GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

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Highlights

- FY 2007-08 came in on target with a $68 million General Fund surplus (actual collections compared to budgeted).
- The April consensus forecast lowered previously projected 2008-09 revenues by $66.5 million.
- The first two months of the fiscal year continue the trend begun in June with very little year-over-year growth in the economy-based taxes.
- The slow unwinding of the housing and financial upheaval along with higher gas prices pushes the economy to the brink of recession.

2007-08 RECAP

- A significant slowdown in the economy meant the healthy surpluses of the last several years would not be repeated.
- Collections were $68.3 million above the forecasted $19.8 billion of general fund revenues.
- Rising food and gas prices this spring and summer really took a toll on Sales and Use Tax collections in the second half of the fiscal year.
- A conservative budgeting approach in the face of strong economic headwinds, meant the state avoided the sizable shortfalls many states experienced, including most of our neighboring states.

2007-08 RECAP (Continued)

- Here's how key revenue items turned out ($ million)

	Budgeted	Actual	Difference
Personal Income Tax			
Withholding	$9,220.1	$9,300.4	$80.3
% Growth	4.0%	5.0%	
Non-Withholding *	$3,467.6	$3,565.1	$97.5
% Growth	2.5%	5.4%	
Net Collections**	$10,895.1	$10,902.3	$7.2
% Growth	3.7%	3.8%	
Sales Tax			
Gross Collections	$8,663.9	$8,588.0	($75.9)
% Growth***	2.9%	1.7%	
Corporate Income Tax	$1,050.4	$1,111.7	$61.3
% Growth***	-1.1%	-0.9%	

*Quarterly estimated payments plus April 15 tax remittances.
**Collections less refunds and transfers
***Baseline growth rates (adjusted for tax law changes and one time collections).

2007-08 RECAP (Continued)

- The budget forecast had anticipated a slowdown in the economy-based taxes. It is noteworthy that North Carolina was one of the last states to feel the impact, which was different compared to past slowdowns where the state would be one of the leaders heading into a slowdown.
- The sales tax forecast anticipated the cutback in consumer spending due to residential real estate woes. However, the rapid increase in prices at the gas pump this spring was not anticipated. Forecast models did not expect crude oil prices to grow to nearly $150 per barrel driving pump prices to over $4 per gallon this summer.
- Employment woes in the real estate, construction, and financial sectors began to impact personal income withholding collections early in the fiscal year. The impact was gradual and mostly anticipated by the forecast model. By the final quarter, monthly collections were falling well below long term trend (6.4%) as the slump in these sectors continued to worsen.

2007-08 RECAP (Continued)

- To conclude, FY 2007-08 became the tale of two halves. The first halve of the fiscal year performed better than anticipated where surpluses grew to $150 million. It appeared the state might avoid the problems caused by a stumbling national economy.
- Unfortunately, housing woes and financial sector failures coupled with rising food and gas prices began to take a toll on state collections. Most notably, the growth in sales tax collections began to fall and income tax withholding growth stalled.
- The slowdown, which started in earnest the second half of the fiscal year, reduced the $150 million revenue surplus to $68.3 million by the end of the fiscal year.

2008-09 Revised Revenue Estimates Continue Cautious Approach

- 2008-09 revenue forecast was revised downward by $66.5 million
  - Revised: $20,869.5
  - Original: $20,936.0
- Estimates reflect consensus outlook of Governor's Budget Office and Fiscal Research Division.
- Forecast philosophy was to remain cautious recognizing much of the State's economic difficulties were still ahead of us. This resulted in lowering the already cautious 2008-09 forecast from 4.6% growth to 3.5%.
- Budget decision makers agreed to reserve an additional $45 million as a precaution against further deterioration in the State's economy.
- Baseline (economy-based) General Fund Revenue Growth and 2008-09 forecast 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%	4.2%	3.3%

How Do 2008-09 Revenues Look So Far?

- The first months of the fiscal year are the least important months as an indicator of revenue trends for the fiscal year.
  - The major receipts in these months (sales, withholding tax) closely track the experience of the last few months of the prior fiscal year.
  - Volatile revenue sources (corporate income, non-withholding personal income tax), do not show up until the second half of the fiscal year.
  - With these qualifiers in mind, we can say that net withholding and sales tax collections in July and August are running $110 million behind their $2.6 billion target and September is expected to follow this trend.
  - Note that nearly half of this short fall is a result of timing with respect to payments of sales tax refunds (nearly $40 million) and local government sales tax reserve payments. This means the economy-based, gross collections are approximately $60 - $70 million below target.

How Do 2008-09 Revenues Look So Far?

- Economy-based taxes continue to show the effects of a sluggish economy.
  - Baseline sales tax growth for July-August was flat at (0.1)% vs. 4.0% growth last year (see page 16).
  - Withholding tax growth has fallen considerably and is at 3% compared to 8% last year. There are many contributing factors, but financial and construction job markets are the leading source of this drop in revenue growth (see page 17).
  - Real estate conveyance tax collections, while not a part of the general fund, continue to reflect the struggles in the housing market (see page 18).

2008-09 Forecast Assumptions

- In May, national forecasts projected that the worst of the economic troubles plaguing the nation would be behind us by summer's end and sluggish, but positive, economic growth could be expected through the rest of the forecast period.
- North Carolina seemed to be affected less by the housing slump than some states (California, Arizona, Florida), and was expected to avoid slipping into a recession like these states and others scattered across the Midwest and Northeast.
- This was not to say that the loss of household wealth from the real estate slowdown would not impact consumer spending growth. In fact, sales tax growth, excluding tax law changes, was expected to be only 3.1% compared with the long growth of 5.6%.
- Additionally, the forecast anticipated that sub-par job growth due to a soft economy would lead to lower growth of personal income tax collections.

2008-09 Forecast Assumptions (continued)

- Corporate profits were forecast to grow at only 2.4%. This modest growth assumes that input prices will moderate and the economy, both nationally and globally, does not slip into a recession.

- The May forecast cautioned that there were risks to the State's economic well-being, which included a variety of economic and non-economic events. Namely:
  - Significant energy and commodity price increases;
  - Continued decline in housing markets;
  - Further tightening of consumer credit;
  - Financial market disruptions;
  - A weakened economy is also susceptible to external shocks such as terrorist attacks, global conflicts, or Katrina-like natural disasters.

- The forecasting/budgeting philosophy was to adopt a cautious approach in light of these potential risks.

Economic Outlook

- Some of the State's industry sectors, once thought resistant to the national housing and financial market meltdown, are now showing signs of vulnerability.
- Weak housing, high commodity prices (both gas and food), and tight credit are taking a toll on consumer spending. This is beginning to cause some disruptions in the service and retail sectors.
- The national economy is expected to grow at no more than 1 or 2% through 2009 according to most forecasters. Moody's economy.com forecast envisions only 1.2% growth in the State's gross product in 2008 and 2.9% for 2009.
- Thus, employment growth may stall causing personal income tax growth to slow beyond previous expectations.

Economic Outlook (continued)

- The housing recession has caused a lot of damage to the economy as housing prices fall and consumer wealth is reduced.
  - Recent, albeit preliminary, reports suggest there may be at last a light at the end of the tunnel on housing. Nonetheless, there is still a long way to go before the housing mess is fully behind us.
- The anticipated rise in energy prices came earlier than expected, has lasted longer than expected, and was higher than expected. Consumer confidence plummeted as gas and food prices continued to rise through the spring and summer.
- The fiscal stimulus package rolled out by the Feds this summer may have propped-up capital investment (bonus depreciation), but the rebates may not have had as big an impact on consumer spending as some had hoped.

Economic Outlook (continued)

- While this spring and summer was not good for consumers, there are some potential improvements on the horizon.
  - Housing prices may have bottomed-out and after-tax monthly mortgage payments are at historically lower levels measured as a percent of after-tax income.
  - Financial market interventions by the Fed (including Fannie and Freddie) have lowered mortgage rates and further improved housing market prospects.
  - The possibility of low lending rates, lower gas prices, and lower grocery bills may lead to improved consumer confidence and provide sufficient stimulus to keep us out of a recession.

Economic Outlook (continued)

- Well below normal economic growth is expected for the remainder of 2008 and 2009: 0% to 2 % inflation-adjusted growth instead of 3%. Many economists think the probability of a recession remains high. The global economic slowdown, unstable commodity prices, and the financial market turmoil could prove troublesome.

- Exports continue to support economic growth, but the slowdown in both developing and mature international markets fuels recession concerns in the U.S.

- This means the economy will remain at risk, especially consumer spending, for the following reasons:
  - the loss of household wealth, a result of the prolonged real estate recession;
  - tighter consumer credit from the sub-prime/foreclosure debacle;
  - weak income growth from a soft labor market; and
  - elevated food and energy prices.

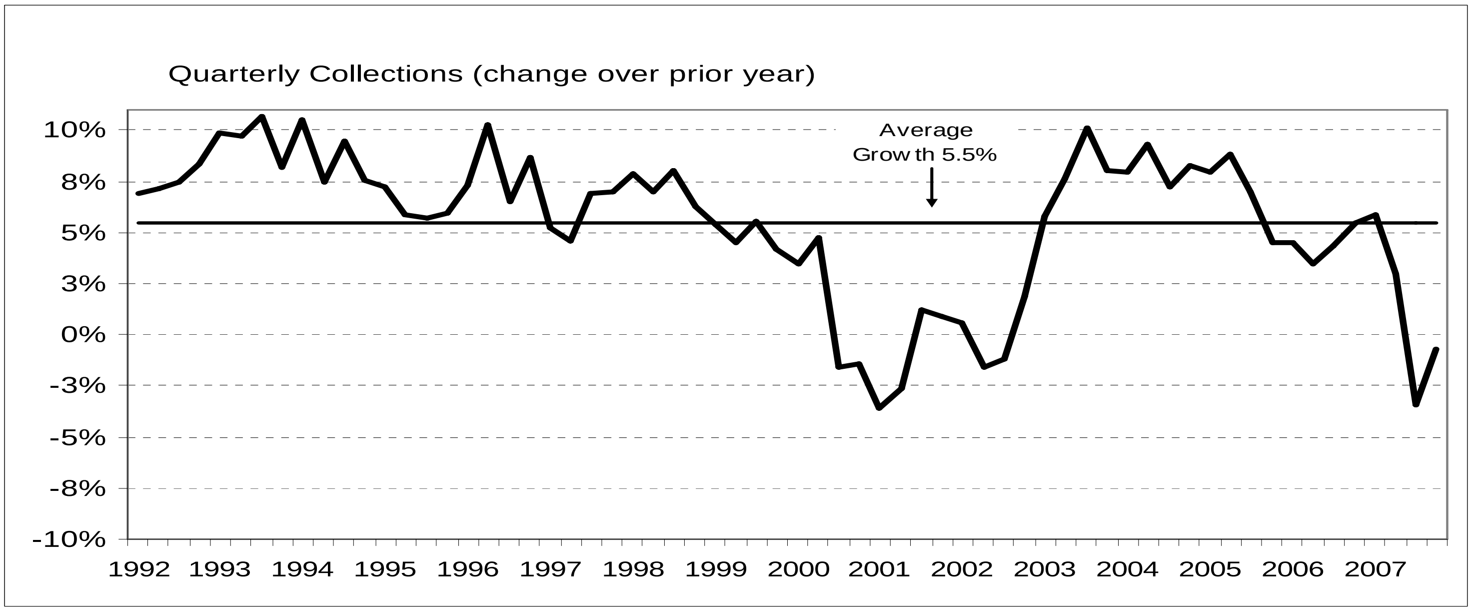
- These economic conditions will lead to below average growth in employment and a growing number of people unemployed.

Things to Watch

- The severity of companies pulling back on employment if the slowdown worsens and product demand declines.
- Any new spikes in energy prices, including both gas and heating fuels, will be hard on consumers & businesses.
- Will housing finally rebound improving residential construction or will tighter credit hurt both residential and commercial construction?
- Will the State’s labor market continue to weaken, and how much impact will the weak labor market have on the State’s wage & salary growth?

Key Revenue Collection Trends

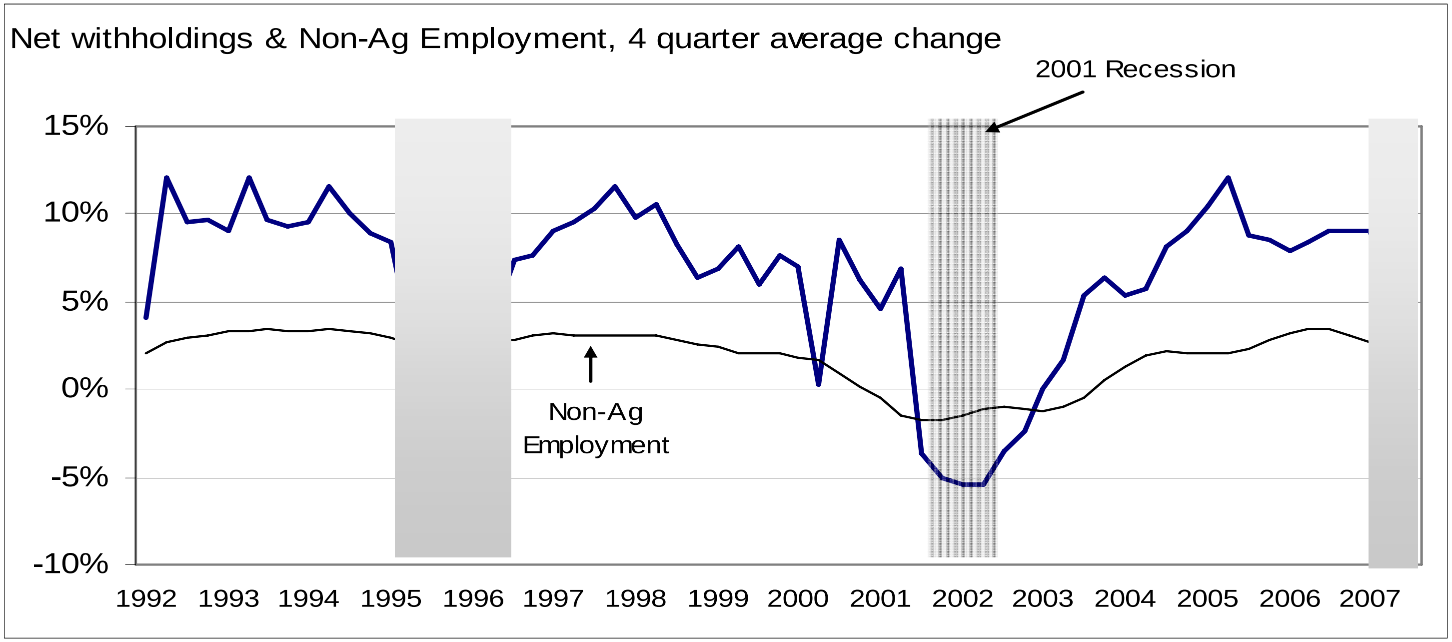
Sales & Use Tax Collections
(adjusted for tax law changes)



Sales tax collections go negative the last quarter of FY 2007- 08 with only a modest rebound to start the new fiscal year.

Key Revenue Collection Trends (Cont.)

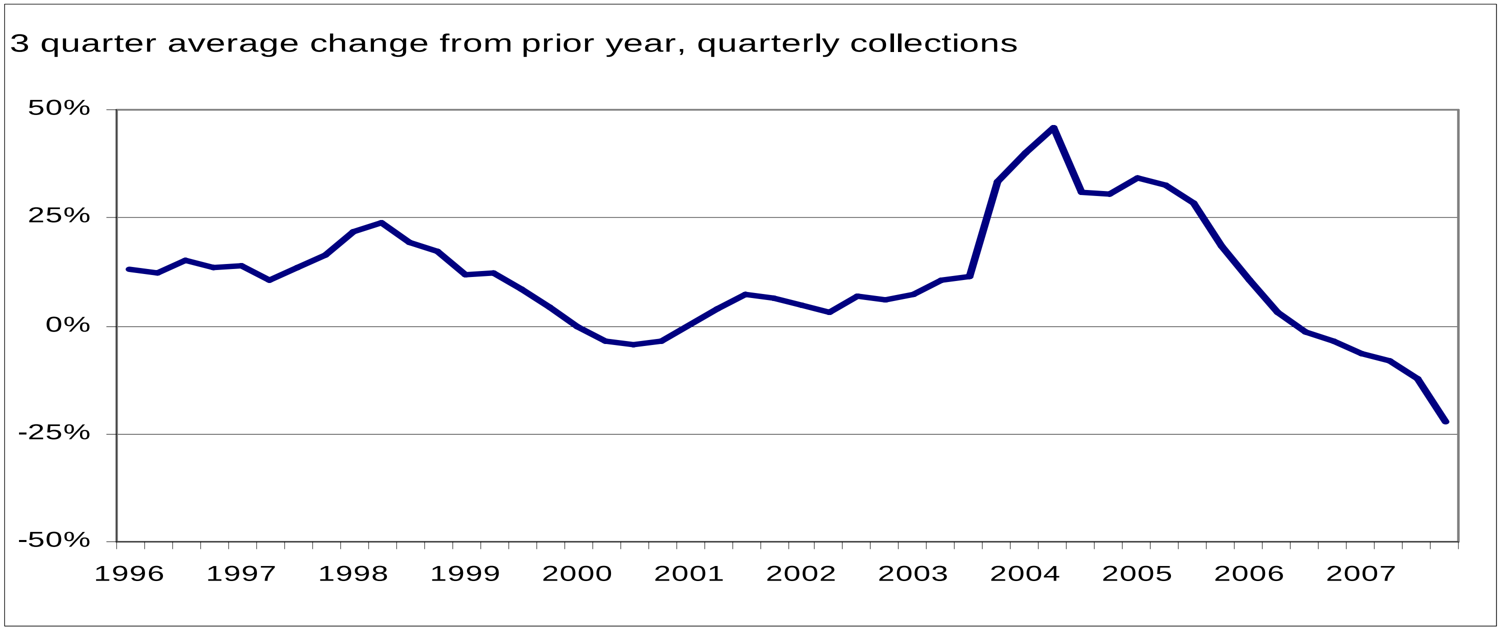
Withholding Tax Receipts



Withholding continues its downward trend coinciding with the slowdown in Non-Ag employment growth.

Key Revenue Collection Trends (Cont.)

Real Estate Conveyance Collections



While the Real Estate Conveyance tax is not part of the General Fund, it does illustrate the impact of the housing slump on these collections and in turn the potential impact on other real estate related activity such as residential construction and retail furniture sales.