

COUNCIL ON REVENUES

Department of Budget and Finance Conference Room
No. 1 Capitol District, Hemmeter Center
Third Floor, Room 306

Tuesday, March 13, 2007
1:00 P.M.

PRESENT:

Council Members:

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

Staff Members:

Department of Taxation: Tu Duc Pham, Yvonne Chow, Glenn Ifuku, Cathleen Tokishi, and Michele Toma

Department of Budget and Finance: Keith Shimada, Karen Matsunaga, and Terri Ohta

Others:

Gordon Arakaki, Senate Committee on Ways and Means
Harry Blanchette, Senate Minority Research Office
Richard Borreca, Honolulu Star-Bulletin
Derrick DePledge, Honolulu Advertiser
Shannon Hough, House Minority Research Office
Lowell Kalapa, Tax Foundation of Hawaii
Kurt Kawafuchi, Department of Taxation
Nandana Kalupahana, House Committee on Finance
Titin Liem, Department of Taxation

CALL TO ORDER:

The Vice Chair called the meeting to order at 1:00 P.M. with a quorum present, as the Chair was delayed. While awaiting the arrival of the other members, the Council first addressed the minutes of the meeting of December 12, 2006.

MINUTES OF THE MEETING OF DECEMBER 12, 2006:

The Vice Chair asked if there were any corrections to or comments about the minutes of the December 12, 2006, meeting. There were none, so the Vice Chair called for a motion to approve the minutes.

It was moved by Dr. Bonham and seconded by Dr. Imada Iboshi, that the minutes of the December 12, 2006, meeting be accepted. The Vice Chair called for the vote, and the motion passed with the following votes:

Paul Brewbaker	Absent
Jack Suyderhoud	Yes
Carl Bonham	Yes
Vito Galati	Yes
Michael Hirai	Absent
Pearl Imada Iboshi	Yes
Eric Yeaman	Absent

At this time, the Vice Chair asked the Department of Budget and Finance representatives to present their report on other revenues.

REPORT BY THE DEPARTMENT OF BUDGET & FINANCE ON OTHER REVENUES

Ms. Ohta reported the significant changes from their December 2006, report.

General Fund Non-Tax Revenues: Ms. Ohta reported that in the category, Revenues from Use of Money and Property, the increases in FYs 2008-2013 reflect higher interest earnings based on projected increases in the bond fund investment pool balance resulting from revised bond issuance plans.

Dr. Suyderhoud asked if the change was due to the total amount of balances available rather than changing interest rate assumptions. Mr. Shimada stated that it was primarily due to the balances available.

Special Fund Tax Revenues: There were no significant changes.

Special Fund Non-Tax Revenues: In the category, Use of Money and Property, the increases in FYs 2008-2013 reflect higher estimated interest earnings due to projected Airports revenue bond sale proceeds. Dr. Bonham asked if they were going to sell more bonds than expected, put the money in the bank, and earn interest on those proceeds. Ms. Matsunaga explained that the projected sale had not been included in the December report, and that it had been included in this report based on the Governor's proposed budget.

In the category, Charges for Current Services – Others, the increases in FYs 2006-2013 reflect increases resulting from updated University of Hawaii tuition rates.

In the category, Non-Revenue Receipts, the increase for FY 2007 reflects the transfer of \$10 million from the General Fund to the Hydrogen Investment Capital Special Fund.

Other than Special Fund Non-Tax Revenues: In the category, Charges for Current Services, the changes for FYs 2008-2013 reflect increases in risk management revenues resulting from increased property insurance premiums and increased reimbursements for Medicaid rehabilitation option services. Dr. Suyderhoud asked if the State was in the insurance business. Ms. Ohta explained that the Department of Accounting and General services collects money from the other departments. Mr. Yeaman observed that it was actually a matter of money going from the left pocket to the right pocket.

At this time, with all members present, the Chair called for a motion to approve the report.

It was moved by Dr. Suyderhoud and seconded by Mr. Yeaman, that the report of the Department of Budget and Finance be accepted. The Chair called for the vote, and the motion passed with the following votes:

Paul Brewbaker	Yes
Jack Suyderhoud	Yes
Carl Bonham	Yes
Vito Galati	Yes
Michael Hirai	Yes
Pearl Imada Iboshi	Yes
Eric Yeaman	Yes

COMMUNICATION TO THE COUNCIL:

Dr. Pham briefed the Council on a letter from Rep. Marcus Oshiro, Chair of the House Committee on Finance. Rep. Oshiro asked how the Council had accounted for the December 31, 2006, expiration of the general excise tax exemption for ethanol blended fuel and the anticipated non-tax revenue resulting from the 10% portion of the 0.5% county surcharge in its December 2006 forecast. Dr. Pham had previously provided to the Council a copy of Rep. Oshiro's letter and a working draft of a possible response.

Dr. Pham noted that the general excise tax exemption for ethanol-blended fuel was not discussed at the Council's December 2006 meeting.

Clarification was apparently being requested because answers previously provided by the Department of Taxation to House Committee on Finance questions during budget briefings

interpreted the lack of a below the line adjustment in the December forecast to mean that the Council did not increase its forecast to account for the expiration of the exemption after December 31, 2006. The Council actually had not made any assumption at all; it had not been discussed.

In response to a question from Dr. Imada Iboshi, Dr. Pham stated that the tax is estimated to be about \$2.5 million per month; \$32 million per year.

The Chair pointed out that a $\pm 1\%$ difference was within the bandwidth of error, such that, at the end of the day, it didn't matter. Dr. Bonham noted that the Council did regularly include below the line items that had a smaller impact, such that it may look odd to not include this item. However, the Chair stated that a number of the below the line factors of similar magnitude recur and are thus of some interest, but that this is not a recurring item, it is not material to the forecast, and the Council's inclination is to minimize the number of factors that they take into account.

The Chair expressed concern with regard to the letter asking for an explanation of what the Tax Department said. Mr. Galati echoed those concerns, and stated that the Department of Taxation could say what it wants but that it should not attribute its positions to the Council since the Council's mission is very limited. They don't look at all the details. The Chair clarified that this is not big enough to materially affect their forecast. Dr. Bonham cautioned that it is not true that 1% of tax revenue is immaterial; however, they are not able to forecast so precisely that they could say how much this little tax change would matter, as 1% is of a small order of magnitude with respect to their forecast.

The Chair stated that he would draft a more general response regarding the Council not making any below the line adjustments to take into account this change, that they understand the change in the law, and that they would forecast accordingly.

In view of the Council's inclination to minimize the number of factors that they take into account and an observation by Dr. Bonham that the Council does not forecast the general excise tax revenues on fuel sales specifically but instead provides an aggregated forecast, Mr. Galati stated that the expiration of this exemption is included in the forecast in a general sense, but that it is not separately identified and is not intended to be separately identified. The Chair agreed with Mr. Galati's point that the Committee may incorrectly believe that the Council uses a bottom-up strategy to do their forecast.

Dr. Suyderhoud expressed concern with the third item in the draft response provided by Dr. Pham with respect to the expected non-tax revenue the county surcharge would generate for the State for FYs 2007-2013. The concern shared by all members of the Council was that those numbers would incorrectly be attributed to the Council when they are in fact numbers provided by the Department of Taxation to the Department of Budget and Finance. The Chair reiterated that those projections were not Council forecasts and would not be included in his response.

His draft will be sent to Dr. Pham and Ms. Tokishi who would solicit input from the other members of the Council.

GENERAL FUND TAX REVENUE FORECAST:

The Chair began by asking if they had changed their economic assumptions. Dr. Imada Iboshi stated that the assumptions they sent in had not changed much.

The Chair then asked if their inflation forecasts had changed due to the new Consumer Price Index (CPI) numbers. Dr. Bonham was not surprised by the CPI, which he computed as being 1% higher for the current fiscal year than the one he used for the December meeting; real income was 0.75% lower; nominal construction completed was slightly higher but lower in 2008. He noted that, for years after FY 2007, the differences were very small, mostly positive changes of 0.1% or 0.2%.

The Chair noted that their economic assumptions show that inflation would be about 4% for the remainder of the year – 5.9% for the second half of calendar year 2006 and 4% for the first half of calendar year 2007 for an average of 4.9% for FY 2007 – and then decline to a 3% steady state. The Chair stated that his steady state was 2%. Dr. Bonham stated that his steady state was almost 2.75%, but that it would be a while before that steady state was reached and that the beginning of the next construction cycle would begin near the end of their forecast period in 2013 or 2014. His inflation rate for FY 2007 was 5.5%; his number is about 20 basis points higher until 2011, after which it is about the same.

The Chair explained that he began with that question because they were really talking about nominal revenues. Dr. Bonham commented that they used to have huge elasticity in their CPI forecast, and a discussion on the effect of the CPI in their model parameters followed.

The Chair noted that this should be watched, as the change in the CPI was a pretty big surprise. Though they were gravitating in that direction, their 1%-2% difference was pretty big. Dr. Bonham stated that it was a surprise, but that it shouldn't have been. They rebuilt their price model from scratch and found that, during the last housing cycle, the peak in the CPI was a full year to a year and a half after the peak in home prices. Therefore, either they missed a peak in the latter half of 2006 or there is a peak in CPI yet to come through the rent component in the first half of 2007. There is a long lag from a year to two years.

Dr. Suyderhoud asked if rent would have a significant impact on revenue, which the others agreed was an interesting question. He thought that the reason they underestimated revenues during the last couple of years when they thought inflation would be higher was in part due to a false sense of the true price inflation in the economy in terms of how it affected revenues. Dr. Bonham thought that there could be various reasons, but he felt it was because they missed some of the real increase rather than the nominal. Dr. Suyderhoud stated that, if so, then the risk they run is that they would over-forecast revenues on the way down. The Chair noted that they

did just that in the 1990's; Dr. Bonham thought that occurred because they didn't believe that the real side of the economy would fall as quickly as it did. However, the Chair stated that real personal income was fairly flat on average and didn't fall too much.

Regardless, the issue raised by Dr. Suyderhoud as to whether the disinflation that will occur would translate directly into the general excise part of the revenue stream or whether it would translate into the model correctly or incorrectly is of concern. This, therefore, bears watching in addition to other factors such as the effect of the 0.5% county surcharge on the general excise tax, new legislation, etc.

With respect to increasing or decreasing their revenue forecast, Dr. Bonham did not think the revenue forecast should be adjusted at all. Mr. Yeaman concurred, commenting that although the model indicates that they should increase their forecast, at least for FY 2007, they should not do so in light of their discussion. Dr. Bonham noted that the model probably suggests increasing the forecast because of an increased nominal income calculation. The 1.4% real income growth for FY 2007 appeared overly optimistic and is unlikely to be more than zero for the remainder of the year. The Chair pointed out that job growth was about 2.5%, but Dr. Bonham noted that it had been 2.5% all year.

The Chair asked how the Council felt about a 6.4% total personal income growth rate for FY 2007 in nominal terms, and the consensus was that a 6.4% figure was reasonable. Dr. Bonham stated that his nominal total personal income growth rate was 6.5% with a higher inflation number, and Dr. Imada Iboshi stated that her nominal total personal income growth rate was 6.3%.

The Chair observed that all other forecasts of key economic indicators looked reasonable, including the shallow trough in the forecast for construction completed, with the possible exception of visitor arrivals approaching 2%. Dr. Suyderhoud noted that the visitor expenditure numbers largely reflected inflation.

The Council then asked the Department of Taxation if there were any large anomalies that should be considered such as the large one-time collection events of the past. Director Kawafuchi reported that the Department was ahead of last year's record-setting delinquent collections by about 10%.

The Chair expressed concern with the 4.3% increase in year-to-date state General Fund tax revenues, which was lower than the Council's current forecast. Dr. Suyderhoud explained that accounting for last year's large settlement added another 1%-1.5% bringing the number up to 6%, which is ahead of where they currently were.

Dr. Imada Iboshi asked if anyone could explain the big revenue bump in May of last year. No explanation was proffered, but Dr. Suyderhoud observed that a large bump had occurred at the end of many fiscal years after it had appeared to be slowing and suggested that they consider a seasonal adjustment factor for the last quarter.

The consensus was that the forecast suggested by the model was too high. Dr. Bonham's rough calculation of the general excise tax base and the elasticity between the base and the CPI by itself was about 1.8, almost 2, while the TPI according to the model was 0.6. The Chair stated that, if they were off by 1% in their inflation forecast, they could be 1.5% or 2% off on the general excise tax, which is about half of the total and which would in turn make it about 1% of the total growth.

Dr. Bonham felt there was insufficient information to justify raising the forecast in addition to enough uncertainty about the real side of the economy and his inflation forecast, which along with increased tax rates would drive revenues up.

Dr. Suyderhoud noted that the Council would be accountable for the actual revenues rather than the adjusted revenues, and actual revenues, assuming a 6% growth rate, would only increase by 4%. Although their forecast is currently 6% based on adjusted revenues, he asked if anyone thought that actual revenues would increase by 6% unless there was a "kick" due to the higher inflation rate Dr. Bonham forecasted or, as Dr. Imada Iboshi pointed out, an end of the fiscal year surge.

Responding to the Council's questions, Director Kawafuchi stated that some of the delinquent collections are currently included in the revenue numbers, but pointed out that there are a number of settlements that are in progress at any given time. The Department has currently collected \$215 million in delinquent taxes right now compared with \$190 million at this time last year. Delinquent collections for all of last year were \$263 million. He pointed out that some of last year's bump was seasonal. For example, he cited back taxes paid when liquor licensees obtain their annual tax clearances by the end of June and every two years when contractors must obtain a tax clearance by September 2006 for their license renewals. He also cited special projects such as the realtors project that generated substantial income, and added that more revenue could be gained if the Legislature approved their ITIMS (Integrated Tax Information Management System) funding, perhaps \$60-90 million over five years, though front-loaded.

With respect to the 6% forecast for FY 2007, Dr. Bonham's forecast was 7.5%, probably due to contracting, Dr. Imada Iboshi's was at the mean (6.6%), Dr. Suyderhoud's was 6.8%, and the Chair's was 5.4%. Dr. Suyderhoud asked if the Chair would entertain a motion to keep the FY 2007 forecast at 6%, and he said he would.

There was some discussion about the "below the line" adjustments in response to a question by Dr. Imada Iboshi. It was agreed that the adjustment for the Ko Olina credit should be eliminated in the future. Dr. Imada Iboshi explained that the Ko Olina credit had never been claimed and pending legislation could repeal it. However, there was a \$4 million adjustment for this credit and the concern was that eliminating it could give the erroneous impression that there was more money available to spend. Dr. Pham pointed out that the below the line adjustments are provided only to aid the Council in its deliberations and that only the table with net amounts is reported to

the Governor. With respect to the Ko Olina adjustment, he added that it is rather small and would have less than a 0.1% impact on the total.

Of the other below the line adjustments, Dr. Pham, in response to a question from the Chair, stated that they had "a good feeling" regarding the adjustments for individual tax credits, corporation tax credits, and insurance companies – high tech credit. Dr. Bonham noted that they never really have "a good feeling" about the below the line numbers, though Dr. Imada Iboshi asserted that they should be considered because the numbers were huge. The Council did agree that the adjustments for transient accommodations tax distributions to the counties and special funds as well as the weekend effect were okay.

In response to a question from the Chair, Dr. Pham explained that the tax credit adjustment was added when the Council decided to change the model's forecasted 5% growth rate to 6% and, as noted in the September 2006 minutes, this adjustment was suggested as a means of effecting that result.

Dr. Imada Iboshi suggested combining some of the smaller below the line adjustments. The Chair agreed that they wanted to clear some of the below the line clutter and leave the net total the same.

Dr. Bonham questioned the tax credit adjustment, as he thought that the usual procedure was to distribute what they essentially felt was a model error evenly above the line; Dr. Pham stated that he was instructed at the September meeting to create a below the line adjustment instead. Dr. Imada Iboshi recalled that they had discussed at that meeting the \$1 billion dollar estimate for the high technology tax credits through 2013, and while they were uncertain about the estimate, they felt that they couldn't adjust that specific estimate as Dr. Pham had the numbers for that calculation and instead chose this alternative solution to arrive at the 6% rate.

To remove the tax credit adjustment as a below the line adjustment, they agreed that it should be distributed above the line.

Further discussion was held on the issue of the below the line deductions in general. It was noted that, in general, the Council itself had not voted on the inclusion of the various below the line adjustments, and that those adjustments had largely been left to the discretion of the staff. There was some agreement to moving the Ko Olina, conveyance tax, and adjustments to tax credits below the line adjustments above the line and that there was some value in keeping at least some of the below the line adjustments, such as the weekend effect.

Due to some confusion over what was included in the tables, Dr. Suyderhoud provided the following clarification: the Council members provide their input and the model's equations produce the above the line figures (top of Table 3B); the adjustments modify the above the line number to arrive at the below the line figures (bottom of Table 3B); the adjustments are then spread out over the above the line figures to arrive at the model's forecast (Table 3A). He added that the adjustments were theoretically the real things that happen such as the weekend effect.

At this time, the Chair called for a motion on the 2007 forecast.

It was moved by Dr. Suyderhoud and seconded by Mr. Galati, that the 6% December forecast for 2007 be retained. The Chair called for the vote, and the motion passed with the following votes:

Paul Brewbaker	Yes
Jack Suyderhoud	Yes
Carl Bonham	Yes
Vito Galati	Yes
Michael Hirai	Yes
Pearl Imada Iboshi	Yes
Eric Yeaman	Yes

The Chair then called for a motion on the 2008-2013 forecasts.

It was moved by Mr. Yeaman and seconded by Mr. Galati, that the December forecasts for 2008 through 2013 of 6%, 4.1%, 4.6%, 4.5%, 4.9%, and 5.6%, respectively, be retained. The Chair called for the vote, and the motion passed with the following votes:

Paul Brewbaker	Yes
Jack Suyderhoud	Yes
Carl Bonham	Yes
Vito Galati	Yes
Michael Hirai	Yes
Pearl Imada Iboshi	Yes
Eric Yeaman	Yes

NEXT MEETING:

The Chair asked if the Council would like to hold a workshop ahead of the next meeting to deliberate the forecast, given the earlier discussion on the below the line adjustments, so as to not bog down their actual deliberations. Dr. Suyderhoud added that they were supposed to have a workshop on methodologies but that it had not yet been held.

Dr. Pham stated that the next two General Fund reporting dates were June 1 and September 10.

They decided to have one combined meeting in May for up to two hours, with homework to be done ahead of time.

The Chair proposed that they first do the housecleaning task of removing the Ko Olina, conveyance tax, and adjustments to tax credits below the line adjustments with an understanding

of how that will affect the difference between the above the line and below the line sections and the distribution of those adjustments across the line items.

Second, if they are going to have a general excise and individual income tax line item detail, they need to address the quality of those numbers methodologically. Dr. Bonham asked if the Chair meant that they would then do a bottom up forecast. The Chair does not. However, they both observed that they have provided a table with those numbers, which people have erroneously attributed to the Council.

Third, they will deliberate on the General Fund forecast.

The next meeting is May 21, 2007, from 12:00 P.M. to 2:00 P.M. It will be a brown bag working lunch meeting.

ADJOURNMENT:

The Chair called for a motion to adjourn. Dr. Imada Iboshi moved to adjourn the meeting and Dr. Bonham seconded the motion. The motion carried unanimously and the meeting adjourned at 2:17 P.M.