GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

September 2009

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Highlights

- The first two months of the fiscal year continue the trend established in the last quarter of FY 2008-09 with negative year-over-year growth in the economy-based taxes.
- The May consensus forecast anticipated an additional 1% decline for 2009-10 in General Fund revenues (-1.7% baseline).
- FY 2008-09 General Fund revenues were $3.22 billion below the $20.85 budgeted amount. The fall in revenues represents an unprecedented 10.8% decline over the previous year.
- The latest expectations are that the recession is over, but it will continue to feel like we are still in a recession as current economic conditions show little sign of recovery. These conditions are expected to persist through this fall and well into 2010.

How Do 2009-10 Revenues Look So Far?

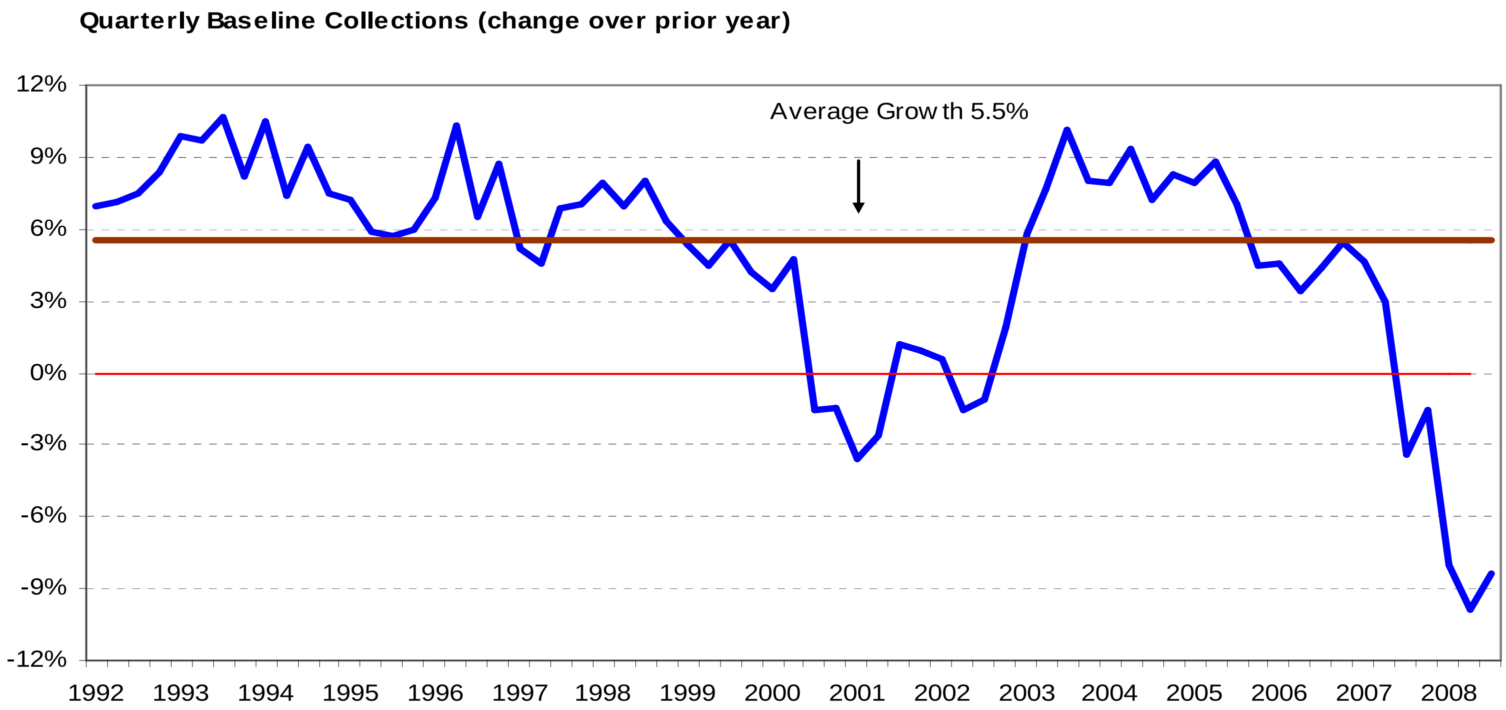
- The first months of the fiscal year are the least important months as an indicator of revenue trends for the fiscal year.
  - The major receipts in these months (sales, withholding tax) closely track the experience of the last few months of the prior fiscal year.
  - Volatile revenue sources (corporate income, non-withholding personal income tax), do not show up until the second half of the fiscal year.
  - With these qualifiers in mind, collections in July and August are running right on target up $6 million over a $2.57 billion target.
  - While the two months met budget targets, targets were set quite low and net collections were down 2.5% from last year.
  - Note that the first quarter of this fiscal year is expected to be the worst collection period as we slowly work our way out of the recession.

How Do 2009-10 Revenues Look So Far?

- Economy-based taxes continue to show the effects of an economy in recession.
  - Baseline sales tax growth for July-August was down 11% vs. a 0.75% decline last year (see page 4).
  - Withholding tax collections continues to erode and are 3.8% below last year. There are many contributing factors, but mounting job losses are the leading source of this drop in revenue growth (see page 5).
  - Real estate conveyance tax collections, while not a part of the general fund, continue to reflect the ongoing struggles in the housing market (see page 6).

Key Revenue Collection Trends

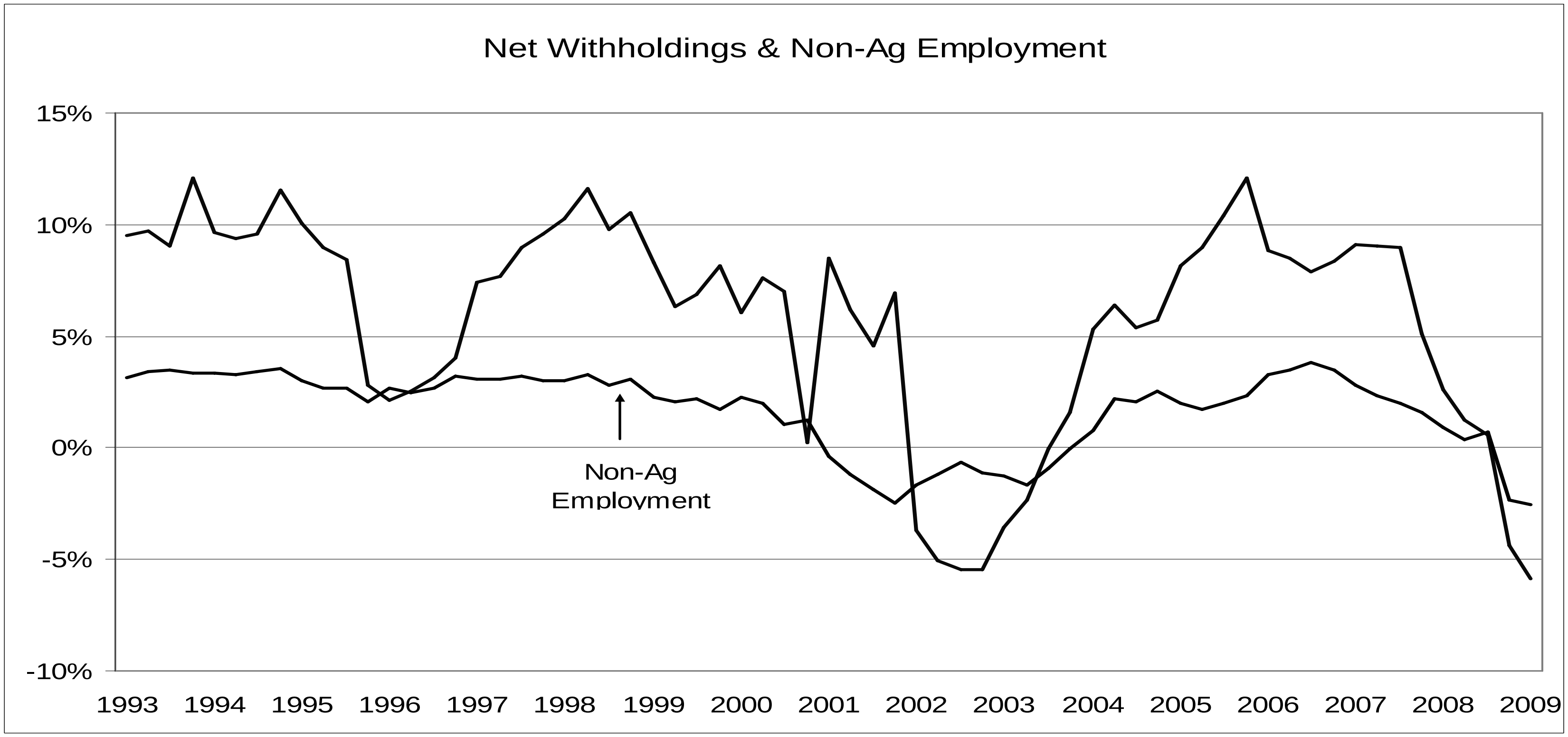
Sales & Use Tax Collections (adjusted for tax law changes)



Sales tax collections continue to plummet throughout the 2008-09 fiscal year.

Key Revenue Collection Trends (Cont.)

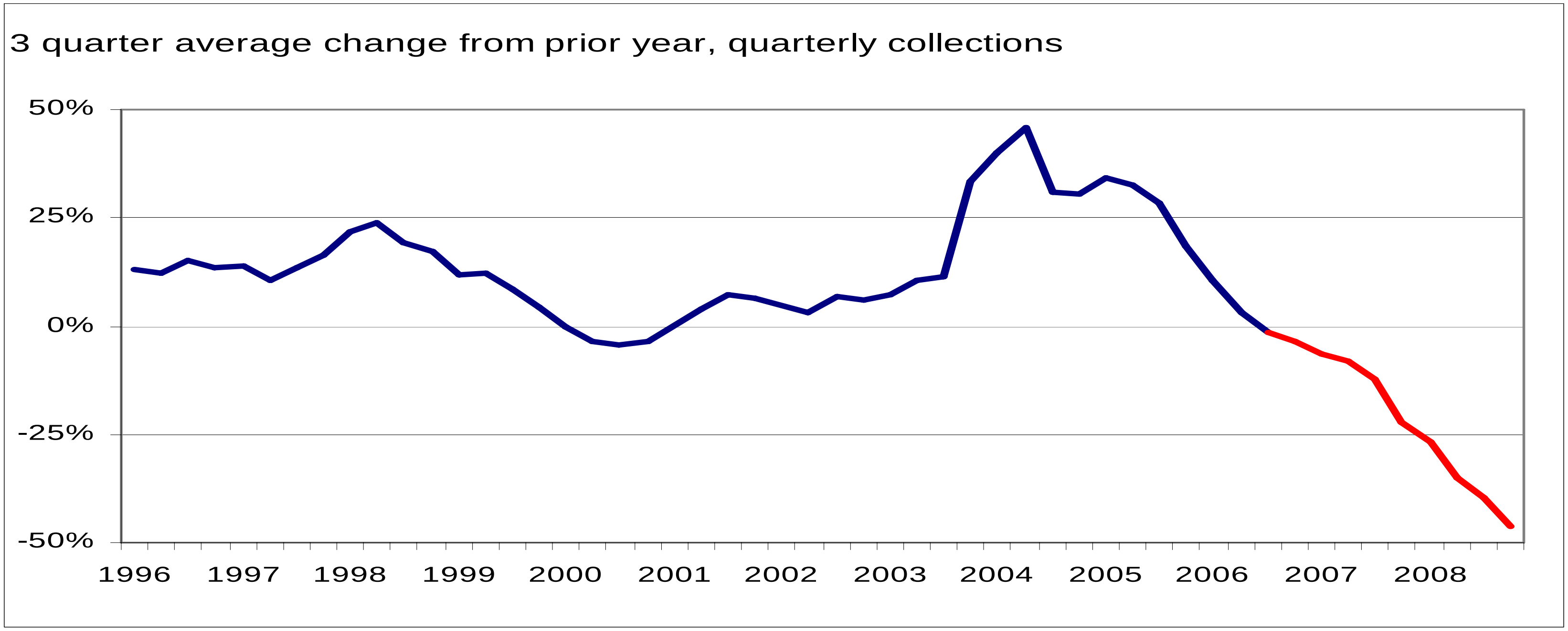
Withholding Tax Receipts



Withholding continues its downward trend coinciding with the decline in employment.

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 impact on other real estate related activity such as residential construction and retail furniture sales.

Revenue Estimates Take Cautious Approach

- Estimates reflect consensus outlook of Governor's Budget Office and Fiscal Research Division.
- Forecast philosophy was to take a cautious approach recognizing much of the State's economic difficulties were still ahead of us. This resulted in a 2009-10 baseline forecast dropping another 1.9% off of 2008-09's decline of 10.0%.
- Baseline (economy-based) General Fund revenue growth and biennium forecast are shown below.

01-02	02-03	03-04	04-05	05-06	06-07	07-08	08-09	09-10	10-11
-6.2%	- 0.4%	5.7%	9.4%	12.1%	9.2%	4.2%	-10.0%	-1.9%	3.2%

2009-10 Forecast Assumptions

- The forecast assumed that the worst of the recession would be behind us at the start of the new biennium, yet there would remain a long way to go before a full recovery would be underway.
- Based on various surveys of national forecasters indications were that a national economic recovery was unlikely until the last quarter of 2009. We agreed with this scenario and anticipated the State's experience would track closely with the national picture.
- The May forecast risks relate to the length of time for an employment recovery which can lag significantly behind the onset of an economic recovery.
- The forecast assumes that an employment recovery would not be underway until the second half of 2010 though monthly losses would begin to improve by the third quarter of 2009.
- Because employment is closely tied to personal income, little growth was forecast in withholding collections and overall personal income collections are expected to decline another 1.5% in 2009-10.

2009-10 Forecast Assumptions (continued)

- Corporate profits were forecast to be basically flat coming off a 25% decline last year. Despite the onset of a recovery, long-term losses sustained during the recession will continue to suppress corporate profits.
- Putting all these assumptions together leads to an estimated 1.9% lower baseline in General Fund revenues for 2009-10, and weak 3.2% growth in 2010-11. These rates compare to 9.2% in 2006-07, 4.2% in 2007-08 and the current unprecedented decline of -10.0% for 2008-09.
- The biggest risk to the forecast is the possibility of a double-dip or W-shaped recovery. Thus, the economy could have a brief period of recovery 1 or 2 quarters and then slip back into a recession.
- The fact that the structural difficulties that lead us into a recession, the housing and financial market upheavals, still have a way to go before they are stabilized makes a W-shaped recovery a possibility.

FY 2008-09 RECAP

- The Great Recession, which began in December 2007, caused unprecedented declines in the State's economy-based taxes.
- Collections were $3.2 billion below the forecasted $20.8 billion of general fund revenues. The decline was 10.8% below last years collections.
- Looking over collections dating back to 1971, the state has never experienced a fall-off in collections of this magnitude. Of the previous two recessions, only the most recent recession in 2001-02 had a major budget shortfall at 6.2% (baseline).
- A major contributor to the shortfall was the April 15 final payment checks which were 39.7% below last years. This compares with 20% declines in the previous two recessions.

2008-09 RECAP (Continued)

- The 2008-09 budget forecast had anticipated a slowdown in the State's economy, but not a major recession. It is noteworthy that North Carolina was one of the last states to feel the downturn's impact, which was different compared to past slowdowns where the State would be one of the leaders heading into a slowdown.
- The revised May 2008 forecast downgraded collections from a overall growth rate of 4.5% to 3.2%.
- Employment woes in the real estate and construction sectors from the ongoing housing recession had begun to moderately impact personal income withholding collections early in the fiscal year.
- Thoughts were that most employment losses would be constrained to those two industries.
- The global financial market collapse of September 2008 altered the severity of the recession globally, nationally and here in the state.

2008-09 RECAP (Continued)

- Any thoughts of a mild recession were dashed with the collapse of the international financial markets as private activity from consumers and investors came to a halt.
- The Great Recession was now underway as economies across the globe had to begin a lengthy process of unwinding the structural deficiencies in the interrelated housing and financial markets.
- Tremendous loss of wealth was occurring as a result of housing losses and the subsequent equity market retrenchment from the financial sector debacle.
- The table on the following page highlights the length and severity of the current recession as compared to recent recessions and the depression of the 1930s.

The Great Recession

Start	End	Months	% Non-Farm Employment Loss*
August-29	**Mar-33**	**43**	**-32.2%**
Nov-73	Mar-75	16	-1.4%
Jan-80	Jul-80	6	-0.2%
Jul-81	Nov-82	16	-1.8%
Jul-90	Mar-91	8	-1.0%
Mar-01	Nov-01	8	-1.2%
Dec-07	**?**	**20+**	**-4.7%**

This recession will be the worst on record in terms of length and employment loss, but it will not come close to the job losses experienced during the Great Depression

*1929-1933 estimated using annual employment data from the Historical Statistics of the U.S. 1973-2001 estimated using Bureau of Labor Statistics. 2007-2009 estimated using an employment forecast by Moody's economy.com

2008-09 RECAP (Continued)

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

	Budgeted	Actual	Difference
Personal Income Tax			
Withholding	$9,658.5	$9,115.8	$(542.7)
% Growth	3.8%	(2.0%)	
Non-Withholding *	$3,717.7	$2,571.6	$(1,146.1)
% Growth	4.3%	(27.9%)	
Net Collections**	$11,386.2	$9,474.0	$(1,912.2)
% Growth	4.1%	(13.1%)	
Sales Tax			
Gross Collections	$8,861.4	$8,012.3	($849.1)
% Growth	3.1%	(6.7%)	
Corporate Income Tax	$1,191.5	$836.2	$(355.3)
% Growth	2.4%	(25.0%)	

*Quarterly estimated payments plus April 15 tax remittances.
**Collections less refunds and transfers

Economic Outlook

- The nation has been mired in the longest, sustained period of economic contraction since the depression of the 1930s.
- It is likely the recession is coming to an end and a recovery will be underway by the 4th quarter of this year.
- As we move from the recession phase into the expansion phase of the business cycle investment and production will be the first areas to recover. Usually, employment lags from 3-6 months behind the start of the recovery
- In the 2001 recession, it was 19 months after the recession ended before the State returned to employment levels realized prior to the recession. According to NC Employment Security Commission records, as of July 2009, the State employs 228,599 fewer people than before the start of the recession (a 5.3% decline).

Economic Outlook (continued)

- The intensity of the recession is clearly easing, but a robust recovery is not on the horizon.
- Purchasing manager surveys and studies by the regional Federal Reserve banks suggest that the decline in manufacturing orders are slowing and some sectors are seeing a modest uptick.
- Recent improvements are primarily related to increases in global demand and businesses no longer reducing their current inventory levels.
- Additionally, increased government spending is having some short term success in abating widespread losses.
- Employment has yet to respond to the improvement, though layoff announcements are fewer and monthly job losses are smaller than they were a few months ago.

Economic Outlook (continued)

- While chances for a near-term recovery are increasing, the economy still faces significant obstacles and the prognosis is for limited growth over the next 4-6 quarters.
  - North Carolina is expected to see a continued decline in Gross State Product for this fiscal year and a modest rebound that is well below the long term average the following year.
  - The State's employment picture will remain bleak as yet another jobless recovery takes hold. Various State forecasts peg double digit unemployment rates for the rest of this fiscal year and into the next year as well.
- Coming out of the 81-82 recession economic growth was at 6%, nearly twice the long-term rate. This time around weak consumer demand will undercut the potential for a robust recovery.

Economic Outlook (continued)

- In fact, the main cause of the slow growth scenario is weak consumer demand, which represents 70% of economic growth (GDP).
- Here are some of the reasons consumer demand is expected to remain weak for most of 2010 and into 2011.
  - Fiscal stimulus programs will only have a temporary impact on spending.
  - It will take quite a while for normal credit flows to return so consumers will continue to face tight credit markets
  - The destruction of household nest eggs from falling housing and equity prices means increased saving and less spending in the future
    - This transition may hold back spending for years
  - Unemployment, job security, and low income growth will continue to take a toll on consumption.

Things to Watch

- The May revenue forecast was built on a scenario where the State's economic conditions gradually improve starting the 2nd quarter of the fiscal year. For that to happen employment losses will have to abate, wage & salary incomes will need to show year-over-year improvements and consumer spending on items in the sales tax base will have to begin a modest rebound.
- The financial sector is still on shaky ground and will remain under duress as the credit losses continue to mount. Another major setback in the financial sector could severely hamper the economic recovery.
- Housing appears to have bottomed-out and finally is starting to show some signs of life. An improving residential market could bolster consumer confidence and provide some stimulus to consumer spending.
- Employment in the State's traditional manufacturing sectors such as textiles and furniture will be very slow to recover. "New economy" industries like high-tech mfg. and research-based industries, which have increased their presence in the state over the last decade, may help lead the state to a recovery. Look for the struggling financial sector to reverse employment losses in the later part of 2010.