



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: Revised General Fund Revenue Consensus Forecast

The Fiscal Research Division and the Office of State Budget and Management have reached consensus on revising the 2015-17 biennium revenue forecast. The notes below summarize revised forecast.

Forecast Summary

The forecast expects FY 2014-15 collections to be above the budgeted amount by \$400 million (or 2%)¹ with steady growth over the next biennium. The anticipated surplus is predominately due to higher income tax payments and lower refunds from the 2014 tax year. The revised forecast envisions that solid employment gains will continue, improving the prospects for better income growth over the biennium.

Fiscal Year	Revised Forecast* (\$ in m)		February Forecast (\$ in m)
	Revenue	Gain Over Prior Year	Revenue
FY 2013-14	\$ 20,143.7		\$ 20,143.7
FY 2014-15	21,401.1	1,257.4	20,730.1
FY 2015-16	21,965.1	564.0	21,409.9
FY 2016-17	22,576.2	611.1	22,296.6

*** Revised forecast is net of statutorily-mandated reductions in the Corporate Income Tax Rate. This change is discussed in depth in the “Biennium Forecast” section of this memo.**

Personal Income tax collections this April increased significantly above February’s expectations. April always has the potential to be a volatile collection month, in which income from dividends, capital gains, and business income can result in sizable swings in income tax collections. The added volatility from recent tax law changes compounded the difficulty in estimating net revenue from April 15th tax returns.

The key reasons for the significant upswing in April collections were:

- **A cautious forecast meant greater upside risks:** As noted in the February consensus forecast, “given the uncertainty surrounding the fiscal implication of major tax code

¹ Average forecast error ±2.5%

changes (S.L. 2013-316), which affected over \$2 billion in revenue items this fiscal year, the forecast adopts a very cautious approach.”

Errors are inherent in estimating fiscal impacts of extensive and complex tax law changes, and lower-than-expected Personal Income tax revenue in the first half of the fiscal year heightened the sense of uncertainty. For these reasons, the Forecast erred on the high side by estimating larger negative revenue impacts for FY 2014-15 Personal Income tax revenue. While the choice to provide conservative estimates is prudent from a budgeting perspective, the cautious forecast left more room for a positive April “surprise”.

- **Growth in April payments was consistent with other states’ experiences:** Based on information from other budget and revenue officers across the nation, April tax payments were up 15-20%. North Carolina had yearly growth of that magnitude, which was well above expectation given tax law changes. It appears that the increase was driven by increases in business income, which is often paid under the Personal Income tax, and by capital gains from the sale of stocks and real estate holdings. However, detailed IRS data will not be available until this time next year.
- **Refunds declined an estimated fifty-seven percent:** Tax law changes allowed for more accurate withholding tables, which reduced the refunds claimed by taxpayers. The 57 percent drop this year was much larger than the anticipated 35 percent reduction and resulted in an additional \$375 million in Personal Income tax collections than projected in February. Looking over the last twenty-five years the drop-off in refunds was more than double the biggest year-over-year decline.

Current Year Revenues

General Fund revenues are forecast to increase by 6.1 percent over FY 2013-14 collections, which is higher than the four percent growth that was forecast in May 2014. The result is an estimated \$400 million revenue surplus above the \$21 billion budgeted amount for FY 2014-15 (i.e., two percent above forecast).

Personal Income tax growth began to strengthen in the second half of the fiscal year, and Personal Income tax collections are estimated to exceed the original forecast by 1.8 percent. Wage growth is still expected to be one percentage point below forecast and withholding revenue is projected at three percentage points below forecast for the fiscal year. The surplus this fiscal year is predominately the result of strong growth in business income, which resulted in a surge of final payments this April. We can only speculate, but tax shifts in 2012 and 2013 due to the Federal fiscal cliff, and the State’s \$50,000 business income tax exemption, which was repealed for the 2014 tax year, could have led to underestimating the potential for business income revenue this year.

Sales tax revenues, which were growing at an estimated 2.3 percent above forecast, have weakened slightly and are projected to fall \$30 million short of the February consensus forecast. Lower gas pump prices have not provided as much support for higher retail sales as once projected. Nonetheless, baseline growth is projected at an above average 5.4 percent.

Biennium Forecast

In general, other than Personal Income tax, there was little movement in the revenue numbers from the February biennium forecast projections. Corporate Income tax and Franchise tax moved up slightly from growth in the corporate tax base. Sales tax collections are slightly lower due to moderating growth in retail sales. Most other revenue sources are expected to track close to what was originally envisioned when the biennium forecast was produced in February. Except for the

resurgence of business income growth there has been little else to change in the economic forecast for the nation and the State's economy.

Statutorily-Mandated Corporate Income Tax Rate Reduction

The revised forecast is net of revenue reductions that result from an automatic Corporate Income tax rate decrease from five to four percent in 2016 and to three percent in 2017. G.S. 105-130.3C specifies that the Corporate Income Tax Rate must be reduced if total revenue collections exceed the amounts specified in the statute (\$20.2 billion in FY 2014-15; \$20.975 billion in FY 2015-16). The rate reduction will not officially trigger until the tax revenue reported in the June Statement of Collections are reported for the respective fiscal years. Nonetheless, tax revenue projections are high enough above the trigger amounts, \$195 million and \$115 million respectively, that the forecast projection takes them into account. The following table summarizes the estimated impact of the rate changes over the next five fiscal years.

Revenue Impact of G.S. 105-130.3C (\$ in m)		
Fiscal Year	Corporate Income Tax Rate as of Jan. 1	Revenue Change from Current
FY 2014-15	5%	
FY 2015-16	4%	(109.1)
FY 2016-17	3%	(349.1)
FY 2017-18	3%	(503.2)
FY 2018-19	3%	(528.3)
FY 2019-20	3%	(554.7)

Other Revenue Sources

There were no significant changes to the main revenue drivers: employment and personal income. The forecast still envisions that employment gains will continue improving the prospects for better income growth over the biennium. The consensus forecast envisions 3.7 percent and 4.2 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. We do consider growth in business income an expansion in the overall tax base, but we do not anticipate a continuation of that pace of growth during the upcoming biennium.

The biennium forecast remains necessarily cautious; because of the comingling of impacts from changes in tax law and economic conditions, several years of data will be needed to better understand the revenue impacts due to the tax law changes.

The revenue outlook for the 2015-17 biennium reflects a continuation of moderate, steady economic growth. Employment growth will continue to show improvement as employment markets continue to stabilize. Concern along the economic front continues as global economic weakness and social instability continue to keep risks slightly 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.

As a final note, end-of year revenue estimates produced after April collections usually fall within a range of plus or minus \$20 to \$30 million of the projection. A little more volatility is in play this year given the recently enacted tax law changes that have impacted both personal income tax withholding and estimated payments. This added volatility, based on taxpayer behavior, could increase the margin of error in projecting the final surplus for FY 2014-15, but only major shifts in economic conditions would have significant implications with respect to the Corporate Income tax rate trigger.