GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

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Highlights

- General Fund revenue for the first half of the fiscal year met the forecast target.
- Key revenue sources, sales tax collections and withholding income tax, are slightly ahead of projections.
- Recent national and State economic data indicate the recovery is finally starting to gain solid footing.
- Economic forecasts are expecting conditions to improve throughout 2011, but growth will remain modest.
- Modest growth means regaining the ground lost during the recession is unlikely for at least another year or two.

How Do 2010-11 Revenues Look So Far?

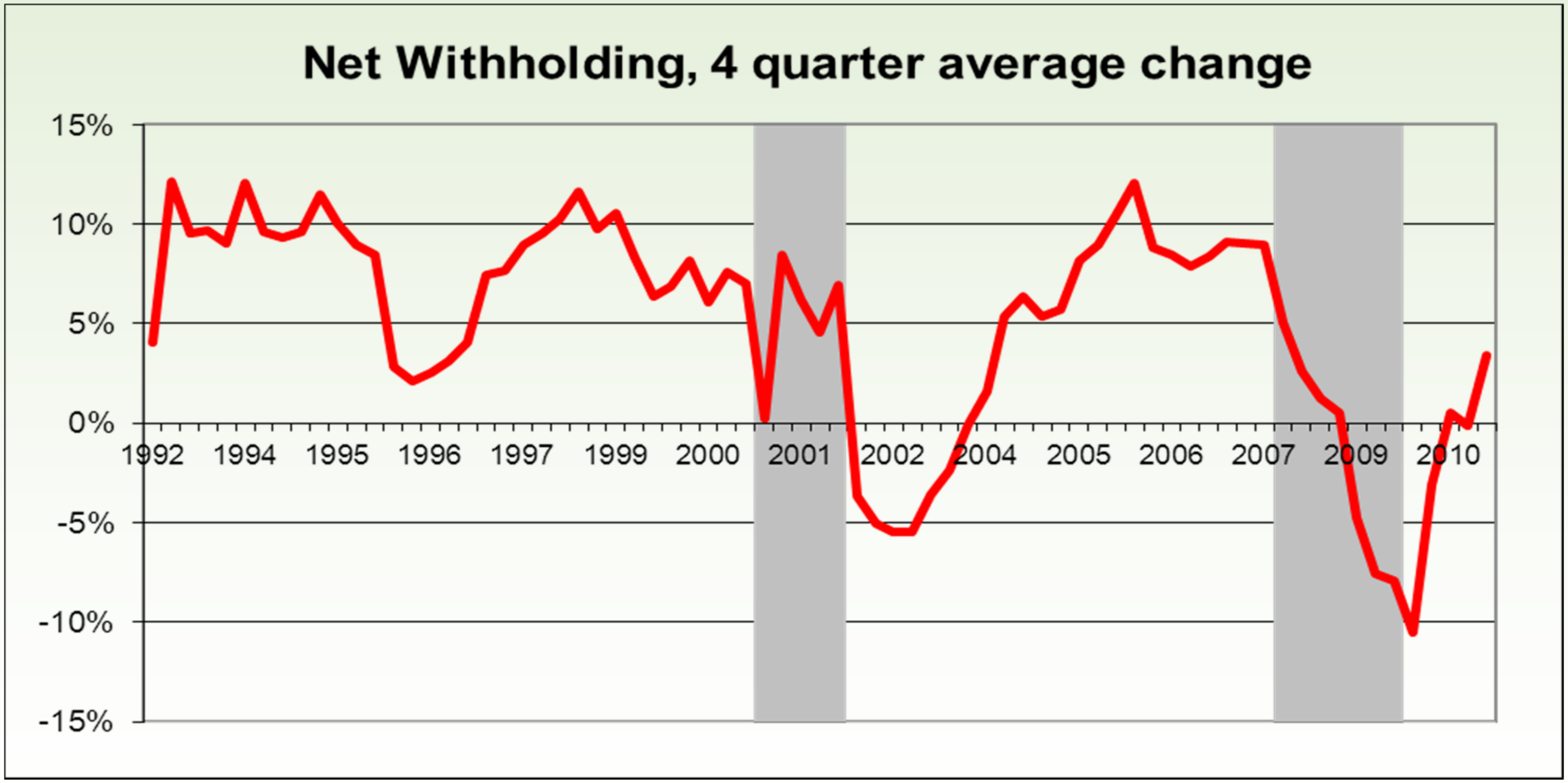
- Through December, General Fund revenues are running $10 million below a $9.4 billion forecast target.
  - Tax revenues are $40 million above the $8.9 billion target. Non-tax revenues, which include short-term investment income and judicial fees, are $50 million below the $300 million target.
    - Key sources for this time of year, sales tax and income tax collections, are meeting their forecast targets.
    - Non-tax revenues are not trend-based and are difficult to target from month to month.
  - While the first half of the fiscal year is on target, it is important to remember **most of the forecast risk resides in the second half of the year.** This is when large income payments and refunds come into play.

How Do 2010-11 Revenues Look So Far?

- Net income tax withholding on wages and salaries are up 1.1% for the first half of the fiscal year. At this time last year they were down 4.1%.
  - Withholdings from larger employers have posted positive year-over-year gains the last several months and were up 2.6% in December.
- Gross sales tax collections have improved significantly and December collections were up over last year by 8.5%. December's collections matched the positive reports coming from retailers about Holiday sales.
  - Baseline (tax-adjusted) collections for the second quarter of the fiscal year were up 2.7%. This is still 13% below where we were prior to the onset of the recession in December 2007.
  - Net sales tax collections, however, are only up 0.12% over target. Despite strong gross collection growth, refunds are running 50% above target . Non-profit refunds, which represent 65% of all refunds, are 70% higher than last year.

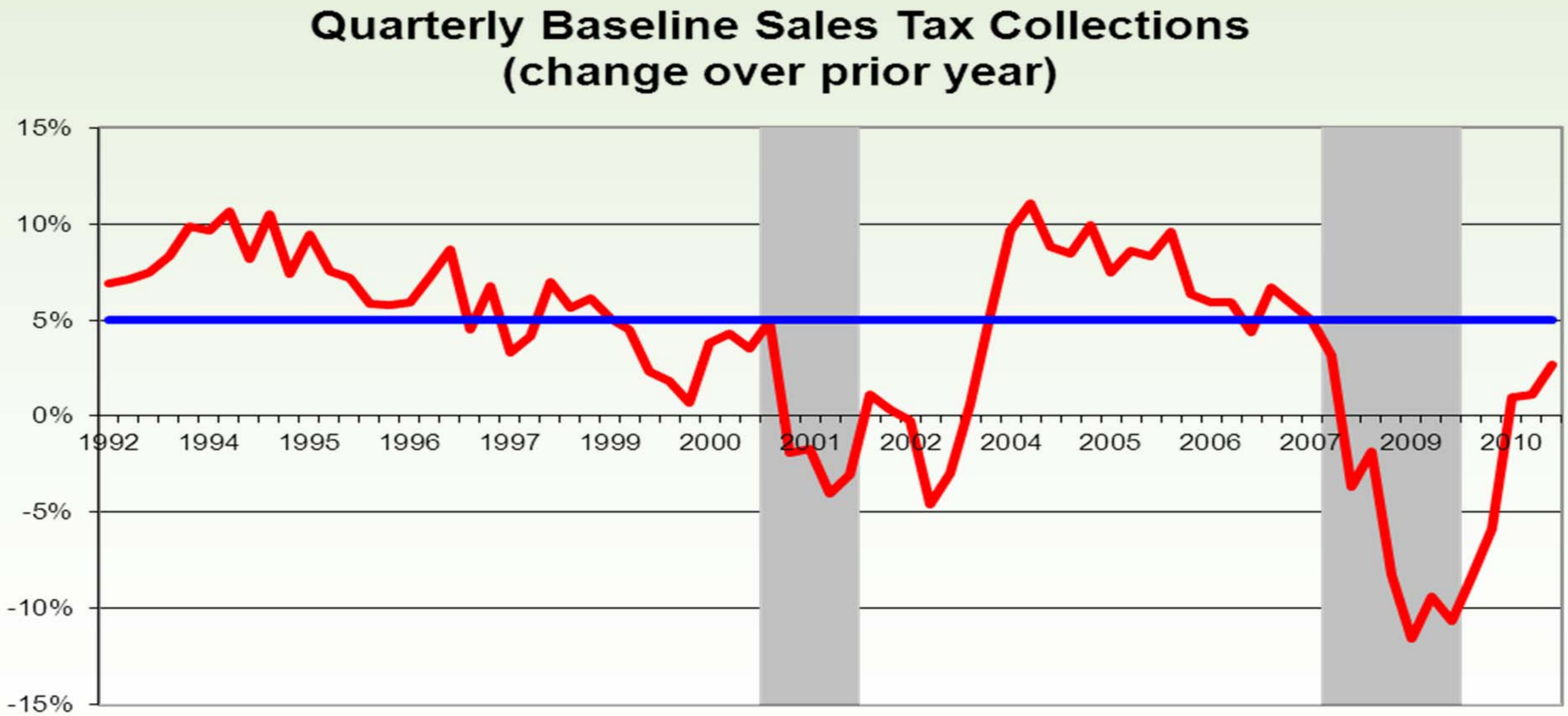
Tracking Economy-Based Collections

Net withholdings (withholdings less refunds) continue to strengthen. If modest employment improvements materialize this spring, then withholding will meet its forecast target.



Tracking Economy-Based Collections

Baseline sales tax collections have moved into positive growth territory despite weak consumer confidence and very little positive news available on the employment picture. Both of these key indicators for retail sales will have to improve before collections reach long-term growth of 5%.

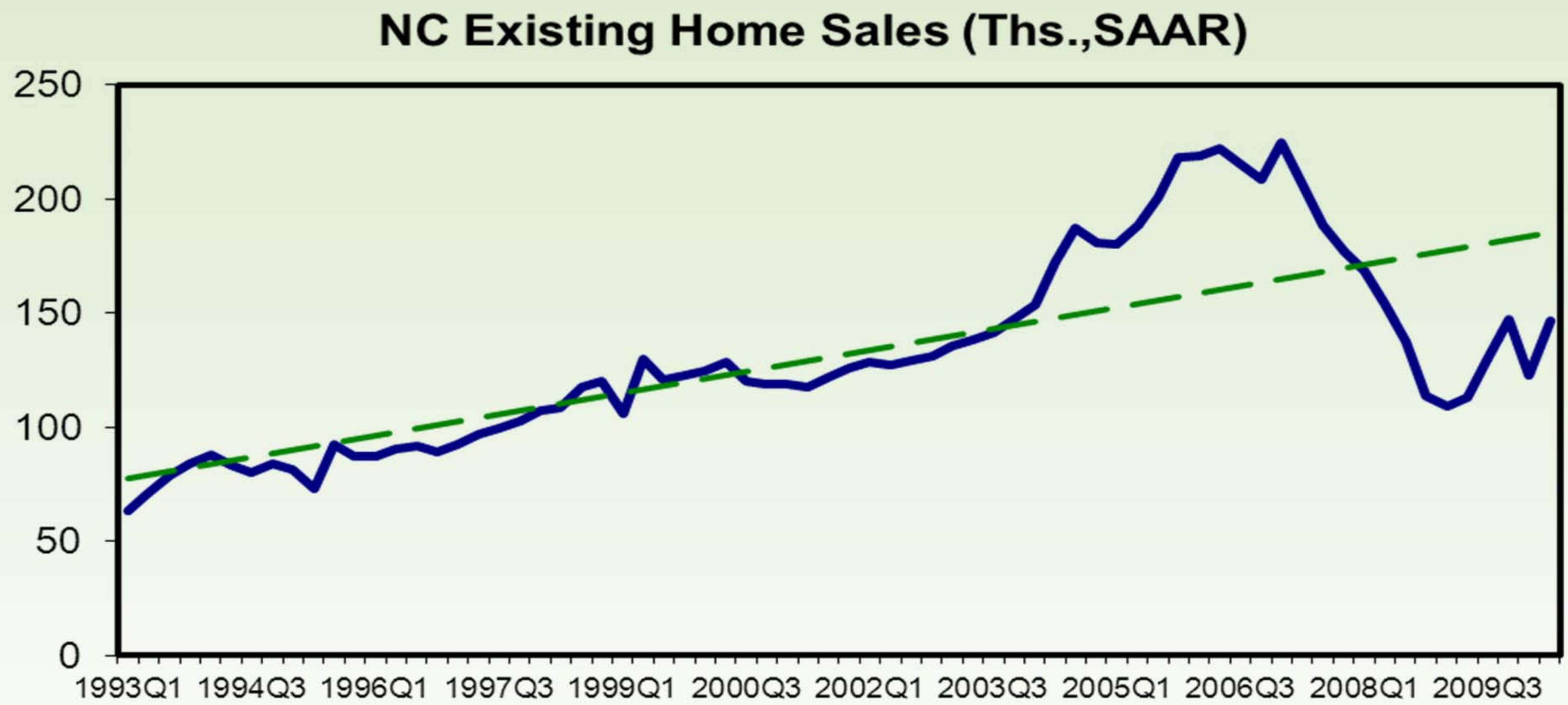


Key Economic Trends

•Source: The Conference Board

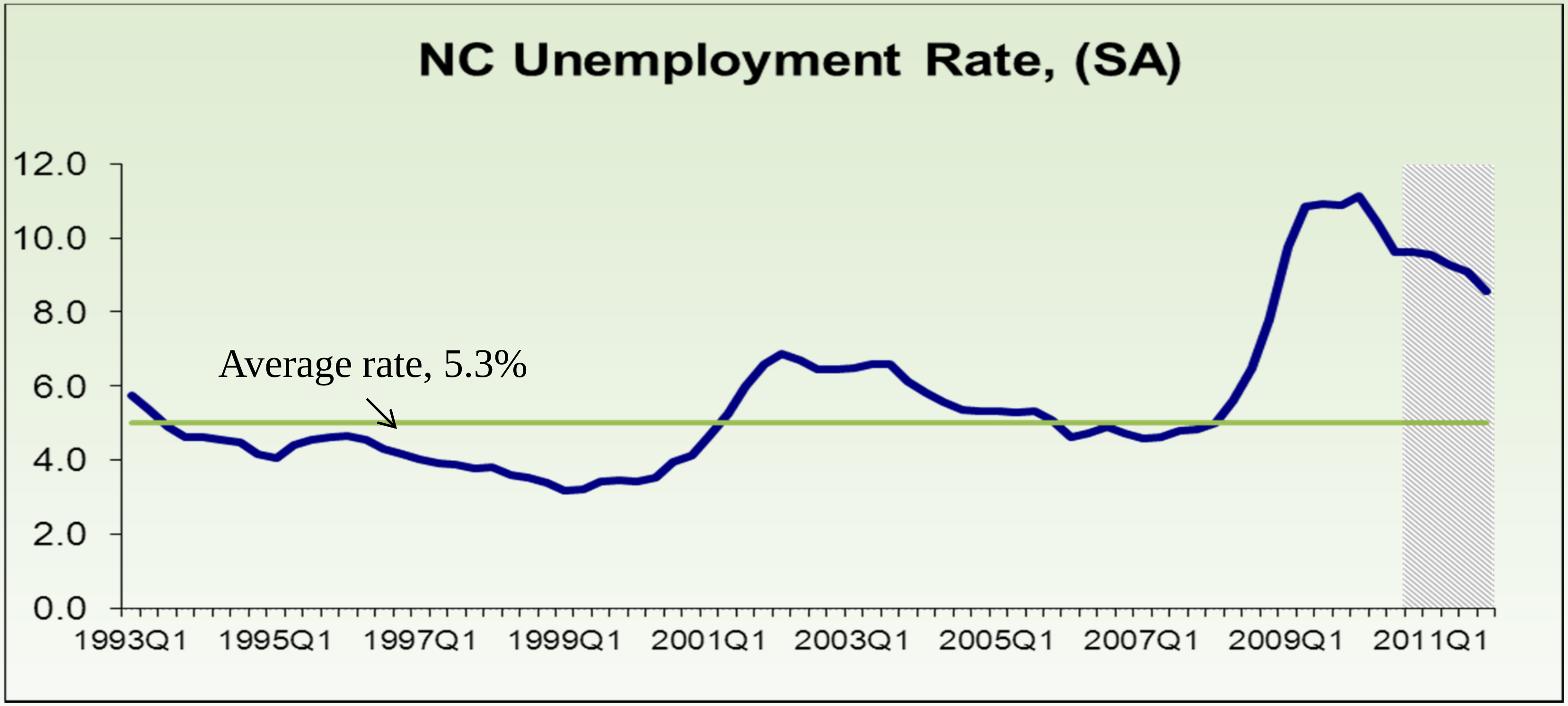
The rebound in consumer confidence has stalled-out and is well below pre-recession levels. Confidence remains affected by the weak employment news and the shaky housing market.

Key Economic Trends



Existing home sales show the build up from easy credit in the early to mid 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. Existing home sales are expected to remain below this trend throughout 2011.

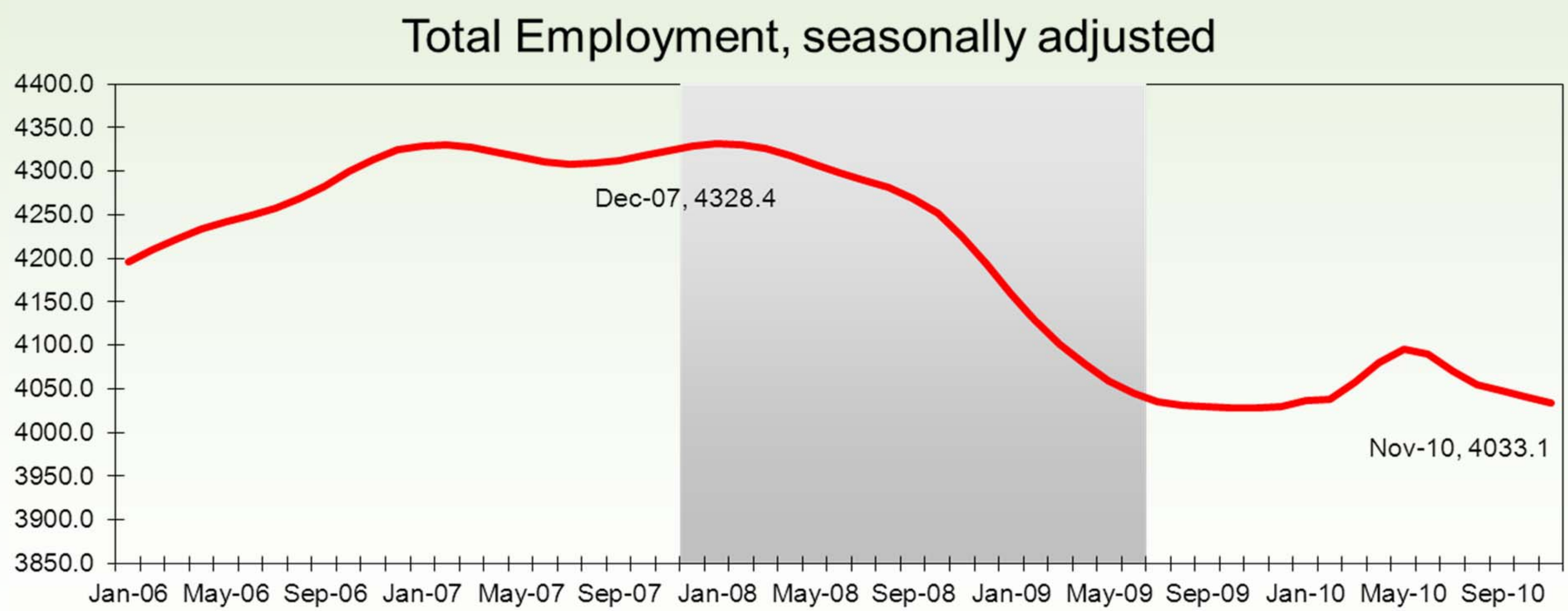
Key Economic Trends



The unemployment rate (forecast shaded in gray) is expected to remain above 9% even as employment numbers improve. The reason is the return of discouraged workers plus new entrants into the workforce.

Key Economic Trends

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 290,000 jobs. The uptick in employment this past summer was the result of temporary employment by the U.S. Census Bureau.



Source: NC Employment Security Commission

Key Economic Trends

Initial claims, a measure of the number of jobless claims filed by individuals seeking to receive State jobless benefits, have dropped significantly since the onset of the recession. They are still elevated above the pre-recession levels of 2007.

State's Economic Outlook

- Employment numbers in most of the State's industry sectors remain near recession levels.
  - The good news is that both wages and hours worked have started to increase. This is typically a precursor to an increase in hiring.
- Compared to last November, the industry sectors Construction, Manufacturing, Trade, and Entertainment and Hospitality have experienced losses in employment. The Government sector, which had held steady for most of the recession has begun to shed jobs.
  - Private Sector Employment, Nov. '09 to Nov. '10: down 2,900 jobs
  - Government Sector Employment, Nov. '09 to Nov. '10 : down 3,200 jobs

State's Economic Outlook

- The State's economic recovery is gaining strength; however, headwinds from the housing market's problems, in addition to the weak employment market, will be a drag on economic growth during 2011.
  - The housing market is still out of balance with many more houses available than buyers.
  - Foreclosures will only exacerbate and prolong the housing market's woes suggesting housing prices will continue to slump in 2011.
  - Existing home sale prices across the State continue to fall and were down 1.9% in the third quarter of 2010.
  - Since the start of the recession, the average price of an existing home sold in the State has dropped 12%.

State's Economic Outlook

- Most economists agree that the economy in 2011 will build on the improvements that were underway the second-half of 2010; the question is, by how much?
  - Dr. Michael Walden of NC State University stated in his most recent economic outlook that "the very modest recovery in North Carolina continued in 2010 and all signs point to the same pattern in 2011 and 2012".
  - His index of leading indicators, the *NC State University Index of North Carolina Leading Economic Indicators*, which forecasts the economy's directions four to six months ahead, increased "a robust 1.7% in October from its level in September."
  - Similarly, Dr. John Connaughton, at UNC-Charlotte, reports in his most recent forecast that the State's unemployment rate will close out the year around 9.5%. He goes on to forecast that employment growth for 2011 will be 1.0%, adding a little less than 40,000 jobs. This would be well short of the 290,000 needed to reach pre-recession employment.

State’s Economic Outlook

- Based on these and other forecasts for the State, significant changes in the employment picture should not be expected until the second half of 2011 at the earliest.
  - Employment has a long way to go to reach pre-recession levels. Given the 6% decline that occurred during the recession, it could take another 2 to 3 years before the State returns to pre-recession levels of employment.
  - The slow rate of recovery unfortunately is consistent with recessions caused by structural problems in the financial markets.
- Moody’s economy.com forecasters expect significant improvement in the State’s personal income for 2011. They are forecasting growth above 4%, which is nearly twice the growth projected for 2010. Nonetheless, this is a downgrade from earlier forecasts for 2011, which envisioned growth of well over 5%. The downgrade is consistent with national forecasts calling for only modest improvements over 2010’s economy.

State's Economic Outlook

- Wage and Salary income in the State, the major component of personal income revenue, fell 4% in 2009, and is estimated to have grown a little less than 3% in 2010.
  - Based on State and national forecasts, FRD currently estimates Wage and Salary personal income will grow by 4.5% for FY 2011-12.
  - The slow rate of employment growth will keep wage growth below the long term average of just over 5%, and much lower than one might expect after several years of depressed growth and losses.
- Recent national economic data suggest that the economy is beginning to accelerate. The economy is finally starting to leave behind the doldrums that have plagued the nation for past three years.
- Nonetheless, expectations for a return to a robust economy are being pushed out into 2012 because of the troubles still hampering household budgets, most notably the ongoing housing market recession.

Conclusions

- The State's economy is expected to follow the national trend and continue down the current path of a slow, steady recovery.
- National surveys on state tax revenue collections indicate that, as with North Carolina, personal income tax collections are picking up and sales tax collections are finally starting to rebound from the double-digit declines of the last two years.
- The economy is gaining solid footing on many fronts, but as long as households remain cautious due to lagging employment growth and a faltering housing market, the recovery will continue along a slower track.
- At this point in the fiscal year, revenue collection trends suggest that the cautious budget forecast will finish on target with the caveat that it is still difficult to project the downside risks of an "April surprise". The risk is created by the volatility of 2010 final payments and refunds, as well as, 2011 estimated income payments.