

 HdL Companies

CALIFORNIA FORECAST

SALES TAX TRENDS & ECONOMIC DRIVERS

JUNE 2022



Huntington Beach, CA

Delivering Revenue, Insight and Efficiency to Local Government Since 1983

HdL provides relevant information and analyses on the economic forces affecting California's local government agencies. In addition, HdL's Revenue Enhancement and Economic Development Services help clients to maximize revenues.



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Overview: Current and next year's effects on sales taxes include continuous high inflation into 2023. Intertwined are the three Federal Fund's interest rate increases to date with additional hikes expected through the remainder of this calendar year. Fuel price instability, stock market woes and rising consumer prices (as raw materials and components are more expensive) could further weaken consumer confidence and households will likely pull back on discretionary purchases. International supply chain issues show a steady recovery. Employee costs and worker shortages are holding back rebounds in hospitality and travel, and pandemic cycles may impact future spending patterns.

2021/22 | 2022/23

**Autos/Transportation**

12.4% | 4.0%

Several vehicle manufacturers recently reported the supply chain crisis is easing earlier than anticipated, with production returning to full capacity. However, as companies work to fulfill their large backlog of existing orders, industrywide vehicle inventory available on dealers' lots remains at a record low. Rising financing rates and high prices are also clouding the outlook for consumer demand going forward. While tax receipts increased another 15% in the first calendar quarter of 2022, recent sales reports for April and May indicate a worsening trend. As inventory slowly recovers, dealers are expected to lower prices to more affordable levels to coax reluctant consumers to buy. The forecast for modest growth over the next year reflects the interplay of these various elements.

**Building/Construction**

9.2% | 2.5%

The first quarter saw a jump in the amounts contractors passed on to owners for cost increases in materials, plumbing and electrical equipment. Lumber rates fell during this same quarter and prices should continue to slide closer to pre-pandemic levels. Statewide construction permits issued reflected modest gains in new housing units as valuations shot up 13%. Higher mortgage rates are limiting the number of new home buyers while also slowing the pace of home price appreciation. Meanwhile the Infrastructure Investment and Jobs Act (IIJA) started to produce cash disbursements along with complex regulations. The construction forecast shifts from neutral to growth, reflecting materials price inflation and the uptick in the statewide permit results.

**Business/Industry**

12.6% | 3.5%

Continuing its pandemic bounce-back, first quarter returns shot up 10% and most of the group's 21 unique business types posted gains over the prior year period. Even with supply chain and labor challenges, industrial products demand surged, and the electrical equipment sector saw significant growth. Technology demands and other B2B needs buoyed business services outcomes. The first quarter reflected a continuing need for medical/biotechnology apparatus and supplies (note future quarters may slow). Comprising a solid 25% of all B&I revenues, fulfillment centers remained flat compared to a year ago which had swelled from e-commerce sales previously allocated to countywide pools. HdL projects modest improvement in results for the next few quarters.

**Food/Drugs**

2.2% | 2.0%

While food sales are generally non-taxable items, non-food merchandise is still subject to sales taxes; grocery store's quarter filings rose 3% and paced overall improvement from this category. Drug stores also reported better totals. In contrast, cannabis retailers saw declines as competitiveness with unlicensed vendors and market saturation crept into some regions. Supermarkets and drug stores integration of traditional shopping experiences with online technologies plus stronger demand for in-home delivery is persistent. Looking ahead, households will tighten up budgets, yet moderate tax improvement is expected over the next year.

**Fuel/Service Stations**

51.6% | 8.8%

This sector endures upward pressure from multiple factors including restricted supplies (resulting from the Russian-Ukraine crisis), persistent record oil barrel and pump-related prices, and slow implementation by Saudi Arabia to increase production of global supply. A strong demand for greater road and air travel, refinery production interruptions, and conversion to summer petroleum blends are also contributing components. As a result, HdL forecasts a surge in sales tax for three more quarters, followed by a reduction beginning first quarter 2023. Additionally, the scheduled gas tax hike was proposed to be suspended by the Governor, but Legislative rejection of this idea allows Senate Bill 1 higher per gallon tax rates to take effect July 1, 2022.

**General Consumer Goods**

13.3% | 1.1%

First quarter sales tax outpaced previous expectations by just over 1%. Results were skewed due to a portion of fuel sales captured by discount department stores. Most segments expanded, but lower than expected activity from apparel retailers indicate shoppers might be shifting spending to cover higher food and gas prices. Many establishments reported data supporting customers being more mindful of basket size with lower spending on discretionary items. Despite these headwinds, outlay remains strong as households draw from a stockpile of savings and available credit. HdL projects mild growth through fiscal year 2022/23 (attributed to consumer spending resiliency) and for higher borrowing costs and inflation to contribute to a slight pullback in fiscal year 2023/24.

**Restaurants/Hotels**

34.5% | 4.5%

Restaurant operators' optimism has dwindled since mid-2021. While visits to restaurants continue to rise, escalating costs and staffing shortages present on-going challenges. Third-party restaurant delivery companies have reduced direct allocation to this group with a corresponding jump in allocations to the county pools. Over 3.5% of restaurant sector revenue is now reporting via the pools. Staffing shortages plague the hotel and entertainment industries as well. International tourism and business travel still have a long recovery ahead, but these other challenges are expected to slow growth over the coming few quarters.

**State and County Pools**

3.8% | 5.0%

The first quarter of 2022 saw an unexpected spike in use taxes distributed proportionally based upon each agency's place of sale results within their respective counties. Revenue surges were noteworthy in private-party auto sales and contractor activity, along with strong capital investment from several segments within the business-industry group. Multiple experts confirm e-commerce sales should continue to expand with bigger portions of overall retail sales activity benefitting both B2C and B2B enterprises. Pools use taxes moderate at lower growth levels. Anticipated gains reflect the resilient desire for buying online with upticks in prices on digitally available merchandise.

Proposition 172 projections vary from statewide Bradley-Burns calculations due to the state's utilization of differing collection periods in its allocations to counties. HdL forecasts a statewide increase of 16.2% for Fiscal Year 2021/22 and 3.1% for 2022/2023.

2021/22 | 2022/23


U.S. Real GDP Growth

4.1% | 2.1%

The economy has roared back from the brief pandemic-induced recession. In fact, many worry it is overheated and nearing the end of the decade-long expansionary period that began after the Great Recession. Inflation rates are at four-decade highs, driven in large part by strong consumer demand. Beacon Economics believes there is a very high probability of a recession in the next few years, although not likely in 2022.

A primary driver of this demand is the government stimulus that was injected into the U.S. economy during the pandemic – \$6 trillion by Congress and another \$5 trillion from the Federal Reserve in the form of quantitative easing. In retrospect, this was excessive. A look at national income data suggests the U.S. economy suffered \$1.2 to \$1.6 trillion in income losses in 2020 and the first half of 2021. The scale of the stimulus compared to the size of the loss and damage to the economy was oversized. All the extra cash in the economy pushed interest rates down, asset values surged, and as a result, spending has grown to unsustainably high levels.

Economist Herbet Stein wrote, “If something cannot go on forever, it will stop.” The Federal Reserve has finally accepted it cannot allow its loose monetary policy to continue forever. The realization that high inflation was not “transitory” came late, and the Fed only recently began removing cash from the economy by raising rates and through quantitative tightening. While the fundamentals of the U.S. economy are strong and will continue to be so over the short-term, the question is whether the inflated economy will pop in the next couple years and end in a serious recession or if the Fed will be able to slowly reduce the extra pressure in a measured manner. The latter seems increasingly unlikely. The Fed is expected to continue raising rates for the rest of the year.

Gasoline and diesel prices are at record highs, not just because Russian supply in the Ural region has been disrupted, but because refining capacity is severely limited. The greater bottleneck for increased production is at the level of refining capacity, not oil extraction. While Urals are not meeting Western demand, they are still meeting demand. Notably India, and allegedly China, have been stocking up on this heavily discounted oil (discounted due to sanctions). Thus, the substantial crude needs of the world's two most populous countries are likely to be met by the discounted Urals, serving as a pressure valve for what could be higher crude prices.



U.S. Unemployment Rate

4.2% | 3.4%

As normalization in economic activity gradually progressed, the U.S. unemployment rate fell in tandem. The two-month business cycle of 2020 (Feb-April) is a technical recession, but hardly representative of a natural business cycle. It was preceded by 128 consecutive months of economic expansion. Throughout these 128 months, the unemployment rate steadily trended lower, declining from 10.0% to 3.5%. As of May 2022, national unemployment rate stood at 3.6%, back to its pre-pandemic level.

The national labor market continues to be extremely tight across all sectors. According to the U.S. Bureau of Labor Statistics, there are a record high number of jobs available in the United States, placing upward pressure on wages. With no real signs of this situation changing, Beacon Economics expects a strong job market to continue for the foreseeable future.



CA Unemployment Rate

5.7% | 4.4%

California's unemployment rate fell to 4.6% in April 2022, still higher than the national rate of 3.6%. The underperformance of California's labor market is due to several interrelated factors. For one, there was a sizeable out-migration at the height of California's pandemic-related restrictions, largely by the virtual/mobile workforce. Simultaneously, other U.S. regions were booming and attracted workers that may have been underutilized in California due to pandemic restrictions. California's labor force participation rate troughed in May 2020 to 59.8%, only to spike back to 61.3% in July 2020 and revert back to 59.8% by October 2020. Since November 2020, California's labor force participation rate has been trending higher, most recently at 62.1%.

Since February 2020, the state's labor force has contracted by 358,100 workers, a 1.8% decline. Notably, in all regions that cover the state's major employment centers, the unemployment rate is now below the pre-pandemic rate. These figures tell us that, despite there being fewer workers employed in California than there were prior to the pandemic, for those seeking a job, there is ample work available.



CA Total Nonfarm Employment Growth

6.4% | 3.6%

There are currently 1.2 million job openings in California. To place this figure in context, in the five years prior to the pandemic, a period of economic expansion, there were 686,000 job openings in the state, on average.

Employment has returned to pre-pandemic levels in a growing number of sectors, and in the sectors where employment still lags, growth has been especially strong over the past year. From April 2021 to April 2022, employment grew fastest in Arts and Entertainment (34%), Accommodation and Food Services (19%), and Other Services (11%), which includes hair and nail salons. These sectors were the most affected by restrictions put in place to curb the spread of the COVID-19 virus and they will continue to outpace growth in other sectors of the economy throughout the year.

The labor market recovery has also been stronger in the inland parts of the state. There are more jobs today than there were prior to the pandemic in the Inland Empire, Sacramento, and Fresno. Bakersfield has had the next strongest recovery along this measure. Specifically in California, Logistics employment is now 18% higher than the pre-pandemic level, fueled by the continued and accelerated transition to online consumption.



CA Residential Building Permits

118,532 | 120,077

Home building permits will increase over the next year, but not enough to fundamentally improve the housing scarcity problem in California. In 2021, home building permits rose after a major decrease in 2020. Even with this upward trend continuing into 2022 and 2023, it is unlikely to meet Governor Newsom's 2019 goal of 3.5 million new units by 2025.



CA Median Existing Home Price

\$669,680 | \$686,369

In the first quarter of 2022, house prices in California averaged \$685,000, an increase of 13% on a year-over-year basis. This compares to a 16% increase nationally. The tight supply fundamentals that have driven strong price growth since the outset of the pandemic have not changed, although elevated mortgage rates will constrain demand. Home building permits have been relatively flat since 2019, while new listings are comparable to levels in the pre-pandemic years. Continued constraints on supply will act as a buttress to house prices in the presence of declining demand in the face of rising mortgage rates.



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California's allocation data trails actual sales activity by three to six months. HdL compensates for the lack of current information by reviewing the latest reports, statistics and perspectives from fifty or more economists, analysts and trade associations to reach a consensus on probable trends for coming quarters. The forecast is used to help project revenues based on statewide formulas and for reference in tailoring sales tax estimates appropriate to each client's specific demographics, tax base and regional trends.

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Beacon Economics has proven to be one of the most thorough and accurate economic research/analytical forecasting firms in the country. Their evaluation of the key drivers impacting local economies and tax revenues provides additional perspective to HdL's quarterly consensus updates. The collaboration and sharing of information between Beacon and HdL helps both companies enhance the accuracy of the work that they perform for their respective clients.