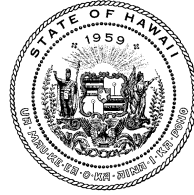


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COUNCIL ON REVENUES

STATE OF HAWAII
P.O. BOX 259
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January 5, 2017

The Honorable Jill N. Tokuda
Chair, Senate Committee on Ways and Means
State Capitol, Room 207
Honolulu, HI 96813

The Honorable Sylvia Luke
Chair, House Committee on Finance
State Capitol, Room 306
Honolulu, HI 96813

Chairpersons and Members of the Committees:

Thank you for inviting the Council on Revenues (Council) to appear before your committees to present the current tax revenue forecasts for the State of Hawaii. My name is Kurt Kawafuchi and I am the Chair of the Council on Revenues. Today, I would like to present a review of recent trends and of the Council's latest forecasts.¹

Recent Revenue Trends

Results for fiscal year 2016

In fiscal year (FY) 2016, the State's General Fund tax revenues increased by 8.0% over 2015. This growth rate was larger than the growth rate for FY15 of 6.8%. In dollar terms, General Fund revenue grew to \$6,194.4 million in FY16 from \$5,735.1 million in FY15. Please note that there was no deposit into the Hurricane Relief Fund in FY16. There was a mandatory deposit of \$55.5 million into the Hurricane Relief Fund for FY14 and FY15.

The rise in economic activities in key economic sectors resulted in an increase in tax administration. The Tax Services and Processing Division of the Department of Taxation

¹Because the Council on Revenues will have its next general fund meeting during the afternoon of Wednesday, January 4, 2017, we may supplement this testimony by additional written testimony and/or updated information and/or by verbal testimony at the hearing on Thursday, January 5, 2017.

indicate that the number of business licenses increased from 669,000 in FY15 to 705,336 in FY16.

The general excise tax (GET) comprises approximately half of total General Fund tax revenues. GET revenue grew by 5.2% from FY15 to FY16. Driving this growth was continued strong growth in visitor arrivals and expenditures, job counts, and construction activity. Construction completed, measured by general excise tax base for contracting, increased 11.8% from \$7,322 million in FY15 to \$8,185 million in FY16.

Results for the first five months of fiscal year 2017

At its last general fund meeting on September 2, 2016, the Council revised its forecast for General Fund revenues up from 5.0% to 5.5%. At that meeting, the Council noted that Hawaii's economy continued to be strong, but cited uncertainty about the future. In particular, the Council expressed concerns that Hawaii's economy may have reached the end of its current expansionary cycle during the seven-year budget window. It noted that visitor arrivals and expenditures, job counts, and construction activities all continued to be strong. However, the Council was concerned that the construction cycle may have peaked.

Subsequent to its September 2016 general fund meeting, the preliminary data through November 30, 2016 shows a General Fund growth rate of 0.7% for the first five months of FY17 compared to the same period in FY16. Cumulative net collections of GET revenue for FY17 were \$1,339.9 million, compared to \$1,328.2 million for the same period in FY16, for a year-over-year growth rate of 0.9%.

Below is the cumulative growth rate in General Fund revenues during FY17 over the same period in FY16.

July 2016	(0.5%)
August 2016	(1.1%)
September 2016	(3.7%)
October 2016*	1.0%
November 2016*	0.7%

* Preliminary data

To date, the cumulative growth rate has remained below the estimated 5.5% growth rate for FY17. At the Council's most recent meeting on September 2, 2016, only the July 2016 general fund cumulative growth rate of (0.5%) was available for consideration.

The above collection figures for the first five months of FY17 may have been impacted by the collection of approximately \$39 million from the online travel companies (OTC) case in FY16. This collection increased collections for FY16 thus increasing the base against which FY17's collections are compared to. Of the \$39 million, approximately \$29 million was received in September of 2015, meaning that \$29 million is included in

the base that the collections for the first five months of FY17 are being compared to. This may be partly contributing to the slower than expected General Fund growth rate during the first five months of FY17.

Cumulative net collections of individual income tax revenues for FY17 were \$826,500, compared to \$832,820 for the same period in FY16, for a year-over-year growth (negative growth) rate of (0.8%). Cumulative net collections of corporate income tax for FY17 were \$43,914 compared to \$62,516 for the same period in FY16, for a year-over-year growth rate of (29.8%).

Below is a breakdown of net individual and corporate income tax revenues through November 2016 compared to the same period of FY16.

Year-on-year net income tax collections FY16 and FY17 –by Component*

	FY17	FY16	DIFFERENCE	
			AMOUNT	% CHANGE
Corporate income tax	43,914	62,516	(18,603)	(29.8%)
Decl. Est. Taxes	53,658	49,172	4,486	9.1%
Payments w/ returns	17,211	24,260	(7,049)	(29.0%)
Refunds	(26,955)	(10,915)	16,040	146.9%
Individual income tax	826,500	832,820	(6,320)	(0.8%)
Decl. Est. Taxes	113,447	149,909	(36,462)	(24.3%)
Payments w/ returns	45,931	44,514	1,417	3.2%
WH tax on wages	758,154	722,778	35,376	4.9%
Refunds	(91,032)	(84,380)	6,652	7.9%

* Based on preliminary data for October and November

The breakdown of net income tax revenues for corporations shows that the largest drags on corporate income tax revenues are increased refunds and lower payments with returns. For individual income tax revenues, the component with the largest decrease is declaration of estimated taxes. There is an increase in individual income tax refunds and an increase in withholding taxes on wages.

The lower estimated tax payments and increase in refunds are often caused by lower than expected profits (i.e., taxable income) for individuals and corporations. Declaration of estimated taxes consists mainly of taxes on taxable income from business profits and investments including capital gains taxes paid. The decrease in estimated taxes may also partially be explained by the expiration of Hawaii’s higher tax rates December 31, 2015.

The Council's Forecasts of General Fund Tax Revenues

Before providing the Council's latest forecast, I will explain how the Council produces its forecasts and cover some errors that have been made by the Council. The Council meets four times per year to forecast General Fund tax revenues. The Council's forecasts are due by January 10, March 15, June 1, and September 10 of each year.

Prior to each General Fund meeting, each Council member completes a survey provided by the Office of Tax Research and Planning (TRP) in the Department of Taxation (Department). The survey asks for the member's forecasts for growth in key economic variables, including construction, the Honolulu consumer price index, total visitor arrivals coming to Hawaii by air, U.S. Gross Domestic Product (GDP), the U.S. GDP deflator (a measure of inflation in the national economy), total State wages, visitor expenditures, and Hawaii GDP in real (deflated) terms. After receiving the Council members' growth for key economic variables, the TRP staff inputs such variables into econometric models to estimate the implied growth in General Fund tax revenue.

The primary model used by TRP staff has a separate econometric equation to predict the growth in revenues from each major tax type (the Individual Income Tax, the Corporate Income Tax, the General Excise Tax, the Public Service Company Tax, and others). All of the models incorporate estimates for the effects of changes in tax law that will affect the General Fund tax revenues. TRP staff provide historic data on the economic variables to be forecast by the Council members, the econometric predictions of General Fund revenue growth based on the Council's economic forecasts (including incorporating the effects of changes in tax laws), and information about matters of tax administration that could affect the General Fund tax revenues, such as delays in processing or unusual collections of delinquent taxes. However, TRP staff do not engage in any economic forecasting.

In their meetings, Council members review the results of the econometric models and consider other factors, such as the current trends in monthly collections and changes in the economy that might change the current trends. The members then decide on the official forecast for the growth in General Fund tax revenue. The forecast may or may not agree with the results of the econometric models. The Council forecasts only the total General Fund tax collections. To get the implied growth in collections of the individual tax types, TRP staff change the economic variables in the primary model until the model produces a growth rate for total General Fund tax revenues that matches the Council's forecast, so that the forecasts of tax revenue growth for the individual tax types are consistent with the Council's forecast for overall General Fund tax revenue growth.

The Council's Recent Forecast Errors

Table 1 compares the average forecasts of key economic indicators that our members submitted to the TRP Office slightly before each of the four meetings during FY16. As can be seen from the table, the Council estimated the growth of Hawaii's economy during the last fiscal year fairly accurately. The actual growth rate of nominal total personal income, the most important factor to forecast tax revenues, was 4.6% in FY16, compared to the 4.2% to 4.7% growth rate range forecast by the Council members for FY16. The members' forecasts for FY16 were more accurate than those for FY15. For FY15, actual growth was 4.7% while the forecasts ranged from 4.0% to 4.3%.

The same can be said of the Council's estimation of the visitor industry. In the last couple years, the Council underestimated the rate of growth in visitor arrivals by air. The Council estimated growth in visitor arrivals by air accurately after that. The

underestimation in the visitor industry from previous years was partly due to capacity of then, existing hotel rooms and hotel rooms under renovation and a possible underestimation in capacity of the vacation rental and bed and breakfast industries.

Regarding the other key indicator of Hawaii's economy, the construction industry, the Council overestimated growth for FY16. Table 1 shows that actual growth in completed construction was 7.4%, whereas the Council's members estimated growth of between 9.0% and 14.9% for FY16 in their meetings throughout the fiscal year. In FY15, the Council's members estimated completed construction slightly more accurately by estimating growth of between 7.3% and 11.5% at their meetings compared to an actual growth rate during FY15 of 7.4%.

The overestimation of the growth of the construction industry was, similar to last year, based on the robust growth in construction permits and on notable large construction projects Council members were aware of in the Kaka'ako, Ala Moana and Waikiki areas. This continued growth in permits and projects was not matched by growth in tax revenue in the contracting, i.e., construction category.

Table 2 presents the four forecasts of tax revenues made by the Council during FY16 and the errors for each forecast. Please note that the distribution of the overall forecasts of General Fund tax revenues to various components has been done by the TRP Office for illustration and other purposes. While these forecasts are consistent with the overall forecasts, the component forecasts should not be considered the Council's forecasts.

During the Council's September 3, 2015 General Fund meeting, the Council raised its growth rate for FY16 from 2.7% to 6.0%. The drastic increase was due to the Department's processing status of individual income tax refunds. In May 2015 (FY15) the Department informed the Council that approximately \$104 million in individual income tax refunds would be delayed and paid in FY16 rather than in FY 2015. However, at the September 3, 2015 meeting the Department informed the Council that the refund delays had been remedied meaning most refunds had been paid out in FY15. At the Council's October 31, 2016 personal income meeting, the Council was also informed that the cumulative general fund revenue to date does not appear to likely have been significantly impacted by the Tax Modernization System implemented in August 2016.

Additionally, at the Council's September 3, 2015 FY16 General Fund meeting, the Council took account of the payment due from the Hawaii Supreme Court's decision in the online travel company case after the Department informed the Council that approximately \$39 million from the case would be received in FY16. The Department has since confirmed that at least \$39 million was received in FY16.

I would like to note that revenue forecasts are multi-year forecasts, errors in a fiscal year can be offset or compounded by errors in another fiscal year. To review the performance of the Council's forecasts over time, table 3 compares the forecasts made in March, the time that the legislature finalizes the budget, over three fiscal years. Table 3 compares the fiscal year when the budget is formed and the next two fiscal years, considering the

fact that the legislature concentrates on the actual biennium budget. As shown in table 3, the Council underestimated the General Fund tax revenues by 1.2% over the three-year period in March 2014, down from 4.4% in March 2011, reflecting the continuing conservative view of the economy after the severe recession.

In March 2013, the Council overestimated the tax collections over the three-year period by 3.1%, mainly due to unanticipated slowdown of the economy in FY14, which resulted in a decrease of 1.8% in General Fund tax collections for that fiscal year. Actual data for tax collections for FY17 and FY18 are not available. We do not know exactly the performance of the forecasts made by the Council in March 2015 and March 2016 because the three-year period has not yet concluded.

The Council's Current Forecasts

At its latest total personal income meeting on October 31, 2016 maintained its forecast of growth in total personal income at 4.5% for calendar years 2016 and 2017.

At its latest General Fund meeting on September 2, 2016, the Council raised its forecast of growth in General Fund revenues for FY17 from 5.0% to 5.5%.

The Council left unchanged the forecast for growth in FY18 at 5.0%, but lowered the forecast for growth in FY19 from 5.0% to 4.4% and lowered the forecast for growth in FY's 20 through 22 from 4.5% to 4.4%. The Council also forecast growth of 4.4% for FY23. Because of the higher base for FY16 (increase of 1.9%) compared to FY15 and the higher growth forecast for FY17, the Council's current forecast on September 2, 2016 results in increased revenue from FY18 through FY22 when compared to the previous forecast from May 24, 2016.

The Council discussed the strength of Hawaii's economy. The Council believed that the economy remained strong but was also apprehensive of uncertainty in the future. The Council noted that visitor arrival and expenditures, job counts, and construction activities all remained strong, but that the current expansionary cycle may have reached its peak. Members were also concerned that the construction cycle may have peaked. Table 4 summarizes the recent key economic and tax revenue data and table 5 shows the average forecasts of key economic indicators provided by the Council's members.

As can be seen from table 5, the Council expects that inflation, as measured by the Honolulu Consumer Price Index for All Urban Consumer (CPI-U), will be slightly above 2% per year over the forecast horizon. As a matter of comparison, the Honolulu CPI-U increased 1.3% in FY15 and 1.8% in FY16, as reported by the U.S. Bureau of Labor Statistics (see table 4A).

The Council also expects that the number of visitor arrivals by air will increase at an annual average growth rate of about 1.5% through the forecast window of FY17 through FY23. This view of visitor arrivals is down compared to the Council's forecasts through FY22 from last fiscal year. As reported by DBEDT in their 4th Quarter 2016 Quarterly Statistical and Economic Report, the Blue Chip Economic Consensus Forecast 0.8%

growth in real GDP for Japan in calendar year 2017 as compared to 2.2% growth rate of the U.S. economy for the same year. The latest UCLA Business Forecast, subscribed by the Tax Research and Planning Office, expects the U.S. economy will grow at a similar pace of 2.4% in 2017.

Another key economic factor impacting the growth of tax revenue collections is the strength of the construction industry. Construction permits (private building authorizations), an indicator of future construction activity increased 5.25% in FY16 over FY15. The Council forecasts average growth rates for construction activity of 9.9% for FY17, 6.8% for FY18, and 4.2% in FY19. Total personal income, a comprehensive indicator of Hawaii's economy, is expected to grow between 4.3% and 4.5% during this fiscal year and the next biennium, FY18 and FY19.

Revised forecasts of General Fund tax revenues for FY17 through FY22 and the new forecast for FY23 are shown in the table below.

General Fund Tax Revenues

Fiscal Year	Amount (in Thousands of Dollars)	Growth From Previous Year
2017	\$6,535,046	5.5%
2018	\$6,861,798	5.0%
2019	\$7,163,717	4.4%
2020	\$7,478,921	4.4%
2021	\$7,807,993	4.4%
2022	\$8,151,545	4.4%
2023	\$8,510,213	4.4%

In producing its forecasts, the Council adopted specific adjustments recommended by the Department of Taxation to reflect effects on General Fund tax revenues of tax law changes enacted by the 2016 Legislature, including the following:

- Act 129, Session Laws of Hawaii (SLH) 2016, accelerates the period over which the State low-income housing tax credit may be claimed from ten years to five years. This change accelerates the credit and allows the total benefits to be claimed over the first five credit years. The Act is expected to reduce General Fund revenues by \$9 million in FY 2019, \$18 million in FY20, and \$27 million in FY21.
- Act 202, SLH 2016, repeals the ethanol facility income tax credit and creates a new, nonrefundable income tax credit for production of renewable fuels. The credit is available for five consecutive years beginning with the first taxable year in which the taxpayer claiming the credit begins producing at least 15 billion British thermal units of renewable fuel per year. Fuels must be produced from renewable feedstocks, which include various agricultural crops and various types of waste. The credit is 20 cents per 76,000 British thermal units of renewable fuel

sold for distribution in Hawaii. The credit has a per-taxpayer cap of \$3,000,000 per taxable year and an aggregate cap to \$3,000,000 per tax year. The annual General Fund revenue loss is estimated to be \$3,000,000 per year beginning in FY18.

- Act 223, SLH 2016, extends the \$103,000,000 total allocation of transient accommodations tax revenues to the counties for FY17. Act 174, SLH 2014, increased the counties' allocation to \$103,000,000 from \$93,000,000 for FYs 2014 and 2015. The General Fund revenue loss is \$10 million for FY17.

The Council also took into account provisions from earlier legislation, including the following:

- Act 84, SLH 2015, establishes maximum dollar amounts for the allocations of the Conveyance Tax to the Land Conservation fund and the Rental Housing trust fund, and eliminates allocations to the Natural Area Reserve fund starting in FY16. The annual General Fund revenue gain is estimated to be \$19.7 million for FY16 and later.
- Acts 117 and 121, SLH 2015, changed allocations of the Transient Accommodations Tax (TAT). According to Act 121, TAT allocations for FY16 and later are as follows: Tourism special fund \$82 million; Counties \$93 million (except \$103 million in FY 2016); Convention Center special fund \$26.5 million; and Turtle Bay conservation easement \$1.5 million. Act 117 allocated \$3 million annually to the Special Land Development fund starting in FY17. The changes in allocations are expected to yield \$5 million in additional General Fund tax revenues in FY16 and \$2 million annually thereafter.
- Act 120, SLH 2015, provides a tax credit for converting cesspools to a septic system or connecting to a wastewater system. The tax credit expires December 31, 2020 and is estimated to reduce General Fund tax revenues by \$5 million annually from FY16 through FY21.
- Act 238, SLH 2015, reduces the allocation of tobacco taxes to the Trauma special fund, caps the amount allocated to the fund, and also caps the allocations to the Emergency Medical Services and Community Health Centers special funds, effective July 1, 2015. The Act is estimated to increase General Fund tax revenues by \$4 million in FY's 2016 and later.
- Act 107, SLH 2014, reestablished the energy systems development special fund. It also extends the \$1.05 per barrel rate for the environmental response tax, which was set to expire at the end of fiscal year 2015, through fiscal year 2030, as well as the allocations of the tax to the General Fund. The annual General Fund revenue gain is estimated to be \$15.5 million for fiscal years 2016 through 2030.

- Act 89, SLH 2013, amends the motion picture digital media and film production tax credit. The Act increases the credit rate from 15% to 20% for productions on Oahu and from 20% to 25% for productions on the neighbor islands. The Act also increases the cap on the amount of the credit per production from \$8 million to \$15 million and moves the expiration date for the credit from January 1, 2016 to January 1, 2019. The Act is estimated to raise the annual cost of the tax credit by about \$21 million.
- Act 163, SLH 2013, makes permanent the GET exemption for certain expenses paid by hotel operators and timeshare projects and removes the cap on the aggregate amount of the exemptions that can be claimed. The Act is estimated to reduce GET collections by about \$13 million annually.

The Department of Taxation has prepared a report (attached table 6) detailing line-item forecasts for various components of the General Fund, reconciled to the Council's forecast growth rate for total General Fund tax revenues. The line-item forecasts include components, such as revenues from the general excise tax and from the individual income tax that the Council does not forecast separately.

That concludes my presentation. I am available to answer any questions you may have.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Kurt Kawafuchi', written in a cursive style.

KURT KAWAFUCHI
Chair, Council on Revenues