

TESTIMONY BY GEORGINA K. KAWAMURA
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE SENATE COMMITTEE ON WAYS AND MEANS
AND
THE HOUSE COMMITTEE ON FINANCE

January 5, 2009

Chairs Kim and Oshiro and Members of the Committees:

Thank you for this opportunity to present to you an overview of the State's financial condition.

The year 2008 will be remembered as a time of great economic challenge for Hawaii as well as for many parts of the world. At the national level, problems that arose last year in the housing sector and sub-prime mortgage market have been neither resolved nor contained. They weakened the foundation of the credit and financial markets to such an extent that real economic operations became seriously constrained by the lack of financing. The spreading adverse impact can be seen in business bankruptcies and closures, in lower consumer confidence and spending, and in job losses and rising unemployment. For state and local governments, the financial crisis and economic downturn have caused great hardship by reducing tax revenues at a time when operating costs continued to rise. As reported by the National Association of State Budget Officers, the majority of state governments in the United States currently face a significant shortfall in their budgets.

THE ECONOMY

Hawaii experienced exceptional economic growth in 2004, 2005 and 2006. When the economy leveled off in 2007, we had anticipated the slowdown and had developed cautionary, preemptive fiscal measures to keep State spending in check. What no one could reasonably

foresee was the unprecedented size and rapidity of the economic contraction that would occur at the national and global levels.

The negative impact of these external events on Hawaii has been felt in many sectors. In the first nine months of 2008, visitor arrivals declined 9.1% and visitor expenditures were down 7.4%. The construction industry had a slowdown from the peak of previous years with a reduction in building permits and job losses. The housing market has also shown weakness, although at a milder level than on the mainland. Contraction in these main industry sectors is affecting retail businesses and the services sector as well. Hawaii's unemployment rate rose above 3% for the first time in 2008 after three straight years of being in the 2% range and among the lowest in the nation. It is now at 4.9%.

The consensus among business, academic and government economists is that Hawaii's economy will experience no growth in 2009 and may go through a further, deeper contraction before improvements can be expected. However, there are a number of encouraging factors. Important federal and military expenditures in Hawaii continue to provide a measure of stability for the local economy. Inflation is moderating. Oil prices have declined significantly, resulting in lower energy costs. And the commitment of the new federal administration to provide substantial financial assistance to the states in the coming months is welcome news. Also on the positive side is the Administration's plan for a major capital improvement initiative to aggressively implement between January 2009 and June 2010 \$1.8 billion of currently authorized projects.

REVENUE PROJECTIONS

Actual general fund tax collections in the first five months of FY 09 (July to November) declined by -2.6% over the same period in the previous year.

At its most recent meeting on October 29, 2008, the Council on Revenues projected that general fund revenues would decrease by -0.5% in FY 09 and increase by 3.5% in FY 10 and by 4.5% in FY 11. Revenue growth for the four out-years is currently projected to be in the range from 5.3% to 6.5%. To put these numbers in perspective, it is helpful to look at past revenue increases. General fund tax revenues increased by 8.3% in FY 04, 16.0% in FY 05, 10.9% in FY 06, 3.4% in FY 07, and 1.2% in FY 08. Clearly, lower revenue growth has resulted from the economic moderation in recent years, and negative growth rates are the fiscal reality we face in the current year.

In addition to a smaller revenue base, we have had to respond to successive reductions in revenue forecasts by the Council throughout 2008. For the current FY 09, the estimates were revised from an increase of +4.1% (as projected in January 2008) to a decrease of -0.5% (as of October 2008). This translates to a reduction of \$411.7 million in projected tax revenues over a 10-month period. The cumulative effect of these successive reductions in revenue estimates for FYs 09, 10 and 11 is a substantial decrease in the amount of money that the State can expect in the immediate and near future. Given the level of spending that had been authorized by the 2008 Legislature and the anticipated rising cost of government operations, it was clear that our revenues and expenditures were out of balance. Without immediate corrective action, the projected cumulative budget shortfall from general funds would amount to \$1.1 billion by the end of FY 11.

Further, we are concerned that revenue projections may be reduced again due to continuing economic weaknesses in Hawaii as well as on the mainland U.S. and around the world. The Council will meet later this week on January 9, 2009. Certainly, we will need to address any new revision to the revenue numbers, and we stand ready to work with you in this

session to develop the necessary and appropriate actions to bring the budget into balance, as required by the State Constitution.

ACTIONS TO RESTORE FISCAL BALANCE

Six months ago, we approached FY 09 with caution. While the economic environment at that time did not seem as troubling as it does now, we saw the need for immediate steps to control spending, reduce expenses, and economize general funds. Actions to bridge the budget gap in FY 09 included the following:

- Implement a 4% restriction on discretionary general fund expenses (\$34.6 million).
- Establish a general hiring freeze except in areas that impact public health and safety. (The savings are part of the restrictions.)
- Restrict allotment for most off-budget, specific appropriations (\$19.1 million).
- Restructure debt on general obligation (G.O.) bonds (\$95.0 million).
- Adjust the bond issuance plan (\$9.8 million).
- Restrict and convert cash CIP to bond financing for the Department of Education (DOE) (\$50.0 million).
- Restrict and convert cash CIP to bond financing for the University of Hawaii (UH) (\$12.5 million).

In total, these actions produced \$221 million in general fund savings. However, with continuing reductions to FY 09 revenue projections, we anticipate the need for a transfer of \$40 million from the Emergency and Budget Reserve Fund, Hawaii's rainy day fund. The combination of these measures will enable us to maintain a positive balance in the General Fund at the end of FY 09.

The restrictive budget execution policies for FY 09 were the first phase of a coordinated plan to reshape the State Budget and redirect the commitment of public resources. We believe that the current fiscal environment can be an opportunity for State government to become more focused and efficient. This is the foundation upon which the Executive Budget for FB 2009-11 was developed.

As an integral part of budget preparation, departments and agencies were directed to conduct a critical review and assessment of their core functions and essential services. Budget ceilings were established and funding requirements were adjusted to meet revenue constraints. Departments were instructed to develop and submit their budget requests at three levels corresponding to mandatory reductions of 10%, 15% and 20% of their current discretionary expenses. These contingency plans were designed to prepare for further adjustments, as necessary, if revenue conditions worsened.

The result is a biennium budget that reduces operating costs by a net general fund total of \$395 million (\$209 million in FY 10 and \$186 million in FY 11). While special funded programs were not subjected to mandatory reductions, they, too, are required to operate under a ceiling.

Executive Budget proposals for FB 2009-11 were developed to meet the following objectives:

1. **Align program requirements with appropriate means of financing.** We identified programs and activities that should be funded with revenue sources other than general funds. As a result, 64 existing positions and related program expenses are proposed to be funded from federal, special, revolving, or trust funds. General fund savings amount to \$20 million each year.

2. **Continue to restructure and refinance G.O. bond debt.** Debt restructuring has been an important tool of fiscal management as we seek to find market opportunities for reducing the debt service costs of the State's borrowing program. We plan to aggressively pursue debt restructuring in the coming months as uncertainty in the credit markets abates. Total reduction in debt service costs that will result from refinancing and restructuring current G.O. debt is estimated to be \$205.2 million in the biennium.
3. **Reduce operating costs to meet mandatory budget cuts and preserve essential services of State government.** The need to understand what government can and should do is heightened at a time when resources are severely limited. The necessity of having to set priorities in the budget gives clarity to our collective goals. For the fiscal biennium, substantial cuts were made across the board as well as in targeted areas. The overall reduction from general funds amounted to 14% of discretionary costs and was achieved through consolidating operations, eliminating non-essential or newly added services, eliminating programs of low priority, and modifying levels of benefits and services. In the coming weeks, the individual departments will have an opportunity to discuss the specific adjustments in their programs when they come before you to present their biennium budget requests.
4. **Minimize cuts in areas of strategic importance to Hawaii.** While budget reductions were unavoidable in this severe economic downturn, we maintained strong support for the critical investments that must be made to build a stronger foundation for Hawaii's future. Public education and clean energy initiatives are two of the highest priority areas. Budget recommendations for the DOE reflect the reductions that were proposed by the Superintendent and approved by the Board of Education. Total general fund reductions amount to \$40 million each year and a decrease of 240 positions (148 permanent,

92 temporary). The proposed cuts are mainly from the State and district levels, support services, and categorical programs and do not affect any of the classroom teaching positions. A conscious effort was made to minimize impacts at the school level.

The same concern was extended to the UH. General fund reductions of \$13.5 million each year, as approved by the Board of Regents, are recommended for the biennium. At this level, the cuts are not expected to affect core instructional activities.

5. **Minimize negative impact on our employees.** In making the necessary program cuts, we were aware of and sensitive to the impact that these budget reductions would have on the welfare of our State employees. At a time when businesses are cutting payroll and laying off workers, government should not be adding to the unemployment rolls. We are committed to the goal of no layoffs for State employees and are able to meet this goal for the fiscal biennium.

In light of the State's current economic and fiscal condition, we will not propose pay increases for our employees in the current collective bargaining negotiations.

Additionally, as indicated by the Governor, legislation will be introduced to recommend the deferral of authorized pay raises for officers of State government, including the Executive Branch, the Judiciary and the Legislature.

For FB 2009-11, the capital improvement plan is focused on an expanded Major Repair and Maintenance Program to implement projects quickly to address the current backlog and stimulate Hawaii's economy. We again seek a major infusion of G.O. bond funds to build more rental and for-sale affordable housing. Priority was given to projects currently in progress or nearing completion. Projects that improve energy efficiency or contribute to the development of clean energy alternatives for Hawaii also received support. We will continue to move forward with the modernization of the State's airports and harbors.

ADDITIONAL PROPOSALS TO RESTORE FISCAL BALANCE

Under the prevailing economic and financial conditions, our revenue gap of \$1.1 billion cannot be closed by budget reductions alone. Further cuts to programs may prove unproductive and destabilizing at this time when public spending and employment are a necessary stabilizing force for the economy. Therefore, to supplement reductions in the budget, we propose the following actions to provide the State with additional resources at this critical time:

1. Transfer from the Emergency and Budget Reserve Fund (EBRF). The rainy day fund was established to address the exact kind of economic difficulties we are facing in this downturn, a condition that may continue through 2010. The current balance in this fund is \$74 million. As stated earlier, a transfer of \$40 million to the General Fund for FY 09 will be proposed through an emergency appropriation bill to be submitted in the 2009 Legislative Session. To help close the revenue gap in FB 2009-11, an additional transfer of \$35 million for FY 10 is recommended. With annual deposits coming from the Tobacco Settlement Fund, the EBRF will continue to accumulate additional reserves and the fund balance is projected to be \$15.7 million at the end of FY 11.
2. Transfer of excess balances from special funds. As a short-term, one-time remedy, we propose to transfer excess balances from two special funds into the General Fund. The amounts will be \$36 million from the Deposit Beverage Container Special Fund and \$9 million from the Wireless Enhanced 911 Special Fund. We are cognizant of the recent decision by the Hawaii Supreme Court on the issue of special fund transfers to the General Fund and assure you that our proposal will proceed based on current law and with advice of the Attorney General.

3. Tax proposals. To support the Administration's goal of making Hawaii's tax system efficient and equitable, a number of proposals will be submitted to tighten up tax laws, improve tax collection and administration, and reduce excessive tax credits. We propose to conform to the federal Internal Revenue Code for accuracy-related penalties, establish a special enforcement section to monitor the cash economy, and tighten Act 221 investment tax credits to conform to the federal tax code. These efforts are expected to add \$122 million to our tax collections in the biennium.

THE GENERAL FUND FINANCIAL PLAN

The Multi-Year General Fund Financial Plan is presented in Attachment 1. The General Fund balance was \$331.2 million on June 30, 2008 and is estimated to be \$42.5 million on June 30, 2009.

The General Fund Six-Year Financial Plan encompassing FB 2009-11 and the four subsequent years shows a positive balance in each fiscal year. Under the constraint of declining revenues, as projected by the Council on October 29, 2008, these positive balances were achieved from the following combination of actions:

- Executive Branch budget reductions and adjustments as proposed;
- Assumed comparable budget reductions from other branches of State government, including the Judiciary, the Legislature and the Office of Hawaiian Affairs; and
- Legislative approval and authorization for Administration proposals with revenue and expenditure impact.

We recognize that further adjustments to the General Fund Financial Plan may be required by new revenue projections and/or by other critical developments in the economy. I look forward to our collaboration as we work together in the coming months to meet this challenge.

I would like to add that the State's disciplined approach in managing its budget has been favorably recognized by all three major credit rating agencies, even in these difficult times. In their latest November 2008 reports, they affirmed the State's G.O. bond ratings of Aa2, AA and AA, respectively. These strong ratings reflect their assessment that Hawaii State government has consistently displayed prudence and discipline in its fiscal management and governance.

THE EXECUTIVE BUDGET RECOMMENDATIONS

THE OPERATING BUDGET

For FB 2009-11, total operating budget requests from all means of financing amount to \$11.1 billion in FY 10 and \$11.3 billion in FY 11.

<u>Means of Financing</u>	<u>FY 09 Allocation</u> (\$million)	<u>FY 10 Request</u> (\$million)	<u>FY 11 Request</u> (\$million)	<u>FB 2009-11 Request</u> (\$million)
General Funds	5,484.9	5,361.3	5,464.0	10,825.3
Special Funds	2,145.8	2,431.9	2,482.3	4,914.2
Federal Funds	1,730.5	1,746.5	1,750.5	3,497.0
Private Contributions	0.4	0.4	0.4	0.8
County Funds	0.7	0.7	0.7	1.4
Trust Funds	76.9	89.6	92.7	182.3
Interdept. Transfers	1,161.2	1,085.1	1,125.1	2,210.2
Revolving Funds	376.0	381.9	380.9	762.8
Other Funds	<u>15.9</u>	<u>12.9</u>	<u>12.9</u>	<u>25.8</u>
Total	10,992.3	11,110.3	11,309.5	22,419.8
Change from FY 09 allocation		\$118.0 m	\$317.2 m	
Percentage change		1.1%	2.9%	

The "Budget in Brief" (Attachment 2) provides summary details of the Executive Budget. Distribution of the Operating Budget by funding sources and by departments is presented on pages 4 through 9. Highlights of the Operating Budget by departments are presented in the sections that follow, starting on page 17.

General Fund

Total requests from the General Fund amount to \$5.36 billion in FY 10 and \$5.46 billion in FY 11. These amounts represent a decrease of \$123.6 million (-2.3%) in the first year and \$20.9 million (-0.4%) in the second year over the current FY 09 allocation level.

It should be noted that the general fund budget bases for FY 10 and FY 11 were projected (as of June 30, 2008) to be at higher levels (\$5.57 billion and \$5.65 billion, respectively) due to anticipated increases in operating expenses. Therefore, when compared to these base levels, the proposed budget recommendations represent a reduction of \$209.3 million (-3.8%) in FY 10 and \$186.1 million (-3.3%) in FY 11.

Change in Positions

The Executive Budget requests a significant change in the number of permanent and temporary positions from all means of financing.

	<u>Total FY 10</u>	<u>Permanent</u>	<u>Temporary</u>
Total net change in positions	(479.42)	(185.92)	(293.50)
By means of financing:			
General Funds	(578.72)	(282.97)	(295.75)
Special Funds	86.30	76.30	10.00
Federal Funds	(0.50)	8.75	(9.25)
Trust Funds	.....	3.00	(3.00)
Interdept. Transfers	(1.00)	0.50	(1.50)
Revolving Funds	14.50	8.50	6.00
Other Funds	.....	.....	.....

The request for FY 11 changes with an additional 16 permanent positions from special funds.

The biennium budget proposes a reduction of 579 general funded positions; among these, 283 positions are permanent and 296 are temporary. The reductions are mainly from

vacant positions, except for 240 positions in the DOE. According to the DOE, no classroom teaching position is affected and the incumbents are expected to be assigned to other programs within the Department.

Changes in positions funded from non-general fund sources reflect a net increase of 99 positions (97 permanent and 2 temporary), including the 64 positions previously paid for from general funds.

THE CAPITAL IMPROVEMENT (CIP) BUDGET

For FB 2009-11, total requests for capital improvements amount to \$1.4 billion in FY 10 and \$1.6 billion in FY 11, to be funded from the following sources:

<u>Means of Financing</u>	<u>FY 10 Request (\$million)</u>	<u>FY 11 Request (\$million)</u>	<u>FB 2009-11 Total (\$million)</u>
General Funds	.....	.....	.....
Special Funds	112.6	87.4	200.0
G.O. Bonds	443.0	444.3	887.3
G.O. Reimbursable	22.1	45.8	67.9
Revenue Bonds	488.5	785.8	1,274.3
Federal Funds	323.3	138.2	461.5
Private Contributions	4.7	.....	4.7
County Funds	.....	.....	.....
Interdept. Transfers	2.0	.....	2.0
Other Funds	<u>5.6</u>	<u>49.6</u>	<u>55.2</u>
Total	1,401.8	1,551.1	2,952.9

Of these amounts, the request for G.O. bonds, including reimbursable issues, is \$465.1 million in FY 10 and \$490.0 million in FY 11. Distribution of the CIP Budget by funding sources and by departments is presented on pages 10 through 15 of the "Budget in Brief." Highlights of the CIP program by departments are presented in the sections that follow, starting on page 17.

THE MANDATORY TAX REFUND/CREDIT

Section 6 of Article VII of the Hawaii State Constitution provides for a mandatory tax refund or tax credit if the general fund balance exceeds 5% of general fund revenues at the end of two succeeding fiscal years. For FYs 07 and 08, the ratios were 9.6% and 6.3%, respectively, and thus met the constitutional criteria. The Legislature will need to consider the enactment of legislation in this 2009 Session to comply with the mandatory tax refund/credit as stipulated by the State Constitution.

THE GENERAL FUND EXPENDITURE CEILING

By law, general fund appropriations must comply with the expenditure ceiling requirements that are set forth in Section 9, Article VII of the Hawaii State Constitution and Section 37-92 of the Hawaii Revised Statutes.

At the aggregate level, including all branches of government, total proposed appropriations from the General Fund are within the expenditure ceilings for both FY 10 and FY 11.

For the Executive Branch, total proposed appropriations from the General Fund (which include the Executive Budget for FB 2009-11 and other specific appropriation measures to be submitted) are also within the Executive Branch's appropriation ceilings for both FY 10 and FY 11.

A summary statement on the General Fund Expenditure Ceiling and Executive Branch Appropriation Ceiling is included in Attachment 3.

THE DEBT LIMIT

Section 13, Article VII of the Hawaii State Constitution places a debt limit on G.O. bonds that may be issued by the State. The limit requires total debt service (principal and interest payments) not to exceed 18.5% of average general fund revenues. It has been

determined that the total amount of principal and interest calculated on: a) all bonds issued and outstanding; b) all bonds authorized and unissued; and c) all bonds proposed in the Executive Budget, including State guaranties, will not cause the debt limit to be exceeded at the time of each bond issuance.

The Declaration of Findings with respect to the G.O. bond debt limit is included in Attachment 4.

In closing, I want to thank you again for the opportunity to make this presentation. As always, we will work with you on an ongoing basis during the 2009 Session to address issues related to the Executive Budget and the General Fund Financial Plan.

Attachments

UNIVERSITY OF HAWAII

Department Summary

Mission Statement

To serve the public by creating, preserving, and transmitting knowledge in a multi-cultural environment.

Department Goals

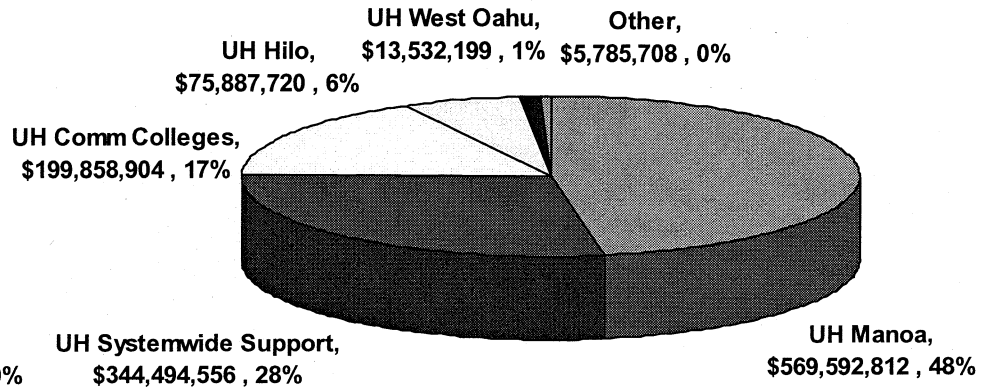
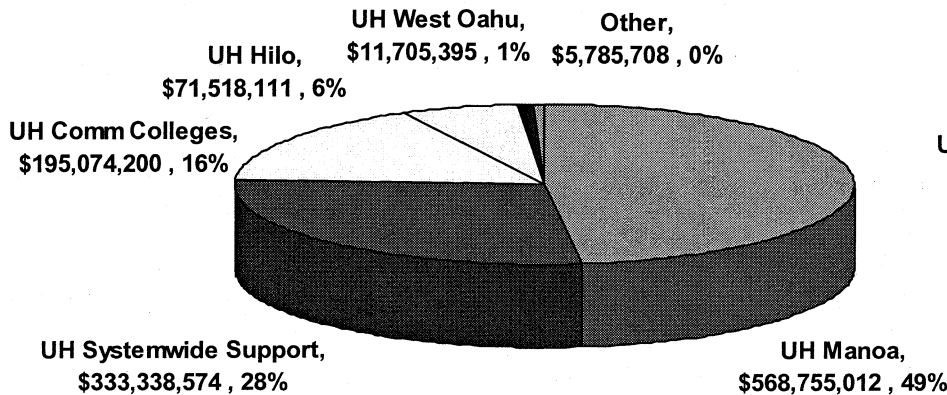
To achieve educational effectiveness and student success; provide a learning, research, and service network; be a model local, regional, and global university; maximize investment in faculty, staff, students, and their environment; and provide resources and stewardship.

Significant Measures of Effectiveness

	<u>FY 2010</u>	<u>FY 2011</u>
1. Percentage of degrees granted to freshman four years ago	70	70
2. Percentage of graduates entering UH graduate schools	14	14
3. Course completion ratio of undergraduates	96	96

FB 2009-2011 Operating Budget by Major Program Area

FY 2010
FY 2011



UNIVERSITY OF HAWAII MAJOR FUNCTIONS

- Provides instruction, research and public service in the fields of the liberal arts and sciences, agriculture, professional education, medicine, law, health sciences, business administration, engineering sciences and such other branches of the higher learning as the Board of Regents prescribes.
- Administers and operates a system of community colleges; coordinates academic programs which include college transfer, general education, vocational, technical, semi-professional, and continuing education programs; coordinates community service programs with the various campuses, community agencies and groups; and coordinates student-related programs and services.
- Operates a summer session which gives variety and flexibility to the instructional programs of the University; provides college-level instruction to students who wish to obtain it during the summer; accommodates teaching institutes, workshops, and special courses with schedules of varying lengths; sponsors lecture series and other cultural events during the summer and supervises overseas study tours offered for credit.
- Provides key personnel in the government policy-making process with timely research, analyses and data concerning governmental and related problems to enable them to make informed decisions among alternative courses of action.
- Participates in intercollegiate athletics programs for men and women; contributes toward the availability of non-academic cultural, social, recreational and intellectual programs made available to the students, faculty and community at large; and provides a limited intercollegiate program for a variety of minor sports.

MAJOR PROGRAM AREAS

The University of Hawaii has programs in the following major program areas:

Formal Education

UOH 100 University of Hawaii, Manoa
UOH 210 University of Hawaii, Hilo
UOH 220 Small Business Development
UOH 700 University of Hawaii, West Oahu
UOH 800 University of Hawaii, Community Colleges
UOH 900 University of Hawaii, Systemwide Support
UOH 915 Debt Service Payments - UH

UOH 941 Retirement Benefits Payments – UH
UOH 943 Health Premium Payments – UH
UOH 973 Risk Management Payments – UH

Culture and Recreation

UOH 881 Aquaria

University of Hawaii
(Operating Budget)

	Positions	Allocation		
		FY 2009	FY 2010	FY 2011
Funding Sources:		6473.59	6474.09	6474.09
General Funds	\$	734,255,078	718,083,786	729,339,768
		453.25	467.25	483.25
Special Funds		327,762,307	352,419,905	364,156,822
		97.66	97.66	97.66
Federal Funds		11,014,028	11,264,761	11,264,761
		150.75	150.75	150.75
Revolving Funds		99,521,056	104,408,548	104,390,548
		7,175.25	7,189.75	7,205.75
Total Requirements		1,172,552,469	1,186,177,000	1,209,151,899

Major Adjustments in the Executive Budget Request: (general funds unless noted)

1. Deletes \$3,000,000 each year in electricity expenditures by implementing conservation measures, and \$2,253,523 each year by deferring filling of vacant positions at UH Manoa.
2. Deletes \$812,573 by deferring filling of vacant non-teaching regular positions, non-regular casual hires, and overloads; and reducing other current expenses at UH Hilo.
3. Deletes \$127,504 by deferring filling of vacant instructional positions at UH West Oahu.
4. Deletes \$854,446 for electricity by implementing conservation measures, and \$500,000 each year for enrollment growth at UH Community Colleges.
5. Deletes \$984,684 by deferring filling of vacant positions, and reducing casual/temporary personnel, lecturer replacements, SAT and COMPASS test-preparation courses, campus security services, and other current expenses at UH Community Colleges.
6. Deletes \$700,703 by deferring filling of vacant positions and reducing other current expenses for information technology, human resources, fiscal, student affairs, and academic support services for UH System-wide.

7. Deletes \$4,254,311 by transferring funding for general fund program expenditures to special, revolving, federal, or other available sources of funds at UH.
8. Deletes \$15,582,409 in FY 10, and \$11,806,444 in FY 11 for debt services payments.
9. Adds \$1,023,398 in FY 10, and \$1,329,119 in FY 11 for retirement benefits payments.
10. Adds \$5,391,000 in FY 10, and \$5,491,000 in FY 11 to support STEM and innovation initiatives at UH.

University of Hawaii
(Capital Improvements Budget)

	<u>FY 2010</u>	<u>FY 2011</u>
Funding Sources:		
General Obligation Bonds	75,000,000	75,000,000
Revenue Bonds	6,700,000	85,800,000
Total Requirements	81,700,000	160,800,000

Highlights of the Executive CIP Budget Request: (general obligation bonds unless noted)

1. Provides \$75,000,000 each year to be allocated at UH's discretion for health and safety projects, capital renewal projects, and projects with appropriated construction funds that require equipment.
2. Provides revenue bond funds of \$1,700,000 in FY 10 and \$20,800,000 in FY 11 to develop an addition to the Biomedical Sciences Building at UH Manoa.
3. Provides revenue bond funds of \$5,000,000 in FY 10 and \$65,000,000 in FY 11 to develop and expand faculty housing at UH Manoa.