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MEMORANDUM

TO: North Carolina General Assembly

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

SUBJECT: General Fund Revenue Update

A **consensus** revenue forecast for the 2011-13 biennium 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.

Forecast Summary

The forecast expects FY 2010-11 collections to exceed the budgeted amount by $156.4 million and for modest growth to occur during the next biennium off this slightly higher base:

	Revenues (millions)	Change (millions)
2010-11	$19,134.2	
2011-12	$18,822.6*	($311.6)
2012-13	$19,884.1*	$1,061.5

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*An additional $80 million reduction is likely because of changes to the Federal Estate Tax in 2011 and 2012. The Federal changes will reduce the number of estates with a State Estate Tax liability. The decline in FY 2011-12 revenue is the direct result of expiring temporary tax increases.

Given the uncertainty surrounding the pace of growth in the economy, the consensus forecasters took a cautious approach. This approach seemed particularly prudent with the ongoing weaknesses and instability in the housing and employment markets. At no time during the biennium are revenues expected to grow faster than the long term average of 5.7 percent. Quite often in a full expansionary economy revenue growth can exceed 9 percent. The forecast ruled out the possibility of a full-blown economic expansion throughout the biennium.

Budget Gap

A recent publication by Fiscal Research estimated the potential size of the budget gap for FY 2011-12[1]. The size of the budget gap was a function of expiring tax increases, the end of federal stimulus dollars, and both mandatory and discretionary spending pressures. One component of the budget gap was an assumption on General Fund revenue for FY 2011-12. The estimate assumed that revenue would grow by $700 million off of a base of $17.5 billion. Thus, General Fund revenue was estimated at $18.2 billion. The new consensus forecast has increased both the revenue base and the rate of growth that was used in the estimate. The result is General Fund revenues will be approximately $600 million higher than what was used to originally estimate the budget gap.

Current Year Revenues

(1) The estimated **revenue surplus** for the current year is $156.4 million above the $18,977.8 billion budgeted amount. General Fund collections are forecast to increase 2.7 percent over the amount collected in FY 2009-10**.** The 2.7 percent growth rate is quite modest, and is reflective of the very sluggish economic recovery.

(2) Key revenue sources have now strung together six months of positive collection growth and January saw a continuation of that trend. The result is net baseline tax collections are forecast to grow 3.1 percent. That compares to the original budget forecast that envisioned 2.8 percent growth in tax revenue.

(3) Sales tax growth is now estimated at nearly six percent above the budgeted amount. There are two reasons for the higher than expected growth rate. First, collections at the end of FY 2009-10 were higher than anticipated when the budget numbers were being crafted. The second reason is the growth of this tax has picked up considerably beginning the second quarter of this fiscal year. Baseline sales tax collections for the year are expected to finish up 1.5 percent over last year. Larger than expected refunds from non-profits and local governments are keeping the overall growth rate below 2 percent.

(4) The personal income tax is forecast to fall by 0.5 percent this year. Unlike the Sales Tax, personal income taxes were lower than expected in FY 2009-10, thus growth was off of a lower base than originally projected. Despite coming off a base nearly 1.5 percent lower, growth in withholding collections will make up most of the difference.

(5) This forecast does recognize that the economy is at a turning point making the swings in volatile collections difficult to forecast. In many years a “ballooning” effect can occur during April as final payments from the previous tax year come due and estimated payments based on the experience of last year are made. Further complicating the forecast are expectations for refunds, which have been running much higher than in typical years. The consensus forecast expects refunds to remain elevated, but not by as high a margin as in the past two years.

[1] “North Carolina’s FY 2011-12 Budget Gap”, Fiscal Brief, Fiscal Research Division of the North Carolina General Assembly, December 7, 2010.

Outlook for the 2009-11 Biennium

(1) The recession that began in December 2007, technically ended in June 2009. The recovery phase coming out of the recession has lasted 19 months and we are just now on the cusp of entering the expansionary phase of the business cycle. The housing market downturn, which spread throughout the economy during 2008, combined with the global financial market collapse in October 2008 sent the economy into a prolonged and severe recession. Thirty-eight months after the onset of the recession the housing market has yet to fully heal and the financial sector, while gaining solid footing, is still susceptible to weaknesses. Nonetheless, State and national forecasters have been upgrading their forecasts with more and more positive economic data being reported. These forecasts expect the economy to show ever increasing improvement throughout 2011. While robust expansionary growth may be 18 to 24 months away, solid, sustained growth is anticipated throughout the biennium. The revenue forecast was influenced by improving economic conditions, but forecasters chose to take a much more cautious approach than some recent forecasts might suggest is 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 may not begin until the end of 2011. Thus, despite improvements along many economic fronts, the employment outlook for the state has not been upgraded. Employment is expected to experience gains close to two percent each year of the biennium, adding as many as 175,000 new jobs by the end of FY 2012-13. The majority of these gains will start to occur in the second half of 2011. Even with the two percent growth, the State is forecast to have 100,000 fewer jobs than at the onset of the Great Recession.

(3) Employment is closely tied to personal income and extensive employment losses from layoffs and cutbacks by key businesses such as the financial sector have ended, thus improving the prospects for income growth over the biennium. The consensus forecast envisions 4.4 percent and 6.5 percent growth in personal income for the respective fiscal years. Those numbers are built primarily on the anticipation of modest employment and wage growth. Additionally, twenty percent of Personal Income Tax collections come from non-withholding such as investments and business income. The forecast expects non-withholding to rebound given the ongoing strength in equity markets and business profits. Part of the gain from these sources will be offset by the carry forward of losses experienced during the recession. By comparison, the two years following the last recession Personal Income Tax grew by 6.1 percent and 11.1 percent, respectively.

(4) Sales Tax collections are forecast to increase by 5.3 percent and 4.5 percent, respectively this biennium. These are modest growth rates given the significant drop-off in collections over the last three years. During the last few years, retail sales in North Carolina plummeted by double-digits as employment losses mounted and consumer confidence sank. The housing market, which led us into the recession, has yet to fully heal and the result is many household balance sheets remain out of balance. The employment market has stabilized and there is some growing confidence by consumers, which is starting to show up in the consumer spending data. Nonetheless, the modest growth rates reflect that overall conditions will not have fully rebounded during the biennium, and therefore, we project lower growth

than what one might expect after the significant drop-off in collections that have occurred over the last 3 years. To put the forecasted growth in perspective, the increase in net collections will only be on par with the amount of revenue generated during the 2006-07 fiscal year, and yet there will be an estimated 600 thousand more people living in the State.

(5) Net corporate profits are expected to grow by 11 percent over the next biennium. Corporate income is always very volatile with yearly swings by as much as 30 percent to 40 percent. For the upcoming biennium we think these receipts will be relatively flat in the first year. Growth is forecast at only 2.2 percent reflecting the mild economic recovery, plus the losses from the lengthy recession that will continue to be taken against the bottom line. The second year of the biennium corporate tax receipts are expected to grow by 8.6 percent, which is closer to the long run average growth. Another business tax, the Franchise Tax, declined significantly this fiscal year with a baseline drop estimated at 10.4 percent. The key reason is that an important basis for calculating the tax, capital stock, declined significantly during the recession, thus lowering the amount of Franchise Tax owed. We expect a rebound during the biennium, but only at rate of 6 to 7 percent.

(6) **Putting all these assumptions together leads to a 4.6 percent higher baseline of General Fund revenues in 2011-12, and 5.5 percent growth in 2012-13.** The following table provides a comparison of baseline growths starting in FY 2000-01.

Fiscal Year	Baseline Growth Rate (Percent)
2000-01	4.5
2001-02	(6.1)
2002-03	(0.4)
2003-04	5.8
2004-05	9.3
2005-06	12.0
2006-07	7.2
2007-08	5.4
2008-09	(11.1)
2009-10	(3.5)
2010-11 (e)	2.8
2011-12 (e)	4.6
2012-13 (e)	5.5

(7) The revenue outlook for the 2011-13 biennium reflects a continuation of the slowly developing economic recovery in 2011. Employment growth will lag behind the pace of the recovery, yet will show continued improvement throughout the biennium. Revenue collections will be bolstered by an improvement in consumer confidence, the gradual healing of the housing market, and continued wage and salary growth. Therefore, the prospects for revenue collections to return to long term average growth as we move into 2012 are quite good. Nonetheless, the toll taken on the State by the Great Recession will not be behind us for at least another two or three years.