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Economics Group

Special Commentary

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North Carolina Outlook

Changes and Challenges for a New Decade

Until the recent recession, North Carolina's economy was growing faster than the national average, and with this growth came a rising standard of living. Population was booming as the state added nearly 2 percent per year to its population over the course of the 1990s and continued adding during the 2000s at a slightly slower pace. In both decades, state population growth far exceeded the national average. Yet the sharp and deep recession in 2007-2009 hid the strength that continued for several years into the 21st century as it marred much of the income, employment and housing data. Still the first decade of the century saw personal income growth and state tax revenue gains of around 5 percent per year. The second, current, decade has certainly begun on a weak note, however, and we have little hope that the state will see anywhere near the prosperity or growth rates of the past two decades. Any strength that may appear this decade will have to be back weighted once the national economy has had a chance to recover. In this report, we take a look back at North Carolina's economy over the past few decades, and use that history to guide our discussion of the future. What are the long-term trends for employment, income and building activity? How will long-term demographic issues, which vary meaningfully across the state, shape economic outcomes? For a more near-term focus, the interested reader will find tear sheets beginning with page seven with a discussion of short-run economic prospects for three major metropolitan areas in North Carolina—Charlotte, the Triangle and the Triad.

Any strength that may appear this decade will have to be back weighted once the national economy has had a chance to recover

Table 1

North Carolina Through the Years

(Percent Change Per Annum)

	1970s	1980s	1990s	2000s
Population	1.5	1.2	1.9	1.7
Personal Income	10.9	9.7	6.8	4.9
Employment	3.1	2.6	2.3	0.2
Single Family Housing Permits	-	-	6.1	(8.6)
Multi Family Housing Permits	-	-	5.5	(8.3)
Coincident Index	-	4.7	4.2	1.1
State Tax Revenue[1]	-	-	7.5	5.3
Sales Tax Revenue[1]	-	-	7.7	4.4
Personal Income Tax Revenue[1]	-	-	8.1	3.1

[1] Begins in 1991

Source: Federal Reserve Bank of Philadelphia, U.S. Department of Commerce, U.S. Department of Labor, Nelson A. Rockefeller Institute of Government and Wells Fargo Securities, LLC

Population Growth and the Tax Base: Slower Gains, High Expectations

A tough economy and housing market nationally made it more difficult to relocate to North Carolina

North Carolina has seen enormous growth over the past three decades; population grew nearly 60 percent in the state, while the nation only saw slightly better than half that pace of growth (Figure 1). With a bigger population comes a bigger consumer base and labor force and, therefore, a more robust economy, generating higher tax revenues, all else equal. Unfortunately, it appears the era of growth has, at least temporarily, ended. The strong growth rates (more than 2 percent annually) that reigned for five straight years during the 1990s returned briefly in the middle of the last decade, but by 2009, growth had dropped back considerably, and we expect slower population growth will continue for the next few years. In 2009, net domestic migration was less than half of what it had been in 2006 and 2007—when migrations were responsible for more than 60 percent of population growth (Figure 2). A tough economy and housing market nationally then made it more difficult for relocations to North Carolina. Add to this the acute weakness in the North Carolina labor market and you have a clear picture of why population growth slowed sharply. If population growth has slowed sharply and is unlikely to return to the pace of the prior decade in the near term, then what are the consequences?

Figure 1

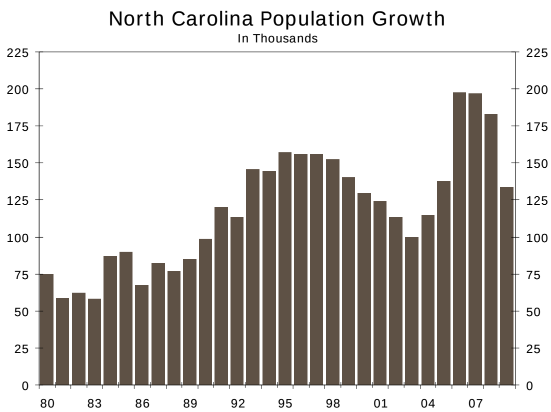
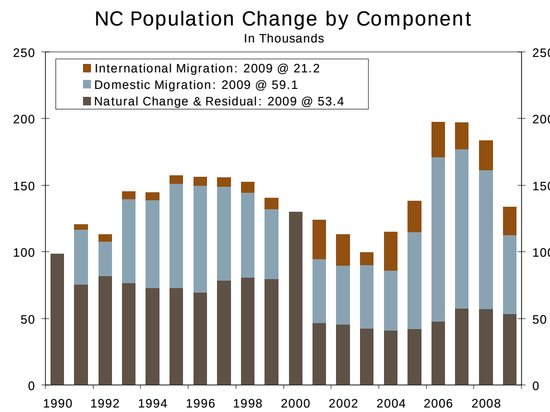


Figure 2



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Slower population growth will manifest itself across the economy, from a smaller consumer base to less tax revenue

Slower population growth will manifest itself across the economy, from a smaller consumer base to less tax revenue, and perhaps less strain on municipal services. This could be especially true in areas that have seen much faster growth than their infrastructure—like roads, schools and utilities—could handle. Over the short run, gains or losses in tax revenue are more closely associated with current business cycle conditions, and in the recent cycle, just as in 2001, state tax revenues took a considerable hit. Indeed, all major categories of taxation (personal, corporate and sales) posted declines for at least one year (Figure 3).

In the near term, we see a revenue bounce back. Any economic recovery, compared against the height of a financial crisis, will necessarily look better (Figure 4). However, over the long run, as comparisons get more difficult, we expect revenue growth rates to moderate. Losses in level terms have been substantial. For example, corporate income tax receipts, despite an astonishing 458 percent rise from their year-ago levels, still have not regained their peak from mid-2008. Outright strength will likely not be evident until 2011, when the economic recovery should have enough steam to start pushing tax receipts higher on trend, but the pace of revenue gains over the long run remains an issue, especially when compared to the level of services voters expect. In Governor Perdue's fiscal 2010-2011 budget proposals, there are plans to reduce or eliminate 70 programs and add more than $100 million to replenish the state's rainy day fund—both welcome moves. The 600-pound elephant in the room remains the entitlement spending that will be required from unfunded state pension liabilities and the growing Medicaid burden.

Figure 3

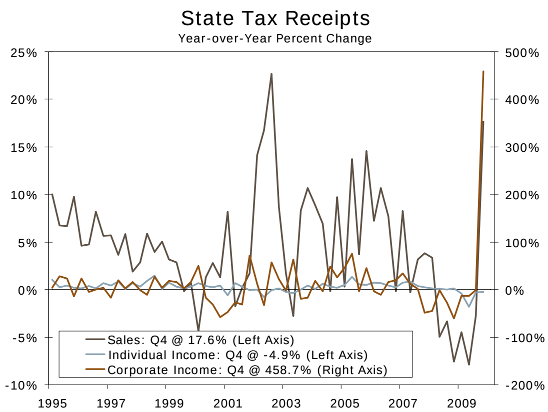
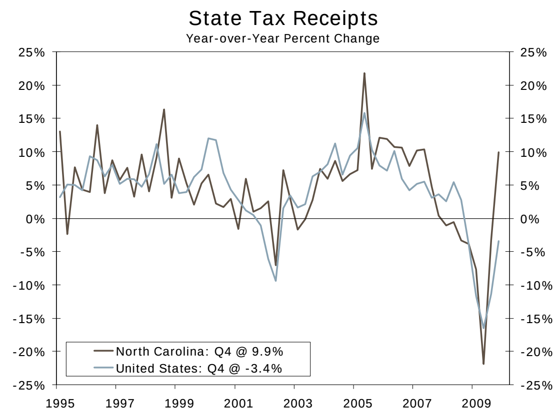


Figure 4



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

The Long-Run Issue

Population growth is a long-run concern for state and local revenue growth. By increasing the consumer and employee bases, population growth leads to higher sales tax revenues as well as personal income tax revenue in states like North Carolina that employ both tax sources. A bigger consumer base can also help drive profitability at state businesses pushing up corporate tax receipts. But, ominously, today's slower population growth sets up a slower growth trajectory going forward for both the economy as well as tax revenue. This is not to suggest that tax revenue will not start growing again or that the economy is to languish for many years, but all else equal, higher population growth would have put us on a better long-run growth trajectory. The lower growth profile is in stark contrast to many of the promises policymakers have made.

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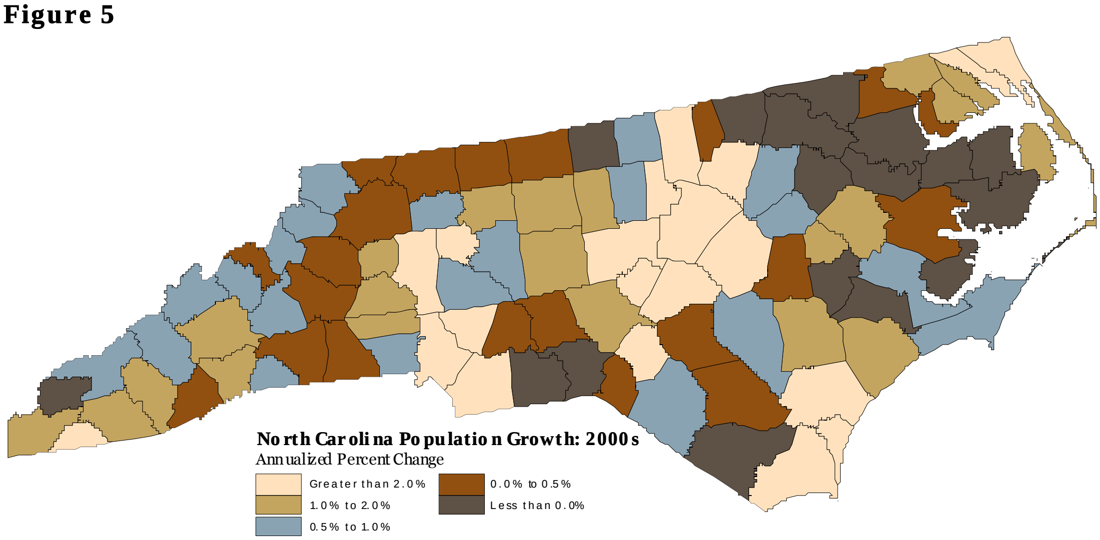
Figure 5



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

A second concern with population growth across the state is how unequal the gains have been by region (Figure 5). This is a continuing long-run problem for the state, as the economy has evolved away from agriculture and manufacturing toward services over the past 30 years. Much of the growth has been concentrated in the greater Charlotte metro area, especially up the I-77 corridor and east into Union county as well as in the greater Triangle area. Other pockets of growth have included the Wilmington area—which grew as a retirement destination during the housing boom—and the extreme northeastern counties of Currituck and Camden—which benefited from the growth in the greater Norfolk and Hampton Roads economies. The biggest problems are

Population growth has been uneven as the economy has evolved away from agriculture and manufacturing toward services

likely to be seen in a string of counties from Warren on the Virginia border down through Hyde on the coast that outright lost population from 2000-2009. All told, 17 counties in the state saw population contraction during the last decade.

The more rural and manufacturing-focused counties will also need to find a new engine for economic growth

This pattern of population growth will likely continue in the coming decade as better job growth and lower unemployment will continue to be concentrated in major metro areas such as Charlotte and the Triangle. One potential change, at least in the near term, will be in the retirement-heavy markets around Wilmington and Asheville, which both saw good growth in the last decade. These markets may be adversely affected by the major problems in national housing markets. Retirees who are unable to sell their homes in other places will not be able to relocate to these retirement markets. The more rural and manufacturing-focused counties will also need to find a new engine for economic growth as old line industries such as furniture and textiles will not be catalysts for job and population growth in the coming years.

Education, Jobs and the Policy Framework

While economic outcomes cannot be fully controlled by policymakers, the economic framework established by government certainly influences the pace and nature of economic growth. North Carolina Governor Beverly Perdue has stated the top priority for her administration over the next few years will be the preservation and creation of “jobs, jobs and more jobs.”[1] While employment clearly directly benefits the individual, it also increases consumer spending, helping other businesses remain viable, and raises income and sales taxes, funding an important part of the state’s budget. Strong employment growth of more than 2 percent during the 1980s and 1990s outpaced population growth, leading to lower unemployment rates, a major boon to the economy. However, the most recent decade witnessed a loss of much of that employment growth during the recession, while population growth continued. This imbalance led to higher unemployment rates and a greater focus on the labor market.

High Tech: Organic Growth

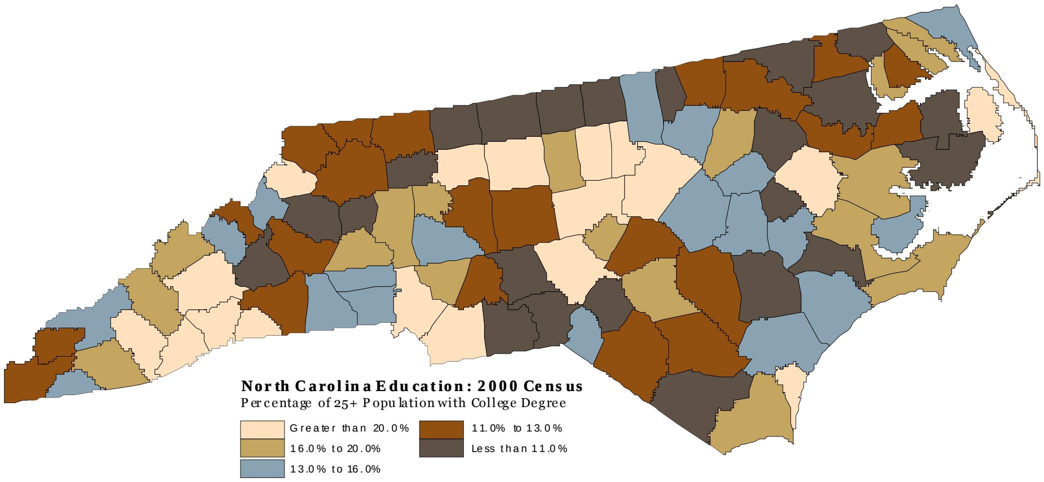
Technology, along with research and development, can create permanent jobs, as opposed to temporary jobs generated solely by stimulus dollars

Among the state’s strong points are the high-tech base near the capital, due to the concentration of universities and Research Triangle Park. Also, the growing presence of research and development in the Charlotte area, thanks to private and public ventures, such as the Charlotte Research Institute, which provide some geographic diversity. Technology, along with research and development, can create permanent jobs with future growth potential, as opposed to temporary jobs generated solely by stimulus dollars. Universities across the state help to attract high-tech firms, which support the organic creation of jobs and therefore, income, spending and economic growth. The process, like many others, is best done naturally.

Financial services continue to have a strong presence in the state, notably in Charlotte, where the fallout from the financial crisis has begun to subside. Ally Bank and Fifth Third Bank have recently increased their presence in Charlotte, and future expansion is likely as the economy recovers. These industries are well-positioned for future growth, and will be a boon to the state—how much of a boon is partially dependent on the decisions of policy-makers, both local and national. With employment the top priority of the state government, regions and sectors generating jobs need to be supported, especially sectors generating higher-skilled jobs with significant positive impact and future promise.

[1] Planning Guidelines for North Carolina State Government. State of North Carolina Office of State Budget and Management. March 1, 2010. Planning Guidelines for North Carolina State Government.

Figure 6



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Strategic Initiatives in Education and Jobs

North Carolina policymakers could best demonstrate their commitment to the long-term success of the state, not by creating temporary jobs for the short-term and thereby postponing the problems for the future, but by following a principle further down the current priority list, and "ensure all students graduate career and college ready."[2] The focus on educating the state's population is more important than ever—in periods of high unemployment the difference in unemployment rates between levels of education is striking. As evidenced in Figure 7, a college degree is a ticket to greater job stability in a downturn (Figure 7). With many opportunities in lower-skilled manufacturing and construction positions drying up on a permanent basis across the nation, every state would be well served by focusing on sustaining the businesses that have demonstrated an ability to employ the population. In contrast to manufacturing and construction, the jobs that are increasingly available in the United States require higher levels of education or training, generally insisting on high school diplomas and with a strong preference for college degrees or advanced technical training. These generally higher-paying jobs have greater and longer lasting economic impact, increasing spending, supporting business, and helping the dire state budget situation over time.

Every state would be well served by focusing on sustaining the businesses that have demonstrated an ability to employ the population

Much of the state, notably Charlotte and the Triangle, has benefitted from an influx of highly educated, often young, workers who relocated to North Carolina for employment purposes (Figure 6). In addition, many students flock to North Carolina's universities from out of state, though the in-state population has not had the degree of employment success that could be expected from a state, which has several top-rated public and private colleges in its boundaries and a 16-campus strong public university system. Indeed, the state's unemployment rate, at 11.2 percent, reaches into the top 10 states nationally—while that ranking has come down, it is certainly not a source of pride.

In order to ensure jobs, and therefore, income and spending, policymakers must make education improvement a top priority

Where does this disparity between higher education and employment come from? The primary and secondary schools have not been successful enough in graduating students that are prepared to begin post-secondary schooling, nor are they getting training that would provide the skills necessary to perform and adapt to the evolving landscape of the U.S. labor market.[3] Increasingly, skills associated with a high school diploma (or less) are not enough to make a successful job candidate at any level. In order to ensure jobs, and therefore, income and spending ability for the state's population, policymakers must make education improvement a top priority. Improving

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[2] **Planning Guidelines for North Carolina State Government. State of North Carolina Office of State Budget and Management. March 1, 2010. Planning Guidelines for North Carolina State Government.**

[3] **For further details see our note: *Labor Market Evolution: Realities and Romantics*. June 19, 2009. Available on our website.**

the quality and narrowing the focus of primary and secondary schools is an important goal for the medium term. At the same time, keeping the children of North Carolina in school to earn their high school diploma by whatever means possible can also help future job and income prospects. Employed individuals are vital for the state's economic growth as they are the engine of consumer spending and tax revenues.

Figure 7

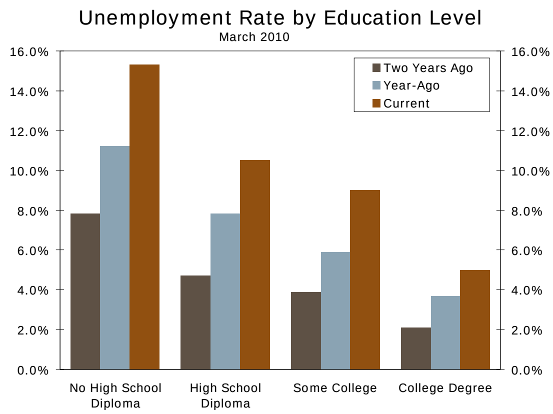
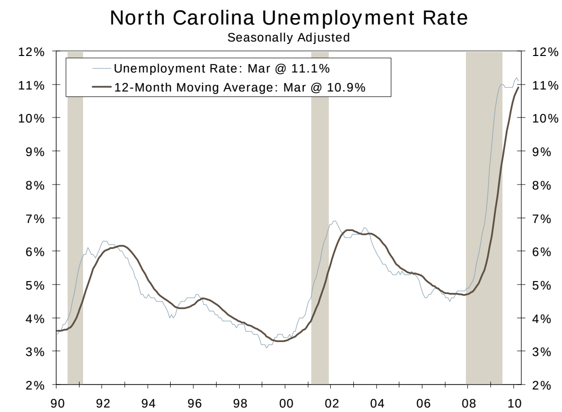


Figure 8



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Housing and job markets are truly intertwined

If policymakers are successful in preparing the population, not just of North Carolina but of the United States, as a whole for work in the industries that will maintain or gain relevance in the future, housing demand will follow. Insistence on homeownership with little regard for the financial appropriateness of that investment for each individual has been proven a disaster. Homeownership can provide stability and economic benefit if it is achieved through sustainable measures, such as a better-educated and a more employable populace. Housing and job markets are truly intertwined. While single-family and multi-family housing permits grew at more than a 5 percent pace during the 1990s, the collapse of new building at the end of the 2000s led to a decline in permits of more than 8 percent. While population growth will eventually create demand for some of the surplus of homes currently in existence, new building will be supported by new buyers. New buyers will think more carefully than before about purchasing a home, and a steady income will be instrumental in their purchase decision. While temporary solutions, such as the first-time homebuyer tax credit as well as Federal Reserve intervention into mortgage markets, can help sustain a base level of transactions in the short run, the housing market is not yet functional on its own. Preparing a future generation of homeowners for that responsibility requires a longer-term solution that would complement the temporary fixes—but is no less important to the viability of the housing market.

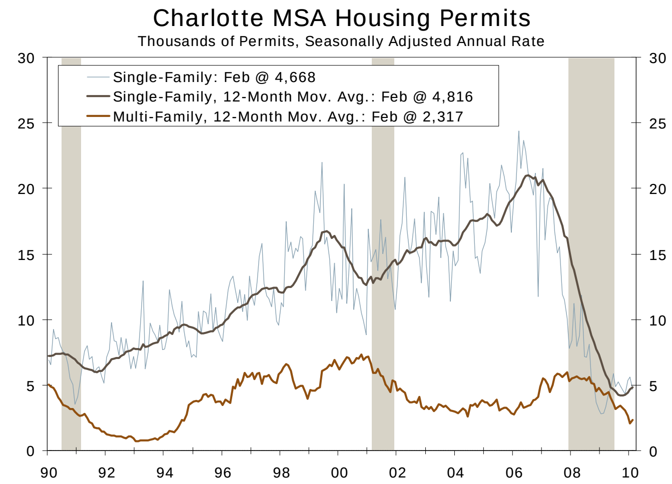
Conclusion: Tough Love for the Home State

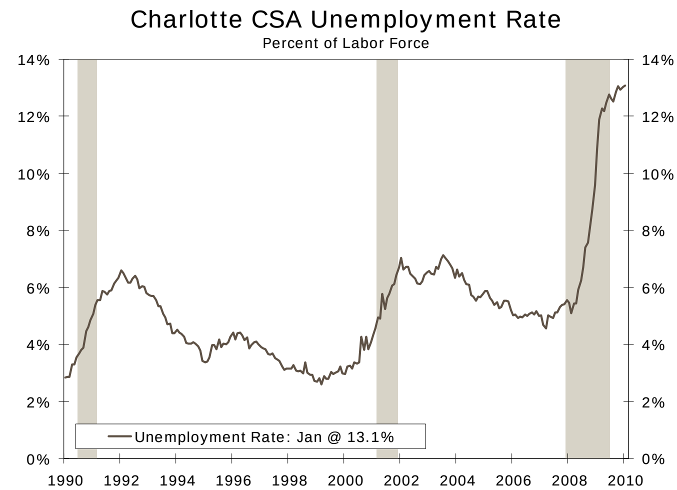
North Carolina was unprepared for the recent downturn

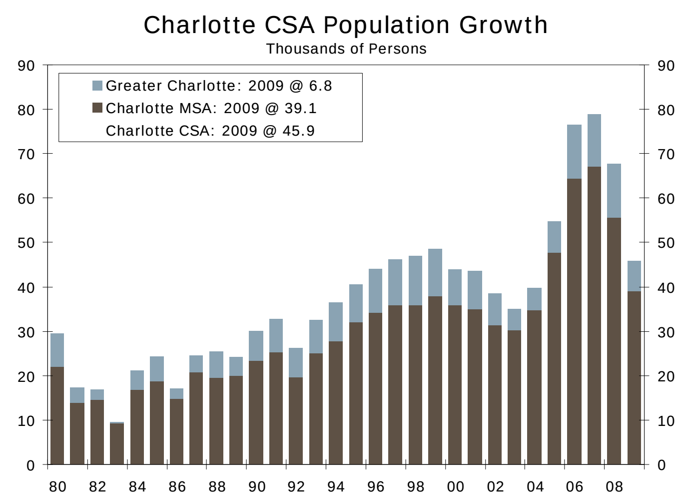
North Carolina was unprepared for the recent downturn. The state is still off-track and needs to make the hard decisions to get back on-track for the recovery and the business cycles to come. The state's labor force continues to be ill-prepared for the 21st century job market. Despite a select group of world class public and private universities, the primary and secondary education systems are not providing a sufficient number of job-ready workers. Community college efforts at remedial English and math are commendable, but reinforce the impression that lower schools are not succeeding. North Carolina's state budget, despite the lessons of the 2000 recession, was again not prepared to deal with the imbalances that resulted from a downdraft in revenues with growing entitlement spending. Growth alone will not bail us out. Hard decisions on Medicaid, state college tuitions, state employee pensions and benefits and our tax statutes should have been addressed after the 2000 recession. The state needs to make up for that mistake now, recognizing that solutions may require challenging the status quo and their strong constituencies.

Charlotte

- Charlotte and the surrounding area comprise the largest metropolitan area in the state. The broad reaching combined statistical area encompasses outlying cities such as Lincolnton, Salisbury and Shelby and several counties in northern South Carolina as well.
- Upon recovery from the recession, longer-term prospects for the region are bright. However, the region as a whole has struggled mightily in this downturn due to the key financial services industry taking a considerable hit and the weak national economy.
- Housing did not experience the boom and bust to the extent of many other parts of the country, but still felt the effects of the recession. Construction took a major hit thanks to the national downturn in the housing market. Housing permits remain extremely subdued, and will likely ramp up very slowly as the recovery continues. Price movement will be mixed for several more quarters due to foreclosures and a continued weak job market. Continued population growth will help to reduce the excess supply on the market over the long term.
- While the unemployment rate remains above the state average, some signs of hope have arrived in the metro area. Several financial services firms are moving into the area (e.g., Ally Bank, Fifth Third Bank), and while financial services are not the primary driver of the economy, the sector remains vitally important to the region's labor market and income base. High dependency on private sector employment has lifted the unemployment rate in Charlotte. However, the financial industry is slowly beginning to add jobs and stabilize. Another suffering sector affecting the greater metro area is traditional manufacturing, an industry that has continued to decline as a source of jobs and income.
- Population growth slowed sharply in the past year, especially in the outlying counties. Like the rest of the state, Charlotte has seen a weaker labor market and challenges across the nation have made relocating less attractive. A well-educated population base that continues to grow is attractive to business and a boon to economic growth over time, but the cyclical challenge remains.



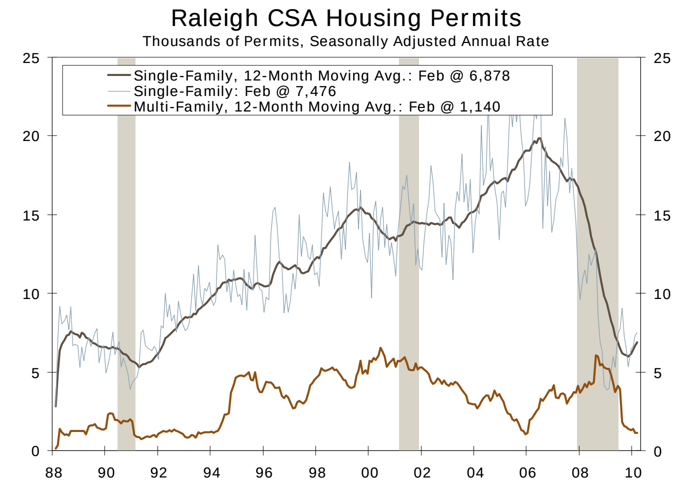


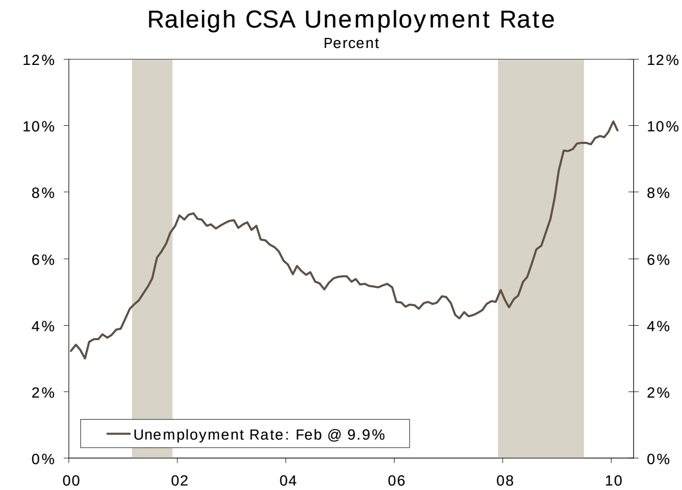


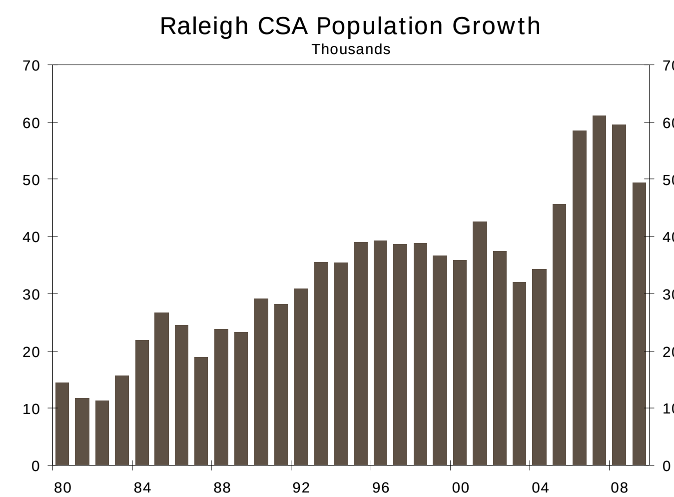
Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

Triangle

- The Triangle, which has come to stand for the combined Raleigh, Durham and Cary statistical areas, is recovering roughly in line with the state. Peaks and troughs seem to have been set in most economic indicators, with housing permits beginning an upturn and the unemployment rate, at least hopefully, peaking. While the problems created or exacerbated by the recession still exist to a large extent and the outlook is not for sunny skies today, there are important factors in the near term and long term that are encouraging to the region's economic outlook.
- The housing market in the Triangle remains in flux. The pace of sales remains extremely slow, which stifles the need for new building activity. Housing permits have begun to advance gradually in recent months, and the coming year will likely see continued gains. However the pace of recovery will be slow. Some building activity was likely spurred by the first-time homebuyer tax credit so the end of the tax credit will not help keep the pipeline filled. Instead, population growth and economic stability will have to drive housing demand, which in turn will drive construction.
- Fortunately, population growth has held up well in the Triangle, and we expect solid demographic trends will support the region in the coming years. The high concentration of universities is a steady source of educated young people for the region. Many students are dispersed among UNC-Chapel Hill, NC State and Duke, making the area an educational hotspot.
- The education sector, along with state government, provides relatively stable employment opportunities, key to the health of the labor market. In addition, private sector jobs are created by businesses attracted to the high levels of educational attainment in the region. Technology is anchored strongly in Research Triangle Park, with various firms announcing expansion plans in recent months. While the private sector struggled mightily during the recession, growth is slowly returning and the unemployment rate in the Triangle will not likely move meaningfully higher. Raleigh in particular has the benefit of the state government as an employer in the capital.





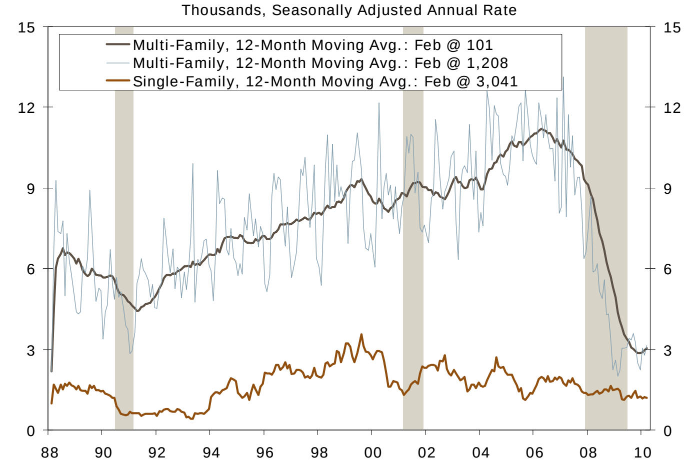


Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

Triad

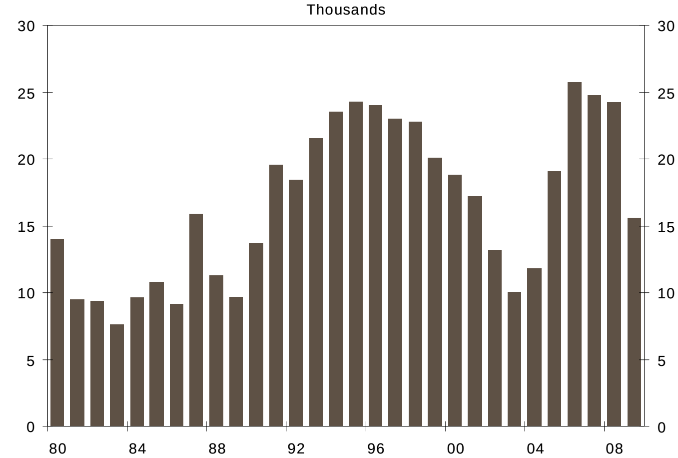
- The Triad area encompassing Greensboro, Winston Salem and High Point, has not fared nearly as well in the recent years as its larger cousins in the Triangle or Charlotte metro areas.
- While strong population growth has been the hallmark strength of the state and primarily the Triangle and Charlotte areas, the Triad has not seen the same kind of growth. Over the past 10 years, population growth has been just 1.2 percent per year—slower than the state average and less than half of the rate enjoyed in the other two major metro areas. The lack of population growth is concerning for the longer-run health of the community.
- The employment base of the greater Triad area still has an over reliance on manufacturing jobs and this has led to considerable weakness during the downturn. While manufacturing has been broadly strengthening and output has been ramping back up, job gains have been slow to materialize. Some gains in employment may come from manufacturing employers in the near term, but we do not expect the area to recover all of the manufacturing jobs that were lost in the latest downturn. At the same time, the unemployment rate may still go higher topping out at a sky-high 12 percent.
- Healthcare providers such as the Wake Forest Baptist University Medical Center (Winston Salem) and the Moses Cone System (Greensboro), provide some diversification to the regions manufacturing base and should be a positive for the labor market going forward. In addition, new expansions at employers like those at LabCorp will also help.
- The housing market across the Triad region did not see the bubble conditions that existed across much of the country. Without the same run-up in prices, the downside for the region has been more limited. Building activity, however, has still taken a considerable hit, and it appears to be stabilizing at much lower levels at this point. Without strong population growth, demand for new housing units will be limited. We do not expect a rapid bounce in building activity.

Greensboro CSA Housing Permits
Thousands, Seasonally Adjusted Annual Rate



Greensboro CSA Unemployment Rate
Percent

Greensboro CSA Population Growth
Thousands



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

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