

# STATE BUDGET PROSPECTS: IT'S NOT SUPPOSED TO BE THIS WAY!



**Fiscal Research Division**  
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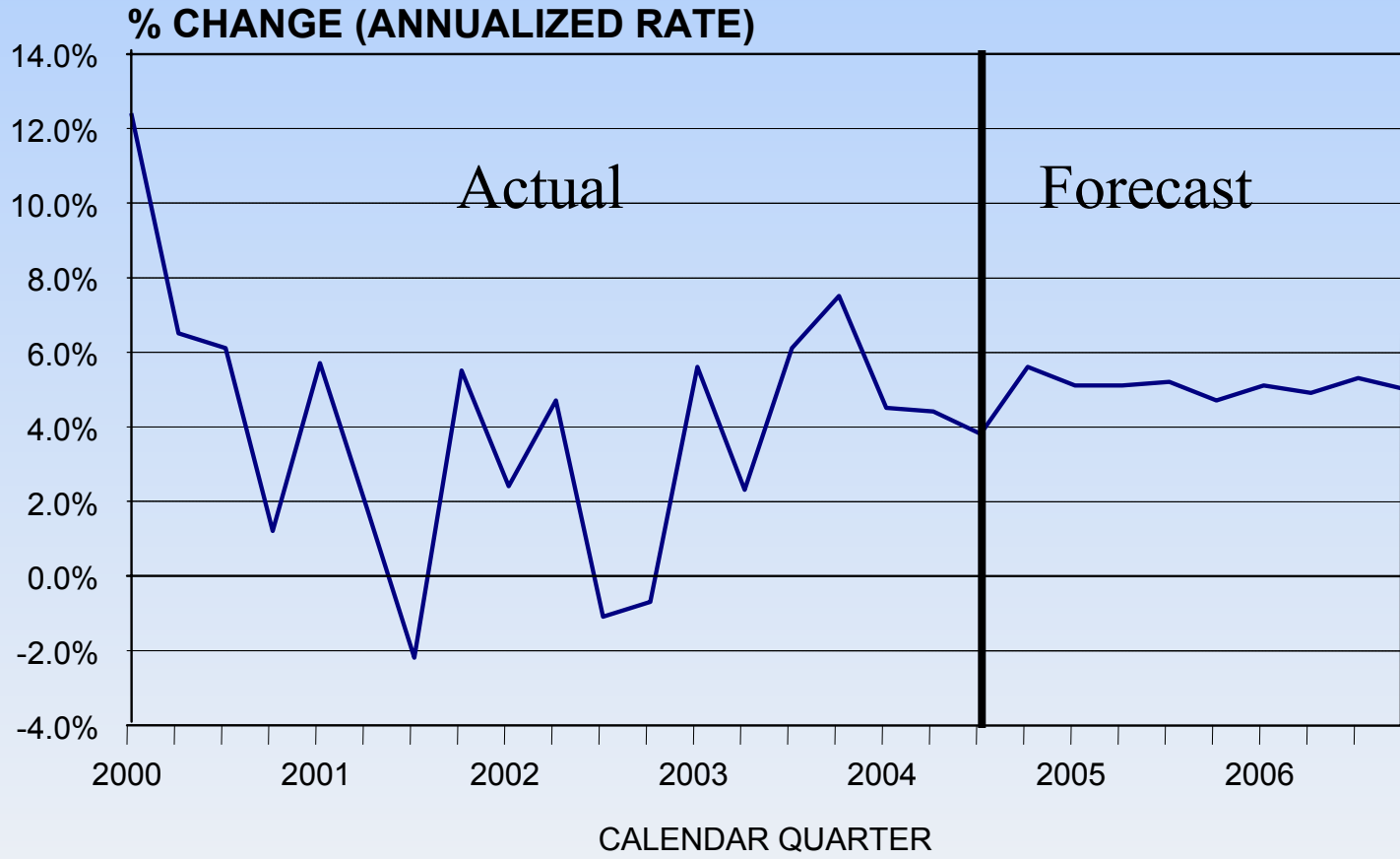
# SUMMARY

- Almost all states are facing a substantial 2005-06 budget gap even though the economy continues to recover and revenues are coming in ahead of schedule.
- During a typical business cycle rebound, improving revenues would lead to talk of a budget surplus.
- However, the current cycle is unique. Why?
  - A subpar economic recovery, especially in jobs.
  - The widespread use of one-time fixes in recent budgets.
  - No relief from large health care cost increases.
- Let's look at each of these issues.

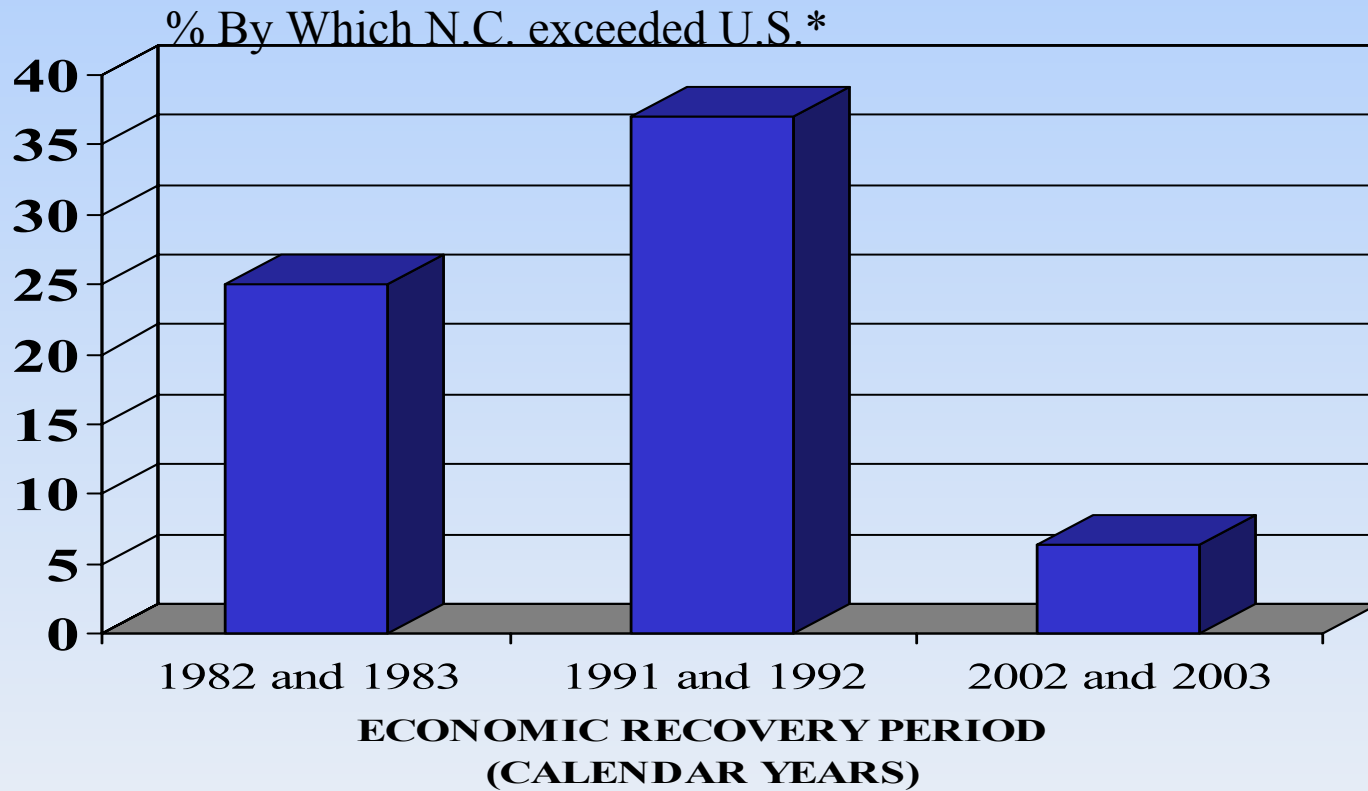
## **CURRENT REVENUES ARE AHEAD OF SCHEDULE BUT FAR BEHIND THE TYPICAL RECOVERY**

- Through January, General Fund revenues running \$116.0 million ahead of \$8.9 billion target for the period (1.3%). Equivalent to 6.8% rate versus 5.5% budget forecast.
- However, the corporate income tax, (6% of revenue base) makes up 45% of the surplus. Revenue recovery is not broad-based.
- In addition, \$30 million of the revenue surplus is from a one-time settlement of long-outstanding tax dispute.
- Rate of 2004-05 revenue surplus growth has slowed from \$23 million per month to \$11 million.

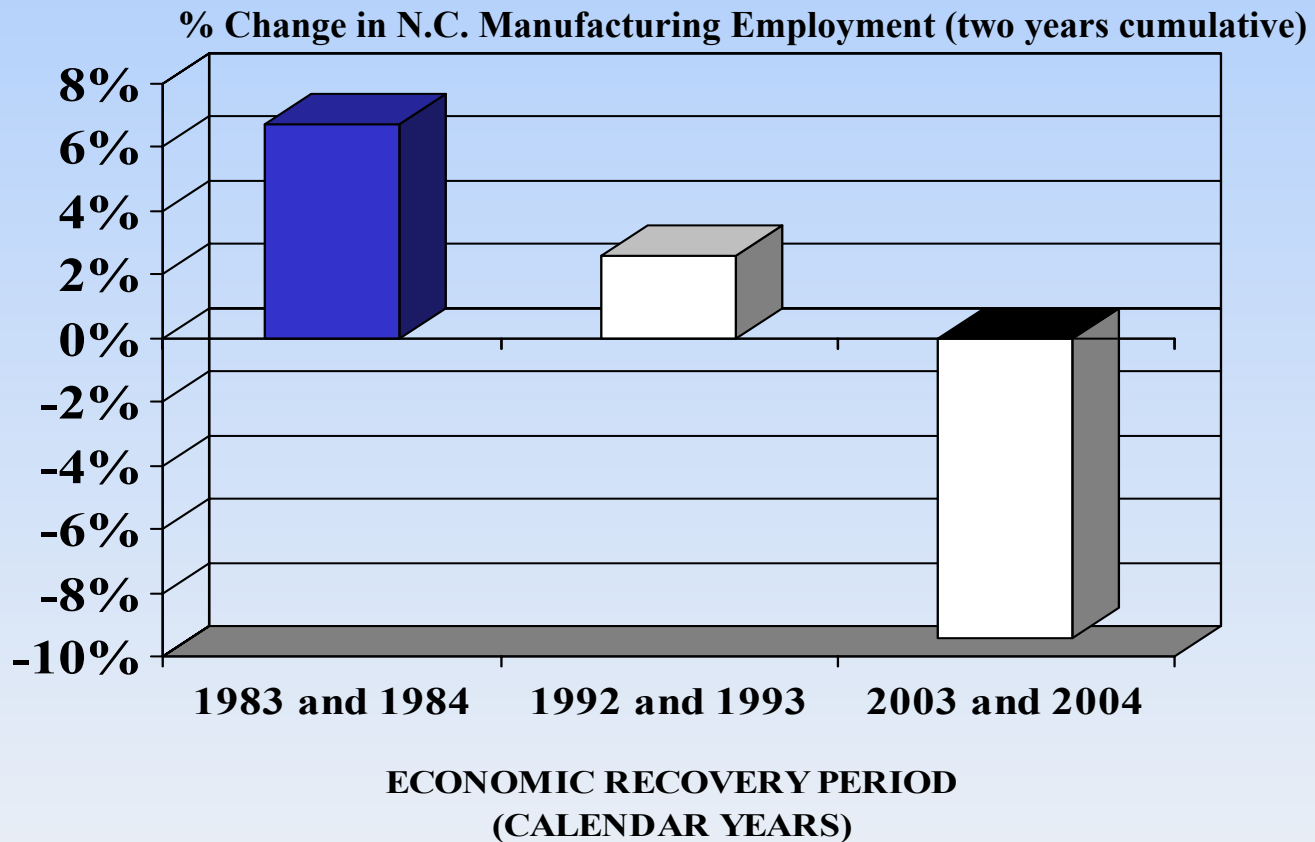
**THE NORTH CAROLINA ECONOMY IS EXPERIENCING A RECOVERY: N.C. PERSONAL INCOME\***



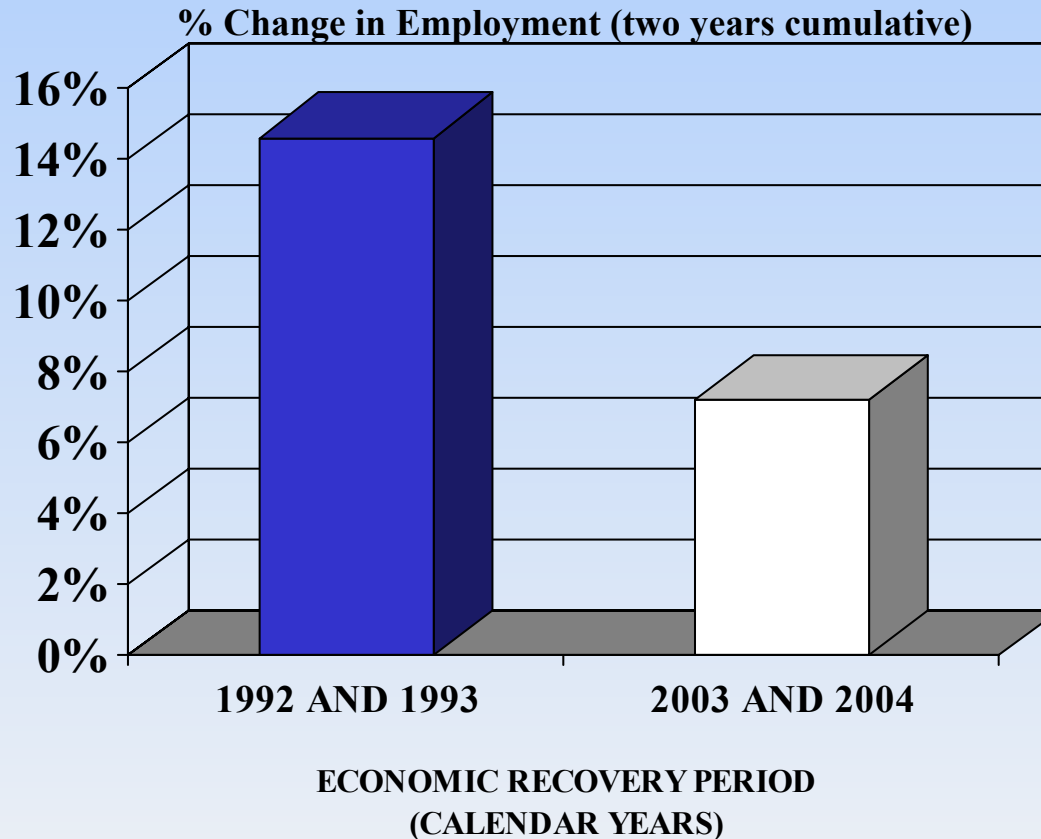
## HOWEVER, WE ARE NOT SEEING THE USUAL RECOVERY PREMIUM



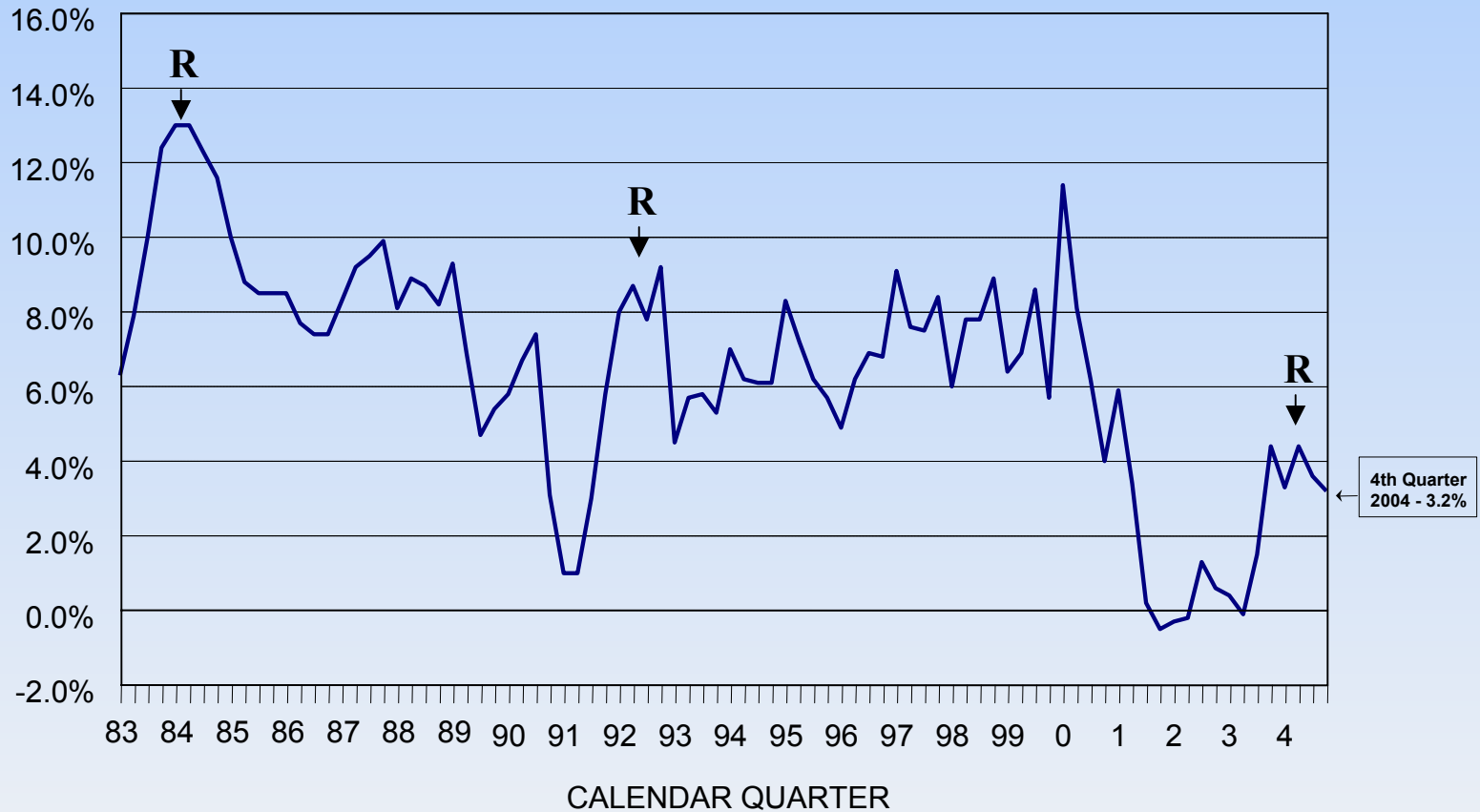
**PRIMARY REASONS: HIGH N.C. DEPENDENCE  
ON MANUFACTURING\* AND LACK OF  
TURNAROUND IN THIS SECTOR**



**EMPLOYMENT RECOVERY HAS BEEN SLUGGISH  
IN OTHER SECTORS AS WELL: EDUCATION  
AND HEALTH SERVICES EMPLOYMENT**

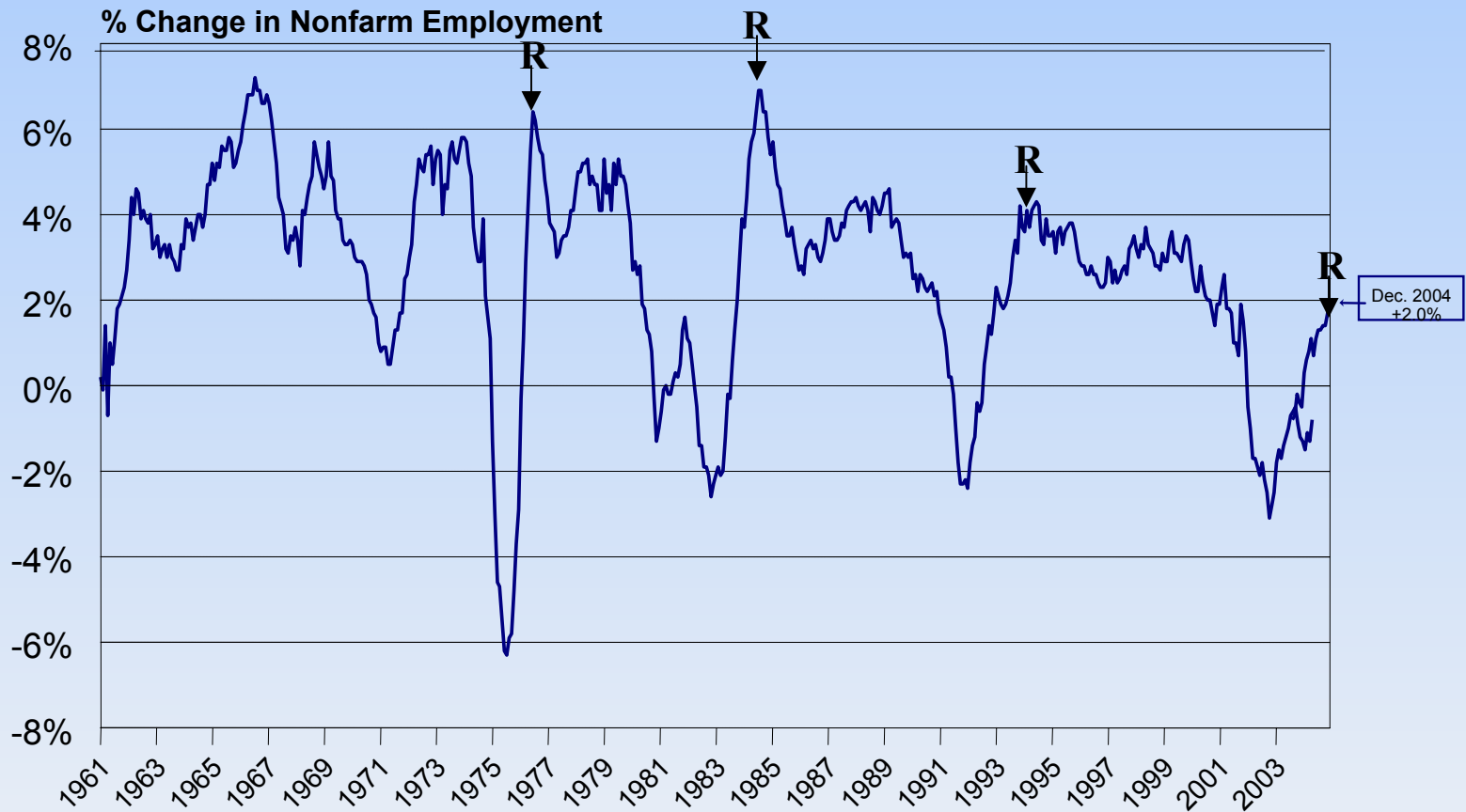


# WAGE AND SALARY PAYMENTS IN NORTH CAROLINA, A DRIVING FORCE BEHIND WITHHOLDING TAX RECEIPTS, HAVE EXPERIENCED A SUBPAR RECOVERY



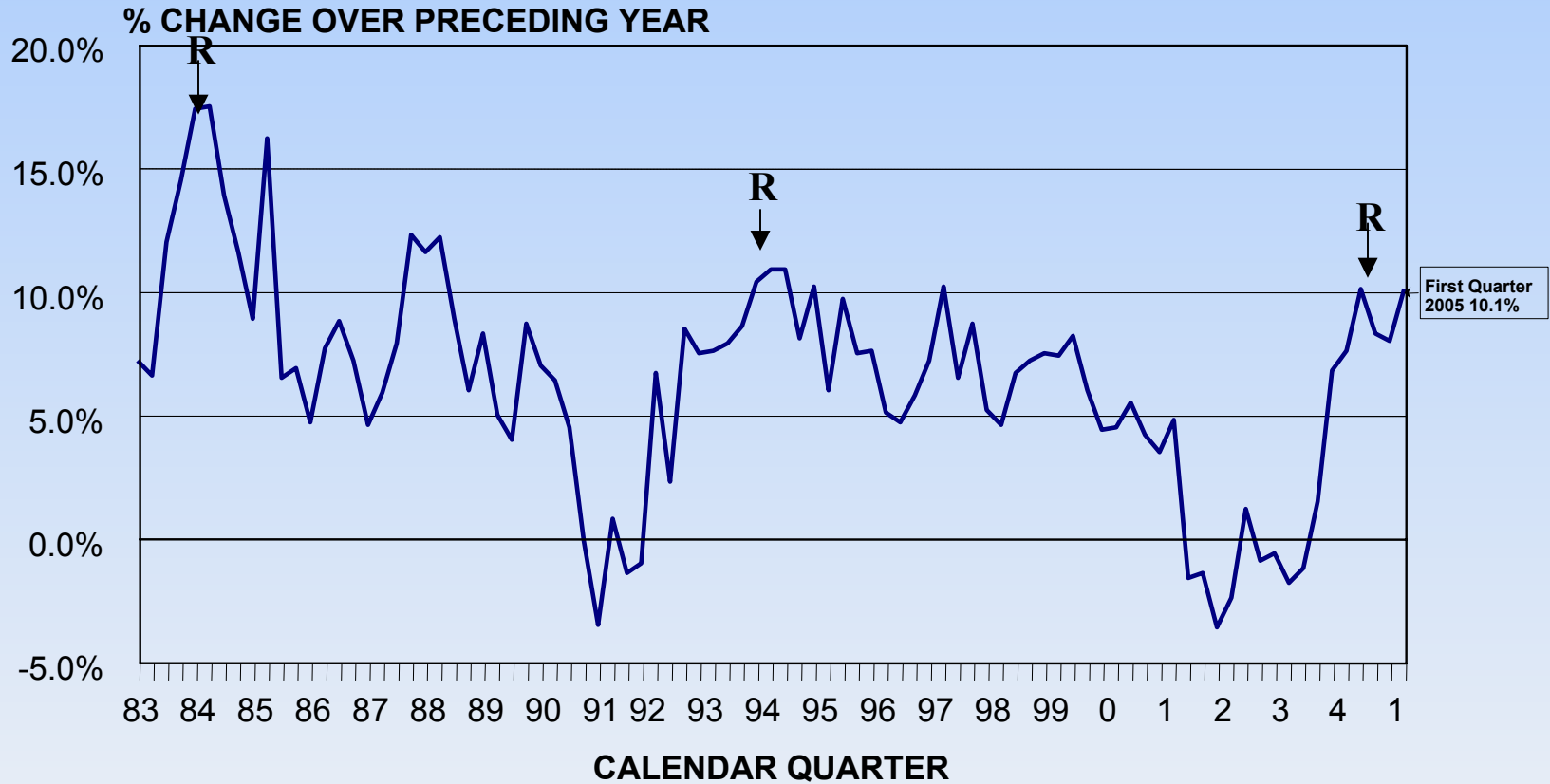
R = Recovery Period

## THE PRIMARY REASON HAS TO DO WITH SLUGGISH JOB GROWTH (RELATIVE TO PRIOR RECOVERIES)



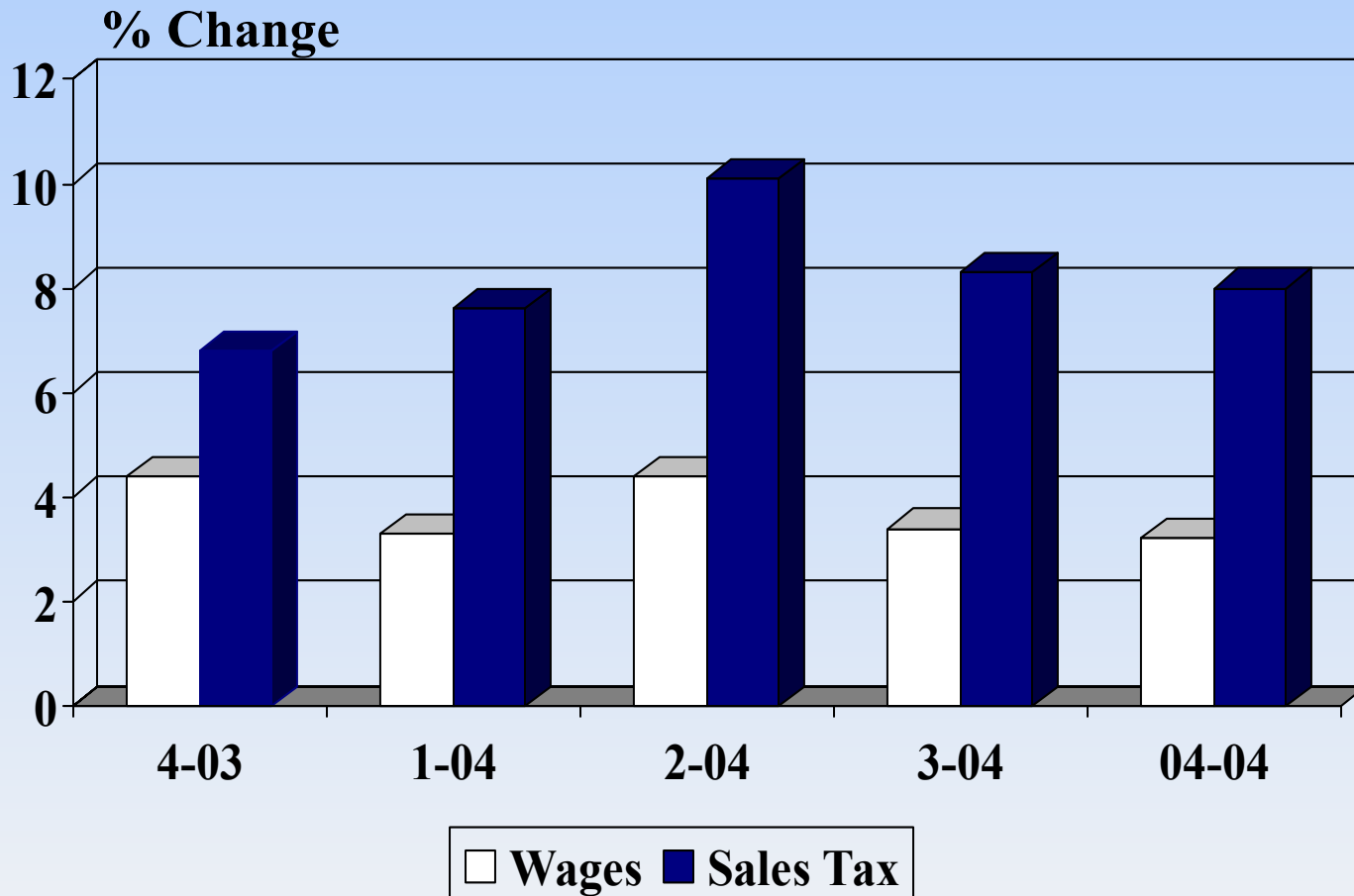
R = Recovery Period

## SALES TAX REVENUES ARE EXPERIENCING A TYPICAL TURNAROUND



**R** = Recovery Period

**SALES TAX REVENUES CONTINUE TO OUTSTRIP  
THE GROWTH IN THE INCOME OF THE STATE'S RESIDENTS**

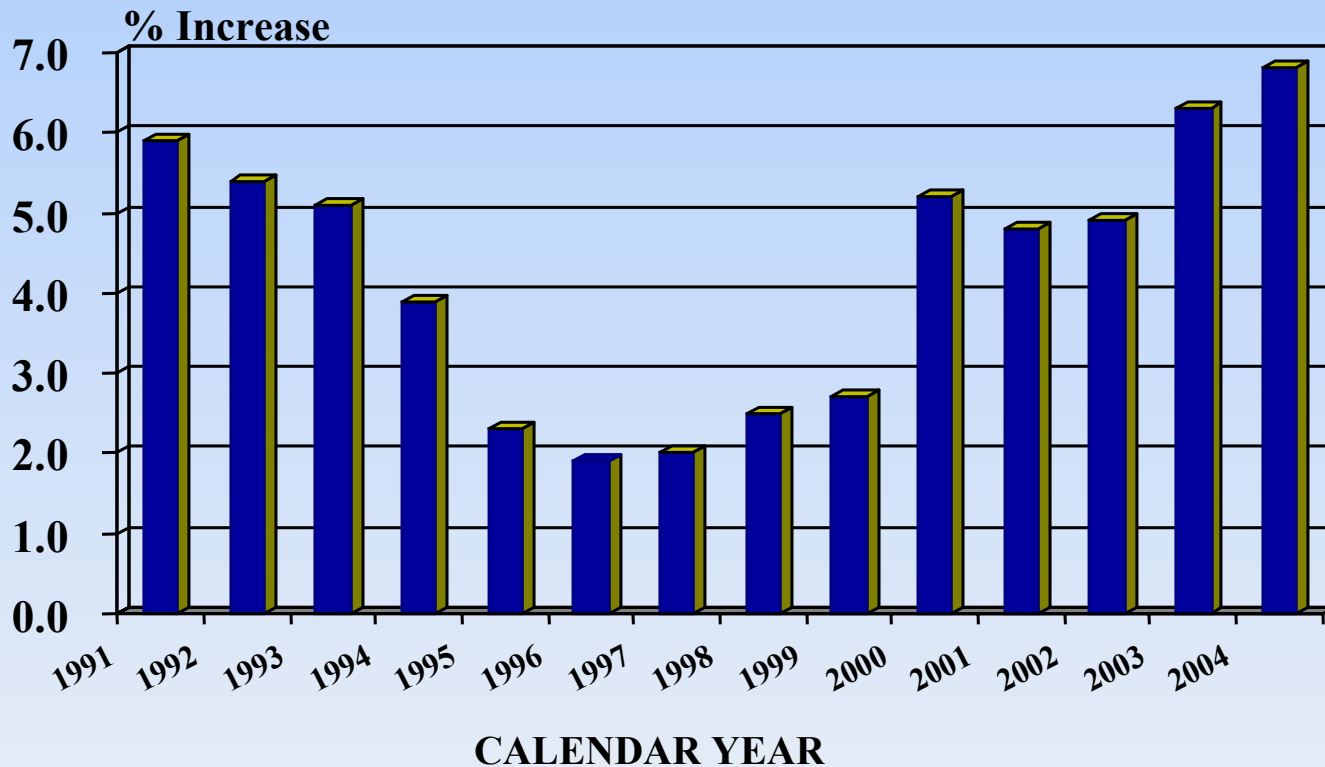


**ANOTHER UNIQUE FEATURE OF THE CURRENT  
RECOVERY IS STUBBORNLY HIGH HEALTH CARE  
COST INCREASES: IMPLICATIONS**

- The State's cost of the Medicaid budget amounts to \$2.4 billion. Thus, 10% annual growth\* amounts to over \$240 million.
- Budget requirements for the cost of state health plan for teachers, state employees, and retirees will be substantial.

\*Used for example purposes. Budget year forecast is still under discussion.

**HERE IS AN EXAMPLE: AVERAGE EMPLOYMENT BENEFIT COSTS FOR CIVILIAN WORKERS\*: CONTINUED ACCELERATION DURING THIS RECOVERY VERSUS SLOWER GROWTH DURING THE LAST TURNAROUND**



\*The primary source is the increase is health insurance costs.

**THE 2005-06 BUDGET OUTLOOK REFLECTS  
THE CARRY FORWARD OF THE STRUCTURAL  
BUDGET SHORTFALL FROM 2004-05**

- State budget solutions around the country depended heavily on one-time budget fixes. Reasons:
  - Resistance to tax hikes
  - No appetite for deep cuts to education, human services, corrections/judicial (90% or more of most state budgets).
  - Perception that normal economic recovery would bail out future budgets.
- States creative in use of one-time measures.
- Result: Practically every state faces a 2005-06 budget gap.

## **HERE'S WHAT COMPRISES \$1.1 BILLION STRUCTURAL BUDGET GAP CARRIED OVER FROM 2004-05**

- Sunset of three major revenue sources: around \$480 million for 2005-06 and about \$650 million for 2006-07.
- Remaining \$600 million of 2004-05 structural budget gap due to use of:
- Highway funds transfer
  - Disaster relief transfer
  - Tobacco settlement transfers
  - Tax collection initiative
  - Tax compliance initiative
  - One-time budget cuts

\*1/2 cent sales tax, 8.25% income tax rate, estate tax.

## **OUTLOOK FOR CAPITAL SPENDING AND OTHER ONE-TIME FUNDING**

- Lack of capital funding capacity and budget reserves due to \$1.5 billion of tax litigation payouts and \$1.0 billion for natural disasters since 1996.
- Weaker-than-normal “current year revenue surplus” limits year-end credit balance.
- Most of year-end credit balance needed for hurricane relief, rainy-day fund, and repairs/renovations of state facilities.
- Rapid rise in state debt levels in recent years may rule out this financing option.

## **STATES ARE PESSIMISTIC ABOUT FEDERAL BUDGET PROSPECTS**

- Ballooning deficit, recent round of tax cuts, and defense spending needs may lead to sharp cuts in state and local aid (includes Medicaid).
- Conformity to federal tax changes costs up to \$40 million for 2005-06.
- Congress may prohibit sales taxes on remote transactions (mail-order, internet) and internet telephone calls.

## ANOTHER WAY TO LOOK AT THE BUDGET ISSUE

- State budget fortunes normally “balloon” during typical recovery. Example:
  - Current year revenues exceed cautious forecast by \$200-400 million.
  - Translating into a similar adjustment for budget year (another \$200-400 million).
  - Medicaid and Community College enrollment growth slows dramatically, saving \$200 million for current year.
  - Growth rate and base for these items is adjusted down for budget year, lowering budget requirements by \$300 million.
- **Result:** Budget fortunes can improve by \$1 billion or more overnight.
- **Challenge:** It’s not happening this time.

## WHY IS IT DIFFICULT TO FINALIZE THE CURRENT YEAR REVENUE FORECAST UNTIL MAY 1

- Large corporate final payments in March may not be related to estimated payments that have already been made.
- High-income individuals with a lot of nonwage income have a choice as to whether to settle up on January 15 or April 15 (penalty is 5% interest).
- Final personal income tax payments affect quarterly estimated payments for new tax year (April 15, June 15).
- Most corporations make first two estimated payments for new tax year in April and June.
- Result: bunching of highly volatile tax payments in March-June period leads to large forecast error range.

## OUTLOOK FOR 2005-06 REVENUES

- Withholding tax collections ramp up due to rehiring (6.1%).
- Slower sales tax growth (4.5% forecast) due to lack of stimulus.
- Double-digit growth in corporate income tax collections drops to a more normal level.
- Stock market recovery, combined with disappearance of loss carryforwards, could lead to double digit increase in capital gains for 2005 tax year.
- Conclusion: Growth in baseline General Fund revenues of over 5%. Far less than typical recovery and below long-run historical rate of (6.6%).

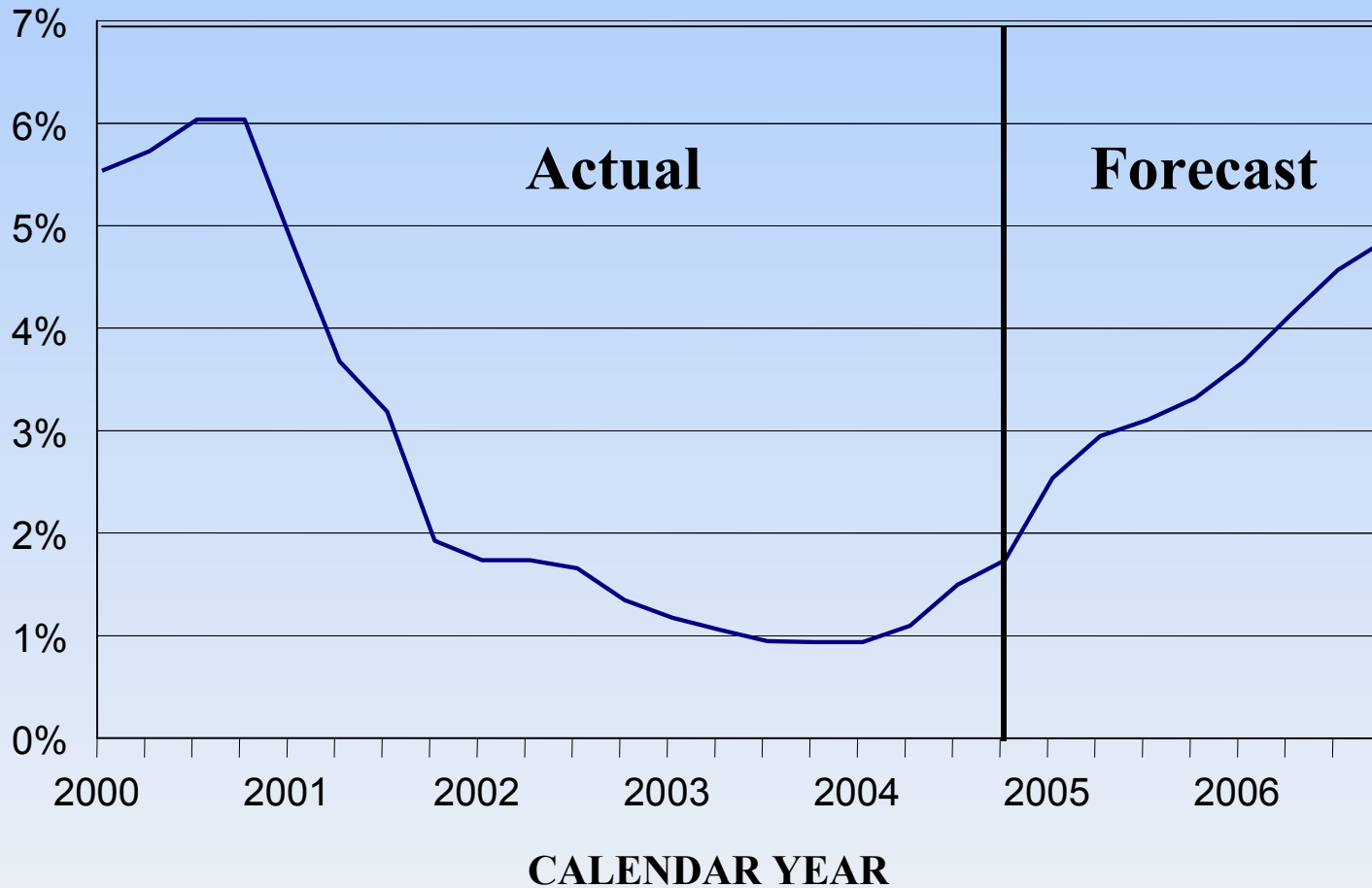
## **WE PAY A LOT OF ATTENTION TO PERSONAL INCOME TAX**

- Amounts to 52% of the General Fund revenue base.
- This share rises over time due to tax structure.
- Wage and salary portion of the base is fairly stable in short run. However, the sheer size of this component means that any movement can mean big dollars.
- Capital gains make up only 4% of income tax base but extreme volatility can affect overall tax collections.

## OUTLOOK FOR CAPITAL GAINS (STOCK PRICES)

- Stock prices from 1982 to 1994 due to lower interest rates. This trend is over.
- The 1995-2000 stock market bubble is over and reported capital gains are almost back to 1994 level. Stock prices and capital gains for the next few years will be influenced by traditional factors (interest rates, corporate profits). Typical annual return: 5-8%.
- Stock market losses in recent years offset by gains from bonds and real estate. Still, gains from the recovery might be dragged down by carryforward losses.

# WHERE ARE INTEREST RATES HEADED: 3-MONTH TREASURY BILLS



# WHERE ARE INTEREST RATES HEADED: FIXED MORTGAGE RATES



# General Fund Revenue Major Revenue Sources (2004-05 Budgeted)

Total Revenues = \$15.6 Billion

