HdL Companies

CALIFORNIA FORECAST

SALES TAX TRENDS & ECONOMIC DRIVERS

MARCH 2022

Laguna Niguel, 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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STATEWIDE SALES TAX TRENDS

2021/22 | 2022/23

TOTAL 12.3% | 2.4%

Overview: Current and next year's influences include high inflation passed along in the cost of goods and expected interest rate increases by the Federal Reserve. Food service, hospitality and retail trade industries struggle to find and retain employees. Impacted by the Ukraine-Russia crisis, fuel prices remain volatile. Supply chain and raw material interruptions could disrupt some sales. COVID still remains a public health challenge.

2021/22 | 2022/23

Autos/Transportation — 10.3% | 3.4%

Car dealerships available onsite inventory remains at record lows as global conflicts continue to disrupt product supply chains. Vehicle production is predicted to trail demand through late 2023 and possibly into early 2024. The lack of supply caused new car prices to jump 12% and used car prices 41% above January 2021 figures. Vehicle pricing is likely at a peak and not expected to return to pre-pandemic levels any time soon. The combination of strong demand and inflated prices will sustain tax receipts into the next year. Future increases are expected to be relatively modest, however, compared to the 16% surge in calendar year 2021. RV, truck, and large vehicle sales will also be hampered by soaring gasoline prices.

Building/Construction — 4.9% | 0.5%

Material prices were more reasonable during the fourth quarter, however, lumber rose to $1,200 per 1,000 board feet in early January (three times the pre-pandemic price). The end of 2021 saw a 2% rise in construction permit values. This offers homebuilders a backlog to work on as nonresidential construction sees an increase in demand. Rising mortgage interest rates have not yet dampened demand for new homes and will benefit home supply outlets. Plumbing/electrical materials increased by at least 15% in first quarter 2022, following three straight quarters of double-digit price jumps. Prior estimates remain true; even if construction activity increases, the rate of declining material prices after the first quarter offsets those gains through the first quarter of 2023.

Business/Industry — 10.6% | 3.3%

A 17% fourth quarter tax surge was a pleasant surprise. Fulfillment centers with robust ecommerce sales and taxes previously allocated to countywide pools were major contributors. A few segments struggled through pandemic-related challenges such as raw material access and qualified worker shortages. Medical/biotech activity remained strong but pulled back slightly compared to a year ago. B2B transactions yielded steady growth. Food service equipment sales increased as the sector resumed more normal operations and wineries soared 21%. Overall, the group is hitting pre-pandemic levels. HdL projects modest improvement with localized predictions varying based on the type and quantity of companies within each city or county.

Food/Drugs — 1.9% | 2.0%

Grocery stores saw increased prices on non-taxable products which resulted in less dollars spent on tax-generating merchandise in the other aisles. Recent results rose less than 1%. E-commerce grocery sales doubled the pre-pandemic year's numbers and are predicted to grow in the year ahead. Drug store's returns were hit hard in 2020 but reported recovery in the latter months of 2021. Cannabis activity plateaued, but industry champions are hopeful that state tax and regular relief strengthens the vitality of these merchants. The outlook shows nominal gains, primarily due to costs of wholesale goods, transportation and labor being passed along to consumers.

2021/22 | 2022/23

Fuel/Service Stations — 38.9% | -2.7%

This sector continues to experience short term spikes in tax collections triggered by ongoing increases in consumption and demand for fuel. Economic recovery was evident in the latter part of 2021 and into early 2022 as consumers paid record prices at the pump for regular and diesel gasoline along with higher jet fuel costs, primarily linked to a surge in air travel. The Russian invasion of Ukraine restricted global supplies of fuel, which pushed West Texas Intermediate crude oil barrel prices up significantly beginning in early March. These combined factors contribute to an estimated revenue boost over the next three quarters, followed by a slowdown starting in fourth quarter 2022 through the end of fiscal year 2022/23.

General Consumer Goods — 12.4% | 0.4%

Following holiday 2021 record levels, core retail sales exceeded estimates in January, while February data showed a cooling trend. Healthier receipts are partially attributed to escalating prices. Volumes also reflected persistent demand. Consumer confidence and sentiment fell in recent weeks indicating lower optimism for the economy, though those emotions are not yet reflected in recent tax data. Uncertainty comes to mind as consumers begin to gauge the economic outlook while other sectors garner more of consumer spending, resulting in a mild pullback from this group. Coming off a strong fiscal year 2021/22, the outlook anticipates decelerated growth as we progress through fiscal year 2022/23.

Restaurants/Hotels — 36.8% | 5.7%

The pandemic created significant "stored-up" demand for food service and leisure experiences, and the emergence of Omicron did not deter restaurant customers. Sales for onsite dining establishments surpassed fourth quarter 2019 and are projected to outpace quick service restaurants as consumers continue to focus on the experience of eating out. Rising menu prices are furthering the gains. While hotel occupancy has neared recovery, taxable sales at hotels are still lagging behind as business and international travel slowly recovers. Growth from this category could be curbed as consumer's react to volatile fuel prices.

State and County Pools — 1.0% | 4.0%

While online sales were strong this past holiday season, brick and mortar outlets grew at a larger percentage rate. Buyer's desire to shop in person outweighed technology's conveniences. The end of year quarter percentages declined, compounded by the fourth (and final) time a taxpayer's portion of revenues was allocated to in-state fulfillment centers. Calendar year 2021 saw 43% of pool dollars generated from general retail/marketplace sellers and 32% from business-industrial companies. Enthusiastic gains of the last two years have slowed with fiscal year 2021/22 growth pegged at lows not seen in a decade. Next year's expectations see variable economic impacts noted above.

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 13.7% for Fiscal Year 2021/22 and 1.7% for 2022/2023.

HdL Companies Consensus Forecast
March 2022

NATIONAL AND STATEWIDE ECONOMIC DRIVERS

Beacon Economics

2021/22 | 2022/23

U.S. Real GDP Growth — 4.7% | 3.9%

The standard reaction to news about inflation in the United States has been to worry about how U.S. consumers are being hurt when, in reality, it is excessive consumer demand that is driving inflationary pressures. That can be seen in the strong growth in overall consumer spending, which has been expanding faster than overall GDP growth since 2017—with no slowing in sight. Historically, periods when consumer spending grew faster than output have always had ugly endings, such as before the downturn in the stagflation 1970's and in the lead up to the Great Recession. Beacon Economics believes that public policy discussions must quickly focus on this looming crisis. What this next expansion looks like critically depends on what course of action policymakers choose. The more rapidly the Federal government moves to close fiscal deficits and reduce the money supply, the less harm this brewing financial bubble and excessive consumer spending can ultimately cause to the economy.

Russia's decision to invade Ukraine has sent shock waves through global markets. From an economic perspective, it is hard to see how Russia will come out ahead from this unprovoked attack on a sovereign nation and the horrors being inflicted on a civilian population. What does this invasion mean for the U.S. economy? The short answer is not that much. The biggest economic impact has been in global energy markets where oil prices have shot up to close to $100 per barrel, but energy prices are not the real issue here. Inflation is affecting a wide variety of consumer spending categories. Unfortunately, blaming inflation on commodity markets is an effective way to distract consumers from the real sources of the problem.

U.S. Unemployment Rate — 4.2% | 3.9%

The pandemic-driven business cycle ended in the last half of 2021, when levels of aggregate consumption reached long run trend and unemployment dropped below 4%—all in less than two years. As Beacon Economics anticipated near the beginning of the crisis, it was a 'V-shaped' cycle, a deep decline followed by a rapid recovery, and that cycle is now complete. Still, as far as business cycles go, this one was truly unique—it was the deepest and shortest in U.S. history and was followed by one of the most rapid recoveries ever seen. Why so different? This recession was supply-shock driven, without the typical longer-term consequences that come from, for example, an asset bubble collapse that drives a demand shock, which is what powered the Great Recession. Of course, monetary and fiscal stimulus also played a role in the strong recovery, both in guiding the nation through the first few weeks of (clearly unwarranted) financial panic, as well as supporting businesses and workers who were truly hard hit, but the scale of the intervention in the economy was vastly more than was needed under the circumstances.

2021/22 | 2022/23

CA Unemployment Rate — 5.2% | 4.2%

California's unemployment rate fell to 6.5% in December, elevated relative to the 3.9% rate in the United States overall. The state's higher unemployment rate is primarily due to the underperformance of California's labor market relative to the national picture. Since February 2020, the state's labor force has contracted by 358,100 workers, a 1.8% decline. However, higher wages should draw workers back into the labor force, and there is already some evidence of this. Nominal wages in California were up 5% in 2021 in the state, as employers paid more in their search for relatively scarce workers. However, real wages in the state barely rose during the year due to inflation.

CA Residential Building Permits — 120,075 | 129,288

California's economy has, in many areas, fully recovered from the sudden and dramatic fallout of the pandemic, and some parts of the economy have even exceeded their pre-pandemic trend. This growth has been fueled in part by unprecedented fiscal and monetary stimulus, as well as the unique attributes of this recession. Today, the challenges facing the state's economy are very much the same as they were prior to the pandemic. In fact, the pandemic has acted as an accelerant to these long-standing issues. Housing scarcity has pushed median home prices in the state above $650,000, double the national figure.

CA Median Existing Home Price — $661,566 | $691,924

The state's housing market continued to see considerable strength in 2021, with median home prices growing 20% over the year, fueled by healthy consumers, low inventory, and low mortgage rates. This rate of price growth was double the already lofty 9% growth rate in 2020. While housing supply remains constrained in the state, the specter of higher interest rates will weigh on price appreciation in 2022.

CA Total Nonfarm Employment Growth — 5.9% | 4.2%

The recovery in total jobs as well as the unemployment rate continue to lag the national performance. As of December 2021, California had recovered just 72% of the jobs that were lost in March and April 2020, and there were still 768,600 fewer people employed in California compared to February 2020. Total nonfarm employment in the state has contracted 4.4% since this time compared to a 2.3% drop nationally. However, during 2021, California added jobs at a faster rate than the national economy. Payrolls in the state expanded 6% from December 2020 to December 2021, well above the 4.5% increase nationally over the same period. California's outperformance should continue in 2022.

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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.