



NORTH CAROLINA GENERAL ASSEMBLY

Legislative Services Office

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MEMORANDUM

TO: North Carolina General Assembly

FROM: Barry Boardman, Ph.D. Nathan Knuffman
Fiscal Research Division 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 2015-17 biennium. The notes below summarize the forecast.

Forecast Summary

The forecast expects FY 2014-15 collections to be below the budgeted amount by \$271 million (down 1.3 percent) and for modest growth to occur during the next biennium. For additional context, the median forecast error since 1987 is 2.5 percent.¹ The anticipated shortfall is predominately the result of slower than expected wage growth.

Fiscal Year	Revenues (millions)	Change (millions)
2013-14	\$20,143.7	
2014-15(e)	\$20,730.1	\$586.4
2015-16(e)	\$21,409.9	\$679.8
2016-17(e)	\$22,296.6	\$886.7

Given the uncertainty surrounding the fiscal implication of major tax code changes (SL. 2013-316), which affected over \$2 billion in revenue items this fiscal year; the forecast adopts a very cautious approach. This approach is further warranted given the persistent weaknesses in wage growth and the ongoing instability of the global economy. At no time during the biennium are baseline revenues (i.e., collections adjusted for tax rate and base changes) forecast to grow faster than the long-term average of five percent. Quite often during an expansionary economy revenue growth is well above five percent.

¹ Pew Center on the States and The Nelson A. Rockefeller Institute of Government, *States' Revenue Estimating: Cracks in the Crystal Ball*, March 2011.

While the forecast took a cautious approach, risks persist with respect to the current year's forecast. **The key underlying assumption is that due to tax code changes, April 15th tax filings will result in lower refunds and higher final payments by individual income taxpayers.** Starting with the 2014 tax year, income tax rates were lowered reducing withholding on wages, but the tax base was broadened primarily by limiting itemized deductions and eliminating the business income deduction of the first \$50,000 of business income. The business deduction was allowed in 2012 and 2013. Many taxpayers have yet to fully adjust their tax payments, which means final payments and refunds in April will be affected, as will estimated payments for the 2015 tax year. April always has the potential to be a volatile collection month where sources of income from dividends, capital gains, and business income can result in sizable swings in income tax collections. The added volatility from tax code changes compounds the difficulty in estimating net revenue from April 15th tax returns.

Current Year Revenues

- (1) General Fund revenues are forecast to increase by 2.9 percent over the amount collected in FY 2013-14. This is below the four percent growth that was forecast in May 2014. The result is an estimated revenue shortfall of \$271 million below the \$21 billion budgeted amount for the current fiscal year (1.3% below forecast).
- (2) Sales tax growth has improved and revenues are now estimated at 2.3 percent above the budgeted forecast. Sales tax collections began to gain momentum this past spring, and as consumer confidence grew Sales tax collection accelerated. The Consumer Confidence Index, which measures how optimistic consumers are about the economy, has increased nearly twenty percent this fiscal year. Lower gas pump prices are also providing some support for higher retail sales.
- (3) Personal income tax collections are estimated to fall *below* the forecast by 3.8 percent this year. Unlike the Sales tax, Personal Income tax growth has not strengthened. Wage growth is expected to be 1.6 percentage points below forecast and withholding revenue is running nearly four percentage points below forecast for the first seven months of the fiscal year. The anticipated shortfall this fiscal year is predominately the result of weak wage growth.
- (4) This forecast recognizes that the economy remains in a moderate, steady growth pattern, but that much uncertainty still resides in April. In April, final income payments and refunds from the previous tax year are settled, and estimated income payments based on the current tax year's expectations are made. Further complicating this year's forecast are expected changes to refunds and final payments, a result of changes to the Personal Income tax withholding tables from changes to the tax rate structure, plus measures taken to broaden the income tax base.

Outlook for the 2015-17 Biennium

- (1) The economy has steadily improved during the current expansionary phase of the business cycle. However, since the end of the Great Recession in 2009, the economy has never gained sufficient momentum to enter a robust growth phase. Employment numbers have finally caught up to where we were seven years ago, prior to the onset of the Great Recession. Despite the steady gains in the economy, State and national forecasters continue to expect the growth in overall economic activity to remain at or slightly below average. While robust expansionary growth is not expected, solid, steady growth is anticipated throughout the biennium. These forecasts for continued moderate economic conditions influenced the revenue forecast, and suggest that cautious projections remain prudent.
- (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 of the last five years exacerbated that tendency, and only now are we beginning to see positive momentum in employment. The employment outlook for the state has stabilized and further improvement is anticipated. Employment is expected to experience gains of 2.3 percent the first year of the biennium, which compares to growth of 2.4 percent expected this fiscal year. Non-farm employment is forecast to net 85,000 to 95,000 jobs in each fiscal year.
- (3) Employment is closely tied to personal income, and projected employment gains should improve the prospects for better income growth over the biennium. The consensus forecast envisions 3.7 percent and 4.5 percent growth in personal income collections for the respective fiscal years. Those numbers are built primarily on the anticipation of employment gains placing upward pressure on wages. Wage and salary growth has been well below expectations by not keeping pace with the improving overall economy.
- (4) Sales tax collections are forecast to increase by 5.2 percent and 5.1 percent, respectively this biennium. Growth is projected to be slightly above average. Several factors influence the forecast. Household balance sheets have improved over the last several years and consumers are more confident about making spending decisions. Additionally, lower energy prices, which are expected to persist into 2016, will free up income for other purchases.
- (5) Corporate Income tax collections are always volatile with yearly swings by as much as 30 to 35 percent. After several years of double-digit growth, corporate profits are expected to moderate over the next several years. The 5.5 percent growth expected over the biennium will be offset by recently-enacted Corporate Income tax rate reductions. The 6.9 percent tax rate from 2013 was lowered to six percent in 2014 and will drop again to five percent in 2015. The result is that net Corporate Income tax collections will fall 5.7 percent in the upcoming fiscal year and grow by 1.3 percent in the following year.

- (6) **Putting all these assumptions together yields 3.9 percent baseline growth of General Fund revenues in 2015-16 and 4.1 percent growth in 2016-17.** The following table compares baseline actual and expected growth rates over the past decade.

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	7.3
2013-14	1.8
2014-15 (e)	2.3
2015-16 (e)	3.9
2016-17 (e)	4.1

- (7) The revenue outlook for the 2015-17 biennium reflects a continuation of moderate, steady economic growth. Employment growth will continue to show improvement throughout the biennium as employment markets stabilize. Concern along the economic front continues as global economic weakness and social instability continue to keep risks elevated. Nonetheless, the forecast envisions the pace of growth to remain stable in 2015 and into 2016, with the State's growth in economic activity keeping pace with the nation as a whole. Below are key income indicators that influenced the forecast.

KEY ECONOMIC INDICATORS

Economic Indicator	January 2015 Forecast FY 2014-15	January 2015 Forecast FY 2015-16	January 2015 Forecast FY 2016-17
NC Real Gross State Product	3.0%	3.1%	3.5%
NC Total Non-Farm Employment	2.4%	2.3%	2.0%
NC Unemployment Rate	6.2%	5.7%	5.5%
NC Income: Total Personal	3.8%	4.1%	4.7%
NC Income: Wages & Salaries	3.5%	4.3%	4.5%
NC Retail Sales: Total	5.0%	5.7%	5.8%
NC Population	1.2%	1.3%	1.5%
Consumer Confidence Index	94.0	96.0	97.8

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