Office of the Vermont State Treasurer

Capital Expenditure Cash Fund, Bonds and Capital Projects Fund

Presentation to the
House Committee on Corrections and Institutions

February 2, 2022

VERMONT

What is Pay-Go?

- Pay-Go is a very simple concept—paying for a portion of capital projects with cash as opposed to bonding.
- Pay-Go may include additional resources and/or utilizes existing funds set aside for this purpose.
  - The State uses excess dollars in the TIB revenues (after depositing required funds for the debt service reserve fund, for pay-go projects).
- In some cases, those funds are replenished by future revenues, although there are one-time examples.
  - Vermont did have one such example tied to the CDAAC process. A sizeable amount of the CDAAC $34 million authorization for FY2001 was paid down through pay-go funding using surplus funds.

The Context:
Revenues vs. Financing

- Bonding or financing is often mistakenly seen as a source of revenue.

- ***Financing*** involves the use of strategies, <u>including bonding</u>, that capture or leverage the value of a stream of revenue and then paying over time for the current use of those future revenues.

- ***Funding*** refers to the generation of revenue through various means such as taxes, fees, and licenses as well as identification of existing sources that may be redirected or the use of reserves/surplus funds.

Source: Washington State Department of Transportation, Transportation Infrastructure Financing Alternatives, 2004, p1, cited in Vermont State Treasurer's Office, <u>Bridges and Culverts Long-Term Assessment and Funding</u>, 2009, p. 17.

Bonding and Pay-Go

- Bonding makes sense when:
  - Costs are saved through accelerated construction
    - inflation and preventative maintenance exceed the interest paid on the funds.
  - Quantifiable economic benefits exceed the cost of borrowing
  - A future identifiable and available revenue source exists to pay for the bonds
  - Intergenerational Equity
  - Pay-Go funds are not available

But…..

Pay-Go Cash Options Can Save The Taxpayer Money

- Reduce interest costs associated with bonds.
- Bond interest payments impose a real cost to the State.
- Even when the interest environment is favorable, bonding over a 20 year period is expensive.
- Estimated that G.O. debt interest costs are at least $400,000 for each $1 million of debt at current rates.
- Bonding involves moving a future stream of revenues to current use.
    - Bonding will result in there being less funds available for other future uses.

Recommendation: Create a Fund to Accumulate and Utilize Pay-Go Dollars

Capital Expenditure Cash Fund (CECF)

- Accumulates cash reserves for future capital needs
- Get projects off the ground
- Interest is accrued in the fund – invest a portion of the fund in the Trust Investment Account (TIA)
- Pay for expenditures that may not represent the optimal use of bonds

Bottom Line....

Earn interest rather than paying interest through bonds

Eligible Expenses per Proposed Statute

- Costs associated with a proposed capital project that occur prior to the construction phase of that project, including but not limited to feasibility, planning, design, engineering and architectural costs.

- Projects with an anticipated lifespan less than 20 years.

- Other eligible capital projects or debt service expenditures as recommended by the Governor or appropriated by the General Assembly.

Same Capital Budget but Another Source of Funds

Source of Funds

- One-time appropriations

- The value of future debt service payments (principal and interest) avoided from bonds that have been redeemed at a call date.

- A set amount each year appropriated though debt service with surplus going to Capital Expenditure Cash Fund.

- Others:
  - Grants and donations

  - Transfers from the General Fund

  - Unexpended balances from completed capital projects (cannot be bond proceeds)

  - Interest on investments

  - Year-end surpluses or from reserves

Set Amount Each Year Appropriated: Process

- Establish a baseline debt service appropriation as a percent of general fund budget.

- Appropriate that amount each year:
  - The amount that is not needed for debt service can be transferred to the CECF.
  - If the debt service appropriation is not sufficient in a given year, and once the fund is established, then CECF funds can be used to supplement the appropriation.

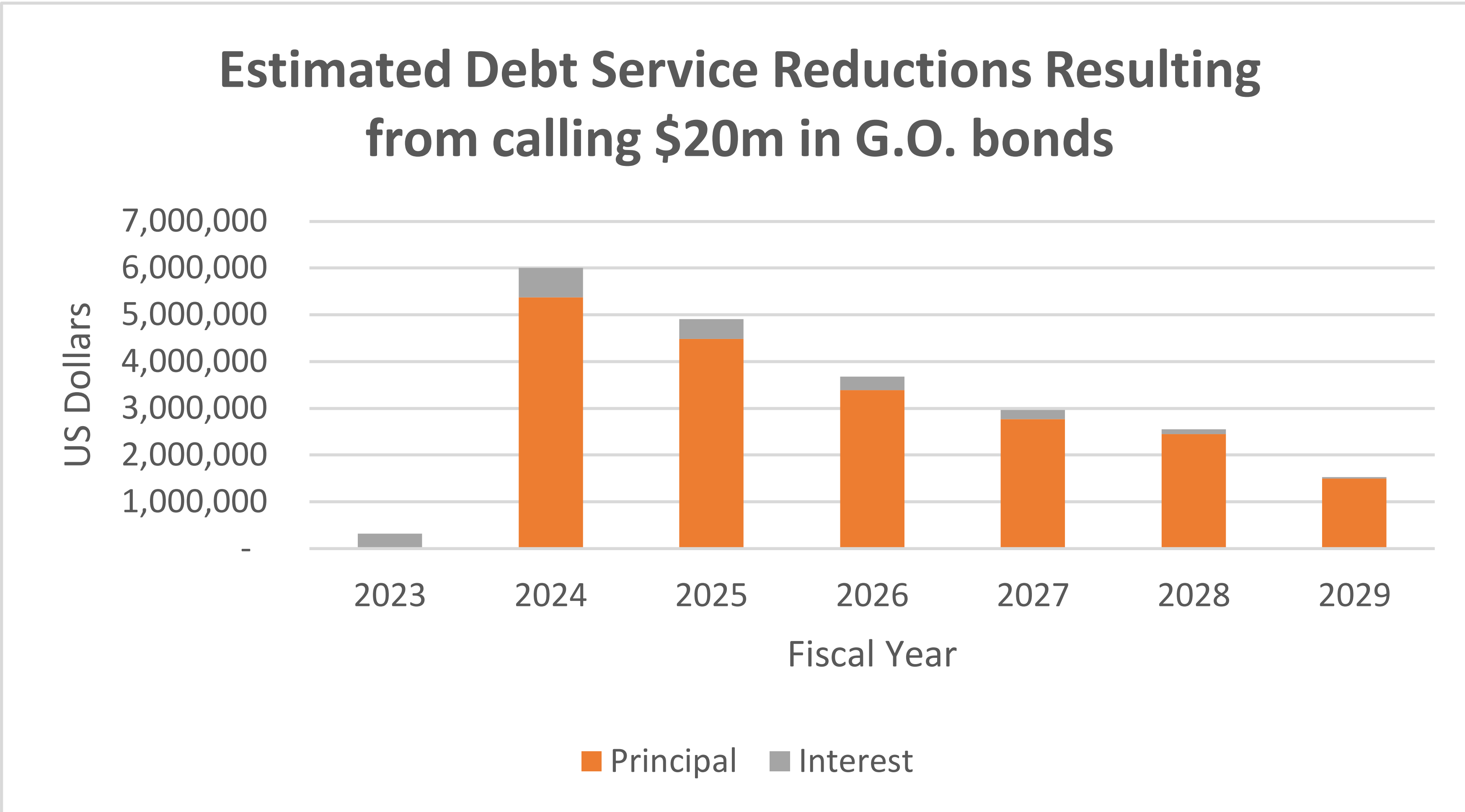
- Stabilizes base annual appropriation for debt service.
- More predictable appropriation, without fluctuations from year to year depending on timing of debt service payments.

Current Proposal for Start-Up:

- Appropriate $20 million to redeem bonds with call dates in FY23.

- Use any debt service payments avoided through the early redemption of State bonds or notes before maturity as pay-go funds to defray the costs of future capital expenditures.

- $6.2 million General Fund transfer



Source: Finance & Management, data from Treasurer's Office and Public Resources Advisory Group (PRAG)

CECF Uses (dos and don’ts)

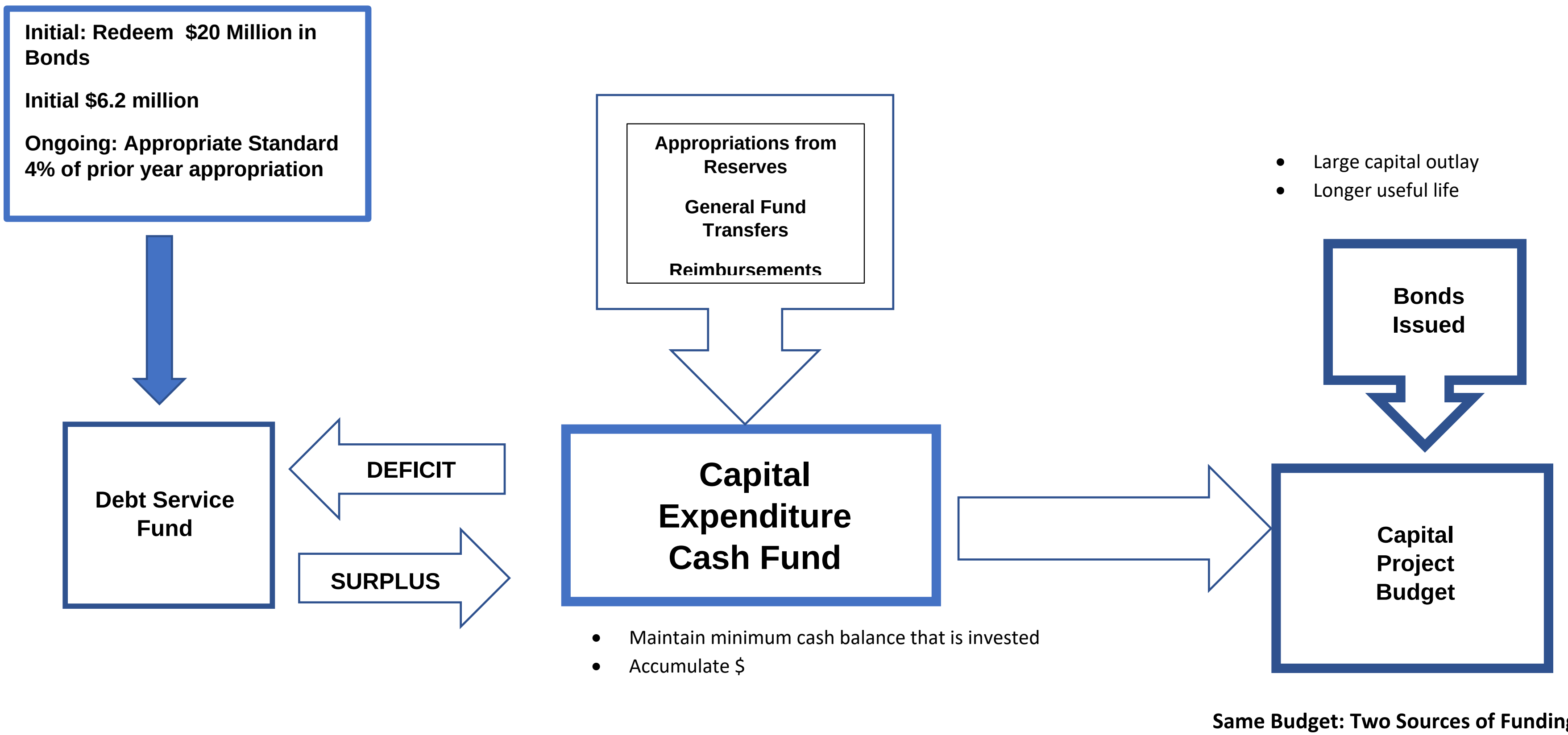
- Do use it for:
  - One-time projects and smaller dollar amounts
  - Construction feasibility studies
  - Capital projects as an alternative to debt
  - Treasury Recommendation: Establish a policy that Pay-Go is used as option of first choice, as funds are available.
    - Example (subject to revision): “whenever possible, capital costs should be financed by means other than borrowing and should utilize pay-as-you-go methods such as regular contributions from the General Fund and funds in the Capital Expenditure Cash Fund (CECF). down payments from operating funds”

- Don’t use it for:
  - Operating expenses
  - It should not be in addition to the amounts recommended by CDAAC (the idea is to reduce reliance on debt, not to supplement it)

Exercise Discipline to Maintain Balance

- Maintain a balance for future use
- Earn interest on balance
- Need to establish withdrawal policy so that CECF funds are not depleted
- Possible Options:
  - Similar to Higher Education Trust Fund in Statute: Appropriations from the CECF do not exceed interest income on accumulated principal deposited into the fund
  - Or set a minimum balance in the fund and/or limit the percentage of CECF funds that may be appropriated in a given year.
  - Other options for consideration with the Administration and General Assembly

<u>Model: Capital Expenditure Cash Fund, Bonds and Capital Projects Fund</u>



Advantages:

- Lower interest costs associated with bonds
- Stabilizes annual appropriation for debt service – more predictable appropriation
- Reduces debt financing costs
- Accumulates cash reserves for capital needs
- Get projects off the ground
- Accumulates funds for future projects
- Interest is accrued in the fund
- **<u>More Projects with Less Dollars</u>**

National Trend: Increasing Use of Pay-Go Funds to Pay for Capital Projects

The National Association of State Budget Officers (NASBO) reported capital spending increased by 10.3% (reaching $126.6 billion) in fiscal 2020 from the year prior, the highest level in 20 years.

Pay-Go has grown to 74% of state spending on capital expenditures in fiscal 2020. The distribution of those dollars by fiscal year is as follows:

Total Capital Expenditures by Funding Source

Year	General Fund Cash Resources	Other State Cash Resources	Federal Cash Resources	Total Cash/Pay-As-You-Go	Bonds
2020	5.6%	42.6%	25.8%	74.0%	26.0%
2015	5.3%	34.7%	28.1%	68.1%	32.0%
2010	4.8%	30.8%	26.8%	62.4%	37.6%
2005	4.4%	36.8%	27.2%	68.4%	31.6%

Examples of State Initiatives

- In 2014, the National Association of Budget Officers (NASBO) completed a study, “Capital Budgeting in the States”. While somewhat dated, it contains data on Pay-Go financing. Findings include:
  - 22 States have either formal or informal Pay-Go policies
  - In many states, Pay-Go is the norm with little or no issuance of bonds (Alaska, Iowa, Missouri, Nebraska, and North Dakota). Some have statutory prohibitions (Nebraska) except in certain conditions.
  - West Virginia uses lottery receipts to fund the School Building Authority

Table 35: Financing Capital Projects

State	State Maintains a Formal or Informal Pay-As-You-Go Policy for Financing Capital Projects	Additional Explanations on Formal or Informal Pay-As-You Go Policies and Bond Financing Capital Projects
New Mexico		General obligation bonds are limited by policy to 10 years, and only 10-year bonds are issued. Severance tax bonds are statutorily allowed to be issued for up to 10 years, but the Board also routinely issues short-term severance tax notes to use additional severance tax revenues to finance capital projects on a pay-as-you-go basis.
New York		Based on availability of funds and type of project.
North Carolina	X	Historically, capital improvement projects have been funded with tax revenue over collections and/or state agency reversions.
North Dakota	X	Debt is incurred for capital projects only when current state general and special fund revenues are inadequate to meet the capital budget needs.
Ohio		
Oklahoma	X	
Oregon		As the primary landlord for state agencies, the Department of Administrative Services (DAS) traditionally funds certain types of capital projects on a pay-as-you-go basis using rent revenues. Such projects include major building envelope repairs, roof or carpet replacements, HVAC system upgrades, etc.
Pennsylvania	X	Only for projects financed by general revenues; included within the Governor's Executive Budget.
Rhode Island	X	Constitution establishes the Rhode Island Capital Plan Fund which is to be used for pay-as-you-go capital projects. Funding is derived from surplus funds in the Budget Reserve (rainy day) fund per prescribed formula.
South Carolina	X	For projects not funded with some sort of bond funds, the funding for the projects must be available to the agencies or institutions at the time the projects are approved. Projects cannot be approved for construction with the promise of funding at a future time. Therefore, when projects are submitted for approval by Joint Bond Review Committee and Budget and Control Board, the agency submitting it must already have the availability of the funds for expenditure before the construction budget is approved.
South Dakota		
Tennessee		
Texas	X	Article III, Section 49a, of the Texas Constitution sets out the "pay-as-you-go" limit. It requires that bills making appropriations be sent to the Comptroller of Public Accounts (CPA) for certification those appropriations are within available revenue. Capital projects must be within this "pay-as-you-go" limit as well when they are part of appropriations.
Utah		
Vermont	X	Informal—situational.
Virginia		
Washington		
West Virginia	X	School Building Authority - $22.0 million of Lottery appropriations are designated "Pay As You Go".
Wisconsin		
Wyoming		
District of Columbia	X	Certain identified dedicated revenue streams are moved through Paygo to capital projects during formulation. Further, we use available/unneeded operating budgets and transfer the budget through Paygo to capital projects.
Total	**22**	

NASBO prepared a table identifying the 22 states having a policy (formal or informal) and a brief description of these.

Vermont listed as "informal"- possibly related to transportation funding.

North Carolina had a recent legislative effort to develop a Pay-Go model for school construction to lower the interest costs and move projects at a more rapid pace. At this time, additional research is needed to assess outcome of that effort.

Other State Initiatives

- **Maryland:** After funding of reserves and other statutory funds, funds are credited to a newly created Fiscal Responsibility Fund, which the Governor must use to provide Pay-Go appropriations for public school, community college, and four-year higher education projects.
- **Montana:** Recently, the state implemented new legislation that requires the governor to propose in his budget that 1% of the budget go towards a Capital Development Fund.
- **Louisiana:** The State Constitution sets out requirements for the use of non-recurring funds. After meeting certain statutory reserves requirements and deposit into pension funds, the balance is to be applied towards additional deposits to the Budget Stabilization Fund or unfunded accrued liability of the Louisiana retirement systems, retiring or defeasing bonds, funding capital outlay projects, or deposit into the Coastal Protection and Restoration Fund.
- **New Hampshire** and **Connecticut**, among others, authorize the creation of capital reserves that can be used to fund Pay-Go capital projects

Source: Public Resources Advisory Group

Municipalities

- In the analysis, Treasurer's Office looked at the Pay-Go strategies of the following Connecticut municipalities:
    - West Hartford
    - Tolland
    - Simsbury
    - Cheshire
    - Glastonbury
    - Westbrook
    - Wallingford
- Pay-Go funds permit more flexibility in paying for capital budgets, serve as a source of pay-as-you-go funding, and provide dollars for emergency projects.