

GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

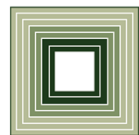


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FISCAL RESEARCH DIVISION

A Staff Agency of the North Carolina General Assembly

Highlights

- General Fund revenue through December is \$6.5 billion below a \$9.8 billion revenue target.
- Key revenue sources, sales tax collections and withholding income tax, continue to track closely to the budget forecast.
- Economic data indicate the recovery is slowly regaining the traction lost this past spring and summer.
- The employment picture has stabilized and is beginning to show signs of improvement.
- Global economic risks and concerns over federal fiscal policy decisions continue to threaten the recovery.

2012-13 Revenue Through December

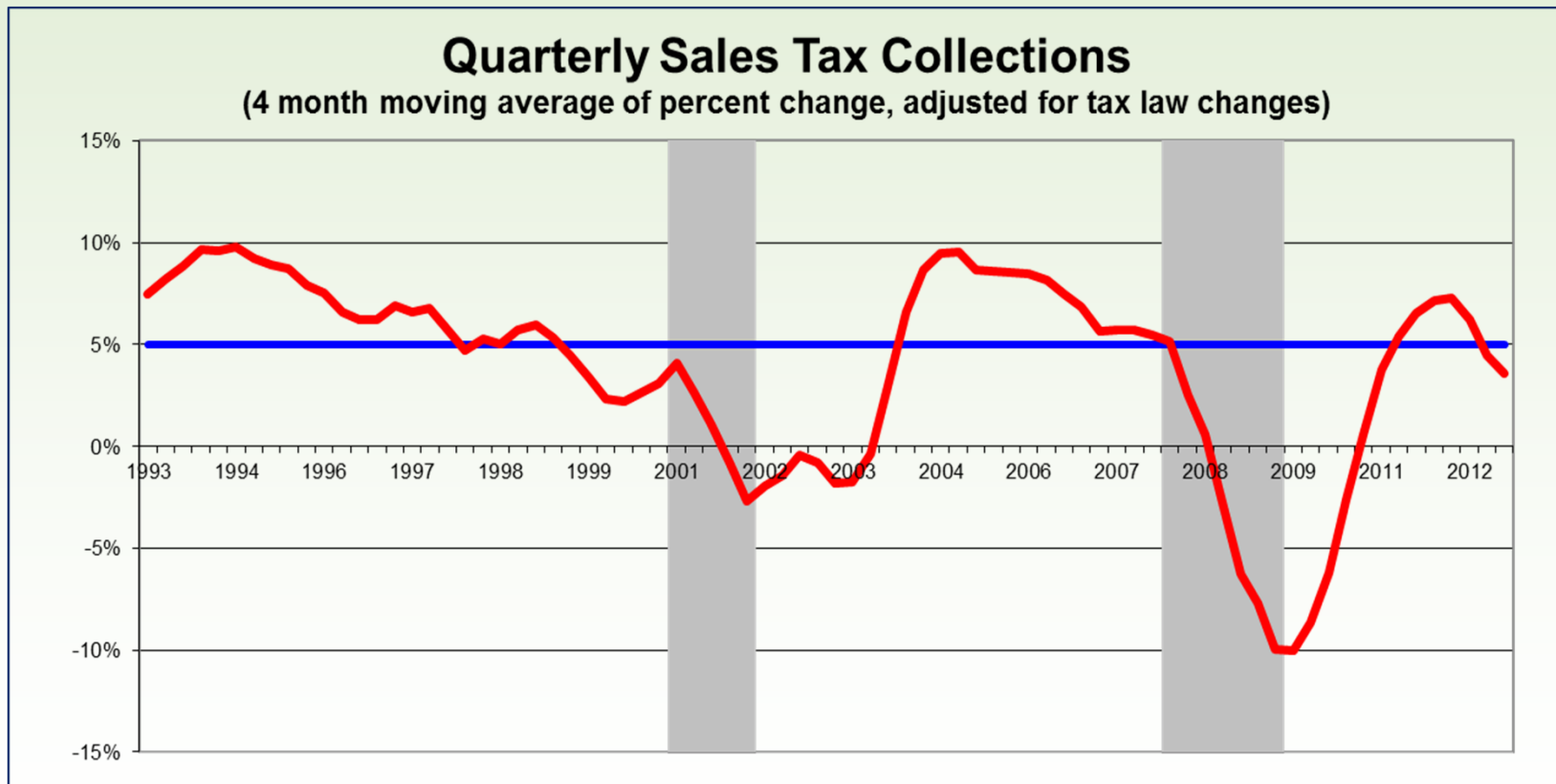
- Through December, General Fund revenue is \$6.5 million below a \$9.8 billion revenue forecast target.
 - Tax revenues are \$38 million *above* the \$9.3 billion target.
 - Income tax collections are essentially on target, less than 1% below target.
 - Sales tax collections have been a little weaker than income collections and are 1.2% below target through December.
 - Non-tax revenues, which include short-term investment income and judicial fees, are \$44.5 million below the \$334 million target.

2012-13 Revenue Through December

- Through December, income tax withholding on wages and salaries is up over last year by 4.4%.
 - Withholdings from larger employers are 4.6% above last year, and are the main reason for the gains.
- Baseline sales tax collections have slowed significantly. December's collections were up only 1.0% over last year.
 - Because some of the holiday sales carry over into January, the impact of holiday sales will not be understood until we have January's collections.
 - For the year, net sales tax collections (after refunds and transfers) are \$32 million below the \$2.7 billion target.

Tracking Economy-Based Collections

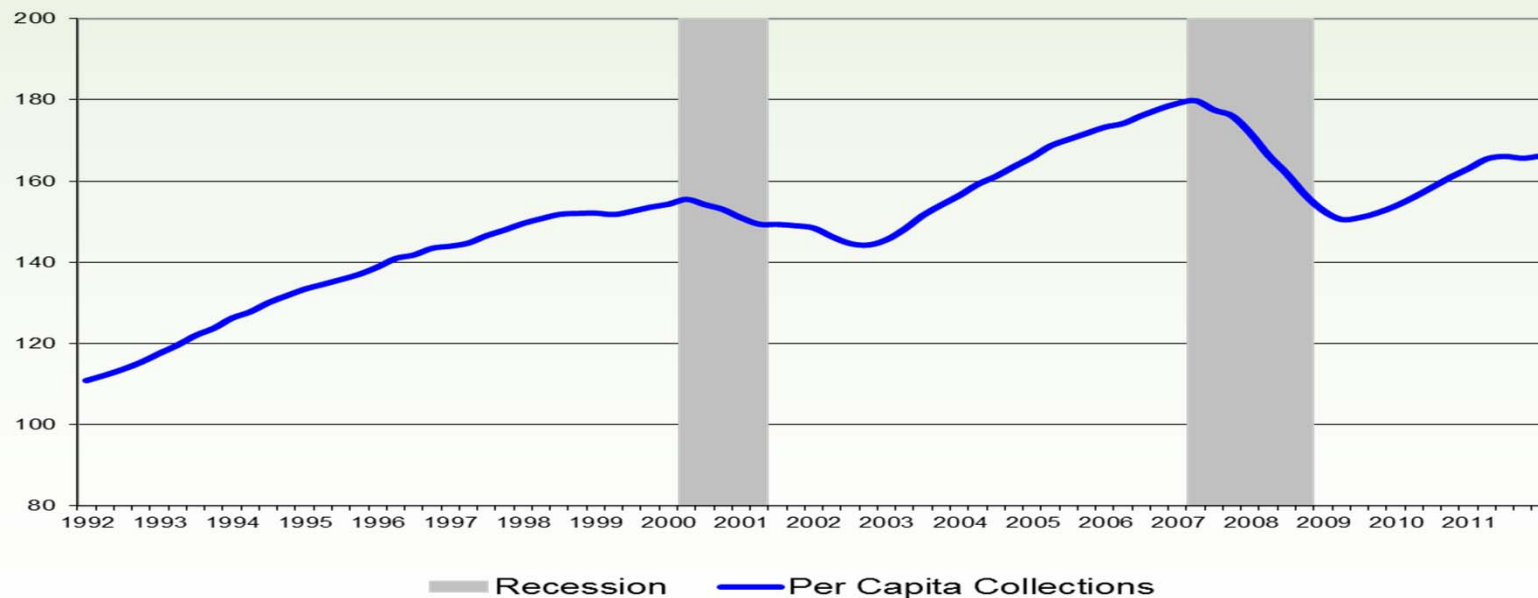
The consensus forecast expects baseline sales tax growth for FY 2012-13 to be 3.7%, well-below last year's growth of 6.2%. Weak growth the first-half of the fiscal year has put added pressure on the second-half of the fiscal year to meet this expectation.



Tracking Economy-Based Collections

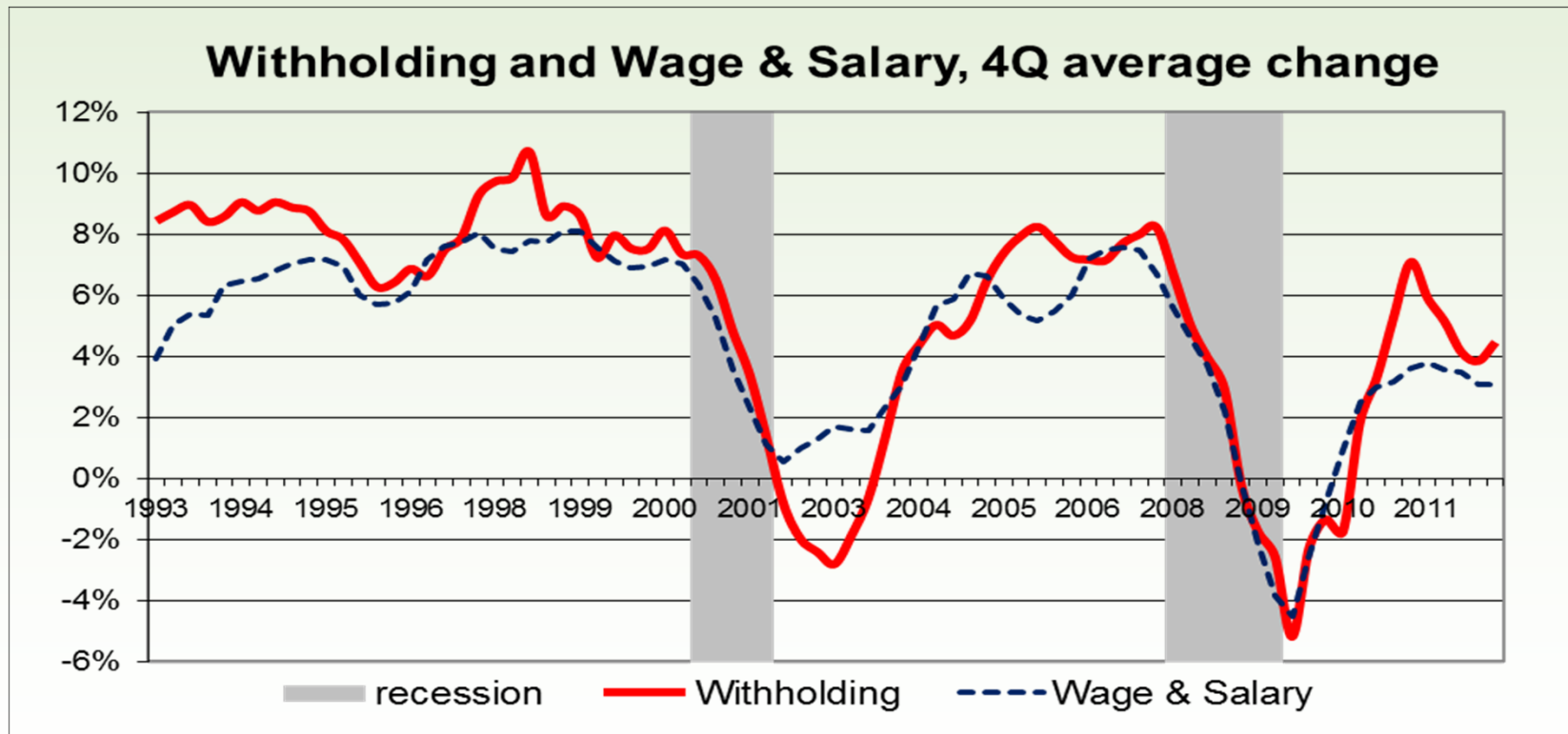
Per capita sales tax collections are still below pre-recession levels of 2007. Of equal importance, the rate of growth, has reverted to the steady growth of the 1990s rather than the faster paced growth of the 2000s. This is consistent with most economists expectations after the housing bubble burst. A big concern of late has been the flattening-out of growth the last two quarters.

Per Capita, Quarterly Sales Tax Collections (baseline)



Tracking Economy-Based Collections

The growth in Personal Income withholding began to moderate in Q3 and Q4 of 2012, but remains the strongest most consistent source of revenue this fiscal year. As a rule, wage and salary withholding is the most stable revenue source for the General Fund.



State's Economic Outlook

- The State's economy is beginning to gain traction after a slowdown last spring and should begin to pick-up pace as we move through 2013.
- Employment growth, while stabilizing, will not accelerate to a pace fast enough to significantly lower the unemployment rate until mid-2014.
- Once global conditions stabilize, the housing market sufficiently improves, and federal policy decisions are behind us, we can expect North Carolina's economy to operate closer to full capacity and begin to expand faster than the US economy overall. Unfortunately, all of those elements are unlikely to be solidly in place until we get closer to 2015.
- Key drivers to track during that time will be consumer spending, tourism, exports, and homebuilding.

Key Economic Trends

Non-Agricultural employment has increased by 145,000 jobs since February 2010, but remains almost 182,000 below the peak in 2008. Jobs in the construction industry are 30.5% below peak (76,000 fewer jobs), while manufacturing is finally starting to turn the corner, growing 1.6% in the last year, but still 89,600 fewer than peak.



Source: NC Employment Security Commission

Key Economic Trends

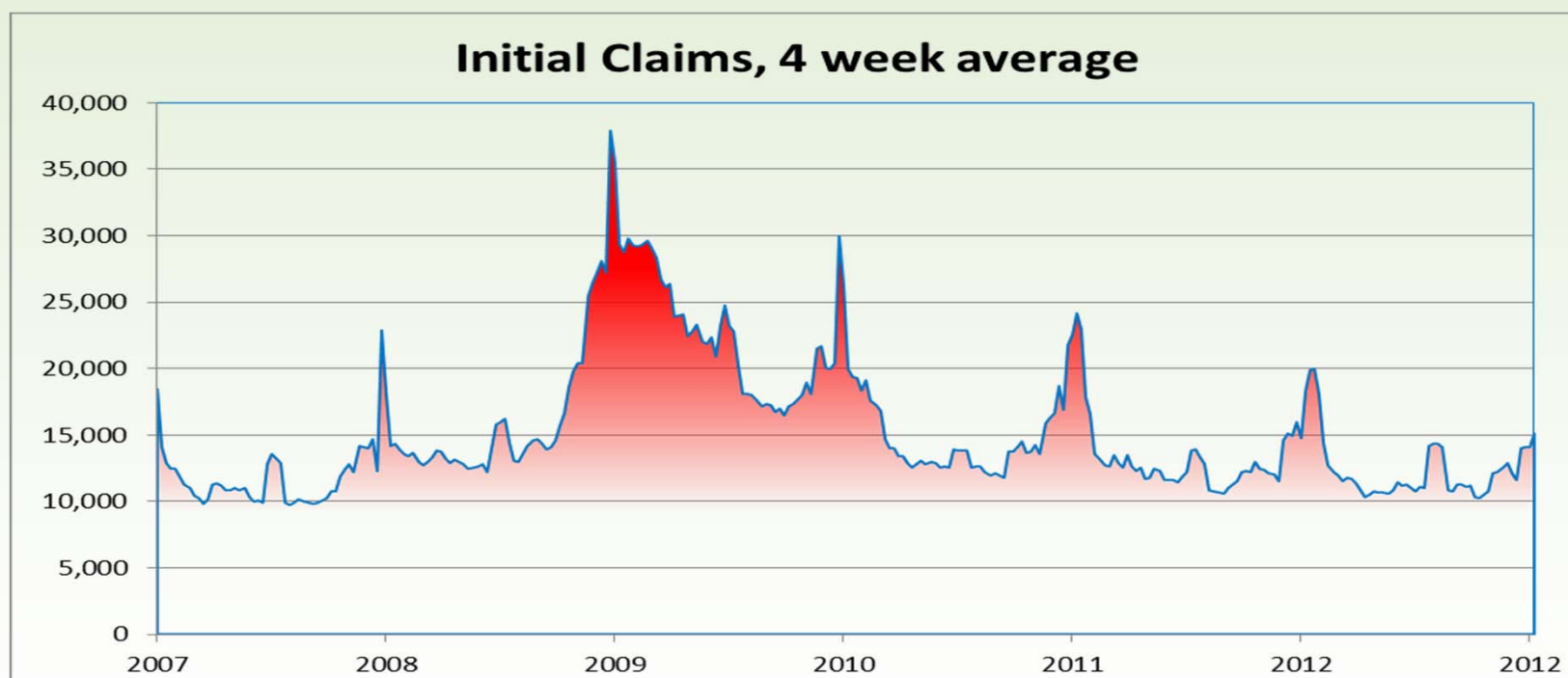
- The construction and manufacturing industries often lead the way in job growth coming out of an economic downturn. North Carolina's industry mix is well-positioned to take advantage of that type of recovery.
- The recovery from the Great Recession has been far different. Housing was the main reason for the economic downturn, and has suffered through a very prolonged recession (estimated at 5 years). As a result, jobs in construction and related industries have yet to recover and in some areas are still in decline.
- Manufacturing bottomed out at about 430,000 employees. By November of this year, 439,700 were estimated to be employed in manufacturing. The good news is the industry grew by 6,800 jobs over last year and appears poised for additional gains in 2013.

Key Economic Trends

- The recent Babson Capital/ UNC-C economic forecast developed by Dr. Connaughton anticipates very modest growth in manufacturing (0.8%) for 2013. The forecast estimates that total Non-Ag employment will increase by 1.4 percent. A key component of growth is expected to come from construction with 1.9 percent growth.
- These projections, as well as other national forecasts, suggest a continuation of the slow growth scenario that has described the economy for the last several years.
- The pace of growth may quicken. Dr. Michael Walden's (NCSU) North Carolina economic index for December reached its highest level in five years, and suggests "an acceleration of North Carolina's economic growth rate may be developing for early 2013."

Key Economic Trends

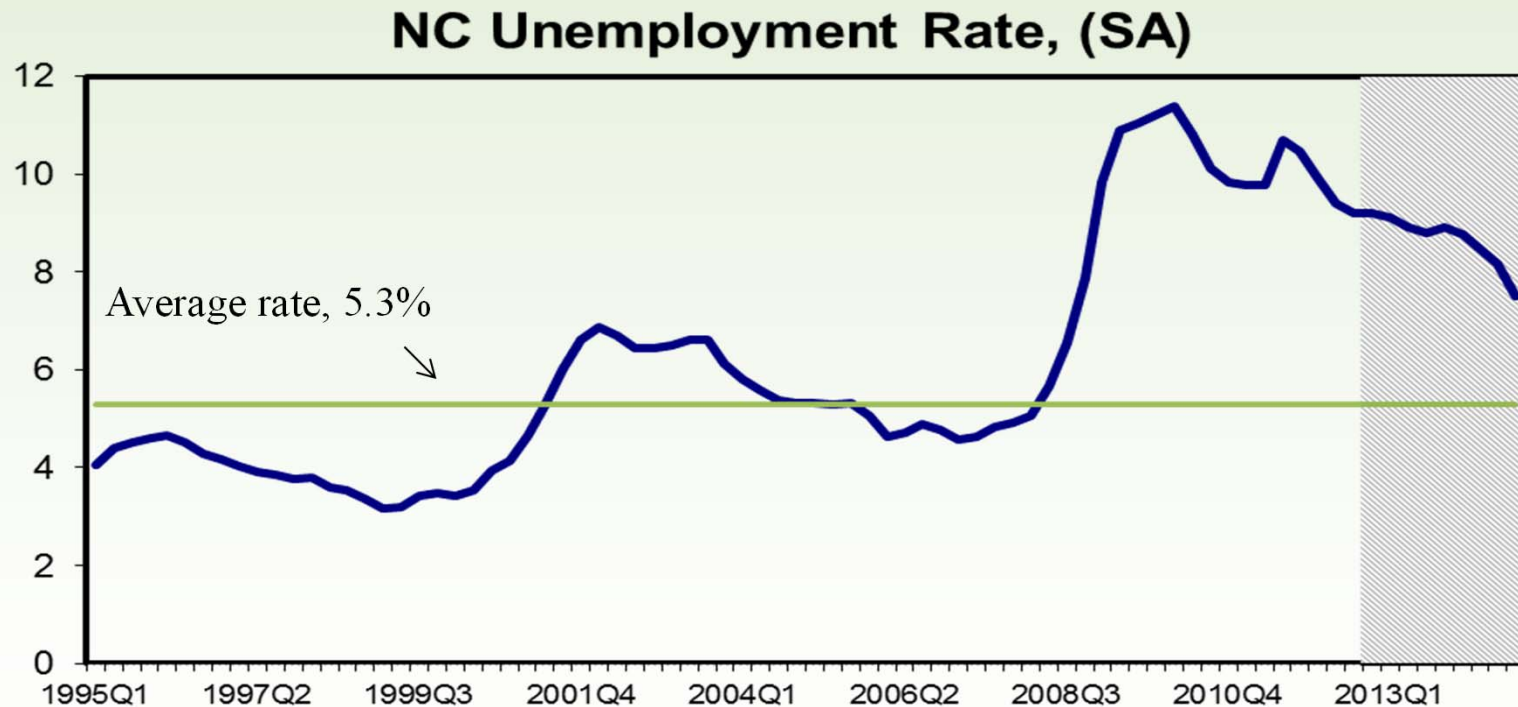
- There are signs that the job market is improving. The number of new jobless claims filed by individuals seeking State jobless benefits have lessened and are similar to the pre-recession levels of 2007.



Source: NC Employment Security Commission

Key Economic Trends

- The unemployment rate was 9.1% in November. Unfortunately, over the next twelve months the State's unemployment rate is expected to show only slight improvement. In the fourth quarter of 2013, the rate is forecast to be 8.5%.



Source: Actual data from the NC Employment Security Commission, Forecast by FRD shaded in gray

Risks to the Revenue Forecast



Risks to Revenue Forecast

Given the struggling recovery, the current revenue forecast was approached with added caution. The State's economic forecast for this fiscal year has been downgraded since the revenue forecast produced in May. A further downgrade in expectations would definitely place the forecast at risk.

<u>FY 2012-13 Growth Forecast</u>	<u>April</u>	<u>December</u>
Gross State Product (nominal)	5.6%	4.7%
Wage & Salary Income	5.4%	3.6%
Employment (Non-Ag)	1.1%	1.0%
Unemployment Rate	9.1%	8.9%
Retail Sales	6.1%	5.2%

Risks to Revenue Forecast

1. Fiscal cliff decisions by federal policy makers

~~Across the board tax increases~~ -- *resolved, but...*

- The State legislature will need to consider taking action as a result of some of the federal income tax code changes. State income taxes are tied to the federal tax code, and some of the changes recently enacted by Congress will have a significant impact on the State's revenue barring any action by the legislature.
- Decisions are still pending on spending cuts and the debt ceiling. Debt ceiling discussions in 2011 led to the fiscal cliff this year. A replay of 2011 could lead to a significant drag on the economy similar to what occur in late-summer of that year.

Risks to Revenue Forecast

2. Global demand improving but remains weak.

- Eurozone sovereign debt problems have held back the economy for the past 18 to 24 months sending many countries back into a recession and slowing the recovery here. European leaders are indicating the worst is behind and an economic recovery in the Eurozone may finally be underway
- China's economy has slowed significantly partly induced by a need to curtail inflation and partly from a decrease in global demand from Europe and emerging economies such as Indonesia and India.

3. \$50k business exemption adds volatility to second-half of FY.

- The second-half of the fiscal year is always the most volatile, but the addition of the new business exemption increases uncertainty. The business exemption affects every taxpayer reporting non-passive, business income on their personal income tax form.

Risks to Revenue Forecast

- Does the 2010/2011/2012 cycle of a late-spring slowdown repeat? Just as with last year, the economy appears to be on solid footing, but the threat of rising prices in commodities, continued slow employment growth, and the potential for recessions in Europe continue to cause concern.
- The US economy withstood the last round of negative economic shocks, and most indicators point to stronger growth. Is the economy strong enough to withstand another round of shocks without a significant pullback in the economy?
- Economic forecasters envision our economy staying at or below moderate growth levels in 2013. Some are suggesting that meaningful employment growth is still a year or more away.
- Therefore, some assumptions made in the FY 2012-13 revenue forecast may struggle to come to fruition. The forecast adhered to a cautious philosophy, which could minimize the impact if any further downturn in the economy occurs.

Risks to Revenue Forecast

An improving economy may reduce the level of risk.

1. Housing is improving, and is finally poised for a rebound. Steady population growth and the estimated excess demand for NC housing suggests that housing construction may be set to take off in 2014.
2. Employment is stabilizing. National job-openings data has steadily increased with hires gaining over job separations. NC unemployment claims data now resembles pre-recession levels.

Risks to Revenue Forecast

An improving economy may reduce the level of risk.

3. The service sector of the economy is gaining strength and is clearly in an expansion mode.
4. Based on national and State leading indicator indices, steady improvement in the overall economy can be expected.
5. Many investment and hiring decisions have been waiting out the uncertainty of the fiscal cliff and global economic concerns. As these issues are resolved, these decision are likely to come off the sideline, fueling a faster-pace recovery.

Conclusions

- The State's economy is expected to continue the trend of slow, yet steady, economic growth.
- The economy is on solid footing on most fronts, but as long as the State's employment growth remains tepid, then the recovery will continue along a slower track. This will also make the upturn in the overall economy more fragile and susceptible to economic shocks.
- Each year since the end of the recession in 2009, economic shocks have occurred. While they haven't fully derailed the recovery, they have been a drag on the pace of recovery.
- As before, there are similar risk to this fiscal year's General Fund revenue resulting from yet another downgrade to the economic recovery in the first-half of 2013.
- Because only a modest pace of growth is expected in 2013, and the economy will be more fragile with respect to economic shocks, greater caution will be warranted regarding the 2013-15 biennium revenue projections.