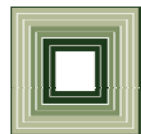


# GENERAL FUND REVENUE & ECONOMIC OUTLOOK



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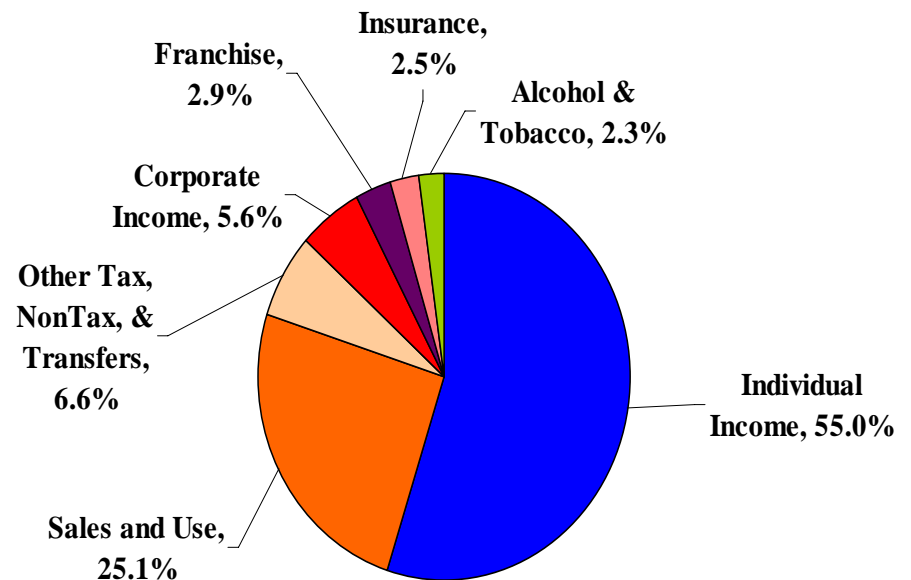
**FISCAL RESEARCH DIVISION**  
A Staff Agency of the North Carolina General Assembly

# Highlights

- A significant downturn in the economy continues to affect economy-based taxes such as the sales tax and personal income withholding tax. Collections remain 5% below target.
- The housing market recession and subsequent financial market meltdown put the economy in risk of a significant and long-term recession. Forecasts indicate the summer of 2009 is the soonest a recovery could be underway.
- State economic conditions deteriorate as housing, financial, and global downturns impact consumers and employment.
- Budget pressures mount with slowdown in revenue collection.

# State General Fund, FY 2007-08

**Eighty-six percent of the State's General Fund revenues are derived from the Personal Income Tax, the Sales & Use Tax., and the Corporate Income Tax. These three sources of revenue are directly affected by changes in the economy.**



## How Do 2008-09 Revenues Look So Far?

- FRD can report that through October, General Fund revenues are running \$320 million below a \$6.3 billion target for the period.
  - Collections continue to follow the trend established this summer. The growth in economy-based taxes collections began to slow this summer and October collections continue this trend. Total collections remain about 5% below expectations.

# How Do 2008-09 Revenues Look So Far?

- Personal Income tax withholding on wages and salaries grew at 3% in October. The weakest area for withholding taxes are monthly and quarterly withholding payments (8% decline). One reason is that the smaller businesses, who pay on a monthly or quarterly schedule, are cutting back on their payrolls.
- Sales tax collections reflect how this economic downturn is having a big effect on consumers. Baseline state & local collections are down from last year by nearly 3%.
- Two taxes paid by businesses, Corporate and Franchise taxes, are down 7.5% for the year. The economy's impact on corporate income tax collections will not be fully understood until April 15<sup>th</sup> final payments.

## How Do 2008-09 Revenues Look So Far?

- Regarding revenues in the first half of the fiscal year, keep these caveats in mind:
  - The first months of the fiscal year are the least important from an end-of-year indicator point of view.
  - Major receipts in these early months (sales tax and withholding tax) closely track the experience of the last few months of the prior fiscal year.
  - Volatile revenue sources such as the corporate income tax and the non-withholding part of the personal income tax do not show up until the second half of the fiscal year.

# 2008-09 Revised Revenue Estimates

## Continue Cautious Approach

- Revenue estimates reflect consensus outlook of Governor’s Budget Office and Fiscal Research Division.
- The forecast recognized much of the State’s economic difficulties were still ahead, which resulted in lowering the already cautious 2008-09 forecast from 4.6% growth to 3.5%.
- Budget decision makers agreed to reserve an additional \$45 million as a precaution against further deterioration in the State’s economy.
- Baseline (tax changes removed) General Fund Revenue Growth and 2008-09 forecast are shown below.

<u>01-02</u>	<u>02-03</u>	<u>03-04</u>	<u>04-05</u>	<u>05-06</u>	<u>06-07</u>	<u>07-08</u>	<u>08-09</u>
-6.3%	- 0.4%	5.7%	9.4%	12.1%	9.2%	4.2%	3.5%

## 2008-09 Forecast Assumptions and Risks

- When lowering the General Fund's growth estimate, the forecast lowered growth rates of economy-based taxes consistent with a moderate downturn and the possibility of a mild recession this summer.
- The forecast envisioned a slow recovery from the economic downturn beginning no later than the first quarter of 2009.
- Thus, the forecast projected below normal growth in the economy-based taxes for 2008-09:
  - 3.8% PIT v. 7.0% trend (baseline)
  - 3.1% SUT v. 5.5% trend (baseline)
  - 2.4% CIT v. 5.8% trend (baseline)



# Thoughts on 2008-09 Outlook

- Since the May forecast, the economy has seen economic headwinds intensify. Some would say they are now gale-force winds.
  - Housing prices continue to fall - down 18% nationally over the past two years
  - The housing recession fueled a financial market crisis
  - Consumers forced to cut back on spending
  - Global economy weakens significantly
- The Feds have undertaken several important and historical steps to reverse the financial market crisis and thaw frozen credit markets. These may prove beneficial, but insufficient to head-off a prolonged and difficult recession.

# Thoughts on 2008-09 Outlook

- **Consumers are being hit hardest in this economic downturn.**
  - Falling employment through 2009
  - Lower inflation-adjusted wages
  - Loss of wealth from housing recession
  - 35-40% decline in equity markets
  - Tight credit conditions
  - High debt burden

## Additional Thoughts on 2008-09 Outlook

- “Housing is front and center of the financial crisis,” said Mark Zandi, chief economist at Moody’s Economy.com in West Chester, Pennsylvania. “So long as house prices are declining and foreclosures mounting, the financial system will struggle and the economy will be in recession.”
- Actions by the Feds will provide some relief, but the economy is in a recession and early prognostications suggest it will be 2010 until a full economic recovery will be underway.
- Fiscal difficulties around the nation and in the state are likely to escalate as unemployment increases and income taxes begin to decline.
- A conservative budgeting/forecasting approach was adopted here in North Carolina has helped soften the impact, but the recession’s affects over the next two years could result in a difficult fiscal situation.

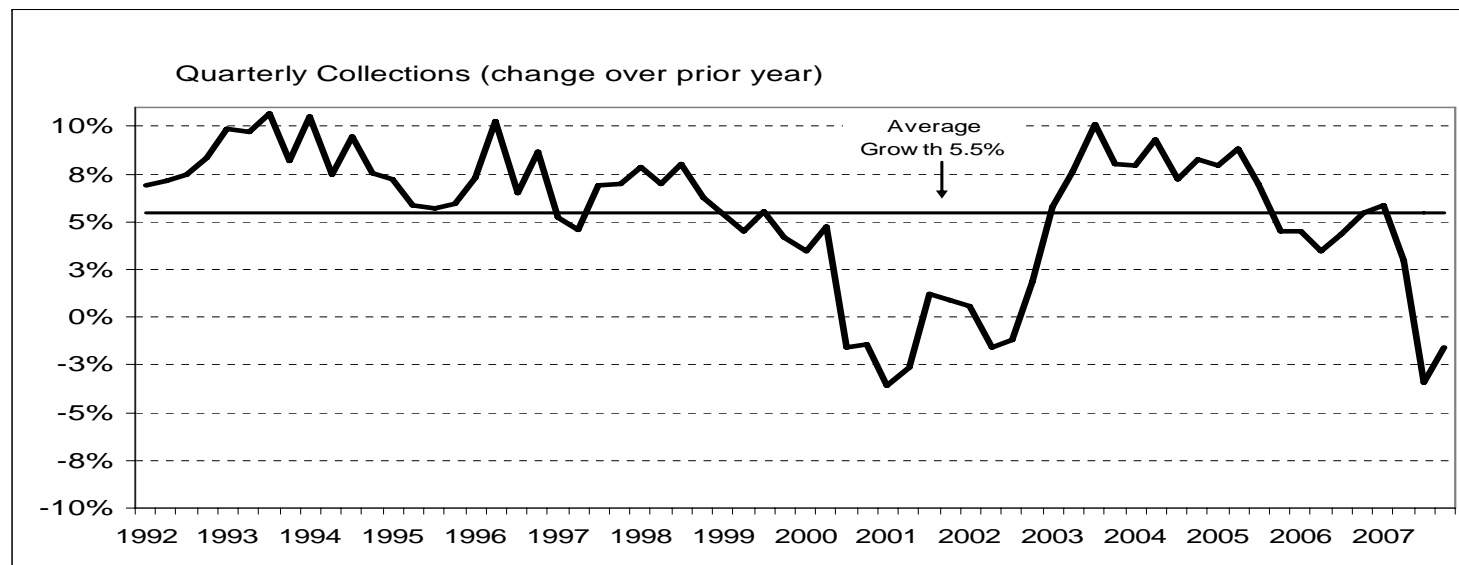
# Thoughts on 2009-10 Outlook

- Current economic forecasts indicate a prolonged economic downturn is well underway with a sluggish recovery to follow.
  - Recession-like conditions for much of 2009
  - A very sluggish recovery the first-half of 2010
  - Employment does not begin to rebound from the downturn until the summer or fall of 2010
- Under the scenario outlined above, an austere revenue picture could unfold. Meaning baseline (economy-based) revenue growth could be well below the usual 5 to 6 percent in FY 2009-10.

# Tracking Economy-Based Collections

It is clear from looking at economy-based taxes that the national economic downturn has made its way into the State. Year-over-year sales tax collections are down 2.3% for the first four months of this fiscal year. The fall in collections is indicative of the impact the downturn is having on consumers.

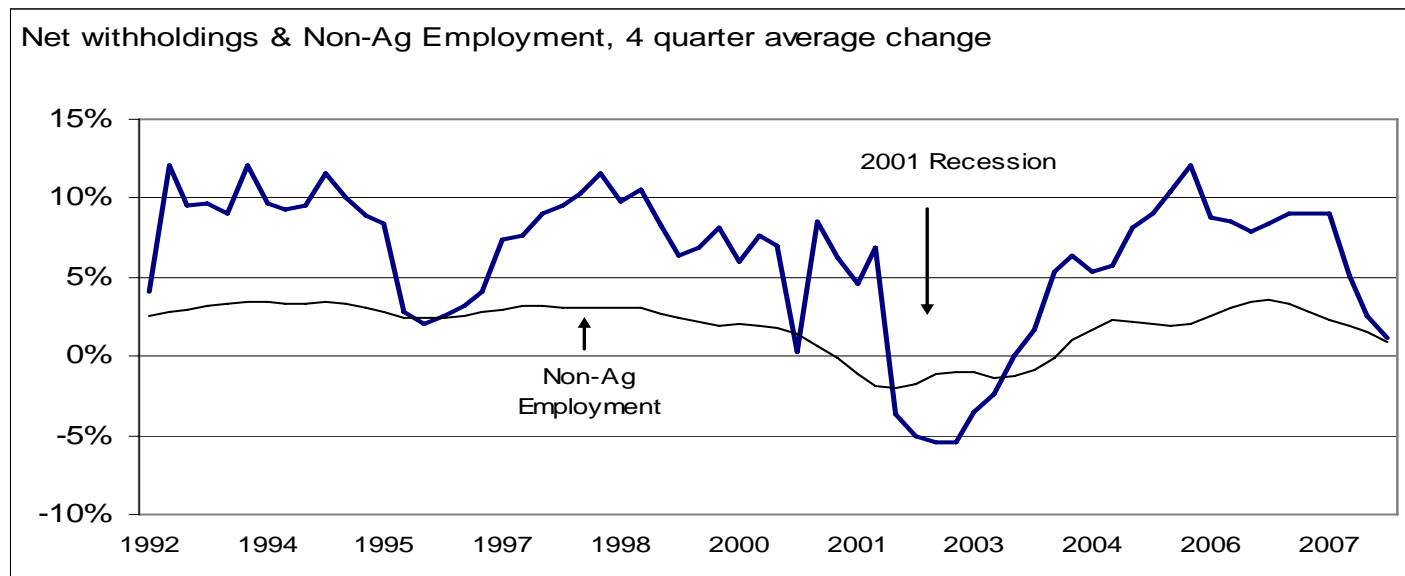
## Sales & Use Tax Collections (adjusted for tax law changes)



## Tracking Economy-Based Collections (cont.)

Net withholdings continue to steadily slow and are nearly 2% below a \$2.9 billion target. The economic downturn is now being felt broadly across most industry sectors and is reflected in the drop of wage & salary withholding collections.

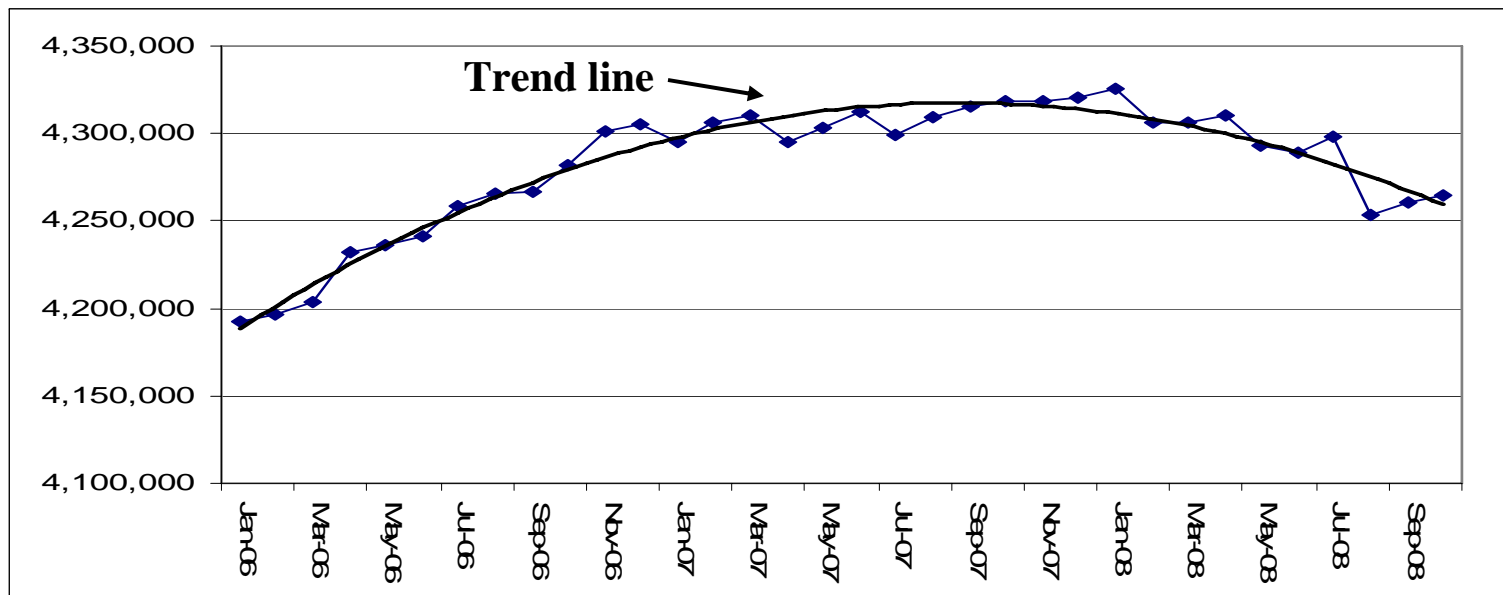
### Withholding Tax Receipts



# Tracking Economy-Based Collections (cont.)

One explanation for the decline in the economy-based taxes is the weakening employment market. Since October of last year, the state now has 54,000 fewer people employed. This downward trend in employment is expected to persist for most, if not all, of 2009 and potentially into 2010.

## Non-Agricultural Employment, Seasonally Adjusted



# State's Economic Outlook

- Many of the State's industry sectors, once thought resistant to the national housing and financial market meltdown, are now showing signs of vulnerability.
- The combination of a weak housing market and tight credit have taken a toll on consumer spending. This is beginning to cause declines in the service and retail sectors.
- A stalwart growth industry, financial services, has been hit hard by the financial markets troubles. Job losses in the State are now expected in this industry over the next 4 to 6 quarters.
- The manufacturing sector continues to shed jobs (a rate of 2% to 4%), but this recession should not accelerate job losses like the last recession in 2001-2002, where manufacturing experienced quarterly declines of over 10%.



# State's Economic Outlook

- Thus, overall employment growth will stall in the State with no growth or a slight decline envisioned for this fiscal year and less than 1% in FY 2009-10. This will translate into well below normal growth in personal income.
- Moody's economy.com forecasters envision only 2.7% growth in the State's personal income for 2009, which is far less than the 5.5% to 7.5% growth of the previous 4 years.
- The State, by comparison, is expected to fair better than the nation where national employment is projected to fall 1% in FY 2008-09 and the possibility of no growth the following year.
- Likewise, personal income is anticipated to grow faster in the State than the nation as a whole.

# State's Economic Outlook

- Because of all the negative conditions facing consumers, the state is forecast to see a drop in retail sales by 1% in FY 2008-09 with only a slight rebound in FY2009-10.
- The State remains in a relative better position than many states, which began to experience recession-like conditions as early as mid-year 2007. Nonetheless, recession-like conditions will persist in the State through at least the first two quarters of 2009 and possibly extend into 2010.

# Budget Outlook

- Mounting pressures for remainder of FY 2008-09 and into FY 2009-10:
  - Potential for a significant revenue shortfall and limited growth in 2009-10
  - State Health Plan will need additional infusion of cash (\$200 - \$300 million)
  - Medicaid and other income assistance programs are counter-cyclical to the economy
  - Post-secondary enrollment often runs counter-cyclical to the economy and could place added demands on universities and community colleges

# Budget Outlook

- Governor is managing FY 2008-09 as per G.S. 143C-6-2
  - Reducing agency allotments
  - Delaying expenditures, where appropriate
  - Carefully monitoring Medicaid and other key budget areas