NORTH CAROLINA GENERAL ASSEMBLY

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February 11, 2013

MEMORANDUM

TO: North Carolina General Assembly

FROM: Barry Boardman, Ph.D., Fiscal Research Division; Nathan Knuffman, Office of State Budget and Management

SUBJECT: General Fund Revenue Consensus Forecast

Fiscal Research and the Office of State Budget and Management have reached a consensus on the revenue forecast for the 2013-15 biennium. The notes below summarize the results of the consensus forecast.

Forecast Summary

The forecast expects FY 2012-13 collections to exceed the budgeted amount by $102.6 million and for modest growth to occur during the next biennium off this slightly higher base:

Revenues (millions)		**Change (millions)**
2012-13	$20,106.6*	
2013-14	$20,567.1*	$460.5
2012-13	$21,513.6*	$946.5

*Revenue estimates incorporate the effects on North Carolina taxpayers from the recent changes to the Federal Internal Revenue Code as they are to be amended by pending legislation (HB82/SB64).

Given the uncertainty surrounding the pace of growth in the economy, the forecast adopts a more cautious approach. This approach is particularly prudent with the persistent weaknesses and instability of the global economy, as well as the slow-moving improvements in employment. At no time during the biennium are baseline revenues (collections adjusted for tax rate and base changes) expected to grow faster than the long-term average of 5.5 percent. Quite often during an expansionary economy revenue growth has exceeded nine percent. The forecast ruled out the possibility of a full-blown economic expansion at any point during the biennium.

Added Revenue Volatility

While the forecast used a cautious approach, risks persist with respect to the current year's forecast. The threat of higher federal taxes from the "fiscal cliff" policy outcomes along with the new $50,000 business exemption has added volatility to collections that will culminate with the April 15th tax filings. Because one of the possible outcomes from federal "fiscal cliff" negotiations was higher marginal tax rates, many taxpayers chose to pull taxable income into the 2012 tax year. Much of this income is in the form of dividends and capital gains. In addition to this shift in taxable income, starting with the 2012 tax year taxpayers with business income may deduct the first $50,000 of business income when computing their North Carolina personal income tax. Many taxpayers have yet to adjust their tax payments, which means final payments and refunds in April will be affected, as will estimated payments for the 2013 tax year. These sources of income - dividends, capital gains, and business income- can result in sizable swings in income tax collections. This added volatility compounds the difficulty in estimating net revenue from April 15th tax returns.

Current Year Revenues

(1) The estimated **revenue surplus** for the current year is $102.6 million above the $20,004.0 billion budgeted amount. General Fund collections are forecast to increase 2.9 percent over the amount collected in FY 2011-12**.** Because of the business income tax exemption, the 2.9 percent growth rate is somewhat misleading. The exemption is expected to lower revenues by over $400 million this fiscal year. Net baseline tax collections are forecast to grow 5.2 percent. That compares to the budget forecast that envisioned 4.2 percent growth in tax revenue.

(2) Sales tax growth remains weak and is now estimated at 2.3 percent below the budgeted amount. Increased refunds from non-profits and local governments are also keeping growth below three percent. There are two reasons for lower than expected growth. First, collections slowed considerably this summer and into the fall as the economy appeared to stall and consumers grew more cautious. A second reason is retail sales are expected to slow the second-half of the fiscal year, resulting from reduced disposable income from the two percent Federal payroll tax break ending in 2012.

(3) The personal income tax is estimated to beat the forecast by 1.3 percent this year. Unlike the sales tax, personal income taxes have remained solid with growth in wage withholding revenue running nearly one percentage point above forecast for the first seven months of the fiscal year.

(4) This forecast recognizes that the economy remains in a slow, steady growth pattern, yet much uncertainty still resides in April, when final payments from the previous tax year and estimated payments based on the experience of last year are made. Further complicating the forecast are expectations for elevated refunds, a result of the business income exemption.

Outlook for the 2013-15 Biennium

(1) The economy has yet to enter into an expansionary phase of the business cycle. Since the end of the Great Recession in 2009, the economy has remained in a slow-growth recovery phase. The housing market downturn, which spread throughout the economy during 2008, is only now showing signs of improvement. Nearly five years after the onset of the housing market collapse, housing continues to be a drag on economic growth. State and national forecasters have begun to upgrade their forecasts for the housing market as more and more positive economic data is being reported. Improving housing market forecasts are expected to impact the overall economy helping to fuel economy-wide improvement as we approach 2014. While robust expansionary growth may be 18 to 24 months away, solid, sustained growth is anticipated throughout the biennium. These forecasts for improving economic conditions influenced the revenue forecast, but we chose to take a more cautious approach than some recent economic forecasts might suggest would be warranted.

(2) Employment has always been a lagging economic indicator, not changing direction until well after the turn in the business cycle. The sluggish, lengthy recovery has exacerbated that tendency and significant gains in employment have yet to occur. The employment outlook for the state has stabilized and gradual improvement is anticipated. Employment is expected to experience gains of 1.5 percent the first year of the biennium, which compares to growth of only 0.9 percent expected this fiscal year. By the end of FY 2014-15, as many as 145,000 new jobs are projected. Gains in employment are expected to pick up pace the second-half 2013. New claims for unemployment insurance have slowed to resemble pre-recession levels, suggesting that the basis for stronger employment growth is in place.

(3) Employment is closely tied to personal income and extensive employment losses have ended, thus improving the prospects for income growth over the biennium. The consensus forecast envisions 4.4 percent and 4.5 percent growth in personal income collections for the respective fiscal years. Those numbers are built primarily on the anticipation of increased employment. Additionally, twenty percent of personal income tax collections come from non-withholding such as investments and business income. For 2013, the forecast expects little growth in non-withholding despite the ongoing strength in equity markets and business profits. Taxpayers taking gains and dividends in 2012 will offset part of the growth normally expected from these sources.

(4) Sales tax collections are forecast to increase by 2.7 percent and 4.3 percent, respectively this biennium. These are very modest growth rates and are below average growth. Several factors are influencing the forecast. The recessed housing market has yet to rebound and the result is many household balance sheets remain out of balance. Any improvements in household finances have occurred by reducing household debt and increased savings. While both are good for the economy long-term, they will suppress retail sales during the transition. Additionally, while the employment market has stabilized, unemployment remains elevated and consumer confidence remains low. Consumer confidence is projected to remain below pre-recession confidence throughout the biennium. The result is sales will lag behind improvements elsewhere in the economy.

(5) Corporate profits are expected to grow by 9.2 percent over the next biennium. Corporate income tax collections are always very volatile with yearly swings by as much as 30 percent to 35 percent. For the upcoming biennium, these receipts are expected to be relatively flat in the first year. Growth is forecast at 0.1 percent, reflecting the mild economic recovery, plus the losses from the lengthy recession that continue to be taken against the bottom line. The second year of the biennium, corporate tax receipts are expected to grow by 5.5 percent, which is slightly below the long run average growth. Another business tax, the Franchise Tax, declined significantly during the recession with a baseline drop estimated at 12.8 percent. The key reason is that an important basis for calculating the tax base, capital stock, declined significantly during the recession. Some of the reduction in the base has returned, but the forecast expects very little additional growth in the tax base mostly because the formation of new businesses subject to the tax is forecast to be limited (only C-corporations and S-corporations pay the tax). During the biennium, the forecast projects growth in collections of 0.4 percent and 1.1 percent, respectively.

(6) **Putting all these assumptions together leads to a 3.6 percent higher baseline of General Fund revenues in 2013-14, and 4.1 percent growth in 2014-15.** The following table provides a comparison of baseline growths starting in FY 2007-08.

Fiscal Year	Baseline Growth Rate (Percent)
2007-08	5.4
2008-09	(11.2)
2009-10	(5.5)
2010-11	5.4
2011-12	6.2
2012-13 (e)	5.2
2013-14 (e)	3.6
2014-15 (e)	4.1

(7) The revenue outlook for the 2013-15 biennium reflects a continuation of the weak economic recovery persisting well into 2013 and the pace does not change significantly until 2015. Employment growth will continue to lag behind the pace of the recovery; yet will show continued improvement throughout the biennium as most employment markets stabilize. The forecast was necessarily cautious given these economic conditions in the State, the nation, and globally. Nonetheless, the forecast envisions the pace of growth to accelerate markedly in the second-half of 2014, with the State's growth in economic activity outpacing the nation as a whole by 2015.

Key Economic Indicators: Growth Forecast

	FY2012-13	**FY2013-14**	**FY2014-15**
NC Gross State Product	4.5%	4.5%	5.2%
NC Employment: Total Nonagricultural	0.9%	1.5%	2.1%
NC Unemployment Rate	9.6%	8.6%	8.2%
NC Income: Total Personal	5.2%	3.5%	4.9%
NC Income: Wages & Salaries	3.4%	3.9%	5.1%
NC Retail Sales: Total	2.9%	3.6%	5.8%
NC Average Hourly Earnings: Mfg.	-1.0%	-0.2%	1.6%
NC Population	1.3%	1.4%	1.6%
US Consumer Confidence Index	66.60	70.78	70.64

Source: Developed by Fiscal Research and OSBM using forecasts from Moody's Analytics Economy. Com and IHS Global Insight