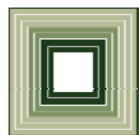


GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK



May 2010
Barry Boardman, Ph.D.
Fiscal Research Division
North Carolina General Assembly



FISCAL RESEARCH DIVISION
A Staff Agency of the North Carolina General Assembly

Highlights

- A big April “surprise” never materialized. Based on the consensus forecast, April revenues came in as expected. Year-to-date collections are now \$320 million below the fiscal year budget numbers. The State’s on track for an anticipated \$390 million end of year shortfall for 2009-10.
- Three economic events continue to drag down the US and NC economy: the ongoing housing recession, cautious consumers, and tight credit conditions. Each of these are taking a toll on consumer spending and placing a drag on the pace of the recovery.
- The length and severity of the recession, plus the anticipated slow recovery in employment are the key factors influencing the April forecast revisions. The result is the FY 2010-11 forecast was revised downward with baseline growth declining from 3.3% to 2.6%.



How Do 2009-10 Revenues Look So Far?

- General Fund revenue through April is \$320 million below \$16.3 billion target for the period.
 - Weak economy-based taxes remain the key reason for the budget shortfall. The revenue targets are based on the May 2009 consensus forecast. That forecast anticipated a somewhat stronger recovery in the State, especially with respect to Sales tax collections.
 - Another source of weakness that shows up in April is current year estimated payments by Personal and Corporate taxpayers. Despite being 6-8 months into the recovery, these payments are under performing the expectations built into the May 2009 biennium forecast.



How Do 2009-10 Revenues Look So Far?

- Net income tax withholding on wages and salaries are down 2.3% through April compared with last year. That is a slight improvement over where we were a couple of months ago but still nearly 2% below expectations.
 - Financial sector bonuses, absent from last year's withholdings, have returned and are helping stop the slide in withholding.
 - Job growth across most industry sectors is expected to continue but it will be too slow to significantly impact withholding tax collections this year.
- Sales tax collections continue to suffer as consumers react to weak job and housing reports.
 - Baseline (tax-adjusted) collections for the first 9 months of the fiscal year are down 9.7% compared to last year.
 - Net State collections, including tax law changes, are up 13.2%; however, revenue targets projected a 17.2% increase. The result is net sales tax collections are \$165 million short of expectations.

2009-11 Biennium Forecast

April 2010 Consensus Forecast: FRD and OSBM agree to revised revenue numbers

	<u>Revised Revenues</u>	<u>Revision</u>
FY2009-10	\$18,535.7	(\$391.0)
<hr/>		
FY2010-11	\$18,936.0	(\$702.9)



Revenue Estimate Summary

- Based on the revised consensus forecast, General Fund Revenues for this fiscal year will come in \$391.0 million under the budgeted amount (\$18,535.7 vs. \$18,926.7 budgeted):
 - Despite the economic recovery, key economy-based taxes continue to fall further behind last year's collections.
 - The decision to plan for a modest decline in the FY 2009-10 baseline budget helped the State avoid the sizeable revenue shortfalls that other states are grappling with as they go through the budgeting process this year.
- The revised baseline revenue growth for FY 2009-10 is a negative 4.5% vs. the negative 2.2% budgeted.



Revenue Estimate Summary

- The April 2010 General Fund consensus forecast includes a downward revision for FY 2010-11. Revenues are forecast to be \$702.9 million less than was budgeted (\$19,638.9 vs. \$18,936.0 budgeted):
 - Three economic events continue to drag down the US and NC economy: the ongoing housing recession, cautious consumers, and tight credit conditions. Each of these continue to take a toll on consumer spending and are a drag on the recovery.
 - The key factors influencing the April forecast revisions were the length and severity of the recession, which continues to impact key revenues, and the anticipated slow recovery in employment. The result is the FY 2010-11 forecast was revised downward with baseline growth declining from 3.3% growth to 2.6%.
 - In addition to the downward revision, the one-year expiration of the federal estate tax means an additional loss in General Fund revenue of \$85 million making **the net revision \$787.9 million.**



Revenue Estimate Summary

- The new consensus forecast set very low expectations for April collections and those low expectations came to fruition.
- Thus, a big April “surprise” never materialized, and we are on track for the forecasted \$391 million shortfall.
 - Key April collections include final payments on last years income, mostly from non-withholding, plus estimated payments from personal and corporate income taxpayers based on the current tax year, and personal income tax refunds.
 - The April consensus forecast anticipated that these payments would continue to decline further from last year’s drop-off and refunds would be higher than normal again. The result was April payments and refunds corresponded with these consensus expectations.
 - Because there was no April surprise (in either direction) and with no change in economic conditions, there was no need to revisit the consensus forecast numbers produced last month.

FY 2010-11 Revenue Revision and Economic Conditions

- The May 2009 forecast expected the economy to be in full expansionary mode by now; however, the economy, while expanding, is doing so at a very slow pace with respect to employment and consumer spending.
 - The economy continues to be entangled by the housing recession and the slow unwinding of this problem will continue to be a drag on the economy into 2011.
 - Tighter financial markets continue to slow some investments and are adding to the economic malaise.
 - Consumer spending is finally starting to show signs of life after nearly two years of decline.
 - Business investment and export demand growth have been fueling the economic recovery.



FY 2010-11 Revenue Revision and Economic Conditions

- The global financial market collapse in October 2008 sent an already contracting economy into a prolonged and severe recession and had a major impact on the State's economy.
- The worst is behind us and a recovery is well underway, but there is still a long way to go before we return to pre-recession levels.
- Based on the latest surveys of national forecasters, compiled by the Wall Street Journal and Associated Press, the economic recovery is expected to unfold very slowly.
 - The pace of the recovery will struggle to produce economic activity at the level of long-term, average growth. This anticipated slow paced recovery will not be strong enough to produce job growth that will return us to pre-recession employment over the next year.

FY 2010-11 Revenue Revision and Economic Conditions

- Given these economic conditions, a cautious approach was taken with the 2010-11 forecast. The downward revision was driven by:
 - the lower base from which to increase revenue, the result of lower revenue collections for the current fiscal year,
 - and the downgraded economic growth forecast for the nation and the State's economy.
- In addition to a weak economic forecast, a key reason for taking a cautious approach with the revenue forecast is our expectations for volatile revenue sources such as capital gains on stocks and real estate, and corporate income (25-30% of General Fund revenue).
- Because many of these taxpayers will be able to carry forward the significant losses experienced during the recession, we think these sources of revenue will remain depressed despite the recovery.
 - This will keep tax liabilities down even as these individuals and businesses begin to earn profits and gains from their investments.

FY 2010-11 Revenue Revision and Economic Conditions

- The economy-based taxes forecast reflects the slow economic recovery:
 - Withholding growth is forecast to remain below long term trend. Wage and salary growth is revised down from 1.3% to 0.1% for the 2010 tax year and from 3.8% to 3.6% for 2011.
 - Baseline sales tax growth drops to 1.5%, from 2.4%.
- As noted, the volatile revenue sources have been pushed back due to losses:
 - Net non-withholding is forecast to decline for the 2010 and 2011 tax year.
 - Corporate income taxes are revised downward from 5.6% to 3.6% baseline growth.



Risks to the Revised Forecast

- Two of the nation's leading forecasting firms (Moody's economy.com and Global Insight) have stated that the national economy can expect moderate growth the rest of the year.
- Nonetheless, consumer spending, will be constrained with continued tight credit, high household debt burdens, and the government's monetary and fiscal stimulus programs coming to an end.
 - Because of the protracted slow recovery over the next year, expectations for revenue growth in FY 2010-11 have been lowered.
- I remain less pessimistic about the State's economic outlook over the next 2 years than some economists are about the national economy. The State's economy is posed to fare better than many large Western states (California, Arizona) and Mid-West states (Michigan, Ohio), but strong growth is still at least a year away as the employment picture slowly recovers through the rest of 2010.



Risks to the Revised Forecast

- Sovereign debt problems of European countries, most notably Greece, are expected to be a drag on their economic growth.
- The debt problem is likely to extend the time horizon of our own slow-growth scenario.
- To date, export demand has been a key to developing a sustainable recovery here in the U.S.
- While the sovereign debt problem is not expected to approach the magnitude of the global financial crisis of 2008, it will be a drag on global and national economies.



Risks to the Revised Forecast

- The affect of the sovereign debt crisis on export demand and lending rates, along with the strength of consumer spending, will be two crucial concerns as we monitor economic conditions.
- The modest growth scenario will remain at risk because of weakness in consumer spending caused by:
 - the loss of household wealth, a result of the prolonged real estate downturn;
 - relatively high debt burdens;
 - tight consumer credit from the ongoing sub-prime/foreclosure debacle; and
 - weak or flat growth in disposable income.
- Finally, any recovery during the second half of this year and the first half of 2011 will be modest at best. A true expansionary economy may be another year away. The housing recession and the interrelated credit crisis have taken a very long time to unwind. We may be well into 2011 or 2012 before we see an end to the excess in housing inventory and a return to a regular housing market.

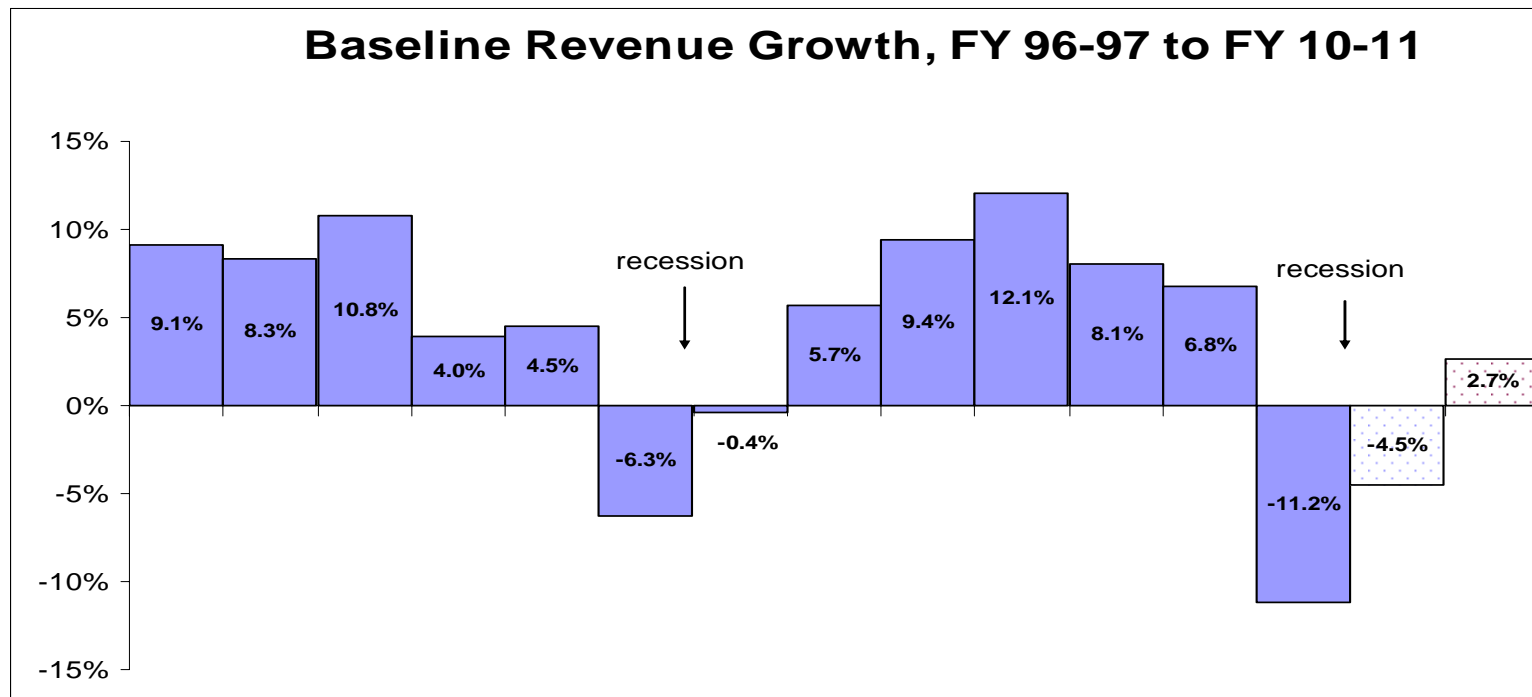


KEY REVENUE

COLLECTION TRENDS

Revenue Estimate Summary

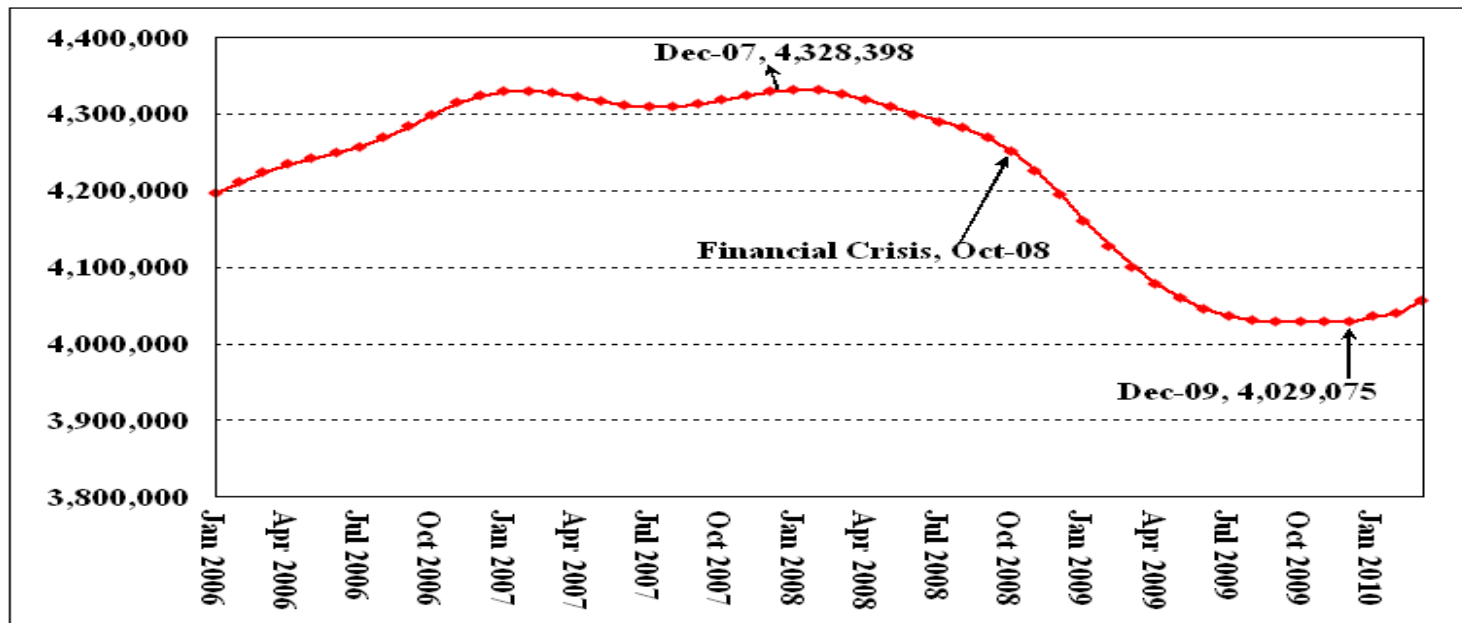
The Great Recession's impact on State revenues can be seen by looking at the yearly, economy-based growth rates.



Note: The last two columns represent the current forecast baseline estimates.

Key Revenue Collection Trends

Non-Agricultural Employment, Seasonally Adjusted

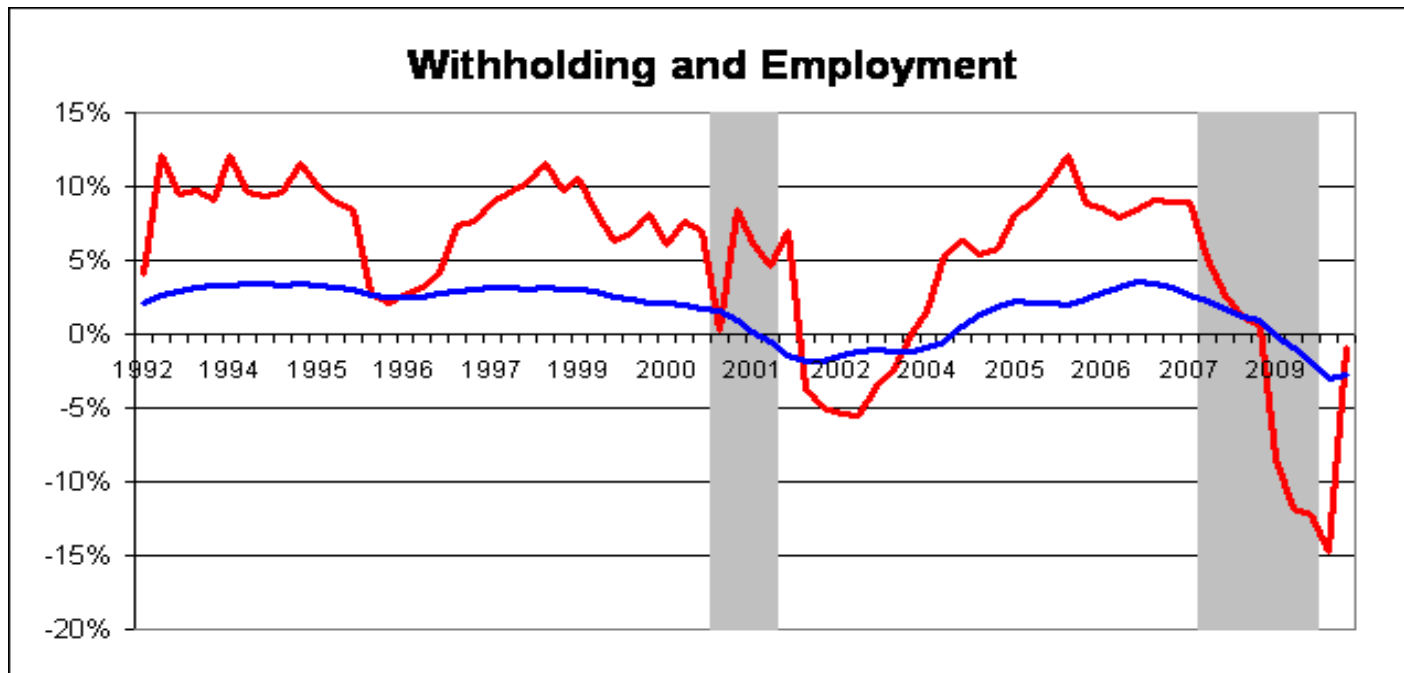


The trend of monthly net job losses has ended and a slight uptick in the last couple of months has occurred.

Source: North Carolina Employment Security Commission

Key Revenue Collection Trends

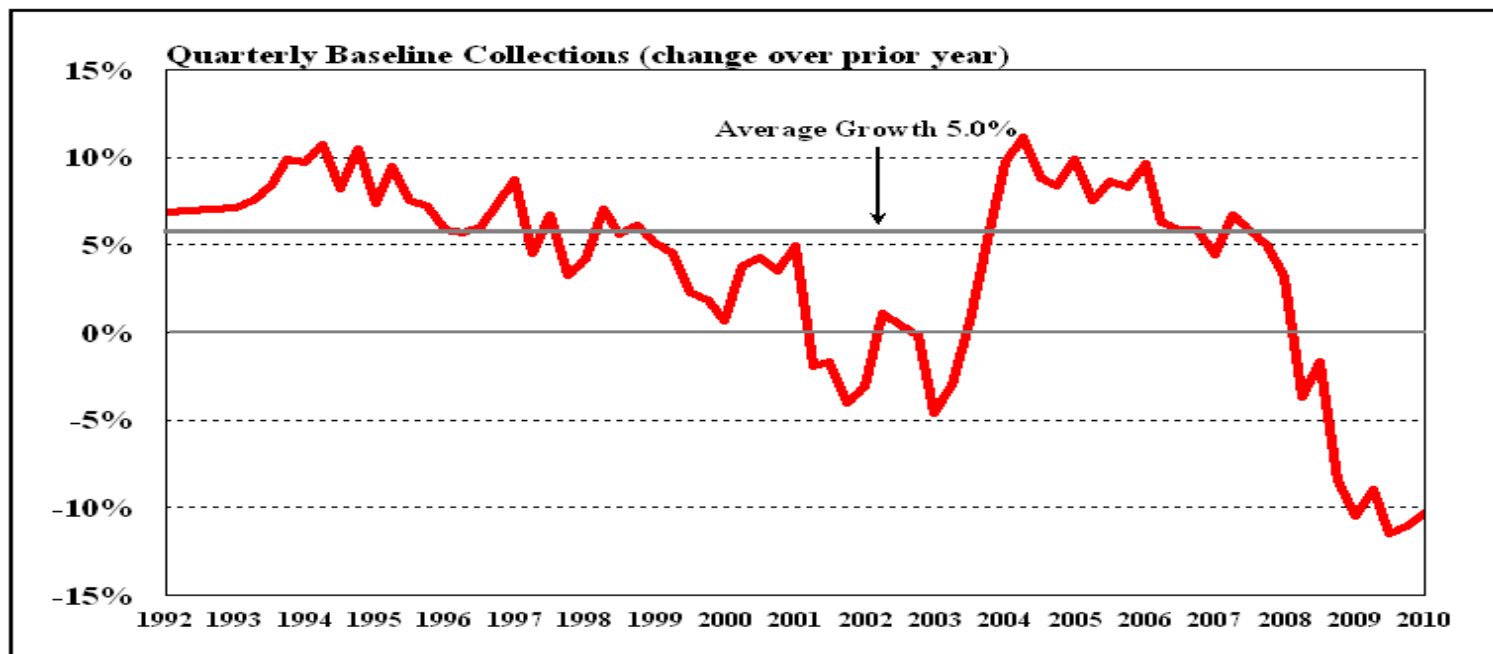
Withholding Tax Receipts



Withholding continues to show signs that the worst is over but the slow-growth employment forecast will keep strong growth withholding in check. Bonus payments have temporarily added a boost.

Key Revenue Collection Trends

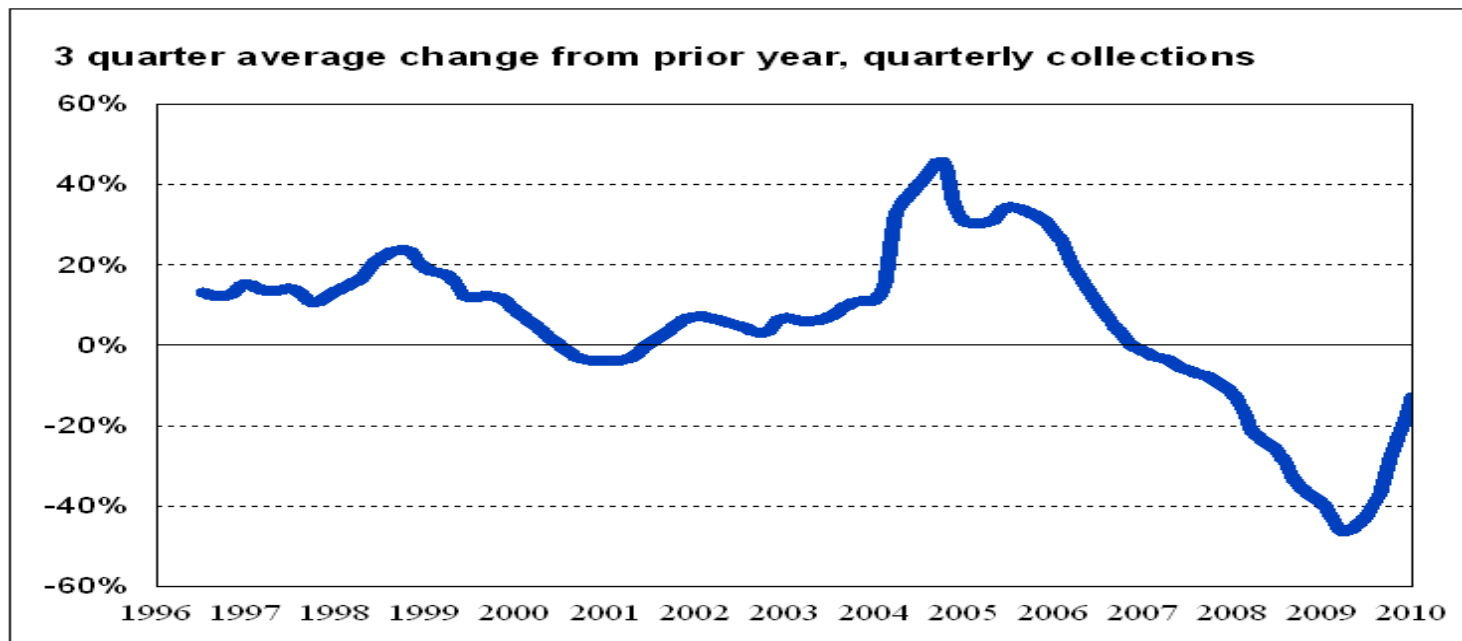
Sales & Use Tax Collections (adjusted for tax law changes)



Sales tax collections went negative beginning in the second quarter of 2008 and continued to plummet for the next 6 quarters. They finally seem to be bottoming out.

Key Revenue Collection Trends

Real Estate Conveyance Collections



Real Estate Conveyance tax illustrates the magnitude of the housing build-up (2003-06) and subsequent recession in the housing market. A slight upturn is detected but still running in the negative despite the preceding huge declines.