GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

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Highlights

- First quarter collections were essentially on target; net baseline collections were up slightly over last year.
- The stagnant, slow growth scenario that emerged this summer is expected to stay with us the rest of 2010 and into 2011. This implies that elevated unemployment is likely for all of 2011.
- The cautious forecasting approach taken with the FY 2010-11 budget are now aligning with the downgraded outlook for the recovery.
- $3.2 billion used in FY 2009-10 General Fund availability will either expire (temporary taxes) or dry up (ARRA funds and one-time items) at the start of the new biennium budget.

How Do 2010-11 Revenues Look So Far?

- Collections through September are running $18 million below a $4.5 billion target.
- The first quarter was essentially on target, net baseline* collections were up slightly (less than 1% over last year). Caveats:
    - The first quarter targets were set below expected growth for the year. The forecast outlook expects gradual improvement in the economy throughout the fiscal year, and the targets will reflect that expectation.
    - The first quarter is not a reliable indicator of revenue trends for the full fiscal year. Mainly because the outcome of volatile revenue sources (corporate income and non-withholding personal income), which make up 25% of total collections, do not show up until the second half of the fiscal year.
- The main sources of tax revenue for the State seemed to have bottomed out. While they have yet to show signs of sustained growth, a small uptick has replaced the losses.

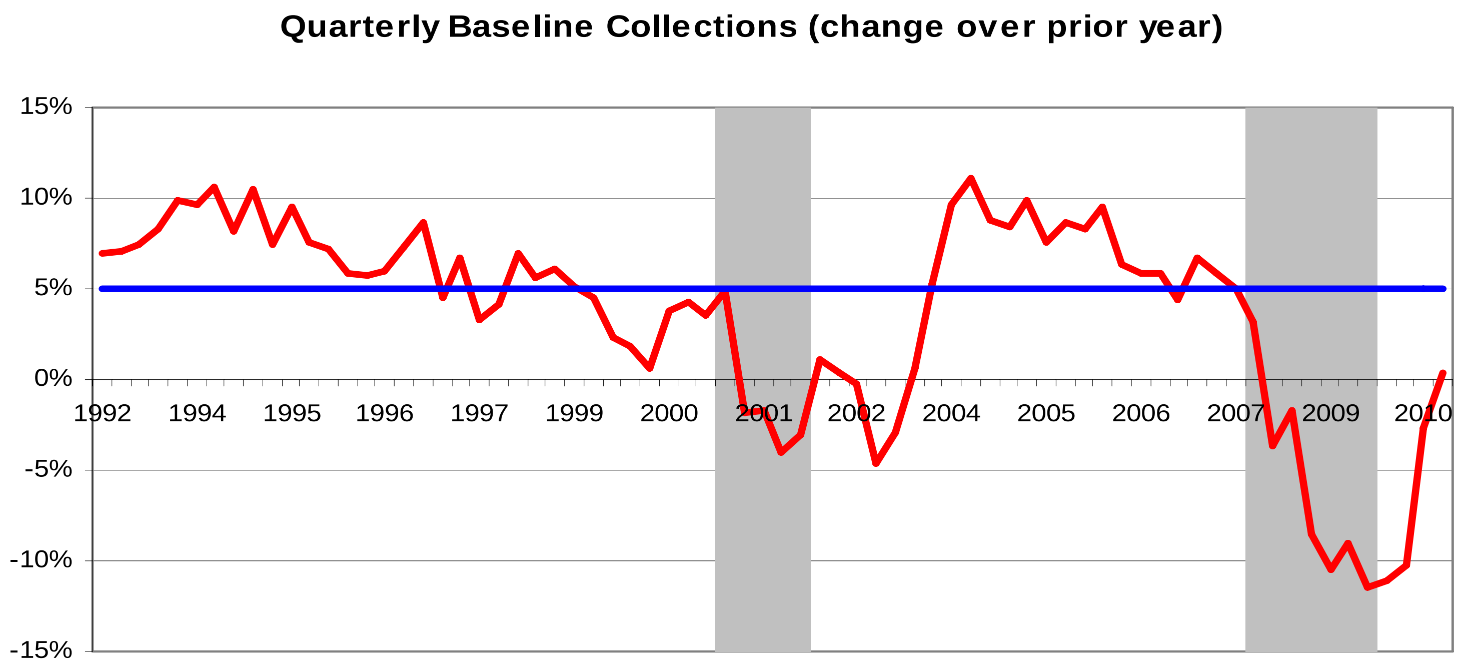
*Baseline collections are calculated by controlling for tax law changes such as a tax rate increase.

How Do 2010-11 Revenues Look So Far?

- Economy-based taxes have ended their precipitous decline and now reflect the sluggish economic recovery with very little or no growth.
  - Baseline sales tax growth for July-September was up 0.8% vs. a 11.5% decline last year (see pages 4 and 5).
  - Withholding tax collections remain weak and are 0.4% below last year. (see pages 6 and 7).
  - Employment growth is a concern for collections going forward. Growth of any significance is not expected to take off until next year (see page 8).

Key Revenue Collection Trends

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



Sales tax collection losses have ended after two years of significant declines.

Key Revenue Collection Trends: Sales Tax

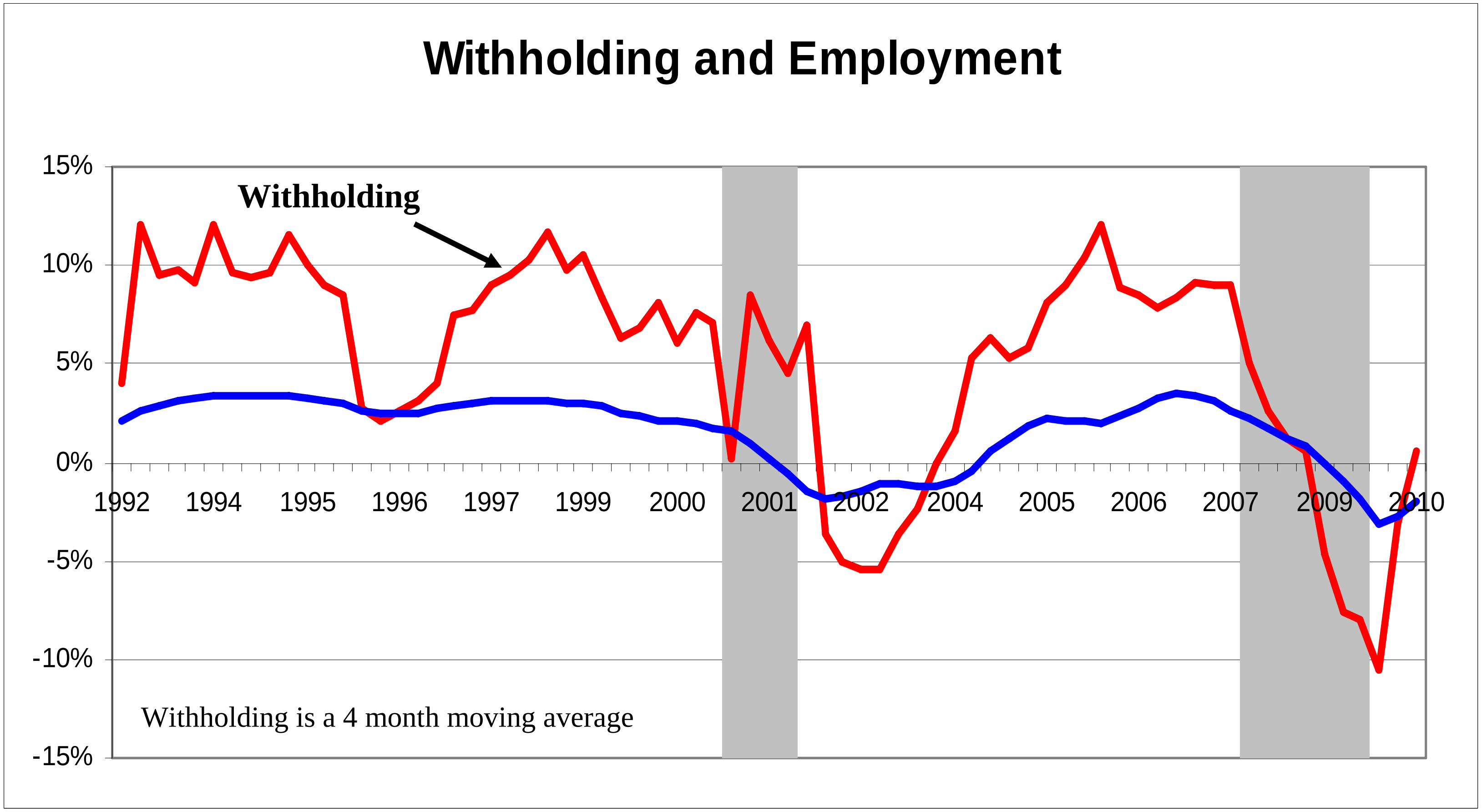
- Starting in July collection declines came to an end as year-over-year collections were up in each month, but by less than 1% (baseline).

- The double-digit year-over-year losses for baseline sales tax collection have ended, but we have yet to see annual growth above 1% (long term average is 5%) despite large losses over the last 2+ years.

- This modest growth is encouraging but is tempered by the fact that collections for this quarter are 12.6% below the first quarter of FY 2007-08.

- The baseline year-over-year growth is only forecast to be 1.5% for the year in anticipation of a sluggish recovery.

Key Revenue Collection Trends



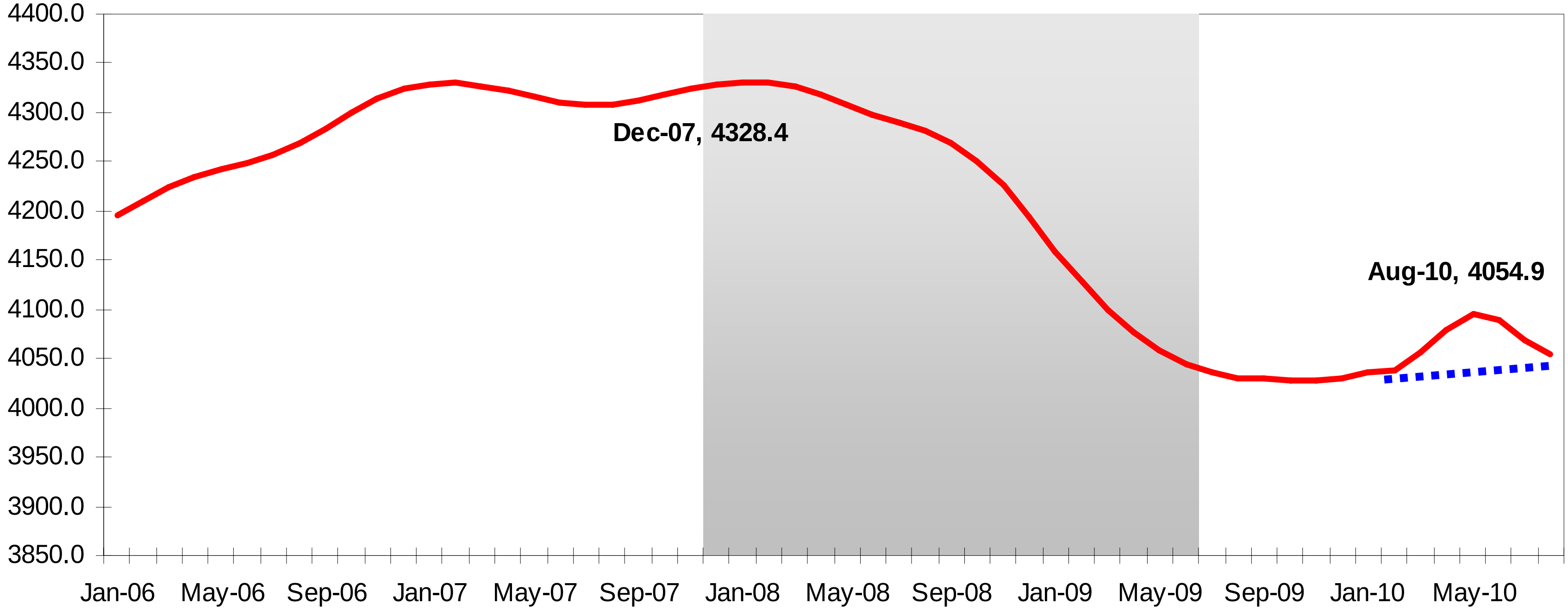
Withholding begins to rebound following a slight increase in employment as well as in the number of hours worked.

Key Revenue Collection Trends: Personal Income Tax

- Recent withholding collections (wage & salary income taxes) offer a glimmer of hope that this key revenue source (40% of total General Fund revenue) is poised to move into positive growth territory.
- Through September, net withholding (all wage & salary withholding less refunds) was down 0.5%. This time last year, net withholding was down by 3.5%.
- After adjusting for key collection day differences compared to last year, withholding is showing positive growth.
  - Net withholding increased by over 3% in September.
- Caution is warranted, however, as job growth remains stagnant. Continual employment gains are needed to sustain growth in the income withholding tax.

Key Revenue Collection Trends

Total Employment (thousands)

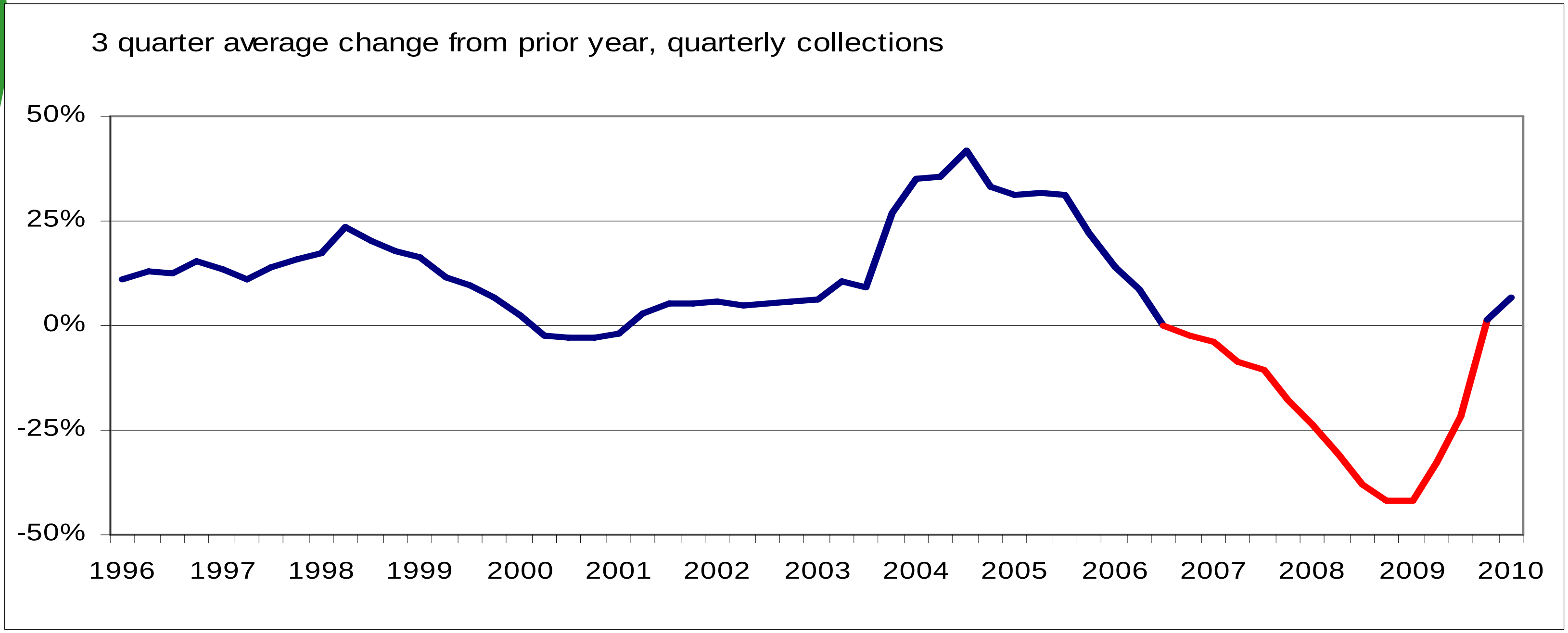


The trend of monthly net job losses has ended, but there has been little rebound in employment. The temporary uptick from Census jobs can be seen in the early summer (the dotted blue line is an FRD estimate of total employment without the census uptick).

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 housing market decline and much of the current economic malaise is tied up in the housing market's continued troubles. Despite the apparent upswing, collections are 55% below what they were at the peak in 2007 ($9M v. $19.5M).

FY 2010-11 Forecast:

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 that the State's economic difficulties would be slow to recover. The result was a downward revision of the FY 2010-11 baseline forecast from 3.3% to 2.7%. Long-term average growth is close 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 Estimates Take Cautious Approach

- The forecasted baseline growth rates of key revenue components, which represent 87% of the General Fund are:
  - Personal Income Tax 3.0%
  - Sales Tax 1.5%
  - Corporate Income Tax 3.6%

Revenue: Things to Watch

- The April 2010 consensus revenue forecast was built on a scenario where the State's economic conditions would show improvement as the economic recovery matures. Most forecasts at the time expected economic growth to be at or slightly above the long-term average trend of around 3% by the 3rd quarter of the fiscal year.
- Since then, most economic forecasts have been downgraded to below normal growth of only 2%. This low growth scenario is expected to persist throughout the rest of the fiscal year.
- 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.

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

Revenue: Things to Watch

- In light of the downgraded outlook for the recovery, it is fortunate that the State's consensus forecast adopted a more pessimistic outlook for the fiscal year than the majority of economic forecasts suggested at the time.
- **However, this means that the cautious approach taken with the FY 2010-11 revenue forecast are now aligning with the revised economic forecasts.**
- In addition to a weak economic outlook, 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.
  - September's estimated payments were down 6%, consistent with this view.

Economic Outlook: Choppy Waters Ahead

- Each change in the business cycle has its own unique characteristics and this time will be no different. Because the structural problems in the housing and financial markets that drove us into a deep recession will not be quickly resolved, the recovery phase will be filled with soft spots along the way. It may be as much as a year from now before most employers and consumers feel like we are in an expanding, vibrant economy again.
- In the mean time, economic news whipsaws us back and forth with "bad" news and then "good" news" (see the following page for example).
- The key is to look at trends over a longer time horizon. These trends suggest that the economy is expanding, but only a fragile recovery is underway. Unfortunately, this growth trajectory will be too flat for employment changes to happen quickly. Therefore, our take is that choppy waters will be with us for while longer - most likely another six months. After which, barring any unforeseen shocks, the economy will be poised for a somewhat stronger growth path and smoother sailing.

Economic Outlook: Choppy Waters Ahead

- Recent "Good" News
  - Unemployment claims on the decline
  - Consumer confidence more up than down
  - Chain-store sales increase in September
  - Private hours worked are on the increase
  - Pending house sales increased in September
- Recent "Bad" News
  - Total labor force is declining as more drop out
  - BLS employment index drops to near recession levels
  - Local Government employment took a big drop in September
  - Mfg. and trades sales flat last 5 months

Economic Outlook: Choppy Waters Ahead

- Based on data from the Bureau of Labor Statistics, employment in the State's manufacturing sector has been slow to recover. Compared to August 2009, there are 700 fewer employed in manufacturing.
- Construction jobs continue to plummet and are down 13,600 compared to this time last year.
- On the other hand, service providing jobs are up, over half of the growth was from the public sector.
- Compared to August of last year, there are 24,000 more people employed. This increase in employment is quite modest 12 months into a recovery and in the face of nearly 280,000 jobs lost during the recession.
  - According to the September forecast by UNC-C's economic forecasters, only 4 of the state's 10 non-agricultural industry sectors are expected to rebound in 2010 – wholesale & retail trade and services are expected to lead the way.
  - In order for the state to meet its 2010-11 budget forecast, improvements in employment will need to persist.

Fiscal Problems Ahead

- Total General Fund Availability for FY 2010-11 was $18.956 billion (S.L. 2010-31)
  - Includes $1.6 billion in federal dollars (ARRA Funds)
  - Includes $1.3 billion in temporary Sales Tax & Income Surtax
  - Includes other one-time items totaling about $300 million

Impact on General Fund Availability, $3.2 billion less for FY 2011-12

General Fund Spending

In addition to the $3.2 billion less in FY 2011-12 availability, the General Assembly will face:

- Mandated spending pressures from
  - Medicaid
  - Public School Enrollment
- Additional spending pressures include
  - An estimated $572.4 million is needed over the next biennium to maintain current benefit levels and anticipated growth in the State Health Plan;
  - Additional funds may be needed to increase the State's employer contribution to the State Retirement System depending on the results of the System's annual actuarial valuation.
  - Post-Secondary enrollment growth

Conclusions

- The second quarter of this fiscal year will be important for the State in order to meet its revenue targets for the year.
  - Projections anticipated first quarter collections would show a little growth over the last quarter of FY 2009-10, which came to fruition. The remainder of the year anticipates the continuation of this gradual improvement for each quarter thereafter.
  - For that scenario to play out, unemployment claims will need to continue to fall and more jobs will need to be created in order to keep pace with the anticipated revenue growth included in the 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. Given the expectation of slow, unsteady growth the economy will remain vulnerable to mild economic shocks increasing the risks to the forecast.
- Additionally, this slow growth outlook for the rest of 2010 means that for many it will continue to feel like a recession. High unemployment is expected to be with us for the rest of the year and most, if not all, of 2011. Robust signs of a recovery are not expected any earlier than the spring of 2011.
  - A copy of this Outlook report can be found at FRD's website:

http://www.ncleg.net/fiscalresearch/generalfund_outlook/generalfund_outlook.shtml