North Carolina General Fund Revenue Consensus Forecast

Forecast Highlights

- Overcollections in the current fiscal year projected to reach $3.25 billion.
- Revenue collections in the upcoming biennium are expected to be slightly below projected revenue for the current fiscal year.
- The forecast includes reductions in revenue resulting from tax changes and new statutory transfers out of the General Fund.
- Consumer spending has remained strong despite persistently high inflation, bolstering individual, corporate income, sales tax revenues.

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The Fiscal Research Division and the Office of State Budget and Management issued a revised General Fund revenue forecast for FY 2022-23 and an initial General Fund revenue forecast for the upcoming FY 2023-25 biennium on February 15, 2023. This report summarizes the Consensus Forecast.

Revenue collections for FY 2022-23 are projected to surpass budgeted revenue by $3.25 billion (10.7%). This revision is relative to the certified budget, which was based on the May 2022 consensus forecast, with adjustments for changes enacted during the 2022 Regular Session. Revenue collections in the upcoming biennium are expected to be slightly below FY 2022-23 revenues, totaling $33.71 billion in FY 2023-24 and $33.65 billion in FY 2024-25.

February 2023 General Fund Consensus Revenue Forecast ($ in millions)

Fiscal Year	Revenue	Change from Prior Year ($)	Change from Prior Year (%)
2022-23	$33,760.2	$551.5	+1.7%
2023-24	$33,706.4	($53.8)	-0.2%
2024-25	$33,648.3	($58.1)	-0.2%

Forecast Overview

At the time of the last forecast, persistently high inflation had recently displaced COVID-19 transmission rates as the predominant economic headline. In response, policymakers at the Federal Reserve ("Fed") had begun tightening monetary policy, raising interest rates for the first time in two years in an attempt to suppress consumer demand. The Fed had also recently signaled that, if warranted by economic conditions, they were willing to act aggressively to rein in inflation.

Since the May 2022 forecast, inflation has surpassed previous estimates and proven much more persistent than expected. The prior forecast assumed that consumer demand would slow as consumers became less willing to absorb price increases. However, contrary to expectations, consumer spending remained strong despite even higher price increases than predicted. The Fed's tightening of monetary policy escalated in response, increasing interest rates more than the previous forecast anticipated.

Although this aggressive tightening of monetary policy increases the risk of recession, the economic outlook underlying this forecast continues to assume the economy will avoid an outright downturn. Rather, this forecast predicts that the economy will experience what has recently been termed a "slowcession", whereby economic growth comes to a near standstill without slipping into reverse for any extended period. This forecast anticipates a period of stagnant growth to endure for

- Inflation-boosted revenues depend on strong consumer spending, which is expected to slow.
- "Slowcession" expected to flatten economic growth, but economy expected to avoid outright recession.
- Strong year-to-date collections suggest prior forecast underestimated the tax base.
- Collections in final two months of prior year exceeded predictions by $557.5 million (12.3%), an unusually large deviation from projections.
- The revised forecast expects more of last year's revenue growth to persist in the current fiscal year.
- Most of the impacts of PPP deduction were likely realized in prior years, adding $450 million in overcollections.

a significant portion of 2023, followed by a period of slower-than-average growth over the remainder of the biennium. The forecast assumes the top level of the target federal funds rate will increase to 5% in March as the Federal Reserve continues its fight against inflation. While interest rates are expected to begin falling during the first year of biennium, monetary policy is expected to remain restrictive throughout the forecast period. Inflation is expected to slow while remaining above the Federal Reserve's 2% target well into 2024. The forecast expects a small decline in North Carolina employment in the first year of the biennium followed by a full recovery the following year. Wage growth is expected to come down from recent highs but remain above historical norms.

Although higher prices, wages, and interest rates have thus far boosted revenue, persistently high inflation has historically led to decreased consumer and business spending and, as a result, weaker collections. When combined with statutory reductions in available revenue and tax rates, revenue for each year of the upcoming biennium is likely to fall below projected revenue for the current fiscal year.

Current Fiscal Year Revenue

The revised forecast for FY 2022-23 projects net General Fund revenue of $33.76 billion, an upward revision of $3.25 billion (10.7%) from budgeted revenue and a 1.7% increase over FY 2021-22 revenues. The May 2022 forecast expected FY 2022-23 revenue to decline relative to the prior year by 5.9%, but strong year-to-date collections suggest that the prior forecast significantly underestimated the tax base. Several factors likely contributed to this underestimate.

As noted in the May 2022 report, considerable uncertainty arising from administrative irregularities and tax law changes heightened the likelihood that actual collections at the end of the fiscal year would deviate from projections. This ultimately proved to be the case: Collections in the final two months of FY 2021-22 exceeded the predicted amount by $557.5 million (12.3%). While the prior forecast attributed much of the exceptional strength in individual and corporate income tax revenue in FY 2021-22 to sources that were unlikely to recur, this forecast now expects more of last year's revenue growth, which was even larger than expected, to persist in the current fiscal year.

A substantial amount of overcollections stems from the prior forecast's reallocation of the revenue impact of a provision of the 2021 State budget into the current fiscal year. This provision retroactively made expenses related to forgiven loans from the Paycheck Protection Program (PPP) and similar pandemic-related programs tax deductible. However, more recent data revealed that most of the impact had likely already been realized in prior years. The result was an increase of approximately $450 million in projected corporate and individual income tax collections for the current fiscal year.

Robust consumer spending in the face of persistent high rates of inflation beyond our previous estimates is another major driver of overcollections in the current fiscal year. This resilience had a pervasive impact on tax revenues. Continued spending on goods and services, along with higher prices, has increased sales tax collections and, by extension, driven higher-than-expected year-to-date collections in both corporate income tax and individual income tax in the form of pass-through business income. In addition, investment income earned on the operating cash and reserves in the General Fund has exceeded expectations due to interest rates increasing more than expected.

- Overall, the revised forecast for the current fiscal year anticipates slow growth relative to the prior fiscal year.
- Individual income tax and franchise tax revenue are expected to decline in the current year.
- Other major sources of revenue are expected to increase, leading to an overall growth of 1.7% in FY 2022-23.
- New entity-level tax further complicates assessment of underlying strength of the State's tax base, making an "April Surprise" more likely.
- Nontax revenue from investment income is expected to be more than 10 times higher in the current year due to higher interest rates.

Overall, the revised forecast for the current fiscal year anticipates slow growth relative to the prior fiscal year despite tax reductions and new transfers out of the General Fund. Individual income tax and franchise tax revenue are expected to decline due to statutory changes. However, other major sources of revenue are expected to increase, more than offsetting this decline and leading to an overall increase of 1.7% year-over-year.

Individual Income Tax: Individual income tax revenue, which makes up approximately half of General Fund revenue, is expected to decline by $819.7 million (4.7%) relative to the prior year, in part due to increased deductions and tax rate reductions. Withholding revenue was above projections for the first seven months of the fiscal year, reflecting higher-than-expected wage growth, and is projected to finish the year 2.1% ahead of the prior forecast. On a year-ago basis, withholding revenue is expected to decline by 0.4%.

Non-withholding revenue was up 28.8% year-over-year through January, but this strength is not expected to continue during the rest of the fiscal year. Growth in the first part of the fiscal year partially reflects late payments on tax year 2021 liabilities. In addition, a substantial portion of collections reported in December and January were estimated payments for pass-through businesses electing to be taxed at the entity level. These payments will be credited against business owners' individual income tax liability for tax year 2022 and may lower final payments expected in April and increase refunds. However, because this entity-level election is new and complex, it is difficult to predict how it will impact the timing of collections. Other states that have enacted similar laws have seen marked shifts in collection patterns, especially in the first year, but state pass-through entity tax structures and rules vary widely, making comparisons difficult. Moreover, because estimated payments for pass-through entities are not distinguishable from final and extension payments in the collections data, we have limited information upon which to make inferences.

Business Taxes: Franchise tax collections are expected to decline by $46.5 million (5.2%), as the impact of changing the formula to eliminate the two property bases is realized. Without these tax changes, we would expect strong growth of approximately 6.7%. Corporate income tax is expected to increase 4.1% ($67.1 million) year-over-year, as the continued strength of consumer spending drives higher-than-expected corporate profits. Insurance premiums tax revenue is also expected to show strong year-over-year growth of 17.6% ($171 million) due to large increases in insurance premiums and the phase-in of additional Medicaid capitation payments to private insurance companies.

Sales and Use Tax: General Fund Sales tax revenue is expected to grow by $586.6 million (5.8%) over the prior fiscal year, even after accounting for the introduction of a statutory transfer of over $200 million to the Highway Fund, driven largely by higher prices and strong consumer spending.

Nontax Revenue: Investment income earned on the State's operating cash and reserves is expected to total $668.1 million, more than 10 times higher than the previous year due to the higher interest rate environment.

Outlook for the FY 2023-25 Biennium

Revenue collections are expected to decline slightly in the upcoming biennium, falling 0.2% each year and ending the biennium 0.3% below projected revenue in

- Revenue expected to decline in each year of the upcoming biennium as consumer spending weakens and statutory reductions take effect.
- Baseline revenue growth expected to be positive but below average pre-pandemic growth rates.
- Major sources of revenue are expected to end the biennium below current year's levels.
- Corporate profits are expected to moderate after two years of double-digit growth.
- Investment income earned on operating cash and reserves is expected to be the largest source of nontax revenue in the upcoming biennium

the current fiscal year. This forecast expects $33.71 billion in revenue for FY 2023-24 and $33.65 billion for FY 2024-25.

Reflecting a slowing economy, this forecast predicts that growth in total baseline revenue – that is, anticipated revenue without the upcoming tax law changes – will be positive during the upcoming biennium, but below the historical, pre-pandemic average growth rate. However, major revenue sources are expected to fall as various tax law changes are phased in. Franchise tax revenue is expected to decline as a result of modifications to the statutory calculation. Lower tax rates will reduce individual income tax in FY 2023-24, and both individual and corporate income tax revenue in FY 2024-25. After two years of double-digit growth, corporate profits are expected to moderate, reducing corporate income tax revenue. In addition, a larger transfer of revenue to the Highway Fund and Highway Trust Fund is expected to produce a year-over-year decline in available sales tax revenue. The second year of the biennium will see tax revenue return to slow growth, but declines in non-tax revenue will push overall projected revenue below estimates for the current fiscal year.

Individual Income Tax: Individual income tax is expected to decline in the upcoming biennium, due to expected moderation in income from businesses and capital gains, nearly stagnant employment growth, and reductions in the tax rate. Despite the tax rate declining from 4.99% to 4.75% in tax year 2023, 4.6% in tax year 2024, and 4.5% in tax year 2025, this forecast anticipates only a modest decline in revenue in the first year of the biennium followed by a slight rebound in growth, ending the biennium slightly above projected revenue for the current year. Without these adjustments to the tax rate, individual income would be expected to show slow growth over the upcoming biennium, increasing more slowly than average in FY 2023-24 before returning to just below long-term growth trends in FY 2024-25.

Sales and Use Tax: General fund sales and use tax revenue is forecasted to decline over the upcoming biennium. The 2022 State budget requires 2% of sales tax revenue ($207.6 million) be transferred to the transportation funds in FY 2022-23, increasing to 4% ($419.6 million) in FY 2023-24 and 6% ($643.5 million) in FY 2024-25. Without these transfers, predicted moderation in consumer spending would slow growth in sales and use tax revenue to 0.7% in FY 2023-24 and 2.4% in FY 2024-25. After adjusting for these transfers, however, sales tax revenue available for General Fund appropriation is expected to decline by 1.1% in FY 2023-24 and increase by 0.2% in FY 2024-25, ending the biennium $96.6 million (0.9%) below what we expect for the current fiscal year.

Business Taxes: After two years of strong growth, corporate income tax collections are expected to fall by 0.7% in the first year of the biennium due to falling profits. In the second year of the biennium, the first of a series of tax rate reductions will go into effect, precipitating a larger decline relative to the current fiscal year. Insurance premiums have recently increased substantially, but growth is expected to normalize. However, due to timing factors related to prepaid health plan payments, forecasted growth in revenue from insurance premiums tax is expected to be much higher in the first year of the biennium (11.1%) than in the second year (0.1%).

Nontax Revenue: Investment income earned on operating cash and reserves is expected to be the largest source of non-tax revenue in the upcoming biennium. Following expected changes in interest rates, this revenue source is expected to increase by 28.2% in the first year of the biennium and to decline by 24.7% in the

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- Collections from final income tax payments, due in mid-April, are difficult to predict.
- If April collections differ significantly from expectations, we will issue a revised revenue forecast in May.

second year. Actual collections will depend on the trajectory of interest rates as well as the amount and timing of actual spending during the biennium.

Summary

Risk of recession remains high as the Fed escalates its efforts to combat persistently high inflation, but this forecast predicts a "slowcession" rather than an outright economic downturn. Economic growth is expected to flatten in 2023 before resuming a slow, but more typical, pace. Inflation has thus far boosted tax revenues but depends on strong consumer spending, which is expected to slow. Statutory reductions in individual income and corporate taxes, available sales tax revenue, and changes to the franchise tax are expected to reduce revenues in the upcoming biennium. In the current fiscal year, net General Fund revenue is expected to grow modestly before declining slightly in each year of the upcoming biennium.

It is important to note that most of the forecast's risk and volatility reside in the second half of the fiscal year. Collections from final income tax payments, due in mid-April, are difficult to predict because income from dividends, capital gains, and businesses can result in sizable swings in collections. While year-to-date collections are often a useful barometer, accounting changes related to the new entity-level tax complicate our ability to assess the underlying strength of the State tax base, increasing the probability of an "April Surprise" — which may be negative or positive. If April collections differ significantly from expectations, we will issue a revised revenue forecast in May.