

COUNCIL ON REVENUES

DBEDT Conference Room
No. 1 Capitol District, Hemmeter Center
Fourth Floor, Room 436

Tuesday, August 1, 2006
2:00 P.M.

PRESENT:

Council Members:

Paul Brewbaker (Chair), Jack Suyderhoud (Vice-Chair), Carl Bonham, Michael Hirai, Pearl Imada Iboshi, and Eric Yeaman

Staff Members:

Department of Taxation: Tu Duc Pham, Cathleen Tokishi, and Uddhav Bhandari
Department of Budget and Finance: Shirl Fujihara

Others:

Lowell Kalapa, Tax Foundation of Hawaii

CALL TO ORDER:

Dr. Brewbaker called the meeting to order at 2:05 P.M.

COMMUNICATION TO THE COUNCIL:

None.

MINUTES OF THE MEETING OF MAY 30, 2006:

Dr. Brewbaker asked if there were any corrections to or comments about the minutes of the May 30, 2006, meeting. There were none, so Dr. Brewbaker called for a motion to approve the minutes. Mr. Yeaman so moved and Dr. Suyderhoud seconded the motion. The motion carried without opposition and the minutes were approved.

Before moving on to the next agenda item, Dr. Pham distributed copies of the draft 2003 tax credit report, which had been previously requested by the Council to assist them in preparing for next month's meeting on the General Fund Revenue forecast. He noted that it is labeled as a draft because Tax Director Kurt Kawafuchi had not yet reviewed the report.

TOTAL PERSONAL INCOME FORECAST:

Dr. Brewbaker distributed a copy of "Hawaii Economic Trends," dated July 31, 2006, which he prepared as Chief Economist for the Bank of Hawaii. He noted that Dr. Bonham had earlier prepared county forecasts. The general theme for discussion is the extent to which they think the economy is starting to slow down and the extent to which that will show up in personal income.

Table 2 of the handout prepared by staff for the Council shows nominal personal income growth.

Dr. Bonham stated that they had maintained their forecast of real personal income growth at 3% for 2006, and their inflation forecast is 3.8%, as it has been for a couple of years, so that it 6.8% nominal. That, noted Dr. Brewbaker, is close to last year. Dr. Bonham stated that real personal income growth was 3.1% and inflation was roughly 3.8%; so it is pretty close despite the slowing of nominal personal income growth in the last several quarters, which Dr. Brewbaker specified as 4 to 6 quarters. That is inconsistent with the Bureau of Labor Statistics (BLS) in terms of employment. They are not seeing any marked statewide slowing.

Dr. Brewbaker noted that, on page 3 of his report, there is a little bit of slowing in the jobs numbers. More striking (without the June number) is that the unemployment rate slid up in the first few months of this year, which he attributed to the bad weather resulting in a slowing of construction because people couldn't get to the job site, etc. However, he noted that everything seems to be moving at the pace at which they had expected deceleration or worse. That was his concern about tourism for a couple of months and the housing market has slowed; he's holding out till the August CPI for the first half to see how much is getting eaten up by the unexpected energy inflation and by the surprise housing component, and then waiting for corroboration in the job counts to see if deceleration is more aggressive than previously thought. If he starts with Dr. Bonham's 6.8% that's about the same but he thinks this year is not as good as last year or 2004.

Dr. Bonham thinks that last year's 6.9% will be revised upward when the data comes out in September as the total personal income figure should be consistent with the data for jobs, visitors, expenditures, housing, and tax revenue. Therefore, they are still expecting a deceleration, but from a higher number – say from 7.5% to 6.5%. In the county report, which did not include second quarter jobs data, it was noted that job growth seemed to be slowing. Oahu seemed to be the stronger economy with a shift in growth from the neighbor islands to Oahu.

Dr. Pham stated that job growth was about 3% for the first six months of CY 2006. Dr. Bonham stated that, if so, it would not appear that the economy is slowing. The table on page 21 in the Personal Income packet prepared for the Council shows the jobs data at 3.5% for the first quarter and 2.7% in the second quarter for a 3.1% change for the calendar year to date.

Dr. Brewbaker stated that from over 3% to under 3% is interesting, and noted that it is lagging although not too much with respect to the personal income calculation. It is the last thing that will show up after housing "hits the wall", after the visitor count goes flat due to the energy costs and all the other things that are accumulating this year including interest rate increases. He

doesn't know what is going on with the international visitor count, which is decoupled from the regional economic performance.

Dr. Bonham pointed out that the Japanese visitor count had not been good for years and has been decoupled from regional performance for the last 2-3 years. Dr. Brewbaker agreed, but noted that the GDP was up to 2% instead of 0%. Dr. Imada Iboshi and Dr. Bonham pointed out that there are other factors such as a lack of airline seats and hotel rooms since hotels are no longer saving rooms for the wholesalers as they did before, which is important since Japanese tourists usually book really late.

Dr. Suyderhoud stated that expenditures should grow faster than visitors and should be reflected in higher prices. Dr. Brewbaker noted that they are seeing higher yields as well due to longer stays. Dr. Imada Iboshi stated that longer stays are reflected in the shift away from Japanese visitors and towards domestic visitors.

Dr. Brewbaker asked if everyone is comfortable with the 6.5% personal income growth number for calendar year 2006. Dr. Bonham noted that they are likely to get an inflation number of close to 4%. Dr. Brewbaker is using 4.2% for the first half, which would be below 3% real personal income growth in his arithmetic, which after a 2.5% GDP number in the second quarter would not be unlikely.

Mr. Yeaman noted that the Council had projected a range of 6.5% to 6.9% of total personal income growth for 2006 from their last meeting. Dr. Brewbaker stated that it is the character of the deceleration that bothers him. Dr. Bonham noted that UHERO provided a deceleration forecast for 2007 for total personal income, including a halving of job growth.

Mr. Yeaman asked if the 5.9% for 2007 that they had estimated at their last meeting was too high. Dr. Bonham stated that his forecast for 2007 is 5.4% for nominal personal income growth, composed of 3.2% inflation rate and 2.2% real personal income growth.

Dr. Bonham suggested 6.5% for 2006 and 6% for 2007. In light of the conversation about the coming deceleration in 2007, Dr. Suyderhoud asked why 6% for 2007 instead of something lower. Dr. Bonham stated that it was because the government unions would begin negotiating soon, the large University professor salary increases start next year, and hotels are in contract talks now. Unless tax revenues slide dramatically, the HGEA and the HSTA will go for increases since they are playing catch-up with the 4% inflation for this year, which will show up in 2007.

Dr. Brewbaker stated that the estimate of 6% growth rate for personal income is a combination of 3.5% inflation and 2.5% real growth.

Dr. Brewbaker called for a motion to submit to the Governor a total personal income forecast for an increase of 6.5% for 2006 and 6.0% for 2007. Dr. Bonham so moved and Mr. Yeaman seconded the motion. The motion carried unanimously.

GENERAL FUND REVENUE MODEL:

Dr. Brewbaker stated that the existing methodology is quite old and in need of revision.

Dr. Pham noted that the Council had expressed frustration with the number of the below-the-line items. Looking at Table 1 of the General Fund Tax Revenues packet prepared by staff for the Council, there is a forecast error of about \$14 million, virtually all of which can be accounted for by the delinquent tax collections.

Dr. Imada Iboshi stated that they need more timely information on delinquent tax collections. Dr. Pham asked if they wanted the monthly report, but the Council asked only that he update it when they get these packets.

Regarding the number of the below-the-line items, Dr. Pham is proposing Table 3 as an alternative. For example, there normally is a large above-the-line number and a large below-the-line number for the transient accommodations tax (TAT). Table 3 just has the net amount above-the-line. The detailed forecast for TAT gross collections are in a separate table, Table 2.

Dr. Pham adjusted the dependent variable to net amounts. Also, since the tax rates were changed, the data was adjusted to current rates to create pseudo historical data that can be compared; this was done by doing revenue impact analyses using actual data. The dependent variable is a construct net of credit.

Dr. Brewbaker indicated the data series needs to be analyzed further.

Dr. Suyderhoud stated that the forecasting model is the same as it was 20 years ago when they first started doing this kind of forecasting and uses the same variables and methodologies. He and the then Tax Research and Planning Officer, Robert Koike, developed them. His first question is whether there is an alternative to this bottom up forecasting. His second question is why the Council wants to tie itself to this multiple regression model rather than to some other methodology such as a time series extrapolation methodology.

Dr. Brewbaker stated that it is important to many, including the Legislature, who wants to know what is happening to all the pieces even though it is not important to the Council. The Council is really interested in four pieces: 1) individual income tax; 2) general excise tax; 3) corporate income tax; and 4) all others. Bottom up detail should be done, but not by the Council; if done by the Council, then in conjunction with a top down approach.

Dr. Suyderhoud would like a regression-based causal model structural equation for the total collections and a vector autoregression to see the results of both.

Dr. Brewbaker and Dr. Suyderhoud agreed that they could use a bottom up model and disaggregate a little, but still pick a small number for more sophisticated estimations. Dr. Suyderhoud suggested taking advantage of the resources at the University.

Dr. Brewbaker asked how they could do this for no money. Dr. Bonham was asked if he knew of any students who needed a project for a semester such as a graduate assistant or for a senior paper, who could work with the several members of the Council who do teach anyway. Perhaps something could be arranged. Dr. Brewbaker further suggested that it could be done as part of a class, but Dr. Bonham and Dr. Imada Iboshi disagreed. Dr. Bonham said the main problem was faculty time.

Dr. Suyderhoud suggested that perhaps this work should be contracted out, perhaps to the University of Hawaii Economic Research Organization (UHERO), for which Dr. Bonham is the Executive Director.

Dr. Bonham noted that if someone is paid to develop a model and it is delivered, the model ages. Econometric models "need constant care and feeding" and forecasting literature indicates that nothing says that a well-specified model will forecast any better than a broken model.

Dr. Brewbaker agreed, and said that what might be useful is that such a project may result in an operational model that could lead to an ongoing collaboration costing little money.

They agreed that only 1 graduate student would be needed. Dr. Bonham stated that they currently have 6 research assistants at UHERO, but all are busy. They have a problem getting students when someone wants something within a couple of months as opposed to a year, but it is the faculty time that is more difficult.

Dr. Pham stated that the current job market makes it difficult to hire a qualified student, and suggested that they may want to contract a person such as Dr. Byron Gangnes to do the work instead.

Dr. Brewbaker summarized by saying that it appears unlikely that they could get either Dr. Gangnes or Dr. Bonham to do the work during the Fall 2006 semester as a consultant. Dr. Imada Iboshi suggested a contract with UHERO for a graduate assistant, which Dr. Suyderhoud said would be about \$8,000 for 6 months, plus an additional amount for overhead. However, Dr. Bonham explained that it would take 2 months for UHERO to get the contract paperwork done through the University of Hawaii, and that is why UHERO does not consider contracts under \$10,000. Dr. Brewbaker and Dr. Suyderhoud stated that their idea was to simply hand over a data set to the student and let them deal with it.

As another possibility, Dr. Suyderhoud noted that a Japanese econometrician from Kansai who will be working with them from October to March might be interested.

Dr. Bonham stated that organizations like UHERO housed within schools of business or economics do economic forecasting for state agencies around the country. However, it is not the model that does the forecasting, but the forecaster. With people like Dr. Pham and the Council members, who all have a fair amount of historical experience, he suggests that they get somebody to 1) develop a set of equations, 2) do some historical forecasts using those models for recent periods of time, 3) present them to the Council for input, and 4) come up with a final consensus model. That person should also do some sample forecasts for the Council. He noted

that they do subjective adjustments, as does the Council, and that one forecast may concurrently affect another forecast.

Dr. Bonham stated that the Council should consider any proposal made by UHERO without him being present. Dr. Brewbaker noted it would actually be Director Kawafuchi that would request the proposal since the Council does not have a budget. Dr. Pham noted that in November 2005 the Council did not support his request for additional research budget in this fiscal year. He stated that if the Council or the Department considers hiring Dr. Bonham to develop the model, then we would need to clear the process through the Attorney General's Office, given Dr. Bonham's dual roles.

The matter will be discussed further during the next Council meeting.

NEXT MEETING:

The next meeting to forecast General Fund Revenue was scheduled for Wednesday, September 6, 2006, at 3:00 P.M. in the Office on Aging Conference Room, at the Hemmeter Center, No. 1 Capitol District.

ADJOURNMENT:

Dr. Brewbaker called for a motion to adjourn. Dr. Bonham so moved and Mr. Yeaman seconded the motion. The motion carried unanimously and the meeting adjourned at 3:25 P.M.