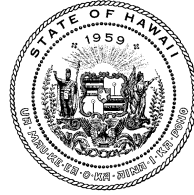


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COUNCIL ON REVENUES

STATE OF HAWAII
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January 2, 2018

The Honorable Donovan M. Dela Cruz
Chair, Senate Committee on Ways and Means
Hawaii State Capitol, Room 208
Honolulu, Hawaii 96813

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

Chairpersons and Members of the Committees:

Thank you for inviting the Council on Revenues (Council) to appear before your committees to present its current General Fund tax revenue forecasts for the State of Hawaii. My name is Marilyn Niwao, and I am the Vice-Chair of the Council on Revenues. Unfortunately, the Council's Chair, Kurt Kawafuchi, could not attend this briefing today. As a starting point, the following is an overview of the Council's process to derive its forecasts followed by a discussion of the Council's recent forecasts.¹

Overview

Overview of Sources of Hawaii General Fund Tax Revenues

The bulk of the State of Hawaii's tax revenue comes from consumption taxes, such as the Hawaii General Excise taxes and Transient Accommodation taxes. In addition, income taxes from individuals and corporations also are significant sources of revenue. Estate and conveyance taxes comprise only a small part of the overall state tax revenue.

General Excise Taxes

The General Excise Taxes (GET) is a gross income tax on receipts of sales and other business activities in Hawaii. It is imposed on the privilege of doing business in the State of Hawaii. It raises significant revenue through a low rate and broad base. Unlike a

¹ Because the Council on Revenues will have its next general fund meeting during the afternoon of Monday, January 8, 2018, we may supplement this testimony with additional written testimony using updated information.

retail sales tax that is primarily used by other states, the GET is imposed on services and rental income, in addition to tangible goods. As such, it has been remarkably more stable in generating revenue than the sales taxes utilized by other states.

Individual Income Taxes

The Hawaii income taxes are very progressive relative to other states. Refundable credits such as the Food credit and Renter's credit offset the burden for lower income individuals.

The largest state specific exemptions are pensions and social security, which are expected to grow with time due to state demographics and the aging baby boomers.

Hawaii has one of the highest marginal tax rates in the country. However, the income threshold of the top 1% of filers in Hawaii is relatively very low at \$281,620. Although there are many wealthy individuals with residences in Hawaii, they oftentimes choose to be residents in other lower-taxed states. In addition, Hawaii does not have the types of businesses that generally pay more.

Aside from certain limitations for higher earners, there is no cap on the amount of state and local taxes (SALT) that could be deducted on the returns of Hawaii taxpayers for 2017 and earlier years, and Hawaii was able to export a large portion of the individual income tax burden to the Federal government. With the change of tax laws effective in 2018 and the SALT limitations of \$10,000, this would affect many higher income Hawaii taxpayers.

Transient Accommodation Taxes

Transient Accommodation Taxes (TAT) are imposed on transient accommodations for less than 180 consecutive days. More than half of all TAT revenue goes to the General Fund.

Factors Considered by the Council in its Forecasts

The Council is tasked with the responsibility of forecasting General Fund Tax Revenue Growth and Total Personal Income Growth. In forecasting General Fund Tax Revenue growth rates, the Council considers:

1. The output of three economic models (discussed in Exhibit A as the "Regular Model," the "UCLA Model," and "Single Regression Equation Model").
2. Tax laws and tax law changes affecting tax collections.
3. The impact of DOTAX administrative policies and procedures, such as the timing of the collection of taxes, payment of tax refunds to taxpayers, and allocations to the City and County of Honolulu.
4. Other factors raised and discussed at Council meetings.

Other factors include, but are not limited to, the potential effect of external international and national events, noncompliance with existing tax laws, the effect of possible internet tax fraud in collection efforts, and monthly tax collections. After discussion of various factors and the results of the economic models, 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 output of the economic models since the forecast encompasses other considerations not directly incorporated in the economic models.

The Council forecasts only the total General Fund tax collections. To get the implied growth in collections of the individual tax types, the DOTAX Tax Research Planning Office (TRP) staff change the economic variables in the primary model until that 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 State of Hawaii recognizes General Fund Tax Revenue on the cash basis of accounting. The cash basis of accounting records revenues when cash is received and tax refunds disbursed. This method differs from the accrual basis of accounting which accounts for revenues when earned.

Errors in forecasting General Fund growth rates can be the result of:

- 1) errors in estimating the underlying economic growth rates;
- 2) timing differences (i.e., where there was a delay in the collection of taxes or payment of refunds);
- 3) errors in estimating the impact of new tax laws or compliance with existing tax laws; or
- 4) errors in estimating the impact of other factors or external events.

The Council's Forecasts of General Fund Tax Revenues

Results for fiscal year 2017

In fiscal year 2017 (FY17), which ran from July 1, 2016 to June 30, 2017, the State's General Fund tax revenues increased by 2.0% over FY16. This was lower than the Council's forecasted rate of 2.5% and considerably lower than the FY16 growth rate of 8.0%. In dollar terms, General Fund revenue grew to \$6,315.2 million in FY17 from \$6,194.4 million in FY16.

The general excise tax (GET) comprises approximately half of total General Fund tax revenues. GET revenue grew by only 1.0% from FY16 to FY17. Individual income tax revenue, the second largest source of General Fund revenue, grew by 3.5%

The deceleration in revenue growth of the GET and the General Fund was in part due to timing differences in the receipt of funds. In September 2015, a litigation settlement with online travel companies resulted in a \$29M revenue gain. This resulted in abnormally high revenue in the first half of FY16 to which FY17 revenues are being compared.

Additionally, accounting adjustments transferred \$40.6M out of the GET fund in the beginning of FY17. Of the \$40.6M, \$15.6M was transferred in July 2016 to a litigated fund, and \$25M was transferred from the GET to the Transient Accommodation Tax (TAT) fund in August 2016 (note: the \$25M transfer would not have affected the General Fund numbers). If the \$29M is taken out from the reference year FY16 and \$40.6M is added back into the GET fund, the annual growth rate for the GET would have been 3.6% and 2.9% for the General Fund.

Results for the first five months of fiscal year 2018

At its meeting in September 7, 2017, the Council revised its forecast for General Fund revenues up from 4.0% to 4.3%. 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 reach 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.

The Council also has expressed concerns about international events, such as a potential North Korea conflict, which may affect Hawaii's economy. In addition, the Council has discussed noncompliance with Hawaii tax laws and the shift of retail sales taxed locally to online purchases, which for the most part remains untaxed by out-of-state sellers.

The Council also raised the forecast for growth in FY19 to 4.3%, but lowered the forecast for growth from 4.5% to 4.0% for FY20 to FY24.

General Fund Tax Revenues Growth Forecasts

Fiscal Year	Amount (in Thousands of Dollars)	Growth From Previous Year
2018	6,586,769	4.3%
2019	6,870,000	4.3%
2020	7,144,800	4.0%
2021	7,430,592	4.0%
2022	7,727,816	4.0%
2023	8,036,929	4.0%
2024	8,358,406	4.0%

Subsequent to its September 2017 meeting, the preliminary data through November 30, 2017 shows a General Fund growth rate of 4.7% for the first five months of FY18 compared to the same period in FY17. Cumulative net collections of GET revenue for FY18 were \$1,415M, compared to \$1,339.9M for the same period in FY17, for a partial year-over-year growth rate of 5.6%.

Below is the cumulative growth rate in General Fund revenues during FY18 over the same period in FY17.

July 2017	12.2%
August 2017	8.9%
September 2017	9.5%
October 2017	5.1%
November 2017*	4.7%

* Preliminary data

To date, the cumulative growth rate (4.7% as of November 2017) has remained above the Council’s forecasted 4.3% growth rate for FY18. At the Council’s most recent meeting on September 7, 2017, only the July and August 2017 general fund cumulative growth rate of 8.9% was available for consideration.

The first several months of the fiscal year had larger than average growth rates in part due to the low GET collection amounts that occurred in July and August of 2016. In other words, the growth numbers are larger because last year’s base numbers were unusually low. Additionally, collections that were due in the last part of FY16 were processed in the early part of FY17.

Cumulative net collections of individual income tax revenues for FY18 were \$909 million compared to \$827 million for the same period in FY17, for a year-over-year growth rate of 10.0%. Cumulative net collections of corporate income tax for FY17 were \$6 million compared to \$43 million for the same period in FY16, for a year-over-year growth rate of -86% (i.e., a significant decline).

Below is a breakdown of net individual and corporate income tax revenues through November 2016 compared to the same five-month period for FY17.

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

			DIFFERENCE	
	FY17	FY16	AMOUNT	% CHANGE
Income Tax – Corp.	6,080	43,914	(37,834)	-86.2%
Estimated tax payments	52,011	58,931	(6,919)	-11.7%
Payment with returns*	(15,605)	17,451	(33,056)	-189.4%
Refunds	(30,326)	(32,468)	2,142	-6.6%
Income Tax – Ind.	909,294	826,500	82,794	10.0%
Estimated tax payments	170,910	132,695	38,215	28.8%
Payment with returns	47,575	47,478	97	0.2%
WH Tax on Wages	815,427	758,154	57,272	7.6%
Refunds	(124,617)	(111,828)	(12,789)	11.4%

* Based on preliminary data for November

The breakdown of net income tax revenues for corporations shows that the largest drags on corporate income tax revenues are lower payments with returns. For individual income tax revenues, the component with the largest increase is the declaration of

estimated taxes. There is also an increase in individual income tax refunds and an increase in withholding taxes on wages.

Revenues from corporate taxes, apart from being a small portion of general fund revenues, are extremely volatile since tax planning efforts by corporations may allow them to shift tax liabilities over multiple years.

The Council expects that inflation, as measured by the Honolulu Consumer Price Index for All Urban Consumer (CPI-U), to be slightly above 2% per year over the forecast horizon. As a matter of comparison, the Honolulu CPI-U increased 1.8% in FY16 and 2.0% in FY17, as reported by the U.S. Bureau of Labor Statistics.

The Council also expects that the number of visitor arrivals by air will increase at an annual average growth rate of about 1.5% over the forecast window of FY18 through FY24, remaining elevated in the near term and then gradually declining in the years further out.

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 4.3% in FY17 over FY16. The Council forecasts average growth rates for construction activity of 5.1% for FY18, 4.2% for FY19, and 3.2% in FY20.

Total personal income, a comprehensive indicator of Hawaii's economy, is expected to grow between 3.4% and 3.9% in the subsequent years. At its latest total personal income meeting on October 25, 2017, the Council lowered its forecast of growth in total personal income to 3.0% for calendar year 2017 and 3.5% for calendar year 2018.

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 2017 Legislature, including the following:

- Act 107, SLH 2017 reinstates three tax rates and brackets (9.0%, 10.0%, and 11.0%) for the highest-income taxpayers imposed by Act 60, SLH 2009, for taxable years beginning after December 31, 2017. The gain to the General Fund is estimated to be \$50.7 million in FY19, \$53.3 million in FY20, \$55.9 million in FY21, \$58.7 million in FY22, \$61.6 million in FY23, and \$64.7 in FY24.
- Act 107, SLH 2017 establishes a nonrefundable earned income tax credit (EITC) equal to 20 percent of the Federal EITC. The tax credit applies to tax years 2018 through 2022. The loss to the General Fund is estimated to be \$16.7 million in FY19, \$20.4 million in FY20, \$23.8 million in FY21, \$27.1 million in FY22, \$30.1 million in FY23, and \$0.0 in FY24.
- Act 107, SLH 2017 repeals the sunset date (December 31, 2017) for the amendments to the refundable food/excise tax credit by Act 223, SLH 2015. The resulting loss to the General Fund is estimated to be \$6.5 million per year from FY19 to FY24.

- Act 143, SLH 2017 amends the motion picture, digital media, and film production tax credit by limiting total amount of credit to \$35 million per year and extending the credit to January 1, 2026. Total tax credits claimed per qualified production shall not exceed \$15 million. The estimated revenue loss to the General Fund is \$35 million from FY20 to FY24.
- Act 54, SLH 2017 exempts certain affordable rental housing projects from the general excise and use tax. The legislation limits total amount of exemptions to \$7 million per year starting July 1, 2017 through June 20, 2022. The expected revenue loss is \$7 million in FY19 to FY22.
- Act 1, SLH 2017 increases the TAT rate from 9.25% to 10.25%, effective January 1, 2018 through December 31, 2030, and allocates the tax revenue generated from the increase to the Mass Transit Special Fund. The Act also increases the annual allocation to the counties from \$93 million to \$103 million, beginning in FY18. The expected revenue loss to the General Fund is \$10 million from FY18 to FY24.

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

- Acts 117 and 121, SLH 2015 changed allocations of the 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 FY16 and FY 2017); 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 \$2 million in additional General Fund tax revenues in FY17 and thereafter. Note that Act 107, SLH 2017 directs \$103 million from FY18 and beyond.
- 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 FY17 through FY21.
- Act 223, SLH 2015 modifies the food/excise tax credit (an increase for certain taxpayers) for tax years 2016 and 2017. The Act is estimated to reduce General Fund tax revenues by \$6.5 million in FY17 and in FY18.
- 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.

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The Honorable Sylvia Luke
January 2, 2018
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Effect of Recent Passage of Tax Cuts and Jobs Act

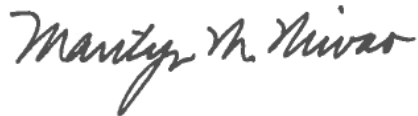
Although the massive Federal tax law changes in the Tax Cuts and Jobs Act (the “Act”) reduces overall tax rates, many Hawaii taxpayers may find themselves paying more taxes depending on their circumstances. In particular, for the tax years 2018 through 2025, the Act limits deductions for taxes paid by individual taxpayers by limiting the aggregate deduction to \$10,000 (\$5,000 for married filing separately) for State and local income taxes, State and local real property taxes, State and local personal property taxes, and general sales taxes (if elected). Accordingly, the timing of State tax collections may be accelerated one time into late December 2017 or early January 2018.

Since the Council will be meeting on January 8, 2018, it has not had a chance to meet to discuss the effects of the new Act on Hawaii General Fund collections. In any case, any new Hawaii conformity laws passed will likely have an impact on future State revenue collections.

Thank you for this opportunity to testify. I would like to thank Seth Colby, PhD, Tax Research & Planning Officer and staff of the TRP for their assistance in providing graphs, data, and assistance in putting together this report, and to Kurt Kawafuchi, J.D., LL.M., MBA, CPA (not in public practice), Chair of the Council on Revenues, for his assistance in this presentation.

I am available to answer any questions you may have.

Respectfully submitted,



Marilyn M. Niwao, M.S.P.H., J.D., CPA, CGMA
Vice Chair, Council on Revenues

Attachment