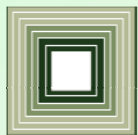


State Revenue Outlook



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Outlook Summary

- The intentionally cautious 2006-07 revenue forecast, along with the modest nature of the economic slowdown, has led to a substantial revenue surplus for the year.
- For the third year in a row a sizable portion of the gains are due to one-time sources.
- The turnaround in budget fortunes during the last three years is a “payback” for five sub-par years of revenue growth.
- The recurring portion of the current year surplus has sharply reduced the 2007-08 structural budget gap.
- The revised consensus revenue estimate is based on the prospect of a modest, but prolonged, economic slowdown driven by the bursting of the real estate bubble. The magnitude and duration of the housing slowdown is the biggest risk factor in the 2007-09 forecast.

Forecast Risks Have Turned Negative In Recent Days

- Stock prices slipped, due in part to concerns of an eroding economic outlook
- The recent Greenspan comments, while misinterpreted, do highlight the fact that risks have increased
- State and local sales tax receipts in North Carolina rose only 3.2% in February, compared to 5.1% for the Christmas holiday season
- Trucking firm activity, a respected leading economic indicator, continues to slide
- A respected national survey of service industries suggests that the weakness in housing may be spreading to many other sectors
- Subprime lending problem is leading to a tightening of loan standards for real estate
- Real estate conveyance tax collections in North Carolina fell 6% for January and February combined. This compares to a flat situation during the second half of 2006 and growth of 20-40% during the peak.

Not All The News is Gloomy

- Withholding tax collections, which comprise 40% of revenue base, continue to be surprisingly healthy due to bonuses and stock options for the first quarter of 2007.
- In recent decades recessions have been caused by a combination of a slowing economy, due to Federal Reserve policy, and some type of “shock” to the system (energy price spike, new military engagement, financial crisis). For now we do not have a shock on the horizon.
- The Federal Reserve has been successful on many occasions in engineering a soft landing. If economic conditions worsen, short term interest rates can be adjusted quickly.
- Even with the recent correction, stock prices are still up 70% from 2003 levels. In addition, the real estate downturn has still been mild in North Carolina so far.
- On balance any damage to the State budget outlook from slower job growth and retail sales will likely be offset by stronger-than-expected capital gains that will show up on April 15 tax returns.

How Are Revenues Doing So Far This Year?

- For the first eight months, General Fund receipts came in around \$560 million ahead of the budget forecast for the period. This is up from the revised \$480 million surplus through January. It is tempting to extrapolate this surplus to the full year.
- However, \$221 million of this total (40%) came from one-time settlements of long-standing corporate income tax disputes.
- In addition, the lion's share of forecast uncertainty is concentrated in the last four months. Prime examples include final payments for the prior tax year under both income taxes as well as the first two estimated tax payments for those taxes for the new tax year.
- Key economy-based revenues are continuing to reflect the economic slowdown.

Overview of 2006-07 Revenue Surplus

- By design consensus revenue forecast last May was the most conservative in over three decades. Reasons:
 - Explosive growth in 2004-05 and 2005-06
 - High-growth years in past have been followed by major declines
 - Heightened risk due to volatile revenue sources and real estate slowdown
- Actual experience has exceeded expectations. Why?
 - So far the real estate market downturn has not had a dramatic impact on overall economy (jobs, retail sales). This differs from experience during the real estate boom.
 - Job growth is still catching up from last recession, leading to strong income growth
 - Bonuses and stock options are back
 - Corporate managers have continued to wring out cost savings, propping up corporate income tax collections
 - Stock market recovery since 2003 has fueled retail sales and business investment
- Result: \$825.0 million revenue surplus estimate (revised consensus forecast).

2006-07 Revenue Surplus Details

- \$825.0 million total for full year
 - \$251.2 million due to one-time corporate settlements of long-standing tax disputes
 - \$573.8 million from regular revenues (equal to 3.2% of forecast base)
- Factors leading to regular revenue surplus
 - Economy-based taxes
 - Withholding collections are now expected to rise 6.2% for the year, compared to budget forecast of 4.4% (growth was 8.4% for first 8 months)
 - Gross state and local sales tax receipts, up 5.3% for July-February, will be up 5.1% for the full year.
 - Volatile revenues
 - Baseline corporate income tax will be flat for the year, compared to the budgeted 9% decline.

2006-07 Revenue Surplus Details (Cont'd)

- Personal income tax will exceed forecast by \$427.1 million.
 - Stronger than expected job growth has led to better wage/salary gains
 - Capital gains reported on tax returns will rise 8.5% for 2006 tax year and 2.2% for 2007, compared to cautious budget forecast of 25% decline for 2006 and 10% drop in 2007
 - New federal tax treatment of dividends (15% rate) continues to fuel increases in payouts by corporations
 - Mild nature of economic slowdown to date has caused Federal Reserve to delay interest rate cuts, propping up interest income received by taxpayers
 - For these reasons, April 15 income tax payments, budgeted at zero growth last May, should rise by ___ %.
- General Fund investment income will be well above forecast due to explosion in cash balances (affected by both revenues and expenditures)

Economic Framework for 2007-09 Revenue Forecast

- Fiscal Research outlook is similar to recent testimony of Federal Reserve Chair Bernanke. Key points in outlook:
 - Rapid rate of economic expansion in recent years has slowed to more sustainable pace.
 - Slowdown has primarily been driven by “substantial cooling” of housing market and impact on residential construction activity (housing starts).
 - While residential real estate activity is stabilizing, the reduced activity level will be a drag on the economy for many quarters (February 2007 forecast of Wachovia Securities in Charlotte has U.S. housing starts down 30% from peak for all of 2007 and 2008).
 - Consumer spending continues to be surprisingly resilient. It should “expand solidly in coming quarters” but at a rate less than income growth.
 - Employment growth will be moderate.

Economic Framework for 2007-09 Revenue Forecast (Cont'd)

- Capital purchases by businesses will expand at a moderate pace.
- Growth in exports should continue to be steady.
- Conclusion: Federal Reserve, based on prolonged modest slowdown outlook, projects around 4.9% nominal economic growth (includes inflation) for 2007. The 2008 gains are highly dependent on inflation outlook. For now 2008 is similar to 2007 expectations.
- When looking at the real estate “recession” it is worth noting that speculative excesses in a sector can take many years to work out. Examples include 2000 stock market crash and excess spending on computers and telecommunications equipment in the late-1990’s.

Specifics of 2007-09 Economic Forecast

- The outlook is guided by the Federal Reserve vision, as well national and state economic forecasts of Moody's Economy.com (contracted for by Fiscal Research) and Global Insight Incorporated (contracted by Office of State Budget and Management).

Annual Growth of Key North Carolina Economic Variables

	2004	2005	2006 (e)	2007(e)	2008(e)	2009(e)	20 Yr. Avg.
Gross State Product	5.2	7.0	8.1	5.5	5.7	5.3	6.3
Wage & Salary Income	5.5	5.5	6.3	5.1	5.6	5.7	6.0
Non-Farm Employment	1.3	1.9	1.8	1.3	1.6	1.7	2.0
Population	1.5	1.9	2.2	2.0	1.8	1.7	1.7
Existing Home Sales	23.4	13.5	7.4	-7.4	-0.9	0.3	6.8

Source: Data compiled by Moody's economy.com

Key Items in 2007-09 Revenue Forecast

- The Fiscal Research revenue estimates assume the temporary .25% sales tax hike and 8.0% income tax rate will expire.
- The State's economy will continue to experience a modest but prolonged economic slowdown.
- On an **economic growth basis** (jobs, retail sales, etc.), the baseline projected revenue growth is 4.9% for 2007-08 and 4.3% for 2008-09.
- **Baseline General Fund revenues**, which grow slightly faster than overall economy due to tax structure, will rise 5.5% in 2007-08 and 4.8% for 2008-09. Below is the most recent experience:

2004-05	9.3%
2005-06	11.6%
2006-07	6.4% (revised estimate)

Key Items in 2007-09 Revenue Forecast (Cont'd)

- The personal income tax (55% of General Fund revenue base) will be up 6.5% next year and 5.4% for 2008-09. These rates compare to the 11.1% gain for 2004-05 and 13.1% for 2005-06. Growth rates for the components of the tax base include:

	Tax Year				
	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Wages and salaries	5.5%	6.2%	5.0%	5.6%	5.7%
Capital gains	43.2%	8.5%	2.2%	-6.7%	-8.4%
Dividends*	7.0%	11.1%	9.1%	9.6%	8.5%
Business Income**	12.0%	5.7%	4.6%	5.5%	5.5%

*Strongly impacted by preferential federal tax rate.

**Includes sole proprietorships as well as pass-through income from partnerships and S corporations.

- The sales tax (25% of revenue base) should increase 3.6% in 2007-08 and 4.6% in 2008-09, compared to 9.4% in 2005-06 and 5.1% for 2006-07.
- Baseline corporate income tax collections will experience low single digit growth for 2007-08 and remain flat in 2008-09. This compares to 23-31% growth for peak years