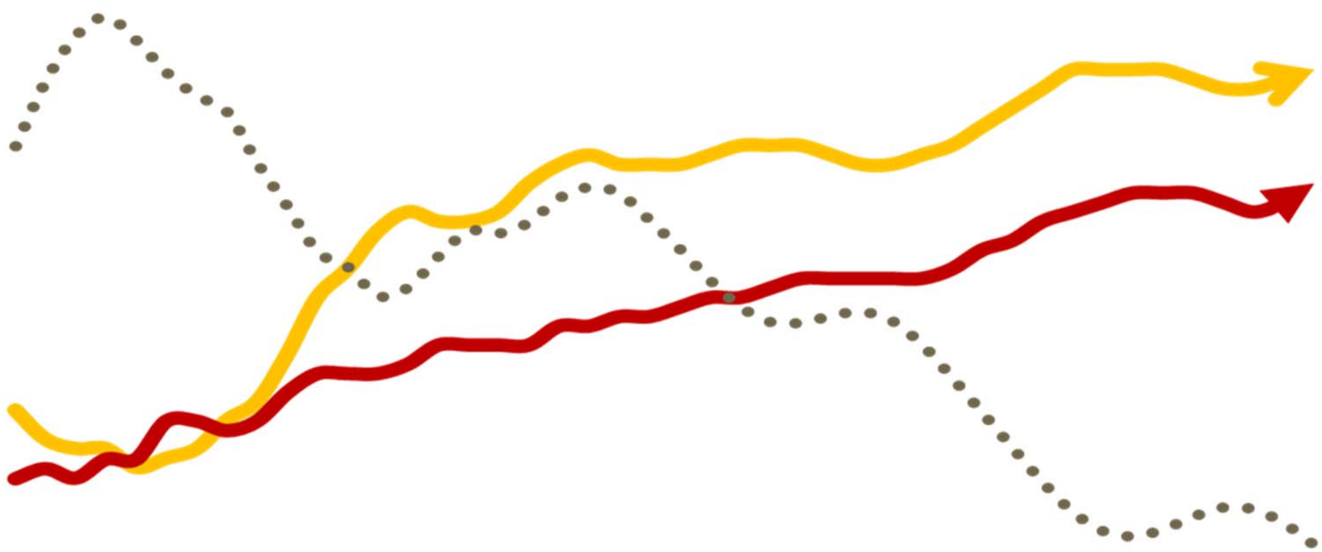
Quarterly General Fund Revenue Report



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

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Highlights

» FY 2015-16 Revenue through December: Essentially on track at 1.2% ($120 million) above the 6-month revenue target.

» Economic Outlook: The economy is on solid footing, and moderate growth is expected to continue throughout the fiscal year.

» Revenue Outlook: Ongoing improvements in employment set the stage for faster overall wage growth, which increases the likelihood of meeting this fiscal year's revenue forecast.

FY 2015-16 Revenue Through December

- General Fund revenue was $120.1 million above the $10.1 billion target for the first half of the fiscal year.
- Second quarter revenues (Oct.-Dec.) were $79.7 million above target.

GENERAL FUND REVENUE BY SOURCE, FISCAL YEAR-TO-DATE ($ millions)					
	FY 2015-16				FY 2014-15
Net Tax Revenue	Target	Actual	$ | % Difference		Actual
Individual Income	$5,277.3	$5,384.5	$107.2	2.0%	$4,895.2
Sales and Use	3,392.7	3,292.6	(100.1)	(3.0)	3,175.0
Corporate Income	444.7	488.9	44.2	9.9	536.8
Franchise	98.2	148.9	50.7	51.6	90.1
Other	543.2	556.4	13.2	2.4	530.9
Total Net Tax Revenue	$9,756.1	$9,871.3	$115.2	1.2%	$9,228.0
Nontax Revenue & Transfers	$360.7	$365.6	$4.9	1.4%	$418.4
Total General Fund Revenue	**$10,116.8**	**$10,236.9**	**$120.1**	**1.2%**	**$9,646.4**

FY 2015-16 Revenue Through December

» The main General Fund revenue sources are performing close to expectations for the first half of the fiscal year.

1) Corporate Income Taxes: $44 million (9.9%) above target.
   - Represents the biggest revenue surprise thus far.
   - Collections are $43 million lower than last year due to 1% rate reduction to 5%.
2) Personal Income Taxes: $107 million above target for the year.
   - Growth is 6.0% over last year, helped by on-target wage & salary withholding and a $165.1 million increase in Estimated and Final Payments over last year.
   - Withholdings growth is aligning with wage & salary growth.
     - This is unlike last year, when the shift in the income tax rate and amount withheld created a temporary break in the relatively-tight relationship with wage growth.
   - Revenue gains are slightly offset by prior-tax-year refunds running $35 million higher than expected.

FY 2015-16 Revenue Through December

» (Cont'd): The main General Fund revenue sources are performing close to expectations for the first half of the fiscal year.

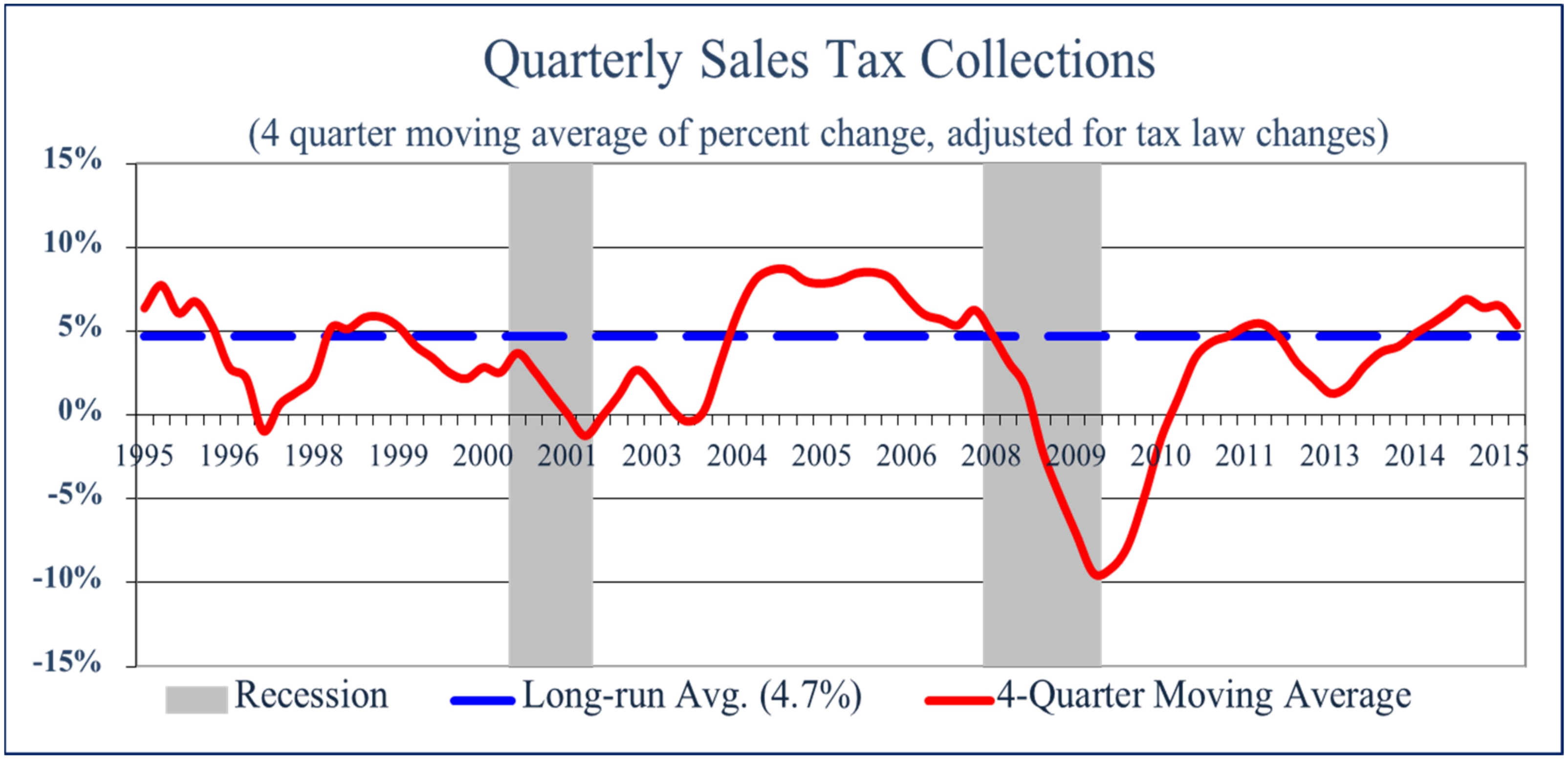
3) Sales Taxes: $100 million below target.

- Gross collections 1.0% below target; refunds up 40% ($57 million over target).
- Collections have not maintained the pace of growth established this past summer. Baseline collections for the first quarter of the fiscal year (adjusted for base and rate changes) were up 7% over the same period last year. The second quarter was up only 2.8% compared to last year's second quarter.

4) Franchise Taxes: $51 million above target.

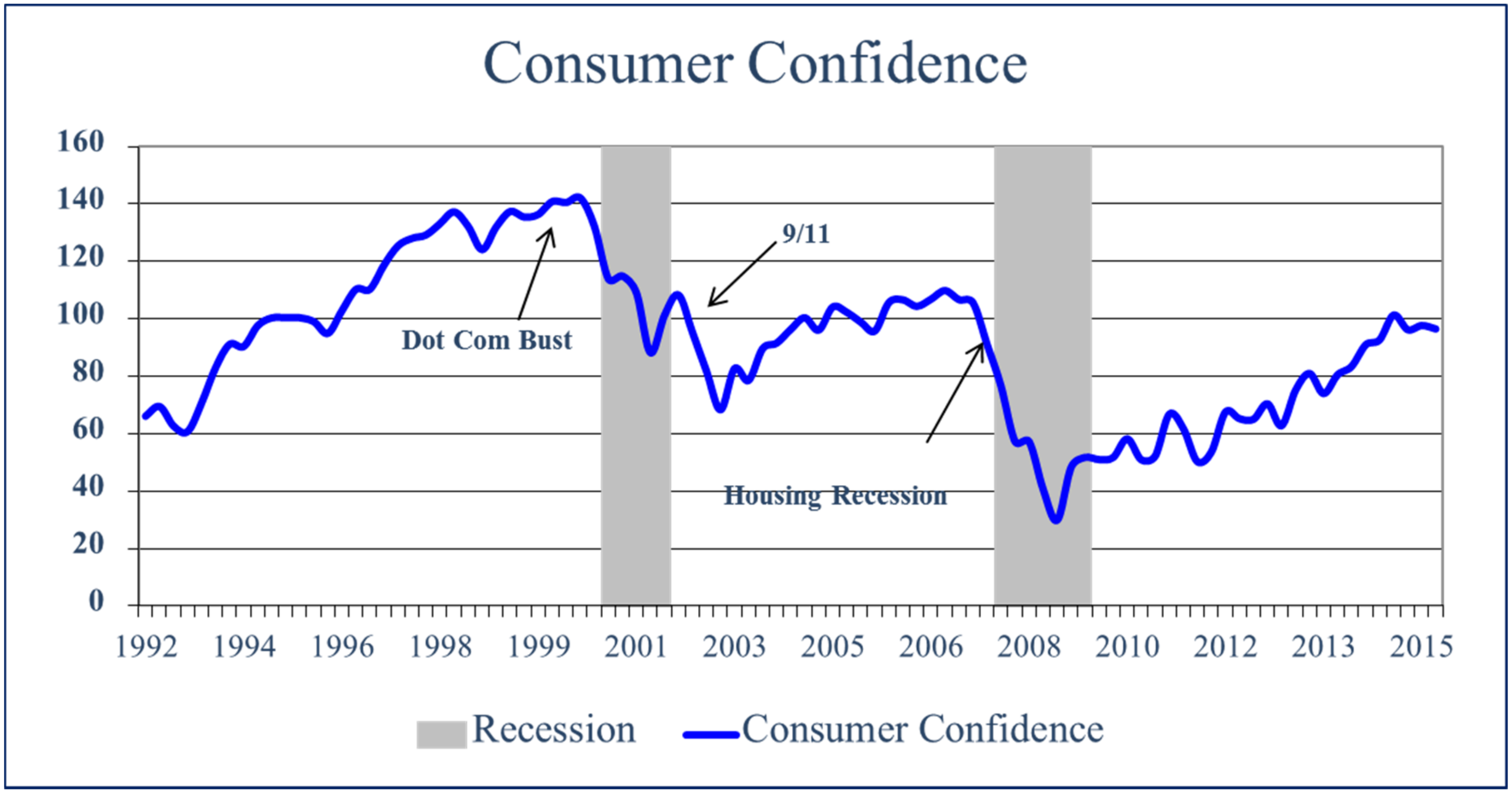
- Most Franchise tax payments for this fiscal year are paid in March and April. However, collections can fluctuate considerably in the first half of the fiscal year if the State receives a few large tax payments on previous years' liabilities.

Tracking Economy-Based Collections



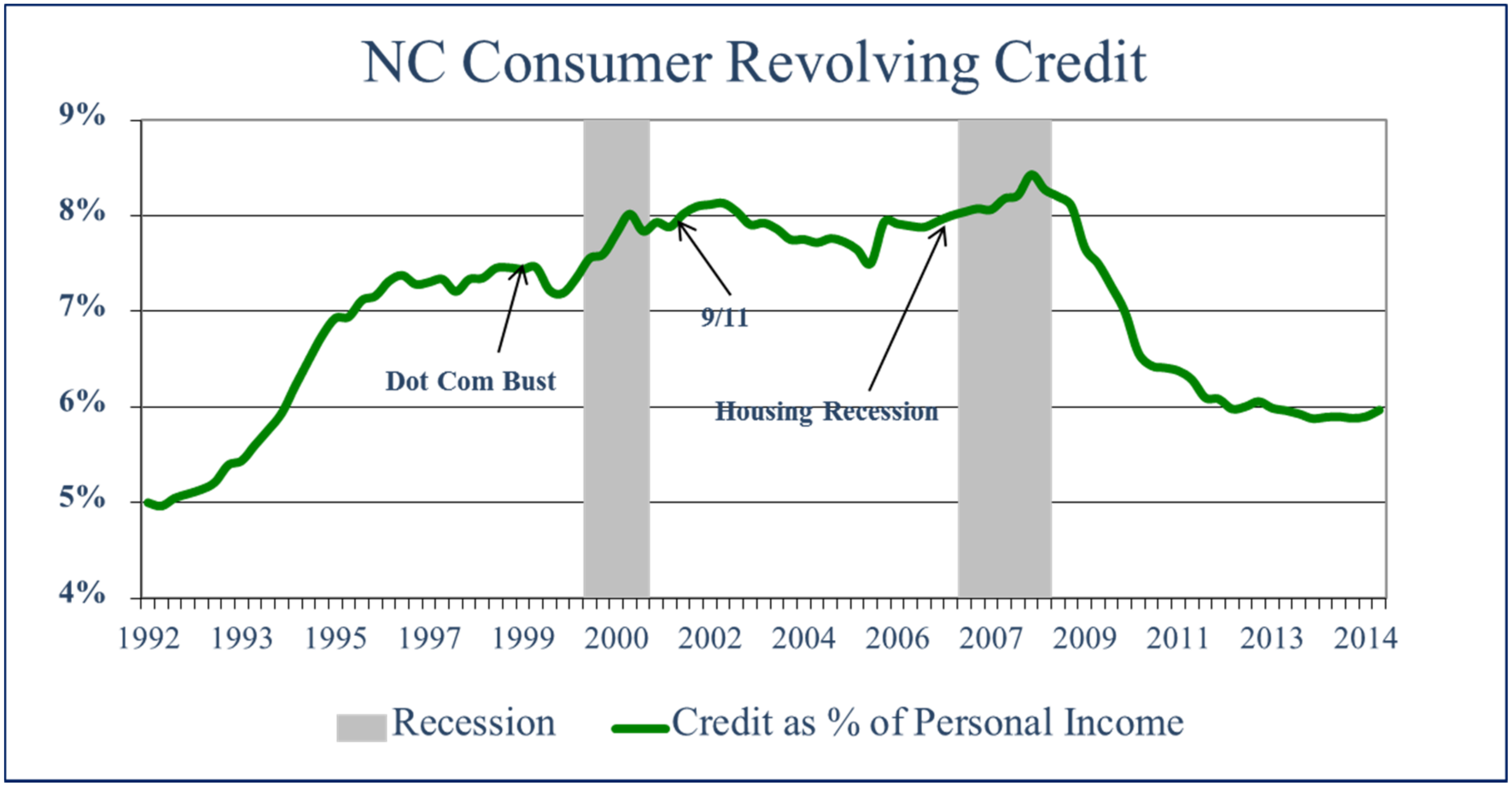
Baseline growth in the first-half of the fiscal year was 5.1%, which is below the projected 5.4% growth rate for the fiscal year. The second quarter slowed significantly with only 2.8% growth, pushing the 4-quarter average down to 5.3%.

Tracking Economy-Based Collections



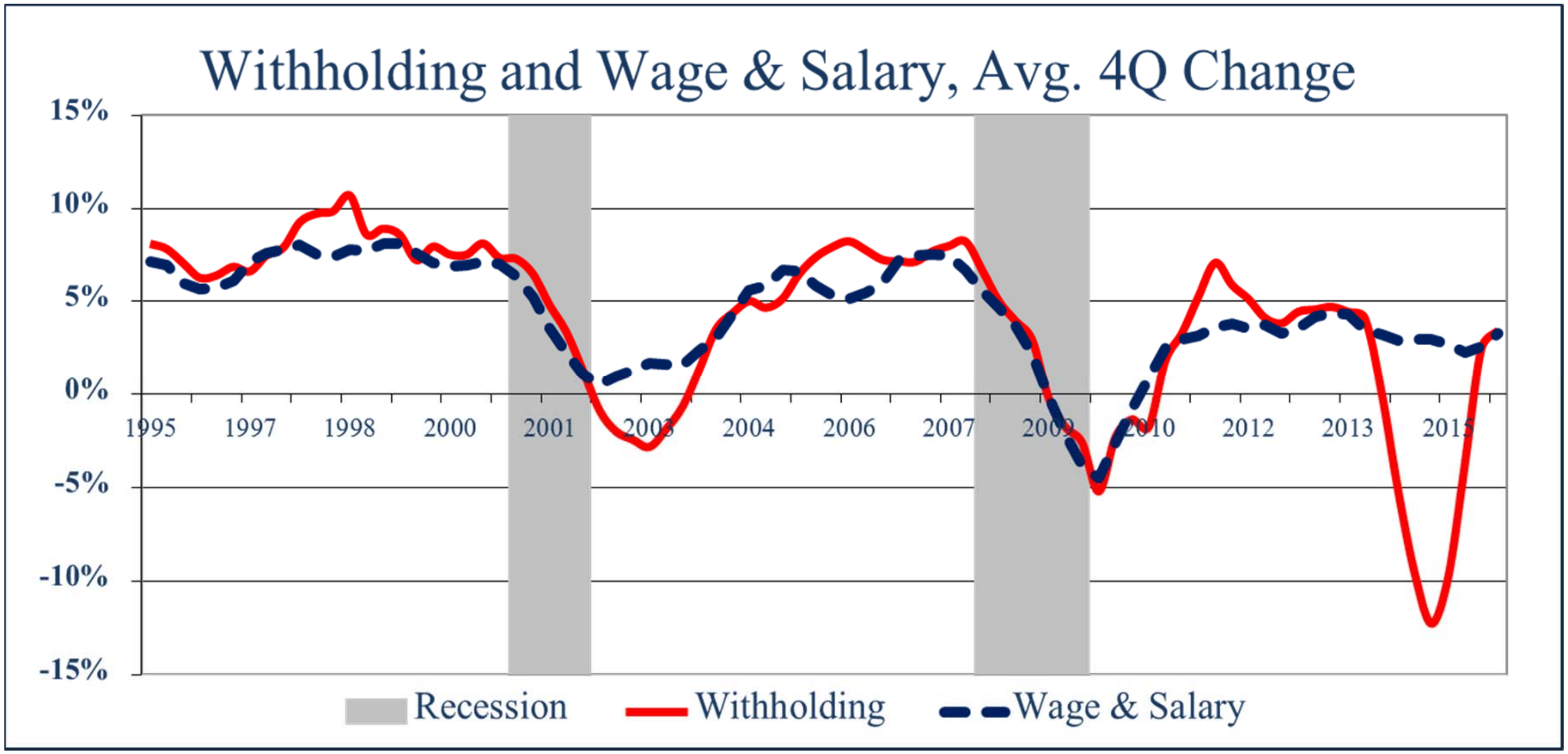
Consumer confidence has improved with an increase in economic stability, an improving jobs market, and better housing market conditions. The rise in consumer confidence has coincided with improving Sales tax collection in the State, which was averaging below 4% two years ago.

Tracking Economy-Based Collections



In the 1990s, revolving credit for household purchases grew rapidly and the 2000 recession did not slow this trend. When the housing bubble burst later in the decade, the revolving credit trend reversed. Since the sell-off after the recession, credit has stabilized near 6% of total income, still higher than in the early 1990s.

Tracking Economy-Based Collections



Net Withholding income growth (i.e., withholdings less refunds) fell dramatically as a result of tax law changes in S.L. 2013-316. Those changes no longer affect the yearly average change, and withholding and wage growth are now more closely aligned as they have been in the past.

Economic Outlook

- The State's economy is at its strongest since the recession ended six and a half years ago. The pace of growth remains moderate, however, but has quickened sufficiently to improve overall economic conditions.
- National economic forecasts continue to expect the growth in the nation's economy to remain slightly below average. While robust expansionary growth is not projected, moderate, steady growth is anticipated throughout 2016.
- During the post-recession recovery, the State's economy has tracked closely with the recovery of the nation's and this trend is expected to continue as the State tracks along with this moderate, steady growth.

Economic Outlook

- Given that the national economy in 2016 is positioned for stable growth, the risks of small economic shocks curtailing the economy's progress have been greatly reduced. As such, recession probabilities remain below 20 percent.
- Improvements in the overall economy have resulted in a stronger job market. Recently, job growth has reduced much of the slack in the labor market, which had many more people looking for jobs than were available.
- The tighter job market has begun to put some upward pressure on wages, although the economic data do not yet show consistent wage increases.

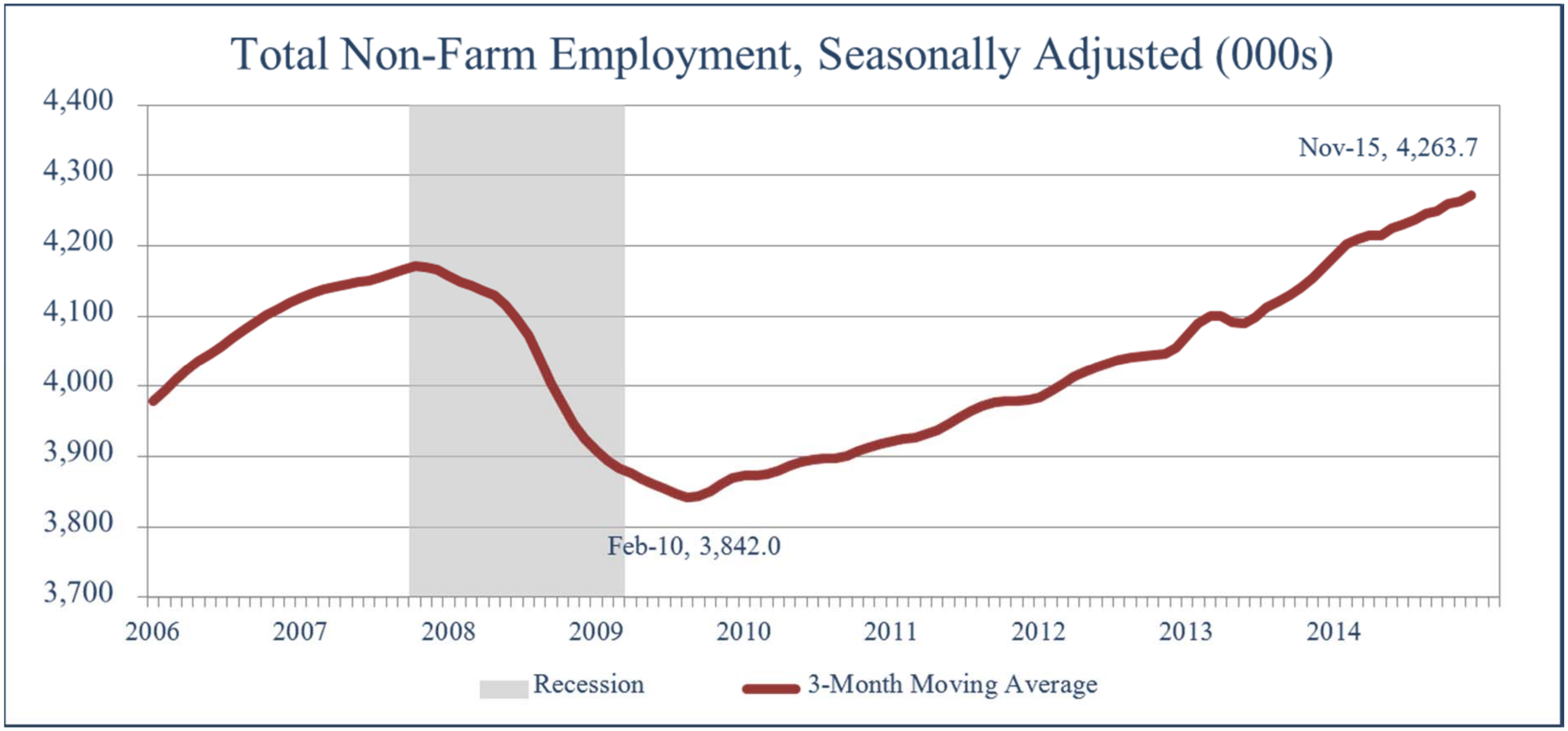
Economic Outlook

- There has been very little inflation this year – less than 1% – primarily due to modest per-job wage growth and low oil prices. Wage inflation, one sign of an economy operating at its fullest capacity, is not expected to materialize over the next 9-12 months.
- For the State, the increase in Personal Income withholding has had more to do with the increase in the number employed rather than increases in wages of those already employed. Nonetheless, if the pace of employment growth stays on track, it will greatly improve the prospects for stronger wage growth this year.
- The State's employment outlook has stabilized. The economy is expected to produce a net gain of 100,000 to 105,000 jobs in 2016.
- Last fiscal year, non-farm employment grew by 97,900 jobs, which was similar to the 96,300 jobs added the previous year.

Economic Outlook

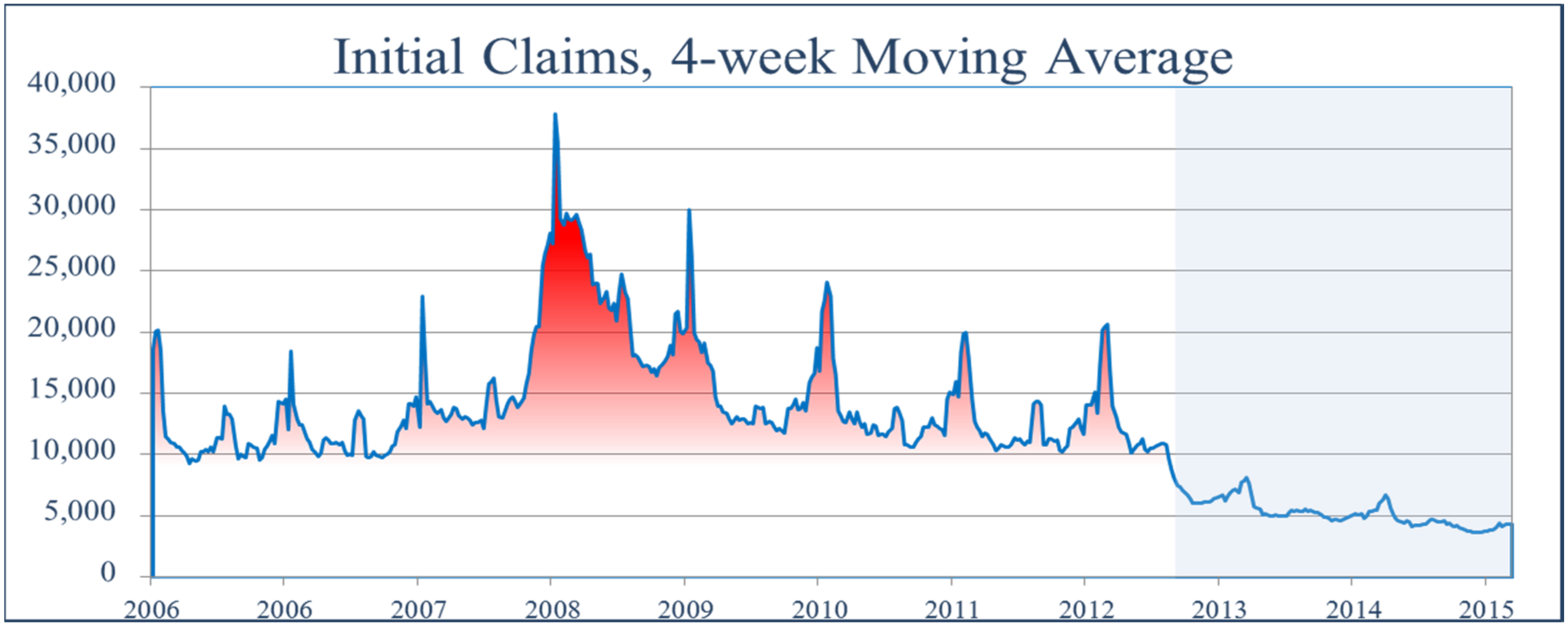
- Through the first five months of the current fiscal year, non-farm employment appears to have increased by 40,600 jobs (using preliminary data for November).
- This solid pace of employment growth will reduce slack in the State's labor market and should begin to impact individual wages. Throughout the recovery individual wage growth has lagged behind other improvements in the economy.
- For the State, key economic indicators including Employment, total Personal Income, and Retail Sales are growing within the bounds expected in the revenue forecast.
- The greatest economic risks continue to come from a global economic downturn, as well as other international risks such as the ongoing volatility in the Middle East.

Economic Outlook



Because the unemployment rate can sometimes be misleading with respect to economic conditions, we focus more on the employment level and employment growth rate. The chart shows how total non-farm employment has been on a modest, yet steady growth path since employment bottomed-out in February 2010.

Economic Outlook



Shaded area indicates initial claims after policy changes enacted in 2013.

Initial jobless claims (i.e., new claims from job losses) are a leading indicator of where the economy is headed and are related to the unemployment rate, which was 5.7% in November 2015.

Initial claims returned to pre-recession levels in 2011. Policy changes in 2013 further reduced claims. The new trend levels do not indicate a change in the economy's direction.

Revenue Outlook

- With the State's economy on a path of solid, modest growth similar to the overall national economy, baseline revenue growth (adjusted for tax changes) should continue to follow the trend it has been on the last 12-18 months.
- Since May of last year when the current consensus revenue forecast was developed, there has been little change in the national or State economic outlook.
- Revenues have tracked closely to the consensus revenue forecast. If April collections meet expectations, the current target surplus should not change significantly.
  - It is important to note that April collections are nearly twice the amount of the other months and consist of potentially-volatile sources such as final income payments and refunds.
  - April almost always holds a surprise, and what happens in April will determine both how we finish the fiscal year and what type of revision might be needed for next fiscal year's revenue forecast.

Conclusions

- Revenue collections through December are 1.2% above the consensus target; income collections are the main source for the target surplus.
- As the economy continues to move forward, the pressure on job pay should begin to build. Growth in pay has been stagnant but as the economy nears full-employment and the unemployment rate drops to five percent we should begin to see some movement on wages.
- Inflation has been minimal with falling gas prices and stagnant wage growth. The forecast doesn't expect inflation to reach or surpass 2% until the end of 2016 or possibly into 2017.
- Through the first half of the fiscal year, General Fund revenues met forecast expectations. There has been little change in the State's economic forecast, which means the forecast for the rest of the fiscal year should stay on track.
- Only a big swing in April collections could impact this fiscal year's revenue forecast or lead to significant revisions to next year's forecast.

Table and Chart Sources

- Slide 2: NC Department of Revenue, compiled by the Fiscal Research Division
- Slide 5: Fiscal Research Division calculations and estimates based on data provided by the NC Department of Revenue
- Slide 6: The Conference Board Consumer Confidence Index
- Slide 7: U.S. Board of Governors of the Federal Reserve System
- Slide 8: Bureau of Economic Analysis; NC Department of Revenue
- Slide 13: U.S. Bureau of Labor Statistics
- Slide 14: U.S. Bureau of Labor Statistics