SHOULD THE HAWAII GENERAL EXCISE TAX LOOK LIKE OTHER STATES' SALES TAXES?

REPORT PREPARED FOR THE
2002 STATE OF HAWAII TAX REVIEW COMMISSION

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INTRODUCTION[1]

This report is an evaluation of the Hawaii General Excise Tax (GET) with a specific focus on the implications of moving the tax to one that is more similar to the sales taxes that are imposed in other states. The report has been prepared for the Hawaii Tax Review Commission. A major conclusion of the report is that there is no standard state sales tax that can be used as a benchmark, but instead there is a continuum of sales tax structures that encompass a broad range of tax rates and tax bases. Combined state and local tax rates reach 10 percent and above, as in Alabama and Louisiana, and are as low as the 4 percent rate imposed in Hawaii and a number of other states. The breadth of the base also varies widely, with Hawaii having the broadest base of any state and several New England and other states that have bases that are less than one-third as broad as Hawaii's. Another major conclusion is that Hawaii has made the right choice by selecting a tax structure at the extreme with a very broad base and a very low rate. Movement to a higher rate, narrower base structure would not, in general, be an improvement–it is Hawaii, not other states, that is closer to getting it right. This is not to say that the GET is perfect. For example, continued narrowing that would be achieved by exempting certain carefully selected business-to-business transactions remains appropriate.

The paper is divided into seven major sections following this introduction. The first is a description of how the GET fits in the broad conceptualization of taxation. The second is a review of sales taxes as they are structured in the U.S. and an analysis of how the GET compares with the taxes that are imposed by other states. The next section describes the goals that are generally used for designing taxes and defines the GET tax base. The fourth section is a discussion of the exemptions that are currently allowed from the GET. The fifth is an examination of the desirability of allowing additional exemptions from the GET. The next section is a description of the Streamlined Sales Tax Project (SSTP) that is currently underway in the U.S., and the implications of the SSTP for Hawaii. The final section is a brief summary and a listing of some policy options for the Tax Commission to consider.

[1] The author wishes to thank Chairman Craig Hirai and other members of the Tax Review Commission, Director Marie Okamura and other staff of the Department or Taxation, and Kevin Wakayama for helpful comments and insights. The findings and conclusions are solely those of the author.

UNDERSTANDING THE GET

This section reviews the conceptualization of the GET that was developed for the 1989 Tax Review Commission and defines the basis for the tax structure (Fox, 1989). An understanding of the GET and what it is intended to tax are essential to making good decisions on the appropriate structure. Since the intent of the tax is not clearly specified in legislation and evolves over time the approach here is to conceptualize the intended base that is implied by legal definitions of the tax, current practice, trends in restructuring the base, and economic theory.

Section 237-13 of the Hawaii code says that "There is hereby levied and shall be assessed and collected annually privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross income, whichever is specified." This plus the remainder of Section 237-13 indicate the tax is legally a privilege tax against all manufacturers, sellers of tangible personal property, contractors, theaters, sales representatives, service businesses, insurance solicitors and agents, professionals, and other businesses. The same statute indicates that some privileges are taxed at 4.0 percent and others at 0.5 percent. Insurance solicitors and agents are taxed at a 0.15 percent rate on their commissions rather than their gross sales.

Despite the coverage of all businesses within a single type of tax and a single statute, for the reasons to be given below, it would appear that the GET is best defined as two taxes: a retail sales tax levied at 4.0 percent and a privilege tax levied at 0.5 percent (plus the small tax on insurance commissions). The GET is generally levied at 4.0 percent on gross revenues of retail sellers of tangible personal property, contractors, providers of entertainment, sales representatives, service businesses, professionals, and other businesses. The tax is levied at 0.5 percent on manufacturers, wholesalers, intermediary services, sugar processing, pineapple canning, and producing. The different rates are imposed by type of activity and not by type of firm. So, for example, a manufacturer who both sells to retailers and sells at retail pays a different rate on each. This entails additional compliance burdens in determining what is taxable at each rate.

One reason the GET can be categorized as two taxes is the decision to levy widely different rates on manufacturing and wholesaling transactions versus final (retail) consumption transactions. Another reason is that the 0.5 percent tax is levied on production type activities and the 4 percent tax is levied heavily on sales to final consumers, although this distinction is not precisely true, as is described below. Further, the 4 percent portion of the tax is more in the spirit of other state sales taxes and the 0.5 percent portion is similar to the business gross receipts taxes that are relied upon by a few states, such as Washington.

The tax base assessed at 4.0 percent dominates the GET. Total GET tax revenues in 2001 were $1640.1 million. The 4.0 percent tax base raised about 90 percent of total GET revenue and the base at 0.5 percent generates only about 5 percent of receipts. In fiscal year 2001, $1,484.9 million was collected at the 4 percent rate and $80.4 million was collected at the 0.5 percent and 0.15 percent rates. The remaining $74.8 million in GET revenue are collections that cannot be allocated. Nonetheless, the activities taxed at 4 percent represented only 69.0 percent of the total tax base (Department of Taxation, 2001, p. 20).

Sales Tax Base

The base taxed at the 4.0 percent rate is similar to a very broad based (comprehensive) retail sales tax that is levied on all sales of good and services to final consumers. There are several reasons why the GET can be classified as a sales tax even though it is imposed as a privilege tax on vendors. First, this legal distinction tells little of the legislative intent or the economic effects of the GET, and these are most important factors for categorizing the tax. The economic effects in terms of who's income ultimately is reduced through payment of the tax and the tax's effects on the product's price and quantity demanded are the same regardless of whether the tax is legally incident on the seller's receipts or the buyer's purchase. As a result legal incidence provides little guidance for measuring the intent. Further, Hawaii is not unique in creating its sale tax through a vendor levy. Thirteen states including Hawaii levy their sales tax on the privilege of engaging in business as a vendor (Due and Mikesell, 1995, p. 28-29). Fifteen

states and the District of Columbia levy their tax as a hybrid between a tax on vendors and on consumers. Only 17 states have a legally specified consumer levy.

Second, exemption of goods and services produced for export to the mainland or other countries is evidence that the intent is to impose a tax on the purchase of goods for use in Hawaii. This is reinforced by the enactment of a use tax that is intended to tax the consumption in Hawaii of goods purchased outside the state and consumed in the state.

No assertion is made that Hawaiian policymakers began with a grand scheme to create a retail sales tax through design of the GET. Legislation may have been enacted to levy a use tax or to exempt exports for reasons that were not specifically related to developing a sales tax. Nonetheless, the result has been a sales tax like structure.[2] Also, the argument should not be interpreted to mean that the current set of goods and services in the GET base accords perfectly with a retail sales tax, as is discussed below. Hawaii's tax structure, like that of other states, has elements that are inconsistent with the logic on which the overall tax structure now rests.

Privilege Tax Base

The tax at 0.5 percent can be seen as a levy on the privilege of transacting business with purchasers who are not final consumers. A similar business privilege tax is imposed in Washington, but the like tax in West Virginia was replaced in 1987. Indiana began phasing out its gross receipts tax several years earlier. Such taxes have no logical basis in the theory of taxation and are likely to violate many goals of taxation, like the desire to minimize the effects on decisions by people and businesses.

Privilege taxes of the form described here are business production taxes. They have the potential to affect how business activities occur, such as reducing production in Hawaii or causing businesses to bring activities in house rather than subcontract the functions. But, the low rate part of the GET is unlikely to create serious distortions in behavior. Higher rates on the privilege tax component could cause greater problems.

The existence of multiple rates requires many decisions on what is taxable at 4.0 percent versus 0.5 percent. These decisions must even be made within individual firms.

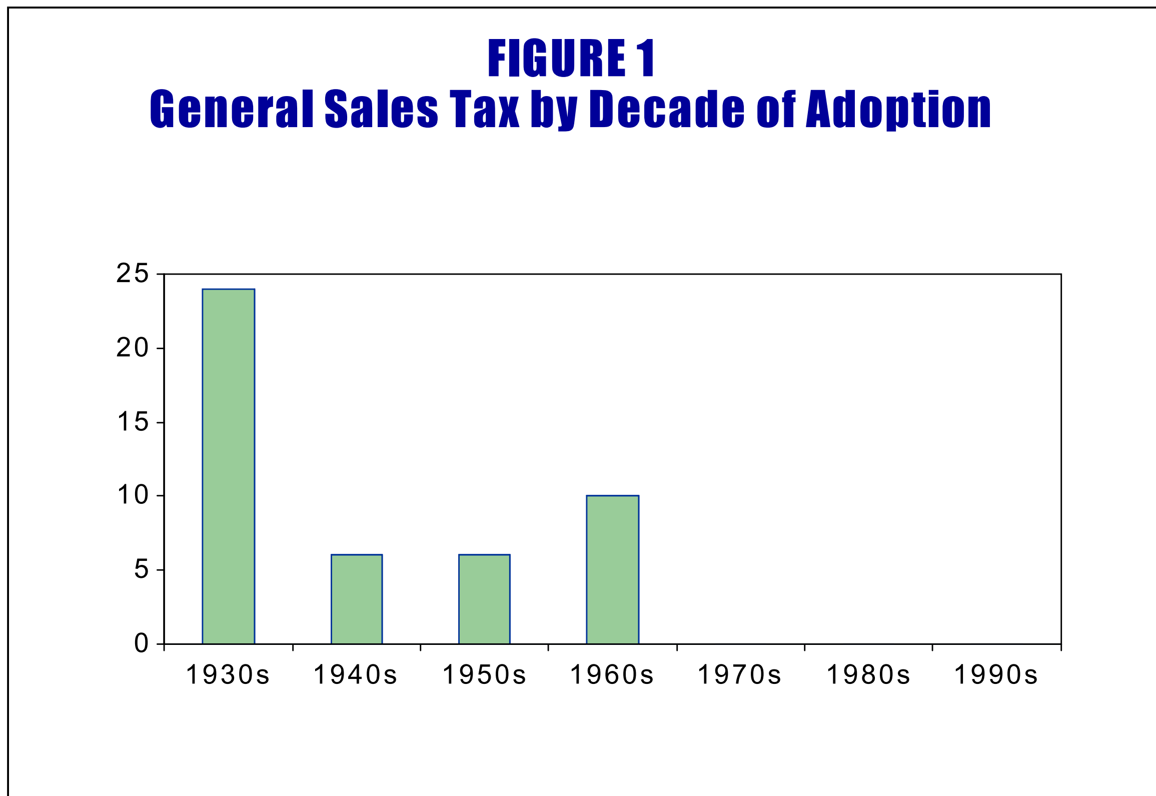
[2] Interestingly, Bock, Brilliant, and Gerding (1989, p. 182) claim it is not a sales tax and Arthur D. Little (p. 1) argues it is. The different views likely result because the former is taking a legal perspective and the latter an economic perspective on the tax.

The existence of differential rates increases administration and compliance costs, often with relatively small implications for tax revenues. A number of other states levy their sales tax at multiple rates as well (see Due and Mikesell, 1995, pp. 52-54). At least 10 states tax the purchase of producer related goods at different rates and some states also allow motor vehicles and manufactured homes to be taxed at different rates. A number of other differential sales tax rates are imposed as well.

This report focuses on the sales tax component of the GET and the lower rate privilege tax is treated as a levy on firms that are exempt from the retail sales tax part of the structure. The major reasons for the focus are the revenues from the sales tax part are dominant and a logically consistent sales tax structure can be defined. Unless otherwise indicated the reader should think of the GET levied at 4.0 percent in the following discussion.

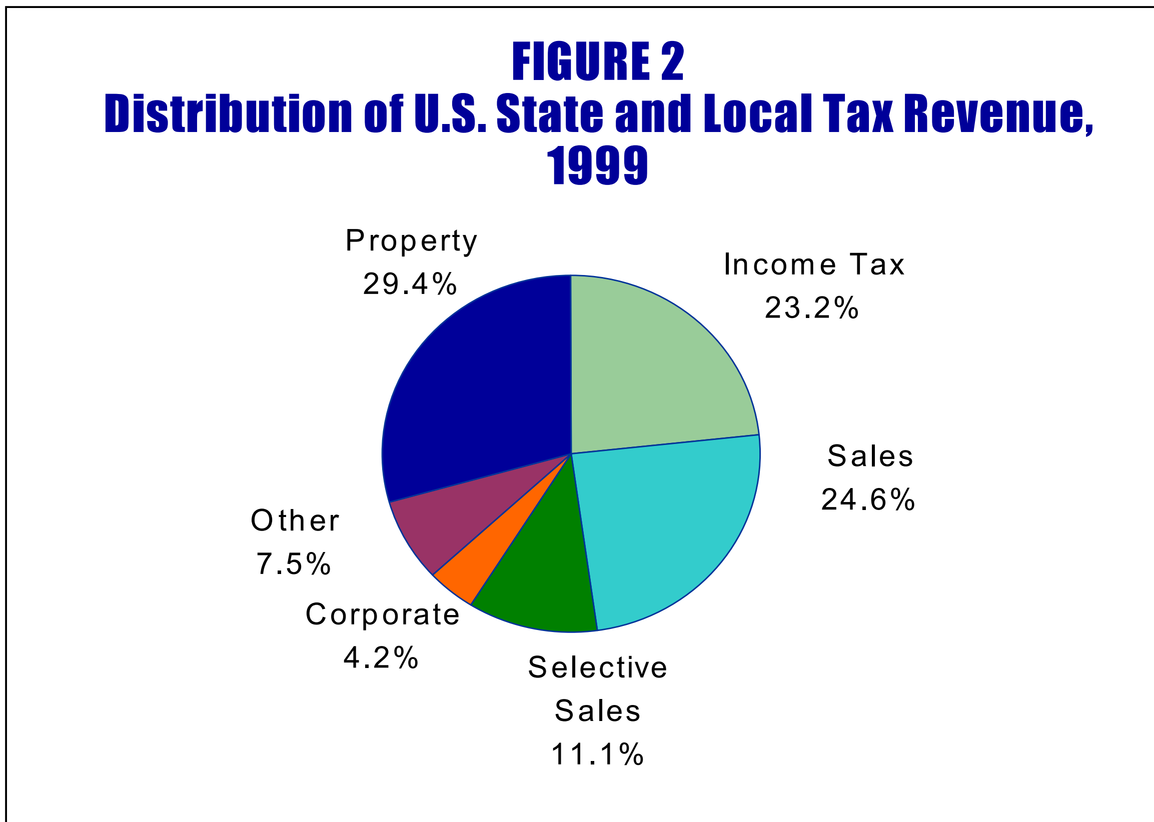
SALES TAXES IN THE UNITED STATES

The GET can be likened to retail sales taxes imposed by a total of 45 states plus the District of Columbia, though comparison with the specific structure of any particular state is very difficult because of the widely differing rates and base definitions. Hawaii's tax, introduced in 1935, was one of the 24 state sales taxes begun during the 1930s (see Figure 1). The GET was a replacement for the business excise tax, which had been imposed in 1932. This suggests that the original intent was to tax businesses, though the plan could have been to use businesses as an administratively convenient means to tax people. Several other states also had business occupations taxes as forerunners to their sales tax. The old business excise tax was closer in form to a value added tax than to the existing GET and the change was made because of poor revenue performance from the business excise tax (Arthur B. Little, 1968). The GET, chosen because of its revenue generating capacity, was an immediate success on this basis.



Sales Tax Revenue

The sales tax is the second most important tax source for both the combination of state and local governments and the second most important source for state governments. The property tax, of which 95.1 percent of the revenue is raised by local governments, is the largest state and local revenue source, followed by the sales tax, which raises 24.6 percent of state/local revenue[3] (see Figure 2). The personal income tax is the largest state government tax.



State governments collected $179.2 billion in general sales tax revenues during fiscal year 2001, representing 32.1 percent of their total tax collections (see figure 3). Local governments collected another $39.5 billion in sales tax revenues (11.5 percent of

[3] The sales tax is the second largest revenue source based on 1998-99 data, the last year for which state and local revenue data are available. However, estimates suggest that the income tax will have surpassed the sales tax by 2001 as the second most important states and local source.

local tax revenues),[4] meaning the combined state and local sales tax revenues were $218.7 billion.

Strong sales tax collections were the result of relatively good sales tax growth until 2002. State sales tax collections rose 5.7 percent annually between 1993 and 2001, about the same rate that national personal income increased. Nonetheless, the sales tax was the largest state revenue source until 1998, but even more rapid income tax growth (8.0 percent annually from 1993 to 2001) resulted in the sales tax falling relative to the income tax. As a general rule, state sales tax revenues grow more slowly than personal income, when evaluated over long time periods. The rapid sales tax growth of the late 1990s resulted in part because there was no recession and consumer spending grew particularly fast. A long-term analysis recently conducted by the author indicates that sales tax revenues in the average state grew about eight-tenths as fast as personal income since the late 1960s. Hawaii, because of its very broad base, has seen revenues grow better than the national average, at 1.1 times personal income growth (5th fastest among the states).

The GET, raising 46.8 percent of tax revenue, is much more important to Hawaii than is the sales tax to the average state (see Figure 3). Hawaii raises a higher percent of personal income in sales taxes than any other state (4.76 percent) and the percent is well over twice that raised in the average state (see Table 1). Hawaii is also highest in the per capita sales tax revenues that are raised, again at well over twice the national average. But, the average statistics hide the wide diversity across the states. As evidenced by Figure 4, the sales tax plays a widely different role in the finance of states. Five states--Florida, Nevada, South Dakota, Tennessee, and Washington--raise well over one-half of their revenues with the sales tax. On the other hand, five states--Alaska,[5] Delaware, New Hampshire, Montana, and Oregon--have no sales tax. Of the states imposing sales taxes, Vermont raises the least share of revenues from a sales tax (13.8 percent). In addition, 34 states permit or require local option sales taxes, though Hawaii does not.

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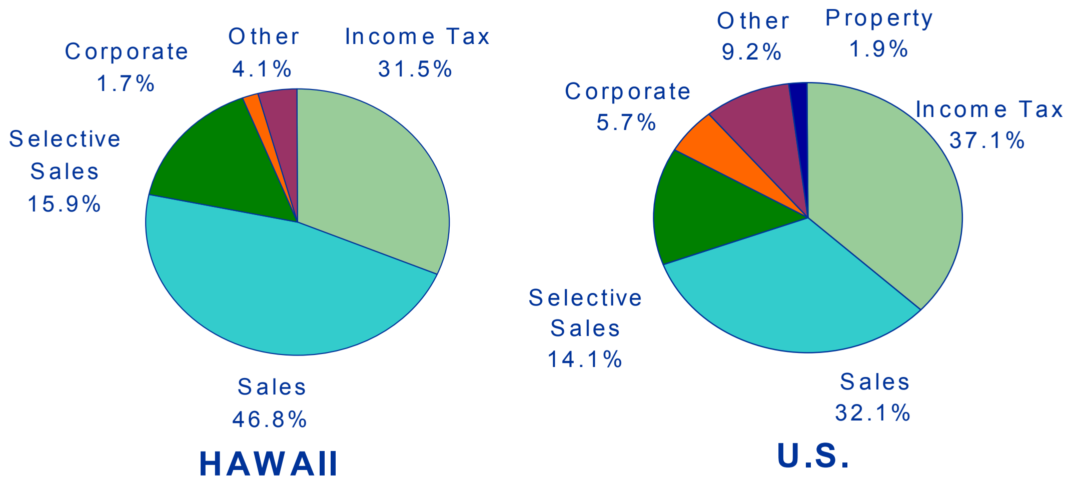
[4] Local government sales tax collections were assumed to grow at the same rate as state collections from 1999 (the last year for which local data are available) to 2001.

[5] Local sales taxes are imposed in Alaska.

FIGURE 3
Distribution of State Tax Collections, Hawaii vs. U.S., 2001



Sales Tax Rates and Bases

The differences in both sales tax rates and base breadth illustrate the wide diversity of state sales tax structures. One measure of the breadth is the tax base[6] divided by the state's personal income.[7] Despite the introduction of exemptions and other tax structure changes over the years, the GET is regarded as having the broadest base of any state because of the extensive taxation of services and rentals[8] (see Table 2). The Hawaii tax base, at 108.2 percent of personal income, is greater than personal income, evidencing that transactions are on average taxed more than once through the chain of distribution.[9]

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[6] The tax bases are estimated by dividing each state's sales tax revenues by its sales tax rate. The calculation has been adjusted based on an analysis by John Mikesell (2000) that accounts for the degree to which the sales tax revenues reported by the U.S. Census Bureau fail to accurately reflect the sales tax structure. For example, some states (such as Kentucky) do not include sales taxes collected on automobiles in their sales tax revenues.

[7] Personal income is a comprehensive measure of the state economy. It is defined as, "Personal income is the income received by all persons from participation in production, from government and business transfer payments, and from government interest. Personal income is the sum of net earnings by place of residence, rental income of persons, personal dividend income, personal interest income, and transfer payments." U.S. Department of Commerce, Bureau of Economic Analysis.

[8] See Due and Mikesell, p. 90.

[9] For this purpose, only the tax levied at 4 percent is used. The entire tax base, using both the 4 and 0.5 percent rate, is 156.2 percent of personal income.

TABLE 1: General Sales Tax Revenue, 2001				
	Per Capita	Rank	% of Pers Inc	Rank
United States	$ 630.56		2.10	
Alabama	$ 380.89	43	1.59	37
Alaska	$ --	NA	0.00	NA
Arizona	$ 739.75	12	2.96	7
Arkansas	$ 658.08	18	2.93	9
California	$ 704.28	13	2.17	27
Colorado	$ 445.95	40	1.36	42
Connecticut	$ 1,014.47	3	2.44	18
Delaware	$ --	NA	0.00	NA
Florida	$ 897.50	5	3.21	6
Georgia	$ 585.23	30	2.09	31
Hawaii	**$ 1,339.90**	**1**	**4.76**	**1**
Idaho	$ 592.02	26	2.48	15
Illinois	$ 506.31	36	1.56	38
Indiana	$ 589.70	27	2.16	28
Iowa	$ 600.81	24	2.23	25
Kansas	$ 647.50	21	2.31	22
Kentucky	$ 555.61	31	2.27	24
Louisiana	$ 537.52	33	2.28	23
Maine	$ 635.49	22	2.46	16
Maryland	$ 492.40	38	1.44	41
Massachusetts	$ 588.78	29	1.52	40
Michigan	$ 772.99	10	2.64	12
Minnesota	$ 758.43	11	2.33	20
Mississippi	$ 813.73	8	3.82	4
Missouri	$ 498.20	37	1.80	35
Montana	$ --	NA	0.00	NA
Nebraska	$ 597.18	25	2.12	30
Nevada	$ 972.82	4	3.34	5
New Hampshire	$ --	NA	0.00	NA
New Jersey	$ 678.77	16	1.80	36
New Mexico	$ 885.93	6	3.93	3
New York	$ 461.78	39	1.30	43
North Carolina	$ 422.19	42	1.55	39
North Dakota	$ 536.48	34	2.13	29
Ohio	$ 552.82	32	1.95	32
Oklahoma	$ 443.88	41	1.83	34
Oregon	$ --	NA	0.00	NA
Pennsylvania	$ 589.05	28	1.95	33
Rhode Island	$ 657.19	19	2.23	26
South Carolina	$ 612.98	23	2.53	14
South Dakota	$ 679.94	15	2.60	13
Tennessee	$ 780.97	9	2.96	8
Texas	$ 689.69	14	2.45	17
Utah	$ 652.04	20	2.75	11
Vermont	$ 349.31	44	1.27	44
Virginia	$ 336.63	45	1.06	45
Washington*	$ 988.72	2	3.17	2
West Virginia	$ 515.06	35	2.31	21
Wisconsin	$ 668.25	17	2.34	19
Wyoming	$ 821.75	7	2.93	10

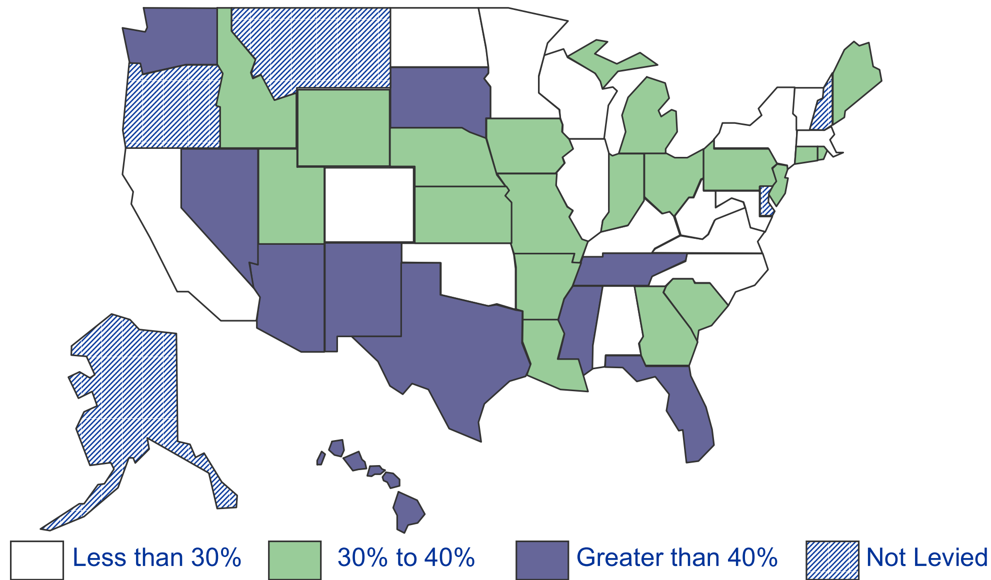
Source: State Tax Collections, U.S. Bureau of the Census and Bureau of Economic Analysis.
NA—Does not impose sales tax and Indicates rank 46-50.
*The Business and Occupation Tax was subtracted from the General Sales Tax Total.

No other state has a base nearly as large, and the average base is less than one-half of that used in Hawaii. New Mexico is closest, with a base that is more than 20 percent smaller. At the other extreme are east coast states like New Jersey, Massachusetts, and Rhode Island, all of which have a base that is only about 30 percent of personal income.

A number of factors that explain why tax bases differ by state are summarized in Table 3. One factor is the propensity to exempt certain tangible goods. Food for consumption at home and clothing are two obvious examples that are taxed in Hawaii, but not in many some other states. Twenty-nine states exempt food from the state tax and three states tax it at a reduced rate.[10] Two states that exempt food from the state rate allow the local rate to be levied on the transactions. Eight states allow exemption of much or all clothing.

Another factor is the propensity to exempt many services. The Federation of Tax

[10] All states exempt purchases made with food stamps.



Administrators undertook a survey of state taxation of services. A total of 164 services were investigated, of which Hawaii taxes the greatest number at 157 services (see Table 3). At the other extreme, Nevada taxes only 11 of the services.[11] Several specific examples are included in Table 3. For example, only four states (including Hawaii tax physicians and dental services) and many states tax only a limited set of utility services.

Both the average combined state and local sales tax rate and the state only rate are reported in Table 4. The median state levies a 5 percent rate, with 17 states imposing rates above 5 percent. State rates range from a low of 2.9 percent in Colorado to a high of 7 percent in Mississippi, Rhode Island and Tennessee. Thirty-six states levy a higher state rate than Hawaii, and only Colorado and Virginia and states without the tax impose

[11] The services listed in Table 3 are taxed under structures other than the general sales tax in some states.

TABLE 2: Sales Tax Base as a Percent of Personal Income, 2001		
State	**Percent**	**Rank**
HI	**108.20**	**1**
NM	84.07	2
LA	77.36	3
WY	73.17	4
SD	67.49	5
OK	64.60	6
UT	57.83	7
AR	57.25	8
MS	54.59	9
FL	53.53	10
GA	52.06	11
NV	51.42	12
ND	50.87	13
SC	50.82	14
ID	49.60	15
TN	49.42	16
ME	49.15	17
AZ	48.65	18
WA	47.97	19
KS	47.05	20
TX	47.03	21
CO	46.98	22
WI	46.75	23
WV	45.81	24
KY	44.71	25
MI	44.70	26
IA	44.57	27
MN	43.99	28
IN	43.31	29
MO	42.62	30
NE	42.30	31
CT	40.62	32
OH	39.05	33
NC	38.59	34
VA	37.82	35
VT	37.71	36
CA	37.65	37
AL	37.46	38
MD	35.62	39
NY	33.76	40
PA	32.51	41
RI	31.78	42
IL	31.32	43
MA	30.49	44
NJ	29.98	45
U.S.	42.36	

a lower state rate.[12] The median combined state and local rate is 6.1 percent, with rates ranging from a low of 1.05 percent in Alaska to a high of 9.35 in Tennessee.[13] Only Alaska, with no state rate, and states with no sales taxes impose a lower combined state/local rate than Hawaii.

[12] Hawaii's rate is calculated on the total revenue received by a business (including payment of the tax), making the effective rate on the consumer price 4.167 percent. Most other states determine the tax liability based on the consumer cost. Thus, states with 4.0 percent legislated rates actually levy a lower tax rate than Hawaii.

[13] There are a small number of places in Alabama and Louisiana that levy rates above 9.35 percent.

TABLE 3: Selected Sales Tax Exemptions by State

		Taxation Status				No. of Services Taxed	
	Taxable	Food	Clothing	Phys & Dentists	Const	Utility Service (4)	Const (5)
AL	32	E	T	E	E	9	0
AK	1			-	-	0	0
AZ	57	T	T	E	5.0%	12	4
AR	65	T	T	E	E	14	0
CA	18	E	T(2)	E	E	5	0
CO	14	E	T	E	E	4	0
CT	87	E	E(3)	E	6.0%	10	4
DE	142			0.4%	0.65%	9	4
DC	63	E	T	E	E	10	0
FL	64	E	T	E	E	7	0
GA	34	E	T	E	E	10	0
HI	157	T	T	4.0%	4.0%	16	4
ID	29	T	T(2)	E	E	0	0
IL	17	T(1)	T	E	E	12	0
IN	22	E	T	E	E	8	0
IA	94	E	E(3)	E	E/5%*	13	3
KS	76	T	T	E	4.9%	10	4
KY	26	E	T	E	E	10	0
LA	60	LT	T	E	E	12	0
ME	27	E	T	E	E	9	0
MD	39	E	E(3)	E	E	5	0
MA	20	E	E(3)	E	E	9	0
MI	29	E	T	E	E	12	0
MN	61	E	E	E	E	15	0
MS	70	T	T	E	3.5%/7.0%	8	4
MO	28	T(1)	T	E	E	8	0
MT	19			-	1.0%	12	1
NE	49	E	T	E	E	14	0
NV	11	E		E	E	0	0
NH	11			-	-	8	0
NJ	50	E	E(3)	E	E	6	0
NM	152	T	T	5.0%	5.0%	16	4
NY	74	E	E(3)	E	E	9	0
NC	28	LT	T	E	E	10	0
ND	25	E	T	E	E	6	0
OH	52	E	T	E	E	8	0
OK	32	T	T	E	E	8	0
OR	0	T		E	E	0	0
PA	61	E	E	E	E	8	0
RI	28	E	E	E	E	10	0
SC	32	T	T	E	E	4	0
SD	141	T	T	E	4.0%	12	4
TN	71	T(1)	T(2)	E	E/6%	11	1
TX	78	E	T	E	E/6.25%	12	3
UT	54	T	T	E	E	7	0
VT	23	E	E(3)	E	E	3	0
VA	18	T	T	E	E	1	0
WA	154	E	T	1.829%	6.5%	16	4
WV	110	T	T	E	E/6%	10	1
WI	69	E	T	E	E	11	0
WY	63	T	T	E	E	11	0

Source: *Sales Taxation of Services: 1996 Update*. Federation of Tax Admin. April 1997. *State Tax Guide, 2000*. CCH Publishing.

Notes: E--exempt; T—taxable; LT—local tax only; (1) taxable at a reduced rate; (2) exemption allowed on some clothing transactions for nonprofit orgs.; (3) exemption only applies to clothing costing less than a certain amount; (4) Includes both industrial and residential use for intrastate telephone and telegraph, interstate telephone and telegraph, cellular telephone, electricity, water, natural gas, other fuels, sewer, and refuse; (5) Includes gross income of construction contractors; carpentry, painting, plumbing and similar trades; construction service (grading, excavating, etc.); water well drilling.

TABLE 4: Sales Tax Rates		
	State Rate (Percent)	**Combined Average State, City and County Rate (Percent)**
Alabama	4.00	7.40
Alaska	0.00	1.05
Arizona	5.60	7.60
Arkansas	5.13	6.80
California	6.00	7.90
Colorado	2.90	5.80
Connecticut	6.00	6.00
District of Columbia	5.75	5.75
Florida	6.00	6.50
Georgia	4.00	6.55
Hawaii	4.00	4.00
Idaho	5.00	5.05
Illinois	6.25	7.40
Indiana	5.00	5.00
Iowa	5.00	6.10
Kansas	5.30	6.60
Kentucky	6.00	6.00
Louisiana	4.00	8.35
Maine	5.00	5.00
Maryland	5.00	5.00
Massachusetts	5.00	5.00
Michigan	6.00	6.00
Minnesota	6.50	6.65
Mississippi	7.00	7.00
Missouri	4.23	6.55
Nebraska	5.00	5.75
Nevada	6.50	7.15
New Jersey	6.00	5.95
New Mexico	5.00	5.95
New York	4.00	7.95
North Carolina	4.50	6.55
North Dakota	5.00	5.45
Ohio	5.00	6.15
Oklahoma	4.50	7.55
Pennsylvania	6.00	6.25
Rhode Island	7.00	7.00
South Carolina	5.00	5.55
South Dakota	4.00	5.10
Tennessee	7.00	9.35
Texas	6.25	7.80
Utah	4.75	6.40
Vermont	5.00	5.00
Virginia	3.50	4.50
Washington	6.50	8.30
West Virginia	6.00	6.00
Wisconsin	5.00	5.40
Wyoming	4.00	5.25
Source: Sales Tax Clearinghouse website.		

DESIGNING THE TAX BASE

Goals for Defining the Tax Base

Decisions on the best tax structure for a state require weighting the relative importance of several goals and making the appropriate tradeoffs between conflicting goals. The goals for the tax system likely include:

1. The tax structure must raise the necessary revenues. In fact, this is the reason why almost all taxation occurs. A tax system which is perfect on all other grounds, yet does not raise the needed revenues, will almost surely be a failure. The appropriate amount of revenues will vary between states based on the demand for publicly provided services and other factors.
2. The tax structure should be equitable. Equity can be evaluated in terms of two concepts, horizontal equity and vertical equity. A) Horizontal equity refers to the tax liabilities imposed on people with the same income (capacity to pay taxes). A tax system is normally thought to be horizontally equitable when people with the same income have the same tax burdens. The GET appears to score well on horizontal equity because of the broad tax base, but pyramiding of the GET results in different implicit tax burdens depending on how many stages a product goes through before it reaches the final consumer, which means horizontal equity will be distorted. Pyramiding can only be corrected by ensuring that the GET is levied exclusively on sales to final consumers. B) Vertical equity refers to the relative tax burden of people with different income. A tax system is defined as regressive, proportional or progressive, depending on whether the *percentage* paid in taxes falls, stays the same, or rises as taxpayers with higher income are evaluated. But these terms are only descriptions of the tax system and do not define whether the tax is vertically equitable. Hawaii residents must decide whether the Hawaii system should be regressive, progressive, or proportional, because this is mostly an issue of local preferences. A very important point is that vertical

equity only needs to be established for the overall tax system; there is no requirement and should be no expectation that any individual tax will be vertically equitable.

3. The tax structure should be efficient. An efficient structure is one, which creates minimal effects on the decisions of business firms and individuals because economic well being is lessened when decisions are distorted. Where the tax system distorts decisions it should be in ways to encourage economic development or achieve other public policy goals.
4. The tax system should be low cost for public sector administration and for private sector compliance. Resources devoted to administration are not available for delivering the desired public services and compliance costs reduce the well being of taxpayers.
5. The tax system should be well accepted by residents and businesses. This means it must be both constitutional and publicly supported.

These five goals often will conflict. For example, the factors that make a tax good for administration often make it bad for compliance. Characteristics that enhance equity often harm economic development or economic efficiency, and so on. Thus, the best tax system is likely to vary according to the views of the person making the decision and according to sentiments in the state. Therefore, differences in tax structures should be expected to exist across states.

Defining the General Excise Tax Base

This section defines the components of a conceptually sound sales tax in the context of the goals described above. The basis for the discussion is the assumption that the GET is intended to be a tax on consumption as economists view this concept. Though it cannot be proven on theoretical grounds, the strongly accepted conventional wisdom is that for any desired level of revenues, taxation of final consumption with a broad base and low rates is more efficient than narrow tax bases with high tax rates.[14] The related tenet is that the tax rate should be constant on all commodities or, at a minimum, close

[14] The common approach to theoretical development of tax structures considers only three goals: raising sufficient tax revenues, having taxes with minimal influence on economic decisions, and achieving horizontal equity.

substitutes should be subject to the same rate.[15] Practically, these guidelines can best be achieved by imposing a single rate on all final consumption so that the tax does not pyramid and consumers are not implicitly subsidized to buy untaxed items. These same characteristics are consistent with horizontal equity because they mean people with the same consumption expenditures pay the same tax.

The remainder of this section is an attempt to practically define taxable final consumption in a manner that allows all consumption to be taxed and minimizes pyramiding. In the discussion it is recognized that sales taxes as used in the U.S. generally have developed as hybrids that tax both final consumption and many intermediate purchases by business and government purchases. The following discussion is separated both according to types of buyers and types of sellers.

Household Consumption

All household purchases are final consumption and the proceeds from these transactions are appropriately the target of sales taxation. This should include all purchases of both goods and services. The consumption value should be taxed whether the good is to be used over many years (such as a house) or to be used up immediately.[16] A pure consumption tax would have in its base both the purchases for which payments are made and the value of items received in kind.

Sales by private firms, by government, and by not-for-profit entities belong in a consumption base, where the interest is to tax the final consumer.[17] That sales by businesses would be taxed is obvious. Sales by not-for-profit entities should normally be taxed because the intent is to tax the purchaser not the seller and the tax is on the transaction, not on profit. Justification for the failure to tax not-for-profit transactions is often based on the assumption that these organizations are undertaking activities that are in the public interest, and this leads to an assumption that their transactions should be subsidized. This logic should be questioned for several reasons. First, not-for-profit

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[15] Optimal tax theory has led to the conclusion that under certain assumptions about the demand for goods, the tax rate on each commodity should vary inversely with the elasticity of demand. This means higher tax rates should be imposed on those commodities where quantity demanded responds very little to price changes. In practice, different rates are used infrequently except for a limited group of goods such as gasoline, cigarettes, and alcohol and a few others (see the discussion above).

[16] Economists view the use rather than the purchase of long term assets, such as housing and automobiles as consumption.

[17] The federal government cannot be required to collect tax on its sales.

entities undertake different degrees of activities in the public interest, and the definition of a not-for-profit normally does not require that the organization be undertaking activities that the Legislature would choose to subsidize. Second, the extent of the implicit subsidy that arises from tax exemption is determined by the level of activity chosen by the not-for-profit and not by the state. Third, not-for-profit entities often have both for profit and not-for-profit companies, and they carefully determine which activities to produce in each in order to limit their tax liability. Fourth, the goods and services provided by the not-for profit firms are often in direct competition with for profit entities, and the failure to impose the GET places the for profit firms at a disadvantage. Thus, any exemptions for not-for-profit entities should be very narrowly construed and their sales should be taxed as a norm.

Taxation of government sales also requires careful consideration. For this analysis it is best to think of governments as public producers, much as business firms are private producers. Also, it is useful to divide government goods into those financed through their sales and those financed with tax revenues. Applying the tax on the sale of government services to households is appropriate as the tax is conceptually being levied on consumption (even if legally on the seller), and whether it is privately or publicly provided is immaterial. The selling government agency is merely collecting the tax for remittance to the taxing authority; the consumer is the intended taxpayer. This concept is broadly accepted for many government sales of commodities, such as when a state university sells a soft drink, but has been infrequently applied to other government sales of services. Parks and recreational facilities, bus transportation, water and other services are often substantially financed with user prices and could be taxed.[18] The price or user fee is a lower bound measure of the value in consumption that could be taxed even if the good is partly tax financed.

The intended benefits of economic efficiency and horizontal equity will not be attained unless the tax is imposed on government sales. When these sales are not taxable, households that choose to consume large amounts of publicly provided services, such as households using public golf courses rather than private facilities, will pay lower taxes on

[18] Bus transportation may be an exception where subsidization is appropriate because of the positive externalities arising from lower congestion.

their consumption compared with those who purchase more goods from the private sector. Further, private sector provision of these same activities is placed at a competitive disadvantage when it is taxed and public provision is not. A disadvantage of levying the tax on government sales is that it could provide a small incentive for counties to use tax rather than fee revenues to finance services.

No sales tax should be levied on tax financed government services. In this case there is no sale of service and payment of the tax is uncorrelated with receipt of the government service. Thus, neither economic efficiency nor horizontal equity would be improved with the tax.

Electronic and Remote Commerce

As described in the previous section, a consumption tax should be levied on the purchase and use of commodities by individuals in Hawaii, regardless of the vendor. The goal should be to collect GET on both in-state and out-of-state transactions where the consumption will occur in Hawaii. This conclusion applies both to vendors in Hawaii selling goods for use in Hawaii and to vendors from outside of Hawaii selling goods for use in Hawaii. Payment of the tax on sales by non-Hawaii vendors must occur through the use tax. Currently, the nexus standard (which determines which vendors must collect the use tax on behalf of Hawaii) is based on a U.S. Supreme Court ruling (*Quill v. North Dakota*, 112 U.S. 298 (1992)) that says that only vendors with substantial physical presence must collect the tax on behalf of Hawaii. Collection of the tax must be from the consumer, unless the vendor has substantial physical presence in Hawaii. As a practical matter use tax compliance is very poor, particularly for individuals.

The inability to collect use tax places Hawaii vendors at a significant disadvantage since they must collect the sales tax while they compete with remote (often large) vendors that are not required to collect the tax. Thus, Hawaii vendors are placed at a competitive disadvantage. Further, Hawaii vendors that must comply with the GET and bear the compliance costs not borne by the remote vendors. As a result, local vendors face the prospect of losing customers who must pay a higher price because of the tax. The result can be lost jobs in Hawaii and a more regressive sales tax (because of the digital divide) because low-income households have less access than high income households to

the internet. Further, Hawaii state government can expect to lose tax revenues. Bruce and Fox (2000, 2001) estimate that Hawaii lost $55.7 million in new revenue (above losses already in place from mail order, etc.) during 2001 because of the use tax that could not be collected on the growth in electronic commerce. This loss is expected to grow to $191.9 million by 2006.

Considerable discussion has taken place during the past several decades about a new nexus standard that would require collection of the use tax by remote vendors. In the Quill case, the Supreme Court ruled that the limitation on states asserting nexus on remote vendors arises from the commerce clause, which is under the control of Congress. This means Congress can pass legislation to create a new nexus standard that is appropriate for today's electronic age. Such legislation would be in the best interest of Hawaii (see Fox and Luna, 2001). The Streamlined Sales Tax Project (see below) derives mostly from state concerns about these issues.

Government and Business Purchases

Governments and businesses not only sell to consumers but they purchase goods and services. Their purchases should be exempt from the base since they do not represent final consumption. Businesses are not viewed by economists as consumers because businesses purchase in order to produce, with the ultimate expectation of selling the production to consumers.[19] This logic seems compelling to most when applied to direct inputs in the production process, such as when steel, glass, and rubber tires are inputs into the production of automobiles. There is normally agreement that no tax (or in Hawaii's case, a 0.5 percent gross receipts tax) should be imposed on the purchase of these inputs since such a tax would discourage business production in Hawaii and distort the way that businesses structure themselves and operate. For example, one distortion is when firms are encouraged to bring activities in-house to avoid making taxable purchases. However, some question the exemption logic when applied to other business purchases and particularly to the purchase of items that do not become a component part of the business' final product. But, items such as computers used for accounting, desks and stationary are also vital parts of firms' total operations, even though they are only

[19] Of course, many businesses sell to other businesses, but these purchases are used by the buying firms to ultimately produce items that are consumed by individuals.

indirectly used in the making of goods or services. Therefore, failure to exempt intermediate purchases or to tax them at a low rate, both of which are done in Hawaii, causes the sales tax to include some traits of a turnover tax (which is levied on every sale that occurs) that pyramids into higher product prices and distorts business purchases.

As a practical matter, all business and government purchases are not exempt from any state's sales taxes The taxation of business-to-business inputs in Hawaii, as in other states, usually results for three reasons. First, the concept of consumption is often misunderstood, and businesses are inappropriately viewed as consumers. Second, it is very difficult to distinguish between business and individual buyers. Broad exemptions for business can often open a wide opportunity for evasion that can be accomplished by forming a business so that sales tax is not paid on purchases that are intended for households. Third, business-to-business taxation allows a lower tax rate and permits the extent of taxation to be hidden from the voter and final consumer. An additional reason that applies less to Hawaii than to most other states is that the tax is levied on purchases by service producing firms as an indirect means of taxing the services that are exempt when sold to the final consumer.

The taxation of intermediate purchases by business is an area where other non-economic, objectives have been allowed to determine the tax structure. The effects can be dramatic. The Hawaiian consumer's share of the GET burden has been estimated to be only 28 percent, dramatically below the national average of 59 percent (see Ring, 1999). But, the non-consumer share includes tourist purchases in addition to business and government purchases. So, Hawaii's taxation of business and government is less out of line than is apparent from the Ring estimate.

Decisions on which business purchases to exempt and which to tax must be based in part on the degree of pyramiding which Hawaii is willing to accept. The rules that have been developed can allow an understandable, tax that can be administered, but inclusion of business purchases means the structure continues to offer the disadvantages of pyramiding. A major goal for providing additional exemptions on business-to-business sales is to ensure that the most egregious distortions in business practices are eliminated. Most states use a component parts rule as one way to limit such distortions. Purchases that become part of the buyer's final product are exempted and other business purchases

are taxed with a component parts rule. An example of its application is that purchase of cloth by an apparel factory would be exempt but purchase of a desk by the same firm would be taxable. In practice, careful decisions must still be made on how to apply this rule and these may vary by state. Most states also allow a sale-for-resale exemption, which means a transaction is exempt if the purchased item is to be resold. But, these are insufficient as the economy becomes more complicated. The Department of Taxation must continue to track business practices to identify new and emerging problems.

Rather than exempt many component parts or sales for resale Hawaii allows these transactions by manufacturers and wholesalers to be taxed at 0.5 percent. Sales by service firms are taxed at the 4.0 percent rate. Purchases of capital equipment are often exempt, as only 7 states and the District of Columbia fully tax them (Due and Mikesell, 1995, p. 64). Hawaii collects the tax on such purchases but then allows a 4.0 percent credit against the income tax.

Some have argued that many services should be exempt from sales taxes because businesses are the primary purchaser. Accounting and legal services are examples. Therefore, their taxation increases the propensity for the sales tax to deviate from a consumption tax. However, the sales tax becomes a levy on the purchase of tangible goods not a tax on consumption if services are omitted from the base. The better solution would be to include services in the base as a general rule and exempt certain business-to-business transactions with a liberal component parts rule, rather than omit services from the base.

As described above, the principal for Hawaii's collection of the tax on sales to governments is as weak as for collection of the tax on sales to business. Administrative and revenue justifications rather than conceptual grounds are the reasons for the inclusion of these transactions in the base. Administrative convenience suggests that government purchases should be taxed under the same guidelines as business purchases. Only eight states including Hawaii, Arizona, and California impose the tax on purchases by state and local governments, though there is considerable variation across the states in the imposition of the tax on governments (Due and Mikesell, 1995, p. 100-101).

Sales to the federal government are constitutionally exempt in states where the tax is on the consumer. States with tax structures like the GET can collect the tax because it

is legally on the vendor. Any state can collect the tax due on sales to federal contractors operating with a fixed price contract. Arizona and South Carolina are the only states to tax all sales to the federal government, though New Mexico and Hawaii tax sales of services to the federal government.

In sum, based on the economic conceptualization of good tax policy, the optimal base for a consumption tax levied on sales would have the following characteristics. First, it would include all sales to households, whether the vendor is a private firm, a public agency, or a not-for-profit firm, and whether produced in Hawaii or imported from another state or country. These sales would be taxed whether they represent the purchase of tangible goods or of services. Second, it would exempt all sales to governments or businesses. Thus, the economist's ideal is for a sales tax that taxes all purchases by individuals and no purchases by business. However, though this cannot be justified based on economic efficiency and horizontal equity, the base often is broadened to include many business and government purchases because of the administrative convenience and the revenue consequences. A rule is necessary to exempt those purchases that most clearly lead to excessive pyramiding. Imposition of a lower rate on manufacturing and wholesaling is used in Hawaii to reduce the extent of pyramiding, but further narrowing of the tax on business-to-business purchases will remain necessary.

EXEMPTIONS FROM THE GET

The GET has been narrowed from a tax on all transactions in the economy (termed a turnover tax) using a series of exemptions and the 0.5 percent rate. This section examines the exemptions that currently exist and whether additional exemptions, particularly of more consumer transactions, would be good tax policy. For this purpose, the transactions taxable at 0.5 percent are treated as if they are exempt from the GET.

Current Exemptions from the GET

Hawaii, like all states, provides exemptions both by type of vendor and by type of transaction. Ten "persons" are exempt from the GET under Section 237-23 of the Code. Examples include public service companies, fraternal benefit societies, hospitals, cooperative associations and nonprofit shippers associations. In addition, the revenues from more than 40 types of transactions are not taxable under Section 237-24 through 29. These include amounts received under life insurance policies, gifts, salaries, and alimony; taxes on liquor and cigarettes; federal excise taxes; amounts received by condominium associations; amounts received from purchases made with food stamps; amounts received by financial institutions from interest, discounts, points and finance charges; and amounts received by management companies from related entities engaged in the sale of common carrier telecommunications services. The Department of Taxation administers these exemptions by developing clear, consistent guidelines and enforcing them very strictly. This requires that any exemptions be clearly spelled out.

Justifications for Tax Base Exemptions

States normally permit exemptions for several reasons. First, business purchases are exempt to avoid pyramiding and to make the sales tax more consistent with the consumption tax structure outlined above. In Hawaii, this is normally achieved with the 0.5 percent rate, but many of the exemptions outlined above are also intended to move

the tax closer to a consumption base. These types of exemptions are consistent with the intended goals of economic efficiency and horizontal equity.

Other exemptions are often allowed by states even though they violate the tenets of a broad consumption tax base that were discussed above. One or more of several justifications is used, and similar justifications have been used when arguments have been made for narrowing the GET base. First, some items are often exempted with the expectation that this will make the sales tax less regressive. Food and clothing are exempted in many states, at least in part in an attempt to reduce perceived vertical inequities. The viability of this justification is examined below. Other exemptions may be granted because of further concerns that their taxation would be unfair. Some types of health care, such as cancer treatments, could be an example. Second, activities that are deemed to be socially desirable, such as charitable activities, are often exempted. The desirability of such exemptions was strongly questioned above. Third, purchases of items that are already taxed with a special excise tax, such as gasoline, are exempt in many states. Of course, the gasoline tax is intended to pay for construction of roads, and an additional tax to reflect the consumption of transportation activities is not inconsistent. Finally, some exemptions are granted because the cost of administering and complying with the tax is prohibitive. Examples are casual sales and imputed consumption (such as imputed rents).

The remainder of this report examines whether the GET base would be improved by expanding the exemptions to achieve some of these goals. The basic conclusion is that the GET rate would need to be increased significantly, the perverse incentives created by the GET tax would be made worse, and any effects on fairness could be better achieved through other means. Therefore, the finding is that the GET base would be made worse by reducing the set of consumer items that is taxable.

IMPLICATIONS OF GRANTING EXEMPTIONS FROM THE GET

This section addresses the implications of narrowing the GET base by exempting certain transactions. This discussion must begin with a definition of the specific set of transactions that are to be exempted from the tax. The tax base can be divided into two types of transactions: those involving business-to business sales and those involving business-to-consumer sales. Of course, there is considerable overlap in the items purchased by the two groups, but the distinction allows a focus on the intent of the base narrowing. Eliminating additional business purchases would move the tax closer to the economist's ideal of a sales tax that operates as a consumption tax, but narrowing the base on business-to-business purchases has not been the focus of concerns about the base in Hawaii. Instead, the focus has been on providing exemptions to make the GET appear more like other state sales taxes by excluding certain consumer purchases. As described above, there is no typical sales tax, with a near continuum of different structures in place. But, in this context, there is a set of potential exemptions that often receives consideration as ways to enhance tax fairness because of an expectation that the exempt items are heavily purchased by low-income households or are otherwise deemed unfair for taxation. Thus, this section addresses the implications of eliminating from the base certain specific items that are purchased mostly by individuals. Six specific categories of exemptions are addressed in this section: construction, health care, utilities,[20] housing, apparel, and food for consumption at home. In addition, a general calculation of the implications of narrowing the GET so that it would represent the same percent of personal income as in the average state is provided.

Exemptions are evaluated in terms of several criteria. First, the revenue implications are examined in terms of the dollars lost and the relative importance of the revenue loss for the overall tax system. An issue is whether the revenue lost by narrowing the base would be replaced by raising the GET rate, raising another tax rate, or reducing the size of government. Accounting for the effects of reducing the size of government is

[20] Utilities are subject to the Public Service Company Tax instead of the GET. Nonetheless, the intent is to levy a GET type tax on utilities, so the tax on utilities is addressed as if it is the GET. The tax on utilities is at 5.885 percent to account for exemption of utility property from the property tax.

beyond the scope of this paper, so this alternative is not considered. Instead, the analysis is placed in the context of replacing the revenue by raising the GET rate.[21] Calculations provided in this section for each type of potential exemption include the revenues that would be lost at the existing GET rate if the exemption was provided, the percent that each represents of GET revenues, the percent that each represents of total tax revenues, and the increase in the GET rate that would be necessary to replace the revenue. Second, the effects on vertical and horizontal equity are discussed in the following section. Third, the effects of additional exemptions on administration and compliance are given. Finally, the economic effects of more exemptions are discussed.

Revenue Implications of Narrowing the Base

Narrowing the GET to the average state tax base would result in a dramatic reduction in tax revenue and would require that a very high tax rate be set to replace the revenue. The average state has a base equal to 42.4 percent of personal income (Table 2), compared with the 108.2 percent in Hawaii (the base taxed at the 4 percent tax rate). Further, most states do not levy a tax comparable to the 0.5 percent levy. Changing the Hawaii structure to eliminate the 0.5 percent portion of the tax and reducing the base to 42.36 percent of personal income would have lowered 2002 GET revenues by $997.97 million dollars, or 60.19 percent of GET revenues (see Table 5).[22] A 10.2 percent tax rate would be necessary on this narrower tax base to raise the same revenues that are generated by the GET.

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[21] The estimates prepared here are generally based on a static rather than a dynamic approach to revenue estimating. Two types of responses to rate changes can be imagined from narrowing the base. First, there are changes in the microeconomic behavior of individuals as they are confronted with higher rates on the items that remain taxable. Second, there are changes in the macroeconomic environment in the Hawaii economy. The latter changes are particularly difficult to address, as evidenced by debate in the U.S. House Rules Legislative and Budget Process Subcommittee (see State Tax Notes, May 12, 2002, pp. 952-960). In fact, Alan Greenspan had reacted to this issue earlier by noting, “the analytical tools required to reach it (full dynamic estimates) are deficient.” (Joint Hearing of the Senate and House Budget Committees, January 10, 1995). In any event, a smaller macro effect should be expected in the context used here because the assumption is that there is no change in the size of government or amount of revenues that are collected, only in the GET rate used to generate the revenue. But, a reasonable expectation is that the economic effect of higher tax rates to raise the same revenue would be negative (see below).

[22] The last line of Table 5 illustrates the effects of narrowing the GET base to tax the same percentage of personal income as in the average state. Revenue collected based on the 0.5 percent rate is excluded in these calculations. The combined effects of these two changes result in the revenue losses reported in the Table.

As noted in footnote 19, a microeconomic response would be expected from consumers if they faced the dramatically higher tax rate that would be necessary with such broad exemptions. Consumers would be expected to reduce their consumption of taxable items and increase their consumption of non-taxable items. The tax rate would need to be 11.0 percent if consumers reduced their consumption of taxable items one percent for each one percent increase in the tax rate (a price elasticity of 1.0). This rate is lower than some previous estimates of the rate needed to replace the revenues from a narrower base, but it is still a shockingly high rate since it would be 60 percent higher than the highest rate imposed by any other state government. The revenue neutral rate is lower than in past estimates in part because the GET structure has been changed, such as occurred through the de-pyramiding legislation of several years ago. Further, the calculation makes no allowance for the additional tax evasion that can be expected at such a high tax rate.

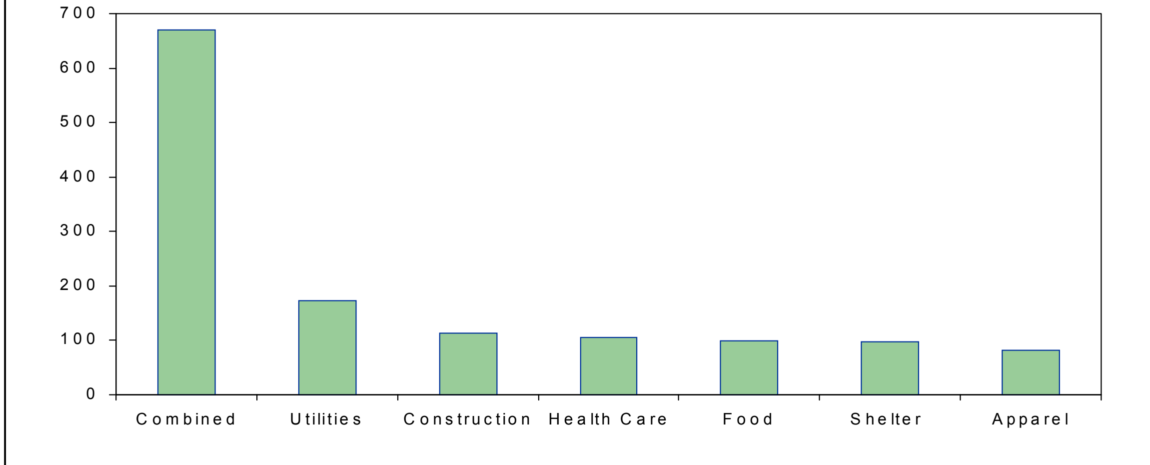
TABLE 5: Revenue Effects of Exemptions, Selected Transactions, 2002

	Revenue Loss (millions)	Total Tax Collections (Percent)	GET Collections (Percent)	Tax Rate Necessary to Replace Revenue Loss
Utilities	$ 172.50	4.63	10.40	4.46
Construction	$ 113.36	3.05	6.84	4.29
Health Care	$ 105.37	2.83	6.35	4.27
Food	$ 99.12	2.66	5.98	4.26
Shelter	$ 97.30	2.61	5.87	4.25
Apparel	$ 81.75	2.20	4.93	4.21
Combination of All Listed Exemptions	$ 669.40	17.97	40.32	6.71
Average State Tax Structure	$ 997.97	26.81	60.19	10.2--11.0

Revenue estimates were prepared for each of the six specific potential exemptions considered in this paper (Table 5). The revenue loss from the exemptions ranges from $172.5 million for utility services[23] to $81.75 million for apparel, as shown in Figure 5. The cost of exempting food is based on food for off-premise consumption, excluding

[23] The revenue loss for utility services is calculated at the 5.885 percent tax rate.

FIGURE 5
GET Loss from Selected Potential Exemptions, FY2002



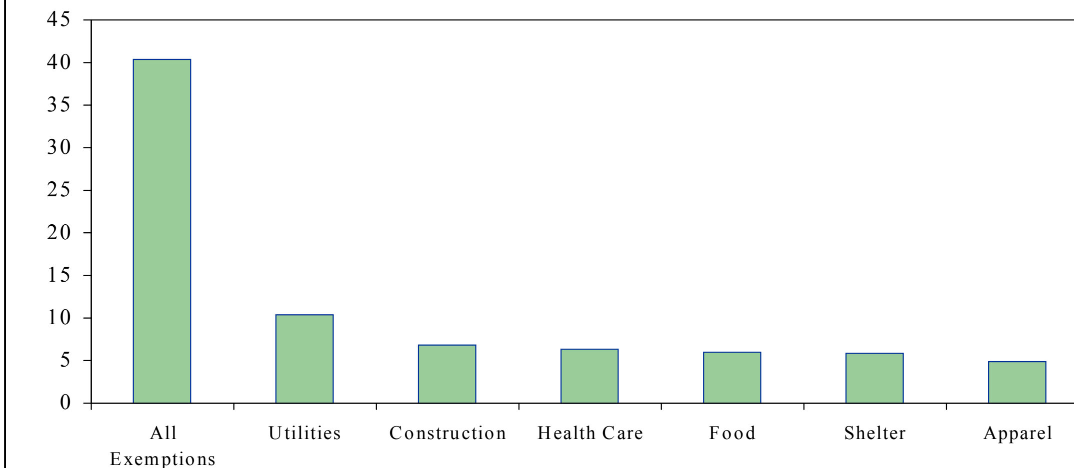
alcoholic beverages. The largest of the exemptions, utility services, amounts to about 10 percent of GET receipts, so no single exemption devastates the base. However, combined these six exemptions would reduce collections by $669.4 million, or more than 40 percent of total GET revenues, as shown in Figure 6. The total revenue loss would represent nearly 18 percent of total tax revenues (see Figure 7).

Again, the tax rate increase that is necessary to replace the revenue is small for each individual exemption (Table 5). For example, the rate would need to be increased by 0.46, yielding a total rate of 4.46, to replace the revenue lost from exempting utility services. Figure 8 illustrates the amount the rate must be increased from the current 4.0 percent, if the exemptions are to be granted in a revenue neutral setting. But, the effect cumulates across the exemptions so the rate would need to be 6.71 percent (2.71 percent higher) if these six exemptions were allowed.

Equity Implications

This section is an analysis of the equity characteristics of the GET and the effects on equity of narrowing the tax base to exclude various expenditures. Nonetheless, evaluation of whether taxes are fair is best placed in the context of the overall tax

FIGURE 6
GET Loss from Selected Exemptions as a Percent of GET Collections, FY2002



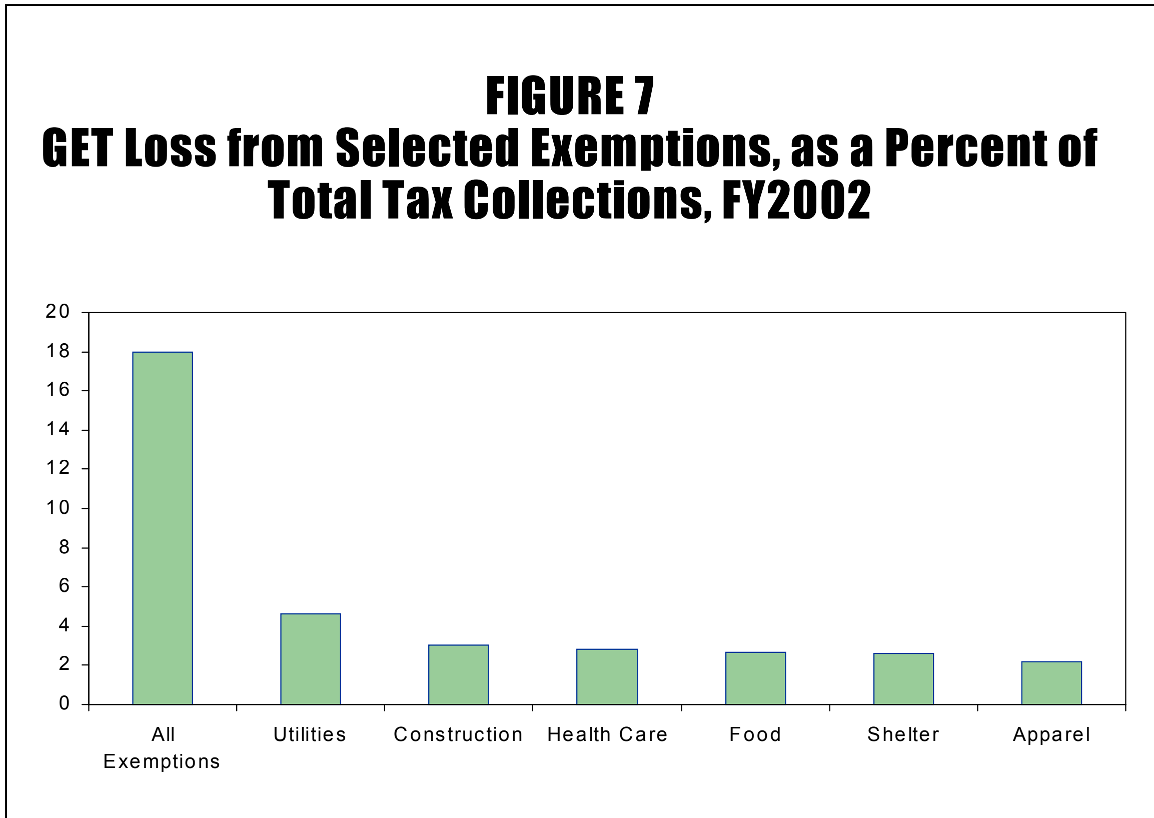
structure rather than in the context of individual taxes. This issue is addressed in more detail below.

Horizontal Equity

The horizontal equity implications of narrowing the base are very straightforward. Ensuring that people with the same income or the same consumption bear the same tax burden requires that the tax base be very broad. The existing GET performs very well in terms of horizontal equity because the base is so broad. The main concern is that the imposition of tax on business-to-business transactions results in pyramiding of the implicit liability, but there is no basis to know specifically how this affects horizontal equity. Allowing the six exemptions described in the previous section would make the GET much less horizontally equitable than the broad tax structure employed today. People who are heavy consumers of housing and clothes, for example would bear a much lower tax burden than people who are heavy consumers of items that would continue to be taxed. Thus, horizontal equity is best maintained by not allowing additional exemptions of business-to-consumer purchases.

Vertical Equity

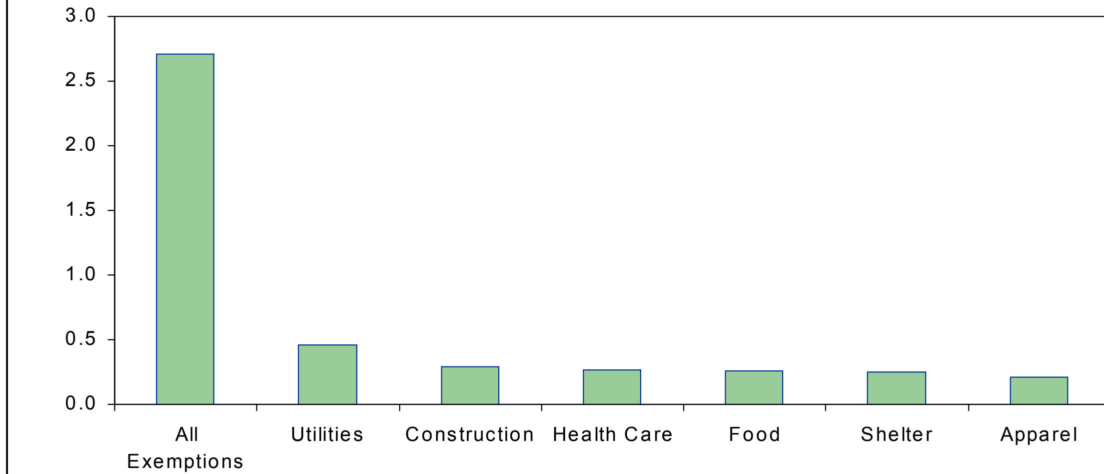
Examination of vertical equity requires determination of the tax burden for households in different income brackets. The distribution of Hawaii tax liabilities was measured using the 1999 Consumer Expenditure Interview Survey for Hawaii, U.S. Department of Labor, Bureau of Labor Statistics. The usable survey consists of 500 Hawaii households that provided detailed data on their purchasing behavior during



1999.[24] The survey respondents were divided into quintiles based on income, allowing analysis of tax burdens in five different income ranges. Each quintile included 100 households though the households were weighted according to their representation of the population. Tax burdens were estimated for each household in the sample based on whether the stated purchases and use of money was taxable under the GET and the tax burdens were calculated as a percent of income.

[24] A total of 560 households, of which 60 were not usable, provided data through the survey. The primary reason for deleting households was that they reported zero or negative income.

FIGURE 8
Tax Rate Increase Necessary to Replace Lost GET Revenue, FY2002



Existing tax burdens as a percent of current income are reported in Table 6 for the average household in each income bracket and are illustrated with the top line in Figure 9. The tax is found to be very regressive relative to current income, with the share of income paid in GET by people earning between $14,400 and $27,400 (calculated at $21,088) being more than three times that of people with incomes about $70,000 (calculated at $128,666). All calculations are presented assuming the tax rate was 4 percent.

TABLE 6: Existing Tax Burden as a Percent of Current Income Before Taxes					
	INCOME LEVEL				
	Less Than $14,400	$14,400 To $27,400	$27,400 To $45,000	$45,000 To $70,000	$70,000 And Over
Food	1.55	1.07	0.61	0.39	0.25
Alcoholic Beverages	0.07	0.05	0.04	0.02	0.01
Housing	1.91	1.03	0.79	0.53	0.34
Utilities, Fuel & Public Service	0.51	0.30	0.22	0.14	0.09
Household Operations	0.06	0.07	0.07	0.06	0.03
Housefurnishings and Equipment	0.26	0.11	0.08	0.06	0.04
Apparel and Services	0.17	0.16	0.12	0.09	0.09
Transportation	0.89	0.42	0.29	0.21	0.17
Healthcare	0.09	0.10	0.07	0.05	0.02
Entertainment	0.30	0.28	0.18	0.15	0.10
Personal Care Products & Services	0.06	0.05	0.03	0.02	0.02
Reading	0.03	0.03	0.02	0.02	0.01
Education	0.19	0.08	0.04	0.04	0.06
Tobacco Products & Smoking	0.15	0.04	0.03	0.01	0.01
Miscellaneous	0.01	0.02	0.02	0.01	0.00
TOTAL	**6.26**	**3.81**	**2.60**	**1.79**	**1.24**

Much of the regressivity arises because households are being measured at different points in their life cycle. For example, young people have relatively low income as a group and have high taxable expenditures because they are borrowing from parents and others to finance their expenditures, are setting up their first house, are having their children and so forth. Evidence of this can be seen in that the lowest two quintiles have expenditures that are much greater than their income. Thus, their tax burdens look high relative to households that have been through these same phases in their life and paid the taxes when they were younger. This balances out to some extent across the course of people's lives, as most go through these same steps. Differences are much smaller when people at the same point in their life cycle, but with different incomes are compared. This means that sales taxes are much less regressive when compared with people's lifetime income. No direct measures of lifetime income are available, but people's expenditures at a point in time are often viewed as a reasonable proxy for their lifetime income. Tax burdens as a percent of household expenditures are much less regressive than as a percent of personal income. Calculation of tax burdens as a percent of household expenditures (see Table 7 and Figure 10) reveals much less regressivity. Indeed, the tax burden line in

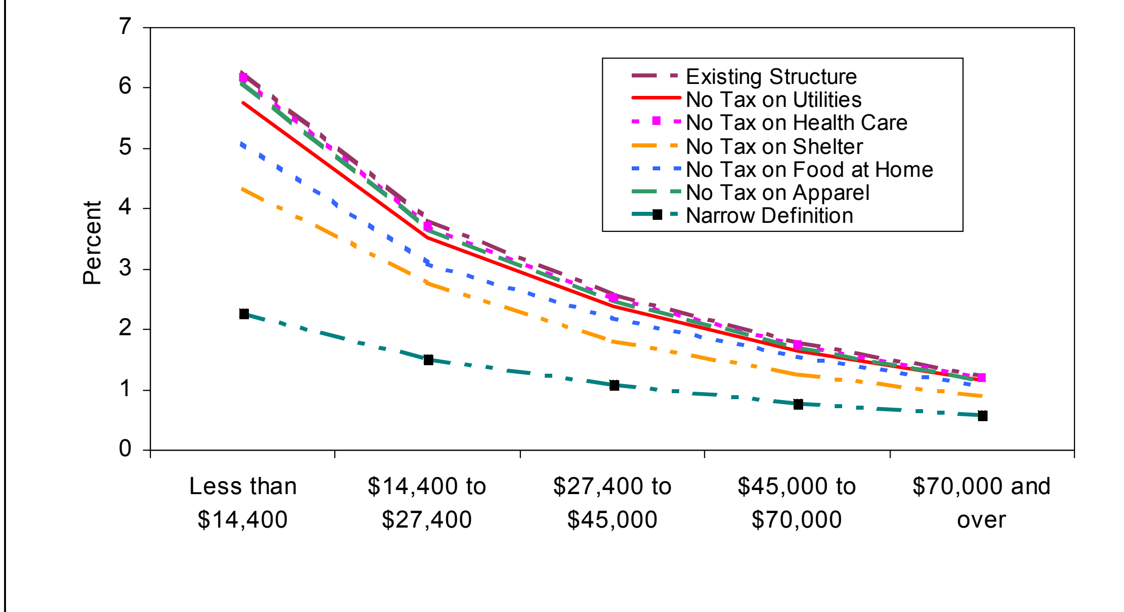
Figure 10 is much flatter when drawn using lifetime income than when using current income. Using lifetime income, the tax is only regressive for the lowest two quintiles and is proportional for the upper three groups.

The potential exemptions listed in Table 5 also have implications for vertical equity. Nonetheless, providing these exemptions as a means to enhance equity can be questioned for a variety of reasons. First, there is no reason to achieve the vertical equity desired in Hawaii by causing each tax to have the degree of progressiveness sought for the entire tax system. The goal should be to achieve the desired vertical equity for the entire system, without focusing on the implications of each tax. In particular, the personal income tax can be structured to offset any undesired effects of the GET, with the base of the GET being unchanged. The personal income tax is a better means of targeting tax relief to the intended groups, and specifically to low income taxpayers. Further, the comparison of tax burdens with lifetime income provided above indicates that the tax is less regressive than has often been thought. In any event, low-income households spend a greater percent of their income on most items, so it is very difficult to identify a set of exemptions that would eliminate the measured regressivity relative to current income.

TABLE 7: Existing Tax Burden as a Percent of Lifetime Income

	INCOME LEVEL				
	Less Than $14,400	**$14,400 To $27,400**	**$27,400 To $45,000**	**$45,000 To $70,000**	**$70,000 And Over**
Food	0.79	0.84	0.56	0.56	0.47
Alcoholic Beverages	0.04	0.04	0.04	0.03	0.03
Housing	0.98	0.80	0.72	0.77	0.63
Utilities, Fuel & Public Service	0.26	0.23	0.20	0.21	0.16
Household Operations	0.03	0.06	0.06	0.08	0.05
Housefurnishings and Equipment	0.13	0.09	0.08	0.09	0.07
Apparel and Services	0.09	0.13	0.11	0.14	0.16
Transportation	0.46	0.33	0.26	0.30	0.33
Healthcare	0.05	0.08	0.06	0.07	0.05
Entertainment	0.15	0.22	0.16	0.22	0.19
Personal Care Products & Services	0.03	0.04	0.03	0.03	0.03
Reading	0.02	0.02	0.02	0.02	0.02
Education	0.10	0.06	0.03	0.06	0.11
Tobacco Products & Smoking	0.07	0.03	0.02	0.01	0.02
Miscellaneous	0.01	0.02	0.02	0.01	0.01
TOTAL	**3.21**	**2.99**	**2.36**	**2.60**	**2.33**

FIGURE 9
Tax Burden as a Percent of Current Income



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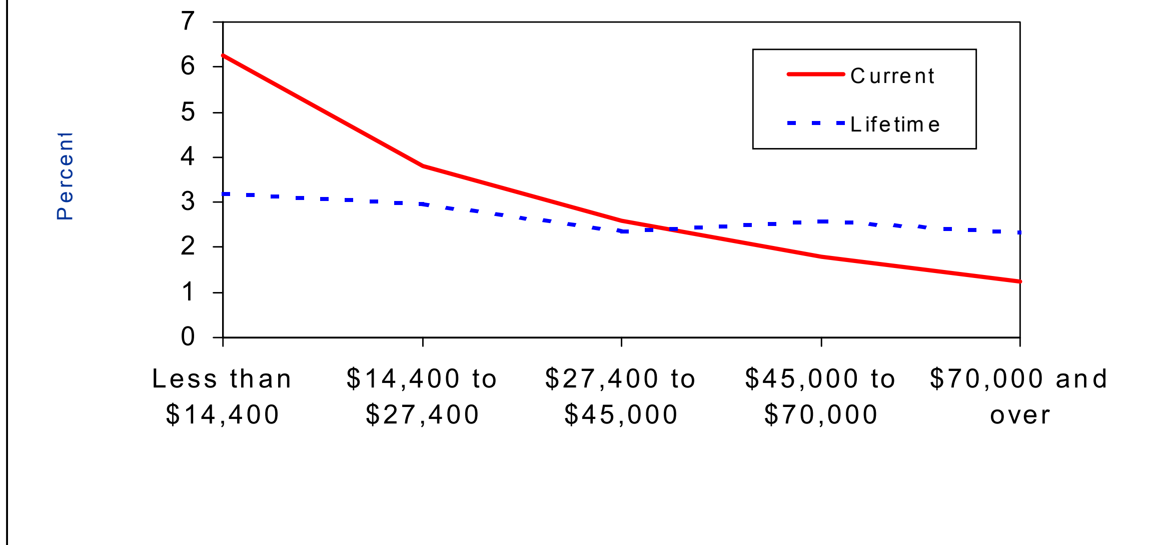
Second, the provision of additional exemptions raises administrative and compliance costs because of the decisions that must be made on what are taxable transactions. Third, a broad GET base allows the tax to be levied on tourists, but other taxes, and specifically the personal income tax, cannot be levied on non-residents except in very specific circumstances. Fourth, horizontal equity and tax efficiency for the GET are reduced as the base is narrowed.

The implications for vertical equity of providing these exemptions were examined, despite the disadvantages of exempting portions of the tax base as a means to help low income households (see Table 8 and Figures 9 and 11).[25] The results are shown for the existing tax base, the existing base less the effects of each exemption, and the narrow base that would result from providing the full range of exemptions. The tax burden is slightly less regressive since the existing relative tax burden of low-income households (6.27/1.24 = 5.1) is higher than with all of the exemptions (2.27/0.58 = 3.9).

[25] Note that in this housing an exemption for construction is not treated separately from an exemption for housimg.



Still, the tax burden remains very regressive against current income. The GET would be approximately proportional against lifetime income if these exemptions were permitted.

All Hawaii resident taxpayers appear to receive a tax reduction as a result of the exemptions. A major reason is that the estimates in Table 8 are prepared at a 4 percent tax rate, which means the estimates are not revenue neutral. The tax burdens at revenue neutral tax rates are estimated and presented in Table 9. Still, the tax burdens with the various exemptions are always lower than the current tax burden, as evidenced by the percentages in lines 2 through 7 of Table 9 being less than the existing burden. This occurs because the set of exemptions is for items purchased more by Hawaii residents and tourists. However, the tax imposed on business is likely to be reflected in higher product prices, meaning the total tax burden, including both the tax levied directly on consumers and the tax coming through higher product prices, is higher than it appears. Thus, little should be read into the burden seeming lower.

TABLE 8: Equity Implications as a Result of Exemptions, 4% Tax Rate					
Sales Tax as a Percent of Current Income					
	Income Level				
	Less Than $14,400	$14,400 To $27,400	$27,400 To $45,000	$45,000 To $70,000	$70,000 And Over
Existing Structure	6.26	3.81	2.60	1.79	1.24
No Tax on Utilities	5.75	3.52	2.38	1.65	1.15
No Tax on Health Care	6.17	3.72	2.53	1.75	1.21
No Tax on Shelter	4.35	2.79	1.81	1.27	0.90
No Tax on Food at Home	5.09	3.10	2.19	1.56	1.07
No Tax on Apparel	6.09	3.66	2.48	1.71	1.15
Narrow Definition	2.27	1.51	1.09	0.77	0.58
Sales Tax as a Percent of Lifetime Income					
	Income Level				
	Less Than $14,400	$14,400 To $27,400	$27,400 To $45,000	$45,000 To $70,000	$70,000 And Over
Existing Structure	3.21	2.99	2.36	2.60	2.33
No Tax on Utilities	2.95	2.76	2.16	2.40	2.16
No Tax on Health Care	3.17	2.91	2.30	2.54	2.28
No Tax on Shelter	2.23	2.19	1.65	1.84	1.70
No Tax on Food at Home	2.61	2.43	1.99	2.26	2.01
No Tax on Apparel	3.12	2.87	2.26	2.48	2.16
Narrow Definition	1.16	1.19	1.00	1.12	1.09

Achieving Equity Through the Income Tax

The personal income tax can be used in conjunction with the GET to achieve the desired degree of vertical equity without the disadvantages of providing exemptions through the GET. The disadvantages of additional exemptions include the administration and compliance costs of determining what is taxable, distortions in what people buy, the tax savings for non-residents, and the inability to target the benefits to low income households (since exemptions are available to anyone buying products rather than only to low income households). The difficulty of targeting assistance to the lowest income taxpayers is evident from the calculations provided in Table 10. The numbers in the table indicate the percentage of total tax savings that would accrue to each income bracket if

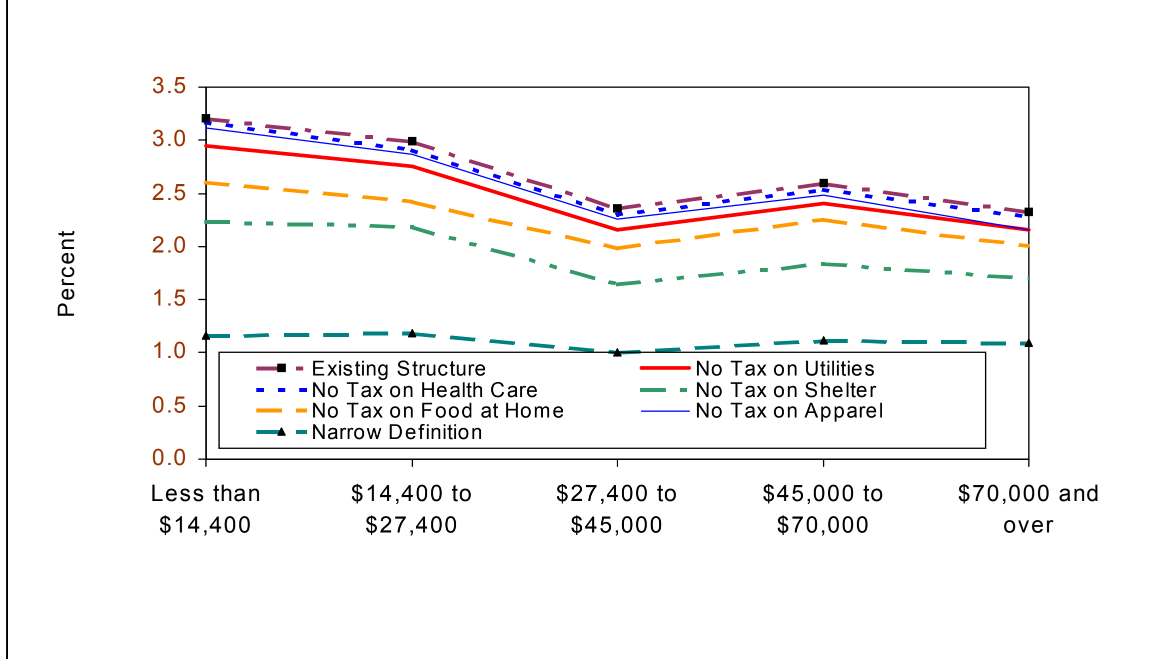
the particular item were exempted from the GET. For example, highest income taxpayers would receive 29.0 percent of the total tax reduction from exempting food for consumption at home, while the lowest income taxpayers would receive only 14.0 percent of the benefits.[26] The major disadvantage of using the income tax to achieve the desired equity is that people must file a return to receive the intended benefits, meaning some households may not receive the tax relief.

TABLE 9: Equity Implications as a Result of Exemptions, Revenue Neutral

Sales Tax as a Percent of Current Income	Income Level				
	Less Than $14,400	$14,400 To $27,400	$27,400 To $45,000	$45,000 To $70,000	$70,000 And Over
Existing Structure	6.26	3.81	2.60	1.79	1.24
No Tax on Utilities	6.41	3.92	2.65	1.84	1.29
No Tax on Health Care	6.59	3.97	2.70	1.87	1.30
No Tax on Shelter	4.63	2.97	1.93	1.35	0.96
No Tax on Food at Home	5.34	3.26	2.30	1.64	1.12
No Tax on Apparel	6.41	3.85	2.61	1.80	1.21
Narrow Definition	3.73	2.48	1.80	1.27	0.95

Sales Tax as a Percent of Lifetime Income	Income Level				
	Less Than $14,400	$14,400 To $27,400	$27,400 To $45,000	$45,000 To $70,000	$70,000 And Over
Existing Structure	3.21	2.99	2.36	2.60	2.33
No Tax on Utilities	3.29	3.08	2.41	2.68	2.41
No Tax on Health Care	3.38	3.11	2.46	2.71	2.43
No Tax on Shelter	2.37	2.33	1.75	1.96	1.80
No Tax on Food at Home	2.74	2.55	2.09	2.37	2.11
No Tax on Apparel	3.29	3.02	2.38	2.61	2.28
Narrow Definition	1.91	1.95	1.64	1.85	1.78

[26] The data in Table 10 are not adjusted for the tax-exempt status of food stamp purchases. Therefore, the share of tax savings to low-income households is over-stated. Once food stamps are taken into account, the lowest two income brackets combined would receive about 21.4 percent of the tax savings if food were exempt.



There are two basic means of reducing low-income tax burdens through the personal income tax: 1) making rates more steeply progressive so lower income people pay relatively less income tax than higher income people and 2) granting refundable tax credits to low-income households. Hawaii does both. Personal income tax rates are steeply progressive, with rates for single taxpayers that rise from 1.4 percent for taxable incomes up to $2,000 to 8.4 percent for incomes above $40,000. Hawaii also provides a low-income refundable tax credit (up to $35 per qualified exemption) and a low-income household renters credit ($50 per qualified exemption). The progressive rates and refundable tax credits allow reductions in tax burdens to be aimed directly to the intended low-income households, providing greater tax relief at lower cost in foregone tax revenues. Any desire to provide further reduction in the tax burden for low-income households could be most efficiently achieved by raising the amounts of the existing credits rather than by developing new credits or using GET exemptions. The total revenue cost would be approximately $19.9 million in 2002 if a credit equal to the GET

on food at home, medical care and housing were granted to the lowest quintile of taxpayers.

TABLE 10: Percent of Savings of Each Exemption by Income Category					
	Income Level				
	Less Than $14,400	$14,400 To $27,400	$27,400 To $45,000	$45,000 To $70,000	$70,000 And Over
No Tax on Utilities	12.10	16.37	20.40	21.70	29.43
No Tax on Health Care	7.24	18.99	21.17	24.00	28.59
No Tax on Shelter	5.77	6.62	19.60	19.41	48.60
No Tax on Food at Home	13.98	19.80	19.07	18.19	28.95
No Tax on Apparel	6.08	13.10	16.22	20.77	43.83
Income Received in Each Bracket	3.58	8.35	14.00	22.62	51.44

Income Tax Credits for Business Taxpayers

Hawaii has recently extended a series of tax credits to business and passed several new ones that were vetoed by Governor Cayetano in June. Examples include the capital goods tax credit, the hotel construction and remodeling tax credit, and the residential construction and renovation credit. Each was initially given with a 4 percent credit on qualifying expenditures, suggesting the intent was to refund the GET paid by the vendor to the buyer. Thus, the effective GET base is smaller than it would appear based on GET revenues.

The logic supporting the use of tax credits as an appropriate means for providing tax relief to low-income households cannot be extended to provision of credits to business. Good sales tax policy indicates that narrower taxation of business-to-business transactions would be appropriate. However, the use of a series of tax credits is not the best means to achieve this objective. Exemption normally occurs through defining the taxable sale so that certain business-to-business transactions are exempt; exempting certain types of transactions or exempting selected uses of certain purchases. The administration and compliance costs for reducing taxation of business-to-business burdens through credits are very high because the credits must be given to each buyer

(rather than operating through the seller), potentially meaning a large number of returns with credits and the need for the Department of Taxation to identify whether the taxpayers qualify for the narrowly construed credits. Second, only taxpayers with sufficient income tax liability receive the full benefits of the credits, unless the credits are refundable, meaning the credits do not result in an even refund of the GET across all potential beneficiaries. New firms and less profitable firms receive less of a tax reduction than older, more profitable firms.

Third, and most important, is that the granting of credits is a fiscally dangerous direction to head. The selection of which credits to grant requires the Legislature to pick a series of winning transactions for which the GET will be refunded. The public sector does not have the information necessary to choose which industries to favor based on their long-term ability to enhance the Hawaiian economy and so it has no basis for selecting which credits to offer. The likely outcome is that the areas for credits will be granted using political rather than economic criteria and the tax base will be significantly eroded in very inefficient ways. Further, there will be strong political pressures to increase the credits over time.[27] One example is the November 2001 movement of the hotel construction and remodeling credit from 4 to 10 percent. This credit does not require that the materials be purchased in Hawaii or that a statement is made that the use tax has been paid. As a result, this credit and similar credits could significantly reduce Hawaii revenues. The bottom line is that any appropriate exemption of business-to-business transactions is better undertaken through exemptions available to all firms and operating directly through the GET.

Administration and Compliance Effects

Exemptions for food, clothing, and other consumer commodities raise the cost of administering and complying with the sales tax. The exemptions are for specific commodities rather than for types of vendors, which means that little or no reduction in the number of taxpayers should be anticipated. For example, grocery stores would remain GET taxpayers because many of their commodities (toilet paper, soap, and so forth)

[27] See Fox and Mayes (1994) for a discussion of some reasons why corporate tax credits and concessions are likely to become excessive.

would still be taxable. Thus, the main effects are to require that definitions be developed for the commodities to be exempted, to require taxpayers to apply these definitions, and to require the Department of Taxation to audit the decisions. Taxpayers in other states are able to comply with sales taxes that allow broad exemptions for many goods and services and the departments of taxation administer the taxes. But, new exemptions in Hawaii will require significant costs as the taxpayers and tax administration learn the new rules and litigate disagreements.

Much of the administrative concerns arise from the higher GET rate necessary to replace the revenues lost from a narrower tax base. The higher tax rate necessary to replace the revenue can be expected to increase the incentives to avoid and evade taxes. Each dollar that businesses underreport taxable sales reduces taxes by $0.04 today, but would reduce taxes by $0.0652 with the higher tax rate associated with the narrow tax base described in Table 5 above. The greater tax savings increases the likelihood of evasion. Further, the larger number of exemptions opens new opportunities to evade taxes. Today, underreporting sales is the major means of avoidance. With a narrower tax base, firms would also be able to claim the sales took place but of exempt rather than taxable goods. The expected outcome is lower collections unless the Department of Taxation expends more resources auditing taxpayers.

Use tax compliance presents the largest reporting problem for sales taxes, and the problem will be exaggerated by a higher GET rate. Consumers will also have a greater incentive to purchase via mail order or the Internet. Goolsbee (2000) found that consumers increase their propensity to shop online if they live in states with higher sales tax rates. The result will be a greater loss in revenues due to the inability to collect use taxes on remote transactions across the U.S. About 90 percent of Internet activity involves business-to-business transactions (se Bruce and Fox, 2001) and these will also be encouraged by higher tax rates. Use tax compliance is better for business purchases,[28]

[28] Very little analysis of use tax compliance for business-to-business purchases is available. The State of Washington undertook a study of use tax compliance of registered taxpayers for 1991 and found 19.9 percent non-compliance for the use tax, the highest non-compliance of any tax. The Washington study can be expected to understate non-compliance for remote sales. Some of the reasons include: many firms, and particularly out of state firms, may not register for tax purposes; use tax compliance in the study is a combination of compliance on remote purchases (which is probably not as good) and compliance for items purchased with a resale certificate but which are ultimately taxable; audit rates are generally very low, and normally well below 3 percent (see Due and Mikesell, 1995); and the inability to uncover non-compliance

but research indicates there is also a significant evasion problem on business purchases. Little can be done to enhance use tax compliance by individuals, but some additional audits can increase use tax compliance of businesses.

Further, avoidance can be expected to rise with tax rates. Businesses and individuals could lower their tax liabilities by producing activities, that otherwise would be outsourced, at home or in the business. For example, households and businesses may choose to prepare their own income tax returns rather than hire an accountant. These avoidance activities reduce tax revenue, but do not require any additional administrative efforts.

Economic Effects of a Normal State Tax Base

In general terms, the GET differs from other states' sales taxes in that the rate is lower and the base is broader, both because the GET taxes more consumer and more business purchases. Obviously, movement of Hawaii's tax to look like other states would require a higher rate combined with a narrower base. This section is a consideration of the effects of a higher rate, narrower base structure on the performance of the Hawaii economy. The discussion will be decomposed into the effects of the higher tax rate and the effects of the narrower base, though they are interdependent. This section also includes a discussion of effects of exemptions on prices faced by consumers.

Narrower Base

The economic effects of more exemptions depend heavily on what is exempted. Broad exemption of business-to-business transactions and continued taxation of consumer purchases should cause the economy to operate more efficiently. This is consistent with a basic conclusion of optimal tax theory, which is that production taxes create large inefficiencies in the economy. Elimination of the GET on business purchases will allow decisions on what to produce and how to produce it to be made in ways that

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through audit. Further, non-compliance may grow with e-commerce. Tennessee offers a good example of use tax behavior. Use tax collections were 4.4 percent of 1998 sales and use tax collections, but use tax collections on remote sales were less than 2.3 percent of revenues. Based on Ring's (1999) estimates of the consumer share for the sales and use tax, only about 6.1 percent of taxes paid by business come from use tax paid on remote sales. This suggests either firms buy very few inputs from outside the state or compliance is relatively low.

use the least resources. It also will reduce the cost of producing in Hawaii, making Hawaiian businesses more competitive for export and for sales to the mainland. Further, uneven pyramiding will be eliminated, meaning that the effective tax rate will be neutral on all consumer transactions.

However, the economy is likely to be harmed if the base is narrowed by exempting a potpourri of items because they are politically attractive or intended to enhance fairness. The narrower base creates distortions in purchasing behavior for both individuals and businesses. The effect is to encourage the purchase of untaxed items at the expense of taxed items. Thus, the purchase of food for consumption at home, clothing, utilities, and so forth should go up and the purchase of items that are still taxable should go down. Effectively, this makes the tax structure a more important component of what is purchased than occurs today, when the majority of transactions are taxed at a relatively low rate. As a result, highly taxed sectors will grow more slowly and lightly taxed sectors more rapidly. For example, Merriman and Skidmore (2000) estimate that as much as one-third of the relative decline in the retail sector can be attributed to imposition of the sales tax on this sector and as much as one-eighth of the relative growth in the service sector is attributable to failure to tax this sector. Thus, the granting of exemptions can influence which sectors grow fastest. But, the net effect of more exemptions is likely to be less vigorous economic growth overall because the government will play a bigger rather than a smaller role in decisions.

Higher Rates

Economic theory leads to the conclusion that the economic distortions caused by taxation grow very rapidly (at the square) with the tax rate. This means that everything else equal, low tax rates are much preferred to high tax rates. Thus, the distortions caused by taxing some items and not others will be even greater because of the resulting need for higher tax rates. Incentives to evade taxes, avoid taxes, buy untaxed items, purchase online, and so forth, are all greater with higher tax rates. The effects would be particularly pronounced if the Hawaii structure were changed to look like the current state's average base, and therefore required a rate of at least 10.2 percent.

The relative tax burdens will shift depending on what is exempted. For example, if the exemptions given to achieve the narrow structure in Table 9 were given along with imposition of a revenue neutral tax rate of 6.52 percent, a small relative shift would take place away from low-income taxpayers and to high-income taxpayers. Also, the apparent tax burden would rise on businesses and tourists. Businesses will seek to shift the burden to individuals, but this will occur in uneven ways across commodities. The result will be somewhat higher prices in the Hawaii economy.

THE STREAMLINED SALES TAX PROJECT AND HAWAII[29]

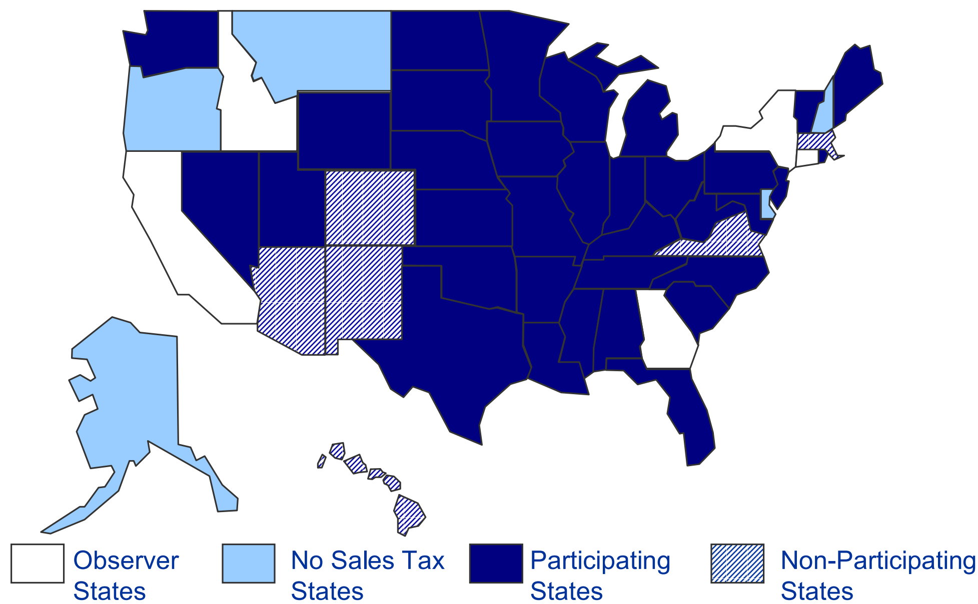
History of Sales Tax Simplification Efforts

The growth in remote commerce (e.g., Internet, mail order) and the difficulties that states have in achieving effective compliance through the use tax has led to a series of efforts over the past five years to reach agreement between business and government on how improved collection might be achieved. The National Tax Association Project, begun in 1997, was the first effort. The Project brought 39 people together, 16 from government, 16 from business, and 7 others, to examine the major issues of electronic commerce and sales taxation, and to seek agreement. The National Tax Association Project was successful in identifying an important set of issues and beginning the discussions but failed to achieve broad agreement between the two major interest groups (see Houghton and Cornia, 2000).

The Advisory Commission on Electronic Commerce (ACEC) was created by Congress in 1999 as the next attempt to achieve consensus between business and government. The Commission was composed of 19 members representing business; federal, state and local governments; and taxpayer groups. After months of debate, the ACEC was unable to arrive at a consensus recommendation (which required an agreement of 2/3 of the commission), although a majority proposal was forwarded to Congress. The proposal would have substantially limited the ability of states to tax any form of electronic commerce and was regarded as a self-serving proposal developed by a narrow set of business interests. For example, the ACEC majority report proposed codifying that online subsidiaries of bricks and mortar stores (such as Barnes & Noble) could avoid sales tax collection responsibilities through creation of a separate corporation.

The Streamlined Sales Tax Project (SSTP) arose in 2000, at least in part from the simplification proposals of the minority report of the ACEC and from suggestions made by the National Governors Association (NGA). Participants include representatives from 39 states, of which 34 are Implementing States with voting rights and five are observing

[29] This section was authored by LeAnn Luna, Assistant Professor of Accounting, University of North Carolina, Wilmington.



states that participate in the discussions but cannot vote (see Figure 12). The SSTP is an attempt to simplify and modernize the design, collection, and administration of sales taxes. The SSTP goals include developing uniform definitions of the tax base, simplifying audit and administration procedures, and developing technologies that make it possible for remote and local vendors to efficiently comply with the sales tax in the 45 states assessing the tax. The ultimate ambition, at least in the minds of some, is the design of a system simple enough that remote vendors can comply with sales tax laws without significant compliance burdens. The hope then, is that Congress would pass legislation requiring an economic as opposed to a physical presence nexus standard for the sales tax. Alternatively, the Supreme Court could rule that sales tax compliance no longer places undue burdens on interstate commerce and could effectively establish a new nexus standard that requires many more remote vendors to collect use taxes.

Purpose of the SSTP

Multi-state vendors argue that they bear undue compliance burdens because the sales tax structures, including rates, bases, administrative policies, and so forth, vary tremendously across the U.S. Tax rates, of course, vary both from state to state, and across localities in the twenty-nine states that allow local governments to independently set tax rates. However, equally troubling for remote vendors are the many differences in the tax base from one jurisdiction to another, as well as different filing deadlines, forms, audit procedures etc. The SSTP is an effort to address and harmonize the entire sales tax system. Unfortunately, this discussion of the importance of the SSTP for Hawaii must be in general, inconclusive terms because states are still meeting and the SSTP process is still underway. The remainder of this section addresses some of the general issues being considered by the SSTP, and the next section considers the implications for Hawaii.

Tax Rate Issues

Several of the general issues can be used to illustrate the types of discussions that have been underway. Sales tax rate differences across states do not create significant problems per se, but differential rates on different types of commodities are much more difficult for a remote vendor operating in multiple states to handle. For example, in South Carolina, non-food purchases by individuals aged 65 or older are subject to a 4 percent rate versus the 5 percent rate applicable to purchases by those under 65. Further, several states tax food at a lower non-zero rate than that applied to other purchases, and to make the situation more complicated, the definition of food varies significantly from one jurisdiction to another. With the current system, a remote vendor must know the general rate of up to 7,500 state and local governments and must be able to deal with the many exceptions, exclusions, or special rates applicable for that area. As a solution, at this point the SSTP would require that participating states have one rate and that each of their local governments have no more than one rate.[30] In other words, food must be completely exempted or taxed at the general sales tax rate, and in South Carolina, seniors must be taxed at the same rate as all other citizens. In addition, the practice of subjecting

[30] As of this writing, the SSTP allows a second rate that would apply to purchases of food, drugs, and various forms of energy such as natural gas, oil, and electricity.

an item to tax only at the state or local level, but not both, would end under current proposals.[31]

Tax Base Issues

The intent is to create uniformity across states in the way in which the general tax base is structured, but not in the tax base itself. Tax base issues include consideration of concerns such as caps on taxable transactions and definitions of taxable and exempt items. Many states are concerned about tax base limitations, both because of the desire of some to target certain items for preferential treatment and because of the detailed definitions that must exist to clearly categorize the millions of products potentially subject to tax. Caps and thresholds create significant problems for multi-state vendors. For example, in Louisiana the first $50,000 of commercial farm equipment is exempt from the state sales tax. In Connecticut, clothing and footwear priced below $75 is exempt, and in Ohio all items priced below 16 cents are exempt. Other states limit the tax on certain large purchases, exempt classes of goods, such as manufacturing or farming equipment, or offer specific tax exemptions for particular industries. Caps and thresholds would not be allowed under the SSTP.

The SSTP would include the definitions of several broad categories of goods (such as food and non-prescription drugs) that would be used if the category is declared exempt from the tax by a state. The problems in defining food are illustrative. In many states, soft drinks are considered food and therefore are exempt from sales and use tax. However, in Texas, soft drinks are explicitly taxed, and the state derives approximately $200 million in sales taxes on soft drinks. The Texas tax base would be reduced substantially unless soft drinks are included in the broad category of food. What constitutes candy is similarly complicated. Retailers want a bright line definition, and one such bright line could involve flour. If items, such as Reese's Sticks, contain flour, they are food; if other similar items, such as the Reese's Peanut Butter Cup, contain no flour, they are candy. At this point, the SSTP has not chosen to define a single category of food, but instead to have several subcategories, such as candy or soft drinks, in addition to the general definition of food. States can then choose whether or not to tax

[31] For example, food in North Carolina is exempt from the state sales tax but subject to the local sales tax.

each of these groups. But the net result would be that food and various subcategories would be defined uniformly from state to state, and each state could choose what to include in its tax base.

Administrative Issues

The SSTP's harmonized approach to sales and use taxes also affects administrative practices as states agree to audit and compliance standards set by the SSTP members. For example, vendors using approved methods of collecting sales and use taxes will at most be subject to a limited audit. Vendors also cannot be held liable for under-collection of tax if they make reasonable efforts to determine the proper location and rate, nor are they responsible for improper granting of exemptions if purchasers supply the information required by the SSTP.

Implications for Hawaii

Hawaii is one of only a few sales taxing states that is not represented on the SSTP project, either as a voting member or an observer (see Figure 12). Even though a substantial portion of the SSTP model legislation has been approved, much work has yet to be completed, and Hawaii still has the opportunity to influence the outcome of final conclusions reached through the SSTP. In addition, by participating, policymakers and administrators would have the opportunity to think about Hawaii's current tax structure in greater detail and to consider whether changes in the structure are appropriate in this continuously changing economy, even if Hawaii never participates in the final outcome.

Hawaii should see the decision to participate in the SSTP as having two components: whether to join the implementing states that are trying to reach agreement on the SSTP provisions (which probably requires legislation) and whether to legislate the final SSTP agreement. Participation in the implementing states would allow Hawaii, the state with the broadest tax base, to participate in the development of the SSTP. Hawaii should join the SSTP implementing states based on the expectation that the benefits of streamlining the GET could justify the costs of adopting the new guidelines, even if there are no gains from greater use tax collections from remote vendors. Fortunately many of the benefits remain even without major action towards a nationwide responsibility to

collect use taxes. For example, the state and Hawaii businesses will still benefit from any efficiency gains of streamlining the system, such as new technologies, forms, and so forth.

Should the SSTP reach a set of agreements, Hawaii would then need to decide whether to legislate the SSTP guidelines. Legislative adoption of the guidelines would almost surely be a prerequisite for benefiting from greater use tax collections if Congress or the Supreme Court allowed for a broader nexus standard. This decision of whether to legislate the SSTP agreement can be reached later. Indeed, given the uncertainty regarding the final form of the SSTP and therefore the implications for Hawaii should it choose to legislatively adopt any final agreement, this decision should await a clear understanding of the SSTP details. But, if Congress acts, the SSTP guidelines probably must be adopted if Hawaii is to benefit from additional use tax collections.

From the State's perspective, participation in development of the SSTP, and even adoption of the proposals, appear to present little downside risk with the opportunity to significantly improve the entire sales tax process. The ultimate advantages accruing to Hawaii will depend on whether or not Congress or the courts require sales tax collection by remote vendors. If either body does so, the advantages of adopting the SSTP potentially include the following:

(1) Enhanced capacity for remote vendors to collect use taxes that are due on purchases by Hawaii residents and businesses, and the corresponding increase in sales tax collections.
(2) Decreased administrative and compliance costs (as a share of revenues collected) by both the Department of Taxation and resident businesses.
(3) Increased compliance by out of state vendors.
(4) Indirect economic efficiency gains by leveling the playing field of local and remote vendors.

The most tangible long-term benefit of the SSTP is the prospect of collecting more use taxes on remote purchases. Nonetheless, in the short term, Hawaii should not experience a large boost in revenues following any SSTP agreement, even if the agreement were adopted. Few remote vendors can be expected to voluntarily collect revenues, so action by Congress or the Supreme Court is essential to collection of

additional revenues. However, the revenue losses from remote transactions are likely to become very large for Hawaii and it is imperative that Hawaii finds a means to enhance compliance.

The SSTP, if successful, would allow each state, including Hawaii, to implement a set of new administrative techniques that allow the existing sales tax to be administered more efficiently. The efficiency of electronic reporting and payment will benefit both the state and its businesses by making it easier for all firms to accurately calculate tax liabilities. Hawaii firms selling remotely could be required to collect use taxes for residents of other states, but will benefit from simplified procedures for doing so.[32] The state also could experience efficiency gains in its audit and collection functions and use of technologies relating to both foreign and domestic taxpayers.

Even without Congressional or Supreme Court action, the SSTP provisions could immediately affect Hawaii businesses selling goods that are already subject to sales tax in other states that adopt the SSTP provisions. Specifically, multi-state vendors sited in Hawaii will benefit from the simplification provisions proposed by the SSTP. For example, the sales tax assessment task (determining taxability and the rate to be assigned) should be significantly streamlined through the SSTP proposals. Also, registering and filing tax returns, as well as dealing with audits from the various states, will be simplified (most will be accomplished electronically) for both foreign and domestic firms.

In a more general economic sense, subjecting all similar sales to similar taxation produces efficiency gains across the U.S. Remote firms and bricks and mortar firms in Hawaii can be required to compete on a level playing field where the tax is levied equally. This would allow consumers to decide what to purchase based on the characteristics of the goods and services, not the tax burden. This means that Hawaii's bricks-and-mortar retailers will benefit through elimination of the sales-tax-free advantage of their remote competitors. Also, firms will be free to make operational decisions without carefully considering how to avoid nexus in states where they do not currently have physical presence.

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[32] The requirement that Hawaii based firms comply with use taxes in other states will probably depend on any actions by Congress or the Supreme Court, and not on Hawaii adopting any agreement reached through the SSTP.

The loss of autonomy in structuring the GET is a cost of legislating the agreement. For example, one problem could be the existence of multiple tax rates with the GET, since the provisions could allow only one tax rate. Hawaii could be forced to eliminate the 0.5 percent rate. Alternatively, Hawaii may be able to redefine the 0.5 percent tax structure as a special business tax. Final definitions of the base may raise other issues. The broad base used by the GET suggests that the definitions may have little current concern for Hawaii, but they could influence any future changes that Hawaii wanted to make. Debate also continues on governance of the compliance with the SSTP provisions. Initially, state representatives will determine whether or not each state's legislation is in compliance with SSTP guidelines, though at this point it is not clear what will constitute compliance or what elements of a sales tax system would preclude certification. The final make-up of the SSTP governing body is also still unknown. Some California legislators, for example, are concerned that the state collects almost 25 percent of all sales taxes but would not be proportionally represented on any final governing board. Finally, although the SSTP has determined that states will pay for the design of compatible software and will reimburse vendors for their administrative costs incurred in the collection of the tax, the funding mechanism has not yet been determined.

Many uncertainties regarding the SSTP still exist. As mentioned previously, it is not known to what extent sales tax reform must progress for Congress or the courts to require remote vendors to collect use taxes, or how long the process will take. Even if the process is streamlined so that compliance is not a burden to remote sellers, they have little incentive to voluntarily collect use tax and increase the after-tax cost of their products or services. Given that both remote sellers and their customers are likely to oppose extending the sales tax to remote sales, pressure will remain on politicians across the spectrum to maintain the status quo and Congress could be slow to act. Of course, there are countervailing political forces, including state and local governments and the National Retailers Federation.

SUMMARY AND POLICY OPTIONS

The GET is best interpreted as two taxes, a sales tax, levied at 4.0 percent, and a privilege tax mostly on non-retail tangible goods transactions, levied at 0.5 percent. The sales tax portion is normally evaluated as a consumption tax. An appropriately structured consumption tax is best levied on all purchases by individuals, regardless of the vendor. The GET does well on this standard by comparison with other state sales taxes since Hawaii imposes the broadest sales tax of any state. However, like other states, the tax suffers from the inability to collect the use tax on many out-of-state purchases. Also, a consumption tax would not be levied on business-to-business transactions. However, as with all state sales taxes, the GET allows for significant taxation of business-to-business transactions. The result is pyramiding of the tax, horizontal inequities, and incentives for businesses to vertically integrate. Reducing the taxation of business is the only way to limit these consequences, but administrative difficulties and other problems preclude elimination of the full extent of business taxation.

The GET offers many attributes that are the envy of other states: it generates significant revenue at low rates, it has not been subject to the slow base erosion through legislated exemptions to the extent that has occurred in other states, it taxes consumer purchases widely, it imposes much of the burden on non-residents, it provides for good revenue growth and so forth. As a result, the basic character of the tax should be maintained. The State should guard very carefully against permitting gradual erosion of the sales tax portion of the structure through legislated exemptions. Reductions in tax revenues, should they be sought, should be achieved through a lower tax rate and not through narrowing of the base.

Several options for consideration by the Tax Commission follow from the Report including:

1. The tax base on consumer transactions should be kept broad. Exemption of clothes, food, housing and other transactions is a poor mechanism for reducing any concerns about regressiveness of the GET. The benefits of exemptions are poorly targeted to low-income households and the exemptions create substantial administrative, compliance, and economic costs. Low-income tax credits provided

against the personal income tax are a more effective means of achieving the desired degree of vertical equity in the overall tax system.

2. Credits granted against other taxes, such as the corporate income tax, in an attempt to reduce the GET burden should be used very sparingly, if at all, as a means of reducing the tax burdens arising from the GET. Such credits are likely to be motivated more by their political than their economic attractiveness and are likely to harm rather than help performance of the Hawaii economy. They are also likely to create significant administrative difficulties and uneven tax burdens across firms. Further, the magnitude of several recently enacted credits is very troubling. The credits for high tech investment and for ethanol production facilities, both of which are worth at least 100 percent of the initial expenditure, are very large on the standard of what is normally granted by states. Such credits create perverse incentives for business, cause uneven tax burdens across firms, potentially distort sound economic development and significantly hamper Hawaii's ability to generate tax revenues.
3. GET statutes contain a growing number of exemptions for various social policy purposes and it is important that such exemptions be provided within a carefully considered framework. Two basic rules should govern any exemptions regarding not-for-profit entities. First, sales by not-for-profit firms should be taxable as a general principle, since the intent is to impose the tax on the buyer not the seller. The vendor should not determine the tax status of the transaction. In Hawaii, an exemption is allowed for activities that are in the public interest and are not intended to further the not-for-profit organization.[33] The exemption is not allowed for "any activity the primary purpose of which is to produce income even though the income is to be used for or in furtherance of the exempt activities of such persons." (HRS 237-23(b). This statute is difficult to enforce and is part of the reason for poor GET compliance by not-for-profits. If any exemption is to remain, consideration could be given to allowing exemptions only in cases where a certain specified minimum (but relatively high) level of the not-for-profit's overall

[33] Nearly every sales taxing state exempts sales by certain not-for-profits, but normally not on the basis of such a difficult to administer rule.

activity is in the public interest. All activities of the qualifying not-for-profits could conceivably be exempt if the standard for public purpose is set sufficiently high. Second, the taxation of purchases by not-for-profit firms should normally follow the taxation of other business-to-business transactions. Purchases by not-for-profits should be taxable when other business-to-business transactions are taxable.

4. As a general principle, business-to-business transactions do not belong in a consumption tax base, but as a practical matter it is not possible to exempt all such purchases.[34] The best approach for Hawaii is to be very careful to limit additional exemptions on business-to business transactions to those cases in which taxation creates the most egregious problems. Sales of services between businesses is an area where problems have traditionally arisen, though the de-pyramiding aspects of legislation passed several years ago should limit the issue by defining many of these as wholesale transactions (HRS 237-4). The 0.5 percent tax is imposed when manufactured and wholesaled goods are sold and also when many services are sold from one business for resale to others. Thus, a 0.5 percent tax is levied when one CPA firm contracts with another or one law firm contracts with another to deliver services for a single client. The low rate tax should have little effect on efficient business practices that could otherwise be significantly distorted by imposition of the 4 percent rate. It is appropriate for the Department of Taxation to track business practices continuously to identify cases where business operations are particularly distorted by imposition of the GET. These transactions can then be exempted or taxed at the 0.5 percent rate. There must be a recognition that the economy is changing constantly and the tax statutes must adapt with the economy. The granting of any other exemptions must be carefully

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[34] No state exempts all business-to-business purchases. In fact, legislators appear to support some taxation of business purchases because of the additional revenue that is generated and because the tax burden is frequently hidden from voters. In any event, in practice it is very difficult to provide complete exemption. One important reason is that a strong incentive to create fictional businesses would exist if all business purchases were exempt. The concept of a business could be defined, but it would be wide open to fraud and abuse. Second, vendors must distinguish between individuals and businesses. This can be handled with an exemption certificate, but the costs of complying with the sales tax would rise rapidly if exemption certificates were used more broadly. Both of these problems create large opportunities for fraud (false businesses, fraudulent use of certificates, etc.) that would significantly increase any state's compliance costs.

considered to ensure that they are being given because of economic benefits rather than as political decisions that distort the economy and accrue to the gain of a small number of firms.

5. Hawaii should be a member of the Streamlined Sales Tax Project in order to participate in decisions that are currently being made on how states will harmonize and coordinate their sales tax structures.
6. The Hawaii Congressional delegation should be strongly encouraged to support a new nexus standard for remote vendors that allows the state to collect use taxes much more effectively.

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