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ResearchReport

OLR Backgrounder: Connecticut's Volatility Cap and Budget Reserve Fund

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Issue

Explain Connecticut's volatility cap and Budget Reserve Fund. This report updates OLR Report 2018-R-0041.

Summary

The volatility cap is a mechanism for diverting volatile tax revenue to the Budget Reserve Fund (BRF). It is tied to (1) personal income tax revenue from estimated and final payments (generated from taxpayers who make estimated income tax payments on a quarterly basis) and (2) pass-through entity (PE) tax revenue. The cap effectively limits the amount of revenue from these two sources that may be used to balance the budget and requires 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 2017 as part of a group of changes to the state's BRF law included in the FY 18-19 budget and implementer act (PA 17-2, June Special Session (JSS), §§ 704 & 707-708). The same act also required certain state bonds issued from May 15, 2018, to June 30, 2020, to include a pledge to bondholders (i.e., bond covenant) that the state will comply with the BRF law, along with other specified state fiscal controls (PA 17-2, JSS, § 706). This bond covenant requirement applied for five years from the bonds' first issuance date.

In 2023, the legislature enacted a similar bond covenant requirement for bonds issued in FYs 24 and 25 (PA 23-1, § 14). The new bond covenant, as described below, applies for 10 years (i.e., through FY 33), unless the General Assembly adopts a resolution not to continue it beyond FY 28.

Volatility Cap

> ### *Consensus Revenue Estimates*
> *The Office of Policy and Management secretary and Office of Fiscal Analysis director jointly 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).*

The volatility cap is tied to two state revenue sources: estimated and final income tax revenue and PE tax revenue. 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 PE tax is an entity-level income tax on most pass-through businesses and is similarly volatile due to these fluctuations.

The volatility cap functions as a limit on the amount of this revenue that may be used to balance the budget. It does so as a result of two related provisions. First, it requires the state treasurer to transfer to the BRF revenue the state receives each fiscal year in excess of the volatility cap threshold (CGS § 4-30a(a), as amended by PA 23-1). Originally set at $3.15 billion for FY 18, the threshold is annually adjusted for the five-year average growth in personal income; for FY 24, it is $3.78 billion.

Second, it requires consensus revenue estimates to include a line item, designated as the volatility adjustment, that reflects the estimated amount of this transfer (CGS § 2-35(b)(1)(B)). Consensus revenue estimates are the basis for the governor's proposed budget and the revenue statement included in the budget act the legislature passes. So, the volatility adjustment effectively reduces the amount of General Fund revenue available for appropriation in the budget.

Budget Reserve Fund

Required Transfers and Maximum Balance

Current Law Through FY 24. State law requires the state treasurer to transfer to the BRF any unappropriated General Fund surplus that remains after the accounts have been closed at the end of each fiscal year, including the income and PE tax revenue the state realized in excess of the volatility cap threshold. The BRF's balance is currently capped at 15% of net General Fund appropriations for the current fiscal year.

Once the BRF reaches the 15% ceiling, any remaining General Fund surplus is automatically appropriated for reducing the State Employee Retirement System's (SERS) or Teachers' Retirement System's (TRS) unfunded liability by up to 5%, as the state treasurer determines to be in the state's best interests (except as described below). Any amounts that remain after the maximum appropriation to SERS and TRS may be used to make additional payments to either retirement system, as the treasurer determines to be in the state's best interests, or to paying off other specified forms of outstanding state debt (CGS § 4-30a(c)(1)(A) & (d)), as amended by PA 23-1, § 15).

A provision in the FY 24-25 budget and implementer act requires the treasurer, through the end of FY 24, to determine that it is in the state's best interest to appropriate any excess surplus funds (1) first to reduce the SERS' unfunded liability by up to 5%, (2) second to reduce the TRS' unfunded liability by up to 5%, and (3) third to make additional payments toward the SERS' unfunded liability (PA 23-204, § 114).

FY 25 and After. Under a 2023 law, beginning July 1, 2024, the BRF's maximum balance increases from 15% to 18% of net General Fund appropriations. As under current law, once the BRF reaches the 18% ceiling, any remaining surplus is automatically appropriated to SERS and TRS or other outstanding debt, as described above. In addition, when the BRF's balance is at least 15% but less than the 18% maximum, half of any surplus funds that remain after the accounts have closed must also be automatically appropriated to SERS and TRS in this way. The other half must be transferred to the BRF, up to the 18% cap (CGS § 4-30a(c)(1)(B)-(C) & (d), as amended by PA 23-1, § 15).

Use of BRF Funds

The law specifies three allowable uses of the BRF: (1) to close a certified deficit for the preceding fiscal year, (2) to fund a projected revenue shortfall for a current or future fiscal year, and (3) to make additional unfunded pension liabilities.

Certified Deficits. By law, BRF funds are automatically appropriated in any fiscal year in which the comptroller has certified a deficit for the immediately preceding fiscal year (CGS §4-30a(f)(1), as amended by PA 23-1, § 15). The comptroller announces preliminary deficit (or surplus) estimates in late September after the close of the fiscal year and releases final audited figures at the end of December (CGS § 3-115(b)).

Projected Deficits. The legislature may also transfer funds from the BRF to the General Fund when a deficit is projected. By law, 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 (CGS §4-30a(f)(2) & (3), as amended by PA 23-1, § 15).

Unfunded Pension Liability Payments. The 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 SERS or TRS, 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 (CGS § 4-30a(e), as amended by PA 23-1, § 15).

Bond Covenant Tied to BRF Law and Other State Fiscal Controls

PA 23-1, § 14, requires the state treasurer to include a pledge to bondholders in general obligation (GO) and credit revenue bonds issued during FYs 24 and 25 that the state will comply with the following laws, except under limited circumstances, during each fiscal year to which the pledge applies:

1. BRF law, including the volatility cap (CGS § 4-30a, as amended by PA 23-1, § 15);
2. state spending cap (CGS § 2-33a);
3. cap on General Fund and Special Transportation Fund appropriations (i.e., the “revenue cap”) (CGS § 2-33c, as amended by PA 23-1, § 16); and
4. debt limit and caps on GO and credit revenue bond allocations, issuances, and allotments, including specified procedural requirements under the GO bond act (CGS §§ 3-20 & 3-21, as amended by PA 23-1, §§ 17 & 18).

The pledge to bondholders is that the state will not enact any laws taking effect in FYs 24-28 and FYs 29-33, except as described below, that change the state's obligation to comply with the laws listed above during the years to which the pledge applies, 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 his statutory authority to reduce appropriated accounts (CGS § 4-85), (b) at least three-fifths of the members of each house of the General Assembly approve the change, and (c) the change is limited to the fiscal year in progress.

This pledge applies through FY 33 unless the General Assembly adopts, by June 30, 2028, a resolution not to continue it beyond FY 28. It does not apply to refunding bonds issued to pay the original bonds.

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