GENERAL FUND REVENUE REPORT

February 13 , 2008

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

Highlights

- Revenues through January remain modestly ahead of forecast with a surplus of $140 million.
- Big risks continue to persist for the 2007-08 forecast. The national economic slowdown driven by housing and financial sector losses is well underway. These risks should be adequately covered by the cautious budget forecast that builds in downside protection for volatile revenue sources.
- The Feds have undertaken significant actions to try to prevent a full-scale recession. The Federal Reserve Board has lowered by 125 basis points the targeted lending rate and Congress has approved a $151 billion fiscal stimulus package.

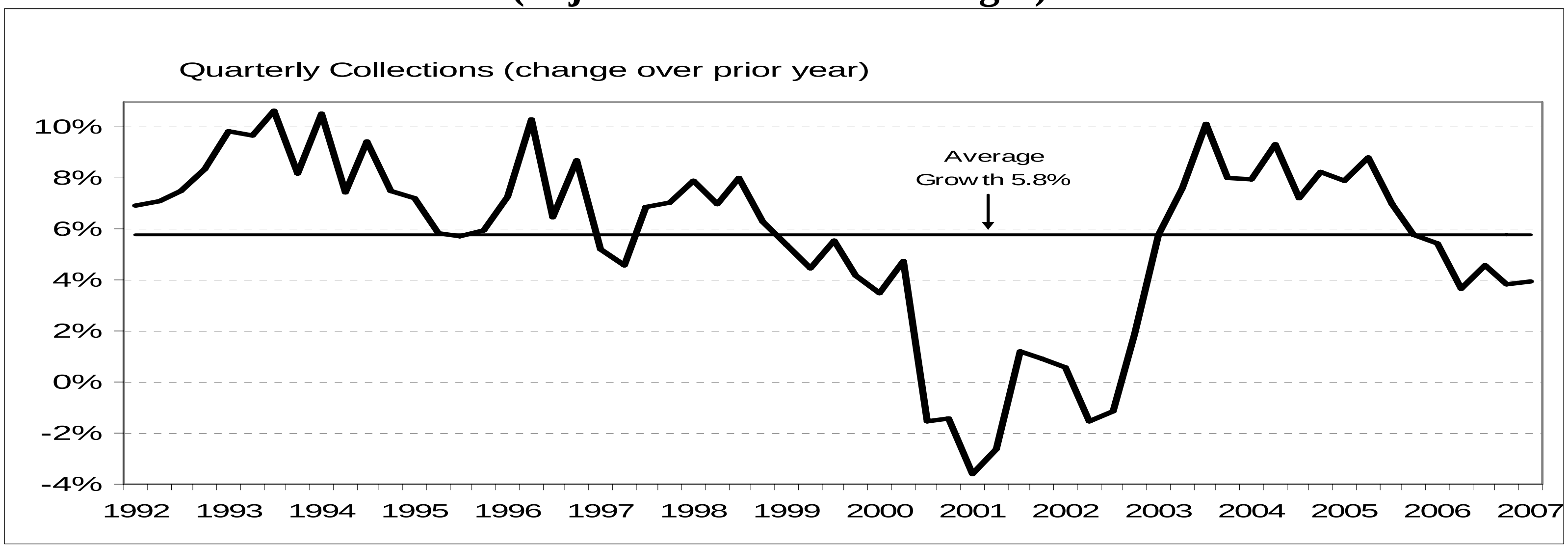
How Do 2007-08 Revenues Look So Far?

- General Fund revenue for the first half of the fiscal year came in about $140 million ahead of a $11.1 billion target for the period.
  - So far, collections are running 1.25% above expectations. It is noteworthy, however, that the weakening economy is having an effect on consumer spending, and therefore, on the State's economy-based taxes. Revenue forecast assumptions anticipated this slowdown and revenue growth is expected to continue to slow dramatically during the last five months of the fiscal year.

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 January was 3.6%, well below the long-term average of 5.8%, but above the forecasted growth of 2.9%. December and January reflected the much talked about cutback in consumer spending as sales collections slowed considerably.

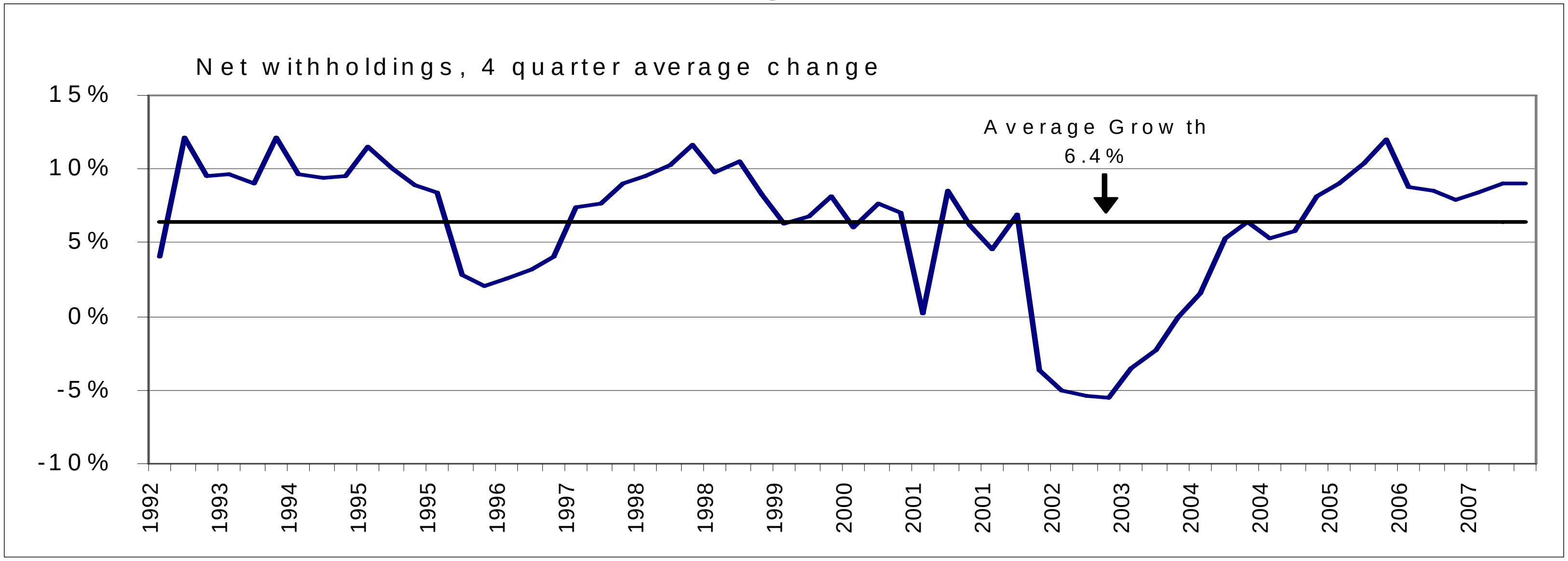
Sales & Use Tax Collections
(adjusted for tax law changes)



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

Withholding continues to be resilient in the face of the slowdown with growth of 7.25% through January. Growth has slowed from the 8-10% rate during 2005 and 2006, yet remains above the historical average of 6.4%. This suggests N.C. wage & salary employment has yet to feel the full impact from the national economic slowdown.

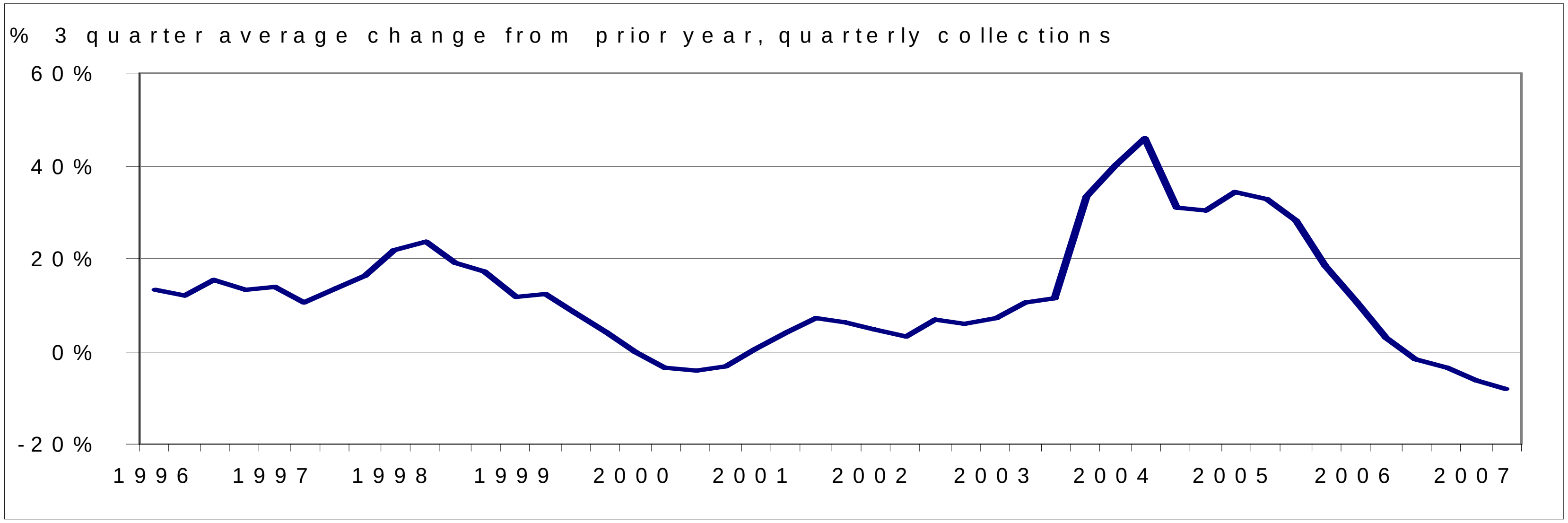
Withholding Tax Receipts



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

The real estate slump has significantly reduced real estate conveyance tax collections. Collections continue their decline and are down 10.5% compared to July-January 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



We Still Have a Long Way to Go

- The first 6-8 months of the fiscal year are valuable for assessing which direction the stable, economy-based tax collections such as the sales tax are headed. These months provide little indication of the outcome of the more volatile revenue sources. This means the final quarter (April – June) of the fiscal year contains most of the forecast risk.

- The greatest unpredictability is tied to corporate income tax payments and non-withholding personal income tax payments.
  - This creates a "doubling-up" impact for both sources since it entails April 15 final income tax payments (2007 tax year in this case) as well as quarterly estimated income tax payments in April and June for the new tax year.

We Still Have a Long Way to Go

- Volatile non-withholding income tax payments during April-June come from a wide variety of individuals with a lot of non-wage income. Most of the dollars are concentrated in a small number of high-income individuals with diverse income sources including:
  - Capital gains on shares of stock
  - Gains on sale of investment real estate
  - Profits on the sale of a business
  - Independent contractor income
  - Pass-through income from sole proprietorships, partnerships, S Corporations, LLC's
  - Sales commissions
  - Pensions
  - Dividends
  - Interest income

We Still Have a Long Way to Go

- While all of these income sources are hard to predict, capital gains on stock and real estate investments present a particular problem. Even if we could predict future asset prices, we do not know what year investors will sell nor the asset's original purchase price.

- There are additional challenges to forecasting April revenues from high-income individuals
  - Unlike wage earners, there are no "average" taxpayers and individual experiences can vary tremendously from one year to the next.
  - In addition, taxpayers with a lot of additional income in a tax year can choose between increasing their estimated payments or settling up on April 15, with risk of a "penalty" for insufficient estimated tax payments (going interest rate). This means that even with the availability of the December & January estimated tax payment data (available in February), we still do not know what April 15 will bring.

- As with high-income individuals, the April-June period includes a similar concentration of volatile payments for the corporate income tax.

Revenue Forecast Outlook

- A sluggish national economy is expected to persist through 2008. The aftereffects from the U.S. housing recession and the subprime financial problems, could be a drag on the economy well into 2009.
- The effects of this slowdown are starting to show up in North Carolina's housing data and the Sales and Use tax (see pages 3 and 5).
- The biggest risk is to consumer spending caused by the loss of household wealth, which is the result of the real estate downturn plus tighter consumer credit.
- Slower job and wage growth typically follow a fall in consumer spending. Due to the slowing economy, we will eventually begin to experience lower growth of income tax withholding. The 2007-08 forecast envisions withholding gains of 5.3% (it was 7.7% in 06-07).

The National Economic Outlook

- There remains little doubt that the economy is contracting. 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 quarter of 2008, and possibly for the second quarter as well. Only a sluggish recover is expected the second half of the year and into the first quarter of 2009. The global economy will impact the magnitude of the slowdown as well as the speed of the recovery.
- Both business confidence and consumer confidence indicators are pointing downward in anticipation of a possible recession.
- The Fed has taken aggressive steps to head-off a protracted slowdown
  - The Federal Reserve Board through two separate actions lowered the federal funds rate target by 1.25 percentage points
  - Congress passed a fiscal stimulus package that offers bonus investment depreciation and cash rebates against 2008 tax liability. The rebates are expected to be in consumers hands beginning in May

The National Economic Outlook

- The housing downturn, financial turmoil, and increasingly reluctant consumers are weighing heavily on economic growth.
- At this point, most economists expect either a mild recession relative to previous post WWII recessions, or a major slowdown but no recession.
- The economic slowdown has several unique characteristics. Much of the angst is driven by housing and financial woes, which are largely regional in nature. So, different parts of the country may be experiencing various degrees of an economic slowdown, and some may not have any slowdown with respect to employment.

Feds Take Actions to Avoid a Nationwide Recession

- Our assessment of the possibility of a nationwide recession has increased to 50%; 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.
    - 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 has been very aggressive in dealing with the sub-prime lending fallout and is expected to lower the federal target rate again at there next meeting.
  - 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.
  - Continued surging economic growth from global emerging economies creates 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

- Even though we are not as pessimistic on the odds of recession as some economists, the budgeted revenue forecast for the year has built in slower withholding and sales tax growth for the second half of 2007-2008 fiscal year.

- At the same time for the last couple of years our forecast has placed a lot of emphasis on 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.
  - Eventually there will be a stock market correction.

- The end result is that our forecasts in these areas have been much more cautious than those of other states. For now, we are not experiencing the same revenue shortfalls as Virginia, Florida, and Tennessee.

Long-Term Budget Outlook

- Strong revenue growth in recent years, combined with cautious revenue estimates and the permanent extension of the ¼ cent sales tax have brought the General Fund budget into an essentially balanced situation. Barring a major, protracted downturn in the economy or a ramping up of new spending/tax cut initiatives, balancing the 2008-2009 budget should be much less difficult than the last decade.
- Key Points:
  - Budget availability for future years will be highly dependent on health care costs (State Health Plan, Medicaid). During the last three decades, high growth in this area has crowded out spending on other budget priorities.
  - A tight budget situation can still occur if the economic slowdown turns into a full-blown recession and/or Medicaid expenses 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