GENERAL FUND REVENUE REPORT

December 13 , 2007

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

Highlights

- Revenues through November are slightly ahead of forecast with a surplus of $120 - $125 million.
- The biggest risk surrounding the 2007-08 forecast continues to be the real estate slump, plus the financial sector upheaval. Higher energy prices are also a potential risk to General Fund receipts.
- These risks should be adequately covered by a moderately cautious total revenue forecast of only 4.0% baseline growth.

Revenue Forecast Assumptions

- The economic slowdown will continue well into 2008 and will impact housing and financial sectors of the economy.

- The effects of the slowdown have begun to show up in a major way in North Carolina’s housing data and the Sales and Use tax (see pages 4 and 6).

- The loss of household wealth from the real estate slowdown plus tighter consumer credit will lower consumer spending growth. This means that state sales tax growth, excluding tax law changes, will slow to 2.9% (4.5% in 06-07 and 9.3% in 2005-06).

- Modest job growth in North Carolina, due to the slowing economy, will eventually lead to lower growth of income tax withholding. The specific 2007-08 forecast envisions withholding gains of 5.3% (7.7% in 06-07).

How Do 2007-08 Revenues Look So Far?

- General Fund revenue for the first five months of the fiscal year came in about $120-$125 million ahead of a $7.4 million target for the period.
  - In other words, collections are running 1.7% above expectations. The impact of the housing crunch and the economic slowdown will have the greatest impact later in the fiscal year. This is reflected in the targeted growth rate of 5.5% for the first five months, but only 4.0% for the full year.

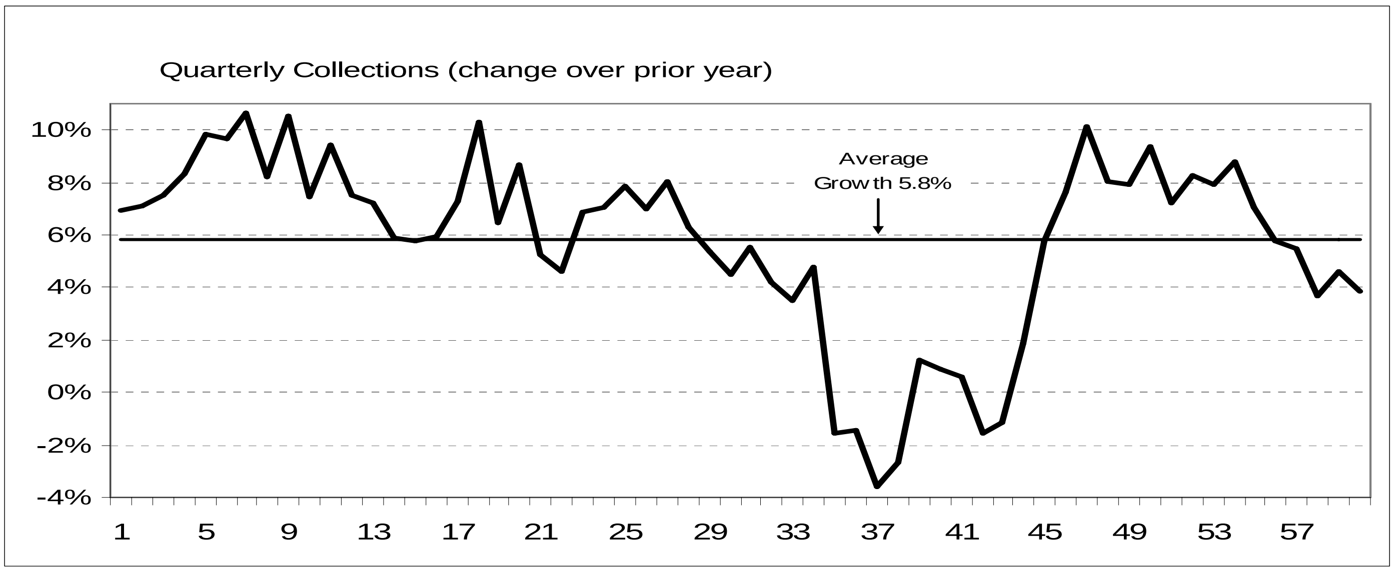
How Do 2007-08 Revenues Look So Far?

- There are some caveats to keep in mind. First, the bulk of the surplus comes from the personal income tax and sales tax.
  - Withholding continues to grow above the long term rate of 6.3%. A persistent downturn in the economy may dampen that growth in future months.
  - Caution is needed with the sales tax. With the early Thanksgiving holiday, sales that might have occurred in December could have been pulled forward into the last week of November inflating the receipts for the month.
- As a reminder, the early part of the fiscal year is the least important from an indicator point of view.
  - Volatile revenue source do not show up until the second half of the fiscal year (corporate income, non-withholding portion of personal income tax).

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

It is clear from looking at economy-based taxes that an economic slowdown is underway. Baseline sales tax growth for July-November was 4.1%, well below the long-term average growth of 5.8%, but above the annual forecast growth of 2.9%.

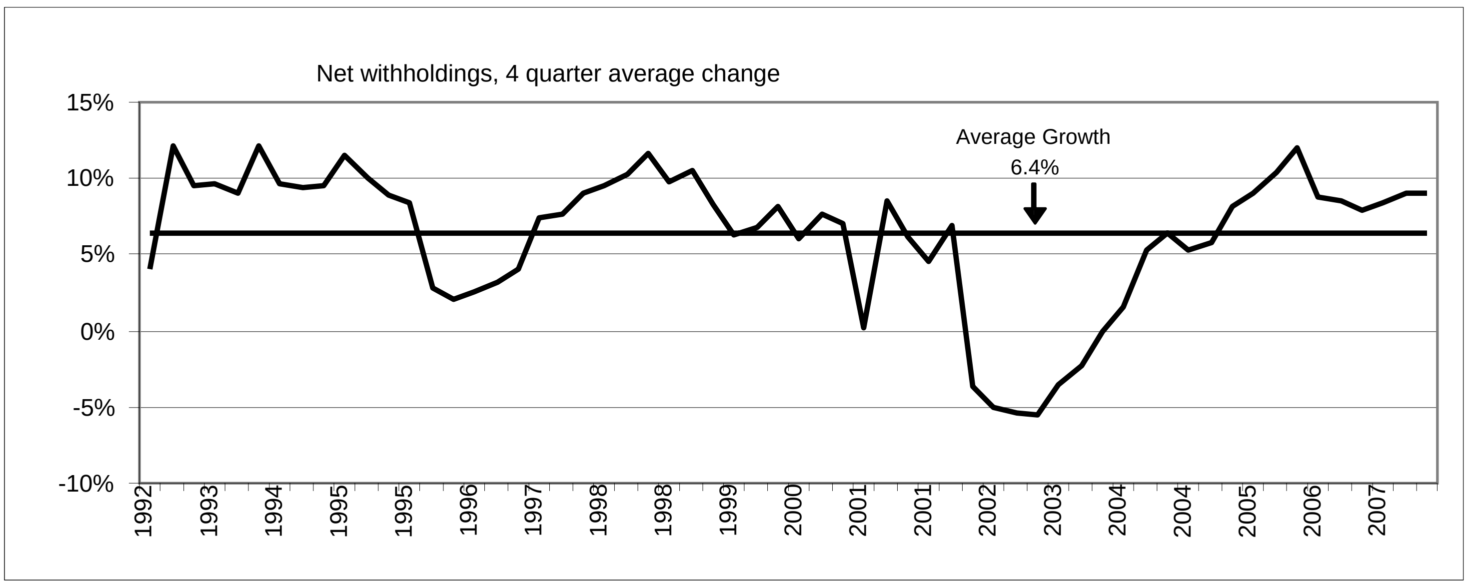
Sales & Use Tax Collections
(adjusted for tax law changes)



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

Withholding continues to be surprisingly resilient with growth of 7.7% through November, which is essentially the same rate as 2006-07. It has slowed slightly from the 9-10% rate during 2005 and part of 2006, yet remains above historical growth of 6.4%. This suggest withholding has yet to be significantly impacted by the national economic slowdown.

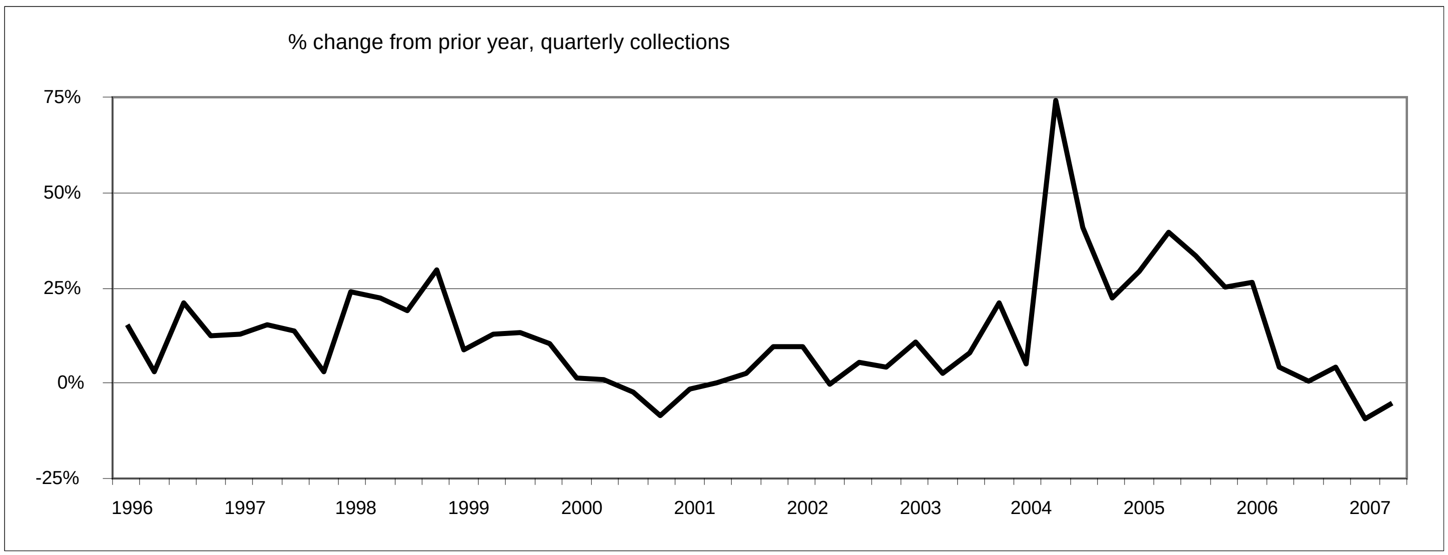
Withholding Tax Receipts



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

The real estate slump has significantly reduced real estate conveyance tax collections, though not at much as in many other states (California, Nevada, Florida, Virginia for example). Collections were down 8.2% compared to July-November of last year. Though this tax does not go to the General Fund, it is a good economic indicator of retail sales.

Real Estate Conveyance Collections



The National Economic Outlook

- The economy can expect below normal growth for the remainder of 2007 and 2008: 1% to 2 % inflation-adjusted growth, according to the Federal Reserve Board, versus of the long term average of 3%.
- Sub-prime lending implosion and the subsequent defaults and foreclosures are affecting the financial sectors, prolonging the impact of the housing slump. Federal bailout efforts may somewhat ameliorate the situation.
- Exports to developing countries has been a major support for economic growth in recent years. A slowdown in the international trade sector would raise recession fears in the U.S.
- The Federal Reserve has responded aggressively to lowered inflation expectations and problems in real estate with another 25 basis point cut in the banks' lending rate. The Fed will continue to monitor the financial sector upheaval closely for fear of spillover into other parts of the economy.

North Carolina is Well Positioned for a Slowdown

- North Carolina's handling of the revenue forecast risk differs from other states
  - Our forecast for the last couple of years focused on risks associated with volatile revenue sources such as the non-withholding portion of the income tax (capital gains show up here) and the corporate income tax.

  Reasons:
  - A few years of super-charged growth is always followed by steep declines
  - We have long felt that the housing bubble would eventually burst and that the decline would be steep and long-lasting.
  - Eventually there will be a major stock market correction.
  - On these issues, our state has taken a more cautious stance than most otherplaces

How Big are the Risks?

- We are not as concerned about a recession
  - The job market, both in N.C. and the nation, is still relatively healthy.
    - One reason is 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 the declining demand outlook.
  - In North Carolina, strong growth in service-based jobs has offset the continued loss of traditional manufacturing jobs. Thus, our annual withholding tax growth remains amazingly stable holding above 7%.
    - Our job growth in North Carolina is 1.5-2.0% higher than in other states and has not slowed during the last 12 months. This is important because withholding tax collections represent 40% of total revenues.
  - The loss of manufacturing jobs has been so great that in recent years this sector does not carry as much weight in N.C. as in past business cycles

How Big are the Risks? (Cont.)

- Residential real estate problems in N.C. have been largely confined to resort areas and commercial real estate remains relatively healthy, at least for now.
  - Unlike some states, we are experiencing negative real estate activity, but not a deep real estate recession.
  - In addition, residential real estate amounts to less than 5% of the nation's overall economy
- Surging economic growth in developing countries creates a demand for U.S. exports
- The Federal Reserve has been very aggressive in dealing with the sub-prime lending fallout

♦ Conclusions, a U.S. recession is not likely and N.C. will continue to fare better than the nation. At the same time, the budget forecast builds in some slowing to cover a situation where the housing slump and sub-prime lending problem spread to the overall economy.

Long-Term Budget Outlook

- Barring any major surprises, the cautious nature of the 2007-08 and 2008-09 consensus revenue estimates should help in meeting 2008-09 and future year spending needs.
- Budget availability for future years is highly dependent on health care costs (State Health Plan, Medicaid). During the last three decades, high growth in these areas has crowded out spending on other budget priorities.
- A tight budget situation can still occur if the improved outlook leads to an increase in commitments (expansion budget requests, tax cut proposals, catch-up pay raises). In addition it is still remain a possibility that the economic slowdown could turn into a full-blown recession and/or Medicaid expenses could accelerate.

Turnaround in State Budget Reserves

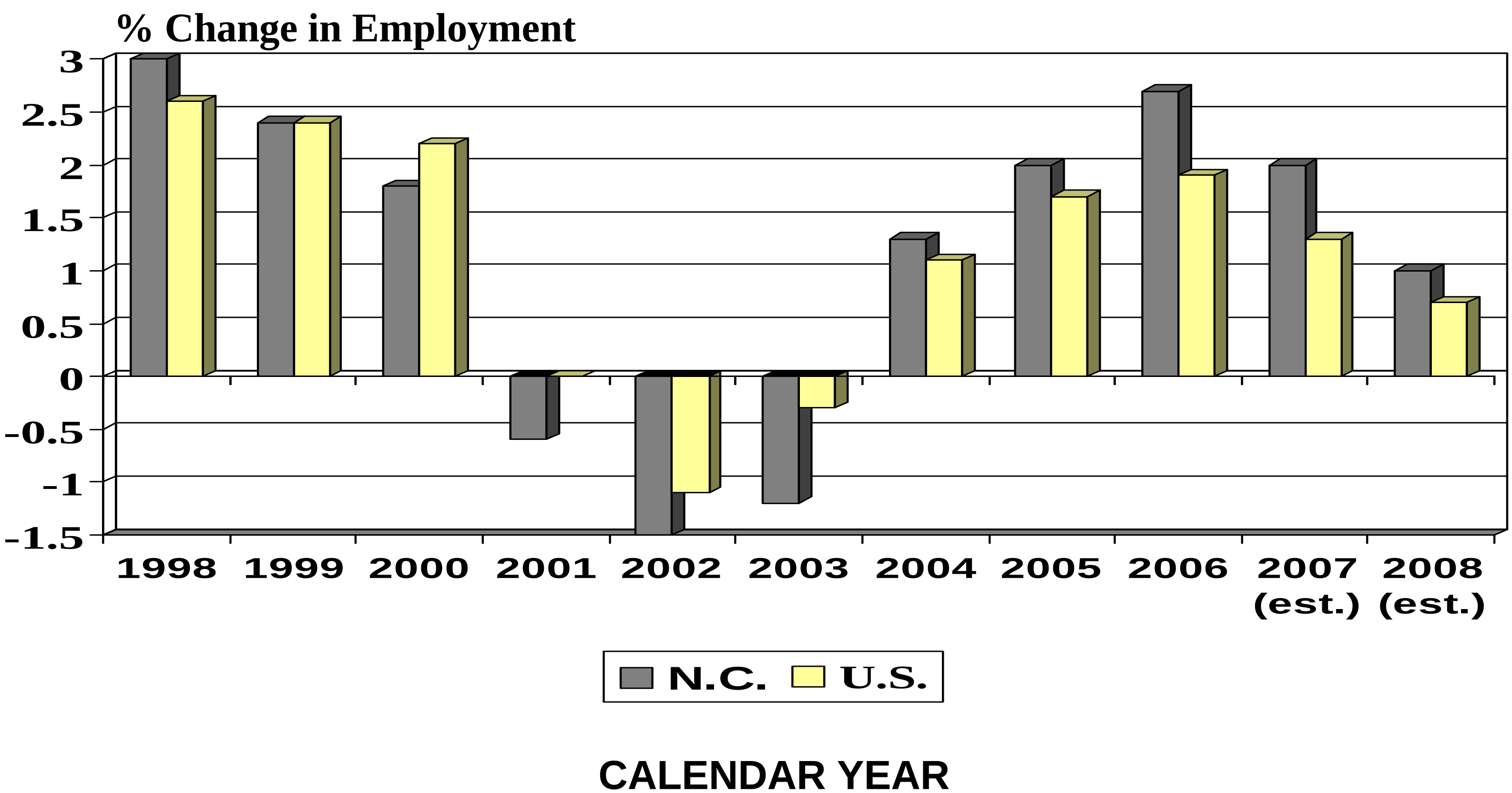
- During the last decade a combination of natural disasters, tax lawsuit payouts, and economic woes depleted the state's financial reserves. This was a major reason for loss of our Triple A bond rating by Moody's.
- The strong economic performance in recent years, coupled with stock market and real estate gains and cautious revenue estimates, has helped to restore budget reserves.
- The current reserves are the strongest in more than a decade.
  - Rainy-day fund amounts to almost $800 million
  - Repairs/renovations funding of $145 million can be pulled back in emergencies
  - Capital appropriations can be reverted if necessary
  - Governor can force agencies to revert more authorized spending
  - Cautious revenue estimates for 2007-08 should provide a final cushion

2007-08 Revenue Estimates

- Estimates reflect consensus outlook of Governor's Budget Office and Fiscal Research Division.
- Forecast philosophy recognizes that much of recent extra revenue has been concentrated in volatile items (non-withholding portion of personal income tax, corporate income tax), adding to forecast uncertainty.
- In addition, the projections provide a hedge against worsening residential real estimate market. Fiscal Research has been more bearish on housing outlook than most economists for last year. In our view, the unwinding of market "bubbles" is usually more severe and longer lasting than most observers believe.
- Baseline General Fund Revenue Growth and budget forecasts are shown below.

01-02	02-03	03-04	04-05	05-06	06-07	07-08	08-09
-6.3%	- 0.4%	5.7%	9.4%	12.1%	9.2%	4.0%	4.6%

How is N.C. Economy Doing Relative To U.S.?



After the usual deeper decline during the recession, N.C. has been surging ahead of U.S.