State of the State Budget 2016

An Analysis of the Multi-Year State Budget

GRASSROOT
INSTITUTE OF HAWAII

Prepared by the Research Staff of the Grassroot Institute of Hawaii

Keli'i Akina, Ph.D.
President / CEO

Grassroot Institute of Hawaii

Report on Multi-Year Budget

Introduction

We are told that it is overly simplistic to compare the challenge of budgeting a home or a business to that of running a government budget, but certain principles are eternal. Foremost among these is the need to deal transparently and honestly with the numbers involved—both in terms of expenditures and revenues. Without an accurate estimate of the state's expenditures and liabilities, the balanced budget is just an illusion. Rather than creating accountability to the state's taxpayers, it confuses the appearance of fiscal responsibility with the best practices that will ensure Hawaii's long-term financial health.

Governor Ige's Executive Supplemental Budget for fiscal year 2017 was transmitted to the legislature in December, giving the Grassroot Institute the opportunity to examine the state's multi-year financial plan in light of the revised revenue and spending projections. Unfortunately, what we found is that there is still a long way to go when it comes to creating true fiscal accountability in the Aloha state. Though the Governor has pledged to make the government more efficient, we lack the information to determine whether there is any weight behind the promises or whether we are looking at yet another series of overly optimistic projections that will only push the state's economic woes further down the road.

Adding to that concern is the continued inability of the state to confront the depth of the liabilities related to the Employee Retirement System and Employee Union Trust Fund. There are millions of dollars that remain unaccounted for, and even the rosiest predictions of the state's economic future are stymied by the size of this particular budget sinkhole. While some might claim that considering worst-case scenarios on the ERS/EUTF liabilities paints too gloomy a picture, ignoring them so as to create a more optimistic financial plan is tantamount to lying to both the taxpayers and the employees themselves.

Projected Revenues vs. Projected Expenditures

Where has the state's financial plan donned those rose-colored glasses? Predictably, an analysis of the numbers finds problems with the expenditure projections—both in terms of how they match up with historical spending and in what is missed.

Revenue projections in Hawaii are fairly straightforward, as they come from the Council of Revenues, an independent body that uses an established model (and expert opinion) to arrive at the state's projected revenues. It is worth noting that the Council of Revenues considers the growth rate of the state's General Excise Tax as its primary revenue assumption.

Table 1: Impact of the Council on Revenues, Projections (in thousands)

FY	2016	2017	2018	2019	2020	2021	2022
Tax Revenues: Council (9/3/15)	$6,079,249	$6,413,608	$6,766,356	$7,104,674	$7,424,384	$7,758,481	$8,107,613
Revised Growth Rate	6.70%	5.50%	5.50%	5.00%	4.50%	4.50%	4.50%
Tax revenues: Council (1/7/16)	$6,119,395	$6,455,962	$6,811,040	$7,151,592	$7,473,414	$7,809,717	$8,161,155
Additional Anticipated Tax Revenues	$40,146	$42,354	$44,684	$46,918	$49,030	$51,236	$53,542

On January 7, 2016, the Council of Revenues increased its revenue projections for FY2016 from 6% to 6.7%, representing an additional $83 million for the state's coffers in FY 2017. However, the Council has also issued an implied warning in its predictions, forecasting slower (or even contracting) growth beginning as early as FY 2018. The stability of the state's economy—especially the tourism industry—cannot be taken for granted in predicting the state's financial future.

Governor Ige's stated desire to improve government efficiency becomes evident in the expenditures projections for FY 2017 and beyond. The supplemental financial plan projects that expenditures will decline by 1% in 2018 and grow by an average of 2% per year from FY 2019 on. While the national inflation rate has fallen below the Federal Reserve's goal of 2% in recent years, there have been indications that the rate may rise above that mark, raising the question of what factors went into the 2% growth estimation.

The issue of transparent budget planning becomes critical at this point. The Governor's supplemental plan does not reveal how he arrived at these expenditure projections. The calculations behind the decline and modest growth expectations are not available for critique, nor is there an explanation as to why the projections do not match historical figures for spending growth. It would be nice to think that this reflects a sudden burst of restraint on the part of the state, but (again) there is no indication that this is the case.

Historically, general fund expenditures have grown by an average of 4.9% per year—more than twice what is envisioned in the supplemental financial plan. If the strongest indication of future behavior can be found by looking at the past, we are looking at the continuation of a trend that has been extremely damaging to our state's economy. Applying the historical growth rate to the current financial plan beginning in FY 2018 finds that the plan has underestimated long-term expenditures by as much as $1.2 billion. This is compounded by the fact that revenue growth and expenditure growth are not moving at the same rate. In fact, the long term trend shows expenditures growing at a quicker rate than revenues, creating an inherent instability in the state's long-term financial outlook.

Table 2: Multi-Year Financial Plan – Expenditure Growth Forecasting Errors (in Millions)

	FY 2012	FY 2013	FY 2014	FY 2015
Biennium Budget - FY 09-11	$5,741.2	$5,875.3	$5,964.2	$6,065.0
Supplemental Budget - FY 09-11	$5,379.3	$5,495.0	$5,605.9	$5,702.3
Supplemental Budget - FY 11-13	x	x	$5,890.7	$6,077.7
Average Long-Term Expenditure Projections:	**$5,560.3**	**$5,685.2**	**$5,820.3**	**$5,948.3**
Actual Expenditures:	**$5,641.2**	**$5,842.3**	**$6,275.4**	**$6,440.0**
Absolute Forecasting Error	$80.9	$157.2	$455.1	$491.7
Relative Forecasting Error	1%	3%	8%	8%

This is where the use of the General Excise Tax (GET) comes into play. In the past few years, we have seen an increased tendency on the part of the legislature to treat the GET as an inexhaustible well that can be used to solve the state's fiscal woes. When it became clear that the cost of rail was going to outstrip its original projections, the immediate response was to raise and/or extend the rail surcharge. At least one proposal suggested making the surcharge permanent. Although a public outcry resulted in a more modest extension, the issue is far from dead. And the precedent has been set—the legislature is prepared to bump up taxes wherever possible in order to meet its spending commitments. The possibility of cutting spending is rarely discussed or seriously considered. When the projected expenditures continue to exceed projected revenues, Hawaii taxpayers should worry.

Table 3: Analysis of actual revenue and expenditure growth (FY 2004-2017)

FY	Actual Expenditures	Actual Revenues	Actual Revenues over Expenditures	Annual Expenditure Growth	Annual Revenue Growth	Expenditure Growth (Compounded Annual Growth Rate)	Revenue Growth (Compounded Annual Growth Rate)	Source
2004	$3,826,338	$3,860,456	$34,118					
2005	$4,157,011	$4,391,004	$233,993	9%	14%	8.6%	13.7%	CAFR
2006	$4,599,976	$4,905,322	$305,346	11%	12%	9.6%	12.7%	CAFR
2007	$5,051,054	$5,104,058	$53,004	10%	4%	9.7%	9.8%	CAFR
2008	$5,437,614	$5,204,747	-$232,867	8%	2%	9.2%	7.8%	CAFR
2009	$5,345,362	$4,824,278	-$521,084	-2%	-7%	6.9%	4.6%	CAFR
2010	$4,878,654	$4,811,699	-$66,955	-9%	0%	4.1%	3.7%	CAFR
2011	$4,939,928	$5,026,908	$86,980	1%	4%	3.7%	3.8%	CAFR
2012	$5,468,324	$5,641,054	$172,730	11%	12%	4.6%	4.9%	CAFR
2013	$5,618,100	$6,189,291	$571,191	3%	10%	4.4%	5.4%	CAFR
2014	$6,275,400	$6,096,200	-$179,200	12%	-2%	5.1%	4.7%	CAFR
2015	$6,189,200	$6,541,900	$352,700	-1%	7%	4.5%	4.9%	FY17 Supplemental Executive Budget
2016	$6,584,744	$6,723,500	$138,756	6%	3%	4.6%	4.7%	FY17 Supplemental Executive Budget
2017	$7,131,848	$7,086,100	-$45,748	8%	5%	4.9%	4.8%	FY17 Supplemental Executive Budget

Of course, taxpayers should already be worried about several large expenses that are not even contemplated in the multi-year plan. Take, for example, the recent court decision finding that the legislature has insufficiently funded the Department of Hawaiian Home Lands administrative and operating budget. The DHHL currently receives $9.6 million in general funds, but has requested $28 million. That's $19.2 million that needs to come from the general fund to meet the court's determination. And that may just be pennies compared to the obligations created by the ERS and EUTF.

Unfunded Liabilities and Beyond

Expiring collective bargaining agreements in FY 2016 could also mean an unaccounted-for expense for the state. The Senate Minority Office estimates that expenses related to the expiring agreements could cost the state as much as $85 million annually, based on the agreements' own payroll growth assumption of 3.5%.

Then there is the matter of the unfunded liabilities for the ERS and EUTF. The state's share of that is estimated to be approximately $14.9 billion, and the Governor and legislature have both pledged to reduce that number. Beginning in FY 2019, the state will be required by law to pay the full Annual Required Contribution for both the ERS and the EUTF—approximately $1.2 billion annually. The Governor has even taken the bold step of proposing to expedite the schedule and begin paying the ARC in FY 2017; he has also included a request for an additional $163.9 million for prefunding the EUTF.

Taking steps to reduce the state's unfunded liabilities is an important and a positive step. However, it is also important that the financial plan accurately reflect the possibility that actuarial valuation of the EUTF may change in light of a volatile health care market and the need to renegotiate state employee health insurance contracts as the collective bargaining contracts expire. Because the price of health insurance premiums has been rising, the assumption of an annual increase of 9% and 6.4% in health costs and premium increases may no longer be accurate. This is an area where a small difference can translate to tens of millions of dollars. One analysis estimates that as little as a 1% increase in health costs and premiums can translate to a 21% increase in the state's ARC, which would be $121 million.

Conclusion

What is needed to restore public trust in the government? The answer is surprisingly simple: transparency. This is even more important when public funds are at stake. The state's multi-year financial plan looks rosy enough on paper, but what is behind the numbers? Why has the state seemingly failed to take certain expenses and contingencies into account? Why ignore past spending growth as an indication of future expenditures? While we would like to believe that it represents a move towards fiscal responsibility and efficiently-run government, without the numbers to back it up, we are forced to wonder whether we are viewing an overly-optimistic calculation or the start of a broken promise.

Regardless of which is the case, Hawaii's taxpayers are the ones who will ultimately have to open their wallets if the state continues to overspend. They deserve to know what they're paying for.

Grassroot Institute of Hawaii
335 Merchant St., #3377
Honolulu, HI 96801
808-591-9193
info@grassrootinstitute.org