Quarterly Revenue Report:

July-September (Q1), FY 2017-2018

February 21, 2018

NC LEAGUE OF MUNICIPALITIES

ABOUT THIS DOCUMENT

The Revenue Report below, and others released during each quarter, summarize actual state-collected local revenues as they are distributed throughout the year, and compare them to historical data. Questions about this report, should be directed to League Director of Research and Strategic Initiatives, Chris Nida.

Note: *The League's full Revenue Projection report, released in March each year, provides a more detailed analysis and forecast of state-collected local revenues for the remainder of the current fiscal year and the upcoming fiscal year.*

REPORT OVERVIEW

The Department of Revenue (DOR) collects a variety of taxes in North Carolina. A portion of several types of local taxes are collected by the state before being returned to local governments. These include Local Option Sales and Use Taxes, Utility Sales Taxes on electricity, piped natural gas, telecommunications, and local video programming, Beer and Wine Tax, and Solid Waste Disposal Tax. These taxes are distributed periodically throughout the fiscal year according to formulas outlined in state law. For more information on the different types of state-collected local taxes and distribution formulas, see the League's "State-Collected Local Taxes: Basis of Distribution" memo.

This report includes discussion of the following new DOR data, released since the publishing of the last Revenue Report in November:

- Sales and use tax distributed for sales made during July through September, 2017[1]
- Utility sales tax distributed for Q1 of the 2017-2018 Fiscal Year
- Solid waste tax distributed for Q1 of 2017-2018 Fiscal Year
- Total beer and wine tax collected by the state since October 2017

The first quarter of Fiscal Year 2017-18 showed overall growth in state-collected tax revenue distributed to local governments. Sales and use tax revenue was up by roughly 6.9 percent over the previous fiscal year. Beer and wine and solid waste disposal tax revenue both increased from last year. Utility tax revenue for sales on natural gas increased, though tax revenue from electricity, telecommunications, and video programming decreased. Economic reports continue to project growth, though at a slightly slower pace. North Carolina is currently outpacing the nation as a whole. Of course, economic growth is not being experienced uniformly across the state, as the League frequently notes in its projections.

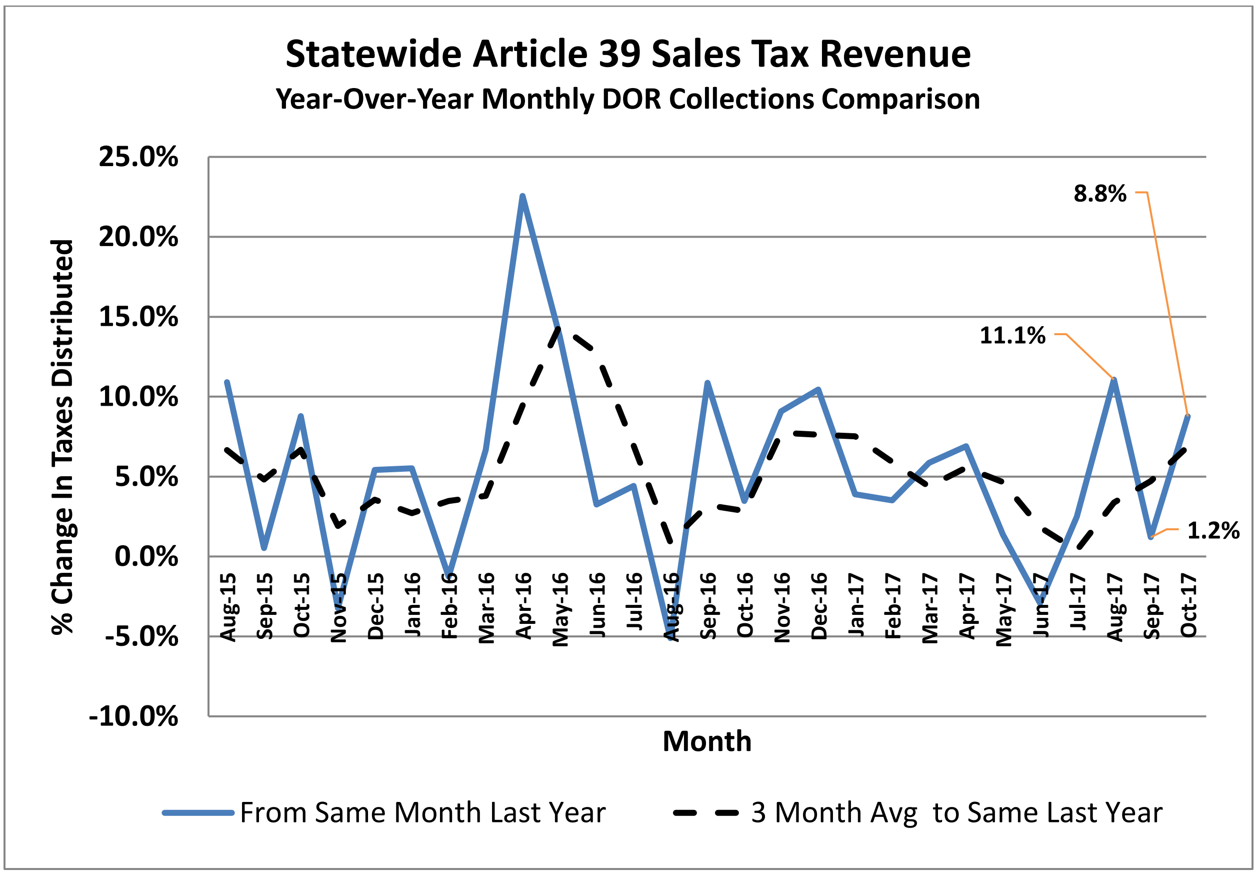
[1] Distributions received in October are generally representative of July sales, those received in November are representative of August, etc. Based on state accounting guidelines, the League assumes that revenues are accrued for 90 days. Please refer to memo #1015, "Recognition of Sales Tax and Other Revenues at Year-End," issued by the LGC on March 31, 2004, for further details and guidance.

LOCAL GOVERNMENT SALES & USE TAXES

Of the taxes distributed to local governments by DOR, sales and use taxes make up the largest amount of revenue received. Local sales taxes are divided into different Articles, though not all are levied by every county. This report focuses only on Article 39 sales tax. Article 39 tax is charged in every locale and distributed to counties on the basis of where the Article 39 sale occurred. Because of this, Article 39 sales tax revenues perhaps best reflect the sales trends in local government sales tax revenue.

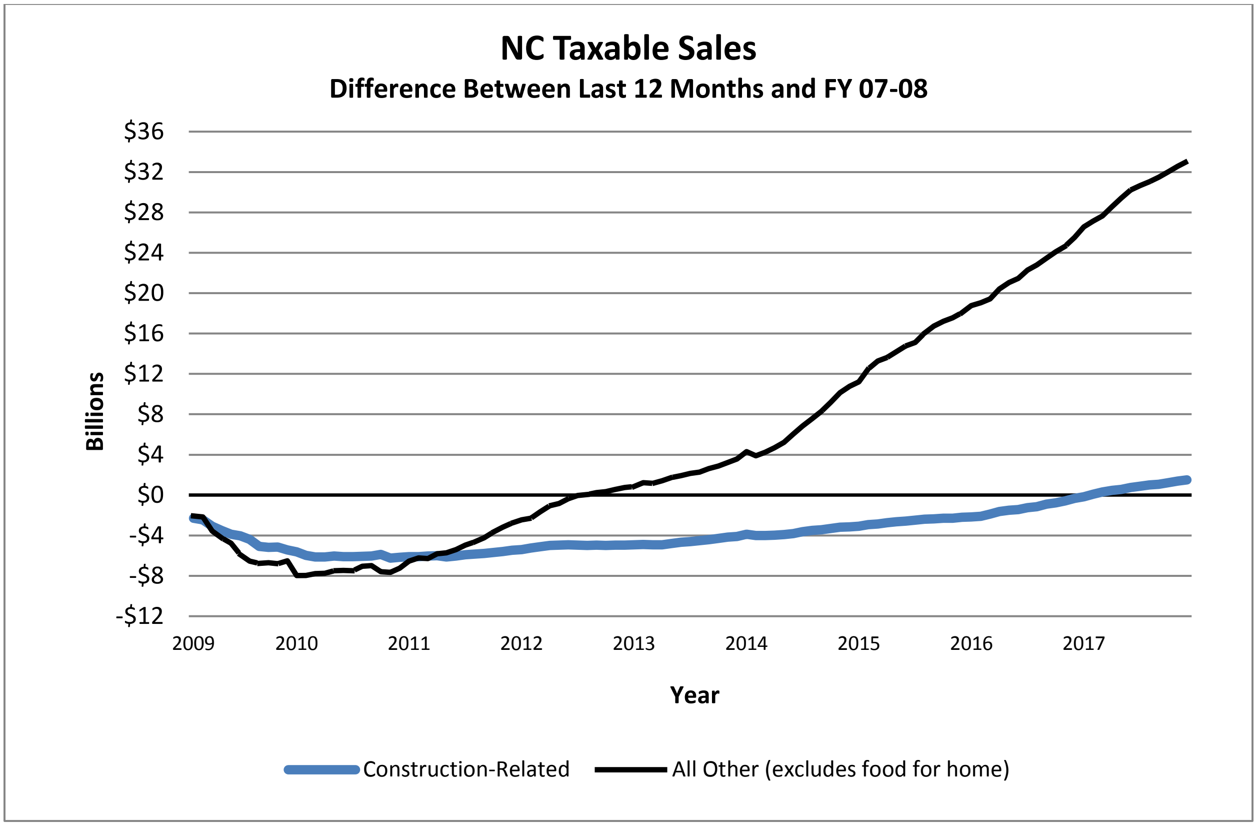
For first-quarter sales of Fiscal Year 2017-18, local governments received 6.9 percent more Article 39 sales taxes from DOR, compared to the same quarter the previous year. Half of counties experienced an increase equal to or greater than 6 percent, with 84 counties seeing positive growth. On the other hand, 16 counties experienced a decrease in sales tax revenue for the first quarter of Fiscal Year 2017-18 compared to Fiscal Year 2016-17.

The chart below shows year-over-year comparisons of Article 39 sales tax revenues distributed to local governments. The solid line represents the percent change in sales tax distributions from the same month in the previous fiscal year. The dotted line represents the sum of the previous three months' distributions as compared to the same three months in the previous fiscal year.



August, September, and October collections (July through September sales) were all higher than the same month last year. Most notably, August collections (July sales) increased by 11.1 percent compared to last year. October collections (September sales) increased by 8.8 percent, while September collections (August sales) saw the smallest increase of 1.2 percent. The three month average was also higher than last year for each month of the first quarter. The three month average change has now remained positive year-over-year since March 2013.

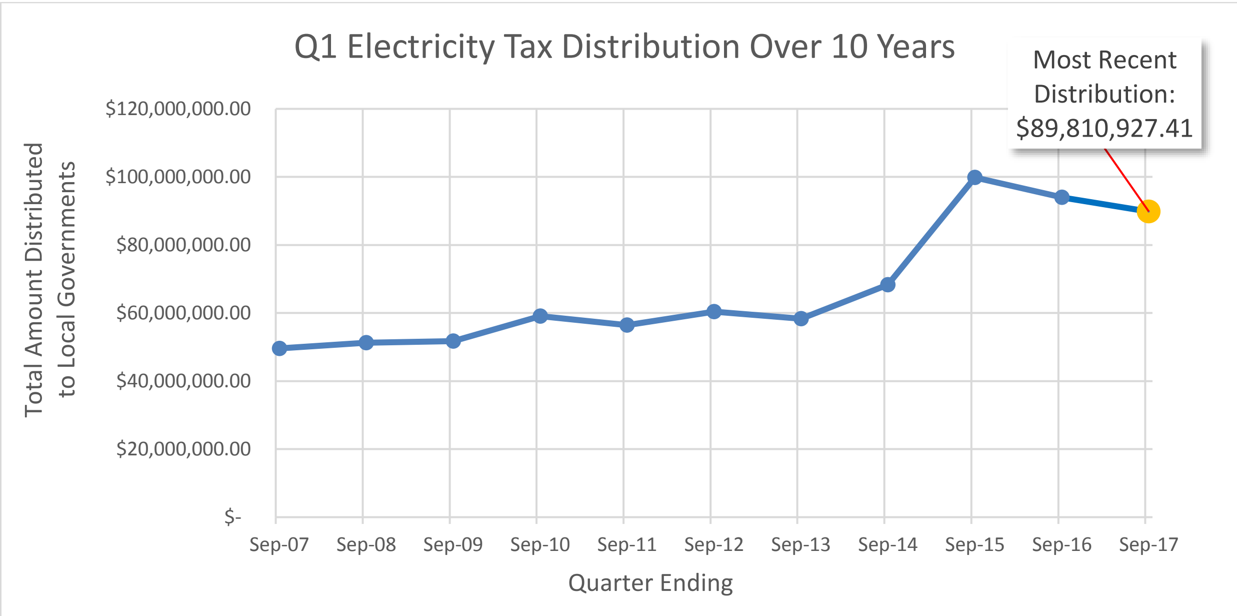
Taxable sales trends were similarly positive. As of January, the most recent 12 months of sales in construction-related areas had surpassed pre-recession fiscal year levels (Fiscal Year 2007-08) by $1.5 billion. All other sales continued to grow steadily as well.



UTILITY SALES TAXES

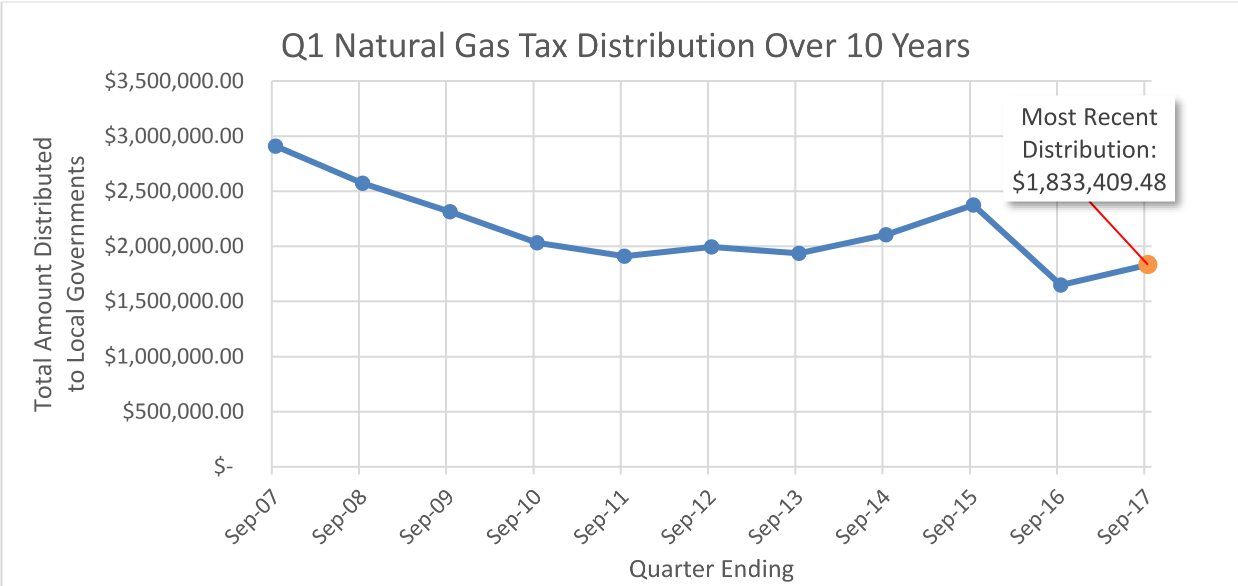
Quarterly, the Department of Revenue distributes sales tax from four separate utilities – electricity, natural gas, telecommunication services, and video programming. The most recent distribution of utility sales taxes occurred on December 15, 2017. This distribution reflected utility sales tax revenue collected during the first quarter of the current fiscal year (July through September, 2017). Here is a quick look at the distribution for each utility:

Electricity: Local governments received $89,810,927 in electricity sales tax revenue for the first quarter of Fiscal Year 2017-18. This is a 4.4 percent decrease from the same quarter in the previous year.



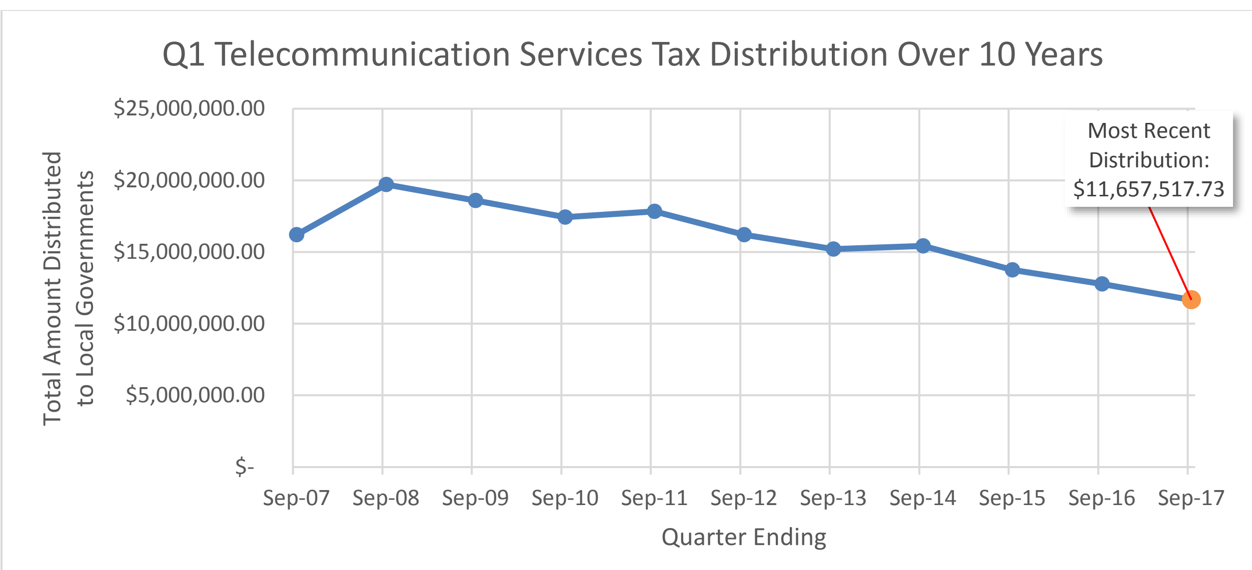
During the 2014-15 Fiscal Year, the electricity franchise tax was eliminated, and local governments began receiving a percentage of tax on electricity sales instead. Electricity tax revenues remain increased as a result of the change, but have declined from their 2015-2016 Fiscal Year peak. This continues to be a weather- and energy cost-dependent revenue source, so factors like the price of electricity and consumer consumption levels will continue to play a significant role in the amount of revenues received going forward.

- **Natural gas:** Local governments received $1,833,409 in natural gas sales tax revenue for the first quarter of Fiscal Year 2017-18. This is an 11.2 percent increase from the same quarter in the previous year.



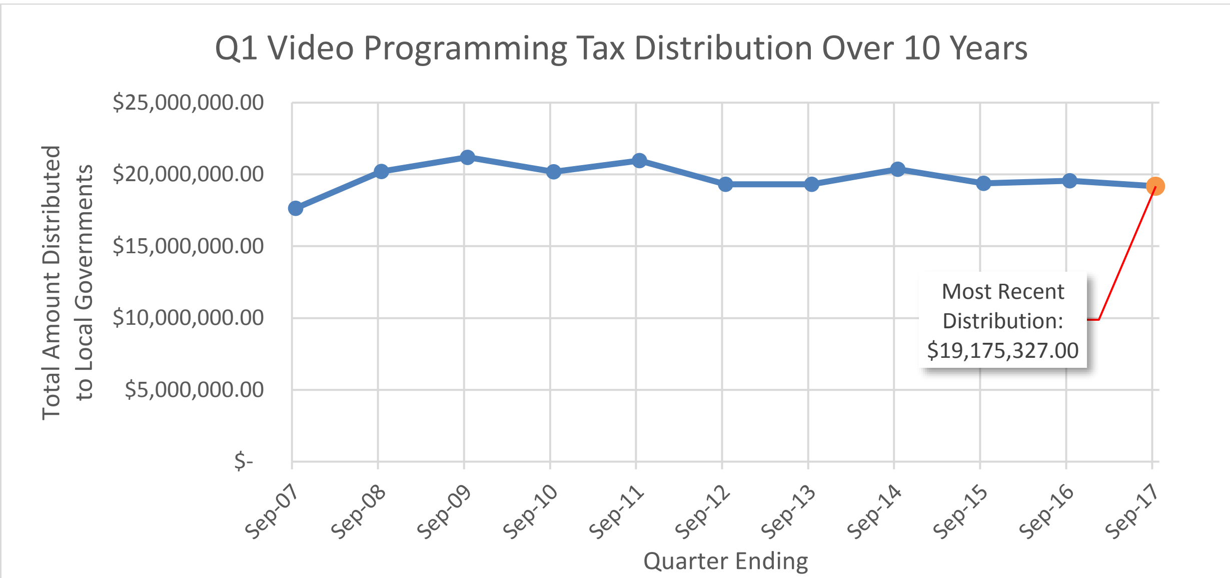
Like the electricity tax revenue, local governments now receive a percentage of tax revenue from the sale of natural gas, rather than the previous franchise tax. Revenues from natural gas sales remain lower than they were prior to this change, but unlike electricity revenues, they are trending upward. Like electricity, natural gas revenue varies based on weather and energy prices.

- **Telecommunication services:** Local governments received $11,657,517 in telecommunication sales tax revenue for the first quarter of Fiscal Year 2017-18. This is an 8.7 percent decrease from the same quarter in the previous year.



Taxes on telecommunication services continue to be negatively impacted by a growing reliance on cell phones in place of land line phone connections. Quarter one distributions have decreased year-over-year by an average of 6.3 percent for the past five years. It appears this trend is continuing into the 2017-2018 Fiscal Year.

- **Video programming:** Local governments received $19,175,327 in video programming sales tax revenue for the first quarter of Fiscal Year 2017-18. This is a 2 percent decrease from the same quarter in the previous year.



Video programming tax revenue, like telecommunication service tax revenue, is consistently declining as other technologies for video programming are adopted by consumers. However, refunds have had a less pronounced effect on video programming revenues, compared to telecommunications. Distributions for the final two quarters of the 2016-2017 Fiscal Year were 3.5 and 1.5 percent less than the previous year, and this trend continues in the 2017-2018 Fiscal Year.

SOLID WASTE DISPOSAL TAX

Solid waste disposal tax revenue for the first quarter of Fiscal Year 2017-18 was 4.0 percent higher than the first quarter distribution in Fiscal Year 2016-17. Distributions have now shown year-over-year increases for seven consecutive quarters. As mentioned in the November Revenue Report, the Environmental Review Commission has an ongoing directive to study the solid waste disposal tax. However, the Commission met just once in 2017 and did not propose any changes to the solid waste disposal tax at that time. The League will continue to monitor the study and will inform its members of any findings or recommendations that may affect this revenue source going forward.

BEER & WINE TAXES

Since October 1, 2017, state collections of alcohol-related taxes have increased each month compared to the same month the prior year. These increases range from just over 0.0 percent in January 2018 to 5.3 percent in November 2017. While not a perfect proxy for the annual local distribution, the continued increase in sales indicated by these tax revenues hopefully indicates, at a minimum, that no revenue decrease is expected for the upcoming annual distribution in March.

ECONOMIC INDICATORS

Optimism regarding the North Carolina economy continues to be more tempered since the last Revenue Report in November. Dr. Michael Walden's Index of North Carolina Leading Economic Indicators again decreased 0.5 percent from November to December, due in large part to a nearly 26 percent decrease in building permits.[2] Dr. John Connaughton's December 2017 forecast for Gross State Product concluded with 2.0 percent growth for 2017 over the 2016 level, followed by subsequent 2.2 percent projected growth in 2018.[3] Wells Fargo reported that an average of 9,900 jobs were added during each of the last three months of 2017, though unemployment rose slightly to 4.5 percent by the end of 2017.[4] The January Carolinas Survey of Business Activity reported continued, but slowing, growth as indicated by general business conditions and sales. The availability of employment skills needed rose to zero, having been negative in the last quarter of 2017. A rise in wages and capital expenditures is expected to continue, along with acceleration in price growth.[5]

Since the November Revenue Report, the General Assembly's Fiscal Research Division released its January report on state revenue in the first half of Fiscal Year 2017-18.[6] At the end of the first two quarters, total General Fund revenue was running $42.6 million short of targets. Second quarter revenue was $7.9 million above target, which helped make up for the first quarter's $50.4 million below-target revenue. Despite the shortfall, the Fiscal Research Division predicts the state is on track to reach projected revenue. Sales and use taxes were only 0.7 percent under projections, and 4.7 percent growth in net collections (refunds, distributions, and transfers) is still expected. State economic growth is outpacing federal growth, though wage growth will need to increase for overall state revenue collections to reach projections.

Overall, reports indicate that North Carolina's economy continues to be on stable footing, with additional growth expected, though perhaps slowed. The outcomes of new federal developments at the federal level remain to be seen. The Tax Cuts and Jobs Act of 2017 nearly doubles standard deductions, and lowers the corporate income tax rate to 21 percent, among other reforms. It also caps State and

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[2] https://ag-econ.ncsu.edu/wp-content/uploads/2015/11/january2018.pdf
[3] https://belkcollege.uncc.edu/sites/belkcollege.uncc.edu/files/media/Forecast%20PP_120517.pdf
[4] https://www08.wellsfargomedia.com/assets/pdf/commercial/insights/economics/regional-reports/nc-employment-20180123.pdf?https://www.wellsfargo.com/assets/pdf/commercial/insights/economics/regional-reports/nc-employment-20180123.pdf
[5] https://www.richmondfed.org/-/media/richmondfedorg/research/regional_economy/surveys_of_business_conditions/carolinas/2018/pdf/car_01_25_18.pdf
[6] https://www.ncleg.net/FiscalResearch/generalfund_outlook_pdfs/17-18%20Outlooks/January%202018%20General%20Fund%20Revenue%20Update.pdf

Local Tax deductions at $10,000. In December, the Federal Reserve raised interest rates, with additional rate increases expected in 2018. The new Federal Reserve Chair, Jerome Powell, was sworn in earlier this month.

LGERS

The Board of Trustees of the Local Governmental Employees' Retirement System (LGERS) met in January. During that meeting the Board voted to accept staff's recommendation to continue with the previously adopted Employer Contribution Rate Stabilization Policy. This means that, for Fiscal Year 2018-19, employer contribution rates for both general employees and law enforcement officers will increase by 25 basis points (0.25%). This brings the base contribution rate to 7.75% for general employees and 8.5% for law enforcement officers. There can be some variation in a local government's specific LGERS contribution rate, and if you have questions about your employer's contribution rate you should contact a representative from the N.C. State Treasurer's office. However, in general, an employer's contribution rate for FY18-19 should be 25 basis points higher than the contribution rate in FY17-18.

RESOURCES

- Local government revenue distribution data can be found on the N.C. Department of Revenue website.
- The N.C. Association of County Commissioners has been providing a helpful monthly breakdown of sales tax distributions on its County Research Pulse blog.
- Information on economic indicators used in this report can be found in the following locations:
    - Federal Reserve Bank of Richmond
    - Wells Fargo
    - Dr. Michael Walden of N.C. State University
    - Dr. John Connaughton of UNC-Charlotte