Introduction

Senate Joint Resolution No. 1 (SJR1), as passed by the 1996 Legislature, will be placed on the ballot in the 1996 General Election as Amendment A. SJR1 was introduced at the request of the Commissioner of School and Public Lands. It was passed by the Senate 35-0 and by the House of Representatives 58-10. SJR1 (hereafter referred to as Amendment A) is similar to Amendment C of the 1994 General Election. Amendment C was rejected by the voters of the state with 130,785 votes for, and 168,232 votes against (43.74% for and 56.26% against).

Amendment A, like its Amendment C predecessor, would remove some current restrictions on the types of investments that may be made with the principal amount of the Permanent School Fund. Currently, the South Dakota Constitution specifies that the Commissioner of School and Public Lands may invest the Permanent School Fund only in bonds of the United States, securities guaranteed by the United States, or bonds of any school corporation, organized county, or incorporated city in South Dakota. Amendment A would remove these restrictions and make the South Dakota Investment Council, rather than the Commissioner of School and Public Lands, responsible for investing.

The Permanent School Fund

Depending on the time of year and payment schedule to the common school districts and endowed institutions, the size of the Permanent School Fund ranges from $120 to $130 million. In FY1996, approximately $10,145,000 will be paid to the common school districts on a per student basis. This amounts to $67 per student. Additionally, over $1,745,000 will be paid to the endowed institutions. These payments are made from both interest and earnings of the assets of the Permanent School Fund, and revenue from surface and mineral leases.

Amendment A: Investment Flexibility

Amendment A would allow the assets of the Permanent School Fund to be invested, without restriction, by the South Dakota Investment Council. This would lead to a more diverse investment portfolio most likely to include corporate bonds and common stock--perhaps also real estate or other investment instruments. Although there is no assurance that past trends will be a predictor of future events, past experience would indicate that a more diverse portfolio would lead to a larger Permanent School Fund, and greater interest earnings from that fund. The current constitutional restrictions provide for the utmost safety in the instruments in which the assets of the Permanent School Fund are invested--this is consistent with a low risk, low return
investment strategy. Amendment A would allow the professionals of the South Dakota Investment Council to consider risk and reward together in the investment decisions.

Even though Amendment A repeals language directing the Legislature to provide by law, such rules, regulations and safeguards as it may deem necessary to secure safe and continuous investment of such funds, the Legislature may always enact laws directing the manner in which the assets of the Permanent School Fund are invested.

The Implications of Other Sections of the Constitution on Amendment A

This section is virtually the same as part of Issue Memorandum 94-25--dealing with Amendment C on the 1994 General Election Ballot.

Article VIII, 2 speaks to the maintenance of a perpetual fund, the proceeds arising from the sale of public lands, property falling to the state by escheat, or gifts or donations for public school purposes. Article VIII, 2 clearly states how this perpetual fund (known as the Permanent School Fund) is to be maintained. The last two sentences of Article VIII, 2 state: "It shall be deemed a trust fund held by the state. The principal shall forever remain inviolate, and may be increased, but shall never be diminished, and the state shall make good all losses thereof which may in any manner occur." Article VIII, 7 similarly speaks to the maintenance of a perpetual fund, the proceeds coming from land, money, or property donated for a university, agricultural college, normal schools, or other educational or charitable institution. Article VIII, 7 contains similar language: "The principal of every such fund may be increased, but shall never be diminished, and the interest and income only shall be used. Every such fund shall be deemed a trust fund held by the state, and the state shall make good all losses therefrom that shall in any manner occur."

These two sections of the Constitution clearly indicate that the Permanent School Fund is to be invested in instruments whose value is guaranteed (as specified in Article VIII, 11 as it is currently written); and should that value decline, the Legislature has the responsibility to replace any losses to the Permanent School Fund.

Investing part of the Permanent School Fund in common stock or other investments raises some questions which are not clearly answered in the Constitution or Amendment A.

First, how are losses to the Permanent School Fund defined? Does the term "never shall be diminished" apply to the entire fund, or to individual components of the Permanent School Fund portfolio? For example, if the value of the bond portfolio increases by $5 million and the value of the stock portfolio decreases by $2 million, has a loss occurred?

Second, how is the value of the portfolio determined? In the case of bonds, is the value the face value of the bond or is it the current market value of the bond? In the case of the common stock portfolio, the current market price of the portfolio seems to be the only reasonable method to measure the value of the portfolio.

Third, over what time frame are losses or gains measured? The value of each portfolio of the Permanent School Fund and the value of the Permanent School Fund will fluctuate daily,
according to the financial markets. The language "never be diminished" is quite strong and would suggest the impractical notion that the Legislature would need to make up losses to the Permanent School Fund on a daily basis. This conclusion is based on the word "never" in the Constitution. A July 1 to June 30 fiscal year measure of gains or losses would seem to be the most practical time frame.

Amendment A is not solely responsible for these questions, but the inclusion of common stock or other investments in the Permanent School Fund portfolio certainly makes these questions important. Given the Legislature's immense responsibility to make good any losses to the Permanent School Fund, the Legislature may want to define answers to the above questions through the passage of legislation.

Summary, Pros and Cons

When the authors of the Constitution addressed the issue of interest earnings on the Permanent School Fund, the investment climate was not what it is now. Had stock markets, bond markets, and markets for other securities existed then as they do now, perhaps there would be different constitutional guidelines for the investment of the Permanent School Fund. Certainly Amendment A will allow for a more contemporary method of investing the assets of the Permanent School Fund. Also, as mentioned earlier, the Legislature at any time may provide for statutory guidelines to the Investment Council for investing the assets of the Permanent School Fund.

The points in favor of Amendment A are: 1) it allows for a more diverse portfolio which should be less subject to fluctuations in the investment markets; 2) diversification away from bonds would allow for more growth in the portfolio during inflationary times; 3) diversification away from bonds to include other investment instruments would most likely increase the earnings of the portfolio. On the other hand, current constitutional guidelines which would be repealed by Amendment A provide for the utmost safety of the portfolio in the event of an economic depression. If substantial losses to the Permanent School Fund were to occur, those losses would need to be restored by the Legislature.

This issue memorandum was written by Dale Bertsch, Chief Analyst for Fiscal Research and Budget Analysis for the Legislative Research Council. It is designed to supply background information on the subject and is not a policy statement made by the Legislative Research Council.