HOUSE RESEARCH ORGANIZATION bill analysis — 5/27/2003 — SB 206 Ellis (Pitts)

SUBJECT:	Adopting a total-return investment strategy for Permanent School Fund
COMMITTEE:	Appropriations — favorable, without amendment
VOTE:	25 ayes — Heflin, Luna, Berman, Branch, B. Brown, F. Brown, Crownover, J. Davis, Deshotel, Dukes, Ellis, Gutierrez, Hamric, Hope, Isett, E. Jones, Kolkhorst, McClendon, Menendez, Pickett, Raymond, Solis, Stick, Truitt, Wohlgemuth 0 nays 4 absent — Eiland, Hupp, Pitts, Turner
SENATE VOTE:	On final passage, May 9 — voice vote
WITNESSES:	None

BACKGROUND:

Stocks, bonds, oil and gas royalties, and other income from state-owned lands comprise the $16.6 billion Permanent School Fund (PSF), a perpetual endowment for the public schools that generates interest and dividend income of about $765 million annually. The Available School Fund (ASF) contains earnings from the PSF, one-fourth of collections from motor-fuels taxes, and one-fourth of collections from state occupation taxes (Education Code, sec. 43.001).

After PSF administrative costs are paid, a portion of the ASF is placed in the State Textbook Fund. The remainder is distributed to schools through the Foundation School Program according to the number of students. The per-capita distribution varies from year to year. The ASF distributed $197 per student to school districts in the 2001-02 school year and will distribute an estimated $212 per student in the current school year.

Texas Constitution, Art. 7, sec. 5 requires that the PSF distribute only interest and dividend income to the ASF. The State Board of Education (SBOE) manages the PSF according to trust law principles, which require capital gains to be reinvested in the corpus of the fund. To redirect capital gains from the PSF, Texas voters would have to approve a constitutional amendment.

DIGEST:

SB 206 would redefine the composition of the PSF and the ASF to reflect a change to total-return management of the PSF, contingent upon voter approval of a constitutional amendment that would direct income from PSF assets to be deposited into the PSF and a percentage of the total market value to be spent annually as the ASF to support public education.

On January 2, 2004, the comptroller would have to transfer from the PSF to the ASF an amount equal to five-twelfths of the annual distribution for fiscal 2004. Thereafter, on the first working day of each month, the comptroller would have to transfer an amount equal to one-twelfth of the annual distribution from the PSF to the ASF for that fiscal year.

The General Land Office would have to ensure that no loss to the PSF would occur as the result of trading any PSF land. All income received by the land commissioner would be credited to the PSF, rather than the ASF.

The bill would make conforming amendments to four chapters of the Natural Resources Code relating to coastal public land, oil and gas, minerals, and land, timber, and surface resources to credit to the PSF income from certain state-owned natural resources that normally would have gone to the ASF. It also would repeal a provision directing SBOE how to treat premiums and discounts when buying fixed-income security investments for the PSF.

The bill would take effect January 1, 2004, only if voters approved the constitutional amendment proposed by HJR 66 by Gallego or SJR 13 by Ellis. If the proposed constitutional amendment was not approved, the bill would have no effect.

SUPPORTERS SAY:

SB 206 would allow the PSF to distribute a portion of capital gains to the ASF in addition to interest and dividend income. This change not only would help the state weather the current budget crisis by making available an estimated $537 million in capital gains for the coming biennium, but also would enhance general revenues on a recurring basis by an amount estimated at between $125 million and $130 million per year.

Because PSF investments are managed for income (interest and dividends) rather than for total return (income plus capital gains), distributions to the ASF from the PSF rose only 3 percent from 1990 to 2000. One reason for this slow growth is that under current spending rules, the primary way to increase income for the fund is to transfer assets from stocks to bonds. However, between 1990 and 2000, realized capital gains on the PSF — the gains recorded when assets were sold — increased by 806 percent, while unrealized capital gains — the growth in value of assets held compared to their purchase value — increased by 221 percent. Even counting stock market losses since 1999, the fund has gained more than 100 percent in value since 1990, with a significant increase in both realized and unrealized capital gains.

If PSF spending remains limited to interest and dividend distributions, the PSF may be unable to maintain the purchasing power of its distributions while increasing the market value of PSF assets. These two objectives conflict, because investments that generate high interest and dividend income do not tend to increase in principal value over time.

Precedent exists for redirecting capital gains from a state-managed investment fund. In November 1999, Texas voters approved Proposition 17 by a margin of 61 to 39 percent, authorizing the University of Texas System board of regents to reallocate up to 7 percent of Permanent University Fund (PUF) investment assets for distribution to eligible institutions through the Available University Fund. During the past biennium, the change increased the yield benefitting Texas colleges and universities by more than $100 million.

Because the proposed constitutional amendment would provide for calculating capital gains withdrawals on the basis of a five-year average return on the fund rather than on the most recent year's return, and because withdrawals would be capped at 6 percent, the corpus of the fund would be protected from sudden fluctuations in the stock market. Also, the legislation would build protections into the Constitution so that asset allocations would be determined not by the state's income demands but by what is the most prudent investment to preserve the purchasing power of the PSF for up to 10 years into the future.

OPPONENTS SAY:

PSF investments have lost nearly $6 billion in value since August 1999, when the fund hit an all-time high of $22.5 billion. Between 2000 and 2003, the stock market has experienced four consecutive down years, a phenomenon that has not occurred since 1929 to 1933, and there is no sign of the market rebounding any time soon. SBOE members long have opposed changing to a total-return investment strategy on the grounds that such a move ultimately could jeopardize the soundness of the fund. In years of poor market performance such as experienced recently, diverting capital gains could eat into the corpus of the fund, jeopardizing its long-term growth potential and possibly forcing school districts to raise property taxes.

The PSF was created to benefit school children and is a primary source of funding for school textbook purchases. The state cannot count on reaping capital gains in the current market environment. Drawing off capital gains would be a short-term strategy that would not protect the corpus of the fund to cover long-term enrollment growth in Texas public schools.

OTHER OPPONENTS SAY:

SB 206 would not take effect unless Texas voters approved a constitutional amendment proposed by lawmakers this session. Both of the joint resolutions that would have proposed this amendment have died in the House State Affairs Committee. Without the supporting constitutional amendment, enacting SB 206 would be futile.

NOTES:

SJR 13 by Ellis passed the Senate on May 9 and was referred to the House State Affairs Committee. The companion resolution, HJR 66 by Gallego, was considered in a public hearing by the committee on April 8 and left pending. The proposed constitutional amendments would have authorized SBOE to adopt a capital gains distribution rate by a two-thirds vote. Failing SBOE's adoption of a rate, the rate would have been set at no more than 5 percent of the average market value of the PSF for the previous 16 state fiscal quarters for fiscal 2004 and 2005, and at 6 percent thereafter.