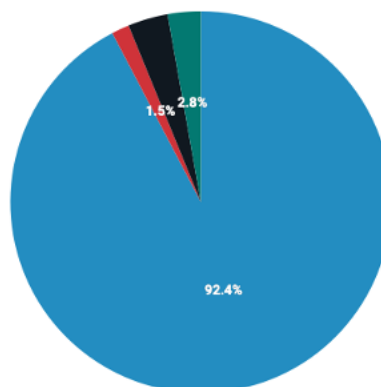
During the Great Recession and following fiscal crisis, the state was forced to use a variety of cost-cutting measures to remain solvent – including not fully funding the K-12 per-pupil funding formula every year. This resulted in years of litigation^v that the state simply could not afford to settle. In 2015, policymakers identified a possible solution that could fully fund K-12 education, protect the health of the General Fund, and settle the ongoing litigation: the Permanent Land Trust Fund (“the Fund”)^{vi}.

Figure 3

Beneficiaries of the Permanent Land Trust

In FY 2023, K-12 ‘Common Schools’ received 92% of the benefit distributions from the State Land Trust funds.

- Common Schools
- University of Arizona
- State Charitable, Penal & Reformatory Agencies
- Other



Source: Arizona State Land Department

- The Fund holds proceeds from the permanent disposition of Land Trust assets not distributed to beneficiaries, and along with the Trust is used to fund several public functions - primarily Arizona’s “common” District K-12 schools.
- Until 2015, distributions from the Fund were limited to approximately 2.5% of the fund balance - a level that allowed Trust Fund growth to far outpace distributions. As a result, the Trust Fund was accumulating excess profits and providing only a relatively small annual benefit to beneficiaries.
- Proposition 123 temporarily raised the distribution level to 6.9% and earmarked the K-12 portion of increased distributions specifically for per-pupil formula funding. This resolved the ongoing litigation and fully funded the state’s K-12 funding formula, while protecting the health and solvency of the State General Fund and without depleting the Trust Fund.

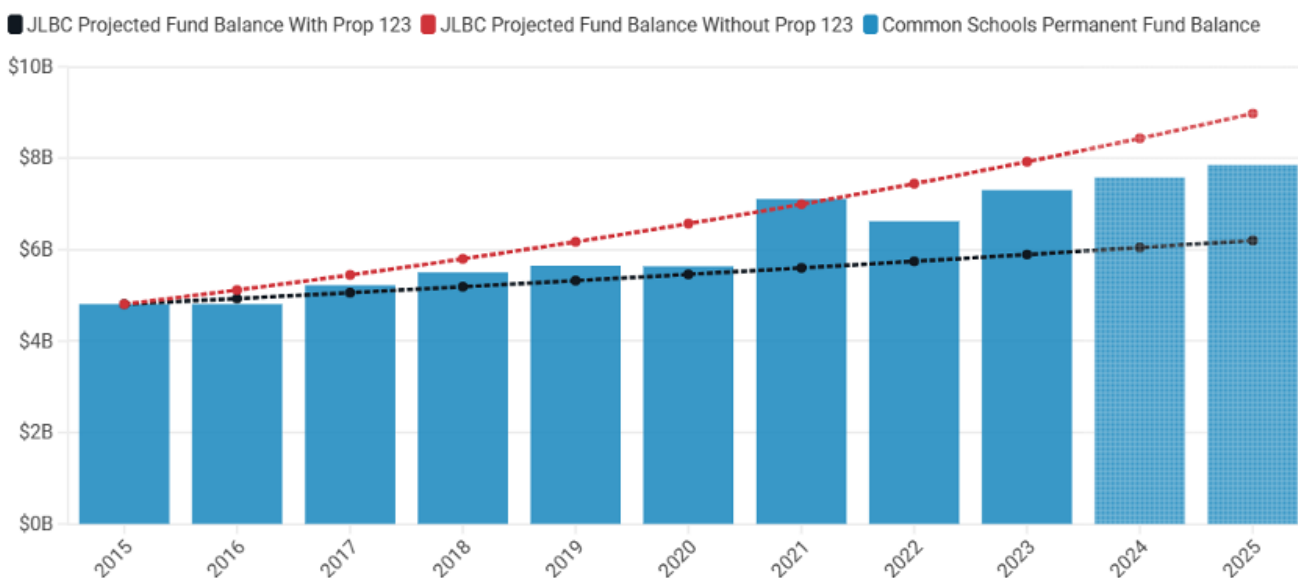
Permanent Land Endowment Trust Fund Performance

In 2016, the loudest argument against Prop. 123 suggested it would “raid funds” by “dipping into the corpus”^{vii}. Despite nearly 10 years of increased distributions under the proposition, the Permanent Land Endowment Trust Fund has continued growing. Strong investment performance and proceeds from the disposition of Land Trust assets offset the higher distribution rates^{viii}.

Figure 4

Common Schools Permanent Fund

While the Common Schools Permanent Fund balance has exceeded projections of the fund under Proposition 123 distributions, it has also performed nearly as well as JLBC’s projections of the fund under a baseline 2.5% distribution rate.



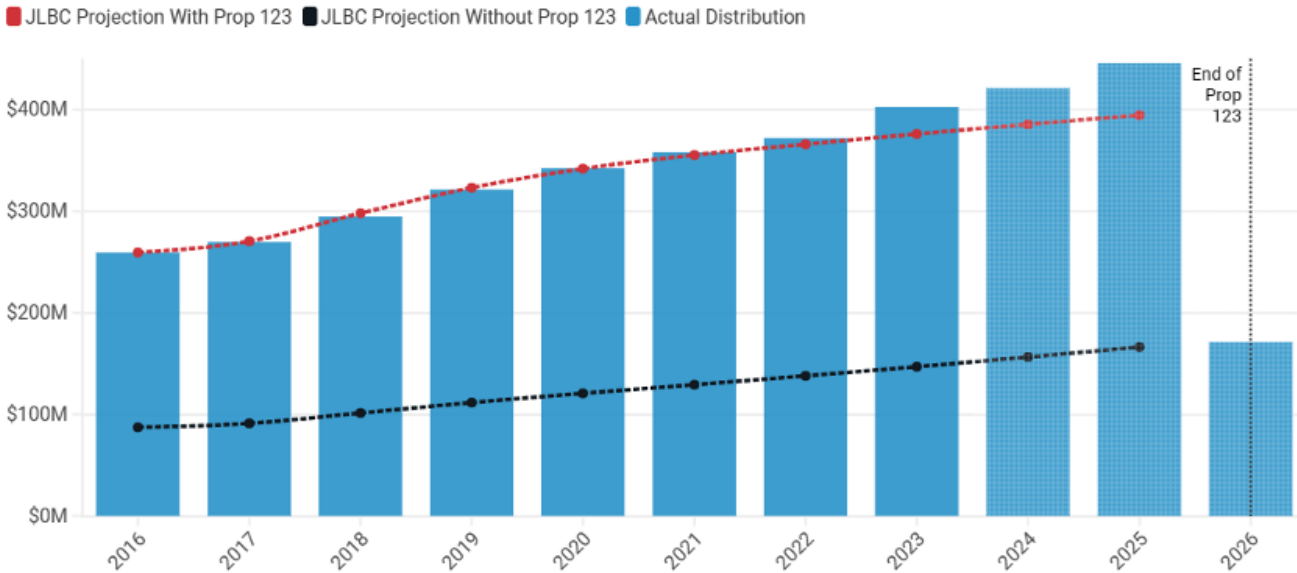
Source: JLBC, Arizona State Treasurer, Arizona State Land Department

- Today the Common Schools’ share of the Permanent Trust Fund balance is over \$7.3 billion, an increase of \$2.5 billion over 2015^{ix}.
- Even with Prop 123, **annual Fund growth over the past 10 years averaged 7%/year.** Without Proposition 123, public schools may have received a cumulative \$1.6 billion less from the Trust Fund, and balance growth would instead have averaged 9.6%/year.
- Annual distributions to K-12 public schools increased from \$76 million in FY 2015 (before Prop 123) to \$402 million in FY 2023. For context, total K-12 formula funding has increased \$2.9 billion since FY 2015^{xi}.

Figure 5

Common School Permanent Fund Fund Distribution Growth

Since enactment, Proposition 123 has distributed more than \$1.6 billion to Arizona public schools beyond what they would have received without it. This is a cumulative \$239 million above what the Prop was officially projected to distribute.



Source: JLBC K-12 Land Trust Projections, FY 2023 Appropriations Report

- The expiration of Prop 123 in FY 2026 would reduce annual distributions from the Fund to an expected \$171 million/year.
- While some of the revenue difference would be backfilled by the General Fund, many competing demands for fewer General Fund resources are likely to force Legislative action. The need to backfill Trust Fund resources with General Fund may necessitate cuts elsewhere (potentially to other parts of K-12 funding).

Basic State Aid Sources

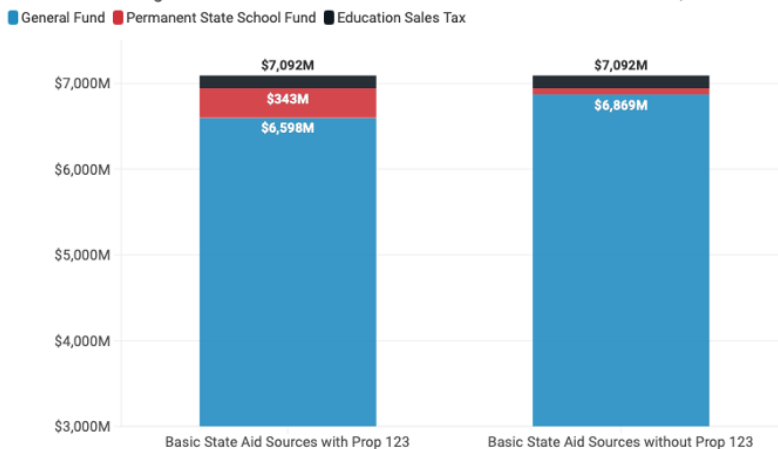
Proposition 123 increased distributions from the Permanent Land Endowment Trust Fund from 2.5% to a total of 6.9%. Of this 6.9%, the incremental 4.4% under Proposition 123 is used for Basic State Aid while the baseline 2.5% is used for a combination of the Classroom Site Fund, School Facilities Division debt, and other (generally non-formula) K-12 funding.

- In FY 2024, approximately \$343 million of the total K-12 Endowment earnings will go directly into Basic State Aid while the remaining amount is allocated to the Classroom Site Fund or Other parts of K-12 funding.
- In the absence of Proposition 123, the 4.4% increase will no longer be able to fund Basic State Aid. Because many elements of the K-12 funding formula are subject to the Voter Protection Act, the General Fund will likely have to backfill the reduced endowment earnings dollar-for-dollar^{xii}.
- Currently, the funding received from the Permanent Land Endowment Trust Fund makes up 4.8% of Arizona’s Basic State Aid. Going forward, the General Fund would need to backfill approximately \$300 million annually if Proposition 123 is allowed to expire.

Figure 6

Basic State Aid Funding Sources

Allowing Prop 123 to expire shifts \$270 million in formula funding to the State General Fund. Indeed, the expiration may not automatically reduce funding to K-12 schools at all. Instead, the General Fund will initially backfill the funding that schools would have received from State Land Trust Funds, if able.



Source: JLBC FY 2024 Appropriations Report

The End of Proposition 123

Prop 123 funding is set to end in FY 2026 and the Permanent Land Endowment Trust Fund distributions will return to 2.5%. This will place an increased burden of \$300 million annually onto the state General Fund.

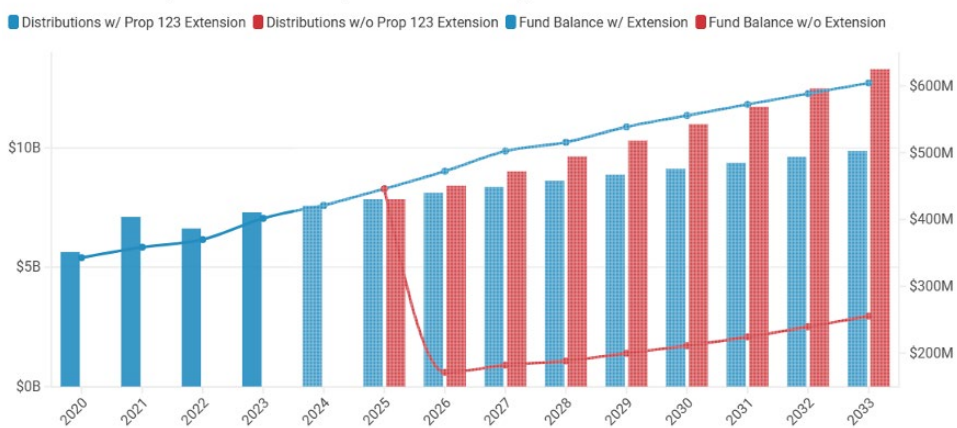
- Over the past 20 years, the Permanent Land Endowment Trust Fund for K-12 has grown at an average annual rate of nearly 10%. Controlling for the disposition of Land Trust assets (deposits into the Endowment Fund) and distributions to beneficiaries (withdrawals from the Fund), **CSI estimates the underlying long-run annual investment return on the Fund to be 6.9%.**
- Deposits into the Permanent Land Trust Fund from the Land Department for the sale of Trust assets have added approximately another \$4.1 billion to the asset balance over the past two decades.
- Given historical Endowment Fund performance, and assuming the expiration of Prop 123 is allowed to occur, CSI projects that the Fund would grow from \$7.3 billion today to \$13.3 billion in FY 2033.
- In FY 2026, distributions from the Fund for K-12 education would decline \$275 million (to \$171 million).
- Disbursements to public education from the Fund could grow from \$402 million in FY 2023 to over \$612 million in FY 2033 if Proposition 123 is extended.

Arizona's District public schools would receive an additional \$2.7 billion in cumulative Permanent Trust Fund support over the next decade if Proposition 123 is extended and not allowed to expire at the end of FY 2025.

Figure 7

Common School Permanent Fund Disbursement and Balance Projections

CSI estimates that distributions to K-12 schools could reach up to \$612 million annually by 2033 if Prop 123 is allowed to continue, based on historic 20 year Permanent Fund growth rates.



Source: JLBC Appropriations Reports, Arizona Land Department, CSI Calculations • Bars represent Fund Balance on right axis. Projections are based on the historic 20 year annual average growth rate

Bottom Line

State policymakers and legislative leaders have rightly made renewing Proposition 123 – in some fashion – prior to its expiration a priority. The imminent expiration of Prop 123 would simultaneously strain the General Fund and risk K-12 education funding. Renewing Prop. 123 without new commitments would have the most beneficial impact on the states projected budget deficit.

Our projections indicate that renewing Prop 123 does not risk the balance of the Permanent Land Trust Fund and would maintain the same common-sense approach that prompted the creation of Prop 123 in the first place: responsibly and efficiently using all the state’s available resources to fund K-12 education.

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- v. Wells, Dave, "A Fiscal Analysis of Proposition 123 and Arizona's Underinvestment of K-12 Education: An Essential First Step for K-12 Funding", *Grand Canyon Institute*, January 7, 2016.
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- viii. "Prop 123 Funding Projections", *Joint Legislative Budget Committee*, December 3, 2015.
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- xii. "FY 2024 Appropriations Report", *Joint Legislative Budget Committee*, July 2023.