

COUNCIL ON REVENUES

Office on Aging Conference Room
No. 1 Capitol District
Hemmeter Center
Fourth Floor, Room 410

Wednesday, September 6, 2006
3:00 P.M.

PRESENT:

Council Members:

Paul Brewbaker (Chair), Jack Suyderhoud (Vice-Chair), Carl Bonham,
Vito Galati, Michael Hirai, Pearl Imada Iboshi

Staff Members:

Department of Taxation: Tu Duc Pham, Yvonne Chow, and Dana Remigio

Department of Budget and Finance: Shirl Fujihara, Sharon Kotaka,
Keith Shimada, and Neal Miyohara

Others:

Hayley Callahan, Department of Taxation
Lowell Kalapa, Tax Foundation of Hawaii
Kurt Kawafuchi, Department of Taxation
Johnnel Nakamura, Department of Taxation

ABSENT:

Council Member Eric Yeaman

CALL TO ORDER:

Dr. Brewbaker called the meeting to order at 3:07 P.M.

COMMUNICATION TO THE COUNCIL:

None.

ELECTION OF CHAIR AND VICE-CHAIR:

Dr. Bonham nominated Dr. Brewbaker for Chair and Dr. Suyderhoud for Vice-Chair. Mr. Hirai moved to approve the nominations and Dr. Iboshi seconded the motion. Dr. Brewbaker called for a discussion and asked the members if there was any problem with the Chair being an employee of the University of Hawaii or of the Department of Business Economic Development and Tourism. Dr. Suyderhoud expressed the opinion that it may be a bad idea for a State

employee to be the Chair. With no further discussion, the motion carried without opposition and the election of Chair and Vice-Chair was approved.

MINUTES OF THE MEETING OF AUGUST 1, 2006:

Dr. Brewbaker called for comments on the minutes of the last meeting. He said that he did not follow up on the analytic initiative for the Total Personal Income for the past month.

Dr. Suyderhoud said that he would like to complement the thoroughness of the minutes, relative to prior minutes. Dr. Pham informed the council that, because of the workload, he doesn't have the same person all the time. He said that Ms. Cathleen Tokishi, a staff member of the Tax Review Commission, took the minutes of the last meeting. Dr. Brewbaker called for a motion to approve the minutes. Mr. Hirai so moved and Dr. Suyderhoud seconded the motion. The motion carried without opposition and the minutes were approved.

REPORT BY THE DEPARTMENT OF BUDGET AND FINANCE ON OTHER REVENUES:

Ms. Fujihara presented the report.

Report on General Fund Non-Tax Revenues: Ms. Fujihara reported that there were only a couple of significant changes. One, in Use of Money and Property, there was an increase in FY06 of \$8.5 M and for each of the out years (FY07 - FY13) to reflect actual investment pool interest earnings reported by Budget and Finance. The other large change was in Non-Revenue Receipts. For FY 07 there was an increase of \$16 M in revenue due to three B&F activities: First, there was an increase in debit service of \$7.7 M for reimbursable G.O. bonds to be collected from special funds. Second, there was an increase of \$6.5 M in the unclaimed property trust fund. Third, there was an increase of \$2 M per year for FYs 07-13 for fees assessed by the Public Utilities Commission due to higher than previously projected growth in public utility revenues.

Special Fund Tax Revenues: Ms. Fujihara reported the only major change in the transfer of transient accommodations tax, \$2 M per year for FYs 07-13, which reflect the Council's most recent projections. Second for Vehicle Surcharge, Tour Vehicle, \$3 M increase for FYs 06 and 07; decreases of \$10 M per year for FYs 08-10 and decreases of \$4, \$3, and \$2 M for FYs 11, 12 and 13, respectively. Lastly, for Unemployment Compensation Tax, higher than projected actual collections of \$12.5 M for FY 06 due to higher than projected covered payroll, and decreases of \$5 M to \$17 M per year for FYs 07-13 that reflect the most current projections.

Special Fund Non-Tax Revenues: B&F reported that there were 4 categories with significant changes. First, in Revenues from Use of Money and Property, the largest change of for the Department of Transportation. Increases of \$10 M to \$15 M per year for FYs 06-13 is the net of adjustments to reflect current projections from investment earnings for Airports, Highways, and Harbors divisions. In Federal Grants, the biggest decrease is for DOT highways: lower than projected actual of \$12 M for FY 06 and net decreases of \$10 M in FY 07 to \$2 M in FY 13 is due to slower than expected progress in repair and construction projects. Third, for Charges for Current Services – Others, the largest change is for UH: increases for FYs 06-13 are due to revised fee schedules for admission to athletic events and UH Manoa summer session program,

and reclassification of revenues from revolving to special funds due to bond fund conversion per Act 138, SLH 2005. Lastly, for Non Revenue Receipts, most significant change for UH is increases of \$38.3 M per year to reflect reclassification of revenues from revolving to special funds due to bond fund conversion Act.

Other than Special Fund Non-Tax Revenues: Ms. Fujihara reported on three categories with significant changes. Federal grants largest decrease is for FYs 06-13 for DOH due to reduced funding for the Clean Water Act and Safe Water Act: \$24 M in FY 06, \$6 M in FY 07, and \$8 M per year for FYs 08-13. Second large change is in Charges for Current Services: biggest decrease is \$17 M per year for FYs 07-13 for UH to reflect reclassification of revenues from revolving to special funds due to the bond fund conversion Act. Last, for Non Revenue Receipts, the largest change is decrease of \$8 M for UH due to decrease in endowment income and decreases of \$43.5 M per year for FYs 07-13 due to reclassification of revenues from revolving to special funds due to bond fund conversion Act.

Ms. Fujihara asked the council if they had any questions. Dr. Brewbaker asked whether it is possible to aggregate all of the numbers into a single number that nets out the kinds of changes that Ms. Fujihara just explained. In his mind he sees four spreadsheets that should add up to one number or one time series. Dr. Brewbaker wondered if the current procedure is making things more complicated than they need to be and that if there were a way to avoid that, it would be great. He noted that Council is looking at analytical enhancements to tie things together. He said that he would meet with Budget & Finance and have a conversation to learn more about the methodology that underlines their reports.

Dr. Brewbaker called for a motion to accept the report. Dr. Suyderhoud made the motion and Mr. Hirai seconded it. The motion carried with no further discussion.

GENERAL FUND REVENUE FORECAST:

Dr. Brewbaker stated that this would be a good time of the year, with a preliminary cut on how assumptions play into the revenue forecast, to think about what's happening to the economic forecast, with half the calendar year past, maybe with a little more inflation, weaker tourism, and housing grinding to a halt little harder than we thought.

Dr. Iboshi distributed copies of the quarterly statistical and economic report, an executive summary for the 3rd quarter 2006. She said that the forecast changed slightly by reducing visitor numbers for this year. The years are coming out much flatter than they expected. The growth rate forecast was 3% earlier and now it is down to slightly more than 2 %.

Dr. Iboshi stated that on Page 6 of the hand out, they changed the inflation number with the really high Consumer Price Index (CPI) number for the first half of the year and expected it to be closer to 4 ½% or in the low 4's for the whole year. She said that with the 5.8% inflation rate for the first half of 2006, her inflation forecast for the year is conservative.

Dr. Brewbaker asked Dr. Iboshi if the tail on this forecast is similar to the prior forecast or whether it has been dialed up a little. Dr. Iboshi said that the numbers have gone up overall and

that the numbers didn't go up as fast as they thought they should have. She said that the CPI took a while to go up and that they kept over-projecting the CPI for a long time, and when it finally rose, it went up a lot. Dr. Iboshi noted that it's going to take a while to get back down.

Dr. Bonham informed Dr. Brewbaker that his forecast has not been released, that it will probably be sent to his client tomorrow (9/7/06), and that there will probably be a press release in a week to ten days.

Dr. Brewbaker asked Dr. Bonham if his forecast would be similar to Dr. Iboshi's forecast. Dr. Bonham stated that his inflation forecast is not dissimilar and will probably end up with inflation above 5% for 2006, and also that he has been doing some background research on the relationship between housing and the CPI index. The 5.8% inflation rate for the first half of 2006 was almost all due to housing. Dr. Bonham also stated that the renter's component goes up slower than home prices do and casual empiricism is telling him that rents are rising.

Dr. Bonham said that he remembers talking to Dr. Sklarz about rents going up back in '97-'98 and nothing was showing, the CPI were still going down. Dr. Bonham noted that the Bureau of Labor Statistics (BLS) is trying to use samples on Oahu and to measure what's actually happening to the rent that people are paying or the rent that people would be paying if they were renting their house.

Dr. Pham stated that starting in 2006, Section 8 has raised the maximum rent for a two bedroom from \$994 to about \$1,400, which is a 40% increase. The military housing allowance has also increased by 40%. Dr. Bonham said he remembers when that happened, because it affected the money flowing into programs. He said that looking at rents and the housing price components in the CPI in the last cycle, there was a two-year lag between the peaks, the peak for home prices was in 1991 and in 1992 we had a fall in home prices. The peak in the CPI rental components didn't happen until a year or two years later. They are assuming it's going to continue for the year or year and a half and that is why they're raising their inflation prices just a bit. Dr. Bonham believes that despite first quarter of '06 showing a negative real income growth, he doesn't feel that it reflects real economic activity because first quarter of '06 had 3% job growth and he still believes that the Bureau of Economic Analysis (BEA) is going to play catch up on the nominal income numbers, that the nominal income numbers will be higher, and that the real income numbers are coming down pretty hard.

Dr. Bonham said that visitors from Japan will come in at -10% for the year and that US market wasn't very good in July. However, the forecast for the US visitor number is still up around 3%.

Dr. Brewbaker stated that with domestic seats, new arrival carriers like ATA/Southwest and America West committed a year ago to build some capacity and it's taking shape, although meanwhile demand is dropping off.

Dr. Bonham stated that he expects 3% growth rate in US arrivals for the year and that we're roughly at 4% year to date. The job forecast is roughly the same at 2.5% (maybe 2.4%) and what it comes down to is who's going to do the biggest revisions on the data. He believes that BEA is going to revise their nominal income numbers up significantly.

Dr. Brewbaker's stated that there seems to be a turning point unfolding. With housing it started a while back, but he's struck by the unemployment numbers rising, which should be a whole different place to make revisions.

Dr. Bonham noted that on page 3 of Dr. Brewbaker's Hawaii Economic Trends Report, if you look at the real income data it's pretty disturbing, it peaked at the middle of '04 and it's been straight down ever since. But if the quarter-to-quarter data are actually increasing from 4.3% in the first quarter, then to almost 6% at the end of the year and the first quarter of '06 is the same, there's no sign in the nominal data that there's a slowing. Dr. Bonham stated that focusing on the real income data tells us how much people are spending money. But if 60% of the people on Oahu or in the State own their own homes, then the 10.5% increase in the rent component is irrelevant. The only people who are getting nailed are the people who are renting and the real income in Oahu has not gone down as much as the data show.

Dr. Brewbaker said first the inflation burns up the nominal metrics, then the production metrics and last the job loss. Dr. Bonham noted that it's a typical scenario for a cycle, where you get overheating on the price/inflation side and the Fed usually overreacts, driving the interest rates up enough to cause the recession. He stated that we are at the point where we have to decide if these high single nominal revenue growth rates have a shot at persisting, but that we don't have to decide all of it today.

Dr. Suyderhoud stated that the models we berated at our last meeting (8/1/06) are leading us to a growth forecast for this and next fiscal year of around 5.5-6%. Dr. Brewbaker said 5.5% to 6% this and next fiscal year and it will be dropping to 4's and 5's thereafter.

Dr. Suyderhoud stated that the models are forecasting what the Council really thinks is going to happen. Dr. Iboshi (referring to Forecast of General Fund Tax Revenues) stated that the problem is the revenues don't line up with anything. Dr. Bonham stated that income tax collections do line up with the nominal income growth.

Dr. Pham indicated the footnote at the bottom of the forecast table and said staff has taken into account the law changes on the individual income tax. He invited Director Kawafuchi and Ms. Nakamura to brief the council on the tax law changes.

Mr. Kawafuchi stated that there are number of tax law changes going into effect. The first change is that the standard deduction is going to go up to 40% of the current federal level beginning 2007. The tax brackets for all individuals will expand by 20%, also at the beginning of 2007. Mr. Kawafuchi said that they are looking at changing the withholding tables starting January 1, 2007 and that the cost of the two changes is estimated to be about \$41 million to \$42 million per year. There's also a one-time credit for victims of heavy rain and floods, which is a one shot deal of about \$9.5 million. Changes will also occur to the energy incentives, taking away the sunset date and expanding some of the credit, but the revenue cost is still \$2.5 million per year.

Mr. Kawafuchi introduced Ms. Johnnel Nakamura (his chief in-house counsel) and Ms. Hayley Callahan, both of whom went to Georgetown for their graduate law degrees. Dr. Brewbaker thanked Mr. Kawafuchi, Ms. Nakamura and Ms. Callahan for attending the meeting.

Dr. Suyderhoud stated that for '07 we are estimating growth of 6.5% and for '08 we are estimating growth of 7.1%. Dr. Suyderhoud asked the Council members if they would like it to reflect on the 1% slowdown that our forecast seems to be creating and the .5% for tax law changes. Dr. Suyderhoud also stated that he will buy the .5% but he's not confident that the deceleration is going to be that fast.

Dr. Bonham asked Dr. Pham that if they adopt the 5.5% below-the-line growth rate for FY07, would it be possible to realign the rest of the tables to reflect that. Dr. Pham stated that he would try to give the Council whatever it wants.

Mr. Galati stated that they should keep the above-the-line growth rates the way they were in the last meeting (8/1/06). He also asked Dr. Pham what was the difference between table 1b and table 4b.

Dr. Pham answered that at the base we have calendar year '04, which goes into FY05, so we start to adjust the numbers above the line to match FY05 and FY06. We also have preliminary work on '04. Mr. Kawafuchi stated that they have to claim the high technology business investment tax credit by the end of '05 and also noted that it takes a while for us to go through and compile the data, so we are actually looking at the beginning of '06 before we have all the data.

Mr. Galati asked, since they were off in '04 so is there any reason to think the tax credit should continue to grow? Mr. Kawafuchi stated that FY05 is a hard number, but the number for FY06 is just a projection. Dr. Pham stated that the FY06 number is a projection based on the '05 data, so he made the '05 figure the same over the years, which is shown on page 10.

Dr. Pham stated when doing the revenue impact for the production credit, the high tech credit would go down and the production credit would go up and the two changes would cancel each other out.

Dr. Bonham made a motion to take below the line rates of 6%, 6%, 6%, 4.5%, and 4 1/2%, and from FY11 on we can leave them like they are. Dr. Brewbaker asked whether we could just modify the motion to leave '09 thorough '13 as submitted and just adopt 6% for the next two years. Dr. Pham stated that he would adjust it.

Dr. Bonham restated the motion as follows: change the FY07 below-the-line number to 6%, and leave everything else the same. Dr. Bonham suggested changing the above-the-line number, otherwise the tax credit will be low in '07 and in '08.

Dr. Bonham stated that as the final motion, on page 7, table 4b, change the below the line growth rate to 6% for FY07, make adjustments in the tax credit and leave all other growth rates the same.

Dr. Brewbaker called for a motion to move, Dr. Bonham made the motion and Mr. Galati seconded it. The motion carried.

NEXT MEETING:

The next meeting to forecast Total Personal Income was scheduled for Thursday, November 2, 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 Michael Hirai seconded the motion. The motion carried unanimously and the meeting adjourned at 4:35 P.M.