GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

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Highlights

- The first two months of the fiscal year continued the trend established earlier this summer with flat to slightly negative year-over-year growth in the economy-based taxes.
- The April consensus forecast downgraded the initial 2010-11 General Fund revenues (from 3.2% to 2.7% baseline growth).
- FY 2009-10 General Fund revenues were $290 million below the $18.8 billion budgeted amount, which was 1.5% below forecast.
- The latest expectations are that the stagnant, slow growth scenario that emerged this summer will stay with us the rest of 2010. Most economic forecasts expect an uptick in economic growth by mid-2011.

How Do 2009-10 Revenues Look So Far?

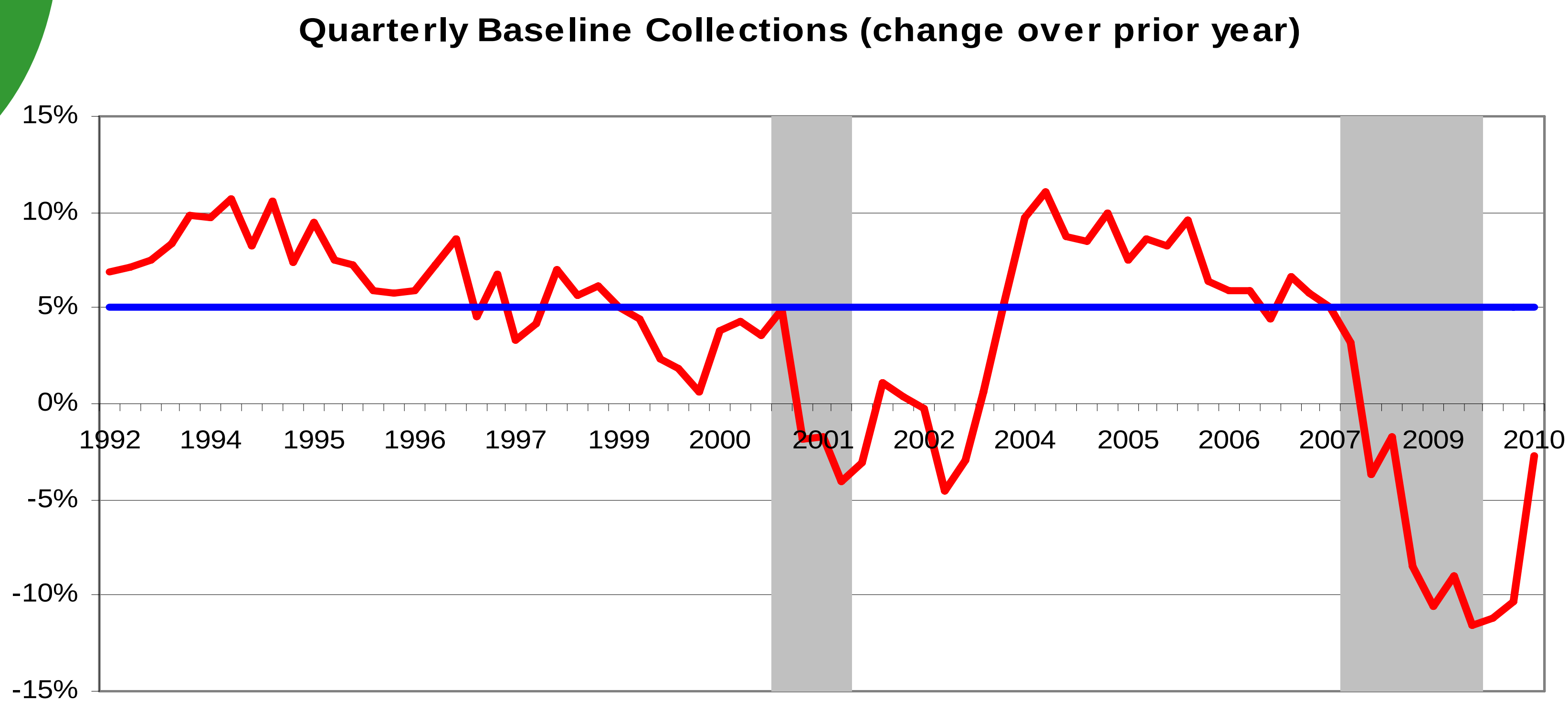
- Through August, General Fund revenue was $25 million below the $2.75 billion target set for the first two months of the fiscal year.
  - The main component of the shortfall was the timing of tax refunds. These refunds showed up at the start of this fiscal year rather than in May and June of the previous fiscal year.
  - While the two months were close to meeting budget targets, the targets were set below expected growth for the year. The forecast outlook expects gradual monthly improvement in the economy throughout the fiscal year, and the targets will reflect that expectation.
- The first months of the fiscal year are the least important months as an indicator of revenue trends for the fiscal year.
  - The major receipts in these months (sales, withholding tax) closely track the experience of the last few months of the prior fiscal year.
  - Volatile revenue sources (corporate income, non-withholding personal income tax) do not show up until the second half of the fiscal year.

How Do 2009-10 Revenues Look So Far?

- The key economy-based taxes, wage and salary withholding and the sales tax, continue to reflect poor employment conditions and bleak consumer sentiment.
  - Significant declines in baseline sales tax growth eased during July and August and were down only 1.0% vs. a 11.5% decline at this time last year (see page 4).
  - Net personal income withholding collections (withholding less refunds) continue to show modest improvement and essentially were on target the first two months. (see page 5).

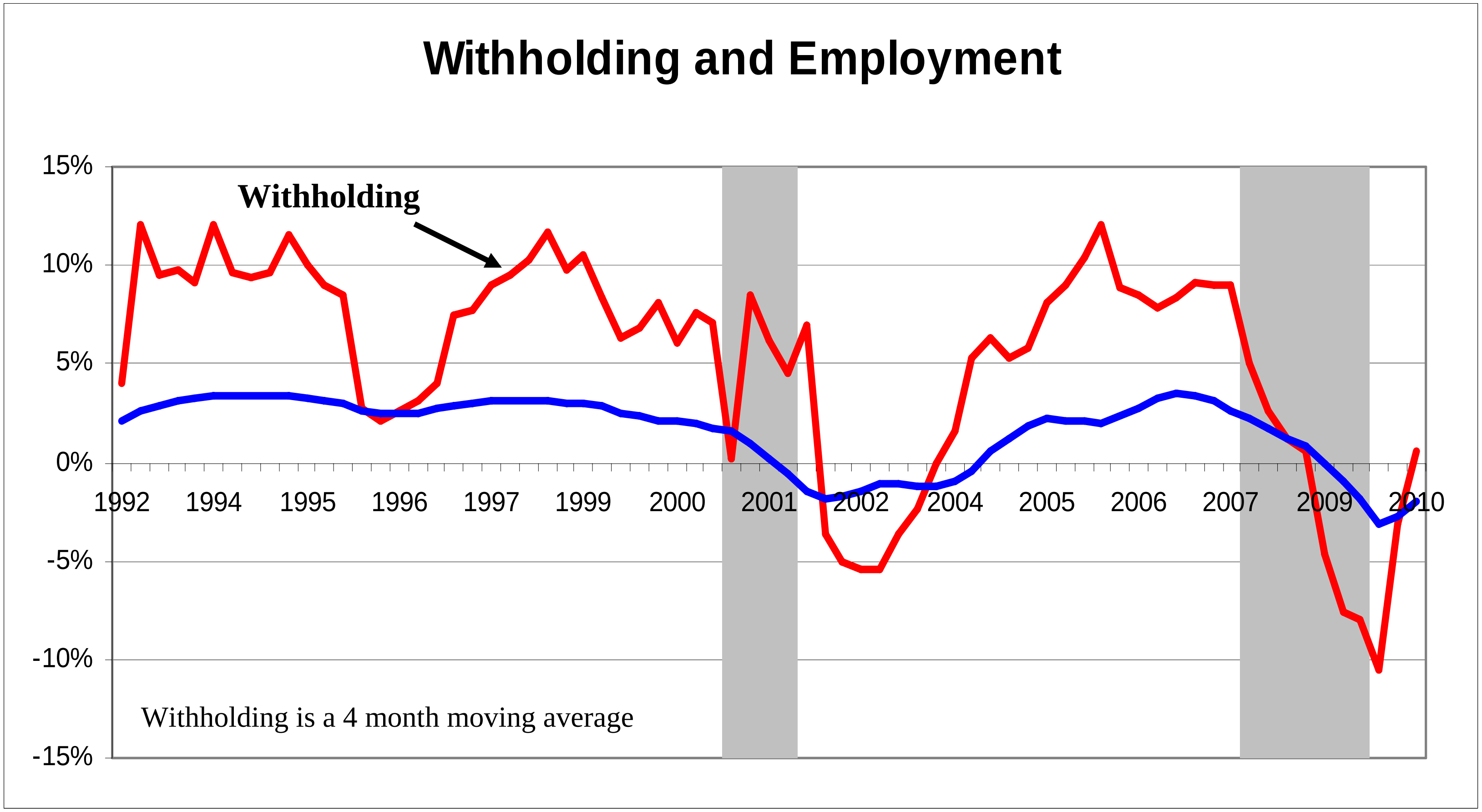
Key Revenue Collection Trends

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



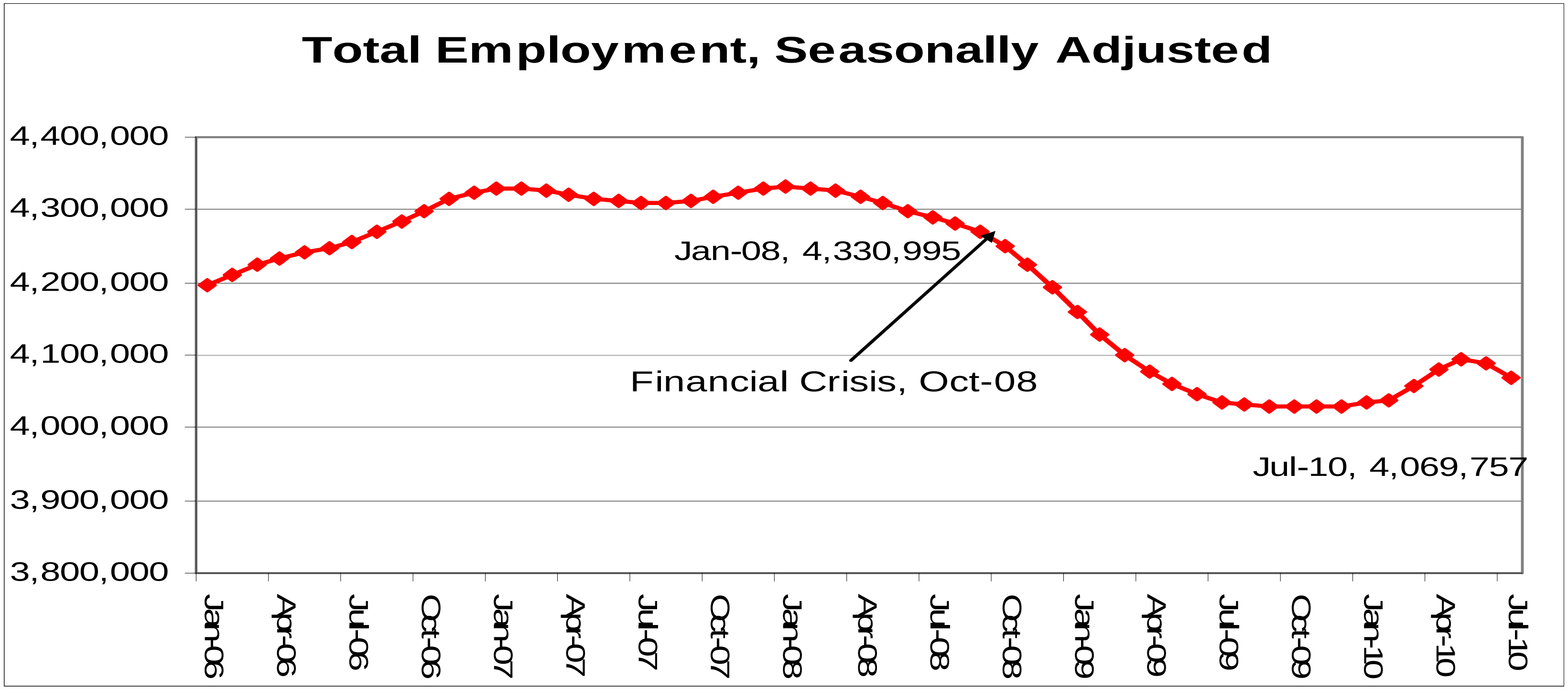
Sales tax collections declines slow after two years of significant losses.

Key Revenue Collection Trends



Withholding begins to rebound following a slight increase in employment as well as in the number of hours worked.

Key Revenue Collection Trends

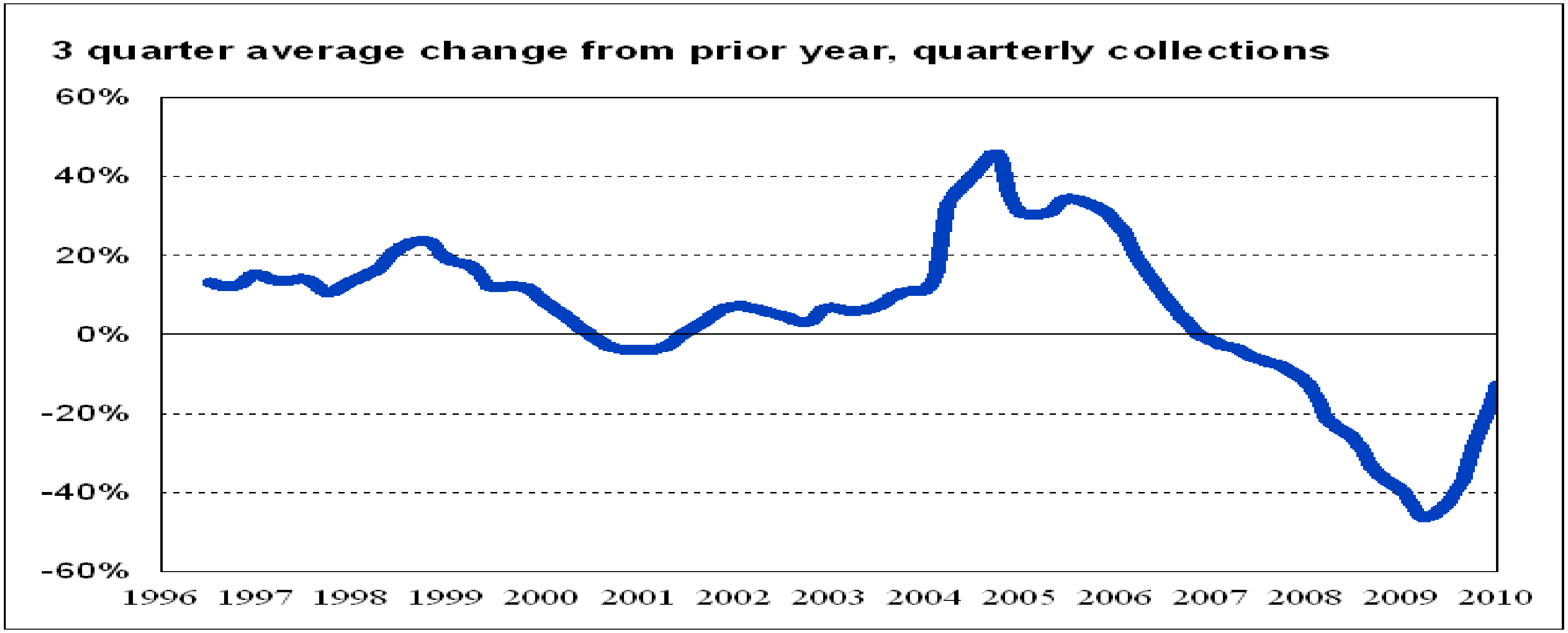


The trend of monthly net job losses has ended, but there has been little rebound in employment. The modest uptick from Census jobs can be seen in the early summer.

Source: North Carolina Employment Security Commission

Key Revenue Collection Trends

Real Estate Conveyance Collections



The Real Estate Conveyance tax is not part of the General Fund, but it does illustrate the magnitude of the housing slump. The recession was driven by a housing market decline and much of the current economic malaise is tied up in the housing market's weakness.

FY 2009-10 RECAP

- The Great Recession ended in mid to late summer of 2009, but the aftermath of the global financial crisis continued to place a significant drag on the economy. Both employer and consumer sentiment showed little signs of an economic recovery.

- As a result, collections were $290 million below the forecasted $18.8 billion General Fund revenue. The baseline decline was 4.5% below last years collections.

- The key reason the shortfall did not reach the $390 million forecast in April was the timing of tax refunds. Sales and Corporate tax refunds were nearly $70 million below target in May and June. Most of those refunds have shown up in July and August of this year.

FY 2009-10 RECAP

- The FY 2009-10 decline coupled with last year's tumultuous drop in revenue means that baseline revenue has declined 15% from the peak in FY 2007-08.
- Actual collections, which reflect tax law changes such as temporary tax increases, were up 5.8% for the year and are down 6% from the peak in FY 2007-08.
- Given that the FY 2009-10 shortfall was $100 million less than expected, it is reasonable to ask if this will carryover into improved collections for the current fiscal year. Because the difference in the shortfall is largely the result of the timing of refund payments, there were no changes in expectations for this year's revenue growth.

2009-10 RECAP

- Here's how key revenue items turned out ($ million)

	Budgeted	Actual	Difference
Personal Income Tax			
Withholding	$9,082.20	$9,137.20	$55.00
% Growth	-0.40%	0.20%	
Non-Withholding *	$2,374.60	$2,122.70	($251.90)
% Growth	-7.60%	-17.50%	
Net Collections**	$9,514.20	$9,047.60	($466.60)
% Growth	0.40%	-4.50%	
Sales Tax			
Net Collections**	$5,628.60	$5,565.00	$63.60
% Growth	20.40%	19.00%	
Corporate Income Tax			
Net Collections**	$990.60	$1,197.90	$207.30
% Growth	18.50%	43.30%	

*Quarterly estimated payments plus April 15 tax remittances.
**Collections less refunds and transfers.

FY 2010-11:

Revenue Estimates Take Cautious Approach

- The forecast estimate reflects a consensus outlook between the Governor's Budget Office and the Fiscal Research Division.
- Forecast philosophy was to take a very cautious approach recognizing the State's economic difficulties would be slow to unwind. The result was a downward revision of the FY 2010-11 baseline forecast from 3.3% to 2.7%. Long-term average growth is closer to 5.5%, but it has been very volatile the past decade.
- Baseline (economy-based) General Fund revenue growth and FY 2010-11 forecast are shown below.

01-02	02-03	03-04	04-05	05-06	06-07	07-08	08-09	09-10	10-11
-6.2%	- 0.4%	5.7%	9.4%	12.1%	9.2%	4.2%	-10.0%	-4.5%	2.7%

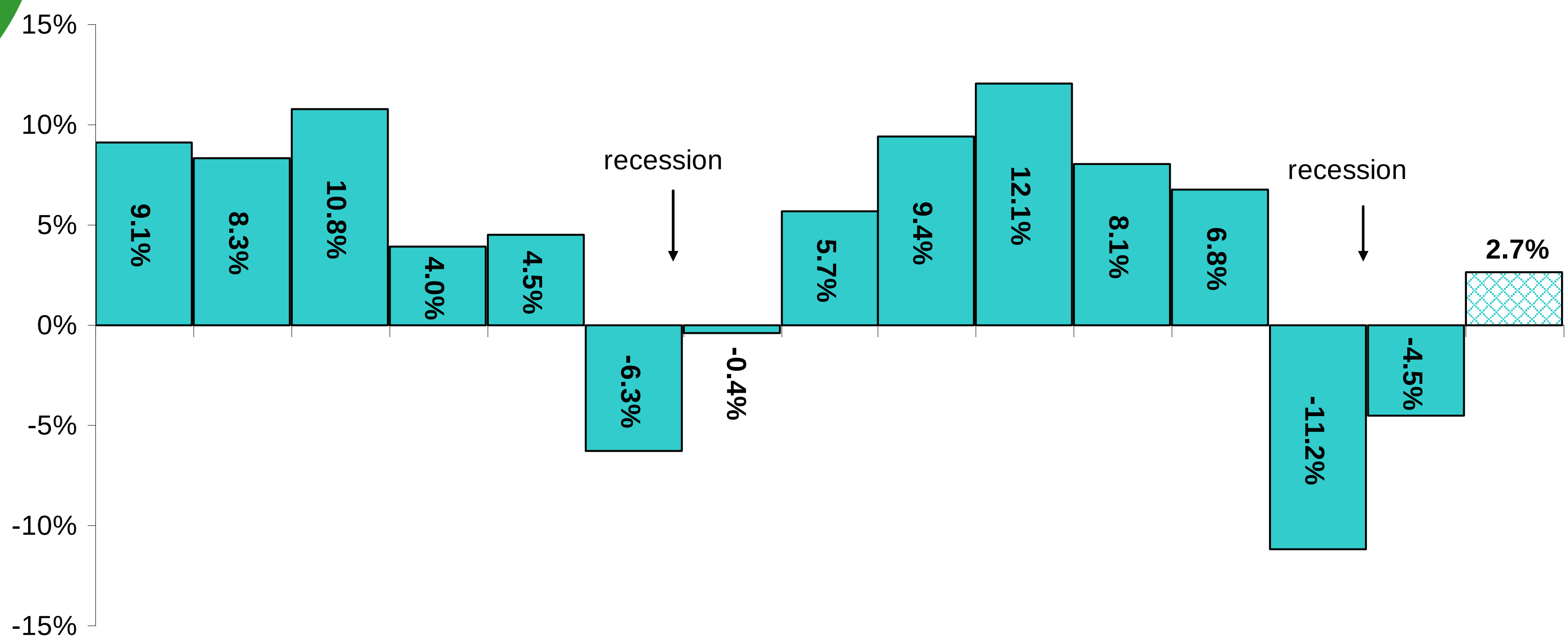
FY 2010-11 Revenue Estimate Summary

- The April 2010 General Fund consensus forecast included a downward revision for FY 2010-11 with revenues forecast to be $702.9 million less than was budgeted ($19,638.9 vs. $18,936.0 budgeted):
  - 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.
  - In addition to the downward revision, the one-year expiration of the federal estate tax means an additional loss in General Fund revenue of an estimated $85 million making **the net downward revision $787.9 million**.

Revenue Estimate Summary

The Great Recession's impact on State revenues can be clearly seen from the economy-based growth rates.

Baseline Revenue Growth, FY 1996-97 to FY 2010-11



Note: The last column represents the current forecast baseline estimate.

Economic Outlook

- The nation is coming out of the in the longest, sustained period of economic contraction since the depression of the 1930s. Given the length and severity of the recession, one might expect a robust recovery similar to what occurred coming out of the 81-82 recession (6% growth). We are unlikely to see that type of robust expansion anytime soon because of the structural problems that sent us into a recession; housing and financial, take much longer to correct and are historically followed by much slower, prolonged recovery phases.
- Over the next 12 months, in order for the economy to move from this slow recovery phase into the expansion phase of the business cycle, personal investment (consumer demand) will have to rebound, business investment and production will need to continue to grow, and a solid credit market will need to emerge. Usually, employment will lag 3-6 months behind the start of a recovery. However, given the nature of this recession, employment growth may lag as much as 18-24 months behind.
- In the 2001 recession, it was 19 months after the recession ended before employment in the State reached pre-recession levels. According to NC Employment Security Commission records, as of July 2010, the State employs 258,641 fewer people than before the start of the recession (a 6% decline). Some economists have suggested this time around it will take as many as 36 months to reach pre-recession levels.

Economic Outlook

- The recent talk of a "double-dip" recession is almost a technicality with unemployment hovering just below 10%, and the economy's pace of recovery inadequate to increase employment numbers over a reasonable time horizon.
- Nonetheless, the US economy is plodding along, and a "double-dip" recession in the technical sense seems unlikely. August numbers on business investment and consumer spending came in stronger than thought. Though economic data remains mixed, key indicators such as industrial production remain positive.
- A quarter-over-quarter improvement in the economy is expected, albeit at a slow rate. During this phase of the recovery the capacity of the economy to absorb any new shock regardless of the origin could cause the growth to stall and possibly lead to another contraction.
- The European sovereign debt problem, which softened global economic growth, is one such shock that slowed the US recovery as export demand for US products weakened. The health of global economies along with the strength of consumer spending in the US are two crucial areas of concern as we monitor economic conditions.

Economic Outlook

- A key to sustained growth will be consumers, and one of the main causes of the slow growth scenario is weak consumer demand. Household spending represents 70% of economic activity (GDP).
- Consumer demand is expected to remain weak for the remainder of 2010 and into 2011, because:
  - Fiscal stimulus programs which have ended such as cash-for-clunkers and the home buyer credit only have a temporary impact on spending.
  - It will take quite a while for normal credit flows to return and consumers continue to face tight credit markets. Restructuring of the home mortgage market means many potential home buyers will not qualify as they once did in the previous decade.
  - The destruction of household nest eggs from falling housing and equity market prices means increased savings and less spending in the future
    - This transition may hold back spending for years
  - Unemployment, job security, and low income growth continue to take a toll on consumer confidence and consumption.
  - Economic uncertainty persists. Consumers still reeling from the recession remain in a very cautious spending mode. Each slowdown scare will tend to exacerbate the problem.

Economic Outlook

- Chief financial officers in Duke's most recent survey (June 2010) claim "they have limited plans to hire over the next 12 months, although nearly 60 percent won't return their staffing to pre-recession levels until 2012 or later." They also report that "credit is still tight for small firms, which is hindering hiring plans and constraining growth."
- Consistent with the survey, most economists are forecasting the US unemployment rate will remain above 9% through much of 2011. North Carolina is not expected to fare any different than the nation with respect to employment growth and the unemployment rate.
- In summary, three economic events continue to drag down the US and NC economy: the ongoing housing recession and the concomitant tight credit conditions, wary consumers that are still reeling from the recession, and the ongoing uncertainty of business leaders about the economy and their reticence to hire new employees. Each of these continue to take a toll on the economy and are expected to keep economic growth suppressed for the next 9 to 12 months.

Risks to Revenue Forecast

- Key issues:
  - The economy continues to be entangled by the housing recession and the slow unwinding of this problem will be a drag on the economy well into 2011.
  - Tight financial markets continue to slow business and personal investments and are adding to the economic malaise.
  - Consumer spending is finally starting to show signs of life after nearly two years of decline, but consumer sentiment is well below what one would expect during an economic recovery.
  - Business investment and export demand growth had been fueling the economic recovery. Both of these sources of growth are slowing.
  - Global demand has stalled as growing debt problems plague many European nations.

Risks to Revenue Forecast

- With the recent downward revision of current economic conditions, the necessarily cautious approach taken with the 2010-11 forecast are now aligning with the latest revised forecasts.
- Continuing weakness in the economy could put at risk the revenue forecast for the economy-based collections, particularly the sales tax and withholding income tax collections.
  - The forecast anticipated this weakness, but further declines in the economy could be problematic.
- In addition to a weak economic forecast, a key reason for taking a cautious approach with the revenue forecast is our expectation for volatile revenue sources such as capital gains on stocks and real estate, as well as 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 as the recovery intensifies.

Risks to Revenue Forecast

- With the worst of the economic downturn behind us and a recovery, although a weak one, underway, it is important to recognize that there is still a long way to go before we return to pre-recession levels.
- Determining the rate of recovery coming out of the Great Recession has proven difficult. Recent research by the IMF[1] on advanced economies indicates that recessions driven by a financial crisis are characterized by recoveries which are quite sluggish and can take, on average, 5 to 6 quarters before the economy is running at or above its pre-recession peak.
- We see no reason to believe this recovery will be any different, but could possibly drag on a bit longer than average because of the housing market problems related to the financial crisis.

1. Kannan, Prakash, International Monetary Fund Working Paper WP/10/83, "Credit Conditions and Recoveries from Recessions Associated with Financial Crises". March 2010.

Risks to Revenue Forecast

- Recognizing that the structural problems that sent us into the recession have yet to fully heal, we expect the recovery to proceed along a slow, unsteady path over the next 2 to 3 quarters as a result (we already have 4 full quarters of weak to modest growth behind us).
- Based on the latest survey of economic forecasters compiled by the Wall Street Journal (July 2010), this view of rocky recovery is held fairly consistently by a majority of the forecasters.
- Ultimately, the pace of the recovery will struggle to produce economic activity at the level of long-term, average growth (3%). This anticipated slow-paced recovery will not be strong enough to fuel job growth that can return us to pre-recession employment levels anytime soon.
- Given the expectation of slow, unsteady growth the economy will remain vulnerable to mild economic shocks increasing the risks to the forecast.

Fiscal Hard Times Continue

- Key budget issues arise to start the new Biennium. The FY 2011-12 budget will have to grapple with:
  - Expiring temporary taxes,
  - Expiration of federal stimulus dollars, and
  - a weakened economy assuring only modest growth, at best.
- Static analysis for next year's budget by FRD (no spending or revenue changes included) gives an indication of the work that lies ahead for the legislature.
  - FY 2009-10 budget
    - Included $1.3 billion in temporary taxes
    - $1.6 billion federal stimulus dollars
    - $0.3 billion in non-recurring budget reductions
    - **Static budget gap going into next biennium $3.2 billion**