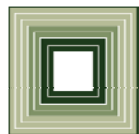


GENERAL FUND REVENUE REPORT



April 14 , 2008



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

Highlights

- March revenues came in below target and year-to-date collections are now only \$15 to \$20 million ahead of forecast. As usual, the volatile April income tax revenues will have a major impact on the final 2007-08 outcome.
- Three major economic shocks are slowing down the US and NC economy: the housing recession, the financial crisis, and rising energy prices. They are all taking a heavy toll on consumer spending.
- The weakening national economy is already being described as a mild recession by two of the leading economic forecasting firms (Moody's economy.com and Global Insight). The length and severity of the slowdown are the key questions for the May forecast revision and will impact whether the tentative 4.6% growth projection for 2008-09 will need to be adjusted.
- The Federal government took aggressive steps in both the fiscal and monetary policy arenas to prevent a full-scale recession. The latest moves by Congress are targeted on the financial market turmoil caused by the housing and credit crisis.

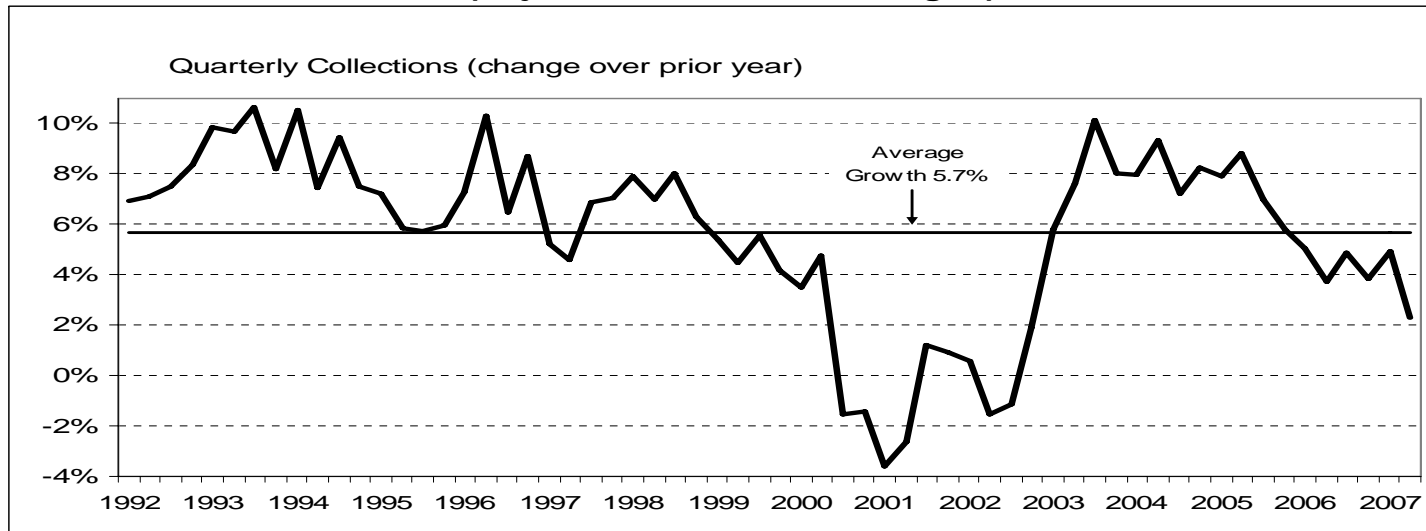
How Do 2007-08 Revenues Look So Far?

- General Fund revenue for the first nine months of the fiscal year are \$15-\$20 million ahead of the \$13.5 billion target for the period.
 - Collections through March are on target, the weakening economy is continuing to have an effect on the State's economy-based taxes. The good news is that the revenue forecast for FY 07-08 anticipated this slowdown and included significant slowdowns for the last quarter of the fiscal year. This means that the sales tax and withholding revenue growth targets for the rest of the year are modest.
 - The decision to plan for only modest growth in the FY 2007-08 budget has helped the State avoid the shortfalls other states are grappling with as they go through the budgeting process this year.

How Do 2007-08 Revenues Look So Far?

The economy-based taxes clearly indicate the economic expansion of the last several years is over. Baseline sales tax growth through March fell to 2.3%, well below the long-term average of 5.7%. Much of this decline was forecasted when calculating the fiscal year growth rate. However, continued declines in consumer spending could lead to lower than expected collections for the fiscal year.

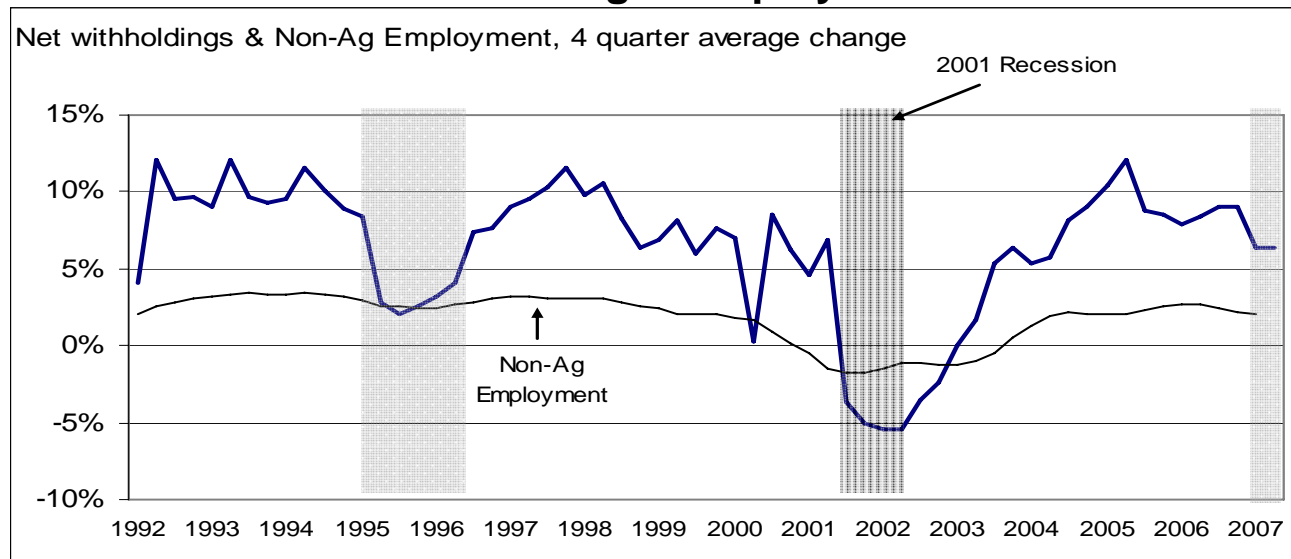
**Sales & Use Tax Collections
(adjusted for tax law changes)**



How Do 2007-08 Revenues Look So Far? (cont.)

March withholding receipts were up over last year by 6.0%, but that is a slowdown from 7.3% in January. The bright spot is that the current year-to-date rate of growth equals the historical average of 6.4%. This recent decline in growth suggests that N.C. wage & salary employment is feeling the impact from the nation's economic distress. The question remains, will N.C. experience only a mid-cycle slowdown similar to 1995 or is this the beginning of negative growth like what occurred near the end of the 2001 recession and persisted for 6 more quarters?

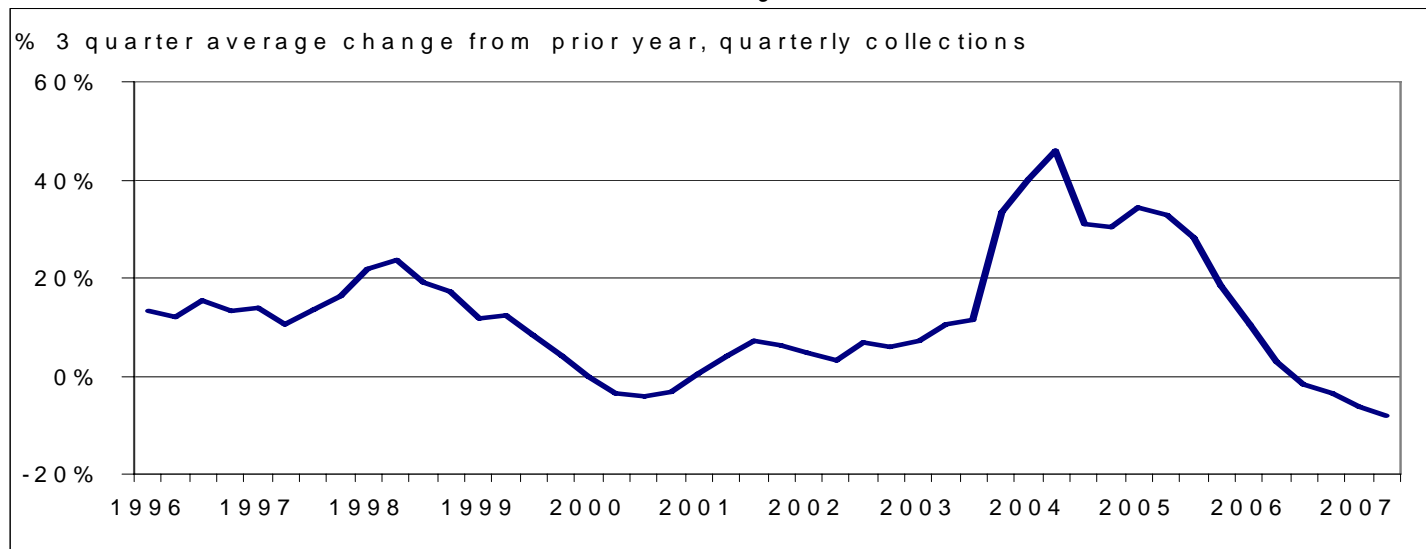
Withholding & Employment



How Do 2007-08 Revenues Look So Far? (cont.)

The housing downturn has significantly reduced real estate conveyance tax collections. Collections continue their decline and are now down 13.4% compared to July-March of last year. Though this tax does not go to the General Fund, it can be a good economic indicator of retail sales.

Real Estate Conveyance Collections



Economic Slowdown in North Carolina and Forecast Risks

- Two of the nation's leading forecasting firms (Moody's economy.com and Global Insight) are now saying that the national economy is in the early stages of what will be a mild recession. A recession they see lasting through early summer. Official marking of business cycle events such as when the nation goes into recession is the responsibility of the National Bureau of Economic Research, and usually lags behind the actual occurrence by 12-18 months.
- I am currently not as pessimistic about the State's economic outlook as some economists are about the national economy. The State's economy may fare quite a bit better than some states such as California and Florida.
- It is fortunate that the budgeted revenue forecast for this fiscal year built in significantly slower withholding and sales tax growth for the second half of 2007-2008 fiscal year. This means there is a lot of downside protection built into the current budget for the key economy-based taxes.
- Clearly, a protracted and significant slowdown or recession will dampen expectations for revenue growth in FY 2008-09 and may mean that the tentative 4.6% growth rate will need to be lowered. Continued monitoring of both the credit crisis and the impact of rising food and gasoline prices on consumer spending, wages and job growth is crucial.

April & June Have the Most Variability

- The experience through the first nine months is valuable for assessing which direction the stable, economy-based tax collections such as the sales tax are headed. However, there is little indication of the outcome for the more volatile revenue sources that are concentrated in the final quarter of the fiscal year.
- The greatest unpredictability is tied to corporate income tax payments and non-withholding personal income tax payments.

April & June Have the Most Variability (contd.)

- For example, during April we get final tax payments from both high income individuals with a lot of non-wage income plus calendar year corporations.
- At the same time these same taxpayers make their first quarterly estimated payment for the new tax year. This payment can be a good predictor of the June remittance.
- In short, there is a “doubling-up” of the impact on revenues from these very volatile revenue sources.

April & June Have the Most Variability (contd.)

- Why are the April numbers so hard to predict? The main reason is a large part of April's revenues are concentrated in a relatively small number of higher-income taxpayers.
- These taxpayers have income tax liability from diverse sources such as capital gains and real estate investments and there are no "average" taxpayers in this group. Their tax liability are determined by many factors including the current economy, but to a lesser extent than the traditional economy based taxes.
- Therefore, changing economic conditions and contemporaneous financial decisions (final payments) plus expected future outcomes (estimated payments) create far more variability than the other sources of revenue.

April & June Have the Most Variability (cont.)

- The largest source of this volatility for these taxpayers in recent years has been capital gains. While there is a wealth of investment data available to researchers, we are missing key information necessary to answer two questions: what did the investors pay for their assets and when will they sell?
- Finally, it is impossible to predict how a gain in tax liability will be split between estimated tax payments made earlier in the tax year and final payments on April 15. What this means is that even if we know on January 31 how estimated tax payments fared for the prior tax year, we still do not know what will happen on April 15. One reason is that under federal and state law the “penalty” for underpayment during the tax year is simply interest (7% in 2007).
- It is these factors that lead to the April “surprise” and make April and June so unpredictable.

2008-2009 Forecast Outlook

- The biennial budget for 2007-2009 included a tentative 4.6% baseline revenue growth rate for the 2008-09 fiscal year. One of the purposes of the upcoming budget session is to adjust this outlook in light of the new environment.
- A sluggish national economy teetering on the brink of a recession will lower economic output for the rest of 2008. The aftereffects from the U.S. housing recession and the growing credit crisis is expected to be a drag on the economy well into 2009. The effects of the national slowdown are starting to show up in North Carolina's housing data and the economy-based taxes (see pages 3 to 5).
- The economy is at risk, especially consumer spending, for the following reasons:
 - the loss of household wealth, a result of the prolonged real estate downturn;
 - tighter consumer credit from the sub-prime/foreclosure debacle;
 - weakening income growth;
 - rising food and energy prices.

2008-2009 Forecast Outlook (contd.)

- So far state employment has held up relatively well. However, job growth is slowing and consumer spending will be affected. The national economy posted small job losses for the last three months. While the losses are small they are a clear signal that economic conditions are weakening.
- In addition, any recovery during the second half of the year and the first half of 2009 will be modest at best. A true expansion may be a year or two away. The housing recession and the credit crisis are interrelated and will take a long time to unwind. We may be well into 2009 before we see an end to an excess in housing inventory and falling house prices.
- The global economy will have a major impact on the magnitude of the slowdown as well as the speed of the recovery. Global inflation fueled by rising fuel and food prices could hurt businesses already being squeezed by declining demand. Both wages and employment may bear the burden of this problem.
- Both business and consumer confidence measures are pointing to a possible recession. Consumer confidence is at a 16 year low near 1991 recession levels. Higher gas prices at the pump are adding to consumer's pessimism. Business confidence measure are not as pessimistic.

2008-2009 Forecast Outlook (contd.)

- The Federal government continues to take aggressive steps to head-off a protracted slowdown:
 - Through 6 separate actions beginning in September of last year the Federal Reserve lowered the federal funds rate target by 3 percentage points (5.25% to 2.25%).
 - In addition the Fed has gone to extraordinary lengths to inject liquidity into the banking system.
 - Congress passed a fiscal stimulus package that offers bonus investment depreciation for capital purchases and cash rebates against 2008 income tax liability. The rebates are expected to be in consumers hands beginning in May. It is estimated that the 2nd quarter will see a 14% increase in disposable income from the stimulus, but a cautionary note is that most of that income may not go back into the economy by way of consumer spending.
 - Congress is in the process of developing legislation geared towards relief for homeowners and lenders facing defaults and foreclosure as a result of the housing recession.

2008-2009 Forecast Outlook (contd.)

- A major factor that will keep a lid on any recovery is the housing recession, which may take another couple of years to work through. This means that real estate prices have farther to fall before the turnaround can begin.
- The severity of the economic downturn differs by region, similar to the housing market decline. It is still possible that not all states will experience recession-like economic conditions.
- Nonetheless, housing market problems, financial market turmoil, rising fuel and food prices, and slow income growth means North Carolina will notice a significant slowdown in consumer spending and employment growth.