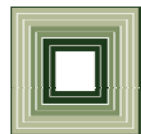


# GENERAL FUND REVENUE REPORT



January 14 , 2008



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

# Highlights

- Revenues through December are slightly ahead of forecast with a surplus of \$125 - \$130 million.
- The biggest risk to the 2007-08 forecast is the national economic slowdown driven by housing and financial sector losses. Higher energy prices are a risk to General Fund receipts if they begin to cut into consumer spending.
- Unlike many other states, these risks should be adequately covered by a moderately cautious revenue forecast. The forecast builds in a lot of downside protection for the volatile revenue sources (April 15 returns) and assumes a slowdown in the economy-based withholding and sales taxes.

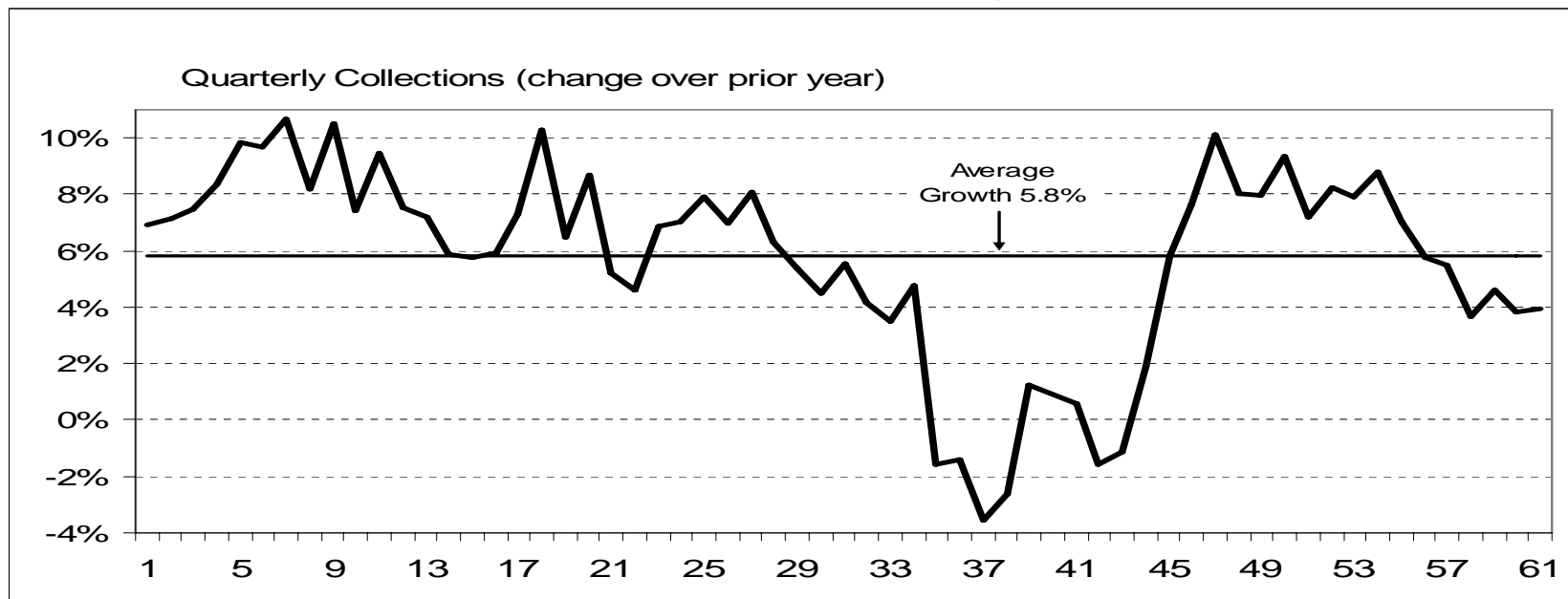
## How Do 2007-08 Revenues Look So Far?

- General Fund revenue for the first half of the fiscal year came in about \$125-\$130 million ahead of a \$9.1 billion target for the period.
  - In other words, collections are running 1.4% above expectations. However, the impact of the weakening economy on consumer spending is beginning to have an effect on the State's economy-based taxes. Revenue forecast assumptions have anticipated this slowdown and revenue growth is expected to slow dramatically during the second half 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 for July-December was 3.9%, well below the long-term average growth of 5.8%, but above the annual forecast growth of 2.9%.

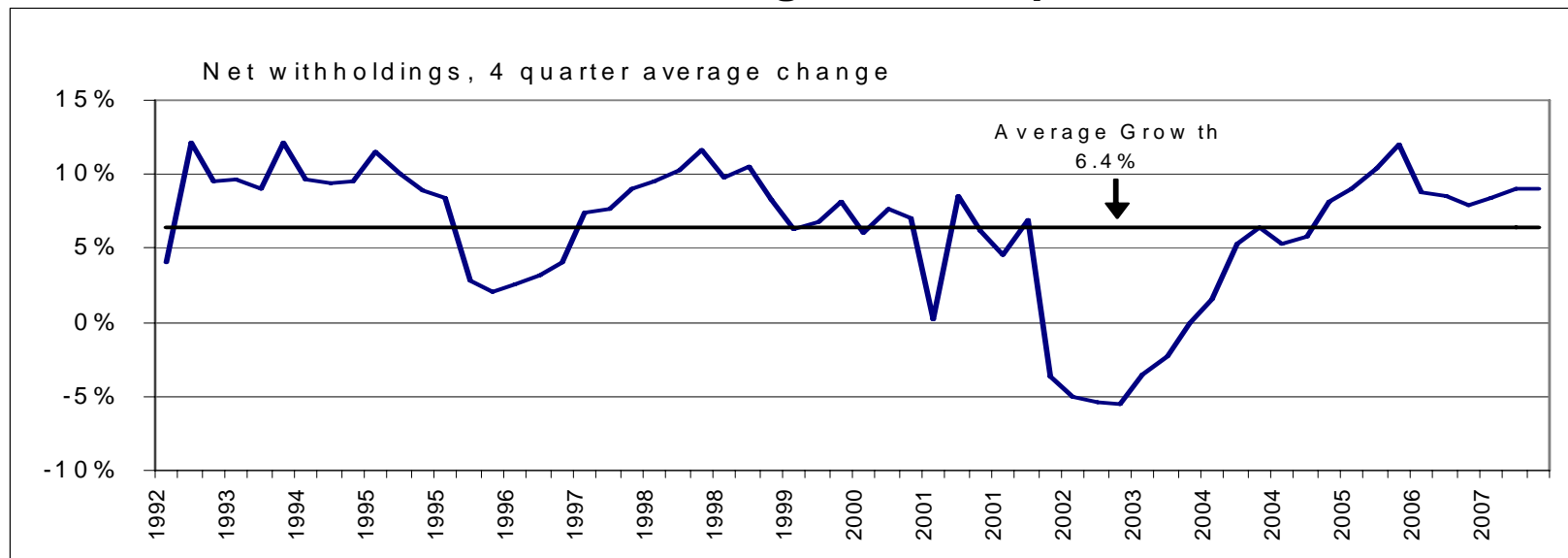
## Sales & Use Tax Collections (adjusted for tax law changes)



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

Withholding continues to be surprisingly resilient with growth of 7.4% through December. Growth has slowed from the 9-10% rate during 2005 and part of 2006, yet remains above historical growth of 6.4%. This suggests wage & salary employment has felt little impact from the national economic slowdown.

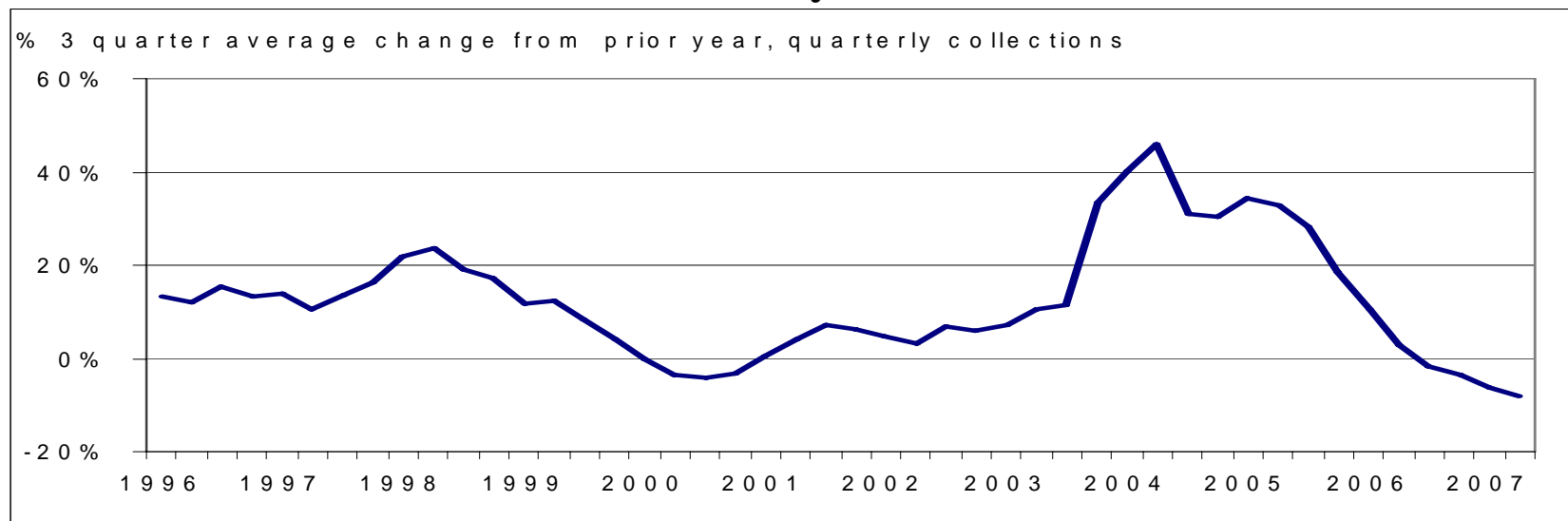
### Withholding Tax Receipts



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

The real estate slump has significantly reduced real estate conveyance tax collections, though not at much as in many other states (California, Nevada, Florida, Virginia for example). Collections were down 9.4% compared to July-December 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 six months of a fiscal year typically contain about half of the annual tax payments, but only 20% of forecast risk.
- Most of the remaining unpredictability comes in the April-June period and is tied to corporate income tax payments and non-withholding payments under the personal income tax.
  - The latter category includes April 15 final payments (2007 tax year in this case) as well as April and June quarterly estimated tax payments for the new tax year.

# We Still Have a Long Way to Go

- Non-withholding income tax payments 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

- Forecasting capital gains on stock and real estate investments presents 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.
  - Unlike wage earners, there are no “average” taxpayer situations for a given tax year 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 increase their estimated payments or settle 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.
  - For the corporate income tax, the April-June period includes a similar concentration of volatile payments as with high-income individuals.

# Revenue Forecast Outlook

- The economic slowdown will continue through 2008. The impact on the economy from the U.S. housing.
- The effects of the slowdown continue to show up in North Carolina's housing data and the Sales and Use tax (see pages 3 and 5).
- One of the biggest risks from the loss of household wealth as a result of the real estate slowdown and tighter consumer credit is a reduction in consumer spending growth .
- Slower 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).

# The National Economic Outlook

- The economy can expect well below normal growth for 2008: 1% to 1.5 % inflation-adjusted growth, according to the Federal Reserve Board. The long term average is 3.1%.
- A recent speech by the Federal Reserve Board Chairman Ben Bernanke stated more cuts in the bank lending rate may be forthcoming as “a number of factors, including higher oil prices, lower equity prices, and softening home values, seem likely to weigh on consumer spending.”
- Unemployment rises as payrolls rose by only 18,000 jobs in December. This means that last year was the worst year for job creation since 2003.
- With oil prices up 70 percent from a year ago, the economy risks a double whammy of both slow job growth and increased inflation.

# Forecast Risk Strategy in N.C.

- Most states are focusing on the recession possibility, with the impact falling on economy-based revenues such as the sales tax and withholding tax payments.
- Fiscal Research handles revenue forecast risk differently than many states. Our assessment of the possibility of recession, 30%, is lower than most. There are a number of reasons.
  - 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.

# Forecast Risk Strategy in N.C.

- 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 relatively high at over 7%, though this is expected to change as the impact of real estate woes begin to filter through the job market
  - Our annual job growth in recent years has outpaced the nation's and has not slowed during the last 12 months.
- The loss of manufacturing jobs has been so great that in recent years this sector does not carry as much weight as in past cycles
- Surging economic growth from global emerging economies creates a demand for U.S. exports

# Forecast Risk Strategy in N.C.

- 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.
- The Federal Reserve has been very aggressive in dealing with the sub-prime lending fallout.

# Forecast Risk Strategy in N.C.

- Even though we are not as pessimistic on the odds of recession, the budgeted revenue forecast for the year builds in slower withholding and sales tax growth for 2007-2008.
- 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.
- 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.

# 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 any major surprises or a ramping up of new spending/tax cut initiatives, balancing the 2008-2009 budget should be much less difficult than the last decade.
  - 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