MEMORANDUM

JOINT BUDGET COMMITTEE

To	Members of the Joint Budget Committee
From	Craig Harper, JBC Staff (303) 866-3481
Date	December 17, 2024
Subject	Department of Higher Education R8

Higher Education Request R8

Department of Higher Education request R8 asks the Committee to sponsor legislation to change the investment of a portion of the statutory General Fund reserve. The goal of the request is to make additional funds available to support controlled maintenance projects at institutions of higher education and free up General Fund for other uses. The Governor's Office estimates that the proposal would make an additional $20.0 million General Fund available per year for the next five years. The proposal would:

- Transfer $500 million from the General Fund to a TABOR-exempt account managed by an institution of higher education (IHE). The request frames this transfer as a loan to the IHE for a period of five years.
- Allow the IHE to invest the $500 million and use the interest earnings to support controlled maintenance projects across all IHEs. The request assumes a 4.0 percent annual rate of return, resulting in the estimated $20.0 million per year in interest.
- Interest earned on the existing General Fund reserve is TABOR revenue. In a time of TABOR refunds, that interest increases the TABOR refund. The IHEs are enterprises. As a result, interest earned on their investments is outside of the State's TABOR district (as long as it stays with the IHEs). As a result, the earnings would be available for expenditure rather than forcing additional TABOR refunds.
- The request is submitted as a budget balancing measure and assumes that the earnings would reduce the General Fund that the State would otherwise spend on IHE controlled maintenance, making that General Fund available for other uses.

The Take-home Message

JBC Staff understands the appeal of the proposal. It could generate additional revenue outside of the TABOR cap to support important state needs. However, staff questions whether the benefits would really outweigh the costs and potential negative impacts – at least without more risk than staff would recommend accepting for the General Fund reserve. Staff recommends that the Committee consider the following:

- Staff is not confident that the anticipated returns are feasible without additional risk and does not believe that adding real risk to the investment of the reserve is appropriate.
- Staff is concerned about the potential for unforeseen complications. Drafting a bill to implement this proposal (and implementing that bill) would require a lot of detail and

additional infrastructure and process, both to "tier" the reserve and to implement the mechanics of the bill. Staff worries that the complexity adds more risk.

- The request frames the proposal as a five-year loan, and staff's understanding is that it requires a three- to five-year commitment to be confident in the return on investment. Staff questions whether the State is in any position to make a multi-year commitment that could lock up a significant portion of the reserve.
- Staff recommends considering the proposal in light of both the December 2024 revenue forecasts and the variety of available options to adjust the State's TABOR refund obligation for balancing. For example, enterprising the nursing provider fees in HCPF could open far more budgetary space ($65.2 million vs. the estimated $20.0 million in this proposal) and may offer other benefits (e.g., allowing for a fee increase that would draw down additional funds). Staff believes these other alternatives may provide more "bang for the buck" at lower risk and notes that recent actions have reduced TABOR refund projections.

JBC Staff continues to strongly recommend maintaining the 15.0 percent General Fund reserve. Previous JBC Staff analyses demonstrate the need for that size of reserve and the need for it to be accessible.[1] Staff is also uncertain whether maintaining that reserve will be politically feasible given budgetary pressures. Staff would be even more concerned about locking up significant funds in a multi-year commitment if the General Assembly may consider reducing the statutory requirement.

Note: Staff will return to the Committee in January with a "stress test" that provides more extensive out-year projections and incorporates the December 2024 revenue forecasts and the January 2, 2025, budget requests. Staff is optimistic that the additional information will be helpful as the Committee considers balancing options going into the 2025 Session.

Recommendation 1: Topics for Discussion

Staff recommends that the Committee discuss the request with the institutions of higher education (specifically the University of Colorado and Colorado State University) and the Governor's Office during their respective hearings in January.

Questions for IHEs

- The request assumes that the investment would earn 4.0 percent in interest each year, for a total of $20.0 million annually. However, based on the annual reports from Treasury, 2024 and 2025 are the only years since at least 2016 in which the T-pool earned more than 3.0 percent (with 3.7 percent in 2024 and in 2025 year to date). The average return for 2016 through 2024 year was 1.9 percent.[2] Is 4.0 percent a reasonable assumption on an

[1] For a thorough discussion of the reserve requirement and the need for a 15.0 percent reserve, see the 2022 JBC Staff document available at: https://leg.colorado.gov/sites/default/files/gfreserve-11-15-22.pdf

[2] Staff notes that even the 1.9 percent average is heavily influenced by the inclusion of 2024. For 2016 through 2023, the average was 1.6 percent.

ongoing basis? If the portfolio would be more aggressive than the Treasurer's current investments then please discuss the potential risk. These funds would remain a part of the General Fund reserve and must remain available in the case of an economic downturn.

- Please discuss the additional infrastructure, oversight, and staff that would be necessary to manage the investment account. Would it require a separate investment committee? Would the IHE require more staff? What would that look like and how much would it cost each year? Please discuss all administrative and management costs that would be necessary – and whether they could be paid for from the earnings.
- The request proposes to have one institution of higher education manage the funds and then to use the interest earnings for controlled maintenance projects at all institutions. What process do you envision for the approval of projects and the distribution of funds among institutions? What infrastructure would need to be in place for one institution to manage the investments and allocate funds to the other institutions?

Questions for the Governor's Office and Others (Controller, Treasurer, Architect)

- How would removing $500 million from the General Fund (by transferring it to an account with an institution of higher education) affect the State's ability to manage cash flow through the fiscal year? Would taking that amount out of the General Fund require additional short-term borrowing to meet cash flow needs? Please discuss the potential impact on the need to borrow and the potential borrowing costs.
- Proponents of the proposal recommend "tiering" the reserve so that this money would be the last piece of the reserve to be spent. How would taking these funds out of the pool and making it the last money available affect the State's investment strategies for the Treasury Pool (this question is likely best addressed to the Treasurer)? How would that change affect earnings on the State's other investments? Would it increase the risk of losses in other funds should the reserve become needed in a crisis?
- This money would remain part of the General Fund reserve and must remain available during a downturn, including when the General Assembly is not in session. What triggers would you recommend to ensure that the money would transfer back to the General Fund when needed? For example, should statute require such a transfer if the projected year-end reserve dipped below a certain percentage, a certain dollar amount, or based on another mechanism altogether? Please provide detail.
- Please outline the Executive Branch's vision of the role of the Office of the State Architect and the Office of the State Controller in this scenario. For example, other capital construction and controlled maintenance projects are paid on a reimbursement basis, with the Office of the State Architect overseeing much of the project evaluation, recommendations to OSPB and the CDC, and oversight of funds to ensure payment. Do you envision the same roles for this system? Does the location of the account (within an IHE) affect that process?

Recommendation 2: Mitigating Risk

Staff is not making a concrete recommendation on the proposal at this time and hopes that the hearing process will help inform the decision. However, looking toward the figure setting process and the recommendation, staff would recommend against moving forward with any plan that did not meet *all* of the following criteria:

- First, staff recommends that potential sponsors work closely with the Treasurer's Office to plan for an appropriate timeline for the transfer out of the General Fund. Treasury will have to plan for a transfer (or series of transfers) of that magnitude to both avoid losses *and* maintain sufficient liquidity to manage the State's cash flow. Staff does not believe that the transfer can happen quickly without significant impacts.
- Second, JBC Staff does not have the necessary expertise to identify appropriate diversification requirements that would increase returns (relative to the T-Pool) *and* keep risk to a minimum. However, JBC Staff asserts that the requirements must: (1) keep risk of losses to an absolute minimum (and be mindful that when the money is needed the economy is likely to be struggling) *and* (2) ensure that the money can be available quickly when needed. The pace of need would depend on the specific recession scenario but it is staff's understanding that the need was virtually *immediate* based on the impact of COVID-19 on revenue estimates in March 2020.
- Third, setting aside the amount of the returns, staff recommends that any appropriation of these earnings be in arrears. That is the only way that the General Assembly can be confident about the actual amount of interest available. In order to be certain of the amount available, staff would recommend only appropriating the earnings received through a date prior to the introduction of the Long Bill (e.g., the end of the previous calendar year). **As a result, there may not be any earnings that would be available for FY 2025-26 (depending on the date of the transfer and when the General Assembly elected to make the first appropriation).**
- Fourth, the bill must create a trigger that would initiate a process to return the money from the IHE to the General Fund when required for the reserve. Having never managed the state's cash flow or investments, JBC Staff does not have the expertise to define that trigger. However, any bill implementing this proposal should specify the conditions under which the Treasurer would be able to recall the money *without further action by the General Assembly and when the General Assembly is not in session.*

As noted above, JBC Staff understands the appeal of the proposal. If the request were just using other one-time funds to capitalize a trust fund for long term investments, then staff would have fewer concerns. However, the prospect of using the reserve requires more consideration of the risk and the necessary steps to mitigate that risk.

Background – General Fund Reserve

Current statute requires the General Assembly to balance the budget with a 15.0 percent reserve, with relatively minor adjustments pertaining to specific bills. [3] The reserve is calculated as a percentage of *appropriations*, specifically appropriations that are subject to the reserve. It does not include *transfers* out of the General Fund or certain other expenditures that are addressed in the quarterly revenue forecasts and classified as "rebates and expenditures" (e.g., the homestead property tax exemption, among others).

Statute describes the reserve for each fiscal year as the "unrestricted general fund year-end balances" that must be retained as a reserve. That definition raises important points.

- The General Assembly balances the budget for each year based on *projections of the year-end balance*. However, the General Fund balance fluctuates throughout the year (with expenditures starting on July 1 and revenue collections weighted late in the year). In most years, when the State does not begin the year with a large *excess reserve*, the General Fund would inherently spend much of the year below that year's reserve requirement.
- The Treasurer and the Executive Branch must balance investing the T-pool (which includes the General Fund and cash funds) against liquidity needs for cash flow purposes. When the reserve is inadequate to support cash flow needs, the General Fund balance may even be temporarily negative (as happened in June 2020). Inadequate liquidity can also force the Treasurer to borrow money to manage cash flow needs (at a cost).

For context, the current FY 2024-25 appropriation includes $15.4 billion in General Fund appropriations that are subject to the reserve, and the reserve requirement equates to $2.3 billion. Based on a 2.3 billion reserve, the proposed transfer represents 21.5 percent of the reserve. It would represent 20.7 percent of the required reserve for FY 2025-26 based on the Governor's November 1 request.

JBC Staff continues to strongly recommend a General Fund reserve of at least 15.0 percent (see the 2022 JBC Staff document linked above). It is important to note that if the General Assembly reduced the reserve requirement, then the proposed $500 million would represent an increasing share of the reserve, exacerbating the risks and concerns discussed below.

Interest Earnings and TABOR

The State Treasurer manages the State's cash flow and invests the General Fund reserve as part of the "T-pool" (which includes the General Fund and many cash funds). Interest earned on the General Fund remains in the General Fund. Statute directs the disposition of interest earnings

[3] Section 24-75-201.1 (1)(d)(XXIII), C.R.S., requires a fiscal-year-end Genera Fund reserve equal to 15.0 percent of appropriations from the General Fund for the fiscal year beginning in FY 2022-23. House Bill 24-1231 reduces the reserve requirement by $41.25 million based on the estimated amount held in escrow in association with the College of Osteopathic Medicine at the University of Northern Colorado.

for each cash fund created in statute, although most bills creating cash funds specify that interest earnings remain in the cash fund.

In a period of TABOR refunds, interest earnings can be an important factor.

- Interest earned on revenues that are subject to TABOR ("regular" General Fund and many cash funds) are *also subject to TABOR*. Every dollar of such interest earnings adds to the TABOR refund obligation.
- For the General Fund, that means the interest earnings are not available for appropriation.
- For cash funds subject to TABOR, the interest earnings actually *reduce the amount of General Fund available* because current law pays all TABOR refunds from the General Fund.
- Conversely, interest earned on exempt funds is also exempt from TABOR. So, earnings on funds associated with enterprises and many funds approved by voters (e.g., marijuana taxes) are not subject to TABOR and do not have the same impact on the refund.

The crux of this request is to transfer a portion of the General Fund to an IHE to both (1) increase the rate of return relative to Treasury's investments and (2) make the earnings available for appropriation (rather than adding to the TABOR refund) because the IHE is an enterprise.

How much would it earn? And at what risk?

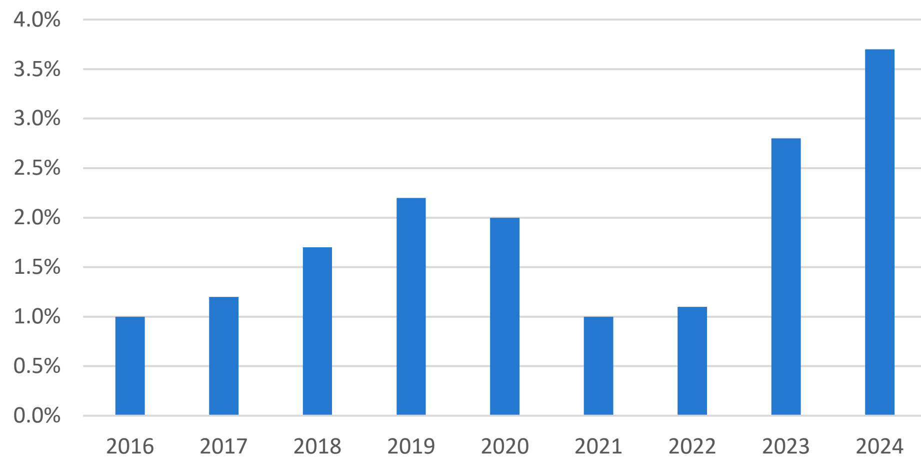
The request assumes that the proposal would generate 4.0 percent per year in interest earnings, equating to $20.0 million per year. The Governor's Office and other proponents of the proposal have indicated that they believe that this is a realistic (and possibly even conservative) scenario. Given current interest rates, that seems reasonable (staff understands that as of early December many Treasury Bills are paying more than 4.0 percent).

However, staff is uncertain whether a 4.0 percent return is a reasonable assumption on an ongoing basis – for example, if interest rates continue to fall. Staff is especially concerned because the investments should be relatively short in duration to ensure that money can be available when needed. As of December 13, 2024, the Treasury Bill yield curve is still inverted, with short-term bills earning a higher rate than longer-term bills, although all are above 4.0 percent. However, that is presumably a temporary scenario.

Staff notes that the Treasurer's investment of the T-pool averaged 1.6 percent in returns for 2016 through 2023. Including 2024 pushes that average up to 1.9 percent – but that is because 2024 earned 3.7 percent. Most years over that period were below 2.0 percent (see graphic on the following page).

Staff assumes that the proposal would allow the IHE to invest somewhat more aggressively than the Treasurer. For example, the investments might include certain corporate bonds. Staff understands that diversification would likely increase returns. Staff also understands that expanding beyond the portfolio available to the Treasurer may still keep risk very low. However, staff worries that achieving a 4.0 percent return in a more normal environment may require more risk than staff would consider reasonable *for the General Fund reserve* (the Committee and the General Assembly may have a higher risk tolerance than staff).

T-pool yields have generally been below 2.0 percent since 2016 and have never exceded 4.0 percent.



What would be the impact of a "tiered" reserve?

Request R8 does not discuss creating "tiers" for the General Fund reserve. However, other interested parties have told JBC Staff that the legislation should create tiers so that the corpus of this fund would be the last portion of the General Fund reserve to be spent, with a goal of leaving the principal untouched for at least three to five years. In effect, the bill would direct the Treasurer to use all of the rest of the reserve before accessing this money. Staff notes the following for the Committee's consideration:

- Doing so would maximize the earnings on the trust fund by leaving it invested for longer and would reduce the risk of penalties for terminating the investments early.
- However, this also displaces both of those risks onto the funds invested by the Treasurer. Treasury may need to change the management of the T-Pool (and thus the main part of the General Fund reserve) to accommodate a separate tier of the reserve for this money.
- It is staff's understanding that Treasury does not specifically invest/manage the "reserve" at this time. Rather, the General Fund reserve is part of the overall T-Pool. Creating tiers in the reserve could require them to change that practice, and could require additional resources to manage the reserve.

Obviously, the need to access this final tier would depend on the specifics of the situation. A minor recession may not force the State to dip into this account. However, it is staff's understanding that the 2001 recession, the Great Recession in 2008-2009, and the COVID scenario would all have required the State to access these funds in order to sustain operations (with varying degrees of notice).

The nuts and bolts matter.

On its face, the proposal is straightforward. The IHE would invest the money and the State would benefit from having additional funds available for controlled maintenance. The sections above summarize staff's concerns about potential returns, risk, and impacts on the State's other investments. However, staff also notes that legislation to implement this proposal would require many additional details. For example, capital construction and controlled maintenance are complicated processes, involving the State Architect, the State Controller, agencies with projects, and the contractors doing the work. The bill would need to detail the process for this fund source.

- Would it be another fund source for the existing process? If not, how would it change and who would be responsible for each component?
- What infrastructure would need to be in place at the IHE managing the fund? Would the other offices require more staff? What additional cost would be necessary?

What about a non-refund scenario?

Setting aside the risks outlined in the previous sections, staff notes that the proposal offers two types of benefits to the state.

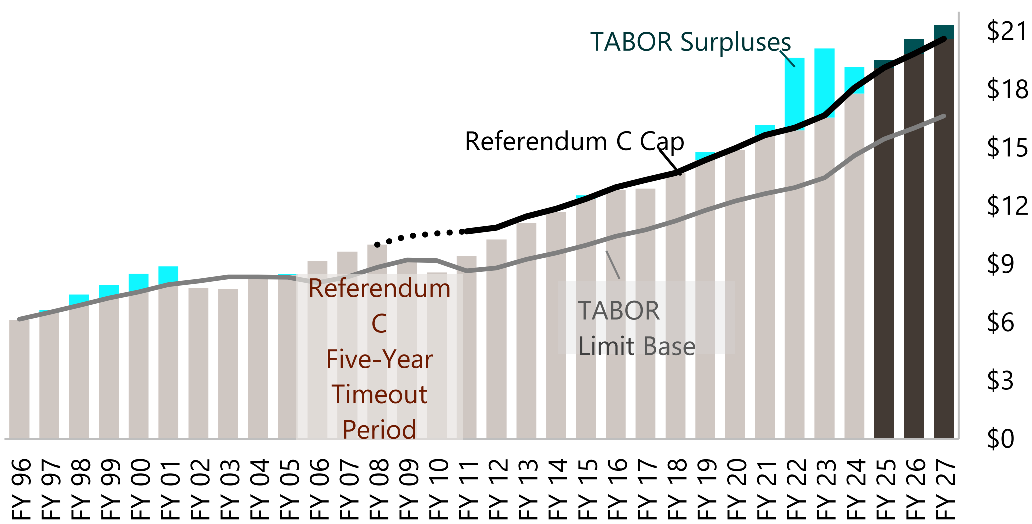
- First, the money could earn **greater returns** than the Treasury's more restricted investments. This is a tradeoff with risk that staff does not have the expertise to evaluate. But staff agrees that opening the investments up beyond the constraints on the Treasurer could increase returns relative to leaving the money in the T-pool.
- Second, as discussed at greater length above, in a TABOR refund environment, it makes **the earnings available** for use regardless of whether the return is higher because it would not push out refunds.

In light of the second bullet (TABOR refund), staff notes that the past few years have been quite anomalous. TABOR refunds have been far from the norm since TABOR's approval in 1992 (see graphic on following page created by Legislative Council Staff and reflecting their September 2024 revenue forecast). From FY 1995-96 through FY 2023-24, refunds occurred in only 11 of 29 years, with far fewer years with large refunds.

While revenue forecasts continue to anticipate refunds for the forecast period, that could easily change. On top of "normal" economic uncertainty, the General Assembly has taken a number of actions that have reduced projected TABOR refunds, and the magnitude of refunds is now within a modest level of forecast error. Outside of a TABOR refund scenario, staff suggests that the potential benefits of this proposal would not outweigh the risks and potential negative impacts discussed above.

Staff also notes that the Committee has received a number of requests and options that would impact the TABOR refund for balancing purposes (including requests in multiple departments as well as JBC Staff-generated options such as enterprising nursing provider fees). If projected TABOR refunds remain tight, then the Committee will want to prioritize the available balancing options, and others may offer more benefit and less risk.

TABOR refunds have been relatively uncommon since its adoption ($ in billions)



Conclusions

Staff is concerned about the risk required to significantly increase return on investment (relative to current practice) and about the potential for complications that staff has not contemplated at all. In short, staff questions whether the benefits would really outweigh the costs and potential negative impacts – at least without more risk than staff would recommend accepting for the General Fund reserve.

On the other hand, staff appreciates that the Committee needs to consider all available options, and certainly understands the appeal of either making additional General Fund available or having more funding available for controlled maintenance. Staff also appreciates the benefit of "putting the reserve to work" in a way that would create an immediate benefit to sustaining the 15.0 percent reserve and an incentive to keep it. If legislation can mitigate the risks and the Committee is confident in the magnitude of the benefits then the proposal would be promising.

If the Committee intends to consider moving forward, then staff hopes that the upcoming revenue forecasts and the hearing process will provide additional information that would inform and improve the legislation. JBC Staff has neither the investment expertise nor the specific implementation background necessary to address staff's concerns with the proposal, and the hearings will provide an important venue for discussion with people that do have more expertise in those areas.

Finally, staff is aware of discussions of a similar mechanism to allow PERA to invest a portion of the reserve. Staff has restricted this memorandum to Higher Education R8 because that is the request officially before the Committee. Staff notes that many of the same concerns would apply to the PERA scenario (except for the ones related to capital construction). Staff also understands that PERA's status as a Special Purpose Authority would raise additional legal hurdles and would require additional discussion.