Not much lift from tax cuts in Hawaii's soaring economy

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THE ECONOMIC RESEARCH ORGANIZATION AT THE UNIVERSITY OF HAWAI'I

The federal tax cuts are welcome news for local households. They will matter less for Hawaii's already-hot economy.

Hawaii's economy continues to grow, but with expected slowing as the cycle matures. Tourism is booming, construction remains on a healthy plateau, and jobs are plentiful. The big story this quarter is the federal tax cuts that went into effect on January 1. These will provide a modest boost for Hawaii families, who have seen little income growth in the expansion so far. Tightness in tourism and labor markets will limit the overall effect on the State's economy.

Visitors keep on coming

Hawaii tourism rounded out 2017 with another strong quarter. The number of arrivals surged nearly 5%, bringing the annual total to more than 9.2 million, a gain of 435,000 visitors. And still the industry continues to be bullish. Airlines have raised scheduled air seats for the February to April period by more than 10% over last year, with the biggest percentage increases on direct flights from the US mainland to the Neighbor Islands. Flights from Western US markets to Kauai are up an astounding 60%; to Kona they are up 30%. Hawaiian Airlines, Virgin America, and United Airlines have all expanded their West Coast routes.

Whether airlines will fill all these seats is another matter. Even on the Neighbor Islands, hotel occupancy rates are running at levels not seen since before the Great Recession. On the Big Island, they are the highest on record. While hotel surveys have limited coverage, the rise in these figures suggests that accommodations are becoming increasingly tight. Airlines appear to expect some filling in of visitors during the shoulder periods in February and April, when occupancy is lower, but they also anticipate maintaining record-high lift throughout the remainder of the year.

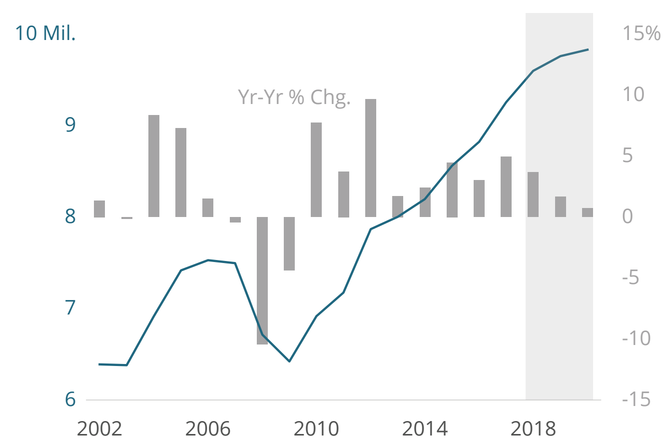
To be sure, a portion of the surging visitor pool is being accommodated by the growth in transient vacation rentals (TVRs). The precise number of such units is hard to determine, since many are operating illegally. But based on the implied hotel room shortage, it is likely considerably higher than the 13,500 units in the official Visitor Plant Inventory. Efforts to reign in TVRs continue. The counties have so far resisted State and TVR industry proposals to tax revenues, because of concerns that they would help owners skirt regulations, and the Governor has also rejected such measures. This legislative session has brought several new bills addressing these concerns. One would provide a one-time tax amnesty, while enlisting TVR brokers in tax collection, and requiring them to de-list properties identified as out of compliance with county or state law. Other bills would substantially increase penalties for builders or owners of properties illegally operating as TVRs. The Administration is also reportedly working on its own proposal.

Visitor spending finished off the year with moderate overall growth, if down from the strong year-on-year gains seen in the second half of 2016 and the first quarter of last year. For the year as a whole, real visitor spending rose 3.6%, the strongest showing since 2012. The gains were largest for the US market, but total spending by Japanese and Canadian visitors also rose sharply. The gains in overall spending by international visitors masked some weakness in their per-person spending. It is not clear what is driving weaker international spending, since currencies have generally been steady or have strengthened a bit against the dollar since last year.

And global conditions continue to look favorable. As we discussed in our fourth quarter [Annual Hawaii Forecast with Asia-Pacific Outlook](), world growth has accelerated moderately over the past year and most countries and regions are participating. The federal tax cuts will provide an added boost to US travelers' disposable income. (See

Visitor Arrivals

Hawaii's long tourism expansion continues.



Tax Cuts Will Give a Boost, But How Big?

In December, the US Congress passed the most sweeping tax overhaul in decades. The legislation slashes the corporate income tax rate, accelerates capital expensing, and provides a temporary incentive for multinationals to repatriate foreign income. For households, the new law reduces personal income tax rates and raises the standard deduction, while capping deductions for state and local taxes. It also caps the mortgage interest deduction for new mortgages above $750,000 and eliminates the deduction for most home equity loans. Among other elements of the law are favorable treatment of "pass-through" income, higher thresholds for estate taxation, and a repeal of the Obamacare mandate. Changes in personal income taxes are phased out by 2027; changes in corporate taxation are permanent.

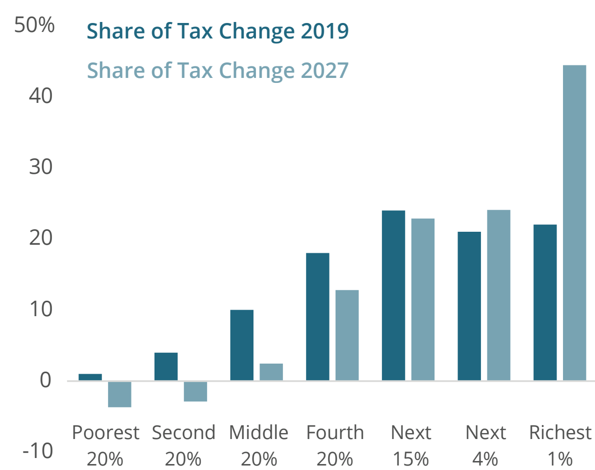
How much tax relief will the new law provide in Hawaii? According to the non-partisan Institute on Taxation and Economic Policy, the new law will result in a $1.3 billion cut in federal taxes on Hawaii residents. Nearly all families will enjoy a tax cut initially, although the benefits are heavily skewed toward those with higher incomes—about two-thirds of the tax savings accrue to the top 20%. In part, this is because higher-income households claim the lion's share of savings from tax cuts on small businesses and corporations. (Foreign investors also enjoy this benefit.) Because of the personal income tax cut phase-out, by 2027 lower-income households will see a small net increase in tax burden, while there will still be some positive impact at higher incomes.

How might the new tax law affect the Hawaii economy? The primary near-term impacts will come from increased spending induced by higher disposable incomes, both here and on the mainland. Increased demand will be felt across a wide range of businesses serving both local residents and tourists. Higher after-tax business profits may well lead to higher pay for some workers. Over the long run, investment incentives could result in expansion of the local capital stock, whether in resorts, residential, or commercial spheres. This would provide opportunities for income and employment gains.

How big will these effects be? The overall near-term impact will be very small for several reasons. First, the spending rise will be limited, because most tax savings go to well off families, who tend to consume a much smaller proportion of their income than do poorer households. The spending that does occur will result in very little job creation, given the historically tight Hawaii labor market. Stronger demand will lead to wage growth and an increase in aggregate income, but may also drive up prices, limiting gains in real purchasing power. The growth effects, then, will necessarily occur over the long run as capital investment raises capacity and perhaps productivity. However, credible estimates for the US economy find these effects to be relatively small.

The bottom line is that we should expect tax cuts to benefit households to the extent that they free up disposable income, more for some and less for others. But don't expect a substantial effect on the overall path of aggregate growth.

Largest Benefits for Higher-Income Households



Source: Institute on Taxation and Economic Policy

the box, *Tax Cuts Will Give a Boost, But How Big?*) This sets the stage for further tourism gains despite tight accommodations and firming prices. We expect the number of visitors to rise by 3.7% in 2018 and 1.7% in 2019. The recent missile scare introduces some uncertainty into the picture, since foreign visitors in particular have been sensitive to security concerns in the past. So far, there is no clear evidence of an adverse impact.

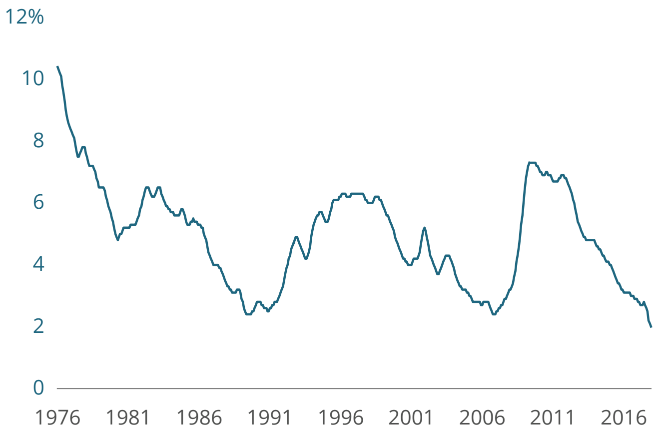
The strength and staying power of this industry expansion has fueled considerable renovation and expansion of the state's visitor plant. There are now roughly 80,000 units in the hotel and timeshare pool, the largest number on record. Corporate tax relief and investment incentives under the new tax law may help to ensure that existing plans for further resort development come to fruition.

Labor can't get any tighter

Hawaii's unemployment rate plunged to 2% in December, the lowest rate on records extending back more than four decades. The long expansion has driven employment gains year after year, so that now virtually everyone who wants a job has one. Businesses report difficulty finding available

Unemployment Rate

Hawaii's labor market has never been tighter.



workers across all skill levels and job types. This will serve as the primary limit to growth for the next several years at least.

The growing labor shortage has been exacerbated by out-migration that has effectively halted population growth in the Islands. In fact, data for the second half of 2017 show a net decline in the size of the labor force, although these preliminary data should be taken with a very large grain of salt. In any case, the limited labor force response to the ever-tighter job market is somewhat surprising. This may reflect the fact that labor markets are tight everywhere in the US, so that attractive job opportunities in less expensive mainland markets are drawing workers away.

As surplus labor has disappeared, the rate of payroll job growth has declined from nearly 2% in 2015 to roughly 1% last year, according to UHERO estimates of the forthcoming government benchmark data revision. Further deceleration is in the offing this year, with growth dropping to 0.8%. Even a modest pace of employment growth will require some positive labor force response, either through an end to the recent out-migration or the effect of rising wages pulling in workers who have remained on the sidelines in the years since the Great Recession. In some industries, companies may have to actively recruit workers from the national labor market.

There are nevertheless areas where we can expect to see increases in labor demand. The visitor industry will continue to expand, if at a decelerating rate, and it will account for the lion's share of incremental job gains. The accommodations and food services sector alone will account for nearly 35% of all new jobs created through the end of the decade. Stronger tourism will also contribute to robust hiring in the transportation and utility sector. Job growth in health care will be less robust than in the past, but will outpace the market overall as the need for medical care continues to expand. There may be some negative short-term impact from the removal of the Affordable Care Act insurance mandate, particularly as premiums on the ACA exchange have risen appreciably. But this affects only a relatively small number of people, because of Hawaii's extensive employer-based healthcare system. Faced with budget constraints, the public sector will not see any substantial gain in payrolls.

After edging downward throughout much of 2016 and 2017, the number of construction jobs jumped back up in the final quarter of last year, driven by strong hiring on Oahu. Again, these are preliminary estimates, but they support our view that the industry has settled at a relatively high plateau and is not poised for a period of sustained decline. We continue to have a fairly sanguine view of industry prospects, given the substantial number of residential projects still in the pipeline and ongoing public infrastructure work. Our outlook for the industry remains largely unchanged, with essentially the current level of employment continuing through the end of the decade.

Having said that, the general environment surrounding construction and housing has become more uncertain with the passage of the federal tax legislation and recent financial market responses. Here there are both upside and downside risks. Corporate tax changes may support increased investment across residential, resort, and non-resort commercial sectors. And increased disposable income will help to ameliorate affordability problems for households. However, new caps on deductible mortgage interest may hurt. On Oahu, half of all single-family homes now sell for more than $750,000, the new limit for mortgage interest deductibility.

Rapidly rising interest rates could put a brake on building. Markets are clearly concerned that a sharp Fed reaction to any inflation uptick would raise short-term rates at the same time that burgeoning federal debt is raising long-term rate expectations. The 30-year mortgage rate has surged more than 50 basis points since September, and the yield on the 10-year Treasury note is at its highest level since 2014.

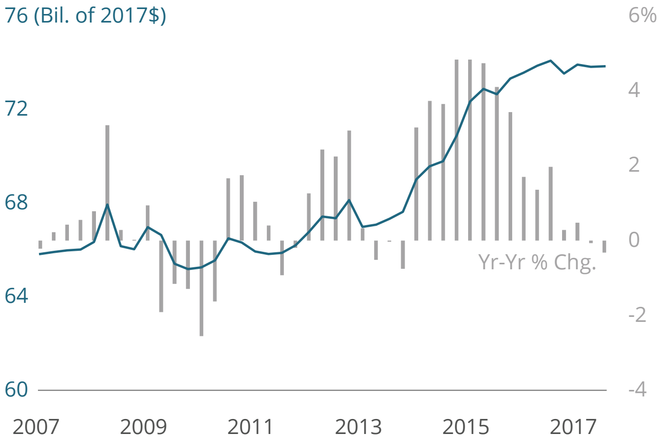
Income is AWOL

Stagnant income has been a problem throughout much of this expansion. After some progress in 2014-2015, income gains fell off once again. The picture was particularly bleak last year. In the three quarters for which we have data, inflation-adjusted real income was unchanged from a year earlier, both overall and in per capita terms. We estimate that real labor income per employed person, a broad measure of wages, actually declined slightly in 2017.

The lack of real income gains is perplexing, given the marked tightening of local labor market conditions that has occured. It mirrors, in a more pronounced way, the paucity of personal income growth at the national level.

Real Personal Income

There was no growth in inflation-adjusted income last year.



Explanations range from disappointing productivity gains to the possibility that firms are able to draw on a persistent pool of marginally attached workers. In Hawaii, the recent weakness may in part be compositional, since the strongest job growth has been in relatively low-wage sectors.

In any case, we do not think this situation will last. The record-low unemployment rate coupled with anecdotal evidence of labor shortages suggests that the environment is ripe for at least some growth in real wages. And of course this year's tax cuts will increase after-tax income for most households. In recent weeks some firms have announced bonuses or increases in wages at the bottom of their pay scale, although it is difficult to know whether this is a result of the tax law changes or simply a response to existing labor market conditions.

Inflationary pressures continue to build, but at a restrained pace. Headline inflation for Honolulu came in at 2.5% last year, somewhat higher than the 2.1% experienced for the US overall. Rising shelter costs have been the main driver. In the second half of last year, the shelter component of the CPI increased by 4.1% year-over-year, the fastest climb since 2007. Energy prices are also on the rise, after two years of marked decline. In the fourth quarter, gasoline prices on Oahu averaged $3.05 per gallon, up 10% from the same period in 2016. Recently, HECO was granted a 2.3% increase in its base tariff, although there is ongoing discussion with the PUC about how corporate tax relief will be passed through to consumers.

Inflation will continue to pick up steam this year and next, peaking at 3.3% in 2019. There is some upside risk to the forecast if the federal tax cuts and spending increases push up demand sharply in the face of current capacity constraints.

Seven months into the current fiscal year, cumulative State General Fund tax revenues are up more than 6% compared with the same period in FY 2017. This puts the State in good position to meet the Council on Revenues forecast of 4.5% for the fiscal year as a whole. The Ige administration's supplemental budget request for FY 2019 largely maintains the current operating budget of just over $14 billion and requests an additional $1.5 billion for capital improvements, bumping it to nearly $2.2 billion for the following fiscal year. The administration is requesting additional funds for construction at the state's public schools and university system, as well as infrastructure work on airports, harbors, and roadways statewide.

The federal budget measure adopted on February 9 lifts the sequester caps on both military and non-defense spending. The bill increases defense funding by $80 billion and non-defense discretionary funding by $63 billion for the current fiscal year. While it is still early to assess specific impacts, Hawaii's large military sector can be expected to benefit. The budget deal also provides increased funding for Veterans Affairs facilities, which could mean new or upgraded clinics here. But more budgetary wrangling still lies ahead. The latest measure only provides stopgap funding through late March, setting up the potential for yet another federal government shutdown.

Ruminating on risk

The past quarter has both reinforced ongoing trends in Hawaii and introduced important new elements. Robust visitor growth has continued in the face of now record-low unemployment, but with scant evidence that households are seeing improved incomes. The dramatic fiscal changes at the federal level will deliver tangible near-term benefits here, but they also raise risks. To an even greater degree than for the country overall, the timing of the fiscal stimulus is poor, threatening to push up demand when there is precious little capacity for expansion. The risk is that the stimulus results in little growth, but instead gets dissipated as higher inflation. Or that monetary fallout nationally will wash onto our shores.

The past few weeks have brought a renewed awareness of the importance of risk. Stock market volatility—or even losses—may have only limited direct impact on spending, but could have broader adverse effects on business and household sentiment. The good news is that current economic conditions are healthy, and the global economic environment, which plays an important role in the Islands, has only strengthened. While tax cut timing is unfortunate, it may yet have positive effects on investment that will support longer-term growth. That jury is still out.

TABLE 1: HAWAII ECONOMIC INDICATORS
YEAR-OVER-YEAR PERCENT CHANGE

	2015	2016	2017	2018	2019	2020
Visitor Arrivals	4.5	3.0	4.9	3.7	1.7	0.7
U.S. Visitor Arrivals	6.9	4.6	5.1	4.4	1.8	0.5
Japan Visitor Arrivals	-1.9	0.4	5.4	1.1	0.7	0.7
Other Visitor Arrivals	3.1	0.4	3.9	3.7	1.9	1.5
Non-farm Payrolls	1.8	1.6	1.0	0.8	0.7	0.6
Employment	2.2	2.1	1.2	0.5	0.7	0.4
Unemployment Rate (%)	3.6	3.0	2.5	2.0	2.5	3.0
Inflation Rate, Honolulu MSA (%)	1.0	2.0	2.5	2.8	3.3	2.8
Real Personal Income	4.3	1.3	0.4	2.1	1.9	1.5
Real GDP	4.9	1.6	1.1	1.7	2.2	1.5

Note: Source is UHERO. Non-farm Payrolls for 2016 and 2017 are UHERO estimates of the benchmark revision. Figures for income and GDP for 2017 are UHERO estimates. Figures for 2018-2020 are forecasts.

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