GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

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Highlights

- A big April "surprise" never materialized. While personal income collections improved slightly over the consensus forecast, other key revenue components were at, or just below, expectations.

- Year-to-date collections are now $180 million over the fiscal year budget numbers. Given the remaining end-of-year refunds and the more aggressive monthly targets, we do not anticipate adding any more to the surplus the last two months of FY 2010-11.

- Since the February forecast, little has changed with respect to the overall economic picture. We agree with most forecasters that the current energy prices will remain above last year's levels, but the spike experienced in March and April was transitory.

April Collections

- April is the biggest collection month of the fiscal year, and the most volatile. Collections can easily swing up or down $400 to $500 million compared to budget targets for the month.
- Most of the volatility is from large taxpayers on both the personal and corporate end settling-up last year's tax payments, plus making an estimated payment on the current tax year. It's the swing in these payments along with the amount of total refunds that can lead to an April surprise.
- **This year there were no major surprises**. Final payments on last year's taxes were a little higher than expected, but every thing else came in on target, or slightly below.

April Collections

- Thus, with no major surprises and taking stock of current economic trends, over-collections for this fiscal year will be an estimated $180.8 million, which is $24.5 million more than the $156.3 million forecast in February.
- The need to slightly downgrade the forecast for economic activity for the 2nd and possibly the 3rd quarter of this year (April- September) has been broadly recognized by most economic forecasters. Key factors are energy prices, global slowdown, and natural disasters, which are causing temporary disruptions.
- Because of the slight downgrade, it was estimated that the increase in over-collections would non translate into any significant change to the next biennium's forecast.

Total General Fund Revenues Through April

- General Fund revenue through April is $180 million above the $16.2 billion target.
- Personal Income tax collections are the main reason the General Fund is running a surplus. Payments on the 2010 tax year were better than expected in the consensus forecast, while refunds matched expectations.
- Net income tax withholding on wages and salaries are up 4.1% through April compared with last year. That is a slight improvement over where we were a couple of months ago and 1.1% above expectations.
  - The strongest growth in wage and salary withholding continues to come from larger businesses. Small businesses are doing only slightly better than last year.

Total General Fund Revenues Through April

- Sales tax collections continue to track close to expectations. Elevated refunds and higher gas prices remain a concern.
  - Collections continue to surpass last year’s numbers and have remained resilient in the face of weak consumer sentiment from the struggling job and housing markets.
  - Baseline (tax-adjusted) collections for the first 10 months of the fiscal year are up 3.1% compared to last year, which is nearly double the original budget forecast.
  - While baseline collections are beating the forecast expectations, elevated refunds have held back net collections. Net collections are 2.3% above target through April.
- Corporate Income tax collections were only slightly below what was expected for this April, leaving expectations for June’s estimated tax payments unchanged.

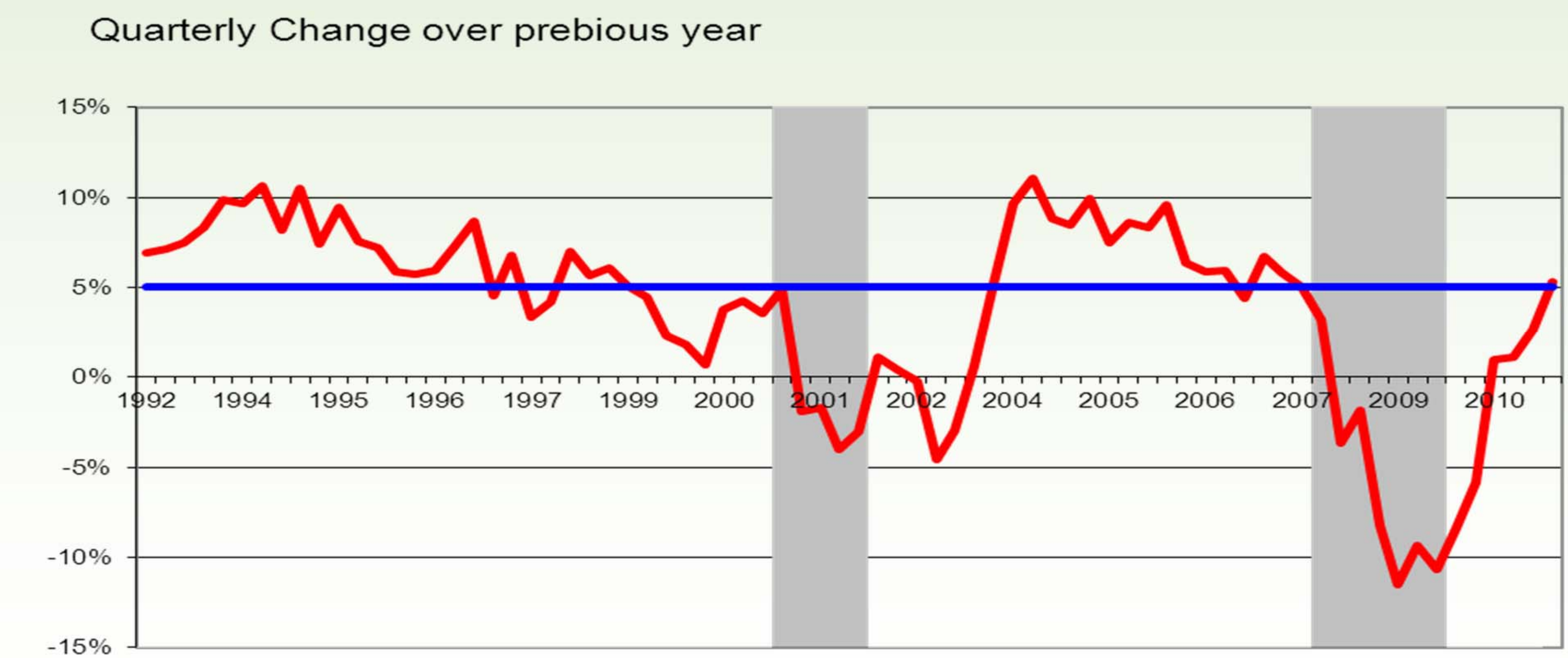
Tracking Economy-Based Collections

Net withholdings (wage and salary withholdings less refunds) continue to strengthen. These gains have occurred despite very little reported employment or wage growth, and suggest future upward revisions in one or both of these series may be likely.

Tracking Economy-Based Collections

Baseline sales tax collections are maintaining positive, steady growth. Higher gas and food prices did not dampen collections in April, but if prices start to rise again they will shift purchases away from the sales tax base.

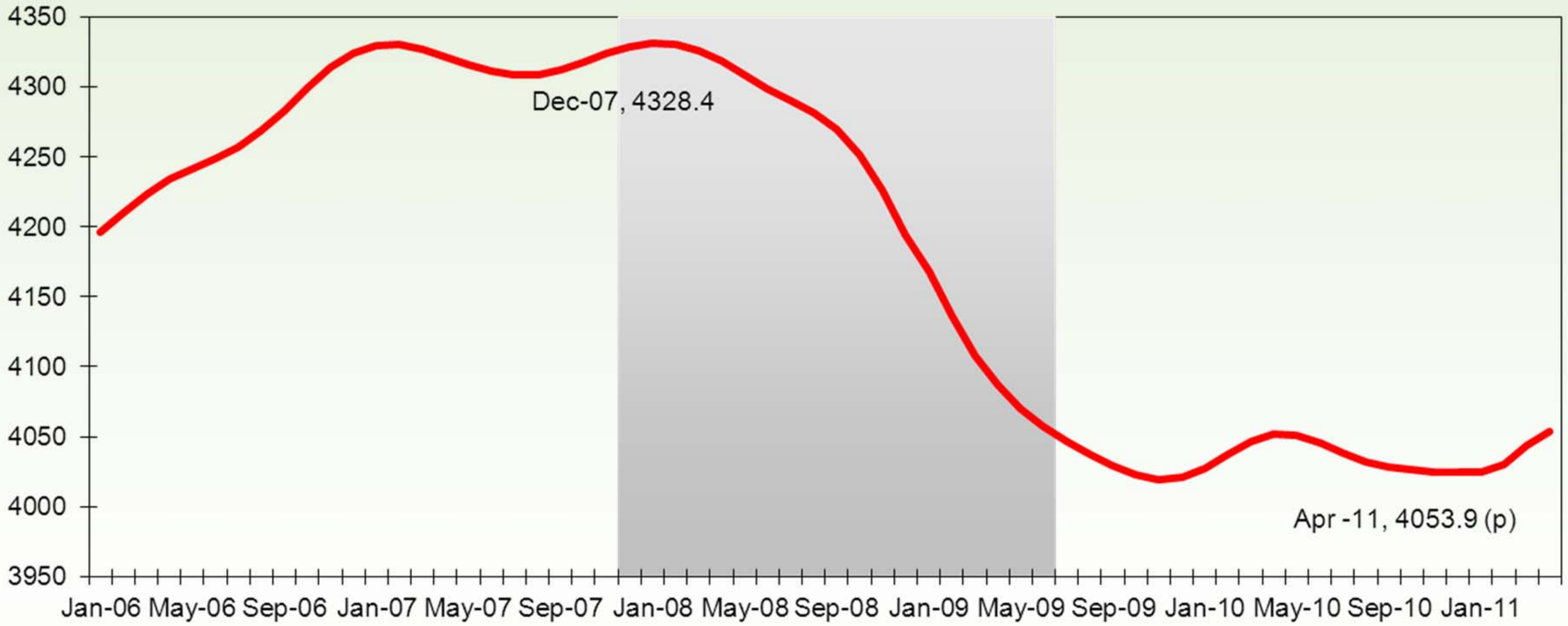
Sales Tax Collections, adjusted for tax law changes



Key Economic Trends

Total employment is finally starting to grow after 21 months into the economic recovery (the slight increase last summer was the result of temporary census jobs). Growth in April is estimated at 10,700 jobs.

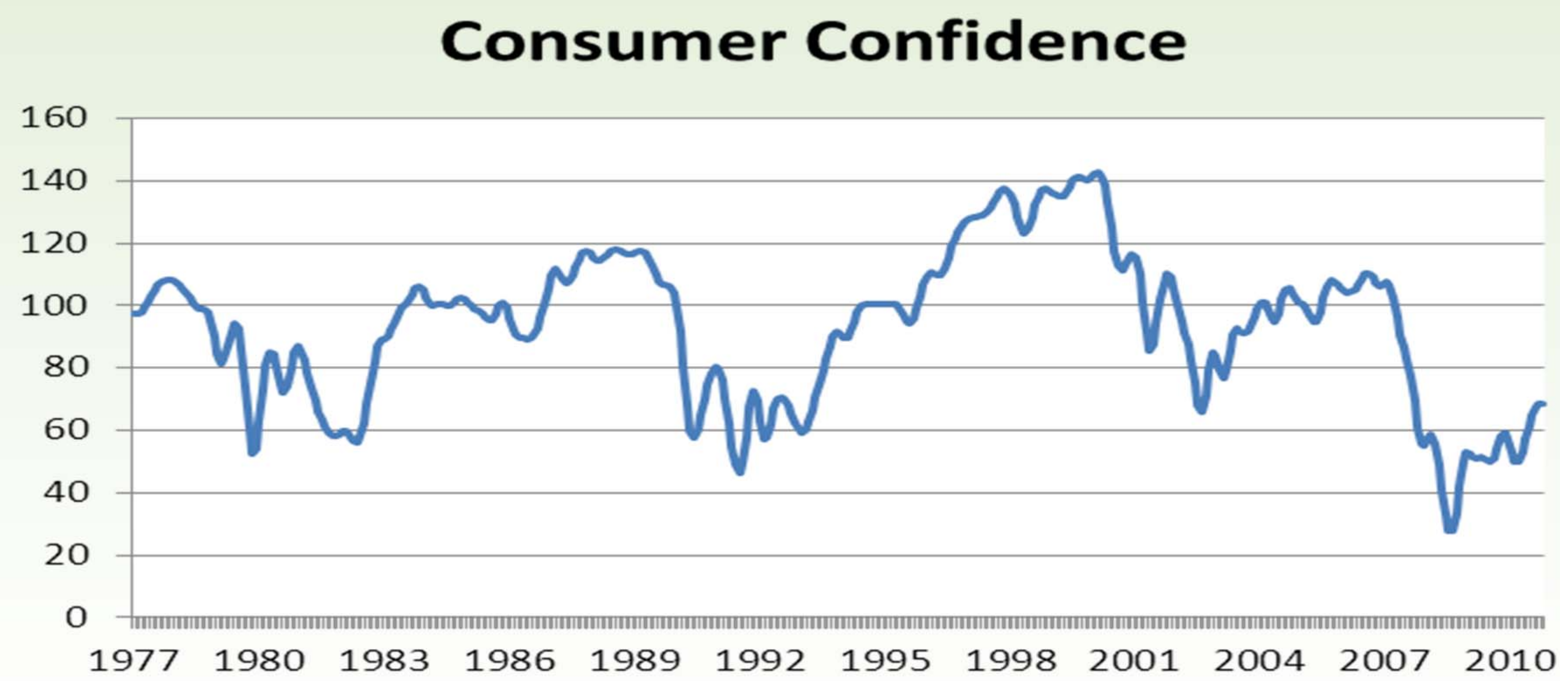
Total Employment, seasonally adjusted



Source: NC Employment Security Commission

Key Economic Trends

Consumer confidence is slowly moving out of recession territory, reaching its highest level since March 2008. Confidence is still below pre-recession levels. If gas prices take another jump, consumer confidence will certainly be shaken and will start to slide backwards.



Source: The Conference Board

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 end of the recession. Nonetheless, the 4-week average is still higher than pre-recession levels of 2007.

Source: NC Employment Security Commission

Biennium Forecast Risks: The Downsides and Upsides

The Downsides

- As noted in the last outlook, rising food and energy prices, stagnant employment growth, and little wage growth are a potent cocktail for an economic slowdown or downturn. All of which are in play.
  - Several factors have driven oil prices above $100. Most economists think consumers and the overall economy can absorb this increase. If there is another shock to oil markets and prices rise to the $140 to $150 per barrel range, then the probability of going into recession greatly increase.
- Tight credit and the continued decline in housing prices are a major drag on the economy. Plus, higher prices at the gas pump and grocery store means consumers will take yet another hit. Nearly 70% of all economic activity is directly related to household consumption.
- Employment growth is expected to remain sluggish placing the expansion on less solid footing. The fiscal crises at all levels of government have added to the malaise offsetting some of the small improvements in the private sector.

Biennium Forecast Risks: The Downsides and Upsides

The Upsides

- The most important upside to the forecast is that much of what the economy has been struggling with lately is considered short-term.
  - Oil prices are expected to stabilize and have dropped about $15 off the highs of several weeks ago.
  - Supply disruptions from the Japan earthquake should be over by mid-summer.
  - Weather related drags such as recent floods and tornados are skewing some of the data downward, but the effects should be short lived.
- Businesses that survived the Great Recession are stronger and are starting to expand there investments. Currently most of the investment is in equipment and software.

Biennium Forecast Risks: The Downsides and Upsides

The Upsides (cont.)

- Preliminary household employment numbers show an increase of 10,700 jobs in April. Payroll employment has added 35,700 jobs since last November.
- There is plenty of room for the economy to grow. The State is operating at closer to 2006 economic levels and there are now 500,000 more people in the State. This should bode well for housing and retail sales.
- Household credit conditions continue to improve:
  - Debt-to-income has fallen from 23.1% at the start of the recession to 20.2% this past quarter.
  - Number of delinquent loans peaked 1st quarter of 2010 at 9.82% and are estimated to only be at 6.64% this quarter (this is still above pre-recession levels, which were below 6%).

Conclusions

- The State's economy is expected to follow the current path of a slow, steady recovery. Once the economy picks up steam, North Carolina is expected to outpace national average growth.
- The economy is showing some resilience as it shrugs off several mild economic shocks (oil price spike, natural disasters). The upturn in the economy is more fragile because of these shocks, but seems to have pulled through.
- While there is plenty of reasons to be cautious about the economic forecast, there seems to be more positive news released each month.
- The recent improvement in the State's revenue collections have mainly come from growth in Personal Income taxes (53% of the General Fund). Sales taxes and business taxes have softened slightly, but are expected to rebound if the economy stays on track.