# 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.

## Recent Revenue Trends

*Results for fiscal year 2015*

As I mentioned in my testimony last year, changes in the tax laws made by the Legislature and signed into law by the Governor in 2014 regarding the extension of the $1.05 per barrel rate for the environmental response tax and the general excise tax exemptions for the hotel operators as well as changes in the allocations of the environmental response tax, the transient accommodations tax, and the conveyance tax to the State general fund had a net effect of reducing the State general fund tax revenues for FY14 by $31 million. While FY14 had a decline of (1.8%) in general fund revenue, the State general fund tax revenues grew in FY15 by 6.8% and in terms of dollars, increased from $5,370.3 million in FY14 to $5,735.1 million in FY15. Please note that the laws mandated the deposit of $55.5

million from the collection of general excise tax to the Hurricane Relief Fund in both fiscal years 2014 and 2015 which, in turn, lowered the growth rate of State general excise tax by about 1.8% in FY14 but only marginally affected the growth rate of FY15 from FY14 since an equal amount was deducted from the general fund in both fiscal years.

Part of the increase is due to tax administration. Data compiled by the Tax Services and Processing Division of the Department of Taxation indicate that the number of business licenses increased from 623,000 in FY14 to 669,000 in FY15. While there is continuous improvement in tax administration, the main reason for the increase in tax revenues was the growth of key sectors of Hawaii's economy.

The general excise tax (GET) makes up about half of the total general fund tax revenues and usually is a good indicator of economic activity in Hawaii. Revenue from the largest tax category (i.e., GET) increased by 5.8% from FY14 to FY15, as a result of the healthy increase in visitor arrivals and construction activity as well as increase in consumption expenditures spent by Hawaii's residents. Construction completed, measured by general excise tax base for contracting, increased by 4.6% from $7,053 million in FY14 to $7,374 million in FY15. At the same time, the total number of visitors to Hawaii increased by 4.0% from 8.04 million to 8.37 million, as reported by the Hawaii Tourism Authority. The latest data from the U.S. Bureau of Economic Analysis indicated total personal income in Hawaii increased by 4.9% in FY15 significantly higher to the inflation rate of only 1.3%, as measured by changes in the Honolulu Consumer Price Index for All Urban Consumers (CPI-U). Data on the Honolulu Consumer Price Index for All Urban Consumers are surveyed, compiled and reported by the U.S. Bureau of Labor Statistics.

Total personal income, as reported by the Bureau of Economic Analysis, grew by 4.9% in FY15 and the Department of Taxation reported that income tax withheld from wages grew by 6.4%. However, total net collections, including declaration of estimated taxes, payments with returns and net of refunds, showed a very healthy 13.9% growth rate. One of the possible explanations of the double-digit percentage increase (11.9%) in declaration of estimated taxes which likely indicate increased taxable income and business profits and likely certain the expansion of businesses, e.g., hiring of additional personnel, as the result of the fast growing economy during the last fiscal year.

*Results since the beginning of FY2016*

Preliminary data for December show that the cumulative general fund tax revenues for the first six months of FY16 (July through December of 2015) are up by 9.5% compared to the same period in FY15. Here is what happened with cumulative collections from the general excise tax and the individual income tax in the first six months of FY16:

- Cumulative net collections of the GET (before allocations to the Hawaii Hurricane Relief Fund) were $1585.2 million, compared to $1,492.2 million for the same period in FY15. The year-over-year growth rate for the tax is 6.3%.

- Cumulative net collections for the individual income tax were $1,018.8 million, compared to $953.0.million for the same period in FY15, a growth rate of 6.9%.

The tabulation below shows the growth in cumulative general fund tax revenues in FY15 over the same period in the previous fiscal year.

Growth rate in cumulative general fund tax revenues, as of the end of:

| | |
|---|---|
| July 2015 | 4.7% |
| August 2015 | 17.5% |
| September 2015 | 18.1% |
| October 2015 | 10.8% |
| November 2015* | 9.2% |
| December 2015* | 9.5% |

* Preliminary data.

## The Council's Forecasts of General Fund Tax Revenues

Before providing the Council's latest forecast, I would like to explain how the Council produces its forecasts and errors in the forecasts made by the Council on Revenues. 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 members' 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. TRP staff put the members' economic forecasts 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.

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 Recent Forecast Errors*

Table 1 compares the average (mean) forecasts of key economic indicators that our members submitted to the Tax Research and Planning Office slightly before each of the 4 meetings during the FY15. As can be seen from the table, the Council underestimated the growth of the Hawaii's economy during the last fiscal year. The actual growth rate of total personal income, the most important factor to forecast tax revenues, actually increased by 4.9% as compared to the 4.0% to 4.3% growth rate range forecast by the Council over time. Regarding the two key industries of the economy, while the Council underestimated the strength of the visitor industry, the Council overestimated the growth of the construction industry. The underestimation of the strength of the visitor industry has been based in part by, among other things, the capacity of existing hotel rooms and hotel rooms under renovation. The overestimation of the growth of the construction industry was based in part, because of the robust growth in permits and known and visible large construction projects including in the Kaka'ako, Ala Moana and Waikiki areas, which were not matched by an expected growth rate in tax revenue in the contracting, i.e., construction category.

Table 2 presents the forecasts of tax revenues and the errors for the four (4) forecasts made by the Council during FY15. I would like to note again that the distribution of the overall forecasts of general fund tax revenues to various components has been done by the Tax Research Planning Office for illustration and other purposes. While these forecasts are consistent with the overall forecasts, the component forecasts should not be labeled as "Council on Revenues' forecasts". In September 2014, the Council lowered its growth rate from 5.5% (May 2014 forecast) to 3.5% mainly due to the lower than expected actual general tax collections for FY14. The forecast was raised to 4.5% and 5.5% in January 2015 and March 2015, respectively. The March forecast, which is used by the legislature to finalize the budget, erred 1.2% on the conservative side (i.e., the Council forecast 5.5% but the actual FY15 was 6.8%) consistent with the slight underestimation of the strength of the economy during the fiscal year. The May 2015 forecast of 7.5% produced a much smaller error, however, that forecast was technically the same as the March 2015 forecast, mainly because the Council, based on the information of the Department of Taxation administration, estimated that $104 million of State income tax refunds would be delayed and shifted that refund amount from FY15 to FY16. This turned out not to be the case, as the Department of Taxation was finally able to catch up with refunds right before the end of FY15 (June 30, 2015).

I would like to note that revenue forecasts are multi-year forecasts, error in a fiscal year can be offset or compounded by errors in another fiscal year. To review the performance of the Council forecasts over time, table 3 compares the forecasts made in March, the time that the legislature finalizes the budget, over three fiscal years, the same fiscal year when the budget is formed and the next two fiscal years, considering the fact that the legislature concentrates on the actual biennium budget.

As shown in table 3, the Council underestimated the general fund tax revenues by 4.9% over the three-year period in March 2010, reflecting the common very pessimistic view of the economy right after the severe recession. As more data indicated that the recovery had been holding, the forecast performance improved substantially in March 2011 and March 2012. In March 2013, the Council overestimated the tax collections over the three-year period 3.1%, mainly due to unanticipated slowdown of the economy in FY14, which resulted in a decline of 1.8% in general fund tax collections for that fiscal year. Actual data for tax collections for FY16 and FY17 are not available. We do not know exactly the performance of the forecasts made by the Council in March 2014 and March 2015.

*The Council's Current Forecast*

At its meeting on January 7, 2016, the Council on Revenues raised its forecast for growth in the State's general fund tax revenues in fiscal year (FY) 16 from 6.0% to 6.7%. The Council retained the forecast annual growth rates for FY17 and later fiscal years: 5.5% for FY17 and FY18, 5.0% for FY19, 4.5% for FY20, FY21 and FY22.

The forecast change for FY16 and actual FY16 to date are largely based on two factors. First, Act 62 (2011) did not require that $55 million be set aside for the Hurricane Relief Fund. The second factor is based upon information provided by the Department of Taxation on the status of general excise tax payments by online travel companies. The Department indicated that payment of about $29 million of the total $39 million from the Hawaii Supreme Court's decision in the online travel companies was already released to the general fund in FY16 earlier this fiscal year. The remainder amount of $10 million is expected to be released to the general fund from the litigated claims fund later this fiscal year.

Council members discussed the effects of the significant drop in oil prices in 2015, of the continued strength of the U.S. dollar in foreign exchange markets, and of the recent slowdown in economic growth in China. Table 4 summarizes the recent key economic and tax revenue data and table 5 exhibited the average forecasts of key economic indicators provided by members of the Council. As can be seen from table 5, the Council expects that inflation, as measured by the Honolulu Consumer Price Index for All Urban Consumer (CPI-U), will be about 2% a year over the forecast horizon due to expected increase in oil prices and housing costs. As a matter of comparison, the Honolulu CPI-U increased 1.4% in FY14 and 1.3% in FY15, as reported by the U.S. Bureau of Labor Statistics. The Council also expects that the number of visitors will continue to increase at an annual average growth rate of about 2% in the foreseeable future. Because of the strength of the dollar, it is expected that U.S. visitors will grow faster than international visitors during the forecast period, in my own opinion. As reported by DBEDT in their 4$^{th}$ Quarter 2015 Quarterly Statistical and Economic Report, the Blue Chip Economic Consensus Forecast 1.1% growth in real GDP for Japan in calendar year 2016 as compared to 2.6% growth rate of the U.S. economy for the same year. The latest UCLA Business Forecast, subscribed by the Tax Research and Planning Office, expects the U.S. economy will grow at an even stronger 3% growth rate in 2016. Another key economic factor impacting the growth of tax revenue collections is the strength of the construction industry. Construction permits, an indicator of future construction activity, increased 32.1% in FY15, followed by 10.3% during the first 5 months of the current fiscal year. Consistent to that data, the Council average forecasts of the growth rate for the construction activity are 14.9% for FY16, 12.1% for FY17 and 8.3% in FY18. Total personal income, a comprehensive indicator of Hawaii's economy, is expected to grow between 4.7% and 4.8% during this fiscal year and the next biennium, FY17 and FY18.

Revised forecasts of State general fund tax revenues for FY16 through FY21 and the new forecast for FY22 are shown in the table below.

General Fund Tax Revenues

| Fiscal Year | Amount (in Thousands of Dollars) | Growth From Previous Year |
|---|---|---|
| 2016 | 6,119,395 | 6.7% |
| 2017 | 6,455,962 | 5.5% |
| 2018 | 6,811,040 | 5.5% |
| 2019 | 7,151,592 | 5.0% |
| 2020 | 7,473,414 | 4.5% |
| 2021 | 7,809,718 | 4.5% |
| 2022 | 8,161,155 | 4.5% |

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 2015 Legislature, including the following:

- Act 84, SLH 2015 establishes maximum dollar amounts for the allocations of the Conveyance Tax to the Land Conservation fund and the Rental Housing trust fund, and eliminates allocations to the Natural Area Reserve fund starting in FY16. The annual general fund revenue gain is estimated to be $19.7 million for FY16 and later.

- Acts 117 and 121, SLH 2015 changed allocations of the Transient Accommodations Tax (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 FY 2016); 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 $5 million in additional general fund tax revenues in FY16 and $2 million annually thereafter.

- 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 FY16 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 FY's 2017 and 2018.

- Act 238, SLH 2015 reduces the allocation of tobacco taxes to the Trauma special fund, caps the amount allocated to the fund, and also caps the allocations to the Emergency Medical Services and Community Health Centers special funds, effective July 1, 2015. The Act is estimated to increase general fund tax revenues by $4 million in FY's 2016 and later.

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

- Act 107, SLH 2014 reestablished 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 fiscal year 2015, through fiscal year 2030, as well as the allocations of the tax to the general fund. The annual general fund revenue gain is estimated to be $15.5 million for fiscal years 2016 through 2030.

- 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.

- Act 163, SLH 2013 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 GET collections by about $13 million annually.

The Department of Taxation has prepared a report (attached table 6) detailing line-item forecasts for various components of the general fund, reconciled to the Council's forecast growth rate for total general fund tax revenues. The line-item forecasts include components, such as revenues from the general excise tax and from the individual income tax that the Council does not forecast separately.

That concludes my presentation. I am available to answer any questions you may have.

Very truly yours,

KURT KAWAFUCHI
Chair, Council on Revenues

Attachments