GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

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Highlights

• Revenues through February are $45 million short of forecast.
• Downward trends of economy-based taxes have flattened-out, but there are very few signs an upturn can be expected anytime soon.
• This means budget pressures will continue to mount as prolonged weaknesses in the economy affect revenue collections the remainder of the fiscal year.
• The 2010-11 revenue adjustment will be affected by the forecasted pace of the recovery and the expected lower base from weak 2009-10 collections.
• The temporary expiration of the federal Estate Tax in 2010, will result in lower State collections by an estimated $85 million in 2010-11.
How Do 2009-10 Revenues Look So Far?

• General Fund revenue for the first 8 months of the fiscal year are $45 million below a $12.1 billion target for the period.

  – Through the efforts of the Department of Revenue and its resolution payment initiative, the revenue shortfall has been greatly reduced with the collection of $422 million from over 200 taxpayers. That is $272 more than what was included in the budget.

  – Without this additional $272 million in revenue the shortfall would be close to $320 million or 2.6% below the budget target.

  – Weak economy-based taxes remain the key reason for the budget shortfall.
How Do 2009-10 Revenues Look So Far?

• Gross income tax withholding on wages and salaries are down 4.1% through February. That is essentially the same as in December and January meaning the downward trend has stalled.
  – We will need another couple of months of similar results from withholding collections before we can say that collection declines have bottomed-out.
  – Financial sector bonuses, absent from last year’s withholdings, have returned and are helping stop the slide in withholding despite continued job losses across most industry sectors.

• Sales tax collections continue to suffer as consumers react to weak job and housing reports.
  – Baseline (tax-adjusted) collections for the first 8 months of the fiscal year are down 11.0% compared to last year.
  – Net State collections, including tax law changes are up 12.2%; however, budget targets projected a 15.9% increase. The result is net sales tax collections are $125 million short of expectations.
Tracking Economy-Based Collections

The recession ended in late summer 2009, but 6 months later consumer confidence has remain at recessionary levels. In February, sales collections showed slight improvement over previous months, but a couple of more months are needed to before we can say we have turned the corner.

Sales & Use Tax Collections
(adjusted for tax law changes)
Why have Sales Tax collections been slow to recover?

• Double-digit unemployment (11.1% for the State in January) has eroded consumer confidence and with continued employment uncertainty cautious consumer behavior is expected.

• Key reasons why consumer spending is down:
  – Dismal employment outlook expected to extend into much of 2010
  – Lower inflation-adjusted salary & wages than before start of recession
  – Tremendous loss of household wealth from housing recession and equity market losses
  – Tight credit conditions persist
  – Rather than continuing to spend by increasing debt until the recession’s effects subside, consumers are doing the opposite - they are choosing to pay off their debt. Credit card debt fell 20% in November and new credit card issues are off 46%.
Net withholdings (wage & salary taxes less refunds) continue to reflect a dismal job market. Through February net withholdings are down 4.2% from last year, and 2.2% below a $5.4 billion target for the first eight months of the fiscal year. There was a slight improvement in withholding this month – stay tuned!

**Withholding Taxes**

![Withholdings & Total Employment (4th Quarter Moving Average)](chart)
According to the latest numbers from the Employment Security Commission, the State added 8,000 jobs in January. The recently revised employment numbers show that there are 295,000 fewer jobs (6.8%) compared to pre-recession employment.

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<th>Total Employment, Seasonally Adjusted</th>
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Financial Crisis, Oct-08

Jan-08, 4,330,995
Jan-10, 4,036,018
We Still Have a Long Way to Go

• The first 6-8 months of the fiscal year are valuable for assessing which direction the more stable, economy-based tax collections such as the sales tax are headed. These months provide little indication of the outcome of the more volatile revenue sources. This means the final quarter (April – June) of the fiscal year contains the majority of the forecast risk.

• The greatest unpredictability is tied to corporate income tax payments and non-withholding personal income tax payments.
  – This creates a “doubling-up” impact for both sources since it entails April 15 final income tax payments (2009 tax year in this case) as well as quarterly estimated income tax payments in April and June for the new tax year.

• Our view is that since taxpayer’s losses from the recession can be carried forward into future tax years, taxable income from these sources will be suppressed for several years.
We Still Have a Long Way to Go

• While all of these income sources are hard to predict, capital gains on stock and real estate investments present a particular problem. Even if we could predict future asset prices, we do not know what year investors will sell nor the asset’s original purchase price.

• There are additional challenges to forecasting April revenues from high-income individuals
  – Unlike wage earners, there are no “average” taxpayers and individual experiences can vary tremendously from one year to the next.
  – In addition, taxpayers with a potential loss in income for a tax year can choose between decreasing their estimated payments or settling up on April 15, with risk of a “penalty” for insufficient estimated tax payments (going interest rate). This means that even with the availability of the December/January estimated tax payment data (available in February), we still do not know what April 15 will bring.

• As with high-income individuals, the April-June period includes a similar concentration of volatile payments for the corporate income tax.
Slow Economic Recovery and Forecast Risks

• Our assessment on a sustainable, nationwide recovery has increased since the last report; however, there are a number of reasons why we believe the lingering effects from the recession may be with us for a while:

• Job conditions, both in N.C. and the nation, are showing few signs of improving and remain relatively poor.
  – 4 week average unemployment claims are showing little improvement through March and are indicative of a struggling economy.
  – Compared to last year claims are 10,000 fewer (4 week avg. 19,000 versus 29,000 last year)

• Consumer confidence drops 10.5 index points to 46.0 in February. That is the largest decline since last February. It appears that consumers are still forced to purchase only those things they have to buy and not what they want to buy.
  – With household savings on the rise, consumers are choosing to rebalance household balance sheets – that’s good for the long run, but will slow the recovery.
2009-2010 Revenue Outlook

• Because the employment picture has yet to show expected improvement, this continues to impact key economy-based taxes. A downside risk to the 2009-2010 forecast is the lack of improvement in consumer spending driven by a poor jobs market.
  – Without improvements to consumer spending (70% of the national economy) the pace of the recovery will remain very slow.

• The expected slower job and wage growth will not only hurt consumer spending, but delay the growth of income tax withholding.
  – The 2009-10 forecast envisioned zero growth for withholding for the year, but positive improvement was expected the last quarter.
  – Withholding refunds, a contributor to last year’s shortfall, are not expected to exceed the high rate of last year, nonetheless, they are expected to remain on par with last year.
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2009-2010 Revenue Outlook (cont.)

- Even though the national and State forecasts for this fiscal year have grown more pessimistic since last May, the expectations are that the recovery has taken hold and this spring and summer gradual improvements can be expected.

- However, we remain pessimistic, as are most economists, on the prospects for a full, robust recovery in 2010.

- Our budgeted revenue forecast built in some improvement to withholding and sales tax growth for the second half of 2009-2010 fiscal year, but not nearly as much as most forecasters were projecting at the time.

- This cautious budgeting approach will help reduce the negative impact on revenues being felt by many other states.
Our forecast places a lot of emphasis on managing the risks associated with explosive, volatile revenue sources such as the non-withholding portion of the income tax (capital gains show up here) and the corporate income tax. Despite our efforts to remain cautious, these will continue to be very challenging revenue sources to assess (see pages 8-9 for more discussion).

Key Reasons:
- A few years of super-charged growth is followed by steep declines (plus or minus 35%).
- Unprecedented recent declines may not mean the usual rebound given the huge losses taxpayers can use to offset non-withholding or business income.
- Instability in the key real estate, financial, and equity markets will add to the volatility.
- Gauging taxpayer behavior based on possible federal tax law changes adds to the complexity.

For these reasons the budget forecast for these items will remain super-cautious.
2010-2011 Forecast Outlook

• The biennial budget for 2009-2011 included a tentative 3.2% baseline revenue growth rate for the 2010-11 fiscal year. One of the purposes of the upcoming budget session is to consider adjusting this outlook to reflect recent changes in the economic environment.

• The national economy is struggling to gain traction coming out of the Great Recession. The result will be lower economic output for the rest of 2010 than what was envisioned back in May 2008. It appears that the aftereffects from the recession could be a drag on the economy into 2011.

• Since the May 2008 forecast, the forecasted growth for 2010 in the State’s personal income has been significantly lowered. The lower growth is the result of a far more severe recession than envisioned at the time and its significant impact on employment in the State. We now expect less than 1.5% growth in 2010 personal income. This is far less than what was envisioned last May (2.9% was expected).
2010-2011 Forecast Outlook (cont.)

• So far, national and State employment trends have not reversed course. Until job growth resumes and the unemployment rate falls, consumer spending will be negatively affected.

• In addition to weak stateside spending, the widespread credit crunch is still affecting global markets and hurting the demand for U.S. exports. The historically low values for the dollar have given a boost to export trade, but the uptick has not been strong enough to boost employment demands.

• Despite poor employment numbers, recent data leaves little doubt a recovery is underway. For example, economic activity as measured by GDP growth in the last quarter of 2009 was 5.7%. Consistent with the slow growth scenario going forward, the latest estimates indicate below average growth in each quarter of 2010 (2 to 2.5%).

• Given that the recovery during the second half 2010 and into the first quarter of 2011 will be modest at best, employment under this slow growth scenario will have a hard time gaining traction.
• Business confidence has been pointing towards a recovery since the fall of last year, but consumer confidence measures still reflect the recession-like conditions felt by many households.
  – Despite growing confidence in the business sector, confidence is not on solid enough footing to spur permanent hiring decisions.
  – Temporary hiring is on the rise and usually is a harbinger of future increases in full-time employment hiring.
• One key factor that will remain a drag on the recovery is the housing recession, which has spread to the commercial real estate markets. The reason the markets continue to be a drag is the speculative bubble that occurred in the 2003-2006 period in these sectors may take another couple of years to work through. This means that real estate will remain weak and the construction jobs associated with a more vibrant residential and commercial real estate market will not return anytime soon.
2010-2011 Forecast Outlook (cont.)

• The federal Estate Tax expired for the 2010 tax year\(^1\)
  – NC estate tax is tied to the federal tax and the State will not receive estate tax collections from inheritances in 2010.
  – The net loss for 2010-11 collections is estimated at $85 million.
  – The federal estate tax is set to be reinstated in 2011 and the NC estate tax will be applicable again (an update to the federal internal revenue tax code may or may not be needed depending on actions taken by Congress).

• The full fiscal impact from the expiring tax will be offset somewhat as heirs who sell inherited property will claim higher capital gains. This occurs because the basis for calculating the gains are far less favorable for heirs in the absence of the estate tax. The impact from this change in basis will increase personal income tax collections, but the amount of revenue increase to the state will be modest.

\(^1\) Estate tax information based on analysis by the Department of Revenue and the Legal Research Division of the NC General Assembly