GENERAL FUND REVENUE & ECONOMIC OUTLOOK

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Fiscal Research Division
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Highlights

- As the recession deepens, economy-based taxes push general fund collections below forecast target. Now down 6.1%.
- The National Bureau of Economic Research calls recession start date: December 2007. Forecasts indicate mid to late summer of 2009 is the soonest a recovery can be expected.
- The persistence of the national recession (12 months and counting) continues to weaken the State's economy.
- Budget pressures mount with the likelihood of a prolonged economic downturn and only a sluggish recovery expected in 2010.

How Do 2007-08 Revenues Look So Far?

- FRD can report that through November, General Fund revenues are running $520 million below a $7.2 billion forecast target for the period.
  – Collections continue to follow the downward trend established this summer. The growth in economy-based taxes collections began to slow this summer and November collections continue this trend. Total collections are 6.1% below expectations.

How Do 2007-08 Revenues Look So Far?

- Income tax withholding on wages and salaries has grown 2.8% through November.
  - Monthly and quarterly withholding payments continue to decline (Y/Y 7.5% decline). One reason for this decline is smaller businesses, who pay on a monthly or quarterly schedule, are cutting back.
  - Personal income tax refunds are on the rise – 32% higher than at this time last year.

- Sales tax collections reflect how the economic downturn is having a big effect on consumers. Baseline collections are down from last year 3%.

- Two businesses taxes, Corporate Income and Franchise tax, are down a combined 25% for the year.
  - Current year corporate refunds are up 60%.
  - **The economy's impact on corporate income tax collections will not be fully understood until April 15th final payments.**

How Do 2008-09 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.
    - This means 75% of the forecast risk occurs with April final payments and refunds

How are other states doing?

- Based on a recent survey by NCSL (Nov. 2008)
  - 44 states are "concerned" or "pessimistic" about their revenue outlook for FY09
  - 20 states below personal income tax targets
  - 28 states below sales tax targets
  - 23 states below corporate income tax targets
  - 26 states projecting **FY10** budget gaps greater than 5% of budget
  - 13 states may face budget gaps in FY08, FY09, and FY10 (including Georgia, South Carolina, and Virginia)

Thoughts on FY 2008-09 Outlook

- Since the May forecast, the economy has seen economic headwinds intensify. Some would say they are now gale-force winds (NBER dates recession starting in December 2007, see page 11)
  - Housing prices continue to fall - down 20% nationally over the past two years (Case-Shiller Composite Index)
  - The financial market crisis sends economy reeling
  - Consumers forced to cut back on most spending
  - Widespread global recession now underway
- The Feds continue to undertake important and historical steps to reverse the financial market crisis and thaw frozen credit markets. These may eventually prove beneficial, but will be insufficient to head-off a prolonged and difficult recession.

Fed’s Latest Actions

- On December 16, 2008, the Federal Reserve Board’s Federal Open Market Committee (FOMC) lowered its target for the federal funds rate by at least 75 basis points to a range of zero to 25 basis points, the lowest rate in more than fifty years.

- In doing so, the FOMC cited a deteriorating economy (recession) and improved inflation outlook (diminishing).

- The FOMC also announced it will “employ all available tools to promote the resumption of sustainable growth and to preserve price stability.” The Fed is committing to a continued expansion of its balance sheet to support financial markets and the U.S. economy.

A Consumer Driven Recession

- **Consumers lead nation into recession as they are hit hard by economic conditions.**
  - Falling employment beginning in December 2007 and expected through all of 2009
  - Lower inflation-adjusted wages
  - Tremendous loss of wealth from housing recession
  - 35-40% decline in equity markets
  - Very tight credit conditions continue
  - Highest household debt burden on record

The Economy and FY2008-09 Outlook

- "The economy is suffering its worst setback since the Great Depression." said Mark Zandi, chief economist at Moody's Economy.com in West Chester, Pennsylvania. He adds, "So long as house prices are declining and foreclosures mounting, the financial system will struggle and the economy will be in recession."
- Recession is now widespread affecting every industry and region of the country.
- Financial markets are starting to improve, but still are far from normal.
- Fiscal difficulties are likely to escalate as recession-related unemployment increases and economy-based taxes continue to decline.
- A conservative budgeting/forecasting approach here in North Carolina helped soften the impact, but the recession's effects over the next two years will result in a difficult fiscal situation.

Thoughts on FY 2009-10 Outlook

- Economic forecasters expect a prolonged recession and a sluggish recovery to follow.
  - Recession-like conditions for much of 2009, mid- to late-summer rebound at the earliest
  - A very sluggish recovery the first-half of 2010, only 1% growth in GDP
  - Employment lags behind recovery and does not begin to rebound from recession until the summer or fall of 2010
- Under the scenario outlined above, an austere revenue picture could unfold. In FY 2009-10, baseline (economy-based) revenue growth will be suppressed and would be well below the usual 5 to 6 percent.
- It is highly probable that it will be FY 2010-11, before revenues equal the amount budgeted in FY 2008-09.

Business Cycles and Recessions

Recession Date*	Months
April 1960 – February 1961	10
December 1969 – November 1970	11
November 1973 – March 1975	16
January 1980 – July 1980	6
July 1981 – November 1982	16
July 1990 – March 1991	8
March 2001 – November 2001	8
December 2007 – ?	12 and counting

*The National Bureau of Economic Research (NBER) is a private academic group charged with dating expansions and contractions in the national economy

Business Cycles and State Revenues

NBER Recession Date*	Months	Revenue Shortfall	
July 1981 – Nov. 1982	16	FY 1981-82	-9.2%
July 1990 – March 1991	8	FY 1990-91	-8.1%
March 2001 – Nov. 2001	8	FY 2001-02	-8.8%
December 2007 – ?	?	?	

State’s Economic Outlook

- Many of the State’s industries, once thought resistant to the national housing and financial market problems, are now starting to contract. Employment losses continue to grow.
- The combination of a weak housing markets, tight credit, plus job cutbacks and losses have taken a toll on consumers Spending declines have hurt most of the service and retail sectors. Only educational/health services are expected to add jobs in the coming year.
- Financial services, a stalwart growth industry in the State, has been hit extra hard by the financial market’s troubles. Job losses are now expected for the next 4 to 6 quarters.
- The manufacturing sector continues to shed jobs (a rate of 2% to 4%), but this recession should not accelerate job losses like the last recession in 2001-2002, where manufacturing experienced quarterly declines of over 10%.

State’s Economic Outlook

- Thus, overall employment growth will stall in the State with a slight decline envisioned for this fiscal year and less than 1% in FY 2009-10. This will translate into well below normal growth in personal income.
- 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 for much of 2009.
- The State’s economy is expected to slow significantly over the coming year, but will fair somewhat better than the nation and is expected to consistently outperform the nation in the future.

2008-09 Revised Revenue Estimates Assumptions

- Revenue estimates reflect consensus outlook of Governor’s Budget Office and Fiscal Research Division.
- The forecast recognized much of the State’s economic difficulties were still ahead, which 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.
- General Fund Revenue baseline growth (has tax changes removed) plus the 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%	3.5%

2008-09 Forecast Assumptions and Risks

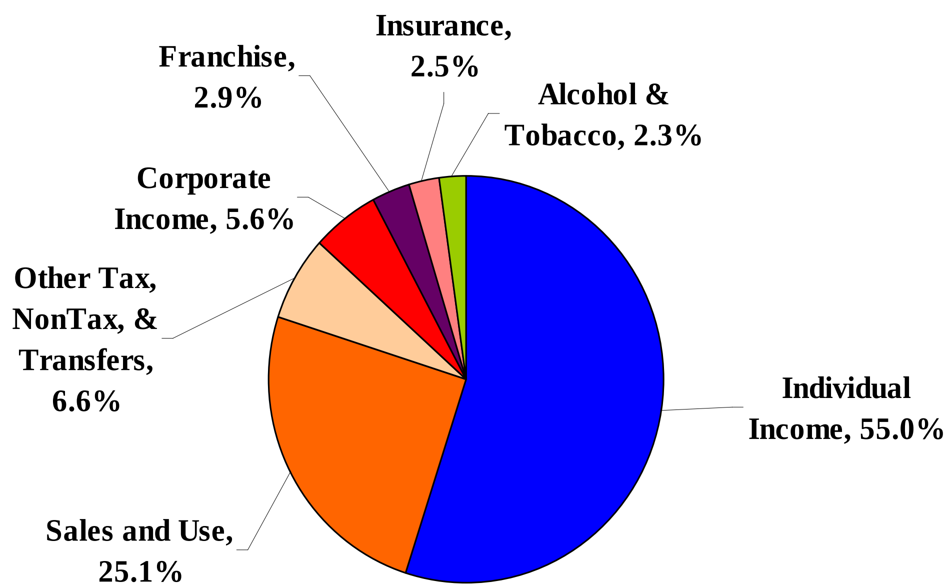
- When lowering the General Fund's growth estimate, the forecast lowered growth rates of economy-based taxes consistent with a moderate downturn and the possibility of a mild recession this summer.

- The forecast envisioned a slow recovery from the economic downturn beginning no later than the first quarter of 2009.

- Thus, the forecast projected below normal growth in the economy-based taxes for 2008-09:
  – 3.8% PIT v. 7.0% trend (baseline)
  – 3.1% SUT v. 5.5% trend (baseline)
  – 2.4% CIT v. 5.8% trend (baseline)

State General Fund, FY 2007-08

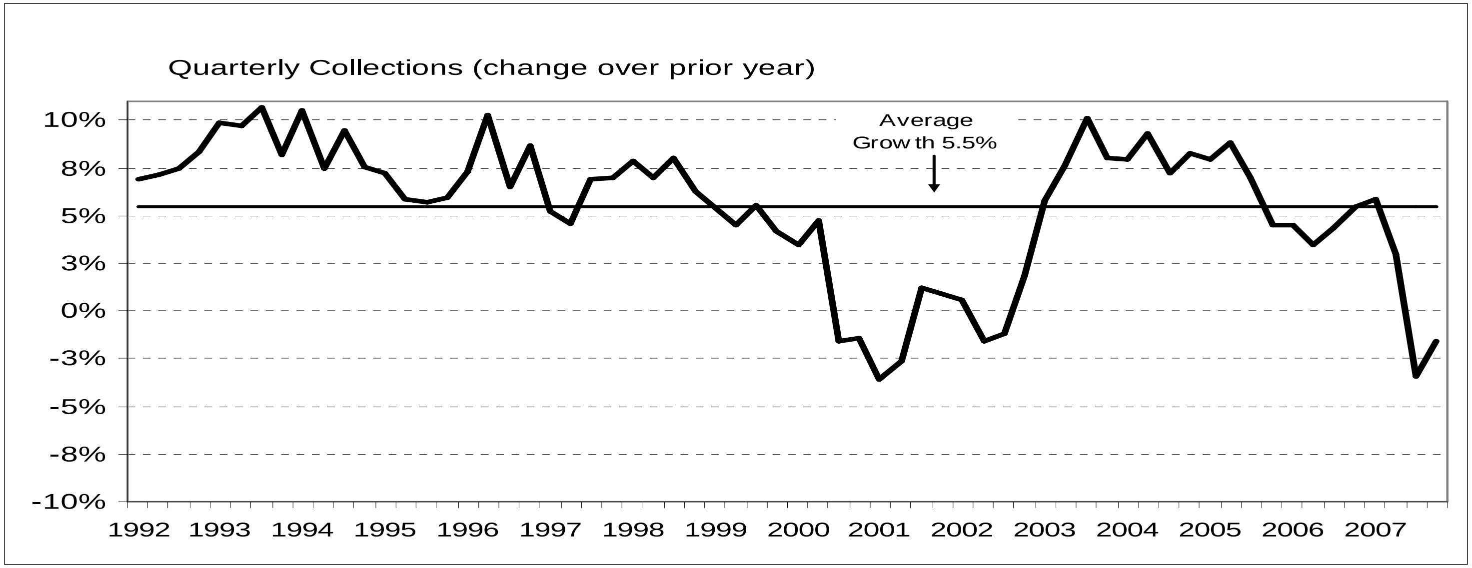
Eighty-six percent of the State's General Fund revenues are derived from the Personal Income Tax, the Sales & Use Tax., and the Corporate Income Tax. These three sources of revenue are directly affected by changes in the economy.



Tracking Economy-Based Collections

It is clear from looking at economy-based taxes that the national economic downturn has made its way into the State. Year-over-year sales tax collections are down 3% for the first five months of this fiscal year. The fall in collections is indicative of the impact the recession is having on consumers.

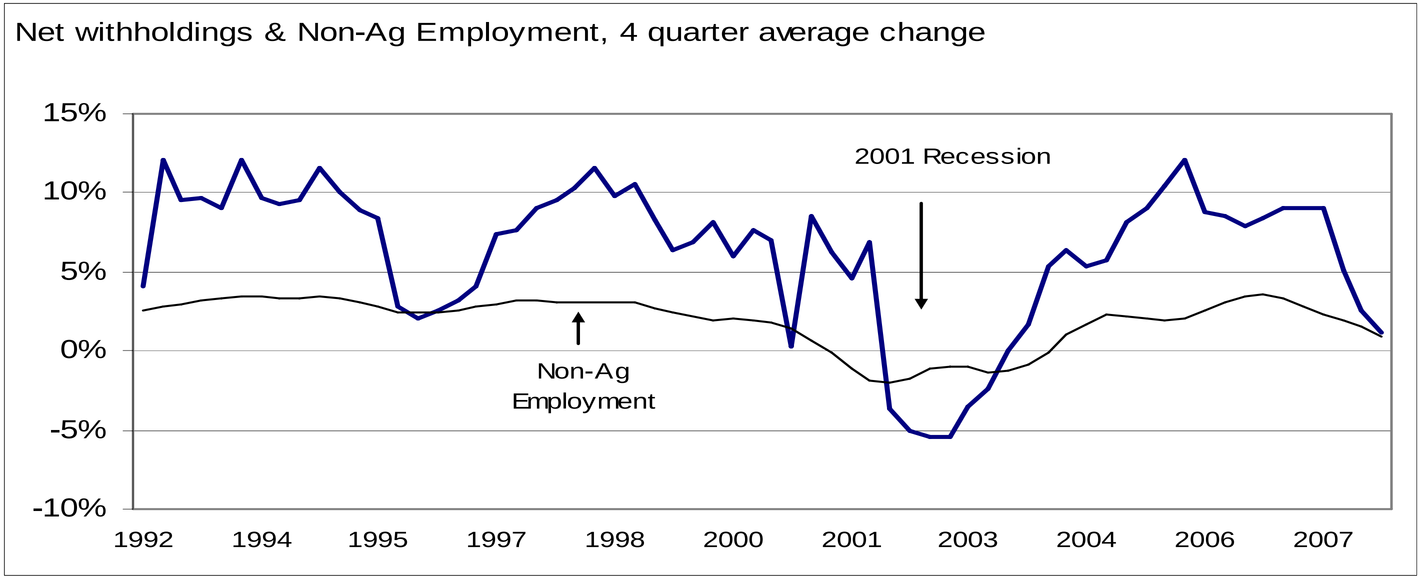
Sales & Use Tax Collections
(adjusted for tax law changes)



Tracking Economy-Based Collections (cont.)

Net withholdings continue to steadily slow and are nearly 2.3% below a $3.6 billion target. The economic downturn is now being felt broadly across most industry sectors and is reflected in the drop of wage & salary withholding collections.

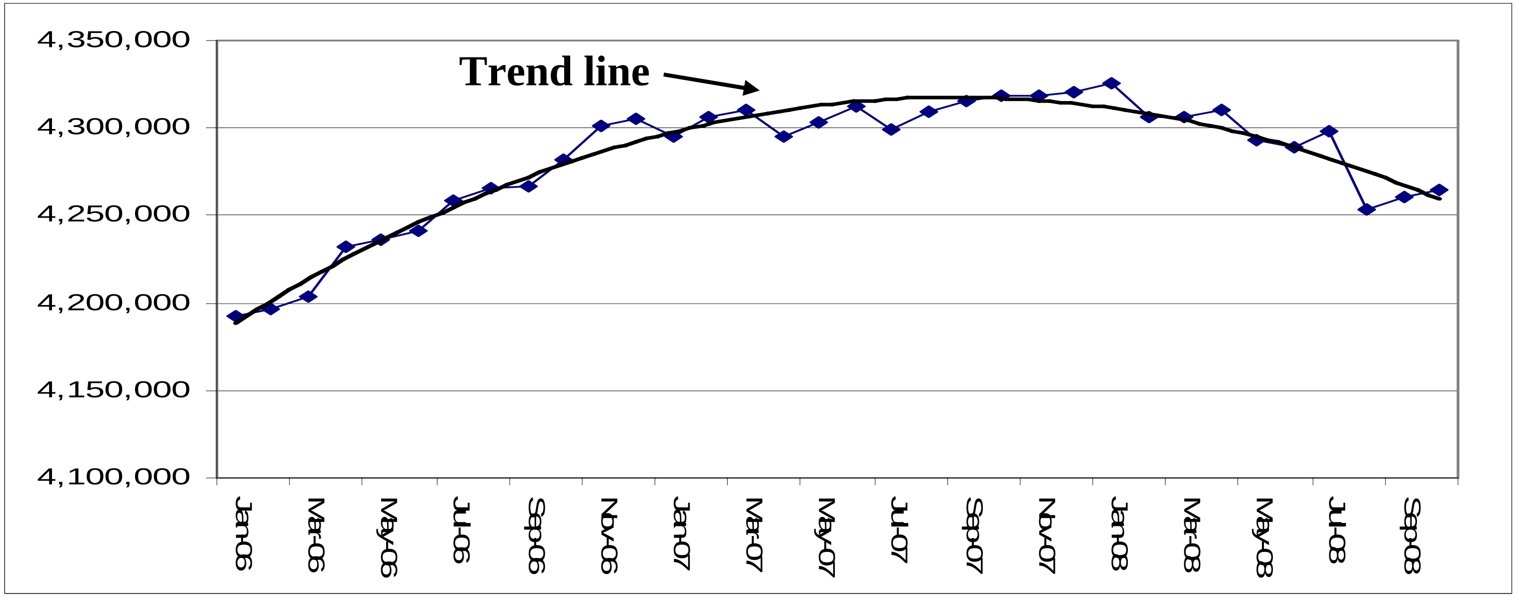
Withholding Tax Receipts



Tracking Economy-Based Collections (cont.)

One explanation for the decline in the economy-based taxes is the weakening employment market. Since October of last year, the state now has 54,000 fewer people employed. This downward trend in employment is expected to persist for most, if not all, of 2009 and potentially into 2010.

Non-Agricultural Employment, Seasonally Adjusted



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

Budget Outlook

- Mounting pressures for remainder of FY 2008-09 and into FY 2009-10:
  - Potential for a significant revenue shortfall and limited growth in 2009-10
  - State Health Plan will need additional infusion of cash ($200 - $300 million)
  - Medicaid and other income assistance programs are counter-cyclical to the economy
  - Post-secondary enrollment often runs counter-cyclical to the economy and could place added demands on universities and community colleges

Budget Outlook

- Governor is managing FY 2008-09 as per G.S. 143C-6-2
  - Reducing agency allotments
  - Delaying expenditures, where appropriate
  - Carefully monitoring Medicaid and other key budget areas