

GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK

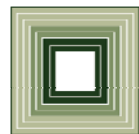


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Overview

- Revenues for the first quarter of the fiscal year are one percent below target.
- Sales tax collections and withholding income taxes continue to tumble as employment woes drag on.
- The first quarter of the fiscal year was projected to be the worst quarter with economic conditions slowly improving the rest of the year.
- The consensus is the recession ended in August, even though current economic conditions show few signs of a recovery. Unfortunately, recession-like conditions may be with us the rest of the fiscal year.

How Do 2009-10 Revenues Look So Far?

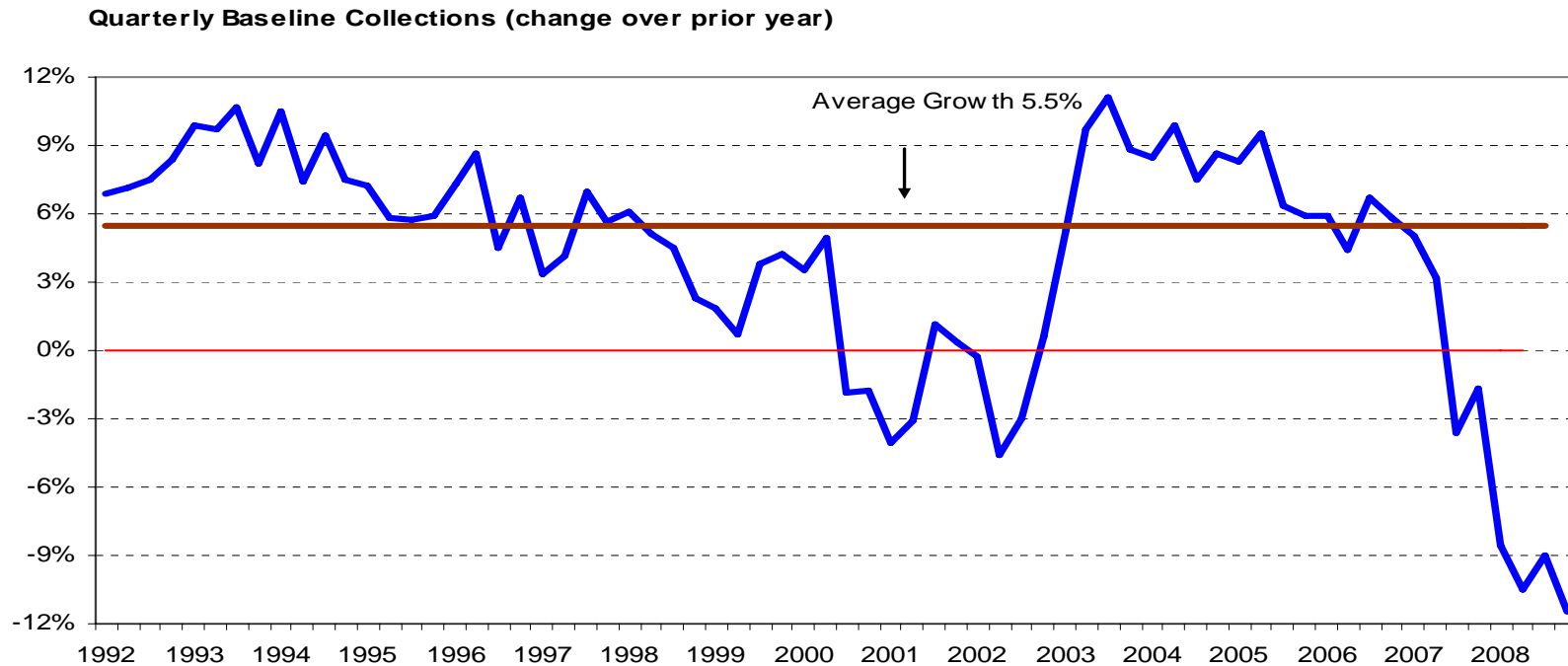
- Collections through September are running \$45 million below a \$4.2 billion target.
- While the first quarter was only slightly below target (down one percent), the target was set quite low and net collections were down 4.1% from last year (\$4.20 vs. \$4.38 billion last year).
 - Caveats:
 - The first quarter of this fiscal year was expected to be the worst collection period as we slowly work our way out of the recession.
 - This quarter is not a reliable indicator of revenue trends for the full fiscal year. Mainly because volatile revenue sources (corporate income, non-withholding personal income), which make up 25% of total collections, do not show up until the second half of the fiscal year.
- North Carolina is faring better than many states according to a recent report by the National Association of State Budget Officers. Some states are experiencing 1st quarter budget shortfalls in the 8-10% range.

How Do 2009-10 Revenues Look So Far?

- Economy-based taxes continue to show the effects of an economy in a recession.
 - Baseline sales tax growth for July-September was down 11.5% vs. a 1.7% decline last year (see page 4).
 - Withholding tax collections continues to erode and are 3.5% below last year. There are many contributing factors, but mounting job losses are the leading source of this drop in revenue (see page 6).
 - Employment woes continue with a modest recover not expected until next year (see page 8).

Key Revenue Collection Trends: Sales Tax

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



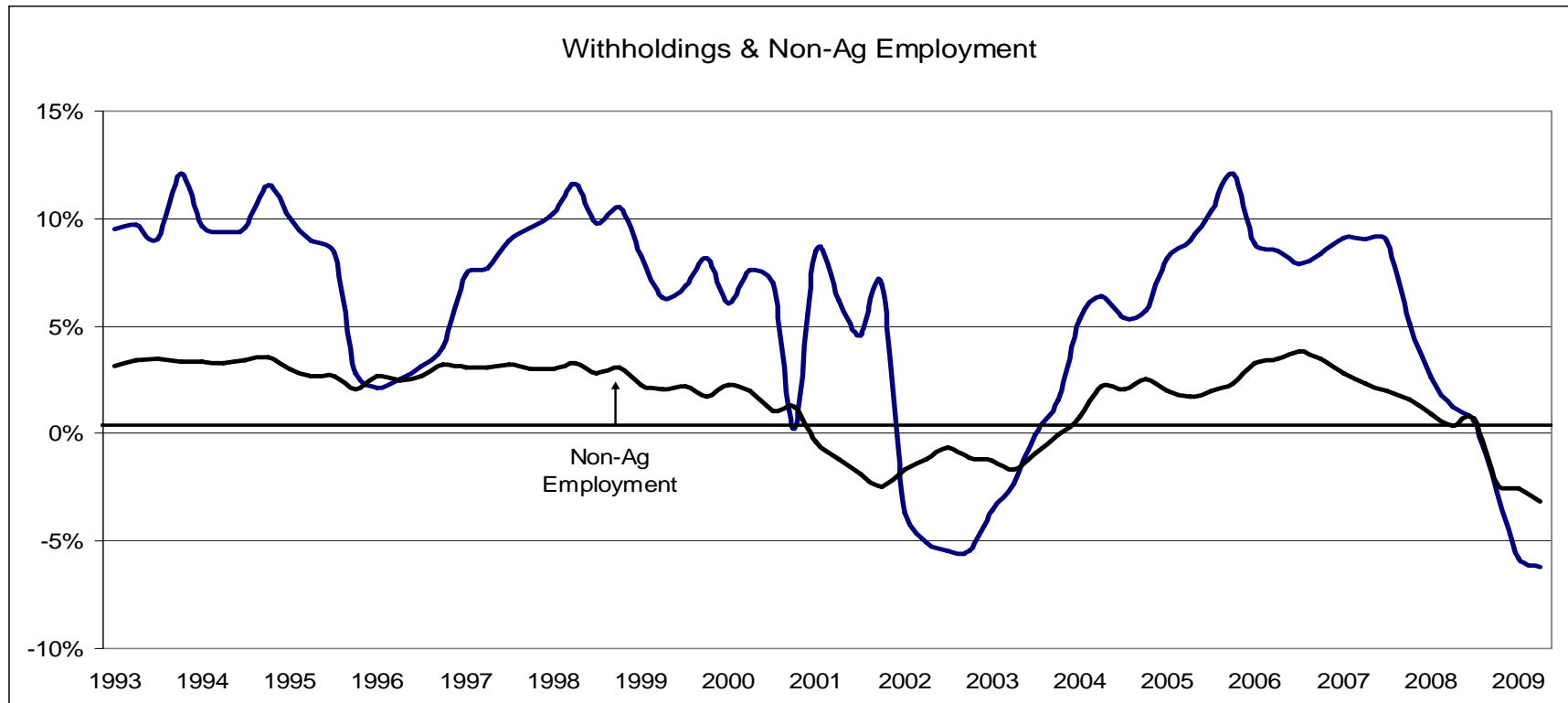
Sales tax collections continue to plummet in the 1st quarter of FY 2009-10.

Key Revenue Collection Trends: Sales Tax

- Sales tax collection continue to perform very poorly in the current economic environment.
- July –September 2009 was the worse quarter for baseline collections since the start of the recession.
- Because of the big drop in collections that began in October 2008 (the onset of the global financial crisis), we expect baseline year-over-year declines to approach a zero growth scenario this next quarter.

Key Revenue Collection Trends: Personal Income Tax

Withholding Tax Receipts



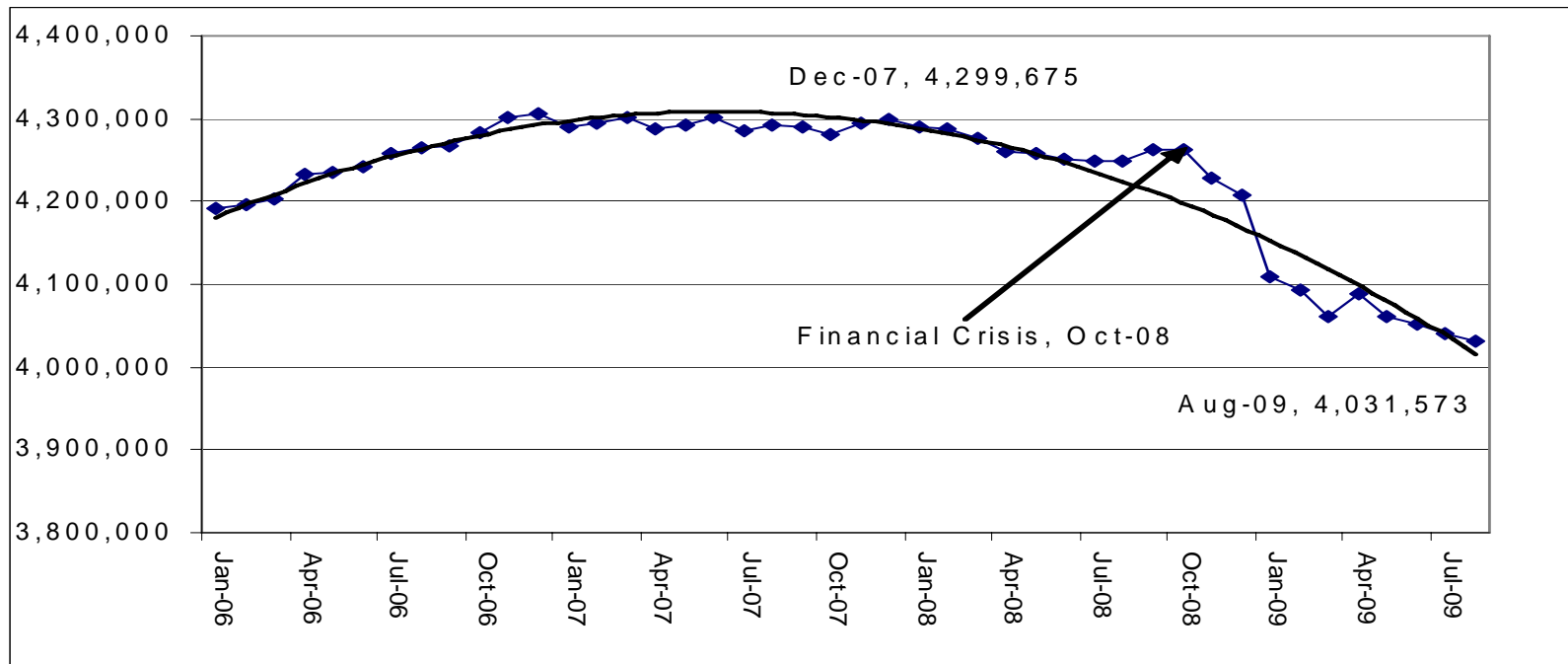
Withholding continues its downward trend coinciding with the decline in total employment.

Key Revenue Collection Trends: Personal Income Tax

- Withholdings (wage & salary income taxes) continue to fall as accelerated withholdings, representing most wage & salary taxpayers, were down 3.3%.
- Through September, net withholding (all wage & salary withholding less refunds) was down 2.4%. This time last year, net withholding was still growing at 1.8%.
- Job losses continue to mount. Until total employment numbers start to grow, withholding taxes will continue to weaken.

Key Revenue Collection Trends (Cont.)

Non-Ag Employment (seasonally adjusted)



Nearly 270,000 jobs lost since start of recession, 230,000 since financial crisis in October 2008. The employment picture will need to improve before income and sales taxes rebound.

Revenue: Things to Watch

- The May revenue forecast was built on a scenario where the State's economic conditions would stop deteriorating and gradual improvement would begin by the 3rd 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 will have to rebound.
 - At this point last year the severity of the recession was just beginning to be felt. The first two months were basically no growth months and through September 2008, revenues had slipped 3.3% below targets and were \$230 million below target.
 - The second quarter (October – December) saw significant erosion in sales tax collections falling 8-9% below previous year collections. Corporate and Individual estimated payments, which had been weak, tumbled to 20-25% below the previous year. State budget shortfall had grown to \$600 million.

Revenue: Things to Watch

- Employment in the State's traditional manufacturing sectors will be very slow to recover. Some "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 in the recovery. The struggling financial sector may not reverse some of its employment losses until the later part of 2010, at the earliest.
 - According to a forecast by UNC-C's economic forecasters, 6 of the state's 10 non-agricultural industry sectors are expected to rebound in 2010 – wholesale & retail trade and services are expected to lead the way.
 - In order for the state to meet its 2009-10 budget forecast, early in 2010, a reversal in employment losses will need to materialize.



Revenue: Things to Watch

- The financial sector is on shaky ground and will remain under duress as credit losses continue from housing corrections and the credit losses brought on by the recession.
 - Another major setback in the financial sector could severely hamper the economic recovery.
- The recovery is anticipated to follow the usual pattern of an investment recovery, followed by an improvement in consumer sentiment, and finally, a recover in the job market.
 - The investment recovery appears underway, but there is still a long way to go for employment to make significant strides.
- Housing appears to be showing some signs of life. An improving residential market could bolster consumer confidence and provide some stimulus to consumer spending, which ultimately will drive-up the demand for employment.

Biennium Revenue Estimates

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

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

Economic Outlook

- The nation has been mired in the longest, sustained period of economic contraction since the depression of the 1930s.
- Most economist agree that the recession has come to an end and a very slow recovery is now underway. The intensity of the recession is clearly easing, but a robust recovery is not on the foreseeable horizon
- 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 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.

Economic Outlook (continued)

- 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 growing smaller with each passing month.

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 drop in Gross State Product for this fiscal year and only 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 early part of next year as well.
- Coming out of the 81-82 recession economic growth was at six percent, nearly twice the long-term rate. This time around weak consumer demand will undercut the potential for a robust recovery. It is looking more like a repeat of the 2001 recession recovery - long and slow.

Economic Outlook (continued)

- One of the main causes of the slow growth scenario is weak consumer demand, which represents 70% of economic growth (GDP).
- Here are some reasons why 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.

Conclusions

- The second quarter of this fiscal year will be important for the state in order to meet its revenue targets for the year.
 - The projections anticipate a bottoming-out of collection declines and the onset of some improvement by December, especially in the sales tax.
 - Starting in October, the 1-cent state sales tax increase begins to show up in monthly collections placing an even greater burden on a sales tax recovery.
- It will continue to feel like we are in a recession for the rest of 2009, but gradual improvements are expected. Robust signs of a recovery are not expected any earlier than the spring of next year.
- Despite the anticipated gradual improvements, a sound expansionary economy is still a year or two away.
 - This Outlook and previous Revenue Outlooks can be found at FRD's website:
http://www.ncleg.net/fiscalresearch/generalfund_outlook/generalfund_outlook.shtml