

**Report
of the
Tax Review Commission**

**December 1, 1989
Honolulu, Hawaii**

Tax Review Commission

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REPORT OF THE
TAX REVIEW COMMISSION

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Executive Summary

"When everybody has got money they cut taxes, when they're broke they raise 'em. That's statesmanship of the highest order."

Mark Twain

INTRODUCTION

A commission given a broad mandate to conduct a systematic review of the tax structure and recommend tax and revenue policy has a temptation to seek perfection. Unfortunately, tax systems cannot be perfected because they serve conflicting objectives and must respond to the dynamics of society and the economy.

On balance, the tax system in Hawaii is a good one, and it has not been the Tax Review Commission's intent to comment on every imperfection in the system. The Commission's desire has instead been to focus on the nagging inequities or inefficiencies that might be corrected, the trends that should be observed, and adjustments that might be made to position the tax system for the future.

Each tax review commission must take into account the economic and political circumstances of its time, and today the states are trying to put their tax systems in order under the weight of federal tax changes, the cessation of federal grant-in-aid programs, and federal budget deficits.

It is a time when state tax systems have not yet accommodated the effects of deregulation, technological change, and the emerging global economy. It is also a time when Hawaii is enjoying the benefits of a healthy economy, fueled by tourism and foreign investment.

Short-term circumstances should not obscure the need to address problems of equity and efficiency that may exist today and to position the tax structure for tomorrow. Care should also be taken to ensure that the tax system does not aggravate the fundamental economic problems facing Hawaii, which are the projected decline in the long-term rate of economic growth and the lack of economic diversity.

Tax Review Commission The tax review commission was established pursuant to a 1978 amendment to the Hawaii Constitution and is directed by the Hawaii Revised Statutes to conduct a systematic review of the State's tax structure, submit to the legislature an evaluation of the State's tax structure using such standards as equity and efficiency, and recommend revenue and tax policy. The deadline for the report to the legislature is set by law as

thirty days prior to the convening of the second regular session of the legislature after the appointment of the commission.

The commission is activated every five years when the Governor appoints the seven members who will serve as the tax review commission. The first commission was appointed in 1980, but the members resigned after they failed to get funding. A replacement commission was appointed in 1983 and completed its duties in 1984. The current commission ("Commission") was appointed in 1988 and held its first meeting on July 1, 1988. It has met regularly during the months since then and will disband after the adjournment of the 1990 legislative session.

The Commission issued a brief preliminary report to the legislature in January 1989. By that time, the Commission had established its agenda, solicited advice from experts and other third parties, and reviewed the results of other state tax studies, but was not yet in a position to provide much information. As a result, the preliminary report was primarily to notify the legislature that the tax review commission had been reactivated.

A more detailed interim report was released in April 1989, serving as a more widespread notification of the Commission's agenda and timetable. Public hearings were held on the major islands in June 1989. The months since June were spent reviewing the results of studies conducted on the Commission's behalf.

Scope of the Review The tax system in Hawaii is an expression of the willingness of its citizens to pay for government services and promote responsible behavior. A review of the tax system offers a look at whether existing policies create a useful link between that willingness and desired services; once-useful policies can become outdated and mired in the system while potentially useful policies may find entry into the system difficult.

The Commission identified many potential topics for review and decided that certain areas warranted particular attention because of changes in circumstances since the prior tax review commission report in 1984 or because of the relative importance of certain issues. Several topics that normally would have been investigated were covered in the 1984 report and did not need to be revisited at this time. Given the recurring nature of the tax review process and the work done by the previous commission, this commission was able to concentrate on a few issues and still evaluate the tax system as a whole.

Particular attention was paid to the personal income tax, the general excise tax, and county revenues.

As requested by the legislature during the 1989 session, there was also an analysis of the liquor tax escalator provision, detailed in a working paper in Volume 2.

A major change since the 1984 commission report was the federal Tax Reform Act of 1986. The Commission felt obligated to look at the effects of the State's response as well as the continuing impact of federal tax law changes.

It was clear that there should be an investigation into the policy implications of deregulation, the increasing influence of technology, the development of a global economy, and the federal government's budget problems.

It was also clear that the atmosphere for discussing county revenues has changed. There is more of a sense that the counties are facing fiscal problems. Whether the problems are due to a refusal by the counties to utilize their resources or because their resources are too limited, the issue had to be explored.

Finally, it was clear that, although it has already been extensively researched, the general excise tax so dominates the tax system that there must be a review of how it is operating.

Overview of the report The next few pages summarize the Commission's findings and recommendations. The next two chapters provide an overview of the Hawaii fiscal system and comparisons with other states. The succeeding chapters contain more information on the findings and recommendations. Staff working papers and reports by consultants to the Commission are in Volume 2.

The Commission tried to consider options from the standpoint of good tax policy--what would improve the tax structure and make it more equitable and efficient?--rather than solely on the basis of their revenue impact. While some recommendations in this report make more sense when considered in conjunction with others--notably, the income tax recommendations--the Commission did not attempt to "package" its recommendations into a single proposal. Nor is the legislature expected to act on all the recommendations as if they were a package.

Unlike the case with many state tax studies in which an ad hoc group is asked to find ways to raise money or fix a long-neglected system, Hawaii's policy of having a tax review every five years encourages a more orderly process, with mid-course adjustments rather than fitful, sporadic overhauls. Consequently, the recommendations in this report do not constitute a revenue package, a reform package, or a call for sweeping overhaul of the tax system. It would be wrong therefore to assume that every recommendation must necessarily be implemented immediately or to the extent suggested in this report.

The Commission was well aware of the importance of revenue considerations but did not rule out recommendations purely on the basis of their revenue impact; to do so would have been to preempt legislative prerogative. The proper level of taxation depends upon government spending policies, and it is for citizens and their government to decide what those ought to be.

Criteria for evaluation Section 232E-3 of the Hawaii Revised Statutes states that the tax review commission shall conduct a systematic review of the State's tax structure, using such standards as equity and efficiency, and submit an evaluation to the legislature. The Commission applied the standards of equity and efficiency, along with other commonly accepted standards as follows in evaluating the tax structure:

■ **Equity.** The tax burden should be fairly shared. Fairness is understood to mean that taxes should be borne: (1) by the person who receives the benefit of a government service (the benefit principle) or; (2) by those with the means (the ability-to-pay concept). Taxpayers in similar circumstances should be taxed alike (horizontal equity), and taxpayers in unequal circumstances should be taxed on the basis of their ability to pay (vertical equity).

Income is the most commonly used measure of ability to pay. A tax structure is said to be "progressive" when the tax burden varies directly with income (borne to a greater extent by higher income taxpayers), "regressive" when the burden is inversely related to income (disproportionately borne by lower income taxpayers), and "proportional" when there is no change in burden as income changes.

■ **Adequacy.** The tax system should generate sufficient tax revenues to meet government obligations and to fund spending plans. The other side of the adequacy standard is that, after allowing for normal fluctuations, the system should not produce tax revenues in excess of what is needed. For purposes of this review, and consistent with the idea that the tax review commission is an ongoing process, the period for judging the adequacy of the system includes the years through 1994 (when the next commission will conduct its review).

■ **Stability.** The tax system should provide a stable and predictable flow of tax revenues. It should minimize the need for frequent or radical adjustments as economic conditions change and allow the government and taxpayers to make their plans with some certainty as to the impact of taxes.

■ **Economic Neutrality (Efficiency).** The tax system should not interfere with private economic decisions. Taxpayers should not be inclined to structure their activities for the purpose of avoiding a tax or gaining a tax advantage. They should be able to compete on a "level playing field" where taxes do not confer an advantage on one party over another.

■ **Simplicity.** The tax system should not be unduly difficult for taxpayers to comply with or for the government to administer. The cost of compliance and administration should not be out of proportion to the means at hand or the amount of tax involved.

■ **Competitiveness.** The Hawaii tax system should compare favorably with the tax systems of other states so that it does not discourage people from living in Hawaii and conducting business here.

A good tax system attempts to strike a balance among inherently incompatible standards, and tradeoffs are inevitable. Even the best tax system will require occasional adjustments because of changes in policy objectives and public sentiment.

Since each tax cannot by itself achieve a balance among the standards, the goal should be to achieve a balance for the tax system as a whole. Thus, inequity or inefficiency may be tolerated in one tax if there are compensations in other parts of the tax system, so long as that on an overall basis the tax system is reasonably equitable and efficient.

To the extent that the tax system as a whole cannot achieve equity and efficiency, there ought to be compensating adjustments to other parts of the fiscal system, such as through spending policies.

These criteria, together with economic conditions, underlie the findings and recommendations that follow.

FINDINGS

The Hawaii tax system utilizes all the major taxes that are typical in state and local tax systems and is responsive to the economy. As in most states, the general excise tax and personal income tax generate most of Hawaii's general fund revenues, with the general excise tax alone accounting for half the State's general fund tax revenues. Besides contributing a third of State general fund tax revenues, the personal income tax is also important as a vehicle for reducing the regressivity of the overall tax system. The tax system is mildly regressive, approaching proportionality

over a wide range of income. Roughly one quarter of Hawaii's taxes is exported to nonresidents.

The basic components of a tax are the tax base and tax rates. The general excise base is among the broadest in the nation, which promotes efficiency and contributes to revenue stability. A continuing challenge is to prevent the erosion of the base, given the constant pressure to grant exemptions, while trying to ensure that the tax is fair.

The existence of a multi-rate structure under the general excise tax violates economic principles, promotes inefficiency, and complicates the system. Hawaii is one of just a couple of states that still has this feature, left over from the early days of sales tax development in the 1930s. Since the rate structure has been a feature of the tax from the beginning (since 1935), people have gotten used to it, and there doesn't appear to be a pressing need to correct it at this time. Eventually, however, thought should be given to having a single rate structure.

The Hawaii personal income tax base conforms to the federal base, with some exceptions--the major one being the exclusion of retirement income. The problems with the personal income tax primarily involve the balancing of the need for revenues against the desire to lessen the regressivity of the overall tax system. An often overlooked dimension is the disincentive effect of the income tax.

Findings that might call for adjustments:

The system generates more general fund tax revenues than is needed to fund current policy initiatives, but tax collections are highly cyclical with respect to changes in the economy. Barring a severe recession or unforeseen economic dislocations, the present system is likely to continue generating excess revenues given current level services and the constitutional spending ceiling. On the other hand, there is a need for stability, given the volatility of tax collections.

The general excise tax is not equitable or efficient when similarly situated taxpayers are not treated the same or when income from goods and services are not treated the same. Equity is diminished when one taxpayer is relieved of paying the tax that a similarly situated taxpayer must pay. It is also diminished when income from services is not treated the same as income from goods since the general excise tax makes no distinction between the two as suitable for inclusion in the tax base.

Until the other states start taxing service income, the current tax treatment of income from services will keep Hawaii businesses at a competitive disadvantage.

The tax system is relatively simple, with the exception

of certain tax forms and the special taxes on certain industries. Most of the Hawaii income tax forms are unnecessary because the Hawaii income tax law conforms closely to the Internal Revenue Code. The requirement for filing Hawaii forms that duplicate the federal forms creates unnecessary paperwork and adds to the cost of compliance and administration. In addition, the design of the Hawaii general excise tax form could be improved.

The Public Service Company Tax and Franchise Tax on banks and other financial institutions add complexity to the system. The historical justification for these separate taxes is being eroded by deregulation and technological change.

The counties are prevented by their limited sources of revenue from having proper control over their finances. A tax system based almost exclusively on the property tax does not allow the counties to raise revenues in a manner and to an extent that is consistent with the wishes of their residents, commensurate with county responsibilities, and responsive to changing circumstances.

The issue is not whether the counties "need" more money. The issue is whether the allocation of functions and revenue authority between the State and the counties enhances or impedes the delivery of services and whether the tax system allows the counties to adapt to growth and increased demands for services in a fiscally sound manner.

RECOMMENDATIONS

The following recommendations are intended to position the fiscal system for the future as well as to improve the equity and efficiency of the tax structure. Some would increase tax revenues and others will result in a decrease in revenues, but the important consideration is that they reflect good tax policy.

GENERAL

1. Lower the overall level of State taxes. In the aggregate, Hawaii's State taxes are being maintained at a higher level than necessary to fund current policy initiatives. Given the constitutional spending ceiling, the overall level of taxes could be lowered.

A high level of taxes can provide some cushion against an economic downturn, but it can also lead to a misallocation of resources between the public and private sectors. There are better ways of providing fiscal stability.

2. Establish an explicit budget stabilization fund. Money

should be set aside when the economy is strong in order to smooth out the impact of fluctuations in the business cycle. The traditional thinking has been that a reserve of about 5 percent of expenditures should be maintained. Because the federal government cannot be counted on to establish economic stability or provide direct assistance in the event of a downturn, it might be prudent to set aside reserves at a higher level than the traditional 5 percent.

3. Continue to conform to the Internal Revenue Code. Even though the Code has been amended almost every year during the 1980s and has kept state tax systems off balance, it is still preferable to conform to the Code for the sake of simplicity. If amendments to the Code continue, the emphasis should be on responding through tax rate adjustments rather than through a decoupling from Code provisions.

4. Simplify the filing of income tax returns. Because Hawaii conforms closely to the Internal Revenue Code, the Department of Taxation should develop one or two page individual and corporate income tax returns to which a copy of the federal return could be attached.

5. Avoid the creation of special funds that earmark general fund tax revenues as opposed to income from user related charges. Given the recent surge in tax revenues and the constitutional spending limitation, there may be a temptation to create a certain type of special fund that earmarks general fund revenues and avoids to some extent the spending limitation. The use of this type of fund is a departure from Hawaii's sound fiscal policies and should be avoided.

Special funds typically involve an earmarking of revenues from enterprise-like services, with some direct connection between a public service and the beneficiary of that service. An example is the highway fund, which has user-related charges paid by beneficiaries of a public service. Special funds can be justified under the benefit principle in such circumstances.

Special funds that merely set aside general fund revenues for general fund expenditures cannot be justified; they restrict budget flexibility, create inefficiencies, and lessen accountability. The purpose for such funds may be laudable and worthwhile, but the use of this type of special fund is not. Desired programs and services can be given priority under the normal budget process without resorting to this type of financing.

6. Revenues from contractual arrangements that include a "monopoly rent" should not be earmarked entirely to

special funds. Revenues derived from what are essentially monopoly rents, such as certain airport concession fees and similar receipts, should not be treated solely as special fund revenues. The portion of such revenues that represents the cost of public services provided to the contractor can be earmarked for the special funds that support such services. Amounts received in excess of the cost of providing services are attributable to the granting of an exclusive right rather than the cost of services and should be considered general fund revenues.

PERSONAL INCOME TAX

Hawaii's personal income tax laws were amended in 1987 and again in 1989, largely in an effort to offset the "windfall" from the federal Tax Reform Act of 1986. For the most part, that effort has been successful in offsetting the expected windfall; however, much of that success is attributable to temporary measures that will soon expire.

Unless permanent adjustments are made, the windfall will begin to grow after the temporary measures expire. Rather than continually extending the temporary measures, the better approach is to lower the effective tax rates and to target the benefits by means of the standard deduction, tax brackets, and credits.

Besides offsetting the impact of federal tax reform, future adjustments should be designed to offset the regressivity of the overall tax system and to ensure that Hawaii's tax system is competitive with those of other states. There should be an effort to ensure that those whose income is below the poverty level do not incur an income tax liability.

7. Increase the general excise tax credit to take into account food and medical costs. The current food tax credit is a flat dollar amount available to everyone regardless of income. Enacted in 1987 and due to expire in 1990, this food tax credit is more properly characterized as a means of refunding the expected windfall from the Tax Reform Act of 1986 than as a measure to reduce the regressivity of the general excise tax. It should be allowed to expire.

The food credit should be replaced with an increase to the existing general excise tax credit. Such an increase should also take into account an average level of medical costs. The advantage of using the general excise tax credit is that it is phased out according to income. An allowance for food and medical costs as part of this type of credit makes the tax system less regressive and results in a better targeting of relief for lower income taxpayers than would an exemption or a credit that is available to everyone.

8. Increase the standard deduction. The Hawaii standard deduction is substantially less than the federal standard deduction. A low standard deduction keeps lower income taxpayers on the tax rolls and complicates the filing of tax returns because the standard deduction determines who itemizes. Many taxpayers who do not itemize for federal tax purposes are forced to itemize on their Hawaii returns, a result that disproportionately affects lower-income taxpayers.

9. Reduce the number of tax brackets. The Hawaii income tax system has too many tax brackets. This works against middle income taxpayers because the benefits of lower brackets are largely lost as inflation and small increases in income push taxpayers into the higher tax brackets.

The reason for having brackets is to make the tax system more progressive, but having too many tax brackets over small increments tends to work to the disadvantage of middle income taxpayers.

10. Reduce the top tax rate. Hawaii exercised prudence in responding to the effects of the federal Tax Reform Act of 1986. While other states rushed to reduce rates to offset the windfall from the broadening of the tax base, Hawaii undertook a measured response with temporary adjustments that refunded the windfall from Tax Reform and avoided the miscalculations that several states made in estimating the extent of the windfall. Now that three years have elapsed since the Tax Reform Act and data are available, it is time, with the advantage of hindsight, to make permanent adjustments by reducing tax rates.

Hawaii's top tax rate is among the highest in the country. States with high income tax rates typically rely on the income tax for a greater share of their revenues than Hawaii does. States that receive a high percentage of their tax collections from general excise sales taxes, as Hawaii does, typically have no income tax or have low income tax rates. Given the productivity of the general excise tax, the income tax should be used to improve the overall tax and fiscal systems.

In addition to reducing regressivity, for example, the income tax should be sensitive to the impact of marginal tax rates on business location decisions. The perception of Hawaii as a high tax state (or anti-business) should not be reinforced by maintaining high personal income tax rates if Hawaii is to attract and retain businesses that contribute to a higher standard of living in Hawaii.

11. Replace the medical services credit with a credit that is tied to the itemized medical deduction. The existing

medical services credit is a good idea that is misfocused because it is limited to a maximum amount regardless of how much cost is actually incurred. Since the intent should be to provide relief to those who suffer misfortune, a credit for the general excise tax on medical expenses resulting from a catastrophic illness should not be limited. Above a threshold amount, a credit should be allowed based upon a person's entire medical costs. The floor for computing the itemized deduction for medical expenses can serve as the threshold since it is already available under income tax reporting and easy to monitor. This credit would be in addition to the itemized deduction.

The two persistent concerns about the general excise tax on medical services are that: (1) the tax falls too heavily on the poor, and (2) people should not be taxed on their misfortune. The response is in two parts. First, include a base level of medical costs for lower income taxpayers in a credit that is phased out according to income, as in recommendation 7. Second, since the extent to which medical expenses represent hardship depends upon a person's ability to pay, provide relief to everyone with extraordinary medical expenses through a credit geared to income, as in this recommendation 11. (Because Hawaii's income tax exempts retirement income, the elderly will be likely beneficiaries of this credit.) The combination of these recommendations will provide relief for those who need it, at a net savings to the State.

12. Conform to the federal treatment of capital gains. There is no policy reason for not following the federal rules for capital gains taxation. Furthermore, the current capital gains tax in Hawaii is inequitable because it imposes a maximum tax rate on capital gains in a way that primarily benefits upper-income taxpayers, unlike the former treatment of capital gains, which at least granted a deduction for all capital gains, regardless of income bracket, and effectively reduced the capital gains tax rate for all taxpayers.

GENERAL EXCISE AND USE TAX

The general excise tax generates a great deal of revenue because its broad tax base includes virtually every business transaction. The emphasis of general excise tax policy should be on preserving a broad base while ensuring equal treatment for taxpayers who are similarly situated.

Because the general excise tax applies equally to income from goods and services, the treatment of income from services should be more consistent with the treatment of income from goods; the use tax should also treat goods and services the same.

13. Do not grant exemptions as a means of achieving vertical equity. Hawaii has chosen to rely upon the general excise tax for a large proportion of its tax revenues, which in many ways makes sense because Hawaii has a service economy and a high degree of tax exporting through tourism. The broad tax base that makes the general excise tax so productive and simple to administer also ensures that the tax will fall on many transactions without regard to whether the consumer is wealthy, a lower-income resident, or a tourist.

If the general excise tax were more like a typical retail sales tax, there might be a more persuasive argument for providing exemptions for food or medical costs to minimize the regressivity of the tax. Since the State has no inclination to make substantial changes to the nature of the general excise tax, it is better to recognize the nature of the tax and what it is intended to accomplish--generate money from a broad base at a low rate while remaining simple to administer--and to counteract the regressivity of the tax in other ways, such as through income tax credits and spending policies targeted to lower income residents.

14. Limit the granting of exemptions to those items that are necessary to enhance horizontal equity. Taxpayers who are similarly situated should be treated the same; it is unfair when one person pays the tax while another who is in a similar position does not. Recommendations 17, 19, and 20, for example, are in response to instances where an uneven granting of exemptions among similarly situated taxpayers has created inequities and inefficiencies.

15. Eliminate or minimize the tax pyramiding on interbusiness transactions. There is no tax policy justification for imposing a general excise tax on interbusiness transactions. Such a tax violates principles of equity and efficiency and, furthermore, is hidden from the consumers who ultimately pay it in the form of higher prices on goods and services. Nevertheless, in recognition of the large amount of revenues that would be lost by a complete and immediate elimination of this tax, the short-term recommendation is to exclude "direct use" purchases of goods and services from the calculation of the 4% general excise tax payable by the intermediary purchaser.

16. Eliminate or minimize the tax pyramiding on multiple-lease transactions. Rents paid by those with intermediary positions in multiple-lease transactions should be excluded from the calculation of the 4% general excise tax payable by those intermediaries for the same reasons as stated in recommendation 15.

17. Exempt exported services. This is intended to promote equity for those who earn income from services and to place exported services on par with exported goods.

Hawaii taxpayers who earn income from services performed for mainland customers are at a disadvantage when they incur a tax that their out-of-state competitors do not incur (because Hawaii taxes service income under a general excise tax while most other states do not).

This was recognized as a problem for Hawaii producers of goods that are exported and addressed in 1987 with the granting of an exemption for such exported goods. That exemption should be extended as well to exported services.

18. Subject imported services to a use tax. This is the other side of promoting equity for those who earn income from services and equal treatment of goods and services.

A Hawaii taxpayer who pays general excise tax on services provided to a Hawaii customer is at a competitive disadvantage when a mainland firm that provides the same services to the same customer does not pay the same tax.

While it is not always practical to assess general excise tax on a mainland seller of services (because of limitations on tax jurisdiction), it is practical to assess a use tax on a Hawaii purchaser of services from a mainland provider.

Goods purchased from out-of-state vendors for use in Hawaii are subject to a use tax; the same should be true for services.

19. Exempt residential rental income. This is intended to treat renters the same as homeowners. The rental value of a home is consumption and should be included in the general excise tax base, but this is also true for the imputed consumption value of home ownership. Equity and efficiency are enhanced when close substitutes are treated evenly for taxation.

Since the current system taxes only the rental property, the tax base should either be broadened to include owner-occupied property or narrowed to exclude rental property. Broadening the tax base to include the consumption value of home ownership is an unlikely policy option. This suggests that both home ownership and residential rentals should be excluded from the base.

If an exemption is granted for residential rental income, there would be no basis for continuing the renter's credit under the income credit to the extent that the credit was intended to offset the general excise tax on rentals.

20. Eliminate blanket exemptions and substitute in their stead exemptions for specific transactions. Insurance companies and Franchise Taxpayers are completely exempt from the general excise tax while other taxpayers are

exempt from the general excise tax only to the extent of income from non-profit activities or other special types of income. Complete exemptions for entire classes of taxpayers cannot be justified when those taxpayers are increasingly engaged in activities--often in competition with general excise taxpayers--not contemplated in 1935 when the general excise tax was enacted and the exemptions granted and for which there are no evident policy reasons for exemption.

TAXATION OF FINANCIAL INSTITUTIONS

The Franchise tax on banks and other financial corporations was adopted in 1957 when the federal government controlled state taxation of banks and when the banking industry was more local, regulated, and limited in scope. The Franchise Tax law has remained virtually unchanged since then even though the fundamental assumptions underlying its structure are outdated and no longer applicable.

The banking industry has changed and the tax system has not kept pace. The Franchise Tax itself should be retained but made more similar to the corporate income tax, and that adjustment alone will simplify the tax system and better position the tax system to accommodate further change.

21. Retain the Franchise Tax, but simplify it. Under federal law, states cannot tax interest income from federal obligations except through a franchise tax (or similar tax in lieu thereof). Since federal obligations typically make up a large portion of bank assets, the Franchise Tax is preferable to the corporate income tax for taxing banks and other financial institutions and should be retained.

The existing Franchise Tax had its origins in a different era of banking and state taxation and contains unnecessary features that contribute nothing to equity, efficiency, or simplicity. It should be simplified by making it more like the corporate income tax by:

- **Eliminating the Franchise Tax deduction for federal income taxes.** This deduction cannot be justified under good state tax policy. It is a major difference between the corporate income tax and the Franchise Tax and causes the effective Franchise Tax rate to be substantially less than the stated rate of 11.7%.

If the deduction is eliminated in conjunction with a change of the Franchise Tax rate to conform to the corporate income tax rate, the net result should be a simpler and more rational Franchise Tax system, achieved without a significant revenue impact.

- **Setting the Franchise Tax rate equal to the corporate**

income tax rate. The Franchise tax rate was a device to comply with the limitations on state bank taxation imposed by federal law and was designed to take into account the combined corporate income and general excise tax rate paid by other taxpayers. That federal law was repealed in 1976 and is no longer relevant.

If other recommendations are followed to simplify the Franchise Tax and to eliminate the complete exemption of Franchise Taxpayers from the general excise tax, the Franchise Tax rate should be set equal to the corporate income tax rate for simplicity, equity, and efficiency.

- **Conforming to the corporate income tax rules for the allocation and apportionment of income.** The allocation and separate-accounting methods for determining income under the current Franchise Tax law will become more inequitable and inefficient as the industry continues to change and more products and services are offered across state lines.

COUNTY REVENUES

The counties should have a more flexible revenue structure that enables them to respond to growing demands in a systematic way without eventually having to face a crisis or series of crises. The preferable option is to grant the counties additional taxing authority and to rely less on grant-in-aid programs.

22. Retain the liquor and tobacco taxes at the State level. This option is addressed only because it was proposed during the 1989 Legislative Session and is still under consideration as House Bill 1858. The subject of that bill is a purported transfer of taxing authority for liquor and tobacco taxes to the counties along with certain parks.

Whether it's that proposal or one with a real transfer of taxing authority for liquor and tobacco taxes, such a measure would not improve equity or efficiency, promote policy, or bear a sufficient connection to county functions and responsibilities to justify the transfer. It would amount to a mere shifting of funds from a revenue source without a rational basis for designating those funds for transfer as opposed to others.

It is not evident how the counties would be better off by having the State grant them the more regressive and inelastic taxes of the Hawaii tax system, and there are no discernable policy considerations that could make these taxes preferable to other, more suitable taxes as a source of revenues for the counties.

On the other hand, the health and welfare costs that are associated with liquor and tobacco consumption are more typically borne by the State than by the counties,

suggesting that the liquor and tobacco taxes should be retained at the State level.

23. Transfer the taxing authority for the Transient Accommodations Tax (TAT) to the counties and, if necessary, set a limit on the rate that can be applied, but not less than the current TAT rate. The TAT is far more suitable for transfer to the counties than the liquor and tobacco taxes. The case for granting each county the authority to impose a TAT begins with the proposition that the incidence of the tax is, more than any other revenue source in Hawaii's fiscal system, on the visitor. The TAT is especially well suited as a source of revenue to finance public services from which visitors benefit significantly.

An analysis of the budgets of the State and the counties indicates that approximately 53 percent of all public outlays for services from which visitors to Hawaii directly benefit are made by the counties.

By comparison, the major services for which the State government is responsible primarily benefit residents of the State. The most important of these services are elementary, secondary, and higher education, public welfare, hospitals, and urban redevelopment and housing. Services directly benefiting visitors are responsible for less than 14 percent of State expenditures.

An additional factor in considering transfer of the TAT to the counties is its close relationship to the real property tax, the primary source of county revenues. In an important sense, the Tax is a substitute for a property tax targeted to hotels and other transient accommodations. Furthermore, the information generated by the process of compliance with the TAT should be of substantial value in estimating the market value of such properties. It makes sense to vest responsibility for both taxes (the property tax and the TAT) with the counties.

A transfer of taxing power should include the ability to impose any rate that a county might choose; a cap could be set on the rate if there were some matter of Statewide concern that warranted imposing a limit on the extent to which rates might be raised.

24. Use unrestricted State grants only when necessary to equalize the fiscal capacity of the counties. Unrestricted grants remove accountability and perpetuate unsatisfactory relationships between the State and the counties. They should only be used to compensate for disparities in revenue raising capacity among the counties. Capital improvement grants or categorical grants should still be used as needed.

25. **The counties should make better use of their existing revenue authority.**

- **Property tax administration** across the country tends to be marked by policies that erode the tax base and create inefficiencies. As the counties take full control of the property tax, there should be a reevaluation of the use of exemptions and other variances from 100 percent assessment. Mechanisms for providing property tax relief without regard to a taxpayer's ability to pay should be avoided. The proliferation of tax classifications should also be avoided. Although the property tax is an unpopular tax, it does satisfy many of the standards for a good tax and should be the cornerstone of a county tax system, especially in Hawaii with its land-based economy and where land ownership represents much of the economic wealth.

- **User fees and charges** reflect the principle that those who benefit from a service should pay for it and are good sources of local government financing to the extent that they are not too costly to administer and do not impose undue hardship on lower income residents. The counties should make best use of such fees and charges.

- **Development fees and exactions** should be based upon an accurate assessment of the infrastructure and maintenance costs that are imposed by a development. These fees and exactions should be more evenly applied on a consistent and predictable basis, rather than on an ad hoc basis. In recent years, the tendency has been to focus on high-visibility projects, with less emphasis on other developments. In the aggregate, the result has been a probable underestimation of the total additional costs imposed by development.

26. **Continue the Public Service Company Tax, but share some portion of the tax with the counties.** There is some uncertainty about the overlap in jurisdiction between the Public Service Company (PSC) Tax and the property tax after November 1989 since the PSC tax is intended to be a means of taxing utility property. Good tax policy would call for the abandonment of the PSC tax and bring utilities and other public service companies under the general excise tax and property tax. However, property taxation for utilities is a complicated issue in many taxing jurisdictions because of the difficulty in assessing the value of utility property and because the situs of property does not necessarily indicate where income is earned.

With the counties taking control of the property tax, a compromise might be preferable to having the State and the counties start vying for utility taxes. A reasonable compromise would be for the State to retain and share the PSC tax (which is simple to administer) with the counties,

while the counties refrain from assessing property taxes on utility property, for as long as both sides can agree to such an arrangement.

NONRESIDENT INVESTMENT

27. **Subject real estate sales to an income tax withholding to be applied as a credit against the income tax on any gain.** This tax would be withheld at the time of sale and is designed to promote a greater level of compliance in reporting income from property sales, particularly on the part of nonresident investors in Hawaii property. It would be in the nature of a withholding in anticipation of a payment of income tax on any gain and would not increase the amount of tax actually paid by a person who reports the gain on a Hawaii income tax return.

OTHER

28. **The tax base for the Transient Accommodations Tax should be reconciled with visitor lodging expenditure estimates using data published by the DBED and HVB.** There is a substantial discrepancy between the official data, indicating either a substantial overestimate of visitor expenditures in Hawaii by the Department of Business and Economic Development and Hawaii Visitors Bureau or an underreporting of transient accommodations receipts for tax purposes. In either case, the information is critical for economic planning and enforcement of the tax laws and should be more consistent.

29. **The Highway fund should be self funding.** The fees and taxes that support the highway fund should be maintained at the levels needed to ensure that the fund is adequately financed without continual infusions from the general fund.

30. **Consolidate the fuel tax at a single level of government.** The overlapping responsibility for highway maintenance is wasteful. A consolidation of responsibility would argue for the entire tax to be assessed and collected by the level of government that assumes full responsibility.

31. **Liquor and tobacco taxes should be made to cover the costs that are incurred by government as a result of the use of liquor and tobacco products.** Nationwide there is a recognition that liquor and tobacco consumption impose costs that may not be covered by the associated taxes. As with a user fee or benefit charge, liquor and tobacco taxes ought to pay the cost of the services that are associated with the use of those products.

32. Tax like-kind exchanges of Hawaii property for non-Hawaii property. Under current law, like-kind exchanges of Hawaii property for non-Hawaii property follows the federal income tax treatment, which calls for deferral of gain recognition until the replacement property is sold. However, whereas the federal income tax is merely deferred, the State income tax tends to be deferred and shifted to another state.

33. The Department of Taxation should develop a system for identifying the source and nature of general excise tax receipts to provide for more detailed information on the types of receipts that are being reported. The prior tax review commission recommended that the Department of Taxation conduct annual statistical analyses of general excise tax data. It is still difficult to analyze the general excise tax because information is lacking.

The Commission had great difficulty arriving at reasonable estimates of the revenue impact of its general excise tax recommendations. The Department of Taxation should at least make an effort to collect better information on the amount of income attributable to the following:

1. Intermediary purchases of goods and services,
2. Intermediary positions in multiple-lease transactions,
3. Residential rental property, and
4. Exported and imported services.

OTHER ISSUES

LIQUOR TAX ESCALATOR

The legislature gave a specific charge to the Tax Review Commission during the 1989 Regular Session to evaluate the taxation of liquor in the State, with special emphasis on the "escalator" provision of the Liquor Tax Law (HRS 244D as amended by Act 344 SLH 1986). The charge was part of general action on S.B. 1187 which essentially continued the gallonage basis taxation of liquor, while suspending administrative authority to set unit tax rates under the "escalator" clause. The bill provided for a two year period, through June 30, 1991, during which time the liquor tax rate adjustment formula could be reviewed by interested parties.

The Commission studied the taxation of liquor in Hawaii, the background and operation of the escalator provision, and the policy implications of continuing with or changing the law. The escalator provision was intended to maintain some element of ad valorem taxation of liquor after the Hawaii liquor tax law had been struck down by the U.S. Supreme Court (though not strictly because of its

ad valorem feature). In brief, however, the administrative adjustment mechanism of the liquor tax law has created inequities and inefficiencies because it is not symmetric and has resulted in preferential treatment of certain categories of liquor. In addition, there has been a probable reduction of tax revenues. (See report in Volume 2.)

The alternatives for liquor taxation are to: (1) tinker with the escalator provision so that it is not as asymmetrical, (2) return to an ad valorem tax, or (3) go to a straight unit tax based on gallonage. The choice between an ad valorem tax and a unit tax basically hinges on whether the tax should grow with liquor prices or require frequent adjustment of the rates and whether an ad valorem tax would be subject to another legal challenge. The Commission believes that an ad valorem tax could be designed to withstand such a challenge.

CORPORATE INCOME TAX

The Commission did not examine the corporate income tax because the important tax policy for a state that has a corporate income tax is to conform to the Internal Revenue Code, and Hawaii does so. The State need only decide how much of a contribution the corporate income tax should make to general fund revenues and adjust the tax rate accordingly.

Tax theorists generally say there should be no corporate income tax. They view the corporate tax as little more than a convenient way of collecting taxes, but there is no way to determine who ultimately pays the tax: it may be shifted forward to consumers, shifted onto labor, or shifted backward to shareholders. From a policy standpoint, this is a major flaw inherent in the corporate income tax.

To the extent that the corporate tax is shifted forward to consumers, it can be said to be a varied-rate excise tax, which violates economic principles and creates inefficiencies. To the extent that it is shifted onto labor, the tax can be regressive and create inefficiencies.

To the extent that it is shifted backward to shareholders, the corporate income tax might make the tax system more progressive (less regressive), but it raises questions of equity because capital is treated differently depending on whether business is conducted in corporate form. There is no reason to believe that the economic status of owners of unincorporated businesses differs from that of corporate owners, but the two are taxed differently when corporate earnings are taxed at the corporate level and then taxed again at the shareholder level upon distribution.

Part of the justification for the tax is the administrative convenience of collecting the tax at the corporate level. In

order to treat corporate and non-corporate owners equally, corporate income would either have to be attributed to its shareholders each year (as with partnership taxation), or the shareholders would have to be allowed a credit for the corporate income tax paid on income distributed through dividends. The U.S. has grappled with this issue of integration between the individual tax and the corporate tax for years and has so far settled on a policy of less than full integration.

Since Hawaii does have a corporate income tax and does conform to the Code, the remaining question is how much of a contribution to the general fund should be expected from the corporate income tax and, from that, the tax rate that should be applied. The corporate income tax at a top rate of 6.4 percent accounted for less than 4 percent of general fund tax revenues for fiscal years 1987, 1988, and 1989. If the decision is made to raise or lower corporate taxes, it can be accomplished simply by adjusting the tax rates.

If there is a common complaint with the Hawaii corporate income tax, it is that the tax is unevenly enforced, and the Department of Taxation is encouraged to pursue more even enforcement.

TAX AMNESTY PROGRAMS

Tax amnesty programs had been a campaign issue during the past Presidential election and were in the news more when the Commission began its deliberations than they are today. Information obtained from the states that had conducted tax amnesty programs was supplemented by a survey of the literature on amnesty programs. The Commission concluded that a tax amnesty program would not be good for Hawaii and should be avoided.

Most state amnesty programs are self-described successes, with less than a handful of states considering their programs to have been failures. The "successful" states offered suggestions on conducting a successful amnesty program and they can be summarized as follows:

- All state taxes should be covered under an amnesty program. In other words, a targeting of amnesty to particular taxes rather than to all taxes generally diminishes the prospects for success.
- Accounts receivable should be subject to amnesty in addition to previously unreported taxes, and notices should be sent to those with open accounts.
- Penalties should be forgiven but interest on delinquent taxes should not.
- There should be plenty of publicity.
- An amnesty program must be integrated with a comprehensive strengthening of enforcement capability,

including improvements to the Department of Taxation and increased penalties and interest.

These steps suggest a tax system in disarray, which can only be reinvigorated through an extensive overhaul, beginning with an amnesty program to clear out unfinished business before the implementation of stiffer penalties and stepped up enforcement.

Nothing in Hawaii's experience suggests that tax evasion is rampant or that the tax system is anywhere near a condition approaching disarray. It is likely that noncompliance, other than with respect to illegal activities, is concentrated in underreporting of rental income under the general excise tax, a problem that can be mitigated by the recommendation to exempt residential rental income from the general excise tax. Most tax amnesty programs on the other hand have primarily been concerned with the income tax. It would thus make no sense in Hawaii to have an amnesty program that extended to all taxes.

In some respects the lack of need for a tax amnesty in Hawaii attests to the efficacy of having a very broad-based, low rate tax such as the general excise tax. The tax is so pervasive that there may be less incentive to cheat.

BUSINESS CLIMATE

There is a concern that Hawaii may not be receptive to business. One aspect of that concern is the tax climate: compared with other states, is Hawaii's tax system hospitable or hostile to business expansion, relocation, or employment creation?

Theoretically, it is not the particular level of tax burden that ought to influence business decisions; rather, it is the relative tax burden that is important, i.e., deviations of one state's tax burden from those in other states. Moreover, tax burden differences are important only if they do not reflect differences in the quantity or quality of public services essential to firms.

Empirical evidence on the importance of tax differentials on the business climate is mixed. In a recent survey article, the author observed that "The flippant answer to the question of what we know about taxes and location is that we know tax differentials matter. We don't know how much they matter."

Empirical evidence on Hawaii's business climate indicates that Hawaii's business tax climate is not particularly disadvantaged relative to other states. A study by for the 1984 Hawaii Tax Review Commission looked at the comparative profitability (including taxes) of a Hawaiian site compared with eight out-of-state locations for firms representing twelve manufacturing types and general business contractors. The manufacturing firms

included high tech industries. The study found that Hawaii's business tax structure was fairly competitive with other states included in the comparative analysis in terms of the retention and expansion of Hawaiian-domiciled companies in Hawaii.

A 1988 study completed for the State of Nevada, using a similar approach, compared effective business tax rates in Nevada against fourteen other states, including Hawaii. The study compared five industries (plus gaming) with growth potential - wholesaling, printing, pharmaceuticals, instruments, and electronics. While these are not the ideal business comparisons for Hawaii, the results nonetheless indicate that among the fifteen states, Hawaii had the second lowest (next to Nevada) effective tax burden on pre-tax income at 4.7% compared to the fifteen-state average of 8.0%. Hawaii's overall tax burden was low because of its low property tax rates - 1.6% of pre-tax income compared to 5.1% for the fifteen-state average, which had not been adjusted to take into consideration Hawaii's unusually high real estate values.

Studies of business tax climate usually do not include near-taxes such as unemployment insurance and workers' compensation. The principal argument against the inclusion of payroll and other near taxes in business tax studies is the conventional assumption that the incidence of these taxes fall on labor rather than on capital.

Nevertheless, given the frequency of complaints about these taxes - particularly the workers' compensation insurance - by the business community in Hawaii, the Commission did examine the impact of unemployment insurance (UI) and workers' compensation (WC) on the cost of doing business in Hawaii.

A survey of unemployment insurance programs among the fifty states indicates that Hawaii is not a particularly high cost state. Hawaii's unemployment tax rate ranks below the median among the fifty states. Presently, the effective tax rate is less than 1% of total wages paid; hence it is difficult to conclude that the State's unemployment insurance program is a deterrent to business relocation, expansion, or employment creation in Hawaii.

The survey of workmen's compensation programs among the states leads to a conclusion that Hawaii's WC program is relatively costly. In 1989, Hawaii's average earned rate of 3.92% of total payrolls ranks seventh among thirty-seven states for which data are available. Among manufacturing establishments, WC insurance rates were nearly 45% higher in Hawaii relative to the national average in 1988, although it was the lowest among the western states. (See Volume 2.)

Fiscal Statistics

STATE AND LOCAL REVENUES

In FY 1987, state and county general revenues in Hawaii totalled \$3.275 billion, 16% of which came from federal grants and 84% from own source revenues. Taxes accounted for 65% of the total. (See Table 1.)

Table 2 shows sources of government revenues for

state and local governments separately. At the State level, general sales taxes in Hawaii comprise a larger share of tax revenues than the national average. At the local level, Hawaii's counties depend more heavily on taxes in general, and the property tax in particular contributes a higher percentage of local government in Hawaii than the

TABLE 1: State and Local Government General Revenues (Combined) by Source: Fiscal Year 1987.

<u>Source</u>	<u>Hawaii % of Total</u>	<u>U.S. Average % of Total</u>
Federal Government	16%	17%
Own Source	84%	83%
Taxes	65%	59%
Property	11%	18%
General Excise	25%	14%
Income	19%	16%
Other	10%	11%
Charges & Miscellaneous	19%	24%

Data: Department of Commerce, Bureau of the Census, Government Finance in 1986-87 (November 1988).

TABLE 2: State and Local Government General Revenues (Separately) by Source: Fiscal Year 1987.

<u>Source</u>	<u>Hawaii</u>		<u>U.S. Average</u>	
	<u>State</u>	<u>Local</u>	<u>State</u>	<u>Local</u>
From Federal Government	16%	15%	23%	5%
From State and Local	--	9	2	33
Own Sources	84%	76%	75%	62%
Taxes	64%	59%	59%	39%
Property	--	48%	1%	28%
General Sales	31%	--	19%	4%
Income	23%	--	23%	2%
Other	10%	11%	16%	5%
Charges and Misc.	20%	17%	16%	23%

Data: Department of Commerce, Bureau of the Census, Government Finance in 1986-87 (November 1988).

Fiscal Statistics

national average. The counties receive less own source revenues from charges and miscellaneous income than local governments nationally.

Table 3 compares the major sources of tax revenues among the states. Compared with the other states, excise/sales taxes make up a larger share of total state and local government tax revenues in Hawaii than the national average. Only five states--Louisiana, Mississippi, New Mexico, Tennessee, and Washington-- have a greater reliance on general sales taxes. By contrast, property taxes make up a smaller share of combined state and local taxes in Hawaii. Only Alabama, Delaware, Louisiana, and New Mexico rely less on the property tax than Hawaii.

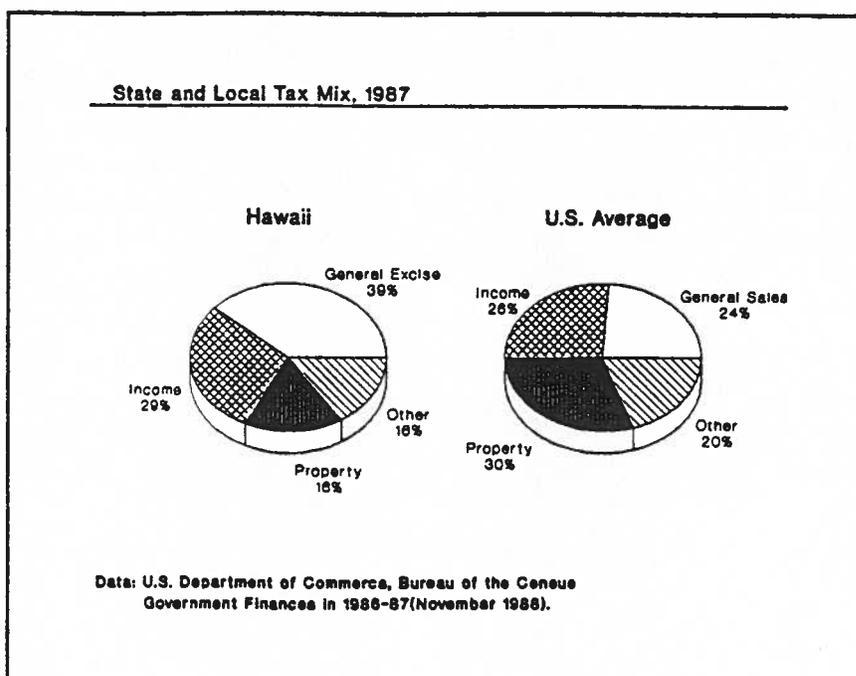


TABLE 3: State and Local Taxes, Fiscal Year 1987

State	Income Taxes	Property Taxes	Sales Taxes	Other Taxes	State	Income Taxes	Property Taxes	Sales Taxes	Other Taxes
Alabama	24.7%	11.4%	30.2%	33.7%	Montana	20.7%	48.3%	0.0%	31.0%
Alaska	8.5	37.6	3.3	50.6	Nebraska	18.3	43.6	19.7	18.4
Arizona	17.8	29.3	34.8	18.1	Nevada	0.0	22.2	34.2	43.6
Arkansas	26.3	19.0	31.4	23.4	New Hampshire	10.9	62.0	0.0	27.0
California	35.0	25.7	25.7	13.6	New Jersey	22.9	40.3	18.1	18.7
Colorado	22.0	35.7	26.7	15.7	New Mexico	17.4	11.7	41.7	29.2
Connecticut	16.1	38.0	25.6	20.3	New York	37.6	28.8	19.2	14.4
Delaware	42.9	13.8	0.0	43.4	North Carolina	35.8	21.4	23.8	19.0
Florida	3.6	33.2	33.6	29.6	North Dakota	13.3	31.7	23.4	31.7
Georgia	30.4	25.3	28.0	18.3	Ohio	31.7	27.4	23.4	17.5
Hawaii	29.3	16.3	38.6	15.8	Oklahoma	19.1	20.1	26.3	34.4
Idaho	26.6	28.4	25.3	19.7	Oregon	36.4	44.4	0.0	19.2
Illinois	20.7	34.5	24.2	20.6	Pennsylvania	28.8	26.5	19.2	25.4
Indiana	25.2	31.9	31.2	11.6	Rhode Island	26.3	37.9	20.7	15.0
Iowa	25.5	37.8	19.1	17.6	South Carolina	28.4	23.3	27.8	20.4
Kansas	20.7	37.4	24.6	17.4	South Dakota	2.9	41.5	31.3	24.3
Kentucky	31.8	16.9	19.8	31.5	Tennessee	6.5	21.5	45.9	26.1
Louisiana	11.5	16.1	39.6	32.8	Texas	0.0	41.3	25.7	33.0
Maine	25.7	32.9	22.9	18.5	Utah	25.9	28.9	29.9	15.2
Maryland	39.8	24.4	15.1	20.8	Vermont	22.4	39.5	12.3	25.9
Massachusetts	42.0	30.4	15.1	12.4	Virginia	30.3	27.7	16.2	25.8
Michigan	31.9	37.7	17.3	13.1	Washington	0.0	28.5	48.1	23.5
Minnesota	33.8	30.1	18.3	17.8	West Virginia	24.5	17.5	33.9	24.1
Mississippi	16.1	23.7	39.1	21.1	Wisconsin	31.4	34.5	19.2	14.9
Missouri	26.0	21.8	33.7	18.5	Wyoming	0.0	48.3	17.0	34.7
					U.S. Average	26.3	29.9	23.9	19.9

Source: U.S. Department of Commerce, Bureau of the Census, Government Finances in 1986-87 (November 1988)

In 1987, Hawaii's state and local governments generated \$1,955 per capita in state and local taxes, placing Hawaii 7th among the 50 states (see Table 3). The national average per capita state and local taxes was \$1,665, so per capita taxes in Hawaii were 17% higher than the national average. However, it is likely that a larger percentage of Hawaii's taxes were exported to non-residents. In calendar year 1988, approximately one

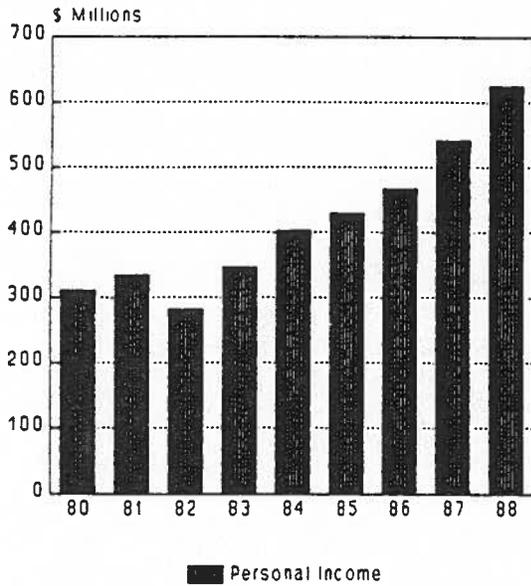
quarter of Hawaii's taxes was exported. (See Distribution of State and Local Tax Burden by Income Class in Volume 2.) Lack of comparable data for other states makes it impossible to determine precisely whether or not per capita state and local taxes in Hawaii were significantly higher than the national average after accounting for tax exporting and importing.

TABLE 3: STATE AND LOCAL GOVERNMENT TAXES PER CAPITA, 1987

State	Per Capita Tax		State Share of Total	State	Per Capita Tax		State Share of Total
	Revenue	Rank			Revenue	Rank	
Alaska	\$ 3,162	1	64.7%	Ohio	1,509	26	59.5
New York	2,773	2	50.0	Kansas	1,508	27	56.8
Wyoming	2,293	3	57.3	Nebraska	1,460	28	52.2
Connecticut	2,216	4	62.0	New Hampshire	1,389	29	37.3
Massachusetts	2,105	5	69.1	Georgia	1,372	30	62.4
New Jersey	2,099	6	59.0	Montana	1,366	31	53.6
Hawaii	1,955	7	81.0	Florida	1,365	32	59.8
California	1,926	8	67.2	North Carolina	1,363	33	71.3
Minnesota	1,904	9	67.9	Utah	1,360	34	60.9
Maryland	1,904	10	60.5	Texas	1,329	35	50.2
Wisconsin	1,787	11	66.3	New Mexico	1,308	36	80.3
Michigan	1,776	12	57.0	Indiana	1,304	37	66.7
Delaware	1,752	13	85.5	North Dakota	1,276	38	66.9
Rhode Island	1,720	14	64.7	Missouri	1,247	39	60.9
Washington	1,697	15	72.7	South Carolina	1,233	40	76.2
Illinois	1,650	16	54.5	Louisiana	1,227	41	61.8
Vermont	1,631	17	60.7	Oklahoma	1,218	42	67.5
Nevada	1,622	18	68.8	West Virginia	1,217	43	78.3
Maine	1,614	19	68.4	Kentucky	1,210	44	77.8
Oregon	1,612	20	50.9	South Dakota	1,194	45	49.2
Colorado	1,602	21	49.1	Idaho	1,178	46	69.1
Arizona	1,595	22	64.8	Tennessee	1,156	47	64.3
Pennsylvania	1,554	23	61.6	Alabama	1,088	48	72.7
Virginia	1,548	24	60.4	Arkansas	1,037	49	76.0
Iowa	1,530	25	62.8	Mississippi	990	50	73.1
				U.S. Average	\$ 1,665	—	61.0%

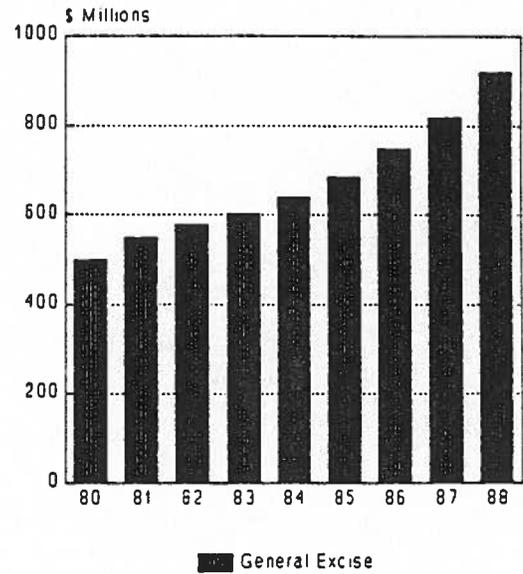
Source: U.S. Department of Commerce, Bureau of the Census, Government Finances in 1986-87 (November 1988).

Personal Income Tax
Fiscal Years 1980-1988



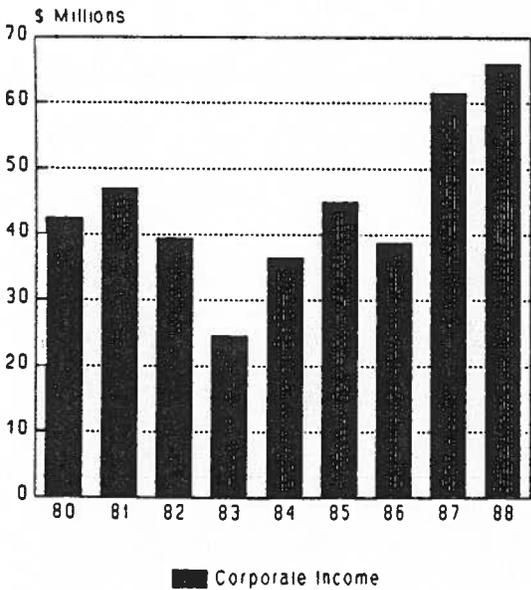
Source: Gov't in Hawaii

General Excise Tax
Fiscal Years 1980-1988



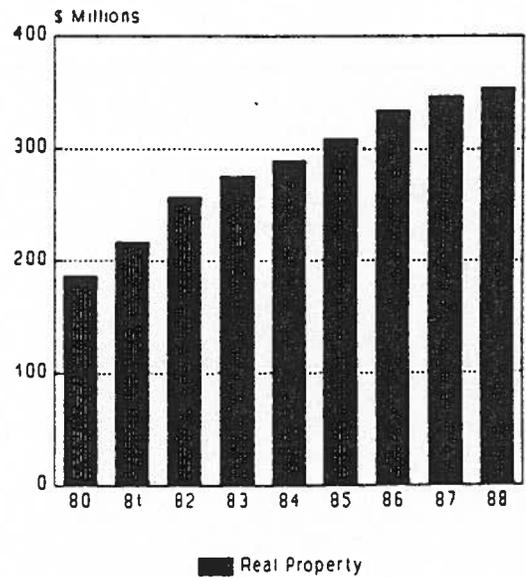
Source: Gov't in Hawaii

Corporate Income Tax
Fiscal Years 1980-1988



Source: Gov't in Hawaii

Real Property Tax
Fiscal Years 1980-1988



Source: Gov't in Hawaii

RATES AND BASES OF HAWAII STATE TAXES, 1989

DESCRIPTION OF TAX	RATE AND BASE	
Personal Income Tax (married, joint)	\$ 0 - \$ 3,000	2.00% of taxable income
	\$ 3,001 - \$ 5,000	4.00% of taxable income
	\$ 5,001 - \$ 7,000	6.00% of taxable income
	\$ 7,001 - \$11,000	7.25% of taxable income
	\$11,001 - \$21,000	8.00% of taxable income
	\$21,001 - \$31,000	8.75% of taxable income
	\$31,001 - \$41,000	9.50% of taxable income
	over \$41,000	10.00% of taxable income
	Capital gains taxed at a maximum of 7.25%	
Corporate Income Tax	\$ 0 - \$25,000	4.4% of taxable income
	\$25,001 - \$100,000	5.4% of taxable income
	over \$100,000	6.4% of taxable income
	Capital gains taxed at 4%	
Estate and Transfer Tax	A tax equal to the amount of the federal credit is imposed on the transfer of property at death	
General Excise Tax	Wholesaling, intermediary services, manufacturing, producing, canning, and blind, deaf or totally disabled persons: 0.05% of gross income	
	Insurance solicitors: 0.15% of gross income	
	Retail sales of goods, services and other activities: 4.00% of gross income	
Transient Accommodations Tax	5% on gross rental proceeds for the furnishing of transient accommodations	
Use Tax	0.5% on goods imported for resale at retail and 4% on all other imports of tangible personal property imported or purchased from an unlicensed seller	
Public Service Companies Tax	Minimum rate 5.885%, maximum rate 8.2% on public utility and 5.35% on land carriers gross incomes based on ratio of net to gross income; 4% of gross income for motor carriers, common carriers by water and contract carriers	
Banks and Other Financial Corporations Tax	11.7% on the net incomes of banks, building and loan associations, industrial loan companies and other financial corporations	
Fuel Tax	Liquid fuel:	\$0.11 per gallon
	Diesel oil:	\$0.01 per gallon
	Aviation fuel:	\$0.01 per gallon
Liquor Tax	Distilled spirits:	\$5.42 per gallon
	Sparkling wines:	\$2.00 per gallon
	Still wines:	\$1.30 per gallon
	Cooler beverages and beer:	\$0.86 per gallon
	Draft beer:	\$0.50 per gallon
Tobacco Tax	40% of the wholesale price of all tobacco products	
Conveyance Tax	\$0.05 per \$100 on the consideration paid for the transfer of realty \$1 minimum tax on each transaction	
Motor Vehicle Weight Tax	0 lbs. - 4,000 lbs.	\$0.50 per pound
	4,001 lbs. - 7,000 lbs.	\$0.55 per pound
	7,001 lbs. - 10,000 lbs.	\$0.60 per pound
	over 10,000 lbs.	\$0.65 per pound
	\$2 annual minimum	
Insurance Premiums Tax	Life insurance:	
	1.918% on gross premiums for domestic	Casualty and other insurance:
	3.197% on gross premiums for foreign firms	2.9647% on gross premiums for domestic
		4.2824% on gross premiums for foreign firms
	Surplus line brokers:	
	4.68% on gross premiums	Ocean marine insurance: 0.8775% of gross underwriting profits

Fiscal Statistics

TABLE 5
STATE AND COUNTY TAX COLLECTIONS IN HAWAII
Selected Fiscal Years

Unit of Government Source	1988	1987	1986
State of Hawaii			
General Excise & Use	\$ 920,231,598	\$ 817,949,166	\$ 747,102,409
Transient Accommodations ^a	67,289,516	23,519,051	--
Fuel	85,190,074	73,295,619	67,559,069
Liquor	38,201,225	34,546,649	29,851,839
Tobacco	21,318,154	19,060,096	19,740,731
Insurance	38,009,445	35,949,389	34,609,170
Public Service Companies	63,586,627	61,791,619	70,264,948
Banks & Other Financial Corp.	12,035,596	15,276,289	4,934,437
Corporate Income ^b	66,017,436	61,516,739	39,588,870
Individual Income Tax ^c	626,008,717	542,689,337	467,206,178
Inheritance and Estate	7,314,264	5,177,736	5,971,395
Real Property ^d	191,155	--	24,897
Conveyance	4,210,529	3,622,266	1,947,474
Licenses, Permits & Others	6,565,190	5,980,292	6,442,513
Unemployment Compensation	77,009,668	76,055,780	66,951,310
Sub-Total	\$2,033,179,194	\$1,776,430,028	\$1,562,195,240
Counties			
Real Property ^d	\$ 353,880,368	\$ 346,171,147	\$ 333,670,014
Liquor Licenses & Fees	2,813,821	3,687,809	3,561,653
Utility Franchise	15,775,843	15,523,566	18,048,711
Motor Vehicle Weight ^e	39,311,011	35,619,384	32,504,308
Licenses, Permits & Others	10,222,899	11,264,291	9,644,793
Sub-Total	\$ 422,003,942	\$ 412,266,197	\$ 397,429,479
TOTAL	\$2,455,183,136	\$2,188,696,225	\$1,959,624,719

a. Effective January 1, 1987.

b. Includes payments of estimated taxes less refunds.

c. Includes withheld and estimated taxes less refunds.

d. Article VIII, Section 3 of the State Constitution, as amended in 1978, mandated the transfer of real property tax administration to the counties, effective July 1, 1981. State collections after fiscal year 1981 represent taxes for prior years and are distributed to the respective county funds.

e. Includes state motor vehicle weight tax from 1978.

Source: Tax Foundation of Hawaii, Inc.

GOVERNMENT SPENDING

In FY 1987, total state and county government expenditures in Hawaii were \$3.456 billion, or \$3,191 on a per capita basis, which placed Hawaii 19th amongst the fifty states on a per capita basis (see Table 6).

In the same year, total general expenditures were \$3.066 billion, or \$2,834 on a per capita basis, and Hawaii ranked 15th (see Table 7). Thus, overall, Hawaii ranks relatively high amongst the fifty states in terms of per capita state and local government expenditures.

TABLE 6: State and Local Government Spending Per Capita, Fiscal Year 1987.

State	Per Capita Government Spending	Rank	State	Per Capita Government Spending	Rank
Alaska	\$ 11,281	1	Ohio	\$ 2,922	26
Wyoming	4,951	2	Louisiana	2,912	27
New York	4,683	3	Georgia	2,892	28
Washington	3,802	4	Illinois	2,885	29
Minnesota	3,758	5	Tennessee	2,859	30
California	3,745	6	Texas	2,816	31
Massachusetts	3,602	7	Kansas	2,814	32
Colorado	3,449	8	Iowa	2,814	33
New Jersey	3,431	9	Pennsylvania	2,792	34
Nebraska	3,431	10	Florida	2,749	35
Arizona	3,385	11	South Dakota	2,744	36
Utah	3,357	12	Maine	2,737	37
Michigan	3,333	13	Virginia	2,641	38
Nevada	3,288	14	West Virginia	2,635	39
Delaware	3,287	15	Oklahoma	2,628	40
Oregon	3,281	16	North Carolina	2,624	41
Montana	3,250	17	South Carolina	2,556	42
Connecticut	3,237	18	New Hampshire	2,476	43
Hawaii	3,191	19	Alabama	2,475	44
North Dakota	3,170	20	Indiana	2,425	45
Wisconsin	3,154	21	Kentucky	2,383	46
Rhode Island	3,113	22	Idaho	2,361	47
Maryland	3,084	23	Missouri	2,329	48
Vermont	3,065	24	Mississippi	2,306	49
New Mexico	2,988	25	Arkansas	2,185	50
			U.S. Average	\$ 3,185	—

Source: U.S. Department of Commerce, Bureau of the Census, Government Finances in 1986-87 (November 1988).

Fiscal Statistics

Among the individual expenditure categories, Hawaii ranked below the median in lower education (ranked 46th), hospitals (36th), highways (49th), and sewerage (26th); and above the median in higher education (23rd), public welfare (21st), health (9th), police (16th), fire (14th), corrections (7th), and parks and recreation (4th).

TABLE 7: Hawaii State and Local Government Ranked According to Selected Per Capita General Expenditure
Amounts: Fiscal Year 1987

<u>Expenditure</u>	<u>Per Capita Expenditure</u>	<u>Rank</u>
Total General Expenditures	\$ 2,834.72	15
Current Expenditure	2,323.14	18
Capital Outlay	511.58	5
Education		
Higher Education	269.49	23
Lower Education	475.10	46
Public Welfare	288.53	21
Hospitals	102.40	36
Health	82.81	9
Highways	136.57	49
Police	101.63	16
Fire	44.29	14
Corrections	78.54	7
Parks and Recreation	74.17	4
Sewerage	53.81	26
Interest on General Debt	242.34	11
Salaries & Wages	1,117.62	19

Source: U.S. Department of Commerce, Bureau of the Census, Government Finances in 1986-87 (November 1988).

Several factors may account for the high level of per capita expenditures in Hawaii, including:

The presence of many tourists in the islands who require government services. On an average day in 1987, there were 134,270 tourists present in the islands. Compared with other states, Hawaii has a much larger daily census of tourists. To accommodate them, Hawaii's state and local governments have to provide airports, police protection, and other tourist-related services beyond the needs of their own residents.

The high cost of living. Government agencies, as well as private citizens, in Hawaii pay higher prices for the goods and services they buy than in any other state except Alaska.

Hawaii's centralized government contributes to above-average spending. Most states have higher standards for public services in their cities and suburbs than in their rural areas. In Hawaii, where the major programs are administered by the state, there is more or less a single, higher urban standard for all areas.

Although this means a more equal administration of the laws, it also means larger budgets.

There are substantial differences between Hawaii and the rest of the U.S. in terms of the division of spending between the state and local governments. Because Hawaii has a highly centralized government, the state is responsible for several important functions--notably elementary and secondary education-- that are usually provided by local governments in other states. As a result, the four county governments in Hawaii account for a much smaller percentage of total state and local government general expenditures compared with local governments in the other states. In fiscal year 1987, the state government accounted for 77% of total state and local government spending while the four counties accounted for only 23% (see Table 8).

The average for state government expenditures among the fifty states is 40% for state government spending compared with 60% for the local governments.

Table 8 shows that in no area is Hawaii's local governments' share of total state and local government expenditures larger than the U.S. average.

TABLE 8: State and Local Spending for Selected Functions: Hawaii and U.S. Average (1987)

<u>Function</u>	<u>Hawaii</u>		<u>U.S. Average</u>	
	<u>State</u>	<u>Local</u>	<u>State</u>	<u>Local</u>
General Expenditures	77%	23%	40%	60%
Education				
Elementary & Secondary	100%	--	1%	99%
Higher	100%	--	84%	16%
Social Services	98%	2%	65%	35%
Highways	63%	37%	60%	40%
Public Safety	38%	62%	31%	69%
Environment & Housing	35%	65%	20%	80%
Government Administration	64%	36%	38%	62%

Source: U.S. Department of Commerce, Bureau of the Census, Government in Finances, 1986-87 (November 1988).

Appendix A

DEVELOPMENT OF HAWAII'S TAX SYSTEM

The tax system in Hawaii reflects a highly centralized system of government. Although Hawaii's first attempt at a modern day tax, the income tax of 1896, was found to be unconstitutional, the power to tax was clearly centralized. With the passage of the Organic Act and the creation of the Territory of Hawaii, revenue collection was placed under the Territorial Treasurer, who collected the bulk of public revenues from real and personal property taxes.

The deficiencies of the earlier law were corrected in a 1901 law that imposed a tax of 2% on income of all individuals in excess of \$1,000 and 2% on corporate net profits. An inheritance tax was added in 1905. The flat income tax was modified in 1921 with the approval of a graduated income tax ranging from 2% to 5% for individuals; the corporate rate was increased to 5%.

The formation of a Territorial Tax Board in 1929 led to a new tax system in 1932, with an emphasis on a new business excise tax, a public utilities tax, and bank excise tax. A fuel tax and a poll tax on employees were also enacted. A five dollar per capita poll tax consolidated school, road, and poll taxes that had been imposed by the kingdom and the republic of Hawaii. Although called a poll tax, it was never a qualification for voting. The real property tax was revised to lower the tax burden and the personal property tax was repealed. The revenues generated by this new tax system fell short of expectations, and in 1934 Governor Poindexter appointed a thirteen member committee to review and analyze the territorial tax system and to develop an equitable and adequate tax system.

The Committee paid considerable attention to those states that had enacted a sales tax or gross income tax in one form or another. The goal was to find a tried form of taxation that had been litigated, satisfied constitutional requirements, where rules and regulations had been established, was reasonably equitable, and where the amount of revenues raised met expectations.

Upon completing its review and evaluation, the Committee recommended a tax reform package that included: the repeal of the bank excise tax, to be replaced with a tax based on bank shares; elimination of the exemption of dividend income under the income tax; repeal of the personal property tax; and most importantly, the replacement of the business excise tax with a "broader based" gross income tax. This latter recommendation was to be the birth of the modern general excise tax.

The fundamental change made by the 1935 reform of the tax system was the redistribution of the tax burden among consumers and businesses. In contrast to the old

business excise tax which focused primarily on taxing businesses, the general excise tax encompassed all activities for financial gain and economic benefit, including the consumer. Although the rate of the general excise tax has been increased over its half century of existence, the nominal rate remains below the average "retail sales tax" rate found on the mainland.

Other significant additions to the tax system during the years of the Depression included the enactment of a Hawaii Unemployment Relief Act of 1933 and a new personal property tax. The Hawaii Unemployment Relief Act taxed compensation and dividends and just before WWII broke out was renamed the "Public Welfare Tax."

Taxes on liquor and tobacco products were imposed at a rate of 6% of retail sale price by the 1939 session of the territorial legislature. The base of the tax was later changed to the wholesale sales price. Again, Hawaii was unique in imposing ad valorem taxes rather than specific excise taxes, common throughout the nation.

The War years brought little change to Hawaii's tax system largely because the Territory was under martial law from day of Pearl Harbor through mid-1944. The poll tax on employees was repealed in 1943 following the passage of the 2% Compensation and Dividends tax.

A compensating use tax was enacted in 1945. It applied to purchases of tangible personal property made from sellers who were not located in the Territory and therefore not licensed under the general excise tax law. Two years later, the retail rate for both the general excise tax law and the compensating tax was increased to 2.5%. In 1948, the personal property tax was repealed, and the first evidence of a sharing of tax revenues with county governments became a part of territorial law.

With renewed efforts to seek statehood for Hawaii underway in earnest, 1957 proved to be a landmark year for the Territorial tax system. After an initial attempt to reform the territorial tax system was rejected, a special session of the legislature repealed the Compensation and Dividends Tax and replaced it with a graduated income tax law. The new income tax law attempted to conform closely to the recently revised Internal Revenue Code of 1954, with some modifications and exceptions.

Rate changes were made to the general excise tax, with reductions for producing, manufacturing, wholesaling, canning, and intermediary services, and an increase in the retail rate. Rates were also increased for liquor, tobacco, public utilities and insurance premiums taxes. The dollar ceiling on real property tax collections was eliminated and replaced with a maximum tax rate for the tax.

Appendix A

If nothing else, decision makers of 1957 intended to position the territorial tax system for the coming of statehood, realized two years later. Statehood brought a burst of growth and an increased demand for public services and infrastructure. The dawning of the commercial jet age brought thousands of visitors to Hawaii and placed an extraordinary pressure on the young state to meet the new demand for public services.

Just six years after statehood, recommendations of a gubernatorial commission were before the legislature for their consideration. The primary recommendation was an across-the-board increase in tax rates (with the exception of the fuel and inheritance taxes). The rates enacted as part of the 1965 reform are basically those that taxpayers see today (such as the 4% general excise tax rate). The consumption and compensating taxes were repealed and replaced with the current use tax law, placing out of state business on equal footing with in-state businesses.

The county sharing provisions of the general excise and consumption taxes were replaced with a new State grant-in-aid program based on fiscal need and capacity. This repeal of tax sharing was in conjunction with the State's assumption of the counties' school construction and maintenance programs.

The income tax was updated to conform to the federal law, with new rates and brackets for the individual income tax. The use of tax credits for low income individuals and to discourage school dropouts was initiated as part of the amendments; both were based on income and need.

An increase in the general excise tax rate to 4% led to a study of the tax and its effect on businesses in Hawaii by the consulting firm Arthur D. Little. Some of its recommendations were reflected in changes made by the 1970 legislature to alleviate some of the pyramiding of the tax. Other recommendations were resisted on the basis that the changes would cause substantial revenue losses.

Individual income tax changes included: conforming the personal exemption to the federal amount, exemption of armed forces reserve income, and the establishment of a consumer credit to address the regressivity of the general excise tax on the purchases of food and drugs. An unusual departure was the use of "modified adjusted gross income" to determine credit eligibility.

A near missed attempt during the 1973 session of the legislature to increase tax rates in response to an expected \$200 million deficit for the fiscal year 1974--which never materialized--led to the creation of an ad hoc commission on operations revenues and expenditures. The commission found no pressing need to raise tax rates at that time. However, it noted that should the state be faced with a

similar crisis in the future, consideration might be given to imposing a tax on the rental of hotel rooms.

The commission also recommended the establishment of a commission to examine the functional responsibilities and revenue resources of the two levels of government, leading to the establishment of the Commission on the Organization of Government in 1976. The report of that commission to the 1977 legislature noted a number of overlapping responsibilities between the state and county governments and made recommendations to streamline the relationships, but there was no legislative response.

The practice of adopting Code changes was haphazard and relied on the citation of various public laws. In many cases, taxpayers did not know with certainty whether or not federal changes were operative for State income tax purposes. The conformity statute in 1978 reflected a modern approach to conforming to the federal law: adopting the Code as it had been amended during the previous year with the exception of certain on-going provisions of the federal law. This adoption by exception made it simpler to comply with and administer the tax.

Besides the conformity statute, 1978 is also remembered as the year of the most recent constitutional convention, which transferred real property tax administration and policies to the counties, led to the constitutional ceiling on State general fund expenditures and the mandated refund of surplus tax dollars, and established the tax review commission.

Changes during the past decade include an overhaul of the inheritance and estate tax in 1983, which was replaced by a pick-up of the federal tax credit as the state tax; the establishment of a 5% tax on transient accommodations in 1986; and a change in the method of taxing liquor from an ad valorem basis to one based on gallonage.

The tax reforms of 1987 and 1989 made changes to income tax rates and brackets, added income tax credits for food, medical services, and the purchase of capital goods. An exemption from the general excise tax was also provided for manufactured goods and agricultural commodities exported for sale outside the state.

The tax system of Hawaii has evolved from the tributes paid chiefs and kings of old Hawaii to the customs duties and tariffs paid by shipping companies trading in the Hawaiian waters during the 1800's to the modern tax system that we know today. While the form and substance of the tax system has evolved over the last two hundred years in Hawaii, the purpose for which taxes are imposed has not changed: taxes are raised to fund public services and the operation of government. How they are raised and by whom they are paid is the delicate balance that represents the challenge for policy makers.

Revenue Adequacy

A tax system should generate the revenues needed to fund government operations and the cost of providing public services. Although tax collections will fluctuate, public services can be maintained through economic downturns if collections grow with good times and do not contract too much in bad times. Over time, collections should be about equal to the amount needed to fund desired levels of services.

Revenue adequacy and fiscal stability are thus the vital first concerns of a tax system, and a tax review commission's first task is to determine whether the system can be expected to generate enough revenues to fund the demand for services. Judgmental issues--identifying the future costs of services and anticipating the economic and political backdrop--ensure that any such determination will be open to question, but a discussion of the State's future can begin in earnest only after an examination of the premises for fiscal policies.

There are normally two approaches to estimating future government expenditures. The first is to start with current policies or spending habits and estimate the projected future cost of maintaining those policies or habits. The other approach is to anticipate the future demand for services, including new services, and make estimates based upon those demands.

On the revenue side, estimates are vulnerable to fluctuations in the economy and unforeseeable changes such as amendments to the federal tax law. Estimates of revenues and expenditures must be used with caution both in making recommendations and in setting policy.

Official State Government Estimates The benefit of a tax review is in the policy directions that are highlighted, but a discussion of good tax policy can easily degenerate into a dispute over statistics. Rather than developing a new set of estimates, the Commission analyzed the State government's estimates of revenues and expenditures to see what those estimates indicate and to determine whether they are reasonable or likely to be realized.

This analysis included revenue estimates by the Council on Revenues, expenditure estimates by the Department of Budget and Finance, and forecasts of personal-income growth by the Department of Business and Economic Development.

Though the tax revenues forecast by the Council on Revenues through 1995 were found to be conservative, they substantially exceed the estimates of expenditures provided by the Director of Budget & Finance to the Commission for the same period.

The Budget Director had cautioned that the expenditure estimates he presented to the Commission during a June 9, 1989 Commission meeting did not take into account future pay raises, off-budget items, and unforeseen expenditures by the Legislature and Judiciary.

Absent further guidance from the Director, the Commission concluded that his estimates of future expenditures were far too low and had to be increased significantly. The estimates were thus increased by a billion dollars to allow for pay increases, off-budget items, unforeseen expenditures, and to bring estimated expenditure appropriations up to the estimated constitutional spending ceiling for each year through 1995.

This chapter explains the measure of the adequacy of the tax system. The next chapter discusses fiscal stability.

Constitutional Spending Limitation Article VII, Section 9 of the Hawaii State Constitution imposed a ceiling on State government expenditures by limiting the growth of general fund (GF) appropriations, excluding federal funds received, to the estimated growth of the State's economy. The enabling legislation, Act 277, S.L.H. 1980, defines the growth of the State's economy as the rate of increase in total state personal income averaged over the preceding three calendar years. The legislature is permitted to exceed the spending limitation by a two-thirds vote of each house.

Table 1 compares actual expenditure ceilings vs. GF appropriations for fiscal years 1979 to 1988 with estimates for 1989 to 1991. Since passage of Act 277, appropriations have exceeded the expenditure ceiling in only one year, 1990 (the ceiling was not in place in time for 1981). In other years, appropriations were below the ceilings.

The reluctance to spend all that was permitted under the constitutional limitation can probably be attributed to fiscal conservatism in response to declining rates of growth of revenues in the early 1980s and uncertainties regarding the economy and the continuation of federal funds in an environment of mounting federal budget deficits. As a result of conservative policy, GF expenditures exceeded GF revenues in only three years between FY1980 and FY1988 (see Table 2). Had the State spent up to the expenditure ceilings, it would have amassed a deficit in excess of \$219 million, instead of the \$404 million surplus actually realized for the period.

The need to impose restraints on expenditures is not indicative of a fundamental inadequacy of the State tax system, as Hawaii's tax system is highly volatile in the short-run. Table 2 shows that between FY1979 and

FY1988, annual growth of GF revenues varied from -1.1% to +17.7%. (After adjusting for tax rebates and contested liquor and insurance premium taxes, the annual growth of GF revenues varied from 2.3% to 17.2% between calendar years 1980-1988.) A better way to evaluate the structural

adequacy of Hawaii's state tax system is to look at the long-run relationship between its revenues and expenditures.

What assumptions should be made about the long-run growth of GF expenditures? The simplest assumption is

Table 1
COMPARISON OF GF APPROPRIATIONS AND EXPENDITURE CEILINGS
(in millions of dollars)

<u>Fiscal Year</u>	<u>Expenditure Ceiling</u>	<u>General Fund Appropriations</u>	<u>Appropriations as % of Ceiling</u>
1978-79		\$ 918.6	-
1979-80	\$1,004.9	1,001.8	99.7%
1980-81	1,109.5	1,177.9	106.2
1981-82	1,256.2	1,252.5	99.7
1982-83	1,421.0	1,396.7	98.3
1983-84	1,567.2	1,426.6	91.0
1984-85	1,691.2	1,499.2	88.6
1985-86	1,831.4	1,646.3	89.9
1986-87	1,881.0	1,732.3	92.1
1987-88	2,035.1	2,009.8	98.8
1988-89*	2,169.5	2,165.5	99.8
1989-90*	2,344.2	2,707.9	115.5
1990-91*	2,535.2	2,475.4	97.6

*Estimated

Data: Letter from Yukio Takemoto, Director, Department of Budget & Finance to Tax Review Commission dated May 26, 1989.

Table 2
GENERAL FUND REVENUES AND EXPENDITURES
(in millions of dollars)

<u>Fiscal Year</u>	<u>General Fund Revenues</u>	<u>Percent Change</u>	<u>General Fund Expenditure</u>	<u>Percent Change</u>
1979-80	\$ 1,084.9	15.1	\$ 972.1	10.7
1980-81	1,198.7	10.1	1,146.0	17.9
1981-82	1,185.8	-1.1	1,207.5	5.4
1982-83	1,252.5	5.6	1,333.0	10.4
1983-84	1,354.6	8.2	1,379.0	3.5
1984-85	1,475.5	8.9	1,451.1	5.2
1985-86	1,605.3	8.8	1,597.8	10.1
1986-87	1,889.8	17.7	1,687.7	5.6
1987-88	2,075.7	9.8	1,944.3	15.2

Data: Department of Budget and Finance

that in the long run, GF appropriations will rise to the levels of the expenditure ceilings, which will probably impart an upward bias to revenue requirements since appropriations during the 1980s have generally been below the expenditure ceilings.

Given that the Hawaii Constitution limits the growth of State government spending to the rate of growth of personal income in Hawaii, the tax system is adequate if tax and non-tax revenues grow at approximately the same rate as personal income.

Tax and Nontax Revenues; How Fast Must Taxes grow? GF nontax revenues are highly volatile. Between FY1974 and FY1987 nontax revenues grew at an average annual rate of 5.2%; since FY1977, they have grown at an average annual rate of 12.3%. However, in his presentation to the Commission, the Budget Director forecast no growth in nontax revenues between FY1990 and FY1995. This means tax revenues must grow faster than the growth of personal income.

Assuming no growth in nontax revenues, and assuming a beginning balanced budget in which nontax revenues comprise approximately 10% of total GF revenues, it would require GF tax collections to grow approximately 10% faster than the growth rate of personal income for the tax system to generate enough revenues to meet projected expenditure appropriations. In other words, the overall elasticity of the GF taxes must be close to 1.1.

Elasticity of General Fund Taxes The elasticity of a particular tax measures the revenue responsiveness of that tax to a change in total personal income (other things held constant). It is measured as the percentage increase (or decrease) in tax revenues as a result of a 1% increase (or decrease) in nominal total personal income. If the elasticity (coefficient) is 1, then a 5% increase (or decrease) in personal income would lead to a 5% increase (or decrease) in tax revenues.

An elastic tax has an elasticity coefficient greater than 1, meaning that tax revenues will increase or decrease at a faster rate than the rate of change of State personal income. An elastic tax is a volatile tax since revenues tend to rise rapidly during an economic boom and fall rapidly during a bust.

An inelastic tax is one that has an elasticity coefficient less than one. The advantage of an inelastic tax is that it provides stability since it is subject to less fluctuation than the State's economy. On the other hand, revenues also grow at a slower pace than the overall growth in the

State's economy, thus requiring periodic rate increases to keep pace with growing expenditure appropriations.

Table 3 shows the elasticities for each of twelve individual state taxes and the overall elasticities for the GF and Total taxes. In computing the elasticities, *actual tax collection data were adjusted to include income tax rebates given to individual taxpayers since FY1982 as well as the contested liquor and insurance taxes held in escrow*. This is necessary to evaluate the tax revenue-generating potential of the current tax system.

Table 3 also shows that the GET, personal income, insurance premium, motor vehicle, and conveyance taxes are elastic. On the other hand, the fuel, public service company, corporate income, liquor, tobacco, banks and inheritance and estate taxes are inelastic. Overall, the GF taxes are fairly elastic with an overall elasticity value of 1.09. This means that in the long run GF tax revenues can be expected to rise by 1.09% whenever personal income rises by 1%. The elasticity estimate for the GF taxes is close to the 1.1 elasticity estimate derived for the 1984 Tax

Table 3: TAX ELASTICITIES

<u>Tax</u>	<u>Elasticity</u>
General Fund	1.09
General Excise	1.07
Personal Income	1.14
Fuel	0.73
Public Service Company	0.99
Corporate Income	0.86
Insurance	1.36
Liquor	0.95
Tobacco	0.83
Motor Vehicle	1.18
Banks	0.66
Inheritance & Estate	0.82
Conveyance	1.14
All Other	0.27
All Taxes	1.09

Source: Computed from data supplied by the Department of Taxation and the Department of Business and Economic Development.

Note: Computed by regressing the logarithms of the respective adjusted tax collection data for the calendar years 1973 to 1988 against the logarithm of nominal state personal income for the same years.

Review Commission.

The conclusion is that over the long run, the current tax system will most likely be able to generate enough revenues to meet the normal growth of GF expenditures.

Cyclical Fluctuations The elasticity estimates shown in Table 3 are long run estimates. There are, however, substantial year-to-year variations in the revenue response of each tax to fluctuations in personal income. Table 4 displays the short-run (i.e. annual) "elasticities" for the (adjusted) GF tax revenues. These were calculated by dividing the year-to-year percentage change in adjusted GF tax collections by the annual percentage change in the state personal income. Note that the "elasticities" range from a high of 1.97 in 1975 to a low of .37 in 1982.

During the economic recessions of the early 1980s, GF tax collections grew much slower than the growth of personal income in Hawaii resulting in falling elasticities. Since then, GF tax collections, except for 1985, have generally grown much faster than personal income. Not surprisingly, during the early 1980s, the state government incurred budget deficits despite conservative spending policies; but since the mid-1980s, the state government has been accumulating annual surpluses.

The budget surpluses have been augmented by the imposition of a transient accommodations tax (TAT) beginning in January 1987, which has generated an additional \$124 million for the state general fund during 1987 and 1988.

The failure of tax receipts and expenditures to move together has, at times, posed difficult budgetary problems for the State. Lagging tax collections have induced the State to impose unanticipated last-minute budgetary cuts, disrupting programs and the planned delivery of services.

It is important to emphasize again that the existence of periodic revenue short-falls is insufficient evidence to indicate that there is a structural inadequacy in Hawaii's tax system. The occasional short-run imbalance between revenue collections and expenditure requirements can be alleviated by establishing a budget stabilization fund, as long as revenues and expenditures are balanced in the long run. The long-run elasticity estimate for the GF tax collections (1.09) suggests that over time, Hawaii's tax system is more likely to produce budget surpluses than deficits.

Prospects for the 1990s In his presentation to the Tax Review Commission, the Budget Director submitted a GF Financial Plan for FY1988 to FY1995 (Summarized in

Table 5.) According to that plan, the accumulated surplus for the General Fund is projected to grow to \$1.8 billion by FY1995. The bases for this projected surplus are: the revenue projections in Table 5 prepared by the Council on Revenues, an independent body appointed by the Governor and the Legislature; and expenditure estimates prepared by B&F.

The Budget Director observed that his expenditure estimates beyond fiscal year 1991 were underestimated because they did not include future pay raises, off-budget items, or unforeseen expenditures by the Legislature and the Judiciary. Indeed, an examination of the B&F Financial Plan shows that between FY1991 and FY1992, GF expenditures are projected to grow at only .2%, and thereafter to grow annually at 4.8% through FY1995. These growth rates are significantly below the likely growth of future expenditures. A more reasonable assumption about the future growth of GF expenditures is that expenditures will rise to the levels of the expenditure ceilings.

Table 4
Short-Run GF Tax "Elasticities"

<u>Calendar Year</u>	<u>"Elasticity"</u>
1974	.95
1975	1.97
1976	.82
1977	.91
1978	.99
1979	1.58
1980	1.05
1981	.81
1982	.37
1983	.41
1984	1.55
1985	.99
1986	1.44
1987	1.60 (2.02)
1988	1.37 (1.44)
Average	1.12 (1.15)

Source: Computed from data supplied by the Department of Taxation and the Department of Business and Economic Development. The values in () include the transient accommodation tax.

Revenue Adequacy

Table 5

Department of Budget & Finance
Financial Plan
(in millions of dollars)

<u>Fiscal Year</u>	<u>General Fund Revenues</u>	<u>General Fund Expenditures</u>	<u>Difference</u>	<u>Accumulated Surplus</u>
1988	\$ 2,088.3	\$ 1,956.8	\$ 131.5	\$ 470.6
1989	2,379.9	2,272.2	107.7	578.3
1990	2,285.6	2,722.6	(437.0)	141.3
1991	2,607.8	2,497.5	111.3	251.6
1992	2,792.7	2,502.3	290.4	542.0
1993	2,980.0	2,623.0	357.0	899.1
1994	3,169.5	2,749.4	420.4	1,319.4
1995	3,375.5	2,882.2	493.3	1,812.7

Source: Presentation by Yukio Takemoto, Director, Department of Budget and Finance to The Tax Review Commission, June 9, 1989.

Table 6

Revised General Fund
Financial Plan
As Computed By Tax Review Commission
(in millions of dollars)

<u>Fiscal Year</u>	<u>General Fund Revenues</u>	<u>General Fund Expenditures</u>	<u>Difference</u>	<u>Accumulated Surplus</u>
1988	\$ 2,088.3	\$ 1,956.8	\$ 131.5	\$ 470.6
1989	2,379.9	2,272.2	107.7	578.3
1990	2,285.6	2,618.5*	(332.9)	245.4
1991	2,607.8	2,393.7**	214.1	459.5
1992	2,792.7	2,659.9	132.8	592.3
1993	2,980.0	2,870.1	109.9	702.2
1994	3,169.5	3,079.6	89.9	792.1
1995	3,375.5	3,292.1	83.4	875.5

Source: Department of Budget and Finance and Tax Review Commission

Notes: * = 1989-90 appropriation of \$2,707.9 x .967 (see Table 1)

** = 1990-91 appropriation of \$2,475.4 x .967 (see Table 1)

Table 6 presents the re-estimated B&F Financial Plan assuming that GF appropriations for fiscal years 1992-1995 will equal the expenditure ceilings. The expenditure ceilings were computed using forecasts of nominal personal income prepared by the Department of Business and Economic Development. It was assumed that expenditures will be equal to 96.7% of appropriations--the average of the actual ratios of expenditures to appropriations during FY1979-FY1988. A comparison of Tables 5 and 6 shows that the B&F's estimated accumulated budget surplus of \$1.8 billion in FY1995 falls to \$875.5 million. Table 6 also uses the Council on Revenues revenue projections even though, historically, its forecasts have consistently been conservative.

The combination of a high expenditure assumption and conservative revenue estimates means that the actual budget surpluses will likely be larger than those displayed in Table 6.

Administration Study In October 1989, Price Waterhouse submitted to the Director of Taxation a report on a study conducted under the auspices of three departments of the Administration: Taxation, Budget & Finance, and Business & Economic Development, showing the impact of a global recession or fluctuations in the value of the dollar relative to the Japanese yen on Hawaii general excise tax and income tax collections for fiscal years 1989 through 1995.

The Administration's study estimated general excise tax and income tax collections under four scenarios:

- (1) baseline trend;
- (2) dollar devaluation, which assumes a decline in the value of the dollar to 93 yen;
- (3) dollar appreciation, which assumes a rise in the dollar to 182 yen; and
- (4) global recession, which assumes a recession in 1990 and 1991 in Japan as well as the United States.

Under the worst case--the dollar rising to 182 yen--the study estimates that combined general excise and income tax collections for the entire six-year period from 1990 through 1995 would be \$439 million less than forecast by the Council on Revenues, an average of \$73 million a year.

Assuming a global recession in 1990 and 1991, including Japan and the United States, the general excise tax and the income tax as estimated by Price Waterhouse would generate \$28 million less in tax revenues than the

Council on Revenues is forecasting for the same period, an average difference of less than \$5 million per year.

The study indicates that if tax collections follow their baseline trend, they will exceed the Council on Revenues estimates by \$271 million over the same period.

Finally, if the dollar falls to 93 yen, the study shows that general excise tax and income tax collections will exceed Council on Revenues estimates by \$941 million.

While granting that the Council on Revenues forecasts through 1995 already reflect slower growth and tend to be conservative, it is unlikely that a two-year global recession would have such a minor impact that tax collections would differ by only \$28 million (in total over six years) from the estimates by the Council on Revenues. In any event, the results of the Administration's study did not alter the Commission's findings and recommendations.

Fiscal Prudence Official State government estimates show a tax system that generates more revenues than needed to fund current policy initiatives. The Commission's estimates of revenues indicate that Council on Revenues forecasts are conservative, a conclusion that is supported by a study commissioned by the Administration. *The question of revenue adequacy therefore hinges on new policy initiatives and the allowances to be made for contingencies.*

The recommendations in this report should be considered within the context of the demands for expanded services and new programs, tempered by prudence. The wisdom of having a restraint on spending as a safeguard within the Hawaii Constitution should not be casually disregarded in the rush to fulfill deferred promises or to meet growing needs, or Hawaii could find itself in the same position as many other states: looking at fiscal distress within the near future.

There will be sufficient revenues through the period ending with fiscal 1995 unless the constitutional spending limitation is regularly exceeded by the legislature in the coming years. The spending ceiling should be superseded when circumstances warrant it, but treating the violation of the spending ceiling as a routine matter trivializes the Hawaii Constitution and can become a matter of habit rather than constituting a fiscal policy.

Fiscal Stability

The maintenance of fiscal stability is a continuing concern for state budget authorities. Within the past ten years, a number of states have adopted new fiscal devices to counteract the destabilizing influences of economic fluctuations and the uncertainties of the changing federal role. For many states, the adoption was prompted by fiscal stress resulting from the depletion of state budgets and tax limitations of the Tax Revolt of the late 1970's. In Hawaii, budget authorities have responded to declines in revenue growth with restraint on the expenditure side.

More recently, fiscal stability in Hawaii has depended, by default, on a tax structure highly responsive to economic growth and on the maintenance of large general fund balances. A concern arising from this default is the efficiency of resource allocation. If the tax structure and the surpluses it generates correctly reflect the public choice regarding the level of government goods and services relative to private goods and services, then the structure is efficient. If tax costs do not reflect the relative value of public goods, then there are efficiency gains to a change from a dependency on an stabilization function implicit in the tax structure to a more formalized stabilization mechanism.

Budget stabilization funds are intended to accumulate tax revenues during periods of strong revenue growth for expenditure use during periods of weak or declining revenue growth. These funds are not necessarily intended to cover all revenue shortfalls. Sustained budgetary problems may indicate a need to reevaluate the priority of expenditures and the revenue structure. Nevertheless, states have increasingly shifted away from dependence on general fund balances and toward budget stabilization funds to cushion against revenue shortfalls; thirty eight states have adopted the use of budget stabilization or other special reserve funds.

Defining Stability and Options Fiscal stability is the product of stability on the expenditure side and stability on the revenue side. Given the public sector decision to provide particular goods and services, expenditure stability provides for the efficient (minimum cost) flow of these goods and services. Erratic starts and stops in program spending can be counter-productive in terms of program start up costs and rational budgeting by program administrators.

On the revenue side, stability in the tax structure provides taxpayers with a greater ability to plan than would be the case if elements in the tax structure were subject to constant change. Revenue fluctuations, however, are a

concomitant feature of tax structure stability, especially when the tax structure is responsive to underlying changes in the economy. A policy of expenditure and tax structure stability will then result in periods of budget surplus and budget deficit. There are four general options available to budget authorities for dealing with the cyclical nature of tax revenues relative to expenditures:

1. **Implicit stabilization funds** accumulate excess revenues in the general fund.
2. **Explicit stabilization funds** accumulate excess revenues in a special budget stabilization fund.
3. **Predetermined tax/expenditure contingency plans** identify the expenditure cuts or tax increases which are automatically triggered by specific revenue shortfall conditions.
4. **Reactive tax/expenditure alterations** basically adjust expenditures to conform to new revenue estimates or adjust tax rates to support given expenditures. This option is an extreme case of option 3.

Options 3 and 4 violate structural stability on either the expenditure side or the tax side, although may match revenues to expenditures in the short run. Indeed, these options tend to be procyclical, exacerbating economic fluctuations by increasing the fiscal drag of taxes or decreasing the injection of government spending during a downturn.

Given a need for stability, the choice then devolves onto the choice between options 1 and 2 above. The underlying issue in this choice is the delegation of authority to the public body and the accompanying level of discretionary power.

At one extreme, housing the stabilization function in the general fund balance provides full flexibility to authorities in determining the size of the cushion and the timing of flows. Flows into the fund are automatic, the result of revenue inflows generated by the tax structure. Flows out of the fund are appropriated, subject to the sole limitation of the constitutional general fund expenditure ceiling in Hawaii's case. The size of the cushion is residually determined by expenditure decisions.

However, using the general fund as an implicit stabilization fund allows budget authorities to avoid making explicit decisions concerning the size of the fiscal cushion and the allocation of the balance. Because general fund balances perform a timing function for the

minor differences in flows of expenditures and revenues, the absence of a definition of the appropriate amount for the stabilization function creates a situation in which the function sizes are ill-defined. Indeed, the recognition of the existence of excess funds is also avoided, calling into question the efficiency of the public-private allocation of resources.

In FY 1988, Hawaii's general fund balance was 24 percent of expenditures, a level much higher than the commonly recommended 3-5 percent. It was also higher than the combined average proportion of general fund and budget stabilization fund balances for all states. Over a longer time period, the general fund 1980-1988 average balance of 15 percent was still higher than the balance for most other states. This large balance is the result of the accumulation of revenues resulting from a tax structure strongly responsive to economic growth. In addition, state legislators have demonstrated a reluctance to refund excess general fund balances, indicating a preference for using budget surpluses as a hedge against revenue shortfalls or, perhaps, as a contingency fund for expanding the scope of publicly provided goods or services.

There are other problems associated with the use of the general fund balance as a stabilization fund. Stabilization funds are generally characterized by sometimes high fund levels, a condition that might not be tolerated by taxpayers when there is no clear definition of the target fund size. In addition, the maintenance of expenditure stability, despite high balances, requires budgetary discipline. An explicit stabilization fund is thought to avoid these political problems, with the formulation of such a fund signaling and confirming a conscious effort to promote fiscal stability.

However, the establishment of a formal stabilization fund creates a statutory institution that is by nature less flexible than the informal or implicit stabilization fund. The very design of such funds in terms of the size and the timing, volume and nature of flows can create a continuum of discretionary authority, ranging from the very flexible to the very restrictive. States use three general approaches for determining stabilization fund sizes and flows:

1. Annual legislative appropriation of revenues to the fund is flexible in terms of discretionary authority and direct in terms of stabilization fund inflow decisions. The method essentially allows the legislature latitude in annually deciding the amounts to be held and placed in the stabilization fund. A consequent characteristic is that the legislature must make explicit decisions with respect to fund inflows. Most states using this approach do not have statutory fund goals.

2. Statutory specification of all surplus revenues until the fund reaches a cap, determined as a percentage of revenues or appropriations, is also flexible in terms of discretionary authority, but is less direct than the first option. Stabilization fund inflows, as the balance of revenues over expenditures, are determined residually instead of explicitly; legislative flexibility is preserved in terms of expenditure decisions. States which have adopted this approach typically specify a statutory cap, essentially defining a long range target for the fund.

3. Statutory specification of revenues above some threshold, determined by the growth rate of an economic indicator, such as real personal income, provides little flexibility from the legislative perspective. This approach uses a formula or rule under which the fund grows automatically as the underlying economy grows. Because the growth of the fund is tied to economic variables, this method does not necessarily define a fund size. It is commonly coupled with a fund outflow rule related to the same economic indicator.

For either of the first two approaches, a stabilization fund size should be determined, regardless of whether the size is specified in statute. The determination of a fund size for the third option may not be required if flows into and out of the fund are automatic, but is desirable if the automatic inflows and outflows become decoupled. The size then provides a measure by which budget authorities can judge the adequacy of fund flows. This fund size is also better specified as a proportion of expenditures, despite the problems that can arise with this technical measure. The alternative use of absolute amounts can result in decreasing fund responsiveness to budgetary conditions over time.

The bench mark recommendation regarding the size of a stabilization fund, either implicit or explicit, is 5 percent of expenditures. For those states that have specifically opted to declare a stabilization cap, the fund caps range from 2 percent to 10 percent of expenditures.

Clearly, a major factor affecting the choice of fund size is the relative volatility of revenue flows. The maximum historical revenue shortfall expressed as a percent of expenditures represents a rough measure of fund size. For Hawaii over the period from FY 1980 to FY 1988, this maximum is 6 percent. Another measure is the maximum revenue shortfall from a long run trend line. Over the same period, this maximum shortfall for Hawaii amounts to \$103 million, representing 7.5 percent of expenditures for the corresponding year.

These proportions might be doubled to provide

coverage in two consecutive years of revenue shortfall. In addition, the probability of revenue shortfall of any given size might be estimated and used to compute an average expected revenue shortfall. Ultimately, though, the optimal fund size can only be the result of value judgement and stabilization fund experience.

State experience with procedures for the outflow of monies from budget stabilization funds are more varied:

1. **Automatic flows back to the general fund**, when a general fund deficit occurs, is the most direct with respect to the management of general fund finances, but bypasses an explicit decision to draw down the stabilization fund. The expenditure results of this method are identical to what occurs when the general fund is used as an implicit budget stabilization fund.

2. **Legislative appropriation of monies back to the general fund** is less direct in terms of general fund management, but does require the explicit decision to drawn down the stabilization fund, in contrast to the automatic flow option. In some cases this might require a special legislative session.

3. **Automatic flows back to the general fund**, conditional on growth in real personal income falling below some floor, provides no legislative discretion regarding the flow of monies out of the stabilization fund to the general fund.

Used in conjunction with an automatic rule for flows into the stabilization fund, and conditioned on the same economic indicator, this rule would automatically deplete the stabilization fund to supplement revenue flows into the general fund which have decelerated with slowdowns in the economy.

4. Other alternatives include an advisory consultation process between the governor and the legislative appropriations committee and explicit annual contingency plans for the use of fund monies. These alternatives appear in the stabilization plans of only two states.

A knowledgeable observer suggests that automatic rules are less appropriate for the disbursement of monies out of a stabilization fund than it might be for placing monies into the fund. In particular, there is need for budget authorities to take explicit action regarding the draw down of stabilization funds. The major implication of this recommendation is that stabilization funds should only be accessed through legislative appropriation.

General experience with budget stabilization funds in

other states have produced mildly positive results. In a 1989 survey of state fiscal officers conducted by the National Conference of State Legislatures (NCSL), 30 percent of the respondents indicated the fund was effective as a stabilization device, while 20 percent of the respondents indicated the fund did not perform its function well. For other states, the fund was either too recent to judge or there had never been a need to draw on the fund. Eight states with budget stabilization funds did not respond to the survey.

There are a number of considerations relevant to the design of a budget stabilization fund for Hawaii. First, general fund expenditure levels in Hawaii cannot exceed a ceiling determined by the rate of growth of personal income. The existence of this spending ceiling has special implications for the accounting treatment and the method by which monies flow into and out of the stabilization fund.

For Hawaii, consistency with the constitutional spending limit requires that flows at either the time of entry or time of exit from the fund be counted as general fund expenditures. Of the two alternatives, recording expenditures at the time of actual outflow from the stabilization fund represents a more accurate recognition of use. Moreover, flows into the stabilization fund would be a simple transfer for the purpose of building the fund. This avoids the otherwise necessary tradeoff between current expenditures and the stabilization of future expenditures that the ceiling constraint would impose.

The method by which the spending ceiling is determined has additional implications for the method by which the stabilization fund should receive inflows. Because the spending ceiling is designed to grow with the rate of growth of personal income, the ceiling reflects one of the elements in the fiscal equation: increases in personal income will increase the demand for public services, which will in turn require larger expenditures. Increases in personal income will also increase tax revenues, with tax revenues responding more than proportionately to growth in personal income. This suggests two methods by which inflows to stabilization fund in Hawaii might be signalled: 1) when the rate of growth of tax revenues exceeds the rate of growth of personal income; 2) when the rate of growth of personal income exceeds some predetermined level, for example, a long run real rate of growth. Another method commonly used by states is the allocation of some proportion of the year-end surplus. There is some evidence suggesting that automatic types of fund inflows lead to stronger stabilization funds, but the results are not definitive. Although an automatic type of inflow would promote accountability regarding the disposition of budget

surpluses, the use of a simple guideline would permit flexibility while recognizing the need for some kind of decision regarding flows into the fund.

Outflows from the stabilization fund may require explicit appropriations or may occur automatically. Given the use of stabilization fund monies for general fund purposes, flows out of the fund might occur in a manner similar to that in which expenditures are made out of the general fund. In particular, these fund outflows should be accomplished by appropriation. This represents legislative choice and is consistent with general recommendations concerning how stabilization funds are spent.

Another consideration, related to the constitutional tax refund provision, is the manner in which stabilization fund balances should be treated, relative to the general fund balance. Combining the fund balances for the purpose of the 5 percent threshold would be too limiting with regard to the size of the stabilization fund. If a stabilization fund cap is determined, and the fund is at its full size, then additional revenues would remain in the general fund and legislators would have the current option regarding the size of tax refund. If the fund is not at full size, then legislators would have the additional choice of applying any general fund surpluses toward the stabilization fund.

Interest earnings of the fund may be retained in the fund or returned to the general fund. According to the 1989 NCSL survey, thirteen states add interest earnings of the stabilization fund back into the fund; seventeen states return the interest earnings to the general fund.

Additional concerns center on the use of stabilization fund monies. A budget stabilization fund may be designed for limited use, explicitly stating those functions for which fund monies may be used (health, safety and general welfare), or those functions for which fund monies may not be used (legislative expenses and salary adjustments for appointed officials). However, use limitations should allow for flexibility in interpretation, and a proliferation of restrictions must be viewed cautiously. A budget stabilization fund program with too many restrictions can so constrain budget authority actions that the stabilization function cannot be performed. The proper choice of fund design is somewhere between the extremes.

CONCLUSION

No state can isolate itself from the impact of economic fluctuations on revenue stability. However, efforts toward fiscal stability are enhanced by a specific determination of how this stability might be achieved. An examination of

some fiscal alternatives yields the following results:

- Stabilization funds, whether implicit in the general fund or explicit in a budget stabilization fund, are more consistent with fiscal stability than contingency or reactive measures.
- The institution of an explicit budget stabilization fund promotes accountability in decision making with regard to the size of the stabilization function. The optimal fund size is variable, but consistency with the State Constitution indicates a level of at least 5 percent. Experience may indicate a larger size.
- The institution of an explicit budget stabilization fund creates another formal institution in the budget structure but may represent the necessary tradeoff for changes in the tax structure.
- With an explicit stabilization fund, appropriations from the fund appear to be better than the use of automatic rules to draw down the fund balance in times of need. Excessive restrictions here can be counter productive for the stabilization function.

Income Tax

The role of state income taxes has traditionally been understood to be restricted to revenue generation because their limited range precludes state income taxes from performing the redistribution and countercyclical functions expected of the federal income tax. However, given the productivity of the general excise tax, Hawaii's income tax can be used to redress imbalances in the overall tax system. For example, the income tax has the advantage of relating the tax burden to a person's ability to pay and can be used to counter the regressivity of the general excise tax. The income tax can also be used for competitive positioning relative to other states.

Generally, policy options for achieving these objectives can be approached through some combination of tax rates and tax base. Because Hawaii's income tax base is largely established by the federal government through conformity with the Internal Revenue Code, the primary policy decision is in setting the tax rates. In designing the appropriate state income tax rates, personal exemptions, standard deductions, and credits can be used to direct the benefit of adjustments because they are elements of the "effective tax rates" that are applied to the base. It might also be noted that the gains from conforming to the federal tax rules outweigh the reduction in flexibility; conformity is thus a policy that should be continued.

The Hawaii personal income tax rates and brackets have been adjusted twice in recent years, in 1987 and in 1989. The thrust of those adjustments has been to offset the impact of the federal Tax Reform Act of 1986. While the tax brackets and rates were adjusted to offset some of the base broadening of the federal amendments, the State also adopted a flat dollar food credit against the income tax to return some of the "windfall" revenues.

Tax Reform Act of 1986 The Tax Reform Act of 1986 was a sweeping revision of the federal tax system. It has been portrayed as accomplishing three major tax policy goals: expansion of the tax base, tax system simplification through a reduction in tax brackets, and a reduction in tax rates.

The likely impact of federal reforms on state taxes has been well understood virtually since the federal legislation began to take shape, but states have had a difficult time defining its precise dimensions. The impact of the federal reforms are immense and encompass both direct revenue effects -- positive and negative -- and so-called "behavioral responses" as taxpayers react to changes in the tax code.

One of the clearest examples of this latter phenomenon is the pattern of capital gains realizations by investors.

The 1986 law generally taxes capital gains at lower tax rates, but it also eliminated provisions in the old law which excluded 60 percent of gains on long-term investments from taxation. Thus, the revenue impact of the change involved a tax increase from the elimination of the capital gains exclusion and a partly offsetting reduction because of lower tax rates.

But the effects of the law change did not end there. Also having an effect were changes in taxpayer behavior resulting from elimination of the gains exclusion. Initially, there was a surge in capital gains realizations the year prior to the Act taking effect as taxpayers sought to avoid the effects of base broadening. Following on the heels of this acceleration, there was a sharp drop in capital gains realizations in the first year of tax reform. Tax reform is also believed to have had an effect on how long taxpayers are willing to hold on to certain investments, producing a long-term behavioral effect in addition to the short-term acceleration.

Given these complexities, many states have wrestled with the dual problem of what tax reform means for them and how they should respond to its implications. In this regard, Hawaii is similar to other states. There was an early recognition that the State, because its law is relatively closely tied to federal law, would reap a sizable reform "windfall." In 1987 and again in 1989, the State took steps to return this windfall to the taxpayers and made other changes which reduced overall state tax liability.

Thus, since the Tax Reform Act took effect in 1986, there have been two sets of legislative forces operating on the Hawaii individual income tax. First, there are the effects of federal base broadening, which produced a sizable increase in tax liabilities over and above what the Hawaii tax would have produced in the absence of reform.

Second, there are the provisions enacted by the State in response to the federal changes, which were designed at least in part to distribute the gains from the federal changes back to Hawaii taxpayers.

Impact on Hawaii Taxpayers In the first two years after tax reform, the State's permanent law changes failed to offset the entire windfall. The temporary allowance of a food tax credit, however, more than offset the remaining windfall in both years. The permanent changes enacted in 1989 succeeded in offsetting the windfall, but for only a while. Over time, the windfall will grow faster than the State's legislated changes erode it.

Ironically, this is directly related to the State's efforts to direct its tax law revisions to lower income taxpayers.

Income Tax

Provisions such as increasing the standard deduction and expanding the excise tax credit affect only lower income taxpayers, but as incomes increase over time, taxpayers benefitting from these provisions become ineligible for the excise tax credit and begin to itemize their deductions. Thus, unless the standard deduction or the excise tax credit threshold also increase, the amount that can be returned to the taxpayers through these mechanisms cannot grow.

At the same time, federal tax reform had a great impact on itemizers and high income taxpayers. As incomes grow, more taxpayers itemize their deductions, invest in IRAs, and engage in other economic activity whose tax benefits were curtailed by the Tax Reform Act. As a result, the windfall increases steadily over time, while the State's changes lag somewhat. Unless the State undertakes additional changes, it will find itself benefitting from the windfall again within a few years. (See Volume 2 for a detailed analysis.)

Mitigating Regressivity The Hawaii personal income tax is the second most productive source of State general fund tax revenues. Because income is a measure of a taxpayer's ability to pay, the income tax is also valuable as a vehicle

for relieving regressivity in the tax system.

Income tax credits have been used in Hawaii since the 1960s to reduce the regressivity of the overall tax system. Because credits can be designed to target individuals with lower incomes, a credit approach enhances the overall progressivity of the system. In recent years, however, lawmakers have enacted fixed-dollar credits available to all taxpayers without regard to income. Such flat credits do not significantly mitigate the regressivity of the overall system and are not an effective tool.

The standard deduction is another tool for relieving regressivity because it recognizes subsistence expenditures and benefits taxpayers at lower income levels by exempting some minimum level of income from taxation.

While taxpayers with higher income levels have the flexibility of itemizing deductions, this advantage is not shared to the same degree by taxpayers at the lower end of the income scale. A larger standard deduction compensates somewhat for this difference between itemizers and non-itemizers, under the presumption that lower-income individuals will have made the otherwise deductible expenditures within the limits of the standard deduction amount. A larger standard deduction would also relieve individuals with minimal income from filing income tax returns.

TABLE 1
COMBINED EFFECTS OF FEDERAL TAX REFORM AND STATE RESPONSE ON
HAWAII INDIVIDUAL INCOME TAX LIABILITIES
AS A RESULT OF STATE TAX LAW CHANGES
CALENDAR YEARS: 1986 - 1994
(MILLIONS OF DOLLARS)

	1986	1987	1988	1989	1990	1991	1992	1993	1994
Federal Tax Reform	\$16.0	72.7	84.9	99.7	111.4	125.4	135.7	144.1	153.8
State Response	\$0.0	-45.2	-59.6	-101.7	-109.7	-117.8	-125.9	-132.5	-140.4
Permanent Effects	\$16.0	27.5	25.3	-2.0	1.7	7.6	9.8	11.6	13.3
Temporary Provisions	\$0.0	-35.1	-36.0	-144.9	-45.0	-8.3	0.0	.00.0	
TOTAL EFFECTS	\$16.0	-7.6	-10.7	-146.9	-43.3	-0.7	9.8	11.6	13.3

Source: KPMG Peat Marwick, Policy Economics Group

Notes: Temporary Provisions include the Food Credit enacted in 1987 and due to expire in 1990, the Medical Services Credit enacted in 1989 and due to expire in 1991, and the surplus refund in 1989. The \$16 million impact in 1986 is from capital gains taken in anticipation of the effective date of the Tax Reform Act.

Inflation and Bracket Creep A graduated personal income tax responds to changes in income, but until they were modified in 1987, Hawaii's personal income tax rates and tax brackets had remained virtually unchanged since 1965. Because the brackets and rates had not been changed during the inflationary periods in the late 1970s and early 1980s, subsistence incomes of the 1980s were paying top or near top tax rates under the personal income tax system.

The legislature did provide tax relief in 1987 and in 1989, but the effect of State tax changes was to offset the expected windfall from impact of the 1986 federal Tax Reform Act, while leaving much of the cumulative effect of years of inflation intact. Some of the impact of inflation was addressed when the number of brackets was reduced from eleven to eight in 1987, but the brackets themselves continued to be narrow, causing taxpayers to move into higher rate brackets because of small increases in income.

Although it might have once been argued that the top tax rate applies to a relatively small amount of income after deductions and exemptions have been taken into account, that is less true since the Tax Reform Act. Because of the reduction or elimination of deductions and exclusions, the opportunity for taxpayers to reduce taxable income has been decreased and the amount of income exposed to tax rates has increased. Middle income taxpayers are most affected by the number and size of the tax brackets.

Maintaining Competitiveness The personal income tax is a highly visible tax for those who are deciding whether to locate or remain in Hawaii. When people think of personal income taxes, they tend to think in terms of the top marginal tax rate, and Hawaii's is among the highest in the country. This raises the issue of whether a high marginal tax rate harms the ability of the State to compete for labor and capital.

A high marginal tax rate has two potential effects with regard to competitiveness. First, within a jurisdiction, high taxes on wages creates a disincentive in the tradeoff between work and leisure, with more pronounced effects as the marginal rate increases. This disincentive results in suboptimal production of output and inefficient uses of resources.

Second, across jurisdictions, relative rates of taxation are a factor in business and individual location decisions. Whether or not the top rate of the personal income tax is integral to maintaining the State's competitive position, the rate does influence people's perceptions. If a lower

top marginal tax rate promotes productivity and expansion of the overall economy, consideration should be given to a meaningful reduction.

The objective of maintaining competitiveness in the tax structure must be balanced with the objectives of raising revenues and mitigating regressivity. To focus solely on maintaining competitiveness would be to lose some of the emphasis on making the system fairer. On the other hand, to focus solely on making the system more progressive would be to impose economic inefficiencies onto the system and diminish the State's competitiveness.

POLICY OPTIONS

The Hawaii personal income tax has been subject to the effects of inflation and the economy. It has also been subject to a number federal tax law changes, the more recent of which have broadened the income tax base. The tax should be adjusted in response to those influences and be positioned for the future. The income tax should not be viewed in isolation, but evaluated on the basis of its role within the overall tax system. Recommendations for change are not necessarily an indication of shortcomings within the income tax structure itself; they include adjustments that would improve the overall tax system by making it less regressive and more competitive.

It has been three years since the enactment of the federal Tax Reform Act of 1986. The State's response to the expected "windfall" has included adjustments to income tax rates, with a reduction in the top rate from 11% to 10%. However, a major part of the State's response has been to provide temporary relief in the form of tax credits that were enacted with expiration dates.

That policy of defensive budgeting was prudent at the time, given the uncertainty of the impact of federal tax reform on the economy and on tax receipts. Now that three years have gone by and data are available regarding the effects of the federal changes, reductions should be made permanent by way of rate reductions rather than through an extension of tax credits. Tax credits should be used to target tax benefits; they should not be used as a continuing vehicle for refunding excess collections.

The food credit introduced in 1987 and due to expire in 1990 is more accurately described as a device for returning the expected windfall from the Tax Reform Act of 1986 than as a response to the regressivity of the general excise tax: its operation mimics the credit that is granted to refund excess revenues under the State Constitution. A credit intended to benefit lower income

Income Tax

taxpayers should not apply equally to all taxpayers regardless of income.

In developing its recommendations, the Commission had in mind a tax structure in which the tax burden would be more evenly distributed among income groups, while making the overall tax system less regressive and more competitive. Progress has been made in recent years in providing relief to the poor, but there is still room for improvement. In addition, the middle income taxpayer has benefited less from recent reforms and is entitled to relief. Relief is targeted to the poor through an increase in refundable tax credits and increases in the standard deduction, and to middle income taxpayers through a reduction in the number of tax brackets and a broadening of the brackets.

- A credit that should be increased is the refundable tax credit for low income taxpayers because it does target relief to the poor. The existing food tax credit should be allowed to expire after 1990 as scheduled. The \$45 that is now the food tax credit could be added to the existing general excise tax credit of \$55, for a total credit of at least \$100, phased out according to income. As a result, the general excise tax credit should reflect a base level of food and medical costs. As with the existing general excise tax credit, a consolidation of credits does tend over time to lose the identity of the individual items that are consolidated. The credit might be renamed to indicate that it is intended to cover food and medical costs.

- The standard deduction should also be increased. The standard deduction benefits lower-income taxpayers more than it does wealthier taxpayers, who tend to claim itemized deductions. The Hawaii standard deduction at \$1,900 for a married joint return substantially lags the federal standard deduction of \$5,450.

Because the standard deduction sets the threshold for filing returns and for claiming itemized deductions, the smaller Hawaii standard deduction causes taxpayers to file Hawaii returns or itemize their deductions even though they may not have to file a federal return or do not itemize on their federal return. This complicates the filing of returns for many lower-income taxpayers.

- The number of income tax brackets should be reduced and the brackets broadened. The large number of tax brackets and resulting steep increase in tax rates hurts middle income taxpayers because they are pushed rapidly into the highest tax brackets.

- The 10 percent, double digit top tax rate should also be

reduced; it hurts the competitiveness of the Hawaii tax system relative to those of other states and could weaken the perception of Hawaii as a place to live and work. The perception of Hawaii as a high-tax state works counter to the efforts to diversify the economy and make Hawaii an economic hub of the Pacific.

- The State should also conform to the federal treatment of capital gains. Current Hawaii law differs from federal law by allowing a special rate for capital gains, unlike the federal law which fully taxes capital gains. Whatever the outcome of the current discussion at the federal level to again grant preferential treatment to capital gains, the recommendation is to conform to the federal rules.

- The targeting of relief for medical costs could be improved by replacing the current medical services credit, which is limited to \$200 or \$400 regardless of the actual amount of expenses incurred, with an unlimited credit for costs in excess of a floor amount. A floor amount that is already in use is the 7.5% threshold for the itemized medical deduction.

The medical services credit should be designed to avoid having someone pay general excise tax on misfortune. The allowance of a maximum credit of \$200 or \$400 credit does not cover catastrophic costs. As noted earlier, a credit that is granted without regard to a person's ability to pay or economic circumstance is an inefficient and wasteful use of tax resources.

General Excise Tax

The goal of General Excise Tax (GET) policy should be to maintain the broad tax base that makes the tax productive and simple to administer, while controlling the less equitable aspects of the tax.

The key to maintaining a broad tax base is in the careful granting of exemptions. Unless exemptions are granted in a clear and consistent manner that reflects what the tax is and what it is intended to accomplish, there will be a tendency to erode the tax base. Part of the difficulty in developing a clear basis for exemption lies in the nature of the tax itself, which is legally a tax on the privilege of doing business, but which in effect is a tax paid by consumers on the purchase of goods and services.

Since the intent of a tax is not clearly specified in legislation and evolves over time, the intended base for the general excise tax may be conceptualized by relying on legal definitions of the tax, current practice, trends in restructuring the base, and economic theory. (See study by William F. Fox in Volume 2.) For purposes of analysis and comparisons with other states, the G.E.T can be thought of as two taxes combined in one law:

1. The tax at the 4 percent rate is similar to a very broad-based (comprehensive) retail sales tax levied on all sales of goods and services to final consumers.
2. The tax at the 0.5 percent rate can be seen as a levy on the privilege of transacting business with purchasers who are not final consumers.

This does not suggest that the GET is or should be a retail sales tax. It is solely for purposes of understanding the impact of the tax and developing a rational basis for granting or denying exemptions.

In assessing whether or not an exemption should be granted, the following are criteria that the Commission believes are consistent with the intent of the tax:

- The tax should generally be assessed on the basis of consumption rather than production.
- Goods and services should be treated the same.
- The treatment of imported or exported goods and services should not place Hawaii businesses at a disadvantage relative to non-Hawaii businesses.
- Exemptions should generally be granted only when they are necessary to promote horizontal equity.

- Blanket exemptions should not be granted. Instead, exemptions should be granted for the specific types of income that are targeted for exemption.

Sales Tax Comparison The 4 percent GET can be likened to retail sales taxes imposed by 45 states plus the District of Columbia. Hawaii's GET base is 129.2% of personal income, meaning that the tax is levied on a base which is 29.2% above all income received by residents. No other state has a base even equal to personal income--the closest is New Mexico at 87.2%. Hawaii's high base is partly attributable to the effects of tax exporting.

GET collections in 1987 represented 5.2% of personal income in 1987--the highest in the country--vs. the U.S. average of 2.3%. The State of Washington, Mississippi, and New Mexico were the only other states at 4% or more.

The GET generates 48% of Hawaii's state tax revenues vs. the U.S. average of 32%. Six states, led by Washington, have a higher percentage, but Hawaii has the highest per capita receipts, slightly above Washington. The 4 percent tax rate is lower than the rate in 29 states.

There are several reasons why the 4 percent GET can be likened to a sales tax even though it is imposed as a privilege tax on vendors.

First, the legal classification tells little of the legislative intent or the economic effects of a tax, and these are most important in defining the tax. The economic effects in terms of whose income ultimately is reduced by the tax and on product price and consumption level, are the same regardless of whether the tax is legally incident on the seller's receipt or on the buyer's purchase. As a result, legal incidence cannot be used to establish intent. Further, Hawaii is not unique in creating its sales tax in this manner: 13 states, including Hawaii, levy their sales tax on the privilege of engaging in business as a vendor.

Second, exemption of goods produced for export to the mainland or other countries is evidence that the intent is to impose a tax on the final purchases of goods in Hawaii. This is reinforced by the enactment of a use tax on goods purchased outside the state. The net effect is to exempt goods produced in Hawaii and consumed outside the state (unless purchased by a tourist in the state) and to tax goods produced outside the state and consumed in the state. Though the legal basis remains unchanged, these characteristics of the GET shift the incidence from a tax on the privilege of selling or producing in Hawaii to a tax on consumption of final goods.

Finally, the legislature has demonstrated its belief that

the GET is ultimately paid by consumers by granting credits against the individual income tax for general excise tax payments which are implicit in the price of food and medical care.

CONSUMPTION BASED TAX

The common approach to the theoretical development of a tax structure considers three goals: raising sufficient tax revenues, having taxes with minimal influence on economic decisions, and achieving horizontal equity. For any desired level of revenues, the best way to avoid having decisions distorted by taxation is to define the tax base very broadly so people cannot avoid the tax by purchasing untaxed items. In addition, the tax rate should be constant across all commodities; at the least, close substitutes should be taxed at the same rates.

Practically, this can only be accomplished by using a single rate on all final consumption so that the tax does not pyramid. These same characteristics are consistent with horizontal equity because they mean people with the same consumption expenditures pay the same tax.

Businesses are intermediary purchasers of goods and services, and business purchases should be exempt from the tax base because they are not final consumption. Failure to exempt intermediate purchases, or to tax them at a low rate as in Hawaii, causes the sales tax to become a turnover tax which pyramids into higher product prices.

In sum, tax theory would indicate that the optimal base for a consumption-based tax levied on sales should include all sales to households without regard to whether the vendor is a private firm or a public agency and regardless of where the goods or services are produced. It should exclude all sales to governments or businesses.

Though it cannot be justified under tax theory, the base is often broadened to include sales to business and government for administrative convenience and because of revenue considerations. Therefore, a rule is necessary to exempt those purchases which most clearly lead to excessive pyramiding. The component parts rule is used in Hawaii and most states.

Examples of the tax treatment of specific transactions under a consumption based sales tax are:

Rentals of Real Property The rental value of a home is consumption and as such should be included in the tax base, but this also is true of the imputed consumption value of home ownership. Equity and efficiency are

promoted by ensuring that close substitutes are treated evenly for taxation. Since the current system taxes only rental property, the tax base either should be broadened to include owner-occupied property or narrowed to exclude rental property.

Levying the GET on the sale of owner-occupied housing is approximately equivalent to taxing the annual consumption value of owner occupied property, but broadening the base in this manner would be difficult. This suggests that both home ownership and residential rentals should be excluded from the base.

The revenue loss could be reduced by continuing to tax rentals from land leases where the ownership of the land is separate from the ownership of the structure. Owner-occupied housing on leasehold land and rental housing on leased land would be treated equally, since each would be subject to the land lease rent. There would not be equal treatment of home owners in fee and home owners on leasehold land, but policy and revenue considerations might warrant the continued taxation of land lease rents.

Business rental is not consumption and should be exempt or taxed at a 0.5 percent privilege rate. Failure to do so treats firms differently based on whether they own or lease their property.

Hotel rentals and other tourist accommodations are consumption and should remain in the base. This also enhances tax exporting.

Business Services provided to final consumers should be included in the GET base, but a pure consumption tax would exempt all services provided to businesses, or tax them at a low privilege tax rate. Recognizing that the revenue loss from a complete and immediate exemption may be too great, an alternative is to develop a rule for exempting direct use purchases of services by businesses.

A direct use rule for services is analogous to the component parts rule for tangible goods. The component parts rule exempts the sale of tangible items that become physical ingredients in a product that is manufactured or produced, or taxes them at a lower rate. Since the general excise tax draws no distinction between goods and services as suitable for inclusion in the tax base, there is no reason to treat services differently from tangible goods.

The difficulty is that services cannot be incorporated into a product or service in a way that is "discerned by the senses," as with tangible goods. A review of what other states are doing is of little use because most states do not tax services to the extent that Hawaii does. Services can, however, become part of a product or another service. In those instances, services should be

General Excise Tax

treated the same as tangible goods are treated under the component parts rule.

Although the adoption of a direct use policy could make compliance and administration more complicated than it is under current law, it could be kept relatively simple if the intermediary purchaser were allowed to deduct direct use purchases from income subject to the GET. A deduction method is much more straightforward than requiring the exchange of certificates as in other states. A deduction is also more consistent with the fact that the GET is a tax on the seller and not on the buyer as in other states. With a deduction, each taxpayer is in a position to determine his intermediary purchases, and the audit trail for the Department of Taxation should be the same as with any deduction claimed for tax purposes.

Food and Medical Costs As consumption items, food and medical purchases are properly included in the tax base. Many states allow an exemption for food costs, but they also tend to have higher tax rates and a substantially narrower tax base than Hawaii does. A tax tends to be more equitable and efficient when rates are low and the base is broad.

The general rationale for granting an exemption for food costs is to reduce regressivity. However, any effort to reduce regressivity by means of an exemption from the GET will make the tax less simple, less stable, and less productive. The inclusion of food in the tax base promotes revenue stability since food purchases are not as sensitive to economic fluctuations.

While it may be intended to benefit the poor, a blanket exemption for food or medical costs would be indiscriminate in the actual incidence of benefits. The tax cost of such an exemption would greatly exceed the benefit that accrues to the poor since all food purchases, including those by the more affluent and tourists, would be exempt. In addition, some experts say that the inclusion of medical expenses in the tax base actually makes the tax system more progressive because the consumption of medical services tends to increase with income.

In any event, the preferable approach to reducing GET regressivity is to direct the benefits of tax relief more specifically to the intended beneficiaries through income tax credits and government spending policies. There is no reason to achieve vertical equity by causing each tax to have the degree of progressiveness which is sought for the entire tax system. The best approach to accomplishing vertical equity is by adjusting a tax which is directly imposed on individual ability to pay, such as the individual income tax. Exemptions from an indirect tax such as the

GET do not work as well.

Imports and Exports of Services Under current law; tangible goods are taxed on a consumption basis: goods that are produced and purchased in Hawaii are taxed; goods that are produced in Hawaii and exported are exempt; goods that are imported into Hawaii are taxed under the use tax. Services, on the other hand, are taxed on a production basis: services that are performed in Hawaii are taxed; services that are performed outside Hawaii are exempt. As a result, Hawaii service providers are treated differently from producers of goods and are at a disadvantage relative to their out-of-state competition.

Consistent with equal treatment of goods and services and a view of the GET as a consumption-based tax, the taxation of services that are imported or exported should be like the taxation of goods that are imported or exported.

Imported services provided to consumers in Hawaii should be subject to the GET. If there isn't sufficient nexus to tax imported services under the GET, the services should be taxed under the use tax, as imported goods are. Exported services should be exempt from the GET, as exported goods are.

OTHER EQUITY ISSUES

Not-for-Profit Organizations Exemptions cannot be justified simply on the basis of not-for-profit status since the tax is not imposed on profits and is intended to be passed to the consumer. Exemptions for "merit goods" can be justified as a means of promoting a particular activity on humanitarian grounds or as a quid pro quo for services that the public sector would otherwise need to deliver.

Such an exemption can be just as legitimate for a profit making entity as for a not-for-profit entity if the intent is to support the provision of a service. Hospitals may be an example where an exemption should apply to all hospitals, rather than solely to not-for-profit hospitals, if the goal is to encourage the provision of health care.

Public Utility Companies If the property tax is imposed, it would be appropriate to consider eliminating the public service company tax and imposing the GET on utilities so their tax burden is similar to other firms. Further, eliminating special taxes and bringing all producers under the GET generally is preferable since it will enhance administration, equity, and efficiency. This would permit

the playing field to remain level between utility companies and their competitors.

Blanket Exemptions Section 237-23 of the general excise tax law grants exemptions to certain persons and should be eliminated because it poorly reflects the intent of the law.

Exemptions are generally granted under one of two sections of the GET law: one section grants exemptions to certain persons, the other grants exemptions for certain amounts received. There is no reason why all exemptions should not be framed in terms of exempt amounts rather than having some exemptions for persons and other exemptions for amounts.

Of the 16 "persons" listed as being exempt in section 237-23, only 5 are actually exempt as persons. The others are exempt only to the extent of a qualifying portion of their income. Since the intent is to exempt a portion of income, those exemptions would be better included in the section that exempts amounts and not persons.

The remaining persons actually do have blanket exemptions:

1. banks taxable under Chapter 241,
2. public utilities owned and operated by the State or county,
3. insurance companies which pay premium taxes under chapter 431,
4. building and loan associations taxable under Chapter 241, and
5. non-profit shippers associations operating under part 296 of the Civil Aeronautics Board Economic Regulations.

Ignoring the two clearly specialized exemptions for government-owned utilities and the shippers associations under the Civil Aeronautics Board Regulations, there are only three taxpayers that are exempt as persons from the general excise tax: banks, insurance companies, and building and loan associations. Banks, insurance companies, and building and loan associations are thus the only taxpayers granted complete exemption from the general excise tax no matter what kind of activities they engage in or where their income comes from. There is no policy justification for such complete exemptions. In contrast, hospitals, which are currently under the same section of the law, are exempt only with respect to non-profit activities.

The manner in which exemptions are cast under the current system obscures the differences in treatment and

confuses the intent of the law. Blanket exemptions should generally be avoided, but if there are policy reasons for granting them, they can be just as easily--and more clearly--granted under section 237-24 which specifies which amounts are to be exempt.

As it is now, the tax base has been eroded through the granting of blanket exemptions to three taxpayers and the tax made more complicated as a result of an inconsistent delineation of exemptions under two different sections of the general excise tax law.

Insurance Companies and Franchise Taxpayers There are conceptual reasons and policy considerations that justify the exemption of certain amounts received by insurance companies and franchise taxpayers, but there is no justification for completely exempting insurance companies and franchise taxpayers from the general excise tax.

Consistent with the concept of a consumption based tax, the GET should not be levied on the entire amount of insurance premiums since much of it is a form of savings rather than consumption. Similarly, dividend and interest income earned from investment portfolios are not consumption and should be exempt. On the other hand, income from fees and rental income do represent consumption and should be taxed. There are also equity considerations with fees and rental income since other taxpayers must pay general excise tax on fees and rental income.

Franchise taxpayers should be subject to the same rationale. There are several reasons why interest income earned by franchise taxpayers should be exempt. As stated above, interest income is not consumption. In addition, federal law prohibits state taxation of interest income earned on federal obligations except through a franchise tax (or nonproperty tax in lieu thereof). Since federal interest income must be exempt, the State would want to exempt state interest income to maintain market parity.

There are equity reasons for exempting all other interest income earned by franchise taxpayers. Given the current status of interstate banking and the State's limited ability to capture the in-state activity of out-of-state banks, all interest income earned by banks and other franchise taxpayers should be exempt.

General Excise Tax

**GENERAL EXCISE AND USE TAX COLLECTIONS
FOR FISCAL YEARS 1985 - 1989**

SOURCE OF REVENUES	6/30/89	6/30/88	6/30/87	6/30/86	6/30/85
Retailing	438,005,877	401,866,268	353,912,994	358,232,453	331,219,259
Services	140,769,117	122,728,089	109,819,373	104,271,155	97,118,185
Contracting	110,156,236	87,993,568	72,145,408	66,421,351	45,541,374
Theater, Amuse., Radio, etc.	6,768,604	6,717,457	6,312,998	6,344,030	6,277,759
Interest	9,488,545	10,268,313	8,810,470	8,026,363	8,665,356
Commissions	22,486,834	20,367,662	16,045,856	13,606,903	12,541,517
Hotel Rentals	57,607,768	56,671,637	49,918,830	45,440,470	43,937,333
All Other Rentals	98,048,139	87,585,383	79,497,809	80,032,788	73,372,852
Use (4%)	21,149,045	13,901,288	11,879,000	13,209,974	13,562,736
All Others (4%)	28,416,458	19,712,531	15,476,372	14,030,172	12,946,928
SUB-TOTAL	932,896,623	827,812,196	723,819,110	709,615,659	645,183,299
Insurance Solicitors	276,546	221,172	314,075	198,927	315,707
Sugar Processing	205,069	1,741,738	1,840,364	1,828,746	1,882,452
Pineapple Canning	14,756	11,885	11,324	355,070	922,476
Producing	1,560,347	1,423,180	1,349,360	1,222,003	1,333,079
Manufacturing	3,176,820	2,971,370	2,989,242	2,770,640	2,503,454
Wholesaling	30,469,411	26,832,934	24,290,029	21,097,890	20,263,455
Services (Intermediary)	919,091	829,933	697,265	596,173	567,558
Use (1/2%)	13,648,737	11,699,938	10,060,332	9,011,650	10,658,865
SUB-TOTAL	50,270,777	45,732,150	41,551,991	37,081,099	38,447,046
Allocated Collections	983,167,400	873,544,346	765,371,101	746,696,758	683,630,345
Unallocated Net Collections*	41,810,917	46,251,274	52,154,276		
GRAND TOTAL	1,024,978,317	919,795,620	817,525,377	746,696,758	683,630,345

*The unallocated net collections category includes amounts resulting from collections from penalty and interest, assessments and corrections, delinquent collections, refunds, protested payments and settlements, etc.

Appendix B

DIRECT USE RULE

A direct use rule for services under the GET attempts to treat services in a manner that is similar to the treatment of tangible goods. It does so by drawing an analogy between "direct use" services (intangible input) and the "component parts" (tangible input) concept as applied to products. This requires an attempt to identify what it is that ties an input to an end product.

The reason for trying to treat services and products similarly is because the GET treats both services and products as taxable items. In Hawaii, services as well as materials are thus potentially subject to tax both as items in and of themselves and as ingredients of a taxable item. As in most states, the Hawaii tax law recognizes that the materials that go into the manufacturing or production of a product should not be taxed both as a product in and of itself and as an ingredient of the product when it is sold. The same should be true for services. Most states, however, generally do not tax services under their sales tax, so most tax analyses are not concerned with the treatment of services, either as taxable items in and of themselves or as ingredients.

A component part is incorporated into a product that is sold to an end user, and component parts rules generally require that the part be evident in the product in a way that is discernable to the senses. Such a test cannot be easily carried over to a direct use concept for services because services cannot be discerned by the senses. In addition, a service can (unlike materials) become a "part" of another service as well as becoming part of a product.

The rationale for a direct use rule should deal with each of these potential applications of services.

A Service as Part of a Product What distinguishes a goods that becomes a component part of a product?

1. A component part is incorporated into a product. It should therefore be portable. When a product is transferred, the component part is transferred as part of the product. A service can be thought of as being incorporated into a product if can be understood to be somehow "embedded in" or "attached to" that product so that the embedded service would also be transferred as part of the product upon sale.
2. A component part is particular to a product. A service must also be particular to a product. It cannot, in other words, be a service whose cost is merely apportioned among products (i.e., overhead). It must instead be a service performed directly in connection with one product that is sold to one end user.

A Service as Part of Another Service In the case of a service that is part of another service, the portability criterion is less instructive because the transfer of a service, an intangible, is not as susceptible to portability.

A more useful measure is whether there can be a "direct tracing" of the service from the original vendor to the end user. Subcontracting is a clear example.

Examples

Service as part of a Product For example, services related to the development of a hotel and involving an intermediary purchaser: This involves a product, the test should therefore be whether the services can reasonably be understood to be embedded in or attached to the hotel and transportable. The following should apply:

A. Direct Use:

Legal fees for building permits and zoning, or for obtaining a right of way.

Architect Fees for the plan that is actually built.

B. Not Direct Use:

Legal fees for:

1. The acquisition of the property. This is specific to the owner, not transferred with the hotel.
2. Title clearance - For the same reason.
3. Hotel permits and licence - Related to operations, not embedded in or attached to the hotel.

Service as part of another Service For example, services employed by an engineer: This involves the purchase of services by a service provider, who may or may not pass the purchased services on to a customer.

A. Direct Use for employing independent draftsman.

B. Not Direct Use:

1. The payment of legal fees on retainer.
2. The use of a janitorial service for office cleaning.

Definitions

An "end user" means a person who pays for a product or service on which the seller was subject to the GET or the use tax and who does not resell that product or service or incorporate that product or service into a product or service for resale.

An "intermediary purchase" means a purchase by a person who is subject to the GET and is not an end user.

Appendix C

The General Excise Tax (GET) has been a major component of Hawaii's tax system for the past fifty years. This is a summary of the evolution of the GET and its impact on Hawaii's tax structure. Further discussion and analysis of the GET is addressed in the consultant report, "Defining the General Excise Tax Base: Exemptions and Pyramiding" by William Fox. (See Volume 2.)

BACKGROUND

Hawaii's GET law was adopted in May, 1935 to address the fiscal crisis of the territorial government during that time period. Prior to the GET law, the territorial government relied primarily on the real and personal property tax to meet governmental needs.

However, in 1932 when revenues fell short of the estimates made by the 1931 legislature, a special session was convened to address the shortfall. In addition to various amendments made to the existing tax structure, a "business excise tax", which was a tax on the privilege of doing business in Hawaii, was enacted.

BUSINESS EXCISE TAX

The business excise tax, a combination of a gross profit and gross income tax, was 2% of the sum of the operating costs and the net taxable income of any firm doing business within the Territory, less any net losses which may have been incurred by the firm attributable to doing business within the Territory. Operating costs included in the tax base were comprised of federal and territorial taxes and license fees paid; salaries, wages and other compensations paid; depreciation and amortization on property used in the business; marketing and agency costs; the costs of crops grown by the taxpayer; and all other ordinary and necessary expenses incurred in doing business within the Territory. Not included were interest; rents; the purchase price of merchandise purchased and sold by the business; and materials used in its production processes. The rationale of the business excise tax was to tax the value added in production or distribution by each firm, or the portion of gross income received by the business which was attributable to its activities.

In 1934, confronted with a budget deficit of over \$5,000,000 at the end of the 1935-37 biennium and a deep concern for a tax system which would assure sufficient revenues to meet governmental needs and at the same time spread the burden of taxation equitably among taxpayers, Governor Joseph Poindexter appointed a thirteen member advisory committee on taxation. The

Committee was charged to:

- 1) Review the history of Hawaii's tax system since its inception;
- 2) Analyze the fundamental changes which had been made to the tax system since 1929 and the reasons therefor;
- 3) Determine the cause for community discontent with the existing tax laws;
- 4) Develop fundamental principles upon which an equitable and adequate tax system might be based; and
- 5) Develop, for the Governor, a taxation program based upon such fundamental principles.

REPORT OF THE GOVERNOR'S ADVISORY COMMITTEE ON TAXATION

In its review of the territorial tax structure and the cause for community discontent with the tax laws, the Committee found the business excise tax and the personal property tax to be unsatisfactory and causing the most discontent with the community. The business excise tax was found to be unfair to businesses which produced within the territory in comparison to competitive businesses whose products were produced outside of the Territory, and to businesses who did not operate on borrowed capital and/or rented property; while the personal property tax was found to be difficult to administer, inequitable in its operation, and it was doubtful whether it was a satisfactory measure of ability to pay.

The Committee also reviewed various tax laws which were enacted by other states during 1932 and 1933 which were meant to address the revenue shortfall situation similar to what Hawaii experienced during the time when the business excise tax law was adopted. Twenty-eight states enacted a sales tax or gross income tax, in one form or another, to raise revenues to meet governmental spending. The Committee, hoping to find a tax based on some tried form of taxation where various points of law had been passed upon by the courts; where points of constitutionality had been definitely decided; where administrative rules and regulations had been laid down and effective; where the taxes had proven to be reasonably equitable and where the amount of revenues raised had equalled the estimates, found that the gross income tax would satisfactorily meet its requirements. During its deliberations on developing fundamental principles upon which ability to pay taxes may be determined with a reasonable degree of accuracy and which might properly be used as a guiding factor in recommending revisions to

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Hawaii's tax system, the Committee found:

It appears then that the present, past and future income producing ability of the various groups should be the controlling factor in determining group ability to pay taxes. These groups should be divided not only as to kinds and classes of taxpayers, but also, broadly, on the basis of their ability to pass on to others the taxes assessed against them. In following out such a principle those groups which can pass their taxes on to others might properly be required to pay taxes in one form, while those without ability to pass this burden might properly be required to pay taxes on an entirely different basis. Having determined group ability to pay taxes, and compared one group with another, the problem then is to determine the kinds of taxes which will most equitably distribute the burden among the taxpayers within the various groups.

In the determination of a broad, general taxation policy this Committee has considered the subject from three viewpoints, each of which is of tremendous importance to the attainment of a satisfactory solution:

1. Whether the tax basis should be broadened and taxation made more visible and direct.
2. If it is determined that taxation should be more visible and direct and the tax basis broadened, what type of taxes should be imposed to accomplish this result?
3. The specific kind or kinds of tax which will most satisfactorily accomplish this result, taking into consideration:
 - (a) The equity of the tax applied in comparison and in connection with other existing taxes;
 - (b) The estimated revenues to be derived by the application of the various rates;
 - (c) The administrative problems of collection; and
 - (d) The cost of collection.

Based upon the Committee's findings and its taxation policy, the Committee proceeded to recommend to the governor a tax reform program which would:

1. Repeal the bank excise tax law and replace it with a tax on the value of the shares in the hands of the shareholders, collectible through the banks;
2. Amend the income tax laws to eliminate the exemption of dividends;
3. Repeal the personal property tax; and
4. Replace the business excise tax with a "broader based" gross income tax.

This tax program, submitted to the legislature as the "administration's tax reform program" (and later adopted, as amended), would "balance the budget and also effect a fairer and more equitable distribution of the tax burden."

GENERAL EXCISE TAX

The gross income tax, now more commonly referred to as the general excise tax, "is a cumulative tax, not merely applied to the value added at each stage of production and distribution as under the business excise, but at each stage taxing again the values added at all earlier stages."

As a "broad base" tax, the business activities subject to the GET included:

producing, wholesaling, and certain manufacturing	.25%
professional services	.50%
printing and publishing	1.00%
retailing, sugar processing and canning, services other than strictly professional, contracting, theatres, amusements, and radio broadcasting, interest and discounts, commissions, rentals, and all other incomes	1.25%

At the close of the 1935-37 biennium, the GET surpassed its initial estimate by 25.06%, unlike the business excise tax, which produced only about 1/2 of the \$4,000,000 it was estimated to generate. The GET generated over \$6.4 million, even after the rate was lowered by the Governor (a holdover provision from the business excise tax would allow the rate to be reduced by the treasurer with the approval of the governor, or increased no more than 0.25%, according to the treasury needs). The revenues generated during this biennium

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erased a deficit, reinstated a previous salary cut, allowed for automatic salary increases, and still netted a surplus of over a million dollars. The GET collections accounted for 20.25% of the total tax collections for the 1935-37 biennium.

The 1935 tax reform program was not only successful in generating the revenues needed to balance the territorial budget, but it also redistributed the tax burden among businesses and consumers. The business excise tax primarily focused on taxing businesses in Hawaii, whereas the GET reached out to all persons engaged in any and all activities for financial gain and economic benefit, including the consumer.

REVISIONS TO THE RATE STRUCTURE

Since its inception, the GET rate structure has undergone five major revisions:

1) In 1945 the rates on final production and sale were increased from 1.25% to 1.50%, the provision to adjust the general excise tax rate depending on the treasury needs was repealed, and a compensating tax law was enacted to impose a tax on sales of tangible personal property to local businesses by representatives of non-licensed firms who were not located within the Territory (and who would otherwise not be subject to the GET).

2) In 1947 the rates in all categories were increased to 2.50%.

3) In 1957 the rates on final production and sale were increased to generate more revenue; and the rates for manufacturing, producing, wholesaling and compensating were lowered to reduce pyramiding.

4) In 1960 the rates on various categories were reduced to provide tax relief to all taxpayers; specifically, rates on sugar and pineapple production were reduced to enable these industries to effectively compete with similar producers in other areas, the tax rate for producing was lowered to aid and promote the expansion of this industry, and the rates on wholesaling and intermediary services and the compensating tax were reduced to the minimum tax rate in which any industry should pay so long as the GET structure is in existence.

5) In 1965 the rates on final production and sale were increased to raise sufficient additional revenues to implement the "New Hawaii" program; the compensating and consumption tax laws were repealed and a "comprehensive use tax law which covers all transactions and situations presently taxable under the consumption and compensating taxes, as well as taxing the value of goods purchased directly from non-licensed sellers and brought into the State for resale" was enacted.

In 1986 telecommunications was recognized by the legislature as a "new industry in this State", and therefore should be included in the GET base. Act 324, Session Laws of Hawaii 1986 imposed a tax on an apportioned percentage of the gross income of businesses selling interstate or foreign common carrier telecommunications services in the State.

IMPACT OF GET ON HAWAII'S TAX STRUCTURE

Over the years the GET has become an integral part of Hawaii's tax collections. As shown in the chart below, the GET collections as a percentage of total tax collections has grown from 19% in the 1930s, to almost 40% in the 1980s.

<u>Year</u>	<u>% of total collections</u>
1930s	19%
1940s	28%
1950s	41%
1960s	38%
1970s	36%
1980s	39%

Source: Historical Statistics of Hawaii;
Government in Hawaii, various years

Taxation of Financial Institutions

Banking and taxation are different from the way they were thirty years ago when the Franchise Tax was enacted or ten years ago when the legislature last considered bank taxation, and Hawaii faces issues that are being faced by every state in trying to adapt to the changes.

The banking industry, which for Hawaii tax purposes includes savings and loan associations and other Franchise Taxpayers, poses particular problems for state tax systems because it combines all the elements that were identified earlier as being current issues in the evolution of state tax systems: it is part of the service economy, at the heart of the global economy, an innovative user of technology, and one of the prime beneficiaries of deregulation.

Any review of bank taxation should be mindful of the environment in which banks conduct business, because much of what drives state bank taxation involves questions of equity and how banks are to be taxed in relation to other taxpayers. When banks operate across state lines, the issues are those of interstate banking. For banks that operate within Hawaii, the issue is one of general excise tax treatment.

Interstate Banking Hawaii does not officially recognize full interstate banking, but the notion of what interstate banking involves is an evolving one as banks continue to develop new products using new technologies in a less regulated environment. There is an ongoing expansion of both the types of services offered and the reach of those services.

For example, credit cards and automated teller machines are generally seen as forms of banking activity that regularly and easily take place across state lines. Banks offer loans by phone and through the mail. McCray notes that the New England Federal Savings Bank of Wellesley, Massachusetts, opened in 1986, has no walk-in place of business. (See report in Volume 2.) Customers conduct business by mail, by phone, or through automatic teller machines. This is bank that makes home mortgage loans and commercial loans, provides credit card services, and offers IRAs and Keogh accounts.

What this says is that traditional tax concepts for identifying when and where economic activity takes place are inadequate for today's banking industry.

There is no consensus on how states can adapt their tax systems to this new environment. A large part of the problem is that states are limited in their ability to enforce their tax laws much beyond their borders. Minnesota, New York, and Indiana have made some attempts to adapt to their tax systems to reach interstate banking activity, but

it has yet to be seen how successfully their laws can be enforced.

Part of the reason for a lack of consensus even among the states is because states have conflicting interests. The clearest conflict is between states whose banks conduct a substantial portion of their business outside the home state (i.e., money-center banks) and those states whose residents are the customers. Money-center states would want source-based rules that would say that the economic activity takes place where the bank is located, while the other states would want destination-based rules.

Until the states reach some agreement, or the federal government imposes rules on the state taxation of interstate banking, interstate banking will be underassessed or be in jeopardy of overassessment.

It's clear that some sort of resolution will be necessary for state taxation of interstate banking, and eventually international banking. It is also clear that the evolution of banking has not reached the point where resolution is imminent.

An underlying theme in this report is the idea that the tax system should be positioned to accommodate change. Hawaii should position its bank taxes to anticipate the development of a consensus and better methods of taxing banking activity. One part of that positioning is to discard the parts of the Franchise Tax that make no sense and unduly complicate the system - to clean up the basic tax on financial institutions.

General Excise Tax A discussion of interstate banking involves competition among banks. A discussion of banking and the Hawaii general excise tax is necessarily a discussion of fair treatment for banks and other businesses under the GET, both in terms of direct competition and as taxpayers who share the tax burden.

The general excise tax should be maintained with as broad a base as possible because a broad base enhances economic efficiency, stability, horizontal equity, and simplicity. It enables the State to generate sufficient revenues while maintaining a relatively low tax rate. Because of the pervasiveness of the general excise tax, exemptions from the tax should bear close scrutiny. There are two aspects of the general excise tax that should be taken into account in reviewing the taxation of banks.

First, there should be no difference in the tax treatment of direct competitors. Where financial institutions compete with other taxpayers they should be equally taxed or equally exempt.

The second aspect is more difficult because no rational

framework has been set out for thinking about why banks should be exempt from the general excise tax in the first place. When the general excise tax was adopted in 1935, the view was that national banks were "instrumentalities" of the federal government and could not be taxed under the general excise tax because of the doctrine of federal tax immunity. Hawaii did with the general excise tax what it and the other states have done historically in bank taxation, it refused to subject its own state-chartered banks more severely than it was allowed to treat national banks (the largest bank at that time was a national bank). As a result, all banks have been exempt from the general excise tax from the very beginning.

Federal law was amended in 1976 to allow the states to tax national banks in any nondiscriminatory manner, removing the issue of banks as instrumentalities of the federal government. States have been slow in adapting their bank taxes to the federal law change, but the debate has recently been pushed forward by the other changes in the industry.

In the meantime, any ostensible reason that might have existed for allowing banks a complete exemption from the general excise tax no longer exists.

POLICY IMPLICATIONS

State tax systems have not yet adapted to the changes in the banking industry. Deregulation, innovation, and technological changes have blurred the traditional boundaries between banking and commerce. The term "banking" itself no longer captures the industry as it evolves into what is now more often to as the "financial services" industry.

In addition to the problems with definitions, there are also jurisdictional issues as the global market evolves. States are limited in the extent to which they can enforce tax assessments beyond their borders, and new questions of tax nexus further limit the jurisdictional reach. Interstate banking is here, the global market is here, but how should state taxes apply to transactions that are no more than transmissions of electronic data, that take place in some indeterminate place?

At what point in the evolution of the financial services industry can state taxation be changed to capture the economic activity of the financial industry and be applied fairly and efficiently? Until tax theory and jurisdiction can catch up with the development of the financial services industry and the global market, the existing tax system should be positioned to accommodate further change.

Franchise Tax The existing Franchise Tax reflects outdated concepts and is unduly cumbersome. The Franchise Tax itself should be retained because it is only with a franchise tax that federal interest income can be taxed by states, and federal obligations make up a large part of bank assets. There is no reason for keeping the structure of the tax the way it is.

The Franchise Tax can be simplified without causing dislocations and without a significant revenue impact by:

1. **Eliminating the deduction for federal income taxes.** There is no reason for allowing such a deduction for state tax purposes. It artificially props up the nominal tax rate without conferring any real benefit on either the taxpayer or the government.

2. **Setting the Franchise Tax rate equal to the corporate income tax rate.** The peculiar Franchise Tax rate (11.7%) was devised during an era when federal law dictated state bank taxation. It was intended to take into account the combined corporate and general excise tax rate paid by other businesses in order to comply with a federal law requirement regarding the taxation of national banks. The era of federal domination ended in 1976, and there is no longer a justification for the rate structure.

If the deduction for federal income taxes is eliminated and the blanket exemption from the general excise tax is also eliminated, there would be no reason for maintaining a rate that is different from the corporate income tax rate.

3. **Conforming to the corporate income tax rules for allocating and apportioning income.** As the financial services industry becomes less distinguishable from other businesses and becomes more global, the use of accounting rules that differ from the rules that are generally applied will make inequities and inefficiencies more likely than if everyone were subject to the same rules.

General Excise Tax The rationale for eliminating blanket exemptions from the general excise tax is explained in the general excise tax chapter of this report. The blanket exemption should be eliminated and replaced with specific exemptions that reflect policy decisions regarding the taxation of the financial services industry.

The traditional view regarding banks and the general excise tax has been that if the general excise tax should be extended to banks it would be limited to income from "nonbanking" activities. There is no basis for such a presumption that income from "banking" activities should somehow be automatically exempt from the GET.

Appendix D

EVOLUTION OF HAWAII BANK TAXATION

The Federal Role State (Territorial) taxation of national banks appears to have been a settled matter for much of the history of Hawaii taxes prior to 1927. The United States government had early on staked out a claim of federal tax immunity, which extended to state taxation of national (federally chartered) banks. Through a combination of court cases and legislation, the federal government limited the ability of states to tax national banks, declaring in effect that states could tax national banks only to the extent that it chose to allow. Because states were reluctant to subject their state-chartered banks to more onerous taxes than they could impose on national banks, federal law dominated state bank taxation for over a century and a half (from 1819 to 1976).

The Supreme Court initially set out a doctrine of federal immunity in McCulloch in 1819 and reaffirmed it Weston in 1829, both cases involving the constitutionality of state taxes imposed in some fashion on national banks.

Congress codified the McCulloch decision with the National Currency Act of 1864, which outlined a scheme that granted the states a choice of taxing national banks upon either: (1) the rate of tax assessed upon "other moneyed capital" in the hands of citizens in the state, or (2) the rate imposed on the shares of any state-chartered bank.

Congress relaxed its grip between 1923 and 1926 by amending the law so that states could tax national banks under any of 4 different methods: (1) bank shares, (2) a dividends tax, (3) a tax on net income, or (4) according to or measured by net income. That has been the genesis of most state bank tax laws.

Congress essentially removed all restrictions with a 1969 amendment that required only that a national bank be treated the same as a bank chartered within its domiciliary state. Senate Report 91-530, U. S. Senate (1969), discussing the background of the 1969 amendment, states that while there might have at one time been a justification for giving national banks privileges and immunities that were denied state banks, under the theory that national banks are peculiarly an instrumentality of the federal government, the Senate Committee was in agreement that there was no longer any justification for Congress continuing to grant national banks immunities from state taxation that were not afforded to state banks. The prior language of section 5219 was entirely eliminated and amended to read:

For purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located.

The effective date was initially deferred until 1973 and then again until 1976. It has been the law since then.

Hawaii Bank Taxes before the Franchise Tax There was no separate Hawaii bank tax until 1932, and there is no indication that Hawaii took any steps to tax or exempt national banks prior to 1927. State banks appear to have been subject to the income tax.

In 1927, Hawaii responded to amendments to federal law by amending its own net income tax law to add national banks to the list of corporations subject to income tax. Hawaii enacted the Hawaii Bank Act of 1931, which provided that banks were not taxed in respect of their property, real or personal, under any other law, to a greater extent than competing national banks in the territory.

In 1932, with the passage of the Banking Excise Tax, assessed at 10% of net income, Hawaii enacted its first tax directed specifically at banks.

In 1935, the Banking Excise Tax was changed to a flat dollar amount of \$50,000 to be apportioned among the banks.

In 1947, the flat dollar Bank Excise Tax was increased from \$50,000 to \$125,000. In 1951, it was again increased from \$125,000 to \$175,000.

The Franchise Tax was introduced during a Special Session of the Legislature in 1957 and brought banks, savings and loans, and other financial institutions together for the first time under a single tax apart from the income tax.

The Franchise Tax

The Franchise Tax was adopted during a 1957 Special Session of the legislature that produced a major restructuring of Hawaii's taxes including, besides the Franchise Tax: the elimination of the Compensation and Dividends tax in favor of a comprehensive personal income tax, substantial conformity with the Internal Revenue Code, the introduction of differential rates on insurance premiums for domestic and foreign insurers, the elimination of the dollar ceiling on property taxes, and reductions in income tax rates.

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That effort largely reflected the adoption of recommendations that were made by a panel that had reviewed the tax system during the preceding nine months and reported its findings in January 1957.

The law that was enacted did not treat national banks differently from other banks as recommended. Instead, it not only placed all banks under the same franchise tax system but included building and loan associations and financial corporations as well.

Measure and Rate of Tax

The section 241-4 measure of tax is virtually unchanged from the original scheme set out in 1957. The rate has increased from 10% to 11.7%. Most of the changes to Section 241-4 have been to update the references to the Internal Revenue Code or to other chapters of the Hawaii Revised Statutes. The substantive changes to date:

- 1965 - Increased the tax rate from 10% to 11.7%.
- 1975 - Added subsection 241-10 regarding gains and losses on bonds.
- 1987 - Incorporated the Hawaii capital goods credit.

Otherwise, the scheme is as it has always been, which is basically as follows:

Start with income that would normally be reported by a regular corporation under the income tax. Make the

following adjustments under section 241-4(b):

- (b)(1) - Add the interest income from government obligations;
- (3) - Exclude out-of State income;
- (5) - Allow deductions connected with income that is required to be included under the Franchise Tax, and disallow deductions connected with income that is excluded under the Franchise Tax. For this purpose, the income tax rules for the disallowance of interest deductions related to exempt bonds are not applicable;
- (6) - Deduct one half of such capital gain as, under the Code, is entitled to alternative tax treatment;
- (7) - Take a deduction for worthless debts that have been charged off, or in the discretion of the Department of Taxation a reasonable addition to a reserve; provided that the department may allow a partial charge-off;
- (8) - deduct federal income taxes on in-State income;
- (10) - Treat gains and losses on securities in accordance with Code section 582(c).

Hawaii Bank Taxes

<u>Year of Enactment</u>	<u>Type of Tax</u>
1901	Income Tax
:	
1927	National banks subject to income tax
:	
1932	Bank Excise Tax at 10% of net income
:	
1935	Bank Excise Tax at flat \$50,000
:	
1947	Bank Excise Tax increased to \$125,000
:	
1951	Bank Excise Tax increased to \$175,000
:	
1957	Franchise Tax at 10% of entire net income
:	
1965	Franchise Tax rate increased to 11.7%

County Revenues

The counties' plea for more money is not unique to Hawaii. Across the country, local governments are looking to the state for more assistance, and the states in turn are looking to the federal government for the same. As the federal government tries to cope with its budget problems, it will have a tendency to pass along responsibilities--and costs--to the states while at the same time competing with the states for revenues. Local governments are in a precarious position because they face growing demands but have limited power. A knowledgeable observer at the national level has suggested that the result will be a period of "fend-for-yourself federalism" and believes this will be the issue facing state legislatures in the 1990s.

This has a unique twist in Hawaii because education is funded at the State level and the amount of power vested in the counties is less than is typical throughout the rest of the country. That uniqueness has made the debate over county revenues in Hawaii more contentious because comparisons are not easily drawn, and it has been difficult to establish suitable reference points for analysis.

There is a recognition across the country that state/local relations need sorting out. Recent studies have focused not only on the tax and revenue implications of intergovernmental policies but also on the efficiency and quality-of-life questions that arise because of the changing responsibilities and shifting balances between levels of government.

In Hawaii, every committee, commission, advisory group, or task force that has looked into the State/county relationship has had a limited scope and studied certain issues more or less in isolation. The result has been a series of partial analyses rather than the comprehensive analysis that is needed. A comprehensive analysis would cover revenues, spending, and the allocation of functions and responsibilities between the State and the counties.

The Tax Review Commission's mandate is limited to evaluating the tax structure and recommending tax and revenue policy, so this review should be considered a preliminary step in the process of sorting out State and county relationships in Hawaii.

County Revenues: A Question of Efficiency and Revenue Flexibility The debate over county revenues in Hawaii has been framed in terms of whether or not the counties "need" more money. That is not helpful or useful because it amounts to a disagreement over identifying the exact point at which the counties will be in distress. The two possible outcomes of the current approach to county revenues are: (1) at some point services will be allowed to

deteriorate, or (2) property taxes will be increased and eventually reach a level that will not be tolerated.

The focus on waiting until the counties are in distress is ill considered. An analysis of county revenues should instead focus on the allocation of functional responsibilities and revenue authority between the State and the counties, with the goal of ensuring the efficient delivery of public services.

Efficiency in this context can be understood to have two general senses. The first relates to the overall level of economic activity and the role of government when the market fails to provide goods and services, and when private actions give rise to benefits and costs that are not taken into account by the market. The second sense of efficiency concerns the desire to ensure that public services are delivered at minimum cost.

Revenue flexibility is an overlooked aspect of efficiency. Unless a local government can finance public services in a manner that reflects to some degree the cost and beneficiaries of the services it provides, there will be inefficiencies. For example, the trend is to tout user fees and benefit charges as the preferred means of financing local government, and to the extent that fees and charges can be administered at reasonable cost and do not impose undue hardship on the poor, they probably ought to be used. In many instances, however, local governments provide services for which fees and charges might not always be appropriate, such as for police and fire protection. In such cases, much of the financing must come from other sources.

With the property tax often likened to a benefit charge, there is pressure to have the property tax assume the function of financing local services for which fees and charges are insufficient or inappropriate. In Hawaii, however, the property tax also funds services, particularly in support of the visitor industry, that often bear little direct relationship to benefits received by property owners. In addition, given the large percentage of renters in Hawaii relative to other states, the connection between public services and beneficiaries is often obscured because renters do not see the direct impact of property taxes.

Finally, the property tax is an unpopular tax. It was the property tax that sparked the "Tax Revolt" with Proposition 13 in California and Proposition 2-1/2 in Massachusetts. To insist that the counties rely solely on the property tax and be forced to increase property taxes against the protests of citizens, because of a fashion for fees and benefit charges, is an unreasonable demand.

Balance within Hawaii's fiscal system Fiscal balance, in its various dimensions, is a concept of fundamental importance to the analysis of any state-local fiscal system. Fiscal balance is a precondition for the economic neutrality of the system. Unless fiscal disparities are fully capitalized in property values--an unlikely prospect--they provide purely fiscal incentives for people and businesses to move from one locality to another (or not to move when economic considerations call for it). The result is a less efficient economy and lower incomes for residents than might otherwise have been achieved.

A balanced fiscal system is also important to avoid serious inequities among residents of different areas of the state. Such inequities arise when the tax burdens on residents with similar incomes living in different localities differ for comparable levels of services.

The central issue in evaluating fiscal balance is the relationship between revenue-raising ability and the cost of the expenditure responsibilities of the governments in a state. Two important dimensions of fiscal balance are vertical balance and horizontal balance.

A state's fiscal system is vertically balanced when the cost of the expenditure responsibilities assumed by the state government, on the one hand, and local governments as a group, on the other hand, are roughly commensurate with the potential productivity at reasonable rate of the revenue sources available to each level of government.

The data for fiscal 1987 suggest that both revenues and expenditures for the State of Hawaii exceed the national average: revenues were around 40 percent above average, while expenditures were about 30 percent above average. County revenues and expenditures, on the other hand, were both below the national average, at about 40 percent of average.

These data suggest that to the extent that vertical imbalance does exist in the Hawaii fiscal system, it occurs at the State level, where revenues relative to the national average exceed expenditures relative to the national average.

Horizontal balance exists when the fiscal capacity of each county is adequate to enable it to provide some specified levels of services for which it is responsible, without excessive tax rates. Fiscal capacity means the potential ability of a county to raise revenues from its own sources relative to the costs of its service responsibilities.

The data for fiscal 1987 indicate that there is a moderate horizontal imbalance in Hawaii, that is, the counties are not quite equal in revenue capacity or expenditure requirements, and State grant-in-aid programs have not tended to improve the situation. Horizontal imbalance may not necessarily be a problem if it reflects

differing preferences for services among the counties.

State/County Relations in Hawaii The question of county revenues in Hawaii can be properly addressed only within the context of the entire State and county relationship. A review of the history of Hawaii's State/county system suggests a number of conclusions.

First, simplicity of structure has not produced simplicity in or consensus on the division of functional responsibilities and revenue-raising authority between the State and the counties.

Second, the constitutional and political goals of giving the State government sufficient authority and fiscal capacity to address "statewide concerns" have not been addressed satisfactorily. There has been considerable debate over what constitute areas of "statewide" concern and the extent to which that rubric could be used to maintain control over county decisions.

Third, the State Constitution provides neither sufficient detail on State/county relations nor sufficient home rule to ensure stability in those arrangements. Instead, the legislature and, secondarily, the administration and the supreme court have considerable discretion to tinker with the State/county system, particularly with county powers, and to intervene directly in county affairs.

Fourth, increases in governing authority for the counties have been obtained more often through constitutional revision than through the legislative process, even though local self-government has never been an especially prominent issue in any constitutional convention.

Fifth, the legislative process has generally produced a greater centralization of functional responsibilities in the State since 1959.

Sixth, practically every independent body established to study the allocation of functional responsibilities and revenue-raising authority has, to a greater or lesser degree, recommended increased local self-government.

This suggests a paternalistic relationship perpetuated by State and county officials. Arguments against granting the counties additional revenue authority or responsibilities frequently rest on the notion that the counties are not "mature" enough to manage or are not equipped to administer new responsibilities. The counties, for their part, have often contributed to the continuation of paternalism by indicating a preference for either State grant-in-aid programs or a tax sharing over county taxing powers. A continued reliance on State grants or shared taxes delays the development of county capability for handling local functions and reinforces the case for not expanding county authority and responsibility.

Division of Service Responsibilities In a market economy, such as that of the United States, decisions about the allocation of resources are made by individual consumers and investors. In an economy of this type, governments have important roles to play when markets fail. Among the most important of these roles are the provision of goods and services for which people would be willing to pay but that are not available in the market, and ensuring that benefits and costs external to market transactions (often referred to as "spillovers," or "externalities") are taken into account in private decisions. It is also important that governments minimize their unintended effects on economic behavior, as when tax and other policies modify relative prices.

Conceptual considerations offer a powerful rationale for structuring decision-making and the financing and delivery of public services on a decentralized basis to the maximum possible extent. Decentralization significantly enhances the effectiveness of the political process. In a decentralized system, choices about expenditures are closely linked to costs. A corollary of decentralization is the principle of autonomy, which calls for restraint by state governments in their dealings with local jurisdictions.

In general, the essence of the allocation of functional responsibilities among governments lies in an effort to assign each to the jurisdiction whose borders most closely correspond to the range of benefits from a service, so that responsibility vests with the smallest unit of government that can efficiently provide the service. Even the most conscientious effort to assign responsibilities in accord with this logic, however, will leave cases where some of the benefits or costs of a service will spill over the boundaries of the government providing the service.

The importance of this in the case of local governments is that these spillovers, or externalities, will be ignored by local decision-makers. As a consequence, they will produce less of the service than would be appropriate if the demands of all beneficiaries were taken into account, thereby reducing the overall efficiency of the economy. The state government can ensure that the right amount of the service is produced by subsidizing the financing of the service to the extent of the external benefits.

In the special case of benefits that are received by visitors to a locality (an especially important case for Hawaii, where visitors are major beneficiaries of many local services) the state may be able to ensure that the right amount of a service is produced by making taxing authority available to the locality that enables it to collect from visitors an appropriate share of the cost of the service.

When action by a local government creates external

costs, the responsibility of the state is to ensure that those costs are paid by the locality. Most analysts agree that programs whose major objectives relate to the distribution of income and wealth--public welfare, for example--should be the responsibility of the federal government, with possible involvement of state governments in adapting broad national policies to the specific conditions of individual states. Local governments, however, should confine their agendas to the provision of services that do not have strong elements of income redistribution, and finance those services to the maximum possible extent in accordance with the benefit principle. The simple logic of this is that local tax bases and service populations tend to be too mobile to permit the differences between taxes paid and benefits received that are the essence of redistributive policies to be sustained if they reach significant magnitudes.

In addition to spillovers, the existence of substantial fiscal disparities among local governments is also an important rationale for action by a state government. This is the heart of the issue of horizontal fiscal balance.

Assignment of Revenue Authority The overall efficiency of the economy is impaired when the fiscal system is not "neutral," that is, when tax (and service) differentials among jurisdictions influence the decisions of individuals and businesses about where to locate, or induce people to incur substantial costs in efforts to avoid taxes.

Differentials could be avoided by imposing a uniform tax structure throughout the state, but this would be inconsistent with the existence of autonomous local governments. Autonomy without independent authority to raise revenues is a contradiction in terms.

This being the case, the approach most consistent with economic efficiency is for localities to tax bases with low mobility. The base with the lowest mobility is real property (land, of course, has no mobility) so it is not surprising that the property tax is universally viewed as the most appropriate tax for local governments. User charges are also well suited to local governments because--by linking payments to benefits actually received--they do not create an incentive for people to modify their economic behavior.

Consumption taxes are usually regarded as appropriate for state governments but not localities because of the so-called border problem--the ease of avoiding the tax by visiting a neighboring jurisdiction with a lower tax rate or no tax at all. In Hawaii, the border problem is less of an obstacle to county reliance on consumption taxes than it is for local governments on the mainland, where shopping

in a lower-tax jurisdiction may be a 10-minute drive rather than a \$100 round-trip flight.

Income taxes are generally viewed as appropriate only for the federal government and the states because of the high potential mobility of the base. Most local income taxes are limited to "earned" income earned in the jurisdiction. Administrative costs are also an important consideration in the assignment of revenue-raising authority. Although they differ significantly for some taxes, the advent of the microcomputer has significantly reduced the differences.

POLICY OPTIONS

The structure of Hawaii's society and economy is changing, and a powerful rationale is developing for structuring decision making and the financing and delivery of public services on a decentralized basis. Excessive centralization of government in Hawaii will lead to an inefficient allocation of resources, less responsive government, and a loss of accountability.

Based upon information provided by the public sector and private sector, input at public hearings, national trends, and the results of a consultant study conducted on the Commission's behalf (See ACIR study in Volume 2), the Commission's conclusion is that the counties should have additional taxing authority. The property tax is an essential foundation of a local tax system and should be utilized to best advantage, but the counties need to have more flexible revenue structures if they are to maintain the services that residents expect and demand. The revenue diversification that marks the strength of the State tax system is singularly lacking in the county tax system.

An effort was made to consider virtually every proposal for county financing advanced during the past few years. Among the categories of policy options considered were: shifts in revenue-raising authority between the State and the counties, county supplements to State taxes, new taxing authority for the counties, State payments to the counties, revised treatment of purchases by the counties under the general excise tax, and increased reliance by the counties on user fees and charges.

Five sources of State revenues have been identified in recent discussion as possible candidates for transfer to the counties: the alcohol and tobacco taxes, the transient accommodations tax, the State fuel tax for highway use, and the proceeds from fines and forfeitures levied pursuant to county laws.

An alternative to a transfer is a county supplement to

a State tax. A county supplement is a specified increment to a State tax rate, enacted at the option of the county. The policy options considered were county supplements to the general excise tax, to the transient accommodations tax, and to the individual income tax.

A variation is a tax sharing rather than a tax supplement. The distinction is that a county supplement would be imposed by the county as an add on to an existing State tax--"piggybacking"--and collected by the State along with the State tax. A tax sharing, on the other hand, is merely an allocation of part of a State tax. (See Volume 2 for the analysis of options not shown here.)

Shifts in Revenue Raising Authority Authorizing (but not requiring) the counties to levy a new tax--or a tax formerly used by the State--is consistent with the principle of accountability that the government that spends public funds should be responsible for raising them.

The taxing authority must present a genuine option to the counties in order to promote accountability. If a county has no choice in the matter, the tax is really a State tax, and the proceeds that are "shared" with the counties are really a grant-in-aid. Clearly, a grant paid by the State to the counties diminishes accountability because the counties would be spending funds raised by the State government.

An additional consideration is that a grant may be a less reliable source of revenue for the counties in the long run. Authority to levy a tax, experience throughout the nation seems to suggest, is less likely to be revoked than a grant is to be reduced or eliminated--as was the federal Revenue Sharing Program in 1986, for example. At the same time, the revenues from taxes may be somewhat less predictable from year to year than those from a State grant program.

Another rationale for shifting revenue-raising authority would be to achieve a better alignment of sources and service responsibilities, where the services provided pursuant to those responsibilities lend themselves to being financed by charges or taxes conforming with the benefit principle.

1. **Transfer of alcohol and/or tobacco excises from the State to the counties** A proposal purporting to transfer the State's excise taxes on alcohol and tobacco to the counties is contained in House Bill 1858, introduced during the 1989 session of the legislature and still under consideration for the 1990 session. In fact, however, the proposal does not contemplate a true transfer of these taxes to the counties, as a transfer of taxing authority is defined and understood.

The proposal was termed, and has been discussed as, a "complete" transfer of the liquor and tobacco taxes to the counties. Among its restrictions, however, are provisions of House Bill 1858 that tell the counties how to increase or decrease the tax rates, how to share the tax collections, and how to spend the money.

Even if the proposal were changed to allow a true transfer of taxing authority, there is no evident reason why the liquor and tobacco taxes are likely candidates for transfer from the State to the counties. There is no indication that either equity or efficiency would be improved as a result of a transfer.

It isn't evident what social policies the counties might have better control over as a result of such a transfer. If, for example, one county wished to discourage smoking and increased taxes to a prohibitive level, people could easily buy cigarettes in another county. If all the counties raised taxes to prohibitive levels, a black market would develop.

It is also not evident why the counties would be better off by having the State grant them the more regressive and inelastic taxes of the Hawaii tax system, and there are no discernable policy considerations that could make these taxes preferable to other, more suitable taxes as a source of revenues for the counties.

Finally, there is no clear connection between those taxes and the distribution of the benefits of public services for which the counties are responsible. In fact, there is a stronger case for retaining the liquor and tobacco taxes at the State level because it is the State that has responsibility for the health and welfare functions that are associated with the costs to society from the use of liquor and tobacco products.

2. Transfer of taxing authority for the transient accommodations tax from the State to the counties The primary case for transferring the TAT to the counties rests on the proposition that the incidence of the tax is, more than any other revenue source in Hawaii's fiscal system, on the visitor. This suggests that, if the benefit principle is to be accorded high priority in tax policy-making, the TAT is especially well suited as a source of revenue to finance public services from which visitors benefit significantly. The key question, then, is what are those services, and are they predominantly provided by the State or by the counties?

The analysis of the budgets of the State and the counties in Chapter V of the ACIR report indicates that approximately 53 percent of all public outlays for services from which visitors to Hawaii directly benefit are made by the counties. (These services are summarized in Table VIII.1 of the report.) Beyond observing that no services

of significant budgetary consequence benefit visitors exclusively, it is not possible to estimate what proportions of the benefits from these services are enjoyed by visitors. However, the functions shown in Table VIII.1 account for 64 percent of all county expenditures.

By comparison, the major services for which the State government is responsible provide nearly all their benefits to residents of the State. The most important of these services are elementary, secondary, and higher education, public welfare, hospitals, and urban redevelopment and housing. Services directly benefiting visitors are responsible for less than 14 percent of State expenditures.

An additional factor to be weighed in considering transfer of the TAT to the counties is its close relationship to the real property tax, the cornerstone of the county revenue system. In an important sense, the TAT is a substitute for a property tax targeted to hotels and other transient accommodations. Further, the information generated by the process of compliance with the TAT should be of substantial value in estimating the market value of such properties. This being the case, it might well make sense to vest responsibility for both taxes in the counties.

Moreover, the TAT, like the property tax, is peculiarly suited to use and administration by a county because the taxed transaction takes place within the physical boundaries of the government. Then too, the room rate typically comprehends a substantial element of economic (location) rent, which is uniquely amenable to taxation by local authorities. In other words, there is little risk, at remotely competitive tax rates, of migration of the tax base to other jurisdictions.

Finally, county control of the property tax and the TAT would allow each county to choose its own balance between hotel development and residential development and its relative reliance on the associated taxes. To the extent that a county chooses to develop hotel properties, it can rely on TAT collections; to the extent that a county chooses to preserve its residential character, it should rely on the property tax.

3. Exemption of transient accommodations from the general excise tax coupled with a transfer of taxing authority for the TAT to the counties, with an authorization to set a rate of up to some maximum level The Hawaii State tax on transient accommodations is 9.4 percent, which is within an average range for room taxes in the largest cities on the mainland. In Hawaii the tax consists of two taxes: the GET and the TAT. This proposal is related to the recommendation to exempt residential rentals from the GET and would provide a

simpler, more rational basis for taxing accommodations under a single tax. The major issue is whether the State would give up the revenues.

The recommendation to exempt residential property from the GET is intended to equalize the tax treatment of renters and home owners. That rationale does not extend to short term rentals, and the proposed exemption is not intended to apply to transient accommodations because of the policy objective to export taxes.

The question then becomes a matter of defining what is or is not a residential rental. The TAT already provides guidelines for determining what transient accommodations are. Rather than having inconsistent definitions and an overlapping between the GET and the TAT, it would be simpler to exempt all lodgings, whether residential or transient, short-term or long-term, and then tax transient accommodations under a single tax. Since the TAT has already been suggested as being suitable for county control--it is more often a local tax elsewhere--the unified taxation of transient accommodations could properly rest with the counties.

A transfer of taxing power should include the ability to impose any rate that a county might choose; a cap could be set on the rate if there were some matter of Statewide concern that warranted imposing a limit on the extent to which rates might be raised.

Tax Sharing A tax sharing arrangement is an alternative to a shift in revenue raising authority. A tax sharing means that the counties would receive a portion of an existing State tax. Shared taxes are essentially grant-in-aid programs funded by earmarking a part of a particular State tax and thus are unattractive for the same reasons as a grant-in-aid: they diminish accountability, and they are more likely to be revoked than would a grant of taxing authority.

Despite the drawback of shared taxes, a candidate for tax sharing is the Public Service Company (PSC) Tax because of a possible overlap in jurisdiction. The PSC tax is a State tax on the gross income of public utilities, common carriers by water, motor carriers, and contract carriers. The tax rate for public utilities ranges from 5.885% to 8.2%; the rate applied to the others is 4%. Annual collections of the PSC tax are about \$60 million, of which \$50 million is from public utilities and the balance from the carriers.

The PSC law specifies that the tax is a means of taxing the property of public utilities. With the counties now having complete control of the property tax, there is a potential overlap in jurisdiction between the State PSC

and the county property tax. From the standpoint of good tax policy, it's questionable whether a separate tax such as the PSC should be retained instead of subjecting PSC's to the same taxes as other businesses, namely the general excise tax and the property tax. Because the PSC is based on gross income, it does have the advantage of simplicity, unlike property taxation of utilities, which requires assessments of property values that may be difficult to obtain.

It is in the counties' interest to broaden their tax base, and public utility property represents a potential addition to the base. If the State is unwilling to repeal the PSC tax and subject public utilities to the general excise tax, there is a possible conflict between the interests of the State and the interests of the counties that could be resolved by a sharing of the PSC tax.

County Supplements Unlike a shared tax, which remains entirely a State tax, a county supplement is a tax levied by the counties as an addition to an existing State tax (a "piggybacking" onto a State tax). The county supplement is collected along with the State tax and remitted by the State to the counties. The most frequently mentioned candidate for a county supplement is the general excise tax. As a county supplement to a State tax is really a State-administered local tax, any proposal for a supplement must be considered with a view toward the appropriateness of the tax as a source of local revenue. On balance, it would seem that the GET would not be an appropriate tax for the counties.

One consideration is the complexity of identifying the source of GET collections. There have been a number of proposals to require the identification of the source of income by county, but it still is not certain how much of an additional compliance and administrative burden would result from such a requirement. In addition, as a State administered tax, it is uncertain how much of an incentive the State would have to monitor the reporting since its share of the tax would be based on total collections without regard to source.

Another consideration with the GET as a source of county revenue is that its apparent incidence among individuals bears little relation to the distribution of the benefits of public services for which the counties are responsible. The evidence suggests that the incidence of the tax is regressive, whereas it is likely that the distribution of the benefits of services for which the counties are responsible is more or less proportional to income or to the value of residential property. If this is the case, the GET is not well suited as a means for the

counties to finance, in accordance with the benefit principle, their service responsibilities that cannot be funded by fees and charges.

A final consideration is that a county supplement, like a shared tax, tends to cloud accountability. If there is an issue of possible Statewide concern, such as with proposals for mass transit systems, there is no reason for preferring a county supplement to the GET over categorical State grants as a means of financing such projects.

Existing Revenue Authority As of November 1989, the counties have full control of the property tax. By many measures the property tax in Hawaii is below national averages, but peculiarities of the State/county relationship in Hawaii make comparisons less helpful. The issue of additional revenue authority for Hawaii's counties is one of efficiency and revenue flexibility and should not be obscured by whether Hawaii's property tax is or is not in line with national averages.

Nevertheless, the property tax is a cornerstone of local tax systems and should be recognized as such in Hawaii. The policy of county officials should be the same as that of State officials with respect to the tax system: the base should be kept broad and the rates low. The tendency to provide tax relief and erode the tax base through exemptions should be avoided, as should the inclination to adopt policies that result in less than 100 percent assessment of property. The counties should guard against the proliferation in the number of tax classifications.

In addition to property taxes, the counties have control over user fees and benefit charges for county services. Fees and charges should generally be a preferred means of financing county services because they more nearly reflect the benefit principle. By some measures, the degree to which counties in Hawaii rely on user charges is substantially less the averages nationwide and for the western states. The counties should make best use of such fees and charges.

Finally, a major concern of the counties is the cost of development. Many of the arguments put forward in support of requests for money by the counties center around infrastructure costs. An analysis of the counties' use of development fees and exactions suggests that these sources of revenues, which should cover much of the infrastructure costs imposed by development, are not being properly utilized.

It appears that development fees and exactions have been applied on an ad hoc basis that has tended to focus on high-visibility projects while neglecting other developments. Overall there has probably been an

underestimation of the costs imposed by development. A more consistent and uniform application of fees and exactions, with a more realistic assessment of additional costs, should be considered.

Nonresident Investment

As a regional economy, Hawaii has historically depended on external investment flows to finance the capitalization of both its commodity based production of sugar and pineapple and its service based production of tourism. This dependence is a direct result of the constraints on the availability of locally generated investment funds, imposed by Hawaii's relatively limited resource base and economic output. This situation is likely to persist into the future.

Although few would dispute the role that external investment has played in the growth of the Hawaiian economy, with its accompanying increase in the standard of living for residents, increases in foreign direct investment have greatly increased the level of debate over the economic consequences of foreign investment.

Within this arena, there are two major issues. The first is an equity issue of insuring equal tax treatment, or a "level playing field," for both resident and nonresident investors and businessmen. Although state tax laws cannot discriminate between resident and foreign, or nonresident, investments and activities, the enforcement of nonresident compliance may be more difficult than the enforcement of resident compliance, when the nonresident is also foreign.

These difficulties may arise because of distance, absence of sufficient incentives to encourage full reporting by nonresidents, general measurement problems, and the existence of tax avoidance mechanisms. Such enforcement problems can create implicit tax preferences for the nonresident investor or businessman. Examples include the treatment of capital gains from the sale of real estate and gross receipts reporting in the rental market and tour packaging market.

The second issue deals with use of tax policy to achieve economic goals. Of particular concern is whether foreign acquisitions for speculative purposes exists, whether there are uncompensated costs, or negative externalities, for Hawaii residents, and whether some kind of tax policy change is the appropriate policy measure.

The Commission concluded that the tax system was not the proper vehicle for attempting to control the impact of investment in Hawaii. (See working paper in Volume 2.) The tax system should treat taxpayers equally, whether or not they are residents of the State.

The use of special taxes on real estate transactions, such as speculator taxes, was investigated and found to be impractical and difficult to manage and enforce.

Any attempt to ensure that taxes are paid by nonresidents should probably have a withholding feature, given the limitations on the State's ability to enforce assessments on nonresidents. A nondiscriminatory tax

withholding on real estate transactions might be used to ensure that taxes are paid on gains from real estate, the most evident and traceable type of investment by nonresidents.

One possibility is to have an income tax withholding at the time of transfer for all real estate transactions. All taxpayers would be entitled to claim the withheld amount as a credit against the income tax paid on the gain, in effect paying no greater tax than under current law after taking into account the tax credit.

If a nonresident investor reports the gain on a Hawaii income tax return, he would end up paying only the income tax (after the allowance of the credit). If not, the State will retain the withheld tax.

There are practical difficulties with extending an income tax withholding to all real estate transactions. Hawaii residents would resist a withholding tax on sales of residences. The mechanism for relieving residents from going through the process of having a tax withholding followed by a later claim for the credit might prove to be cumbersome.

If the tax were extended to only certain classes of real estate transactions, such as those above a certain amount, there would be questions of unequal treatment that might invalidate the tax. If the tax were to exempt sales of residences that fell within IRS rules and definitions, the tax base may be so eroded and the administration so complicated that the effort would not be warranted.

The Commission concluded that a withholding tax should be pursued as a mechanism for ensuring a greater level of compliance in reporting gains from the sale of real estate. The Department of Taxation could develop procedures to address the concerns of residents who may sell their homes or intend to roll over the proceeds from a real estate sale. Examples of such procedures might include some type of verification that tax returns have been filed and taxes paid in the past, the filing of an affidavit, or some other proof that the tax will be paid on the gain or that the proceeds will be reinvested.

Revenue Implications

The Commission's recommendations are statements of policy direction for revenues and taxes, and the extent to which the recommendations can be implemented depends upon how well they fit with overall fiscal policy. Taken as a whole, the recommendations would result in a revenue loss that might be unacceptably large, but the Commission is not presenting its recommendations as an all-or-nothing package. If it is prudent to do so, recommendations can be adopted with deferred effective dates or be phased in over time.

The options presented below are presented in order to provide bench marks for gauging that impact; they should not be seen as a recommendation that specific annual revenue adjustments be made. The effects are assumed to begin no sooner than fiscal year 1991 since the revenue impact will come after the 1990 Session.

PERSONAL INCOME TAX

The thrust of the income tax recommendations is to yield a better distribution of the tax burden, and it may make sense to view the recommendations in concert with each other. The Commission estimated the revenue impact of its personal income tax recommendations under a assumed set of options with the help of a computer model created by the Policy Economics Group of KPMG Peat Marwick Main & Company in Washington, D.C. The Peat Marwick model has been used by several states as well as for analyses of the impact of the federal Tax Reform Act on all fifty states.

The assumptions were an attempt to identify plausible levels of adjustment for the income tax for purposes of estimating the revenue impact. (See Peak Marwick report in Volume 2.):

- The maximum general excise tax credit was assumed to be increased from \$55 to \$125. The \$125 was chosen as an amount that would include the current \$45 food tax credit which is due to expire, plus an additional \$25 for medical costs. The general excise tax credit itself as originally intended already takes into account food and medical costs, so this would be in addition to that allowance.
- The standard deduction was assumed to equal the federal amount. Since the Hawaii amount substantially lags the federal amount (\$1,900 vs. \$5,450 for married filing joint), and at most Hawaii would conform to the federal standard deduction, the federal amount represents the maximum to which the Hawaii standard

deduction might be increased and therefore the maximum revenue impact.

- The number of tax brackets was assumed to be reduced from eight under current law to three as shown in the following schedule.
- The top tax rate was reduced from 10% to 9% and would start at the income levels shown in the schedule.
- Under current federal tax law, capital gains are fully taxed. The impact of fully taxing capital gains for Hawaii tax purposes is estimated.
- The current medical services credit that allows a maximum credit of \$200, \$400, or \$600 (depending on age and filing status) regardless of income would be replaced with a credit that does take into account income. The replacement credit would be based upon the amount claimed as an itemized deduction for medical expenses and would have no maximum. The result is a tax savings relative to current law and a better targeting of relief.

GENERAL EXCISE TAX

Estimates of the revenue impact of the general excise tax recommendations were difficult to arrive at because of insufficient data. For the most part, the estimates are based upon secondary sources of information.

- The cost of eliminating tax pyramiding on interbusiness transactions was based upon work that had been done for the prior tax review commission regarding tax pyramiding and data from the Department of Business and Economic Development (DBED). The impact is assumed to begin no sooner than fiscal 1992 because even if the recommendation were to be enacted during the 1990 Session, it would be prudent to delay the effective date for a year so that the Department of Taxation and the business community can have time to develop rules and regulations.

- There was no way of arriving at a reasonable measure of the extent of multiple-leases or the revenue impact of exempting them from the general excise tax, and no estimate is presented.

- The net impact of exempting exported services and taxing imported services was assumed to be a wash for

Revenue Implications

purposes of the estimates, even though Hawaii imports at least 4 times the amount of services that it exports, according to information from DBED, and is likely to generate additional tax revenues.

The cost of exempting exported services alone, without taking into account taxes collected on imported services, was estimated to be less than \$4 million, based upon DBED estimates of slightly less than \$100 million of exported services.

- The impact of exempting residential rental income was particularly difficult to estimate because of a lack of information regarding the amount of taxes currently attributable to residential rental income or the degree of non-compliance. The estimate shown below is based again on DBED data on residential rental activity and is not adjusted for any assumed level of non-compliance. As shown, the estimate suggests that roughly half the general excise tax collections for rentals is from residential rentals (as opposed to commercial rentals or equipment rentals, for example).

- There are no estimates of the impact of eliminating blanket exemptions, but a better focussing of exemptions should result in a net increase in collections.

TAXATION OF FINANCIAL INSTITUTIONS

The recommendations to simplify the Franchise Tax and to make it more similar to the corporate income tax, including an adoption of the corporate income tax rates, are not assumed to have a material revenue impact. Franchise Taxpayers would likely pay about the same total amount of tax under a simplified Franchise Tax. For the fiscal year 1989, total Franchise Tax collections were \$15.7 million.

COUNTY REVENUES

The shifting of taxes from the State to the counties does not change the overall level of tax, but it does affect general fund collections at the different levels of government.

- Transfer of the TAT from the State to the counties is estimated by reference to the forecast by the Council on Revenues, which is the official estimating body for the State.

- Total PSC tax collections for fiscal years 1988 and 1989 were \$63.4 Million and \$64.6 million, respectively. Of

those totals, public utilities paid \$53.3 million and \$53.9 million, while the balance was paid by motor and contract carriers. The estimate of the revenue impact of an allocation of part of the PSC to the counties is based upon an assumption that the public utilities are paying the tax at 5.88% and that the excess over a 4% GET equivalent amount is allocated to the counties.

OTHER

There are no estimates of the revenue impact of a withholding tax on real estate sales or from taxing non-Hawaii like-kind exchanges.

The estimate of the gains from self funding of the highway fund is based upon transfers into the fund from the general fund in recent years.

TAX EFFECTS OF RECOMMENDATIONS ASSUMING FULL ENACTMENT IN 1990

	Projected (\$ Millions)		
	FY 91	FY 92	FY 93
Individual Income Tax: *			
Top Rate at 9%	(11.5)	(12.8)	(14.0)
Food/Low Income Credit	(7.8)	(22.0)	(22.0)
Federal Standard Deduction	(40.0)	(45.2)	(50.9)
Reduce # of Tax Brackets	(37.0)	(40.5)	(44.0)
Tax Capital Gains	16.6	19.5	22.6
Medical Credit	10.8	10.7	10.5
Total Income Tax Effect	(68.9)	(90.3)	(97.8)
General Excise Tax:			
Inter-Business Purchases	(37.0)	(40.0)	(44.0)
Multiple Lease Pyramiding	-	-	-
Imported/Exported Services (net)	+	+	+
Residential Rental Income **	-	-	-
Eliminate Blanket Exemptions	+	+	+
Counties:			
Existing TAT	(84.0)	(89.7)	(95.3)
PSC Tax	(17.0)	(17.0)	(17.0)
Less: Pre 1989 Grants-in-aid	40.0	40.0	40.0
Total "Counties" Tax Effect	(61.0)	(66.7)	(72.3)
Other:			
Withholding Tax on Real Estate Sales	+	+	+
Taxing Non-Hawaii Like-Kind Exchanges	+	+	+
Highway Fund Self-Sufficiency	14.0	14.0	14.0

* The projected amounts are an example which would make the Individual Income Tax more progressive. The first four items are to be viewed in conjunction with each other.

** Residential Rental Income amount was difficult to estimate; however, if we were to assume 100% compliance (which is unlikely), the revenue loss could be as much as \$55 million.

NOTES: See tax brackets on following schedule.

Food/Low Income Credit at \$125, phased out at \$30,000.

1989 Grants-in-aid to the counties was \$70,000,000 as opposed to the 1988 amount of \$40,000,000.

TAX REVIEW COMMISSION'S EXAMPLE FOR CHANGES TO THE INDIVIDUAL INCOME TAX

	<u>Current</u>	<u>Example</u>
Standard Deduction		
Single	1500.	3250.
Married/Joint	1900.	5450.
Head of Household	1650.	4800.
Additional Standard Deduction for Blind and Over 65		
Single	0.	0.
Married/Joint	0.	0.
Head of Household	0.	0.
Minimum Standard Deduction for Taxpayers Claimed as Dependents on Another Return		
	500.	1000.
Medical Services Excise Tax Credit		
Qualified Expenses	All Medical	Med. Deduction
Maximum Credit	200.	None
Additional Max for Elderly	200.	None
Excise Tax Credit		
Below \$ 6000	55.	125.
\$ 6000 - 8000	45.	102.
8000 - 10000	35.	80.
10000 - 12000	25.	57.
12000 - 15000	20.	45.
15000 - 20000	15.	34.
20000 - 30000	10.	23.
Over \$30000	0.	0.
Maximum Tax Rate on Capital Gains		
	7.25%	9.00%
Taxable Income Tax =		
<u>Single</u>		
\$ 0 - 6000	\$ 0 + 5.50% of the amount over \$ 0	
\$ 6000 - 18000	\$ 330 + 7.25% of the amount over \$ 6000	
\$18000 -	\$1200 + 9.00% of the amount over \$18000	
<u>Married/Joint</u>		
\$ 0 - 12000	\$ 0 + 5.50% of the amount over \$ 0	
\$12000 - 36000	\$ 660 + 7.25% of the amount over \$12000	
\$36000 -	\$2400 + 9.00% of the amount over \$36000	
<u>Head of Household</u>		
\$ 0 - 8000	\$ 0 + 5.50% of the amount over \$ 0	
\$ 8000 - 24000	\$ 440 + 7.25% of the amount over \$ 8000	
\$24000 -	\$1600 + 9.00% of the amount over \$24000	

Source: KPMG Peat Marwick, Policy Economics Group

TAX REVIEW COMMISSION'S EXAMPLE FOR CHANGES IN THE INDIVIDUAL INCOME TAX
FISCAL YEAR 1991 DISTRIBUTION OF STATE TAX CHANGE AND NUMBER OF RETURNS AFFECTED

- a) 9% TOP RATE & 3 RATE BRACKETS: 5.5%, 7.25%, 9%
- b) FEDERAL STANDARD DEDUCTION
- c) LOW INCOME CREDIT OF \$125 PHASED OUT AT \$30,000
- d) CAPITAL GAINS

INCOME CLASS	9% TOP RATE & 3 RATE BRACKETS			FED. STAND. DEDUCT.			LOW INCOME CREDIT			CAPITAL GAINS		
	NUMBER OF RETURNS (UNITS)	AMOUNT OF TAX DECREASE (\$ MIL)	NUMBER OF RETURNS (UNITS)	AMOUNT OF TAX DECREASE (\$ MIL)	NUMBER OF RETURNS (UNITS)	AMOUNT OF TAX DECREASE (\$ MIL)	NUMBER OF RETURNS (UNITS)	AMOUNT OF TAX DECREASE (\$ MIL)	NUMBER OF RETURNS (UNITS)	AMOUNT OF TAX INCREASE (\$ MIL)	NUMBER OF RETURNS (UNITS)	AMOUNT OF TAX INCREASE (\$ MIL)
***** < 5,000	0	0.000	6339	0.109	30636	(0.905)	68478	(1.907)	0	0.000	0	0.000
5,000 < 10,000	0	0.000	49116	2.370	54030	(5.469)	51269	(1.527)	0	0.000	0	0.000
10,000 < 15,000	19006	(0.164)	37295	1.444	56168	(8.287)	62432	(1.326)	0	0.000	0	0.000
15,000 < 20,000	19192	(0.874)	19318	1.454	37792	(6.959)	44953	(0.732)	903	0.001	903	0.001
20,000 < 30,000	36666	(3.756)	20799	0.890	45190	(9.084)	52288	(1.357)	3872	0.015	3872	0.015
30,000 < 50,000	68795	(11.232)	10828	0.726	42211	(7.793)	20643	(0.702)	6199	0.136	6199	0.136
50,000 < 100,000	61431	(21.103)	3741	0.182	10707	(1.466)	5789	(0.194)	16396	1.387	16396	1.387
100,000 < 200,000	13005	(9.436)	149	0.010	417	(0.048)	267	(0.008)	6989	2.526	6989	2.526
200,000 +	3307	(9.092)	0	0.000	80	(0.012)	54	(0.005)	2626	12.548	2626	12.548
TOTAL	221403	(55.658)	147584	7.185	277231	(40.023)	306172	(7.759)	36984	16.613	36984	16.613

Source: KPMG Peat Marwick, Policy Economics Group

Follow up to First Commission

RECOMMENDATIONS

The First Tax Review Commission, in its report to the legislature dated December 17, 1984, made 31 recommendations. This is a list of those recommendations.

ON OVERALL TAX STRUCTURE

- 1 The Commission recommends continued adherence to the policies that State taxes used to support the general fund should be levied in a manner that reflects, in aggregate, the ability of residents to pay these taxes. The incidence pattern of these taxes should reflect no taxation of income up to a threshold level with progressive marginal rates thereafter leveling off to a flat rate.
- 2 To broaden the tax bases and to keep tax rates low, the Commission recommends that many narrow tax preferences in the existing State tax code should be eliminated. Since it is difficult to consider the large number of such tax provisions involved in any one legislative session, all provisions should be "sunsetting" to expire by 1987 unless explicitly retained by the legislature. Specific preferences recommended for review are discussed in recommendations 14 and 20.
- 3 The State should establish a formal general fund stabilization, or "rainy day" fund, to stabilize the year-to-year expenditure changes. Contributions to this fund should be made during times of budget surpluses and draw-downs should occur in times of fiscal stress. The fund balance should be allowed to grow to a level which can provide adequate reserves in the event of revenue shortfalls.
- 4 The following state special funds should be self-supporting and should not be subsidized by infusion from the general fund on a permanent basis: highways, airports, harbors, parking, unemployment compensation, and disability compensation.

The financing requirements should reflect realistic costing of services provided by the funds, including overhead charges to the general fund, sinking funds adequate to replace depreciating capital, and balances to offset revenue declines during periods of fiscal stress.

In addition to the special funds mentioned above, the state should evaluate its other user charges and fees to determine if they are consistent with the value of services exchanged and the true cost of providing those services. This includes regulatory activities, recreation, licensing, inspection services, and water supply.

ON TAX EXPORTING

- 5 Hawaii's taxes should be structured in such a way as to maximize the "exporting" of taxes consistent with constitutional criteria and other goals of the state.

ON BUSINESS IMPACT OF HAWAII'S TAXES

- 6 The Commission recommends that there should be no large-scale reduction or increase in direct business taxes.
- 7 The Commission recommends that if the legislature perceives the need to provide specific reliefs or incentives to business that this be done via case-by-case expenditure assistance.

ON GENERAL EXCISE TAX

- 8 Income tax credits are the appropriate vehicles to offset the regressive effects of excise taxes on food and drugs. While past inflation and equity considerations require some adjustment of the value of these credits, the Commission recommends that the credit approach is advantageous compared to across-the-board exemption of food and drugs from excise taxes.
- 9 The amount of the excise tax credits and the income brackets that determine the levels of the credit should be adjusted for inflation.

It is further recommended that adjusted gross income be modified for determining the amount of the credit. This modification should add back to income the following exclusions: 60% of capital gains, excluded dividends and interest, payments to IRA and Keogh plans, unemployment and worker's compensation payments, public assistance benefits, and payments to individual housing accounts.

- 10 The Commission recommends that no substantial

Follow up to First Commission

changes be made in the present general excise tax with the exception of minor adjustments which will remove some of the more inequitable aspect of the tax - see recommendations 11, 12, and 13.

- 11 To remove the inequitable taxation of certain inter-affiliate business transactions, the Commission recommends that receipts from the sale of goods or services by a parent company doing business in Hawaii to its wholly-owned subsidiaries not be taxable if the parent to whom the receipts accrue is not in the business of providing those goods and services to anyone but its subsidiary firms.
- 12 The Commission recommends that the price paid by the purchaser for a good or service should be the measure of gross receipts. In the event that such a price is not directly observable because the good or service is sold through an agent, the actual receipts should be "grossed up" by a reasonably assumed or demonstrable sales commission. The commission should not automatically be assumed equal to the difference between actual receipts and receipts based on the list or "rack" price.
- 13 The receipts from goods shipped outside the state should be exempt from the 4% general excise tax. Included in the definition of goods are services with tangible by-products such as computer software and mailing lists.
- 14 To reduce the complexity of the general excise tax, certain narrow tax preferences should be reviewed for possible sunseting by no later than 1987. These include, but are not limited to, the following exempt organizations:
 - fraternal, charitable, religious, scientific organizations
 - Hansen's disease patients
 - state-supported radio promoting tourism
 - local development companies approved by the Small Business Administration
 - prepaid legal services
 - nonprofit cemeteries
 - nonprofit shippers association
 - nonprofit hospitals

Further, other exempt transactions should also be granted renewed specific legislative exemption or be

required to sunset by 1987:

- first \$2000 of gross receipts of blind, deaf, disabled
- foster home receipts
- brooms manufactured by the blind
- certain petroleum products to be further refined
- bagasse by-products
- scientific contracts with the U.S. government
- low-income housing
- air pollution devices
- repairs of Federally owned ships or ships in international or interstate business
- gasohol

In addition, certain classes of activities should be reviewed for the low rates at which they are currently taxed:

- insurance commission (.15% versus 4% on other commissions) (see also Recommendation 27)
- alternate energy receipts (% versus 4%)
- receipts by blind, deaf, and disabled person (% versus 4%)

15 Consistent with the Commission's intent to increase the degree of tax exporting, a differential tax on short-term (less than 30 days) transient accommodations is recommended without earmarking the resulting revenues.

16 As an alternative to the hotel room tax, the legislature should consider raising the general excise tax and to refund the proportion not exported to resident taxpayers through enlarged excise tax credits. Again, the net new revenues should not be earmarked.

ON INDIVIDUAL INCOME TAX

17 The Hawaii State individual income tax should be adjusted to take into account the effects of inflation since the income tax was last adjusted. The rate brackets and standard deduction should be enlarged. However, formula or automatic tax indexation should be avoided. The state standard deduction should be made equal to that provided by the Federal government: \$2300 for a single taxpayer or a single head of household, \$3400 for those married filing a joint return,

Follow up to First Commission

and \$1700 for married filing separately. The tax brackets in effect since 1966 should be doubled. It is further recommended that these income tax reductions should be phased in over a four-year period.

- 18 To enhance the equity of the state individual income tax, the base of the state income tax should be brought into closer conformity with that of the Federal individual income tax. This would help to narrow the growing gap between taxable income and actual economic income received by individuals, thus reversing base erosion.

At a minimum the following types of personal income should be restored to the state individual income tax base consistent with Federal tax treatment: portions of pension income and part of social security benefits of high-income taxpayers. To protect elderly taxpayers from taxes on subsistence income, a double standard deduction should be provided when a single filer reaches age 65 or when either filer reaches 65 for a joint return.

- 19 To provide equity in the State's income tax, the conformity between the Hawaii individual income tax and the Federal individual income tax should be further enhanced by the adoption of the Alternative Minimum Income Tax for state purposes. The state minimum tax should be modeled after the Federal Alternative Minimum Tax.

- 20 To reduce the complexity of the individual income tax, certain special interest credits should be allowed to sunset as scheduled or be amended to sunset by 1987 unless specifically extended by the legislature:

- credit to discourage sales of dangerous items
- credit for regulated investment companies
- solar energy device tax credit (scheduled to sunset Dec. 1985)
- heat pump tax credit (scheduled to sunset Dec. 1985)
- heat insulation tax credit (scheduled to sunset Dec. 1985)
- credit for child care expenses
- child passenger restraint system tax credit
- tax credit for fuel taxes paid by commercial fishers

In addition, the Commission recommends that no

further "check-offs", such as that for the Hawaii Election Campaign Fund, be added to the current income tax.

ON CORPORATE NET INCOME TAX

- 21 The Hawaii corporate income tax brackets should be adjusted to add a greater degree of progressivity to this tax and to offset the effects of inflation on the bracket structure.

- 22 Hawaii should partially "de-couple" from the federal accelerated depreciation rules (ACRS) by substituting pre-ACRS provisions for real property but not for personal property for purposes of determining both individual as well as corporate taxable income.

- 23 Given the uncertainty regarding the Federal position on worldwide unitary taxation, the State should not adopt such a policy with regard to taxation of multi-state companies operating within several states, including Hawaii. The present policy of allowing either domestic apportionment policy or separate accounting is appropriate. The separate accounting approach for corporations operating in different countries will have to be continued with regard to their foreign operations.

ON PUBLIC SERVICE COMPANY TAX

- 24 Public service companies should be subject to the general excise tax rather than to the in-lieu public service company tax.

The State Constitution should be amended to allow county governments to assess and tax at appropriate property tax rates the real property of public service companies in their jurisdiction.

- 25 The State should establish a mechanism (e.g. franchise tax) to insure that commercial airlines (interisland, domestic, and international) pay directly for the privilege of doing business in Hawaii and contribute to the general fund.

ON OTHER REVENUE SOURCES

- 26 The Commission recommends that all excise taxes be imposed on an ad valorem basis rather than on a

Follow up to First Commission

specific amount per unit. This pertains specifically to the wholesale liquor tax but it is also applicable to the fuel tax.

- 27 Firms presently taxed under the insurance premium tax should be required to pay the general excise tax on rentals and other business receipts.
- 28 The Commission feels it is appropriate to integrate financial institutions and insurance companies with other business in Hawaii under a single tax code instead of the current in-lieu taxes. However, the complexities of such a change suggest that it should be evaluated in detail, perhaps by a subsequent Commission, before action is taken.
- 29 The State should adopt a lottery to replace revenues lost due to recommended equity and efficiency adjustment.

ON MISCELLANEOUS RECOMMENDATIONS

- 30 The State tax structure should be carefully monitored to detect any long-term declines in its responsiveness to real or inflationary economic growth.
- 31 In addition to its current statistical studies of the individual and corporate income taxes, the Tax Department should conduct annual statistical analyses of general excise tax data.

SUBSEQUENT LEGISLATION

Over the past five years the legislature has enacted tax measures which reflect some of the concerns and/or recommendations of the first Tax Review Commission. In some cases, the legislature has acted contrary to the first Commission's recommendations.

1. Act 232, SLH 1985 extends to 12/31/92, the income tax credit for solar or wind energy devices and heat pumps.

Act 70, SLH 1986 extends the credit for solar, wind energy devices and heat pumps to ice storage systems.

Act 40, SLH 1987 repeals the income tax credit to discourage sales of dangerous items.

Act 64, SLH 1988 repeals the income tax credit for insulation of hot water heaters.

Act 307, SLH 1989 increases the amount of the solar, wind, etc. credit from 15% to 20% of the total cost.

These measures addressed the Commission's recommendation that certain special interest credits should be allowed to sunset as scheduled or be amended to sunset by 1987 unless specifically extended by the legislature.

2. Act 88, SLH 1985 exempts from the general excise tax amounts received as payments for the administration of an employee benefit plan.

Act 211, SLH 1985 made permanent the 0.5% rate imposed on sales of generated electricity to a public utility for resale to the public by deleting the sunset date.

Act 232, SLH 1985 extends, to 6/30/92, the general excise tax exemption allowed for sales of gasohol for consumption or use by the purchaser and not for resale.

Act 39, SLH 1987 repeals the exemption from the general excise tax allowed for businesses that are supported solely by state funds and organized to broadcast radio programs promoting the Hawaii tourist industry to areas outside the state.

Act 39, SLH 1987 repeals the general excise tax exemption of proceeds from the sale of brooms manufactured by blind individuals working at the adult blind shop.

Act 292, SLH 1987 rewrote the exemption of interstate commerce from the general excise tax by specifying that the exemption shall apply to income received from the loading and unloading of ships or aircraft, tugboat services, and related services.

Act 43, SLH 1988 removes the sunset clause for the general excise tax exemption allowed for sales of gasohol.

Act 163, SLH 1988 clarifies the definition and types of scientific contracts made with the federal government which qualify for an exemption from the general excise tax.

These measures addressed the Commission's

Follow up to First Commission

recommendation that certain narrow tax preferences should be reviewed for possible sunseting by no later than 1987, and that other exempt transactions should also be granted renewed specific legislative exemption or be required to sunset by 1987.

3. Act 308, SLH 1986 and Act 167, SLH 1988 provide that funds paid by a customer or the customer's agent to a travel agent or tour package for tickets or reservations for a particular tour or package of travel services or accommodations, or both, that are not transmitted to those who are to furnish the travel services or accommodations will be presumed not to be a part of the gross proceeds or income received or accrued by such persons or entities who are subject to either the public service company law or the general excise tax law.

These measures addressed the Commission's recommendation that the price paid by the purchaser for a good or service should be the measure of gross receipts. In the event that such a price is not directly observable because the good or service sold through an agent, the actual receipts should be "grossed up" by a reasonably assume or demonstrable commission.

4. Act 30, SLH 1985 as amended by Act 20, SLH 1987 broadened the application of the exemption from the public service company tax for cruise ships sailing the island waters and extended the sunset date to June 30, 1991.

Act 78, SLH 1986 as amended by Act 390, SLH 1989 provides a tax credit against taxable income of a corporation, partnership, sole proprietorship, financial institution, or public service company that is attributable to the conduct of business in an enterprise zone; provides a tax credit against any taxes due the state in an amount equal to a percentage of unemployment taxes paid on employees employed at the business' establishment located within the enterprise zone; and an exemption from the payment of general excise taxes on the gross proceeds from items sold in an enterprise zone.

Act 57, SLH 1988 grants an exemption from the general excise tax income arising from the sale and leaseback of a solid waste processing facility.

Act 295, SLH 1988 as amended by Act 118, SLH 1989 grants an exemption from the general excise tax for certain income received by a stock exchange and exchange

members and sets a sunset of the exemption at June 30, 1992.

These measures addressed the Commission's recommendation that if the legislature perceives the need to provide specific reliefs or incentives to business, that this be done via case-by-case expenditure assistance.

5. Act 340, SLH 1986 as amended by Act 241, SLH 1988 provides for a new tax equal to 5% of the gross proceeds derived from the furnishing of transient accommodations.

This measure addressed the Commission's recommendation to maximize tax exporting.

6. Act 239, SLH 1987 establishes a food tax credit of \$45 per exemption for individuals filing a resident individual income tax return. The credit is to be deducted from income tax liability and is scheduled to sunset for the calendar year 1990.

This measure addressed the Commission's recommendation that the income tax credit approach be taken to offset the regressive effects of excise taxes on food and drugs.

7. Act 239, SLH 1987 as amended by Act 173, SLH 1988 establishes a general excise tax exemption for the value or sales proceeds of goods shipped to out-of-state purchasers, and for certain computer services.

This measure addressed the Commission's recommendation that the receipts from goods shipped outside the state should be exempt from the 4% general excise tax; including tangible by-products such computer software and mailing lists.

8. Act 239, SLH 1987 adjusts the person income tax rates by reducing the number of brackets and lowering the top rate.

Act 321, SLH 1989 further adjusted the personal income tax rates and made them permanent.

These measures addressed the Commission's recommendation that the Hawaii State individual income tax should be adjusted to take into account the effects of inflation.

9. Act 239, SLH 1987 adjusts the corporate income tax

Follow up to First Commission

rates by increases the number of brackets and slightly lowering the top rate.

This measure addressed the Commission's recommendation that the Hawaii corporate income tax brackets should be adjusted to add a greater degree of progressivity to this tax and to offset the effects of inflation on the bracket structure.

10. Act 11, SLH 1988 adjusts the excise tax credit schedule to keep up with inflation.

This measure addressed the Commission's Recommendation the excise tax credits be adjusted for inflation.

11. Act 175, SLH 1988 exempts amounts received by common paymasters representing disbursement for remuneration to employees of two or more related corporations where the common paymaster is making the remuneration on behalf of such corporations, and for imputed or state interest on loans and amounts received for certain services furnished by one related entity to another related entity.

This measure addressed the Commission's recommendation that receipts from the sale of goods or services by a parent company doing business in Hawaii to its wholly owned subsidiaries not be taxable if the parent to whom the receipts accrue is not in the business of providing those goods and services to anyone but its subsidiaries.

12. Act 306, SLH 1986 exempts gross income arising from the sale of prescription drugs and prosthetic devices from the general excise tax.

This measure runs counter to the Commissions recommendation that the regressive effect of the excise tax on drugs be off set by the use of income tax credits rather than by applying a broad exemption.

13. Act 239, SLH 1985 as amended by Act 54, SLH 1986 increases all highway user taxes and fees by increasing the vehicle registration fee from \$1 per vehicle to \$10, increases in the motor vehicle weight tax, and increases the state fuel tax from 8.5 cents per gallon to 11 cents per gallon.

Act 344, SLH 1986 converted the state liquor tax from a

20% ad valorem tax on the wholesale price to a per unit tax based on gallonage. Six categories of alcoholic beverages are established. Also provides for an automatic adjustment of the rates based on changes in price and volume. Sets a sunset date of June 30, 1989 when the tax is to revert to the ad valorem basis.

Act 149, SLH 1989 repeals the sunset date for the liquor tax thereby retaining the gallonage approach and temporarily suspends the escalator clause which provides for automatic rate adjustment until June 30, 1991.

These measures run counter to the Commission's recommendation that all excise taxes be imposed on an ad valorem basis rather than a specific amount per unit and which noted that its recommendation pertained specifically to the wholesale liquor tax and the fuel tax.

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**Appendix:
Prior Reports**

Interim Report
of the
Tax Review Commission

April 19, 1989

TAX REVIEW COMMISSION

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FOREWORD

A 1908 Report of the Tax Commission to the Governor of Hawaii stated that "...the taxation system in this Territory is, with perhaps one or two exceptions, modern and advanced in character.... This Territory has already adopted the principle of the income tax (a workable income tax act has been in operation since 1901) and that of the inheritance tax as parts of its system, while in other jurisdictions the effort is still being made to incorporate these in their tax system."

Hawaii did have in 1908, as it does today, a tax system modern and advanced in character. A 1911 Wisconsin income tax law is often regarded as the first modern state income tax primarily because it was centrally assessed and administered at the state level rather than at the local level - a situation that had existed in Hawaii (though not yet a state) since 1901.

A 1931 Report of the Tax Board of the Territory of Hawaii observed that the property tax was likely to remain the mainstay of the Hawaii tax system for the foreseeable future - unaware of the future implications of the general excise tax law that was to be enacted in 1935 (at about the same time that states were adopting sales taxes in response to the Depression). Even though Hawaii and the states did create their respective versions of a sales tax at the same time, the consensus is that the Hawaii general excise tax is by many measures advanced in comparison with most of the similar types of taxes in other states.

Hawaii tax studies have been conducted over the years by various commissions and boards, but the periodic tax review did not become a permanent part of the governing process until a 1978 amendment to the Hawaii Constitution provided for the establishment of a tax review commission appointed by statute every five years. Recent tax studies in other states have recommended similar proposals for establishing a regularly scheduled tax review process.

The Tax Review Commission acknowledges Hawaii's role as a leader among the states in tax policy. The early adoption of a modern income tax, a general excise tax law that is a model for other states, and the establishment of a systematic tax review process attest to a prudent development of policy. Experts throughout the country consider the Hawaii tax system to be a good state tax system, and the Commission shares that opinion while recognizing that even the best tax system struggles to maintain a balance among competing policy goals and adapt to changing circumstances.

It is from that vantage that the Tax Review Commission undertakes its review of the tax structure, and it is with that in mind that the Commission will make its recommendations.

INTERIM REPORT
OF THE
TAX REVIEW COMMISSION

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Appendix

 Time Table

 Article VII, Section 3, Hawaii State Constitution

 Chapter 232E, Hawaii Revised Statutes

I. INTRODUCTION

The tax review commission was established by the Hawaii Revised Statutes pursuant to a 1978 amendment to the Hawaii Constitution. It is reactivated every five years when the Governor appoints the seven members who will serve as the tax review commission. The first commission was appointed in 1980 but resigned when it found that it could not fulfill its mandate. A replacement commission was appointed in 1983 and completed its duties in 1984. The current commission ("Commission") was appointed in July 1988.

The tax review commission is charged with a duty to review the State's tax system and submit an evaluation to the Legislature along with policy recommendations.

The evaluation of the tax system is based on standards such as equity and efficiency. In forming its evaluation, the Commission will review the total tax system, with an emphasis on the income tax, the general excise tax, business taxes, and property taxes.

The first goal of any tax system is to generate tax revenues, and the Commission will determine whether the Hawaii tax system can be expected to provide the revenues that the government needs. The system must be also be fair and reasonable in the manner in which it does raise revenues, and the Commission will try determine the extent to which that is the case in Hawaii. In conjunction with its evaluation, the Commission will develop recommendations on policy matters that affect the equity and efficiency of the tax system or the health of the State's fiscal system.

The deadline for submitting the report to the Legislature is set by law as thirty days prior to the convening of the second regular session of the Legislature after the appointment of the commission. The current commission must therefore complete its task by December 1989 and submit its report to the 1990 session of the Legislature.

The commission has the authority to hire a staff and engage the services of consultants if necessary to carry out its duties. There is currently a staff of five who will do research and assist in the preparation of the report. Studies will be conducted by outside consultants to complement the Commission's own work and will be incorporated into the Commission's report.

This interim report is intended to explain what the tax review commission is, what its duties are, how those duties are to be accomplished, and what the time frame is for accomplishing them.

The Commission plans to hold public hearings on the major islands in June 1989 in order to hear the concerns of Hawaii's taxpayers. Those with an interest in particular issues are also encouraged to submit their views to the Commission in writing before then.

II. BACKGROUND

A. TAX REVIEW COMMISSION

The tax review commission was established by mandate under the Hawaii Constitution (Article VII, Section 3) and is directed by the Hawaii Revised Statutes (Chapter 232E) to conduct a systematic review of the State's tax structure, submit to the legislature an evaluation of the State's tax structure using such standards as equity and efficiency, and recommend revenue and tax policy.

Article VII, Section 3 was added to the Hawaii Constitution by amendment in 1978 and provides for the establishment of a tax review commission on or before July 1, 1980 and every five years thereafter. The Committee on Taxation and Finance for the 1978 Constitutional Convention (Standing Committee Report No. 66) found that a tax review commission was needed since neither the Executive Branch nor the Legislature had reviewed the overall tax system against such standards as equity and efficiency. At the time of the Constitutional Convention there had not been a systematic review of the tax structure in more than two decades.

Chapter 232E was enacted in 1979 to establish the tax review commission. In 1980, Senate Resolution No. 311 requested that the commission analyze and report on thirteen issues relating to tax administration, the income tax, and the general excise tax. Also in 1980, House Resolution No. 77 requested a progress report to the 1981 regular session.

A seven member tax review commission was sworn in on May 28, 1980 and was to have submitted its report to the Legislature 120 days prior to the opening of the 1982 regular session. In its initial meetings in the summer of 1980, the commission found itself unable to reconcile its budget appropriation with its mandate under the Hawaii Constitution as developed under Ch. 232E H.R.S and the 1980 Legislative requests. In subsequent meetings, members of that commission reviewed tax studies of a number of states, solicited the advice of concerned groups regarding the nature and scope of the review, consulted with experts on managing the review process, and developed a research agenda. When their request for funding to carry out the agenda was denied, the members of the first tax review commission resigned.

Chapter 232E was amended by Act 212, Sessions Laws of Hawaii 1983, to provide for the appointment of a replacement member should any vacancies occur in the membership of a tax review commission prior to the completion of its duties. The Act provided for an increased sum to be appropriated out of the general fund to carry out the purpose of the Act and changed the time for submission of the evaluation and recommendations from 120 days to 30 days prior to the session.

A reconstituted first tax review commission (with its replacement members) was then convened on August 5, 1983 and submitted its report to the Legislature on December 14, 1984.

The current tax review commission is thus the second to be appointed under the constitutional provisions of Article VII Section 3. It held its first meeting on July 1, 1988 and will submit its report to the Legislature in December 1989. In the eighteen months between July 1988 and December 1989, the Commission will have set its agenda, solicited advice from experts and concerned third parties, conducted public hearings, reviewed the results of other state tax studies and its own research studies, and formulated its view of the Hawaii tax system and the direction of revenue and tax policy.

B. CURRENT ENVIRONMENT

1. STATE TAX TRENDS

The Hawaii tax review is taking place at a time when many states have conducted or are considering a tax study. Hawaii is fortunate not to have the kind of fiscal crisis that has led to tax studies in other states, primarily in search of additional tax revenues. Even those states, however, are guided by a desire to get their tax systems in order.

State tax systems have gone through three identifiable periods: (1) an age when the property tax was dominant, (2) the expansion of income and sales taxes since the 1930's, and (3) a period of base broadening to fund programs in the 1960's and 1970's. State tax laws have typically been enacted as needed, often in response to fiscal stress, without much thought of an overall structure. The result in some cases has been, as with the Internal Revenue Code prior to the Tax Reform Act of 1986, an accumulation of tax provisions that were not always consistent with other policy objectives or an imbalance within the tax structure itself.

Today, however, there is a greater emphasis on establishing an integrated fiscal plan in which a balanced tax system plays an important role. Although tax revenues remain the focus of tax laws, there is a desire to raise the revenues in a manner that is more consistent from an overall policy perspective. The push for more rational tax systems is roughly traceable to the tax revolt or reform movement that had California's Proposition 13 in 1978 as its catalyst.

2. FEDERAL ROLE

The relationship between the states and the federal government has changed over the years as the nature of federalism has evolved.

During the next few years the direction of federalism is likely to be controlled in large part by the federal budget deficit, and the states will be affected by measures taken by the federal government to address its problems. The implication is that there is apt to be a shifting of responsibilities and thus costs on the one hand and some competition for resources on the other hand.

The federal government has a direct impact on state taxes when states conform their tax laws to the Internal Revenue Code. The 1980's have seen significant changes to the Code, ranging from the use of the Code to promote economic and social goals under the 1981 Act to a repudiation of at least parts of that policy by subsequent legislation, culminating with the 1986 Act. Major tax reductions have been followed by major tax increases. States must now decide how much they want to conform to the Code and at what risk to the stability to their own tax systems.

Federal regulatory policies also have an effect on state taxes. The deregulation of transportation, telecommunications, and financial services, for example, has transformed the taxation of those industries. The uncertainty as to the implications of deregulation (complicated by Constitutional issues that are often associated with those industries) makes it difficult for states to develop tax policies that respond equitably and efficiently to such changes.

3. ECONOMIC CONDITIONS

Regulatory changes have coincided with technological changes that have strained the ability to apply traditional tax concepts. With the increasing importance of computers and prevalence of electronic products in the economy, for example, it is not always clear when a taxable transaction does take place or how the nexus rules are to be applied in determining where it should be taxed.

The problems are aggravated when issues extend to foreign countries and nonresident taxpayers where different tax regimes and treaty provisions further complicate the development and enforcement of tax rules.

At this time, Hawaii has a particular interest in the taxation of nonresidents because of the impact of tourism and foreign capital on the Hawaiian economy. Efforts to ensure that the Hawaii tax laws are extended to visitors and investors in Hawaiian property and businesses must not lose sight of equity and efficiency.

Although efforts are underway to promote a more balanced economy, the Hawaiian economy is skewed toward the service industry, and the tax structure should be designed to sustain tax revenues in the event of an economic downturn.

III. COMMISSION MANDATE

The Commission issued a four page Preliminary Report to the Legislature on January 18, 1989. At the time of that report, the Commission had for the most part established its agenda, solicited advice from experts and third parties, and reviewed the results of other state tax studies. The means and manner of accomplishing the Commission's agenda, however, were still being refined as the nature and scope of research studies and the format of the report required further deliberation. Under the circumstances, the Preliminary Report could not be as detailed or as specific as the Commission would have liked or as necessary to provide a full understanding of the direction of the Commission's review and to promote a discussion of the issues that are of concern to Hawaii's taxpayers and citizens.

The hope is that this interim report will provide that full understanding and promote a discussion of the issues. The Commission encourages taxpayers and citizens to make their views and concerns known, and to do so as early as possible. There will be little time to give full consideration to input received after June 1989, because the Commission members will have to devote their time from July through November to the results of research studies, the evaluation and recommendations, and the report.

The first tax review commission (both as originally cast and as reconstituted) advanced the idea that the tax review should be seen as an ongoing process in which each succeeding commission builds upon and adapts the efforts of its predecessors according to changing circumstances. The current tax review commission endorses that view and commends it to future commissions.

The research that was conducted by the prior commission, and the report thereon, were fitting for a first such commission. The intent of the current commission is not to revisit the groundwork that has been well laid out by that earlier report, except to the extent of providing updated information where appropriate and relevant. The Commission will instead focus on issues that are of current concern or require attention for the future..

The agenda is dictated by Section 232E-3 H.R.S., which provides that the tax review commission shall conduct a **review**, submit an **evaluation**, and **recommend** revenue and tax policy.

A. THE REVIEW

The review will provide the basis for the evaluation of the tax structure. It will also serve as a primary source but not be the sole basis for the Commission's recommendations, since under the law the Commission must recommend revenue and tax policy.

A systematic review of the tax structure requires a framework that includes historical information, tax data, economic conditions, policy trends, and comparisons with other states. It also requires assumptions about the future. In its report to the legislature, the Commission will outline the framework and summarize the data (including projections of future results) that will form the basis for its evaluation.

B. THE EVALUATION

By law the evaluation is to be based upon such standards as equity and efficiency. The Commission will apply the following standards for a good tax system in making its evaluation:

EQUITY - The tax burden should be fairly shared. Fairness is understood to mean that a tax should be borne: (1) by the person who receives the benefit of a government service (the benefit theory) or; (2) in cases where the benefit theory is not appropriate, by those with the means. Taxpayers in similar circumstances should be taxed alike (horizontal equity), and taxpayers in unequal circumstances should be taxed on the basis of their ability to pay (vertical equity). Income is the most commonly used measure of ability to pay. A tax structure is said to be "progressive" when the tax burden varies directly with income, "regressive" when the burden is inversely related to income, and "proportional" when there is no change in burden as income changes.

EFFICIENCY - The tax system should generate tax revenues with a minimum disruption of economic activity. The efficiency standard embodies several standards that warrant individual attention:

a. **ADEQUACY** - The tax system should generate sufficient tax revenues to meet government obligations and to fund spending plans. The other side of the adequacy standard is that, after allowing for normal fluctuations, the system should not produce tax revenues in excess of what is needed. For purposes of this review, and consistent with the idea that the tax review commission is an ongoing process, the period for judging the adequacy of the system will include the years through 1994 (when the next commission will conduct its review).

b. **STABILITY** - The tax system should provide a stable and predictable flow of tax revenues. It should minimize the need for frequent or radical adjustments as economic conditions change and allow the government and taxpayers to make their plans with some certainty as to the impact of taxes.

c. **ECONOMIC EFFICIENCY** - The tax system should not interfere with private economic decisions. Taxpayers should not be inclined to structure their activities for the purpose of avoiding a tax or gaining a tax advantage. They should be able to compete on a "level playing field" where taxes do not confer an advantage on one party over another.

d. **SIMPLICITY** - The tax system should not be unduly difficult for taxpayers to comply with or for the government to administer. The cost of compliance and administration should not be out of proportion to the means at hand or the amount of tax involved.

A good tax system attempts to strike a balance among inherently incompatible standards, and even the best tax system will require occasional adjustments because of changes in policy objectives and public sentiment.

C. RECOMMENDATIONS

The Commission's recommendations will reflect a time in which there is a rapidly changing regulatory and technological environment; a shifting away from the use of the tax system to promote economic and social goals; a State economy that is healthy, but skewed toward the service industry and dependent upon foreign capital; and uncertainty about the potential long-term effects of federal budget deficits.

The recommendations will therefore be of two types. The first will be designed to remedy deficiencies in the tax structure, should any become evident during the review. The second will take a broader perspective of revenue and tax policy and take into account the political and economic climate and trends in federal and state policy. The Commission will bear in mind the need to avoid the inadvertent consequences that can result from adjustments to the tax system.

Deficiencies in the tax structure will be measured by reference to the standards previously described. Equity is often difficult to measure and will likely be the standard that causes concern. The Commission will not rule out the possibility that, in seeking a balance among the standards, an inequitable situation might be better remedied by measures that are outside the tax structure, such as through spending programs. Nor will it rule out the option of recommending adjustments in one tax system to remedy an inequity that might exist in another tax system, such as with the allowance of credits against the income tax to address concerns of general excise tax regressivity or property tax hardship.

IV. RESEARCH AGENDA

Much of the Commission's research will be directed toward the task of applying the standards for a good tax system to the existing tax structure in order to submit an evaluation to the legislature. That will involve a review of historical information, a compilation of data, assumptions as to economic and political trends, and projections of future results.

In addition, the following topics warrant closer examination:

INCOME TAXES

The impact of recent changes to the federal income tax laws should be evaluated. The Commission intends to devote its attention to an analysis of the individual income tax. The corporate income tax will not be examined in great detail except to the extent of reviewing the separate tax systems for certain industries such as utilities and financial institutions.

The Commission understands that the federal Tax Reform Act of 1986 was intended to combine lowered tax rates with a broadening of the tax base. Because Hawaii conforms closely to federal rules, the base broadening provisions have largely been incorporated into the Hawaii income tax law. Since the Hawaii tax base has changed, it is appropriate to evaluate the extent to which tax rates should be adjusted, if at all. Any recommendations for rate changes will take into account items that factor into the effective tax rate, such as exemptions, standard deductions, and credits.

There will also be some discussion on conforming the Hawaii tax law to the Internal Revenue Code. Conformity has generally been seen as desirable because it reduces the compliance requirements for taxpayers and because the tax office can benefit from I.R.S. information. In conforming to the Code, the tax base is subject to the vagaries of federal tax law changes, which in recent years have been frequent and sometimes dramatic. The issue today is how much the state income tax can conform to the federal law and remain stable.

GENERAL EXCISE TAX

The Commission realizes that any review of the Hawaii tax system cannot be complete without taking into account the general excise tax, which generates about half the State's tax revenues. It also recognizes, however, that the general excise tax has been studied and analyzed in great detail and that purported deficiencies in the general excise tax system have been known and discussed by experts and concerned parties for some time.

The general excise tax is a productive tax with a broad base and relatively low rate. It is also relatively easy to administer and comply with - the type of tax that economists generally recommend. The persistent concerns about the tax involve the allowance of exemptions, either to address fairness or to remove instances of tax pyramiding - the standards of equity and economic efficiency.

With that in mind, the Commission will analyze the structure of the general excise tax with a view toward establishing a framework for understanding the tax and evaluating exemptions from the tax. The hope is that, with a clear understanding of what the general excise tax is and what it is intended to reach, there will be a rational basis for reviewing requests for exemption.

The arguments for or against an exemption should not rest on considerations such as the budget surplus. General excise tax exemptions should prevent the tax from reaching what is outside the intent of the tax; they should not serve unintended purposes such as the distribution of surplus funds (for which more appropriate vehicles are available). If the surplus is attributable to structural problems, those problems should be dealt with directly.

Unless the continual requests for exemption are evaluated within a consistently applied framework of what the general excise tax is and what it is intended to accomplish, there will be a tendency to erode the tax base. On the other hand, when an exemption does fit within the intent of the tax, it should be allowed.

Once the framework has been established, the analysis will extend to issues such as the following:

1. The exemption of food or medical costs.
2. The treatment of intercompany services.
3. The treatment of multiple lease transactions.
4. The continuation of categories of exemptions.

COUNTY REVENUES

The Commission will attempt to determine the extent to which the counties need revenues and, if existing sources of revenues prove to be inadequate, what options should be pursued.

The analysis will first review the allocation of functions between the State and the counties in an effort to identify exactly what responsibilities the counties have and what their revenue needs are. It will then extend to the existing sources of county revenues and the question of whether they are being properly utilized. The analysis will be sensitive to the historical basis for the relationship between the State and its counties.

In Hawaii Constitutional Convention Studies 1978 Article VI: Taxation and Finance, a report by the Legislative Auditor, it was noted that "The issue of taxing powers for the counties was discussed in the 1950 convention; it was reviewed in 1968; it surfaces in practically every legislative session; and it is likely to emerge again as in issue in the 1978 convention." (p. 61).

Although the same may be said again years from now, the Commission will attempt to determine whether or not the counties can meet their current responsibilities. Should there be a need for additional sources of revenues, the recommendations will take into account current suggestions, including, but not limited to:

1. Proposals to grant the counties the authority to impose their own taxes;
2. Proposals to earmark a percentage of the existing State general excise tax to be allocated among the counties;
3. Proposals to earmark a portion of the Transient Accommodations Tax to be allocated among the counties;
4. Proposals to adjust existing State grants-in-aid;
5. Proposals to adjust fee income.

The Commission is mindful that the constitutionally mandated transfer of the real property tax to the counties will be completed in November of this year. The property tax will be reviewed to determine whether it is being properly utilized. There will be a discussion of property tax issues such as the administration of the tax, questions concerning uniformity, and the proper role of the State, if any.

REGULATORY AND TECHNOLOGICAL CHANGES

The Commission is aware that the states are attempting to respond to regulatory and technological changes that are transforming the taxation of industries such as transportation, financial services, and telecommunications. The Commission's report will include an analysis of the impact of such changes on the ability of the State to tax those industries in an equitable and efficient manner.

At this point there is no consensus among experts on how such issues should be resolved, and Constitutional questions that often arise in connection with these industries make a satisfactory resolution more difficult to achieve.

NONRESIDENT INVESTMENT

The Commission does not intend to comment on non-tax aspects of foreign investment in Hawaiian property and businesses. There will be some analysis of the extent to which the tax laws have or should be applied in an equitable and efficient manner to nonresidents.

V. COMMISSION REPORT

The Commission will submit a report to the Legislature in December 1989. The report will contain an Executive Summary that will begin with an evaluation. The evaluation will discuss the Commission's findings as to how the tax structure fares on the standards of equity, adequacy, stability, economic efficiency, and simplicity.

Following the evaluation will be recommendations for remedying deficiencies in meeting the standards. Those will be followed by other recommendations for adapting the tax structure to the economic and political climate. There will be estimates of the revenue impact of recommendations.

The remainder of the report will consist of the information and assumptions that were taken into account in arriving at the conclusions in the Executive Summary. A second volume will contain reports of studies conducted by consultants to the Commission and working papers prepared by the Commission staff.

A draft of the report will be released in October 1989 so that interested parties will have an opportunity to prepare their comments on the final report. The Commission encourages full participation by those who have an interest in the tax review process. It should be noted that full and proper consideration can be given to input that is received prior to July 1989; because of time constraints, the same may not be true for input that is provided only in response to the draft.

VI. SUMMARY

The Tax Review Commission looks forward to fulfilling its mandate and carrying out the agenda that it has set out. Each commission must conduct its review within the context of the economic and political circumstances of its time, and today is a time when states are trying to put their tax systems in order. Hawaii is no different in that respect, although it does start out with a healthy tax system - an advantage over many states at the outset.

It is a time when the federal government faces fiscal problems that leave it little room to consider the needs of the states, when the federal tax system waits for the other shoe to drop in connection with the changes that have been made to the Internal Revenue Code.

It is a time when tax systems have not yet accommodated the effects of changes in the regulatory and technological environment, when traditional boundaries between regulated industries have become blurred and traditional tax concepts have become strained, when the global economy is a reality, and when Hawaii finds itself in the forefront of the evolution of a world market.

It is also a time when Hawaii is enjoying the benefits of a vibrant economy, when the budget surplus is growing steadily. Short-term circumstances should not, however, obscure the need to address problems of equity and efficiency that may exist today and to position the tax structure for tomorrow's economy.

In its meetings since July 1, 1988, the Commission has tried to approach its mandate with these considerations in mind. From now through June, the Commission hopes to hear from Hawaii's taxpayers and citizens. There will be public hearings on the major islands during the month of June.

After that, the Commission will spend the months of July, August, and September analyzing the results of consultant studies and staff working papers and spend the months of October and November writing its report. A draft of the report will be released in October and the report itself will be submitted to the Legislature in December.

Hawaii's status as a leader in tax policy is well established and every effort should be made to maintain it.

HAWAII STATE CONSTITUTION

Article VII

TAX REVIEW COMMISSION

Section 3. There shall be a tax review commission, which shall be appointed as provided by law on or before July 1, 1980, and every five years thereafter. The Commission shall submit to the legislature an evaluation of the State's tax structure, recommend revenue and tax policy and then dissolve.

HAWAII REVISED STATUTES

CHAPTER 232E

TAX REVIEW COMMISSION

[Sec. 232E-1] **Establishment of the commission.** There shall be a tax review commission, hereinafter called the commission. The commission shall consist of seven members who shall be appointed by the governor with the advice and consent of the senate and shall be in the department of taxation for administrative purposes. The commission shall elect its chairperson from one of its members. The members shall receive no compensation for their services, but shall be reimbursed for actual expenses incurred in the performance of their duties.

The commission may enter into contracts with consultants and engage employees necessary to perform its duties without regard to chapter 76 or 77. Departments of the state government shall make available to the commission such data and facilities as are necessary for it to perform its duties.

Sec. 232E-2 Term. A commission shall be appointed on or before July 1980, and a new commission shall be appointed on or before July 1 every five years thereafter; provided that if any vacancy occurs in the membership of a commission prior to the completion of its duties or dissolution, the governor shall appoint a replacement member in accordance with sections 232E-1 and 26-34. The commission shall meet from time to time as necessary to execute its duties. Upon completion of its duties, the commission shall dissolve.

Sec. 232E-3 Duties. The commission shall conduct a systematic review of the State's tax structure, using such standards as equity and efficiency. Thirty days prior to the convening of the second regular session of the legislature after the members of the commission have been appointed, the commission shall submit to the legislature an evaluation of the State's tax structure and recommend revenue and tax policy, except that for the commission appointed on or before July 1, 1980, or the replacement commission intended to function prior to the appointment of a new commission on or before July 1, 1985, the commission shall submit the required evaluation and recommendations to the legislature thirty days prior to the convening of the regular session of 1985.

JOHN WAIHEE
GOVERNOR

RENJI GOTO
EXECUTIVE DIRECTOR



JOHN R. MARKS
CHAIRPERSON

ADDIE L. LAMBERTH
VICE-CHAIRPERSON

TAX REVIEW COMMISSION

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ALAN M. L. YEE

PRELIMINARY REPORT

January 18, 1989

To the Honorable Members of the Fifteenth Legislature:

The Tax Review Commission, established by Act 218, Session Laws of Hawaii 1979, begs leave to report as follows:

The Tax Review Commission (hereinafter referred to as the commission) shall, pursuant to Section 232E-3, Hawaii Revised Statutes, conduct a systematic review of the State's tax structure, using such standards as equity and efficiency.

Thirty days prior to the convening of the Legislature for the Regular Session of 1990, the commission shall submit to the Legislature an evaluation of the State's tax structure and recommend revenue and tax policy.

The commission consists of seven members who were appointed by the Governor with the advice and consent of the Senate and assigned to the Department of Taxation for administrative purposes.

The commission held its first meeting on July 1, 1988 and elected John R. Marks to serve as its chairperson and Addie L. Lamberth to serve as its vice-chairperson. It has since met on a regular basis and shall continue to meet as necessary to execute its duties. Upon completion of its duties the commission shall dissolve.

The commission wishes to extend an offer of assistance to the Legislature on matters pertaining to its consideration of the commission's report and intends to testify before the Legislature if called upon to do so during the Regular Session of 1990.

The commission intends to solicit opinions on the State's tax structure from a cross-section of Hawaii's citizens and taxpayers and encourages interested parties to make their views known to the commission. It is hoped that the dialogue will be furthered by a

series of public hearings to be conducted by the commission.

The Legislature is invited to be an early and regular participant in the discussion process. The commission intends to keep the Legislature apprised of the progress of its review and hopes that the Legislature will avail itself of opportunities to exchange its views with the commission.

The commission plans to release an interim report no later than the end of April, 1989. The interim report will identify issues to be reviewed. The hope is that the interim report will serve sufficient notification of the commission's mission and form the basis for a public discussion of taxpayers' concerns.

The commission has deliberated at length on its mission and the state of the tax system. Article VII, Section 3 of the Hawaii Constitution as amended in 1978, provides for the appointment of a tax review commission on or before July 1, 1980 and every five years thereafter. The regular appointment of a tax review commission at five-year intervals leads the commission to conclude that its mission is to build upon the results of prior tax review commissions, to evaluate the State's tax system as it currently stands and as it is expected to be throughout the period preceding the appointment of the succeeding tax review commission, and to raise the level of debate for future considerations.

The commission therefore plans to focus its evaluation of the State's tax structure on the years through 1994, but intends to make recommendations for the future direction of the tax system, if warranted, as well as for the period through 1994. Its evaluation will take into account the following standards:

1. ADEQUACY - The tax system should provide sufficient taxes to satisfy revenue requirements through 1994. The Multi-Year Program and Financial Plan and Executive Budget will be accepted as reflecting the budgetary impact of policy objectives and will be used as the primary basis for determining revenue requirements for the years through 1994.
2. EQUITY - The tax burden should be fairly shared according to the ability to pay, and similarly situated taxpayers should be similarly taxed.
3. EFFICIENCY - Tax considerations should not interfere with private economic decisions. Taxpayers should not be prompted to structure their activities for the purpose of avoiding a tax cost or gaining a tax advantage.
4. SIMPLICITY - The tax system should not be unduly difficult or costly for taxpayers to comply with or for the government to administer.
5. STABILITY - The tax system should provide a stable and predictable flow of tax revenues. It should minimize the need

for frequent or radical adjustments as economic conditions change.

A good tax system attempts to strike a balance among inherently incompatible standards, but even the best tax system will require periodic adjustments because of changes in policy objectives and public sentiment. The commission will be guided by the actions and statements of the elected representatives of Hawaii's taxpayers in evaluating the extent to which policy objectives warrant a recommendation for changes to the tax system.

The commission intends to include all aspects of the State's tax structure in its review but recognizes that two issues must be given particular attention: (1) the effects of the Tax Reform Act of 1986, and (2) county revenues.

TAX REFORM ACT OF 1986

A major goal of the Tax Reform Act of 1986 was to broaden the tax base to support the lowered tax rates. There was also a desire to make the federal income tax system more efficient. The repeal of or limitation on tax credits and deductions, in conjunction with rate reduction, make tax benefits less valuable and less of an influencing factor in economic decisions. There is expected to be some shifting of the incidence of taxation among income groups and categories of taxpayers both as a direct result of tax law changes and because of the impact of the Act's provisions on the economy as taxpayers adjust to the new rules.

Hawaii's income tax, like that of most states, conforms closely to the federal rules. As a result, the base broadening measures of the Act have largely been incorporated into the Hawaii tax system. Since a broadened base was intended to go hand in hand with lowered rates at the federal level, the commission intends to determine the extent to which corresponding adjustments, such as tax rate changes, are warranted or unwarranted at the State level.

The commission also intends to review the extent to which the Tax Reform Act affects other Hawaii taxes either directly (e.g., because such taxes might be deductible or nondeductible) or indirectly (e.g., as a result of adjustments in economic decisions because of the disallowance of interest deductions).

COUNTY REVENUES

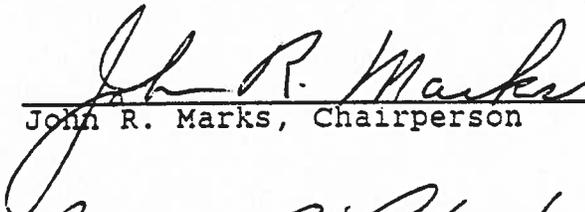
The commission appreciates the great difficulties associated with a discussion of county revenues. Despite such difficulties, the commission concludes that it should devote particular attention to issues concerning county revenues because: they are relevant to the State's tax structure; they are of sufficient concern and import to Hawaii's citizens; and they must be taken into account in recommending revenue and tax policy as the commission is required to do under Section 232E-3, Hawaii Revised Statutes. The interim report will indicate the issues to be reviewed.

The commission plans to release a draft of its final report no later than 60 days (October 15, 1989) prior to its submission of the actual report to the Legislature to allow interested parties to review and comment on its contents.

The commission does not recommend that the Legislature defer action on tax relief measures that are determined to be necessary in the current session.

The commission sends its best wishes to the Legislature and thanks the Legislature for its interest and support for the commission's efforts.

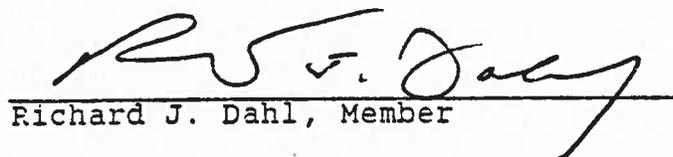
Respectfully Submitted,



John R. Marks, Chairperson



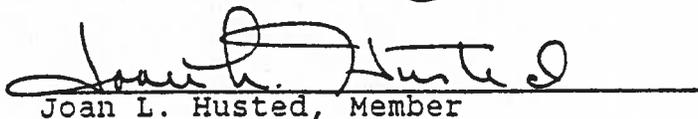
Addie L. Lambert, Vice-Chairperson



Richard J. Dahl, Member



Mark N. Henry, Member



Joan L. Husted, Member



Randall W. Roth, Member



Alan M. L. Yee, Member