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September 19, 2018

FINANCE MEMORANDUM

MEMO NO. 18-16

TO: All Department Heads

FROM: Laurel A. Johnston
for Director of Finance

SUBJECT: Fiscal Biennium 2019-21 Executive Budget Request and the Program and Financial Plan for the Period 2019-25

The following policies and guidelines shall be used in preparing the Executive Budget Request for FB 2019-21 and the Program and Financial Plan for the period 2019-25.

General Background

Hawai'i's economic expansion is in its ninth year. The tourism industry, a significant factor in Hawai'i's economy, has continued to surprise us. Having experienced only one quarter of negative growth since the third quarter of 2009, this consistent growth has often been at record levels.

Through July 2018, year-to-date visitor spending of $10.92 billion reflects an increase of 9.8% compared to the same period last year, while average daily spending by visitors rose by 2.7%. Visitor arrivals were also up by 7.7% versus the same period in 2017. While capacity and infrastructure issues remain, continued growth of the industry is still projected.

Job numbers in the construction industry have been up and down for years. Current activity in the construction sector has flattened, though at a higher level, but the number of building permits has increased. Hence, these and other planned projects should sustain the industry at the current level going forward.

Hawai'i's preliminary seasonally adjusted unemployment rate remains at historically low levels, ranging from 2.0% to 2.1% since October 2017. However, low unemployment levels may also indicate "full employment" and potential manpower limitations which may constrain further growth.

While the State's economy is geared toward expansion, there is significant pressure on the labor market and infrastructure to keep pace. Thus, we remain optimistic about Hawai'i's economy but recognize that downturns are part of every economic cycle. It is our responsibility to ensure that the State is prepared.

Our experiences with the recent disasters such as the flooding on Kaua'i and O'ahu and the ongoing eruption on the island of Hawai'i and, most recently, Hurricanes Lane and Olivia, serve as timely reminders of how quickly things can change. While those directly impacted may still be feeling the effects, the statewide economic impact is not expected to be long term.

We are fortunate but, nevertheless, vulnerable in the middle of the Pacific. We must look beyond our State and keep a watchful eye on national and international actions which may impact our economy, such as possible trade wars and increased tensions in the Middle East.

This Administration has generally approached the budget in a cautious manner, in part because fluctuating general fund revenue growth often did not reflect the State's economic situation and the expansion of the economy. Again, we must closely monitor general fund tax revenues, as collections for the first two months of FY 19 are less than 1.0% more than last year.

Other factors, such as providing funding for the State's unfunded liabilities in the Employees' Retirement System and the Hawai'i Employer-Union Health Benefits Trust Fund, also weigh heavily. We understand the significant commitment to address these liabilities in the years to come and must ensure that we are able to provide the funding to address these liabilities. As we construct the budget for the next biennium, we must keep in mind our continued concern regarding State expenditures outpacing revenues until FY 21.

Potential reductions to federal grant programs and necessary mitigation efforts must also be considered. The State must be prepared to provide additional funds to support the continuation of programs which it deems critical. Beyond the costs to transition federal programs to State funding, we must consider the economic impact of the reduced amount of federal funds being spent.

Collective bargaining (CB) negotiations for all of the bargaining units (BU) for FB 2019-21 are also underway. These factors reinforce the continual need to be fiscally prudent and responsible with our expenditures to ensure the State's fiscal stability in FY 20 and beyond.

Therefore, we will continue a cautious approach in developing the FB 2019-21 Executive Budget. All budget requests must be sustainable and reasonable.

<u>The State's Fiscal Condition</u>

Preliminary actual general fund tax revenue growth for FY 18 was 7.6%, 0.3% higher than projected by the Council on Revenues (COR). Even with a higher base for FY 18, the COR maintained its general fund tax revenue growth rate forecast at its September 6, 2018 meeting due to the expected continued growth of the tourism sector and uptick in construction activity. Currently, the COR projects general fund tax revenue growth of 5.0% in FY 19 and 4.0% in FY 20 through FY 24. In addition, the COR forecasted growth of 4.0% for FY 25, which was not previously projected.

The State ended FY 18 with a general fund balance of approximately $750 million. This carryover balance will help to support the increasing costs of State programs.

For FY 19, preliminary general fund tax revenue collections are 0.8% more than last year for the first two months. A significant decrease in July 2018 in the volatile corporate income tax revenues has negatively impacted the positive growth in all other tax categories; in addition, general excise tax revenues have thus far grown at a slow clip of 0.4% this fiscal year.

Reasonable and Sustainable

Since the beginning of this Administration, we have been focused on providing a government which is more responsive to Hawai'i's people, while improving the efficiency and transparency of our operations. We will continue to pursue initiatives to improve the lives of our families, our children, and our kupuna, including those focused on:

- Education, which is fundamental to our children and our future. We must provide more support at the school level to ensure suitable learning environments.
- Affordable housing, which is in great need for Hawai'i's families to rent or buy.
- Homelessness, which continues to significantly impact our communities. We need to provide more shelters and social services.
- Local food production, which is necessary to develop a sustainable food supply.
- Our 100% clean energy future, which will reduce the State's reliance on fossil fuels.
- Correctional facilities, where we must alleviate overcrowding.

There is still much to be done but our resources are limited. We are the keeper of the public purse and the public's trust; hence, we must prudently use our resources and ensure that State funds are spent wisely.

Working together, we can achieve these common goals. We highly encourage departments to realign their budgets to best meet their current needs, including eliminating long-term vacancies where appropriate. Departments may consider requests which are reasonable and sustainable in cases where realignment cannot address those needs.

Again, bear in mind that the State is projected to spend more than it is taking in this fiscal year and is facing significant increases in funding pension and other post-employment benefits (OPEB) liabilities, in addition to other demands on our limited resources. Departments must consider the long-term impact to the State's resources when building their budget requests.

Budget Transparency

Departments should review their FY 19 operating budget details for items which do not align with anticipated expenditures and can be addressed immediately. Each department's review should include, but should not be limited to, the following, as applicable:

- Negative adjustments
- Underfunded, unfunded or unbudgeted positions
- Specific budget line items which do not align with anticipated expenditures

Additionally, Act 160, SLH 2015, provides that, effective July 1, 2017, no funds shall be expended to fill a permanent or temporary position if the filling of that position causes the position ceiling to be exceeded, with specified exceptions. "Position ceiling" is defined as the maximum number of permanent and temporary positions that an expending agency is authorized for a particular program.

Consequently, it is highly recommended that all departments review their unbudgeted positions to determine which positions are not exempt under Act 160. Such positions which are <u>critical and on-going should be incorporated into the budget</u>.

Additional funding will not be provided for these requests because they are currently funded within existing budgets; as such, in order to reflect necessary changes, departments should submit the following:

1. "Conversion of Unbudgeted Positions" requests to authorize unbudgeted positions; or

2. Trade-off and transfer adjustment requests necessary to correct negative amounts, fully fund underfunded or unfunded positions, or realign the budget to expenditures; or

3. Base adjustment requests to delete underfunded or unfunded positions.

Act 160 also requires that permanent and temporary position ceilings for each program be provided in the budget documents. As such, departments must provide permanent <u>and temporary</u> position counts in their BJ Summary tables for the FB 2019-21 Executive Budget.

Federal Fund Budgeting

In 2013, the State began a process to change the way federal awards were budgeted and expended, with the intent of increasing transparency and improving the State's ability to meet anticipated federal reporting requirements. Since then, the Federal Fund Information for States list of major, recurring federal awards was used to determine which federal awards were appropriated as means of financing (MOF) "N" (federal funds). All other federal awards, which were anticipated to be received in FY 18 or FY 19, were appropriated as MOF "P" (other federal funds).

Each operating federal grant award anticipated to be received was provided a unique appropriation symbol and an extended lapse date (operating federal funds lapse after three fiscal years, instead of one fiscal year) to accommodate the difference between the State and the federal fiscal years and performance periods which extend beyond one year. Also, CIP federal fund appropriations, which have been deemed necessary to qualify for federal-aid financing and reimbursement, will lapse five fiscal years after the fiscal biennium to encourage the timely implementation of federally-funded projects and expenditure of federal grant awards.

Each department will begin the FB 2019-21 budget process with federal fund and other federal fund ceiling amounts, which must be appropriately allocated by program ID. Departments should submit requests to adjust the FY 20 and FY 21 ceiling amounts to more accurately reflect anticipated federal award amounts or to correct the MOF of recurring awards, if necessary, as reflected on each program's corresponding list of "Federal Awards for FB 2019-21" (**Form FF**). For planning purposes, it should not be assumed that State funding will automatically replace federal funding in situations where federal funding is disrupted or discontinued.

This department's Office of Federal Awards Management will send out further information on the online electronic workflow process which should be used to complete your department's Form FF for the FB 2019-21 budget process.

A. General Policies

The general policies for the development of the FB 2019-21 Executive Biennium Budget are as follows:

1. For operations, the Executive Budget will be based on FY 19 appropriations from Act 49, SLH 2017, as amended by Act 53, SLH 2018, minus non-recurring costs and plus CB (except for federal and other federal funds) and other adjustments as applicable. Individual departmental budget ceilings are established for all departments by the Department of Budget and Finance (B&F).

2. Under their respective budget ceilings, departments are authorized and encouraged to recommend trade-offs and transfers within and among programs under their purview to reflect the department's current priorities, changing conditions and to improve efficiency.

3. Non-general fund programs should plan for a fringe benefit assessment rate of 60% for FY 20 and FY 21. The projected cost to fund OPEB and the statutory increases in premium contribution rates account for significant portions of this rate, which is expected to remain at around 60% for FY 22 and beyond.

4. The Bipartisan Budget Act (BBA) of 2018 increased the spending caps imposed by the Budget Control Act (BCA) of 2011. The BBA raised non-defense spending caps by $68 billion in federal FY (FFY) 19 relative to the BCA caps of 2011 and $18 billion relative to non-defense spending caps in FFY 18.

   According to the Federal Fund Information for States, the additional federal funds will be spread unevenly among a variety of federal programs that distribute funds to state governments. Hawai'i should expect an increase in federal funding for FFY 18 of 5.3% for mandatory programs and 10.3% for discretionary programs.

   However, the President's Budget for FFY 19, while not likely to be enacted, proposed cuts for Hawai'i of 10.7% for mandatory programs and 17% for discretionary programs. Thus, regardless of the spending available under the BBA, the desire of the current administration to reduce the size of the federal government requires us to take a cautious approach regarding future federal spending.

   In budgeting for FFY 19 and beyond, departments should assume that the recent increases in funding in BBA will not be repeated, with the exception of Medicaid. For planning purposes, departments should assume a range of possibilities from a slight increase in federal funding to reductions in federal funding of 5.0% to 10% and should continue to keep abreast of potential changes to federal funding levels by working closely with their federal counterparts.

   Given the uncertain nature of future federal funding levels, programs should not assume that State funds will be available to support program costs if federal funds are reduced or no longer available. All agencies receiving federal funds for operational purposes shall review such operations for possible changes to anticipated federal grants or other federal funding agreements. At this time, the use of discretionary federal funds for positions is discouraged and should be minimized.

5. Pursuant to Section 37-68(1), HRS, any proposal for new programs, regardless of funding sources, must demonstrate that such programs are appropriate functions of State government and can be implemented by government as cost-effectively as by the private sector.

6. Departments should be prepared to initiate necessary enabling legislation, or appropriate rule changes, to coincide with budget requests, as applicable. Legislative proposals shall be coordinated with the Office of the Governor. Additionally, the B&F analyst assigned to your department should be informed of the applicable proposals as part of the budget review. (**Form A**, *Request for*

Operating Budget Adjustment, should be used to provide the necessary information to justify the related request and indicate the required legislation.)

B. Submission Requirements and Formats

1. Biennium Budget requests shall be submitted according to the requirements and formats as specified in the attachments.

2. All budget submissions will be subject to review and evaluation by B&F and the Governor. Worksheets and other supporting details may be requested and should be made available upon request.

C. Due Dates/Other Requirements

The following must be provided to this office:

1. By Friday, October 12, 2018, the following must be submitted, reflecting your budget submission:

   a. Two hard copies of Forms A, A-Attachment, B, C, and FF (relating to the operating budget); and Tables P, Q, and R, and Forms CIPOp, CIPOpB, PAB and S (relating to CIP budget).

   b. All Excel files which reflect your department's budget submission of Forms A, A-Attachment, B, and C (relating to the operating budget); and Forms CIPOp, CIPOpB, PAB and S (relating to CIP budget) should be transmitted to your B&F analyst.

2. By Friday, November 30, 2018, the following must be submitted, reflecting the Governor's final budget decisions:

   a. For all departments except the Department of Education (DOE), the University of Hawai'i (UH), and the Department of Transportation (DOT): Updated BJ Summary Tables in eBUDDI. Totals (by cost element and MOF) must match the grand totals on the Form B for the Governor's decision.

   b. For DOE, UH, and DOT: Hard copies, Excel files, or other electronic files of the updated BJ Summary tables. Totals (by cost element and MOF) must match the grand totals on the Form B for the Governor's decision.

   c. All departments: Two copies of the updated Budget Narratives; Forms PAB, CIPOp and CIPOpB.

   d. All departments: Updated Tables P, Q, and R in eCIP and Tables A, B and C (Performance Measures) in eAnalytical. Total (by cost element and MOF) for all Table P must match the grand total on the Form S for the Governor's decision.

e. All departments: All Excel files which reflect the Governor's final budget decisions of Forms A and A-Attachment (relating to the operating budget); and Forms CIPOp, CIPOpB, and PAB (relating to CIP budget) should be transmitted to your B&F analyst.

3. By Friday, November 30, 2018: Two copies of Form DMC (additional requirement for deferred maintenance costs). The Excel file of Form DMC must be transmitted to your B&F analyst.

4. By Friday, December 28, 2018: The BJ details updated in eBUDDI reflecting the Governor's final budget decisions for all departments, except DOE, UH, and DOT for which Excel or other electronic files are required.

Attachments

Attachment 1: FB 2019-21 Operating Budget Ceilings

Attachment 2: Guidelines for the Operating and Capital Improvement Program Budgets for FB 2019-21 and the Planning Period

Attachment 3: Additional Operating Budget Detail Guidelines FB 2019-21 and the Planning Period

Attachment 4: Operating Budget Submission Forms (Forms A, A-Attachment, B, C, FF)

Attachment 5: CIP Submission Tables and Forms (Tables P, Q, R; Forms CIPOp, CIPOpB, PAB, S, DMC)

Attachment 6: General Budget Information and Instructions for Completing Program Budget Request Forms (September 2018)

Attachment 7: Major, Recurring Federal Funds for State FB 2019-21