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Journal
California Journal of Politics and Policy, 9(4)

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Publication Date
2017

DOI
10.5070/P2cjpp9437346

THE CALIFORNIA *Journal of*
Politics & Policy

Hawai'i: A Prosperous but Vulnerable State

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Abstract

Hawai'i adopted a state budget that authorizes $14.1 billion in spending for the 2018 fiscal year. Although the state economy has benefited from a robust tourism industry and increased federal defense spending, the state's roads and bridges are in poor repair, and its public employee pension system is underfunded by more than $14 billion. Additionally, the high-speed rail system that is currently being built to serve Honolulu—which state taxes support—faces a funding shortfall of $1.3 billion. Overall, the state's fiscal condition is reasonably good, but Hawai'i remains vulnerable to declines in the tourism industry and reduced federal spending.

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> I know we can work together to craft a responsible budget that, at the end of the day, is not my budget, not the Legislature's budget, but the people's budget.
>
> —Governor David Y. Ige, State of the State Address, January 23, 2017

By many measures, times are good in Hawai'i. The Aloha State has the third lowest unemployment rate in the nation, the tourism industry has enjoyed five record-setting years, and the state's residents are the healthiest people in the United States. However, all is not perfect in paradise. The cost of living is punishing, the state tax burden is borne disproportionately by the poor, and many studies indicate that Hawai'i has the highest per capita homeless population in the nation. Additionally, the state's roads and bridges are in poor repair, and its public employee pension system is underfunded by more than $14 billion. To add to these troubles, the Honolulu Authority for Rapid Transit (HART), a state tax-supported rail system that is currently being built to serve suburban commuters—and which state taxes support—faces a funding shortfall of $1.3 billion.

At the State Capitol in Honolulu, legislators usually avoid making tough decisions on taxation, spending, and compensation for public employees. Although Governor David Ige is a former state senator, he has a strained relationship with his colleagues in the overwhelmingly Democratic state legislature who regularly criticize him for a lack of vision and leadership. This is reflected in his 35 percent approval rating among Hawai'i voters, a majority of whom would prefer someone else to lead the state (Eagle 2017c). Consequently, policymaking in Hawai'i feels rudderless, and legislative battles are often the result of personal vendettas rather than genuine policy disagreements.

The state has long relied on the munificence of the federal government for its economic success, but after years of enjoying special favors from Washington, many fear that federal dollars will no longer flow so freely to Honolulu. The death of Senate Appropriations Committee Chairman Daniel Inouye and the retirement of Senator Daniel Akaka left Hawai'i with little sway on Capitol Hill. The state's combative response to President Donald Trump's immigration ban and Republican majorities in the House and Senate mean that blue Hawai'i is unlikely to regain its influence anytime soon. Although Hawai'i's economy is strong today, it remains deeply dependent on federal spending, and many worry that the state will be hit hard by the Trump administration's promise to cut federal jobs.

Despite these challenges, the state legislature adopted a balanced biennium budget that authorizes \$14.1 billion in spending for the 2018 fiscal year and \$14.3 billion for the 2019 fiscal year. In recent years, the state has carefully managed its finances, and Wall Street has rewarded this newfound financial responsibility with a higher credit rating for its general obligation bonds. There has also been increased attention to issues of economic justice and homelessness, with significant investments in shelters and social services. In May, legislators approved some much-needed tax reforms after they authorized state earned-income tax credits for Hawai'i's lowest-income residents. This was financed by the reinstatement of the highest income tax brackets for families with an annual income greater than \$300,000. Overall, the state is reasonably well managed and prosperous, but its economic dependence on the volatile tourism industry and defense spending may pose problems in the future.

Population and Demographics

The Aloha State is the most racially and ethnically diverse state in the nation. Only 26 percent of Hawai'i residents identify as white, compared to 77 percent in the country at large (see Table 1). Japanese Americans are the largest ethnic group, but Hawai'i also has a significant Filipino and Pacific Islander population, as might be expected for a Polynesian archipelago in the central Pacific. Immigration to Hawai'i from Asia and the Pacific continues to be high, leading the state to have a higher number of foreign-born residents than the U.S. at large. Hawai'i also has a rapidly aging population. Residents age 65 and older now comprise 17.1 percent of the population—one of the highest proportions in the nation—and this will likely put more pressure on the state's beleaguered health and pension systems (Kaiser Family Foundation 2017).

Hawai'i's population has continued to grow modestly (Figure 1), but with only 1.43 million residents, it remains one of the least populous states. Unlike many small states, however, most residents are urbanites, the vast majority of whom live in Honolulu. The city and county of Honolulu, which encompasses the entire island of O'ahu, has a dense urban core and accounts for nearly 70 percent of the state's population (Table 2). In contrast, Hawai'i Island, despite being the largest county by land area, accounts for slightly less than 14 percent of the state's population. Hawai'i's wealthiest households are concentrated in the east O'ahu suburbs of Honolulu and the wealthy retirement communities of Hanalei on Kaua'i and Wailea on Maui (Page, Schack, and Trevino 2017).

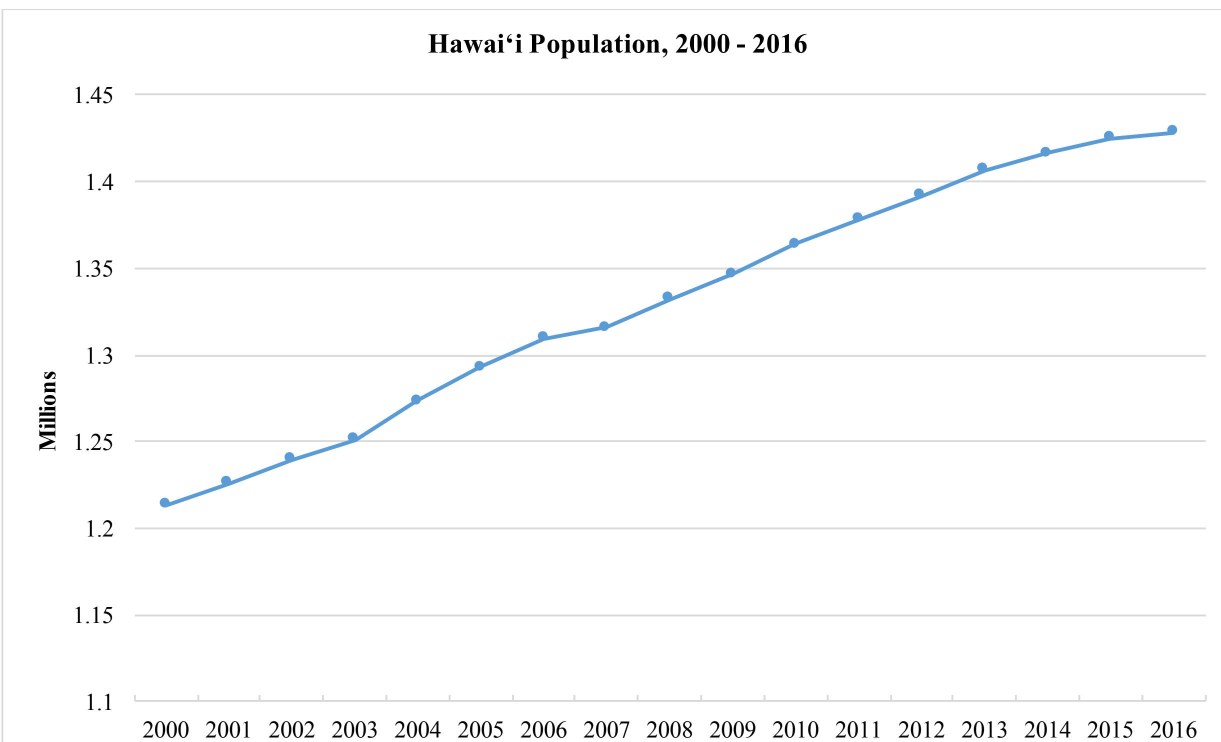
Honolulu, the only major city in the state, is the center of most commercial activity, government offices, and the state's one research university. It is home to several major military bases,

Table 1. Demographic Comparisons in 2016: Hawai'i v. U.S. (Percentages)

	Hawai'i	U.S.
White	26.7	77.1
High School Graduate	91.0	86.7
Bachelor's Degree or Higher	30.8	29.8
Born in US	17.7	13.2
Persons in poverty	10.6	13.5
Persons without Insurance (< 65 yr)	4.7	10.5
Civilian labor force (> 16 yr)	61.5	63.3
Population per square mile	211.8	87.4
Median household income	$69,515	$53,889

Source: U.S. Bureau of the Census

Figure 1.



Source: U.S. Bureau of the Census

Table 2. Demographic Comparisons in 2016: Hawai'i Counties

	Hawai'i	Honolulu	Maui	Kaua'i
Population Disbursement	13.8	69.4	11.6	
Bachelor's Degree or Higher	26.8	32.7	26.1	28.0
Foreign Born Persons	11.2	19.1	17.9	16.5
Population in Civilian Labor Force	58.3	60.9	68.6	64.4
Race: White Alone	34.3	23.3	35.8	33.8
Persons in poverty	18.3	9.2	10.7	11.2
Persons without Insurance (< 65 yr)	5.9	4.4	5.4	5.2

Source: American Community Survey, U.S. Bureau of the Census

including Joint Base Pearl Harbor-Hickam, the headquarters of the U.S. Pacific Fleet and a major civilian employer. The city's economic and cultural dominance leads to urban and rural tensions in state budget negotiations, and it is not unusual for state lawmakers to face accusations that they care only about O'ahu. Legislators who represent the largely rural islands of Hawai'i, Maui, Moloka'i, Lana'i, and Kaua'i frequently band together to support increased spending and services in the so-called "neighbor islands." These legislators often draw attention to the rural islands' higher rates of poverty and unique infrastructure challenges—and their concerns are not without merit. The Big Island of Hawai'i, for example, is the poorest county in the state, with a dramatically higher percentage of people who live in poverty than Honolulu (Page, Schack, and Trevino 2017).

The rural areas of the state are deeply dependent on public assistance, but residents face difficulties accessing heath care and other public services. Hawai'i recently entered into a public-private partnership with the Kaiser Permanente Health Care system to run Maui Memorial Medical Center—the island's only major hospital—but this required $73 million from the state for capital improvements to the hospital (Civil Beat Editorial Board 2017). It is still not clear if this partnership with Kaiser will be a permanent solution to the financial challenges faced by this rural hospital.

Overall, Hawai'i is a relatively wealthy and well-educated state, with a slightly higher number of residents with bachelor degrees than the nation at large, and with a significantly higher median household income of $69,515, compared to $53,889 in the country as a whole (Table 2). In 1974, Hawai'i became the first state to mandate that employers provide health insurance. Today, only 4.7 percent residents lack health insurance, which is among the lowest rates in the nation (See Table 1). The state's higher wages, along with its relatively generous social welfare policies, mean that only 10.6 percent of Hawaii residents are considered poor compared to a national average of 13.5 percent.

Despite its success on some measures of social well-being, Hawai'i has the highest per capita homeless population in the United States (Nagourney 2016). Although a number of things have contributed to this unfortunate situation, one causal factor stands out: relative to the median wage, Honolulu, where the majority of residents live, is the most expensive city in the nation. Indeed, only three American cities had a higher median price for a single-family home than Honolulu (LaCroix 2016). The state's high population density (211.8 persons per square mile compared to 87.4 persons per square mile), as well as real estate purchases by mainland and international investors, continues to put upward pressure on housing costs. The median rent for a two-bedroom apartment is 16 percent over the national average, making even rental units too expensive for many local residents (UHERO 2017). When asked, the public regularly lists the lack of affordable housing and the increasing homeless population as their chief complaints (Blair 2016a). In Hawai'i, a mere 25 percent of residents were satisfied with the availability of affordable housing, the highest rate of dissatisfaction in the nation (Jones 2016).

State of the Economy in Hawai'i

Hawai'i has enjoyed seven years of increasing prosperity, driven mainly by a strong tourism sector and high rates of construction spending. Although the state will likely continue to see modest rates of growth, most economists believe it is expected to slow in the years ahead. The University of Hawai'i's Economic Research Organization (UHERO) predicts a two percent increase in real GDP during 2017 (Table 3). This growth is expected to continue through the beginning of the next decade. The state's Council of Revenues—a panel of economists, accountants, and business executives—currently projects a four percent growth rate for 2018 and 2019 and a 4.5 percent growth rate for 2020 to 2023 (Eagle 2017b).

As a result of the state's strong economy, the labor market is very tight. Hawai'i's unemployment rate is among the lowest in the nation at 2.8 percent (See Figure 2). The labor market continues to expand, with job growth for the 26th consecutive quarter (Department of Business, Economic Development, and Tourism 2017). The hotel and food services industry and the health care industry continue to be major employers. Construction employment has been near an all-time high, and this should continue until at least 2019 as new resorts and single-family homes drive demand (UHERO 2017). Nevertheless, wage growth has been sluggish. UHERO economists expect real income growth to fall to two percent in 2017, and to decrease again in 2018 and 2019. The state's gross domestic product is also expected to increase slowly, with predicted growth of 1.7 percent in 2018 and 1.6 percent in 2019 (UHERO 2017).

Tourism remains a vital sector in Hawai'i's economy, and visitor arrivals continue to increase. In 2016, 8.8 million people visited Hawai'i, which was an increase of three percent over the previous year. O'ahu received the most international visitors, while the other islands were more reliant on domestic tourists. In 2017, visitor arrivals are expected to break nine million (UHERO 2017). Employment in the leisure and hospitality industry has recovered from its dramatic decline during the Great Recession, and it now employs nearly 120,000 people (Figure 3). However, this sector is extremely vulnerable during economic slowdowns (See Figures 2 and 3). During the last recession, nearly 10,000 jobs disappeared, causing the state's unemployment rate to exceed seven percent.

Military spending plays a major role in the local economy as well, with about $7.8 billion in annual defense spending that results in direct and indirect economic impacts that exceed $14.7 billion. There are over 50,000 military personnel stationed in Hawai'i, and military spending is responsible for a total of 102,000 civilian jobs in the state (NCLB 2017, *Governing Data* 2017). In 2017, the National Conference of State Legislatures ranked Hawai'i as second only to Virginia in military spending as a percentage of state GDP. Overall, the federal government contributes 12.4 percent of the state's gross domestic product, and direct federal employment accounts for about 5.6 percent of all jobs. Some policymakers worry that President Donald Trump's proposed cuts to federal employment will be particular damaging to Hawai'i, yet others argue that Hawai'i's strategic geographic location will result in increased federal spending in the islands (Downey 2017a).

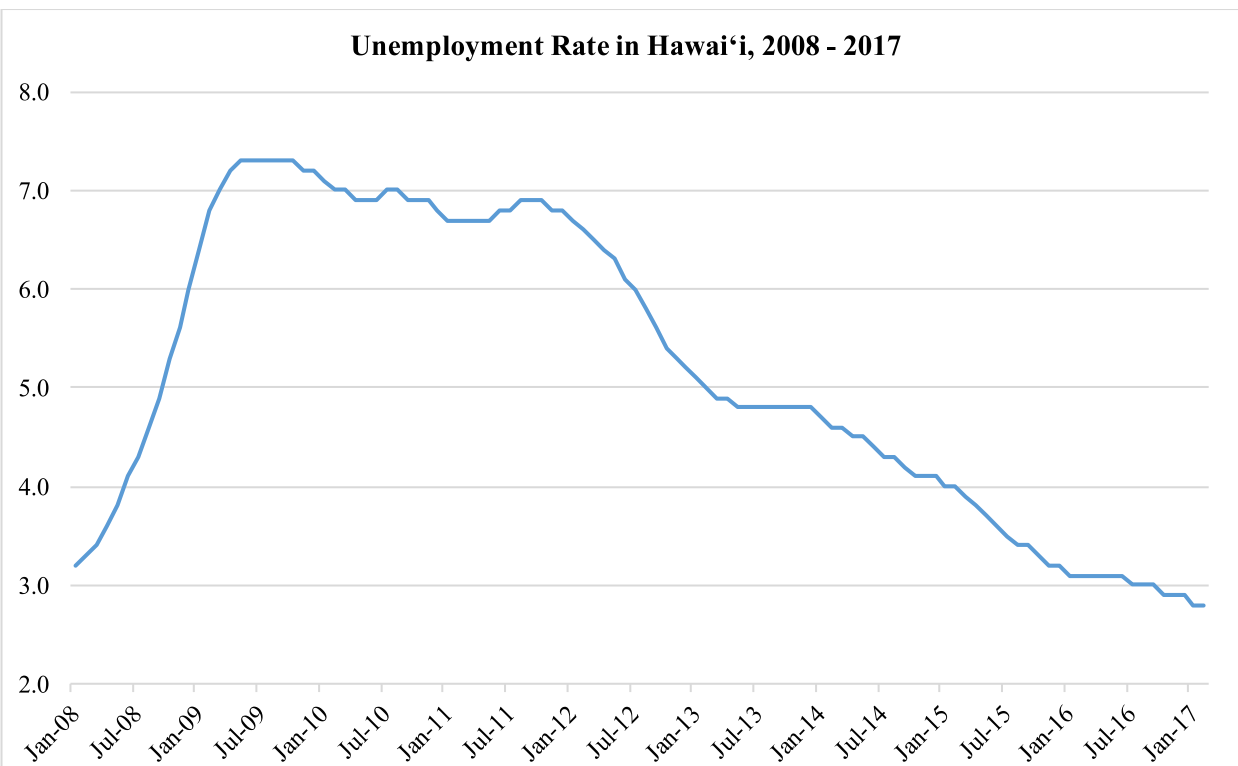
Table 3. Hawaii Economic Indicators: Year-Over-Year Percentage Change

	2014	2015	2016	2017	2018	2019
Visitor Arrivals	2.4	4.5	3.1	2.2	1.1	0.9
U.S. Visitor Arrivals	1.1	6.9	4.1	3.0	1.4	0.8
Japan Visitor Arrivals	-0.4	-1.9	0.4	1.6	-1.0	0.9
Other Visitor Arrivals	9.2	3.1	2.6	0.1	1.8	1.4
Non-farm Payrolls	1.4	1.7	1.7	1.1	0.9	0.6
Unemployment Rate (%)	4.4	3.6	3.2	2.9	3.0	3.3
Inflation Rate, Honolulu	1.4	1.0	2.0	2.6	2.7	2.6
Real Personal Income	3.6	3.7	2.5	2.1	1.8	1.5
Real GDP	1.1	3.9	2.5	2.0	1.7	1.6

Note: Figures for 2017 – 2019 are forecasts.

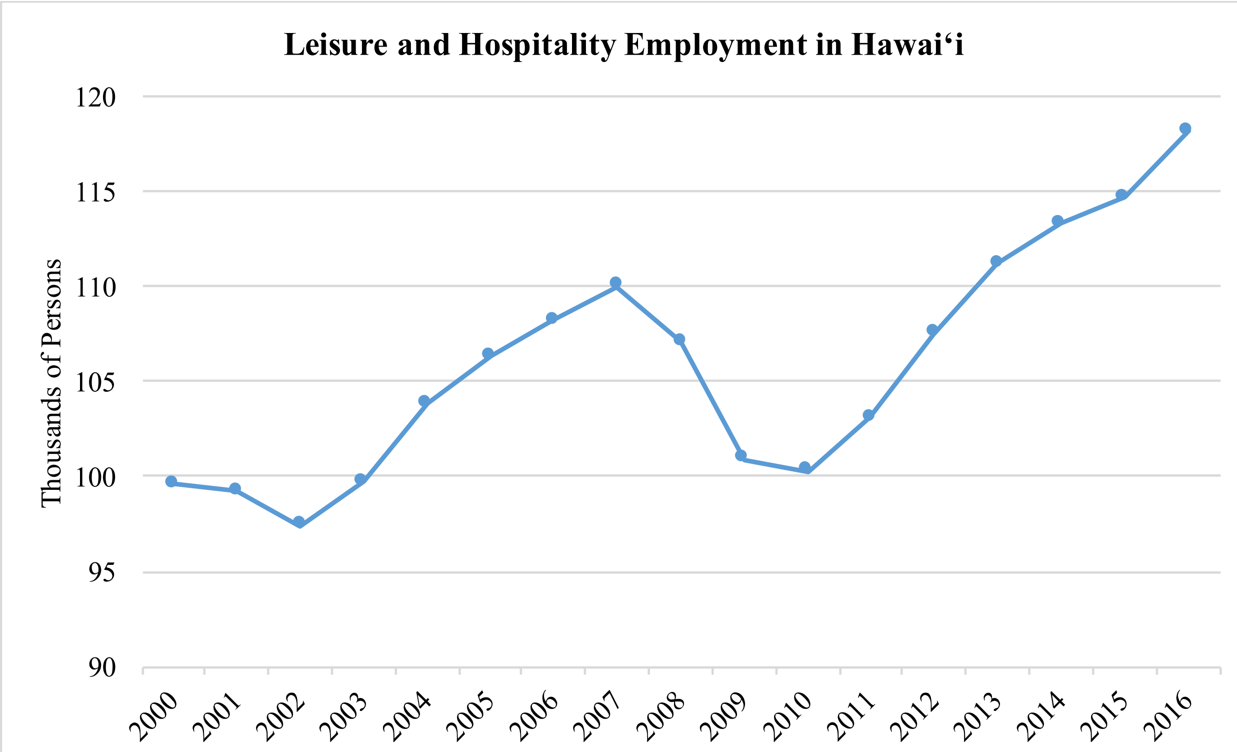
Source: "UHERO Forecast Update, Public Edition," University of Hawaii Economic Research Organization, March 3, 2017. <http://www.uhero.hawaii.edu/assets/17Q1StateUpdate-Public.pdf>

Figure 2.



Source: U.S. Bureau of Labor Statistics

Figure 3.



Source: U.S. Bureau of Statistics, St. Louis Federal Reserve

At this point, the more optimistic projections seem to be correct. The $21 billion increase in the defense budget will almost certainly help Hawai'i. Military construction projects in Hawai'i in FY 2018 are expected to cost $266 million, an increase of $69 million from FY 2017, and include $90 million for a new command facility for the U.S. Army at Fort Shafter in Honolulu (Downey 2017b). Given the U.S. military's planned pivot to Asia, it is likely that defense investments in the state will continue to be significant.

Although the picture looked bleak early in the federal budget negotiations, Hawai'i is projected to benefit under current spending proposals. The Trump administration's budget proposal includes substantial increases in spending on Native Hawaiian social services, including $2 million for Native Hawaiian housing, $14.4 million for Native Hawaiian health centers, and $47.2 million for Native Hawaiian educational assistance (Downey 2017c). Whether these appropriations represent a one-time reprieve for the state or can be expected to continue in the years to come is an open question.

Hawai'i's Fiscal Health

Hawai'i relies on three major taxes to support its general spending. The first is a general excise and use tax of 4.5 percent that is imposed on all business activity, including rental property, in the state. The second is a personal income tax that ranges from 3.2 percent to 8.25 percent. The third is a transient accommodation tax—popularly known as the hotel tax—which is a special state tax applied to hotel rooms and apartments that are occupied for fewer than 180 consecutive days (Department of Budget and Finance 2017b). Hawai'i's tourism-dominated economy means that visitors pay for the hotel tax and a large proportion of the general excise tax, but it also means that these key sources of state revenue suffer dramatic declines when the visitor industry faces hard times.

The record-breaking number of visitor arrivals and increases in federal spending has led to increased revenue during the 2017 fiscal year. In the first quarter of 2017, state general fund tax revenues were up $71.9 million or 4.8 percent over the same period of 2016. State general excise tax revenue increased $13.6 million or 1.7 percent in the first quarter of 2017 compared to first quarter 2016 (Department of Business, Economic Development, and Tourism 2017, Eagle 2017b). Table 4 includes the expected revenues for the state budget of approximately $14.2 billion, a four percent increase from FY 2017. In addition to increases in tax revenue, Hawai'i has made dramatic improvements in its fiscal health since 2010. Its general obligation bonds were recently upgraded by Moody's Investors Service to AA+, the highest rating for the state's bonds in its history. This is welcome development given the state's poor bond ratings over the past two decades (Office of the Governor 2016).

The volatility of Hawai'i's tourism industry means that a healthy rainy day fund is often crucial to the state's ability to meet its payments during economic downturns. During the last recession, the state relied heavily on its cash reserves, and, by 2011, it had completely exhausted its rainy day fund, even after raiding a special emergency hurricane relief account. The result was a damaging downgrade of its credit rating (Pew 2017). However, as the economy has recovered, the state has dramatically increased its cash reserves, and Hawai'i's AA+ rating now puts it among the top half of states. The Mercatus Center of George Mason University ranks Hawai'i 27th in overall fiscal condition in the nation (Norcross and Gonzalez 2017).

Budget Process

The Hawai'i State Legislature is a part-time legislature that meets from January to May every year. In 2017, the legislature convened on January 18 and adjourned on May 4. The governor is required to present a budget request that is prepared by the Department of Budget and Finance in consultation with executive departments. This budget is a biennial request in budget years, and a supplemental request in off-years. FY 2018 is a budget year, so the budget presented included spending requests for FY 2018 and FY 2019. The governor is also mandated to present a six-year financial plan for the state. The governor submits the budget 30 days before the legislative session convenes. The governor's budgetary request reflects the needs of 17 departments, his office, the office of the lieutenant governor, and the University of Hawai'i System.

The Senate Ways and Means Committee and House Finance Committees are Hawai'i's "money committees." All spending bills must originate in the House. The budget is broken into two proposals. The first is for general departmental spending, and the second is for Capital Improvement Project (CIP) appropriations that include state infrastructure investments and upgrades. "First decking" is the date by which the budget must be passed out of the House Finance Committee so it can be voted upon by the full House. The date on which bills are passed from one chamber to the other is called "crossover," which occurs earlier than other bills.

Table 4. FY 2018 Operating Budget, Statewide Totals by Means of Financing

	Original Budget $ in millions	Percent of Total
General Funds	7,377.9	52.0%
Special Funds	2,877.5	19.7%
Federal Funds	2,750.8	19.1%
Other Federal Funds	240.7	1.6%
Private Contributions	0.7	0.0%
County Funds	2.2	0.0%
Trust Funds	431.4	3.0%
Interdepartmental Transfers	100.5	0.7%
Revolving Funds	453.3	3.1%
Other Funds	19.3	0.1%
Total	14,254.3	

Source: Hawaii Department of Budget and Finance, 2016

When the budget reaches the Senate, it is referred to the Ways and Means Committee. Second crossover occurs when the budget proceeds out of the Senate and to a conference committee. Final decking is when the budget proceeds out of conference and back to both chambers for a final vote. All members of the legislature will vote three times on the state's budget. The Hawai'i Constitution requires that the budget be balanced every year, and this often requires the legislature to make off-year amendments to adjust spending.

Executive Budget and Legislative Response

In his 2017 State of the State address, Governor Ige outlined several policy priorities, including setting aside more land for local food production, continuing efforts to meet the state's 100 percent renewable energy target, more attention to Hawai'i's massive homeless problem, and new funding for business startups. Among his most important capital improvement project requests was a $50 million proposal to build a permanent international facility at the Kona airport on Hawai'i Island. This airport expansion has long been on the wish list of Big Island legislators who see it as a necessary step to attract more tourism from Asia. The governor also committed to paying down $385 million annually in unfunded liabilities in the state's pension system (Ige 2017).

Ige put particular emphasis on improving Hawai'i's beleaguered public schools system. He requested $700 million for new schools, classrooms, and science facilities, as well as $150 million for university facilities (Ige 2017, Blair 2016b). The governor also asked for $61.7 million to invest in air conditioning systems in school classrooms, which he has long acknowledged as a top priority. This appropriation would be added to the $100 million the legislature approved in 2016. The temperatures in some Hawai'i classrooms during August and September regularly exceed 90 degrees, a fact that the press has frequently highlighted to force the governor and legislature into action (Wong 2014b). Although nearly everyone agrees that something must be done, the price of these improvements has been a major stumbling block. In his speech to the legislature last year, the governor promised to install air conditioning in 1,000 classrooms by the end of 2016, but only 209 had been installed by February 2017 (Teague 2017).

Ige was required to make several adjustments to his ambitious agenda after the state's Council on Revenues reduced its forecast of tax collections by $150 million. To adjust for these losses, Ige proposed lowering payments to the public employee pension system by $74 million and slightly reducing funding for public schools by $18 million (Dayton 2017a). Reducing contributions to the state pension system has long been a favored tactic of Hawai'i's governors when revenue projections have come up short. All told, Ige's proposed budget totaled $14.2 billion for fiscal year 2018 (an increase of four percent), and $14.3 billion (an increase of five percent) for fiscal year 2019.

Legislative Budget

As is often the case in Hawai'i, the legislature proved to be slightly more fiscally conservative than the governor, and the final budget trimmed about $173 million from the Ige's proposal. Although state lawmakers were pleased by Ige's focus on education and his commitment to paying down the state's massive unfunded liabilities, some of his proposals were deemed vague and unrealistic. Many legislators were particularly frustrated by his decision not to anticipate wage increases for public employees whose contracts are up for renewal in 2017 (Blair 2017a).

House Finance Chair, Sylvia Luke, and Senate Ways and Means Chair, Jill Tokuda, are known for being cautious and methodical legislators. Both were concerned that Ige's proposed budget exceeded the state's expected revenues, and neither favored drawing down the state's cash reserves to pay for the governor's entire list of spending priorities. Senator Tokuda announced at her presentation of the Senate's budget, "This is the result of digging deep into the base budgets of each state department and thoroughly examining how to make cuts without impacting the basic, essential needs of our community: keeping the lights on in our schools, providing housing, protecting our natural resources, and ensuring health care services are available to *keiki* [children] and *kupuna* [the elderly]" (Blair 2017a).

Table 5 provides the governor's proposed budget, which is broken down by state department, and the final appropriations by the legislature. Although some departments, particularly the state's school system, actually saw their appropriations increase after the budget was adopted by the legislature, most saw modest cutbacks in spending.

On a programmatic level, there is continued emphasis on funding services to solve the homeless problem in Honolulu, which has the highest per capita population in the nation. For example, $3 million is slated to go to Hawai'i's innovative Housing First Program. The legislature also designated additional money for a program to help compensate caregivers for taking time off work to care for elderly parents (Blair 2017a). The Department of Education received significant funding for an Early College High School Initiative and $2.8 million per fiscal year for the next two years for the Hawaii Keiki Program, which provides funds for more school nurses. Hawai'i has been desperately short of school nurses, and the goal of this program is to meet the national standard of one nurse for every 750 students (Blair 2017a).

The legislature's budget also supported several of the governor's capital improvements proposals, such as $20 million for the purchase of 500 acres of agricultural lands to lease to local farmers; nearly $200 million to update facilities at the Daniel K. Inouye Honolulu International Airport, the state's central transportation hub; $190 million for bridge replacements and up-

Table 5. FY 2018 Executive Budget Proposal and Final Budget

	Executive Budget ($ millions)	Final Budget ($ millions)
Accounting and General Serv.	217.7	211.3
Agriculture	64.1	53.9
Attorney General	99.7	103.6
Business, Ec. Dev., & Tourism	299.9	275.3
Budget and Finance	2,647.9	2,636.3
Commerce & Consumer Aff.	86.3	82.3
Defense	135.8	134.1
Education	2,008.5	2,113.0
Governor	4.0	3.5
Hawaiian Home Lands	31.3	57.0
Health	1,097.4	1,829.0
Human Resource Develop.	24.4	25.3
Human Services	3,499.3	3,459.4
Labor & Industrial Relations	469.9	472.7
Land & Natural Resources	167.8	163.8
Lt. Governor	1.1	1.1
Public Safety	285.5	280.6
Taxation	29.4	28.3
Transportation	1,011.3	1,000.8
University of Hawaii	1,188.1	1,170.8
Totals	14,254.3	14,111.6

Source: Department of Budget and Finance, State of Hawai'i; Hawai'i State Legislature.

grades; and $83 million for the modernization of facilities at the University of Hawai'i. The state's deficient IT system is also slated to receive over $2 million for improvements in FY 2018.

Many of these infrastructure improvements are desperately needed. In 2016, one independent report ranked Hawai'i 48th in performance and cost-effectiveness of its highway system, and rated the state as the very worst in the nation for its interstate highway pavement condition (Hartgen et al. 2016). The University of Hawai'i has a maintenance backlog that is estimated to be more than $500 million, and the campus is plagued by outdated buildings and failing air conditioning and electrical systems (Teague 2016).

Major Budgetary Issues

Honolulu Authority for Rapid Transit

Honolulu's over-budget rail system continued to be a major source of frustration during the 2017 legislative session. The HART system is currently projected to cost almost $10 billion for a 20-mile route from the west O'ahu suburb of Kapolei to central Honolulu. The legislature earlier extended O'ahu's 0.5 percent excise tax surcharge until 2027 to pay for rail, but even with this increased funding, the rail system still faces a shortfall of $1.3 billion.

Although the majority of residents favor the completion of the HART system, 87 percent think it is being poorly managed (Grube 2017). The unpopular HART system forced reluctant legislators to raise taxes, causing the rail funding to be the most contentious issue of the 2017 legislative session. Although state legislators were under enormous political pressure to solve this problem, they missed no opportunity to voice their fury about the situation. Some legislators argued that more of these costs should be borne by the city and county of Honolulu, and many expressed their frustration with Honolulu Mayor Kirk Caldwell's continued pleas for additional state funds (Blair 2017b).

Mayor Caldwell and the Honolulu City Council threatened that they would be forced to raise property taxes if additional funds were not provided by the state. The state is under particular pressure to find a solution to the rail system's funding shortfall in order to receive $1.55 billion in federal funding that was pledged by the Federal Transit Administration. These funds could be in jeopardy if HART cannot demonstrate that it has sufficient funds to pay for the entire 20-mile route (Blair 2017b).

One proposal debated by the legislature would have raised $1.2 billion by reducing the administrative fee it currently takes out of the rail surcharge from 10 percent to 1 percent. This, combined with extending the tax surcharge for another two years, would cover most of the current funding shortfall (Blair 2017b). This funding package was favored by many legislators in the Senate and was the one that most political observers expected to be adopted. During the final days of the legislative session, however, a second proposal emerged out of the House that would have increased the state's hotel tax from 9.25 percent to 10.25 percent until 2028 instead. This last-minute change to the proposed funding mechanism faced vehement opposition from many senators and the state's powerful tourism industry (Blair 2017c). In a last-minute deal, Senator Tokuda, chair of the Senate Ways and Means Committee, agreed to the House version of the bill. Her decision to vote against her colleagues led to her ouster as the chair of Ways and Means. In the end, the legislature was unable to agree on a plan to fund the project when the regular legislative session ended on May 4. At this point, a special session is planned in August to revisit the issue (Dayton 2017b).

Tax Revenue from Vacation Rentals

As in 2016, the legislature struggled to find a solution to the increasing popularity of vacation rental operators like Airbnb. Hawai'i's high cost of living makes renting rooms to tourists an attractive option for homeowners, and a recent study by the Hawai'i Tourism Authority shows that consumers increasingly prefer this type of accommodation (Shaefers 2017). The question is whether Hawai'i should embrace and tax or resist and regulate this new type of accommodation.

Airbnb's supporters argue that it increases the number of possible accommodations and boosts the tourism industry, therefore generating more tourist spending and increasing tax revenue. Furthermore, many local residents have come to rely on the extra income provided by vacation rentals, and they bristle at the suggestion that the state would prevent them from renting rooms in their own homes to tourists. Yet some critics, particularly Hawai'i's hospitality workers' union, contend that it limits the number of well-paid hotel jobs that provide healthcare and other benefits.

During the 2016 legislative session, a bill was passed to allow Airbnb to collect taxes for rental home operators and submit them to the state, but it was vetoed by Governor Ige. At the time, Ige argued that the bill would make regulation difficult because it did not require individual homeowners to post their individual excise tax numbers on Airbnb rental sites. The governor and others were concerned that this would make tax enforcement nearly impossible, forcing the state to accept Airbnb's own accounting of the revenue that the state was owed. A similar bill was proposed during the 2017 session, but it was not adopted, despite $100 million in expected annual tax revenue (Shaefers 2017) and heavy lobbying by the industry. A bill to regulate and tax Airbnb and other vacation rentals will almost certainly reemerge as a major issue during the 2018 session.

Public Employee Pension Fund

Hawai'i's public employee pension fund, which covers over 120,000 public employees and retirees, is underfunded by more than $14 billion. The fund was left with an even larger deficit after it lost nearly $1 billion in 2016. Hawai'i residents are among the longest-living people in the nation, with a life expectancy of 81 years on average, which has put even more pressure on the state's pension system (Eagle 2017a). The fund's board of trustees recently revised the expected investment return downward with more realistic assumptions about the mortality rates of retirees. Consequently, a recent actuarial analysis currently estimates that the funded ratio is 54.7 percent, and it would take 66 years for the fund to become solvent at the current level of contributions (Eagle 2017a).

The legislature has been slow to manage this problem. In his 2017 State of the State Address, Governor Ige announced a plan to pay down $385 million annually until the pension system is fully funded, but he reduced the state's contribution by $75 million after state revenue projections were reduced. The health of the pension fund will continue to be a major policy challenge for state lawmakers well into the future.

Tax Reform

According to the Institute on Taxation and Economic Policy (ITEP), Hawai'i has the 15th most unfair tax system in the nation, placing one of the highest tax burdens on low-income families (Hofschneider 2017). ITEP estimates that over 13 percent of income goes to taxes for the lowest 20 percent of taxpayers, while only seven percent goes to taxes for the top one percent of earners. Much of this discrepancy is the result of Hawai'i's general excise tax, which hits low earners much harder than high earners, because it taxes virtually every transaction a consumer makes, including rent and food (ITEP 2015).

In a move that caught many political observers by surprise, the legislature agreed to establish a nonrefundable state earned income tax credit for low-income working people worth up to 20 percent of the federal earned income tax credit. Hawai'i will now join 26 other states that provide a state earned-income tax credit (Dayton 2017d). To fund this benefit, the highest income tax brackets of 9 to 11 percent, which were allowed to expire in 2015, were reinstated and will take effect on January 1. It is estimated that the reinstated tax brackets will provide the state with $51 million in new revenue, with only $16.7 million of that going to pay for the new tax credit. The legislature also made permanent a refundable tax credit to reduce food costs for low-income residents—a decision that is expected to cost the state $6.5 million in lost revenue (Dayton 2017d).

Collective Bargaining

Organized labor plays a powerful role in Hawai'i politics. Unions were central in the struggle of workers against the sugar plantation industry during the state's territorial period, and they have retained broad public support even as membership has declined since its peak of 30 percent in 1989 (Coffman 2003). Nevertheless, nearly 20 percent of workers are still represented by unions, giving Hawai'i the second highest rate of union membership in the nation behind New York State (U.S. Bureau of Labor Statistics 2017). The close ties between the unions and the state's dominant Democratic Party mean organized labor has tremendous influence on state policy.

Today, the public sector unions that represent teachers and government employees are among the most influential. Governor Ige's victory over Neil Abercrombie during the 2014 gubernatorial race was largely attributed to the strong support he received from these unions, particularly the Hawai'i State Teachers' Association (Wong 2014a). As expected, the public sector unions used their political power to gain generous raises for their members in 2017. The total bill for these wage increases and benefits is expected to total $102 million in additional funds for FY 2018 and $239 million for FY 2019 (Dayton 2017c).

Conclusion: Hawai'i's Fiscal Situation

Overall, the state remains in historically good fiscal shape. The $14.1 billion budget for the 2018 fiscal year demonstrated the legislature's prudence, but it did little to address some of the state's festering problems. Hawai'i's rail system will likely saddle citizens with higher excise taxes for decades, and the state's large unfunded liabilities for retirees could lead to a fiscal crisis if lawmakers do not begin investing more money into the system. Finally, Hawai'i's extremely high cost of living and alarming homelessness problem show no signs of being resolved in the near future. However, Hawai'i is well positioned to benefit from increased federal defense spending, and the dominant tourism industry shows no signs of slowing. While Hawai'i is still prone to the threats of declining tourism or minimized federal spending, there is no doubt that Hawai'i is prosperous today.

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