

*Hawaii's Economy &
the State's
"Ability to Pay"
Public Sector Salaries*

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This is a brief update for UH faculty on the status of the economy and the state's financial condition. I have written this so faculty can work their way through various claims which have been made and arrive at reasonable conclusions concerning our own contract. Our public dialogue concerning the status of the state's economy and its finances has been incredibly poor, and unnecessarily confusing, due to the propaganda of special interest groups. I've included two cartoons on the cover of this report which reflect public attitudes about the state's public finances. In one, printed at the time of the gubernatorial election, Governor Waihee welcomes Ben Cayetano and Mazie Hirono with an empty money sack and a big pig labeled state government. In the other, printed right after the Death of Education march, radical, apparently irrational students demanding a "first class education" face President Mortimer who suggests that they failed economics.

In terms of this last cartoon one should consider a slightly different formulation: can the state afford not to have a first class higher education system. The cartoonist, along with the public, dismisses the argument that higher education and the development of a first class research institution is a necessity. The underlying assumption is that a "first class" higher educational system is a luxury that can be easily cut when there is a fiscal crisis. On the other hand, something like new prison facilities are a necessity that must be paid for no matter what. When one understands the public's attitude clearly then the inescapable conclusion is that the budget cuts effecting the University are not rooted in "economics" but in priorities.

Because of this I feel that I must begin at the beginning and work my way through to the status of our contract. I apologize in advance for the length of what would normally be a brief document but I assume we all are used to reading longer, and perhaps even more boring pieces. I have broken this down into the following sections; the size of state government, the problem with the state's constitution, short and long term trends in the Hawaiian economy, and the economic condition of UH faculty.

The Size of State Government

The grossest misunderstanding about the state's financial condition has to do with the size of state government. Often, in editorials in the two major newspapers these two issues are combined; the state's fiscal crisis means this would be an ideal time to cut state government. If state government is too large then a potential shortfall can be easily made up by cutting expenditures, and these cuts will not be very painful.

This is part of the propaganda put out by The Tax Foundation, The Chamber of Commerce, and other groups. Specifically they say that Hawaii has the largest number of "state employees" of any state in the United States. This at best is a half truth. It is true Hawaii has the highest rate of per capita state employment. Hawaii, however, has many state employees who are county employees in other states. These employees include lower education teachers, airport workers and others. If one compares state and local public employment Hawaii ranks sixteenth. This is important for faculty because if one wanted to reduce the "size" of government the bulk of bodies, and a large proportion of state expenditures, are in higher and lower education. The question I think for many who understand this has been is the states fiscal crisis being exaggerated in order to meet this agenda?

Hawaii's System of Public Finance

Hawaii's public finances are determined first of all by the state's constitution and secondly by the evolution of various taxes and expenditures. The state constitution is unusual in that it has a "super" balanced budget provision rather than the normal one. Specifically Article 6. Section 6. of Hawaii's Constitution states

Whenever the state general fund balance at the close of each of two successive fiscal years exceeds five percent of general fund revenues for each of the two fiscal years, the legislature in the next regular session shall provide for a tax refund or tax credit to the taxpayers of the state, as provided by law.

In Article 6. Section 5. the constitution states

General fund expenditures for any fiscal year shall not exceed the State's current general fund revenues and unencumbered cash balances.

Article 6. Section 7. establishes the Council on Revenues to estimate these tax revenues.

Finally to be doubly (triple?) sure that the budget was balanced Article 6. Section 9 establishes that the

legislature shall establish a general fund ceiling which shall limit the rate of growth of general fund appropriations, excluding federal funds received by the general fund, to the estimated rate of growth of the State's economy as provided by law.

In other words the projections for the general fund must match projections for growth in the economy as a whole. The general fund must grow and shrink at the same rate as the economy.

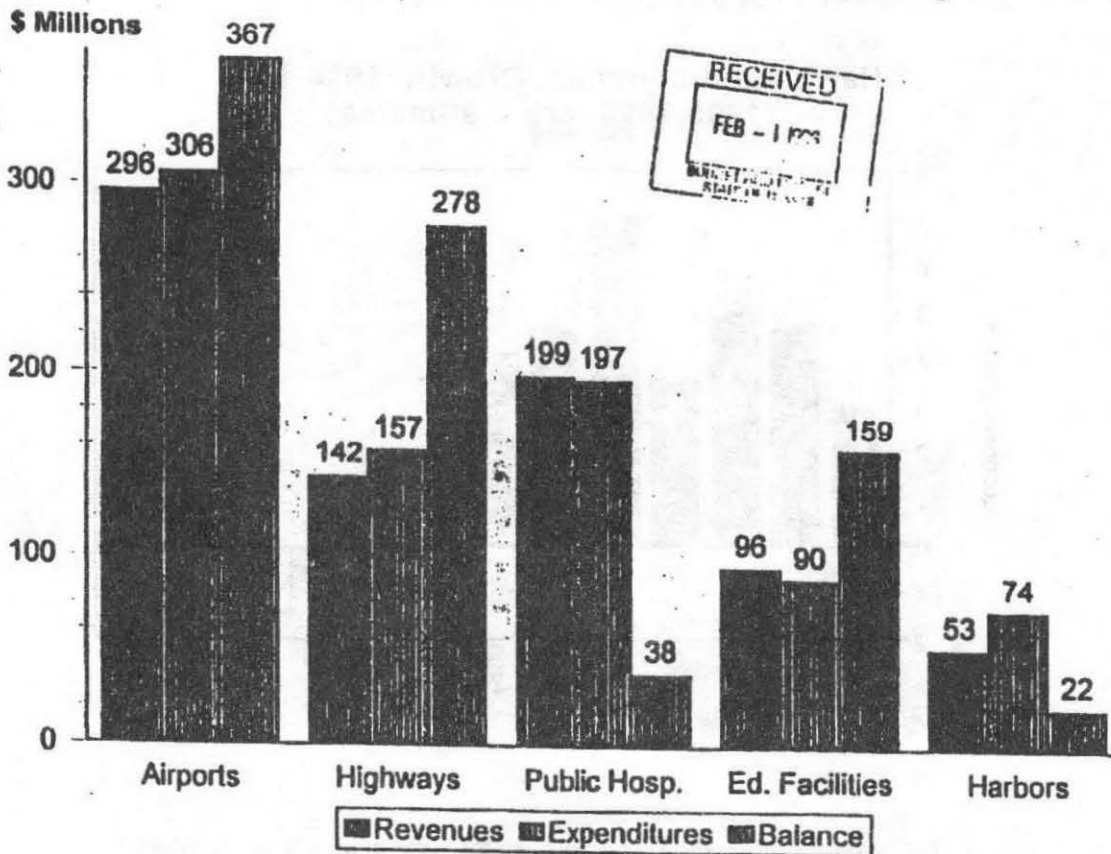
To sum up the State's Constitution mandates its general fund:

- 1) Can never run a deficit.
- 2) Can never have a surplus above 5 percent after two years.
- 3) Must grow, and shrink, at the same rate as the economy.

Point number one is a normal balanced budget provision. The second two points mean the state can neither save nor counteract shocks to its economy through increasing construction expenditures during periods of slow economic growth. It means during periods of normal economic growth the state must spend what it receives through tax rebates or appropriations. This, as we have seen above, drives down the unemployment rate below the full employment rate and drives up inflation. It also means that the state must short circuit programs which tend to stabilize the economy such as unemployment and welfare assistance (entitlements) with cuts. These have the effect of pushing the economy away from full employment for prolonged periods of time.

In practice these provisions provide an incentive not only to spend general fund revenues quickly it also means that general fund revenues are taken out of the general fund and placed in other funds. Below I have charted the State's major special funds along with their balances. **If the state budget was taken as a whole it would show a one billion dollar surplus.**

Major Special Funds-FY 1995 Preliminary



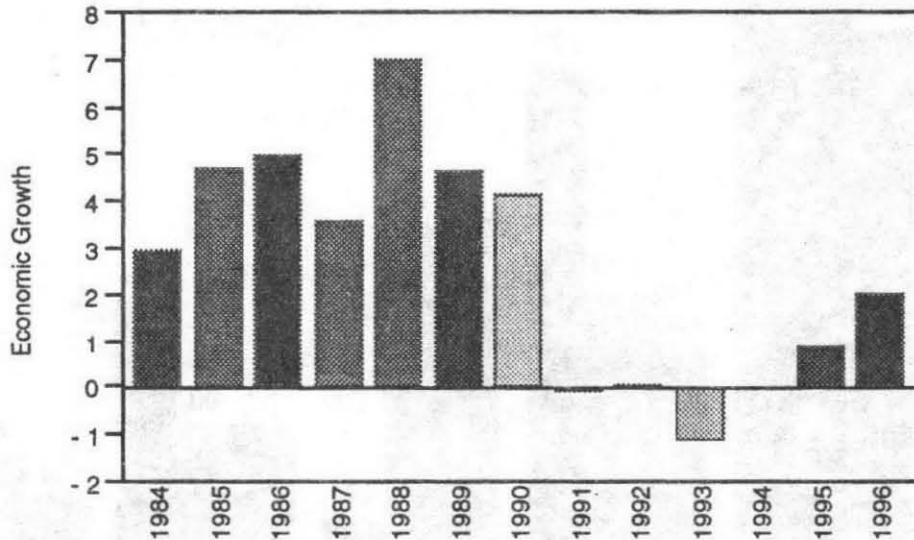
We should add to these constraints the informal constraint claimed by the employer that the state must maintain a 5 percent balance for bond rating purposes. If we take all of these provisions together it would make it virtually impossible for any public employee to ever receive a raise at any point in the business cycle. The state can never run a surplus beyond five percent, progressively less and less funds are left in the general funds, general fund expenditures grow and shrink with the economy (or projections made of economic growth), and the state is constitutionally committed to prolonging periods of economic bust.

Short Term Trends in the Hawaiian Economy

There is no question that Hawaii has had stagnant growth between 1991 and 1994. The initial GSP numbers have not been reported yet for 1994 but the initial

numbers appear to be in the 1 percent range. The chart below reports the percent change in GSP between 1984 and 1994.

Hawaiian Economic Growth 1984-1996
(1995,1996 are estimates)



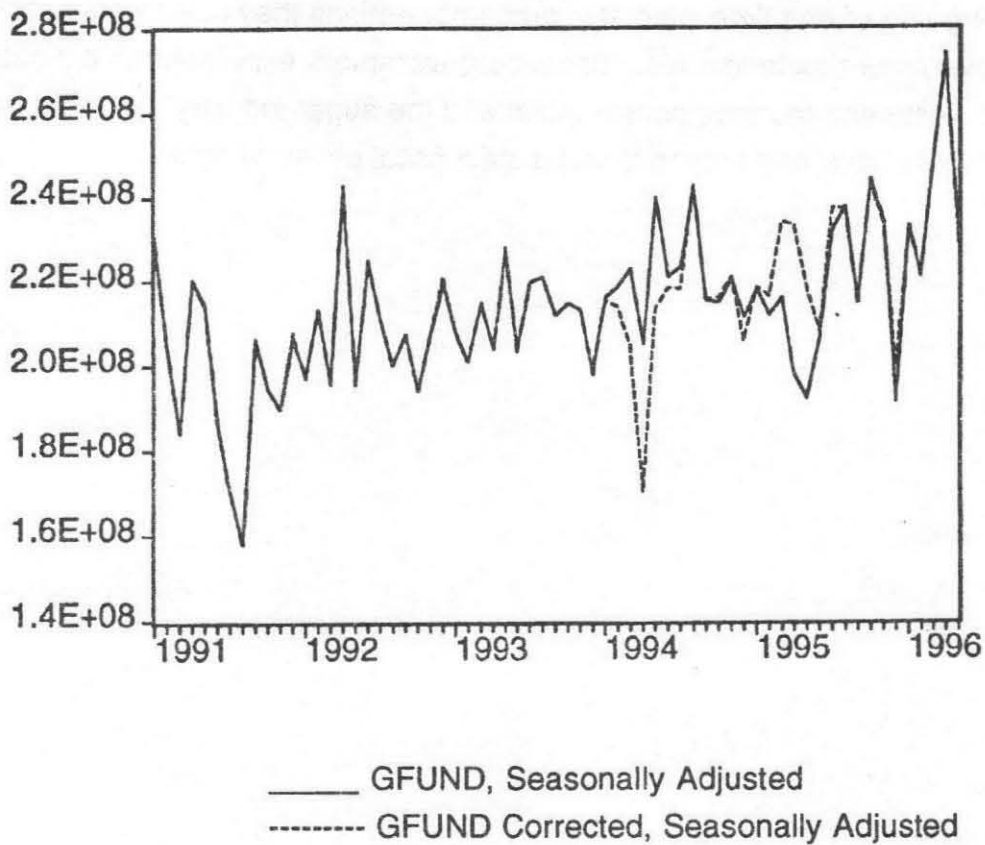
Estimates are based on mean growth for 1995 across three quarters, 1996 consensus forecasts and experience indicate 2 percent growth.

As can readily be seen the state's economic crisis peaked in 1993 with a recession, while 1994 actually had a small negative decline as well. Recovery began in 1995 with mild growth, yet this was the fiscal year when the state's financial crisis struck.

Part of the reason for this anomaly is that the state changed the withholding rates on income taxes from 8 percent to 10 percent in FY 1994. Since the average withholding rate on income taxes is 8 percent the state paid this back in FY 1995. This amounted to approximately \$85 million dollars and was what drove the state's fiscal crisis for FY 1995 and 1996. The overall effect of this policy made FY 1994, the year that the Hawaiian economy bottomed out, appear better than it was. While the state's fiscal crisis was backloaded to 1995, and has effected a promising recovery. I have made a seasonal adjustment and "corrected" tax revenues in the chart below. What the chart indicates is we would have had a serious fiscal crisis in 1994, while 1995 would have had a dramatic improvement in tax revenues. The real world does not

function so neatly. If the state had actually combined a fiscal crisis with its economic crisis we might still be climbing out of a very deep hole. Similarly, the fiscal crisis from 1995 has continued to effect peoples expectations about the economy.

Tax Revenues, Actual Collections Seasonally Adjusted and Compared With Correction for Excess Withholding .



The shortfall which occurred in FY 1995 should have occurred in FY 1994. The anticipated shortfall, the publicity around the state's fiscal crisis, and to a certain amount the actions the state was forced to take in 1995 had a profound effect on economic activity in 1995. Publicity surrounding the shortfall, the unknown effects of state actions and cuts in construction expenditures by the state affected consumer confidence and dampened consumption expenditures. Direct cuts in government expenditures, especially construction expenditures, had a multiplier effect on the real economy further reducing growth.

There were shocks to the economy in 1991, 1992, 1993 and 1994 which included respectively, the Persian Gulf War, a mainland recession, recession in Japan, the collapse of direct investment from Japan, an actual decline in visitors in 1993 and

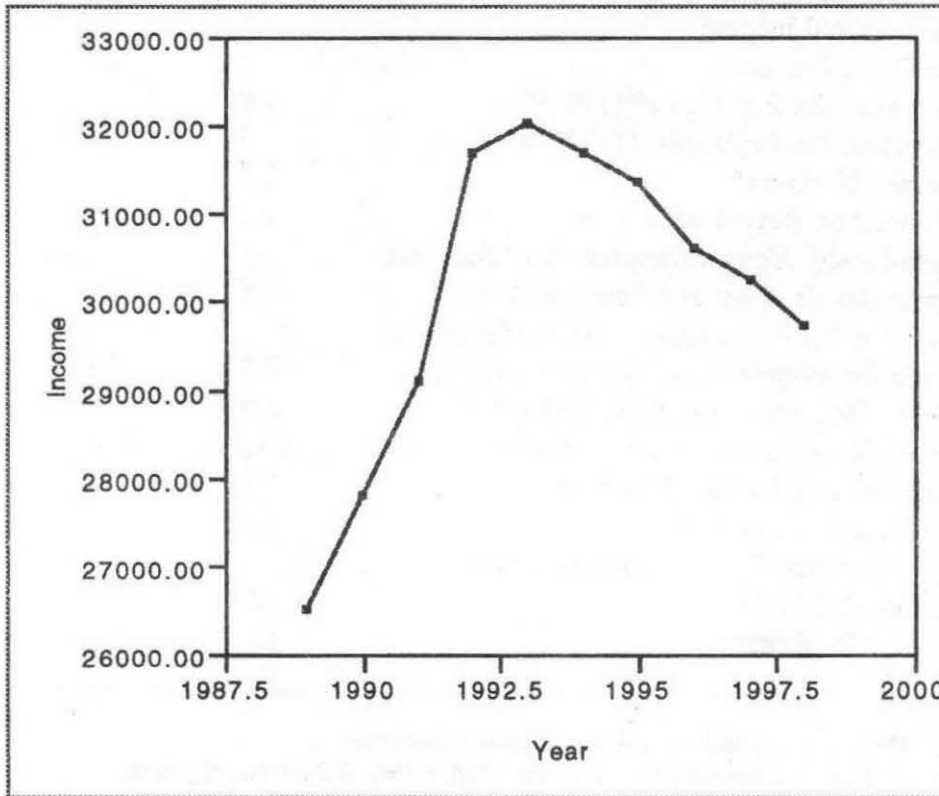
1994, and the collapse of the sugar and pineapple industry in 1993 and 1994. Considering these shocks it is a wonder the economy performed as well as it did. To these one must add the "after-shock" of the state's financial crisis in 1995.

Given the procyclical fiscal policy (described above) imposed by the state's constitution, Hawaii's legislature and the executive branch should be given high marks for ameliorating what could have been a worse disaster. Through emptying out special funds, making use of one time windfalls, and other actions they used state surpluses to maintain government expenditures. Because government expenditures did not shrink along with investment, tourism, consumption and the sugar industry, GSP did not fall as far as it would have had they followed a strict fiscal conservatism.

The Economic Condition of University of Hawaii's Faculty

It appears that many faculty at UH are concerned first of all for their institution, the library, their students, and their research. Concerns about salary might appear selfish but they are also integral to the institution. Faculty can leave and UH competes for faculty at a national and international level. Loss of faculty in the late eighties and early nineties led the Waihee administration to increase faculty salaries at a 7 percent rate over 4 years. Since that contract has expired there have been no wage increases and the effect of that has been the erosion of faculty's salaries through inflation. Below I have plotted a typical salary and adjusted it for inflation.

Income of an Entry Level Nine Month Faculty Adjusted For Inflation



UHPA has proposed a series of step increases that would keep faculty pay at the same level as currently exists. The total cost of this item is in the thirteen million dollar range. It was proposed that this could be paid out of the tuition increase. The administrations response was that the money from the tuition increase needed to go to maintenance.

All of the other major unresolved issues are non-cost items.

Below I include a table of various forecasts for the Hawaiian economy.

Hawaii Real Gross Product Growth Rate Forecasts

Annual percent change; details as noted

Source	1996	1997
Carl Bonham, Byron Gangnes and James Mak <i>UH Department of Economics (1995)**</i>	1.7	
Carl Bonham and Byron Gangnes <i>UH Department of Economics (1996):†</i>		
Real Personal Income	1.2	2.2
Real Gross Product	1.3	2.3
Paul Brewbaker, <i>Bank of Hawaii (1995)*</i>	1.0	
Paul Brewbaker, <i>Bank of Hawaii (1996)†</i>	1.3	2.5
Randy Havre, <i>JB Havre*</i>	1.5	
Hawaii Council on Revenues ^o	2.0	
Pearl Imada-Iboshi, <i>Hawaii Department of Business, Economic Development and Tourism (1995)*</i>	2.5	
Pearl Imada-Iboshi, <i>Hawaii Department of Business, Economic Development and Tourism (1996)†</i>	2.3	2.6
Leroy Laney, <i>First Hawaiian Bank (1995)*</i>	2.0	
Leroy Laney, <i>First Hawaiian Bank (1996)†</i>	1 - 2	2 - 3
David McClain, <i>UH School of Business*</i>	1.5	
Regional Financial Associates††	1.1	
Wharton Econometric Forecasting Associates Group, Inc. (WEFA)‡	2.5	
Henry Wong, <i>City Bank††</i>	1.0	

*December 1995 forecast published in *Hawaii Business* magazine.

**December 1995 forecast prepared for but unpublished in *Hawaii Business* magazine.

^o Carl Bonham, Paul Brewbaker, Ming Chew, Leroy Laney, Jim Mak, Mike Sklarz, Henry Wong; consensus from State revenue forecasting panel; inferred from fiscal year forecasts.

†April 1996 Hawaii Economic Association Conference.

††Media reports.

‡Inferred from World Travel & Tourism Council (WTTC) *State of Hawaii Travel & Tourism: A New Economic Perspective* (April 1996).

Compiled by: Economics Department, Bank of Hawaii