CALIFORNIA FORECAST

SALES TAX TRENDS AND ECONOMIC DRIVERS

APRIL 2020

HdL Companies

Sierra Foothills, California

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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FY 19/20 & 20/21 FORECAST

Given the unusual circumstances we are all living in today, we have modified the April 2020 HdL Consensus Forecast. We are providing broader explanations about two major ongoing events which impact fiscal year 2019/20 and 2020/21 statewide sales tax trends. As is our tradition, we also offer context that supports our major industry group projections. We trust this information communicates clearly a broad understanding of where sales tax revenue is headed, knowing these vital resources are essential to addressing your communities needs during these trying times.

CORONAVIRUS (COVID-19) Impacts on California Sales Tax

The swift reaction by consumers and businesses to the outbreak of coronavirus (Covid-19) in the U.S. is causing a huge decrease in spending on certain goods and services. The national and state response, combined with the uncertainty of how long the presence of the virus will disrupt the U.S. economy has made revenue forecasting particularly challenging. This forecast was developed in mid-March after reviewing the impacts of previous downturns, studying the data, reports and projections of numerous industry specific analysts and monitoring all updates up to that time.

The forecast assumes that adequate testing will have been completed by early April to allow health care agencies to have a clearer understanding of the extent of the virus and implement more site specific containment actions that allow the majority of businesses and schools to reopen and return to work. Based on initial recovery reports from China and South Korea, our forecast assumes that the virus will have run its course by the end of September. It also assumes that the majority of supply chain disruptions impacting manufacturers will have been resolved by mid-summer and that proposed federal actions will be successful in avoiding a deep recession. Under our scenario, declines in sales tax revenues are expected to bottom out by the fourth quarter of 2020 with subsequent gains expected to be moderate for several quarters after. The most dramatic decreases are expected during the first and second quarter 2020. Although future comparisons to these periods will be positive, overall dollars will still be less than the same period in 2018.

Already marginal or overly leveraged businesses may not survive a lengthy shutdown even with federal subsidies and our observation from previous downturns; the return to previous spending patterns after significant income interruptions is not immediate and often evolves. Consumers may take time to fully get back to previous leisure travel, dining and discretionary spending habits. Businesses similarly become more cautious about capital investment and the number of employees to hire after emerging from an economic crisis. Business travelers who had to resort to teleconferencing may continue to teleconference. Formerly avid brick-and-mortar shoppers may find that online shopping and delivery services suits them just as well. The percentage changes in these quarterly forecasts are statewide. Every local jurisdiction has its own distinctive sales tax demographics and business characteristics and the depth of the impact will vary. Further, as individual client budget forecasts are constructed, we will continue to monitor for subsequent economic changes that may have not been reflected in this initial forecast and factor those changes into our client’s projections.

Wayfair Update - Implementation Enhances Taxes in Pools

In June 2018, the United States Supreme Court overturned two rulings which had previously freed retailers from collecting and remitting taxes for states and local jurisdictions where they had no physical presence, even though the buyer then became responsible for paying a corresponding "use tax." The 2018 reversal acknowledged the unworkability and costs of tracking use tax for individual online shopping purchases was diminishing local tax revenues and creating an unfair competitive disadvantage for local retailers.

To implement this change, California amended the Revenue and Tax Code under AB147 (Wayfair Bill) which contained two key provisions. First, beginning April 1, 2019, out-of-state retailers with annual sales of tangible personal property of $500,000 or more in a calendar year were required to collect and remit the state's sales and use taxes. Second, effective October 1, 2019, Marketplace Facilitators such as Amazon, Ebay and Etsy became obligated to collect and remit sales and use taxes for third party retailers who contract with the facilitator to provide sales related services (e.g. order taking, payment processing, fulfillment, etc.). The same $500,000 threshold applies to Marketplace Facilitators. The local portion of these tax collections are being allocated to cities and counties on a pro-rata basis through the State and County Pools.

Over the four years prior to the Wayfair decision, sales tax allocations to State and County Pools averaged 7% annual increases. These gains were attributable to changes in sales patterns which declined at brick and mortar locations, as consumer spending patterns increased considerably through online platforms and mobile technologies. The Wayfair decision increased state-wide sales tax collections as evidenced by the County Pools experiencing growth of 14% for the second quarter and 15% for the third quarter of 2019. Fourth quarter Pools taxes were 27% higher when measured against the comparable 2018 period. Marketplace Facilitators first-time reporting contributed over $45,000,000 statewide which represented 12% of this gain.

Our forecast for the State and County Pools (20.1% in FY 2019/20 and 9.4% in FY 2020/21) reflects Wayfair taxes collected to date along with projections for full program implementation. Specific allocations to local agencies continue to be pro-rata based upon point-of-sale activity for each jurisdiction relative to the total taxes generated by all municipalities within each county. While individual results will vary, the majority of cities and counties should expect an increase in revenue from the County Pool in the current and next fiscal years. AB147 also obligated retailers with statewide sales of $500,000 or more in a calendar year to collect and remit voter-approved transaction and use taxes (district taxes) for every jurisdiction imposing such a tax, regardless of the level of sales within each district. For those agencies with voter-approved transactions taxes, Wayfair compliance has also boosted local measure revenues received to date; full Wayfair implementation is anticipated to make a positive impact on revenue projections into fiscal year 2020-21.

HDL CONSENSUS FORECAST – APRIL 2020

STATEWIDE SALES TAX TRENDS

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TOTAL 1Q20 **-3.6%** | 2Q20 **-14.6%** | 2020/21 **-1.6**

Autos/Transportation

1Q20 -6.0% | 2Q20 -32.0% | 2020/21 -7.2%

Auto sales had already started declining prior to the COVID-19 outbreak, with rising vehicle prices propping up sales tax receipts. Our forecast now expects similar short-term impacts to the initial Great Recession period of 2008. New and used vehicle acquisitions will experience dramatic declines into the spring months. In response to the sudden and significant slowdown of the economy, it's anticipated that many auto dealers will ramp up incentives and decrease prices to move inventory. Longer term growth rates are attributed to a comparison with dramatic short-term declines and the probability of lower interest rates available to elongate the stimulus to the economy.

Building/Construction

1Q20 -2.0% | 2Q20 -5.0% | 2020/21 1.4%

Reports show overall construction will continue but at a slower pace with the outdoor environment helping COVID-19 concerns. However, with spending on appliances and indoor-outdoor garden supplies making up 20%-25% of home improvement center sales, negative impacts are expected due to reduced spending compared to last year. Economic uncertainties may also put pressure on home sales during the coming summer months thus hurting the contractor's sector.

Business/Industry

1Q20 -13.5% | 2Q20 -16.5% | 2020/21 -6.8%

Most categories within this group are expected to decline for several quarters with the COVID-19 disruption of supply chains provoking the deepest impacts in the first and second quarters of 2020. Companies needing components to manufacture consumer electronics, pharmaceuticals, machinery and trucks may be particularly squeezed. Depending on inventory availability, there may be a temporary boost in the demand for food processing, medical, and telecommunication equipment and supplies. The sector most suited to gain will be industrial zoned fulfillment and logistics centers that are "point of sale" for the products that they ship. COVID-19 quarantines will further enhance the shift from brick-and-mortar stores to online shopping and produce double digit growth in many cases.

Fuel/Service Stations

1Q20 -3.0% | 2Q20 -20.0% | 2020/21 -4.7%

As a result of COVID-19, the economy is experiencing a unique combination of a decrease in the demand for automobile and jet fuel coupled with an increase in supply of oil by OPEC and Russia. These factors have pushed the price of crude oil back to 2002 lows. Projections are for fuel prices in California to drop for the remainder of this calendar year and into the first quarter of 2021. Afterwards, oil prices should increase into the range of $45 to $60 per barrel toward the end of 2021 and into 2022. However oversupply may keep gas prices relatively low and moderate potential sales tax growth.

Food/Drugs

1Q20 5.0% | 2Q20 5.0% | 2020/21 2.0%

With consumers stocking up for a quarantine period, expected longer periods of school closures, and most dining out options minimized, consumers will return to eating at home supporting continued growth in this relatively small sector.

General Consumer Goods

1Q20 -9.5% | 2Q20 -25.0% | 2020/21 -5.6%

Core retail sales are expected to see a significant drop as society implements social distancing measures to combat the spread of COVID-19 at the recommendation of health professionals and government leaders. Large shopping centers and popular retailers have announced periods of closure as many consumers and employees are encouraged and/or required to stay home to limit the spread of the disease. While the immediate fallout subsides, brick and mortar retail sales are expected to be bleak in the second quarter. As consumer confidence drops and employment woes set in, the effects are projected to negatively impact discretionary spending throughout the remainder of 2020.

Restaurants/Hotels

1Q20 -9.5% | 2Q20 -20.0% | 2020/21 0.2%

Like the General Consumer Goods forecast, the Restaurant and Hotel sectors are anticipated to experience major impacts due to cancelation of events at large venues and COVID-19 quarantines. Restaurants and other facilities that prepare and serve food are being restricted to delivery or take-out and some are striking agreements with delivery providers to offer 'hands-off' options. Consumers are shifting their food spending to groceries as quarantines continue, which could impact the long-term outlook for the sector if dining habits change. This industry is also the most vulnerable to closures given the already increasing tight operating margins and staff costs placing pressure prior to the COVID-19 impacts. Most major hotels have laid off most of their staff, while others have announced they will temporarily shut down.

State and County Pools

1Q20 19.0% | 2Q20 16.0% | 2020/21 9.4%

Forecasting of pools revenues is unique at this time. While COVID-19 impacts are generating negative prognostications across the point of sale industry groups noted above, continued consumer behavior toward online procurement combined with new 'Wayfair' related taxes push forecast estimates into positive territory over the next eighteen months. Results will be influenced by consumer behavior along with business adaptation to address consumer needs and expectations during this national health emergency.