GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

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Overview

- A slowdown in the economic recovery has caused collections to weaken, producing a $26 million revenue target shortfall for the first two months of the current fiscal year.
- While problems in the economy are not expected to worsen, collections may struggle to meet the consensus forecast if the current growth rate does not improve.
- FY 2011-12 General Fund revenues were $392 million (1.8%) above the $19.13 billion budgeted amount.
- The slow growth pattern that re-emerged this spring and summer is expected to affect the rest of 2012. Most economic forecasts anticipate improving, but below-average growth in 2013. This view is consistent with the revenue forecast.
- Household debt, the federal fiscal cliff, Eurozone problems, and weakening emerging economies, especially China, could all spell potential trouble for the economy.

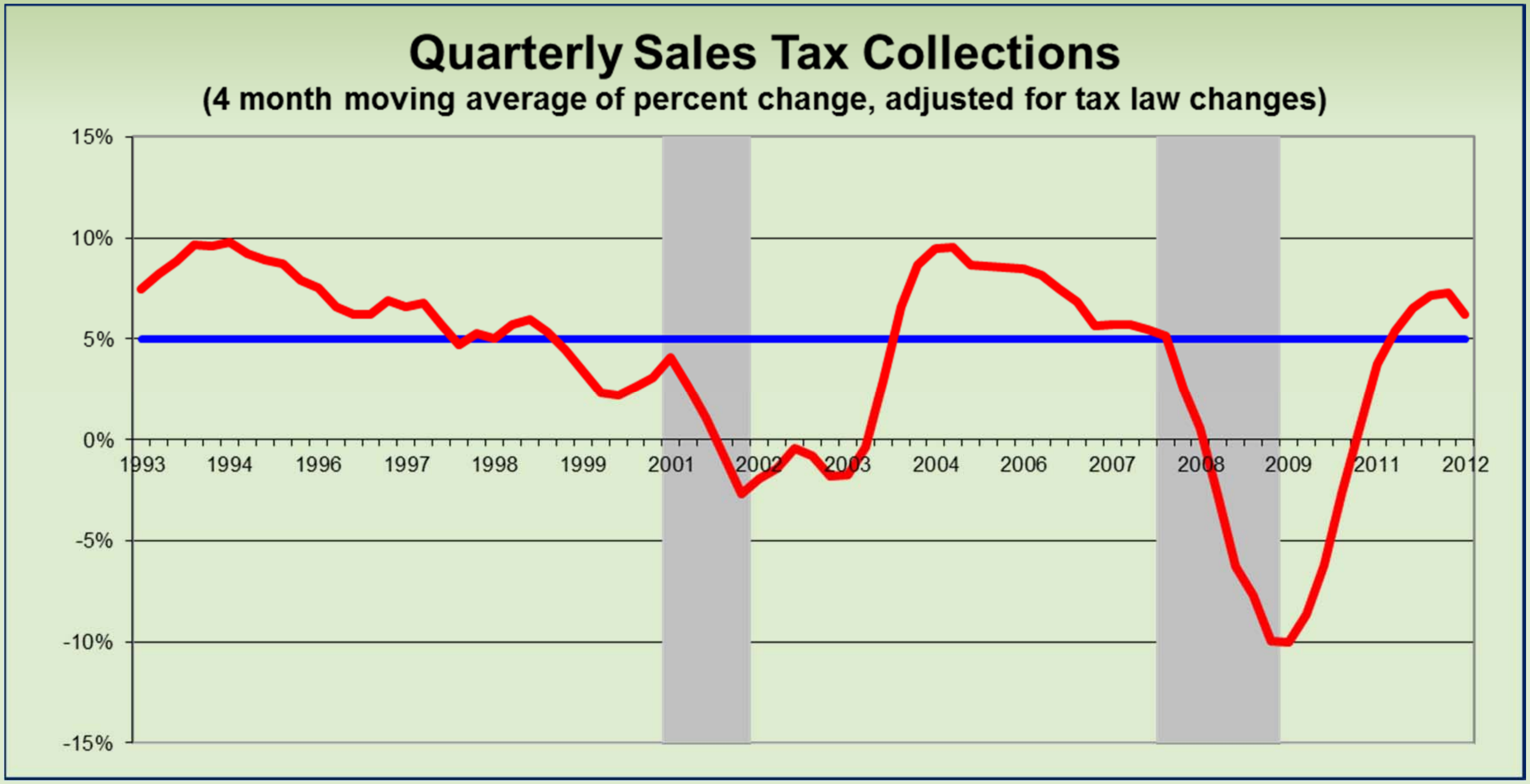
How Do FY 2012-13 Revenues Look So Far?

- Through August, General Fund revenue was $26 million *below* the $3.01 billion target set for the first two months FY 2012-13.
  - The timing of Non-Tax collections (down $29 million) led to the shortfall.
  - Personal Income collections were $2.3 million below the budget target of $1.6 billion.
  - Sales Tax collections missed target expectations by $37 million, nearly 4% below target.
  - Corporate Income collections were up $33.5 million, the result of $22 million in one-time payments.
- **Reminder:** The first several 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.

How Do FY 2012-13 Revenues Look So Far?

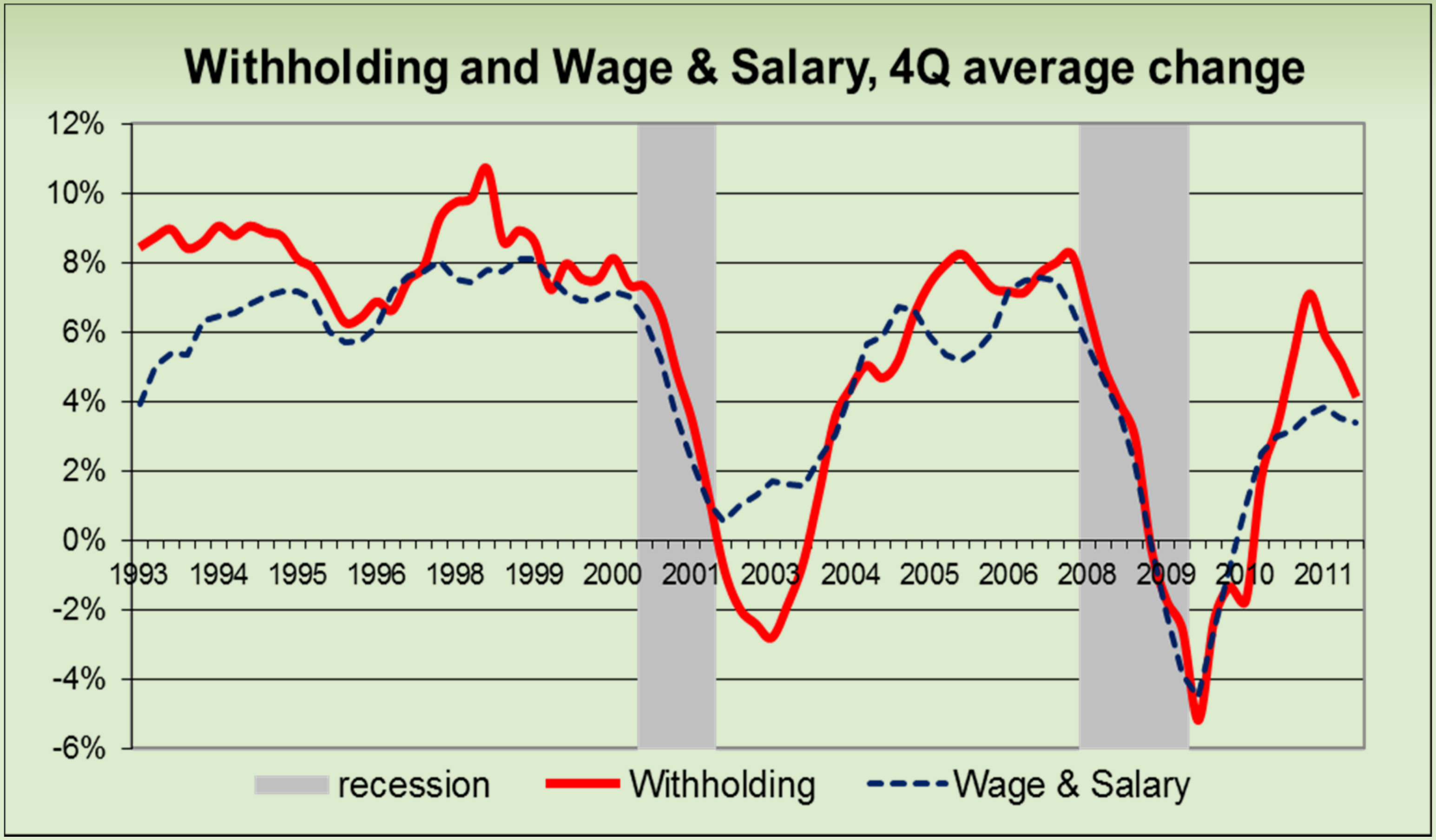
- Growth in key economy-based taxes, the wage and salary withholding income tax and the sales tax, slowed the last several months.
  - Baseline Sales Tax growth cooled the last quarter of FY 2011-12 to 3.1%, and during July and August net collections slipped below target expectations (see page 4).
    - Slow employment growth and an unsteady recovery are beginning to effect Sales Tax collections.
  - Net Personal Income withholding collections (withholdings less refunds) continue solid year-over-year growth and came in just under target for the first two months. (see page 5).

Tracking Economy-Based Collections



The consensus forecast expected baseline Sales Tax growth for FY 2012-13 to be 3.7%, nearly half of last year's growth. Any further slowdown in collections will put pressure on the second-half of the fiscal year to meet this expectation.

Tracking Economy-Based Collections



Net Withholding income growth (withholdings less refunds) slowed to 4% yearly growth in the second quarter of 2012.

FY 2011-12 Recap

- At the start of FY 2011-12, the economy was modestly improving after a sluggish spring and summer leading into the fiscal year. Nonetheless, throughout the fiscal year the economic recovery remained subpar. By the end of the fiscal year, employment remained well below the pre-recession peak.
- The slow growth matched the cautious consensus forecast and as a result, collections were $392 million (1.8%) above the forecasted $19.1 billion General Fund revenue.
  - Much of the surplus was attributable to the delay in taxpayers taking advantage of the $50k business exemption (available for the first time in the 2012 tax year); $40 million in unanticipated, one-time tax payments also added to the surplus.

FY 2011-12 Recap

- Personal income tax collections were $475.8 million over a $9.8 billion forecast. An estimated $150 million of this is attributable to misjudging when the business tax exemption would start to impact collections.
- Sales tax collections were $36 million less than the $5.3 billion forecast.
- Franchise Tax collections came in $37 million below forecast. It has been difficult to forecast this tax because the economic downturn has had an extended affect on corporate Franchise Tax calculations.
- Non-Tax revenue was down $85 million, mostly from over projecting returns on investment income and the amount of judicial fees collected. Those two Non-Tax items accounted for $62.4 million of the Non-Tax shortfall.

FY 2011-12 Recap

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

	Budgeted	Actual	Difference
Personal Income Tax			
Withholding *	$7,393.70	$7,743.20	$349.5
% Yearly Growth		5.66%	
Non-Withholding**	$2,406.40	$2,528.90	$122.40
% Yearly Growth		5.10%	
Net Collections	$9,800.10	$10,272.10	$475.80
% Yearly Growth		5.52%	
Sales Tax			
Net Collections*	$5,293.20	$5,257.60	($35.7)
% Yearly Growth		-10.48%	
Corporate Income Tax			
Net Collections*	$1,000.20	$1,132.60	$132.6
% Yearly Growth		11.60%	

*Collections less refunds and transfers.
**Quarterly estimated payments plus April 15 tax remittances.

Economic Outlook: Risks to Revenue Forecast

- The economic recovery has never gained full momentum. The economy has been unable to grow at, or above, average growth for a sustainable period of time. While the economy has gradually improved, it has not grown fast enough to produce a marked improvement in employment.
- This slow growth is predominately a result of the housing and financial sector problems that sent us into a recession back in 2008. Economic downturns from these problems have a history of producing a slower and more prolonged recovery phase.
- Adding to the burden of mending these problems are added risks from the Eurozone debt problems, the pending federal "fiscal cliff", and the cooling-off of emerging growth economies.

Economic Outlook: Risks to Revenue Forecast

Housing and the related household debt are critical:

- The economy continues to struggle with the housing recession's aftermath. This has been a major drag on economic growth, but new construction and existing home sales are slowly showing signs of a recovery.
- The housing market recession resulted in a significant decline in household wealth affecting how households manage their debt.
  - Household debt had reached an untenable position by 2007, putting households under even greater financial pressure with the decline in the housing market.
  - Household debt as a percent of disposable income reached 130% in 2007. It was 70% in 1980. Much of the rise in debt was mortgage related.
  - Because the majority of middle income households have most of their wealth tied-up in their home, having to use income to pay down debt will now take far longer after the housing bubble burst.

Economic Outlook: Risks to Revenue Forecast

Housing and the related household debt are critical:

- Household debt and foreclosures continue to hold back the economy.
  - An estimated four million Americans have lost their homes since the onset of the housing recession.
  - Another 3.5 million homeowners are in the foreclosure process or may soon be based on delinquent payment reports.
  - An additional 13.5 million homeowners are estimated to owe more on their home than it is worth.

Economic Outlook: Risks to Revenue Forecast

Global economic problems are also hampering the U.S. economy:

- The extended debt crisis in Europe has pushed most of the Eurozone into recession. The U.S. economy, thus far, has weathered the European downturn. The longer the crisis persists, the more U.S. exports will be hurt. Europe accounts for 25% of all U.S. exports.
- Important export markets of fast growing emerging markets, such as China, India, and Southeast Asia, have slowed. This may weaken demand for U.S. goods and services.
- NC is an increasing player in the export market, further exacerbating concerns.

Economic Outlook: Risks to Revenue Forecast

The federal "fiscal cliff" also threatens the recovery:

- The "fiscal cliff" refers to a combination of significant tax increases and spending reductions set to take place beginning in 2013. Policymakers will be struggling to balance the short-run risk of an economic downturn with the need to manage the federal debt and long-run fiscal sustainability.

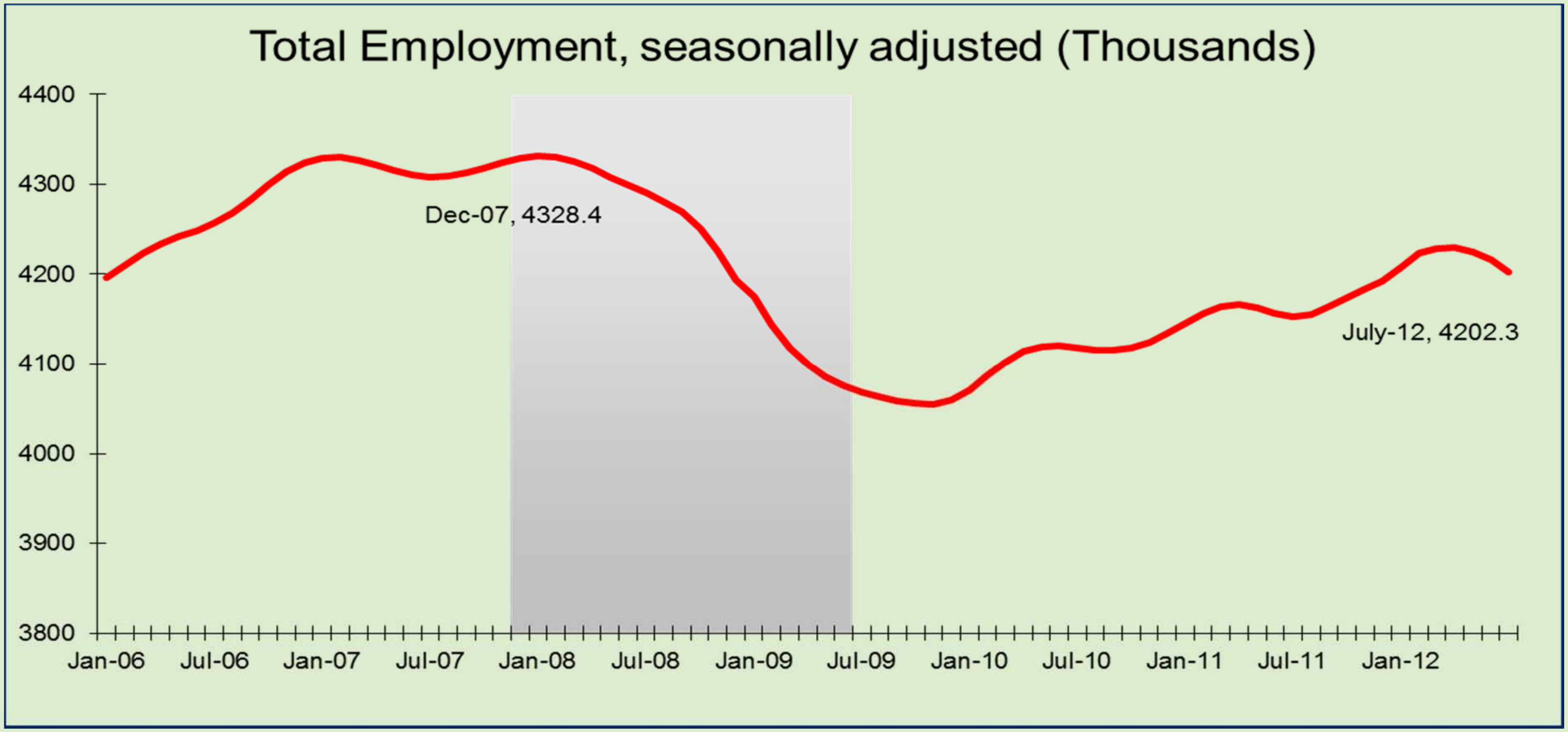
Each of the three events noted above are difficult enough for an economy to weather, but the combination of all three (a prolonged European crisis, further declines in emerging economies, and falling off the "fiscal cliff") would prove more than the economy could withstand, especially given the current slow pace of growth.

Economic Outlook: Risks to Revenue Forecast

- Despite the challenges, the US economy continues to move forward,
  - A recent survey by the Wall Street Journal of over 50 economists, placed the recession risk at just above 20%. Nonetheless, the survey downgraded economic growth expectations though 2013, with average growth in economic activity of 2.4%.
- The probability of another recession currently remains low because the economy is posting positive, albeit not robust, economic numbers. Economic data remain somewhat mixed, but key indicators such as industrial production and consumer spending are still positive.
- The big concern is that during this ongoing, slow-growth period the economy will not have the capacity to absorb any new shock regardless of the origin. Given the weakened demand for U.S. goods and services from sources at home and abroad, the chances of a downturn from a shock are heightened.

Key Economic Trends

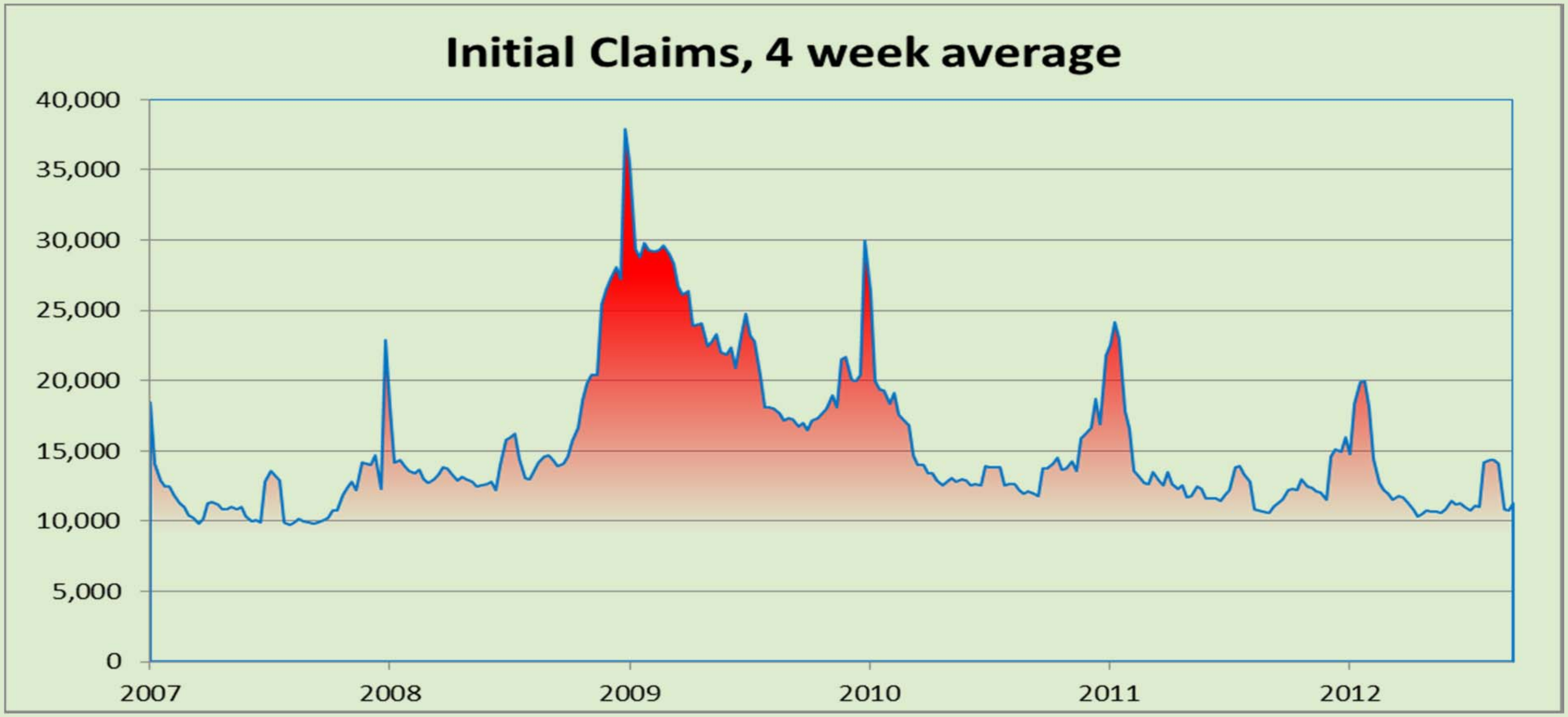
Based on the household survey of employment, there are 126,453 more people employed in the State than at the end of the recession in June 2009. These modest employment gains have kept the unemployment rate elevated above 9% (it was 9.6% in July).



Source: NC Department of Employment Security

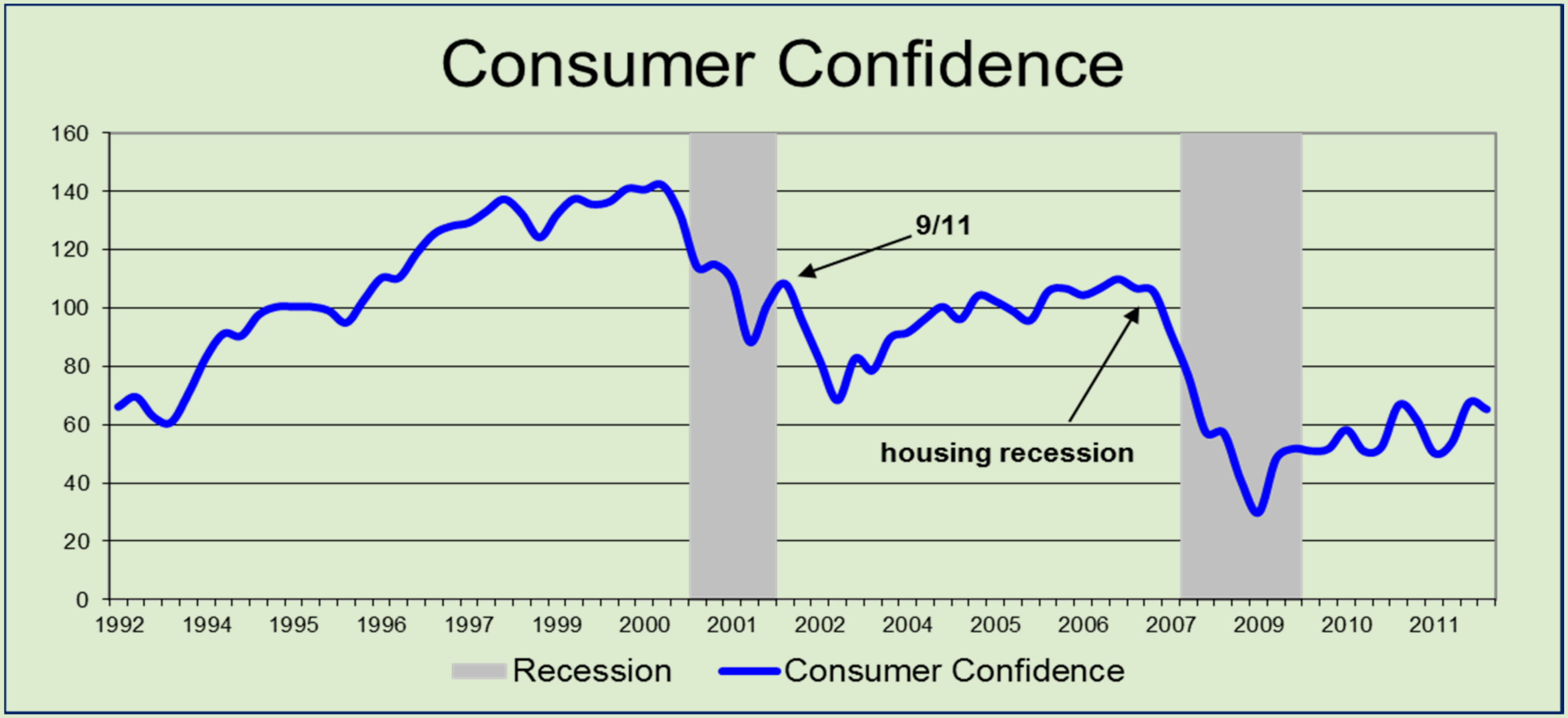
Key Economic Trends

Initial claims, a measure of the number of jobless claims filed by individuals seeking to receive State jobless benefits, are no longer at recessionary levels and resemble the pre-recession levels of 2007.



Key Economic Trends

U.S. consumer confidence index fell to 60.6 in August, and reflects the continued concern consumers have about the overall strength of the economy.



Source: The Conference Board

Conclusions

- Recent economy-based collections have reflected the slowdown in economic activity. Growth remains positive, but is weaker than it was six months ago.
- In July and August, Personal Income Tax withholding growth was steady. Sales Tax collections have weakened the most and are running slightly behind target.
- Concern is warranted as economic headwinds persist, increasing the difficulty for revenue collections to keep pace with the revenue forecast.
- The revenue forecast produced in April envisioned a slow recovery throughout the fiscal year and produced a cautious estimate of 4.3% baseline growth. This is well below the long-run average of 5.7% and should improve the chances of meeting fiscal year revenue projections.