ECONOMIC OUTLOOK

In 2024, the U.S. and California economies generally performed in line with the Governor's Budget forecast, experiencing slowing but relatively stable growth in the midst of a mature economic expansion. In fact, in 2024, the state passed Japan to become the fourth largest economy in the world as measured by Gross Domestic Product (GDP) and official exchange rates. However, the outlook has abruptly and significantly dampened as a result of various federal policies, including broad and elevated tariffs, strict immigration policies, and cuts to the federal government workforce. Anticipation of tariffs has already led to a slight contraction of 0.3 percent in U.S. real GDP growth in the first quarter of 2025 due to a surge in imports, which is a negative in the calculation of GDP.

As the federal administration's policies continue to take effect, the U.S. is projected to experience a "growth recession," which is a period of below-trend growth along with rising unemployment. As a result, U.S. real GDP growth is downgraded by 0.3 percentage point per year on average from 2025 to 2028 (the forecast window) relative to the Governor's Budget. This "growth recession" is expected to occur during the first three quarters of 2025, bringing GDP growth for the entire calendar year of 2025 to just 1.3 percent. After the projected "growth recession" ends, U.S. GDP growth is projected to accelerate slightly to 1.7 percent in 2028, remaining well below the 2015-2019 pre-pandemic average growth rate of 2.6 percent.

The May Revision forecast was finalized in mid-April and incorporates announced tariffs and other current law federal policies as of the time. In contrast, the Governor's Budget did not incorporate any tariffs into the baseline since they were not enacted but instead recognized as downside risks. The May Revision forecast assumes 25-percent tariffs on steel, aluminum, autos, and Canadian and Mexican goods that are not compliant with the existing United States-Mexico-Canada (USMCA) agreement, 145-percent tariffs on Chinese goods, 10-percent tariffs on all countries through July 8, 2025 before increasing to various elevated rates after the 90-day pause with an exception for various Chinese-made tech goods. With these newly imposed tariffs, California's average tariff rate is estimated to have increased to 27 percent as of mid-April, significantly higher than the 2.4 percent rate in 2024. The state is expected to be especially vulnerable to tariffs as California serves as a gateway to goods imported from Asia and as Canada, Mexico, and China are three of the state's largest trading partners. The tariffs will have immediate and broad-reaching impacts affecting nearly all the state's $500 billion worth of imported goods as of 2024, nearly 12 percent of its economic output. The forecast does not include the trade deal announced on May 12, 2025 with China which temporarily cuts tariffs on Chinese goods from at least 145 percent to a base rate of 30 percent for a period of 90 days while Chinese tariffs on U.S. goods are cut from at least 125 percent to 10 percent.

The cost of tariffs is largely expected to be passed on to consumers, leading to increased inflation across all major consumer price index (CPI) categories. At the Governor's Budget, U.S. inflation was projected to decelerate from 2.9 percent in 2024 to 2.3 percent in 2025, broadly reaching the Federal Reserve's inflation target rate after a long battle to get inflation back down to normal levels following elevated rates of over 9 percent at the height of supply chain issues in 2022. However, due to the inflationary impacts of tariffs, the inflation forecast is revised significantly higher for both the nation and the state, by more than a full percentage point per year in 2025 and 2026. U.S. consumer price inflation is now projected to accelerate to 3.5 percent in 2025 and 3 percent in 2026, up from 2.3 percent and 2.2 percent, respectively, in the Governor's Budget forecast. Similarly, as tariffs are expected to push prices upward, California inflation is projected to accelerate from 3.1 percent in 2024, to 3.8 percent in 2025 and 3.5 percent in 2026, up from 2.3 percent and 2.6 percent, respectively, in the Governor's Budget.

New vehicles and apparel are especially vulnerable and impacted because the federal administration imposed a 25-percent tariff on most car imports regardless of country of origin and because nearly a third of the nation's apparel comes from China. With higher projected inflation, the Federal Reserve is now expected to cut target interest rates just once by the end of 2025, a stark contrast from the six rate cuts projected at the Governor's Budget. As a result, credit conditions are anticipated to remain tight, which will limit growth in business investment and interest-sensitive consumption as federal manufacturing incentives taper off. On the consumer side, higher prices will lead to reduced purchasing power and lower demand and spending, contributing to lower economic growth.

Following annual revisions, U.S. and California job growth was softer in 2024 than initially estimated. Additionally, the state lost 18,000 jobs per month in the first three months of 2025 while the Governor's Budget had projected a gain of 13,000 jobs per month. Unlike California, the nation's labor market remains comparably more stable as the U.S. added 144,000 jobs per month in the first four months of 2025, higher than the Governor's Budget projection of about 75,000 jobs added per month in the first half of 2025. California job growth is downgraded compared to the Governor's Budget as job growth is expected to slow through 2026. This is driven mainly by impacts from tariffs which are broadly assumed to dampen job growth across most sectors but particularly in the manufacturing, leisure and hospitality, trade, transportation and utilities, and professional and business services sectors. The state is projected to add 6,000 jobs per month in 2025 and just 3,000 jobs per month in 2026 before slightly accelerating to add 8,000 jobs per month by the end of the forecast period in 2028, remaining substantially below the 2015-2019 rate of around 30,000 jobs added per month. This is significantly lower than the Governor's Budget projected monthly gains of 13,000 jobs per month in 2025 and 10,000 jobs per month in 2026.

The California personal income forecast is also downgraded from the Governor's Budget due to lower estimates in 2024 and a more pessimistic economic outlook in the forecast window. Actual 2024 wages were $21 billion, or 1.2 percent, lower than projected in the Governor's Budget and this gap is projected to widen to $31 billion, or 1.7 percent, in 2025 and $41 billion, or 1.9 percent, by 2028. In addition to wages, most income components were downgraded relative to the Governor's Budget forecast including proprietors' income, interest income, and rental income. As a result, the state's projected total personal income from 2025 to 2028 was downgraded by nearly $30 billion or about 0.8 percent on average per year.

The biggest downside risk for the May Revision forecast continues to be federal policy uncertainty. The federal administration's approach to tariff policies has been remarkably inconsistent thus far, with tariff schedules changing frequently and making it very difficult for consumers and businesses to plan. Even if federal policy in this area were to stay stable for a period of time, tariffs near or above the current levels have no recent historical precedent and are expected to both spur inflation and distort many goods markets, significantly impeding economic growth. In the event tariffs are substantially scaled back, the state and national economies will likely remain on a lower trajectory compared to before the sweeping tariffs were announced, since businesses and consumers are likely to remain cautious in the face of ongoing uncertainty. Moreover, the U.S. may no longer be seen as a safe haven by investors who may pull back on investment in the long-term. The federal administration's immigration policies are also unclear as it has indicated that it will implement a large-scale deportation program that could significantly degrade the state's labor force.

Select Economic Indicators

Annual Percentage Change unless Otherwise Indicated

					Forecast			
Column1	2020	2021	2022	2023	2024	2025	2026	2027	2028
United States									
Real GDP									
May Revision, April 2025	-2.2	6.1	2.5	2.9	2.8	1.3	1.5	1.5	1.7
Percentage Point Change from Governor's Budget	-	-	-	-	0.1	-0.7	-0.3	-0.1	-0.1
Unemployment Rate (percent)									
May Revision, April 2025	8.1	5.4	3.6	3.6	4.0	4.4	4.9	5.1	4.9
Percentage Point Change from Governor's Budget	-	-	-	-	-0.0	0.1	0.4	0.5	0.4
Nonfarm Employment									
May Revision, April 2025	-5.8	2.9	4.3	2.2	1.3	0.9	-0.0	0.0	0.3
Percentage Point Change from Governor's Budget	-	-	-	-	-0.3	0.1	-0.3	-0.1	0.1
Personal Income									
May Revision, April 2025	6.8	9.2	3.1	5.9	5.4	4.7	4.5	4.8	4.5
Percentage Point Change from Governor's Budget	-	-	-	-	-0.4	0.0	-0.5	0.1	0.0
CPI Inflation Rate (percent)									
May Revision, April 2025	1.2	4.7	8.0	4.1	2.9	3.5	3.0	2.5	2.4
Percentage Point Change from Governor's Budget	-	-	-	-	0.0	1.2	0.9	0.2	0.2
California									
Unemployment Rate (percent)									
May Revision, April 2025	10.2	7.4	4.3	4.7	5.3	5.4	5.5	5.5	5.3
Percentage Point Change from Governor's Budget	-	-	-	-	0.1	0.2	0.4	0.6	0.6
Civilian Labor Force									
May Revision, April 2025	-2.4	0.0	1.4	1.3	0.9	0.4	0.1	0.2	0.2
Percentage Point Change from Governor's Budget	-	-	-	-	0.6	0.1	-0.2	-0.2	-0.2
Nonfarm Employment									
May Revision, April 2025	-7.1	3.5	5.5	0.9	0.7	0.4	0.2	0.4	0.5
Percentage Point Change from Governor's Budget	-	-	-	-	-0.3	-0.5	-0.4	-0.4	-0.3
Residential Permits (thousands of units)									
May Revision, April 2025	105	120	113	110	100	100	100	101	104
Percentage Point Change from Governor's Budget	-	-	-	-	-3.3	-6.3	-11.7	-17.3	-21.2
Average Wages									
May Revision, April 2025	11.2	7.8	-0.7	3.4	5.5	3.2	3.9	4.3	4.1
Percentage Point Change from Governor's Budget	-	-	-	-	-0.9	-0.2	0.2	0.4	0.1
Personal Income									
May Revision, April 2025	9.0	8.7	-0.2	5.4	6.5	4.0	4.1	4.6	4.7
Percentage Point Change from Governor's Budget	-	-	-	-	-0.2	-0.2	-0.5	-0.1	0.0
CPI Inflation Rate (percent)									
May Revision, April 2025	1.7	4.3	7.4	3.9	3.1	3.8	3.5	3.1	3.2
Percentage Point Change from Governor's Budget	-	-	-	-	0.1	1.5	1.0	0.5	0.6

2025-26 Governor's Budget Forecast based on data available as of November 2024.

2025-26 May Revision Forecast based on data available as of April 2025. Figures in italics indicate forecasts.

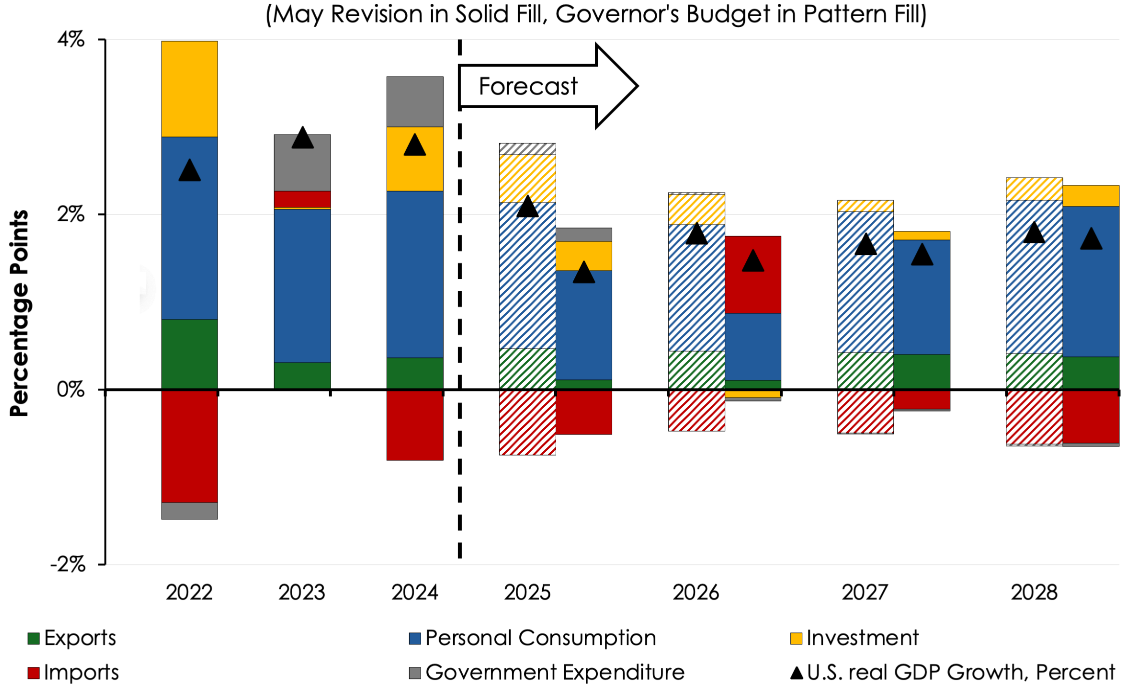
Source: U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics; U.S. Census Bureau; California Employment Development Department, Labor Market Information Division; California Department of Finance, 2025-26 May Revision Forecast.

U.S. AND CALIFORNIA FORECASTS

"GROWTH RECESSION"

The U.S. is projected to be in a "growth recession", a period of below-trend growth and rising unemployment during the first three quarters of 2025. U.S. real GDP contracted by 0.3 percent in the first quarter of 2025 driven by a surge in imports as domestic producers and consumers stockpiled foreign goods ahead of when most tariffs took effect. Economic growth is downgraded by 1.4 percentage points in the second quarter, 1.2 percentage points in the third quarter and by 0.3 percentage point in the fourth quarter relative to the Governor's Budget driven by tariff-related uncertainty and price increases. Unlike the imports surge from the first quarter, the projected slow growth in the last three quarters of 2025 is due to weakening consumption and nonresidential fixed investment (downgraded by 1.3 percentage points and 5 percentage points, on average, respectively, relative to the Governor's Budget) as the overall economic environment is projected to deteriorate for the year. After the growth recession ends in the fourth quarter of 2025, U.S. GDP growth is projected to average 1.7 percent from 2026 through 2028, 0.1 percentage point lower than the Governor's Budget forecast as markets adapt and adjust to tariffs.

Contributions to U.S. Real GDP Growth
(May Revision in Solid Fill, Governor's Budget in Pattern Fill)

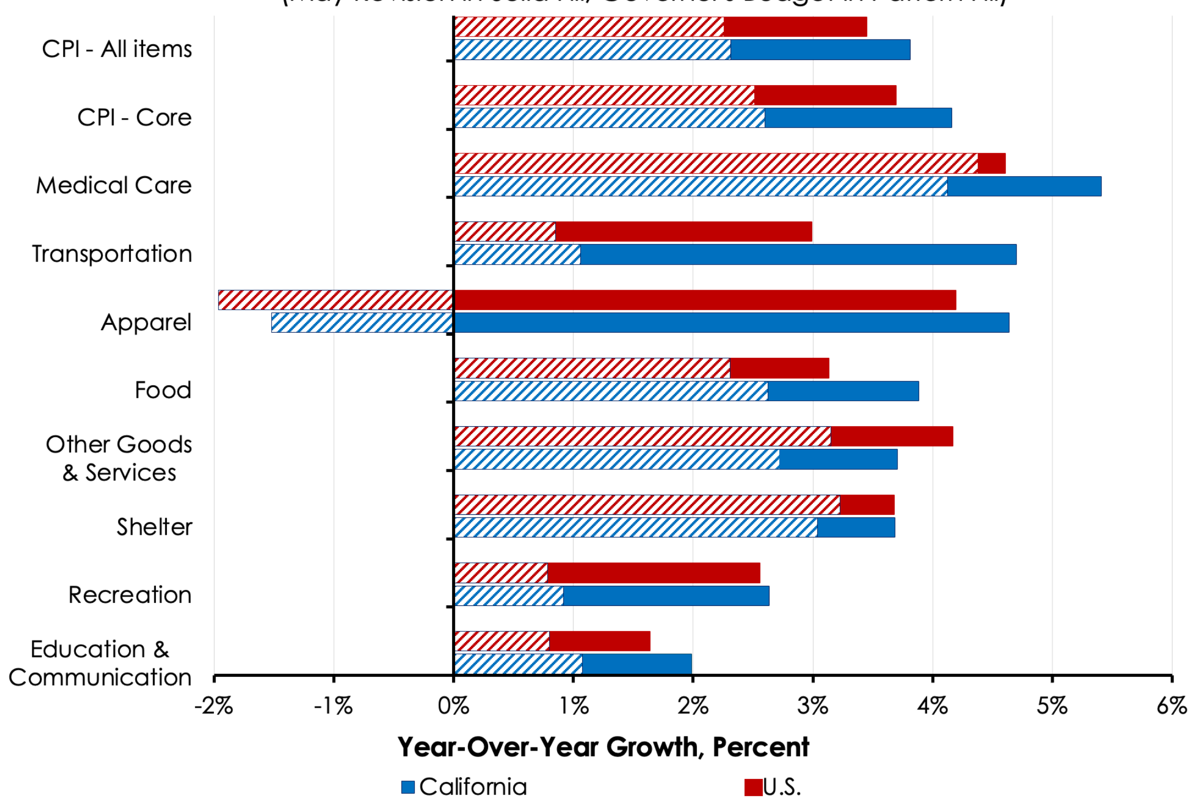


Source: U.S. Bureau of Economic Analysis (BEA); California Department of Finance, 2025-26 May Revision Forecast.

INFLATION PROJECTED TO SPIKE IN 2025 AND 2026 DUE TO TARIFFS

For both the state and the nation, all major CPI components are projected to experience higher inflation in 2025 and 2026 as a result of the broad and elevated tariffs. While new vehicles and apparel have the greatest projected inflationary impacts, tariffs are projected to significantly raise inflation in most categories including household furnishings, food, medical care, recreation, and other goods. Shelter is also projected to be impacted by tariffs due to higher input costs. As a result, California projected shelter inflation—which includes rents as well as homeowners' "equivalent rent"—is upgraded to 3.7 percent in 2025, compared to 3 percent in the Governor's Budget. The outer years of the forecast project more moderate inflation rates as consumers and prices are expected to adjust to higher prices. Overall, there has been a notable upward shift in inflation assumptions relative to November when U.S. headline inflation was decelerating toward the Federal Reserve's 2-percent target rate.

2025 U.S. and California Consumer Price Index
(May Revision in Solid Fill, Governor's Budget in Pattern Fill)



Source: U.S. Bureau of Labor Statistics (BLS); California Department of Finance, 2025-26 May Revision Forecast.

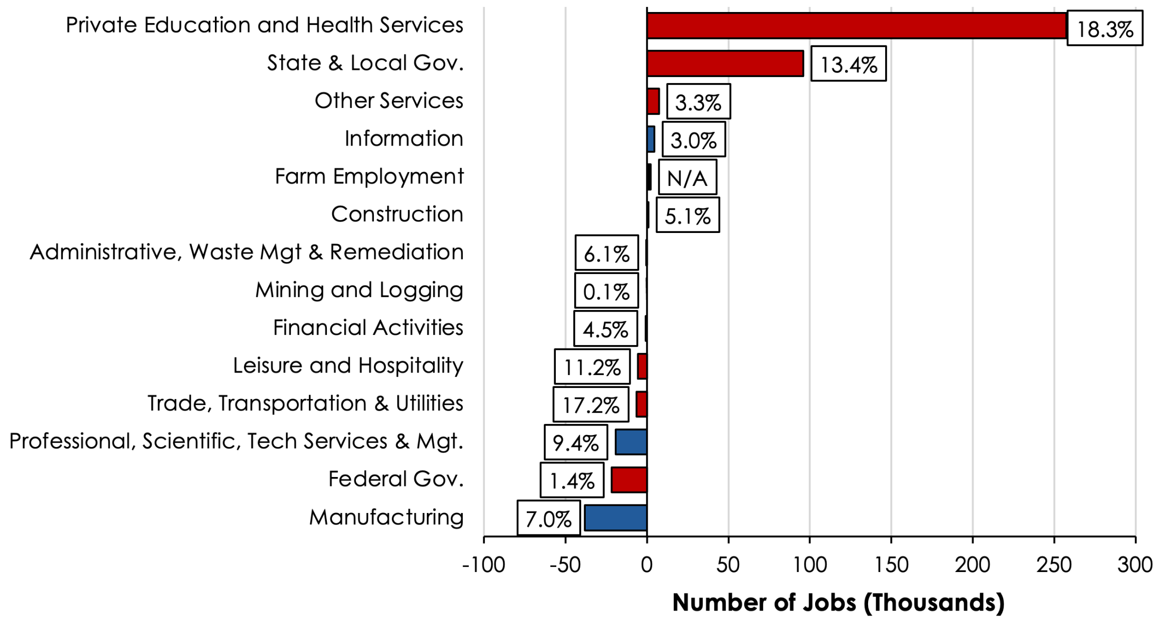
CALIFORNIA JOB GROWTH TO SLOW AND REMAIN SUBDUED

Since the Governor's Budget forecast was finalized in mid-November 2024, California added fewer than 8,000 jobs per month between October 2024 and March 2025—roughly half of the Governor's Budget projection of about 14,000 jobs added per month during the same period. Subdued job growth has been driven primarily by losses in the high-wage sectors while most low-wage sectors have buoyed total job growth. "Low-wage sectors" are defined as sectors with an average wage that is lower than the state's average wage—around $96,000 in 2024—while "high-wage sectors" have average wages above the state average. According to this definition, low-wage sectors are comprised of construction, trade, transportation, and utilities, private education and health services, leisure and hospitality, other services and government while high-wage sectors are comprised of mining and logging, manufacturing, information, financial activities, and professional and business services.

Job losses were more pronounced in the manufacturing sector, which lost about 3,000 jobs per month between October 2024 and March 2025 compared to the Governor's Budget projection of fewer than 100 jobs lost per month during the same period. Job losses also remained higher in the professional and business services sector which lost about 7,000 jobs per month. In contrast, the only sector that saw stronger job growth than projected was the private education and health services sector, which added around 14,000 jobs per month during the same period compared to the Governor's Budget projection of just over 5,000 jobs added per month. Meanwhile, the government sector and the health care and social assistance subsector continue to be the largest drivers of growth, averaging a combined gain of nearly 18,000 jobs added per month during the same period.

Looking ahead, job growth was downgraded by 0.4 percentage point on average between 2025 and 2028 due to both weaker labor market conditions through March 2025 and the federal administration's policies regarding immigration, tariffs, and federal government layoffs. Tariffs are expected to have the largest broad-based adverse effects on job growth, with the leisure and hospitality, professional and business services, manufacturing, and trade, transportation, and utilities sectors projected to be disproportionately impacted. Job growth in the leisure and hospitality sector is expected to be dampened as these jobs tend to be supported by tourism and travel while the state's technology sector (defined as information plus professional, scientific, technical services and management of companies sectors) benefits largely from foreign direct investment and a higher share of a foreign-born workforce. Moreover, job growth in the state's manufacturing sector and trade, transportation, and utilities sector, which broadly includes logistics and port activity, is expected to be affected due to reduced port and trade activity. California's job growth is projected to continue to be driven by health care and social assistance and government jobs, since these sectors are the least exposed to tariffs and deportations.

Change in Jobs by Sector Between 2024 and 2028



Note: Data labels represent industry percent share of total nonfarm in 2024. Blue represent high-wage sectors, red bars represent low-wage sectors.
Source: California Department of Finance, 2025-26 May Revision Forecast.

California's unemployment rate is projected to be about 0.4 percentage points higher per year on average through 2028 due largely to more subdued growth from household employment in the near term because of slower economic activity stemming from the impact of federal policies. California household employment growth is projected to slow from 0.3 percent in 2025 to 0.1 percent in 2026, compared to 0.4 percent and 0.5 percent respectively in the Governor's Budget. As a result, the state's unemployment rate is projected to increase from an average of 5.3 percent in 2024 to 5.5 percent in 2026, compared to a decrease to 5.1 percent in 2026 projected in the Governor's Budget. Moreover, tariffs are expected to continue to slow employment growth beyond 2026, while the high-interest rate environment is also projected to continue to dent the pace of employment growth, including self-employment in interest-sensitive sectors such as construction and professional and business services, keeping the unemployment rate at or around 5.5 percent through 2027. In 2028, California's unemployment rate is projected to tick down to 5.3 percent, remaining slightly above the state's pre-pandemic 2015-2019 historical average of 5 percent.

CALIFORNIA REAL WAGE GROWTH DOWNGRADED

Real average wages grew by 2.4 percent in 2024, lower than the 3.3 percent projected in the Governor's Budget. Wage growth was lower than projected due to downward revisions and lower-than-anticipated actuals driven mainly by lower growth in the state's high-wage sectors (information, professional services, and finance in particular), which missed the forecast by 0.9 percentage point in 2024. The state's real average wage is projected to contract by 0.6 percent in 2025 before averaging 0.8 percent growth from 2026 to 2028. This is a significant downgrade from the Governor's Budget projections of real average wage growth of 1.1 percent in 2025 before averaging 1.3 percent growth from 2026 to 2028.

CALIFORNIA PERSONAL INCOME GROWTH SLIGHTLY DOWNGRADED

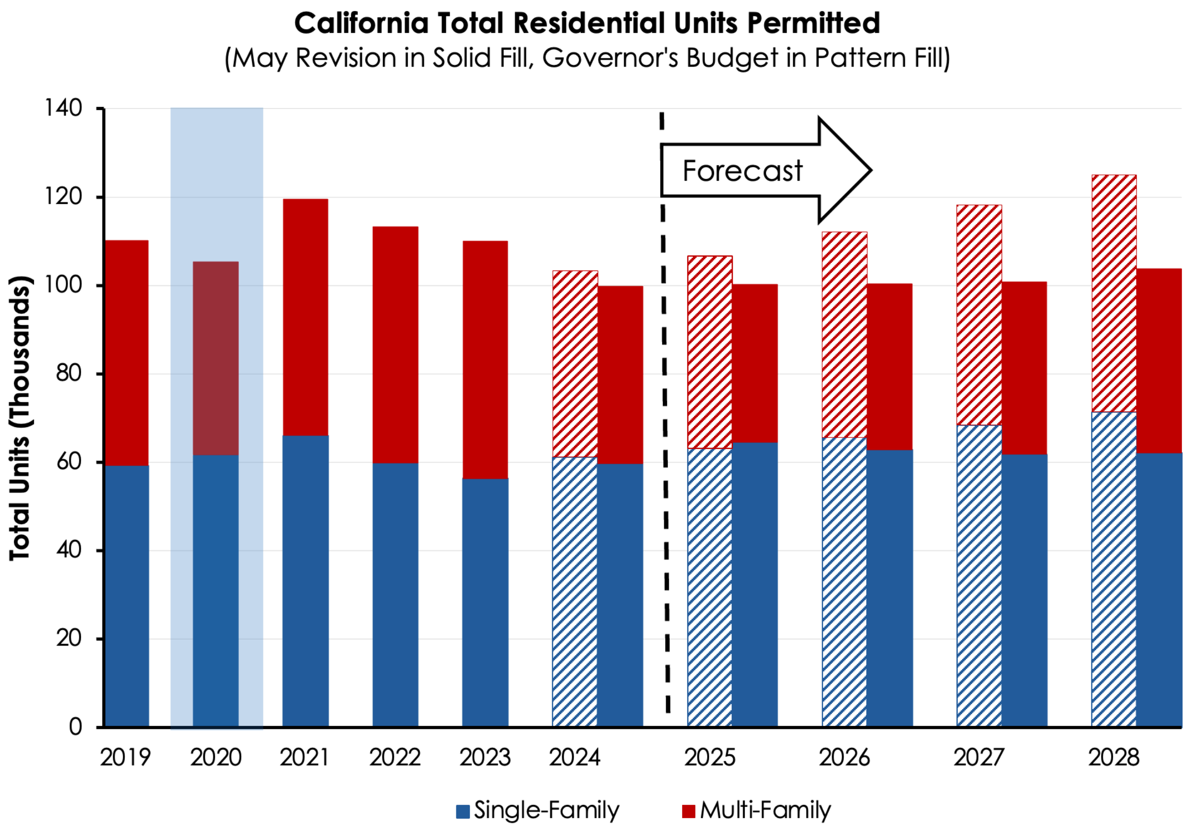
Personal income generally captures all income earned in the economy in nominal terms. As a result, the negative impacts of lower overall economic activity are partially lessened by higher prices, which positively affect personal income. From 2025 to 2028, the forecast for California personal income is downgraded by approximately $30 billion or 0.8 percent per year on average. Overall, California personal income growth is expected to slow from 6.5 percent in 2024 to 4 percent and 4.1 percent in 2025 and 2026, respectively (compared to 4.2 percent and 4.6 percent in the Governor's Budget) due to general weakening economic conditions. Notably, wages and salaries are downgraded by $36.2 billion per year or 1.8 percent. Following a strong growth of 6.2 percent in 2024, wages are projected to slow to 3.6 percent growth in 2025 as the economy slows before gradually returning to normal growth. Employer-paid benefit growth is projected to slow along with wage growth. Proprietors' income is downgraded by $11.7 billion per year or 4 percent. Its projected growth is just 2.5 percent in both 2025 and 2026, down from 5.1 percent and 5 percent respectively in the Governor's Budget as these are likely to be difficult years for non-corporate businesses due to weak economic growth and especially weak profit growth. From 2027 on, total personal income growth is projected to be just above the estimated steady-state rate of 4.5 percent, similar to the Governor's Budget projections.

CALIFORNIA HOUSING PERMITS SIGNIFICANTLY DOWNGRADED

High interest rates continue to hamper residential construction activity, which is also now projected to be further slowed by tariffs, leading to a significantly downgraded housing permits forecast. Residential units permitted fell substantially in 2024, declining by 9.2 percent year-over-year from 110,000 total units in 2023 to just under 100,000 units in 2024, on a seasonally adjusted annualized average basis, compared to a 6.1-percent decline to 103,300 total units projected at the Governor's Budget. Weakness in permitting activity continued into the first quarter of 2025, with authorized units declining 13.1 percent year-over-year to 94,400 units, falling short by nearly 10,000 units relative to the Governor's Budget forecast.

The decline in permitting has been driven by multi-family permitting, which is disproportionately impacted by high interest rates. The number of authorized multi-family units averaged 40,200 units in 2024, 25.1 percent lower than the over 53,600 units permitted in 2023 and 23.7 percent lower than the 52,700 average authorized units during the 2015 to 2019 pre-pandemic period. On the other hand, single-family units averaged 59,700 units in 2024, 6 percent above the 56,400-units permitted in 2023 and 9.4 percent above the 54,600 average units permitted during the 2015 to 2019 pre-pandemic period. Additionally, in the first quarter of 2025, single-family permits averaged 66,000 units, 6.2 percent higher than the 62,100 permitted units projected in the Governor's Budget forecast, while multi-family permits averaged 28,400 units, about 32.3 percent below the projected average of nearly 42,000 permitted units in the Governor's Budget forecast.

The forecast for permitted units is downgraded by 14,000 units or 12 percent on average through the forecast window due to low actuals since Governor's Budget, higher projected interest rates, tariff-induced material cost increases, and potential labor supply issues. Residential permits are projected to remain low through 2025, 2026, and into 2027, averaging about 100,600 units, compared to an average of 112,300 units projected in the Governor's Budget. Rebuilding activity in Los Angeles following the January fires is expected to account for around 11,000 single-family units and 1,500 multi-family units of total permitted units through 2026. Growth is expected to pick up very slightly starting in mid-2027, a lagged result of interest rates falling in the second half of 2026 making construction inputs more affordable and lowering mortgage rates for potential homebuyers, spurring the real estate sector.



Note: Shaded area indicates the COVID-19 Pandemic Recession.
Source: U.S. Census Bureau; California Department of Finance, 2025-26 May Revision Forecast.

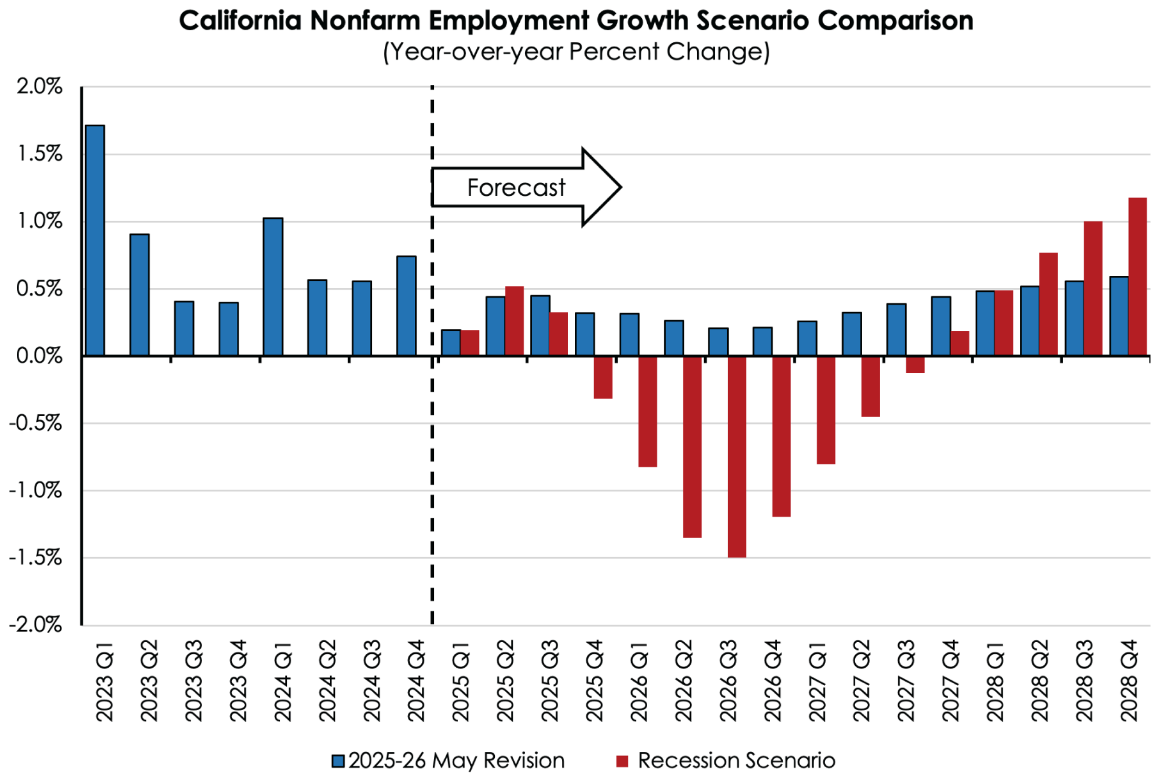
RISKS TO BASELINE FORECAST

While there is more information on federal policy at the May Revision than at the Governor's Budget, risks and uncertainty remain elevated due to the fast-moving and changing landscape of federal policies. The federal administration has been inconsistent in its approach to tariffs, with actual and proposed tariff schedules regularly changing. Uncertainty remains about the future course of tariffs (and retaliatory measures by trade partners), immigration policy, and tax policy. For example, further escalations in the trade war with China or other countries would likely impact the economy even more negatively through higher inflation due to higher costs of goods, which would lead to lower consumption and would negatively impact businesses, leading to even more suppressed economic growth or even a contraction. There would also likely be more volatility and further declines in the stock market, which would negatively impact state revenues. Due to restrictive immigration and trade policies creating an unwelcome environment, tourism to the U.S. and California has already been slowing and may decline even further, which would disproportionately affect the leisure and hospitality sector.

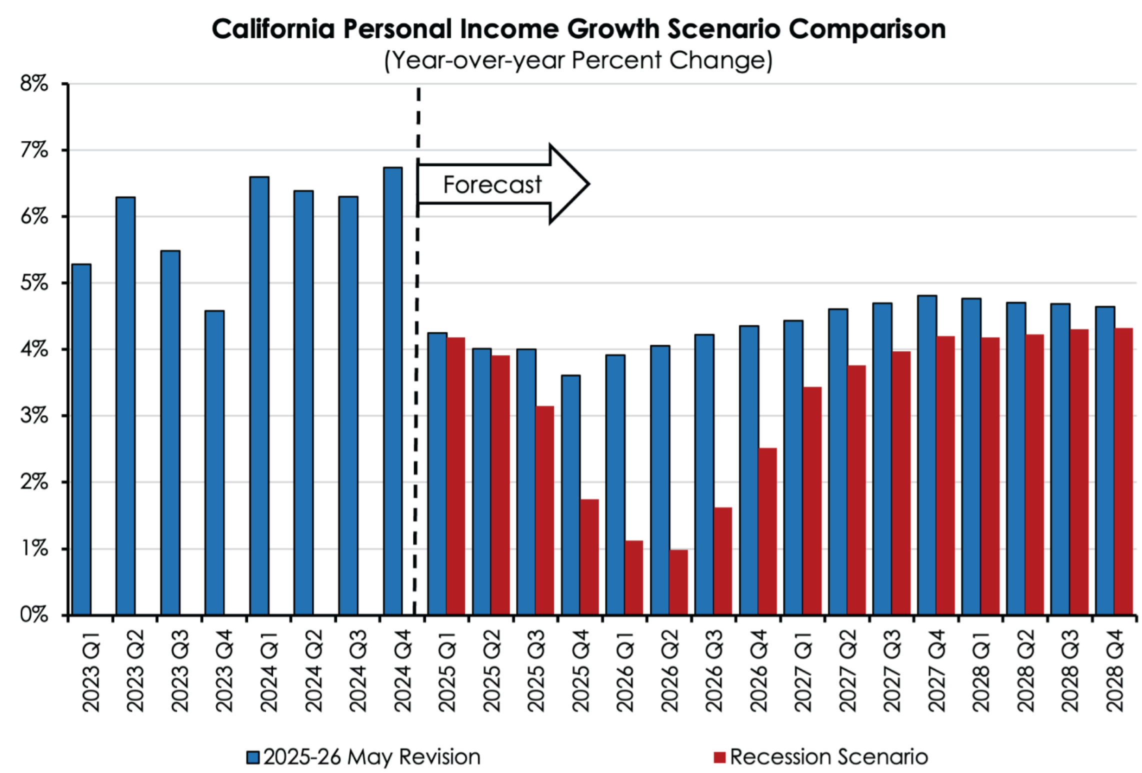
RECESSION SCENARIO

The stock market and periodic surveys indicate that financial markets, consumers, and business leaders are especially unsettled about the economy's near-term prospects, with recession probabilities ranging from 35 percent to 60 percent as of the end of April 2025. Widespread expectations of weakness can make households and businesses reluctant to spend and increasing the risk of "stagflation,"—meaning a period when GDP growth contracts even while inflation increases. Restrictive monetary policy from persistent inflation could lead the Federal Reserve to keep target interest rates higher for longer than projected, which would dampen business and consumer confidence further and lead to lower economic growth and lower stock prices, which would negatively impact state revenues. Continued or worsening stock market volatility and declines would disproportionately impact high-income earners and state revenues as a result. Any other federal cuts such as cuts to key social safety net programs will create additional impacts through job losses, decreased local spending, and long-term adverse health and educational outcomes.

A mild recession along the lines described above driven by more stringent federal policies would result in a contraction in economic growth and payroll employment while leading to higher unemployment relative to the baseline forecast for the May Revision. The Department of Finance has modeled a mild recession scenario which assumes a larger negative response of households, businesses, and investors to the administration's tariffs and other federal policies. This scenario projects an economic slowdown in mid-2025 to early 2026, with outright real GDP contractions of 1.3 percent and 1.6 percent annualized in the last two quarters of 2025. Under this scenario, nonfarm payroll employment contracts from late 2025 through most of 2027, and the state unemployment rate peaks at 6.7 percent in 2027, a somewhat smaller increase than during the early 2000s recession when unemployment rose from 4.7 percent to 7 percent. Personal income would also grow more slowly in this scenario, slowing to 1.6 percent in 2026, and cumulative state personal income would be approximately $460 billion or 3.1 percent lower over the forecast window relative to the baseline forecast. In comparison, personal income growth was 1.5 percent in 2002.



Source: U.S. Bureau of Labor Statistics, California Department of Finance, 2025-25 May Revision Forecast.



Source: U.S. Bureau of Economic Analysis, California Department of Finance, 2025-26 May Revision Forecast.

Other structural risks remain, including more extreme and frequent disasters such as wildfires, droughts, or floods. Long term, the state's labor force, and hence economic output will be affected by reduced net migration of working-age residents and declining fertility rates. The state’s high living costs, especially due to persistent housing shortages, also continue to constrain the economy.