Agenda item IV. a.

Revised MEMORANDUM

TO:	FROM:
Acting State Auditor Jan Yamane and State-County Functions Working Group	John Kirkpatrick for the Belt Collins team
COMPANY:	DATE:
State of Hawai'i	August 24, 2015 ***Revised September 3, 2015 per WG suggestions***
SUBJECT:	JOB NUMBER/REFERENCE NUMBER:
Summary and Comparison of Allocation Models based on Working Group Discussions and Presentations	2015.70.0300

This memo is intended to bring together in one place the various models discussed by the Working Group (WG). The memo provides calculations for some of the allocation models, with the aim of eliciting clarifications as needed from the Working Group (WG). The Working Group may review the calculations and assumptions, and identify refinements that are needed. For each model, the shares of the State and the Counties as a group are presented. The following models are discussed:

1. Current allocation (based on presentation to the WG by ASA at the 7/1/2015 meeting);
2. Tiered "Historical Intent" model sketched by the Allocation Models IG (5/29/2015 memo);
3. Allocation Models IG draft "Recommended" model; and
4. Models based on estimates of the proportionate share of tourism expenses for State and Counties.
5. Models based on proportionate share of "public services."

Additions for this revision consist of formatting changes and comments in italics.

The Counties' share of allocations using these models is as shown below:

Allocation of TAT Revenues (Models 1 to 3)

Current Allocation:	24%	Counties' share of all TAT revenues
Tiered "Historical Intent" Allocation:	51%	
Allocation IG "Recommended":	29%	

Allocation of Expenditures on Behalf of Tourists and the Visitor Industry

4.1 Direct expenditures (State IG assumptions):	52%	Counties' share of expenditures
4.2 Weighted direct and indirect expenditures:	43%	
4.3 County IG procedures for direct +indirect:	~44%	
4.4 Average estimated by Allocation IG	40%	
4.5 Comment in 1989 ACIR report	53%	

Allocation of all "Public Service" Expenditures

5.1 Total Expenditures, State and Counties	23%	Counties' share of expenditures

The analysis of expenditures could be used as a stand-alone basis for TAT allocation or as part of a multi-step approach such as Model 3.

The Working Group and its Investigative Groups (IGs) have generated several tables concerned with spending on tourism by each County and by the State. As far as we can see, the information in these tables has not yet been combined in a table for review by the WG. Much of the information in those tables deals with differences among the Counties. For the WG deliberations, we understand the key question to be the share of the TAT or tourism expenditures allocated to the Counties as a whole, not to each individual County.

Model 1: Current Allocation

Assumptions:

1. Total TAT revenue for FY 2015 estimated as $425,000,000[1]
2. Rate = 9.25%

Source: Auditor's handout, July 1, 2015 meeting of WG

Allocations:

Turtle Bay	$1,500,000
Convention Center	$26,500,000
Tourism Special Fund	$82,000,000
Counties	$103,000,000
DLNR	$3,000,000
Remainder to state General Fund	$209,000,000
Counties' share:	24.2%

[1] TAT collections for May 2014 through April 2015 = $411 million. If FY 2015 TAT revenues are forecast on the basis of historical trends, the annual total could be between $421 and $456 million. The high figure is based on the growth rate in recent years (with the 9.25% TAT rate). The assumed revenue amount used in this memo is a mid-range figure assuming that the 9.25% rate continues, not a prediction.

Model 2: Tiered "Historical Intent"

Assumptions:

1. Total TAT revenue for FY 2015 estimated as $425,000,000

Source: Allocation Working Group Memo dated May 29, 2015[2]

Allocation:

Tier 1	5%	of the 9.25%	(54% of total)		$229,729,730
		95%	to Counties	$218,243,243	
		5%	to State	$11,486,486	
Tier 2	2.50%	of the 9.25%	(27% of total)		$114,864,865
		Convention Center and HTA			
Tier 3	1.75%	of the 9.25%	(19% of total)		$ 80,405,405
Counties' share					51.4%

Model 3: Allocation IG "Recommended"

Assumptions:

1. Total TAT revenue for FY 2015 estimated as $425,000,000 (See next page for implications of different revenue levels)

Source: Allocation Working Group Memo dated May 29, 2015

Allocation:

Tier 1	Hawai‘i Tourism Authority (HTA)		$83,000,000 (fixed)
Tier 2	Legislative allocation		
	10% of (Total - Tier 1)		$34,200,000
Tier 3	Allocation to St/Counties of		
	90% of (Total - Tier 1)		$307,800,000
	60% State	$184,680,000	
	40% Counties	$123,120,000	
Counties' share:			29.0%

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2 *As noted at the September 2 meeting, this allocation, derived from the IG memo, does not quite follow the historical pattern. To reflect the increase from 5% to 7.25%, the second tier should be 2.25%; the third tier would then be 2%, to reflect the rise from 7.25% to 9.25%. This issue does not affect the key finding reported here, i.e., the Counties' share of the total distribution, given the model assumptions.*

NOTES for Model 3:

1. Minimum Counties' share is $100,000,000. If 40% of the Tier 3 funds is less than that, then the Counties receive the minimum and the State share of Tier 3 is reduced. *Minimum State share is also $100,000,000.*
2. State share of Tier 3 includes allocations now earmarked for specific ends (debt service for Convention Center and Turtle Bay; conservation funding for DNLR). These are not called out as separate items in this approach.
3. What happens to legislative allocations in subsequent years? Presumably, that is for the Legislature to decide. An appropriation may lapse after a year, or be continued as part of the State's Tier 3 share, or be nominated for re-funding in Tier 2 in later years.
4. *Members of the allocation Working Group noted that the $100,000,000 minimum applied both to the Counties and to the State. If so, the order of "tiers" should be changed, with the State and County shares identified as Tier 2 and the Legislative appropriation for new initiatives identified as Tier 3. That change would mean that, if collections totaled $283 million, the allocation would be:*
   - *TSF: $83 million*
   - *State: $100 million*
   - *Counties: $100 million*
   - *Legislative new appropriations: $0*

   Below $283 million, a further rule would be needed to distribute funds, since the total TAT revenues would be less than the amount called out for set-asides.

Model 3 with alternative assumptions about total TAT revenues:

Total TAT revenues		$325.0	$350.0	$375.0	$400.0	$425.0	$450.0	$475.0	$500.0	$525.0	$550.0	$575.0	$600.0
TSF: set amount		$83.0	$83.0	$83.0	$83.0	$83.0	$83.0	$83.0	$83.0	$83.0	$83.0	$83.0	$83.0
Leg 10%		$24.2	$26.7	$29.2	$31.7	$34.2	$36.7	$39.2	$41.7	$44.2	$46.7	$49.2	$51.7
State: 60% of Tier 3		$117.8	$140.3	$157.7	$171.2	$184.7	$198.2	$211.7	$225.2	$238.7	$252.2	$265.7	$279.2
Counties: 40% of Tier 3		$100.0	$100.0	$105.1	$114.1	$123.1	$132.1	$141.1	$150.1	$159.1	$168.1	$177.1	$186.1
	TSF share	25.5%	23.7%	22.1%	20.8%	19.5%	18.4%	17.5%	16.6%	15.8%	15.1%	14.4%	13.8%
	County share	30.8%	28.6%	28.0%	28.5%	29.0%	29.4%	29.7%	30.0%	30.3%	30.6%	30.8%	31.0%

Within the range illustrated here, the Counties' share does not vary greatly. *See Note 4 above for discussion of allocations at lower levels.*

Model 4: Allocations based on tourism expenditures by State and Counties

The IGs have gone to some effort to identify expenditures that seem to provide direct and indirect support to the visitor industry. Several versions of the expenditure model can be considered.

Model 4.1 Direct expenditures (adapted from State IG handout)

In May, the State IG broke out State expenditures by functional category, and marked some as directly involved in supporting the visitor industry. This analysis can be extended to the Counties. In Model 4.1, all expenditures in a functional category are counted. (The tourism share of spending is presumably proportionate with the visitor share in the de facto population. Since the Counties are being viewed in combination, not separately, the visitor share for the State and Counties is the same, and this factor is not used in this model.)

	TOTAL FY 2014 EXPENDITURES		DIRECT	*State*	*All Cties*
	State	*All Cties*			
General Government	567,941,000	475,173,353	-	-	-
Public Safety	533,727,000	620,217,641	1	533,727,000	620,217,641
Public Works		25,087,937	-	-	-
Highway & Streets	554,039,000	91,682,104	1	554,039,000	91,682,104
Sanitation		99,805,019	1	-	99,805,019
Human Services		3,061,400	-	-	-
Culture & Recreation	104,303,000	157,338,632	1	104,303,000	157,338,632
Public Welfare	2,879,813,000	87,952,053	-	-	-
Utilities/Transportation		1,775,465	1	-	1,775,465
Debt Service		385,043,468	1	-	385,043,468
Miscellaneous		556,531,854	-	-	-
Net Transfer		5,330,031	-	-	-
Capital Outlay		106,796,300		-	-
Proprietary Funds		490,185,313	1	-	490,185,313
Airports	346,699,000		1	346,699,000	
Harbors	89,327,000		1	89,327,000	
Unemployment	244,947,000			-	
Other	87,031,000				
Conservation of Natural Resources	101,587,000		1	101,587,000	-
Health	849,493,000			-	-
Education	3,400,095,000			-	-
Urban Redevelopment, Housing	137,160,000			-	-
Economic Development and Assistance	166,455,000			-	-
Interest Expense	239,760,000			-	-
TOTAL	10,302,377,000	3,105,980,570		**1,729,682,000**	**1,846,047,642**
Counties' share			52%		

The list of functional expenditure categories in the above chart follows the list used by the County IG, then adds categories used by the State IG. (In other words, the assignment of direct categories follows State IG assumptions, while the category totals follow the County analysis of functional categories.)

Model 4.2 Direct and Indirect Expenditures (adapted from State IG handout)

The handout simply identifies functional categories as directly or indirectly related to tourism. For this version of the model, these relations have been recast as 25%, 50%, 75% or 100% support. The shares were assigned by the consultant team and are provisional. As with Model 4.1, the visitor share of population factor has not been used.

	TOTAL FY 2014 EXPENDITURES		Nuanced	*State*	*All Cties*
	State	*All Cties*	25/50/75/100		
General Government	567,941,000	475,173,353	25%	141,985,250	118,793,338
Public Safety	533,727,000	620,217,641	100%	533,727,000	620,217,641
Public Works		25,087,937	25%	-	6,271,984
Highway & Streets	554,039,000	91,682,104	100%	554,039,000	91,682,104
Sanitation		99,805,019	100%	-	99,805,019
Human Services		3,061,400	0%	-	-
Culture & Recreation	104,303,000	157,338,632	75%	78,227,250	118,003,974
Public Welfare	2,879,813,000	87,952,053	0%	-	-
Utilities/Transportation		1,775,465	50%	-	887,733
Debt Service		385,043,468	75%	-	288,782,601
Miscellaneous		556,531,854	0%	-	-
Net Transfer		5,330,031	0%	-	-
Capital Outlay		106,796,300	0%	-	-
Proprietary Funds		490,185,313	75%	-	367,638,985
Airports	346,699,000		100%	346,699,000	
Harbors	89,327,000		100%	89,327,000	
Unemployment	244,947,000		0%	-	
Other	87,031,000		0%		
Conservation of Natural Resources	101,587,000		100%	101,587,000	-
Health	849,493,000		50%	424,746,500	-
Education	3,400,095,000		0%	-	-
Urban Redevelopment, Housing	137,160,000		0%	-	-
Economic Development and Assistance	166,455,000		0%	-	-
Interest Expense	239,760,000		0%	-	-
TOTAL	10,302,377,000	3,105,980,570		**2,270,338,000**	**1,712,083,379**
Counties' share			43%		

Model 4.3: County IG Analysis, extended to the State

For each of the Counties, the FY 2014 CAFR expenditures have been assessed as tourism-related. These expenditures are summed in general categories; the actual analysis involved consideration of more specific expenditure items. The terminology used by the different Counties varies slightly; so does the

assignment of expenditures as more or less tourism-related. For this model, the Counties' analyses are incorporated into the model. State expenditures are (a) pro-rated by the visitor share of the de facto population and (b) allocated using the "Nuanced" allocation of broad functional categories found in Model 4.2.

	TOTAL FY 2014 EXPENDITURES		Nuanced	State	All Cties
	State	*All Cties*	25/50/75/	13.3%	
General Government	567,941,000	475,173,353	25%	18,938,118	19,563,292
Public Safety	533,727,000	620,217,641	100%	71,188,977	69,720,705
Public Works		25,087,937	25%	-	701,142
Highway & Streets	554,039,000	91,682,104	100%	73,898,210	18,020,837
Sanitation		99,805,019	100%	-	15,527,903
Human Services		3,061,400	0%	-	
Culture & Recreation	104,303,000	157,338,632	75%	10,434,020	22,848,011
Public Welfare	2,879,813,000	87,952,053	0%	-	5,713,194
Utilities/Transportation		1,775,465	50%	-	158,016
Debt Service		385,043,468	75%	-	19,411,067
Miscellaneous		556,531,854	0%	-	13,434,851
Net Transfer		5,330,031	0%	-	448,528
Capital Outlay		106,796,300	0%	-	6,632,399
Proprietary Funds		490,185,313	75%	-	43,626,493
Airports	346,699,000		100%	46,243,018	
Harbors	89,327,000		100%	11,914,514	
Unemployment	244,947,000		0%	-	
Other	87,031,000		0%	-	
Conservation of Natural Resources	101,587,000		100%	13,549,764	
Health	849,493,000		50%	56,653,062	
Education	3,400,095,000		0%	-	
Urban Redevelopment, Housing	137,160,000		0%	-	
Economic Development and Assistance	166,455,000		0%	-	
Interest Expense	239,760,000		0%	-	
TOTAL	10,302,377,000	3,105,980,570		**302,819,683**	**235,806,438**
Counties' share					44%

NOTE: Procedures used to estimate State and Counties' shares are distinct, as described above.

The procedures used to generate models 4.2 and 4.3 involve some guesses about the deliberations of the County IG and further guesses about the share of expenditures to be associated with the visitor industry. Consequently, these models are for discussion purposes only.

4.4: Allocation Model IG Comment

The Allocation Model IG has commented that the State vs. Counties' tourism expenditures was distributed at about 60% to 40%.

4.5 ACIR Comment

The 1989 paper by the Advisory Committee on Intergovernmental Relations (prepared for the Tax Review Commission) includes a comment: "approximately 53% of all outlays for services from which visitors directly benefit are made by the counties." (p. 149).

5: Allocations based on Expenditures for "Public Services"

Model 5.1: Total Expenditures

The 2014 CAFR reports show total expenditures as:

- State: $10,302,377,000
- Counties: $3,105,980,170

The Counties' share of the total expenditures is 23.2%.

Clearly, some government expenditures could be treated as not for "public services." The consultants have not attempted to refine the definition of "public services" in advance of input from the WG.

A handout will be prepared for the September 16 meeting concerning preliminary allocation models.

Sharing TAT Revenues in Hawaii: A Background Paper

James Mak

(Draft)

I. Introduction

Section 2 of Act 174, SLH 2014 passed by the Hawaii State Legislature establishes a 13-member Working Group (WG)

> 1) To evaluate the division of duties and responsibilities between state government and counties (City and County of Honolulu, and Counties of Hawaiʻi, Kauaʻi, and Maui) relating to the provision of public services; and
>
> 2) Submit a recommendation to the Legislature on the appropriate allocation of the transient accommodations tax (TAT) revenues between the State and counties that properly reflects the division of duties and responsibilities relating to the provision of public services.

The Working Group comprises of members appointed by county mayors (4), the Governor (4), President of the Senate (2), Speaker of the House (2), the Chief Justice of the Hawaii Supreme Court (who would chair the working group) (1) to review and provide recommendation to the 2016 Legislature on how best to allocate TAT revenues between the State and the counties.[1] Between October, 2014 and September 2, 2015 the Working Group met 12 times as a whole and a lot of information and data have been gathered and distributed.[2]

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[1] Two of the members from among those appointed by the Senate, House of Representatives and the Supreme Court cannot currently be employed by the State or any of the counties. The two turned out to be from the visitor industry.

[2] See http://auditor.hawaii.gov/task-forceworking-group/

The following draft report provides some background research that examines the TAT allocation issue from a bigger picture perspective. It also integrates some of the handouts into a coherent story. The paper may be helpful when the final report is written for the Legislature.

At the outset, it is noteworthy that Act 174 does not mention the parallel tax on timeshare occupancy—the timeshare occupancy tax (TOT). Currently, timeshare units that are rented for money are subject to the TAT and those that are occupied through exchange are subject to the TOT. If revenues from the TOT are not included in the allocation project, it would be an unfortunate omission.

II. Background: State Aid to Local Governments in the U.S.

State aid to local governments is an important feature of state-local public finance in the U.S. Historically, state aid has been provided in three ways. First, state governments can directly assume responsibilities to provide specific public services. Second, states can authorize local governments to impose a variety of taxes, fees and user charges. Third, states can provide direct grant-in-aid to provide partial funding for public services that are of mutual concern or to enhance intergovernmental fiscal equity within a particular state. In 2009-2010, California sent 66.4% of its own-source revenue to local governments;[3] the corresponding number was 3.2% for Hawaii (the lowest amongst the 50 States). The average for all 50 States was 48.2%. State grant-in-aid accounted for 32.6% of local government general revenue in California while in Hawaii it was only

[3] An explanation for this high percentage is Proposition 13 which has crippled the ability of California local governments to raise money from the local property tax to fund schools.

7.1%. The national average was 29.2%. Vermont led all States at 60.8%.[4] The latest U.S. Census of state and local government finances shows that in 2012 states distributed $469 billion in financial aid to local governments. Local governments in Hawaii received $234 million from the Hawaii State government.[5] State aid to Hawaii's four county governments represented 7.7% of their aggregate general revenue.

The use of grant-in-aid money can either be restricted or unrestricted. Obviously, if the objective of aid is to induce recipient governments to spend more on a particular public service, restrictions should be imposed to achieve the intended outcome. If the purpose is to provide general government assistance, it should be unrestricted.[6] Most of the state aid to local governments in the U.S. is conditional/restricted aid. Local school districts are the largest recipients of state aid. Not in Hawaii. In Hawaii, the provision of K-12 public education is a state responsibility unlike in the other 49 states. Not surprisingly, a study of state to local aid programs in 1999 by the Tennessee Tax Review Commission revealed that unrestricted aid as a percentage of total state aid to local governments was highest in Hawaii—74%.[7]

The U.S. Advisory Commission on Intergovernmental Relation (ACIR) defines unrestricted money as "revenue sharing."[8] According to the ACIR, "State-local revenue sharing can be defined as money given to localities…to be spent on purposes determined

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[4] National Conference of State Legislatures (NCLS), *State Aid to Local Governments,* 2015.
[5] U.S. Census Bureau, *Local Government Finances by Type of Government,* 2012. Local governments in Hawaii also received $279 million in aid from the Federal Government. At:
http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk
[6] ACIR, 1989, p. 150.
[7] The Tennessee Advisory Commission on Intergovernmental Relations (TACIR), 2004, p. 7.
[8] ACIR, 1980, p. 2.

by the localities themselves. The amount and method of allocating aid is determined by the state legislature… This definition of state-local revenue sharing excludes categorical aids to all local governments and most payments to school districts and special districts since such districts generally must spend all aid in their particular functional area. The definition of state-local sharing also excludes piggyback taxes where there is a local option to tax or to determine the local tax rate." A Congressional Research Service study defines general revenue sharing simply as "General revenue that can be used for any purpose not expressly prohibited by federal or state law and is not limited to narrowly defined activities."[9]

Fisher and Bristle note that only about half of the states provide "true" revenue sharing which they define, more restrictively, as aid that redistributes revenues amongst local governments and their use is unrestricted to local governments.[10] In the U.S. such grants account for only a small percentage of local government revenue. Only 10 states provide ("true") revenue-sharing grants to local governments that exceed 10% of local revenues.[11]

State aid to local governments is distributed in four ways.[12] First, is situs or origin based distribution. Revenue is distributed to local governments according to where it is generated. Hence, there is no revenue redistribution among the local governments. Second, as a reimbursement to offset local revenue losses due to state

[9] Dilger, 2015, p. 2.
[10] Hence, they would not consider it "true" revenue sharing where there are centralized revenue collection agreements in which the state collects tax revenues for the local governments and sends the revenues collected to the local governments.
[11] Fisher and Bristle, 2012, p. 239.
[12] See TACIR, 2004, pp. 3-4.

mandated expenditures, tax relief programs or state tax exemptions. For example, in Hawaii, public utility companies are exempt from paying local property taxes and instead pay an in lieu tax—the public company service tax—to the State. Third, population or per capita based distribution. Population or per capita based distribution is the most common and simplest method of distribution. It is also perceived to be "fair" in that every person is treated the same (horizontal equity). Population is also generally regarded as the best indicator of "need" in general purpose intergovernmental aid.[13] Typically, the more narrowly defined the goals of the program, the more likely "need" is measured by something other than population.[14] Fourth, equalization (and need based) distribution. Equalizing (or "need" based) aid tries to account for the fact that "fiscal capacities" among localities differ--i.e. costs are higher and resources are lower in some areas than in others-- and to attempt to offset these disparities. Last month (August, 2015), the North Carolina State Senate passed a bill to change the way the state distributes state sales tax revenues from origin based distribution to one where half the revenue would stay with the county where the goods are sold and the other half distributed to counties based on their population. The purpose of the change is to aid rural counties "that aren't growing and are losing population." In response to complaints from urban counties that stood to lose revenue, one senator responded, "We're trying to change a system so that we can become one North Carolina."[15]

According to the Tennessee Tax Modernization and Reform Commission (TTMRC), an "equitable method of distribution should be related to the needs of the local

[13] Michigan Department of Treasury; also ACIR, 1980.
[14] Bradbury et al, 1984, pp. 152-53.
[15] Campbell, August 10, 2015.

governments, as estimated from various economic and demographic indicators, for example, population, income, area, and miles of road. In this way, more aid should be distributed to those government units in which the estimated needs are greater." In addition, the TTMRC suggested that consideration also be given to the ability of local governments to raise their own revenue and their actual tax effort.[16] For example, the well-known Federal Government General Revenue Sharing (GRS) program that existed between 1972 through 1986 distributed a set annual amount of federal funds to nearly 39,000 general purpose local governments (and all 50 states) to spend as they wished.[17] Funds were distributed to local governments based on population, income, and tax effort. The formula gave more, on a per capita basis, to local governments in lower income areas and those that helped themselves with greater tax effort.[18]

A government's fiscal capacity can change over time as a result of long-run economic (e.g. slowing down of tourism growth in Hawaii) and demographic changes (e.g. population growth or aging).[19] Hence, allocation formulae developed to address existing fiscal disparities need to be reviewed periodically and, perhaps, amended. This would also apply to any formula adopted to allocate Hawaii's TAT revenues.

State revenue-sharing programs to support the general operations of local governments vary widely across the country. They can differ in which revenue streams are shared and how they are distributed. Some are more complicated than others. In sum, there is not one single model that describes all of them.

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[16] TACIR, 2004, p. 24.
[17] This was in addition to categorical grants. Federal general revenue sharing with the states ended in 1981.
[18] TACIR, 2004, pp. 27-28.
[19] See, for example, Fisher, 2010.

South Carolina distributes money from a broad based fund, the State's general fund. A broad based fund is likely to be less volatile than a stream of revenues from a single tax. Since 1991, South Carolina law, entitled *State Aid to Subdivisions Act,* has set the amount to be given to local governments (the Local Government Fund) at 4.5% of the State's last completed fiscal year's general fund. Amounts received by county and municipal governments depend solely on their population. Section 6-27-30 further stipulates that the amount is not subject to mid-year cuts except by a majority vote of the entire State Budget and Control Board. Even then cuts are permitted only if counties and municipalities do not receive less funding than in the immediate preceding fiscal year. (A bill introduced in the Legislature this year would delete both provisions. Instead, language in the bill allows appropriations to the state aid fund to be increased by 2% when the State's general fund is projected to grow by at least 4%.[20])

In Michigan, the State shares a portion of its 4% state sales tax with local governments. Since 1947, the Michigan Constitution requires the state to share sales tax revenues with the state's local governments. Michigan's unique revenue sharing program is composed of two parts, one established by the State Constitution and the other by statute. An amendment to the Constitution in 1963 apportions 15% of the gross collections from the 4% state sales tax to be distributed to local governments on a per capita basis. The statutory portion apportions 21.3% of the 4% state sales tax to local governments.[21] For many years the level of constitutionally mandated revenue sharing has remained fairly stable. In contrast, statutory revenue sharing has decreased sizably as

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[20] *State Aid to Subdivisions Act,* South Carolina General Assembly, 121st Session, 2015-2016.

[21] For details on how the money is distributed among the local governments, see Michigan Department of Treasury.

a result of severe economic problems in Michigan since 2003.[22] New revenue sharing programs adopted since 2011 have further cut funds to local governments. Business economist Martin Lavelle notes that in Michigan "economic downturns…added volatility and uncertainty into the revenue relationship between state and local governments."

The decline of state aid to local governments has occurred in many states. Indeed, as a result of the Great Recession (2007-2009), nominal state-local tax revenues were lower in 2009 than in the previous two years. The recession hit state governments harder than local governments because states do not have the (more) stable property tax.[23] As a result, many states made discretionary aid cut to their local governments. In hard times, states often suspend their statutory formulae and adopt *ad hoc* distribution arrangements, at least temporarily. In 2009, 22 states provided less nominal aid to their local governments than in the previous year. In 2010, 27 states provided less aid than in 2009.[24] One challenge facing Hawaii's current effort to apportion the TAT between the State and the four county governments is how to design a revenue sharing system that minimizes harm to local governments when the economy is in recession.

III. Brief Profile of Hawaii's State and County Governments and Revenue Sharing

In 2012 there were 38,910 general purpose local governments in the U.S.; they include 3,031 counties, 19,519 municipalities, and 16,369 townships. Hawaii, by contrast, has a very simple government structure. Government in Hawaii is highly centralized with the state government being the dominant player. Local governments in Hawaii comprise essentially of four county governments: Hawaii County, Maui County,

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[22] Lavelle, 2014, p.2.
[23] Fisher, 2010, p. 9.
[24] Nguyen-Hoang and Hou, 2013, p. 1.

Kauai County, and the City and County of Honolulu. Hawaii State Constitution assigns responsibility for a number of important service functions to the state government that elsewhere is assigned to local governments. The most notable such service responsibility is K-12 public education.

Local governments in Hawaii also have less revenue authority than similar institutions in most states.[25] Hawaii's state government guards its taxing power jealously. Hawaii has 17 separate tax laws of which 14 are administered by the State; the counties administer only the local property tax, the motor vehicle weight tax, and the public utility franchise tax.[26] Counties in Hawaii were not even authorized to set their own property tax rates until 1989. In 2012, local property tax revenues represented nearly 70% of local tax revenues in Hawaii and slightly over half (52.7%) of local own source revenues. (Own source revenues are revenues generated by local governments from their own resources—e.g. taxes, user charges, fees, etc.—and exclude intergovernmental revenues/grants.) As seen in Table 1, the State government in Hawaii accounts for (approximately) 75% of state and local government revenues and direct expenditures in 2012; the comparable percentages are significantly lower for all state governments in the U.S.[27]

[25] ACIR, 1989.
[26] Mak, 2008, p. 80.
[27] The ACIR estimated that in FY 1987 the Hawaii State Government received 82 percent of total State and county own-source revenues while the counties received the remaining 18 percent. ACIR, 1989, p. 154.

Table 1

State Government's Share in State and Local Finance in Hawaii and the U.S.: 2012

	Hawaii	U.S.
State Gov't Share of State-Local Revenues	77%	63%
State Gov't Share of State-Local General Revenues	78	63
State Gov't Share of State-Local Own Source Revenues	75	54
State Gov't Share of State-Local Taxes	74	58
State Gov't Share of State-Local Direct Expenditures	75	54

Source: U.S. Census Bureau, *2012 Census of Governments: Finance— Survey of State and Local Government Finance.*

Table 1 shows that in most states the state government collects more revenue than required by its spending responsibilities. On average state governments generated about 63% of total state and local revenues but accounted for only 54% of total state and local government direct expenditures. The vertical fiscal gap is 9 percentage points, i.e. money that can be used to fund aid to local governments.[28] However, there is a lot of variation among the states, which helps to explain the observed differences in the importance of state aid to local governments.[29] In Hawaii, the State's share of total state-local revenues was 77%; its share of total state and local "own source" revenues was 75%. By comparison, State direct spending as a percentage of total state-local government spending was 75%. This suggests that Hawaii's state government has less financial wiggle room to provide fiscal aid to its local governments. In 2012, the $234 million of state aid distributed to the four county governments represented 2.7% of State's general revenues. Statistically, state aid to the counties is more important (as a percent of their general revenues) than is the revenue loss to the State.

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[28] The gap was 20 percentage points before the Great Recession. Fisher and Bristle, 2012, pp. 215-231.

[29] See, for example, Fisher and Bristle, 2012, pp. 215-231.

Hawaii's state government has a lengthy history of sharing its revenues with the counties. Between 1947 and 1965 portions from the yield of the general excise tax (GET) (and the modest public company service tax) were distributed to the counties by formula.[30] According to Lowell Kalapa of the Tax Foundation of Hawaii, for many years Hawaii's counties received about 40% of the GET revenues.[31] Of the amounts distributed, Honolulu received 55%; Hawaii County, 20%; Maui County, 15%; and Kauai County 10%.[32] Beginning in 1965, GET revenue sharing was replaced by a system of grants-in-aid (Act 155, SLH 1965). Distribution of Act 155 fiscal aid money was based on how much effort each county made to raise property tax revenues.[33] A parade of county mayors to the Legislature to lobby for additional State aid is held every year . Grants-in-aid to the counties increased annually from $9.363 million in FY 1966 to a peak of $19.5 million by FY 1972.[34] The counties could spend the money any way they wished.

In October 1972 the Federal Government (under Republican President Richard Nixon) initiated a program of General Revenue Sharing (GRS) with state and county governments in the U.S. The program was terminated during the presidency of Ronald Reagan in October 1986. (Reagan feared that the Federal Government was getting too big.) In Hawaii 69.1% of the GRS local government money was distributed to the City and County of Honolulu, 9.9% to Maui, 14.9% to Hawaii County, and 6.1% to Kauai

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[30] ACIR, 1989, p. 149.
[31] Kalapa, 1992, p. 42. GET revenues increased from $17.8 million in FY 1949 to $54 million in FY 1965. Schmitt, 1977, p. 637.
[32] ACIR, 1989, p. 154.
[33] Kalapa, 2013.
[34] Schmitt, *Historical Statistics of Hawaii,* 1977, p. 154.

County.[35] In order to receive revenue from the program, a state government "must maintain the amount of aid to local units at a level not less than the amount of aid given by the state in fiscal year 1972…"[36] If Hawaii's state government could not reduce aid to the counties without losing federal general revenue sharing money, it was not obliged to increase it either. And it did not. [37] Act 155 grants-in-aid were terminated around the time the Federal GRS ended.

In 1986, the Hawaii Legislature enacted legislation (Act 340) to tax occupancy of transient accommodations (widely referred to as a hotel room tax or TAT) beginning January 1, 1987. The tax rate was set at 5%.[38] In FY 1987 (January 1 to June 30, 1987 only), the Department of Taxation (DOTAX) collected $23.5 million from the TAT; for the first full fiscal year in 1988, DOTAX collected $67.3 million. Initially, money collected from the TAT was not allocated to the counties directly as a replacement for Act 155 fiscal aid but was allocated, instead, to the State's General Fund. Pursuant to Act 345 (SLH 1986), the State distributed grants-in-aid to the counties for "infrastructure/or tourism related activities." The State distributed $12 million to the counties in FY 1987; the amount was raised to $20 million in FY 1989.[39] The money came from the General Fund. Since 1990 the counties have received some portion of the TAT revenues each year as general revenue sharing.

IV. History of the TAT in Hawaii

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[35] ACIR, 1989, p. 151.
[36] ACIR,1974, p. 2. Over this period, the Federal Government distributed about $83 billion to state and local governments. General revenue sharing with state governments ended in 1981.
[37] Kalapa, 1992, p. 49.
[38] This was in addition to the 4% GET.
[39] ACIR, 1989, p. 154.

The lodging/hotel room tax (known as the transient accommodation tax in Hawaii) is the most widely employed tourist tax in the world. In the U.S the lodging tax—separate from local sales taxes levied on tourist lodgings[40]—is levied by both state and local governments, but most frequently at the local government level. Only five states, including Hawaii, do not allow local/municipal governments to levy a separate lodging tax.[41]

Although the TAT in Hawaii is imposed on (the gross rental receipts of) lodging suppliers (e.g. hoteliers), it is essentially passed on to consumers; thus it is a consumption tax.[42] Since most of the consumers are non-resident visitors, the burden of Hawaii's TAT is largely exported. Research by several University of Hawaii economics professors found that Hawaii's 5% TAT of 1987 had no negative revenue impact on lodging suppliers.[43] Since 1987 the tax rate has been raised several times to the current rate of 9.25%. Table 2 displays TAT rate changes and the corresponding effective dates since its inception:

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[40] Hawaii also imposes its 4% GET on transient accommodation rentals. Hawaii's prolific GET is not a "tourist tax" as most of its revenues are generated from local residents. (See Miklius, Moncur, and Leung, 1989.) Although virtually all the taxes in Hawaii are, in varying degrees, partly shifted to tourists, the only Hawaii tax that generates most of its revenues from tourists is the TAT.

[41] Michel, 2012. The other four states are: Connecticut, Delaware, Maine, and New Hampshire.

[42] By comparison, recent research suggests that property taxes levied on hotels and resorts in Hawaii are not as easily passed on to tourists. Mak, 2015. Miklius, Moncur and Leung (1989) estimated that in 1988, 97% of the TAT was paid by tourists compared to 8.67% of county (overall) property taxes. They also determined that nearly 22% of the GET was paid by tourists in that year.

[43] Bonham et al, 1992.

Table 2

TAT Rate Changes and Effective Dates, 1987-Current

Effect Date	Rate
January 1, 1987	5.0%
July 1, 1994	6.0%
January 1, 1999	7.25%
July 1, 2009	8.25%
July 1, 2010	9.25%

Source: State-County WG (TAT) Interim Report **DRAFT** 11/28/2014

Hawaii was a latecomer in taxing hotel room rentals. In 1946, New York City became the first locality to levy a hotel room tax in the U.S.; by 1983, every state except Wyoming had hotel room taxes either at the local or state level, or both.[44] Hawaii's late entry was not due to the lack of interest much earlier.[45] Arguably, the most ardent proponent of a hotel room tax for Hawaii was the former mayor of Honolulu, Frank Fasi. But there was strong opposition from the visitor industry and powerful politicians, including Governor John Burns. Clamor for a hotel room tax became louder whenever the State's economy performed poorly, as in the early 1970s. In time, even the majority members of the Honolulu Chamber of Commerce came to support a tax on transient accommodation rentals. Most importantly, the visitor industry wanted to have a dedicated source of funding for generic tourism promotion, and later, a world-class convention center. A survey conducted by the 1984 Hawaii Tax Review Commission

[44] Mak, 2012, footnote no. 31, p. 779.
[45] This section relies heavily on Mak, 2008, Chapters 4 and 5.

found that hotel room tax revenues were most often used for tourism-related activities such as tourism promotion and convention center financing. In Hawaii, money to fund the Hawaii Visitors Bureau (HVB) for tourism promotion was raised through private membership subscriptions and State appropriation. Soliciting private money was difficult work and did not produce the desired results. Over time, the State's share of HVB's budget grew.[46] The industry simply could not raise enough money on its own to support HVB. While many wanted to see more money spent on tourism promotion, there were not enough of them who were willing to dip into their own pockets to pay for it. The incentive is to let someone else contribute and the non-contributor can still benefit as a freerider (or, freeloader). Economists refer to this type of private failure as "market failure". The only way to overcome it is to tax the industry to minimize freeriding and use the revenue to pay for the desired expenditures. It is one instance where the government does something good for the industry that the industry cannot do for itself and with better outcomes for both the industry and the community. This is precisely the reason why the Waikiki Improvement Association recently successfully lobbied the Honolulu City Council to levy a special tax on property owners in Waikiki to fund beach restoration in Waikiki.

There was also the matter of finding money for the still-to-be-built $350 million Hawaii Convention Center. The Hawaii Visitors Bureau was interested in attracting conventions to Hawaii as early as the 1960s.[47] Hawaii did not have a convention center to hold large meetings and conventions. Convention centers in the U.S. are generally

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[46] Bonham and Mak, 1996; and Mak and Miklius, 1993.

[47] Indeed, the convention trade was a significant business for Hawaii's fledging tourist industry before World War II and Hawaii actively promoted it. Mak, 2015, *Creating Hawaii Tourism…*

money-losers. The City and County of Honolulu tried to get a private developer to build one for free in exchange for higher density development at the current (former Aloha Motors) site. A proposal by an Indonesian businessman was ultimately rejected because the proposed private convention center would not be world-class and it would not have enough exhibition space. Once this proposal fell through, Honolulu was out of the running since it did not have the resources to pay for the construction of the convention center and subsequent operating expenses. Honolulu had neither the authority to levy a hotel room tax nor an excise tax that could have funded a county facility. The State was in a better financial position to take on the task.

The State had (and continues to have) a compelling interest in building a convention center as tourism growth had slowed down considerably in the 1980s. Even as tourist numbers continued to climb, they were climbing at ever-slower rates. Visitor spending adjusted for inflation had been flat for about a decade. In 1986, the visitor industry formed the non-profit Hawaii Convention Park Council to lobby for a world-class convention center. Two years later, the State Legislature created the Convention Center Authority to oversee the development and completion of a convention center. The Legislature felt that it was time to seriously develop this market to spur economic development and diversification for Hawaii. It would be diversification within an existing industry, one in which Hawaii had already demonstrated considerable competitive advantage. Although the convention center would be located in Honolulu, it was argued that delegates would be enticed to visit the Neighbor Islands before and/or after their meetings; this would persuade the Neighbor Islands to support a statewide hotel room tax. It was a case of mutual interest.

However, when Hawaii's statewide transient accommodation tax was first implemented in 1987, State lawmakers did not (and likely could not) immediately dedicate revenues from the 5% TAT to Hawaii Visitors Bureau, a private entity.[48] The Hawaii Convention Center—a State property—was still not close to being built in 1987; it would be completed 10 years later in October, 1997. In 1990, the Legislature decided to allocate 95% of the revenues from the TAT to the counties, retaining the remaining 5% to defray "TAT-related administrative purposes". The counties received the following shares: 44.1% to the City and County of Honolulu, 22.8% to Maui County, 18.6% to Hawaii County, and 14.5% to Kauai County.[49] The overall distribution rate to the counties would be changed more than a dozen times over the next two decades.[50]

As the convention center approached completion, there was no more money to pay for it unless the Legislature took back the TAT revenues from the counties. Instead, the Legislature raised the 5% TAT rate to 6% in 1994 to gain a head start in raising revenue for the convention center, and raised it again to 7.25% in 1999. TAT money was now divided into 3 pools. The Convention Center Capital Special Fund received 17.3%

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[48] No problem. Act 156 signed into law by Governor Ben Cayetano on July 9, 1998, established the public Hawaii Tourism Authority (HTA) to oversee tourism marketing.
[49] The Conference Committee Report on the bill that introduced the county allocations noted that both houses of the Legislature also considered other taxes as potential candidates for revenue-sharing, including a portion of the public service company tax, animal fines, and unadjudicated traffic and parking fines and forfeitures to the counties, but the Conference Committee argued that "administrative costs and burdens of distributing revenues from several smaller sources will be considerably greater than the costs of distributing from one large source." The Committee recommended that money should be distributed to the counties in proportion to their population. (The Department of Taxation Presentation handouts—April 1, 2015.) It did not turn out to be that way.
[50] State-County WG (TAT) Interim Report **DRAFT** 11/28/2014, p. 6. at http://auditor.hawaii.gov/task-forceworking-group/

of the proceeds, the Tourism Special Fund (for marketing) received 37.9%, and the counties received the remaining 44.8%.

General (macro-) economic conditions in the State dictated how the State distributed the TAT revenues. The State Legislature acted more generously in good times; in bad times, the State diverted some of the TAT money for itself. In recent years, capping existing distributions and diverting any excess revenues to the State's General Fund was one way the State dipped into the TAT revenue pool.[51] In lieu of a fixed percentage of the TAT (44.8%), the 2011 Legislature capped the amount of TAT revenue going to the counties at $93 million. In a Conference Committee Report, the Legislature explained that it was part of a package of measures intended to increase and preserve State revenues derived from the TAT because of the State's extended economic crisis.[52] Another measure, following the Great Recession of 2007-2009, was to raise the tax rate and allocate the additional money generated to the State's General Fund. The TAT tax rate was raised to 8.25% effective July 1, 2009 and to 9.25% temporarily in 2010 (till 2015) but in 2013 the Legislature made it permanent. The new law allocated $93 million to the counties (instead of 44.8% of TAT revenues) but removed the cap. The Convention Center Enterprise Special Fund received $33 million instead of 17.3%, and the Tourism Special Fund received $82 million instead of 34.2%.[53] The State kept what was left for itself.

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[51] For additional details see State-County WG (TAT) Interim Report **DRAFT** 11/28/2014 11:44 a.m. at http://auditor.hawaii.gov/task-forceworking-group/

[52] See State-County WG (TAT) Interim Report DRAFT 11/28/2014, p. 9.

[53] See State-County WG (TAT) Interim Report DRAFT 11/28/2014, p. 11.

Act 174 (H.B. No. 1671) enacted in 2013 to take effect on July 1, 2014 allocated $103 million to the counties in FY 2014-15, the same amount in FY 2015-16, and (back down to) $93 million for each fiscal year thereafter. The City and County of Honolulu would receive 44.1%; Maui County, 22.8%; Hawaii County, 18.6%; and Kauai County, 14.5%, the same shares as in 1990.[54]

Through all of the above changes, nominal TAT revenues collected by the State increased by nearly 6-fold, from $67.3 million in FY1988 to $395.2 million in FY2014.[55] During those 27 years, and through some trying times, collections declined in only four of those years, 1991, 1994, 2002, and 2009. The largest percentage decline in a single year was in FY2002 at 11.1%, followed by FY2009 at 8.2%.

Adjusted for inflation, TAT collections increased by 2.7 fold from $99.6 million to $270.7 million in (constant) year 2000 dollars.[56] Inflation-adjusted (real) TAT revenues declined during 7 fiscal years, 1991, 1993-1994, 2002, and 2007-2009. The increase in TAT revenues was in part fueled by several tax rate increases. A useful metric is the implied tax base that measures the lodging industry's taxable gross income.[57] It provides some indication of the financial health of the lodging industry. Table 3 displays TAT collections and the associated tax bases in both nominal and

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[54] Twenty-Seventh State Legislature, Second Special Session of 2013. *Act 174,* p. 613. In 2015, a bill was introduced in the Senate (SB408) that would again change the amounts allocated to the counties from a specific sum to a percentage of the revenues collected. The WG asked the Legislature to defer a decision until it finished its work mandated by Act 174.

[55] Department of Taxation Presentation handout, April 1, 2015.

[56] Although imperfect, I used the Honolulu CPI-U as the deflator. Since the TAT revenue data are for fiscal years, I converted the annual CPI-U to a fiscal year basis. For example, for FY1987, I averaged the first half CPI-U for 1987 and the second half CPI-U for 1986, and so on. CPI-U data came from the 2014 State of Hawaii *Data Book*.

[57] This is done by dividing the annual TAT revenues by the applicable tax rate. Tax Revenue=Tax Base x Tax Rate.

constant (year 2000) dollars for FY2000 to FY 2014. FY2000 was chosen as the starting point because the State claimed almost none of the TAT revenues for its General Fund in that year.

Table 3

Nominal and Real TAT Revenues and Bases, FY2000-FY2014
(millions of $)

Fiscal	TAT Collections		Implied Tax Base	
Year	Nominal	Real	Nominal	Real
2000	$168.6	$168.6	$2,326	$2,326
2001	177.2	174.8	2,444	2,410
2002	157.6	153.6	2,174	2,119
2003	170.9	164.5	2,357	2,269
2004	181.9	176.4	2,509	2,434
2005	198.8	192.6	2,742	2,657
2006	217.0	194.4	2,993	2,571
2007	224.9	183.4	3,102	2,530
2008	229.4	178.4	3,164	2,460
2009	210.6	160.6	2,714	2,070
2010	224.3	167.0	2,563	1,908
2011	284.5	204.2	3,076	2,208
2012	323.9	229.4	3,502	2,480
2013	368.6	253.9	3,985	2,744
2014	395.2	270.7	4,272	2,926

Source: Department of Taxation Presentation handout, 4/1/2015 and author's calculations.

Table 3 shows that Hawaii now collects about $400 million in TAT revenues from taxable lodging industry room revenues of nearly $4.3 billion. The lodging industry faced tough times during the second half of the 2000-decade as real TAT tax base declined every year between 2005 and 2010. Typically, in the private sector, falling demand leads to lower prices. In Hawaii, lower demand for lodging led to higher tax rates on lodging (in 2009 and 2010).

V. Allocating TAT Revenues between the State and the Counties

The allocation of TAT revenues between the State and the counties involves two tasks: (1) Determining the share of total TAT revenues that goes to the counties and the share that goes to the State; (2) determine the division of the county shares among the 4 counties. We begin with task (2).

In deciding how best to allocate TAT revenues, several guiding principles might be helpful: The final allocation model should

1.) Comply with enabling statute.

2.) Strive to achieve the goals established for the TAT.[58]

3.) Provide a predictable stream of revenues to facilitate budgeting.

4.) Be (perceived to be) fair.

5.) Be simple (low cost) to administer.[59]

6.) Be politically accepted.

V.1 Dividing Counties' Share of TAT Revenues Among the Four Counties

The task of dividing the counties' share of TAT revenues among the four counties likens to playing a zero sum game. If one county gets more, the others must get less. During the 1980s there were several proposals on how best to allocate appropriated state aid among Hawaii's counties. A 1984 proposal by the City and County of Honolulu for a state revenue sharing program suggested the following distribution: Honolulu, 43.6%; Maui, 18.3%; Hawaii, 20.7%; and Kauai, 17.4%.[60] In 1987, the Hawaii State Association of Counties proposed the following formula: 50% to Honolulu, 17.5% to Maui, 18.5% to

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[58] Thus, if the intent of the TAT is to fund tourism marketing and a convention center, then both should be adequately funded.
[59] 4 and 5 may conflict, and compromise may be necessarily.
[60] ACIR, 1989, p. 151.

Hawaii, and 14% to Kauai.[61] In 1989 the Governor proposed to allocate tobacco and liquor tax collections and $20 million in TAT appropriation as follows: City and County of Honolulu, 46.5%; Maui County, 23%; Hawaii County, 16.3%, and Kauai County, 14.2%. Actual distributions of state aid to the counties in FY1987 were 37.2% to Honolulu; 24.3% to Maui; 25.1% to Hawaii, and 13.3% to Kauai. In FY 1989, Honolulu's share rose to 42.6%; Maui declined to 16.5%; Hawaii declined to 23.8%; and Kauai increased to 17.1%. How these percentages were determined is a mystery.[62] Obviously, none of the above proposals employed population as the principal method of distribution. In 1980 the City and County of Honolulu had 79% of the State's total resident population; Maui County, 7.4%; Hawaii County, 9.5%; and Kauai County, 4.1%.[63] Allocation from the TAT to the counties began in FY 1991 ($62.8 million), to the convention center in FY 1996 ($19.3 million) and to tourism promotion in FY 1999 ($29 million).[64] The current distribution of TAT revenues among the four counties is as follows: 44.1% to the City and County of Honolulu, 22.8% to Maui County, 18.6% to Hawaii County, and 14.5% to Kauai County.

There was some sentiment among the Working Group members that the current formula is a fair formula and that the Working Group should leave it alone and, instead, focus on the division of TAT revenues between the State and the counties as a group. Arguably, there is some empirical evidence to support that. Table 4 displays the current

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61 ACIR, 1989, p. 151.
62 ACIR, 1989, p. 151.
63 State of Hawaii *Data Book* for 2014, Table 1.01.
64 Department of Taxation Presentation to the WG handout—April 1, 2015. The amount allocated to tourism increased to $63.9 million in FY 2000.

distribution among the four counties and the shares of selected population and fiscal variables for the four counties.

Table 4

Current County Shares of TAT vs Shares of Selected County Variables: 2014

	Honolulu	Maui	Hawaii	Kauai
Current TAT Distribution	41.1%	22.8%	18.6%	14.5%
Individual County Shares of the Total for all Counties By:				
Resident Population	69.9%	11.5%	13.7%	5.0%
De Facto Population*	66.8	13.5	13.5	5.8
Total Operating Expenditures	69.4	11.7	13.4	5.5
Daily Visitor Census	46.7	27.2	14.6	11.5
Visitor Plant Inventory	48.7	25.4	14.5	11.5
Situs (Source of TAT Revenue)	48.9	29.3	12.5	9.3
County Expenditures on Visitors	50.6	22.7	13.5	13.1

Sources: Population (resident, de facto and tourist) data from State of Hawaii 2014 Data Book; visitor plant inventory from HTA *2014 Visitor Plant Inventory;* TAT revenue by county of generation from Department of Taxation; and county operating expenditures (total and on visitors) from WG handout dated 6-3-15.

Note: (*) Defacto population includes the number of visitors present and subtracts the number of residents who are temporarily away from the State. The percentages do not always add up to 100% due to rounding.

In Table 4, the county variables that appear to most closely correlate with the current distribution of the TAT among the four counties are the visitor daily census and the visitor plant inventory. Both variables, not surprisingly, are also highly correlated with each other. Also both variables are highly correlated with where TAT revenues are actually generated *and* county expenditures on visitors. More tourists (and more lodging units) mean more total spending on lodging and, thus more TAT revenues are generated.

Likewise, more tourists mean higher demand for public services. Total population (resident or de facto) is not highly correlated with the current TAT distribution formula but it is highly correlated with total county government operating expenditures. Again, not surprising. More people means greater demand for total public services. Thus "population" is a good proxy variable for total public service "needs". The daily visitor census and visitor plant inventory are good proxy variable for tourist demand for lodging and public service needs of visitors. To the extent that the current TAT revenue distribution formula approximately mirrors where revenues are actually generated and spent can understandably be judged as a "fair" distribution. Thus, leaving the current distribution formula unchanged may not be a poor decision.

Finally, a comparison of the distribution by situs with the current TAT distribution formula indicates that there is still some revenue redistribution going on among the counties. Revenues are still being diverted from Honolulu and Maui to Hawaii and Kauai, but not by much. The current (percentage) division of TAT revenues is the same as that in 1990, but around 1990 Honolulu generated 60% of total TAT revenues; Maui, 23%; Hawaii, 9%; and Kauai, 8%.[65]

V.2 TAT Revenue Sharing Between the State and the Counties

Table 5 shows the amount of TAT revenues divided among four pools: the counties, the convention center, tourism, and the State's General (G-) Fund between FY2000 and FY2014. The numbers in ( ) are the percentages of allocated money in each pool, which add up to 100%. The current process of allocating TAT money to the four pools is best described in Act 174 as follows: The State Legislature first appropriates

[65] Kalapa, 1992, p 42.

money to the counties, the convention center, and tourism; the difference between what is collected and the amounts allocated to the first three pools is distributed to the General Fund. The amounts allocated to the counties, the convention center and tourism for the next few fiscal years are already known; the amounts going into the G-Fund are not known.

Table 5

Distribution of TAT Revenues: FY2000-FY2017

(millions of $)

Fiscal Year	Counties	Convention Center	Tourism	G-Fund
2000	$75.4	$29.2	$63.9	$ .2
	(44.7%)	(17.0%)	(21.3%)	(0.1%)
2001	$79.4	0	$67.1	$30.7
	(44.8)	(0)	(37.9)	(17.3)
2002	$70.6	0	$59.7	$27.3
	(44.8)	(0)	(37.9)	(17.3)
2003	$76.5	$29.6	$63.3	$1.5
	(44.8)	(17.3)	(37.0)	(0.9)
2004	$81.4	$31.5	$63.3	$5.6
	(44.8)	(17.3)	(34.8)	(3.1)
2005	$89.1	$32.5	$64.8	$12.4
	(44.8)	(16.4)	(32.6)	(6.2)
2006	$97.2	$32.7	$70.7	$16.4
	(44.8)	(15.1)	(32.6)	(7.6)
2007	$100.8	$33.8	$73.3	$17.1
	(44.8)	(15.0)	(32.6)	(7.6)
2008	$102.8	$32.5	$78.2	$15.9
	(44.8)	(14.1)	(34.1)	(7.0)
2009	$94.4	$30.7	$72.0	$13.6
	(44.8)	(14.6)	(34.2)	(6.4)
2010	$90.6	$32.8	$69.1	$31.7
	(40.4)	(14.6)	(30.8)	(14.1)
2011	$102.9	$36.8	$85.0	$59.8
	(36.2)	(12.9)	(29.9)	(21.0)
2012	$93.0	$35.6	$69.0	$126.3
	(28.7)	(11.0)	(21.3)	(39.0)
2013	$93.0	$33.0	$71.0	$171.6
	(25.2)	(9.0)	(19.3)	(46.6)
2014	$93.0	$33.0	$82.0	$187.2
	(23.5)	(8.4)	(20.7)	(47.4)
2015	$103.0	$33.0	$82.0	
2016	$103.0	$33.0	$82.0	
2017	$93.0	$33.0	$82.0	

Sources: Department of Taxation Presentation handout, 4/1/2015 and Act 174.

Table 5 shows that from virtually nothing in FY2000, the State now controls almost 50 percent—indeed, the largest pool--of total TAT revenues. By comparison, the counties' share of total TAT revenues has declined from 44.7% in FY2000 to less than 25% (23.5%) in FY2014. If the State's current allocation policy remains unchanged, and total TAT collections continue to rise, the gap between the counties' and the State's shares will widen further.

For the counties, *nominal* TAT revenues increased almost every year between FY2000 and FY2008 and remained, at best, flat thereafter. Nonetheless, in FY2014, the counties received nearly $18 million more than they did in FY2000. But not in *constant* dollars (Table 6).

Table 6

County TAT Revenues in Constant (Year 2000) Dollars: FY2000-FY2014

(Millions of $)

Year	Amount	Year	Amount
2000	$75.4	2008	$79.9
2001	78.3	2009	72.0
2002	68.8	2010	67.5
2003	73.6	2011	73.9
2004	79.0	2012	65.9
2005	86.3	2013	64.0
2006	83.5	2014	63.7
2007	82.2		

Source: Author's calculations

Table 6 presents TAT revenues received by the counties in constant (year 2000) dollars between FY2000 and FY2014. The data show long-run erosion in the purchasing power of TAT revenues received by the counties. The counties' TAT revenues were nearly $12 million less in FY2014 than in FY2000, after adjusting for inflation.

In enacting Act 174, State lawmakers seek recommendation on how best to allocate TAT revenues between the State and the counties in a manner “that properly reflects the division of duties and responsibilities relating to the provision of public services taking into account their respective spending responsibilities in providing public services.” The legislative language can be interpreted in several ways. The following three scenarios appear to comply with its mandate:

Scenario A: A simple split of 25% for the counties and 75% for the State as reflected in their respective spending responsibilities (Table 1). (The counties’ share is roughly the same as the actual split in FY2014—i.e. 23.5%). The State would be responsible for all expenditures related to the convention center and tourism promotion. If Scenario A were in place in FY2014, the counties would have received $98.8 million instead of the $93 million actually received. Hawaii’s own data for FY2014 indicate that the counties accounted for 22% of total State and county operating expenditures implying that county TAT revenues would have been $86.9 million, or less than what was actually received.

Scenario B: In this scenario, the counties’ share of total TAT revenues would be permitted to grow to cover costs due to increased workload and inflation, but not to cover the additional costs of new programs and/or improvements in quality and/or scope of existing programs. This is accomplished by applying the growth in de facto population (a proxy variable for work-load) and an inflation factor to TAT revenues *in a base year* to determine future county TAT revenues. For new expenditure initiatives, the counties would have to go to the Legislature and request additional funding.

The base year selected is (again) FY2000 when the State's share was virtually zero. Between FY2000 and FY2014, Hawaii's de facto population increased by 16.7 percent and prices (Honolulu CPI-U) increased by 46%. By adjusting for changes in the work-load and inflation, the counties' share of TAT revenues would have risen from $75.4 million in FY2000 to $122.7 million in FY2014, or 31.0% of the actual total amount collected in FY2014.

Scenario C. This scenario is the same as Scenario B except it replaces de facto population by the average daily census of visitors.[66] It assumes that TAT revenues are intended to defray county expenditures on tourism related expenses.[67] Under Scenario C, the counties' share of TAT revenues would have been $126.4 million in FY2014, or about 32% of total collections in that year.

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[66] Between 2000 and 2014, the average daily census of visitors increased by 13.1% in the City and County of Honolulu, 27.3% in Maui County, 30.8% in Kauai County, and 37.5% in Hawaii County. (From the 2000 and 2014 *Annual Visitor Research Report* at http://dbedt.hawaii.gov/visitor/visitor-research/) I calculated a weighted average increase for the 4 counties using the average daily census figures for each county in 2014 as weights.

[67] They are not. TAT revenues have historically been used by the counties and the State as they wished. It is noteworthy that the counties also derive other revenues from tourism besides their share of TAT revenues. In FY2014, the counties collectively generated property taxes of $196.168 million from hotels/resorts, $19.246 million from vacation rentals, and $23.067 million from timeshares for a total of $238.481million. (https://www.realpropertyhonolulu.com/portal/rpadcms/Reports?parent=REPORTS) These three are just the most obvious taxes. However, almost all the taxes levied in Hawaii are in varying degrees passed on to tourists (See Miklius, Moncur, and Leung, 1989). By comparison, the four counties spent a total of $228,573,305 on tourism (WG handout on 6-3-2015) entitled "County spending on tourism." If the expenditure figures on tourism are accurate, the tourism industry pays more taxes on tourism (not counting the TAT revenues) than amounts spent on the industry. Thus, TAT allocation is not really exclusively about generating revenue to defray the cost of government spending on tourism.

The Investigative Committee of the Working Group has offered its own recommendation.[68] It suggests that the amount for tourism marketing should first be subtracted from total TAT collections. Then take 90% of the balance and allocate 60% to the State and 40% to the counties, but in either case, no less than $100 million *each*.[69] The State would be responsible for expenses related to the convention center and all other State spending initiatives. The Committee explained that, instead of a flat sum, this formula allows the counties to share in future increases in (total) TAT collections. If this formula were in place in FY2014, the counties would have received $112.75 million or 28.5 % of total TAT collections.

Finally, since expenditure priorities/responsibilities change over time with changing consumer demand for public services, periodic review of existing allocation formula should be conducted.

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[68] Memo to Chair Acoba, Members, State-County Functions Working Group (TAT) from Ray Soon, Members of the Allocation Models Investigative Group, "Report on our Progress to Date," dated May 29, 2015, p. 3 (WG handout on 6-3-2015)

[69] The 40-60 split is very roughly based on the ratio of the counties' operating expenditures on tourism and the State's operating expenditures on tourism. In FY2014, the counties were estimated to have spent $228.6 million on visitors (33.5%) while the State spent an estimated $453.2 million (66.5%).

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Agenda item IV.

September 11, 2015

INITIAL HANDOUT TO THE STATE-COUNTY FUNCTIONS WORKING GROUP IN PREPARATION FOR THE SEPTEMER 16 MEETING

from the Belt Collins Hawaii LLC Consulting Team

We are drafting our presentation, to be shared with you in advance of the meeting. After the presentation is summarized and discussed, a workshop section of the meeting will deal with:

a. Tourism and revenue forecasts
b. Ways to calculate floors, shares and ceilings: *current (real) dollars, dollars adjusted for inflation, or shares of allocations*
c. Variance in allocations over ten years – *what difference is made when models use different terms and structures?*

We plan to set up tables and models based on:

FORECASTS:

- DBEDT's forecast for the economy in the next few years;
- Hospitality Advisors' forecasts of supply and demand of visitor lodging, leading to a forecast of total TAT revenues (given the current tax structure);
- A rough estimate of potential additional TAT revenues if the share of visitor lodgings for which TAT is paid increases over the next decade. (This figure can be refined later, given information to be requested from Department of Taxation).

MODELS:

- The current (Act 174) allocation
- The "recommended" model of the Allocation Models Investigative Group
- An adaptation of the "recommended" model that the Consultant Team would like the WG to consider
- A simplistic model in which the TSF, counties and State each receive a set share of total revenues

We hope that these will cover the range of issues and concerns that the WG wants to review on September 16. We will be able to input different numbers or assumptions during the meeting. If we have omitted forecasts and allocation models that members of the Working Group want to discuss on September 16, we request that you describe those items in an e-mail sent to John Kirkpatrick and Jayna Oshiro of the Auditor's office in advance of the meeting:

jkirkpatrick@bchdesign.com
joshiro@auditor.state.hi.us

Any requests or comments sent by e-mail will be described during the meeting and, if all goes well, resolved. Thanks!

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Agenda item IV c.

MEMORANDUM

TO:	FROM:
State-County Functions Working Group (WG) Acting State Auditor Jan Yamane	John Kirkpatrick for Consulting Team
COMPANY:	DATE:
State of Hawai‘i	September 14, 2015
SUBJECT:	JOB NUMBER/REFERENCE NUMBER:
Allocation Models for Review by WG	2015.70.0300

Proposed Outline:

1. Overview and Discussion
   a. Principles relevant to Transient Accommodation Tax (TAT) allocation
   b. Some Implications of the models
   c. Alternative approaches to TAT allocation
2. Workshop
   a. Tourism and revenue forecasts
   b. Ways to calculate floors, shares and ceilings
   c. Variance in allocations over ten years

Overview:
Much of the first two parts of this presentation is based on materials circulated by Dr. James Mak, who is not able to attend the September 16 meeting. Rather than try to channel him at the meeting, we combine his insights with contributions by the others on the team to present our view of key components of the modeling effort. At the meeting, this material will be summarized for discussion by the Working Group, after which we will move on to the workshop section of the meeting.

Principles
Dr. Mak wrote in his background report:

In deciding how best to allocate TAT revenues, several guiding principles might be helpful: The final allocation model should

1. Comply with enabling statute.
2. Strive to achieve the goals established for the TAT.
3. Provide a predictable stream of revenues to facilitate budgeting.
4. Be (perceived to be) fair.
5. Be simple (low cost) to administer.
6. Be politically accepted.

He notes that some of these principles may conflict in practice. Also, it may be difficult to reach consensus on how to act on some principles.

The WG has already discussed the goals for the TAT at some length, finding evidence for different goals in the course of the tax’s legislative history. (See also the draft Chapter 1 report from the Auditor.)

As discussed by the WG, the Maui County *Charter* includes a Declaration of Policy for its budgeting:

> It is declared to be the policy of the county to promote economy, efficiency and improved service in the transaction of the public business in the legislative and executive branches of the county by:
>
> 1. Limiting expenditures to the lowest amount consistent with the efficient performance of essential services, activities, and functions.
> 2. Eliminating duplication and overlapping of services, activities, and functions.
> 3. Consolidating services, activities, and functions of a similar nature.
> 4. Abolishing services, activities, and functions not necessary to the efficient conduct of government. (Section 3-9, Amended 2012)

This declaration focuses on government spending, not taxation. It aligns with the principle of simple administration listed above. It can also raise the question of whether tax allocations work to promote or limit efficient spending.

We can spell out some of the implications of emphasizing one or another of three key principles;

- Predictability
- Fairness
- Simplicity/ Efficiency

For these three principles, we discuss ways to maximize each principle. Later, we will sketch out their implications for the next ten years. Next, we point to ways to combine them. The other principles are met by revisions of statute and recognizing legislative intent, and do not provide a clear starting point for alternative approaches.

Predictability

Allocations should be both predictable and sufficient for the recipient to plan on key activities. To the extent that predictable allocations allow an agency to focus on its core mission, rather than on seeking funds, these allocations encourage efficiency in government. However, predictable funding cam reduce incentives to cut costs, unless the funding is tied to particular operations.

From Act 174, baseline allocations of $82 million for the TSF and $103 million for the counties can be derived. A baseline for the State of $103 million would parallel the county baseline. In its presentation, the Allocation Model Investigative Group suggested that similar sums would go a long way to reduce uncertainty for each of these parties. WG members have viewed those allocations as less than adequate to fund desirable operations, but sufficient to reduce uncertainty.

In this memorandum, those figures will be assumed to be sufficient for FY 2015-2016. Over time, distinct issues arise in anticipating economic growth or decline. With economic growth, it would be reasonable to tie changes in funding to change in the cost of operations. On this basis, it would be reasonable use an inflation index (such as the Consumer Price Index for Honolulu urban consumers (CPI)-U) to adjust the

base allocations. If the baseline figures change over time in line with anticipated increases in the CPI, the resulting basic set-asides would rise from $288 million in 2015 to $374 million in 2025.[1]

A model that emphasized predictability for HTA, the counties, and the State budget would include regular increases in the amounts reserved for all three. Those increases could be tied to the CPI -U (except for set-asides for fixed debt service, which would presumably not increase from year to year).

If, however, TAT collections decline due to a shrinking economy, then all parties would have reason to seek an increase in their guaranteed funds. More money would be needed by HTA for tourism marketing, to reverse the decline. The counties and State could argue that with economic decline comes increased demand for welfare spending and economic development. If TAT revenues are appropriately seen as a benefit to the host community, then all of these arguments deserve consideration. In other words, the baseline figures for all three parties would reasonably vary with inflation in any economic conditions. The next table compares these baseline figures to potential collections, from 2015 to 2025

TAT revenues greater than the baseline figures might be allocated in several ways:

- If the principle of predictability is emphasized, TAT revenues greater than the baseline figures could be allocated by a rule: recipients can anticipate some pre-determined share of the additional funds. If predictability alone is of concern, that share could be zero, i.e., only the baseline amounts would be guaranteed, and any additional funds for recipients would be allocated by the Legislature according to its current view of State needs.

- The Recommended Model proposed a set-aside for the TSF, after which revenues would go to the counties and State based on a ratio; no further allocation to the TSF would be guaranteed.

- The WG could propose that a share of the amount over the baseline be allocated to selected recipients – TSF and the counties – with the remainder going to the State general fund.

Another way to assure predictability would be to tie allocations to the costs of specific activities or operations of the recipient parties. For example, a set of tourism marketing activities could be identified as covered by the FY2015 amount reserved for the TSF, and future years' allocations could be for the funds needed to replicate those activities in the next years. This approach is not considered further here, since it tends to commit recipients to set activities, rather than strategies that respond to current needs. Also, this approach would be a disincentive towards efficient spending of TAT revenues, since it treats past productivity as a given.

Fairness

Predictability could be assured by fixing amounts in dollar terms (with or without adjustments for inflation) or by tying allocations to the costs of specific activities of the recipients. Fairness is typically understood in terms of shares of the total amount to be allocated. Attention shifts from the amount received by one party or another to the division of the total collected.

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[1] Increases in CPI-U to 2018 based on DBEDT analysis *in Quarterly Statistical and Economic Report, Third Quarter, 2015*, published in August 2015. Beyond 2018, the 2018 increase (2.7%) assumed to continue.

The idea that allocations should reflect the ratio of public service expenditures follows a sense of fairness. But which expenditures should be counted? Several calculations have been presented in earlier handouts, to which we can add a few more:

Calculation	State Share	Counties' Share
1.Total expenditures, FY 2014	77%	23%
2. Direct expenditures on tourism. FY 2014 (State IG)	48%	52%
3. Weighted direct and indirect expenditures on tourism (County IG)	57%	43%
4. Average of total expenditures, 2002-2012	78%	22%
5. Net expenditures, subtracting intergovernmental transfers, 2002-2012	78%	22%
6. Net expenditures, subtracting revenue raised via government operations, 2002-2012	78%	22%
7. Net expenditures, combining analysis for Nos. 5 and 6		

After reviewing several calculations of State and counties' shares of relevant expenditures, the AMIG found a 60%/40% split to be a mid-range version, presumably acceptable to most parties involved.

Any discussion of fairness raises the question: Fair to whom? One approach sketched out in discussions before the WG would be to consider limiting growth of the total TAT revenues in order to reduce impacts on the visitor industry. If collections exceed a threshold based on previous years' collections – say 110% of the preceding year's collection – TAT taxpayers could be granted credits against future TAT collections.

The aim of this approach would be to reduce the impact of the TAT on the visitor industry. .

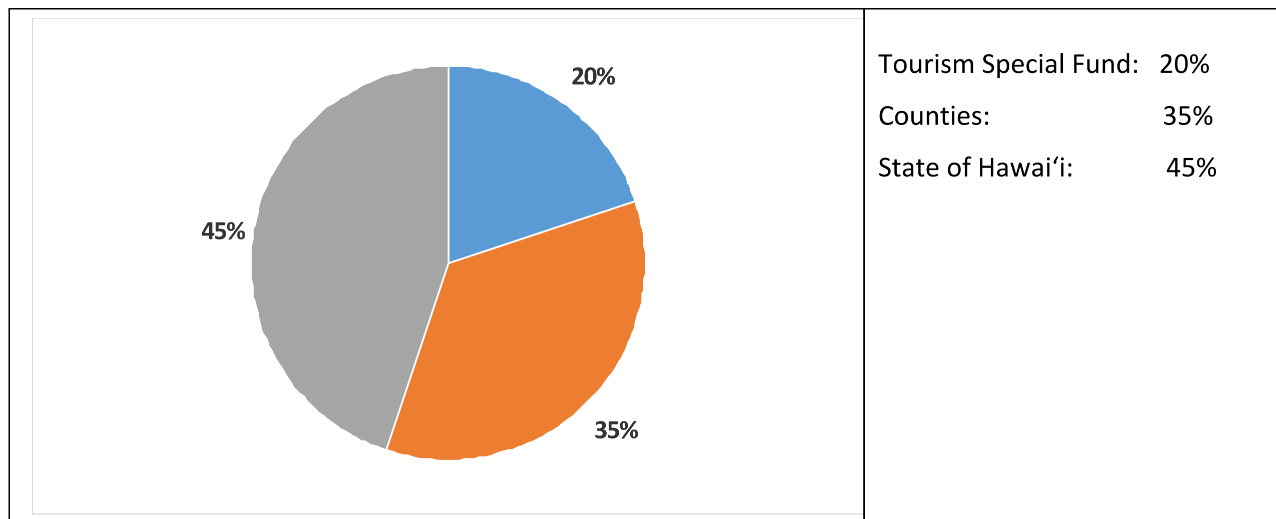
*** describe (JToy)
*** ? note that this becomes very tricky: credits; do you base future limits on annual collections or annual amounts collected up to the ceiling?

Simplicity/Efficiency

The simplest models could take one of two forms:

1. A version with capped allocations for some parties, and the residuum for the State. A variant on the current allocation, with $82 million going to the TSF, $103 million to the counties, and all the rest to the State, exemplifies this form.

2. A model defined by shares could also be simple. The "Pure Percentages" model (invented for this discussion) would allocate 20% of TAT revenues for the Tourism Special Fund (TSF), 35% for the Counties, and 45% for the State of Hawai'i. It would not have minimum allocations (baseline figures) or limits on the growth of particular allocations:



The first of the simplest models would, over time, direct all revenue growth to the State; the second would distribute additional revenues among the three parties.

Viewed in relation to anticipated revenue streams, the above three principles have distinct implications for allocation:

- **Predictability**: This principle provides a start to allocations, but in most cases not the basis for comprehensive distributions. As shown below, in the forecast distribution of Recommended Model funds, the fixed TSF allocation could shrink from 20% to 14% of total collections.
- **Fairness:** This principle yields good discussions but no obvious resolution. Since no single set of ratios for allocation is objectively identifiable as the basis for fair distributions, fairness must in practice be a matter of consensus among stakeholders. However, consensus can only be certain when the parties involved agree on principles and recognize others' right to share in decision-making. For the TAT, all powers of taxation reside in the State, so it would be difficult for all involved to agree – and continue to agree! – that any allocation is fair.
- **Simplicity:** In the simplest Percentages allocation model, revenue increases are independent of parties' expenditures and the rate of growth of those expenditures.

Members of the WG have expressed some support both for the idea of minimum allocations and for an upper limit on automatic allocations for the TSF. Members have also indicated that the counties should receive increased allocations as total TAT revenues grow. Consequently, the two simplest models are not under serious consideration, but provide a point of contrast with more complex models.

Implications of the Models: A Critique

The models currently under study can be assessed in relation to the above principles:

PRINCIPLE	Current Allocation	Recommended Allocation from AMIG	Pure Percentages
Comply with statute	Yes	Yes (but would need rewrite and would need to specify how set-asides and EUTF are handled)	Yes (but would need rewrite and would need to specify how set-asides and EUTF are handled)
Meet TAT goals	Yes	Yes	Yes
Provide predictable revenue stream	Yes (but Counties reduced in future)	Yes unless revenues fall by more than 20%	Yes
Fairness	Legislative consensus for a short-term solution	Intended to reduce risk while allowing both State and counties to enjoy revenue growth	Problematic. Some concern that TSF should be protected when revenues down, not increase automatically with revenue growth.
Simple to administer; efficient	Fairly complicated (and will be more so with EUTF provision)	Simpler	Simplest
Politically acceptable	TBD	TBD	TBD

NOTE; TBD = "to be determined" by Working Group.

Questions about the Recommended Model

The Recommended Model divides up TAT revenues as follows:

- The amount for tourism marketing—Tourism Special Fund-- ($83 million) should first be subtracted from total TAT collections.
- Then take 90% of the balance and allocate 60% to the State and 40% to the counties, but in either case, no less than $100 million each. The State would be responsible for expenses related to the convention center and all other State spending initiatives, including those already committed—e.g. Turtle Bay, DLNR, etc. AMIG explains that, instead of a flat sum, this formula allows the counties to share in future increases in (total) TAT collections.
- The final 10% would be allocated to the Legislature to be spent at its discretion with the recommendation that at least some of it should be spent on tourism-related activities.

Dr. Mak has raised several questions for the WG to consider:[2]

1. Both visitor industry marketing and funding for the Convention Center have been identified as economic priorities of the State. <u>Why should one be viewed as the first priority</u>, and the other included in the mix of programs funded out of the State's share of revenues? (One explanation might be that the former can be implemented to serve all parts of the State equally, but the impacts of the Convention Center are not equitably distributed among the counties.)

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[2] Dr. Mak's notes are re-organized here but incorporated nearly word-for-word.

2. A second issue is why a fixed sum ($83 million) is allocated for tourism marketing instead of some percentage of the TAT revenues. If a percentage distribution formula is good for the counties, why is it not good for funding tourism marketing?

   A fixed percentage of TAT revenues earmarked for tourism marketing reduces the costly lobbying that the visitor industry has to go through to obtain the desired level of appropriation. That is a big plus. The negative side is that it may result in less fiscal accountability. Or it may generate too much money (than is justified by benefit-cost analysis) for tourism marketing. As one Working Group (WG) member said, "If TAT revenues increased by 30% next year, should we be spending 30% more on tourism marketing? Probably not." However, the problem of potential over-funding can be solved by placing a cap on the annual percentage increase so that, in any year, money allocated to the Tourism Special Fund cannot increase by more than, say, 8% (actual percentage to be determined later after further investigation) of the amount in the previous fiscal year.

   On the other hand, a percentage allocation formula probably would not work as well in financing the convention center. The capital cost of the Hawaii Convention Center—measured by depreciation plus interest-- is essentially fixed. The variable cost is the operating cost of the conventional center, which is driven by workload (e.g. how many events and how many attendees) and inflation. Between FY 2003 and FY2011 (i.e., before the caps were put in place beginning in FY2012), the convention center fund grew from $29.6 million to $36.8 million, a modest increase of $7 million over 8 years or by 24%; by comparison, inflation in Honolulu (measured by the Honolulu CPI-U) increased by 34%. Over the same period, TAT revenues increased by 90%. There is no compelling reason why the annual increase in the expense of the convention center—on which a large part is fixed—should be determined by the increase in TAT revenues.

3. The 40-60 split between the counties and the State is apparently based, albeit very loosely, on the current ratio of the counties' operating expenditures on visitors and the State's operating expenditures on visitors. This procedure respects the Legislature's charge to the WG. But, is this germane? Is this the sole point at which TAT allocations can and should be tied to public expenditures on visitors?

   This issue can be approached in somewhat different ways:

   - Beyond the initial year, the nexus between the cost of providing public services and TAT revenues disappears under the AMIG recommended model. Going forward, TAT revenue growth may or may not parallel the growth in the cost of providing public services either to everyone present in the counties or just tourists.

   - One set of estimates (June 3, 2014 WG handout) indicates that in FY2014, the counties were estimated to have spent $228.6 million to provide public services to visitors (33.5%) while the State spent an estimated $453.2 million (66.5%). County expenditures on visitors represented 7.9% of their total operating expenditures; for the State government, it was 4.4%.

- Visitors to Hawaii certainly should be asked to pay for the cost of public services they consume. The TAT is a particularly good tax for that purpose because it narrowly targets tourists. But it is also noteworthy that the counties also derive other revenues from tourism besides their share of TAT revenues. In FY2014, the counties collectively generated property taxes of $196.2 million from hotels/resorts, $19.2 million from vacation rentals, and $23.1 million from timeshares for a total of $238.5 million. These three are just the most obvious tourism related taxes. However, almost all the taxes levied in Hawaii are in varying degrees passed on to tourists. By comparison, the four counties spent a total of $228.6 to $235.8 million on tourism (per WG handouts). If the expenditure figures on tourism are accurate, visitors and the tourism industry pay more in property taxes to county governments than the amounts spent on them. This was true in the 1970s; it remains true today.

4. To defray the cost of public services consumed by tourists is not the only reason why taxes are levied on visitors. Taxes paid by visitors are a benefit to the host community. How we decide to distribute the TAT money within the community determines how the benefits of tourism are shared among the State's residents.

5. The 10% earmark to the Legislature would have amounted to $31.3 million in FY2014. That is just another bundle of money in the State's pot. All of the State's revenues are appropriated at the discretion of the Legislature. It is unclear if yet another special fund (e.g. TAT Legislature Fund) will be set up to receive these funds. What it conjures up is an image of another special fund that is open to abuse. This fund is different from either the Tourism Special Fund or the convention center fund in that the latter came about because of the inability of the industry to raise sufficient money to properly fund generic tourism promotion and a world-class convention center due to "market failure". Not so with this 10% earmark, which has no specific use designated.

   (From the rest of the Consultant Team): Whether or not a Special Fund is established, the 10% allocation underlines the point that the WG is proposing a limit on the power of the legislature to allocate funds. The Legislature is the final decision-maker. Should the Legislature find the 10% too small, the result would likely be a reduction of the funds available for distribution to the counties and for other State purposes.

6. In discussions, members of the WG argued that the Hawai'i Tourism Authority (HTA) could come before the Legislature to request funding over and above the $83 million. However, HTA would face the criticism that it had already received a guaranteed share of the TAT revenues, while other deserving applicants had not. It might be in a weaker position when applying for further funding than others.

7. Finally, the fixed sums used in the Recommended Model are not based on specific requests or decisions by the concerned parties. The current allocations are $82 million for the TSF and $103

million for the counties (with $93 million in subsequent years). These figures may be arbitrary ones chosen by the Legislature – but at least they were chosen by the Legislature.

Summary of the Critique: The Recommended Model achieves some important objectives. It provides a predictable revenue stream for both the TSF and the counties. It allows funding for the counties and State to grow in tandem when TAT revenues increase. But are the ratios and rates of growth involved the ones the WG wants to propose? More on this point below.

The details of the Recommended Model can be questioned as inconsistent and as not firmly based in the analysis of expenditures. The last criticism could be made of nearly any model, since there is no consensus as to how to define the public services with which the TAT distribution between the counties and State is associated.

Alternative Approaches to Allocation [3]

Before any further discussion of dividing up revenues, it helps to see how those revenues have changed and could change in the future.

Exhibit 1 shows both annual TAT collections from 2000 to 2014 and the amounts that would have been collected, from 2010 onward, if the rate had remained 7.25%. The second table uses the implied tax base for the TAT[4] to estimate year-to-year change in possible collections, absent any change in rate. In recent years, the tax base has increased by as much as 15.7% in a single year, and fallen by as much as 15.9% in a year's time. As the WG considers how to allocate future TAT revenues, it seems prudent to anticipate that annual changes could be on the order of + or – 20% in future years. Any allocation strategy should be able to weather such changes from year to year.

[3] We understand our charge to be to discuss ways to allocate TAT revenues, not the larger problems of how to tax visitors or how much to tax them. Those questions can be discussed elsewhere if necessary.
[4] From James Mak, "Sharing TAT Revenues in Hawaii: A Background Paper." Draft circulated to WG.

Exhibit 1: Change in TAT Collections over Time

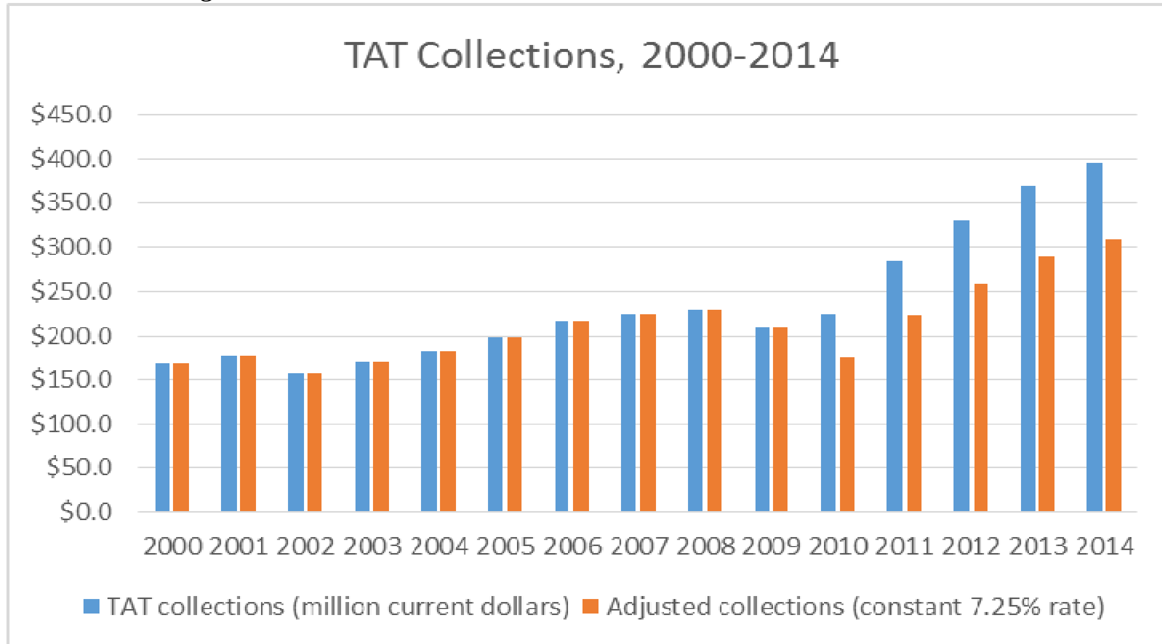
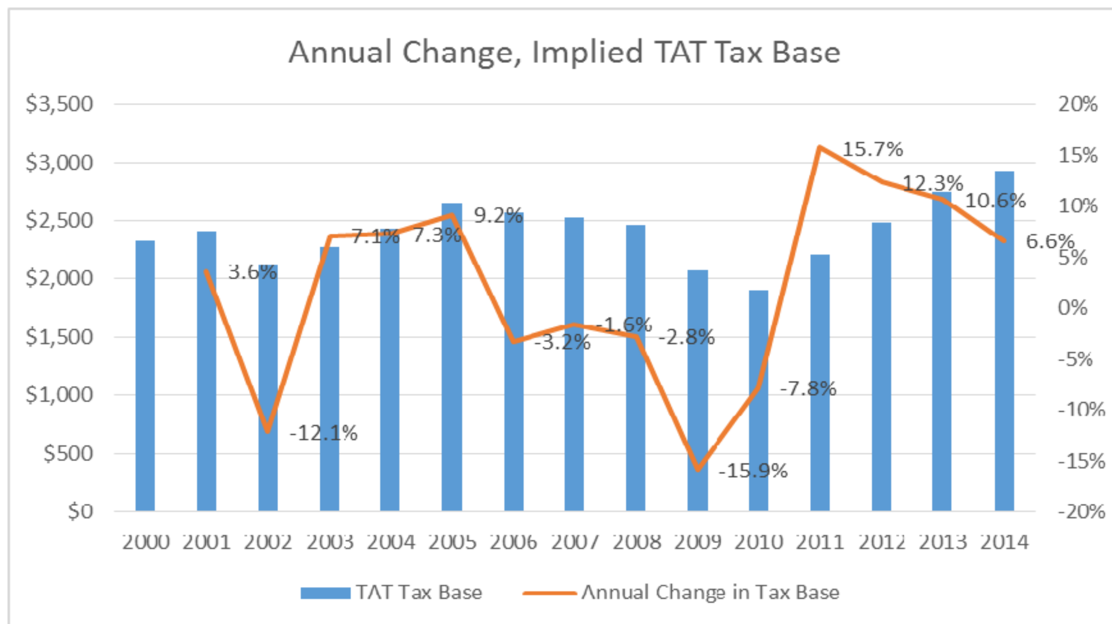


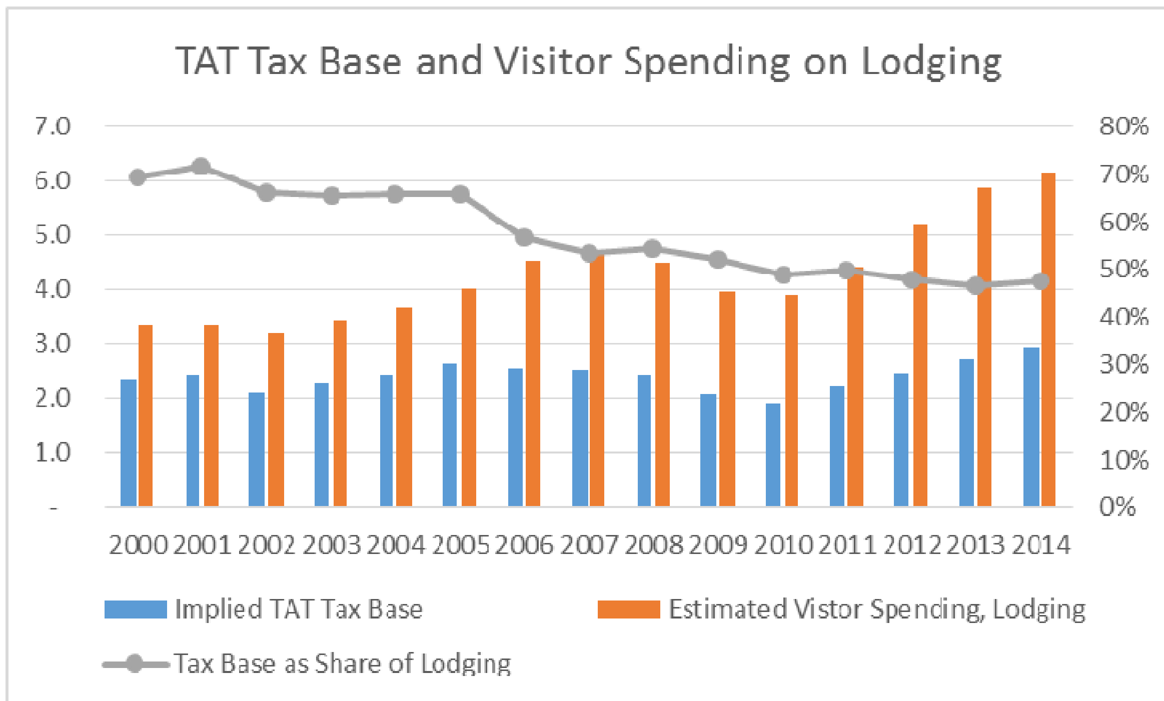
Exhibit 2: Annual Change in TAT Tax Base



NOTE: The tax base is shown in current (real) million $s for Fiscal Years. .

TAT is not collected from all visitor accommodations. When the implied TAT tax base is contrasted with the estimated total visitor spending on accommodations, it appears that about 50% to 70 % of visitor spending on accommodations is actually taxed – and the share taxed has been steadily declining.[5]

Exhibit 3: TAT Tax Base compared to HTA Estimated Annual Visitor Spending on Lodging



NOTES: Dollar values are billions of current dollars. Fiscal year values for visitor spending estimated by averaging the amounts for the former and latter calendar year in each fiscal year.

We can estimate future TAT collections on the basis of scenarios for visitor spending and for TAT compliance. Over the long term, visitor spending is anticipated to increase slowly, as shown in the DBEDT 2040 Series forecast:

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5 The implied tax base was calculated by Dr. Mak in Table 3 of the background paper circulated to the WG. The estimate of total visitor spending on accommodations comes from the *Annual Visitor Research Reports* published by DBEDT and HTA. Because the two series are based on different sources, with different limitations, the differences between the two could be due to many factors, of which failure of some accommodations to pay the TAT is only one possible source.

Exhibit 4: DBEDT Forecast of Population and Visitor Spending, to 2040

	2010 to 2015	2015 to 2020	2020 to 2025	2025 to 2030	2030 to 2035	2035 to 2040
Resident Population	0.8%	0.9%	0.8%	0.8%	0.7%	0.6%
Average Visitor Census	2.0%	0.7%	0.9%	0.8%	0.8%	0.8%
Visitor Expenditures (Mill $s)	5.0%	3.5%	3.3%	3.3%	3.3%	3.3%

Hospitality Advisors anticipates growth in visitor units and spending over the next ten years. This growth will be described at the September 16 meeting. Two scenarios can be described:

- Collections at current rate and level of compliance; and
- Increased collections, with compliance increasing (as measured by TAT tax base increasing from 50% to 70% of total visitor spending on lodging).

Exhibit 5 anticipated those scenarios, using $425 million as the FY 2015 starting point and the DBEDT rates of change in visitor spending to forecast TAT revenue growth. The results can be compared with the amount needed for a fixed baseline (starting at $82 million for the TSF, and $103 million each for the State and counties, and increasing with the CPI-U). Exhibit 6 compares future collections (using the lower of the two scenarios) with the baseline.

The anticipated future collections, even with current levels of compliance, are large enough that baseline amounts come to less than 80% of collections in the preceding year, i.e., a sudden one-year decline in the visitor industry and in collections would not jeopardize the baseline allocations, as shown in Exhibit 6.

Exhibit 5: TAT Scenarios, using DBEDT Forecast Growth in Spending

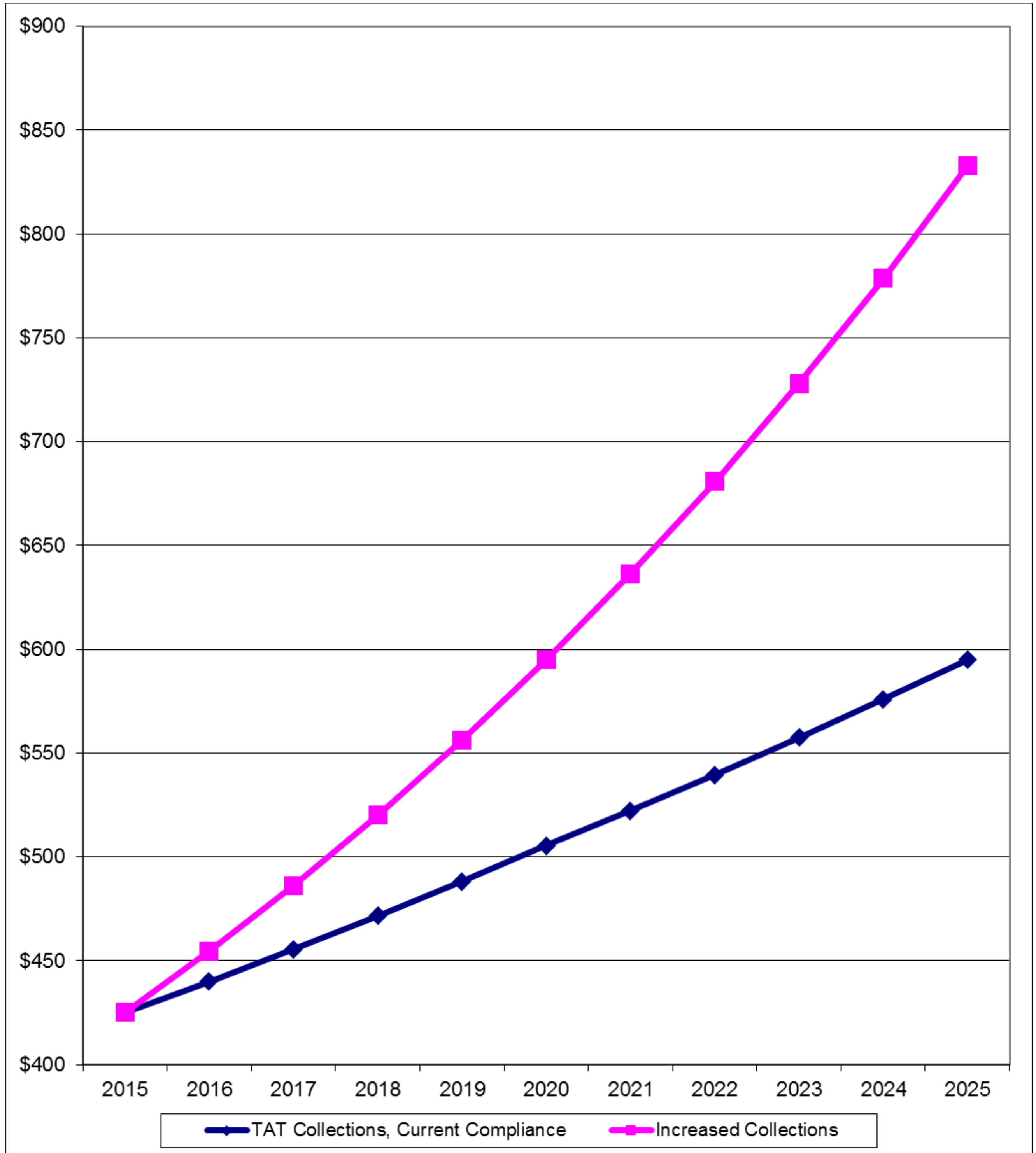
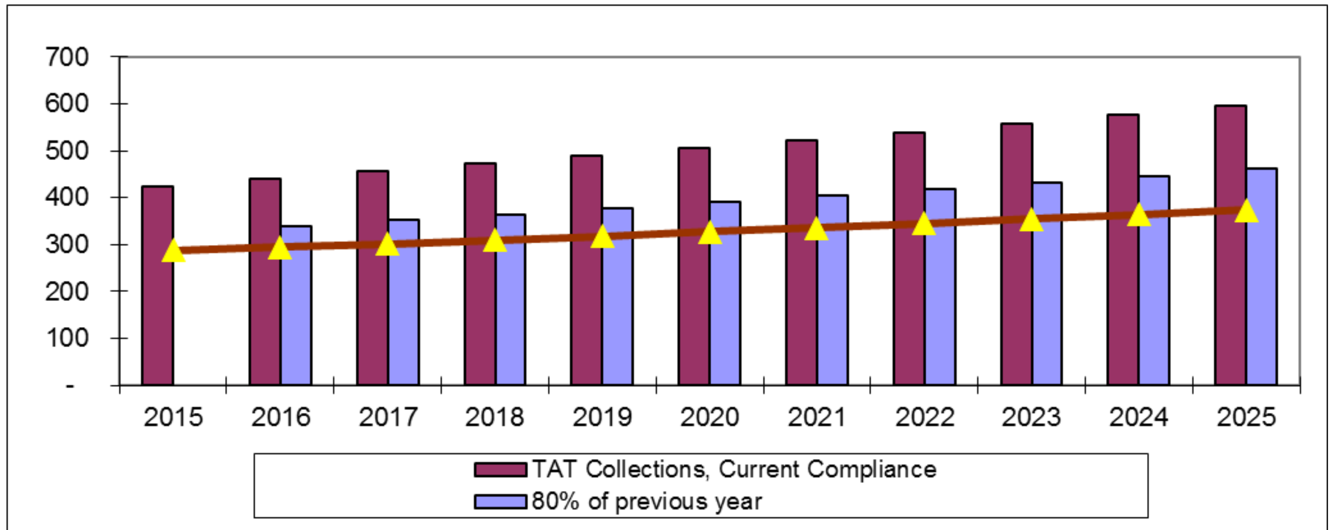


Exhibit 6: TAT Collections vs. Baseline



NOTE: 80% of previous year is used here as low estimate of each year's collections in the event of a major downturn.

With these revenue scenarios in hand, allocations can be anticipated for the simple Percentages Model, the Recommended Model, and a version of the Recommended Model in which the TAT allocation is pegged at 20% of collections (in Exhibits 7-9).

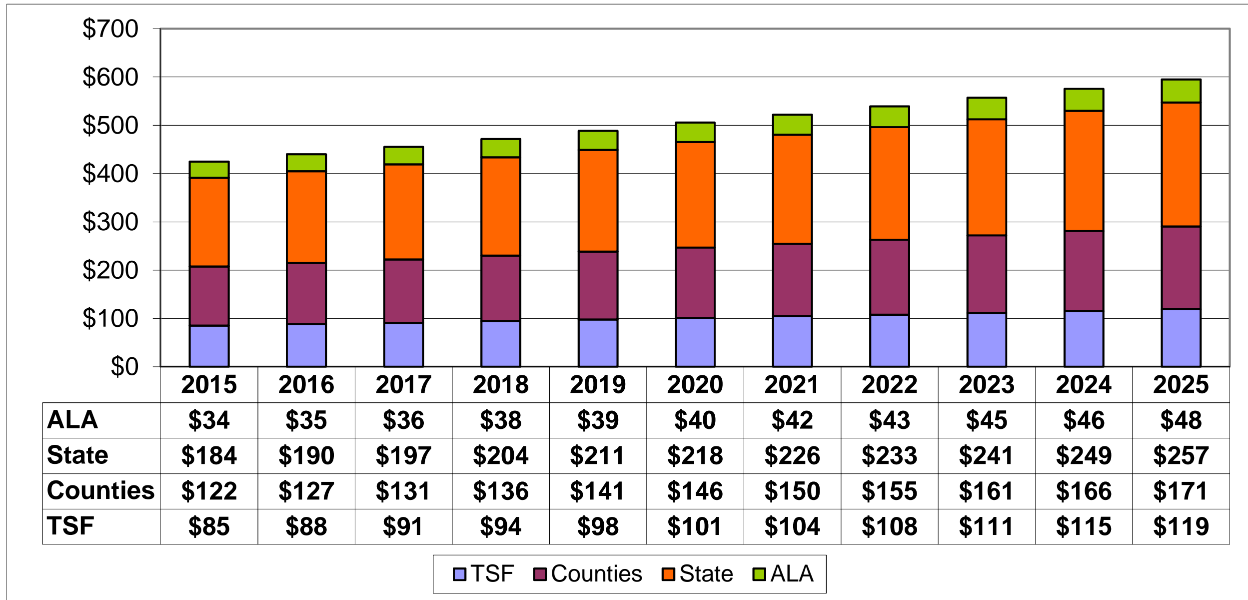
Exhibit 7: TAT Allocations, Percentages Model

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
State	$191	$198	$205	$212	$220	$227	$235	$243	$251	$259	$268
Counties	$149	$154	$159	$165	$171	$177	$183	$189	$195	$202	$208
TSF	$85	$88	$91	$94	$98	$101	$104	$108	$111	$115	$119

Exhibit 8: TAT Allocations, Recommended Model

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
ALA	$34	$36	$37	$39	$41	$42	$44	$46	$47	$49	$51
State	$185	$193	$201	$210	$219	$228	$237	$247	$256	$266	$276
Counties	$123	$129	$134	$140	$146	$152	$158	$164	$171	$177	$184
TSF	$83	$83	$83	$83	$83	$83	$83	$83	$83	$83	$83

Exhibit 9: TAT Allocations, Variant of Recommended Model, TSF defined by Share



	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
ALA	$34	$35	$36	$38	$39	$40	$42	$43	$45	$46	$48
State	$184	$190	$197	$204	$211	$218	$226	$233	$241	$249	$257
Counties	$122	$127	$131	$136	$141	$146	$150	$155	$161	$166	$171
TSF	$85	$88	$91	$94	$98	$101	$104	$108	$111	$115	$119

An Approach Based on Lessons Learned from Reviewing the Above Models:

The following approach is presented for review by the WG. It draws on the Recommended Model and the critique offered above.

1. Identify annual baseline shares for TSF, counties and State based on FY 2015 distribution ($82 million, $103 million, $103 million) increased in line with inflation.[6]
2. Once TAT revenues will clearly exceed the combined baseline shares, distribute these amounts.[7] If TAT revenues appear unlikely to exceed the combined baseline shares, distribute the full TSF share and reduce the share of the State and counties proportionately.
3. Hold the next 20% of the combined baseline shares until the end of the fiscal year. If by that time, collections exceed 120% of the baseline shares, distribute the 20% to the TSF, counties, and State in proportion with their baseline shares (i.e., a division of 29.1%, 35.45% and 35.45%).If the total collection does not exceed 120% of the combined baseline shares, all revenues over the baseline are to be allocated by the Legislature.
4. Additional revenues would be allocated by the Legislature.

This approach provides for predictability and, by some measures, fairness. It is meant to be simple. Because it calls for two phases of distribution, based on revenues collected, it demands an additional step beyond those of the Recommended Model. It differs from the Recommended Model in allotting both the

[6] Inflation can be usefully pegged to the reported year-over-year increase in CPI-U for Honolulu (through June or September) reported in DBEDT's *Quarterly Statistical and Economic Report* each December.

[7] Distributions may be made on an annual basis or for shorter terms (e.g., monthly or quarterly). This question can be addressed after discussion with the Department of Taxation.

TSF and the Counties a share in revenues above the combined baseline, but then limiting their total guaranteed amount. The two-step allocation process makes 20% of baseline potentially available to the Legislature for strategic redistribution to respond to near-term events (e.g., a sudden reduction in tourism spending).

This model explicitly treats revenues as distributed when received, not when the Legislature chooses to include them in budgets. The Legislature can rely on the estimates developed for the Council on Revenues by the Departments of Taxation and Department of Budget and Finance to project the amount available for the State through the fiscal year.

Exhibit 10: TAT Allocation by "Lessons Learned" Approach

$700
$600
$500
$400
$300
$200
$100
$0

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
State	$203	$218	$234	$250	$266	$283	$300	$317	$335	$354	$373
Counties	$124	$124	$124	$124	$124	$124	$124	$124	$124	$124	$124
TSF	$98	$98	$98	$98	$98	$98	$98	$98	$98	$98	$98

TSF Counties State