The Fiscal Research Division and the Office of State Budget and Management have reached consensus on the revenue forecast for the 2019 biennium. This report summarizes the forecast. Forecast Summary The forecast expects FY 2018-19 collections to be above the budgeted amount by $150.8 million (0.6%) and expects stable, modest growth to continue during the upcoming biennium. The current-year anticipated revenue surplus is mainly due to Sales tax collections, which were helped by the U.S. Supreme Court's June 2018 ruling that required remote sellers to begin collecting Sales tax on their sales in the State. The State's economy is now fully in the expansionary phase of the business cycle, which is producing solid employment as well as individual wage growth.

Accordingly, the biennium forecast assumes these economic conditions continue through the end of FY 2020-21. Current Fiscal Year Revenue The consensus forecast represents a cautious approach that reflects a continuation of steady economic growth. The forecast projects that total baseline revenue (i.e., total collections adjusted for tax rate and base changes) will grow this fiscal year at a pace near the long-term average growth rate of 4.5% By June 30th, General Fund revenue is forecast to increase by 2.2% over the amount collected in FY 2017-18. This surplus will be driven by strong Sales tax collections, better-than-expected withholding on Personal Income, and a significant increase in Investment income due to rising interest rates.

The result is revenue reaching almost $24.1 billion, yielding an estimated surplus of $150.8 million (0.6%) over the $23.9 billion budgeted amount. As a reminder, April always has the potential to be a unpredictable collection month in which income from dividends, capital gains, and business income can vary considerably from year to year, which result in sizable swings in income tax collections. The added volatility from federal tax code changes due to the federal Tax Cuts and Jobs Act compounds the difficulty in estimating net State revenue Table 1. General Fund Consensus Summary ($ in Millions) Fiscal Year Revenue Change 2017-18 $23,565.9 n/a 2018-19 (est.) $24,080.8 $515.7 2019-20 (est.) $24,814.1 $733.2 2020-21 (est.) $25,801.4 $987.3 2 General Fund Revenue Update February 13, 2019 from April 15th tax returns. Potential tax changes at the federal level could impact the timing of gains and losses taken by taxpayers when filing their 2018 taxes and 2019 estimated payments. This possibility increases the odds of an "April surprise." Personal Income Tax Personal Income tax collections are estimated to finish below the forecast by 0.4%, mainly due to the federal Tax Cut and Jobs Act. Taxpayers reacted to the legislation's enactment by making higher-than-normal estimated payments in December of 2017. Those overpayments added to last fiscal year's over-collections. The result was that in January 2019, taxpayers reduced the amount of their final estimated payments on the 2018 tax year, and these payments were $148 million below what would have been expected. The forecast assumes that the drop in estimated payments will not impact final payments or refunds in April. Offsetting most of the reduction has been solid growth in Individual wages. Withholding revenue is running nearly 1.4% above forecast for the first seven months of the fiscal year. Sales and Use Tax Sales tax revenue is estimated to be

ahead of the budgeted forecast by 1.5%. Sales tax collections began to gain momentum in the last fiscal year, and collections stabilized as consumer confidence grew. Gross collections are above forecast, in large part because of the U.S. Supreme Court's June 2018 ruling in South Dakota v. Wayfair, Inc., which granted states additional authority to require retailers to collect and remit sales tax. However, due to a jump in taxpayer refunds, net Sales tax collections do not fully reflect the increase that Wayfair brought. Refunds are $105 million higher than the target projection for the first seven months. Part of the reason refunds are higher than expected relates to the timing of when refunds are paid. Refunds that were expected to be paid out in June did not show up until August and were $70 million higher than was projected for that month. Business Taxes Business tax collections on Corporate income, the Franchise tax, and the Insurance gross premium tax are projected to finish close to their original projections and are expected to finish a combined $16.5 million above target. Non-Tax Revenue A final component of this fiscal year's surplus comes from Non-Tax revenue, particularly Investment Income. Earnings on the State's cash holdings have increased significantly. Rising interest rates have increased the expected return and are projected to be $44.3 million above the original forecast. Outlook for the 2019 Biennium Since the end of the Great Recession in 2009, the economy has made steady gains, adding 75,000 to 95,000 jobs per year. However, overall economic activity has remained at or slightly-below average.

The State's economy is now fully in the expansionary phase of the business cycle, which is producing solid employment as well as individual wage growth. Accordingly, the forecast assumes steady, solid growth throughout the upcoming biennium. The employment outlook for the State is expected to continue following the upward trend established at the end of the last Personal Income taxes remain on track for FY 2018 -18, although the federal Tax Cuts and Jobs Act caused some changes in taxpayers' withholding practices. Sales tax growth is strong, partly due to a June 2018 U.S. Supreme Court ruling about the collection of taxes for online sales. The "Wayfair decision" has led to increased sales tax collections from retailers who are located outside of North Carolina. Business taxes include the Corporate Income tax, the Franchise tax, and the Insurance gross premium tax.

All three of these sources are running close to target for the current fiscal year. Corporate Income tax, the Franchise tax, and the Insurance gross premium tax. All three of these sources are running close to target for the current fiscal year. 3 General Fund Revenue Update February 13, 2019 downturn. Employment is expected to experience steady gains of 1.2% in each year of the biennium. Employment is closely tied to personal income, and projected employment gains should improve the prospects for better income growth. The forecast envisions 1.9% and 4.0% growth in Personal Income tax collections for the respective fiscal years (growth rates include tax reductions for 2019, enacted in 2017). Those numbers are built primarily on the anticipation of employment gains continuing to place upward pressure on wages. Wage and salary growth has been well below expectations, not keeping pace with the improving overall economy.

Recent data on wages suggest that trend is starting to change. According to the US Bureau of Labor Statistics, inflation-adjusted average hourly wages increased by 1.6% in 2018. Sales and Use Tax Sales tax collections are forecast to increase by 5.3% and 4.6%, respectively, this biennium, which is slightly above average. A key reason for above-average Sales tax collections is the Wayfair decision. In FY 2019-20 alone, revenue is expected to increase by $125 million as a result of the decision. Several other factors influenced the forecast. Rising individual wage growth combined with lower energy prices, which are expected to persist through 2019, continue to free up consumer income for other purchases. Business Taxes Corporate Income tax collections are often volatile, and after several years of double-digit growth, corporate profits are expected to moderate over the next several years. The 5.7% growth expected over the biennium will be offset by the State's Corporate Income tax rate reduction that takes effect with the 2019 tax year. The 3% tax rate from 2018 was lowered to 2.5% in 2019.

The result is that net Corporate Income tax collections will fall by 1.6% in the upcoming fiscal year and grow by 6.3% in the following year. The Franchise tax and the Insurance Gross Premiums tax are far less volatile and growth over the biennium is expected to average 2.7% and 3.0%, respectively. Recap The revenue outlook for the 2019 biennium reflects a forecast for solid economic growth. Employment growth is projected to continue at its current pace throughout the biennium. The forecast envisions economy to remain stable throughout the forecast period. Below are key income indicators that influenced the forecast. Source: FRD estimates based on national and state forecasts provided by Moody