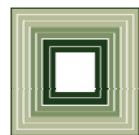


GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK



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A Staff Agency of the North Carolina General Assembly

Highlights

- Even with the economic recovery underway, economy-based taxes remain weak and general fund collections are below the forecast target. They remain at 1.5% below target through November.
- Sales Tax collections are by far the weakest component of the economy-based taxes.
- A national recession persisting for at least 20 months has significantly impacted the State's employment conditions and we are not out of the woods yet.
- Budget pressures mount as the prolonged economic downturn increases demand for those government services related to an economic downturn.

How Do 2009-10 Revenues Look So Far?

- FRD can report that through November, General Fund revenues are running \$110 million below a \$7.4 billion forecast target.
 - Collections have not rebounded from the lows established this summer. Economy-based tax collections reached their largest year-over-year decline this summer and through November have not begun to recover from that low point. Total collections are 1.5% below expectations.

How Do 2009-10 Revenues Look So Far?

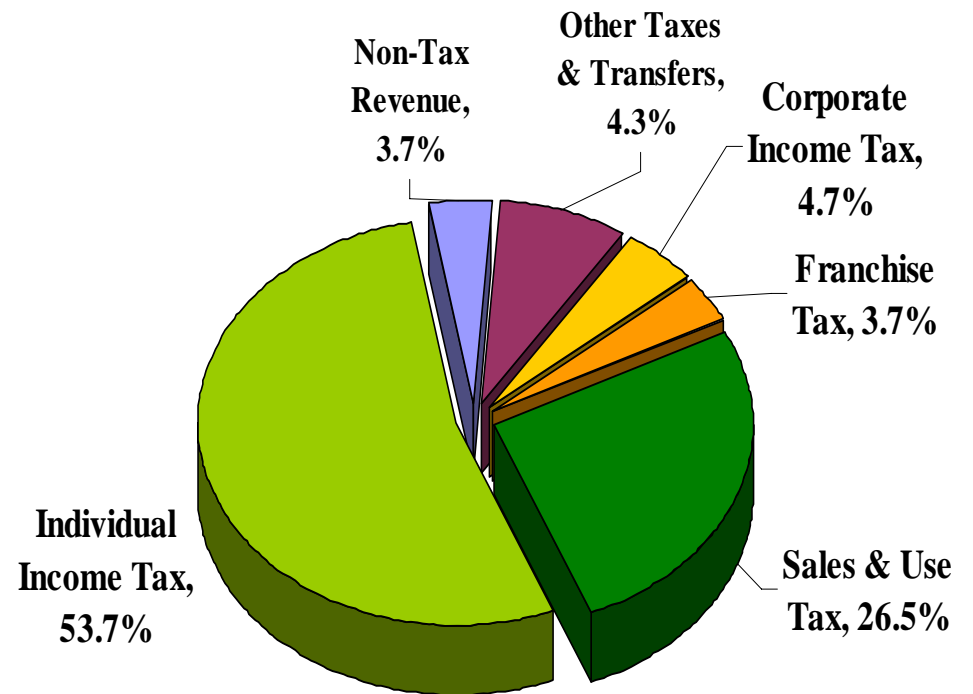
- Income tax withholding on wages and salaries are down 3.8% through November.
 - Monthly and quarterly withholding payments hardest hit (Y/Y 12.4% decline). One reason for this decline is smaller businesses, who pay on a monthly or quarterly schedule, are still not hiring or adding work hours.
- Sales tax collections reflect how this economic downturn has had a big effect on consumers. Baseline collections are down from last year almost 12%.
- Two business taxes, Corporate Income and Franchise tax, are up 6% over last year.
 - Included in that number are one-time tax payments of \$27 million.
 - **The economy's impact on corporate income tax collections will not be fully understood until April 15th final payments.**

How Do 2009-10 Revenues Look So Far?

- Regarding revenues in the first half of the fiscal year, keep these caveats in mind:
 - The first months of the fiscal year are the least important from an end-of-year indicator point of view.
 - Major receipts in these early months (sales tax and withholding tax) closely track the experience of the last few months of the prior fiscal year.
 - Volatile revenue sources such as the corporate income tax and the non-withholding part of the personal income tax do not show up until the second half of the fiscal year.
 - Most of the forecast risk occurs with April final payments and refunds

State General Fund, FY 2008-09

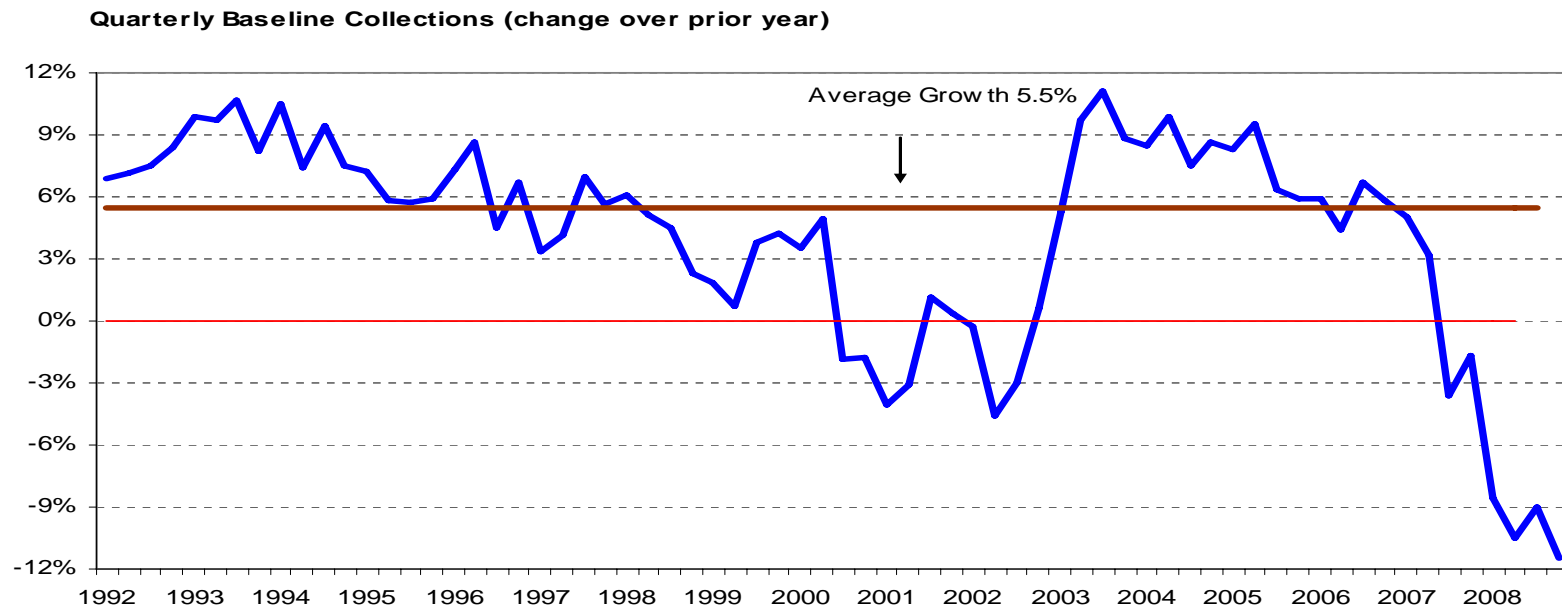
Eighty-five percent of the State's General Fund revenues were derived from the Personal Income Tax, the Sales & Use Tax, and the Corporate Income Tax. These three sources of revenue are directly affected by changes in the economy.



Tracking Economy-Based Collections

It is clear from looking at economy-based taxes that the recession is still impacting consumers. Year-over-year baseline sales tax collections are down 11.7% for the first five months of this fiscal year.

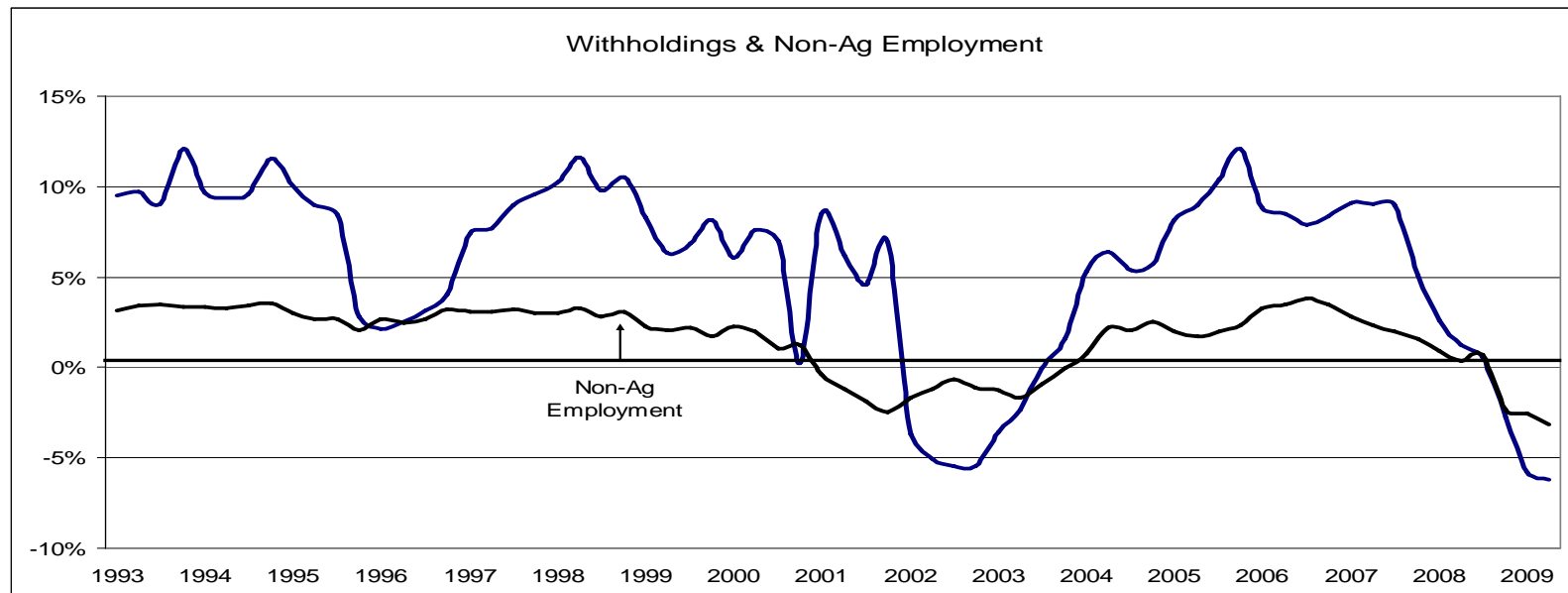
Sales & Use Tax Collections (adjusted for tax law changes)



Tracking Economy-Based Collections (cont.)

Net withholdings (withholdings less refunds) continue to weaken and are nearly 1.8% below a \$3.5 billion target. The recession broadly affected most industry sectors and continues to do so as reflected in the continued drop of wage & salary tax collections.

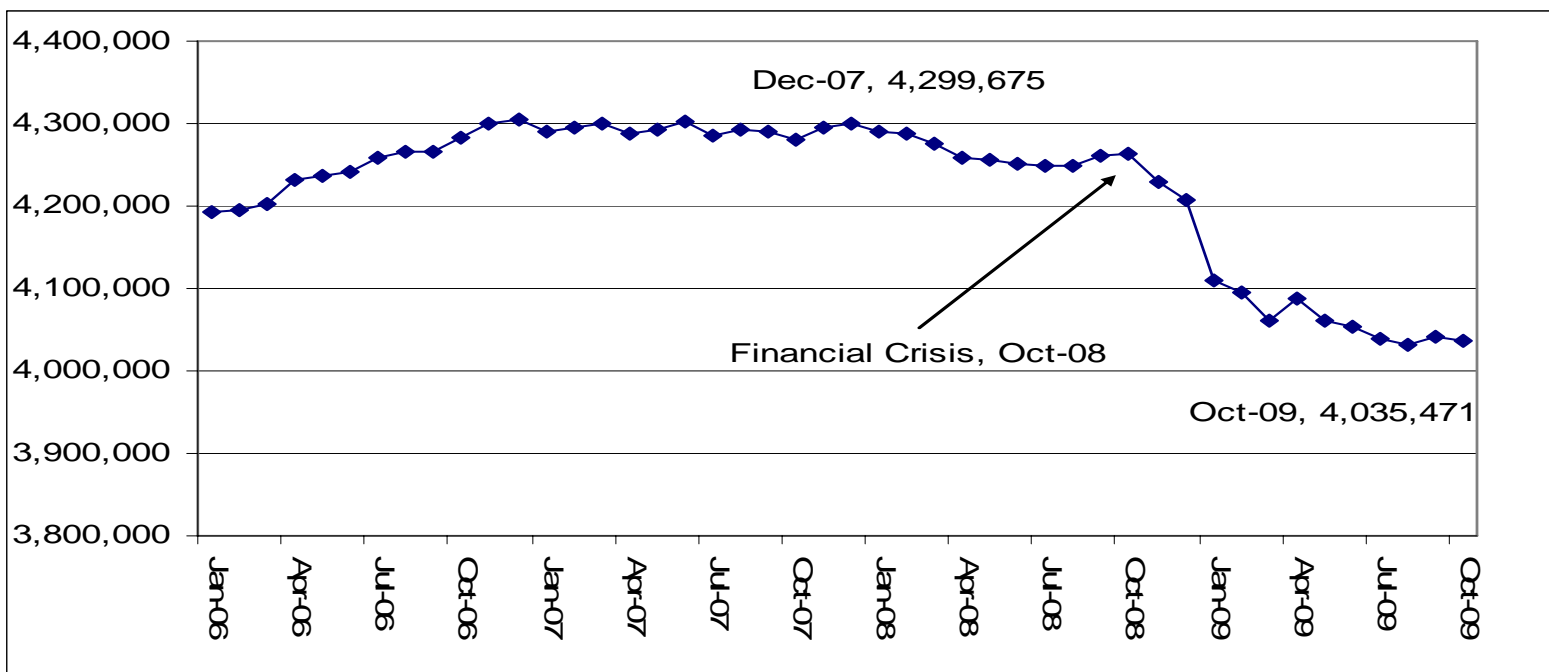
Withholding Tax Receipts



Tracking Economy-Based Collections (cont.)

Nearly 270,000 fewer people employed since start of recession, 230,000 since financial crisis in October 2008. The overall employment picture has a strong influence on income and sales taxes collections.

Non-Agricultural Employment, Seasonally Adjusted



How are other states doing?

- Based on a recent survey by NCSL (Nov. 2009)
 - 43 states are “concerned” or “pessimistic” about their revenue outlook for FY 2009-10
 - 29 states below personal income tax targets
 - 38 states below sales tax targets
 - 21 states below corporate income tax targets
 - 9 states projecting FY 2009-10 budget gaps greater than 5% of their budget
 - 40 states forecasted lower revenues for FY 2009-10 than FY 2008-09

Thoughts on FY 2009-10 Outlook

- In the May consensus forecast, the intensity of the recession was expected to have eased to start the new fiscal year. Moreover, there is now wide agreement among economists that the recession ended sometime in the third quarter of this year. Nonetheless, choppy waters are ahead for some time to come.
 - Housing market problems are still unwinding
 - Employment woes will continue at least into the spring of 2010
 - Consumers continue to cut back on most spending
 - Credit market constraints could slowdown or derail the recovery
- The Feds most recent comments suggest a long slow recovery.
 - “economic recovery likely to remain weak”
 - “inflation will remain subdued”

Why have Sales Tax collections been hit so hard?

- Consumers are suffering the most from current economic conditions.
- Here is why:
 - Weak employment outlook expected through all of 2009 and into first quarter of 2010
 - Lower inflation-adjusted salary & wages than before start of recession
 - Tremendous loss of household wealth from housing recession and equity market losses
 - Very tight credit conditions continue
 - Highest household debt burden on record at start of recession

The Economy and FY 2009-10 Outlook

- The worst of the Great Recession is behind us and optimism grows for a full recovery to be in place by mid-2010.
- Consumers, a key to any recovery, are still trying to lower their debt to match the decline in their household's assets (housing and investments). This will limit the pace of the recovery.
- Financial markets are starting to improve, but are still far from normal.
- It is safe to say that fiscal difficulties are unlikely to abate as recession-related unemployment continues. The result will be the continuation of weak economy-based tax collections.
- As the recession's effects linger well into next year, this will create a difficult fiscal situation going forward.

Thoughts on FY 2010-11 Outlook

- As expected there is no consensus by economic forecasters as to the timing of the recovery, but most agree with the Federal Reserve Board that a protracted, sluggish recovery is ahead of us.
 - Recession-like conditions into the spring of 2010 with some improvement moving into late spring and summer
 - A very sluggish recovery most of 2010, only 2% growth in GDP
 - 2011 is expected to return to near normal growth of 3%
- Under the scenario outlined above, austere revenue conditions would persist. In FY 2010-11, baseline (economy-based) revenue growth is unlikely to rise significantly and is expected to remain below the average of 5 to 6 percent.

State's Economic Outlook

- Many of the State's industries have begun to increase output. This has already had a modest impact on employment.
- For example, the downward trend in initial job loss claims signals an improving employment picture in the not-to-distant future.
- The housing market in the State appears to have bottomed-out earlier this year. Sales are no longer in decline, prices have stabilized and are trending up, and residential construction has stabilized.
- Dr. Michael Walden of NC State University stated in his most recent economic outlook that "In the economic recovery year of 2010, North Carolina will resume its tradition of growing faster than the nation."
- He goes on to caution that there will be regional disparities within the recovery and unemployment rates may reach as high as 11.5% before they begin to gradually fall with a rate slightly under 10% expected by the end of 2010.

State's Economic Outlook

- Thus, positive employment growth is not expected until the second-half of 2010. The State will have a long way to go to reach pre-recession levels given the 6% decline that occurred since the start of the recession.
- Moody's economy.com forecasters envision only 3.1% growth in the State's personal income for 2009 and 3.8% in 2010. This is far less than the 6.0% to 7.0% annual growth from 2004 to 2007.
- Housing and financial service related industries will continue to struggle to get solid footing as we move into 2010.
- The State's economy is expected to slowly rebound over the coming year. Expectations for the future are for the State to consistently outperform the nation as a whole.

Budget Outlook

- Mounting pressures for remainder of FY 2009-10 and beyond:
 - The budget included a 1-cent increase in the State's sales tax rate putting more pressure on this revenue source to rebound in 2010.
 - Expenditures for Medicaid and other income assistance programs may exceed budgeted amounts.
 - Enrollment from people seeking to improve their job-skills has placed added pressure on post-secondary education, especially on the community college system, which is experiencing unprecedented growth.

Budget Outlook

- Mounting pressures for remainder of FY 2009-10 and beyond (cont.):
 - The Unemployment Insurance Fund has borrowed \$1.4 billion from the Feds (projected to reach \$2 billion) by the end of calendar year 2010.
 - A looming issue on the horizon will be the FY 2011-12 revenue picture. Temporary taxes are set to expire, fiscal stimulus money dries up, and early projections indicate revenue growth will not be sufficient to close the gap.