EXECUTIVE SUMMARY

December 2022

A recession now appears more likely than not. The consensus among national forecasters, and our office's advisors expects a mild recession to begin within the next year. This change in the baseline forecast is not due to any fundamental deterioration in the economy in recent months, but rather a shift in assessing the risks. In particular with inflation remaining well above the Federal Reserve's target, expectations are that interest rates will need to be higher and held there longer than previously thought. Slamming on the brakes of a speeding car will cause it to skid and even fishtail. The question is whether the driver is able to pull out of it or end up in the ditch. Most economists today believe a recession is likely, even if the exact path of the economy is uncertain.

Our office has now incorporated a mild recession in Oregon starting next summer. Job losses total 24,000 for a 1.2 percent decline. Job losses will be larger in goods-producing industries like construction and manufacturing, and industries tied to them like finance, and transportation and warehousing. The unemployment rate increases from today's 3.8 percent to a peak of 5.4 percent in early 2024. Income and spending slow, but do not turn negative. Such a cycle would be one of the shallowest, and shortest recessions on record, similar to 1990. The nature of the cycle is more technical than fundamental, more of a fender-bender than a head-on collision.

There are three reasons why a milder recession is to be expected today. First, businesses, financial markets, and households all indicate that they expect today's high inflation to slow in the years ahead. If high inflation is not fully embedded in long-term decision making, it likely only takes a milder recession to bring inflation down.

Second, it has been difficult to find workers for the past handful of years. The labor market is cyclical tight due to a strong economy, and structurally tight for demographic reasons as the large Baby Boomer generation continues to retire. Firms do not want to let go of workers, and likely will work to hold onto workers even as sales slow in the years ahead. Economists call this labor hoarding. With record corporate profits, many businesses have the financial room to do just that.

Third is the strong financial position households are in. Consumer spending is expected to hold up well in the pending recession in large due to the higher level of savings, which is for households across the distribution. Should spending remain strong, firms will have less incentive to cut jobs. Today's strong household balance sheets can help short-circuit the typical negative feedback loop of a recession.

The baseline economic outlook now calls for a mild recession. This is hard to see in the topline outlook for state revenues, as the forecast for available resources remains roughly unchanged in the near term. The recession is expected to be mild, and personal income is expected to remain stable despite job losses. Underlying personal income is not only the primary driver of Oregon's dominant personal income tax, but also a wide range of consumption-based taxes including the corporate activity tax and lottery sales.

In terms of job losses, the baseline scenario looks identical to the recession of 1991. The 1991 cycle was unique in that it did not result in a pronounced downturn in state revenues, only a couple of relatively flat years of available resources.

Unlike what was seen during the 1991 cycle, revenues are expected to drop going forward with or without a recession. General Fund revenues are due for a hangover in 2023-25 even if the economic expansion persists. Recent gains have been driven by taxpayer behavior as well as by underlying economic growth. After so much nonwage income was pulled into tax years 2020 and 2021, less will be realized in the near term. As profits and investment income return to earth, and a record kicker is paid out, expected revenues next biennium will be around $3 billion lower than the current biennium. That said, it is surprising that the recession call did not make this expected decline noticeably worse.

This taxpayer behavior also puts Oregon's revenues at risk of the sharp declines experienced after asset market corrections in 2001 and 2007. With recession on the horizon, profits and gains could soon turn into losses, and a smaller share of filers could be subject to the top rate. Recent revenue growth has been more pronounced than during any other period on record. During tax year 2021, personal income tax liability grew at almost double the pace of that was seen during the peaks of the housing and technology booms. Hopefully, the upcoming hangover in revenue growth will not be as pronounced.

The bottom line is that the unexpected revenue growth seen this year has left us with unprecedented balances this biennium, followed by a record kicker in 2023-25. The projected personal kicker is $3.7 billion, which will be credited to taxpayers when they file their returns in Spring 2024. The projected corporate kicker is $1.3 billion, which will be retained for K-12 educational spending.