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American Sovereign Wealth

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AMERICAN SOVEREIGN WEALTH

Paul Rose *

The rise of sovereign wealth funds signals a shift in the balance of economic and financial power in the world, with fast-rising powers creating sovereign wealth funds to invest billions in relatively new-found wealth. Discussions and analyses of sovereign wealth thus tend to focus on international relations and politics. But those who study the history of sovereign wealth funds recognize that many SWFs have existed for decades, and that some of these older SWFs are owned by U.S. states, thus also implicating federal relations and domestic politics. A great deal of research has focused on the international aspects of new, foreign sovereign wealth; this article instead examines older (but much less studied) domestic sovereign wealth funds, with a focus on their origins, purpose, and governance, as well as the role they play within a federalist system of government.

I.	INTRODUCTION	2
II.	PRIMARY TYPES OF STATE SOVEREIGN WEALTH FUNDS	4
A.	<i>Creation and Funding of U.S. Severance Tax Funds</i>	7
1.	New Mexico.....	7
2.	Wyoming	7
3.	Alaska	8
4.	Montana	9
5.	North Dakota.....	10
6.	Alabama	11
7.	Louisiana.....	12
B.	<i>Creation and Funding of Land Grant Funds</i>	13
1.	Texas.....	15
2.	Other Land Grant States.....	16
C.	<i>Creation of Tobacco Settlement Funds</i>	19
III.	THE JUSTIFICATIONS FOR STATE SOVEREIGN WEALTH FUNDS	21
A.	<i>Smoothing Revenues.</i>	23

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1. State Sovereign Wealth and the Financial Crisis	23
2. Managing Short-Term Temptations	25
B. <i>Credit Ratings Agencies as “Catalyst”: The SWF as a Mechanism to Decrease the Cost of Public Debt</i>	27
C. <i>Intergenerational Equity</i>	30
D. <i>Preservation of Autonomy</i>	33
1. State SWFs as Bulwarks against National and International Pressures	34
IV. STATE SOVEREIGN WEALTH GOVERNANCE: INVESTMENT AND DISTRIBUTION POLICIES ...	38
A. <i>Supporting Social Programs while Seeking High Returns: The New Mexico Severance Tax Permanent Fund and the Permanent Wyoming Mineral Land Trust</i>	40
B. <i>The Many Uses of Wyoming’s Severance Tax Funds</i>	43
C. <i>The Dividend: Alaska’s Permanent Fund</i>	47
1. The Creation of the APF Dividend	48
2. APF Investment Policies	49
D. <i>The Governance Implications of Targeted Investments and Dividends</i>	50
1. Investment Policies and Agency Costs	52
2. Distribution Policies and Agency Costs.....	58
I. CONCLUSION	64

I. INTRODUCTION

Sovereign wealth funds (SWFs) stand at the intersection of public governance and private markets—the state acting as a participant in (and at least with respect to its own jurisdiction, a regulator of) capital markets. For many observers, the rise of SWFs signals a shift in the balance of economic and financial power in the world, with fast-rising powers creating SWFs that invest potentially trillions of dollars in relatively newfound wealth. And, of course, the investment targets often include U.S. assets, including equity in U.S. corporations. Recent discussions of sovereign wealth have thus primarily focused on complex issues of trade policy, international relations, and relative economic and political power.¹

This suggests the typical narrative of SWFs involves newfound wealth held by foreign governments. This article, however, describes sovereign wealth that is neither

¹ See, e.g., Larry Catá-Backer’s important articles on Norway and China’s SWFs: *Sovereign Wealth Funds as Regulatory Chameleons: The Norwegian Sovereign Wealth Funds and Public Global Governance Through Private Global Investment*, 41 *GEO. J. INT’L L.* 425 (2010); and *Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State Owned Enterprises and the Chinese Experience*, 19 *TRANSNAT’L L. & CONTEMP. PROBS.* 3 (2010).

foreign nor especially new. While the term “sovereign wealth fund” was only recently introduced,² the history of SWFs stretches back many decades. A workable definition of a SWF is a “government-owned and controlled (directly or indirectly) investment fund that has no outside liabilities or beneficiaries (beyond the government or the citizenry in abstract) and that invest their assets, either in the short or long term, according to the interests and objectives of the sponsoring government.”³ To this definition we can further narrow the concept of SWFs to include only funds that operate under an “endowment” model, so that the fund produces income through investment of the fund’s corpus, with only the income distributed.⁴ Under this definition, some of the oldest SWFs are not foreign funds, but funds created by acts of the U.S. Congress and state legislatures over a century ago. Because U.S.-based SWFs do not raise international relations issues from the perspective of U.S. regulators and U.S.-based firms, scholars have paid little attention to these funds. As a result, a wide range of political, legal and governance issues surrounding U.S. subnational SWFs has not been addressed. This article begins to fill that gap by providing an analysis of U.S. state SWFs, with special focus on some of the largest funds, including those sponsored by Alabama, Alaska, Louisiana, Montana, New Mexico, Texas and Wyoming, which together manage over \$100 billion.

Because state SWFs operate within a federalist system, they create unique challenges and concerns; some of these concerns, including the taxation of resource extraction by states and the allocation of federal spending among states, are made weightier because of the Financial Crisis and subsequent Congressional efforts to reduce

² The term was first used in 2005 by analyst Andrew Rozanov. See Andrew Rozanov, “Who Holds the Wealth of Nations,” *State Street Global Advisors*, August 2005.

³ Ashby H.B. Monk, *Is CalPERS a Sovereign Wealth Fund?*, Center for Retirement Research at Boston College, December 2008, Number 8-21, <http://www.publicpensionsonline.com/public/images/CalPERS%20Sovereignty.pdf>.

⁴ This definition distinguishes SWFs from other governmental funds, including investment funds that are designed primarily for economic stimulus. Although SWFs may be used for this purpose, they are primarily set up as intergenerational funds. See Part III, *infra*. This article distinguishes state SWFs from the numerous “rainy day” funds many states have established, in which states set aside excess revenues for use if the state suffers a budget shortfall. For a list of these funds, see <http://www.ncsl.org/Portals/1/documents/fiscal/rdf08apa.pdf>. While most state SWFs contribute directly to the state budget, they differ from rainy day funds because state SWFs are funded out of resource sales as opposed to temporary budget surpluses. More importantly, the enabling documents of state SWFs—the state constitution or, in some cases, state statutes—generally allow only the interest of the funds, and not the principal, to be drawn down at any time. As is discussed below, SWFs are more commonly established to fund particular state programs and to respond to general concerns over intergenerational equity.

governmental spending. State SWFs also raise important concerns about state governance and state management of resource wealth. This article illuminates these issues by asking a few foundational questions: Why was the SWF created, and what role does it currently play? What are the financial, economic or equitable principles underlying its formation? Should a SWF be drawn down in times of economic distress? And how does the legal framework in which these funds operate ensure the funds achieve their stated goals?

This article addresses these questions first by describing the three principal types of SWFs in operation in the United States: severance tax funds, land grant trust funds, and tobacco settlement funds, discussed in Part II. In Part III, the article turns to an analysis of the justifications of state SWFs through a review of the stated objectives of the funds, the funds' governance and distributions mechanisms, the role the funds play in state policy making and budgeting, and the aspects of federalism implicated by state sovereign wealth. The article identifies three common justifications for state sovereign wealth: revenue smoothing, intergenerational equity, and autonomy preservation. The analysis of these justifications shows that for most states these justifications often fail to explain state SWF behavior. The analysis also raises questions about the use of state SWFs within a federalist system of government.

After Part III provides answers to the question of why we have state sovereign wealth, Part IV describes how states invest, and what states do with the returns from those investments. These choices have important governance implications, as the choices affect not only the returns from the investments but can also either enhance or reduce agency costs imposed by politicians and asset managers.

II. PRIMARY TYPES OF STATE SOVEREIGN WEALTH FUNDS

This section introduces the three main types of state sovereign wealth funds: severance tax funds, land grant funds, and tobacco settlement funds.

Like many of their international cousins, a large number of state SWFs are funded through taxes on natural resource extraction, commonly labeled as "severance taxes." While most states generally impose severance taxes on resource extractors,⁵ not all states

⁵ Approximately 35 states impose a severance tax on non-renewable natural resource extraction. Stephen Herzenberg, ed., *Responsible Growth: Protecting the Public Interest with a Natural Gas Severance Tax*, Pennsylvania Budget and Policy Center, 25 (2009),

create permanent funds from these tax revenues. Indeed, only a handful of states, including Alabama, Alaska, Louisiana, Montana, New Mexico, North Dakota and Texas, have permanent funds of noteworthy size.⁶

While severance tax fund states benefit from abundant natural resources, the benefits are offset by significant costs. Indeed, when one hears of a “resource curse” affecting countries with abundant natural resources, the term refers not only to the irony that lower economic development is frequently associated with resource-rich countries, but also that the land is often made much worse as a result of the extraction of resources. The land may no longer be arable, ground water may become polluted, and air quality may be compromised. Indeed, it is this aspect of resource extraction that led Former New Mexico Governor Jerry Apodaca to exclaim:

Let there be no mistake—the West will not become an energy colony for the rest of the nation. We will not sacrifice our greatest assets—our blue skies and clear streams, our unblemished plains and mountains—to an endless national thirst for energy.⁷

The severance taxes imposed by resource-rich states are thus set at levels that are designed to produce revenues that offset the burdens associated with resource extraction, while accounting for the value that resource extraction already brings to a state (aside from the tax revenues) in terms of employment and related benefits to local economies. Resource extractors and the states that are net importers of these resources have historically viewed severance taxes as, in the words of two commentators, “ill-disguised attempts to carve out larger shares of the profits derived from resource extraction. These larger shares are said to be unrelated to the costs the states incur from stepped-up mining.”⁸ On the other hand, resource-rich states such have countered that “mining depletes their physical wealth, imposes undesirable consequences on portions of their

<http://www.pennbpc.org/sites/pennbpc.org/files/Responsible%20Growth%20-%20PA%20Severance%20Tax.pdf>.

⁶ Colorado and Utah have also established permanent funds, but they are relatively small. West Virginia is also considering the creation of a severance tax permanent fund.

⁷ Jerry Apodaca, governor of New Mexico, *quoted in* Lee Peters, *An Outline for Development of Cost-Based State Severance Taxes*, 20 NAT. RESOURCES J. 913 (1980).

⁸ Michael B. Browde & Charles T. DuMars, *State Taxation of Natural Resource Extraction and the Commerce Clause: Federalism’s Modern Frontier*, 60 OR. L. REV. 7, 8 (1981).

population, and may foreclose other developmental alternatives.”⁹ Under this view, severance taxes are a way to force resource-poor states to pay for the negative externalities—both short term and long term—created by resource extraction.

This kind of externality taxation does not operate within a simple, efficient transactional framework wherein a severance tax is placed on resources and the cost of resources is increased and ultimately passed on to consumers in a way that perfectly (i.e., not over- or under-) compensates the resource-producing states. A similar problem may occur with any resource-rich sovereign. The OPEC nations, to use the most obvious example, operate a cartel that is perpetually accused of exploiting oil-importing countries. What makes New Mexico, Alaska and other resource-rich states different is that they operate within a federal framework. Severance taxes thus pose important questions for federalism, but these questions are an iteration of a question that has long animated U.S. politics: what is the relation between the states and the federal government as expressed through rights and burdens of taxation? A recent formulation of this question considered the interaction of the Commerce Clause with severance taxes.¹⁰ After much debate in the 1970’s (when numerous states began to impose severance taxes and several of the severance tax funds were formed), the U.S. Supreme Court in *Commonwealth Edison Co. v. Montana* (1981) affirmed the constitutionality of severance taxes when it held by a 6-3 decision that Montana’s severance tax did not violate the Commerce Clause. Concerns over the longer-term budgetary effects of this accumulation of wealth—now in hindsight increasingly relevant given increasing federal aid to states—were not prominent in these earlier severance tax debates.

To add a couple of complications to the severance tax equation, resource extractors argue that they or their insurers already compensate for many of the negative externalities produced by the extraction processes, and that the federal government also absorbs some of the costs for these externalities, in part through federal funding for environmental protection and rehabilitation projects.¹¹ If severance taxes on states

⁹ *Id.*

¹⁰ Michael B. Browde & Charles T. DuMars, *State Taxation of Natural Resource Extraction and the Commerce Clause: Federalism’s Modern Frontier*, 60 OR. L. REV. 1 (1981).

¹¹ For example, the United States Department of Agriculture, Natural Resources Conservation Service, lists as of 1998 approximately two dozen federally-funded projects relating to water quality alone. United States Department of Agriculture, Natural Resources Conservation Service, Federal Funding

overcompensate the resource-rich state, then the state enjoys a form of federal subsidy. On the other hand, if the severance tax fails to adequately compensate the state, the state is subsidizing other states.

Against this backdrop, a handful of states have for several decades accumulated vast funds through severance taxes, placing the funds in endowment trusts for the benefit of the state and its citizens. The following sections describe the largest state severance tax funds, and then turn to the governance, investment, and distribution policies of the funds.

A. *Creation and Funding of U.S. Severance Tax Funds*

1. New Mexico

New Mexico was the first state to use severance tax revenues on natural resources, including copper, timber, and rare and precious metals, to establish a permanent fund. The New Mexico legislature established the Severance Tax Permanent Fund (STPF), which currently holds approximately \$3.5 billion, as a permanent endowment fund through a legislative act in 1973. The creation of the fund appears to have been motivated by a couple of factors. First, the state simply had excess funds, and, through the earlier creation of its land grant fund, described below, already had in place a means of profitably investing those funds rather than immediately spending them. Second, as noted above, state officials were concerned with the negative externalities created by resource extraction, and wanted to set aside funds to offset these externalities for present and future generations.

2. Wyoming

The foundation for the Permanent Wyoming Mineral Trust Fund was laid in 1969 with a bill to impose a mineral severance tax (initially, a 1.0% tax).¹² Legislators sought to increase the tax in 1974, but then Governor Stanley Hathaway threatened to veto the legislation unless part of the money was set aside in a permanent fund created through constitutional amendment. The amendment was placed on the ballot in November 1974,

Sources for Water Quality Activities, New Mexico Food and Agricultural Council Water Quality Subcommittee – Draft August 1998, *available at* <http://www.nm.nrcs.usda.gov/technical/water/fund.html>.

¹² Wyoming Taxpayers Association, Permanent Mineral Trust Fund (PMTF), *available at* <http://www.wyotax.org/PMTF.aspx>.

and passed by a wide margin.¹³ With the creation of the PWMTF, Wyoming raised the severance tax to 2%. Thirteen years later, the state reduced the tax to 1.5%, and committed a portion of the revenues to the state's rainy day fund.¹⁴ In 2005, Wyoming raised the tax again, this time to 2.5%. The severance tax rates have been regularly adjusted by statute, and now are differentiated by the type of product.¹⁵ While most of the funds in the PWMTF are from severance taxes, the state has also large direct appropriations for the benefit of the PWMTF.¹⁶

Not all of the severance taxes revenues are deposited with the PWMTF. While the PWMTF typically receives the largest portion of the severance tax revenues, significant amounts are also deposited in the state's general fund, as well a number of other funds including a capital construction account, a highway fund, a road construction fund, and several water development funds.¹⁷ Wyoming cities and towns also receive significant revenues from severance taxes.¹⁸

The PWMTF was valued at approximately \$4.6 billion at the end of fiscal year 2010.¹⁹

3. Alaska

Alaska soon followed New Mexico and Wyoming with the creation of the Alaska Permanent Fund, now valued at over \$40 billion dollars.²⁰ The construction of the trans-

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *See, e.g.*, Wyoming Department of Revenue, Severance Tax Manual (2010), *available at* <http://revenue.state.wy.us/PortalVBVS/uploads/SevClass2010.pdf>.

¹⁶ The Wyoming Taxpayers Association reports that "\$411,442,146 was provided by direct legislative appropriation from 2001-2009, and \$627,317,972 was put in the fund above the constitutional requirement for the same period." Wyoming Taxpayers Association, Permanent Mineral Trust Fund (PMTF), *available at* <http://www.wyotax.org/PMTF.aspx>.

¹⁷ *See* State of Wyoming Department of Revenue, 2010 Annual Report, <http://revenue.state.wy.us/PortalVBVS/uploads/2010%20DOR%20Annual%20Report.pdf>.

¹⁸ *Id.*

¹⁹ Wyoming State Treasurer: Annual Report, 5-6 (2010), <http://treasurer.state.wy.us/pdf/annualweb10.pdf>.

²⁰ The groundwork for the creation of the Alaska Permanent Fund was laid in 1969, when the State of Alaska sold drilling rights on 164 tracts of state-owned land at Prudhoe Bay. The lease netted the state

Alaska oil pipeline brought considerable tax revenues to the state, and Alaskans “became increasingly convinced that it would be wise to take at least a portion of the future oil wealth and save it rather than spend it.” A ballot proposition was eventually presented before voters in the 1967 General Election that would create a perpetual trust fund to oversee the management and growth of the revenues. The proposition resulted in a constitutional amendment creating the Alaska Permanent Fund, with 25 percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses placed in a permanent fund. The fund began operation in 1977.

4. Montana

Montana has one of the smallest state SWFs, the Montana Coal Severance Tax Permanent Fund (“MCSTPF”). The MCSTPF, established in 1976, no longer receives revenues from the severance taxes as the legislature has recently determined to redirect the revenues to four other funds: the Coal Tax Bond Fund (providing financing for renewable resource projects that alleviate the “social and economic impacts created by coal development” and promote “a clean and healthy environment;”²¹ the Treasure State Endowment Fund²² (providing financing for local government infrastructure projects), the Treasure State Endowment Regional Water System (funding regional water system projects); and the Big Sky Economic Development Fund (providing grants and loans to local governments and regional development corporations for the purpose of “creating good-paying jobs for Montana residents,” “promoting long-term, stable economic

\$900 million, and “also put the state into the oil exploration and development business for the long term, with the winning oil companies as its partners.” *An Alaskan’s Guide to the Permanent Fund*, at 1. (12th ed. 2009), available at <http://www.apfc.org/home/Media/publications/2009AlaskansGuide.pdf>. To put this amount into perspective, the state budget for 1968 was only \$112 million. The state decided to spend the money on infrastructure projects and social and educational needs, including a student loan program and a longevity bonus program that paid out funds to senior citizens. After funds began to be dispersed, however, Alaska’s citizens began a kind of buyer’s remorse, and “it wasn’t long before the spending consensus was forgotten and a statewide, negative reaction to the ‘wasting of the \$900 million’ began to develop. The money hadn’t been wasted, but Alaska is such a large area with so many needs that it was difficult for some citizens to appreciate where the money had gone.” *Id.*

²¹ Mont. Code Ann. § 17-5-719 (2010).

²² This fund will cease receiving revenues as of the end of fiscal year 2016.

growth,” “encouraging local economic development organizations,” and “retaining or expanding existing businesses.”²³

The MCSTPF continues to earn interest for the state, and these funds are placed in the state’s general fund.²⁴ Since 2006, however, no coal severance tax revenues have been placed in the permanent fund. The total value of all of Montana’s severance tax funds is approximately \$836 million.

5. North Dakota

North Dakota’s Coal Development Trust Fund was formally established in 1980 as voters approved a constitutional measure setting aside 30 percent of the state’s coal severance tax revenue in a constitutional trust fund. By state statute, the fund is administered by the Board of University and School Lands.²⁵ Seventy percent of the funds in the trust are to be transferred to a special fund for lignite research,²⁶ and the remaining thirty percent of these funds are to be used to provide loans to coal-impacted localities, and to provide loans to school districts for the construction of school buildings.²⁷

North Dakota also has two oil revenue funds, the Permanent Oil Tax Trust Fund (“POTTF”) and the Legacy Fund. The POTTF was created in 1997, and the enabling legislation provides that the first \$71 million of all oil and gas tax revenues in a biennium period are to be deposited in the state’s general fund, and additional funds are to be placed in the POTTF. The interest generated from the POTTF is deposited back to the general fund. The Legacy Fund, which became effective July 1, 2011, receives 30 percent of all oil and gas tax revenues.²⁸ The Permanent Oil Tax Trust holds approximately \$475 million in assets, the Legacy Fund approximately \$619 million, and the Coal Development Trust Fund approximately \$61 million.

²³ Montana’s Coal Severance Tax...Distribution Detail, Fiscal Pocket Guide (2010), http://www.leg.mt.gov/content/Publications/fiscal/leg_reference/revenue/2010-coal-tax-distribution.pdf.

²⁴ Mont. Code Ann. § 17-5-704 (2010).

²⁵ N.D. Cent. Code § 57-62-02 (2009).

²⁶ N.D. Cent. Code § 57-61-01.5 (2009).

²⁷ N.D. Cent. Code § 57-62-02 (2009).

²⁸ N.D. Const. art. X, § 26.

6. Alabama

Alabama's \$3.1 billion wealth fund is one of the more recent state severance tax funds. In 1978, large deposits of natural gas were discovered in Mobile Bay. In 1981, the state received bids totaling \$449 million for rights to develop the offshore gas deposits. The following year, Alabama voters approved the creation of the Alabama Heritage Trust Fund ("AHTF"), which was initially funded with the revenues from the sale of these rights.²⁹ This initial income was used to finance a bond issuance for several capital outlay projects.³⁰

The state received over \$347 million in 1984 through the lease of additional offshore tracts, and the following year voters approved a second, irrevocable trust, the Alabama Trust Fund ("ATF").³¹ By constitutional amendment,³² the ATF was to serve as the investment vehicle for revenues generated from sales of offshore drilling rights and royalties from natural gas production. Alabama passed several additional constitutional amendments tightening the general purpose of the fund, which was initially only loosely defined as "for the continuing benefit of the state of Alabama and the citizens thereof."³³ Amendment 543, passed in 1993, created the Alabama Forever Wild Land Trust ("FWLT") to promote state policies to "protect, manage, and enhance certain lands and waters of Alabama with full recognition that this generation is a trustee of the environment for succeeding generations"; to "protect, to the fullest extent practicable, recreational lands and areas of unique ecological, biological and geological importance"; and to "promote a proper balance among population growth, economic development, environmental protection, and ecological diversity."³⁴ The FWLT was tasked with "identifying, acquiring, managing, protecting and preserving natural lands and waters that

²⁹ Alabama State Treasurer, History of the Alabama Trust Fund, *available at* <http://www.treasury.state.al.us/content/Documents/History%20of%20the%20Alabama%20Trust%20Fund2.pdf>.

³⁰ *Id.*

³¹ *Id.*

³² Ala. Const. of 1901, amend. 450.

³³ Alabama Trust Fund, Ala. Const. of 1901, amend. 450, § 1.

³⁴ Acquisition, Maintenance and Protection of Unique Lands and Water Areas, Ala. Const. of 1901, amend. 543, § 1(a)-(c).

are of environmental or recreational importance.”³⁵ In 2000, the state created two additional trust funds, the County and Municipal Capital Improvement Trust Fund (“CMCITF”) and the Alabama Capital Improvement Trust Fund (“ACITF”).³⁶ Finally, Alabama also created the Education Trust Fund Rainy Day Account in 2002, then subsequently overhauled the operation and coverage of this account in 2008 through constitutional amendment. Alabama also added a General Fund Rainy Day Account, funded through the ATF, in 2008.

7. Louisiana

Louisiana’s severance tax fund is also relatively young. In 1986, the state determined to set aside a portion of its revenues from its share of the funds from offshore drilling in the Gulf of Mexico.³⁷ Louisiana voters chose to use the proceeds for educational purposes, and the approved the creation of the Louisiana Educational Quality Trust Fund. As of June 30, 2009, the fund’s market value was approximately \$962 million [more recent figure?].

³⁵ Acquisition, Maintenance and Protection of Unique Lands and Water Areas, Ala. Const. of 1901, amend. 543, § 1(c).

³⁶ The state offered several justifications for these funds, including that: “the capital improvements and technology required by many governmental programs could be more efficiently funded through the establishment of a special trust fund dedicated to funding such improvements,” that “municipal and county governments require assistance in the funding of capital improvements,” and that general obligations bonds supported by these funds could, among other things, promote “economic development and industrial recruitment in the state.” County and Municipal Government Capital Improvement Trust Fund; Alabama Capital Improvement Trust Fund, Ala. Const. of 1901, amend. 666, § 1. “Capital Improvements” is defined in the Alabama Constitution as “capital outlay projects that include the planning, designing, inspection, purchasing, construction, reconstruction, improvement, repair or renovation of permanent buildings, docks, structures and sites therefor for the executive, legislative or judicial branches of state government,” as well as “the construction or improvement of roads and bridges in the highway system; payment of debt service on the bonded indebtedness issued by the State of Alabama or any public corporation or authority of the State of Alabama; funding economic development and industrial recruitment activities; and the procurement of technical equipment, including computer and telecommunications equipment, required for the operation of any governmental entity”..” County and Municipal Government Capital Improvement Trust Fund; Alabama Capital Improvement Trust Fund, Ala. Const. of 1901, amend. 666, § 2.

³⁷ Under the Outer Continental Shelf Lands Act, states and the federal government share leasing revenues. The division of the jurisdiction over the waters depends on the state; in the case of Louisiana, the state’s jurisdiction extends for three miles, while for Texas, because of treaties that existed prior to Texas joining the union, state jurisdiction extends 9 miles.

The LEQTF was intended to provide supplemental funding for educational enrichment programs. Some of these funds are distributed through a grant program administered by the Louisiana Department of Education.³⁸ The Louisiana Department of Education reports that since 1986, the grant program has allocated over \$790 million, funding over 7100 projects.³⁹

B. Creation and Funding of Land Grant Funds

The history of state land trusts began with the General Land Ordinance of 1785 and the Northwest Ordinance of 1787, under which Congress granted federally-owned lands to states, often for educational purposes. The practice became a common feature of accession to the Union, starting with Ohio in 1803.⁴⁰ However, these early grants were not restricted—the trusts were not permanent trusts—so states often squandered their trust lands. In 1835 Michigan created a permanent school fund, with restrictions on the sale of the lands, coincident with its entry into the Union in 1837.⁴¹ Following Michigan's example, most of the states subsequently admitted to the Union have some kind of permanent land trust for the benefit of schools, typically established by U.S. congressional acts coupled with state constitutional amendments. These land grants are most prominent in Western states, where large sections of land were placed in trust. As Culp, Conradi and Tuell describe:

If you look at a map of public land ownership in almost any Western state, amongst the great blocks of green (usually national forests and national parks), orange (usually Indian reservations), yellow (usually Bureau of Land Management lands), and white (usually private lands), you will find some light blue: the color traditionally reserved by mapmakers for state trust lands. In total, these lands comprise approximately forty-six million

³⁸ Louisiana Department of Education, Louisiana Board of Elementary & Secondary Education, 8(g) Elementary & Secondary Education Grants, https://www.louisianaschools.net/bese/qe_8g.html.

³⁹ *Id.*

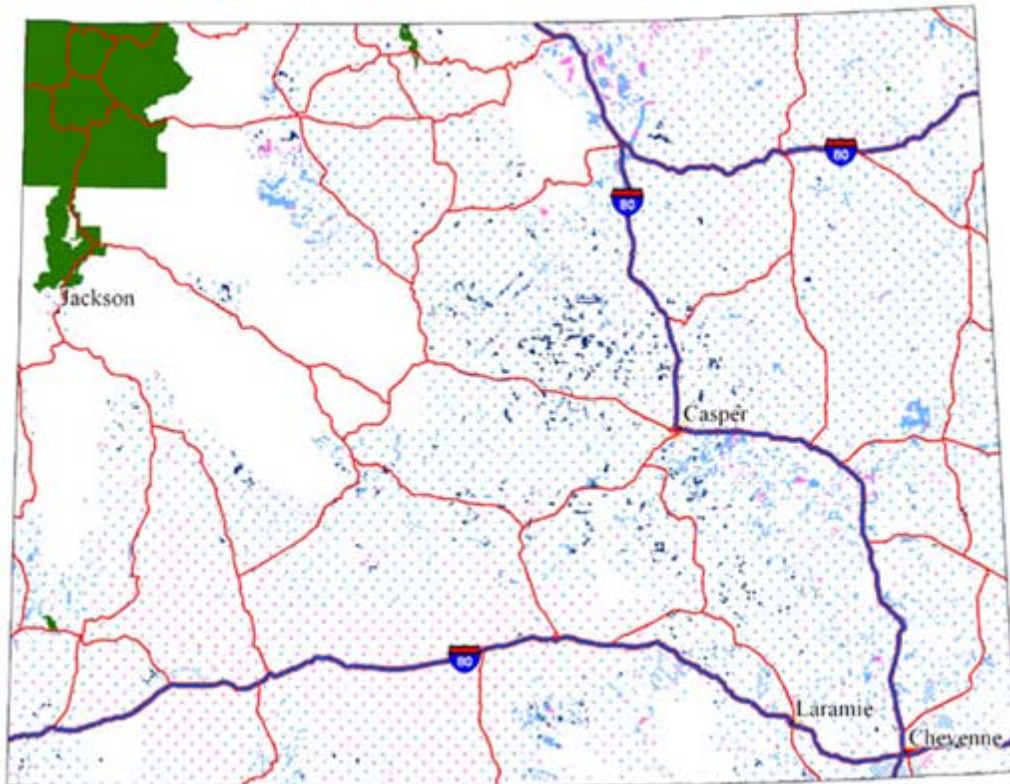
⁴⁰ Peter W. Culp, Diane B. Conradi & Cynthia C. Tuell, Trust Lands in the American West: A Legal Overview and Policy Assessment, <http://www.lincolnst.edu/subcenters/managing-state-trust-lands/publications/trustlands-report.pdf>, at 7.

⁴¹ *Id.* at 13.

acres of land spread across twenty-four states, primarily located to the west of the Mississippi River.⁴²

An example of how these lands are evenly distributed by township sections throughout a state is shown on the map of Wyoming below.

Wyoming's Trust Lands



Map: Lincoln Institute of Land Policy

⁴² According to the authors, “Twenty-three states continue to hold some quantity of their original state trust land grants: Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Louisiana, Minnesota, Mississippi, Montana, Nebraska, New Mexico, Nevada, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wisconsin, and Wyoming. Several of these states have retained only a tiny fraction of the original grant lands; Nevada, for example, retains only around 3,000 acres of its original 2.7 million acre grant. By contrast, Alaska, Arizona, Montana, and Wyoming have each retained between 85 and 90 percent of their original state trust land grants.” P. 54.

These state trust lands were typically reserved for the benefit of public schools, and the lands are, as Culp, Conradi and Tuell report, “actively managed for a diverse range of uses, including: timber, grazing, mining for oil and gas and other minerals, agriculture, commercial and residential development, conservation, and recreational uses such as hunting and fishing.”⁴³ Aside from direct payments into local school systems, the revenues generated from these trusts also support school bond financings, school construction projects, and provide limited support to a wide range of other institutions, including universities, hospitals, and even penitentiaries.

Recalling our definition of SWFs as, *inter alia*, funds without designated beneficiaries outside of the government and citizenry in general, arguably land grant funds strain a categorization as SWFs. However, note that the funds have no direct obligation to specific individuals, a feature which distinguishes SWFs from other types of publicly managed funds such as public pension funds. A public pension fund is a public institution managed for private individuals, whereas a SWF is a public institution managed for intra-governmental purposes. What distinguishes land grant funds from other SWFs, however, is that while a national government typically manages a SWF for general governmental purposes, a state land grant SWF manages state funds for the purposes of specific state and local public institutions. Nevertheless, the public-directed management of SWFs (whether for general or specific purposes) seems to be one of their common and defining aspects; together with the fact that land grant funds do not have liabilities to private institutions or individuals, the public character of land grant funds suggests that they should fall within the SWF definition.

Because of the similarities among most land grant funds, a state-by-state review is unnecessary. State land grant funds can be arranged in just two categories: “Texas” and “every other state”.

1. Texas

This brief overview of state land grant funds starts with the outlier: The Texas Permanent School Fund (“TPSF”). The TPSF was established in 1854, making it one of the oldest permanent funds in the world. Unlike the other land grant funds, which were established by a direct grant by the U.S. government of federal land to newly admitted states in order to support public education, the TPSF was created by grants and funding

⁴³ *Id.* at 2.

provided by the State of Texas itself. First, the Texas legislature appropriated \$2,000,000 for the TPSF out of a \$10 million payment from the U.S. government in exchange for relinquishing claims to lands claimed by the former Republic of Texas.⁴⁴ The Texas Constitution of 1876 also provided that certain lands and all associated rights to the lands should be held by the TPSF.⁴⁵

Additional funding for the TPSF comes from revenues relating to oil drilling in the Gulf of Mexico. In a suit that also established that Louisiana, Mississippi and Alabama had jurisdiction over all the lands, minerals and other natural resources underlying the Gulf of Mexico within three geographical miles from the coast of each state,⁴⁶ Texas, in accordance with its recognized boundaries prior to accession, was granted jurisdiction within three marine leagues (approximately ten geographical miles). Texas also has a long history of profitable drilling operations in the western part of the state. This wealth has made the TPSF one of the largest state SWFs: as of the end of the 2010 fiscal year, the fund balance was \$24.4 billion.⁴⁷

2. Other Land Grant States

The list of land grant states is large,⁴⁸ yet most of these states' citizens probably do not realize that their state manages a type of sovereign wealth fund. New Mexico and Wyoming's land grant funds are typical in their origins and operations, and because of the relatively large mineral wealth in these states, they are two of the largest funds. These two states provide useful examples of the origins and operations of state land grant SWFs.

Upon Wyoming's accession to the Union in 1890, the federal government provided the state with a means of funding its public educational institutions by granting lands to be held in trust for designated beneficiaries.⁴⁹ The federal government granted

⁴⁴ TEXAS PERMANENT SCHOOL FUND, TEXAS EDUCATION AGENCY, COMPREHENSIVE ANNUAL FINANCIAL REPORT (2010), available at http://ritter.tea.state.tx.us/psf/PSF_Annual_Report.pdf, at 5.

⁴⁵ Tex. Const., art. 7 cec. 5.

⁴⁶ United States v. Louisiana, 363 U.S. 1 (1960).

⁴⁷ TEXAS PERMANENT SCHOOL FUND, TEXAS EDUCATION AGENCY, COMPREHENSIVE ANNUAL FINANCIAL REPORT (2010), available at http://ritter.tea.state.tx.us/psf/PSF_Annual_Report.pdf.

⁴⁸ See note 99, *infra*.

⁴⁹ Act of July 10, 1890, ch. 664, 26 Stat. 222.

3.6 million surface acres and 4.2 million mineral acres;⁵⁰ as in the later New Mexico grant, the legislation set aside sections numbered 16 and 36 in every township. Wyoming currently holds in trust approximately 3.5 million surface acres and 3.9 million mineral acres.⁵¹ Revenues from state lands are primarily generated through mineral extraction (oil and gas, sodium, and trona), timber sales, grazing leases, and real estate transactions. A large majority of revenues are generated from mineral royalties.⁵² The state classifies revenues according to their source: if the revenues are generated from non-renewable resources, such as mineral royalties, real estate sales, surface damages and easements, the funds are distributed to the Permanent Land Fund (“PLF”) (and the PLF subaccounts, the largest of which is the Common School Permanent Land Fund). If the revenues are generated by sources classified as renewable, such as surface and mineral lease rentals, mineral lease bonus bids, temporary use permits, and timber sales, the revenues are deposited into the Permanent Land Income Fund.⁵³ The corpus of the PLF must remain inviolate, although the interest earned on PLF assets may be appropriated by the legislature.⁵⁴ All funds deposited in the Permanent Land Income Fund are available for appropriation by the legislature.

New Mexico’s Land Grant Permanent Fund (“LGPF”) was created through the enactment of the Ferguson Act of 1898, which transferred certain federally-held lands to the territory of New Mexico. Under the Ferguson Act, sections 16 and 36 in every township were granted to the territory, and the territory was to raise funds through the sale or lease of these mineral-rich lands, with the funds held in trust for various state and

⁵⁰ See The Lincoln Institute of Land Policy, *Wyoming Trust Lands & Education Funding*, available at <http://www.lincolninst.edu/subcenters/managing-state-trust-lands/state/ed-funding-wy.pdf> (stating that “Surface acres include land that is managed for agriculture, grazing, timber and commercial and residential development uses. The mineral acres include lands that contain large deposits of oil, gas, coal and other minerals.”) (citing Lynne Boomgaarden, Director of the Wyoming Office of State Lands and Investments. Personal communication, 2005).

⁵¹ STATE OF WYOMING OFFICE OF STATE LANDS & INVESTMENTS, STRATEGIC PLAN, FISCAL YEAR 2011-2012, available at <http://slf-web.state.wy.us/osli/reports/2009StrategicPlan.pdf>.

⁵² For example, in 2010 approximately \$233 million was generated from trust lands. Of this \$233 million, approximately \$222 million was generated through mineral royalties. STATE OF WYOMING OFFICE OF STATE LANDS & INVESTMENTS, SUMMARY OF STATE LAND TRUST REVENUE (February 28, 2001), available at <http://slf-web.state.wy.us/osli/BoardMatters/2011/0411/Trust0411.pdf>.

⁵³ STATE OF WYOMING OFFICE OF STATE LANDS & INVESTMENTS, 2010 ANNUAL REPORT, available at <http://slf-web.state.wy.us/osli/reports/AnnualReport10.pdf>.

⁵⁴ *Id.* at 12.

federal institutions, including public schools. This legislation was later affirmed in the Enabling Act of 1910, which allowed the people of New Mexico to form a constitution and state government. The Enabling Act also included additional land grants to New Mexico—sections 2 and 32 of each township—with earnings and royalties associated with mineral rights again held in trust “for the support of common schools.”⁵⁵ The Jones Act of 1927 later provided that the grants included mineral rights, along with the surface acreage.

The LGPF is the largest of New Mexico’s permanent funds, holding in trust 13.4 million acres of mineral lands and 8.8 million acres of surface land.⁵⁶ In 2009 the State Investment Council distributed more than \$523 million in interest from the LGPF, and in 2010 distributed more than \$596 million. Most of the funds (greater than 80%) are distributed to New Mexico public schools, and the remainder is distributed to universities, colleges, hospitals, and other public works and institutions. Because specific lands are held in trust for particular beneficiaries of the LGPF, the proportion of funds distributed varies according to the revenues associated with the specific lands. Thus, the discovery of new minerals or the depletion of minerals will affect a given beneficiary’s share.⁵⁷

The funding of the LGPF is coordinated through the New Mexico State Land Office and the SIC. The State Land Office collects revenues from state-owned lands and transfers the funds to the SIC. As with other commodities funds, the annual revenues to the LGPF are tied to global energy prices, and have averaged about 5% of the total value of the fund.⁵⁸ These funds are combined with the return on existing investments; the long-term average rate of return on LGPF investment is approximately 6.5 percent.⁵⁹

⁵⁵ Arizona-New Mexico Enabling Act, Act June 20, 1910 § 6, c. 310, 36 U.S. Stat. 557.

⁵⁶ NEW MEXICO STATE INVESTMENT COUNCIL, LAND GRANT PERMANENT FUND http://www.sic.state.nm.us/land_grant.htm (last visited July 12, 2011).

⁵⁷ New Mexico Voices for Children, *New Mexico’s Land Grant Permanent Fund: A Primer* 1 (November 2010), http://www.nmvoices.org/fpp_attachments/lgpf-primer-12-3-10.pdf.

⁵⁸ *Id.* at 2.

⁵⁹ *Id.* [Better source—direct from SIC if possible].

C. Creation of Tobacco Settlement Funds

In November 1998, 46 state attorneys general signed a Master Settlement Agreement (“MSA”) with the major U.S. tobacco companies which obligates the tobacco companies to pay approximately \$206 billion over 25 years.⁶⁰ Four other states not party to the MSA—Florida, Minnesota, Mississippi and Texas—signed individual settlement agreements with the tobacco companies that in total require payments of \$40 billion over 25 years.

As noted in a 2001 United States General Accounting Office Study, “[t]he MSA imposes no requirements on how states spend their MSA payments; states are free to use the funds for any purpose. As a result, the receipt of millions of MSA dollars has presented states with a unique opportunity to finance programs in a variety of policy areas.”⁶¹ The first issue for most states was whether and how to set aside the funds. Not all states created permanent funds to invest the money from the tobacco settlement. California, for instance, allocated the first installment of the \$25 billion it is to receive directly to the general budget.⁶²

As of the publication of the GAO study, 36 states had created some type of dedicated fund, and 19 states had created endowment funds, which the GAO categorized as funds in which the principal is held inviolate. This would suggest that these 19 funds could be considered as sovereign wealth funds, provided that the states have not obligated the funds to specific individual claimants or liabilities.

Despite the fact that 19 states have created endowment funds for MSA payments, in most cases only a percentage of MSA payments are placed in the endowment funds; typically, a majority of the funds are placed in special funds and/or allocated to the general budget.⁶³ The GAO reports that in fiscal years 2000 and 2001, 41 percent of MSA funds went to health-related programs, including Medicaid and State Children’s Health Insurance Program (SCHIP) programs. Twenty-six percent of the MSA payments

⁶⁰ The Master Settlement Agreement is available at http://www.naag.org/backpages/naag/tobacco/msa/msa-pdf/MSA%20with%20Sig%20Pages%20and%20Exhibits.pdf/file_view.

⁶¹ United States General Accounting Office, *States’ Use of Master Settlement Agreement Payments* (June 2001), <http://www.gao.gov/new.items/d01851.pdf>.

⁶² Chris Schreiber, *Money Matters: State’s share of tobacco settlement will go into general fund*, NURSEWEEK (July 1, 1999), <http://www.nurseweek.com/features/99-7/settle.html>.

⁶³ Government Accounting Office, *States’ Use of Master Settlement Agreement Payments*, at 23-24

went to a variety of governmental programs, including education, social services, infrastructure, and rainy-day funds. Twenty percent of MSA payments remained unallocated. Two states used MSA payments to reduce taxes, while seven states provided 6 percent of their MSA payments to tobacco farmers and related economic development projects.⁶⁴

New Mexico and Louisiana both provide examples of how MSA funds have been set aside in SWFs. New Mexico's Tobacco Settlement Permanent Fund ("TSPF") was created in 2000, and was designed to provide funding for "health and educational purposes,"⁶⁵ including: support of public school programs, "extracurricular and after-school programs designed to involve students in athletic, academic, musical, cultural, civic, mentoring and similar types of activities";⁶⁶ "any health or health care program or service for prevention or treatment of disease or illness";⁶⁷ university or state agency research "addressing the impact of smoking or other behavior on health and disease";⁶⁸ "public health programs and needs";⁶⁹ and "tobacco use cessation and prevention programs, including statewide public information, education and media campaigns."⁷⁰

TSPF funds are to be invested by the SIC in the same manner as New Mexico's LGPF. The distribution of TSPF funds is heavily front-loaded. In fiscal years 2003-2006, 100% of the money distributed to the TSPF was distributed to the state's general fund.⁷¹ Beginning in 2007, 50% of the tobacco settlement distributions have been retained by the TSPF, and once the fund reaches sufficient size, it will retain all payments made to the TSPF, but will, like New Mexico's severance tax fund, distribute 4.7% of its year-end value to the general fund of the state. As of the end of the 2010 fiscal year, the TSPF held approximately \$133 million in net assets.⁷²

⁶⁴ *Id.* at 6.

⁶⁵ N.M. Stat. 6-4-10 (2000).

⁶⁶ N.M. Stat. 6-4-10(B)(1) (1978).

⁶⁷ N.M. Stat. 6-4-10(B)(2) (1978).

⁶⁸ N.M. Stat. 6-4-10(B)(3) (1978).

⁶⁹ N.M. Stat. 6-4-10(B)(4) (1978).

⁷⁰ N.M. Stat. 6-4-10(B)(5) (1978).

⁷¹ N.M. Stat. 6-4-9 (1978).

⁷² State of New Mexico Investment Council Financial Statements, 2010, <http://www.sic.state.nm.us/PDF%20files/Moss%20Adams%20SIC%20Financial%20Statements%206-30-10.pdf>.

Louisiana's Millennium Trust Fund was established in 1999 to manage MSA funds, and the Millennium Fund is itself divided into three sub-funds, reflecting the different uses intended for the funds: the Health Excellence Fund, the Education Excellence Fund, and the Taylor Opportunity Program for Students (TOPS) Fund. As with Louisiana's LEQTF, the Millennium Fund is managed by Louisiana's Investments Division. As of June 30, 2009 the fund had a market value of \$1,377,206,203.92.⁷³

III. THE JUSTIFICATIONS FOR STATE SOVEREIGN WEALTH FUNDS

The first Part of this article described the primary types of state SWFs, but we have yet to consider a fundamental question: why do some states have SWFs? The obvious answer—that the states simply had large amounts of revenues and so created a vehicle to hold those revenues—merely tells us that state legislatures decided to hold at least some of the revenue rather than immediately spend it (as some other states do). But why retain these funds? And when (if ever) and how should the states spend the funds? The next two Parts address those questions both descriptively and normatively, first by focusing attention on the various justifications for state SWFs, and second by describing how states invest the funds coming into their SWFs.

Much of the legal literature on nation-level SWFs explains SWFs in terms of political risk, or the potential use of SWFs as political tools. The use of a SWF as a political tool is but one among many explanations for the existence of SWFs, and while it may be true that some SWFs are used for political purposes on occasion (though there exists scant evidence of this), less nefarious purposes seem to drive the creation of most SWFs. Indeed, for most state SWFs, an educational purpose was directly tied to the creation of the funds.

This section critically examines the purposes underlying the creation of state SWFs, which in turn provides a foundation to analyze whether the state's SWF governance and distribution mechanisms effectively achieve these purposes. For land grant funds, the initial purpose was essentially to provide the equivalent of a property tax base for the benefit of public schools, but the initial reason may not be the exclusive justification for the operation of a state land grant SWF. Other justifications may arise as the fund matures. Although the specific reasons justifying the existence of a SWF are

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Citation needed

expressed in unique ways, the various justifications may be grouped together under several general categories. None of the justifications are necessarily exclusive, although for most SWF sponsors one or two justifications will predominate. Because the state funds described in this article all have their origin in commodities sales, with the exception of tobacco settlement funds, focusing primarily on justifications for commodity funded SWFs (as opposed to the justifications for funds generated from currency reserves) gives the greatest insight into the intended function of state SWFs.⁷⁴

⁷⁴ “Dutch disease,” one of the justifications for national SWFs, is not applicable to state SWFs. Dutch disease refers to the phenomenon wherein resource exports lead to rising currency appreciation, which in turn affects the relative pricing of manufactured goods from the same country. As the currency appreciates, other products become less competitive, resulting in a distortion to the economy, and possibly a reduction in total exports. However, U.S. states do not have their own currencies and states would not (and probably could not) reasonably expect to regulate a response to whatever effect their mineral, oil and gas sales would have on the national currency. Additionally, sovereign wealth funds have also been explained as products of state capitalism, as effectively described by Gilson and Milhaupt: “[S]ome major developing countries (China foremost among them) increasingly reflect a form of state capitalism—what we call the new mercantilism. In this form, the country is the unit whose value is to be maximized, with a corresponding increase in the role of the national government as a direct participant in and coordinator of the effort.” Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1346 (2008). Mercantilist theories seem inapt to describe state SWF behavior since international trade policy is primarily regulated at the national level. However, state SWFs could be seen as expressing a kind of state capitalism to the extent that they are used to directly fund social policy initiatives. As a general matter, it may be difficult to extricate the political from the economic when analyzing SWF creation and behavior. SWF and state-owned enterprise investments occur against a backdrop of political relations between the SWF sponsor country and the target investment’s home country, and it should not be surprising that warm economics accompanies warm politics. For example, Jiang describes a significant reduction in Chinese investment in Canada from 2006 to 2009, as the newly elected conservative government attempted a “cold politics, warm economics” approach to China, with the result that “Canada lost ground to China on the economic and trade fronts.” Wenran Jiang, *The Dragon Returns: Canada in China’s Quest for Energy Security* (October 2010), available at http://www.asiapacific.ca/sites/default/files/filefield/the_dragon_returns-_canada_in_chinas_quest_for_energy_security_-_wenran_jiang.pdf. Ultimately, Canada’s government realized that the policy was hurting Canada much more than China, and “continued disengagement at the highest level would only put Canada in a more disadvantageous position.” *Id.* The investments themselves may also be made for hybrid political-economic purposes, of course: investments by Chinese enterprises and Chinese SWFs form part of the “go-out” strategy of the central government to seek out and secure reliable sources of energy and materials around the world in order to meet domestic manufacturing and energy demands.

A. *Smoothing Revenues.*

As commodity prices fluctuate, governments that are dependent on commodity sales for a portion of their revenues may have difficulty in planning expenditures in the face of revenue volatility. As Monk explains, “volatile commodity revenues have a negative impact on the growth of resource-rich countries . . . [and] fluctuating revenues make it extremely difficult to pursue a prudent fiscal policy, especially over the long-term which, in turn, aggravates other problems in resource economies.”⁷⁵ Norway’s SWF is perhaps the best example of the creation of a SWF in response to this problem.⁷⁶ Used in this way, SWFs serve as a kind of self-renewing rainy-day fund that may be drawn down to maintain domestic economic stability. “In this sense,” writes Monk, “countries have not established SWFs because they are resource-rich; they established SWFs because being a resource dependent economy means their societies are vulnerable to changes in the global market for commodities.”⁷⁷

1. State Sovereign Wealth and the Financial Crisis

Although state SWFs create a long-term source of revenue that will persist after revenue generating resources are depleted, state severance tax SWFs typically do not use their funds primarily to smooth out lumpy earnings in the short term or in times of crisis because such a use would require the funds to vary the distributions of the funds in response to revenue shortfalls. State constitutions and statutes, as described above, generally limit the ability of the state government to spend any more than the income produced by the fund. The corpus of the fund cannot be spent. With the exception of Alabama, state SWFs do not appear to have a general “rainy day” function as part of their funds’ objectives. Even in Alabama, the ATF only lends money to state rainy day funds, and the ATF must be repaid within 6 or 10 years, depending on the type of loan. While

⁷⁵ Ashby H.B. Monk, *Sovereignty in the Era of Global Capitalism*, OXFORD: CLARENDON PRESS (citing Auty, R. & Mikesell, R.F. *Sustainable development in mineral economies*, 1998); Mikesell, R. L., *Explaining the resource curse, with special reference to mineral-exporting countries*. RESOURCES POLICY 23(4): 191–199 (1997); Stevens, P., *Resource Impact – Curse or Blessing?* IPECA Working Paper, March 2003.

⁷⁶ Clark and Monk, 2010, reporting that “the establishment of Norway’s SWF was based on the potential short-term costs of fluctuating revenues for macroeconomic stability, which is a characteristic shared by many commodity-based economies.”

⁷⁷ Monk, *supra* note 140, at 10. Emphasis in the original.

there is some “smoothing” that may be achieved through these loans, the founding and governance documents of the ATF, as with the other state SWFs, do not suggest that smoothing revenues is a primary justification for the funds.

The income from land grant trust SWFs, on the other hand, may have allowed some states to weather the Financial Crisis slightly better than others. Although states do not receive a large amount of education funding from land grant SWFs, the funding may have been sufficient to act as a buffer for some states, allowing them to avoid cuts to K-12 education. At least 34 states made cuts to K-12 education during the Financial Crisis, but states with large land grant SWFs, including Texas, New Mexico and Wyoming, were not among them.⁷⁸

But wasn't the Financial Crisis—a once-in-a-generation event that has severely strained state budgets—the kind of event that would justify the use of the corpus of state severance tax SWFs? There is some evidence that, in response to the Financial Crisis, nationally owned SWFs did, in fact, respond to the crisis by pulling money out of some foreign assets and reinvesting it in local businesses or infrastructure. Balin reports that between June 2008 and late 2009 ten different sovereign wealth funds participated in stabilization efforts, including direct capitalization of banks, the purchase of domestic real estate, and financing budget shortfalls.⁷⁹ While such a response might seem justified, it also creates the impression (which SWFs have been at pains to avoid) that SWFs can be politically manipulated. SWFs are thus in a quandary—the use of a SWF as a rainy day fund may alleviate some of the shocks created by severe economic downturns, but it may also increase the risk that the fund could be used as a political expedient. Balin argues that this “re-coupling of SWFs with their sovereign governments may also create an undesirable follow-on effect: governments may now be rhetorically better-positioned to squander national resources for short-term political gain.”⁸⁰ Clark and Knight describe this risk as a temptation requiring a principled approach to political decision-making:

In modern democracies, subject to the ups and downs of electoral cycles, the short-term political advantages of spending windfall earnings are

⁷⁸ Center on Budget and Policy Priorities, *An Update on State Budget Cuts* (February 9, 2001), <http://www.cbpp.org/cms/index.cfm?fa=view&id=1214>.

⁷⁹ Brian J. Balin, *The Impact of the Global economic Crisis on Sovereign Wealth Funds*, 24 ASIAN-PACIFIC ECONOMIC LITERATURE (ISSUE 1) 1, 4 (2010).

⁸⁰ *Id.*

readily apparent; it is also apparent that the beneficiaries of long-term investment are often not represented in the political process. Put more formally, the democratic political process heavily discounts the future – the discount rate being the product of the length of the political cycle, the degree to which sectional interests underwrite the power of governing parties, and the synchronization of the political cycle with the economic cycle.⁸¹

Succumbing to this temptation also had another negative effect for SWFs. As Balin reports, prior to the Financial Crisis many SWF fund managers did not believe that their fund would be tapped by the national government for current spending needs, and so their portfolios contained relatively few liquid assets such as cash, bonds, and interest-bearing deposits, and instead favored riskier, less liquid but higher-yielding assets like corporate equities, venture capital, and real estate; “When sovereigns did call upon SWFs to participate in domestic stabilization efforts, some managers were caught by surprise, forcing them to sell assets at substantial losses to cover their sovereign’s funding request.”⁸²

2. Managing Short-Term Temptations

State SWFs are, of course, susceptible to the same temptations as national SWFs. Texas provides an example of how budget pressures have affected state SWFs, and of how the legal structure is related to the temptation presented by the fund. Texas created a permanent endowment fund, the Permanent Health Fund, with the tobacco settlement funds it receives under the MSA. However, in an effort to cover large cuts to the funding of state health-related institutions, Texas senate budget writers voted to liquidate the fund and distribute the corpus to the institutions.⁸³ Again, however, this liquidation seems more likely with tobacco settlement funds than natural resource-based funds because of a weaker link to intergenerational equity concerns.

⁸¹ Gordon L. Clark and Eric R. W. Knight, *Temptation and the Virtues of Long-Term Commitment: The Governance of Sovereign Wealth Fund Investment*, at 8.

⁸² Balin, *supra* note 144, at 4 (citing an interview with S. Steinitz, January 21, 2010).

⁸³ Curt W. Olson, *Tobacco settlement money goes up in flames*, TEXAS BUDGET SOURCE (Apr. 13, 2011), <http://www.texasbudgetsource.com/2011/04/tobacco-settlement-money-goes-up-in-flames/>.

Most state SWFs have attempted to avoid such issues through incorporating within their founding documents a strong commitment device: the corpus of the funds generally can only be drawn down through a constitutional amendment, which will require a vote of the citizens of the state. However, even though the corpus may not be spent, legislators may still attempt to maximize short term gains in order to maximize the amount of funds available to them during their terms of office. To structurally and statutorily discourage such behavior, states typically have legal restrictions on the kinds of investments that SWFs can make (discussed in Part IV, *infra*), which make it more difficult for those administering the SWF to sacrifice long-term prosperity for short-term benefits.

The robustness of these measures is ultimately dependent on the will of the citizens, because they may by constitutional amendment (or by demanding a statutory amendment) either change the mandated fund allocations or other investment restrictions, or allow for the fund corpus to be drawn down. In the case of Wyoming, at least, voters have shown a surprising resilience to the temptations to draw down on the PWMTF. The issue came to a head in 2005 when the Wyoming Attorney General issued an informal opinion that only the severance tax portion of the PWMTF was untouchable. Subsequently, a House Joint Resolution called for a constitutional amendment specifying that “all monies deposited in the Permanent Wyoming Mineral Trust Fund are inviolate permanent funds of the state.”⁸⁴ The original language of the Wyoming constitutional provision creating the PWMTF was rather vague, stating only that the “fund shall remain inviolate.”⁸⁵ The proposed amendment sought to clarify that “[t]he fund, including all monies deposited in the fund from whatever source, shall remain inviolate.”⁸⁶ In the 2006 general election, voters overwhelmingly—by a 3-1 margin—approved the proposed amendment.⁸⁷ Consequently, the language of Art 15, § 19 of the Wyoming constitution now more clearly affirms that the corpus of the fund is untouchable and only the income can be spent by the legislature. Part of the explanation for the lopsided vote lies in the fact that what was at stake was not whether funds would be distributed directly to the

⁸⁴ Proposed Const. Am. A, Wyo. Legis. (2006).

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ 2006 Election Results, Wyo. Sec’y of State, *available at* http://soswy.state.wy.us/Elections/Docs/2006/06Results/06General/SW_Const.Amendments_Summary.pdf

citizens of the state, as in Alaska, but rather whether the legislature should be granted additional funds to be spent at its discretion. When presented in this light, the outcome of the vote is predetermined.

Alabama's voters also recently resisted efforts to use the Alabama Trust Fund for stabilization purposes. In 2010, Alabama voters resoundingly voted against a constitutional amendment that would have allowed for a legislative appropriation of the ATF for state and local transportation purposes.⁸⁸ This vote is significant because, unlike Wyoming's vote, the issue was presented to voters in the midst of the Financial Crisis, yet they refused to allow for additional funds to be appropriated to the legislature.

The reliability of the constitutional amendment as a commitment device derives from the checks-and-balances within the amendment itself: the legislature only has access to the income of the funds, the public does not have direct access to the funds, and the legislature cannot grant itself additional funds without the approval of the public. While other kinds of commitment devices (such as heightened standards of duty) may provide security that the funds will be less susceptible to political manipulation, the constitutional amendments and statutory restrictions discussed here provide a robust and time-tested means of reducing political opportunism and short-termism.

B. Credit Ratings Agencies as "Catalyst": The SWF as a Mechanism to Decrease the Cost of Public Debt

Credit ratings agencies may also play a significant role in catalyzing the formation of sovereign wealth funds both here and abroad. Credit ratings agencies recognize that while the typical legal structure of the SWF as a permanent fund means that the SWF cannot serve as a reserve or rainy day fund, the income generated by the fund produces a relatively stable source of income for the state.⁸⁹ An example of how a state may be influenced by the credit rating agencies is apparent in West Virginia's debate on whether to create a severance tax-based SWF. West Virginia has been advised that, among other

⁸⁸ See 2010 Alabama General Election Results, available at <http://www.sos.state.al.us/Downloads/election/2010/general/2010GeneralResults-AllStateAndFederalOfficesAndAmendments-CompleteWithWrite-inAppendix.pdf>, at 198.

⁸⁹ See, e.g., Standard & Poors, Wyoming: General Obligation (May 6, 2011) ("Wyoming's permanent mineral trust is established by the state constitution (Article 15, section 19) and constitutionally receives a 1.5% mineral severance tax. The corpus in the mineral trust fund cannot be spent, although the fund income is deposited as unrestricted income in the general fund.") at 4.

benefits, a severance tax permanent fund will “[b]uild assets toward the state’s unfunded pension and long-term liabilities (West Virginia ranked 4th highest in the nation, according to Moody’s Investors Service) and improve the state’s credit rating.”⁹⁰

Because the creation of a SWF can improve the state’s credit rating, the state’s cost of capital can be lowered in two ways. First, as in the case of Wyoming, the existence of the SWF improves the state’s credit rating,⁹¹ which in turn makes the state’s debt issuances relatively more marketable. This allows the state to offer debt with a relatively lower rate of return, thereby producing interest payment savings for the state.

The existence of a state SWF may also have a second and perhaps even more beneficial effect. A state SWF which by statute provides support for locally-issued bonds (such as municipal school bonds) may help those municipalities issue debt at relatively lower rates, thereby incrementally reducing the need for direct state support. Texas provides an example of how this works in practice. The Texas Permanent School Fund guarantees local school district bonds, allowing the local school districts to effectively piggy-back on the ratings of the State of Texas.⁹² Ely reports that “[s]tates with substantial natural resources followed the lead of Texas’ PSF to create programs that leverage royalty-supported permanent funds.”⁹³

The benefits derived from SWF support of local bond financing seems to be significant from the point of view of the individual school districts, but not very substantial when compared to the overall educational budget of the state. Before the Financial Crisis, most school districts issuing debt would have been able to purchase private bond insurance as a credit enhancement and would have received interest rate savings comparable to what a PSF guarantee would provide. However, Ely reports that after the Financial Crisis “no active insurer has comparable credit quality to the PSF’s

⁹⁰ Jill Kriesky, West Virginia Center on Budget and Policy, *Creating a Severance Tax Permanent Fund in the Mountain State: Presentation to the Joint Commission on Economic Development* (June 13, 2011), available at http://www.wvpolicy.org/downloads/Eco_Div061611.pdf.

⁹¹ See Office of Wyoming State Treasurer Joseph B. Meyer, Press Advisory: State’s Issuer Credit Rating Upgraded (May 10, 2011) (attributing the AAA S&P rating in part to “[m]aintenance of large general fund balances, despite the cyclical components of the state’s economic base, enhanced by the existence of a permanent fund, whose interest earnings are available for general fund expenditures”).

⁹² See Dwight Denison, Wenli Yang & Zhirong Zhao, *Is Management Performance a Factor in Municipal Bond Credit Ratings? The Case of Texas School Districts*, Public Budgeting & Finance (Winter 2007).

⁹³ Todd Ely, *Indirect Aid for Uncertain Times: State Credit Enhancement Programs for School Districts* (March 25, 2011) [need permission to cite].

‘AAA’ rating and access to a competitive insurance market is more limited for issuers with lower credit quality.”⁹⁴ Ely estimates that a total annual interest cost savings to school districts of \$140 million.⁹⁵ He notes, however, that “the savings are small when compared to either the annual Texas formula assistance of nearly \$17 billion or school district property tax revenues of almost \$18.8 billion in 2008. Annual savings for Texas school districts, at the full \$140 million annual estimate, are less than one percent of state formula assistance.”⁹⁶

Although the credit enhancement effect of a state SWF may provide some benefits to both local and state governments, the lower cost of capital may result in an “overinvestment” by governments. Overinvestment can occur because as the cost of capital is lowered, the government may undertake projects with a lower rate of return than those in the private markets.⁹⁷ This in turn may result in the “crowding out” of superior private projects as funding flows to inferior public projects.⁹⁸

Arguably, the effects of these funding shifts are primarily felt in the larger national and perhaps even international markets for debt issuances. In other words, a municipal bond is one of thousands of issuances in the debt markets, and the effects of the credit enhancement of a particular state will be dispersed across the markets rather than concentrated at the level of the state’s private issuers. From the point of view of the state, then, the credit enhancement provided by a SWF is a low-cost means of lowering the overall cost of capital for numerous governmental entities without significant negative effects on local private businesses. In the case of West Virginia, a SWF based on a coal severance tax is thought to have the potential to achieve these savings with relatively limited local effects (ignoring the broader market effects of a shift in funding from private to public projects), because the tax is a “[h]ighly exportable tax (e.g. 87% of coal produced in WV is exported) with little effect on employment, production, and business location decisions.”⁹⁹

⁹⁴ *Id.* at 28.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ Ely at 13.

⁹⁸ *Id.*

⁹⁹ Jill Kriesky, *Creating a Severance Tax Permanent Fund in the Mountain State: Presentation to the Joint Commission on Economic Development*, *supra* note 90, at 19.

C. *Intergenerational Equity*

SWFs are also thought to be a mechanism for ensuring intergenerational equity; this is particularly true of land grant trust funds and severance tax trust funds. The term intergenerational equity is somewhat ambiguous, as it can refer both to an imperative to save present capital in order to use it to satisfy future commitments, such as pension benefits, or as an imperative to save it specifically for the benefit of future generations, irrespective of commitments to present generations. In ageing populations, intergenerational equity suggests a fairness concern that if a citizen has paid taxes and social security or equivalent public pension payments, they have a proper claim on the government for a reasonable income in their retirement. Intergenerational equity can also refer to a principle of distributive justice: the primary concern in this sense of the term is not that present generations may enjoy some of the fruits of their life's work through government benefits in retirement, but that future generations should be able to enjoy the fruits of the nation's resources just as present generations have. Thus, a SWF is not saving to (or merely to) provide a present generation with an acceptable standard of retirement benefits, but that future generations should also benefit from the sale of a finite store of resources taken from the land that they are to inherit.¹⁰⁰

Intergenerational justifications for saving a portion of present wealth have also been used to justify university endowments. As Tobin explains:

The trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations. The trustees of an endowed university . . . assume the institution to be immortal. They want to know, therefore, the rate of consumption from endowment which can be sustained indefinitely. . . . In formal terms, the trustees are supposed to have a zero subjective rate of time preference.¹⁰¹

¹⁰⁰ Brett M. Frischmann, *Some Thoughts on Shortsightedness and Intergenerational Equity*, 36 LOY. U. CHI. L.J. 457 (2004-2005).

¹⁰¹ Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. Leg. Stud. 3, 14 (1990) (quoting James Tobin, *What is Permanent Endowment Income*, 64 AM. ECON. REV. 427 (1974)).

The concerns for present and future generations overlap as the obligations owed to older generations saddle younger generations with enormous commitments that can affect the quality of life of future generations through heavier tax burdens and reduced benefits. Australia created its Future Fund with these concerns in mind: as stated by then-Treasurer Peter Costello, the Future Fund was “designed to fund Australia to meet the costs of the ageing of the population,” and “in particular, unfunded superannuation liabilities.”¹⁰² Similar concerns have also driven other resource-rich countries to create SWFs.

Generally, the concept of setting aside funds to provide for future generations, as opposed to shorter-term spending to businesses or support institutions that may or may not be valuable to future generations, is not without controversy. In the context of endowment funds, which also raise intergeneration concerns, Hansmann argued:

There is every reason to believe that, over the long run, the economy will continue to grow in the future as it has in the past and that future students will therefore be, on average, more prosperous than students are today, just as today’s students are more prosperous than their predecessors. Thus, equity does not call for a transfer of wealth through saving, from the present generation to later ones. On the contrary, it would seem more equitable to have future generations subsidize the present.¹⁰³

Likewise, Andrew Rozanov questions the principle of intergenerational equity:

[S]hould one suppress current consumption and capital formation by the present generation in an underdeveloped economy – all for the sake of maximising financial savings of future generations? And what would future generations actually prefer: inheriting a broadly diversified global financial portfolio or a broadly diversified, highly advanced local economy, which provides plenty of local employment opportunities and a solid entrepreneurial potential?¹⁰⁴

¹⁰² Clark & Knight, *supra* note 146, at 12.

¹⁰³ Hansmann, *supra* note 155.

¹⁰⁴ Andrew Rozanov, *Sovereign Wealth Funds: Defining Liabilities*, STATE STREET GLOBAL ADVISORS (May 2007).

Alaska's experience provides a good example of how the intergenerational equity debate helped shape the purpose of the APF. Proponents of the APF offered several rationales for the creation of the Alaska Permanent Fund: first, the Fund would "help to create an investment base from which to generate future income. Then, when oil revenues ran out, there would still be a major source of state revenues to pay out the costs of government services;" second, the APF would "remove a significant portion of the oil revenues from the legislative spending stream, thus reducing the opportunities for excessive spending by the Legislature;" and third, the fund would prudently "transform" oil wealth into a "renewable source of wealth for future generations."¹⁰⁵ Although the APF had several clear purposes for its existence, the particular means of achieving these general goals had not yet crystallized by the time the APF began receiving funds. The debate focused on generational issues: should the APF be managed as an investment fund that would distribute income over the long-term, or should it be managed as a development bank and used to "force-feed" Alaska's economy in the short-term?¹⁰⁶ This second possibility is not necessarily inconsistent with the third rationale, intergenerational wealth transfer, justifying the creation of the APF. By using the APF as a development bank, providing loans and grants to Alaskan businesses, the fund could increase the number of small businesses in Alaska, which would serve to increase the number of jobs and broaden the economy, thereby ultimately decreasing the dependence of the state on oil and other natural resource revenues. On the other hand, a development bank would increase the possibility of political mischief as the Fund could be used as a mechanism for political patronage.

Those arguing in favor of the investment fund model were motivated by the protection of the principal managed by the APF. They believed the APF should manage the funds in accordance with the prudent investor rule and only make investments that were of "trust-grade quality" at market rates. Ultimately, the proponents of the investment fund model prevailed, although the state allocated some funds that were not part of the 25% of revenues dedicated to the APF to create several state agencies¹⁰⁷ charged with achieving some of the short-term goals envisioned by the proponents of the development bank model.

¹⁰⁵ Clark & Knight, *supra* note 146, at 12.

¹⁰⁶ *Id.* at 7.

¹⁰⁷ These agencies include the Alaska Housing Finance Corporation, the Alaska Industrial Development and Export Authority, and the Alaska Renewable Resources Corporation.

By contrast, a mixed objective model prevailed in New Mexico and Wyoming. A mixed model indicates political compromise (with some wanting the funds spent on pressing current needs, while others wanting to save the funds), but also complicates the goal of using an SWF to promote intergenerational equity. The mixed model requires a state to make bets on present funding opportunities in the hope these will pay out for both present and future generations. Or, in the case of some state agency recipients of state SWF funds, there may in fact be no particular goal of providing for future generations or for the general economic welfare of the state; short-term regional or local needs may control.

Aside from state-level concerns about the appropriate means of providing for future generations—whether to use a SWF as a development fund or an investment vehicle, for example—significant federal concerns come into play. When combined with a fiscal federalism in which states receive increasingly large federal subsidies, the issue of intergenerational equity becomes not merely whether and how present citizens of SWF sponsor-states should subsidize future citizens, but also whether other states' citizens should subsidize present and future sponsor-state citizens despite the existence of a state SWF.

D. Preservation of Autonomy

Although intergenerational equity may be the primary stated reason for the creation of a state SWF, they can be also explained as a tool to preserve autonomy and sovereignty. This function may occur first at the level of the citizenry of the SWF sponsor state or, second, at the level of the elites that govern the SWF sponsor state. In the first case, focusing on the preservation of autonomy of the citizenry, Monk argues:

If we look at those SWFs that are in the early stages of creation, we can see this clearly: the Maldives President Nasheed saw the creation of a SWF as a tool to buy new land and move his country's people should the Maldives end-up totally submerged due to climate change. In addition, some subnational governments have come to see SWFs as a tool to facilitate their independence (i.e. Autonomy). For example, Greenland recently set up a SWF for the purpose of facilitating independence from Denmark. Likewise, Scotland mooted the idea of a SWF to facilitate independence from the UK. Even South Australia's Commissioner for Aboriginal Engagement, Klynton Wanganeen, saw a SWF as an

innovative tool to help Aboriginal communities support themselves instead of relying upon government welfare. . . Viewed in this light, SWFs are perceived by some policymakers to be a means of insulating completely against the outside world; the SWF is seen to be a tool to allow the state sponsor to continue with institutions, plans or policies that, in a totally open and competitive world, would be sub-optimal.¹⁰⁸

Hatton and Pistor offer a description of the second type of autonomy preservation. Focusing on China, Singapore, Kuwait, and Abu Dhabi, which they state are “without representative democracy, or where the institutions of democracy are clearly subordinate to authoritarian rule,” Hatton and Pistor argue that “SWFs act to maximize the domestic autonomy of the ruling elite in the sponsor-country.”¹⁰⁹ In such states, these elites are not directly accountable to the public in general, and “it is easy to see how “governmental interest” becomes tied to the personal interests of the ruling elite. Indeed, the internal governance structures of the SWFs themselves ensure that SWF management is directly accountable to the ruling elite in each sponsor country.”¹¹⁰

1. State SWFs as Bulwarks against National and International Pressures

Because state SWFs operate in a federalist system with a powerful national government, there is little traction for the idea that a state SWF exists to provide protection for its citizens against the forces of globalization. Even if such a purpose were intended, it would show remarkable prescience given that many state SWFs date from periods when globalization was either a non-existent or unimportant issue for state citizens. It is also unlikely that state SWFs could serendipitously serve such a role, given their limited effect on state economies. However, as Monk has pointed out, some SWFs

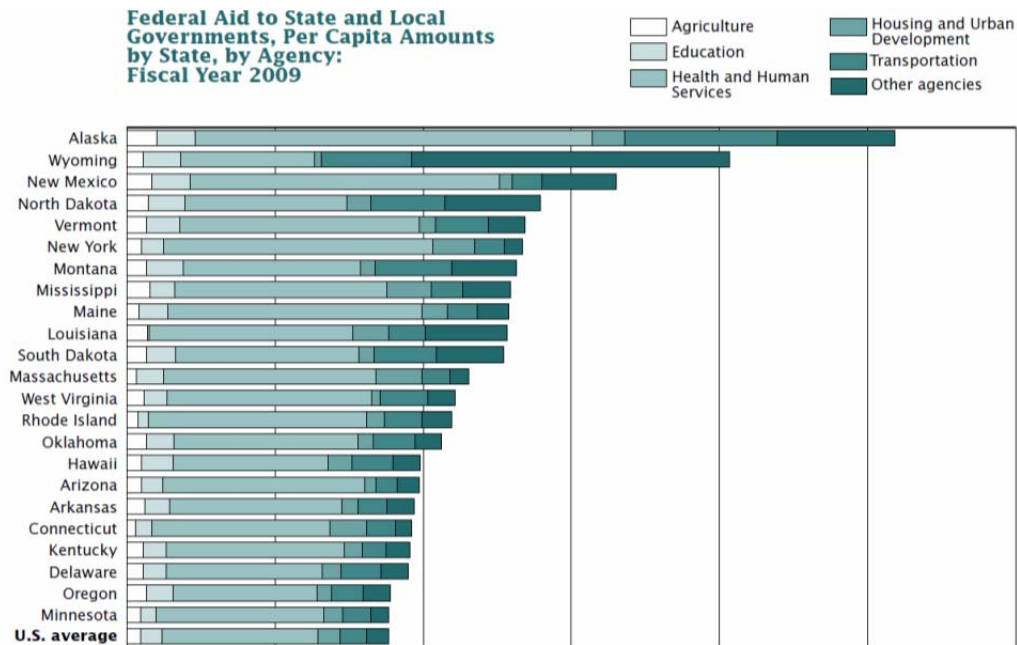
¹⁰⁸ Monk, *supra* note 140, at 23–24.

¹⁰⁹ Kyle Hatton & Katharina Pistor, *Maximizing Autonomy in the Shadow of Great Powers: The Political Economy of Sovereign Wealth Funds* (Columbia Law School Working Paper No. 395, 2011), available at

<http://ssrn.com/abstract=1787565>.

¹¹⁰ *Id.* at 10.

are not designed to serve as much as a bulwark¹¹¹ against international forces as against *national* forces. The question thus arises as to whether state SWFs could be used as vehicles to maximize state autonomy within the federal system. For instance, could a state SWF be used as a substitute for federal funding, thus eliminating the need of the state to comply with obligations the federal government might attach to such grants?¹¹² The perhaps surprising answer is that state SWFs do not serve this function, and, in fact, states with large SWFs (with the exception of Texas) also tend to be the states that receive the *most* federal funding, as shown in the graph below.



U.S. Census Bureau, 2010

The irony of this federal funding is striking. Alaska, for example, is known for rugged individualism that sometimes translates into animus against the federal government; yet as a New York Times reporter recently stated, Alaska is a paradox, “a

¹¹¹ This idea was seminally proposed in Gordon L. Clark and Ashby H. B. Monk, *Government of Singapore Investment Corporation: Insurer of Last Resort and Bulwark of Nation-State Legitimacy*, PACIFIC REVIEW (forthcoming May 1, 2009), available at <http://ssrn.com/abstract=1397713>.

¹¹² For a discussion of the tension between states and federal government with respect to funding and compliance, see Bruce J. Casino, *Federal Grants-In-Aid: Evolution, Crisis, and Future*, 20 URB. LAW. 25, 40 (1988).

nation-size state of about 700,000 souls where many seem to revile the federal government even as their politicians excel at reeling in and spending its money.”¹¹³ Alaska has long enjoyed significant federal funding, so much so that a finance scholar at the University of Iowa recently purported to demonstrate that “in financial terms, [the purchase of] Alaska has clearly been a negative net present value project for the United States.”¹¹⁴

Wyoming, on the other hand, is considering the drastic step of refusing federal education funds because at least some legislators do not want to accept the federal guidelines, regulations and reporting requirements which reportedly burden local school districts.¹¹⁵ Since income taxation of Wyoming individuals and entities contributes at least in part to this funding, however, Wyoming would in effect be funding other states’ educational systems. For reasons I will address below, this is not necessarily an inequitable outcome.

As a general matter, state SWFs simply do not produce the kind of revenue that would allow for complete autonomy, even in a limited area like education policy. Considering just the nine states that hold approximately 85% of all remaining trust lands in the lower 48 states, New Mexico receives by far the largest percentage of public school funding from its permanent fund at approximately 14%. No other state receives more than 5% of its public school funding from its permanent fund. By comparison, of the \$1.13 trillion spent at the state level on education for the 2010-2011 school year, the U.S. Department of Education contributed about 10.8% of the total.¹¹⁶ While a state SWF may provide a state with flexibility in its spending, it does not serve as a replacement for federal funding.

¹¹³ Michael Powell, *How Alaska Became a Federal Aid Magnet*, N.Y. TIMES (August 18, 2010, 3:20 p.m.), <http://economix.blogs.nytimes.com/2010/08/18/how-alaska-became-a-federal-aid-magnet/>.

¹¹⁴ David Barker, *Was the Alaska Purchase a Good Deal?* (August 10, 2009), <http://www.news-releases.uiowa.edu/2009/november/David%20Barker-Alaska.pdf>.

¹¹⁵ Jackie Borhardt, *Bill targets facts about federal education funding in Wyoming*, *Wyoming Star-Tribune*, CASPER STAR-TRIBUNE (January 16, 2011), http://trib.com/news/state-and-regional/govt-and-politics/article_b06ee50d-2c03-5ef6-9d89-4d29d76831cb.html.

¹¹⁶ U.S. Department of Education, *The Federal Role in Education*, ED.GOV (Mar. 30, 2011), <http://www2.ed.gov/about/overview/fed/role.html>.

What explains the large amount of federal funding that flows to Alaska, Wyoming and New Mexico? Like many Western states, these states have vast territories that require roads, bridges and other transportation funding to facilitate interstate commerce, but also have relatively sparse populations, translating into a high per-capita distribution of federal funds. Not all (or even most) of the federal funds go to highway projects, however. Significant portions go to Medicaid/Medicare costs, to educational funding, and to innumerable other “programmatic requests” for federal funding.

The large amount of federal funding of state programs raises concerns about the equity in allocation of federal resources. It is perhaps a truism, but one worth repeating, that the allocation of federal funds may be more a result of the political acumen of particular state representatives than of a reasoned process of analysis and prioritization of needs among the citizens of all states and territories. As a matter of public governance, however, it is worth asking the question of whether this allocation is equitable, and whether the federal government has appropriate mechanisms in place to reduce the likelihood that inequitable allocations are made.¹¹⁷

Federal funding to states with SWFs raises the additional question of interstate equity: given the resource wealth that these states enjoy, should the federal government continue to fund SWF-owning states at these levels? This article will not attempt to do more than raise this extremely complex question, but it is a critical question that should be addressed by policymakers not only in the United States but in other jurisdictions that have or are considering the creation of subnational SWFs. The implication of high funding levels for SWF-owner states is that other states are effectively subsidizing states that are resource-rich. As subnational entities are more integrated within the national government and economy, this may be less of a concern, but where a bright-line form of political federalism or quasi-independence obtains, such an arrangement seems correspondingly less equitable. If an increasingly larger part of the benefits and services

¹¹⁷ As examples of the sort of mechanism that seeks to address potential inequalities, President Obama vowed in his 2011 State of the Union address to veto any legislation containing “earmarks”, and the House of Representatives has also stated that it will not approve legislation containing “earmarks.” Instead, members of the House are to make “programmatic requests” for funding. A.B. Stoddard, *Earmarks indelible in Congress*, THE HILL’S PUNDITS BLOG (November 24, 2010) <http://thehill.com/blogs/pundits-blog/lawmaker-news/130691-earmarks-indelible-in-congress>. It is unclear whether the distinction between earmarks and programmatic requests is meaningful.

provided to citizens come from federal rather than state dollars, should the federal government receive a portion of the severance taxes collected by resource-rich states?

IV. STATE SOVEREIGN WEALTH GOVERNANCE: INVESTMENT AND DISTRIBUTION POLICIES

This Part shows how the key choices discussed above—how to spend SWF funds and whether to provide a dividend—have important political and fund governance implications. State SWFs differ significantly in their investment and distribution philosophies, and the differences are particularly apparent when considering the management of severance tax funded SWFs.

Some states may have more than one SWF in operation. Land grant funds, severance tax funds and tobacco funds may have come about for somewhat different reasons, and may operate somewhat differently. State trust lands are typically invested through an investment division operating within the state’s land management department or the state’s education department, or, in the case of states with a severance tax fund, both of the state’s SWFs are managed by a single investment entity that may operate as a stand-alone entity. In Texas, for example, the Permanent School Fund is managed by the State Board of Education, while the administrative activities for the PSF are handled by an investment division of the Texas Education Agency. In New Mexico, on the other hand, both the LGPF’s and the STPF’s investments are managed by the State Investment Council.

Because the income generated by the funds is typically dedicated to various public entity beneficiaries, land grant funds traditionally do not invest funds in social programs as, discussed below, some states do with their severance tax funds, nor can revenues from trust lands be redirected to other purposes. Texas is again an exception to the rule, however, as legislation passed in 2007 allows the State Land Commissioner to designate some funds that would have been deposited in the PSF to be redirected to a “real estate special fund account,” and also expanded the PSF’s investment authority, allowing the PSF to invest in “land; interests in real property for biological, commercial, geological, cultural or recreational purposes . . . [to make investments] to protect,

maintain, or enhance the value of public school lands; [or, to make investments to] acquire . . . an investment or interest in public infrastructure, or other interests.”¹¹⁸

Tobacco funds have the greatest variation in governance and purpose, with many states spending much of the money on current state needs. Many states did not have an investment management structure in place and created an investment strategy from scratch. Others, like New Mexico and Louisiana, took advantage of existing governance and investment policies. Because of the nature of the funds—the MSA essentially works as a type of tobacco tax, with the funds expected to go at least in part to cover the public health costs of smoking—states should be expected to treat tobacco settlement funds differently from land grant trust funds and severance tax trust funds, since these latter were generally intended to provide for intergenerational equity by compensating future generations for the consumption of non-renewable resources. Tobacco funds are intended to (but not required to be directed to) cover present and future health care costs related to smoking; they do not represent part of a state’s heritage to future generations. It should not be surprising, then, that many states did not create permanent funds, or that states with permanent funds should put only a fraction of the settlement funds in the permanent fund. States with permanent funds should also be expected to manage the funds with more of a focus on present budgetary concerns than providing a source of wealth for future generations.

The balance of this section briefly describes the governance structure, investment policies and distribution mechanisms of the three largest state severance tax SWFs: the Alaska Permanent Fund, the Wyoming Permanent Mineral Trust Fund, and the New Mexico Severance Tax Permanent Fund. Most state SWFs use outside investment managers to help invest some or all of their funds, and fiduciary standards and asset allocation requirements serve to constrain the behavior of the SWFs and their investment managers. Aside from these similarities, the three funds discussed in this Part have considerably different investment goals, ranging from an aggressive, total return-focused management style that produces a large annual cash dividend for Alaskans, to mixed total return and social investment strategies in Wyoming and New Mexico. After describing these models, the article then turns to the governance implications of the models, and argues that Alaska’s dividend model provides a more sound governance structure than the mixed-motive, budget-expanding model used by New Mexico and Wyoming.

¹¹⁸ Tex. Nat. Res. Code Ann. § 51.402 (2007).

A. *Supporting Social Programs while Seeking High Returns: The New Mexico Severance Tax Permanent Fund and the Permanent Wyoming Mineral Land Trust*

New Mexico's State Investment Council ("SIC") is tasked with management of the STPF. The SIC is chaired by the Governor of New Mexico and has ten other members, including the State Treasurer, the Commissioner of Public Lands, the Secretary of the Department of Finance and Administration, four public members appointed by the Legislative Council, one of whom must be the Chief Financial Officer "of a state institution of higher learning,"¹¹⁹ and three Governor appointees. Public members are appointed with the advice and consent of the New Mexico Senate, and must be confirmed by the Senate.¹²⁰ Currently there are two vacancies on the SIC.¹²¹ Additionally, New Mexico has a Private Equity Investment Advisory Committee, chaired by a SIC member and including three additional public members and the State Investment Officer.¹²² The public members selected to serve on the SIC must be "qualified by competence and not less than ten years' experience in the field of investment or finance."¹²³

As with states SWFs generally, the SIC and its managers are obligated by statute to apply a "prudent investor" standard of care; in the case of New Mexico, the standard is that found in the Uniform Prudent Investor Act (UPIA).¹²⁴ The SIC's general investment

¹¹⁹ N.M. Stat. Ann. § 6-8-2 (West 1978); *see also* New Mexico State Investment Council, Council Members, (2011), *available at* http://www.sic.state.nm.us/council_members.htm.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² New Mexico State Investment Council, Private Equity Advisory Committee, (2011), *available at* <http://www.sic.state.nm.us/peiac.htm>.

¹²³ N.M. Stat. Ann. § 6-8-3(B) (West 1978).

¹²⁴ The standard requires the manager to "invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust . . . In satisfying this standard, the trustee shall exercise reasonable care, skill and caution, [and] a trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Uniform Prudent Investor Act, 7 (1995), *available at* <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.pdf>; *see also* N.M. Stat. Ann. § 45-7-602 (West 1978); *see also* New Mexico State Investment Council, SIC General Investment Policy (2008.), *available at*

policy also states that “[i]nvestments of the fund shall be diversified to minimize the risk of significant losses. Total return, which includes realized and unrealized gains, plus income, less expenses, is the primary goal of the Funds.”¹²⁵

Notwithstanding this basic total return focus, the investment activities of the SIC from STPF funds are complicated by numerous statutory imperatives. When the STPF was formed, New Mexico’s legislature also created a patchwork of investment targets for the STPF, with a specific social policy associated with each type of investment target. The legislature effected this by separating the fund’s investment into two general categories: “differential rate investments” and “market rate investments.” Differential rate investments are intended to “stimulate the economy of New Mexico and to provide income to the severance tax permanent fund,”¹²⁶ while market rate investments are only intended “to provide income to the severance tax permanent fund.”¹²⁷

The investment criteria for market rate investments are relatively standard and similar to those employed by other large institutional investors. The investment policies place limitations on the total amount of equity securities that may be owned, for instance, and restrict the percentage of ownership of any given company. On the other hand, the list of differential rate investment targets reveals a remarkable effort at social engineering on the state level, with some of the investments paralleling federal efforts. Among other things, the SIC may make investments in mortgage pass-through securities (stimulating the mortgage market and increasing home ownership levels), New Mexico small businesses, and the New Mexico film industry.

<http://www.sic.state.nm.us/PDF%20files/080314%20SIC%20GENERAL%20INVESTMENT%20POLICY-Final.pdf>.

¹²⁵ *Id.*

¹²⁶ N.M. Stat. Ann. § 7-27-5 (West 1978).

¹²⁷ *Id.*

Differential Rate Investment	Limitations
Conventional mortgage pass-through securities	\$100,000,000
New Mexico business investments	20% of the STPF
Educational loan notes	\$10,000,000
Educational institution research and development facilities revenue bonds	10% of the STPF
New Mexico private equity funds and business investments ¹	9% of the STPF
Employers mutual company revenue bonds	\$10,000,000
Deposits in New Mexico financial institutions ¹	20% of the STPF
Deposits in New Mexico credit unions	Not Limited
New Mexico lottery revenue bonds	\$3,000,000
Investment in obligations issued for corrections facilities	Not Limited
Investment in obligations issued for state capitol buildings and renovations	\$10,155,000
Investment in films to be produced in New Mexico	6% of the STPF

The State Investment Council has published detailed investment policies for its private equity, film, real estate, mortgage loan, and hedge fund investments. Overall, the general investment policy of the SIC attempts to balance the two objectives of the differential rate program of the STPF—first, to produce a “risk adjusted rate of return under the Prudent Investment Rule,”¹²⁸ and second, “to enhance the economy of New Mexico”¹²⁹—by ensuring that “credit quality is maintained and risk is minimized, market-based yields that are proportional to the assumed risks are obtained, each investment will stimulate the economy of New Mexico on a continuing basis, each investment will expand business activity in the state, and each investment will promote the creation and preservation of jobs.”

¹²⁸ SIC General Investment Policy, *supra* note 46, at 13.

¹²⁹ *Id.*

B. *The Many Uses of Wyoming's Severance Tax Funds*

Wyoming also has multiple objectives for its severance tax SWF investment program. The general policy for Wyoming trust funds requires the State Loan and Investment Board to invest public funds “in a manner that strives for maximum safety, provides adequate liquidity to meet all operating requirements, and achieves the highest possible investment return consistent with the primary objectives of safety and liquidity.”¹³⁰ Wyoming holds the Board, the state treasurer, and any fiduciary appointee (such as an external manager) to the prudent investor standard set out in the Uniform Prudent Advisor Act as enacted by Wyoming.¹³¹ The Board is made up of the Governor (as President of the Board), the Secretary of State, the State Auditor, the State Treasurer, and the State Superintendent of Public Instruction. The State Treasurer handles most of the monitoring of external managers and is tasked with setting up internal controls systems and developing and recommending investment policies, among other things.¹³² All of these officials are elected in statewide general elections and serve a four-year term.

Wyoming has set out by statute a set of permissible investments and investment allocations. The statutes contain only two significant restrictions on investments. First, only up to 35% of the fund may be invested in common stocks. Second, prior board approval must be obtained before the state is allowed to invest in “alternative investments.”¹³³ The Board’s investment policy adds to these restrictions by prohibiting

¹³⁰ State of Wyoming State Loan and Investment Board, Master Investment Policy and Sub-Policies, 3 (June 3, 2010), available at <http://treasurer.state.wy.us/pdf/investmentpolicy060310.pdf>. Along with safety of principal and liquidity, the Board also lists the following “objectives and priorities”: Yield; Recognition of differing objectives and needs of various fund portfolios; Conformance with state law and other pertinent legal restrictions; Maximization of the total rate of return on investment consistent with the foregoing objectives; Diversification by asset type, security and investment manager in order to smooth the volatility of quarterly returns. *Id.* at 3.

¹³¹ 913.Wyo. Stat. Ann. § 4-10-901 to -913 (West 1977). The standard requires, inter alia, that a trustee “invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust.” Wyo. Stat. Ann. § 4-10-901 (West 1977).

¹³² State of Wyoming State Loan and Investment Board, Master Investment Policy and Sub-Policies, *supra* note 69, at 6-7

¹³³ “Alternative investments” are defined as “investments in nontraditional asset classes or in traditional asset classes which are utilized in a nontraditional strategy.” Wyo. Stat. Ann. § 9-4-714(a)(i) (West 1977). The statutes grant authority, however, for the state’s chief investment officer (by statute, the

self-dealing transactions, floating rate securities, individual certificates of deposit, letter stock and other unregistered equity, commodities (if not part of an alternative investment), most real estate transactions, natural resource properties, and short sales and margin transactions.¹³⁴ Derivatives may be used to manage risk, and the use of derivatives, “in pursuit of strategies to achieve ‘above market’ performance is considered speculative and is strictly forbidden,”¹³⁵ except as part of an approved alternative investment program.

Like New Mexico, Wyoming’s statutes also expressly permit state permanent funds to invest in various investments that further targeted social policies. Among other things, the state treasurer is permitted to invest (or in some cases, pledge) up to \$25 million in non-delinquent federally guaranteed or insured higher education loans from any nonprofit Wyoming corporation organized to acquire such loans;¹³⁶ up to \$300 million from the common school account in the permanent land fund to guarantee school district bonds;¹³⁷ up to \$100 million to guarantee local government bonds;¹³⁸ and, “to promote economic development,” the state treasurer may invest up to \$100 million in industrial development bonds issued by joint powers boards, municipalities or counties.¹³⁹ The state treasurer may not invest more than \$50 million “for a specific public purpose authorized or directed by the legislature,” although the amount may be adjusted by recommendation of the state treasurer and approval by a Board subcommittee on capital financing and investments.¹⁴⁰

state treasurer) to invest funds in any investment authorized by the legislature or authorized or approved by the board. Wyo. Stat. Ann. § 9-4-715 (West 1977).

¹³⁴ State of Wyoming State Loan and Investment Board, Master Investment Policy and Sub-Policies, *supra* note 69, at 11.

¹³⁵ State of Wyoming State Loan and Investment Board, Master Investment Policy and Sub-Policies, *supra* note 69, at 11-12.

¹³⁶ Wyo. Stat. Ann. § 9-4-715(f) (West 1977) (repealed by Laws 2011, ch. 129, § 207, eff. July 1, 2011).

¹³⁷ Wyo. Stat. Ann. § 9-4-715(g) (West 1977).

¹³⁸ Wyo. Stat. Ann. § 9-4-715(h) (West 1977).

¹³⁹ Wyo. Stat. Ann. § 9-4-715(m) (West 1977). Investments under this statute require the recommendation of the Wyoming business council created by W.S. 9-12-103, and also require written approval of the governor. A number of other restrictions also apply, and new investments of this type are not allowed to be made as of June 30, 2011. *Id.*

¹⁴⁰ Wyo. Stat. Ann. § 9-4-715(n) (West 1977).

The state investment policy also sets out various portfolio guidelines. For example, the state may only own one percent or less of the common stock of any corporation,¹⁴¹ and only up to one and one-half percent of the total book value of permanent funds may be invested in the common stock of any corporation.¹⁴² Like many funds, Wyoming also acknowledges the challenge of matching its investment policy to its fiduciary duties when a higher return may be generated with investments that are at odds with other social, ethical and political goals. In a somewhat convoluted provision, the state investment policy attempts to discourage certain investments while reaffirming its commitment to invest in the economic interest of the fund:

The Board is concerned with terrorism and human rights violations occurring worldwide, yet recognizes its fiduciary responsibility to invest only in the best economic interest of the portfolio. While the Board cannot make investments based on social or political objectives, it does consider the economic effects of social and humanitarian issues in the analysis of investments. The Board seeks to avoid investments that support terrorism or the violation of human rights. As such, the Board will require its investment managers to acknowledge that they will seek to avoid such investments.¹⁴³

The actual investment of the funds is outsourced to a number of different external managers, including core plus fixed income managers, corporate fixed income managers, mortgage fixed income managers, global/emerging market fixed income managers, public equity managers, cash and extended cash managers, private equity (alternative

¹⁴¹ State of Wyoming State Loan and Investment Board, Master Investment Policy and Sub-Policies, *supra* note 69, at 12. However, “[a]n exception may be made for Alternative Investments and for companies with a market capitalization below \$5 Billion.”

¹⁴² *Id.*

¹⁴³ The policy imposes the following requirement on its investment managers: “Investment Managers are required to check portfolio holdings no less frequently than quarterly against the companies listed on the Specially Designated Nationals List and the countries listed on the Lists of Sanctioned Countries, maintained by the U.S. Treasury Department Office of Foreign Assets Control (“OFAC”), to ensure that the companies or countries on the list are not represented in the portfolios. If a current holding appears on the list at the time of the quarterly check, the Manager will eliminate the position from the portfolio within a reasonable period of time and will not make additional purchases unless the issuer is removed from the OFAC list.” *Id.*

investment) managers, real estate (alternative investment) managers, overlay strategy (alternative investment) managers, and absolute return (alternative investment) managers.¹⁴⁴

The subpolicy for the PWMTF provides additional detail on the strategy, distributions and allocation of the PWMTF. Under this subpolicy, in accordance with statute, the corpus of the PWMTF is inviolate; only income and capital gains may be distributed.¹⁴⁵ The subpolicy notes, however, that the state legislature has often directed portions of the PWMTF to “directed investments” mandated by the legislature, and therefore “only the remaining portion is available for discretionary investments by the State Treasurer’s Office.”¹⁴⁶ Because the legislature may withdraw significant portions of the PWMTF, “the fund must be managed to allow an extensive range of investment maturities that will provide for funds availability for directed investments as they come into existence as mandated by the Legislature.”¹⁴⁷

c. Distribution of Severance Tax SWF Income to State General Funds

In the case of both New Mexico and Wyoming, most of the income from their severance tax SWFs is deposited in the state’s general funds. Under the Constitution of the State of New Mexico, the STPF distributes 4.7% of the average of the year-end market values of the fund for the immediately preceding five calendar years. The distributions are made in 12 equal monthly increments. The fund distributions are “appropriated by the legislature as other general operating revenue is appropriated for the benefit of the people of the state.”

As with New Mexico, the income from the PWMTF is deposited in the state’s general fund.¹⁴⁸ The PWMLTF provides a large portion of Wyoming’s general fund. In 2008, for example, the PWMLTF contributions made up 24% of the state’s general fund. In 2009 the PWMLTF contributed 12.7% of the state’s general fund, and in 2010 the

¹⁴⁴ *Id.* at 12-16.

¹⁴⁵ *Id.* at 25-26.

¹⁴⁶ *Id.*

¹⁴⁷ However, “a specially managed portion” of the PWMLTF must be held inviolate,” even against the occasional legislative mandate; “[t]hese funds are to be invested for the long term to produce a higher return without the cash flow or legislatively directed investments.” *Id.*

¹⁴⁸ Wyo. Const. Art. 15, § 19 (2011).

PWMLTF was expected to contribute 13.6%.¹⁴⁹ The constitution also provides that the legislature may specify “conditions and terms under which monies in the fund may be loaned to political subdivisions of the state.”¹⁵⁰ The PWMLTF presently loans money under several programs, including the Farm Loan Program, the Joint Powers Act Loan Program (providing loans to local governments), and the Hot Springs State Park Loan Program (providing loans for capital improvements to businesses in the park).¹⁵¹

C. *The Dividend: Alaska’s Permanent Fund*

The Alaska Permanent Fund (“APF”) is directly overseen by the Alaska Permanent Fund Corporation (“APFC”), a state-owned entity that operates as a “quasi-independent state entity, designed to be insulated from political decisions yet accountable to the people as a whole.”¹⁵² The establishment of a corporation as a separate entity, rather than as an agency within the state government, is intended to “protect the Fund’s long-term performance by keeping it as removed as possible from short-term political considerations.”¹⁵³ Yet at the same time, the APF was created as a means of controlling political power; while the fund’s structure (as set out by Alaska’s constitution and statutes) prevent the APF from being employed for short-term political uses, the dividend structure, described below, imposes on the government overseers of the APF the incentive to maximize the value of the fund.

The APFC retains direct political accountability through an annual APFC report to the Legislative Budget and Audit Committee, and through approval of the APFC budget by the Legislature.¹⁵⁴ The APFC also has a six-person Board of Trustees, all of which are appointed by the governor. Four of the trustees are public members, and two are cabinet members (the Commissioner of Revenue and another cabinet member

¹⁴⁹ Wyoming Taxpayers Association, Permanent Mineral Trust Fund (PMTF), *available at* <http://www.wyotax.org/PMTF.aspx>.

¹⁵⁰ Wyo. Const. Art. 15, § 19 (2011).

¹⁵¹ State of Wyoming Office of State Lands and Investments, Summary of State Loan Programs and Associated Loan Loss reserve Funds (April 30, 2011), *available at* <http://slf-web.state.wy.us/osli/BoardMatters/2011/0611/SLIB/Loan0611.pdf>. The combined loan balances for fiscal year 2011 were approximately \$44 million. *Id.* at 4. Loan interest rates vary by program and range from 4% to 10%. *Id.* at 2-3.

¹⁵² *Id.* at 31.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

selected by the governor). The four public appointees must possess “recognized competence and expertise in finance, investment and other business management-related fields.” The public appointees serve staggered four-year terms, and each year one of them is elected to serve as the chair of the Board.

1. The Creation of the APF Dividend

The distinguishing feature of Alaska’s SWF is that a significant portion of the income generated by the fund is paid out to Alaskan citizens in the form of an annual dividend. The dividend is paid out according to a specific formula as set out by statute.¹⁵⁵ After this calculation, a determination is made as to whether there are sufficient funds in the earnings reserve account to pay the dividend. The dividend may not be paid out of the principal¹⁵⁶

¹⁵⁵ The dividend is essentially calculated by averaging the net income of the APF over the past five years, multiplied by 21 percent, divided by 2, then divided by the number of eligible applicants. In 2010, the amount was calculated as follows (amounts in thousands, except individual dividend amount): Net income from previous five years, \$8,171; multiplied by 21% = \$1,716, divided in half = \$858, then after various minor adjustment are made, the total is divided by the estimated number of dividend applicants: $\$822,100,000/641,595 = \1281.00 (rounded to nearest whole dollar).

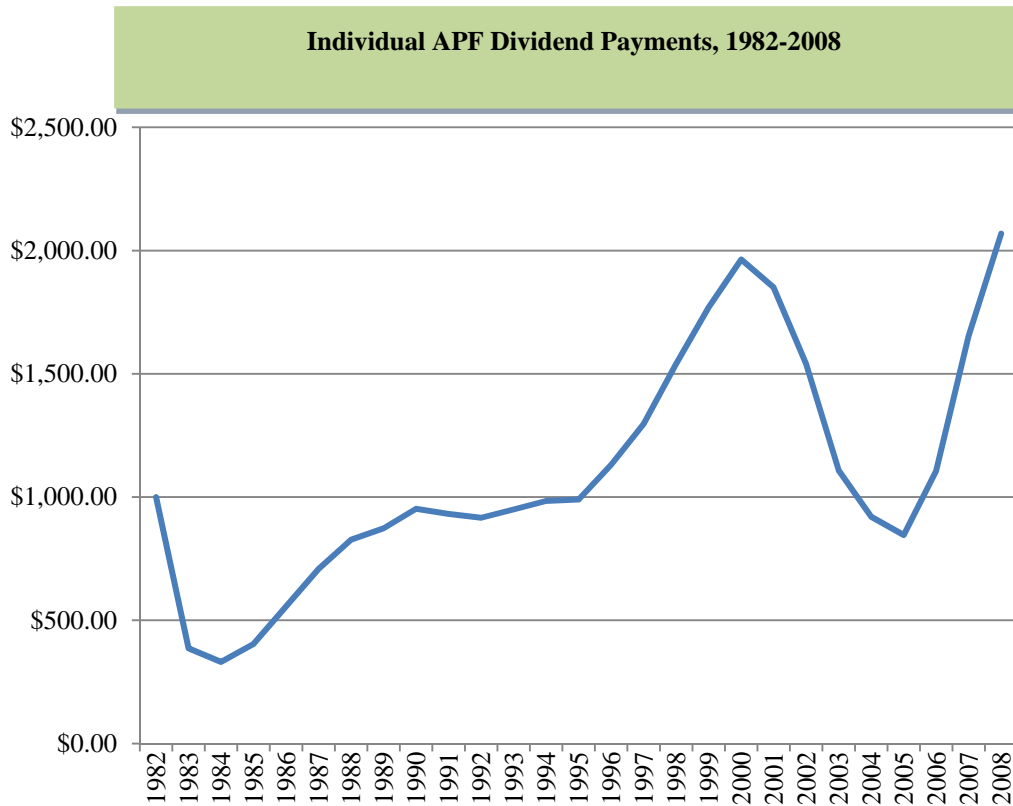
¹⁵⁶ As succinctly reported in a recent news article,

The Permanent Fund’s value is divided into two categories — principal and “realized gains.” The categories let managers calculate how much can be used for state expenses and how much is off limits from such spending. The principal is the value of the assets owned by the corporation at any given time, and it’s off limits, as mandated by the Alaska Constitution. The realized gains are dividends, rents, bond interest payments and profits from sales of assets, and they can be spent by the Legislature.

As of June 30, the realized gains account held more than \$2 billion. By law, up to half that account can be used to pay the Alaska Permanent Fund Dividend to Alaskans. The formula that’s used to calculate the dividend put the full cost of the October 2010 checks at \$858 million, so the account held enough to pay the bill. The Legislature approved that spending.

Editorial, *Steady Hands: Permanent Fund Managers Oversee Continued Recovery*, Fairbanks Daily News-Miner (February 5, 2011), available at http://newsminer.com/view/full_story/11289912/article-Steady-hands--Permanent-Fund-managers-oversee-continued-recovery.

The APF paid out over \$16.7 billion to Alaskans between 1982 and 2008. For many Alaskans, particularly native Alaskans and those in rural Alaska, the dividend is a major source of income.



2. APF Investment Policies

In the early years of the APF, the fund’s investment policy was based on traditional asset allocation techniques, and was heavily invested in bonds. However, in 2009 the Board of Trustees “recognized that some investments might have more in common with investments from other asset classes with regard to their expected levels of risk and return.” For example, corporate bonds may not act like U.S. Treasuries as much as they act like stock; “this makes sense when you consider that the companies that issue these corporate bonds are the same companies traded in the stock markets.” Under its new strategy, the Board thus determined to group assets by risk characteristics, rather than by asset class. So rather than grouping assets as stocks, bonds, cash, etc., the APF now classifies investments as “Cash,” “Interest Rates,” “Company Exposure,” “Real

Assets,” and “Special Opportunities.” “Cash” includes liquid instruments with durations of less than 12 months. “Interest rates” includes low credit-risk securities such as U.S. Treasury bonds and non-U.S. government bonds. “Company Exposure” includes investment grade and high-yield bonds, U.S. and foreign stocks, bank loans and private equity investments. “Real Assets” includes real estate, infrastructure, and Treasury inflation protected securities (TIPS). The “Special Opportunities” category includes, among other things, absolute return assets, distressed debt, and commercial mortgage-backed securities.

The discussion surrounding the move to this new strategy reveals the grip of the APF’s governance mechanisms. When the managers approached the Board about the shift (after significant consultation with external advisors), the Board initially balked. APF Chief Investment Officer Jeff Scott proposed moving money into a hedge fund investment, but encountered some resistance. Trustee Nancy Blunck expressed concern that APF staff was moving too quickly into alternative investments, and the Board and the public were not “in the loop.” “This is public money,” stated Blunck, “It is not corporate money, it’s not private money.” The relationship between political accountability and fund performance is evident here: the Board operates with the knowledge of how important the dividend payout is to Alaskans, and is very reluctant to jeopardize a consistent payout. They thus have a political incentive to maintain strict control over APF fund managers. At the same time, letting the public “in the loop,” may affect the performance of the Fund as the market generally becomes aware of the fund’s strategy before the fund may execute the strategy. Another trustee, Pat Galvin, also voiced concern with the move to alternative investments: “It seems to me like we are being slow-walked down a path with these incremental decisions.” Scott expressed frustration at the comments, stating “if I can’t do anything, I need to know.” Ultimately Galvin indicated that the Board may want to reconsider whether it should invest in hedge funds, but did not block the proposal.

D. The Governance Implications of Targeted Investments and Dividends

If appropriately structured and managed, a state SWF can act as a governance mechanism for controlling governmental use of income from resources—a large-scale, governmental commitment device. A SWF can enhance accountability in several ways. First, a SWF typically forms part of a structure to redirect certain revenues and place restrictions on how those revenues may be spent. In a corporate context, this would be

akin to taking some spending discretion away from managers by forcing a certain amount of income to be reserved. This decision may be the result of a desire to restrict government expenditures generally, but it may also have a more partisan political objective. For instance, Oklahoma's legislature recently sought to create a SWF (the bill providing for the creation of the SWF was ultimately vetoed by the governor), and Monk speculates that the SWF was designed in part to serve as an accountability mechanism with political motives:

“Politically, the state leans Republican in national elections. Also, the House Speaker (who proposed the new SWF) is a Republican. However, the state has had a Democratic governor since 2003. So, perhaps the new SWF represents a policy tool implemented by Republicans (i.e. fiscal conservatives) to discipline the spending of a Democratic governor?”¹⁵⁷

SWFs can also serve as mechanisms for leveraging political accountability through trustee accountability—in the case of a SWF, the management of the SWF should produce clear results that allow for citizens to judge the quality of the SWF management. While elected officials rarely have a direct hand in managing SWF investments, at least some officials typically serve on boards that oversee state SWFs. They are thus ultimately responsible for the overall direction of the fund (subject to constitutional and statutory parameters) and for the selection of asset managers of the fund. Politically, the politician is incentivized to manage the fund well so as to ensure re-election. Since politicians are elected by current rather than future citizens, they may also have the incentive to maximize the welfare of the present generation of voters at the expense of future voters. The private law concept of trustee fiduciary duties is grafted onto constitutional and statutory restrictions on the use of funds to temper politicians' incentives to benefit present generations at the expense of future generations. As with fiduciaries in private settings, transparency and accountability are key to managing the agency costs under this framework. As will be discussed below, cash transfers such as

¹⁵⁷ Ashby Monk, *Oklahoma Loves SWFs*, (March 5, 2010), <http://oxfordswfproject.com/2010/03/05/oklahoma-loves-swfs/>. Commenter Rien Huizer agrees, and states that the SWF is a tool to “make vote buying by the other side harder,” and finds it an “interesting use of [government surplus] (similar to the Australian Future Fund), but here in a country that has severe budgetary problems.” But this, of course is the result of a federalist form of government, and the fact that local surpluses not only do not have a significant effect on the federal budget, but also do not seem to have the effect of decreasing the funds granted to states with significant natural resource revenues.

Alaska's offer a relatively clear and transparent signal of management quality, thereby providing a significant impact on political accountability. On the other hand, a poorly designed SWF merely layers agency costs on agency costs—managerial agency costs may be layered onto existing political agency costs. If the results of the fund are either not transparent or are ignored because the fund has little impact on the lives of current citizens, agency costs are likely to increase because politicians may not be incentivized to contain them. The SWF may thus become a vehicle for rent-seeking at the expense of both present and future generations.

1. Investment Policies and Agency Costs

Investment constraints written into the investment policies of the state—and in some cases, state statutes and even the state constitution—are often intended to serve as agency cost reducing mechanisms by restricting the ability of the managers to invest in riskier assets. As described below, these restrictions most often take the form of hard asset allocation rules, as well as lists of permissible investments. These fixed restrictions can serve as agency cost reduction mechanisms, but the restrictions can also limit the returns of the fund and expose the fund to additional, uncompensated risks. Perhaps because of the relatively larger size of the fund and because of its dividend policy, Alaska has been the most active state in matching its investment policies with current best practices for asset management. As discussed earlier, Alaska, like many national SWFs and other large asset managers (such as CalPERS), is moving away from a traditional asset allocation approach to a “factor-based” or “risk-oriented” approach. These approaches classify assets by risk characteristics, rather than simply by broad asset class labels such as “corporate bonds” or “US public equities.” As Monk explains, “an asset allocation based on equities, bonds, and alternatives may ultimately be providing very little diversification in terms of the underlying factors that drive returns. So, by focusing on the factors, an investor can better grasp what asset classes will provide the desired risk exposures.”¹⁵⁸ He also notes how the Financial Crisis demonstrated the dangers of an asset-focused portfolio:

During the credit crunch, the “asset-oriented” approach didn't provide the amount of diversification that the funds had expected/hoped. All the assets

¹⁵⁸ Ashby H. B. Monk, *The Appeal of Factor-Based Allocations* (February 9, 2011), <http://oxfordswfproject.com/2011/02/09/the-appeal-of-factor-based-allocations/>.

in their portfolios seemed to be moving in the same direction: down. For example, take CalPERS, which is one of the most diversified investors in the world. It lost \$100 billion in roughly 18 months — the fund was worth \$260 billion in October 2007 and touched \$160 billion in March 2009.¹⁵⁹

While a factor-based approach “allows a better understanding of risk-return trade-offs,”¹⁶⁰ as Ang argues, it also provides a more precise means of tailoring the fund’s investments to its payout model because “SWFs with different governance structures and payout rules have different optimal bundles of factors.”¹⁶¹ Creating a factor-based approach is complicated in Alabama, however, where the asset allocation strategies are defined by the state constitution, because a new strategy would need to receive public approval. In other states, the complication is somewhat less daunting because only the legislature would need to approve amendments to state statutes governing the investment policies of the funds.

Investment policies can also create classic governance problems like self-dealing and waste. Notwithstanding the fact that New Mexico, for example, has general policies that appear oriented to measurable economic outcomes, using STPF revenues for differential rate investments creates numerous (and apparently justified)¹⁶² concerns about how those funds will be allocated and increases the risk of political patronage. New Mexico’s history of limited public spending and a Constitutionally-mandated balanced budget (along with the allocation limitations mentioned above) eased concerns over wasteful spending.¹⁶³ The investment choices have been presented not as mere subsidies,

¹⁵⁹ *Id.*

¹⁶⁰ Andrew Ang, *The Four Benchmarks of Sovereign Wealth Funds* 1, 19 (September 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1680485.

¹⁶¹ *Id.*

¹⁶² In 2011, the SIC filed lawsuits in state and federal court alleging that former SIC officials were engaged in pay-to-play schemes. *Capitol Report: New Mexico, The shoe finally drops: New Mexico files lawsuits in federal and state courts in “pay to play” scandal (May 6, 2011)*, *available at* <http://www.capitolreportnewmexico.com/?p=4365>.

¹⁶³ Considering spending of STPF funds on the film industry, for example, reporter Simon Romero writes that “there was little resistance to legislation allowing the state to invest in film projects. In fact, the state’s finances allowed officials to expand the authority and influence of its film commission while other states were cutting back.” Simon Romero, *Coming Soon to a Screen Near You: New Mexico*, *N.Y. Times*, January 26, 2004, *available at* <http://www.nytimes.com/2004/01/26/business/media-coming-soon-to-a-screen-near-you-new-mexico.html>.

but as investments in industries that should develop over time, produce a significant return for the state economy, and, if possible, become self-sustaining. In discussing New Mexico's film investments, for example, former Governor Bill Richardson stated "[o]ur main objective is to become a supportive satellite of Hollywood 'We don't want to be greedy with this, but for a state with low per capita income, it's a way for us to attract a clean, environmentally friendly industry that leaves a positive impact.'"¹⁶⁴

New Mexico's experience with film investment reveals the difficulty of effectively pursuing its dual-objective investment approach. The result of New Mexico's film loan program has been moderately successful in enticing film projects to the state,¹⁶⁵ with New Mexico recently (and perhaps unfortunately) branded as "Tamalewood."¹⁶⁶ However, the SIC recently made significant changes to its film investment policies because of concerns that the state was not achieving adequate returns from the program. A primary problem was that the state apparently did not fully understand (or neglected to account for) the fact that it was unlikely to receive interest payments on its loans if the

¹⁶⁴ *Id.*

¹⁶⁵ Several major recent films have been filmed in New Mexico, including *Cowboys and Indians*, *Iron Man 2*, *True Grit*, *Transformers*, and *No Country for Old Men*, among many others. A list of television programs and films shot in New Mexico may be found at <http://nmfilm.com/filming/filmography/>.<http://nmfilm.com/filming/filmography/> (last visited Aug. 1, 2011). For a list of the outstanding loans made under the film investment program, see Film Investment Program: Outstanding Loans (2010), <http://www.sic.state.nm.us/PDF%20files/3E2%20-%20NM%20Film%20Investment%20Program%20-%202012-31-10%20-%20Final.pdf>. For a discussion of the investment selection process, see Joshua Schonauer, *Star Billing? Recasting State Tax Incentives for the "Hollywood" Machine*, 71 Ohio St. L.J. 381 (2010). For an analysis of the impact of New Mexico's film industry tax credits and investments on New Mexico's economy, see Ernst & Young, "Economic and Fiscal Impacts of the New Mexico Film Production Tax Credit" (2009), available at http://www.sic.state.nm.us/PDF%20files/NM_Film_Credit_Impact_Analysis.Final.pdf.

¹⁶⁶ The name "Tamalewood" has been copyrighted by Leonard Sanchez, who appears to bear responsibility for the term: "I was working on a film in Taos in September of 2005 when I came up with the name *Tamalewood*. I mentioned it to someone I shouldn't have trusted and the next thing I knew, The Santa Fe Reporter was using it as a headline. Nevertheless, I own the legally registered Service Mark "Tamalewood" in the state of New Mexico and I've applied for federal registration of my Service Mark." Leonard Sanchez, History of TAMALEWOOD, available at http://www.tamalewood.com/HISTORY_OF__TAMALEWOOD_.html.

payout is contingent on a film's profitability.¹⁶⁷ Essentially, New Mexico took the position of a junior creditor, and so only after more senior film creditors were paid could New Mexico begin to collect interest on its loans. Often, the films did not make enough money to pay out any interest to New Mexico, and so the state only received its principal in return. Out of nearly \$240 million loaned to film producers of 23 films over the past 10 years, only 1 film has produced a profit to New Mexico.¹⁶⁸

Because of these losses, the SIC is making substantial changes to its film investments policies: under prior investment rules, New Mexico provided zero-interest loans to film and television producers; under new guidelines, the state will lend at the national prime rate plus 1.5%. Additionally, in an effort to more tightly link film investment to local economic impacts, 75% of the loan recipient's film crew (with exceptions for the director, producer, and certain other employees) must be New Mexicans (up from 60%),¹⁶⁹ 75% of the crew payroll must go to New Mexicans,¹⁷⁰ and 85% of a loan recipient's shooting schedule must be in New Mexico (up from a "majority"). The SIC also determined to fire Peter Dekom, a Hollywood entertainment lawyer who had helped New Mexico create and advise on its film loan program. Mr. Dekom was paid \$2,153,566 over the course of his engagement with the SIC, making \$260,000 a year under his most recent contract (after taking a pay cut from \$370,000 under his prior agreement), although he was reportedly only required to work for the SIC a total of 30 hours a month.¹⁷¹

¹⁶⁷ Larry Barker & Jason Auslander, *State Film Loans, a Flop for Taxpayers*, onpolitix (May 26, 2011), available at <http://newmexico.onpolitix.com/news/50738/state-film-loans-a-flop-for-taxpayers?referrer=krqe.com>.

¹⁶⁸ *Id.*

¹⁶⁹ Trip Jennings, *Investment Panel Alters Film Loan Rules*, *The New Mexican* (May 24, 2011), available at <http://www.santafenewmexican.com/Local%20News/Investment-panel-alters-film-loan-rules>.

¹⁷⁰ *Id.* Again, with exceptions for directors, producers, and certain other employees.

¹⁷¹ Rob Nikolewski, *SIC extends \$260,000 a year contract to film consultant*, *Capital Report New Mexico* (July 27, 2010), available at <http://www.capitolreportnewmexico.com/?tag=new-mexico-film-commission>. Mr. Dekom allegedly had conflicts of interest in his role with the SIC because at the same time he represented the SIC "he advise[d] producers and directors about doing business in New Mexico while, at the same time, his law firm writes contracts and represents Hollywood clients who make and distribute movies and television shows." *Id.*

Concerns have also arisen over the purpose of the New Mexico Small Business Investment Corporation (“NMSBIC”), which receives funds from the STPF. The NMSBIC operates independently from the management of the SIC, and the NMSBIC has its own mission: “to create new job opportunities by making equity or debt investments in New Mexico small business in cooperation with financial professionals.”¹⁷² SIC board member Doug Brown explains that the SIC and the NMSBIC thus have a “fundamental conflict” between the SIC’s purpose and the NMSBIC’s mission, “given that the SIC’s primary duty is to bring the best possible return on the state’s investments—regardless of any social benefit associated with the enterprise—while the SBIC’s primary goal is to help small businesses thrive, not necessarily to make money for the state.”¹⁷³

Some members of the SIC view the NMSBIC as a “social program”¹⁷⁴ and believe that its funding should originate from the general funds of the state “at levels determined appropriate by the legislature and governor” rather than from an investment program using permanent funds.¹⁷⁵ Part of the anxiety for SIC members stems from the fact that while the NMSBIC selects how to appropriate funds, it does not do so under the same “prudent man” investment criteria that govern SIC investments; as stated by NMSBIC chairman Paul Goblet, “We’re not governed by the ‘prudent man rule.’”¹⁷⁶ This difference reflects the fundamental tension not just between the SIC and state agencies, however, but between the differential rate investments and the market rate investments

¹⁷² Minutes of the New Mexico State Investment Council, April 26, 2011, *available at* <http://www.sic.state.nm.us/PDF%20files/SIC%20MINUTES%204-26-2011.pdf>.

¹⁷³ Rob Nikolewski, The state’s small business agency has lost \$9 million; is this a big deal?, *Capitol Report New Mexico* (April 26, 2011), *available at* <http://www.capitolreportnewmexico.com/?m=20110426>.

¹⁷⁴ *Id.* at 13.

¹⁷⁵ *Id.*

¹⁷⁶ Rob Nikolewski, The SIC tries to rein in the state’s small business corporation: “We’ve got an agency that’s running loose,” *Capitol Report New Mexico* (May 27, 2011), *available at* <http://www.capitolreportnewmexico.com/?tag=new-mexico-small-business-investment-corporation>. In response to this, SIC member Leonard Lee Rawson noted, “But we have to book your assets. This is where the tension builds.” *Id.* In an interview, Rawson also stated, “Their assets are recorded on our books as part of the Permanent Fund, and yet they have no accountability to us, no accountability to the Governor and really to the legislature. And so they’re kind of out there doing their own thing, and the responsibility, the accountability and the authority aren’t combined together.” Rawson on NM Small Business Investment Agency, *YouTube* (May 27, 2011), *available at* http://www.youtube.com/watch?feature=player_embedded&v=i9cGzduWVKI.

dichotomy created by New Mexico when it created the STPF. Because the state has an investment program that operates according to a profit-maximization rule but is at the same time required to fund agencies that have broader social goals, the SIC will be faced with governance difficulties as it attempts to manage an agent which, by statutory authority, has incentives that are misaligned with its own. The SIC is currently attempting to remedy these governance issues by appointing new members to the NMSBIC board, considering changes to the statute governing the NMSBIC, specifically considering how the NMSBIC makes investment decisions, and by issuing a request for proposals from independent investment advisers to help oversee NMSBIC decisions.¹⁷⁷ The sensible goal of the SIC seems to be to align investment decisions with an overall profit-maximization focus, which will necessitate significant legislative effort.

Wyoming's directed investments program presents similar concerns. Directed investments represent an opportunity for political patronage and waste, and it seems unlikely that Wyoming's voters would approve such a potential use of severance tax funds if the issue were put to a statewide referendum; the state appears to recognize the governance concern directed investments create, and has considered evaluating its policies regarding legislatively-designated investments.¹⁷⁸

Political patronage and waste are not the only concerns with directed investment programs, however. In the case of New Mexico's struggling film and other private sector investments, serious questions were raised not only about the possibility of corruption but also the losses incurred by the fund. To be sure, an investment focused on job or economy growth should not be expected to produce a direct return as large as an investment focused purely on financial returns. However, many of these investments will

¹⁷⁷ *Id.*

¹⁷⁸ For example, a 1997 state audit report noted that "[o]ur research on selected states with significant permanent funds and on the pension funds of several states suggests that they do targeted investing under two circumstances: they either have defined guidelines for making such investing in targeted investments, or do so only when such investments result in at least a market rate of return. Unlike these comparators, Wyoming's investment in LDIs for public infrastructure, economic development projects, and social programs generates reduced earnings." The report recommends that "[i]n the future, the Legislature could consider defining the terms and conditions under which it will accept less-than-market returns on its investments." Wyoming Legislature Management Audit Committee, *Legislatively Designated Investments* (May 1997), available at <http://legisweb.state.wy.us/progeval/reports/1997/ldi/ldi.htm#concluded>.

not only fail to produce a positive net return, but may actually produce losses. The losses may decrease the legitimacy of the state, in the eyes of its citizens, as a manager of the state's wealth.¹⁷⁹ A crisis of legitimacy may be allayed with careful metrics that demonstrate how the investment resulted in a certain number of jobs or provided other measurable benefits, although in the federal context such claims have been met with some suspicion.¹⁸⁰

2. Distribution Policies and Agency Costs

The distribution imperative—how and when to pay out the earnings of the fund—necessarily impacts the governance of the SWF. Most state SWF funds are designed to lock away the corpus of the fund from the legislature, and most share the goal of doing so for the benefit of future generations. How those funds are dispensed to future generations varies significantly. For New Mexico, Texas and Wyoming, a portion of the revenues generated from the states' mineral wealth is distributed to educational recipients, as required by state and/or Congressional fiat. Other revenues are generated through severance taxes, and the income from these funds goes into the state budgets, although, as noted above, some states set aside funds for targeted investment. Alabama also sets aside some of its revenues for specific purposes, such as the Alabama Forever Wild Land Trust. Whether the funds are sent to school districts, subfunds like the Forever Wild Land Trust, or to the general budget, the state intercedes as a mechanism for determining the appropriate allocation of resources to citizens and future citizens. With targeted investments in New Mexico, secondary mechanisms—the film council and the NMSBIC, for example—also play a role in determining the allocation of resources. On the other hand, Alaska uses a direct mechanism—the annual dividend payment—to transfer wealth to future (and present) generations. As will be discussed in more detail below, Alaska's

¹⁷⁹ As Monk states, “over the long-term, any fund focused on development will likely pay a price for this in financial returns (since the fund's investment decision-making is as equally focused on “jobs” as it is on “profits”). And, as a result, the SWF could end up losing some of its domestic legitimacy due to a perception of “wasted resources” through loss-making investments (even if the fund is nonetheless successful at creating jobs or bringing technologies from abroad).” Ashby Monk, *Khazanah: Commercial and Strategic Success?*, Oxford SWF Blog (October 11, 2010), available at <http://oxfordswfproject.com/2010/10/11/khazanah-commercial-and-strategic-success/>.

¹⁸⁰ See, e.g., Eleanor Clift, *White House's Job-Creation Dodge*, The Daily Beast (September 13, 2011), available at <http://www.thedailybeast.com/articles/2011/09/12/white-house-won-t-risk-predicting-stimulus-job-creation-numbers.html>, (stating that following accusations of fabricating employment numbers from the first Obama Administration stimulus package, the Administration would not provide estimates of the number of jobs President Obama's Jobs Act would provide).

dividend was designed in large part to get money out of the hands of politicians and to make politicians more accountable to citizens.

The distribution imperative and the governance structure of a fund are inextricably bound. From the perspective of the APF's mandate, the issue becomes quite clear: make sufficient returns to pay out a substantial dividend. This creates a simpler governance structure: the fund is designed to achieve this goal, and is required to focus on the bottom line. If we look at the fiduciary framework that promotes this goal, it should likewise be narrowly focused. As the legislative mandate narrows, so too should the range of permissible activity and the scope of acceptable (non-liable) conduct. A broader focus will be difficult to reconcile with accountability, because non-economic results will not be easily quantifiable. The scrutiny on Alaska's fund has reflected this connection between accountability and payout. As noted above, the actions of Alaska's fund managers are on occasion heavily scrutinized, making it difficult for them to act in the markets without signaling to the markets exactly what they plan to do.

New Mexico, on the other hand, has taken a different view of how the fund should pay out its earnings. Instead of paying out annual dividends, New Mexico's fund pays into the general fund. Also, instead of investing simply to maximize the returns to the fund, New Mexico makes numerous differential-rate investments designed to provide funding to various programs or industries the New Mexico legislature has determined need the benefit of governmental funding. This creates a different sort of governance problem, as the sphere of accountability must expand to match the increased sphere of permissible use of the funds, in some cases for programs that may not repay the fund or the state for years, if ever. If non-economic goals (or economic goals that are not readily quantifiable) are an integral part of a fund's mission, traditional fiduciary concepts such as the "prudent man rule" are perhaps not appropriate measures of the duty of the manager for funds with non-economic goals. When NMSBIC chairman Paul Goblet stated that "We're not governed by the 'prudent man rule,'" he was exposing the tension between accountability and non-economic goals. This is not to say that funds should never have non-economic goals, but to acknowledge that when funds do have non-economic goals, they introduce a new set of agency costs to the parent fund or state. The state already has agency costs at the fund manager level, and funds often have common

agency costs as multiple principals push the fund to do one thing or another.¹⁸¹ A firm set of investment policies helps eliminate common agency costs, but as non-economic factors come into play, investment policies become more difficult to create and to enforce. For example, a policy to invest in only public companies expresses a decision to narrow the range of permissible actions and to avoid certain types of risks. On the other hand, a subfund with a mandate to invest in emerging companies not only accepts those risks, but also may be doing so for broader social goals: to increase the prominence of a certain industry in the state, to produce jobs in a certain part of the state, or (in the case of film investments) perhaps to increase tourism in the state. While such purposes may be legitimate political goals worthy of the investment of public funds, empowering agents to enact such goals creates a set of costs that are difficult to manage. The desire to keep such costs under control is precisely the reason why New Mexico is now making a push to contain both their film project investments and their investments through the NMSBIC. With complexity of the mandate comes complexity of the investment management structure and a corresponding increased need to create appropriate governance mechanisms to manage the agency costs created by the investment management structure.

The objective to provide for intergenerational equity—which, as stated above, is a primary reason for the creation of many state SWFs—is complicated by the lack of a defined end-goal for the fund; state SWFs operate like university endowments in that they are designed to exist in perpetuity, and do not have a set date at which the corpus of the fund is to be distributed. This means, in practical terms, that the goal of most state funds is to transfer wealth to future generations through the income generated by the fund that is then paid to the general budget of the state. In the case of Alaska, the transfer occurs more directly, through payments to citizens. There are several reasons why Alaska’s transfer mechanism arguably produces a more efficient result for citizens and future citizens. Primarily, a state SWF’s distributions to the general budget can be thought of as an increasing tax upon the citizens, yet it is a tax increase that occurs incrementally and perhaps without representation. An incremental tax, largely increasing without notice, will likely not face challenge from the citizenry. It is probably also safe to assume the increase in distributions from a state SWF are not typically met with a

¹⁸¹ See, e.g., Avinash Dixit, *Power of Incentives in Private Versus Public Organizations*, 87 AM. ECON. ASS’N PAPERS AND PROC. 378, 378–379, (1997). Dixit argues that “a distinct feature of government bureaucracies is that they must answer to multiple principals,” and “the executive, . . . Congress, courts, media and organized lobbies, all have a say.” Id. at 378–79.

corresponding decrease in the tax burden for citizens (although Alaska and Wyoming, notably, do not impose a state income tax). What mechanisms are in place to ensure that the funds are spent in a way that will maximize the benefits to present and future generations? It is likely that the increase is spent on bureaucratic increase, but since direct taxes, such as a state income tax, are not increased, the citizenry does not feel the pain of the increase and so is not motivated to hold the legislature accountable.

SWF sponsor states can also promote accountability of elected officials by requiring that some of the SWFs' revenues are paid out through direct cash transfers. As Moss explains,

Cash transfers from natural resource revenues would give citizens strong incentives to carefully monitor the incoming revenue, management of the resources, and how it is distributed. Because citizens would now have a direct personal stake in the resource, cash transfers would likely create an intense constituency for responsible management and demands for accountability. It is one thing to stand by quietly as oil reserves are mismanaged when the oil rents are kept in an offshore bank account or are distributed as patronage to a select few. It is quite another thing when the mismanagement of those oil fields threatens a direct source of income. This was the primary purpose of the Alaska plan: to limit government waste by creating greater incentives for citizens to hold their governments accountable.¹⁸²

From the perspective of the SWF as accountability mechanism, the benefit of paying a dividend as opposed to merely sequestering the funds for future generations is that the government is not able to hoard funds which, as discussed above, may prevent an expansion of government that may provide relatively weaker benefits for future generations, compared to a cash distribution. The question for the citizens of a state with a SWF is whether they believe that placing the interest earned by the SWF into the states'

¹⁸² Todd Moss, *Oil to Cash: Fighting the Resource Curse through Cash Transfers*, (Center for Global Development Working Paper 237, 2011), available at <http://www.cgdev.org/content/publications/detail/1424714/>.

general fund is a better use of the funds than the distribution of some or all of that interest to the citizens in the form of an annual dividend like Alaska's.¹⁸³

Aside from the accountability effect an SWF—and particularly one paying dividends to its citizens—may have on state government, Moss also argues that cash payments like Alaska's have two important equitable effects. First, cash transfers are more equitable and “pro-poor” compared to budget spending patterns in that a “uniform and universal cash payment would instead allocate equally to every citizen (ideally, including children),”¹⁸⁴ and would avoid regional spending disparities. Second, cash transfers “would have immediate and significant economic benefits for poor households—and ultimately for development. . . . Indeed, it is hard to imagine any public services that would deliver an immediate income benefit of, say 10%, to the poor other than cash transfers.”¹⁸⁵

It is important to note that moving to a cash transfer system does not obviate the intergenerational equity function of a state SWF. It simply implies that the governance of state SWFs may be improved by allocating some funds to present individual uses, which can have the salutary effects of enhancing accountability of state management of the funds, and reducing or eliminating natural expansion of state budgets in response to an increasing fund distribution.

A distribution structure designed to create accountability typically affects the asset allocation of the fund. Funds must be structured so that they can meet liabilities as they arise. If a state legislature or a state's citizenry demands an annual revenue stream, the fund must hold sufficiently liquid assets to pay out of the fund as required. SWFs are generally thought to be patient, long-term investors able to take advantage of certain asset classes (such as private equity, infrastructure and real estate) that are unattractive to many other investors. However, to the extent that state SWFs are expected to pay out annual distributions, SWFs will invest more like pension funds with set distribution imperatives rather than as other SWFs which have no set liabilities and, consequently, a truly long-term investment focus.

¹⁸³ Note that the question is not whether the state can adequately manage the funds as an investment manager—in the case of Alaska or New Mexico, the state is clearly assumed to be capable of investing the funds appropriately. Rather, the issue is what the states should do with the interest generated by the SWF.

¹⁸⁴ Moss, *supra* note 183.

¹⁸⁵ *Id.*

Lessons from some SWFs' response to the Financial Crisis are instructive, as Balin highlights the connection between accountability and asset allocation:

In response to this new need to realize positive returns over a shorter time horizon and keep funds on-hand for sovereign stabilisation, fund managers have increased their cash positions and shifted some assets into securities that offer payouts over a shorter period. Increased scrutiny of SWF returns by democratic and authoritarian states alike has also put pressure on managers to focus on shorter time horizons. . . . Although the demand for stable positive returns may spur some SWFs to invest in safer assets such as investment grade bonds, a demand for high short-term returns could also spur SWF managers to take on more risk. As annual SWF returns are now more closely scrutinized by sovereign governments, SWF executives could feel pressured to focus on more risky, speculative assets that could generate high initial returns but could later destroy value in an SWF's portfolio.¹⁸⁶

For Alaska, then, the increased accountability created by its payout structure may have some negative effect on the total returns generated by the fund *if* fund managers and supervising politicians respond to pressures to produce short term gains (and it is not clear that they are). If so, it is also unclear whether the agency costs that the distribution mechanism is designed to reduce are less than the returns that would flow from a longer-term approach. Just as Alaska may struggle with this issue, states that receive income from their SWFs may also be subject to the same temptations in that legislators may want to increase returns in the short term so that they maximize the funds available to them in their terms of office. As discussed earlier, however, these temptations may be mitigated with investment restrictions. The restrictions attempt (though not always successfully) to balance the agency problems presented by SWFs with the need for a responsive and flexible money management policy. The consequences of this balancing of accountability and asset selection by SWFs are a worthwhile subject for future empirical investigation.

¹⁸⁶Balin, *supra* note 144, at 5.

I. CONCLUSION

In analyzing the primary purposes for creating and maintaining state SWFs, it is clear that the governance structures and distribution imperatives for the funds not only often fail to achieve these purposes, but often are serious impediments to the funds' success. First, state SWFs are not typically used to smooth revenue fluctuations in the short term, although the funds are designed to help protect revenues in the long term (for example, when the state no longer has significant severance tax revenues because of mineral depletion). This is by design: states have typically put in place constitutional and statutory safeguards that provide the legislature with access only to the income, but not the corpus, of the funds. These safeguards help reduce rent-seeking and agency costs. On the other hand, the restrictions also inhibit the ability of the state to deal with significant economic crises, such as the Financial Crisis that began in 2007-2008.

Second, the typical mechanisms for providing for intergenerational equity, the primary justification for many state SWFs, appear to be relatively inefficient methods of transferring wealth to future generations. The largest and most important state SWFs, severance tax SWFs, usually pay income into the general fund. As noted above, a state SWF's distributions to the general budget operate as an increasing tax upon the citizens if we assume that the funds are held in trust for the citizens of the state and not merely in trust for the government administration itself. As the size of the SWF increases, appropriate mechanisms do not appear to be in place to ensure that the funds generated by the SWF are spent wisely. One such mechanism would be to ensure by statute or through the constitution that increases in funds distributed to the general budget by the SWF result in proportionate decreases in the citizens' tax burdens. Alternatively, states could put limits on how the funds are used, so that SWF distributions are directed to spending initiatives that are tied to direct benefits for citizens, and that this spending would not result in reductions in other spending priorities or tax increases to present such spending reductions. Essentially, appropriate rules should ensure that increases in SWF distributions do not merely result in increased government waste. Alaska has dealt with this problem in part by distributing much of the cash generated by its SWF directly to its citizens. Alaska does not distribute the corpus of the fund to its citizens, however, thus protecting the fund for future generations of Alaskans.

Third, while some nations use SWFs as a bulwark against the forces of globalization, state SWFs typically do not use their SWFs to enhance their autonomy. In

fact, as discussed above, many states with large SWFs are also among the highest recipients of federal aid. This curious fact should again highlight issues of equity that were first raised several decades ago as mineral-rich states began charging severance taxes. While it is clear that the revenue-generating activities that provide income for state SWFs create numerous negative externalities for the states, these externalities are increasingly paid for through federal programs, rather than through state funds. For example, in 1970, around the time when many severance tax SWFs funds were being formed, federal funding of health-related programs (which should compensate for significant negative externalities associated with mining operations) amounted to around \$20 billion (inflation adjusted). By 2007, federal funding of health programs exceeded \$200 billion.¹⁸⁷ Because the federal government is increasingly important—from a budgetary perspective—to state citizens since the formation of most state SWFs, states with SWFs may be unfairly compensated for the externalities that severance taxes (and severance tax SWFs) were designed to address. In effect, states without SWFs may be subsidizing states with SWFs.

Finally, despite some of the concerns with state SWFs discussed above, SWFs may, if properly designed, leverage political accountability through market accountability. This is especially likely to be the case in Alaska, where an easily identified, market-related result—the annual dividend payment—encourages citizen attention to the government’s management of state resources. On the other hand, a poorly designed and poorly governed SWF is likely to increase problems with political accountability, as the SWF adds another means of rent-seeking by politicians and others. SWFs that follow (even in part) an economic development model are particularly likely to have higher agency costs and rent-seeking. By contrast, an investment fund model that does not include economic development initiatives should be significantly easier to manage, from agency cost perspective, than an economic development model. Funds that follow an investment mandate have, by design, a narrower mandate that is easily measured by yearly returns. As the legislative mandate narrows, so should the range of permissible activity and the scope of acceptable (non-labile) conduct. A broader focus, such as a mandate to provide for general economic development initiatives, will be more

¹⁸⁷ Chris Edwards, *Federal Aid to the States Historical Cause of Government Growth and Bureaucracy*, POLICY ANALYSIS No. 593 (May 22, 2007) at 7, available at <http://www.cato.org/pubs/pas/pa593.pdf>.

difficult to reconcile with accountability, because non-economic results will not be easily quantifiable.