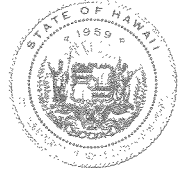


CALVIN K.Y. SAY
SPEAKER

HOUSE OF REPRESENTATIVES

STATE OF HAWAII
STATE CAPITOL
HONOLULU, HAWAII 96813



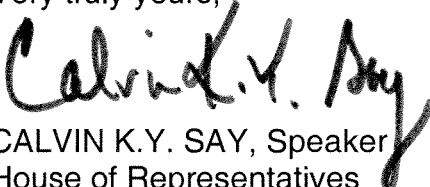
September 7, 2012

Mr. Randall Y. Iwase, Chair
and Members
2010-2012 Tax Review Commission
c/o Department of Taxation
State of Hawaii
Post Office Box 259
Honolulu, Hawaii 96809-0259

Dear Chair Iwase and Members:

Please find attached our comments on the draft report entitled Study of the Hawaii Tax System: Final Report, dated August 28, 2012, by The PFM Group.

Very truly yours,


CALVIN K.Y. SAY, Speaker
House of Representatives
State of Hawaii


MARCUS R. OSHIRO, Chair
Committee on Finance
House of Representatives
State of Hawaii

cc: Governor Neil Abercrombie
Mr. Frederick D. Pablo, Director
State Department of Taxation

Attachment

ATTACHMENT

I. OPPOSITION TO RECOMMENDATIONS

We oppose the recommendations to increase general revenues in the draft report entitled Study of the Hawaii Tax System: Final Report, dated August 28, 2012, by The PFM Group. The recommendations are intended to generate net general revenues of approximately \$481 million in 2014 and, apparently, at least that amount annually thereafter (this is assumed because the PFM report does not identify the projected net revenue increases in the out-years, and the appendices are not available for review).

In particular, we oppose the following: the increase of the general excise tax rate by 0.5 per cent, the imposition of the income tax on pension income, the increase of the corporate income tax rate, and the elimination of the income tax deduction for real property taxes paid.

II. REASONS FOR OPPOSITION

Our disagreement with the recommendations is based on the following major reasons.

Significant Tax Increase Detrimental

(1) Such a significant net tax increase probably will be detrimental to private businesses, residents, or both. The transfer of about \$481 million annually to the public sector likely will have adverse impacts on the private sector. Specifically, PFM has not analyzed the impact of its recommendations on the Hawaii economy. PFM also has not

analyzed who will actually bear the burden of the tax increases, whether residents, businesses, or tourists.

Tax Increase Difficult To Justify In Near Term

(2) A significant net tax increase will be difficult to justify in the near term. Because of the 14.9 per cent actual increase of general fund revenues in fiscal year 2010-11 and the Council on Revenues' out-year projections, the State government, if executing a judicious financial plan, has the opportunity to generate sufficient annual ending balances into the near future without any tax increase. Consequently, public acceptance of a \$481 million tax increase, additional to the expected ending balances, will be highly unlikely.

Budgetary Impact Of Tax Increase Difficult To Ascertain

(3) The budgetary impact of the recommended tax increase is difficult to ascertain from the PFM Report.

The table on page 150, entitled "baseline projection with full implementation of recommendations", shows unbelievably huge annual surpluses and ending fund balances. For example, in fiscal year 2019-20, the surplus (revenues minus expenditures) is projected at \$520 million and the ending balance is projected at \$3.693 billion.

The table on page 150, however, apparently does not include annual expenditures for accrued pension and OPEB liability. See the table on page 98, entitled "FY 2012 - FY 2025 general fund budget projections: accrual basis scenario - full pension and OPEB liability".

PFM appears to justify the recommended tax increase partly on the need to amortize the accrued liability through annual required contributions in the State budget. The report, however, does not make clear the sufficiency of the tax increase to fund the baseline expenditures plus the accrued liability contributions.

If the tax increase generates excessive revenues, as suggested by the table on page 150, then the recommendation should be appropriately altered to reduce the tax increase.

If the tax increase generates insufficient revenues, then a strategy other than the recommended tax increase may have to be pursued.

Annual Revenue Growth Without Tax Increase Is Fairly Healthy

(4) Even without the recommended tax increase, annual general revenue growth is projected to be fairly healthy. The table on page 91, entitled "key revenue growth rates", indicates that general revenues will annually increase by more than 4.0 per cent between 2013 and 2017 and then by 5.2 per cent annually until 2025 (most residents would be delighted with 4.0 to 5.0 per cent annual increase of their personal income).

Recommendations "Expenditure Driven"

(5) The recommended tax increase is "expenditure driven", an inappropriate way to make public policy. The methodology is biased towards balancing the State budget by revenue increases exclusively. PFM rightfully notes that expenditure reductions

alone cannot balance the future State budget. PFM then, however, erroneously takes the approach of relying solely on tax increases rather than combining expenditure reductions and revenue enhancements.

The present Tax Review Commission should not rely on PFM's methodology to address the question of whether the tax structure is adequate. Instead, the present Commission should use the same methodology as past Tax Review Commissions. Our understanding is that those Commissions measured tax adequacy by comparing the growth of general revenues to personal income. Those Commissions did not base their analyses on projecting future State expenditures, which is properly the jurisdiction of elected policymakers.

Misunderstanding Of General Excise Tax

(6) PFM does not inspire confidence because of its apparent misunderstanding of the general excise tax.

PFM seems to equate the general excise tax to a sales tax, calling the general excise tax a "consumption tax" and the 4.0 per cent rate low in comparison to sales tax rates elsewhere. This is erroneous, as the general excise tax is a tax on the seller's gross income, not buyer's purchase price.

PFM also appears to believe that pyramiding will be reduced by repealing the 0.5 per cent wholesale rate and increasing the final consumer rate by 0.5 per cent (for a State rate of 4.5 per cent from 4.0 per cent). This recommendation ignores the effect on business-to-business transactions, all of which will be subject to the 0.5 per cent increase. PFM has not done any

analysis of the net effect on businesses from the exacerbated pyramiding that its recommendation likely will cause.

PFM also has not studied whether the tax increase will be passed on by businesses to consumers or whether businesses will have to absorb the increase and compensate by reducing other costs, such as labor costs.

Finally, PFM does not make any recommendation for an increase of the public service company tax or insurance premium tax, both of which are imposed in-lieu of the general excise tax.

Lack Of Studies On Issues

(7) PFM makes statements about the regressivity and exportability of taxes, but has not conducted its own study of those issues. Nor has PFM conducted a tax incidence study. As such, the statements are without solid bases. Such studies would have been much more helpful to the Legislature.

III. COMMENDATION FOR EMPHASIS ON TWO POINTS

Notwithstanding the comments above, PFM deserves commendation for emphasizing two points that the House of Representatives has been attempting to address over the years.

(1) The first is the unfunded liability problem of the employees' retirement system and Hawaii employer-union health benefits trust fund. (One comment, however, is that PFM seems to assume that the public employer's entire annual required contribution for the retirement system and health fund will be paid exclusively from the general fund. Non-general funds

should be assessed for a fair, proportionate share of the public employer's contribution.)

(2) The second is the necessity for better control of tax credits.