

State Revenue Outlook



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

Revenue Outlook Summary

- ❑ State revenues are coming in well ahead of schedule, even in the face of a slowing economy.
- ❑ The biggest uncertainty surrounding the 2006-07 and 2007-08 forecast is the impact of the real estate slowdown in the State. However, this risk should be adequately covered by the very cautious budget forecast adopted last July.
- ❑ Improved revenue prospects for this year and 2007-08 will significantly reduce, but not eliminate, the structural budget gap for 2007-08.

How Are Revenues Doing?

- ❑ For the first six months of the fiscal year, General Fund receipts came in around \$285 million ahead of the \$8.7 billion budget forecast for the period. It is tempting to talk in terms of a 3.2 percentage point revenue surplus for the year.
- ❑ However, \$221 million of this amount came from one-time settlements of long-standing corporate income tax disputes.
- ❑ In addition, the experience for the first six months is not indicative of what might happen for the full year. The primary reason is that 75% of the forecast uncertainty for the year is concentrated in the last half of the year. Prime examples include the corporate income and the non-withholding portion of personal income tax.
- ❑ Key economy-based revenues are beginning to be weighted down by the long-expected “mid-decade economic slowdown”.

Recent Revenue Surpluses Have Been Handled With Care

- ◆ Voluntary Compliance Initiative (2004-05).
 - ◆ Business taxpayers affected by Limited case (trademarks) kicked in almost \$300 million for back taxes.
 - ◆ Recent budgets assumed all of the proceeds were one-time in nature.
 - ◆ In fact, some of the surplus in 2005-06 and 2006-07 is due to follow-up compliance in the wake of the court decision.

- ◆ Tobacco buyout.
 - ◆ Taxes due on payout will be over \$100 million
 - ◆ Recipients can choose between annual stream of payments or discounted lump sum. Budgets have assumed all parties would select stream of payments option.
 - ◆ However, anecdotal evidence suggests that many quota holders are taking lump sum.

Recent Revenue Surpluses Have Been Handled With Care (Continued)

- ❑ Traditionally volatile revenue sources.
 - ❑ Corporate tax growth across the U.S. has exploded during this economic recovery (20-40% annual increases in N.C.)
 - ❑ Capital gains on income tax returns were up 49% for 2004 tax year and 40-45% for 2005. Gains on sale of real estate have been a larger factor than usual during current cycle.
 - ❑ These volatile revenue sources will crash sometime during the next couple of years. For 2006-07 budget it was assumed that much of decline would be in 2006-07.
 - ❑ Capital gains will fall 25% in 2006 and another 10% in 2007.
 - ❑ Corporate tax collections will drop by 9% for 2006-07.

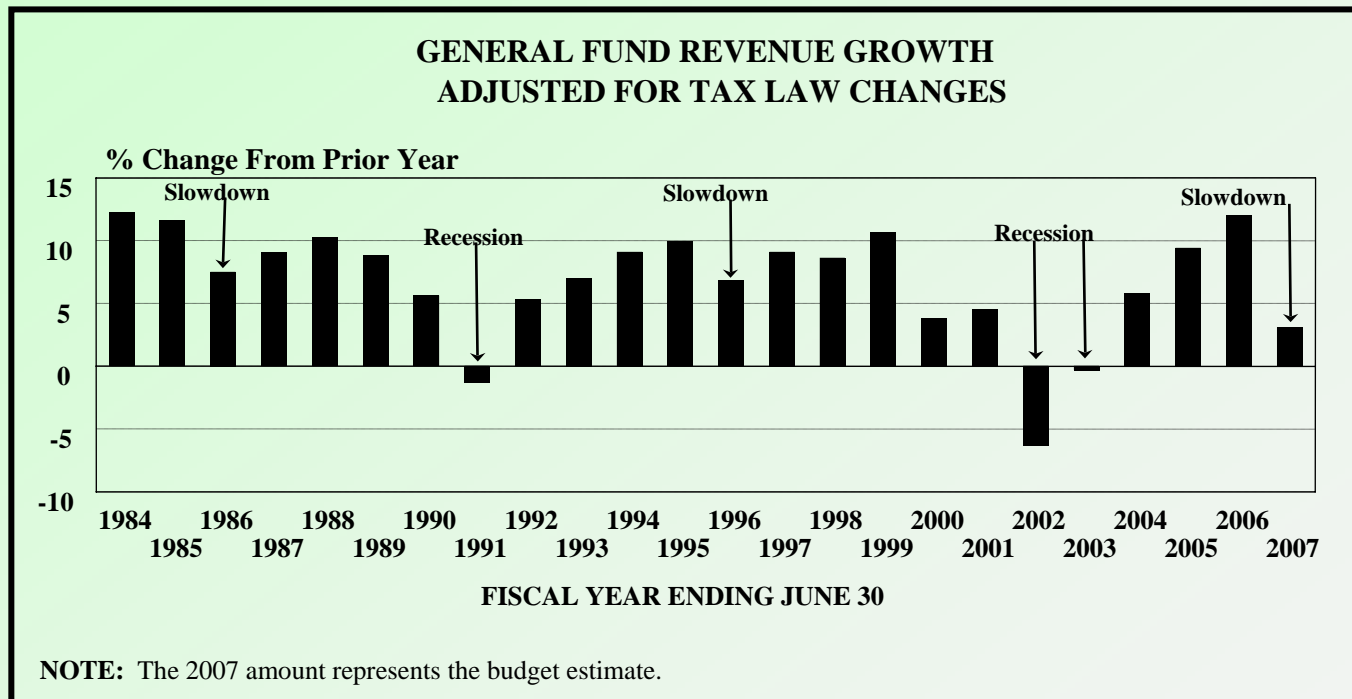
- ❑ In reality, it is likely that deepest hit will be in 2007-08.

Recent Revenue Surpluses Have Been Handled With Care (Continued)

- ❑ Outlook for economy-based taxes reflects a moderate national economic slowdown due primarily to weakening real estate market and delayed impact of higher interest rates and energy prices.
 - ❑ Withholding growth slows to under 6% (was 8.0% in 05-06).
 - ❑ Sales tax rise drops to 5.4% (7-10% since mid-2003).

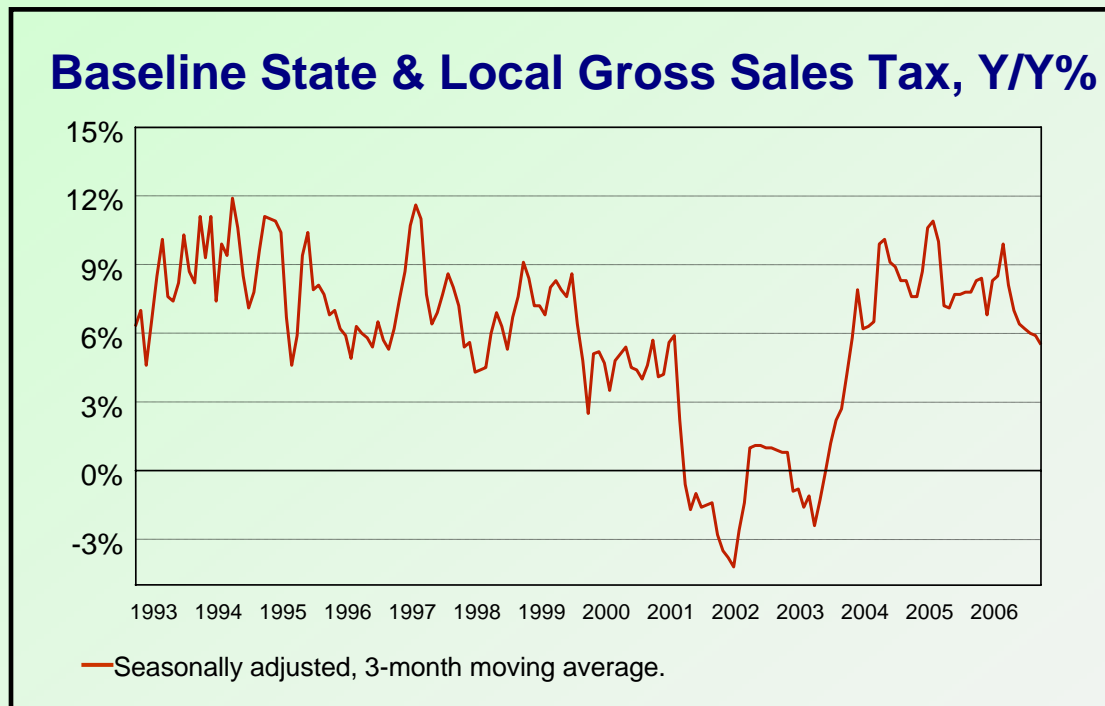
Recent Revenue Surpluses Have Been Handled With Care (Continued)

- Results of analysis: original baseline growth forecast for 2006-07 of 5.2% was revised during 2006 session to 3.2% (compared to actual 11.8% for 2005-06 and 9.3% for 2004-05).



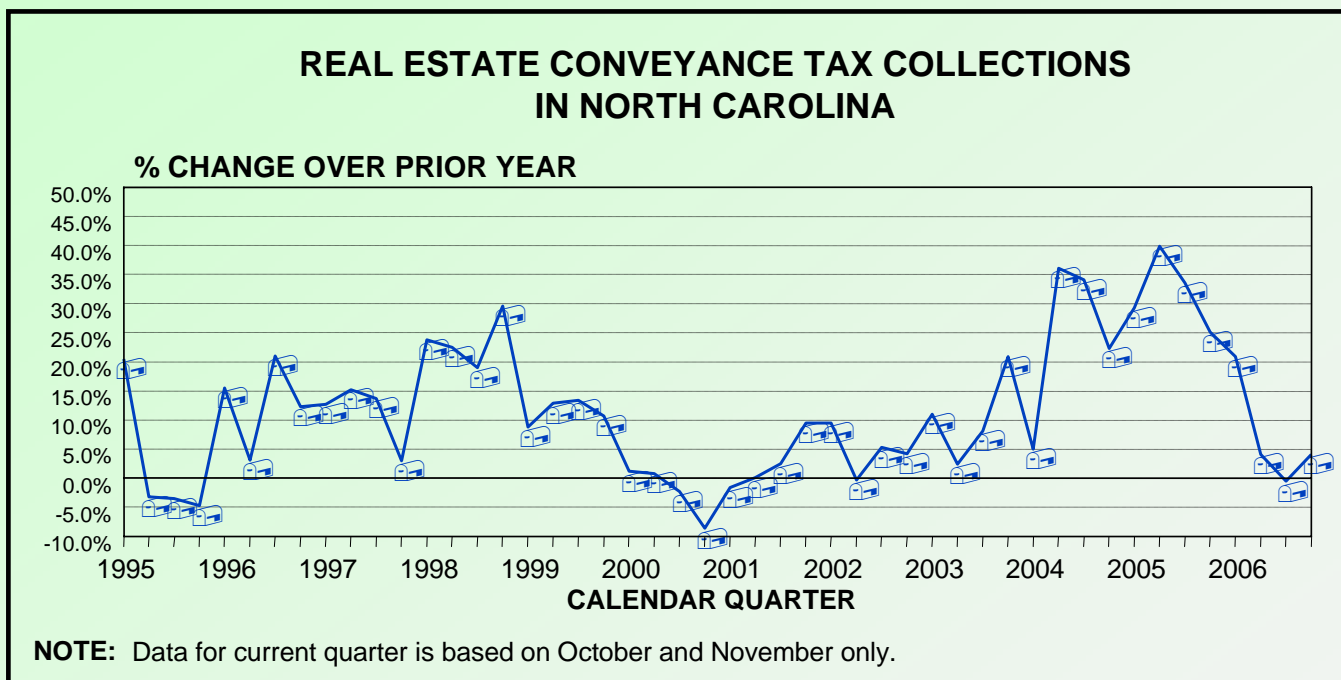
The “Mid-Decade Economic Slowdown” Has Finally Arrived

- ❑ Growth in sales tax revenues, which represent 28% of the revenue base, has begun to slow. Coming out of the last recession, growth averaged around 8 percent, but has now dropped below 6 percent beginning in October 2006.



The “Mid-Decade Economic Slowdown” Has Finally Arrived (Continued)

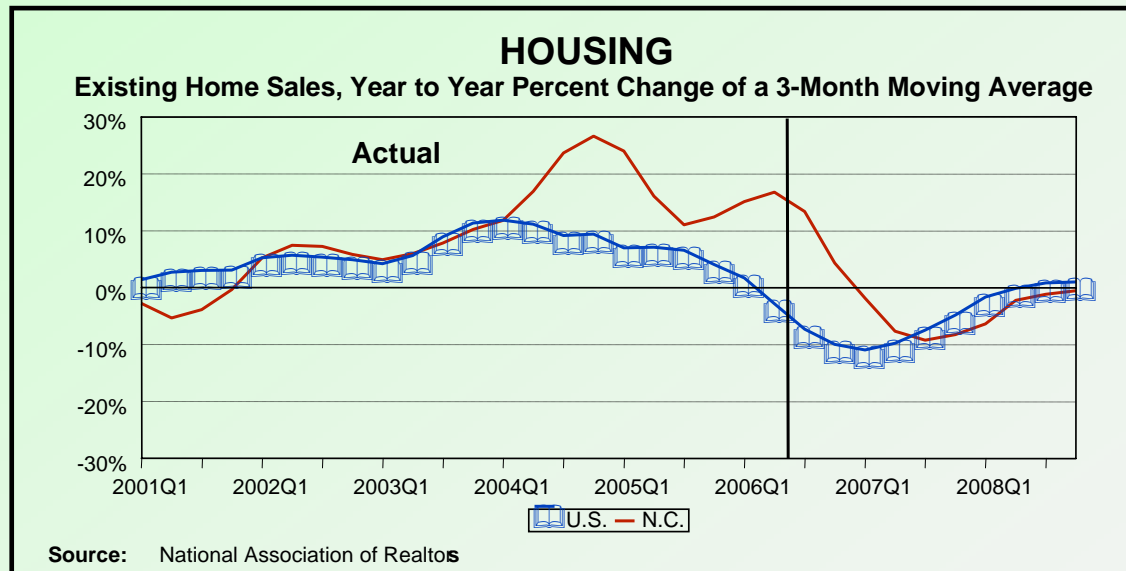
- ❑ Real estate conveyance tax collections* were up only 4.1% for April-June and up 2.2% for July-December, compared to a 20.9% increase for January-March.



*Not part of General Fund. Shown for economic indicator purposes only.

HOUSING

- ❑ North Carolina is just now beginning to catch-up with rest of the country with the slowdown in housing sales.
- ❑ Much of the credit for post recession growth was given to the robust housing market. What effect the current housing slowdown will have on sales tax revenue remains unclear at this point, but it appears to be having some impact.



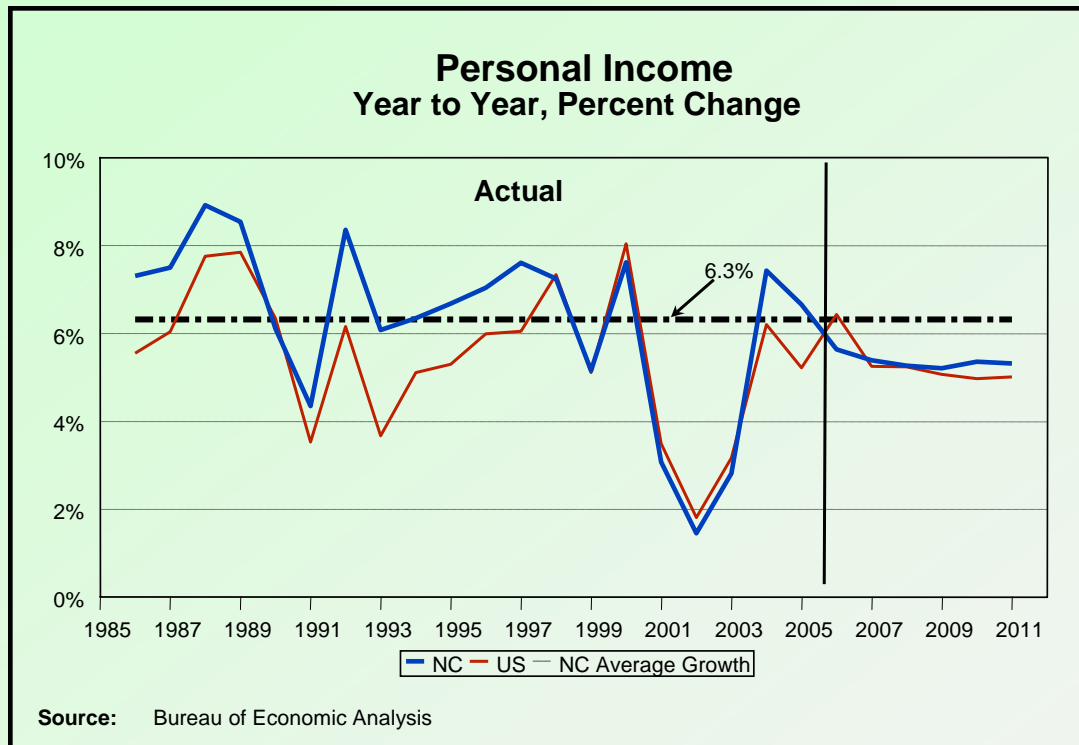
The “Mid-Decade Economic Slowdown” Has Finally Arrived (Continued)

- As with the sales tax, income tax withholding (40% of the revenue base) has begun to slow – going from 8.3% growth for the January to June period to 6.8% growth for October to December.



PERSONAL INCOME

- Year over year growth in personal income slips below long-run trend.



Why Is The Real Estate Sector So Important During This Business Cycle?

- ❑ For the last couple of years strength in this sector has more than offset any damage from high energy costs and rising short-term interest rates. This buffer has propped up state and local sales tax collections.
- ❑ The connection between real estate activity and retail sales may work through consumer confidence and the indirect impact of new construction and existing home sales on furniture and appliance purchases.
- ❑ In addition to the confidence factor, the “cashing out” of residential real estate through gains on sale of property, refinancing, and home equity lines led to a huge surge of resources available to consumers.

Why Is The Real Estate Sector So Important During This Business Cycle? (Continued)

- ❑ Preliminary third quarter numbers indicate the housing market slowdown has finally arrived in North Carolina.
- ❑ The nationwide decline in housing activity has been extraordinary and is expected to be a drag on the overall economy. The slowdown in the nation and here in North Carolina is expected to persist for most of the next year, with declining or zero year over year growth.
- ❑ Our budget forecast is based on the premise that these relationships will continue during the negative part of the cycle, thereby driving down retail sales and job creation.

Why Is The Real Estate Sector So Important During This Business Cycle? (Continued)

- ❑ Except for resort property and high-end homes in urban areas, the real estate bubble was not as strong in North Carolina as it was in certain markets of the country. Hopefully, this will mean that the downside will not be as severe. As an example, for the second quarter of 2006 existing home sales in North Carolina were up 11% while activity declined 20-25% in many “bubble” markets (including Virginia).
- ❑ The steepness of the nationwide decline in home sales, housing starts, asset prices, and financing activity has been extraordinary and merits watching.

How Is Job Growth In The State Doing?

- A defining characteristic of the 2002-2004 economic recovery was sluggish employment growth.
 - The national weakness was due to reticence of employers to re-hire in an uncertain environment after September 11 and the other types of bad news. In addition, substantial overcapacity in computers and telecommunications will take years to work through.
 - For North Carolina and other manufacturing intensive states the loss of jobs to overseas locations, although at a diminished level, continues to be a drag on employment gains.

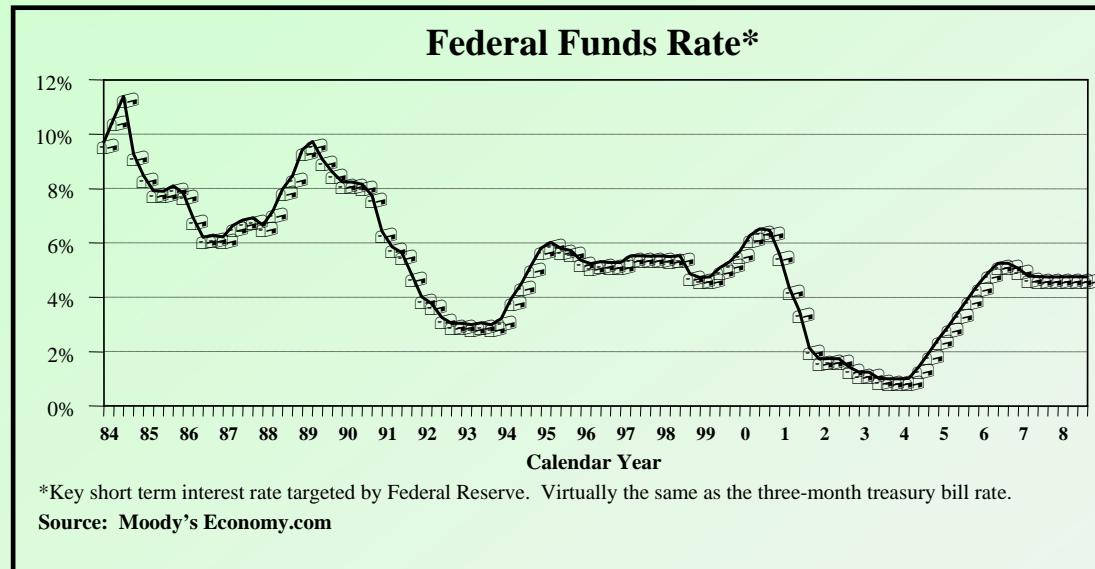
- Beginning in early 2005 North Carolina finally began experiencing a genuine recovery. For example, the unemployment rate in the state in December was 4.9%, compared to 7.0% in January 2002. However, in early 1999 the rate was only 3.2%.

How Is Job Growth In The State Doing? (Continued)

- ❑ Announced employment growth in North Carolina was only 1.4% for the most recent 12 month period, compared to the usual 3-4% rise in previous business cycles. Even if the current numbers are revised to adequately account for start up companies, the annual growth would still be less than 2.0%.

Outlook for Interest Rates

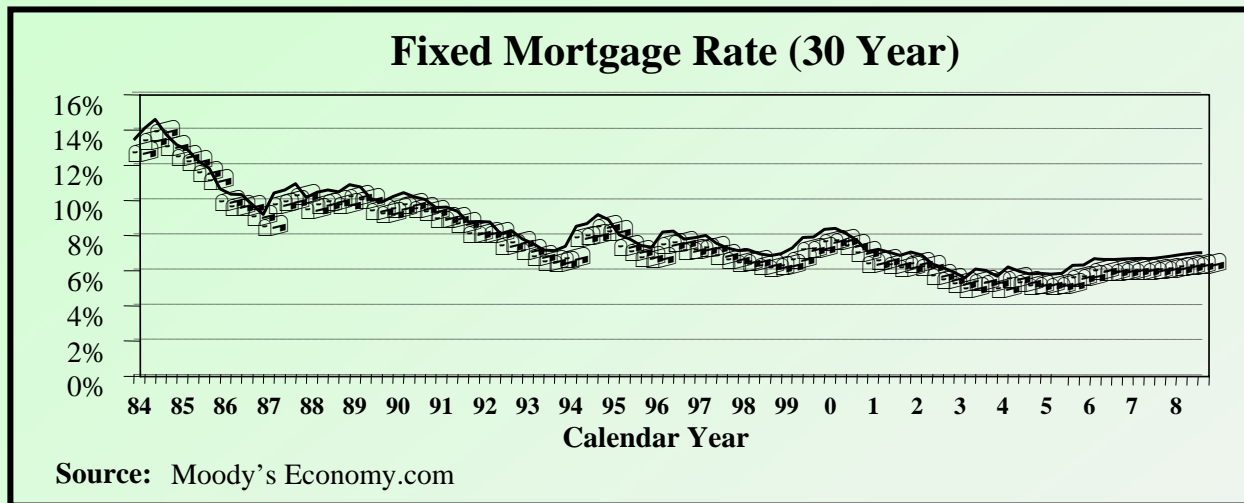
- During the current tightening cycle short-term rates have risen from 1% to 5¼% (from 5% to 9¼% for prime rate).



- Distinct signs of a slowing economy means that the Federal Reserve may have completed its mission.
- If the downturn worsens, and inflation fears abate, the Fed could lower rates as early as this summer.

Outlook for Interest Rates (Continued)

- ❑ In a typical tightening cycle, long-term rates (including fixed rate mortgages) follow the first few short-term hikes before stabilizing as the economy slows and inflation threat fades. During this cycle long rates have remained unusually restrained, due primarily to the influx of funds from overseas.



- ❑ The magnitude of the drop in short-term rates will depend on severity of economic slowdown.
- ❑ Long-term rates are expected to remain flat for the next couple of years.