COUNCIL ON REVENUES

STATE OF HAWAII
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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 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 the recent trends and the Council's latest forecast. I will conclude with some of my own observations on certain factors that might affect Hawaii's economy and our General Fund tax revenues going forward.

Recent Revenue Trends

Results for fiscal year 2014

In fiscal year (FY) 2014, the State's General Fund tax revenues declined by 1.8%, from $5.47 billion in FY 2013 to $5.37 billion in FY 2014. The drop can probably be attributed to processing delays caused from City and County of Honolulu surcharge payments adversely impacting FY 2014's General Fund, to a special allocation of General Excise Tax revenues to the Hawaii Hurricane Relief Fund, and to certain tax law changes that also impacted the FY 2014's General Fund revenues. For example, Act 97, SLH 2011 scheduled the increases in the standard deduction and personal exemption in the Individual Income Tax. Act 161, SLH 2013 increased allocations of the Transient Accommodations Tax (TAT) to the Tourism Special Fund. Act 89, SLH 2013 increased the film production tax credit beginning July 1, 2013.

The actual drop in the General Fund tax revenues from FY 2013 to FY 2014 was about $97 million. The vast majority of the $97 milllon decrease in General Fund revenues resulted from the special allocations to the Hawaii Hurricane Relief Fund and the processing delays from the City and County of Honolulu surcharge payments. Combined with the tax law changes mentioned above, these factors probably reduced the General Fund tax revenues by more than $97 million; thus, adjusting for these factors, the General Fund tax revenues might have grown slightly in FY 2014.

Currently, the General Excise Tax (GET) makes up slightly more than half of the total General Fund tax revenues, or $2.8 billion out of $5.4 billion of the General Fund revenues. The GET is usually a good indicator of economic activity in Hawaii. Revenue from GET tax fell by 2.2% from FY 2013 to 2014, but the drop was caused partly by changes in County Surchage allocations and there is also uncertainty over the effects of Act 105 on the GET collections.

In previous years, data from the GET on contracting activities has been used to measure construction spending. However, the uncertainty over the effects of Act 105 (which eliminated the subcontractor's deduction) make the measure unreliable for comparisons between FY 2013 and FY 2014.

Total personal income (as reported by the Bureau of Economic analysis) grew by 2.9% in FY 2014 and the Department of Taxation reported that income tax withheld from wages grew by 4.0%. However, total net collections of the Individual Income Tax (after estimated tax payments and refunds) grew by only 0.6%.

Results since the beginning of FY 2015

Preliminary data for December show that the cumulative General Fund tax revenues for the first six months of FY 2015 (July through December of 2014) are up by 6.3% compared to the same period in FY 2014. Here is what happened with cumulative collections from the General Excise Tax and the Individual Income Tax in the first six months of FY 2015:

- Cumulative net collections of the GET (before allocations to the Hawaii Hurricane Relief Fund) were $1,492 million, compared to $1,393million for the same period in FY 2014. The year-over-year growth rate for the tax is 7.1%.

- Cumulative net collections for the Individual Income Tax were $953 million, compared to $878 million for the same period in FY 2014, a growth rate of 8.5%.

The tabulation below shows the growth in cumulative General Fund tax revenues in FY 2015 over the same period in the previous fiscal year.

Growth rate in cumulative General Fund tax revenues, as of the end of:

July 2014	14.1%
August 2014	6.2%
September 2014	2.9%
October 2014	5.6%
November 2014*	7.1%
December 2014*	6.3%

* Preliminary data.

The Council's Forecasts of General Fund Tax Revenues

Before providing the Council's latest forecast, I would like to provide a brief summary and explanation of how the Council produces its forecasts. The Council meets four times a year to forecast General Fund tax revenues. The forecasts are due by January 10, March 15, June 1 and September 10 of each year. Prior to a General Fund meeting, each Council member completes a survey provided by the Office of Tax Research and Planning (TRP) in the Department of Taxation. 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 meeting, 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 Latest Forecasts

At its meeting on January 6, 2015 the Council on Revenues raised its forecast for growth in the State's General Fund tax revenues in FY 2015 from 3.5% to 4.5%, which implies an increase in the level of General Fund tax revenues from $5.56 billion to $5.61 billion. If we are to meet that forecast, General Fund tax revenues for the remainder of the fiscal year (January through June of 2015) will have to surpass those of the same period in FY 2014 by only 2.8%.

The Council left its forecasts for growth in General Fund tax revenues at 5.5% per year for FY 2016 to FY 2021. Although the growth rates were left unchanged, because they are applied to a higher base in FY 2015, the forecasts for the levels of General Fund tax revenues are higher in all years of the budget window.

In arriving at its forecast, the members noted that General Fund tax revenues have been growing faster so far in FY 2015 than their earlier forecast, but they expressed concern about the future. In their deliberations, they noted that construction spending was not growing as expected, that employment and salaries of federal civilian workers in Hawaii were down, and that the recent increases in the value of the dollar against the Japanese yen and other currencies will raise the price of a Hawaii vacation for foreign visitors and therefore may adversely affect tourism. The Council did not expect the adverse effect on tourism to be significant, however. While becoming more visible, the Chinese tourist market share is still not a substantial portion of the Hawaii tourism market. The Council also noted that declining oil prices are expected to have a net positive influence on the U.S. economy, on the visitor industry, and on potential spending in Hawaii by consumers and businesses.

Revised forecasts of State General Fund tax revenues for FY 2015 through FY 2021 are shown in the table below. As in all multi-year forecasts, the estimates for the later years are subject to greater uncertainty.

General Fund Tax Revenues

Fiscal Year	Amount (in thousands of dollars)	Growth From Previous Year
2015	5,611,930	4.5%
2016	5,920,586	5.5%
2017	6,246,218	5.5%
2018	6,589,760	5.5%
2019	6,952,197	5.5%
2020	7,334,568	5.5%
2021	7,737,969	5.5%

Table 1 shows the forecasts, broken down by individual tax type.

Forecasting Is Challenging

The following materials are presented to give you some idea of the amount of uncertainty involved in the forecasts. As I mentioned before, one of the things the Council considers in deriving its forecast is the recent trend in collections of the General Fund tax revenues. Here is what we get if we try to project for the rest of FY 2015 based on collections as of the end of December 2014, when the cumulative General Fund tax revenues was up by 6.3%. (The projections are made after removing the effects of one-off events, such as the refund delays in FY 2010 and the allocations to the Hawaii Hurricane Relief Fund in FY's 2014 and 2015). Using the low, high and average of the shares over the past decade we get:

The low projected revenue growth rate for FY 2015 is -4.5%
The high projected revenue growth rate doe FY 2015 is 15.2%
The average projected revenue growth rate for FY 2015 is 6.7%.

Figure 1 shows errors in the Council's General Fund tax revenue forecasts in recent years.

Some Additional Factors That Might Affect Hawaii's Economy and Our General Fund Tax Revenues Going Forward

- The U.S. economy appears to be on a fairly strong recovery path. Nominal GDP growth was 3.6% in FY 2013, 4.0% in FY 2014 and 4.3% in the first quarter of FY 2015 (using Hawaii's fiscal year). A strong U.S. recovery should help Hawaii's visitor industry, which is heavily based upon U.S. mainland visitors.

- Japan appears to have adopted the strategy of monetary easing to help its economy. At the end of 2014, the yen hit a seven year low relative to the dollar. A weaker yen will adversely affect Hawaii's visitor industry by raising the price of a Hawaii vacation for Japanese visitors, although the effect is not expected to be strong. Further, Japan delayed the second scheduled sales tax increase which may have reduced spending by the Japanese consumer, including on travel to Hawaii.

- Low interest rates and an improving economy have led to five straight years of growth in auto sales in the United States. Sales of autos and other consumer durables may enter a cyclical decline if the need for them becomes sated, which may slow growth in the U.S. economy.

- Geopolitical events could have serious adverse effects on the global economic recovery and therefore Hawaii's economy. Perhaps the biggest danger is still the weakness in the euro area, especially among the heavily indebted members.

- Economic growth in China appears to be slowing, but easing of visa requirements and growing knowledge of Hawaii may offset any adverse effects on Chinese visitors to Hawaii. While Hawaii may be well known in parts of Southern China, it is not as well known in Northeastern China (e.g., Shanghai and Beijing) as other destinations with popular TV shows or movies, such as Seattle, Mauritius, and Thailand.

- The U.S. Federal Reserve is expected to raise interest rates this summer. Generally, we would expect this to be an encouraging sign, because it would mean the economy was deemed strong enough to allow the rate increase. However, the consequences for Hawaii may be ambiguous. The interest rate rise may cause the dollar to rise relative to other currencies, which may increase the cost of Hawaii vacations to foreign visitors. This may curb somewhat the expected positive effect on domestic tourism that would come from the stronger U.S. economy. Figure 2 shows what has happened to visitor expenditures from various market areas.

- Global oil prices have been falling dramatically. The drop may be attributed partly to increases in supply, such as from shale formations in North Dakota or oil sands in Alberta. However, the drop may be attributed also to slowing global demand. If the latter is the dominant cause of the drop in oil prices, it might be a symptom of slowing global economic growth, in which case, rather than expecting a boost to spending in our economy, we might anticipate slower economic growth if a slowdown abroad caused tourism to suffer.

Recent Legislation

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 Legislature. The following list includes measures that would affect the growth rate in General Fund tax revenues during the budget period relative to their base in FY 2014.

- Act 107, SLH 2014 reestablishes 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 FY 2015, through FY 2030, as well as the allocations of the tax to the General Fund. The effect on General Fund tax revenue is estimated to be a loss of $2.6 million for FY 2015 and annual gains of $15.5 million for FY's 2016 through 2030.

- Act 163, SLH 2014 increases allocations of the Conveyance Tax to the Rental Housing Trust Fund from 30% to 50% beginning July 1, 2014. The General Fund revenue loss is estimated to be $11.5 million per year starting in FY 2015.

- Act 174, SLH 2014 increases allocations of the TAT to the counties from $93 million to $103 million for FY's 2015 and 2016. The General Fund revenue loss is $10 million in each of FY's 2015 and 2016.

- Act 163 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 annual GET collections by about $7 million less in FY 2015 and later years than it did in FY 2014.

- Act 62, SLH 2011, allocates GET revenues directly to the Hurricane Relief Fund to replace amounts that were taken from the Fund in prior years. The Act reduced GET allocations to the General Fund by $55.5 million in FY 2014 and will do so again in FY 2015.

I am available to answer any questions you may have.

Sincerely,

KURT KAWAFUCHI
Chair, Council on Revenues

Attachments