



General Fund Revenue Update

State of North Carolina

REVENUE HIGHLIGHTS

- **FY 2017-18 Revenue**
This quarter's modest \$43 million target shortfall means the State is essentially on target to reach the fiscal year's \$23.1 billion revenue target.
- **Economic Outlook**
The economy is on solid footing and remains in a stable growth pattern. Forecasters project this pattern will continue throughout 2018.
- **Revenue Outlook**
Economic conditions are tracking closely with expectations; collections are expected to remain on target throughout the fiscal year.
- **Federal Tax Reform**
Federal tax changes will not have a significant, ongoing impact on the State's revenue, but taxpayers shifting income between tax years could affect Final Payments in April of 2018 and 2019.

Staff Contact:

Barry Boardman, Ph.D.
Barry.Boardman@ncleg.net

Chief Economist
Fiscal Research Division
North Carolina General Assembly

This report highlights the State's key revenue collections through December 2017, which is the halfway point of Fiscal Year 2017-18. It also looks at the potential State revenue impact of federal tax changes and discusses the economic and revenue outlook for the rest of the fiscal year.

FY 2017-18 REVENUE THROUGH DECEMBER

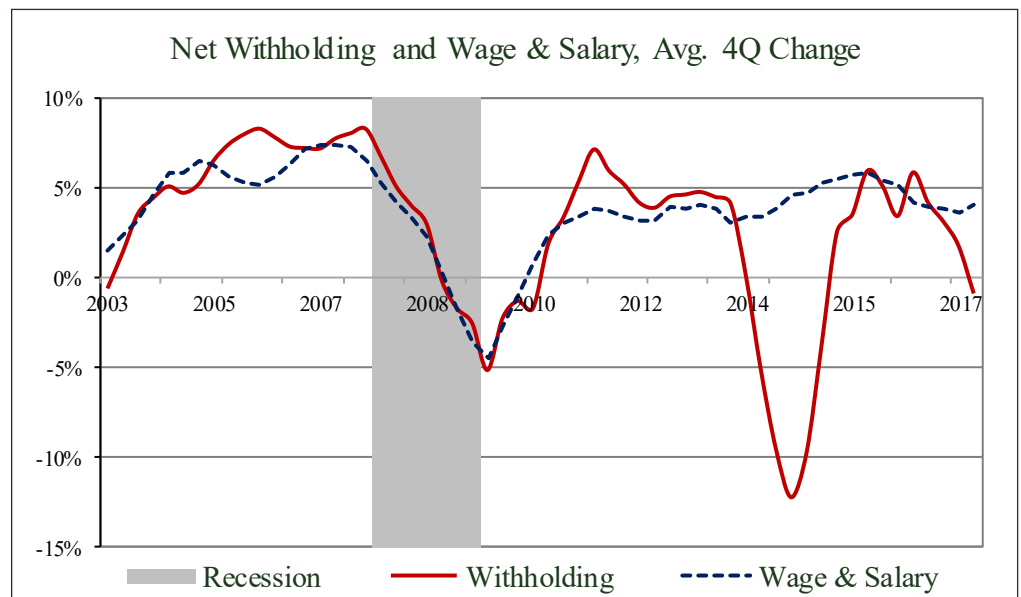
For the first half of the fiscal year, General Fund revenue was \$42.6 million below the \$10.8 billion revenue target. The revenue targets are monthly projections based on the May 2017 consensus forecast, 2017 legislative session adjustments, and previous monthly collection trends.

Second quarter revenue (Oct.-Dec.) was \$7.9 million above target, while the first quarter's revenue was \$50.4 million below target. Overall, the main General Fund revenue sources are running slightly behind expectations. While it is important for revenue collections to keep pace with expectations, the risk and volatility to the forecast reside in the second half of the year; slight variations in the first half of the fiscal year are neither unexpected nor concerning. Since the economy has stabilized and is stronger than it has been since the onset of the Great Recession, risks to the revenue forecast are minimal.

The bottom line is that this quarter's modest \$43 million target shortfall means the State is essentially on track to reach the fiscal year's \$23.1 billion revenue target.

Personal Income Taxes

Through December, net Personal Income tax (PIT) collections are 1.1% (or \$62.5 million) below target. Although PIT growth is 0.1% greater than last year, net wage



Source: Bureau of Economic Analysis; NC Department of Revenue

Personal Income tax collections are \$62.5 million below the revenue targets for the first half of the fiscal year. This is 1.1% below the forecast target.

Sales tax collections are essentially were off by 0.7%, is \$27 million below target. Collections did improve in the second quarter (October through December).

The growth in quarterly collections, shown in the graph, is ahead of what the State has on average experienced in post-recessionary periods.

Collections from corporate taxpayers are nearly on target, at a net \$8.2 million below the \$517 million 6-month target.

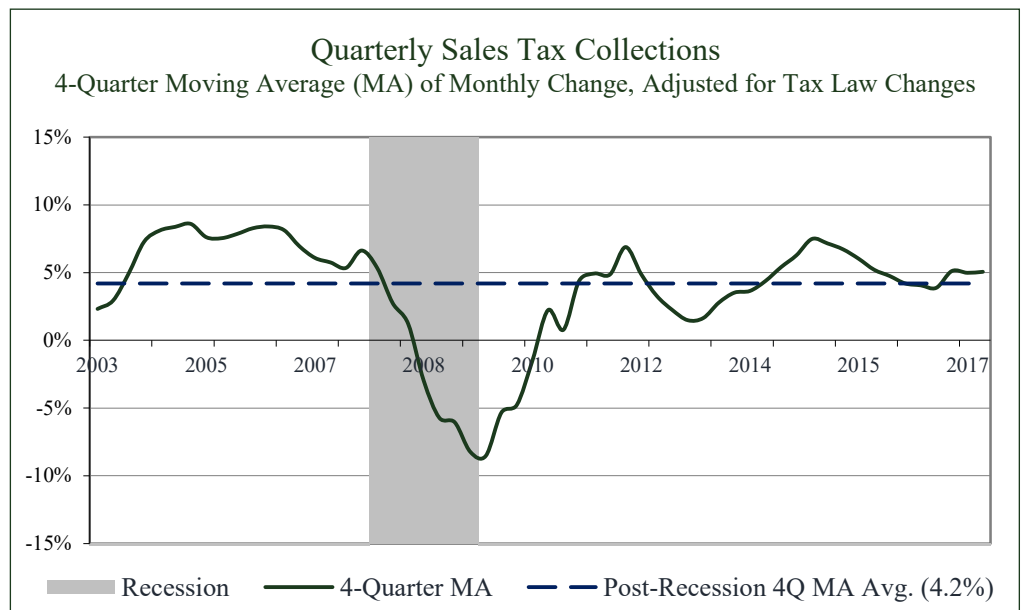
and salary withholding is below target by 3.5% (or \$171.1 million). This weak withholding is offset by higher Estimated and Final Payments, which are \$93.7 million above target.

The below-target withholding collections suggest that the pace for wage & salary growth is slightly below what was projected for the first half of the fiscal year, as withholding collections and wage growth typically are closely aligned.

Due to State tax law changes, net withholding (i.e., withholdings less refunds) fell dramatically in 2014, as the prior graph shows. The State’s rate reduction for the 2017 tax year reflects another significant change in withholdings on wage and salary income, from 5.75% to 5.499%.

Sales and Use Taxes

Through December, net Sales and Use tax collections are essentially on target with revenue within 0.7% of the 6-month target (down \$27.0 million). The consensus revenue forecast for the fiscal year expected 4.7% growth in net collections, which are collections net of refunds, distributions, and transfers. The forecast anticipated that collections would improve from 4.4% growth in the first half of the fiscal year to 5.0% in the second.



Source: Fiscal Research Division calculations and estimates based on data provided by NC Department of Revenue.

Long-run baseline growth was 5.0% this past quarter, which was well ahead of the post-recession average of 4.2% and is slightly above the pre-recession average of 4.8%. Baseline growth indicates that collections are close to forecast expectations, but will need a modest uptick in order to meet the forecast for the fiscal year.

Corporate Income and Franchise Taxes

Through December, the combined Corporate Income and Franchise tax collections from corporate taxpayers are nearly on target, and are \$8.2 million below the 6-month expected amount. Corporate Income tax collections are \$42.2 million below expectations, offset by Franchise tax collections that are \$34.0 million above target.

Income from corporations is made up of Corporate Income taxes (\$42.2 million under target) and Franchise taxes (\$34.0 million above target).

The federal tax legislation's impact on North Carolina revenue will not be as significant as it may be on other states' finances, because the major federal tax changes do not impact NC income tax revenue.

Some provisions of the Tax Cuts and Jobs Act may have a fiscal impact on North Carolina. How these provisions are administered by the IRS may affect how NC tax calculations are made and their resulting fiscal impact.

During the 2018 legislative session, the General Assembly will be faced with the question of whether or not to conform to the federal changes that have a fiscal impact on the State.

The economy is stronger than it was a year ago and is beginning to look like an economy that has entered into a true expansionary phase.

Corporate Income tax collections are down significantly over last year, largely due to the State rate reduction from 4% to 3% effective with tax year 2017. This drop was anticipated in the forecast for FY 2017-18. However, collections after that adjustment are still 17% below target.

Corporate tax payments can fluctuate considerably over this time period if the State receives even a few large tax payments or issues larger-than-expected refunds on previous years' tax liabilities. Therefore, it is typical in the first half of the fiscal year for corporate tax payments to vary from the target. We will have a better picture of whether revenue from these two corporate taxes will meet the revenue forecast's projections later this Spring, when the State receives Final Payments on Corporate Income (April) and regular payments on Franchise taxes (March/April).

FEDERAL TAX CHANGES: IMPACT ON NORTH CAROLINA TAX REVENUE

In December, Congress enacted a substantial piece of tax policy legislation: P.L. 115-97, the Tax Cuts and Jobs Act ("Act"). The Act's impact on North Carolina revenue collections will not be as significant as it may be on other states due to how North Carolina taxable income is calculated:

- North Carolina sets its own personal and corporate tax rates, meaning that the federal rate changes will not impact State collections.
- North Carolina does not conform to federal personal exemption amounts or standard deduction amounts, so the elimination of federal personal exemptions and changes to the federal standard deduction will not affect State collections.
- North Carolina only partially allows certain federal itemized deductions; therefore, the elimination of, and changes to, numerous federal itemized deductions will not impact taxpayers who itemized their deductions when filing their State income taxes.
- North Carolina does not fully conform to federal business and expensing tax laws, meaning that the federal changes to business depreciation and expensing will not impact the State's revenue collections.
- North Carolina's calculation of taxable income begins with Federal Adjusted Gross Income (FAGI), and the revised federal treatment of business income for certain pass-through business income will not change how FAGI is determined.

However, some of the Act's provisions could have a relatively small fiscal impact on North Carolina. Throughout 2018, the IRS will issue guidance on how several of the Act's provisions will be administered; depending on the guidance, some provisions could affect how NC tax calculations are made and their resulting fiscal impact.

States whose tax calculations mirror federal tax calculations must decide whether to conform to the many federal tax changes. In North Carolina, the General Assembly will need to consider whether to conform to the federal changes that have a fiscal impact as part of the Internal Revenue Code update legislation it considers during the 2018 Regular Session.

ECONOMIC OUTLOOK & REVENUE FORECAST

The economy is experiencing the second-longest recovery after a recession on record; in seven more months it will surpass the 128-month recovery that ended in

Wage growth will need to pick up the pace in the second half of the fiscal year if overall collections are to be on target.

Employment continues to grow at a steady pace and should spur additional overall wage growth.

Similar to 2012, last minute changes were made to the tax code at the end of 2017. This could lead to another round of taxpayer income shifting.

March, 2001. For now, most forecasters see a minimal risk of a downturn and are reporting more upside than downside risks to their forecasts (Wall Street Journal, Economist Survey December 2017).

Since October 2017, when the last [General Fund Revenue Update](#) was published, the economy's course has changed little. The economy is stronger now than it was a year ago, and it is beginning to look like an economy that has entered a true expansionary phase.

The national economy is expected to operate slightly below its long-term average growth rate of 3.0% in 2018. Short-term economic stimulus from the federal tax changes is likely to bolster that projection.

For North Carolina, current data on income and overall economic activity (i.e., Gross State Product) indicate that the State's growth is starting to outpace average national growth. The State's typical pattern is one in which downturns are bigger and upturns are more robust compared to the national average. It took seven years for that pattern to develop after the last recession.

The consensus forecast expects the total wage base to grow by 4.8% this fiscal year. This is similar to last fiscal year's estimated growth of 4.7%, but less than the pre-recession growth rates of 6% to 7%.

Through the first half of the fiscal year, Personal Income tax revenue on withholding indicates that wage growth is somewhat slower than the 4.8% forecast target. Wage growth will need to pick up the pace if overall collections are to be on target. The good news is that employment continues to grow at a steady pace and should spur additional overall wage growth.

ANOTHER FISCAL CLIFF?

With respect to April 2018 collections, the federal tax changes that were enacted at the end of 2017 may have some impact on April collections.

In 2012, as the 2002 federal tax decreases were set to expire, taxpayers responded by increasing their income tax liability in 2012 to take advantage of the lower rates. This meant that the April 2013 collections surpassed expectations. The shift in income meant income tax collections were anticipated to fall the following tax year, and in fact, final payments in 2014 were \$160 million less than in 2013. This was one of the effects of what was generally referred to at the time as the "fiscal cliff."

Similar to 2012, last minute changes were made to the tax code in December, 2017. This could lead to another round of taxpayers shifting income. Because there were more changes to the tax code this past December than just rate changes, the magnitude of the shift of income out of 2017 and into 2018 may not be as dramatic (the opposite effect of the 2012 fiscal cliff). And because these changes were uncertain until the very end of 2017, taxpayers may have had less of an opportunity to shift income from one tax year into another, thus further limiting the amount of income shifting.

Nonetheless, it is quite possible that April's final payments on the 2017 tax year from both Personal and Corporate taxpayers will come up short of expectations. The State will not have solid data on these payments until this coming April.

APPENDIX**North Carolina General Fund Revenue by Revenue Source, Fiscal-Year-to-Date
(\$ in Millions)**

Tax Revenue	Budget 2017-18	Actual 2017-18	Target Difference	Actual 2016-17	Y/Y Pct. Change
Personal Income	\$ 5,674.3	\$ 5,611.8	\$ (62.5)	\$ 5,604.4	0.1%
Sales and Use	3,736.4	3,709.4	(27.0)	3,578.6	3.7%
Corporate Income	245.5	203.3	(42.2)	242.9	(16.3%)
Franchise	271.9	305.9	34.0	335.9	(8.9%)
Insurance	148.1	166.3	18.2	144.3	15.2%
Alcoholic Beverage	186.0	186.7	0.7	177.3	5.3%
Inheritance	-	10.0	10.0	0.5	N/A
Privilege License	15.2	14.8	(0.4)	12.6	16.7%
Tobacco Products	131.6	132.1	0.5	133.4	(1.0%)
Real Estate Conveyance	34.5	37.3	2.8	33.4	11.5%
White Goods Disposal	2.0	5.5	3.5	2.1	161.7%
Scrap Tire Disposal	6.3	5.9	(0.4)	6.1	(3.5%)
Mill Machinery	24.1	21.7	(2.4)	23.3	(6.6%)
Solid Waste Disposal	2.0	5.9	3.9	5.8	1.1%
Other	-	3.3	3.3	-	N/A
Total Tax Revenue	\$ 10,477.9	\$ 10,419.8	\$ (58.1)	\$ 10,300.7	1.2%
Nontax Revenue					
Investment Income	\$ 28.5	\$ 40.9	\$ 12.4	\$ 28.3	44.7%
Judicial Fees	116.9	114.9	(2.0)	115.4	(0.5%)
Insurance	14.2	18.9	4.7	21.5	(12.1%)
Disproportionate Share	115.8	115.8	-	147.0	(21.2%)
Master Settlement Agreement	-	-	-	-	N/A
Other	54.3	54.8	0.5	44.8	22.4%
Total Nontax Revenue	\$ 329.7	\$ 345.2	\$ 15.6	\$ 356.9	(3.3%)
Total General Fund Revenue	\$ 10,807.6	\$ 10,765.0	\$ (42.6)	\$ 10,657.6	1.0%

Source: NC Department of Revenue, compiled by the Fiscal Research Division