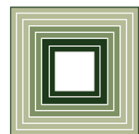


QUARTERLY GENERAL FUND REVENUE REPORT



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

Highlights

- General Fund collections through December are \$83.5 million above the revenue target of \$10.0 billion.
- Corporate income tax revenue is the main reason collections are ahead of target. Continued signs of weakness in wage and salary income tax withholding may be a cause for some concern.
- A steady, moderate growth pattern emerged in 2013 and is expected to be with us throughout the fiscal year. In 2014, most economic forecasts anticipate an improving economy with growth slightly below average.
- Employment growth, while showing signs of improving, has yet to advance like other parts of the economy. Developing strength in the national economy, as well as the global economy, should help the employment picture this year.

FY 2013-14 Revenue Through December

- General Fund revenue was \$83.5 million *above* the \$10.02 billion target for the first-half of the fiscal year.
- The second quarter of the fiscal year (Oct.-Dec.) was essentially on target with very little change to the \$80 million surplus established in the first quarter of the fiscal year.
 - Stronger than expected Corporate Income tax revenue (up almost \$90 million) is the main reason collections stayed ahead of target.
 - Total Personal Income collections were \$30.4 million *below* target; the result of wage and salary withholding running 1.2 percent below target for the year (\$60 million below a \$5.3 billion target).
 - Sales Tax collections were \$33.6 million *over* target; gross collections were up 4.4 percent over last year.
 - Other tax revenue was bolstered by unanticipated revenue of \$15.9 million in Estate tax collections. The revenue represents settlements from previous tax years. The Estate tax was repealed beginning with the 2013 tax year.

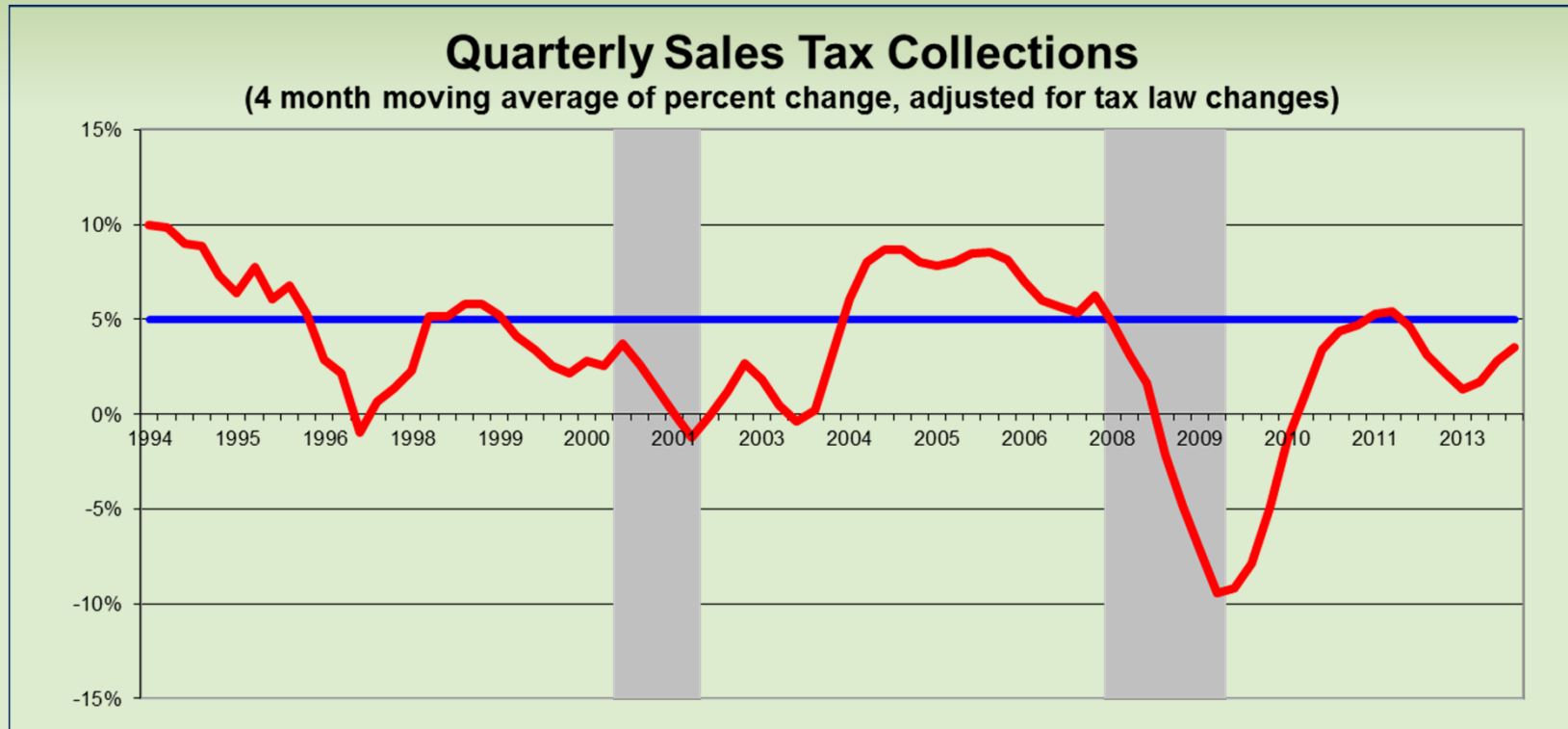
FY 2013-14 Revenue Through December

FISCAL YEAR-TO-DATE (millions)					
	Target	Actual	Target	Actual	Y/Y Pct.
Net Tax Revenue	2013-14	2013-14	Difference	2012-13	Change
Individual Income	\$5,550.4	\$5,520.0	(\$30.41)	\$5,412.4	2.0%
Sales and Use	\$2,738.3	\$2,771.9	\$33.62	\$2,662.9	4.1%
Corporate Income	\$494.9	\$584.5	\$89.63	\$436.5	33.9%
Franchise	\$274.8	\$270.2	(\$4.67)	\$274.8	-1.7%
Other Tax Revenue	529.9	551.2	\$21.31	573.0	-3.8%
Total Tax Revenue	\$9,588.4	\$9,697.9	\$109.5	\$9,359.6	3.6%
Nontax Revenue & Transfers	\$432.0	\$406.0	(\$26.0)	\$413.8	-1.9%
Total General Fund Revenue	\$10,020.4	\$10,103.9	\$83.5	\$9,773.3	3.4%

FY 2013-14 Revenue Through December

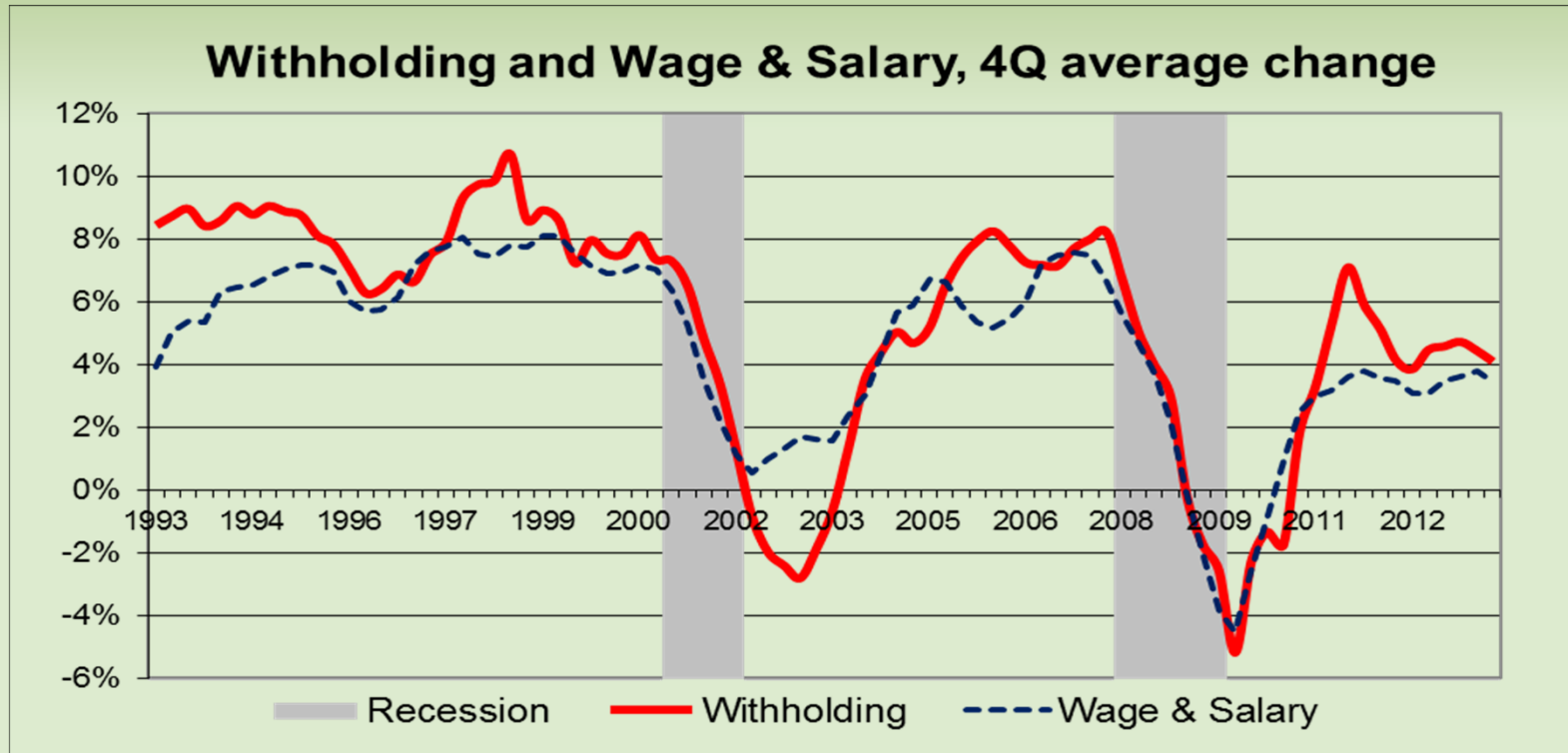
- Growth in key economy-based taxes, wage and salary withholding income tax, and the sales tax, are close to the forecast targets for the first half of the fiscal year.
 - Baseline Sales Tax growth maintained the solid growth established earlier in the summer and during the first quarter of the fiscal year. Net collections (after refunds and transfers) were 4.2 percent above last year (see page 5).
 - Net Personal Income withholding (collections less refunds) continue to grow, but the growth is nearly 2 percent below the revenue target and total income tax collections were a half percent below target with only 2.0 percent growth. Higher than expected estimated and final payments have offset the weakness in withholding collections. (see page 6)

Tracking Economy-Based Collections



The consensus forecast growth rate for the current fiscal year is 2.9 percent. In the first quarter growth was at a revised 3.9 percent, and second quarter growth was 4.1 percent.

Tracking Economy-Based Collections



Withholding income (the income tax on wages and salaries) improved the first-half of last year with 4.9 percent growth, but weakened in the second-half growing only 3.3 percent. The pace of growth will have to improve to meet the current fiscal year target of 4.3 percent.

Economic and Revenue Outlook

- The economic recovery has settled into solid albeit modest growth pattern. The start of 2014 has most economists expecting growth to remain slightly below average. While the pace of recovery may not create a robust job market, employment conditions are expected to improve throughout the year.
 - A survey of 50 economists by the Wall Street Journal on average expect national economic growth to remain between 2.5 and 2.9 percent during 2014. The survey also suggests most economists think inflation will be in check and the national unemployment rate will drop to 6.5 percent by the end of the year.
- Given that the national economy in 2014, is positioned for stronger, sustained growth, the risk from small economic shocks curtailing the rate of improvement has been greatly reduced.

Economic and Revenue Outlook

- Thus far, economic conditions and the resulting revenues have aligned with expectations, and the current economic forecast does not suggest any swings in revenue either up or down.
- Changes in economic conditions and their impact on revenues are often difficult to recognize. This difficulty will be exacerbated somewhat with new tax laws enacted this past session (S.L. 2013-316). The changes to the income taxes that broadened the tax base and lowered rates will result in changes to 2014 estimated payments in April and June, as well as changes to some taxpayers withholding amounts.
- While staff has worked to anticipate the fiscal impact of these changes, it nonetheless, will be trickier to discern movements in tax payments that are economy-based and not a result of tax law changes.
- The added uncertainty will warrant greater caution when assessing the revenue picture for this fiscal year and the next.

State's Economic Outlook

- The State's economy throughout the past year steadily gained strength. While we do not anticipate the pace of economic growth to significantly quicken in 2014, we do expect it to stay on a steady, upward trend.
- The table below has some key economic indicators for FY 2012-13, and what we expect in the current and upcoming fiscal years.

North Carolina Economic Indicators – Percent Change			
	FY2012-13	FY2013-14	FY2014-15
	Actual	Projected	Projected
State Gross Product	5.3%	4.5%	5.9%
Personal Income	3.6%	5.2%	6.0%
Wages & Salaries	3.4%	5.3%	6.1%
Retail Sales	6.3%	6.1%	6.5%
Unemployment Rate	9.3%	7.9%	7.3%
Employment (Nonagricultural)	1.7%	2.0%	2.2%
Population	1.5%	1.8%	2.1%
Existing Single-family Home Sales	20.5%	7.9%	3.1%

State's Economic Outlook

- Economic activity in the State as measured by the Gross State Product has picked up pace, and the State is now outperforming the US as a whole.
- Personal Income, particularly wages, have not reflected the advancement in overall economic activity but is forecast to grow at a six percent pace in FY 2014-15
- The rate of payroll employment growth is expected to reach two percent this year. This would add as many as 85,000 to 95,000 jobs next year. The unemployment rate has fallen dramatically in the past several months (1.5 percentage points since July), but the rate may not continue to fall if, as in past job recoveries, improving economic conditions encourage people to re-enter the labor force.

State's Economic Outlook

- Additionally, Dr. Mike Walden at NCSU publishes a monthly index of North Carolina's Leading Economic Indicators. The index provides a forecast of the direction the economy may be heading four to six months from now. His December report states "increases in the index are signaling a noticeably stronger economy for the State in the new year."
- These updated indicators for the State remain consistent with the economic expectations built into the consensus revenue forecast for this and the upcoming fiscal year.
- The newly revised outlook is consistent with our expectations for the economy, especially for two key drivers that influence State revenue: employment and income.

State's Economic Outlook

- The rest of the report will look more closely at these two key economic components of the State's economy and how some related statistics can, at times, be misleading.
- Two common economic statistics used to gauge the health of an economy are **per capita income** and the **unemployment rate**. Both are generally useful, but they can prove to be misleading or at best they don't tell the whole story much of the time.
 - For revenue forecasting purposes we focus on employment and income levels rather than rates such as income per person or number of unemployed as a percent of the work force.

Per capita Income

- Per capita income is simply total personal income divided by the total population in the State, which includes children, working adults, and retirees.
- There are three main components to Personal income.

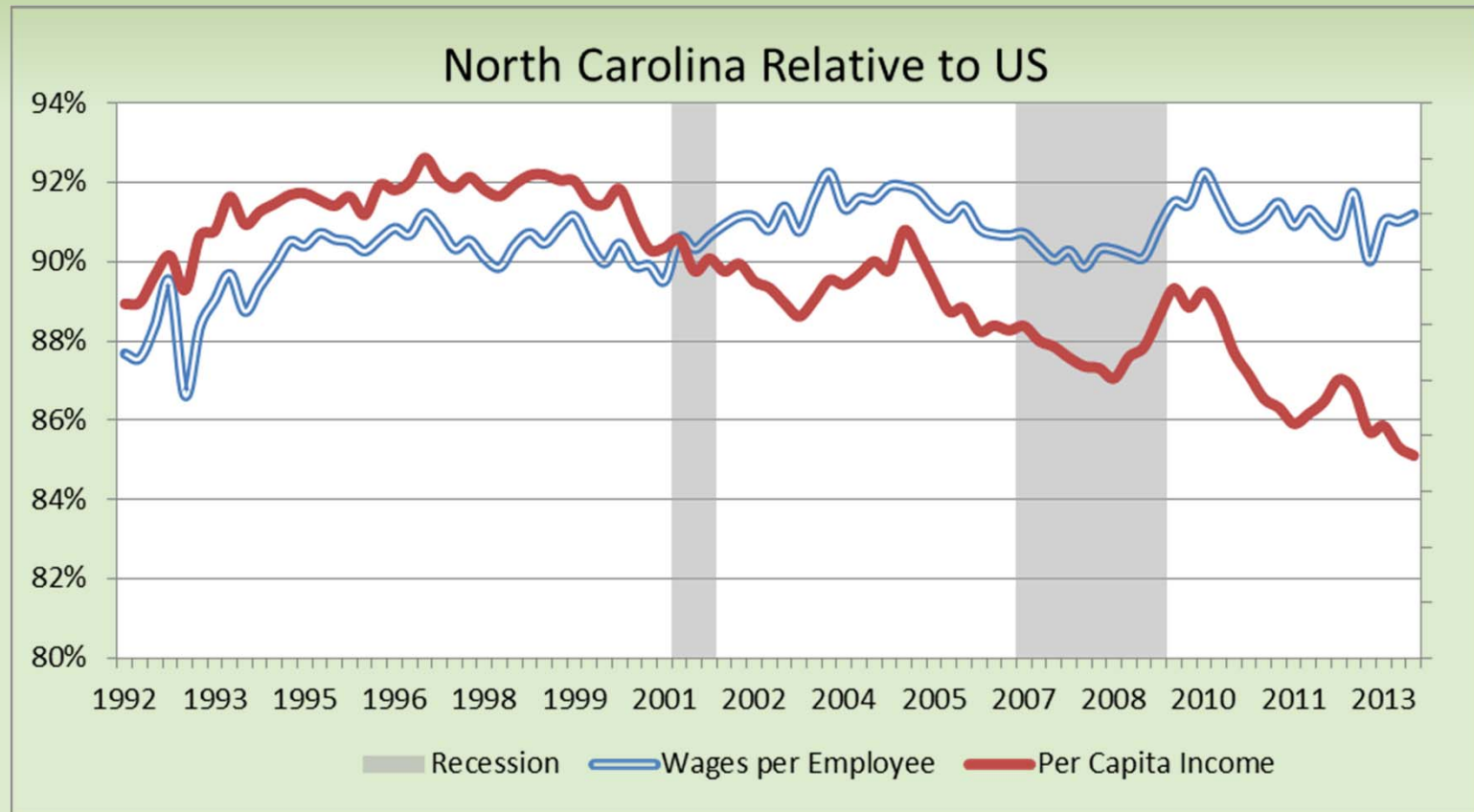
State's Economic Outlook

- The three components of personal income are (with the share of total income in parentheses, 2012):
 - **Earned Income** (62.9%) – traditional income from labor including salaries and bonuses
 - **Property Income** (17.2%)– payments in the form of dividends, interest, and rents from the use of capital
 - **Transfer Payments** (19.9%) – Social Security income, Medicare payments, Medicaid payments, and Veterans Benefits are the main components.
- The share of income derived from these components have shifted over the years, and in the last decade transfer payments have grown, while the share of earned income has fallen. As much as anything this shift is a result of demographic changes.

State's Economic Outlook

- A concern of late has been the decline in the State's per capita personal income relative to the US. This decline in relative per capita income *if it implies a worsening of worker pay compared to the nation* would be cause for concern.
- In order to confirm both the decline in relative personal income and to measure relative worker pay, we compiled data from June 1992 to June 2013 for both the State and the US. The data included total personal income, wage and salary income, total non-agricultural employment, and population.
- To measure worker pay we divided total wage and salary income by the number of total payroll, non-agricultural employees. The graph on the following page shows how these two income measures for the State have changed relative to the US.

State's Economic Outlook



Each line in the graph represents the State's income relative to the US.

State's Economic Outlook

- From the graph we can see that since the beginning of the last decade, per capita income has been on a slow, steady decline relative to the US.
- As mentioned earlier, if this was a result of falling wages relative to US wages, then this would be troublesome.
- The chart however, shows that the average wage per employee has been holding steady since it increased in the mid-1990s.
- The main culprit for the drop-off in relative per capita income appears to be demographics.

State's Economic Outlook

- From 2000 to 2010, US Census data shows that North Carolina's population grew at nearly twice the pace of the US and the percent of children under the age of 18 and the elderly (65 or older) increased in NC, while it was falling in the US.
- These population trends indicate that more of the State's income was spread across more children and nonworking elderly, and would therefore, lower the State's per capita income relative to the US.
- Because income data includes more than just wages, and the way population demographics can influence per capita calculations, using per capita income to compare the State with the US or another state has the potential to be misleading.

State's Economic Outlook

The Unemployment Rate

- Employment is another key driver of General Fund revenues and is also an important focus of policymakers in the State.
- Unfortunately, using the unemployment rate to assess economic conditions may not always be helpful.
- While this report, as with many others, tends to focus on the unemployment rate, it can be a deceptive measure for understanding the improvement of a state or nation's employment.
- As implied, the unemployment rate is a ratio, and needs to be understood with respect to its components: labor force size, total number employed, and the difference between the two - the unemployed.

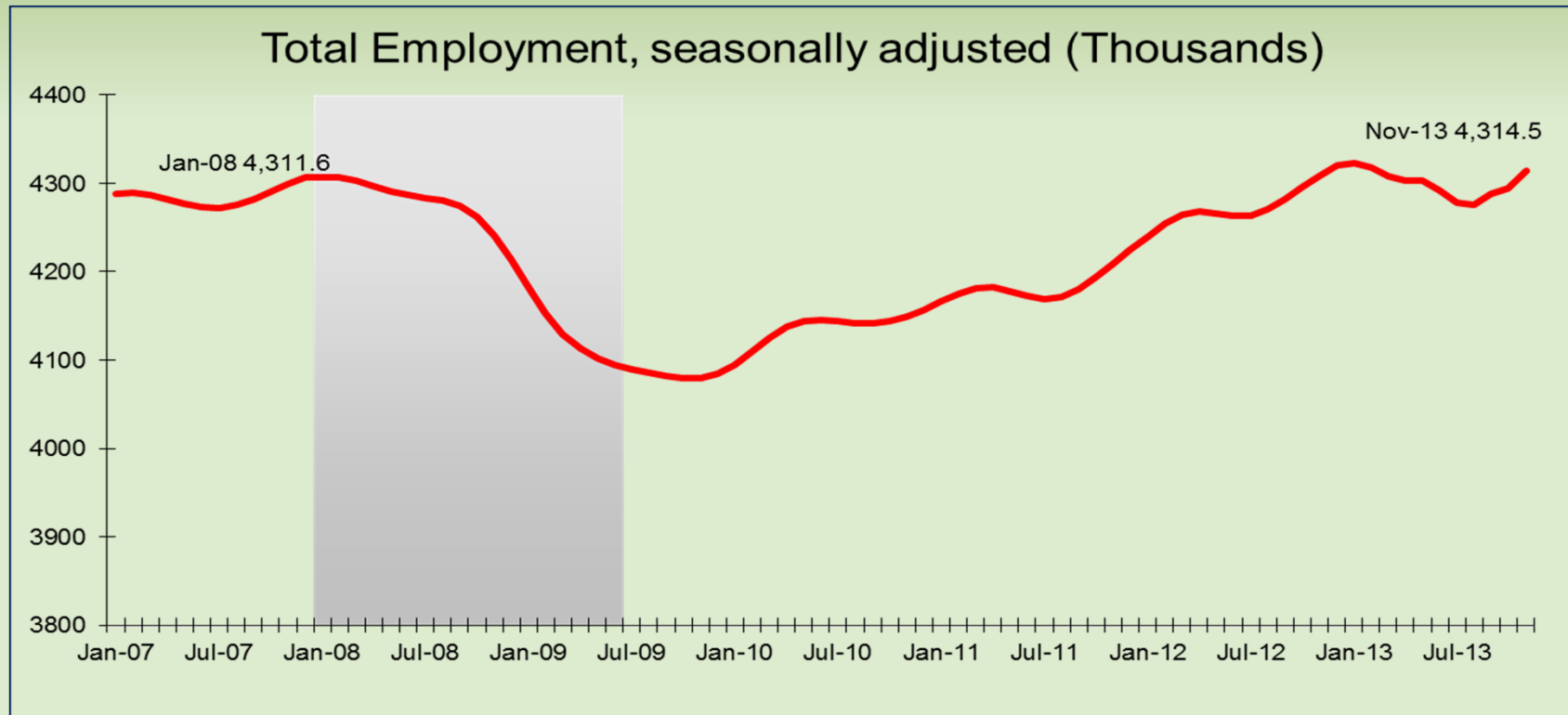
State's Economic Outlook

- Both the number of unemployed and the number in the labor force can change at the same time. Thus, understanding the change in the rate requires an analysis of both factors.
 - For example a large increase in the labor force with only a modest increase in the number employed would cause the unemployment rate to increase even though total employment had increased.
- It is these types of changes to more than one component of the unemployment rate that has recently made it difficult to interpret the decline in the State's unemployment rate.
- Compared to November 2012, the number employed in the State this November had only increased by 6,082 (a 0.14 percent increase). Despite the modest increase, the unemployment rate fell from 9.4 percent the previous November to 7.4 percent.

State's Economic Outlook

- A growth in employment of 6,000 jobs is not enough to reduce the unemployment rate by two percentage points. The rate fell primarily because the number of people in the labor force decreased.
- Since last November, the labor force shrank by just over 95,000 people, and the participation rate (the labor force as a percent of the adult population) fell over the same period from 63.2 percent to 61.3 percent. Prior to the onset of the Great Recession, by comparison, the participation rate was 65.2 percent.
- While the drop in the unemployment rate couldn't be fully attributed to job growth, the good news is that household employment has improved and has returned to the pre-recession employment levels seen in 2007.
 - Despite the recent decline in the labor force, it is still larger than it was in 2007; and in November, the unemployment rate was 2.5 percentage points higher than in 2007.

State's 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.

Conclusion

- Revenue collections for the first-half of the fiscal year are slightly above the consensus target, and were essentially on target the second quarter.
- The first half of the fiscal year has provided mixed results. Personal Income tax withholding on wages was below target. Sales tax collections are slightly ahead, and Corporate Income tax payments are well ahead of target.
- The national economy continues to strengthen, yet the pace of growth remains below average. The economy is entering a more sustainable phase; therefore, we are less susceptible to economic and policy shocks than we were a year ago.
- Given the recently enacted tax laws affecting 2014, there will be added uncertainty to any swings in revenue collections. This will warrant greater caution when assessing the revenue picture for this fiscal year and the next.