OFFICE OF LEGISLATIVE RESEARCH
Objective Research for Connecticut's Legislature

ResearchReport

OLR Backgrounder: Connecticut's Volatility Cap

By: Rute Pinho, Principal Analyst

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Issue

Explain Connecticut's volatility cap and the related bond covenant requirement.

Summary

The volatility cap is a mechanism for diverting volatile tax revenue to the Budget Reserve Fund (BRF). It is tied to personal income tax revenue from estimated and final payments (generated from taxpayers who make estimated income tax payments on a quarterly basis). Estimated and final income tax payments are the most volatile component of personal income tax collections. They generally come from investments, such as capital gains realized in the stock market, and thus fluctuate with economic booms and busts. The mechanism effectively caps at $3.15 billion the amount of revenue from these payments that may be used to balance the budget, thus requiring any excess amounts to be transferred to the BRF after the close of General Fund accounts each fiscal year.

The legislature enacted the cap in the FY 18-19 budget and implementer act, as part of a group of changes to the state's BRF law (PA 17-2, June Special Session (JSS), §§ 704 & 707-708). The same act also included a provision requiring certain state bonds to include a pledge to bondholders that the state will comply with the BRF law, along with other specified state laws, as long as the bonds are outstanding (PA 17-2, JSS, § 706). The bond covenant provision takes effect on May 15, 2018.

Volatility Cap

The volatility cap functions as a $3.15 billion cap on the amount of estimated and final income tax revenue that may be used to balance the budget. It does so as a result of two related provisions. First, the law requires the state treasurer to transfer to the BRF revenue the state receives each fiscal year in excess of $3.15 billion from personal income tax estimated and final payments. Second, it requires consensus revenue estimates to include a line item, designated as the volatility adjustment, that reflects the estimated amount of this transfer. Consensus revenue estimates are the basis for the governor's proposed budget and the revenue statement included in the budget act the legislature passes. Thus, the new volatility adjustment effectively reduces the amount of General Fund revenue available for appropriation in the budget.

In establishing the volatility cap, the legislature repealed existing provisions, originally enacted in 2015 and scheduled to take effect July 1, 2019, requiring mid-year diversions to the BRF of projected surpluses in revenue from the corporation income tax and personal income tax estimated and final payments. The prior law's diversions were based on a threshold level calculated using the average revenue from these two sources over 10 years (PA 17-2, JSS, § 729).

> ***Consensus Revenue Estimates***
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> *The Office of Policy and Management secretary and Office of Fiscal Analysis director must agree on and issue consensus revenue estimates each year by November 10. The estimates must cover a five-year period that includes the current biennium and the three following fiscal years. The offices must, by January 15 and April 30 each year, issue any necessary consensus revisions of those estimates or a statement that no revision is needed.*
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> *The law establishes a procedure for determining consensus revenue estimates if the secretary and director cannot come to a consensus (CGS § 2-36c).*

Budget Reserve Fund

The FY 18-19 budget and implementer act established the volatility cap as part of a group of complementary changes to the BRF law. The act (1) increased the BRF's maximum balance from 10% to 15% of net General Fund appropriations for the current fiscal year and (2) authorized surplus funds to be used to pay down unfunded pension liabilities and to fund a projected deficit.

Directing Surplus Funds to Pay Unfunded Pension Liabilities

Under the new law, once the BRF reaches the 15% ceiling, the treasurer must transfer any remaining General Fund surplus, as she determines to be in the state's best interests, for reducing either the State Employee Retirement Fund's or Teachers' Retirement Fund's unfunded liability by up to 5%. Any amounts that remain after this transfer may be used to make additional payments to either retirement system, as the treasurer determines to be in the state's best interests, in addition to paying off other forms of outstanding state debt.

The new law also provides statutory authority for the legislature to transfer funds from the BRF to pay unfunded pension liabilities when the fund's balance equals 5% or more of net General Fund appropriations for the current fiscal year. It authorizes the legislature to transfer funds above the 5% threshold amount to either the State Employee Retirement Fund or Teachers' Retirement Fund, as it determines to be in the state's best interests, in consultation with the treasurer. Any amounts transferred to either retirement system must be in addition to statutorily required contributions or payments (PA 17-2, JSS, § 704).

Use of BRF Funds for Projected Deficits

By law, BRF funds are deemed appropriated in any fiscal year in which the comptroller has certified a deficit for the immediately preceding fiscal year. The new law also allows the legislature to transfer funds from the BRF to the General Fund when a deficit is projected.

Under the act, if any consensus revenue estimate for the current biennium projects a decline in General Fund revenue for the current biennium of at least 1% from the total amount of General Fund estimated revenue on which the budget act (or any adjusted appropriation and revenue plan) was based, the legislature may transfer funds from the BRF to the General Fund at any time during the remainder of the current biennium. In addition, if any April 30 consensus revenue estimate projects a decline in General Fund revenue in either year or both years of the subsequent biennium of at least 1% from the total General Fund appropriations for the current year, the legislature may transfer funds from the BRF to the General Fund in the fiscal year for which the deficit is projected.

Bond Covenant

Beginning May 15, 2018, certain state bonds must include a pledge to bondholders that the state will comply with the BRF law (except under limited circumstances), in addition to complying with other statutory requirements (PA 17-2, JSS, § 706). Under the new law, for each fiscal year during which state general obligation (GO) or credit revenue bonds issued from May 15, 2018 to June 30, 2020, are outstanding, the state must comply with the following:

1. the BRF law (CGS § 4-30a);
2. the newly established cap on General Fund and Special Transportation Fund expenditures in effect as of October 31, 2017 (PA 17-2, JSS, § 705);

3. the state spending cap (CGS § 2-33a, as amended by PA 17-2, JSS, § 709); and

4. the caps on GO and credit revenue bond authorizations, allocations, issuances, and expenditures (CGS §§ 3-20 & 3-21, as amended by PA 17-2, JSS, §§ 710-712).

The new law also requires, for GO and credit revenue bonds issued during this timeframe, that the treasurer include a pledge to bondholders that the state will not enact any laws taking effect from May 15, 2018 to June 30, 2028, that change the state's obligation to comply with the laws listed above until the bonds are fully paid off, unless the following conditions are met:

1. bondholders are protected in another way or

2. (a) the governor declares an emergency or the existence of extraordinary circumstances in which he invokes the statute allowing him at his discretion, and requiring him whenever the comptroller projects a General Fund budget deficit greater than 1%, to reduce appropriated accounts by up to 5% and total fund appropriations by up to 3% (CGS § 4-85), (b) at least three-fifths of the members of each house of the General Assembly approve the change in compliance, and (c) the change is limited to the fiscal year in progress.

The pledge must apply for 10 years from the bonds' first issuance date, but not to refunding bonds issued to pay the original bonds.

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