

COUNCIL ON REVENUES

Princess Ruth Keelikolani Building
DLIR Conference Rooms Third Floor
Rooms 310-313
Honolulu, Hawaii 96813

Tuesday, August 1, 2017
2:00 p.m.

PRESENT:

Council Members:

Kurt Kawafuchi (Chair), Marilyn M. Niwao (Vice-Chair), Carl S. Bonham,
Christopher Grandy, Ed Case, and Jack P. Suyderhoud

Staff Members:

Department of Taxation (the Department): Seth Colby and, J. Guitguiten

Department of Budget and Finance (B&F): Terri Ohta, Gregg Hirohata-Goto,
Donovan Chun, and Kenneth Shirokane

Others:

Dane Wicker, Senate Ways & Means
Alika Ke-Paloma, Senate Ways & Means

ABSENT:

Kristi L. Maynard, Member

CALL TO ORDER:

The Chair called the meeting to order at 2:00 p.m. A quorum was present.

COMMUNICATIONS TO THE COUNCIL AND PUBLIC COMMENT:

Chair Kawafuchi asked if there was any communication to the Council on Revenues (the Council). There were none.

MINUTES OF THE MEETING OF MAY 30, 2017:

Chair Kawafuchi called for a motion to approve the minutes. Dr. Suyderhoud moved to approve the minutes. Ms. Niwao seconded. Dr. Grandy abstained due to he was excused and not present at the last meeting.

It was moved by Dr. Suyderhoud and seconded by Ms. Niwao that the minutes of the August 1st meeting be accepted. The Chair called for the vote, and the motion passed with the following votes:

Kurt Kawafuchi	Yes
Marilyn Niwao	Yes
Carl S. Bonham	Yes
Christopher Grandy	Abstain
Ed Case	Yes
Jack P. Suyderhoud	Yes
Kristi L. Maynard	Absent

TOTAL PERSONAL INCOME FORECAST FOR CY 2017:

Chair Kawafuchi asked Dr. Colby if he had anything to report on the current year to the Council. Dr. Bonham said our last forecast was 4.5% and the Bureau of Economic Analysis (BEA) came out with their revised estimates of 2016 income at 4.3% for the year. He said there was more of a downward revision in the second half for the year. And, the first quarter of 2017 data is pretty weak—about 1 percentage point below UHERO's (UH Economic Research Organization) forecast was for that quarter. Dr. Bonham said UHERO's quarterly model at 3.9% for the 1st quarter and BEA's number is 3.

Dr. Bonham said the last Council number was closer to 4, 4.1, 4.2. Dr. Bonham thought there's some reason for caution. He said the jobs numbers for 2017 came in at or below expectations of 1% or less than 1%. There's been some significant slowdown in job growth over the last couple of years. He said he thought you'd expect to see some continued slowing in income growth.

Dr. Colby asked with the record-low unemployment rate in higher job vacancies do you expect wages to go up. Dr. Bonham said hence why we were forecasting closer to 4% growth and the one sector that really has slowed down significantly at least on the jobs numbers, is construction. And, we know from the tax models that tend to have an oversized effect—bigger than the sort of sector's weight in the economy. He said he would be happier with a number closer to 3.5% for nominal income for the calendar year. Dr. Bonham said we're talking about very real income growth of maybe 1%. Dr. Suyderhoud said 2.5% inflation. Dr. Bonham said yes and thought their inflation will get a little higher than that but the 1st half was 2.6% for calendar year 2017. Ms. Niwao said if we've seen a reduction in the growth rate of wages its probably due to the fact that we're losing some higher wage jobs from industries such as construction.

Dr. Bonham said close to 1% real and that's actually still relatively good by this cycle of standard. He said we did have a couple of years of 2.5% real income growth. Dr. Suyderhoud asked how much of collective bargaining wage increases going to play a role overall. Dr. Bonham said that's a good question. He said everybody settled and all those pay raises are in the 2 to 5% range depending on which Union. He said those are all nominal. Dr. Bonham said he

hasn't looked at every contract and we don't always get all the details. He said his sense was they were coming in at the 2 to 4% range.

Chair Kawafuchi asked if that was just the wages or the total benefits. Dr. Bonham said usually what's reported is just the salaries and the benefits. He said that could actually drag down the total income number a little bit because the benefit enhancements (he thought) had been more constrained. He said there's been more of an effort to cap the amount that the state was contributing to healthcare benefits. He said he doesn't know how successful they were. He said they don't publish all the details. Dr. Bonham said without complete information all he could say is it seems like that's sort of consistent with a number in the 3.5% range.

Chair Kawafuchi asked Dr. Suyderhoud if he had any thoughts he would like to share. Dr. Suyderhoud said the DBEDT (Department of Business, Economic Development and Tourism) forecast is 4.7% nominal for 2017 is slightly on the high side. Dr. Bonham said we might be that high as well. Dr. Suyderhoud said for 2018 as well and for a few years out we've got 4.6%, 4.7% nominal and cut that by 50% for real. Dr. Bonham said he thought their last nominal was probably 4%. Dr. Suyderhoud said if we're talking about 1% real and they're talking 2% real we've got a bit of a disconnect. He said that's his only thought there.

Dr. Suyderhoud asked if the BEA data have the same kind of 1st quarter problems as the GDP (Gross Domestic Products) have? Dr. Bonham said that's a good question. He said he had not noticed that in the past that kind of seasonal effect going on. He said presumably it would for GDP whether it does for personal income he didn't know. Dr. Suyderhoud said his thought was the revision might bump up the 1st quarter. Dr. Bonham agreed.

Dr. Grandy asked Dr. Suyderhoud whether he was talking about personal income number for Hawaii and not the Nation. Dr. Suyderhoud said yes but there might be systematic relationships there.

Dr. Bonham said in 2015/2016 the 1st quarter was the strongest growth rate for Hawaii in the revised data and he didn't know what it was in the preliminary data.

Dr. Grandy said if we were concerned about a seasonal effect jumping out, it may not be obvious that's happening. Dr. Bonham said he has not seen any evidence of that. Mr. Case said he thought there's reason for caution. And, he agrees with perspectives and thought that from the visitor industry's perspective they think that its slower at the end of this year that some of the projections we're seeing out of DBEDT/HGEA (Hawaii Government Employees Association) on the high side for versus the pacing that we can see going on right now. He said he thought in terms of the question on the unemployment rate, he would agree with Ms. Niwao that's probably focused more on the low side of the wage scale.

Mr. Case said he liked the idea of adjusting it downward. Ms. Niwao said she's fine with 3.5%. Dr. Colby said lower individual income tax has been lower across the board throughout the nation—33 states missed their budget forecast. Dr. Colby said one of the prevailing hypotheses is high income individuals are moving their income forward to next year in anticipation of tax

cuts. And, so what that would do in regards to high income earners, they would not have claimed it in FY 2017 and would be claiming it in FY 2018 presuming that they need the income within the two-year period. Dr. Colby thought that is one reason why we had lower than expected individual income tax revenues.

Ms. Niwao said that the corporate income tax collections last year were very low compared to the prior year. Dr. Colby said corporate is a very small marginal part of general fund collections (1.5%) and it's most volatile aspect.

Ms. Niwao said most of her clients are S corporations (taxed similar to partnerships, where business income flows through and are taxed to the individual shareholders). She said the larger companies and some construction companies are C corporations and are taxed at the corporate level. She said those are the ones that are oftentimes the bigger construction companies – the ones that pay the big salaries.

Dr. Colby said one of the reasons we caution against reading too much into the corporate income data is because corporations probably engage in tax planning more than any other entity which means that they're very good at maintaining their credits and using them at different times. And, with their tax code it's actually easier for them to move tax credits around. He said that he was just cautioning against reading too much into that data.

Chair Kawafuchi asked if the Council had a number for 2017. Dr. Bonham said he suggested 3.5%. Chair Kawafuchi asked if there was a second. Dr. Grandy seconded. Dr. Suyderhoud said we're talking 3.5 and of that 2.5 is inflation and 1% real. Chair Kawafuchi asked if there was any further discussion. There were none. Chair Kawafuchi took a vote in support of 3.5% for CY 2017. The vote was unanimous.

A motion was made by Dr. Bonham and seconded by Dr. Grandy that the Total Personal Income forecast be 3.5% for CY 2017. The Chair called for the vote, and the motion passed with the following votes:

Kurt Kawafuchi	Yes
Marilyn Niwao	Yes
Carl S. Bonham	Yes
Christopher Grandy	Yes
Ed Case	Yes
Jack P. Suyderhoud	Yes
Kristi L. Maynard	Absent

TOTAL PERSONAL INCOME FORECAST FOR CY 2018:

Dr. Bonham proposed the same number (3.5%) for CY 2018. Mr. Case asked, what is the projection on inflation for that year versus CY 2017? Dr. Bonham said our last inflation forecast for CY 2017 was 2.5, CY 2018 was 2.5% and CY 2019 is 2.3. Chair Kawafuchi asked about the

Feds and whether they will keep pushing interests up. Dr. Bonham thought they will probably raise rates one more time this year.

Dr. Bonham said what's driving our inflation right now is 1) rebound of energy prices but also its mostly shelter. Dr. Suyderhoud said if it's mostly shelter, he's surprised it's only 2.5. Dr. Bonham said he doesn't disagree with that. He said if you look at some of the specialty indices without shelter, without energy you've actually got prices falling in some categories. He said he would've expected it. He said remember this is the CPI (Consumer Price Index)—it takes time for them to rotate their samples and to work in all of the past-thru of rents. He said he saw something in the news the other day about some realty company spouting out their latest PRP on what's happening to rents and claiming that rents were falling on Oahu. In their argument was that they had basically over-shot.

Ms. Niwao said she was concerned about the North Korean missile launches. We are within range, although the US mainland is probably in range also. Dr. Bonham said South Korea has a lot more visitors than we do and they're a lot closer. Dr. Suyderhoud said that might encourage Japanese visitors to Hawaii.

Mr. Case said he didn't think it will make that much difference. Mr. Case said if you take a look for example at Guam, we have a property in Guam. He said Guam has been within range for a long, long time and it's not seeing any depression.

Mr. Case said the downside variable is a precipitous decline in the stock market—a bubble bursting.

Chair Kawafuchi asked if there was further discussion and if they are ready to vote. Dr. Bonham said he moves 3.5% for CY 2018. Ms. Niwao seconded. Chair Kawafuchi asked if there were any further discussion. There were none. Chair Kawafuchi asked for a vote. The vote was unanimous.

A motion was made by Dr. Bonham and seconded by Ms. Niwao that the Total Personal Income forecast be 3.5% for CY 2018. The Chair called for the vote, and the motion passed with the following votes:

Kurt Kawafuchi	Yes
Marilyn Niwao	Yes
Carl S. Bonham	Yes
Christopher Grandy	Yes
Ed Case	Yes
Jack P. Suyderhoud	Yes
Kristi L. Maynard	Absent

Chair Kawafuchi said that Mr. Case wanted to talk about an issue but first discussed the next tentative date and time for the next general fund meeting. Ms. Guitguiten said the date for reporting is September 10. Dr. Colby said the Council will have the preliminary report by the next meeting. He said the report comes out 5 business days after the first of the month. Dr. Colby said the Tax department should have August preliminary report out by September 7 and the department would require at least one day to turnaround. Dr. Bonham asked if the Council had its meeting on September 7 would they have the report by then, which the Council will have two months of data (July/August). Dr. Colby said no because the report is put out at the end of the day by 3pm. Dr. Colby said he could make a considered effort to push everybody to try but he wouldn't be able to guarantee it.

The Council agreed to tentatively schedule the next meeting on Thursday, September 7th at 2pm.

Mr. Case said he was interested in the last year and asked for the Council's thoughts on why they ended up where they did versus the May 30 meeting at 2.2%, which was pretty late in the year.

Ms. Niwao said she had some concerns because she has clients that kept saying 'where's my refund' and, didn't receive it until sometime in July.

Ms. Niwao said her clients didn't get their refund checks. Ms. Niwao said returns were filed April 15th and they didn't receive their refunds until later and she was concerned that maybe there was going to be more refunds that we haven't seen. Chair Kawafuchi asked Ms. Niwao if she thought it was going to be later in the year.

Ms. Niwao said you'll see the effect if anything in July. Dr. Suyderhoud said in aggregate he didn't think it was a refund story and he thought basically the story is GET. He said that Dr. Colby's point at the beginning was that the GET was really high in July 2016.

Dr. Suyderhoud asked whether the tax department is using the returns or the checks as a measure of the tax collections. Dr. Colby said the checks. He said the department has two different systems: 1) cash and base counting which is basically all the preliminary numbers—allocating everything to different accounts.

Dr. Suyderhoud said category doesn't matter to him. Dr. Colby said depending how you look at things, it is generally done when the cash goes in (allocated to that month) and if the return is for a different month, it will be moved around so the numbers constantly change.

Chair Kawafuchi said it doesn't show up in the monthly cash receipts even though it's collected in June. Dr. Colby said it will show up in the monthly cash receipts in July. Chair Kawafuchi said if it's cashed in July (for a June return). Chair Kawafuchi asked if it was about \$30 million that got reallocated (came into the general fund and reallocated to TAT). Dr. Colby said exactly. He said that's one of the reasons we had a really low GET number and a really high TAT number is because we transferred money from the GET number to TAT number.

He said just to go back and give his complete understanding of what happened throughout the year, he said we started out the year with negative growth in GET because of the one-off adjustments that occurred primarily in the first half of the fiscal year. He said from January into June GET was moving up in every single month (.1% or .2% growth) except for the month of

May which is the one that threw everybody off. He said that GET is the most stable form of revenue for us so you wouldn't expect things to move up 1 or 2% without a major budget reallocation. Dr. Colby said he thought they started off incredibly low and things will move up by .1 or .2% but it's incredibly rare to move more than that. He said the thing that was causing most of the jumps (in at least the 2nd half of the fiscal year) was the individual income tax. He said in February when everything was looking great maybe because we were at 8% and then we went down to 3%, we ended the year at 4.4% which is 3.6% much lower than what was anticipated. He said normally we would expect something to be between 5 and 6%.

Dr. Colby made the following points about revenue throughout the country: 1) the number of returns filed by the IRS is down and 2) most states missed their general fund revenue. He said his colleagues went to the annual Federation of Tax Administrators (FTA) and the most common theory given was people are moving back their income; higher income earners in terms of anticipating better tax breaks on the federal income tax returns.

Mr. Case asked are you saying the lower actuals over projections for the GET was a May versus a June. Dr. Colby said if you still take the trend line you're still moving in the same general trajectory. He said if you account for all those adjustments, his recollection you're somewhere in the range of 2.8, 3.1 and if you take into account all those adjustments.

Chair Kawafuchi said there was a bill that passed requiring employers that are paying more than \$5,000 in withholding taxes (up to \$40,000) to pay monthly versus quarterly. Chair Kawafuchi asked how much money is in that category. Dr. Colby said he didn't feel comfortable stating that fact off the top of his head. Chair Kawafuchi said okay.

Dr. Bonham said the data is so noisy that for us to even debate the difference between 2% and 2.5% in a forecast is questionable. We certainly don't have that kind of precision. He thought there's a chance that the underlying economy was weaker than we really thought. And, the primary evidence for that is the construction jobs peaked in 2016 and have been falling fairly steadily ever since. Then you counter that with the enormous strength in visitor spending. He said he hadn't looked to see how much of that is – with the allocation are they really just renting hotels rooms and not spending as much in retail side, that was a problem before as room rates were going up there was sort of a cannibalization of things that would be earning GET. And, we ended up with 3.6% for the year on income tax collections that is a little bit weaker than we would've thought we were going to get more like 4.5 or 5.

Ms. Niwao said the US House of Representatives passed HR 1393 limiting the authority of States to tax certain income of employees for employment duties performed in other states. Dr. Snyderhoud asked how many people file state income taxes to begin with. Mr. Case said when it even gets on the US Senate calendar its worth talking about. He said chances are it will just die—the odds are against it. Mr. Case said he may have to 'eat his words' but it doesn't sound like that kind of bill that will easily move through Congress unless they do it in terms of a larger tax reform bill where they stick it in there—he doesn't see that happening.

Dr. Bonham said if you want to worry about something on tax reform, worry about losing the exemption of our state income taxes. Chair Kawafuchi asked if anyone had a potential impact versus the general fund. Dr. Colby said he didn't look into that issue enough to give a formal

opinion. Chair Kawafuchi said because they get the excess of 4% but there's some kind of off-set too on Oahu if they move off the 4.5%, Oahu loses the half but they gain the 1.8.

Dr. Bonham said he assumes that when they meet for the general fund deliberations they're going to get the full rundown on the tax rules that were changed (tax laws and the impact of the higher bracket and EITC changes, etc.)

Dr. Colby said the big question is in terms of the revenue impacts of the high income brackets, is how much you believe how much do people engage in tax planning. Dr. Bonham questioned whether Hawaii had higher tax rates than California's, or lower? Dr. Colby said Hawaii with this income tax rate is a second highest in the nation after California but California only kicks in for millionaires. He said by a lot of metrics you can say that Hawaii has higher taxes. Chair Kawafuchi said don't many states have an 11% rate? Some COR members said no. Dr. Grandy asked if Hawaii's highest bracket is 11%. Dr. Bonham said yes they reinstated the higher tax bracket and that's for single individual making \$200,000.00. Chair Kawafuchi said California is close to 13%. Dr. Bonham said incredible, it's mind-boggling.

Dr. Colby said 13% but you have to make a million dollars a year. Chair Kawafuchi said they have a lot of millionaires in terms of numbers. Dr. Colby said the big difference for us is if you make \$150,000.00 in Hawaii, you're in the top 10% of high income earners. That's lower than a lot of other states—we don't have a lot of high income individuals. People who are high income individuals are more likely to be living here on their own volition and they may opt to decide not to reside in the state because they are not deriving income that's directly tied with their territorial presence. He said that is a big *if* and the other difference is, before the tax increased rates were temporary versus permanent and an economist could argue that there would be different types of behavioral responses to a permanent tax increase versus a temporary one.

Mr. Case asked what kind of tax planning would they engage in. Dr. Colby said there's a couple of things 1) you would be more out to pay yourself in equity and 2) capital (capital gains are 7.25%). Chair Kawafuchi said that still taxed as ordinary income if it's compensatory stock (compensation income). Dr. Colby said there are a couple studies when tax rates go up people move into S corporations, generally it's easier for people to pay less taxes. Chair Kawafuchi said if you work for a public company or your company is going public it's not an S corp. Ms. Niwao agreed.

Dr. Colby said there's a number of different ways to minimize taxes and, a lot of tax planners that know more than him. He said there's definitely been a lot of empirical evidence suggesting that people will pay themselves, especially high income earners. Dr. Bonham said so we will not get all of the revenue that you might expect if you just do simple math. Ms. Niwao said what happens is they seek advice from a tax practitioner and ask, "tell me which states are the lowest taxed states considering my income?" They make the decision to reside in a state according to which is the lowest taxed state, and avoid residing in the higher taxed states. This is tax planning for very, very wealthy people who oftentimes have more than one home. Dr. Bonham said you have to make big enough returns to justify all that work.

Ms. Niwao said many people who are coming here are people from California, for example, who have pensions and are advised to retire in Hawaii because we have lower tax rates when pensions

are considered. Pension income is exempt from taxes in Hawaii, but not in California and many other states. Dr. Bonham said so our excise tax collection should be going up because they're spending money and they're living here. Ms. Niwao said both types of taxpayers would be spending money whether they are here part of the year or longer. She said the people that move here are those with pensions that are exempt from Hawaii taxes, whereas those with other types of income may choose to live here only part-time and reside elsewhere in order to avoid Hawaii taxes.

Dr. Grandy said all the previous Tax Review Commissions have suggested transitioning on exempting all of pension income. Ms. Niwao said it has never been a very politically popular subject to tax pensions. She said the only thing we have in Hawaii is inequity because those who work for smaller businesses who save retirement money in 401Ks and IRAs are taxed when their retirement savings are distributed, whereas retirement distributions from qualified pensions of larger companies and the government are not taxed.

Dr. Colby told the Council that if they are interested in seeing the value of those tax exemptions, he included that in his recent powerpoint presentation to the Tax Review Commission, which is on the DOTax website's Tax Review Commission page. Chair Kawafuchi asked if there was further discussion. There were none.

NEXT MEETING:

The Council tentatively agreed to meet on Thursday, September 7, 2017 at 2 p.m. However, the date and time will be re-confirmed by email. The Council staff will attempt to secure the DLIR Conference Rooms 310-313.

ADJOURNMENT:

The meeting adjourned at 2:55 p.m.