Economic Impacts of Granting a GET Exemption for Sales to the Federal Government

Report to the Hawaii State Legislature

Pursuant to Senate Concurrent Resolution 164, 2016 Legislative Session

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Research and Economic Analysis Division

Department of Business, Economic Development and Tourism

State of Hawaii

STATE OF HAWAII • DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT & TOURISM

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<u>Overview of federal contracts performed in Hawaii</u>

- On average, $2.4 billion dollars of federal contracts were awarded every year for works performed in Hawaii during the past decade. During the FY2011-2015 period, about 90 percent, by dollar obligated, of total federal contracts performed in Hawaii were awarded by the Department of Defense. Grouped by the place of work performed, the federal contracts were highly concentrated in Honolulu County, accounting for 93 percent of the total federal contracts awarded in Hawaii during the five year period.

- Of the total federal contracts awarded in Hawaii during the FY2011-2015 period, 15.5 percent were to purchase goods while the remaining 84.5 percent were to purchase services. The top three areas the federal government purchased services in Hawaii were Maintain/Repair/Alter Real Property ($425M/year), Construction of Structure/Facilities ($421M/year) and Maintain/Repair/Rebuild Equipment ($252M/year).

- By dollar amount obligated, federal contracts awarded during the FY2011-2015 period were more to local businesses than to out-of-state businesses. Of the total federal contracts performed in Hawaii, 58.8 percent were awarded to local businesses. The share of the contracts awarded to local businesses were especially high in the area of R&D (86.1%), Utility and Housekeeping (69.5%), Maintain/Repair/Alter Real Property (64.9%), and Construction of Structures/Facilities (63.3%).

<u>GET tax base from sales to the federal government</u>

- Not all the federal contracts performed in Hawaii were subject to the state general excise tax (GET). Some of them were exempt from GET under the current Hawaii tax law. The current exemptions from GET that are relevant for federal contract activities include;
  - Sales by tax exempt entities
  - Sales of tangible goods to the federal government
  - Building and repair of surface ships owned by the federal government
  - Certain scientific contracts with the United States
  - Certified or approved housing projects

- Taking account of all five exemptions granted currently, it was estimated that about 44.5 percent by dollar obligated of federal contracts performed in Hawaii were already exempt from GET. In other words, of the average $2.4 billion federal contracts performed in Hawaii per year, $1.4 billion (55.5 percent) sales to the federal government were estimated to be liable for GET.

<u>GET tax revenue from sales to the federal government</u>

- If we assume no significant change in future federal contracting from what we observed in past years, the expected loss in state tax revenue as a result of the proposed tax exemption would be the amount of the GET that the state has been collecting for sales to the federal government. Since businesses don't report the source of their revenue when they file GET, the actual GET collection data don't allow us to separate the sales to the federal government from the company's other sales, and therefore have a very limited use in estimating the GET revenue from sales to the federal government.

- We estimated the GET tax revenue based on the estimated GET tax base making the following two assumptions.

  1. All local businesses complied with Hawaii tax laws.
  2. An out-of-state business complied with Hawaii GET tax laws if the business had an active Hawaii GET license during the tax period.

- If we project that the future level of sales to the federal government in Hawaii would be similar to the average of what we experienced in FY2011-2015, which was $2.4 billion per year, the expected loss in state tax revenue from the proposed tax exemption would be $57.8 million per year ($52.2 million per year in the state general fund revenue and $5.6 million per year in the Honolulu rail surcharge).

Likely impacts of the proposed tax exemption on federal contract competition

- The proposed tax exemption will allow local businesses to lower their bidding prices by 4 - 4.5% at federal contract competition. However, it will not necessarily increase local companies' chance of winning against out-of-state businesses. A local business will gain competitive advantage from the proposed tax exemption only if the company is competing with out-of-state businesses that have not been paying Hawaii GET.

- We examined the tax- paying practices of out-of-state businesses that have awarded Hawaii federal contracts in FY2015. Our research showed that among the 1,707 out-of-state businesses, 43 percent (726 businesses) had an active GET licenses during the tax period. The contracts carried out by the 726 companies accounted for 90 percent of the total GET tax base from sales to the federal governments in that year, implying a high likelihood that the proposed tax exemption may not help local businesses successfully compete for federal contracts.

- We also conducted a survey of the federal contract officers who have handled Hawaii contracts in the past as to how the 4% price cut would impact the federal agency's selection of contractor. The survey responses showed a more or less even distribution among "slight impact", "moderate impact", and "strong impact" with about 4% expressing "no impact at all".

- During the FY2011-2015 period, 23 percent, by dollar obligated, of total federal service contracts awarded to out-of-state businesses were awarded without competition, i.e. only one offer received. They might include the contracts that were not available for competition, and contract actions that were full and open competition but didn't have more than one business who was interested in or was capable of carrying out the work. The proposed tax exemption is not expected to increase the chance of local businesses' winning the contract at least for this portion of contract activities. It is also likely that the cost-saving from the tax exemption is not be passed onto the federal government in this low-competition case.

<u>Economic impacts of the proposed tax exemption</u>

- The immediate impact of the proposed tax exemption would be the reduced tax revenue to the state government. While the state government loses its revenue, the businesses who have been paying GET for sales to the federal government, both local and out-of-state businesses, would benefit from the tax exemption. If we assume that the businesses would lower their bid prices by the saving from the tax exemption, the saving will eventually be passed on to the federal government. If not, the saving will stay with the businesses.

- If the state government increases taxes on other sectors to keep the same level of tax revenue after granting the proposed tax exemption, the resources would shift from the other sectors affected to the businesses who sell services to the federal government or to the federal government if the saving is passed on to the federal government.

- The positive impacts on Hawaii economy are expected if a local business is awarded a federal contract that would otherwise be awarded to an out-of-state business as a result of the tax exemption. Replacing an out-of-state business with a local business to conduct a Hawaii contract would create some positive impacts on Hawaii economy as in general local businesses are more likely to hire and buy locally thus creating new jobs in the local area and boosting other local businesses.

- However, the extent of the positive impacts would be different depending on how the out-of-state businesses are doing business in Hawaii. If the out-of-state business would do the Hawaii project remotely without using many local resources, the impacts of the switch would be large. The positive impacts of the switch would be relatively small though if the out-of-state business would do the Hawaii project by heavily relying on local resources.

GET revenue estimate based on the FY2011-2015 Data

Total sales to the federal government occurred in Hawaii

On average, $2.4 billion per year

Subtract current exemptions from GET

- Sales by tax-exempt entities
- Sales of tangible goods to the federal government
- Building and repair of surface ships owned by the federal government
- Certain scientific contracts with the federal government
- Certified housing projects

-->44.5% are currently exempt

GET tax base from sales to the federal government

On average, $1.4 billion contracts were liable for GET per year

Assume that;

1. Local businesses are complying with GET laws
2. Out-of-state businesses pay GET if they have active GET licenses

GET revenue from sales to the federal government

$58 million GET revenue per year

The proposed tax exemption will result in a shift of resources from the state government (or other sectors in Hawaii if state government increases taxes on other sector to keep the same level of revenue) to the businesses who sell services to the federal government or to the federal government if the saving from the tax exemption is passed on to the federal government.

Economic Impacts of the proposed tax exemption

Will the local businesses have a 4% comparative advantage in price as a result of the tax exemption?

Among the 1,707 out-of-state businesses that engaged in Hawaii federal contracts in FY2015, 726 businesses (43%) had a GET license. In terms of the GET tax base, these businesses accounted for 90% of the GET tax base from sales to the federal government in that year.

Is "4% price cut" critical enough to change the federal agency's selection of contractors?"

Not Certain. According to our survey of federal contracting officers, the answers were divided more or less evenly among "slight impact", "moderate impact", and "strong impact".

Yes ?

Economic impacts of "Local business doing a Hawaii project" vs. "Out-of-state business doing the Hawaii project"

Since local businesses tend to hire and purchase more locally, the replacement of out-of-state businesses with local businesses would create positive impacts on Hawaii economy.

1. Introduction

Senate Concurrent Resolution No. 164, Hawaii 2016 regular session requested DBEDT to conduct a study on the potential increase in economic activity that would result from granting an exemption for the sale of goods and services to the federal government from the state general excise tax (GET). The positive economic impacts would be generated if the proposed tax exemption could help local businesses win federal contracts that used to be awarded to out-of-state businesses. In order for this to happen, a few conditions have to be met. In this study, we first estimate the expected loss in state tax revenue from the proposed tax exemption, which is the immediate impact of the tax exemption. Then, we discuss the likely positive impacts of the tax exemption on Hawaii economy by examining the preconditions.

Section two provides an overview of the federal contracts awarded for the sale of goods and services performed in Hawaii. Special attention was given to the location of contractors as different GET payment practices by the location of contractor was indicated in the Senate resolution. As a prerequisite to estimate the GET revenue, the GET tax base from sales to the federal government was estimated in section three. The main task in this section was to identify federal contracts that were already exempt from the GET based on information available from the federal procurement database. Section four estimated the expected loss in state tax revenue from the proposed tax exemption. Section five presents results from a survey of the federal contract officers who actually have handled Hawaii contracts as to how the 4 percent price cut made possible from the proposed tax exemption would affect the contracting agency's selection of contractor. Incorporating all the findings from the previous sections, section six discusses the impacts of the proposed tax exemption on Hawaii economy.

<u>Data source</u>

The main data source for this study was the federal procurement database assessable on the USAspending.gov website. The database was launched by the Federal Funding Accountability and Transparency Act (FFATA) as the official database for federal contracts, grants, loans, insurance, and other financial assistance. The data on USAspending.gov is updated daily. Agencies are required to submit data files within 30 days after making an award or after making a modification/transaction to an award, except for the Department of Defense which delays its submission by 90 days to protect operations.[1] The federal procurement data used in this study were downloaded on July 12, 2016.

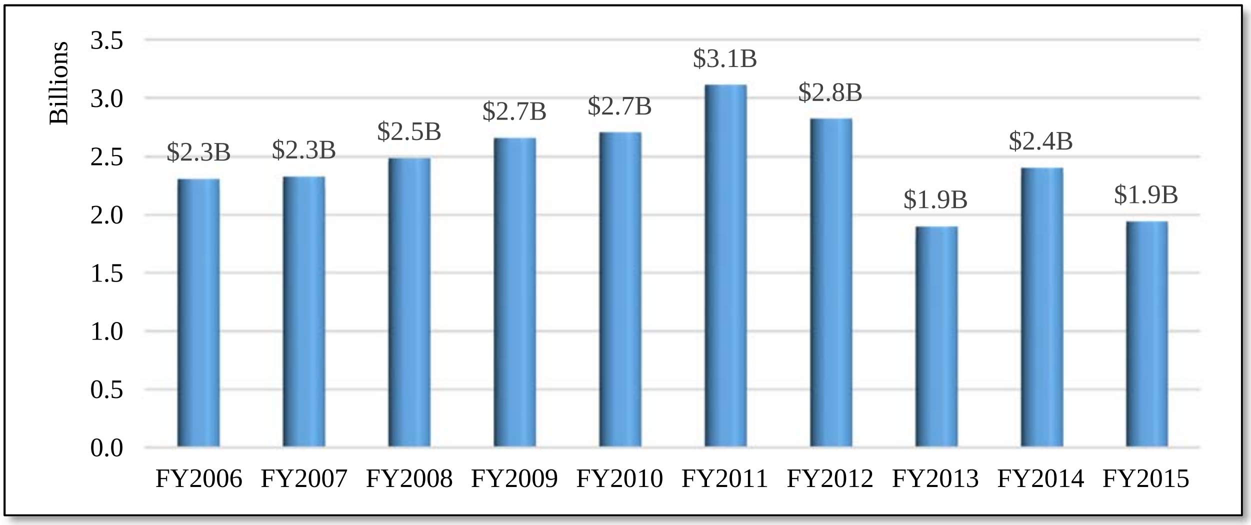
2. Overview of federal contracts in Hawaii

A good understanding of sales to the federal government occurring in Hawaii is a must for studying the impacts of the proposed tax exemption. In this section, we examined the magnitude

[1] https://www.usaspending.gov/about/Pages/TheData.aspx

and major characteristics of the federal contracts performed in Hawaii in past years. Figure 1 presents total amounts of the federal contracts awarded for works performed in Hawaii from FY2006 to FY2015.[2] The total amounts were relatively stable in the range of $2.3-2.7 billion until 2010 while the next 5 years showed more fluctuation. Even if the total amounts varied sometimes extensively by year, roughly 2 to 3 billion dollars of federal contracts were awarded annually for works performed in Hawaii during the past decade.

Figure 1. Total federal contracts awarded for works performed in Hawaii *



* Hawaii is the primary place of performance

We also examined the major characteristics of the federal contracts performed in Hawaii based on the past five year contract data. During the FY2011-2015 period, about 90 percent by dollar obligated of total federal contracts performed in Hawaii were awarded by the Department of Defense. The Department awarded a total of $11 billion in contracts during the five year period, which was $2.2 billion per year on average. General Service Administration was the second from the top awarding on average $62 million contracts annually. Departments of the Interior, Veterans Affairs, Homeland Security, Housing and Urban Development, and Transportation followed, awarding $20-30 million in federal contracts annually for works performed in Hawaii.

Grouped by the place of work performed, the federal contracts were highly concentrated in Honolulu County, accounting for 93 percent of total federal contracts performed in Hawaii during the five year period. This is relatively a high share considering that Honolulu County consisted of 69.8 percent of total state population and 76.6 percent of total state GDP in 2015. This is because the bulk of the federal contracts were awarded by the Department of Defense and Honolulu County is where the majority of military population and facilities are located.

[2] FY in this report denotes the fiscal year for the federal government which begins on October 1 and ends on September 30.

Figure 2. Hawaii federal contracts by agency (FY2011-15, by contract amount)

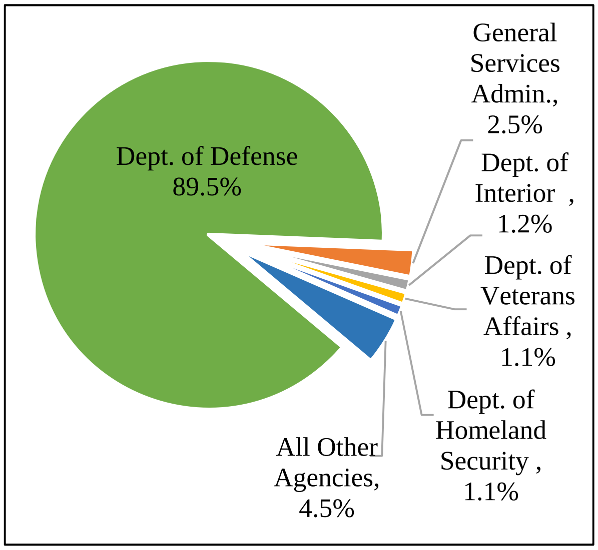
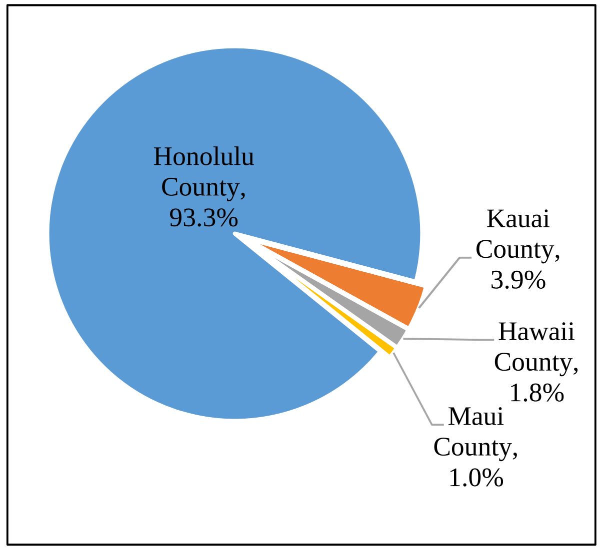
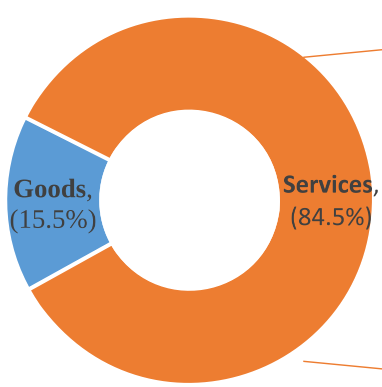


Figure 3. Federal contracts by place of work performed (FY2011-15, by contract amount)



Each contract activity is classified by the contracting agency using a multiple classification system such as NAICS (industry code) and PSC (product service code). Figure 4 shows federal contracts performed in Hawaii by PSC, i.e the products and services that were purchased through the contract. This classification was especially useful in this study because some of GET exemptions could be identified based on PSC classification. Of the total federal contracts awarded in Hawaii during the FY2011-2015 period, 15.5 percent were to purchase goods. The top items purchased by the federal government during the period included Liquid Propellants-Petroleum Base ($168M/year), Misc Communication Equipments ($24M/year), and Dairy Foods and Eggs ($18M/year). The remaining 84.5 percent of the federal contracts were to purchase various services. The top three areas the federal government purchased services in Hawaii were Maintain/Repair/Alter Real Property ($425M/year), Construction of Structure/Facilities ($421M/year) and Maintain/Repair/Rebuild Equipment ($252M/year).

Figure 4. Hawaii federal contracts by products and services to be purchased (FY2011-2015)



Total services	**84.5%**
Maintain, Repair, Alter Real Property	17.4%
Construction of Structures/Facilities	17.3%
Maintain, Repair, Rebuild Equipment	10.3%
Support Serv. (Prof, Admin, Mgmt)	8.2%
Utilities and Housekeeping	5.0%
ADP and Telecommunications	5.0%
Architect/Engineer Services	4.3%
All Other Services	17.0%

Share of federal contracts awarded to local businesses

By dollar amount obligated, the federal contracts awarded during the FY2011-2015 period were more to local businesses than to out-of-state businesses. In fact, 58.8 percent of the total federal contracts were awarded to local businesses while the remaining 41.2 percent were awarded to out-of-state businesses. However, the share of contracts awarded to local businesses varied significantly by what products or services were purchased. In general, the role of local businesses was more important in the sale of goods than in the sale of services. Among the sale of services, the share of local businesses was relatively high in R&D (86.1%), Utility and Housekeeping (69.5%), Maintain/Repair/ Alter Real Property (64.9%), and Construction of Structures/Facilities (63.3%), while the share was relatively low in the area of Transport/Travel/Relocation (27.9%), Support Services (33.2%), Natural Resource Management (39.8%), ADP & Telecommunication (42.5%), and Architect/Engineer Services (45.1%).

Figure 5. Hawaii federal contracts by location of awardee (in terms of contract amount)

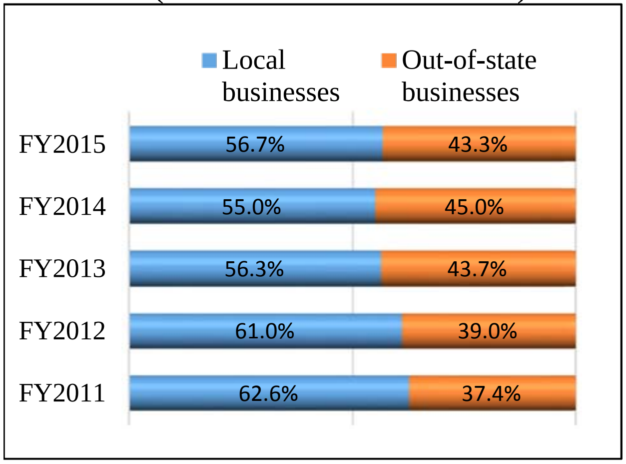


Table 1. Hawaii federal contracts by product service code & by location of awardee(FY2011-15)

	Total contract amount for 5yrs FY2011-2015 ($ million)	Avg. annual amount of contracts ($ million)	Contracts awarded to local businesses (%)	Contracts awarded to out-of-state businesses (%)
Total	**$12,186**	**$2,437**	**58.8%**	**41.2%**
Goods	$1,885	$377	70.8%	29.2%
Services	$10,301	$2,060	56.6%	43.4%
Maintain, Repair, Alter Real Property	$2,124	$425	64.9%	35.1%
Construction of Structures/Facilities	$2,105	$421	63.3%	36.7%
Maintain, Repair, Rebuild Equipment	$1,259	$252	59.4%	40.6%
Support Services (Prof, Admin, Mgmt)	$1,001	$200	33.2%	66.8%
Utilities and Housekeeping	$607	$121	69.5%	30.5%
ADP and Telecommunications	$605	$121	42.5%	57.5%
Architect/Engineer Services	$528	$106	45.1%	54.9%
Research and Development	$457	$91	86.1%	13.9%
Operation of Gov't Owned Facility	$452	$90	72.4%	27.6%
Natural Resources Management	$306	$61	39.8%	60.2%
Transport, Travel, Relocation	$289	$58	27.9%	72.1%
Medical Services	$270	$54	43.3%	56.7%
All Other Services	$299	$60	28.6%	71.4%

3. Tax base for Hawaii GET from sales to the federal government

Not all the federal contracts presented in the previous section were subject to the Hawaii GET. Some of them were exempt from GET under the current Hawaii tax law. In general, the location of the business is not the factor to determine any of the current GET exemptions. For the sale to the federal government that GET is applied under current Hawaii tax law, out-of-state businesses are subject to GET same as local businesses would be, assuming that the out-of-state business has a nexus with Hawaii to conduct the Hawaii project.

Who and what activities are currently exempted from Hawaii GET?

Certain persons and certain business activities are already exempt from the Hawaii GET.

- Sales by tax exempt entities (§237-23)

  The current GET laws list eleven groups who are exempt from GET, including corporations, associations, trusts, or societies organized and operated exclusively for religious, charitable, scientific, or educational purposes.

- Sales of tangible goods to the federal government (§237-25)

  Tangible personal property sold to the federal government, except federal cost-plus contracts, are exempt.

- Building and repair of surface ships owned by the federal government (§237-28.1)

  All of the gross proceeds arising from shipbuilding and ship repairs rendered to surface vessels federally owned or engaged in interstate or international trade are exempt.

- Certain scientific contracts with the United States (§237-26)

  The gross income earned by a contractor or subcontractor from certain scientific contracts with the federal government are exempt from GET. Scientific work is work involving primarily the research and development for, or the design, manufacture, instrumentation, installation, maintenance, or operation of aerospace, agricultural, astronomical, biomedical, electronic, geophysical, oceanographic, test range, or other scientific facilities. Maintenance or operation, for purposes of this exemption, shall include housekeeping functions in providing certain nonscientific logistic and support services.

- Certified or approved housing projects (§237-29)

  The gross income received by contractors and other businesses for the planning, design, financing, construction, sale, or lease of a qualified low or moderate income housing project in the State is exempt from GET.

Estimation of GET tax base from sales to the federal government

The GET tax base is the total amount of business activities that the state government can tax under Hawaii GET tax law. To estimate the GET tax base, we first identified the federal contracts that were likely to be exempted from GET using information available from the federal procurement database.

The federal procurement database used in this study includes 225 variables with detailed information on contracts, purchasing agencies, competition type, and various characteristics of contractor. Some information, such as tax-exempt status, organization type, product and service code, etc., were useful in determining their eligibility for GET exemptions. However, since none of those variables were directly about its eligibility for Hawaii GET exemptions, the exercises done in this section produced only approximates of the actual GET exemptions.

The composition and characteristics of the federal contracts performed in Hawaii varied by year. To minimize the impact of the year-specific variations, we analyzed five year contracting activities rather than one year activities to estimate the size of the federal contracts eligible for GET exemption. Based on the federal contract activities conducted during the FY2011- 2015 period, the sales to the federal government that were exempt from GET were estimated as follows;

- Sales by tax exempt entities

  Tax-exempt for federal income tax purposes doesn't necessarily mean the business is automatically exempt from paying GET. But, since no direct information on GET exemption of each contract was available from the database, we estimated the GET exempt status of the business based on its federal tax-exempt status and other variables on organization type. About 3.2 percent ($79 million per year) of total federal contracts awarded during the FY2011-2015 period were estimated to have been awarded to the GET-exempt entities.

- Sales of tangible goods to the federal government

  As mentioned in the previous section, 15.5 percent of sales to the federal government performed in Hawaii during the FY2011-2015 period were the sale of goods. Excluding the contracts awarded using the cost-plus contract method, about 15.2 percent ($370 million per year) of total federal contracts awarded for Hawaii project were estimated to be exempt from GET under this exemption.

- Building and repair of surface ships owned by the federal government

  Using the product and service code for ship repairs and the contract description as supplementary information, about 6.2 percent ($150 million per year) of total federal contracts performed in Hawaii were estimated to be eligible for this exemption.

- Certain scientific contracts with the United States

  Identifying scientific work that was eligible for the GET exemption was challenging. Contracts involving research and development were approximated based on the product and service code (PSC). The PSC also allowed us to identify some design or maintenance work that was for scientific facilities. However, many contracts lacked the information about whether the work was for a scientific facility or not. Thus, we adopted the estimate done by the Hawaii Department of Taxation. In a response to the state legislature's request, the Department estimated the total amount of scientific contracts with the federal government at $500 million per year. For the contract activities of which relation with the scientific facility could not be determined by the information in the database, we assumed that a certain percentage of the contracts in each PSC category were for scientific facilities. The percentage of the scientific facility work in each PSC category was determined to produce the total of $500 million per year. $500 million per year was 20.4 percent of the total federal contracts performed in Hawaii during the FY2011-2015 period.

- Certified or approved housing projects
  It was assumed that all federal construction projects in the PSC category of "Construction of troop housing" were eligible for this exemption. About 1.1 percent ($131 million contracts during the FY2011-2015, which is $26 million per year) were estimated to be eligible for this exemption.

Taking account of all five exemptions granted currently, it was estimated that about 44.5 percent by dollar obligated of the federal contracts performed in Hawaii were already exempt from GET. In other words, among on average the total of $2.4 billion federal contracts performed in Hawaii per year, $1.4 billion (55.5 percent) sales to the federal government were estimated to be liable for GET.

<u>When are out-of-state businesses subject to GET?</u>

An out-of-state-business would subject to GET if it has a nexus with Hawaii. Although the exact definition of nexus varies by state and by tax, the following statement by Sales Tax Institute, a sales-tax resource agency, explains what "nexus" is.[3]

> Nexus, also known as sufficient physical presence, is the determining factor of whether an out-of-state business selling products into a state is liable for collecting sales or use tax on sales into the state. Nexus is required before a taxing jurisdiction can impose its taxes on an entity. Nexus is created if your company maintains a temporary or permanent presence of people (employees, service people or independent sales/service agents) or property (inventory, offices, warehouses). The temporary presence is created through traveling people visiting states to call on customers or prospects, trade show attendance, or consigned inventory in warehouses.

[3] Sales Tax Institute, http://www.salestaxinstitute.com/

The Hawaii Department of Taxation defined the nexus for Hawaii GET as follows in a tax information release. [4]

> "Nexus" means the activity carried on by a seller in Hawaii which is sufficiently connected with the seller's ability to establish or maintain a market for its products in Hawaii. It includes issues of taxability addressed under the Due Process and Commerce Clauses of the United States Constitution to support the application of the GE tax and the use tax under chapters 237 and 238, Hawaii Revised Statutes ("HRS"), respectively.

Various easier-to-understand version of tax information on Hawaii GET nexus are also provided by many tax experts. However, they are only guidelines as is the information from the Hawaii Department of Taxation. The actual nexus standing of each business activity has to be determined by tax professionals after careful examination of the business activity and the state tax law. For this reason, it could not be estimated based on the federal procurement database how much of the sales to the federal government carried out by out-of-state businesses had GET nexus with Hawaii and therefore subjected to GET.

4. Estimation of expected loss in GET revenue

If we assume no significant change in the future federal contracting from what observed in the past, the expected loss in Hawaii tax revenue as a result of the proposed tax exemption would be the amount of GET that the state has been collecting for sales to the federal government.

In FY2015 alone, about 1,000 local businesses and about 1,700 out-of-state businesses had at least one transaction with the federal government for the federal contracts performed in Hawaii. It includes all types of purchases made by the federal government, ranging from a few hundred dollars of delivery order of bread to over $50 million construction contract. The federal contracts performed in Hawaii by local businesses would subject to Hawaii GET unless the business is a GET exempt entity or the activity is exempt from GET. If they actually paid GET or not is an issue of tax evasion, which is beyond the scope of this study. Thus, we simply assumed that local businesses were complying with the Hawaii tax law and focused on explaining the tax-paying practices of out-of-state businesses to estimate the GET revenue collected for sales to the federal government.

As for the federal contracts performed in Hawaii and fulfilled by out-of-state businesses, depending on the nature of the work, it might be possible for an out-of-state business to carry out a Hawaii project without having a GET nexus with Hawaii, and therefore not subject to GET. Or, some out-of-state businesses simply were not complying with the Hawaii tax law. In order to get some inkling on the tax-paying practices of out-of-state businesses, DBEDT requested the state Department of Taxation to check the actual amount of GET paid by the top 100 out-of-state businesses for the federal fiscal year 2015 from October 2014 to September 2015. The ranking

[4] Tax Information Release No. 95-5, Department of Taxation, State of Hawaii, December 19, 1995,

was determined by the estimated GET tax base from sales to the federal government occurred in FY2015. To protect confidentiality of individual tax record, the Department of Taxation provided DBEDT only aggregated results of its examination.

According to the Department of Taxation, 12 businesses of the 100 businesses did not have a GET license or had a company name that exactly matched the taxpayer names on the license. Of the 88 businesses that had a GET license, 22 businesses didn't file any G-45 or G-49 between October 2014 and September 2015. Of the 66 businesses that filed G-45 or G-49, 10 businesses didn't have any GET liability and 56 companies paid a total of $24.9 million GET during the one year period. [5]

Possible explanation for the businesses that didn't have a GET license, didn't file GET form, or had no GET liability might be subcontracting and time difference between award and actual revenue. Although the exact relationship between prime contracts and subcontracts could not be identified, the subcontract database showed that 25 out of the top 100 out-of-state businesses have subcontracted out some of the contracts they awarded by the federal governments.

A total of $24.9 million GET collection implies over $550 million GET tax base. Since businesses don't report the source of their revenue when they file GET, we can't tell what portion of this tax payment were for their sales to the federal government. However, at least it tells us that many, if not all, out-of-state businesses have been complying with Hawaii tax law.

<u>Estimating the GET revenue using federal procurement database and GET license</u>

Due to the time and resource constraint, the Hawaii Tax Department checked the actual tax payment of the top 100 businesses instead of all 1,707 out-of-state businesses. Even if the tax department was able to do the checking for all businesses, the actual tax collection data would have only limited use in estimating the GET revenue from sales to the federal government. This is because the tax collection data doesn't allow us to separate sales to the federal government from the company's other sales. Instead, we attempted to estimate the GET revenue from sales to the federal government based on the GET tax base derived in the previous section.

We first searched for GET license of all 1,707 out-of-state-businesses that awarded federal contracts performed in Hawaii in FY2015. Table 2 summarizes the search results. Among the 1,707 out-of-state businesses, 43 percent (726 businesses) had an active GET licenses during the tax period. However, the dollar amount of the contracts carried out by the 726 companies accounted for 90 percent of the total GET tax base from sales to the federal government in that year. This is because the businesses without a GET license were likely to be one with no or small GET liability probably due to various current GET exemptions or subcontracting.

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[5] G-45 and G-49 are tax forms to be used to file periodic and annual GET tax returns.

Table 2. Businesses with GET license as percentage of total out-of-state businesses (FY2015)

Product or Service sold to federal government	Total number of out-of-state businesses engaged in Hawaii federal contract in FY2015	Out-of-state businesses with GET license (as percentage of total out-of-state businesses)	
		In terms of "no. of businesses"	In terms of "GET tax base"
Total	**1,707**	**43%**	**90%**
Goods	723	23%	100%
Services	984	57%	90%
Support Services (Prof, Admin, Mgmt)	187	50%	87%
Maintain, Repair, Rebuild Equipment	182	56%	98%
ADP and Telecommunications	108	62%	80%
Medical Services	64	58%	87%
Education and Training	58	21%	93%
Maintain, Repair, Alter Real Property	51	78%	99%
Architect/Engineer Services	48	73%	92%
Construction of Structures/Facilities	45	82%	99%
Natural Resources Management	36	50%	21%
Transport, Travel, Relocation	36	47%	61%
Utilities and Housekeeping	35	77%	98%
All Other Services	134	54%	39%

Next, we made the following two assumptions to estimate the GET tax revenue that the state has collected in FY2015 from sales to the federal government.

1. All local businesses complied with Hawaii tax laws.
2. An out-of-state business complied with Hawaii GET tax laws if the business had an active Hawaii GET license during the tax period.

A total of $1.9 billion federal contracts were awarded in FY2015 for works performed in Hawaii. Among those, $1.1 billion were estimated to subject to GET after taking account of all current exemptions. Assuming that all out-of-state businesses with a GET license paid their GET liability, it was estimated that the state has collected $45.5 million GET from sales to the federal government occurred in FY2015. For this estimation, the GET rate of 4.5% was applied to contracts performed in Honolulu County while the GET rate of 4.0% was applied to contracts performed in other three counties.

We also attempted to estimate the GET tax revenue from sales to the federal government for the period of FY2011-2014. Since searching for GET licenses was a very time-consuming task, GET license search was done only for the 1,707 out-of-state-businesses that awarded federal contracts in FY2015. Instead, we applied the PSC specific GET license holding practices that we found from the FY2015 list to the FY2011-2014 federal contract database. During the FY 2011-2015 period, an average of $2.4 billion federal contracts were awarded annually to be performed in Hawaii. Among those, $1.4 billion were estimated to subject to GET and an average $57.8 million GET were estimated to be collected per year during the five year period.

Table 3. Estimated GET tax base and GET revenue collected for sales to the federal government

Period	Total federal contracts performed in Hawaii	Estimated GET tax base from sales to the federal government	Estimated GET revenue from sales to the federal government
FY 2015	$1.9 billion	$1.1 billion	$45.5 million
FY 2011-2015 average (per year)	$2.4 billion	$1.4 billion	$57.8 million

Expected loss in tax revenue from the proposed GET exemption

If we assume that the overall characteristics of sales to the federal government in the future years would be similar to what were observed in the past years, the figures in the last column in Table 3 would serve as the best estimates of the expected loss in state tax revenue from the proposed tax exemption. If we assume that future sales to the federal government would be about the same as in FY2015 at $1.9 billion, the expected loss in state tax revenue would be $45.5 million per year. Or, if we believe that the 2015 level was abnormally low and the future level would be similar to the average of FY2011-2015 period, which was $2.4 billion per year, then the expected loss in state tax revenue from the proposed tax exemption would be $57.8 million per year ($52.2 million per year in the state general fund revenue and $5.6 million per year in the Honolulu rail surcharge).

5. Likely impacts of the proposed exemption on contract competition

The proposed tax exemption will allow local businesses to lower their bidding prices by 4 -4.5% at federal contract competition. However, it will not necessarily increase local companies' chance of winning against out-of-state businesses. A local business will gain competitive advantage from the proposed tax exemption only if the company is competing with the out-of-state businesses that have not been paying Hawaii GET.

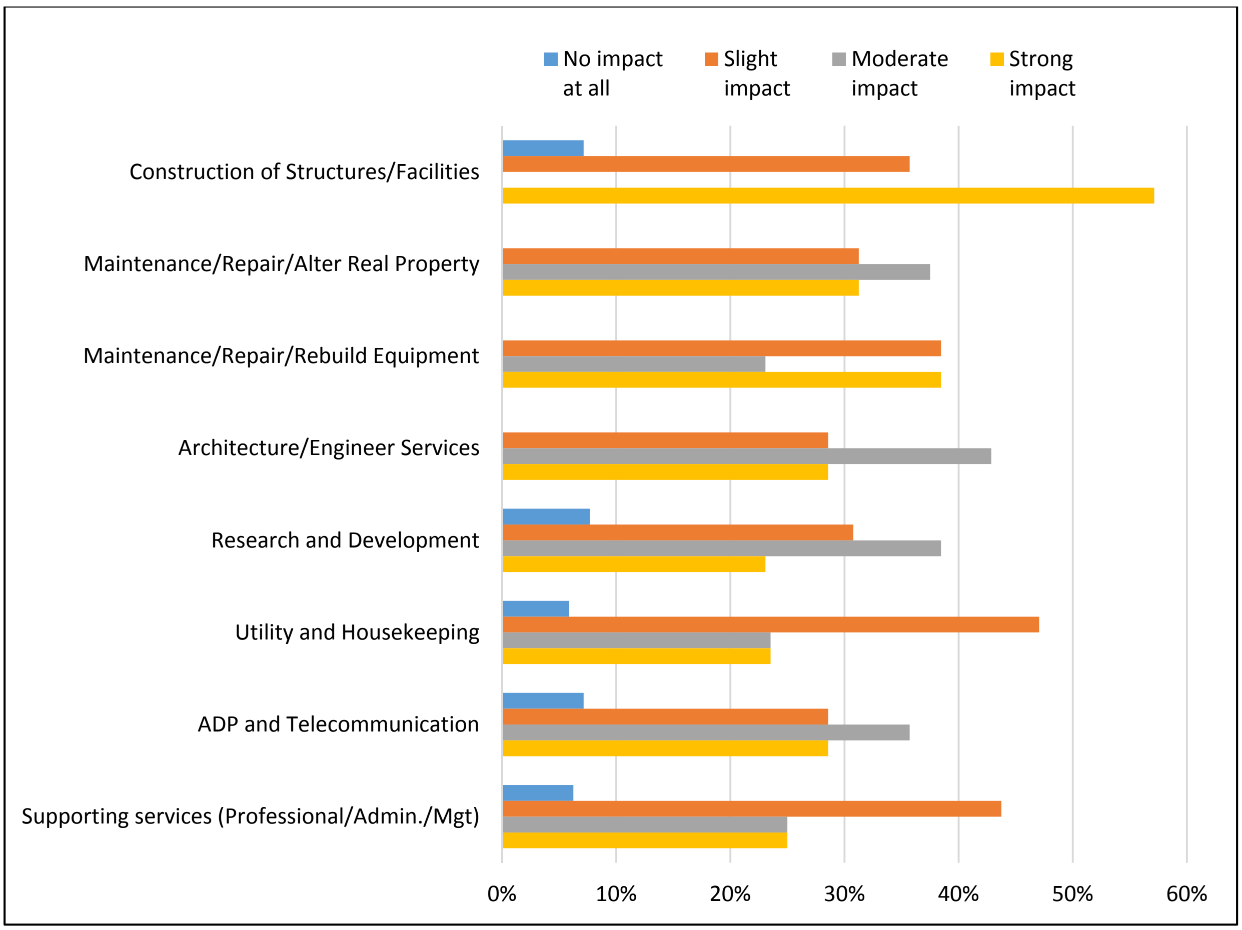
The previous section examined the tax- paying practices of out-of-state businesses that have awarded Hawaii federal contracts in FY2015. Our research showed that some out-of-state businesses that awarded Hawaii projects didn't have a Hawaii GET license that was the prerequisite to pay Hawaii GET. If a local business competes with one of these companies for a federal contract, the 4-4.5% cost cut that becomes possible as a result of the proposed tax exemption would put the local company in a favorable position at competition.

Then, the next question to be answered would be how critical the price cut is in the contractor selection decision. This section examines the likely impacts of a 4% price cut on final selection of contractor at federal contracting. In order to get a clue on this question, we conducted a survey of federal contract officers who have handled Hawaii projects in the past. In the survey, we asked

> *When bidding for a federal contract, what would you estimate to be the potential impact of a 4 percent decrease in the bid amount. In other words, if a Hawaii company could reduce its bid price by 4 percent, what would be the impact on the final contractor-selection in the following eight categories:*

A total of 17 federal contract officers or contract specialists responded to the survey and the summary of the responses are presented in Figure 6.

Figure 6. Likely impact of 4% price cut on federal contracting (summary of survey responses)



The responses distributed more or less evenly among “slight impact”, “moderate impact”, and “strong impact” while about 4 percent of responses indicated “no impact at all”. The share of responses that indicated “strong impact” was highest for the work category of “Construction of Structures/Facilities”. Yet, 43 percent of the responses expressed “no impact at all” or “slight impact” for the category.

A few people added additional comment in the survey saying that the impact would depend on the amount of contract. If a contract amount is 50 million dollars, the possible price cut due to the tax exemption would be 2 million dollars, which is a significant amount. Those who answered “no or slight impact” for the construction category might have considered the fact that the quality of work is more important than the price. Those who answered “moderate or strong impact” might have focused on the fact that most construction projects are big in amount.

Another opinion expressed in the survey was that the cost saving due to the tax exemption might not be passed onto the federal government. If the level of competition is low, businesses may not need to lower their bid prices to reflect the saving they made from the tax exemption. Table 4 and 5 below show the service contracts awarded from FY2011 to FY2015 by the number of actual offers/bids received in response to the solicitation. We focused on the service contracts here because sales of goods to the federal government are currently exempted from GET. During the 5 year period, 28 percent by dollar obligated of total service contracts performed in Hawaii were awarded without any competition. Among the service contracts that were awarded to out-of-state businesses during the five year period, 23 percent by dollar obligated were awarded without competition. They might include the contracts that were not available for competition for various reasons, and contact actions that were full and open competition but didn’t have more than one business who was interested in or was capable of carrying out the work. The proposed tax exemption is not expected to increase the chance of local businesses’ winning the contract at least for this portion of contract activities.

Table 4, Federal service contracts by the number of offers received (Hawaii, FY2011-2015)

	Number of offers received (percentage of total in terms of dollar obligated)		
	1 offer	2-5 offers	More than 5 offers
All service contracts awarded	28.1%	45.6%	26.3%
Service contracts that were awarded to local businesses	32.0%	38.8%	29.2%
Service contracts that were awarded to out-of-state businesses	22.9%	54.3%	22.8%

Table 5 shows the service contracts awarded to out-of-state businesses by the number of offers/bids received for the top five services purchased by the federal government during the five year period. Most of contracts that were awarded to out-of-state businesses in the work category of “Construction” or “Maintain/Repair/Alteration of Real Property”, were awarded with some competition. The share of contracts awarded without competition was only 2-5 percent of the total contract awarded in the category, suggesting more room for the proposed tax exemption to be effective in bringing the federal contract to local businesses. Meanwhile, the share of contracts awarded without competition was relatively high in the work categories of “Maintain/Repair/Rebuild Equipment”, “ADP & Telecommunication”, and “Support Services”. Among the work categories that were included in “Others”, more than 85 percent of “Operation of Government Owned Facility” and more than 95 percent of “Quality Control, Test, Inspection”, by dollar obligated, were awarded to out-of-state businesses without competition.

Table 5, Federal service contracts awarded to out-of-state businesses by the number of offers received (Hawaii, FY2011-2015)

Type of service purchased by federal government	Annual contract amount (Avg. of FY2011-2015)	By the number of offers received		
		1 offer	2-5 offers	More than 5 offers
All service contracts that were awarded to out-of-state businesses	$893.6 M	22.9%	54.3%	22.8%
Construction of Structures/Facilities	$154.6 M	2.0%	57.1%	40.9%
Maintain, Repair, Alter Real Property	$149.3 M	4.4%	73.9%	21.7%
Support Services (Prof, Admin, Mgmt)	$133.7 M	30.5%	46.2%	23.3%
Maintain, Repair, Rebuild Equipment	$102.1 M	48.5%	49.5%	2.0%
ADP & Telecommunication	$69.6 M	31.2%	57.3%	11.5%
Others	$284.3 M	29.2%	47.4%	23.4%

6. Economic impacts of the proposed tax exemption

The immediate impact of the proposed tax exemption would be the reduced tax revenue to the state government. While the state government loses its revenue, the businesses who have been paying GET for sales to the federal government, both local and out-of-state businesses, would benefit from the tax exemption. If we assume that the businesses would lower their bid prices by the saving from the tax exemption, the saving will eventually be passed on to the federal government. If not, the saving will stay with the businesses.

If the state government increases taxes on other sectors to keep the same level of tax revenue after granting the proposed tax exemption, the resources would shift from the other sectors affected to the businesses who sell services to the federal government or to the federal government if the saving is passed on to the federal government.

The positive impacts on Hawaii economy are expected if a local business is awarded a federal contract that would otherwise be awarded to an out-of-state business as a result of the tax exemption. Replacing an out-of-state business with a local business to conduct a Hawaii contract would create some positive impacts on Hawaii economy as in general local businesses are more likely to hire and buy locally thus creating new jobs in the local area and boosting other local businesses. However, the extent of the positive impacts would be different depending on the business practices of the out-of-state business. If the out-of-state business would do the Hawaii project remotely without using many local resources, the impacts of the switch would be large. The positive impacts of the switch would be relatively small though if the out-of-state business would do the Hawaii project by heavily relying on local resources. For instance, a construction company with headquarter in California may bring all resources including labors from the mainland to carry out a construction project in the Schofield Barrack. Or, it may hire labors locally and buy local products, or it may subcontract the significant portion of the project out to local companies. Any attempt to estimate the economic impacts without knowing the details of how the out-of-state businesses are doing business in Hawaii could be misleading.

7. Concluding observations

We didn’t attempt to estimate in this study the potential increase in economic activity that would result from granting the tax exemption, although it was requested in the Senate resolution. In order for the proposed tax exemption to create positive economic impacts, a few conditions have to be satisfied. First, the tax exemption has to successfully help local businesses win at federal contract competition with out-of-state businesses. It occurs only if the 4-4.5% cost saving due to the proposed tax exemption is given exclusively to local businesses, which is true when the competing out-of-state businesses have not been paying Hawaii GET for any reason. Our research showed that among the 1,707 out-of-state businesses who engaged in Hawaii federal contracts in FY 2015, 726 businesses (43%) had an active GET licenses during the tax period. The contracts carried out by the 726 companies accounted for 90 percent of the total GET tax base from sales to the federal governments in that year, implying a high likelihood that the proposed tax exemption may not help local businesses successfully compete for federal contracts.

The other condition is that the 4-4.5% price cut has to be critical enough to change the federal agency's selection of contractor. The impact couldn’t be asserted as the responses to the survey of federal contract officers as to this question divided more or less evenly among “slight impact”, “moderate impact” and “strong impact”.

If these two conditions are not meet, the proposed tax exemption would just result in the shift of resources from the state government to local or out-of-states businesses who sell services to the federal governments or to the federal government if the tax exemption is passed on to the federal government. The estimated loss of state tax revenue as a result of the proposed tax exemption is $58 million per year if we project the future sales to the federal government would be similar to the average level of the FY2011-2015 period, which was $2.4 billion per year.

If the proposed tax exemption successfully help the local business win a federal contract that would otherwise be awarded to an out-of-state businesses, it will create some positive impacts on Hawaii economy as locally owned businesses tend to use more local resources. The extent of the economic impacts would vary by how the out-of-state business would do business in Hawaii.

Appendix

Senate Concurrent Resolution No.164

(Hawaii 2016 Regular Session)

THE SENATE
TWENTY-EIGHTH LEGISLATURE, 2016
STATE OF HAWAII

S.R. NO. 164

SENATE RESOLUTION

REQUESTING THE DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT, AND TOURISM, IN CONSULTATION WITH THE DEPARTMENT OF BUDGET AND FINANCE, AND DEPARTMENT OF TAXATION, TO CONDUCT A STUDY ON THE ECONOMIC IMPACT OF GRANTING AN EXEMPTION FOR THE SALE OF GOODS AND SERVICES TO THE FEDERAL GOVERNMENT FROM THE STATE GENERAL EXCISE TAX.

WHEREAS, contracts to provide goods and services to the federal government are a vital part of Hawaii's economy, and these contracts provide opportunities for Hawaii small businesses to establish themselves and to create well-paying careers for Hawaii residents; and

WHEREAS, of the approximately $2,000,000,000 of federal contracts that are available for bid annually in Hawaii, approximately $900,000,000 is set aside for small businesses; and

WHEREAS, businesses are assessed a State's general excise tax rate of four percent for the sale of goods and services to the federal government and another half percent surcharge for the sale of goods and services on Oahu, but goods and services used and consumed outside the State are not taxed under the general excise tax; and

WHEREAS, Hawaii is one of only three states in the nation — the others being Washington and Vermont — that apply the general excise tax to the provision and sale of goods and services by businesses domiciled in their states to the federal government; and

WHEREAS, federal agencies overseeing the bidding process have opined that since the sale of goods to the federal government is not subject to the State's general excise tax, the federal government will not enforce the State's tax on out-of-state small businesses bidding to provide goods and services to the federal government; and

WHEREAS, the Hawaii Department of Taxation has admitted that they are unable to effectively track the sale of goods and services that are made to the federal government by out-of-state vendors, and are unable to accurately determine and report on the aggregate amount of excise taxes that are due and are owed to the State from these out-of-state vendors; and

WHEREAS, because businesses domiciled and based in Hawaii are assessed the State's general excise tax, but businesses outside the State are not, Hawaii businesses are effectively at a disadvantage when they bid on federal contracts for goods and services, and as a result most of these contracts are awarded to out-of-state businesses; and

WHEREAS, when Hawaii's small businesses lose these contracts for providing goods and services to the federal government in Hawaii, the overall economic activity decreases within the State, which negatively affects the State's tax revenue and economy; and

WHEREAS, this body would like to better understand the effect of granting an exemption from the general excise tax for the sale of goods and services to the federal government, especially as it relates to federal contracts awarded to in-state small businesses, economic activity in the State, job creation in the State, personal and corporate income, and the state tax revenue; and

WHEREAS, three state agencies have expertise over various aspects of this issue:

(1) The Department of Business, Economic Development, and Tourism is responsible for fostering economic development within the State;

(2) The Department of Budget and Finance is responsible for administering the state budget and developing near and long range financial plans for the State; and

(3) The Department of Taxation is responsible for administering the tax laws of the State; now, therefore,

BE IT RESOLVED by the Senate of the Twenty-eighth Legislature of the State of Hawaii, Regular Session of 2016, that the Department of Business, Economic Development, and Tourism, in consultation with the Department of Budget and Finance and Department of Taxation, is requested to determine the potential increase in economic activity, including the number of jobs, personal and corporate income, and personal and corporate taxes that would result from granting an exemption for the sale of goods and services to the federal government from the state general excise tax; and

BE IT FURTHER RESOLVED that the Department of Budget and Finance and Department of Taxation are requested to cooperate and assist the Department of Business, Economic Development, and Tourism; and

BE IT FURTHER RESOLVED that the Director of Business, Economic Development, and Tourism is requested to submit findings, recommendations, any proposed legislation, and a clear narrative of the methodology the departments used to conduct this analysis to the Legislature no later than twenty days prior to the convening of the Regular Session of 2017; and

BE IT FURTHER RESOLVED that certified copies of this Resolution be transmitted to the Director of Business, Economic Development, and Tourism; Director of Finance; and Director of Taxation.

OFFERED BY: ______________________________