

State Budget Outlook



Fiscal Research Division
December 7, 2006

Budget Outlook Summary

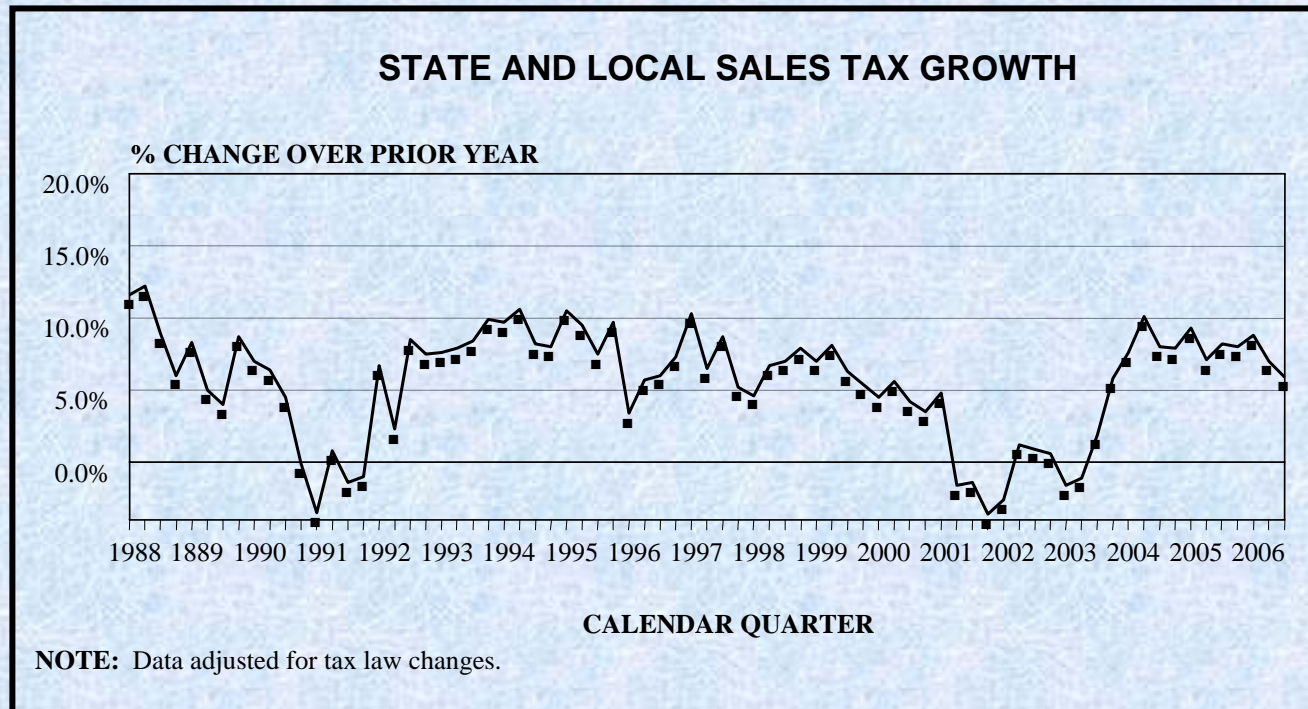
- ◆ State revenues are coming in comfortably ahead of schedule, even in the face of a slowing economy.
- ◆ The biggest uncertainty surrounding the 2006-07 forecast is the impact of the real estate slowdown in the State. However, these risks should be adequately covered by the very cautious budget forecast adopted last July.
- ◆ Revenue collections prospects for this year and 2007-08 could significantly reduce, but not eliminate, the structural budget gap.
- ◆ High growth in health care costs will continue to crowd out state spending for education.

How Are Revenues Doing?

- ◆ For the first five months of the fiscal year, General Fund receipts came in \$130-160 million ahead of \$7.1 billion budget forecast for the period. This is a surplus of 1.9-2.3 percentage points.
- ◆ The bulk of the extra collections (\$70 million) came from the continued surge in corporate tax receipts. Of this amount \$40.5 million came from a one-time settlement.
- ◆ The early part of the fiscal year is the least important from an indicator point of view.
 - ◆ Many taxes closely track experience of last part of 2005-06 fiscal year (sales, withholding tax).
 - ◆ Volatile revenue source do not kick in until the second half of the fiscal year (corporate income, non-withholding portion of personal income tax).

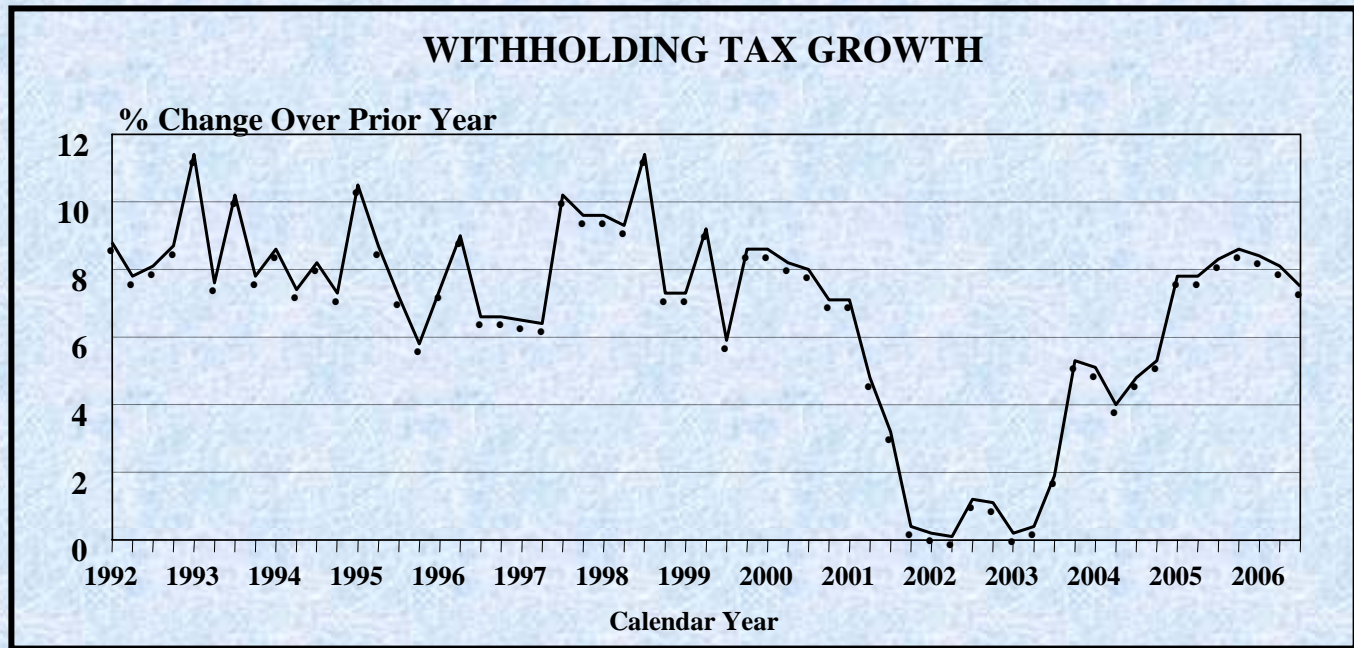
The “Mid-Decade Economic Slowdown” Has Finally Arrived

- ◆ Sales tax growth (28% of revenue base) for July-November was 5.8% vs. 7-10% range since mid 2003.



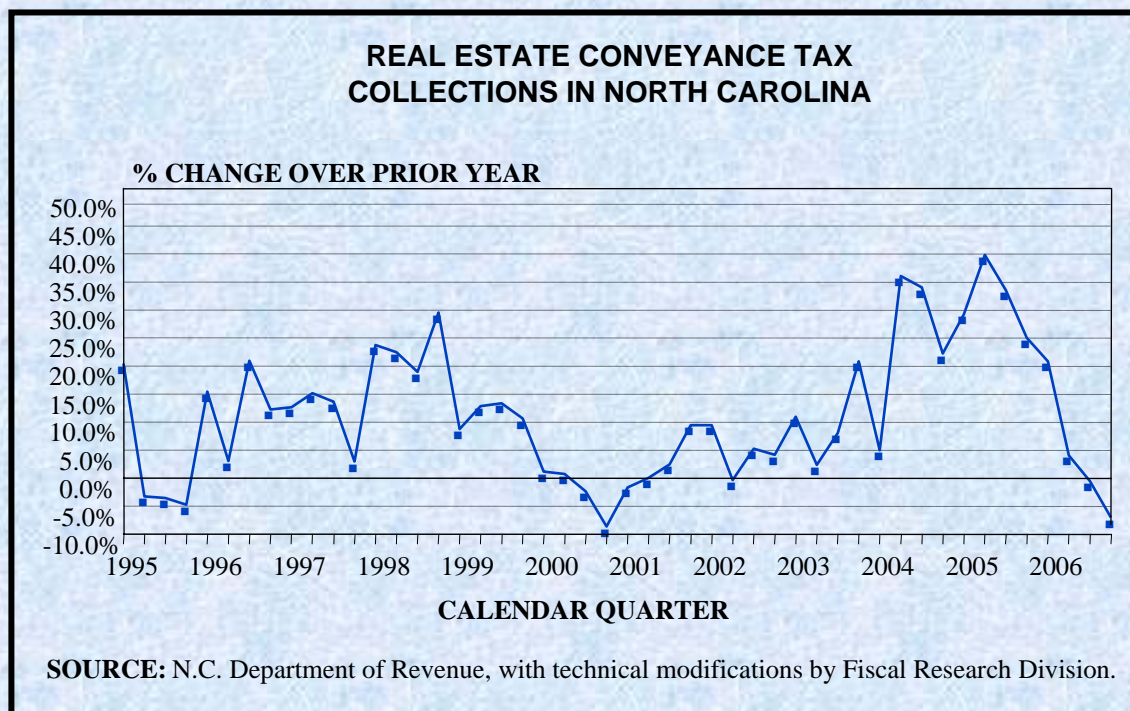
The “Mid-Decade Economic Slowdown” Has Finally Arrived (Continued)

- ◆ Withholding tax growth (40% of revenue base) has slowed from 8.3% for January-June period to 6.4% for July-November.



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

- ◆ Real estate conveyance tax collections* were up only 4.1% for April-June and down .5% for July-September, compared to a 20.9% increase for January-March. For October and November these receipts were down 5.7%.



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

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.
- ◆ 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)

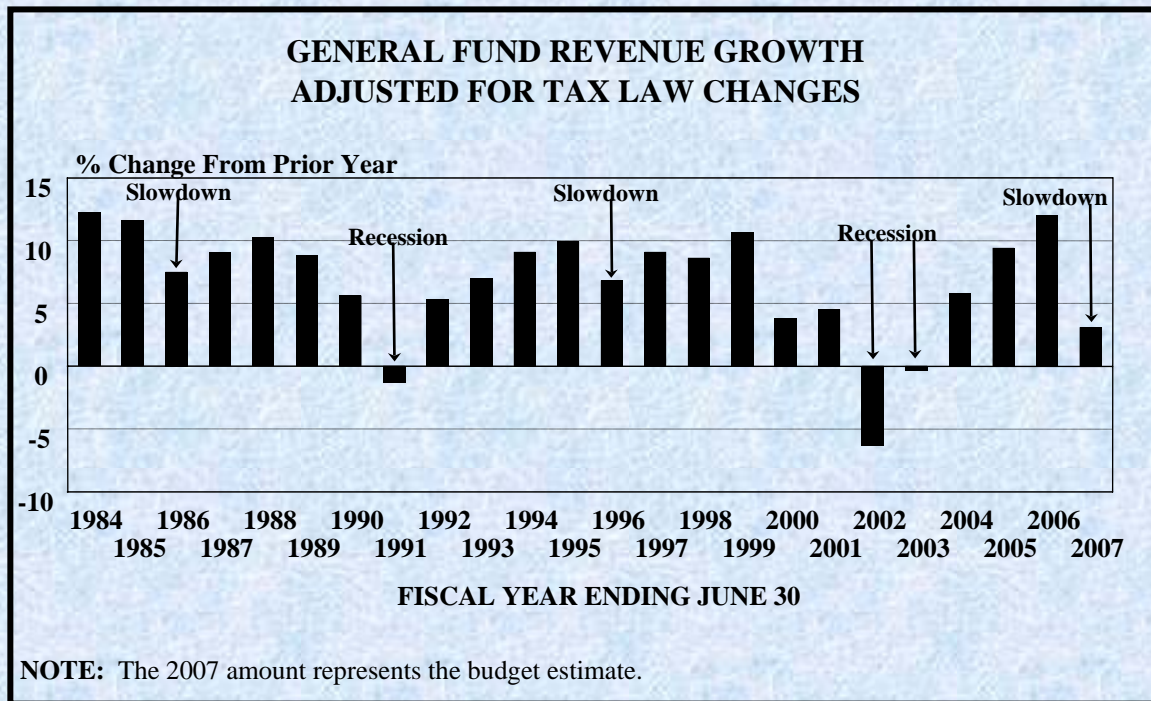
- ◆ Traditionally volatile revenue sources.
 - ◆ Corporate tax growth across the U.S. has exploded during this economic recovery (20-40% annual increases in N.C.)
 - ◆ Capital gains on income tax returns were up 49% for 2004 tax year and 40-45% for 2005. Gains on sale of real estate have been a larger 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 5.9% (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).



Let's Put Revenue Picture in Perspective

- ◆ We were long overdue for a couple of good years!
 - ◆ Acceleration of manufacturing job losses and 1999-2000 sales tax slump (rise in gas prices) led to budget challenges prior to recession.
 - ◆ Next came a deep recession fueled by stock market crash, events of September 11, and build-up to Iraq invasion.
 - ◆ Finally, North Carolina experienced an unprecedented sluggish recovery, relative to U.S. experience, due to continued struggles of manufacturing sector.
- ◆ We had a good year in 2004-05, except for struggling job market. In 2005-06 everything came together: all major revenue sources came in well ahead of expectations.
- ◆ Our economic growth is finally exceeding national average by typical margin (15%). However, we are now heading into a nationwide slowdown.

The 2007-08 Budget Outlook

- ◆ Normal Fiscal Research Division update will take place in January 2007.
- ◆ Outside groups were suggesting structural budget gap is around \$1.1 billion a couple of months ago.
- ◆ However, the recurring portion of 2006-07 revenue surplus could lower any potential gap significantly. In addition, the tentative 2007-08 revenue growth assumption is only 3%. A recovery from current slowdown could push this rate up.*

*Each 1% equals \$180 million. Long-term average rate is around 6.5%.

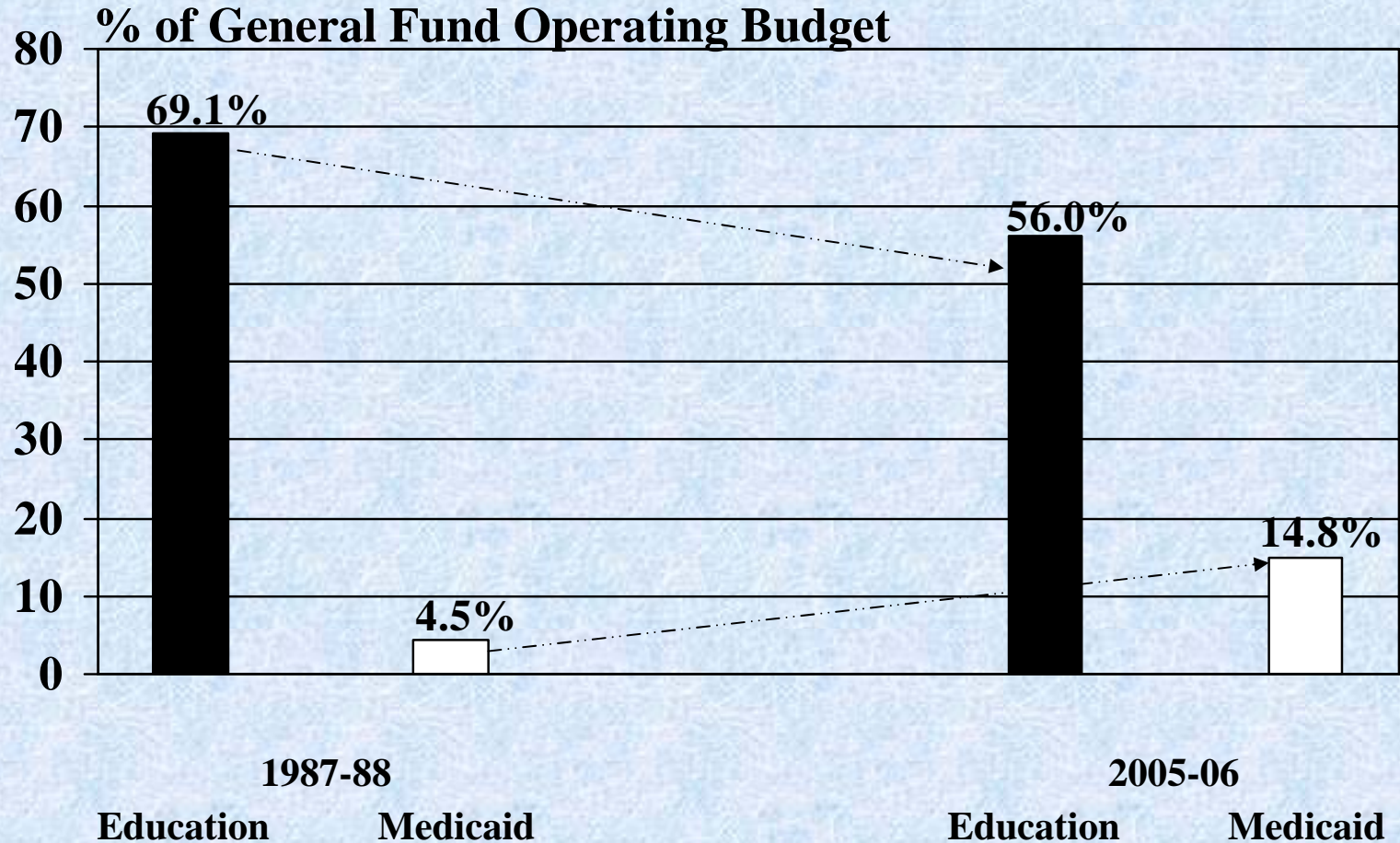
The 2007-08 Budget Outlook (Continued)

- ◆ Remaining portion of expiring tax increases is a key decision item.
 - ◆ ¼ cent sales tax (\$260 million)
 - ◆ 8.0% income tax rate (\$80 million)
- ◆ Challenge: If expiring taxes are gone, how do we make significant budget cuts when 90% of General Fund budget is comprised of education, health/human services, corrections, judicial functions.

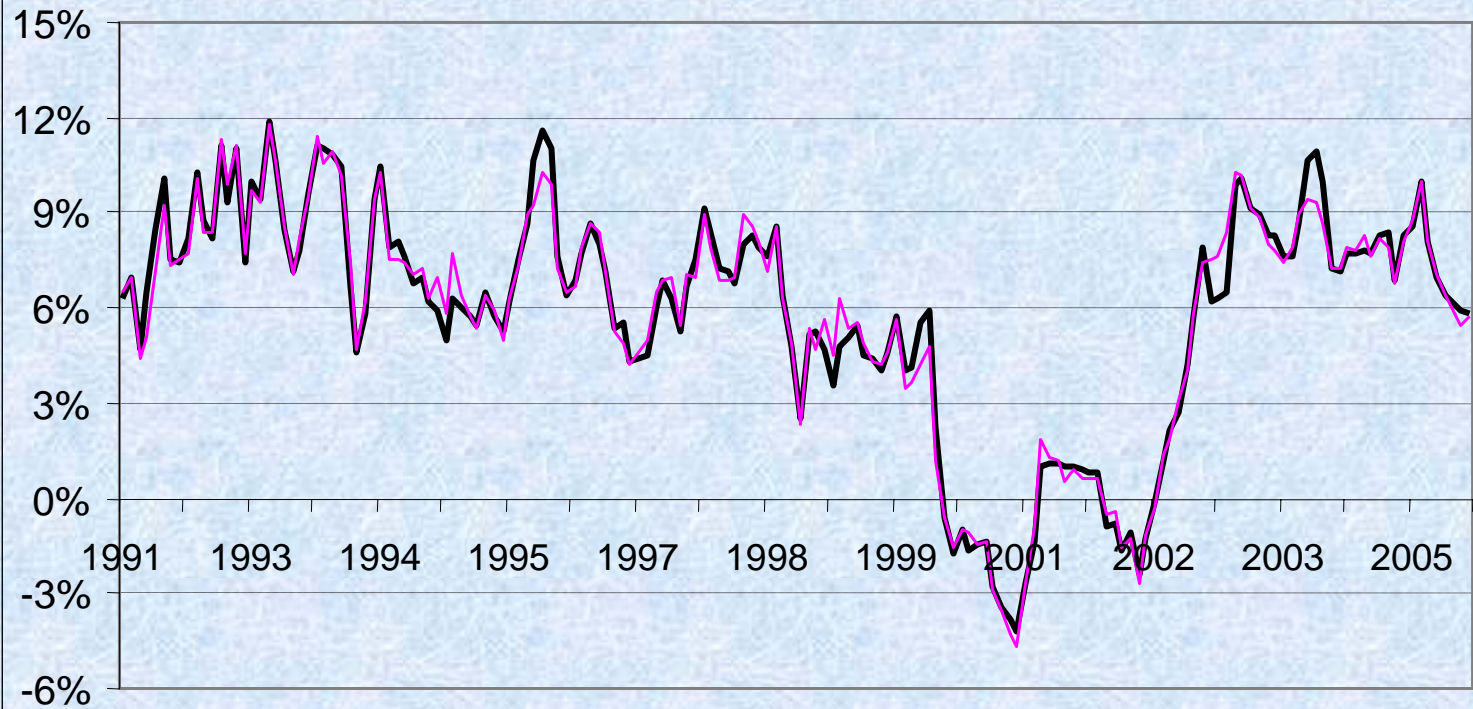
Long-Term Budget Outlook

- ◆ Prospects depend partly on 2007-08 budget fix.
- ◆ High growth in health care costs will still be a major problem:
 - ◆ Medicaid
 - ◆ State health plan
- ◆ Spending on education and other functions will continue to be “crowded out” by health care requirements.

“Crowding Out” of Education Spending



Baseline State & Local Gross Sales Tax, Y/Y%



- Seasonally adjusted, 3-month moving average.
- 3-month moving average, not seasonally adjusted.

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)

- ◆ 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.
- ◆ 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?

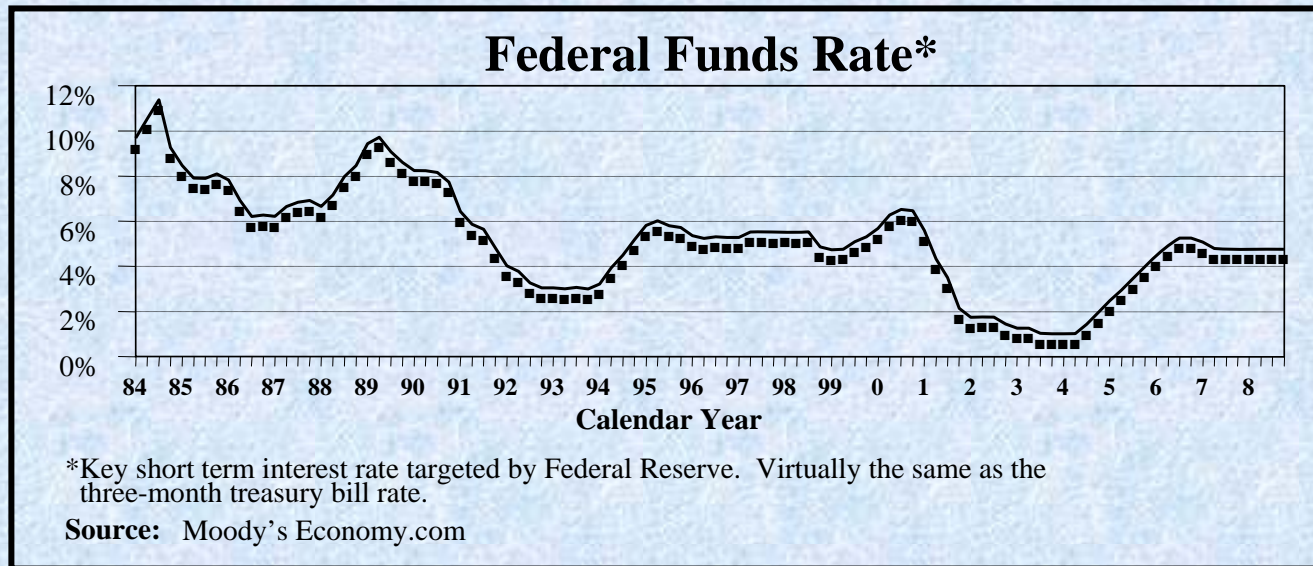
- ◆ A defining characteristic of the 2002-2004 economic recovery was sluggish employment growth.
 - ◆ The national weakness was due to reticence of employers to re-hire in an uncertain environment after September 11 and the other types of bad news. In addition, substantial overcapacity in computers and 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 September 2006 was 4.7%, 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 1.7% 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 2.5%.
- ◆ A detailed review of unemployment data indicates that while monthly claims are at a typical recovery level, the duration of unemployment remains abnormally high. For example, the monthly payout of unemployment benefits continues to run \$60-70 million instead of the more normal \$40-50 million.

Outlook for Interest Rates

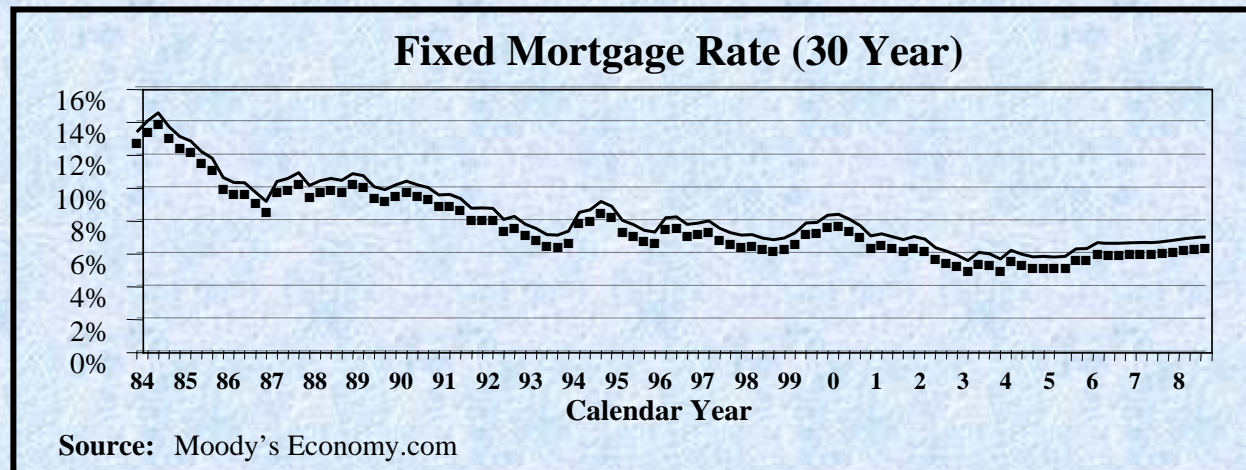
- ◆ During the current tightening cycle short-term rates have risen from 1% to 5¼% (from 5% to 9¼% for prime rate).



- ◆ Distinct signs of a slowing economy and the real estate crash means that the Federal Reserve has completed its mission.
- ◆ If the downturn worsens quickly, the Fed could lower rates as early as next Spring.

Outlook for Interest Rates (Continued)

- ◆ In a typical tightening cycle, long-term rates (including fixed 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.



- ◆ The magnitude of the drop in short-term rates will depend on severity of economic slowdown and the real estate crash.
- ◆ Long-term rates should remain flat for the next couple of years.