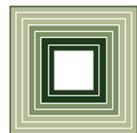


# QUARTERLY GENERAL FUND REVENUE REPORT



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**FISCAL RESEARCH DIVISION**  
A Staff Agency of the North Carolina General Assembly

# Highlights

- General Fund collections through December are \$199.2 million (2%) below the six month revenue target of \$9.8 billion.
- Collections on wage and salary income continue to lag behind forecast expectations. Sales and Corporate Income tax collections have offset some of the weakness in Personal Income tax collections.
- The steady, moderate economic growth that re-emerged last summer is expected to continue throughout the fiscal year. In 2015, most economic forecasts anticipate a continuation of this growth path with the economy operating at near average growth.
- Employment growth has steadily improved over the last six months. Widespread wage growth has yet to develop. The ongoing improvements in the employment picture should begin to place upward pressure on wages.

# FY 2014-15 Revenue Through December

- General Fund revenue was \$199.2 million *below* the \$9.8 billion target for the first half of the fiscal year.
- Second quarter revenues (Oct.-Dec.) were \$137 million below target.
  - Weak income continued to be the main reason collections were running behind target.
  - **Personal Income:** \$247 million *below* target for the year; the result of wage and salary withholding running 2.7 percent below target and Final Payments down \$77 million.
  - **Sales Tax:** \$78 million *over* target; baseline growth (adjusted for tax changes) was up 6.2%.
  - **Corporate Income:** \$57 million *over* target. Collections are \$48 million less than last year, the result of the rate reduction from 6.9 to 6.0 percent (the rate goes to 5.0 percent in 2015).
  - **Franchise:** \$54 million *below* target. This may be attributable to the timing of these payments now that electricity, which was partially included in the Franchise tax, is fully taxed under the Sales tax.

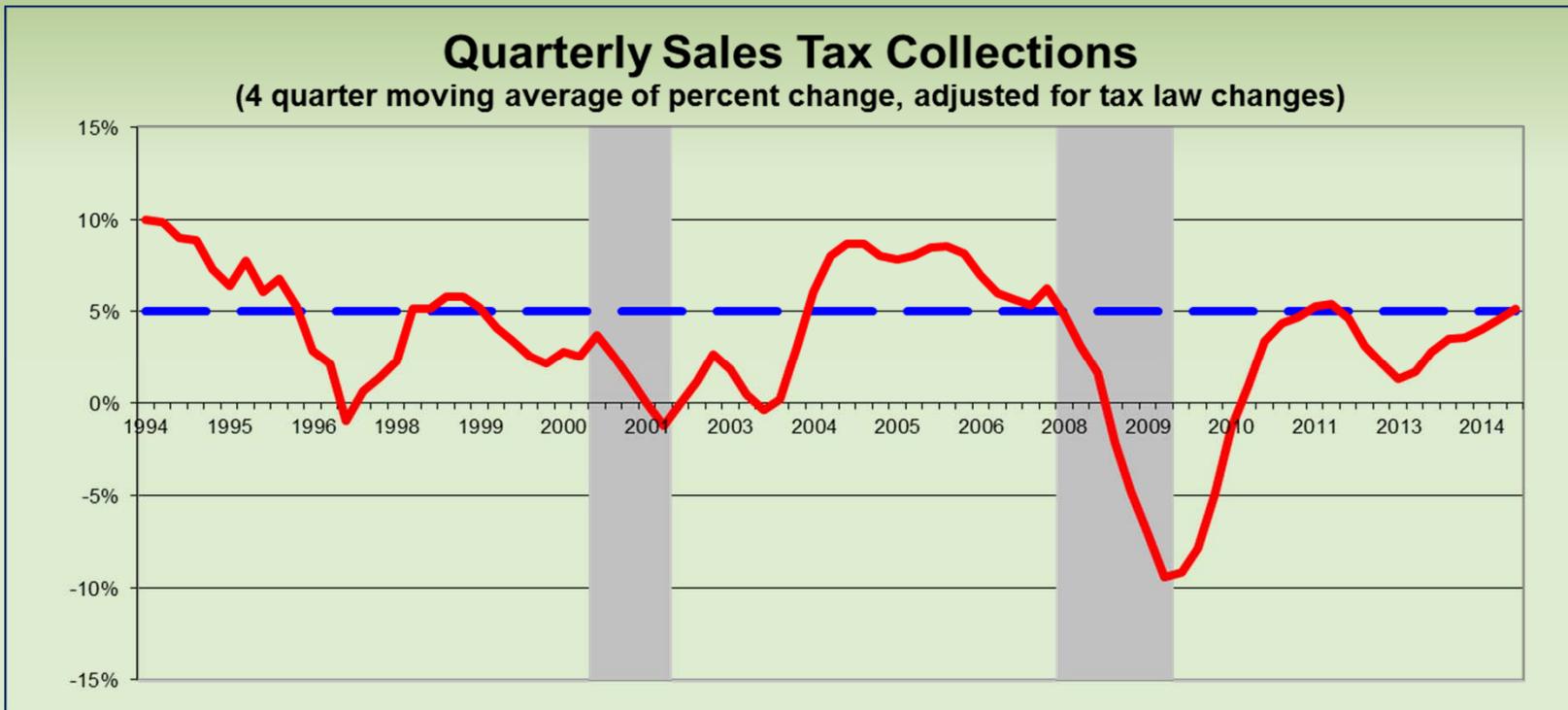
# FY 2014-15 Revenue Through December

<b>FISCAL YEAR-TO-DATE (millions)</b>					
	<b>Target</b>	<b>Actual</b>	<b>Target</b>	<b>Actual</b>	<b>Y/Y Pct.</b>
<b>Net Tax Revenue</b>	<b>2014-15</b>	<b>2014-15</b>	<b>Difference</b>	<b>2013-14</b>	<b>Change</b>
Individual Income	\$5,141.8	\$4,895.2	(\$246.6)	\$5,520.0	(11.3)
Sales and Use	3,087.0	3,164.8	77.8	2,773.1	14.1
Corporate Income	479.6	536.8	57.2	584.7	(8.2)
Franchise	144.3	90.1	(54.2)	270.2	(66.7)
Other	540.0	530.9	(9.1)	551.3	(3.7)
<b>Total Tax Revenue</b>	<b>\$9,392.7</b>	<b>\$9,217.7</b>	<b>(\$175.0)</b>	<b>\$9,699.3</b>	<b>(5.0)</b>
<b>Nontax Revenue &amp; Transfers</b>	<b>\$442.6</b>	<b>\$418.4</b>	<b>(\$24.2)</b>	<b>\$411.4</b>	<b>1.7</b>
<b>Total General Fund Revenue</b>	<b>\$9,835.3</b>	<b>\$9,636.1</b>	<b>(\$199.2)</b>	<b>\$10,110.7</b>	<b>(4.7)</b>

# FY 2014-15 Revenue Through December

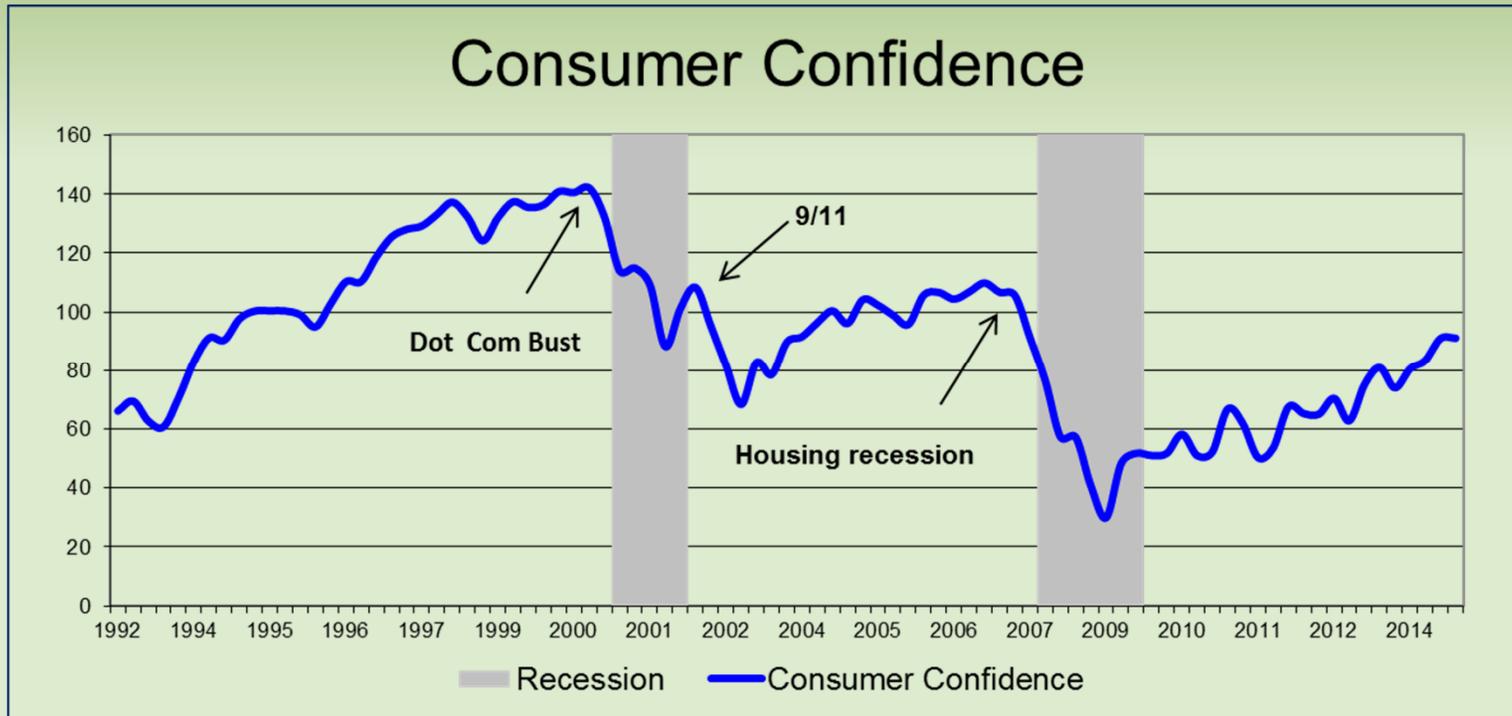
- The three main General Fund revenue sources, Personal and Corporate income tax and the Sales tax, have had mixed results the first half of the fiscal year.
  - **Sales** tax collections maintained the solid growth established earlier in the summer. Net collections (after refunds and transfers) were 14.1 percent above last year (baseline collections are up 6.2 percent, see page 5).
  - **Net Personal Income** withholding (collections less refunds) continue to underperform (see page 6). Growth is 3.4 percent below the revenue target and total income tax collections were 4.8 percent below target. Final payments on the 2013 tax year are below target, the remnants of the Federal fiscal cliff, which pulled income out of 2013.
  - **Corporate Income** taxes are performing better than expected with net collections \$57 million (11.9 percent) over target.

# Tracking Economy-Based Collections



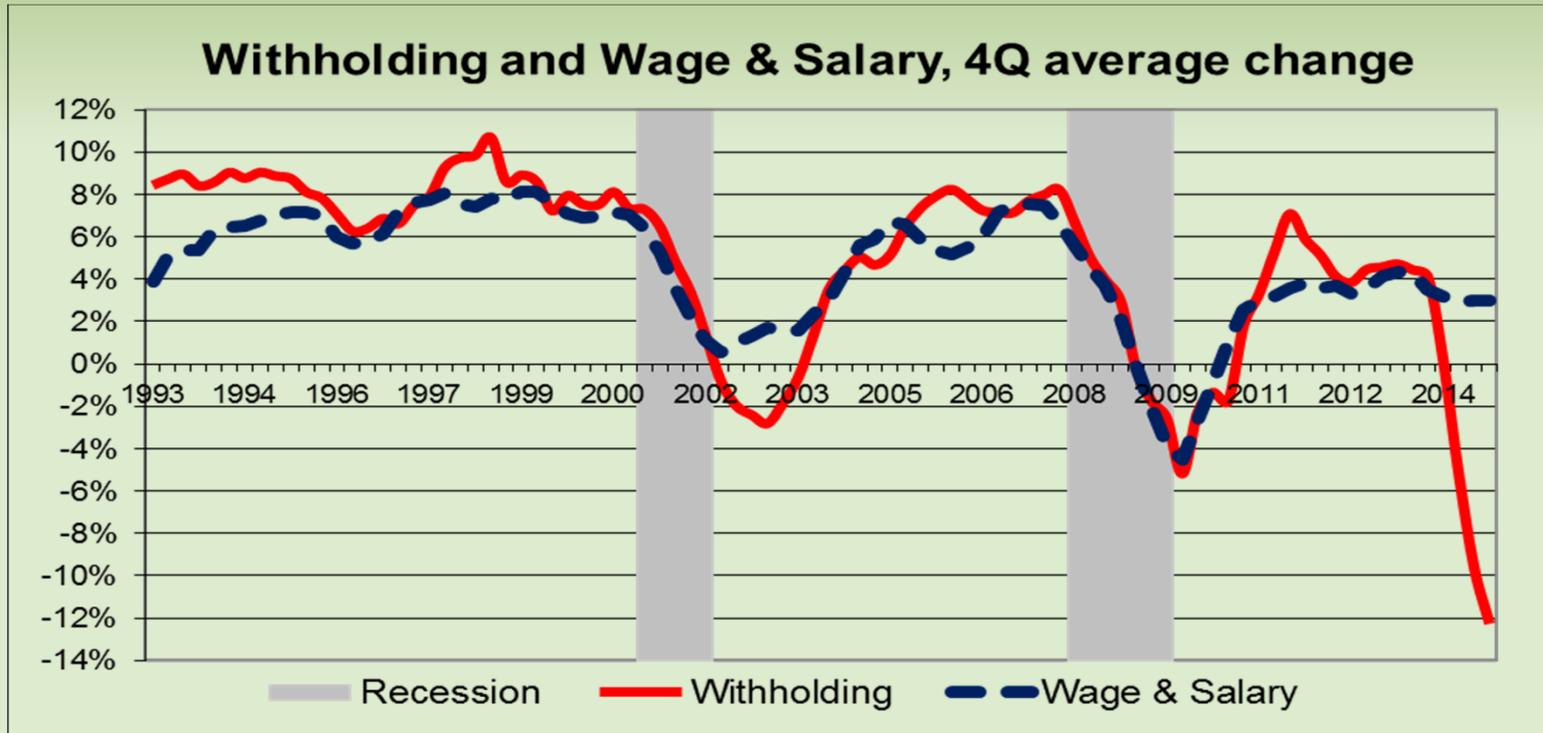
The year-over-year growth in the monthly baseline collections are averaged over four quarters. The dashed line at five percent is a proxy for when Sales taxes reflect better economic conditions. The first quarter of the fiscal year growth was a solid 6.0 percent. The second quarter saw further improvement with 6.4 percent growth, and pushed the 4-quarter average above five percent.

# Tracking Economy-Based Collections



Sales tax growth has been bolstered by a return of consumer confidence in the economy. An improving jobs market, better housing market conditions, and economic stability have switched consumers back from the savers they became during the recession, to buyers again. Although consumers are buying more, it remains below the exuberant pace prior to the recession.

# Tracking Economy-Based Collections



Net Withholding income growth (withholdings less refunds) dropped off dramatically from last year as a result of tax law changes in S.L. 2013-316. Even without the change net withholding would have weakened as wage and salary growth has dropped below three percent.

# Economic Outlook

- The economy has settled into a steady growth pattern. Most economists expect growth to remain near average, or slightly below, throughout 2015. The pace of the recovery has not created a robust job market; however, employment conditions have improved noticeably since this time last year.
  - A survey of 50 economists by the Wall Street Journal expects national economic growth will remain steady this year. Growth is projected between 2.8 and 2.9 percent. The survey also suggested most economists think inflation will be in check and the national unemployment rate will drop to 5.3 percent by year's end.
- Given that the national economy in 2015 is positioned for stable, sustained growth, the risks of small economic shocks curtailing the pace of growth have been greatly reduced.

# Economic Outlook

- The greatest economic risks come from a global economic downturn, as well as other international risks such as the ongoing volatility in the Middle East. Despite these risks, the chances for an economic downturn in the next six months are below 30 percent.
- Thus far, economic conditions including retail sales, economic output (GDP), and employment have aligned with expectations. Unfortunately wages have yet to respond.
- Prior to the recession in 2008, wages were growing above four percent. Data for this December indicate that wages grew by only 1.7 percent compared to a year ago.
- The labor market has seen marked improvement this past year, yet has still not fully recovered from the recession that ended five and a half years ago. If the pace of employment growth stays on track this year, it will greatly improve the prospects for stronger wage growth by 2016.

# Economic Outlook



Because the unemployment rate can at times be misleading with respect to economic conditions, we tend to focus on the level of employment and the rate of employment growth. The chart shows how total employment has recovered since the end of the recession. In October and November, employment surpassed the previous peak in February, 2008.

# Economic Outlook

- Economic conditions have mostly aligned with the revenue forecast produced last April, yet wages have lagged behind expectations.
  - Wages are expected to rise as the unemployment rate draws closer to a the full-employment level of five percent, but in the near-term, weak wage growth the first half of the fiscal year has made it more difficult for revenue collections to meet the FY 2014-15 consensus forecast.

## Changes in Economic Growth Forecast, April 2014 to December 2015

Economic Indicator	Actual FY2013-14	April 2014 Forecast FY2014-15	December 2014 Forecast FY2014-15
NC Gross State Product	2.7%	3.4%	3.2%
NC Total Non-Farm Employment	1.7%	1.8%	2.4%
NC Unemployment Rate	7.0%	6.6%	6.2%
NC Income: Total Personal	2.9%	4.8%	3.8%
NC Income: Wages & Salaries	3.4%	4.5%	2.6%
NC Retail Sales: Total	3.7%	5.9%	6.1%
NC Population	1.0%	1.2%	1.3%

Source: Fiscal Research Division, based on national and state forecasts provided by Moody's Analytics

# Economic Outlook

- The updated State indicators are consistent with the current revenue picture, especially the downgrade in personal income growth. Early projections for the upcoming biennium expect these growth trends to stabilize and wage income to rebound.
- Additionally, Dr. Mike Walden at NCSU publishes a monthly index of North Carolina's Leading Economic Indicators. The index forecasts the economy's direction four to six months from now. His December report states "the Index has been essentially constant, suggesting the pace of economic growth experienced in the state since mid-year will continue into early 2015."
- The revised outlook, especially for two key drivers that influence State revenue, employment and income, suggests that the new biennium should see stable employment growth with wage growth still facing headwinds until the labor market moves closer to full-employment status.

# Revenue Outlook

- When and how shifts in economic conditions will impact revenues are difficult to anticipate. This difficulty has been compounded by the significant tax laws changes enacted in the 2013 session (S.L. 2013-316). These changes began to impact collections in 2014.
- Despite extensive efforts to provide accurate estimates, North Carolina will not understand for several years the full fiscal implications of these myriad changes to the tax code, which exceeded \$1.5 billion per year.
- This increased uncertainty warrants greater caution when assessing the revenue picture for the next biennium.

# Revenue Outlook

- Some of the most significant and difficult tax changes to measure were those made to the personal income tax. Not only were rates reduced from a three tier system to a flat rate, but many deductions, exemptions, and credits were altered or eliminated.
- Some of the year-to-date shortfall in personal income tax collections may be due to these changes and should be offset by lower refunds and higher final payments in April.
- **These expectations on refunds and final payments put added pressure on April collections, an already important, and often volatile, collection month.**
- Because of this, April will be especially important in terms of how the State finishes this fiscal year and how we assess revenue forecasts for the next biennium.

# Revenue Outlook

- If this April meets our expectations, we do not expect the current shortfall to grow significantly, but the slower than expected wage growth will still contribute to collections not meeting the budget target.
- Turning to the next biennium, we do expect the State's economic growth to remain on a path of solid, modest growth similar to the overall national economy. Baseline revenues (adjusted for tax changes) should continue to follow this trend as they have the last several years.
- Currently lower gas prices are being assessed with respect to how long they will persist, and what, if any, impact on the overall economy can be expected. Most economist currently are not forecasting big changes to the national economy.

# Conclusion

- Revenue collections through December are two percent below the consensus target, income collections have fallen behind because of weak wage growth and reduced final payments on the 2013 tax year (the fiscal cliff).
- But for wages the economy is picking up steam and pressure on wage growth should begin to build. Wages may remain stagnant until the economy nears full-employment and the unemployment rate drops to five percent.
- Revenue projections have been complicated by over \$1.5 billion in annual tax changes. Most of these changes began to take effect in 2014.
- Expectation for the upcoming biennium indicate that steady economic growth throughout the period will produce *baseline* revenue projections that approach an average rate of growth. Actual growth will be muted somewhat with income tax rate reductions for both personal and corporate taxpayers in 2015.