LINDA LINGLE
GOVERNOR

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# COUNCIL ON REVENUES

STATE OF HAWAII
P.O. BOX 259
HONOLULU, HAWAII 96809-0259

March 15, 2010

The Honorable Linda Lingle
Governor, State of Hawaii
Executive Chambers
State Capitol, Fifth Floor
Honolulu, HI 96813

Dear Governor Lingle:

At its meeting on March 11, 2010, the Council on Revenues retained its previous forecast for State General Fund tax revenue growth in fiscal year (FY) 2010 at –2.5 percent. The Council lowered its revenue growth forecast for FY 2011 from 7.6 percent to 6.0 percent. The growth rates for FY 2012 through FY 2016 were unchanged from previous forecasts.

Revised forecasts of State General Fund tax revenues for FY 2010 through FY 2016 are shown in the table below:

**General Fund Tax Revenues**

| Fiscal Year | Amount (in Thousands of Dollars) | % Growth From Previous Year |
|---|---|---|
| 2010 | $4,097,243 | -2.5% |
| 2011 | $4,343,078 | 6.0% |
| 2012 | $4,603,662 | 6.0% |
| 2013 | $4,879,882 | 6.0% |
| 2014 | $5,172,675 | 6.0% |
| 2015 | $5,431,309 | 5.0% |
| 2016 | $5,702,874 | 5.0% |

Detailed estimates of state General Fund tax revenues by category for FY 2010 through FY 2016 are presented in the attached table. The detailed line-item forecasts are constructed by the Tax Research and Planning Office, based on the Council's forecast for total state General Fund tax revenues and on econometric models.

Along with the consensus forecasts, the Council reported the high and the low forecasts from its members as proxies for confidence intervals.

**General Fund Tax Revenues**
**Growth Rate**

| Fiscal Year | High | Low |
|---|---|---|
| 2010 | 0.08% | -3.60% |
| 2011 | 8.00% | 1.30% |
| 2012 | 8.00% | 4.00% |
| 2013 | 8.00% | 4.00% |
| 2014 | 8.00% | 4.00% |
| 2015 | 7.00% | 3.00% |
| 2016 | 7.00% | 3.00% |

These high and low revenue growth estimates are based on: (1) the Council's forecasts of key economic indicators used as assumptions in econometric models maintained by the Tax Research and Planning Office; and (2) individual members' own revenue forecast models. It is customary for the Council to use all of these inputs in reaching its decision. Model specification alone can be a source of forecast variation, under the same economic assumptions. In addition, economic assumptions may vary from member to member, producing varying forecast outcomes from the same model.

The variation in assumptions and in modeling outcomes provides some indication of uncertainty associated with the revenue forecast. Greater dispersion among the various revenue forecasts, irrespective of the source (assumptions or models) can be an indication that less confidence should be assigned to an average forecast than might be attributed to one in which individual members' forecasts are closely bunched. Typically, revenue forecasts will both cluster and tail off in one direction or other, relative to the cluster. Such skewness also may contain information on the direction Council members' views are changing.

At the same time, it should always be remembered that even when members' forecasts are clustered—so that dispersion is small—or even when they are not subject to significant skewing, it is still possible for unforeseen events dramatically different from those on which expectations were conditioned to produce outcomes significantly different from those forecast. Typically these events are infrequent, but potentially catastrophic and often unpredictable. Financial crisis, terrorist attacks, meteorological and biological events all have provided pertinent and multiple examples in recent decades. Such shocks can and often do have both static and dynamic effects—instantaneously they may alter revenue outcomes, but over time the economy's trajectory itself can be altered, with multi-year impacts on revenues.

Also, the Council's forecast often is *not* the average of individual members' forecasts from one or another model: certain judgmental adjustments inevitably arise during Council deliberations that may lead the Council's ultimate decision to differ from various forecast estimates or their averages. Econometric models and open deliberations are tools with which forecast decisions are made. Thus, indicators such as the forecast ranges reported above reflect members' *ex ante* thinking prior to Council meetings, but the decisions made at the meeting are the only *ex post* indication of their agreed-upon forecast.

With those points in mind, consider that members' FY2010 revenue growth forecasts spanned a range of –2.2% to –0.4%, with a mean of –1.5%, using Tax Research and Planning's legacy model. Using the more recent UCLA model, members' FY2010 revenue growth forecasts ranged from –3.6 to –1.5%, with a mean of –2.8 percent. Two Council members' individual forecasts for FY 2010, prepared closer to the meeting date and reflecting more recent employment data revisions, were at or above the upper end of those ranges: –0.9 percent in one case and +0.08 percent in the other. From this evidence we can infer that members' views were fairly close with a tendency to move upward: a range of about two percentage points in absolute value spanned the high and low forecasts, and some more recent estimates were slightly higher than previously obtained. The decision to retain the prior FY 2010 forecast revenue growth estimate was made in the context of this information.

Members' FY 2010 forecasts also appear modestly skewed to the high side—the high forecasts lies further above the mean forecasts than the low forecasts in the legacy and UCLA models. During the course of fiscal year 2009, in contrast, when the intensification of the financial crisis and deepening of the economic recession followed the collapse of Lehman Brothers in September 2008, members' forecasts tended to be skewed to the low side, rather than the high side. That is, the most pessimistic forecasts were farther from the mean than the most optimistic. Not only were forecasts being revised downward repeatedly during FY 2009, the negative skewness of forecast distributions was, for a time, an indication of the risk of where things might be headed. In more recent revenue forecasts, positive skewness may be informative. It reveals that expectations may be shifting from declining to rising economic momentum. This expectation for overall economic performance would be consistent with a transition from falling to stabilizing General Fund revenues, and to renewed revenue growth in the future.

Members' FY 2011 General Fund tax revenue growth forecasts ranged from 2.2% to 6.5% with a mean of 3.6% using the legacy model, and from 2.1% to 6.5% with a mean of 3.2% using the UCLA model. The dispersion for FY2011 forecasts in these two models was around 4.0-4.5 percentage points, roughly twice the dispersion for FY2010 forecasts. Moreover, the two models' forecasts were positively skewed: the highest forecasts were twice as far from the mean forecast, in absolute value, as were the lowest forecasts. Other FY2011 forecasts considered at the meeting had an even wider range, as indicated in the table above. Greater uncertainty, positive skewness, and more positive revenue growth expectations all characterized members' views for the coming fiscal year. In this instance, for FY 2011, Council members were inclined to place greater weight on the higher forecasts and made the forecast decision accordingly.

The expectation of higher revenue growth in the coming fiscal year, with recognition of risks to the forecast, was also extended to the "out-years" FY 2012 through FY 2016. Down the road more confidence is associated with members' revenue forecast growth rates: dispersion between high and low forecasts narrows to a range of 2-3 percentage points in the legacy and UCLA models, with mean forecasts fairly well-centered in the middle of those high-low ranges.

In recent quarters economic data have begun pointing to recovery in Hawaii's economy, following the Great Recession of 2008-2009. Hawaii tourism volumes have been in a stable pattern for almost a year and a half, with the inflation-adjusted value of tourism receipts showing signs of recovery during just the last six months. Housing markets and valuations also have stabilized, with some upward movement on Oahu, despite lingering credit losses and a foreclosure inventory build-up. Job loss in Hawaii remains persistent, but in smaller monthly increments than was the case during the last two years, and the unemployment rate has been stable since the middle of last year. The Council expects these patterns of stabilization and improvement to continue, with better performance indicators such as those from Hawaii's tourism complex eventually to be followed by lagging indicators such as those comprising employment information. The Council expects Hawaii's inflation rate, as measured by changes in the Honolulu Consumer Price Index, to rise from 0.3% in the second half of FY 2009, and 0.7% in the first half of FY 2010, to 0.9% for the full FY 2010, and to 1.5% in FY 2011. Broadly, these and other indicators are consistent with gradual economic recovery in the current and coming fiscal years. Recent revisions of Hawaii employment data revealed a weaker Hawaii labor market in the recent past than previously was reported, but global economic recovery frames Hawaii's current economic stabilization and greater clarity is now available regarding local impacts of federal fiscal stimulus. All of these elements seem likely to underscore forthcoming economic improvement in the islands. As noted earlier, risks to the recovery abound, and members' revenue forecasts reflect those uncertainties, but the shift in expectations for future Hawaii economic performance from negative to positive is palpable.

An illustration of actual nominal Hawaii General Fund revenue trends, under seasonal-adjustment, is attached to this correspondence (based only on this author's estimates).

In producing its forecasts, the Council adopted specific adjustments recommended by the Hawaii Department of Taxation reflecting the impacts on General Fund tax revenues of recent tax law changes enacted in the recent past and in 2009 including the following:

- Act 209, Session Laws of Hawaii (SLH) 2007—exempts from the general excise tax sales of alcohol fuel.

- Act 211, SLH 2007—provides a refundable food/excise tax credit.

- Act 143, SLH 2008—amends provisions relating to agricultural businesses qualifying for enterprise zone benefits.

- Act 156, SLH 2008—allows state and county governments to hire retired state or county government employees.

- Act 233, SLH 2008—provides an important agricultural land qualified agricultural cost income tax credit.

- Act 14 SS, SLH 2009—phaseout of the personal exemption.
- Act 40, SLH 2009—reduces the interest rate applied to overpayments of tax.
- Act 56, SLH 2009—increases the cigarette tax by one cent on July 1, 2009, July 1, 2010, and July 1, 2011.
- Act 58, SLH 2009—increases the tobacco tax on tobacco products other than cigarettes and taxes "little cigars" as cigarettes.
- Act 59, SLH 2009—increases the conveyance tax and reduces the conveyance tax allocations to the Rental Housing Trust Fund and to the Natural Area Reserve Fund.
- Act 60, SLH 2009—temporarily increases the income tax rate on high income individuals and increases the standard deduction and personal exemption amounts.
- Act 61, SLH 2009—provides an additional 1% transient accommodations tax from July 1, 2009 through June 30, 2010, and an additional 2% transient accommodations tax from July 1, 2010 through June 30, 2015.
- Act 134, SLH 2009—Tax Administration; Cash Economy Enforcement Act.
- Act 166, SLH 2009—conforms to certain Federal penalties; promotes expedited tax appeals; creates 15 year collection statute.
- Act 178, SLH 2009—establishes a temporary 80% tax credit cap (80% of tax liability) and restricts carryover credits for the high technology business investment tax credit and the technology infrastructure renovation tax credit for investments made on or after May 1, 2009. Limits the investment credit allocation ratio to 1 to 1. Temporarily suspends the capital goods excise tax credit (May 1, 2009 – December 31, 2009).
- Act 196, SLH 2009—Electronic filing and payment of taxes; accelerates tax payments.

In addition, the Department of Taxation reported to the Council that issuance of net income tax refunds for tax year 2009, including individual, corporate, and fiduciary income tax returns, will be delayed until after July 1, 2010 and that the current budget plan calls for the same delay to continue in FY 2011 and thereafter. It reported that delaying refunds might provide an estimated one-time increase in the State General Fund tax revenue collections of $275 million for FY 2010, intended to balance the State budget. Because of uncertainties associated with *intended* policy strategies not included in tax law, not the least of which would include future actions of the next Administration, the impact of delaying tax refunds is *not* factored in the Council's current forecasts. However, any *actual* impacts of this strategy obviously will be manifested in General Fund tax revenue collections and the calculation of year-over-year growth rates, and possibly will be reflected in Special Fund and other revenues as well. The Council will deal with those changes and their impacts on the revenue forecast on an ongoing basis.

As is customary, the Council did *not* contemplate revenue impacts of pending legislation.

Various revenue estimates provided to the Council by the Hawaii Department of Budget and Finance at the Council's March 11, 2010 meeting were accepted as submitted; notable changes to those estimates are highlighted in the next several paragraphs.

General Fund Non-Tax Revenue estimates for FYs 10 and 11 reflect increases in transfers from the tobacco settlement special fund pursuant to Act 119, SLH 2009.

Special Fund Tax Revenue estimates for FYs 10-16 reflect decreases in transfers of Transient Accommodations Tax and decreases in projected cigarette tax revenues for the Department of Health's Trauma System Special Fund and the Emergency Medical Services Special Fund.

Special Fund Non-Tax Revenue estimates for FYs 09-16 reflect adjustments due to decreases in investment earnings for the Department of Transportation's (DOT) Airports Division; increases in revenues for Airport terminal improvement projects; and decreases due to the reallocation of tobacco settlement monies to the Emergency and Budget Reserve Special Fund (B&F) from 24.5% to 15.0% pursuant to Act 119, SLH 2009.

Other than Special Fund Non-Tax Revenue estimates for FYs 09-16 reflect adjustments for the Department of Human Services' (DHS) medical assistance federal grants; increases for the University of Hawaii research and training federal grants; increases in federal American Recovery and Reinvestment Act grants for the State Energy Program (Department of Business, Economic Development and Tourism (DBEDT)); and increases in bond issues to provide interim construction loans to facilitate the construction or rehabilitation of affordable rental housing projects (DBEDT) .

Please advise us if we can be of further assistance or if we can answer any questions you may have.

Sincerely,

Paul H Brewbaker

PAUL H. BREWBAKER, Ph. D.
Chair, Council on Revenues

Attachments

The Honorable Linda Lingle
March 15, 2010
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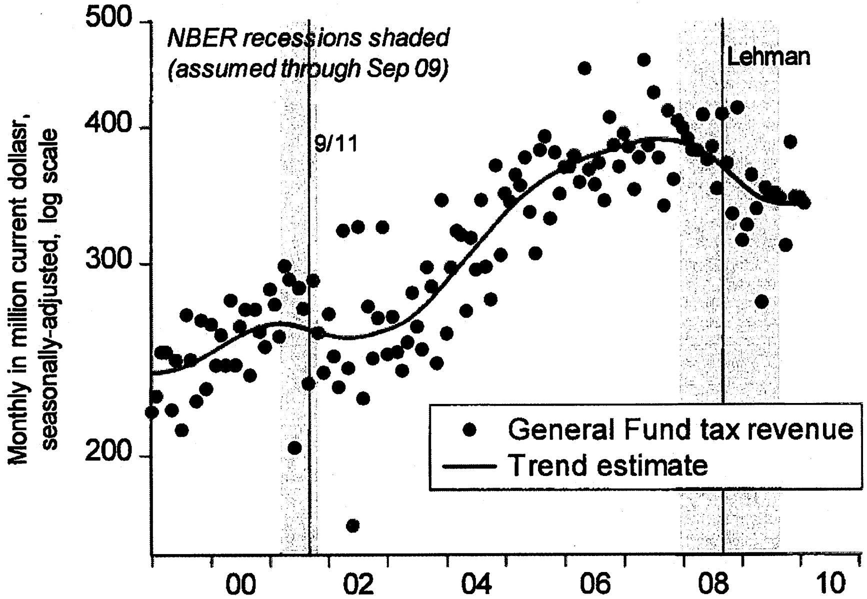
Nominal Hawaii General Fund tax revenue
through February 2010




Sources: Hawaii Department of Taxation, seasonal adjustment and trend filtering by the author

# Table A

## ESTIMATES OF GENERAL FUND TAX REVENUE: FY 2010 to FY 2016

### Adjustments above the Line

(in thousands of dollars)

| | ACTUAL | | ESTIMATED | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| TYPE OF TAX | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 | FY 2016 |
| General Excise & Use 2/ | $2,618,787 | $2,417,580 | $2,350,845 | $2,496,261 | $2,640,781 | $2,803,402 | $2,970,883 | $3,123,153 | $3,324,785 |
| Income - Individual 4/ | 1,544,307 | 1,338,451 | 1,264,796 | 1,349,172 | 1,435,393 | 1,533,166 | 1,634,242 | 1,718,735 | 1,835,805 |
| Income - Corporation | 85,081 | 53,522 | 50,103 | 36,724 | 39,290 | 47,964 | 59,525 | 71,776 | 84,610 |
| Public Service Company | 127,481 | 126,069 | 124,519 | 124,476 | 125,387 | 127,200 | 129,743 | 132,730 | 136,591 |
| Insurance Premiums | 95,742 | 93,720 | 90,703 | 90,880 | 96,324 | 97,425 | 98,651 | 97,810 | 97,382 |
| Tobacco & Licenses 5/ | 83,443 | 76,955 | 94,253 | 93,736 | 90,045 | 84,032 | 80,845 | 77,911 | 75,175 |
| Liquor & Permits | 45,620 | 47,242 | 49,446 | 51,953 | 54,454 | 56,891 | 59,247 | 61,483 | 63,628 |
| Banks & Other Fin Corps | 18,212 | 26,075 | 24,318 | 25,790 | 32,361 | 36,530 | 40,132 | 42,171 | 45,510 |
| Conveyance 3/ | 6,513 | 8,311 | 9,551 | 8,866 | 8,632 | 6,280 | 6,224 | 6,188 | 6,162 |
| Miscellaneous * | 751 | 810 | 535 | 537 | 540 | 542 | 544 | 545 | 547 |
| Transient Accommodation Tax 1/ | 15,935 | 13,566 | 38,174 | 64,683 | 80,455 | 86,450 | 92,639 | 98,807 | 32,679 |
| NET TOTAL | $4,641,872 | $4,202,301 | $4,097,243 | $4,343,078 | $4,603,662 | $4,879,882 | $5,172,675 | $5,431,309 | $5,702,874 |
| GROWTH RATE | 1.2% | -9.5% | -2.5% | 6.0% | 6.0% | 6.0% | 6.0% | 5.0% | 5.0% |

Notes:

1/ Deposits of 44.8% of TAT revenues to counties (Act 156, SLH 1998); 32.6% to the tourism special fund and 5.3% to the TAT trust fund (Act 250, SLH 2002); 17.3% to the convention center enterprise fund (Act 253, SLH 2002); all net of general fund deposits of excess of fund ceilings. Act 235, SLH 2005, increases allocation to the tourism special fund to 34.2% and repeals the TAT trust fund. Effective on July 1, 2007. Act 209, SLH 2006, increases ceiling on allocation to the convention center enterprise fund to $33 million. Effective on July 1, 2006. Act 61, SLH 2009, temporarily imposes an additional 1.0% TAT for the period 7/1/2009 through 6/30/2010, and an additional 2.0% TAT for the period 7/1/2010 through 6/30/15. These additional amounts will be deposited into the general fund. Act 5, Special Session Laws of Hawaii 2009, allocates 12.5% of the reveunes derived from Act 61 to the tourism special fund for one fiscal year (FY 2011).

2/ Act 209, SLH 2007, exempts gross income received from the sale of alcohol fuel from the general excise tax. Effective on July 1, 2007, provided that the exemption repeals on June 30, 2009. Act 40, SLH 2009, reduces the interest rate on overpayments due to taxpayers from 2/3 of 1% to 1/3 of 1% per month or fraction thereof.

3/ Due to the expiration of Act 222, SLH 2007, on June 30, 2008, the amount of conveyance tax deposited into the General Fund increased from 15% to 35%. Act 59, SLH 2009, increased the conveyance tax rates for properties valued $1 million or more.

4/ Act 60, SLH 2009, temporarily increases the standard deduction and personal exemption amounts for taxable years beginning after 12/31/10, and also temporarily creates new 9%, 10%, and 11% tax brackets for certain individuals with high taxable income beginning with taxable years beginning after 12/31/08. Act 60, SLH 2009, will be automatically repealed on December 31, 2015.

5/ Act 58, SLH 2009, taxes "little cigars" in the same manner as cigarettes beginning 9/30/09; increases the tax on tobacco products other than cigarettes, little cigars, and cigars from 40% to 70% beginning 9/30/09; imposes a 50% tax on cigars. Act 56, SLH 2009, increases the cigarette tax from 11¢ to 13¢ on 7/1/09, from 12¢ to 14¢ on 7/1/10, and from 13¢ to 15¢ on 7/1/11; and also amends the dates on which changes in the allocation of cigarette tax revenues changes.

* Includes inheritance and estate tax.