GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

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A Staff Agency of the North Carolina General Assembly

Overview

- Growth trends established earlier this year continued in the first two months of FY 2011-12, producing a $130 million surplus over revenue targets.
- Significant problems in the economy may reverse these trends.
- FY 2010-11 General Fund revenues were $205 million above the $18.98 billion budgeted amount, which was 1.1% over forecast.
- The slow growth scenario that re-emerged this summer is now expected to stay with us the rest of 2011. Most economic forecasts now anticipate below average growth through the first two quarters of 2012, heightening the prospects for another economic downturn.

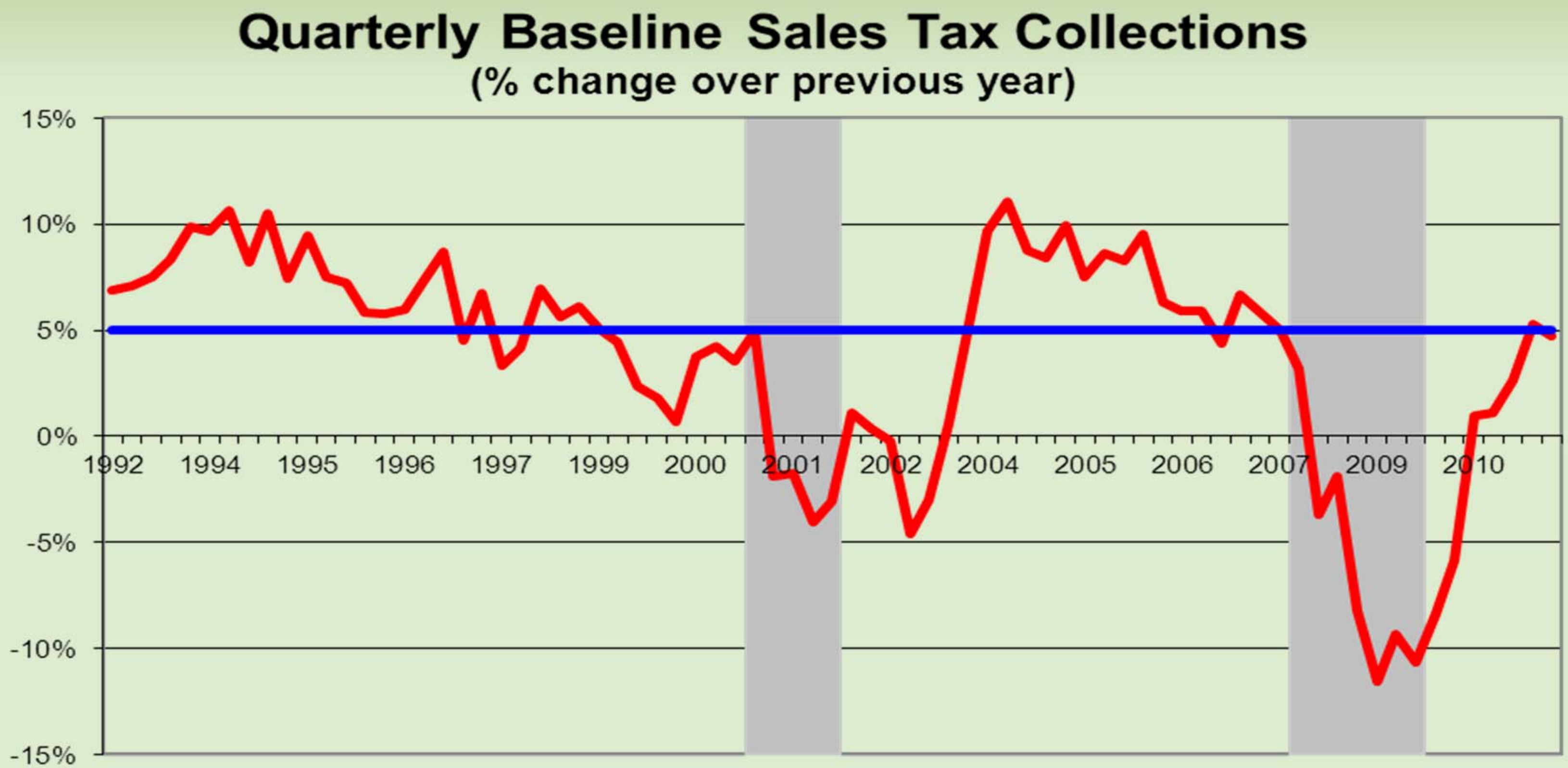
How Do FY 2010-11 Revenues Look So Far?

- Through August, General Fund revenue was $130 million above the $2.85 billion target set for the first two months FY 2011-12.
  - Personal Income collections were $59 million above the budget target.
  - Sales Tax collections surpassed target expectations by $37 million despite overall economic conditions suggesting collections might weaken.
- **Caution:** The first months of the fiscal year are the least important months as an indicator of revenue trends for the full 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.
  - **Significant headwinds in the economy may reverse many of the growth trends that developed earlier this year and continued into August.**

How Do FY 2010-11 Revenues Look So Far?

- The key economy-based taxes, the wage and salary withholding income tax and the sales tax, continued to exhibit solid year-over-year growth. Weak employment numbers thus far have not had an affect on these taxes.
  - Baseline Sales tax growth accelerated during July and August and was up 12.1% compared to this time last year (see page 4).
  - Net Personal Income withholding collections (withholdings less refunds) continue to show improvement and were above target for the first two months by 2.8%. (see page 5).

Tracking Economy-Based Collections



If September comes in on target, then baseline growth for the first quarter of the fiscal year will move well ahead of the long-term average growth of 5%.

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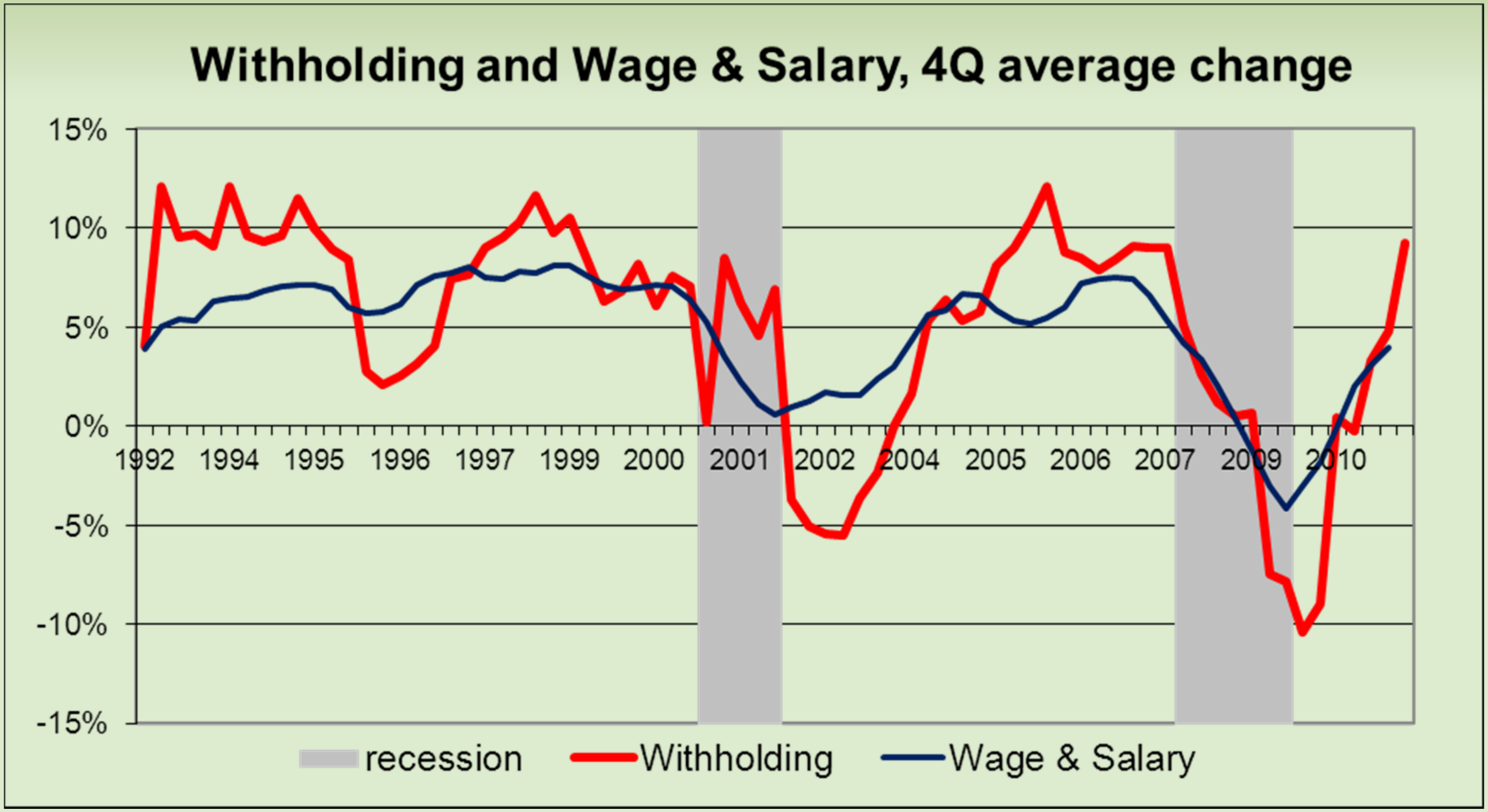
Tracking Economy-Based Collections



Net Personal income (withholdings less refunds) continue to strengthen.

FY 2010-11 RECAP

- At the start of FY 2010-11, the economy was modestly improving and the Great Recession had officially ended a year earlier. Nonetheless, the economic recovery remained subpar throughout the year and with very little employment growth.
- This slow-growth scenario matched the cautious consensus forecast and as a result, collections were $205 million (1.1%) above the forecasted $18.98 billion General Fund revenue.
- The baseline increase was 4.7% above the previous fiscal year's collections.
- The tax revenue surplus was $288 million, which was offset by the non-tax revenue shortfall of $83 million.

FY 2010-11 RECAP

- Both the personal income tax and the sales tax performed better than anticipated.
  - Personal income tax collections were $191.5 million over a $9.5 billion forecast.
  - Sales tax collections were $182 million over a $5.7 billion forecast.
- The forecast did not fully account for how losses during the economic downturn would affect corporations' balance sheets and their Franchise tax calculations. Thus, Franchise tax collections came in $90 million below forecast.
- Non-Tax revenue, was down $83 million, mostly from over projecting returns on investment income and the amount of judicial fees collected. Those two Non-Tax items accounted for $58.4 million of the forecast shortfall.

FY 2010-11 RECAP

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

	Budgeted	Actual	Difference
Personal Income Tax			
Withholding **	$7,325.20	$7,296.30	($28.90)
% Yearly Growth		3.82%	
Non-Withholding *	$2,218.10	$2,438.50	$220.40
% Yearly Growth		20.74%	
Net Collections	$9,543.30	$9,734.80	$191.50
% Yearly Growth		7.59%	
Sales Tax			
Net Collections**	$5,690.80	$5,872.80	$182.00
% Yearly Growth		5.53%	
Corporate Income Tax			
Net Collections**	$1,017.50	$1,013.60	($3.90)
% Yearly Growth		-15.40%	

*Quarterly estimated payments plus April 15 tax remittances.

**Collections less refunds and transfers.

Economic Outlook: Significant Risks to Revenue Forecast

- Since the end of the Great Recession, economic growth has been sluggish. There has been improvement in overall economic activity, but very little improvement in employment.
- This slow growth is mainly due to the structural problems that sent us into a recession; the housing and financial sectors. Problems in these sectors tend to take much longer to correct and are historically followed by a much slower, prolonged recovery phase.
- The State's economic growth recession had ended by mid-2009. The State's Gross State Product, a broad measure of economic activity, exhibited positive growth in 2009 and 2010.
- Economic forecasts for the State expect positive economic growth, as measured by the Gross State Product, for both 2011 and 2012.

Economic Outlook: Significant Risks to Revenue Forecast

- While overall economic activity has picked-up, the employment recession continues some 40 months after the initial onset of employment losses in January 2008.
  - Current forecasts suggest we are unlikely to see the type of robust expansion necessary to reduce the employment problems anytime soon.
  - These forecasts expect unemployment rates to hover around 10%.
  - In the 2001 recession, it was 19 months after the recession ended before employment in the State reached pre-recession levels.
  - It has been 26 months since the official end of the recession and according to the latest NC Employment Security Commission records, as of August 2011, the State employs 297,495 fewer people than before the start of the recession.

Economic Outlook: Significant Risks to Revenue Forecast

Housing is the key issue:

- The economy continues to be entangled by the housing recession and the slow unwinding of this problem is *the* major drag on economic growth.
  - In the last quarter of 2010, housing prices seemed poised to rise and the market ready to recover, but price declines have picked up steam again this year.
- The housing market recession has resulted in a continuing decline in household wealth. Defaults and "underwater" mortgages are depressing consumer sentiment and spending.
- With fewer homebuyers in the market the need for new construction is diminished, leaving few opportunities for employment growth in the construction industry.
- The most recent UNC-Charlotte economic forecast highlights these points and notes that the continued weakness in the State's economy will be driven by a weak construction sector, a result of the high number of vacant homes and new mortgage rules.
- The housing problems make it difficult for homeowners to sell their homes so they can relocate for better job opportunities.

Economic Outlook: Significant Risks to Revenue Forecast

Other issues:

- Financial markets continue to work on improving their balance sheets and have kept their lending tight. Tighter lending slows business and personal investments and adds to the economic malaise.
- Consumer spending has been showing some signs of life, but consumer sentiment is well below what one would expect during an economic recovery. While consumer sentiment is not always tied to consumer actions, the persistently low sentiment and confidence in the economy could become a drag on demand for goods and services.
- To date, business investment and export demand have been the main drivers of the economic recovery. Both of these sources of growth are slowing as global demand stalls. The growing debt problems that plague many European nations has thwarted much of the global recovery that was underway.

Economic Outlook: Significant Risks to Revenue Forecast

- The recent talk of a another recession is almost a technicality with unemployment hovering above 9% (10.4% in NC for August). The economy's current pace of recovery is inadequate to increase employment numbers significantly over a reasonable time horizon.
- Overall, the US economy is moving forward, and the chances of another recession in the technical sense is now in the 40-50% range.
- Key reasons why the likelihood of another recession is less than 50% is August numbers on business investment and consumer spending remain in positive territory. Though economic data remains quite mixed, key indicators such as industrial production are still positive.
- The big concern is that during this slow-growth phase in the economy the capacity to absorb any new shock regardless of the origin increases the possibly of another economic contraction. Given the high unemployment and weak consumer demand, as long as economic growth is at or below 2% the chances of a downturn are heightened.
- Forecasts expect GDP growth near 2% for the third and fourth quarter of 2011 and the first quarter of 2012.

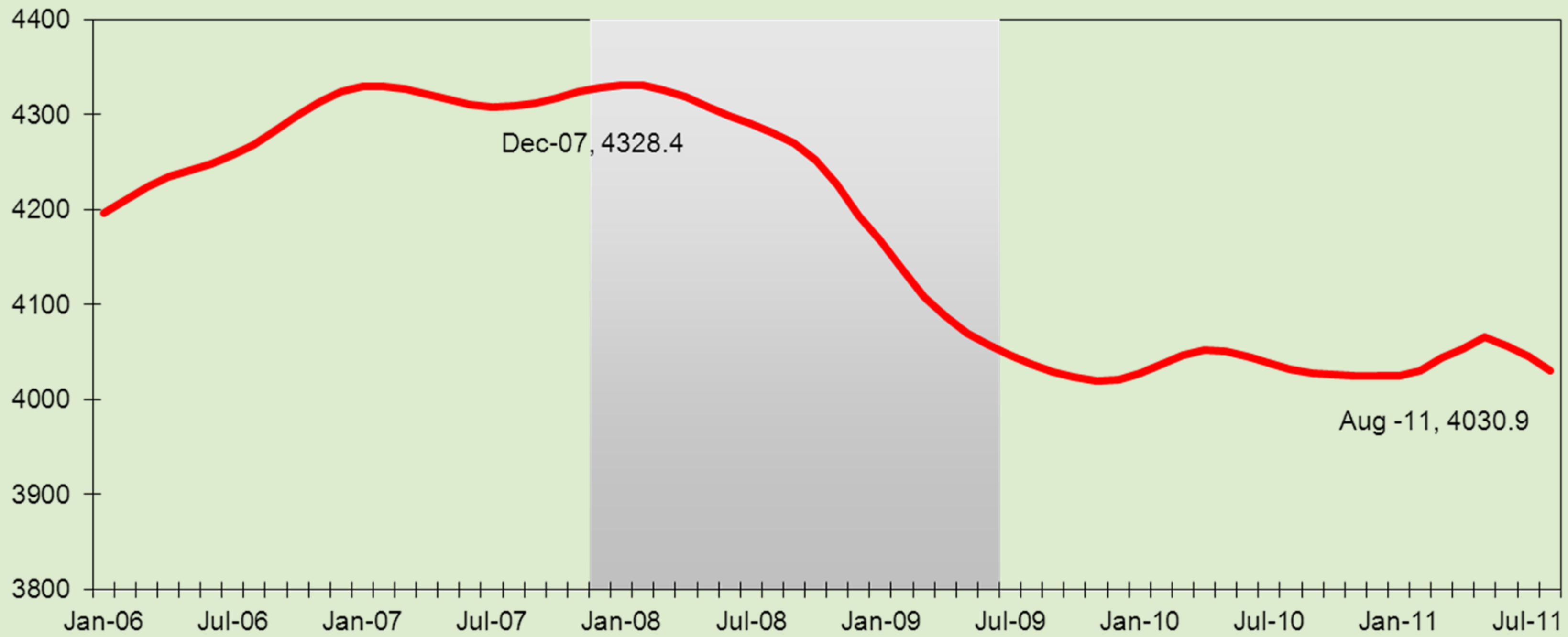
Economic Outlook: Significant Risks to Revenue Forecast

- For now, most economists continue to expect improvements in the economy, but at a much slower pace than was previously anticipated. The recent rapid spike in gas prices, supply disruptions caused by the natural disasters in Japan, and weather related disruptions here in the US contributed to a slowdown in economic growth this spring and summer.
  - A recent survey by the Wall Street Journal of over 50 economists showed that economic growth expectations have been downgraded from 2.6% growth in 2011 to only 1.5%; and from 3.1% to 2.4% for 2012.
- Given the downgrade in expectations, the health of global economies along with the strength of consumer spending will be two crucial areas of concern as we close out 2011, and move into 2012.
- Ultimately, the housing market will need to show some signs of life before the recovery can pickup steam and give a lift to consumer confidence, and allow employment growth to gain traction.

Key Economic Trends

Based on the household survey of employment there are 26,229 fewer people employed in the State than at the end of the recession in June 2009. Employment gains have been very limited. There were 979 fewer people employed this August than last year.

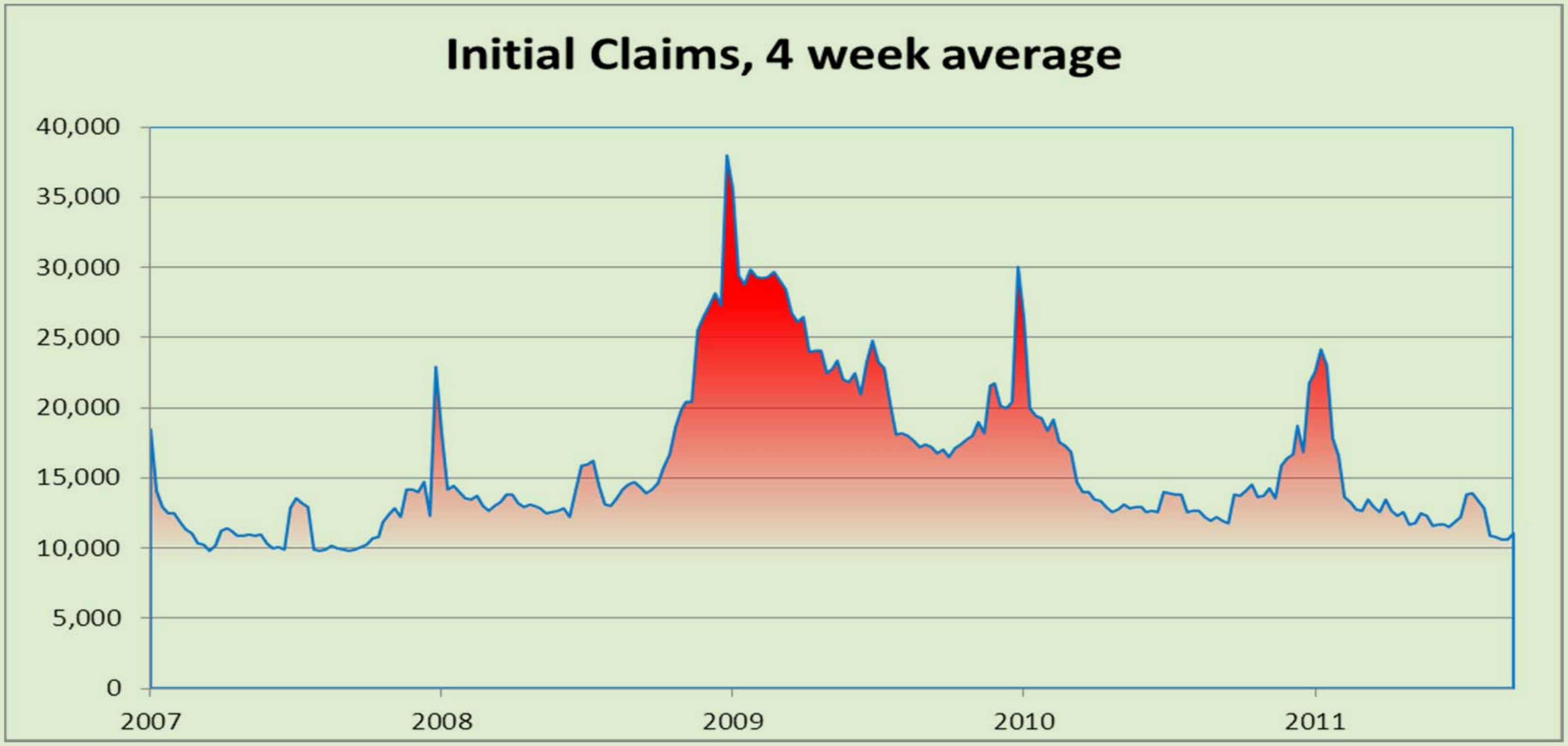
Total Employment, seasonally adjusted



Source: NC Employment Security Commission

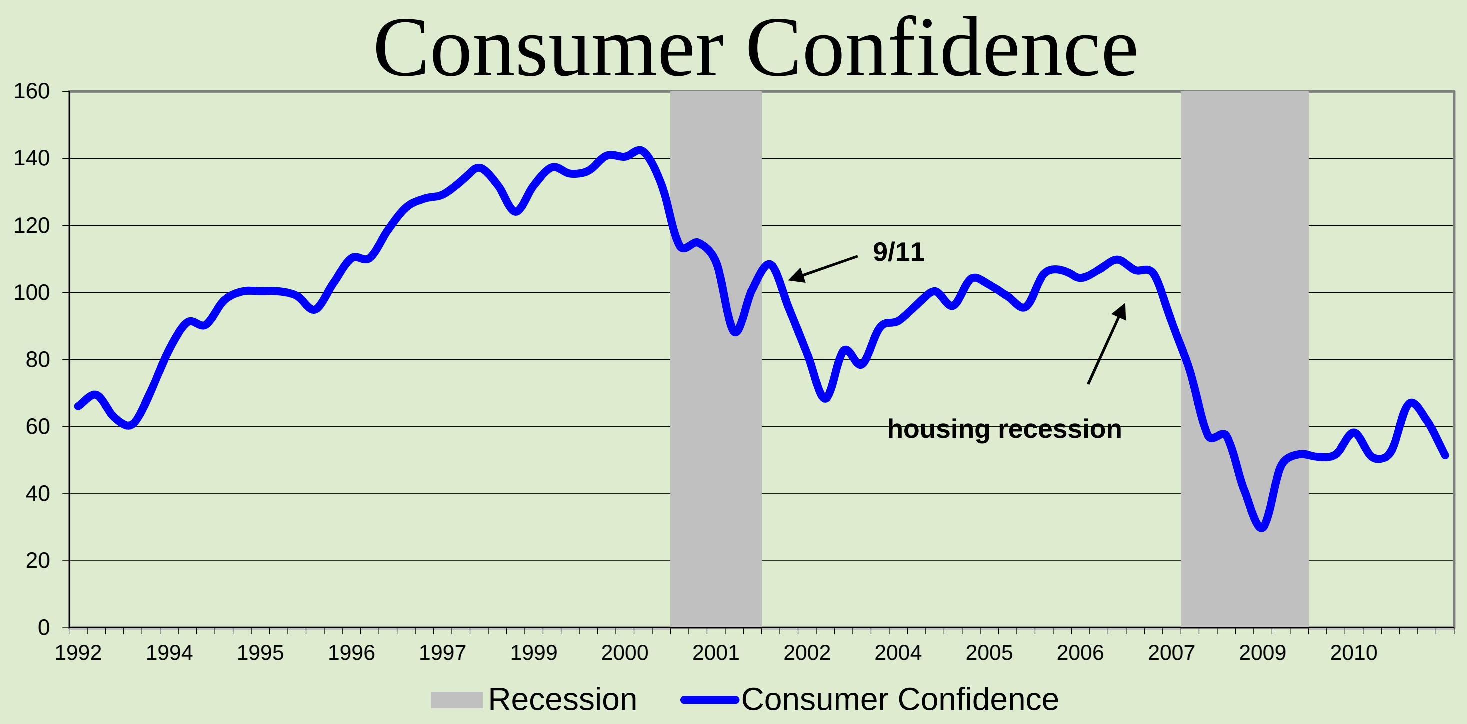
Key Economic Trends

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 and are nearing the pre-recession levels of 2007.



Key Economic Trends

Consumer confidence fell in July and August and is at the lowest point since the depth of the last recession.



Source: The Conference Board

Conclusions

- Economy-based collections have defied some of the economic data that show little or no growth in employment and income. Year-over-year baseline sales tax and income tax (adjusted for tax changes) growth has continued steadily going back to November, 2010.
- That growth picked up steam in July and August giving us a surplus of $130 million over the revenue target for those two months.
- Nonetheless, caution is warranted as economic headwinds have strengthened making it increasingly more difficult for the growth in revenue collections to continue.
- The recent downturn in current economic conditions, which have significantly reduced expectations of economic growth, have put the revenue forecast in a tenuous position. Any additional shocks to the economy such as the gas spike of this past spring will make it hard to meet the revenue forecast.

Conclusions

- If the weaknesses in the national economy continue well into 2012, as some are forecasting, this will put at risk the revenue forecast. Particularly the economy-based sales tax and withholding income tax collections.
- Those weaknesses have yet to show up in collections, but the persistence of a sluggish recovery may begin to put a drag on these key collections.
- With the recent economic downgrade for the rest of the year and the start of 2012, the revenue surplus established the first two months of this fiscal year will help offset the risk of a revenue shortfall at the end of the fiscal year.
- The revenue forecast produced in March envisioned a slow recovery and produced a cautious estimate. Baseline revenues only need to increase by 3.8% in FY 2011-12 to meet forecast. This is well below the long-run average of 5.7%.