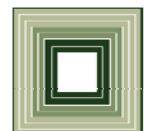


# **GENERAL FUND REVENUE REPORT & ECONOMIC OUTLOOK**



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**FISCAL RESEARCH DIVISION**  
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# Highlights

- Revenues through January are \$35 million short of forecast.
- Downside risks continue to persist for the 2009-10 forecast with the sluggish economic recovery struggling to take hold.
- This means budget pressures will continue to mount as prolonged weaknesses in the economy affect revenue collections the remainder of the fiscal year.
- At this stage of the recovery economic signals remain mixed, yet most economist believe a sustainable recovery is underway.
- The remaining question is, what will be the pace of the recovery?



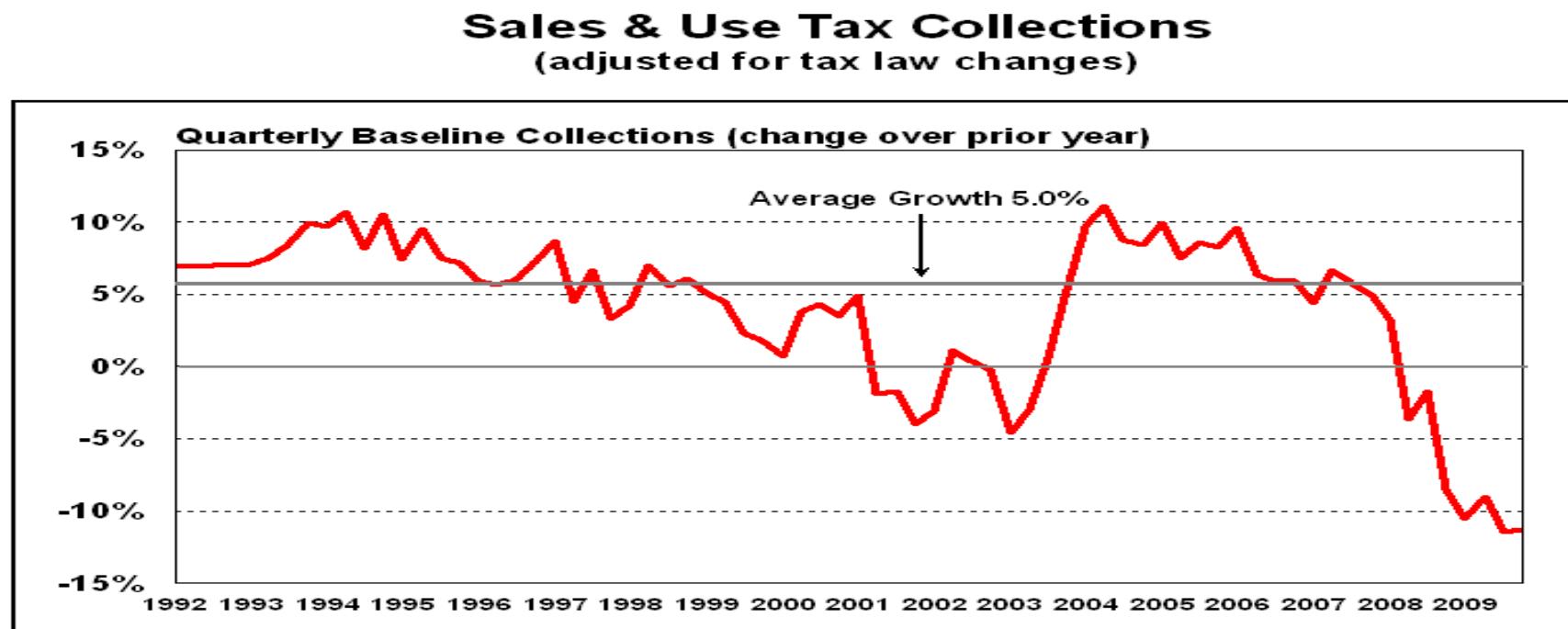
# How Do 2009-10 Revenues Look So Far?

- General Fund revenue for the first half of the fiscal year came in about \$35 million below a \$11 billion target for the period.
  - So far, collections are running just below expectations. It is noteworthy, however, that the weak economy continues to affect consumer spending, and in turn, the State's economy-based taxes. Revenue forecast assumptions anticipated slow economic growth with a gradual improvement during the second-half of the fiscal year.
  - Also of interest are the December/January estimated payments. They were about 5% (or \$20 million) below expectations. For a general discussion on estimated payment see pages 7- 9.
  - Note, the reason collections are near the budget target is the \$472 million of one-time collections from corporate taxpayers. That represents \$272 million more than was budgeted.



# Tracking Economy-Based Collections

Most economist believe the recession ended in late summer 2009, but 4 to 5 months later consumer confidence has shown little improvement. In January, collections showed some improvement over previous months, but a couple of more months are needed to see if we have turned the corner on sales collections.



## Why have Sales Tax collections been slow to recover?

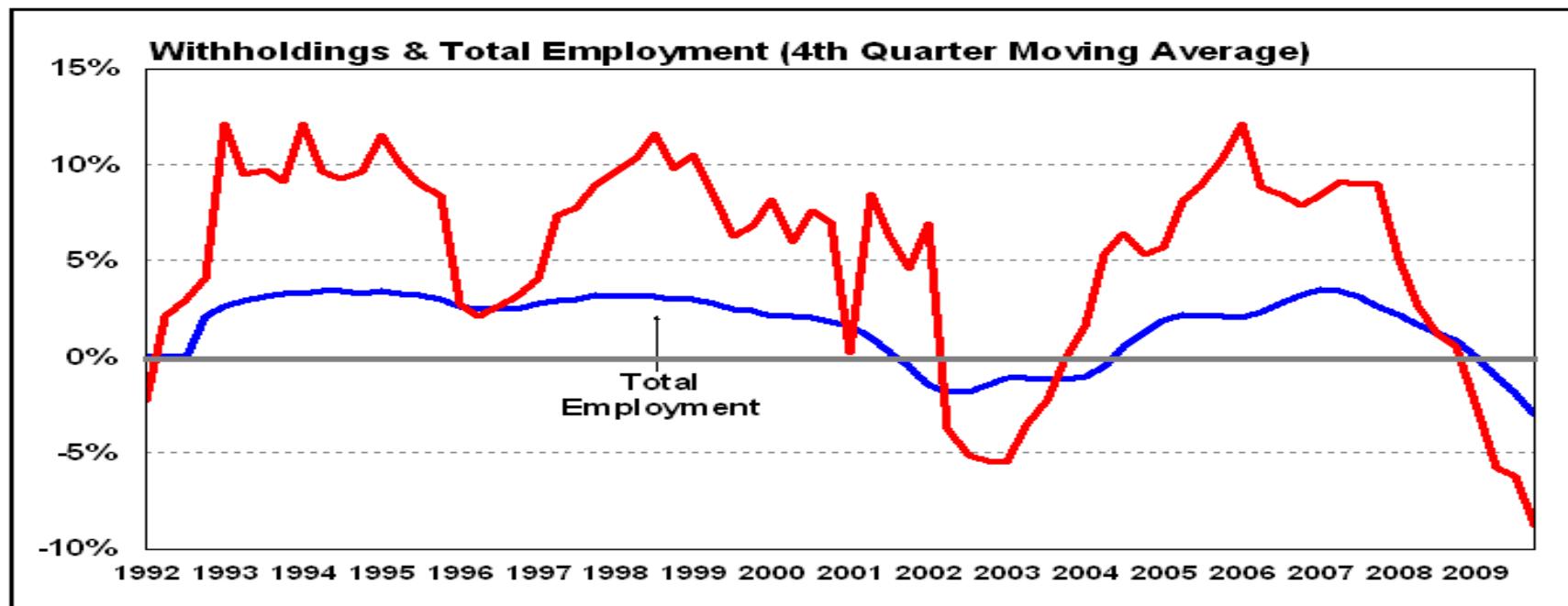
- Double-digit unemployment has eroded consumer confidence and with continued employment uncertainty cautious consumer behavior continues.
- Key reasons why consumer spending is down:
  - Dismal employment outlook expected to extend into much of 2010
  - Lower inflation-adjusted salary & wages than before start of recession
  - Tremendous loss of household wealth from housing recession and equity market losses
  - Tight credit conditions persist
  - Rather than continuing to spend by increasing debt until the recession's effects subside, consumers are doing the opposite - they are choosing to pay off their debt. Credit card debt fell 20% in November and new credit card issues are off 46%.



# Tracking Economy-Based Collections

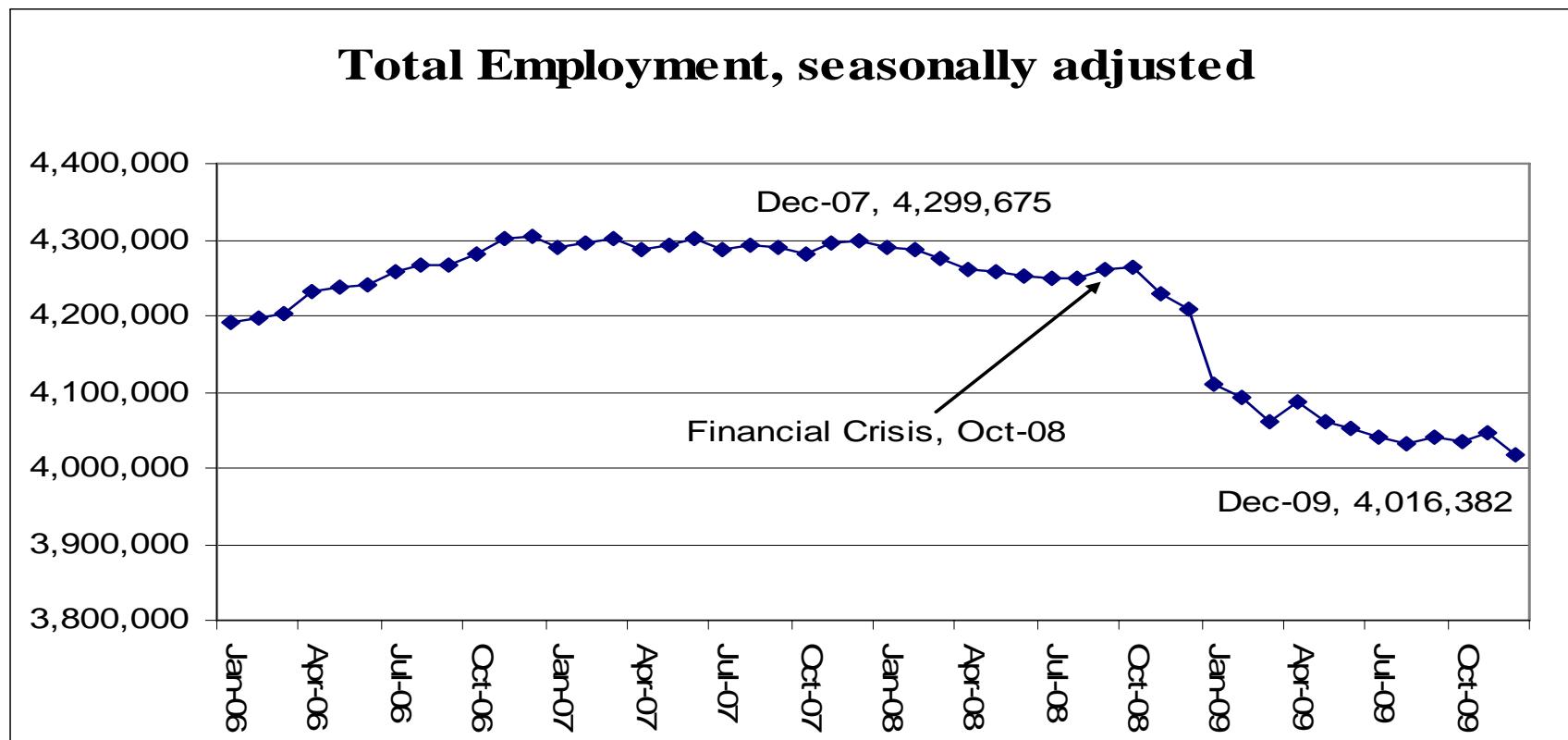
Net withholdings (wage & salary taxes less refunds) continue to reflect a dismal job market. Through January net withholdings are down 4.7% from last year, and 2.4% below a \$5 billion target for the first seven months of the fiscal year.

## Withholding Taxes



# Tracking Economy-Based Collections

From the start of this fiscal year the State's economy has shed nearly 24,000 jobs (seasonally adjusted). **Total employment is now 280,000 jobs (6.6%) below pre-recession employment.**



# We Still Have a Long Way to Go

- The first 6-8 months of the fiscal year are valuable for assessing which direction the more stable, economy-based tax collections such as the sales tax are headed. These months provide little indication of the outcome of the more volatile revenue sources. This means the final quarter (April – June) of the fiscal year contains the majority of the forecast risk.
- The greatest unpredictability is tied to corporate income tax payments and non-withholding personal income tax payments.
  - This creates a “doubling-up” impact for both sources since it entails April 15 final income tax payments (2009 tax year in this case) as well as quarterly estimated income tax payments in April and June for the new tax year.



# We Still Have a Long Way to Go

- Volatile non-withholding income tax payments during April-June come from a wide variety of individuals with a lot of non-wage income. Most of the dollars are concentrated in a small number of high-income individuals with diverse income sources including:
  - Capital gains on shares of stock
  - Gains on sale of investment real estate
  - Profits on the sale of a business
  - Independent contractor income
  - Pass-through income from sole proprietorships, partnerships, S Corporations, LLC's
  - Sales commissions
  - Pensions, dividends, and interest income
- Our view is that since taxpayers losses from the recession can be carried forward into future tax years, taxable income from these sources will be suppressed for several years.



# We Still Have a Long Way to Go

- While all of these income sources are hard to predict, capital gains on stock and real estate investments present a particular problem. Even if we could predict future asset prices, we do not know what year investors will sell nor the asset's original purchase price.
- There are additional challenges to forecasting April revenues from high-income individuals
  - Unlike wage earners, there are no “average” taxpayers and individual experiences can vary tremendously from one year to the next.
  - In addition, taxpayers with a potential loss in income for a tax year can choose between decreasing their estimated payments or settling up on April 15, with risk of a “penalty” for insufficient estimated tax payments (going interest rate). This means that even with the availability of the December/January estimated tax payment data (available in February), we still do not know what April 15 will bring.
- As with high-income individuals, the April-June period includes a similar concentration of volatile payments for the corporate income tax.



# Revenue Forecast Outlook

- A sluggish national economic recovery is now expected to persist through 2010 and possibly into 2011. Employment will be the key. Most forecast now agree that any significant changes in the employment picture cannot be expected until the second-half of 2010.
  - The State will have a long way to go to reach pre-recession levels given the 6.6% decline that has occurred since the start of the recession. Some are suggesting it could take as much as five years to return to pre-recession levels.
- Because the employment picture has yet to show expected improvement, this continues to impact all the economy-based taxes. In fact, a key source of risk to the forecast is the lack of improvement in consumer spending caused by the shaky employment picture and the loss of household wealth. Without improvements to consumer spending (70% of the national economy) the pace of the recovery will be very slow.
- The expected slower job and wage growth will delay the growth of income tax withholding. The 2009-10 forecast envisioned zero growth for withholding for the year, but positive improvement was expected the last quarter.



# Revenue Forecast Outlook

- Since the May 2008 forecast, forecasted growth in the State's personal income for 2010 has been significantly lowered. The lower growth is the result of a far more severe recession than envisioned at the time and its significant impact on employment in the State. We now expect less than 1.5% growth in 2010 personal income, which is far less than what was envisioned last May (2.9% was expected).
- Wage & Salary income, the major component of personal income taxes is estimated to have fallen 3.3% in 2009 and growth for 2010 is now expected to be only 1.3%.
- Even though the national and State forecasts for this fiscal year have grown more pessimistic since last May, the expectations are that the recovery will take hold and this spring and summer a slow, gradual improvement can be expected.



# **Slow Economic Recovery and Forecast Risks**

- Even though we are pessimistic on the prospects for a full recovery in 2010 as are most economists, a cautious budgeting approach will help reduce the negative impact on revenues felt by many other states. Our budgeted revenue forecast built in some improvement to withholding and sales tax growth for the second half of 2009 - 2010 fiscal year, but not nearly as much as most forecasters were projecting at the time.
- Our forecast has placed a lot of emphasis on managing the risks associated with explosive, volatile revenue sources such as the non-withholding portion of the income tax (capital gains show up here) and the corporate income tax. Despite our efforts to remain cautious, these continue to be very challenging revenue sources to assess (see pages 7 - 9 for more discussion).
  - Key Reasons:
    - A few years of super-charged growth is followed by steep declines (plus or minus 35%).
    - Unprecedented recent declines may not mean the usual rebound given the huge losses taxpayers can use to offset non-withholding or business income.
    - Instability in the key real estate, financial, and equity markets will add to the volatility.
    - Gauging taxpayer behavior based on possible federal tax law changes add to the complexity.



# The State and National Economic Outlook

- Employment conditions remain very weak. Losses have lessened, but continue and the pace of hiring is very slow.
  - Average initial job loss claims for this January were 27,900. This marks an improvement compared to 36,600 for January 2009.
  - Despite the drop in weekly average initial claims, the rate of hiring has barely changed.
  - On the upside, Mark Vitner, senior economist at Wells Fargo notes “It appears labor market conditions are not getting any worse, and that’s a plus.”
- The stagnant job market is not completely unexpected given the severity of the recession. We agree with those forecasters that think the state is positioned to come out of the recovery faster than the nation once job hiring begins to pick-up.
  - Dr. Mike 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 does caution that national growth is expected to be below normal.



# The State and National Economic Outlook

- Nationally, consumer spending has begun to show a glimmer of improvement.
  - Consumer confidence is slowly rising, but still remains well-below pre-recession levels.
  - Good news is consumer expectations for the next 6 months are at their highest since October 2007.
  - Regarding improvements in consumer spending, caution is warranted because unemployment remains in double-digit range, real estate and financial markets are still struggling, and household balance sheets have shrunken.
- Bottom-line, the overall economy is in much better shape than a year ago. Nonetheless, recession-like conditions will be with us for a while longer.



# 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
  - 9 states were already 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
- A recent report from the Rockefeller Institute of Government estimates that state revenue collections for the third-quarter 2009 fell 10.9% over last year.
  - 48 states reported year-over-year declines.
  - 22 reported double-digit declines.



# 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 perform as forecasted.
  - 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 has been experiencing unprecedented growth.



# Budget Outlook

- Mounting pressures for remainder of FY 2009-10 and beyond (cont.):
  - 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.

