At Risk - The Permanent School Fund

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Overview

Members of the Texas House and Senate are now considering legislation to change the Permanent School Fund. Three proposed constitutional amendments, if adopted, would change who makes decisions about the fund, what the spending policy is and would expand the beneficiaries of the fund.

The Permanent School Fund is a $20 billion investment account that is dedicated by the Texas Constitution to public school children. The fund is managed by the State Board of Education, and has been used over the past century almost exclusively to purchase textbooks. However, the current search for monies to finance health insurance for public school employees, paired with a decade-long effort to divest authority from the State Board, now prompt legislative proposals to change governance of the "textbook fund" and its spending policy, while diverting monies for teacher compensation.

Changes to policies affecting the Permanent School Fund could have grave consequences and should be carefully examined. Furthermore, there are overreaching structural issues that must also be addressed to allow the State Board of Education to manage the fund properly.

I. **Criticized, Yes, but the SBOE Should Still Govern**

A. Investment decisions made by the State Board have never diminished the value of the fund, and have, in fact, contributed to the high returns generated by the fund. The investment performance of the fund has never been questioned or identified as a problem.

B. Two recent audit reports on the State Board's management of the Permanent School Fund were critical but did not accuse any board member of self-dealing or illegal activity. Instead they faulted certain Board members for relying on persons for investment advice who had not disclosed their financial ties with each other and a broker-dealer doing business with the fund. It should be noted that Board policy did not require these disclosures.

C. Although the State Board is responsible for the management of the Permanent School Fund, it is the Commissioner of Education (appointed by the governor) who has exclusive authority to hire and fire the investment staff of the fund. The Board, therefore, does not have direct authority over the staff charged with implementing its investment policies and the staff is not directly accountable to the Board. This disconnect between responsibility for the fund and commensurate authority has directly contributed to the present challenge to the Board's authority to govern the fund.

II. **Policy in Investment Decisions Should Stay with the SBOE**

A. Legislation filed that would transfer authority to manage the Permanent School Fund from the State Board to a board of financial experts is unprecedented and unjustified. There are no major public funds in Texas that are exclusively governed by a board of financial experts. Although members of the State Board are not required to have financial expertise, they have had an Investment Advisory Committee in the past, and currently have four outside consultants and the investment staff at the Texas Education Agency to help advise them. The Board's previous Investment Advisory Committee was discontinued sometime before 1998, when a dispute arose between the Commissioner of Education and the Board over who had the authority to appoint the committee. There is no body of evidence to indicate that an appointed board of experts can provide better governance or better investment results than an elected citizen board with proper access to expert advice.

B. Proposed legislation to change governance over the Permanent School Fund is part of a comprehensive and decade-long effort to strip the State Board of its authority and to transition an elected board back to an appointed board. Texans rejected an appointed board in a 1987 referendum that restored elected representation. This current effort is directed toward establishing a board membership that will support, not debate, state agency public education proposals.

C. Over the past decade, the Texas legislature has reassigned in a piecemeal fashion the authority of the State Board to other entities. The result is a management system with poor lines of authority in several areas. For instance, authority over charter schools, teacher certification, instruction, assessment, and textbook review has been partially or fully transferred to others. This structure promises to exacerbate problems of governance over the coming years.

III. **Debate over Spending Policies**

A. The currently mandated spending policy is to spend only the interest and dividends earned by the Permanent School Fund; any capital gains must remain with the corpus. The new policy would make no distinction between fund earnings and the corpus, but calls for spending a percentage of total return: interest and dividends, plus any capital gains or losses.

B. The new spending policy is widely accepted by public endowment funds, but most funds adopted the policy after 1985. Some argue that it has not been tested in anything but appreciating markets.

C. There is no question there is immediate potential for large gains in fund payout: in the last decade, the market value of the fund has increased 149%, realized gains have increased by 806%, and unrealized gains by 221%. Five-year projections report over $700 million in additional earnings in each of the next two bienniums.

D. Of particular concern to the Board's lead financial consultant is any spending percentage over 5% and not using a 3-5 year averaging of the fund balance. Fund averaging is used to smooth out income distribution from year to year.

E. Under currently proposed legislation, the spending percentages range from 3-7% and fund averaging is either at a fixed 3-year or a fixed 5-year period rather than a range of 3-5 year averaging.

F. Two recent studies of total-return spending policies caution endowment funds on how difficult it is to maintain a constant spending rate of 5% and note that funds which have taken lower capital markets into account have generally lowered their spending rate, even during periods when investment performance was strongest.

IV. **Proposal to Divert Textbook Monies to Financing Health Insurance for Public School Employees**

A. Proposed legislation to change the spending policy would also distribute 20-33% of the total income distribution away from the Available School Fund into a new public-school employees health insurance plan.

B. With one exception, legislative proposals to divert funds from the Permanent School Fund offer no provision to first ensure fund distributions are sufficient to maintain the required growth of the textbook fund before any other distributions are made.

V. **Recommendations**

A. Oversight of the Permanent School Fund should remain with the State Board of Education. To give the Board the authority needed to manage effectively the Permanent School Fund, it should be encouraged to form a non-profit corporation to manage the fund. Under existing statute, the Board could contract with a nonprofit corporation. The chief administrator and investment staff could report directly to the corporation board, which would consist of State Board members, and the Board could add financial expertise by appointing at least three outside advisors with substantial background and expertise in investments. A second, although more difficult, means of establishing clearer Board authority over the fund investment staff would require enacting new legislation.

B. In order to provide comprehensive information to the Texas Legislature in support of the most appropriate policy structure for the Permanent School Fund additional analysis of the proposed spending policy should be conducted by the State Board, its consultants, and investment staff.

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[1] Derived from interviews with State Board of Education members, the Permanent School Fund (PSF) investment staff, two PSF consultants, the State Auditor's Office, and legislative staff; proposed legislation and the following key reports: House Research Organization's January 2000 report, *State Board of Education: Controversy and Change; House Committee on General Investigating Interim Report 2000*; the State Auditor's two reports, *Review of Controls over Investment Practices at Six Major State Investing Entities* (November 1996) and *A Follow-Up Report on Two Reviews of Controls over Investment Policies at State Investing Entities* (January 2001); 1999 NACUBO Endowment Study by Cambridge Associates, Inc., and the April 2000 report *Sustainable Payout for Foundations*, a study Commissioned by the Council of Michigan Foundations.

About the Author:

Deborah Powers is a CPA and retired state employee. She received a bachelor of arts from the University of Texas at Austin in French and Asian Studies, then later returned to earn a degree in accounting. She was a supervising auditor at the State Auditor's Office for eight years and was manager of the Deferred Compensation Section at the State Comptroller's Office. She researched and implemented the 401-k plan for the State of Texas. *She is the author of The Third Court of Appeals, 1892-1992*, published in 1992, and co-author with her husband of *Texas Painters, Sculptors & Graphic Artists: A Biographical Dictionary of Artists Active in Texas before 1942*, published in 2000.

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