Hawai‘i Tax Review Commission
Study of the Hawaii Tax System
August 29, 2012

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Today’s Agenda

- Introductions
- Project Status
- Financial Model: Demonstration
- Financial Model Baseline and Alternate Scenarios
- Findings on Sufficiency
- Observations and Preliminary Recommendations
- Discussion
Project Status

- Phase 1 – Project Planning: Completed
- Phase 2 – Information Gathering: Mostly Completed
  - Phase 3 – Evaluation: Mostly Completed
  - Phase 4 – Recommendations: Draft Submitted
Expenditure and revenue data sufficient for the baseline projection have been obtained.

There are still some key expenditure areas (such as Medicaid) where data has been promised but not delivered.

Revenue assumptions are hampered somewhat by lack of recent data, but we are working with DOTAX to get the best information we can.

As a result, the general findings are valid, but some movement on revenue and expenditure numbers will take place between the draft and final report.
PFM Long-term Financial Projection Model

- PFM has been a leader in developing models for multi-year planning at the state and local level.

- The model facilitates the development of multiple revenue and expenditure alternatives that can be built into scenarios and tested for their impact on budgets for multiple years in real time.

- The model and documentation will be turned over to the State as a project deliverable, and state staff will be trained on its use.

- Christopher Wheeler, the chief model developer for this project, is going to now demo it for you.
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Financial Projection Model
The preliminary methodology includes the following:

- **Flat Growth (0%)** = areas of significant decline in spending or incomplete historical data
- **State CPI Forecast** = areas of significant growth in spending or incomplete historical data (3% in 2012, 2.8% in 2013, 2.5% in 2014 and beyond)
- **Other State Provided Forecasts** = areas where growth / decline is currently known or forecasted with reasonable confidence (i.e. health benefits, pension contributions, current debt service)
- **Blended AAG / CAGR** = expense areas with similar Average Annual Growth Rate and Compounded Annual Growth Rate were determined using a blended average
- Council on Revenues projections for 2013-2018 on revenues

*Based on 2nd Quarter Forecast published by Hawaii’s Department of Business, Economic Development, and Tourism*
Baseline Scenario

- The PFM baseline was developed in consultation with DOTAX and includes regression analysis done by PFM.

- It projects revenues and expenditures on a current level of service approach – although the model can accommodate alternate approaches for either revenue or expenditures.

- The PFM baseline projects that the State will experience structural budget problems throughout the forecast period:
Alternate Scenarios

- PFM also constructed optimistic and pessimistic revenue scenarios that forecast stronger or weaker than baseline growth during key periods of the model.

- As can be expected, they diverge in opposite directions from the baseline, with the optimistic scenario leading to a cumulative $16 billion surplus and the pessimistic scenario a cumulative $14 billion deficit.

- While neither is particularly likely, PFM would view the pessimistic scenario as more likely of the two to occur.

- PFM also modeled the budget on an accrual basis, with the long-term required funding for pension and other post employment benefits (OPEB) realized as a liability.

- Under this scenario, the State experiences a funding gap similar to that experienced in the pessimistic revenue forecast scenario.
High Level Findings: Sufficiency

- The PFM long-term projection model suggests that the current revenue structure will be insufficient to maintain structural balance during the forecast period.

- This is supported by other national forecasting models, such as the state and local government model maintained by the GAO.

- While expenditure reductions may also be part of the equation for budget balance, there are indications that budget reductions alone cannot cure the structural imbalance:
  - The nature of the pension and OPEB liabilities
  - The fact that payroll cuts can actually increase the pension funding requirement
  - Federal requirements for Medicaid – and solutions to Medicare.
The Commission charge included examining possible tax changes from the perspective of key tax policy principles – and particularly mentioned equity and efficiency.

PFM also examined the principles of reliability, stability and sufficiency, as well as maintaining a balanced, broad structure and preferring systems with ease of compliance and administration.

It should be noted that in many instances, tax principles will come into conflict.

Given the need to achieve structural balance, when tax principles collided, PFM tended to give greater weight to reliability, stability and sufficiency.
Jean Baptiste Colbert

“The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing.”
Key Strategies

- Expand the Tax Base
- Reduce Regressivity
- Reduce Pyramiding
- Export a Significant Portion of the Tax Burden
- Use Moderate Rate Changes to Increase Revenue
- Improve System Administration, Compliance and Transparency
Key Strategies

- Expand the Tax Base
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Base Expansion

- Reduce the pension exemption in the Individual Income Tax
- Eliminate the deduction for property taxes paid
- Cap or replace with grant programs certain tax credits
Reduce Regressivity and Pyramiding

- Provide a low income exemption of up to $20,000 of adjusted gross income for the individual income tax
- Double the refundable food/excise tax credit
- Eliminate the 0.5 percent GET and use tax rate for business to business transactions
- Allow the Act 105 temporary suspensions to sunset on schedule
- Eliminate the three-tiered corporate net income tax with a single rate of approximately 9 percent to recoup some of the lost GET tax revenue
Export Tax Burden/Attain Positive Externalities

- Increase cigarette and tobacco taxes
- Increase gallonage taxes on beer, wine, and distilled spirits
- Eliminate the sunset on the Transient Accommodations Tax
- Restore the surcharge on rental cars
Rate-raising and Improved Administration

- Increase the GET rate to 4.5 percent
  - Median state rate is 6.0 percent
  - Will still be the lowest combined average rate (state and local) in the country

- Develop tax gap compliance systems using vendors via a performance-based contract

- Create a compliance and productivity account to fund technology and staffing improvements from increased tax collections related to improved compliance

- Provide tax expenditure reports on a regularly scheduled basis
Next Steps

- The Project Team will refine the model assumptions for revenue and expenditure alternatives and work to finalize all models and outputs in the next four weeks.

- Based on feedback, a final report detailing project findings will be delivered the week of September 24th.

- We will work with you and key stakeholders to communicate project findings as appropriate.
Questions and Discussion