

Report of the Sequestration Impact Response Team (SIRT)
September 30, 2013

In Satisfaction of Executive Order 13-02

For Presentation to:

The Honorable Neil Abercrombie
Governor, State of Hawaii

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FOREWORD

The spending cuts resulting from the Budget Control Act of 2011 will adversely impact Hawaii's economy, but reduced funding is likely just the beginning of a new reality of diminishing federal support for states and municipalities. Actually, sequestration is not an entirely new experience. Other sectors of the economy have often dealt with shortfalls in revenues, resulting from downturns in the economic engines that feed our economy.

In response to these conditions, many in the private sector have had to alter their business processes to be more efficient and productive, to lower costs in the face of declining revenues. Companies have had to adapt to these economic realities to survive. And, many companies have learned that they can not only survive but thrive by improving processes, better serving their customers or constituents, and being fiscally responsible.

Government must do likewise! Government should carefully examine existing processes and practices for opportunities to improve efficiency and productivity. But, such re-engineering must be done without adversely impacting Government's overall responsibilities to the community. In fact, there should be an important focus toward making it easier for all sectors of the economy to survive and thrive.

Hopefully, sequestration will be a catalyst for reinventing government. With the realization that declining federal support will impact the whole community, state government must find ways to help everyone deal with the new realities. Government must help by simplifying and facilitating approvals, eliminating barriers, reducing costs and encouraging business development and innovation for all sectors in the economy.

This report contains findings and recommendations to deal with the immediacy of the sequestration of federal funds. But, it will hopefully serve as just the beginning of a collaborative framework to improve government and foster the continued economic vitality of our beautiful state.

INTRODUCTION

The Sequestration Impact Response Team (SIRT) was established by Executive Order No. 13-02 on April 5, 2013. The Executive Order defined purpose and objectives of the SIRT in general are “to assess and provide advice and recommendations on the post-sequestration impacts to Hawaii’s economy and government services and programs, including the potential effects of furloughs and loss of income.” There are 31 team members representing various segments of local businesses, government and industry.

The SIRT held four public meetings from July to September 2013 and received information on the Budget Control Act of 2011 (BCA) and the impact of the federal fiscal year (FFY) 2013 sequestration actions.

One of the responsibilities of the SIRT is to provide a written report on specific measures, alternatives and actions the State could consider to mitigate the impact of the BCA and sequester and to provide findings and recommendations to address the long-term effects of the BCA on Hawaii’s economy. In its first meeting, members of the SIRT agreed to work towards compiling a report that could be completed before the conclusion of the federal fiscal year (September 30, 2013).

The SIRT respectfully submits the following report which includes a number of findings, informational presentations and recommendations with specific actions that could be taken to mitigate the impact of BCA and sequestration on our local economy, residents, businesses and community organizations. Not all of the SIRT members agree with all of the recommendations in this report.

FINDINGS

During each of the SIRT meetings, the team heard from different sectors of our community on what they anticipate as potential impacts from the BCA and sequestration. Some of the discussion revealed that there is not a lot of definitive information on the extent of sequestration and the exact funding impact to specific federal departments, agencies or offices. As such, federal outlays of funding for operations, personnel, contracts, etc. was still foggy. There remains a need for increased clarity on the landscape of sequestration before more critical analysis can be done.

A presentation compiled by the Hawaii State Economist, Dr. Eugene Tian, summarized the context of federal funding to state government and the contribution of funding of federal programs or services in Hawaii as part of the gross state economy (presentation provided in addendum). The overlaying message to the SIRT is that when viewed or analyzed from a high-level perspective, sequestration of federal funds has a very small impact on the overall state economy. However, when compared to reports given to the SIRT on non-profit /community social service programs and sequestration impact on the military in Hawaii (including civilian contractors), there was recognition that the impact at the lower-level of analysis could be significant. For example, the Team did hear anecdotal instances of significant reductions in spending at a number of federal installations (i.e. Tripler Medical Center, Pearl Harbor Shipyard, etc.). Spending reductions in these areas were being identified as significantly impacting income of families, degrading service levels, and causing uncertainty as to the future sustainability of programs.

The minutes of each SIRT meeting as well as complete copies of panel presentations are provided in the addendum of this report to provide more specific overview of discussion and findings.

In summary, the SIRT outlines the following FINDINGS in this report.

1. The BCA spending caps will likely remain in place.

The BCA discretionary spending caps represent hard federal spending limits through the year 2021. The SIRT finds that it is likely these spending caps, along with the sequester enforcement mechanism, will remain in place and that Congress will not significantly modify them. The State should plan on the BCA spending caps remaining in place.

2. State policy makers, businesses and the public need a better understanding of the importance of federal expenditures and how changes in federal funding impact Hawaii's economy.

Federal expenditures are very important to Hawaii's economy. In any given year, federal expenditures are as significant a portion to Hawaii's economy as the

revenues generated by the tourism industry. However, policy makers and the public perceive that federal expenditures in Hawaii are assumed to be static each year. The general sentiment is that reductions in net federal spending to Hawaii may be at low-risk of materializing. A contributing factor to complacency may be the lack of readily available data on federal expenditures in Hawaii.

3. The overall economic impact of the BCA for 2013 to Hawaii's economy is estimated to be approximately \$684 million.

According to the Department of Business, Economic Development, and Tourism (DBEDT), the direct loss in federal spending to Hawaii's economy for FY 2013 will be \$462 million. The total loss to Hawaii's gross domestic product (GDP) is estimated to be \$684 million. The general fund tax revenue reduction is estimated to be \$51 million. Considering that Hawaii's GDP for 2013 is forecasted to be \$76.6 billion, the impact of BCA reductions equates to 0.9% of total GDP. Optimistically, Hawaii's overall strong economy may offset and therefore mask the specific impact of the BCA cuts. But individuals, groups and organizations that do receive federal funds will feel the direct impact of the sequester reduction.

4. For FFY 2013, the state government should plan on a reduction of \$20 million in federal grants.

The Federal Fund Information for States (FFIS) estimates a net reduction of \$17,134,000 to major, recurring federal awards awarded to Hawaii state government organizations due to FFY 2013 sequester. Most of the anticipated impact from sequester will occur in the 4th quarter of FFY 2013. These figures do not include impacts to competitive awards and research grants. Making allowances for grants not included in the FFIS data provides a planning figure for FFY 2013 of a reduction in \$20 million to state organizations. As of this writing, state and county governments are still evaluating program impacts as many have not been fully communicated from federal agencies or counterparts.

5. Hawaii non-profits will be significantly impacted by the BCA

Hawaii non-profits will be expected to provide critical community services to help address the direct and indirect impact of BCA and sequester. However non-profits organizations will see a reduction in federal funds received directly from the federal government as well as a reduction in funds received indirectly as a pass-through from state organizations. Social service programs note that need for their services and programs is expected to increase as funding (from federal sources) is expected to decrease. This would lead to increased pressure to develop other funding sources which ultimately mean contributions from other portions of our community.

6. The impact to the military services in Hawaii is being felt now.

The following statistics highlight our State's economic relationship with the Military:

- 18.4 percent of Hawaii's gross domestic product (GDP) is tied to the defense industry
- \$14.7 billion of economic output is attributable to defense spending in Hawaii
- 16.5 Hawaii jobs are tied to every \$1 million in defense spending, translating to about 102,000 jobs that account for generating household earnings totaling \$8.4 billion for Hawaii families
- Defense procurement in which Hawaii was the principal place of performance averaged \$2.3 billion annually in FY 2007–2009
- Defense personnel expenditures in Hawaii averaged \$4.2 billion per year in FY 2007–2009

The Budget Control Act of 2011 mandated across the board cuts totaling \$487 billion over 10 years. Sequestration will add up to \$500 billion on top of that amount. The total impact to the Department of Defense will approach \$1 trillion. Sequestration and the decade-long defense spending drawdown will undoubtedly have adverse implications for Hawaii's economy and people. We have already seen Defense civilian pay reductions and furloughs realized in May with automatic 20 percent pay cuts for Hawaii's 15,000 non-exempt defense civilian employees. Future cuts may lead to Hawaii-based Military force reductions and base realignments, with emphasis on Army and Marines forces and installations. Defense contractors and defense-tied businesses will see a shift towards funding only the most mission essential contracts and services. Large companies have taken steps to survive anticipated cuts. Some defense business may suffer because of their heavy reliance on defense contracts and grants. As a result, contracted workers and service providers may be laid off as contracts and contract amounts are reduced. Hawaii businesses will also feel the ripple effect of these impacts through decreased patronage.

We acknowledge the State is limited in its ability to curb the direct Military-related Sequestration impacts such as furloughs and decreased Federal contract awards. However, Sequestration along with the Military's drawdown and emphasis on achieving efficiencies raises a deeper concern that financial considerations may prevail over Hawaii remaining a key strategic location to command and control military operations in the Pacific. We must acknowledge that the Military is a critical driver of Hawaii's economy.

In this new fiscal environment, the Military is moving towards a business model where Military force structure is based on cost benefit. Hawaii can no longer rely on its geographic location as an anchor to keep Military presence and associated spending in Hawaii. The Military has expressed concerns about the

comparatively higher costs associated with operating and maintaining forces in the State. Moreover, the Commanding General, 25th Infantry Division, has indicated that Sequestration will require that the Army be able to use all of its existing training areas on Oahu to meet its combat training requirements. Much will depend on the Army's success in gaining Federal court approval to resume use of its live-fire training range at the Makua Military Reservation and in being able to develop a jungle training area on Oahu. It should be noted that combat training requirements also apply to the Marines based in Hawaii, as well as the Hawaii Army National Guard.

As defense spending remains critical to state economies, other states are collaborating proactively with commanders to protect the Military's presence in their respective defense communities. In some states, the Army has existing bases with infrastructure capacity and the required state support to add more combat units. To expound on this, as a potential scenario, existing Army bases in Washington and Alaska are attractive lower cost alternatives to Hawaii where operating costs are higher and affordable access to suitable training areas is limited. The cited Army bases have the required infrastructure and training areas to support additional combat units and are co-located with Air Force bases that have C-17 transport aircraft to support rapid deployments. Sequestration will require that Hawaii consider taking steps necessary to compete favorably with the cost benefit advantages offered by the above states.

RECOMMENDATIONS

The SIRT provides the following recommendations that can be implemented either by administrative action or by legislation this session to address the impact of the BCA on Hawaii's economy.

Recommendation #1: Improve data collection and communication

- A. The State should establish a federal expenditure data branch at the Department of Business, Economic Development and Tourism (DBEDT) to collect data and disseminate information on federal spending in Hawaii's economy.**

Background: Hawaii's policymakers and the public need ready access to current information about federal spending in Hawaii in order to be able to respond quickly to changes in federal spending levels. Currently, there is no government or private entity collecting, analyzing and disseminating federal expenditure data in Hawaii in a comprehensive way. In 2010, the U.S. Census Bureau terminated the "Consolidated Federal Fund Report" which had provided detailed information on federal spending by state.

Recommended Action: Establish a three person federal expenditure data branch at DBEDT to produce comprehensive, quarterly reports on federal expenditures in Hawaii.

Estimated Cost: \$200,000 a year.

- B. The State should require all state organizations to post federal correspondence referencing a reduction in federal resources due to the BCA on a public website.**

Background: State organizations should communicate clearly and frequently to the public about the BCA and how sequester reductions will be implemented. Sufficient notice should be provided to entities like non-profits who provide services to the State using federal funds so that there will be time to react.

Cost: Existing state funds.

Recommendation #2: Use State Funds To Offset FFY 2013 BCA Reductions To Major, Recurring Federal Awards To State Departments.

- A. The State should anticipate that it may need to supplement federal funds with state appropriation. An estimate of the initial State requirement could be in the range of an additional \$5 million for the Sequestration Impact Fund (SIF) in the 2014 legislative session. By using State funds to offset reductions in Federal funds due to sequestration, sufficient time will be provided to state organizations,**

and organizations like non-profits to make necessary adjustments. Even at the above funding levels, it may not be enough to replace all Federal funding reductions or spare program reductions.

Background: In the 2013 Legislative Session, the Hawaii State Legislature provided \$15 million for a SIF to offset reduction due to sequestration to major, recurring federal grants received by State departments.

Cost: \$5 million in State funds.

Recommendation #3: The State should implement necessary measures to keep existing Military presence in Hawaii and make conditions favorable for Military strategic planning decisions on future force structure, basing, military construction, and missions in Hawaii.

Background: First, we need to work to *keep the Military presence we have*. Second, we need to *make conditions favorable for the Military to strategically plan future force structure, basing, military construction, and missions in Hawaii*. These actions are crucial as the Military is examining strategic choices now and decisions are potentially being made. We must ensure Hawaii is recognized as a collaborative partner, amicable to the Military's mission readiness and support needs. Going forward, this calls for a change to our current way of doing business. SIRT proposes consideration of the following recommendations which not only benefit the Military but the greater Hawaii business environment and our economy.

- A. Shift Political Will to Elevate Favorable Conditions to Meet Military Requirements.** State leadership and community support is essential to support our recommendations. *This calls for informing political leaders and constituents of the economic and social benefits of the Military presence here.* This will help alleviate misunderstanding and naturally improve support to pursue mutually beneficial programs and activities.

- B. Increase Access to Oahu Training Areas.** Though Pohakuloa Training Area is being improved to be a good joint training area, the Military still spends millions of dollars to send troops and equipment to the Big Island of Hawaii Island for training. A lower cost alternative is required for some training in and around Oahu. Marine Corps combat units, Navy ships and submarines, Air Force/Navy/Marine Corps aircraft, and Hawaii Army and Air National Guard units require access to local combat training areas/ranges. *This calls for Legislative and whole of community support for the Military's use of Oahu's training areas/ranges to meet the Military's needs of maintaining combat ready forces on Hawaii.* Without access to and use of required training areas/ranges, there would be little justification to position combat ready forces in Hawaii.

C. Secure Critical Infrastructure and more efficient Permitting procedures. A critical component to preserving Hawaii's Military presence is our ability to improve State support systems which provide security and sustainment of services. The needed critical infrastructure security also benefits Hawaii's citizens and businesses, as well the Military. These support systems and services call for a reliable and redundant electrical grid, secure and redundant communications such as broadband, network security, water security, and food security.

A major challenge to pursuing these needed systems and services as well as many initiatives in the State, whether it is a Military or business project, is the State permitting process. As an example, permit processing for the building of secure landing sites for broadband cables will take up to two years in Hawaii. In comparison, Oregon takes only six months to process a similar permit. *This calls for working through the Legislative process to modernize the permitting process.*

D. Grow and Communicate Improvements to Quality of Life Programs. Improving education systems and the affordability of quality housing are of high interest to both the State and Military. The State has done much to improve public education yet a perception of poor school systems still exists amongst the Military community. *This calls for working with the Military to understand what Hawaii will need to do to help change this perception and how to communicate awareness of Hawaii's improved education system. An example of improvement is an increase in public high school SAT scores.*

E. Encourage Public-Private Partnerships (PPP). More partnerships would enable the Military to reduce high base operating costs, ensure energy security and other ventures that contribute to reducing the Military's cost in providing essential services. *This calls for continued Legislative support to energy savings initiatives.* One of the most successful partnership ventures is the complete privatization of the military's family housing program, which completely resolved the military's most serious quality of life concern. Ongoing PPP initiatives on renewable energy projects such as building a bio-fuel plant on Schofield Barracks and establishing liquid natural gas storage capability at Pearl Harbor are other examples of success.

F. Evaluate Resource Allocation to the State Historic Preservation Office (SHPO). The Federal government has delegated environmental review authority to SHPO for all military construction projects. This has been an issue in Hawaii over the past years due to the delays encountered in the review of military funded projects. At one point the Chief of Naval Operations stated to the Military Affairs Council that delays in SHPO reviews could jeopardize approvals of MILCON projects for Hawaii. We understand that SHPO is currently under review and may be required to relinquish its authority to review federally funded projects. The concern is that the transfer of federally required reviews to Washington, D.C. could result in causing further delays in processing military

construction projects for Hawaii. *The State is encouraged to provide the required level of resources and support necessary for SHPO to retain federal review authority.*

Consideration of these recommendations and moving forward with implementation will help send a clear message to the Pentagon and ensure that Hawaii maintains its role as a key strategic and cost-effective partner, a partner capable of working with and being supportive of Military presence and readiness needs. In doing so, Hawaii can be buffered from significant Military cost cutting measures and associated adverse economic implications caused by sequestration.

Implementation of these recommendations will be challenging. But Sequestration, as well as a change in our Nation's Defense Strategy, is forcing the military to make drastic changes, to downsize, to make important strategic choices, and to look at cost, efficiencies, and partnerships to plan its future force structure and basing locations. These are decisions being made "now" that will affect the future of Hawaii.

State leaders, in conjunction with the Military Affairs Council and the community, need to seriously look at supporting these recommendations to accommodate the Military. Many are not new recommendations. Accomplishing some of these recommendations will also directly and indirectly help Hawaii businesses as well and help insure that our economy will continue to prosper during this period.

Cost: Unknown at this time.

Recommendation #4: Government at all levels should refrain from actions which will reduce nonprofit revenues or increase nonprofit expenses.

- A. Support federal charitable deduction, avoid changes in excise tax laws, and do not make changes to property tax laws.** The State and elected officials at all levels of government should actively help to protect the federal charitable deductions. If a federal cap on charitable deductions is implemented, many nonprofits will see a decrease in monetary or other donations which has the potential to impact budgets and cause further reduction of services. Keeping this deduction in place will minimize the further effect on nonprofit sector. At the State level we should avoid any changes to Excise tax laws that would impact nonprofits negatively. Finally, at the City & County level, we should refrain from changes to the property tax laws covering nonprofit real estate.
- B. Increased communication.** State government should communicate with increased frequency during this time with the nonprofit sector about where Sequester cuts will occur and how they will be implemented. Government should remain open to options proposed by the nonprofit sector to best meet community needs in response to budget reductions.

- C. Identify the “safety net”.** The State should be clear about the type of services that fall under the “safety net” and identify where loss of funding could create a broader impact on the community. For example, in past years when funding reductions occurred, safety net priorities included food, shelter, clothing, health and safety, and employment and training services for those in need. This provided a framework for programs that should be preserved despite budget reductions.
- D. Improve contracting and invoicing procedures.** The State should continue to improve contracting and invoicing procedures to further reduce delays in payments to nonprofits for services rendered. Additionally, it is suggested that the State consider longer term contracts for providers of health and human service programs in order to provide consistency to people in need of services and increase stability to the nonprofits that provide them.

Cost: Unknown at this time.