



# NORTH CAROLINA GENERAL ASSEMBLY

## Legislative Services Office

George R. Hall, Legislative Services Officer

Fiscal Research Division  
300 N. Salisbury Street, Suite 619  
Raleigh, NC 27603-5925  
Tel. 919-733-4910 Fax 919-715-3589

Marilyn Chism, Director

April 13, 2010

### MEMORANDUM

**FROM:** Barry Boardman, Ph.D.  
Economist  
Fiscal Research Division

**SUBJECT:** General Fund Revenue Update

A revised **consensus** revenue forecast for FY 2010-11 has been reached between Fiscal Research and the Office of State Budget and Management. The notes below summarize the results of the consensus revenue estimating process.

#### Overall Revision Summary

The impact of the updated forecast is a **downward adjustment** to the FY 2010-11 General Fund revenue forecast as included in the 2009-11 Biennium Budget:

	<b>Biennium Forecast (adjusted by S.L. 2009-451)</b>	<b>Revised Revenues</b>	<b>Difference</b>
2009-10	\$18,926.7 million	\$18,535.7 million	(\$391.0 million)
2010-11	\$19,639.0 million	\$18,936.0 million*	(\$702.9 million)

\*An additional \$85 million reduction is likely because of the one-year expiration of the Federal Estate Tax.

#### Current Year Revenues

The estimated revenue shortfall for the current year is \$391 million. Continued weaknesses in the economy have suppressed employment growth and held back consumer spending. Both of these effects are impacting the two major sources of General Fund revenues, Personal Income Tax withholding and Sales Tax collections.

The May 2009 biennium forecast envisioned a stronger rebound in consumer spending and a slightly stronger rebound in employment and wages. The result is that the two key sources of revenue, Personal Income Tax and Sales Tax, are forecast to come in 3.6 percent and 5.8 percent below the biennium forecast projections, respectively. Another key revenue source, Corporate Income Tax, is expected to come in on target. In addition, an extra \$272 million more than expected was collected through a resolution payment initiative undertaken by the Department of Revenue. The net affect on Corporate Income Tax collections is estimated to be a 25.6 percent increase over forecast.

One caution regarding the current year shortfall is warranted. The consensus forecast does not take into account April final payments for the 2009 tax year and estimated payments for the current tax year. Every effort was taken to make a cautious, reasonable estimate of these key collections, which invariably lead to an “April surprise”. Given the unprecedented 40 percent decline in final payments last year, the additional 15 percent decline for this year was considered to be erring on the side of caution. A 15 percent decline this year would result in a total decline since the 2007 tax year in final payments of almost 50 percent. The revised forecast also reflects higher refunds on withholding than usual and is consistent with last year’s refund to withholdings ratio.

### **Revenue adjustment for 2010-11**

The FY 2010-11 revenue forecast is revised downward lowering the projection by \$702.9 million. In addition to the \$702.9 million adjustment, another \$85 million loss from the Estate Tax is anticipated. The State’s Estate Tax is tied to the federal internal revenue code referencing the federal estate tax, which expired January 1, 2010 (it is to be reinstated in 2011). In the absence of the federal tax no State tax will be collected. **Thus, the net impact on revenues for FY 2010-11 is expected to be \$787.9 million less than what was included in the biennium budget.**

There are two key reasons for the reduction in the forecast. The first is the lower base from which to increase revenue as a result of lower revenue collections for the current fiscal year. The second is the downgraded economic growth forecast for the nation and the State’s economy. The net outcome is baseline revenue collections (removing tax law changes) for FY 2009-10 have been lowered to a 4.5% year-over-year decline compared to a 2.2% decline forecast last May, and for FY 2010-11, the forecast downgraded growth from 3.3% to 2.7%.

The global financial market collapse in October 2008 sent an already contracting economy into a prolonged and severe recession and had a major impact on the State’s economy. The worst is behind us and a recovery is underway, but there is still a long way to go. Based on the latest surveys of national forecasters, as compiled by the Wall Street Journal and the Associated Press, indications are that the economic recovery will unfold very slowly and employment growth will remain sluggish throughout 2010. We agree with this slow growth scenario and do not expect a true expansionary economy with normal to above-normal growth until the second half of 2011 at the earliest.

Employment has always been a lagging economic indicator, not changing direction until well after the turn in the business cycle. Given the modest expectations for the recovery, any employment gains in North Carolina will be quite modest throughout 2010. Employment is closely tied to personal income and the slow growth scenario has dampened the prospects for income growth over the next fiscal year. The May 2009 forecast envisioned 2.4% growth in personal income for FY 2010-11. The revised forecast lowered the growth rate to 1.3%.

The poor employment picture has had a big impact on retail sales. The prolonged recession and slow recovery has pushed consumers into buying only what they have to buy and buying little of what they want to buy. Given that over 60 percent of consumers’ disposable income goes towards the purchase of services, much of what consumers are currently buying is not

in the State's Sales Tax base. Moreover, because the residential real estate market is still depressed, many of the purchases associated with growth in Sales Tax collections such as furniture and home appliances are still not being purchased. The result is current fiscal year baseline collections are expected to decline 7.5% following a 7.4% decline in FY 2008-09. Because of the weak employment outlook, weakness in the real estate market, and subsequently the low level of consumer confidence only 1.5% growth in Sales Tax collections is expected in FY 2010-11. This represents very little growth after two years of major declines and is a downward revision from 2.1% growth included in the biennium forecast.

Another key reason for a cautious revenue forecast are the volatile revenue sources including capital gains on stocks and real estate, and corporate income. We think these sources of revenue will remain depressed despite the recovery because many of these taxpayers will be able to carry forward the significant losses experienced during the recession. This will keep tax liabilities down even as these individuals and businesses begin to earn profits and gains from their investments.

Thus, the forecasting challenge is to acknowledge the long-term historical pattern of capital gains: a couple of years of steep declines are followed by super-growth, but this growth expectation will be offset with huge losses being carried forward over the next several years. For this reason the revised revenue forecast assumes another year of net losses eroding any gains with a 20% drop for the 2010 tax year and a cautious 5% increase in 2011.

Corporate profits are expected to increase through 2010 and be flat (less than 2% growth) in 2011. Corporate income can be very volatile with yearly swings by as much as 30% to 40%. Through March however, baseline corporate income tax collections were down less than 5%. For the upcoming fiscal year, these receipts will probably be flat, reflecting the very mild economic recovery. In addition, the losses from the lengthy recession will continue to be taken against the bottom line. One-time collections in FY 2009-10 from the resolution payment initiative did not significantly impact baseline collections going forward.

**Putting all these assumptions together leads to an estimated 2.2% growth in revenues in FY 2010-11.**

The revenue outlook for FY 2010-11 reflects a continuation of a weakened economy with only a mild, slowly developing recovery throughout 2010 and into 2011. Employment growth will continue to lag behind the recovery and revenue collections will lag behind the modest improvements in the employment picture. Therefore, a return to long term revenue growth patterns is not expected any earlier than late 2011.