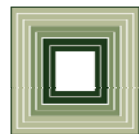


GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK



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

Highlights

- Efforts by the Department of Revenue generated \$272 million more than expected (\$422 total) with its resolution payment initiative, thus wiping out the budget shortfall.
- Sales Tax collections remain well below expectations and withholding income tax continues to weaken.
- The most recent national and State forecasts indicate the recovery may take longer to unwind before it gains solid footing.
- Despite being on target with respect to revenue collections, budget pressures will continue to mount as the prolonged weaknesses in the economy affect revenue collections the second-half of the fiscal year.

How Do 2009-10 Revenues Look So Far?

- FRD can report that through December, General Fund revenues are running \$30 million **above** a \$9.4 billion forecast target.
 - Through the efforts of the Department of Revenue and its resolution payment initiative, the revenue shortfall was wiped out with the collection of \$422 million from over 200 taxpayers.
 - The budget included \$150 million from this initiative, but the department collected \$272 more than anticipated.
 - Without the additional \$272 million in revenue from the resolution payments the shortfall would be \$240 million or about 2.6% of the budget target (note: previous shortfall estimates did not account for initiative payments collected from August to October).

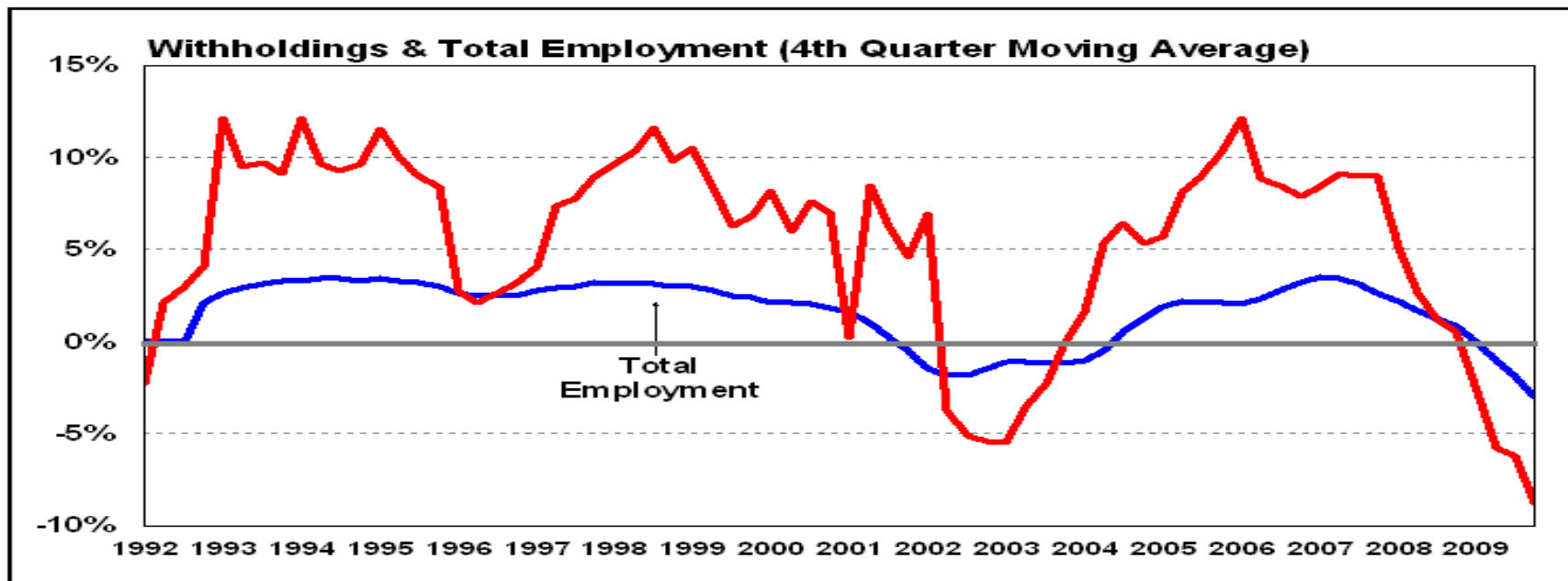
How Do 2009-10 Revenues Look So Far?

- Net income tax withholding on wages and salaries are down 4.1% through December. That compares with 3.8% through November.
 - Monthly and quarterly withholding payments are still the hardest hit (Y/Y 12.3% decline). One reason for this decline is smaller businesses, who pay on a monthly or quarterly schedule, are still not hiring or adding work hours.
- Sales tax collections suffer as consumers continue to react to recession-like conditions in the State.
 - Baseline (tax-adjusted) collections for the second quarter of the fiscal year are down 11.3% from last year .
 - Net collections, including tax law changes are up 6.5%; however, budget targets projected a 11.5% increase. The result is net sales tax collections are \$120 million short of expectations.

Tracking Economy-Based Collections

Net withholdings (withholdings less refunds) continue to weaken and are nearly 2.0% below a \$4.3 billion target. If modest employment improvements materialize this spring, then withholding may come close to meeting its forecast target.

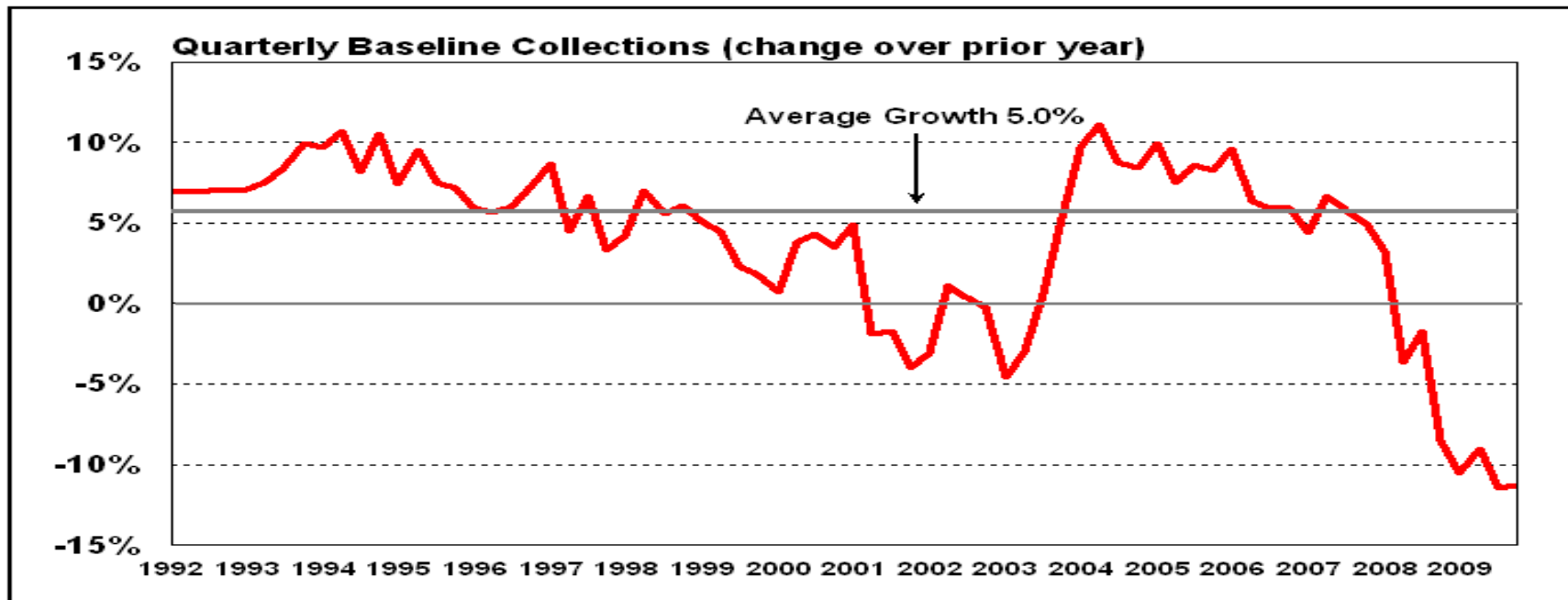
Withholding Taxes



Tracking Economy-Based Collections

Most economist believe the recession ended in late summer, but 4 to 5 months later consumer confidence has yet to rebound. With little positive news available on the employment picture confidence may be depressed for months to come.

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



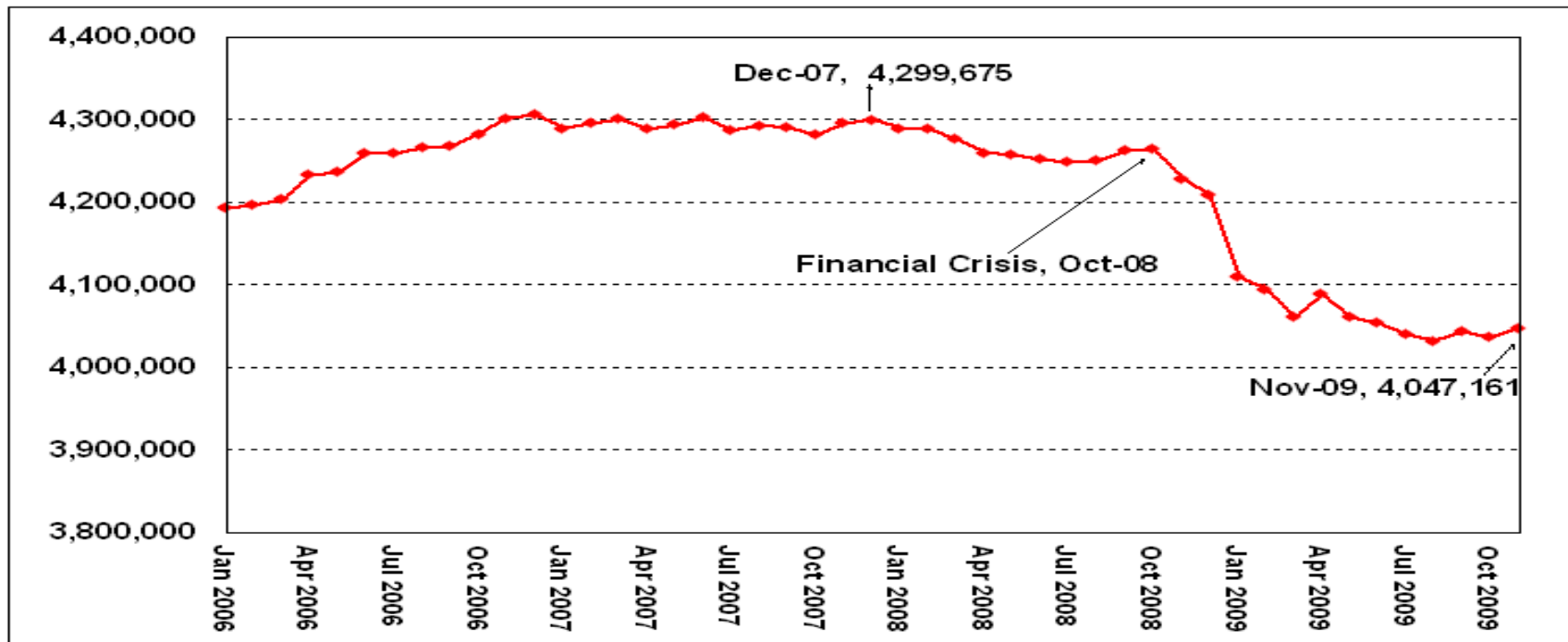
Why have Sales Tax collections been hit so hard?

- Double-digit unemployment has eroded consumer confidence and continued employment uncertainty suggests cautious consumer behavior.
- Main reasons why consumers are not buying:
 - Dismal employment outlook expected to extend into much of 2010
 - Lower inflation-adjusted salary & wages than before start of recession
 - Tremendous loss of household wealth from housing recession and equity market losses
 - Very tight credit conditions continue
 - Rather than continuing to spend by increasing debt until the recession effects subside, consumers are doing the opposite. They are choosing to pay off their debt, which was at an all time high at the start of the recession. Consumer credit fell a record \$17.5 billion in November.

Tracking Economy-Based Collections (cont.)

From September through November the State's economy added almost 16,000 jobs (seasonally adjusted). This still leaves employment short of pre-recession employment by 240,000 jobs.

Total Employment, Seasonally Adjusted



State's Economic Outlook

- Many of the State's industries have begun to increase output, yet this has had little impact on full-time employment. Only the Health & Education Services and Government sectors had year-over-year growth in November.
- For 2009, the Construction, Manufacturing, Mining, and Wholesale Trade sectors experienced the biggest losses in employment. The Government sector is the only sector expected to realize employment gains for the year.
- The housing market in the State appears to have bottomed out. Existing home sales are no longer in decline and prices are starting to stabilize in some areas.
 - Nonetheless, the housing market is still struggling. Residential permits for new construction were still in decline this fall and existing home sale prices across the State were down 1.7% in the third quarter of 2009.
 - Likewise, home mortgages in the State with payments more than 90 days past due were still on the rise through September.

State's Economic Outlook

- The economy in 2010, is expected to see some improvement over last year; the question is, how much?
 - Dr. Michael Walden of NC State University stated in his most recent economic outlook that “In the economic recovery year of 2010, North Carolina will resume its tradition of growing faster than the nation.” Unfortunately, national growth is expected to be well below normal.
 - He goes on to caution that there will be regional disparities within the recovery and unemployment rates may reach as high as 11.5% before they begin to gradually fall with a rate slightly under 10% expected by the end of 2010.
 - Similarly, Dr. John Connaughton, at UNC-Charlotte, reports in his most recent forecast that the State's unemployment rate will hover around the 11% mark for the first-half of the year. He goes on to forecast that employment growth for 2010 will only be 0.8%, adding only a little more than 30,000 jobs. This is well short of the 240,000 needed to reach pre-recession employment.

State's Economic Outlook

- Based on these and other forecasts for the State, changes in the employment picture are not expected until the second-half of 2010.
 - The State will have a long way to go to reach pre-recession levels given the 6% decline that occurred since the start of the recession. Some are suggesting it could take as much as five years nationally to return to pre-recession levels of employment.
- Moody's economy.com forecasters significantly lowered growth in the State's personal income for 2010. They now forecast 1.9% growth, which is half of what was in their last forecast (3.8%).
- Wage & Salary income, the major component of personal income is estimated to have fallen 4.4% in 2009 and growth for 2010 will only be 1.8%.
- The State's economy is expected to slowly rebound over the coming year. It is important to note that national and State forecasts have grown more pessimistic and expectations for a return to a robust economy are being pushed out into 2011 and 2012.

How are other states doing?

- Based on a recent survey by NCSL (Nov. 2009)
 - 43 states are “concerned” or “pessimistic” about their revenue outlook for FY 2009-10
 - 9 states are projecting FY 2009-10 budget gaps greater than 5% of their budget
 - 40 states forecasted lower revenues for FY 2009-10 than FY 2008-09
- A recent report from the Rockefeller Institute of Government states that third quarter 2009 collections fell 10.9% over last year’s collections. That compares with a 4.4% decline here over the same period.
 - 48 states reported year-over-year declines.
 - 22 reported double-digit declines

Budget Outlook

- Mounting pressures for remainder of FY 2009-10 and beyond:
 - The budget included a 1-cent increase in the State's sales tax rate putting more pressure on this revenue source to rebound in 2010. To date, there has been no improvement in collections.
 - Expenditures for Medicaid and other income assistance programs may exceed budgeted amounts.
 - Enrollment from people seeking to improve their job-skills has placed added pressure on post-secondary education, especially on the community college system, which is experiencing unprecedented growth.

Budget Outlook

- Mounting pressures for remainder of FY 2009-10 and beyond (cont.):
 - A looming issue on the horizon will be the FY 2011-12 revenue picture. Temporary taxes are set to expire, fiscal stimulus money dries up, and early projections indicate revenue growth will not be sufficient to close the gap.