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Updated "Big Three" Revenue Outlook

December 1, 2023

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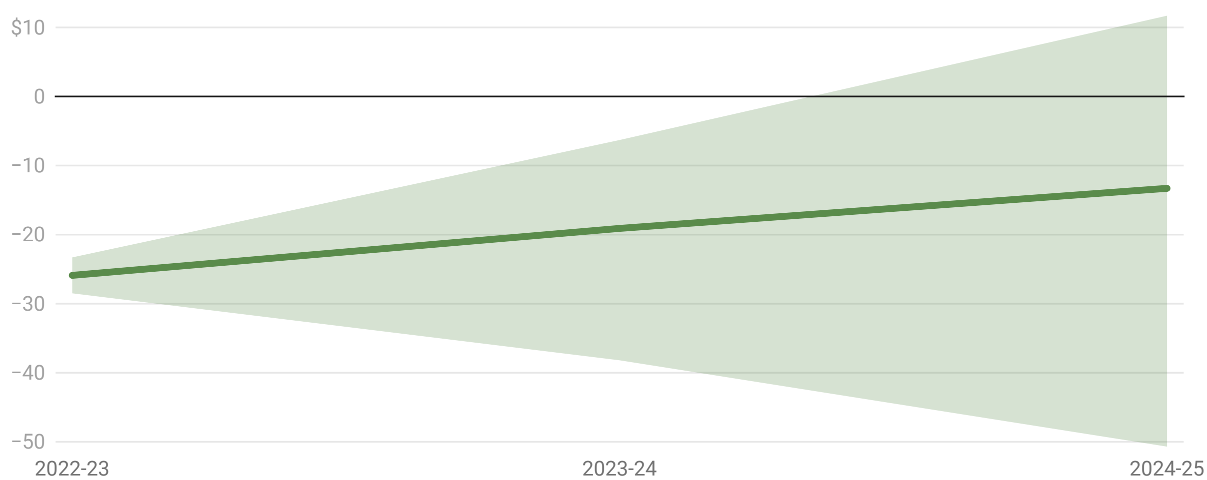
Bottom Line. With the recent receipt of various postponed tax payments, the impact of recent economic weakness and last year's financial market distress on state revenues has become clearer. The postponed payments came in much weaker than anticipated. As a result, we now estimate 2022-23 revenues to be $26 billion below Budget Act projections. Historical experience suggests this weakness is likely to carry into this fiscal year and next. Overall, our updated revenue outlook anticipates collections to come in $58 billion below Budget Act projections across 2022-23 to 2024-25. We will release our Fiscal Outlook next week, which will discuss the ramifications of this revenue shortfall for the state's budget.

How Much Could Revenues Differ From Budget Act Projections?

LAO Forecast Minus Budget Act (In Billions)



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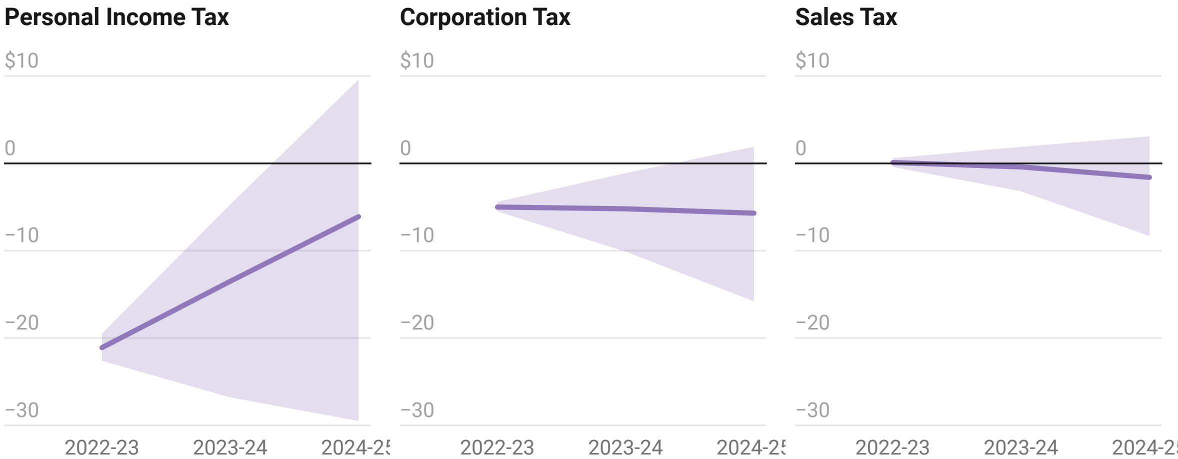

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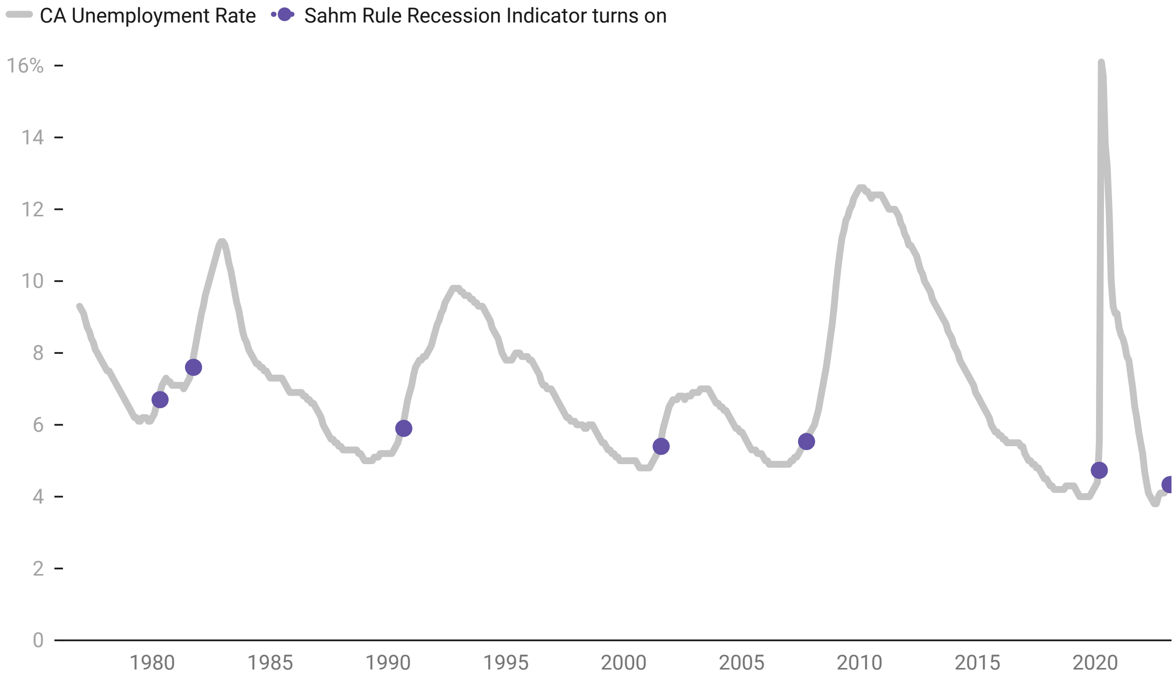
Higher Borrowing Costs and Reduced Investment Have Cooled California's Economy. In an effort to cool an overheated U.S. economy, the Federal Reserve has taken actions over the last two years to make borrowing more expensive and reduce money available for investment. This has slowed economic activity in a number of ways. For example, home sales are down by about half, largely because the monthly mortgage to purchase a typical California home has gone from $3,500 to $5,400. Some effects of the Federal Reserve's actions have hit segments of the economy that have an outsized importance to California. In particular, investment in California startups and technology companies is especially sensitive to financial conditions and, as a result, has dropped significantly. For example, the number of California companies that went public (sold stock to public investors for the first time) in 2022 and 2023 is down over 80 percent from 2021. As a result, California businesses have had much less funding available to expand operations or hire new workers.

State's Economy Entered a Downturn in 2022. These mounting economic headwinds have pushed the state's economy into a downturn. The number of unemployed workers in California has risen nearly 200,000 since the summer of 2022. This has resulted in a jump in the state's unemployment rate from 3.8 percent to 4.8 percent. Similarly, inflation-adjusted incomes posted five straight quarters of year-over-year declines from the first quarter of 2022 to the first quarter 2023.

Real-Time Recession Indicator ("Sahm Rule") Triggered in March

Federal policymakers use the Sahm Rule to track the start of recessions in real time. The Sahm Rule has accurately indicated -- with no false positives -- the prior six U.S. recessions as well as California downturns.



Sahm Recession Indicator signals the start of a recession when the three-month moving average of the unemployment rate rises by 0.5 percentage points or more relative to its low during the previous 12 months.

Chart: California Legislative Analyst's Office, based on work by Claudia Sahm • Source: St. Louis Federal Reserve Bank • Created with Datawrapper

Recent Revenue Collections Show Impact of Economic Downturn. With federal actions postponing deadlines for tax payments on investment and business income for much of the past year, the state adopted the 2023-24 budget without a clear picture of the impact of recent economic weakness on state revenues. Regardless, there have been signs of revenue weakness over the past year. The portion of income taxes collected directly from workers' paychecks was down 2 percent over the last twelve months compared to the preceding year. Sales tax collections have been essentially flat, despite above-average growth in consumer prices. The full extent of revenue weakness, however, came into full focus recently with the arrival of the postponed tax payments. With the deadline passed, collections data now show a severe revenue decline, with total income tax collections down 25 percent in 2022-23. This decline is similar to those seen during the Great Recession and dot-com bust. While the slowdown of investment in California companies and corresponding broader economic weakness likely was a primary driver of this decline, another important factor was financial market distress in 2022.

Significant Risk That Weakness Could Persist into Next Year. Whether the recent weakness will continue is difficult to say. However, the odds do not appear to be in the state's favor. Past downturns similar to this recent episode have tended to be followed by additional weakness. For instance, an increase in the unemployment rate similar to the recent period has consistently been followed by an extended period of elevated unemployment. Similarly, in the past, years with large revenue declines typically have been followed by an additional year of lackluster revenue performance. History does not always repeat itself and may not this time. Nonetheless, there is a significant risk the current weakness could continue into next year.

Revenue Outlook Reflects Risk of Continued Weakness. Reflecting the risk of a continued weakness, our revenue outlook anticipates collections will be nearly flat in 2023-24, after falling 20 percent in 2022-23. Our outlook then has revenue growth returning in 2024-25 and beyond. Based on this trajectory, our revenue outlook expects collections to come in $58 billion below Budget Act assumptions across 2022-23 to 2024-25, with about half of this difference ($26 billion) attributable to 2022-23. As always, this forecast is highly uncertain. It is entirely possible that revenues could end up $15 billion higher or lower than our forecast for 2023-24 and $30 billion higher or lower for 2024-25.

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