

## Introduction

As part of the biennial budget for fiscal years 2018-19, the Connecticut General Assembly passed two fiscal accountability measures, known as the spending cap and the volatility cap.<sup>1</sup> These measures include changes to multiple sections of the Connecticut General Statutes, which are discussed in this policy brief.

## History of the Spending Cap

In the 1991 biennial budget, the General Assembly adopted the state personal income tax in Connecticut. This budget also included a statutory spending cap, intended to be a check on the new revenue stream.<sup>2</sup> In 1992, Connecticut voters approved a constitutional amendment to further codify these spending constraints on the General Assembly.<sup>3</sup> The constitutional spending cap bars the legislature from increasing general budget expenditures in an amount that exceeds the increase in personal income revenue or inflation, whichever is greater, unless the governor declares a state of emergency and three-fifths of each house of the General Assembly approves the additional expenditure. The constitutional amendment also required the General Assembly to define three primary terms: "increase in personal income," "increase in inflation," and "general budget expenditures." However, between FYs 1993 and 2017, these terms remained undefined, resulting in budgets having different interpretations of the spending cap.<sup>4</sup>

Since 1993, the General Assembly's Office of Legislative Research has identified at least 74 bills proposed by legislators that would have defined the above terms. However, none of these bills passed both chambers of the General Assembly with the required three-fifths majority, and therefore, the terms remained undefined.<sup>5</sup> In the 2015 December Special Session, the General Assembly created a 24-member Spending Cap Commission, which was charged with creating spending cap definitions.<sup>6</sup> However, in January 2017, the Commission suspended its work and reported it could not come to an agreement on a set of recommendations for defining the necessary terms.<sup>7</sup> Instead, the Commission submitted "separate statements" from various groups of legislators named to the Commission.<sup>8</sup> Therefore, the spending cap definitions included in the biennial budget for FYs 2018-19 (Conn. Acts 17-2 (June Special Session)), passed by a three-fifths majority of the General Assembly, are the first definitions to be set in statute by the General Assembly since the constitutional cap was approved by voters more 25 years ago.<sup>9</sup>

## Spending Cap Definitions Contained in Conn. Acts 17-2 (June Special Session)

**Increase in personal income.** Conn. Acts 17-2 (June Special Session) defines an increase in personal income as the compound annual growth rate of personal income in the state over the preceding five calendar years, using data reported by the U.S. Bureau of Economic Analysis.<sup>10</sup>

**Increase in inflation.** Conn. Acts 17-2 (June Special Session) defines an increase in inflation as the increase in the Consumer Price Index for all urban consumers, all items, less food and energy, during the preceding calendar year (CPI-U), using data reported by the U.S. Bureau of Labor and Statistics.<sup>11</sup>

**General budget expenditures.** Conn. Acts 17-2 (June Special Session) defines general budget expenditures as expenditures from appropriated funds authorized by a public or special act of the General Assembly. The adopted definition exempts from the spending cap the following expenditure types:

- Expenditures for payment of the principal and interest on bonds;
- Notes or other types of indebtedness; and
- Transfers of surplus revenue to the budget reserve fund.

Special exemptions from the spending cap are made in the following circumstances:

- Expenditures for federal mandates or court orders are exempt in the first year the expenditures are authorized but are included in subsequent years.
- Expenditures for federal programs in which Connecticut currently participates, for which the state receives federal matching funds, are included under the cap. However, expenditures for future programs where the state may receive federal matching funds are exempt for the first year the expenditure is approved.
- For FYs 2018-2022, expenditures to pay the Actuarially Determined Employer Contribution (ADEC) of any retirement system managed by the Connecticut State Employees Retirement Commission, current or future, are exempted from the spending cap. Beginning in FY 2023, these payments are included in general budget expenditures.
- For FYs 2018-2026, expenditures to pay the ADEC for the Teachers' Retirement System are also exempt from the cap. However, in 2027, these payments are included in general budget expenditures.<sup>A</sup>

**Base year adjustment.** Conn. Acts 17-2 (June Special Session) authorizes a base year adjustment to be made in the following circumstances:

- If any expenditure funded in the previous fiscal year by an appropriation is funded in the current year by state bonding, a revenue intercept,<sup>B</sup> or other non-appropriated state funding source, as long as the purpose of the expenditure is essentially the same in each year.

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<sup>A</sup> It is important to note ADEC payments for the Teachers' Retirement System are currently projected to nearly \$4 billion between FYs 2027-2032. Based on Conn. Acts 17-2 (June Special Session), these increased payments will be under the spending cap and could restrict the General Assembly's ability to use General Fund expenditures for other purposes.

Aubry, J., & Munnell, A.H. (2015). *Final Report on Connecticut's State Employees Retirement System and Teachers' Retirement System*. Chestnut Hill, MA: Center for Retirement Research at Boston College. Retrieved from [http://crr.bc.edu/wp-content/uploads/2015/11/Final-Report-on-CT-SERS-andTRS\\_November-2015.pdf](http://crr.bc.edu/wp-content/uploads/2015/11/Final-Report-on-CT-SERS-andTRS_November-2015.pdf).

<sup>B</sup> A revenue intercept is an accounting maneuver that exempts funds from falling under the constitutional spending cap by redirecting them to outside of the state budget.

Phaneuf, K.M. (2015, April 28). Panel will consider plan to boost CT income taxes on the wealthy. *The Connecticut Mirror*. Retrieved from <https://ctmirror.org/2015/04/28/panel-will-consider-plan-to-boost-ct-income-taxes-on-the-wealthy/>.

- If any expenditure funded in the previous fiscal year by state bonding, revenue intercept, or other non-appropriated state funding source, is funded in the current fiscal year by an appropriation, as long as the purpose of the expenditure is essentially the same in both years.<sup>12</sup>

**Statutory Spending Cap.** Section 705 of Conn. Acts 17-2 (June Special Session) includes a new, additional statutory spending cap, which limits the General Assembly from increasing appropriations beyond a certain percentage of consensus revenue estimates, and contains the following provisions:

- On or after July 1, 2019, the General Assembly is barred from authorizing General Fund or Special Transportation Fund appropriations for any fiscal year that, in the aggregate, exceeds a certain percentage of the consensus revenue projections. This cap begins at 99.5 percent of projected revenues in FY 2020, and decreases 0.25 percent each year until it reaches 98 percent in FY 2026, where it will remain for each fiscal year thereafter. The General Assembly may only exceed this cap in the following cases:
  - If the governor declares an emergency or the existence of extraordinary circumstances, AND
  - At least three-fifths of each chamber of the General Assembly votes to exceed the cap, AND
  - The appropriation is only for the fiscal year in progress, OR
  - Each house of the General Assembly approves exceeding the cap for the purposes of an adjusted appropriation and revenue plan.<sup>13</sup>

## Volatility Cap

Conn. Acts 17-2 (June Special Session) also includes language that limits the General Assembly's ability to spend specific income tax revenue that exceeds a certain threshold, and diverts these funds into the state's Budget Reserve Fund, also known as the "Rainy Day Fund." This language has been referred to as the "volatility cap."<sup>14</sup> Section 704 of Conn. Acts 17-2 (June Special Session) concerns the volatility cap and requires:

- All revenue in excess of \$3.15 billion in estimated and final personal income tax revenue, in each fiscal year, is to be transferred by the state treasurer to the Budget Reserve Fund.
- After accounts for the General Fund have been closed for each fiscal year, and when the comptroller has determined a surplus, the state treasurer is to transfer this surplus to the Budget Reserve Fund.
- Whenever the Budget Reserve Fund equals 15 percent of the net General Fund appropriations for the current fiscal year, the state treasurer is empowered to apply any additional surplus to either the unfunded liabilities of the State Employees Retirement Fund and/or the Teachers' Retirement Fund, in addition to the ADEC, but the surplus applied may not exceed five percent of the unfunded liabilities of either system.

- If, after transfers to the State Employees Retirement Fund and/or Teachers' Retirement Fund, there is an additional surplus, the state treasurer is empowered to apply these funds in the following ways:
  - Toward any existing indebtedness of the State;
  - For the purchase of outstanding indebtedness of the State in the open market;
  - To place the funds in an escrow account to be used solely for scheduled payments on state indebtedness;
  - For making additional payments toward the unfunded liabilities of either the State Employees Retirement Fund and/or Teachers' Retirement Fund; or
  - Pending these uses, funds may be invested in U.S. Treasury securities or other U.S. government obligations.
- When the amount in the Budget Reserve Fund equals five percent or more of the net General Fund appropriations for the current fiscal year, the General Assembly may transfer funds in excess of the five percent threshold from the Budget Reserve Fund for the purpose of paying down the unfunded liability of the State Employees Retirement Fund and/or Teachers' Retirement Fund.
- In any fiscal year where the comptroller has determined a deficit applicable to the immediately preceding fiscal year, funds in the Budget Reserve Fund will be credited to this deficit.
- The General Assembly may transfer funds from the Budget Reserve Fund to the General Fund if any consensus revenue estimate projects a decline in General Fund revenue of one percent or more in the current biennium from the appropriation in the previous biennial budget.
- The General Assembly may transfer funds from the Budget Reserve Fund to the General Fund if the April 30<sup>th</sup> consensus revenue estimate projects a decline in General Fund revenue of one percent or more in either or both years of the following biennium. This transfer must be applied to the fiscal year in which the deficit is projected.<sup>15</sup>

Section 707 of Conn. Acts 17-2 (June Special Session) also contains language related to the volatility cap, including:

- Requiring consensus revenue estimates be supplied to the Finance, Revenue and Bonding Committee of the General Assembly;
- Requiring consensus revenue estimates include an itemized estimate of withholding payments and estimated and final payments of the state personal income tax; and
- Requiring consensus revenue estimates include a line item designated as the volatility adjustment, which reflects the amount of the estimated transfer to the Budget Reserve Fund, under the volatility cap provisions discussed above.<sup>16</sup>

## Discussion of the Volatility Cap

The volatility cap has recently been discussed in the media and by public officials, as FY 2018 revenue estimates from Connecticut's Office of Policy and Management (OPM)

projected a surplus of nearly \$900 million in personal income tax over the administration's previous estimates.<sup>17</sup> Governor Dannel Malloy has asserted<sup>18</sup> that, under the volatility cap, only \$10 million of this increased revenue can be applied by the General Assembly to the current fiscal year projected deficit of \$240.2 million,<sup>19</sup> and the remaining \$890 million must be diverted to the Budget Reserve Fund. This calculation appears to be based on Section 704 of Conn. Acts 17-2 (June Special Session), which stipulates that any personal income, estimates and finals, revenue in excess of \$3.15 billion must be diverted to the Budget Reserve Fund. Because the November consensus revenues estimates projected \$3.14 billion in personal income estimates and finals, only the \$10 million required to reach \$3.15 billion can be applied to the General Fund for the current fiscal year.<sup>20</sup> The latest consensus revenue estimates were released by OPM and the General Assembly's Office of Fiscal Analysis (OFA) on January 16, 2018. These estimates showed a surplus of approximately \$665 million over the \$3.15 billion volatility cap in personal income tax, estimates and finals, for FY 2018. Total revenue estimates were calculated less this \$665 million, which is shown as a transfer to the Budget Reserve Fund, or as the "volatility adjustment."<sup>21</sup>

Although OPM and OFA have set aside the personal income tax revenue in excess of the volatility cap for transfer to the Budget Reserve Fund, the volatility cap, as drafted in Conn. Acts 17-2 (June Special Session), may require some additional clarification. Subsection (a) of Section 704 requires the state treasurer to transfer personal income, estimates and finals, revenue over \$3.15 billion to the Budget Reserve Fund. Notably, the estimates and finals line item includes capital gains, interest, and dividend income,<sup>22</sup> which means the wording of this subsection could restrict the General Assembly's ability to apply any revenue to the General Fund that might result from any future tax increases on these income types. Additionally, the subsection does not specify a date at which the transfer to the Budget Reserve Fund must be made.<sup>23</sup> Prior to the revisions contained in Conn. Acts 17-2 (June Special Session), all transfers to the Budget Reserve Fund were made after the comptroller had closed all accounts for the fiscal year, and had certified if there was a surplus.<sup>24</sup> However, the new wording is unclear as to the schedule at which the specified personal income estimates and finals revenue must be transferred to the Budget Reserve Fund.

Per subsection (b) of Section 704 of Conn. Acts 17-2 (June Special Session), if the comptroller certifies a deficit for FY 2018, after the accounts for this fiscal year have closed, the funds in the Budget Reserve Fund will be applied to the final deficit.<sup>25</sup> This means the General Assembly could choose not to undertake deficit mitigation strategies in the current fiscal year, close the year in deficit, wait for the comptroller's certification, and then allow the state treasurer to make the required transfer from the Budget Reserve Fund to the General Fund to cover the deficit. As a result, the structure of this provision may weaken the impact of the personal income component of the volatility cap.

Additionally, subsection (d) of Section 704 of Conn. Acts 17-2 (June Special Session) contains language allowing the General Assembly to apply funds in the Budget Reserve Fund to the current fiscal year's deficit if any consensus revenue estimate projects a one percent decline in *total* revenue, below the consensus revenue estimate on which the current biennial budget was based.<sup>26</sup> Ostensibly, this could mean, depending on

the schedule of transfers to the Budget Reserve Fund of personal income revenue, the General Assembly, based on a different metric, could access these funds to apply them to current fiscal year deficits, which may also reduce the impact of the personal income component of the volatility cap.

## Endnotes

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- <sup>1</sup> Conn. Acts 17-2 (June Special Session).
- <sup>2</sup> Johnson, K. (1991, August 23). Budget is passed for Connecticut with income tax. *The New York Times*. Retrieved from <http://www.nytimes.com/1991/08/23/nyregion/budget-is-passed-for-connecticut-with-income-tax.html?pagewanted=all>.
- <sup>3</sup> Pinho, R., & McCluskey, C. (2016). *Spending Cap Definitions (2016-R-0137)*. Hartford, CT: Connecticut General Assembly, Office of Legislative Research. Retrieved from <https://www.cga.ct.gov/2016/rpt/pdf/2016-R-0137.pdf>.
- <sup>4</sup> Ibid.
- <sup>5</sup> Ibid.
- <sup>6</sup> Connecticut General Assembly. (n.d.). Spending Cap Commission. Retrieved from [https://www.cga.ct.gov/app/taskforce.asp?TF=20160330\\_Spending%20Cap%20Commission](https://www.cga.ct.gov/app/taskforce.asp?TF=20160330_Spending%20Cap%20Commission).
- <sup>7</sup> Widlitz, P., & Cibes Jr., W.J. (2017). *Report of the Chairpersons, Spending Cap Commission*. Hartford, CT: Connecticut General Assembly, Spending Cap Commission. Retrieved from [https://www.cga.ct.gov/app/tfs/20160330\\_Spending%20Cap%20Commission/Complete%20Set%20of%20Reports%20and%20Separate%20Statements%20Produced%20by%20Spending%20Cap%20Commission%20Members.pdf](https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/Complete%20Set%20of%20Reports%20and%20Separate%20Statements%20Produced%20by%20Spending%20Cap%20Commission%20Members.pdf).
- <sup>8</sup> Ibid.
- <sup>9</sup> Pinho, R., & McCluskey, C. (2016). *Spending Cap Definitions (2016-R-0137)*. Hartford, CT: Connecticut General Assembly, Office of Legislative Research. Retrieved from <https://www.cga.ct.gov/2016/rpt/pdf/2016-R-0137.pdf>.
- <sup>10</sup> Conn. Acts 17-2 § 709 (June Special Session).
- <sup>11</sup> Ibid.
- <sup>12</sup> Ibid.
- <sup>13</sup> Conn. Acts 17-2 § 705 (June Special Session).
- <sup>14</sup> Conn. Acts 17-2 § 704 (June Special Session).
- <sup>15</sup> Ibid.
- <sup>16</sup> Conn. Acts 17-2 § 707 (June Special Session).
- <sup>17</sup> State of Connecticut, Office of the Governor. (2018). Gov. Malloy Announces Collection of Personal Income Taxes in December and January Will Exceed Expectations by More Than \$900 Million [Press release]. Hartford, CT: Author. Retrieved from <http://portal.ct.gov/Office-of-the-Governor/Press-Room/Press-Releases/2018/01-2018/Gov-Malloy-Announces-Collection-of-Income-Taxes-in-December-and-January-Will-Exceed-Expectations>.
- <sup>18</sup> Ibid.
- <sup>19</sup> Phaneuf, K.M. (2018, January 19). Malloy says CT budget deficit worsens slightly. *The Connecticut Mirror*. Retrieved from <https://ctmirror.org/2018/01/19/malloy-says-ct-budget-deficit-worsens-slightly/>.
- <sup>20</sup> Phaneuf, K.M. (2018, January 8). CT income tax receipts surging, but most can't be used to balance budget. *The Connecticut Mirror*. Retrieved from <https://ctmirror.org/2018/01/08/ct-income-tax-receipts-surging-but-most-cant-be-used-to-balance-budget/>.
- <sup>21</sup> Barnes, B., & Ayers, N. (2018). *Consensus Revenue - January 16, 2018*. Hartford, CT: State of Connecticut, Office of Policy and Management. Retrieved from [http://www.ct.gov/opm/lib/opm/FINAL\\_CONSENSUS\\_JAN16\\_2018.pdf](http://www.ct.gov/opm/lib/opm/FINAL_CONSENSUS_JAN16_2018.pdf).
- <sup>22</sup> State of Connecticut, Department of Revenue Services. (1993). *Estimated Connecticut Income Taxes (IP 92(5.3))*. Hartford, CT: Author. Retrieved from <http://www.ct.gov/drs/cwp/view.asp?A=1510&Q=266750>.
- <sup>23</sup> Conn. Acts 17-2 § 704(a) (June Special Session).
- <sup>24</sup> Conn. Acts 17-2 § 704(b) (June Special Session).
- <sup>25</sup> Ibid.
- <sup>26</sup> Conn. Acts 17-2 § 704(d) (June Special Session).