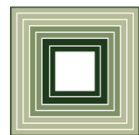


GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK



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



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

Overview

- General Fund revenue through October is on target.
- Employment has not improved and continues to slow growth in the income tax withholdings and sales tax collections.
- Revenues for the second quarter are projected to show modest improvement over the first quarter.
- Most economists believe the economic recovery is on solid footing. Unfortunately, the currently weak level of economic activity means the recovery is fragile.

How Do 2009-10 Revenues Look So Far?

- Collections through October are \$20-25 million above the \$6.1 billion target. This compares with a \$95 million shortfall this time last year.
- Tax revenue is nearly \$45 million above target. This is due in part to almost \$25 million in one-time collections from business taxpayers.
- Non-tax revenues, which make up about 3% of total revenues this time of year, are down \$20 million.

How Do 2009-10 Revenues Look So Far?

- Fiscal Year-to-Date Revenues (\$ millions)

	Budget 2010-11	Actual 2010-11	Actual 2009-10
Tax Revenue	\$5,874*	\$5,923*	\$5,590
Non-Tax & Transfers	\$192	\$166	\$188
Total General Fund Revenue	\$6,091*	\$6,112*	\$5,780

* Includes higher sales tax collections from the 1-cent tax increase and the ¼ cent takeover from the Medicaid transfer

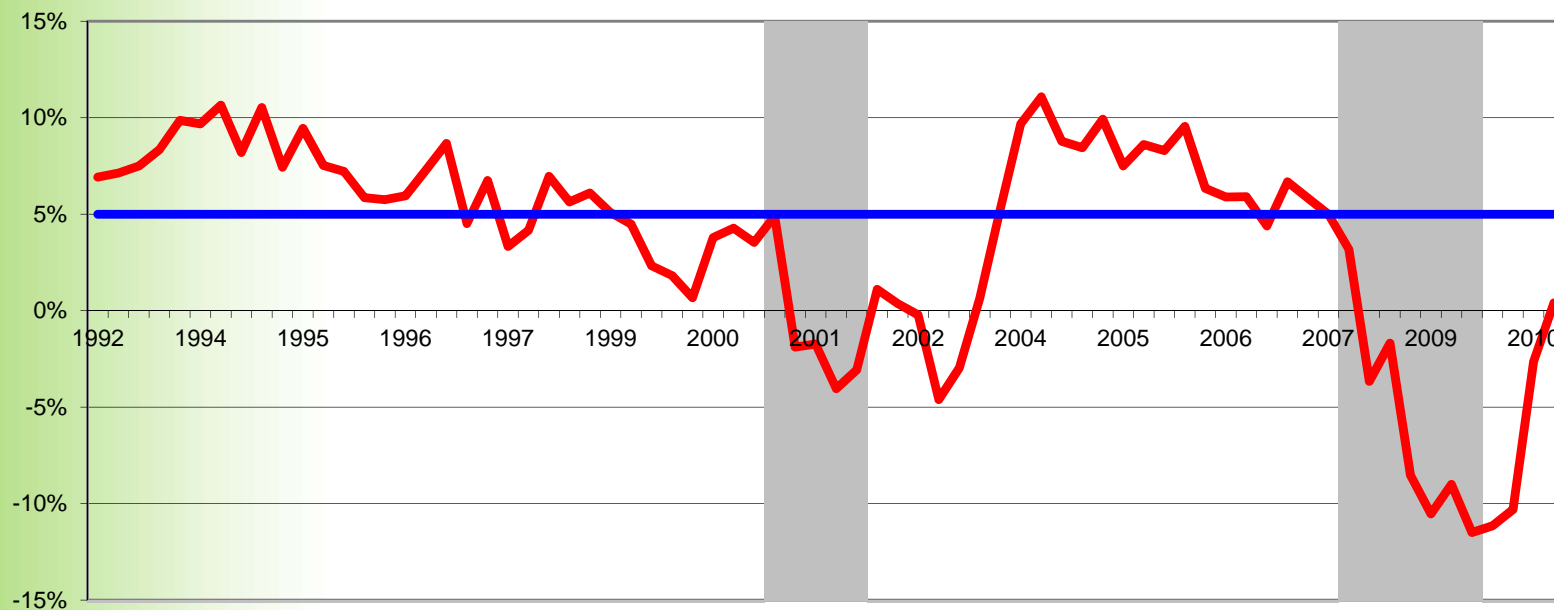
How Do 2009-10 Revenues Look So Far?

- Economy-based taxes are starting to show signs that an economic recovery is underway:
 - Baseline sales tax growth for July-October is up 0.8% vs. a 11.7% decline last year (see page 5).
 - Withholding tax collections are improving and are up 1.2% over last year. The modest rebound is not entirely consistent with the current employment picture (see page 7).
 - Employment conditions remain weak . There was a slight downturn in total employment (seasonally adjusted) in September (see pages 9 and 10).

Key Revenue Collection Trends

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

Quarterly Baseline Collections (change over prior year)

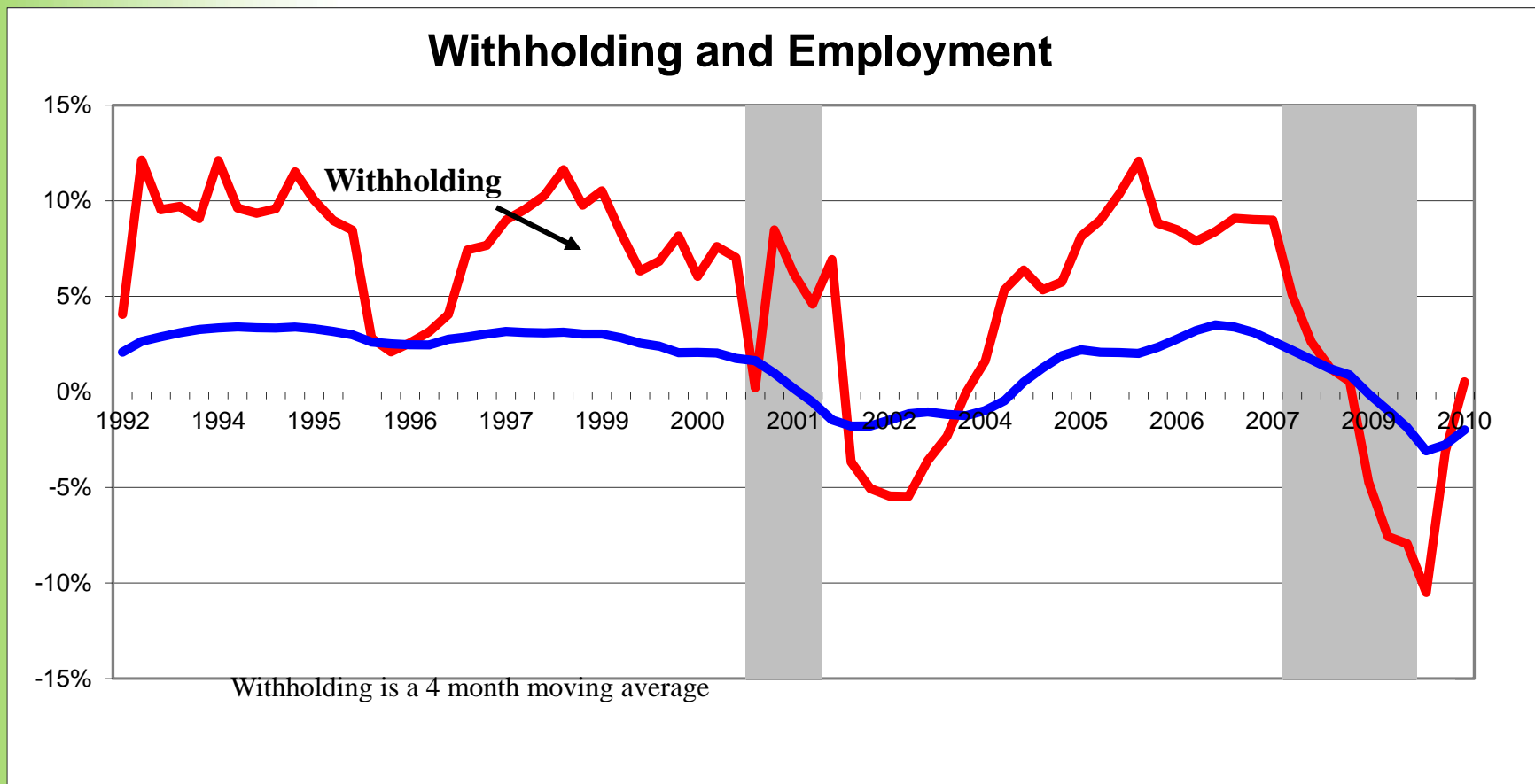


Collection losses have ended after two years of significant declines (long run average growth close to 5%).

Key Revenue Collection Trends: Sales Tax

- Starting in July, collections moved into positive territory in year-over-year comparisons. They were up in each month in the 1% range (baseline).
- Even though the double-digit losses have ended, we have yet to see annual growth above 1% despite the large losses over the last 2+ years (long term average growth is 5%) .
- A key statistic is sales tax refunds, which are up \$75 million over last year and 30% more than expected. Of the \$244 million in refunds thus far, non-profit refunds make up 73% .
- Because the end of FY 2009-10 collections were slightly higher than the March/April forecast expected, and with baseline growth forecast at 1.5%, collections should be able to meet the budget forecast.

Key Revenue Collection Trends



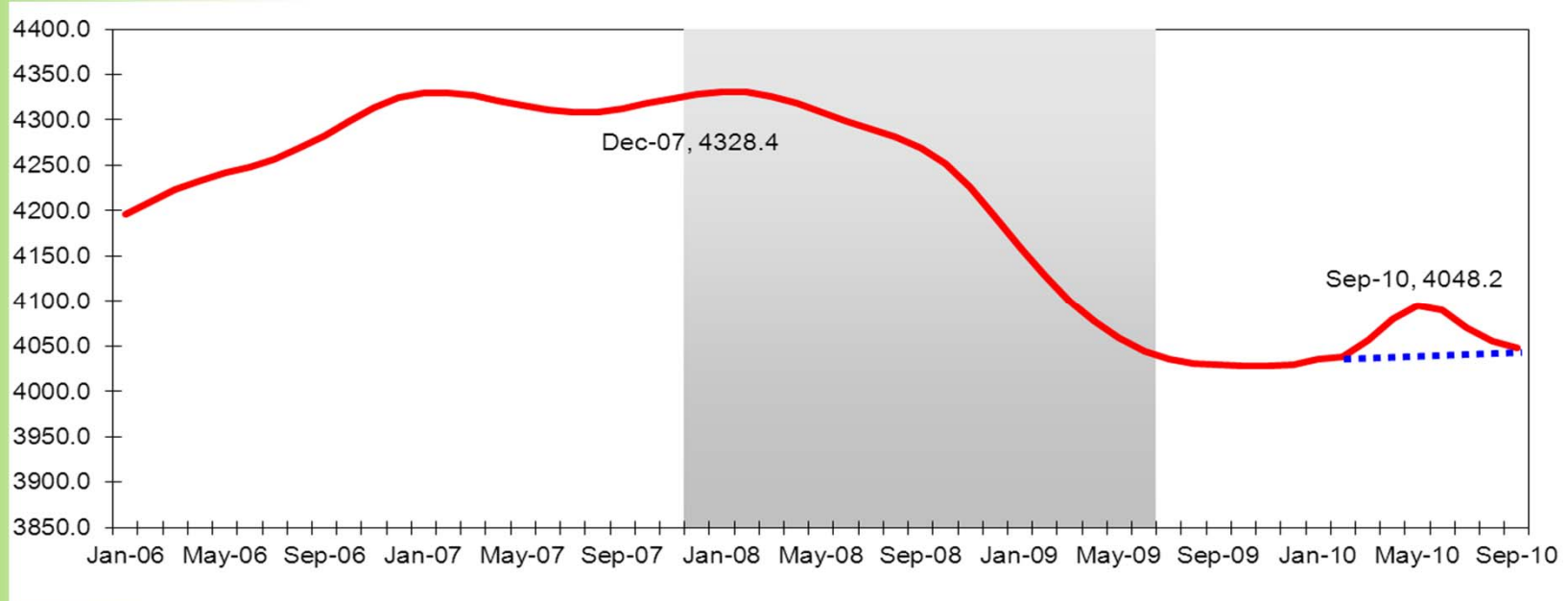
Withholding has started to rebound following a slight increase in employment as well as in the number of hours worked.

Key Revenue Collection Trends: Personal Income Tax

- Recent withholding collections (wage and salary income taxes) offer a glimmer of hope as this key revenue source (40% of total General Fund revenue) has posted back-to-back positive months.
- Through October, total personal income (including both withholding and non-withholding) are down by 0.2%. This time last year, they were down by 2.7%.
 - Collections increased 1.2% in September, and 3.8% in October
- **Caution is warranted**, however, as job growth remains stagnant and the fundamentals do not seem in place to proclaim sustainable growth is underway.
 - Continual employment gains are needed to sustain growth in income withholding.

Key Revenue Collection Trends

Total Employment (thousands)

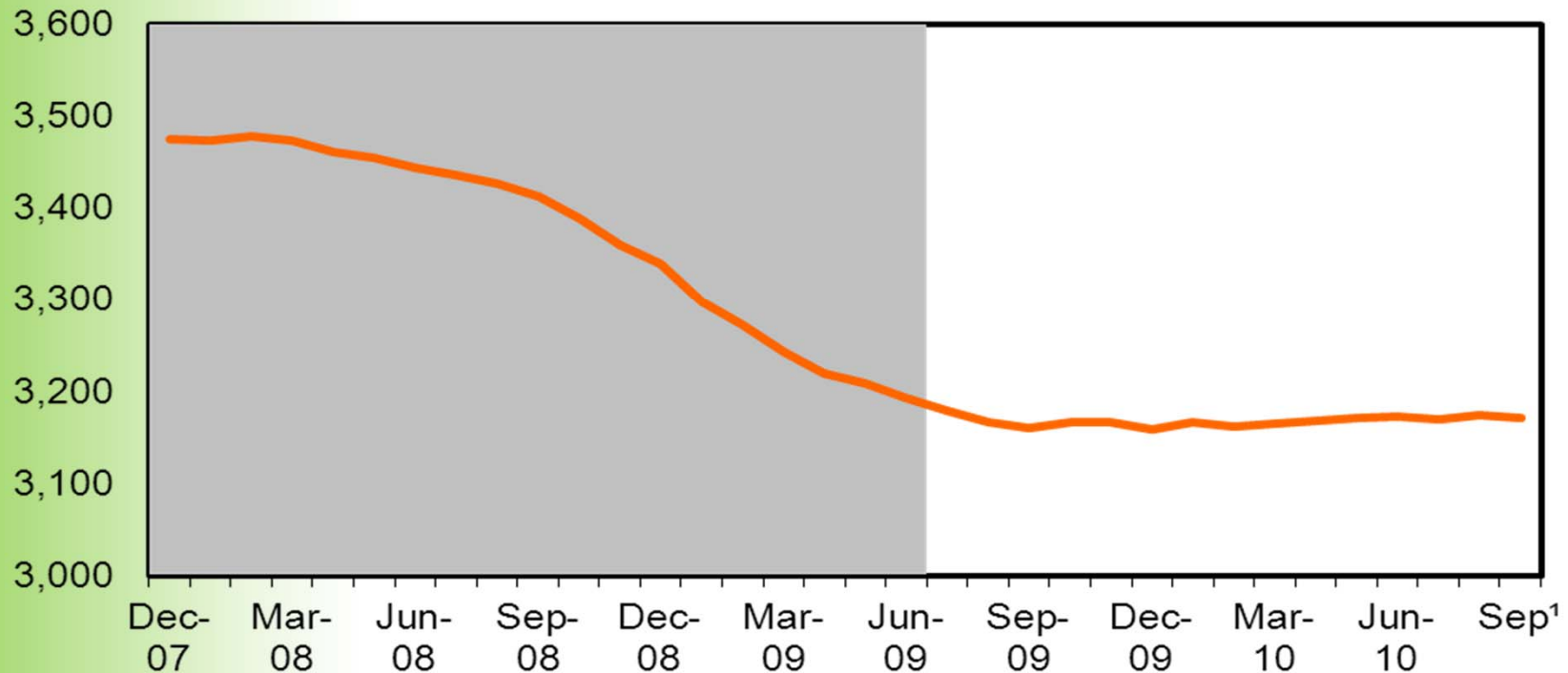


The trend of monthly net job losses has ended, but there has been little rebound in employment. The temporary uptick from Census jobs can be seen in the early summer (the dotted line is an FRD estimate of total employment without the census uptick).

Source: North Carolina Employment Security Commission

Key Revenue Collection Trends

Total Private Employment (thousands)



Private employment has increased by only 11,600 jobs since last September (less than one-half of a percent). Shaded area denotes the recession.

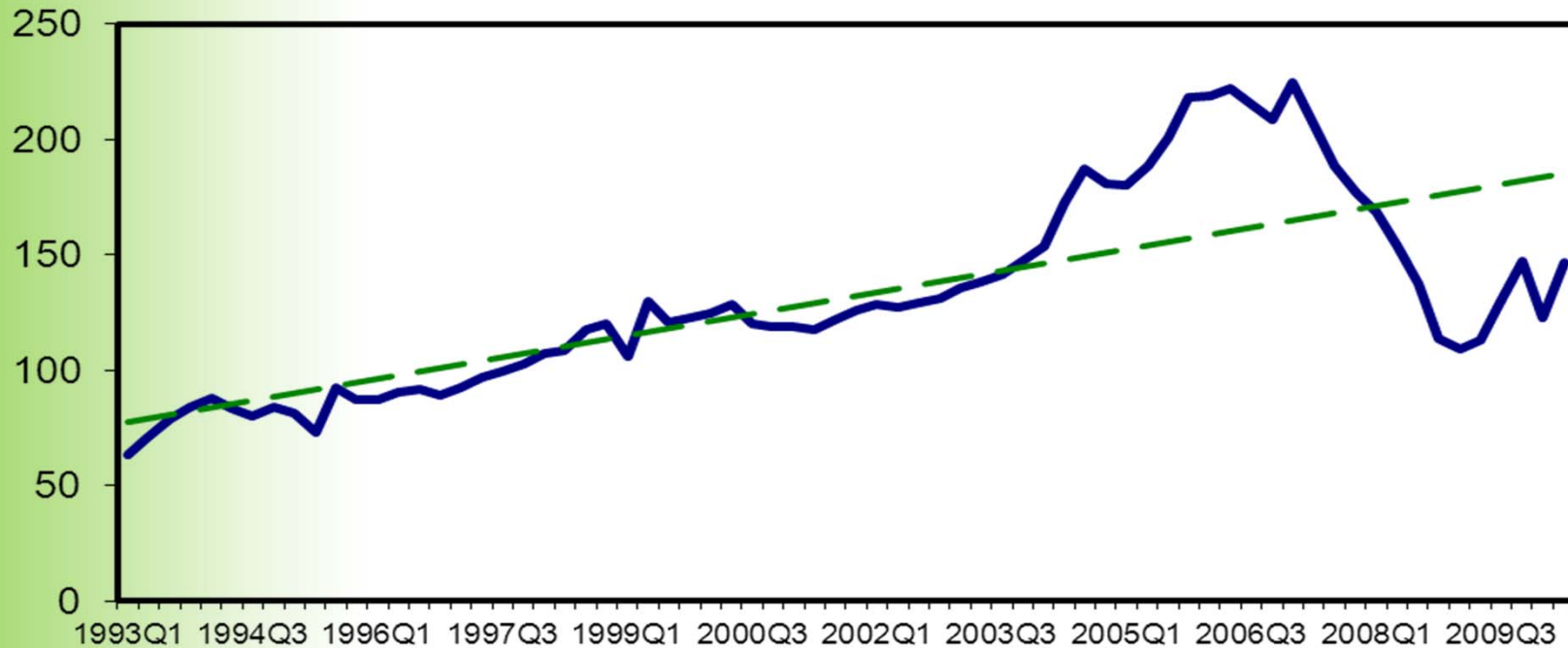
Source: North Carolina Employment Security Commission

Revenue: Things to Watch

- The budget revenue forecast was built on a scenario where the State's economic conditions would improve each quarter of the fiscal year.
- The first quarter met that expectation and for rest of the year to continue improving employment gains will have to pick up, consumer confidence will need to pick up steam, and housing problems will need to wind down.
 - Since the third quarter of 2009, the economy has been growing, and it grew at an annualized rate of 2% in the third quarter of 2010. Key indicators have moved upward since the deepest trough of the recession. Nevertheless, the pace of growth remains sluggish.
 - Growth is expected to remain sluggish for quite some time as households, the key to a robust expansion, remain on the sidelines. The bursting of the housing bubble wiped out nearly \$11 trillion in net worth, damaging household balance sheets. The repair to household balance sheets will take time and until then the economy will move at a slower pace.

Key Economic Trends

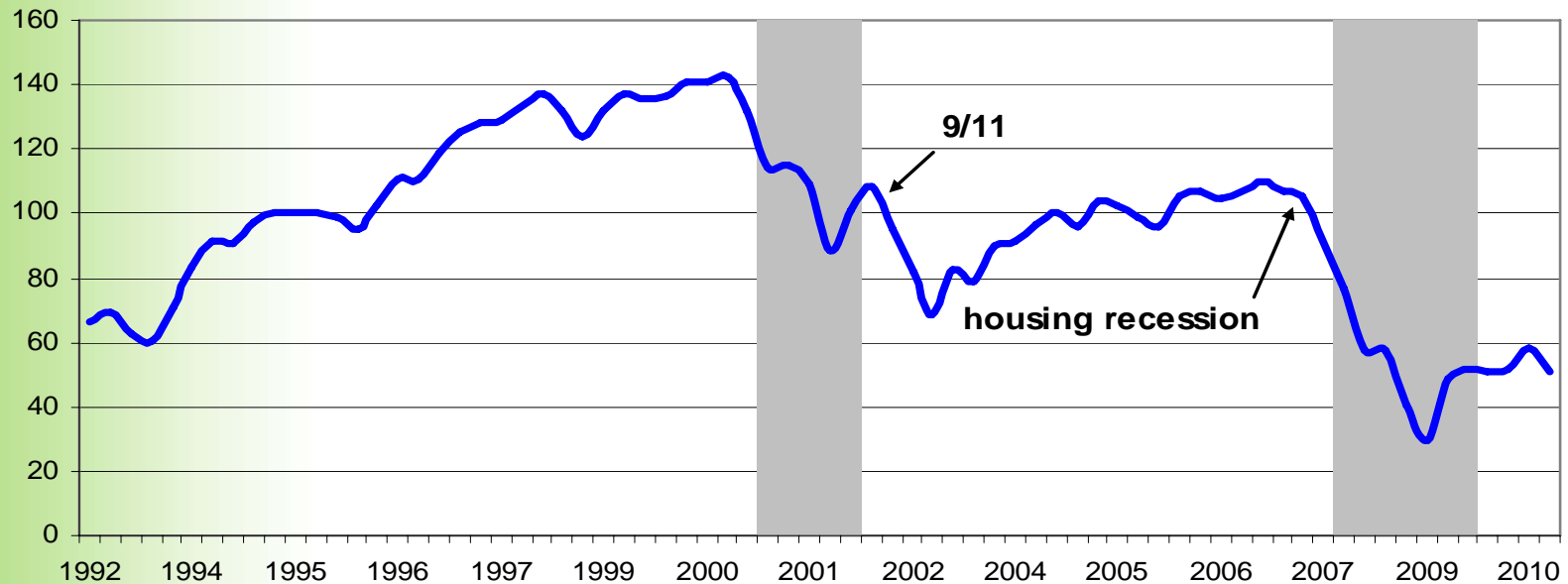
NC Existing Home Sales (Ths., SAAR)



Existing home sales show the build up from easy credit in the early part of the 2000s and the subsequent recession in the housing market that began in 2007. The dotted line traces the long range trends established in the 1990s.

Key Economic Trends

Consumer Confidence



Source: The Conference Board

The rebound in consumer confidence has stalled-out and has a long way to go to reach pre-recession levels.

Revenue: Things to Watch

- Employment is the main key to a sustained, robust recovery and an improving revenue picture.
- Compared to September of last year, there are only 19,000 more people employed. This increase is modest 15 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 four of the state's ten non-agricultural industry sectors are expected to rebound in 2010. The wholesale and retail trade sectors and the service are expected to lead the way.
 - In order for the State to meet its FY 2010-11 budget forecast, improvements in employment will need to persist.

Revenue: Things to Watch

- Are employment conditions improving?
 - The National Association of Business Economists' most recent industry survey indicated “planned business hiring” has improved and is at the highest level since 2006. It should be noted that nearly half of all respondents indicated they would not be hiring over the next six months despite expecting an improvement in economic conditions.
 - Based on the survey, the Service sector and the Finance, Insurance, and Real Estate sector are expected to post the biggest gains
 - The Bureau of Labor Statistics reports that temporary employment, a precursor to permanent job hiring, has been steadily on the rise.
 - Based on our analysis, it appears that one more quarter of modest growth will be needed to favorably tip the scale for businesses to make hiring decisions.

Revenue: Things to Watch

- The recovery is **not** anticipated to follow the usual pattern of an investment recovery, followed by an improvement in consumer sentiment, and finally, a full recovery of the job market.
- Recovery from a financial crisis, one that wiped out trillions of dollars of net worth, is expected to follow a slower, unsteady path taking much longer to reach a strong expansionary economy. Both business and household investments will take longer to materialize, and as such, employment gains will take much longer to materialize. This will further suppress both household investment and consumer sentiment.

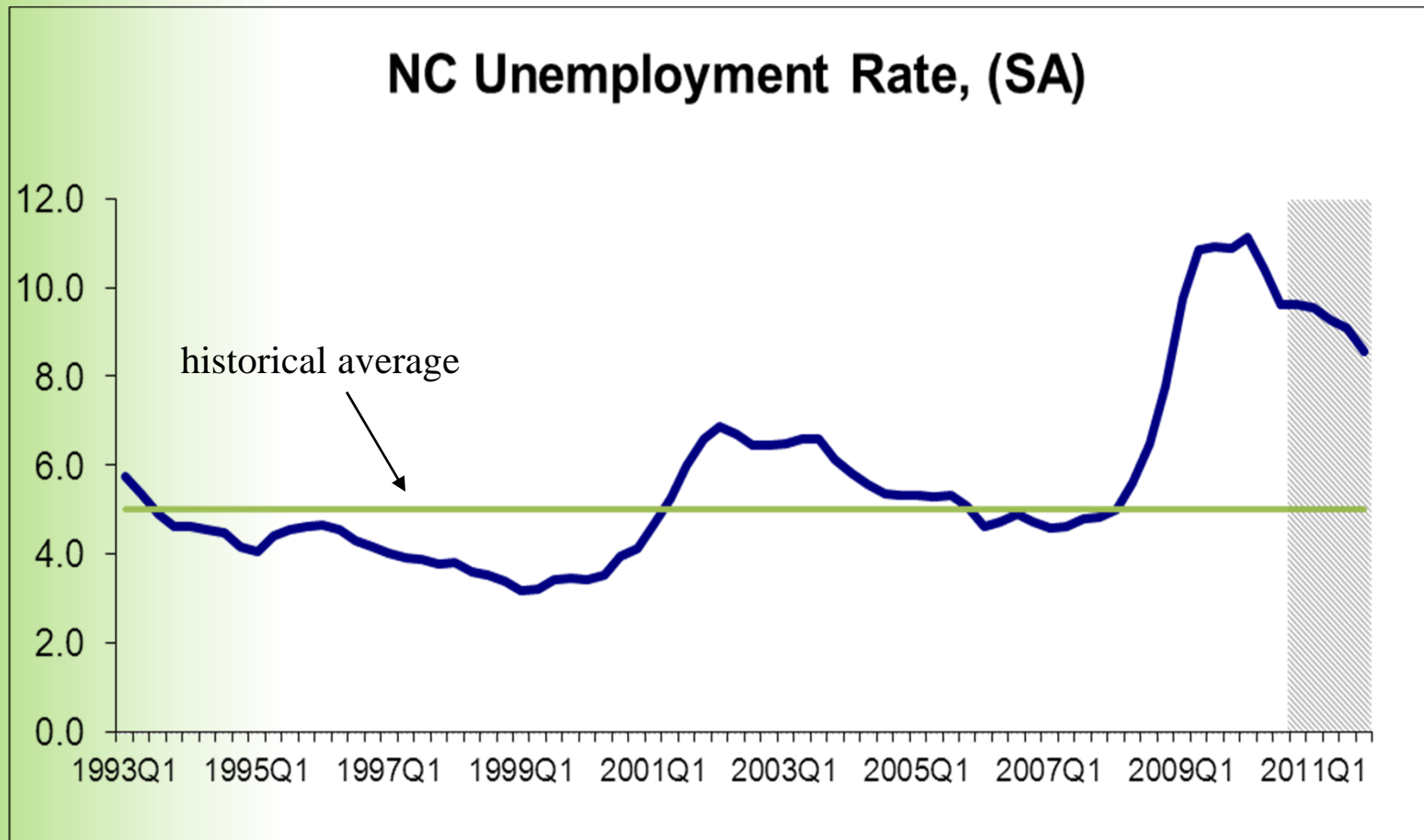
Revenue: Things to Watch

- Housing appears to be showing some signs of life. However, with foreclosures mounting most markets will still have many more houses available than buyers. Housing prices will continue to fall, making it more difficult for households to repair and rebuild their balance sheets.
- This is one of the key reasons many economist still hold out a 30% chance or better of the economy contracting yet again, resulting in what has been referred to as a “double-dip recession”.
- The main point is that the economy remains weak and will be susceptible to even mild economic shocks.

Economic Outlook

- For the State, the after-effects of the recession are still lingering, and a robust recovery is not on the foreseeable horizon. This will keep the unemployment rate elevated through 2011, as economic growth will not be strong enough to pull the rate down below 8.5%.
- For the nation as a whole, the Federal Reserve Board in its last meeting decided to keep bank lending rates at their lowest point citing that “economic activity is likely to remain weak” and “inflation will remain subdued for some time”. This also allowed the Fed the opportunity to buy more bonds in the open market (through printing more money). This action runs the risk of fueling inflation, but given the weakened state of the economy the risk was considered minor by the board.

Economic Outlook



Unemployment rate forecast shaded in gray.

Conclusions

- While the second quarter of this fiscal year will be important for the State to meet its budget forecast, it is important to remember that many of the volatile sources do not show up until the second half of the fiscal year.
 - Key collections from corporations and final payments from wealthy taxpayers including S-corps and LLCs often lead to an April surprise, which is when these payments and refunds are reported.
- Economic conditions will continue to be frustrating as the sluggish recovery plods along. Gradual improvements are expected, yet signs of a recovery in employment are not expected until the spring of next year.
- Despite the anticipated gradual improvements in the economy, a full expansionary economy is still at least two or three quarters away.
 - This Outlook and previous Revenue Outlooks can be found at FRD's website <http://www.ncleg.net/fiscalresearch/>