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GOVERNOR

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LT. GOVERNOR

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John M. Knox
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William Pieper II

TAX REVIEW COMMISSION

STATE OF HAWAII
C/O RULES OFFICE
830 PUNCHBOWL STREET, ROOM 219
HONOLULU, HAWAII 96813

February 8, 2018

To the Honorable Members of the Twenty-Eighth Legislature:

We are pleased to present the report of the Tax Review Commission, which gives our review of the State of Hawaii's tax structure and our recommendations for change. We are submitting the report in accordance with Article VII, Section 3 of Hawaii's Constitution as amended in 1978, and Chapter 232E of the Hawaii revised Statutes.

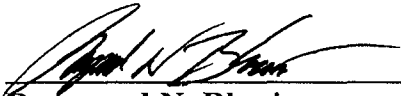
The report represents a consensus that we have reached. This does not mean that every member approves of every recommendation: some of the recommendations were reached through compromise and some were reached by majority vote. However, each of us approves and supports the report as a whole. We take pride in the results of our efforts and we sincerely hope that you find our recommendations helpful in your future efforts to formulate tax policy.

Respectfully Submitted

TAX REVIEW COMMISSION

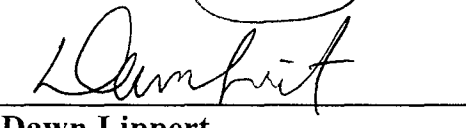

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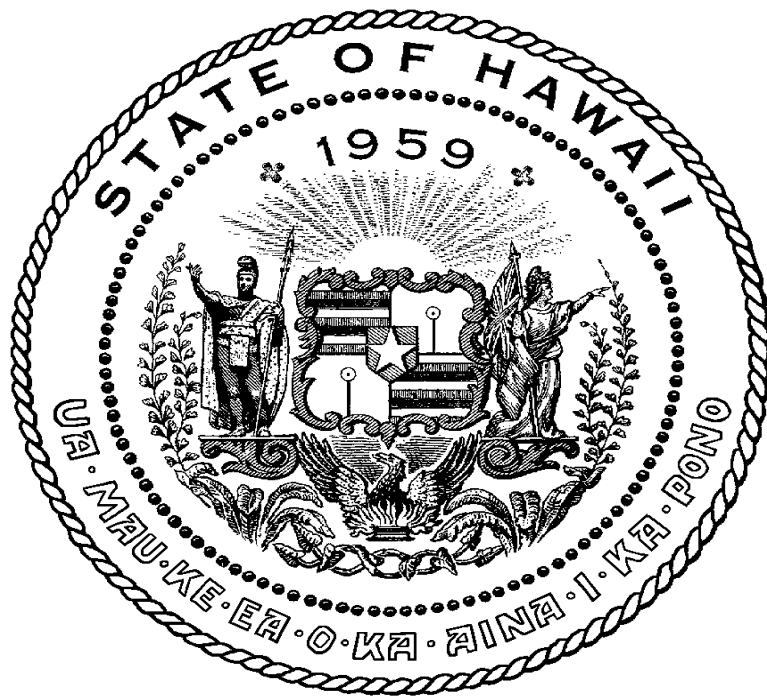

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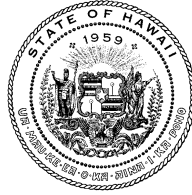

Dawn Lippert


William (Billy) Pieper, II



REPORT OF THE
2015 – 2017 TAX REVIEW COMMISSION

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LT. GOVERNOR



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ACKNOWLEDGEMENTS

This is the report of the 2015-2017 Tax Review Commission. The Commission is composed of seven unpaid members who have generously donated their time to help the State evaluate the structure of its taxes.

The Commission wishes to acknowledge staff of the Department of Taxation for administrative support. Sondra Kaawa prepared minutes for the Commission's meetings and arranged travel for its members. Titin Sakata coordinated the Commission's meeting, kept records of its correspondence, and generally helped with the Commission's administrative chores. She also gave us a presentation and a study on the effects of eliminating the income tax for those in poverty, and a compilation of recommendations made by previous Tax Review Commissions. Seth Colby gave us thought-provoking presentations and a report on the structure of Hawaii's taxes. Don Rousslang gave us presentations and studies on Hawaii's corporate income tax and on principles of sound tax policy and helped us draft our report. We also thank Wesley Machida, former Director of the Department of Budget and Finance, for providing data on General Fund spending on various items and we thank Deputy Attorney General Randall S. Nishiyama for excellent legal assistance. Lastly, we thank people in the tax community and from the public at large who attended our meetings or who offered suggestions or comments.

THE 2015-2017 TAX REVIEW COMMISSION

Colleen M. Takamura
Chair
Manager, Niwao & Roberts, CPA's, a P.C.

Vaughn G.T. Cook
Vice-Chair
Director, Torkildson Katz Hetherington Harris & Knorek

Raymond N. Blouin
Retired, Hotel and Resort General Manager/Kauai, 1981-2018

M. Nalani Fujimori Kaina
Executive Director, Legal Aid Society of Hawaii

John M. Knox
Principal, John M. Knox & Associates, Inc.

Dawn Lippert
Chief Executive Officer, Elemental Excelsior

William (Billy) Pieper II
Vice President, U.S. Partnerships, Barclays

Commission Staff

Ted S. Shiraishi, Co-Executive Director and Administrative Rules Officer
Dr. Seth S. Colby, Co-Executive Director and Tax Research and Planning Officer
Titin L. Sakata, Technical Coordinator
Dr. Donald J. Rousslang, Writer and Researcher
Sondra-May N. Kaawa, Secretary

EXECUTIVE SUMMARY

We, the members of the 2015-2017 Tax Review Commission (TRC), devoted the bulk of the resources provided to the TRC to study two issues. The first issue is that the State faces budget challenges in the coming years, because retirement benefits that have been promised to the State's employees were not adequately funded. The second issue is how to distribute the burden of the State's taxes more progressively, to lessen the burden on those who can least afford to pay taxes. We commissioned PFM Group Consulting, LLC to study these issues. We also commissioned a study on Hawaii's corporate income tax, which the 2005-2007 TRC had recommended abolishing. In addition, we received studies from the Department of Taxation on the effect of eliminating the State's individual income tax for those in poverty and a study on the trade-offs among the State's main taxes. Following are the main findings from the studies:

- Additional payments needed to fund retirement pension and health care benefits for State employees will average over \$400 million annually from 2018 through 2022. In their study, the PFM Group opined that the additional payments will require more revenue than can reasonably be expected to come from Hawaii's current tax structure.
- The average share of income that Hawaii residents pay in state taxes rises from about 6 percent to about 8 percent as annual household income rises from \$25,000 to \$50,000, but the share is relatively flat as income rises

above \$50,000. In their study, the PFM Group concluded that although Hawaii's tax system is only modestly progressive, it is significantly more progressive than that of most other states.

- The study on Hawaii's corporate income tax concluded that the State should not eliminate the statutory tax rates, but that corporations should be allowed to expense new investments (instead of depreciating the investments over their useful life) to encourage businesses to invest within the State.
- The personal exemption and standard deduction in Hawaii's individual income tax have each been eroded by inflation over time and are now out of date. Although tax credits eliminate the latent tax liability for most households with income below the poverty threshold, there are still instances where they are required to pay the State's income tax.

The TRC's Recommendations

Based on findings from the studies and on our deliberations, we make the following recommendations:

Net Income Tax Recommendations

- Modernize the individual income tax by increasing the personal exemption and standard deduction to the levels in the federal income tax as of tax year 2017 and index for inflation thereafter. Alter the tax rates and tax brackets to make the modernization revenue neutral.

- Tax retirement income more evenly by making social security payments and income from employer-provided pensions subject to the State's income tax. To help people plan for the tax change, enact it with a five year lag.
- Allow corporations to expense new investments when calculating the corporate income tax liability.

Recommendations Related to Revenue Adequacy

- Expand efforts to collect tax on remote sales, including e-commerce and mail order sales, by requiring retailers to report their sales to the Department of Taxation when they have annual sales in Hawaii of \$100,000 or more.
- Tax e-cigarettes at a rate equivalent to the tax on regular tobacco cigarettes.
- Establish a "Simpson-Bowles" Commission to examine how to handle the unfunded and underfunded liabilities for health care and pension benefits for retired State workers, including measures to raise revenues and to reduce expenditures.

Recommended In-Depth Studies

In addition to our recommendations, we recommend that in-depth studies be commissioned on the following measures.

- Study whether Hawaii should institute a carbon tax. The study should consider the effect on other State goals, on what to do with the revenue, and on the best way to apply the tax.
- Study whether the rate of withholding on sales of real property by nonresidents (HARPTA withholding) should be restored to its original rate of 9 percent from the current rate of 5 percent.
- Study whether it would be cost effective for the Department of Taxation to increase efforts to educate the public in order to improve compliance with Hawaii's tax laws.

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- Appendix D: "Effects of Eliminating the Hawaii Individual Income Tax for Taxpayers with Income Below Poverty Level," Titin L. Sakata and Dongliang Wu
- Appendix E: Principles of Sound Tax Policy for Hawaii," Dr. Donald J. Rousslang
- Appendix F: "Summary of Recommendations Made by Tax Review Commissions," Titin L. Sakata

REPORT OF THE 2015-2017 TAX REVIEW COMMISSION

1 INTRODUCTION

1.1 The Tax Review Commission's Mandate

In 1978, the people of Hawaii amended their State Constitution to create the Tax Review Commission, which is to be reconstituted every five years, and charged it with the duty to "submit to the legislature an evaluation of the State's tax structure, recommend revenue and tax policy, and then dissolve."¹ The implementing law is Section 232E of the Hawaii Revised Statutes, which directs each Tax Review Commission to "conduct a systematic review of the State's tax structure, using such standards as equity and efficiency."

In addition to the mandate we, the members of the Tax Review Commission of 2015-2017, received four resolutions from the Legislature and a letter from Governor Ige, asking us to examine specific tax issues. Senate Concurrent Resolution (SCR) 58 asked us to examine all income tax credits, exclusions and deductions. SCR 59 asked us to evaluate whether the standard deduction and personal exemption in Hawaii's individual income tax should be increased to conform to those in the Internal Revenue Code (IRC). SCR 138 asked us to study the effects of increasing the general excise tax (GET) to fund public education and long-term care as proposed in recent Senate bills. Finally, Senate Resolution 103 asked us to update a study that was done for the 1989 Tax Review Commission on the distribution, by income class, of Hawaii's state and local tax burdens.

¹ Hawaii State Constitution, Article VII, Section 3.

The letter from Governor Ige asked us to study how the tax brackets in Hawaii's individual income tax could be adjusted to replace the revenue that would be lost if the State's personal exemption and standard deduction were increased to conform to those in the IRC, to recommend an equitable way to allocate the revenues from the transient accommodations tax (TAT) among the counties and the State, to examine whether the structure of the TAT discriminates against investment in hotel capacity in favor of time share units, and to evaluate methods to prevent inflation from eroding the effective rate of the specific taxes levied on liquor, fuel and motor vehicles.

1.2 Focus of the Tax Review Commission's Work

We did our best to fulfill the mandate and to respond to the requests from the Legislature and from the Governor, but given the limited resources at our disposal, we focused our attention on two central goals of tax policy that we believe are of paramount importance for Hawaii. The first goal is tax adequacy. In preliminary investigations, we discovered that the State continues to face budget challenges going forward, largely owing to unfunded or underfunded liabilities for health care and pensions for retired state workers. The second goal is how to make the State's taxes more progressive.

We considered studying the exemptions from Hawaii's GET in response to SCR 58, but decided against it on several grounds. Most importantly, we do not have reliable data on the amount of the exemptions being claimed. The Department of Taxation's Office of Tax Research and Planning has recently compiled data on the exemptions, but

complete data are limited to the first six months of 2017.² Secondly, Act 177, Session Laws of Hawaii (SLH) 2017 already requires the State Auditor to conduct an extensive review of the costs and benefits of the GET exemptions, as well as other exemptions, exclusions, tax credits and deductions provided under Hawaii's tax laws. Accordingly, we decided to devote our resources to the studies on tax adequacy and on the distribution of the State's tax burdens.

In order to guide our study of Hawaii's taxes, we began by assembling a list of principles of sound tax policy with the goal of shaping a tax system that best serves Hawaii's residents. To aid us in our deliberations, we contracted for a study by PFM (Public Finance Management) Group Consulting LLC. We also received several presentations and studies from staff of the Department of Taxation. The PFM Group's study examined the questions of who bears the burden of Hawaii's taxes, of ways to make the State's taxes less regressive, and of ways to generate more revenue to help meet the obligations to retired State workers without making the tax system more regressive. The presentations by Department of Taxation staff described the State's main taxes, including the individual income tax, the GET, and the transient accommodations tax. The staff also provided studies on the effects of eliminating the individual income tax for those below the poverty level and a study (which we commissioned) on the effects of eliminating the corporate income tax. The studies by staff and by the PFM Group are presented in appendixes.

² Data on the exemptions are provided in Tax Research and Planning Office, Hawaii Department of Taxation, "Hawaii General Excise & Use Tax Exemptions: Tax Year 2017" (December 2017).

The rest of our report is organized as follows. We begin with a discussion of the principles of sound tax policy. This is followed by a broad review of the State's tax structure and of some of the imminent budget challenges the State faces from liabilities that have accumulated over the years for future health care and pension benefits for retired State workers, but that were not adequately funded. We then present findings from the studies prepared by the consultant and by staff of the Department of Taxation that bear on the goal of achieving tax adequacy or the goal of making the State's taxes more progressive. We conclude with our observations and recommendations.

2 PRINCIPLES OF SOUND TAX POLICY FOR HAWAII

The two basic principles for sound tax policy are that taxes should be fair and they should be efficient. Standards for what makes taxes fair are hard to set, because they are subjective, but it is important that taxpayers generally deem taxes to be fair so that they are more willing to comply with the tax laws. An efficient tax system is economical and easy for tax officials to administer and for taxpayers to comply. It also interferes as little as possible with economic decisions of individuals and of businesses.³ Another basic principle of sound tax policy is that the tax system should be adequate, that is, it should provide enough revenue to fund desired government services.

³ An exception is taxes that provide a public benefit in addition to revenue, as discussed in subsection 2.3.2 below.

"For Hawaii" is added to the title of this section, because it is important to take account of Hawaii's unique characteristics when formulating the State's tax policy. First among these is that visitors and other nonresidents spend large amounts on goods and services that are consumed within the State. For example in 2016, visitors spent more than \$15.9 billion in Hawaii, which was about 19 percent as great as the State's gross domestic product.⁴ Also, in 2016 there were more than 107,000 military personnel and their dependents in Hawaii,⁵ most of whom are nonresidents, as well as other nonresidents who own homes in Hawaii and live here part time. The nonresident spending within the State provides an opportunity to shift (or "export") an important part of the burden of the State's consumption taxes to the nonresidents.

Secondly, because Hawaii is geographically isolated, people have limited ability to avoid the State's consumption taxes by shopping in another state that has lower taxes. This allows Hawaii to rely more heavily than other states on consumption taxes for its tax revenue.

Thirdly, income of Hawaii residents is more evenly distributed compared with other states. For example, in 2016 Hawaii had the sixth highest median household income in the nation at \$64,859, but the income threshold for the top 1 percent of earners in

⁴ Data on visitor spending and the State's gross domestic product are from Research and Economic Analysis, Department of Business, Economic Development and Tourism, *2016 State of Hawaii Data Book*, tables 7.26 and 13.03, available at <http://dbedt.hawaii.gov/economic/databook/db2016/>.

⁵ *Ibid*, table 1.24.

Hawaii was the 45th lowest in the country.⁶ The relatively even income distribution in Hawaii limits the State's ability to raise revenue by taxing high-income individuals. In contrast, income of nonresidents who are required to file a Hawaii State income tax return is significantly more concentrated in the upper end of the income distribution.⁷

Finally, we note that although income generally is used to measure the ability to pay tax, wealth is an alternative measure that can be used for this purpose. It is important to distinguish between wealth and income. Annual income is the amount earned during the year, whereas wealth is total assets minus total debts. Wealth is a substantial part of the tax base for many other states,⁸ but in Hawaii the State is precluded from taxing real property, which is the most common and practical way to tax wealth.⁹ This limits the State's ability to shift the burden of its taxes to nonresidents, because nonresidents own a

⁶ See Dr. Seth Colby, "The Economic Trade-Offs of Hawaii's Major Tax Types," report prepared for the 2015-2017 Tax Review Commission (September 2017), pages 8 and 9. (*See Appendix B.*)

⁷ In tax year 2015, nonresident filers with income of \$300,000 or more accounted for about 63 percent of the total income of all the nonresident filers, whereas Hawaii residents in this income class accounted for only about 19 percent of the total income of all residents. See Tax Research and Planning Office, Hawaii Department of Taxation, "Hawaii Individual Income Tax Statistics: Tax Year 2015," (December 2017), pages 22 and 30.

⁸ See PFM Group Consulting LLC, "State of Hawaii Tax Review Commission: Study of the Hawaii Tax system," report to the 2015-2017 Tax Review Commission, November 14, 2017, pages 55-56. (*See Appendix A.*)

⁹ The State is precluded from taxing real property tax by Article VIII, section 3 of the Hawaii State Constitution. Alternative (but less effective) ways to tax wealth are the estate tax and taxes on personal property.

substantial amount of property in Hawaii but have little income subject to the State's income tax.¹⁰

What follows is a brief discussion of principles of sound tax policy for Hawaii. A more complete discussion of the principles is given in Appendix E.

2.1 Fairness

Fairness of taxes, or tax equity, usually is measured using two standards: horizontal equity and vertical equity. A third standard sometimes mentioned is the "benefits principle."

2.1.1 Horizontal Equity

Horizontal equity requires that taxpayers in the same situation face the same tax burden. Tax breaks for selected classes of individuals or for selected activities are examples of things that violate horizontal equity.

2.1.2 Vertical Equity

Vertical equity is usually taken to mean that people with higher income should pay tax at a higher rate than people with lower income. The notion is that taxes should be based on the ability to pay, or said another way, that the pain of taxes should be the same for everyone. Graduated income tax rates are often used to help achieve vertical equity.

¹⁰ It is estimated that nonresidents own 12.4 percent of the total value of homes in Hawaii. See Research and Analysis Division, Department of Business, Economic Development and Tourism, "An Analysis of Real Property Tax in Hawaii," (March 2017), page 44. However, the nonresidents have only 6.7 percent of the total income subject to Hawaii's individual income tax. See Tax Research and Planning Office, Hawaii Department of Taxation (November 2017), *Op. cit.*, pages 30 and 33.

However, vertical equity is hard to measure by objective standards, as no one can say with authority how progressive tax rates should be.

2.1.3 The Benefits Principle

The benefits principle says that those who benefit from the government services should pay for them. At the state level, most government services are provided by government, instead of by the private sector, either because it would be hard to make people who benefit from the services pay for them (such as public safety), or because the services go to people who cannot afford them (such as public welfare). In these cases, the benefits principle can't be applied. However, if the services can be limited to beneficiaries who can afford them, they should be paid for with fees instead of with taxes, because this causes users to take account of the cost of the services, which discourages wasteful overuse.

2.2 Efficiency

The costs of administering and collecting the taxes should be kept as small as possible, but these costs usually are low anyway. The bigger costs of taxes are the costs of complying with the tax laws and the costs that taxes impose by distorting economic decisions.¹¹ For example, taxes on income discourage people from working and from saving. Most of the other things included in lists of principles of sound tax policy are

¹¹ Estimates for the size of the various costs imposed by taxes are given in Dr. Donald J. Rousslang, "Principles of Sound Tax Policy for Hawaii," report prepared for the 2015-1017 Tax Review Commission, December 28, 2017, pages 8-10. (*See Appendix E.*)

things that improve the efficiency of taxes. The following are some attributes that make the tax system more efficient

2.2.1 Simplicity

A simple tax code has the advantages of being easier for tax authorities to administer and to enforce and easier for taxpayers to comply with, which lowers both the cost of tax administration and the cost of tax compliance. Simplicity of taxes also makes them more transparent, so that it is easier to hold accountable the parties responsible for designing and administering the tax system, including legislators.

2.2.2 Stability

Stability of the tax code reduces the costs of tax administration and compliance. It also reduces uncertainty about the future, which helps individuals and businesses to make better plans. Another kind of stability sometimes mentioned in principles of sound tax policy is that tax revenues should be stable. Stability of tax revenues reduces uncertainty in government budget planning, because the State's operating budget is constrained by law to balance.

2.2.3 Tax Neutrality

The standard of tax neutrality requires that a tax be levied uniformly on its base, with no special tax breaks for selected activities or taxpayers. Uniform application of a tax helps minimize the effects on economic decisions. In addition to distorting economic decisions, special tax breaks complicate the tax code and make it harder to administer.

2.2.4 Broad Base, Low Rates

Uniform application of a tax to its base helps keep the base as broad as possible, so that the needed tax revenue can be gotten with the lowest tax rate possible. Keeping the tax rate low is important, because it reduces the costs of economic distortions caused by the tax.

2.3 Other Principles of Sound Tax Policy for Hawaii

2.3.1 Tax Exporting

When designing Hawaii's tax system, tax authorities should be mindful of opportunities to export the burden of local taxes to nonresidents. The ability to export the tax burden varies greatly among Hawaii's taxes.

2.3.2 Taxes That Provide a Public Benefit in Addition to Revenue

Instead of imposing an extra cost by distorting economic decisions, some taxes provide an extra public benefit by discouraging things that are deemed socially undesirable. For example, taxes on tobacco and alcohol discourage smoking and drinking and a carbon tax discourages pollution. Such taxes can be efficient sources of revenue.

2.3.3 Tax Adequacy

A requirement for any tax system is to produce enough revenue to fund government services. The need to provide adequate revenue limits the alternatives available to tax officials. In most cases there are only three tax bases broad enough to support a state government's spending needs: income, consumption and wealth. Hawaii's Constitution prohibits the State from taxing real property, so income and consumption are the State's main tax base alternatives.

2.3.4 Competitiveness

Helping local businesses compete with businesses in other taxing jurisdictions is often given as the reason for tax breaks for selected activities. The argument is that tax incentives are needed to attract or keep the activities in order to broaden the economy or to create jobs. However, as discussed above, such incentives violate the principle of tax neutrality and may also violate notions of tax equity.

3 HAWAII'S BUDGET AND TAX ADEQUACY

The study by the PFM Group found that Hawaii will continue to face budget challenges going forward.¹² In this section, we describe the nature of the challenges and put them in perspective with the State's economy and overall budget.

3.1 Hawaii's Budget – a Brief Overview

The State's budget is divided into three types of funds, called Fiduciary Funds, Proprietary Funds, and Governmental Funds. The Fiduciary Funds are used to account for resources held for the benefit of parties outside the State. They are not included in the government-wide financial statements, because their funds cannot be used to support the State's own programs. The Proprietary Funds are for the State's activities that resemble commercial enterprises and include the Unemployment Compensation Fund and funds for the operations of highways, airports, harbors and other business-like activities. The Proprietary Funds have their own dedicated sources of revenue that make them virtually

¹² PFM Group Consulting LLC (November 14, 2017), *Op cit.*, page 124.

self-supporting and they are budgeted independently from other State government spending. The Governmental Funds are used for most of the State's other activities and are supported mainly by tax revenues and by intergovernmental transfers.

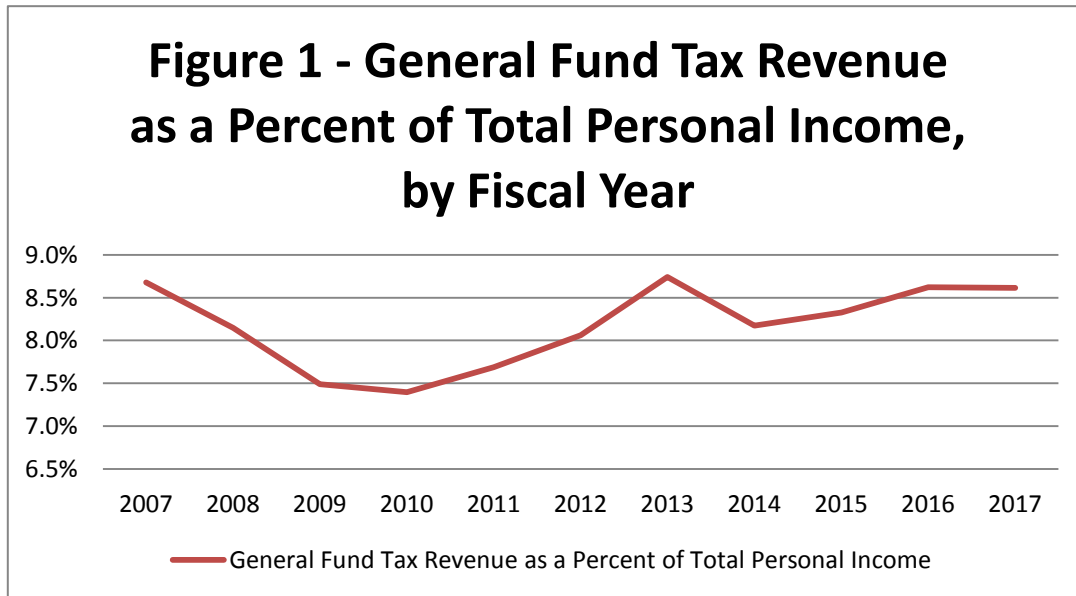
The General Fund is the biggest of the Governmental Funds and gets the bulk of the State's tax revenues. In fiscal year 2017, the State collected a total of \$6.9 billion in taxes, of which \$6.3 billion, or 91 percent, went to the General Fund. The General Fund also gets some non-tax revenues, but most of its revenues come from taxes: in fiscal year 2017, total General Fund revenues were \$7.4 billion, of which \$1.0 billion, or 14 percent of the total, came from non-tax revenues, which were mostly charges for services.

The bulk of Hawaii's General Fund tax revenues come from two taxes, the GET and the individual income tax. The GET is Hawaii's biggest tax and accounted for 51 percent of the General Fund tax revenue in fiscal year 2017. The individual income tax is Hawaii's second-biggest tax and accounted for 35 percent of the General Fund tax revenue in fiscal year 2017.¹³ These two taxes dominate the General Fund tax collections; the next biggest source of General Fund tax revenue, the TAT, accounted for less than 5 percent of the General Fund tax revenue in fiscal year 2017.

Although the GET and the individual income tax are both relatively stable, the General Fund tax revenues tend to vary more than the economy as a whole. Figure 1 shows how General Fund tax revenues have changed relative to total personal income over the last decade. It is clear from the figure that General Fund tax revenues tend to be

¹³ Table 1 in the next subsection shows the contributions to the General Fund from the State's main taxes.

less stable than the economy as a whole. In particular, during the Great Recession, General Fund tax revenues as a share of income fell from 8.7 percent in fiscal year 2007 to 7.4 percent in fiscal year 2010, or a decline in the share of about 17 percent.



Notes: The revenue from the individual income tax has been adjusted to remove the effects of a temporary measure to withhold \$187.4 million in refunds at the end of fiscal year 2010.

Source: Data on total personal income are from the Bureau of Economic Analysis. The General Fund tax revenues are from Monthly Collection Reports produced by the Hawaii Department of Taxation (available at tax.hawaii.gov/stats/a5_3txcolrpt/).

3.2 The State's Future Budget Prospects and Tax Adequacy

According to the latest forecast from the Council on Revenues, the growth in General Fund tax revenues is expected to continue at an annual rate of 4 percent or better over the budget window, although growth in total General Fund revenues is expected to be low in FY 2018, owing to a decline in nontax revenues for that year.¹⁴ Table 1 shows

¹⁴ See the Council on Revenues forecast from the meeting of September 7, 2017, available at http://tax.hawaii.gov/useful/a9_1cor/. Nontax General Fund revenues are expected to drop by about \$360 million from fiscal year 2017 to fiscal year 2018. (See Table 2 of Attachment 3 for the meeting.)

the forecast made by the Council on Revenues for the State's General Fund revenues at its meeting of September 7, 2017 for the period from fiscal year 2018 through fiscal year 2022.

TABLE 1 - FORECASTS OF GENERAL FUND REVENUES, BASED ON THE FORECAST MADE BY THE COUNCIL ON REVENUES AT THE MEETING OF SEPTEMBER 7, 2017

(By Fiscal Year, in Millions of Dollars)

| | BASE | FORECASTS | | | | |
|------------------------------|----------------|------------------|----------------|----------------|----------------|----------------|
| TAX | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
| General Excise Tax | \$3,239 | \$3,366 | \$3,484 | \$3,607 | \$3,735 | \$3,864 |
| Individual Income Tax | 2,192 | 2,285 | 2,416 | 2,517 | 2,634 | 2,760 |
| Corporate Income Tax | 77 | 91 | 89 | 104 | 106 | 109 |
| Public Service Company Tax | 122 | 126 | 130 | 135 | 139 | 144 |
| Tax on Insurance Premiums | 165 | 170 | 174 | 178 | 183 | 188 |
| Transient Accommodations Tax | 292 | 317 | 340 | 361 | 382 | 402 |
| All Others | 228 | 231 | 238 | 244 | 251 | 260 |
| TOTAL TAX | \$6,315 | \$6,587 | \$6,870 | \$7,145 | \$7,431 | \$7,728 |
| Growth Rate | 2.0% | 4.3% | 4.3% | 4.0% | 4.0% | 4.0% |
| NONTAX | 1,036 | 776 | 799 | 844 | 880 | 896 |
| GENERAL FUND TOTAL | \$7,351 | \$7,363 | \$7,669 | \$7,989 | \$8,311 | \$8,624 |
| Growth Rate | 3.8% | 0.2% | 4.2% | 4.2% | 4.0% | 3.8% |

Notes: Tax revenues are General Fund allocations from the tax. The line "All Others" includes the Tobacco Tax, the Liquor Tax, the Franchise Tax, the Estate Tax, the Conveyance Tax and interest, fees and penalties from the various taxes.

Source: Council on Revenues meeting of September 7, 2017, *Op. cit.*

Despite solid growth during the economic recovery from the Great Recession, however, Hawaii faces serious budget challenges going forward, due mainly to the growth in health and pension benefits for retired State workers. Over the period from fiscal year 2007 to fiscal year 2017, total General Fund tax revenues grew by 38 percent, while spending from the General Fund for pensions and health care benefits for retired

State workers grew by 74 percent.¹⁵ This has put continued pressure on other programs financed with the State's General Fund spending.¹⁶ In their report to the 2010-2013 Tax Review Commission, the PFM Group stated

[I]t is not likely that the challenges facing the State can be "solved" with approaches that only focus on expenditures. The State has already cut its workforce and extracted wage and other benefit concessions from workers, limiting its opportunities to further constrain growth in this key area. Meanwhile, the pension and [health care] obligations for current employees are inescapable and will grow throughout the period of this analysis.¹⁷

Although growth prospects for the future tax revenues appear solid, the budget pressures are expected to continue, because General Fund payments for benefits for retired State workers are set to increase. Act 268, SLH 2013, and Act 17, SLH 2017, require the State to pay additional amounts toward reducing the unfunded liability for health benefits for retired State workers and to make up for past underfunding of their

¹⁵ According to data provided to us by the Department of Budget and Finance, in the period from fiscal year 2007 to 2017, spending from the General Fund on health benefits for retired State workers grew from \$174 million to \$332 million, and spending from the General Fund on pensions for retired State workers grew from \$551 million to \$927 million.

¹⁶ A symptom of the budget pressures may be seen by looking at what has happened to wages of State employees, which accounts for the bulk of the General Fund spending. As a typical example, from July of 2007 to July of 2017, pay of mid-level employees (SR-24) in Bargaining Unit 13 ("Professional and Scientific Employees") grew by 14 percent at all levels, while pay of their mid-level managers (EM-7) grew by 26 percent for the entry level and by 47 percent for the senior level. (Pay scales for State employees are available at <http://dhrd.hawaii.gov/state-hr-professionals/class-and-comp/salary-schedules/>.) Compare these increases with those of all U.S. workers. The U.S. Bureau of Labor Statistics reported (at https://www.bls.gov/oes/oes_arch.htm, accessed on October 22, 2017) that the average hourly wage for all occupations rose from \$19.33 in May 2007 to \$23.76 in May 2016 (the latest year available), an increase of 23 percent.

¹⁷ PFM Group Consulting LLC, "Study of the Hawaii Tax System: Final Report," September 21, 2012, in Appendix A of the Report of the 2010-2013 Tax Review Commission (November 28, 2012), page 136.

pensions. Table 2 shows the planned payments for fiscal years 2018 through 2022 to satisfy the Acts.

TABLE 2 - REQUIRED GENERAL FUND CONTRIBUTIONS TO HEALTH CARE AND PENSION FUNDS FOR RETIRED STATE WORKERS

(In Millions of Dollars)

| CONTRIBUTIONS | 2018 | 2019 | 2020 | 2021 | 2022 |
|----------------------|-------------|-------------|-------------|-------------|-------------|
| Health Care | 297 | 375 | 375 | 354 | 341 |
| Pensions | 74 | 169 | 136 | 31 | 32 |
| Total | 371 | 544 | 511 | 385 | 373 |

Notes: The payments to the State retirees' health care fund are set by Act 268, SLH 2013.

The payments to the State retirees' pension fund are set by Act 17, SLH 2017.

Source: PFM Group Consulting LLC (November 14, 2017), *Op. cit.*, pages 71 and 74.

The required contributions in Table 2 range from 5 percent to 7 percent of the General Fund forecasts shown in Table 1. In their report to us, the PFM Group commented on the requirements set by Act 268, SLH 2013, saying

*While the State has made progress in working down this funding requirement, it is difficult to construct a logical set of circumstances where that level of funding can be attained without a new source (or sources) of revenue.*¹⁸

They go on to give other reasons why the State is likely to need additional revenues, including the length of the current business cycle (pointing out that it is only a matter of time before there is another economic contraction) and likely cuts in federal government support, particularly for Medicaid.

¹⁸ PFM Group Consulting LLC (November 14, 2017), *Op. cit.*, page 124.

4 COMPARING THE LEVEL AND DISTRIBUTION OF TAX BURDENS IN THE VARIOUS STATES

In this section, we compare the burden of state and local taxes in Hawaii with those in other states. We also compare how the tax burdens are distributed among income classes in Hawaii and in the other states.

4.1 The Level of State and Local Taxes in Hawaii Compared with Other States

In comparisons with other states, Hawaii consistently shows up as having a high burden of state taxes, whether the burden is measured per person or as a share of income. But an important reason for this result is that in Hawaii, the State funds primary education, which is funded mainly by local governments in most other states. In fact, the state tax revenue as a share of the total tax revenues of state and local governments combined is higher for Hawaii than for any other state.¹⁹

Looking at the total of state and local taxes combined, the burden per person or as a share of income is still high for Hawaii when compared with other states.²⁰ However, a substantial part of the state and local tax burden in Hawaii is borne by nonresidents, mainly tourists. If one looks at the tax burden on a typical resident family, Hawaii ranks low (in the bottom 20 percent), primarily because property taxes in Hawaii are low.²¹

¹⁹ See Colby (September 2017), *Op. cit.*, page 2.

²⁰ See PFM Group Consulting LLC (November 14, 2017), *Op. cit.*, pages 54-5.

²¹ *Ibid*, pages 55-6.

4.2 The Distribution of the Burden of Hawaii's Taxes by Income Class

As shown in Table 3, the GET by itself is regressive, but the individual income tax is progressive, so overall the burden of the State's taxes is distributed in a mildly progressive fashion in the lowest income categories (from \$25,000 to \$50,000), after which the overall State tax burden grows approximately in proportion to income.

TABLE 3 - ESTIMATED BURDENS OF MAJOR STATE TAXES FOR A FAMILY OF THREE, BY INCOME LEVEL

| Tax Type | Household Income Level | | | | |
|------------------------------|------------------------|----------|----------|-----------|-----------|
| | \$25,000 | \$50,000 | \$75,000 | \$100,000 | \$150,000 |
| GET | \$1,281 | \$1,847 | \$2,184 | \$2,598 | \$3,219 |
| Percent of Income | 5.1% | 3.7% | 2.9% | 2.6% | 2.2% |
| Individual Income Tax | \$0 | \$1,858 | \$3,413 | \$4,951 | \$8,499 |
| Percent of Income | 0.0% | 3.7% | 4.6% | 5.0% | 5.7% |
| Auto Taxes | \$200 | \$210 | \$295 | \$372 | \$375 |
| Percent of Income | 0.8% | 0.4% | 0.4% | 0.4% | 0.3% |
| Total Tax Burden | \$1,481 | \$3,915 | \$5,892 | \$7,921 | \$12,094 |
| Percent of Income | 5.9% | 7.8% | 7.9% | 7.9% | 8.1% |

Notes: Based on data for 2015, but adjusted to include the effects of the State's Earned Income Tax Credit, which was established by Act 17, SLH 2017.

Source: PFM Group Consulting LLC (November 14, 2017), *Op. cit.*, page 48.

4.3 The Distribution of State Tax Burdens in Hawaii Compared with Other States

It is hard to make objective statements about whether the burden of Hawaii's taxes is distributed fairly, but the study by the PFM Group offers some interesting comparisons with other states. They looked at how the average effective rate of tax for all state and local taxes changes as income rises for the biggest city in each state. They found that Honolulu was tied for eleventh place in the nation for most progressive tax structure as

income rose from \$25,000 to \$100,000, and in eleventh place as income rose from \$100,000 to \$150,000. They conclude:

*In sum, Hawaii's tax system is mildly progressive. This results mainly from the state's highly progressive individual income tax, partially offset by the very regressive GET. Although the progressivity of Hawaii's system is modest, it is significantly more progressive than other states. In the aggregate, wealthier households tend to pay higher effective tax rates than is the norm in the rest of the country.*²²

5 TAX REVIEW COMMISSION RECOMMENDATIONS

5.1 Net Income Tax Recommendations

5.1.1 Modernize the individual income tax by increasing the personal exemption and standard deduction. Alter the tax rates and tax brackets to make the modernization revenue neutral. Index the new tax structure for inflation in subsequent years.

Discussion

The standard deduction and personal exemption in Hawaii's individual income tax have been eroded over time by inflation and are now outdated. For example, for tax year 2017, for a married couple with one child, Hawaii's standard deduction and personal exemption added up to \$7,872. The federal standard deduction and personal exemption for the family added up to \$24,850. According to the poverty guidelines issued by the U.S. Department of Health and Human services, the poverty level for a family of three in Hawaii was \$23,480.

Hawaii provides refundable tax credits (the earned income tax credit, the food/excise tax credit and the low-income renters' tax credit) that eliminate the State's

²² PFM Group Consulting LLC (November 14, 2017), *Op. cit.*, page 57.

income tax for many low-income households. However, there are still instances where people below the poverty threshold are required to pay the tax. An income tax should exempt income below the level deemed required for essential needs. We believe the best way to do this would be to adopt the federal standard deduction and personal exemption for tax year 2017, indexed for inflation in subsequent years. To offset the revenue cost of these changes, we propose changing the tax rates and brackets, and perhaps adjusting some tax credits. The new tax should also have fewer tax brackets.²³ The standard deduction, personal exemption and tax brackets should be indexed for inflation after 2017, so that inflation does not cause the new tax adjustments to become outdated. The proposed income tax modernization would simplify tax administration, as many taxpayers would be exempt from filing a Hawaii state income tax return.

The first step in the effort to modernize Hawaii's income tax would be to ask the Department of Taxation's Office of Tax Research and Planning to provide various options from which the Legislature may choose. In assessing the revenue consequences of the proposed tax changes, the effects on wage withholding should be taken into account. Owing to wage withholding, collections of Hawaii's individual income tax typically are greater than the amount of liabilities reported on the income tax returns.

²³ Hawaii's individual income tax has more income brackets than the tax of any other state. See Colby (September 2017), *Op. cit.*, page 24.

5.1.2 Tax Retirement Incomes More Evenly.

Discussion

Retirement income is taxed unevenly by the State of Hawaii.²⁴ Under current law, Hawaii exempts social security payments and income from employer-provided pensions from the individual income tax, but taxes income from deferred compensation plans whereby taxpayers voluntarily set aside part of their earnings for retirement. The TRC recommends that the Legislature conform to the federal tax treatment of social security income and also conform to the federal treatment of employer-provided pensions, after allowing a deduction for income attributable to employee contributions that were subject to state or municipal taxes. To lessen the burden of the tax change on retirees, the TRC recommends that it be enacted with a lag, taking effect five years after its enactment in order to give people time to plan for the change.

The TRC recommends this approach, rather than exempting all retirement income up to a base amount per year, because it helps the State meet the goal of tax adequacy. The 2001-2003 Tax Review Commission also recommended taxing all retirement income equally, but with a delayed phase-in period and only after careful study. The 2005–2007 Tax Review Commission also recommended that Hawaii tax employer-provided pensions, but suggested excluding an annual base amount (e.g. \$50,000) to lessen the effect of the change on individuals who had planned their retirement assuming the current law exemption would continue.

²⁴ For a comparison of how Hawaii and other states tax retirement income, see PFM Group Consulting (November 14, 2017), *Op. cit.*, page 102.

5.1.3 Allow corporations to expense new investment when calculating the corporate income tax liability.

Discussion

Eliminating Hawaii's corporate income tax could improve Hawaii's reputation as a business-friendly state and attract new corporate investment to Hawaii, which could provide benefits to residents in the form of higher wages for workers and lower prices for consumers. However, as explained in the background study, setting the statutory corporate income tax rates to zero would likely create substantial transfers of income from residents to nonresidents (including the federal government and nonresident shareholders) that would probably outweigh the long-run benefits to residents of greater corporate investments.²⁵ Allowing C-corporations to expense new investments, instead of requiring them to depreciate the investments over their economic lives, would bring the same advantages in attracting new corporate investment as setting the statutory tax rates to zero, but would avoid the income transfers from residents to nonresidents.

Recent tax reforms at the national level allow corporations to expense new investments. We recommend that Hawaii conform to this provision in the new federal tax law. We realize that the tax change will cost revenue in the short run, but believe it is a better way to encourage economic growth and development than tax credits targeted to specific industries or activities.

²⁵ See Donald J. Rousslang and Yvonne Chow (November 6, 2017), "Should Hawaii Tax Corporate Income? A Cost-Benefit Analysis," report prepared for the 2015-2017 Tax Review Commission (November 6, 2017), pages 17-28.

5.2 Recommendations Related to Revenue Adequacy

5.2.1 Expand efforts to collect tax on remote sales, including e-commerce and mail order sales, by requiring retailers to report their sales to the Department of Taxation when they have annual sales in Hawaii of \$100,000 or more.

Discussion

E-commerce and other remote sales are growing in importance.²⁶ When such sales escape the GET, they enjoy an unfair advantage competing with taxed sales. The failure to collect the tax, either because the seller fails to collect and remit the GET or because the buyer fails to remit use tax, may also lead to significant revenue losses.²⁷ Hawaii should adopt a mandatory reporting requirement for retailers when their sales exceed \$100,000, similar to measures that have been adopted by some other states (Colorado, Vermont and Louisiana) and to the measures that were considered by Hawaii's Legislature in 2017 (Senate Bill 620 and House Bill 345).

5.2.2 Tax e-cigarettes at a rate equivalent to the tax on regular tobacco cigarettes.

Discussion

Hawaii should tax so-called e-cigarettes (or more accurately e-liquid, the cartridges used in such devices) at a rate equivalent to the tax on regular tobacco cigarettes. Although the science on the effects of vapor from e-cigarettes is not yet settled, the Commission does not believe there is sufficient reason to encourage their use as a substitute for smoking regular tobacco cigarettes by taxing one and not the other. The

²⁶ E-commerce sales have grown from about 3.5 percent of total retail sales in 2008 to about 9.0 percent in 2017 in the second quarter of 2017. See U.S. Census Bureau, "Quarterly Retail E-Commerce Sales," available at <https://www2.census.gov/retail/releases/historical/ecommm/17q2.pdf>.

²⁷ See PFM Group Consulting LLC (November 14, 2017) *Op. cit.*, pages 110-111.

revenue from the tax on e-cigarettes could be used to augment the funds from the current tax on cigarettes that go toward cancer research and community health, as well as provide revenue for the State's General Fund. Partly owing to shifts by smokers to e-cigarettes, collections from the cigarette and tobacco tax have declined in recent years, from \$143 million in fiscal year 2011 to only \$124 million in fiscal year 2017. It is estimated that taxing e-liquid at 95 percent of the wholesale price would yield about \$4.5 million annually.²⁸ The amount would grow as popularity and consumption of e-cigarettes increases.

5.2.3 Establish a "Simpson-Bowles" Commission to examine the unfunded and underfunded liabilities for health care and pension benefits for retired state workers, including measures to raise revenues and to reduce expenditures.

Discussion

The TRC reiterates the recommendation from the previous (2010-13) TRC that the State create a task force mandated to recommend an overall strategy for addressing Hawaii's likely substantial upcoming budget shortfalls through an integrated broad strategy involving both revenue enhancement *and* spending adjustments. The TRC is not empowered to make recommendations related to expenditures, but we believe the budgetary challenge raised by government retiree health care obligations – despite some progress made by the State since the last Commission – remains large enough that expenditure reductions must also be considered in a systematic way. The 2010-13 TRC's concluding statement, echoed here by this TRC, was as follows:

²⁸ See PFM Group Consulting LLC (November 14, 2107), *Op. cit.*, page 91.

The TRC believes that, given the magnitude of the projected budget shortfall, policy makers should give serious consideration to establishing a commission similar to the National Commission on Fiscal Responsibility and Reform (also known as the “Simpson-Bowles Commission”), which was created at the federal level. Such a commission, with its singular focus, will provide a “drill down” study and recommendations that should be of great value to policy makers.²⁹

5.3 Recommended In-Depth Studies

Owing to constraints on our resources, we were unable to come up with recommendations on some issues that we nevertheless believe deserve consideration. In particular, we recommend that in-depth studies be commissioned on the following measures.

5.3.1 The Legislature should commission an in-depth study on instituting a carbon tax for the State of Hawaii.

Discussion

The largest potential new revenue source listed in the report by the PFM Group is a carbon tax for the State of Hawaii.³⁰ Currently, other states and some regions have regulated greenhouse gas emissions, yet none have implemented a full carbon or greenhouse gas emission tax.³¹ Hawaii could be a leader in this arena and help pave the

²⁹ Report of the 2010-2013 Tax Review Commission (November 28, 2012), *Op. cit.*, pages 4-7.

³⁰ PFM Group Consulting LLC (November 14, 2017), *Op. cit.*, pages 88-9.

³¹ Jason Bardoff and John Larsen, "U.S. Carbon Tax Design: Options and Implications," Columbia SIPA Center on Global Energy Policy (January 16, 2018). Available at <http://energypolicy.columbia.edu/research/report/us-carbon-tax-design-options-and-implications>.

way for other states. The TRC recommends that the Legislature commission a comprehensive study of a carbon tax and related revenue sources with an organization that is experienced in the areas of energy and the environment, or work with such an organization that independently conducts such a study. The TRC recommends that the commissioned study include the following elements:

1. Overall impact on Hawaii's goals: An assessment of how the carbon tax would interact with, support, change or complement other State of Hawaii goals and laws.
2. Revenue allocation: An assessment of how the revenue from the carbon tax should be used. The TRC recognizes that a carbon tax could increase the cost of electricity and fuel for consumers in the near term, but part of the revenue from the tax could be returned to residents as dividends to offset the cost increases, while continuing to ensure that polluters pay.
3. Scope of coverage: An assessment of which sectors and which carbon/greenhouse gases would be taxed, and of the amount of Hawaii's total carbon/greenhouse gas emissions that would be taxed.
4. Point of taxation: An assessment of whether the carbon tax should be applied in the same manner as Hawaii's barrel tax, or in a different way. The tax could be applied at the point of import, at the point of fuel consumption, or at a point in between. Reporting requirements and administrative burdens should be considered when assessing the options.

5. Tax rate: An assessment of how much the tax should be to meaningfully impact behavior and investment decisions, and an assessment of the method for setting the tax rate.
6. Recommendations for implementation: The study should provide recommendations for how Hawaii's carbon tax should be structured and for how it should be implemented.

5.3.2 Study whether the rate of withholding on sales of real property by nonresidents (HARPTA withholding) should be restored to its original rate of 9 percent from the current rate of 5 percent.

Discussion

Hawaii currently withholds 5 percent of the gross sales price when a nonresident sells his or her real property in Hawaii. The withholding is mainly designed to make sure that nonresidents pay Hawaii income tax on any capital gains that are due on the sale. The maximum rate of income tax is 7.25 percent on long-term capital gains and 11 percent on short-term capital gains, whereas the HARPTA withholding is 5 percent of the gross selling price. It is therefore possible for the income tax liability to exceed the HARPTA withholding, particularly in cases where the property has been depreciated over a long period of time and the taxpayer has little basis. Furthermore in some cases, the nonresident seller may have been renting the property and neglected to pay TAT and GET on the rental income. In such cases, the HARPTA withholding can be insufficient to

cover the tax liability. An increase in the rate of HARPTA withholding to 9 percent (which was the rate in the original legislation)³² would reduce such occurrences.

5.3.3 Study whether it would be cost effective for the Department of Taxation to increase efforts to educate the public in order to improve compliance with Hawaii's tax laws.

Discussion

Efforts to educate taxpayers about their tax obligations may provide greater tax revenue and at the same time improve services to taxpayers. For example, a substantial number of nonresidents own property in Hawaii³³ and many of them are unaware of their obligations to pay Hawaii taxes on rental income, such as the GET and the TAT. Often, the nonresident property owners only become aware of their Hawaii tax obligations when they try to sell the property, or when they learn by chance of their GET and TAT liabilities and are suddenly faced with potential multi-year filing obligations, and with penalties and interest on top of the underlying tax liability. Also, many providers of transient accommodations, both residents and nonresidents, are not aware that mandatory resort fees are subject to the TAT. The Department should study whether it would be cost effective to devote more resources to educating the public about their tax responsibilities.

³² Act 213, SLH 1990. The rate of withholding was reduced to 5 percent by Act 279, SLH 1991.

³³ See Department of Business, Economic Development and Tourism, "An Analysis of Real Property Tax in Hawaii" (March, 2017) for estimates of nonresident ownership of real property in Hawaii.

APPENDIX A:

REPORT OF THE PFM GROUP CONSULTING LLC –

**"State of Hawaii Tax Review Commission:
Study of the Hawaii Tax System"**

State of Hawaii

Tax Review Commission

Study of the Hawaii Tax System

November 14, 2017

PFM Group Consulting LLC
BNY Mellon Center
1735 Market Street
43rd Floor
Philadelphia, PA 19103



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Introduction and Project Background



Report Background

Article VII, Section 3 of the Hawaii State Constitution requires that a Tax Review Commission be appointed, as provided by law, on or before July 1, 1980, and every five years thereafter. The commission is required to submit to the Legislature an evaluation of the State's tax structure, recommend revenue and tax policy and then dissolve. This requirement was a product of a 1978 Constitutional Convention. As a result, Chapter 218 of the Laws of 1979 created the Hawaii Tax Review Commission (Commission or TRC), which is to consist of seven members who are appointed by the Governor, with the consent of the Senate. As its primary responsibility, the Commission is to “conduct a systematic review of the State's tax structure, using such standards as equity and efficiency.”¹

While the 2012 Commission focused its primary research efforts on the question of revenue adequacy in light of budget challenges associated with the Great Recession and its aftermath, the 2017 Commission sought research assistance on three specific areas of tax policy. These are:

- Who bears the burden of Hawaii's taxes (including how much is exported to visitors)?
- What are the most effective ways to reform Hawaii's taxes to make them less regressive?
- What are the best ways to generate more revenue through new and existing sources, and through improved compliance with Hawaii's tax laws?

In February 2017, the TRC engaged PFM Group Consulting LLC (PFM or project team) to perform a systematic review of the State's tax structure, with particular emphasis on assisting the Commission with addressing the three questions. PFM had also been retained by the 2012 Tax Review Commission and was able to use that prior knowledge and experience in its 2017 analysis, and findings.

Discussions with members of the TRC indicated that the analysis of question one should present State and county tax incidence by income class, and also estimate the portion of each tax that is exported to nonresidents. Similar studies have been done for past Tax Review Commissions in 1989 and 2005.

With respect to question two, the project team determined that solutions should consider reducing State reliance on more regressive taxes in favor of taxes that are more progressive, or making the individual income tax more progressive, and that resulting reform recommendations should be designed to either raise tax revenue, or to be revenue neutral.

Finally, the third area of study should consider, at least broadly, how much revenue will be needed to maintain the current level of government services (tax adequacy). The RFP provided that one way to meet this test would be to identify resources that could cover the unfunded or underfunded liabilities for pension and health care benefits for retired state workers. The analysis in this area was to identify possible additional revenue by 2018 to fund the annual required contribution (ARC) to the Employer-Union Benefits Trust Fund, as well as including a qualitative assessment of the effects of current proposals on the overall economy and on its major sectors. It should be noted that later the TRC requested that PFM also analyze sufficiency related to the Hawaii Employees' Retirement System (ERS), and this analysis was made a part of the project and its final report.

With this direction, PFM developed a detailed project plan for the execution of this engagement.

¹ Hawaii Revised Statutes, Chapter 232E-3, Tax Review Commission Duties.



Methodology

To conduct the review within the specified areas of focus, PFM used the following methodology and key elements. In general, PFM relies on official state budget, revenue, economic, demographic and related data and information. This is augmented by other widely used and understood data sources, such federal data maintained by U.S Census Bureau, Bureau of Economic Analysis and Bureau of Labor Statistics. It also includes other government sources, such as the Federation of Tax Administrators, the National Association of State Budget Officers and the National Conference of State Legislatures.

Within each phase of the project, the PFM team has provided regular updates and communication with the Tax Review Commission and the project managers within the Department of Taxation. PFM has also prepared several written documents and presentations to assist the Commission in its advisory role.

The project plan called for the study to be conducted in four phases. The following details these phases:

Planning and Research Design

This phase communicated project details, finalized a detailed project plan, organized, scheduled and conducted a project kick-off and devised reporting and communications protocols. The project was staffed by analysts and subject matter experts with prior work experience in state budgeting and tax policy supported by a PhD level economist to assure that the project was executed efficiently and in the context of Hawaii state government's capabilities and the state's economic capacity.

Information Gathering

To help the project team understand current revenue and expenditure trends, State priorities and likely future performance, the project team engaged in extensive data gathering as well as structured interviews with department leaders, subject matter experts and internal and external stakeholders.² Many of these interviews were conducted on site in Hawaii in March 2017. The team reviewed past research and current modeling and forecasting around key revenue sources (GET, personal and corporate income tax, specific excise taxes) and selected expenditure drivers. Recent and past Commission reports were also reviewed and key budget and financial information (proposed and enacted budgets, CAFRs and annual reports) and reports were also reviewed. Workforce information, including pension and other post-employment benefits (OPEB) valuations and reports, collective bargaining agreements and pay plans, State statutes, regulations, civil service rules and other legal mandates, benefit schedules, health plans, headcount breakdown and other relevant information was collected and included in this analysis.

Modeling, Analysis and Evaluation

The team designed and constructed analytical models to assist in the synthesis, manipulation and analysis of the large amount of data and information collected and to test results of various scenarios. As indicated by baseline and future year revenue modeling, the team analyzed, reviewed and compared the State's revenue trends and performance to determine to what extent the current revenue system was sufficient to attain and/or maintain structural budget balance.³

² A full list of interviews, discussion groups and presentation groups can be found in Appendix A.

³ Revenue growth rates and model outputs can be found in Appendix B.



The team identified alternative revenue approaches and structures used in other states, analyzed their applicability and appropriateness for the State of Hawaii and quantified, to the extent possible given the available data, changes in revenue bases or rates and their impact on the Hawaii economy in the aggregate and as they may relate to key industries or sectors. Also, the project team examined taxpayer and household characteristics, including income, supported by other analysis and research to assess the relative regressivity of the major revenue sources.

The project team also conducted best practice research that used a variety of nationally accepted tax subject matter experts (such as the Brookings Institute, Center on Budget and Policy Priorities, Council on State Taxation, Institute on Taxation and Economic Policy, Rockefeller Center on Government, Tax Policy Center, Tax Foundation and the Urban Institute).

Optimal Alternatives Phase

The team met or spoke with the Tax Review Commission and key contacts within the Department of Taxation on multiple occasions to provide project updates, vet findings and to resolve any outstanding project issues. In July, the project team provided the TRC and key staff with a project update and discussed high level findings based on the data and analysis compiled to date. The team sought feedback on areas for further research and study and carried out follow-up discussions and interviews with key staff and stakeholders. Following this mid-project briefing, the project team conducted additional analysis, did follow-up research to refine revenue projections and assumptions and further developed high level findings. This analysis was used to create the resulting draft report.

Once the TRC had sufficient time to review the draft report, the project team appeared at a following meeting of the Commission to present on the report and answer questions. Based on written and oral feedback, the project team prepared a final report for the TRC to consider as it crafts its report to the legislature.

Timing Issues

The project team began its work in March and provides this final report in September. In the meantime, the State Legislature considered multiple public policy issues with an impact on the State revenue structure. In at least two prominent instances, legislative changes have impacted on the project team's State tax structure and tax policy analysis.

The first relates to changes to the Individual Income Tax. During the summer, the Legislature passed and Governor Ige signed a bill that reinstated three top marginal income tax brackets that had expired in December 2015. At the same time, the bill also created a state earned income tax credit equal to 20 percent of the value of the federal earned income tax credit. Because these changes were made while the project was still in the analytical phase, the project team has taken these into consideration while conducting its analysis and writing its report.

The second concerns continued funding for the rail project on Oahu. A plan to extend funding for that project was not completed during the regular legislative session. A special session was held in late-August, and a plan approved and signed by Governor Ige on September 5, 2017. That plan extends the 0.5 percent GET surcharge on Oahu for three additional years, through 2030. It also raises the statewide Transient Accommodations Tax (TAT) by 1 percent for the next 13 years. Given the fact that the project team's draft report had already been submitted to the Commission (in August 2017), there was not sufficient time to consider these changes in the



draft report's analysis. The project team has provided a brief update related to its analysis after these changes in the final report.

State Background

As part of the 2012 TRC report, PFM provided an extensive history of Hawaii and its government structure and approaches to revenues and expenditures. That background is still relevant but not repeated here.

From the perspective of a study of tax issues since 2012, Hawaii has experienced much of the same trends and approaches as other states. The Great Recession had a profound impact on state budgets with no real exceptions. As a result, the years in the period leading up to the 2012 TRC were primarily focused on stabilizing existing revenue structures or making changes necessary to raise sufficient revenue to balance state budgets. In many cases, these revenue raising changes were broad-based so as to 'spread the pain' associated with tax increases and to resist, as much as possible, exacerbating the negative effects of tax increases on an already fragile economy. Hawaii did its share of revenue-raising during that timeframe, with 2009 in particular spawning a variety of changes – some of which were temporary changes. The PFM report in 2012 analyzed some of the temporary changes to determine whether they should be allowed to expire.

Thankfully, economic conditions in the U.S (and for most states) have improved significantly since that particular time period. In fact, in the years immediately after the 2012 report, most states either made tax law changes that were a net reduction in revenue or made little or no changes to their tax structure. As state revenues improved, that opportunity increasingly presented itself. Hawaii embarked on no major revenue increasing measures during this time period, and most tax law changes were relatively narrow.

In the past couple of years, tax policy among the states has diverged, with several states again facing budget pressures on either the expenditure side or revenue estimates not hitting their targets. This has created a dichotomy where some states that embarked on significant multi-year tax reductions (usually individual or corporate income tax rate reductions) have worked to continue to phase those in, while other states, looking to balance their budgets, have resorted to either focused excise tax increases (cigarette and tobacco taxes and similar 'sin taxes' in particular) or, in some instances, broad-based tax increases (sales tax rate increases or base expansion being the most prominent).

During this timeframe, Hawaii has not had to rely on tax changes to balance its budget – its underlying economy has performed quite well, and the tourism industry in particular continues to meet expectations in terms of visitors and length of stays. It did, however, make a significant change in its individual income tax rate structure in 2017, but this was (at least partly) to enact a state Earned Income Tax Credit that should make the overall State tax structure a bit less regressive.

In the coming years, however, there is likely to be continued pressure on the State budget related to long-term retiree pension and health care costs and concerns about federal support for key programs and federal policy (such as issues related to travel and immigration) that might negatively impact the State economy and budget. These issues will no doubt be areas of interest and concern for the TRC and state policymakers and stakeholders. As appropriate, these will be touched upon during the remainder of the report.



Current Revenue Structure



Overview

States have wide latitude in how they choose to raise revenue to fund government services. State revenue methods have evolved over the years. Prior to 1902, the largest source of state revenue across the U.S was property taxes – a total of 45 percent. During this time period, local governments also largely relied on property taxes – 73 percent of all local government revenue.⁴

However, in the early 20th century, state governments began to diversify their revenue sources, turning increasingly to state sales and income taxes. State sales taxes were a product of the Great Depression, and by the 1930s approximately half of the states had enacted a form of the tax.⁵

Personal and corporate income taxes had a similar genesis. Ten states adopted individual income taxes before 1920, with Wisconsin, and Mississippi even doing so before the adoption of the federal income tax in 1913. Additional states enacted income taxes in the Great Depression era, particularly Western states as a reaction to a decline in property tax collections during that era. It is notable that Hawaii adopted an income tax before any State (in 1901), but this was well before it achieved statehood in 1959.⁶

The rise of the importance of income and sales taxes led to a concomitant reduction in the importance of the property tax. In fact, by 1992, property taxes comprised 1.2 percent of state revenues and 18 percent of combined state and local revenues.⁷

Given Hawaii's history with the income tax, it is not surprising that its state and local tax structure has focused more on income and consumption taxes and less on those associated with wealth (property taxes). In many respects, this is a trend that continues at the state and local level around the country – although the property tax is, across the U.S., still the predominant source of local tax revenue.

While taxes are generally the largest source of state and local revenue, other sources are also important. In fact, at the local level in particular, the rise of the importance of fees and charges for services is an important development.

General Characteristics

As in many states, Hawaii derives the great majority of its total General Fund revenues from taxes. Other sources, including charges for services and non-revenue receipts (e.g. sales of real property and investments; general obligation and revenue bond proceeds; deposits, gifts, donations, private grants; transfers from other funds; etc.) provide the remainder of the revenue that funds operations and services.

In fiscal year (FY) 2016, Hawaii collected \$7.1 billion in General Fund revenue. **Of that total, 87.5 percent was tax revenue;** the remaining 12.5 percent was composed of charges for current services (7.1 percent), non-revenue receipts (4.2 percent) and all other sources (1.2 percent). This distribution is reflective of other years in recent history, as shown in the following table.

⁴ John Joseph Wallis, "A History of the Property Tax in America," in Property Taxation and Local Government Finance, Wallace E. Oates, ed. Cambridge: Lincoln Institute of Land Policy, pp. 123-147, 2001. Accessed electronically at <http://econweb.umd.edu/~wallis/MyPapers/PTFinal.pdf>

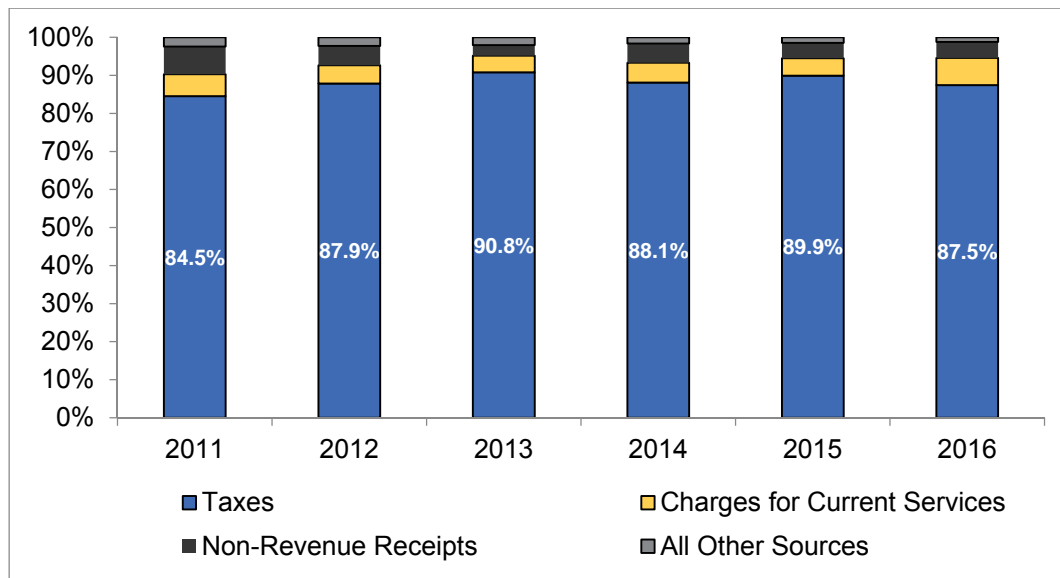
⁵ Tax Foundation, "When Did Your State Adopt Its Sales Tax?" July 11, 2014, accessed electronically at <https://taxfoundation.org/when-did-your-state-adopt-its-sales-tax/>

⁶ Tax Foundation, "When Did Your State Adopt its Income Tax?"

⁷ Ibid.



Figure 1: General Fund Revenue Sources, FY2011-2016



Source: Tables Indicating the Basis for Revenue Estimates, Executive Biennium Budgets 2013-2015, 2015-2017 and 2017-2019

What the State Taxes

Across the U.S., taxes generally have as their basis one of the following three methods:

- **Tax consumption** (purchases of goods and services by individuals and businesses);
- **Tax income** (generally all sources, including wages, rents, dividends and interest);
- **Tax wealth** (generally property, which can be real estate or personal property).

As mentioned in the overview, three major taxes generally comprise the vast majority of the taxes imposed in a state, (when combining state and local government taxes). These three also align with the three methods of taxation. They are:

- **Sales and use tax** (consumption);
- **Income tax** (income);
- **Property tax** (wealth).

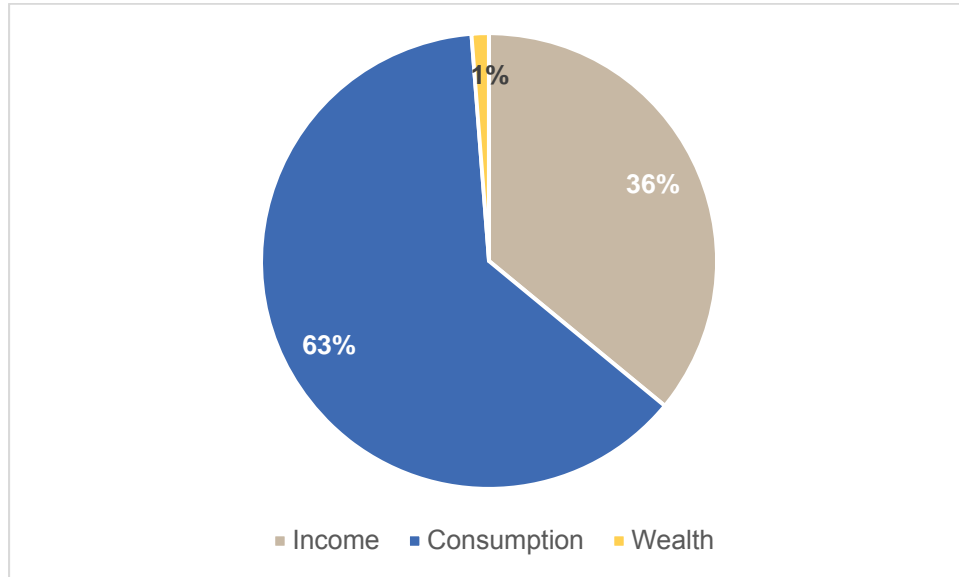
There are additional taxes that fit into each category. For example, Hawaii's general excise tax (GET) is primarily a consumption tax (although collected from most business activities), as are the transient accommodations tax (TAT), cigarette and tobacco and alcohol taxes. The corporate income tax is another addition to the taxes on income. The inheritance tax is an additional tax on wealth.

The following details the Hawaii State taxes broken into the consumption, income and wealth components:⁸

⁸ Taxes on income include the individual and corporate income tax and the tax on banks and other financial corporations. Consumption taxes include GET, public service company tax, tax on insurance premiums, the TAT, and tax on cigarettes and tobacco and liquor. Wealth taxes include inheritance/estate and conveyance tax.



Figure 2: Hawaii Taxes by Type, 2016



Source: Hawaii Council on Revenues

The major caveat of this break-down is that it does not include local government property taxes. This is typical, as the majority of local government revenue in the U.S. comes from the property tax (both real and personal property), while few states use this as a primary revenue source. In the case of Hawaii, its Constitution prohibits a State property tax, so this situation is not likely to change anytime in the foreseeable future.

The State's largest revenue source is the General Excise Tax (GET), which is primarily a tax on consumption. In FY2016, collections totaling \$3.2 billion accounted for 51.8 percent of all General Fund revenues collected and 45.3 percent of all revenues collected. **The Individual Income Tax (IIT) is the second largest revenue source for Hawaii**, generating \$2.1 billion in FY2016 (equal to 34.2 percent of General Fund revenues and 29.9 percent of total revenues). Taken together, the GET and IIT accounted for 86.0 percent of General Fund revenues. The remaining portion came from the combination of many smaller sources – the next largest being the Transient Accommodations Tax (TAT), accounting for \$233.8 million, or 3.8 percent.

Other smaller tax sources include Public Service Company Tax, Taxes on Insurance Premiums, Corporate Income Taxes, Cigarette and Tobacco Taxes, Liquor Taxes, Inheritance and Estate Taxes, Conveyance Taxes, Taxes on Banks and Other Financial Corporations, and Miscellaneous Taxes.

Table 1: 2016 General Fund Tax Revenue

| Tax | Revenue | % of Total | Tax Type |
|------------------------------|-----------------|------------|-------------|
| General Excise and Use Tax | \$3,206,154,000 | 51.8% | Consumption |
| Individual Income Tax | \$2,116,392,000 | 34.2% | Income |
| Transient Accommodations Tax | \$233,781,000 | 3.8% | Consumption |
| Public Service Company Tax | \$152,760,000 | 2.5% | Consumption |
| Tax on Insurance Premiums | \$153,173,000 | 2.5% | Consumption |

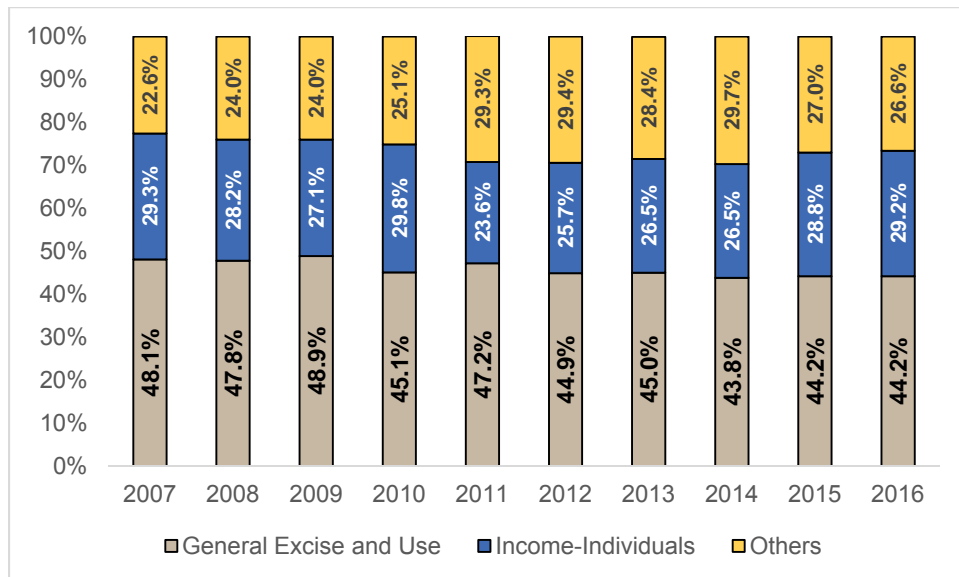


| Tax | Revenue | % of Total | Tax Type |
|---|------------------------|---------------|-------------|
| Corporate Income Tax | \$93,036,000 | 1.5% | Income |
| Cigarette and Tobacco Tax | \$83,685,000 | 1.4% | Consumption |
| Liquor Tax | \$50,590,000 | 0.8% | Consumption |
| Inheritance and Estate Tax | \$49,613,000 | 0.8% | Wealth |
| Conveyance Tax | \$26,415,000 | 0.4% | Wealth |
| Miscellaneous Taxes | \$16,067,000 | 0.3% | N/A |
| Tax on Banks and Other Financial Corps. | \$12,691,000 | 0.2% | Income |
| Total | \$6,194,357,000 | 100.0% | |

Source: Hawaii Council on Revenues

The following details the relative share and dollar value of the three broad categories of Hawaii state taxes:

Figure 3: Hawaii Tax Revenue Composition (All Funds), 2007-2016



Source: Hawaii Department of Taxation Annual Report, 2016

The following table provides more detailed breakdown on the State's tax revenues from FY2011 to FY2016:

Table 2: Hawaii Tax Revenues, FY2011-FY2016 (millions)

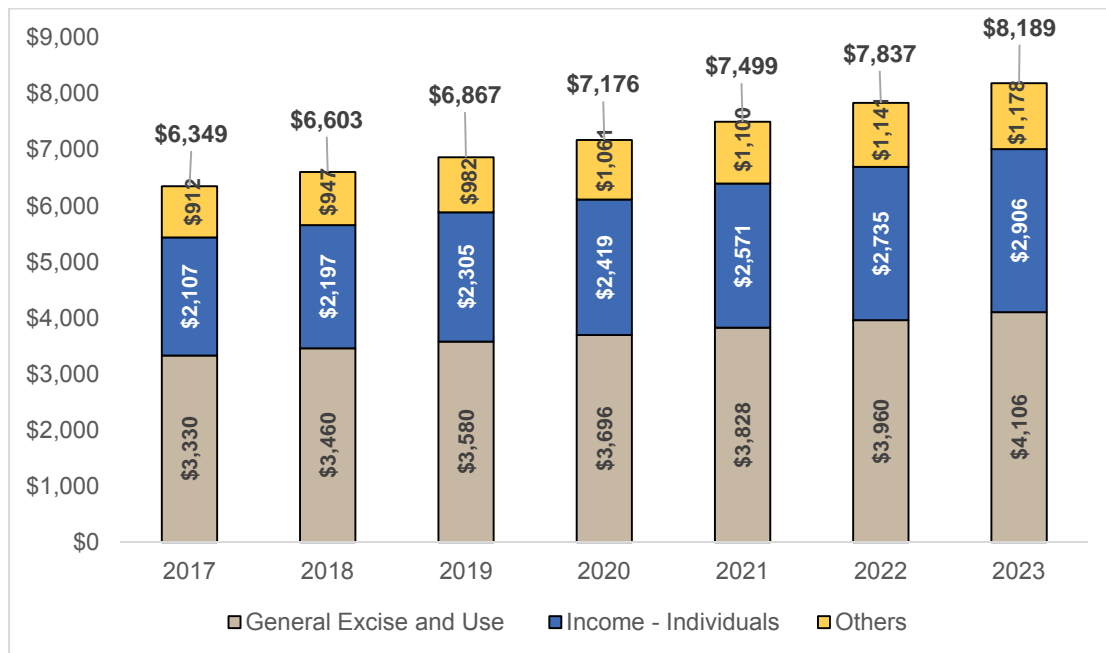
| Tax Revenues | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|------------------------------|---------|---------|---------|---------|---------|---------|
| General Excise and Use Tax | \$2,496 | \$2,698 | \$2,945 | \$2,825 | \$2,993 | \$3,206 |
| Individual Income Tax | \$1,247 | \$1,541 | \$1,736 | \$1,745 | \$1,988 | \$2,116 |
| Transient Accommodations Tax | \$60 | \$126 | \$172 | \$187 | \$203 | \$234 |
| Public Service Company Tax | \$118 | \$151 | \$164 | \$166 | \$164 | \$153 |
| Tax on Insurance Premiums | \$141 | \$117 | \$132 | \$137 | \$146 | \$153 |
| Corporate Income Tax | \$35 | \$73 | \$101 | \$87 | \$52 | \$93 |
| Cigarette and Tobacco Tax | \$106 | \$103 | \$94 | \$78 | \$83 | \$84 |
| Liquor Tax | \$48 | \$49 | \$49 | \$48 | \$50 | \$51 |



| Tax Revenues | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|-------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Inheritance and Estate Tax | \$7 | \$14 | \$15 | \$15 | \$12 | \$50 |
| Conveyance Tax | \$22 | \$19 | \$19 | \$27 | \$12 | \$26 |
| Miscellaneous Taxes | \$20 | \$83 | \$21 | \$18 | \$16 | \$16 |
| Tax on Banks/Financial Corps. | \$32 | \$5 | \$21 | \$37 | \$18 | \$13 |
| Total Tax Revenues | \$4,329 | \$4,978 | \$5,467 | \$5,370 | \$5,735 | \$6,194 |

As with many states, Hawaii uses a consensus revenue estimating process. The Hawaii Council on Revenues meets on a quarterly basis to develop the overall revenue estimate that is used by the Governor and the Legislature in preparing the state budget. Going forward, the following breaks down projected tax collections (based on the State's Council of Revenues most recent estimate):

Figure 4: Hawaii Projected Tax Collections (General Fund), 2017-2023 (millions)



Source: Hawaii Council on Revenues Estimates as of May 30, 2017

The following details the most recent estimate of the Hawaii Council on Revenues on a more detailed basis.⁹ It is notable that the current Hawaii FY2018 revenue estimate projects less than one percent growth (primarily because of a decrease of \$92.6 million in Non-revenue receipts). In the following years, the official estimate projects growth of between 3.8 and 4.3 percent, with all but one year being over 4 percent. These estimates will be relied upon throughout the analysis.¹⁰

⁹ It should be noted that the Council on Revenues only determines the overall revenue growth rate for the period it estimates. The Department of Taxation then applies individual growth rates across the various revenue sources to get to the aggregate growth rates.

¹⁰ Because the Council on Revenue meets quarterly, adjustments to growth rate assumptions are common. At the same time, these adjustments are often 'on the margin' and will not materially impact on future revenue estimates (absent a major change in the economy or other event that specifically impacts a revenue source).

**Table 3: Projected General Fund Revenue, 2017 to 2023: Baseline Scenario (millions)**

| Tax Revenues | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| General Excise and Use Tax | \$3,330 | \$3,460 | \$3,580 | \$3,696 | \$3,828 | \$3,961 | \$4,106 |
| Individual Income Tax | \$2,107 | \$2,197 | \$2,305 | \$2,419 | \$2,571 | \$2,735 | \$2,906 |
| Transient Accommodations Tax | \$250 | \$278 | \$295 | \$312 | \$329 | \$345 | \$362 |
| Public Service Company Tax | \$158 | \$163 | \$169 | \$174 | \$180 | \$186 | \$192 |
| Tax on Insurance Premiums | \$157 | \$162 | \$166 | \$170 | \$175 | \$181 | \$187 |
| Corporate Income Tax | \$95 | \$83 | \$92 | \$140 | \$142 | \$149 | \$150 |
| Cigarette and Tobacco Tax | \$86 | \$88 | \$91 | \$94 | \$97 | \$100 | \$104 |
| Inheritance and Estate Tax | \$51 | \$51 | \$52 | \$53 | \$54 | \$55 | \$56 |
| Liquor Tax | \$51 | \$52 | \$52 | \$52 | \$53 | \$53 | \$54 |
| Conveyance Tax | \$27 | \$29 | \$30 | \$33 | \$37 | \$41 | \$46 |
| Miscellaneous Taxes | \$16 | \$16 | \$16 | \$16 | \$16 | \$16 | \$16 |
| Tax on Banks and Other Financial Corps. | \$22 | \$26 | \$20 | \$17 | \$17 | \$15 | \$12 |
| TOTAL TAXES | \$6,349 | \$6,603 | \$6,867 | \$7,176 | \$7,499 | \$7,837 | \$8,189 |

| Non-Tax Revenues | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Charges for Current Services | \$539 | \$406 | \$420 | \$429 | \$440 | \$450 | \$463 |
| Non-Revenue Receipts | \$339 | \$246 | \$250 | \$255 | \$259 | \$263 | \$267 |
| Judiciary | \$36 | \$37 | \$37 | \$38 | \$38 | \$39 | \$40 |
| Repayment of Loans & Advances | \$21 | \$19 | \$22 | \$23 | \$24 | \$26 | \$27 |
| Revenues from Use of Money and Property | \$22 | \$25 | \$22 | \$21 | \$20 | \$18 | \$17 |
| Federal | \$13 | \$12 | \$12 | \$12 | \$11 | \$11 | \$11 |
| Revenues from Other Agencies | \$3 | \$3 | \$3 | \$3 | \$3 | \$3 | \$3 |
| Fines, Forfeits & Penalties | \$2 | \$2 | \$2 | \$2 | \$2 | \$2 | \$2 |
| Licenses & Permits | \$1 | \$1 | \$1 | \$1 | \$1 | \$1 | \$1 |
| TOTAL NON-TAX REVENUES | \$976 | \$751 | \$769 | \$782 | \$798 | \$813 | \$831 |

| | | | | | | | |
|------------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| TOTAL GENERAL FUND REVENUES | \$7,325 | \$7,354 | \$7,637 | \$7,959 | \$8,297 | \$8,650 | \$9,020 |
|------------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|

Source: Council on Revenues

The focus of the PFM analysis for the 2017 Tax Review Commission is primarily on tax burden, regressivity (particularly methods to reduce it for the State tax structure) and opportunities to increase revenue to meet existing and future needs related to providing health care and other benefits for retired state employees. As a result, the discussion mostly focuses on the key tax revenue sources that impact on these topics.



Discussion of Hawaii's Primary General Fund Taxes

The following details recent performance for the State's key tax revenue sources, which for this discussion is limited to those that provided over \$150 million per year in tax revenue to the General Fund in FY 2016. Beyond these individual sources, there will also be some discussion of excise taxes in general, particularly in relationship to their use in other states.

It is notable that the five revenue sources that each make up at least \$150 million in General Fund revenue (GET, Individual Income Tax, TAT, Tax on Insurance Premiums and the Public Service Company Tax) make up nearly 95 percent of total General Fund revenue.

General Excise Tax

FY2016: \$3,206.2 million (57.6 percent of General Fund revenue)

Overview

The GET is a business privilege tax on gross proceeds of sales or income. **Unlike a typical state or local sales tax, the GET is imposed on the business (although in most cases the GET is added to the price of the good or service when the sale is completed).** The rate is 0.5 percent on wholesaling, wholesale services, producing and sugar processing and pineapple canning. All other activities are taxed at 4.0 percent, except insurance commissions (0.15 percent). Besides the retail sales typically taxed by a state consumption tax (which in most states is a sales and use tax), the GET also taxes most services, including professional services.¹¹ Besides professional services, the GET also taxes contracting, theatre, amusement, radio, interest, commissions and rentals.

The City/County of Honolulu levies an additional surcharge of 0.5 percent. In prior years, the State's General Fund has received 10.0 percent of the City/County surcharge revenue to cover administrative costs associated with collection and remittance to the City/County. The issue of the portion of the surcharge that should be allocated to the State for administration was the subject of considerable debate during the last legislative session. During the 2017 special legislative session, this percentage was reduced from 10.0 to 1.0 percent.

The GET is complemented by a use tax levied on tangible personal property imported or purchased from unlicensed sellers for use in the State. The purchase price or value of the tangible personal property is the base for calculating the tax. The use tax rate is 0.5 percent if for resale and 4.0 percent for use or consumption. The tax also applies to services or contracting performed by an unlicensed seller at a point outside the State and imported or purchased for use in the State. As with the GET, the City/County of Honolulu levies an additional use tax surcharge of 0.5 percent.¹²

¹¹ While some services are included in the sales tax base of most states, very few tax professional services. The few that do are primarily states without a broad-based individual income tax.

¹² Hawaii Department of Taxation, "Outline of the Hawaii Tax System as of July 1, 2016," accessed electronically at <http://files.hawaii.gov/tax/news/pubs/16outline.pdf>



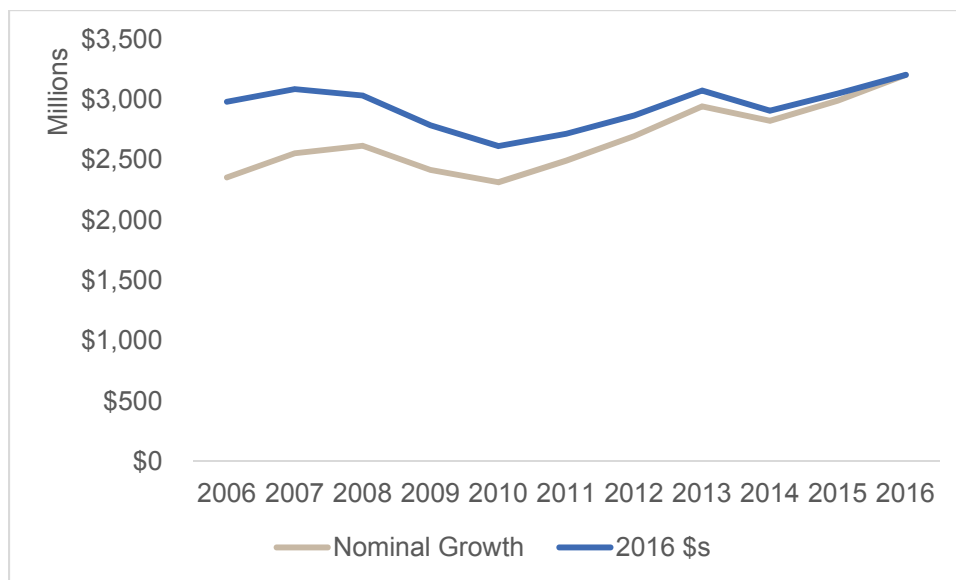
Table 4: Hawaii General Excise Tax Description

| | Rate | Description/Overview | Receiving Fund |
|---------------------------------|----------|--|---------------------------|
| General Excise Tax | 4.0% | Retail sale of goods, sale of services, contracting, commissions, rent, interest, and other activities; utilities exempt | <i>State General Fund</i> |
| | 0.5% | Wholesaling, selected intermediary services, manufacturing, producing, real property subleasing, canning and blind, deaf or totally disabled persons | |
| | 0.15% | Insurance solicitors | |
| | Exempted | Gross income from contracting and other services exported out of the state, exports of tangible personal property, sales of tangible personal property to the federal government, financial services income, or income subject to the public service company tax income (and others not listed). | |
| General Excise Tax (Use) | 4.0% | On tangible personal property imported or purchased from an unlicensed seller. Tax on value of services performed by unlicensed sellers at a point outside the state and imported or purchased for use in the state | <i>State General Fund</i> |
| | 0.5% | On goods imported for resale at retail | |

Recent Experience

GET revenue has generally exhibited an upward trajectory with declines associated with The Great Recession (FY2009 and FY2010) and a decline in FY2014. From FY2007 to FY2016, GET revenues have increased by \$650 million, which reflects a CAGR of 2.6 percent. This performance is shown in the following figure:

Figure 5: General Excise Tax (General Fund Revenue) 2007-2016



Source: Department of Taxation Annual Report, 2016



Legislative Actions

Effective for FY2012, GET exemptions were suspended for certain entities and activities (mostly business-to-business transactions), which subjected them to the 4.0 percent rate.¹³ Suspended exemptions included:

- Amounts deducted from gross income received by a contractor
- Gross receipts of home service providers acting as service carriers providing mobile telecommunications services to other home service providers
- Gross income of nonprofit organizations from certain conventions, conferences, trade show exhibits or display spaces
- Amounts received from the sale of liquor, cigarettes and tobacco products and agricultural, meat, or fish products to persons or common carriers engaged in interstate or foreign commerce
- Amounts received as high technology research and development grants
- Gross proceeds from the sale of items to the federal government:
 - Liquor
 - Tobacco products and cigarettes
 - Other tangible personal property
- Leasing or renting aircraft or keeping aircraft solely for leasing or renting for commercial transportation of passengers and goods or the acquisition or importation of aircraft or aircraft engines
- Use or sale of liquor, cigarette and tobacco products imported into the State and sold to any person or common carrier for consumption out of State by person, crew, or passengers on shippers vessels or airplanes

The temporary suspension was effective on July 1, 2011 and sunsetted on June 30, 2013. This, of course, broadened the GET base for FY2012 and FY2013 – primarily because of additional pyramiding. It is notable that there was a significant increase in GET revenue in both FY2012 and FY2013, with an actual reduction in GET collections in FY2014, which is consistent with the return to the previous GET base related to these business-to-business transactions.

In fact, the Council on Revenues estimated that the suspension added about \$50 million to total GET collections in FY2012 and \$70 million in FY2013. It is notable that the 2012 PFM report to the TRC recommended sunseting the suspension as planned (and occurred).

There have been other (mostly smaller impact) changes made to the GET in the years since the 2012 TRC report. These include:

- Eliminated the GET exemption for liquor, tobacco and food sold to common carriers (2013, effective January 1, 2014). The estimated revenue impact from this change was an increase of \$5.9 million.
- Made permanent the GET exemptions for common hotel managers and employees expenses paid by hotel operators and timeshare projects (2013, effective January 1, 2013).

Projected Outlook

Going forward, the Council on Revenues projects 3.5 percent revenue growth for GET in the out-years of its forecast. This reflects growth similar (but slightly below) overall state tax revenue growth.

¹³ Act 105, SLH 2011.



Key Considerations

The GET is a unique tax that defies ready categorization among other major state consumption taxes. Many national surveys (even from knowledgeable tax practitioners, including the Federation of Tax Administrators, which is the professional organization for State revenue department directors and their management staff) list it as synonymous with state sales taxes. This overlooks (or glosses over) the fact that the tax applies to an entity's sales or gross income – as opposed to most state sales taxes, which are transaction-based. It also creates different rules for application of nexus.

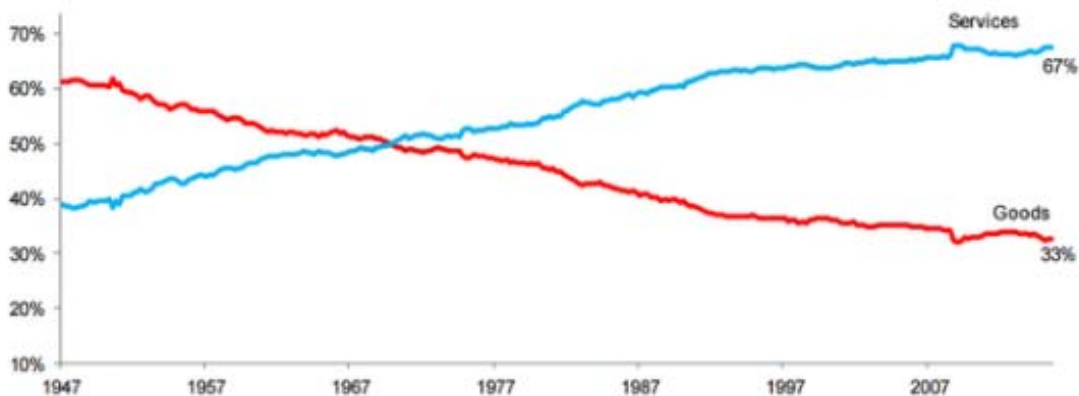
Most studies of state tax structures recognize that the Hawaii GET is applied to a very broad base. This impacts on key tax principles that the project team was to consider in its analysis. Many state sales tax structures exempt certain goods from its tax (most notably prescription drugs – which the GET also exempts – and also food and utilities, with some states also exempting clothing). While this may be considered beneficial for the minimum wage worker purchasing macaroni and cheese, in practice it also applies to the high income individual purchasing beef tenderloin. That also is the case for the lower income family cooling a 1,000 square foot home and the higher income family doing the same for their 5,000 square foot mansion. In this respect, Hawaii may be more aligned with tax policy 'best practices' by keeping a broad base (and relatively lower rate) and providing targeted tax credits for those in need of assistance.

The advantage of this broad base is that the tax is less susceptible to business cycle volatility. While the GET exhibited some diminished performance during the Great Recession, it has generally been a stable source of revenue, with its share of state revenue showing little year-to-year variation.

Most of the tax policy discussions for general consumption taxes focus on the following key concerns, primarily related to the erosion of the consumption tax base:

- **What we consume is changing** – while tangible goods were long the staple of consumption, today's economy is more focused on intangible goods and services. The following chart demonstrates that national change in consumption:

Figure 6: Percent of Personal Consumption: Goods and Services



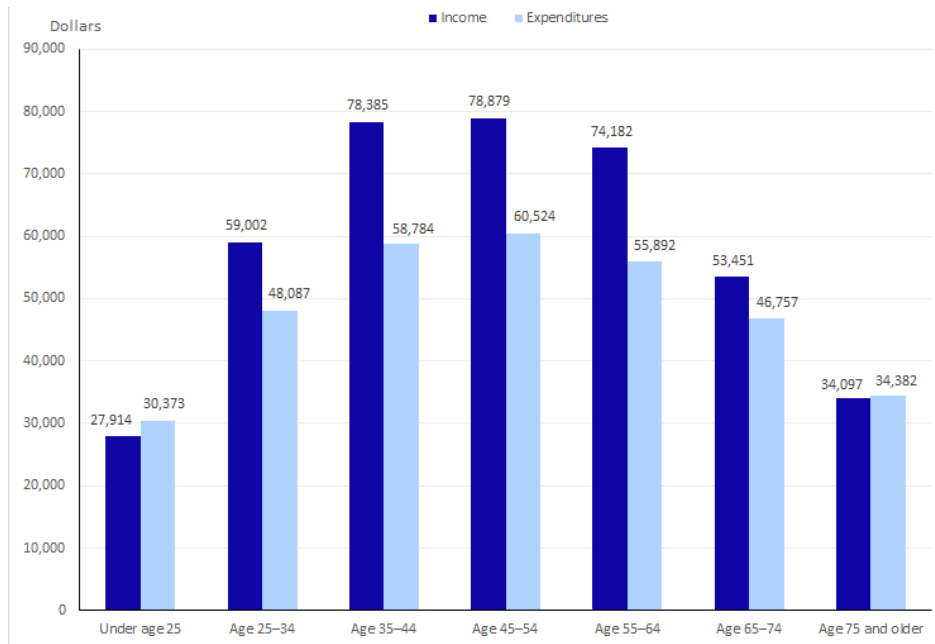
Source: Bureau of Economic Analysis, Macquarie Research, November 2015

- **What we tax is changing** – legislatures have often carved out exemptions for certain activities that are no longer subject to the consumption tax. Not surprisingly, these are often areas of significant (or emerging) activity.



- **Who consumes is changing** – the population as a whole is getting older, and older consumers consume less than their younger counterparts.¹⁴

Figure 7: Income and Expenditures by Age of Reference Person, 2013



Source: U.S Bureau of Labor Statistics

- **How we purchase our consumption is changing** – traditional retail transactions are increasingly performed electronically. According to the U.S Department of Commerce, the estimate of U.S retail e-commerce sales for the first quarter of 2017, adjusted for seasonal variation, but not for price changes, was \$105.7 billion. During that quarter, e-commerce sales accounted for 8.4 percent of total sales.¹⁵ This level of sales is expected to grow in the years to come.

Individual Income Tax

FY2016: \$1,246,672,000 (29.2 percent of General Fund revenue)

Overview

Hawaii's second largest revenue generating tax, it is levied on individual (or those filing jointly) income. Taxpayers may claim a standard deduction, with the amount subject to marital status and the presence of dependents – currently \$4,000 for married filing joint or surviving spouse with dependent child, \$2,000 for single or married filing single and \$2,920 for head of household. The personal exemption amount is \$1,040 per qualified exemption. Hawaii generally follows the federal definitions for determining taxable income, but it has its own exemptions, tax credits and tax rates. **Among exemptions, a major difference from the federal individual income tax is Hawaii's treatment of public pension income, which is entirely exempt from state income tax.**

¹⁴ Bureau of Labor Statistics, "Consumer Expenditures Vary by Age," December 2015, accessed electronically at <https://www.bls.gov/opub/btn/volume-4/consumer-expenditures-vary-by-age.htm>

¹⁵ U.S. Department of Commerce, Quarterly Retail E-Commerce Sales, 1st Quarter 2017, May 16, 2017.



Hawaii has made numerous changes to key features of its individual income, particularly in the years around and after The Great Recession. These changes have related to the number of brackets, rates, exemptions and credits.

In recent years, the number of state tax brackets and rates has varied considerably. Hawaii has 12 tax brackets based upon single/joint income with a corresponding specific rate levied for each income bracket, which is shown in Table 5.

Hawaii enacted significant changes to its individual income tax in 2009, as part of an overall revenue package designed to mitigate the impacts from The Great Recession. The income tax increase was retroactive to January 1, 2009, and expired on December 31, 2015.

The broadest individual income tax increase was an increase on higher-income earners. The legislation added three income tax brackets on top of the current nine, at rates of 9 percent on income over \$150,000 (\$300,000 for joint filers), 10 percent on income over \$175,000 (\$350,000 for joint filers), and 11 percent on income over \$200,000 (\$400,000 for joint filers). When enacted, Hawaii had both the highest top individual income tax rate but also the most tax brackets of any state.

The following details the 12 tax brackets and rates established in 2009. It is notable that the Hawaii rates rise relatively quickly, with the 5.5 percent rate applying at \$4,801 of taxable income.

Table 5: Hawaii Individual Income Tax Bracket (Current)

| | Rate | Description/Overview | Receiving |
|----------------------------------|--------|--|--|
| Individual Income Tax | 1.40% | On the first \$2,400 of taxable income. | <i>State General Fund and State Election Campaign Fund</i> |
| | 3.20% | On taxable income between \$2,401 and \$4,800. | |
| | 5.50% | On taxable income between \$4,801 and \$9,600. | |
| | 6.40% | On taxable income between \$9,601 and \$14,400. | |
| | 6.80% | On taxable income between \$14,401 and \$19,200. | |
| | 7.20% | On taxable income of \$19,201 and \$24,000. | |
| | 7.60% | On taxable income of \$24,001 and \$36,000. | |
| | 7.90% | On taxable income of \$36,001 and \$48,000. | |
| | 8.25% | On taxable income of \$48,001 and \$150,000. | |
| | 9.00% | On taxable income of \$150,001 and \$175,000. | |
| | 10.00% | On taxable income of \$175,001 and \$200,000. | |
| | 11.00% | On taxable income of \$200,001 and above. | |

While there was significant discussion about maintaining the temporary tax rates during the deliberations of the 2012 TRC, the 2009 legislation was allowed to sunset on December 31, 2015. As a result, **for tax years beginning on January 1, 2016, Hawaii's top tax bracket applied to taxable income of over \$48,000 and was taxed at a rate of 8.25 percent.**

In 2017, the Legislature enacted and the Governor approved a return to the additional brackets and rates first approved in 2009. HB 209, effective for tax years beginning on January 1, 2018, is projected to raise an additional \$51 million in tax revenue. **As part of the same bill, a State Earned Income Tax Credit**



(EITC) was created, which will be equal to 20 percent of the Federal EITC. Unlike the federal credit, the State EITC will not be refundable and is projected to reduce State revenues by approximately \$17 million.

With the return of the top three marginal income tax brackets with the 2017 legislation, Hawaii again has 12 tax brackets. This is the largest number of brackets of any state with an individual income tax bracket. The following table provides a breakdown of the number of brackets by states:

| Brackets | States |
|----------|--------|
| 1 | 8 |
| 2 | 1 |
| 3 | 4 |
| 4 | 7 |
| 5 | 4 |
| 6 | 6 |
| 7 | 4 |
| 8 | 2 |
| 9 | 3 |
| 10 | 1 |
| 12 | 1 |

Missouri is the state with the next largest number of brackets (10). It is notable that 8 states have a flat individual income tax, and 9 states have no broad based individual income tax (although two states, New Hampshire and Tennessee, tax dividends and interest income). Based on the current numbers, the average state with an IIT has between 4 and 5 brackets.

While there were a variety of other changes to the individual income tax in the Great Recession years, there had been few changes since the 2012 TRC. Those few included:

- Act 256 (2013), Effective for tax years beginning on January 1, 2013, removed charitable deductions from the limits on itemized deductions that were imposed by Act 97 in 2011, SLH 2011.
- Act 120 (2015) provided a tax credit for converting cesspools to a septic system or for connecting to a wastewater system, from July 1, 2015 to December 31, 2020.
- Act 223 (2015) increased the food/excise tax credit, but eliminated the tax credit for single taxpayers with federal adjusted gross income (AGI) of \$30,000 or more, or other taxpayers with federal AGI of \$50,000 or more. The Act applies to tax years 2016 and 2017, and is repealed on December 31, 2017.
- Act 230 (2016) allows taxpayers engaged in medical marijuana businesses to deduct business expenses and claim tax credits on their income taxes. Act 230 is effective for tax years beginning after December 31, 2015.
- Act 235 (2016) amends the income tax credit for dependent care expenses by increasing the amount that certain taxpayers may claim for the dependent care expenses. Act 235 is effective for taxable years beginning after December 31, 2015.
- Act 258, (2016) provides a new tax credit for organic food production. The tax credit applies to taxable years beginning after December 31, 2016 and is repealed December 31, 2021.

Recent Experience

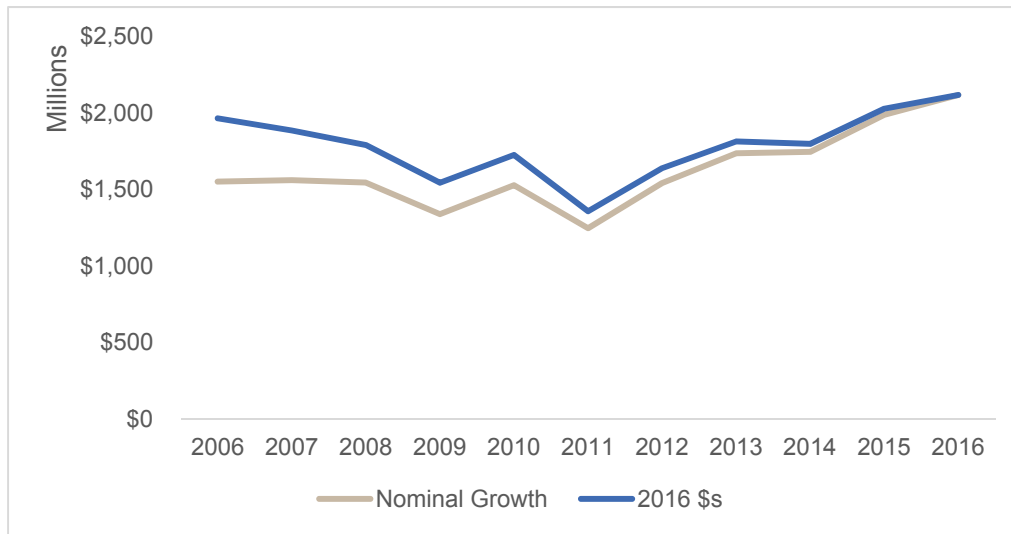
From FY2007 to FY2011, the State's individual income tax receipts declined in all years except for FY 2010. The largest decline occurred in FY 2011, when it was 18.4 percent lower than in FY 2010. Much of this decline was due to a delayed payment in tax refunds, which were withheld in the last half of FY 2010 and paid



out in July of 2010 (the first month of FY 2011) because of budget difficulties associated with the Great Recession. During the five-year period, the average annual growth rate was -4.6 percent.

In the years from FY2012 to FY2016, the individual income tax has performed better – partly because of the increases in the rates for those in the higher income brackets. The following details the performance over the entirety of the period from FY2006 to FY2016.

Figure 8: Individual Income Tax (General Fund Revenue) 2006-2016 (millions)¹⁶



Source: Department of Taxation Annual Report, 2016

Projected Outlook

The Council on Revenues projects that individual income tax revenue will grow by approximately 4.3 percent in each of the years of its projections.

Transient Accommodations Tax (TAT)

FY 2016: \$233.8 million (3.8 percent of General Fund revenue)

Overview

After actions taken in the 2017 special legislative session, the tax is now 10.25 percent and is levied on hotel rooms, apartments, suites and other rental/transient properties occupied for less than 180 consecutive days.¹⁷ The TAT is a significant source of revenue for the State – and one that has provided differing amounts to the General Fund and other funds over this time period. For example, total collections in FY 2016 were \$446.8 million, which is distributed to the General Fund as well as the Counties, Convention Center Enterprise Special Fund and the Turtle Bay Easement Fund. Much of this tax is exported to tourists and other visitors to the State.

¹⁶ Inflation per US Department of Labor, Bureau of Labor Statistics – Honolulu CPI-U, 2007-2016.

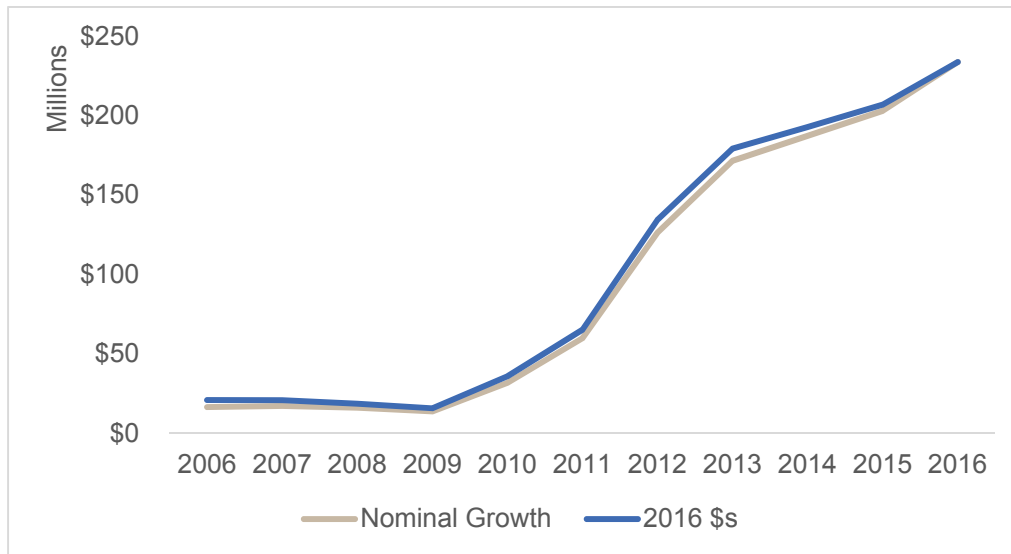
¹⁷ The 10.25 percent rate is a recent development. During the August 2017 special legislative session, the rate was increased from 9.25 percent to 10.25 percent to help fund the rail project on Oahu. Governor Ige signed the bill into law in September 2016.



Recent Experience

TAT revenue dedicated to the General Fund was relatively flat in the period from FY 2007 until FY 2011, which reflected a downturn in tourism and the effects of the Great Recession. Beginning in FY2011, the TAT has exhibited steady General Fund increases. Much of this reflects legislative changes (both in the rate and how it is allocated) and also a stronger tourism market in general.

Figure 9: Transient Accommodations Tax (General Fund Revenue) 2006-2016 (millions)¹⁸



Source: Department of Taxation Annual Report, 2016

Legislative Actions

Given its tourism and visitors base, it is not surprising that the TAT has been the subject of significant scrutiny and change over the years. Some major changes pre-dated the 2012 TRC report. For example, prior to 2009, the State's TAT base rate was 7.25 percent, and there was a complex formula for allocating TAT revenue to multiple sources.¹⁹

- Act 61 (2009) temporarily increased the transient accommodations tax rate for FY 2010 through FY 2015. The legislation added an additional 1 percent to the rate from July 1, 2009 through June 30, 2010, and 2.0 percent from July 1, 2010 through June 30, 2015. As a result of these changes, the TAT rate was 9.25 percent through the end of FY 2015. The additional 1 percent and 2 percent transient accommodations tax collections were deposited into the General Fund, while the distribution of the existing 7.25 percent transient accommodations tax was unchanged. This had the effect of increasing the General Fund portion of TAT and also increasing revenue deposited into the General

¹⁸ Inflation per US Department of Labor, Bureau of Labor Statistics – Honolulu CPI-U, 2007-2016.

¹⁹ According to the 2008-2009 Department of Taxation State of Hawaii Annual Report, the allocation for FY2009 was 44.8% to the counties; 17.3% to the Convention Center Enterprise Special Fund, provided that the revenues in excess of \$33.0 million in any calendar year are deposited into the General Fund; 34.2% to the Tourism Special Fund, provided that, of the first \$1.0 million, 90.0% is transferred to the State Parks Special Fund, and 10.0% into the Special Land and Development Fund, and further that 0.5% of the 34.2% is transferred to a sub-account in the Tourism Special Fund to fund a safety and security budget, and additional amounts are transferred into the Tourism Emergency Trust Fund, as needed, to maintain a fund balance of \$5.0 million; and 3.7% to the General Fund. In FY 2009, only \$13.6 million was deposited into the General Fund; a decrease of \$2.4 million or 14.9% from FY 2008.



- Fund. This helps to explain the revenue increases from this source beginning in FY 2010 and FY 2011.
- Act 103 (2011) temporarily limited the distribution from the TAT to counties and the tourism special fund to a combined total of \$162 million. Previously, counties and the tourism special fund received 79 percent of the TAT at the 7.25 percent rate. The Act sunsetted on June 30, 2015. Once again, this had the effect of increasing the State portion of TAT revenues (and, of course, reducing the transfer to the Counties).
 - Act 161 (2013) made the 'temporary' TAT rate of 9.25 percent permanent. It also made permanent the caps on allocations of the TAT for each fiscal year as follows: \$82.0 million to the Tourism Special Fund, \$93.0 million to the counties, and \$33.0 million to the Convention Center Enterprise Special Fund. The Act also eliminated the \$10 daily TAT on each transient accommodation furnished on a complimentary basis that was imposed by Act 103, (2011). Act 161 took effect July 1, 2013.
 - Act 81 (2014) reduced allocations of the TAT to the Convention Center Enterprise Special Fund from \$33.0 million to \$26.5 million annually and allocated \$3.0 million to the Turtle Bay Easement Special Fund. However, the new allocations mandated by the Act were not made in FY 2015, owing to the pending status of the Turtle Bay purchase.
 - Act 174 (2014) reversed some of the earlier course and increased allocations of the TAT to the counties from \$93.0 million to \$103.0 million per year for fiscal years 2015 and 2016.
 - Act 93 (2015) raised the tax on resort time share vacation units from 7.25 percent to 8.25 percent in calendar year (CY) 2016, and to 9.25 percent in CY 2017 and thereafter.
 - Act 117 (2015) allocates \$3.0 million of the TAT annually to the Special Land Development Fund, starting in FY 2017.
 - Act 121 (2015) allocates \$1.5 million of the TAT to the Turtle Bay Easement Special Fund, replacing the \$3.0 million annual allocation made by Act 81 (2014).
 - Act 223 (2016) extends the TAT allocation of \$103.0 million to the counties to FY 2017.

Given the Legislature's extensive involvement in TAT revenue decisions, this may continue to be a source of year-to-year funding decisions. While funding allocation decisions do not necessarily impact on revenue performance, some levels of tax rate and base continuity are generally positively associated with overall system performance. As a recent paper noted, "stability is one of the three fundamentals for policymakers to consider when trying to design and implement a good tax system, alongside simplicity and certainty ... they are the three key benchmarks that taxpayers can use to assess the effectiveness of government in maintaining and improving that system."²⁰

Projected Outlook

The Council on Revenue forecasts that TAT revenue will grow by approximately 11 percent in FY2018, by 6 percent in FY2019 and FY2020, and then by 5 percent through FY2023. This is, of course, very strong growth, and does not include the additional growth that will occur because of the recently enacted rate increase. There are a number of underlying risks associated with this level of growth, including an economic downturn (which is probably more likely than not to occur during the forecast period) and changes to U.S policy related to travel, particularly by commercial air travel.

²⁰ "Foundations for a Sound Tax System: Simplicity, Certainty and Stability," the Association of Chartered Certified Accountants, June 2015, accessed electronically at <http://www.accaglobal.com/content/dam/acca/global/PDF-technical/tax-publications/ea-tax-fundamentals.pdf>



Insurance Premiums Tax

FY2016: \$153.2 million (2.5 percent of General Fund revenue)

Overview

The Insurance Premiums Tax is levied on insurance companies (underwriters) based on premiums written in the State. Insurance companies pay the tax in lieu of other taxes (except for property taxes and taxes on purchase, use or ownership of tangible personal property). The tax varies depending on the type of policy, as shown in the following table. For qualifying insurers, there is a 1.0 percent tax credit to help offset the costs of regulatory oversight.

Table 6: Hawaii Insurance Premiums Tax Description

| Insurance Premiums Tax In lieu of General Excise and Net Income Taxes | Rate | Description/Overview | Receiving Fund |
|---|---------------------------------------|--|---|
| | 2.75% | Life insurance | State General Fund |
| | 4.265% | Casualty and all other insurance | |
| | 4.265% of risk premium | Real property title insurance | |
| | 4.68% | Surplus Lines | |
| | 0.8775% of gross underwriting profits | Ocean marine insurance | |
| Captive Insurance Premiums | | | |
| | 0.25% | on \$0 to \$25 million of gross | Insurance Administrative Fund |
| | 0.15% | on more than \$25 million to \$50 million of gross premiums; | |
| | 0.05% | on more than \$50 million of gross premiums; | |
| | 0.00% | on premiums more than \$250 | |
| Insurance Fees | | Rates vary | 50% of increases to the State General Fund until FY2015 |

Legislative Actions

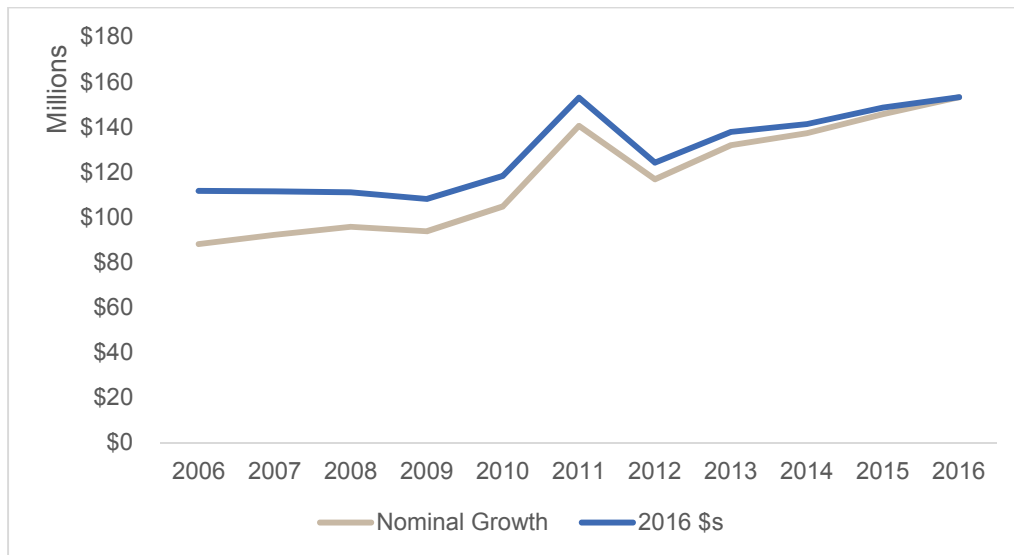
Act 59 (2010) temporarily increased certain insurance fees and specified that the increased fees be deposited equally into the compliance resolution fund and the General Fund as an insurance license and service tax. The temporary increases expired on June 30, 2014. The insurance fees were determined to be non-tax revenues and are not included in the calculations of General Fund tax revenues (and, of course, Insurance Premium tax revenues).

Recent Experience

The tax has generally exhibited a gradual increase, although its share of General Fund revenues has declined since the 2012 TRC report (when it was 3.2 percent). The significant FY 2011 growth reflected a one-time \$25 million revenue increase by insurance premium tax payments being received monthly instead of quarterly. The following year saw a return to what would have been a normal trajectory for this revenue source.



Figure 10: Tax on Insurance Premiums (General Fund Revenue) 2006-2016 (millions)²¹



Source: Department of Taxation Annual Report, 2016

Projected Outlook

The Council on Revenue projects Insurance Premium Tax revenue to grow by approximately 3.2 percent a year during the forecast period. This is in line with prior year increases for this revenue source. Insurance premium taxes are something of a counter-cyclical revenue source, as the demand for insurance does not significantly change based on short-term economic conditions.

Public Service Company Tax

FY2016: \$152.8 million (2.5 percent of total General Fund tax revenue)

Overview

In lieu of paying the GET, public service companies (public utility businesses) pay a tax on gross income for the preceding calendar year. The tax varies, and only the first 4.0 percent goes to the State, with the rest distributed to counties that provide a real property tax exemption for property used by the public utility in its business. However, for a carrier of passengers by land between points on a scheduled route, the entire tax (5.35 percent of gross income) goes to the State General Fund.

Table 7: Hawaii Public Service Companies Tax Description

| | Rate | Description/Overview | Receiving Fund |
|-------------------------------------|---------------|--|---|
| Public Service Companies Tax | 5.885% - 8.2% | On public utility gross income at graduated rates based on ratio of net to gross income. | State General Fund and county general funds. (for revenues generated from a rate greater than 4% from utilities that are not taxed under the respective county real property tax). Land carriers tax is entirely deposited into the State General Fund. |
| | 5.35% | Land carriers (public transportation) | |

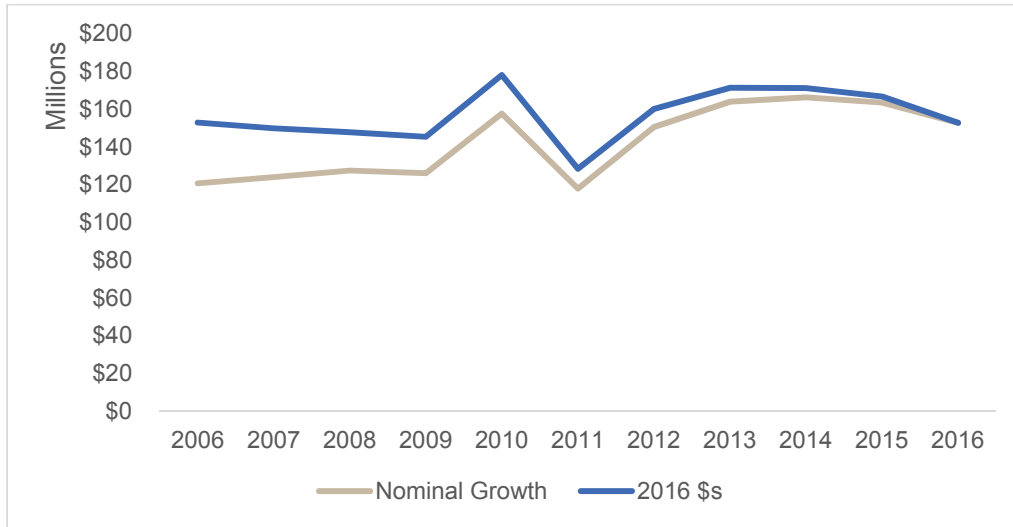
²¹ Inflation per US Department of Labor, Bureau of Labor Statistics – Honolulu CPI-U, 2007-2016.



Recent Experience

Revenue from the Public Service Companies Tax has been somewhat erratic over the years, with little discernable trend in collections. In some instances, changes in fuel prices can change the tax collections (since it is based on gross income and utility costs may increase with increases in major inputs).

Figure 11: Public Service Companies Tax (General Fund Revenue) 2006-2016 (millions)²²



Source: Department of Taxation Annual Report, 2016

Projected Outlook

The Council on Revenues projects that Public Service Company Tax revenues will grow by approximately 3.4 percent in the years they estimate.

General Fund Revenue from Excise Taxes

While a sales or general excise tax is applied to a broad category of goods and services, an excise tax applies to a specific good or service. It is generally considered a tax on consumption, and in many cases it is charged to the manufacturer, supplier or wholesaler prior to sale and reflected in the overall price for providing a good or service. The specific excise tax can be a fixed unit cost (such as so many cents per gallon of motor fuel or per pack of cigarettes) or taxed on an ad valorem (percent of value) basis, such as 10.25 percent of the furnishing of a room, apartment or suite customarily occupied by a transient for less than 180 consecutive days (which is the case for Hawaii's TAT).

There are differing rationales for excise taxes. Some excise taxes are referred to as 'sin taxes' because they apply to activities that may create negative externalities. Taxes on cigarettes and tobacco products or alcohol are examples. In some cases, the additional excise tax (on top of a general excise or sales tax) is justified as a way to reduce consumption or pay for social costs associated with the use of the products or services. In other cases, excise taxes are dedicated to specific purposes and may be justified as a form of 'user fee' – fuel taxes that are dedicated to the construction and maintenance of roads and bridges are an example of this type of excise tax.

²² Inflation per US Department of Labor, Bureau of Labor Statistics – Honolulu CPI-U, 2007-2016.



Nationally, the most prominent excise taxes are those on cigarettes and tobacco products, alcohol and motor fuels. Besides these taxes, which are all applied by the State of Hawaii, the TAT is a very prominent form of excise tax. Other examples from around the U.S include:

- Amusement Tax;
- Car Rental Tax;
- Fireworks Tax;
- Hotel/Motel (TAT) Tax;
- Marijuana (medicinal and/or recreational) Tax;
- Restaurant Meal Tax;
- Sugared Beverage/Junk Food Tax.

While the following two excise taxes do not meet the \$100 million threshold, they are longstanding taxes with a history of changes in rates as revenue-raising measures – both in Hawaii and in other states. Besides the excise taxes on cigarettes and tobacco products and alcohol, the other major excise tax that is applied in Hawaii, motor fuel taxes, are not included, as their revenue is not (and cannot) be dedicated to the General Fund.

Cigarette and Tobacco Tax

FY 2016: \$83.7 million (1.4 percent of General Fund revenue)

Overview

Hawaii levies an excise tax on the sale or use of tobacco products and on each cigarette sold, used or possessed. Aside from cigarettes and little cigars, the State levies the tobacco tax on 70 percent of the wholesale price of tobacco products (other than large cigars) and 50 percent of the wholesale price of large cigars. Cigarette and tobacco wholesalers and dealers are required to affix stamps to individual cigarette packages as proof of payment of tax.

The following details the taxes and how they are applied:

Table 8: Hawaii Tobacco Tax Description

| Tobacco Tax | Rate | Description/Overview | Receiving Fund |
|-------------|--------|--|---|
| | \$0.16 | per cigarette (\$3.20/pack) | Through June 30, 2013: <i>State General Fund (\$0.12), Cancer Research Fund (\$0.02), Trauma System Fund (\$0.0075), Emergency Medical Service Fund (\$0.005) and Community Health Center Fund (\$0.0075).</i> |
| | 50% | on wholesale price for cigars | |
| | 70% | on wholesale price for all other tobacco products | As of July 1, 2013: <i>State General Fund (\$0.10), Cancer Research Fund (\$0.02), Trauma System Fund (\$0.015), Community Health Center Fund (\$0.0125), Emergency Medical Services Special Fund (\$0.0125)</i> |
| | 1.70% | on denominated value of tax stamp | <i>State cigarette tax stamp enforcement special fund and State cigarette tax stamp administrative special fund.</i> |
| | 0.40% | discount on value of required cigarette tax stamps | |

Recent Experience

Hawaii increased the per-cigarette tax in all but one year from 2002 through 2011. The State's cigarette tax revenue registered double-digit percentage increases in all but one fiscal year from FY 2007 through FY 2011 (FY 2009 saw 3.4 percent growth). At the same time, the General Fund revenue portion declined in both FY 2008 and FY 2009 before increasing by 11.1 percent in FY 2010 and 24.1 percent in FY 2011.

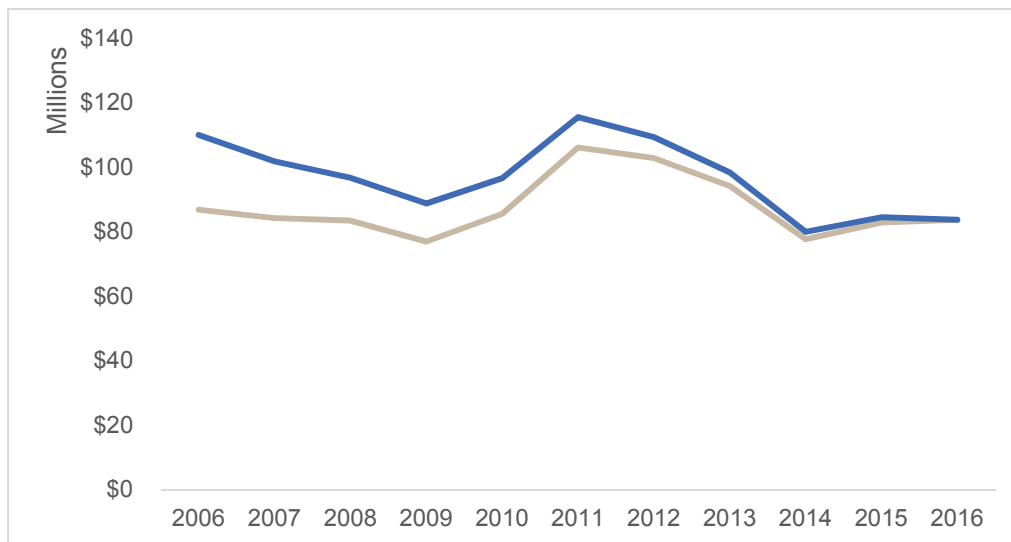


During that five-year period, annual General Fund cigarette and tobacco-related tax revenue grew from \$84.2 million to \$106.1 million, a 26.0 percent increase. The strongest growth, 24.1 percent, occurred in FY 2011 when the tax rate increased by 2 cents per cigarette. This resulted in a General Fund revenue increase of \$20.6 million.

Since the high collection mark in FY2011, cigarette and tobacco tax revenue has generally declined, to a low of \$121.7 million in FY2014, with a slight rebound to \$125.1 million in FY2016. It should be noted that the difference between overall tax revenue and revenue dedicated to the General Fund is because of transfers to a variety of other health-related funds before the balance is deposited into the General Fund. In recent years, the Legislature has also transferred a slightly larger share of overall revenues to these other funds, which makes the General Fund revenue decline appear slightly larger than it actually is.

The decline in this tax revenue source in the years since the high-water mark in FY2011 is at least somewhat mitigated by the reduced consumption brought about because of the use of higher cigarette tax rates. Most research associated with increases in the tax on cigarette and tobacco products has shown some resulting decrease in consumption (although some may also be the result of smuggling and black markets that evade the State tax).

Figure 12: Cigarette and Tobacco Tax (General Fund Revenue) 2006-2016 (millions)²³



Source: Department of Taxation Annual Report, 2016

Legislative Actions

In FY 2007, FY 2008 and FY 2009, the State increased its per-cigarette tax effective September 30 of each year. The tax per cigarette increased by 1 cent in each year – going from 7 cents per cigarette (as of September 29, 2006) to 10 cents (as of September 30, 2008). The rate increased to 13 cents on July 1, 2009, 15 cents on July 1, 2010 and 16 cents beginning July 1, 2011.

Act 238 (2015) changed some of the allocations of the tax to other funds (including reductions in the allocation to the Trauma System Special Fund and increases to the Community Health Centers Special Fund and the Emergency Medical Services Special Fund.

²³ Inflation per US Department of Labor, Bureau of Labor Statistics – Honolulu CPI-U, 2007-2016.



Projected Outlook

The Council on Revenues projects that Cigarette and Tobacco Tax revenue will grow by 2.2 percent per year in the covered period. In general, most consumption and revenue trends around the country are seeing little increase or declines in this revenue source.

Liquor Tax

FY 2016: \$50.6 million (0.8 percent of total revenue)

Overview

Hawaii levies a gallonage tax upon dealers and others who sell and/or use liquor. As with all states that apply a gallonage tax, the rates differ for wine, distilled spirits, sparkling wine, still wine, cooler beverages, non-draft beer and draft beer. These are detailed in the following table:

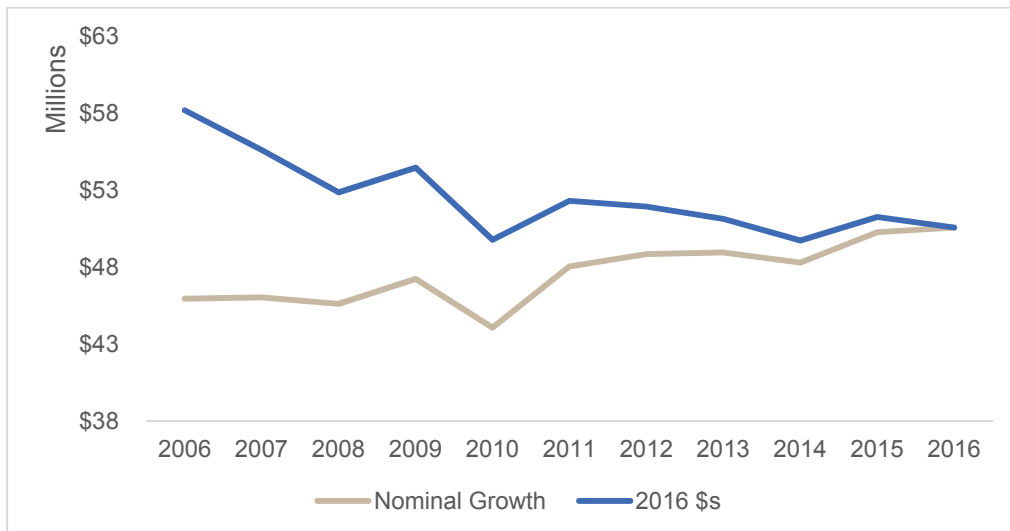
Table 9: Hawaii Liquor Tax Description

| Liquor Tax (per gallon) | Rate | Description/Overview | Receiving Fund |
|----------------------------|--------|----------------------|--------------------|
| | \$5.98 | distilled spirits | State General Fund |
| | \$2.12 | sparkling wines | |
| | \$1.38 | still wines | |
| | \$0.85 | cooler beverages | |
| | \$0.93 | non-draft beer | |
| | \$0.54 | draft beer | |

Recent Experience

Liquor tax revenue has been relatively flat for the entire period from FY2006 to FY2016, with collections slightly up or down throughout the period, primarily within the range of \$45 to \$50 million. The following details that performance:

Figure 13: Liquor Tax (General Fund Revenue) 2006-2016 (millions)²⁴



Source: Department of Taxation Annual Report, 2016

²⁴ Inflation per US Department of Labor, Bureau of Labor Statistics – Honolulu CPI-U, 2007-2016.



Projected Outlook

The Council on Revenues projects that Liquor Tax revenue will grow by 0.9 percent a year during the forecast period. Given the slow growth rates over the last decade, this seems about right for a long-range forecast.

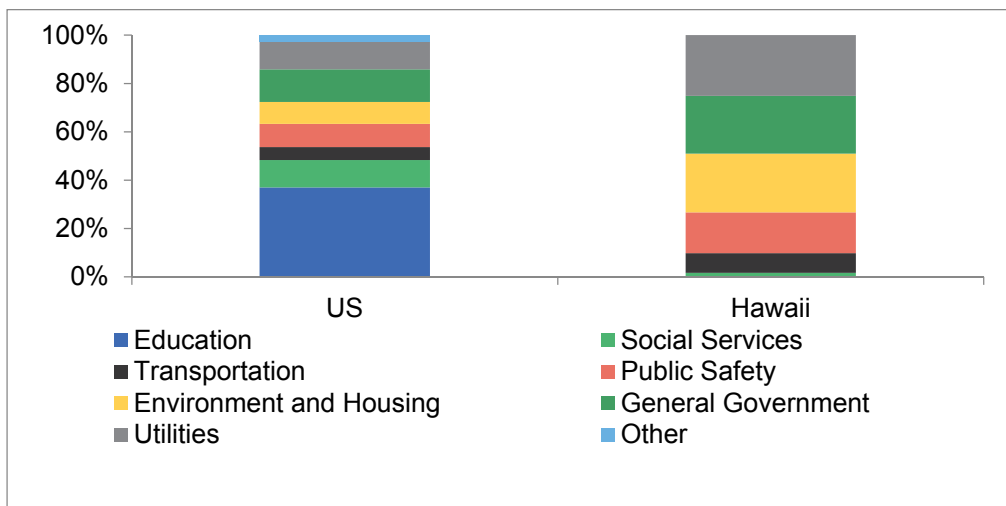
Relationship of State and Local Revenues

To get a balanced understanding of a state's tax structure and its tax burden, it is generally necessary to also consider its local tax structure and tax burden. It should also be taken into consideration that local governments are creatures of the state, and their powers and duties are mostly determined and subsequently modified by the State.

A unique characteristic of Hawaii's governmental structure is the lack of municipal governments – all local government is administered at the county level.²⁵ The only incorporated area in the State is a consolidated city-county, Honolulu, which governs the entire island of Oahu. County Executives are referred to as mayors; the Mayors of Hawaii, Honolulu, Kaua'i and Maui are all elected in nonpartisan races.

In addition to the dearth of municipal governments, **Hawaii is the only state where the public school system operates under a single system administered and funded solely by the State.** Nationally, the largest local government expenditure is to support K-12 education. For all U.S local governments, direct expenditures for education averaged 37.0 percent in 2014, compared to less than 1.0 percent of local government spending in Hawaii, as shown in the figure below.

Figure 14: U.S and Hawaii Local Government Spending by Function, 2014



Source: US Census Bureau, 2014 Annual Surveys of State and Local Government Finances

²⁵ Conversely, Connecticut and Rhode Island have no county forms of government.

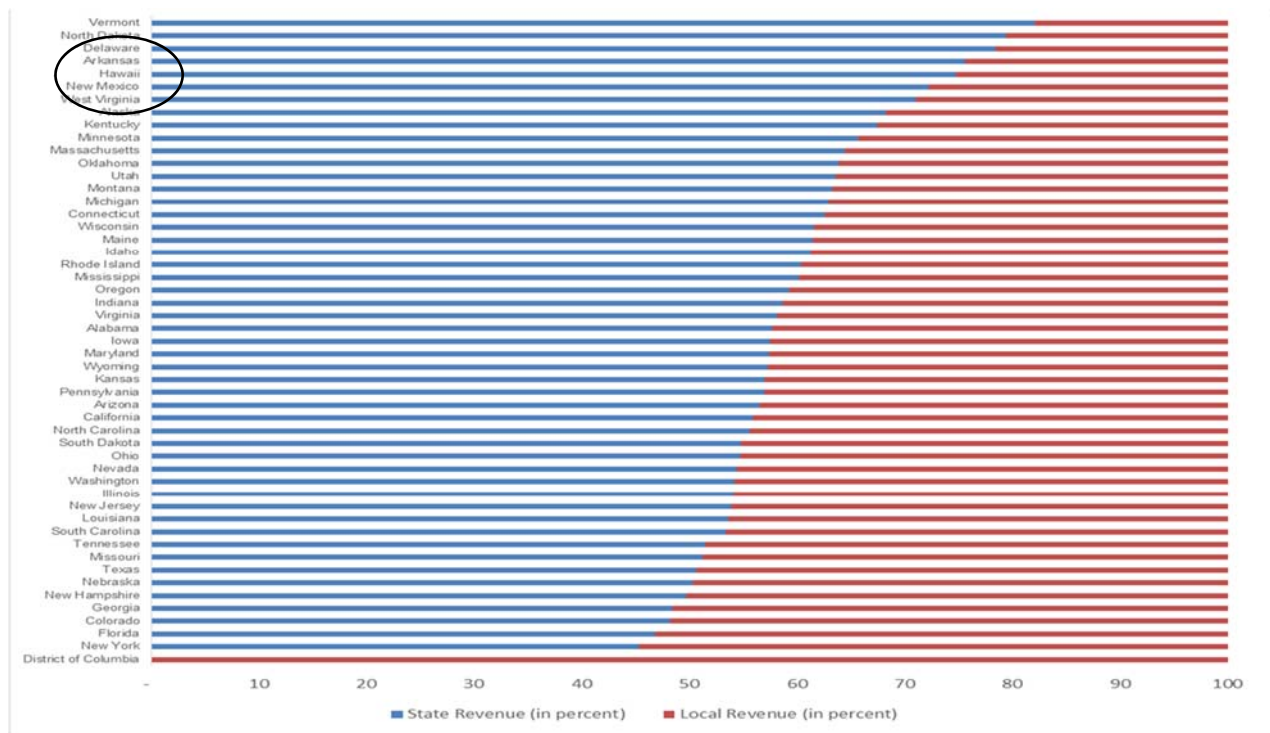


Hawaii state government provides far more revenue to support the K-12 education function than any other state; nationally, 46.7 percent of K-12 programming revenue is derived from state sources. In Hawaii, state education funding represents 87.3 percent of total education funding.²⁶

Among local governments in the U.S, the primary source of revenue is the property tax. **On average, property taxes comprise 72.5 percent of own-source tax revenue for all U.S local governments**; that percentage is similar to Hawaii local governments, where property taxes comprise 67.2 percent of own-source tax revenue.²⁷

As a result, the revenue sources split between state and local government is decidedly tilted to the state for Hawaii. The following figure shows the share by state between state and local revenue:

Figure 15: 2014 State and Local Own Source Revenue



Source: U.S. Census Bureau, *Census of Governments*

With a diminished need to fund a primary local government service, property tax collections in Hawaii are lower than for the nation as a whole. The following table lists median residential property taxes and property taxes as a percentage of median home value for Hawaii and its most populous counties:

Table 10: Median Property Taxes and Taxes as a Percentage of Median Home Values

| | U.S | Hawaii County | Honolulu County | Maui County |
|---------------------|---------|---------------|-----------------|-------------|
| Median Property Tax | \$2,424 | \$1,019 | \$1,658 | \$970 |
| % of Home Value | 1.23% | 0.32% | 0.29% | 0.19% |

Source: 2011-2015 American Community Survey 5-Year Estimates

²⁶ US Census Bureau, *Public Education Finances: 2014*

²⁷ US Census Bureau, *2014 Annual Surveys of State and Local Government Finances*



Additionally, a 2017 Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence (MCFE) study of property taxes in all 50 states **confirmed Hawaii's relatively low property taxes**.²⁸ The analysis compared 2016 urban city residential property tax bills for the largest city in each state (as well as Aurora, Illinois; Buffalo, New York; and Washington DC) for homes valued at \$150,000 and \$300,000 as well as the median valued home. Of the 53 cities surveyed, Honolulu had the second-lowest property tax for homes valued at \$150,000, the lowest property tax for homes valued at \$300,000, and the lowest property taxes for the median valued home.²⁹

Table 11: Urban Cities with Residential Tax Ratings in Top Five or Bottom Five (for \$150,000 and \$300,000 Valued Homes)

| City | State | \$150,000 | | \$300,000 | |
|-----------------|-----------|--------------|--------------|--------------|--------------|
| | | Tax | Rank (of 53) | Tax | Rank (of 53) |
| Bridgeport | CT | \$6,060 | 1 | \$12,120 | 1 |
| Detroit | MI | \$5,964 | 2 | \$11,929 | 2 |
| Aurora | IL | \$5,210 | 3 | \$11,106 | 3 |
| Newark | NJ | \$4,342 | 4 | \$8,683 | 4 |
| Milwaukee | WI | \$4,193 | 5 | \$8,599 | 5 |
| Denver | CO | \$994 | 49 | \$1,988 | 50 |
| Birmingham | AL | \$990 | 50 | \$2,032 | 48 |
| Washington | DC | \$650 | 51 | \$1,897 | 51 |
| Honolulu | HI | \$242 | 52 | \$765 | 53 |
| Boston | MA | \$175 | 53 | \$1,746 | 52 |

Source: Lincoln Institute of Land Policy/Minnesota Center for Fiscal Excellence

Of course, it should also be noted that while property taxes as a percentage of median home values are low, the actual home values in Hawaii are high. For example, a commonly cited measure of construction costs, done by Rider Levett Bucknall, placed Honolulu as having the highest per square foot residential building costs among a group of 12 major urban metropolitan areas.³⁰

Commercial property taxes are also low in relation to other comparable cities. The Lincoln Institute/MCFE study found that of 53 urban cities, Honolulu ranked 52nd in each of three value cohorts (\$100,000, \$1.0 million and \$25.0 million) for commercial property taxes for businesses.

Table 12: Urban Cities with Commercial Tax Rankings in Top Five or Bottom Five

| City | State | \$100,000 | | \$1,000,000 | | \$25,000,000 | |
|---------------|-------|-----------|--------------|-------------|--------------|--------------|--------------|
| | | Tax | Rank (of 53) | Tax | Rank (of 53) | Tax | Rank (of 53) |
| Detroit | MI | \$5,057 | 1 | \$50,574 | 1 | \$1,264,360 | 1 |
| New York City | NY | \$4,760 | 2 | \$47,597 | 2 | \$1,189,931 | 2 |
| Chicago | IL | \$4,632 | 3 | \$46,323 | 3 | \$1,158,087 | 3 |
| Providence | RI | \$4,376 | 4 | \$43,575 | 4 | \$1,093,931 | 5 |

²⁸ 50-State Property Tax Comparison Study – Lincoln Institute of Land Policy/Minnesota Center for Fiscal Excellence, 2017.

²⁹ Ibid., p. 18.

³⁰ "North America Quarterly Construction Cost Report, First Quarter, 2017," Rider Levett Bucknall, p.4. The surveyed markets were Boston, Chicago, Denver, Honolulu, Las Vegas, Los Angeles, New York, Phoenix, Portland, San Francisco, Seattle and Washington DC.



| City | State | \$100,000 | | \$1,000,000 | | \$25,000,000 | |
|-----------------|-----------|----------------|--------------|-----------------|--------------|------------------|--------------|
| | | Tax | Rank (of 53) | Tax | Rank (of 53) | Tax | Rank (of 53) |
| Bridgeport | CT | \$4,098 | 5 | \$40,978 | 7 | \$1,024,462 | 7 |
| Wilmington | DE | \$1,320 | 49 | \$13,199 | 49 | \$329,984 | 49 |
| Virginia Beach | VA | \$1,173 | 50 | \$11,726 | 50 | \$293,155 | 50 |
| Seattle | WA | \$1,136 | 51 | \$11,358 | 51 | \$283,947 | 51 |
| Honolulu | HI | \$1,089 | 52 | \$10,892 | 52 | \$272,304 | 52 |
| Cheyenne | WY | \$831 | 53 | \$8,309 | 53 | \$207,719 | 53 |

Source: Lincoln Institute of Land Policy/Minnesota Center for Fiscal Excellence

Finally, this low ranking relative to other urban cities is also observed for industrial property taxes. As shown in the table below, Honolulu ranked 52nd of 53 cities surveyed for industrial property taxpayers at \$100,000, \$1.0 million and \$25.0 million levels.

Table 13: Urban Cities with Industrial Tax Rankings in Top Five or Bottom Five

| City | State | \$100,000 | | \$1,000,000 | | \$25,000,000 | |
|-----------------|-----------|----------------|--------------|-----------------|--------------|------------------|--------------|
| | | Tax | Rank (of 53) | Tax | Rank (of 53) | Tax | Rank (of 53) |
| Columbia | SC | \$7,943 | 1 | \$79,434 | 1 | \$1,985,861 | 1 |
| Memphis | TN | \$5,439 | 2 | \$54,390 | 3 | \$1,359,750 | 3 |
| Jackson | MS | \$5,364 | 3 | \$53,640 | 4 | \$1,341,000 | 4 |
| Houston | TX | \$5,141 | 4 | \$51,413 | 5 | \$1,285,325 | 5 |
| Indianapolis | IN | \$4,814 | 5 | \$48,137 | 6 | \$1,203,424 | 6 |
| Cheyenne | WY | \$1,337 | 49 | \$13,375 | 50 | \$334,374 | 50 |
| Philadelphia | PA | \$1,327 | 50 | \$22,473 | 39 | \$609,345 | 37 |
| Wilmington | DE | \$1,320 | 51 | \$13,199 | 51 | \$329,984 | 51 |
| Honolulu | HI | \$1,194 | 52 | \$11,937 | 52 | \$298,437 | 52 |
| Virginia Beach | VA | \$1,025 | 53 | \$10,246 | 53 | \$256,155 | 53 |

Source: Lincoln Institute of Land Policy/Minnesota Center for Fiscal Excellence

This is an important consideration for discussions of state taxes and tax burdens. Hawaii's tax structure should be viewed in the context of the state and local structure and burden. These comparisons tend to mitigate what might otherwise be seen as a high state tax burden.

This should also be considered in the context of other taxes where the State may choose to share revenue with local governments, in particular, the Transient Accommodations Tax (TAT). This has been subject to change over time, and it is worthy of discussion and analysis as to how this tax does (or should) fit into the overall state and local government revenue picture.

Primary Revenue Structure Components and Comparison to Other States

As has been noted, Hawaii is as unique among the 50 states as any. Its island status, relative isolation, valued tourist destination and historically strategic location all provide it specific attributes that are not found in many other U.S. states. Of course, some of these attributes can, under certain circumstances, also work against the State.



These characteristics make it very difficult to determine logical comparison states. In many benchmarking exercises, the first set of comparators is based on contiguous states. This makes sense, as there is often 'border competition' and the possibility of attracting new residents or businesses based on proximity. This is generally not the case for Hawaii.

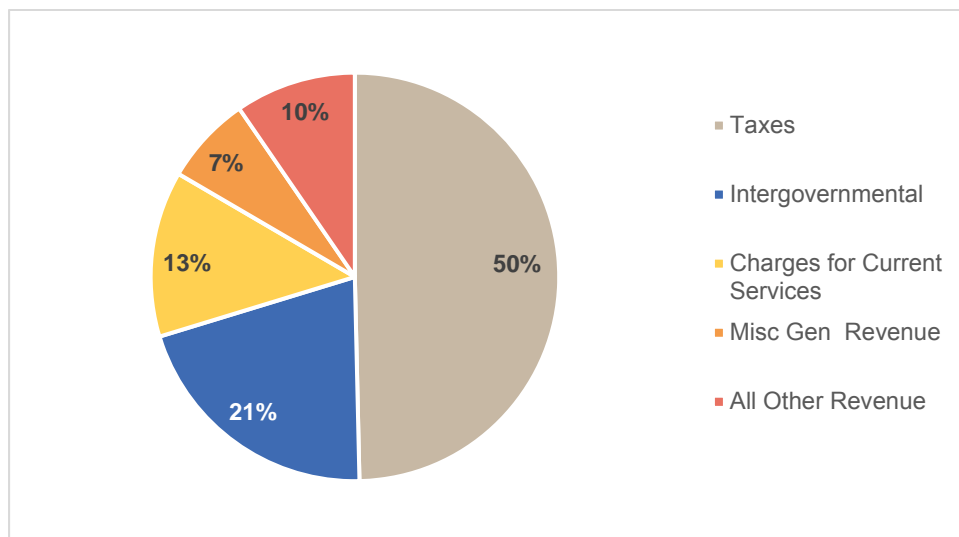
In some benchmarking exercises, key businesses and industries may be useful for comparison, as how the tax structure impacts on these may be insightful. In the case of Hawaii, other states with significant tourism industries may be useful, however states like Florida and California have much more broad-based economies, which makes the comparisons difficult.

From the project team's perspective, it is as useful to observe how structures are used in general (or in relevant specific instances) as opposed to focusing on one or two 'close to perfect twins' among the states.

There are a variety of characteristics of Hawaii's revenue structure that also set it apart from most states. The method for funding K-12 education (and its spin-off effect of reducing local property tax burdens) has already been noted. There are other aspects of Hawaii's revenue structure that will be compared and contrasted with other peer benchmark states.

As the following pie charts show, Hawaii relies more on taxes for its revenue and less on intergovernmental transfers (which would primarily be payments from the federal government). Part of this would be Hawaii's higher than average per capita personal income, which reduces the federal share for programs like Medicaid.

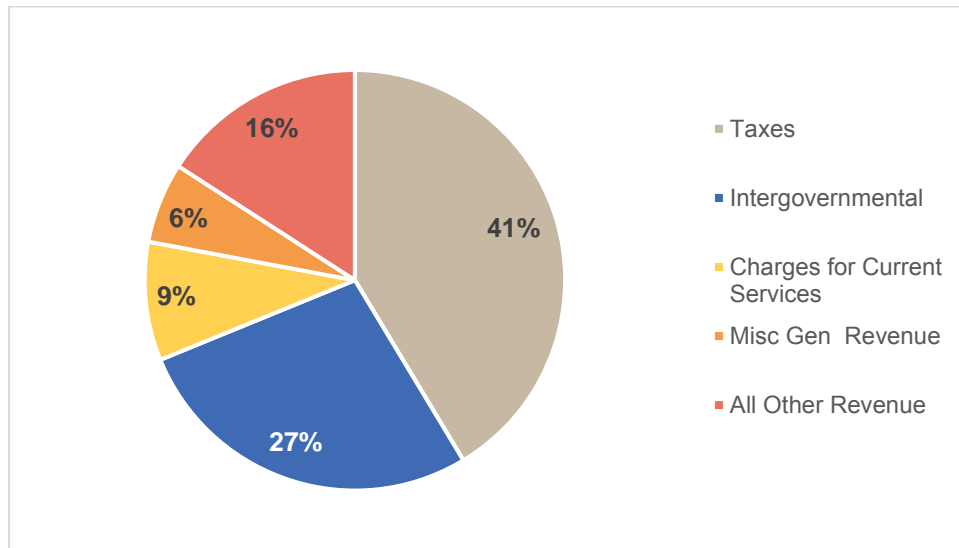
Figure 16: Hawaii Revenue Sources, 2015



Source: U.S Census 2015 Annual Survey of State Government Finances



Figure 17: Revenue Sources, All States, 2015



Source: U.S Census 2015 Annual Survey of State Government Finances

Among the taxes, Hawaii relies much more on sales/gross receipts and excise taxes than the U.S states as a whole. This makes sense, as the lack of cross-border competition works in the State's favor – there are few opportunities to escape Hawaii excise taxes in comparison to the situation that exists in many of the continental U.S states. In fact, the 2012 report noted that both Alaska and Hawaii were on the high end of some key excise taxes – in particular, alcohol, cigarette and tobacco and motor fuel taxes.

By contrast, Hawaii collects a relatively smaller share of its revenue from income taxes, where both individual and corporate income taxes lag the percentage for all states. Hawaii also collects no revenue at the State level from property taxes (and is constrained from doing so by the State Constitution). While this is not a major source of funding for states, there are states with some reliance on it – often through taxes on personal (as opposed to real) property.

Of course, relative share of taxes does not delve into questions related to the actual tax rates and tax base that form the basis for tax collection. In these areas, Hawaii is on the high side for several taxes. The Federation of Tax Administrators (FTA) maintains information on state tax rates and base for a variety of taxes. The following table is from the FTA (unless otherwise noted) and provides information on Hawaii's standing as of January 1, 2017 (with the highest state tax ranked first, the second highest second, etc.) among the states that impose the tax.



| Tax | Hawaii Tax Rate | Rank Among States | Comments |
|-----------------------------|-------------------|---------------------------|--|
| General excise or sales | 4.0 percent | 40th (tied) ³¹ | For comparison purposes, Hawaii's GET is classified as a general excise or sales tax. ³² |
| Gasoline | 0.185 per gallon | 44th ³³ | Does not include county taxes, which vary from an additional 0.088 a gallon (Hawaii) to 0.23 (Maui). |
| Cigarette | \$3.20 per pack | 5th | |
| Alcohol – distilled spirits | \$5.98 per gallon | 7th | 17 states control wholesale and/or retail sales and apply a separate mark-up, which is generally higher than Hawaii's gallonage tax. |
| Alcohol – wine | \$1.38 per gallon | 9th | 3 states only sell through state stores and apply a separate mark-up, which his generally higher than Hawaii's gallonage tax. |
| Alcohol – beer | \$0.93 per gallon | 2nd | Only Alaska has a higher tax. Most (but not all) states also apply sales tax (or GET for Hawaii). |

It is also notable that Hawaii's top individual income tax rate (as of the changes in the 2017 legislative session), 11 percent, will be higher than the top individual income tax rates in every state but California with an individual income tax. California has three brackets with higher rates: 11.3 percent (single filers with marginal income over \$322,499 and joint filers with marginal income over \$644,998), 12.3 percent (single filers with marginal income over \$537,498 and joint filers with marginal income over \$1,000,000) and 13.3 percent (single filers with marginal income over \$1,000,000 and joint filers with marginal income over \$1,074,996).

State Taxes Performance

The report to the 2012 TRC detailed some difficult years for state budgets and state revenue performance. The Great Recession had a profound impact on most state budgets, with significant fall-off in revenue collections among its key sources – primarily income taxes but also consumption taxes. As a result, many states had to resort to multiple tax increases from various sources, and this was the case for Hawaii as well.

While the states as a whole (and Hawaii as well) have largely recovered (in terms of revenue collection) from the Great Recession, that recovery was slow and uneven. The following table, culled from reports from the National Conference of State Legislatures (NCSL) and the National Association of State Budget Officers (NASBO), provides a look at how states have collectively responded during the period since the 2012 TRC report. State responses have been far from uniform, and the five year period has seen ebbs and flows for different revenue sources and states or regions. A prominent recent example are oil and gas producing states,

³¹ This information is from a recent report from the Tax Foundation, "State and Local Sales Tax Rates, Midyear 2017," Fiscal Fact No. 553, July 2017. Several states have a 4.0 percent rate – Alabama, Georgia, Hawaii, New York and Wyoming.

³² A strong case can be made that Hawaii's 4.0 GET rate is effectively higher when compared to state sales tax rates, because Hawaii applies the tax on multiple activities that get built into the price of finished goods and services (and then also subject to the GET). It is likely that the GET effective rate is in the range of 5 percent.

³³ Compiled by the US Energy Information Agency as of February 2017.



which, during this time period, experienced strong revenue growth during oil's run-up to \$120 a barrel – only to experience severe budget shocks as oil dropped to \$30 a barrel.

| Year | Net Change, Tax Policy Actions | Comments |
|------|---|---|
| 2013 | \$1.3 billion net reduction in taxes, which is a change of 0.2 percent, possible because of strong general fund revenue growth: 5.3 percent above FY 2012 levels. Much of the increase attributed to pushing income into tax year 2012 to avoid anticipated increases in federal tax rates in 2013. | Individual income tax cuts of \$1,892 million for FY2014; Motor fuel tax cuts of \$532 million, but several states (Maryland, Massachusetts, Vermont, Wyoming raised these taxes to fund transportation efforts. Sales and use tax increases of a net \$720 million, driven by a handful of states – Virginia increased sales taxes by nearly \$1.3 billion (to fund transportation), Maine increased its general sales tax rate, and Minnesota and Ohio expanded the sales tax base. Arizona and Kansas lowered their sales tax rate. At least 13 states reported 'tax reform' efforts. |
| 2014 | \$3.1 billion net reduction in taxes, which is a change of 0.4 percent. | Four states (Illinois, Indiana, Minnesota and Ohio) reduced net taxes by more than 1 percent. The largest single net tax decrease, \$1.8 billion, occurred in Illinois as a result of temporary income tax increases that expired. Personal income taxes experienced the largest decrease of the tax categories, at about \$3 billion (including Illinois). States also collectively reduced corporate income (-\$1,150 million) and sales taxes (-\$420 million). Five states (Delaware, Michigan, New Hampshire, Pennsylvania and Vermont) reported a net increase of more than 1 percent. Forty-one states made no significant net tax change. The collective increase in taxes was primarily health care taxes as a result of Michigan's reinstatement of a 6 percent tax on Medicaid managed care organizations. Less interest in 'tax reform' efforts, with only six states reporting major tax reform. |



| Year | Net Change, Tax Policy Actions | Comments |
|------|---|---|
| 2015 | Minimal net change, with a net decrease of \$324 million, which is a zero percent change when compared to the previous year's collections. | <p>"State tax changes in 2015 were all over the board. Unlike the past three years when lawmakers embraced major tax reduction packages, this year saw net increases in most tax categories with reductions only in personal and corporate income taxes. However, the reductions were big enough to offset all other categories for a slight net tax cut across all the reporting states." (NCSL)</p> <p>Tax increases targeted motor fuel to help with transportation costs and tobacco – and more states included e-cigarettes in the tax base.</p> <p>Twelve states reported net tax increases of more than 1 percent (Alabama, Connecticut, Georgia, Idaho, Iowa, Kansas, Louisiana, Nevada, South Dakota, Vermont, Virginia and Washington). The largest net increase was in Connecticut (\$806 million) through a comprehensive package that included increases in income, tobacco and health provider taxes and expanding the sales tax base.</p> <p>The largest categories for net tax increases were motor fuel (\$1,120 million) and tobacco (\$548 million).</p> <p>Seven states reported a net tax decrease of more than 1 percent (Florida, Indiana, Maine, North Dakota, Ohio, Rhode Island and Texas). Texas reported the largest decrease, primarily the result of lower business franchise taxes.</p> <p>Personal income taxes had the largest decrease of all tax categories, at nearly \$2 billion, primarily the result of Ohio's phased- in rate reduction.</p> <p>Corporate income taxes were also reduced by a net of \$514.6 million.</p> |
| 2016 | <p>"Continuing the same trend as in 2015, this year saw net reductions in personal and corporate income taxes and increases across most other tax categories." (NCSL)</p> <p>There was a net \$2.3 billion revenue increase across all reporting states (0.3 percent of the prior year's tax collections)</p> | <p>Across the nation, the trend of multi-year reductions in individual and corporate income taxes continued. Tax increases included multiple state increases in motor fuel taxes to fund transportation projects and substantial sales tax increases in two states, as well as increased health care provider taxes to offset insurance costs and tax increases on many tobacco products.</p> <p>Six states (Louisiana, New Jersey, Oklahoma, Pennsylvania, South Dakota and West Virginia) reported net tax increases of more than 1 percent. Louisiana and South Dakota had the largest increases by raising the sales tax rate. Louisiana raised \$1.5 billion in new revenue, an increase of 16.4 percent.</p> <p>Five states (Georgia, Indiana, Mississippi, New Mexico and Wisconsin) reduced net taxes by more than 1 percent.</p> <p>Indiana reported the largest tax decrease (a net reduction of 2.3 percent), as the result of phasing in individual and corporate income tax reductions that were enacted during the 2013 legislative session.</p> |



There is significant concern, particularly among budget and revenue professionals, that states may be experiencing something of an inflection point as it relates to revenue estimates. **Multiple states have experienced shortfalls in actual revenue collections compared to estimates.** As NASO reported in its recent fiscal survey of the states: “Governors’ budgets for fiscal 2018 are extra cautious as states contend with slow revenue growth, limited budget flexibility and substantial federal uncertainty. Under executive budget proposals, state general fund spending would increase just 1 percent in fiscal 2018 compared to current estimated spending levels – the smallest increase recommended by governors since fiscal 2010, when states were in the depths of the Great Recession.”³⁴

Some key findings from the report include:

- States experienced sluggish general fund revenue growth in fiscal 2017 of 2.4 percent, with 33 states reporting collections below budget projections.
- At least 23 states have already made net mid-year budget cuts totaling \$4.9 billion in fiscal 2017.
- State general fund spending would increase just 1 percent under governors’ fiscal 2018 budgets, while general fund revenues are projected to grow 3.1 percent.
- Governors’ proposed tax and fee changes would result in a net increase of \$3.7 billion.

Summary

The following are key points to consider relating to state and local revenue structures, both for Hawaii and other U.S states:

General Characteristics

- The basis for taxation is primarily wealth (property tax), consumption (general sales and excise taxes) or income (income taxes).
- Prior to the 20th century, both state and local revenue structures were centered on property taxes.
- In the 20th century, states diversified their structures, moving away from property taxes and instituting sales and income taxes. Local governments have also (to a lesser extent) reduced their reliance on property taxes, although they remain the largest source of local tax revenue.
- Hawaii would have been the first state to enact an income tax (in 1901), were it a state at that time.

³⁴ National Association of State Budget Officers, Spring 2017 Fiscal survey.



Hawaii Characteristics

- Hawaii state government primarily relies on the GET (52 percent of General Fund revenue) and the IIT (34 percent). No other source provides more than 4 percent (TAT at 3.8 percent).
- While sometimes compared to state sales taxes, the GET is actually a business privilege tax assessed on nearly all business activities, which makes it a much broader based tax than a general sales tax. This tends to make it a stable source of revenue.
- Because it is assessed against so much business activity, there is more pyramiding that occurs compared to State sales tax structures. Pyramiding occurs when inputs into a finished good or service are taxed at multiple points in the process.
- The Hawaii IIT is a progressive tax, and the highest of its 12 marginal tax bracket is the second highest among U.S. states. The 12 brackets is the most of any state, and Hawaii's lower brackets are closely spaced, meaning average income earners move fairly quickly to higher marginal tax rates than in most states.
- Hawaii has a broad array of excise taxes that are similar to those in other states. Because of Hawaii's unique island location, issues of cross-border competition are less of a concern than in most states, and excise tax rates tend to be higher than average as a result.

Relationship of State and Local Revenues

- It is generally necessary to study combined state and local revenue structures, because there is wide variation in how funding for key local government service funding responsibility is allocated. These are generally state government decisions, as local tax structures generally require state approval for the collection of specific taxes or changes to tax rates or the tax base.
- Hawaii is unique in funding nearly all of K-12 education expenses at the state level. K-12 education is, in nearly every state, the largest expenditure category for local tax revenue, which is primarily property taxes.
- The vast majority of Hawaii state and local revenue is raised at the state level, and Hawaii local property taxes are generally low compared to other states.

State Taxes Performance

- States are dealing with a variety of issues that impact on state tax performance. In particular, erosion of state sales tax bases (because of economic, demographic and tax collection issues) has been a major concern.
- State tax structures have also proven to be more volatile than in the past, primarily because of an increased reliance on progressive income tax structures, which are susceptible to revenue swings related to the business cycle.



- Corporate income taxes have become a smaller component of state revenue structures, and this trend is not likely to be reversed in coming years.
- There is concern that, at the current time, state revenue structures are at something of an inflection point, and sluggish growth is often forecast by individual states. A report by NASBO noted that states experienced below average revenue growth (2.4 percent) in fiscal year 2017, with 33 states reporting collections below official projections.



Tax Burden



Overview

It is generally understood that different taxes impact on individual taxpayers in different ways. At the core of the tax burden discussion is an understanding that paying taxes (while necessary for ordered society) reduces the ability of taxpayers to put those same dollars to other productive use. Tax burden analysis seeks to quantify how much and what percentage of (otherwise disposable) income is directed away from taxpayers (via the tax code).

Research over the years suggests that this impact will vary depending on a variety of factors: income, age, education, geographic location and household make-up are just a few of these factors. As policymakers have looked to shape tax policy that makes sense for the overall economy and its taxpayers, they have used tax burden analysis as one tool to examine policy impacts at the national, state and local level.

Tax burden is an important consideration for the two tax principles identified as key for analysis by the Tax Review Commission:

- Equity (how the tax burden is allocated amongst taxpayers, including those at differing income levels);
- Efficiency (how the tax burden may impact on marketplace decisions by individuals and businesses).

There are several methodologies that have been developed to examine and report on tax burden. Because this is a complex subject, it is understandable that it has been approached from a variety of angles. For Hawaii, the project team has chosen an approach that it believes aligns with some key aspects of the State's tax structure and those who ultimately pay Hawaii taxes.

The approach used for this report uses a representative family and, via assumptions about typical household expenditures and taxes at various income levels, determines the estimated tax burden for that family within five income cohorts. There are other methods that have been used for tax burden analysis, and the discussion will highlight them, discuss strengths and weaknesses, and provide some further commentary on Hawaii's relative position related to those alternate approaches.

Finally, the analysis will also take into consideration how much of the overall State tax collections are paid by nonresidents. This is an important consideration, because it may ameliorate some of the calculations of burden on residents: if aggregate calculations of tax collections are used that do not consider these nonresident tax payments, it creates a misperception of the amount of taxes (and burden) borne by residents. The analysis will also seek to provide an updated estimate of the impact of taxes borne by tourists to Hawaii.

Current Structure Tax Burden

Taxes imposed by the State have varying impacts by class of taxpayer. To chart these impacts, the project team constructed a tax burden model loosely based on the District of Columbia's annual tax burden assessment.³⁵ The model assesses the 2015 tax burden for a hypothetical married couple with a young child

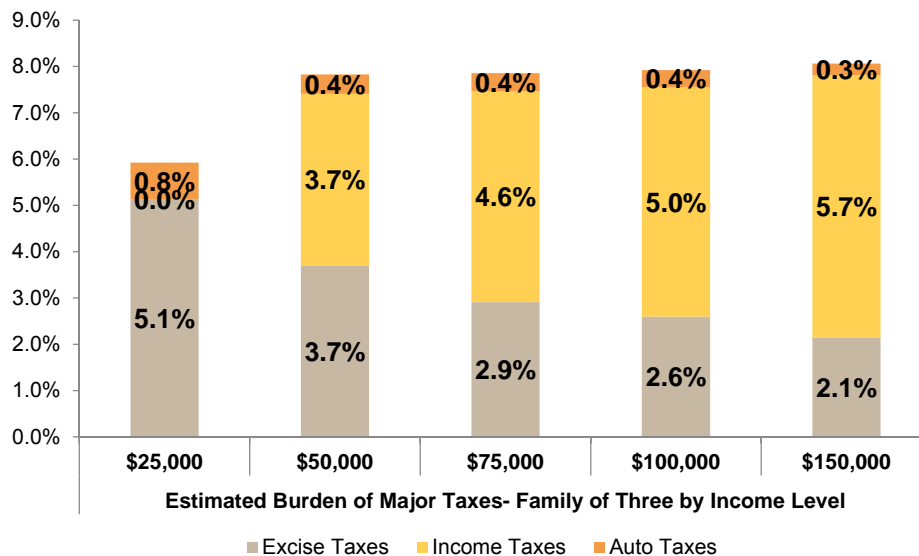
³⁵ The most recent version of the annual assessment, which includes a discussion of its methodology can be accessed on the District of Columbia Office of the Chief Financial Officers website at <https://cfo.dc.gov/sites/default/files/dc/sites/ocfo/publication/attachments/2015%2051City%20Tax%20Burden%20Study%20Final.pdf>



living in Honolulu.³⁶ The estimated burden for this family represents the sum of all property, auto, consumption (sales/excise), and income taxes, which compose the vast majority of all taxes directly paid by a typical household. Burdens from state excise, auto, and income taxes are also shown separately to examine the particular effects of state-levied taxes levied statewide.

The following chart shows the estimated tax burden for this hypothetical family of three at five income levels. Results show that Hawaii's tax system is only progressive between low income and middle-income households. A family making \$25,000 pays approximately 6.0 percent of its income in Hawaii taxes. Families making \$50,000 up to \$150,000³⁷ pay approximately the same rate of 8.0 percent, with only mild escalation as incomes rise.

Figure 18: State Tax Burden as a % of Income



Source: PFM analysis of Census, BLS and DOTAX data

³⁶While this analysis concentrates on the burden for an individual family, a comparative assessment of tax burden on the overall state economy can be found in the 'Components and Comparison to Other States' Burden' section on page 51.

³⁷ PFM also explored showing tax burdens at higher levels (above \$150,000). Limitations from a lack of reported data on consumer expenditures and property taxes at these very high-income levels made estimates for very high-income households not a viable option.



Table 14: Estimated Burden of Major State Taxes - Family of Three by Income Level

| | \$25,000 | \$50,000 | \$75,000 | \$100,000 | \$150,000 |
|----------------------------------|-----------------|-----------------|-----------------|------------------|------------------|
| Consumption Taxes | \$1,281 | \$1,847 | \$2,184 | \$2,598 | \$3,219 |
| % of Income | 5.12% | 3.69% | 2.91% | 2.60% | 2.15% |
| Property Taxes | \$0 | \$0 | \$0 | \$0 | \$0 |
| % of Income | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Income Taxes | \$0 | \$1,858 | \$3,413 | \$4,951 | \$8,499 |
| % of Income | 0.00% | 3.72% | 4.55% | 4.95% | 5.67% |
| Auto Taxes | \$200 | \$210 | \$295 | \$372 | \$375 |
| % of Income | 0.80% | 0.42% | 0.39% | 0.37% | 0.25% |
| Total Tax Burden | \$1,481 | \$3,915 | \$5,892 | \$7,921 | \$12,094 |
| Tax Burden as % of Income | 5.9% | 7.8% | 7.9% | 7.9% | 8.1% |

Source: PFM analysis of Census, BLS and DOTAX data

The GET is by far the most regressive of Hawaii's taxes, consuming 5.0 percent of income for the \$25,000 household but 2.2 percent for the \$150,000 household. This is partially offset by the food individual income tax credit, which was recently made permanent. The State auto registration, weight, and gas taxes are also regressive, taking two times the share of income from \$25,000 households than those making \$50,000 or more.

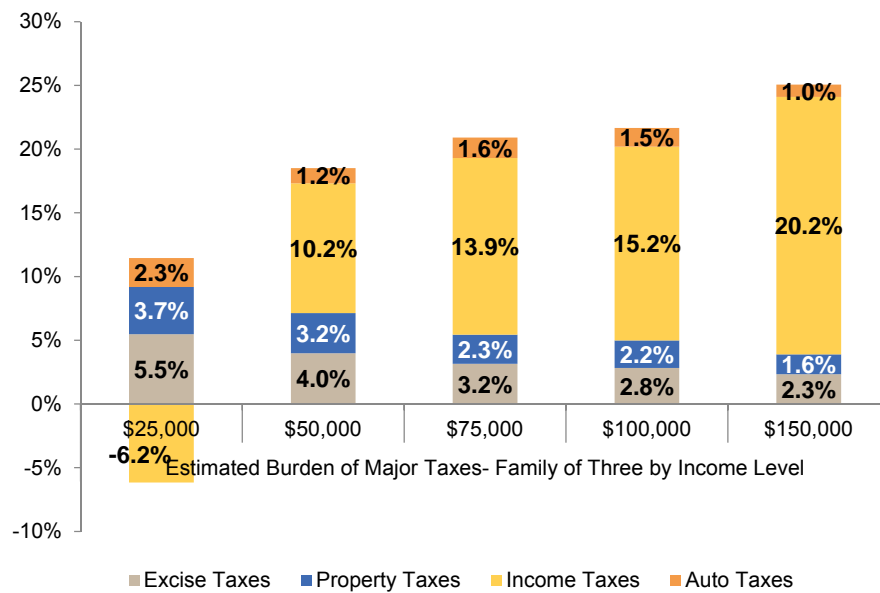
By contrast, the state individual income tax is progressive. The percent of income paid in individual income tax steadily rises as incomes increase, from 3.7 percent at \$50,000 to 5.7 percent at \$150,000. The recently enacted State Earned Income Tax Credit (EITC) effectively eliminates income taxes for the \$25,000 income household, which will significantly reduce the burden for these households and reduce taxes portion of these households' income by 1.8 percent. Without the state EITC, state taxes would account for 7.7 percent of income for the \$25,000 income household, a rate on par with that of higher income households.³⁸

Considering the total tax burden including all state, local, and federal taxes, the tax structure is progressive for the hypothetical family – primarily due to the progressive federal tax structure. The \$25,000 income family pays roughly 5.3 percent of its income in taxes, compared to 25.1 percent for the \$150,000 income family. The federal refundable EITC offsets much of the regressivity of the tax system, while the progressive structure of both state and federal income taxation contributes to the progressivity of the combined tax system. Property and auto taxes are very regressive, with the tax burden steadily falling as incomes increase.

³⁸ It should be noted that the State EITC is not refundable, so the credit can only be used to offset State individual income tax obligation. In this respect, it is less useful for reducing tax burden (and system regressivity than, for example, the refundable food/excise tax credit).



Figure 19: Total Tax Burden as % of Income



Source: PFM analysis of Census, BLS and DOTAX data

Table 15: Estimated Burden of All Major Taxes - Family of Three by Income Level

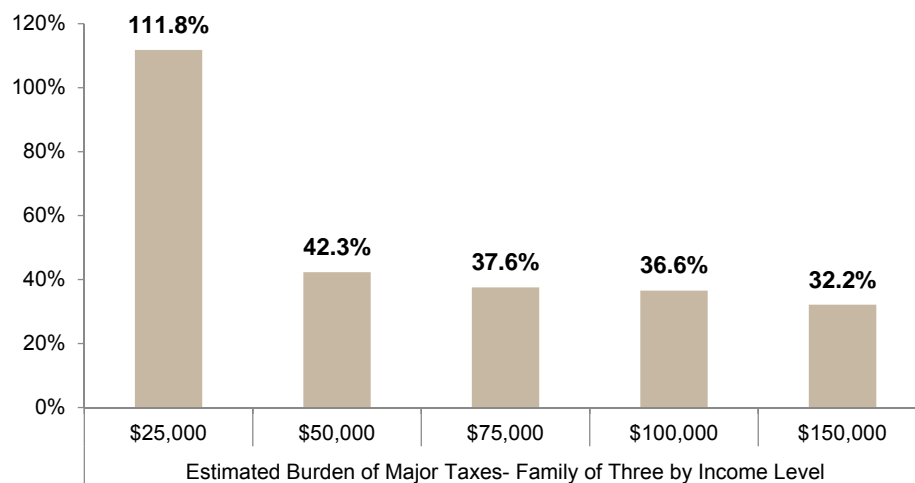
| | \$25,000 | \$50,000 | \$75,000 | \$100,000 | \$150,000 |
|----------------------------------|-----------------|----------------|-----------------|-----------------|-----------------|
| Consumption Taxes | \$1,367 | \$1,990 | \$2,365 | \$2,829 | \$3,511 |
| % of Income | 5.47% | 3.98% | 3.15% | 2.83% | 2.34% |
| Property Taxes | \$926 | \$1,578 | \$1,710 | \$2,156 | \$2,329 |
| % of Income | 3.70% | 3.16% | 2.28% | 2.16% | 1.55% |
| Income Taxes | -\$1,540 | \$5,090 | \$10,402 | \$15,207 | \$30,301 |
| % of Income | -6.16% | 10.18% | 13.87% | 15.21% | 20.20% |
| Auto Taxes | \$571 | \$595 | \$1,203 | \$1,462 | \$1,445 |
| % of Income | 2.28% | 1.19% | 1.60% | 1.46% | 0.96% |
| Total Tax Burden | \$1,325 | \$9,254 | \$15,680 | \$21,654 | \$37,585 |
| Tax Burden as % of Income | 5.3% | 18.5% | 20.9% | 21.7% | 25.1% |

Source: PFM analysis of Census, BLS and DOTAX data

Hawaii taxes account for a larger share of all taxes at lower incomes than higher incomes. These taxes represent 112 percent of total taxes paid by the \$25,000 family. The percentage above 100 percent is offset by \$1,540 in refundable federal EITC. Beyond the \$25,000 income level, Hawaii's share of total taxes steady declines, from 42.3 percent at \$50,000 to 32.2 percent at \$150,000. The State's tax structure makes the overall tax structure less progressive than it would otherwise be. This is because the federal tax structure is highly progressive, much more progressive than any state tax system. Although Hawaii's State tax system itself is just mildly progressive, these state taxes – as well as the very regressive county property taxes – offset some of the strong progressivity of the federal system.



Figure 20: State Share of Total Tax Burden



Source: PFM analysis of Census, BLS and DOTAX data

Exported Tax Revenue

A key factor for the discussion of Hawaii taxes is that a significant share are borne by nonresidents of Hawaii. As one of the nation's leading tourism destinations, every year Hawaii attracts over 8.9 million visitors that spend \$15.6 billion within the State economy.³⁹ Hawaii is also home to a large number of military personnel from other states that spend money within the state. Much of this spending activity is captured by the State's GET, TAT, liquor tax, gas tax, rental vehicle surcharge tax, corporate net income tax, and other taxes. County property taxes are also exported to out-of-state visitors that use vacation rental or seasonally-occupied housing.

Several studies have produced varying estimates on the level of tax exporting to nonresidents in Hawaii. The variation stems from differences in assumptions, calculation methodologies, and the period of study. Across these studies, taxpaying nonresidents are generally split into four categories: the federal government (whose military presence produces substantial spending subject to GET), residents, visitors, and non-resident property and business owners.

The following tables illustrate the differing calculations of the GET and total tax exported by taxpayer category from previous studies:

³⁹Hawaii Tourism Authority. "Hawaii Tourism Industry Set[s] New Records in 2016: \$15.6 billion in visitor spending; 8.9 Million Arrivals." January 30, 2017. <http://www.hawaiitourismauthority.org/default/assets/File/research/monthly-visitors/December%202016%20final%203.pdf>

**Table 16: General Excise Tax Burden by Taxpayer Type**

| Study | Residents/ State and Local Gov't | Federal Gov't | Tourists (A) | Nonresident Business and Property Owners (B) | All Nonresidents (A + B) |
|-----------------------------------|---|------------------|-----------------|---|--------------------------------|
| Miklius, Moncor, and Leung (1988) | 66.4% | 1.8% | 21.9% | 9.8% | 31.7% |
| Bowen and Leung (1989) | 66.7% | 2.3% | 25.0% | 6.0% | 31.0% |
| 2006 DOTAX Study | 62.1% | 6.3% | -- | -- | 31.6% |
| PFM (2017) | -- | -- | 19.0% | -- | -- |
| Study Average | 65.1% | 3.5% | 22.0% | 7.9% | 31.5% |

Source: PFM analysis

Table 17: Total State and Local Tax Burden by Taxpayer Type

| Study | Residents/ State and Local Gov't | Federal Gov't | Tourists (A) | Nonresident Bus. and Prop. Owners (B) | All Nonresidents (A + B) |
|-----------------------------------|--|------------------|-----------------|--|--------------------------------|
| Miklius, Moncor, and Leung (1988) | 67.5% | 7.2% | 16.1% | 9.3% | 25.4% |
| Bowen and Leung (1989) | 67.9% | 2.3% | 22.0% | 7.8% | 29.8% |
| 2006 DOTAX Study | 68.5% | 9.6% | -- | -- | 21.9% |
| Study Average | 67.9% | 6.4% | 19.1% | 8.5% | 25.7% |

Source: PFM analysis

Visitors shoulder a significant portion of the tax burden in Hawaii. A 1988 TRC study by Miklius, Moncor, and Leung put the visitor share of the GET at **22 percent** and 16 percent of all state and local taxes.⁴⁰ A 1989 study by Bowen and Leung estimated that tourism accounted for 17 percent of final sales in Hawaii and that tourists pay **25 percent** of the GET. Altogether, the study found that nonresidents accounted for 32 percent of all major Hawaii taxes including corporate net income, property, fuel, tobacco, and liquor taxes. The corporate net income and liquor taxes were most heavily borne by visitors at 23 and 40 percent respectively.⁴¹ A 2006 Department of Taxation report prepared for the TRC put the non-federal, nonresident GET share at **32 percent**, the property tax share at 22 percent, the transient accommodations tax share at 64 percent, and the overall tax burden share at roughly 22 percent. However this figure is not strictly comparable to previous estimates, because it includes nonresident property and business owners.⁴²

To supplement this research with findings from more recent data, the project team performed a new calculation of the tourist GET burden using Hawaii Tourism Authority (HTA) data and GET collection data from the Council on Revenues. Here, the project team adopted a different methodology than typically employed by other studies. Instead of relying on macroeconomic data to calculate the implied amount of taxes paid by visitors, the project team calculated the visitor share based on HTA statistics on visitor days and air visitor⁴³ personal daily spending and actual GET collections for 2004-2016. It is estimated that tourists (excluding non-resident owners and the

⁴⁰ Miklius, Walter, James E. T. Moncur, and PingSun Leung, "Distribution of State and Local Tax Burden by Income Class," in Hawaii Tax Review Commission, Working Papers and Consultant Studies, vol. 2, Honolulu: State of Hawaii, Department of Taxation, 1989, pp. 7-19.

⁴¹ Bowen, R. L., & Leung, P. (1989). Tax pyramiding and tax exporting in Hawaii: an input-output analysis.

⁴² "Tax Research and Planning Office, Hawaii State Department of Taxation. "Study on the Progressive or Regressive Nature of Hawaii's Taxes." http://files.hawaii.gov/tax/stats/trc/docs2007/Final_Report-Appendix_D.pdf

⁴³ These visitors account for 99 percent of all visitors.

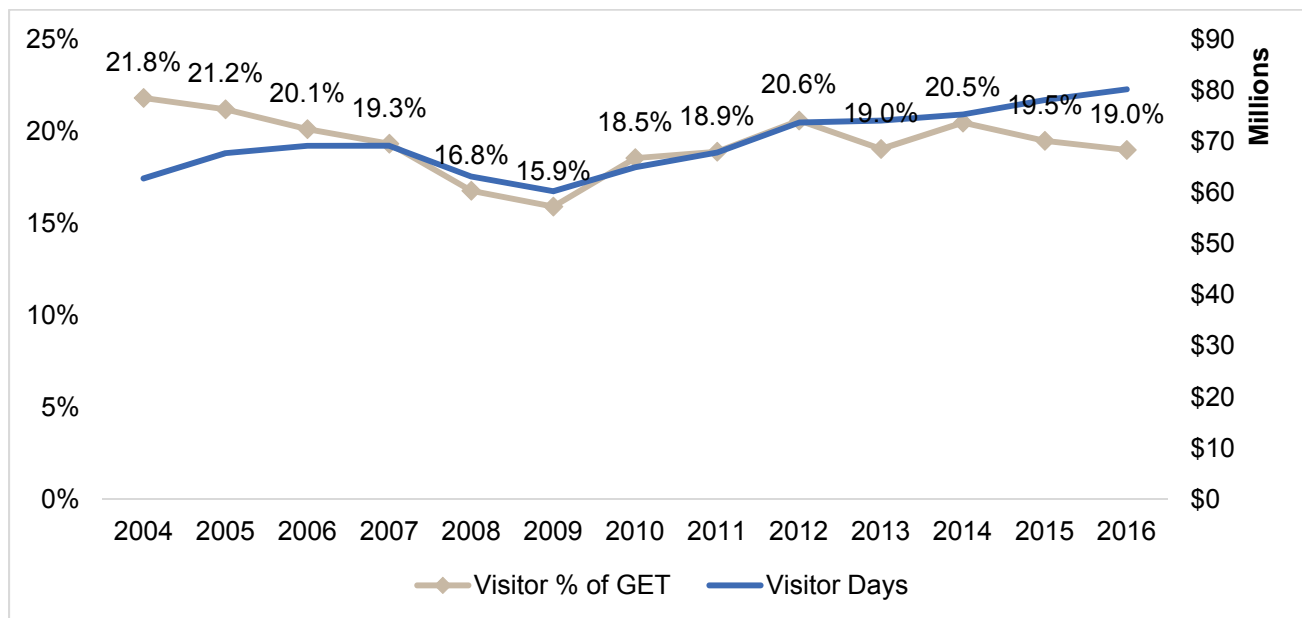


federal government) on average account for **19.3 percent**⁴⁴ of state General Excise Tax collections (excluding the Oahu surcharge), a slightly lower figure than many previous estimates, but closer to the figures from the Miklius, Moncor, and Leung and Bowen and Leung studies.⁴⁵ Roughly 19 cents of every GET dollar comes from tourists.

Using the same methodology, the project team also studied the change in visitors' share of the GET over time. In 2004, visitors accounted for 21.8 percent of GET collections, which declined steadily to 15.9 percent by the onset of the Great Recession. After 2009, the visitor share began to rise with the economic recovery, reaching its highest level since 2005 by 2012. Since 2012, the share has fluctuated around an average of **20 percent**, although the share has consistently declined since 2014. The overall 12-year average for the visitor's GET share is just over **19 percent**.

The visitor share of the GET seems to be most closely aligned with the number of visitor days over the long term, although recent years have shown a slight divergence between the trends. These results suggest that visitors' share of the GET does not remain flat over time. Instead, it varies in line with the number of visitor days, which is itself impacted by the business cycle. This suggests that over the long term as tourism to Hawaii increases, so will the visitors' share of GET collections. However this also means that visitor GET share estimates at different points in time are not strictly comparable, because they reflect different levels of tourist visits to Hawaii.

Figure 21: Visitor % of GET vs. Total Visitor Days



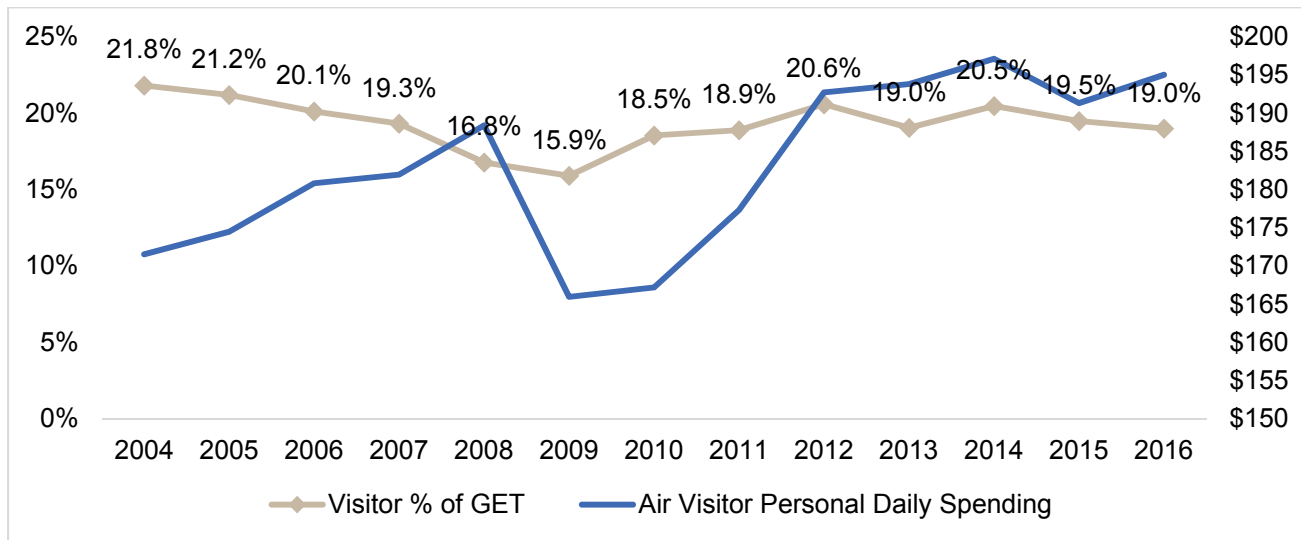
Source: PFM analysis of Hawaii Tourism Authority and DOTAX data

⁴⁴ 2004-2016 average.

⁴⁵ This share was calculated by calculating total visitor expenditures for Oahu and the rest of Hawaii from Hawaii Tourism Authority data. Next, the TAT and GET imbedded within these expenditures were backed out. The GET was removed by using 4.71% for Oahu and 4.17% for the rest of Oahu, the rates commonly charged by businesses to consumers to recoup the GET. These rates take pyramiding into account by adding an additional 0.17 percent (outside Honolulu) and 0.22 percent (Honolulu) to the statutory rate. The TAT was removed using 7.25%, 8.25%, or 9.25% of tourist lodging expenditures, the various rates that were effect from 2004 through 2016. These expenditures less paid GET and TAT were added together then multiplied by the 4.17% effective state GET rate to estimate State GET paid by visitors. This was divided by actual GET collections in 2016 to compute a visitor share of 19 percent. Although visitor expenditures reported by the HTA likely include some smaller taxes, tips, and gratuities not subject to GET, HTA data on the distribution of spending suggest these amounts are not large enough to significantly bias the estimates.



Figure 22: Visitor % of GET vs. Personal Daily Spending



Source: PFM analysis of Hawaii Tourism Authority and DOTAX data

Considering the non-tourist share of taxes, Miklius, Moncor, and Leung estimated the federal GET share at 1.8 percent and the total state and local tax share at 7.2 percent. However, the 2006 Department of Taxation study report put the federal share at 6.3 percent of GET and 9.6 percent of all taxes. Miklius, Moncor, and Leung's study estimates the nonresident business and property owner GET share at 9.8 percent and the overall state and local tax share at 9.3 percent. Bowen and Leung's study put the nonresident business and property owner GET share at 6.0 percent and the overall state and local tax share at 7.8 percent.

To summarize, previous studies suggest that visitors' share of the GET is somewhere between 19 and 25 percent. The federal share lies somewhere between 1.8 percent and 6.3 percent while nonresident property and business owners likely pay between 6.0 and 9.8 percent of the total tax. Residents shoulder between 62.1 and 66.7 percent of the GET burden. In terms of all state and local taxes, studies suggest the visitor burden lies between 16.1 and 22.0 percent, while the federal burden lies between 2.3 and 9.6 percent. Nonresident business and property owners likely pay between 7.8 and 9.3 percent, while residents pay between 67.5 and 68.5 percent. Although the breakouts by nonresident taxpayer vary, **studies consistently show that Hawaii residents pay just over two-thirds of all state and local taxes.**

Components and Comparison to Other States' Burden

Additional insights on Hawaii's tax burden can be gained from comparing it to that of other states. Generally, high level state tax burden estimates differ from household assessments, because they focus on tax collections' share of overall statewide income. Hawaii has one of the highest marginal income tax rates for upper income taxpayers in the nation, and one of the most broad-based consumption taxes in the GET. In addition, Hawaii's economy is unusually dependent on tourism when compared to other states, and visitors account for a relatively large share of paid taxes. For some tax burden studies, this will inflate measures of burden based on ratios of total taxes paid to resident incomes or the number of residents.

For this reason, Hawaii is often in the top rank of states on high-level per capita and tax-to-income ratios. Including taxes paid by tourists in aggregate measures of resident tax burden is a major weakness of many tax



burden studies. Resident burden is consistently overstated since the numerator includes taxes paid by everyone but the denominator is limited to residents or their incomes. Hawaii is not the only state that exports a significant share of its tax burden (and for a variety of reasons). For example, there are cities (such as New York City, Philadelphia, Chicago, etc.) where the daytime working population increases dramatically with commuters from other states. These commuters pay a variety of taxes (including general sales and excise taxes) that may not be considered in these aggregate analyses. Likewise, other tourist destination states, such as Florida and California, also export revenue to visitors – although it is unclear if any of these states reach the same level of exporting as Hawaii. Even with these caveats, it is still important to measure tax burden on the overall state economy and not only on a particular household.

2014 data from the FTA shows that Hawaii state and local taxes per capita are the ninth highest in the nation, at \$5,708 per resident. As a percentage of personal income, Hawaii taxes are the fifth highest in the nation, at 12.9 percent.

Table 18: FTA - State and Local Taxes per Capita and as % of Personal Income, 2014

| | State and Local Taxes Per Capita | | | Taxes % of Personal Income | |
|----------------------|----------------------------------|--------------|----------|----------------------------|----------|
| | Taxes (\$ million) | Per Capita | Rank | % of Personal Income | Rank |
| North Dakota | 7,212 | 9,753 | 1 | 17.9 | 1 |
| New York | 166,087 | 8,411 | 3 | 15.5 | 2 |
| District of Columbia | 6,378 | 9,680 | 2 | 14.8 | 3 |
| Alaska | 5,568 | 7,558 | 4 | 14.7 | 4 |
| Hawaii | 8,103 | 5,708 | 9 | 12.9 | 5 |
| Vermont | 3,473 | 5,543 | 12 | 12.1 | 6 |
| Maine | 6,395 | 4,808 | 17 | 12.1 | 7 |
| Minnesota | 30,781 | 5,640 | 10 | 12.0 | 8 |
| Illinois | 70,821 | 5,498 | 13 | 11.8 | 9 |
| New Jersey | 57,638 | 6,448 | 6 | 11.7 | 10 |

Source: Federation of Tax Administrators 2014 State Tax Revenue Tax Burden Comparison - U.S Census Bureau 2014 Population Estimates

A similar 2012 analysis from the Tax Foundation found that Hawaii had the 14th highest state and local tax burden as a percentage of state income (10.2 percent) and the 15th highest state and local tax burden per capita (\$4,576). However when considering paid state taxes alone, Hawaii ranks 11th in the nation at \$3,480 per resident. The Hawaii tax burden is one of the highest in the nation as a share of *all* incomes.

Table 19: Tax Foundation - State and Local Taxes per Capita and as % of Personal Income, 2012

| State | State-Local Tax Burden as a Percent of State Income | Rank | State-Local Tax Burden per Capita | Rank | Taxes Paid to Own State per Capita | Rank |
|-------------|---|------|-----------------------------------|------|------------------------------------|------|
| New York | 12.7% | 1 | \$6,993 | 3 | \$5,588 | 1 |
| Connecticut | 12.6% | 2 | \$7,869 | 1 | \$5,516 | 2 |
| New Jersey | 12.2% | 3 | \$6,926 | 4 | \$4,876 | 4 |
| Wisconsin | 11.0% | 4 | \$4,734 | 12 | \$3,602 | 10 |
| Illinois | 11.0% | 5 | \$5,235 | 8 | \$4,015 | 8 |
| California | 11.0% | 6 | \$5,237 | 7 | \$4,126 | 7 |



| State | State-Local Tax Burden as a Percent of State Income | Rank | State-Local Tax Burden per Capita | Rank | Taxes Paid to Own State per Capita | Rank |
|---------------|---|-----------|-----------------------------------|-----------|------------------------------------|-----------|
| Maryland | 10.9% | 7 | \$5,920 | 5 | \$4,387 | 5 |
| Minnesota | 10.8% | 8 | \$5,185 | 9 | \$3,980 | 9 |
| Rhode Island | 10.8% | 9 | \$4,998 | 10 | \$3,476 | 12 |
| DC | 10.6% | 10 | \$7,541 | 2 | \$5,231 | 3 |
| Oregon | 10.3% | 10 | \$4,095 | 23 | \$3,063 | 18 |
| Vermont | 10.3% | 11 | \$4,557 | 16 | \$3,129 | 17 |
| Massachusetts | 10.3% | 12 | \$5,872 | 6 | \$4,220 | 6 |
| Maine | 10.2% | 13 | \$3,997 | 25 | \$2,895 | 22 |
| Hawaii | 10.2% | 14 | \$4,576 | 15 | \$3,480 | 11 |

Source: Tax Foundation, FY2012 State-Local Tax Burdens by State

Yet when considering individual households, a different tax burden picture emerges. Nationally, Hawaii's (Honolulu's) middle class individual taxpayers have relatively low tax burdens.⁴⁶ As previously noted, for tax burden comparison purposes at the household level, the project team has used data from an annual study conducted by the Chief Financial Officer for Washington DC. This study compares the tax burden for the District of Columbia and each of the largest cities in all 50 states. The study is useful because it provides a national point of comparison of state and local taxes. It should be noted that unlike many other tax burden studies, the DC study does not measure the burden from taxes paid by nonresidents, only taxes paid by a hypothetical resident household. Moreover, it does not measure tax incidence, only the estimated dollar value of taxes paid by a household and taxes' percentage of that household's income.

According to Washington DC's annual tax rate and tax burden study,⁴⁷ Honolulu households with incomes above \$50,000 have low property tax burdens relative to most other large cities in the U.S. Households with incomes between \$50,000 and \$150,000 (the highest income cohort included in the study) on average have tax burdens between 6.1 and 7.5 percent of income – ranking in the lowest 20 percent nationwide, as shown in the following table.

Table 20: Honolulu, Hawaii National Tax Burden Ranking, 2015

| Income Level | Taxes | | | | | Tax Burden | |
|--------------|---------|---------|----------|-------|-----------------|------------|--------------|
| | Sales | Income | Property | Auto | Total | Percent | Rank (of 51) |
| \$50,000 | \$823 | \$1,293 | \$692 | \$251 | \$3,059 | 6.1% | 46 |
| \$75,000 | \$1,105 | \$2,443 | \$1,178 | \$434 | \$5,160 | 6.9% | 43 |
| \$100,000 | \$1,354 | \$3,758 | \$1,664 | \$555 | \$7,331 | 7.3% | 41 |
| \$150,000 | \$1,653 | \$6,437 | \$2,636 | \$537 | \$11,263 | 7.5% | 40 |

Source: Washington DC Tax Rates and Tax Burdens 2015

Hawaii's low property taxes are a major reason for the state's low tax burden on low and middle-income families. Compared to other states, property taxes in Hawaii are also relatively low. Hawaii has the 19th lowest median

⁴⁶ In the study, tax burden attributed to property tax is higher for those at \$25,000 than other households because it is calculated off an assumed rent for a 3-person family rather than off the assumed assessed value of a home. The median rent in Hawaii is approximately 56 percent above the national average, resulting in higher assumed property taxes paid through rent. However, property taxes in Hawaii are relatively low – the median paid residential property tax in Hawaii was over 1/3 below the national average in 2015. Therefore, the project team believes a 20 percent of rent assumption is highly inflated, and therefore that income cohort is not included in this analysis.

⁴⁷ Washington DC Tax Rates and Tax Burdens 2015 – A Nationwide Comparison. Issued December 2016.



property taxes and the lowest property taxes in the nation when measured against home values.⁴⁸ When measured against homeowner incomes, the property tax burden in Hawaii is the 6th lowest of any state.

Table 21: Hawaii Property Taxes, 2015

| | Median Property Taxes Paid | Property Tax to Home Value Ratio | Median Property Taxes to Homeowner Median Income Ratio |
|-------------|----------------------------|----------------------------------|--|
| Performance | \$1,482 | 0.3% | 1.6% |
| Rank | 19 th lowest | Lowest | 6 th lowest |

Source: U.S Census Bureau, American Community Survey 1-Year Estimates

Washington DC's annual tax rate and tax burden study also included data on effective tax rates at five levels of income. The project team used this data to compute the average increase in the effective tax rates between income gains of \$25,000 for families making between of \$25,000⁴⁹ and \$100,000. This functions as a measure of the progressivity of a tax structure. Honolulu ties for eleventh most progressive in the nation, meaning Hawaii's tax structure is very progressive when compared to most other states. Honolulu is also 11th in the nation when the analysis is expanded to include tax rate increases from \$100,000 to \$150,000.

Table 22: Tax Burden Progressivity, Largest City in Each State, 2015

| Largest City | Avg. Effective Tax Rate Increase, \$25,000 Income Gain, \$25k - \$100k | Rank |
|---------------------|--|-----------|
| Burlington, VT | 4.9% | 1 |
| Bridgeport, CT | 2.4% | 2 |
| Milwaukee, WI | 1.3% | 3 |
| Baltimore, MD | 1.3% | 3 |
| Newark, NJ | 1.1% | 5 |
| Detroit, MI | 1.0% | 6 |
| Minneapolis, MN | 0.8% | 7 |
| Des Moines, IA | 0.7% | 8 |
| Boise, ID | 0.6% | 9 |
| Omaha, NE | 0.5% | 10 |
| Honolulu, HI | 0.5% | 11 |
| Oklahoma City, OK | 0.5% | 11 |
| Albuquerque, NM | 0.4% | 13 |
| Columbus, OH | 0.2% | 14 |
| Billings, MT | 0.1% | 15 |

⁴⁸ Home values in Hawaii are amongst the highest in the nation, therefore low property tax rates do not always translate to small property tax bills.

⁴⁹ PFM's effective tax rate for \$25,000 households used instead of the DC study estimate due to concerns over its property tax share of rent assumptions.



In sum, **Hawaii's State tax system is mildly progressive.** This results mainly from the state's highly progressive individual income tax, partially offset by the very regressive GET. Although the progressivity of Hawaii's system is modest, it is significantly more progressive than other states. In the aggregate, wealthier households tend to pay higher effective tax rates in Hawaii than is the norm in the rest of the country.

Summary

It is important to distinguish between the relative tax burden of key components and of the structure as a whole. In this respect, Hawaii's tax burden has some widely divergent components. The following provides key points related to the State and local tax burden.

Current Structure

- The GET is a regressive tax, which consumes 5.0 percent of income for a household with \$25,000 income but only 2.2 percent for a household with \$150,000 of income. This is partially offset by the food IIT refundable credit, which was recently made permanent.
- The IIT tax is a progressive tax, where the percent of income paid steadily rises as incomes increase – from 3.7 percent at \$50,000 to 5.7 percent at \$150,000. The recently-enacted EITC effectively eliminates IIT for the \$25,000 income households.
- The property tax is regressive, with the tax burden rising as incomes increase. It is notable, however, that actual property taxes paid in Hawaii are lower than in nearly all other states, which reduces their impact.
- When combining federal, state and local taxes paid in Hawaii, the structure is progressive at each income level. However, the federal IIT is highly progressive and contributes to the overall progressivity of the system.

Exported Tax Revenue

Not all tax revenue is borne by Hawaii resident taxpayers. In fact, given the importance of tourism (and, to a lesser extent, federal non-resident employees), Hawaii likely exports more of its tax burden than nearly any other state. This replaces some of the burden for Hawaii resident taxpayers. Multiple studies have identified the share of Hawaii major taxes. The following identifies estimates of that exported burden:

- Share of GET estimates have varied from 31.0 to 31.7 percent.
- The PFM study estimates that the tourists' share of GET is 19.0 percent.
- Total state and local tax burden by non-residents has varied from 21.9 to 29.8 percent.
- Although the breakouts vary, studies consistently show that Hawaii residents pay just over two-thirds of all state and local taxes.



Components and Comparisons to Other States' Burden

As discussed in the overview, high level state tax burden estimates differ from household assessments because they focus on tax collections' share of overall statewide income. Some also only focus on state tax collections, and, given Hawaii's unique characteristics, these generally inflate these rankings. Given those caveats, the following identify Hawaii rankings in other tax burden comparisons:

- FTA 2014 data indicate that Hawaii state and local taxes per capita are the ninth highest in the nation. As a percentage of personal income, Hawaii taxes are the fifth highest in the nation.
- An analysis by the Tax Foundation (2012) found that Hawaii had the 14th highest state and local tax burden as a percentage of state income and 15th highest state and local tax burden per capita.
- Using the individual households approach, Honolulu's middle class individual taxpayers have relatively low tax burdens and particularly low property tax burdens (among the lowest in the U.S. among comparison cities).
- Using the individual households approach and effective tax rates, Honolulu has the 11th most progressive tax structure in the nation.



Tax Regressivity



Overview

The discussion of tax burden is important for determining the progressive and regressive features of a tax structure as well as its overall standing. As discussed in the chapter on Tax Burden, the overall Hawaii State tax structure is mildly progressive using the household income approach to determining tax burden. At the same time, individual features of the tax structure (which was also discussed in the Tax Burden chapter) can be regressive and may have greater impacts on certain taxpayers than other tax components.

Introduction

The TRC directed PFM to consider opportunities to make the Hawaii tax structure less regressive. As a starting point, it is important to discuss how tax structures are characterized and what it means for a state tax structure to be considered regressive.

Regressivity is a key tax equity (and tax construction) issue, and it is closely linked with the previous discussion of tax burden. Tax structures and/or individual taxes are often described as being progressive, regressive or proportional. A progressive tax is one that takes a larger percentage of income from high income groups than from low income groups. A proportional tax is one that takes the same percentage of income from all income groups. A regressive tax is one that takes a larger percentage of income from low income groups than from high income groups.

In fact, very few (perhaps no) taxes are designed to impose rates that increase as income decreases (which would mean there are no purely regressive taxes on their face). In practice, however, various taxes are regressive, because a greater proportion of a lower income individual's income is dedicated to paying the tax, even though individuals pay the same tax rate. For example, it is generally accepted that lower income individuals spend a greater percentage of their income on the tangible goods and services that are subject to a general sales tax. As a result, that type of tax is generally considered to be a regressive tax (although the extent of that regressivity is subject to some debate). It is also notable that an overall tax structure can be progressive while some of its components are regressive – which is generally the case for Hawaii.

State tax structures are often viewed in combination with local taxes. This helps for “apples to apples” comparison purposes, as States have made differing determinations of how certain services (such as K-12 education) will be provided and who (state or local governments and taxes) will pay for them. Hawaii is notable in that it is the only state that assumes nearly all the costs of K-12 education at the state level. In other states, this is generally more of a shared state and local funding responsibility.

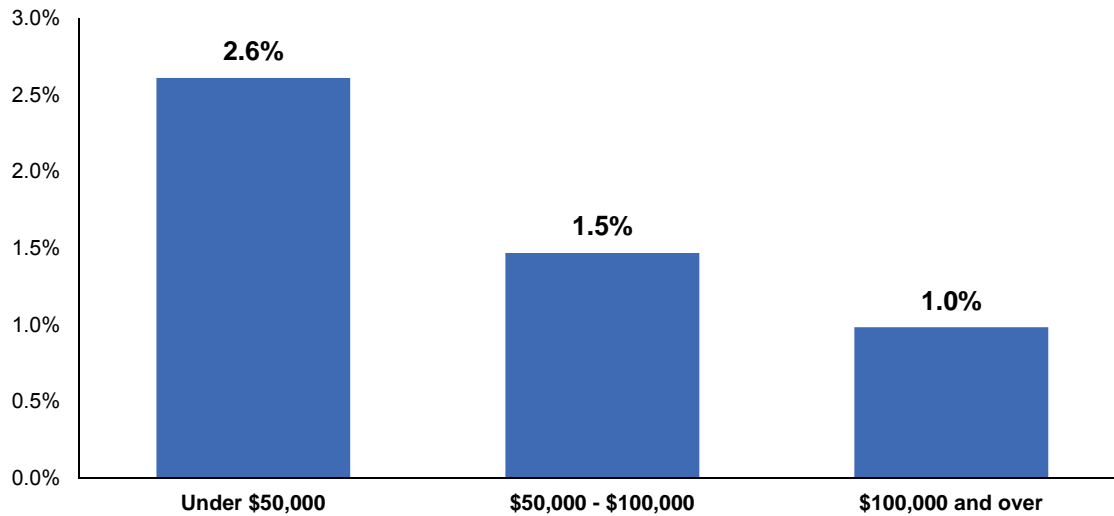
Current Measures of Regressivity

Given the distribution of tax burden, it is important to consider the overall regressivity of Hawaii's major taxes in terms of percentage of income and share of overall tax collections. Hawaii's largest tax revenue source, the GET, is highly regressive. The percentage of income going to the GET steadily declines as incomes rise. Honolulu households making less than \$50,000 pay roughly three cents per dollar earned in excise taxes, while



those making \$100,000 or more pay only one cent on the dollar. This is largely because lower income households spend more of their income on consumption expenditures subject to the GET.⁵⁰

Figure 23: Ratio of General Excise Taxes Paid to Household Income by Income Range, 2014

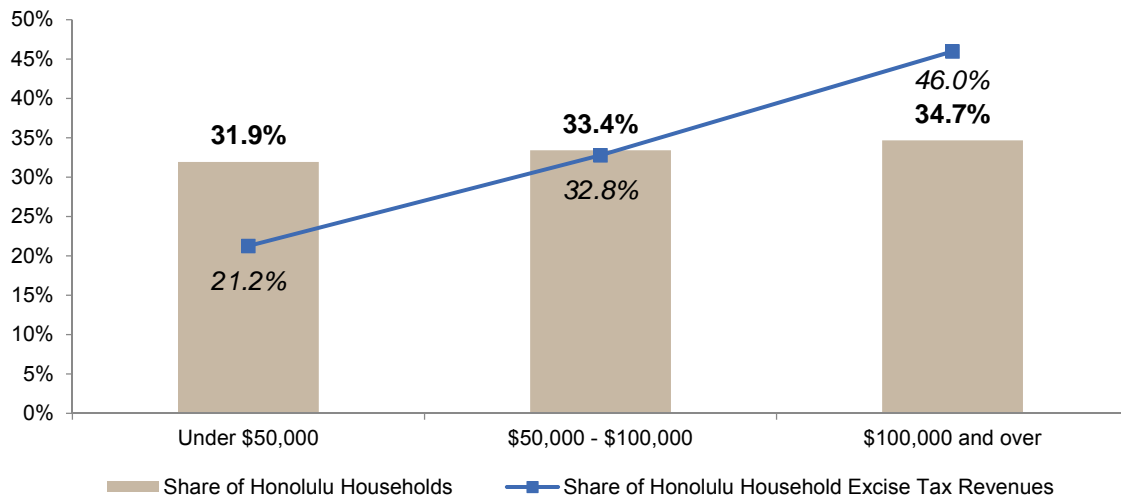


Sources: Hawaii Department of Business, Economic Development & Tourism. Honolulu Consumer Spending: 2013-2014. April 2016; U.S Bureau of Labor Statistics, 2015 Consumer Expenditure Survey. August 2016; U.S Census Bureau, American Community Survey 2014 1 Year Estimates.

However, in the aggregate, upper income taxpayers pay a disproportionate share of general excise taxes. Honolulu households making under \$50,000; between \$50,000 and \$100,000; and \$100,000 and over have nearly equal shares of Honolulu households – yet those making \$100,000 or more shoulder about 46 percent of the burden. This is because these households tend to spend more money in the aggregate on goods and services subject to the GET.



Figure 24: Share of Honolulu Households & Total Excise Tax Revenues by Income Range, 2013-2014



Sources: Hawaii Department of Business, Economic Development & Tourism. Honolulu Consumer Spending: 2013-2014. April 2016; U.S Bureau of Labor Statistics, 2015 Consumer Expenditure Survey. August 2016; U.S Census Bureau, American Community Survey 2014 1 Year Estimates.

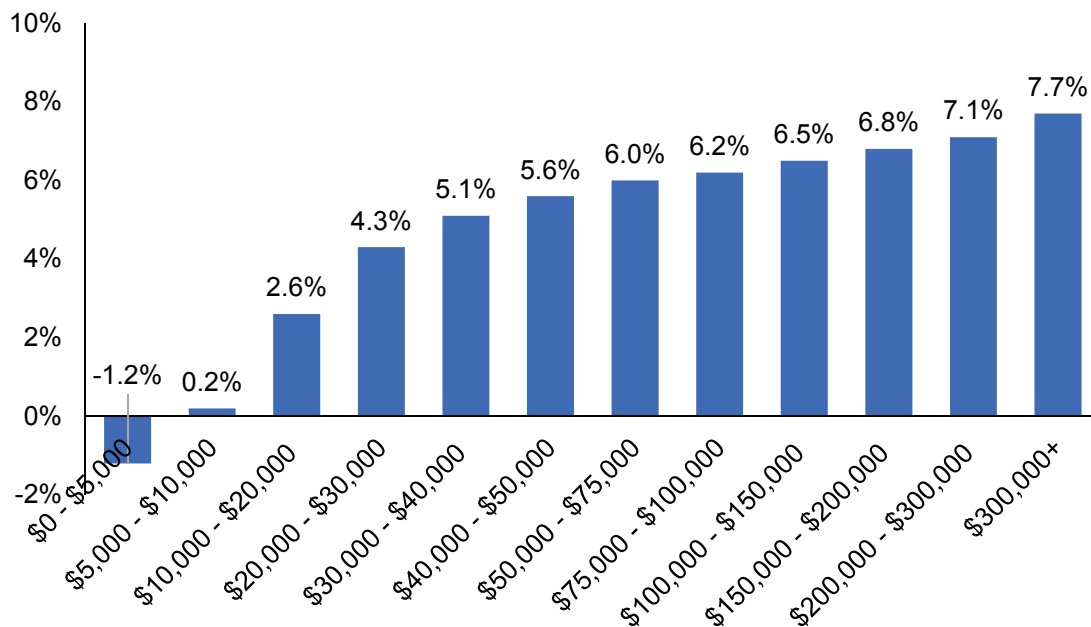
A previous study showed that when viewed over a typical taxpayer's lifecycle, Hawaii's general excise tax structure appears less regressive, with the tax burden only declining modestly as the taxpayer's income rises over the course of his or her lifetime.⁵¹ This occurs because middle-aged adults tend to spend less on consumption than young adults and senior citizens, as they save for retirement. **Thus, while the GET is very regressive across all households, its effects are different for single taxpayers, since consumption patterns vary over their lifetimes.**

Hawaii's second largest tax revenue source, the individual income tax, is broadly progressive. It is progressive at every increase along the income distribution, even between the lowest income ranges. The most significant marginal increases in effective tax rates occur between \$0 and \$40,000. Between \$40,000 and \$200,000, marginal increases are consistent but modest. A more significant rise in the effective tax rate occurs between \$300,000 and \$300,000 and more. Households making over \$300,000 and filing as a head of household pay 11 cents on the marginal dollar, one of the nation's highest marginal tax rates for upper income earners. The very wealthy pay at a significantly higher effective rate than other taxpayers.

⁵¹William Fox (2006). Hawaii's General Excise Tax: Should the Base be Changed? Tax Review Commission 2005-2007.



Figure 25: Effective Hawaii Income Tax Rate by Adjusted Gross Income Range, 2014



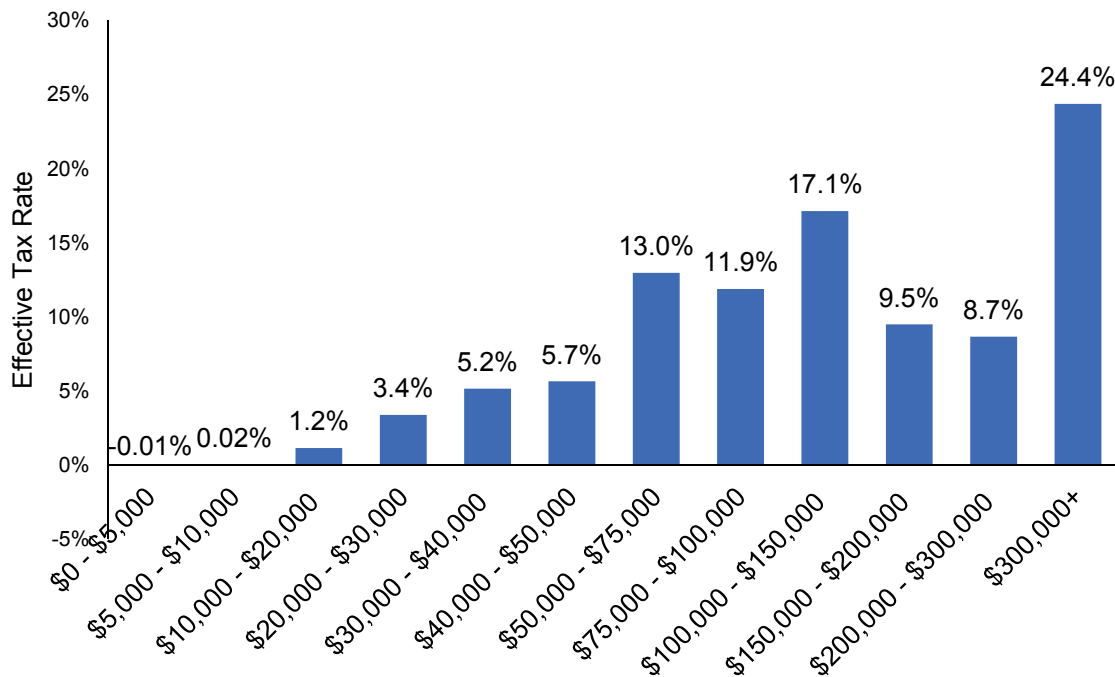
Source: Hawaii Department of Taxation, Hawaii Income Tax Statistics Tax Year 2014

Upper income households bear a disproportionate share of the Hawaii income tax burden. Households making over \$100,000 pay approximately 60 percent of all Hawaii income taxes. There is a notable dip at \$150,000 through \$300,000. Those at the \$150,000-\$200,000 and \$200-\$300K brackets are a relatively small share of filers at 3.8 percent of returns combined, which contributed to the drop. The share jumps at \$300,000 because the marginal rate jumps to 11 percent for a head of household making more than \$300,000. Since high income Hawaii residents account for a disproportionate share of statewide personal income and pay at the highest rate, the share of taxes paid by these filers is quite high relative to their number.

Those making \$300,000 and over pay nearly a quarter of all taxes, despite accounting for only 1.4 percent of all taxpayers. Middle income taxpayers (\$50,000 - \$100,000) pay about another quarter. Lower income households shoulder a relatively small percentage of the burden at about 10 percent. Since the brackets for individual income taxation are fixed, the effective tax rate paid by lower-income households will gradually increase as the value of the dollar declines over time.



Figure 26: Share of Total Resident Hawaii Income Tax Liability by Adjusted Gross Income Range, 2014



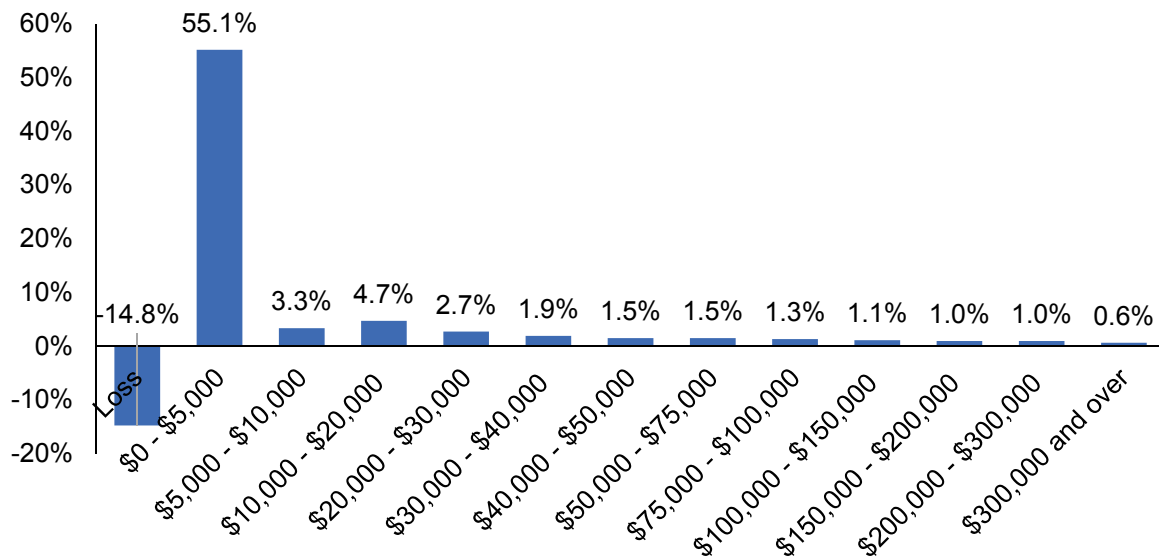
Source: Hawaii Department of Taxation, Hawaii Income Tax Statistics Tax Year 2014

Although levied only by county governments, property taxes are a significant component of taxes paid by Hawaii families. As a percentage of income, property taxes in Hawaii are regressive. The ratio of taxes to income steadily declines as incomes rise. Although comprising a very small segment of the population, homeowners making below \$5,000 pay an especially large portion of their incomes in property taxes, a function of their extremely low incomes making even low property taxes exceptionally burdensome.⁵²

⁵²Data derived from a random sample of 3,016 property tax-reporting Hawaii households from the 2015 American Community Survey 2015 Public Use Microdata Sample (PUMS).



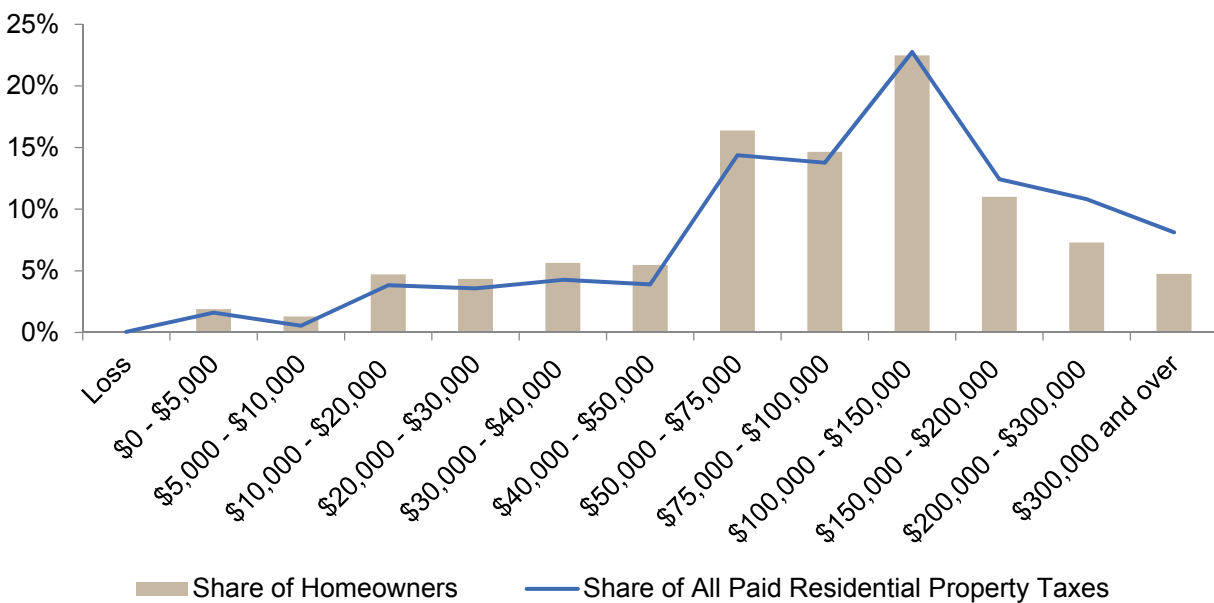
Figure 27: Paid Property Taxes as a Percentage of Homeowner Income by Income Range, 2015



Source: U.S Census Bureau, American Community Survey 2015 Public Use Microdata Sample (PUMS)

Middle and upper income homeowners shoulder the vast majority of the residential property tax burden. Homeowners making over \$50,000 account for 82.3 percent of all residential property taxes. The share of the property tax burden closely mirrors the share of homeowners by income range. No particular income class bears a disproportionate burden relative to its share of homeowners.

Figure 28: Share of Homeowners and All Paid Residential Property Taxes by Income Range, 2015



Source: U.S Census Bureau, American Community Survey 2015 Public Use Microdata Sample (PUMS)

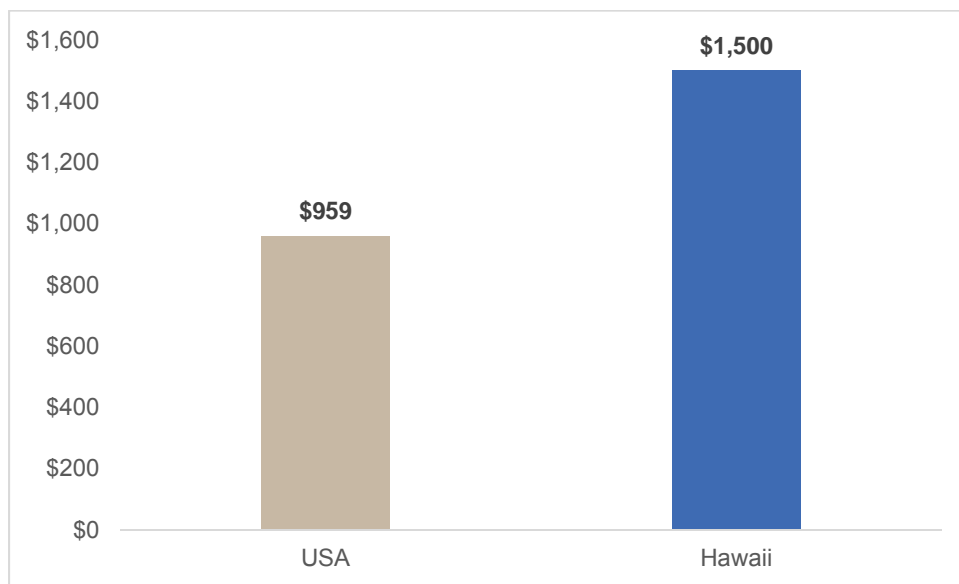


Renter Affordability in Hawaii

Property taxes are generally considered to be a component of overall residential housing costs for home owners. However, affordability issues related to rental housing should also be considered. Rental housing in Hawaii is very expensive. Hawaii's median gross rent (including utilities and housing subsidies) at \$1,500 is over 56 percent above the national median. The State's median gross rent to household income ratio, a measure of general rent affordability, is over three percentage points above the U.S average. These higher rents also do not translate into more spacious housing. The average number of rooms per rental housing unit is over 8 percent lower in Hawaii than the national average.

Renter housing affordability is a particularly severe challenge in Hawaii. Yet, for low-income households, the challenges are even worse. Nearly nine in ten renter households making less than \$20,000 are rent cost-burdened, paying 30 percent or more of income in gross rent. Although this is slightly lower than the national average, Hawaii has a larger share of such households with severe rent burdens (50 percent or more of income) than is the national norm. Low income households are exceptionally burdened by the cost of rental housing in Hawaii. Although the Hawaii tax credit for low-income renters, limited to \$50 per exemption, helps reduce this burden, the severity of the problem suggests additional tax help may be needed to offset an unusually severe rent affordability problem.

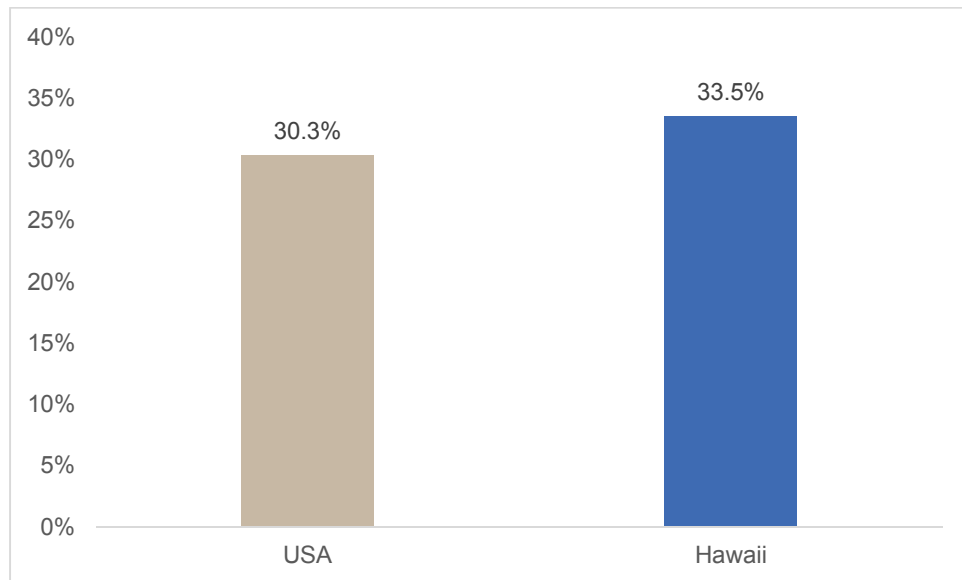
Figure 29: Median Gross Rent, 2015



Source: U.S Census Bureau, 2015 American Community Survey 1-Year Estimates

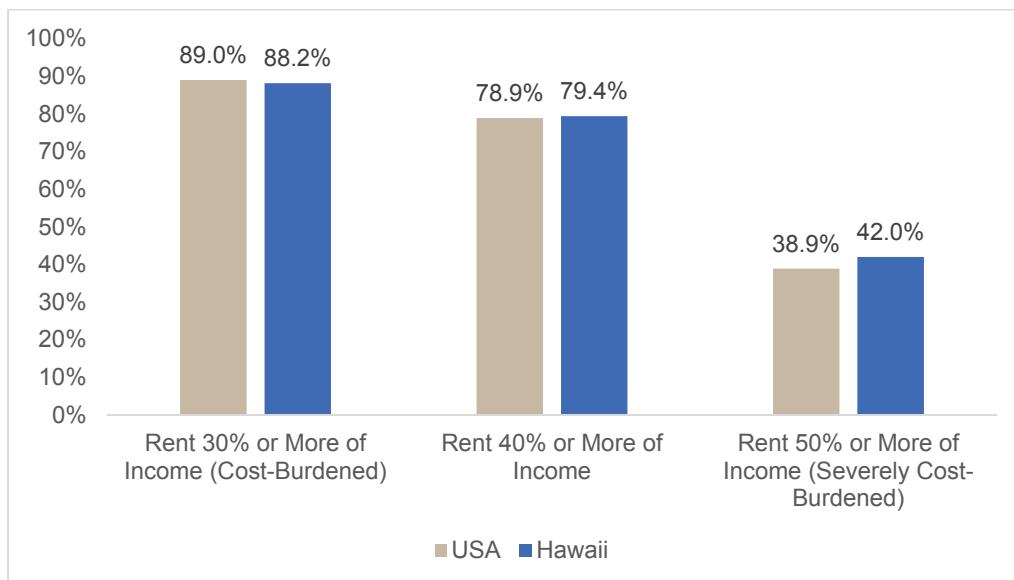


Figure 30: Median Gross Rent as a % of HH Income, 2015



Source: U.S Census Bureau, 2015 American Community Survey 1-Year Estimates

Figure 31: % Rent Cost Burdened, Renter Households Making <\$20,000, 2015



Source: U.S Census Bureau, 2015 American Community Survey 1-Year Estimates



Strategies to Reduce Regressivity

As discussed in the Tax Burden chapter, certain types of taxes tend to be regressive, and some are not. Since regressivity generally occurs when lower income individuals pay a larger portion of their income in taxes than those with higher incomes, taxes on ‘necessities’ (such as food, clothing, shelter, prescription drugs, utilities) have a strong likelihood of being regressive. Many state sales taxes exempt these items based on necessity arguments – as a way of being less regressive. The counter argument is that this type of broad-based exemption applies to high end purchases as well as necessities. While bread, milk and hamburger may be exempt, so are foie gras, beef tenderloin and caviar. Broad-based exemptions also reduce the overall revenue raising ability of these taxes and may make them more volatile – another case where tax policy principles may collide (equity versus adequacy and stability).

At the other end of the spectrum of consumption taxes, excise taxes on what could be considered ‘luxuries’ would reduce overall system regressivity. In some states, items like personal aircraft, yachts, high dollar value jewelry, etc., are subject to this type of tax.

Excise taxes are the tax type with a fair amount of ‘grey area’ related to regressivity. Some excise taxes (such as on motor fuel) could be characterized as applying to necessities (or at least close to it in many areas and professions). On the other hand, other items where excise taxes apply (such as cigarettes and alcohol) are not necessities. In fact, one of the justification for these ‘sin taxes’ is the possibility that the taxes might reduce consumption (or at least provide revenue to help remedy some of the social ills that may result). There is some evidence that this may be the case for some consumers – for example, teen smokers have been shown to be more price sensitive, and teen smoking rates have declined with higher tax rates.

At the other end of the spectrum, income taxes have a strong propensity for being a less regressive form of tax. If, for example, the only tax assessed was an income tax, even a flat tax (where each taxpayer paid the same percentage of their income as tax) would not be regressive. In most states, a progressive income tax is applied as a way of ameliorating the negative effects of other (more regressive) taxes. A progressive income tax can also be augmented with refundable credits that specifically replace some of the tax burden for specific types of lower income taxpayers (such as Hawaii’s food or renters’ credit).

Based on these discussions, the following strategies could help reduce (or at least not increase) regressivity:

- Provide deductions or credits that will primarily benefit lower income individuals;
- Focus excise tax increases on non-essential items;
- Focus tax increases on areas where there is significant exportability of the tax burden.

The discussion of regressivity provides a foundation for understanding how the current system operates in relationship to differing types of taxpayers. Specific opportunities to make the system less regressive will be discussed within the revenue alternatives analysis, particularly as it relates to opportunities to combine differing tax choices. As previously discussed, tax policy considerations often collide, and methods to both collect additional revenue and reduce system regressivity can be difficult to achieve.



Summary

- Tax structures (and individual taxes) are often described as progressive (taking a larger percentage of income from high income groups than from low income groups), proportional (taking the same percentage of income from all income groups) or regressive (taking a larger percentage of income from low income groups). Some taxes may be regressive but still part of an overall progressive tax structure – and vice-versa.
- State and local taxes are often discussed in tandem, as tax and expenditure relationships vary from state to state.

Current Measures of Regressivity

- The GET is highly regressive – the percentage of income going to the GET steadily declines as incomes rise. Honolulu households making less than \$50,000 pay roughly three cents per dollar earned in excise taxes, while those making \$100,000 or more pay only one cent on the dollar.
- The IIT is broadly progressive – at every increase along the income distribution. Households making over \$300,000 and filing as head of household pay 11 cents on the marginal dollar, one of the nation's highest marginal tax rates for upper income earners.
- Property taxes are very regressive at the lowest income levels.
- Renter affordability is a concern, with a higher percentage of cost burdened renter households than the nation as a whole.

Strategies to Reduce Regressivity

For the State, the following strategies could help reduce (or at least not increase) regressivity:

- Provide deductions or credits that will primarily benefit lower income individuals;
- Focus excise tax increases on non-essential items;
- Focus tax increases on areas where there is significant exportability of the tax burden.



Possible Revenue Changes



Overview

There are a variety of important tax principles, and one that is of particular concern for those who rely on government provided services is adequacy. The 2012 TRC PFM study spent considerable time and effort discussing tax adequacy (whether the existing revenue structure was able to generate the revenue necessary to meet identified expenditure needs and obligations). The 2017 TRC also sought input on this issue, and the goal of raising sufficient revenue to fund the annual required contribution to the Employer-Union Benefits Trust Fund (Trust Fund) was determined to be one measure of tax adequacy. This is a useful measure, because the funding to the Trust Fund has been determined to be a statutory requirement (unlike some of the spending needs identified in the 2012 report, which could be considered options rather than requirements for additional spending).

Employer Benefits Trust Fund

By way of background on the additional resources for the Trust Fund, in July 2013, Act 268 was signed into law. In addition to establishing the EUTF Task Force to examine further steps to address unfunded liability, the law requires the State to pay additional amounts toward reducing the unfunded liability until 2019, when 100 percent of the annual required contribution must be paid. Commencing in 2019, GET revenues will be used to fund any difference between the annual required contribution (ARC) and the payment made by the State.⁵³

The State's 2017-2019 Executive Biennium Budget⁵⁴ includes contributions of \$297 million in 2018 and \$375 million in 2019 and 2020 in order to satisfy the requirements of Act 268, as shown in the table below. According to the most recent actuarial valuation (July 1, 2015), the additional cost of prefunding in 2021 will be \$354 million, decreasing to \$333 million by 2023.

It should be noted that the figures cited below are based on 30-year estimates, and even a small change can have significant effects on the State's obligations. The two factors with the largest impact on contribution amounts are lifespan of the retirees and rate of return on investment. For example, on July 1, 2017, the assumed rate of return on investment of the Hawaii Employees' Retirement System (ERS) was lowered from 7.5 percent to 7.0 percent due to anticipated market conditions – an adjustment that increased the pension plan's funding shortfall by \$2 billion. Additionally, life expectancy assumptions were updated to reflect that ERS members are living longer in retirement – a change that increased the shortfall by \$1.5 billion.⁵⁵

Table 23: EUTF Retiree Health Care Plan Annual Required Contribution Attributable to Act 268 Prefunding Requirement (in millions)

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|----------------------------------|---------|---------|---------|---------|---------|---------|
| Act268/13 Prefunding Requirement | \$297.1 | \$375.2 | \$375.2 | \$354.3 | \$340.8 | \$332.5 |

Source: 2018-2020 figures per 2017-2019 State of Hawaii Budget; 2021-2023 figures per July 1, 2015 Actuarial Valuation

This level of contribution relates to the increased costs associated with retiree health care benefits. The costs associated with public employee pensions are separate and distinct and not included in this table. In fact, they are addressed in the following section.

⁵³ State of Hawaii 2016 CAFR

⁵⁴ Per 2017-2019 Pension and Other Post-Employment Benefits Liability Table (Budget Appendix 6)

⁵⁵ Honolulu Star-Advertiser, "Nest Egg Shortfall Tops \$12 Billion." January 10, 2017.



Hawaii Employees' Retirement System

The Hawaii Employees' Retiree System (ERS) provides retirement, disability, survivor, and other benefits to more than 120,000 members. Its membership is comprised of retirees, beneficiaries, inactive vested members and active public employees working for the State & Counties of Hawaii.

As noted in the 2012 study provided to the Commission by PFM, there have been funding concerns related to the ERS, and the 2012 study recommended additional resources to improve the overall funding of the system. The State has undertaken several specific actions to improve the overall position of the ERS. Most notable was a series of actions taken in 2011.

Those changes increased employee contributions, reduced pension benefits, increased age and service requirements and reduced cost-of-living adjustments. A significant change was to establish a new tier for state employees, teachers and public safety officers hired after June 30, 2012. Members of the new tier received reduced benefits, a reduced cost of living adjustment, make greater contributions and are required to work longer to become eligible to receive full retirement benefits.

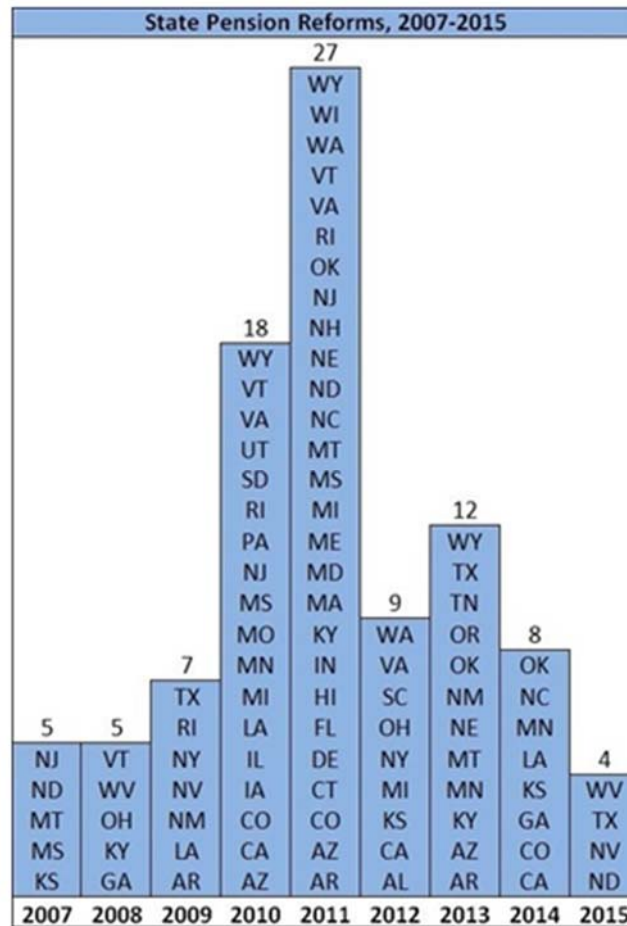
While the biggest changes were made for new hires, there were also changes made for employer contributions, phased in over several years. Initial savings for the reforms totaled approximately \$440 million from FY2012 through FY2016.

The following provides additional detail on the changes for new hires:⁵⁶

- Increased the age needed to qualify for normal retirement – must reach age 55 within 25 years of service or age 60 with 10 years;
- Increased the employee contribution from 7.8 percent of salary to 9.8 percent for general employees and teachers, and from 12.2 percent to 14.2 percent for public safety employees;
- Increase the statutory employer contribution rates, from 15 percent to 17 percent for general employees and teachers, and from 19.7 percent to 25.0 percent for public safety worker, phased in over several years;
- Lengthened the period used to calculate the final average salary, from 3 to 5 years;
- Increased the vesting period, from 5 to 10 years;
- Reduced the retirement multiplier (which is used to calculate retirement benefit based on final average salary and years of service), from 2.0 percent to 1.75 percent;
- Reduced the annual cost-of-living adjustment (COLA) from 2.0 percent to 1.5 percent;
- Reduced the interest rate on accumulated contributions, from 4 percent to 2 percent.

Hawaii was not alone in enacting significant changes to its pension system. Since the Great Recession, nearly every state passed meaningful reform to its pension plans. In fact, Hawaii made its changes at the point in time where states as a whole were making adjustments. The following figure shows that 2011 was the 'high water mark' for state pension reforms from 2007 to 2015.

⁵⁶ "Effects of Pension Plan Changes on Retirement Security, Center for State and Local Government Excellence and National Association of State Retirement Administrators, April 2014; Appendix, "Significant Reforms to State Retirement Systems, National Association of State Retirement Administrators, June 2016.



Each year, the ERS obtains an actuarial evaluation. The latest valuation, done by Gabriel Roeder Smith and Company (GRS) was issued on January 9, 2017 and provided a valuation as of June 30, 2016, the end of FY2016. At that time, GRS determined that the funding period to pay off the unfunded actuarial accrued liability (UAAL) of the system was 66 years. Hawaii Revised Statutes 88-122(e)(1) provides that the employee contribution rates are subject to adjustment when the funding period is in excess of 30 years.⁵⁷

It is notable that the ERS had also undertaken some administrative actions that led to the growing UAAL for the system. Effective July 1, 2017, ERS lowered its assumed rate of return to 7.0 percent, from 7.55 percent. It had been scheduled to go to 7.5 percent on July 1, 2017 as part of a plan approved several years ago to incrementally lower the pension fund's assumed rate of return over three years.⁵⁸

⁵⁷ Gabriel Roeder Smith and Company, "Employees' Retirement System of the State of Hawaii, Report to Board of Trustees on the 91st Annual Actuarial Valuation, for the Year Ending June 30, 2016," January 9, 2017.

⁵⁸ "Hawaii Employees lowers assumed rate of return to 7%," Pensions and Investments Online, December 19, 2016, accessed electronically at <http://www.pionline.com/article/20161219/ONLINE/161219853/hawaii-employees-lowers-assumed-rate-of-return-to-7>



This mirrors actions being taken across the country to lower assumed rates of return. Some of this action has been spurred by the major credit rating agencies. For example, in June 2017, Fitch Ratings Agency lowered its assumed rate of return for public pension systems from 7 percent to 6 percent.⁵⁹

Even in the midst of concerns about State pension obligations, Moody's Investors Services upgraded the State credit rating to Aa1 from Aa2 (in September 2016). At the time, Moody's noted that "the upgrade reflects the State's positive economic and revenue trends, the restoration and maintenance of sizable reserves, and proactive measures to improve the funding of its pension and OPEB liabilities."

Both Moody's and Standard and Poor's reiterated this perspective when rating the State's 2017 general obligation bonds. Moody's assigned the \$800 million issuance an Aa1 and a stable outlook, noting that "the State is also planning to phase in higher pension contributions in response to an increase in the estimated pension liability."⁶⁰ Standard and Poor's assigned the issuance a AA+/Stable rating. Standard and Poor's delved into the issues around ERS funding in more depth, noting the reductions in the system's actuarial assumed rate of return as well as revisions to mortality expectations in light of its experience study. Standard and Poor's also noted that "In our opinion, the successful adoption and implementation of the increased contribution rate is vital to the State's long-term financial capacity and is essential to maintain its credit quality."⁶¹

Governor Ige had already introduced legislative bill 936 to raise contribution rates before the Standard and Poor's report, and ultimately the Legislature enacted Act 17/2017, which contained the Governor's recommendations. Part III of the Act increases employer contributions by the State and counties, phased in over the next four years beginning with FY2018. The Act requires:

- Employer contributions will increase for Police/Fire categories from the current 25 percent of payroll to 41 percent of payroll;
- Employer contributions will increase for all other employee categories from the 17 percent of payroll to 24 percent of payroll.

Based on their analysis, Standard and Poor's estimated that pension costs as a percentage of budgetary general fund expenditures is estimated at 10.3 for FY2017 and is expected to increase to about 11.3 percent in FY2018 as a result of the increased contribution rates. Standard and Poor's also estimated that pension costs could increase to about 13.5 percent by FY2021.

According to calculations based on the increased employer shares attributed to the General Fund, total estimate employees and compensation, the following are the additional dollar amounts needed to fund the additional employer share by fiscal year:

| Fiscal Year | Additional General Fund Expenditure |
|-------------|-------------------------------------|
| 2018 | \$74 million |
| 2019 | \$169 million |
| 2020 | \$136 million |
| 2021 | \$31 million |
| 2022 | \$32 million |

⁵⁹ "Fitch lowers investment return assumptions for public pension plan liabilities," Pensions and Investments Online, June 1, 2017. Accessed electronically at <http://www.pionline.com/article/20170601/ONLINE/170609995/fitch-lowers-investment-return-assumptions-for-public-pension-plan-liabilities>

⁶⁰ "State of Hawaii, New Issue – Moody's Assigns Aa1 to \$860 million Hawaii GO bonds; outlook stable," Credit Opinion, Moody's Investors Service, April 19, 2017.

⁶¹ "Hawaii; Appropriations; General Obligation," Standard and Poor's, April 28, 2017.



Within the context of a growing General Fund budget, these increases may be managed within existing revenue growth – although that will, of course, depend on how the economy performs (and what needs may be encountered in other expenditure growth areas). Within the context of an estimated \$7.4 billion General fund budget in FY2018 and \$7.5 billion in FY2019, there certainly are opportunities to build this level of additional employer contribution into expenditure decisions. On the other hand, should additional revenues be sought, there are sufficient options provided within this chapter to do so. In general, however, the project team’s review of the additional funding requirements, overall revenue performance, status of State reserve funds and credit rating agency’s perspective on the State’s overall health lead the project team to believe that the State can meet these new levels of employer match within expected existing resources.

Tax Policy Principles

The 2012 TRC report discussed a number of common tax policy principles that helped guide that report’s analysis and recommendations. The background discussion around identifying relevant tax policy principles is still important but has not materially changed since 2012 so will not be restated in its entirety.

The following are the general tax principles/standards from the 2012 report:

1. **The system should minimize interference by taxes in market decisions**
2. **The system should be reliable, stable, and sufficient**
3. **The system should be simple, allow for compliance, and ease of administration**
4. **The system should be equitable**
5. **The system should have a balanced variety of sources/broad base**

It is notable that the enacting legislation related to the Tax Review Commission identifies that its deliberations should be guided by such “standards as equity and efficiency.” Given this direction, the following provides additional explanation around these concepts for application to this study and report. Principles for continued consideration will focus on issues of fairness, stability, economic competitiveness and ease of administration. The following discusses these key considerations.

Fairness

A good tax system should distribute the tax burden across taxpayers in a manner that is consistent with the accepted norms of fairness and equity. These norms typically define fairness according to the relationship between the amount of taxes paid (or borne) by taxpayers and their respective abilities to pay the tax, or to the benefits received by them from government programs. Three widely-accepted norms of fairness are:

- **Vertical Equity.** This concept requires that the amount of tax paid by taxpayers with different income levels should reflect their respective abilities to pay the tax. Specifically, taxes paid as a percentage of income should not unduly burden taxpayers with limited ability to pay the tax. Some would view this principle as satisfied by a proportional tax burden, where taxes paid are the same percentage of income for taxpayers at all income levels. Others believe that the principle requires that taxes paid as a percentage of income should be higher for taxpayers with more income than those with less income (a progressive tax burden).
- **Horizontal Equity.** According to this concept, taxpayers with similar abilities to pay a tax should pay comparable amounts of the tax. More generally, the principle of horizontal equity enjoins the government from levying taxes that have arbitrary and peculiar distributions of tax burdens across



taxpayers or from levying dissimilar tax burdens on taxpayers that are not justified by differences in their ability to pay or by distinctions in the benefits they receive from government programs.

Stability

A good tax system is expected to generate sufficient revenue to pay for established public services without the need for continuous or drastic changes in tax rates or in the tax base. Stability also reflects a structure that can withstand economic and other shocks without encountering dramatic swings in revenue collections.

Economic Competitiveness

A good tax system should not distort economic decisions. Distortions cause a measurable loss in the economic value of production and consumption, which increases the tax burden on the resident taxpayers.

Simplicity/Ease of Administration

Individuals should be able to readily understand and comply with their obligations as a taxpayer. The rules, record-keeping and computation requirements should be simple enough that the tax system can be administered at low cost by the tax collection agency without imposing an undue compliance burden on the taxpayer.

Trade-offs with Policy Goals

It is a basic fact of taxation that there is no perfect tax. As a result, governments often tailor a tax (or a broader tax structure) to ameliorate some of its more problematic features. For example, most states that have an individual income tax have adopted a progressive rate structure.⁶² This reflects the fact that there is general agreement that most (if not all) state general consumption and excise taxes are regressive; creating a progressive rate structure for the individual income tax helps to mitigate some of the system regressivity. Likewise, many broad-based general sales taxes will exempt from tax certain goods and services that are considered necessities, including food, utilities, prescription drugs, health care services and clothing.

While the general principles of taxation are logical – and mostly non-controversial – these general tax principles will sometimes conflict, and it will be necessary to weigh the costs and benefits of adhering to the principles. For example, the converse of the example of exceptions for certain purchases is that a broad sales tax that taxes goods and services that are perceived to be necessary (rather than optional) purchases will promote revenue adequacy and stability but have a negative impact on vertical equity. As another example, some taxes exhibit a trade-off between revenue adequacy and volatility or stability. Over the years, the personal income tax has exhibited significant volatility based on the business cycle and other variables. At the same time, in strong growth periods they have out-performed other revenue sources in terms of levels of growth and “bounce back.”

In general, these trade-offs suggest the need for the use of several forms of taxation to off-set specific impacts or defects in a particular tax. This type of complementary approach is considered a taxation “best practice.” Often this approach means a combination of taxes on different types of economic activity or outcomes. As has

⁶² According to the FTA, 7 states have a single bracket and a broad-based individual income tax (Colorado, Illinois, Indiana, Massachusetts, Michigan, North Carolina, Pennsylvania and Utah). Of the remaining 34 states, the number of brackets ranges from a low of 2 (Kansas) to a high of 10 (Missouri). The FTA survey was prior to Hawaii's 2017 change that increased its number of brackets to 12.



been previously noted, taxes generally are imposed on wealth (such as a property tax), income (such as an income tax) or consumption (such as a general sales or excise tax). A balanced structure seeks to combine these approaches. In tax parlance, this sort of a balanced approach is sometimes referred to as a ‘three legged stool.’

From this set of principles, the discussion of regressivity can be seen as one that touches on whether the system is equitable. The following builds on that discussion.

Revenue Alternatives

In general, there are four ways to raise additional tax revenue:

1. **Create a new tax**
2. **Expand the base of an existing tax**
3. **Increase the rate of an existing tax**
4. **Increase taxpayer compliance with an existing tax**

There are advantages and disadvantages to each approach. **Creating a new tax** can mean an exceptional (and often unanticipated) burden for some, particularly when that tax would be paid by a narrow class of taxpayers. When that tax affects a basic household spending activity (as opposed to a luxury activity), it can increase regressivity by disproportionately expanding the burden on lower income households. For example, a new tax on sugary beverages would expand the tax burden on lower income households, since spending on those beverages takes up a larger share of their incomes.

Expanding the base of an existing tax subjects a new activity to taxation that was previously untaxed. To the extent that activity is commonly undertaken by a particular class of taxpayer, expanding the base can significantly raise the burden on that class. Moreover, if that activity consumed a large share income for lower income households, regressivity can also be adversely affected. For example, subjecting public transportation fares to the GET would have a disproportionate effect on lower income households, increasing regressivity, since these households tend to rely most on this form of transport.

Increasing the rate of an existing tax can exacerbate the progressivity or regressivity of the tax structure, depending on whether it disproportionately affects lower income or higher income taxpayers. The impact on tax burden is a function of the size of the rate increases, and rate increases on taxes paid mainly by particular types of taxpayers can produce a sizable increase in their share of tax collections. For example, an increase in the TAT should increase tourists’ share of the overall tax burden, while reducing residents’ share.

The final approach (**increased compliance**) has the benefit of not imposing an additional tax or increasing an existing tax’s base. Since this approach merely boosts collections, it has only a minimal impact of tax burden and regressivity. On the other hand, compliance rates on most major taxes are already relatively high (and further increases can be costly from an administrative perspective). As a result, tax policy changes usually focus on the first three alternatives. However, because regressivity is an important factor in this analysis, opportunities to increase compliance will also be considered.

Current Structure and Characteristics

It is helpful to recall some of the key attributes of the current Hawaii tax structure and system in the context of possible changes to it. The following are key points that were identified in the Current Revenue Structure chapter of the report:



- Among the taxes, Hawaii relies much more on sales/gross receipts and excise taxes than the U.S. states as a whole;
- Hawaii state government primarily relies on the GET (52 percent of General Fund revenue) and the IIT (34 percent). No other source provides more than 4 percent (TAT at 3.8 percent).
- While sometimes compared to state sales taxes, the GET is actually a business privilege tax assessed on nearly all business activities, which makes it a much broader based tax than a general sales tax. This tends to make it a stable source of revenue.
- Because it is assessed against so much business activity, there is more pyramiding that occurs compared to State sales tax structures. Pyramiding occurs when inputs into a finished good or service are taxed at multiple points in the process.
- The Hawaii IIT is a progressive tax, and the highest of its 12 marginal tax bracket is the second highest among U.S. states. The 12 brackets is the most of any state, and Hawaii's lower brackets are closely spaced, meaning average income earners move fairly quickly to higher marginal tax rates than in most states.
- Hawaii has a broad array of excise taxes that are similar to those in other states. Because of Hawaii's unique island location, issues of cross-border competition are less of a concern than in most states, and excise tax rates tend to be higher than average as a result.

Revenue Strategies/Approaches

The following revenue strategies take into consideration the tax policy principles described above. These strategies are presented by tax type, exploring both the pros and cons of various alternatives. Where possible, the project team provides estimates or research related to the potential financial impact of the strategies discussed.

Excise Tax Alternatives

Excise taxes represent an important component of the overall revenue structure for Hawaii. In 2016, the FTA reported that 16.0 percent of Hawaii's total state tax revenue was from excise taxes. Hawaii ranked just above the U.S. state median of 15.7 percent.⁶³

Excise tax increases have been a common revenue-raising method for Hawaii and the states as a whole. For example, the cigarette tax has been a fairly constant area of tax rate increases over the past two decades. It is notable that since the year 2000, 48 states and the District of Columbia have passed 135 state cigarette tax increases.⁶⁴ Hawaii has been a part of that trend as well – in fact, the State has been on the leading edge of cigarette and tobacco tax increases, as the following table shows:

⁶³ FTA 2016 State Tax Collection by Source (Percentage of Total) based upon US Census Bureau data.

⁶⁴ Campaign for Tobacco-free Kids, "Cigarette Tax Increases by State by Year 2000-2017," accessed electronically at <http://www.tobaccofreekids.org/research/factsheets/pdf/0275.pdf>



| Year | Increase Per Pack | New Tax Per Pack |
|-------|-------------------|------------------|
| 2002 | \$0.20 | \$1.20 |
| 2003 | \$0.10 | \$1.30 |
| 2004 | \$0.10 | \$1.40 |
| 2006 | \$0.20 | \$1.60 |
| 2007 | \$0.20 | \$1.80 |
| 2008 | \$0.20 | \$2.00 |
| 2009 | \$0.60 | \$2.60 |
| 2010 | \$0.40 | \$3.00 |
| 2011 | \$0.20 | \$3.20 |
| Total | \$2.20 | |

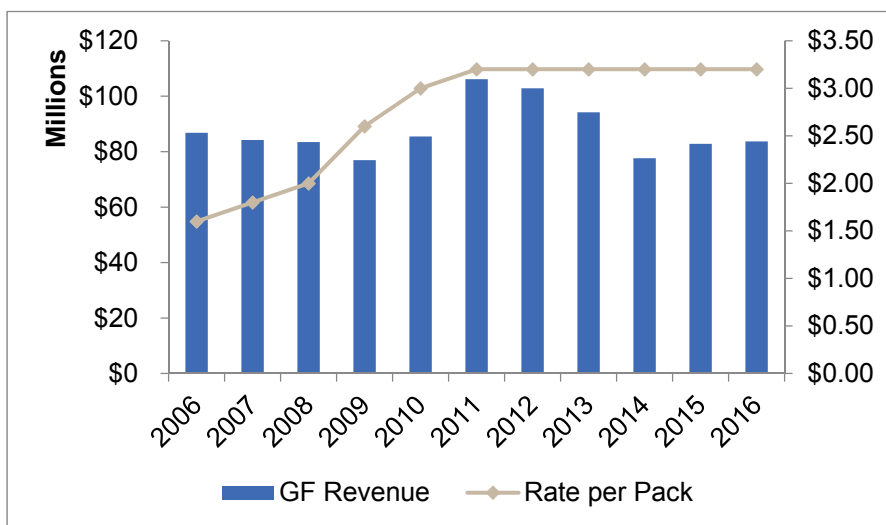
The following are selected excise tax revenue alternatives.

Alternative 1: Increase Cigarette and Tobacco Tax Rates

The State of Hawaii levies an excise tax on the sale or use of tobacco products and on each cigarette sold, used or possessed. Aside from cigarettes and little cigars, the State levies the tobacco tax on 70 percent of the wholesale price of tobacco products (other than large cigars) and 50 percent of the wholesale price of large cigars. Cigarette and tobacco wholesalers and dealers are required to affix stamps to individual cigarette packages as proof of payment of tax.

At \$3.20 per pack, Hawaii currently has the fifth highest per-pack cigarette tax among states – trailing only New York (\$4.35), Connecticut (\$3.90), Rhode Island (\$3.75) and Massachusetts (\$3.51). At \$0.16 per cigarette (\$3.20 per pack for a standard 20 cigarette pack), the State's tax is double the U.S median (\$0.08 per cigarette). As noted in the prior table, from 2002 to 2011, Hawaii increased the cigarette excise tax in every year but one – but the rate has remained the same since.

Figure 32: Hawaii Cigarette Tax Rates and General Fund Revenues, 2006-2016



General Fund cigarette tax revenues declined each year until 2015, when they rebounded slightly. General fund revenues are expected to increase at a compound annual growth rate of 3.2 percent between 2017 and 2023. The projected increases align with the general research that suggests cigarette demand is somewhat inelastic – which is logical given the addictive nature of smoking. Additionally, there is no cross-border competition among states to sell significant volumes of cigarettes. Consumers in Hawaii cannot readily travel to buy cigarettes in bulk to avoid taxes in their home



state. Further, a portion of cigarette tax burden is exported, as visitors purchase cigarettes for consumption during their stay in the State. A moderate increase in the cigarette tax will likely result in increased revenue for the State without a significant reduction in sales.

Assuming no change in consumer behavior, it is expected that increasing the cigarette tax rate to \$4.00 per pack would result in additional revenues totaling between \$20 million and \$24 million annually, as shown in Table 24. Even applying a 10 percent discount would bring revenue into the range of \$20 million annually during the period of the revenue estimates.

Table 24: Estimated General Fund Impact (millions)⁶⁵

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---------------|---------------|---------------|---------------|---------------|---------------|
| Baseline - Cigarette & Tobacco Tax | \$87.5 | \$90.6 | \$93.5 | \$96.7 | \$100.0 | \$103.5 |
| Estimate Attributable to Cigarettes ⁶⁶ | \$81.0 | \$84.0 | \$86.6 | \$89.6 | \$92.7 | \$95.9 |
| Projection at \$4.00/Pack | \$101.3 | \$104.9 | \$108.3 | \$112.0 | \$115.8 | \$119.8 |
| Estimated Impact | \$20.3 | \$21.0 | \$21.7 | \$22.4 | \$23.2 | \$24.0 |

Impact on Tax Burden and Regressivity

This excise tax is currently applied in all 50 states and is generally considered regressive but also a ‘user tax’ that has been shown to decrease consumption, particularly among younger smokers. Hawaii has a history of raising this tax on a regular basis for a very good reason. Cross-border impacts are limited and raising the tax helps recoup medical treatment costs incurred by the State from smoking activity. Since cigarette and tobacco purchases consume only a very small portion of household incomes (0.5 percent overall), the tax burden impact would be limited. Yet increasing the cigarette/tobacco tax is likely to make the tax structure slightly more regressive. Lower income households spend significantly more on these products as a percentage of income than higher income households. For example, households making \$25,000 on average spend about 1.3 percent of income on these products, a percentage that steadily declines to 0.2 percent at the \$150,000 income level. This measure would disproportionately impact lower income households, but may produce public health benefits by discouraging smoking.

| Pros | Cons |
|---|--|
| <ul style="list-style-type: none">▪ Exports a share of the tax burden▪ Cigarette demand is somewhat inelastic – especially with no cross-border competition▪ Relatively easy administration and collection▪ Cigarette tax increases have proven to be politically more palatable than other tax increases, as smokers are a minority of the population | <ul style="list-style-type: none">▪ Considered regressive▪ Hawaii already among highest tax rates among the 50 states▪ Other states have begun to see and forecast declines in cigarette tax revenues as a result of tax increases leading to higher prices⁶⁸▪ Higher prices increase incentives to evade the tax via black market or illegal Internet purchases |

⁶⁵ Estimates based on Council on Revenues’ May 30, 2017 General Fund forecast.

⁶⁶ According to data from the Department of Taxation’s monthly collection reports, nearly 93 percent of total cigarette and tobacco tax General Fund revenues are attributable to the sale of cigarettes.

⁶⁸ In November 2016, California votes approved a \$2 per pack increase in cigarette taxes. California cigarette sales have declined significantly as a result – 56 percent year-over-year in the two months following the increase.

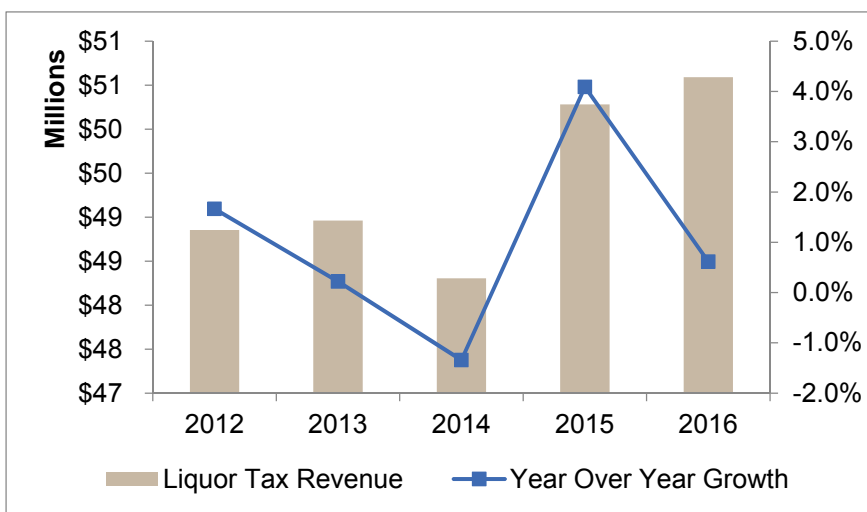


| Pros | Cons |
|--|------|
| <ul style="list-style-type: none">Evidence that tax increases reduce purchase of cigarettes by youth and low income individuals⁶⁷ | |

Alternative 2: Increase Gallonage Taxes on Beer, Wine and Distilled Spirits

Hawaii levies a gallonage tax upon dealers and others who sell and/or use liquor. Varying gallonage tax rates apply to wine, distilled spirits, sparkling wine, still wine, cooler beverages, non-draft beer and draft beer.

Figure 33: General Fund Liquor Tax Revenue, 2012-2016



Hawaii currently has the third highest gallonage tax on beer (\$0.93; draft beer is taxed at \$0.54), the tenth highest gallonage tax on wine (\$1.38; sparkling wine is taxed at \$2.12 and wine coolers are taxed at \$0.85) and the seventh highest gallonage tax on spirits (\$5.98).⁶⁹

Despite a decline in 2014, liquor tax revenues have generally increased year over year, ending the five-year period with approximately \$1.7 million in growth. Future revenues are projected to increase modestly, growing by a compound annual

growth rate of 0.8 percent between 2017 and 2023.

A 10 percent across-the-board increase in the tax rates would likely lead to some drop-off in consumption of alcohol, resulting in revenue growth of less than 10 percent. Studies have shown a correlation between increased taxation of alcohol and decreased consumption at the aggregate population level. An increase in the tax rate would help to discourage young people from drinking in Hawaii, as data indicate that young people are more responsive to changes in price (and taxation) than adults. However, there is an argument that can be made that the decline in consumption in other jurisdictions is mostly a change in where purchases are made, as several studies of high tax states suggest cross-border competition. Other studies suggest chain-weighting – that if the taxes on one portion of alcoholic beverages (such as distilled spirits) are raised but not another (such as beer), price-sensitive consumers will substitute for the power-priced product. If taxes are raised for each segment, this effect can be minimized.

⁶⁷ A 2014 study by the Center on Budget and Policy Priorities states that the Congressional Budget Office summarized existing research and found that a 10 percent increase in cigarette prices will lead people under the age of 18 to reduce their smoking by 5-15 percent. The study also notes that people with incomes below the median reduce their cigarette consumption by four times more than people with incomes above the median in response to cigarette price increases. Center on Budget and Policy Priorities – Higher Tobacco Taxes Can Improve Health and Raise Revenue. March 19, 2014. Available at <https://www.cbpp.org/research/higher-tobacco-taxes-can-improve-health-and-raise-revenue>

⁶⁹ Federation of Tax Administrators, January 2017.



Overall, this is a revenue alternative with positive health benefits but a minimal financial impact – generating a maximum of approximately \$5 million annually.

Table 25: Estimated General Fund Impact (millions)⁷⁰

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|----------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Baseline Projection | \$51.51 | \$51.97 | \$52.38 | \$52.80 | \$53.22 | \$53.64 |
| Projection at 10% Increase | \$56.66 | \$57.16 | \$57.61 | \$58.08 | \$58.54 | \$59.01 |
| Estimated Impact | \$5.15 | \$5.20 | \$5.24 | \$5.28 | \$5.32 | \$5.36 |
| % Increase | 10.0% | 10.0% | 10.0% | 10.0% | 10.0% | 10.0% |

Impact on Tax Burden and Regressivity

The tax is considered regressive but also a ‘user tax’ that has been shown to decrease consumption. Similar to the cigarette/tobacco tax, increasing this tax would also contribute to regressivity and have a disproportionate impact on low income households. It would not produce a significant increase in tax burden since beer and wine purchases only account for less than two percent of household expenditures and consume less than one percent of household incomes. However since lower income households spend a greater percentage of their income on these beverages (0.84 percent for \$25,000 households vs. 0.79 percent for \$150,000 households), this measure would harm these households the most, but possibly also promote public health by discouraging excessive alcohol consumption.

| Pros | Cons |
|--|--|
| <ul style="list-style-type: none"> ▪ A portion of the tax burden is exported ▪ Relatively easy administration and collection ▪ Tourism consumption likely to help alleviate some level of destruction of sales from in-state residents ▪ Alcohol is relatively inelastic and a tax increase is unlikely to yield a comparable decline in consumption ▪ Alcohol taxes have proven to be politically more palatable than general increases to broad-based taxes such as sales or income taxes | <ul style="list-style-type: none"> ▪ Considered regressive ▪ Low monetary impact ▪ Already among the top gallonage tax rates ▪ Efforts to increase the alcohol tax rate were met with opposition in 2011 |

Alternative 3: Restore the Surcharge on Rental Cars

Hawaii levies a rental motor vehicle and tour vehicle surcharge tax, paid via a daily rate for rental vehicles and on a monthly basis for tour vehicles. Lessors pay the tax for rental cars and tour vehicle operators pay the tax on vans and buses.

Currently, the rate for rental vehicles is \$3.00 per day; revenues are deposited into the State Highway Fund. Until July 2012, there was a temporary surcharge of \$4.50 per day that was deposited into the General Fund.

⁷⁰ Estimates based on Council on Revenues' May 30, 2017 General Fund forecast.



Tour vehicles with between 8 and 25 seats are taxed at \$15 per month, while vehicles with 26 or more seats are taxed at \$65 per month.

As of March 2015, more than 40 states levied a charge on rental cars, either by imposing an additional tax, daily fee, or both. Only 5 states impose a flat daily fee: New Jersey (\$5/day), Hawaii (\$3/day), Colorado and Florida (both \$2/day), and West Virginia (\$1-\$1.50/day).

Of states with rental fees that are strictly a percentage of the total rental cost, Maryland's is highest at 11.5 percent, while Alabama's is lowest at 1.5 percent. The median tax rate is 5.9 percent while the average is 6.1 percent.

The DBEDT's 2015 Data Book found that the cheapest daily rental rate in Hawaii was \$38 in 2015, ranking 29th among the largest cities in each state.⁷¹ Assuming this rate grows at inflation, and that the average vacation to Hawaii lasts 10 days,⁷² at \$3 per day, visitors in 2017 are paying 7.6 percent of the base price of the car rental. The following table illustrates this with an example for demonstrative purposes only.

| | |
|---|----------|
| Daily rental fee: | \$3 |
| Average trip duration: | 10 days |
| Average daily rental cost: | \$39.54 |
| Cost for 10 days: | \$395.35 |
| Rental fee for 10 days: | \$30 |
| Rental fee as % of rental cost: 7.6% | |

Given this example, Hawaii's tax structure is likely comparable to yet slightly higher than the median and average for states imposing the tax at a percentage of the total rental cost.

Following the expiration of the temporary surcharge in 2012, revenues have been relatively flat, increasing at a compound annual growth rate of 1.7 percent. The Council on Revenues' May 2017 forecast projects that vehicle rental revenues will increase by 0.5 percent annually, totaling \$57 million by 2023. While vehicle rentals are directly associated with tourism trends, the increasing popularity of ride-sharing services like Uber and Lyft are lessening the demand for rentals. According to a May 2017 article by Travel Weekly, 50 percent of corporate travel buyers reported an increase in ride-sharing services between October and April, while 28 percent of those buyers reported a drop in traditional car rentals.⁷³

If Hawaii were to reinstate a surcharge directed toward the General Fund, as it did until July 2012, most of the revenue associated with the tax would likely be generated from non-resident rentals. The estimated impact of the measure would be approximately \$18 million annually, although, for the reasons already identified, it is unlikely to be a revenue source that exhibits much future growth.

⁷¹ Table 14.18 Top 50 Car Rental Destination Rates in the US, 2015. The prices displayed in the table reflect the average daily rate for the cheapest available rental car in each destination during the period spanning October 1, 2014 through September 30, 2015.

⁷² JLL, Hawaii's Home and Vacation Rental Market: Impact and Outlook. Prepared for the Hawaii Tourism Authority. December 29, 2016.

⁷³ Travel Weekly. "Analysts: Ride-Hailing Putting a Dent in Car Rental Revenue." May 16, 2017. Available at <http://www.travelweekly.com/Travel-News/Car-Rental-News/Analysts-Ride-hailing-putting-dent-car-rental-revenue-Uber>.

**Table 26: Estimated General Fund Impact (millions)⁷⁴**

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|--------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Baseline Projection | \$55.4 | \$55.7 | \$56.0 | \$56.3 | \$56.5 | \$56.8 |
| Projection at \$4.00/Day | \$73.9 | \$74.3 | \$74.6 | \$75.0 | \$75.4 | \$75.8 |
| Estimated Impact | \$18.5 | \$18.6 | \$18.7 | \$18.8 | \$18.8 | \$18.9 |

Impact on Tax Burden and Regressivity

Restoring this tax to its former level would reduce the tax revenue burden on residents and broaden the tax base. An increase in the car rental tax would disproportionately affect nonresident visitors, therefore the impact on residents would likely be minimal. Spending on vehicle rental, leases, licenses, and other charges is also quite limited at around 0.9 percent of income, therefore the tax burden impact would be negligible. Since spending on these items as a percentage of income steadily declines with incomes beyond \$50,000, this measure would make the tax system slightly more regressive.

| Pros | Cons |
|--|---|
| <ul style="list-style-type: none"> Exports tax burden to tourists Some studies suggest demand for rental vehicles is somewhat inelastic Many top tourist destination states have higher rental car tax rates Ease of administration Provides a way, other than through the gas tax, to recover costs of using the state's roads | <ul style="list-style-type: none"> While a large amount of tax would be exported, residents would also experience tax increase if renting vehicle Some studies suggest demand for rental vehicles is somewhat elastic |

Alternative 4: Institute a Tax on Sugary Beverages

Perhaps the most controversial 'new' tax is one that is now or will soon be in place in many of the country's largest cities and counties. Current cities and counties with this form of tax are shown in Table 27.

Table 27: Sugary Beverage Taxes by City/County as of July 2017

| City/County | Effective Date | Tax Per Ounce |
|-------------------|-------------------------|---------------|
| Boulder, CO | July 1, 2017 | \$0.02 |
| Seattle, WA | January 1, 2018 | \$0.0175 |
| Philadelphia, PA | January 1, 2017 | \$0.015 |
| Cook County, IL | Pending court challenge | \$0.01 |
| Berkeley, CA | March 1, 2015 | \$0.01 |
| Albany, CA | April 1, 2017 | \$0.01 |
| Oakland, CA | July 1, 2017 | \$0.01 |
| San Francisco, CA | January 1, 2018 | \$0.01 |

This tax is applied on sugar-sweetened beverages and is meant to improve health and raise revenue. This tax is usually imposed by the ounce of product and ranges from one to two cents per ounce.

Because this is a relatively new tax, few examples currently exist to gauge the amount of revenue that can be raised through implementation.

⁷⁴ Estimates based on Council on Revenues' May 30, 2017 General Fund forecast.



However, by way of comparison, Philadelphia (which is similar in population size to Hawaii) generated \$39.3 million in its first six months of operation.⁷⁵

The City of Philadelphia experience has not been entirely positive and provides some guidance on how to create and implement the tax. First, it is not surprising that there has been significant resistance from the soda industry to the tax. There have been claims of significant consumer resistance, including shopping outside of the City for the beverages and other consumer purchases as well. There is at least local evidence of job losses associated with the changes in economic activity. PepsiCo announced it would lay off 80 to 100 Philadelphia-area employees as a direct result of lower sales following implementation of the tax, and a grocery franchise is laying off as many as 300 workers.⁷⁶

One feature of the Philadelphia tax is that it applies to no calorie diet sodas as well as those with sugar. This relates to the fact that the tax was advocated as a revenue raising measure foremost, to pay for pre-K programs in the City. This likely mixes the usual message on health benefits from the tax.

It is notable that many of the negative impacts are more likely to materialize with a local tax, where consumers can avoid the tax by making their purchases outside the city limits. Those opportunities within Hawaii would be far fewer. Further, while there may well be consumption changes, the evidence in other locations suggests that if there is a reduction in the purchase of sugared beverages, consumers are likely to switch to other beverages (such as those without sugar) as to abstain from making beverage purchases. Of course, this would still reduce revenues – but probably not significantly cut into economic activity.

Additionally, the UCONN Rudd Center for Food Policy and Obesity created a ‘Revenue Calculator for Sugary Drink Taxes’ that estimates potential annual revenues from excise taxes on sugary drinks. The tool is intended to provide a rough estimate and starting point to project the revenue from a tax on sugary drinks, and to illustrate how various assumptions affect the projections.⁷⁷ The Center estimates that, at \$0.015 per ounce in line with Philadelphia, a sugary beverage tax in Hawaii could generate more than \$50 million annually. The projection considers the price elasticity of various beverage types (for instance, that the sale of carbonated soft drinks would be more impacted than ready-to-drink coffee or energy drinks).

The Center’s estimate assumes 100 percent compliance; however, to account for the likely occurrence of non-compliance by some distributors, the project team has applied a discount rate of 10 percent to the revenues, bringing the 2018 estimate to just under \$50 million.

Table 28: Projected Sugary Beverage Tax Revenues, 2018

| Sugary Drink Type | 2018 | |
|------------------------|--------------|---------------------|
| | Gallons Sold | Annual Tax Revenues |
| Carbonated Soft Drinks | 10,697,048 | \$20,538,332 |
| Fruit Drinks | 3,733,164 | \$7,167,675 |
| Sports Drinks | 4,018,599 | \$7,715,710 |

⁷⁵ Philadelphia Business Journal – “With June Revenue In, Philadelphia’s Soda Tax Falls Just Short of FY17 Projection.” (July 24, 2017). Available at <https://www.bizjournals.com/philadelphia/news/2017/07/24/philly-soda-tax-pbt-june-17-revenue.html>

⁷⁶ New York Post – Philly’s Soda Tax is Crushing the City’s Beverage Business. March 7, 2017. Available at <http://nypost.com/2017/03/05/phillys-soda-tax-is-crushing-the-citys-beverage-business/>

⁷⁷ The Revenue Calculator for Sugary Drink Taxes is available at <http://www.uconnruddcenter.org/revenue-calculator-for-sugary-drink-taxes>



| Sugary Drink Type | 2018 | |
|---|-------------------|----------------------------|
| | Gallons Sold | Annual Tax Revenues |
| Ready-to-Drink Tea | 3,975,156 | \$7,632,300 |
| Energy Drinks | 4,343,387 | \$8,339,302 |
| Enhanced Water | 492,242 | \$945,104 |
| Ready-to-Drink Coffee | 980,764 | \$1,883,066 |
| Total | 28,240,360 | \$54,221,489 |
| <i>With 10% Noncompliance Adjustment</i> | | <i>\$48,799,340</i> |

Source: UCONN Rudd Center for Food Policy and Obesity

There are strong arguments in favor of the tax. Where there is still debate about its health effects, the theory behind taxing products with unhealthy outcomes is generally accepted (and applied in Hawaii, for example, to cigarettes and other tobacco products as well as alcohol). Recent research has shown that sugary beverage taxes effectively reduce consumption. After Berkeley, California instituted a tax in 2015, sales of sugary drinks fell almost 10 percent, while sales of water and other unsweetened beverages rose over the same period.⁷⁸

Table 29: Estimated General Fund Impact (millions)⁷⁹

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|--|--------|--------|--------|--------|--------|--------|
| Projected Revenue at \$0.015 per Ounce | \$48.8 | \$49.9 | \$51.2 | \$52.5 | \$53.9 | \$55.4 |

Impact on Tax Burden and Regressivity

The tax is considered regressive but may have health benefits, which is currently hotly debated. The sugary beverage tax would likely have a limited impact on consumers since nonalcoholic beverages account for 0.7 percent of household expenditures and consume only 0.5 percent of household incomes. However, it is a much greater share of expenditures and consumes a greater share of income for lower income households than higher income households. Imposing this tax would contribute to the regressivity of the tax system, but may have some public health benefits.

| Pros | Cons |
|--|--|
| <ul style="list-style-type: none"> ▪ Portion of tax burden exported to tourists ▪ Potential health benefits ▪ Not subject to cross-border competition | <ul style="list-style-type: none"> ▪ Considered regressive ▪ Strong anti-tax lobby |

Alternative 5: Tax Medical Marijuana

While medical marijuana has been legal in Hawaii since 2000, there were no dispensaries in the state – instead, patients and caregivers had to grow their own plants.

⁷⁸ PLOS Medicine – Changes in Prices, Sales, Consumer Spending and Beverage Consumption One Year After a Tax on Sugar-Sweetened Beverages in Berkeley, California, US: A Before and After Study (April 2017).

⁷⁹ Estimates based on UCONN Rudd Center for Food Policy and Obesity projections, 2017-2020.



In 2015, the Hawaii legislature passed into law Act 241, which created the Medical Marijuana Dispensary Program and established a process to allow for state-licensed sales and regulatory oversight. As of the date of this report, the state has eight licensed entities. The first business is expected to open this summer. Despite this progress, the State is in the process of determining how to tax the dispensaries, which will significantly impact the amount of revenue raised.

It is assumed that Hawaii will impose some level of tax on the marijuana. The Department of Health estimated that the 8 licensees could be paying approximately \$400,000 in taxes each month if all the dispensaries are open and selling the maximum amount of marijuana per patient.⁸⁰ This assumes sales will total \$10 million.

The estimated impact of taxing dispensary sales at 15 percent (in alignment with California and Colorado rates) instead of 4 percent is \$13 million.⁸¹

| | |
|---|---------------------|
| DOH monthly tax revenue estimate, 4 percent rate: | \$400,000 |
| Annual tax revenue estimate, 4 percent rate: | \$4,800,000 |
| Annual tax revenue estimate, 15 percent rate: | \$18,000,000 |
| Additional revenue at 15 percent rate: | \$13,200,000 |

North American marijuana sales are projected to increase at a compound annual growth rate of 25 percent annually until 2021. While high, this estimation is in line with actual state experience. Colorado, Washington and Oregon all saw sales increase by more than 50 percent between 2015 and 2016.⁸² Using a 25 percent year over year growth assumption, it is estimated that the State could generate an additional \$40 million in revenues annually by 2023.

Table 30: Estimated General Fund Impact (millions)⁸³

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|------------------|--------|--------|--------|--------|--------|--------|
| Estimated Impact | \$13.2 | \$16.5 | \$20.6 | \$25.8 | \$32.2 | \$40.3 |

Impact on Tax Burden and Regressivity

It is difficult to determine the tax burden and regressivity impact since there is a lack of reliable data on medical marijuana expenditures in Hawaii. However, Department of Health data show there were approximately 13,021 valid medical marijuana patients in 2016, only 0.9 percent of the population. Therefore this tax would only affect a very small proportion of households. If spending patterns by income level follow that of all prescription drugs, the tax would have a greater impact on lower income households and contribute slightly to the regressivity of the tax system.

| Pros | Cons |
|---|----------------------------------|
| ▪ Significant source of potential revenue | ▪ Considered somewhat regressive |

⁸⁰ State of Reform. "Medical Marijuana Dispensaries Face Continued Delays, Challenges." June 2, 2017. Available at <http://stateofreform.com/featured/2017/06/medical-marijuana-dispensaries-face-continued-delays-challenges/>

⁸¹ Of course, actual revenues depend on sales and the tax treatment adopted by the State.

⁸² Forbes, "Marijuana Sales Totaled \$6.7 Billion in 2016." January 3, 2017. Available at <https://www.forbes.com/sites/debraborchardt/2017/01/03/marijuana-sales-totaled-6-7-billion-in-2016/#4ccd121675e3>

⁸³ Estimates based on Hawaii Department of Health estimated 2017 revenue for 8 licensees selling the maximum amount of marijuana per patient.



Alternative 6: Institute a Carbon Tax

In 2007, Act 234, the Global Warming Solutions Act of 2007, became law. It mandates that statewide greenhouse gas (GHG) emissions be reduced to 1990 levels by 2020. Hawaii is not alone in its commitment to reduce emissions – as of September 2016, 20 states and Washington DC have GHG emissions targets.⁸⁴

One way states are considering reducing emissions is through the implementation of a carbon tax. In fact, the U.S Energy Information Administration (EIA) found that if the country had set a carbon tax of \$25 per ton in 2015 and increased it by 5 percent each year, CO₂ emissions would have fallen to 32 percent below 2005 levels by 2030.⁸⁵

A carbon tax is a fee imposed on the burning of carbon-based fuels (coal, oil and gas). It belongs to a group of taxes referred to as Pigovian taxes. These are taxes targeted at activities that generate negative externalities that are not factored into the market price of the final goods or services. The tax is intended to correct an inefficient market outcome, either by the tax equaling the social cost or reducing the activity associated with the negative externalities. The tax can take varying shapes and forms, which impact on the tax base, rate, and point of taxation.⁸⁶

For a carbon tax, the point of taxation is important, as it determines who would be required to monitor and report emissions and make payments. For example, a state could impose the tax on fuel producers, distributors, or the facilities and consumers that combust them. At the state level, the point of taxation could be the point of existing Federal Environmental Protection Agency (EPA) data collection for stationary sources. For example, power plants, refineries, and a wide range of industrial facilities must report their GHG emissions to EPA each year. EPA makes this data publicly available and any state can use this information to identify potential taxable emissions and estimate their potential revenues under different assumptions about which facilities would be subject to the tax.

Likewise, the methods for collection of existing state fuel excise taxes could be used for carbon tax collection. Hawaii, (as with all states) already taxes liquid transportation fuels, and others tax other uses of liquid fuels – for example, Virginia imposes a tax on natural gas consumption. With a state carbon tax, the existing state taxing authorities would calculate the per-unit tax for each fuel based on the carbon content of that fuel. For example, a carbon tax of \$25 per ton of CO₂ would convert to about \$1 per thousand cubic feet of natural gas. It would add about 24 cents per gallon to the price of gasoline and about 28 cents per gallon to the price of diesel fuel.

In order to implement a carbon tax, the State would have identify which sources and sectors will be subject to the tax. For example, for carbon in fossil fuels, this means choosing whether to tax carbon in fuels in electric power production (mainly coal and natural gas), transportation fuels (primarily petroleum products), fuels used in homes and commercial buildings for heating and cooling, and/or fuels used in industrial processes.

⁸⁴ Center for Climate and Energy Solutions – Greenhouse Gas Emissions Targets (September 2016). Available at <https://www.c2es.org/us-states-regions/policy-maps/emissions-targets>

⁸⁵ US EIA – Further Sensitivity Analysis of Hypothetical Policies to Limit Energy-Related Carbon Dioxide Emissions. July 18, 2013. Available at <https://www.eia.gov/outlooks/aeo/supplement/co2/>.

⁸⁶ Brookings Institution Climate and Energy Economics Project, Adele C. Morris, Yoram Bauman and David Bookbinder, “State Level Carbon Taxes: Options and Opportunities for Policymakers,” July 28, 2016. Available at <https://www.brookings.edu/wp-content/uploads/2016/07/State-level-carbon-taxes-Options-and-opportunities-for-policymakers.pdf>



As of the date of this report, no state has instituted this form of tax. However, five states (Washington, Massachusetts, Rhode Island, Connecticut and Vermont) have introduced legislation.

A recent notable attempt to enact a state-level carbon tax was in the State of Washington, where a voter initiative to institute a carbon tax was defeated. The measure would have instituted a gradually increasing carbon tax starting at \$15 per metric ton of CO₂ on fossil fuels sold or consumed in the state. The plan was designed to be revenue neutral and came with a one percentage point reduction in the state sales tax and rebates for lower-income residents. The initiative put before the voters divided environmental and social justice groups, some of whom believed it did not dedicate enough additional resources to climate change efforts and others who noted its impact on lower-income individuals. They were joined (in an unlikely alliance) by the oil and gas industry to defeat the proposal.

As for why other states have not instituted a tax, the reasons vary. They include the fact that it is a new tax (there are always some concerns about how it will operate in practice and possible unintended consequences). Second, it will tax raw materials and products that have already been subject to tax (such as motor fuels). Third, there are some issues of interstate commerce related to taxing fuels that are simply passing through the state (although this is less of an issue in Hawaii than probably every other state). Finally, there is general disinterest in many states with raising any sort of tax – let alone a new tax with the potential of raising substantial revenue.

A July 2016 report by the Brookings Institution⁸⁷ estimated that **the State of Hawaii could generate more than \$360 million annually in carbon tax revenues**. To arrive at this figure, the study used 2013 state-level data on per capita energy-related carbon dioxide emissions, as well as 2013 combustion data for electric power and industrial. The revenue estimates assume a tax rate of \$20 per metric ton of CO₂, higher than the Washington proposal.

This estimate is based on high-level assumptions, and actual revenues would depend significantly upon actual activity, the rate at which the tax was imposed, and the method of imposing the tax. Additionally, because no other state has implemented a carbon tax, the project team cannot use other state experience to form future estimates. Therefore, the project team has not supplied annual estimates through 2023.

Table 31: Estimated Impact of Carbon Tax, State of Hawaii

| Per capita energy related CO ₂ emissions in 2013 | 2013 Electronic Power Fossil Combustion CO ₂ | 2013 Industrial Fossil Fuel Combustion | Total including transport | Total potential revenue, assuming 2013 emissions and tax rate of \$20/ton CO ₂ | Total carbon tax potential revenue as a share of state GDP in 2013 |
|---|---|--|---------------------------|---|--|
| metric tons CO ₂ /person | MMTCO ₂ | MMTCO ₂ | MMTCO ₂ | \$ millions | % |
| 12.9 | 6.8 | 1.5 | 18.3 | \$365 | 0.49% |

Source: Brookings Institution State-Level Carbon Taxes, 2016

Impact on Tax Burden and Regressivity

The carbon tax would likely affect the cost of energy, transportation, and goods produced in Hawaii. Because the tax would affect a very significant portion of consumer expenditures, the tax burden impacts are expected to be quite significant. Existing studies have shown that the carbon tax would be regressive since lower income

⁸⁷ Brookings Institution; State-Level Carbon Taxes: Options and Opportunities for Policymakers (July 28, 2016)



households spend a greater percentage of their incomes on energy. Those making \$25,000 spend 5.3 percent of their income on electricity, natural gas, and heating fuels, a percentage that declines to only 2.5 percent at an income level of \$150,000. Given the scale of spending on energy goods by lower income households, a carbon tax would make Hawaii's tax system significantly more regressive. However, the revenue gains from such a broad-based tax could be substantial.

| Pros | Cons |
|---|---|
| <ul style="list-style-type: none">▪ Positive environmental impacts▪ Conforms with principle of efficient tax policy▪ Little administrative burden▪ Federal regulations a potential "action forcing event"▪ Relatively stable revenue source | <ul style="list-style-type: none">▪ Potentially regressive▪ No existing "lessons learned" from other states▪ Potentially a hard sell politically▪ Revenue declines over time |

Alternative 7: Institute Vapor/e-Cigarette Tax

Vapor products, also known as electronic cigarettes, have grown steadily in popularity over the past 10 years – due in part to their reputation as a less harmful alternative to traditional cigarettes. According to the CDC, as of 2014, there were more than 9 million e-cigarette users in the U.S.⁸⁸

Despite their increase in popularity, determining the appropriate tax treatment is still challenging for states. Because there are a wide variety of approaches to excise tax policy, each of the 7 states (and Washington DC) that has levied taxes on vapor products has implemented a different method, described below:⁸⁹

Based on percentage of purchase price (ad valorem tax):

- California: State Board of Equalization is directed to adopt regulations implementing tax on electronic cigarettes equivalent to the Cigarette Distribution Tax of \$1.00 per cigarette.
- District of Columbia: Vapor products taxed at rate equal to tax imposed on cigarette packs, expressed as percentage of average wholesale price.
- Minnesota: Tax of 95 percent of wholesale price imposed on tobacco products, including e-cigarettes.
- Pennsylvania: Electronic cigarettes taxed at rate of 40 percent of purchase price charged to the retailer.

Based on milliliters of consumable product (unit tax):

- Kansas: Privilege tax for sale or dealing of electronic cigarettes at the rate of \$0.20 per milliliter or consumable material.
- Louisiana: Vapor products and electronic cigarettes taxed at \$0.05 per milliliter of consumable nicotine liquid solution or other material containing nicotine that is depleted as a vapor product is used.
- North Carolina: Vapor products taxed at rate of \$0.05 per milliliter of consumable product.
- West Virginia: E-cigarette liquid taxed at rate of \$0.075 per milliliter.

⁸⁸ Centers for Disease Control and Prevention – Electronic Cigarette Use Among Adults: United States, 2014. Available at <https://www.cdc.gov/nchs/data/databriefs/db217.pdf>

⁸⁹ Public Health Law Center – US E-Cigarette Regulation: A 50-State Review (March 2017). Available at <http://www.publichealthlawcenter.org/sites/default/files/E-Cigarette-Legal-Landscape-50-State-Review-March-2017.pdf>



An additional 20 states have contemplated legislation, signaling that this revenue source is becoming a more politically palatable one, especially as states look to new revenues sources to support increasing costs.

Despite the increase in e-cigarette popularity, market data (and past performance in other locations that have vape taxes) suggest that the revenue raised by taxation is small, as it still does not have the market share of traditional tobacco products. However, it is likely that this revenue source would continue to grow over time.

In Minnesota, e-cigarettes and e-juice have been subject to the tobacco tax since 2012 – and generated \$5.6 million in 2014. The following example estimates the potential impact of implementing a similar measure in Hawaii.

Hawaii accounts for approximately 0.3 percent of all regular cigarette packs sold in the U.S in 2015.⁹⁰ Applying that consumption percentage to the estimated \$3.7 billion U.S e-cigarette market yields approximately \$10.9 million in e-cigarette sales in Hawaii. Applying a 40 percent tax avoidance factor lowers Hawaii's taxable e-cigarette sales to \$6.5 million. At an average cost of \$2.50 per millimeter, approximately 2.6 million millimeters of taxable e-liquid are sold in Hawaii each year.

Assuming the average wholesale price for 1 milliliter of e-liquid is \$1.80 (72 percent of the average retail price of \$2.50), applying a 95 percent tax on the wholesale price of the 2.6 million milliliters sold would generate \$1.71 in tax revenue per milliliter, or **\$4.5 million annually**. It is estimated that the global electronic cigarette industry will exhibit a growth of 22.36 percent (CAGR) from 2015 to 2025.⁹¹ Given this projected growth, it is estimated that revenues could reach more than \$12 million by 2023.

Table 32: Estimated General Fund Impact (millions)⁹²

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---------------------------------------|-------|-------|-------|-------|--------|--------|
| Projected Revenue at 95% of Wholesale | \$4.5 | \$5.5 | \$6.7 | \$8.2 | \$10.0 | \$12.3 |

Impact on Tax Burden and Regressivity

Similar to the cigarette tax increase, the tax burden impact on a typical household would be small, however the tax would be regressive, affecting lower income households disproportionately.

| Pros | Cons |
|--|--|
| <ul style="list-style-type: none">▪ Sin taxes are generally a palatable form of taxation▪ Tax gaining popularity nationally | <ul style="list-style-type: none">▪ Low monetary impact▪ Not much existing state experience |

Alternative 8: Increase the GET Rate to 4.5 Percent

For the 2012 TRC, the project team recommended a 0.5 percent increase in the GET. This was motivated by the size of projected budget deficits and the charge of the 2012 TRC to recommend revenue measures that could achieve structural balance. While not included in the alternatives for discussion in the High Level Findings

⁹⁰ Campaign for Tobacco Free Kids – State Cigarette Annual Pack Sales and Revenues, 2015. Available at <https://www.tobaccofreekids.org/research/factsheets/pdf/0099.pdf>

⁹¹ BIS Research, Electronic Cigarette and Vaporizer Market Research Reports (2016). Available at <https://bisresearch.com/industry-report/electronic-cigarette-market-size-forecast.html>

⁹² Estimates based on 2015 pack sales and revenues.



memo to the 2017 TRC, discussion between the Commission and the project team at a subsequent Commission meeting led to a request to at least include this option within the report.

As discussed previously, GET is imposed on most activities, goods and services at a rate of 4.0 percent (wholesaling, wholesale services, producing and sugar processing and pineapple canning are taxed at 0.5 percent; insurance commission are taxed at 0.15 percent). Approximately 96 percent of all GET revenues are generated at this 4.0 percent rate.⁹³ Increasing the rate on applicable goods and services to 4.5 percent would result in additional revenues of more than \$400 million annually.

As has been noted, the GET benefits from a very broad base, which has allowed the State to maintain a relatively low rate (in comparison to other state general consumption taxes). It also means that a moderate increase can raise a significant amount of revenue, as shown in the following table.

Table 33: Estimated General Fund Impact (millions)⁹⁴

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|----------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Baseline GET Projection | \$3,460 | \$3,580 | \$3,696 | \$3,828 | \$3,960 | \$4,106 |
| Applicable Baseline | \$3,322 | \$3,437 | \$3,549 | \$3,676 | \$3,803 | \$3,942 |
| Additional Revenue @ 4.5% | \$415 | \$430 | \$444 | \$459 | \$475 | \$493 |

Impact on Tax Burden and Regressivity

Of course, for reasons already discussed, this change would have a significant negative impact on tax burden and regressivity for lower income taxpayers. Some of that impact can be lessened by the use of refundable individual income tax credits, such as the Food/Excise Tax Credit. For example, the analysis from the 2012 TRC report noted that (based on estimates of consumption at that time via the Consumer Expenditure Survey), a family of four with an AGI of \$20,000 would currently receive an IIT Food/Excise Tax Credit of \$180. Using income shares for similar families around the country, a family with income before taxes of \$25,000 would spend approximately 13.7 percent of their income on food. This would equate to approximately \$3,425 – and the 4.0 percent GET would total \$137.216. If the GET were increased to 4.5 percent, the total GET devoted to food for the family of \$25,000 would be \$154. Of course, there are other expenditures subject to the GET that impact lower income individuals to a greater extent than higher income taxpayers. However, the combination of the higher tax credit and IIT exempted income could help reduce the impact of any GET rate increase.

| Pros | Cons |
|---|---|
| <ul style="list-style-type: none">▪ Raises a lot of revenue with a small percentage increase▪ An increase would still leave Hawaii on the low end of rates for States with broad-based consumption taxes | <ul style="list-style-type: none">▪ Regressive form of tax that will increase the tax burden – disproportionately – on lower income individuals |

⁹³ Department of Taxation calendar years 2015 and 2016 data

⁹⁴ Estimates based on Council on Revenues' May 30, 2017 General Fund forecast.



Transient Accommodations Tax Alternatives

It should be understood that the State dedicates a significant amount of public resources to providing services for nonresident visitors to Hawaii. This includes helping ensure public safety, the construction and maintenance of infrastructure (like highways and bridges) and helping ensure public health and human services. The State relies on a variety of taxes on non-residents to help provide those services, and the TAT is arguably the largest state revenue source that is primarily focused on collections from nonresidents.

The TAT is levied on hotels rooms, apartments, suites and other rental/transient properties occupied for less than 180 consecutive days. The tax is an important part of the overall revenue structure, as it exports a significant share of the overall tax burden to visitors.

Alternative 9: Increase the TAT and TOT Rates

State general fund revenue from the TAT totaled \$234 million in 2016 and accounted for 3.3 percent of General Fund revenue. Legislation enacted in 2009 temporarily increased the rate from 7.25 to 8.25 percent through June 30, 2010 and then to 9.25 percent. The legislation was set to expire on June 30, 2015, but the increased rate was made permanent in 2013 in advance of the sunset date.

Relative to other states, Hawaii's tax on hotel stays (13.25 percent) ranks third, trailing Connecticut (15.0 percent) and Maine (13.5 percent). However, as a top U.S tourist destination and island state, the comparison of hotel rates on the mainland is not particularly relevant to Hawaii. While business and industry conference coordinators will argue that the industry is price conscious, the lure of Hawaii is strong, and the State is already something of an outlier compared to other locations.

A full list of hotel/motel and sales tax rates by state can be found in **Appendix C**.

Table 34: States Ranked by Total Ad Valorem Tax Rates on Lodging Accommodations, 2015

| Rank | State | Sales Tax Rate | Lodging Tax Rate | Total Rate |
|----------|----------------------------|----------------|------------------|---------------|
| 1 | Connecticut | 6.35% | 8.65% | 15.00% |
| 2 | Maine | 5.50% | 8.00% | 13.50% |
| 3 | Hawaii⁹⁵ | 4.00% | 9.25% | 13.25% |
| 4 | Rhode Island | 7.00% | 6.00% | 13.00% |
| 5 | New Jersey ⁹⁶ | 7.00% | 5.00% | 12.00% |

Source: HVS 2016 Lodging Tax Report

In April 2017, House legislators proposed increasing the TAT rate to 12 percent for the next 10 years to generate funding for the Honolulu rail project. The legislature recessed in May 2017 without resolving the rail funding issue but announced it would hold a special session to find a solution. In July 2017, Governor Ige voiced support for increasing the rate by 1 percent, to 10.25 percent. In fact, during the recently concluded special legislative session, the TAT was raised to 10.25 percent. The new revenue was dedicated to the Honolulu rail project.

⁹⁵ Additional 0.5 percent state sales tax in Oahu.

⁹⁶ New Jersey State Occupancy Fee is imposed at a rate of 1 percent in cities that also impose local taxes or fees on hotel/motel occupancies.



The following analysis assumed the base rate would be 9.25 percent. It is the project team's belief that it would be difficult to impose a further increase to generate additional revenue.

The TAT would be expected to increase at a compound annual growth rate of 6.4 percent between 2017 and 2023, reaching \$362 million by 2023.⁹⁷ Increasing the rate to 10.0 percent would represent a rate increase of 8.1 percent. Assuming the increase to 10.0 percent would not impact consumer behavior, an additional \$23 million could be generated in 2018, growing to \$29 million by 2023, as shown in Table 35.

Table 35: Estimated General Fund Impact (millions)⁹⁸

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|-----------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Baseline Revenue Projection | \$277.6 | \$294.8 | \$311.8 | \$328.6 | \$345.1 | \$361.6 |
| Projected Revenue at 10% | \$300.1 | \$318.7 | \$337.1 | \$355.3 | \$373.0 | \$390.9 |
| Initiative Impact | \$22.5 | \$23.9 | \$25.3 | \$26.6 | \$28.0 | \$29.3 |
| % Increase | 8.1% | 8.1% | 8.1% | 8.1% | 8.1% | 8.1% |

Impact on Tax Burden and Regressivity

This measure would further export the tax burden to nonresidents and reduce the share of taxes paid by residents. Increasing the TAT would increase tax revenues from tourists without a significant burden on residents.

The bulk of transient accommodation taxes are borne by tourists therefore the tax burden impact on residents would likely be limited. Temporary lodging only consumes about 1 percent of household income and 1.3 percent of household expenditures therefore an increase would not significantly burden the typical Hawaii household. While temporary lodging consumes a higher share of income at an income of \$25,000 than \$50,000, beyond \$50,000, temporary lodging expenditures steadily rise as a percentage of income. Therefore this measure would likely contribute to the progressivity of the tax system.

| Pros | Cons |
|--|---|
| <ul style="list-style-type: none"> Exports tax burden to tourists Because an island state, not subject to cross-border competition | <ul style="list-style-type: none"> Increase already being considered for rail project; if adopted, additional increase would be unfeasible |

Alternative 10: Begin Collecting TAT on Resort Fees

Resort fees are per-room, per-night, mandatory fees charged by some hotels that are separate from the room rate. According to the hotel industry, the purpose of the fees is to provide hotel customers with certain hotel services, such as internet access, parking and use of the hotel's health club. According to a January 2017 Federal Trade Commission report,⁹⁹ consumers paid resort fees estimated at about \$2 billion in 2015, an increase of 35 percent over the previous year.

⁹⁷ Per Council on Revenues May 30, 2017 projection.

⁹⁸ Estimates based on Council on Revenues' May 30, 2017 General Fund forecast.

⁹⁹ Federal Trade Commission Bureau of Economics – Economic Analysis of Hotel Resort Fees (January 2017).



As of October 2016, 107 hotels and resorts in Hawaii charged resort fees. As shown in Table 36, these hotels offer a total of more than 35,000 rooms and impose resort fees that average \$23 per room per night. Of the islands, Oahu has the highest occupancy rate (84 percent), while Hawaii has the lowest (69 percent).

Table 36: Summary of Hawaii Hotels Charging Resort Fees

| Island | Total # of Hotels | Total # of Rooms | Occupancy Rate | Avg. Daily Resort Fee |
|--------------|-------------------|------------------|----------------|-----------------------|
| Oahu | 49 | 18,116 | 84.2% | \$22.49 |
| Maui | 30 | 8,930 | 75.9% | \$23.93 |
| Kauai | 16 | 3,595 | 72.6% | \$24.63 |
| Hawaii | 12 | 4,372 | 68.8% | \$23.09 |
| Total | 107 | 35,013 | 75.4% | \$23.28 |

Sources: list of hotels per x; resort fee rates and room totals per hotels.com; occupancy rates per HTA Hawaii Tourism Facts

Using the available hotel/room data and occupancy rates, hotels charging resort fees statewide have more than 10 million nightly stays per year, resulting in more than \$270 million in room fees. Applying TAT to these fees could result in more than \$25 million in annual tax revenue for the State.

Table 37: Estimated Foregone TAT Revenue, 2017

| Island | Rooms Booked/Year | Total Room Fees | Potential TAT Revenue |
|--------------|-------------------|----------------------|-----------------------|
| Oahu | 5,567,590 | \$153,582,294 | \$14,206,362 |
| Maui | 2,473,923 | \$60,963,707 | \$6,035,602 |
| Kauai | 952,639 | \$34,917,065 | \$2,358,762 |
| Hawaii | 1,097,897 | \$21,748,947 | \$2,861,909 |
| Total | 10,092,049 | \$271,212,013 | \$25,462,635 |

Assuming hotel rates increase at an inflationary rate and market behavior does not change, the implementation of resort fees could generate an estimated \$26 million in 2018, increasing to \$29 million by 2023.

These findings align with those of a study conducted by Travel Hawaii in December 2015. In it, researchers determined that the 105 Hawaii hotels charging resort fees were expected to collect around \$271 million in 2015 from guests.¹⁰⁰

These projections were based on the project team's understanding that resort fees were not currently subject to TAT; however, discussions with the Department of Taxation lead the team to believe that it is already being enforced. To the extent that it is true, it will have minimal financial impact. Assuming increased compliance results in a 10 percent increase in resort fee revenue, the State would gain an additional \$2-3 million annually.

It is possible that this and other revenue alternatives dealing with accommodations taxes would benefit from greater stakeholder education and dialogue. While it is impossible to determine the possible increased revenue that might result, there likely would be some increase and some greater compliance generated.

¹⁰⁰ Travel Hawaii, Study of Resort Fees at Hawaii Hotels. December 2015. Available at <http://travel-hawaii.com/hawaii-resort-fee-study.html>



Table 38: Estimated General Fund Impact (millions)¹⁰¹

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|-----------------------------|--------|--------|--------|--------|--------|--------|
| Estimated Potential Revenue | \$26.0 | \$26.4 | \$27.0 | \$27.6 | \$28.1 | \$28.7 |
| 10% Increase | \$2.6 | \$2.6 | \$2.7 | \$2.8 | \$2.8 | \$2.9 |

Impact on Tax Burden and Regressivity

This measure would further export the tax burden to nonresidents and reduce the share of taxes paid by residents. Subjecting these charges to the TAT would boost revenues from tourists.

The bulk of transient accommodation taxes are borne by tourists therefore the tax burden impact on residents would likely be limited. Temporary lodging only consumes about 1 percent of household income and 1.3 percent of household expenditures therefore an increase would not significantly burden the typical Hawaii household. While temporary lodging consumes a higher share of income at an income of \$25,000 than \$50,000, beyond \$50,000, temporary lodging expenditures steadily rise as a percentage of income. Therefore this measure would likely contribute to the progressivity of the tax system.

| Pros | Cons |
|--|---|
| <ul style="list-style-type: none">▪ Resort fees are often perceived as unfair to consumers▪ The fees are already a subject of scrutiny by the FTC | <ul style="list-style-type: none">▪ Tourism industry resistance |

Alternative 11: Begin Imposing TAT on Alternative Accommodation Rentals

Hawaii's timeshare occupancy tax is imposed on the occupants of timeshare vacation units. The rate was 7.25 percent prior to December 31, 2015; 8.25 percent between January 1, 2016 and December 31, 2016, and is 9.25 percent effective January 1, 2017 and thereafter. Like the TAT, the tax is an attractive alternative, as it exports tax burden to tourists rather than residents.

One key group of rentals gaining popularity is alternative accommodations such as Airbnb and HomeAway. According to a December 2016 study commissioned by the Hawaii Tourism Authority (HTA)¹⁰², consumer demand for alternative accommodations is growing. The study found that the share of visitors staying in a "rental house" increased from 4.6 percent in 2010 to 7.4 percent in 2015, and 38 percent of visitors said they expect their use of home/vacation rentals to increase in the future.

Many other state and local governments have enacted laws to tax these rentals. As of the date of this report, Airbnb (probably the largest operator in this category) collects and remits taxes to 24 states and Washington, DC. While the State does technically impose TAT on rental through online hosting, there is likely room for improved compliance. Tax forms do not require taxpayers to disclose if a renter used an online service to rent a property, and Get data are broken down by "Hotel Rentals" and "All Other Rentals," but the distinction is based on whether the rental was subject to TAT. As a result, the current process of verifying compliance is a manual one. It should be noted that Hawaii's situation is not due to lack of interest or intent, and the taxation of

¹⁰¹ Estimates based on October 2016 hotel room data.

¹⁰² JLL – Hawaii's Home and Vacation Rental Market: Impact and Outlook (December 2016).



alternative accommodation companies has been a topic of discussion in the legislature and at large for the past several years.

In 2016, Governor Ige vetoed a bill that would have allowed these companies to act as tax brokers on behalf of the State but noted that he was in favor of the bill's intent. He asked lawmakers to keep the issue alive with an intent to propose changes.

In 2017, Airbnb formally supported two similar bills.¹⁰³ The company estimated that allowing it to act as a broker could generate \$100 million in tax revenue for the State.¹⁰⁴ The 2016 JLL report commissioned by the HTA had similar findings. It estimated that, based on housing unit data and visitor and resident survey data, that collecting TAT revenue on Airbnb and other alternative accommodation stays would generate \$136 million in 2018, growing to \$173 million by 2023. Using trend analysis, PFM projects that revenues would reach more than \$200 million by 2023.

It is understood that the State is collecting some amount of revenue from online rentals. However, imputing compliance by comparing Hawaii Tourism Authority data to Department of Taxation data is a challenge, as the Department's TAT collection totals include timeshare occupancy tax as well as tax from timeshare rentals subject to TAT. Therefore, the estimates discussed above and displayed below are optimistic and assume full compliance with the proposed changes.

Table 39: Estimated Impact of Collecting TAT on Alternative Accommodations¹⁰⁵

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|----------------|----------------|----------------|----------------|----------------|----------------|
| Hawaii Housing Units | 534,587 | 535,656 | 536,727 | 537,801 | 538,876 | 539,954 |
| % of Residents Participating | 10.3% | 10.9% | 11.5% | 12.0% | 12.7% | 13.5% |
| Physical Stock | 55,300 | 58,400 | 61,500 | 64,700 | 68,700 | 73,000 |
| Estimated Occupancy Rate | 43% | 43% | 43% | 43% | 43% | 43% |
| Total Occupied Nights (millions) | 8.6 | 9.1 | 9.5 | 10.0 | 10.6 | 11.2 |
| Median Nightly Rate | \$180 | \$186 | \$191 | \$197 | \$203 | \$209 |
| Total Revenue (millions) | \$1,467 | \$1,597 | \$1,732 | \$1,875 | \$2,035 | \$2,208 |
| Projected TAT Revenue (millions) | \$135.7 | \$147.7 | \$160.2 | \$173.4 | \$188.3 | \$204.2 |

Source: JLL report: *Hawaii's Home and Vacation Rental Market: Impact and Outlook (December 2016)*.

As with the alternatives dealing with resort fees, this is also an area where a public education campaign with stakeholders may yield some benefits related to compliance and additional revenue. While this additional revenue cannot be estimated, it is likely that it will provide additional revenue over time.

Impact on Tax Burden and Regressivity

This measure would further export the tax burden to nonresidents and reduce the share of taxes paid by residents. The bulk of transient accommodation taxes are borne by tourists therefore the tax burden impact on residents would likely be limited. Temporary lodging only consumes about 1 percent of household income and 1.3 percent of household expenditures therefore an increase would not significantly burden the typical Hawaii household. While temporary lodging consumes a higher share of income at an income of \$25,000 than \$50,000,

¹⁰³ HB 1471 and SB 1087.

¹⁰⁴ <https://www.bizjournals.com/pacific/news/2017/02/20/airbnb-tries-again-on-hawaii-tax-broker-bills.html>.

¹⁰⁵ 2018-2021 estimates per JLL report; 2022 and 2023 estimates based on trend analysis.



beyond \$50,000, temporary lodging expenditures steadily rise as a percentage of income. Therefore this measure would likely contribute to the progressivity of the tax system.

| Pros | Cons |
|--|---|
| <ul style="list-style-type: none">▪ Exports tax burden to tourists▪ Airbnb supportive▪ Already an area of interest for the legislature▪ Significant source of revenue | <ul style="list-style-type: none">▪ Potential for noncompliance▪ Prior attempts vetoed by Governor▪ Some argue taxation would legitimize illegal vacation rentals |

Income Tax Alternatives

Alternative 12: Move to a Single 9 Percent Corporate Net Income Tax Rate

Corporate income taxes, levied in 44 states, are one of the smallest sources of state and local tax revenues. New Hampshire depends most heavily on the corporate income tax (9.4 percent of total tax collections) due to the lack of an individual income tax (except on interest and dividends) or a sales tax. At the other end of the spectrum, Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming do not levy a corporate income tax, though four of these states (Nevada, Ohio, Texas, and Washington) levy a handful gross receipts tax instead. Some of these states will still show a small amount of corporate income tax revenue due to taxes on corporate net income of special types of corporations (like financial institutions). At 1.6 percent reliance on corporate income taxes, Hawaii ranks 44th.¹⁰⁶ Part of the reason that Hawaii's net income tax is not as considerable in terms of revenue collection as in other states is that the GET is a significant tax on corporations – more so than sales taxes in most other states.

Additionally, the rates imposed on corporations vary from state to state. **A full list of corporate income tax rates by state can be found in Appendix D.**

Currently, the State of Hawaii taxes the income of corporations at a series of marginal rates ranging from 4.4 percent to 6.4 percent:

- Income up to \$25,000 taxed at 4.4 percent
- Income over \$25,000 up to \$100,000 taxed at 5.4 percent, less \$250
- Income over \$100,000 taxed at 6.4 percent, less \$1,250

According to Hawaii Department of Taxation (DoTax) data¹⁰⁷, C- and S-corporation taxable income is highly volatile, increasing from \$2.3 billion in 2010 to nearly \$5 billion in 2014, and then decreasing to \$3.6 billion one year later. Though the State uses a tiered tax structure, aggregate corporate net profits (inclusive of capital gains) are taxed at an average of between 5.0 and 5.8 percent. The amount that is deposited to the General Fund is net of refunds and also includes payments with returns.

¹⁰⁶ Tax Foundation – To What Extent Does Your State Rely on Corporate Income Taxes? April 19, 2017. Available at <https://taxfoundation.org/corporate-income-taxes-percent-collections/>

¹⁰⁷ Per DoTax C- and S-Corporation Income Tax Statistics, 2010-2015 (Forms N30 and N35).

**Table 40: Corporate Taxable Income and Tax Liability, 2010-2015 (millions)**

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---------------------|---------|---------|---------|---------|---------|---------|
| Net Profits | \$2,357 | \$2,444 | \$1,909 | \$3,813 | \$4,999 | \$3,640 |
| Gross Tax Liability | \$124 | \$127 | \$111 | \$217 | \$249 | \$205 |
| Aggregate Tax Rate | 5.2% | 5.2% | 5.8% | 5.7% | 5.0% | 5.6% |

Source: Hawaii DoTax C- and S-Corporation Income Tax Statistics, 2010-2015 (Forms N30 and N35)

The Council on Revenues projects that total corporate income tax collections (which includes taxes on corporate net gains) will increase by a compound annual growth rate of 12.5 percent between 2018 and 2023. Given this projection, it is estimated that transitioning to a single 9 percent corporate net income tax rate would yield an estimated \$100-\$200 million annually, as shown in the following table.

Table 41: Estimated General Fund Revenues (millions)¹⁰⁸

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|--------------|--------------|--------------|--------------|--------------|--------------|
| Total Taxable Corporate Income (a) | \$5,797 | \$6,371 | \$9,748 | \$9,905 | \$10,332 | \$10,455 |
| Gross Tax Liability (a) | \$315 | \$346 | \$529 | \$538 | \$561 | \$567 |
| Refunds (b) | \$159 | \$174 | \$267 | \$271 | \$283 | \$286 |
| Corp Tax Revenues, Current Structure | \$156 | \$171 | \$262 | \$267 | \$278 | \$281 |
| Gross Tax Liability at 9% Rate | \$522 | \$573 | \$877 | \$891 | \$930 | \$941 |
| Refunds | \$263 | \$289 | \$442 | \$449 | \$469 | \$474 |
| Corp Tax Revenues, Proposed | \$259 | \$284 | \$435 | \$442 | \$461 | \$467 |
| Value of Revenue Initiative | \$103 | \$113 | \$173 | \$175 | \$183 | \$185 |

Impact on Tax Burden and Regressivity

There is no consensus on whether an increase in this tax would make a tax structure more progressive. Some argue raising the corporate net income tax would reduce the capital income received by higher income households and therefore contribute to progressivity.¹⁰⁹ Others argue corporate income tax increases are regressive because they reduce worker wages paid by corporations.¹¹⁰ Given existing research, it is likely there would be some adverse effect on worker wages and some reducing effect on capital incomes, although the magnitude of these effects is still up for debate. Given the diffuse and indirect effects of the corporate income tax on household income streams, the specific tax burden and regressivity impacts of an increase remain uncertain.

| Pros | Cons |
|---|--|
| <ul style="list-style-type: none"> Relative to other states, current rates are low | <ul style="list-style-type: none"> Federal corporate tax treatment could drive business activity Corporate net income taxes a relatively volatile revenue source |

¹⁰⁸ Estimates based on 2015 DOTAX data

¹⁰⁹ Tax Policy Center of the Urban Institute and Brookings Institution. "Briefing Book: A citizen's guide to the fascinating (though often complex) elements of the federal Tax System." <http://www.taxpolicycenter.org/briefing-book/are-federal-taxes-progressive>

¹¹⁰ Laurence Kotlikoff. "Is the Corporate Income Tax Regressive?" National Center for Policy Analysis. <http://www.ncpa.org/pdfs/st336.pdf>



Alternative 13: Increase Corporate Net Income Taxes by 50 Percent

Alternatively, the State could retain the tiered structure, but apply an across the board increase in the tax rates imposed on corporations. Increasing total corporate net income taxes, inclusive of net capital gains taxes, would result in more than \$40 million in additional revenues in 2018, growing to \$75 million by 2023.¹¹¹

Table 42: Estimated General Fund Impact (millions)¹¹²

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|------------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Baseline Revenue Projection | \$83.3 | \$91.6 | \$140.1 | \$142.4 | \$148.5 | \$150.3 |
| Revenue Projection at 50% Increase | \$125.0 | \$137.3 | \$210.1 | \$213.5 | \$222.7 | \$225.4 |
| Estimated Impact | \$41.7 | \$45.8 | \$70.0 | \$71.2 | \$74.2 | \$75.1 |

Impact on Tax Burden and Regressivity

There is no consensus on whether an increase in this tax would make a tax structure more progressive. Some argue raising the corporate net income tax would reduce the capital income received by higher income households and therefore contribute to progressivity.¹¹³ Others argue corporate income tax increases are regressive because they reduce worker wages paid by corporations.¹¹⁴ Given existing research, it is likely there would be some adverse effect on worker wages and some reducing effect on capital incomes, although the magnitude of these effects is still up for debate. Given the diffuse and indirect effects of the corporate income tax on household income streams, the specific tax burden and regressivity impacts of an increase remain uncertain.

| Pros | Cons |
|---|--|
| <ul style="list-style-type: none"> Relative to other states, current rates are low | <ul style="list-style-type: none"> Federal tax changes could drive business activity Corporate net income taxes a relatively volatile revenue source |

Alternative 14: Increase Corporate Net Capital Gains Rate to 5 Percent

Currently, the State taxes corporate net capital gains at a rate of 4 percent. It is estimated that corporate net gains tax revenues account for 31 percent of all Corporate Income Tax revenues deposited into the General Fund. Increasing the rate imposed on corporate net gains to 5 percent would result in additional revenues totaling between \$6 and \$12 million annual between 2018 and 2023, as shown in the table below.

Of course, corporate gains taxes are contingent upon corporate activity and decision-making, which is highly sensitive to both economic trends and tax policies (including at the federal level). Capital gains are often associated with roller coaster revenue and therefore, additional revenues resulting from this initiative are difficult to anticipate.

¹¹¹ Estimate assumes no change in corporate business activity resulting from tax increase.

¹¹² Estimates based on Council on Revenues' May 30, 2017 General Fund forecast.

¹¹³ Tax Policy Center of the Urban Institute and Brookings Institution. "Briefing Book: A citizen's guide to the fascinating (though often complex) elements of the federal Tax System." <http://www.taxpolicycenter.org/briefing-book/are-federal-taxes-progressive>

¹¹⁴ Laurence Kotlikoff. "Is the Corporate Income Tax Regressive?" National Center for Policy Analysis. <http://www.ncpa.org/pdfs/st336.pdf>



Table 43: Estimated General Fund Impact (millions)

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|--|--------|--------|---------|---------|---------|---------|
| Total General Fund Corporate Income Tax | \$83.3 | \$91.6 | \$140.1 | \$142.4 | \$148.5 | \$150.3 |
| Amount Attributable to Corporate Net Gains | \$25.8 | \$28.3 | \$43.4 | \$44.1 | \$46.0 | \$46.5 |
| Value of Increasing Net Gains Rate to 5% | \$6.4 | \$7.1 | \$10.8 | \$11.0 | \$11.5 | \$11.6 |

Impact on Tax Burden and Regressivity

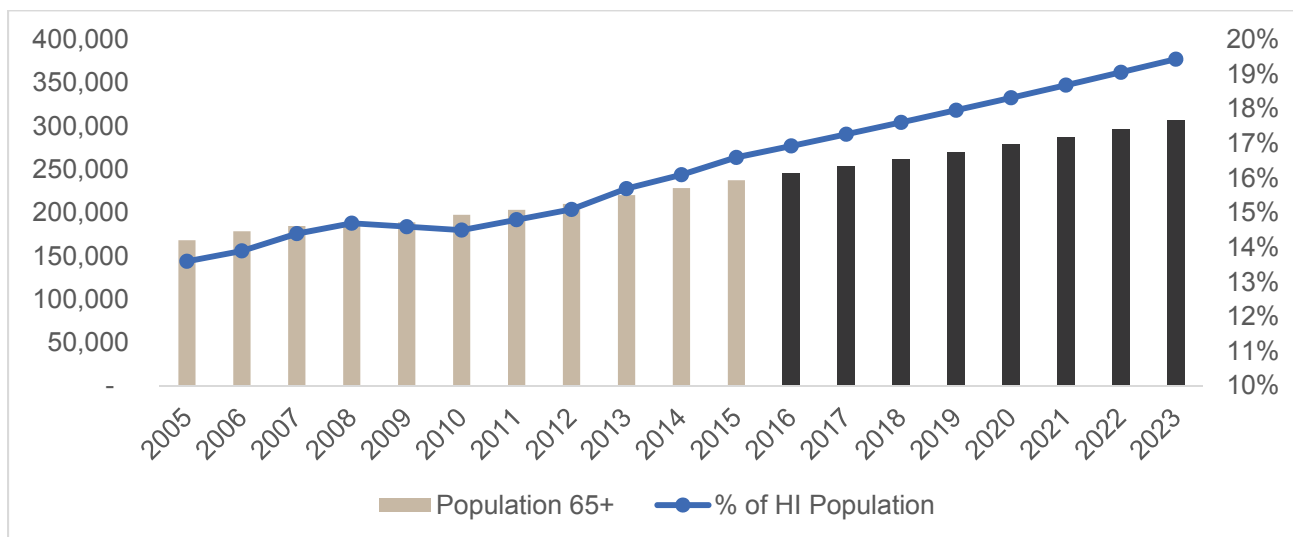
This measure would boost revenues without a significant direct impact on residents. Similar to the corporate income tax, it is unclear whether this would contribute to the regressivity of the tax structure, given the questionable impacts on worker wages and shareholder compensation.

| Pros | Cons |
|------|---------------------------|
| ▪ | ▪ Volatile revenue source |

Alternative 15: Reduce the Pension Exemption in the IIT

The number of retirees in Hawaii is growing. The percentage of Hawaii's population aged 65 and older was 16.6 percent in 2015 and is projected to increase to 19.4 percent by 2023. Between 2006 and 2015, the population aged 65 and older grew by 3.2 percent annually, while the total population in the state grew by just 1.2 percent.

Figure 34: Hawaii Population Aged 65+

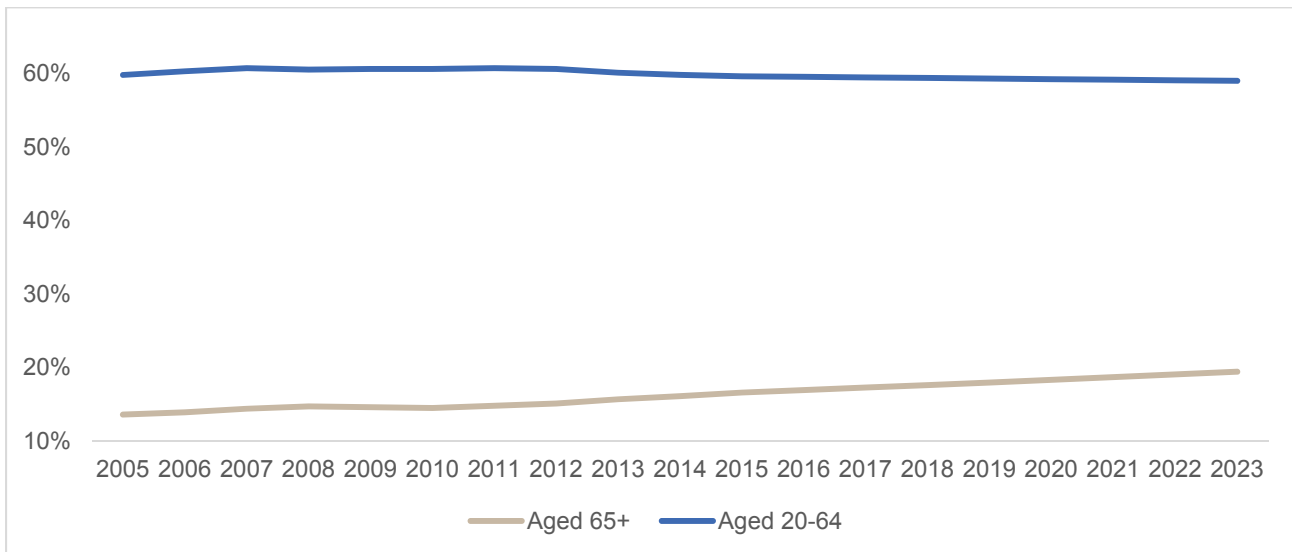


Source: American Community Survey 1-Year Estimates, 2005-2015

Additionally, the portion of the population considered working age (20-64) is stagnant, decreasing by a compound annual growth rate of 0.1 percent.



Figure 35: Percentage of Hawaii Population Aged 65+ and 20-64



Source: American Community Survey 1-Year Estimates, 2005-2015

As Hawaii's population ages, pension and social security income becomes a larger component of overall income. To maintain a sufficient base of individual income tax revenues, it is increasingly necessary to include at least some portion of that income in the tax base.

There is a wide variety of approaches to taxation or exemption of pension income among the states, and this variation extends to types of pensions. Many states treat private pensions differently than state and local, federal civilian and military pension. In general, public pension income is more likely to be excluded, while private pension income is more likely to be taxed.¹¹⁵ Hawaii is one of ten states – along with Alabama, Illinois, Kansas, Louisiana, Mississippi, New Hampshire, New York, Pennsylvania and Tennessee – that provide full exemption for public pension income. On the other hand, there are 7 states that provide no public or private pension exemption (California, Minnesota, New Mexico, North Dakota, Rhode Island, Utah and Vermont). Between these extremes, the majority of states exempt only a portion of pension income. A full list of state treatment of pension income can be found in **Appendix E**.

By eliminating or substantially reducing tax exemptions for federal and state pension income, Hawaii could realize a significant increase in General Fund revenue. According to the Department of Taxation, federally taxable pension income not taxed by Hawaii for tax year 2009 was \$2.4 billion. Additionally, total tax expenditures related to employer-provided pensions were approximately \$156 million in TY 2009. These accounted for 98.8 percent of all income not deductible for federal income taxes.¹¹⁶

The value of this measure in 2014 would have been \$38 million. To estimate annual revenues in subsequent years, the team applied actual and Council on Revenues-project annual individual income tax growth. The project team estimates that eliminating the pension exemption over \$25,000 would generate between \$45 million and \$65 million annually.

¹¹⁵ A commonly cited source for state tax exclusion for pension and retirement income is 'Individual Income Tax Provisions in the States,' Wisconsin Legislative Fiscal Bureau, January 2017. A table from this report, which lists all states with an individual income tax and their treatment of pension income, is included in the appendices.

¹¹⁶ Table 2 – Tax Expenditures in Hawaii's Net Income Taxes, "Tax Expenditures in Hawaii," Hawaii Department of Taxation, February 2012.



It was noted during discussion with the TRC that providing the \$25,000 exemption was not consistent with treatment of private pension income and 401k and similar plan distributions (which are entirely taxable). This is correct, and if the TRC wished to subject all pension income to state tax, it would materially increase the additional revenue. On the other hand, there has been strong political opposition to any taxation of public pensions, and the project team views the \$25,000 exclusion as an accommodation for those with more modest public pensions.

Table 44: Estimated General Fund Impact (millions)¹¹⁷

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|--|--------|--------|--------|--------|--------|--------|
| Value of Exemption Elimination Over \$25,000 | \$47.8 | \$48.1 | \$52.6 | \$55.9 | \$59.5 | \$63.2 |

Impact on Tax Burden and Regressivity

The remaining exemption would apply per person, meaning a married person household could use two exemptions. Most states provide for some taxation of pension income; with the provision to exempt the first \$25,000 of pension income. Eliminating the exemption for pensions over \$25,000 is a means to increase revenues while sparing lower income individuals. This proposal would only affect a minority of retirees. Based on 2015 Census Bureau micro data, only 43 percent of Hawaii households with retirement income receive pension income over \$25,000. 57 percent of pensioner households do not. For the typical retiree household with pension income exceeding \$25,000, this would translate into an additional **\$1,197 per year** in income taxes.¹¹⁸

Eliminating this feature would also make the tax structure more progressive by subjecting pension income above \$25,000 to Hawaii's progressive income tax rates. This would shift more of the tax burden to higher income pensioner households, which could see a sizable increase in their tax burden. Maintaining the exemption up to \$25,000 preserves the safety net for older Hawaii residents while taxing a portion of pension income above that to cover the most basic living expenses.

| Pros | Cons |
|---|--|
| <ul style="list-style-type: none">▪ Can be tailored in a progressive structure, with various rates based on certain income levels▪ Provides a broader and more stable tax base▪ May improve horizontal equity▪ Widely practiced among other states | <ul style="list-style-type: none">▪ At odds with general belief that those on fixed income are less able to deal with additional costs, including taxes▪ May violate a form of 'social compact' between public employees and government▪ If enacted on prospective pension filers, would not see benefits for many years▪ Potentially subject to litigation |

Alternative 16: Eliminate Exemption for Foreign Pension Income over \$25,000

According to Census Bureau data, 49 percent of Hawaii residents aged 65 and older were born outside of the state. Using 50 percent as a proxy, eliminating the exemption for foreign pension income over \$25,000 could reasonably generate an estimated \$20-30 million annually for the State.

¹¹⁷ Estimates based on Tax Year 2014 Hawaii Income Patterns.

¹¹⁸ Based on the average income for households with retirement income above \$25,000 (\$50,711) and an effective tax rate of 4.7%, the total effective rate for the \$50,000 to \$75,000 income range.

**Table 45: Estimated General Fund Impact (millions)¹¹⁹**

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---------------|---------------|---------------|---------------|---------------|---------------|
| Elimination All Pension Income | \$47.8 | \$48.1 | \$52.6 | \$55.9 | \$59.5 | \$63.2 |
| Eliminating Foreign Pension Income (49%) | \$23.9 | \$24.1 | \$26.3 | \$28.0 | \$29.8 | \$31.6 |

Impact on Tax Burden and Regressivity

All of the points regarding elimination of the exemption above \$25,000 discussed above also apply to elimination of the exemption for foreign pension income. In addition, this measure would minimize the burden on native-born pensioners.

| Pros | Cons |
|--|---|
| <ul style="list-style-type: none"> Considered a progressive measure | <ul style="list-style-type: none"> Potentially subject to litigation |

Alternative 17: Implement a Personal Income Tax Rate Recapture

This measure would implement a top-rate recapture mechanism for high income taxpayers. In this approach, for taxpayers with income above a certain level (\$100,000 in this analysis for purposes of demonstration), the benefit of lower brackets would be phased out, and when income reaches \$150,000, the taxpayer would pay the top rate on the first dollar of income. This would be a highly progressive feature.

Connecticut, New York and Nebraska implement this method, using the methodologies described in the table below.

| Connecticut ¹²⁰ |
|--|
| <ul style="list-style-type: none"> Joint Filers: \$180 per \$10,000 of AGI over \$400,000; an additional \$100 for each \$10,000 above \$1,000,000 AGI. Maximum total recapture amount is \$6,300. Single Filers: \$90 per \$5,000 of AGI over \$200,000; an additional \$50 for each \$5,000 above \$500,000 AGI. Maximum total recapture amount is \$3,150. Head of Household Filers: \$140 per \$8,000 of AGI over \$320,000; maximum recapture \$4,200; an additional \$80 for each \$8,000 above \$800,000 AGI. Maximum total recapture amount is \$4,920. |
| New York ¹²¹ |
| <ul style="list-style-type: none"> Joint Filers: 8.82% rate recapture for incomes \$2,190,900 and above. Single Filers: 8.82% rate recapture for incomes \$1,120,350 and above. Head of Household Filers: 8.82% rate recapture for incomes \$1,655,650 and above. <p>This measure, which impacts 45,000 taxpayers (half of whom are nonresidents), is expected to raise \$3.4 billion in 2018.</p> |

¹¹⁹ Estimates based on Tax Year 2014 Hawaii Income Patterns and 2015 Census Bureau residency data.

¹²⁰ State of Connecticut Department of Revenue Services – 2015 Legislative Changes Affecting Income Tax Withholding and the Income Tax.

¹²¹ https://www.tax.ny.gov/pdf/current_forms/it/it201i_nys_tax_computation_wshts.pdf



Nebraska¹²²

- **Joint Filers:** 0.438% of AGI above \$311,300 but not over \$372,500; \$268.06 + 0.333% of the excess over \$372,500 but not over \$678,600; \$1,287.37 + 0.183% of the excess over \$678,600 but not over \$903,100; \$1,698.21 if AGI is over \$903,100. **Maximum recapture amount is \$1,698.21.**
- **Married, Filing Separately:** 0.438% of AGI above \$155,650 but not over \$186,250; \$134.03 + 0.333% of the excess over \$186,250 but not over \$339,350; \$643.85 + 0.183% of the excess over \$339,350 but not over \$451,500; \$849.18 if AGI is over \$451,550. **Maximum recapture amount is \$849.18.**
- **Single Filers:** 0.438% of AGI above \$259,400 but not over \$290,000; \$134.03 + 0.333% of the excess over \$290,000 but not over \$443,100; \$643.85 + 0.183% of the excess over \$443,100 but not over \$555,300; \$849.18 if AGI is over \$555,300. **Maximum recapture amount is \$849.18.**
- **Head of Household Filers:** 0.438% of AGI above \$285,350 but not over \$342,450; \$250.10 + 0.333% of the excess over \$342,450 but not over \$579,250; \$1,038.64 + 0.183% of the excess over \$579,250 but not over \$724,150; \$1,303.81 if AGI is over \$724,150. **Maximum recapture amount is \$1,303.81.**

To estimate the impact of this option, the project team calculated the number and percent of resident tax returns in 2014 that were above the \$100,000 threshold. In total, 78,215 returns (comprising 15 percent of all returns) met this threshold. The aggregate adjusted gross income (AGI) for these filers was \$16.3 billion, equal to 50 percent of the state's aggregate AGI across all income levels.

Table 46: Selected Data from Resident Tax Returns by AGI Class & Filing Type, \$100,000+, 2014

| | Number of Returns | | | Hawaii AGI (thousands) | | |
|--------------------------|-------------------|---------------|--------------|------------------------|---------------------|------------------|
| | Single | Joint | H/H | Single | Joint | H/H |
| \$100,000 - \$150,000 | 7,216 | 36,108 | 2,056 | \$850,963 | \$4,386,645 | \$242,483 |
| \$150,000 - \$200,000 | 1,806 | 14,219 | 386 | \$307,615 | \$2,429,287 | \$65,418 |
| \$200,000 - \$300,000 | 1,248 | 7,913 | 234 | \$298,471 | \$1,881,613 | \$55,827 |
| \$300,000 and over | 1,121 | 5,699 | 209 | \$900,403 | \$4,698,164 | \$133,286 |
| Total, \$100,000+ | 11,391 | 63,939 | 2,885 | \$2,357,452 | \$13,395,709 | \$497,014 |

Source: Hawaii Individual Income Tax Patterns, 2014

Of this amount, \$13.9 billion was considered taxable income, resulting in a tax liability of \$1.1 billion (60 percent of statewide liability). At the taxpayer level, average taxable income ranges from \$93,000 (head of household at the \$100,000-\$150,000 range) to more than \$750,000 (single filer at the \$300,000+ range). The resulting average tax liability ranges from \$6,000 to \$70,000. The table below displays the average taxable income and tax liability by income level and filing type in 2014.

Table 47: Average Taxable Income and Tax Liability by AGI Class & Filing Type, \$100,000+, 2014

| | Avg Taxable Income, 2014 | | | Avg Tax Liability, 2014 | | |
|-----------------------|--------------------------|-----------|-----------|-------------------------|----------|----------|
| | Single | Joint | H/H | Single | Joint | H/H |
| \$100,000 - \$150,000 | \$103,929 | \$94,932 | \$93,091 | \$7,771 | \$6,355 | \$6,544 |
| \$150,000 - \$200,000 | \$155,174 | \$137,519 | \$149,606 | \$11,943 | \$9,813 | \$11,109 |
| \$200,000 - \$300,000 | \$221,959 | \$212,345 | \$216,201 | \$18,135 | \$15,900 | \$16,543 |
| \$300,000 and over | \$752,332 | \$749,108 | \$603,794 | \$70,548 | \$64,108 | \$54,014 |

Source: Hawaii Individual Income Tax Patterns, 2014

¹²² http://www.revenue.nebraska.gov/tax/16forms/f_1040n_booklet.pdf



The project team used Census ACS Housing Unit PUMS data for 2014 to generate cohort estimates of average income and percent of total incomes in the \$100,000-\$150,000 range.

The team then estimated the average tax liability for filer type under the current tax system and under the proposed tax system; the difference between the two is the average increase in taxpayer liability. These average increases were added to the actual average tax liability from the DoTax data and multiplied by the actual number of filers. The difference between these new aggregate tax liability figures and the existing aggregate liability is equal to the estimated revenue impact of the proposed revenue initiative.

Phasing in the rate recapture between \$100,000 and \$150,000 could be designed to subject those with income between \$100,000 and \$100,000 to 20 percent of the recapture, \$110,000-\$120,000 to 40 percent, \$120,000-\$130,000 to 60 percent, \$130,000-\$140,000 to 80 percent, and \$140,000-\$150,000 to 100 percent.

Using this methodology, the project team estimates that the impact of the initiative in 2014 (the last year for which detailed DoTax data is available) would have been \$161 million. Using actual (2015 and 2016) and Council on Revenues-projected (2017-2023) annual individual income tax increases, it is estimated that the initiative could generate upwards of \$200 million annually.

These estimates are significant but reasonable, given that filers making over \$100,000 account for approximately half of all taxable income. Based on these assumptions, the proposal would raise the effective tax rate for \$100,000+ filers by an average of 1 percent of income.

It should be noted that this option involves the combined effect of individual taxpayer liability calculation, which vary widely; therefore, the projection is a rough estimate for demonstrative purposes.

Table 48: Income Tax Rate Recapture Estimated 2017 Impact

| | Increased Tax Liability (thousands) | | |
|--------------------------------|-------------------------------------|------------------|------------------|
| | Single | Joint | H/H |
| \$100,000 - \$150,000 | \$2,651 | \$30,063 | \$1,347 |
| \$150,000 - \$200,000 | \$3,653 | \$21,783 | \$476 |
| \$200,000 - \$300,000 | \$7,838 | \$12,805 | \$680 |
| \$300,000 and over | \$13,686 | \$63,884 | \$2,592 |
| Total, \$100,000+ | \$27,828 | \$128,534 | \$5,095 |
| Total, All Filing Types | | | \$161,457 |

Table 49: Estimated General Fund Impact (millions)¹²³

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|------------------|---------|---------|---------|---------|---------|---------|
| Estimated Impact | \$203.2 | \$213.3 | \$223.8 | \$237.9 | \$253.0 | \$268.8 |

Impact on Tax Burden and Regressivity

This would be a highly progressive feature and would greatly enhance the progressivity of the tax structure. The tax burden impact is potentially very significant on higher income taxpayers (depending on the design of the recapture), however these taxpayers do have a much greater ability to pay than lower income residents of Hawaii.

¹²³ Estimates based on Tax Year 2014 Hawaii Income Patterns.



| Pros | Cons |
|---|--|
| <ul style="list-style-type: none">▪ Considered a highly progressive feature | <ul style="list-style-type: none">▪ A significant additional increase in the effective tax rate that begins (at least in the example) at a relatively low level of income. |

Property Tax Alternatives

Alternative 18: Eliminate the Deduction for Property Taxes Paid

Under the U.S tax code, any state, local or foreign taxes on real property levied for the general public welfare are deductible. Most states use federal adjusted gross income as the starting point for state IIT purposes, but others do not. Among these states are Colorado, Minnesota, Oregon and South Carolina.

Hawaii is unique among the states in its full support for K-12 education, which in most states is a shared state-local responsibility, with the local funding primarily supported by property taxes. Nationally, 40 percent of total local direct general expenditures were in support of elementary and secondary education in 2014.¹²⁴ Given this, the State of Hawaii is making a significant funding commitment to local schools.

Hawaii's state and local property tax revenues are equal to 0.3 percent of national state and local totals.¹²⁵ Applying this share to the tax year 2014 U.S total real estate tax deductions (\$181 billion)¹²⁶ results in an estimate of aggregate Hawaii real estate taxes of \$540 million. The project team then applied the effective tax rate for all Hawaii individual income taxpayers (5.5 percent before credits, based on adjusted gross income)¹²⁷ to this figure to estimate that the value of the initiative would be approximately \$30-\$40 million annually. It should, of course, be noted that actual revenues are based on individual taxpayer tax liability calculations.

Elimination of the real estate tax deduction would effectively increase the property tax burden by removing the deduction against income taxes. To the extent the property tax is regressive, this would increase regressivity. However, for individuals with no state income tax liability (or who do not itemize), there would be no additional tax implications from this change. As a result, it would likely be a progressive feature.

Table 50: Estimated General Fund Impact (\$ millions)¹²⁸

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|------------------|--------|--------|--------|--------|--------|--------|
| Estimated Impact | \$31.0 | \$32.5 | \$34.1 | \$36.3 | \$38.6 | \$41.0 |

Impact on Tax Burden and Regressivity

Removing the reduction would increase the share of taxes paid by higher income Hawaii residents, since lower income Hawaii residents more commonly take the standard deduction. For individuals with no state income tax liability (or who do not itemize), there would be no additional tax implications from this change. Removing the real estate tax deduction would disproportionately affect higher income earners, yet it would make Hawaii's income tax structure slightly less progressive at higher levels of income. The differences between effective tax

¹²⁴ US Census, Survey of State and Local Government Finance, 2014.

¹²⁵ Census Survey of State and Local Governments, 2014

¹²⁶ IRS Table 2.1. Returns with Itemized Deductions, Tax Year 2014 (Filing Year 2015)

¹²⁷ As shown in Table A-6 of Hawaii Income Patterns, 2014

¹²⁸ Estimates based on Tax Year 2014 real estate data



rates at higher levels of income would decline under this option. With the deduction removed, those making \$50,000 would pay a higher effective tax rate than those making \$75,000. This is because the deduction heavily favors middle income taxpayers, which through this measure, deduct a much greater share of income from taxation than higher income taxpayers. Although the nominal impacts rise with income, in percentage of income terms, removing the deduction would have the largest impact on middle income taxpayers making \$50,000 (0.21% of income) and the smallest impact on upper middle-income households earning \$150,000 (0.13%). Households making \$25,000 would be largely unaffected. This proposal would shift much of the tax burden share away from the lowest income households.

| Pros | Cons |
|---|---|
| <ul style="list-style-type: none">Some aspects progressiveHelps reduce disparity by increasing state tax burden for property taxpayers | <ul style="list-style-type: none">Some aspects regressive |

Alternative 19: Shift Certain K-12 Education Expenses to Property Taxes to Lower State Costs

Because the State Constitution prohibits a state property tax, the only mechanism to increase the use of this tax (and thus reduce the use of other major taxes) would be to shift expenditures from the State to local governments. As mentioned previously, Hawaii is the only state that fully assumes the operational costs of K-12 education at the state level. Under this initiative, the State could select specific expenditures to shift. As an example, it could shift the DOE's Public Libraries general fund operating costs to property taxes and reduce General Fund expenses by approximately \$35 million annually. Alternatively, shifting the DOE's School Support Program budget (which includes food services; services and supplies related to construction, operation and maintenance of grounds and facilities; and student transportation services) would free up \$191 million in the State's General Fund per year.

Impact on Tax Burden and Regressivity

Any shift to property tax from more progressive taxes (such as the income tax) would be regressive – however, it would be possible to ameliorate some of these impacts through expanding refundable credits such as the GET/renter's credit. The exact tax burden impacts would depend on the magnitude of expenditures shifted to county governments.

| Pros | Cons |
|---|---|
| <ul style="list-style-type: none">Most other states already share funding responsibility with local governments | <ul style="list-style-type: none">Potentially regressiveRail funding complicating local finances |

Compliance Alternatives

Compliance initiatives are important, because they can increase voluntary compliance and create greater confidence in the system by those taxpayers (who are the vast majority of Hawaii taxpayers) who pay their taxes in full and on time.

The State has undertaken compliance initiatives in the past and continues to implement changes that are focused on increasing collections, particularly for cash-based enterprises. For example, Act 134 (2009), the Cash Economy Enforcement Act committed additional resources over time to the Department of Taxation to raise additional revenue owed to the State. The primary focus of the Act was the creation of a Special



Enforcement Section, including civil investigators and support staff. The Department of Taxation is required, as part of the Act, to provide regular reports to the Legislature related to the resources committed to implementing the Act and the additional revenues raised as a result of the Act.

The most recent report, for the period from July 1, 2015 to June 30, 2016, identified revenue collected in the last three years from the Act as \$805,776 in FY2014; \$1,619,235 in FY2015; and \$3,505,618 in FY2016. These represent a significant upward trajectory in revenue collections.

A major current initiative that should assist with overall system compliance is the Department of Taxation's Tax System Modernization (TSM) Program. This is a collection of initiatives that will upgrade and replace existing tax systems, many of which are past their useful life and do not allow for sharing and use of disparate data sets. Some features of the program have already gone live, including online mechanisms for some tax collection and reporting.

There have been concerns raised with the implementation of parts of the project, and, in fact, these concerns led to the Legislature, earlier this year, suspending funding for some of the project.

The State hired, as part of the project, a vendor, AdvanTech LLC, to perform independent Verification and Validation (IV&V) services for the TSM Program. As part of their services to the State, AdvanTech performs periodic assessments to help identify strengths, weaknesses, issues and risks related to the implementation of the Program and to make recommendations for improving the implementation process.

The most recent (of five) IV&V reports issued by AdvanTech was submitted in May 2017. The report identifies a number of issues and risks, including taxpayer difficulty registering for components of the website, some user discomfort and Department concerns about rushed training and testing.

The legislature has also directed the State Auditor to conduct an audit of the TSM Program using a third party auditing firm. More recently, the Department is going to roll out new changes to an 'enhanced online experience' related to Hawaii Tax Online (part of the TSM Program). This will be rolled out after August 14, 2017.

It is notable that states across the country are experiencing shortfalls in tax collections versus estimates. While it is possible (and not in this case dissimilar from other major system rollouts) that some revenue loss is being experienced during roll-out, it is also likely that this will be a short-term obstacle – and most of that outstanding revenue will eventually be collected.

Given the fact that there is another firm doing IV&V and the State Auditor will be engaging another party to do an audit of the system, it was not cost beneficial for this project team to spend significant project resources on its own look. As a result, no specific estimate could be developed as to possible impacts from the TSM Program.

There are notable instances across the country where taxpayer compliance can be a significant issue for the amount of tax revenue that can be generated. There are taxes where 'black markets' are fostered because of taxes owed on specific products, such as cigarettes. More recently, concerns about payment of sales and use taxes owed because of online purchases has become a prominent issue for States – and also for Hawaii as it relates to the GET.



Alternative 20: Expand Efforts to Incent E-Commerce Collection of GET

Economic nexus is an area with significant legislative action across the country, although the constitutionality of some recently enacted state laws is being challenged in several state and federal court cases.

Typically, an online retailer only has to collect sales tax in states where they have a physical presence, such as a storefront or a distribution center. This loophole is a potentially costly one for states – and Hawaii is no exception. According to the National Conference of State Legislatures, the State had an estimated \$60 million in uncollected sales and use tax from electronic business to business and business to customer sales in 2012.¹²⁹

Across the country, states are adopting new methods so that businesses will have nexus in their state sufficient to require them to collect sales (or in the case of Hawaii, GET) tax. Effective July 1, 2017 the Colorado Department of Revenue began enforcing notice and reporting requirements for retailers with at least \$100,000 in annual sales that make sales into Colorado but do not collect Colorado state sales tax. These non-collecting retailers are required to collect the purchaser's name, billing and shipping address, and the dollar amount of each purchase – this information is then reported by the retailer to the Department on an annual basis. Additionally, at the time of purchase, retailers must provide a transaction notice to Colorado customers informing them that the Colorado state sales tax has not been paid, and the customer may have an obligation to the state. The non-collecting retailers must provide an annual customer notification by January 31 of the following year for Colorado customers with at least \$500 in purchases in a calendar year.¹³⁰

The Hawaii legislature recently proposed several measures aimed at increasing e-commerce taxation and compliance.¹³¹

- **SB620** and companion bill **HB345** seek to expand the State's definition of nexus. An out-of-state company making at least \$100,000 in sales annually must collect and remit Hawaii tax if it engages in activities with the object of gain or economic benefit (direct or indirect), without regard to having a physical presence in the State.
- **HB398** is similar to the Colorado reporting measure, in that it imposes a use tax notification requirement on all non-collecting out-of-state sellers making sales of tangible personal property in Hawaii. Purchasers must be informed annual that the State requires a use tax return to be filed and use tax to be paid on certain purchases. Sellers must also provide the dates and amounts of the purchases, the category of the purchase, and whether the purchase is exempt or taxable in Hawaii (if known).
- **HB1413** (the Simplified Sellers Use Tax Remittance Act) encourages voluntary collection by non-collecting remote retailers. The Act is modeled on Alabama's Simplified Seller Use Tax Act and allows eligible out-of-state sellers to collect, report and remit a simplified sellers use tax at a rate of 4 percent, instead of the GET. Collection of the simplified tax would relieve the seller of any additional GET; additionally, a 2 percent discount on the properly collected tax would be offered to businesses that collect and remit the tax due in a proper and timely manner.

¹²⁹ National Conference of State Legislatures: Collecting E-Commerce Taxes (11/14/14). Available at <http://www.ncsl.org/research/fiscal-policy/collecting-ecommerce-taxes-an-interactive-map.aspx>

¹³⁰ CCH Tax Group – "Colorado Sales and Use Tax: Notice and Reporting Requirements for Retailers Became Effective July 1, 2017." July 5, 2017. Available at <http://news.cchgroup.com/2017/07/05/colorado-sales-use-tax-notice-reporting-requirements-retailers-became-effective-july-1-2017/>

¹³¹ Avalara. "Hawaii Lawmakers Push to Increase Remote Sales Tax Collections." February 10, 2017. Available at <http://www.taxrates.com/blog/2017/02/10/hawaii-lawmakers-push-to-increase-remote-sales-tax-collections/>. As of the data of this report, all bills are still under consideration by the legislature.



On April 1, 2017, Amazon (which accounts for 43 percent of U.S online retail sales¹³²) began collecting sales tax on purchases in Hawaii, Idaho, Maine and New Mexico – the last four states where it wasn’t doing so. Four other states – Delaware, Montana, New Hampshire and Oregon – have no sales tax, while Alaska doesn’t have a statewide tax, but does have municipal sales taxes.

The amount of revenue the State can expect to gain as a result of increased e-commerce collections is a subject of much debate, and various estimates exist:¹³³

- A 2012 study found that total online sales in Hawaii could generate \$110 million, with Amazon’s contribution estimated at about \$11 million.
- A 2016 DEBDT consumer survey of 2013-2014 household online spending found that taxing online sales would result in \$15 million in GET revenue.
- As mentioned above, **SB620** and companion bill **HB345** aim to require businesses with no physical presence in the state but do more than \$100,000 in sales to collect GET. It is estimated that this measure would generate an additional \$15 million annually.

Of course, imposing the tax with no threshold would result in additional revenue for the State. In 2014, Hawaii’s sales tax revenues were equal to approximately 1 percent of the U.S total.¹³⁴ Amazon’s U.S net sales were \$64 billion. Given this, it can be estimated that net sales in Hawaii were \$595 million. At an estimated 4.5 percent GET rate, Amazon will collect an estimated \$27 million annually on behalf of the state. Total tax collections, inclusive of the Amazon total, are projected to be \$62 million. Given this, it can be estimated that the tax revenue the State could gain through increased collection of taxes related to e-commerce is \$35 million.

Impact on Tax Burden and Regressivity

Taxation of e-commerce/online tax would affect a broad array of consumer expenditures but would have limited effect on the tax burden given the scale of household online spending. According to a 2016 DBEDT Consumer Expenditure Survey, the average Honolulu household making less than \$50,000 spends \$314 per year on online purchases. Those making between \$50,000 and \$100,000 pay \$727, which those making \$150,000 or more \$1,118 or more. These represent only 0.8 percent, 1.2 percent, and 1.3 percent of overall household spending, respectively. Yet spending as a share of income steadily declines as income rises. Given that, this measure would likely contribute to the regressivity of the tax system, with a more substantial impact on lower income households.

| Pros | Cons |
|------------------------------|-----------------------------|
| ▪ Does not require a new tax | ▪ Challenging to administer |

The State is in the process of implementing a data warehouse; in other states, this has provided opportunities to improve compliance and collect additional revenue. These include:

¹³² Business Insider – “Amazon Accounts for 43 Percent of US Online Retail Sales.” February 3, 2017. Available at <http://www.businessinsider.com/amazon-accounts-for-43-of-us-online-retail-sales-2017-2>

¹³³ All estimates per Honolulu Star-Advertiser, “Parcels from Amazon Increase Ahead of Tax Collection.” March 31, 2017. Available at <https://www.pressreader.com/usa/honolulu-star-advertiser/20170331/281487866190816>

¹³⁴ US Census Bureau 2014 Annual Surveys of State and Local Government Finances



Alternative 21: Develop Tax Gap Systems to Identify Under-payment and Non-payment of Taxes

Several states have increased revenue collections through use of sophisticated software connected with a fully functional data warehouse:¹³⁵

- The Iowa Department of Revenue implemented an enterprise data warehouse system to enhance efficiencies and boost taxpayer compliance. The effort produces \$14 million annually.
- The Ohio Department of Revenue implemented an enterprise data warehouse with modules aimed at business intelligence, analytical case management and reporting. This strategy has collected \$70 million over 3 years.
- The Texas Comptroller of Public Accounts implemented its Advanced Database System employing data from multiple sources, advanced data analytical capabilities, and faster querying and reporting. The initiative triggered \$1.2 billion in additional revenue collections over 13 years.

Alternative 22: Additional Audit Programs

Most studies suggest that additional audit staff is cost effective, both in finding additional tax revenue and in spurring additional voluntary compliance.¹³⁶

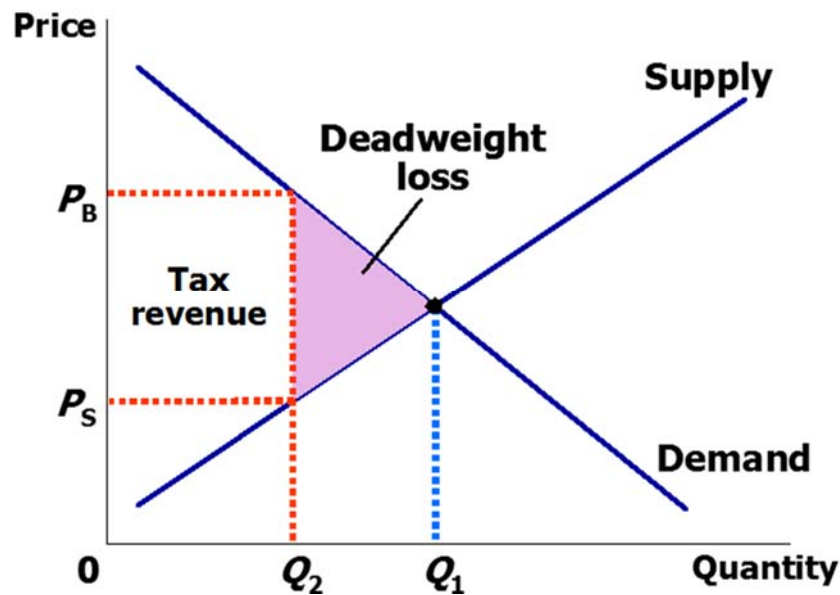
- The Missouri Department of Revenue improved its various operating systems to focus on accurate reporting, better case management and more effective audit targeting. Over seven years the strategy has netted 500,000 discovery leads and \$375 million in additional revenue.
- The New Jersey Division of Taxation implemented an enterprise data warehouse and an enhanced tax compliance system to boost compliance and generate more useful audit leads. The effort has generated \$350 million in revenue over 6 years.

Economic Impacts

There is general agreement among economists that taxes have a dampening effect on an overall economy. This is logical, as taxes increase costs of consumption or reduce disposable income that could benefit individuals or businesses. Basic principles of supply and demand show that the increased cost of goods and services because of added tax will generally reduce the amount of goods or services that are purchased and consumed. This dampening effect, known as the 'deadweight loss' from taxation is demonstrated in the following diagram:

¹³⁵ Bloomberg BNA. State Tax Directors Focus on Fraud, Economic Substance and Closing Tax Gap. March 13, 2014. Available at <https://www.bna.com/state-tax-directors-n17179882909/>

¹³⁶ Ibid.



The question of ‘who pays’ for the deadweight loss is a good one, and it largely depends on the elasticity of demand for the specific good or service being taxed. Where demand is relatively elastic (meaning the amount consumed is highly dependent on the price, the seller may bear more of the burden; while if the demand is relatively inelastic (meaning the amount consumed is not as dependent on price), the purchaser is likely to bear more of the burden.

Determining the economic impacts of tax changes is an inexact science, and there are a variety of factors to consider, which may vary depending on the performance of the economy as a whole – and specific industries within it – at different points in time. It will also depend on demographic and socio-economic factors, federal and international factors and a wide range of other exogenous variables.

Given the complexity of the issues to consider, the following analysis touches on some of the key topics to consider and weighs those factors in relationship to broad categories of taxes. Issues where a specific tax within a category may have specific impacts will also be addressed.

Taxes on Consumption versus Income

One of the notable areas of discussion and debate in taxation concerns the question of the economic impact of consumption versus income taxes. This is far from a settled topic, and the following presents both sides of the argument.

Those who argue that income taxes are preferred to taxes on consumption generally make the following points:

- It better aligns with ability to pay;
- In most states, it is a progressive system and thus more equitable, which means that those with more income are paying a larger percentage of their income as taxes (although specific features, like deductions, exemptions and credits can alter this);



- Its use by the federal government provides some compliance opportunities.

Those who argue that consumption taxes are preferred generally make the following points:

- Income tax creates market distortions, because it taxes savings, which reduces capital that can be used for investment and economic opportunity;
- Taxing income (in a progressive system) reduces the incentive to work more/for higher wages;
- It is fair to base taxes on what is consumed, which ensures that all pay taxes (although regressivity is an issue).

In fact, most states combine income and consumption taxes, in part to balance out concerns of each other. As noted in the discussion of tax burden, the Hawaii major income and consumption taxes create a sort of balance, with the GET having a larger effect on lower income taxpayers and the IIT having a larger effect on higher income taxpayers.

There are also considerations about how each performs at differing points in the business cycle. In recent years, individual income tax structures at the state level have demonstrated increasing volatility, with large gains during the peaks of the business cycle but significant declines around the downturn. By contrast, consumption taxes tend to have fewer 'peaks and valleys' – particularly when they have a broad base. While many states exempt food, prescription drugs and (less frequently) clothing and utilities from tax, Hawaii only exempts prescription drugs off these four from the GET. This helps to maintain collections but can also be seen as a regressive feature of the tax.

Of late, there has tended to be a move among states toward a more consumption-based tax structure.¹³⁷ Some of this trend may be political, and it is not uniform. In fact, as state revenues enter periods of weaker collections, some of these trends have changed in the past.

Business Taxes

While some commentators focus on corporate income taxes as the benchmark for business taxes, that is too narrow a measure of the taxes paid by business. In Hawaii, it has already been noted that the GET is different than most state sales taxes, as it is a form of business gross receipts tax that covers a wide range of goods and services, including many business-to-business activities. Businesses also pay property taxes and some excise taxes (such as motor fuel).

According to an annual study by the Council on State Taxation (COST), in FY2015, for the nation as a whole, business tax revenue accounted for 44.1 percent of all state and local tax revenue. That study (which is done annually, with the latest released in December 2016) determined that the business share has been within one percentage point of 45 percent since FY2003.¹³⁸ According to that survey, Hawaii fared very well in changes in business taxes between FY2014 and FY2015, being fifth lowest, with a percentage decrease in business taxes of 0.9 percent. Hawaii's business taxes under their calculations totaled \$3.7 billion.

¹³⁷ Joe Eleniewski, Doug Nagode and James P. Trebby, "Trends in State Taxation: Consumption Tax Versus Income Tax," Deloitte, Winter 2014.

¹³⁸ "Total State and Local Business Taxes: State-by-state estimates for fiscal year 2015," Council on State Taxation, December 2016, accessed electronically at <http://cost.org/WorkArea/DownloadAsset.aspx?id=94697>



The Tax Foundation also does an annual state business tax climate index. It provides an overall rank as well as ranks for corporate tax, individual income tax, sales tax, unemployment tax and property tax. Based on its formula, for the 2017 rankings, Hawaii placed 26th. The following provides its ranking for each category (lower is better):¹³⁹

| Overall Rank | Corporate Tax | Individual Income Tax | Sales Tax (GET) | Unemployment Insurance Tax | Property Tax |
|--------------|---------------|-----------------------|-----------------|----------------------------|--------------|
| 26 | 11 | 31 | 23 | 24 | 17 |

In its comments on 'notable ranking changes in this year's index' they note that the expiration of the temporary individual income tax increases resulted in the elimination of the top three individual income tax brackets and the lowering of the top marginal rate from 11.0 to 8.25 percent. They indicate that these changes moved the state from 37th to 31st on the individual income tax rankings and from 30th to 26th overall. Given that these rates have now been put back into effect, it is likely that the State's ranking on this composite index will again go down.

Property Taxes

As has been pointed out through the report, Hawaii's property tax system is unique among the states, and its property tax burden under nearly any measure or study is among the lowest. The tax burden analysis done by the District of Columbia found Honolulu property taxes to be among the lowest on most measures among the largest cities in each of the 50 states. Another commonly cited comparison, by the Lincoln Institute of Land Policy and the Minnesota Center for Fiscal Excellence, reached similar findings. In its annual 50-State Property Tax Comparison Study (for taxes paid in 2016), it found that Honolulu had the lowest effective property tax rate (calculated as tax bill as a percent of property value) on a median valued home in the country. It found that the commercial properties effective tax rate was the third lowest and industrial property the second lowest.¹⁴⁰

Property taxes are an important consideration for many types of businesses and, in some areas of the country, can be an impediment to economic activity. However, it is unlikely that any of the changes contemplated here will have a material impact on economic activity as a whole.

General Excise Taxes

It is often noted that broad-based consumption taxes are preferred by the general public to other major taxes (such as income and property taxes), because the tax is paid in a series of nearly ubiquitous small transactions throughout the year. This generally supports the belief that small changes in these taxes will not have a material impact on collections and consumption. At the same time, even small increases can, on large purchases, change either the decision to consume or how to purchase a good or service. Even on small purchases, there is only so much disposable income, and as broad tax rates go up, some other consumption will likely have to go down.

Many studies of sales taxes have found that a one percent increase in the rate can result in a 1-5 percent reduction in generated revenue as a percent of tax. Not all of this is necessarily reduced consumption, as some relates to cross border (or e-commerce) competition for purchases.

¹³⁹ Jared Walczak, Scott Drenkard and Joseph Henchman, "2017 State Business Tax Climate Index," Tax Foundation, 2017.

¹⁴⁰ "50-State Property Tax Comparison Study, for taxes paid in 2016," Lincoln Institute of Land Policy and the Minnesota Center for Fiscal Excellence, May 2017.



Excise Taxes

Excise taxes are often the ‘overlooked’ area of taxation in terms of economic impact. While general consumption taxes often have a broad base and a narrow rate, excise taxes are in many respects their mirror image: the base is limited to a specific good or service, and, as a result, the rate is often considerably higher. The prime example of this are cigarette and tobacco taxes. These taxes have been increasing rapidly for over a decade – in nearly every state and region of the country (even tobacco growing states).

The State of Hawaii is a good example. Hawaii’s current tax rate is \$3.20 per pack of cigarettes. According to one national website that surveys cigarette prices, a pack of Marlboro Red (which is the nation’s largest selling brand, according to the Centers for Disease Control) in Hawaii currently sells for approximately \$2.80 a pack – meaning the tax is well over 100 percent of the retail price. By contrast, the State’s GET is a fraction of that.

As previously noted, taxes increase the cost of purchasing a good or service and will (depending on the elasticity of demand) reduce the amount that is purchased and consumed. Given the significant increase in cost because of some excise taxes, this must be factored into the economic impact of excise tax increases.

Tax Competitiveness

There is a long-standing debate as to how taxes impact on overall economic activity – particularly around location decisions by business and individuals. The spectrum of (learned) opinion runs from the perspective that taxes have little or no impact on these decisions, to it having significant impact. The following details the arguments and at least some of the support for those viewpoints:

- **Tax Changes Have Not Been Shown to Significantly Impact Growth.** Three prominent economists, building on past research, found that “the effects of state tax policy on economic growth, entrepreneurship, and employment remain controversial. Using a framework that in prior research generated significant, negative, and robust effects of taxes on growth, we find that neither tax revenues nor top income tax rates bear stable relationships to economic growth or employment across states and over time. While the rate of firm formation is negatively affected by top income tax rates, the effects are small in economic terms.”¹⁴¹
- **Tax Changes Have Some Impact on Location Decisions, but they are Generally Outweighed by Other Factors.** There are more important considerations for business location, including readily available skilled workforce, transportation and logistics. Taxes are still a small component of overall business costs.¹⁴²
- **The Impact of Taxes Varies Depending on Locations and Points in Time and May or May Not be Significant.** A variety of studies have explored the differing impacts of taxes based on specific surrounding events and circumstances. For example, one study found that the effects of taxation on growth are highly non-linear. Marginal increases in tax rates have a small growth impact when tax rates are low or moderate. When tax rates are high, further tax hikes have a large, negative impact on growth performance.¹⁴³ Another study compared effects of changes in taxation during the decades of the

¹⁴¹ William G. Gale, Aaron Krupkin, and Kim Rueben, “The Relationship Between Taxes and Growth at the State Level: New Evidence,” National Tax Journal, December 2015, accessed electronically at <https://www.urban.org/sites/default/files/publication/79601/2000711-The-Relationship-Between-Taxes-and-Growth-at-the-State-Level-New-Evidence.pdf>

¹⁴² “State and Local Business Taxes are Not Significant Determinants of Growth,” [gradingstates.org](https://www.gradingstates.org/the-problem-with-tax-cutting-as-economic-policy/state-and-local-business-taxes-are-not-significant-determinants-of-growth/?print=pdf), accessed electronically at <https://www.gradingstates.org/the-problem-with-tax-cutting-as-economic-policy/state-and-local-business-taxes-are-not-significant-determinants-of-growth/?print=pdf>

¹⁴³ Nir Jaimovich and Sergio Rebelo, “Non-linear Tax Effects on Growth,” National Bureau of Economic Research, October 2012.



1970s and 1980s and found that while there was substantial connection between state and local fiscal policy and employment and personal income in the 1970s, that relationship did not exist in the 1980s.¹⁴⁴

- **There is Evidence of Location Decisions within Regions for both Businesses and Individuals.** One study examined how differences in state income tax rates, as well as other state and local taxes and public service expenditures, influence the choice of state of residence for households moving into multistate metropolitan statistical areas (MSA). After controlling for other factors believed to affect household location, it found that differences in state income tax rates have a statistically significant impact on the probability a household locates in the low tax state within an MSA.¹⁴⁵ Another recent study, concerning high income 'star scientist' location decisions determined that there were 'large stable' changes in personal and business tax differentials across states based on differing tax rates. These estimated effects of personal and corporate taxes on star scientists' migration patterns suggest that, on the margin, taxes matter.¹⁴⁶
- **Taxes Matter and Have Always Mattered.** This perspective is underscored by a meta-review by Richard Vedder that has appeared in multiple locations discussing government growth and taxes.¹⁴⁷

As with many public policy discussions and debates, it is likely that the 'truth of the matter' lies somewhat within each of these perspectives. It is possible to have some agreement with many of the studies, which are generally not mutually exclusive. It will be necessary to analyze specific alternatives in consideration of the unique characteristics (or shared similarities) with other states.

Market Efficiency

Markets do not always act efficiently, and the market price of products may not consider some of the external negative impacts of the production of a particular good or services. A class of taxes, known as Pigovian taxes, seek to correct for this inefficiency. Generally, these taxes are to be set to recover the negative externalities associated with the activity, although this may be hard to exactly determine.

Examples of Pigovian taxes are carbon taxes, which seek to account for pollution generated by manufacturing or other activities that consume carbon-based fuels; cigarette taxes, which seek to recoup the social costs incurred because of smoking; or rental car taxes, which seek to account for the costs of congestion. While taxes are often viewed as barriers to efficiency, they may also assist in creating more efficient markets.

Tax Issues Specific to Hawaii

While it is mentioned to the point of repetitiveness, Hawaii's relatively isolated location compared to the mainland states is a significant factor in discussing its tax structure. Most notably, the issues around cross border competition that surround discussions of consumption taxes are dramatically mitigated. The evidence is clear – from studies of multiple goods and services and multiple border cities – that tax rates will factor into decisions about where to consume for many people.¹⁴⁸ Those decisions and concerns are largely absent for

¹⁴⁴ Robert Carroll and Michael Wasylenko, "Do State Business Climates Matter: Evidence of a Structural Change," *National Tax Journal*, March 1994.

¹⁴⁵ Ken Stanford and William Hoyt, "Is the Grass Greener on the Other Side of the River: The Choice of Where to Work and Where to Live for Movers," November 2007.

¹⁴⁶ Enrico Moretti and Daniel J. Wilson, "The Effect of State Taxes on the Geographical Location of Top Earners: Evidence from Star Scientists," *American Economic Review* 2017.

¹⁴⁷ Richard Vedder, "Grinding to a Halt: Ohio's Tax Policy and its Impact on Growth," Buckeye Institute for Public Policy Solutions, 2002.

¹⁴⁸ See for example Walsh, M. and J. Jones (1988) "More Evidence on the 'Border Tax' Effect: the Case of West Virginia," *National Tax Journal*, Vol. 14, pp. 362-374; F. Steb Hipple, "Retail Sales and Sales Tax Losses from Tennessee to Virginia in the Tri-states Metropolitan Area 1996 and 2003," State of Tennessee Tax Structure Study Commission, November 6, 2003; Rossitza Wooster and



Hawaii. Yes, it is possible that some visitors will ‘stock up’ on cigarettes or other items before coming to Hawaii, but in general, that tax avoidance will be small.

The same, of course, can be noted about studies that find border or regional competition for ‘star scientists’ or businesses. In some locations, the choice of a state or city with a widely different tax base may be the decision to move across the street (situations that exist in both Bristol Tennessee and Bristol Virginia and Kansas City Missouri and Kansas City Kansas), a decision to locate to or from Hawaii from another state is a much more impactful decision – in terms of time and effort. Given that many businesses locate in a particular area to be close to customers, a resource base or for logistical reasons, it is also likely that Hawaii will be far less impacted by regional competition issues than nearly any other state.

Hawaii is also unique in other respects. It is by far the most diverse state in the country, with the smallest percent of population that describes itself as Caucasian, the largest percentage that is Asian, the largest percentage that describes as Hawaiian or Pacific Islander, and the largest percentage that describes as of one or more races.¹⁴⁹

Hawaii also has an industry and employment structure that is quite different from many other states. For example, the largest sector for employment and wages is government – federal, state and local combined. At the other end of the spectrum, manufacturing is a relatively small component. While the tourism industry is a large employer, it is not as large for overall wages, which suggests that average wages lag other sectors. The following identifies the key sectors for Hawaii, both in terms of percentage of total employment and total wages.¹⁵⁰

| Sector | Employment % | Total Wages % |
|-------------------------------------|--------------|---------------|
| Government | 19.3 | 23.6 |
| Accommodations and Services | 16.1 | 10.6 |
| Retail Trade | 11.1 | 7.2 |
| Health Care and Social Services | 10.5 | 11.5 |
| Administrative and Waste Services | 7.9 | 5.6 |
| Construction | 5.4 | 8.2 |
| Transportation and Warehousing | 4.2 | 4.5 |
| Other Services | 4.0 | 2.8 |
| Professional and Technical Services | 3.8 | 5.7 |
| Wholesale Trade | 2.8 | 3.4 |
| Finance and Insurance | 2.4 | 3.5 |
| Manufacturing | 2.2 | 2.0 |
| Educational Services | 2.1 | 1.8 |
| Real Estate, Rentals and Leasing | 1.9 | 2.0 |
| Arts, Entertainment and Recreation | 1.8 | 1.1 |
| All Others | 3.8 | 6.5 |

Joshua Lehner, “Reexamining the Border Tax Effect: A Case Study of Washington State” September 2008; Patrick Fleenor, “How Excise Tax Differentials Affect Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States,” The Tax Foundation, Background Paper No. 26, October 1998; Mark D. Manuszak and Charles C. Maul, “How Far For a Buck? Tax Differences and the Location of Retail Gasoline Activity in Southeast Chicagoland,” January 26, 2009.

¹⁴⁹ The Kaiser Family Foundation, Population Characteristics by Race and Ethnicity, accessed electronically at <https://www.kff.org/other/state-indicator/distribution-by-raceethnicity/?currentTimeframe=0&sortModel=%7B%22colId%22:%22Location%22,%22sort%22:%22asc%22%7D>

¹⁵⁰ State of Hawaii Data Book, Table 12.28, Employment and Wages by NAICS Industry, 2015



This table also demonstrates the fact that the tourism industry is wide-ranging and includes at least parts of the Accommodations and Services, Real Estate, Rentals and Leasing and Arts, Entertainment and Recreation sectors. Of course, these sectors combined have a larger percentage of employment than wages, which is a factor in terms of economic performance for the State.

Hawaii Tax Considerations

Based on the preceding, the project team would note the following about the considerations of tax economic consequences:

1. It is important to consider Hawaii's unique factors relating to location;
2. The tourism industry is important for employment and exporting tax burden but does not, on average, contribute to growing wages for the State;
3. Specific issues are likely more important than generalities for economic impact;
4. All taxes have a dampening effect on economic activity, and if additional revenue has to be raised, this is the trade-off;
5. Some taxes may contribute to market efficiency.

Based on these, the following are comments related to specific tax categories:

- **GET mirrors the trend of increasing use of consumption taxes.** While the GET is broader than traditional state sales taxes and creates some pyramiding effects, it is a stable revenue source, and its regressive nature has been ameliorated with the individual income tax. Given the continued dedication of a portion to the Oahu rail project, it is difficult to see an additional increase in the near future, but it remains the most viable option of the existing major taxes for a small increase that will likely not significantly impact on economic activity.
- **The individual income tax has recently been increased, and it would be difficult to do so again without some negative consequences.** It is a useful counterpoint to the GET in terms of progressivity, but it is also amongst the highest top rates in the country, and the rates accelerate at relatively low income levels. The use of additional refundable credits or an increase in the standard deduction would benefit lower-income residents and likely return a portion of the foregone revenue as additional GET and excise tax receipts.
- **Excise taxes are a case-by-case determination.** The dedication of additional TAT to the rail project is reasonable, but it also puts the State at the high end (and in double digits) for similar accommodations taxes in other states. Other excise taxes, however, are more incidental – including cigarettes, alcohol, rental cars, etc. Given the portion exported and the fact that they have some positive effect on reducing use or consumption (particularly related to cigarettes), they appear on balance to be worth considering and should not lead to significant reductions in consumption.
- **Suggested new taxes can also improve market efficiency.** A tax on sugary beverages falls into the category of existing excise taxes that may help reduce consumption with positive externalities. The carbon tax has the potential to be a broad-based tax with significant positive environmental impacts.



While there may be concerns about regressivity, some may spur behavior changes (such as increased use of public transportation or alternative generation of electricity) that will, in the long run, reduce the magnitude of the tax. As with other taxes, it can be structured to provide other credits or exemptions to deal with impacts on lower income residents.

- **Property taxes are extremely low compared to other states.** While some of this relates to high market value, even amongst other expensive markets, Hawaii is consistently at the bottom of these rankings. It makes sense to look for ways to rebalance the system to offset some of the higher burdens of other taxes. Given the extremely low rates relative to other locations, these should not be generally burdensome to the State economy.

Summary

Taxation Principles

When discussing tax alternatives, it is important to develop a form of taxonomy for assessing and weighing them individually and as part of a collective tax structure. In analyzing these alternatives, some specific principles have been relied upon as guideposts. These include:

1. **The system should minimize interference by taxes in market decisions**
2. **The system should be reliable, stable, and sufficient**
3. **The system should be simple, allow for compliance, and ease of administration**
4. **The system should be equitable**
5. **The system should have a balanced variety of sources/broad base**

While these are all useful policy goals, their relative importance will vary based on a number of factors. A tax cannot be viewed in a vacuum, and the same applies to any particular tax principle. Of these five, the last, related to a balanced variety of sources and bases, is a pragmatic approach to tax policy but may also collide with other more 'principled' approaches to taxation. As have been noted, a broad tax base may create a reliable structure that, because of regressivity issues for consumption taxes, is not particularly equitable.

Revenue Approaches

In general, there are four ways to raise additional tax revenue. Each has advantages and disadvantages that require specific analysis:

1. **Create a new tax**
2. **Expand the base of an existing tax**
3. **Increase the rate of an existing tax**
4. **Increase taxpayer compliance with an existing tax**

Each of these strategies can be applied to different types of taxes based on consumption, income or wealth. The following identify the key types of taxes and alternatives.



Revenue Alternatives

- **Miscellaneous Excise Taxes.**
 1. Increase cigarette and tobacco tax rates.
 2. Increase alcohol gallonage tax rates
 3. Restore the surcharge on rental cars
 4. Institute a tax on sugary beverages
 5. Tax medical marijuana
 6. Institute a carbon tax
 7. Institute a vapor/e-cigarette tax
- **Transient Accommodation Taxes.** These are also technically excise taxes, but given the variations (and their importance as an exporting tax burden source) they are presented separately.
 8. Increase TAT and TOT rates
 9. Collect TAT o resort fees
 10. Impose TAT on alternative accommodation rentals
- **GET.**
 11. Increase the GET rate by 0.5 percent
- **Income Taxes**
 12. Move to a single 9 percent corporate net income tax rate
 13. Increase corporate net income taxes by 50 percent
 14. Increase corporate net capital gains rate to 5 percent
 15. Reduce the IIT pension exemption to \$25,000
 16. Reduce the IIT foreign pension exemption to \$25,000
 17. Implement an IIT rate recapture for taxpayers in the top bracket
- **Property Taxes**
 18. Eliminate the IIT deduction for property taxes paid (could be considered an income tax change)
 19. Shift certain K-12 education expenses to property taxes
- **Compliance Alternatives**
 20. Expand efforts to incent e-commerce collection of the GET
 21. Develop a tax gap program
 22. Develop additional audit programs and staff

It is notable that some of the alternatives analyzed for the 2012 TRC report were not considered (or recommended) for this study. In those instances, it was the project team's belief that circumstances had changed or other specific considerations made them less attractive than last time.

It should also be understood that some of the draft analysis was modified (primarily related to the TAT) based on actions taken by the Legislature and Governor in late August and September related to additional funding for the rail project on Oahu.



Economic Impacts

It is generally understood that all taxes will have a dampening effect on economic activity. While there is significant discussion and debate about what is the better form of tax and/or tax structure related to the economy, there is little general agreement.

In fact, it is likely that there is some truth to multiple perspectives related to the impact of taxation on the economy, and it will vary by industry, by location and over time. There are some unique characteristics of Hawaii – particularly its location away from the mainland states – that make parts of the discussion around state competition moot.

In general, the taxes that were considered by the project team were done so with a view on overall competitiveness. It is unlikely that any single tax alternative will have a dramatic impact on the economy as a whole, although isolated impacts will always be felt. In the long run, maintaining a balanced structure as a whole will likely be in the State's economic best interest.



Observations and Optimal Revenue Alternatives



The preceding discussion has identified some key funding challenges facing the State in coming years. In fact, the project team was specifically charged with studying the funding needs associated with retiree health care and pension obligations and providing revenue alternatives related to closing any potential funding gaps. Within the Possible Revenue Alternatives chapter, several alternatives are analyzed that, in the project team's opinion, are less suitable choices than others. As a result, this chapter provides the project team's suggestion for optimal revenue alternatives, should the Commission choose to recommend additional changes to the tax structure that raise revenue.

The project team has also identified issues related to changes in federal funding, the economy in general (or some of its component parts, such as tourism), and a general slowdown in state revenue collections across the U.S. These are all reasons for the State to consider possible augmentations to its current revenue structure.

At the same time, the project team – based on its experience in state government and as subject matter experts – believes that there is an additional ‘case for change’ related to multiple areas of the State revenue structure. This follows not only from the discussion about challenges facing the State, but also related to opportunities to create a more balanced and equitable tax structure and, in some instances, advance other tax and economic policy considerations. The following provide key observations related to this study for the 2017 TRC. While the project team provides some guidance on choices, they should be understood to be ‘best options’ for the State policymakers to consider should they seek a revenue solution for any of the issues identified within the report.

Future Concerns Related to Revenue Sufficiency

While the current study did not go to the lengths of the 2012 TRC study to determine whether future revenue would be sufficient to cover on-going expenses, it is likely that, based on current forecasts and likely events, the State will have to generate additional revenue to meet its ongoing requirements related to fully funding the annual required contributions to the Employer-Union Benefits Trust Fund. The existing estimated prefunding requirement for 2019, the year in which Act 268 (2013) requires full funding, is \$375.2 million. While the State has made progress in working down this funding requirement, it is difficult to construct a logical set of circumstances where that level of funding can be attained without a new source (or sources) of revenue or significant reductions in current levels of spending. Of course, spending reductions are beyond the scope of this study.

The following existing conditions, both in Hawaii and among the states (and their relationship with the federal government) all suggest that states are more likely to be confronting additional revenue needs than finding ways to spend (or cut taxes) because of unexpected revenue gains. These conditions include:

- **Length of the Current Business Cycle.** The current expansion phase of the business cycle began more than 8 years ago. The average expansion cycle in modern history (1945 to 2009) has been 58.4 months.¹⁵¹ While economic forecasters are not generally predicting an impending recession, it is only a matter of time before there is another contraction. When that occurs, it will be even more difficult for the State to meet this obligation.
- **Likely Reductions in Federal Support.** The current administration's budget and policy recommendations are unlikely to make it easier for state governments to balance their budgets – let

¹⁵¹ National Bureau of Economic Research, “US Business Cycle Expansions and Contractions.” Available at http://www.nber.org/cycles/US_Business_Cycle_Expansions_and_Contractions_20120423.pdf



alone identify existing revenue to dedicate to additional long-term needs. Proposed health care changes (particularly cuts in funding for Medicaid) would put significant pressure on the states to maintain current levels of service. Other actions, including travel and other restrictions, are also likely to create problems for key Hawaii industries, including tourism.

- **Long-term Budget Concerns.** The General Accountability Office (GAO) maintains a model of U.S. state and local governments. Its most recent update to that model, in December 2016, indicated that the state and local government sector continues to face fiscal challenges which contribute to the nation's overall fiscal challenges. GAO's simulations suggest that the sector could continue to face a gap between revenue and spending during the next 44 years. The simulation assumes that the tax structure is unchanged in the future and that the provision of real government services per capita remains relatively constant.
- **Forecast Moderate State Growth Rates.** While Hawaii has experienced moderate growth over the past five years, current Council on Revenues forecasts suggest this level of growth will continue (but need increase significantly) in the years of their prediction. That level of growth will not provide sufficient funding to make a new funding commitment of the size necessary to meet the requirement of Act 268.

Given this set of circumstances, it makes sense for the TRC to consider options and opportunities to expand State revenues. At the same time, it is also an opportune time to seek to not only expand revenue but do so in a way that aligns with good tax policy. The project team will, where appropriate, explain the rationale for alternatives to create new revenue in relationship with changes that advance other public policy interests as well.

Framework for Weighing Alternatives

During its work on this and the 2012 TRC report, the project team considered dozens of alternative approaches to raising revenue. In the end, many were rejected – both early in the process and later, after considerable research and analysis. In general, the approach for determining the options that would become optimal alternatives consisted of determining their adherence to important tax or public policy considerations and gauging their potential to raise (and continue to generate) state revenue.

Jean Baptiste-Colbert famously noted that “the art of taxation consists in so plucking the goose as to procure the largest quantity of feathers with the least possible amount of hissing.” Besides adherence to tax and public policy principles (and raising revenue), some consideration is also given to those tax policy issues that cannot attract sufficient public support to become viable policies. In that respect, one recommendation from 2012, increasing the rate of the GET, is not recommended by the project team. While this rate increase would generate significant revenue (some of which could be used to offset regressive effects on lower-income Hawaii residents), the general belief of policymakers and other key stakeholders is that the current (relatively) low rate is advantageous to the State. Given that it also generally aligns with the oft-quoted tax policy preference for a tax with a broad base and a low rate, the project team acknowledges that this change is something of a non-starter.

Hawaii state statute suggests that the TRC pay attention to the principles of equity and efficiency in its deliberations. The current TRC's interest in identifying the existing tax burden, determining how much of the current taxes is exported to non-residents and identifying ways to reduce system regressivity suggests that equity is, indeed, an important consideration. Where possible, the project team has used these principles in its determination of what tax changes to recommend. At the same time, the need for additional revenue also



makes this analysis tricky – as most every tax will have some negative impacts – the ‘deadweight loss’ associated with taxation aligns with the concept that there is no such thing as a perfect tax.

Tax Structure Optimal Alternatives

Methods to Reduce Regressivity in Certain Taxes

Multiple sources have identified Hawaii’s tax structure as regressive – a key equity concern. In particular, the broad reach of the GET is an area of concern. While the GET is a cornerstone of the current (and envisioned) tax structure, there are opportunities to reduce some of its regressive features, particularly by changes to the IIT. The following would address regressive aspects of the two largest sources of General Fund revenue.

- **Increase the Standard Deduction for IIT to \$7,500 for single filers, \$15,000 for married and \$10,950 for head of household filers.** The State’s IIT brackets begin at 1.4 percent on the first \$2,400 of taxable income but rise quickly at fairly low levels of taxable income. For example, a single filer will pay a tax of 6.8 percent for taxable income over \$14,400 – an amount of income that is below the federal poverty level. For low income IIT filers (who do not typically itemize deductions), the standard deduction can be used to offset tax liability – while higher income filers will typically itemize anyway. These changes would move the State’s current standard deduction, which is in the lower range of all states, to among the leaders among all states, about equal with New York and trailing Connecticut and Wisconsin. It is notable that many other states with progressive individual income taxes do not reach a similar tax rate until much higher income levels. These include:
 - Arkansas, 6.9 percent at \$35,101
 - California, 6.0 percent at \$30,000
 - Connecticut, 6.9 percent at \$200,001
 - Delaware, 6.6 percent at \$60,001
 - Iowa, 6.8 percent at \$31,461
 - Nebraska, 6.84 percent at \$29,831
 - New Jersey, 6.37 percent at \$75,001
 - New York, 6.85 percent at \$215,401
 - Vermont, 6.8 percent at \$37,951
 - West Virginia, 6.5 percent at \$60,001

This would address several policy issues. First, it helps address issues of vertical equity. Second, it ameliorates any concerns that eliminating the deduction for property taxes will negatively impact lower income individuals. Finally, it is one method for addressing concerns about the regressive nature of the GET. Using the PFM model, it is estimated that the first year reduction in revenue associated with this increased standard deduction would be \$61.0 million.

- **Double the refundable Food/Excise Tax IIT credit.** The application of the GET to food has both positive and negative impacts. On the positive side, it helps to broaden the tax base and makes it more reliable during economic downturns. On the negative side, it makes the tax structure more regressive, as lower income cohorts generally spend a greater share of their income on food than higher income cohorts.

Hawaii currently provides a refundable IIT credit based on income, ranging from \$35 per qualified exemption for those with AGI of \$40,000 to \$50,000 to \$110 for those with AGI under \$5,000. The following is the current credit at various income levels:



| <u>Adjusted Gross Income</u> | <u>Tax Credit per Qualified Exemption</u> |
|------------------------------|---|
| Under \$5,000 | \$110 |
| \$5,000 under \$10,000 | \$100 |
| \$10,000 under \$15,000 | \$85 |
| \$15,000 under \$20,000 | \$70 |
| \$20,000 under \$30,000 | \$55 |
| \$30,000 under \$40,000 | \$45 |
| \$40,000 under \$50,000 | \$35 |
| \$50,000 and over | \$0 |

As an example, a qualified family of four with an AGI of \$20,000 would currently receive an IIT credit of \$220. It is notable that, using income shares for similar families around the country, a family with income before taxes of \$25,000 would spend approximately 13.7 percent of their income on food. This would equate to approximately \$3,425 – and the 4.0 percent GET would total \$137.216.

In tax year 2014, residents claimed a total of \$27.7 million in refundable Food/Excise Tax IIT credits.¹⁵² Because the credit is associated with low income, the project team used the number of residents below the poverty level as a proxy for future credits paid. Between 2010 and 2015, the number of Hawaii residents living in poverty decreased by a CAGR of 2.1 percent.¹⁵³ Therefore, it is estimated that doubling the amount of the credit would result in an additional reduction in revenues equal to \$25 million in 2018, decreasing to \$23 million by 2023.

Methods to Export a Share of the Tax Burden to Non-residents

Given its destination location and home to thousands of federal civilian and military personnel, the State has an opportunity to export a significant portion of its tax burden. The following optimal alternatives address this approach.

- **Increase cigarette and tobacco tax rates (Alternative 1).** The State's cigarette tax is already among the highest rates in the country. According to the FTA, Hawaii's rate, at \$3.20 per pack, is the fifth highest among the 50 states. Hawaii has a history of raising this tax on a regular basis, and the basis for doing so is understandable. First, Hawaii's island location makes it relatively immune from issues of cross-border competition – those who wish to smoke cigarettes in the State have fewer options than in other states for obtaining lower priced cigarettes. Second, there is a logical basis for increased tax rates for cigarettes. While the tax rate is high, the calculations of the negative societal impacts from cigarette smoking suggest that tax increases are justified. According to the Center for Disease Control (CDC), the health and other societal costs associated with consumption of a pack of cigarettes sold in Hawaii is \$10.81, while state and federal taxes per pack total \$4.21. Finally, raising the tax has the added benefit of generally reducing smoking for key target populations, such as children. The CDC argues that increasing the price of cigarettes reduces demand and reduces cigarette use in the United States overall, particularly among youths and young adults.

It has generally been concluded that the cigarette tax is a regressive tax. At the same time, research suggests that higher taxes also encourage lower income individuals to stop smoking – which has a large

¹⁵² Department of Taxation, Tax Credits Claimed by Hawaii Taxpayers, Tax Year 2014.

¹⁵³ US Census Bureau American Community Survey 1-Year Estimates



health and economic benefit in the long run. In general, increases in this and other excise taxes also help to maintain a sufficiently broad tax base that also exports a share of that burden to non-residents.

- **Increase gallonage taxes on beer, wine and distilled spirits (Alternative 2).** Current taxes for beer, wine and distilled spirits are generally among the higher state taxes in the nation. The current tax on beer, \$0.93 a gallon, is the second highest among the states, trailing only Alaska and well above the median rate of \$0.20. The tax on distilled spirits, \$5.98 a gallon, is seventh highest among the 31 states that impose a gallonage tax – and well above the median of \$3.75 a gallon. Finally, the tax on wine, \$1.38 a gallon, is the eighth highest of the 48 states that impose a gallonage tax – again, well above the median of \$0.72 a gallon.

While these tax rates are comparatively high, similar arguments can be made for a moderate increase in these taxes as for the cigarette and tobacco tax: there are health and other positive externalities associated with reduced consumption, and there is little real risk of cross border competition. In this respect, it is notable that the one state that has a higher excise tax on all three categories (beer, wine and distilled spirits) is Alaska – the other U.S. state with little concern for cross border competition.

During discussions with the Department of Taxation, their regression analysis suggests a connection between performance of the leisure and hospitality industry and General Fund revenue performance from these excise taxes; this suggests that a significant portion of the tax is exported.

Among other tax principles, while it is often argued that these excise taxes are generally regressive, the BLS purchasing shares data does not support this. According to that data, alcohol purchases for all consumers totaled 0.9 percent of income; at the lower income levels the share of income devoted to alcohol purchases was actually lower (between 0.6 and 0.7 percent at income levels between \$5,000 and \$29,999), while levels above \$30,000 were generally in the range of 0.8 to 0.9 percent.

The analysis built into the model's alternate revenue structure scenario would increase each of these taxes by approximately 15 percent.

- **Restore the surcharge on rental cars (Alternative 3).** As with the TAT, the State has raised this tax in the past to assist in closing budget gaps. In 2011, the State increased the rental motor vehicle surcharge tax from \$3.00 per day to \$7.50 per day from July 1, 2011 to June 30, 2012. The Legislation deposited a portion of the surcharge (\$4.50 per day) in the State's General Fund and suspended the rental motor vehicle customer facility charges for the period of July 1, 2011 to June 30, 2012.

The temporary \$7.50 per day surcharge expired on June 30, 2012 and reverted to the \$3.00 per day surcharge. The FY 2012 additional surcharge provided a one-year revenue increase of approximately \$61 million to the State's General Fund.

As with the TAT, it is evident that a considerable portion of this excise tax is exported. Restoring the tax to previous levels will also broaden the excise tax base. As with the TAT, there is also a case to be made that the State (and consumers) have experience with the tax – in line with the concept that 'an old tax is a good tax.'



Methods to Improve Economic Efficiency

While not specifically identified by the current TRC in the charge for this study, economic efficiency is an important system characteristic, and the statute that created the Tax Review Commission specifically identifies efficiency and equity as standard for analyzing the Hawaii tax structure. The following two recommended alternatives *may* further system regressivity, but the project team believes their advantages outweigh these concerns.

First, both are new forms of taxes with significant revenue-raising potential. Given the State's need to identify methods to fund ongoing commitments, they are worth consideration. Second, they both create mechanisms to further positive economic and/or social outcomes. Finally, some of the regressive effects from the taxes may be ameliorated by other changes in the tax structure or, more significantly, changes in behavior that will ultimately benefit the State.

- **Institute a Tax on Sugary Beverages (Alternative 4).** There is little doubt that obesity is a major public health concern in the U.S. Sugared non-alcoholic beverages (primarily soda but also other sweetened drinks) have been identified as a significant source of 'empty calories' that create a variety of negative health outcomes or risks.

There have been past attempts – including in various states about a decade ago – to use a tax on sugared beverages as a way of addressing these concerns. It is notable that some states with food exemptions from their general sales tax separate out candy as taxable, based on similar considerations and concerns.

More recently, a number of local governments have instituted this form of tax, generally at a rate of between one and two cents per ounce. While the taxes have proved controversial, they have provided an opportunity to observe the tax in action and generate studies on its efficacy. It is notable that one study, from its use in Berkeley, California, found positive outcomes in terms of individuals choosing non-sugared beverages – so that overall purchases didn't change, but what consumers purchased did. Of course, this can lead to a reduction in the tax revenue, but the health outcomes would likely still be positive.

From the project team's perspective, the tax should be structured to emphasize the positive health outcomes. Philadelphia primarily structured its similar tax as a revenue raising method – as a result, they tax no calorie soft drinks, which certainly creates mixed messages.

There have been reports of negative impacts in some cities related to cross-border competition. These issues are far less likely to be a major concern for Hawaii. Of course, some of the revenue raised will also be exported.

The project team did not recommend this tax in 2012. However, the experience with administration and implementation of the tax – and some studies on its impact – lead the project team to conclude that the tax is now worth consideration as an optimal revenue alternative. While the tax is considered regressive, sugared beverages are far from a necessity. There are (and probably will be even greater) options to avoid the tax by purchasing other non-taxed beverages. These options will also generally help improve health outcomes.

- **Institute a Carbon Tax (Alternative 6).** The State of Hawaii is rightly proud – and, from a tourism standpoint – concerned that it maintain its natural beauty and a healthy environment. The State has exhibited national leadership in this area for many years, as evidenced by its passage a decade ago of the Global Warming Solutions Act of 2007.



A current ‘market failure’ is the inability to factor in the negative impacts to the environment from a variety of activities, particularly the burning of fossil fuels in manufacturing, transportation and other activities (including heating and cooling homes and businesses). The carbon tax is one mechanism to correct that current imbalance.

Because the current economy is very dependent on carbon-based fuels, the tax has the potential to raise significant revenue. Of course, it can be structured in ways to vary that revenue effect. At the same time, the ultimate goal of the tax would be to either change behavior or provide a mechanism to recoup the costs associated with the activities that are harming the environment.

A carbon tax has been proposed in a number of states but, to date, not enacted in any of them. However, in many respects, Hawaii is the perfect state to be ‘first in the nation’ in enacting this tax. First, it does not face some of the concerns about cross-border effects (and inter-state commerce transportation issues) that have complicated its possible implementation and application in other states. Second, Hawaii’s dedication to maintaining its natural resources is long-standing and evident in a variety of areas. This complements those efforts.

There is no doubt that some of its application (such as increasing prices for motor fuels) would have regressive impacts – and, unlike the sugared beverages tax, some of these activities would be considered essential. Other aspects of a carbon tax, however, would have broader tax (and societal) impacts that would be shared by business and industry. From the project team’s perspective, this is a balancing decision where the positive impacts on efficiency (and the opportunity to raise needed revenue from a new revenue source) outweigh the negative effects.

Changes to Improve System Administration and Collection

In the long run, improved technology, processes and reporting can help increase compliance and advance data-driven policy outcomes. Further, many states are developing legislative strategies to induce greater voluntary collection of general sales taxes that could be used to do the same for the GET. The following can assist in advancing those efforts.

- **Develop tax gap systems to identify under-payment and non-payment of taxes (Alternative 21).** Many states have implemented sophisticated data warehouse systems that assist with identifying non-filers of tax returns and non-payers of taxes. These systems are often augmented with business intelligence software and servers. In many instances, vendors are willing to negotiate performance-based solutions, where the newly generated tax revenue is used to pay for the system. As an example, the State of Iowa entered into a three year partnership with a vendor to design, develop and implement a data warehouse solution in November 1999 and realized the first revenues from the program five months later. Within four years, the program had generated over \$71 million in new revenue. It appears that this type of initiative is contemplated once the current tax system implementation is completed.

In general, these approaches align with tax policy best practices – they seek to collect taxes that are rightly due to the State. Taxpayers who make the effort to pay the taxes they are lawfully required to pay should be supportive of these efforts. This can also build confidence in the system and, as compliance increases, heighten the awareness of non-compliant taxpayers that the State is likely to find them and seek payment and penalties.



- **Expand Efforts to Incent E-Commerce Collection of GET (Alternative 20).** Many states are aggressively pursuing methods to establish legal nexus (often through the standard known as economic nexus) or otherwise incent e-commerce providers without a physical presence in Hawaii to collect GET on Internet-based transactions with Hawaii residents. Efforts to establish legal 'economic nexus' usually focus on a dollar value of sales and/or transactions into the State as requiring the collection and remittance of general sales tax. The States of Alabama (which is enforcing its standard administratively) and South Dakota (which passed a law to establish its standard) are prominent in this effort. Alabama collected \$39.1 million in FY 2017 as a result of its program. South Dakota's law was immediately challenged in court (as has been the case in other states as well) and has been suspended until the legal challenge has been resolved. It is notable that South Dakota (a state without an income tax) has a particular interest in overturning Quill, and its legislation has been focused on being the test case to do so.

Perhaps the more promising approach is that undertaken by Colorado (and mimicked by other states). Rather than seeking to compel collection, Colorado focuses on requiring reporting for those selling into the State. The expectation is that the reporting requirements (to both the State and the purchaser) to the e-tailer would prove more burdensome than simply collecting the tax. The advantage of this approach is that it has already survived state and federal court challenges (with the U.S Supreme Court declining to review it).

The revenue potential is real – and the updated estimates from the NCSL are reflected. While there are real costs associated with administering these changes, the continued growth of this economic activity warrants action. While the project team did not recommend this in 2012, there has been sufficient activity among other states for the team to believe it now meets a cost-benefit analysis.

Methods to Expand the Tax Base

Expanding the base upon which taxes are applied helps to keep actual tax rates lower. This is important, because low rates generally have less impact on consumer choices and market efficiency. In some situations, base broadening may also support greater horizontal and vertical equity. The following tax changes are recommended and built into the model's 'reformed tax structure scenario.'

- **Reduce the Pension Exemption in the IIT (Alternative 15).** As discussed in the previous chapter, tax treatment of pension income varies widely among the states. It ranges from states that fully exempt to those that fully tax all pension income – with a wide variety of methods between these polar opposites.

As a starting point, Hawaii breaks with the federal definition of taxable income as it relates to both pension and social security income. The federal government taxes all or a portion of pension or annuity payments from a qualified employer retirement plan.¹⁵⁴ While the State may tax some portion of the payments from a qualified private employer retirement plan, it does not tax pension benefits from public pension systems, including all federal, state/local or out-of-state government pensions.¹⁵⁵ Given the aging of the Hawaii population, it is reasonable to assume that the value of this exemption will grow in coming years. While the dollar value of the exemption of this income grows, the State's obligations to fund the benefits of its public employee retirement system will also grow.

¹⁵⁴ See IRS Tax Topics, Topic 410, Pensions and Annuities, at <http://www.irs.gov/taxtopics/tc410.html>

¹⁵⁵ A list of state treatment of pension and retirement income is found in the Appendices.



Given that the current tax system entirely exempts this pension income from taxation (regardless of the amount per year), taxing these public pensions (and allowing for a \$25,000 exception for lower-income Hawaii residents), will improve overall regressivity. At the same time, a case can be made that the income generating potential of retirees is more limited than others pre-retirement age.

- **Eliminate the Deduction for Property Taxes Paid (Alternative 18).** Under the U.S tax code, any state, local, or foreign taxes on real property levied for the general public welfare are deductible. Most states that use federal adjusted gross income as the starting point for state IIT purposes conform to federal law. However, there are states that do not. Among these states are Minnesota, Nebraska, Wisconsin and, to a limited extent, New Jersey.

Hawaii is unique among the states in its full state support for K-12 education, which in most states is a shared state-local responsibility, with the local funding primarily supported by property taxes. Given that K-12 funding is on average the largest expenditure category for local governments in the U.S, the State is making an extraordinary funding commitment to local schools.

In Hawaii, because the General Fund supports local K-12 school budgets, education expenditures do not have to be calculated when determining property tax rates. In essence, those who pay taxes that go into the General Fund are subsidizing property taxpayers by this funding approach. It can be argued that this is an equity issue, as property owners are receiving a benefit that they would not receive in any other state.

As with the recommendations to the 2012 TRC, the project team believes that eliminating this deduction is a rational revenue approach. By any measure of property tax rates, those in Hawaii are the lowest or among the lowest for every class of property.

- **Tax Medical Marijuana (Alternative 5).** Legal marijuana (for both medical and recreational use) consumption is becoming a more prevalent activity among U.S. states. It is an activity that shares many of the characteristics of other consumption subject to an excise tax. From the project team's perspective, this is a base-broadening tax on consumption. While it is not a particularly large revenue source at the current time, should the State choose to legalize recreational marijuana use, it will be important to have a tax structure in place (and an understanding of the implementation and administration issues associated with it). For that reason, it is a good time to apply this tax – even though it will have minimal revenue impact, at least in the short-term.
- **Institute a Vapor/e-Cigarette Tax (Alternative 7).** As with marijuana, this is an emerging area of consumption. Much of the activity around these products is associated with a switch in consumption from cigarettes and other tobacco products. Given that switch, it makes sense for the State to create an excise tax for this form of consumption as a form of replacement for those who switch from other tobacco products to these. As with medical marijuana, the revenue impact in the short-term is minimal, but it helps to act as a method for 'propping up' cigarette and tobacco tax revenues. As with cigarettes and tobacco products, the tax is likely a regressive one, although this consumption is certainly not a necessity.



Less Desirable Alternatives

In several instances, the project team believes an analyzed tax change would be suboptimal. The following identify these and provide a brief rationale for the decision:

- **Increase the TAT and TOT Rates (Alternative 9).** A special legislative session concerning continued funding for the rail project on Oahu was held in late August, and a plan was approved and signed by Governor Ige on September 5, 2017. That plan raises the statewide TAT by 1 percent for the next 13 years. Given the fact that the increase is nearly equal to the alternative proposed by the project team, it is unlikely that the legislature will again increase the TAT until the impact of the rail-related increase is known.
- **Corporate rate structure changes (Alternatives 12-14).** The TRC has independently commissioned a study on corporate income tax by a notable expert on this subject, Dr. Donald Rousslang. Given his experience and expertise in this area, the project team defers to his study and recommendations.
- **Eliminate the Exemption for Foreign Pension Income Over \$25,000 (Alternative 16).** The project team prefers to treat similar types of pensions similarly for state tax purposes. There are also issues with getting solid data on the share of current public pensions that would be classified as 'foreign pensions.'
- **Implement a Personal Income Tax Rate Recapture (Alternative 17).** While this has the potential to raise significant new revenue, it would create very high effective tax rates at income levels that are out of balance with all other state individual income tax structures.
- **Make the State Earned Income Tax Credit a refundable credit.** Given that the creation of the credit was enacted late in the project – and that the Legislature chose not to make it a refundable credit – the project team chose not to recommend immediate changes to the program. Some concerns over the administrative costs have been raised with other state EITCs, and this issue would be better addressed after some state experience with the existing program.
- **Shift Certain K-12 Education Expenses to Property Taxes to Lower States Costs (Alternative 19).** Hawaii as a State has made a significant commitment to assuming the costs of K-12 education at the state level. While this would move Hawaii more to the national model, using tax policy to drive education policy is probably not the correct model for changing either system.
- **Additional Audit Programs (Alternative 22).** While other states have been successful with increasing Audit staff and efforts, the current collection system modernization should be completed before the State initiates new activity in this area.

Based on the optimal revenue alternatives, the following is a rough estimate of possible additional (or reduced) revenue in the first full year (based on current revenue estimates for FY2017) of implementation. Results will, of course, vary, depending on timing and issues of statutory construction.

Optimal Alternatives Fiscal Impact (FY2018)

| Optimal Alternative | | Estimated Additional Revenue (millions) | Recommended Revenue (millions) |
|---------------------|--|---|--------------------------------|
| 1 | Increase the Cigarette and Tobacco Tax Rates | \$20.3 | \$20.3 |
| 2 | Increase Gallonage Taxes on Beer, Wine and Distilled Spirits | \$5.2 | \$5.2 |



| | Optimal Alternative | Estimated Additional Revenue (millions) | Recommended Revenue (millions) |
|----|--|---|--------------------------------|
| 3 | Restore the Surcharge on Rental Cars | \$18.5 | \$18.5 |
| 4 | Institute a Tax on Sugary Beverages | \$48.8 | \$48.8 |
| 5 | Tax Medical Marijuana | \$13.2 | \$13.2 |
| 6 | Institute a Carbon Tax | \$365.0 | \$365.0 |
| 7 | Institute a Vapor/e-Cigarette Tax | \$4.5 | \$4.5 |
| 8 | Increase the GET Rate | \$415.0 | |
| 9 | Increase the TAT and TOT Rates | \$22.5 | |
| 10 | Begin Collecting TAT on Resort Fees | \$2.6 | \$2.6 |
| 11 | Begin Imposing TAT on Alternative Accommodation Rentals | \$135.7 | \$135.7 |
| 12 | Move to a Single 9 Percent Corporate Net Income Tax Rate | \$103.0 | |
| 13 | Increase Corporate Net Income Taxes by 50 Percent | \$41.7 | |
| 14 | Increase Corporate Net Capital Gains Rate to 5 Percent | \$6.4 | |
| 15 | Reduce the Pension Exemption in the IIT | \$47.8 | \$47.8 |
| 16 | Eliminate Exemption for Foreign Pension Income Over \$25,000 | \$23.9 | |
| 17 | Implement a Personal Income Tax Rate Recapture | \$203.2 | |
| | Increase the Standard Deduction for IIT to \$7,500 for single filers, \$15,000 for married and \$10,950 for head of household filers | -\$61.0 | -\$61.0 |
| | Double the refundable Food/Excise Tax IIT credit | -\$25.0 | -\$25.0 |
| 18 | Eliminate the Deduction for Property Taxes Paid | \$31.0 | \$31.0 |
| 19 | Shift Certain K-12 Education Expenses to Property Taxes to Lower State Costs | TBD | |
| 20 | Expand Efforts to Incent E-Commerce Collection of GET | \$35.0 | \$35.0 |
| 21 | Develop Tax Gap Systems to Identify Under-payment and Non-payment of Taxes | TBD | |
| 22 | Additional Audit Programs | TBD | |
| | TOTAL | | \$641.6 |



Summary

Jean Baptiste-Colbert, the former Finance Minister of France, famously noted that “the art of taxation consists in so plucking the goose as to procure the largest quantity of feathers with the least possible amount of hissing.” While this is a pragmatic approach to determining tax policy, the Hawaii Legislature has provided additional concepts that the TRC is to weigh, including principles of equity and efficiency. Throughout the analysis, the project team has sought to weigh the principled and the practical in the analysis and discussion.

It should be noted and understood that there is no perfect tax: every tax will have some negative impact on the overall economy and consumption. Given that part of the charge provided to the project team was to identify alternatives to raise additional revenue, it should be accepted that these will come at a cost.

Tax Structure Optimal Alternatives

- **Methods to Expand the Tax Base**
 1. Reduce the IIT pension exemption to \$25,000
 2. Eliminate the deduction for property taxes paid
 3. Tax medical marijuana
 4. Institute a vapor/e-cigarette tax
- **Methods to Reduce Tax System Regressivity**
 5. Increase the IIT standard deduction
 6. Double the refundable food/excise tax credit
- **Methods to Export a Share of the Tax Burden to Non-residents**
 7. Increase cigarette and tobacco tax rates
 8. Increase gallonage taxes on alcohol
 9. Expand the taxation of alternative accommodations
 10. Restore the surcharge on rental vehicles
- **Methods to Improve Economic Efficiency**
 11. Institute a tax on sugary beverages (also expands the tax base)
 12. Institute a carbon tax (also expands the tax base)
- **Changes to Improve System Administration and Collection**
 13. Develop tax gap systems to identify under-payment/non-payment of taxes
 14. Expand efforts to incent collection of GET on e-commerce sales



Appendices



Appendix A: List of Interviews, Discussion Groups and Presentation Groups

| Agency/Affiliation | Interviewee(s) |
|--|--|
| Council on Revenues | Kurt Kawafuchi Jack Suyderhoud Marilyn Niwao John Roberts |
| Department of Budget and Finance | Wes Machida Neal Miyahira Laurel Johnston Sharon Kotaka |
| Department of Business, Economic Development and Tourism | Dr. Eugene Tian Dr. Joseph Roos |
| Department of Taxation | Ted Shiraishi Titin Sakata Donald Rousslang Seth Colby Joshua Lee |
| Hawaii Appleseed Center | Nicole Woo |
| Hawaii Chamber of Commerce | Reg Baker |
| Hawaii House of Representatives | Rep. Isaac Choy Rep. Scott Saiki Rep. Sylvia Luke |
| Hawaii Senate | Sen. J. Kalani English Sen. Ronald Kouchi |
| Hawaii Tax Foundation | Tom Yamachika |
| Hawaii Tourism Authority | George Szigeti Randy Baldemor Daniel Nahoopi Charlene Chan |
| Tax Review Commission | Colleen Takamura, Chair Vaughn Cook, Vice Chair Ray Blouin Nalani Kaina John Knox Dawn Lippert Billy Pieper Randy Iwase (prior TRC) |
| University of Hawaii | James Mak (Retired) |
| University of Hawaii Board of Regents | Randy Moore |



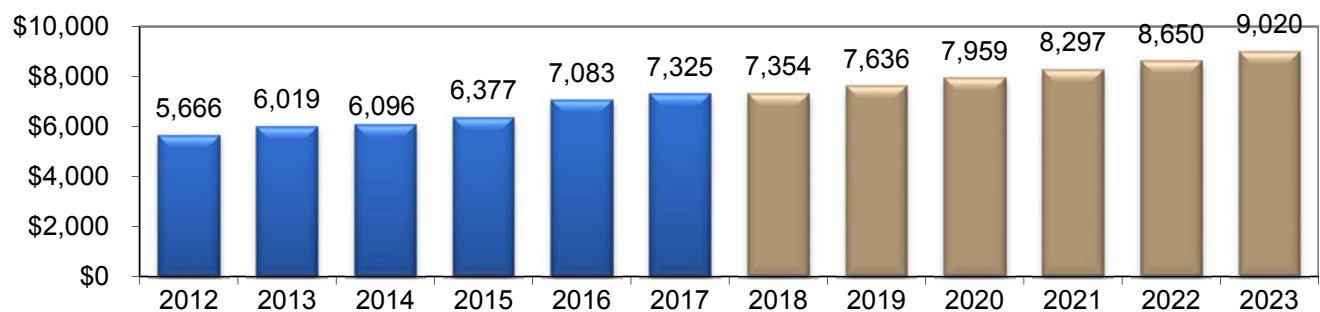
Appendix B: Revenue Growth Rates and Model Outputs

Table B1: Model Growth Rates

| Growth Rate Name | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---------|---------|---------|---------|--------|---------|---------|
| General Excise and Use Tax | 3.87% | 3.89% | 3.47% | 3.24% | 3.57% | 3.46% | 3.66% |
| Individual Income Tax | -0.45% | 4.27% | 4.93% | 4.94% | 6.29% | 6.36% | 6.24% |
| Corporate Income Tax | 2.11% | -12.31% | 9.91% | 53.01% | 1.61% | 4.31% | 1.20% |
| Public Service Company Tax | 3.19% | 3.37% | 3.47% | 3.34% | 3.36% | 3.37% | 3.37% |
| Tax on Insurance Premiums | 2.42% | 3.25% | 2.38% | 2.50% | 3.09% | 3.12% | 3.22% |
| Cigarette and Tobacco Tax | 2.35% | 2.15% | 3.59% | 3.19% | 3.44% | 3.40% | 3.46% |
| Liquor Tax | 0.90% | 0.90% | 0.90% | 0.79% | 0.80% | 0.80% | 0.80% |
| Tax on Banks and Other Financial Corps. | 75.06% | 15.00% | -21.90% | -15.08% | -1.68% | -10.09% | -20.00% |
| Inheritance and Estate Tax | 1.74% | 1.84% | 1.89% | 1.82% | 1.83% | 1.84% | 1.84% |
| Conveyance Tax | 3.31% | 5.32% | 5.56% | 8.37% | 12.43% | 11.53% | 10.98% |
| Miscellaneous Taxes | 0.87% | -0.04% | -0.05% | -0.05% | -0.04% | -0.05% | -0.05% |
| Transient Accommodations Tax | 6.83% | 11.15% | 6.21% | 5.75% | 5.40% | 5.00% | 4.79% |
| Licenses & Permits | 4.85% | -1.16% | -1.46% | 0.00% | 0.00% | 0.00% | 0.00% |
| Revenues from Use of Money and Property | -3.54% | 13.30% | -10.50% | -5.55% | -6.13% | -7.01% | -7.97% |
| Federal | -23.75% | -2.28% | -2.86% | -3.21% | -3.71% | -0.45% | 0.00% |
| Revenues from Other Agencies | -37.24% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Charges for Current Services | 6.97% | -24.67% | 3.34% | 2.14% | 2.53% | 2.46% | 2.85% |
| Fines, Forfeits & Penalties | 45.83% | -1.40% | 0.98% | -0.97% | 0.98% | -0.97% | 0.98% |
| Repayment of Loans & Advances | 353.49% | -9.88% | 13.38% | 5.59% | 5.62% | 5.63% | 5.64% |
| Non-Revenue Receipts | 13.68% | -27.31% | 1.63% | 1.63% | 1.63% | 1.64% | 1.65% |
| Judiciary | 2.65% | 1.44% | 1.78% | 1.54% | 1.55% | 1.56% | 1.56% |

Source: COR Forecast as of May 30, 2017

Table B2: Baseline General Fund Revenue Projection (in millions)





Appendix C: Hotel/Motel and Sales Tax Rates by State, 2015

| Rank | State | Sales Tax Rate | Lodging Tax Rate | Total Rate |
|----------|----------------|----------------|------------------|---------------|
| 1 | Connecticut | 6.35% | 8.65% | 15.00% |
| 2 | Maine | 5.50% | 8.00% | 13.50% |
| 3 | Hawaii | 4.00% | 9.25% | 13.25% |
| 4 | Rhode Island | 7.00% | 6.00% | 13.00% |
| 5 | New Jersey | 7.00% | 5.00% | 12.00% |
| 6 | New Hampshire | | 9.00% | 9.00% |
| 6 | Vermont | 6.00% | 3.00% | 9.00% |
| 8 | Delaware | | 8.00% | 8.00% |
| 8 | Idaho | 6.00% | 2.00% | 8.00% |
| 10 | Indiana | 7.00% | | 7.00% |
| 10 | Mississippi | 7.00% | | 7.00% |
| 10 | Montana | | 7.00% | 7.00% |
| 10 | Tennessee | 7.00% | | 7.00% |
| 14 | Kentucky | 6.00% | 1.00% | 7.00% |
| 14 | South Carolina | 6.00% | 1.00% | 7.00% |
| 16 | Minnesota | 6.88% | | 6.88% |
| 17 | Arkansas | 6.50% | | 6.50% |
| 17 | Nebraska | 5.50% | 1.00% | 6.50% |
| 17 | Washington | 6.50% | | 6.50% |
| 20 | Kansas | 6.15% | | 6.15% |
| 21 | Florida | 6.00% | | 6.00% |
| 21 | Illinois | | 6.00% | 6.00% |
| 21 | Maryland | 6.00% | | 6.00% |
| 21 | Michigan | 6.00% | | 6.00% |
| 21 | Pennsylvania | 6.00% | | 6.00% |
| 21 | Texas | | 6.00% | 6.00% |
| 21 | West Virginia | 6.00% | | 6.00% |
| 28 | Ohio | 5.75% | | 5.75% |
| 29 | Massachusetts | | 5.70% | 5.70% |
| 30 | Arizona | | 5.50% | 5.50% |
| 30 | South Dakota | 4.00% | 1.50% | 5.50% |
| 32 | New Mexico | 5.13% | | 5.13% |
| 33 | Iowa | 5.00% | | 5.00% |
| 33 | North Dakota | 5.00% | | 5.00% |
| 33 | Wisconsin | 5.00% | | 5.00% |
| 36 | North Carolina | 4.75% | | 4.75% |
| 37 | Utah | 4.70% | | 4.70% |
| 38 | Oklahoma | 4.50% | | 4.50% |
| 39 | Virginia | 4.30% | | 4.30% |
| 40 | Missouri | 4.23% | | 4.23% |
| 41 | Alabama | | 4.00% | 4.00% |



| Rank | State | Sales Tax Rate | Lodging Tax Rate | Total Rate |
|------|------------|----------------|------------------|--------------|
| 41 | Georgia | 4.00% | | 4.00% |
| 41 | Louisiana | 4.00% | | 4.00% |
| 41 | New York | 4.00% | | 4.00% |
| 41 | Wyoming | 4.00% | | 4.00% |
| 46 | Colorado | 2.90% | | 2.90% |
| 47 | Oregon | | 1.00% | 1.00% |
| 48 | Alaska | | | 0.00% |
| 48 | California | | | 0.00% |
| 48 | Nevada | | | 0.00% |

Source: 2016 HVS Lodging Tax Report



Appendix D: Corporate Income Tax Rates and Brackets by State, 2017

| State | Rates | Brackets | State | Rates | Brackets | State | Rates | Brackets |
|-------------|-------|-----------|---------------|--------|-----------|----------------|-------|-------------|
| Alabama | 6.50% | \$0 | Iowa | 6.00% | \$0 | New Hampshire | 8.20% | \$0 |
| Alaska | 0.00% | \$0 | | 8.00% | \$25,000 | New Jersey | 9.00% | \$100,000 |
| | 2.00% | \$25,000 | | 10.00% | \$100,000 | New Mexico | 4.80% | \$0 |
| | 3.00% | \$49,000 | | 12.00% | \$12,000 | | 6.20% | \$500,000 |
| | 4.00% | \$74,000 | Kansas | 4.00% | \$0 | New York | 6.50% | \$0 |
| | 5.00% | \$99,000 | | 7.00% | \$50,000 | North Carolina | 3.00% | \$0 |
| | 6.00% | \$124,000 | Kentucky | 4.00% | \$0 | North Dakota | 1.41% | \$0 |
| | 7.00% | \$148,000 | | 5.00% | \$50,000 | | 3.55% | \$25,000 |
| | 8.00% | \$173,000 | | 6.00% | \$100,000 | | 4.31% | \$50,000 |
| | 9.00% | \$198,000 | Louisiana | 4.00% | \$0 | Ohio | | |
| | 9.40% | \$222,000 | | 5.00% | \$25,000 | Oklahoma | 6.00% | \$0 |
| Arizona | 4.90% | \$0 | | 6.00% | \$50,000 | Oregon | 6.60% | \$0 |
| Arkansas | 1.00% | \$0 | | 7.00% | \$100,000 | | 7.60% | \$1,000,000 |
| | 2.00% | \$3,000 | Maine | 8.00% | \$200,000 | Pennsylvania | 9.99% | \$0 |
| | 3.00% | \$6,000 | | 3.50% | \$0 | Rhode Island | 7.00% | \$0 |
| | 5.00% | \$11,000 | | 7.93% | \$25,000 | South Carolina | 5.00% | \$0 |
| | 6.00% | \$25,000 | | 8.33% | \$75,000 | South Dakota | None | |
| | 6.50% | \$100,000 | | 8.93% | \$250,000 | Tennessee | 6.50% | \$0 |
| California | 8.84% | \$0 | Maryland | 8.25% | \$0 | Texas | | |
| Colorado | 4.63% | \$0 | Massachusetts | 8.00% | \$0 | Utah | 5.00% | \$0 |
| Connecticut | 9.00% | \$0 | Michigan | 6.00% | \$0 | Vermont | 6.00% | \$0 |
| Delaware | 8.70% | \$0 | Minnesota | 9.80% | \$0 | | 7.00% | \$10,000 |
| Florida | 5.50% | \$0 | Mississippi | 3.00% | \$0 | | 8.50% | \$25,000 |
| Georgia | 6.00% | \$0 | | 4.00% | \$5,000 | Virginia | 6.00% | \$0 |
| Hawaii | 4.40% | \$0 | | 5.00% | \$10,000 | Washington | | |
| | 5.40% | \$25,000 | Missouri | 6.25% | \$0 | West Virginia | 6.50% | \$0 |
| | 6.40% | \$100,000 | Montana | 6.75% | \$0 | Wisconsin | 7.90% | \$0 |
| Idaho | 7.40% | \$0 | Nebraska | 5.58% | \$0 | Wyoming | None | |
| Illinois | 7.75% | \$0 | | 7.81% | \$100,000 | DC | 9.00% | \$0 |
| Indiana | 6.25% | \$0 | Nevada | | | | | |

Source: Tax Foundation – State Corporate Income Tax Rates and Brackets



Appendix E: State Treatment of Pension Income, Tax Year 2015

| State | Private | State & Local | Federal Civilian | Military |
|----------------------|--------------------------|-------------------|-------------------|-------------------|
| Alabama | State calculation | Most exempt | Exempt | Exempt |
| Alaska | | | | |
| Arizona | None | \$2,500 | \$2,500 | \$2,500 |
| Arkansas | \$6,000 | \$6,000 | \$6,000 | \$6,000 |
| California | None | None | None | None |
| Colorado | \$20,000/\$24,000 | \$20,000/\$24,000 | \$20,000/\$24,000 | \$20,000/\$24,000 |
| Connecticut | None | None/10% Exempt | None | Exempt |
| Delaware | \$2,000/\$12,500 | \$2,000/\$12,500 | \$2,000/\$12,500 | \$2,000/\$12,500 |
| District of Columbia | None | None | None | None |
| Florida | | | | |
| Georgia | \$65,000/\$35,000 | \$65,000/\$35,000 | \$65,000/\$35,000 | \$65,000/\$35,000 |
| Hawaii | State calculation | Exempt | Exempt | Exempt |
| Idaho | None | \$31,956/\$47,934 | \$31,956/\$47,934 | \$31,956/\$47,934 |
| Illinois | State calculation | Exempt | Exempt | Exempt |
| Indiana | None | None | \$8,000 | \$5,000 |
| Iowa | \$6,000 | \$6,000 | \$6,000 | Exempt |
| Kansas | None | Some exempt | Exempt | Exempt |
| Kentucky | \$41,110 | \$41,110/Exempt | \$41,110/Exempt | \$41,110/Exempt |
| Louisiana | \$6,000 | \$6,000/Exempt | Exempt | Exempt |
| Maine | \$10,000 | \$10,000 | \$10,000 | \$10,000 |
| Maryland | \$29,200 | \$29,200 | \$29,200 | \$29,200 |
| Massachusetts | None | Exempt | Exempt | Exempt |
| Michigan | \$20,000/\$49,811 | \$20,000/\$49,811 | \$20,000/\$49,811 | Exempt |
| Minnesota | None | None | None | None |
| Mississippi | Exempt | Exempt | Exempt | Exempt |
| Missouri | \$6,000 | \$36,976 | \$36,976 | 90% exempt |
| Montana | \$3,980 | \$3,980 | \$3,980 | \$3,980 |
| Nebraska | None | None | None | State calculation |
| Nevada | | | | |
| New Hampshire | Exempt | Exempt | Exempt | Exempt |
| New Jersey | \$15,000 | \$15,000 | \$15,000 | Exempt |
| New Mexico | None | None | None | None |
| New York | \$20,000 | Exempt | Exempt | Exempt |
| North Carolina | None | Some exempt | Some exempt | Some exempt |
| North Dakota | None | None | None | None |
| Ohio | \$200 credit | \$200 credit | \$200 credit | Exempt |
| Oklahoma | \$10,000 | \$10,000 | \$10,000 | \$10,000/75% |



| State | Private | State & Local | Federal Civilian | Military |
|----------------|------------------|-------------------|---------------------------|---------------------------|
| Oregon | 9% credit | 9% credit | 9% credit/pre-1991 exempt | 9% credit/pre-1991 exempt |
| Pennsylvania | Exempt | Exempt | Exempt | Exempt |
| Rhode Island | None | None | None | None |
| South Carolina | \$3,000/\$10,000 | \$3,000/\$10,000 | \$3,000/\$10,000 | \$3,000/\$10,000 |
| South Dakota | | | | |
| Tennessee | Exempt | Exempt | Exempt | Exempt |
| Texas | | | | |
| Utah | None | None | None | None |
| Vermont | None | None | None | None |
| Virginia | None | None | None | Most taxable |
| Washington | | | | |
| West Virginia | None | \$2,000/Exempt | \$2,000 | \$22,000 |
| Wisconsin | \$5,000 | State calculation | State calculation | Exempt |
| Wyoming | | | | |

Source: Wisconsin Legislative Fiscal Bureau (January 2017)

APPENDIX B:

REPORT OF DR. SETH S. COLBY –

**"The Economic Trade-Offs of Hawaii's Major Tax
Types"**

The Economic Trade-Offs of Hawaii's Major Tax Types

Prepared for the 2015-2017 Tax Review Commission

By Seth Colby
Tax Research & Planning Officer,
Hawaii State Department of Taxation
September 2017

Introduction:

This document summarizes the trade-offs of the major tax types utilized by the State of Hawaii's public revenue system. The major tax types discussed in this text are General Excise Tax (GET), the Individual and Corporate Income Tax, the Transient Accommodation Tax (TAT), and property tax. These five taxes make up the vast majority of state and local revenue in Hawaii. The GET, Individual Income Tax (IIC), Corporate Income Tax (CIT), and TAT make up roughly 85% of tax collection at the state level. The other 15% of state collections include taxes like fuel tax, motor vehicle taxes, Insurance Premium Tax, Unemployment Tax, tobacco taxes, and alcohol taxes amongst others. Some of these tax revenues are directed to special programs like the fuel taxes (for road construction and maintenance) and Unemployment Tax (for unemployment insurance). Others excise tax revenues like the tobacco and alcohol taxes are meant to discourage certain behaviors while raising revenue. Property taxes are administered at the local level in the state of Hawaii due to a constitutional mandate. In an effort to provide a study of the state's entire tax system, major state and local taxes are discussed in this paper. Both are discussed because state government and the local government can provide similar services (education, security, parks, infrastructure, etc) and the distribution of responsibility vary greatly by state. The structure of state and local government will affect the how revenue collection and program administration is carried out. The document begins with a discussion of Hawaii's governmental structure in relation to other states. It presents concepts that are helpful in the understanding of burden sharing, tax incidence, and how the tax system can facilitate wealth redistribution. It then offers a discussion of different tax types specifically: GET, income tax, TAT and property taxes.

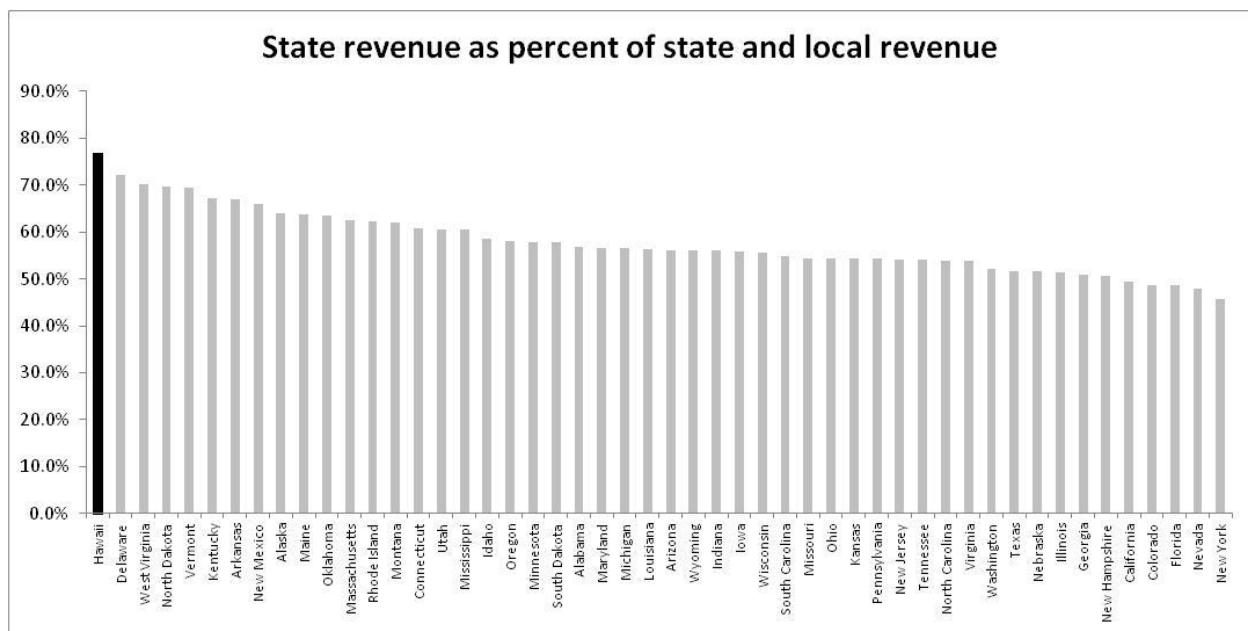
A centralized governmental structure

Hawaii has a centralized revenue and public service provision model relative to most other states.

Most of the revenue collection and expenditure occur at the state level as opposed to the local level. The State of Hawaii receives 76.8% of all state and local revenue, the highest percentage of state funding in the nation (see Graph 1). The national average of state funding is 58% versus 42% local. The high concentration of revenue collection at the state level reflects the fact that the state finances many public services that is financed by local governments elsewhere. For example, Hawaii is unique in that

the state provides 100% of funding for primary and secondary education. In many states, local government revenue goes to education funding, usually through property taxes.

The centralization of the Hawaii state government brings with it advantages and disadvantages. Centralized services help governments achieve economies of scale, an important factor in a small state. However, it also implies that the provision of public services is further removed from the taxpayer and the populace in general. It is easier for the taxpayer to understand what their taxes are funding at the local level because fewer services are provided, (i.e. trash, sewer, roads, security, etc) and the level of government is smaller and (usually) more accessible. By contrast, state government provides more services like infrastructure, social welfare programs, and environmental regulation, and there are more layers of bureaucracy. The state budget is larger and more complicated, making it harder for a taxpayer to understand how their tax dollars are being spent. A more decentralized form of government brings the public service provision closer to the people who consume the service. This makes it easier for taxpayers to participate in and influence the process of public service provision in principle.



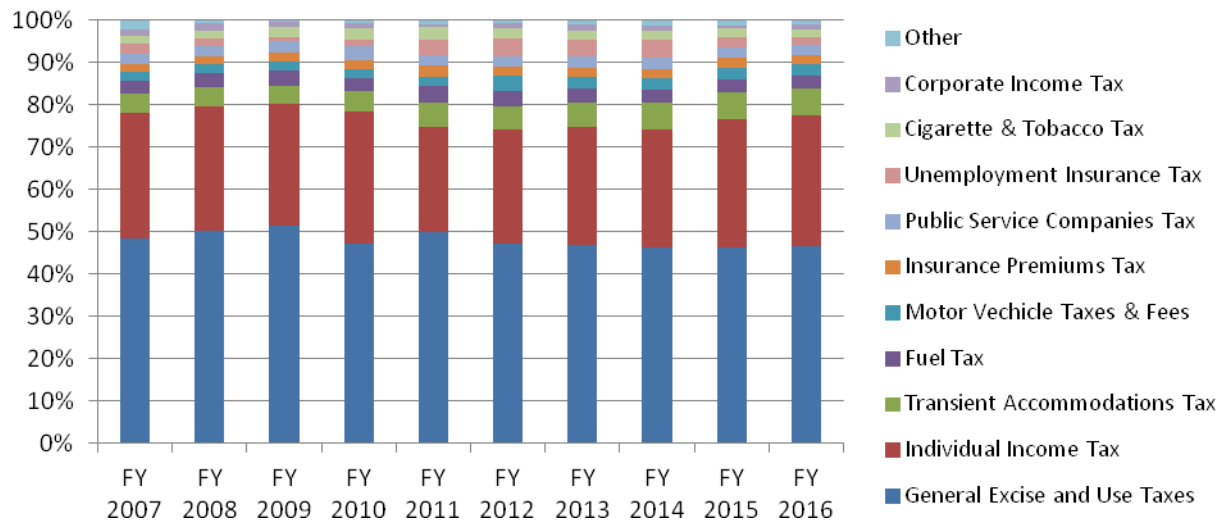
Source: US Census State and Local Finances (2014)

Hawaii Tax System at a Glance

The Hawaii tax system is dependent on two major taxes, the General Excise Tax and the Individual Income Tax, which make up roughly three quarters of revenues. The remaining balance is made up of a number of smaller taxes (see Graph 2). Taxes can be levied on consumption, income, or wealth (see Table 1). In the case of Hawaii, the majority of taxes are levied on consumption; thirty-four percent of the taxes are levied on income; and a very small amount is a tax on wealth (see Graph 3). In comparison to other state, Hawaii collects more revenue at the state and local level from general sales taxes and

other taxes, and it collects less revenue from property tax, individual income tax, and corporate income tax (see graph 4).

Composition of State Revenues

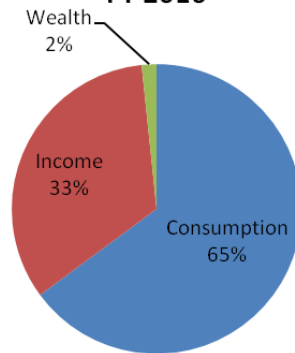


Source: DOTAX

Table 1: State taxes by type

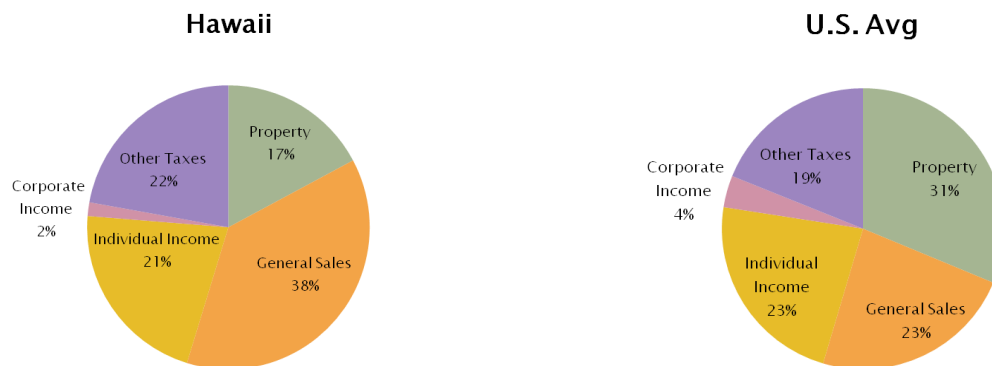
| Consumption | Income | Wealth |
|------------------------------|----------------------------|----------------|
| General Excise and Use Tax | Individual Income Tax | Estate Tax |
| Transient Accommodation Tax | Corporate Income Tax | Conveyance Tax |
| Fuel Tax | Unemployment Insurance Tax | |
| Cigarette & Tobacco Tax | | |
| Public Service Companies Tax | | |
| Insurance Premiums Tax | | |
| Liquor Tax | | |
| Motor Vehicle Taxes & Fees | | |
| Franchise Tax | | |

State revenues by tax type FY 2016



Source: DOTAX

Graph 4: Composition of state and local taxes: Hawaii vs National Average



Source: Tax Foundation

Criteria for evaluating a tax system

It is important to evaluate of the system of taxation holistically, rather than just concentrating on a specific tax. Governments usually rely on a number of different taxes to generate revenue. There are reasons to assess the merits of an individual tax, but it is important to keep in mind that every tax is part of a larger system. While some taxes may be regressive (they impact lower income taxpayers more than higher income ones), the tax system as a whole may be progressive, or vice versa. While this paper evaluates the trade-offs of different taxes using a common criteria, it is important to remember that each tax is operating in a broader system.

Economic efficiency: Efficient tax systems impose the smallest possible distortions on behavior, or to the extent that it does distort behavior, it affects behavior in the desired direction. Economic distortions

reduce economic activity by influencing behavior away from the optimal outcome, reducing wealth generation, and making the society worse off as whole. It is best to levy taxes that minimize distortions.

Fairness: There are two basic ways to evaluate the fairness of a tax system.

The first is the *ability-to-pay principle* which states that taxpayers with more ability to pay (higher levels of discretionary income) should bear a larger share of the tax burden. There are several ways to measure ability-to pay. Horizontal equity refers to the idea that individuals with similar income and assets should pay the same amount in taxes, regardless of tax system in place. That is, the tax system should be neutral and not favor one economic group over another. Targeted tax breaks and other loopholes in the system tend to lower the level of horizontal equity. Vertical equity refers to the idea that those with greater ability to pay (more income) should pay more in taxes. Progressive, regressive, and proportional are ways to describe the vertical equity of a tax system. A progressive system is one where an individual with more income and more assets dedicates a larger percentage of their income in taxes. A proportional system implies that tax liabilities stay constant with income. A regressive system is one where lower income individuals pay a larger part of their income in taxes. Note that even in a regressive system, a high income person could pay more taxes in absolute terms than a low income person, but it would just be smaller percentage of their total income (i.e. they pay less in relative terms).

The second way to evaluate the fairness is through the *benefits-received principle*. This principle implies that, those that receive the services provided by the government ought to be the ones that pay for the same services

Compliance and administrative burdens: Compliance refers to the cost imposed on the private sector to fill out tax returns, comply with requirements of a given tax, and remit payments. Administration refers to the costs the government bears enforcing the tax code and collecting taxes. Good tax systems keep compliance and administrative costs low. This is one reason that economists suggest that a tax system should remain simple as it makes it easier to comply with and administer the tax code. Complicated tax systems usually increase administrative and compliance costs because it requires more expertise, documentation, and effort to abide by statutory requirements.

Revenue adequacy and stability: In general, a good tax system produces revenue growth that keeps pace with the growth in expenditure demands. A good tax also system minimizes revenue volatility. Sudden shortfalls in revenue can prompt costly cuts in public programs during economic downturns when the demand for public services generally increases. To avoid this, it is important to have a tax system that can provide consistent and stable revenue. Reliance on a number of different taxes can reduce volatility through diversification, particularly if the taxes are applied to different areas of the economy. Another way to increase stability is through the utilization of taxes that are more stable. Revenue adequacy refers to whether the tax system can provide the needed over the long run.

Hawaii's state revenue system matches economic growth over the long term, but revenue is sensitive to periods of economic decline. Between FY 2007 and FY 2018, revenue as percentage of state GDP has remained relatively stable at around 8.3% while falling slightly in proportion to Total Personal Income (see Table 2). Revenues did decline more drastically than economic product during the Great Recession of 2009 and they remained depressed for several years after.

Table 2: State Revenues and Economic Indicators

| | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 | FY 2016 |
|---------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| Without County Surcharge | | | | | | | | | | |
| State Rev/GSP | 8.2% | 7.8% | 7.2% | 7.2% | 7.2% | 7.9% | 8.4% | 8.2% | 8.2% | 8.3% |
| State Rev/Total Income | 11.2% | 10.4% | 8.9% | 8.6% | 8.9% | 10.1% | 10.7% | 10.1% | 10.5% | 10.5% |
| With County Surcharge | | | | | | | | | | |
| State Rev/GSP | 8.3% | 8.0% | 7.4% | 7.5% | 7.5% | 8.2% | 8.7% | 8.5% | 8.5% | 8.6% |
| State Rev/Total Income | 11.3% | 10.8% | 9.2% | 8.9% | 9.3% | 10.5% | 11.0% | 10.5% | 10.9% | 10.9% |

Source: DOTAX

Measuring Income and "Ability-to-Pay"

Definitional issues influence the outcomes of studies looking at the regressivity of Hawaii's tax system

There is no "optimal" tax policy; rather good policy should efficiently achieve the outcomes that match the preferences of voters. What is the right amount of economic inequality? How many services should the government provide? How should you distribute the tax burden across the population? While economic ideas can identify the tradeoffs of different policy preferences and propose efficient ways of achieving such goals, the answer to these questions is largely political. In Hawaii, policy makers are particularly interested in the tax burden across different income levels. A central question that the Legislature and the Governor have asked the TRC to study is how to reduce the regressivity of the tax system. The first step in this process is to determine the definition of "ability-to-pay." A progressive tax system, as opposed to a regressive system, places a heavier burden on taxpayers with more ability-to-pay, which is most often measured by income. The definition of income is not straight forward however. Accurate measures of income patterns at the extreme ends of the spectrum, (low income and high income) are very hard to produce. It is important to use extra caution when interpreting the results of studies at the extreme ends of the income scale. To help with these issues, there are several things to keep in mind when using income as a proxy for ability-to-pay.

Income measurements can vary substantially depending on if they are measured annually or over the course of a life-time. Most income statistics are reported using an annual metrics. This is largely due to the fact that most measures of income, namely tax records, are reported annually. Exclusively using annual metrics to define a person's ability to pay presents certain challenges that may distort analytical conclusions. First, an individual's income patterns vary dramatically over a life-time. Earnings tend to

start low in the early periods of life, peak in their 40s and 50s, and then drop as a person enters into retirement. Income rates and savings rates tend to peak during the same periods (40s and 50s), which implies that consumption does not rise commensurately with income over a lifecycle. This is because people are saving in order to defer consumption towards their years in retirement when they will not be receiving an income. Depending on the analytical approach, income for retirees appears to be even lower in states like Hawaii where social security and publicly defined pension benefits are excluded from the income calculation. Secondly, income patterns can be lumpy, meaning that an individual may receive high levels of income in some years while very low ones in others. A business owner that sold their business for millions may decide to not work for several years after the sale. This individual would register very low levels of income, but most would consider that their ability-to-pay has not changed dramatically. Economists have long noted that consumption patterns are much smoother than annual income.¹ This means that consumption patterns do not change dramatically over a life-cycle. Studies have found that income taxes are much less progressive and consumption taxes are much less regressive when looking at the tax burdens over a life-time versus annually.²

Income as reported by most tax authorities is narrowly defined and rarely includes all types of compensation and benefits. First, some compensation is not reported to the tax authorities either because it is not required or the individual simply declines to declare such income. There are many reasons to be paid "off the books," some of which includes increased flexibility, compliance costs, criminal behavior, and lack of documentation. One estimate found the roughly 8% of the United States economy is undeclared.³ Second, another important form of income that is usually not subjected to taxes include fringe benefits and health insurances, which includes things like employer sponsored health care and contributions to retirement plans. These are important sources of income that may go unreported in income because they are not subject to taxation. Third, non-labor income like capital income, capital, gains, and business income is sometimes separated out from labor income in some studies. This type of earning is included in most income studies that are based on taxable earnings, including this in this document. Fourth, tax credits lower the overall tax burden and boost after-tax income. Such credits in Hawaii include the Earned Income Tax Credit (EITC) and the Renewable Energy credit. Most studies using tax records include this type of income in their analysis. Fifth, in-kind government transfers are an important part of the basket of benefits received, particularly for low-income individuals. These include programs like vouchers (food stamps) and other benefits like healthcare (Medicare, Medicaid) and subsidized housing. These benefits are typically not included in studies that use cash compensation as the measure of income, which includes most studies based on tax records.

¹ Friedman, Milton (1957). *A Theory of the Consumption Function*, Princeton, NJ: Princeton University Press

² Fullerton, Don and Diane Lim Rogers (1991). "Lifetime Versus Annual Perspectives on Tax Incidence." *National Tax Journal*, Vol 44, no. 3, (September, 1991), pp 277-87

³ Schneider, Friedrich (2012). "The Shadow Economy and Work in the Shadow: What do we (not) know?". Institute for the Study of Labor. Discussion Paper No. 6423.

Income patterns will vary depending on the economic unit. Many studies of income will look at consumption patterns at the household level. This is usually defined as a group of people living in the same dwelling that are sharing expenses. For instance, studies using the Consumer Expenditure Survey data produced by the US Bureau of Labor and Statistics measure consumption and income at the household level. Other studies will use the tax units as defined by the Internal Revenue Service. Several tax units filing as independents may be part of the same household, yet members of the same household are usually sharing fixed costs. All else being equal, three individuals that share cost and make-up one household will have more disposable income (because they have lower fixed costs) than three individuals making up three distinct household units even if the combined income of both group of three individuals is the same. Similarly, two households with the same level of income may not be equal. A two-adult household where one member works full-time and receives an annual income of \$50,000 while the other stays home to take care of the children and perform household duties is better off than a two-adult household where both adults work full-time and receive an annual salary of \$25,000 each (for a combined household salary of \$50,000). This is because the stay-at-home person in the first household is performing important services like childcare and cleaning that are not being measured by income. The latter household will presumably have to pay for the same services (or give up valuable time) make them worse off all else being equal.

Tax Policy, Inequality, and Hawaii

A tax system can help address inequality within a society, but it is not necessarily the most efficient redistribution tool available. Governments often use the tax system to achieve certain social outcomes, of which a common one is income redistribution. Debate surrounding a tax usually includes an evaluation of its progressivity and regressivity. A government can execute redistribution programs that do not involve taxes however, and taxation is relatively blunt public policy instrument relative to other more targeted programs. In fact, many other European countries have achieved lower levels of inequality than in the United States through redistribution programs that rely less on progressive tax policies. The United States is one of the most unequal countries in the Organization for Economic Cooperation and Development (OECD), an organization of rich countries, yet it has one of the most progressive tax systems. In the United States, the richest decile of income earners bears a larger percentage of the tax burden relative to their incomes than in any other OECD country.⁴ Other countries are more effective reducing inequality through a larger reliance on cash transfer programs that are usually targeted at the low income groups. This is to say that if a government is concerned with inequality, there are programs in addition to the tax system that can be used to address these issues.

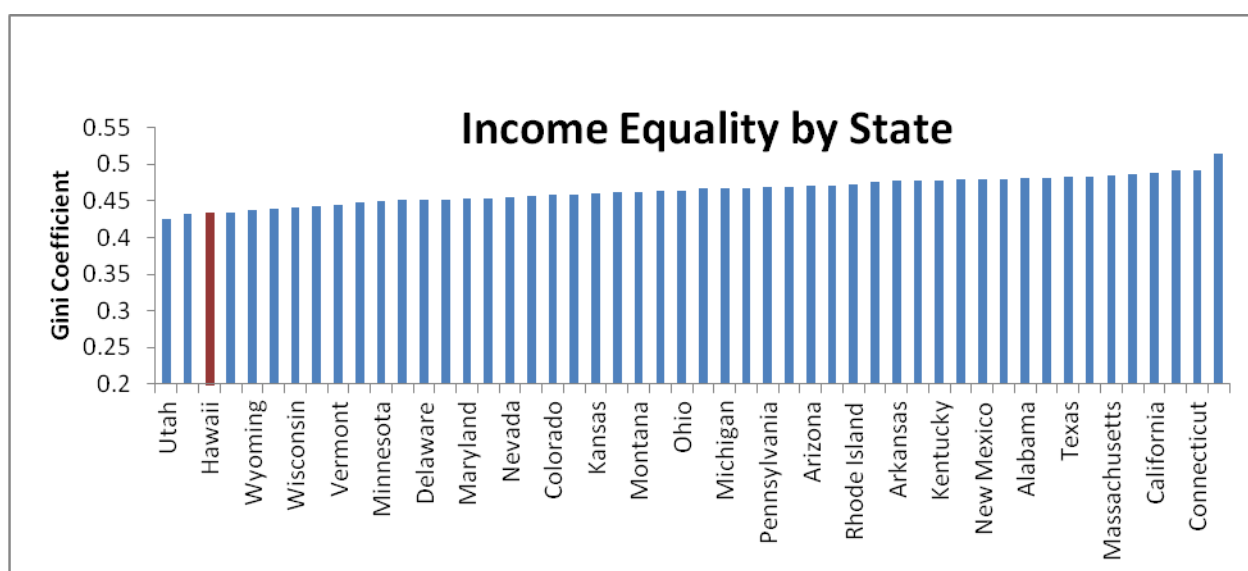
Hawaii is one of the most equal states in the country with the third lowest Gini coefficient (a common measure of inequality (see graph 2)). Hawaii is the second least unequal state based on the ratio of the

⁴ For a broader discussion, see OECD (2008) Growth Unequal? Income Distribution and Poverty in OECD countries. OECD (2008) How much redistribution do governments achieve? And TRP August 2017 presentation to TRC on Income Tax.

top 1% of income earners relative to the bottom 99%. Since the 1970s, global economic forces like free trade and technological advancements have resulted in outsized economic gains for top income earners across the country. This trend has been much less dramatic in Hawaii than in other states however. In Hawaii, the top 1% of households experienced an income increase of 54% between 1979 and 2013. In New York, by contrast, the top 1% of households experienced an income increase of 273%.⁵ The top 1% of resident households takes home 1.9% of all income in Hawaii, compared to an average of 20% in the rest of the country (see graph 3). This suggests that Hawaii does not have as many high income earners that drive inequality in the state.

Hawaii ranks high in terms of median household income, but the incomes of the top 1% of households are some of the lowest in the country. The average median household income in Hawaii was \$64,859 in 2015, the sixth highest in the country. By contrast, the income threshold for the top 1.0% of income earners is \$281,620, the 45th highest in the country (see table 3). The threshold to be in the top 10% of resident tax filers is \$121,860. These numbers indicate that there are not a lot of high income earners in the state. There are a number of potential causes for the low levels of inequality in the state including high levels of unionization and high average wages. However, the most likely reason is that Hawaii is not home to industries that produce large amounts of wealth. Inequality has increased because the economic gains have been concentrated in highest income levels. Hawaii has not benefited from high levels of wealth creation, even if it goes to a relative few.

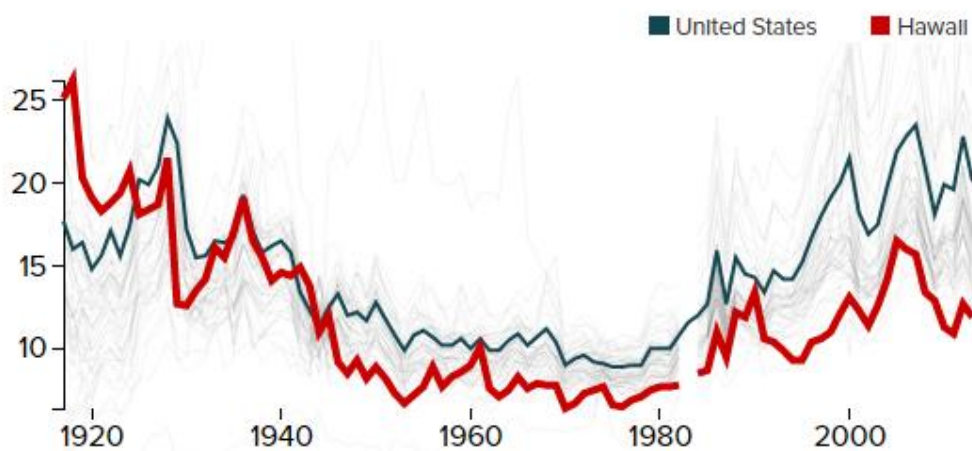
Graph 2:



Source: American Community Survey (2015) Includes all cash income

⁵ Economic Policy Institute

Graph 3 Share of income captured by top 1%, 1917-2013



Source: Economic Policy Institute

| Table 3: Income threshold of top 1.0% of tax filers by state | | |
|--|---------------|------------------------------|
| Rank | State | Income threshold of top 1.0% |
| 1 | Connecticut | \$659,979 |
| 2 | New Jersey | \$547,737 |
| 3 | Massachusetts | \$539,055 |
| 4 | New York | \$517,447 |
| 5 | North Dakota | \$481,188 |
| 6 | California | \$453,772 |
| 7 | Texas | \$424,507 |
| Avg | United States | \$389,436 |
| 45 | Hawaii | \$281,620 |

Source: Economic Policy Institute

General Excise and Use Tax

The GET is the largest source of tax revenue in the state. It is structured in such a way that closely resembles a value-added tax (VAT). The GET is a gross receipts tax that is imposed on the privilege of doing business in the State of Hawaii. This tax is coupled with a Use Tax that applies to the purchase from out-of-state vendors. The Use Tax ensures that locally-owned businesses are not put at a disadvantage relative to out-of-state businesses. While the tax is nominally a gross receipts tax, it is structured more like a VAT (see Table 3). GET is distinct from the common sales tax levied in other states because GET is levied on the business rather than on the consumer.⁶ The GET is also distinct in that it applies to all business transactions made within the state (i.e. it has a broad tax base); whereas most sales taxes are only applied to retail sales of tangible goods. Business-to-business transactions (which are considered inputs of final goods) are taxable under the GET, which is different from a pure VAT where such transactions are exempt. Several exemptions and a wholesale rate of 0.5% reduce the taxes imposed on business-to-business transactions making its final form closer to that of a VAT.

The other advantage of the GET is that the administrative burden is relatively low compared to other taxes. It is relatively straight-forward to calculate the gross-receipts of a business. In contrast, a business must document the cost of all inputs under a VAT, increasing the administrative cost. A sales tax can increase the administration load as well if there are many exemptions of goods that do not have a straight-forward definition that need to be documented. Many sales taxes include exemptions for certain goods like non-prepared food and medicine can increase the complexity of the tax code for example. The GET in contrast applies to all transactions. The burden of complying with the GET does increase if the business is applying for one of the many exemptions available to businesses however.

Table 3: Comparison of consumption taxes

| | GET | Sales | VAT |
|------------------------------|----------------|-----------------------|-------------|
| Taxpayer (statutory) | Business | Consumer | Business |
| Coverage | Broad | Narrow | Broad |
| Activity taxed | Gross receipts | Cost of taxable goods | Value-added |
| Inputs taxed | Yes (kind of) | No | No |
| Administrative Burden | Low | Medium | High |

The GET raises significant revenue through a low rate and a broad base. This tax adheres to one of the general principles of taxation which states that tax rates should be low and its application should be

⁶ The business passes the cost of the GET onto the consumer even though it is nominally levied on the business. In Hawaii, the business is allowed to report the cost of the GET on the receipt for the consumer, so it looks like a common sales tax as found in other states.

broad. By applying the tax most goods and services, the tax system is not biased in favor of a particular sector or good, which decreases the impact on market behavior. Hawaii has one of the lowest combined state and local sales tax rate of any state that has a sales tax (see table 4), but it raises the most amount of collections per capita in the nation (see table 5) and is the broadest in scope (see table 6).

Hawaii's GET rate has been remarkably stable relative to sales tax rates in other states. The state has imposed a state level tax rate of 4.0% since the nineteen-sixties and has remained unchanged since. This rate stability is in contrast to other states that have constantly had to raise rates in order to make up for declining revenue (see Graph 5). The average sales tax rate in the country has steadily increased from 2000 (the first year of data available). Other states like California and Texas have increased their rates from below 4.0% in the sixties to well above that at present. Hawaii has escaped the need to raise rates in part due to the broad scope of its tax base.

The GET is the most stable of Hawaii's major tax types and is closely correlated with economic performance. Revenues from the tax reflect movements in the state GDP and Total Personal income (see Graph 5 and 6). During economic downturns like the one experienced in 2009 however, tax revenue fell further than economic product.

The broad scope of the tax minimizes the distortionary elements. With few exceptions, the GET is applied to most sales of goods and services in the state, which means that few sectors receive privileged status. This reduces the effects on market pricing and promotes market efficiency. One advantage of the wide reach of the tax is that revenues have kept up with economic growth despite changing consumption patterns. An important trend over the last several decades is the move from a consumption basket of mostly durable goods toward a basket where services make up a larger portion of expenditures. Many states have had to raise sales tax rates to generate the necessary amount of revenues because they do not tax services. Hawaii has not had this problem because it treats goods and services equally for the most part

The largest five exemptions by dollar amount include Foreign Trade Zone Sales, Non-profit Organizations, Out-of-state Sales, Subcontractor Deduction, and Drugs and prosthetic Devices. The five exemptions that are the most frequently claimed are Taxes Passed On, Out of State Sales, Subcontractor Deduction, Sales to Federal Government and Credit Union, and Wholesale Transactions (Sales of tangible property imported for further resale at 0.5%). There are 54 different GET exemptions offered in the current tax code. In January 2017, DOTAX adopted a form (Schedule GE) that allows for an easier identification of GE Exemptions claimed via the new software system TSM. DOTAX ran a query for all G-45s between January 1, 2017 and June 30th, 2017, representing 6 months of returns. The Department ran the query on August 15, 2017. During this period, a total of 59,657 exemptions were claimed worth \$13.6 billion (see Table 6). This is probably less than half of what will eventually be claimed during Calendar Year 2017. This is because not all the forms from the first six months of the year have been filed and processed by August 15th. To put things in perspective, taxpayers claimed a total of \$32.6 billion of exemptions in 2015, more than double the amount listed in Table 6. The \$13.6 billion figure represent that amount of gross receipts exempted, not the imputed tax liability exempted.

Table 4: State & Local Sales Tax Rates

As of Jan 1, 2017

| State | State Tax Rate | Rank | Avg. Local Tax Rate | Combined | Rank |
|--------|----------------|------|---------------------|----------|------|
| La. | 5.00% | 33 | 4.98% | 9.98% | 1 |
| Tenn. | 7.00% | 2 | 2.46% | 9.46% | 2 |
| Ark. | 6.50% | 9 | 2.80% | 9.30% | 3 |
| Ala. | 4.00% | 40 | 5.01% | 9.01% | 4 |
| Wash. | 6.50% | 9 | 2.42% | 8.92% | 5 |
| Okla. | 4.50% | 37 | 4.36% | 8.86% | 6 |
| Ill. | 6.25% | 13 | 2.39% | 8.64% | 7 |
| Kans. | 6.50% | 9 | 2.12% | 8.62% | 8 |
| N.Y. | 4.00% | 40 | 4.49% | 8.49% | 9 |
| Calif. | 7.25% | 1 | 1.00% | 8.25% | 10 |
| Ariz. | 5.60% | 28 | 2.65% | 8.25% | 11 |
| Tex. | 6.25% | 13 | 1.94% | 8.19% | 12 |
| Nev. | 6.85% | 8 | 1.13% | 7.98% | 13 |
| Mo. | 4.23% | 39 | 3.66% | 7.89% | 14 |
| N.M. | 5.13% | 32 | 2.43% | 7.55% | 15 |
| Colo. | 2.90% | 45 | 4.60% | 7.50% | 16 |
| Minn. | 6.88% | 6 | 0.42% | 7.30% | 17 |
| S.C. | 6.00% | 16 | 1.22% | 7.22% | 18 |
| Ohio | 5.75% | 27 | 1.39% | 7.14% | 19 |
| Miss. | 7.00% | 2 | 0.07% | 7.07% | 20 |
| Ind. | 7.00% | 2 | 0.00% | 7.00% | 21 |
| R.I. | 7.00% | 2 | 0.00% | 7.00% | 21 |
| Ga. | 4.00% | 40 | 3.00% | 7.00% | 23 |
| N.C. | 4.75% | 36 | 2.15% | 6.90% | 24 |
| Nebr. | 5.50% | 29 | 1.39% | 6.89% | 25 |
| N.J. | 6.88% | 6 | -0.03% | 6.85% | 26 |
| Iowa | 6.00% | 16 | 0.80% | 6.80% | 27 |
| Fla. | 6.00% | 16 | 0.80% | 6.80% | 28 |
| N.D. | 5.00% | 33 | 1.78% | 6.78% | 29 |
| Utah | 5.95% | 26 | 0.81% | 6.76% | 30 |
| S.D. | 4.50% | 37 | 1.89% | 6.39% | 31 |
| Conn. | 6.35% | 12 | 0.00% | 6.35% | 32 |
| Pa. | 6.00% | 16 | 0.34% | 6.34% | 33 |
| W.Va. | 6.00% | 16 | 0.29% | 6.29% | 34 |
| Mass. | 6.25% | 13 | 0.00% | 6.25% | 35 |
| Vt. | 6.00% | 16 | 0.18% | 6.18% | 36 |
| Idaho | 6.00% | 16 | 0.03% | 6.03% | 37 |
| Ky. | 6.00% | 16 | 0.00% | 6.00% | 38 |
| Md. | 6.00% | 16 | 0.00% | 6.00% | 38 |
| Mich. | 6.00% | 16 | 0.00% | 6.00% | 38 |
| Va. | 5.30% | 31 | 0.33% | 5.63% | 41 |
| Maine | 5.50% | 29 | 0.00% | 5.50% | 42 |
| Wis. | 5.00% | 33 | 0.42% | 5.42% | 43 |
| Wyo. | 4.00% | 40 | 1.40% | 5.40% | 44 |
| Hawaii | 4.00% | 40 | 0.35% | 4.35% | 45 |
| Alaska | -- | -- | 1.76% | 1.76% | 46 |
| Del. | -- | -- | -- | -- | -- |
| Mont. | -- | -- | -- | -- | -- |
| (d) | -- | -- | -- | -- | -- |
| N.H. | -- | -- | -- | -- | -- |
| Ore. | -- | -- | -- | -- | -- |

Table 5 State General Sales Tax Collections per Capita

Fiscal Year 2015

| State | Collections per Capita | Rank |
|--------|------------------------|------|
| Hawaii | \$ 2,090 | 1 |
| N.D. | \$ 1,835 | 2 |
| Wash. | \$ 1,746 | 3 |
| Nev. | \$ 1,412 | 4 |
| Wyo. | \$ 1,384 | 5 |
| Tex. | \$ 1,226 | 6 |
| Miss. | \$ 1,144 | 7 |
| Conn. | \$ 1,137 | 8 |
| S.D. | \$ 1,131 | 9 |
| Ind. | \$ 1,100 | 10 |
| N.M. | \$ 1,082 | 11 |
| Fla. | \$ 1,075 | 12 |
| Ark. | \$ 1,069 | 13 |
| Kans. | \$ 1,049 | 14 |
| Ohio | \$ 1,025 | 15 |
| N.J. | \$ 1,021 | 16 |
| Minn. | \$ 999 | 17 |
| Tenn. | \$ 992 | 18 |
| Calif. | \$ 983 | 19 |
| Iowa | \$ 973 | 20 |
| Maine | \$ 963 | 21 |
| Ariz. | \$ 947 | 22 |
| Nebr. | \$ 943 | 23 |
| Mich. | \$ 928 | 24 |
| R.I. | \$ 908 | 25 |
| Idaho | \$ 885 | 26 |
| Mass. | \$ 854 | 27 |
| Wis. | \$ 848 | 28 |
| U.S. | \$ 844 | |
| Pa. | \$ 771 | 29 |
| Ky. | \$ 738 | 30 |
| Md. | \$ 734 | 31 |
| S.C. | \$ 729 | 32 |
| W.Va. | \$ 701 | 33 |
| Ill. | \$ 696 | 34 |
| Okla. | \$ 686 | 35 |
| N.C. | \$ 683 | 36 |
| N.Y. | \$ 662 | 37 |
| Utah | \$ 628 | 38 |
| La. | \$ 627 | 39 |
| Vt. | \$ 586 | 40 |
| Mo. | \$ 556 | 41 |
| Colo. | \$ 516 | 42 |
| Ga. | \$ 515 | 43 |
| Ala. | \$ 507 | 44 |
| Va. | \$ 452 | 45 |
| Alaska | \$ - | -- |
| Del. | \$ - | -- |
| Mont. | \$ - | -- |
| N.H. | \$ - | -- |
| Ore. | \$ - | -- |

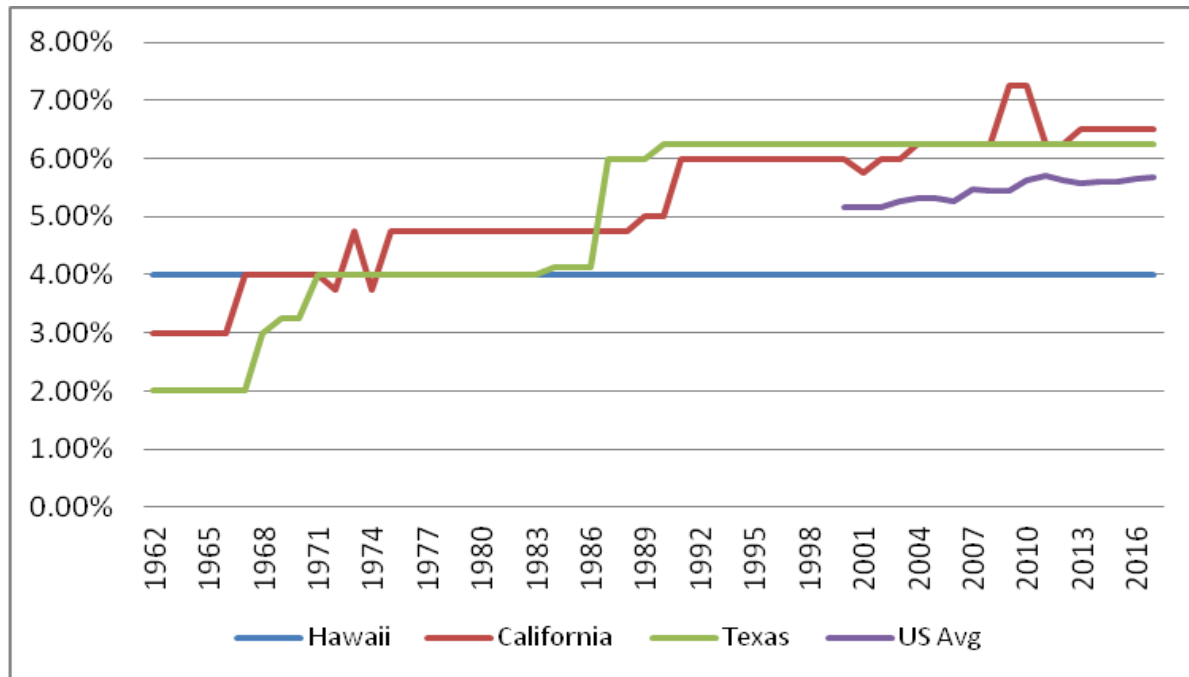
Table 6: State Sales Tax Breadth

Fiscal Year 2015

| State | Sales Tax Breadth | Rank |
|------------|-------------------|------|
| Hawaii (a) | 104% | 1 |
| N.D. | 73% | 2 |
| S.D. (a) | 65% | 3 |
| Wyo. | 62% | 4 |
| N.M. (a) | 59% | 5 |
| Nev. | 49% | 6 |
| Miss. | 47% | 7 |
| Ark. | 43% | 8 |
| Tex. | 42% | 9 |
| Maine | 41% | 10 |
| Ariz. | 41% | 11 |
| Fla. | 40% | 12 |
| Ind. | 40% | 13 |
| Idaho | 38% | 14 |
| Wash. | 38% | 15 |
| W.Va. | 37% | 16 |
| Wis. | 37% | 16 |
| La. | 37% | 18 |
| Kans. | 36% | 19 |
| Ky. | 36% | 20 |
| Mich. | 36% | 20 |
| Iowa | 35% | 22 |
| Ala. | 35% | 23 |
| Nebr. | 35% | 24 |
| Ohio | 35% | 24 |
| Colo. | 35% | 26 |
| Utah | 34% | 27 |
| Tenn. | 34% | 28 |
| N.C. | 34% | 29 |
| Okla. | 34% | 29 |
| Minn. | 33% | 31 |
| Ga. | 32% | 32 |
| S.C. | 32% | 33 |
| Mo. | 31% | 34 |
| Calif. | 28% | 35 |
| N.Y. | 27% | 36 |
| Conn. | 26% | 37 |
| R.I. | 26% | 38 |
| Md. | 26% | 39 |
| Pa. | 26% | 39 |
| Vt. | 25% | 41 |
| N.J. | 24% | 42 |
| Ill. | 23% | 43 |
| Va. | 23% | 44 |
| Mass. | 22% | 45 |
| U.S. | | |

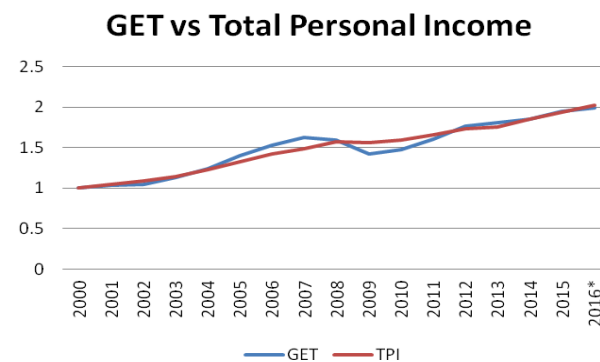
Source: Tax Foundation

Graph 5: State Sales Tax Rates



Source: DOTAX

Graph 5



Graph 6

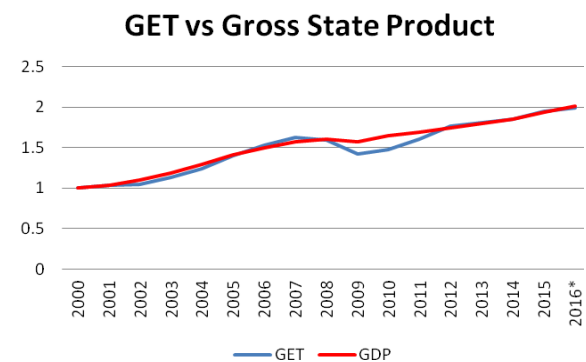


Table 6: GET Exemptions Claimed

From Sch GE Jan 1-June 30th, 2017. Report ran on August 15, 2017

| | Amount | # | of total amount (%) | of total claimed (%) |
|---|---------------|-------|---------------------------|-------------------------|
| Foreign Trade Zone Sales (§212-8) | 2,932,099,805 | 374 | 21.6% | 0.6% |
| Non-profit Organizations (§237-23) | 2,593,488,294 | 1,343 | 19.1% | 2.3% |
| Subcontract Deduction (§237-13(3)(B)) | 1,424,110,663 | 6,415 | 10.5% | 10.8% |
| Out of State Sales (§237-29.5(1)) | 1,169,562,953 | 8,732 | 8.6% | 14.6% |
| Drugs and Prosthetic Devices (§237-24.3(6)) | 755,413,237 | 885 | 5.6% | 1.5% |

| | | | | |
|--|----------------|--------|--------|--------|
| Wholesale Trans (prop imported for resale at 1/2%) (§237-29.55) | 744,138,352 | 2,390 | 5.5% | 4.0% |
| Taxes Passed On (§§237-24(8), 237-24(9), 237-24(10), 237-24(12)) | 582,689,240 | 19,819 | 4.3% | 33.2% |
| Affordable Housing (§§46-15.1, 201H-36 237-29, 238-3(j)) | 503,882,723 | 939 | 3.7% | 1.6% |
| Maintenance Fees (§§237-24.3(2), 237-24(16)) | 381,208,149 | 2,158 | 2.8% | 3.6% |
| Sales to Federal Government and Credit Unions (§237-25(a)) | 320,317,787 | 3,153 | 2.4% | 5.3% |
| Enterprise Zones (§209E-11) | 197,062,950 | 332 | 1.5% | 0.6% |
| Discounts and Returned Merchandise (§237-3(b)) | 190,971,932 | 1,521 | 1.4% | 2.6% |
| Federal Preempted Amount (§§237-22, 238-3(a)) | 172,468,827 | 343 | 1.3% | 0.6% |
| Service Related to Ship & Aircraft (§237-24.3(3)) | 170,923,153 | 139 | 1.3% | 0.2% |
| Intercompany Charges (§237-23.5(a)) | 161,687,357 | 678 | 1.2% | 1.1% |
| Certain Oahu Sales (§237-8.6) | 150,629,940 | 1,138 | 1.1% | 1.9% |
| Food Stamps and WIC (§237-24.3(5)) | 118,631,949 | 1,691 | 0.9% | 2.8% |
| Employee Benefit Plans (§237-24.3(4)). | 107,817,086 | 151 | 0.8% | 0.3% |
| Air Pollution Control Facilities (§§237-27.5, 238-3(k)) | 103,372,580 | 190 | 0.8% | 0.3% |
| Out of State Services Foreign Customers (§238-2.3(1)(C)) | 89,217,032 | 944 | 0.7% | 1.6% |
| Exported Services (§237-29.53) | 85,190,888 | 689 | 0.6% | 1.2% |
| Shipbuilding and Ship Repairs (§237-28.1). | 76,845,799 | 208 | 0.6% | 0.3% |
| Subleases of Real Property (§237-16.5) | 68,027,513 | 1,747 | 0.5% | 2.9% |
| Scientific Contracts (§§237-26, 238-3(j)). | 61,983,043 | 338 | 0.5% | 0.6% |
| Reimbursement of Payroll Costs (§237-24.7(9)) | 46,490,001 | 111 | 0.3% | 0.2% |
| Hotel Operator/Suboperator (§237-24.7(1)) | 39,018,197 | 163 | 0.3% | 0.3% |
| Certain Contracts Entered into Before 6/30/2006 (§237-8.6(c)) | 37,344,705 | 68 | 0.3% | 0.1% |
| Real Estate Sales (§237-3(b)) | 31,930,852 | 341 | 0.2% | 0.6% |
| Federal Cost-Plus Contractors (§237-13(3)(C)) | 31,894,139 | 64 | 0.2% | 0.1% |
| Aircraft Service and Maintenance Facility (§§237-24.9, 238-1) | 24,333,948 | 82 | 0.2% | 0.1% |
| Bad Debts (§237-3(b)) | 22,257,587 | 774 | 0.2% | 1.3% |
| Professional Employer Organizations (§237-24.75(3)) | 19,707,563 | 88 | 0.1% | 0.1% |
| Aircraft Leasing (§§237-24.3(11), 238-1) | 17,615,405 | 19 | 0.1% | 0.0% |
| Labor Organizations (§237-24.3(9)) | 10,355,643 | 33 | 0.1% | 0.1% |
| Hawaii Convention Center Operator (§237-24.75(2)) | 8,757,132 | 22 | 0.1% | 0.0% |
| Wholesale Amusements (§237-4(a)(13)) | 8,168,643 | 119 | 0.1% | 0.2% |
| Contracting Activity in an Enterprise Zone (§209E-11) | 7,757,349 | 74 | 0.1% | 0.1% |
| Certain Convention, Conference and Trade Show (§237-16.8) | 5,686,635 | 15 | 0.0% | 0.0% |
| Merchants' Association Dues (§237-24.3(8)) | 4,180,826 | 25 | 0.0% | 0.0% |
| Common Paymaster Exemption (§237-23.5(b)) | 4,164,995 | 39 | 0.0% | 0.1% |
| Shipping and Handling of Agricultural Commodities (§237-24.3(1)) | 3,938,566 | 38 | 0.0% | 0.1% |
| TRICARE (§237-24(17)) | 3,732,808 | 139 | 0.0% | 0.2% |
| Producers (Certain property used) (§238-4) | 2,365,303 | 34 | 0.0% | 0.1% |
| Potable Water (§237-23(a)(7)) | 2,103,214 | < 10 | 0.0% | 0.0% |
| Orchard Operator (§237-24.7(4)) | 1,792,657 | 31 | 0.0% | 0.1% |
| Mass Transit (§237-24.7(2)) | 1,347,635 | < 10 | 0.0% | 0.0% |
| Insurance Proceeds Because of a Natural Disaster (§237-24.7(6)) | 1,097,466 | < 10 | 0.0% | 0.0% |
| Petroleum Refining (§237-27) | < 1 million | 30 | 0.0% | 0.1% |
| Small Business Innovation Research Grants (§237-24.7(10)) | < 1 million | 14 | 0.0% | 0.0% |
| Disability Provisions (§237-24(13)) | < 1 million | 294 | 0.0% | 0.5% |
| Diplomats and Consular Officials (§§237-24.3(10), 238-1) | < 1 million | 111 | 0.0% | 0.2% |
| Sugar Cane Payments to Independent Producers (§237-24(14)) | < 1 million | < 10 | 0.0% | 0.0% |
| Patient-Centered Community Care (§237-24(18)) | < 1 million | 22 | 0.0% | 0.0% |
| Stock Exchange Transactions (§237-24.5) | < 1 million | 11 | 0.0% | 0.0% |
| Mislabeled/unspecified | 55,550,215 | 543 | 0.4% | 0.9% |
| Total | 13,556,929,064 | 59,647 | 100.0% | 100.0% |

Several exemptions are designed to reduce taxes on business-to-business transactions, which reduces pyramiding and makes the GET more closely resemble a VAT. The wholesale rate is taxed at 0.5% rather than the standard 4.0%, reducing the tax on business inputs. If the GET were to behave strictly like a VAT, all business inputs including wholesale transactions would not be subject to tax. Additionally, all out-of-state exports are not subject to the GET tax so as not make exporting companies uncompetitive relative to out-of-state entities that do not have to pay the GET. Entities like insurance companies and public utility companies are exempted from the GET tax to avoid pyramiding issues. However, they are subject to alternative taxes with rates more appropriate to their industries. Contractors can deduct the expenses paid to subcontractors. Finally, there is a refundable income tax credit for GET paid on the purchase of capital goods. While this tax credit derives from the income tax, the intent is to eliminate the GET tax liability on investments in fixed capital goods. A study found that tax pyramiding results in an effective rate of 4.5% versus the actual rate of 4.0%.⁷

The amount of exemptions being claimed has been growing, reducing the overall tax liability to the state. There has been a gradual increase in the amount of exemptions claimed relative to total gross receipts reported. In 2004, filers claimed that 15.6% of gross receipts were exempt from the taxable base. In 2015, 25% of gross receipts were claimed exempt, representing a 9.4% increase over an 11 year period (see Table 7 and Annex 1). Graph 6 shows that exemptions claimed have been growing faster than the gross receipts in relative terms. These shifts represent significant changes to the amount of GET revenue collected over time. If the rate of exemptions in 2015 would have been the same as in 2004 (15.6%), the state would have received \$256 million more in revenue during the fiscal year. The number of exemptions has not increased as rapidly as the amount of the exemptions claimed. In 2004, 8.8% of the lines populated with a gross receipt amount were associated with an exemption. In 2015, the number of lines populated was 9.7% suggesting the relative number of exemptions has not increased dramatically. Alternatively, the amount of the average exemption line claimed (number of exemptions/ amount of exemptions) was \$581,000 in 2004 versus \$1,293,000 in 2015, a more than 100% increase.⁸ The increase in the amount of claimed exemptions occurred in a select few categories including: services, hotel rental, other rental, all other and Use (4%) at the 4% rate and in wholesaling, manufacturing, producing, and intermediary services at the 0.5% rate (see Table 7). Segments like retailing (the most important sector in terms of revenue) and contracting did not see a commensurate increase in exemptions claimed.

There are several possible explanations for the increase in exemptions relative to gross receipts. 1) Taxpayers may be correctly claiming more exemptions than in the past. 2) Taxpayers may be incorrectly claiming more exemptions (e.g., Taxpayer used to claim just the subcontracting exemption but is now also claiming scientific contracts, air pollution control facility, etc.) and incorrectly claiming higher

⁷ Tax Research and Planning Office, Hawaii Department of Taxation. "Study of the Progressive or Regressive Nature of Hawaii's Taxes (Appendix D) 2005-2007 Tax Review Commission

⁸ Adjusted for inflation, the 2015 average exemption figure would be \$1,025,000 in 2004 dollars versus \$581,000 in 2004.

amounts of income as exempt. State tax auditors have noticed that taxpayers have become more aggressive with both the number of exemptions claimed on their returns and the amounts that they claim.⁹ 3) In 2010, the state enacted Act 155 which required all taxpayers to file information regarding gross proceeds whether they had a tax liability or not. This prompted many organizations with no tax liability like non-governmental organization to file tax forms for the first time. This would have increased the amount of exemptions in relation to the total tax base. While Annex 1 shows that there was large increase in exemptions in calendar year 2011, the year after the law was enacted, the general trend towards higher exemptions as percentage of gross receipts increased before and after the 2010, suggesting that this is only part of the explanation. The numbers suggest that it would be worth taking a closer look at GET exemptions (particularly the amounts) to ensure that they are justified.

Table 7: Exemptions as percentage of gross proceeds over time

| | Exemptions/gross proceeds | | | % of Total GET Tax Liability |
|------------------------------|---------------------------|--------------|--------------|---------------------------------|
| | 2004 | 2015 | Difference | 2015 |
| TOTAL | 15.6% | 25.0% | 9.4% | 100.0% |
| ALL 4% | 16.9% | 24.5% | 7.6% | 95.9% |
| Retailing | 14.7% | 15.1% | 0.4% | 42.8% |
| Services | 12.3% | 28.0% | 15.7% | 18.9% |
| Contracting | 34.1% | 34.1% | 0.0% | 11.2% |
| Amusement | 4.8% | 6.1% | 1.3% | 0.5% |
| Interest | 0.0% | 0.0% | 0.0% | 0.0% |
| Commissions | 30.6% | 29.8% | -0.9% | 1.6% |
| Hotel Rental | 4.2% | 12.8% | 8.6% | 6.1% |
| Other Rental | 4.9% | 12.0% | 7.1% | 9.3% |
| All Other | 29.4% | 63.2% | 33.8% | 4.1% |
| Use 4% | 7.1% | 21.6% | 14.5% | 1.3% |
| ALL UNDER 4% | 12.5% | 26.6% | 14.1% | 4.1% |
| Wholesaling | 16.2% | 30.4% | 14.1% | 2.5% |
| Manufacturing | 17.1% | 36.2% | 19.1% | 0.1% |
| Producing | 10.9% | 63.0% | 52.1% | 0.1% |
| Intermediary Services | 9.2% | 55.7% | 46.5% | 0.1% |
| Insurance Commissions | 7.7% | 7.9% | 0.2% | 0.0% |
| Use (1/2%) | 5.2% | 7.4% | 2.3% | 1.3% |

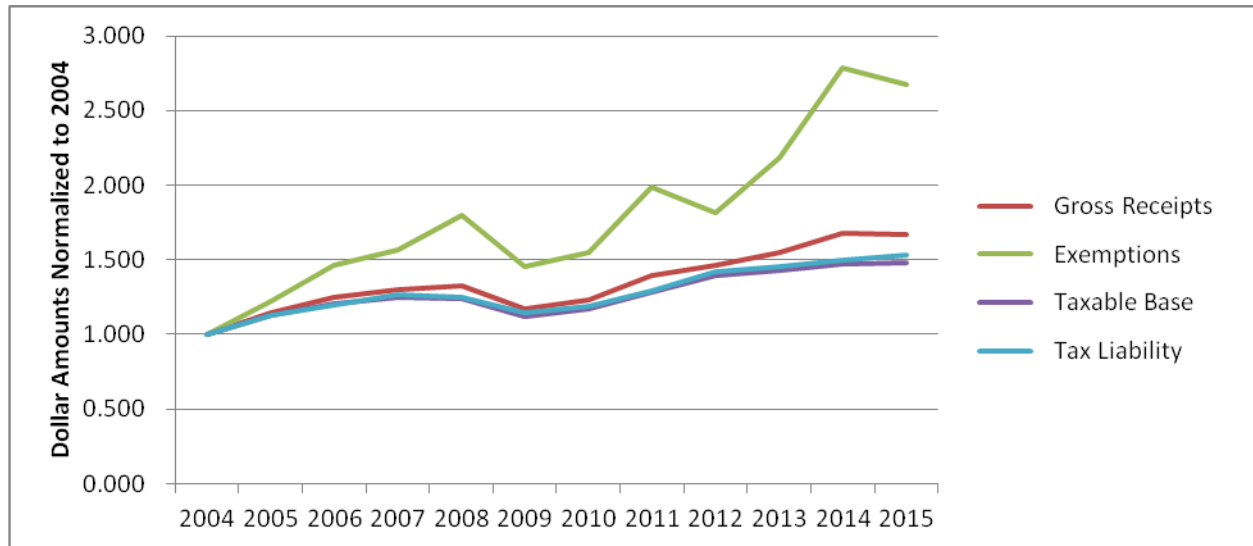
⁹ The numbers produced in Table 7 and Annex 1 are the aggregate figures reported on the tax forms G45 or G49. They do not represent audited numbers or the final amount paid by the taxpayer since they do include adjustments due to audits or any formal investigation from the Department of Taxation.

Use 4% = Imports for Consumption.

Use (1/2%) = Imports for Resale.

Calculated by the Department of Taxation, Tax Research and Planning Office.

Graph 6: The growth of GET exemptions relative to other gross receipts, taxable base, and tax liability



A sizable percentage of the GET is exported to non-resident taxpayers. One advantage, from state resident's point of view, is that much of the tax burden is paid by non-residents. This is due to the fact that many non-residents engage in high levels of consumption within the state. The two largest populations are tourists and non-resident military personnel. A number of studies have attempted to quantify the amount of GET paid by out-of-state residents, the results of which range between 20% to 38%. Older studies find that the amount of tax exported is 20% (Bowen and Leung 1989) and 32.9% (Miklikus et al 1988).¹⁰ A more recent study found that the amount exported is 37.9% (Tax Research & Planning 2006).¹¹

GET is regressive like most consumption taxes. Nearly all consumption taxes are found to be regressive, and the GET is no exception. This is because lower income people spend a larger percentage of their income on consumption than higher income folks. The GET may be more regressive than sales tax found in some other states because it does not exempt basic items like groceries and healthcare which make up a larger percentage of consumption at lower income levels. The regressive aspects of the excise tax have been documented in different studies. DOTAX finds that burden falls from 5.75% of income for

¹⁰ Bowen, Richard and Pingsun Leung (1989). "Tax Pyramiding and Tax Exporting in Hawaii: An input-output analysis." Research Extensions Series 102

¹¹ Tax Research and Planning Office, Hawaii Department of Taxation. "Study of the Progressive or Regressive Nature of Hawaii's Taxes (Appendix D) 2005-2007 Tax Review Commission

annual income levels lower than \$14,400 to 1.15% for incomes over \$70,000 per year.¹² Another study (Fox 2006) finds that the burden is 4.95% for people with income brackets under 14,400 and 1.05 for annual incomes over \$70,000.¹³

Looking at estimates of the amount of tax paid relative to income may lead to misleading conclusions about regressivity however. There are a number of potential reasons for this fact which include: 1) people use savings to make up for lower income as one would expect for retirees or people between jobs; 2) low income households often receive in-kind benefits like housing and food stamps that boost their consumption potential; and/or 3) people may be underreporting their income.¹⁴ Consumption patterns tend to be smoother and more constant than income over a lifetime. There are reasons to believe that consumption is a more appropriate indicator of average lifetime income than annual income.¹⁵ Studies have found consumption taxes to be much less regressive using lifetime measures versus annual measures.¹⁶ These findings hold in the case of Hawaii as well. Both of the studies on the distribution of the tax burden of GET mentioned above find that taxes are less regressive when using lifetime measures (i.e. using consumption as the denominator instead of income). The DOTAX studies find that the GET burden declined by 80% between the lowest and highest income brackets when measured by annual income versus 27% when measured by lifetime earnings. Fox (2006) finds an 82% (5.95% to 1.05%) decline using the income metric versus a 35.5% decline (3.21% to 2.07%) (see graph 7) In summary, the GET is regressive but when measured in terms of consumption it is less regressive than what the initial results of many studies suggest.

Graph 7:

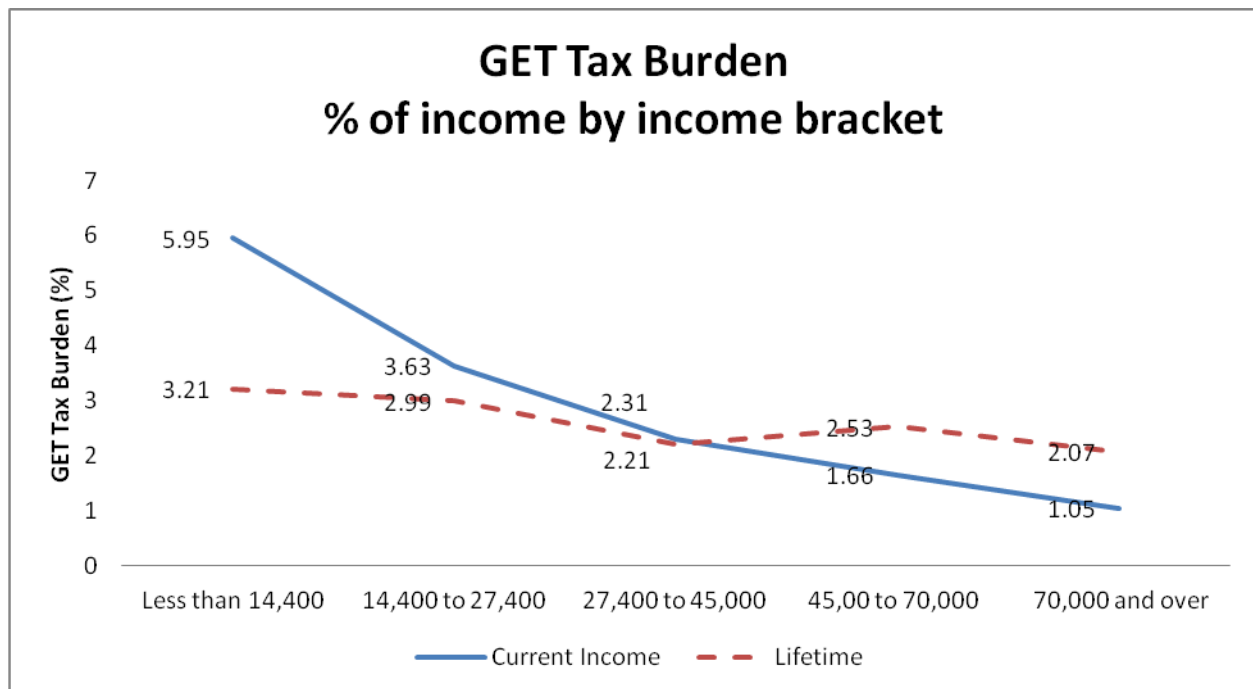
¹² Tax Research and Planning Office, Hawaii Department of Taxation. "Study of the Progressive or Regressive Nature of Hawaii's Taxes (Appendix D) 2005-2007 Tax Review Commission

¹³ Fox, William (2006). "Hawaii's General Excise Tax: Should the Base be Changed? TRC 2005-2007

¹⁴ Most of the studies on the distributional impact of consumption taxes in the United States depend on data from the Consumer Expenditure Survey. The survey design methodology is better at measuring consumption patterns than income. There is evidence that income tends to be underreported in the survey.

¹⁵ Csperen Erik, Gilerbert Metcalf (1994). "Is a Value Added Tax Regressive? Annual versus lifetime incidence measures." *National Tax Journal*. Vol 47, n. 4 (December, 1994), pp. 731046.

¹⁶ See Csperen Erik, Gilerbert Metcalf (1994). "Is a Value Added Tax Regressive? Annual versus lifetime incidence measures." *National Tax Journal*. Vol 47, n. 4 (December, 1994), pp. 731046. Fullerton, Don and Diane Lim Rogers (1991). "Lifetime Versus Annual Perspectives on Tax Incidence." *National Tax Journal*, Vol 44, no. 3, (September, 1991), pp 277-87



Source: William Fox (2006). Hawaii's General Excise Tax: Should the Base be Changed? TRC 2005-2007

GET is the largest source of General Fund revenue, and small changes in rates can have large impacts on collections. Due to the size and the breadth of the GET, a straightforward way to make revenue adjustments is through rate changes to the GET. Every 0.5% change in the GET rate roughly equates to a 6.2% change (\$384 million) in general fund revenues (see table 8).

Table 8: GET headlines numbers and revenue Implications (\$ thousands)

| Rate Changes | 3.5% | 4.0% | 4.5% | 5.0% | 5.5% |
|----------------|-----------|-----------|-----------|-----------|-----------|
| Rev Collection | 2,820,970 | 3,205,733 | 3,590,496 | 3,975,260 | 4,360,023 |
| Net Impact | (384,763) | 0 | 384,763 | 769,526 | 1,154,290 |
| % of GET | -12.0% | 0.0% | 12.0% | 24.0% | 36.0% |
| % of GF | -6.2% | 0.0% | 6.2% | 12.4% | 18.6% |

As far as taxes go, the GET performs well against standard criteria such as economic efficiency, administrative burden, and stability; it does less well in terms of fairness if progressivity is a priority. The broad scope of the tax does not favor or disfavor particular sectors of the economy like goods versus services. This minimizes economic distortions and maintains economic efficiency. The large base and targeted exemptions keep tax pyramiding relatively low. Some taxes are levied on many business-

to-business transactions which increase the cost of doing business however. In terms of fairness, the tax is regressive because lower income individuals spend a larger percentage of their income on taxed consumption. However, the tax is less regressive if a life-cycle measure is used. The administrative burden associated with compliance costs and administering the tax is low for the both the taxpayer and the state government. Finally, the GET provides stable form of government revenue that is closely associated with economic growth (see table 9).

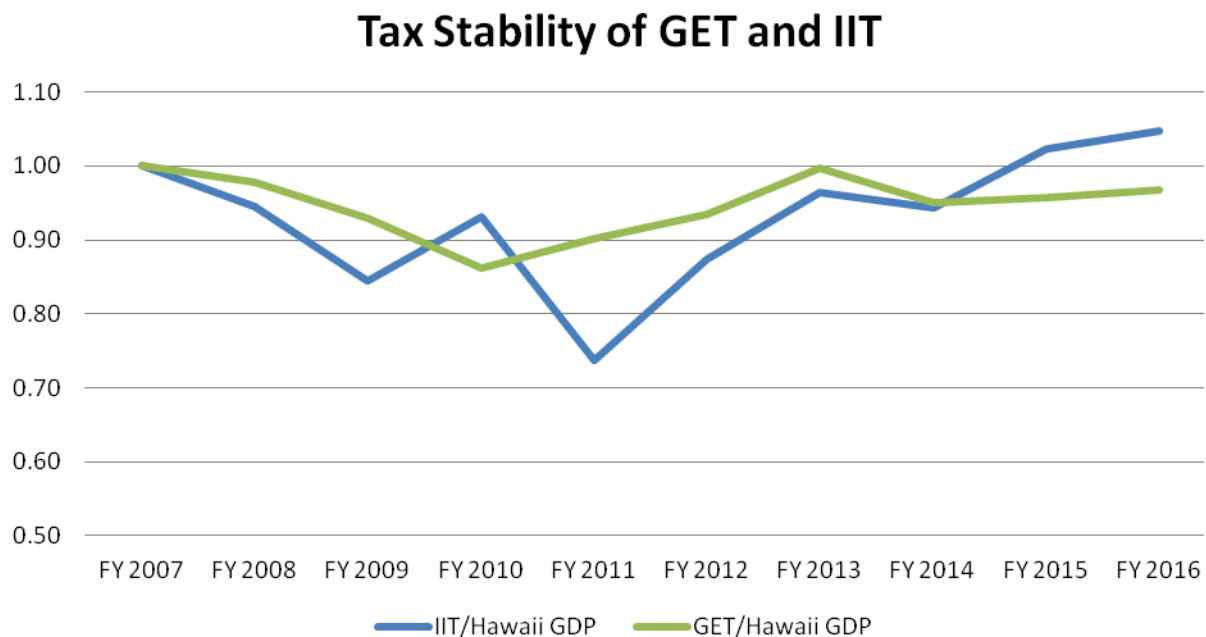
Table 9: Assessing the GET

| | |
|------------------------------|--|
| Economic Efficiency | <ul style="list-style-type: none"> • The broad base and targeted exemptions keep tax pyramiding relatively low • There is still some tax on most business-to-business transactions, which increases the cost of doing business • Broad scope does not favor or disfavor a particular sector (low distortions) |
| Fairness | <ul style="list-style-type: none"> • Regressive because lower income people spend a larger percentage on taxed consumption • Less regressive if lifecycle is taken into account |
| Administrative Burden | <ul style="list-style-type: none"> • Low compliance costs and low administrative costs by the government |
| Stability | <ul style="list-style-type: none"> • GET revenue is closely correlated with GDP growth but falls more significantly during economic downturns |

Individual Income Tax

State individual income tax is the second most important source of General Fund revenue, contributing slightly less than 30% of revenues. In terms of the contribution to the state and local taxes, the individual income tax contributes 21% of tax revenues for Hawaii. This is in line with the national average where 23% of taxes come from the individual income tax. The individual income tax is a more volatile tax than the GET (see Graph 8).

Graph 8:



Source: DOTAX

Despite the fact that its common use by governments, incomes taxes have the potential to impose distortions on the economy. Individual income tax is effectively a tax on labor, an economic input. In simplistic economic models, firms have to decide how to best utilize the inputs of capital and labor in order to produce a good or service that is consumed by the population at large. A tax on an input has a greater propensity to influence economic decision making because you are effectively changing the price of labor versus capital (or vice versa), which in turns influences the firm's decision on how to utilize amount of labor versus the amount of capital. Taxing income discourages work since the individual is not collecting all the economic gains directly through their wages—since part of their wage goes to taxes. Individuals will then withdraw their labor, which leads to a decline in economic output.

Relative to consumption taxes, income taxes also provide a disincentive to save. This is because income taxes favor present consumption over future consumption. While the tax is applied in the present, the consumption takes place in the future. Since all things in the future are uncertain, it should be discounted by some time variable. This is in contrast to a consumption tax which only applies the tax at the moment of consumption (regardless of whether the income was saved or not). A consumption tax taxes current and future consumption at the same rate, whereas an income tax in effect taxes future consumption at a higher rate than current consumption. This is one of the reasons why many governments allow retirement savings such as a 401(K) to be tax deductible.

Table 10: Income tax versus consumption tax

| | Individual Income Tax | Consumption Tax |
|------------------------------|--|---|
| Equity | Tend to be more progressive (using graduated rates) | Regressive (less in life cycle terms) |
| Efficiency | Moderate distortion: Taxation of input reduces work, depends a lot on rates. Discourages savings | Minimal distortion: If applied equally to all consumption goods |
| Administrative Burden | Easy to moderate | Easy |
| Avoidance | Moderate to high | Low |

Most governments tax labor inputs more than capital (i.e capital gains taxes and corporate income tax are less than labor tax) because capital is mobile whereas labor is more domiciled (and thus it is harder to avoid the tax). Moreover, capital accumulation is strongly correlated with growth, so governments lower the tax on capital to promote investment. Labor traditionally is considered to be less mobile, but this may be changing in the e-economy. When people can work from anywhere, they can elect where they want to reside and effectively choose their tax jurisdiction, especially when deciding to reside in states where there is a large differential in tax rates is significant.

Governments tend to utilize income taxes due to its ability to redistribute wealth. Such a tax allows authorities to apply different rates according to individual's "ability to pay." Applying a graduated tax schedule can help redistribute wealth and reduce inequality. It is important to remember that income is not wealth however, and wealth is probably the most appropriate measure of "ability to pay." Taxing both wealth and income can be difficult since many assets and even income are easily moveable. Wealthy individuals that can employ the help of sophisticated accountants have an easier time "hiding" their income from the tax authorities. They are also better able to engage in tax planning which further reduces their tax liability.

There are several notable features of the Hawaii individual income tax. The system is progressive relative to other states. Unlike federal rates, the brackets are not indexed to inflation. There is a relatively low standard deduction compared to the federal rate (Hawaii is \$4,400 for married filing jointly versus \$12,600 at the federal level). There are a number of refundable credits that offset the tax burden for lower income individuals. The state exports a large amount of the tax burden to the federal

government, particularly at high income levels. The largest and most costly state specific exemption is pensions and social security, which expected to grow over time.

Hawaii has one of the highest marginal tax rates in the country. Of the 43 states that levy individual income taxes, Hawaii has the second highest rate in the country.¹⁷ Only California levies a higher rate of 13.30%, a rate which is imposed on income exceeding \$1 million. Hawaii's 11% rate takes effect at \$400,000 for a joint filer, meaning the state imposes the highest rate on a lower amount of income (see table 11). The state has the most brackets in the country with 12 different brackets. California and Missouri have the second most amounts of tax brackets with 10 each. Hawaii's income brackets are steep on the extremes and relatively flat in the middle (see table 12). Another approach to measuring the progressivity of a tax structure is to look at the effective tax rate of a typical household at different income levels. Table 13 conducts such an analysis for five different states. It uses the standard deduction with no dependents and does not account for any refundable tax credits. It then looks the difference in the effective tax rate between a married, filing jointly household with an annual income of \$350,000 versus one making \$50,000. The results suggest that Hawaii has the second most progressive income tax structure after California not taking into account refundable credits.

Table 11: Highest Marginal Tax Bracket

| | | |
|-----------|------------|--------|
| 1 | California | 13.30% |
| 2 | Hawaii* | 11.00% |
| 3 | Maine | 10.15% |
| 4 | Oregon | 9.90% |
| 5 | Minnesota | 9.85% |
| 6 | Iowa | 8.98% |
| 7 | New Jersey | 8.97% |
| 8 | Vermont | 8.95% |
| 9 | DC | 8.95% |
| 10 | New York | 8.82% |
| 11 | Wisconsin | 7.65% |
| 12 | Idaho | 7.40% |

Source: Tax Foundation

Table 12

¹⁷ This analysis includes the high income tax brackets of 9%, 10%, 11% approved by the State Legislature in 2017.

Tax brackets for Selected States (Joint Filers)

| | | | | |
|---|--|---|---|--|
| Colorado 4.63% of federal taxable income | Virginia 2.00% > \$0 3.00% > \$3,000 5.00% > \$5,000 5.75% > \$17,000 | Maryland 2.00% > \$0 3.00% > \$1,000 4.00% > \$2,000 4.75% > \$3,000 5.00% > \$150,000 5.25% > \$175,000 5.50% > \$225,000 5.75% > \$300,000 | California 1.00% > \$0 2.00% > \$16,030 4.00% > \$38,002 6.00% > \$59,978 8.00% > \$83,258 9.30% > \$105,224 10.30% > \$537,500 11.30% > \$644,998 12.30% > \$1,074,996 13.30% > \$1,074,996 | Hawaii* 1.40% > \$0 3.20% > \$4,800 5.50% > \$9,600 6.40% > \$19,200 6.80% > \$28,800 7.20% > \$38,400 7.60% > \$48,000 7.90% > \$72,000 8.25% > \$96,000 9.00% > \$300,000 10.00% > \$350,000 11.00% > \$400,000 |
|---|--|---|---|--|

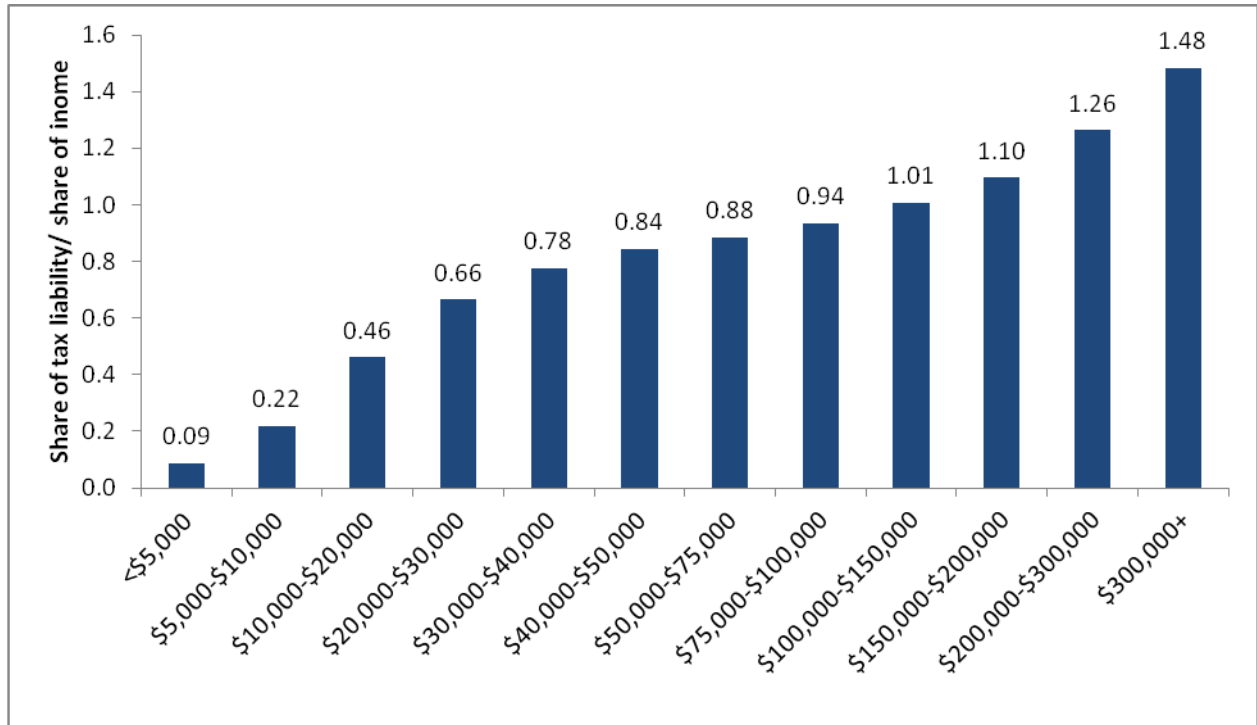
Table 13 Rates on Taxable Income for selected states (married, filed jointly)

| Adjusted Gross Income | 50,000 | | 75,000 | | 100,000 | | 150,000 | | 350,000 | | Ratio |
|-----------------------------|--------------------|-------|--------------------|-------|--------------------|-------|--------------------|-------|--------------------|-------|--------------------|
| | Marginal Effective | | Marginal Effective | | Marginal Effective | | Marginal Effective | | Marginal Effective | | 350,000/ 50,000 |
| Hawaii (2018) | 7.60% | 5.72% | 7.90% | 6.36% | 8.25% | 6.76% | 8.25% | 7.25% | 10.00% | 7.93% | 139% |
| California | 4.00% | 2.16% | 6.00% | 3.17% | 8.00% | 4.21% | 9.30% | 5.86% | 9.30% | 7.83% | 363% |
| Maryland | 4.75% | 4.64% | 4.75% | 4.68% | 4.75% | 4.70% | 5.00% | 4.71% | 5.50% | 5.13% | 110% |
| Colorado | 4.63% | 4.63% | 4.63% | 4.63% | 4.63% | 4.63% | 4.63% | 4.63% | 4.63% | 4.63% | 100% |
| Virginia | 5.75% | 5.23% | 5.75% | 5.41% | 5.75% | 5.49% | 5.75% | 5.58% | 5.75% | 5.68% | 109% |

Source: Dotax calculations (year 2016 exempt in case of Hawaii)

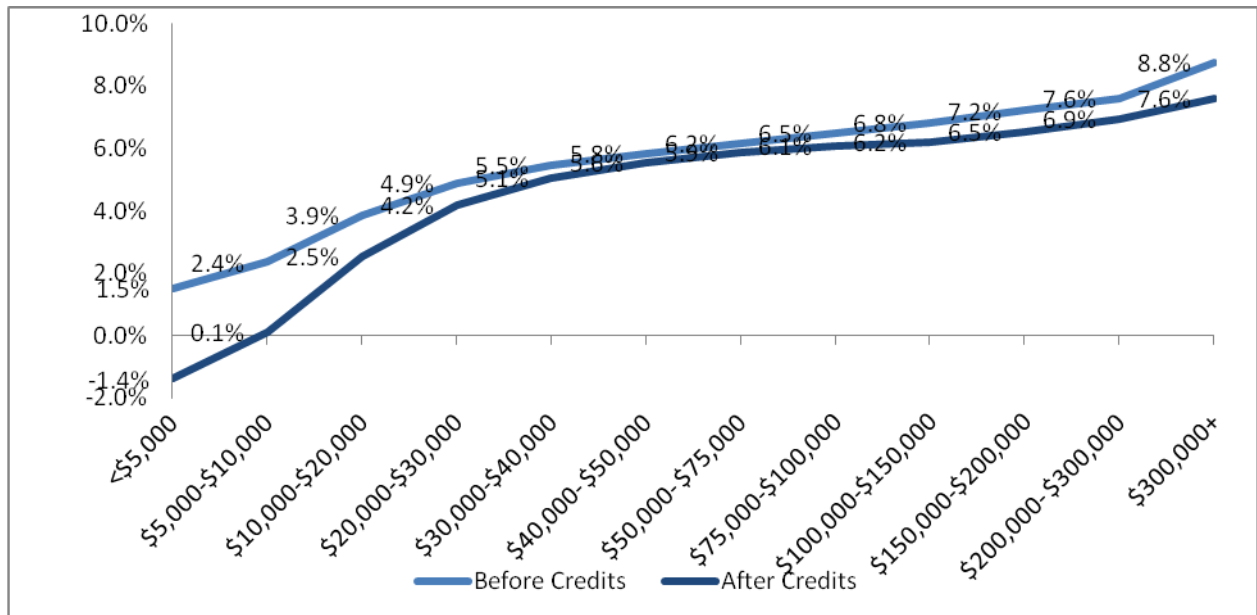
The individual income tax is progressive according to a number of metrics. Graph 9 shows the share of taxes paid into the system versus the share of income received for a given income group. A score of 1.0 means that for a given bracket the amount of income received relative to the income of the entire state equals the amount of taxes paid relative to the amount of taxes received by the state. A score of 1.0 across all income brackets would suggest that the tax is proportional. Numbers greater than 1.0 at the high end and lower than 1.0 at the low end of the income spectrum would suggest that the tax is progressive. The graph shows that for taxpayers earning less than \$150,000, the share of the state's income is larger than their share of taxes paid. It also shows that the share of taxes paid by taxpayers making more than \$300,000 is 48% more than their share of income. The numbers which are greater than 1.0 on the high end of the income spectrum implies that Hawaii's individual income tax is progressive. Graph 10 shows that the effective tax rate amongst different income classes. The effective tax rate increases with income another sign of progressivity. Refundable tax credits reduce the tax burden of lower income individuals substantially.

Graph 9: The share of tax liability/ share of income along income brackets



Source: DOTAX 2013 tax returns. Includes top income brackets of 9%, 10%, 11%

Graph 11: Effective tax rates by income



Source: Individual Income Patterns (2015)

Residents benefit from a number of federal and state deducts that reduce the overall tax burden. The majority of the large deductions derive from federal exemptions. The State of Hawaii conforms to the federal IRS code unless specifically stated otherwise. The largest tax expenditures at the federal levels include the employee-sponsored health insurance deduction, pension contribution and earning deduction, and the mortgage interest rate deduction (see table 14). The largest deduction that occurs at the state level is the exemption of employee sponsored pension income and Social Security, estimated to cost the state \$226 million in annual revenues. The forgone revenue from the state retirement deduction is expected to grow. This is because the percentage of the state's population that is 65 and older is expected to grow. Between 2010 and 2016, three quarters of the state's net population growth was attributable to residents 65 and older growing from 14.3% of the population to 17.1%.

| Table 14: Major deductions and reductions in tax liability | | |
|---|-----------------------|----------------------|
| Deduction | Federal (2013) | Hawaii (2013) |
| Major Federal | | |
| Employee-sponsored health insurance | \$260 Billion | \$358 million |
| Pension contribution and earnings | \$140 Billion | \$192 million |
| Mortgage interest rate deduction | \$ 70 Billion | \$96 million |
| State | | |
| Pension and Social Security exemption | | \$226 million |

*DOTAX calculation: Dollar amounts represent cost to the federal government and state of Hawaii.

| Table 15: Value of state and local tax deduction to Hawaii taxpayer by deciles (2015) | | | |
|--|----------------|----------------------|----------------------|
| Deciles | Fed AGI | Amount | Percent/total |
| 0 | <\$6,433 | \$158,662 | 0.0% |
| 0.1 | \$6,433+ | \$217,131 | 0.1% |
| 0.2 | \$13,994+ | \$535,362 | 0.2% |
| 0.3 | \$21,811+ | \$995,372 | 0.3% |
| 0.4 | \$29,435+ | \$2,144,375 | 0.6% |
| 0.5 | \$38,177+ | \$6,117,689 | 1.8% |
| 0.6 | \$49,042+ | \$12,452,639 | 3.6% |
| 0.7 | \$64,283+ | \$26,007,302 | 7.6% |
| 0.8 | \$86,163.5+ | \$56,829,448 | 16.6% |
| 0.9 | \$121,860+ | \$237,595,988 | 69.3% |
| Total | | \$343,053,968 | 100% |

Source: DOTAX

Hawaii exports a large portion of the individual income tax burden to the federal government. Being amongst the states that have high individual income tax rates, the Aloha state is a large beneficiary of the federal income exemption that exempts state and local taxes paid. The state and local tax exemption reduced resident's federal tax burden by \$343 million in 2015. Elimination of this federal exemption would have a large impact on residents since it would increase their overall tax burden, especially in comparison to low income tax states (see Table 15). High income earners are the biggest beneficiaries of this federal exemption because they pay a larger share of the state's taxes and they are more likely to claim itemized deductions.

In summary, the individual income tax in Hawaii provides an important and relatively stable income source that is quite progressive compared to other states. As noted above, the individual income tax discourages savings relative to a consumption tax. The high rates found in the state have the potential to prompt tax avoidance behavior, which lowers the potential to generate revenue. The progressivity of the tax plays an important role in making Hawaii's overall tax system more progressive, which compensates for other regressive taxes like the GET. The administrative burden and compliance costs are moderate for the tax. The income is generally stable in that it rises proportionally with state expenditures, yet it can be a more volatile source than GET (see Table 16).

| Table 16: Assessing the Individual Income Tax | |
|--|--|
| Economic Efficiency | <ul style="list-style-type: none"> • IIT penalizes savings in comparison to consumption tax (mitigated by tax breaks on retirement savings) • High rates (especially in higher incomes) may prompt tax avoidance and lower potential to generate revenue |
| Fairness | <ul style="list-style-type: none"> • Progressive, a common mechanism for redistribution |
| Administrative Burden | <ul style="list-style-type: none"> • Moderate compliance costs and moderate administrative costs by the government |
| Stability | <ul style="list-style-type: none"> • IIT revenue is more volatile than GET revenue |

Corporate Income Tax

The Corporate Income Tax generates a relatively small amount of revenue for the state. The discussion of this tax in this document is less thorough than other taxes because it represents a small percentage of states revenue and the Tax Review Commission has commissioned a paper specifically looking at this issue. The corporate income tax generated 1.2% of total collections from 2011 to 2016. Of the 44 states that collect corporate income tax, Hawaii ranks last (44th) in terms of collections per capita. Hawaii's top corporate income tax rate of 6.4% falls in the middle of the range of tax rates nationally. North Carolina has the lowest corporate tax rate at 3.0% while Iowa has the highest at 12.0%.

Graduated corporate tax systems like the one that exists in Hawaii make less sense than graduated individual tax systems. This is because corporate earnings are not indicative of the "ability to pay" as is

the case for individuals. Graduated rates may incentivize firms to engage in economically wasteful tax planning, such as keeping their profits below a certain threshold to avoid the tax rate increase. Hawaii has three graduated tax brackets and a distinct capital gains rate (see table 17).

| Table 17: Hawaii's Corporate Income Tax Rates (2017) | |
|---|-------------|
| Bracket | Rate |
| Less than or equal to \$25,000 | 4.4% |
| Above \$25,000 to \$99,000 | 5.4% |
| \$100,000 and above | 6.6% |
| Capital Gains | 4.0% |

Transient Accommodation Tax

The Transient Accommodation Tax (TAT) is the third largest source of tax revenue and has grown rapidly in recent years. The TAT generated 6.5% of total tax collections in 2016, up from 4.5% in 2010 (see graph 12), and the tax collections from TAT have grown quicker than the GET (see graph 13). The reason for the increase in TAT revenue includes rate increases that occurred in 2009 and 2010, rising prices of room rates in the state, and a larger number of rooms being rented out that are subject to TAT. The tax is levied on gross rental proceeds derived from furnishing "transient accommodation" for less than 180 consecutive days. The state allows certain exemptions for non-governmental organizations, health care facilities, students, publicly subsidized lodging, and military personnel. The TAT rate has nearly doubled since its creation in 1986 (see graph 14) to the current rate, as of June 2017, of 9.25%. The TAT is levied on time share vacation units in a special subset of the tax called the Timeshare Occupancy Tax (TOT). The TOT rate had been lower than the TAT rate, but the rates were equalized beginning January 1, 2017. The TAT and TOT are now reported by DOTAX as one figure in their reports. TOT represents a small amount of overall TAT revenue, making up only 3.8% of all TAT revenues between 2012 and 2016. Oahu generates the most amount of TAT revenue at 47.6% of total, followed by Maui (31.0%), Hawaii (12.2%), and Kauai (9.2%) (see Table 19). As of July 1, 2017, the counties received \$93 million annually from TAT funds. Of this amount, Honolulu receives 44.1% of the funds; Maui receives 22.8%; Hawaii receives 18.6%; and Kauai receives 14.5%. This means that Kauai and Hawaii receive a slightly higher percentage of revenue than their share of revenue contribution, while Oahu and particularly Maui contribute more.

More than half of TAT revenues go to the General Fund. A large portion (\$203 million) of TAT revenues are earmarked for special programs.¹⁸ The counties receive \$93 million, a tourism special fund receives \$82 million, and the convention center receives \$25.6 million, with the rest going to special programs that are conservation related (see graph 15). Any TAT revenues in excess of the \$203 million go to the General Fund. TAT revenues are more volatile than GET revenues, meaning that they tend to fall further in percentage terms during periods of economic downturns (see graph 16).

Increases in TAT rates do not appear to adversely affect visitor arrivals or spending at the current rates. The legislature increased the TAT rates three times in the last 20 years, once in 1999, 2010, and 2011. Visitor arrivals increased after each subsequent rate increase (see graph 18). Visitor spending does not appear to be affected by rate increases either (see graph 19).

Using the criteria set out in this document, the TAT performs well in terms of economic efficiency, fairness, and administrative burden. At current rates, the tax does not appear to affect visitor's decision to come to Hawaii. The tax has the added benefit in that it is largely born by non-resident visitors. It also taxes a unique "comparative advantage" of the state that is difficult to replicate in other jurisdictions. Other states cannot easily recreate the beaches, topography, and culture of Hawaii that draws tourists, which makes demand for the Hawaii tourism product less price sensitive (since there are fewer close

¹⁸ According to state law as of June 1, 2017.

substitutes). The tax can be considered "fair" in the sense that it is a targeted tax that is not born by low income residence. The compliance costs and administrative burden are relatively low, on par with the GET. The tax revenues are more volatile since tourism purchases are more sensitive to economic performance than other goods.

Graph 12: TAT revenues vs total tax collections

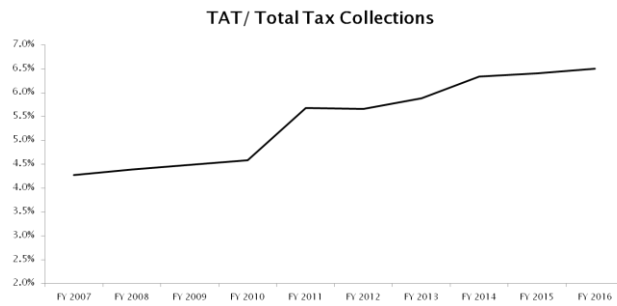
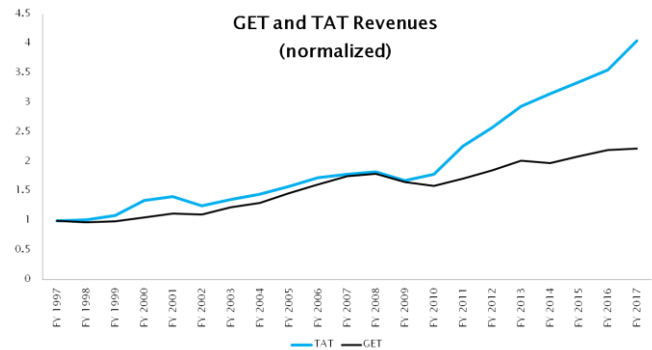
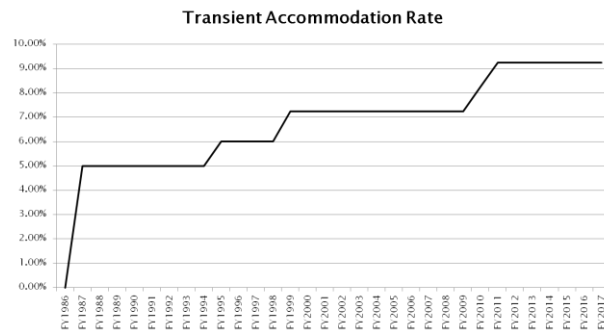


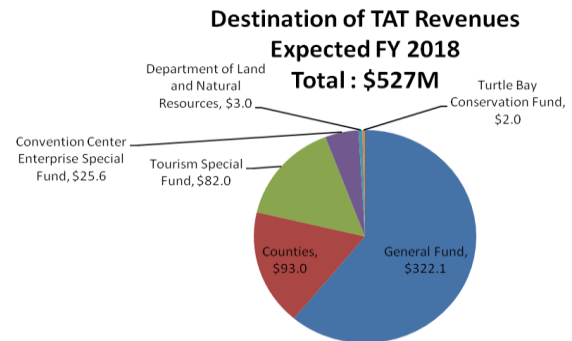
Table 14: TAT and GET revenue growth



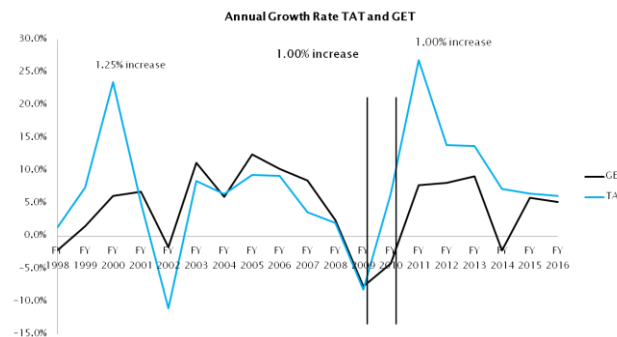
Graph 14: Transient Accommodation Rate



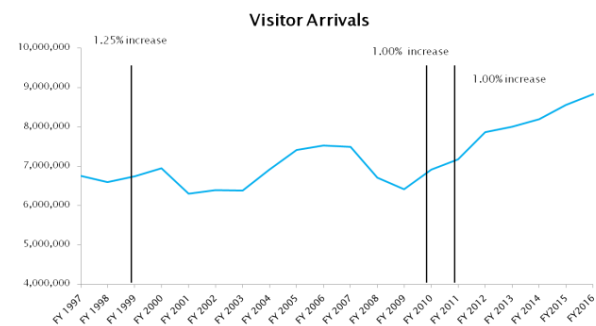
Graph 15:



Graph 16



Graph 17



Graph 18

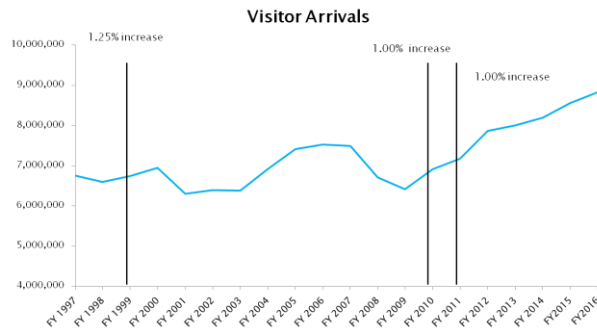


Table 19

| TAT Liability by county | | | | |
|-------------------------|--------------|--------------|--------------|-------------|
| | Oahu | Maui | Hawaii | Kauai |
| 2011 | 45.5% | 33.5% | 12.1% | 8.9% |
| 2012 | 46.5% | 32.5% | 12.0% | 9.0% |
| 2013 | 48.0% | 31.4% | 11.7% | 9.0% |
| 2014 | 49.9% | 28.2% | 12.5% | 9.4% |
| 2015 | 48.1% | 29.5% | 12.8% | 9.6% |
| Mean | 47.6% | 31.0% | 12.2% | 9.2% |

Table 18: Assessing the TAT

| | |
|------------------------------|---|
| Economic Efficiency | <ul style="list-style-type: none"> Reasonable: At current rates, does not appear to affect visitor's decision to come to Hawaii Exported: Largely born by non-residents Taxes a unique "comparative advantage" of Hawaiian economy |
| Fairness | <ul style="list-style-type: none"> Progressive: Targeted tax that affects tourists and not low income residents |
| Administrative Burden | <ul style="list-style-type: none"> Relatively low compliance costs and low administrative costs by the government |
| Stability | <ul style="list-style-type: none"> TAT revenue is more volatile than GET and is sensitive to economic downturns |

Property Tax

Residential property taxes are amongst the lowest in the country in terms of rates and collections.

Only 17% of state and local taxes come from property tax compared to an average 31% nationally. Of the property tax that is collected, most collections come from commercial taxes rather than residential. Residential property tax rates are amongst the lowest in the country. Hawaii ranked fiftieth in terms of property taxes paid as a percentage of owner-occupied housing values (see table 19). The Aloha state is one of 14 states in the country where property taxes are not levied at the state level. Only counties are allowed to levy property taxes according to the state constitution.

Given the structure of the state's economy and its endowments, there are several reasons why a residential property tax would be appropriate. Land is one of the scarcest resources in the state and one of the leading sources of wealth. Given its scarcity, it is incumbent on Hawaii to efficiently use its land to achieve the social outcomes desired by its electorate. A property tax promotes the efficient use of land because it adds a cost associated with owning the land, making it more costly to speculate on land and use it merely as a store of wealth. One commonly cited complaint of Hawaii residents is that wealthy individuals coming from outside the state purchase precious real-estate and use it as second homes, driving up prices while using their homes for only a portion of the year. A property tax would discourage people from buying second homes and leaving them empty for much of the year because it would add an additional cost to owning the property. Additionally, much of the property tax would be exported to non-residents, who are more likely to own higher priced homes. Two studies have estimated that roughly a third of property taxes would be exported to non-residents.¹⁹ A property tax would make the cost of buying and holding property more costly to do. In a state like Hawaii where housing prices are already high, a property tax may actually curb price increases. Potential buyers would take into account the cost of owning due to property taxes when estimating the final price that they are willing to pay for a property. By paying a higher price for a property, they would have to incur higher levels of property taxes.

A real property tax tends to rank well in terms of fairness, economic efficiency, and administrative burden, and revenue stability. In terms of fairness, there is a strong correlation between the value of one's property and one's income. Higher income families tend to live in higher valued residences, meaning the tax tends to be relative progressive (see Table 21). Moreover, property taxes revenues traditionally go to pay for local services like schools, public safety, and roads. This means the people that are paying the tax are those that receive the benefits. A study by the OECD found that the immovable

¹⁹ DBEDT (2017) *An Analysis of Real Property Tax in Hawaii*, finds that 32.3% of the tax is exported using statutory incidence. Tax Research and Planning Office, Hawaii Department of Taxation. "Study of the Progressive or Regressive Nature of Hawaii's Taxes (Appendix D) 2005-2007 Tax Review Commission, finds that 34.3% of the tax is exported using economic incidence criteria. Statutory incidence refers to which entity resides who is legally obligated to pay the tax. Economic incidence refers to which entity ultimately bears the cost of the tax.

property taxes are the least distortive taxes and thus the most economically efficient.²⁰ The low level of distortion of immovable property tax derives from the fact the supply of land is fixed and that it is immovable. Levying a tax on land does not affect the supply of the good, and since it is impossible to move property, it is difficult to avoid such a tax. Real property taxes tend to be one of the most stable public revenue sources since real-estate values do not change much year to year. The tax is also easy to administer since governments already know who owns which properties, and the compliance cost is low. Housing already receives favorable treatment from the tax code through the interest payment exemption and capital gain exemption.

Hawaii's low property tax rates go hand-in-hand with low spending on public services. In most parts of the United States, local governments are the primary providers of basic public services like education, public safety, and roads. Local governments get assistance from the state, but most of these services are funded locally through property tax. In the case of Hawaii, the state assumes a larger part of the funding responsibility. In the case of education, the state assumes the entire part of the funding responsibility. There is a noticeable correlation between spending on basic services and property tax rates in the case of Hawaii. Hawaii has the lowest property taxes in the nation, and it also devotes the lowest shares of state and local revenues to education (see Table 20). Hawaii does not rank high in terms of spending on other public safety services either (see Table 21).

Non-residential properties pay disproportionately more in taxes in Hawaii. States often apply different tax rates to residential, commercial, industrial, and agricultural properties. A study by the Tax Foundation using the US Census Bureau data on State and Local finances found that commercial and industrial properties pay 72% of property taxes versus 28% from residential sources.²¹ Most states tax commercial and industrial properties more than residential properties, but Hawaii is one of the most extreme cases. The same Tax Foundation study found that the effective commercial property tax rate relative to the effective residential tax rate is a ratio of 3.73, the second highest disparity in the nation. In another study, DBEDT (2017) found that commercial, industrial, and hotel/resort property pay 41.2% of all property taxes despite making up only 8.9% of the properties in the state. Commercial property taxes are not born directly by the residents, but they do get passed on consumers in the form of higher prices.

Targeted tax relief mechanisms can promote equitable burden sharing and protect low-income home owners. A commonly cited disadvantage to a property tax, particularly in places with rapidly increasing home values, is that property taxes may increase so much that it places unfair burden on homeowners. This is a particular concern for elderly residents with fixed incomes that have homes that have substantially appreciated in value. There are a number of mechanisms that have been successfully

²⁰ OECD (2010). *Tax Policy, Reform and Economic Growth*. OECD Publishing. Paris. The rank of least distortive taxes from least to most are: immovable property tax, consumption tax, other property taxes, environmental taxes, personal income tax, and corporate income tax.

²¹ Tax Foundation (2012) State and Local Property Taxes Target Commercial and Industrial Property

implemented in other parts of the country that provide tax relief to special segments of the population and ensure that property taxes do not threaten the financial stability of the household. A list of examples of different mechanisms is listed below, some of which already exist within Hawaii. The appropriateness and effectiveness of each mechanism would have to be evaluated in a local context. In general, it is better to have targeted tax relief mechanisms that are linked to a homeowner's ability-to-pay than to have broad tax relief mechanisms that benefit people regardless of their ability-to-pay. This can be accomplished through a "circuit breaker" that provides relief, usually via a refundable tax credit, to individuals whose property tax bill is higher relative to their household income.

Examples of Property Tax Relief Mechanisms:

- **Homestead Exemptions:** Shelter's a certain amount of a house's value from tax for owner-occupiers.
- **Circuit breakers:** limits a property tax bill to a certain percentage of a person's income (usually only available to low income individuals and/or seniors).
- **Deferral programs:** allow taxpayers to defer tax liabilities over multiple years if they exceed a certain threshold. Can wait until the house is sold
- **Split-roll:** apply different rates to different types of property (agriculture, commercial, tourism, industrial).

In summary, a property tax has the advantages of being economically efficient, progressive, highly exported, and easy to administer, but the disadvantages of the tax include its unpopularity. A property tax imposes low levels of economic distortion and promotes efficient use of the land, making it more costly to speculate. The tax is generally considered to be progressive since higher income individuals have higher levels of property ownership and have higher valued homes. The issues of equity can further be addressed through the adoption of targeted tax relief mechanisms that are linked to income. A large portion of the tax is exported to non-residents and the federal government. The tax is hard to avoid, easy to administer, and the revenue is amongst the most stable of any public revenue. The drawbacks are that is an unpopular form of taxation and it adds apparent costs in an environment where housing costs are already uncomfortably high. Property taxes are frequently cited to be the least popular type of taxation. However, a property tax could act as a break on upward trends in housing prices since it would make it more costly to use property as a form of investment.

Table 19 Property taxes paid by state (% of owner-occupied housing value) in 2015

| Top Ten | | | Bottom Ten | | |
|--------------|--------------------|------|---------------|--------------------|------|
| State | Effective Tax Rate | Rank | State | Effective Tax Rate | Rank |
| N.J. | 2.13% | 1 | Utah | 0.64% | 40 |
| N.H. | 1.99% | 2 | Miss. | 0.61% | 41 |
| Ill. | 1.97% | 3 | Ark. | 0.59% | 42 |
| Wis. | 1.72% | 4 | Del. | 0.56% | 43 |
| Vt. | 1.71% | 5 | D.C. | 0.57% | (43) |
| Conn. | 1.65% | 6 | Colo. | 0.55% | 44 |
| Tex. | 1.63% | 7 | S.C. | 0.55% | 45 |
| Nebr. | 1.59% | 8 | Wyo. | 0.54% | 46 |
| Ohio | 1.57% | 9 | W.Va. | 0.53% | 47 |
| R.I. | 1.51% | 10 | La. | 0.48% | 48 |
| | | | Ala. | 0.38% | 49 |
| | | | Hawaii | 0.28% | 50 |

Source: Tax Foundation

Table 19

Education Expenditure Share of Current Operations Spending 2014
(state and local government combined)

| <i>Education Share of State's Current Operations Spending</i> | | | <i>Elementary and Secondary Education Share of State's Current Operations Spending</i> | | |
|---|------------------------------|--------------|--|------------------------------|--------------|
| 1 | Texas | 45.0% | 1 | New Jersey | 33.2% |
| 2 | New Jersey | 43.4% | 2 | New Hampshire | 29.6% |
| 3 | North Dakota | 43.2% | 3 | Georgia | 29.0% |
| 4 | Utah | 42.9% | 4 | Connecticut | 28.3% |
| 5 | Iowa | 42.5% | 5 | Texas | 27.8% |
| | <i>United States Average</i> | <i>37.2%</i> | | <i>United States Average</i> | <i>24.1%</i> |
| 45 | New York | 32.8% | 45 | Tennessee | 20.3% |
| 46 | Maine | 31.8% | 46 | Arizona | 20.2% |
| 47 | Florida | 30.9% | 47 | Mississippi | 20.1% |
| 48 | Tennessee | 30.9% | 48 | North Carolina | 19.4% |
| 49 | Alaska | 29.2% | 49 | Oregon | 19.2% |
| 50 | Hawaii | 27.3% | 50 | Hawaii | 17.8% |

Source: U.S. Census Survey of State and Local Government Finances

Source: DBEDT (2017) An Analysis of Real Property Tax in Hawaii

Table 20

**Police, Fire Safety and Corrections Expenditure Share of Current Operations
Spending 2014 (state and local government combined)**

| <i>Police Expenditure as a Share of State's Current Operations Spending</i> | | | <i>Fire Protection Expenditure Share of State's Current Operations Spending</i> | | | <i>Corrections Expenditure Share of State's Current Operations Spending</i> | | |
|---|------------------------------|-------------|---|------------------------------|-------------|---|------------------------------|-------------|
| 1 | Nevada | 6.9% | 1 | Rhode Island | 3.4% | 1 | California | 4.2% |
| 2 | Florida | 5.8% | 2 | Nevada | 3.1% | 2 | Nevada | 4.2% |
| 3 | Illinois | 5.2% | 3 | Florida | 2.8% | 3 | Arizona | 4.2% |
| 4 | Maryland | 5.2% | 4 | Arizona | 2.7% | 4 | New Mexico | 4.0% |
| 5 | Arizona | 5.0% | 5 | Illinois | 2.5% | 5 | Virginia | 3.9% |
| | United States Average | 4.2% | | United States Average | 1.8% | | United States Average | 3.1% |
| 29 | Hawaii | 3.8% | 25 | Hawaii | 1.6% | | | |
| 45 | Iowa | 3.0% | 45 | Minnesota | 1.0% | 45 | Minnesota | 2.0% |
| 46 | Indiana | 2.9% | 46 | West Virginia | 0.9% | 46 | Massachusetts | 2.0% |
| 47 | West Virginia | 2.8% | 47 | North Dakota | 0.9% | 47 | Maine | 1.9% |
| 48 | Nebraska | 2.5% | 48 | Vermont | 0.8% | 48 | New Hampshire | 1.8% |
| 49 | Kentucky | 2.5% | 49 | Pennsylvania | 0.7% | 49 | Iowa | 1.8% |
| 50 | Maine | 2.5% | 50 | Delaware | 0.4% | 50 | Hawaii | 1.8% |

Source: U.S. Census Survey of State and Local Government Finances

Source: DBEDT (2017) An Analysis of Real Property Tax in Hawaii

Table 21

Table 21. Home Ownership Status: State (Average of 2011-2015)

| Household income | Number of households | Own | Rent | No pay | Total |
|-------------------------|-----------------------------|------------|-------------|---------------|--------------|
| Less than \$25,000 | 77,184 | 35.1% | 59.2% | 5.7% | 100% |
| \$25,000 to \$34,999 | 34,481 | 41.7% | 55.0% | 3.3% | 100% |
| \$35,000 to \$49,999 | 51,950 | 47.5% | 49.6% | 2.9% | 100% |
| \$50,000 to \$74,999 | 84,199 | 51.7% | 45.4% | 2.9% | 100% |
| \$75,000 to \$99,999 | 63,263 | 61.4% | 36.1% | 2.5% | 100% |
| \$100,000 to \$149,999 | 79,204 | 71.3% | 27.4% | 1.4% | 100% |
| \$150,000 to \$199,999 | 31,869 | 79.6% | 19.6% | 0.9% | 100% |
| \$200,000 or more | 28,420 | 85.7% | 13.7% | 0.6% | 100% |
| Total | 450,570 | 56.5% | 40.7% | 2.8% | 100% |

Source: U.S. Census Bureau, 2011-2015 American Community Survey Public Use Microdata Sample (PUMS); calculations by the Hawaii State Department of Business, Economic Development & Tourism.

Annex 1

Gross Receipts, Exemptions, Taxable Base, and Tax Liability
By Taxable Activity - CY 2004-2015 Total
(Dollar Amounts in Thousands)

source: G49 & G45

| Total | <u>Gross Receipts</u> | | <u>Exemptions</u> | | <u>Taxable Base</u> | | <u>Tax Liability</u> | <u>Percent of Gross*</u> | |
|-------------|-----------------------|---------------|-------------------|--------------|---------------------|--------------|----------------------|--------------------------|---------------|
| Year | Number | Amount | Number | Amount | Number | Amount | Amount | Exemptions | Tax Liability |
| Year | Gross Receipts | | Exemptions | | Taxable Base | | Tax Liability | Exemptions | Tax Liability |
| 2004 | 239,603 | \$78,061,722 | 20,974 | \$12,191,288 | 236,840 | \$65,870,434 | \$1,961,482 | 15.6% | 2.5% |
| 2005 | 246,154 | \$89,262,834 | 21,623 | \$14,936,675 | 243,086 | \$74,326,159 | \$2,210,861 | 16.7% | 2.5% |
| 2006 | 259,678 | \$97,282,408 | 25,084 | \$17,859,429 | 255,486 | \$79,422,979 | \$2,348,971 | 18.4% | 2.4% |
| 2007 | 268,923 | \$101,346,603 | 24,207 | \$19,061,230 | 265,194 | \$82,285,373 | \$2,475,202 | 18.8% | 2.4% |
| 2008 | 262,317 | \$103,668,348 | 22,967 | \$21,887,053 | 258,751 | \$81,781,295 | \$2,449,270 | 21.1% | 2.4% |
| 2009 | 262,470 | \$91,538,350 | 21,456 | \$17,750,107 | 259,166 | \$73,788,243 | \$2,243,234 | 19.4% | 2.5% |
| 2010 | 259,969 | \$96,342,386 | 21,732 | \$18,897,829 | 256,507 | \$77,444,557 | \$2,326,156 | 19.6% | 2.4% |
| 2011 | 257,657 | \$108,951,944 | 25,009 | \$24,227,637 | 251,745 | \$84,724,304 | \$2,539,513 | 22.2% | 2.3% |
| 2012 | 259,975 | \$114,037,853 | 22,879 | \$22,107,185 | 251,504 | \$91,930,661 | \$2,778,759 | 19.4% | 2.4% |
| 2013 | 262,263 | \$120,878,509 | 24,366 | \$26,605,978 | 253,761 | \$94,272,525 | \$2,862,161 | 22.0% | 2.4% |
| 2014 | 265,597 | \$130,884,991 | 25,066 | \$33,932,977 | 254,238 | \$96,952,004 | \$2,937,834 | 25.9% | 2.2% |
| 2015 | 258,900 | \$130,050,001 | 25,178 | \$32,558,790 | 249,678 | \$97,491,203 | \$3,011,449 | 25.0% | 2.3% |

APPENDIX C:
REPORT OF DR. DONALD J. ROUSSLANG AND
MS. YVONNE CHOW –
"Should Hawaii Tax Corporate Income?
A Cost-Benefit Analysis"

Should Hawaii Tax Corporate Income?

A Cost-Benefit Analysis

Report Prepared for the 2015-2017 Hawaii Tax Review Commission

Colleen M. Takamura, Chair
Vaughn G.T. Cook, Vice Chair
Raymond N. Blouin, Member
M. Nalani Fujimori Kaina, Member
John M. Knox, Member
Dawn Lippert, Member
William (Billy) Pieper II, Member

by

Donald J. Rousslang
Rules Office
Hawaii Department of Taxation*

and

Yvonne Chow
Tax Research and Planning Office
Hawaii Department of Taxation*

*The views expressed are those of the authors and should not be ascribed to the Hawaii Department of Taxation. We thank Brian Kim, John Knox, Sumner La Croix, Titin Sakata, Ted Shiraishi, Jonathan White and participants in a faculty seminar at the University of Hawaii, Manoa, for helpful comments.

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Introduction and Summary

“It is better to be roughly right than precisely wrong.”

— *John Maynard Keynes*

In this study, we examine the costs and benefits of eliminating Hawaii's corporate income tax. To avoid confusing the results with those of a general tax cut, we perform a proper public finance experiment and replace the lost corporate income tax revenue with an increase in Hawaii's general excise tax (GET) or with an increase in its individual income tax. We begin with an overview of Hawaii's corporate income tax, followed by a review of the literature. We then develop a framework for calculating the costs and benefits.

The bulk of Hawaii's corporate income tax liabilities are offset by tax credits. The tax liabilities before tax credits averaged \$134 million annually in tax years 2013 to 2015, but they averaged only \$40 million after tax credits. Of the \$94 million in average annual tax credits claimed by the corporations, \$84 million were refundable (meaning the corporation gets a check from the State if it owes less tax than the amount of its tax credits) and \$10 million were nonrefundable. For our analysis, we assume that corporations would continue to claim the refundable tax credits if the corporate income tax were eliminated. The assumption is justified on the grounds that either the corporations would devise ways to continue to claim the refundable tax credits, or they would be explicitly allowed to claim the tax credits if the corporate income tax were eliminated. For example, in tax years 2013 through 2015, the film production tax credit was the biggest refundable tax credit claimed by corporations, but film producers were already exempt from Hawaii corporate income tax.

The assumption allows us to focus on the costs and benefits of the corporate income tax; without it, the calculations would need to include the costs and benefits of the main refundable

tax credits, namely the film production tax credit, the tax credit for renewable energy technologies and the tax credit that reimburses corporations for the general excise tax paid on depreciable assets.

According to our calculations, in the long run, the main benefit to residents from eliminating the corporate income tax would come from lower consumer prices. However, the calculations show that eliminating the tax would give a temporary windfall gain to nonresident shareholders (who own the great bulk of the corporate investment in Hawaii) that would come at the expense of residents. The calculations also show that more of the corporate income tax is permanently exported to nonresidents compared to the replacement taxes. An important part of the tax exporting occurs when the state tax is deducted from the federal taxable income, including the part that is exported to the federal government when the state tax is deducted from the federal taxable income. Together, the temporary income transfers to nonresident shareholders and the permanent loss in tax exporting swamp the long-run benefit to residents, so we conclude that residents would lose from eliminating Hawaii's corporate income tax.

The calculations assume that Hawaii's corporate income tax base does not contain so-called "supernormal" profits, such as windfall gains or monopoly profits. The burden of a tax on supernormal profits is borne entirely by shareholders, so eliminating the tax on them does not help attract investment to Hawaii, but just transfers income from residents to nonresident shareholders. If there are supernormal profits in Hawaii's corporate income tax base, the case for keeping Hawaii's corporate income tax is even stronger.

Allowing corporations to expense new investment (instead of requiring them to depreciate the investment over its useful life) effectively eliminates the corporate tax on normal profits from new investment, but keeps the tax on supernormal profits and on normal profits

from old investments. This means that allowing expensing encourages new investment the same as eliminating the corporate income tax, but it avoids the income transfers to nonresident shareholders, including any caused by supernormal profits. Also, with expensing, the loss in tax exporting plays a smaller role in the cost-benefit calculations. Thus, residents might benefit from allowing corporations to expense new investment.

If the federal government eliminates the deduction for state and local income taxes from federal taxable income, then tax exporting from Hawaii's corporate income tax would fall substantially and residents would definitely benefit from allowing corporations to expense new investment. The same is true if the federal corporate income tax rate is reduced substantially, say by one third or more. Whether residents would gain from eliminating the corporate income tax under these circumstances depends on how much supernormal profits are in Hawaii's corporate income tax base.

Overview of Hawaii's Corporate Income Tax

Hawaii's corporate income tax is administered under chapter 235 of the Hawaii Revised Statutes (HRS). The tax was imposed by Act I, Special Session Laws of the Territory of Hawaii, 1957.¹ Originally, the tax rate on ordinary income was set at 5 percent for income of \$25,000 or less and at 5.5 percent for income over \$25,000. Income eligible for capital gains under the Internal Revenue Code was taxed at 2.75 percent. Today, the tax rate on ordinary income is 4.4 percent for taxable income of \$25,000 or less, 5.4 percent for taxable income greater than \$25,000 but not over \$100,000, and 6.4 percent for taxable income over \$100,000.² The tax rate

¹ The proposed legislation was vetoed by the Governor on June 7, 1957, but the veto was overridden by the Legislature on the same day.

² The current rates of tax on ordinary income were set by Act 239, Session Laws of Hawaii, 1987. Some people might view tax equity as the reason for graduated corporate income tax rates, similar to the reason

for corporate net long-term capital gains is 4.0 percent.³ The bulk of corporate taxable income in Hawaii is ordinary income subject to tax at the top rate (6.4 percent).⁴

Hawaii income tax law follows the federal definition of taxable corporate income fairly closely, including the federal provisions for the alternative corporation tax. To determine its share of the corporation's national taxable income, Hawaii uses the three-factor formula established by the Uniform Division of Income for Tax Purposes Act of 1957 ("UDITPA"). Under the formula, Hawaii's share of the corporation's national taxable income is measured as the average of its shares of the corporation's national property, payroll and sales, where each share has a weight of one third.

For tax year 2017, Hawaii's top statutory corporate income tax rate is lower than that in 26 states and higher than that in 18 states.⁵ However, the statutory tax rate does not tell the whole story about how the corporate income tax affects investment. The effective tax rate on new investment is what matters for corporate investment decisions and this rate depends on other things besides the statutory tax rate. For example, although UDITPA's three-factor formula

for graduated individual income tax rates, but the better argument is that the graduated corporate income tax rates promote economic efficiency. Most corporate investment comes from retained earnings and new corporate businesses usually start out small, so a lower tax rate on smaller corporations allows successful new ventures to grow faster in the early stages.

³ The current tax rate on capital gains was established by Act 10, Session Laws of Hawaii, 1988 and applies to net capital gains taken after March 31, 1987. There is no special tax rate for capital gains in the federal corporate income tax.

⁴ The average effective rate of Hawaii's corporate income tax (before tax credits) for tax years 2013 through 2015 was 6.1 percent, which includes long-term capital gains taxed at the rate of 4.0 percent (see Table 1 below). It is not clear to us why Hawaii has the special rate for corporate long-term capital gains: the federal corporate income tax has no such feature.

⁵ See Federation of State Tax Administrators, "Range of State Corporate Income Tax Rates" (February 2016), available at https://www.taxadmin.org/assets/docs/Research/Rates/corp_inc.pdf.

started out as the norm among the states, it has become the minority practice as some states altered their formula to reduce the effective rate of their tax to attract corporate investment.⁶ By 2012, only twelve states used equal weights for all three factors, eighteen states gave a double weight or more to sales, and thirteen states used a single factor to apportion income.⁷ Currently, five states (Nevada, Ohio, South Dakota, Washington, and Wyoming) have no corporate income tax.⁸

Hawaii provides a number of generous tax credits that reduce the net corporate income tax payments. The bulk of the tax credits claimed by corporations are refundable. The biggest tax credits (by value) claimed by corporations in recent tax years are the motion picture, digital media and film production tax credit (provided by section 235-17, HRS), the renewable energy technologies tax credit (provided by section 235-12.5, HRS), and the capital goods general excise tax credit (provided by sections 235-110.7 and 241-4.5, HRS).⁹ The tax credit for

⁶ An apportionment formula skewed towards sales typically will reduce the state tax for manufacturers who sell globally from a single plant, because the fraction of the corporation's total profit that is subject to the state's tax will be limited to the fraction of the total sales made within the state.

⁷ See Judith Lohman, "Corporation Income Tax Apportionment Formulas," *OLR Research Report*, September 26, 2012, available at <https://www.cga.ct.gov/2012/rpt/2012-R-0414.htm>.

⁸ See Federation of State Tax Administrators (2016) Op. cit.

⁹ The film production tax credit was originally provided by Act 107, Session Laws of Hawaii 1997; later legislation increased the amount of the tax credit. The renewable energy technologies tax credit was originally provided by Act 207, Session Laws of Hawaii 2003, which was set to expire in 2008. Later legislation extended the tax credit and increased the amounts. The capital goods excise tax credit was provided by Act 239, Session Laws of Hawaii 1987. For tax years 2013 and 2014, corporate claims averaged \$33 million for the film production tax credit, \$28 million for the renewable energy technologies tax credit (both refundable and nonrefundable claims), and \$21 million for the capital goods excise tax credit. See the Hawaii Department of Taxation's reports, "Tax Credits Claimed by Hawaii Taxpayers: Tax Year 2013" (December 2015) and "Tax Credits Claimed by Hawaii Taxpayers: Tax Year 2014" (December 2016). The reports are available at http://tax.hawaii.gov/stats/a5_4credits/. Claims by type of tax credit have not yet been published for tax year 2015.

renewable energy technologies provides an incentive to reduce consumption of non-renewable fossil fuels. The tax credit for film production is designed to attract investment in the film industry to Hawaii. The capital goods excise tax credit provides taxpayers an income tax credit in the amount of the general excise tax paid on depreciable capital assets. Besides being an efficient way to encourage investment, the capital goods excise tax credit also reduces tax pyramiding in Hawaii's general excise tax (GET). All three tax credits are refundable, although taking the renewable energy technologies tax credit in refundable form reduces the amount that can be claimed by 30 percent.

Table 1 shows the average annual Hawaii corporate income tax liabilities in tax years 2013 through 2015 for major industries. The averages over three years are shown, because the corporate income tax liabilities are "noisy," often changing substantially from one year to the next. An average of three years gives a more reliable picture of the tax. As shown in the Table, the gross corporate tax liabilities before tax credits were more than three times as great as the net liabilities after tax credits: For tax years 2013 through 2015, the gross average annual tax liability was \$134 million before tax credits, but the net tax liabilities were reduced to only \$40 million, owing to \$10 million in nonrefundable tax credits and \$84 million in refundable tax credits.¹⁰

¹⁰ Our figures for net income tax liabilities of the C-corporations are much lower than the figures for net collections in the tax in Hawaii Department of Taxation, "Monthly Collection Reports." For example, the average of the net corporate income taxes in the collections reports for calendar years 2013 through 2015 was \$93 million. One source of discrepancy is that our data are liabilities reported by tax year, whereas the Monthly Collection Reports show the amount of the tax received by the State in the calendar year. Another source of discrepancy is that the figures for corporate income tax collections in the Monthly Collection Reports include things besides tax payments by C-corporations, such as the withholding payments on sales of real property and other payments made by S-corporations and by partnerships on behalf of their members. The Monthly Collection Reports are available at http://tax.hawaii.gov/stats/a5_3txcolrptarchive/.

Judging by taxable profits, Hawaii's corporate income tax is most important for the Retail Trade industry, followed by the Manufacturing, Real Estate Rentals, Management Services, and Accommodations and Food Services industries. The tax liabilities as a percent of taxable income varied from a low of 5.1 percent to a high of 6.4 percent among the industries, whereas the tax liabilities after tax credits varied from a low of -35.5 percent to a high of 5.9 percent. The lowest average tax rate after tax credits belonged to the Information industry (which contains the Motion Picture industry)¹¹ and the highest belonged to the Education Services industry, although the latter industry had little in the way of corporate taxable profits.¹² Economists generally regard uneven tax rates among industries as undesirable, because it causes resources to be allocated less efficiently.

Review of the Literature

Who bears the burden of the corporate income tax? The theory

"Taxes are paid in the sweat of every man who labors"

— *Franklin D. Roosevelt*

Only people can suffer the burden of a tax, and it is seldom easy to determine who truly bears the burden of any particular tax. Knowing who pays the tax to the government doesn't answer the question, because the distribution of the tax burden is determined by supply and demand curves, which are unobservable theoretical constructs. It comes as no surprise, then, that

¹¹ The Information industry also contains Newspaper Publishers, Book Publishers, Periodic Publishers, Software Publishers, Sound Recording, Radio Broadcasting, Television Broadcasting (including cable), Telecommunications, Data Processing, News Syndicates and Internet Publishing.

¹² Hawaii conforms to the federal corporate income tax provisions that allow a real estate investment trust (REIT) to subtract dividends paid to shareholders when determining its taxable income. As a result, REIT's operating in Hawaii pay little in Hawaii corporate income tax.

although economists have long been studying the question of who bears the burden of the corporate income tax, the question has not been settled beyond dispute, nor are the economists' answers widely accepted by the public.

Seminal work on the distribution of the corporate income tax burden was done by Arnold Harberger at the University of Chicago in the early 1960's.¹³ Harberger studied the effects of the tax in a closed economy (one with little cross-border investment) and concluded that in the long run, the burden of the tax was borne mainly by shareholders. However, he later concluded that in an open economy (an economy with substantial cross-border investment) the burden of the tax is eventually shifted to workers and other local factors of production, or to local consumers.¹⁴ The reason is that corporate investors care only about the after-tax profit on their investments and can choose from an array of global investment opportunities. So if a country or other taxing jurisdiction raises its tax on corporate income, then corporate investors will require just that much more in pretax profits to compensate for the tax increase. That is the mechanism by which corporate shareholders avoid the burden of the tax.

Indeed, Harberger showed that the total loss in wages to all workers in the economy can be a multiple of the corporate tax burden. He posited an open economy in which much of the total corporate investment was in manufacturing and in which cross-border competition prevented the corporations from passing any of the corporate income tax on to consumers. The manufacturing production used only capital and labor, so workers in the industry bore the full

¹³ Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, Volume 70 (June 1962), at 215-240.

¹⁴ Arnold C. Harberger, "Corporation Tax Incidence: Reflections on What Is Known, Unknown, and Unknowable," paper prepared for a conference, in John W. Diamond and Geroge R. Zodrow, eds., *Fundamental Tax Reform: Issues, Choices, and Implications* (Cambridge, Mass.: MIT Press, 2006).

burden of the corporate income tax in the form of reduced wages. The effect on wages in manufacturing was transmitted to workers in other industries through the labor market, so all workers suffered the same wage reduction. Because workers in manufacturing accounted for only a fraction of total wages in the hypothetical economy, the collective loss in wages was a multiple of the income tax paid by the manufacturing corporations.¹⁵

Roger Gordon showed that in an open economy, workers and other local production factors bear the full burden of the corporate income tax.¹⁶ He concluded that it would be better to tax the local factor incomes directly, instead of indirectly with the corporate income tax, because then the economy would have more investment, and wages and other local factor incomes would be higher.¹⁷ That is, the tax change would produce the same tax revenue but impose a smaller total tax burden on the economy.

Roger Gordon and Lans Bovenberg point out that exchange rate uncertainty, differences in law, and differences in language and culture can handicap foreign investors and inhibit the tendency for international investment flows to equalize the after-tax rates of return among

¹⁵ Harberger (2006, Op. cit.) ignored the efficiency losses from the tax and assumed that its total burden was equal to the corporate income taxes paid, so any extra losses to labor had to be made up by gains for other factors of production.

¹⁶ See Roger Gordon, "Taxation of Investment and Savings in a World Economy," *American Economic Review* (December 1986), at 1086-1102. If a country is not small relative to the rest of the world, its corporate income tax could depress the after-tax returns on investment world-wide, in which case corporate shareholders world-wide would bear a part of the burden of the tax. In Gordon's analysis, the price of corporate output is fixed by international competition, so none of the burden of the corporate income tax is passed forward to consumers in the form of higher prices.

¹⁷ Harberger (1962 and 2006, Op. cit.) ignored the economic efficiency losses imposed by the corporate income tax, so the tax burdens borne by various economic actors add up to the amount of the tax in his calculations. Gordon (1986, Op. cit.) includes the economic efficiency losses, so the total tax burden is bigger than the amount of the tax in his calculations.

countries.¹⁸ None of these things act to inhibit investment flows within the United States, though, so the economic model for the small open country seems apt for an individual state. However, as we shall see, some adjustments are needed before we can apply the analysis to Hawaii or to any other U.S. state.

More recently, researchers have taken into account so-called "supernormal" profits when distributing the burden of the corporate income tax. The notion is that a tax on the supernormal profits is borne by the investor, on the assumption that the returns must be made subject to the tax in order to be earned.¹⁹ Supernormal profits have become a bigger part of total corporate earnings in a world where the importance of physical capital is waning and the importance of intangible property rights is growing, with companies like Apple and Google dominating equity values. There is some question, however, about how much supernormal profits are subject to corporate income tax, even on the national level, because income earned from intangible property rights is particularly susceptible to being located abroad in low-tax jurisdictions through transfer pricing.²⁰ Also, investors may be able to garner the supernormal profits in a state without putting much of the profits in the state's taxing jurisdiction.

¹⁸ See Roger Gordon and Lans Bovenberg, "Why Is Capital So Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation," *American Economic Review* (December 1996), at 1057-1075.

¹⁹ See Julie Anne Cronin, Emily Y. Lin, Laura Power, and Michael Cooper, "Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology," *National Tax Journal*, March 2013, at 239-262.

²⁰ Corporations can do this by using transfer prices to source profits offshore in low-tax jurisdictions, where it escapes U.S. tax until it is repatriated, or by "inverting" so that the parent company is domiciled abroad. Profits from valuable intellectual property rights are especially subject to relocation. For early research on the topic, see Donald J. Rousslang, "International Income Shifting by U.S. Multinational Corporations," *Applied Economics* (March 1997), at 925-934. In 2011, the top 20 of the Fortune 500 companies reported almost \$800 billion in non-repatriated foreign income. See, for example, Citizens for Tax Justice, "Which Fortune 500 Companies Are Sheltering Income in Overseas Tax Havens? Ten

Who bears the burden of the corporate income tax? The empirical evidence

A number of authors have tried to determine empirically who bears the burden of a corporate income tax. Kevin Hassett and Arpana Mathur used international comparisons to see how a corporate income tax affects wages in the local economy.²¹ They found that an increase in a country's corporate income tax leads to a drop in wages of local workers of about the same percent as the increase in the tax rate. R. Alicia Felix used a similar method and came to a similar conclusion.²² Jennifer Gravelle noted that in both studies the results implied a wage loss that is a multiple of the corporate income tax burden.²³ Harberger explained how this can happen,²⁴ but the international evidence on the effects of corporate investment on wages has been strongly criticized by Kimberly Clausing.²⁵ Clausing argues convincingly that after adjusting for various shortcomings in the previous studies, there is no robust evidence to support the view that international corporate investments influence wages in the host country.

Corporations Admit Paying Little Tax on Offshore Income; More Likely Do the Same," October 17, 2012, available at <http://ctj.org/pdf/offshoreincome.pdf> and Huffington Post, Business, "Apple is Paying Almost No Taxes on the \$102 Billion It Has Stashed Offshore: Report," May 20, 2013, available at http://www.huffingtonpost.com/2013/05/20/apple-offshore-taxes_n_3307591.html.

²¹ Kevin A. Hassett and Arpana Mathur, "Taxes and Wages," Working Paper 128, American Enterprise Institute (June 2006).

²² R. Allison Felix, "Passing the Burden, Corporate Tax Incidence in Open Economies, Working Paper 07-01, Federal Reserve Bank of Kansas City (October 2007).

²³ Jennifer C. Gravelle, "Corporate Tax Incidence: A Review of Empirical Estimates and Analysis," Working Paper 2011-01, Congressional Budget Office (June 2011).

²⁴ Harberger (2006), Op. cit.

²⁵ Kimberly Clausing, "Who Pays the Corporate Income Tax in a Global Economy?" *National Tax Journal* (March 2013) at 151-184.

Felix also examined the effect of a state corporate income tax and found that it reduced local wages by as much as 360 percent of the state's corporate income tax collections.²⁶ Using a similar method, Robert Carroll estimated that an increase in a state's corporate income tax would reduce local wages by 250 percent of the increase in the corporate income tax collections.²⁷ Gordon and Bovenberg provide reasons why international corporate investments might fail to bring the results predicted by the theory,²⁸ but as noted above, the reasons do not apply to investment flows among U.S. states. Therefore, the failure of empirical work to find an effect of corporate investment on wages among countries does not imply a similar failure in the research on the effect of corporate investment on wages among states.

Determining the Costs and Benefits of Hawaii's Corporate Income Tax:

Some Things That Need to be Added to the Conventional Analysis

We adopt a parochial view in that all that matters to us is the economic welfare of Hawaii residents.²⁹ We assume that other states and the federal government ignore any actions taken by Hawaii's tax authorities. We consider experiments in which Hawaii's corporate income tax is replaced with an increase in its individual income tax or in the GET, with no change in tax revenues, in public spending, or in the government budget. We adopt the following assumptions

²⁶ R. Alicia Felix, "Do State Corporate Income Taxes Reduce Wages," *Economic Review*, Federal Reserve Bank of Kansas City, volume 94, number 2, 2009.

²⁷ Robert Carroll, "Corporate Taxes and Wages: Evidence from the 50 States," Working Paper No. 8, Tax Foundation (August 2009).

²⁸ Gordon and Bovenberg (1996), Op. cit.

²⁹ We define residents as those eligible to vote in the state's elections and their dependents.

to simplify and make feasible the task of evaluating the costs and benefits of Hawaii's corporate income tax:

1. Corporate income subject to Hawaii tax consists of the normal rate of return on the corporate investments and the supply of corporate investment to Hawaii is determined by the after-tax rate of return available to the corporate investors on a global array of investment opportunities.
2. The great bulk of corporate investment in Hawaii is owned by nonresident shareholders.
3. In Hawaii's traded goods industries (agriculture and manufacturing), the price of the corporate output is fixed by competition from cross-border trade.
4. For the non-traded goods industries and the services industries, Hawaii's corporate income tax burden (net of the federal tax offset) is fully passed forward to consumers in the form of higher prices.
5. Hawaii's refundable tax credits that are claimed by corporations will continue to be claimed if Hawaii eliminates its corporate income tax.
6. Other tax and non-tax distortions in Hawaii's economy (besides federal income taxes) can safely be ignored when assessing the costs and benefits of Hawaii's corporate income tax.

Assumption 1 says that corporate investment in Hawaii occurs under competitive conditions and the corporate investments are allocated to equalize the rates of return in their alternative occupations. The notion is a basic principle of economics, yet some assert that taxes have little effect on investment decisions and support their view with cites to business surveys that ask what matters most for investment decisions. Economists, though, are not surprised to learn that businesses use sophisticated software to take account of state income taxes when deciding where to locate a new facility or where to hire more workers.³⁰

³⁰ See William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal* (September 2002), at 501. As an example of how taxes can affect investment, in 1701 Peter the Great gave owners of a Dutch ship the privilege of paying no Russian custom duties on its cargo for the rest of the ship's life. The ship was kept in service for almost a century, three or four times the normal span. (See Fernand Braudel *The Wheels of Commerce*. Berkeley: University of California Press, 1992, at 241.) Harberger (1962, Op. cit., at 217) argued that if an objection to the assumption that capital markets work to equalize rates of return among investment opportunities "is

The burden of a corporate income tax on supernormal profits is borne primarily by corporate shareholders,³¹ but corporations with important intangible property, such as a valuable trade name or a patented product that provides supernormal profits might be able to organize their operations to avoid exposing much of the profits to Hawaii's taxing jurisdiction. In fact, as we have already noted, they are often able to escape the U.S. corporate tax on such profits.

We used assumption 1 for the calculations, because we have no reliable estimates of the amount of supernormal profits in Hawaii's corporate income tax base. Estimates of supernormal profits at the national level have ranged from 60 percent to 70 percent of the total corporate profits.³² If a similar range applied for investment in Hawaii, then the bulk of the burden of the state's corporate income tax would be borne by shareholders. We are skeptical of this result. We reviewed the data on Hawaii's corporate income tax liabilities and found that companies paying the tax look pretty much like companies that were doing business in the 1960's, when Harberger first examined the question.

based on the idea that the capital market might not be very adept at seeking the best available net return on their invested funds, I believe it must be rejected for the United States, for in the United States the capital market is obviously highly organized, and the bulk of the funds involved are commanded by able and knowledgeable people." Note that the investment returns that we assume are equalized are after allowances for risk premiums.

³¹ See Joint Committee on Taxation, "Modeling the Distribution of Taxes on Business Income," JCX-14-13 (October 2013) available at <http://www.actontaxreform.com/wp-content/uploads/2013/10/JCT-Report-10-16-13.pdf>.

³² See Cronin, et al. (2013, Op. cit.) and the references they cite. We note that corporate after tax profits are much more important for the national economy than for Hawaii. For example, in 2014, corporate profits after tax were about 10 percent of U.S. gross domestic product (GDP). (See https://ycharts.com/indicators/corporate_profits_usgdp). But pretax profits in Hawaii in 2014 were only about \$2.2 billion (based on our data), so after-tax profits were about \$1.5 billion. This is less than 2 percent of the state's GDP in 2014 (\$76.8 billion) (see <http://dbedt.hawaii.gov/economic/datawarehouse/>).

For any state the great bulk of corporate shareholders will be nonresidents, so a tax borne primarily by shareholders would be an excellent opportunity to export the state's tax burden. Also, a tax on supernormal profits would not discourage local investment. That states have not been more aggressive in taxing corporate profits implies to us either that they have not found it easy to tax the supernormal profits, or that such profits are not a big part of the corporate income tax bases of the states.

Assumption 2 is an approximation. Corporate shares are traded on central exchanges and the bulk of the shares by value are in corporations with assets spread across the globe.³³ Typically only a small part of the total investment returns in a resident's portfolio would be subject to Hawaii's corporate income tax. A reasonable guess would be that resident shareholders receive one half of one percent of the income subject to Hawaii corporate income tax, which is Hawaii's share of the national economy. Some businesses that grew from local roots are likely to have greater resident ownership, but even if we use a figure of five percent for local ownership, it would be a small portion of the total.³⁴

³³ The corporate income tax was once widely regarded as being a tax on the privilege of having limited liability for shareholders, who could never be held to account for more than the money they invested in the corporate shares. However, innovations in ways to achieve limited liability without incurring the corporate income tax grew to the point where now the tax applies almost exclusively to publicly traded companies.

³⁴ For example, Hawaii's Department of Business, Economic Development and Tourism (DBEDT) conducted an in-depth survey of REIT ownership in Hawaii. The survey results indicated that between 0.5 percent and 3.0 percent of residents had investments in REIT's that owned property in Hawaii. See DBEDT, Economic Research and Analysis Division, "Real Estate Investment Trusts in Hawaii: An Analysis and Survey of Results" (September 2016), available at http://files.hawaii.gov/dbedt/economic/data_reports/REIT_Final_9.19.16.pdf.

Assumptions 3 and 4 are also approximations. As noted earlier, Hawaii's corporate sector is a small part of the economy, so it is reasonable to presume that wages and other local factor returns are set by the rest of the economy.

Assumption 5 is justified on two main grounds. First, corporations could devise ways to continue claiming the refundable tax credits if Hawaii's corporate income tax were eliminated, for example by creating single-member entities to claim the tax credits. Secondly, there is good reason to believe that measures would be taken to allow corporations to claim most of the refundable tax credits if the corporate income tax were eliminated. For example, corporations engaged in film production that claim the refundable film production tax credit are already exempted from the corporate income tax by section 235-9, HRS. The capital goods excise tax credit is good tax policy, regardless of the income tax liability of the business, because it alleviates pyramiding in the GET. That the refundable tax credits require no tax liability to be claimed is itself an indication that the purpose of the tax credits goes beyond alleviating the income tax of the business.

To cover the case where the refundable tax credits are lost along with the corporate income tax, we would need to expand the scope of the study to examine the costs and benefits of the tax credits themselves. Even the analysis of the capital goods excise tax credit, which has an effect similar to a change in the corporate income tax rate, would need to be expanded to include the effects of anti-pyramiding relief in the GET.

With assumption 5, any consequences of the refundable tax credits would continue if the state's corporate income tax were gone, with the main difference being that the refundable tax credits would be taxed directly by the federal government, instead of indirectly through the

reduced deduction for the state's income tax. The assumption increases the net corporate income tax payments that would be lost and therefore the amount that needs to be raised from the replacement tax. Because the refundable tax credits are so big compared to the corporate income tax payments, without assumption 5 the effects of the refundable tax credits would dominate the cost-benefit calculations. Another way to look at our exercise is that it examines the costs and benefits of Hawaii's corporate income tax if the refundable tax credits were not present.

Assumption 6 is needed, because without it we could make no progress in our inquiry. As an example, although Hawaii's GET is a model for other states, it pyramids on itself, because it applies to many business-to-business sales, sometimes at the retail rate. There are many distortions in the state's tax code and accounting for their effects is simply beyond the scope of our exercise. However, as far as we can determine, none of them would cause a serious misstatement in our calculations.

Who pays Hawaii's corporate income tax?

Hawaii's corporate income tax is deductible from the federal taxable income, so an important part of the burden of the tax is exported to the federal government in the form of reduced federal income tax payments. In essence, the federal government pays part of Hawaii's corporate income tax.

Workers bear part of the tax burden, because the tax reduces the incentive to invest in Hawaii, which in turn reduces the demand for workers and depresses wages, in both the corporate and non-corporate sectors. As pointed out earlier, the loss in wages can be a multiple of the corporate income tax burden. However, for Hawaii's economy the bulk of corporate investment is in non-traded goods industries and in services industries. In Harberger's model,

wages of workers in these industries would decline by the same amount as in the traded goods industries,³⁵ but we find the result improbable for Hawaii, because the traded goods industries account for such a small share (less than 4 percent) of private sector wages in Hawaii.³⁶ Instead, we assume that the entire burden of the corporate income tax in the non-traded goods industries and in the services industries is passed on to consumers in the form of higher prices.³⁷

Hawaii has monopoly power in the markets for some of its output; a Hawaii vacation is a unique product and Hawaii's strategic location has attracted a big U.S. military presence. Thus, some of the burden of the corporate income tax in the non-traded goods industries and in the services industries is exported in the form of higher prices on sales to tourists, to nonresident military personnel, and to the federal government in its role as a consumer of goods and services in Hawaii.³⁸

Under our assumptions, shareholders don't suffer any of the burden of Hawaii's corporate income tax in the long run, but in the short run, corporations won't raise wages or lower prices in

³⁵ Harberger (2006), Op. cit.

³⁶ In 2014 (the midpoint of our data period) wages in manufacturing and agriculture in Hawaii were \$790 million, whereas total wages in Hawaii (excluding government) were \$21.5 billion. (Data on wages are from the Hawaii Department of Labor and Industrial Relations, at <https://www.hiwi.org/gsipub/index.asp?docid=420>. Wage data by industry for 2015 were not available at time of writing.)

³⁷ Part of the tax burden in these industries is probably borne by the shareholders and part is probably borne by workers and by owners of other local production factors, and this can happen even if the corporate income tax raises output prices by exactly the amount of the tax per unit of corporate output. (Harberger, 1962, Op. cit., provides a good explanation for why this is true.) The assumption is meant to provide a reasonable approximation.

³⁸ Technically, sales to nonresidents are exports, even when made within Hawaii. However, we use the terms "traded" and "non-traded" to distinguish between sales of outputs that are, and that are not, subject to price arbitrage by strong cross-border competition.

their Hawaii operations until forced to do so, either by new competitors attracted by the tax cut, or by expanded investments of existing competitors. The immediate effect of eliminating Hawaii's corporate income tax, then, is to transfer income from residents to the nonresident shareholders. In the long run, as corporate investment responds to the tax change, the income transfers to the shareholders decline and eventually disappear, leaving a permanent income gain to Hawaii's residents. So eliminating Hawaii's corporate income tax on the normal profits can be viewed as an investment in the local economy for the long-run gains. The question is whether it is a good investment, that is, if the long-run gains merit the short-run costs.³⁹

The burden of the corporate income tax on any supernormal profits is borne entirely by the shareholders in the long run as well as in the short run. Eliminating the tax on supernormal profits does nothing to encourage investment in Hawaii and simply transfers income from residents to the nonresident shareholders.

The corporate income tax is considered by some people to be a progressive income tax, because wealthy individuals own a disproportionate share of the total value of corporate shares. However, our analysis implies that Hawaii's tax is probably regressive for its residents, because it is borne mainly by consumers in the form of higher prices, as is the burden of the GET. The income transfers to shareholders that would happen if the corporate income tax were eliminated would not have much effect on income distribution among Hawaii residents, because the shares are owned mainly by nonresidents.

³⁹ The temporary income transfer to shareholders is less important in the national debate over whether the United States should keep the federal corporate income tax, because the shareholders are mostly U.S. residents. There, the main issue is the effect on income distribution.

Measuring the Costs and Benefits of Hawaii's Corporate Income Tax

Calculating the distribution of Hawaii's corporate income tax burden

We begin by calculating the federal tax offset for Hawaii's corporate income tax, which is the amount of Hawaii's corporate income tax multiplied by the marginal effective rate of the federal corporate income tax, that is, the rate of federal income tax that applies to an additional dollar of corporate earnings in Hawaii. For various reasons, the marginal effective federal corporate income tax rate can be lower than the statutory tax rate of 35 percent: It has been estimated to lie somewhere between 23 percent and 35 percent.⁴⁰ For our calculations, we assume it is 29 percent, the average of the above range. The net loss in federal income tax deductions is calculated as the amount of Hawaii corporate income tax after subtracting the nonrefundable tax credits, but before subtracting the refundable tax credits.⁴¹ According to the data in Table 1, this amount is \$124 million, so the federal tax offset would be \$36 million (= \$124 million X 0.29).

To calculate the amount of Hawaii's corporate income tax that is exported to nonresidents in the form of higher prices, we first subtract the federal tax offset for Hawaii's corporate income tax and then allocate the remaining burden between resident and non-resident consumers. We measure the share exported to nonresidents in each industry as the share of the non-resident

⁴⁰ See Laurence Kotlikoff, "Abolish the Corporate Income Tax," The New York Times, The Opinion Pages, January 5, 2014, available at <https://www.nytimes.com/2014/01/06/opinion/abolsih-the-coporate-income-tax.html>. The average rate of the federal corporate income tax is only about 13 percent.

⁴¹ The calculation assumes that the nonrefundable tax credits reduce the burden of the corporate income tax dollar for dollar, which, as explained in the technical appendix, may overstate the effect on the output prices. Also, the renewable energy technologies income tax credit accounts for the bulk of the nonrefundable tax credits claimed by corporations and it is possible that some of the credits would continue to be claimed in refundable form if the corporate income tax were eliminated.

consumption in total final demand for the industry's output. We assume that a portion (one-third) of the increase in prices paid by tourists was shifted back to domestic residents, because tourists can respond to a higher price of a Hawaii vacation by going elsewhere, and so are able to escape some of the tax burden.⁴² None of the burden of the tax in the traded goods industries is shifted to consumers, because we assume that the output prices are fixed by cross-border competition.

Our results are shown in Table 2. We calculate that in the period from 2013 through 2015, about \$10 million of Hawaii's corporate income tax was exported annually to nonresident consumers in the form of higher prices. Adding \$36 million for the federal tax offset, we estimate that about \$46 million of the tax was exported annually, which is about 37 percent of the tax ($= \$46 \text{ million} / \$124 \text{ million} \times 100$).

More sophisticated calculations would account for the effect of the corporate income tax on the cost of capital in the industry and would include input-output effects to capture pyramiding of the price effects.⁴³ Such calculations might show a different pattern of tax incidence, but would not change the size of the overall tax burden, nor can we discover any clear

⁴² The estimate for the amount of a tax that is shifted back to Hawaii residents is taken from a study by Edwin Fujii, Mohammed Khaled, and James Mak, "The Exportability of Hotel Occupancy and Other Tourist Taxes," *National Tax Journal* (June 1985), at 169-77.

⁴³ For an example of such calculations, see Donald J. Rousslang, "The Effects of Recent Corporate Tax Changes on U.S. International Trade," *National Tax Journal* (December 1987), at 603-615. Note, however, that it would be a mistake simply to apply input-output analysis to get a total effect on prices, including tax pyramiding, because this would allocate an amount that is a multiple of the total corporate income tax burden.

reason why they should yield a higher or lower estimate for the share of Hawaii's corporate income tax that is exported to nonresidents.⁴⁴

Other elements of the cost-benefit calculations

We examine the costs and benefits of replacing Hawaii's corporate income tax with an increase in either its individual income tax or in the GET. An increase in the GET is probably the more appropriate alternative, because the burden of the corporate income tax, like that of the GET, probably is borne mostly by consumers in the form of higher prices for the corporate output. However, we consider both alternatives, because an increase in the GET seems harder to accomplish.⁴⁵ Either alternative would be at a disadvantage in the public debate, because much of the true burden of the corporate income tax is hidden, whether it is borne by workers in the form of lower wages or by consumers in the form of higher prices, whereas the burdens of the individual income tax and of the GET are highly visible.

Using the Hawaii individual income tax liabilities and federal tax paid by residents for tax year 2014, we estimate that the federal offset for the resident individual income taxes was about

⁴⁴ For the purposes of the burden distribution calculations, we ignore the net welfare gains or losses from the tax, on grounds that such values generally are small.

⁴⁵ Since 1966, the rate of the GET has stayed at 4 percent, whereas the brackets or rates of Hawaii's individual income tax have been adjusted numerous times. Get collections at the retail rate averaged about \$2.71 billion for fiscal years 2014 and 2015, so adding \$124 million to the GET collections would require an increase in the retail rate from 4.00 percent to about 4.18 percent. There is no practical reason why the rate of the GET tax could not be increased by such a small percentage. As currently applied, merchants regularly pass along the tax to the consumer, which means the seller charges an odd tax amount, because the tax passed forward becomes part of the seller's taxable gross receipts. This requires solving an infinite series to calculate the tax, which merchants accomplish regularly with no apparent difficulty, charging 4.166 percent for purchases on the neighbor islands (where the statutory rate is 4 percent on retail sales) and charging 4.712 percent for purchases on Oahu (where the statutory rate on retail sales is 4.5 percent). Thus, the public already deals with a tax rate that, when expressed as a percent, has three places after the decimal point.

28 percent and that an additional 6 percent of the tax was paid by nonresidents, so the total amount of the tax that was exported was about 32 percent ($= 28 \text{ percent} \times 0.94 + .06$). This implies that the tax exporting for \$124 million in additional collections of the tax would be about \$40 million ($= 32 \text{ percent of } \124 million), assuming the tax was increased in proportion to current rates.⁴⁶ Thus, we estimate that replacing the corporate income tax with an increase in the individual income tax would result in an annual loss in tax exporting of about \$6 million ($= \$46 \text{ million} - \40 million).

A study done for the 2005-2007 Tax Review Commission estimated that about 38 percent of the burden of the GET is exported to nonresidents in the form of higher prices and a study done for the 1989 Tax Review Commission estimated that about 32 percent of the GET is exported.⁴⁷ Using the midpoint of the estimates (35 percent) yields an estimated \$43 million in tax exporting if the GET is the replacement tax ($= 35 \text{ percent of } \124 million). Thus, we estimate that replacing the corporate income tax with an increase in the GET would result in an annual loss in tax exporting of \$3 million ($= \$46 \text{ million} - \43 million).

The long-run gain to Hawaii's residents includes the increase in wages of workers, the increase in payments to other immobile production factors (mainly property rents), and the reduction in consumer prices caused by the extra corporate investment. As explained in the

⁴⁶ \$124 million is about 6.6 percent as great as the average annual collections of the individual income tax over the period from 2013 to 2015. See Hawaii Department of Taxation, "Monthly Collection Reports," Op. cit.

⁴⁷ See Tax Research and Planning Office, "Study on the Progressive or Regressive Nature of Hawaii's Taxes," Report of the 2005-2007 Tax Review Commission, Appendix D, December 2006, available at http://files.hawaii.gov/tax/stats/trc/docs2007/Final_Report-Appendix_H.pdf, Op. cit., and Walter Miklius, James Moncur and PingSun Leung, "Distribution of State and Local Tax Burden By Income Class," Report of the 1989 Tax Review Commission: Working Papers and Consultant Studies, available at http://files.hawaii.gov/tax/stats/trc/docs1989/TRC_Work_Papers_and_Consultant_Studies_1989.PDF.

Technical Appendix, the annual amount of the long-run gain can be approximated as one half of the percent response of corporate investment to a change in the tax rate, times the square of the effective rate of Hawaii tax after the federal offset, and times the amount of the Hawaii corporate profits before tax. For the long-run percent increase in corporate investment, we rely on estimates that have been made for the response of investments at the national level. The estimates imply that the percent increase in investment will be half as great, or as great, as the effective rate of Hawaii's corporate income tax on new investments.⁴⁸

We used an effective tax rate on new corporate investment of 4.5 percent, which is Hawaii's statutory corporate income tax rate of 6.4 percent reduced by a federal tax offset of 29 percent. This means that eliminating the tax would increase the expected after-tax returns by 4.5 percent, which we assume will cause the new equilibrium stock of corporate capital in Hawaii to grow by 2.3 percent to 4.5 percent. Using the midpoint of the range gives us a long-run annual welfare gain of about \$2 million.⁴⁹

The last element in the calculations is the short-run income transfers to the nonresident corporate shareholders. We consider two scenarios. In the first scenario, it takes corporate investment stocks six years to reach the new equilibrium. In the second scenario, it takes only

⁴⁸ The investment response is taken from the survey by Kevin A. Hassett and R. Glenn Hubbard, "Tax Policy and Business Investment," in *Handbook of Public Economics*, Volume 3 (January 2002) edited by Alan J. Auerbach and Martin Feldstein, at 1325. The authors conclude that the "consensus" elasticity of capital with respect to the after-tax return is between -0.5 and 1.0. The national estimate seems appropriate for Hawaii, although it might understate the response in states where corporate outputs face strong competition from cross-border trade.

⁴⁹ See the calculation in the Technical Appendix. We get an almost identical result if we perform similar industry-by-industry calculations using the effective tax rates before tax credits and the gross corporate tax liabilities before tax credits.

four years to reach the new equilibrium. In both scenarios, we assume the movement between the two equilibriums takes place in equal steps, with the same increase in investment in each year.⁵⁰

Because the various costs and benefits come at different times, they must be discounted to the present so we can compare them. Because the projections are not subject to inflation, the real (inflation-adjusted) discount rate is appropriate. We chose 2 percent, which is at or above the consensus estimate.⁵¹

Our results are shown in Tables 3 and 4. Table 3 shows the results for scenario 1 (six-year adjustment) and Table 4 shows the results for scenario 2 (four-year adjustment). In both scenarios, the income transfers to nonresident shareholders decline and the income to residents rises as investment grows in response to the drop in corporate taxes.⁵² The income transfers to nonresident shareholders go to zero when the new equilibrium is reached, but the annual income gains to residents continue at the level of the new equilibrium. The annual gain or loss from tax exporting continues at the same rate throughout the adjustment period and beyond.

The calculations imply that replacing the corporate income tax with an increase in the GET or in the individual income tax produces a net loss for residents in both scenarios, but the loss is smaller if the GET is the replacement tax. The difference between the results in Tables 3 and 4 shows that the speed of adjustment of corporate investments is important in determining the net cost or benefit to residents, but we are unable to offer much in the way of hard evidence

⁵⁰ Although the incentive to invest is greater early on, before investment flows bring the returns closer to the new long run equilibrium, there are lags in implementing new investments.

⁵¹ See James D. Hamilton, Ethan S. Harris, Jan Hatzius, and Kenneth D. West, "The Equilibrium Real Funds Rate: Past, Present and Future," February 27, 2017, available at http://econweb.ucsd.edu/~jhamilto/USMPF_2015.pdf.

⁵² See the analysis in the technical appendix.

on this variable. Clearly, the speed will vary by industry. For example, industries that use mobile equipment can accommodate an increase in desired output in Hawaii fairly quickly. Even output that requires investments in fixed assets can be adjusted at the margin, for example, by buying or renting existing buildings and converting them to new use, or by remodeling, or by spending more on maintenance. Only a small adjustment in the stock of corporate investments is contemplated (2.3 percent to 4.5 percent) to reach the new equilibrium, so a lengthy adjustment lag seems unlikely.

Overall, two factors dominate the calculations: the change in tax exporting and the size of the income transfers to nonresident shareholders. Neither factor can be measured with precision. The net gain from greater investment is small, but this result was expected, as the net welfare effects of taxes (the 'triangles' described in the technical appendix) are seldom big when compared to the tax revenues.⁵³ Of the variables used in the calculations, the most reliable estimates are probably those for the federal tax offsets for the individual and corporate income taxes, but the estimate for the individual income tax depends on the way that the tax rates are increased. For example, if the individual income tax is raised in such a way that taxpayers in the higher income tax brackets pay a greater share of the tax increase than the share they pay of the current tax, then tax exporting from the individual income tax will be higher than the estimate we used.

Our calculations give only rough estimates for the overall economy, but an attempt to refine them is probably not warranted by the current state of art. The estimates for the long-run income gains are especially subject to error, but they are not a dominant part of the calculations.

⁵³ For example, in his work on the distribution of the corporate income tax burden, Harberger (1962, *Op. cit.*) ignored the net welfare effects as being of only second order in importance.

Note that the estimates do not include a calculation of jobs created by the tax change. As explained in the Technical Appendix, such calculations are out of place in a cost-benefit analysis for secular changes in taxes, including tax credits that target selected industries. However, the calculations account for any wage gains for local workers, including both the gains from higher wages and from greater employment.

If corporate profits subject to Hawaii's corporate income tax contain a substantial amount of supernormal profits then, when combined with the federal offset, tax exporting from the state's corporate income would be huge. For example, if 60 percent of the taxable corporate profits were supernormal (as has been estimated at the national level), then 72 percent of the state's tax would be exported.⁵⁴ In this case, setting the state's corporate income tax rates to zero would produce large and permanent income transfers from residents to nonresident shareholders with little in the way of benefits to residents from greater corporate investments.

The calculations do not account for supernormal profits. However, even if supernormal profits are an important part of Hawaii's corporate tax base, the calculations can still be used to assess the costs and benefits of allowing new corporate investments to be expensed, instead of requiring the company to depreciate the investment over its useful life. Expensing of new corporate investments eliminates the tax on normal profits from new corporate investment, but leaves in place the tax on existing investments and on any supernormal profits received by the

⁵⁴ Ignoring both resident shareholders and the amount of the remaining tax burden exported to nonresidents in the form of higher prices, the tax exporting is calculated as follows. We have used the figure of 29 percent as the federal offset of the corporate income tax, leaving 71 percent of the state's tax to be distributed between shareholders on the one hand, and local factors of production and local consumers. If supernormal profits were 60 percent of the total, then shareholders would bear 43 percent of the net tax burden after the federal offset ($= 71 \text{ percent} \times 60 \text{ percent}$). Adding the federal offset of 29 percent yields 72 percent as the amount of the tax exported.

corporations.⁵⁵ It also avoids the income transfers to nonresident shareholders that would come from eliminating the corporate income tax. The main adjustments needed to apply the calculations to the case where there are supernormal profits and where expensing is allowed are to reduce the amount of corporate investment that will respond to the tax cuts (because only the investment producing normal returns will respond) and to reduce the amount of corporate income tax revenue that must be replaced (because the tax is kept on supernormal profits and on the returns to old investments). The adjustments shrink the importance of tax exporting relative to the long run gains to residents from greater corporate investment, so they can cause the calculations to show a net gain to residents.⁵⁶

Designing an Efficient Tax Structure for the Future

Investment decisions are based on the anticipated after-tax rate of return, so they depend on what investors believe the tax rates will be in the future. This means that announcing a cut in the corporate income tax beforehand could reduce the income transfers to nonresident shareholders. However, a better way to avoid the income transfers is to eliminate the corporate

⁵⁵ For explanations of how expensing affects corporate investment, see Joseph J. Cordes, "Expensing" in *The Encyclopedia of Taxation and Tax Policy* (1999 Urban Institute Press), edited by Joseph J. Cordes, Robert D. Ebel and Jane Gravelle, available at <http://webarchive.urban.org/publications/1000528.html>, and Gavin Eakins, Full Expensing is the Federal Government's Best Investment in the U.S. Economy" Tax Foundation, January 9, 2017, available at <https://taxfoundation.org/full-expensing-federal-government-s-best-investment-us-economy/>.

⁵⁶ For example, if supernormal profits are half of the total, then the measure of corporate investment that will respond to the tax cut, and therefore the size of the long-run gain to residents from greater corporate investment, will be half as great as in our calculations. However, because expensing eliminates the corporate income tax only on new investment and keeps the tax on the returns to all old investments (including the one providing only normal returns), the amount of the replacement tax will be less than half as great as when the corporate income tax is eliminated. In the long run, however, expensing will eliminate the tax on all investments producing normal returns, so the corporate income tax advantage in tax exporting eventually will grow to have the same importance as in the original calculations.

income tax only on new investments. A numbers of states tried to attract new investments using discretionary negotiated concession packages that include such things as investment tax credits, property tax abatements, and employment tax credits,⁵⁷ but such measures produce uneven incentives among industries and so distort the allocation of resources in the economy. Also, they are susceptible to the waste that often accompanies attempts to "pick the winners" as a development strategy.

Our calculations imply that even if the income transfers to nonresident shareholders are avoided altogether, residents still would suffer a present-value loss of \$66 million from replacing the corporate income tax with an increase in the GET or a present-value loss of \$166 million from replacing the corporate income tax with an increase in the individual income tax.⁵⁸ However, the estimate for the loss from replacing the corporate income tax with an increase in the GET is within the margin of error of our calculations.

Effects of federal tax changes

National tax reforms are again being considered. Some of the proposals would eliminate the federal deduction for state and local income taxes.⁵⁹ If that is done for the corporate income tax, the gain to residents from replacing their corporate income tax with an increase in the GET

⁵⁷ See, for example, Peter D. Enrich, "The Rise - and Perhaps Fall - of Business Tax Incentives," in *The Future of State Taxation*, edited by David Brunori, Washington D.C.: The Urban Institute Press, 1998, pp. 73-88.

⁵⁸ The margin of error in the estimate for tax exporting is greater for the GET than for the corporate or individual income taxes. This is true, because the bulk of the tax exporting for the income taxes comes from the federal offset, which can be measured with reasonable accuracy. In contrast, tax exporting for the GET depends mainly on the amount of monopoly power enjoyed by Hawaii's tourist industry.

⁵⁹ See, for example, Derek Thompson, "A Comprehensive Guide to Donald Trump's Tax Proposal," *The Atlantic*, April 26, 2017, available at <https://www.theatlantic.com/business/archive/2017/04/a-comprehensive-guide-to-donald-trumps-tax-proposal/524451/>

would be substantial in our calculations, because the tax exporting from the GET would not be affected, whereas the loss of the federal tax offset would cause tax exporting from the corporate income tax to fall from \$46 million annually to only \$10 million annually. In this case, replacing the corporate income tax with a GET increase yields annual gains of \$35 million in tax exporting, so the calculations show that residents would benefit from the tax change immediately in both of our scenarios. According to the calculations, the net present-value gain would be from \$1.7 billion to \$1.8 billion, depending on whether the income transfers to shareholders can be avoided. With no federal tax offset for either tax, the annual tax exporting of the individual income tax falls from \$41 million to \$7 million, which is \$3 million less than the tax exporting of the corporate income tax (\$10 million), so the tax change still produces a net loss for residents.

Some of the national tax reform proposals would change the rates of the federal corporate and individual income taxes. If the deduction for state and local income taxes is kept, then a cut in the federal corporate income tax rate to 15 percent (as in one proposal) could reduce the federal tax offset for Hawaii's corporate income by 50 percent or more. In this case, even if the federal deduction for state and local income taxes is kept, our calculations would again show a substantial net gain to residents from replacing the corporate income tax with an increase in the GET. In this case, (unless the federal individual income taxes are also altered) the calculations also show a gain from replacing the corporate income tax with an increase in the individual income tax.

Recall that our calculations do not account for supernormal profits. If supernormal profits are a substantial share of total corporate profits in Hawaii, then the state's corporate income tax is its most efficient tax, because most of its burden is exported to nonresident shareholders. In this case, eliminating the tax would clearly be inadvisable, even if the federal offset is lost. However,

the conclusions based on our calculations still apply if the corporate income tax is eliminated on new investments by allowing expensing for new corporate investments.

Concluding Remarks

We find that simply eliminating Hawaii's corporate income tax and replacing it with an increase in either the GET or the individual income tax would make residents worse off. The tax change would reduce the amount of Hawaii's overall tax burden that is exported to nonresidents and would transfer income from residents to nonresident corporate shareholders. The loss in tax exporting and the income transfers to nonresident shareholders would outweigh the long-run income gains that residents would get from greater corporate investment. This conclusion is even stronger if Hawaii's corporate income tax base includes supernormal profits.

The long-run gains to residents could be realized without the income transfers to nonresident shareholders if the corporate income tax is eliminated only for new investment. This might explain why many states use special incentives to attract new investment, but keep their corporate income tax. Unfortunately, the approach usually creates uneven incentives among industries that distort the allocation of resources. Allowing corporations to expense new investment avoids the income transfers to nonresident shareholders and also avoids the shortcomings of targeting selected investments.

If corporations are no longer allowed to deduct the state and local income taxes from the federal taxable income, then our calculations imply that residents would realize large gains from allowing corporations to expense new investments when calculating their Hawaii's corporate income tax. The reason is that either federal tax change would reduce the federal tax offset for

Hawaii's corporate income tax. A similar conclusion applies if the federal corporate income tax rate is reduced substantially, because this would also reduce the federal offset.

Our results imply a strange divergence between policy prescriptions for the national and state corporate income taxes. Whereas increasing international capital mobility and a decline in the national share of global corporate investment seem to be strengthening the case for eliminating the U.S. corporate income tax, we find that an individual state would be unlikely to benefit from the same strategy, because it would transfer income from residents to nonresident shareholders and probably reduce the tax exporting from local taxes. If supernormal profits are an important part of the state's corporate income tax base, then eliminating the local corporate income tax is simply out of the question and the best way to attract corporate investment is to allow corporations to expense new investments. Also, if supernormal profits are an important part of the tax bases, the distribution of the corporate income tax will be very different for the state and federal taxes. For the federal tax, because wealthy residents own a disproportionate share of total corporate equity, and because the burden of the tax on supernormal profits is borne by the shareholders, the tax will be progressive. But a state's residents will own little of the income subject to its corporate income tax. Thus, although much of the burden of the state's tax will be exported, the distribution of the remaining burden among its residents will depend mostly on the effect on local wages and prices, so the tax may be regressive for them.

Table 1 - Hawaii's Corporate Income Tax Liabilities: Averages for Tax Years 2013 Through 2015

(Dollar amounts are in thousands)

| Industry | Tax before tax credits | Tax credits | | Tax after non- refundable tax credits | Tax after all tax credits | Positive taxable incomes | Number of returns | Ave. effective tax rate | |
|-----------------------|---------------------------|-------------|----------|---|---------------------------------|--------------------------------|----------------------|-------------------------|----------------------|
| | | Nonref. | Refund. | | | | | Before tax credits | After tax credits |
| Agriculture | \$1,870 | \$668 | \$1,134 | \$1,202 | \$68 | \$29,736 | 242 | 6.3% | 0.2% |
| Mining & Utilities | 1,474 | 12 | 2,636 | \$1,462 | -1,173 | 23,236 | 72 | 6.3% | -5.0% |
| Construction | 6,168 | 1,188 | 1,236 | \$4,980 | 3,744 | 103,398 | 1,106 | 6.0% | 3.6% |
| Manufacturing | 16,687 | 407 | 1,302 | \$16,279 | 14,978 | 273,601 | 913 | 6.1% | 5.5% |
| Wholesale Trade | 6,877 | 607 | 7,727 | \$6,270 | -1,457 | 112,363 | 996 | 6.1% | -1.3% |
| Retail Trade | 29,392 | 1,037 | 2,004 | \$28,355 | 26,351 | 468,245 | 1,243 | 6.3% | 5.6% |
| Transportation | 6,441 | 549 | 1,159 | \$5,892 | 4,733 | 102,367 | 373 | 6.3% | 4.6% |
| Information | 4,677 | 331 | 30,652 | \$4,347 | -26,305 | 74,126 | 464 | 6.3% | -35.5% |
| Finance & Insurance | 4,141 | 228 | 208 | \$3,913 | 3,706 | 68,929 | 1,284 | 6.0% | 5.4% |
| Real Estate Rentals | 15,272 | 629 | 10,365 | \$14,644 | 4,279 | 259,917 | 3,753 | 5.9% | 1.6% |
| Professional Services | 6,300 | 157 | 9,531 | \$6,142 | -3,388 | 103,146 | 2,090 | 6.1% | -3.3% |
| Mgmt. Services | 14,343 | 1,492 | 13,294 | \$12,851 | -443 | 229,708 | 674 | 6.2% | -0.2% |
| Admin. & Waste Serv. | 3,987 | 248 | 273 | \$3,739 | 3,466 | 64,205 | 584 | 6.2% | 5.4% |
| Education Services | 274 | 0 | 4 | \$274 | 269 | 4,572 | 143 | 6.0% | 5.9% |
| Health & Social Asst. | 898 | 18 | 243 | \$880 | 637 | 15,682 | 797 | 5.7% | 4.1% |
| Arts & Entertainment | 609 | 94 | 74 | \$515 | 441 | 9,972 | 272 | 6.1% | 4.4% |
| Accom. & Food Serv. | 12,319 | 2,196 | 1,108 | \$10,122 | 9,015 | 205,530 | 766 | 6.0% | 4.4% |
| Other Services | 1,577 | 195 | 573 | \$1,381 | 808 | 27,069 | 1,157 | 5.8% | 3.0% |
| Unclassified | 909 | 0 | 630 | \$909 | 280 | 17,877 | 386 | 5.1% | 1.6% |
| Sum or Wtd. Average | \$134,214 | \$10,056 | \$84,151 | \$124,158 | \$40,007 | \$2,193,679 | 17,316 | 6.1% | 1.8% |

Source: Hawaii Forms N-30 filed by corporations for tax years 2013 through 2015 and authors' calculations.

Table 2 - Hawaii Corporate Income Taxes Exported to Nonresidents

| Industry | Data from DBEDT's input/output tables for 2012 (Dollars are in millions) | | | | | Average annual corporate income tax liabilities: 2013-2015 (Dollars are in thousands) | | | | Tax exported to nonresidents (Dollars are in thousands) | |
|------------------------|---|-----------------------|-----------------|--|--|---|---|--------------------------|-----------------------|---|--|
| | Visitor expenditures | Federal government | Total output | Visitor expenditures/ total output | Total federal government/ total output | Before tax credits | After non- refundable tax credits | After all tax credits | Federal tax offset | As higher prices | |
| | | | | | | | | | | | |
| Agriculture | \$22 | \$1 | \$942 | 2.3% | 0.1% | \$1,870 | \$1,202 | \$68 | \$349 | \$0 | |
| Mining & Construction | 0 | 538 | 7,655 | 0.0% | 7.0% | 6,556 | 5,368 | 4,127 | 1,557 | 264 | |
| Utilities | 0 | 19 | 3,606 | 0.0% | 0.5% | 1,088 | 1,076 | -1,556 | 312 | 4 | |
| Manufacturing | 108 | 588 | 10,125 | 1.1% | 5.8% | 16,687 | 16,279 | 14,978 | 4,721 | 0 | |
| Wholesale Trade | 106 | 12 | 4,959 | 2.1% | 0.2% | 6,877 | 6,270 | -1,457 | 1,818 | 73 | |
| Retail Trade | 2,023 | 6 | 7,702 | 26.3% | 0.1% | 29,392 | 28,355 | 26,351 | 8,223 | 3,491 | |
| Transportation | 2,900 | 21 | 5,692 | 50.9% | 0.4% | 6,441 | 5,892 | 4,733 | 1,709 | 1,416 | |
| Information | 18 | 25 | 2,511 | 0.7% | 1.0% | 4,677 | 4,347 | -26,305 | 1,261 | 45 | |
| Finance & Insurance | 0 | 1 | 5,246 | 0.0% | 0.0% | 4,142 | 3,913 | 3,706 | 1,135 | 1 | |
| Real Estate & Rentals | 1,409 | 13 | 17,163 | 8.2% | 0.1% | 15,272 | 14,644 | 4,279 | 4,247 | 569 | |
| Business & Prof. Serv. | 435 | 344 | 9,297 | 4.7% | 3.7% | 24,629 | 22,732 | -366 | 6,592 | 1,084 | |
| Educational Services | 137 | 44 | 1,137 | 12.1% | 3.8% | 274 | 274 | 269 | 79 | 23 | |
| Health Services | 145 | 32 | 8,186 | 1.8% | 0.4% | 898 | 880 | 637 | 255 | 10 | |
| Arts & Entertainment | 511 | 2 | 1,026 | 49.8% | 0.2% | 609 | 515 | 441 | 149 | 120 | |
| Accom. & Food Serv. | 7,021 | 18 | 11,015 | 63.7% | 0.2% | 12,319 | 10,122 | 9,015 | 2,935 | 3,022 | |
| Other Services | 128 | 8 | 3,419 | 3.8% | 0.2% | 1,577 | 1,381 | 808 | 400 | 26 | |
| Unclassified | na | na | na | na | na | 909 | 909 | 280 | 264 | na | |
| Total (Private Sector) | \$14,962 | \$1,670 | \$99,681 | 15.0% | 1.7% | \$134,216 | \$124,158 | \$40,007 | \$36,006 | \$10,148 | |

Source: Data on expenditures are from the Hawaii state input output study done by the Research and Economic Analysis Division of the Department of Business, Economic Development and Tourism for 2012, available at dbedt.hawaii.gov/economic/reports_studies/2012-io/. Data on Hawaii corporate income taxes are from Hawaii Forms N-30 filed by corporations for tax years 2013 through 2015. Remaining entries are the authors' calculations.

Table 3 - The Net Costs and Benefits of Eliminating Hawaii's Corporate Income Tax With a Six Year Investment Response
(In millions of dollars)

| Period | Transfers to nonresident shareholders | Discounted transfers to nonresidents* | Income gain from greater investment | Replaced with General Excise Tax increase | | Replaced with Individual Income Tax increase | |
|---------------------|---------------------------------------|---------------------------------------|-------------------------------------|---|--|--|--|
| | | | | Gain or loss in tax exporting** | Net gain or loss from eliminating the corporate income tax | Gain or loss in tax exporting** | Net gain or loss from eliminating the corporate income tax |
| 1 | 78 | 78 | 0 | -3 | -81 | -5 | -83 |
| 2 | 57 | 56 | 0 | -3 | -60 | -5 | -62 |
| 3 | 37 | 35 | 1 | -3 | -39 | -5 | -41 |
| 4 | 16 | 15 | 1 | -3 | -18 | -5 | -20 |
| 5 | -5 | -4 | 1 | -3 | 3 | -5 | 1 |
| 6 | -25 | -23 | 1 | -3 | 24 | -5 | 22 |
| Total | 158 | 157 | 4 | -18 | -172 | -30 | -184 |
| Annual, 7 and after | 0 | 0 | 2 | -3 | -1 | -5 | -3 |
| Discounted total* | | 157 | 84 | -150 | -223 | -250 | -323 |

* Based on a discount rate of 2 percent.

** The tax exporting of the replacement tax less the tax exporting for the corporate income tax.

Source: Authors' calculations.

Table 4 - The Net Costs and Benefits of Eliminating Hawaii's Corporate Income Tax With a Four Year Investment Reponse
(In millions of dollars)

| Period | Transfers to nonresident shareholders | Discounted transfers to nonresidents* | Income gain from greater investment | Replaced with General Excise Tax Increase | | Replaced with Individual Income Tax Increase | |
|---------------------|---------------------------------------|---------------------------------------|-------------------------------------|---|--|--|--|
| | | | | Gain or loss in tax exporting** | Net gain or loss from eliminating the corporate income tax | Gain or loss in tax exporting** | Net gain or loss from eliminating the corporate income tax |
| 1 | 78 | 78 | 0 | -3 | -81 | -5 | -83 |
| 2 | 47 | 46 | 0 | -3 | -50 | -5 | -52 |
| 3 | 16 | 15 | 1 | -3 | -18 | -5 | -20 |
| 4 | -15 | -14 | 1 | -3 | 13 | -5 | 11 |
| Total | 126 | 125 | 3 | -12 | -135 | -20 | -143 |
| Annual, 5 and after | 0 | 0 | 2 | -3 | -1 | -5 | -3 |
| Discounted total* | | 125 | 84 | -150 | -191 | -250 | -291 |

* Based on a discount rate of 2 percent.

** The tax exporting of the replacement tax less the tax exporting for the corporate income tax.

Source: Authors' calculations.

Technical Appendix

Calculating the cost and benefits to residents from eliminating the corporate income tax

The basic analysis is patterned after the one that G.D.A. McDougal developed to examine the costs and benefits of inward foreign investment.¹ It is illustrated in Figure 1. The vertical axis shows the rate of return available to foreign investors on investment opportunities in the host country. The horizontal axis measures the amount of the foreign investment. The line labeled "D" is a schedule of foreign investment opportunities in the host country, ranked from left to right in order of declining profitability. The schedule can also be called the demand curve for inward foreign investment. Investment will be allocated to the most profitable opportunities first, and to successively less profitable opportunities as more foreign investment enters the host country. The supply curve of foreign investment is shown as the line labeled "S." It is a horizontal line, indicating that the host country is small relative to the supply of foreign investment. With competition, in the long-run equilibrium all the investments receive the same after-tax rate of return.

With a tax levied on investment income at rate t , the equilibrium stock of foreign investment in the economy is " Q ," the rate of return before tax is " R " and the rate of return after tax is $(1 - t)R$. If the income tax is eliminated, after foreign investment fully adjusts to the tax change, the new equilibrium stock of foreign investment is " Q_n " and the before-tax and after-tax rates of return converge to " R_n ." We compare the economy with and without the tax on investment income in the same time period, so inflation plays no role in the comparison.

¹ G.D.A. MacDougall, "The Benefits and Costs of Private Investment From Abroad: A Theoretical Approach," *The Economic Record*, 1960, Vol. 36, Issue 73, at 13-35.

With the tax on investment income, the area under the demand curve D and to the left of Q is the total value of output produced by the foreign investment. The area of Triangle **A** represents the income to the other production factors in the host country that is generated by the foreign investment, including the wages of workers and the rents paid to landowners. The area of Rectangle **B** represents the local tax paid by the foreign investors and the area of Rectangle **C** represents their returns after the local tax.

If the tax on foreign investment income is removed, the long-run equilibrium stock of foreign investment in the host country grows to Qn and the income of local production factors is given by the area of Triangle **A** plus the area of Rectangle **B** plus the area of Triangle **C**. There is no income tax paid by foreign investors and the after-tax return to the foreign investment is given by the area of Rectangle **D** plus the area of Rectangle **E**. Thus the area of Rectangle **B**, which was tax collections before, becomes income of production factors in the host country and the total amount of income going to residents increases by the area of Triangle **C** when compared with the economy with the tax on foreign investment income. The area of Rectangle **B** also represents the annual amount of income transferred to foreign investors in the short run, before foreign investment responds to the tax cut. The income transfers continue, although in waning amounts, until the new long-run equilibrium level of foreign investment is reached.

We can derive an estimate for the Area of Triangle **C** based on the rate of the tax on foreign investment income and the amount of foreign investment income. Notice that the height of Triangle **C** is the effective rate of host-country tax on the foreign investment income ($= tR$) and the length of Triangle **C** is the increase in the equilibrium stock of foreign investment ($= Qn - Q$). In the paper, we cite estimates that the percent increase in the investment stock that comes from a change in the after-tax rate of return is half as great, or as great, as the percent change in

the after-tax rate of return. We use the midpoint of the range, so we calculate the percent change in the stock of foreign investment to be 0.75 as great as the percent increase in the after-tax rate of return. The percent increase in the after-tax rate of return is t , so the change in the stock of foreign investment is $0.75 \times t \times Q$. Profits on the foreign investment before tax are given as $R \times Q$, so the change in the stock of foreign investment can be expressed as $0.75t(\text{pretax profits on foreign investment}/R)$. Multiplying by the height of Triangle C (tR) gives its area as $(0.5)(.075)(t)(t)(\text{pretax profits on foreign investment})$.

The analysis depicted in Figure 1 was developed to examine the costs and benefits of foreign investment to the host country, but it is apt for corporate investment in an individual U.S. state, because the great bulk of corporate investment in any state is owned by nonresident shareholders. However, it misses a factor that is important for analyzing the costs and benefits of a state's corporate income tax, namely the federal offset for the state's income tax. The federal offset occurs, because the state tax can be deducted from the federal taxable income. Figure 2 shows how the federal tax offset alters the analysis. There, as before, R_n is the required after-tax rate of return on corporate investment and R is the before-tax rate of return required by the corporations in the presence of the local corporate income tax. However, in this case, the tax rate t is not merely the tax imposed by the state. Instead, it is the marginal effective rate of the state tax faced by the corporate investors after accounting for the deduction of the state income tax from the federal income tax. If the deduction from the federal income tax were not allowed, the corporations would require that the pretax rate of return on local investment rise above the required after-tax rate of return by the full amount of the state tax. The resultant pretax rate of return is shown as " R_g " in Figure 2.

In Figure 2, the area of Triangle **A** plus the area of Trapezoid **B** is the private benefit to residents of the state (a combination of incomes of local factors and consumers' surplus) created by the corporate investment. Tax revenue to the state is given by the area of Rectangle **D** plus the area of Trapezoid **B** plus the area of Triangle **C**. The total benefit to residents from the corporate investment is the private benefit plus the tax revenue (the area of Rectangle **D** plus the area of Trapezoid **B** plus the area of Triangle **C**). Note that the area of Trapezoid **B** appears twice in the benefit to residents of the state, once as a private benefit and again as tax revenue. This happens, because the federal offset acts to increase local corporate investment at the same time that it provides a wealth transfer from the federal government to the state. It is as if the federal government paid part of the state's corporate income tax.

If the state eliminated its corporate income tax, in the new long-run equilibrium, the tax revenue and the federal offset both disappear and the total benefit to residents from corporate investment becomes the area of Triangle **A** plus the area of Trapezoid **B** plus the area of Rectangle **D** plus the area of Triangle **E**. Thus, compared to the case with the corporate income tax, residents of the state gain an amount given by the area of Triangle **E**, but lose an amount given by the area of Trapezoid **B** plus the area of Triangle **C**. In the long-run equilibrium the area of Rectangle **D** is converted from tax revenue to private benefit of local production factors and of consumers. However, if the corporate income tax is eliminated abruptly, the area of Rectangle **D** represents the annual income transfer to nonresident shareholders, which declines over time until the new equilibrium level of corporate investment is achieved. The calculation for the area of Triangle **E** in figure 2 is similar to the calculation for the area of Triangle **C** in Figure 1, except that the height of Triangle **E** is the effective rate of the state tax after the federal offset.

In Hawaii, nonresident consumers bear part of the burden of Hawaii's corporate income tax, along with resident consumers. This is true, because part of the burden of Hawaii's corporate income tax is exported to tourists and to the federal government in the form of higher prices of the corporate output. If Hawaii eliminated its corporate income tax, nonresidents would share in the gain to consumers from the resultant decline in prices of the corporate output. Thus, the benefit to residents of any corporate income tax that was exported to nonresidents in the form of higher prices is permanently lost and the loss does not abate over time. Also, the nonresident consumers claim part of the permanent gain represented by the area of Triangle **E** in Figure 2.

In Figure 2, when the corporate income tax is eliminated, both the net gain from greater corporate investment (the area of Triangle **E**) and the loss of the federal offset (the area of Trapezoid **B** plus the area of Triangle **C**) continue indefinitely. The federal offset can be estimated with reasonable reliability to be between a quarter and a third of Hawaii's corporate income tax revenue. The estimate for the net gain from greater corporate investment in Hawaii is likely to be smaller than the corporate offset and is subject to much more uncertainty. From this, it would seem to be a bad idea for Hawaii to eliminate its corporate income tax. However, Hawaii's general excise tax (GET) also offers an opportunity to export a substantial amount of tax to nonresidents. Hawaii's individual income tax also has a federal tax offset, since it is deductible from the resident's federal income tax, but except for individuals in the highest tax bracket, the federal offset for the individual income tax is smaller than that for the corporate income tax.

The standard analysis is based on the assumption that the prices of corporate outputs are set by cross-border trade competition and that the full burden of the corporate income tax is borne by other local production factors. However, the curves in Figures 2 can also be interpreted

as showing the supply and demand curves for corporate output in industries where output prices are not set by trade competition and where it is assumed that the corporate income tax raises the price of corporate output by the amount of tax paid per unit of output. In that case, the area below the demand curve and above the supply curve represents consumer surplus, rather than returns to production factors.

Calculating the price increases caused by the corporate income tax

For the basic analysis, we assume the supply of corporate capital to Hawaii is perfectly elastic at the global norm for after-tax returns, so the full burden of the tax is passed forward to domestic residents, either as reduced factor payments or as higher consumer prices. Because corporations operating in Hawaii engage in relatively little production of traded goods that are subject to global price arbitrage, we have assumed that the burden of the tax for corporate output of non-traded goods and for services is passed forward to consumers in the form of higher prices. We calculated the corporate income tax burden as the corporate tax payments before subtracting the refundable tax credits, because we assumed that the refundable tax credits would continue to be claimed after the corporate income tax is eliminated, so any effect that they might have on prices would continue.

The effect of Hawaii's corporate income tax credits on the price of corporate output

It is not clear how much Hawaii's tax credits affect the price of corporate output. Harberger (1962) opined that in the long run, the corporate income tax would be included in the price of the product, and would raise the price by the amount of corporate income tax paid per unit of product. However, some of Hawaii's tax credits may not reduce the product price in line with their effect on the corporate income tax payments. Presumably, corporations will engage in

the activity required to secure the tax credits until an additional dollar spent on the activity yields an additional dollar of tax credits. If the average cost of pursuing the tax credits is close to the marginal cost, then the cost of the activity (for example, converting to renewable energy), will absorb most of the tax credits. In some cases, however, the tax credits reduce directly the cost of new investment required for the corporate output. This is true for the refundable capital goods excise tax credit, which reduces the cost of investment in depreciable machinery and equipment. It is also true for the refundable film production tax credit, which reduces the cost of film production and, in many cases, exceeds the corporation's Hawaii taxable income.²

It has been argued convincingly that Hawaii's GET is an efficient consumption tax,³ so it is the natural replacement tax for Hawaii's corporate income tax, which we have found to be largely passed forward to consumers in the form of higher prices. In addition to avoiding the adverse effect on corporate investment in Hawaii, replacing the corporate income tax with an increase in the GET would reduce distortions in relative prices of consumption. The tax change might be hard to sell politically, however, because the GET burden is visible to the public, whereas the price effects of the corporate income tax are invisible. Our calculations indicate that the change in tax exporting that would accompany the tax change is small, unless federal tax reform eliminates the deduction for state and local income taxes or substantially reduces the federal corporate income tax rate.

² Film production is included in the Information industry in Table 1. Corporations claimed \$34 million in film production tax credit in tax year 2014. (See Tax Credits Claimed by Hawaii Taxpayers: Tax Year 2014, Department of Taxation, State of Hawaii, available at http://tax.hawaii.gov/stats/a5_4credits/).

³ Donald J. Rousslang and Jonathan W. White, "Is Hawaii's GET a Good Solution to State Budget Shortfalls?" *State Tax Notes*, March 27, 2017, at 1127-1145.

Employment effects of tax changes

Legislative requests for studies on the effects of various tax changes often ask for the number of jobs "created" in the targeted industries and in the overall economy.⁴ We find such calculations to be fraught with peril and likely to mislead, especially in the long run. Our cost benefit analysis does not include any estimates of the jobs that might be created by eliminating the corporate income tax. Instead, we have contented ourselves with presenting estimates for the costs and benefits to residents, measured in dollars. The benefits consist of greater wages (including wages to workers currently employed and wages from any net increase in total employment), greater payments to other local production factors (mainly property rents) and higher consumers' surplus (from lower prices of corporate outputs).

If the GET is the replacement tax, then the net effect on the overall level of consumer prices will be quite small, since it will consist only of the difference between the effect of the corporate income tax and the increase in the GET on prices. If the individual income tax is the replacement tax, then individuals will have lower after-tax wages, but also lower consumer prices. In either case, the effect on real after-tax wages will be small, so any movement along the labor supply curve would be small.

The labor market always has a pool of unemployed workers, even when the economy is straining its capacity and most employers are having trouble finding qualified applicants to fill vacant positions. A certain level of unemployment (sometimes referred to as the natural rate of unemployment) occurs as resources move from waning economic activities to growing ones or as people move (for a variety of reasons) from one employer to another. Whether the economy is

⁴ See, for example, Act 206, Session Laws of Hawaii (SLH) 2007 and Act 270, SLH 2013.

in a cyclical expansion and adding jobs, or in a cyclical contraction and shedding jobs, the net change in jobs is always small when compared with the total number of vacancies filled during the period. Large numbers of hires and separations occur every month throughout the business cycle. For example, for the year ending April of 2017, for the United States as a whole, new hires totaled 62.9 million and separations totaled 60.7 million,⁵ so the net increase in jobs was only about 3.5 percent of the number of new hires during the year. Thus, at any time in the business cycle, and especially when unemployment is low in Hawaii, it is more likely that new jobs in a targeted industry will be filled by people who would have taken jobs elsewhere in the economy than that they will reduce unemployment. That is, the new jobs in the targeted industry would come mostly at the expense of other activities in the economy.

The economy regularly goes through cycles of expansion and contraction, so in the long run, targeting selected industries will mostly move jobs around within the economy, with little effect on the overall level of unemployment. Even if enlightened tax policy were to expand the size of the overall economy (policy officials were successful in "picking the winners"), the effect on unemployment would be minor in the long run. The net economic expansion would mainly change net migration to the State.

The main problem with calculating the net short-run employment effects is that whereas new jobs in targeted industries are readily apparent, the jobs lost (the job opportunities that go unfilled) are mostly invisible. It is especially inappropriate to use simple input-output calculations to determine the effects of an expansion in the targeted industry on the overall

⁵ See U.S. Bureau of Labor Statistics, "Job Openings and Labor Turnover – April 2017," June 6, 2017, available at <https://www.bls.gov/news.release/pdf/jolts.pdf>.

economy. The input-output calculations assume that industries use inputs, including factors of production, in fixed proportions and that the supply of all inputs, including worker and other factors of production, are perfectly elastic. The input-output calculations ignore completely the effect on industries that compete with the targeted industry for inputs and factors of production.

In sum, even if tax policy can be used successfully to create jobs in a time of high unemployment, if the policies are kept when unemployment is low, they will displace other activities. That is why a secular tax change is a poor tool for meeting short-run employment goals.

Another view is that tax policy should be used to grow new industries to diversify the economy, because Hawaii depends overly much on just a couple of economic sectors (tourism and government spending). The first question policy makers should consider before trying to grow a particular activity is why it is not bigger in the natural business environment, where it competes with other activities for the available resources. Before using tax policy to alter the mix of output in the economy, sophisticated cost-benefit calculations should be undertaken to see if the tax change is a good idea. Given the current state of art, economists generally are skeptical that policy officials can improve economic outcomes by distorting the local tax structure.

FIGURE 1

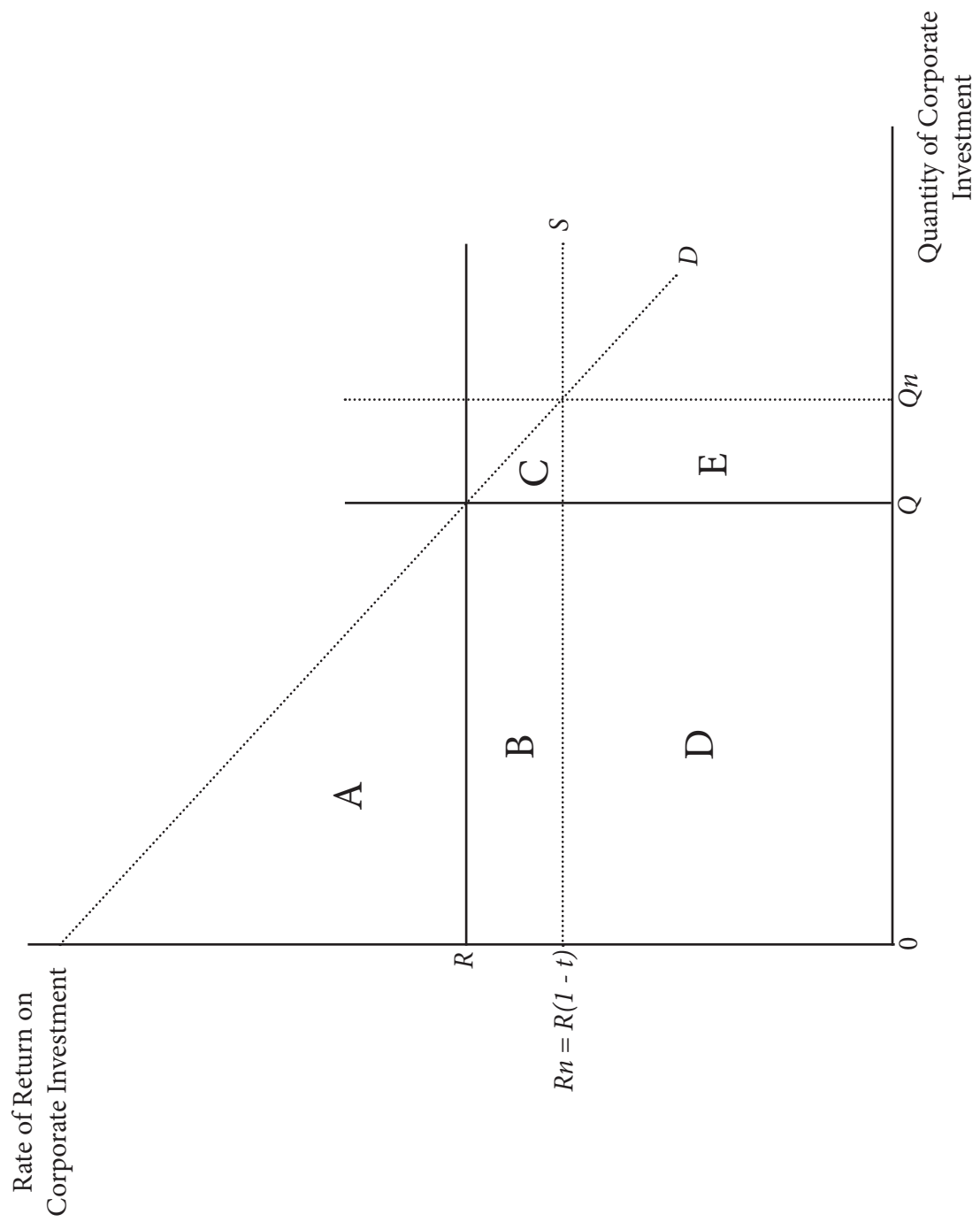
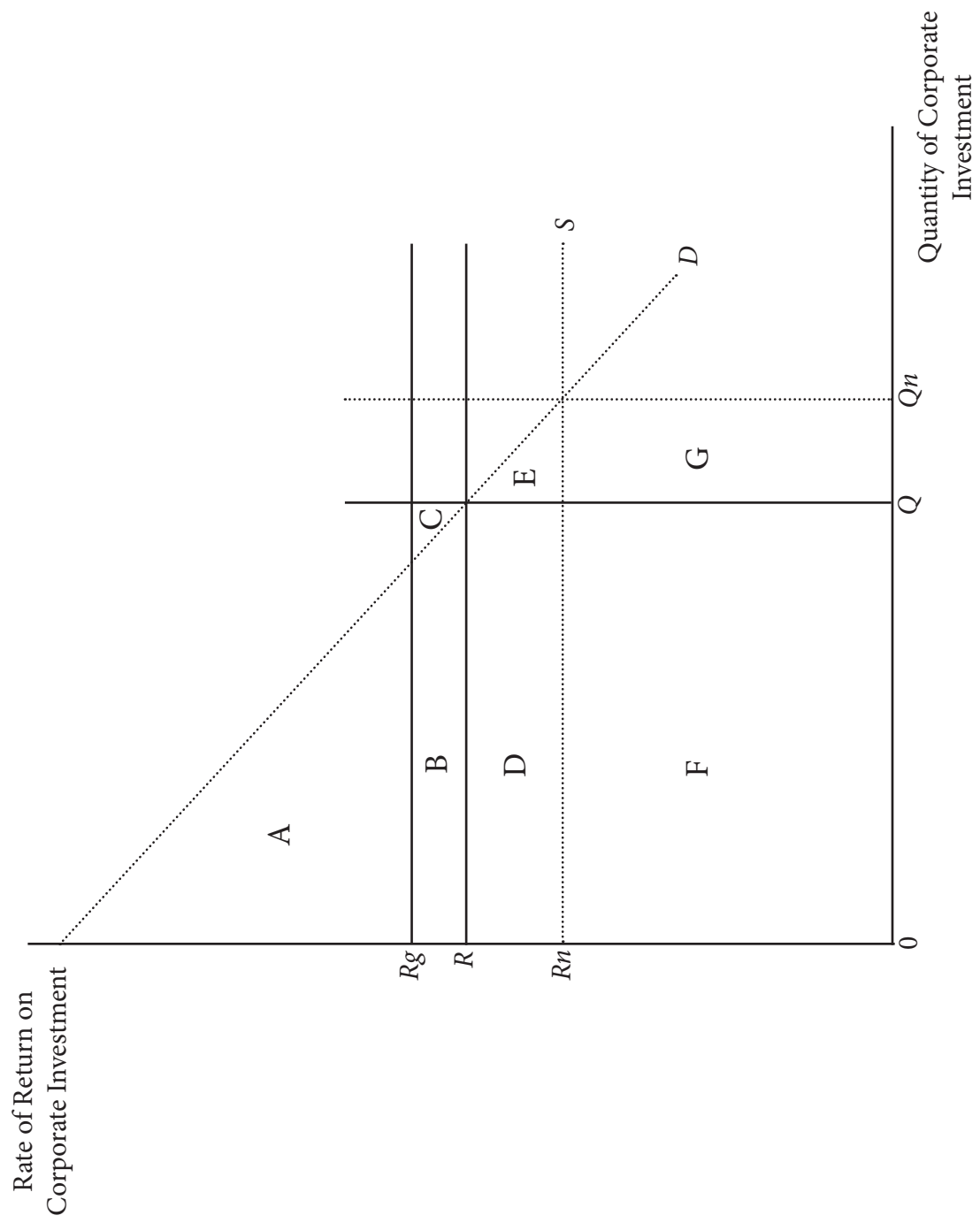


FIGURE 2



APPENDIX D:

**REPORT OF MS. TITIN L. SAKATA AND
MR. DONGLIANG WU –**

**“Effects of Eliminating the Hawaii Individual Income
Tax for Taxpayers with Income Below Poverty Level”**

EFFECTS OF ELIMINATING THE HAWAII INDIVIDUAL INCOME TAX FOR TAXPAYERS WITH INCOME BELOW POVERTY LEVEL

*Prepared by Titin L. Sakata, Rules Office, Hawaii Department of Taxation
and Dongliang Wu, Tax Research and Planning Office, Hawaii Department of Taxation*

December 1, 2017

I. Introduction

The 2015-2017 Tax Review Commission requested an updated analysis of the potential revenue impact of eliminating individual income tax for taxpayers with income below poverty level. This paper examines the impact of eliminating individual income tax for those below poverty level by:

1. Determine who is in poverty;
2. Determine who pays Hawaii's individual income tax;
3. Determine current tax reliefs for the poor; and
4. Determine the potential revenue impact of eliminating individual income tax for those below poverty level.

II. Who Is In Poverty?

There are two ways to measure poverty used by Federal government: (1) poverty thresholds and (2) poverty guidelines.

Poverty Thresholds

Poverty thresholds are the original version to measure poverty. They are updated each year by the United States Census Bureau ("Census Bureau"). The Census Bureau measures poverty by "money income" that varies by family size and composition. "Money income" includes "earnings, unemployment compensation, workers' compensation, Social Security, Supplemental Security Income, public assistance, veterans' payments, survivor benefits, pension or retirement income, interest, dividends, rents, royalties, income from estates, trusts, educational assistance, alimony, child support, assistance from outside the household, and other miscellaneous sources." It is before taxes and does not include capital gains, tax credits, or noncash benefits such as housing subsidies, Medicaid, and food stamps. The poverty thresholds

as defined by the Census Bureau do not vary by geographical area¹. Table 1 shows poverty thresholds for 2016.

| Table 1. Poverty Thresholds for 2016 by Size of Family and Number of Related Children Under 18 Years | | | | | | | | | | |
|--|------------------------------|---------------------------------|--------|--------|--------|--------|--------|--------|--------|-----------|
| Size of family unit | Weighted Average Thresholds* | Related children under 18 years | | | | | | | | |
| | | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 or more |
| One person (unrelated individual): | \$12,234 | | | | | | | | | |
| Under age 65 | 12,486 | 12,486 | | | | | | | | |
| Aged 65 and older | 11,511 | 11,511 | | | | | | | | |
| Two people: | \$15,585 | | | | | | | | | |
| Under age 65 | 16,153 | 16,072 | 16,543 | | | | | | | |
| Aged 65 and older | 14,523 | 14,507 | 16,480 | | | | | | | |
| Three people | \$19,109 | 18,774 | 19,318 | 19,337 | | | | | | |
| Four people | 24,563 | 24,755 | 25,160 | 24,339 | 24,424 | | | | | |
| Five people | 29,104 | 29,854 | 30,288 | 29,360 | 28,643 | 28,205 | | | | |
| Six people | 32,953 | 34,337 | 34,473 | 33,763 | 33,082 | 32,070 | 31,470 | | | |
| Seven people | 37,465 | 39,509 | 39,756 | 38,905 | 38,313 | 37,208 | 35,920 | 34,507 | | |
| Eight people | 41,547 | 44,188 | 44,578 | 43,776 | 43,072 | 42,075 | 40,809 | 39,491 | 39,156 | |
| Nine people or more | | 53,155 | 53,413 | 52,702 | 52,106 | 51,127 | 49,779 | 48,561 | 48,259 | 46,400 |
| Source: U.S. Census Bureau. | | | | | | | | | | |
| Note: *Preliminary figures | | | | | | | | | | |

Poverty Guidelines

The poverty guidelines are updated each by the United States Department of Health and Human Services (“DHS”). The poverty guidelines simplified the poverty thresholds for administrative purposes, that is, to determine eligibility for certain federal programs, such as Special Supplemental Nutrition Program for Women, Infants, and Children, Low-Income Taxpayer Clinics, Legal Services for the Poor, Children’s Health Insurance Program, and Job Opportunities for Low-Income Individuals.

Beginning in the late 1960s, the DHS distinguishes Alaska and Hawaii from the 48 contiguous states. Table 2 shows the poverty guidelines for 2017²:

¹ Source: U.S. Census Bureau, <http://www.census.gov/hhes/www/poverty/about/overview/measure.html>

² Source: U.S. Department of Health and Human Services, <http://aspe.hhs.gov>

| Table 2. Poverty Guidelines for 2017 | | | |
|---|--|----------------------------|---------------------------|
| Persons in Family/Household | 48 Contiguous States and the D.C. | Hawaii | Alaska |
| 1 | \$12,060 | \$13,860 | \$15,060 |
| 2 | \$16,240 | \$18,670 | \$20,290 |
| 3 | \$20,420 | \$23,480 | \$25,520 |
| 4 | \$24,600 | \$28,290 | \$30,750 |
| 5 | \$28,780 | \$33,100 | \$35,980 |
| 6 | \$32,960 | \$37,910 | \$42,210 |
| 7 | \$37,140 | \$42,720 | \$46,440 |
| 8 | \$41,320 | \$47,530 | \$51,670 |
| For families with more than 8 persons, add: | \$4,180/additional person. | \$4,810/additional person. | \$5,230/additional person |

III. Who Pays Hawaii Individual Income Tax?

Every individual doing business in Hawaii and every individual receiving gross income subject to Hawaii income tax law must file Hawaii income tax return. The filing thresholds for individuals receiving gross income subject to Hawaii income tax law, calculated by adding the standard deduction and personal exemption, as follows³:

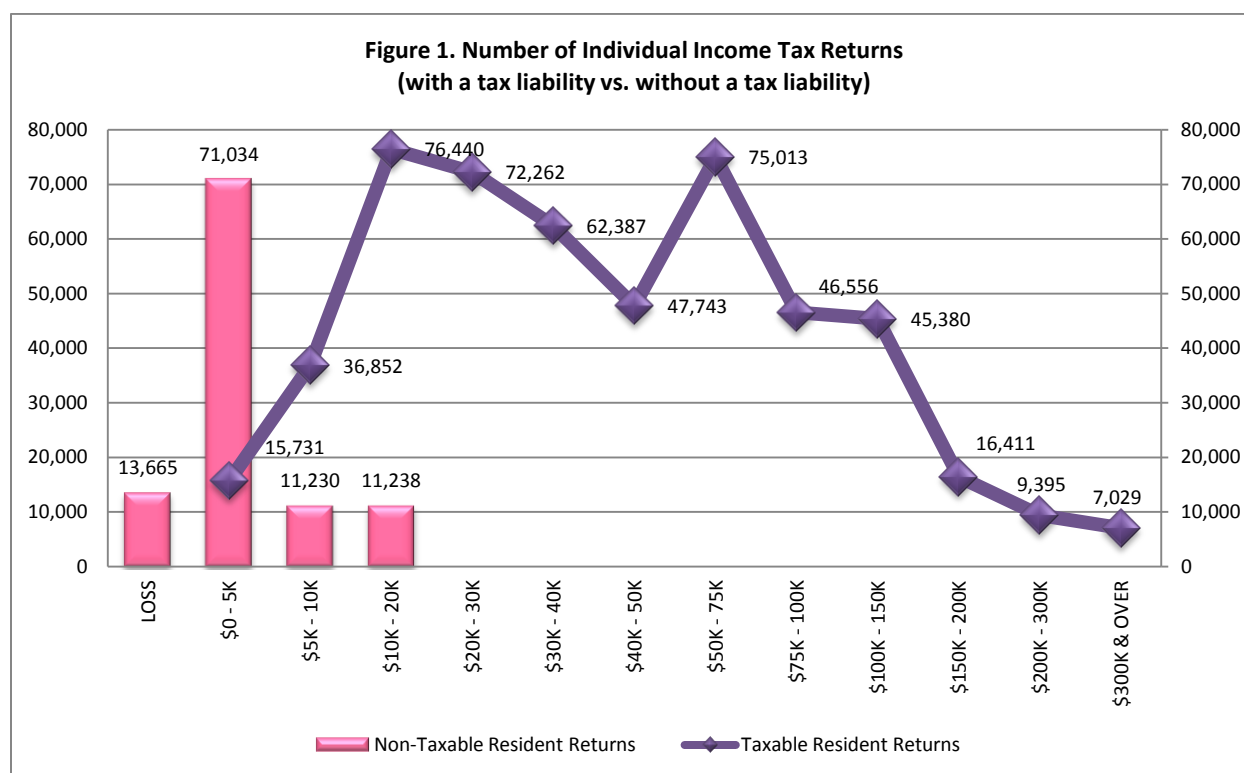
| Filing Status | Standard Deduction | Personal Exemption | Total |
|--|--------------------|--------------------|---------|
| Single; Married filing separately | \$2,200 | \$1,144 | \$3,344 |
| Head of household | \$3,212 | \$1,144 | \$4,356 |
| Married filing jointly | \$4,400 | \$2,288 | \$6,688 |
| Married filing jointly with 2 children | \$4,400 | \$4,576 | \$8,976 |

Hawaii filing thresholds are relatively low compared to the federal thresholds. As a the comparison, the 2017 Federal filing thresholds (calculated by adding the standard deduction and personal exemption) are included in the table below.

| Filing Status | Standard Deduction | Personal Exemption | Total |
|--|--------------------|--------------------|----------|
| Single; Married filing separately | \$6,350 | \$4,050 | \$10,400 |
| Head of household | \$9,350 | \$4,050 | \$13,400 |
| Married filing jointly | \$12,700 | \$8,100 | \$20,800 |
| Married filing jointly with 2 children | \$12,700 | \$16,200 | \$28,900 |

³ Individuals age 65 and over are entitled to additional exemption of \$1,144 per qualified person.

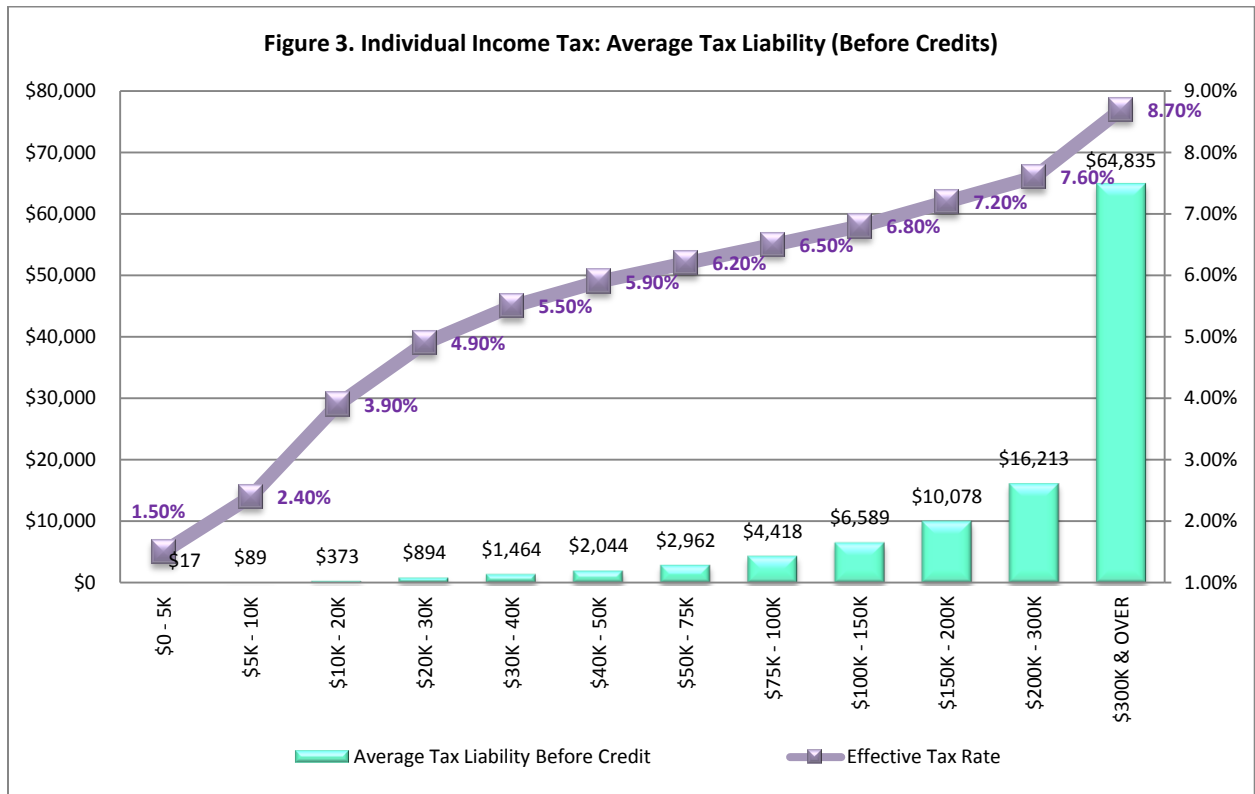
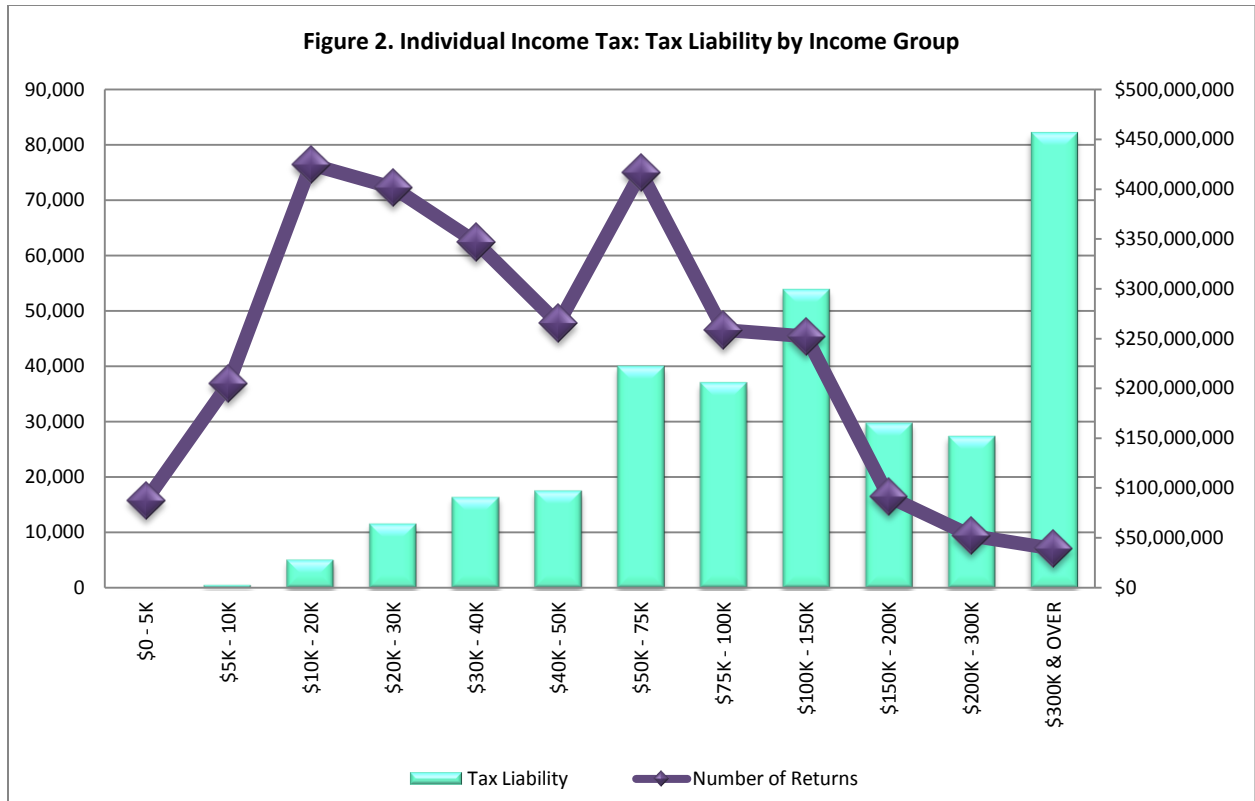
A total of 618,366 individual income tax returns were filed by Hawaii residents for tax year 2014. Of the total resident returns, 83% (511,199) reported a tax liability, and 17% (107,167) reported no tax liability (before applying any tax credits) (see Figure 1). Non-residents filed a total of 85,182 returns.



The total liability for tax year 2014 was \$1.79 billion. Although resident taxpayers with Hawaii adjusted gross income (“HAGI”) of under \$50,000 represents a majority (61%) of the returns with a tax liability, the amount of their total tax liability only accounts for 16% or \$0.29 billion of the total individual income tax. The majority of the individual income tax, 84% (\$1.50 billion), was paid by resident taxpayers with HAGI over \$50,000.

Taxpayers with HAGI of \$100,000 or more represent 15% of returns with a tax liability, but accounts for 60% or \$1.07 billion of the total individual income tax. Taxpayers with HAGI of \$300,000 or more represent 1.4% of returns with a tax liability, but accounts for 26% or \$0.46 billion of total individual income tax (see Figure 2).

The average tax liability within the various income groups range from \$17 (for those with HAGI of \$0 to \$5,000) to \$64,835 (for those with HAGI of \$300,000 or more). The effective tax rates range from 1.5% to 8.7% (see Figure 3).



IV. Tax Credits to Promote Social Welfare

Hawaii provides reliefs to the taxpayers on the lower income level in the forms of income tax credits such as the refundable food/excise tax credit and the income tax credit for low-income household renters.

Food/Excise Tax Credit

The food/excise tax credit⁴ (food credit) is a graduated amount based on income level, which is determined by the FAGI, and the number of qualified exemptions (see Table 3). There is no limit to the number of qualified exemptions that the taxpayers may claim. The food credit is determined by multiplying an allowable tax credit amount by the number of qualified exemptions. For tax year 2014, claims for the food credit totaled \$27.7 million on 325,713 individual income tax returns (46% of the returns filed for tax year 2014).

The food credit is a refundable credit which means that the taxpayers do not need to have a tax liability to claim the credit. A family of five with FAGI under \$5,000, for example, is entitled to a food credit of \$550. If this family of five does not have any income tax liability, they will receive a refund of \$550.

Table 3. Food/Excise Tax Credit

| Federal AGI | Single Filer | All Other Filers | | | | |
|---------------------|-------------------|--------------------------------------|-------|-------|-------|-------|
| | Tax Credit Amount | Tax Credit Amount for Households of: | | | | |
| | | 1 | 2 | 3 | 4 | 5 |
| Under \$5,000 | \$110 | \$110 | \$220 | \$330 | \$440 | \$550 |
| \$5,000 - \$10,000 | \$100 | \$100 | \$200 | \$300 | \$400 | \$500 |
| \$10,000 - \$15,000 | \$85 | \$85 | \$170 | \$255 | \$340 | \$425 |
| \$15,000 - \$20,000 | \$70 | \$70 | \$140 | \$210 | \$280 | \$350 |
| \$20,000 - \$30,000 | \$55 | \$55 | \$110 | \$165 | \$220 | \$275 |
| \$30,000 - \$40,000 | \$0 | \$45 | \$90 | \$135 | \$180 | \$225 |
| \$40,000 - \$50,000 | \$0 | \$35 | \$70 | \$105 | \$140 | \$175 |
| \$50,000 and over | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 |

Low-Income Household Renters' Credit

The credit for low-income household renters (renter's credit) is \$50 per qualified exemptions, provided that each taxpayer 65 years of age or over may claim double the tax credit

⁴ Act 211, Session Laws of Hawaii (SLH) 2007, replaces the low-income refundable tax credit with the refundable food/excise tax credit and increases the amount of the credit. Act 223, SLH 2015, temporary modifies the food/excise tax credit and increases the amount of the credit for tax years 2016 and 2017. Act 107, SLH 2017 made Act 223, SLH 2015, changes permanent.

(see Table 4). The renter's credit is limited to taxpayer with HAGI of under \$30,000⁵. The renter's credit has not been adjusted for twenty two years. For tax year 2014, claims for the renter's credit totaled \$3.6 million on 35,030 individual income tax returns.

An elderly couple, both over age 65, who rents, with a HAGI under \$30,000, for example, is entitled to a renter's credit of \$200. If this elderly couple does not have any income tax liability, they will receive a refund of \$200. A family of five with HAGI under \$30,000, who rents, for example, is entitled to a renter's credit of \$250. If this family of five does not have any income tax liability, they will receive a refund of \$250.

Table 4. Renter's Credit

| Hawaii AGI | Tax Credit Amount for Households of: | | | | | |
|----------------|--------------------------------------|-------|-------|-------|-------|-------|
| | 1 | 2 | 3 | 4 | 5 | 6 |
| Under \$30,000 | \$50 | \$100 | \$150 | \$200 | \$250 | \$500 |

Earned Income Tax Credit

Hawaii earned income tax credit (EITC) is 20% of the federal EITC for the tax year. However, unlike federal EITC, it is non-refundable, meaning if the EITC exceeds taxpayer's tax liability, only the amount up to the tax liability can be claimed. It is applicable for tax years 2018 to 2022.

The Department of Taxation estimated that the EITC will result in savings of \$16.7 million in tax year 2019 for those that qualified for the credit⁶.

Tax Liability After Tax Credits

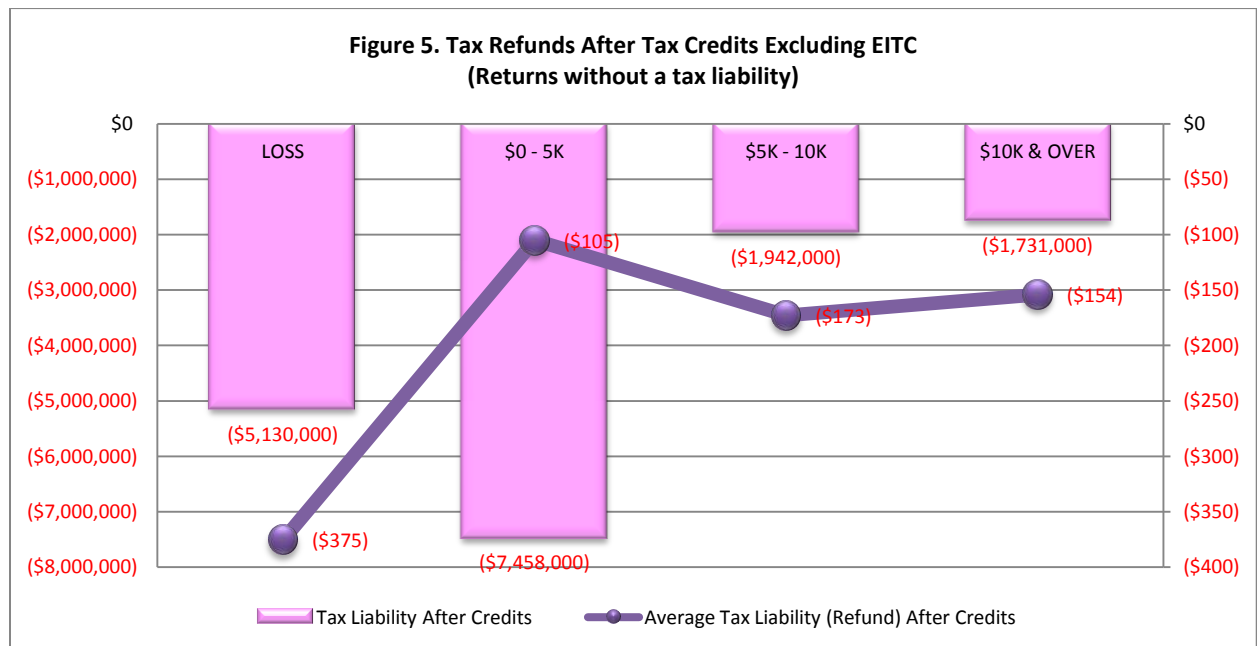
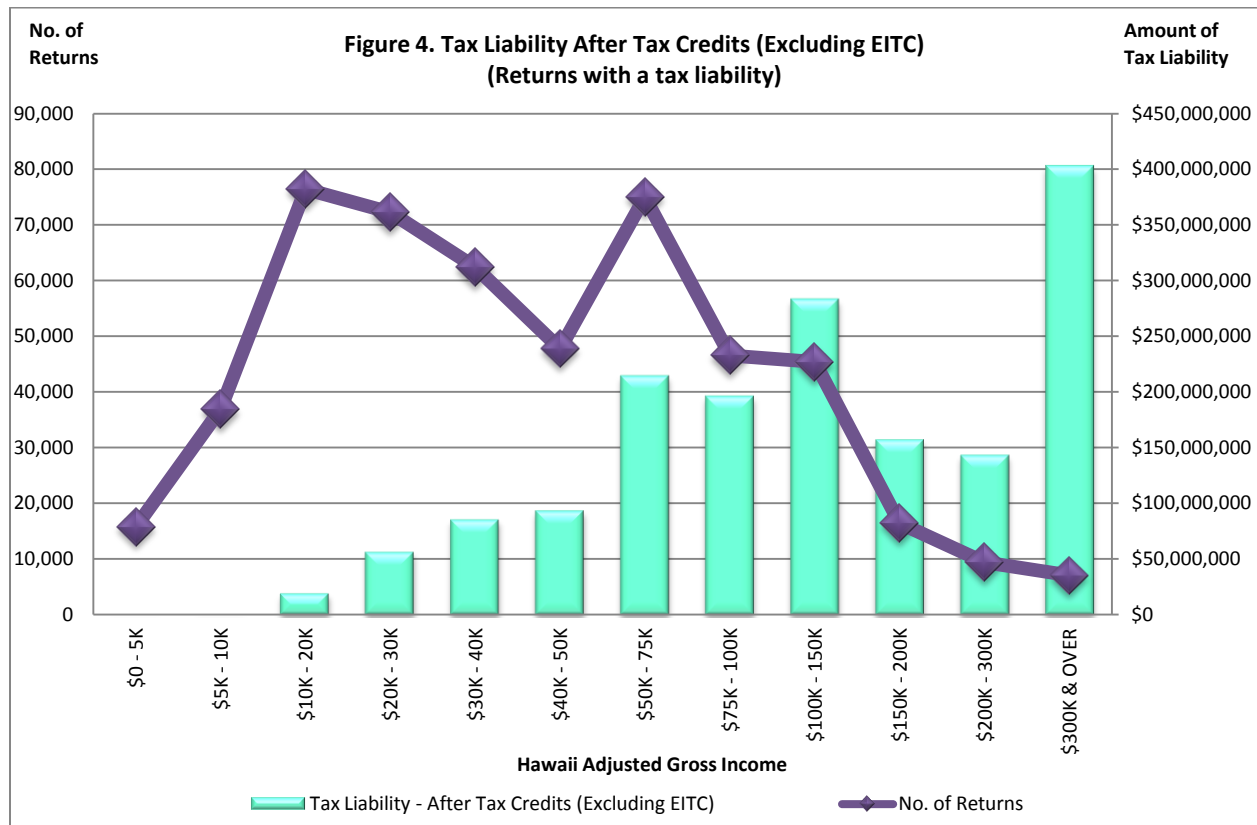
For tax year 2014, taxpayers with HAGI of under \$50,000 paid 15% (\$254.1 million), and the rest of the taxpayers paid 85% (\$1.35 billion) of the total individual income tax after tax credits. Taxpayers with HAGI of \$100,000 paid 60% (\$984.7 million) of the total individual income tax after tax credits. Taxpayers with HAGI of \$300,000 paid 24% (\$402.1 million) of total individual income tax after tax credits (see Figure 4).

Generally, the targeted tax credits resulted in refunds for non-taxable individual income tax returns. Tax credits claimed in the 107,167 *non-taxable returns* for tax year 2014 totaled \$16.3 million. The average refund is \$375 for returns with losses, \$105 for returns with \$0 to

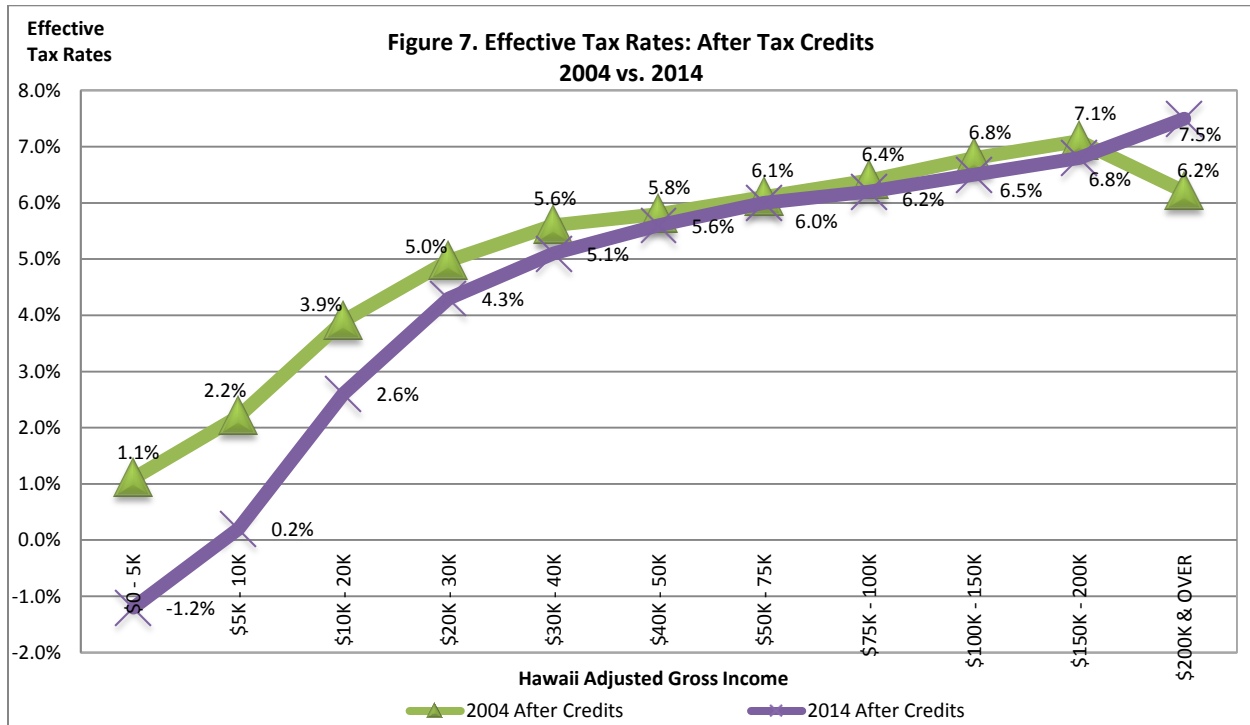
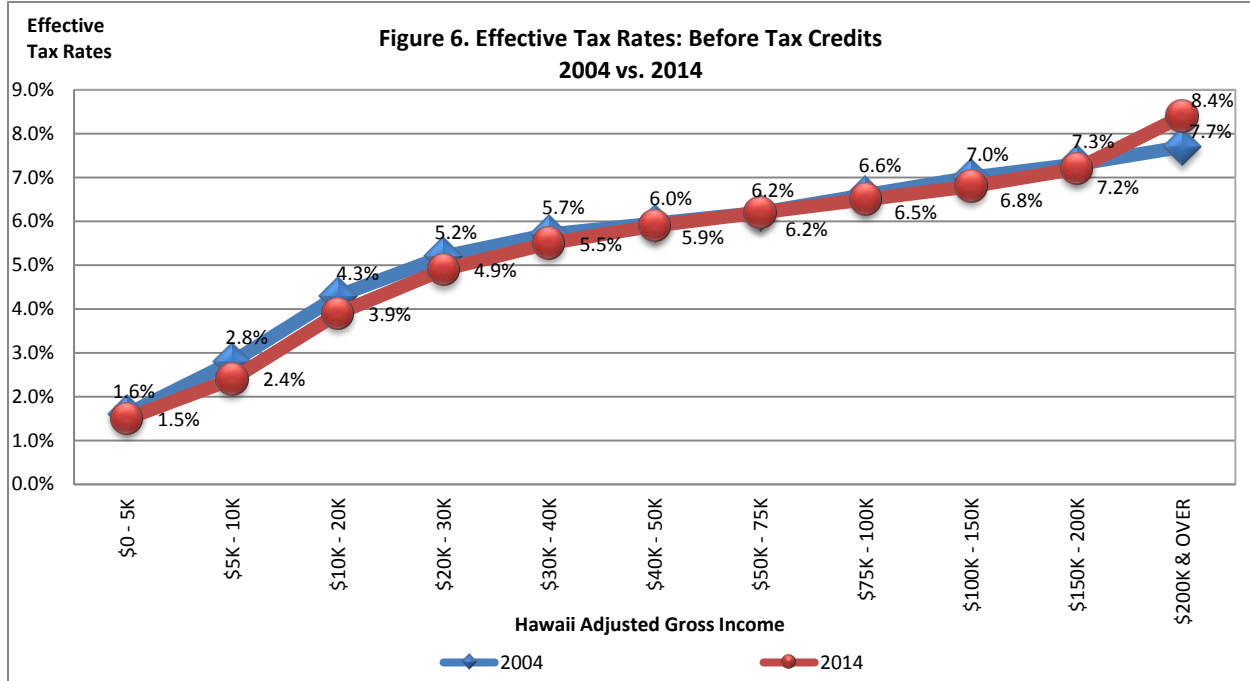
⁵ Act 15, SLH 1977, establishes the income tax credit for low-income renters. The amount of the credit was \$20 per qualified exemption for each taxpayer with an adjusted gross income of less than \$20,000. Act 230, SLH 1981, increases the amount of the low-income renter's credit to \$50 per qualified exemption. Act 321, SLH 1989, increases the income threshold for the low-income renters credit to less than \$30,000. Act 98, SLH 1990, makes the credit refundable (provides the credit to resident taxpayer who has no income or no taxable income).

⁶ Standing Committee Report No. 1338 re: H.B. 209, H.D. 1, S.D. 1, Regular Session of 2017.

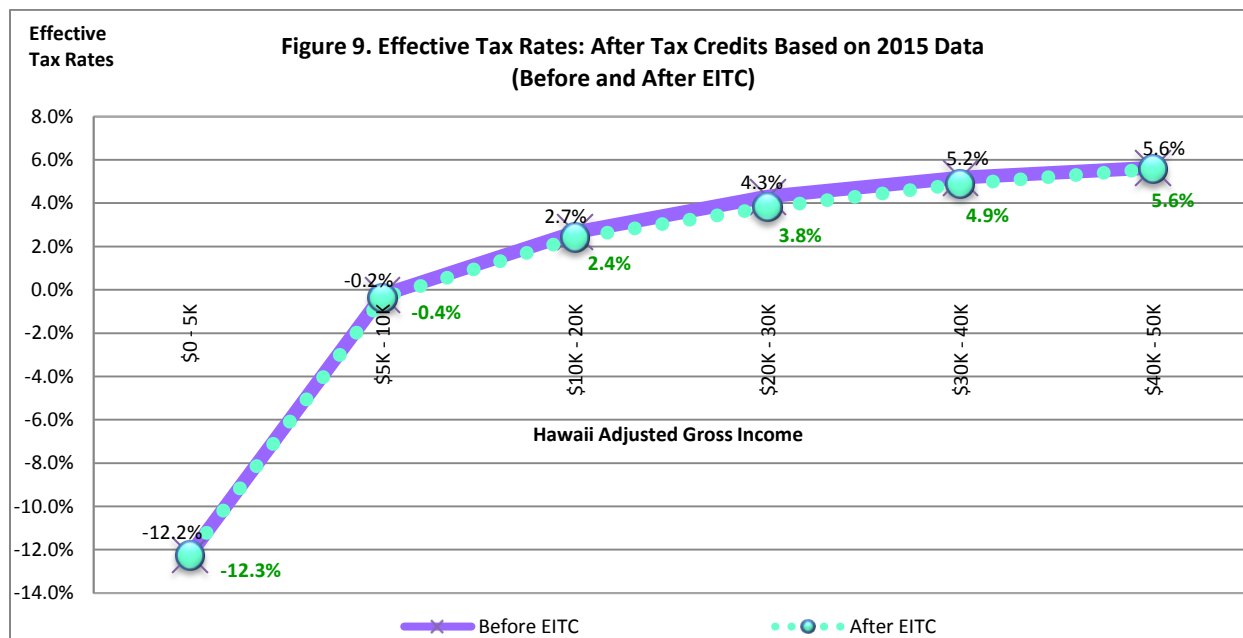
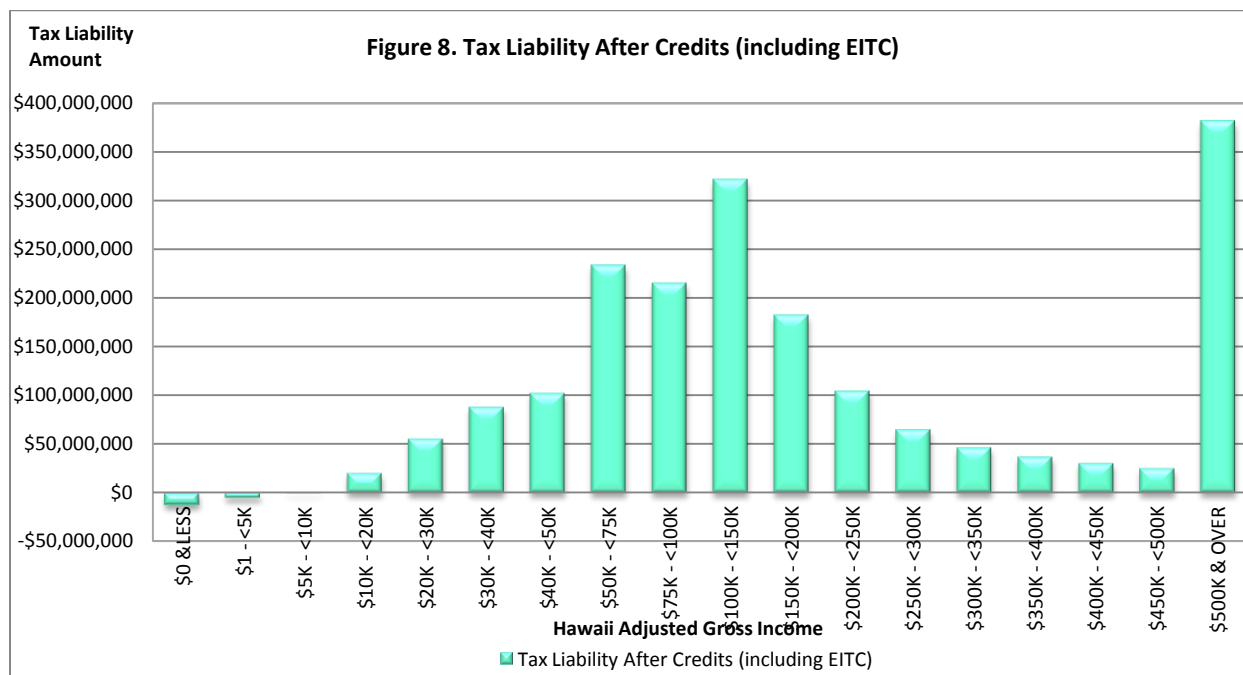
\$5,000 HAGI, \$173 for \$5,000 to \$10,000 HAGI and \$154 for \$10,000 and over HAGI (see Figure 5).



Over the years, the Legislature has passed legislations to promote social welfare. Comparing the effective tax rates for tax year 2004 to tax year 2014, generally, there is an overall decrease in the effective tax rates for all income group, particularly, for taxpayers with HAGI under \$50,000 after tax credits (see Figures 6 and 7).



The State non-refundable EITC as it becomes effective beginning with tax year 2018 will further reduce the income tax liability for family in needs. A statistical simulation using tax year 2015 data shows the EITC reducing the tax liabilities and the effective tax rates for taxpayers with HAGI under \$50,000 (see Figures 8 and 9). A negative effective tax rates mean taxpayers have no tax liability and are getting refunds, mainly due to tax credits to promote social welfare.



V. Estimating the Potential Revenue Impact of Eliminating Individual Income Tax for Those in Poverty

Data and Methodology

The exercise of estimating the potential revenue impact of eliminating individual income tax for those in poverty is accomplished by using historical tax data and applying simulation to the data. Poverty guidelines rather than poverty thresholds were used to determine those in poverty level as the guidelines distinguish Hawaii from the 48 contiguous states.

Both Federal adjusted gross income and Hawaii adjusted gross income are used to determine income level. FAGI excludes cost-of-living allowances (COLA) for federal employees, contributions to the State employees' retirement system (ERS), and interest on out-of-state bonds, whereas Hawaii adjusted gross income includes those income. HAGI excludes certain pensions, social security benefits, first \$6,279 of military reserve or Hawaii national guard duty pay, payments to an individual housing account and other subtractions from Federal adjusted gross income (see Table 5). Therefore, it is determined that to capture the proper income level, both Federal and Hawaii adjusted gross income must be used to determine poverty level.

Table 5. Examples of Differences between FAGI and HAGI

| | Federal Adjusted Gross Income | Hawaii Adjusted Gross Income |
|---|--|---|
| COLA | Not included | Included |
| Contribution to State Employees' Retirement System | Not included | Included |
| Out-of-state Bonds | Not included | Included |
| Employers-funded Pensions | Included | Not included |
| Social Security Benefits | Included | Not included |
| First \$6,279 of Military Reserve or Hawaii National Guard Duty Pay | Included | Not included |
| Payments to An Individual Housing Account | Included | Not included |

The number of people in a household is determined by the number of exemptions reported in the tax return (self, spouse, children and dependent, but excludes an additional exemption due to age sixty five and over).

To estimate the potential revenue loss of eliminating individual income tax for those with income below poverty level, the ordinary income tax rate is set at zero percent if both the FAGI and HAGI is less than the 2017 poverty guidelines as established by the U.S. Department of Health and Human Services.

Formula:

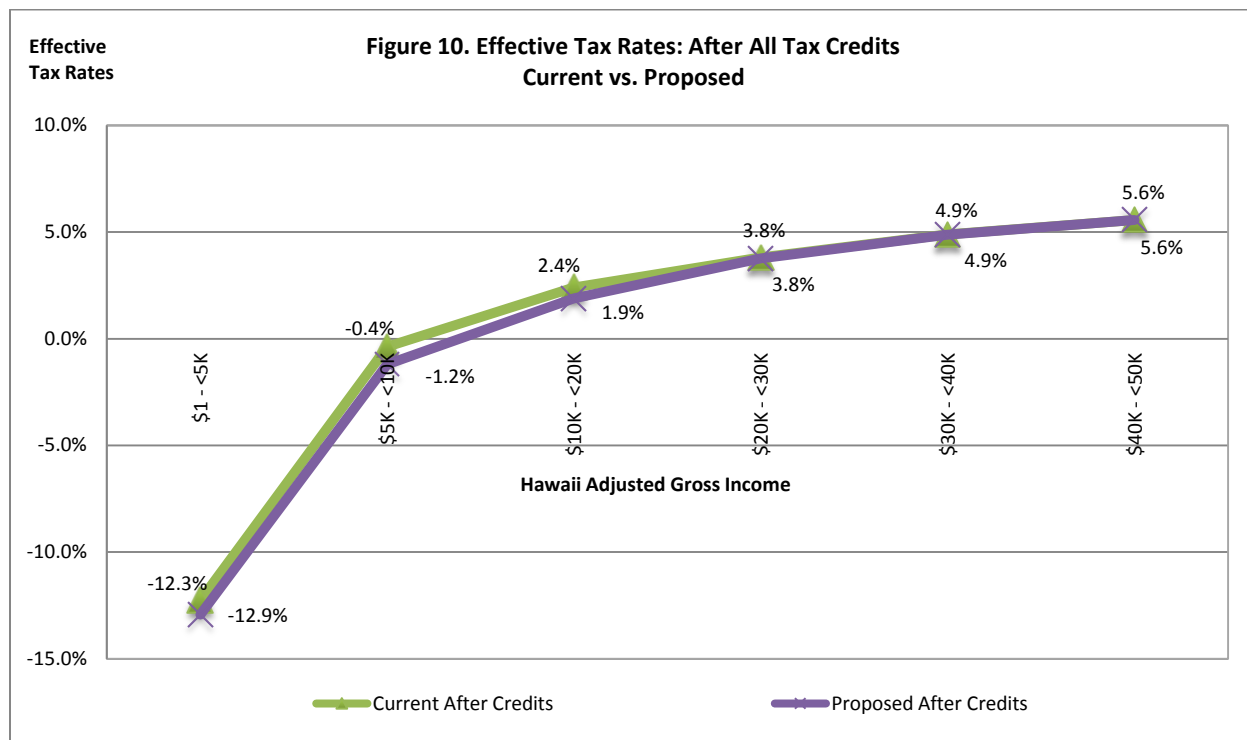
IF HAGI < (\$9,050 + (\$4,810 * Regular Exemption)) AND

FAGI < (\$9,050 + (\$4,810 * Regular Exemption)) THEN Ordinary Liability = 0

Results

Using the latest available data, tax year 2015 data, it is estimated that if those with FAGI and HAGI below poverty guidelines were exempted from individual income tax, only the effective tax rates for those with income below \$30,000 will decrease further after tax credits (see Figure 10).

This exercise shows no impact to taxpayers with income of \$30,000 and above. One conclusion is that the newly enacted EITC eliminates tax liability for most taxpayers with income below poverty guidelines; thus, this exercise has minimal impact to those taxpayers.



The reported liability would decrease by \$19.6 million. Using the U.S. Department of Labor, Bureau of Labor inflation calculator, the estimated reduction in reported liability in 2017 would be \$20.4 million⁷. However, the revenue loss is likely higher. It could be several times higher than the estimated reduction in reported liability. The Department of Taxation's records

⁷ U.S. Department of Labor, Bureau of Labor Statistics at <http://data.bls.gov/cgi-bin/cpicalc.pl>

showed a 20-years average difference between reported liability and tax collection of over \$100 million (or average of over 10% of individual income tax collected). A possible explanation for the difference is that taxpayers who falls below the filing requirement or owes little to no tax that have withholding by their employers, did not file their tax returns⁸. Therefore, the revenue impact of exempting from individual income tax those in poverty is likely much greater than the \$20.4 million estimated reduction in reported liability.

IV. Discussion

Defining “income” to determine poverty level is not an easy task. The issue with using adjusted gross income is that it includes business loss, capital loss, depreciation, etc. Taxpayers with low adjusted gross income may not necessarily be poor. It could be that those taxpayers have a big capital loss for the year, for example.

Income tax reliefs, such as the food credit and renter's credit are available to lower income households. Alternative options to provide tax reliefs to lower income households are increasing the amount of the food credit and renter's credit, indexing/increasing standard deduction, and indexing/increasing personal exemptions. Indexing/increasing standard deduction and personal exemptions are not as targeted to the lower income households as the food/excise tax credit and the renters' credit.

⁸ Reported tax liability data are from tax returns, whereby tax collection data include withholding of income tax by employers. If taxpayers below poverty level are exempted from individual income tax, the employers will no longer have to withheld taxes for those with income below poverty level; hence, individual income tax collection will likely decrease accordingly.

APPENDIX E:

REPORT OF DR. DONALD J. ROUSSLANG –

“Principles of Sound Tax Policy for Hawaii”

PRINCIPLES OF SOUND TAX POLICY FOR HAWAII

Report Prepared for the 2015-2017 Hawaii Tax Review Commission

Colleen M. Takamura, Chair

Vaughn G.T. Cook, Vice chair

Raymond N. Blouin, Member

M. Nalani Fujimori Kaina, Member

John M. Knox, Member

Dawn Lippert, Member

William (Billy) Pieper II, Member

by

Dr. Donald J. Rousslang

Rules Office

Hawaii Department of Taxation*

* The views expressed are those of the author and should not be ascribed to the Hawaii Department of Taxation or to the Tax Review Commission.

December 28, 2017

1 INTRODUCTION

The two basic principles for sound tax policy are that taxes should be fair and they should be efficient. Standards for what makes taxes fair are hard to set, because they depend on the individual's perspective. For example, a tax that seems fair to one person might look too heavy to some and too light to others. An efficient tax system raises enough money to pay for desired government services, it is cheap and easy for tax officials to administer and for taxpayers to comply with, and it interferes as little as possible with economic decisions of individuals and of businesses. The two basic principles complement each other, because if taxpayers deem taxes to be fair, it is easier to get tax compliance. However, as explained below, they also conflict with each other.

What follows is a more detailed discussion of principles of sound tax policy for Hawaii. In establishing the principles, I took it as my goal to maximize the economic welfare of Hawaii residents. That is why I added "for Hawaii" to the title. In particular, it is important to take account of the large amount of spending by nonresidents on goods and services that are consumed within the State. For example, in 2016, visitors spent more than \$15.9 billion in Hawaii, which was about 19 percent as great as the State's gross domestic product.¹ The nonresident spending within the State provides an opportunity to shift (or "export") an important part of the burden of the state's

¹ Data on visitor spending and the state's gross domestic product are from Research and Economic analysis, Department of Business, Economic Development and Tourism, *2016 State of Hawaii Data Book*, tables 7.26 and 13.03, available at <http://dbedt.hawaii.gov/economic/databook/db2016/>.

consumption taxes to nonresidents. I assume other taxing jurisdictions would take no action in response to any tax changes made by Hawaii.

2 FAIRNESS

Fairness of taxes, or tax equity, usually is measured using two standards: horizontal equity and vertical equity. A third standard sometimes mentioned is the "benefits principle."

2.1 Horizontal Equity

Horizontal equity requires that taxpayers in the same situation face the same tax burdens. Horizontal equity is important and should be adhered to rigorously. A "tax cliff," where a small change in the tax base leads to a large change in tax liability, is one way to violate horizontal equity. For example, in Hawaii's individual income tax, the itemized deduction for state income taxes is lost for a single taxpayer with federal adjusted gross income of \$100,000 or more. For some taxpayers, this means that a few dollars less in income would reduce their Hawaii income tax by more than \$600. Those who find themselves in this situation might feel justified in fudging the tax figures. Tax cliffs foster disrespect for tax laws, which leads to noncompliance and makes taxes harder to administer. Another way to violate horizontal equity is to give special tax breaks to selected classes of individuals or for selected activities.

2.2 Vertical Equity

Vertical equity is usually taken to mean that people with higher income should pay tax at a higher rate than people with lower income. The notion is that taxes should be based on the ability to pay, or said another way, that the pain of taxes should be the same for everyone. Typically, to help achieve vertical equity, income below an amount deemed necessary to live is exempt from tax and income above this amount is taxed at graduated rates. Vertical equity is hard to measure by objective standards. Most people would agree that income below an amount needed to live should not be taxed,² and most would also agree that the rich should pay tax at a higher rate than the poor. But no one can say with authority how much income is needed to live or how progressive tax rates should be.

The goal of vertical equity for an income tax conflicts with the goal of tax efficiency, because the efficiency cost of the income tax (for example, the tendency for the tax to discourage people from working and from saving) depends only on the tax rate on the last dollars earned.³ This means that a progressive income tax imposes a greater efficiency cost than a proportional income tax that yields the same revenue.

It is hard to design a sales or excise tax that depends on the income of the consumer, so vertical equity is hard to achieve with these taxes. Sometimes, consumption

² This is probably the biggest shortcoming of Hawaii's individual income tax, because the standard deduction and personal exemption have not been indexed for inflation. Consequently, the tax starts at a level of income that is much lower than that for the federal income tax, even though Hawaii's cost of living is above the national average. For example, for tax year 2017, for a married couple with one child, Hawaii's standard deduction and personal exemptions add up to \$7,872, whereas the federal standard deduction and personal exemptions add up to \$24,850.

³ This is a well-known result in the field of public finance.

of things that are deemed necessities (such as groceries) are exempted from the tax to help achieve vertical equity. However, such exemptions distort consumption choices and increase the costs of tax administration and so conflict with the goal of efficiency. However, it is not necessary that each tax meet a standard of vertical equity on its own, as long as the tax system as a whole meets the public standard for tax equity. For example, Hawaii's general excise tax (GET) is regressive; low-income people tend to save less, so they pay more GET per dollar of income compared to high-income people. But Hawaii's individual income tax is progressive and it also provides refundable tax credits that help reimburse low-income people for the general excise taxes they pay on food and rent. One might presume that Hawaii's current tax structure meets the public desire for a progressive tax system, because it is the product of a democratic process.

2.3 The Benefits Principle

The benefits principle says that those who benefit from the government services should pay for them. At the state level, most government services are in the public sector, instead of in the private sector, either because it would be hard to make people who benefit from the services pay for them (such as public highways), or because the services go to people who cannot afford them (such as public welfare). In these cases, the benefits principle can't be applied. However, the benefits principle is useful for determining which government services should be paid for with user fees and which should be paid for with

taxes.⁴ If the services can be limited to beneficiaries who can afford them, they should be paid for with fees instead of with taxes, because this causes users to take account of the cost of the services, which discourages wasteful overuse.

3 EFFICIENCY

Obviously, the costs of administering and collecting the taxes should be kept as low as possible, but these costs are anyway low. For Hawaii, the Department of Taxation administers and collects the great bulk (about 95 percent) of the State's taxes. In fiscal year 2016, it performed this chore with an annual operating budget of about \$24 million. Net tax collections by the Department that year were about \$6.9 billion, so the administration and collection costs were about 35 cents for each \$100 of net tax revenues, or a little more than one third of one percent.⁵

Taxes usually impose a cost on taxpayers in addition to the tax they pay. Part of the extra cost is the cost of complying with the tax laws. Compliance costs are harder to

⁴ A tax is a compulsory payment in return for which the taxpayer receives no direct or specific benefit, that is, there is no *quid pro quo*. A fee is a charge for a specific benefit, but if the charge raises more money than needed to cover the cost of the benefit, the extra amount is a tax. For example, Hawaii levies fees on insurance producers for the cost of regulating the insurers. In 2010, the Legislature temporarily doubled the fees (for fiscal years 2010 through 2014) and had the extra amount deposited into the General Fund. The increase in the levy was a tax and not a fee. In general, any payment that goes to the General Fund would be considered a tax.

⁵ See the Department of Taxation's *Annual Report: 2015-2016*, page 51. The figure for administration and collection costs does not include the cost of the Department's new Tax System Modernization project, which is estimated to cost about \$60 million over several years. However, the cost of the new system must be amortized over its useful life. Even if we included the costs of the new system as they are incurred (in essence, expensing rather than amortizing them), the cost of administering and collecting Hawaii's state taxes would still be little more than one half of one percent.

estimate than the costs of administering and collecting taxes, but the available evidence is that they probably are bigger by an order of magnitude.⁶ The biggest cost of taxes, though, and also the hardest to measure, is that they tend to distort economic decisions. For example, taxes on income discourage people from working and from saving. For the federal income tax, these distortions have been estimated to cost between 11 percent and 15 percent as much as the total collections.⁷ In fact, most studies of the costs of taxes ("optimal tax theory") focus exclusively on the cost of the economic distortions they cause.⁸

There are two other economic effects that should be considered when designing a tax system, but that usually are not included in lists of principles of sound tax policy. The first is that the burden of a tax can sometimes be exported to nonresidents. The second is that some taxes help offset adverse side effects (called "negative externalities") that arise

⁶ For example, Joel Slemrod, "The Compliance Cost of Taxing Business," April 25, 2006 (available at http://webuser.bus.umich.edu/jslemrod/pdf/cost_of_taxing_business.pdf) presents evidence that the compliance burden was about 2.7 percent of the revenue from the federal corporate income tax and about 5.8 percent of the revenue from state corporate income taxes. Scott A. Hodge, "The Compliance costs of IRS Regulations," Tax Foundation *Fiscal Fact*, (June 2016) (available at <https://taxfoundation.org/compliance-costs-irs-regulations/>) estimates that compliance costs for the federal individual income tax were \$99 billion in 2016, which is about 6 percent of the total collections.

⁷ See Robert Carroll, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," Tax Foundation Special Report, (August 2009) (available at <https://files.taxfoundation.org/legacy/docs/sr170.pdf>).

⁸ See Jonathan Shaw, Joel Slemrod and John Whiting, "Administration & Compliance," prepared for *Reforming the Tax System for the 21st Century: The Mirrlees Review*, The Institute for fiscal Studies (April 2008) (available at www.ifs.org.uk/mirrleesreview).

when the activities of consumption or production impose costs on society that are not reflected in the private cost to the consumer or producer.

Because the economic effects of taxes typically are much bigger than the costs of tax administration or of tax compliance, we break the principles for sound tax policy that promote efficiency into two categories, depending on whether the principle helps reduce the cost of tax administration or compliance, or whether it addresses the economic effects of taxes.

3.1 Principles of Sound Tax Policy to Help Reduce the Costs of Tax Administration and Compliance

The main principles of sound tax policy that help reduce costs of tax administration and compliance are that the tax code should be simple and stable.

Simplicity

A simple tax code has the advantages of being easier for tax authorities to administer and to enforce and easier for taxpayers to comply with, which lowers both the cost of tax administration and the cost of tax compliance.⁹ Simplicity of taxes also makes

⁹ Some compliance costs are self-inflicted and come from an attempt to avoid as much of the tax as possible. Complexity sometimes comes from the need to curtail tax avoidance, but unnecessary complexity helps generate such activities. In this regard, Hawaii's individual and corporate income taxes are burdened with a plethora of tax credits that make the taxes harder to administer and that create opportunities for tax abuse. This is especially true of the refundable tax credits. Hawaii's tendency to use income tax credits drew satire from a nationally known tax analyst. See David Brunori, "Hawaii Tax Credit Craziness," *Tax Analysts*, March 24, 2014 (available at <https://www.forbes.com/sites/taxanalysts/2014/03/19/hawaii-tax-credit-craziness/#584a87db5269>).

them more transparent, so that it is easier to hold accountable the parties responsible for designing and administering the tax system, including legislators.

Stability

Stability of the tax code reduces the costs of tax administration and compliance, and it also reduces uncertainty about the future, which helps individuals and businesses to make better plans. Another kind of stability sometimes mentioned in principles of sound tax policy is that tax revenues should be stable. Stability of tax revenues reduces uncertainty in government budget planning, because the State's operating budget is constrained by law to balance. Thus, the State should not rely overly much on taxes that show great volatility in collections over the business cycle, such as the corporate income tax. However, Hawaii's biggest state taxes are on income and consumption of individuals, which raises the question whether it is more important to keep private consumption or public services stable over economic cycles.¹⁰

3.2 Principles of Sound Tax Policy to Help Reduce the Economic Distortions Caused by Taxes

The main principle of sound tax policy to reduce economic distortions caused by taxes is that taxes should be neutral and not favor one economic activity or type of

¹⁰ As Mark Twain quipped, "When everybody has got money they cut taxes, when they're broke they raise 'em. That's statesmanship of the highest order." The result is a more stable government budget, but less stability for private budgets. As shown in section III, in the recent recession, the State's General Fund tax revenues suffered greater declines than income in the economy as a whole.

consumption over another. A close relative to the principle of tax neutrality is the principle that the tax base should be set as broadly as possible so that the desired revenue can be raised with a lower tax rate.

Tax Neutrality

The standard of tax neutrality requires that a tax be levied uniformly on its base, with no special tax breaks for selected activities or taxpayers. Uniform application of a tax helps minimize the effect on economic decisions. For example, it has been argued convincingly that Hawaii's general excise tax is a model of efficiency for other states to follow, because it has a broader base than sales taxes used on other states.¹¹ The notion is that unfettered private markets are the best way to get the most benefit from economic resources. The consensus among economists is that when tax authorities use tax credits or special tax breaks to encourage selected businesses, they usually reduce the overall economic well-being of residents. In addition to distorting economic decisions, special tax breaks complicate the tax code and make it harder to administer and to enforce.

¹¹ See Donald J. Rousslang and Jonathan W. White, "Is Hawaii's GET a Good Solution to State Budget Shortfalls?" *State Tax Notes*, March 27, 2017, pages 1127-1134. They provide estimates that the annual efficiency gains from having such a broad base compared to the base of the average state sales tax amount to several times as much as the cost of administering and collecting all of Hawaii's state taxes.

Broad Base, Low Rates

Uniform application of a tax to its base helps keep the base as broad as possible, so that the needed tax revenue can be gotten with the lowest tax rate possible. Keeping the tax rate low is important, because it reduces economic distortions caused by the tax.¹²

4 OTHER PRINCIPLES OF SOUND TAX POLICY

4.1 Tax Burdens That Can Be Exported to Nonresidents

When designing Hawaii's tax system, tax authorities should be mindful of opportunities to export the burden of local taxes to nonresidents. The portion of the tax burden that is exported varies greatly among Hawaii's taxes. For example, the background study on Hawaii's corporate income tax that was prepared for the 2015-2017 Tax Review Commission found that according to recent estimates of the share of "supernormal" profits (such as windfall gains or monopoly profits) in the corporate income tax base, more than 72 percent of the State's tax is exported to nonresidents, versus about 32 percent for Hawaii's individual income tax and 32 percent to 38 percent for Hawaii's GET.¹³

¹² The cost of distortions imposed by a tax tends to grow faster than the tax rate. Thus, exempting part of the tax base and making up the revenue by imposing a higher tax rate on the remainder of the base damages economic efficiency in two ways: it distorts the relative prices of the taxed and untaxed portions of the base and it raises the cost of economic distortions per dollar of revenue.

¹³ Donald J. Rousslang and Yvonne Chow, "Should Hawaii Tax Corporate Income? A Cost Benefit Analysis," report prepared for the 2015-2017 Hawaii Tax Review Commission, July 19, 2017. (*See Appendix B.*)

4.2 Taxes That Provide a Public Benefit in Addition to Revenue

Instead of imposing an extra cost by distorting economic decisions, some taxes provide an extra economic benefit by helping discourage negative externalities. For example, a carbon tax discourages pollution.¹⁴ Such taxes are the most efficient sources of tax revenue, but unfortunately their bases are too small to fully fund government services.

4.3 Tax Adequacy

A requirement for any tax system is to produce enough revenue to fund government services, but there is no way to say definitely how much of such services is enough. People choose the amount of government services they want based on the cost and their budget, just as they do for any other goods or services. In fact, at any time one can say that whatever amount of government services was actually provided must have been adequate, given the choices people faced. Instead of trying to define the amount of needed government services, a common approach to assess tax adequacy is to say that the current level of the services is adequate, either in absolute amount or as a share of the total economy, and then to ask whether the tax system will provide enough money to maintain the same level of services in the future.¹⁵

¹⁴ Taxes that offset negative externalities are sometimes called Pigou taxes, after the British economist A.C. Pigou.

¹⁵ See, for example, Joshua O. Fujino and Donald J. Rousslang, "Will Hawaii's Tax Structure Prove Adequate in the Future?" in Appendix E, Report of the 2010-2013 Tax Review Commission.

The need to provide adequate revenue limits the alternatives available to tax officials. In most cases there are only three tax bases broad enough to support a state government's spending needs: income, consumption and wealth. Hawaii's Constitution prohibits the State from taxing real property, so income and consumption are the State's main tax base alternatives.

4.4 Competitiveness

Helping local businesses compete with businesses in other taxing jurisdictions is often given as the reason for tax breaks for selected activities. The argument is that tax incentives are needed to attract or keep the selected activities in order to broaden the economy or to create jobs. Supporters view such attempts as enlightened industrial policy, but most economists (especially those with formal training in the field of public finance) are skeptical of the notion that policy officials can improve the local economy by distorting its taxes and are apt to view such attempts as akin to trying to pull oneself up by one's bootstraps. Usually, the best way to help local businesses compete is to apply each tax uniformly to its base so as to keep the tax base broad and the rate low.

APPENDIX F:

REPORT OF MS. TITIN L. SAKATA –

**“Summary of Recommendations Made by Tax Review
Commissions”**

SUMMARY OF RECOMMENDATIONS MADE BY TAX REVIEW COMMISSIONS

| Recommendation | Commissions | | | | | | Implementation and Comments |
|---|-------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| Overall Tax Recommendations | | | | | | | |
| 1. Maintain General Fund composite progressivity | X | | | | | | Various targeted low-income tax credits have, over time, attempted to mitigate the regressivity of the general excise tax. However, the issue requires further analysis. |
| 2. Eliminate or sunset tax exemptions and credits | X | | | | X | | <p>Some tax credits have been enacted with sunset dates and have sunsetted or been repealed. In some cases, the sunset or repealed credit was replaced with an alternative. These credits have included the Individual Development Account Contribution Tax Credit (§235-5.6, HRS; sunset December 31, 2004), the Energy Conservation Credit (§235-12, HRS; sunset June 30, 2003), which was partially replaced by the Renewable Energy Technologies Credit (Act 70, SLH 2003), and the Residential Construction and Remodeling Tax Credit (§235-110.45, HRS; sunset June 30, 2003).</p> <p>Act 88, SLH 2006: Increased and modified the motion picture, digital media, and film production income tax credit (film credit). Effective for qualified production costs incurred on or after July 1, 2006, and before January 1, 2016. On January 1, 2016, Act 88 is repealed, and section 235-17, HRS, will be reenacted in the form in which it read before Act 88.</p> <p>Act 89, SLH 2013: Extends the sunset date of Act 88, SLH 2006 (film credit) to January 1, 2019. Adds reporting requirements by the Film Office, Department of Business Economic Development & Tourism (DBEDT) to the Legislature.</p> <p>Act 143, SLH 2017: Extends the sunset date of Act 88, SLH 2006, as amended by Act 89, SLH 2013, to January 1, 2026. Adds verification review by a qualified CPA. Adds reporting requirements by DBEDT and DOTAX to the Legislature.</p> <p>Act 105, SLH 2011: Suspended temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from GET and Use Tax and requires the payment of both taxes at 4%. Effective July 1, 2011, and sunsets on June 30, 2013.</p> <p>Act 270, SLH 2013: Reintroduces tax credit for research activities, but conforms to section 41 and section 280C of the Internal Revenue Code. Adds reporting requirements by DBEDT to the Legislature. Applies to tax years from 2013 to 2019.</p> |

| Recommendation | Commissions | | | | | | Implementation and Comments |
|--|-------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| | | | | | | | <p>Act 200, SLH 2014: Establishes a capital infrastructure tax credit for tenants who are relocating due to the Kapalama container terminal modernization project. The credit equals 50% of infrastructure costs incurred by an eligible tenant, up to maximum costs of \$2.5 million per tenant per taxable year. The credit is available for tax years beginning after December 31, 2013 and expires for tax years beginning after December 31, 2019.</p> <p>Act 213, SLH 2017: Expands the capital infrastructure tax credit, among other things, doubling the amount of credit per taxable year from \$1.25 million to \$2.5 million.</p> <p>Act 120, SLH 2015: Creates a temporary, nonrefundable income tax credit for the costs incurred in converting a qualified cesspool to a septic system or to an aerobic treatment unit system, or for the cost of connecting a cesspool to a sewer system. Applies to tax years beginning 2016, and is repealed on December 31, 2020.</p> <p>Act 125, SLH 2017: Expands the class of cesspools for which a tax credit may be claimed on costs to upgrade them to septic systems or aerobic treatment unit systems or to connect to a sewer system.</p> <p>Act 202, SLH 2016: Repeals the ethanol facility tax credit and creates a new, nonrefundable income tax credit for production of renewable fuels. The credit for production of renewable fuels applies to tax years beginning 2017, and is repealed on December 31, 2021.</p> <p>For additional information on the history of tax credits, see the <i>Tax Credits Claimed by Hawaii Residents</i> report published annually by the Department [tax.hawaii.gov].</p> |
| 3. Minimize all tax exemptions and credits | | X | X | X | X | | <p>The number of exemptions and credits, in general, have expanded. Act 105, SLH 2011: Suspended temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from GET and Use Tax and requires the payment of both taxes at 4%.</p> |
| 4. Establish General Fund Stabilization Fund | X | X | X | X | | | <p>Act 304, SLH 1999: Established the Emergency and Budget Reserve Fund.</p> |
| 5. Maximize tax "exporting" | X | | | | | | <p>Hawaii taxes, including the income tax, GET, TAT, and conveyance tax, are all exported to some extent. For more information, see 2002-2005 TRC Report, Appendix D, <i>Study on the Progressive or Regressive Nature of Hawaii's Taxes</i>.</p> |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|---|--------------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 6. Provide direct expenditure assistance, not narrowly targeted tax preferences | X | | | | X | | Narrowly targeted tax preferences have increased. One consideration may be that such preferences are not expenditures subject to the general fund expenditure ceiling established under Article VII, Section 9, of the Hawaii State Constitution. |
| 7. Lower the overall level of state taxes | | X | X | | X | X | <p>Act 157, SLH 1998: Lowered individual income tax rates as well as the tax rates for trusts and estates, increased the number of tax brackets from 8 to 9, and expanded the tax brackets.</p> <p>Act 110, SLH 2006: Increased the standard deduction to 40% of the 2006 federal standard deduction and expanded the tax brackets by 20%.</p> <p>Act 60, SLH 2009: (1) Added three new brackets and rates, 9%, 10%, and 11% for the high income taxpayers for taxable years 2009 to 2015; and (2) Increased the standard deduction and personal exemption by 10% for taxable years 2011 and 2012.</p> <p>Act 97, SLH 2011: (1) Eliminated the deduction for state taxes paid for taxpayers with income above income above specified thresholds; (2) Placed temporary limitations on claims for itemized tax deductions by the lesser of the limitation provided in section 68 of the IRC or the limitation as specified under Act 97; and (3) Delayed the standard deduction and personal exemption increases approved under Act 60, SLH 2009, by two years while also making those increases permanent.</p> <p>Act 107, SLH 2017: (1) Established State nonrefundable EITC equals to 20% of federal EITC for taxable years 2018 to 2022. (2) Added back three new brackets and rates, 9%, 10%, and 11% for the high income taxpayers for taxable years beginning after 12/31/2017. (3) Made permanent the changes to food/excise tax credit by Act 223, SLH 2015.</p> |

| Recommendation | Commissions | | | | | | Implementation and Comments |
|--|-------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| General Excise and Use Tax Recommendations | | | | | | | |
| 1. Maintain the GET structure | X | | | | X | | Structure has been maintained except for marginal changes. |
| 2. Do not use exemptions to achieve vertical equity | | X | | | | | Vertical equity has not been a major consideration in enacting legislation affecting the GET. |
| 3. Limit exemptions to those needed for horizontal equity | | X | | X | | | Horizontal equity has not been a major consideration in enacting legislation affecting the GET. |
| 4. Eliminate or limit exemptions intended to effect social policy such as the following: | | | | | | | |
| (a) \$2,000 exemption for blind, deaf, or totally disabled persons | | | | X | | | Not adopted. The exemption was expanded by Act 110, SLH 2002 , to also include general, limited, and limited liability partnerships all of whose partners are blind, deaf, or totally disabled. |
| (b) Exemption for Hansen's disease patients | | | | X | | | Not adopted. |
| (c) Limiting the 0.5% rate for blind, deaf, or totally disabled persons to the first \$30,000 of gross receipts. | | X | X | | | | Not adopted. |
| 5. Do not exempt health care services, food, apparel, or shelter from the GET and instead pursue those goals, if desirable, through low-income income tax credits or the appropriation and expenditure process | | | | | X | | Act 211, SLH 2007: Amended the Low Income Refundable Tax Credit provided by §235-55.85, HRS, by (1) replacing it with the Refundable Food/Excise Tax Credit; (2) using Federal adjusted gross income (AGI) rather than Hawaii AGI to Federal AGI; (3) increasing the credit amount per qualified exemption; and (4) increasing the income thresholds that a Hawaii resident can earn in order to claim the credit. The credit amount is on sliding scale based on Federal AGI. Act 223, SLH 2015: Temporary increased the food/excise tax credit amount for taxable years 2016 and 2017. Act 107, SLH 2017: Makes permanent changes to the food/excise tax credit by Act 223, SLH 2015. |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|--|--------------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 6. Eliminate pyramiding on multiple lease transactions | | X | | | | | Act 353, SLH 1997: A sublease deduction is allowed sublessors of real property pursuant to a written lease to effect a reduction in (not a total elimination of) the pyramiding effect of the GET on the amount of lease rent paid to the master lessor on the property, or portion of the property, that is being subleased. |
| 7. Eliminate pyramiding on inter-company transactions | | X | | X | | | <p>All of the following Acts were enacted after the publication of the 1988-1990 TRC report and prior to the publication of the 2001-2003 TRC report. While the legislation reduced the pyramiding of the GET on business-to-business transactions, it did not eliminate all pyramiding at the 4% rate, such that the 2001-2003 TRC recommended codifying the principle that the 4% rate on consumption be applied only once; this recommendation was not adopted.</p> <p>Act 71, SLH 1999: Phased-in pyramiding relief to extend wholesale treatment to certain transactions in which the goods, services, amusements, etc., that are identifiable elements of what is resold (i.e., it relaxed the strict no-consumption rule). Qualifying transactions include certain service-to-service, service-to-goods, service-to-contracting, service-to-transient accommodations, goods-to-service, and goods-to-transient accommodations transactions.</p> <p>Act 173, SLH 1999: Allows sales of pre-packaged condiments to eating and drinking retailers to be taxed as a wholesale rather than a retail transaction.</p> <p>Act 27, SLH 2000: Taxes sales of prepaid calling cards as sales of tangible personal property, such that sales to licensed sellers for resale are taxed as wholesale transactions.</p> <p>Act 198, SLH 2000: Expanded Act 71, SLH 1999, to afford phased-in wholesale treatment to amusement-to-service, amusement-to-goods, and amusement-to-transient accommodations transactions. This Act also afforded phased-in wholesale treatment under the public service company (PSC) tax to certain transportation services provided to contractors (see also Act 9, 3rd SpS 2001, below) and to certain sales of telecommunications services by a public utility to an interstate telecommunications provider for resale.</p> |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|--|--------------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| | | | | | | | <p>Act 271, SLH 2000: Extends wholesale tax treatment to sales by a printer to a publisher of magazines or other printed material containing advertisements when the publisher is contracted by the advertisers to distribute a minimum number of magazines, etc., regardless of whether there is a charge to the persons who actually receive the magazines, etc. (e.g., free tourist magazines).</p> <p>Act 9, 3rd SpS 2001: Subjects certain transportation service providers to the GET instead of the PSC tax. Specifies that transportation service providers are service businesses, thus allowing transportation service providers to qualify for the phased-in wholesale rate on transactions other than transportation service-to-contracting transactions.</p> |
| 8. Eliminate or limit gross receipts splitting | | | X | | | | Not adopted. |
| 9. Subject imported services to the use tax | | X | X | | | | <p>Act 70, SLH 1999: Subjects imported services to the use tax.</p> <p>Act 198, SLH 2000: Subjects imported contracting to the use tax.</p> |
| 10. Exempt residential rental income | | X | | | | | Not adopted. |
| 11. Eliminate blanket exemptions in favor of specific exemptions | | X | | | | | <p>Act 286, SLH 1991: Subjects insurance companies to the GET on gross income from the rental of real property and to the TAT on gross rental income from the furnishing of transient accommodations.</p> <p>Act 106, SLH 1992: Subjects financial institutions to the GET on non-financial services income such as gross income from the rental of real property, parking lot fees, safe deposit fees, tax preparation, payroll services, data processing fees, and seminar fees.</p> <p>Act 116, SLH 1994: Subjects employee benefit plans to the GET on gross income from the rental of real property.</p> |
| 12. Eliminate or limit specific exemptions or special rates for: | | | | | | | |
| (a) Scientific contracts with the United States | | | X | | | | Not adopted. |
| (b) Petroleum products refined in Hawaii | | | X | | | | Not adopted. |
| (c) Loading, transporting, and unloading agricultural products | | | X | | | | Not adopted. |
| (d) Sugarcane producers | | | X | | | | Not adopted. |

| Recommendation | Commissions | | | | | | Implementation and Comments |
|---|-------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| (e) Reimbursements to federal cost-plus contractors and sales of tangible personal property to the federal government | | | X | | | | Not adopted. |
| (f) Certain real property rental income received by labor organizations | | | X | | | | Not adopted. |
| (g) Sales of locally produced agricultural, meat, or fish products to common carriers in interstate or foreign commerce for consumption out-of-State. | | | X | | | | Act 135, SLH 2003 , amended this provision to remove the limitation to locally produced products. The Hawaii Supreme Court ruled this provision unconstitutional in 1994 (<i>In Re the Tax Appeal of Hawaiian Flour Mills, Inc.</i> , 76 Haw. 1). The Department issued Tax Information Release No. 93-4 on November 10, 1993, after the Tax Appeal Court determined that the provision was unconstitutional, such that an exemption under this provision could not be claimed although an exemption for fresh food products shipped out of State continued to apply. |
| (h) Air pollution control facilities | | | X | | | | Act 160, SLH 2013 : Eliminates the GET exemption for liquor, tobacco, and food sold to common carriers, beginning with tax year 2014. Not adopted. |
| (i) Solid waste processors (waste-to-energy) | | | X | | | | Not adopted. |
| 13. Eliminate or minimize all GET exemptions | | | X | | X | | Act 105, SLH 2011 : Suspended temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from GET and Use Tax and requires the payment of both taxes at 4%. Also see Overall Tax Recommendation No. 2. |
| 14. Automatically sunset the following "new industry" development exemptions: | | | X | | | | The 1995-1997 TRC specifically mentioned the 3 tax exemptions listed to the left. Some recent exemptions have automatic sunset dates. These include: (1) exemption for call centers (Act 195, SLH 2000), which will automatically sunset on June 30, 2010; (2) exemption for public Internet data centers (Act 221, SLH 2001), which sunset on December 31, 2005; and (3) sales of net operating losses by a qualified high technology business (Act 221, SLH 2001), which sunset on December 31, 2005. |
| (a) Motion picture industry | | | X | | | | This exemption sunset on July 1, 1976. Act 135, SLH 2003, deleted the obsolete provision. |
| (b) Retail sales of alcohol fuel | | | X | | | | Act 289, SLH 2000 : Amended §237-27.1, HRS, to repeal this exemption on December 31, 2006. (NOTE: The original legislation, Act 274, SLH 1980, would have sunset this exemption on July 1, 1985. Act 179, SLH 1981, extended the sunset date to June 30, 1992. Act 42, SLH 1988 repealed the sunset date.) |
| (c) Stock exchange | | | X | | | | Not adopted. A stock exchange has not been established to date. |

| Recommendation | Commissions | | | | | | Implementation and Comments |
|--|-------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 15. Clarify exemptions for nonprofit organizations for better compliance: | | | | | | | Nonprofit organizations are not automatically tax-exempt and must apply for tax-exempt status. Not all nonprofit organizations, including a number of categories that qualify for income tax exemption, are eligible for exemption from the GET. If granted an exemption, not all of an organization's income may be exempt; only income that qualifies under §237-23(b), HRS, is exempt. |
| (a) Require GET licenses for nonprofit organizations | | | X | X | X | | <p>Act 155, SLH 2010: Denied GET tax preference to taxpayers who fail to file their GET annual return and reconciliation later than twelfth month following the prescribed due date of the return. Also created a trust fund for the GET due on each business transaction; held an officer, member, manager, or other responsible person liable for the GET due, including any penalty and/or interest. Effective July 1, 2010, applied to gross income or gross proceeds received on or after July 1, 2010.</p> <p>Act 219, SLH 2012: Provides for 90 days notice before GET benefits may be denied under §237-9.3, HRS for a "nonprofit organization". Act 219 also provides an exemption from personal liability under HRS §237-41.5 for any officer, member, manager, or other person having control or supervision over gross proceeds of a "nonprofit organization". Act 219 basically defined "nonprofit organization" as an entity who received tax exempt status under certain specified paragraphs of IRC §501(c).</p> <p>Act 52, SLH 2013: Amends HRS §§237-9.3(e) and 237-41.5(b), to define "nonprofit organization" as "a corporate entity, association, or other duly chartered entity that is registered with the</p> |
| (b) Require nonprofit organizations to file GET returns if they have more than \$30,000 of gross receipts | | | X | X | | | |
| 16. Extend tax-exemption to skilled nursing facilities and for-profit hospitals, infirmaries, and sanitarium | | | | X | | | Not adopted. |
| 17. Eliminate the exemption for nonprofit organizations <u>OR</u> establish a maximum exemption amount | | | | | X | | <p>The 2005-2007 TRC noted that the elimination of this exemption (§237-23, HRS) would not affect the exemption for donations or gifts pursuant to §237-24(4), HRS.</p> <p>Act 155, SLH 2010: Denied GET tax preference to taxpayers who fail to file their GET annual return and reconciliation later than twelfth month following the prescribed due date of the return.</p> |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|---|--------------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 18. Exempt inter-affiliate business transactions from the GET | X | | | | | | <p>Act 175, SLH 1988: Exempted certain transactions between related entities, including common paymasters. Subsequently amended by Act 178, SLH 1997, Act 165, SLH 1999, and Act 221, SLH 2001.</p> <p>Act 214, SLH 1998: Exempts certain employee cost reimbursements received by a management company from related entities providing interstate or foreign common carrier telecommunications services.</p> |
| 19. Clarify the intermediary services provision and expand it to include a wholesale services concept | | | X | | | | <p>Administrative rules clarifying the application of the services rendered for or to an intermediary wholesale rate provision were adopted, effective January 22, 1999.</p> <p>Act 71, SLH 1999: Phased-in pyramiding relief to extend wholesale treatment to certain transactions in which the goods, services, amusements, etc., are identifiable elements of what is resold (i.e., it relaxed the strict no-consumption rule). Qualifying transactions include certain service-to-service, service-to-goods, service-to-contracting, service-to-transient accommodations, goods-to-service, and goods-to-transient accommodations transactions.</p> <p>Act 198, SLH 2000: Expanded Act 71, SLH 1999, to afford phased-in wholesale treatment to amusement-to-service, amusement-to-goods, and amusement-to-transient accommodations transactions. This Act also afforded phased-in wholesale treatment under the PSC tax to certain transportation services provided to contractors (see also Act 9, 3rd SpS 2001, which subjects certain transportation services to the GET instead of the PSC tax) and to certain sales of telecommunications services by a public utility to an interstate telecommunications provider for resale.</p> |
| 20. Price paid by the purchaser for a good or service should be the measure of gross receipts | X | | | | | | <p>Act 340, SLH 1986: Enacted a division of income provision (i.e., income splitting) for tourism-related services (§237-18(f), HRS). The definition of "tourism-related services" was later expanded by Act 287, SLH 1991.</p> |
| 21. Exempt from the GET goods and services shipped out of Hawaii | X | X | X | | | | <p>Act 239, SLH 1987: Exempts sales of tangible personal property shipped out of Hawaii.</p> |

| Recommendation | Commissions | | | | | | Implementation and Comments |
|---|-------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| | | | | | | | Act 70, SLH 1999: Exempts exported services and contracting. |
| 22. Subject public service companies to the GET and eliminate the PSC tax | X | | | | | | Act 9, 3rd SpS 2001: Subjects certain transportation service providers to the GET instead of the PSC tax. Specifies that transportation service providers are service businesses. |
| 23. Consider a sales tax or a value added tax to replace the GET | X | | | | | | Not adopted. For more information, see 2005-2007 TRC Report, Appendix C, <i>Hawaii's General Excise Tax: Should the Base Be Changed?</i> |
| 24. Rewrite the GET law to achieve clarity and transparency | | | | X | X | | Not adopted. |
| 25. Remain involved in discussions on the Streamlined Sales Tax Project, but do not make a formal commitment at this time. | | | | | X | | Various legislative proposals on this topic since 2007. |
| 26. The 3-year statute of limitations on assessment of the GET should start from the filing of the last periodic GET return (Form G-45) | | | | | X | | Not adopted. |
| Income Tax Recommendations | | | | | | | |
| 1. Maintain existing corporate tax burden | | X | | | | | Not adopted. |
| 2. Eliminate the corporate income tax and study eliminating the individual income tax. | | | | | X | | Not adopted. |
| 3. Provide income tax credits to offset the regressive effects of the GET on food and drugs | | X | X | | | X | At the time the report of the 1988-1990 TRC was issued, sales of food purchased with USDA Food Coupons (i.e., food stamps) and USDA WIC Food Vouchers were exempt from the GET, as were sales of prescription drugs and prosthetic devices and most medical services provided by tax-exempt organizations. A food tax credit had previously been enacted (Act 239, SLH 1987). Act 321, SLH 1989: Enacted a new medical services excise tax credit. The 4% medical services excise tax credit part of this credit was repealed by Act 23, SpS 1995, and the remaining nursing facilities excise credit portion sunset on June 30, 1997. |

| Recommendation | Commissions | | | | | | Implementation and Comments |
|--|-------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| | | | | | | | <p>Act 187, SLH 1990: Repealed the existing excise tax credit and combined it with an expanded version of the existing food credit to create the food/excise tax credit. The excise tax portion of the credit was repealed by Act 134, SLH 1995. The food credit was repealed by Act 157, SLH 1998.</p> <p>Act 157, SLH 1998: Enacted the low-income refundable income tax credit.</p> <p>Act 211, SLH 2007: Amended the Low Income Refundable Tax Credit by (1) eliminating the name of the Low Income Refundable Tax Credit and changed the name to the Refundable Food/Excise Tax Credit; (2) adjusting the Hawaii adjusted gross income (AGI) to Federal AGI and increasing the credit amount per qualified exemption and the AGI that a Hawaii resident can earn in order to claim the credit. The credit amount is on sliding scale based on Federal AGI.</p> <p>Act 223, SLH 2015: Temporarily increased the Refundable Food/Excise Tax Credit. Repealed credit for individual taxpayers with Federal AGI of \$30,000 or above. For all other filers, the income thresholds is at \$50,000. Repealed residency requirement. Applies to taxable years 2016 and 2017.</p> |
| 4. Adjust the general excise tax credit for inflation | | X | X | | | | <p>Act 107, SLH 2017: Made permanent changes to food/excise tax credit made by Act 223, SLH 2015. Not adopted. Act 187, SLH 1990, repealed the existing excise tax credit and combined it with an expanded version of the existing food credit to create the food/excise tax credit. The excise tax portion of the credit was repealed by Act 134, SLH 1995.</p> <p>Act 157, SLH 1998: Enacted the low-income refundable income tax credit.</p> |
| 5. Add back capital gains, dividends, interest, retirement contributions, unemployment and workers compensation payments, public assistance benefits and individual housing account payments to the adjusted gross income base used to determine eligibility for low-income tax credits. | | X | | | | | <p>Act 211, SLH 2007: Replaced the low-income refundable income tax credit with food/excise tax credit which increases the income threshold and the credit amount.</p> <p>Act 223, SLH 2015: Temporarily increased the Refundable Food/Excise Tax Credit.</p> <p>Act 107, SLH 2017: Made permanent changes made by Act 223, SLH 2015.</p> <p>Act 211, SLH 2007: Replaced the low-income refundable income tax credit with food/excise tax credit and replaced the Hawaii AGI with Federal AGI, which includes retirement income not taxed by the State.</p> |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|--|--------------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 6. Expand the individual income tax brackets | X | X | X | X | X | | <p>Act 239, SLH 1987: Reduced the top individual income tax rate from 11% to 10%, reduced the number of tax brackets from 12 to 8, and phased in an expansion of the new tax brackets through 1988.</p> <p>Act 321, SLH 1989: Reduced the lowest individual income tax rate from 2.25% to 2% and expanded the tax brackets beginning in 1989.</p> <p>Act 157, SLH 1998: Increased the number of individual income tax brackets from 8 to 9; phased in over a 4-year period beginning in 1999 a reduction of the individual income tax rates such that the rates in 2002 were 1.40% to 8.25%; and expanded the tax brackets.</p> <p>Act 110, SLH 2006: Expanded the tax brackets by approximately 20% beginning in 2007.</p> <p>Act 60, SLH 2009: Added three new brackets and rates, 9%, 10%, and 11% for the high income taxpayers for taxable years 2009 to 2015.</p> <p>Act 107, SLH 2017: (1) Established State nonrefundable EITC equals to 20% of federal EITC for taxable years 2018 to 2022. (2) Added back three new brackets and rates, 9%, 10%, and 11% for the high income taxpayers for taxable years beginning after 12/31/2017. (3) Made permanent the changes to food/excise tax credit by Act 223, SLH 2015.</p> |
| 7. Increase the standard deduction | X | X | X | X | X | X | <p>Act 321, SLH 1989: Increased the standard deduction to the following: single - \$1,500; married filing joint return and qualifying widow(er) with dependent child - \$4,000; married filing a separate return - \$950; and head of household - \$1,650.</p> <p>Act 110, SLH 2006: Increased the standard deduction to the following: single and married filing a separate return - \$2,000; married filing joint return and qualifying widow(er) with dependent child - \$4,000; and head of household - \$2,920.</p> <p>Act 60, SLH 2009: Increased the standard deduction and personal exemption by 10%. Standard deduction: single and married filing a separate return - \$2,200; married filing joint return and qualifying widow(er) with dependent child - \$4,400; and head of household - \$3,212. Personal exemption: \$1,144. Applied to taxable years 2011 to 2015.</p> <p>Act 97, SLH 2011: Delayed by two years the increase in standard deduction and personal exemption approved under Act 60, SLH 2009, while also made permanent the increases. Applied to tax years beginning after 12/31/10.</p> |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|---|--------------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 8. Provide double the standard deduction to taxpayers over age 65 | X | | | | | | Not adopted. |
| 9. Reduce top individual income tax rates | | X | | | | | <p>Act 239, SLH 1987: Reduced the top individual income tax rate from 11% to 10%; reduced the number of tax brackets from 12 to 8; and phased in an expansion of the tax brackets through 1988.</p> <p>Act 157, SLH 1998: Increased the number of individual income tax brackets from 8 to 9; phased in over a 4-year period, beginning in 1999, a reduction of the individual income tax rates such that the rates in 2002 were 1.40% to 8.25%; and expanded the tax brackets.</p> <p>Act 60, SLH 2009: Temporarily added three income tax brackets that increased the tax on individuals with high net taxable incomes from a maximum of 8.25% to 11%. Applied to taxable years beginning after 12/30/08, set to sunset on 12/31/15.</p> <p>Act 107, SLH 2017: Added back three new brackets and rates, 9%, 10%, and 11% for the high income taxpayers for taxable years beginning after 12/31/2017.</p> |
| 10. Increase the personal exemption | | | X | X | X | X | <p>Act 78, SLH 1985: Increased the personal exemption to \$1,040.</p> <p>Act 60, SLH 2009: Increased the personal exemption by 10% to \$1,144. Applied to taxable years beginning after 12/31/10, and set to sunset on 12/31/15.</p> <p>Act 97, SLH 2011: Delayed by two years the increase in personal exemption approved under Act 60, SLH 2009, while also made permanent the increases. Applied to tax years beginning after 12/31/10.</p> |
| 11. Index the individual income tax standard deduction, personal exemption and tax brackets for inflation | | | | | X | | Not adopted. |
| 12. Change the maximum net capital gains tax rate | | | X | | | | Not adopted. |
| 13. Exempt additional types of pension income | | | X | | | | Not adopted. |
| 14. Phase in taxation of all pension income | | | X | X | | | Not adopted. See Recommendation 15 below for the 2005-2007 TRC's recommendation. |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|---|--------------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 15. Conform to the federal tax treatment of retirement income, excluding an annual base amount (e.g., \$50,000) | | | | | X | | Not adopted. |
| 16. Revise the taxation of nonresidents to prorate the standard deduction and personal exemption | | | X | | | | <p>Act 281, SLH 1997: This Act did not directly prorate the standard deduction and personal exemption amounts claimed by nonresident individual taxpayers. However, it changed the method by which the tax liability of nonresidents was computed to one in which the taxpayers' worldwide income was used to compute the nonresident taxpayers' total tax liability and the total tax liability prorated (note that the standard deduction and the personal exemption amounts were therefore deducted from worldwide income in the same manner as Hawaii residents). This was the California model mentioned in the 1995-1997 TRC's report. This proved hugely unpopular, with letters coming in from many quarters including from U.S. Senators and Representatives on behalf of their constituents in the military.</p> <p>Act 253, SLH 1999: Repealed Act 281, SLH 1997, and provided for the apportionment of the standard deduction and personal exemption.</p> |
| 17. Adopt withholding rules for all nonresident taxpayers involved in pass-through entities such as partnerships, S-corporations, and limited liability companies | | | | | X | | Not adopted. |
| 18. Eliminate military exception for non-recognition of gain from principal residence | | | X | | | | <p>Act 113, SLH 1998: Conformed Hawaii law to §121, Internal Revenue Code (IRC), to exclude the gain on the sale of a residence. This repealed the former deferral of gain provision that included the exception for military personnel.</p> |
| 19. Limit like-kind exchange tax deferrals to situations where the replacement property is in Hawaii | | X | X | | | | Not adopted. |
| 20. Require an exchange facilitator or intermediary of a like-kind exchange to withhold and remit the tax on any shortfall of the amount exchanged at the same rate as sales of real property by nonresidents | | | | | X | | Not adopted. |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|--|--------------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 21. Limit involuntary conversion tax deferrals to situations where the replacement property is in Hawaii | | | X | | | | Not adopted. |
| 22. Eliminate National Guard and Reserve exclusion, political contribution deduction, individual housing account deduction, and child passenger safety restraint credit | | | | X | | | <p>Act 197, SLH 2004: Increased the adjustment to income deduction for those serving in the Hawaii National Guard or in the reserves.</p> <p>Act 59, SLH 2009: Repealed the deduction from taxable income for amounts given as political contributions effective January 1, 2011.</p> |
| 23. Conform to federal requirements for an automatic extension of time to file a tax returns | | | X | | | | <p>The 1995-1997 TRC recommended in its discussion "that the 90% requirement to receive an automatic extension be eliminated".</p> <p>Section 18-235-98, HAR, was amended effective October 6, 2007, to grant an automatic six-month extension. "Property estimated tax liability" (safe harbor) will be presumed if the tax still owing after the due date prescribed by the statute for the filing of a return (determined without regard to any extension) is 10% or less of the total tax shown as due on the return.</p> |
| 24. Conform to federal filing deadlines | | | X | | | | Not adopted. |
| 25. Simplify the filing of income tax returns | X | | | | | | Form N-13EZ was introduced for the 2003 tax year. A short -form that was roughly equivalent to the federal Form 1040EZ, it was for use by certain Hawaii residents with no dependents and was available for tax years 2003 and 2004. Form N-13EZ was discontinued for the 1995 tax year due to the introduction of the Form N-11 for individuals who were Hawaii residents for the entire year and who filed a federal income tax return using the same filing status as the Hawaii return. |
| 26. Replace the medical services excise tax credit with one included under itemized medical deduction | | X | | | | | Not adopted. This credit was repealed by Act 134, SLH 1995. |
| 27. Increase the conformity of the State income tax with the federal income tax | X | X | | X | | | Not adopted. |
| 28. Narrow the gap between taxable income and actual economic income by including portions of pension income and part of social security benefits of high-income taxpayers | X | | | | | | Not adopted. |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|---|--------------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 29. Conform to federal treatment of capital gains | | X | | | | | Act 102, SLH 1988: Added §235-55.6(f), HRS, implementing a maximum tax rate of 7.25% on net capital gain income. |
| 30. Adopt a Hawaii Alternative Minimum Tax | X | | | | | | Not adopted. |
| 31. Do not allow special "check-offs" similar to the Hawaii Election Campaign Fund | X | | | | | | Additional check-offs have been added. Unlike the Hawaii Election Campaign Fund check-off, however, the new check-offs reduce the individual taxpayer's overpayment of tax, thereby reducing the refund the taxpayer would have been entitled to. The new check-offs are: (1) \$2 check-off for the Hawaii School-Level Minor Repairs and Maintenance Special Fund, Act 311, SLH 2001; (2) \$2 check-off for the State Library Special Fund, Act 193, SLH 2003; and (3) \$5 check-off for the Hawaii Children's Trust Fund, Domestic Violence Prevention Special Fund, and Spouse and Child Abuse Special Account, Act 228, SLH 2004. |
| 32. Adjust corporate income tax brackets to increase progressivity | X | | | | | | Act 239, SLH 1987: Expanded the number of corporate tax brackets from 2 brackets (5.85% and 6.435%) to 3 brackets (4.4%, 5.4%, and 6.4%), and added an alternative tax rate for capital gain income (3.08% prior to April 1, 1987, and 4% after March 31, 1987). Act 10, SLH 1988: Amended the corporate tax treatment of capital gain income. |
| 33. Partially "de-couple" from the federal accelerated depreciation rules (ACRS) such that ACRS applies to personal property but not to real property | X | | | | | | Not adopted. |
| 34. Subject sales of real property by nonresident sellers to withholding | | | | | | | Act 213, SLH 1990: Requires purchasers of real property to withhold 9% of the amount realized from nonresident sellers. Act 279, SLH 1991: Reduced the amount to be withheld from 9% to the current 5% rate. |
| 35. Increase the withholding rate on sales of real property by nonresident sellers and impose penalties on withholding agents for noncompliance | | | | | X | | Not adopted. |
| 36. Overhaul the business incentives tax credit process | | | | | | | |
| (a) Overhaul and update the capital goods excise tax credit | | | X | | | | Not adopted. |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|---|--------------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| (b) Conduct a cost-benefit study prior to enacting or revising a tax credit program | | | | X | | | Not adopted. |
| (c) Require periodic evaluations of all tax incentive programs | | | | X | X | | <p>Act 206, SLH 2007: §235-20.5; §235-110.9 (1) Required a qualified high technology business (QHTB) that accepts an investment for which the High Technology Business Investment Tax Credit (HTBITC) may be claimed to complete and file an information survey with the Department before June 30 of each calendar year; (2) Required any QHTB receiving an investment for which a credit may be claimed to waive confidentiality and to allow the Department to disclose that the QHTB is a beneficiary of the HTBITC; (3) Required the Department to prepare a report to the Legislature summarizing the data obtained from the survey by September 1 of each year; and (4) Required the Department to study the effectiveness and impact of the HTBITC and reported to the Legislature by December 1 of each year.</p> <p>Act 261, SLH 2016: Requires the State Auditor to periodically review certain tax exemptions, exclusions, and credits under the GET and use tax, (chapters 237 and 238, HRS), public service company tax (chapter 239, HRS), and insurance premium tax (chapter 431, HRS), beginning in 2018.</p> <p>Specifically, Act 261 requires the Auditor to: (1) determine the amount of tax expenditure for the exemptions, exclusions, and credits for each of the previous three fiscal years; (2) estimate the amount of tax expenditure for the exemptions, exclusions, and credits for the current fiscal year and the next two fiscal years; (3) determine whether the exemptions, exclusions, and credits have achieved and continue to achieve the purpose for which they were enacted by the Legislature; (4) determine whether the exemptions, exclusions, and credits are necessary to promote or preserve tax equity or efficiency; (5) determine whether an economic benefit has resulted, and if so, quantify the estimated benefit directly attributable to the exemptions, exclusions, and credits; and (6) estimate the annual cost of the exemptions, exclusions, and credits per low-income resident of the State.</p> <p>Act 261 also requires the Auditor to recommend whether an exemption, exclusion, or credit should be retained without modification, amended, or repealed.</p> <p>Act 177, SLH 2017: Provides the State Auditor access to any tax records that are required for the Auditor to conduct its review of tax credits, exemptions, exclusions, and deductions. Act 177</p> |

| Recommendation | Commissions | | | | | | Implementation and Comments |
|---|-------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| (d) Require beneficiaries of tax incentive programs to file truth and disclosure reports separately and apart from tax returns and make all aspects of the subsidies public | | | | X | X | | <p>Act 88, SLH 2006: §235-17 Refundable motion picture production income tax credit - Created prequalification standards and oversight by the Department of Business, Economic Development, & Tourism and the Hawaii Film Office. Each taxpayer must apply through the Hawaii Film Office and have the credits certified. A taxpayer claiming this credit must attach the certification with the taxpayer's tax return.</p> <p>Act 89, SLH 2013: Requires DBEDT to prepare a report to the legislature setting forth the non-aggregated qualified production costs that form the basis of the tax credit claims and expenditures, itemized by taxpayer, in a redacted format to preserve the confidentiality of the taxpayers claiming the credit.</p> |
| (e) Embed tax incentives in strategic plans to leverage scarce State resources | | | | X | | | Not adopted. |
| (f) Encourage public participation in and comment on tax incentive use to foster public accountability | | | | X | | | Incorporated, to some extent, into administrative practices. |
| (g) Require sunset provisions to ensure that targeted benefits were realized before extending an incentive. | | | | X | X | | Sunset provisions have been incorporated into some tax incentives, such as the motion picture, research, and high technology business investment tax credits. |
| 37. Gain control of the qualified high technology business investment tax credit tax incentive and curb potential abuses by changing it from a tax credit to a program of grants administered by a State agency <u>OR</u> : | | | | | X | | |
| (a) Require that the reporting of data be mandatory and expand the types of required data to include sales, employment data on compensation, status, and whether the job was full-time, part-time, or seasonal | | | | | X | | <p>Act 206, SLH 2007: §235-20.5; §235-110.9 (1) Required a qualified high technology business (QHTB) that accepts an investment for which the High Technology Business Investment Tax Credit (HTBITC) may be claimed to complete and file an information survey with the Department before June 30 of each calendar year; (2) Required any QHTB receiving an investment for which a credit may be claimed to waive confidentiality and to allow the Department to disclose that the QHTB is a beneficiary of the HTBITC; (3) Required the Department to prepare a report to the Legislature summarizing the data obtained from the survey by September 1 of each year; and (4) Required the Department to study the effectiveness and impact of the HTBITC and reported to the Legislature by December 1 of each year.</p> |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|---|--------------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| (b) Collect the data by NAICS code and make the data periodically available to the public, but not less than annually | | | | | X | | |
| (c) Require a tax confidentiality waiver so that pertinent data can be released to the public | | | | | X | | |
| (d) Conduct an independent evaluation of the credit prior to enacting any extension of the credit | | | | | X | | Not adopted. |
| 38. Allow an extension for certification for the high technology credit | | | | | X | | See Act 206, SLH 2007 above. |
| 39. Require beneficiaries of tax credits to file truth in disclosure reports in addition to income tax returns | | | | | X | | |
| Miscellaneous Recommendations | | | | | | | |
| 1. Ensure that the following special funds are self-supporting | | | | | | | |
| (a) Highways | X | X | | | | | Self-supporting. |
| (b) Airport | X | | | | | | Self-supporting. |
| (c) Harbors | X | | | | | | Self-supporting. |
| (d) Parking | X | | | | | | Self-supporting. |
| (e) Unemployment Compensation | X | | | | | | Self-supporting. |
| (f) Disability Compensation | X | | | | | | Self-supporting. |
| (g) Airport | X | | | | | | Self-supporting. |
| 2. Establish a TAT without earmarking the resulting revenue | X | | | | | | <p>Act 340, SLH 1986: Enacted a TAT without earmarking. However, subsequent amendments earmarked revenues as follows:</p> <p>Act 185, SLH 1990: Earmarked 95% of the TAT collected for the counties.</p> <p>Act 7, SpS 1993: Earmarked a portion of the TAT collected for the Convention Center Capital and Operating Special Fund (currently the Convention Center Enterprise Special Fund).</p> <p>Act 156, SLH 1998: Earmarked a portion of the TAT collected for the Tourism Special Fund.</p> |

| Recommendation | Commissions | | | | | | Implementation and Comments |
|--|-------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| | | | | | | | <p>Act 210, SLH 2002: Earmarked a portion of the TAT collected for the State Parks Special Fund, Hawaii Statewide Trail and Access Program (currently the Special Land and Development Fund established for the Hawaii statewide trail and access program), and TAT Trust Fund.</p> <p>Act 60, SLH 2009: For the period beginning July 1, 2009 to June 30, 2010, the tax increases by 1%, from 7.25% to 8.25%. For the period beginning July 1, 2010 to June 30, 2015, the tax increases another 1% to 9.25%. Act 61 was repealed on June 30, 2015, and the TAT rate was to be reenacted at 7.25% for the period beginning July 1, 2015, and thereafter. The 1% increases was deposited into the general fund, except for FY 2011, 12.5% of the 2% increase was deposited into tourism special fund.</p> <p>Act 161, SLH 2013: Made permanent TAT rate of 9.25%. Specified amounts to be distributed to the counties and other special funds from the TAT.</p> <p>Act 1, Special Session 2017: Temporarily increased TAT from 9.25% to 10.25% from January 1, 2018 to December 31, 2030. The 1% increase in TAT revenues shall be deposited into a newly established mass transit special fund.</p> |
| 3. Transfer TAT taxing authority to the counties | | X | | | | | Not adopted. |
| 4. Reconcile the TAT base with the visitor lodging expenditure estimates using data published by the Department of Business, Economic Development and Tourism (DBEDT) and the Hawaii Visitors Bureau | | X | | | | | Not adopted. |
| 5. Conform to the federal estate tax repeal provisions except the repeal of the state death tax credit | | | | X | | | Not adopted. |
| 6. Continue the PSC tax and share receipts with the counties | | X | | | | | <p>Act 64, SLH 2001: Effectuated an agreement entered into by the State of Hawaii, the City & County of Honolulu, the County of Maui, the County of Kauai, the County of Hawaii, and a number of public service companies to share PSC tax revenues with counties that establish by ordinances an exemption from real property tax for public service companies.</p> |
| 7. Establish a mechanism to tax commercial airlines | X | | | | | | Not adopted. Federal law preempts state taxes on gross receipts of airlines. See <i>Aloha Airlines, Inc. v. Director of Taxation</i> (464 U.S. 7). |
| 8. Impose fuel and liquor taxes on an <i>ad valorem</i> basis rather than on a per unit basis | X | | | | | | Not adopted. |
| 9. Consolidate fuel tax at the state level | | X | | | | | Not adopted. |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|--|--------------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 10. Retain liquor and tobacco taxation at the state level | | X | | | | | Has not been changed. |
| 11. Liquor and tobacco tax collections should cover government costs resulting from the use of these products | | X | | | | | Indeterminate. Settlement funds received pursuant to the 1998 Tobacco Master Settlement Agreement in part mitigate government tobacco-related costs. |
| 12. Subject firms taxed under the insurance premiums tax to the GET for rentals and other business receipts. | X | | | | | | Act 286, SLH 1991: Subjects to the GET and TAT the gross rental income received by taxpayers subject to the insurance premiums tax. |
| 13. Subject insurance commissions to the 4% GET rate rather than the 0.15% rate, and concurrently review the insurance premiums tax rates | | | X | | | | Not adopted. |
| 14. Franchise tax: | | | | | | | |
| (a) Eliminate the in-lieu taxes on financial institutions and insurance companies and integrate the taxation of these types of taxpayers into the regular tax system after a careful evaluation of such a change | X | | | | | | Not adopted. |
| (b) Eliminate the federal income tax deduction from the franchise tax | | X | | | | | Act 106, SLH 1992: Eliminated the deduction for federal income taxes. |
| (c) Set the franchise tax rate equal to the corporate income tax rate | | X | | | | | Not adopted. |
| (d) Conform the franchise tax law to the corporate income tax rules for the allocation and apportionment of income | | X | | | | | Not adopted. |
| 15. Allow taxpayers to make a deposit against future tax liability to stop continued accrual of interest | | | | | X | | Not adopted. |
| 16. Adopt §7430, IRC, to require the Tax Appeal Court to award court fees for actual costs where the position of the Department is found to be "not substantially justified," subject to court approval | | | | | X | | Not adopted. |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|---|--------------------|---------|---------|---------|---------|---------|--|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 17. Establish an Appeals Office modeled after the Appeals Office of the Internal Revenue Service | | | | | X | | <p>Act 166, SLH 2009: Provided the Department with the authority to establish expedited appeals and dispute resolution program. The Director, or designee, shall serve as an independent appeals officer and shall be authorized to compromise, settle, or otherwise resolve any dispute on any basis, including hazards and costs of litigation, considering equally the position of the taxpayer and the department on an impartial basis.</p> <p>In February 2016, the Department launched the pilot phase of the Administrative Appeals and Dispute Resolution Program (AADR). AADR is a streamlined method to quickly and fairly resolve tax disputes involving audit assessments without litigation. The Administrative Appeals Office is an independent body within DOTAX headed by the Administrative Appeals Officer who reports directly to the Director of Taxation. For more information, see Tax Announcement No. 2016-03.</p> |
| 18. Repeal the part of §232-7, HRS, that states that hearings before the Board of Review are public hearings | | | | | X | | <p>Act 166, SLH 2009: Modified §232-7(b) by inserting "A taxpayer's identity and final documents submitted in support or opposition of an appeal shall be public information; provided that an individual taxpayer is authorized to redact all but the last four digits of the taxpayer's social security number from any accompanying tax return".</p> |
| 19. Establish a state lottery | X | | | | | | Not adopted. |
| 20. Use unrestricted State grants only when necessary to equalize the fiscal capacity of the counties | | X | | | | | Not adopted. |
| 21. Counties should make better use of their existing revenue authority (property taxes, user fees and charges, and development fees and extractions) | | X | | | | | Indeterminate. |
| 22. In addition to its statistical studies of the individual and corporate income tax, the Department should conduct annual statistical analyses of GET data. | X | | | | | | Statistics regarding the GET are released, but an analysis is not being conducted due to insufficient resources. |
| 23. The Department should compile detailed information on the GET to better identify the source and nature of the gross receipts | | X | | | | | The Department is in the process of Tax Modernization. |

| <i>Recommendation</i> | <i>Commissions</i> | | | | | | <i>Implementation and Comments</i> |
|--|--------------------|---------|---------|---------|---------|---------|---|
| | 1983-85 | 1988-90 | 1995-97 | 2001-03 | 2005-07 | 2010-13 | |
| 24. Give the Department resources to: (1) monitor business incentive tax credits; (2) conduct out-of-state audits; and (23) improve its collection and enforcement efforts. | | | | X | X | X | In the past, budget cuts, reduction in force, and furlough have decreased the Department's ability to monitor business tax incentive tax credits. Out-of-state audits are being conducted, but are limited by staffing and funding constraints. |
| 25. Support DOTAX's plan to modernize its computer system. | | | | | | X | Additional funding providing by the Legislature for Tax System Modernization. |
| 26. Provide adequate resources to the Tax Research and Planning Office for updating or improving economic forecasting and modeling capabilities for: (a) tax incentives (exemptions and credits); (b) auditing activities; (c) nonprofit organizations; (d) conformity with federal tax laws; (e) equity concerns; (f) bracket creep; (g) administrative costs; and (h) State corporate tax revenue trend analysis | | | | X | X | | One economist position was transferred from DBEDT in 1997, but one statistician position was abolished. Due to budget cuts and reduction in force, the Tax Research and Planning Office is left without any research statistician. In 2009, one (1) permanent research statistician position was eliminated to meet the mandatory reduction in force in FY 2010, and thereafter. In 2010, two (2) permanent and one (1) temporary research statistician positions were eliminated as vacancy reductions in FY 2011, and thereafter. Act 189, SLH 2012 , modifies the publication requirements in section 231-3.4, HRS, and authorizes that Department to establish 3 new permanent full-time position and 1 new temporary position to fulfill the publication requirements pursuant to section 231-3.4, HRS. Act 189 appropriates \$104,505 for FY 2013. Act 134, SLH 2013 : The Legislature approved 3 new positions: 2 management analyst, 1 research statistician. Act 119, SLH 2015 : The Legislature approved converting 2 management analyst positions into 2 research statisticians. Act 49, SLH 2017 : The Legislature reduced 1 research |
| 27. Provide adequate resources to the Tax Research and Planning Office to analyze specific tax credits such as the following: (a) ethanol investment tax credit; (b) high technology business investment tax credit; and (c) energy conservation tax credit | | | | X | X | | Note that ethanol investment tax credit was amended by Act 140, SLH 2004, and renamed the ethanol facility tax credit, and that the energy conservation tax credit sunset on June 30, 2003, and was replaced with the renewable energy technologies income tax credit. |
| 28. Consider the needs of the entire Department, not just revenue-producing positions, for adequate funding as a good investment for the State | | | | | X | | Not adopted. |

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