# State of Hawaii
# Tax Review Commission

# Study of the Hawaii Tax System

## Final Report

September 21, 2012

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# Executive Summary

# Executive Summary

## Background

In 2012, the Hawaii Tax Review Commission (Commission or TRC) engaged The PFM Group (PFM) to perform a systematic study of the State's tax structure, with particular emphasis on answering two key questions:

1. Will the current tax system provide sufficient revenues to meet near and long term future needs for the 21st Century?
2. Are there alternate tax structures that could improve Hawaii's ability to generate sufficient revenues?

To conduct the study, the project team obtained and analyzed state revenue and expenditure data and forecasts, conducted extensive interviews with stakeholders inside and outside of state government, benchmarked Hawaii with other states, and reviewed numerous prior reports, including studies from past Commissions. The project team also conducted best practices research and analysis related to tax structure and tax principles. The project team vetted its analysis with key stakeholders and now submits this draft report, with a final report to follow in September 2012.

Overview

Hawaii's unique history, location and demographics are important for understanding how its expenditure and revenue structure have evolved – and may continue to change – over time. Among the key factors:

- **Island state.** While many states must consider consumer mobility in key aspects of its tax structure, it is less of a concern for Hawaii given that it is 2,400 miles from the nearest U.S. state.
- **Cyclical economy.** Over the years, the economy has been dominated by key industries that have generally ascended and then declined. Beginning with Sandalwood and also including sugar cane, pineapple and tourism, the State economy has generally been less diversified than in most states. This can be a risk, as was the case for the State in the aftermath of the terrorist attacks on September 11, 2001.
- **'Aloha spirit.'** While the native Hawaiian population has declined over time, there continues to be great pride in Hawaii history and traditions. A respect for the land and concern for maintaining Hawaii's unique characteristics is important to many residents.

Demographics

Hawaii's demographics are significantly different than the norm in the US in a number of areas. This also helps to explain why some aspects of its tax and expenditure policy are different from other states – and why benchmarking is a challenge. Among key demographics:

- **Ethnic diversity.** Hawaii is among the most diverse states with the greatest percentage of residents in any state identifying as 'Asian' (38.6 percent) and 'two or more races' (23.6 percent). In addition, Hawaii's percentage of citizens who identify as 'white' is the lowest among the 50 states at 24.7 percent.
- **Growing – but aging – population.** While still a relatively small state in terms of population (1.4 million, 40th among all states), Hawaii's population more than doubled between 1960 and 2010 – a much faster rate than the nation as a whole. The state is also getting older – it ranks 10th among the states in the percentage of population 18 and over, and 12th in the percentage of population ages 65 and over.

- **Above average income.** Hawaii ranks 16th overall in average per capita income; its median household income ranks 5th among all states.
- **Above average educational attainment.** Hawaii ranks 9th among states in percentage of population with a high school diploma and 16th in percentage of population with a bachelor's degree or higher.

Economy

Hawaii's economy has, over the years, depended on industries and sectors that capitalize on the State's unique location and other characteristics. That continues to be reflected in many aspects of the economy today:

- **Lack of diversification.** The State generally ranks low in measures of economic diversification, although the connection between diversification and economic stability and growth is less clear.
- **High concentration of employment in travel-related industries.** Hawaii has a far greater concentration of employment in the leisure and hospitality services industry than the nation as a whole. Employment in the leisure and hospitality industry exceeds 100,000 and is second only to federal, state and local government.
- **High concentration of employment and earnings in government.** As noted above, federal, state and local government are the largest employers in Hawaii, nearly 125,000 in 2011. That sector also pays well, with average earnings per employee of nearly $81,000, ranking third (behind utilities and business services).
- **Small concentration of employment, earnings and output from manufacturing.** While manufacturing accounts for over 12 percent of GDP for the nation as a whole, it accounts for just 2 percent of Hawaii's GDP. It employs just over 13,000 and has average wages ($44,097) well below most key industries.

## Revenue Structure

Current Tax Structure

The State tax structure is dominated by two major taxes, the General Excise Tax (GET) and the Individual Income Tax (IIT). The GET is the largest source, making up 58 percent of General Fund tax revenue, while the IIT makes up 29 percent. The next largest source, the Insurance Premiums Tax, makes up just over 3 percent of General Fund tax revenues. Others that make up the bulk of General Fund tax revenue are Cigarette and Tobacco taxes, the Transient Accommodations Tax (TAT) and corporate net income tax. Key characteristics of the current revenue structure are:

- **Greater reliance on two revenue sources.** Hawaii raises 77 percent of its total tax revenue (General and non-General Fund) from the GET and IIT; by contrast, the average for all states that levy these types of taxes is 65 percent.
- **Little reliance on corporate income tax.** While corporate income taxes are generally referred to as one of the three major taxes among all states (along with sales and individual income taxes), in Hawaii it makes up less than 1 percent of total General Fund revenue.
- **Extremely broad base/low rate for the GET.** As a business privilege tax, the GET is applied to a much broader array of goods and services than most sales taxes. Besides applying to food, it also is broadly applied to services. A Federation of Tax Administrators (FTA) survey of services commonly taxed by states found that Hawaii taxes 160 of 168 services, the most of any state. The GET's 4.0 rate is the second lowest state rate in the nation for a broad-based consumption tax (which in most states is a sales and use tax).

- **Progressive and regressive features of the IIT.** Hawaii's twelve income tax brackets are notable at both the low and high end of the income spectrum. At the low end, the income levels between brackets is relatively narrow, meaning lower income individuals move fairly quickly into higher tax rates. On the high end, Hawaii is tied with Oregon for the highest top marginal tax bracket (11 percent) among the states.

Relationship between State and Local Taxes

Across the country, local taxes can vary widely from state to state (and even from city or county within a state). It is often difficult to make accurate comparisons of state taxes without considering local taxes as well. This difficulty in making state tax comparisons is particularly pronounced in Hawaii, because of the manner in which local schools are funded.

Nationally, the largest local government expenditure category is support for K-12 education – averaging nearly 37 percent. By contrast, local governments in Hawaii spend less than 1 percent of their revenue for this purpose. It is a given that if there is little local government funding for K-12 education, the State is the only real alternative to support this function. In fact, the State of Hawaii provides far more revenue to support this function than nearly any other State – 82 percent in Hawaii compared to 44 percent among all states. As a result, property taxes (the primary local revenue source in Hawaii and among all states) are relatively low in Hawaii for all classes of property (residential, commercial and industrial). In effect, there is a trade-off taking place, with what may be seen as higher taxes at the state level supporting what are commonly considered shared state and local funding responsibilities in other states.

Tax Burden

The project team reviewed a variety of methods that are used to measure tax burden. As previously noted, state tax burden should not be considered in a vacuum but combined with local taxes to reflect the unique nature of funding for K-12 education in Hawaii. To adjust for this, the project team generally relied on the combined state and local tax burden calculations done on an annual basis by the Tax Foundation. This calculates state and local taxes as a percent of income. Because the rankings are of tax revenues as a share of income, it is notable that a state's percent share and relative ranking can rise or fall without changes to its underlying tax structure. Over the years, Hawaii has tended to rank in the upper half of states (with state and local taxes consuming a higher than average percent of personal income). However, the last analysis determined that Hawaii's composite tax burden as a percentage of personal income for 2009 was 9.6 percent – below the national average of 9.8 percent.

While aggregate analysis of tax burden is useful, it is also important to examine how the tax structure impacts those at different income levels. Many taxes are considered regressive – where a larger share of total income goes for paying the tax for those at lower income levels. Several tax burden comparisons examine these factors in its analysis. At least two national surveys suggest that Hawaii's overall tax structure is regressive. One, an annual survey by the District of Columbia, compares the burden of major taxes on a hypothetical family of three in the largest city in each state; it found that taxes paid as a percentage of income in Hawaii were low at income levels of between $50,000 and $150,000 (ranking between 43$^{rd}$ and 33$^{rd}$ of the 50 states), but high (ranking 9$^{th}$) for those at the $25,000 income level.

Tax Performance of All States

Across the nation, nearly every state has had to deal with tax structure fall-out related to 'the Great Recession.' The States as a whole registered negative revenue growth throughout the recession, and revenues were slow to rebound. While circumstances differ from state to state, there are some key themes that have emerged or come into greater focus in recent years. Among them are:

- **Base erosion for key revenue sources.** This has been particularly notable for the sales and use tax, where legislated exemptions and the rise of digital commerce have contributed to a situation where sales tax as a share of personal income has been declining for over 50 years. According to Dr. William Fox, a noted national expert on this topic, the tax loss for the State of

Hawaii related to uncollected GET from e-commerce transactions is estimated at $145 million a year (and growing) for the State of Hawaii. Base erosion has also been an issue for other taxes – for example, aggressive corporate income tax planning and a move by many states to a single sales factor for income apportionment has reduced the taxable base for corporate income taxes.

- **Heightened volatility.** In each of the past two recessions, the depth of the percentage decline in state revenue was much more pronounced than in previous post-world war II recessions. This has made it particularly difficult for states to accurately forecast projected revenues during economic downturns. One survey found that in FY 2009, the collective margin of error by states in forecasting individual and corporate income and sales taxes amounted to a $49 billion shortfall, with a median error of a 10.2 percent overestimate.
- **Changes in consumption.** Most sales tax structures broadly tax goods and more narrowly tax services (in this area, Hawaii is an exception). Over the last 50 years, personal consumption has shifted from 65 percent goods to nearly 60 percent services. In many cases, sales tax structures have not responded to this directly (by adding services to the base) but instead resorted to increases in the sales tax rate – which can create greater economic distortions.
- **Demographic shifts.** The US population is getting older, which also impacts on consumption – and consumption taxes. Nationally, sales tax profile by age cohort indicates that the top age range for per capita sales tax revenues is 35-44 years of age – and steadily declines in each additional age cohort.

These trends, coupled with the severe economic downturn from December 2007 to June 2009 help to explain why the 50 states collectively increased net revenue through tax law changes in each year from 2002 to 2010. While net state tax cuts exceeded tax increases in 2011, the long-term budget outlook for state and local governments is generally not considered to be promising. A model of state and local operating balances maintained by the US Government Accountability Office (GAO) suggests that state and local budget deficits as a percentage of GDP will grow from the years 2015 through 2060 (the entire window of the model).

Hawaii Tax Structure SWOT Analysis

A SWOT (strengths, weaknesses, opportunities and threats) analysis generally looks at a system or organization from two perspectives – that of the internal organization and system (strengths and weaknesses) and the external environment (opportunities and threats). Based on this, the following are identified as key issues in these categories:

*Strengths*

In many respects, the Hawaii tax structure has been developed to capitalize on the State's unique geographic situation in relation to other states. The following are internal advantages of the current tax structure:

- Broad and stable base for the GET
- Relatively low tax rate for the GET
- Insulation from cross-border competition issues
- GET is responsive to demographic and economic changes
- Ability to export a significant share of the state tax burden

*Weaknesses*

The prominence of the GET helps to expose some of its weaknesses as well. Other aspects of the tax structure and how it is administered are also areas of concern for the overall tax structure:

- Largely dependent on two taxes (GET and IIT)
- GET results in some tax pyramiding
- Comparatively high IIT rates at the high and low income levels

- Exempts a growing source of revenue (pension and social security income) from the IIT
- Small source of revenue from the corporate net income tax
- Variety of tax law sunsets in coming years
- Older tax collection systems and processes

*Opportunities*

- Federal solution on e-commerce tax collection
- Voluntary vendor compliance on e-commerce tax collection

*Threats*

- Continued erosion from e-commerce
- Reductions in federal spending
- Decline in tourism, either related to broad-based economic downturns or specific shocks

## Structural Sustainability

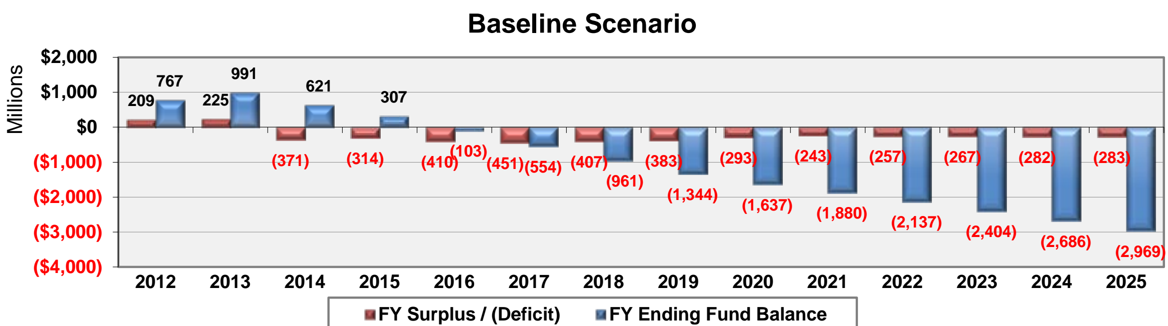
PFM Long Range Financial Forecasting Model

The project team built a multi-year financial forecasting model that projects the State's General Fund revenues, expenditures and financial results through FY 2025. The model uses detailed historic information and management insight to produce a baseline financial projection. The baseline projection assumes maintaining the current level of service for existing programs and mandated (primarily state and federal law) changes as well as the current tax and revenue structure, including any statutorily required changes. In constructing the model, historic revenue and expenditure data was provided by the Department of Budget and Finance, and the Council on Revenue forecasts were also used. The project team performed regression analysis against key economic variables for a number of the State's key tax revenue sources and also calculated annual growth rates that project how the State's revenues and expenditures will change going forward.

In addition to the baseline, the project team built two alternate scenarios to give a sense of the range of potential outcomes, using different revenue assumptions, to create an optimistic and a pessimistic scenario. The following outlines the results under these three assumptions.

Baseline Projection and Alternate Scenarios

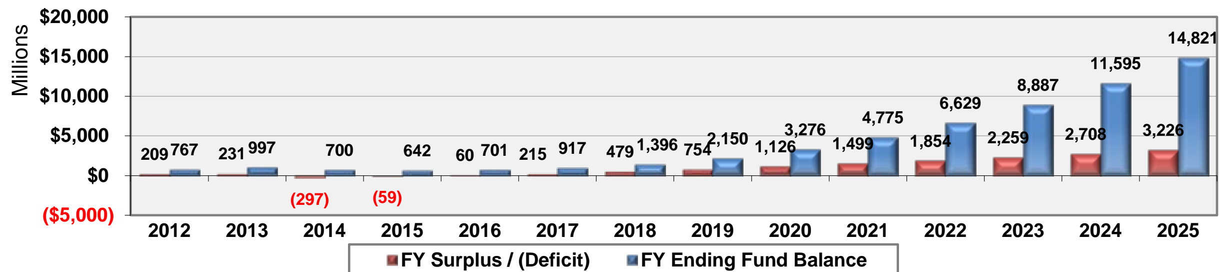
As shown below, diverging revenue and expenditure projections lead to the model forecasting a series of annual budget gaps reaching $283 million by FY 2025 if no corrective action is taken:



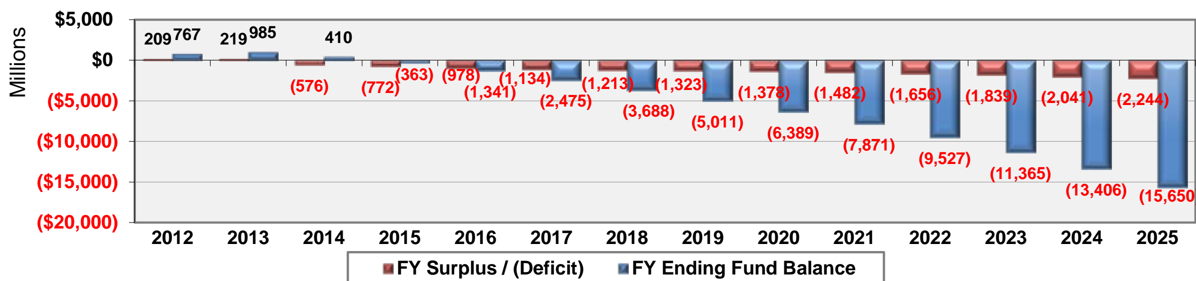
Of course, the magnitude of the budget gaps projected by the model cannot actually occur: As with 48 other states, Hawaii has an obligation to balance its General Fund budget on an annual basis; however, the growing gap between ongoing revenues and expenditures is a sign of a structural issue – which suggests that the current revenue structure is insufficient to meet near and long term needs of the State.

As can be expected, the Optimistic and Pessimistic scenarios diverge from the Baseline in opposite directions. The Optimistic scenario, which assumes that the State experiences a sustained economic upturn similar to the one that occurred in the mid-2000s, allows the State to maintain (and even build) its surplus through most years of the forecast period. The Pessimistic scenario, which assumes that the State experiences an economic downturn similar to the one that occurred in the latter part of the previous decade, creates even larger deficits more quickly than the Baseline projection.

**Optimistic Scenario**

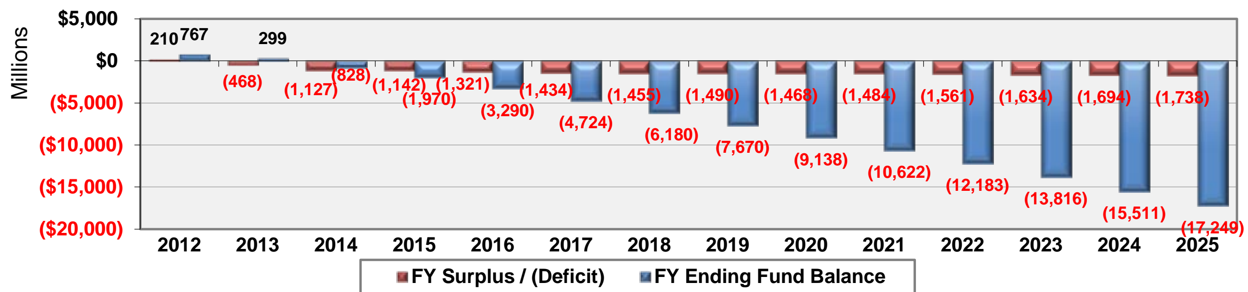



**Pessimistic Scenario**




The project team does not view either of these alternate scenarios as particularly likely, and the magnitude of the projected deficits or surpluses would never materialize in the realm of state public policy – in any state. Again, they are provided to determine whether the State finances would be expected to attain structural balance.

Finally, the Commission requested that the project team develop the model with the ability to view financial results on an Accrual basis (as opposed to the cash basis form of budgeting used by the State – and most other states). To do so, the model reflects the full pension and OPEB liabilities. When it does so, the projected deficits in the Baseline projection become significantly larger and harder to manage:




## Revenue Alternatives

<u>Tax Policy Principles</u>

The study charge directed the project team to examine revenue alternatives that would align with generally accepted tax policy principles. Hawaii statute directs the Commission to conduct its review of the State tax structure 'using such standards as equity and efficiency.' These are cornerstone tax principles and were considered in all aspects of the tax structure analysis. In reviewing numerous sources related to tax policy, the project team settled on the following principles, which were identified by multiple sources:

1. The system should be equitable (equity)
2. The system should minimize interference by taxes in market decisions (efficiency)
3. The system should be reliable, stable, and sufficient
4. The system should be simple, allow for compliance, and ease of administration
5. The system should have a balanced variety of sources/broad base

It is important to acknowledge that tax policy principles can and will collide, and a weighing will often be necessary. This is a case-by-case determination – keeping in mind the perspective that there is no perfect tax and all will have some form of negative consequences. The goal of the analysis is to accentuate the positive in the overall structure and minimize or mitigate the negative.

<u>Possible Revenue Strategies/Approaches</u>

The project undertook a preliminary analysis of approximately 100 tax and revenue options used in states throughout the country. The project team preferred revenue options that are in general use and, to the extent possible, can be modeled with available data. This created some limitations, as available State tax data has, in many areas, not been updated for as many as 10 years. The project team then analyzed a smaller set of alternatives in greater detail. While not all of those analyzed are included in the recommendations, many are built into the project's multi-year financial planning model (which will be turned over to the State upon project completion) and can be developed into alternate scenarios should policymakers wish to consider them. The following alternatives are listed by type of tax.

*General Excise Tax*
Alternatives focus on changes to the base or rate. In general, base broadening is preferred, but some rate changes are likely necessary to maintain a reliable, stable and sufficient system.

- Broaden the base by eliminating the exemption for non-profits
- Eliminate the sunset on the application of the GET to activities in Act 105, Session Laws of Hawaii 2011

- Aggressively pursue nexus
- Increase the rate
- Eliminate the 0.5 percent rate, in conjunction with other corporate tax changes

*Individual Income Tax*
Hawaii uses federal adjusted gross income (AGI) as a starting point for determining state taxable income. There are currently 16 total tax expenditures available to qualifying IIT filers – amounting to approximately $253 million in total tax expenditures in tax year 2009. The following are alternatives to the current structure:

- Eliminate or reduce exemptions on pension income
- Eliminate or reduce exemptions on social security benefits
- Eliminate or reduce specific credits
- Eliminate the deduction for property taxes paid
- Reduce effective tax rates that apply to low-income filers

*Excise Taxes*
An excise tax is essentially a selective sales tax paid by those who use or consume a specific good or service. Excise taxes often provide an effective strategy for exporting a portion of the tax burden. It is considered theoretically sound to export a portion of the burden because non-resident consumers use state services (roads, police protection) while in the state.

- Increase the TAT
- Institute a prepared food tax
- Restore the temporary surcharge on rental motor vehicles and tour vehicles
- Institute an amusement/recreational activities tax
- Increase the cigarette/tobacco taxes
- Increase taxes on beer, wine and liquor
- Increase the motor fuel tax
- Institute a snack food and/or soda tax
- Increase the conveyance tax
- Increase the insurance premium tax
- Increase the cell phone service tax

*Corporate Net Income Tax*
While generally viewed as one of the 'big three' taxes among all states, Hawaii raises less than one percent of its general fund revenue from this source. The following alternatives were considered:

- Increase tax rates and combine with reducing/eliminating GET for business-to-business transactions
- Switch to a single factor method of apportionment for multi-state corporations
- Eliminate net operating loss (NOL) carry-back
- Broaden definitions of nexus

*Other Revenue Sources*
States use a variety of approaches to raise non-tax revenue or enhance compliance and collection of tax revenue. The following alternatives were considered:

- Approve a lottery or other forms of gambling
- Use tax gap programs and other methods to increase collection of taxes already owed

## Observations and Recommendations

Future Lack of Revenue Sufficiency

Based on the constructed baseline from the long range financial model, the State is expected to experience structural budget deficits based on the current revenue structure and levels of service. This trend is exacerbated when liabilities for retiree pensions and health care benefits are factored into the model on an accrual basis.

This general view is supported by other recent reports and analysis both for the nation as a whole and specific to Hawaii. As noted, the GAO model of US state and local governments suggests a long period of decline for state and local government finances. For the State, Moody's May 2011 downgrade from Aa1 to Aa2 warned of several financial concerns, including high debt ratios, pension funded ratios that are low relative to other states and growing OPEB expenses.

Further, it is not likely that the challenges facing the State can be 'solved' with approaches that only focus on expenditures. The State has already cut its workforce and extracted wage and other benefit concessions from workers, limiting its opportunities to further constrain growth in this key area. Meanwhile, the pension and OPEB obligations for current retirees are inescapable and will grow throughout the period of this analysis. Coupled with expected growth in key areas like health care, the expenditure side of the state budget will pose many challenges in the years to come.

At the same time, Hawaii's revenue structure has been shown to be susceptible to economic shocks – both those associated with a deep and prolonged recession and other shocks to key industries, particularly tourism. It is likely that the State will need to build and maintain significant reserves to withstand these inevitable future disruptions.

Framework for Weighing Recommendations

There are literally hundreds of taxes in use and thousands of variations that have been considered or tried in the 50 states. The project team analysis – and ultimately, recommendations – focused on three key areas:

1. Adherence to the five key tax policy principles (with particular weight attached to equity and efficiency)
2. Revenue generating potential
3. Impact on overall tax administration

Within the five key tax policy principles, the recommendations seek to accentuate the positive features of the State's tax system and minimize or mitigate the negative. For example, the GET has a broad base in terms of its application to goods and services; this advances reliability, stability and sufficiency but makes the system more regressive, impacting equity. The recommendations mitigate some of that impact by changes to the IIT targeted at lower income filers. Likewise, efficiency concerns are raised by some aspects of the GET, including tax pyramiding related to the 0.5 rate that is applied to wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale. The recommendations eliminate the 0.5 percent GET rate and makes up some of the foregone revenue with changes to the

corporate net income tax. While improving efficiency, this also has the advantage of taxing profit, as opposed to simple business activities, which improves horizontal equity.

At the same time, this study cannot solely be an exercise in structural improvements based on tax principles. As has been noted, there is no perfect tax – they all have disadvantages that, in some way, will reduce economic activity. On the other hand, taxes are necessary to fund services that Hawaiians rely upon to maintain or improve their overall quality of life. As Justice Oliver Wendell Holmes noted, "taxes are what we pay for civilized society." The impetus for these recommendations is the need for the State to identify changes that can modify the tax structure in ways that will create sufficient revenue to match the expenditure needs in the coming years.

Within the recommendations, their revenue generating potential is a key area for consideration. As noted throughout the report, there are key demographic and economic changes occurring throughout the nation and State. These changes were factored into recommendations to help ensure that the structure will continue to be sufficient in the future. For example, as the population ages, pension and social security income becomes a larger component of overall income. To maintain a sufficient base for IIT purposes, it is increasingly necessary to include at least some portion of that income in the IIT base, and the recommendations reflect that reality.

There are two other practical implications for focusing on revenue generating potential. First, the recommendations focus on taxes that can have a tangible impact on the State's structural deficit; taxes with little revenue potential are often little more than nuisance taxes that create unnecessary compliance burdens for taxpayers and collectors alike. Second, the recommendations are focused on revenue modifications that are in use in Hawaii or around the nation. This concept, sometimes expressed as 'an old tax is a good tax' is based on the premise that these taxes are generally understood by the market, can be complied with, and their revenue generating potential more accurately modeled.

As previously noted, tax administration and compliance is a valid concern; where possible, recommendations are weighed more favorably that reduce the burden on taxpayers and administrators. Overall, a key goal is to improve system operation and transparency. To that end, some of the recommendations do not make changes to the tax code but touch on ways to improve the overall system of reporting, analysis and administration.

Base Expansion

As noted, this conforms with the principle of having a broad tax base. This can, in certain situations, also support greater horizontal and vertical equity.

- **Reduce the pension exemption in the IIT**
  The recommendation would tax all marginal pension income over $25,000. With this as a growing source of income, this base expansion is necessary to maintain stability and sufficiency. The exemption ensures that pension income for lower income filers will still not be subject to tax (a vertical equity issue). At the same time, pension benefits are income, and treating it differently than other forms of income is a horizontal equity issue.
- **Eliminate the deduction for property taxes paid**
  Hawaii is unique among the states in its full state support for K-12 education, which in most states is a shared state-local responsibility, with the local funding primarily supported by property taxes. In essence, the State is subsidizing property taxpayers by this funding approach at the expense of those who do not pay property taxes (an equity issue). Eliminating this deduction helps reduce this disparity by increasing the state tax burden for property taxpayers.
- **Cap or replace with grant programs certain tax credits**
  Hawaii has made extensive use of both IIT and corporate net income tax credits, including the Renewable Energy Technologies and the Motion Picture, Digital Media and Film Production tax

credits. Currently, these and other tax credits are not capped, which can make it difficult to maintain revenue stability and sufficiency over time. A viable alternative in use in many states is to cap or eliminate broad-based credits and replace them with grant, loan and/or forgivable loan programs. These can be more readily directed at specific types of projects and activities and controlled through the application and approval process.

Reduce Regressivity

Multiple sources have identified Hawaii's tax structure as regressive – a key equity concern. The following changes would address regressive aspects of the two largest sources of General Fund revenue.

- **Increase the IIT standard deduction**
  The recommendation increases the IIT standard deduction to $7,500 for single, $15,000 for married or surviving spouse with dependent child and $10,950 for head of household filers. This would address concerns related to the low income levels at which the IIT is applied in Hawaii. It would also ameliorate concerns about the impact on lower income individuals from eliminating the ability to deduct property taxes paid for IIT purposes.
- **Double the refundable food/excise tax IIT credit**
  Hawaii applies its GET to food, which helps to broaden the tax base and makes it more reliable during economic downturns. The current refundable credit is based on income, ranging from $25 per qualified exemption for those with AGI of $40,000 to $50,000 to $85 for those with AGI under $5,000. Doubling this credit will help ameliorate some of the regressive nature of the broad GET base.

Reduce Pyramiding

Economists are nearly uniform in their belief that pyramiding distorts market decisions and reduces overall efficiency. Because the GET applies a 0.5 rate to wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale, pyramiding occurs. The following adjustments would reduce pyramiding and replace some of the lost income with other business-related taxes.

- **Eliminate the 0.5 percent GET and Use Tax rate**
  This would improve overall system efficiency and should also improve horizontal equity – in many instances, certain types of firms can structure their operations to avoid the tax but others cannot.
- **Allow the Act 105 temporary increases to sunset**
  The tax code exempts many business-to-business transactions from the GET. Because of budget concerns, these were temporarily suspended in 2011. The suspensions should be allowed to sunset as scheduled. Restoring these exemptions will help reduce pyramiding.
- **Increase Corporate Net Income Tax revenue**
  Currently, the State has a three tiered structure, with higher tax rates with higher net income. This can be an equity issue, as corporate net income is not necessarily equated with ability to pay. The State should set a single rate in the range of 9 percent. Raising additional revenue from a single tiered corporate net income tax and reducing the GET transaction-related tax would better align with equity and efficiency principles.

Export Tax Burden

Given its destination location and home to thousands of federal civilian and military personnel, the State has an opportunity to export a significant portion of its tax burden. The following recommendations address this approach.

- **Increase cigarette and tobacco tax rates**

This has the added benefit of generally reducing smoking for key target populations, such as children. While it is a regressive tax, research suggests that higher taxes also encourage lower income individuals to stop smoking – which is a large economic benefit in the long run.

- **Increase gallonage taxes on beer, wine and distilled spirits**
  Revenue growth for these taxes has some connection to the performance of the leisure and hospitality industry, suggesting that a significant portion of the tax is exported. While regressive, higher taxes have also been shown to reduce consumption (which is generally perceived to have positive health benefits).
- **Eliminate the sunset on the TAT rate increase**
  Temporary increases in the TAT are scheduled to sunset on June 30, 2015. Retaining the tax will continue to export a significant amount of the tax burden. Based on travel activity, it does not appear that the temporary tax increase significantly impacted the industry.
- **Restore the surcharge on rental cars**
  A temporary surcharge on rental vehicles was allowed to sunset. Restoring the tax to previous levels will export a significant amount of the tax burden. Based on travel activity, it does not appear that the temporary surcharge significantly impacted the industry.

Rate Change to Restore Structural Balance

With two key revenue sources and no logical major alternatives, the State is primarily reliant on the GET and IIT. Of the two, the IIT already has a rate structure that includes the highest top marginal rate among all states. By contrast, the GET rate has remained constant at 4.0 percent since the 1960s.

- **Increase the GET rate to 4.5 percent**
  While Hawaii's GET is not a standard sales tax, the State is one of 13 that levy their broad-based consumption tax on the privilege of engaging in business as a vendor. Hawaii is unique in having the broadest base of any state with a broad-based consumption tax (although, as it relates to taxing services, at least a few states are taxing a similar number of them). Part of the overall GET tax burden is mitigated by the fact that the GET rate is among the lowest in the country for states with a broad-based consumption tax. While Hawaii has not raised its rate in over 35 years, over half of the states have raised their rate since 2000 – in many cases multiple times. Given the need to restore structural balance, an incremental increase in the GET rate is the logical method to improve the long-term financial outlook. While the GET is considered regressive, other recommended changes would reduce some of that impact.

Changes to Improve System Administration

In the long run, improved technology, processes and reporting can help increase compliance and advance data-driven policy outcomes. The following can assist in advancing those efforts.

- **Develop Tax Gap systems to identify under-payment and non-payment of taxes**
  Many states are using sophisticated data warehouses to analyze tax and other state financial information to uncover possible non-compliance with tax laws, rules and regulations. In many instances, vendors will enter into a performance-based agreement that pays for the necessary system improvements from additional tax revenue achieved because of the system improvements. This effort can be built into current plans to improve the overall financial management systems for the State.
- **Create a compliance and productivity account to fund staff and technology improvements to foster taxpayer education, understanding and compliance**
  In many states, a specific funding stream is established to enhance staff and technology related to education and compliance efforts. The State should capitalize a fund that the Department of Taxation could access for staff and technology upgrades with an expected ROI. These

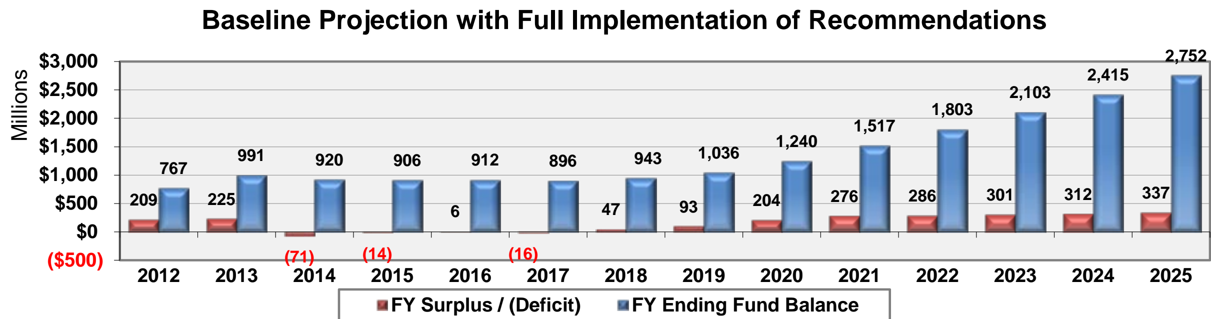
investments would then require a method for tracking performance, with payback to the fund from a portion of the additional revenue received from the initiatives.

- **Provide Tax Expenditure Reports on a scheduled regular basis**
  In previous years, the Department of Taxation published tax expenditure reports and other information related to tax collections and taxpayer characteristics. While these were eliminated because of budget issues, they should be restored. The need for transparent data on key tax issues is critical for informed decision making. In many cases, analysis of actual performance of tax law changes – and how they relate to key tax principles – requires the data and analysis that takes place in a tax expenditure report.

Recommendations Fiscal Impact

According to the assumptions currently developed around the recommendations, the end result would be a structurally aligned expenditure and revenue structure through the years the model projects. In some cases, timing of actual implementation might require some adjustment (which the model allows the project team and the State to do on a real time basis). The following illustrates the baseline projection with the tax structure recommendations fully implemented:

**Baseline Projection with Full Implementation of Recommendations**




The following table summarizes the recommendations and their fiscal impact for 2014:

**Summary of Recommendations**

| Initiative | *2014* |
|---|---|
| **Base Expansion** | |
| Reduce the pension exemption in the IIT* | 17,267,203 |
| Eliminate the deduction for property taxes paid* | 12,513,835 |
| **Reduce Regressivity** | |
| Increase IIT standard deduction* | (42,495,049) |
| Double the low-income food credit* | (15,084,986) |
| **Eliminate Pyramiding** | |
| Eliminate the 0.5 percent GET and Use Tax rate | (134,708,410) |
| Allow the Act 105 temporary increases to sunset** | (74,550,434) |
| Increase Corporate Net Income Tax revenue | 34,822,258 |
| **Export Additional Tax Burden** | |
| Increase cigarette and tobacco tax rates | 9,838,872 |
| Increase gallonage taxes on beer, wine and distilled spirits | 1,886,273 |
| Eliminate sunset on TAT rate increase | 0 |
| Restore the surcharge on rental cars | 65,451,475 |
| **Rate Change to Restore Structural Balance** | |

| | |
|---|---|
| Increase the GET rate to 4.5 percent | 349,899,664 |
| **Changes to Improve System Administration** | |
| Develop Tax Gap systems to identify under-payment and non-payment of taxes | 0 |
| **Total Fiscal Impact** | **299,391,135** |

*FY2014 includes a 50% discount for the unique timing of the recommendation

**Already assumed in baseline revenue projection therefore not including in savings total

## Summary

The study's long range financial forecasting model and the resulting analysis of baseline expenditures and revenues conclude that the State faces a significant financial challenge. On a cash basis, the baseline model projects an accumulated shortfall of $3.0 billion between FY 2013 and FY 2025. While an optimistic scenario was created that could allow the State to avoid a structural deficit, an equally likely pessimistic scenario suggests it will be far worse than even the baseline projection – with an accumulated shortfall of nearly $16 billion through FY 2025. If the focus is shifted to an accrual basis to fully account for liabilities associated with pension and OPEB liabilities, the baseline scenario accumulated shortfall balloons to over $17 billion.

The State of Hawaii is at a crossroads: the study's long range financial forecasting model projects that the State can maintain a positive balance for the next few years under predicted current levels of service and revenue forecasts. However, if the State waits to address the problem, it will lose the opportunity to build reserves, fund an OPEB trust to deal with future obligations or make strategic investments – as in, for example, improving technology – that can assist it to improve overall productivity of the revenue system as well as financial transparency, accountability and compliance in the years to come.

The recommended initiatives form a comprehensive package that build on current, accepted taxes and modify them in ways that raise additional revenue while also focusing on ways to increase equity and efficiency and further export part of the State tax burden. Regardless of the approach the State takes, this sort of a balanced, long-term approach will be most likely to craft a structure that provides sufficient revenue in a way that minimizes the negative effects of taxes on the economy and taxpayers.

# Introduction and Project Background

# Introduction and Project Background

## Report Background

In March 2012, the Hawaii Tax Review Commission (Commission or TRC) engaged Public Financial Management, Inc. (PFM) to perform a systematic study of the State's tax structure, with particular emphasis on answering two key questions:

3. Will the current tax system provide sufficient revenues to meet near and long term future needs for the 21st Century?
4. Are there alternate tax structures that could improve Hawaii's ability to generate sufficient revenues?

The Commission consists of seven members who are appointed by the Governor, with the consent of the Senate. The TRCmeets every five years and is charged with conducting a systematic review of Hawaii's tax structure using such standards as equity and efficiency.[1] While past Commissions have focused generally on issue-specific areas of tax policy, the 2012 TRC sought to take a longer-range approach in evaluating a tax system that has not been substantially modified since the 1970's. Tax policy can be an important social and economic tool; a thorough evaluation of sustainable tax policy in light of developments in the 21st century can help provide direction for policymakers as they seek an equitable tax structure that also allows for economic growth.

In addition to the review by PFM, the Commission has also retained Dr. William Fox to analyze selected issues with the Hawaii General Excise Tax (GET). The study, which is an update of past work Dr. Fox has done for the TRC, was issued on July 22, 2012. That study and other reports generated by the Department of Taxation and previous TRCs were consulting while developing the findings and recommendations within this report.

## Methodology

The following were key elements of the project plan, analysis and report. The project was conducted in the following four phases:

<u>Planning Phase</u>

This phase communicated project details, finalized a detailed project plan, organizing, organized, scheduled and conducted a project kick-off and devised reporting and communications protocols.

<u>Information Gathering Phase</u>

To help the project team understand current revenue and expenditure trends, State priorities and likely future performance, the project conducted extensive data gathering as well as interviews with department leaders, subject matter experts and internal and external stakeholders. The team reviewed past research and current modeling and forecasting around key revenue sources (GET, personal and corporate income tax, specific excise taxes) and expenditure drivers (employee pension and benefits, health and human services, K-12 and higher education, transportation, etc.). Recent and past Commission reports were also reviewed and key budget and financial information (proposed and enacted budgets, CAFR's and annual reports) and reports were also reviewed. Workforce information, including pension and other post-employment benefits (OPEB) valuations and reports, collective bargaining agreements and pay

[1] Hawaii Revised Statutes (HRS) Chapter 232E-3.

plans, State statutes, regulations, civil service rules and other legal mandates, benefit schedules, health plans, headcount breakdown and other relevant information was collected and included in this analysis.

Evaluation Phase

Based on the baseline and future year modeling, the team analyzed, reviewed and compared the State's expenditure and revenue trends and performance to determine to what extent the current system could attain and maintain structural balance. The team identified alternative revenue approaches and structures used in other states, analyzed their applicability and appropriateness for the State of Hawaii and quantified, to the extent possible given the available data, changes in revenue bases or rates and their impact on the Hawaii economy in the aggregate and as they may relate to key industries or sectors.

After extensive discussions on the unique characteristics of the State and the difficulty in identifying comparable jurisdictions, the project team benchmarked Hawaii against relevant states in key issue areas. This allowed the team to analyze the comparability and applicability of relevant data at a more granular level. The project team also conducted best practice research and analysis.

Recommendations Phase

The team met with the Tax Review Commission and key contacts within the Department of Taxation on multiple occasions to provide project updates, vet findings and to resolve any outstanding project issues. In late June, the project team provided the TRC and key staff a project update and discussed high level findings based on the data and analysis compiled to date. The team sought feedback on areas for further research and study and carried out follow-up discussions and interviews with key staff and stakeholders. Following the mid-project briefing in late June, the project team spent the next six weeks conducting additional analysis, doing follow-up research to refine revenue projections and assumptions and further developing high level findings. This analysis was used to create the resulting recommendations.

## State Background

In many states, the underlying tax structure has evolved over time, taking into account changes within the economy, population and other factors. Hawaii's tax structure has perhaps not exhibited as much change as in other states with, in some cases, hundreds of years of statehood. Of course, Hawaii has a long and storied history prior to statehood, and that history continues to have a profound impact on its social, political and economic culture. This, in turn, influences choices that have been made regarding both expenditures and revenues. The following highlight some of the key historical themes of Hawaii that impact on the following discussion and analysis of its tax structure.

Island Nation

It is generally assumed that Hawaii was discovered by Polynesians between the 3rd and 7th centuries, and Hawaii was relatively isolated until 1778, when British Captain James Cook reached the Islands. Through the published writings of Cook and his crew, the islands became a main destination for other British navigators, followed by ships from France, Russia, America and other countries. The role of Hawaii as a destination or stopping-off point has been an important factor throughout its history. While the world has become more inter-dependent and global travel quicker and more frequent, the State's unique geographic location is still an important feature.

Influence of Hawaiian Culture

During the early period of contact with other nations, King Kamehameha the Great took control of the islands and greatly limited native interactions with Westerners and other foreigners in an effort to protect the Hawaiian religion, beliefs and rituals. It was not until after his death, and the transition of control to his son Kamehameha II, that outside influential presence was established on the islands. While other

developments gradually integrated others into the Hawaiian culture, politics and economy, there are still notable examples of the native Hawaiian culture playing a key role.

Native Hawaiian Population Decline

When Captain James Cook arrived in Hawaii in 1778, there were estimated to be between 300,000 and 400,000 Native Hawaiians living in the Islands. As island visitors became more prevalent, the native economy began to change to accommodate foreigners and foreign goods; new products and materials were brought to the islands for practical use. Not all of these developments were positive, however, as invasive plants and new animals had sometimes devastating impacts.

As examples, the Chinese demand for sandalwood depleted forests controlled by Hawaiian chiefs. Because native Hawaiians had no resistance to influenza, smallpox and measles, disease outbreaks were frequent and deadly – one measles outbreak killed a fifth of Hawaii's people.[2] Largely as a result of these outbreaks, the Native Hawaiian population declined by 80 to 90 percent. By 1878, the native population had dropped to an estimated 40,000 to 50,000 people. At that time, the Native Hawaiians still comprised about 75 percent of Hawaii's total population. While those who are part-Hawaiian or who consider themselves to be Hawaiian, has increased steadily over the last century, there are fewer than 8,000 pure Hawaiians living today.[3]

Public Land Ownership

With a need to find alternatives to thrive and survive on the land, King Kamehameha III instituted a formal change in land tenure in 1848 that allowed private ownership of land for the first time on the islands. Lands controlled by the king were formally divided and commoners were able to claim kaleana, or traditional family lands. While much land was never claimed, foreigners were able to obtain large masses of land resulting in native land dispossession.

Economic Booms and Bust

Over the years, the Hawaii economy has been dominated by one or two industries that have ascended and then declined. The Sandalwood Trade economic cycle was short-lived and followed by American and European whalers that wintered in Hawaii. Many found work as farmers and cattle ranchers in the off-season and settled on land within the islands. As the trade economy was replaced by the cash economy, the farming and fishing economy also eroded.

Abundant sugar cane and pineapple fields led to a dominant new industry that required more than the local source of workers could provide. In 1875, Hawaii secured a trade treaty with the United States that resulted in vast profits for growers. Soon, laborers were recruited from China, Japan, Portugal, Korea and the Philippines, the first Japanese immigrants arrived in Hawaii in 1885.

Annexation by the US provided the markets needed to drive the sugar economy for most of the 20th century. The sugar industry dominated the local economy, with five firms (“Big Five”) controlling the planting, harvesting, processing and shipping of the sugar cane. These firms operated large plantations similar to small communities, providing workers with housing, stores, medical care and entertainment.

The firms employed hundreds of workers that worked grueling hours in the sugar cane fields, leading workers to organize strikes against the plantation owners in 1910-1920. These were the first efforts to organize unions, which became (and remains) a driving force in the State economy.

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[2] http://www.digitalhistory.uh.edu/database/article

[3] http://gohawaii.about.com/cs/culture/a/hawaiian_people.htm

The 1920s brought ocean liner travelers to the islands, and regular routes to Honolulu from the west coast of the continental United States spurred the growth of tourism. The 1930s kicked off the service industry economy in Hawaii with travelers coming to Hawaii to enjoy the beautiful beaches, luxury hotels and exotic culture of the Hawaiian Islands. With Hollywood movies showcasing the royal island experience, and radio programs airing Hawaiian music, Waikiki became a sought-after tourist destination.

After World War II, sugar remained the dominant industry within the economy, but the post-war years brought many changes within the labor movement, and the unions became a more prominent voice. The unions were able to obtain major victories in 1949 to improve wages and working conditions. In the 1950s the power of the plantation owners was broken by descendants of immigrant laborers that were born in a U.S. territory and given legal U.S. citizen rights. At that time, what was once the strongly supported Hawaii Republican Party (mainly by plantation owners), was voted out of office. The Democratic Party of Hawaii, supported widely by unions and World War II veterans, went on to dominate politics of that era.

US Annexation and Statehood

While the Provisional Government of Hawaii hoped for a quick annexation by the United States, they were only able to establish the Republic of Hawaii on July 4, 1894 with a government that followed the American model. It took the election of William McKinley as US President in 1896 for Hawaii's annexation to the United States to be discussed again. The previous president, Grover Cleveland, was a friend of Queen Lili‘uokalani, which had limited this opportunity. In June 1897, the United States agreed to a treaty of annexation with representatives of the Republic of Hawaii.[4] The treaty was never ratified by the United States Senate. Instead, despite the opposition of a majority of Native Hawaiians, the Newlands Resolution[5] was used to annex the Republic to the United States, and it became the Territory of Hawaii. In 1900, Hawaii was granted self-governance.

The bombing of Pearl Harbor on December 7, 1941 brought World War II to the forefront for Hawaiians, with significant repercussions. Hawaii became a critical military outpost for the United States as servicemen departed Hawaii on their way to and from battle, and it operated under martial law for the duration of the war. For decades, many Japanese families that settled in Hawaii were impacted by the war.

Hawaii was admitted to the union as the 50th state in March of 1959. Statehood brought many advantages to the islands, building a foundation for economic prosperity through quick modernization to keep up with the tourism industry and new access to federal funds.

Hawaii became the island tourist destination in the 1960s, spurring development and making Waikiki the high-rise village of the islands. While tourism evolved, the pineapple and sugar industries suffered from increased competition from overseas. The plantations slowly closed their doors through the 1970s and 1980s, and the last plantation shut down during the 1990s.

Despite the loss of the plantation lifestyle that was deeply rooted in the island culture, a changing landscape increased the unique cultural appreciation that heightened pride and awareness of traditional Hawaiian practices. The Hawaii State Constitutional Convention of 1978 even incorporated programs

[4] http://libweb.hawaii.edu/digicoll/annexation/pet-intro.html

[5] The Newlands Resolution was a joint resolution written by and named after United States Congressman Francis G. Newlands. It was an Act of Congress to annex the Republic of Hawaii and create the Territory of Hawaii.

such as the Office of Hawaiian Affairs to promote indigenous language and culture[6] and ensure that these traditions remained, in support of maintaining the long-lived traditions and 'Aloha Spirit' of the islands.

In the 1990s, several key state institutions and political leaders were embroiled in controversy. There was concern that programs designed to benefit Hawaiians and their culture would be unfunded and dismantled, leading to popular political dissatisfaction and the election of more Republicans in the late 1990s. After Republican Governor Linda Lingle served two terms (the only Republican Governor since Hawaii gained statehood), Democratic Governor Neil Abercrombie succeeded her in 2010. Governor Abercrombie has made it a priority to shift the State to a more sustainable foundation, including its tax policy.

## Summary

Based on this discussion and analysis, the following key themes will be important for the analysis of the Hawaii tax structure, both in how it has evolved and how it might change in the future:

- While the world is growing more interconnected, among the 50 states, Hawaii (along with Alaska) will always be relatively isolated. This can be both an advantage and a disadvantage from a tax policy perspective, but many of the considerations of how to shape a competitive tax structure that exist for mainland states are less compelling for Hawaii;
- There is a deeply-held respect for land – and public access and use – that differs from states where private ownership rights predominate. This can impact on land use, taxation of land and support for tax and expenditure policies related to preservation and sustainability.
- The influx over time of large worker populations to support major industries like sugar cane plantations led to worker and workplace reforms that still impact the State economy. Hawaii is generally perceived to be a pro-union state, and this shapes key expenditure and tax policies.
- There are a variety of factors that have tended to shape the State economy around one or two key industries. While it is possible that economic, demographic and other factors will alter this over time, tax policy should, at least, be structured to minimize adverse impacts on these key economic drivers.

[6] http://hawaii.gov/lrb/concon78/org.pdf

## Demographics

Population and Land Mass

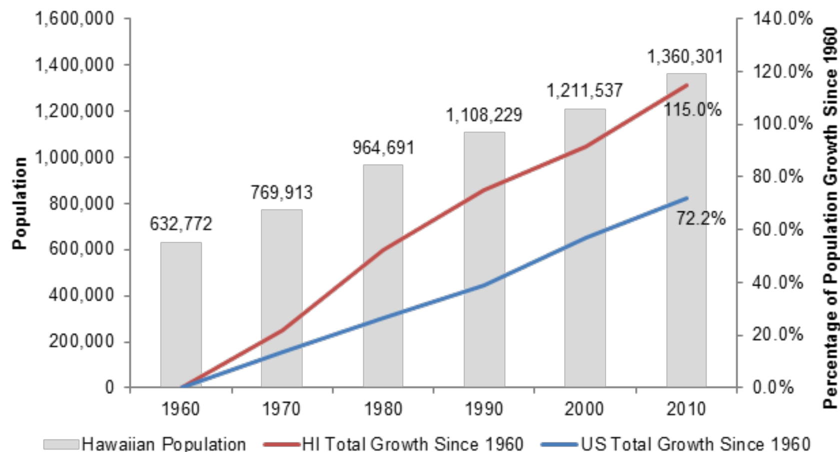
The State of Hawaii primarily consists of a group of six major islands: Kauai, Oahu, Molokai, Lanai, Maui and Hawaii. With a population of approximately 1.4 million residents, the State ranks 40th among the 50 states. Between 1960 and 2010, Hawaii more than doubled its population and grew at a much faster rate than the total US population.

**State Population Ranking - 2010**

| Rank | State | Population | Rank | State | Population |
|---|---|---|---|---|---|
| 1 | California | 37,253,956 | 26 | Kentucky | 4,339,367 |
| 2 | Texas | 25,145,561 | 27 | Oregon | 3,831,074 |
| 3 | New York | 19,378,102 | 28 | Oklahoma | 3,751,351 |
| 4 | Florida | 18,801,310 | 29 | Connecticut | 3,574,097 |
| 5 | Illinois | 12,830,632 | 30 | Iowa | 3,046,355 |
| 6 | Pennsylvania | 12,702,379 | 31 | Mississippi | 2,967,297 |
| 7 | Ohio | 11,536,504 | 32 | Arkansas | 2,915,918 |
| 8 | Michigan | 9,883,640 | 33 | Kansas | 2,853,118 |
| 9 | Georgia | 9,687,653 | 34 | Utah | 2,763,885 |
| 10 | North Carolina | 9,535,483 | 35 | Nevada | 2,700,551 |
| 11 | New Jersey | 8,791,894 | 36 | New Mexico | 2,059,179 |
| 12 | Virginia | 8,001,024 | 37 | West Virginia | 1,852,994 |
| 13 | Washington | 6,724,540 | 38 | Nebraska | 1,826,341 |
| 14 | Massachusetts | 6,547,629 | 39 | Idaho | 1,567,582 |
| 15 | Indiana | 6,483,802 | **40** | **Hawaii** | **1,360,301** |
| 16 | Arizona | 6,392,017 | 41 | Maine | 1,328,361 |
| 17 | Tennessee | 6,346,105 | 42 | New Hampshire | 1,316,470 |
| 18 | Missouri | 5,988,927 | 43 | Rhode Island | 1,052,567 |
| 19 | Maryland | 5,773,552 | 44 | Montana | 989,415 |
| 20 | Wisconsin | 5,686,986 | 45 | Delaware | 897,934 |
| 21 | Minnesota | 5,303,925 | 46 | South Dakota | 814,180 |
| 22 | Colorado | 5,029,196 | 47 | Alaska | 710,231 |
| 23 | Alabama | 4,779,736 | 48 | North Dakota | 672,591 |
| 24 | South Carolina | 4,625,364 | 49 | Vermont | 625,741 |
| 25 | Louisiana | 4,533,372 | 50 | Wyoming | 563,626 |

*Source: US Census Bureau – 2010 Decennial Census*

**Population Growth in Hawaii: 1960 – 2010**




*Source: US Census Bureau 1960-2010 Census Data*

The Hawaiian Islands have a total land area of 6,423 square miles. Hawaii is by far the largest of the islands,[7] while Oahu is by far the most populous.[8]

**Land Area and Population by Island**

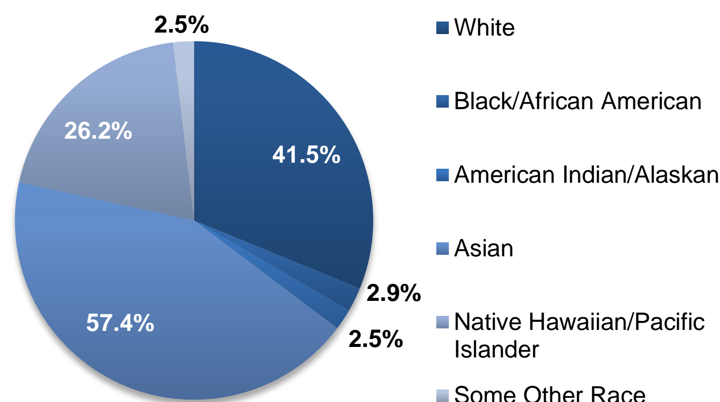
| Name of Island | Area (sq. mi.) | Population |
|---|---|---|
| Hawaii | 4,028.0 | 185,079 |
| Maui | 727.2 | 144,444 |
| Oahu | 596.7 | 953,207 |
| Kauai | 552.3 | 66,921 |
| Molokai | 260.0 | 7,345 |
| Lanai | 140.5 | 3,135 |
| Niihau | 69.5 | 170 |
| Kahoolawe | 44.6 | 0 |
| **TOTAL** | **5,822.1** | **1,360,301** |

A series of smaller islands, atolls and reefs located west of Niʻihau form the Northwestern Hawaiian Islands, or Hawaiian Leeward Islands. All of these are uninhabited. The State of Hawaii recognizes 137 islands in the Hawaii chain; this includes all minor islands and islets offshore of the main islands on the map above.

Race and Ethnicity

Over the last 200 years, Hawaii has become home to a very diverse set of ethnic groups, making it one of the most racially diverse places in the world. The largest super-ethnic groupings of race are the East Asians (largest group are Japanese, Chinese, Korean), then Polynesians, then Southeast Asians (largest group are the Filipinos), then Europeans, then Africans, then Native Americans. Native Hawaiians historically made up the ethnic majority until annexation, when people of Eurasian, American (Amerindian) and African descent began migrating to Hawaii. Below is the latest ethnic profile of these consolidated general population characteristics:

**Hawaii General Population Characteristics**




*Source: US Census Bureau 2010 Profile of General Population Characteristics*

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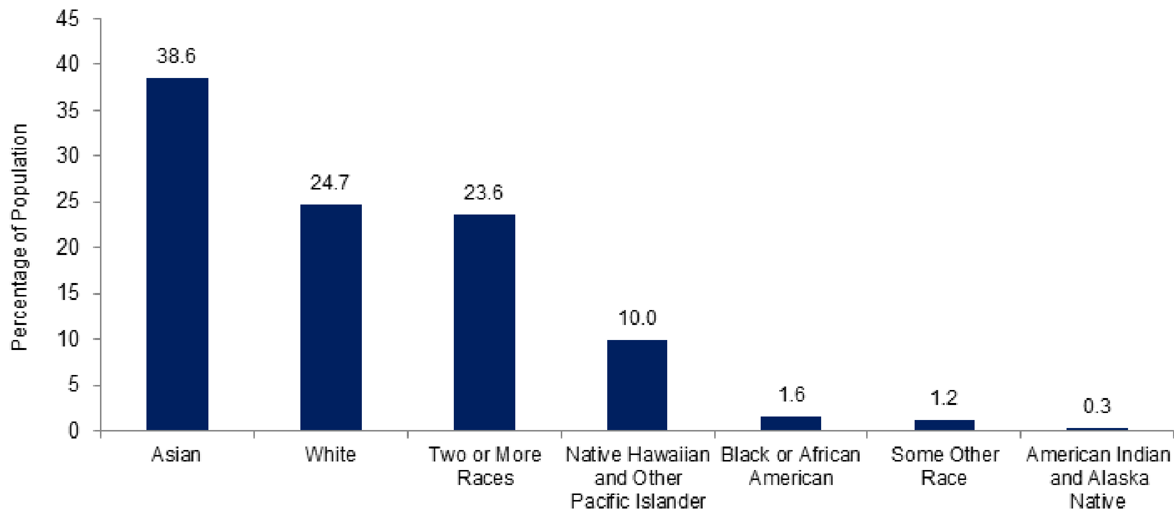
[7] http://geonames.usgs.gov

[8] As of 2010 U.S. Census data.

Hawaii is among the most racially diverse states, with the greatest percentage of residents in any state identifying as 'Asian' (38.6 percent) and 'two or more races' (23.6 percent). In addition, Hawaii's percentage of citizens who identify as 'white' is the lowest among the 50 states at 24.7 percent. This make-up of multi-ethnic background and identification is greater than in any other state.

**Ethnic Diversity of Hawaii's Population – 2010**




*Source: US Census Bureau – 2010 Decennial Census*

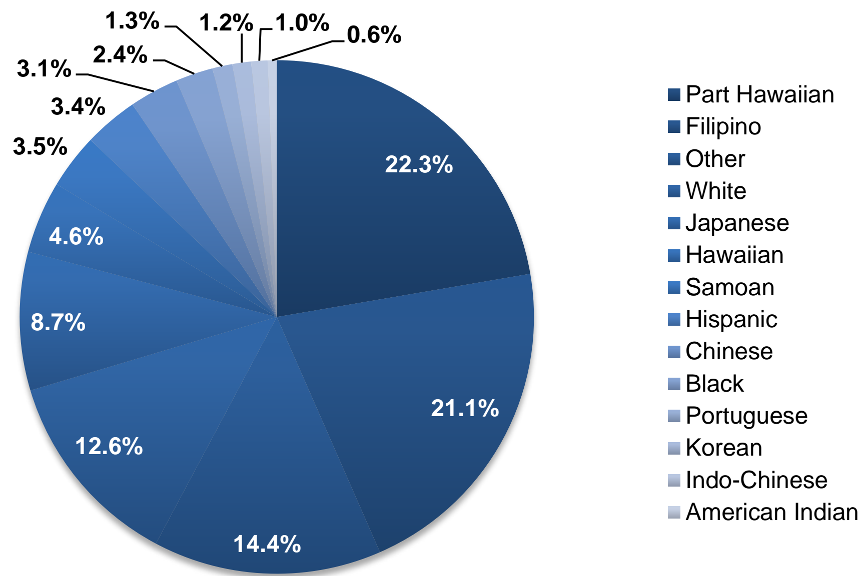
The State Office of Hawaiian Affairs spends millions of dollars each year on programs to benefit Native Hawaiians, promoting the Hawaiian language and pushing for federal recognition of Hawaiians. Most of the funding comes from revenue generated by leasing out land to farmers, developers and harbor users that once belonged to the Hawaiian kingdom.[9]

The State's diversity is also reflected in its public school enrollment. Hawaii's public schools enroll over 178,000 students[10] in grades K-12. A break-down of Hawaii's students by ethnicity can be found below:

[9] Per http://www.oha.org/about/history the establishment of the Office of Hawaiian Affairs set up a public trust as a result of the 1978 Constitutional Convention with a mandate to better the conditions of both Native Hawaiians and the Hawaiian community in general. OHA was to be funded with a pro rata share of revenues from state lands designated as "ceded".

[10] Under Hawaii's Compulsory Attendance Law, children and youth between the ages of six and eighteen years must attend school unless they have an approved exception.

**K – 12 Student Population by Ethnicity**

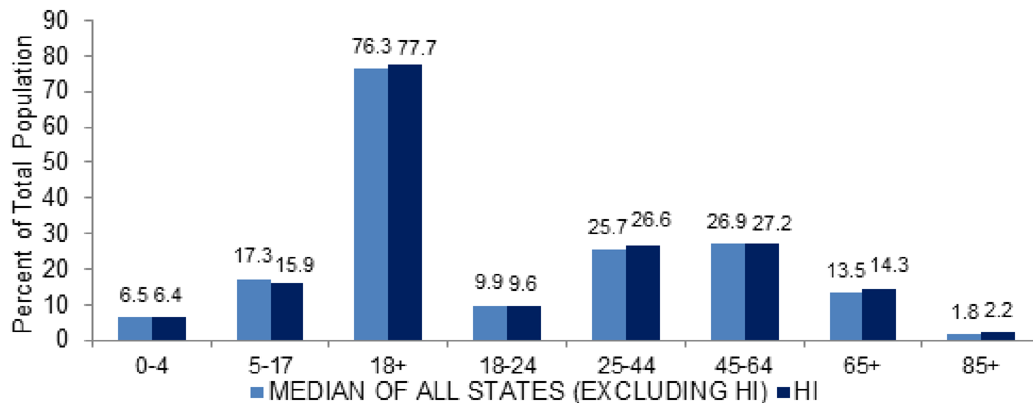



*Source: Hawaii State Department of Education, as of 8/31/09*

Age of Population

Hawaii's population is older than the United States as a whole. Hawaii ranks 10th of the 50 states in the percentage of population ages 18 and over, and 12th in the percentage of population ages 65 and over. As a result, Hawaii's population ages 24 and under comprises a smaller percentage of its total population. Hawaii ranks 38th of the 50 states in percentage of population ages 18-24 and 44th out of the 50 states in percentage of population ages 5-17.

**Age of Population: State Medians**




*Source: US Census Bureau – 2010 Decennial Census*

Educational Attainment

Compared to the 50 states, Hawaii's population is generally well-educated. Hawaii ranks 9th in the percentage of population with a high school diploma or higher (90.2 percent) and 16th in percentage of population with a bachelor's degree or higher (29.2 percent).

While Hawaii's median earnings ranks 16th among states, it is about average for those with bachelor's or advanced degrees. Comparatively, Hawaii has a relatively low percentage of its population who have not achieved at least a high school diploma (9.9 percent) and ranks above average for median earnings for this cohort.

**Educational Attainment**

| | Less than High School Diploma | High School Diploma | Some College (no degree) / Assoc. Degree | Bachelor's Degree | Graduate or Professional Degree |
|---|---|---|---|---|---|
| Hawaii | 9.9% | 28.9% | 32.0% | 19.5% | 9.7% |
| Rank | 41 | 27 | 15 | 12 | 21 |
| Median Earnings | $20,275 | $28,993 | $34,694 | $45,269 | $61,052 |
| Rank | 17 | 13 | 14 | 23 | 22 |

*Source: US Census Bureau 2010 ACS 3-year Estimates*

Income

On typical measures, Hawaii is a relatively high income state. As shown in the following table, the State has an above average per capita income, ranking 16th overall among the states. The State's per capita income is over $3,000 greater than the median of all states and almost $1,500 greater than the per capita income of the US as a whole.

**Per Capita Income**

| | Per Capita Income |
|---|---|
| Hawaii | $28,417 |
| Rank Among States | 16 |
| Variance from US ($) | $1,475 |
| Variance from US (%) | 5.5% |

*Source: US Census Bureau 2010 ACS 3-year Estimates*

Hawaii has among the smallest percentage of its population living in poverty (10.0 percent), ranking 45th out of the 50 states. Similarly, the percentage of Hawaii residents under age 18 and age 65 and above who live in poverty is among the lowest of the 50 states. The only poverty metric where Hawaii trails the majority of states is percentage of its population in poverty who have a bachelor's degree or higher.

**Percent Living in Poverty**

| | Total Population | Children under 18 | Seniors 65 and over |
|---|---|---|---|
| Hawaii | 10.0% | 12.7% | 6.9% |
| Rank Among States | 45 | 47 | 46 |
| US (%) | 14.4% | 20.1% | 9.4% |

*Source: US Census Bureau 2010 ACS 3-year Estimates*

Hawaii's median household income ($66,201) ranks as the 5th highest among all states. The state's median household income is over $17,000 greater than the median among the 50 states.[11]

**Median Household Income**

| | Median Household Income |
|---|---|
| Hawaii | $66,201 |
| Rank Among States | 5 |
| Variance from US ($) | $14,979 |
| Variance from US (%) | 29.2% |

*Source: US Census Bureau 2010 ACS 3-year Estimates*

[11] US Census Bureau 2010 ACS 3-year Estimates.

## Economy

On several key demographic measures, including levels of income and educational attainment, Hawaii scores high relative to all states. These generally translate into a strong state economy. However, some unique State aspects (such as location and distance from mainland supplier and customer markets) may act as a headwind to economic progress.

Economic Diversification

The tourism industry has been a key factor for the State economy. On one measure, employment by industry, the State has a far greater concentration of employment in the leisure and hospitality services category than the rest of the nation. The following table lists employment by industry by location quotient, which is an industry concentration measure of an industry's share of local employment compared to an industry's share of national employment. For these, a location quotient of 1.15 would mean the state is 15 percent more reliant on that industry's employment than is the nation as a whole; a location quotient of 0.85 would mean the state is 15 percent less reliant on that industry's employment than is the nation as a whole:[12]

**Employment by Industry**

| Employment Industry | Location Quotient |
|---|---|
| Manufacturing | 0.24 |
| Information | 0.67 |
| Financial Activities | 0.80 |
| Professional and Business Services | 0.93 |
| Education and Health Services | 0.83 |
| Leisure and Hospitality Services | 1.74 |
| Other Services | 1.06 |
| Government | 1.27 |

While tourism numbers are significant, it may not be an economic engine (given, for example, its relatively low average wage levels and contribution to GDP) that can individually drive the state economy to new heights in the years to come. There are also real concerns about capacity constraints (there are only so many planes that can arrive and depart in a day, and only so many available hotel rooms).

Given these concerns, economic diversification is an important issue, and tax policy can have an impact on it. While there are a number of ways to characterize the diversification of a state economy, at least a couple of methods suggest that there is room for improvement in these measures for the State economy.[13]

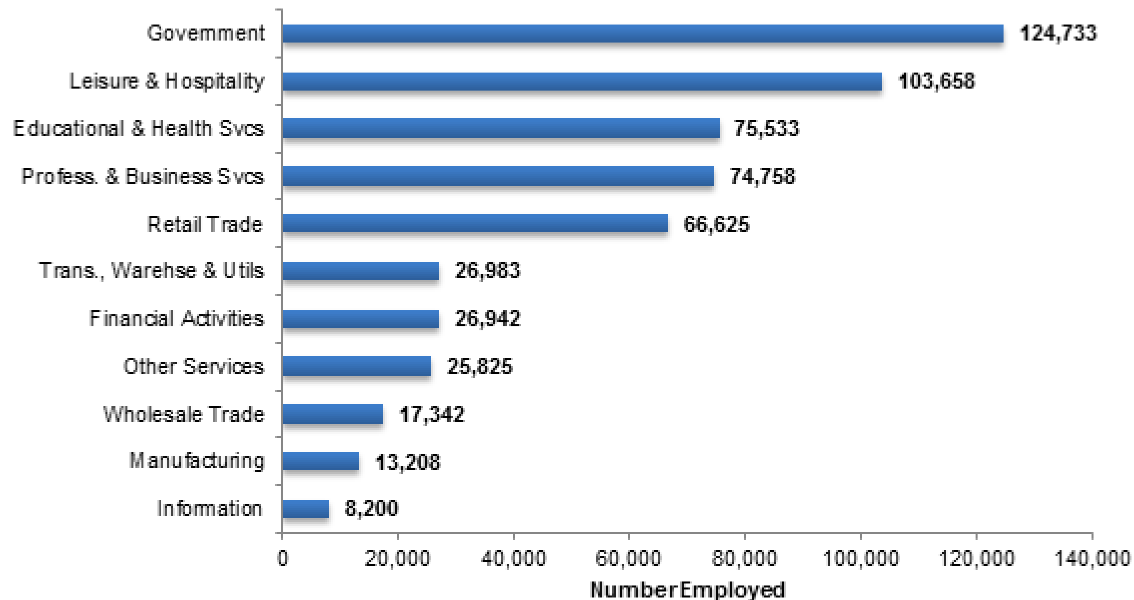
[12] Data from the Federal Deposit Insurance Corporation (FDIC) Regional Economic Conditions (RECON) based on data from the Bureau of Labor Statistics; created 7/24/12 and accessed at: http://www2.fdic.gov/recon/index.asp. According to the FDIC, 'Industry breakouts shown are based on available data only and may exclude certain industries for which LQs are significantly different from 1.0.'

[13] The Research and Economic Analysis Division of the Hawaii Department of Business, Economic Development and Tourism authored a February 2008 report, "Measuring Economic Diversification in Hawaii." This examined economic diversification from a variety of perspectives. Using two common methods, the Hawaii economy ranked in the bottom quintile of states in 1990, 2000 and 2006. At the same time, the study did not find support for a positive association between levels of economic diversity and economic stability and growth. See pages 25-26 and 31-33.

Federal, State and Local Government

As noted in the previous table, government employment in Hawaii is higher than for the nation as a whole, which is impacted by the number of federal workers (largely military personnel) located in the State. The following shows employment by industry for 2011:

**Hawaii Year-end Employment by Industry, 2011 (Not Seasonally Adjusted)**




*Source: Bureau of Economic Analysis (Haver Analytics)*

Since World War II, Hawaii has been a key US military location, and its impact on the State economy is profound. In 2009, there were over 75,473 active, reserve and civilian defense personnel[14] and 16,088 military retirees residing in the State.[15] The earnings of these personnel totaled $4.7 billion per year ($5.0 billion when adding retirement benefits paid to retirees).[16] Besides military personnel, defense procurements where Hawaii was the principal place of performance averaged $2.3 billion annually between 2007-2009.[17] As the following demonstrates, Hawaii's per capita federal spending is among the highest in the nation – ranking fifth among the states in FFY2010:

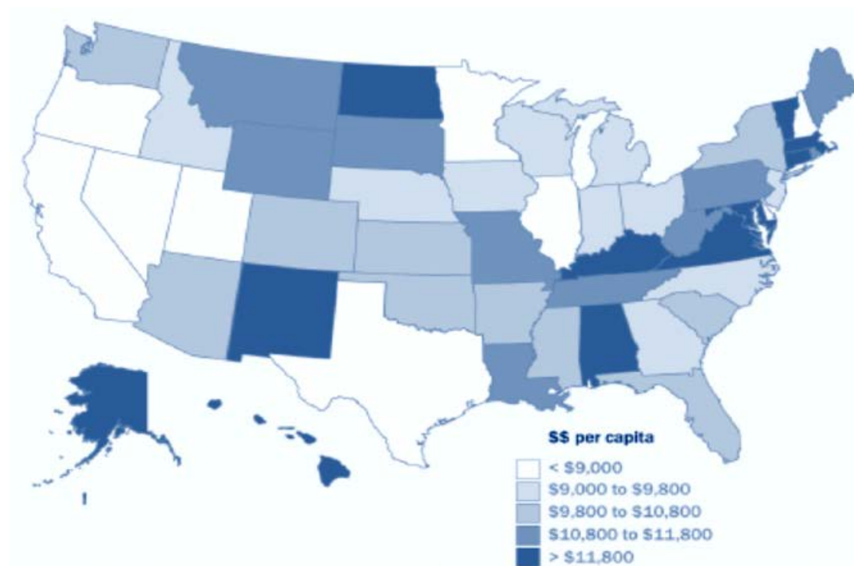
[14] Technical Report, "*How Much Does Military Spending Add to Hawaii's Economy*?", RAND National Defense Research Institute, p.7.

[15] State of Hawaii, "State of Hawaii Data Book", 2009.

[16] Technical Report, "*How Much Does Military Spending Add to Hawaii's Economy*?", RAND National Defense Research Institute, p.5.

[17] Ibid, p.14.

**Per Capita Federal Spending, FFY2010**




*Source: Consolidated Federal Funds Report, US Bureau of the Census*

Potential reductions in federal funding resulting from the federal Budget Control Act of 2011 (BCA) could be critical for the State. As a result, it is likely that Hawaii would be more vulnerable to attempts to deal with the nation's deficit than other states.

A recent analysis forecasted possible reductions in federal spending based on the BCA funding sequester requirements. While the spending reductions mandated by the BCA are significant, they are not uniform. For example, almost three-fourths of grant programs are subject to sequester, but they comprise less than 20 percent of grant funding. Several of the largest state grant programs for states, including Medicaid, Temporary Assistance for Needy Families and Federal Aid for Highways, are exempt from the sequester. As a result, the hypothetical reduction for the State of Hawaii based on the covered grant programs would be approximately $20.1 million for FY2013 but would be offset by estimated increases for exempt programs of approximately $35.2 million.[18] As it relates to Hawaii, the defense sequester could be more damaging. According to the analysis, the potential impact for Hawaii of a defense sequester could be approximately $965.6 million.[19]

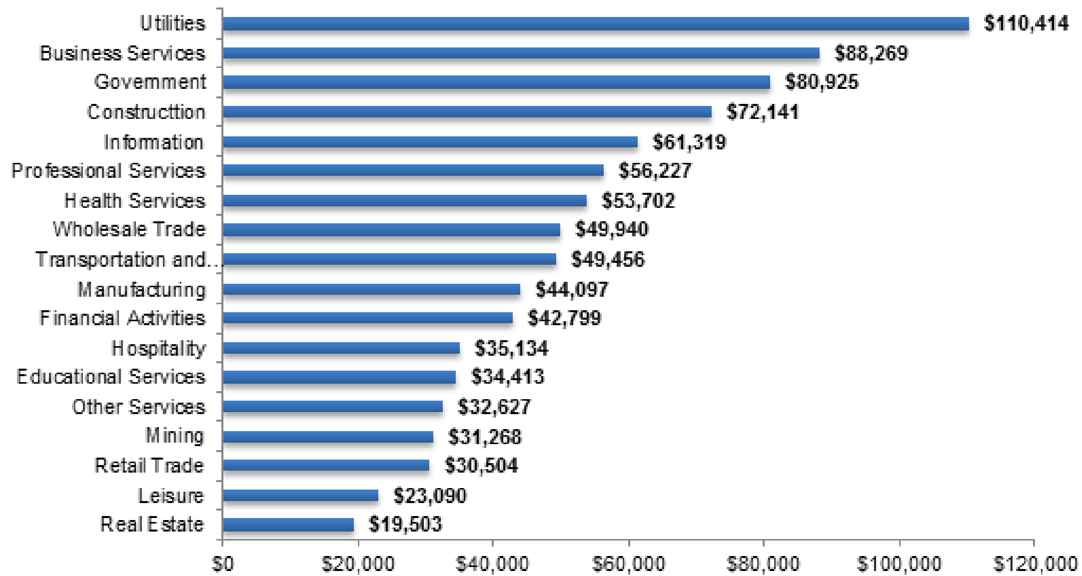
Key Industries for Earnings and Output

While employment numbers are an important measure, it is also useful to examine the typical earnings within the industry. By this measure, the hospitality and leisure industries do not fare as well:

[18] "Potential Impact of BCA Sequester," Federal Funds Information for States, Volume 12, No. 2, June 2012, p. 1-4.

[19] Ibid., p. 7

**Hawaii Average Annual Earnings per Employee by Industry, 2010 (Not Seasonally Adjusted)**




*Source: Bureau of Economic Analysis (Haver Analytics)*

Another common method for assessing an industry's importance to the state economy is by analysis of its share of state Gross Domestic Product. Gross Domestic Product (GDP) is the market value of all the goods and services produced by labor and property located in a state for the period in question. The following lists these components by share of the Hawaii economy in 2011. It should be noted that the government category includes federal as well as state and local government, both civilian and military.

**Employment Industry by Share of GDP, State of Hawaii**

| Industry Code | Employment Industry | 2011 | Percent |
|---|---|---|---|
| 101 | All Industry Total | 66,991 | |
| 178 | Government | 16,548 | 24.7% |
| 155 | Real Estate/Rental/Leasing | 10,940 | 16.3% |
| 174 | Accommodation/Food Service | 5,416 | 8.1% |
| 135 | Retail Trade | 4,649 | 6.9% |
| 167 | Health Care and Social Assistance | 4,499 | 6.7% |
| 111 | Construction | 3,738 | 5.6% |
| 158 | Professional, Scientific and Technical Services | 3,250 | 4.9% |
| 136 | Transportation and Warehousing | 2,611 | 3.9% |
| 150 | Finance and Insurance | 2,424 | 3.6% |
| 163 | Administrative and Waste Management Services | 2,131 | 3.2% |
| 134 | Wholesale Trade | 1,986 | 3.0% |
| 177 | Other Services (Ex Gov't) | 1,735 | 2.6% |
| 110 | Utilities | 1,557 | 2.3% |
| 145 | Information | 1,547 | 2.3% |
| 112 | Manufacturing | 1,368 | 2.0% |
| 162 | Management of Companies and Enterprises | 743 | 1.1% |

| Industry Code | Employment Industry | 2011 | Percent |
|---|---|---|---|
| Industry Code | Employment Industry | 2011 | Percent |
| 166 | Educational Services | 731 | 1.1% |
| 171 | Arts, Entertainment and Recreation | 651 | 1.0% |
| 103 | Agriculture, Forestry, Fishing and Hunting | 452 | 0.7% |
| 106 | Mining | 15 | 0.0% |

*Source: Bureau of Economic Analysis (Haver Analytics)*

By contrast, the GDP for the US as a whole has a much higher concentration of manufacturing. While government is still the largest sector, the difference between it and other sectors is not nearly as large:

**US Employment Industry by Share of GDP**

| Industry Code | Employment Industry | 2011 | Percent |
|---|---|---|---|
| 101 | All Industry Total | 14,981,020 | |
| 178 | Government | 1,883,655 | 12.6% |
| 112 | Manufacturing | 1,837,031 | 12.3% |
| 155 | Real Estate/Rental/Leasing | 1,751,682 | 11.7% |
| 150 | Finance and Insurance | 1,256,158 | 8.4% |
| 158 | Professional, Scientific and Technical Services | 1,171,145 | 7.8% |
| 167 | Healthcare and Social Assistance | 1,151,187 | 7.7% |
| 135 | Retail Trade | 916,951 | 6.1% |
| 134 | Wholesale Trade | 844,928 | 5.6% |
| 145 | Information | 662,324 | 4.4% |
| 111 | Construction | 520,340 | 3.5% |
| 163 | Administrative and Waste Management Services | 444,313 | 3.0% |
| 174 | Accommodation and Food Services | 441,647 | 2.9% |
| 136 | Transportation and Warehousing | 418,807 | 2.8% |
| 177 | Other Services (Ex Government) | 368,747 | 2.5% |
| 106 | Mining | 287,584 | 1.9% |
| 162 | Management of Companies and Enterprises | 282,487 | 1.9% |
| 110 | Utilities | 250,825 | 1.7% |
| 103 | Agriculture, Forestry, Fishing and Hunting | 177,795 | 1.2% |
| 166 | Educational Services | 169,315 | 1.1% |
| 171 | Arts, Entertainment and Recreation | 144,058 | 1.0% |

*Source: Bureau of Economic Analysis (Haver Analytics)*

## Summary

The benchmarking data supports the general view that Hawaii is an outlier on several common methods for state comparison. The following should be taken into consideration in the following analysis and discussion of revenue structure:

- While not a large state in terms of size or population, Hawaii has exhibited much stronger population growth than the nation as a whole.
- Hawaii's population is older than the nation as a whole, and this trend is likely to continue.
- The State has a high median household income and median home value – indicators of income and wealth.
- Tourism is a key employer in the State, but the jobs are generally not high paying.
- A key driver, in terms of GDP and earnings, is government – both federal and state/local.
- Manufacturing is a much smaller share of the State's GFP than the nation as a whole.

The State's economy shows strengths and weaknesses, both in terms of its composition and unique characteristics. It is likely that tourism will continue to be a key source of jobs for the State, but its contribution to overall economic output is mixed. Government is the predominant sector in terms of output (and generally well paying), but federal and state budget cuts are a major concern. The State has made a variety of investments to spur other parts of the economy, and it is an open question whether the State can achieve a greater level of diversification – which it is mostly lacking at present.

# Current Revenue Structure

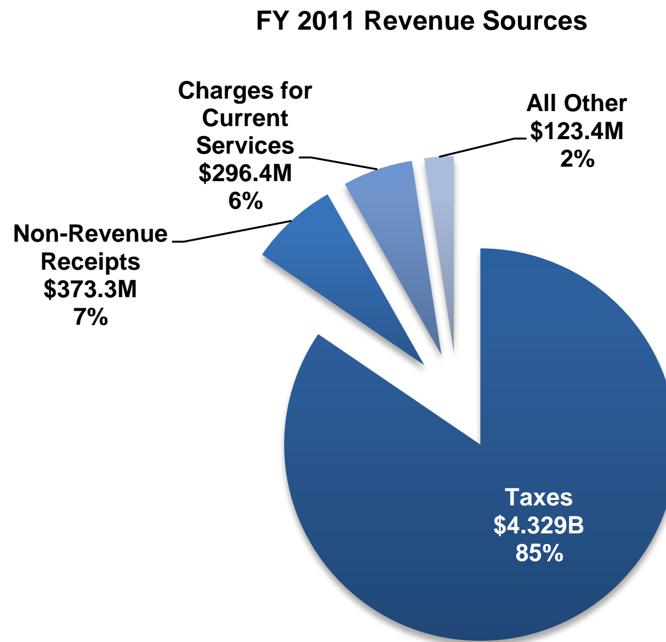
# Current Revenue Structure

## General Characteristics

As in most states, Hawaii derives the great majority of its revenue from taxes. Other sources, including charges for services and non-revenue receipts (e.g. sales of real property and investments; general obligation and revenue bond proceeds; deposits, gifts, donations, private grants; transfers from other funds; etc.), provide the remaining revenue that funds operations and services.

In Fiscal Year (FY) 2011, Hawaii collected nearly $5.3 billion in revenue.[20] Of that, 85 percent ($4.3 billion) was tax revenue. The remaining 15 percent was from non-revenue receipts (7 percent), charges for current services (6 percent) and all other sources (2 percent).[21]

**FY 2011 Revenue Sources**




The state's largest revenue source is the General Excise Tax (GET). In FY 2011, it accounted for $2.5 billion of total revenue collected (47.1 percent). The Individual Income Tax (IIT) is the second largest revenue source for Hawaii, generating $1.2 billion in FY 2011 (23.5 percent of total revenue). Taken together, the GET and the IIT accounted for 70.7 percent of total revenues. The remaining 29.3 percent ($1.6 billion) came from many smaller sources.[22]

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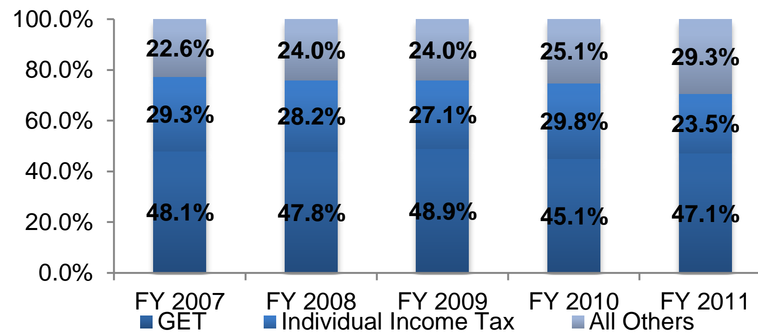
[20] All funds - includes $199,009,525 in Honolulu County Surcharge receipts.

[21] All specific, historical tax performance data were sourced from Council of Revenue data. All aggregate (all fund) tax data were sourced from the Department of Taxation (DOTAX).

[22] All or portions of several taxes are non-General Fund revenue sources. Individual taxes are detailed in greater depth later in this Chapter.




The following table details the State's tax revenue sources from FY 2007 to FY 2011:

**Hawaii Tax Revenues FY 2007 through FY 2011 (All Funds)**

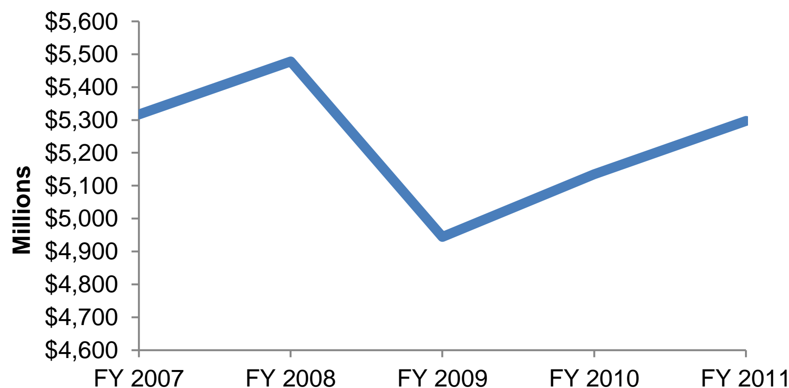
| SOURCE OF REVENUE | FY2007 | FY2008 | FY2009 | FY2010 | FY2011 |
|---|---|---|---|---|---|
| Banks/Financial Corp. 1/ | 18,598,738 | 20,212,121 | 28,075,165 | 20,666,000 | 33,677,284 |
| Conveyance 1/ | 46,886,684 | 43,421,225 | 23,772,408 | 40,633,938 | 47,905,995 |
| Employment Sec. Contri. | 134,611,668 | 92,279,234 | 49,071,105 | 82,016,796 | 190,511,191 |
| Fuel | 169,711,869 | 169,926,559 | 165,717,476 | 155,703,005 | 195,336,475 |
| GE License/Fees | 484,039 | 486,596 | 456,584 | 448,548 | 478,623 |
| General Excise & Use 2/ | 2,555,761,657 | 2,618,786,948 | 2,417,579,853 | 2,316,433,716 | 2,495,807,283 |
| Honolulu County Surcharge 3/ | 53,804,870 | 187,903,947 | 178,728,585 | 175,061,467 | 199,009,525 |
| Income-Corp.: | | | | | |
| Decl. of Est. Taxes | 138,769,224 | 131,461,936 | 97,456,250 | 96,854,697 | 109,860,212 |
| Payment W/Returns | 22,653,038 | 21,851,421 | 23,307,117 | 18,910,524 | 13,981,865 |
| Refunds | (79,588,032) | (68,232,077) | (67,241,079) | (56,579,706) | (89,268,832) |
| *Income-Ind.: 1/* | | | | | |
| Decl. of Est. Taxes | 428,754,210 | 430,197,009 | 262,539,789 | 257,329,246 | 301,476,121 |
| Payment W/Returns | 229,963,690 | 179,208,886 | 135,354,155 | 157,826,746 | 137,753,689 |
| WH Tax on Wages | 1,279,648,612 | 1,370,853,852 | 1,398,638,764 | 1,355,036,369 | 1,418,156,630 |
| Refunds | (378,080,874) | (435,424,466) | (457,477,181) | (242,082,712) | (610,233,543) |
| Inheritance/Estate | 594,629 | 164,149 | 274,164 | 299 | 6,899,215 |
| Insurance Fees | 0 | 0 | 0 | 292,567 | 4,869,047 |
| Insurance Premiums | 92,195,853 | 95,742,388 | 93,720,323 | 104,721,367 | 140,456,112 |
| Liquor and Permits | 46,034,406 | 45,620,195 | 47,242,269 | 44,073,827 | 48,053,576 |
| Mtr. Vehicle Tax/Fees 4/ | 112,411,967 | 112,447,975 | 101,991,063 | 102,319,117 | 106,165,508 |
| Public Service Co. | 124,017,331 | 127,481,081 | 126,069,236 | 157,660,917 | 117,940,356 |
| Tobacco and Licenses 1/ | 94,387,367 | 104,624,254 | 108,163,771 | 123,488,876 | 143,292,924 |
| Trans. Accomm./Time Share Occup. Fees | 11,091 | 9,695 | 7,855 | 8,600 | 9,460 |
| Trans. Accomm. Tax/Time Share Occup. Tax 1/ | 224,931,245 | 229,377,993 | 210,613,996 | 224,242,539 | 284,462,891 |
| All Others 5/ | 29,727 | 89,614 | 70,935 | 33,739 | 460,026 |
| **TOTAL** | **5,398,427,239** | **5,563,571,817** | **4,997,654,893** | **5,194,285,994** | **5,331,634,878** |

1/ Gross collection - does not reflect allocation to Special Funds.
2/ May also contain some revenue from the Honolulu County Surcharge.
3/ Allocated as of June 30, 2008. Taxpayers whose businesses are located outside of Oahu, but have business activities on Oahu may be subject to Honolulu County Surcharge tax.
4/ Includes State Motor Vehicle Weight Tax, Registration Fees, Commercial Driver's License, Periodic Motor Vehicle Inspection Fees, Rental Vehicle Registration Fees and Rental Vehicle Surcharge Tax.
5/ Includes Fuel Retail Dealer Permits and Penalty & Interest - Fuel.

Since FY 2007, Hawaii's tax revenues have experienced both periods of year-to-year growth (FY 2008; FY 2010; FY 2011) and year-to-year decline (FY 2009). Like many states, Hawaii experienced a decrease in tax revenues in FY 2009 as the effects of the recession reduced consumer and business spending. Hawaii's GET revenue declined 7.7 percent in FY 2009. Additionally, the State's tourism industry experienced decreased consumer spending, which impacted certain sources, such as the State's TAT – with FY 2009 receipts 8.2 percent below the FY 2008 level.

Hawaii has experienced growth in its tax revenues since the decline in FY 2009. Growth in FY 2010 was 3.9 percent, and growth in FY 2011 was 3.2 percent. As with many states during this timeframe,[23] legislated changes helped fuel that growth. The State made several temporary revenue adjustments to taxes to assist in stabilizing revenues.[24] Even with the temporary adjustments, the State's overall tax revenues in FY 2011 were slightly less than in FY 2007.

**Hawaii Tax Revenues (All Funds)**
**FY 2007 – FY 2011**



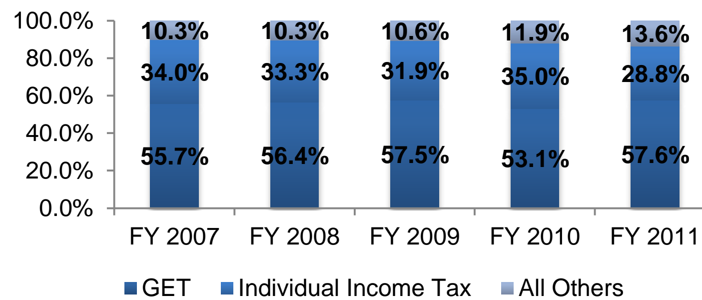

*Note: Does not include revenues from Honolulu County Surcharge.*

From FY 2007 to FY 2011, the State benefited from double digit compound annual growth rates in certain taxes, including the taxes on banks and other financial corporations (16.0 percent), insurance premiums (11.1 percent) and tobacco/cigarettes (11.0 percent). Others – such as the fuel tax, liquor tax and TAT – exhibited more moderate growth rates. The two largest revenue-generating taxes, the GET and the IIT, experienced negative annual growth rates of -0.6 percent and -5.4 percent respectively. These were the primary reason the State experienced a reduction in revenues available to fund operations and services.

[23]"State Tax Actions 2011, Special Fiscal Report," National Conference of State Legislatures, February 2012, p.3. The report notes that state actions to raise revenue (mostly via tax increases) for all states totaled $3.8 billion in 2008, $28.6 billion in 2009 and an additional $3.0 billion in 2010.

[24] Legislative changes to various taxes discussed in more detail in this Chapter.

**Hawaii General Fund Tax Revenue**
**FY 2007 – FY 2011**




**2011 General Fund Tax Revenue**

| Tax | Revenue | % of Total |
|---|---|---|
| General Excise and Use Tax | 2,495,807,000 | 57.6% |
| Individual Income Tax | 1,246,672,000 | 28.8% |
| Corporate Income Tax | 34,573,000 | 0.8% |
| Public Service Company Tax | 117,940,000 | 2.7% |
| Tax on Insurance Premiums | 140,456,000 | 3.2% |
| Cigarette and Tobacco Tax | 106,137,000 | 2.5% |
| Liquor Tax | 48,054,000 | 1.1% |
| Tax on Banks and Other Financial Corps. | 31,677,000 | 0.7% |
| Inheritance and Estate Tax | 6,899,000 | 0.2% |
| Conveyance Tax | 21,527,000 | 0.5% |
| Miscellaneous Taxes | 19,812,000 | 0.5% |
| Transient Accommodations Tax | 59,757,000 | 1.4% |
| **TOTAL** | **4,329,311,000** | **100.0%** |

Hawaii's most notable General Fund taxes are discussed below and listed in order of magnitude (percentage of total FY 2011 General Fund revenue).

General Excise Tax (GET)
*FY 2011: $2,495,807,000 (57.6 percent of General Fund revenue)*

*Overview*
The GET is a business privilege tax on gross proceeds of sales or income. The rate is 0.5 percent on wholesaling, wholesale services, producing and sugar processing and pineapple canning. All other activities are taxed at 4.0 percent, except insurance commissions (0.15 percent). The City/County of Honolulu levies an additional surcharge of 0.5 percent.[25] The State's General Fund receives 10.0 percent of the City/County surcharge revenue.

The GET is complemented by a use tax levied on tangible personal property imported or purchased from unlicensed sellers for use in the State. The purchase price or value of the tangible personal property is the base for calculating the tax. The use tax rate is 0.5 percent if for resale and 4.0 percent for use or consumption. The tax also applies to services or contracting performed by an unlicensed seller at a point outside the State and imported or purchased for use in the State. The City/County of Honolulu levies an additional surcharge of 0.5 percent.[26]

[25] Hawaii Department of Taxation, "Outline of the Hawaii Tax System as of July 1, 2011."

[26] Ibid.

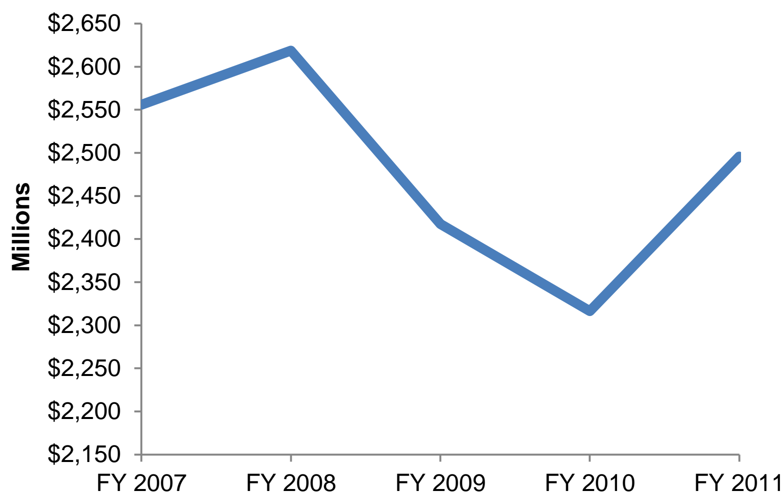
| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **General Excise Tax** | 4.0% | Retail sale of goods, sale of services, contracting, commissions, rent, interest, and other activities. Utilities exempt. | *State General Fund.* |
| | 0.5% | Wholesaling, selected intermediary services, manufacturing, producing, real property subleasing, canning and blind, deaf or totally disabled persons | |
| | 0.15% | Insurance solicitors. | |
| | Exempted | Gross income from contracting and other services exported out of the state, exports of tangible personal property, | |
| | 0.5% | Resold services and subleases, motor carriers, common carriers by water, and contract carriers formerly taxed under the public service company tax | |

| | | | |
|---|---|---|---|
| **General Excise Tax (Use)** | 4.0% | On tangible personal property imported or purchased from an unlicensed seller. Tax on value of services performed by unlicensed sellers at a point outside the state and imported or purchased for use in the state | *State General Fund* |
| | 0.5% | On goods imported for resale at retail | |

*Recent Experience*

GET revenue declined during the period consistent with the national recession (late 2007 to mid-2009). In FY 2009, GET revenue declined by 7.7 percent and further decreased by 4.2 percent in FY 2010. GET revenue increased by 7.7 percent from FY 2010 to FY 2011, but remained 2.3 percent below its FY 2007 level and 4.7 percent below the peak level reached in FY 2008.

**General Excise Tax (General Fund Revenue)**
**FY 2007 – FY 2011**




*Note: May also contain some revenue from Honolulu County Surcharge.*

*Legislative Actions*

Effective for FY 2012, GET exemptions were suspended for certain entities and activities (mostly business to business transactions) – which subjected them to the 4.0 percent rate.[27] Suspended exemptions include:[28]

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[27] Act 105, SLH 2011.

- Amounts deducted from gross income received by a contractor
- Gross receipts of home service providers acting as service carriers providing mobile telecommunications services to other home service providers
- Gross income of nonprofit organizations from certain conventions, conferences, trade show exhibits or display spaces
- Amounts received from the sale of liquor, cigarettes and tobacco products and agricultural, meat, or fish products to persons or common carriers engaged in interstate or foreign commerce
- Amounts received as high technology research and development grants
- Gross proceeds from the sale of items to the federal government:
  - Liquor
  - Tobacco products and cigarettes
  - Other tangible personal property
- Leasing or renting aircraft or keeping aircraft solely for leasing or renting for commercial transportation of passengers and goods or the acquisition or importation of aircraft or aircraft engines
- Use or sale of liquor, cigarette and tobacco products imported into the State and sold to any person or common carrier for consumption out of State by person, crew, or passengers on shippers vessels or airplanes

The temporary suspension was effective on July 1, 2011 and sunsets on June 30, 2013.

*Projected Outlook*

GET revenue is projected to grow steadily through FY 2018, with a one-time smaller growth assumption in FY 2014 as special exemptions resume. The average annual growth rate through FY 2018 is projected to be 5.59 percent. Thereafter, the annual average growth rate through FY 2025 is projected to be 5.46 percent.

Individual Income Tax

*FY 2011: $1,246,672,000 (28.8 percent of General Fund revenue)*

*Overview*

Hawaii's second largest revenue generating tax, it is levied on individual (or those filing jointly) income. Taxpayers may claim a standard deduction, with the amount subject to marital status and the presence of dependents – currently $4,000 for married filing joint or surviving spouse with dependent child, $2,000 for single or married filing single and $2,920 for head of household. The personal exemption amount is $1,040 per qualified exemption. Hawaii has 12 tax brackets based upon single/joint income with a corresponding specific rate levied for each income bracket, which is shown in the following table.

[28] A complete list of suspended exemptions is available in Appendix B. The State originally projected the exemptions would generate approximately $120 million in tax revenue over the two years, but that has been subsequently revised downward to approximately $70 million due to limitations on the available data and substantial scope for taxpayers to avoid the tax increase.

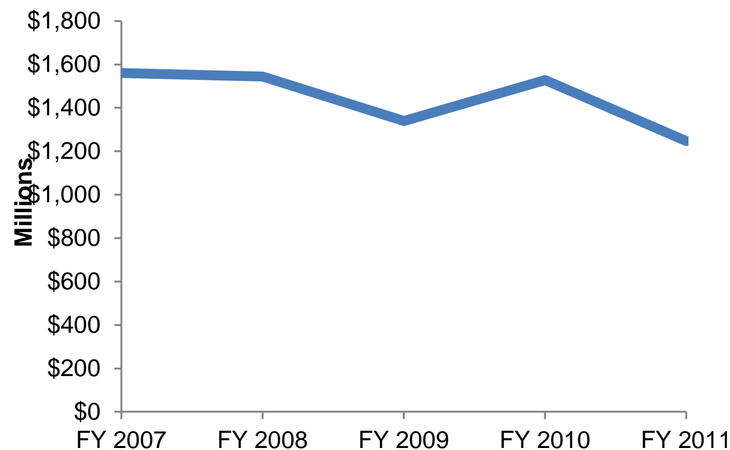
### Hawaii Individual Income Tax Bracket (Current)

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Individual Income Tax** | 1.40% | on the first $2,400 of taxable income. | *State General Fund and State Election Campaign Fund* |
| | 3.20% | on taxable income between $2,401 and $4,800. | |
| | 5.50% | on taxable income between $4,801 and $9,600. | |
| | 6.40% | on taxable income between $9,601 and $14,400. | |
| | 6.80% | on taxable income between $14,401 and $19,200. | |
| | 7.20% | on taxable income of $19,201 and $24,000. | |
| | 7.60% | on taxable income of $24,001 and $36,000. | |
| | 7.90% | on taxable income of $36,001 and $48,000. | |
| | 8.25% | on taxable income of $48,001 and $150,000. | |
| | 9.00% | on taxable income of $150,001 and $175,000. | |
| | 10.00% | on taxable income of $175,001 and $200,000. | |
| | 11.00% | on taxable income of $200,001 and above. | |

*Recent Experience*

From FY 2007 to FY 2011, the State's IIT receipts declined in all years except for FY 2010. The largest decline occurred in FY 2011, when it was 18.4 percent lower than in FY 2010. Much of this decline is due to a delayed payment in tax refunds, which were withheld in the last half of FY 2010 and paid out in July of 2010 (the first month of FY 2011). During the five-year period, the average annual growth rate was -4.6 percent. The compounded annual growth rate for that period was -5.4 percent.

**Individual Income Tax (General Fund Revenue)**
**FY 2007 – FY 2011**




*Note: Gross collection – does not reflect allocation to Special Funds.*

*Legislative Actions*

In 2009, the State increased the income tax rate for high-income brackets for tax years 2009 through 2015.[29] The legislation added tier rates for individuals with incomes over $150,000 (single/married filing separately) or $300,000 (married filing jointly), including a top rate of 11.00 percent for those earning over $200,000 (single/married filing separately) and $400,000 (married filing jointly). The State estimates suggested the new income tax brackets will provide nearly $48 million per year in additional revenue.[30]

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[29] Act 60, SLH 2009.

[30] Hawaii Income Tax Increases Aimed at State's Richest," Derrick DePledge. Honolulu Advertiser, April 29, 2009.

In 2011, legislation also eliminated the deduction for state taxes paid for taxpayers with income above specified thresholds:

- $100,000 for Single or Married Filing Separately
- $150,000 for Head of Household
- $200,000 for Joint Returns or Surviving Spouse

The legislation also placed temporary limitations on claims for itemized tax deductions and delayed the standard deduction and personal exemption increased under Act 60, SLH 2009 by two years (until tax year 2013). It also made the 10 percent increase in standard deduction and personal exemption permanent.[31] The cap on itemized deductions expires after tax year 2015.

*Projected Outlook*

Growth in FY 2012 for individual income tax revenue is projected to be 16.29 percent, following the FY 2011 decline of 18.40 percent. Annual average growth in individual income tax revenue through FY 2018 is projected to be 7.96 percent. A slower growth rate is projected for FY 2017 due to expiring income tax adjustments. From FY 2019 through FY 2025, the average annual projected growth rate is 6.44 percent.

Transient Accommodations Tax (Hotel/Motel Tax)

*FY 2011: $59,757,000 (1.4 percent of General Fund revenue)*

*Overview*

The tax is levied on hotel rooms, apartments, suites and other rental/transient properties occupied for less than 180 consecutive days. The tax is a significant source of revenue for the State – accounting for almost $284.5 million in FY 2011 (5.4 percent of total revenue and 1.4 percent of General Fund revenue). Much of this tax is exported to tourists and other visitors to the State.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Transient Accommodations Tax** | 7.25% (9.25% through FY 2015) | Rental of such accommodations for less than 180 days excluding taxes collected. Time-share vacation units and plans are subject to the tax. | *Convention center enterprise special fund (17.3%) up to $33 million, after which General Fund* |
| | | | *Tourism special fund (34.2%) up to $71 million, until FY2015* |
| | | | *Transient accommodations trust fund (0%). If not drawn into Tourism special fund, then reverts to General Fund* |
| | | | *County governments up to $93 million* |

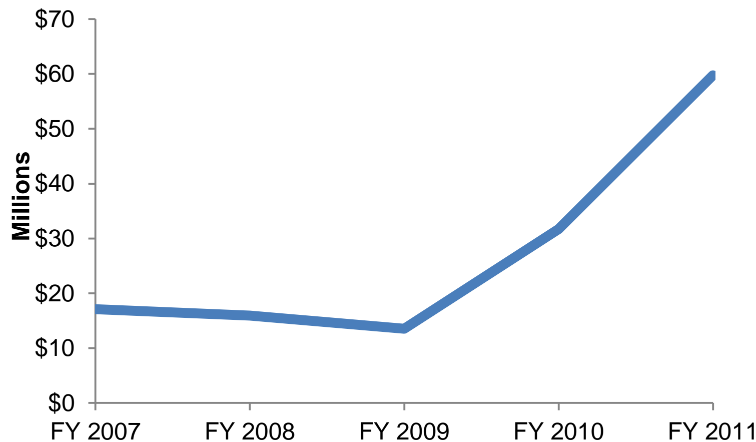
[31] Act 97, SLH 2011. The effect of this legislation is that for tax years 2011 and 2012, the standard deduction and personal exemptions remain at 2009 amounts, and for tax years 2013 and after, the standard deduction and personal exemptions will increase to levels referenced in Act 60, SLH 2009. Those levels are: $2,200 for individual or married filing separately filers; $3,212 for head of household filers; $4,400 for joint or surviving spouse filers. Personal exemption beginning in tax year 2013 and thereafter: $1,144.

| | | | |
|---|---|---|---|
| | | | *per fiscal year until FY2015* |

*Recent Experience*

TAT revenue grew moderately from FY 2007 to FY 2008 before experiencing an 8.2 percent reduction in FY 2009 as the effects of the recession diminished visits to the State. The TAT rate was temporarily increased in 2009 (through 2015) and assisted the TAT's rebound and growth in both FY 2010 and FY 2011.[32] In FY 2010, the TAT grew 133.7 percent in year-over-year General Fund revenue. In FY 2011, the TAT grew 88.5 percent above its FY 2010 level, to $59.8 million.

**Transient Accommodations Tax (General Fund Revenue)**
**FY 2007 – FY 2011**




*Legislative Actions*

The State's base TAT rate is 7.25 percent. Legislation enacted in 2009 temporarily increased the transient accommodations tax rate for FY 2010 through FY 2015.[33] The legislation added an additional 1.0 percent to the rate from July 1, 2009 through June 30, 2010, and an additional 2.0 percent from July 1, 2010 through June 30, 2015. As a result of these changes, the TAT rate is now 9.25 percent through the end of FY 2015.

Act 103, SLH 2011 temporarily limits the distribution from the TAT to counties and the tourism special fund to a combined total of $162 million. Previously, counties and the tourism special fund received 79 percent of the TAT at the 7.25 percent rate. The Act sunsets on June 30, 2015.[34]

*Projected Outlook*

The forecast FY 2012 year-over-year growth rate (total TAT revenue) of 89.06 percent inflated the TAT's annual average projected growth rate of 11.52 percent. The additional 2.0 percent surcharge included in 2009 legislation fueled much of the FY 2012 projected growth.[35] Aside from the large growth in FY 2012, the expiration of the temporary surcharge in FY 2016 will eliminate contributions to the General Fund through FY 2025.

<u>Fuel Tax (Gas Tax)</u> (Non-General Fund)

*FY 2011: $195,336,000 (3.7 percent of total revenue; no General Fund revenue)*

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[32] The increase provided an extra $48.3 million in total TAT revenue in FY 2011.

[33] Act 61, SLH 2009.

[34] Act 103, SLH 2011.

[35] According to DOTAX this accounted for approximately $300 million in revenue above baseline for FY 2012.

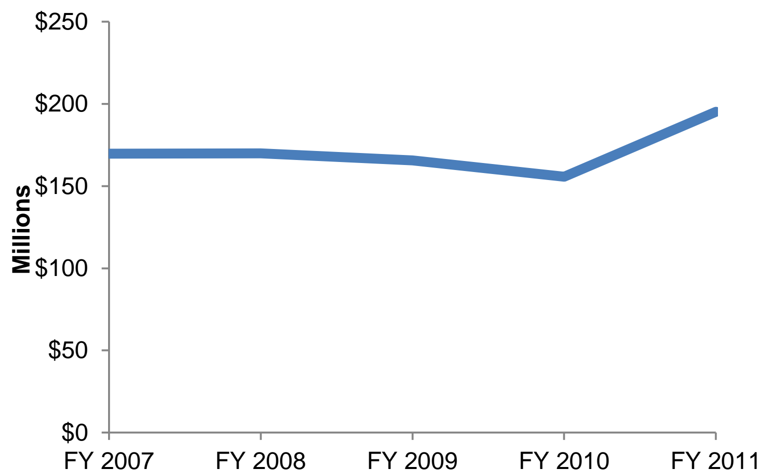
*Overview*

The fuel tax is levied to distributors of various fuels – and is generally passed on to consumers. Based on the type of fuel, the State levies the tax on a per gallon basis at varying rates (shown below). The State also levies an Environmental Response, Energy and Food Security Tax of $1.05 per barrel or fraction thereof that is not aviation fuel sold by a distributor to a retail dealer or end user. In FY 2011, the State collected $195.3 million from the Fuel Tax, accounting for 3.7 percent of total revenue. Counties may levy an additional fuel tax.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Fuel Tax** | $0.170 | Gasoline - Regular and Highway Diesel | *Aviation fuel tax to state airport fund; 1% of state and county fuel tax to boating fund; other state fuel tax revenues to state highway fund; county fuel tax revenues to respective county highway funds.* |
| | $0.052 | Highway LPG | |
| | $0.020 | Non-Highway Diesel, LPG, and Aviation | |
| **Environmental Response, Energy, & Food Security Tax** | $1.05 | Per barrel or fraction thereof (non-aviation fuel) | *$0.05/barrel – Environmental response revolving fund; $0.15/barrel – Energy security special fund; $0.10/barrel – Energy systems development special fund; $0.15/barrel – Agricultural development and food security special fund; and $0.60/barrel – General Fund* |

*Recent Experience*

The State's Fuel tax revenue decreased slightly from FY 2008 through FY 2010 before increasing 25.5 percent year-over-year in FY 2011. An increase in the Environmental Response Tax (renamed the Environmental Response, Energy and Food Security Tax) was the most significant driver of increased year-over-year fuel tax revenue.




*Legislative Actions*

Hawaii temporarily amended §243-3.5, HRS to increase the environmental response tax to $1.05 per barrel of petroleum product sold and changed the name of the tax to the "environmental response,

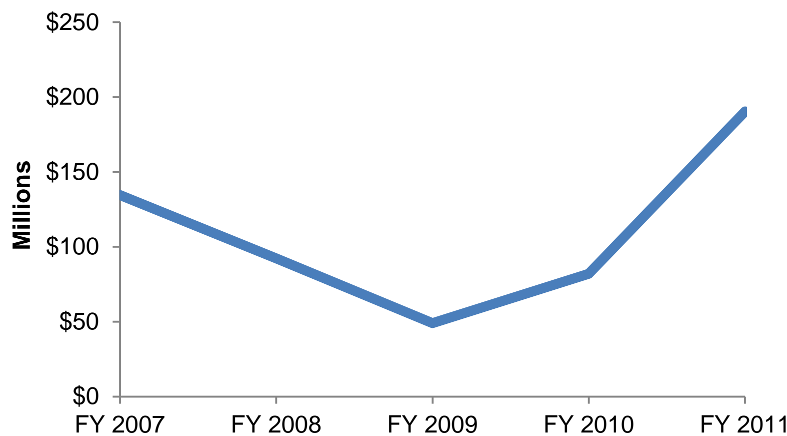
energy, and food security tax."[36] The Act also deleted a provision that required the Department of Health to notify the Department of Taxation when the fund balance exceeds $20 million, at which time fuel distributors would cease collecting the tax until the balance declined to less than $3 million.

Unemployment Insurance Tax (Non General Fund)
*FY 2011: $190,511,000 (3.6 percent of total revenue; no General Fund revenue)*

*Overview*
Hawaii levies a tax on wages paid by employers with one or more employees – with certain exceptions – to fund its unemployment trust fund. The tax rate is determined each year based upon a schedule system. One of eight schedules is used depending on the condition of the Trust Fund. An employer's contribution rate can never be less than 0.0 percent nor greater than 5.4 percent.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Unemployment Insurance Tax** | 0.0% - 5.4% | Employer contribution as percentage of wages (FY 2011 wage base of $34,200) | *Unemployment Insurance Trust Fund and Employment and Training Fund* |
| | 0.02% | Additional Employment and Training Assessment (FY 2011 rate) | |

*Recent Experience*




Cigarette and Tobacco Tax
*FY 2011: $106,137,000 (2.5 percent of General Fund revenue)*

*Overview*
Hawaii levies an excise tax on the sale or use of tobacco products and on each cigarette sold, used or possessed. Aside from cigarettes and little cigars, the State levies the tobacco tax on 70 percent of the wholesale price of tobacco products (other than large cigars) and 50 percent of the wholesale price of large cigars. Cigarette and tobacco wholesalers and dealers are required to affix stamps to individual cigarette packages as proof of payment of tax.

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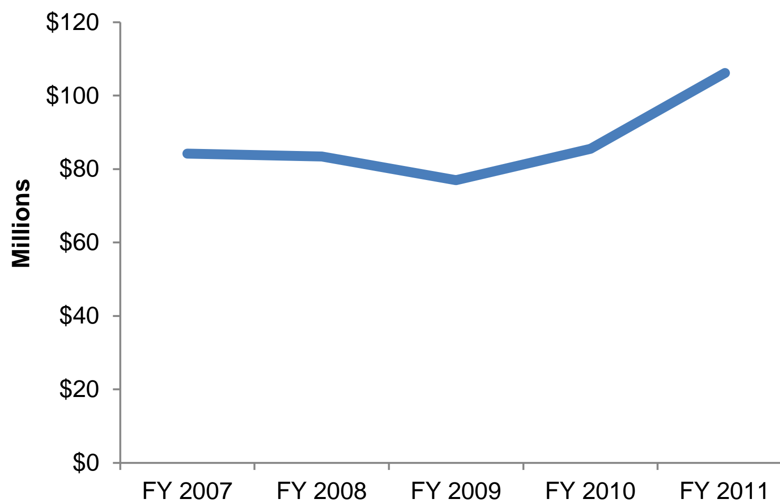
[36] Act 73, SLH 2010.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Tobacco Tax** | $0.16 | per cigarette ($3.20/pack) | *Through June 30, 2013:* *State General Fund ($0.12), Cancer Research Fund ($0.02), Trauma System Fund ($0.0075), Emergency Medical Service Fund ($0.005) and Community Health Center Fund ($0.0075).* *As of July 1, 2013:* *State General Fund ($0.10), Cancer Research Fund ($0.02), Trauma System Fund ($0.015), Community Health Center Fund ($0.0125, Emergency Medical Services Special Fund ($0.0125)* |
| | 50% | on wholesale price for cigars | |
| | 70% | on wholesale price for all other tobacco products | |
| | 1.70% | on denominated value of tax stamp | *State cigarette tax stamp enforcement special fund and State cigarette tax stamp administrative special fund.* |
| | 0.40% | discount on value of required cigarette tax stamps | |

*Recent Experience*

Hawaii increased the per-cigarette tax in all but one year from 2002 through 2011. The State's cigarette tax revenue registered double-digit percentage increases in all but one fiscal year from FY 2007 through FY 2011 (FY 2009 saw 3.4 percent growth). At the same time, the General Fund revenue portion declined in both FY 2008 and FY 2009 before increasing by 11.1 percent in FY 2010 and 24.1 percent in FY 2011. During the five-year period, annual General Fund cigarette and tobacco-related tax revenue grew from $84.2 million to $106.1 million, a 26.0 percent increase. The strongest growth, 24.1 percent, occurred in FY 2011 when the tax rate increased 2 cents per cigarette. This resulted in a General Fund revenue increase of $20.6 million.

**Cigarette and Tobacco Tax (General Fund Revenue)**
**FY 2007 – FY 2011**




*Legislative Actions*

In FY 2007, FY 2008 and FY 2009, the State increased its per-cigarette tax effective September 30 of each year. The tax per cigarette increased by 1 cent in each year – going from 7 cents per cigarette (as of September 29, 2006) to 10 cents (as of September 30, 2008). The rate increased to 13 cents on July 1, 2009, 15 cents on July 1, 2010 and 16 cents beginning July 1, 2011.[37]

*Projected Outlook*

[37] Act 56, SLH 2009.

FY 2012 projected growth is 12.52 percent for cigarette and tobacco tax revenue due to the 2 cent per cigarette tax increase. In FY 2013, it is projected that growth will be 4.94 percent. A 14.11 percent reduction in revenue from the tax to the General Fund will occur in FY 2014, as revenue from the tax to the General Fund decreases. In subsequent years through FY 2025 – absent an alteration of the per-cigarette tax or other changes to the tobacco tax – the tax is projected to grow an average of 2.40 percent per year.

Insurance Premiums Tax
*FY 2011: $140,456,000 (3.2 percent of General Fund revenue)*

*Overview*
The Insurance Premiums Tax is levied on insurance companies (underwriters) based on premiums written in the State. Insurance companies pay the tax in lieu of other taxes (except for property taxes and taxes on purchase, use or ownership of tangible personal property). For FY 2011, the State collected $140,456,000, or 2.7 percent of total revenue (3.2 percent of General Fund revenue) from the Insurance Premiums Tax. A 1.0 percent tax credit is available for qualifying insurers to facilitate regulatory oversight.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Insurance Premiums Tax** ***In lieu of General Excise and Net Income Taxes*** | 2.75% | Life insurance | *State General Fund* |
| | 4.265% | Casualty and all other insurance | |
| | 4.265% of risk premium | Real property title insurance | |
| | 4.68% | Surplus Lines | |
| | 0.8775% of gross underwriting profits | Ocean marine insurance | |
| | | | |
| *Captive Insurance Premiums* | | | |
| | | | |
| | 0.25% | on $0 to $25 million of gross premiums; | *Insurance Administrative Fund* |
| | 0.15% | on more than $25 million to $50 million of gross premiums; | |
| | 0.05% | on more than $50 million of gross premiums; | |
| | 0.00% | on premiums more than $250 million | |
| | | | |
| **Insurance Fees** | | Rates vary | *50% of increases to the State General Fund until FY2015* |

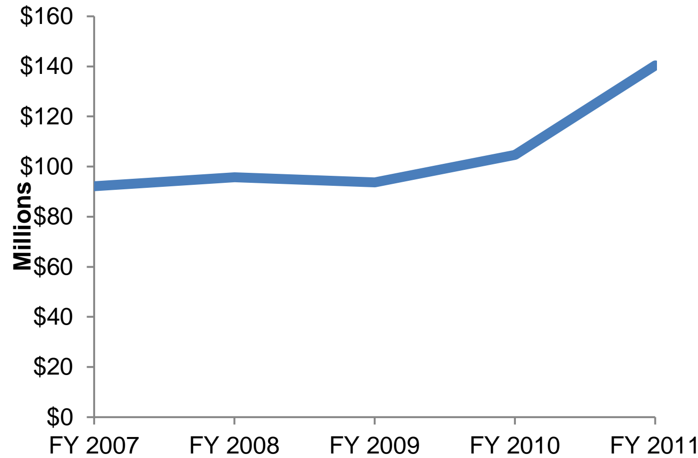
*Legislative Actions*
Act 59, SLH 2010 temporarily increased certain insurance fees and specified that the increased fees must be deposited equally into the compliance resolution fund and the General Fund as an insurance license and service tax.[38] The temporary increases are scheduled to expire at the conclusion of FY 2014.

[38] Act 59, SLH 2010.

*Recent Experience*

From FY 2007 to FY 2011, the Insurance Premiums Tax increased by nearly $48.3 million or 52.3 percent. Much of the growth occurred in Fiscal Years 2010 and 2011. FY 2010 growth was 11.7 percent, and FY 2011 growth was 34.1 percent. The FY 2011 growth was partially generated by a one-time $25 million revenue increase by Department of Taxation payments received monthly instead of quarterly.

**Insurance Premiums Tax and Insurance Fees (General Fund Revenue)**
**FY 2007 – FY 2011**




*Projected Outlook*

Tax revenue growth from insurance premiums project to be moderate, with an annual average growth rate of 2.42 percent through FY 2018 and a 2.50 percent annual average growth rate from FY 2019 to FY 2025.

Public Service Company Tax

*FY 2011: $117,940,356 (2.2 percent of total revenue)*

*Overview*

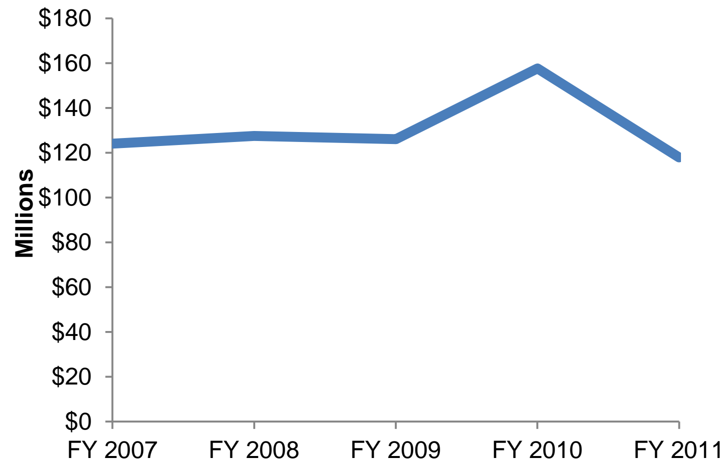
In lieu of paying the GET, public service companies pay a tax on gross income for their preceding calendar year. For FY 2011, this accounted for $117,940,356, or 2.2 percent of total revenue.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Public Service Companies Tax** | 5.885% - 8.2% | On public utility gross income at graduated rates based on ratio of net to gross income. | *State General Fund and county general funds. (for revenues generated from a rate greater than 4% from utilities that are not taxed under the respective county real property tax)* |
| | 5.35% | Land carriers (public transportation) | |

*Recent Experience*

Revenue from the Public Service Companies Tax remained relatively flat through FY 2009 before sharply increasing in FY 2010 and decreasing in FY 2011.[39] At the end of FY 2011, revenue from the tax was 4.9 percent below its FY 2007 level.

[39] DOTAX estimates portions of the one-year increase were attributable to a spike in oil prices.




*Projected Outlook*

Public Service Company Tax annual growth rates project to be 2.78 percent through FY 2018 and 2.50 percent from FY 2019 to FY 2025.

Motor Vehicle Taxes and Fees (Non-General Fund)

*FY 2011: $106,166,000 (2.0 percent of total revenue; no General Fund revenue)*

*Overview*

Owners pay an annual fee based on vehicle weight in addition to an annual $45 registration fee. Hawaii counties levy additional fees based on vehicle weight and/or usage. This is also known as the Weight Tax and Rental Motor Vehicle and Tour Vehicle Surcharge Tax. Combined motor vehicle taxes and fees accounted for $106,165,508, or 2.0 percent of total revenue in FY 2011.[40]

Hawaii levies a rental motor vehicle and tour-vehicle surcharge tax – paid via a daily rate for rental vehicles and on a monthly basis for tour vehicles. Lessors pay the tax for rental cars and tour vehicle operators pay the tax on vans and buses.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Motor Vehicle Weight Tax** | $0.01 | per lb. for vehicles weighing up to 4,000 lbs. | *State Highway Fund* |
| | $0.02 | per lb. for vehicles weighing over 4,000 to 7,000 lbs. | |
| | $0.0225 | per lb. for vehicles weighing over 7,000 lbs. to 10,000 lbs. | |
| | $300 | for vehicles weighing over 10,000 lbs. | |

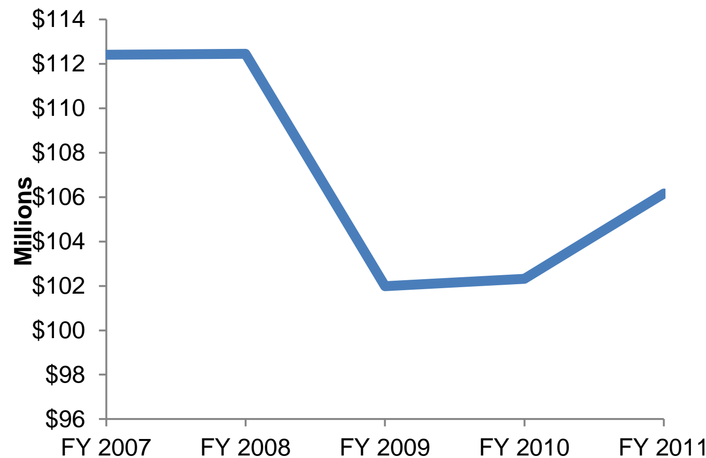
| | | | |
|---|---|---|---|
| **Rental Motor Vehicle And Tour Vehicle Surcharge Tax** | $7.50 | per day for rental vehicles (reverted to $3.00/day as of 7/2012. | ***FY2012:*** *State Highway Fund ($3.00), General Fund ($4.50)* ***FY2013:*** *State Highway Fund ($3.00), General Fund ($0)* |
| | $15 | per month for tour vehicles seating eight to twenty-five persons. | |
| | $65 | per month for tour vehicles seating twenty six passengers or more | |

[40] This figure includes $62,273,699 of County revenue. State-only revenue totaled: $43,891,809 in FY 2011. All FY 2011 Motor Vehicle Tax and fees were designated to the Highway Special Fund.

*Recent Experience*

Hawaii's revenue from the motor vehicle tax and rental/tour vehicle surcharge was relatively flat from FY 2007 to FY 2008. Similar to the TAT, the tax revenue from these sources decreased in FY 2009 by 9.3 percent. Small to moderate growth occurred in FY 2010 and FY 2011, but FY 2011 revenue remained below FY 2007 levels by over $6 million.

**Motor Vehicle Taxes and Fees (Non-General Fund Revenue)**
**FY 2007 – FY 2011**




*Note: Taxes and Fees also include Registration fees, CDL fees, Inspection Fees*

*Legislative Actions*

Effective July 1, 2011, Hawaii increased the annual state motor vehicle weight tax for vehicles.[41] In 2011, the State also increased the rental motor vehicle surcharge tax from $3.00 per day to $7.50 per day for FY 2012. The Legislation deposited a portion of the surcharge ($4.50 per day) in the State's General Fund and suspended the rental motor vehicle customer facility charges for the period of July 1, 2011 to June 30, 2012.

The temporary $7.50 per day surcharge expired on June 30, 2012 and reverted to the $3.00 per day surcharge. The FY 2012 additional surcharge provided a one-year revenue increase of approximately $61 million to the State's General Fund.

Liquor Tax

*FY 2011: $48,053,576 (0.9 percent of total revenue)*

*Overview*

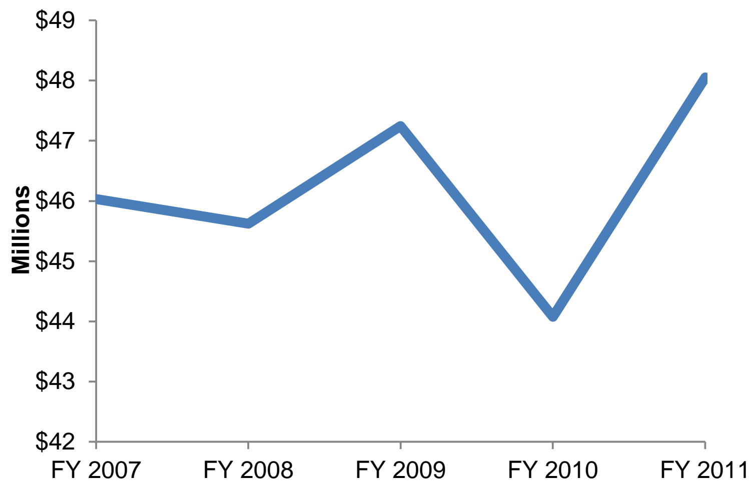
Hawaii levies a gallonage tax upon dealers and others who sell and/or use liquor. This accounted for $48,053,576, or 0.9 percent of total revenue, in FY 2011.

Varying gallonage tax rates apply to wine, distilled spirits, sparkling wine, still wine, cooler beverages, non-draft beer and draft beer. These are detailed in the following table:

[41] Act 86, SLH 2011.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Liquor Tax (per gallon)** | $5.98 | distilled spirits | *State General Fund* |
| | $2.12 | sparkling wines | |
| | $1.38 | still wines | |
| | $0.85 | cooler beverages | |
| | $0.93 | non-draft beer | |
| | $0.54 | draft beer | |

*Recent Experience*
Liquor tax revenue alternated between negative and positive growth during the last five fiscal years – but ended the five-year period with approximately $2.1 million in growth. Revenue decreased by 6.7 percent in FY 2010 before rebounding with 9.0 percent growth in FY 2011. This growth led to the largest revenue collection of the five fiscal years reviewed.




*Projected Outlook*
The Liquor Tax tends to correlate with growth or declines in the tourism industry; as that industry continues to rebound from the effects of the 'Great Recession,' projections suggest that liquor tax revenue will do the same. Projections suggest a 2.17 percent average annual growth rate for liquor tax revenue through FY 2018. From FY 2019 to FY 2025, it is projected to achieve an annual average growth rate of 2.02 percent.

Conveyance Tax
*FY 2011: $21,527,000 (0.5 percent of General Fund revenue)*

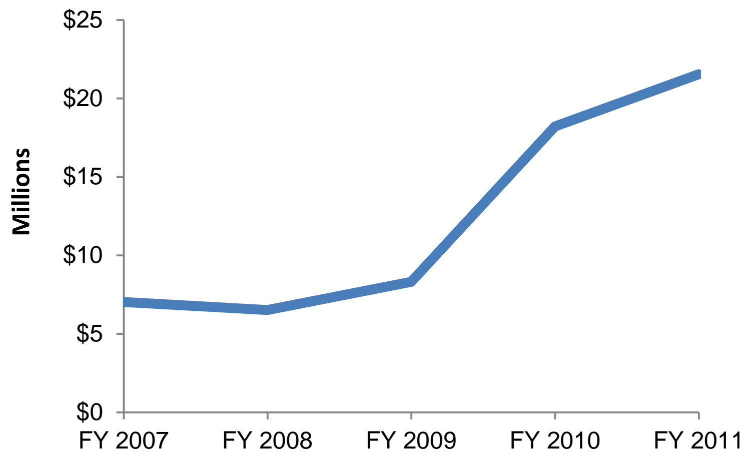
*Overview*
Hawaii imposes the tax on all documents transferring ownership or interest in real property. For FY 2011 this accounted for $47,905,995, or 0.9 percent (across all Funds) -- $21.5 million of which was revenue for the General Fund. The tax rate paid is determined by the actual and full consideration paid or to be paid and the purchaser's eligibility for a county homeowner's exemption on property tax. The tax is levied at varying rates based on the value of the transaction and whether the property serves as a primary residence or is an investment property.

| | Residence Rate | Investment Property Rate | Description/Overview | Receiving Fund |
|---|---|---|---|---|
| **Conveyance Tax** | $0.10 | $0.15 | per $100 for real estate transfers under $600k | ***FY 2012:*** *45% to state general fund, 10% to the land conservation fund, 25% into the rental-housing trust fund, and 20% into the natural area reserve fund.*<br><br>***FY 2013 and beyond:*** *35% to state general fund, 10% to the land conservation fund, 30% into the rental housing trust fund, and 25% into the natural area reserve fund.* |
| | $0.20 | $0.25 | per $100 for real estate transfers under between $600k and $1 million | |
| | $0.30 | $0.40 | per $100 for real estate transfers between $1 million and $2 million | |
| | $0.50 | $0.60 | per $100 for real estate transfers between $2 million and $4 million | |
| | $0.70 | $0.85 | per $100 for real estate transfers between $4 million and $6 million | |
| | $0.90 | $1.10 | per $100 for real estate transfers between $6 million and $10 million | |
| | $1.00 | $1.25 | per $100 for real estate transfers $10 million or more | |

*Recent Experience*

Conveyance tax revenue decreased from FY 2007 to FY 2008, before increasing each year through FY 2011. Significant increases in revenue occurred in FY 2010 (119.2 percent). Hawaii enacted legislation to temporarily divert a larger portion of Conveyance Tax revenue to the General Fund in FY 2010 and 2011. The Department of Taxation also suggested the federal stimulus First Time Homebuyers Tax Credit spurred additional market activity, increasing tax receipts in these two years.

**Conveyance Tax (General Fund Revenue)**
**FY 2007 – FY 2011**




*Projected Outlook*

Hawaii benefits from having the highest median home value among the states. Higher sale prices can help spur growth in conveyance tax receipts. However, the General Fund portion of the conveyance tax will be reduced to 35 percent beginning in FY 2014. Leading up to this reduction, the tax projects to yield less revenue in FY 2012 and FY 2013. After the General Fund portion reduction in FY 2014, tax revenue projects to increase at an average annual growth rate of 7.95 percent through FY 2018. From FY 2019 to FY 2025, the tax projects to grow at an average annual rate of 5.17 percent.

*Legislative Actions*

In 2009, HB 1741 temporarily increased the revenue from the conveyance tax to the General Fund.

<u>Corporate Net Income Tax</u>

*FY 2011: $34,573,000 (0.8 percent of General Fund revenue)*

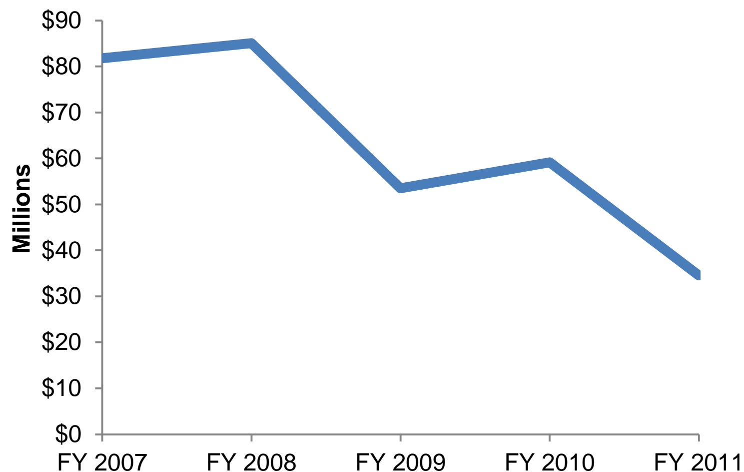
*Overview*

Hawaii's corporate income tax accounted for 0.7 percent of total revenue in FY 2011 and 0.8 percent of General Fund revenue. Similar to the IIT, the corporate income tax applies rates at differing net income levels.

| | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| **Corporate Income Tax (Net)** | 4.40% | Up to $25,000 | *State General Fund.* |
| | 5.40% | $25k - $100k | |
| | 6.40% | Over $100k | |
| | 4.00% | Capital Gains Rate | |

*Recent Experience*

Corporate net income tax revenue produced approximately $47.3 million less revenue in FY 2011 than in FY 2007. During the five-year period, receipts decreased while refunds increased – resulting in a compound annual growth rate of -19.4 percent. Corporate income taxes are generally considered the most business cycle-sensitive of the major taxes, and during the economic downturn corporate income tax collections fell in many states. Hawaii allows losses to be carried either backward or forward, which can also reduce collections during an economic downturn – and even when the economy begins to improve.




*Projected Outlook*

Corporate net income tax revenue is projected to increase in FY 2012 (12.39 percent) as net operating losses carried forward slow and revenues begin to stabilize. Thereafter, projections suggest alternating years of decline and growth, with the episodic growth years being greater than the years of decline through FY 2017. From FY 2019 to FY 2025, the average annual growth rate is projected to average 2.40 percent.

<u>Banks and Other Financial Corporations Tax</u>

*FY 2011: $31,677,000 (0.7 percent of General Fund revenue)*

*Overview*

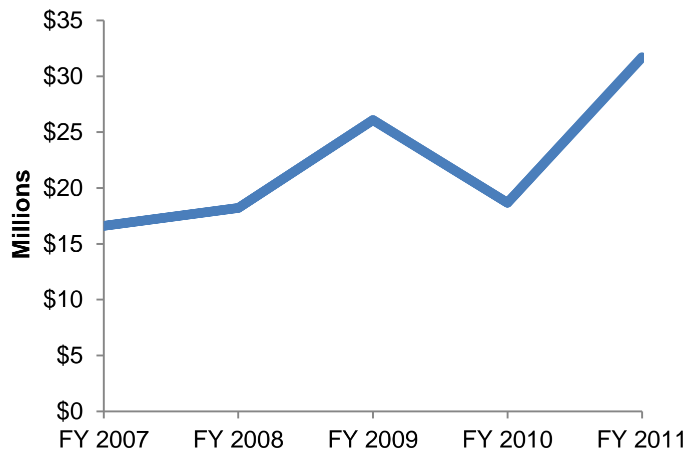
Hawaii levies a franchise tax on banks, build and loan associations, development companies, financial corporations, financial services loan companies, trust companies, mortgage loan companies, financial holding companies, small business investment companies and others in lieu of net income and general excise taxes. The net income for the preceding year (from all sources with certain modifications) serves as the base on which the tax rate is applied. For FY 2011, this accounted for $33,677,000, or 0.6 percent of total revenue, of which $31,677,000 was General Fund revenue (0.7 percent).

| Banks and Other Financial Corporations Tax | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| | 7.92% | On net income of financial institutions in lieu of Excise Tax | *State General Fund; $2 million per fiscal year is allocated to Compliance Resolution Fund.* |

*Recent Experience*

This tax experienced solid growth during the five-year period – growing an average of 17.5 percent This reflected revenue growth of more than $15 million. With the exception of FY 2010, the tax increased each year, including growth of 69.7 percent in FY 2011.

**Banks and Other Financial Corporations Tax (General Fund Revenue)**
**FY 2007 – FY 2011**




*Projected Outlook*

The tax projects to decrease by an annual rate of 11.75 percent in FY 2012 before stabilizing and growing moderately through FY 2018 at an average annual growth rate of 3.53 percent. From FY 2019 to FY 2025, projections suggest the tax will grow at an average annual rate of 2.34 percent.

Estate and Transfer Tax

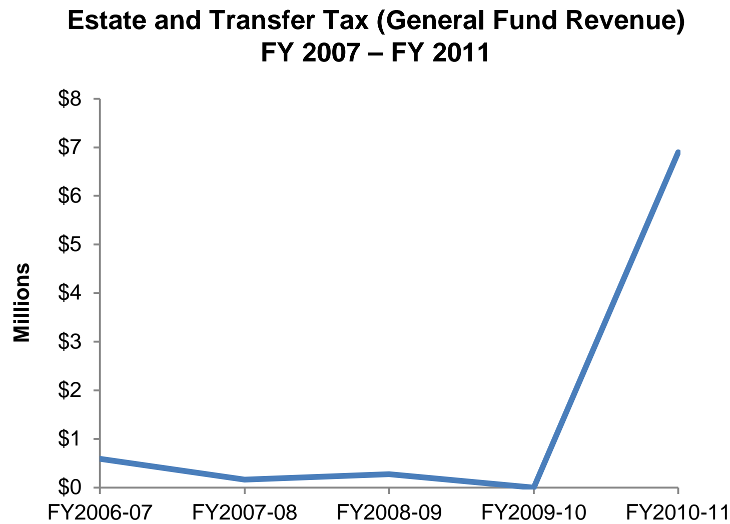
*FY 2011: $6,899,000 (0.2 percent of General Fund revenue)*

*Overview*

Hawaii adopted a new Estate and Transfer Tax in 2010. The tax applies to estates with a value of more than $3,500,000. For FY2011, this raised $6,899,215, or 0.2 percent of total revenue.

| Estate and Transfer Tax | Rate | Description/Overview | Receiving Fund |
|---|---|---|---|
| | 0.8% - 16% | By estate value bracket | *State General Fund* |

*Recent Experience*
During the first year of existence, the Estate and Transfer Tax generated $6.9 million for the State's General Fund.




*Legislative Actions*
Act 74, SLH 2010 reenacted Hawaii's Estate and Transfer Tax for decedents after April 30, 2010.

*Projected Outlook*
It is projected that the tax will grow at 184.10 percent in FY 2012 and then settle into a moderate rate of annual growth. From FY 2013 to FY 2018 the tax is projected to grow at an average annual rate of 2.59 percent. From FY 2019 to FY 2025, the tax is projected to grow at an average annual rate of 2.50 percent. It should be noted that this tax is difficult to predict, as it relies less on economic or other predictable factors than most taxes.

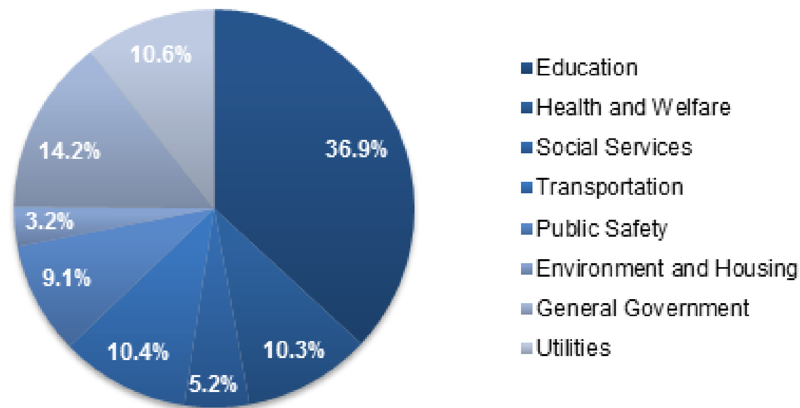
## Relationship of State and Local Revenue and Expenditures

While the sufficiency of the Hawaii revenue structure over the next twenty years is the focus of this report, it is also informative to determine how the Hawaii system compares with other states. Given workforce and business mobility and the impacts of e-commerce and globalization, the State should be mindful of the impact of system change on its overall competitiveness with other states.

At the same time, state revenue structures should not be considered in a vacuum; while state taxes impact on a business, family or individual's tax burden, so too do local taxes. Local taxes can vary widely from state to state (and even from city or county within a state), and this can make state to state comparisons alone at best incomplete and at worst meaningless.

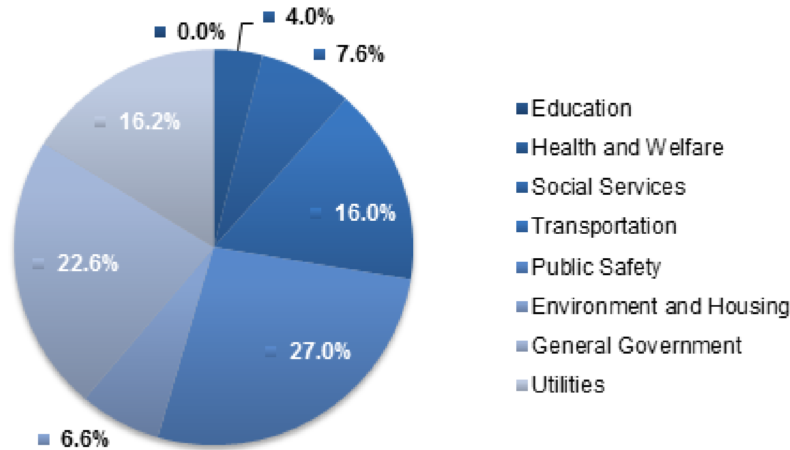
Hawaii is the only state where the public school system operates under a single system administered and funded almost entirely by the State. Nationally, the largest local government expenditure category is to support K-12 education. For all US local governments, direct expenditures for K-12 education average nearly 37 percent, compared to less than 1 percent of local government spending in Hawaii. The following charts highlight this profound disparity:[42]

**US Total Direct Expenditures by Function: Local Government Spending (FY 2009)**



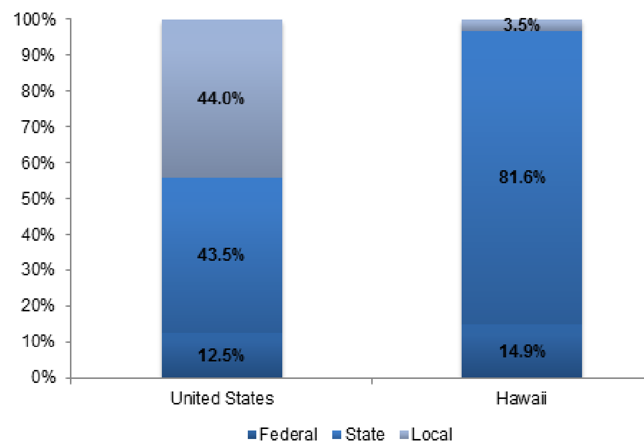

[42] U.S. Census Bureau, 2009 Annual Surveys of State and Local Government Finances, table 1.

**State of Hawaii Direct Expenditures by Function: Local Government Spending (FY 2009)**




It is a given that if there is little local government funding for K-12 education, the State is the only real alternative to support this critical function. This can be expected to have a direct impact on the level of state expenditures for K-12 education (and, logically, the amount of revenue that must be raised at the state level). In fact, the State of Hawaii provides far more revenue to support this function than nearly any other state. The following chart details the funding difference between Hawaii and the combined 50 states:[43]

**Sources of Revenue: K – 12 Education Programming, 2010**



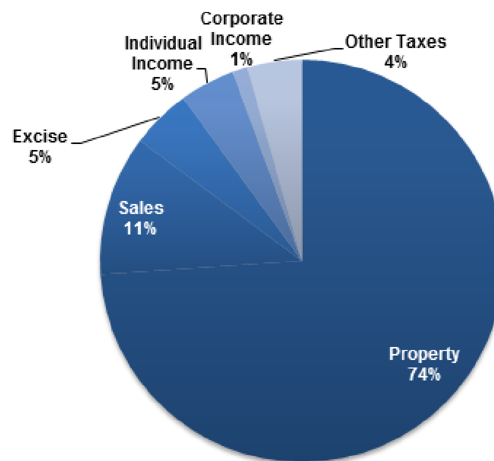

Nationally, K-12 education funding is generally a shared function between state and local governments. That is not the case in Hawaii, where nearly all of the revenue for K-12 education comes from state government. Among the states, only Vermont and Alaska contribute more revenue as a share of personal income to K-12 education than Hawaii.[44]

Among US local governments, the primary source of revenue is the property tax. On average, property taxes make up 74 percent of own source tax revenue for all US local governments; that percentage is similar to Hawaii local governments, where property taxes make up 79 percent of own source revenue.

[43] U.S. Census Bureau, "Public Education Finances: 2010", June 2012, p. 5.

[44] U.S. Census Bureau, 2009 Annual Surveys of State and Local Government Finances, table 1 – the full table detailing state and local spending as a share of $1,000 of personal income can be found in the Appendix.

**US Total General Revenue from Own Sources: Local Government Taxes, 2010**




With a diminished need to fund a primary local government service (K-12 education), it is not surprising that property tax collections in Hawaii would be lower than for the nation as a whole.[45] The following table lists comparable median residential property taxes and property taxes as a percent of home value for selected Hawaii Counties:

| Property Tax | US | Hawaii County | Honolulu County | Maui County |
|---|---|---|---|---|
| Median | $1,917 | $671 | $1,529 | $914 |
| % of Home Value | 1.04% | 0.19% | 0.26% | 0.16% |

These relatively low property taxes were confirmed by another national survey, conducted by the Lincoln Institute of Land Policy and the Minnesota Taxpayers Association. That study compared 2010 urban city residential property tax bills for homes valued at $150,000 and $300,000. Of the 53 cities surveyed, Honolulu had the second lowest property tax for homes valued at $150,000 and the lowest property tax for homes valued at $300,000.[46]

**Urban Cities with Residential Tax Ratings in Top Five or Bottom Five**
**For $150,000 and $300,000 Valued Homes**

| City | State | $150,000 | | $300,000 | |
|---|---|---|---|---|---|
| | | Tax | Rank (of 53) | Tax | Rank (of 53) |
| Detroit | MI | $4,885 | 1 | $9,771 | 1 |
| Aurora | IL | $3,936 | 2 | $8,332 | 2 |
| Philadelphia | PA | 3,927 | 3 | $7,854 | 3 |
| Milwaukee | WI | 3,452 | 4 | $7,060 | 4 |
| Buffalo | NY | $3,330 | 5 | $6,835 | 5 |
| Denver | CO | $779 | 50 | $1,557 | 52 |
| Washington | DC | $646 | 51 | $1,867 | 49 |
| Honolulu | HI | $219 | 52 | $712 | 53 |
| Boston | MA | $159 | 53 | $1,686 | 51 |

[45] One national survey determined that the median property taxes in 2009 were $1,917.

[46] '50-State Property Tax Comparison Study,' Minnesota Taxpayers Association/Lincoln Institute of Land Policy, April 2011, p. 7.

Commercial property taxes are also low in comparison to other comparable cities. The Lincoln Institute and Minnesota Taxpayers Association study found that of 53 urban cities, commercial property taxes for businesses with a commercial parcel value of $100,000, $1,000,000 and $25,000,000 million respectively ranked Honolulu 49th out of 53 surveyed cities in each category.[47]

**Urban Cities with Commercial Tax Rankings in Top Five or Bottom Five for All Values**

| City | State | $100,000 | | $1,000,000 | | $25,000,000 | |
|---|---|---|---|---|---|---|---|
| | | Tax | Rank (of 53) | Tax | Rank (of 53) | Tax | Rank (of 53) |
| Detroit | MI | $4,814 | 1 | $48,141 | 1 | $1,203,536 | 1 |
| Providence | RI | $4,769 | 2 | $47,695 | 2 | $1,192,373 | 2 |
| Des Moines | IA | $4,528 | 3 | $45,282 | 3 | $1,132,041 | 3 |
| Philadelphia | PA | $4,082 | 4 | $40,817 | 4 | $1,020,413 | 4 |
| New York | NY | $3,968 | 5 | $39,681 | 5 | $992,014 | 5 |
| Honolulu | HI | $1,061 | 49 | $10,613 | 49 | $265,329 | 49 |
| Virginia Beach | VA | $965 | 50 | $9,650 | 50 | $241,253 | 50 |
| Seattle | WA | $939 | 51 | $9,394 | 51 | $234,861 | 51 |
| Wilmington | DE | $884 | 52 | $8,838 | 52 | $220,957 | 52 |
| Cheyenne | WY | $782 | 53 | $7,824 | 53 | $195,605 | 53 |

This relatively low ranking was also the case for industrial property taxes; Honolulu ranked 51st of the 53 surveyed cities for industrial property taxpayers at the $100,000, $1,000,000 and $25,000,000 levels.[48]

**Urban Cities with Industrial Tax Rankings in Top Five or Bottom Five for All Values**

| City | State | $100,000 | | $1,000,000 | | $25,000,000 | |
|---|---|---|---|---|---|---|---|
| | | Tax | Rank (of 53) | Tax | Rank (of 53) | Tax | Rank (of 53) |
| Columbia | SC | $6,305 | 1 | $63,055 | 1 | $1,576,367 | 1 |
| Detroit | MI | $5,898 | 2 | $58,977 | 2 | $1,474,418 | 2 |
| Houston | TX | $5,048 | 3 | $50,485 | 3 | $1,262,116 | 3 |
| Jackson | MS | $4,970 | 4 | $49,702 | 4 | $1,242,554 | 4 |
| Indianapolis | IN | $4,636 | 5 | $46,63 | 5 | $1,149,064 | 5 |
| Seattle | WA | $1,301 | 49 | $13,011 | 49 | $325,279 | 49 |
| Cheyenne | WY | $1,274 | 50 | $12,737 | 50 | $318,435 | 50 |
| Honolulu | HI | $1,076 | 51 | $10,759 | 51 | $268,987 | 51 |
| Virginia Beach | VA | $982 | 52 | $9,820 | 52 | $245,503 | 52 |
| Wilmington | DE | $884 | 53 | $8,838 | 53 | $220,957 | 53 |

[47] Ibid., p. 9.

[48] Ibid., p. 11.

This is an important consideration for discussions of state taxes and state tax burdens. As is noted in the discussion of state tax benchmarking, Hawaii's tax structure should be viewed in the context of the state and local structure and burden. These comparisons tend to mitigate what might otherwise be seen as a high state tax burden.

This should also be considered in the context of other taxes where the State may choose to share revenue with local governments, in particular, the Transient Accommodations Tax (TAT). This has been subject to change over time, and it is worthy of discussion and analysis as to how this tax does (or should) fit into the overall state and local government revenue picture.

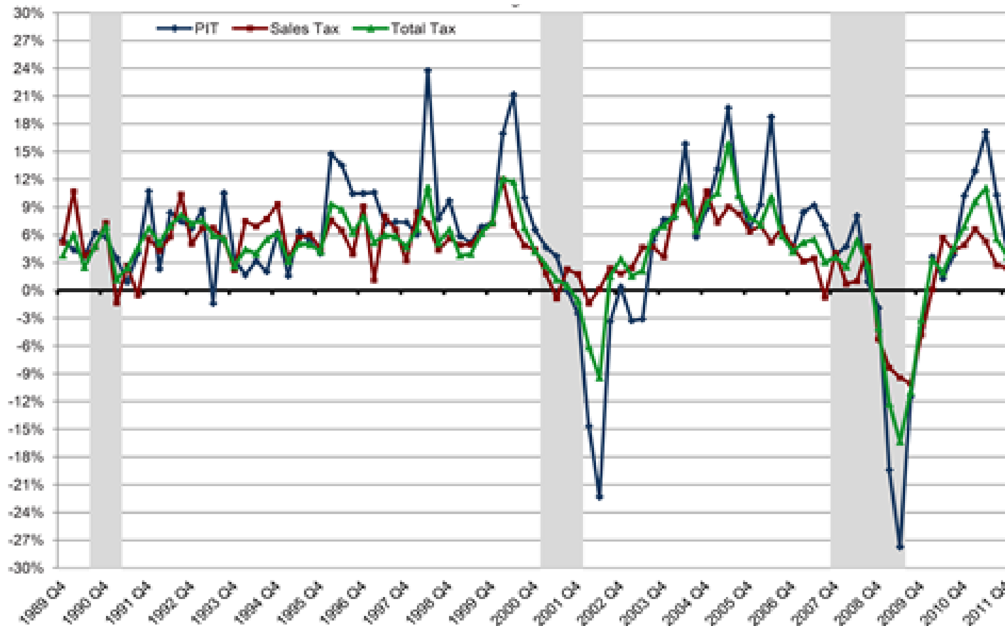
## Primary Components and Comparison to Other States

While there are no "perfect twins" among states – and Hawaii's many unique characteristics make this even more challenging - comparisons can provide helpful points of reference in assessing competitiveness. At the same time, evaluations are only meaningful taken in the context of key differences across various states, including:

- Relative state economics and demographics that drive both revenue generation and service demands
- Differences across labor markets
- Comparative financial resources and burdens

According to US Census Bureau data reported by the Rockefeller Institute, as the economy entered a recession beginning in late-2007 and lasting through mid-2009, state revenues declined significantly – bottoming out in the 2nd quarter of 2009.[49] Overall state tax collections grew in the second half of 2009 and largely increased through 2010 and early 2011 before a decline in mid-late 2011.

**Year-Over Year Nominal Change in State Tax Collections**




*Source: US Census Bureau*

In comparison to the states as a whole, by 2009, Hawaii's tax revenues fell slightly more than all states. Hawaii reached a trough of -7.4 percent growth while the average of remaining states saw -5.4 percent growth. Since 2009, Hawaii has experienced slow-to-moderate growth in tax revenues (while remaining below 2007 tax revenue levels), while the average of all states experienced further decline. From 2010 to 2011, average tax receipts for all states grew by 8.0 percent and Hawaii's tax receipts grew by 0.4 percent.

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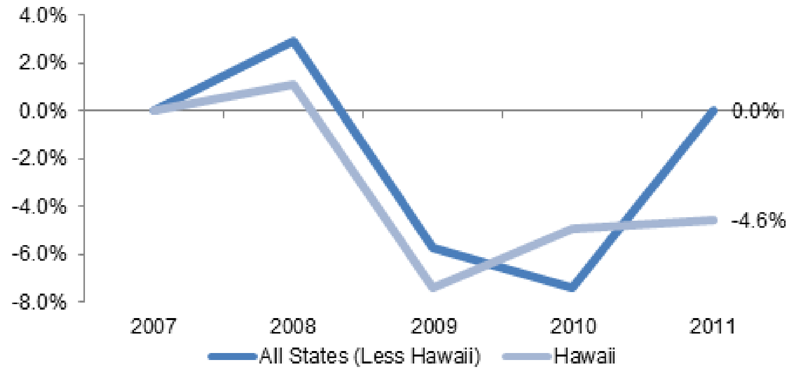
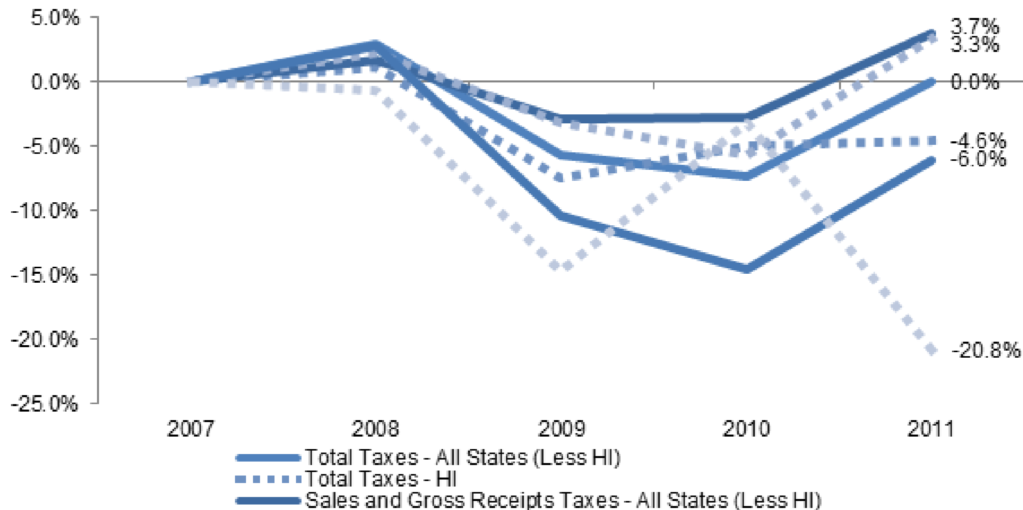
[49] State Revenue Report – April 2012. The Nelson A. Rockefeller Institute of Government.

**All States vs. Hawaii Tax Receipts – All Funds (Percent Change)**
**2007 - 2011**




From 2007 through 2011, Hawaii's total tax revenues have decreased by 4.6 percent, while the average of the rest of the states has been flat.[50] Hawaii's GET and other sales/use tax receipts (shown below as sales and gross receipts for standard display) increased by 3.3 percent since 2007 – slightly below the US states average of 3.7 percent. As shown in the chart below, the most significant reason for Hawaii's departure from the US state average is due to its significant decrease in income tax revenue (20.8 percent below 2007 level).

**Major Tax Revenue Sources – All Funds**
**US State Experiences (Less HI) vs. Hawaii Experiences**
**2007 - 2011**




*Source: US Census Bureau 2007-2011 data*

*Importance of GET and Personal Income Tax Revenues*

Hawaii's state and local governments generate a significant portion of revenue from so-called 'own-sources' (i.e. taxes, charges and miscellaneous revenues). In 2009, Hawaii state and local governments produced 78.9 percent of total revenues from own-sources.[51] This ranked 19th among the 50 states. On a per capita basis, Hawaii's $6,778 in own-source revenue ranked ninth among all states – underscoring its significant reliance on its two major tax revenue sources: the GET and the personal income tax.

[50] 2007-2011 Annual US Census Bureau State Government Tax Collections data.

[51] US Census Bureau 2009 Annual Surveys of State and Local Government Finances (published October 2011).

Compared to other states, Hawaii's total tax revenue is somewhat more reliant upon the GET and Individual Income tax. In FY 2011, 77.1 percent of all tax revenue was raised by the two taxes, compared to an average of 65.4 percent for sales tax and IIT revenue in all 50 states.[52]

The GET is applicable to many more goods and services than most other states. According to US Census Bureau data collected and standardized for all 50 states, Hawaii's GET ranked 5th among the 50 states in sales/business privilege tax revenue as a percentage of total tax revenue – trailing only Washington, Florida, South Dakota and Tennessee.[53] It is notable that each of these states does not impose a broad-based IIT.

According to a study by the Federation of Tax Administrators (FTA) that reviewed sales/business privilege taxation of common services, Hawaii's GET was applicable to 160 of the services – ranking first among all 50 states.[54] The table below displays the results of the FTA survey.

**FTA Survey of Common Services Taxation by State**

| | Utilities | Personal Services | Business Services | Computer Services | Admissions / Amusements | Professional Services | Fabrication, Repair & Installation | Other Services | Total |
|---|---|---|---|---|---|---|---|---|---|
| Delaware | 9 | 20 | 33 | 6 | 10 | 9 | 19 | 37 | 143 |
| **Hawaii** | **16** | **20** | **34** | **8** | **14** | **9** | **18** | **41** | **160** |
| New Mexico | 16 | 20 | 32 | 8 | 14 | 9 | 18 | 41 | 158 |
| South Dakota | 14 | 19 | 28 | 8 | 13 | 5 | 18 | 41 | 146 |
| Washington | 16 | 20 | 33 | 8 | 13 | 9 | 16 | 43 | 158 |
| **Total Number of Services in Category** | **16** | **20** | **34** | **8** | **15** | **9** | **19** | **47** | **168** |
| **HI % of Total Services Taxed** | 100.0% | 100.0% | 100.0% | 100.0% | 93.3% | 100.0% | 94.7% | 87.2% | 95.2% |

Of course, maintaining a broad base (including minimizing exemptions) can help to moderate tax rate increases. As shown below, among states with a BPT or GRT, Hawaii's 4.0 percent rate is tied for the lowest rate. However, Hawaii's GET generated the second greatest dollar amount, despite the State's comparatively smaller population to the below peer group. This suggests that the breadth of goods and services covered by the GET is likely responsible for the performance and comparative heft of the GET.

[52] Federation of Tax Administrators, accessed at http://www.taxadmin.org/fta/rate/11taxdis.html

[53] 2011 US Census Bureau State Government Tax Collections 2011 data.

[54] Federation of Tax Administrators (FTA) 2007 Tax Survey.

**Hawaii GET Comparison to States with Gross Receipts or Business Privilege Taxes (2011)**

| | Hawaii | Arizona* | Alabama** | New Mexico | Tennessee | West Virginia |
|---|---|---|---|---|---|---|
| **Sales Tax Rate** | **4.0%** | 6.6% + Local Option | 4.0% | - | 7.0% | 6.0% |
| **Sales Tax Exemptions** | **Rx** | Food, Rx | Rx | Food, Rx^ | Food at 5.5%; Rx exempt | Food at 2%^^; Rx exempt |
| **FY 2011 Sales Tax Revenue** | **$2,507,980,000** | $1,493,036,999 | $1,933,184,254*** | - | $2,649,385,000 | $1,654,563,000 |
| **BPT or GRT Rate** | **-** | - | $0.25 to $1.75 per $1,000 net worth | 5.125% + Local Option | .00025% of all sales to .003% of gross income depending upon classification | 5.0% on persons providing services in behavioral health and community care |
| **FY 2011 BPT or GRT Revenue** | **-** | - | $143,750,000**** | $1,634,367,000 (FY10) | $220,484,000 | N/A |
| **Total FY 2011 Sales and BPT or GPT Revenue** | **$2,507,980,000** | $1,493,036,999 | $2,076,934,254 | $1,634,367,000 | $2,869,869,000 | $1,654,563,000 |

Another measure of breadth of the GET tax base, dividing state tax base by state personal income, shows that Hawaii has by far the broadest base of any state. According to a recent paper for the TRC, in 2010 Hawaii's base was equal to 100.7 percent of personal income. New Mexico ranked second among the states, at 79.1 percent, while the average state base was just 33.0 percent of personal income.[55]

The individual income tax is the other key revenue source for Hawaii. The State currently has 12 individual income tax brackets, an increase from nine brackets in 2000. In 2008, the State changed the highest bracket's income level from over $40,000 to over $48,000. As discussed earlier in the chapter, the State – as a response to the effects of the recession and its slow recovery -- temporarily increased the income tax rate for high-income brackets for tax years 2009 through 2015.[56] The change in the brackets and rates over time is shown in the following table:

**Hawaii's Personal Income Marginal Rates and Tax Brackets 2000-2011**

| Year | Marginal Rates (range) | # of Brackets | Lowest Bracket (under) | Highest Bracket (over) |
|---|---|---|---|---|
| 2000 | 1.6-8.75% | 9 | $2,000 | $40,000 |
| 2001 | 1.6-8.75% | 9 | $2,000 | $40,000 |
| 2002 | 1.5-8.5% | 9 | $2,000 | $40,000 |

[55] William Fox, "Selected Issues with the Hawaii General Excise Tax," July 22, 2012, p. 3.

[56] Act 60, SLH 2009.

| Year | Marginal Rates (range) | # of Brackets | Lowest Bracket (under) | Highest Bracket (over) |
|---|---|---|---|---|
| 2003 | 1.4-8.25% | 9 | $2,000 | $40,000 |
| Year | Marginal Rates (range) | # of Brackets | Lowest Bracket (under) | Highest Bracket (over) |
| 2004 | 1.4-8.25% | 9 | $2,000 | $40,000 |
| 2005 | 1.4-8.25% | 9 | $2,000 | $40,000 |
| 2006 | 1.4-8.25% | 9 | $2,000 | $40,000 |
| 2007 | 1.4-8.25% | 9 | $2,000 | $40,000 |
| 2008 | 1.4-8.25% | 9 | $2,400 | $48,000 |
| 2009 | 1.4-11% | 12 | $2,400 | $200,000 |
| 2010 | 1.4-11% | 12 | $2,400 | $200,000 |
| 2011 | 1.4-11% | 12 | $2,400 | $200,000 |

Individuals primarily shoulder the majority of Hawaii's income tax burden. In FY 2011, Hawaii's IIT yielded 94.8 percent of all income taxes collected – corporate income tax represented the remaining 5.2 percent. The State IIT's proportion of total income taxes collected was second highest among all 50 states – trailing only Ohio.

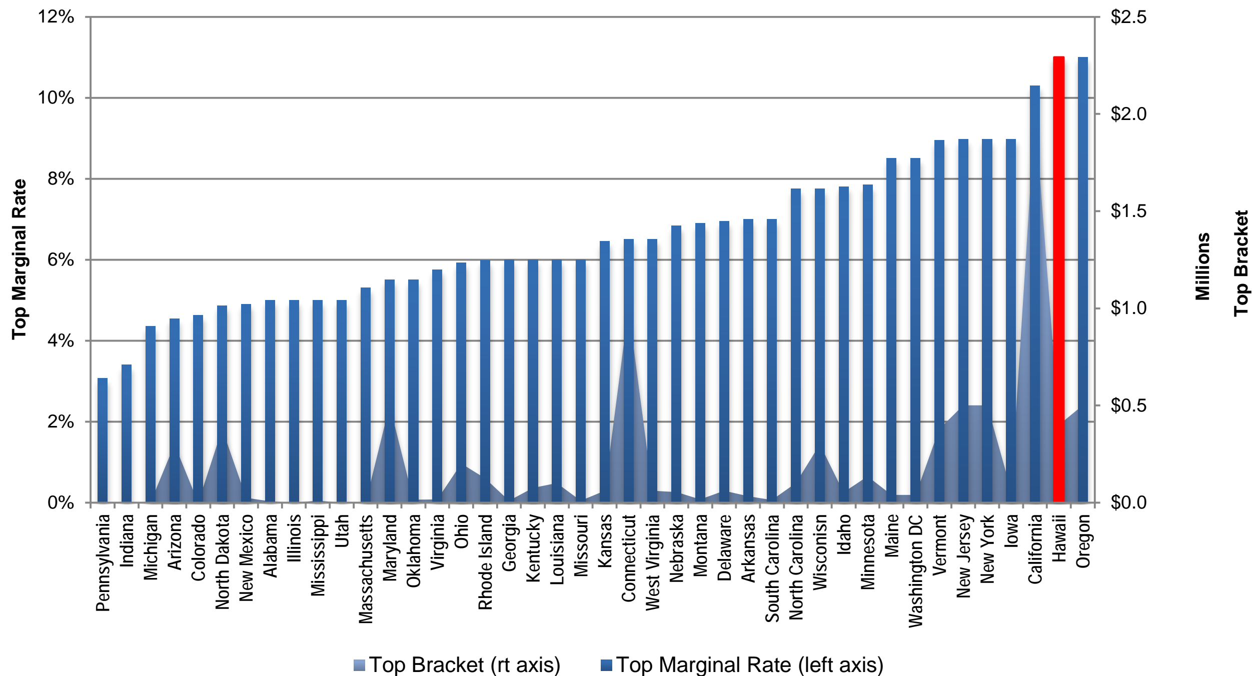
Hawaii's IIT rate as a percentage of income is among the top four of all US states. In 2010, Hawaii's median household income was $63,030. Income at this level (assuming a joint filing) in 2010 was taxed at a rate of 7.6 percent prior to deductions. Using median household incomes for all 50 states, Hawaii's joint filing income tax rate trailed only Oregon, Maine and Iowa.[57]

In 2011, Hawaii had the highest top marginal tax rate among the states (tied with Oregon) at 11 percent. Those with taxable income of at least $200,000 (individual filers) or $400,000 (joint filers) comprise the top bracket.[58] As a result, the State's personal income tax structure may be seen as levying a more significant rate on many comparable income levels (throughout the distribution) as compared to other states

[57] Federation of Tax Administrators (FTA) 2012 data; US Census Bureau 2011 State Government Tax Collections Data; Tax Foundation 2011 data. Note: Iowa and Maine allow for federal deductibility, which dramatically reduces tax burden for high income earners. As such, Hawaii's relative ranking may be even greater viewed in this context.

[58] Center for Colorado's Economic Future – compilation of Tax Foundation data.

**Top Marginal Rate and Tax Brackets: 2011 Individual Income Tax**




*Note: New Hampshire and Tennessee are not included because each only taxes dividends and interest.*
*Source: Tax Foundation data.*

Hawaii's individual income tax structure would generally be classified as progressive. States with progressive income tax structures typically tax higher incomes are higher rates. Other states with progressive income tax structures and a comparatively high top bracket include California, Iowa, New Jersey, New York, Oregon and Vermont.[59] Currently, among states with progressive personal income tax structures, Hawaii has the greatest number of personal income tax brackets (12), the highest marginal rate on its top bracket (11 percent) and the second highest marginal rate on its lowest bracket (1.4 percent).

| State | Income Brackets | Personal Exemptions | | |
|---|---|---|---|---|
| Hawaii | 12 | *Single* | *Married* | *Dependents* |
| | | $1,040 | $2,080 | $1,040 |
| California | 6 | *Single* | *Married* | *Dependents* |
| | | $102 | $204 | $315 |
| Iowa | 9 | *Single* | *Married* | *Dependents* |
| | | $40 | $80 | $40 |
| New Jersey | 6 | *Single* | *Married* | *Dependents* |
| | | $1,000 | $2,000 | $1,500 |
| New York | 8 | *Single* | *Married* | *Dependents* |
| | | $0 | $0 | $1,000 |
| Oregon | 4 | *Single* | *Married* | *Dependents* |
| | | $183 | $366 | $183 |

[59] As mentioned above, some states allow for federal deductibility, which dramatically reduces tax burden for high-income earners.

| Vermont | 5 | *Single* | *Married* | *Dependents* |
|---|---|---|---|---|
| | | $3,700 | $7,400 | $3,700 |

*Assessment of Tax Burden*

A state's tax burden can have a significant impact on its residents' wealth and the state's attractiveness to potential new residents and businesses. It is helpful to compare a jurisdiction's tax burden to other jurisdictions to understand the relative burden shouldered by residents.

There are different ways to conduct a tax burden analysis. Each state and its local governments use an array of taxes and fees to raise revenue to fund government operations. Due to differences in demographics, service provision requirements/expectations, cultural considerations and legal requirements/limitations on spending, comparing one state's tax structure to that of another is generally a complicated discussion.

The project team reviewed three methodologies for determining a state's tax burden. The first, used by the FTA, compares each state's total taxes divided by the state's population to yield a per capita tax burden. Additionally, the FTA analysis calculates the percentage of personal income represented by the per capita tax burden. These data points are compared to relative burdens across states.[60] The second method, used by the Tax Foundation, uses combined state and local tax burdens by calculating the total amount paid by residents (in taxes) of a particular state and dividing that figure by the state's total income.[61] A third method, used by the District of Columbia's annual tax burden assessment, calculates the tax burden for the largest city in each state and uses that product as a comparison point.[62] The estimated burden of major taxes for a hypothetical family of three consists of income taxes, property taxes, sales taxes and auto taxes. The estimated amount of each tax is calculated for each jurisdiction by income level ($25,000, $50,000, $75,000, $100,000 and $150,000).[63]

Each methodology has its proponents and detractors. As there are no perfect taxes, there is likely no perfect way to measure tax burden.[64]

According to the FTA data, in 2011, Hawaii had among the highest tax burdens of all states.[65] The state ranked seventh highest with a per capita tax burden of $3,533 and sixth highest for taxes as a percentage of personal income. For comparison, the average per capita tax burden of all states was $2,456 – accounting for 6.2 percent of personal income.[66]

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[60] Federation of Tax Administrators (FTA) 2011 data.

[61] State-Local Tax Burdens Fall in 2009 as Tax Revenues Shrink Faster than Income, Tax Foundation. February 2011.

[62] Tax Rates and Tax Burdens in the District of Columbia –A Nationwide Comparison 2010; District of Columbia Chief Financial Officer's Office; (Issued September 2011).

[63] The project team reviewed the Hawaii Department of Taxation Tax Research and Planning Office's 2005 "Study on the Progressive or Regressive Nature of Hawaii's Taxes – Appendix D." This Appendix provides a tax burden-calculation methodology. This methodology varies slightly – but importantly – from the methodologies cited by the project team. It is important to note that there have been changes to the State's tax laws since the 2005 study and, as such, data from that report may not be readily comparable to data contained in the project team's work.

[64] One specific note is that some methodologies may not completely disaggregate those taxes primarily paid by non-residents. In Hawaii's case, due to the significant role of tourism in the State's economy, it is likely that taxes such as the TAT and the rental car tax are exported to non-residents and thus do not constitute a significant portion of the tax burden to Hawaiians.

[65] Federation of Tax Administrators 2011 State Tax Revenue Tax Burden Comparison

[66] The median was $2,330 – accounting for 6.3 percent of personal income.

**FTA – 2011 Tax Burden – Sorted by Taxes as Percentage of Personal Income**

| | Total Taxes ($ million) | Per Capita | Rank | % of Pers. Income | Rank |
|---|---|---|---|---|---|
| Alaska | $5,538 | $7,662 | 1 | 17.5 | 1 |
| North Dakota | 3,822 | 5,589 | 2 | 13.2 | 2 |
| Vermont | 2,688 | 4,291 | 4 | 10.7 | 3 |
| | **Total Taxes ($ million)** | **Per Capita** | **Rank** | **% of Pers. Income** | **Rank** |
| Wyoming | 2,462 | 4,333 | 3 | 9.7 | 4 |
| West Virginia | 5,143 | 2,772 | 13 | 8.7 | 5 |
| **Hawaii** | **$4,858** | **$3,533** | **7** | **8.6** | **6** |
| Delaware | $3,018 | $3,327 | 10 | 8.4 | 7 |
| Minnesota | $18,953 | $3,546 | 6 | 8.3 | 8 |
| Arkansas | $7,738 | $2,634 | 17 | 8.1 | 9 |
| California | $123,110 | $3,266 | 11 | 7.8 | 10 |

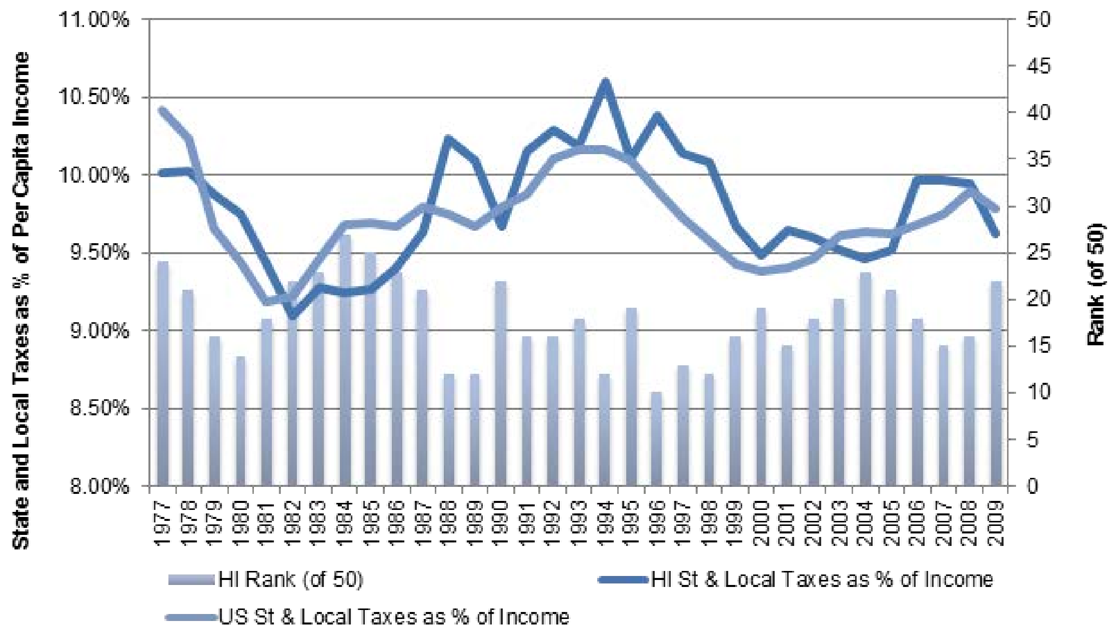
The Tax Foundation analysis shows Hawaii to be more competitive than the FTA. While in past years Hawaii has generally been in the top one-third to one-half by state, that is not the case in its most recent analysis.[67] A notable difference from the FTA analysis, the Tax Foundation includes local taxes. As a result, Hawaii's composite tax burden as a percentage of per capita income (for 2009) was 9.6 percent. By comparison, the average for all states was 9.8 percent.

The Tax Foundation data indicate that Hawaiians paid the 10th highest per capita taxes to their home state and the 27th highest in taxes to other states. Viewing the home state versus other state split as a percentage of total taxes per capita, Hawaiians paid the 4th highest percentage of total taxes to their home state (76.3 percent) and the 4th lowest percentage of total taxes to other states (23.7 percent).

This occurrence is logical, given Hawaii's island status and distance from other US states; its residents do not have readily available alternatives to avoid many consumption-based taxes. Internet shopping may somewhat alter this landscape, though as legislation and tax policy adjusts to increased online shopping, Hawaiians are likely to continue to pay among the highest percentage of total taxes to the State.

[67] Tax Foundation Tax Burden Analysis – 1977 – 2009.

**Tax Foundation – Hawaii Tax Burden – 1977-2009**




The District of Columbia study is primarily useful in comparing city tax burdens. While it is again important to note that significant variations in tax policy exist across cities and states, Honolulu's relative ranking compared to the largest cities in other states offers some context for the tax environment in Hawaii. As shown below, the $25,000 earner pays significantly more of their income as a share of taxes than the other cohorts.[68]

**Honolulu Estimated Burden of Major Taxes as Percentage of Income – For Hypothetical Family of Three - 2010**

| Annual Income | $25,000 | $50,000 | $75,000 | $100,000 | $150,000 |
|---|---|---|---|---|---|
| Citizens' Combined Taxes Paid as Percentage of Annual Income | 12.6% | 6.4% | 6.9% | 7.3% | 7.7% |
| Rank (High to Low) Among States, incl DC (of 51) | 9 | 43 | 38 | 37 | 33 |

Impacts on differing types of taxpayers (touching on issues of vertical equity) have also been considered in other studies. One by the Institute on Taxation & Economic Policy (ITEP) suggested that Hawaii's tax structure placed the sixth highest tax burden on poor residents.[69] According to the report, the GET accounted for 10.0 percent of income among Hawaii's lowest earners in 2007 (those earning less than $18,000 per year). The GET consumes the greatest share of resident income for income segments less than $85,000. For residents earning $85,000 to $176,000, GET consumed 3.3 percent of income, and income taxes accounted for 4.3 percent of income – the first income threshold at which the GET was a smaller percentage of income than income tax.

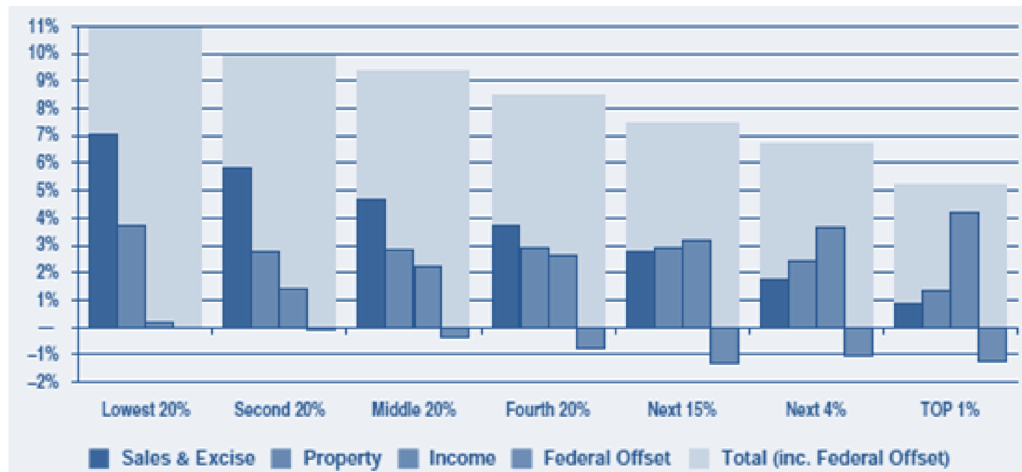
Due to Hawaii's wide application of the GET, ITEP found the State's overall tax structure to have regressive characteristics. The following table shows that higher income earners paid a successively

[68] The GET in Honolulu is 4.5 percent – and includes a 0.5 percent surcharge levied by the City/County of Honolulu and the tax burden of Honolulu citizens differs from that of the remainder of the State.

[69] Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, Institute on Taxation and Economic Policy – Third Edition, November 2009. ITEP generated its data from a micro-simulation model that used a stratified sample of tax returns, micro data sets and aggregated data sources. ITEP's 2009 report is based on 2007 data for federal, state and local governments.

smaller portion of income as State taxes. If federal offsets were included in calculations, the disparity widens even more, with the bottom 20 percent of earners still paying 12.2 percent of income and the top 1 percent of earners paying 6.3 percent of income.

**State and Local Taxes in 2007, Shares of Family Income for Non-Elderly Taxpayers**




*Source: Institute on Taxation & Economic Policy (ITEP).*

*Transient Accommodations Tax (TAT) and Rental Car Tax*

According to a 2009 study, tourism created almost 24 percent of Hawaii's non-farm jobs (over 141,000 jobs in total).[70] The study reports that travelers spent $14.3 billion in the Hawaiian economy in 2009, and the tourism industry had a payroll of $4.2 billion. Additionally, a 2011 study suggested that tourism directly contributed $8.2 billion to Hawaii's Gross State Product (GSP) – with an additional $2.7 billion of indirect contributions to GSP. Taken together, the combined $10.9 billion comprised 16.4 percent of the total GSP and, if including induced effects, the percentage increased to 22.0 percent.

Hawaii is one of the top domestic destinations for US residents and among the top international destinations for international tourists. [71] The project team reviewed the tax structure of the TAT and rental car tax in comparison with other top US tourist destinations in order to provide context. In addition to Oahu and Honolulu, the US Census Bureau identified the following US cities as top travel destinations:

- Boston, MA
- Chicago, IL
- Las Vegas, NV
- Los Angeles, CA
- Miami, FL
- New York, NY
- Orlando, FL
- San Francisco, CA
- Washington, DC

Each city has a different tax rate for hotel stays and rental car use that is comprised of some combination of state, county and/or city taxes. For comparison, the project team used Honolulu as the Hawaiian benchmark. Among the top travel destination cities in the US, Honolulu had the seventh highest hotel tax rate (out of 10 cities). It should be noted that 'travel' and 'tourism' are not synonymous, and several cities

[70] Why Travel Matters to Hawaii, US Travel Association. 2009.

[71] The US Census Bureau combines Oahu and Honolulu as top tourist destinations.

on this list are likely there as much for business travel (particularly Chicago, New York and Washington DC) as tourism. Of course, other destinations, such as Las Vegas and Orlando, are mostly tourist destinations.

| City | Tax Structure |
|---|---|
| **Honolulu** | **13.962%** |
| Boston | 14.45% |
| Chicago | 16.39% |
| Las Vegas | 12.00% |
| Los Angeles | 15.57% |
| Miami | 13.00% |
| New York City | 14.75% + $3.50/night |
| Orlando | 12.50% |
| San Francisco | 15.57% |
| Washington, DC | 14.50% |

Similarly, Honolulu's base rental car tax is comparatively low, but the addition of the temporary surcharge ($7.50 per day) made the per-day taxes and fees noticeably higher. With the expiration of the extra $4.00 per day surcharge in FY 2013, Honolulu's rental tax rate is even more competitive.

| City | Tax Structure |
|---|---|
| Honolulu | 4.712% + $3.00/day |
| Boston | 6.25% + $10 surtax (one-time, not per day) |
| Chicago | 11% + $2.75/day |
| Las Vegas | 21.35% |
| Los Angeles | 12.60% |
| Miami | 7.0% + $2.00/day |
| New York City | 15.00% |
| Orlando | 6.5% + $2.00/day |
| San Francisco | 11.10% |
| Washington, DC | 10% |

*Corporate Income Tax*

The corporate income tax is typically considered one of the "big three" taxes for state governments. However, in Hawaii, the corporate income tax is not among the biggest revenue generators. In FY 2011, the corporate income tax accounted for approximately $67.9 million in revenue – 1.4 percent of total tax revenue.[72] The corporate income tax percentage share of total tax revenue ranked seventh lowest among all states and significantly below the US-state average of 5.3 percent. The corporate share of income tax revenue (5.2 percent) ranked sixth-lowest among the 50 states.

*Summary*

[72] US Census Bureau, State Government Tax Collections 2011. Personal income tax receipts generated approximately $1.25 billion (94.8 percent of total income tax revenue).

The State's tax sources experienced one year of significant decline and three years of moderate growth from FY2007 through FY2011. The State's revenue generation is very dependent upon the GET and the IIT. While other taxes, like the TAT, are important to the State, the performance of its two major taxes generally defines its revenue health.

Hawaii's current tax structure has been characterized as regressive – largely due to the GET. Regardless of which burden methodology is used, the following are key observations:

- The wide application of the GET has regressive characteristics
- There is a comparatively high income tax rate for low wage earners
- The individual income tax brackets grow quickly at comparatively low levels of revenue
- There is a high marginal rate for the top income tax bracket
- The corporate income tax generates a comparatively small amount of revenue
- There is a comparatively lower TAT rate
- Property taxes for all classes of property are among the lowest in the nation

## State Taxes Performance

Across the nation, nearly every state has dealt with tax structure issues related to 'the Great Recession.' For most states, FY 2007-08 marked the peak year for nominal general fund revenue collections, with several years of reduced collections occurring after that. While the National Bureau of Economic Research determined that the last recession began in December 2007 and ended in June, 2009, revenues have been slow to rebound in most states.

A recent state survey found that state expectations as to when their state will return to the previous peak revenue collection level vary widely, with 14 states forecasting that to occur during FY 2012, six forecasting the current fiscal year (FY 2013) but another 15 states indicating it will not happen until sometime between FY 2014 and FY 2018. Another 13 states indicate that they do not know when revenues will return to the previous peak.[73]

While circumstances differ from state to state, there are key themes that have and continue to impact on state revenue structures, including Hawaii's. There are other emerging trends that will also have a significant effect on tax collections now and in the future.

For the better part of the last 50 years, most state tax structures have generally been focused around three key taxes: sales and use, personal income and corporate income taxes. Each of these has created challenges for state revenue structures. In many instances, key developments have impacted the way that many states approach their revenue structure. These include:

- **Base erosion.** This has been particularly notable for the sales and use tax, where legislated exemptions and the rise of digital commerce have contributed to a situation where sales tax as a share of personal income has been declining for over 50 years.[74] In the past 20 years, the emergence of the Internet has changed the way that individuals and businesses access goods and services. Consumers are shifting their purchases to catalog, internet, and other e-commerce transactions, which have lower percentages of actual sales and use tax collection. Transactions involving the sale or purchase of taxable items conducted over the internet are subject to state sales and use tax law. However, the 1992 U.S. Supreme Court's ruling in *Quill vs. North Dakota* has made collection of the tax problematic. In *Quill,* the Court held that a state or local government may only require a mail-order catalogue company to collect and remit sales tax to the state in which the consumer resides if the company has an acceptable form of physical presence (nexus) in the state.

  The best-known study on potential revenue loss from this decision was done by Dr. William Fox and Dr. Donald Bruce at the University of Tennessee Center for Business and Economic Research. The Fox-Bruce study was first done in 2001 and updated in 2008. According to that study, the tax loss for the State of Hawaii related to uncollected GET is estimated at $60.0 million for FY2012.[75]

  Recently, Dr. Fox updated his estimates of the loss from e-commerce for the State of Hawaii. Based on more recent data, Dr. Fox estimates that lost state revenue from uncollected GET taxes from e-commerce transactions totaled $144.9 million in FY 2012.[76] This is a significant increase

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[73] "State Budget Update: Spring 2012," National Conference of State Legislatures, April 2012, p.24-26. According to the survey, Pennsylvania will return to peak revenue collections in FY2012-2013.

[74] William Fox, "Three Characteristics of Tax Structures have Contributed to the Current State Fiscal Crises."" State Tax Notes, August 4, 2003, p. 379.

[75] William Fox, Donald Bruce and LeAnn Lunna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce" April 13, 2009, p. 11

[76] William F. Fox, "Selected Issues with the Hawaii General Excise Tax," July 22, 2012, p.11.

in the estimated revenue loss, which the author attributes to a dramatic rise in e-commerce activity in recent years, as well as better data from the U.S. Economic Census on taxable e-commerce activity.[77]

Base erosion has also been a concern for the other major taxes – for example, aggressive corporate income tax planning combined with a move by many states to a single factor of income apportionment has reduced the taxable base for corporate income taxes.

- **Heightened volatility.** In each of the past two recessions, the depth of the percentage decline in state revenue was more pronounced than previous post-world war recessions. In particular, sales and individual income tax collections were harder hit during and after the 'Great Recession' than in previous recessions.[78] This has made it extremely difficult for states to reliably forecast revenue growth or decline for budgeting purposes.

  An influential recent discussion of state revenue structures and revenue estimating noted that in FY 2009, the collective margin of error by states in forecasting personal income, corporate income and sales tax amounted to a $49 billion revenue shortfall, which was a median error of a 10.2 percent overestimate – meaning that half the states overestimated taxes by 10.2 percent that year.[79] This study also suggested that the forecasting trend has been getting worse: errors in revenue estimates have progressively become less accurate in each of the past three economic downturns, and 2009 ended with the largest overestimates in revenue forecasting of any of the 23 years that were included in the study period.[80]

  This increased volatility can be related to the rise, among all states, of the importance of the 'big three' of sales, personal income and corporate income taxes. Because these are economically sensitive, they are generally more volatile than other revenue sources. Together, these three accounted for 38 percent of state tax revenues in 1950 but had grown to 72 percent by 1990 and continue to increase at present. A recent study noted that 'state tax revenues have become far more sensitive to changing economic conditions since 2000' and that 'increasing responsiveness in the individual income tax has been an important source of this increase.'[81] This is due primarily to capital gains and equity market volatility. The table below outlines the percentage of taxes for all states by these three primary sources:

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[77] Ibid., p. 12.

[78] Lucy Dadayan, State Revenue Report, August 2012, Rockefeller Institute of Government, p. 12-13. The report notes that the decline in retail sales in the last recession was deeper than most recessions, although the 1973 and 1980 recessions were somewhat comparable.

[79] "States' Revenue Estimating: Cracks in the Crystal Ball," Rockefeller Institute of Government and Pew Center on the States, October 2011, p. 7-8.

[80] Ibid, p. 8-9.

[81] Report of the State Budget Crisis Task Force, June 2012, p. 15.

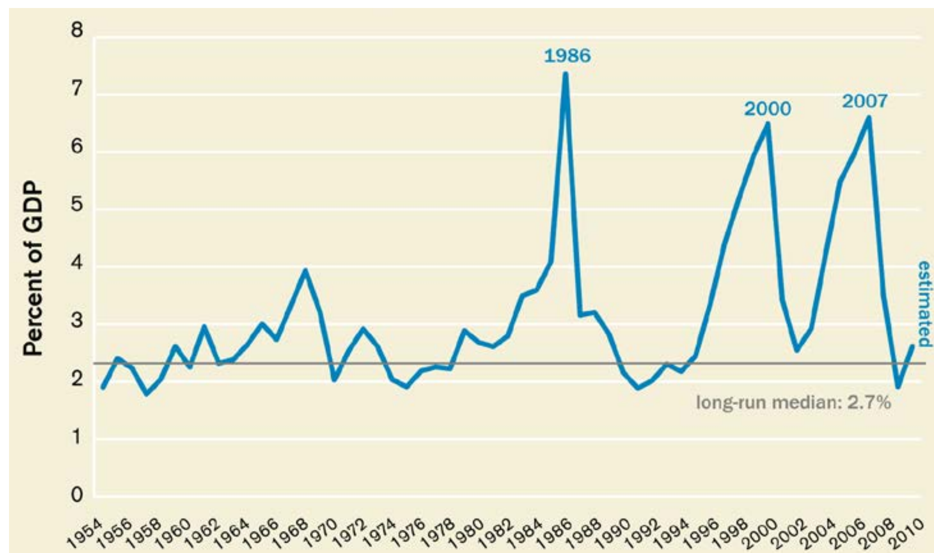
**Percentage of Total State Government Tax Revenue (%): Highly Economically Sensitive Taxes**

| | Personal Income Tax | General Sales Tax | Corporate Income Tax | Sum | Other Taxes | Total |
|---|---|---|---|---|---|---|
| 1950 | 9.1 | 21.1 | 7.4 | 37.6 | 62.4 | 100.0 |
| 1960 | 12.3 | 23.9 | 6.5 | 42.6 | 57.4 | 100.0 |
| 1970 | 19.2 | 29.6 | 7.8 | 56.5 | 43.5 | 100.0 |
| 1980 | 27.1 | 31.5 | 9.7 | 68.3 | 31.7 | 100.0 |
| 1990 | 32.0 | 33.2 | 7.2 | 72.4 | 27.6 | 100.0 |
| 2000 | 36.1 | 32.3 | 6.0 | 74.4 | 25.6 | 100.0 |
| 2005 | 34.1 | 32.7 | 5.9 | 72.7 | 27.3 | 100.0 |
| 2010 | 33.6 | 31.9 | 5.2 | 70.8 | 29.2 | 100.0 |

*Source: Holcombe & Sobel (1950-1990): Census Bureau (2000-2010).*

Among these three key sources, changes in tax collections for the individual income tax are a notable factor. In particular, realized capital gains have become an ever larger component of total tax – and a volatile one, as the following chart shows:

**Capital Gains as Percent of GDP, 1954 – 2010**

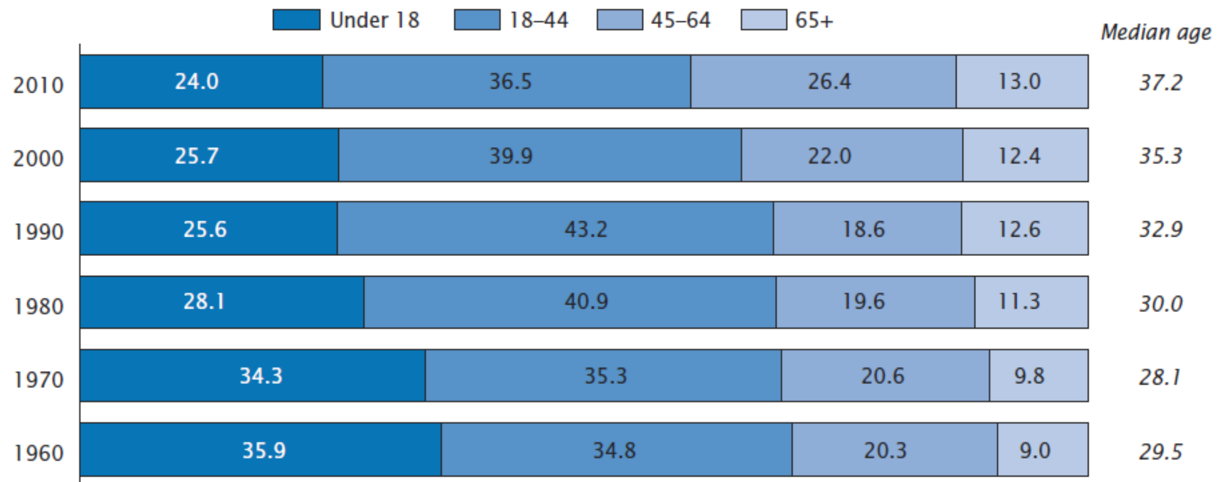



*Source: US Department of Treasury and US Bureau of Economic Analysis*

- **Demographic shifts.** The US population is getting older – the 2010 Census set the median age at 37.2 years of age, and it has been steadily increasing since 1970. At 38.6, Hawaii's median age is slightly older than the nation as a whole. The following graph details this change over time:[82]

[82] "Age and Sex Composition: 2010," United States Census Bureau, May 2011, p.6.

**Age and Sex Composition, 2010**

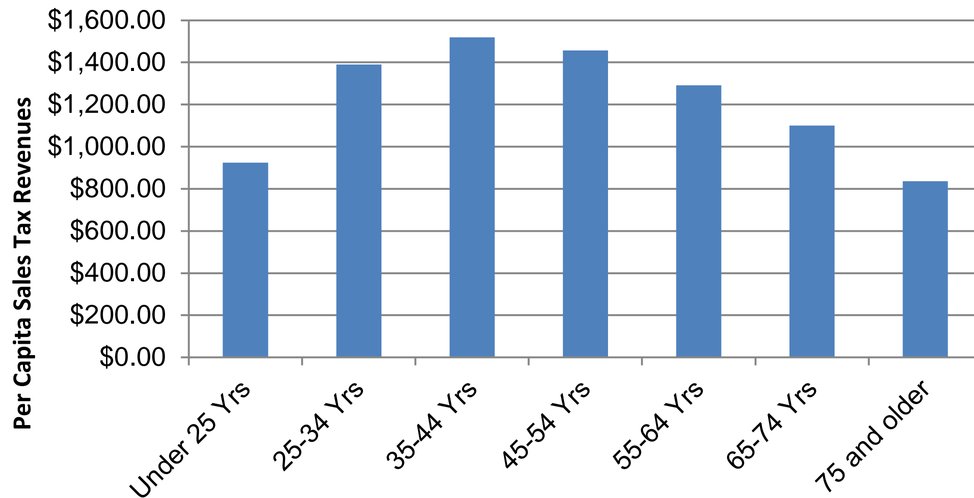



*Source: US Census Bureau*

The portion of the population over age 65 is increasing in size relative to the population as a whole. The aging of the Baby Boom generation into older age cohorts is contributing to the increase, as are stable birth rates and longer average life spans.

This can have an impact on revenue collections. In general, older population cohorts spend less of their income on taxable purchases, both because their households are smaller and because many of the spending big ticket items have already been purchased. Federal Bureau of Labor Statistics data provides a glimpse at the spending patterns of households at varying ages:

**Sales Tax Revenue Profile by Age, 2010**



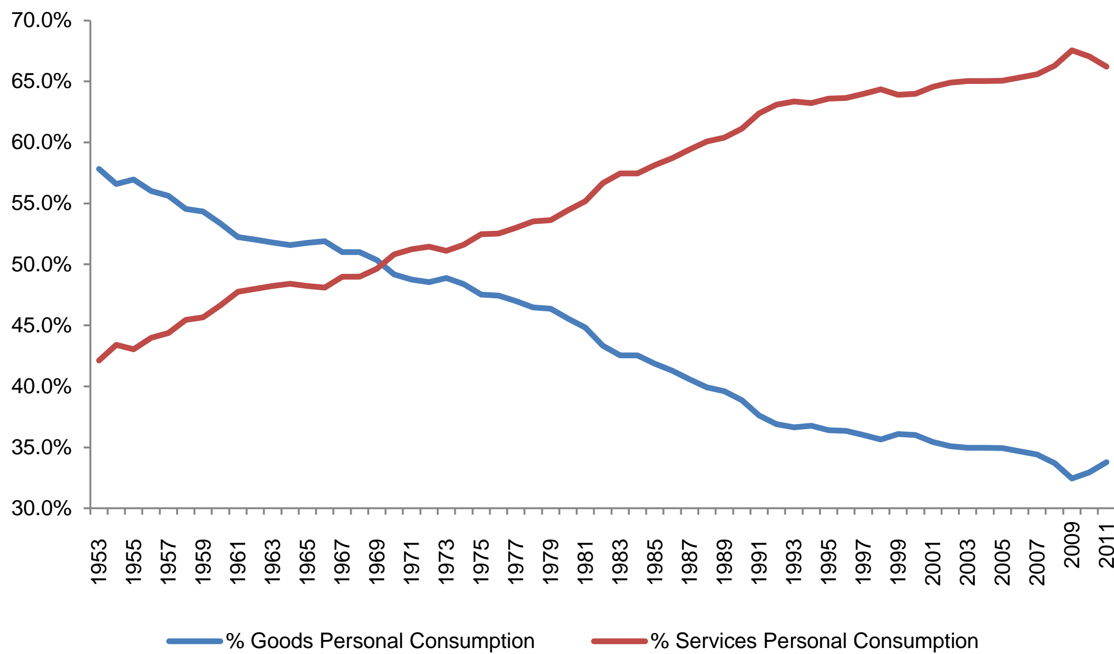

*Source: US Census Bureau*

An aging population can impact State revenues (and expenditures) in multiple ways. While these individuals are generally spending less of their income on taxable purchases, they are also able to shield more of their income from individual income taxes. The State of Hawaii fully exempts social security and public and private pension income from the state individual income tax, which

means that as a greater percentage of the state's residents reach retirement age and/or age 65, a greater percentage of income will generally not be taxed.

- **Changes in consumption.** When most sales tax laws were enacted, the economy was based around consumption of tangible goods. Not surprisingly, most of these statutes applied the sales tax the purchase of all tangible goods unless specifically exempted. On the other hand, services were a much smaller part of overall consumption; as a result, services were generally not subject to tax unless specifically enumerated.

  Over the years, personal consumption in the US has gradually shifted from goods to services. The following graph details this steady shift, with services now a clear majority of personal consumption:

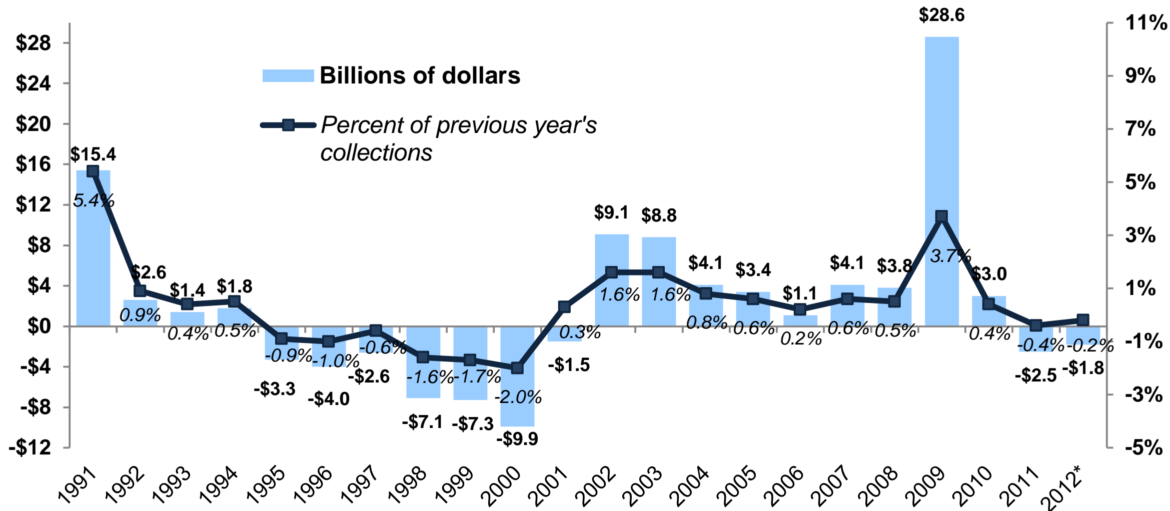



*Source: Bureau of Economic Analysis*

Given these trends and the spending impacts of the last recession, it is not surprising that states have been raising taxes as a method for dealing with at least some of their budget gaps. In fact, the National Conference of State Legislatures reported that 2011 was the first time in 10 years that states cut taxes more than they increased them. The following chart illustrates this trend over time:[83]

[83] National Conference of State Legislatures, "State Tax Actions 2011: Special Fiscal Report," February 2012, p. 3.

**Net State Tax Changes by Year of Enactment, 1991-2011**




*Source: National Conference of State Legislatures' Survey of Legislative Fiscal Offices, 2011.*

While the 'Great Recession' has exacerbated budget problems for States, many of these trends have developed over a number of years. It is also likely that budget pressures will extend well into the future – and will impact states (including Hawaii) over the entirety of the timeframe under discussion in this report.

At least one prominent budget forecast suggests that state and local government's fiscal outlook will decline throughout the period from 2012 to 2060. Since 2007, the U.S. General Accountability Office (GAO) has published a yearly 'State and Local Governments Fiscal Outlook' that creates long-term fiscal simulations for the state and local government sector. These simulations show that, like the federal government, the state and local government sector faces persistent and long-term fiscal pressures that will grow over time.[84]

The GAO simulation shows that state finances have shown some rebound in the past year, largely because of a return, on average, of revenue growth among the states. That said, the model still forecasts a steady decline in budget balance, primarily driven by the same growth pressures associated by health-related costs of state and local expenditures on Medicaid and the cost of health care compensation for state and local government employees and retirees. The results of this latest GAO simulation are presented in the following graph:

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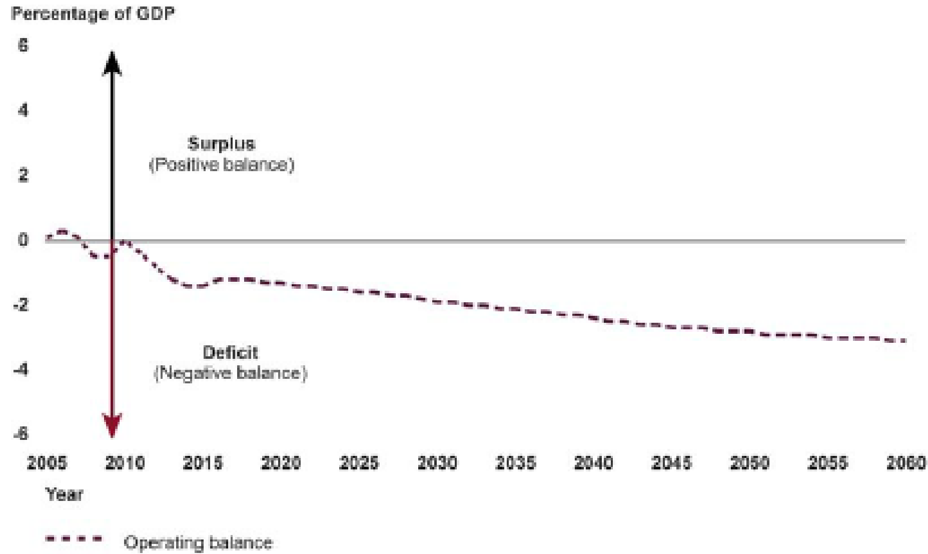
[84] 'State and Local Governments' Fiscal Outlook, April 2012 Update,' United States Government Accountability Office, GAO-12-523SP, p. 1.

**State and Local Operating Balance, as a Percentage of Gross Domestic Product**




*Source: CAO Simulations, updated April 2012*

This simulation is enlightening for a number of reasons. First, it examines state and local governments as a whole and from the vantage point of how state and local governments will do across a variety of political, economic and social perspectives. Clearly, the sector as a whole has a serious disconnect between its current revenue and expenditure structures. While there is a case to be made that individual governments could choose to discontinue doing some of what they do (or do it more efficiently), there is little in the simulation data that suggests the current negative trend will not continue into the future.

## Strengths, Weaknesses, Opportunities and Threats

A SWOT (strengths, weaknesses, opportunities, threats) analysis generally looks at a system or organization from two perspectives – that of the organization or system (internal) and the environment (external). These perspectives are then grouped by those that are helpful or harmful for the organization or system in attaining its goals. The following represents this analytical framework:

| | **Helpful** to achieving the objective | **Harmful** to achieving the objective |
|---|---|---|
| **Internal** (attributes of the organization) | **Strengths** | **Weaknesses** |
| **External** (attributes of the environment) | **Opportunities** | **Threats** |

Strengths

In many respects, the Hawaii tax structure has been developed to capitalize on the State's unique geographic situation in relation to other states. This has advantages (and some disadvantages as well). The following are internal advantages of the current tax structure and the taxes and revenues that comprise it:

- **Broad and stable base for the General Excise Tax (GET)**. The GET has proven resistant to much of the base erosion around the rise of services highlighted in the previous section. It is notable that other states, to maintain similar levels of sales tax revenue, have generally had to resort to rate increases. A paper written for the last Tax Review Commission noted that essentially every other state has raised its sales tax rate during the past 25 to 30 years in the face of tax bases that have been eroded.[85]
- **Relatively low tax rate for the GET**. It is a generally accepted tenet of tax policy that a broad base and a low rate will minimize economic disruption. There is no perfect tax – there will be some 'deadweight' loss associated with any tax, as the tax will increase the final cost of goods and services to the consumer and thus reduce overall levels of consumption. The paper cited in the previous bullet notes that for sales taxes in particular, states have been forced to raise rates to maintain a similar share of revenue from their sales taxes. The paper found that the median state sales tax rate rose from 3.25 percent in 1970, to 4.0 percent in 1980, and to 5.0 percent in 1990. In 2006, 21 of the 45 sales taxing states use a rate at or above 6.0 percent. Hawaii has been able to avoid this spiral of a continually narrowing base and rising rate – which can have a significant impact on business and consumer market decisions.
- **Insulation from cross-border competition issues.** In many states, consumer mobility is an important consideration in devising tax policy. Study after study has identified border leakage in

[85] William Fox, "Hawaii's General Excise Tax: Should the Base Be Changed?" Report Prepared for the 2005-2007 Hawaii Tax Review Commission, October 4, 2006, p.1.

sales of a variety of goods and services, including alcohol,[86] cigarettes,[87] motor fuel,[88] and durable goods.[89] This is understandable, as in many places around the country (and particularly metropolitan areas), the next state is just minutes away – and in some places just across the street. As a border state is hours by plane away from the mainland, Hawaii does not have to concern itself with this natural competition.

- **GET is responsive to demographic and economic changes.** As noted above, the base for the GET has remained stable, which has mitigated the need to increase rates over time. While changing demographics were cited as a key revenue issue for states, the GET appears more able to withstand demographic impacts. For example, many sales tax structures do not tax services related to medical and health care. Given the continued growth of the percentage of GDP associated with health services – and the aging population which consumes a very large share of these services – Hawaii's tax structure will be less impacted by these consumption shifts.
- **Ability to export a significant share of state tax burden.** Hawaii regularly attracts millions of non-resident visitors each year. The majority of these visitors are tourists on holiday or vacation. These individuals generally expect to consume a significant amount of goods and services while visiting Hawaii. This is a benefit to the state, as the tax burden is exported to non-residents. One study estimated that most of Hawaii's taxes exported approximately one-third of the burden to non-residents.[90]

Weaknesses

While the GET is an important strength for the tax structure as a whole, as noted above, there are no perfect taxes, and the GET has particular impacts on certain industries that can be seen as a weakness. Other aspects of the tax structure and the way it is administered are also areas of concern for the overall structure.

- **Largely dependent on two primary taxes.** The GET is Hawaii's primary state revenue source. In FY2011, The GET collected 51.4 percent of Hawaii's tax revenues, which is significantly greater than comparable broad based consumption tax collections in the average state, which averages 31.5 percent. Only Washington, Tennessee, Florida, and South Dakota generate a larger percentage of tax revenues from their sales tax than Hawaii – all states without a broad-based individual income tax. Hawaii's second largest source, the IIT, makes up 29.3 percent of state tax revenues. Combined, these total nearly 83 percent of state revenues, significantly greater than the average state, which derives 65.5 percent of its revenue from these two sources.
- **GET results in some tax pyramiding.** The GET is imposed on a broader set of transactions than any other sales tax, and it varies from sales taxes in that it is imposed on many intermediate purchases (business inputs). The 4.0 percent GET rate on some services and the 0.5 percent GET rate imposed on wholesaling, manufacturing, producing, wholesale services, and use tax on

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[86] T. Randolph Beard, Paula A. Gant, Richard P. Saba, "Border-Crossing Sales, Tax Avoidance, and State Tax Policies: An Application to Alcohol," *Southern Economic Journal*, July 1997, p. 300-302.

[87] See for example Patrick Fleenor, "How Excise Tax Differentials Affect Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States," The Tax Foundation, Background Paper No. 26, October 1998.

[88] Mark D. Manuszak and Charles C. Maul, "How Far For a Buck? Tax Differences and the Location of Retail Gasoline Activity in Southeast Chicagoland," January 26, 2009.

[89] See for example Walsh, M. and J. Jones (1988) "More Evidence on the 'Border Tax' Effect: the Case of West Virginia," *National Tax Journal*, Vol. 14, pp. 362-374; F. Steb Hipple, "Retail Sales and Sales Tax Losses from Tennessee to Virginia in the Tri-states Metropolitan Area 1996 and 2003," State of Tennessee Tax Structure Study Commission, November 6, 2003; Rossitza Wooster and Joshua Lehner, "Reexamining the Border Tax Effect: A Case Study of Washington State" September 2008.

[90] Richard L. Bowen and PingSun Leung, "Tax Pyramiding and Tax Exporting in Hawaii: An Input-Output Analysis," University of Hawaii Research Extension Series 102, January 1989, p. 8.

imports for resale gets layered into intermediate activities that get passed along as part of the price of many finished products or service.

This can have some adverse consequences. Taxes on business inputs have the potential to alter business behavior. As firms seek to limit the amount of tax they pay, they will explore a variety of approaches. A common method is to vertically integrate and bring more activities within a single company. For example, a firm that contracts for professional services (finance, IT, legal, marketing) can bring these in-house to eliminate paying the tax. This may also benefit larger firms with more ability to make these changes than smaller firms, which can alter the competitive landscape. Taxes on inputs may also make Hawaii businesses less competitive in the broader market. Hawaii-based firms that use Hawaii-based goods and services in its production will have higher costs than non-Hawaii based firms or Hawaii based firms that import goods or services as part of its production. Further, this pyramiding can raise the relative price of some goods and cause people to purchase less of these goods.

Of course, these factors must be weighed in conjunction with other taxes that businesses pay in Hawaii and other states. The Center on State Taxation, a business-funded group, does a yearly analysis of all taxes paid by businesses and expresses these as a share of gross state product. According to their analysis, in 2011, the State of Hawaii collected state and local taxes that total 5.9 percent of the State GSP. This ranked 11th highest among all the states.[91]

- **Comparatively high Individual income tax rates at high and low income levels.** Hawaii's individual income tax consists of 12 different rates that start at 1.40 percent of $2,400 of taxable income for individual filers and $3,600 for households. This rate rises relatively quickly to 5.50 percent at $4,800/$7,200 of taxable income. This is a higher rate at lower income levels than are generally found in states with multiple rates and income brackets. At the high end, Hawaii's top rate of 11.00 percent at $200,000/$300,000 of taxable income, is the highest rate in the nation. As with the GET, Hawaii is insulated in some respects from residential location decisions because of its distance from other states.
- **Exempts a growing source of income from the individual income tax.** Demographic changes are resulting in an aging of the national (and state) population. As this occurs, retirement income (public and private pensions and social security) becomes a larger component of total income. The State of Hawaii exempts nearly all of this income, regardless of amount, from state individual income tax. This will, over time, erode the tax base for the state individual income tax.
- **Obtains a comparatively small source of revenue from the corporate income tax.** Hawaii's corporate net income tax raises a significantly smaller portion of overall state tax revenue than in the average state. Nationally, corporate net income taxes average over 5 percent of total state taxes; in Hawaii, it totals just 1 percent. Of course, the application of the GET also functions as a form of business tax. Discussions with internal and external stakeholder identified the corporate net income tax as a complicated tax for compliance and administration relative to the revenue it raises.
- **Variety of tax law sunsets in coming years.** During the economic downturn (and the revenue downturn that also resulted), the State enacted a number of temporary tax changes that resulted in a significant increase in tax revenue. These temporary tax law changes will sunset in the next few years, which will (unless extended) result in a permanent loss of state revenues. There are also other taxes approved in years prior to the Great Recession that are also scheduled to sunset, with similar potential impact on revenue collections.
- **Older tax collection systems and processes.** Efficient and effective tax administration is generally necessary to maximize tax compliance and revenue collections. Across the country, states are using a variety of sophisticated technology-driven approaches to improve compliance

[91] "Total State and Local Business Taxes: State by State Estimates for Fiscal Year 2011," Council on State Taxation, July 2012, p.11.

and collections. Mainstream approaches using audits of sales, income and excise tax returns also generally rely on automated systems. The State of Hawaii's tax administration systems are mostly manual systems that do not allow the State to audit a representative sample of returns – and certainly not to use the latest tax gap hardware and software analytical tools.

External Issues

External opportunities and threats are often difficult to identify and/or quantify, as it relies on activities outside the control of the State. The following touch on a couple of key areas that have already been identified within the chapter.

Opportunities

- **Federal solution on e-commerce.** Because of the importance of sales tax as a revenue source, states have undertaken a variety of strategies to establish nexus for businesses for the purpose of enforcing collection of sales taxes on out-of-state purchases. In Hawaii, this is somewhat mitigated, as the GET, in theory, creates economic nexus sufficient to enforce collection of sales taxes. At the same time, there are likely vendors with economic nexus who are not currently collecting GET, and a national solution should increase overall compliance. Currently, there are at least three different bills in the U.S. Congress that would develop a national solution. Governors of both parties have become increasingly supportive of these efforts, often framing this as a 'main street fairness' issue. It is likely that this momentum will lead to a federal solution sometime in the next 4-10 years. Of course, the terms and conditions of any federal legislated solution will impact on the actual revenue benefit for Hawaii and the other 49 states.[92]
- **Voluntary vendor compliance with e-commerce tax collection.** Some large e-commerce retailers are voluntarily remitting sales tax to some states where they otherwise would not be required to do so. Some of this relates to efforts by states to create greater uniformity through the Streamlined Sales Tax initiative[93] while some has been in response to legislative efforts in states to establish nexus for e-commerce collections.[94] In other instances, retailers have deemed it in their best interest to comply, as it provides them some customer service and customer contact opportunities that they could not use without collecting tax. It is possible that this trend will continue to grow in the future and more states will receive voluntary compliance by vendors – although it is an open question as to whether this will be the case in Hawaii.

Threats

- **Continued erosion from e-commerce.** While the previous analysis suggests that there may be a federal solution related to e-commerce sales tax collection, the timing of this federal solution is unclear, and erosion will continue in the meantime. Second, e-commerce also opens markets for providers of goods and services throughout the world. It is likely that some of the business

[92]See William F. Fox, "Selected Issues with the Hawaii General Excise Tax," July 22, 2012, pp. 12-13 for a discussion of the three bills currently before Congress.

[93] The Streamlined Sales Tax Initiative was created by the National Governor's Association and the National Conference of State Legislatures in 1999 to simplify sales tax collection. It is a cooperative effort involving 44 states, the District of Columbia, local governments and the business community to simplify sales and use tax collection and administration by retailers and states. To date, 24 of the 44 states have passed conforming legislation to become full participants in the Streamlined Sales and Use Tax Agreement. The states that have passed legislation to conform to the Agreement are Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming. Conforming legislation has been introduced in Texas, Massachusetts, Florida, Illinois, Virginia, Missouri, Maine, California, and Hawaii. See http://www.streamlinedsalestax.org/

[94] For example, Amazon dropped a 2011 referendum campaign in the State of California aimed at overturning state legislation that requires remote sellers to collect sales tax if they have affiliates or subsidiaries in the state in return for delaying its enforcement by one year.

activity currently done in the State can and will be done remotely in the future; this can impact on Hawaii business activity and other state tax collections.

- **Reductions in federal spending.** The federal budget deficit continues to be a major topic of conversation in Washington DC. Based on past failed budget negotiations and the 'fiscal cliff' that is now facing Congress, major reductions in federal spending would negatively impact Hawaii, given the size of the federal presence (primarily military) in the State. A major force reduction would reduce consumption and income-based taxes for the State.
- **Significant decline in tourism.** The State derives a significant amount of its revenue from taxes paid by visitors to the State. The State has experienced downturns in the industry from time to time – either because of broad based economic downturns or other related shocks (such as the events surrounding September 11, 2001). Given the reliance on these taxes for the state, these occurrences would have a significant impact on the State's revenues.

# Structural Sustainability

# Structural Sustainability

Exactly what constitutes revenue sufficiency is open to discussion and debate. As directed by the Tax Review Commission, this study is to provide "an analysis of whether the current tax system will provide sufficient revenues to meet near and long term future needs for the 21st Century." As a result, determining whether revenues are sufficient also requires an analysis of the near and long term needs for the State.

<u>Spending Alternatives</u>

States as a whole are facing daunting challenges that will place great financial pressure on the sector in the years to come. In some cases, the costs associated with prior commitments are quantifiable, and in other cases they are less concrete. The following identifies some key challenges where policymakers will have to determine their priority and funding commitment in the future.

Many spending decisions are predicated on making investments that will benefit the state's economy and its citizens. Some of these, related to infrastructure in need of replacement, are most likely going to have to be addressed regardless of the State's budget situation. Other obligations, like the state match for Medicaid funding, will be required because of federal mandate. Finally, state obligations related to pension and retire health care benefits are state legal obligations that will grow in importance as the population ages. In short, there are key issues that the State is likely going to have to address in the next twenty years, and it is likely that they will also impact on state tax policy and the state tax structure. The following address some – but by no means all – of these issue areas.

*Schools and Infrastructure*
It is generally accepted that the future of the economy will rely heavily on a strong education system. The jobs that are currently demanded by the local economy for tourism, construction and the service industries are generally low-wage and low-skill. Jobs for the 21st century will require innovative industries that apply technology at all levels as technology has fundamentally changed the way people live and thrive and conduct business on a daily basis.

Going forward, the State will need to account for future expenses and strategic investments in schools and infrastructure. According to a September 2011 study done with the Hawaii Institute for Public Affairs, there is a $392 million backlog in repair and maintenance to Hawaii schools alone and over 60 percent of schools are 50 years or older. Overall, aging schools, maintenance backlogs and predicted budget shortfalls will need to be addressed in the future year budgets.

In addition to schools, traditional public infrastructure investment for roads, water and sewer will also be in need of funding to maintain existing systems or build new ones. According to the American Society of Civil Engineer's Report Card for America's Infrastructure, the top three infrastructure needs in the State of Hawaii include Mass Transit, Roads and Schools.[95] The report noted that over 70 percent of Hawaii's interstate pavements are in poor to mediocre condition, and Hawaii had a $187 million backlog of deferred road maintenance as of 2007. These statistics, coupled with a 28 percent increase in vehicle travel on Hawaii highways between 1990-2007, make mass transit and roads a key issue that needs to be addressed to ensure adequate infrastructure for the 21st century.

With the distress and congestion of roads and traffic across the State, development of the Hawaii rail system will increase accessibility and mobility options, addressing a solution to one of the State's top infrastructure needs.

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[95] http://www.infrastructurereportcard.org/state-page/hawaii

**Rail Project Status, July 2012**

HART FACTS

July 9, 2012

HART CEO Dan Grabauskas answers community questions about rail transit.

**QUESTION:**
It seems like all large government projects have big cost overruns. What makes you think Honolulu's rail project will be any different?

**DAN GRABAUSKAS:**
Several notable mainland rail projects have come in on time and on budget. Dallas completed a $1.8 billion project, Seattle a $1.7 billion project and Vancouver, B.C. a $2.1 billion (CAD). I'm confident that Honolulu is just as capable of accomplishing this as any major city.

Visit **honolulutransit.org/rail-facts** for more information.

| PROJECT REVENUE STATUS<br>How much money is budgeted and has been received | Projections to Date | Collected or Committed to Date | Percentage (of projections) |
|---|---|---|---|
| REVENUE SOURCE: | (in millions) | (in millions) | |
| General Excise Tax (GET) Surcharge | $3,589 | $859 | 23.9% |
| Federal New Starts Funds | 1,550 | 120 | 7.7% |
| Other Federal Transportation Funds | 214 | 4 | 1.9% |
| Interest Income | 3 | - | 0.0% |
| TOTAL | $ 5,356 | $ 983 | 18.3% |

**Comment: To date, HART has already received more than 18% of rail transit funding and is on track to meet revenue projections.**

| PROJECT COST STATUS<br>End of April 2012 | Current Budget | Amount Committed[1] | Amount Expended[2] |
|---|---|---|---|
| | (in millions) | (in millions) | (in millions) |
| Fixed Guideway/Track | $ 1,114 | $ 509.74 | 0.10 |
| Stations, Parking Facility, Elevators/Escalators | 422 | - | - |
| Maintenance Yard, Support Facilities | 93 | 80.84 | $ 2.73 |
| Rail Vehicles and Systems | 408 | 404.58 | - |
| Sitework and Special Construction | 981 | 453.28 | 158.60 |
| SUB-TOTAL | $3,017 | $1,448.44 | $ 161.43 |
| Real Estate/Right-of-Way | $ 197 | $ 29.96 | $ 26.96 |
| Professional Services (e.g., Planning and Design) | 1,090 | 550.39 | 240.29 |
| Contingencies | 644 | - | - |
| Financing Costs | 215 | - | - |
| SUB-TOTAL | $2,146 | $580.35 | $267.25 |
| TOTAL | $5,163 | $2,028.79 | $ 428.68 |

1 - Approved contract value. 2 - Portion of the work that has been paid for.

**DID YOU KNOW?** The cost of building the rail project will be paid off by the end of 2022. There will be no long-term debt.

*Healthcare/Community Well-Being*

The 2050 Hawaii Sustainability Plan[96] outlines unique qualities associated with the 'Aloha Spirit' that can be found throughout the State of Hawaii. The report identifies the qualities of the islands as they relate to a multi-cultural community that allows people to live with dignity and respect, and exceed the basic requirements of food, shelter, health care, safety and education. As outlined in the report, these include:

- Safe, caring and engaged communities
- Healthy and sustainable surroundings
- Quality job opportunities for present and future generations
- Access to quality education
- Housing and Health Care
- Adequate and well-maintained infrastructure and governmental services
- Access to recreational facilities and leisure activities
- Positive interaction and respect among citizenry

Needless to say, these goals will generally require both public and private investment, and it is an open question as to whether the growth rate assumptions built into the long range forecasts will be sufficient to meet these goals.

*Energy and Import Independence*

The cost of importing goods and services impacts Hawaii more than most states due to its isolation; the State is importing nearly 90 percent of goods and services.[97] Since 1977, the annual cost of importing oil has grown from $500 million to over $5 billion.[98] In light of this, it is encouraging that the US Department of Energy has ranked Hawaii among those states best positioned to expand renewable energy opportunities, based on abundant wind, solar, geothermal and other renewable energy resources.[99]

In 2008, the State signed a long-term Memorandum of Understanding (MOU) with the US Department of Energy to establish a partnership called the Hawaii Clean Energy Initiative. The partnership aims to have

[96] Hawaii 2050, Sustainability Task Force, State of Hawaii, January 2008.

[97] 2010 Abercrombie for Governor, "*A New Day in Hawaii*".

[98] Ibid.

[99] http://www.eere.energy.gov/

70 percent of all of Hawaii's energy needs generated by renewable energy sources by 2030[100] by helping Hawaii develop its renewable energy resources, including solar energy, wind power and bioenergy.

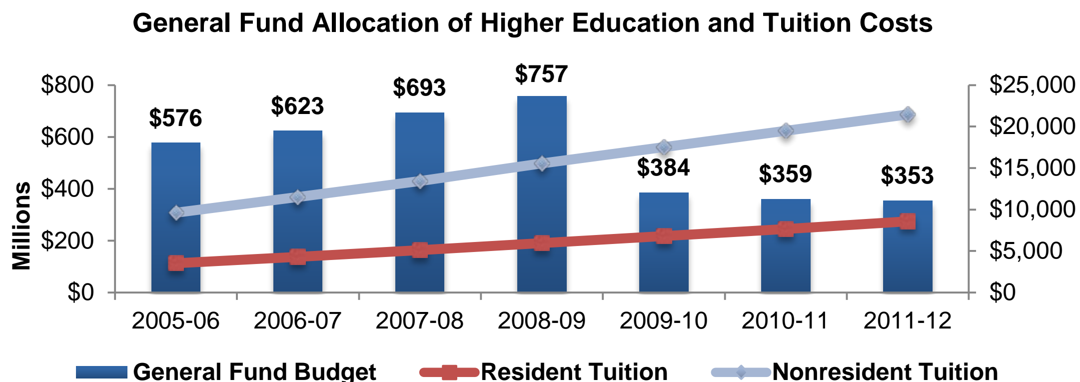
*Sustainable Natural Resources, Agricultural Renaissance and Local Production/Sustainability*
Despite Hawaii's plentiful agricultural land and year-round growing conditions, the State still imports more than 85 percent of food and has less than a 7-day supply of food in stores at any given time. Concerns about community food security, based on the food distribution system's vulnerability to major economic disruptions and environmental disasters have led to the formation of community groups and projects to promote stable and sustainable food production, local agricultural commerce and healthy lifestyles. Additional concerns surrounding the sustainability of local food production include:[101]

- Low availability and high price of locally grown food in markets and restaurants
- Stagnation of the local agricultural economy due to cheap imports
- Increasingly questionable food safety from imported foods of nearly untraceable origin
- Poor nutrition due to overconsumption of cheap processed foods
- Skyrocketing medical costs due to nutrition related non-communicable diseases

By investing in agriculture and producing more food on the islands, the State may be less vulnerable to economic disruptions, protect valued green space and agricultural lands, spur economic activity in the local economy and reduce the risk of invasive species and non-communicable diseases.

*Higher Education*
The University of Hawaii is not only the public system of higher education in Hawaii, but some would say the economic, social and cultural pillar of the Islands. The system includes 10 campuses and a number of educational training and research centers across the islands. Total enrollment at the University is over 60,000 undergraduate and graduate students.[102] According to the University's website, 85 percent of the students are residents of Hawaii, almost ten percent from the mainland or a US affiliate and 3.6 percent foreign with 1.4 percent unknown.

As the State continues to face tremendous pressure to reduce spending, it is likely that the traditional General Fund revenue streams going to fund public higher education will also decrease. This is a trend across the country, forcing these institutions to examine operations and maximize resources through cost and program reductions, alternative revenue sources such as research funding and endowments, and increase overall efficiencies. Below is a graphical illustration of the General Fund allocation to higher education in Hawaii, with an overlay of tuition costs for resident and nonresident students.

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[100] http://www.eere.energy.gov/
[101] http://hawaiihomegrown.net/
[102] http://www.hawaii.edu/about/

*Development Incentives*
In looking to broaden its economy, the State has undertaken significant efforts to support technology-related business and industry. A prominent example is the High-Technology Business Investment and Research Tax Credits, which were created in 1999 and expanded in 2001 to stimulate the growth and development of high technology industries in the State. It has been estimated that claims for these credits totaled nearly $858 million from tax years 1999 to 2010.[103] While the credits have sunsetted, eligible businesses have five years to claim the credits, and this will continue to impact the State budget in coming years. It is an open question whether this form of tax credit is the most effective method for advancing high-tech businesses and may have a significant impact on overall state tax policy.

## Long Range Forecasting Model

To assist in understanding the State's financial position over time, the project team built a multi-year budget forecasting model that projects the State's General Fund revenues, expenditures and resulting financial results through FY 2025. While this does not encompass all of the State's revenues, it covers the vast majority – and it specifically addresses those that are available for appropriation to support general state operations and programs.

The forecasting model uses detailed historic information and management insight to produce a baseline financial projection. A baseline projection assumes maintaining the current level of service for existing programs (as well as any statutorily mandated changes) and the current tax and revenue structure (with any statutorily required changes) through FY 2025.[104] The baseline predicts what the State's financial results are likely to be in the future based on current information. Although the projections assume current service levels will continue, this does not mean that existing, higher or even lower levels of service are recommended. These are policy decisions for State legislators and policy makers. This analysis is undertaken only to estimate the fiscal gap if no major changes are made on either the revenue or expenditure sides of the budget. With that baseline projection in place, State officials and the public can examine choices on both the revenue and expenditure side of the budget to achieve defined outcomes, and the budget model can be adjusted accordingly to group decisions into multiple scenarios.

In constructing the model, historic revenue and expenditure data was provided by the Department of Budget and Finance, and the Council on Revenues General Fund forecasts were also used. Although these projections are on a cash basis, at the request of the TRC, the project team also modeled the financial results when presented on a full accrual basis. This version assumes the State will make pension and retiree health contributions sufficient to fully fund its pension and other post-employment benefit (OPEB) liabilities. Given the current pay-as-you go method of funding for OPEB, the cash-based projection was deemed the most appropriate for the purposes of this report. At the same time, the model can be run on an accrual basis. As the model will be turned over to the State at the end of the project, policymakers can examine this and other 'what if' scenarios in the future.

Based on historical information and interviews with State officials, the project team performed regression analysis against key economic variables for a number of the State's key tax revenue sources. The project team also calculated annual growth rates that project how the State's revenues and expenses will change going forward. In general, the model uses prudent, modestly conservative assumptions. This allows the State to benefit from better-than-anticipated results rather than depending on them to maintain fiscal health.

While the short-term forecasts (FY 2012-2015) are grounded in reasonably reliable statistical relationships among economic variables and tax collections, the longer-term projection (FY 2015-2025) is

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[103] "Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits," Auditor, State of Hawaii, Report No. 12-05, July 2012, p. 20.

(understandably) less grounded in these statistical relationships. As in most any forecasting exercise, the degree of statistical confidence in the estimates declines over time.

For these later years, the model relies more heavily on the Department of Economic Development, Business and Tourism's (DBEDT) predicted long-term economic and population growth trends and less on forecasts derived from current economic conditions. The parameters in the model representing these factors were developed based on data trends and patterns and several generally accepted assumptions and predictions. As a result, the longer-term forecast should be viewed as more suggestive and less definitive than the three-year forecast. However, the longer-term forecasts should serve as a useful guide to policy makers and their general conclusions should prove reasonable barring a major unexpected change in economic or population trends.

In addition to the baseline, the project team built two additional scenarios to give the TRC a sense of the range of potential outcomes, using different revenue assumptions. It is important to note that the projection model is a simulation based on a reasonable (but not the only possible) set of assumptions. Any forecast of a gap between revenues and expenditures is not a definitive projected budget deficit, but a theoretical one based on the simulation. In fact, suggestions of a continually growing structural deficit (or surplus) should be tempered by the understanding that policymakers will react to the circumstances and close budget gaps (generally through a combination of revenue and expenditure changes) before a series of yearly deficits can compound themselves.

Given balanced budget requirements, Hawaii (as with most states)[105] is much different than the federal government – it must confront and balance its budget on a yearly basis. To assist with that possibility, the model develops alternate scenarios for changes to the State revenue structure to address any possible deficit. These scenarios can be grouped together as policymakers see fit to determine how they impact on the State's budget picture over time.

An argument can be made that the scenarios developed within the model address only the revenue side of the equation. It is true that most budget deficits are tackled on both the expenditure and revenue sides. At the same time, many of the obligations that will fuel expenditure growth during this timeframe – such as pension and health care obligations – do not readily lend themselves to a solution on the expenditure side. This is a reality that many states are facing – and it is reflected in the GAO model of state and local government budgets discussed in the previous chapter.

The bulk of this chapter will focus on the baseline scenario forecast. At the same time, assumptions in the alternative scenarios will also be discussed.

Revenue Projections

The **General Excise Tax** (GET) is the State's most important revenue source, accounting for 49 percent of General Fund revenues in FY 2011. For the past five years, the General Excise Tax has grown, interrupted by dips in revenue in FY 2009 and FY 2010. By FY 2011, revenue growth resumed at 7.7 percent. Over time, GET growth has tracked closely with Hawaii personal income growth.

The second largest source is the **Individual Income Tax** (IIT), made up 24.3 percent of the General Fund revenue. Unlike the General Excise Tax, over the past five years IIT revenue growth has been more volatile and sensitive to changes in the economy. However over the long term, historically IIT has also tracked closely to personal income growth.

For the GET and IIT projections, the project team retained the Council of Revenue's growth assumptions for the immediate term, while assuming growth in line with the DBEDT personal income growth forecast

[105] Vermont is the only one of the 50 states that does not have a statutory or constitutional annual balanced budget requirement, although the extent of the requirement varies widely among the states.

over the long-term. The projection mirrors the DBEDT's current economic forecast[106] of modest, sustained personnel income growth, with an upward adjustment to incorporate how these taxes typically change with changes in personal income.

**Key Revenue Growth Rates[107]**

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| General Excise & Use Tax | 8.1% | 5.8% | 3.7% | 6.5% | 6.0% | 5.6% | 5.6% | 5.6% | 5.6% | 5.5% | 5.4% | 5.4% | 5.4% | 5.4% |
| Individual Income Tax | 23.6%* | 6.8% | 7.5% | 7.6% | 7.0% | 3.1% | 6.6% | 6.6% | 6.6% | 6.5% | 6.4% | 6.4% | 6.4% | 6.4% |
| **Total General Fund** | **8.0%** | **4.9%** | **3.9%** | **5.7%** | **2.6%** | **4.1%** | **5.2%** | **5.2%** | **5.3%** | **5.2%** | **5.2%** | **5.2%** | **5.2%** | **5.3%** |

**Increase attributable to onset of temporary tax deduction repeal and new caps on itemized deductions for high income earners.*

As the dominant sources of revenue in the General Fund, these two taxes have the greatest influence on the overall General Fund growth rate. The project team discussed key revenue growth rate assumptions with the TRC at its August 29, 2012 meeting; Commission members expressed concern with the annual growth rate assumptions for the IIT, suggesting that it was too high. While the assumption has not been changed in the model, this is a valid concern. A review of other state forecasts for IIT growth finds surveyed states generally expecting growth in the range of four to six percent. For the current year, the most recent state revenue analysis by the Rockefeller Institute of Government reported 4.7 percent average growth for the second quarter of 2012, after 4.7 percent average growth in the first quarter of 2012.[108]

For all other tax revenues, the project team retained Council on Revenues projections in the short-term, while using average historical growth and growth rates tied to DBEDT forecasts for the long-term.

- Like the GET and IIT, the **Conveyance Tax** grows along with personal income. Long-term forecasted growth rates range from 5.2 to 5.3 percent annually.
- As taxes that tend to rise with inflation, the **Public Service Company Tax, Tax on Insurance Premiums** and **Inheritance Tax,** grow in line with forecasted CPI growth, about 2.5 percent annually.
- The **Corporate Income Tax** and **Cigarette Tax**, which are sensitive to changes in economic growth, grow in line with forecasted nominal and real GDP growth respectively, about 4.0 and 2.4 percent per year.
- Taxes that tend to correlate with inflation and visitor arrival growth, the **Transient Accommodation Tax, Miscellaneous Taxes** and the **Liquor Tax,** are tied to DBEDT's CPI, GDP Deflator and Visitor Arrival growth forecasts. These increases range from 2.2 to 5.0 percent annually.
- Given the close relationship between construction activity and bank net income, the project team used historical average annual growth in the contracting tax base (since 1982) for the **Tax on Banks and Other Financial Corporations.[109]** This growth rate averages 2.3 percent.
- For **Fee and Charge Revenues**, which include Licenses and Permits, Revenues from Use of Money and Property, Charges for Services and Fines, Forfeits and Penalties, the project team

[106]As of DBEDT's 3rd Quarter 2012 Economic Outlook Report. Rates beyond 2015 are annual extrapolations of 10 year forecasts.
[107] Dips in the GET and IIT in FY2014 and FY2017 are due to the expiration of temporary IIT rate increases and suspended GET exemptions.

[108] Lucy Dadayan, "Growth in State Tax Revenues Continued in the Second Quarter of 2012," The Rockefeller Institute of Government, September 19, 2012, p.2.

[109] This tax had a negative result in FY2012 due to the transfer of proceeds to a non-General Fund escrow account. The projection in FY2013 and beyond assumes restoration of revenues to pre-FY2012 levels and a more typical growth pattern.

assumed growth in line with forecasted population growth. These sources tend to be less related to economic activity and more to the size of the served population.

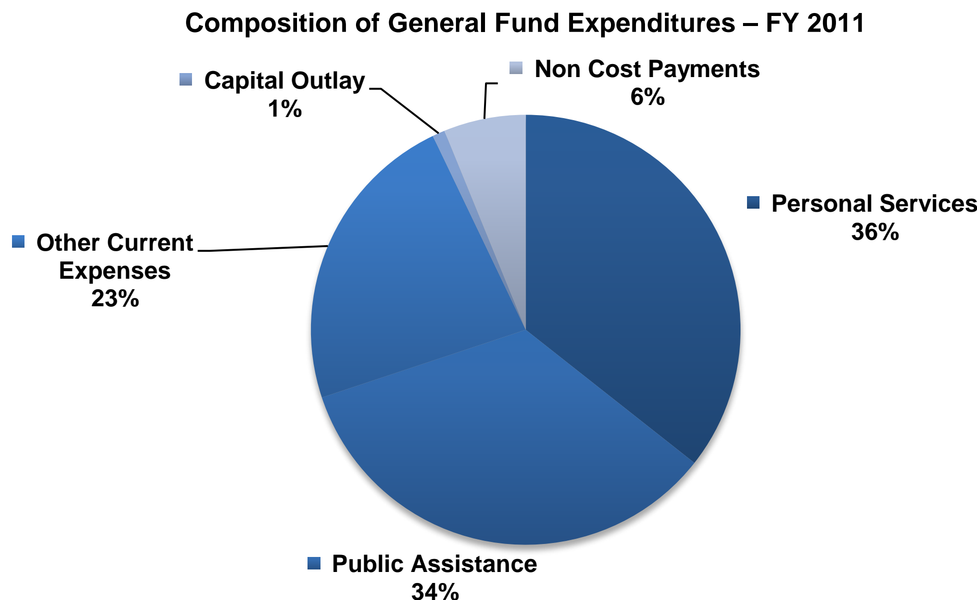
- As **Federal Revenues** depend on decisions by the federal government and cannot be readily predicted, they are assumed to remain flat. As in other areas, the model can be adjusted to reflect State experience over time.
- For **Other Non-tax Revenues,** the project team retained Council on Revenue projections to incorporate State expectations about scheduled receipts of these revenues for the short-term and population growth forecasts in the long-term. These include Revenues from Other Agencies, Repayments of Loans and Advances, Non-revenue Receipts and Judicial Revenues.

Although these revenue projections are generally conservative, the risk remains that the State's revenue performance will not be as strong as forecasted. The most significant risk appears to be the potential loss of federal revenue and spending cuts from the Budget Control Act of 2011. To address this risk, the project team devised an alternative set of revenue growth assumptions, which assumes federal budget cuts of 10 percent will be put in place in FY 2013. This results in federal revenues in the General Fund falling by 10 percent and economically sensitive revenue sources dropping roughly in proportion to the federal government's reduced contribution to Hawaii's personal income.

Another major risk is a slowdown in the State's economy. While the danger of another near-term national recession has diminished (but is still possible), Hawaii's unique island economy leaves it vulnerable to declines in the tourism industry. If tourism growth forecasts do not live up to expectations and related revenues fall short of expectations, the State's fiscal gap will widen. This event is incorporated into the 'pessimistic scenario' described in the section below.

Expenditure Projections

Hawaii's total expenditures have remained relatively stable over the last five years, declining 0.5 percent from FY 2007 to FY 2011. The major driver of this decline has been reduction in wages and public assistance payments, which were a combined 70 percent of total General Fund expenditures in FY 2011. This section highlights the State's major expenditures and cost drivers and provides a baseline expenditure projection – the forecast of future expenditures through FY 2025 under current trends and applicable laws.



**Personal Services** related costs associated with the State of Hawaii's workforce account for the single largest portion of General Fund spending, at 36 percent in FY 2011. From FY 2007 to FY 2011, personal service costs have decreased by 24.2 percent, largely due to salary and benefit concessions and an active effort to reduce the costs associated with the State workforce.

**General Fund Expenditures, FY2007 - 2011**

| General Fund Expenditures | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 | % Δ |
|---|---|---|---|---|---|---|
| Personal Services | $2,334,628,723 | $2,093,216,553 | $2,237,514,534 | $1,915,259,245 | $1,769,883,852 | -24.2% |
| Public Assistance | $1,300,092,659 | $1,354,773,937 | $1,361,546,674 | $1,402,592,703 | $1,702,517,197 | 31.0% |
| Other Current Expenses | $964,702,328 | $1,490,460,142 | $1,437,742,498 | $1,199,544,615 | $1,141,619,821 | 18.3% |
| Capital Outlay | $63,270,616 | $107,132,022 | $130,756,551 | $57,488,754 | $46,727,203 | -26.1% |
| Non Cost Payments | $330,681,788 | $395,205,867 | $352,582,839 | $303,278,487 | $307,056,737 | -7.1% |
| **Total Expenses** | **$4,993,376,112** | **$5,440,788,521** | **$5,520,143,097** | **$4,878,163,804** | **$4,967,804,809** | **-0.5%** |

The project team analyzed historical salary adjustments across all bargaining units and calculated a weighted annual average increase of 3.21 percent as a baseline forecast going forward. In addition to the baseline forecast, the project team used a forecasting methodology based on average annual salary and the number of FTEs by individual bargaining units to determine the impact of restoration of salaries to FY 2009 levels occurring in FY 2014 for bargaining units which experienced reductions between FY 2009 and FY 2014. The project team indexed growth in wages beginning in FY 2014 to FY 2009 wages and salaries. The result is a significantly above average growth rate for a number of bargaining units, particularly those that experienced prior wage and benefit concessions. For all other bargaining units, a four percent assumed annual increase going forward was used.

**Public Assistance Payments (largely Medicaid)** was the second largest expenditure category in FY 2011, accounting for $1.7 billion in costs, or 34 percent of total General Fund spending. Since FY 2007, this category has seen a 31 percent increase in spending, the largest of the five main categories displayed above. For the baseline projection, the project team used budgeted increases in the FY2011–2013 executive biennium budget and the latest FY 2014-2017 projections from the Department of Human Services, which include the estimated cost of Affordable Care Act compliance. For FY 2018 and beyond, the project team included initiatives for future growth in Medicaid based on two historical periods using the Department of Taxation's tax adequacy report from February 2012. In the baseline projection, growth is projected at 9.4 percent, the historical annual average from FY 1968 to FY 2011. For the low end projection, the project team used the average growth rate in expenditures from FY 2006 to FY 2011 (5.9 percent).[110]

**Debt Service** is also a significant expenditure, totaling $419.4 million, or 8.4 percent of General Fund spending in FY 2011. Since 2007, debt service payments have decreased by 23.2 percent as the State retired existing debt while foregoing new issues. Since then, the State Legislature has approved new bond issuances for FY 2013 through FY 2015, ranging from $700 million to $850 million per year. The associated debt service for these issuances was incorporated into the model projections.

The project team assumed the State will continue to issue debt for capital investments throughout the balance of the projection period. After discussions with officials at the Department of Budget and Finance, beginning in FY 2017, the project team assumed $1 billion of new debt issuance every two years with an average coupon rate of 5.25 percent and a 20 year term. It is likely that these amounts would be sufficient to finance necessary capital expenditures and infrastructure investments over the next 13 years.

[110] "Will Hawaii's Tax Structure Prove Adequate in the Future?", Hawaii Department of Taxation, February 2012, page 16

In other expenditure areas, based on analysis of the data provided by the State, significant volatility exists within a number of categories. In order to mitigate this volatility, the project team used a combination of growth rates, as described below:[111]

- ***Flat Growth (0%)*** was assumed in areas of significant decline in spending or where incomplete historical data was available. Rather than assume significant additional decline in spending based on incomplete data or variance in year to year cost, in these cases, the project team carried forward FY 2011 values.
- ***State CPI vs. Total Personal Income (TPI) Forecast.*** The Budget Model allows for the option to assume expenditures will grow at the rate of CPI or TPI growth. The default option is CPI. For CPI, in order to accurately reflect the unique economy of Hawaii, the project team used the regional Consumer Price Index rather than the national Consumer Price Index for urban areas (CPI-U) chained or CPI-U for the West Urban, which encompasses all West Coast and Midwestern states. For growth in TPI, the project team used growth rates estimated by the Department of Taxation.

**State CPI vs. TPI Forecast: FY 2012 – FY 2015**[112]

| Fiscal Year | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| Honolulu CPI | 2.80 | 2.60 | 2.50 | 2.50 |
| TPI | 4.30 | 4.80 | 5.20 | 5.00 |

- ***Other State Provided Forecasts***. In areas where growth or decline is currently known or forecasted with reasonable confidence (i.e. health benefits, pension contributions and current debt service), the project team used those forecasts.
- ***Blended Average Annual Growth Rate / Compound Annual Growth Rate.*** For expenses with similar average annual growth (AAG) and compound average growth rates (CAGR), these were determined using a blended average of the two measures.

[111] For a compilation of all growth rates used, please refer to Appendix C.
[112] Based on 3rd Quarter Forecast published by Hawaii's Department of Business, Economic Development and Tourism. Rates beyond FY 2015 were calculated by an extrapolation from DBEDT's 2040 Long Range Population and Economic Projections.

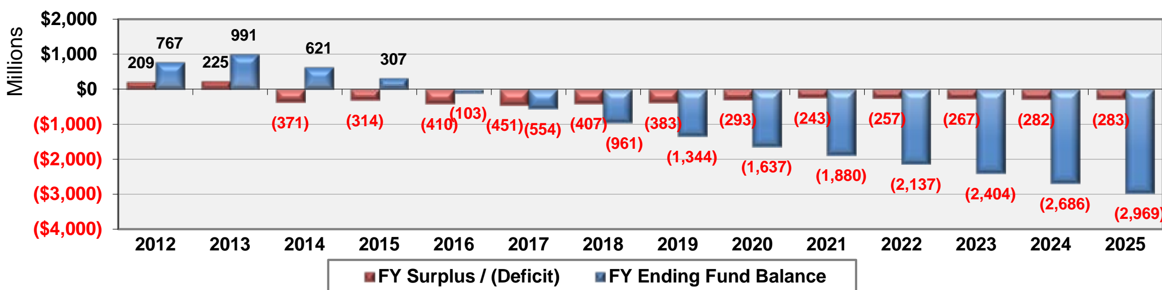
## Sustainability Forecast

Baseline Projections

Based on analysis of data provided by the State, current and future economic conditions and input from State agencies, the project team developed a baseline projection for revenues and expenditures going forward to FY 2025. While the short-term forecasts (FY 2012-2015) are grounded in reasonably reliable statistical relationships among economic variables and tax collections, the longer-term projection (FY 2015-2025) is subject to greater variability.

As shown in the chart below, the baseline model forecasts a series of annual budget gaps reaching $283 million by FY 2025 if no corrective action is taken.[113]

**FY 2012 – FY 2025 General Fund Budget Projections: Baseline Scenario**




By FY 2025, the two major cost drivers – personal services and public assistance – will total $3.1 billion and $5.7 billion, respectively. Based on current financial plan assumptions of full restoration of staffing, wages and salaries to FY 2009 levels, projected growth in wages and salaries will see a significant annual increase beginning in FY 2014.

*Pension Funding Issues*

Across the nation, there is a growing awareness of the magnitude of future public pension and retiree health benefits obligations. The enhanced accounting and financial reporting rules for disclosure surrounding the Governmental Accounting Standards Board (GASB) approved Statements 67 and 68 will be an important issue in coming years. As part of these rules, employers that sponsor a pension plan must begin reporting pension liabilities and costs under the new standards in FY 2015 in a way designed to reflect a more complete representation of the full impact of pension liabilities. This expanded disclosure, and perhaps even more extensive disclosure will be necessary for the State of Hawaii, given recent comparability metrics released by Fitch in March 2012.[114] According to Fitch's new liability metrics, which measure each state's net tax-supported debt combined with the unfunded actuarial accrued liabilities (UAAL) in its major pension system against the state's wealth base (expressed as personal income), Hawaii's 25.8 percent metric was the worst of the 43 states rated.

In its latest actuarial valuation (as of June 30, 2011), the Employees' Retirement System (ERS) has a reported 59.4 percent funded ratio. Based on the most current actuarial analysis, ERS will not realize full funding until FY 2036.[115] While legislative changes and improved investment performance resulted in an improved outlook from the 2010 to 2011 report, the future outlook of ERS is still a matter of serious concern.

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[113] Baseline model growth rates and projections are available in Appendix D.

[114] www.fitchratings.com

[115] https://ers.ehawaii.gov/wp-content/uploads/2012/03/2011Valuation.pdf

It should be noted that Acts 152 and 153, Laws of 2012 address contribution rates and funding issues. Among the changes included in these bills are changes to the definition of final average salary for those who become members of the ERS as of July 1, 2012. For these employees, average final salary will not include overtime, supplementary payments, bonuses, lump sum salary supplements, allowances, or differentials.[116] While these changes will help reduce obligations for those employed after July 1, 2012, it does not address funding issues for those employed prior to that date. The State will need to continue its efforts to contain and begin to fund the unfunded liability while also adjusting its assumptions to recent market conditions.

Pension projections are based on scheduled employer contributions as a percentage of payroll, as established by the Legislature. According to an actuarial valuation conducted in July 2011 by Gabriel, Roeder, Smith & Company (GRS), between FY 2008 and FY 2011, actual contributions to the Employees' Retirement System (ERS) increased from $488.8 million to $534.9 million, or 9.4 percent. These amounts include contributions by the State's counties in addition to the State itself. During this time period, the ERS was 99.6 percent funded, with underfunding occurring in FY 2008 and FY 2011 and overfunding occurring in FY 2009 and FY 2010.

**Schedule of Employer Contributions (including counties): FY 2008 – FY 2011**[117]

| Fiscal Year | Annual Required Contribution ($000s) | Actual Contribution ($000s) | % Contributed |
|---|---|---|---|
| 2008 | $510,727 | $488,770 | 95.7% |
| 2009 | $526,538 | $578,635 | 109.9% |
| 2010 | $536,237 | $547,613 | 102.1% |
| 2011 | $582,535 | $534,858 | 91.8% |
| **Total** | **$2,156,037** | **$2,149,876** | **99.7%** |

The actuarial analysis determined that the assumed return on investment should be lowered to 7.75 percent from the current 8 percent assumption, despite strong earnings in the years following the severe economic downturn in FY 2009.[118] Based on this analysis, the current unfunded actuarial accrued liability of the system stands at $8.154 billion.[119] It is notable that Moody's Investor Services has proposed using a lower assumed return on investment for analyzing state and local government reported pension data. Under the proposed adjustments, the assumed rate of return would be set at 5.5 percent and, in the future, tie the rate of return to a high-grade corporate bond index.[120] This change, as well as other proposed changes, would, if implemented, further reduce the ERS funded ratio in Moody's calculations.

In the model, State pension contributions fluctuate with forecasted payroll and scheduled increases in contribution percentages. The following table and chart shows growth in employer contributions between FY 2012-2018:

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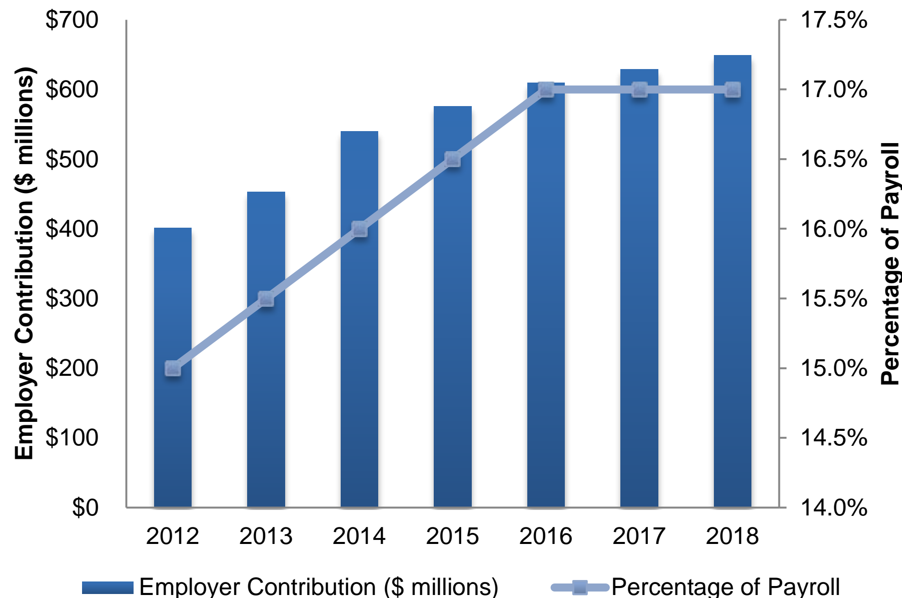
116 "Pensions and Retirement Plan Enactments in 2012 State Legislatures," National Conference of State Legislatures, August 31, 2012, pp. 4, 10,

117 "Employee's Retirement System of the State of Hawaii: Report to the Board of Trustees on the 86th Annual Actuarial Evaluation for the Year Beginning June 30, 2011", Gabriel Roeder Smith & Company, page 42.
118 Ibid, page 2.
119 Ibid
120"Proposed Adjustments to US State and Local Government Reported Pension Data," Moody's Investors Service, July 10,, 2012, p.12.

### Employer Contribution Rate (%)

| Fiscal Year | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| **Employer Contribution ($ millions)** | $402 | $453 | $540* | $576 | $609 | $629 | $649 |
| **Percentage of Payroll** | ***15.0%*** | ***15.5%*** | ***16.0%*** | ***16.5%*** | ***17.0%*** | ***17.0%*** | ***17.0%*** |

**Increase attributed to assumed restoration of wages and headcount to FY2009 levels in FY 2014.*




At the current funded ratio of 59.4 percent and the assumed return on investment of 7.75 percent, the pension system will not be fully funded until FY2036.[121]

The project team also used actuarially forecasted growth in employer contributions assuming a 5 percent[122] annual investment return to create an alternative contribution projection. If the pension trust fund earns 5 percent for the next decade (FY 2013-FY 2022) based on the market value of assets as of June 30, 2012, the employer contribution would increase slowly each year to approximately 18.25 percent in FY 2023. The funding period as of June 30, 2022 would be approximately 35 years based on the currently expected 17 percent contribution rate.[123] Growth in employer contributions under this scenario is illustrated in the following table:

### Employer Contribution Rate (%) Assuming 5% Investment Return*

| 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 15.0 | 15.5 | 16.0 | 16.5 | 17.0 | 17.0 | 17.0 | 17.0 | 17.3 | 17.6 | 17.9 | 18.3 | 18.3 | 18.3 |

**Preliminary projections, subject to change*

[121] Ibid, Table 9c, page 39.
[122] An analysis based on a 4.5 percent return assumption was requested but not available at the time of publication.
[123] Based on information provided by Hawaii Employee Retirement System and GRS.

*Health Insurance*
Health insurance projections are derived from growth projections by the Employer-Union Health Benefits Trust Fund (EUTF). Historically, health insurance has been a major cost driver, growing 20.9 percent from FY 2008 to FY 2011. At 9 percent of the General Fund (FY 2011), it also has a significant impact of the State's financial position. Going forward, medical premium costs are expected to grow at 8 percent per year, prescription drug premiums are expected to rise 6 percent annually, while dental premiums grow at 4 percent and vision at 2 percent.

In addition, the project team assumed retiree health benefit subscriber growth of 3 percent per year to capture recent growth in state government retirements. This assumed subscriber growth represents the average annual growth in the number of state retirees and pension beneficiaries since 2000.

With a restoration of wages, benefits and staffing to FY 2009 levels occurring in FY 2014, a significant increase occurs in health care costs – 14.38 percent – and then returns to growth rates more in line with historical growth and projections in the following years.

**Projected Health Insurance Growth Rates (%)**

| 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5.05 | 4.45 | 14.38* | 9.09 | 8.60 | 8.67 | 8.72 | 8.78 | 8.84 | 8.89 | 8.94 | 8.99 | 9.04 | 9.09 |

**Increase attributable to assumed restoration to FY2009 staffing levels.*

Accrual Accounting Method of Calculating the Fiscal Gap

It is generally recognized that the State has a significant unfunded liability related to its pension system and retire health insurance benefits. Accrual accounting methods generally report these liabilities when incurred, as opposed to a cash method, which reports expenditures when they occur. The Governmental Accounting Standards Board (GASB) promulgates accounting rules for public sector entities, and it uses a modified form of accrual accounting that recognizes that public and private sector entities are different and their accounting standards should reflect those differences. Under modified accrual basis accounting, revenues are considered available when collectible either during the current period or after the end of the current period but in time to pay year-end liabilities, and expenditures are recognized when a transaction or event is expected to draw upon current spendable resources rather than future resources. As a consequence, future pension and retiree health care liabilities are not included in determining the balance in a fiscal year. However, as previously noted, GASB is moving toward broader reporting requirements for state and local governments beginning in 2015. As a result, it is useful to understand the implications this will have on the State's financial statements.

At the request of the TRC, the model includes an alternate scenario assuming the State recognizes the full cost of retiree benefits in FY 2013, including the projected cost of current retiree benefits and an amortization of the unfunded actuarial liability. This projection assumes a 4 percent investment return[124] and would require a substantial increase in funding for retiree health benefits each year. Growth in later years would moderate as the unfunded liability is reduced.

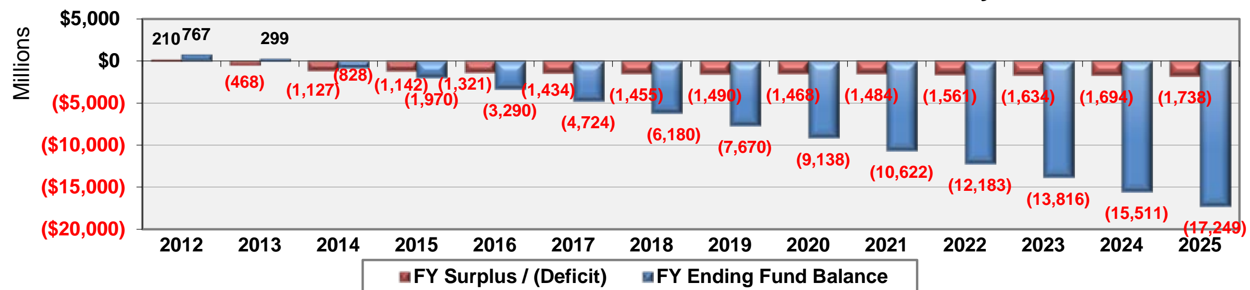
**Projected Health Insurance Growth Rates – Full OPEB Cost (%)**

| 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5.04 | 153.81* | 11.34 | 9.35 | 9.38 | 8.23 | 7.51 | 7.02 | 6.62 | 6.45 | 6.22 | 6.19 | 6.05 | 5.99 |

**First year of covering full OPEB cost.*

[124] An analysis based on a 4.5 percent return assumption was requested but not available at the time of publication.

The following presents these assumptions on an accrual basis, with pension and retiree health contributions sufficient to fully fund the State's OPEB and pension liabilities. As can be expected, under this approach, the fiscal gap is considerably worse, as shown in the following graph:




Alternate Scenarios

Alternate scenarios were developed to show the State's projected revenues and expenditures under an optimistic and a pessimistic forecast. Consistent with the results seen under the baseline scenario, a gap between projected expenditures and revenues also exists in each of these alternative scenarios through FY 2015. However in the optimistic scenario, the State returns to fiscal balance beginning in FY 2016. This section discusses the revenue and expenditure assumptions in each of the alternative model scenarios.

*Optimistic Scenario*

This assumes more robust economic growth than the baseline. It assumes that the State experiences an economic upturn similar to the one that occurred in the mid-2000s. The forecast should be considered optimistic and unlikely. This alternative scenario could more appropriately be viewed as the State following a sustained, steady economic recovery from the recent economic downturn. This scenario provides an upper boundary for the local revenue outcome and assumes increased tourism and convention activity in Hawaii for the entire projection period.

Revenue projections are based on the two strongest years of growth in Hawaii's economy in the last ten years – 2005-2006. Over the longer term, the scenario assumes 6.5 percent personal income growth, affecting the more economically sensitive revenue sources (GET, IIT and Conveyance Tax). This is the personal income growth percentage used in the 'high growth scenario' of the Department of Taxation's February 2012 tax adequacy report.[125] In addition, nominal and real GDP growth is assumed to be one percentage point higher than the baseline scenario, affecting the Corporate Income Tax and Cigarette Tax. Revenue growth for all other sources is the same as the baseline scenario. The projected revenue growth rate increases under this scenario are shown in the following table:

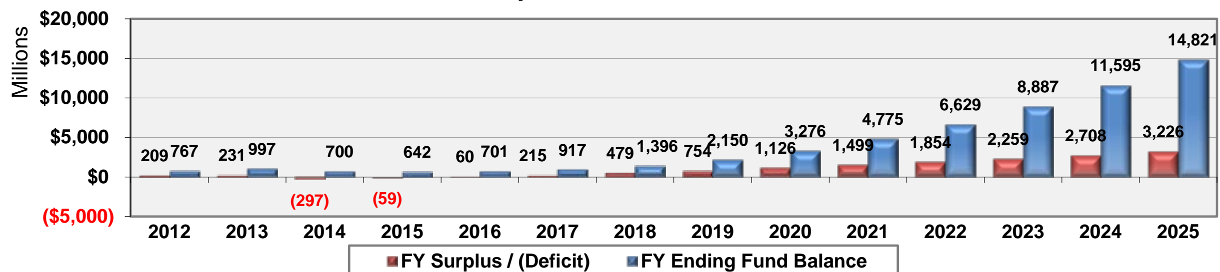
[125] Joshua Fujino and Donald Rousslang. "Will Hawaii's Tax Structure Prove Adequate in the Future?" Tax Research and Planning Office, Hawaii Department of Taxation. February 10, 2012.

**Projected Revenue Growth Rates:
Optimistic Scenario**

| Growth Rate Name | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| General Excise and Use Tax | 8.1% | 5.6% | -0.4% | 1.6% | 4.4% | 4.1% | 4.1% |
| Individual Income Tax | 23.6% | 6.7% | 2.5% | 1.8% | 5.1% | 0.9% | 4.8% |
| Corporate Income Tax | 111.2% | 4.1% | 3.7% | 3.7% | 3.3% | 3.0% | 3.0% |
| Public Service Company Tax | 27.0% | 2.7% | 2.6% | 2.5% | 2.5% | 2.5% | 2.5% |
| Tax on Insurance Premiums | -13.4% | 2.7% | 2.6% | 2.5% | 2.5% | 2.5% | 2.5% |
| Cigarette and Tobacco Tax | -5.4% | 24.8% | -14.1% | 1.4% | 1.4% | 1.4% | 1.4% |
| Liquor Tax | 1.7% | 3.9% | 2.5% | 2.2% | 1.8% | 1.5% | 1.5% |
| Tax on Banks and Other Financial Corps. | -102.7% | -3590.3% | 1.2% | 4.8% | 3.3% | 2.6% | 2.5% |
| Inheritance and Estate Tax | 104.7% | 2.7% | 2.6% | 2.5% | 2.5% | 2.5% | 2.5% |
| Conveyance Tax | -14.6% | -9.4% | -25.1% | 1.5% | 4.1% | 3.8% | 3.8% |
| Miscellaneous Taxes | 331.9% | -77.5% | 0.1% | -26.0% | -92.8% | -3.9% | -4.1% |
| Transient Accommodations Tax | 111.4% | 8.8% | 5.6% | 5.1% | -100.0% | 3.4% | 3.4% |
| Licenses & Permits | -26.0% | 9.4% | 1.0% | -80.8% | 0.9% | 0.7% | 0.7% |
| Revenues from Use of Money and Property | 13.9% | -2.7% | -3.2% | -3.7% | -3.7% | 0.7% | 0.7% |
| Federal | -65.6% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Revenues from Other Agencies | 77.8% | 9.8% | -41.6% | 0.0% | -84.4% | 0.0% | 0.0% |
| Charges for Current Services | -14.6% | 4.1% | 1.4% | 1.2% | 1.1% | 0.7% | 0.7% |
| Fines, Forfeits & Penalties | -9.0% | 6.9% | -6.5% | 6.9% | -6.5% | 0.7% | 0.7% |
| Repayment of Loans & Advances | -4.3% | -10.8% | 0.1% | 3.3% | -2.9% | 0.7% | 0.7% |
| Non-Revenue Receipts | -52.2% | -6.1% | 3.9% | 1.1% | 1.1% | 1.1% | 0.7% |
| Judiciary | -6.9% | 1.7% | 1.8% | 1.8% | 1.8% | 1.8% | 0.7% |
| **Total General Fund** | **8.0%** | **4.8%** | **0.5%** | **1.6%** | **0.9%** | **2.6%** | **3.8%** |

The financial results of this scenario are shown in the following chart:

**FY 2012 – FY 2025 General Fund Budget Projections:
Optimistic Scenario**




Under these assumptions, the gap between revenues and expenditures starts at $297 million in FY 2014. After this brief deficit, surpluses return in FY 2016 at $60 million and could potentially rise to $3.2 billion by FY 2025.

*Pessimistic Scenario*

The pessimistic forecast assumes that the State experiences an economic downturn similar to the one that occurred in the latter part of the previous decade in 2014 and 2015, largely driven by a decline in tourism activity. As a consequence, revenue projections are based off the two weakest years of growth in

Hawaii's economy in the last ten years – 2009-2010. On a long term basis, it assumes personal income growth, and by extension all tax revenues tied to it, will be 3.2 percent. This is the personal income growth percentage used in the 'low growth scenario' of the Department of Taxation's February 2012 tax adequacy report.[126] Nominal and real GDP growth is assumed to be one percentage point lower than the baseline scenario, affecting the Corporate Income Tax and Cigarette Tax. Revenue growth for all other sources is the same as the baseline scenario. The projected revenue growth rates increases under this scenario are shown in the following table:

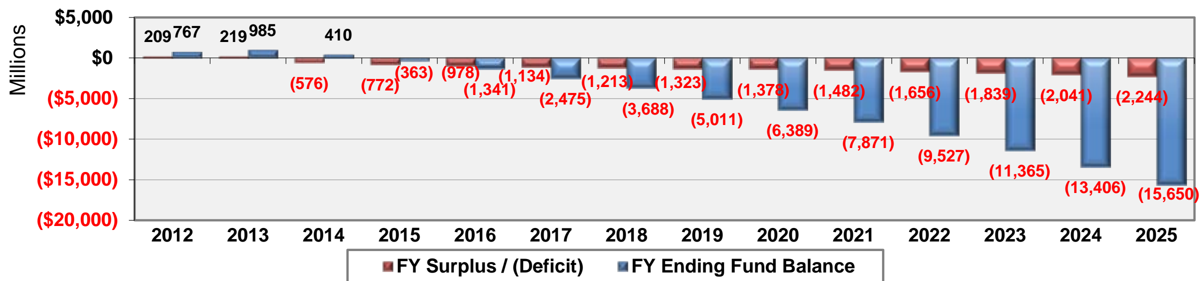
**Projected Revenue Growth Rates:**
**Pessimistic Scenario**

| Growth Rate Name | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| General Excise and Use Tax | 8.1% | 5.6% | -0.4% | 1.6% | 4.4% | 4.1% | 4.1% |
| Individual Income Tax | 23.6% | 6.7% | 2.5% | 1.8% | 5.1% | 0.9% | 4.8% |
| Corporate Income Tax | 111.2% | 4.1% | 3.7% | 3.7% | 3.3% | 3.0% | 3.0% |
| Public Service Company Tax | 27.0% | 2.7% | 2.6% | 2.5% | 2.5% | 2.5% | 2.5% |
| Tax on Insurance Premiums | -13.4% | 2.7% | 2.6% | 2.5% | 2.5% | 2.5% | 2.5% |
| Cigarette and Tobacco Tax | -5.4% | 24.8% | -14.1% | 1.4% | 1.4% | 1.4% | 1.4% |
| Liquor Tax | 1.7% | 3.9% | 2.5% | 2.2% | 1.8% | 1.5% | 1.5% |
| Tax on Banks and Other Financial Corps. | -102.7% | -3590.3% | 1.2% | 4.8% | 3.3% | 2.6% | 2.5% |
| Inheritance and Estate Tax | 104.7% | 2.7% | 2.6% | 2.5% | 2.5% | 2.5% | 2.5% |
| Conveyance Tax | -14.6% | -9.4% | -25.1% | 1.5% | 4.1% | 3.8% | 3.8% |
| Miscellaneous Taxes | 331.9% | -77.5% | 0.1% | -26.0% | -92.8% | -3.9% | -4.1% |
| Transient Accommodations Tax | 111.4% | 8.8% | 5.6% | 5.1% | -100.0% | 3.4% | 3.4% |
| Licenses & Permits | -26.0% | 9.4% | 1.0% | -80.8% | 0.9% | 0.7% | 0.7% |
| Revenues from Use of Money and Property | 13.9% | -2.7% | -3.2% | -3.7% | -3.7% | 0.7% | 0.7% |
| Federal | -65.6% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Revenues from Other Agencies | 77.8% | 9.8% | -41.6% | 0.0% | -84.4% | 0.0% | 0.0% |
| Charges for Current Services | -14.6% | 4.1% | 1.4% | 1.2% | 1.1% | 0.7% | 0.7% |
| Fines, Forfeits & Penalties | -9.0% | 6.9% | -6.5% | 6.9% | -6.5% | 0.7% | 0.7% |
| Repayment of Loans & Advances | -4.3% | -10.8% | 0.1% | 3.3% | -2.9% | 0.7% | 0.7% |
| Non-Revenue Receipts | -52.2% | -6.1% | 3.9% | 1.1% | 1.1% | 1.1% | 0.7% |
| Judiciary | -6.9% | 1.7% | 1.8% | 1.8% | 1.8% | 1.8% | 0.7% |
| **Total General Fund** | **8.0%** | **4.8%** | **0.5%** | **1.6%** | **0.9%** | **2.6%** | **3.8%** |

The financial results of this scenario are shown below:

[126] Joshua Fujino and Donald Rousslang. "Will Hawaii's Tax Structure Prove Adequate in the Future?" Tax Research and Planning Office, Hawaii Department of Taxation. February 10, 2012.

**FY 2012 – FY 2025 General Fund Budget Projections: Pessimistic Scenario**




Under these assumptions, the gap between revenues and expenditures starts at $576 million in FY 2014 and grows to $2.2 billion by FY 2025.

## Summary

Based on current projections for major revenue sources, expenditure drivers and planned initiatives, the State is facing significant structural deficits in the baseline scenario as well as the accrual-based alternative. The restoration of wages to 2009 levels in FY2014, the growing cost of public assistance programs and health benefits for both active and retired are major factors in these structural deficits. Moreover, if the economy continues to lag or remain as it currently stands, it will increase these gaps significantly.

As specific policy decisions are weighed and selected in the model, it will have a direct impact on the forward projections. The project team factored in data, projections and recommendations provided by key stakeholders, particularly staff from the Department of Taxation, Council on Revenues, and other invested state agencies. The result of this collaborative effort is fluid and subject to change, based on the availability of more accurate data and input from key stakeholders.

The model prepared for this study can be used to test alternate scenarios on both the revenue and expenditure side of the budget. In this respect, the report may be seen as a 'point in time analysis' that can be modified through the model to analyze alternate scenarios or track actual performance in the coming years.

# Revenue Alternatives

# Revenue Alternatives

## Tax Policy Principles

There are sometimes widely diverging opinions on what constitutes good tax policy, and in many instances, politics and self-interest enter into the discussion. Various resources examine the issues surrounding tax policy principles in a relatively neutral fashion, and it is useful to review them. The National Conference of State Legislatures (NCSL) represents all 50 state legislatures and provides valuable technical and policy guidance to its members. NCSL has published a frequently-cited list of the "Principles of a High-Quality State Revenue System." Their principles are:[127]

1. A high-quality revenue system comprises elements that are complementary, including the finances of both state and local governments.
2. A high-quality revenue system produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.
3. A high-quality revenue system relies on a balanced variety of revenue sources.
4. A high-quality revenue system treats individuals equitably. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.
5. A high-quality revenue system facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.
6. A high-quality revenue system promotes fair, efficient and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.
7. A high-quality revenue system is responsive to interstate and international economic competition.
8. A high-quality revenue system minimizes its involvement in spending decisions and makes any such involvement explicit.
9. A high-quality revenue system is accountable to taxpayers.

From the perspective of tax preparers, the American Institute of Certified Public Accountants has published a Tax Policy Concept Statement that outlines their guiding principles for good tax policy. In many respects, it aligns well with the NCSL principles:[128]

1. **Equity and fairness**. Similarly situated taxpayers should be taxed similarly.
2. **Certainty.** The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.
3. **Convenience of Payment**. A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.
4. **Economy in Collection**. The costs to collect a tax should be kept to a minimum for both the government and taxpayers.
5. **Simplicity**. The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

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[127] National Conference of State Legislatures, "Principles of a High-Quality State Revenue System, Fourth Edition, June 2001.

[128] "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals," American Institute of Certified Public Accountants, 2001, p. 9-10.

6. **Neutrality.** The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.
7. **Economic Growth and Efficiency**. The tax system should not impede or reduce the productive capacity of the economy.
8. **Transparency and Visibility**. Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
9. **Minimum Tax Gap**. A tax should be structured to minimize noncompliance.
10. **Appropriate Government Revenues**. The tax system should enable the government to determine how much tax revenue will likely be collected and when.

The United States General Accountability Office (GAO) has also weighed in on tax policy principles. According to the GAO, '"long-standing" criteria for evaluating tax policy are:[129]

1. **Equity** – including principles of ability to pay (both horizontal and vertical equity) and benefits received.
2. **Economic Efficiency**
3. Combination of **simplicity** (compliance burden), **transparency** (in tax calculations, logic behind rules, tax burden and compliance), and **administratability** (processing returns, enforcing the law, providing taxpayer assistance.

It is also useful to compare principles among groups with differing political views on tax policy. The Tax Foundation, generally considered a conservative-leaning organization, lists the following as its "Ten Principles of Sound Tax Policy:"[130]

1. Transparency is a must
2. Be neutral
3. Maintain a broad base
4. Keep it simple
5. Stability matters
6. No retroactivity
7. Keep tax burdens low
8. Do not inhibit trade
9. Ensure an open process
10. State and local taxes matter

The Institute on Taxation and Economic Policy, generally considered a liberal-leaning organization, has published their own assessment. They identify the following as the building blocks of a sound tax system:[131]

1. Maintain vertical equity (tax systems should not be regressive)
2. Maintain horizontal equity (taxpayers in similar circumstances should pay similar amounts of tax)

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[129] "Factors for Evaluating Expiring Tax Provisions," US General Accountability Office, GAO-12-760T, June 8, 2012, p.4-6..

[130] The Tax Foundation, "Ten Principles of Sound Tax Policy,: http://www.taxfoundation.org

[131] The Institute on Taxation and Economic Policy, "Tax Principles: Building Blocks of a Sound System," p. 1-2.

3. Adequacy (raises enough funds to sustain the level of services demanded by citizens)
4. Simplicity
5. Exportability (individuals and businesses from other locations that enjoy public services should help pay for them)
6. Neutrality (tax system should stay out of the way of economic decisions)

Finally, several studies of state tax structures have devised their own set of guiding principles. For example, the State of Washington conducted a legislatively-required study in 2004 of the state's tax structure based on articulated tax principles. The final report identified these principles as:

**Adequacy/Stability/Elasticity**: A good tax system is expected to generate sufficient revenue to pay for established public services without the need for continuous or drastic changes in tax rates or in the tax base.

**Equity/Fairness**: A good tax system should distribute the tax burden across taxpayers in a manner that is consistent with the accepted norms of fairness and equity. These norms typically define fairness according to the relationship between the amount of taxes paid (or borne) by taxpayers and their respective abilities to pay the tax, or to the benefits received by them from government programs. Three widely-accepted norms of fairness considered by the Committee are:

- Vertical Equity. This principle of fairness requires that the amount of tax paid by taxpayers with different income levels should reflect their respective abilities to taxpayers with different income levels should reflect their respective abilities to pay the tax. Specifically, taxes paid as a percentage of income should not unduly burden taxpayers with limited ability to pay the tax. Some would view this principle as satisfied by a proportional tax burden, where taxes paid are the same percentage of income for taxpayers at all income levels. Others believe that the principle requires that taxes paid as a percentage of income should be higher for taxpayers with more income than those with less income (a progressive tax burden). To our knowledge, almost no one believes that taxes paid should be a higher percentage of income for less affluent taxpayers than for those with more income (a regressive tax burden).
- Benefits Received. A tax may be considered fair if the taxes paid are matched by benefits received by a taxpayer from the government. This principle is most relevant when a tax is levied specifically for the purpose of providing a particular government service to a specific group of taxpayers. Such "benefit taxes" are impractical for much of government spending because the "benefits" received cannot be determined for each taxpayer. Therefore, this principle is relevant mainly for certain types of selective excise taxes which act like user fees, such as the motor vehicle fuel tax. It also applies to taxes that have much in common with insurance premiums, such as employment security and industrial insurance taxes.
- Horizontal Equity. According to this principle, taxpayers with similar abilities to pay a tax should pay comparable amounts of the tax. More generally, the principle of horizontal equity enjoins the government from levying taxes that have arbitrary and peculiar distributions of tax burdens across taxpayers or from levying dissimilar tax burdens on taxpayers that are not justified by differences in their ability to pay or by distinctions in the benefits they receive from government programs.

**Economic Vitality and Harmony with Other States**: A good tax system should not place business enterprises located within the state at a competitive disadvantage relative to similar enterprises located in other states.

**Economic Neutrality and Efficiency**: A good tax system should not distort economic decisions. Distortions cause a measurable loss in the economic value of production and consumption, which

increases the tax burden on the residents of the state. There are two important methods for minimizing the burden on state residents of raising a given amount of state tax revenue:

**Transparency and Administrative Simplicity**: People should know when they pay taxes and how much they pay. A good tax system is designed to ensure that the tax burdens on residents are clear and evident. The rules, record-keeping and computation requirements should be simple enough that the tax system can be administered at low cost by the tax collection agency without imposing an undue compliance burden on the taxpayer.

**Home Ownership**: The tax system should facilitate, or at least not impede, the ability of individuals and families to purchase and maintain a home consistent with their standard of living.

**Summary from the Various Approaches**

While there is some variation in the terminology, there are some principles that emerge where there is close to complete agreement among the cited sources. These principles are:

1. The system should minimize interference by taxes in market decisions
2. The system should be reliable, stable, and sufficient
3. The system should be simple, allow for compliance, and ease of administration
4. The system should be equitable
5. The system should have a balanced variety of sources/broad base

The analysis that follows will reference these key principles.

## Interaction of Principles

While the general principles of taxation are logical – and mostly non-controversial – it should be accepted that in a number of cases these general tax principles will conflict, and it will be necessary to weigh the costs and benefits of adhering to the principles. For example, a broad sales tax or GET base that taxes goods and services that are perceived to be necessary (rather than optional) purchases will promote revenue sufficiency and stability but have a negative impact on vertical equity. This can occur when the base includes food, healthcare services, utility payments, etc. As another example, some taxes exhibit a trade-off between revenue sufficiency and volatility or stability. Over the years, the personal and corporate income taxes have exhibited significant volatility based on the business cycle and other variables. At the same time, in strong growth periods they have out-performed other revenue sources in terms of levels of growth and ‘bounce back.’ In general, these trade-offs suggest the need for case-by-case analysis and the use of several forms of taxation to off-set specific impacts or defects in a particular tax.

In seeking a balanced tax structure, complementary approaches can include:

- Broad-based, uniform taxes with fewer exemptions can advance the principles of adequacy, stability, neutrality, and horizontal equity. The broader the tax base, the greater the tendency for revenue to grow and fluctuate in concurrence with overall economic activity. Also, a uniform tax rate structure treats different taxpayers even-handedly while minimizing the distorting impact of taxation on taxpayer decisions.
- A more transparent tax structure may be complementary to increased competitiveness. A major cause of non-transparency occurs when taxes levied on businesses are passed on to consumers in the form of higher prices—the so-called “hidden” taxes. When business taxes cannot be

passed on, competitiveness is reduced. Increasing the fraction of taxes levied on households relative to taxes levied on businesses makes the tax system both more transparent and more competitive.

## Revenue Strategies/Approaches

A state's strategic approach to revenue generation is informed and guided by its tax policy principles. Constructing a balanced and equitable tax structure is part 'art' and part 'science' – requiring a state to choose from a variety of tax-related options and decisions as it seeks to raise sufficient revenue to provide services. The following revenue strategies are presented by tax-type, exploring both the pros and cons of various alternatives.

In this analysis, most of the strategies presented are variations on themes of current tax policy. While it is entirely possible that tax policy will be radically altered in the next 20 years, the preceding 50 years do not present a compelling case for this sort of change. While some states raise a majority of their revenue from sources other than 'the big three' of sales, individual and corporate income taxes (primarily states with mineral extraction taxes), there hasn't been a state that radically changed its approach to taxation away from those in general use in decades. As one authoritative source on taxation has noted, "An axiom of public finance is 'an old tax is a good tax' because the marketplace has adjusted to accommodate the tax. In general, improving the equity and neutrality of existing taxes is preferable to introducing a new tax unless the inequities and inefficiencies of the existing taxes are greater than those of a proposed new tax."[132]

General Excise Tax

As already noted, this is the State's largest source of revenue and is a broad-based consumption tax. Generally, existing tax alternatives are focused on either changes to the base or the rate. As a generally accepted tax principle is to maintain as broad as possible a base and as low as possible rate, the analysis will generally favor base-broadening over rate-raising. This key distinction is discussed further in the following analysis.

***Alternative One: Broaden the GET Base by Eliminating the Exemption for Non-Profits***

While the GET is a broad-based tax on consumption, there are some significant exemptions built into the current law. By far the biggest is for non-profit organizations. While the GET exemption is limited to income generated by the organization in performing the duties that qualify it for non-profit status, the forgone revenue is significant. According to a recent paper, these exemptions amounted to nearly $312 million in tax year 2009.[133]

Sales tax exemptions for the programmatic activities of non-profits are common among the states. The general belief is that the mission of most non-profit organizations supports valued policy objectives, and taxing their purchases would reduce the resources available for these activities. At the same time, there is a growing awareness that non-profit organizations are 'resource consumers' and sometimes in competition with for-profit businesses that provide similar services. If that is the case, it can be argued that horizontal equity would prefer that these non-profits be treated similarly to for-profit businesses related to application of consumption taxes.

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[132] Robert L. Bland, "A Revenue Guide for Local Government," ICMA, 2006, p.33.

[133] "Tax Expenditures in Hawaii," Donald J. Rousslang, Tax Research and Planning Office, Hawaii Department of Taxation, February 14, 2012, p. 17.

In fact, a growing number of state and local governments are re-thinking their approach to taxation of non-profit organizations. At the local level, this has taken the form of alternatives to property taxes, which generally exempt non-profits. The rise of municipal services taxes, assessments and fees that apply to both for-profit and non-profit entities is notable, as is the increased use of 'payments in lieu of taxes' negotiated by local governments with non-profit organizations.

At the state level, tax exemptions are also getting another look and, in a number of states, are being eliminated or scaled back. Current analysis and discussion suggests that this trend will continue.

Those who favor limiting the exemption note that this exemption greatly narrows the tax base and has helped contribute to rate increases. They argue that while the activities that are exempt from tax have public benefit, it would be possible to provide direct appropriations or subsidies that better target the activities that best lead to tangible results. While many non-profits serve an important public purpose, the blanket exemption may also provide tax benefits to those who cannot readily demonstrate positive societal outcomes commensurate with the tax benefits.

Those who oppose eliminating the exemption note the historic commitment to non-profit organizations as a part of the social compact to improve the overall health and welfare of citizens. They also note that changing the tax benefit to appropriations would limit their ability to allocate resources to programs in lean budget years and subject their work to the whims of what can be a political budget allocation process.

| Pros | Cons |
|---|---|
| ▪ Broadens the GET base<br>▪ Subjects the GET to what is generally considered a growing area of consumption<br>▪ Addresses horizontal equity issues related to for-profit businesses that provide services similar to non-profit entities that are not subject to the GET | ▪ Is a fundamental shift away from support for non-profit organizations that often provide services that replace/augment state programs<br>▪ If tax exemptions are replaced by appropriations can subject non-profits to the political process in determining service provision. |

***Alternative Two: Eliminate the Sunset on the Application of the GET to Activities in Act 105, Session Laws of Hawaii 2011***

Act 105, 2011 Session Laws of Hawaii temporarily suspended a number of GET exemptions and thus subjected those activities to the GET. The temporary suspension of these exemptions is set to expire on June 30, 2013. According to a paper by the Department of Taxation, these suspended exemptions amounted to about $56 million of additional revenue.[134] The bill specifically states that gross income from "binding written contracts entered into prior to July 1, 2011, that do not permit the passing on of increased rates of taxes" will be exempt from the GET even if the amounts would be made taxable by the suspension of an exemption under the bill.

This particular provision is expected to lead to a significant increase in revenue; it would also be expected to broaden the base of GET revenue. On the other hand, most of the activities subject to the tax are business to business transactions; most economists suggest that this leads to pyramiding that has overall negative tax consequences. As previously discussed, contractors may change their operations (through vertical integration) to escape the tax in ways that my not otherwise be considered economically efficient. It is also possible that some economic activity will not take place because of this additional tax. As a result, there is likely some lost business activity as a result of the tax.

[134] Ibid, p. 12.

| Pros | Cons |
|---|---|
| ▪ Broadens the GET base<br>▪ Maintains a source of revenue that is now understood and administered | ▪ Creates additional tax pyramiding<br>▪ May lead to tax avoidance based on vertical integration and other activities that may not be otherwise economically efficient<br>▪ May reduce business activities because of loss of competition |

***Alternative Three: Aggressively Pursue Nexus***

Across the country, states are adopting new methods so that businesses will have nexus in their state sufficient to require them to collect sales (or in the case of Hawaii, GET) tax. The key battleground on nexus issues for states has been what is called "web nexus." This approach was first developed by the State of New York in 2008, often referred to as the "Amazon tax." Under the statute, a *rebuttable* presumption is created that a nonresident internet seller has nexus with New York for sales/use tax purposes if (i) the nonresident has agreements with in-state companies whereby potential customers are referred to the nonresident, and (ii) the nonresident's gross receipts from customers under such an agreement exceed $10,000 during the previous four quarters.

Since that first state foray – and the litigation that followed – other states have also considered and/or adopted similar legislation. The most prominent of these was California's enactment of its "Amazon Law" and which ended with its temporary repeal.

The latest developments in this area have involved federal action. As was noted in a recent report to the Tax Review Commission,[135] there are at least three bills before Congress that would solve this problem for the states by establishing a requirement for vendors to collect sales tax from out of state sellers. These each carry varying exceptions for tax collection, but they are generally viewed as the states' best opportunity to level the playing field in terms of sales tax collection related to e-commerce and other transactions where vendors cannot be currently compelled to collect sales tax.

This is, of course, a situation that relies on the federal government for action. As a result, it cannot be a state recommendation for a way to broaden its tax base or improve its overall collection rate.

***Alternative Four: Increase the GET Rate***

While it is accepted that maintaining low rates is a good overall tax policy, the GET is not been raised since 1965, and a small general rate increase may now be appropriate. While accepting the fact that the GET is a business privilege tax with a very broad base, the GET rate is low compared to other states. The median state rate for its primary consumption-based tax is 6.0 percent, and 35 states have local sales tax rates as well.[136] Hawaii's state and local GET rate is the lowest among the states when the state rate is combined with the average local tax rate.[137]

While it is understood that broadening the base is preferable to raising the rate, the State has not undertaken this action for many years. As most states have experienced, there likely comes a time that a higher rate is justified. Given the State's low overall rate compared to other states and its lack of border competition, this becomes a viable option for Hawaii.

An increase in the GET can also be combined with other changes that can ameliorate negative aspects of the tax structure from a tax policy perspective. For example, the raise in the GET could be coupled with

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[135] "Selected Issues with the Hawaii General Excise Tax," William F. Fox, July 22, 2012, p. 12-14.

[136] Ibid., p. 3.

[137] Ibid., p. 3

additional low income individual income tax credits related to purchases of food or other critical needs by low income earners. The rise in the GET (understanding that it impacts on businesses, particularly in business to business taxes) could be coupled with a reduction or elimination of Corporate Net Income Tax, which is sometimes a nuisance tax for business taxpayers. Finally, an increase in the GET could be combined with reduction or elimination of the 0.5 percent rate which applies to a variety of business-to-business transactions.

On the other hand, the GET's broad base makes it generally regressive, and any increase will heighten that impact. An increase in the GET may also have a psychological impact, as this is a rate that has not been increased for longer than just about any other state rate for a major consumption tax. It is also a significant tax increase and places even greater reliance on this one revenue source.

Individual Income Tax

In FY 2011, IIT receipts accounted for $1.3 billion, or 28.7 percent of all General Fund tax revenue. Hawaii uses as a starting point for determining state taxable income federal adjusted gross income.[138] From federal adjusted gross income, there are currently 16 total tax expenditures – credits, deductions and exemptions – available to IIT filers. These amounted to approximately $252.7 million in total tax expenditures in TY 2009.[139]

Many tax credits, deductions and exemptions are widely used among the states and are generally believed to serve an important public purpose. At the same time, these tax expenditures generally benefit specific groups of taxpayers, which can raise issues of horizontal equity. To the extent that they reduce overall revenue collection, they also reduce the overall IIT base and may make the system more volatile/less stable. Some tax expenditures may make the tax structure more (or less) regressive. In short, each should be analyzed and weighed on a case-by-case basis. The following exemptions, credits and deductions are potential areas where alternative approaches may be warranted.

***Alternative 1: Eliminate or Reduce Exemptions on Pension Income***

There is a wide variety of approaches to taxation or exemption of pension income among the states, and this variation extends to types of pensions. Many states treat private pensions differently than state and local, federal civilian and military pension. In general, public pension income is more likely to be excluded, while private pension income is more likely to be taxed.[140] Hawaii is one of ten states – along with Alabama, Illinois, Kansas, Louisiana, Mississippi, New Hampshire, New York, Pennsylvania and Tennessee – that provide full exemption for public pension income.[141] On the other hand, there are nine states that provide no public or private pension exemption (California, Minnesota, Nebraska, North Dakota, Rhode Island, Utah and Vermont). Between these extremes, the majority of states exempt only a certain portion of pension income.[142]

Until recently, Michigan had fully exempted public pension income from taxation, while exempting only a portion of private pension income. However, effective January 1, 2012, public employee pension income

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[138] There are some items that are taxed by Hawaii but not taxed by the federal government, including the provision for bonus depreciation, increased IRC section 179 deduction, and inclusion of off-the-shelf computer software as property qualifying for the IRC section 179 deduction. See State of Hawaii Department of Taxation 2011 N-11 Forms and Instructions, p.11-12.

[139] "Tax Expenditures in Hawaii", Hawaii Department of Taxation, February 2012, Table 2

[140] A commonly cited source for state tax exclusion for pension and retirement income is 'Individual Income Tax Provisions in the States,' Wisconsin Legislative Fiscal Bureau, January 2011. A table from this report, which lists all 43 states with an individual income tax and their treatment of pension income is included in Appendix E.

[141] "State Personal Income Taxes on Pensions & Retirement Income: Tax Year 2010", National Conference of State Legislatures, February 2011, page 3.

[142]This runs the gamut, from Connecticut (which taxes 50 percent of military pensions but 100 percent of all other pensions) to Massachusetts (which taxes 100 percent of private pensions but excludes all public pension income), to Arkansas (which exempts $6,000 of income for all pensions) to Georgia (which exempts $35,000 of income for all pensions).

became taxable, with limited exceptions. According to the Michigan State Employees Retirement Association (SERA), the State set up a three-tiered pension tax. Pensioners born before 1945 are exempt from the new tax. Those born in 1946 through 1952 would pay the state's income tax rate on pensions, with $20,000 for individuals and $40,000 for couples exempt. Those born after 1952 would pay taxes on all retirement income other than Social Security. When they reach age 67, they would get the $20,000/$40,000 exemption against all retirement income, including Social Security.[143]

As with many tax policy changes, the Michigan law faced significant opposition. The law, as enacted, was challenged as unconstitutional by SERA and was argued through the courts up to the State Supreme Court. In a 4-3 ruling, the State Supreme Court upheld most of the law, including the taxation of public employee pensions for those individuals born after 1945.[144] SERA estimated that the initial impact would be approximately $40 million in additional revenue to the State.

By eliminating or substantially reducing tax exemptions for federal and state pension income, Hawaii could realize a significant increase in general fund revenue. According to the Department of Taxation, federally taxable pension income not taxed by Hawaii for TY 2009 was $2.4 billion. Additionally, total tax expenditures related to employer-provided pensions were approximately $156 million in TY 2009. These accounted for 98.8 percent of all income not deductible for federal income taxes.[145]

Given the varying tax treatment of pension income among the states, it is not surprising that there are solid arguments that can be made on both sides of this issue. On the side of taxation, reducing or eliminating the exemption helps to broaden the tax base; given that pension income is often paid out in monthly installments of a specific dollar amount regardless of the state of the economy, subjecting it to tax can increase stability and reduce volatility of the IIT. It can also be argued that reducing or eliminating the exclusion improves horizontal equity – for many taxpayers, income is income, regardless of the source; it can be hard to argue that a single head of household with a child earning $35,000 is more able to pay IIT than a single head of household with no dependents and $35,000 in pension income.

There is a long history in this country of favorable treatment for the senior population. In Hawaii, the philosophy of *ku puna* – reverence and respect for the elders of society – is an important consideration. While the public policy implications of this favorable treatment can be debated, there is a general belief that those on a fixed income (generally those of retirement age) are less able to deal with additional costs, including additional taxes. Further, it is often argued that, at least for public pensioners, that exempting this income from tax was a form of compact made between public employees and government – that their tax-exempt pension and benefits would be provided in return for lower public sector wages.

| Pros | Cons |
|---|---|
| ▪ Widely practiced among other states<br>▪ Provides a broader and more stable tax base<br>▪ Can be tailored in a progressive structure, with various rates based on certain income levels<br>▪ May improve horizontal equity | ▪ May be seen as targeting a specific population<br>▪ May violate a form of 'social compact' between public workers and government<br>▪ If enacted on prospective pension filers, would not see benefits for many years.<br>▪ Potentially subject to extended litigation. |

***Alternative 2: Eliminate or Reduce Exemptions on Social Security Benefits***

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[143] Michigan State Employees Retirement Association, http://www.mi-sera.org/letterspress_archive.html

[144] According to SERA, the court's ruling struck down language in the law that would have provided a phase out of the exemption for high income earners, as it violated Article 9 §7 of the Michigan Constitution of 1963.

[145] Table 2 – Tax Expenditures in Hawaii's Net Income Taxes, "Tax Expenditures in Hawaii", Hawaii Department of Taxation, February 2012

Compared to the treatment of pensions, the full exemption of Social Security benefits is a more common practice, with 28 states – including Hawaii – fully exempting these benefits from state income taxes.[146] Federally taxable social security income not taxed by Hawaii in TY 2009 was $905.7 million, according to Department of Taxation.

In recent years, the trend has gravitated towards the full exemption of social security benefits. Beginning in 2008, Wisconsin no longer taxed social security benefits. Iowa has also begun the process of phasing out the taxation of social security benefits, from 2007 to 2014. Missouri is also on the verge of completion of the phase-out of taxing social security benefits through income deductions for taxpayers age 62 whose adjusted gross income is $85,000 or less for single filers and $100,000 or less for married couples filing jointly[147]

As an alternative, Hawaii could adopt the federal standard for exemptions on social security benefits.[148] Eight states follow the federal practice – Connecticut, Minnesota, Nebraska, North Dakota, Rhode Island, Vermont and West Virginia.[149] The advantages and disadvantages to this alternative are similar to those for pension income. However, given that Social Security is seen as the bedrock 'safety net' for seniors on a fixed income, it may be even more difficult to overcome the concern for 'taxing seniors on a fixed income.'

| Pros | Cons |
|---|---|
| ▪ Used in other states<br>▪ May be tailored in a progressive structure, with various rates based on certain income levels<br>▪ Can mirror federal tax treatment, which is generally the starting point for AGI in Hawaii<br>▪ Broadens and makes the base more stable<br>▪ May provide additional horizontal equity | ▪ May be seen as targeting a specific population<br>▪ Erosion of the 'safety net' concerns |

***Alternative 3: Eliminate or Reduce Specific Credits***

According to the Tax Research and Planning Office, Hawaii's tax code currently provides 16 separate income tax credits. Tax credits, like exemptions or deductions, can have positive impacts. At the same time, these tax expenditures generally benefit specific groups of taxpayers, which can raise issues of horizontal equity. To the extent that they reduce overall revenue collection, they also reduce the overall IIT base and may make the system more volatile/less stable. Of the tax credits, the following are warrant further discussion regarding the positive and negative aspects of each, and how other states approach similar situations, where applicable.

Overall, eliminating these specific tax credits would likely produce a significant amount of additional tax revenue. Of course, the general theory for tax credits associated with economic development is that the foregone revenue will generate economic activity sufficient to reduce the overall cost of the specific credit – often by generating additional jobs and income that will then be taxable. Whether this is actually the case is often the crux of the development tax credit debate. One of the recent examples of significant forgone revenue is the High Technology Business Investment Credit, which provided $857.6 million in tax

[146] Total includes the District of Columbia

[147] "State Taxation of Social Security and Pensions in 2006", AARP Public Policy Institute, page 4.

[148] No one pays federal income tax on more than 85 percent of Social Security benefits. Individual filers with combined income of between $25,000 and $34,000 may have to pay income tax on up to 50 percent of benefits, and more than $34,000 up to 85 percent may be taxable. Joint filers with combined income of between 432,000 and $44,000 may have to pay income tax on up to 50 percent of benefits, and more than $44,000 up to 85 percent may be taxable. See 'Benefits Planner: Income Taxes and Your Social Security Benefits," U.S. Social Security Administration, accessed electronically at http://www.ssa.gov/planners/taxes.htm

[149] "Ibid, page 3.

credits between 1999 and 2010. While the tax credit is no longer available for new investors, according to the Department of Taxation, the additional credits that could be claimed by existing investors is approximately $847.2 million over at least the next four years.[150]

*Renewable Energy Technologies Income Tax Credit*

Based on current law, taxpayers who have installed a renewable energy technology system and placed it into service after June 30, 2003 may claim this nonrefundable tax credit. The credit is available to all residents of Hawaii and covers a variety of renewable technologies at varying rates, depending on the type of technology. According to the Department of Taxation, tax credits for renewable energy technologies taken in FY 2009 totaled $29.9 million.

Supporters argue that the tax credit is economically advantageous and efficient. As investments by individuals in these technologies increase, the economic impact on Hawaii could be significant, attracting outside investment and creating new jobs. However, investment in these renewable energy technologies is still a fairly expensive upfront cost and may not be a viable option for low income filers, leading to a lack of equity and fairness across tax brackets.

| Pros | Cons |
|---|---|
| ▪ Encourages investment in green technologies, thus reducing dependence on other energy sources | ▪ Investment in technology is still fairly expensive, raising concerns of equitable application of the tax credit among various classes of income |

*Motion Picture and Film Production Income Tax Credit*

Hawaii taxpayers are eligible for a tax credit for qualified production costs incurred on or after July 1, 2006 and before January 1, 2016. The credit is equal to 15 percent of the qualified costs in the City and County of Honolulu and 20 percent of the qualified costs in Kauai, Maui or Hawaii County. The total tax credits claimed per qualified production are capped at $8,000,000.[151] Based on most recent data available from the 2005 Tax Credit Report, 70 taxpayers claimed the motion picture tax credit in TY 2005 for a total of $2.2 million, compared to $750,748 claimed by 19 taxpayers in TY 2004.[152]

As a popular resort and travel destination for both American and international tourists, Hawaii has long been a location for motion picture and television production. Given this fact, it is unclear whether the credit is really necessary to spur production. There are also horizontal equity issues are raised due to the fact that these credits are aimed at a particular industry, rather than all filers. On the other hand, a variety of states have adopted this form of credit, and there well may be film production 'shoppers' that will seek to locate their productions based on this factor.

| Pros | Cons |
|---|---|
| ▪ May spur additional investment in a highly visual industry<br>▪ May be a tie in with the tourism industry | ▪ Is an issue of horizontal equity<br>▪ Hawaii is a popular film locale; additional incentives for film production are unnecessary |

*Property Tax Credit*

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[150] "The Impact of the High Technology Business Investment Tax Credit on Hawaii's Economy for Calendar Year 2009", Hawaii Department of Taxation, December 2010, page 4.

[151] State of Hawaii Department of Taxation, 2011 N-11 Forms and Instructions, p. 23.

[152] "Tax Credits in 2005", Hawaii Department of Taxation, page 15.

Hawaii currently follows the federal guidelines for itemized deductions, including the deduction of property taxes. Property taxes are substantially lower in Hawaii than most other states, and part of the reason for this is the fact that the State bears most of the burden for funding local K-12 public schools – a responsibility that is, in most states, a shared responsibility. Given this fact, one way to balance this would be to remove this deduction, which acts as a benefit for property owners who are already receiving the benefit of reduced property tax bills.

An alternative would be to reduce the exemption to a capped threshold or eliminate the exemption altogether. The increased revenue could be potentially used to supplement the already heavy burden of education funding borne by the state.

| Pros | Cons |
| --- | --- |
| ▪ Eliminates costly tax exemptions and credits | ▪ Potentially reduces revenue generated by nonprofits, specifically from high income earners |

***Alternative 4: Reduce IIT Liability for Low-Income Filers***

Hawaii is currently one of ten states that apply an income tax against income earners below the poverty line.[153] According to the Center on Budget Policy and Priorities (CBPP), a Hawaiian two-parent family of four with annual income at the poverty line ($23,018 for a family of that size) owed $331 in 2011, the third highest liability in the nation behind Alabama and Illinois.[154]

During tax year 2009, total taxable income for all filers with an adjusted gross income (AGI) of $20,000 and below was $829.2 million, with a tax liability of 3.5 percent of that - $29.7 million. An opportunity exists to provide tax relief for low income individuals, particularly individuals living in severe poverty.

According to the Department of Taxation, eliminating income taxes on households below the poverty line would reduce individual income tax collections by 7.8 percent. However, other mechanisms, such as increasing the standard deduction, can reduce low income tax liability with a reduced impact on overall revenue collections.

| Pros | Cons |
| --- | --- |
| ▪ Reduces tax burden on low income filers<br>▪ Eliminates costly tax exemptions and credits | ▪ Tax burden would be shifted to high income earners, who already pay substantially high rates at the top end of the bracket |

[153] "The Impact of State Income Taxes on Low Income Families in 2011", Center for Budget and Policy Priorities, revised April 17, 2012, page 11.

[154] Ibid, page 1.

Excise Taxes

At its core, an excise tax is a selective sales tax – paid by those who use or consume a specific good or service. Excise taxes can be levied in different manners – either as a 'unit-based' tax (i.e. each gallon of gasoline is taxed at the same amount) or as a percentage of the price of the good or service (i.e. a hotel room is taxed at a given percentage of the per night room rate). Among the major examples of goods/services subject to excise taxes by states are:

- Tobacco
- Alcohol
- Gasoline
- Hotel/motel
- Rental car

Excise taxes are often relied upon to raise revenue dedicated to fund certain governmental services. For instance, in many states, the state's share of gasoline tax is partially or fully dedicated to transportation funding. The revenue generated by a given excise tax is somewhat dependent on the elasticity of demand of the good or service taxed. Excise taxes – like any tax – will generally lower demand for a given good or service.[155] In fact, a rationale for some excise taxes is to reduce consumption of what may be seen as goods with negative externalities – or to pay for the additional societal costs associated with its consumption.[156]

Hawaii's principal excise taxes include:

- Transient Accommodations Tax
- Fuel Tax
- Cigarette and Tobacco Tax
- Insurance Premiums Tax
- Rental Motor Vehicle & Tour Tax
- Liquor Tax

Excise taxes represent an important component of the overall revenue structure for Hawaii. In 2011, the FTA reported that 17.3 percent of Hawaii's total state tax revenue was from excise taxes. Hawaii ranked just above the US state median of 17.2 percent and tied for 22nd largest amount of revenue from excise taxes as a percentage of total tax revenue.[157]

The following are selected excise tax revenue alternatives:

***Alternative 1: Increase the Transient Accommodations Tax***

The TAT is projected to generate nearly $46.8 million less beginning in FY 2016 after the expiration of the 2.0 percent surcharge.[158] The State could consider making the temporary surcharge permanent to generate additional revenue.

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[155] For a more detailed discussion of excise taxes and their effect on consumption – including discussion of elasticity, see: "Economics and Politics of Excise Taxation" by Sijbren Cnossen in Theory and Practice of Excise Taxation, 2005; and "Excise Taxes in the States" (working paper number 11-27) by Thomas Stratmann and William Bruntrager, Mercatus Center – George Mason University, June 2011.

[156] Excise taxes on items like cigarette and tobacco products and alcohol are often referred to as 'sin taxes' as a way of characterizing this rationale for their higher tax rates. The same argument is made for 'junk food' and sugar taxes.

[157] FTA 2011 State Tax Collection by Source (Percentage of Total) based upon US Census Bureau data.

[158] The State's base TAT rate is 7.25 percent. The 2.0 percent surcharge is effective through FY 2015.

Exporting an increased amount of revenue to primarily non-resident visitors shifts a portion of the tax burden from Hawaiians to visitors. A tax on visitors helps offset costs related to state/local services consumed (use of public roads, police and fire protection, etc.) and negative externalities (increased traffic congestion, pollution, etc.) As discussed earlier in the report, the taxes associated with a stay in Honolulu are lower than average for the top 10 US city tourist destinations, suggesting there is some rate increase opportunity.

Derived from hotel room rentals, time share units and other temporary accommodations, TAT revenue – absent rate changes – tends to rise and fall in relationship to the State's tourism industry. A prior study indicates that Hawaii's tourist demand elasticity for lodging is -1.5 – showing it to be modestly elastic.[159] The report suggests that "hotel room taxes are fully exportable to tourists, but the tax has a relatively large negative impact on the tourist demand for lodging services."[160] An elasticity of -1.5 would suggest that the temporary increase in the TAT should have resulted in less revenue, which did not occur. It may be the case that price elasticity of demand for lodging in Hawaii is slightly more inelastic in present times than estimated by this 1988 study. Of course, there may be other factors, such as generally improved economic conditions, that masked the demand reduction associated with this specific tax increase.

The results follow general logic given Hawaii's unique characteristics, desirability as a vacation destination – both domestically and, increasingly, from abroad – and the relative lack of available substitutes for lodging. As a result, it could be argued that an increase in the permanent TAT rate to the temporary 9.25 percent rate can be sustained without significant impairment to the tourism industry.

It is not surprising that the lodging industry is unlikely to support a permanent 9.25 percent rate, although in other areas they will sometimes support the increased rate if it is dedicated to marketing and promotional activity to attract additional visitors.

| Pros | Cons |
|---|---|
| ▪ Significantly exported<br>▪ Temporary rate will be in place for a total nearly 6 years suggesting market is mostly adjusted to rate<br>▪ Compared to other major US-city destinations, Honolulu has relatively low hotel/motel tax rate<br>▪ Provides manner for Hawaii to recover costs associated with providing public services to tourists<br>▪ Straightforward administration/collection | ▪ Lodging industry will likely see little benefit<br>▪ Failing to sunset taxes that are scheduled to do so may create ill will or distrust among taxpayers or industry groups<br>▪ This may make future uses of temporary rate increases more difficult |

***Alternative 2: Institute a Prepared Food Tax***

While food is already subject to the GET, an additional excise tax is sometimes levied on food that is prepared onsite (i.e. restaurant, convenience store) for consumption by a customer. Because visitors generally consume more of their meals in restaurants and similar locations, the tax is another way to export the state tax burden. 'Meals away from home' show a somewhat inelastic price elasticity of

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[159] "The Incidence and Exportability of Hotel Room Taxes: Some Further Estimates" (Working Paper Number 88-9) by E. Fuji, M. Khaled, J. Mak. 1988. For most products, a basic market principle is that there is a relationship between its price and the quantity that will be demanded. This relationship varies, depending on the perceived necessity of the product or service. The measure of responsiveness of quantities demanded with changes in price is known as the price elasticity of demand. In general, price elasticity of demand is a negative number, and is expressed as the change in quantity demanded in response to a one percent change in price. Elasticities of demand of less than -1.0 in absolute value are generally considered relatively inelastic (changes in demand are less responsive to changes in price), while elasticities of demand greater than -1.0 in absolute value are considered relatively elastic (changes in demand are more responsive to changes in price).

[160] Ibid, p. 9.

demand (approximately 0.7-0.8).[161] This suggests that implementing a tax specifically on prepared foods would not alter consumer behavior to a significant extent. A case can also be made that some of the elasticity of demand in cities and states with these taxes is really cross-border competition, with consumers avoiding the tax by visiting restaurants in surrounding cities or states without the tax. That option is not available with a statewide tax in Hawaii.

One argument against food taxes in general is that they are regressive. According to the US Bureau of Labor Statistics' (BLS) 2010 Consumer Expenditure Survey, the percentage of annual income spent on food away from home decreases as income increases – though the relative difference from the second quintile to the fourth quintile (most likely consisting of the middle class) is only 1.2 percentage points. However, the percentage of total food costs that are spent on food away from home increases as income increases.

**BLS Food Expenditures by Income Quintile – 2010**

| | Lowest Quintile | Second Quintile | Third Quintile | Fourth Quintile | Highest Quintile |
|---|---|---|---|---|---|
| Food at Home | $2,270 | $2,816 | $3,433 | $3,917 | $5,683 |
| Food Away from Home | $1,039 | $1,398 | $2,164 | $2,926 | $4,993 |
| Percentage of Food Costs Spent on Food Away from Home | 31.4% | 33.2% | 38.7% | 42.8% | 46.8% |
| | | | | | |
| Annual Income of Consumer Unit | $9,906 | $26,777 | $45,552 | $72,794 | $157,369 |
| | | | | | |
| Percentage of Annual Income Spent on Food Away from Home | 10.5% | 5.2% | 4.8% | 4.0% | 3.2% |

| Pros | Cons |
|---|---|
| ▪ Exports a portion of the tax.<br>▪ Tourist demand for prepared food is likely more inelastic than resident demand.<br>▪ Many top tourist destinations (cities) have a prepared meals tax in addition to sales tax | ▪ Defining what constitutes a prepared meal may be difficult leading to administrative and collection challenges<br>▪ While a large amount of tax could be exported, residents could also experience tax increase if dining at restaurant or ordering take-out food<br>▪ Somewhat regressive, though regressivity may be more muted than other types of sales taxes because of available substitutes |

***Alternative 3: Increase the Rental Motor Vehicle and Tour Vehicle Surcharge Tax***

As of July 1, 2012, the State's temporary, one-year $7.50 per day surcharge reverted to its base of $3.00 per day. Similar to the TAT, rental motor vehicle and tour vehicle tax is very sensitive to the State's tourism industry and tends to perform in similar fashion to the State's tourism industry. Studies vary in estimated price elasticity of demand for rental vehicles. As discussed earlier in the report, the taxes associated with rental vehicles in Honolulu are relatively lower than other top tourist destinations. Since most revenue associated with the tax would likely be generated from non-resident rentals, increasing the tax shifts a portion of the tax burden from Hawaiians to visitors.

[161] 'The Impact of Food Prices on Consumption: A Systemic Review of Research on the Price Elasticity of Demand for Food." Tatiana Andreyeva, Michael W. Long, and Kelly D. Brownell. American Journal of Public Health, February 2010, Vol 100, No. 2, pp. 216-222.

Rental car companies, especially those with significant rental volume from in-state residents, have opposed excise tax increases in other jurisdictions. As noted above, the issue of elasticity of demand (and its likely impact on overall rentals) is an open question – although some studies have also concluded that disparate rental rates leads to cross-border competition (a situation that does not exist in Hawaii).

| Pros | Cons |
|---|---|
| ▪ Mostly exported<br>▪ Some studies suggest demand for rental vehicles is somewhat inelastic<br>▪ Many top tourist destinations (cities) have higher rental car tax rates<br>▪ Ease of administration<br>▪ Provides a way, other than through the gas tax, to recover costs of using the state's roads | ▪ While a large amount of tax would be exported, residents would also experience tax increase if renting a vehicle in-state<br>▪ Some studies suggest demand for rental vehicles is somewhat elastic. |

***Alternative 4: Levy an Amusement/Recreational Tax***

The State could levy an amusement or recreation tax on rentals of recreational equipment and admission fees/charges for recreational activity. Common activities covered by these taxes include:

- Round of golf and driving range usage
- Motorized and non-motorized recreational water vehicle rentals (i.e. jet ski; surfing equipment; kayaks; canoes; etc.)
- Recreational experiences/admissions (i.e. parasailing; harbor cruises; museum admission; sightseeing tours; sporting event admission; etc.)

As with other excise taxes, one of the primary benefits is that a significant share of the tax burden is exported to non-residents. Due to Hawaii's unique geography, climate and cultural history, tourists are likely to seek experiences unlike those available when not on vacation.

The tax may cause some net activity loss because of decreased demand, on the theory that tourists may substitute other activities that are not subject to the amusement/recreation tax. On the other hand, the demand for specialized recreation while on vacation may be relatively inelastic. Of course, residents would also incur the additional tax burden for covered activities as well.

| Pros | Cons |
|---|---|
| ▪ Exports a significant share of the tax burden<br>▪ Tourist demand for unique experiences may be somewhat inelastic, resulting in little drop off in consumption in response to the tax | ▪ While a share of the tax would be exported, residents would also experience tax burden increase for recreational activities<br>▪ If demand is elastic and consumption of covered activities drops significantly, the burden will be borne by the owners of companies selling recreational services |

***Alternative 5: Raise the Cigarette/Tobacco Tax***
Hawaii has the fourth highest per-pack cigarette tax among states – trailing only New York, Rhode Island and Connecticut. At $0.16 per cigarette ($3.20 per pack for a standard 20 cigarette pack), the State's tax is almost $0.10 greater than the US median ($0.0625 per cigarette). From 2002 to 2011, Hawaii increased the per cigarette excise tax in every year but one.

Despite the comparatively high rate of taxation and consistent rate increases, the State experienced yearly revenue growth in each Fiscal Year from 2007-2011; including double digit growth in four years. This aligns with the general research that suggests cigarette demand is somewhat inelastic – which is logical given the addictive nature of smoking. Additionally, there is no cross-border competition among states to sell significant volumes of cigarettes. Consumers in Hawaii cannot readily travel to buy cigarettes in bulk to avoid taxes in their home state. A moderate increase in the cigarette tax will likely result in increased revenue for the State without a significant reduction in sales.

A portion of cigarette tax revenue will be exported as visitors purchase cigarettes for consumption during their stay in the State. Additionally, any increase in this 'sin tax' could result in additional funds to offset the reduction in the General Fund receipt per cigarette ($0.12 through FY 2013 and $0.10 thereafter). Alternatively, the State could dedicate a portion of an increase to the Cancer Research Fund and other dedicated recipient funds from the cigarette tax in lieu of additional contributions from the General Fund.

| Pros | Cons |
|---|---|
| ▪ Exports a share of the tax burden<br>▪ 'Sin tax' dedicates portion of revenue to health-related funds or could offset scheduled decrease in receipts of tax by General Fund (FY2014 and beyond)<br>▪ Cigarette demand is somewhat inelastic – especially with no cross border competition<br>▪ Relatively easy administration and collection<br>▪ Cigarette tax increases have proven to be politically more palatable than other tax increases, as smokers are a minority of the population<br>▪ Evidence that tax increases reduce purchase of cigarettes by youth[162] and low income individuals[163] | ▪ Already among highest per cigarette rates among the 50 States<br>▪ Other states have begun to see and forecast declines in cigarette tax revenues as a result of tax increases leading to higher prices[164] |

***Alternative 6: Increase the Liquor Tax (on beer, wine and liquor)***
The liquor tax performance has somewhat correlated with the performance of the State's tourism industry. While many factors are unique to the tax's performance and the tourism industry's performance, recent

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[162] See, for example, 'Cigarette Taxes and Youth Smoking: New Evidence from National, State, & Local Youth Risk Behavior Surveys," Christopher Carpenter and Philip J. Cook, April 2007, which found that 'the large state tobacco tax increases of the past 15 years were associated with significant reductions in smoking participation and frequent smoking by youths." Accessed at http://web.merage.uci.edu/~kittc/Carpenter-Cook-JHE-Cigarette-Taxes-Youth-Smoking-YRBS.pdf

[163] A recent study found that smokers from lower socioeconomic groups are more price-responsive than those from higher socioeconomic groups, with a 10 per cent increase in taxes causing smoking participation to fall in this category by about 2.3 per cent. See Science Daily, July 11, 2011 Accessed electronically at http://www.sciencedaily.com/releases/2011/07/110713121258.htm

[164] Of course, the counter-argument is that if declines in revenue are due to declines in consumption, there will be positive externalities associated with that decline which may reduce state health care and other costs. Some of the decline in other states is associated with tax avoidance – purchasing cigarettes in states or cities with lower tax rates, on Indian reservations and via the Internet. Some of these options are not as readily available for Hawaii consumers.

growth and recovery in the liquor tax revenues have correlated with the economic recovery and tourism recovery. A portion of this tax is exported to tourists who consume alcohol while in the State.

An increase in the tax would likely lead to some drop-off in consumption of alcohol. There has been extensive research and study done related to the price elasticity of demand for alcoholic beverages. Conclusions have varied from being relatively inelastic to relatively elastic.[165] Studies that differentiate by type of product have also found differing elasticities for beer, wine and distilled spirits, with generally (but not always) lower elasticities of demand for beer and wine than for distilled spirits.[166]

Because this has been an extensive topic for study, additional research has included several 'studies of the studies.' In the case of alcohol price elasticities of demand, three meta-analyses have been conducted.[167] The most recent of these reported average elasticities of -0.46 for beer, -0.69 for wine, and -0.80 for distilled spirits.[168] This analysis, which discussed potential areas of concern with the previous two metastudies, has, of late, become something of a consensus for discussion of elasticities of demand for alcoholic beverages and suggests that alcohol demand is relatively inelastic.

In 2010, Hawaii had the fourth highest gallonage tax on beer, the 11th highest gallonage tax on wine and the 19th highest gallonage tax on spirits.[169] The US BLS data that indicates that the amount spent on alcohol increases as income increases and lower-priced products tend to be purchased by lower-income individuals.[170] Thus, the Liquor Tax as currently constituted is somewhat regressive, because higher value products are taxed the same as lower value products (per gallon), and lower income purchasers are more likely to consumer lower priced wine and spirits. Increasing the liquor tax would exacerbate this regressive feature. To offset some concerns, a portion of a potential increase could be dedicated to enhanced education, health-related initiatives or enforcement activities.

| Pros | Cons |
|---|---|
| ▪ A portion of the tax is exported<br>▪ Relatively easy administration and collection<br>▪ Tourism consumption likely to help alleviate some level of destruction of sales from in-state residents<br>▪ Alcohol is relatively inelastic and a tax increase is unlikely to yield a comparable decline in consumption.<br>▪ Alcohol taxes have proven to be politically more palatable than general increases to broad based taxes such as sales or income taxes | ▪ Already among the top beer and wine gallonage tax rates<br>▪ Efforts to increase the alcohol tax rate were met with opposition in 2011 |

[165] A meta-analysis of studies from 18 countries, including 46 beer own-price elasticity estimates, 54 wine own price elasticity estimates and 50 spirits own price elasticity estimates ranged from 'highly inelastic (-0.09) to elastic (-1.20) with a mean of -0.38.' James Fogarty, "The Nature of the Demand for Alcohol: Understanding Elasticity," *British Food Journal*, 2006, p. 320.

[166] One frequently cited source, S.F. Leung and C.E. Phelps determined price elasticities of demand to be -0.3 for beer, -1.0 for wine, and -1.5 for distilled spirits. "My Kingdom for a drink..? A review of estimates of the price sensitivity of demand for alcoholic beverages", in M.E. Hilton and G. Bloss "Economics and the Prevention of Alcohol-related Problems: Proceedings of a Workshop on Economic and Socioeconomic Issues in the Prevention of Alcohol Related Problems*",* National Institute on Alcohol Abuse and Alcoholism, 1993, p. 1-31.

[167] The first two studies were by Fogarty, previously cited, and C.A. Gallet, "The Demand for Alcohol: A Meta-Analysis of Elasticities," *Australian Journal of Agricultural Resource Economics,* 2007, (51):p. 121-135.

[168] Wagenaar, Salois and Komro, p. 187.

[169] "State Sales, Gasoline, Cigarette, and Alcohol Taxes as of February 1, 2010. Tax Foundation.

[170] US BLS Consumer Expenditure Survey, 2010. Data indicate that those in the lowest quartile of income spend approximately 1.5 percent of income before taxes on alcohol. At the highest quartile of income, alcohol expenditures account for 0.6 percent of income before taxes. The trend through income levels is that alcohol consumption increases as income increases, but the percentage of income spent on alcohol decreases as income increases.

***Alternative 7: Increase the Motor Fuel Tax***
Fuel efficiency increases in vehicles and the increased proliferation of hybrid and alternatively fueled vehicles are combining to render the per gallon fuel excise tax less productive. For this reason, states are beginning to consider alternative revenue sources such as vehicle miles traveled fees or taxes.[171] Hawaii may need to consider newer revenue systems than simply increasing the fuel tax in its current form.

At $0.17 per gallon, Hawaii's gasoline tax is sixth-lowest among the 50 states as of January 1, 2012.[172] In addition to the State gasoline tax, Hawaii allows local option taxes of $0.088 to $0.18 per gallon. Motor fuel tax revenue in Hawaii declined in consecutive years during the recession (FY 2009, FY 2010) before recovering in FY 2011 – year-over-year growth of 25.5 percent. While this tax is a non-General Fund revenue source, to the extent it provides more revenue, the General Fund may not have to supplement other funds or projects. Much of the tax's revenue is likely sourced from Hawaii residents.

A study by the National Bureau of Economic Research (NBER) suggested that gasoline demand is more inelastic in recent years than it was in the late 1970's – indicating a societal reliance on automobiles and other vehicles for transportation as well as a shift in lifestyles and land usage/development.[173]

A fuel tax is generally considered a regressive tax and any increase – either directly related to filling the tank of a vehicle or due to increased costs of taxis and mass transportation – would also be regressive as those with lower incomes would pay a greater proportion of their income on transportation expenses.

| Pros | Cons |
|---|---|
| ▪ Revising the manner in which a Motor Fuel Tax is calculated allows the State to "get ahead" of decreased efficiency in the current Motor Fuel Tax<br>▪ Current tax is among the lowest gasoline taxes levied by States<br>▪ Relatively easy administration and collection<br>▪ Increased revenue could be dedicated toward renewable energy investment and development<br>▪ Places the burden on funding the transportation system on users of the system | ▪ Existence of local option taxes on top of State tax further increases costs to consumer<br>▪ Minimally exported<br>▪ Some consumption decline is likely but given the inability to cross state lines to purchase gasoline and the current relative inelasticity of demand, this may not be significant |

***Alternative 8: Institute a Snack Food and/or Soda Tax***
While approximately half of all states extend their sales tax to soft drinks (including Hawaii where the GET applies), only two states, Arkansas and West Virginia, impose an excise tax on sweetened sodas and other soft drinks.[174] Arkansas' excise tax yields more than $40 million per year in revenue.[175] Additional states have contemplated levying such a tax (including taxes on snack foods), but have not successfully passed legislation. Alternatively, 23 states levy a higher sales tax on soda than on food generally;

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[171] Many states' tax codes tax fuel (gasoline, diesel, aviation, etc.) and do not address alternative fuels. Thus, states often do not capture appropriate revenue from hybrid, electric, biofuel, or other alternative-powered vehicles.

[172] FTA 2012 State Motor Fuel Tax Rates. An alternative means to calculate the gasoline tax is published by the Tax Foundation. The Tax Foundation methodology differs from the FTA and adds other taxes to the calculation to yield their figure.

[173] "Evidence of a Shift in the Short-Run Price Elasticity of Gasoline Demand,(Working Paper 12530)" Jonathan E. Hughes, Christopher R. Knittel and Daniel Sperling. National Bureau of Economic Research, September 2006.

[174] Excise Taxes in the States" (working paper number 11-27) by Thomas Stratmann and William Bruntrager, Mercatus Center – George Mason University, June 2011 and "Tax Sugary Soft Drinks," William Shughart. *Bloomberg Business week*, June 4, 2009.

[175] "Taxing Sugared Beverages Would Help Trim State Budget Deficits, Consumers' Bulging Waistlines, and Health Care Costs," Center for Science in the Public Interest. 2011.

including, California, Colorado, Connecticut, Florida, New Jersey, New York, Pennsylvania and Washington -- and several charge a higher tax on sodas sold from vending machines. [176]

At least 40 states impose a sales tax on snack foods (including Hawaii) – and in several cases the tax rates are greater than the standard sales tax for food.[177] This suggests that some form of state snack taxes exist (if not explicit by name). Maine had a 5.5 percent tax on snacks (including soda, cookies, etc.) from 1991 to 2000, before it was repealed.[178]

Proponents suggest that, in addition to revenue benefits, taxes on sweetened beverages and/or snack foods may alter consumer behavior with positive externalities.[179] The sensitivity of consumer choice and alternate food options would likely result in some level of consumption loss for sweetened drinks and affected snacks. Proponents suggest this serves public health interests – mostly related to obesity and obesity-related health concerns.[180]

Opponents suggest that factors other than soda consumption contribute to and cause obesity. Similarly, opponents indicate that soda and snack taxes would be regressive and disproportionately fall to the poor. Further, they point out that the Center for Disease Control reports that Hawaii's adult obesity rate was 22.7 percent in 2010 – fourth lowest among all states.[181]

Supporters readily acknowledge such taxes would be regressive, but suggest that a portion of the revenue should be used to expand health-related programs – including obesity prevention and intervention programs and alternative food options such as availability of fresh fruit and vegetables – to lessen the perpetual challenges of obesity among lower-income residents. [182]

| Pros | Cons |
|---|---|
| ▪ Increased revenue could be dedicated toward alternative, healthy foods and obesity prevention<br>▪ May be more politically accepted because there is a public health component | ▪ Mixed evidence on actual weight and health impact<br>▪ Significant industry opposition<br>▪ Minimally exported<br>▪ Likely regressive<br>▪ May become administratively difficult to determine what is subject to the tax |

[176] "State Sales Tax on Regular, Sugar-Sweetened Soda (as of January 1, 2011)," Bridging the Gap Program, University of Illinois at Chicago. 2011.

[177] "State Snack and Soda Taxes from 2003-2007: A Public Health Policy Approach to Discouraging Consumption of Snacks and Sodas," Shelby Edison, Jamie Chirqui, Hannalori Bates, Frank Chaloupka on behalf of the MayaTech Corporation for the Institute for Health Research and Policy, University of Illinois at Chicago, 2007.

[178] "Snacks – What Happened to my Twinkie?" The Center for Consumer Freedom, 2012.

[179] In the extreme, a tax cannot both change behavior significantly and raise revenue. However, in the short-term, it may be possible to achieve both goals – albeit modestly. While not a precise comparison, there is significant research on plastic bag taxes causing consumer usage to decline. For instance, a 33-cent tax on grocery bags in Ireland caused a 92 percent drop in usage. Thus a temporary increase in revenue may occur in the initial year of implementation and revenue may subside after the first year or two as consumers respond to the price changes associated with the tax. There may be substitution issues associated with plastic bags that would not exist for many consumers as it relates to snack foods and/or sweetened beverages.

[180] West Virginia uses proceeds to fund a portion of West Virginia University medical, dental and nursing schools.

[181] Center for Disease Control 2010 State Obesity Rates.

[182] "Taxing Sugared Beverages Would Help Trim State Budget Deficits, Consumers' Bulging Waistlines, and Health Care Costs," Center for Science in the Public Interest. 2011.

### *Alternative 9: Increase the Conveyance Tax*

Hawaii's conveyance tax is similar to real estate transfer taxes in other states. The tax is levied at increasingly greater rates as the value of the transfer increases – the tax is levied through 7 different brackets according to the value of the transfer.[183] The lowest rate, $0.10 per $100 in transfer price, applies to transfers under $600,000 for buyers not eligible for a homeowner's exemption. As of September 2010, Hawaii's top-level residential conveyance tax rate, $1.00 per $100 of real estate transfers of $10 million or more for buyers not eligible for a homeowner's exemption, is among the highest rates levied by states.[184] The median home value in Hawaii is $534,900.[185] The associated conveyance tax from transfer of a residential (non-investment) property at the median value would be $0.10 per $100 – or $534.90. This rate (0.1 percent per $100), is within the mainstream of other states' real estate transfer tax rates and may be a bit lower than the norm. As currently structured, the conveyance tax is progressive – those purchasing higher-value homes pay a higher tax rate than those who purchase lower-value homes.

Given Hawaii's attractiveness as a second home destination, some portion of this tax is exported. If the state increases the conveyance tax rate (perhaps bumping up the lower level rates), an income tax credit or other adjustment could be allowed for Hawaii residents who purchase a primary home in the state to offset the additional burden. Increasing the bottom rates of the conveyance tax or collapsing several tiers would create a somewhat more regressive tax structure for Hawaii residents without any corresponding offset. Alternatively, since the State already has a differential structure for primary homeowners versus investment property owners, increasing the rate for those ineligible for the homeowner's exemption could have the same effect.

Additionally, an increase in the conveyance tax could be viewed as a means to offset the State's generous support for local services. Conveyance taxes (and real estate transfer taxes) are generally capitalized along with the selling price. They buyer's monthly payments are the combination of the amount amortized over a given number of years plus local property taxes. If the property taxes are lower because of State support for local function, as in the case of Hawaii, some of the foregone revenue could be made up at the time of property transfer through an increased conveyance tax.

The recent recession and its recovery temporarily reduced the revenue associated with the conveyance tax before it rebounded from its FY 2009 low point. The tax remains sensitive to housing prices and shifts in the market. As a result, predicting the base for the tax is difficult in this uncertain real estate recovery.

| Pros | Cons |
|---|---|
| ▪ Somewhat exported<br>▪ Could be structured as only an increase on those ineligible for homeowner's exemption – increasing exportability of the tax<br>▪ Low-end rates within mainstream to somewhat low compared to other states<br>▪ Relatively easy administration and collection<br>▪ Difficult to evade thus compliance costs are low<br>▪ Comparatively low property taxes in HI suggest that a slightly higher conveyance tax would not unduly burden property relative to other states | ▪ Currently structured as more progressive tax, a shift (depending upon composition) could make it more regressive<br>▪ Somewhat challenging to forecast due to sensitive to the housing market – especially true if market is volatile<br>▪ High-end rates among higher real estate transfer taxes of all states<br>▪ Often taxes related to property are the most politically unpopular |

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[183] For a complete review of the Conveyance Tax and its associated brackets, please see the discussion of the Tax in the Current Revenue chapter of this report.

[184] According to the National Conference of State Legislatures, as of September 2010 Real Estate Transfer Taxes in Delaware, New Hampshire, New Jersey, New York, Pennsylvania, Vermont and Washington top level rates were at or above the level of Hawaii's top level conveyance tax.

[185] US Census Bureau American Community Survey (ACS) 2008-2010 3-year data.

***Alternative 10: Raise the Insurance Premiums Tax***

Insurance companies, in lieu of GET and income taxes, pay Hawaii's insurance premiums tax. The tax is levied on insurance companies based upon premiums written in the State. A 1.0 percent credit is offered to qualifying insurers to facilitate regulatory oversight. The State levies a 2.75 percent tax on life insurance and 4.265 percent tax for casualty and other types of insurance. Several other states subject insurance companies to a corporate income tax rate as well as a premium tax. Hawaii does not subject insurers to the corporate income tax rate – instead levying only the premium tax and a 0.15 GET.

Hawaii does not have a retaliatory insurance premium tax in place to equalize the rates between higher and lower state tax rates (generally used when the home state imposes a higher tax rate than the taxing state). A retaliatory tax "retaliates" against out-of-state firms doing business in the state by charging them a higher tax rate. The remaining 49 US states have a retaliatory tax in place.

According to a 2010 study, Hawaii's health insurance premium tax is higher than most other states – ranking third highest as a percentage of tax to total premium.[186] However, if raised slightly, it could generate additional revenue. Given that insurers are not subjected to corporate income taxes, there may be additional room for increases on par with those in other states. Additionally, the 2010 study reported Hawaii had the fewest number of residents (one-third) of any state participating in self-insured plans – often exempt from premium taxes. Thus, the State should have a relatively strong base of qualified premiums upon which to levy the tax. However, there is likely an upper limit at which further increases risk eroding the base and harming the taxed entities. At a minimum, the State may consider enacting a retaliatory tax provision.

| Pros | Cons |
|---|---|
| ▪ No retaliatory tax provision<br>▪ Insurers not subject to corporate income tax<br>▪ Relatively easy administration and collection | ▪ Limited exportability<br>▪ Relatively higher rate compared to other states |

***Alternative 11: Increase Cell Phone Service Tax***

Hawaii imposes the 14th lowest rate for wireless service taxes and fees among all states in 2010. State and local wireless taxes and fees vary greatly with the highest rate of 18.64 percent levied in Nebraska and the lowest rate of 1.81 percent levied in Oregon. Hawaii's 7.75 percent rate is less than the simple average of all US states (9.87 percent), the weighted average of all US states (11.21) and only 1.5 percentage points more than the 6th lowest-rate (Delaware). Viewed another way, Hawaii's wireless tax rate is 3.75 percentage points greater than its GET rate. The difference between the State's wireless tax and its GET (sales-like tax) ranks 21st among state differences and is almost equivalent to the US weighted average (3.80 percent). Several states allow local governments broad latitude to impose fees, while others are more limited. Tax pyramid concerns also arise in some states as wireless consumers pay an excise tax with a sales tax applied on top of it.[187]

Opponents indicate a cell phone tax violates tax neutrality, as the tax affects a taxpayer's market decision on telecommunication method. Opponents also argue that cell phone taxes are regressive.

Several studies conducted in the early-to-mid 2000's suggested that cell phones were relatively elastic in terms of demand and income. As the mobile market continues to gain deeper penetration, some

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[186] "Taxing Health Insurance: How Much Do States Earn? Estimates of State Premium-Tax Revenues from Health Insurance and the Potential Cost of a Federal Takeover," John R. Graham. Pacific Research Institute. 2010.

[187] Calls originating and ending in the State are not subject to GET. Calls originating or ending outside of the State are subject to the GET, per Department of Taxation Announcement 2002-17.

speculate that the demand elasticity will shift lower, toward a more inelastic good. While only time will tell, it is likely that consumers will retain some available substitutes for mobile phones (or at least tiers of service) and the good will be somewhat elastic – even if elasticity declines.

The State could slightly increase its wireless tax rate to raise additional revenue. A moderate increase of 2.0 percentage points – just below the US average (9.87 percent) – would boost state revenue but also expand a regressive tax.

| Pros | Cons |
|---|---|
| ▪ Relatively low tax rate compared to other states<br>▪ Easy administration and collection<br>▪ Expanding market offers broadening base | ▪ Negligible exportability<br>▪ Regressive composition<br>▪ Neutrality concerns |

Corporate Net Income Tax

While the corporate income tax is generally viewed as one of the 'big three' taxes at the state level, for the State of Hawaii it raises a relatively small amount of revenue – less than one percent of general fund revenue in FY 2011. Part of the reason that Hawaii's net income tax is not as considerable in terms of revenue collection as in other states is that the GET is a significant tax on corporations – more so than sales taxes in most other states.

There are a variety of approaches that could be considered to revise the corporate net income tax to achieve tax policy goals. In particular, some of the effects of the GET on business could be ameliorated by involving the corporate net income tax with revisions to the GET. The following detail some of these alternatives:

***Alternative 1: Increase Corporate Net Income Taxes and Reduce GET for Business-to-Business Transactions***

Application of the GET to business-to-business transactions is commonly raised as a major concern of the current tax structure. This application can lead to pyramiding, which can disrupt markets and motivate businesses to act in ways to escape the tax. The State could use its corporate income tax to mitigate the negative effects of the GET.

This alternative would increase corporate net income tax rates and reduce or eliminate the GET (currently 0.5 percent) applied to wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale. An advantage of this approach (beyond reducing tax pyramiding) would be to tax net income (i.e., profits) as opposed to business activity. A major criticism of gross-receipts taxes is that they have a disproportionate impact on businesses that operate on lower profit margins – a horizontal equity concern.

Of course, an advantage of the current GET is that it raises a significant amount of revenue and is also relatively stable (an advantage of a tax that is based on activity rather than profitability). It would require a significant increase in current corporate net income tax rates to recoup the level of lost revenue, particularly if the goal is to completely eliminate the 0.5 percent rate. Hawaii's current corporate net income tax rates range from 4.4 percent to 6.4 percent, based on the level of net income. Among all states, three states do not have a corporate net income tax or corporate gross receipts tax; at the other end of the spectrum, top corporate tax rates run as high as 12 percent.

A related concern with the current corporate income tax structure is the use of brackets at differing levels of corporate net income. Currently, 31 states have a single corporate tax rate.[188] The argument in favor of a single rate and against differing rates and brackets is that In contrast to the individual income tax, there is no meaningful "ability to pay" concept related to income levels for corporations.[189]

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[188] Federation of Tax Administrators, accessed at http://www.taxadmin.org/fta/rate/corp_inc.pdf.

[189] "2012 State Business Tax Climate Index," Tax Foundation, January 2012, p. 12. As the report notes, "Jeffery Kwall, the Kathleen and Bernard Beazley Professor of Law at Loyola University Chicago School of Law, notes that 'graduated corporate rates are inequitable—that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes."

| Pros | Cons |
| --- | --- |
| ▪ Reduces tax pyramiding<br>▪ Improves horizontal tax equity by focusing on income rather than transactions<br>▪ Broadens tax collection for a major tax | ▪ Less stable and more susceptible to business cycle impacts<br>▪ Can be seen as an erosion of the GET broad base |

***Alternative 2: Transition to a Single Factor Corporate Net Income Tax***

One of the criticisms of transaction-based corporate taxes is that it can make Hawaii-based businesses less competitive with businesses based outside of the state. This can occur for several reasons. For example, the 0.5 percent GET is applied to many business-to-business transactions involving Hawaii corporations, but the same transaction involving a business not located in Hawaii may not be subject to the tax, which can make Hawaii businesses less attractive. As a result, in cases where pyramiding occurs, Hawaii goods and services may be more costly to produce/provide than those from other states, which can either increase the final price or reduce profit.

In several states with transaction-based corporate tax structures, a balancing act has been to change the method for apportioning corporate income. At one time, most states used a three factor apportionment formula for multi-state corporations consisting of property, payroll and sales/receipts. However, over time, two other apportionment formulas have grown in popularity – a three factor formula that double weigh sales, and a single factor sales formula. The theory of these changes is that multi-state corporations with significant payroll and property in the state may benefit from shifting the apportionment formula to one based solely on sales in the state. Indeed, one influential study found that formula weight placed on payrolls had a substantial impact on the growth of manufacturing employment within states.[190]

On the other hand, the actual impact on a business will vary on a case-by-case basis. For example, companies with little in-state employment and property that sell proportionately more of their products in-state will be negatively impacted by the apportionment change – the impact depends on the importance of the state for the purposes of producing goods and services relative to its importance as a market for those goods and services.

| Pros | Cons |
| --- | --- |
| ▪ May compensate for effects of business to business transactions taxed via GET<br>▪ May increase competitiveness for some Hawaii companies, particularly in manufacturing<br>▪ Studies have suggested it increases employment in certain industries | ▪ Some corporations will likely have an increased tax burden<br>▪ Is an erosion of the broader base under the current three-factor apportionment<br>▪ May create an incentive for some corporations to move employees and facilities out of state to eliminate nexus |

***Alternative 3: Eliminate Net Operating Loss Carry-Back***

Hawaii allows corporations to apply net operating losses (NOL) in a tax year to its returns in following years (NOL carry-forward) or amend its returns for past years and use current losses to offset profits and receive refunds of taxes paid in past years (known as NOL carry-back). Allowing NOL carry-back can create additional instability in the tax structure, particularly during economic downturns.

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[190] Austan Goolsbee and Edward L. Maydew, "Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment," NBER Working Papers, 2000, accessed at http://faculty.chicagobooth.edu/austan.goolsbee/research/apport.pdf

It's been noted that corporate net income taxes are a volatile revenue source, and many (if not most) businesses are negatively impacted during recessions and other economic downturns. For businesses that may be in need of cash, using the NOL carry-back provision is a viable option. Unfortunately, for the State, this can come at an inopportune time, as it exacerbates revenue reductions – at a time when states often experience an increased demand for services like Medicaid or other means-tested programs.

Hawaii is currently one of 19 states that allow NOL carry-back deductions. While there are advantages to the State in being able to better forecast its current year revenues and providing some greater stability for a volatile revenue source, it does not impact overall revenues over time – corporations that cannot use the NOL carry-back option will still be able to carry those losses forward.

| Pros | Cons |
|---|---|
| ▪ Should make current year revenue estimating more accurate, particularly during economic downturns<br>▪ Reduces some volatility in the corporate income tax | ▪ Does not increase overall corporate income tax revenue over time<br>▪ Removes a method for corporations to raise cash during a time of stress |

***Alternative 4: Broaden Nexus Definitions***

Generally, corporate taxpayers have nexus in a state when they have physical presence in the state (i.e., property, payroll, and, sometimes, sales). Each state uses its own nexus rules to determine physical presence. In evaluating property, many states consider goods held in a public warehouse, goods held on consignment, leasing of tangible personal property, or the operation of mobile stores as activities that create nexus. Licensing trademarks or software could be a factor that creates nexus under an economic presence standard. Sales activities that create nexus can include activities like having a website accessible in and located on a server in the state. There are a number of factors states consider, including the occasional presence of employees for business meetings and training seminars.

Today, many states are moving toward an economic presence standard for establishing corporate net income tax nexus. Under the economic presence standard, taxpayers no longer need to have a physical presence in the state in order to be subject to a state's income tax. Deriving income from a state alone could create nexus. For example, Connecticut is one state that has recently adopted this economic nexus presence standard. Effective for tax years beginning on or after January 1, 2010, Connecticut will consider a taxpayer to have economic nexus and, thus, require a tax return to be filed if the purposeful direction of business activities in Connecticut produces receipts "attributable" to Connecticut sources of $500,000 or more. The purposeful direction is evaluated based on frequency, quantity and systematic nature of the taxpayer's economic contacts in Connecticut. Although Connecticut has not defined active solicitation for purposes of the economic presence test, other states have identified it as "purposeful" solicitation including mail, telephone, e-mail, advertising or maintenance of a website through which sales transactions occur.

Hawaii could adopt a similar standard and seek broader application of economic presence nexus. This can expand the base for corporate net income taxes and thus expand the reach of the tax structure, which conforms with the principle of broad base, low rates.

On the other hand, Public Law 86-272, a federal law that applies to all states, still provides relief from filing in many states where economic presence is established. Under Public Law 86-272, if a taxpayer's only business activity is the solicitation of sales of tangible personal property when the resulting orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state, the taxpayer is not subject to income tax. It should be noted that Public Law 86-272 does not provide protection for the performance of services or for non-income type taxes such as sales and use tax, gross receipts tax and capital tax.

| Pros | Cons |
|---|---|
| ▪ Broadens the tax base by creating nexus for additional corporate net income taxpayers | ▪ Broadened definitions are often subject to litigation and are not a dependable source of revenue until legal challenges have been settled |

## Other Revenue Sources

***Alternative 1: Approve a Lottery/Other Forms of Gaming***

Across the nation, states have approved a variety of options related to gambling. Nationally, 2.4 percent of state General Fund revenue came from gaming in 2009.[191] Of the forms of legalized gambling, a lottery is the most prominent, with 43 states authorizing one or more forms of a state lottery and total gross sales of over $56 billion in FY2010.[192] Other forms include charitable games/bingo (authorized in 47 states), Slots (39 states), Parimutuel (35 states), and Online Sports Betting (authorized in 4 states and pending in several others).

Lotteries and other forms of gaming have been advanced in recent years as an alternative to more traditional forms of state taxes. Part of their appeal is the fact that they are seen as a form of voluntary tax – individuals choose whether or not to gamble. They have generally been relatively popular with the general public and, in the case of casino forms of gaming, part of a strategy to provide entertainment opportunities within a city or state – locations like Atlantic City and Las Vegas are popular tourism destinations with gaming as a major part of their attraction.

While recent record lottery jackpots have heightened the public's interest (and participation), lotteries and other forms of gaming have their critics. Various studies have found gaming to be a regressive form of 'voluntary taxation.' Unless gaming is attractive to non-residents, it is also likely to reduce sales of other goods and services, particularly for recreation and entertainment activities. Gambling also results in negative externalities, including gambling addiction. Finally, some studies have suggested that dedicating gambling revenues to popular areas of funding (such as K-12 education) can reduce public support for other funding methods – the public perception being that gambling revenue alone should be sufficient to fund their activities.

| Pros | Cons |
|---|---|
| ▪ Is a 'voluntary tax' where individuals can choose whether or not to participate<br>▪ Broadens the revenue base<br>▪ Wide use, particularly for state lotteries<br>▪ Has generally been a growing source of revenue for the states as a whole<br>▪ A portion of the revenue is exported – and can be seen as another attraction for potential visitors | ▪ Is a regressive revenue source<br>▪ Can 'crowd out' consumption of other goods and services<br>▪ Can lead to negative externalities, including gambling addiction and crime<br>▪ When dedicated to a specific use, can lessen public willingness to support that activity with other revenues<br>▪ Is not consistent with Hawaiian culture |

[191] "Back in the Black: States Gambling Revenues Rose in 2010," Lucy Dadayan and Robert B. Ward, Rockefeller Institute of Government, June 23, 2011.

[192] "Lottery Sales Rise to Record as Cash-Hungry States Search for More Revenue," Bloomberg.com, November 24, 2011. Accessed at http://www.bloomberg.com/news/2011-11-30/lottery-sales-rise-to-records-as-states-wager-for-more-revenue.html.

***Alternative 2: Use 'Tax Gap' and Other Methods to Increase Collections of Taxes Owed to the State***

Many states have implemented sophisticated data warehouse systems that assist with identifying non-filers of tax returns and non-payers of taxes. These systems are often augmented with business intelligence software and servers. The State of New York uses data analysis to determine the most likely outliers that are flagged for audit and collection enforcement. This practice can assist states in focusing attention on data-based results yielding enhanced compliance and enforcement. Attention to performance metrics, corporate return data, and abnormalities from strong data analysis software can automate some of the labor intensive processes for staff and result in a stronger return on investment per auditor/collection FTE, without causing an undue burden on taxpayers.

In many instances, vendors are willing to negotiate performance-based solutions, where the newly generated tax revenue is used to pay for the system. As an example, the State of Iowa entered into a three year partnership with a vendor to design, develop and implement a data warehouse solution in November 1999 and realized the first revenues from the program five months later. Within four years, the program had generated over $71 million in new revenue.[193] Of course, these systems require a high level of tax processing system automation. Given the fact that the State is investigating options for new integrated systems, these Tax Gap systems may be a part of an overall approach to funding those systems.

There are other methods for improving overall tax compliance. In many instances, additional auditor positions have been demonstrated to bring in more revenue than the salary, benefit and other costs associated with the new position. In many states, these efforts are coupled with an amnesty period that kicks in before additional audit capabilities and capacity, which helps to improve overall collections. At the same time, it is important to not over-use amnesties, as it has been suggested that some taxpayers will seek to 'wait out' the State in hopes that an amnesty will allow them to reduce penalties or interest payments otherwise owed to the State. The State of Hawaii last undertook an amnesty in May-June 2009, collecting approximately $14 million in revenue.

Given the emerging importance of nexus issues across the states, this would appear to be an area where additional staff resources would prove worth the cost, even when taking into consideration additional current and long-term benefit costs.

In general, it is hard to argue against system changes that heighten overall compliance with tax law. However, there are concerns that auditors may become overly aggressive in pursuing tax law 'gray areas' and that larger staff heightens this possibility. There are also additional compliance costs associated with audits, particularly where no material change in taxes owed occurs. Finally, there is a concern that the additional staff and capital resources necessary for new systems will not actually be made up for by additional revenue generated – to the extent that there are performance clauses written into these capital investments, they can reduce this risk.

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[193] A paper describing the State of Iowa program was presented at the FTA Revenue Estimating and Tax Research Conference in September 2006. It can be accessed at http://www.taxadmin.org/fta/meet/06re_data/pres/lipsman.pdf.

| Pros | Cons |
| --- | --- |
| ▪ Focus is on collecting taxes already owed<br>▪ Increased compliance increases public confidence in the system<br>▪ Modernized systems can improve overall tax administration performance<br>▪ Performance clauses can reduce the necessary up-front capital investment for the State | ▪ Additional audit activities can increase compliance cost for some taxpayers<br>▪ Concern that it may spur over-aggressive audits to justify their existence<br>▪ Generally requires reasonably strong financial systems as a starting point, which may be an issue at present |

# Observations and Recommendations

# Observations and Recommendations

Future Lack of Revenue Sufficiency

Based on the constructed baseline from the long range financial model, the State is expected to experience structural budget deficits based on the current revenue structure and levels of service. The financial picture looks worse when liabilities for retiree pensions and health care benefits are factored into the model on an accrual basis.

This general view is supported by other recent reports and analysis both for the nation as a whole and specific to Hawaii. In the short term, the general belief, summarized by the title of a recent report, is that 'for state budgets, austerity is here to stay.'[194] The long-term trends are even more sobering. The recent report of the State Budget Crisis Task Force, led by Paul Volcker and Richard Ravitch, noted that 'there can be no doubt that the magnitude of the problem is great and extends beyond the impact of the financial crisis and the lingering recession. The ability of the states to meet their obligations to public employees, to creditors and most critically to the education and well-being of their citizens is threatened.'[195] As previously noted, the GAO model of US state and local governments also suggests a long period of decline for state and local government finances.

Specific to the State of Hawaii, Moody's May 2011 downgrade of the state from Aa1 to Aa2 warned of several financial concerns, including high debt ratios, pension funded ratios that are low relative to other states and growing OPEB expenses.[196] Moody's noted that the funding ratio for the State retirement system had registered a 'decade-long declining trend' and State contributions that had not met the actuarially required contribution had contributed to the low funded ratio.

Hawaii is not alone in grappling with these issues. A variety of respected sources have identified pension system funding challenges as a key issue that will impact the states for years to come. As the Congressional Budget Office noted in 2011, "the recent financial crisis and economic recession have left many states and localities with extraordinary budgetary difficulties for the next few years, but structural shortfalls in their pension plans pose a problem that is likely to endure for much longer."[197] Indeed, the concern for Hawaii and other governments is that while they may be able to make required payments for many years, any period of inaction may make ultimate full funding even harder to achieve.[198]

Given the extent of the funding challenges, it is unlikely that the State can 'solve' its projected budget imbalance with approaches that only focus on expenditures. The State has already cut its workforce and extracted wage and other benefit concessions from workers, limiting its opportunities to further constrain growth in this key area. Meanwhile, the pension and OPEB obligations for current retirees are inescapable and will grow throughout the period of this analysis. Coupled with expected growth in key areas like health care, the expenditure side of the state budget will pose many challenges in the years to come.

It is evident that the State understands the magnitude of the issues surrounding its OPEB obligation. During the 2012 session, the legislature enacted and the Governor signed into law Act 304, which

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[194] "For US State Budgets, Austerity is Here to Stay," Standard and Poor's, January, 2012. The report cited concerns about federal fiscal consolidation and implementation of the Affordable Care Act as areas of concern for states in the near future.

[195]Paul Volker and Richard Ravitch, chairmen. "Report of the State Budget Crisis Task Force," July 17, 2012, p. 2.

[196] "Moody's Downgrades State of Hawaii's General Obligation Rating to Aa2 from Aa1," Moody's Investors Service, May 17, 2011.

[197] "The Underfunding of State and Local Public Pension Plans," The Congressional Budget Office, Economic and Budget Issue Brief, May 2011, p.1

[198] Ibid., p. 1

authorizes the board of the EUHBTF to create a trust fund to receive employer contributions that will prefund post-employment health and other benefit costs for retirees and their beneficiaries.[199] Establishing and administering an OPEB trust is considered a best practice, and the Governmental Officers Finance Association recommends that governments prefund their obligations for postemployment benefits other than pensions once it has been determined that the employer has incurred a substantial long-term liability. An OPEB trust provides an opportunity for the State to, over time, lower the cost of providing postemployment benefits. Of course, this requires a sustained commitment to building a corpus and not simply providing the current necessary funding for this liability – and this is an appropriate use for additional revenues generated by the following recommendations.

Hawaii's revenue structure has been shown to be susceptible to economic shocks – both those associated with a deep and prolonged recession and other shocks to key industries, particularly tourism. It is also likely that the State will need to build and maintain significant reserves to withstand these inevitable future disruptions.

When weighing risks associated with the baseline projection, it should be noted that the model does not build in variations in the business cycle – it creates a trend line that factors in growth rates both below and above normal. This is the standard approach for a long-range model – there is no realistic way to build the specific timing of business cycles into a model that projects out for 12 years.

At the same time, current professional economic forecasts of the national economy tend to be more pessimistic than optimistic. For example, the 48 professional forecasters surveyed by the Federal Reserve Bank of Philadelphia, on an annual-average over annual-average basis, predict slower real output growth over the next four years. The forecasters see real GDP growing 2.2 percent in 2012, 2.1 percent in 2013, 2.7 percent in 2014, and 3.1 percent in 2015.[200] Other forecasters have increased their projection of the possibility that the national economy could slip into a recession in the near future. For example, Global Insight now predicts that while modest continued growth is the most likely short term scenario, there is a 25 percent risk of an additional recession over the period of their short-term forecast.[201]

The concern is that an additional recession will it make it more difficult to have sufficient above average growth years to meet the baseline projection. This would be particularly difficult should the national economy have a downturn similar in length and severity to the 2007 to 2009 recession. While economic forecasters are generally not predicting this sort of occurrence, most current forecasts place the likelihood of a short-term under-performance of the economy as more likely than one that out-performs the estimates.

Framework for Weighing Recommendations

There are literally hundreds of taxes in use and thousands of variations that have been considered or tried in the 50 states. The analysis – and ultimately, recommendations – focused on three key themes:

1. Adherence to the five key tax policy principles (with particular weight attached to equity and efficiency)
2. Revenue generating potential

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[199] "Pensions and Retirement Plan Enactments in 2012 State Legislatures," National Conference of State Legislatures, August 31, 2012, p. 24.

[200] "Third Quarter 2012 Survey of Professional Forecasters, Forecasters Revise Downward their Estimates for Growth," Federal Reserve Bank of Philadelphia, August 10, 2012.

[201] "The Economic Outlook," Nigel Gault, HIS Global Insight, National Association of State Budget Officers Annual Meeting, July 30, 2012.

3. Impact on overall tax administration

*Key Tax Policy Principles*
Within the five key tax policy principles, the recommendations seek to accentuate the positive features of the State's tax system and minimize or mitigate the negative. The following provides an analysis of the current system as it relates to each of these principles. Much of this analysis relates to the two key state taxes, the GET and the IIT. This is not surprising, as they make up a large majority of the State's General Fund tax revenue. As a result, they also have the lion's share of the impact on overall state tax policy.

- **Equity.** In general, equity is analyzed on a structure's effect on taxpayers of different income levels. Earlier chapters identify key concerns about vertical equity for both the GET and the IIT. As it relates to the GET, it has a comparatively broad base in terms of its application to goods and services and food – all areas that other states often ignore or exempt from taxation. This advances reliability, stability and sufficiency, but the application to food tends to make the system more regressive, impacting equity, as lower income individuals spend a greater percentage of their income on food, which is generally considered a necessity.[202] The State tax structure also taxes individual income at lower levels than many states.

  There are other state taxes, such as excise taxes, that are generally considered to be regressive. In general, these are considered to be less onerous because the items that are taxed, such as alcoholic beverages, cigarettes and tobacco, hotel rooms and rental cars, are not considered necessities. They also tend to be exported in some degree to non-residents, which reduces their impact on state taxpayers.

- **Efficiency.** As a broad-based tax, there are legitimate concerns that the GET will negatively impact on market decisions. The primary concern is that the GET will be applied to intermediate business activities, and this will lead to tax pyramiding. In particular, there is significant concern related to the 0.5 rate that is applied to many business-to-business transactions.

- **Reliability, Stability, Sufficiency.** The trade-off between tax policy principles is demonstrated by the fact that the GET is a generally reliable and stable revenue source. The broad base that raises some concerns about its equity also helps provide a relatively stable source of revenue throughout most fiscal years. The IIT, on the other hand, because of its progressive nature, is less stable, and some of its exemptions, such as pension income, reduce its overall reliability. In the long run, sufficiency is a matter for the entire structure rather than any individual tax and should be judged in that context.

- **Balanced, Broad Structure.** The State tax structure benefits from a broad based GET. As previously noted its base is the broadest among state general consumption taxes. The IIT is also an important part of the overall tax structure. At the same time, the third leg of the usual 'three legged stool' for many state tax structures, the corporate net income tax, is a minor revenue source for the State. There are many states that substitute another major tax or taxes into their mix – for example mineral extraction taxes in states like Alaska, Texas and Wyoming and gaming taxes in Nevada. In Hawaii, given its significant non-resident population, it makes sense to view excise taxes in the context of the third leg to the revenue structure stool, and taken together, they comprise a significant share of overall State General Fund revenue.

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[202] A typical method for determining purchases as a share of income is the Bureau of Labor Statistics' Consumer Expenditure Survey. The latest survey, based on 2010 data, determined that average annual income spent before taxes suggested that lower income individuals spent a declining percentage of their income on food from $10,000 income and beyond. See the latest survey at http://www.bls.gov/cex/#tables

- **Compliance, Ease of Administration.** Concerns have been expressed about the complexity of the State corporate net income tax. It is also worth investigating whether current administrative policies are sufficient to ensure reasonable tax compliance.

The Commission is rightly concerned with determining that any revenue recommendations align, to the extent possible, with accepted principles of taxation. Hawaii Revised Statute lists the principles of equity and efficiency as methods by which to study the State tax system. At the same time, this study cannot solely be an exercise in structural improvements based on tax principles. Taken to its logical extreme, a study of any tax (or tax structure) would find examples of failures on equity and efficiency grounds – and could thus conclude that the only completely equitable and efficient tax (or tax structure) would be no taxes of any kind.

Of course, that is not a realistic study or approach. While there is no perfect tax – they all have disadvantages that, in some way, will reduce economic activity - taxes are necessary to fund services that Hawaiians rely upon to maintain or improve their overall quality of life. As Justice Oliver Wendell Holmes noted, "taxes are what we pay for civilized society.''

The impetus for these recommendations is the need for the State to identify changes that can modify the tax structure in ways that will create sufficient revenue to match the expenditure needs in the coming years. While there may be genuine discussion and debate about the role that taxes should play in funding what will likely be increasing demands in the coming years, it would be hard to construct a reasonable scenario, given the State's past history and current practices, where additional tax revenue is not at least part of the solution.

Within the recommendations, their revenue generating potential is a key area for consideration. As noted throughout the report, there are key demographic and economic changes occurring throughout the nation and State. These include a population that is getting older on average and that includes a growing number of individuals of retirement age. It includes a population that is increasingly purchasing services rather than tangible goods and is doing so through electronic transactions. Finally, all of this is unfolding in a world that is growing more interconnected and mobile.

These changes were factored into recommendations to help ensure that the structure will continue to be sufficient in the future. For example, as the population ages, pension and social security income becomes a larger component of overall income. To maintain a sufficient base for IIT purposes, it is increasingly necessary to include at least some portion of that income in the base, and the recommendations reflect that reality. Likewise, the impacts of an interconnected and increasingly electronic marketplace must also be considered. While Hawaii has done a better job than most states of anticipating the rise of services in general consumption, electronic commerce continues to erode GET revenue collections – and is likely to continue to do so in the future. In this area, however, it is likely that a federal solution will be necessary to achieve sufficient vendor compliance related to collection of GET taxes from vendors without nexus in the State.

There are two other practical implications for focusing on revenue generating potential. First, the recommendations focus on taxes that can have a tangible impact on the state's structural deficit; taxes with little revenue potential are often little more than nuisance taxes that create unnecessary compliance burdens for taxpayers and collectors alike. Second, the recommendations are focused on revenue modifications that are in use in Hawaii or around the nation. This concept, sometimes expressed as 'an old tax is a good tax' is based on the premise that these taxes are generally understood by the market, can be complied with, and their revenue generating potential more accurately modeled.

This focus helps ensure that the discussion and analysis throughout the report and in this section have practical – rather than simply theoretical – value. While it is no doubt important to seek ways to improve

system performance, evolutionary (as opposed to revolutionary) changes are more likely to be considered (and perhaps adopted) than changes that create significant uncertainty in implementation and use.

As an example, the concept of a value-added tax (VAT) is often raised in state revenue studies. A VAT differs from the GET (or sales taxes) in that it taxes only the value that is added by a business to the goods and services it sells, not the gross value. As a result, the VAT avoids the pyramiding that can occur in the GET and traditional sales taxes. The VAT is certainly not just a theoretical approach to taxation – it is widely used throughout the world. Today, it is a key source of revenue in at least 125 countries. The International Monetary Fund (IMF) estimates that about 4 billion people-70 percent of the world's population-live in counties with a VAT.[203] However, the United States is one of the few major countries in the world that has not adopted a VAT. Regardless of the advantages of this form of tax in comparison to GET or sales taxes, the absence of use in other states would pose numerous difficulties and concerns – both as to how to implement the new tax, how to undertake a (likely significant) educational campaign to ensure understanding and compliance and how to transition existing hardware and software programs. It would also make it difficult to model the resulting levels of tax revenue for the State. Given these major concerns, the report does not consider establishing a VAT in the following discussion and analysis.

As previously noted, tax administration and compliance is a valid concern; where possible, recommendations are weighed more favorably that reduce the burden on taxpayers and administrators. Overall, a key goal is to improve system operation and transparency. To that end, some of the recommendations do not make changes to the tax code but touch on ways to improve other aspects of the tax system related to reporting, administration and analysis.

Methods to Expand the Tax Base

Expanding the base upon which taxes are applied helps to keep actual tax rates lower. This is important, because low rates generally have less impact on consumer choices and market efficiency. In some situations, base broadening may also support greater horizontal and vertical equity. The following tax changes are recommended and built into the model's 'reformed tax structure scenario.'

- **Reduce the Pension Exemption in the IIT**
  As discussed in the previous chapter, tax treatment of pension income varies widely among the states. It ranges from states that fully exempt to those that fully tax all pension income – with a wide variety of methods between these polar opposites.

  As a starting point, Hawaii breaks with the federal definition of taxable income as it relates to both pension and social security income. The federal government taxes all or a portion of pension or annuity payments from a qualified employer retirement plan.[204] While the State may tax some portion of the payments from a qualified private employer retirement plan, it does not tax pension benefits from public pension systems, including all federal, state/local or out-of-state government pensions.[205] According to a paper presented to the Commission earlier this year, the value of pension exemptions is approximately $156 million for tax year 2009.[206]

  Given the aging of the Hawaii population, it is reasonable to assume that the value of this exemption will grow in coming years. At the same time that the exemption for this income grows, the State's obligations to fund the benefits of its employee retirement system will also grow –

[203] Alan Tait, Robert Ebel and Tuan Minh Le, "Value-added tax," The Encyclopedia of Taxation and Tax Policy, 2005.

[204] See IRS Tax Topics, Topic 410, Pensions and Annuities, at http://www.irs.gov/taxtopics/tc410.html

[205] A listing of all state treatment of taxation of pension income is included in the Appendices.

[206] Donald Rousslang, "Tax Expenditures in Hawaii," Draft, February 14, 2012, Table 2.

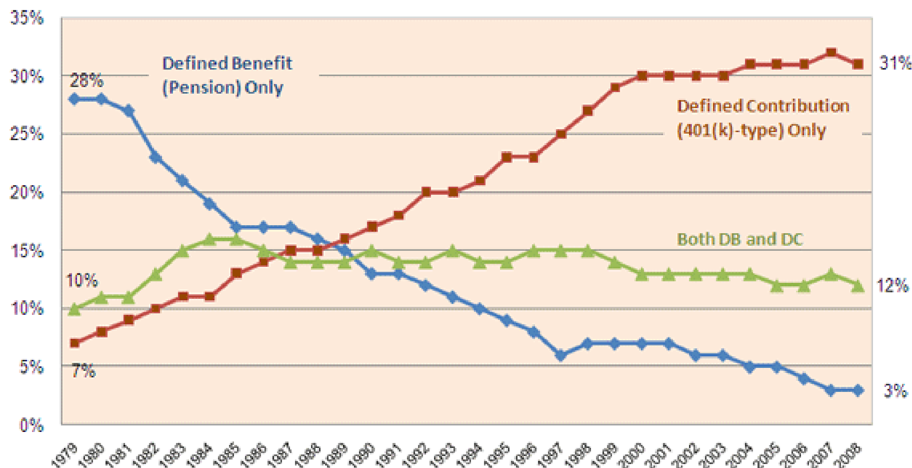
which will increase expenditures at the same time that exempted pension benefits will erode the IIT base.

A common argument against taxing this income is that pension and other benefits are a way to compensate public sector employees for lower wages during their wage earning years. The theory is that public sector employees have accepted lower wages as a sort of trade off for better retirement and other benefits. There are at least three strong responses to this claim.

First, it is far from a settled question that public sector wages are inferior to the private sector. In fact, on average, public sector employment pays wages well above the State median. As was discussed in the Introduction, average earnings in the public sector in Hawaii rank third among all sectors, trailing just Business Services and Utilities. As a sector, Government outperforms what are often considered to be well paying sectors, including Construction, Professional Services and Health Services. Besides wages, public sector employees are generally considered to have other benefits (including paid vacation and sick leave and retiree health care) that are better than their private sector counterparts.

Second, the value of the State's defined retirement benefit is likely to grow in comparison to private sector plans now and into the future. Across the country, private sector businesses are abandoning defined benefit pension plans in favor of defined contribution plans, and the percentage of workers covered by defined benefit pension plans has been declining for over 25 years. From 1980 to 2008, the percentage of private sector workers covered by a defined benefit program was nearly cut in half – from 38 percent to 20 percent. In the same time period, the percentage of workers covered by defined contribution-only pension plans increased from 8 percent to 31 percent. [207] The following graphs this remarkable change in public and private sector retirement plans:

**Private Sector Workers Participating in Employment-Based Retirement Plan, by Plan Type 1979 – 2008** *(Among all workers)*




*Source: US Department of Labor Form 6600 Summaries for 1979-1998; PBGC, Current Population Survey Data for 1999-2008; Employee Benefit Research Institute estimates for 1999-2008.*

[207] Barbara Butrica, Howard Iams, Karen Smith and Eric Toder, "The Disappearing Defined Benefit Pension and its Potential Impact on the Retirement Incomes of Baby Boomers," Social Security Bulletin, Volume 69, No. 3, 2009, p. 1.

Clearly, the decline in defined benefit plans relates to their cost. While public sector commitments to their defined benefit plans are often protected by constitutional and statutory requirements, there have generally been options available to private sector businesses to get out of their defined benefit programs and switch to a defined contribution plan – options that may not be available in the public sector.

Finally, while a strong case can be made for not reducing retiree benefits as part of a compact made with its employees, applying that to taxation of the benefits is a much more tenuous connection. Simply put, tax systems are modified by state legislatures all the time. This should be understood by all who pay taxes – and particularly those who are familiar with the role the Commission plays in Hawaii's tax policy discussions. The Commission exists to examine how the tax structure performs and how it relates to key tax principles, such as equity and efficiency. It makes no logical sense to argue that tax policy decisions made by legislatures from 30 or 40 years ago must remain binding on the current (or future) General Assemblies.

As a result, any assumed 'promise' that the State would never tax public pension income was illusory – there is no ability of a state official or legislator to make that promise – just as no federal official or member of Congress could make that promise to federal workers residing in Hawaii. In short, the changing nature of income and population composition in the State now suggests a different approach to the taxation of pension income.

Besides, taxing public pension income conforms with key tax principles. At its core, pension income is no different than other forms of taxable income – a retiree with a $25,000 annual pension is not all that different that an individual a year or two away from retirement with a $25,000 taxable salary. In this case, similar treatment of that income conforms with the concept of horizontal equity.

At the same time, a case can be made that the income generating potential of retirees is more limited than others pre-retirement age. To adjust for this, the study recommends that a portion of all pension income be exempt from the IIT – the current alternative revenue scenario sets that level at $25,000. It should be noted that a $25,000 pension exemption would be well within the mainstream of states that tax pension income.

- **Eliminate the Deduction for Property Taxes Paid**
  Under the US tax code, any state, local, or foreign taxes on real property levied for the general public welfare are deductible. Most states that use federal adjusted gross income as the starting point for state IIT purposes conform with federal law. However, there are states that do not. Among these states are Minnesota, Nebraska, Wisconsin and, to a limited extent, New Jersey.

  Hawaii is unique among the states in its full state support for K-12 education, which in most states is a shared state-local responsibility, with the local funding primarily supported by property taxes. Given that K-12 funding is on average the largest expenditure category for local governments in the US, the State is making an extraordinary funding commitment to local schools.

  There are very logical public policy arguments in favor of this funding approach. Many state school finance formulas have been the subject of legal challenges, usually based on equal protection grounds. These lawsuits (which have been successful in several states, including Missouri, Ohio and Texas) generally argue that systems that rely on local school funding based on property tax revenue treat students unfairly, as 'property rich' school districts can more readily obtain the funding necessary to fund local schools. The Hawaii system takes the local property tax base out of the equation and funds all schools from a statewide funding source, the General Fund.

While the public policy case for this funding method is sound, the State is, in essence, replacing funding that would otherwise be raised by property taxes. Property taxes are somewhat unique among taxes, as a local property tax levy is generally determined by calculating the revenue that must be raised to support local services and determining the property tax levy based on the taxable value of the property subject to tax in that local jurisdiction. In that respect, it varies from income or consumption-based taxes that are set prior to determining the income or consumption subject to tax.

In Hawaii, because the General Fund supports local K-12 school budgets, education expenditures do not have to be calculated when determining property tax rates. In essence, those who pay taxes that go into the General Fund are subsidizing property taxpayers by this funding approach. It can be argued that this is an equity issue, as property owners are receiving a benefit that they would not receive in any other state.

The project team recommends that the State eliminate this deduction. By any measure of property tax rates, those in Hawaii are the lowest or among the lowest for every class of property. Further, other recommended state tax changes (such as raising the IIT standard deduction for lower income Hawaiian tax filers will mitigate any impact from loss of this deduction.

- **Cap or Replace with Grant Programs Certain Tax Credits**

  Hawaii has made extensive use of both IIT and corporate net income tax credits, including current credits for Renewable Energy Technologies and Motion Picture, Digital Media and Film Production. While now expired, the High-Technology Business Investment and Research Activities tax credit has been a particularly high profile State effort to attract and incent qualified businesses.

  Established in 1999,[208] the High-Technology Business Investment and Research Activities tax credit was originally equivalent to 10 percent of the investment in each qualified high technology business, with a maximum credit of $500,000 for each tax year. The Act was subsequently modified on multiple occasions, first to seek to make it more effective and later to make it more transparent and accountable.[209]

  According to the Hawaii Office of the Auditor, the High-Technology Business Investment and Research Activities tax credit has resulted in claims by eligible businesses of $857.6 million from 1999 through 2010. Research activities tax credit claims have totaled an additional $112.5 million, for total claims of $970.1 million.

  By any measure, an investment of nearly $1 billion in tax credits over an eleven year period is a significant public policy choice. While this may very well be an enlightened investment that is and will pay dividends for the State now and in the years to come, it is difficult, given the information available, to make this determination. This, of course, is the crux of the debate as it relates to broad-based tax expenditures.

  Policy makers nationwide have committed billions of dollars annually on tax incentives for economic development, and every state has at least one tax incentive program – with most

[208] The tax credit was created in Act 178, Session Laws of Hawaii, 1999, as part of a larger legislative package aimed at developing Hawaii business and industry in the high technology sector.

[209] A discussion of the history and activities associated with the tax credit can be found in a recent audit released by the Hawaii Office of the Auditor. See "Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits," Report No. 12-05, July 2012.

having several.[210] Their widespread use suggests that policymakers believe the investments are worthwhile and advance public policy, particularly related to economic development.

It is beyond the scope of this study to provide an in-depth review of state efforts related to tax credits, but a cursory review of the literature suggests that many states have refined their efforts to better target tax incentives (and other forms of development-related incentives). Among the strategies used are to make incentives dependent upon performance, monitor incentives, evaluate the effectiveness of existing incentives, improve the disclosure of economic incentive terms and packages and build claw-back mechanisms into incentive programs when recipient businesses do not meet performance targets.[211] A particular area of concern for Hawaii and all states is their ability to evaluate state tax incentives for jobs and growth. According to a recent review, there are four key criteria for state evaluation. These relate to the degree to which a state uses data and information related to its development programs to:[212]

1. Inform policy choices
2. Include all major tax incentives
3. Measure economic impact
4. Draw clear conclusions

According to this review, 13 states are 'leading the way' by meeting criteria for scope and quality of evaluation of these criteria, 12 states meet only one of the criteria, and 26 states do not meet any of the criteria for scope or quality of evaluation. Hawaii was ranked as a state that did not meet any of the criteria for scope or quality of evaluation.[213]

Given current issues around overall tax credit reporting, it makes sense for the State to identify other alternatives to limit the extent of the use of tax credits. As was noted in the Auditor's review of the High-Technology Business Investment and Research Activities tax credit, a number of states that provide similar tax credits cap those credits or otherwise limit the state's financial impact. These include the States of Arkansas, Colorado, Illinois, Indiana, New Mexico and Wisconsin. The limits range from less than $1 million a year to $20 million a year.[214]

Currently, these and other tax credits are not capped, which can make it difficult to maintain revenue stability and sufficiency over time. The project team recommends that, in the short term, the State either cap or eliminate broad-based credits and replace them with grant, loan and/or forgivable loan programs.

As opposed to tax credits, which are generally administered by revenue or tax departments, grant, loan or forgivable loan programs can be administered by departments responsible for economic development activities. These departments are more likely to have the experience and expertise to evaluate and manage this type of program. These can be more readily directed at specific types of projects and activities and controlled through the application and approval process.

At the same time, the Legislature should establish criteria that ensure that state funding supports specific public policy outcomes. Examples of these in use elsewhere include Job creation

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[210] "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth, Pew Center on the States, April 2012.

[211] Judy Zelio, "Taking the Measure of State Economic Development, The National Conference of State Legislatures, 2009.

[212] Op Cit., p. 3.

[213] Op Cit, p. 2.

[214] Op cit., p. 15.

refundable credits, which award the credit based on net new jobs created. These can be calculated after income taxes have been withheld by the companies from the new employees, which is generally an improvement on providing a tax credit without regard for whether jobs are actually created. A number of states provide a form of high wages/benefits jobs tax credit to target those types of jobs.

The project team recommends that, in the short run, the State cap development-related credits at a dollar amount that is deemed an acceptable and appropriate use of state tax expenditures. Over the long run, the State may wish to transition to appropriations administered by the Department of Business, Economic Development and Tourism.

Methods to Reduce Regressivity in Certain Taxes

Multiple sources have identified Hawaii's tax structure as regressive – a key equity concern. In particular, the broad reach of the GET is an area of concern. While the GET is a cornerstone of the current (and envisioned) tax structure, there are opportunities to reduce some of its regressive features, particularly by changes to the IIT. The following would address regressive aspects of the two largest sources of General Fund revenue.

- **Increase the Standard Deduction for IIT to $7,500 for single filers, $15,000 for married and $10,950 for head of household filers**
  The State's IIT brackets begin at 1.4 percent on the first $2,400 of taxable income but rise to 7.2 percent at taxable income of 19,201. This is a relatively rapid rise compared to other states. For low income IIT filers (who do not typically itemize deductions), the standard deduction can be used to offset tax liability – while higher income filers will typically itemize anyway. These changes would move the State's current standard deduction, which is in the lower range of all states, to among the leaders among all states, about equal with New York and trailing Connecticut and Wisconsin.[215]

  This would address several policy issues. First, it helps address issues of vertical equity. Second, it ameliorates any concerns that eliminating the deduction for property taxes will negatively impact lower income individuals. Finally, it is one method for addressing concerns about the regressive nature of the GET.

- **Double the refundable Food/Excise Tax IIT credit**
  As has been noted on multiple occasions, the application of the GET to food has both positive and negative impacts. On the positive side, it helps to broaden the tax base and makes it more reliable during economic downturns. On the negative side, it makes the tax structure more regressive, as lower income cohorts generally spend a greater share of their income on food than higher income cohorts.

  Hawaii currently provides a refundable IIT credit based on income, ranging from $25 per qualified exemption for those with AGI of $40,000 to $50,000 to $85 for those with AGI under $5,000. The following is the current credit at various income levels:

[215] "Individual Income Tax Provisions in the States," Wisconsin Legislative Fiscal Bureau, January 2011, p. 10.

| Adjusted Gross Income | Tax Credit Per Qualified Exemption |
|---|---|
| Under $5,000 | $85 |
| $5,000 under $10,000 | $75 |
| $10,000 under $15,000 | $65 |
| $15,000 under $20,000 | $55 |
| $20,000 under $30,000 | $45 |
| $30,000 under $40,000 | $35 |
| $40,000 under $50,000 | $25 |
| $50,000 and over | $0 |

As an example, a qualified family of four with an AGI of $20,000 would currently receive an IIT credit of $180. It is notable that, using income shares for similar families around the country, a family with income before taxes of $25,000 would spend approximately 13.7 percent of their income on food. This would equate to approximately $3,425 – and the 4.0 percent GET would total $137.[216]

Were the GET to be increased to 4.5 percent, as the study recommendations suggest, the total GET devoted to food for the family of $25,000 would be $154. Of course, there are other expenditures subject to the GET that impact lower income individuals to a greater extent than higher income taxpayers. However, the combination of the higher tax credit and IIC exempted income should help reduce the impact of any recommended GET rate increase.

Methods to Reduce Pyramiding in Certain Taxes

Economists are nearly uniform in their belief that pyramiding distorts market decisions and reduces overall efficiency. As an example, pyramiding causes businesses to make decisions on how to operate that they might not otherwise make. It can also distort prices paid by certain goods and services and interfere with efficient market decisions.[217] A study for a previous Commission explained that 'the GET is intended as a tax on consumption, but businesses do not consume, they produce.'[218] As a result, taxes applied do not fit within the framework of a tax on consumption.

Because the GET applies a 0.5 percent rate to wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale, pyramiding occurs. This can negatively impact on business decisions about where to locate operations and how to purchase goods and services that are a part of the overall process that leads to a finished product or service. The following adjustments would reduce pyramiding and seek to benefit Hawaii businesses negatively impacted. At the same time, the study recommendations would replace some of the lost income with other business-related taxes.

- **Eliminate the 0.5 percent GET and Use Tax rate**
  As already noted, application of a 0.5 percent rate to many the business-to-business transactions has negative impacts on market efficiency and specific types of State businesses. This is a concern for both horizontal equity and market efficiency principles.

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[216] Bureau of Labor Statistics, Consumer Expenditure Survey, Table 46, Income before taxes: Shares of average annual expenditures and sources of income, 2010. Accessed at http://www.bls.gov/cex/2010/share/income.pdf

[217] Donald Rousslang, "Tax Expenditures in Hawaii, Draft" February 14, 2012, p. 3.

[218] William Fox, "Hawaii's General Excise Tax: Should the Base be Changed?" Hawaii Tax Review Commission, October 4, 2006, p.8-9. For another scholarly discussion of tax pyramiding in a state tax structure see Annette Nellan, "Sales and Use Tax Weakness and Possible Remedies: The Pyramiding Nature of the Tax," 2007, accessed at http://www.cob.sjsu.edu/nellen_a/TaxReform/Report2cSUTPyramiding.pdf

The market efficiency concerns have already been discussed at length. There are also issues related to horizontal equity. Any tax based on gross receipts is going to raise issues related to what is the appropriate base for a tax. Differing types of businesses are going to generate different percentages of profit from their sales. There is a legitimate concern that a tax based on gross receipts will penalize firms that operate on a high volume, low profit margin business plan.

While the revenue associated with this tax is significant, it comes, as explained above, at a cost for Hawaii businesses. Given the significant efficiency and horizontal equity concerns, the recommendation is to eliminate this tax and seek to replace a portion of it with other business taxes.

- **Allow the Act 105 temporary increases to sunset**
  The tax code exempts many business-to-business transactions from the GET. Because of budget concerns, these were temporarily suspended in 2011.

  As noted in the analysis in this chapter, business-to-business taxes are generally to be avoided, as they distort efficient market decisions. That said, this report also acknowledges that there are instances where tax policy will have to take a back seat to the requirement that the state balance its annual budget.

  At the same time, this report is focused on longer-term revenue and budget strategies. Given the fact that there are better options to balance the State budget via changes to the tax structure, the GET suspensions should be allowed to sunset as scheduled. Restoring these exemptions will help reduce pyramiding and contribute to a more efficient tax structure.

- **Increase Corporate Net Income Tax revenue**
  The State currently has a three-tiered corporate net income tax structure, with rates of 4.4, 5.4 and 6.4 percent, based on net income. This can be an equity issue, as corporate net income is not necessarily equated with ability to pay.

  Currently, the majority of states use a single corporate income tax rate (29 states). Of the remaining states with a corporate income tax, 12 use varying brackets.

  The project team recommends that the State should set a single rate in the range of 9 percent. Raising additional revenue from a single tiered corporate net income tax and eliminating the GET 0.5 percent rate would better align with equity and efficiency principles.

Methods to Export a Share of the Tax Burden to Non-residents

Given its destination location and home to thousands of federal civilian and military personnel, the State has an opportunity to export a significant portion of its tax burden. The following recommendations address this approach.

- **Increase cigarette and tobacco tax rates**
  The State's cigarette tax is already among the highest rates in the country. According to the FTA, Hawaii's rate, at $3.20 per pack, is the fourth highest among the 50 states. Hawaii has a history of raising this tax on a regular basis, and the basis for doing so is understandable.

  First, Hawaii's island location makes it relatively immune from issues of cross-border competition – those who wish to smoke cigarettes in the State have fewer options than in other states for obtaining lower priced cigarettes. Second, there is a logical basis for increased tax rates for cigarettes. While the tax rate is high, the calculations of the negative societal impacts from

cigarette smoking suggest that tax increases are justified. According to the Center for Disease Control (CDC), the health and other societal costs associated with consumption of a pack of cigarettes sold in Hawaii is $10.81, while state and federal taxes per pack total $4.21. Finally, raising the tax has the added benefit of generally reducing smoking for key target populations, such as children. The CDC argues that increasing the price of cigarettes reduces demand and reduces cigarette use in the United States overall, particularly among youths and young adults.[219]

It has generally been concluded that the cigarette tax is a regressive tax. At the same time, research suggests that higher taxes also encourage lower income individuals to stop smoking – which has a large health and economic benefit in the long run. In general, increases in this and other excise taxes also help to maintain a sufficiently broad tax base that also exports a share of that burden to non-residents.

- **Increase gallonage taxes on beer, wine and distilled spirits**
  Current taxes for beer, wine and distilled spirits are generally among the higher state taxes in the nation. The current tax on beer, $0.93 a gallon, is the second highest among the states, trailing only Alaska and well above the median rate of $0.19. The tax on distilled spirits, $5.98 a gallon, is sixth highest among the 31 states that impose a gallonage tax – and well above the median of $3.75 a gallon. Finally, the tax on wine, $1.38 a gallon, is the ninth highest of the 45 states that impose a gallonage tax – again, well above the median of $0.67 a gallon.[220]

  While these tax rates are comparatively high, similar arguments can be made for a moderate increase in these taxes as for the cigarette and tobacco tax: there are health and other positive externalities associated with reduced consumption, and there is little real risk of cross border competition. In this respect, it is notable that the one state that has a higher excise tax on all three categories (beer, wine and distilled spirits) is Alaska – the other U.S. state with little concern for cross border competition.

  During discussions with the Department of Taxation, their regression analysis suggests a connection between performance of the leisure and hospitality industry and General Fund revenue performance from these excise taxes; this suggests that a significant portion of the tax is exported.

  Among other tax principles, while it is often argued that these excise taxes are generally regressive, the BLS purchasing shares data does not support this. According to that data, alcohol purchases for all consumers totaled 0.9 percent of income; at the lower income levels the share of income devoted to alcohol purchases was actually lower (between 0.6 and 0.7 percent at income levels between $5,000 and $29,999), while levels above $30,000 were generally in the range of 0.8 to 0.9 percent.

  The recommendation built into the models alternate revenue structure scenario would increase each of these taxes by approximately 15 percent.

- **Eliminate the sunset on the TAT rate increase**
  Legislation enacted in 2009 temporarily increased the TAT. The legislation added an additional 1.0 percent to the rate from July 1, 2009 through June 30, 2010, and an additional 2.0 percent from July 1, 2010 through June 30, 2015. As a result of these changes, the TAT rate is now 9.25

[219] "State Cigarette Excise Taxes – United States 2010-2011," Centers for Disease Control and Prevention, Morbidity and Mortality Weekly Report, Vol. 61, No. 12, March 30, 2012.

[220] Federation of Tax Administrators, accessed electronically at http://www.taxadmin.org/fta/rate/tax_stru.html.

percent through the end of FY2015. Temporary increases in the TAT are scheduled to sunset on June 30, 2015.

As noted in the discussion of benchmark cities, the current TAT rate places Honolulu in the middle of other popular U.S. destination cities. At the same time, cities with TAT rates in excess of the State rate are generally cities with a significant portion of business travelers, and it can be argued that these travelers are relatively indifferent to the tax rate. On the other hand, leisure travelers or event planners may be more willing to factor this tax rate into calculations of overall costs when choosing a destination.

At the same time, the State is currently charging this higher rate, and the tourism industry is having a strong year – if the tax is having a negative impact on overall travel, it is not readily discernible. Given the experience with the current tax rate, eliminating the sunset will reduce base erosion and continue to export a significant amount of the tax burden.

- **Restore the surcharge on rental cars**
  As with the TAT, the State has raised this tax in the past to assist in closing budget gaps. In 2011, the State increased the rental motor vehicle surcharge tax from $3.00 per day to $7.50 per day from July 1, 2011 to June 30, 2012. The Legislation deposited a portion of the surcharge ($4.50 per day) in the State's General Fund and suspended the rental motor vehicle customer facility charges for the period of July 1, 2011 to June 30, 2012.

  The temporary $7.50 per day surcharge expired on June 30, 2012 and reverted to the $3.00 per day surcharge. The FY 2012 additional surcharge provided a one-year revenue increase of approximately $61 million to the State's General Fund.

  As with the TAT, it is evident that a considerable portion of this excise tax is exported. Restoring the tax to previous levels will also broaden the excise tax base. As with the TAT, there is also a case to be made that the State (and consumers) have experience with the tax – in line with the concept that 'an old tax is a good tax.'

Rate Change to Restore Structural Balance

With two key revenue sources and no logical major alternatives, the State is primarily reliant on the GET and IIT. Of the two, the IIT already has a rate structure that includes the highest top marginal rate among all states. By contrast, the GET rate has remained constant at 4.0 percent since the 1960s.

- **Increase the GET rate to 4.5 percent**
  While it is accepted that maintaining low rates is a good overall tax policy, the GET has not been raised since 1965. While accepting the fact that the GET is a business privilege tax with a very broad base, other states have broadened their base to also tax services, which is a key aspect of the Hawaii GET base. While the GET is a business privilege tax (as opposed to a sales tax), 13 states levy their general consumption tax as a vendor levy.

  A key consideration for broad based tax rates is their impact on efficiency. Regardless of the broadness of the GET base, the rate is low compared to other states' general taxes on consumption. Among all states, only Colorado has a lower general rate (2.9 percent) than Hawaii's 4.0 percent rate (Alabama, Georgia, Louisiana, New York, South Dakota and Wyoming also have a 4.0 percent rate). According to a recent study done for the Commission, the median state rate is 6.0 percent, and 35 states have local sales taxes as well.[221] Local sales taxes are

[221] William Fox, "Selected Issues with the Hawaii General Excise Tax," July 22, 2012, p. 3.

significant in most states; one study found that when average local sales taxes are combined with the state sales tax rate, Hawaii had the lowest combined rate of any state with a broad-based consumption tax (usually a sales tax). By contrast, Colorado's combined rate is 7.44 percent, while the states with a 4.0 state rate have combined rates between 5.34 and 8.85 percent.[222]

While Hawaii has not raised its rate in over 35 years, over half of the states have raised their sales tax rate since 2000 – in many cases multiple times. In many cases, these rate increases were for precisely the reason facing the State in the years to come – a need to restore structural balance.

The recommendation, to increase the GET to 4.5 percent, would still leave the State with the lowest combined state and local rate among the states, at 4.85 percent. Given that the recommendations also include eliminating the 0.5 percent rate, the effective rate of the tax should be less than 4.85 percent.[223] Given the need to restore structural balance, an incremental increase in the GET rate is the logical method to improve the long-term financial outlook.

It is true that the GET raises a substantial amount of revenue at a relatively low rate – and this is largely because of its extremely broad base. The inclusion of items often classified as necessities (food, utilities) in the tax base raises concerns about regressivity of the tax. However, other recommended changes (such as the increase in the refundable food/excise IIT credit and the exclusion of a significant portion of taxable income from the IIT) would reduce some of that impact.

Clearly, this is not a recommendation to be taken lightly – it is a significant increase in the overall tax burden for Hawaii residents. However, in relationship to other states, this action keeps Hawaii's primary consumption tax in the low range nationally while affording the State its best opportunity to restore structural budget balance.

Changes to Improve System Administration

In the long run, improved technology, processes and reporting can help increase compliance and advance data-driven policy outcomes. The following can assist in advancing those efforts.

- **Develop tax gap systems to identify under-payment and non-payment of taxes**
  Many states have implemented sophisticated data warehouse systems that assist with identifying non-filers of tax returns and non-payers of taxes. These systems are often augmented with business intelligence software and servers. In many instances, vendors are willing to negotiate performance-based solutions, where the newly generated tax revenue is used to pay for the system. As an example, the State of Iowa entered into a three year partnership with a vendor to design, develop and implement a data warehouse solution in November 1999 and realized the first revenues from the program five months later. Within four years, the program had generated over $71 million in new revenue.[224] This effort can be built into current plans to improve the overall financial management systems for the State.

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[222] "State and Local Sales Tax Rates as of January 1, 2012," The Tax Foundation, February 16, 2012 accessed electronically at http://taxfoundation.org/article/state-and-local-sales-tax-rates-january-1-2012.

[223] One study suggested that the effective GET rate on goods and services purchased by Hawaii residents was an estimated 5.3 cents per dollar of final sales. Richard Bowen and PingSun Leung, "Tax Pyramiding and Tax Exporting in Hawaii: An Input-Output Analysis," University of Hawaii Research Extension Service, Series 102, January 1989, p.6.

[224] A paper describing the State of Iowa program was presented at the FTA Revenue Estimating and Tax Research Conference in September 2006. It can be accessed at http://www.taxadmin.org/fta/meet/06re_data/pres/lipsman.pdf.

In general, these approaches align with tax policy best practices – they seek to collect taxes that are rightly due to the State. Taxpayers who make the effort to pay the taxes they are lawfully required to pay should be supportive of these efforts. This can also build confidence in the system and, as compliance increases, heighten the awareness of non-compliant taxpayers that the State is likely to find them and seek payment and penalties.

- **Create a compliance and productivity account to fund staff and technology improvements to foster taxpayer education, understanding and compliance**
  In many states, a specific funding stream is established to enhance staff and technology related to education and compliance efforts. The State should capitalize a fund that the Department of Taxation could access for staff and technology upgrades with an expected ROI. These investments would then require a method for tracking performance, with payback to the fund from a portion of the additional revenue received from the initiatives.

  As an example, the State of Pennsylvania has a dedicated fund (the Enhanced Revenue Collection Account, or ERCA) that is used to augment its tax audit and enforcement efforts. According to their Department of Revenue, ERCA funding of $3.9 million in FY 2011 provided a 2,100 percent return on investment and exceeded revenue generation goals by $35.2 million. The Department of Revenue's current budget proposal expands and extends ERCA funding to $10 million each year through FY 2016-17 and is estimated to generate $100 million in additional tax revenue for fiscal year 2012-13.

- **Provide tax expenditure reports on a scheduled regular basis**
  In previous years, the Department of Taxation published tax expenditure reports and other information related to tax collections and taxpayer characteristics. While these were eliminated because of budget issues, they should be restored. The need for transparent data on key tax issues is critical for informed decision making. In many cases, analysis of actual performance of tax law changes – and how they relate to key tax principles – requires the data and analysis that takes place in a tax expenditure report.

  Nearly every state now publishes a tax expenditure report on a (generally) regular basis. From review of State reports, at least that 41 states have issued tax expenditure reports (in some cases on an annual or biennial basis) since Hawaii last issued a tax expenditure report.

- **Eliminate net operating loss carry-back**
  Hawaii is one of 19 states that allow net operating losses to be 'carried back' so that businesses can file amended returns and use current losses to offset profits and receive refunds of taxes paid in prior years. While most every state allows a business to carry current year losses forward to be used in future years to offset profits, a majority of states still allow losses to be carried back.

  The project team recommends that the State maintain the ability for corporations to carry losses forward but eliminate the ability to carry losses back. While this will have no material impact on overall tax collections over time, it will provide some greater stability during economic downturns by helping to curtail business tax refunds based on amended returns from prior years.

Alternatives Not Recommended

Many of the alternatives discussed in the prior chapter are not included in the recommendations. There are a variety of reasons for their lack of recommendation. (Policymakers may differ with the analysis, and for that reason the revenue estimates have been built into the model should policymakers wish to consider them.) The following provides a brief explanation for each of the alternatives discussed in the previous chapter:

- **GET exemptions for non-profits.** States and local governments are increasingly re-examining the tax treatment of non-profit corporations. As a recent report to the Commission notes, the exemption is a form of subsidy for these organizations that could be provided via direct payments rather than the indirect method through the tax exemption.[225] In fact, this perspective aligns with the recommendation to cap or curtail economic development tax incentives and replace them with direct grant, loan or forgivable loan programs. The report also notes that many non-profit organizations compete with for-profit firms, which creates horizontal equity issues.

  The potential revenue gain from removing the exemption is significant – projected to be $254.1 million. It is also a fast growing segment – the estimate of potential revenue has grown at a compound annual growth rate of 7.1 percent since a similar estimate from 2006.[226]

  This is certainly a viable revenue option, and there is a rationale based on tax policy as well. Besides the previously mentioned issue of horizontal equity related to the exemption, applying the GET would significantly broaden the base - and likely continue to do so in the future.

  In the end, the project team believed that the GET rate increase was more of a known outcome and thus preferable. The unknown related to how the new tax application might impact smaller non-profit service providers was deemed to be an important factor, but some policymakers may choose to analyze this option as a replacement for other tax changes.

- **GET Nexus.** While some states are aggressively pursuing nexus for consumption tax collection purposes, the possible additional revenue from pursuing these strategies is hard to estimate. Given a variety of opportunities to address administrative and compliance issues – and the possibility that federal action could make these efforts moot – the project team believes the State can better target its limited resources in other areas.

- **Eliminate or reduce the IIT deduction for Social Security benefits.** While the states are evenly split on taxing pension income, there is less division relating to social security income, with a majority of the states deducting this for IIT purposes. While there are eight states that have adopted the federal standard that taxes up to 85 percent of social security income, the project team believes that a reasonable approach is to maintain the deduction for social security as the bedrock safety net for older Hawaiians while taxing a portion of pension income.

- **Prepared Food Tax.** In general, the strategy around changes in excise tax rates was to raise those where there is a strong case that a large percentage of the tax is exported or there are positive externalities associated with higher taxes (as higher tax rates will generally lead to some reduction in consumption). In the case of a prepared food tax, there was less compelling evidence that the tax would be largely exported. It would also be a new tax that would add some additional complexity to the tax system.

- **Amusement or Recreation Tax.** As with the previous example, it was difficult to determine to what extent the tax would be exported and would be a new tax that would add some additional complexity to the tax system. Depending on how amusement or recreation activities were defined, there would also be the possibility of substitution and, as a result, horizontal equity concerns.

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[225] William Fox, "Selected Issues with the Hawaii General Excise Tax," Report Prepared for the 2010-2012 Hawaii Tax Review Commission, July 22, 2012, p. 18.

[226] Ibid. p. 18.

- **Motor Fuel Tax.** It is likely that a majority of the tax increase would be borne by residents. The tax is also a non-General Fund revenue source that would not assist in addressing the coming structural budget gaps.

- **Snack Food/Soda Tax.** It is likely that a majority of the tax increase would be borne by residents. There is also significant disagreement as to whether these taxes reduce consumption or improve health. Finally, this would be a new tax, and definitions of what constitutes a 'snack food' have been difficult to establish in other states.

- **Conveyance Tax.** It is likely that a majority of the tax increase would be borne by residents. Further, this is a relatively small revenue source that would not have a material impact on the State budget situation.

- **Insurance Premium Tax.** This tax is almost entirely borne by residents.

- **Cell Phone Service Tax.** This tax is almost entirely borne by residents.

- **Single apportionment factor for Corporate Net Income Tax.** While some states have shifted to a single factor as a way to attract business and industry (particularly in the manufacturing sector), the project team preferred removing 0.5 percent from the GET rate.

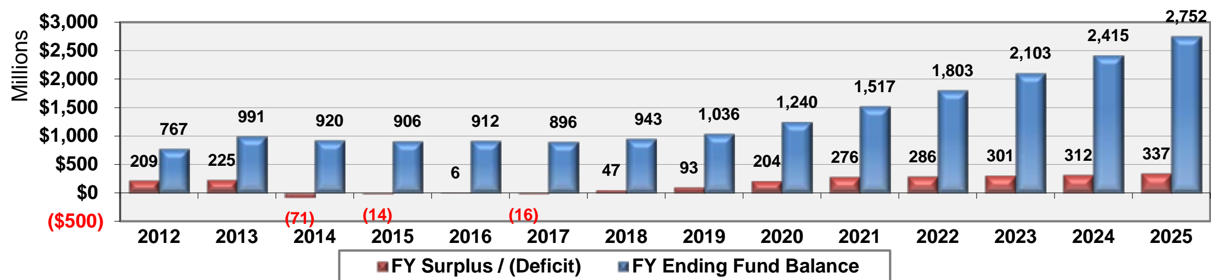
- **Broaden definitions for Nexus.** The project team views this as another largely administrative approach that is less likely to yield additional revenue than other alternatives.

- **Institute a lottery/other forms of gambling.** While the vast majority of states have instituted a lottery, this appears to be an area where there are many with strong cultural and philosophical opposition to State involvement. Given that lotteries raise relatively small amounts of revenue in most states (and can create some belief on the part of taxpayers that these revenues will be sufficient to fund increases in some key program areas), this was viewed as an alternative that would likely create more controversy than benefit. Lotteries and other forms of gaming also tend to be regressive and may create some negative externalities as well.

Recommendations Fiscal Impact

According to the assumptions currently developed around the recommendations, the end result would be a structurally aligned expenditure and revenue structure through the years the model projects. In some cases, timing of actual implementation might require some adjustment (which the model allows the project team and the State to do on a real time basis). The following illustrates the baseline projection with the tax structure recommendations fully implemented:

**Baseline Projection with Full Implementation of Recommendations**




The following table summarizes the recommendations and their fiscal impact for 2014:

**Summary of Recommendations**

| Initiative | 2014 |
|---|---|
| **Base Expansion** | |
| Reduce the pension exemption in the IIT* | 17,267,203 |
| Eliminate the deduction for property taxes paid* | 12,513,835 |
| **Reduce Regressivity** | |
| Increase IIT standard deduction* | (42,495,049) |
| Double the low-income food credit* | (15,084,986) |
| **Eliminate Pyramiding** | |
| Eliminate the 0.5 percent GET and Use Tax rate | (134,708,410) |
| Allow the Act 105 temporary increases to sunset** | (74,550,434) |
| Increase Corporate Net Income Tax revenue | 34,822,258 |
| **Export Additional Tax Burden** | |
| Increase cigarette and tobacco tax rates | 9,838,872 |
| Increase gallonage taxes on beer, wine and distilled spirits | 1,886,273 |
| Eliminate sunset on TAT rate increase | 0 |
| Restore the surcharge on rental cars | 65,451,475 |
| **Rate Change to Restore Structural Balance** | |
| Increase the GET rate to 4.5 percent | 349,899,664 |
| **Changes to Improve System Administration** | |
| Develop Tax Gap systems to identify under-payment and non-payment of taxes | 0 |
| **Total Fiscal Impact** | **299,391,135** |

*FY2014 includes a 50% discount for the unique timing of the recommendation

**Already assumed in baseline revenue projection therefore not including in savings total

## Summary

The long range financial forecasting model and the resulting analysis of baseline expenditures and revenues conclude that the State faces a significant financial challenge. On a cash basis, the baseline model projects an accumulated shortfall of $3.0 billion between FY 2013 and FY 2025. While an optimistic scenario was created that could allow the State to avoid a structural deficit, an equally likely pessimistic scenario suggests it will be far worse than even the baseline projection – with an accumulated shortfall of nearly $16 billion through FY 2025. If the focus is shifted to an accrual basis to fully account for liabilities associated with pension and OPEB liabilities, the baseline scenario accumulated shortfall balloons to over $17 billion.

The State of Hawaii is at a crossroads: the long range financial forecasting model projects that the State can maintain a positive balance for the next few years under predicted current levels of service and revenue forecasts. However, if the State waits to address the problem, it will lose the opportunity to build the corpus in the OPEB trust and make strategic investments – as in, for example, technology – that can assist it to improve overall productivity of the revenue system as well as financial transparency, accountability and compliance in the years to come.

The recommended initiatives form a comprehensive package that build on current, accepted taxes and modify them in ways that raise additional revenue while also focusing on ways to increase equity and efficiency and further export part of the State tax burden. Regardless of the approach the State takes, this sort of a balanced, long-term approach will be most likely to craft a structure that provides sufficient revenue in a way that minimizes the negative effects of taxes on the economy and taxpayers.

## Report Epilogue

After issuing the draft report, the Tax Review Commission solicited and received significant feedback and commentary on the draft findings and recommendations – both positive and negative. This is to be expected, as tax policy changes can have major impacts on individuals and businesses, and many of them weighed into the discussion. It is important to weigh the feedback within the context of individual self-interest and equally important to note that the recommendations relate to an overall tax system. Critiques of individual recommendations often do not address broader system-wide considerations.

In discussing the report, the original study charge should be kept in mind. The charge was to conduct:

- An analysis of whether the current tax system will provide sufficient revenues to meet near and long term future needs for the 21st Century.
- A review of alternate tax structures that could improve Hawaii's ability to generate sufficient revenues.

In conducting its analysis, the project team created a multi-year financial planning model to determine whether expected revenues would be sufficient to provide a current level of services in future years. PFM has built this sort of model for numerous state and local governments around the country. In fact, this long-range financial planning activity is considered a standard practice for state and local governments and has been identified by credit rating agencies and public policy organizations as a best practice.[227] Long-range analysis is critical to assess the State's near and long-term revenue sufficiency as measured against projected expenses associated with current levels of service. This exercise is not only warranted but in many ways necessary for the Commission to fulfill its responsibilities.

The report has been criticized in its approach to the question of 'whether the current tax system will provide sufficient revenues to meet near and long term future needs' because of its focus on the revenue aspect of budgeting. There are differing philosophies and approaches as to how governments should approach and deal with possible budget shortfalls. Many of the revenue-side recommendations in this report could be addressed on the expenditure side as well.[228] However, the focus of the charge from the Tax Review Commission (as its name would suggest) was 'alternate tax structures that could improve Hawaii's ability to generate sufficient revenues.'

The following are brief responses to some of the broad tax policy critiques:

**Tax Burden**

Hawaii statute suggests that the TRC should view the current and any recommended tax structure changes from the perspective of equity. Many of the critiques of the recommendations have focused on specific recommendations without necessarily examining the impact on the tax structure as a whole. In many respects, these are non-unique criticisms, as other national studies have raised concerns about the equity of the current State tax structure.

The study recommendations, as a whole, decrease the tax burden for lower income taxpayers. According to the study calculations, which use federal Bureau of Labor Statistics data on consumer

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[227] See, for example, "Recommended Budget Practices: A Framework for Improving State and Local Government Budgeting," National Advisory Council on State and Local Budgeting, Governmental Finance Officers Association, 1998, pp.43-51. See also "The Top 10 Management Characteristics of Highly Rated U.S. Public Finance Issuers," Standard and Poor's Rating Services, July 22, 2012, p. 7.

[228] As the report notes, neutral third party analysis (such as that conducted by the GAO) suggests that expenditure solutions are unlikely to be the primary vehicle for solving long-term state budget problems.

expenditures by income levels, the recommendations will reduce the tax burden for lower income cohorts while raising it for high income cohorts.

At the same time, the study recommendations are expected to increase the overall amount of revenue the State collects. As a result, the tax burden for some individuals and businesses must necessarily rise. The study recommendations seek to balance the impact on any particular taxpaying group, which generally supports both equity and efficiency principles.

**GET Rate Comparisons**

Commentators have suggested that an analysis of the GET rate in comparison to other state sales tax rates is inappropriate, as the GET is not a sales tax and is applied to the gross receipts of virtually all businesses operating in the State. The study acknowledges the broad base of the GET in relationship to other states, quoting from comparisons done by the Federation of State Tax Administrators (FTA) and Dr. William Fox. However, there are other states that impose a business privilege or transaction tax in lieu of a state sales tax – a past paper for the TRC by Dr. Fox notes that "Hawaii is not unique in creating its sales tax through a vendor levy. Thirteen states including Hawaii levy their sales tax on the privilege of engaging in business as a vendor."[229]

Regardless of the nuance of the tax, these thirteen states are regularly compared to states with a more general state sales tax, and it is acknowledged by tax experts that they largely have the same effect – they are primarily taxes on consumption. Dr. Fox discusses the GET and its relationship to other broad-based sales taxes and notes that "An important conclusion of economics is that the economic effects, in terms of whose 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."[230]

The July 2012 paper for the TRC by Dr. Fox makes similar comparisons as those done by this study – it examines rates for states with sales taxes and other general consumption taxes and makes the similar point that "The standard GET rate (4.0 percent) is low compared with other states."[231] Granted, the base on which Hawaii applies its GET is broad – the broadest of any state. However, other states do also tax a number of services (which is generally viewed as a key component of the broadness of the base). For example, the FTA state survey found that Hawaii was first among the states in taxing common services, with 160 out of 168 taxed, but New Mexico and Washington were not far behind, both taxing 158 services. South Dakota and Delaware also each tax over 140 services.

The primary purpose for discussion and comparison of state general consumption tax rates relates to issues of efficiency and the axiom of taxation to strive for the broadest possible base and the lowest possible rate. The study's use of rate comparisons is primarily to determine whether in the broad application of the consumption tax a 4.5 percent GET rate would be out of step with other states and thus make the economy less competitive with other states based on this tax rate – and the answer is clearly that it would not.

**Tax Pyramiding**

The recommendation to increase the GET rate to 4.5 percent has been criticized as leading to additional tax pyramiding. To the extent that pyramiding occurs with the current 4.0 percent GET rate, it is a fact that an increase in the rate to 4.5 percent will have some additional pyramiding impact. However, the study also recommends eliminating the 0.5 percent rate that is applied to wholesaling, manufacturing,

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[229] William F. Fox, "Hawaii's General Excise Tax: Should the Base Be Changed?" Report Prepared for the 2005-2007 Hawaii Tax Review Commission.

[230] Ibid.

[231] William F. Fox, "Selected Issues with the Hawaii General Excise Tax," Report Prepared for the 2010-2012 Hawaii Tax Review Commission, July 22, 2012, p. 3.

producing, wholesale services, and use tax on imports for resale. The taxing of these activities creates significant pyramiding (for example wholesale activities, by definition, are ‘middleman’ services provided prior to retail sale of a good), and removing the tax will lessen pyramiding.

It is generally accepted by economists that pyramiding has negative consequences – and prior papers for the TRC by Dr. Fox have examined this issue.[232] While it is acknowledged that the GET results in tax pyramiding, the effective GET rate as a result of pyramiding has not been a recent subject of research (and may well be a topic worthy of analysis by the TRC in the future). A 1989 study, which is cited in the report, constructed an input-output model of the State economy and estimated that the effective GET rate (because of pyramiding) was in the range of 5.3 to 5.4 percent.[233] While the study is dated, if this estimate is still reasonable, it suggests that the additional pyramiding impact from raising the GET rate to 4.5 percent will be less substantial than some claim.

While the concept that eliminating the 0.5 percent GET rate will reduce pyramiding is obvious, one local commentator suggested that keeping the 0.5 percent rate was important so as to be able to obtain useful economic information from those subject to this tax. This is a novel theory of taxation – in essence, consumers and businesses should pay for the privilege of providing economic data to the State. However, this theory does not really align with either tax efficiency or equity considerations.

**Individual Income Tax**

A major consideration in the report’s recommendations is to reduce, to the extent possible, the tax burden on lower-income state residents. The study seeks to accomplish this by increasing the IIT standard deduction and doubling the refundable food/excise tax credit. Even when coupled with the increase in the GET rate, this is a net gain for lower income taxpayers – according to the tax burden model constructed for the study, low income taxpayers (in this case, defined as a family of three with income of $25,000) realized in net savings equivalent to 2.3% of their income. Families with income of $50,000 also see some small savings, while those with incomes of $75,000, $100,000, and $150,000 see increases in their tax burden. From the perspective of advancing equity issues, the study recommendations further that important goal.

**Summary**

Many of the critiques of the report and its recommendations are understandable and expected and all deserve careful consideration. At the same time, the recommendations should be viewed in the broad context of a tax structure that is likely to have to generate additional revenue over baseline assumptions during the next 12 years. The recommendations should be viewed collectively, as individual components will have negative impacts that may be outweighed by other suggested changes. When taken as a whole, the recommendations generally align with equity and efficiency considerations and should help the State achieve structural balance over the entirety of the 2012-2025 timeframe.

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[232] Ibid.

[233] Richard L. Bowen and PingSun Leung, “Tax Pyramiding and Tax Exporting in Hawaii: An Input-Output Analysis,” University of Hawaii Research Extension Series 102, January 1989, p.6.

# Appendices

# Appendices

## Appendix A: Interview/Discussion/Presentation Groups

The following is a list of meetings and/or interviews conducted to date:

| Agency | Interviewee(s) |
|---|---|
| Tax Review Commission (TRC)<br>(Initial kick-off meeting, Mid-Project Reporting meeting, and Final Report Draft Presentation) | Randall Iwase, Chair<br>Mitchell Imanaka, Vice Chair<br>Roy Amemiya, Member<br>Peter Ho, Member<br>Mike McEnerney, Member<br>Darryl Nitta, Member<br>Gregg Taketa, Member |
| Dept. of Taxation (DOTAX) (interviews and Final Report Draft Presentation) | Fred Pablo, Director<br>Randy Baldemor, Deputy Director<br>Don Rousslang, Tax Research and Planning Officer<br>Titin Sakata, TRC Technical Officer / Special Assistant to Director of Taxation |
| Hawai'i Institute of Public Affairs (HIPA)<br>(interviews) | Bill Kaneko, President & CEO<br>Jeanne Schultz Afuvai, Executive Vice President |
| House Speaker (meeting) | Representative Calvin Say |
| House Finance Committee members<br>(meetings) | Representative Marcus Oshiro, Chair<br>Representative Kyle Yamashita<br>Legislative Committee Staff |
| Dept. of Accounting & General Services<br>(DAGS) (interviews) | Jan Gouveia, Deputy Comptroller<br>Wayne Horie, Accounting Division Administrator<br>Wayne Chu, Audit Division's Administrator |
| Dept. of Business Economic Development & Tourism<br>(DBEDT) (interview) | Dr. Eugene Tian, Acting Administrator, Research & Economic Analysis Division (READ) |
| Office of the Governor (interviews and presentation of Draft Report and Baseline Model) | Neil Abercrombie, Governor of Hawaii<br>Blake Oshiro, Deputy Chief of Staff<br>Beth Giesting, Healthcare Transformation Coord. |
| DBEDT, Energy Office (interviews) | Mark Glick, Administrator<br>Michelle Toma |
| Employer-Union Health Benefit Trust Fund (EUTF) (interview) | Barbara Coriell, Administrator |
| Employees' Retirement System<br>(ERS) (interviews) | Wes Machida, Administrator<br>ERS Division Directors<br>Colbert Matsumoto, Chair |
| Council on Revenues (COR) (interview) | Rick Kahle, Chair<br>Dr. Jack Suyderhoud, Vice Chair |
| Dept. of Budget & Finance<br>(B&F) (interviews) | Kalbert Young, Director<br>Luis P. Salaveria, Deputy Director<br>Neal Miyahira, Administrator |

| Agency | Interviewee(s) |
|---|---|
| Hawai'i Government Employee Association (HGEA) (interview) | Randy Perreira, Executive Director<br>Michele Kurihara, Legislative Specialist<br>HGEA Union Agent |
| Dept. of Agriculture (DOA) (interview) | Russell Kokubun, Chairperson<br>Ken Kakesako<br>Warren E Takenaka<br>Earl J Yamamoto |
| Senate Ways and Means Committee (meeting) | Senator David Ige, Chair<br>Legislative Staff |
| Dept. of Human Resources & Development<br>(DHRD) (interview) | Barbara Kreig, Director<br>Leila Kagawa, Deputy Director |
| Chamber of Commerce (meeting) | Sherry Menor-McNamara, Chief Operating Officer, Senior VP, Government Affairs<br>Chamber Committee Members |
| Office of Information Management & Technology (IMT) (interview) | Sanjeev "Sonny" Bhagowalia, State Chief Information Officer<br>IMT Staff |
| Dept. of Human Services, QUEST and Medicaid Information (interview) | Dr. Kenneth Fink, Administrator<br>Brian Pang |

# Appendix B: Suspended Exemptions

The following Information is taken from DOTAX Announcement 2011-09, relating to the provisions of Act 105 of 2011, which temporarily suspended certain tax exemptions.

On June 9, 2011, Governor Neil Abercrombie signed into law Senate Bill 754 SD1, HD1, CD1 as Act 105, Session Laws of Hawaii 2011.

This Act suspends temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from the general excise and use tax and requires the payment of both taxes at a four per cent rate. The persons and amounts for which exemption under the general excise tax has been suspended are as follows:

1. Amounts deducted from the gross income received by contractors as described under section 237-13(3)(B);
2. Reimbursements received by federal cost-plus contractors for the costs of purchased materials, plant, and equipment as described under section 237-13(3)(C);
3. Gross receipts of home service providers acting as service carriers providing mobile telecommunications services to other home service providers as described under section 237-13(6)(D);
4. Amounts deducted from the gross income of real property lessees because of receipt from sublessees as described under section 237-16.5;
5. The value or gross income received by nonprofit organizations from certain conventions, conferences, trade show exhibits, or display spaces as described under section 237-16.8;
6. Amounts received by sugarcane producers as described under section 237-24(14);
7. Amounts received from the loading, transportation, and unloading of agricultural commodities shipped interisland as described under section 237-24.3(1);
8. Amounts received from the sale of intoxicating liquor, cigarettes and tobacco products, and agricultural, meat, or fish products to persons or common carriers engaged in interstate or foreign commerce as described under section 237-24.3(2);
9. Amounts received or accrued from the loading or unloading of cargo as described under section 237-24.3(4)(A);
10. Amounts received or accrued from tugboat and towage services as described under section 237-24.3(4)(B);
11. Amounts received or accrued from the transportation of pilots or government officials and other maritime-related services as described under section 237-24.3(4)(C);
12. Amounts received by labor organizations for real property leases as described under section 237-24.3(10);
13. Amounts received as rent for aircraft or aircraft engines used for interstate air transportation as described under section 237-24.3(12);
14. Amounts received by exchanges and exchange members as described under section 237-24.5;
15. Amounts received as high technology research and development grants under section 206M-15 as described under section 237-24.7(10);
16. Amounts received from the servicing and maintenance of aircraft or construction of aircraft service and maintenance facilities as described under section 237-24.9;
17. Gross proceeds from the sale of the following:
    1. Intoxicating liquor to the United States (including any agency or instrumentality of the United States that is wholly owned or otherwise so constituted as to be immune from the levy of a tax under chapter 238 or 244D,

but not including national banks) or any organization to which the sale is permitted by the proviso of "Class 3" of section 281-31 that is located on any Army, Navy, or Air Force reservation as described under section 237-25(a)(1);

2. Tobacco products and cigarettes to the United States (including any agency or instrumentality thereof that is wholly owned or otherwise so constituted as to be immune from the levy of tax under chapter 238 or 245, but not including national banks) as described under section 23725(a)(2); and
3. "Other tangible personal property" to the United States (including any agency, instrumentality, or federal credit union thereof, but not including national banks) and any state-chartered credit union as described under section 237-25(a)(3);

18. Amounts received by petroleum product refiners from other refiners for further refining of petroleum products as described under section 237-27;
19. Gross proceeds received from the construction, reconstruction, erection, operation, use, maintenance, or furnishing of air pollution control facilities, as described under section 237-27.5, that do not have valid certificates of exemption on July 1, 2011;
20. Gross proceeds received from shipbuilding and ship repairs as described under section 237-28.1;
21. Amounts received by telecommunications common carriers from call center operators for interstate or foreign telecommunications services as described under section 237-29.8;
22. Gross proceeds received by qualified businesses in enterprise zones, as described under section 209E-11, that do not have valid certificates of qualification from the department of business, economic development, and tourism on July 1, 2011; and
23. Gross proceeds received by contractors licensed under chapter 444 for construction within enterprise zones performed for qualified businesses within the enterprise zones or businesses approved by the department of business, economic development, and tourism to enroll into the enterprise zone program, as described under section 209E-11.

The persons and amounts for which exemption under the use tax has been suspended are as follows:

1. The leasing or renting of aircraft or keeping of aircraft solely for leasing or renting for commercial transportation of passengers and goods or the acquisition or importation of aircraft or aircraft engines by a lessee or renter engaged in interstate air transportation, as described under paragraph (6) of the definition of "use" in section 238-1;
2. The use of oceangoing vehicles for passenger or passenger and goods transportation from one point to another within the State as a public utility, as described under paragraph (7) of the definition of "use" in section 238-1;
3. The use of material, parts, or tools imported or purchased by a person licensed under chapter 237 that are used for aircraft service and maintenance or the construction of an aircraft service and maintenance facility, as described under paragraph (8) of the definition of "use" in section 238-1;
4. The use or sale of intoxicating liquor and cigarette and tobacco products imported into the State and sold to any person or common carrier in interstate commerce, whether ocean-going or air, for consumption out of State by the person, crew, or passengers on the shipper's vessels or airplanes, as described under section 238-3(g);
5. The use of any vessel constructed under section 189-25 prior to July 1, 1969, as described under section 238-3(h); and
6. The use of any air pollution control facility subject to section 237-27.5 as described under section 238-3(k).

This Act also requires that, beginning July 1, 2011, taxpayers provide information reporting on any general excise or use tax exclusions or exemptions. The Act provides some exceptions to the information reporting requirement. There will be no information reporting on amounts exempt under section 237-24(1) through (7), which includes amounts received from some types of insurance policies, gifts, compensatory tort damages, employee wages, and alimony.

# Appendix C: Growth Rates and Model Outputs

## Table C-1:
## Estimated Revenue Growth Rates, FY2012-13 to FY2024-25:
## Baseline Scenario

| Growth Rate Name | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Beyond Scope of Council on Revenues Forecast | | | | | | |
| General Excise and Use Tax | 8.10% | 5.76% | 3.72% | 6.46% | 5.95% | 5.57% | 5.57% | 5.57% | 5.57% | 5.50% | 5.43% | 5.43% | 5.43% | 5.43% |
| Individual Income Tax | 23.59% | 6.80% | 7.48% | 7.63% | 7.03% | 3.12% | 6.58% | 6.58% | 6.58% | 6.49% | 6.40% | 6.40% | 6.40% | 6.40% |
| Corporate Income Tax | 111.23% | 4.60% | 4.70% | 4.70% | 4.33% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% |
| Public Service Company Tax | 26.95% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Tax on Insurance Premiums | -13.43% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Cigarette and Tobacco Tax | -5.39% | 24.81% | -14.11% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% |
| Liquor Tax | 1.66% | 3.93% | 2.46% | 2.21% | 1.85% | 1.49% | 1.50% | 1.50% | 1.51% | 1.51% | 1.52% | 1.52% | 1.53% | 1.53% |
| Tax on Banks and Other Financial Corps. | -102.70% | -3590.29% | 1.24% | 4.84% | 3.29% | 2.58% | 2.48% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% |
| Inheritance and Estate Tax | 104.74% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Conveyance Tax | -14.55% | -9.37% | -25.08% | 6.12% | 5.64% | 5.28% | 5.28% | 5.28% | 5.28% | 5.21% | 5.14% | 5.14% | 5.14% | 5.14% |
| Miscellaneous Taxes | 331.88% | -77.51% | 0.09% | -25.97% | -92.82% | -3.91% | -4.07% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% |
| Transient Accommodations Tax | 111.36% | 8.75% | 5.60% | 5.05% | -100.00% | 3.36% | 3.36% | 3.36% | 3.36% | 3.36% | 3.35% | 3.35% | 3.35% | 3.35% |
| Licenses & Permits | -26.00% | 9.41% | 0.97% | -80.75% | 0.88% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Revenues from Use of Money and Property | 13.92% | -2.74% | -3.21% | -3.69% | -3.74% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Federal | -65.61% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Revenues from Other Agencies | 77.78% | 9.78% | -41.56% | -0.01% | -84.37% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Charges for Current Services | -14.55% | 4.10% | 1.35% | 1.18% | 1.09% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Fines, Forfeits & Penalties | -9.00% | 6.90% | -6.45% | 6.90% | -6.45% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Repayment of Loans & Advances | -4.31% | -10.79% | 0.12% | 3.34% | -2.86% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Non-Revenue Receipts | -52.22% | -6.10% | 3.95% | 1.13% | 1.13% | 1.13% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Judiciary | -6.87% | 1.71% | 1.76% | 1.77% | 1.77% | 1.77% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |

## Table C-2:
## Projected General Fund Revenue, FY2012-13 to FY2024-25
## Baseline Scenario ($ thousands)

| Amounts in $ thousands | FY2012 | FY2013 | FY2014 | Fy2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Tax Revenues** | | | | | | | | | | | | | | |
| General Excise and Use Tax | 2,697,951 | 2,853,432 | 2,959,716 | 3,150,924 | 3,338,538 | 3,524,623 | 3,721,079 | 3,928,486 | 4,147,453 | 4,375,541 | 4,612,920 | 4,863,177 | 5,127,011 | 5,405,158 |
| Individual Income Tax | 1,540,730 | 1,645,534 | 1,768,546 | 1,903,405 | 2,037,178 | 2,100,805 | 2,239,017 | 2,386,323 | 2,543,320 | 2,708,414 | 2,881,848 | 3,066,387 | 3,262,744 | 3,471,675 |
| Corporate Income Tax | 73,027 | 76,386 | 79,976 | 83,735 | 87,357 | 90,808 | 94,396 | 98,126 | 102,002 | 106,032 | 110,221 | 114,576 | 119,103 | 123,808 |
| Public Service Company Tax | 149,730 | 153,773 | 157,694 | 161,636 | 165,677 | 169,819 | 174,065 | 178,416 | 182,877 | 187,449 | 192,135 | 196,938 | 201,862 | 206,908 |
| Tax on Insurance Premiums | 121,586 | 124,869 | 128,053 | 131,254 | 134,536 | 137,899 | 141,347 | 144,880 | 148,502 | 152,215 | 156,020 | 159,921 | 163,919 | 168,017 |
| Cigarette and Tobacco Tax | 100,417 | 125,328 | 107,639 | 110,222 | 112,868 | 115,576 | 118,350 | 121,191 | 124,099 | 127,078 | 130,128 | 133,251 | 136,449 | 139,723 |
| Liquor Tax | 48,852 | 50,773 | 52,020 | 53,169 | 54,151 | 54,959 | 55,782 | 56,621 | 57,477 | 58,347 | 59,232 | 60,134 | 61,053 | 61,990 |
| Tax on Banks and Other Financial Corps. | -855 | 29,842 | 30,211 | 31,674 | 32,715 | 33,560 | 34,391 | 35,196 | 36,021 | 36,864 | 37,727 | 38,611 | 39,515 | 40,440 |
| Inheritance and Estate Tax | 14,125 | 14,506 | 14,876 | 15,248 | 15,629 | 16,020 | 16,421 | 16,831 | 17,252 | 17,683 | 18,125 | 18,578 | 19,043 | 19,519 |
| Conveyance Tax | 18,394 | 16,670 | 12,489 | 13,253 | 14,001 | 14,740 | 15,519 | 16,338 | 17,201 | 18,097 | 19,027 | 20,005 | 21,033 | 22,114 |
| Miscellaneous Taxes | 85,564 | 19,241 | 19,258 | 14,257 | 1,023 | 983 | 943 | 959 | 975 | 991 | 1,008 | 1,025 | 1,042 | 1,060 |
| Transient Accommodations Tax | 126,302 | 137,353 | 145,045 | 152,370 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| ***TOTAL TAXES*** | ***4,975,823*** | ***5,247,707*** | ***5,475,525*** | ***5,821,148*** | ***5,993,673*** | ***6,259,793*** | ***6,611,310*** | ***6,983,367*** | ***7,377,178*** | ***7,788,711*** | ***8,218,391*** | ***8,672,603*** | ***9,152,774*** | ***9,660,413*** |
| | | | | | | | | | | | | | | |
| **Non-Tax Revenues** | | | | | | | | | | | | | | |
| Licenses & Permits | 5,313 | 5,813 | 5,869 | 1,130 | 1,140 | 1,147 | 1,155 | 1,163 | 1,171 | 1,180 | 1,190 | 1,200 | 1,210 | 1,220 |
| Revenues from Use of Money and Property | 27,759 | 26,999 | 26,131 | 25,168 | 24,227 | 24,395 | 24,563 | 24,733 | 24,905 | 25,093 | 25,300 | 25,508 | 25,718 | 25,930 |
| Federal | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 |
| Revenues from Other Agencies | 25,206 | 27,672 | 16,171 | 16,170 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 |
| Charges for Current Services | 253,305 | 263,703 | 267,264 | 270,424 | 273,361 | 275,253 | 277,157 | 279,075 | 281,006 | 283,135 | 285,467 | 287,818 | 290,188 | 292,578 |
| Fines, Forfeits & Penalties | 435 | 465 | 435 | 465 | 435 | 438 | 441 | 444 | 447 | 451 | 454 | 458 | 462 | 466 |
| Repayment of Loans & Advances | 22,012 | 19,638 | 19,662 | 20,319 | 19,738 | 19,875 | 20,012 | 20,151 | 20,290 | 20,444 | 20,612 | 20,782 | 20,953 | 21,126 |
| Non-Revenue Receipts | 178,338 | 167,462 | 174,075 | 176,038 | 178,019 | 180,024 | 181,270 | 182,524 | 183,787 | 185,180 | 186,705 | 188,242 | 189,792 | 191,355 |
| Judiciary | 38,310 | 38,965 | 39,651 | 40,351 | 41,065 | 41,793 | 42,082 | 42,373 | 42,667 | 42,990 | 43,344 | 43,701 | 44,061 | 44,424 |
| ***TOTAL NON-TAX REVENUES*** | ***555,178*** | ***555,217*** | ***553,758*** | ***554,565*** | ***545,013*** | ***549,952*** | ***553,709*** | ***557,492*** | ***561,301*** | ***565,501*** | ***570,100*** | ***574,736*** | ***579,411*** | ***584,125*** |
| | | | | | | | | | | | | | | |
| **TOTAL GENERAL FUND REVENUES** | ***5,531,001*** | ***5,802,924*** | ***6,029,283*** | ***6,375,713*** | ***6,538,686*** | ***6,809,745*** | ***7,165,019*** | ***7,540,859*** | ***7,938,479*** | ***8,354,211*** | ***8,788,491*** | ***9,247,340*** | ***9,732,185*** | ***10,244,538*** |

# Table C-3:
# Estimated Revenue Growth Rates, FY2012-13 to FY2024-25:
# Optimistic Scenario

| Growth Rate Name | FY2012 | FY2013 | FY2014 | Fy2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Beyond Scope of Council on Revenues Forecast | | | | | | |
| General Excise and Use Tax | 8.10% | 5.89% | 5.09% | 9.86% | 9.41% | 8.23% | 8.23% | 8.23% | 8.23% | 8.23% | 8.23% | 8.23% | 8.23% | 8.23% |
| Individual Income Tax | 23.59% | 6.95% | 9.12% | 11.64% | 11.11% | 6.56% | 9.72% | 9.72% | 9.72% | 9.72% | 9.72% | 9.72% | 9.72% | 9.72% |
| Corporate Income Tax | 111.23% | 5.10% | 5.70% | 5.70% | 5.33% | 4.95% | 4.95% | 4.95% | 4.95% | 4.95% | 4.95% | 4.95% | 4.95% | 4.95% |
| Public Service Company Tax | 26.95% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Tax on Insurance Premiums | -13.43% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Cigarette and Tobacco Tax | -5.39% | 24.81% | -14.11% | 3.40% | 3.40% | 3.40% | 3.40% | 3.40% | 3.40% | 3.40% | 3.40% | 3.40% | 3.40% | 3.40% |
| Liquor Tax | 1.66% | 3.93% | 2.46% | 2.21% | 1.85% | 1.49% | 1.50% | 1.50% | 1.51% | 1.51% | 1.52% | 1.52% | 1.53% | 1.53% |
| Tax on Banks and Other Financial Corps. | -102.70% | -3590.29% | 1.24% | 4.84% | 3.29% | 2.58% | 2.48% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% |
| Inheritance and Estate Tax | 104.74% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Conveyance Tax | -14.55% | -9.37% | -25.08% | 9.34% | 8.92% | 7.80% | 7.80% | 7.80% | 7.80% | 7.80% | 7.80% | 7.80% | 7.80% | 7.80% |
| Miscellaneous Taxes | 331.88% | -77.51% | 0.09% | -25.97% | -92.82% | -3.91% | -4.07% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% |
| Transient Accommodations Tax | 111.36% | 8.75% | 5.60% | 5.05% | -100.00% | 3.36% | 3.36% | 3.36% | 3.36% | 3.36% | 3.35% | 3.35% | 3.35% | 3.35% |
| Licenses & Permits | -26.00% | 9.41% | 0.97% | -80.75% | 0.88% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Revenues from Use of Money and Property | 13.92% | -2.74% | -3.21% | -3.69% | -3.74% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Federal | -65.61% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Revenues from Other Agencies | 77.78% | 9.78% | -41.56% | -0.01% | -84.37% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Charges for Current Services | -14.55% | 4.10% | 1.35% | 1.18% | 1.09% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Fines, Forfeits & Penalties | -9.00% | 6.90% | -6.45% | 6.90% | -6.45% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Repayment of Loans & Advances | -4.31% | -10.79% | 0.12% | 3.34% | -2.86% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Non-Revenue Receipts | -52.22% | -6.10% | 3.95% | 1.13% | 1.13% | 1.13% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Judiciary | -6.87% | 1.71% | 1.76% | 1.77% | 1.77% | 1.77% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |

## Table C-4:
## Projected General Fund Revenue, FY2012-13 to FY2024-25
## Optimistic Scenario ($ thousands)

| Amounts in $ thousands | FY2012 | FY2013 | FY2014 | Fy2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Tax Revenues** | | | | | | | | | | | | | | |
| General Excise and Use Tax | 2,697,951 | 2,856,838 | 3,002,275 | 3,298,324 | 3,608,816 | 3,905,942 | 4,227,531 | 4,575,598 | 4,952,322 | 5,360,063 | 5,801,375 | 6,279,021 | 6,795,994 | 7,355,531 |
| Individual Income Tax | 1,540,730 | 1,647,830 | 1,798,189 | 2,007,483 | 2,230,541 | 2,376,908 | 2,607,900 | 2,861,340 | 3,139,409 | 3,444,502 | 3,779,244 | 4,146,517 | 4,549,483 | 4,991,609 |
| Corporate Income Tax | 73,027 | 76,751 | 81,126 | 85,750 | 90,317 | 94,788 | 99,481 | 104,406 | 109,575 | 115,000 | 120,694 | 126,669 | 132,940 | 139,522 |
| Public Service Company Tax | 149,730 | 153,773 | 157,694 | 161,636 | 165,677 | 169,819 | 174,065 | 178,416 | 182,877 | 187,449 | 192,135 | 196,938 | 201,862 | 206,908 |
| Tax on Insurance Premiums | 121,586 | 124,869 | 128,053 | 131,254 | 134,536 | 137,899 | 141,347 | 144,880 | 148,502 | 152,215 | 156,020 | 159,921 | 163,919 | 168,017 |
| Cigarette and Tobacco Tax | 100,417 | 125,328 | 107,639 | 111,299 | 115,083 | 118,996 | 123,042 | 127,225 | 131,551 | 136,023 | 140,648 | 145,430 | 150,375 | 155,488 |
| Liquor Tax | 48,852 | 50,773 | 52,020 | 53,169 | 54,151 | 54,959 | 55,782 | 56,621 | 57,477 | 58,347 | 59,232 | 60,134 | 61,053 | 61,990 |
| Tax on Banks and Other Financial Corps. | -855 | 29,842 | 30,211 | 31,674 | 32,715 | 33,560 | 34,391 | 35,196 | 36,021 | 36,864 | 37,727 | 38,611 | 39,515 | 40,440 |
| Inheritance and Estate Tax | 14,125 | 14,506 | 14,876 | 15,248 | 15,629 | 16,020 | 16,421 | 16,831 | 17,252 | 17,683 | 18,125 | 18,578 | 19,043 | 19,519 |
| Conveyance Tax | 18,394 | 16,670 | 12,489 | 13,656 | 14,874 | 16,034 | 17,284 | 18,632 | 20,086 | 21,653 | 23,341 | 25,162 | 27,125 | 29,240 |
| Miscellaneous Taxes | 85,564 | 19,241 | 19,258 | 14,257 | 1,023 | 983 | 943 | 959 | 975 | 991 | 1,008 | 1,025 | 1,042 | 1,060 |
| Transient Accommodations Tax | 126,302 | 137,353 | 145,045 | 152,370 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| ***TOTAL TAXES*** | ***4,975,823*** | ***5,253,775*** | ***5,548,876*** | ***6,076,120*** | ***6,463,361*** | ***6,925,908*** | ***7,498,186*** | ***8,120,105*** | ***8,796,046*** | ***9,530,790*** | ***10,329,550*** | ***11,198,007*** | ***12,142,350*** | ***13,169,323*** |
| | | | | | | | | | | | | | | |
| **Non-Tax Revenues** | | | | | | | | | | | | | | |
| Licenses & Permits | 5,313 | 5,813 | 5,869 | 1,130 | 1,140 | 1,147 | 1,155 | 1,163 | 1,171 | 1,180 | 1,190 | 1,200 | 1,210 | 1,220 |
| Revenues from Use of Money and Property | 27,759 | 26,999 | 26,131 | 25,168 | 24,227 | 24,395 | 24,563 | 24,733 | 24,905 | 25,093 | 25,300 | 25,508 | 25,718 | 25,930 |
| Federal | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 |
| Revenues from Other Agencies | 25,206 | 27,672 | 16,171 | 16,170 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 |
| Charges for Current Services | 253,305 | 263,703 | 267,264 | 270,424 | 273,361 | 275,253 | 277,157 | 279,075 | 281,006 | 283,135 | 285,467 | 287,818 | 290,188 | 292,578 |
| Fines, Forfeits & Penalties | 435 | 465 | 435 | 465 | 435 | 438 | 441 | 444 | 447 | 451 | 454 | 458 | 462 | 466 |
| Repayment of Loans & Advances | 22,012 | 19,638 | 19,662 | 20,319 | 19,738 | 19,875 | 20,012 | 20,151 | 20,290 | 20,444 | 20,612 | 20,782 | 20,953 | 21,126 |
| Non-Revenue Receipts | 178,338 | 167,462 | 174,075 | 176,038 | 178,019 | 180,024 | 181,270 | 182,524 | 183,787 | 185,180 | 186,705 | 188,242 | 189,792 | 191,355 |
| Judiciary | 38,310 | 38,965 | 39,651 | 40,351 | 41,065 | 41,793 | 42,082 | 42,373 | 42,667 | 42,990 | 43,344 | 43,701 | 44,061 | 44,424 |
| ***TOTAL NON-TAX REVENUES*** | ***555,178*** | ***555,217*** | ***553,758*** | ***554,565*** | ***545,013*** | ***549,952*** | ***553,709*** | ***557,492*** | ***561,301*** | ***565,501*** | ***570,100*** | ***574,736*** | ***579,411*** | ***584,125*** |
| | | | | | | | | | | | | | | |
| **TOTAL GENERAL FUND REVENUES** | ***5,531,001*** | ***5,808,992*** | ***6,102,634*** | ***6,630,684*** | ***7,008,373*** | ***7,475,860*** | ***8,051,895*** | ***8,677,597*** | ***9,357,347*** | ***10,096,290*** | ***10,899,649*** | ***11,772,743*** | ***12,721,761*** | ***13,753,448*** |

# Table C-5:
# Estimated Revenue Growth Rates, FY2012-13 to FY2024-25:
# Pessimistic Scenario

| Growth Rate Name | FY2012 | FY2013 | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Beyond Scope of Council of Revenues Forecast | | | | | | |
| General Excise and Use Tax | 8.10% | 5.64% | -0.37% | 1.56% | 4.35% | 4.05% | 4.05% | 4.05% | 4.05% | 4.05% | 4.05% | 4.05% | 4.05% | 4.05% |
| Individual Income Tax | 23.59% | 6.65% | 2.53% | 1.84% | 5.14% | 0.88% | 4.78% | 4.78% | 4.78% | 4.78% | 4.78% | 4.78% | 4.78% | 4.78% |
| Corporate Income Tax | 111.23% | 4.10% | 3.70% | 3.70% | 3.33% | 2.95% | 2.95% | 2.95% | 2.95% | 2.95% | 2.95% | 2.95% | 2.95% | 2.95% |
| Public Service Company Tax | 26.95% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Tax on Insurance Premiums | -13.43% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Cigarette and Tobacco Tax | -5.39% | 24.81% | -14.11% | 1.40% | 1.40% | 1.40% | 1.40% | 1.40% | 1.40% | 1.40% | 1.40% | 1.40% | 1.40% | 1.40% |
| Liquor Tax | 1.66% | 3.93% | 2.46% | 2.21% | 1.85% | 1.49% | 1.50% | 1.50% | 1.51% | 1.51% | 1.52% | 1.52% | 1.53% | 1.53% |
| Tax on Banks and Other Financial Corps. | -102.70% | -3590.29% | 1.24% | 4.84% | 3.29% | 2.58% | 2.48% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% |
| Inheritance and Estate Tax | 104.74% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Conveyance Tax | -14.55% | -9.37% | -25.08% | 1.47% | 4.12% | 3.84% | 3.84% | 3.84% | 3.84% | 3.84% | 3.84% | 3.84% | 3.84% | 3.84% |
| Miscellaneous Taxes | 331.88% | -77.51% | 0.09% | -25.97% | -92.82% | -3.91% | -4.07% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% |
| Transient Accommodations Tax | 111.36% | 8.75% | 5.60% | 5.05% | -100.00% | 3.36% | 3.36% | 3.36% | 3.36% | 3.36% | 3.35% | 3.35% | 3.35% | 3.35% |
| Licenses & Permits | -26.00% | 9.41% | 0.97% | -80.75% | 0.88% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Revenues from Use of Money and Property | 13.92% | -2.74% | -3.21% | -3.69% | -3.74% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Federal | -65.61% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Revenues from Other Agencies | 77.78% | 9.78% | -41.56% | -0.01% | -84.37% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Charges for Current Services | -14.55% | 4.10% | 1.35% | 1.18% | 1.09% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Fines, Forfeits & Penalties | -9.00% | 6.90% | -6.45% | 6.90% | -6.45% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Repayment of Loans & Advances | -4.31% | -10.79% | 0.12% | 3.34% | -2.86% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Non-Revenue Receipts | -52.22% | -6.10% | 3.95% | 1.13% | 1.13% | 1.13% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Judiciary | -6.87% | 1.71% | 1.76% | 1.77% | 1.77% | 1.77% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |

# Table C-6:
# Projected General Fund Revenue, FY2012-13 to FY2024-25
# Pessimistic Scenario ($ thousands)

| Amounts in $ thousands | FY2012 | FY2013 | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Tax Revenues** | | | | | | | | | | | | | | |
| General Excise and Use Tax | 2,697,951 | 2,850,003 | 2,839,528 | 2,883,685 | 3,009,237 | 3,131,212 | 3,258,130 | 3,390,193 | 3,527,609 | 3,670,595 | 3,819,376 | 3,974,188 | 4,135,275 | 4,302,892 |
| Individual Income Tax | 1,540,730 | 1,643,223 | 1,684,752 | 1,715,676 | 1,803,847 | 1,819,749 | 1,906,811 | 1,998,039 | 2,093,632 | 2,193,798 | 2,298,757 | 2,408,737 | 2,523,978 | 2,644,734 |
| Corporate Income Tax | 73,027 | 76,021 | 78,834 | 81,751 | 84,469 | 86,962 | 89,528 | 92,170 | 94,889 | 97,689 | 100,572 | 103,540 | 106,595 | 109,740 |
| Public Service Company Tax | 149,730 | 153,773 | 157,694 | 161,636 | 165,677 | 169,819 | 174,065 | 178,416 | 182,877 | 187,449 | 192,135 | 196,938 | 201,862 | 206,908 |
| Tax on Insurance Premiums | 121,586 | 124,869 | 128,053 | 131,254 | 134,536 | 137,899 | 141,347 | 144,880 | 148,502 | 152,215 | 156,020 | 159,921 | 163,919 | 168,017 |
| Cigarette and Tobacco Tax | 100,417 | 125,328 | 107,639 | 109,146 | 110,674 | 112,223 | 113,795 | 115,388 | 117,003 | 118,641 | 120,302 | 121,986 | 123,694 | 125,426 |
| Liquor Tax | 48,852 | 50,773 | 52,020 | 53,169 | 54,151 | 54,959 | 55,782 | 56,621 | 57,477 | 58,347 | 59,232 | 60,134 | 61,053 | 61,990 |
| Tax on Banks and Other Financial Corps. | -855 | 29,842 | 30,211 | 31,674 | 32,715 | 33,560 | 34,391 | 35,196 | 36,021 | 36,864 | 37,727 | 38,611 | 39,515 | 40,440 |
| Inheritance and Estate Tax | 14,125 | 14,506 | 14,876 | 15,248 | 15,629 | 16,020 | 16,421 | 16,831 | 17,252 | 17,683 | 18,125 | 18,578 | 19,043 | 19,519 |
| Conveyance Tax | 18,394 | 16,670 | 12,489 | 12,673 | 13,196 | 13,702 | 14,229 | 14,775 | 15,342 | 15,931 | 16,543 | 17,179 | 17,838 | 18,523 |
| Miscellaneous Taxes | 85,564 | 19,241 | 19,258 | 14,257 | 1,023 | 983 | 943 | 959 | 975 | 991 | 1,008 | 1,025 | 1,042 | 1,060 |
| Transient Accommodations Tax | 126,302 | 137,353 | 145,045 | 152,370 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| ***TOTAL TAXES*** | ***4,975,823*** | ***5,241,603*** | ***5,270,400*** | ***5,362,539*** | ***5,425,154*** | ***5,577,088*** | ***5,805,441*** | ***6,043,469*** | ***6,291,579*** | ***6,550,204*** | ***6,819,798*** | ***7,100,836*** | ***7,393,815*** | ***7,699,249*** |
| | | | | | | | | | | | | | | |
| **Non-Tax Revenues** | | | | | | | | | | | | | | |
| Licenses & Permits | 5,313 | 5,813 | 5,869 | 1,130 | 1,140 | 1,147 | 1,155 | 1,163 | 1,171 | 1,180 | 1,190 | 1,200 | 1,210 | 1,220 |
| Revenues from Use of Money and Property | 27,759 | 26,999 | 26,131 | 25,168 | 24,227 | 24,395 | 24,563 | 24,733 | 24,905 | 25,093 | 25,300 | 25,508 | 25,718 | 25,930 |
| Federal | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 | 4,500 |
| Revenues from Other Agencies | 25,206 | 27,672 | 16,171 | 16,170 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 |
| Charges for Current Services | 253,305 | 263,703 | 267,264 | 270,424 | 273,361 | 275,253 | 277,157 | 279,075 | 281,006 | 283,135 | 285,467 | 287,818 | 290,188 | 292,578 |
| Fines, Forfeits & Penalties | 435 | 465 | 435 | 465 | 435 | 438 | 441 | 444 | 447 | 451 | 454 | 458 | 462 | 466 |
| Repayment of Loans & Advances | 22,012 | 19,638 | 19,662 | 20,319 | 19,738 | 19,875 | 20,012 | 20,151 | 20,290 | 20,444 | 20,612 | 20,782 | 20,953 | 21,126 |
| Non-Revenue Receipts | 178,338 | 167,462 | 174,075 | 176,038 | 178,019 | 180,024 | 181,270 | 182,524 | 183,787 | 185,180 | 186,705 | 188,242 | 189,792 | 191,355 |
| Judiciary | 38,310 | 38,965 | 39,651 | 40,351 | 41,065 | 41,793 | 42,082 | 42,373 | 42,667 | 42,990 | 43,344 | 43,701 | 44,061 | 44,424 |
| ***TOTAL NON-TAX REVENUES*** | ***555,178*** | ***555,217*** | ***553,758*** | ***554,565*** | ***545,013*** | ***549,952*** | ***553,709*** | ***557,492*** | ***561,301*** | ***565,501*** | ***570,100*** | ***574,736*** | ***579,411*** | ***584,125*** |
| | | | | | | | | | | | | | | |
| **TOTAL GENERAL FUND REVENUES** | ***5,531,001*** | ***5,796,820*** | ***5,824,158*** | ***5,917,104*** | ***5,970,167*** | ***6,127,040*** | ***6,359,150*** | ***6,600,961*** | ***6,852,880*** | ***7,115,704*** | ***7,389,897*** | ***7,675,573*** | ***7,973,226*** | ***8,283,374*** |

# Table C-7:
# Estimated Revenue Growth Rates, FY2012-13 to FY2024-25:
# Federal Budget Cuts Scenario

| Growth Rate Name | FY2012 | FY2013 | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Beyond Scope of Council on Revenues Forecast | | | | | | |
| General Excise and Use Tax | 8.10% | 4.24% | 1.79% | 6.03% | 6.01% | 5.61% | 5.61% | 5.61% | 5.61% | 5.54% | 5.46% | 5.46% | 5.46% | 5.46% |
| Individual Income Tax | 23.59% | 5.00% | 5.12% | 7.07% | 7.03% | 2.97% | 6.58% | 6.58% | 6.58% | 6.49% | 6.40% | 6.40% | 6.40% | 6.40% |
| Corporate Income Tax | 111.23% | 4.60% | 4.70% | 4.70% | 4.33% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% | 3.95% |
| Public Service Company Tax | 26.95% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Tax on Insurance Premiums | -13.43% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Cigarette and Tobacco Tax | -5.39% | 24.81% | -14.11% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% | 2.40% |
| Liquor Tax | 1.66% | 3.93% | 2.46% | 2.21% | 1.85% | 1.49% | 1.50% | 1.50% | 1.51% | 1.51% | 1.52% | 1.52% | 1.53% | 1.53% |
| Tax on Banks and Other Financial Corps. | -102.70% | -3590.29% | 1.24% | 4.84% | 3.29% | 2.58% | 2.48% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% | 2.34% |
| Inheritance and Estate Tax | 104.74% | 2.70% | 2.55% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| Conveyance Tax | -14.55% | -9.37% | -25.08% | 5.67% | 5.64% | 5.28% | 5.28% | 5.28% | 5.28% | 5.21% | 5.14% | 5.14% | 5.14% | 5.14% |
| Miscellaneous Taxes | 331.88% | -77.51% | 0.09% | -25.97% | -92.82% | -3.91% | -4.07% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% | 1.68% |
| Transient Accommodations Tax | 111.36% | 8.75% | 5.60% | 5.05% | -100.00% | 3.36% | 3.36% | 3.36% | 3.36% | 3.36% | 3.35% | 3.35% | 3.35% | 3.35% |
| Licenses & Permits | -26.00% | 9.41% | 0.97% | -80.75% | 0.88% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Revenues from Use of Money and Property | 13.92% | -2.74% | -3.21% | -3.69% | -3.74% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Federal | -65.61% | -10.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Revenues from Other Agencies | 77.78% | 9.78% | -41.56% | -0.01% | -84.37% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Charges for Current Services | -14.55% | 4.10% | 1.35% | 1.18% | 1.09% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Fines, Forfeits & Penalties | -9.00% | 6.90% | -6.45% | 6.90% | -6.45% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Repayment of Loans & Advances | -4.31% | -10.79% | 0.12% | 3.34% | -2.86% | 0.69% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Non-Revenue Receipts | -52.22% | -6.10% | 3.95% | 1.13% | 1.13% | 1.13% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |
| Judiciary | -6.87% | 1.71% | 1.76% | 1.77% | 1.77% | 1.77% | 0.69% | 0.69% | 0.69% | 0.76% | 0.82% | 0.82% | 0.82% | 0.82% |

## Table C-8:
## Projected General Fund Revenue, FY2012-13 to FY2024-25
## Federal Budget Cuts Scenario ($ thousands)

| Amounts in $ thousands | FY2012 | FY2013 | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Tax Revenues** | | | | | | | | | | | | | | |
| General Excise and Use Tax | 2,697,951 | 2,812,280 | 2,862,498 | 3,034,971 | 3,217,230 | 3,397,850 | 3,588,573 | 3,789,964 | 4,002,618 | 4,224,254 | 4,454,911 | 4,698,125 | 4,954,577 | 5,224,989 |
| Individual Income Tax | 1,540,730 | 1,617,795 | 1,700,614 | 1,820,839 | 1,948,809 | 2,006,622 | 2,138,638 | 2,279,340 | 2,429,298 | 2,586,991 | 2,752,649 | 2,928,916 | 3,116,469 | 3,316,033 |
| Corporate Income Tax | 73,027 | 76,386 | 79,976 | 83,735 | 87,357 | 90,808 | 94,396 | 98,126 | 102,002 | 106,032 | 110,221 | 114,576 | 119,103 | 123,808 |
| Public Service Company Tax | 149,730 | 153,773 | 157,694 | 161,636 | 165,677 | 169,819 | 174,065 | 178,416 | 182,877 | 187,449 | 192,135 | 196,938 | 201,862 | 206,908 |
| Tax on Insurance Premiums | 121,586 | 124,869 | 128,053 | 131,254 | 134,536 | 137,899 | 141,347 | 144,880 | 148,502 | 152,215 | 156,020 | 159,921 | 163,919 | 168,017 |
| Cigarette and Tobacco Tax | 100,417 | 125,328 | 107,639 | 110,222 | 112,868 | 115,576 | 118,350 | 121,191 | 124,099 | 127,078 | 130,128 | 133,251 | 136,449 | 139,723 |
| Liquor Tax | 48,852 | 50,773 | 52,020 | 53,169 | 54,151 | 54,959 | 55,782 | 56,621 | 57,477 | 58,347 | 59,232 | 60,134 | 61,053 | 61,990 |
| Tax on Banks and Other Financial Corps. | -855 | 29,842 | 30,211 | 31,674 | 32,715 | 33,560 | 34,391 | 35,196 | 36,021 | 36,864 | 37,727 | 38,611 | 39,515 | 40,440 |
| Inheritance and Estate Tax | 14,125 | 14,506 | 14,876 | 15,248 | 15,629 | 16,020 | 16,421 | 16,831 | 17,252 | 17,683 | 18,125 | 18,578 | 19,043 | 19,519 |
| Conveyance Tax | 18,394 | 16,670 | 12,489 | 13,198 | 13,942 | 14,678 | 15,453 | 16,269 | 17,129 | 18,021 | 18,947 | 19,921 | 20,945 | 22,021 |
| Miscellaneous Taxes | 85,564 | 19,241 | 19,258 | 14,257 | 1,023 | 983 | 943 | 959 | 975 | 991 | 1,008 | 1,025 | 1,042 | 1,060 |
| Transient Accommodations Tax | 126,302 | 137,353 | 145,045 | 152,370 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| ***TOTAL TAXES*** | ***4,975,823*** | ***5,178,817*** | ***5,310,374*** | ***5,622,573*** | ***5,783,937*** | ***6,038,776*** | ***6,378,359*** | ***6,737,793*** | ***7,118,249*** | ***7,515,924*** | ***7,931,104*** | ***8,369,995*** | ***8,833,977*** | ***9,324,510*** |
| | | | | | | | | | | | | | | |
| **Non-Tax Revenues** | | | | | | | | | | | | | | |
| Licenses & Permits | 5,313 | 5,813 | 5,869 | 1,130 | 1,140 | 1,147 | 1,155 | 1,163 | 1,171 | 1,180 | 1,190 | 1,200 | 1,210 | 1,220 |
| Revenues from Use of Money and Property | 27,759 | 26,999 | 26,131 | 25,168 | 24,227 | 24,395 | 24,563 | 24,733 | 24,905 | 25,093 | 25,300 | 25,508 | 25,718 | 25,930 |
| Federal | 4,500 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 | 4,050 |
| Revenues from Other Agencies | 25,206 | 27,672 | 16,171 | 16,170 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 | 2,528 |
| Charges for Current Services | 253,305 | 263,703 | 267,264 | 270,424 | 273,361 | 275,253 | 277,157 | 279,075 | 281,006 | 283,135 | 285,467 | 287,818 | 290,188 | 292,578 |
| Fines, Forfeits & Penalties | 435 | 465 | 435 | 465 | 435 | 438 | 441 | 444 | 447 | 451 | 454 | 458 | 462 | 466 |
| Repayment of Loans & Advances | 22,012 | 19,638 | 19,662 | 20,319 | 19,738 | 19,875 | 20,012 | 20,151 | 20,290 | 20,444 | 20,612 | 20,782 | 20,953 | 21,126 |
| Non-Revenue Receipts | 178,338 | 167,462 | 174,075 | 176,038 | 178,019 | 180,024 | 181,270 | 182,524 | 183,787 | 185,180 | 186,705 | 188,242 | 189,792 | 191,355 |
| Judiciary | 38,310 | 38,965 | 39,651 | 40,351 | 41,065 | 41,793 | 42,082 | 42,373 | 42,667 | 42,990 | 43,344 | 43,701 | 44,061 | 44,424 |
| ***TOTAL NON-TAX REVENUES*** | ***555,178*** | ***554,767*** | ***553,308*** | ***554,115*** | ***544,563*** | ***549,502*** | ***553,259*** | ***557,042*** | ***560,851*** | ***565,051*** | ***569,650*** | ***574,286*** | ***578,961*** | ***583,675*** |
| | | | | | | | | | | | | | | |
| **TOTAL GENERAL FUND REVENUES** | ***5,531,001*** | ***5,733,584*** | ***5,863,682*** | ***6,176,688*** | ***6,328,500*** | ***6,588,278*** | ***6,931,618*** | ***7,294,835*** | ***7,679,100*** | ***8,080,975*** | ***8,500,753*** | ***8,944,281*** | ***9,412,938*** | ***9,908,185*** |

# Table C-9:
# Projected General Fund Expenditures, FY2012-13 to FY2024-25 ($ thousands)

| Amounts in $ thousands | FY2012 | FY2013 | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Personal Services** | | | | | | | | | | | | | | |
| Personal Services - Payroll | 1,718,215 | 1,723,629 | 2,164,461 | 2,239,720 | 2,300,182 | 2,374,112 | 2,450,419 | 2,529,178 | 2,610,468 | 2,694,372 | 2,780,972 | 2,870,356 | 2,962,612 | 3,057,834 |
| Personal Services - Other | 15,171 | 15,338 | 15,507 | 15,678 | 15,851 | 16,026 | 16,203 | 16,382 | 16,562 | 16,745 | 16,930 | 17,116 | 17,305 | 17,496 |
| Personal Services - Contracted | 405 | 405 | 405 | 405 | 405 | 405 | 405 | 405 | 405 | 405 | 405 | 405 | 405 | 405 |
| Personal Services - Other State Agencies | 5,715 | 5,733 | 7,200 | 7,450 | 7,651 | 7,897 | 8,151 | 8,413 | 8,683 | 8,962 | 9,250 | 9,548 | 9,855 | 10,171 |
| **TOTAL PERSONAL SERVICES** | **1,739,506** | **1,745,106** | **2,187,573** | **2,263,254** | **2,324,089** | **2,398,440** | **2,475,177** | **2,554,377** | **2,636,119** | **2,720,484** | **2,807,557** | **2,897,424** | **2,990,177** | **3,085,906** |
| **Other Current Expenses** | | | | | | | | | | | | | | |
| Operating Supplies | 36,047 | 37,020 | 37,964 | 38,913 | 39,886 | 40,883 | 41,905 | 42,953 | 44,027 | 45,127 | 46,256 | 47,412 | 48,597 | 49,812 |
| Repair and Maintenance Supplies | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 | 5,617 |
| Office Supplies | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 | 8,139 |
| Food Supplies | 8,480 | 8,545 | 8,610 | 8,675 | 8,741 | 8,808 | 8,874 | 8,942 | 9,010 | 9,078 | 9,147 | 9,217 | 9,287 | 9,357 |
| Other Supplies | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 | 4,808 |
| Dues and Subscriptions | 6,828 | 7,012 | 7,191 | 7,371 | 7,555 | 7,744 | 7,938 | 8,136 | 8,339 | 8,548 | 8,762 | 8,981 | 9,205 | 9,435 |
| Freight and Delivery Charges | 1,783 | 1,835 | 1,888 | 1,942 | 1,998 | 2,056 | 2,115 | 2,176 | 2,239 | 2,304 | 2,370 | 2,438 | 2,509 | 2,581 |
| Postage | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 | 4,445 |
| Telephone and Telegraph | 8,922 | 9,169 | 9,423 | 9,683 | 9,951 | 10,227 | 10,510 | 10,800 | 11,099 | 11,406 | 11,722 | 12,046 | 12,379 | 12,722 |
| Printing and Binding | 802 | 802 | 802 | 802 | 802 | 802 | 802 | 802 | 802 | 802 | 802 | 802 | 802 | 802 |
| Advertising | 276 | 276 | 276 | 276 | 276 | 276 | 276 | 276 | 276 | 276 | 276 | 276 | 276 | 276 |
| Car Mileage | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 | 1,667 |
| Transportation, Intra-State | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 | 2,565 |
| Subsistence Allowance, Intra-State | 728 | 728 | 728 | 728 | 728 | 728 | 728 | 728 | 728 | 728 | 728 | 728 | 728 | 728 |
| Transportation, Out-of-State | 504 | 504 | 504 | 504 | 504 | 504 | 504 | 504 | 504 | 504 | 504 | 504 | 504 | 504 |
| Subsistence Allowance, Out-of-State | 427 | 427 | 427 | 427 | 427 | 427 | 427 | 427 | 427 | 427 | 427 | 427 | 427 | 427 |
| Hire of Passenger Cars | 396 | 396 | 396 | 396 | 396 | 396 | 396 | 396 | 396 | 396 | 396 | 396 | 396 | 396 |
| Motor Pool Cars | 1,584 | 1,594 | 1,603 | 1,613 | 1,623 | 1,633 | 1,642 | 1,652 | 1,662 | 1,672 | 1,683 | 1,693 | 1,703 | 1,713 |
| Other Travel | 68,562 | 89,995 | 92,290 | 94,597 | 96,962 | 99,386 | 101,871 | 104,418 | 107,028 | 109,704 | 112,446 | 115,258 | 118,139 | 121,093 |
| Electricity | 69,379 | 71,284 | 73,242 | 75,254 | 77,321 | 79,444 | 81,626 | 83,868 | 86,171 | 88,538 | 90,970 | 93,468 | 96,035 | 98,673 |
| Gas | 2,454 | 2,731 | 3,040 | 3,383 | 3,765 | 4,191 | 4,664 | 5,191 | 5,777 | 6,430 | 7,156 | 7,965 | 8,864 | 9,866 |

| Amounts in $ thousands | FY2012 | FY2013 | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Water | 6,696 | 7,128 | 7,587 | 8,076 | 8,597 | 9,151 | 9,740 | 10,368 | 11,036 | 11,747 | 12,504 | 13,310 | 14,168 | 15,081 |
| Sewer | 10,265 | 10,501 | 10,743 | 10,990 | 11,243 | 11,501 | 11,766 | 12,036 | 12,313 | 12,596 | 12,886 | 13,182 | 13,486 | 13,796 |
| Other Utilities | 695 | 730 | 766 | 804 | 845 | 887 | 931 | 977 | 1,026 | 1,077 | 1,131 | 1,188 | 1,247 | 1,309 |
| Rental of Land and Building | 20,164 | 20,567 | 20,979 | 21,398 | 21,826 | 22,263 | 22,708 | 23,162 | 23,625 | 24,098 | 24,580 | 25,071 | 25,572 | 26,084 |
| Rental of Equipment | 11,730 | 12,637 | 13,614 | 14,667 | 15,801 | 17,022 | 18,339 | 19,757 | 21,284 | 22,930 | 24,703 | 26,614 | 28,672 | 30,889 |
| Other Rentals | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 | 2,042 |
| Repairs and Maintenance | 36,705 | 36,999 | 37,295 | 37,594 | 37,895 | 38,198 | 38,504 | 38,813 | 39,123 | 39,437 | 39,753 | 40,071 | 40,392 | 40,716 |
| Insurance | 474,088 | 494,716 | 564,378 | 614,746 | 666,743 | 723,618 | 785,838 | 853,926 | 928,463 | 1,010,085 | 1,099,489 | 1,197,446 | 1,304,805 | 1,422,508 |
| Depreciation and Amortization | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Interest on Bonded Debt | 256,786 | 260,828 | 242,345 | 223,886 | 203,225 | 183,409 | 163,389 | 144,715 | 127,294 | 113,195 | 100,344 | 87,159 | 73,881 | 61,068 |
| Other Interest Expense | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| Bond Issuance and Redemption Expense | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 |
| Intergovernmental Grants-in-Aid | 2,837 | 3,061 | 3,302 | 3,562 | 3,843 | 4,146 | 4,472 | 4,825 | 5,205 | 5,615 | 6,057 | 6,535 | 7,050 | 7,605 |
| Other Grants-In-Aid | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 | 4,613 |
| Public Assistance | 2,204,519 | 2,237,290 | 2,379,689 | 2,570,403 | 2,734,312 | 2,889,085 | 3,138,173 | 3,410,458 | 3,708,112 | 4,033,512 | 4,389,259 | 4,778,198 | 5,203,440 | 5,668,391 |
| Workers' Compensation Payments | 18,019 | 18,142 | 18,266 | 18,390 | 18,515 | 18,641 | 18,768 | 18,895 | 19,024 | 19,153 | 19,284 | 19,415 | 19,547 | 19,680 |
| Judgments and Claims | 5,530 | 5,657 | 5,788 | 5,921 | 6,057 | 6,196 | 6,339 | 6,484 | 6,634 | 6,786 | 6,942 | 7,102 | 7,265 | 7,432 |
| Unemployment Benefits Payments | 9,420 | 9,674 | 9,921 | 10,169 | 10,424 | 10,685 | 10,952 | 11,226 | 11,507 | 11,795 | 12,090 | 12,392 | 12,702 | 13,020 |
| Retirement and Pension Cost | 401,599 | 416,293 | 539,627 | 575,840 | 609,305 | 628,889 | 649,102 | 669,965 | 691,499 | 713,724 | 736,664 | 760,341 | 784,779 | 810,003 |
| Social Security and Medicare | 185,790 | 186,376 | 234,042 | 242,180 | 248,718 | 256,712 | 264,963 | 273,479 | 282,269 | 291,342 | 300,706 | 310,371 | 320,346 | 330,643 |
| Services on Fee Basis (Other than State Employees) | 421,473 | 451,272 | 467,183 | 484,090 | 502,119 | 521,414 | 542,146 | 564,512 | 588,745 | 615,116 | 643,943 | 675,598 | 710,519 | 749,220 |
| Other Current Expenditures | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 | 78,296 |
| Interest on Delinquent Payments | 196 | 202 | 207 | 212 | 217 | 222 | 228 | 233 | 239 | 245 | 251 | 257 | 264 | 270 |
| Redistributed Current Expenses | (1,295,355) | (1,315,591) | (1,401,699) | (1,516,846) | (1,615,910) | (1,709,503) | (1,859,772) | (2,023,994) | (2,203,476) | (2,399,646) | (2,614,068) | (2,848,450) | (3,104,665) | (3,384,756) |
| **TOTAL OTHER CURRENT EXPENSES** | **3,090,548** | **3,201,018** | **3,504,633** | **3,682,864** | **3,846,926** | **4,002,257** | **4,203,082** | **4,423,326** | **4,664,627** | **4,930,966** | **5,222,381** | **5,539,627** | **5,885,541** | **6,263,562** |
| Capital Outlay | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Land and Land Improvements | 59 | 61 | 62 | 64 | 66 | 67 | 69 | 71 | 72 | 74 | 76 | 78 | 80 | 82 |
| Buildings | 3,253 | 3,340 | 3,426 | 3,511 | 3,599 | 3,689 | 3,781 | 3,876 | 3,973 | 4,072 | 4,174 | 4,278 | 4,385 | 4,495 |
| Machinery and Equipment | 42,807 | 44,321 | 45,889 | 47,512 | 49,192 | 50,932 | 52,734 | 54,599 | 56,530 | 58,530 | 60,600 | 62,743 | 64,962 | 67,260 |
| Other Capital Outlay | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 | 2,088 |
| Construction in Progress | 87 | 87 | 87 | 87 | 87 | 87 | 87 | 87 | 87 | 87 | 87 | 87 | 87 | 87 |
| **TOTAL CAPITAL OUTLAY** | **48,294** | **49,897** | **51,552** | **53,262** | **55,032** | **56,863** | **58,759** | **60,720** | **62,750** | **64,850** | **67,024** | **69,274** | **71,602** | **74,011** |

| Amounts in $ thousands | FY2012 | FY2013 | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 | FY2025 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Non Cost Payments | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Payments for Debt Retirements | 287,520 | 374,030 | 432,315 | 413,960 | 408,405 | 428,200 | 419,750 | 372,820 | 311,960 | 262,130 | 277,305 | 271,955 | 276,700 | 248,375 |
| Payment for Loans | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Items for Resale or Reissue | 106 | 106 | 106 | 106 | 106 | 106 | 106 | 106 | 106 | 106 | 106 | 106 | 106 | 106 |
| Refunds | 20 | 20 | 21 | 22 | 23 | 23 | 24 | 25 | 26 | 27 | 28 | 29 | 30 | 31 |
| Agency and Clearing Accounts | 237 | 237 | 237 | 237 | 238 | 238 | 238 | 238 | 238 | 238 | 238 | 238 | 238 | 238 |
| Transfers | 155,296 | 162,384 | 169,573 | 177,119 | 185,099 | 193,540 | 202,474 | 211,934 | 221,956 | 232,577 | 243,839 | 255,785 | 268,461 | 281,919 |
| **TOTAL NON-COST PAYMENTS** | **443,179** | **536,778** | **602,252** | **591,444** | **593,869** | **622,106** | **622,591** | **585,123** | **534,285** | **495,077** | **521,515** | **528,112** | **545,535** | **530,669** |
| | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **TOTAL EXPENSES** | **5,321,526** | **5,532,799** | **6,346,010** | **6,590,824** | **6,819,916** | **7,079,667** | **7,359,609** | **7,623,546** | **7,897,781** | **8,211,378** | **8,618,477** | **9,034,437** | **9,492,855** | **9,954,148** |

# Appendix D: Tax Burden Model

## Current Tax System vs. Recommendations, by Income Class

### Aggregate Tax Burden

| | Estimated Burden of Major Taxes- Family of Three by Income Level | | | | |
|---|---|---|---|---|---|
| | $25,000 | $50,000 | $75,000 | $100,000 | $150,000 |
| Baseline | $3,016 | $9,121 | $14,990 | $21,294 | $37,821 |
| GET Increase, IIT Adjustments | $2,430 | $9,117 | $15,256 | $21,648 | $38,243 |
| **Difference** | **-$586** | **-$4** | **$266** | **$354** | **$422** |
| **% Increase** | **-19.4%** | **0.0%** | **1.8%** | **1.7%** | **1.1%** |
| **Difference % of Income** | **-2.34%** | **-0.01%** | **0.35%** | **0.35%** | **0.28%** |

| | | | | | |
|---|---|---|---|---|---|
| Baseline Tax Burden as % of Income | 12.1% | 18.2% | 20.0% | 21.3% | 25.2% |
| GET Increase, IIT Adjustments Tax Burden as % of Income | 9.7% | 18.2% | 20.3% | 21.6% | 25.5% |
| **Difference** | **-2.3%** | **0.0%** | **0.4%** | **0.4%** | **0.3%** |

### State Tax Burden

| | Estimated Burden of Major Taxes- Family of Three by Income Level | | | | |
|---|---|---|---|---|---|
| | $25,000 | $50,000 | $75,000 | $100,000 | $150,000 |
| Baseline | $2,076 | $4,053 | $6,093 | $8,498 | $12,859 |
| GET Increase, IIT Adjustments | $1,490 | $4,029 | $6,381 | $8,874 | $13,322 |
| **Difference** | **-$586** | **-$24** | **$288** | **$377** | **$463** |
| **% Increase** | **-28.2%** | **-0.6%** | **4.7%** | **4.4%** | **3.6%** |
| **Difference % of Income** | **-2.34%** | **-0.05%** | **0.38%** | **0.38%** | **0.31%** |

| | | | | | |
|---|---|---|---|---|---|
| Baseline Tax Burden as % of Income | 8.30% | 8.11% | 8.12% | 8.50% | 8.57% |
| GET Increase, IIT Adjustments Tax Burden as % of Income | 5.96% | 8.06% | 8.51% | 8.87% | 8.88% |
| **Difference** | **-2.3%** | **0.0%** | **0.4%** | **0.4%** | **0.3%** |

| | | | | | |
|---|---|---|---|---|---|
| State Taxes % of Tax Burden - Baseline | 68.82% | 44.43% | 40.64% | 39.91% | 34.00% |
| State Taxes % of Tax Burden - GET Increase, IIT Adjustments | 61.31% | 44.19% | 41.82% | 40.99% | 34.84% |

# Appendix E: State Individual Income Tax Provisions

| State | Private | State & Local | Federal Civilian | Military |
|---|---|---|---|---|
| **Alabama** | State Calculation | Most Exempt | Exempt | Exempt |
| **Arizona** | None | $2,500 | $2,500 | $2,500 |
| **Arkansas** | 6000 | 6000 | 6000 | 6000 |
| **California** | None | None | None | None |
| **Colorado** | $20,000 / $24,000 | $20,000 / $24,000 | $20,000 / $24,000 | $20,000 / $24,000 |
| **Connecticut** | None | None | None | 50% |
| **Delaware** | $2,000 / $12,500 | $2,000 / $12,500 | $2,000 / $12,500 | $2,000 / $12,500 |
| **District of Columbia** | None | $3,000 | $3,000 | $3,000 |
| **Georgia** | $35,000 | $35,000 | $35,000 | $35,000 |
| **Hawaii** | State Calculation | Exempt | Exempt | Exempt |
| **Idaho** | None | $27,876 / $41,814[a] | $27,876 / $41,814 | $27,876 / $41,814 |
| **Illinois** | State Calculation | Exempt | Exempt | Exempt |
| **Indiana** | None / $5,200 | None / $5,200 | $2,000 / $7,200 | $5,000 |
| **Iowa** | $6,000 | $6,000 | $6,000 | $6,000 |
| **Kansas** | None | Some Exempt | Exempt | Exempt |
| **Kentucky** | $41,110 | State Calculation | State Calculation | State Calculation |
| **Louisiana** | $6,000 | $6,000 / Exempt | Exempt | Exempt |
| **Maine** | $6,000 | $6,000 | $6,000 | $6,000 |
| **Maryland** | $24,500 | $24,500[b] | $24,500 | $24,500 |
| **Massachusetts** | None | Exempt[c] | Exempt[c] | Exempt |
| **Michigan** | $45,120 | Exempt | Exempt | Exempt |
| **Minnesota** | None | None | None | None |
| **Mississippi** | Exempt | Exempt | Exempt | Exempt |
| **Missouri** | $6,000 | $6,000 | $6,000 | $6,000 |
| **Montana** | $3,600 | $3,600 | $3,600 | $3,600 |
| **Nebraska** | None | None | None | None |
| **New Hampshire** | Exempt | Exempt | Exempt | Exempt |
| **New Jersey** | $15,000 | $15,000 | $15,000 | Exempt |

| State | Private | State & Local | Federal Civilian | Military |
|---|---|---|---|---|
| **New Mexico** | None | None | None | None |
| **New York** | $20,000 | Exempt | Exempt | Exempt |
| **North Carolina** | $2,000 | $4,000 / Exempt | $4,000 / Exempt | $4,000 / Exempt |
| **North Dakota** | None | None | None | None |
| **Ohio** | $200 credit | $200 credit | $200 credit | Exempt |
| **Oklahoma** | $10,000 | $10,000 | $10,000 | $10,000 |
| **Oregon** | 9% credit | 9% credit | 9% credit / pre-1991 exempt | 9% credit / pre-1991 exempt |
| **Pennsylvania** | Exempt | Exempt | Exempt | Exempt |
| **Rhode Island** | None | None | None | None |
| **South Carolina** | $3,000 / $10,000 | $3,000 / $10,000 | $3,000 / $10,000 | $3,000 / $10,000 |
| **Tennessee** | Exempt | Exempt | Exempt | Exempt |
| **Utah** | None | None | None | None |
| **Vermont** | None | None | None | None |
| **Virginia** | None | None | None | Most Taxable |
| **West Virginia** | None | $2,000 | $2,000 | $22,000 |
| **Wisconsin** | State Calculation[d] | State Calculation[d] | State Calculation[d] | Exempt |

**Notes:**

[a] Applies only in the case of certain public safety officials.

[b] All pension benefits to police and firefighters (or their beneficiaries) as a result of job related injuries (or death) are exempt.

[c] Only contributory pension income is exempt.

[d] Payments from certain systems are exempt if employed before 1964.