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COUNCIL ON REVENUES

STATE OF HAWAII
P.O. BOX 259
HONOLULU, HAWAII 96809

January 13, 2009

The Honorable Donna Mercado Kim
Chair, Senate Committee on Ways and Means
State Capitol, Room 210
Honolulu, HI 96813

The Honorable Marcus R. Oshiro
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 Paul Brewbaker, and I am the Chair of the Council on Revenues. Much of what I present in this document is ably prepared by the Tax Research and Planning Office of the Hawaii Department of Taxation, who serve as technical support for the Council, among other things. My intent is fairly to reflect the Council's general view. If there are any math errors below we can work with Tax Research to correct them.

What follows is a review of recent trends as well as the Council's latest forecast. As has been customary, I also shall make some separate remarks in conjunction with a PowerPoint presentation, after highlighting a number of the points raised in this document.

Current Revenue Trends

Fiscal year (FY) 2008 experienced a relatively modest 1.2% increase in the State's General Fund tax revenues, following a 3.4% increase in FY 2007. Reflecting the decline in tourism at the end of that fiscal year, transient accommodations tax collections increased by only 2.0% in FY 2008, despite the 5.2% increase in hotel room rates during the same period.

General excise and use tax (GET) collections, which typically make up about half of total General Fund tax revenues, were about $2.6 billion in FY 2008. That was 2.5% higher than in the previous fiscal year and, notably, less than inflation during the same period. Besides the decline in the number of visitors to Hawaii at fiscal year-end, general excise tax collections were also affected by a slowdown in construction activity. Following an increase of 18.0% in FY 2007, construction expenditures, as measured by general excise tax for contracting, declined by 1.9% in FY 2008. Rising construction costs at the time implied an even larger real decrease.

Consistent with 5.4% nominal growth of total personal income, withholding taxes on wages rose 7.1% in FY 2008. However, this increase was offset by a substantial increase in refunds and a large decrease in payments with returns when taxpayers filed their 2007 Hawaii State income tax returns during the January to June 2008 period. Part of the increase in refunds was attributed to a one-time, refundable, constitutionally-mandated income tax credit (Act 210, SLH 2007). Netting these changes, individual income tax collections decreased by 1.0% in FY 2008.

Net corporation income taxes increased by 4.0% in FY 2008, mainly because of a 14.3% decrease in refunds.

Delinquent tax collections fell by $16.0 million from $202.9 million in FY 2007 to $186.9 million in FY 2008.

In summary, slowing economic growth and emerging declines in tourism and construction resulted in a modest 1.2% increase in the State's General Fund tax revenues for FY 2008.

During the current fiscal year, FY 2009, an increasingly severe economic recession in the U.S., and weaker economic conditions abroad have had an adverse impact on Hawaii tourism and the overall Hawaii economy. From April through December, 2008, tourism declined at double-digit rates. The end of the construction upswing, a rising Hawaii unemployment rate, and—most recently—subsiding inflation have reduced tax revenue collections for the current fiscal year.

The latest published data indicate that revenues deposited into the State General Fund for the first five months of the current fiscal year decreased by $47.1 million, a change of –2.5%, when compared to the same period in the previous fiscal year. Adjusted for weekend effects and technical factors, State General Fund tax revenues would have been flat for the July to November 2008 period, compared to one year earlier.

Highlights of changes in key components of State tax revenue collections to date in FY 2009 follow.

General excise and use taxes, cumulatively through November 2008, decreased 6.6% from the same period last fiscal year. Transient accommodations tax (TAT), cumulatively through November, declined 8.2% from last fiscal year. Through November of FY 2009, individual income tax collections increased by 3.5% over the corresponding period last fiscal year. Corporate income tax collections for this same period increased 8.7 percent, but only because a 51.2% decrease in corporate refunds swamped a 28.1% decrease in corporate declarations of estimated taxes and payments with returns. Reflecting the weakness of the real estate market, conveyance tax collections in the first five months of FY 2009 declined by 64.1% when compared to the first five months of FY 2008.

Forecasts of General Fund Tax Revenues

Before presenting the current forecasts and the assumptions behind them, let me review the forecasts made by the Council during the past fiscal year.

Table 1 presents actual General Fund tax revenues by category in FY 2008, the forecasts of these revenues made by the Council on Revenues in January 2008, and model-based forecasts using actual economic data as of January 2009, one year later.

The Council reduced its FY 2008 forecast from 4.9% in January 2008 (as shown in Table 1) to 3.3% in May 2008 due to a sharper-than-expected downturn in economic conditions. The January forecast of a 4.9% growth in General Fund collections overestimated actual General Fund tax collections by $169.2 million, or 3.6 percentage points. Percentage forecast errors in line-item detail forecast by the Tax Research and Planning Office, using a model aligned with the Council's overall General Fund tax revenue forecast, were greatest for the conveyance tax (an overestimation of 86.0%). Also overestimated were line-item forecasts for individual income tax collections (by $77.2 million, 5.0%) and GET collections (by $88.7 million, 3.4%).

As shown in Table 1, had actual economic indicators been known in advance, their use in the Tax Research and Planning Office's model would have resulted in a forecast of 3.1% growth in General Fund tax collections for FY 2008, instead of 4.9% as in January 2008. The difference (1.8 percentage points) is consistent with upward biases in Council members' individually forecasted growth rates for key economic variables, but could also be a result of model calibration. Qualitatively, while the Council correctly anticipated the economic slowdown, the degree of the slowdown was underestimated. In January 2008, the Council anticipated that construction activity would grow by only 1.7% for FY 2008; it actually declined by 1.9%. The Council forecast that total personal income would grow by 5.9%; actual nominal personal income growth was 5.4%. The Council forecast (in January 2008) that visitor arrivals would increase by 1.0%; there was an actual decrease of 2.6%.

It should be noted that the model is a multi-year forecasting model from FY 2008 through FY 2014. As in all multi-year forecasts some years are over-estimated and other years are under-estimated. Typically, in most years, the growth in General Fund tax collections is greater than the growth in personal income—in FY 2004, personal income grew by 6.0% and General Fund tax revenues grew by 8.3%, in FY 2005, it was 8.7% and 16.0%, respectively, in FY 2006, it was 7.1% and 10.9%, respectively. In FY 2007 and FY 2008, however, personal income grew by 6.7% and 5.4% respectively, but General Fund tax collections grew by only 3.4% and 1.2%, respectively. General Fund tax collections are also reduced by tax credits. The two-year lag in obtaining tax credit data complicates the problem of arriving at accurate forecasts of actual General Fund tax collections, which are net of tax credits.

At its meeting on January 9, 2009, the Council on Revenues again adjusted forecast growth rates of General Fund tax revenues. Indeed, there was a sequence of downward revisions after mid-2008 at several regular and specially-requested General Fund tax revenue forecasting sessions. The January 2009 forecast for FY 2009 was reduced from –0.5%, the forecast from the October 29, 2008 revision, to –3.0%. The January 2009 forecast deliberations also produced downward revisions from 3.5% to 1.0% for FY 2010, and from 4.5% to 3.5% for FY 2011. The Council also updated its forecasts of General Fund tax revenues for FYs 2012 through 2015, generally lowering the revenue gains while retaining previously forecast percentage increases for the out-year projections.

The revised forecasts of State General Fund tax revenues for fiscal years 2009 through 2015 are listed below:

Fiscal Year	**Thousands of Dollars**	**% Growth From Previous Year**
2009	$4,502,616	-3.0%
2010	$4,547,642	1.0%
2011	$4,706,809	3.5%
2012	$4,956,270	5.3%
2013	$5,253,646	6.0%
2014	$5,595,133	6.5%
2015	$5,958,817	6.5%

Line-item detail forecasts for State General Fund tax revenues from FY 2009 through FY 2015 are presented in the attached Table 2. These detailed forecasts are based on the Council's forecasts of total State General Fund tax revenues, estimated using the econometric model of the Tax Research and Planning Office.

Hawaii's economic condition and its outlook have deteriorated by most measures since I appeared before your committees last year. At that time, the Council was concerned about softening in the economy in FY 2008. Recent financial market turbulence, the resulting credit crunch, and a deterioration of investor and consumer confidence following a period of heightened volatility since September 2008 have sharply eroded economic prospects in the U.S. and abroad. As a result, this has had an adverse impact on Hawaii's economy, and will have an adverse impact for what may be an extended period.

For FY 2009, the mean Council forecast of key economic indicators (Table 3) at its January 9, 2009 deliberations was that construction will decline by 2.0% and visitor arrivals will decline by 10.0%. In arriving at its revenue forecast, the Council assumed that nominal total Hawaii personal income would grow by 1.8%, less than inflation. As measured by the Honolulu Consumer Price Index, inflation was forecast to be 2.5%. For FY 2010, the mean Council forecast was that construction will decline by 3.6%, that visitor arrivals will reverse a recent downward trend but only grow by 1.3%, that nominal total personal income will grow by 2.3%, and that inflation will decrease to 1.8%.

In producing its forecasts, the Council has adopted specific adjustments recommended by the Hawaii Department of Taxation to reflect the impacts on General Fund tax revenues of recent tax law changes, including:

- Act 209, SLH 2007—exemption from general excise tax of alcohol fuel; approximately $40 million for FY 2009.

- Act 211, SLH 2007—refundable food/excise tax credit; approximately $24 million per year starting in FY 2009.

- Act 58, SLH 2008—one-time, refundable, constitutionally-mandated income tax credit; approximately $1 million for FY 2009.

- Act 89, SLH 2008—application of the 0.5% general excise tax rate to certain warranty work performed on behalf of manufacturers; approximately $1.5 million for FY 2009 and annually thereafter.

- Act 143, SLH 2008—changes relating to agricultural businesses qualifying for enterprise zone benefits; approximately $100,000 for FY 2009, $200,000 for FYs 2010–2011, $300,000 for FY 2012, and 500,000 for FY 2012 and annually thereafter.

- Act 156, SLH 2008—allows State and county governments to hire retired State or county government employees; approximately $1.5 million for FYs 2009–2013.

- Act 233, SLH 2008—provides an important agricultural land qualified agricultural cost income tax credit; approximately $7.5 million annually for FYs 2010–2014.

In the past the Council has emphasized the challenge of forecasting revenues as the impacts of significant tax law changes interact with unpredictable external factors. In addition, economic uncertainties have been unusually notable this fiscal year. Still, in arriving at the most recent January forecast, the extent of dispersion of Council members' implied revenue forecasts, based on their individual economic assumptions, has narrowed somewhat since its October 2008 meeting. As noted in our October reports to the Administration and to Senate and House leadership, dispersion at that time was a reflection of the extraordinary extent of economic uncertainty coincident to a period of historically unprecedented financial market volatility. This volatility has abated lately, though it remains heightened against historical benchmarks.

At its January 2009 forecast deliberations, Council members wished for me to convey also that in addition to the unusually volatile character of recent financial and U.S. macroeconomic performance, notwithstanding the more recent reduction in turbulence, risks to the Council's forecast are almost uniformly to the down side. That is, there are few plausible scenarios under which the Council's forecast for fiscal year 2009 will end up too low, but there are many scenarios capable of rendering its most recent forecast too high. Also, these downside risks are of a kind whose enduring effects could mean that it takes a longer time to overcome them than might ordinarily be true of U.S. business cycles. As if often observed, the current U.S. economic recession is one of the worst in a century and may be the most severe, by a variety of measurements, since the mid-20th century when reliable macroeconomic information became available. Furthermore, the Presidential transition raises both hope and uncertainty with regard to federal fiscal policy at a time when monetary policy already has gone to extraordinary lengths to achieve a modicum of financial system stabilization. Under such circumstances, it is customary to attach a larger confidence interval than is usual for point estimates such as the Council's annual General Fund tax revenue forecast growth rates for the next several fiscal years.

This concludes my presentation, and thank you for this opportunity to appear before these Committees.

Respectfully submitted,

Paul H Brewbaker

Paul Brewbaker, Ph.D.
Chair, Council on Revenues

Attachments