
**HOUSE COMMITTEE ON CONSTITUTIONAL REVISION
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2002**

**A REPORT TO THE
HOUSE OF REPRESENTATIVES
78TH TEXAS LEGISLATURE**

**JOE DRIVER
CHAIRMAN**

**COMMITTEE CLERK
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Committee On
Constitutional Revision

January 17, 2003

Joe Driver
Chairman

P.O. Box 2910
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The Honorable James E. "Pete" Laney
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on Constitutional Revision of the Seventy-Seventh Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Seventy-Eighth Legislature.

Respectfully submitted,

Joe Driver, Chairman

Robert Puente, Vice Chairman

Kevin Bailey

Harold Dutton

Glenn Lewis

Anna Mowery

Burt Solomons

Robert Puente
Vice-Chairman

Members: Kevin Bailey, Harold Dutton, Glenn Lewis, Anna Mowery, Burt Solomons

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INTRODUCTION

At the beginning of the 77th Legislature, the Honorable James E. “Pete” Laney, Speaker of the Texas House of Representatives, appointed 7 members to the House Select Committee on Constitutional Revision. The committee membership included: Representatives Joe Driver, Chair; Robert Puente, Vice-Chair; Kevin Bailey, Harold Dutton, Glenn Lewis, Anna Mowery and Burt Solomons.

During the interim, Speaker Laney assigned the following charges to the committee:

1. Evaluate the public perception of the need for comprehensive revision of the Texas Constitution. Additionally, identify specific changes the public would support in Article 4 (Executive Department) and Article 7 (Education) of the Constitution.
2. Identify any remaining obsolete, ineffective, executed or other irrelevant provisions of the Constitution.

The committee chose to address these charges as a full committee rather than dividing into subcommittees.

Finally, the Committee would like to thank Texas Women’s University, Midwestern State University, Texas State University System, University of North Texas System, University of Houston System, Texas Tech System, Texas A&M University System, University of Texas System, the University of Texas Investment Management Company, Legislative Budget Board, Representative Gallego, Representative Keel, Grace Shore, Joe Bernal, Don McElroy, Judy Strickland, Cynthia Thornton, Rene Nunez, Roger Ferris, Carol Smith and Martha McCabe of the State Auditor’s Office, and all of the public organizations who contributed their time and effort to this interim study.

HOUSE COMMITTEE ON CONSTITUTIONAL REVISION

INTERIM STUDY CHARGES

Evaluate the public perception of the need for comprehensive revision of the Texas Constitution. Identify specific changes the public would support in Article 4 (Executive Department) and Article 7 (Education) of the Constitution. Identify any remaining obsolete, ineffective, executed or other irrelevant provisions of the Constitution.

CHARGE ON PERCEPTION OF NEED FOR REVISION

RECOMMENDATIONS

The Committee continues to assert that the State's interests are better served through periodic, sectional review of the Constitution rather than a constitutional commission or convention. In keeping with this opinion, the Committee chose to address specific constitutional issues in its hearings rather than revisit the issue of whether the Constitution should be revised in its entirety.

CHARGE ON ARTICLES 4 AND 7

ARTICLE 4

Committee staff solicited comments from varying sources, including the members of the Executive Branch, on what changes, if any, should be discussed as possible amendments to Article 4 of the Constitution. No substantive concerns were expressed, and no emergent consensus formed as to the need to revise this article. In light of the minimal response, the committee chose to concentrate its time and energy on the issues within Article 7 of the Constitution.

ARTICLE 7

The Select Committee held two public hearings on Article 7 of the Texas Constitution. These hearings were held on May 30 and 31, 2002. The first hearing consisted of testimony on the sections of Article 7 pertaining to constitutional higher education funding, specifically the Permanent University Fund and the Higher Education Fund. The second hearing consisted of testimony on the sections of the article 7 pertaining to primary and secondary education, specifically the State Board of Education and the Permanent School Fund.

BACKGROUND AND ANALYSIS OF THE PERMANENT SCHOOL FUND AND THE STATE BOARD OF EDUCATION

Article 7 establishes the Permanent School Fund, the original lands set apart to form the Permanent School Fund, and appropriate practices and standards for the investment of the fund. This article also establishes the State Board of Education and assigns fiduciary responsibility for the Permanent School Fund to the State Board of Education. The Constitution allows the Legislature to decide in what manner members of the board will be elected or appointed. Currently, members are elected to single member districts serving approximately 1.4 million people with the Governor designating the chairperson. Furthermore, the Constitution dictates an “income based” spending policy for the fund. This policy allows the fund to spend only what it brings in each year in interest and dividends, without reference to overall growth in the value of the fund.

The Permanent School Fund currently contains approximately \$17 billion dollars. Each year, the interest and dividends, along with 25% of the motor fuel tax revenue, become the annual distribution which the Legislature divides among the local school districts based on their weighted average daily attendance.

Therefore, the goal set before the State Board of Education is to maximize the annual distributions from the fund while maintaining a balanced portfolio (a balance between stocks and bonds) that will allow the fund to grow faster than inflation and thus maintain the funds purchasing power in perpetuity. Investment decisions made by the State Board of Education are guided by the “prudent person” rule which states that the board can make decisions “that persons of ordinary prudence, discretion, and intelligence, exercising the judgement and care under the circumstances then prevailing” would make. ¹

The board is supported in its investment decision making by a newly reinstated Investment Advisory Committee. The committee is comprised of 15 members, each chosen by one SBOE member. The committee meets in open meetings on an as needed basis and then advises SBOE members individually or in small groups. They sometimes meet via conference call and those meetings are made available on audio tape.

Additionally, the Commissioner of Education chooses and hires the Executive Administrator of the Permanent School Fund and employs a full time staff of 19, including investment managers and accountants, to advise the SBOE members and implement the policies and decisions adopted by the board.

Finally, the board also retains external managers as well. These are independent investment firms, external both to the board and to TEA, and they usually work on behalf of multiple clients including the Permanent School Fund.

Currently, TEA staff manages 60% of the fund while external managers manage 40 % of the fund. The shift in ratio of internally versus externally managed funds is one of several factors that may highlight the considerable distrust between the board and TEA staff. This distrust could potentially have a negative impact on prudent decision making.

As of July, 2002, the market value of the fund was just over 17 billion dollars with 51 % invested in equities and 49 % invested in bonds. This ratio of equities to bonds has shifted several times over the course of the past 10 years. Prior to 1995, the board shifted from an asset allocation of 1/3 equities and 2/3 bonds to 2/3 equities and 1/3 bonds. This change resulted in significant growth of the market value of the fund, while it adversely affected the annual distribution of the fund. Since then, the ratio has shifted to the current mix of 51 % equities to 49 % bonds. The current goal for the fund is 55% equities and 45% bonds.

Each shift in asset allocation has a dramatic effect on the annual distribution of the fund. Over the past 10 years, the annual distribution has varied as much \$98 million dollars or 13.8% due to interest rate changes and asset allocation shifts necessary to preserve the purchasing power of the fund or increase the annual distributions. The largest positive change in annual distribution during the last decade was \$98 million dollars or 13.8% from 2000 to 2001. The largest negative change was \$70 million dollars or 9.2% from 1996 to 1997. This continuous change in annual distribution is one of the factors leading the Legislature, the SBOE and other state entities to discuss the concept of total return spending.

Total return spending differs from income based spending in that income based spending bases the annual distribution of the fund on:

Interest + Dividends

while total return spending takes into account:

Interest + Dividends + Market Value Changes (increases or decreases)

The perceived benefits of a total return spending policy are that it allows for stable and predictable annual distributions from a fund, that it is not eroded by inflation, and that it allows the fiduciary of a fund to maximize market value of the fund without harming its annual distributions. This is perceived by many to improve the performance of a fund as well as the intergenerational equity of the fund.

Additionally, utilizing a total return spending approach allows the fiduciary of a fund to subtract from its total return for that year the expenses associated with operation of the fund and the rate of inflation prior to determining a prudent spending rate for the endowment.

Total Return
- Endowment Expenses
- Inflation
- Endowment Spending Rate
= Growth in Endowment Purchasing Power

At the conclusion of 2001, 88 % of all public university endowment funds operated under a total return spending policy with an additional 9.5% operating under some form of total return. Only 2.5% of all university endowment funds operated on an income based spending policy. Additionally, no university endowment fund of more than \$500 million dollars operated on with an income based spending policy. Therefore, income based spending appears to be significantly less common at present than total return.

Some people believe that total return should also take into account student population growth when determining the spending rate. This appears to be a difficult financial question since most endowment funds are not created with the intention of sustaining a continuously growing number of beneficiaries. Additionally, from a policy standpoint, it could severely hurt the current annual distributions from the fund. At this time, no consensus appears to exist on the feasibility of outgrowing the current student population growth rate of 1.5- 1.7%.

Currently, in response to struggling economic conditions over the past year, the State Board of Education is experiencing an approximately \$100 million dollar shortfall between the biennial distribution the Legislature expected to receive and the fund's current foreseeable biennial distribution. This is additionally causing a shortfall of \$8-10 million dollars in the amount of funding available to the board to pay its external managers.

There are current political and legal arguments taking place regarding the portions of the Appropriations Act which dictate the expected biennial distributions and the availability of funds to pay external managers (Riders 38 and 90). However, hypothetically, if the board had been able to utilize a total return spending policy, they would have been able to not only avoid the shortfall but exceed the expected biennial distribution to the Legislature by \$83 million dollars. Likewise, the board would have the necessary funds to pay their external managers at their disposal. (SAO materials presented at the 5/31/2002 hearing, Appendix A.)

One of the concerns associated with total return spending is that it is relatively young. Total return spending was first introduced by a reputable source in 1969 in a study of educational endowment funds commissioned by the Ford Foundation. The study states that "the great majority of endowment fund managers are well aware that it is no longer "conservative" or prudent to ignore possibilities for long-term growth in formulating their investment policies. In choosing between a high current yield of dividends and interest on one hand, and long-term

growth of principal on the other, they strive conscientiously to strike a balance between the demands of today and those of tomorrow. But too often, the desperate need of some institutions for funds to meet the current operating expenses has led their managers, contrary to their best long-term judgement, to forego investments with favorable growth prospects if they have a low current yield. It has been suggested that it would be far wiser to take capital gains as well as dividends and interest into account in investing for the highest overall return consistent with the safety and preservation of the funds invested.”² This describes the predicament that those using an income based spending policy may encounter. Since the late 60's, total return spending has gradually become the most common of endowment fund spending policies.

Additionally, many are concerned that if total return spending applied to the Permanent School Fund, then legislators, in the interest of obtaining more revenue for the current budget, would pressure the board to adopt a spending rate that is too high to be prudent or that would endanger the future purchasing power of the fund.

Some have asserted that this concerns could be resolved by ensuring that the entity making the investment decisions and endowed with the fiduciary responsibility also sets the spending rate. Additional potential safeguards include a constitutional cap on the spending rate, a constitutionally set spending rate, and a prohibition on spending increases if the purchasing power of the fund decreases over a 10 year period.

TESTIMONY ON THE PERMANENT SCHOOL FUND AND THE STATE BOARD OF EDUCATION

In preparation for the hearing on May 31, 2002, the Chair sent an invitation to testify to each of the members of the State Board of Education including questions regarding the necessity of the board, whether it should retain control of the Permanent School Fund, whether the structure controlling the PSF should more closely resemble UTIMCO, and whether the board should be allowed to implement a “total return” spending policy for the Fund. Additionally, Representative Gallego was invited to discuss the previous findings of the House General Investigating Committee on the SBOE and the administration of the Permanent School Fund. Representatives Gallego and Keel also testified on suggested changes to the administration of the Permanent School Fund. These changes were presented in SB 512, authored by Senator Duncan and sponsored by Representative Gallego. Finally, committee staff requested that the State Auditor’s Office present testimony on the findings of their 1996 and 1999 audits of the Permanent School Fund. The State Auditor’s Office staff also provided an in-depth presentation on the definition, functioning and foreseeable consequences of a total return spending policy. (Note: The University of Texas Investment Management Company (UTIMCO) presented testimony on May 30, 2002 on the effects of total return on the corpus and annual pay out of the Permanent University Fund. UTIMCO received the ability to use total return spending in November 1999.)

Testimony on the functioning and makeup of the State Board of Education and the oversight of the Permanent School Fund was extremely diverse. The key concerns raised were whether the PSF (Permanent School Fund) would benefit from a governing board with increased financial expertise or internal financial expertise and whether the PSF would benefit from the ability to use a total return spending policy. At best, no consensus emerged on whether change was necessary and if so, what change should take place with regard to the functioning or powers of the board. Additionally, of those who believe that changes to the oversight of the PSF are necessary to maintain its viability of the fund, there is no consensus as to whether the changes should be constitutional or statutory. However, public testimony, including testimony from SBOE members, appears to indicate a shift towards cautious support of total return spending.

RECOMMENDATIONS

As the charge to the House Select Committee on Constitutional Revision is to evaluate specific changes *the public would support* in Article 7, the committee recommends:

- 1) no changes to the constitutional authorities of the board.
- 2) further study of the foreseeable positive and deleterious effects of adopting a total return spending policy.

BACKGROUND AND ANALYSIS OF THE PERMANENT UNIVERSITY FUND

Article 7 establishes the University of Texas and Texas A&M University as a branch of the University of Texas. It likewise establishes the Permanent University Fund as well as which university systems may access the fund, acceptable practices and standards for investment of the fund, and allowable uses of appropriations from the fund.

The Permanent University Fund is a public endowment fund of approximately 6.7 billion dollars constitutionally dedicated to the support of the University of Texas and Texas A&M University Systems. Annual distributions from the Permanent University Fund become the Available University Fund which is divided among the two systems with 2/3 of the funding going to the University of Texas System and 1/3 going to the Texas A&M University System. The Constitution names the University of Texas Board of Regents as the fiduciary for the Permanent University Fund. The Board of Regents is comprised of nine members appointed by the Governor and confirmed by the Senate.

However, beginning in March 1996, the Board of Regents delegated their fiduciary responsibility to the University of Texas Investment Management Company subject to the board's investment policy guidelines, code of ethics and bylaws. UTIMCO (University of Texas Investment Management Company) is also a 9 member board, comprised of 3 UT System regents, the Chancellor of the UT System and 5 outside directors with considerable experience in investment

management. Much of this expertise is not required by the Constitution but by the UT System policies. All members of the board are appointed by the UT board of Regents with one member being chosen from a list of choices provided by the A&M System Board of Regents.

In delegating this authority and by constitutional amendment, investment decisions for the PUF fund are now guided by the “prudent investor” rule rather than the “prudent person” rule. This rule states that the University of Texas Board of Regents may make investment decisions that “prudent investors, exercising reasonable care, skill and caution” would make “in light of the purposes, terms, distribution requirements, and other circumstances of the fund then prevailing, taking into consideration the investment of all assets of the fund, rather than a single investment.”³

Additionally, a November 1999 constitutional amendment permitted the UT Board of Regents to implement a total return spending policy. Under this policy, the annual distributions from the fund are determined based on a percentage of the interest, dividends and market value increases or decreases of the fund available. This change has allowed UTIMCO to optimize its asset mix without harming the annual distributions from the fund. The goal for the ratio of stocks to fixed income securities, or bonds is 80% stocks to 20% fixed income securities. The PUF fund’s current ratio is 79% stocks to 21% fixed income securities. Additionally, the change has provided a stable and increasing stream of distributions from the fund. (See Appendix C, page 11.) Currently, the fund has been successful in maintaining the purchasing power of the fund while increasing annual distributions from the fund under the total return policies.

BACKGROUND AND ANALYSIS ON THE HIGHER EDUCATION FUND

Article 7 also establishes the Higher Education Fund, which universities may access this fund, and allowable uses of appropriations from the fund. This fund was created to bolster and support the higher education institutions other than the portions of the University of Texas and Texas A&M Systems funded by the PUF fund. These institutions include: Midwestern State University, Stephen F. Austin University, Texas Women’s University, the University of North Texas System, Texas State University System, Texas Tech University System, University of Houston System and portions of the University of Texas System or the Texas A&M System not funded through the PUF fund.

Constitutionally, \$100 million dollars per year are dedicated to the maintenance of the higher education institutions served by the HEF. However, in actuality, \$175 million dollars are appropriated each fiscal year to this purpose via constitutional requirement or statute. Additionally, \$49.4 million dollars are appropriated for the purpose of building up the corpus of the HEF fund. The corpus of the HEF funds is currently approximately \$335 million dollars. When the fund reaches \$2 billion dollars, the annual distributions from the fund will replace the general revenue used to sustain the higher education institutions designated under Article 7, sec. 17 of the Constitution. At this time, the Legislature will decide who will administer the fund and the designated fiduciary will be permitted to invest in the same manner set forth for the Permanent University Fund.

TESTIMONY ON THE PERMANENT UNIVERSITY FUND AND THE HIGHER EDUCATION FUND

In preparation for the public hearing on May 30, 2002, each university or university system received an invitation to testify including questions regarding the appropriations from each fund, the restrictions on the use of funds and the division between schools included in the Permanent University Fund and schools included in the Higher Education Fund.

The universities and university systems testifying at the hearing included: Midwestern State University, Texas State University System, University of Houston System, University of North Texas System, Texas Tech University system, University of Texas System and Texas A&M University System. Additionally, the University of Texas Investment Management Company spoke on the status and investment practices of the Permanent University Fund.

The testimony received from the universities indicated overwhelming support for the current constitutional system of higher education funding. Among schools participating in the Higher Education Fund, all but one university indicated that the allowable uses of appropriated funds were sufficient. One university indicated that it would benefit from the ability to use constitutionally dedicated funds to expand their student housing capacity. These universities also indicated that the division between schools funded under the Permanent University Fund and schools funded under the Higher Education Fund is appropriate. Many university systems stated that the creation of the Higher Education Fund in 1985 has greatly improved the higher education system in Texas. The only concern raised by multiple universities participating in the Higher Education Fund pertained to the \$2 billion dollar cap on the corpus of the fund. Several witnesses believed that a \$2 billion dollar corpus is no longer sufficient to sustain these universities due to the vast expansion in enrollment at Texas higher education institutions.

RECOMMENDATIONS

The committee recommends:

1) that the cap on the corpus of the Higher Education Fund be revisited when the corpus nears the \$2 billion dollar limit.

CHARGE ON OBSOLETE, INEFFECTIVE, EXECUTED AND IRRELEVANT PROVISIONS

BACKGROUND

Through the committee's diligent effort during two previous interim studies, it is believed that most of the irrelevant or obsolete provisions of the Texas Constitution have been discovered and removed via constitutional amendment. A few minor changes have been suggested, but the consensus appears to be to leave these minor innocuous issues until enough such changes accumulate to form one substantial constitutional amendment.

RECOMMENDATIONS

The committee recommends no changes at this time.

ENDNOTES

1. Texas Constitution, Article 7, sec. 5.
2. “The Law and the Lore of Endowment Funds, Report to the Ford Foundation” , William L. Cary and Craig B. Bright, 1969.
3. Texas Constitution, Article7, sec. 11b.

Appendix A

Appendix B

Appendix C
