GENERAL FUND REVENUE REPORT

March 18 , 2008

FISCAL RESEARCH DIVISION
A Staff Agency of the North Carolina General Assembly

Highlights

- February revenues came in on target (after accounting for $19 million in one-time corporate refunds), keeping total revenues $125 million ahead of forecast. As usual, volatile April income tax revenues will have a major impact on the final 2007-08 outcome.
- The national economic slowdown, fueled by the financial markets meltdown as well as high energy and food prices, will be the primary driver for the rest of the current year and the upcoming budget. Barring additional economic shocks, revenues will at least reach the cautious 2007-08 budget forecast. The key question for the May forecast revision is how much the tentative 4.6% growth projection for 2008-09 needs to be adjusted.
- The Federal government has taken aggressive steps in both the budget and monetary policy arenas to prevent a full-scale recession. The latest moves are targeted on the financial market turmoil caused by the credit crisis.
- For now we think a full-scale recession can be avoided in North Carolina.

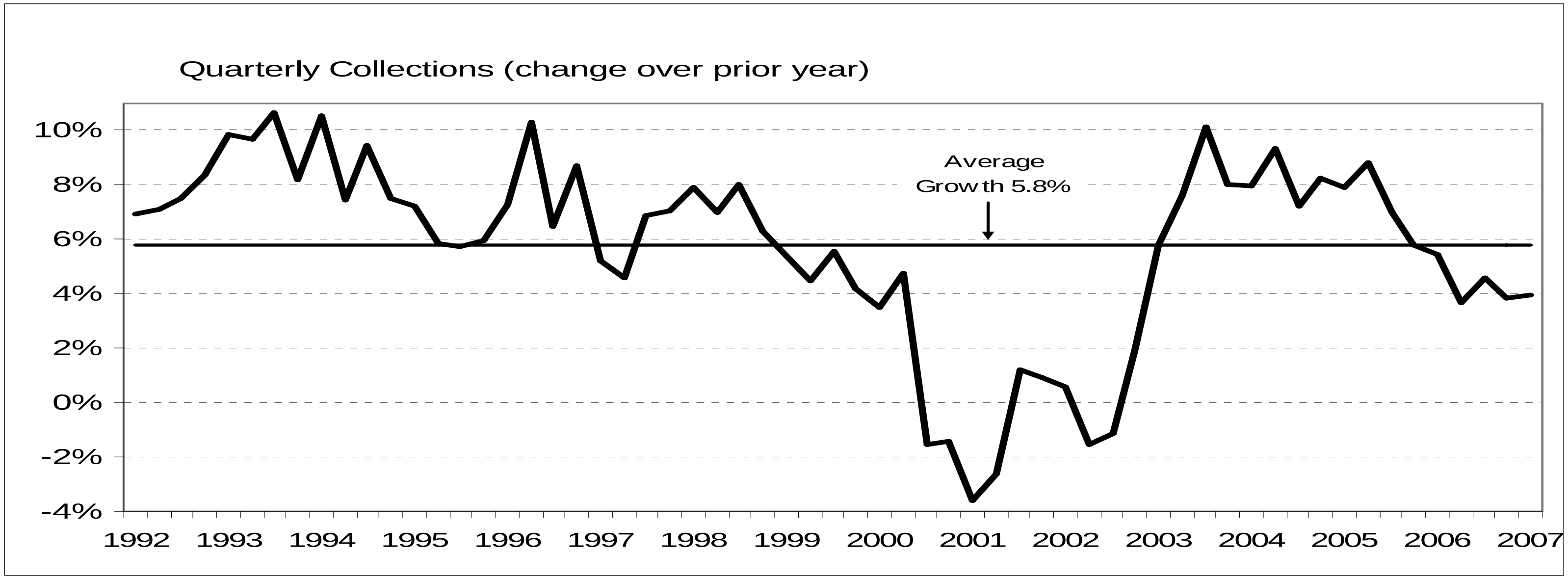
How Do 2007-08 Revenues Look So Far?

- General Fund revenue for the first eight months of the fiscal year are $125 million ahead of the $12 billion target for the period.
  - Even though collections are running just over 1% above expectations, the weakening economy is beginning to have an effect on the State's economy-based taxes. The good news is that the revenue forecast for FY08 anticipated this slowdown. This means that the sales tax and withholding revenue growth targets for the rest of the year are modest.

How Do 2007-08 Revenues Look So Far?

It is clear from looking at economy-based taxes that an economic slowdown is underway. Baseline sales tax growth through February was 2.9%, well below the long-term average of 5.8%, but right on the forecasted fiscal year growth rate. Further decline in baseline growth could cut into the modest surplus built up during the first half of the fiscal year.

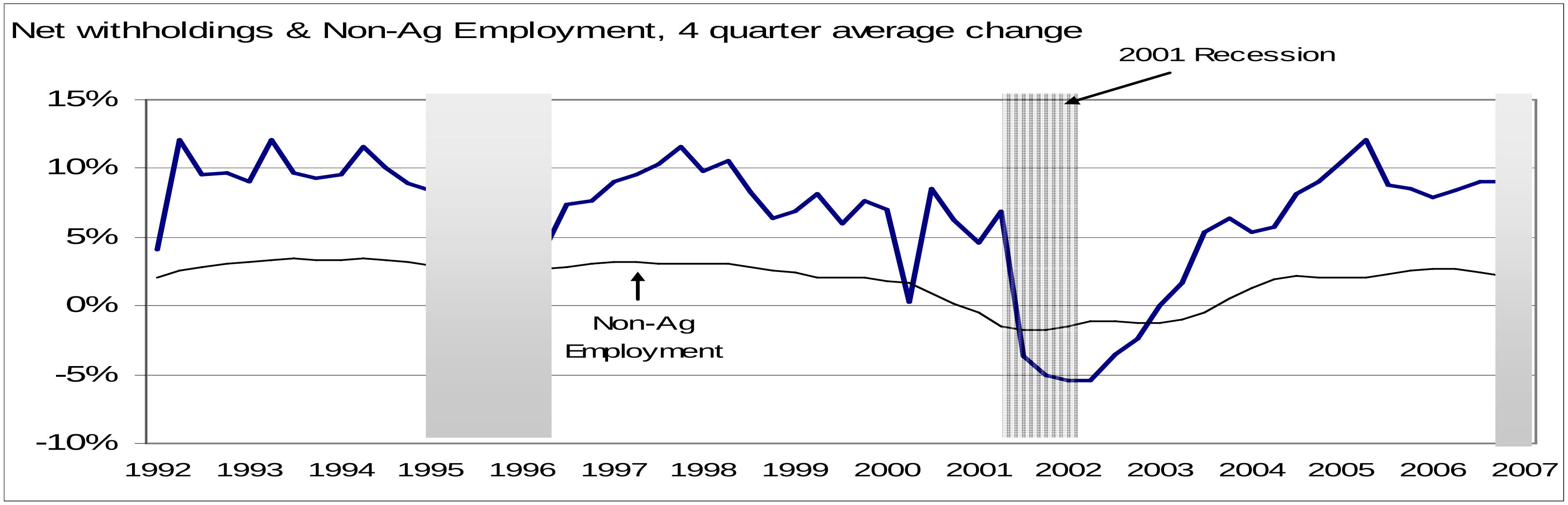
Sales & Use Tax Collections
(adjusted for tax law changes)



How Do 2007-08 Revenues Look So Far? (cont.)

Through February, withholding receipts have risen by 6.5%, a slowing from the 7.3% rate through January. The bright spot is that the current rate remains slightly above the historical average of 6.4%. The recent experience suggests that N.C. wage & salary employment may be feeling the impact from the national slowdown. The question remains for the coming months, will N.C. experience only a mid-cycle slowdown similar to 1995 or the negative growth situation that began near the end of the 2001 recession and persisted for 6 more quarters?

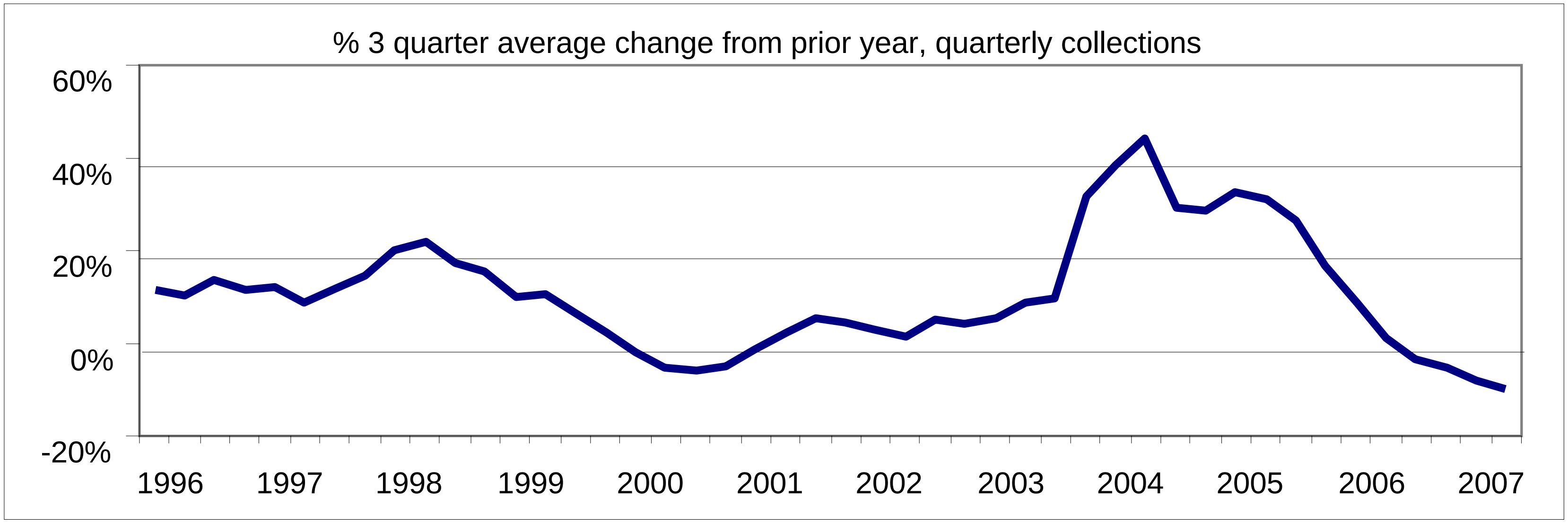
Withholding & Employment



How Do 2007-08 Revenues Look So Far? (cont.)

The housing downturn has significantly reduced real estate conveyance tax collections. Collections continue their decline and are down 11.7% compared to July-February of last year. Though this tax does not go to the General Fund, it can be a good economic indicator of retail sales.

Real Estate Conveyance Collections



We Still Have a Long Way to Go This Year

- The experience through eight months is valuable for assessing which direction the stable, economy-based tax collections such as the sales tax are headed. However, this data provides little indication of the outcome of the more volatile revenue sources that are concentrated in the final quarter of the fiscal year.

- The greatest unpredictability is tied to corporate income tax payments and non-withholding personal income tax payments.

We Still Have A Long Way To Go This Year (contd.)

- For example, during April we get final tax payments from both high income individuals with a lot of non-wage income and calendar year corporations.
- At the same time these taxpayers make their first quarterly estimated payment for the new tax year. This payment is a good predictor of the June remittance.
- In short, there is a "doubling-up" impact for these very volatile revenue sources.

We Still Have A Long Way To Go This Year (contd.)

- Why are these numbers hard to predict? For one thing, the dollars are concentrated in a small number of high-income individuals with diverse income sources including: :
  - Capital gains on shares of stock and investment real estate
  - Profits on the sale of a business
  - Pass-through income from sole proprietorships, partnerships, S Corporations, LLC's
  - Sales commissions
  - Dividends
  - Interest income
- This diversity means there are no "average" taxpayer situations among this group. In addition, the year to year experience of a specific taxpayer can very tremendously.

We Still Have A Long Way To Go This Year (contd.)

- The largest source of the annual volatility for these taxpayers in recent years has been capital gains. While there is a wealth of investment data available to researchers, we are missing information necessary to answer two key questions: what did the investors pay for their assets and when will they sell?

- Finally, it is impossible to predict how a gain in tax liability will be split between estimated tax payments made during the tax year and final settlements on April 15. What this means is that even if we know on January 31 how estimated tax payments fared for the prior tax year, we still do not know what will happen on April 15. The reason is that under federal and state law the "penalty" for underpayment during the tax year is simply interest (7% in 2007).

2008-2009 Forecast Outlook

- The biennial budget for 2007-2009 included a tentative 4.6% baseline revenue growth rate for the 2008-09 fiscal year. One of the purposes of the upcoming budget session is to adjust this outlook in light of the new environment.
- A sluggish national economy teetering on the brink of a recession will lower economic output for the rest of 2008. The aftereffects from the U.S. housing recession and the growing credit crisis could be a drag on the economy well into 2009. The effects of the national slowdown are starting to show up in North Carolina's housing data and the economy-based taxes (see pages 3 to 5).
- Consumer spending is at risk for the following reasons:
  - the loss of household wealth, a result of the prolonged real estate downturn;
  - tighter consumer credit from the sub-prime/foreclosure debacle;
  - weakening income growth;
  - rising food and energy prices.

2008-2009 Forecast Outlook (contd.)

- So far the national and state employment level has held up relatively well However, as job growth slows and the unemployment rate rises, consumer spending will be affected.
- In addition, if the credit crunch spreads to global markets, demand for U.S. exports will be affected (historically low values for the dollar are currently fueling export trade).
- Recent data leaves little doubt a significant slowdown is well underway. For example, the estimated inflation adjusted GDP growth in the last quarter of 2007 was only 0.6%. The latest estimates indicate zero to slightly negative growth for the first and second quarter of 2008.
- In addition, any recovery during the second half of the year and the first quarter of 2009 will be modest at best. The global economy will have a major impact on the magnitude of the slowdown as well as the speed of the recovery.

2008-2009 Forecast Outlook (contd.)

- Both business and consumer confidence measures are pointing to a possible recession.

- The Federal government continues to take aggressive steps to head-off a protracted slowdown

  - Through 6 separate actions beginning in September of last year the Federal Reserve lowered the federal funds rate target by 3 percentage points (5.25% to 2.25%).
  - In addition the Fed has gone to extraordinary lengths to inject liquidity into the banking system.
  - Congress passed a fiscal stimulus package that offers bonus investment depreciation for capital purchases and cash rebates against 2008 income tax liability. The rebates are expected to be in consumers hands beginning in May. It is estimated that the 2nd quarter will see a 14% increase in disposable income from the stimulus, but a cautionary note is that most of that income may not go back into the economy by way of consumer spending.

2008-2009 Forecast Outlook (contd.)

- A major factor that will keep a lid on any recovery is that the housing recession has spread to the commercial real estate markets. The speculative bubble that occurred in the 2003-2005 period in these sectors may take another couple of years to work through. This means that real estate prices have farther to fall before the turnaround can begin.

- The severity of the economic downturn remains regional for now, similar to the housing market decline. This means that not all states will experience recession-like economic conditions. Nonetheless, housing market problems, rising fuel and food prices, and slow or stagnant income growth means every state will notice some slowdown in consumer spending and employment growth.

Economic Slowdown in North Carolina and Forecast Risks

- Our assessment of the possibility of a nationwide recession has increased to 60%; however, there are a number of reasons why we believe a full-blown recession may be avoided, at least in North Carolina:
  - The job market, both in N.C. and the nation, is still relatively healthy.
    - 4 week average unemployment claims were down the first week of March and are more indicative of 1 to 2% economic growth rather than recession. One reason may be that employers did not ramp up employment as much during the 2002-2004 recovery as in past cycles. Thus, current staffing levels may be appropriate for declining demand.
  - The Federal Reserve remains very aggressive in dealing with the sub-prime lending fallout.
  - The Federal fiscal stimulus package, along with Federal Reserve Board rate cuts, may boost consumer confidence and influence spending decisions even before the checks arrive in May.
  - The weak dollar and demand from emerging economies has created a demand for U.S. exports and remains a vital and important component of keeping the nation out of a protracted economic slowdown.

Economic Slowdown in North Carolina and Forecast Risks (contd.)

- While we are currently not as pessimistic about the economic outlook as some economists, the budgeted revenue forecast for the year had built in significantly slower withholding and sales tax growth for the second half of 2007-2008 fiscal year. In short, there is a lot of downside protection built into the current budget for the key economy-based taxes.

- In addition, our forecast for the last few years placed a lot of emphasis on dealing with the risks associated with explosive, volatile revenue sources such as the non-withholding portion of the income tax (capital gains show up here) and the corporate income tax.
  - Key Reasons:
  - A few years of super-charged growth is always followed by steep declines
  - For a long time we have been warning that the housing bubble would eventually burst and the subsequent decline would be steep and long-lasting.
  - The stock market correction is underway.

  For these reasons the budgeted forecast for these items has been super-cautious.

- The end result is that our overall revenue forecast for 2007-2008 was much more cautious than those of other states. This means that we are not experiencing the same revenue shortfalls as many states including California, Virginia, Florida, and Tennessee.

- Clearly, a protracted and significant slowdown or recession will dampen expectations for revenue growth in FY 2008-09 and may mean that the tentative 4.6% growth rate will need to be lowered. Continued monitoring of both the credit crisis and the impact of rising food and gasoline prices on consumer spending and job growth is crucial.