QUARTERLY GENERAL FUND REVENUE REPORT

October 2014
Barry Boardman, Ph.D.
Fiscal Research Division
North Carolina General Assembly

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

Highlights

- Prior year General Fund revenues were $450.3 million (2.2%) below the $20.6 billion budgeted amount.
- General Fund collections for the first quarter of the current fiscal year are $62 million below the revenue target.
- Collections on wage and salary income continues to lag behind forecast expectations. Sales tax collections have offset some of the weakness in Personal Income tax collections.
- A moderate growth pattern re-emerged this spring and summer after a slowdown this winter attributed to the harsh weather. Most economic forecasts anticipate slightly weaker than normal growth in 2014 and the beginning of 2015.
- Employment growth has been stable over the last six months, but job growth has not accelerated to the point where there is upward pressure on wages.

FY 2014-15 First-Quarter Revenue

- Through September, General Fund revenue was $62 million *below* the $4.7 billion target set for the first quarter of the fiscal year.
  - Collections are not further behind target because of stronger than expected Sales tax revenue (up $74 million).
  - Total Personal Income collections were $102 million below expectations. Wage and salary withholding was 1.7 percent below target for the quarter ($36 million below a $2.15 billion target).
  - Corporate Income tax collections were essentially right on target with gross collections up 3.4 percent over last year.
  - Most other tax revenues were close to being on target although the Tobacco and Franchise taxes were a little below target at $4.5 and $8.6 million below target, respectively.

FY 2014-15 First-Quarter Revenue

FISCAL YEAR-TO-DATE (millions)					
Net Tax Revenue	**Target 2014-15**	**Actual 2014-15**	**Target Difference**	**Actual 2013-14**	**Y/Y Pct. Change**
Individual Income	$2,445.2	$2,342.9	($102.3)	$2,712.7	-13.6%
Sales and Use	$1,537.7	$1,611.9	$74.2	$1,419.4	13.6%
Corporate Income	$290.7	$290.4	($0.4)	$358.7	-19.1%
Franchise	$65.4	$56.9	($8.6)	$105.7	-46.2%
Other Tax Revenue	$212.1	$206.2	($6.0)	$226.5	-9.0%
Total Tax Revenue	**$4,551.2**	**$4,508.2**	**($43.0)**	**$4,823.0**	**-6.5%**
Nontax Revenue & Transfers	**$171.0**	**$151.9**	**($19.1)**	**$259.0**	**-41.3%**
Total General Fund Revenue	**$4,722.2**	**$4,660.2**	**($62.1)**	**$5,082.1**	**-8.3%**

- Note that year-over-year comparisons are not very helpful because they do not take into account recent tax changes, large one-time events such as non-tax payments and transfers, as well as other collection anomalies.

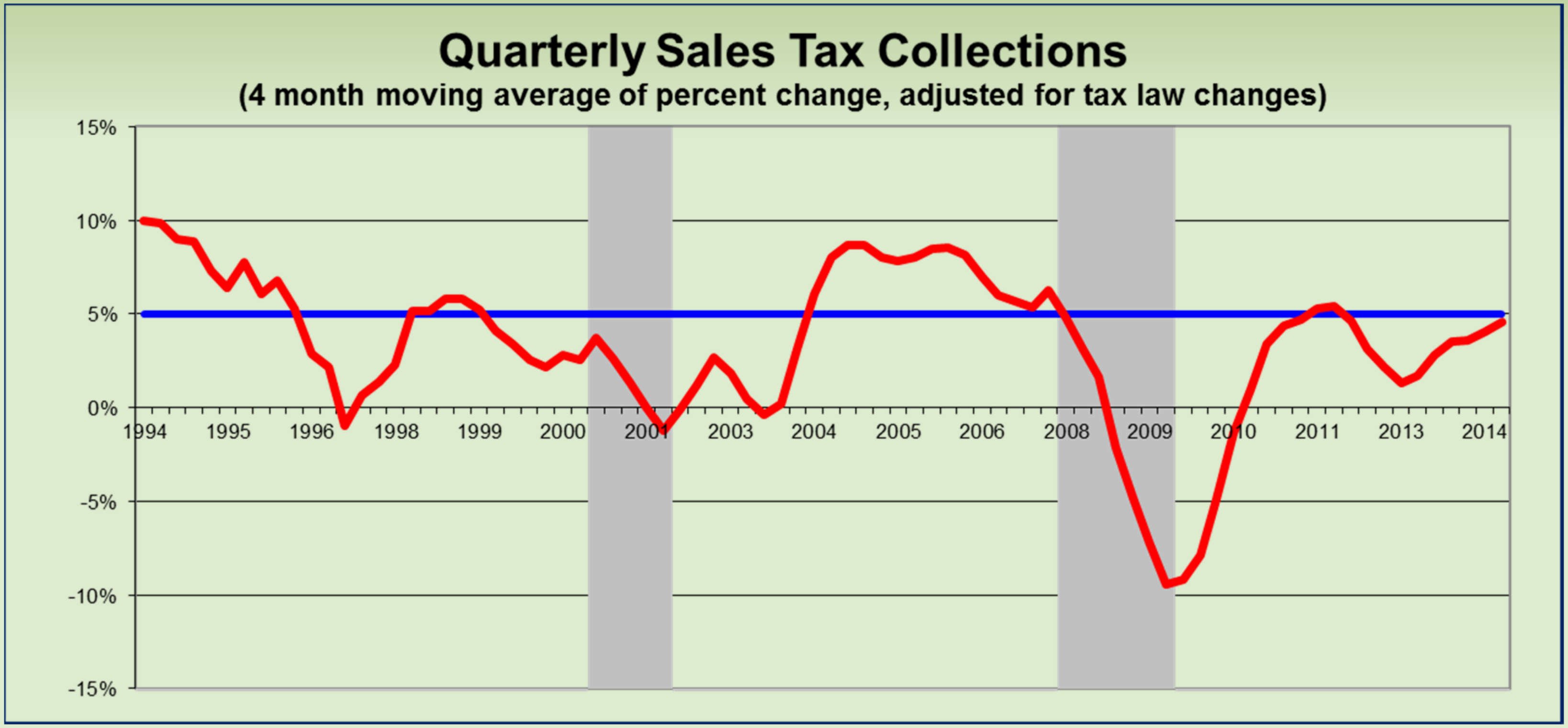
FY 2014-15 First-Quarter Revenue

- **Important Reminder:** The first several months of the fiscal year are typically the least important months as an indicator of revenue trends for the full fiscal year.
  - Major receipts in these months (sales, withholding tax) closely track the experience of the last few months of the prior fiscal year.
  - Revenue from volatile sources (corporate and non-withholding personal income) are not fully realized until the second half of the fiscal year.
  - Personal Income tax law changes that began in 2014 will mean April 2015 payments will hold even greater importance.
    - Income tax base-broadening such as limiting itemized deductions and repealing the business income deduction should mean an increase in end-of-tax-year payments and lower refunds.

FY 2014-15 First-Quarter Revenue

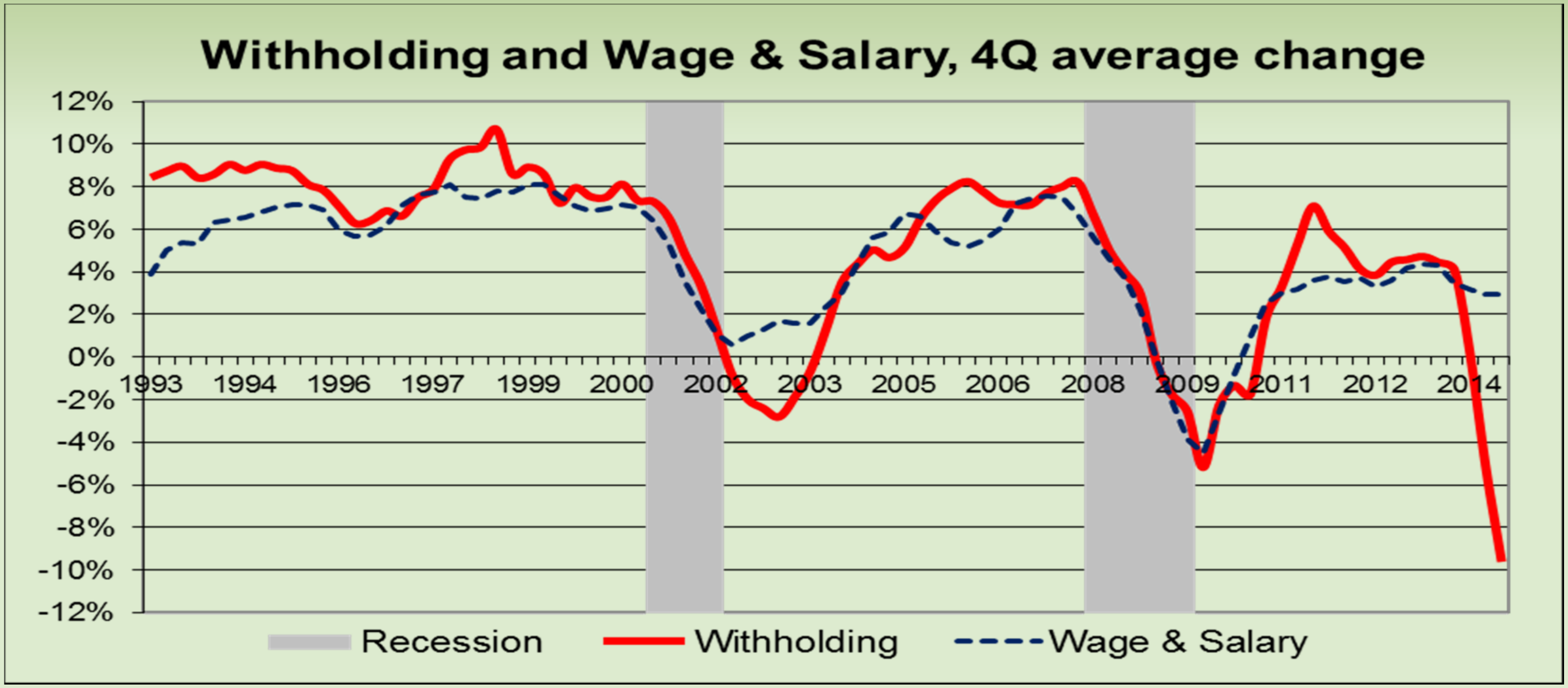
- Growth in key economy-based taxes (wage and salary withholding income tax and the sales tax) continue to move in opposite directions.
  - Baseline Sales Tax growth maintained the solid growth established earlier in the summer and during the first quarter of the fiscal year net collections were 4.8 percent above last year (see page 6).
  - Net Personal Income withholding collections (withholdings less refunds) are below expectations. Year-over-year comparisons are not useful because of the tax changes in S.L. 2013-316 (see page 7).

Tracking Economy-Based Collections



Baseline growth for FY 2013-14 improved to 4.1 percent. The calendar year started slowly with only 2.4 percent growth, but the first quarter of this fiscal year finished strong with 6.0 percent growth. The consensus forecast growth rate for the fiscal year is a cautious 4.5 percent.

Tracking Economy-Based Collections



Net Withholding income growth (withholdings less refunds) have dropped off dramatically over last year as a result of tax law changes in S.L. 2013-316. Even without the changes net withholding would have weakened as wage and salary growth remains at only 3 percent.

Prior Year Recap

- At the start of FY 2013-14, the economy was modestly improving. During the first-half of the fiscal year the economy strengthened and economic output rose above average. The harsh winter at the start of 2014 temporarily halted economic growth, but by spring the economy was back on track.
- The overall moderate growth aligned with the consensus forecast; however, collections were $450.3 million (2.2%) below the $20.6 billion General Fund forecast.
- The shortfall in collections could be attributed to three factors affecting Personal Income tax collections.

Prior Year Recap

- The three factors affecting Personal Income tax collections were:
  - Slower than expected wage and salary growth;
  - timing of taxpayer adjustments to tax law changes enacted last year; and,
  - underestimating the impact of the 2012 federal "fiscal cliff" on 2013 final income payments.

Prior Year Recap

- Personal income tax collections were $724 million below a $10.9 billion forecast. An estimated $425 million of the under-collections were related to difficulties with timing the impact of tax law changes.
  - The impact of lower withholding tables due to the rate cut had an immediate impact on collections, while base-broadening measures will not be realized until April 15th tax payments are due.
- $100 million of the under-collections was attributable to the federal "fiscal cliff".
- Sales tax collections improved throughout the year ending $121 million above the $5.4 billion forecast.
- Corporate income tax collections came in $108 million above forecast.

Prior Year Recap

Here's how key revenue items turned out ($ million)

	Budgeted	Actual	Difference
Personal Income Tax			
Withholding*	$8,308.8	$7,622.1	($686.7)
% Yearly Growth		(6.7)%	
Non-Withholding**	$2,688.0	$2,650.3	($37.7)
% Yearly Growth		(1.4%)	
Net Collections	$10,996.8	$10,272.4	($724.4)
% Yearly Growth		(6.2%)	
Sales Tax			
Net Collections*	$5,444.1	$5,565.2	$121.1
% Yearly Growth		5.1%	
Corporate Income Tax			
Net Collections*	$1,249.2	$1,356.9	$107.7
% Yearly Growth		13.9%	

*Collections less refunds and transfers.

**Quarterly estimated payments plus April 15 tax payments.

Economic Outlook and the Revenue Forecast

- The economy has been unable to move into overdrive an unstable global economy continues to slow the pace of growth.
- The economy does continue to improve, but not at a strong enough pace to produce a robust job market. Recent minutes from the Federal Reserve Board’s Open Market Committee noted that "there remains significant underutilization of labor resources."
- It is this underutilization that has kept improvements in the overall economy from being more widespread. A tighter labor market would place more upward pressure on wages. Last fiscal year, wage and salary growth was an anemic 3 percent, which was well-below the forecasted 4.4 percent growth.

Economic Outlook and the Revenue Forecast

- This fiscal year the forecast envisions wage growth of 4.7 percent. This is still below average growth, but well ahead of last year's pace.
- For wages to grow at this stronger pace, non-farm employment will have to meet projected growth of 2.1 percent (86,000 new jobs) during the fiscal year.
- Last year, non-farm employment grew by 79,300 jobs, which was slightly better than the gain of 77,100 the previous year.
- Through the first quarter, employment is estimated to have grown at an annualized rate of 1.8 percent; wages have grown at 4.2 percent.
  - While these estimated growth rates are below expectations for the full fiscal year, they represent improvements over the second quarter of 2014.

State's Economic Outlook

- Since 2012, the State's economy has steadily been gaining strength. While we do not anticipate the pace of economic growth to significantly quicken, we do expect it to stay on a steady upward trend.
- North Carolina's Gross State Product, a measure of the State's economic output, kept pace with the nation's output in 2012 and 2013, and is forecast to keep pace with the national average pace of growth in 2014 and 2015.
- While manufacturing is not the major employer it once was in the State, it remains an important economic engine. Economic growth in this sector, which had a setback in 2012, is expected to slightly outperform the national average by 2015.

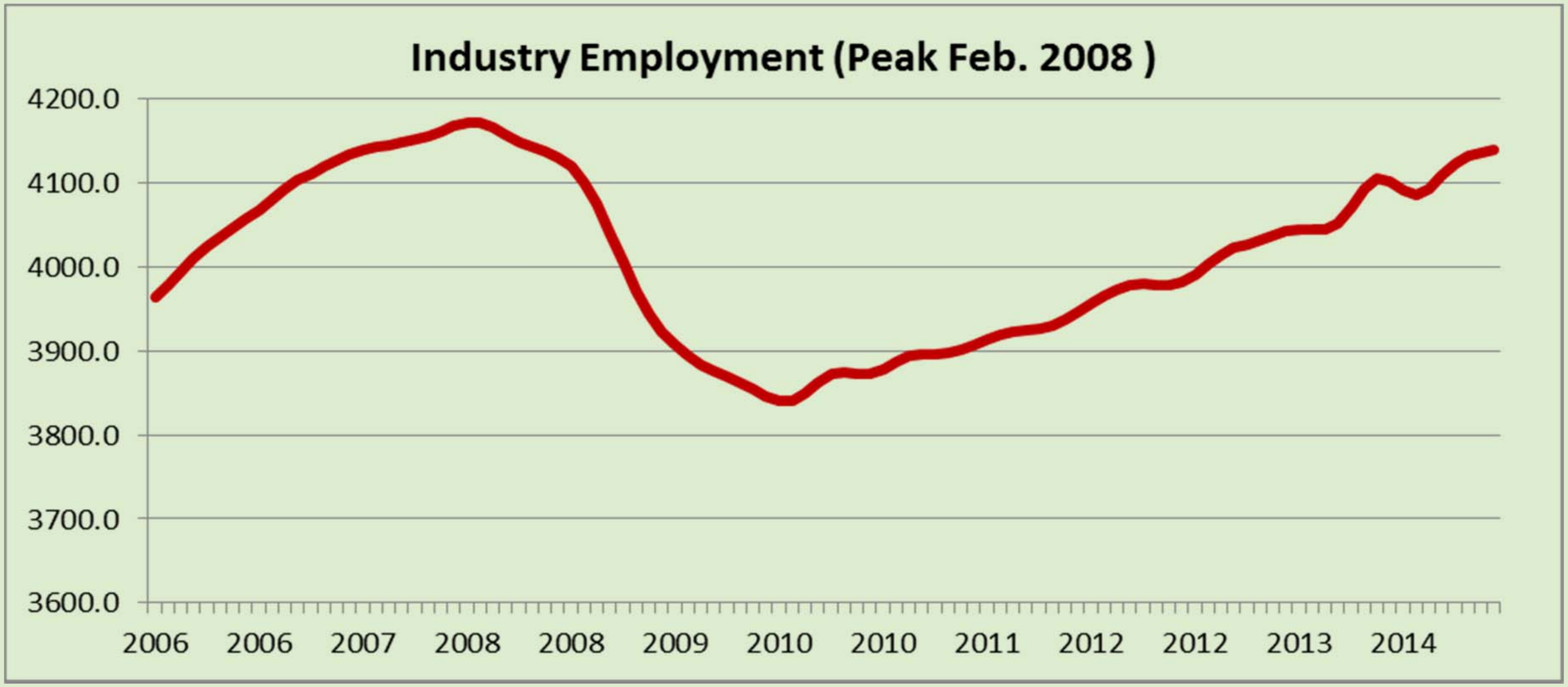
State's Economic Outlook

The unemployment rate was 6.4 percent in August. Over the next six months the State's unemployment rate is expected to stay above 6 percent. While continued job growth will occur a growing labor force is expected to keep the rate from falling by more than a few tenths of a percent. In the first quarter of 2015, the average monthly rate is forecast to be 6.2 percent.

Source: Actual data from the NC Division of Employment Security, Forecast by FRD shaded in gray

State’s Economic Outlook

Changes in non-farm employment have moved at a similar pace as the overall economy. The chart below shows how the State has improved since employment peaked in February of 2008. Non-farm employment is now 31,000 jobs (0.7%) below peak.



Conclusions

- Current year revenue collections are down 1.3 percent through the first quarter of FY 2014-15.
- The first quarter provided mixed results. Personal Income tax withholding on wages was below target. Sales tax collections, on the other hand, are running ahead of target.
- The economy continues to strengthen, but the pace of growth remains below average. The slow growth pattern makes us more susceptible to economic and policy shocks and places the risk to the forecast at a higher level.
- With the first quarter running slightly behind target, pressure increases on the expectation that April 2015 collections will rise significantly as taxpayers make higher final payments and receive smaller refunds. These expectations arise from the tax law changes enacted last year.