July 26, 2017

Memorandum

To: Hawaii Tax Review Commission

From: Randall Bauer, The PFM Group

Re: Responses to Tax Review Commission Members Questions on High Level Findings Memo

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The following are responses to the Hawaii Tax Review Commission 'Questions to PFM Group' regarding the PFM Group High Level Findings Memorandum Dated 07/05/2017. The document sent to PFM by the Tax Review Commission is copied into this Memorandum in its entirety (in black text). The PFM Group responses are in red, bold and italics.

At the outset, we would note (in response to multiple questions), that high level findings should not be considered to be recommendations. As the introduction to the 07/05/2017 memorandum explains, "High level findings are primarily findings of fact or supportable conclusions. They do not generally make recommendations or even suggest conclusions. They are also, of course, subject to modification as additional information and analysis is conducted through the remaining weeks of the project."

Hawaii Tax Review Commission
Questions to PFM Group
Re: PFM Group High Level Findings (Memorandum Dated 07/05/2017)

From: Colleen Takamura, Chair

1. From your high level finds report, it appears that your conclusion is that the tax burden is relatively low compared to other cities but from the tax burden amount and percentage seems progressive. Is this your interpretation of Table 1? If the tax burden is progressive, what will be the impact of the Hawaii earned income credit?

Yes, the burden is low compared to other cities, however the structure of the State's tax system is somewhat progressive. Much of this progressivity originates from the individual income tax, which imposes higher marginal tax rates at higher levels of income. The Hawaii EITC should make the system even more progressive by significantly reducing the burden for low income households. We will discuss the exact impact of the EITC in the final report.

2. You looked at the EUTF Retiree Health Care plan annual required contributions for the State of Hawaii. Does amount include both health care and pension or only pension? If only health care, how much is needed to fund the pension? Part of our proposal was to determine

if Hawaii's tax structure is adequate. Given what you have looked at and the additional revenue required, what is your conclusion as to the tax adequacy of the State of Hawaii?

The project team relied on the language from the RFP, 'the study can take as a goal raising enough additional revenue to fund the annual required contribution to the Employer-Union Benefits Trust Fund (EUTF),' and the calculations are based on that amount. Currently, the calculation represents the additional contributions required as a result of Act 268 – which directs that the State must pay additional amounts toward reducing the unfunded EUTF liability until 2019, when 100 percent of the ARC must be paid.

The EUTF provides medical, chiropractic, prescription drug, dental, vision and life insurance benefits to employees and retirees. The ERS is the agency responsible for administering pension benefits for State and county retirees – therefore, pension contributions are not included in this calculation.

It is the project team's conclusion that the current revenue structure is likely inadequate by itself to fund this additional obligation from existing revenues on a year-to-year basis. Determining Hawaii tax adequacy as a whole was a primary component of the 2012 charge to PFM from that Tax Review Commission, but the entirety of the analysis necessary to make that determination was not within the scope for the 2017 study.

3. You mention that the renter housing affordability is a challenge. When you looked at the rent paid, is the rent paid the gross rent and utilities or is the rent paid net of any housing allowances? If it's the gross rent, what is the effect of housing allowances? Also you mention that you looked at household making $20,000 or less. In the income amounts, did you take into account any assistance that the family is receiving such as food stamps, housing allowances, etc.?

This is the gross rent paid including utilities and including any contributions to rent not made by renters themselves. The income ranges correspond to those reported by the Census Bureau in the American Community Survey. The Census definition of income does not include food stamps and in kind contributions but does include cash benefits. Specifically, income includes "the sum of the amounts reported separately for wage or salary income; net self-employment income; interest, dividends, or net rental or royalty income or income from estates and trusts; Social Security or Railroad Retirement income; Supplemental Security Income (SSI); public assistance or welfare payments; retirement, survivor, or disability pensions; and all other income" (2015 ACS Subject Definitions).

4. You mention that GET is regressive. Could you tell me how much of the GET is exported?

The draft report will have a section summarizing findings from the literature while offering a new, current estimate of the percentage of the GET that is exported to tourists.

5. General excise tax is the largest tax revenue raiser for the State. In you findings, there are no recommendations for GET. Did you look at any possibilities? As a way to expand the tax base of an existing tax, did you look at eliminating GET exemptions? In your prior report, you looked at taxing nonprofits and did not recommend doing so. In this memo, there is nothing mentioned about expanding the base for GET. Have you look at this?

There are no specific recommendations for increases to the GET that were identified in the high level findings, as it is the project team's belief that those revenue raising measures would conflict with the charge that PFM identify ways to make the Hawaii tax system less regressive. It is possible to identify mechanisms to ameliorate some of the GET regressivity, and these were explored in the 2012 PFM report. If the Commission would like the project team to further explore these options, it is possible to do so – which would primarily be an update on the 2012 estimates.

6. Sugary beverage tax – in the prior report, you did not recommend this new tax as you felt that the majority of the tax would be borne by the residents. What has changed that now it is a consideration? Also, how will the tax be implemented? What items would be subject to the tax? This is a tax in other states. How has the other states implemented the tax? Would your recommendation be along their lines or something different?

Again, this is an alternative – we have not formed recommendations. In terms of considering it, the tax has gained some 'foothold' through its use by other governments, so some of the issues around impact and implementation are better understood. There has been a fair amount of study that suggests some impacts on consumption and, as a result, likely positive health benefits as well. While there certainly will be primary impacts on residents, visitors who consume sugared soda and other impacted beverages would also pay the tax.

This tax has been charged on sugared beverages at either the wholesale or retail level, and has generally been at a rate of one to two cents per ounce. While implementation and the amount of the tax would be up to policymakers, the project team analysis will use 1.5 cents per ounce as a mid-range of the tax currently in place in other jurisdictions.

City/County	Effective Date	Tax Per Ounce
Boulder, CO	July 1, 2017	$0.02
Seattle, WA	January 1, 2018	$0.0175
Philadelphia, PA	January 1, 2017	$0.015
Cook County, IL	Pending court challenge	$0.01

City/County	Effective Date	Tax Per Ounce
Berkeley, CA	March 1, 2015	$0.01
Albany, CA	April 1, 2017	$0.01
Oakland, CA	July 1, 2017	$0.01
San Francisco, CA	January 1, 2018	$0.01

7. One of your recommendations is a carbon tax. Please explain what is a carbon tax? You mention that Hawaii would be the first state to implement the carbon tax. Why have other states not charged this tax?

Basically, a carbon tax is one that taxes carbon dioxide and other greenhouse gases (GHGs). It can take varying shapes and forms, which impact on both the tax base, rate and point of taxation. A state could impose the tax on fuel producers, distributors, or the facilities and consumers that combust them. At the state level, the point of taxation could use existing EPA data collection for some carbon sources and the State motor fuel taxes for transportation-related carbon/GHG sources. As a basic example, a carbon tax of $25 per ton of carbon dioxide would convert to about $1.00 per thousand cubic feet of natural gas. It would add about 24 cents per gallon to the price of gasoline and about 28 cents per gallon to the price of diesel fuel.

There are a variety of sources and sectors that could be subject to the tax. For example, the State would have to decide whether to tax carbon in fuels in electric power production (for Hawaii, that would include coal, which is about 14 percent, and petroleum-fired plants, which is about 70 percent of electricity generated in the State), transportation fuels, fuels used in homes and commercial buildings for heating and cooling, and/or fuels used in industrial processes. Other sources that could be taxed include methane associated with livestock production, emissions of greenhouse gases used as refrigerants and in some manufacturing processes.

As for why other states have not instituted a tax, the reasons vary. They include the fact that it is a new tax (there are always some concerns about how it will operate in practice and possible unintended consequences). Second, it will tax raw materials and products that have already been subject to tax (such as motor fuels). Third, there are some issues of interstate commerce related to taxing fuels that are simply passing through the state (although this is less of an issue in Hawaii than probably every other state). Finally, there is general disinterest in many states with raising any sort of tax – let alone a new tax with the potential of raising substantial revenue.

A recent notable attempt to enact a state-level carbon tax was in the State of Washington, where a voter initiative to institute a carbon tax was defeated. The actual initiative put before the voters divided environmental and social justice groups, some of whom believed it did not dedicate enough additional resources to climate change efforts and others who noted its impact on lower-income individuals. They were joined (in an unlikely alliance) by the oil and gas industry to defeat the proposal.

As the draft report will discuss in greater detail, there are also credible arguments for a carbon tax – and Hawaii has some unique characteristics that make it a logical place to consider the tax.

8. Vape and e-cigarette tax – why would the increase in revenues be less than $5 million? How many people smoke vape versus cigarettes? Would the tax be similar to the tax on cigarettes? If so, wouldn't the income also be similar? You mention that increasing the cigarette/tobacco tax by $0.80 per pack would increase the annual revenues by $25-$25 million.

Market data (and past performance in other locations that have vape taxes) suggest that the revenue raised is still small. While use of vape products and e-cigarettes is increasing, it still does not have the market share of traditional tobacco products. It is likely that this revenue source would continue to grow over time. Determining the revenue stream from a new tax on a relatively new product is always subject to significant trial and error – as states with recreational marijuana taxes have learned from their own experience.

By way of comparison, Minnesota (which taxes at 95% of wholesale and has a population of 5.4 million) generated $5.6 million in the most recent fiscal year.

9. Did you consider a tourist tax, similar to what is charged in Miami, Florida? Certain designated areas would charge a tourist tax on consumption. The retail establishments can still get locals to come into the tourist tax area by providing a kamaina discount to residents for the amount of the tourist tax.

It is the project team's understanding that the Miami-Dade Tourism Tax is (mostly) a combination of taxes already collected in Hawaii. The following, from the Miami-Dade website, details these tax sources and uses:

<u>Tourist and Convention Development Taxes</u>
Tourist and Convention Development Taxes fall within three main categories.
Tourist and Convention Development Taxes on Transient Rentals (bed taxes)
In total, there is a six percent (6%) tax collected on the rental amount from any person who rents, leases or lets for consideration any living quarter accommodations in a hotel, apartment hotel, motel, resort motel, apartment motel, rooming house, mobile home park, recreational vehicle park, single family dwelling, beach house, cottage, condominium, or any other sleeping accommodations rented for a period of six months or less. If the rental is for more than six months, a bonafide written lease must be provided in order to be exempt per <u>F.S 212.03</u>. The 6% tax is made up of the following 3 taxes:

- ***Three percent (3%) Convention Development Tax (CDT) collected throughout Miami-Dade County, with the exception of the cities of Surfside and Bal Harbour.***

Two-thirds (2/3) of the CDT receipts are distributed to Miami-Dade County, and one-third (1/3) is used to fund the Miami Arena (excess one-third (1/3) receipts go back to Miami-Dade County).

- ***Two percent (2%) Tourist Development Tax (TDT) collected throughout Miami-Dade County, with the exception of the cities of Surfside, Bal Harbour and Miami Beach. Sixty percent (60%) of the TDT is distributed to the Greater Miami Convention and Visitors Bureau, twenty percent (20%) to the Miami-Dade County Department of Cultural Affairs, and twenty percent (20%) to the City of Miami.***
- ***One percent (1%) Professional Sports Facilities Franchise Tax collected throughout Miami-Dade County, with the exception of the cities of Surfside, Bal Harbour and Miami Beach. This one percent (1%) tax is used only for debt service payments on county debt for professional sports facilities.***

Tourist Development Surtax (TDS) on Sales of Food and Beverages in Hotels/Motels
A two percent (2%) Food and Beverage Tax is collected on the sale of all food and beverages (alcoholic and non-alcoholic) by restaurants, coffee shops, snack bars, wet bars, night clubs, banquet halls, catering or room services, and any other food and beverage facilities in or on the property of a hotel or motel.

The TDS is collected throughout Miami-Dade County with the exceptions of facilities in the cities of Surfside, Bal Harbour or Miami Beach. TDS receipts are distributed to the Greater Miami Convention and Visitors Bureau.

Homeless and Domestic Violence Tax on Sale of Food and Beverages
A one percent (1%) Homeless and Domestic Violence Tax is collected on all food and beverage sales by establishments that are licensed by the State of Florida to sell alcoholic beverages for consumption on the premises, except for hotels and motels. Only businesses that make over $400,000 in gross receipts annually are obligated to collect this tax.

The Homeless and Domestic Violence Tax is collected throughout Miami-Dade County with the exception of facilities in the cities of Miami Beach, Surfside and Bal Harbour. Eighty-five percent (85%) of the tax receipts goes to the Miami-Dade County Homeless Trust, and fifteen percent (15%) goes to Miami-Dade County for domestic violence centers.

10. As a way to increase the tax base, did you look at possibly charging TAT on TAT, similar to GET? Right now, TAT of 9.25% is charged on the base rent and mandatory services charged to the customer. GET of 4.712% on Oahu/4.166% to other counties is charged on the base rent, all services and GET charged to the customer. You would expand the base of the tax by charging TAT on all services and TAT charged. Also, by charging TAT an all services, there would be no confusion as to which services are mandatory and which fees are not mandatory.

Currently, the TAT and GET are imposed exclusively – so it's possible that TAT could be charged on Base+GET or GET could be charged on Base+TAT in order to broaden the base – however, pyramiding is generally considered regressive.

As an example of the current structure, with a room rate of $229.49:

Base:	***$229.49***
GET (4.17% Maui on $229.49):	***$9.56***
TAT (9.25% on $229.49):	***$21.23***
Total	***$260.28***

11. You mention that TAT should be charged on resort fees. Why would TAT not be charged on resort fess. Normally, resort fees are mandatory while staying at a hotel.

Resort fees cover amenities like the gym, pool and wifi – and are currently exempt from TAT – hotels claim that the charges are not for "accommodations"

12. You mention that TOT should be charged on Airbnb rentals. Are you suggesting timeshare occupancy tax should be charged on Airbnb rentals in addition to TAT? What makes Airbnb a timeshare versus a transient accommodations rental?

Airbnb is not currently collecting TAT/TOT on behalf of the State – the project team is suggesting that all alternative accommodations companies begin collecting TAT/TOT at the 9.25% rate.

The transient occupancy tax really falls under the transient accommodations tax – it's just that the occupancy tax is paid by a timeshare owner or a guest when they stay at the property.

13. Increases in corporation income tax would increase prices for consumers. Since the tax is a cost of doing business in Hawaii, the price of goods or services would increase by the amount of the tax. I would think that the corporation would increase their price to get to the same net income after taxes. What effect does that have on Hawaii's economy and the tax burden of the residents? Everything will become more expensive. In the prior report, you mentioned the corporate taxes but did not recommend or not recommend any changes. What factors have changed to have a recommendation to move to a higher single corporate tax rate and a recommendation to increase the corporate tax rate by 50%.

Most economists have settled on the perspective that the burden of corporate tax is mostly shared by capital and labor. While the majority opinion is that a larger share is borne by capital, this is disputed by some economists (including Dr. Rosslang from DoTAX). The proportion between the two is the subject of considerable debate. The primary reason that economists do not believe that corporate taxes are built into prices per se is that, in competitive markets, overall supply and demand (taking into account

elasticities) mostly dictates prices. In the case of corporate taxes, many competing entities in a market have widely different tax structures (such as pass through entities that do not pay corporate income taxes) – it would be very difficult in a competitive marketplace for these businesses to reach dissimilar end prices for otherwise very similar items by simply 'passing along' their corporate taxes.

As noted in the introduction, high level findings are not recommendations – in this section, they are possible revenue alternatives that will be weighed in the draft and/or final reports.

14. Elimination of the exemption for pension income of $25,000 – Is the exemption per person? Where is the equality of having pension plans exempt under $25,000 and the individuals that have 401(k) plans are taxed 100% on their distributions. Have you looked at the effect of exempting all retirement plan distributions up to $25,000, not just pension plans? This would be an equality element of the tax structure.

Yes, the exemption is per person. Eliminating the exemption for pensions over $25,000 is a means to increase revenues while sparing lower income individuals. The project team has not considered exempting all retirement plan distributions – this would not be a revenue raising measure, which is the goal of study #3. It is also notable that while exempting all retirement plan distributions under $25,000 would advance equity issues, the alternative as presented also advances this goal, given that currently all public pension income is exempt from State individual income taxation

15. Eliminate the exemption for foreign pension income – how will you determine that the pension is a foreign (out of state pension)? If the taxpayer has a pension from Hawaii and an out of state pension, will be individual have a $50,000 exemption?

The project team uses Census ACS estimates for retirement income (excludes Social Security) and apply the percentage of those aged 65 or older born outside of Hawaii as a reasonable proxy to create a ballpark estimate.

Our study will not consider the details of a retiree with an in-state and out-of-state pension – it would depend on how the State decided to apply the exemption.

By implementing a personal income tax rate recapture, would that be above what the upcoming rates are going to be in 2018?

Rate recapture is not a higher rate. The concept is that, at some designated income threshold, those taxed at the highest rate lose the benefit of the lower rates they paid on the initial parts of their income and are taxed at that rate for the entirety of their income. Essentially, it means that taxpayers above a certain income pay a flat tax at the highest rate. The project team will analyze a recapture that phases in at the income

level of the State's top bracket and then is flat thereafter. The report will include examples of how this would work in practice to make it more clear.

16. Eliminate the real estate tax deduction – you mention that Hawaii has one of the lowest real estate taxes and there would be no effect on those that do not have itemized deductions. From the information provided, it appears that those that are in the $50,000 - $200,000 tax range would bear the bulk of the burden.

Yes, it would mainly affect higher income households that take that itemized deduction.

Would you also eliminate the deduction of real property tax on rental – residential and commercial? You mention that the homeowner making below $5,000 pay an especially large portion of their income in property taxes. I would assume that these are retired individuals for which social security, pensions, tax-exempt interest, etc. are not taxed. If this is so, the results are quite misleading because this does not encompass all of the income that the individual earns. That means that the individual earns $5,000 in investment income (interest, dividends, etc), which is more than the average individual.

Under those assumptions, that's a valid point. However only 12.5% of the under $5,000 income sample had any investment income and 3.4% had any retirement income. In addition, the income reported here includes a very broad array of sources. Income includes "the sum of the amounts reported separately for wage or salary income; net self-employment income; interest, dividends, or net rental or royalty income or income from estates and trusts; Social Security or Railroad Retirement income; Supplemental Security Income (SSI); public assistance or welfare payments; retirement, survivor, or disability pensions; and all other income" (2015 ACS Definitions).

17. Shift certain educational expense to real property taxes – are you saying that you suggest shifting some if the costs for education to the counties with no increase in the funding for the counties, thereby having the counties increase their real property taxes? Also, how would you allocate the costs to be added to the counties – by the county they live in? Oahu has the largest population with the neighbor islands much less populated. Have you figured out how much of the $35 million savings would be allocated as costs to each county. This is the amount that each county would increase their real property taxes. I would assume that since each county pays for their own education, there would be no need for a "state" Department of Education. How would you determine which educational expenses should be allocated to the counties?

Most states fund K-12 education through a mixture of state and local (primarily real property tax) revenue. The only way to alter the mix in Hawaii is to require that local real property taxes share in the funding mix.

States that allocate the costs of K-12 education between state and local sources use a variety of approaches and generally have a funding formula that allocates state assistance among school districts. Because Hawaii has just one school district, it would make sense to allocate it by county (there are several states, such as Florida) that have school districts that align with County boundaries.

A typical school funding formula provides funding to the school districts (in this example, the Counties) based on actual enrollment (usually a student census is conducted in the first few months of the school year), which is often weighted for characteristics of the students (often giving additional weighting for students with special needs, by grade or other factors) and characteristics of the county (sometimes additional weights based on poverty, sparsity or other factors). Formulas also generally provide a mechanism to increase funding for 'property poorer' school districts to provide equitable access to educational resources.

It is outside of the scope of this study to make recommendations on the characteristics of a funding formula, but all states that rely on property taxes for the general operation of K-12 school districts have them. Most also have a state department of education, as there are a variety of issues that still require state guidance and oversight.

18. Increase collection of taxes related to e-commerce. You have estimated an annual impact of $30-$40 million. Is this calculation on internet sale other than Amazon? What has been the impact of Amazon collection GET on sales to Hawaii?

This is based on other-state experience and national estimates. It is correct that Amazon is now collecting sales tax on purchases and remitting that tax in all 50 states. This is a relatively new development – which was effective April 1, 2017 – so there is insufficient data to date to determine its impact.

19. Tax Gap programs – Do you feel that the tax modernization program is a success? Do you think that with the tax modernization program that there will be sufficient data to add a software program to get information to increase collection and compliance efforts?

It is not possible for this project team, given the fact that the implementation project is still in progress and is just a small component of the project analysis, to make a definitive assessment of its success. In fact, there is another consulting firm that is charged with that specific analysis, and we would generally defer to their judgement on that issue.

The project team believes that there are effective state programs related to using software that can increase collection and compliance issues. Again, it is not possible to assess the current implementation at this point in time related to this question.

Additional audit programs – you mention that adding additional audit staff would help with voluntary and non-voluntary compliance. How many more staff do you think is needed for the DOTax staff to be effective?

Determining effective staffing ratios for optimal collections is an in-depth study of its own and outside the general scope of this work. However, other states have provided additional resources to their tax departments for audit services and obtained generally cost-beneficial results. The status of Tax Departments across the country is that they have not been spared from overall staffing reductions (which is the trend across the country) in comparison to most other departments.

Examples of states that have benefited from a significant increase in their audit staffs include Wisconsin, where adding $11.8 million for audit staff and support generated $26.9 million in additional revenue – and an additional $15 million that was billed but not collected during the fiscal year. Minnesota increased its agents by 208 and generated $1.2 million per year for each agent and auditor. The former director for the Arizona Department of Revenue estimated that the return on investment for additional auditors was $12 to $1.

In looking DOTax, what areas of other compliance do you think should be addressed to get compliance at a higher percentage, how much staff is needed and what is the financial impact.

As noted in the previous question, the detail necessary to fully answer this question is not available and mostly falls outside the scope of the study. However, generally, additional compliance efforts are focused on corporate compliance.

20. HARPTA is Hawaii's version of FIRPTA. As it stands now, 5% of the gross sales price of a property is withheld from the seller. The seller has to file a tax return to get the all or a portion of the monies back. Do you think the rate should be higher? Hawaii has a lot of foreigners investing in Hawaii real estate for rentals. Do you see any mechanism where the state can check to see if a property has been rented and all GET and TAT due has been paid through escrow? Once the sale is finalized, the State will have difficulty collecting any taxes owed.

Given that the State is withholding 5 percent of the gross sale price and the State long term capital gains rate is 7.3 percent, this intuitively seems about right – since capital gains are nearly always going to be a smaller percentage than gross sales. It is notable that the federal withholding is either 10 or 15 percent of the gross sale and the federal long term capital gains rate is, depending on income, between 15 and 20 percent for the upper brackets and 0 percent for the lower income brackets. Again, the Hawaii approach seems reasonable.

21. Do you know of any other taxes that other states charge that may work for Hawaii?

There are a variety of taxes that are used in one state or another, and it is hard to develop a definitive list. That said, some of the more impactful opportunities are prohibited by the Hawaii Constitution (such as a state property tax), and some have no applicability to Hawaii (such as severance taxes on oil, coal or natural gas extraction. In other instances, states have adopted different structures than Hawaii that would be extremely difficult to replicate (such as the 17 states that maintain some control over the wholesale and/or retail distribution of alcoholic beverages. These states earn significantly greater shares of revenue on average from that particular industry than other states – but it would be practically impossible to shift to that system. Since prohibition, multiple states have left all or some of the liquor control business (Iowa, Michigan, Ohio, Pennsylvania, Virginia, Washington), but no state has gone from a license to a control state system.

From: Vaughn Cook, Vice Chair

- Page 2 – "According to a national burden analysis, Hawaii's middle and upper middle income taxpayers have relatively low tax burdens." Relative to other states, are middle and upper middle income taxpayer in Hawaii undertaxed?

The results suggest that the current tax burden on middle and upper middle income taxpayers is not excessive and the share of revenue from these taxpayers could be increased without creating an unusually excessive state burden.

- Does the Washington DC study cited on page 2 consider the effect of Hawaii GET in increasing costs generally?

As a study focused on household tax burdens, it considers the impact of the GET on household consumer expenditures only.

- Are there are other studies that show a relatively higher tax burden for Hawaii taxpayers vs. taxpayers of other states than that shown in the Washington DC study cited on page 3? If so, what are some main reasons for the apparent discrepancies between the different studies? For example, the "State Local Tax Burden Rankings FY 2012" - http://tax.hawaii.gov/stats/a9_2trc/ documents for download dated 12/13/2016 – showed Hawaii ranked #14 for local tax burdens by state.

Many of the studies, such as the Federation of Tax Administrators and Tax Foundation analyses, examine taxes as a percent of personal income or on a per capita basis. By

using aggregate ratios, these analyses include a significant portion of taxes that are actually borne by tourists in ratios against Hawaii resident incomes. In addition, they include tax collections from wealthy taxpayers paying at very high IIT rates, not captured in the Washington DC study's analysis of low, middle, and upper middle income taxpayers. For these reasons, they tend to show a much higher tax burden than household level analyses. The results of these studies, their weaknesses, and their differences will be discussed in the final report.

- In studying who bears the burden of Hawaii's taxes, will the study show the portion of each tax that is exported to nonresidents? This was part of the Scope of Services. I would like to see a breakdown of the percentage and total amount of taxes exported by type of tax so that we can provide that information to the Legislators to consider in possible changes to the incidence of tax as well as to the mix of types of tax.

Yes, we will perform a comprehensive literature review in the report with ranges for these shares and develop new export estimates on the GET.

- In considering changes that may make our tax system less (or more) regressive, will PFM group look at possible changes that are designed to raise tax revenue or changes that are revenue neutral?

Given the charge of the third area of study, which has a revenue-raising component, that will be the primary focus of study. There are obvious ways to make the current tax structure less regressive, but they generally will reduce overall revenue collections and would have to be combined with other changes. The individual income tax changes enacted in the last legislative session are an example. In the last study, we identified ways to use existing refundable credits to reduce regressivity in the system, and we can certainly identify those components that could be used with other revenue-raising alternatives.

- In considering tax adequacy, are there other shortfalls in collections vis a vis the expected level of current government spending/needed future spending, in addition to those in Table 3 (page 10), that are projected to result in additional needed revenue (or cuts)?

The project team would suspect that is the case – the 2012 study identified some. However, as directed by the RFP, we focused on 'the study can take as a goal raising enough additional revenue to fund the annual required contribution to the Employer-Union Benefits Trust Fund.'

- In considering Table 3, it appears that the proposed revenue generation ideas are all fairly small in relation to the projected ARC shortfalls. Will the study include a discussion of what type of possible packages of additional revenue plus increases to other taxes (i.e., GET and income tax) that would fully fund the unfunded liability?

Actually, if enacted (and depending on the base and rate), a carbon tax has the potential to be a large revenue source. There would likely be some concerns about regressivity, but there also are significant positive externalities that would also have to be weighed.

Applied statewide, a sugary beverage tax could also be a pretty significant tax. The State of Illinois recently estimated one version of its tax as having the potential to raise around $500 million a year. Granted, that is a much larger state. Likewise, some of the exemptions (such as pension tax) are not insubstantial and will increase over time (given the demographics of the state).

The calculations for increases in the GET and/or income taxes are not difficult to do, and we could do so if the Commission has an interest in them. Our impression from 2012 was that there was little interest, at least as it relates to the GET rate.

- Will the study include a qualitative assessment of the effects of the proposed revenue generation ideas on the overall economy and its major sectors?

That's a broad topic that is likely not addressable, other than at a very high level.

From: John Knox, Commissioner

- **Entire Section on "Who Bears the Burden?"** In Hawaiʻi, more than most places, one of the key "Who" divides is between non-residents – tourists and military – vs. residents. That doesn't seem to figure into any of these analyses. Without undue burden, could it? That is, while it might be ideal to add some actual *numbers* for exported "burden," at a minimum there might be:

    - Qualitative comments in text; and

We will include a section on tax exporting in the report which will review the literature, provide ranges for burden shares, and offer new estimates on the GET resident vs. nonresident burden

- Notations for any table (perhaps Table 1?) where the methodology might overstate resident burden because the numerator includes taxes paid by everyone but the denominator is limited to residents.

  This is a good point, will make a note of this when that is the case

BTW, the analysis in Table 1 is nice because it allows you to see the difference by income level. But I still would still argue that any comparison to other states (including Rank) ought to reflect burden relative to economic conditions, whether those are define by GDP or personal income.

Another good point, and state comparisons of burden on a per capita and percent of personal income basis from the Federation of Tax Administrators and Tax Foundation analyses will be included in the draft report.

- **Figure 1 and Text:** Worth adding any quick notes about:

  - Effects of inflation on tax burden due to fixed, non-indexed percentage rates (bracket creep)?

    Also a good point that can be discussed in the final report. Over time, this will subject lower-income households to higher effective tax rates as the value of the dollar declines over time.

  - If any new laws (e.g., EITC) will substantially affect conclusions going forward?

    Yes, EITC will make the tax system more progressive and it will be discussed in the report.

- **Figure 2 and Text:** Like what you did in Fig. 3 by super-imposing population percentage line – easy and conceptually reasonable to add here, too?

  Yes, a second Y axis showing number of filers by income bracket can be added on the same chart.

- And it's natural to wonder about that dip for the $150-$200K and $200-$300K brackets – worth a fast note of explanation?

  Those at the $150-$200K and $200-$300K brackets are a relatively small share of filers at 3.8% of returns combined, and that's why the share drops sharply. The share jumps at $300,000 because the marginal rate jumps to 11% for a head of

household making more than $300,000. Since high income Hawaiians account for a disproportionate share of statewide personal income and pay at the highest rate, the share of taxes paid by these filers is quite high relative to their number. We will discuss this in the final report.

- **Table 2:** Ranks are confusing. People are used to a Rank of 1 as meaning highest in nation, but here I think you mean lowest.

  Good point, will adjust the way these ranks are shown in the final report.

- **Figure 4 and Text:** Feels like this pattern is expectable, if only because it focuses "Percentage of Income" and not "Percentage of Wealth" – how much of those low-income brackets consist of pensioners with low income but substantial assets to draw upon? You probably can't reasonably answer that question quantitatively without a lot more study, but is there any way to say if the Hawai'i pattern is fairly typical or clearly atypical for country?

  As you mention, in the absence of reliable assets data, it is difficult to determine if these low-income households have access to assets not reflected in cash income. It can be said that from the PUMS sample, only 9 percent of households making less than $20,000 have retirement income of any kind. That suggests low-income pensioners with assets wouldn't significantly bias the shown results.

- **Figures 7 and 8, and Text:**

  - Minor thing – I'd rewrite the sub-section header to be consistent with how the eye tracks Fig. 7: "… GET is regressive, with the percentage of income paid as GET steadily falling as incomes rise."

    Good idea, will make this update to the text in the final report.

The contrasting points of Figures 7 and 8 need both to be made, but require clear statement: So is the GET really not regressive after all, in light of the context of Fig. 8 and the old Bill Fox study? You sort of do that conclusion in the final sentence, but it's a long, complex sentence that doesn't get any visual emphasis (e.g., bolding). Can you simplify/clarify that sentence, *perhaps* bold it?

Yes, will bold the sentence in the final report.

- **Section on "Ways to Reform Hawai'i's Taxes to Make Them Less Regressive:"** This may reflect a difference in contractual interpretation, but I expected this section to come with

specific recommendations (vs. the last section, which I expected to contain a "menu" of possibilities, which it's close to being). Looking through that lens, with those expectations, it seems as though you're implicitly saying, "Well, after the 2017 legislative change, maybe the Hawaiʻi tax system is about as progressive as any system can get." Is that what you want to convey? If we pressed your for definite recommendations and rationales, is that something you can readily do under your present understanding of contract scope?

As noted above, recommendations will come in the draft and final report, while findings provide the basis for analysis and recommendations.

- **Table 3 and Text:** This is one of the few passages I found initially confusing to read. (On the whole, this was a *very* readable report!). The section starts by saying the 2013 law requires 100% funding by 2023, but the Table suggests that it won't be 100% but will be $703M short. I think you're saying that without additional revenue, by 2023 the law would mandate skimming $703M out of GET proceeds, reducing funds for many other demands. If that's a correct interpretation, right now it's implicit and needs to be made more explicit.

  This will be clarified. Yes, your interpretation is correct: the 2013 law requires 100 percent funding by 2023, but the existing funding gap (without additional resources) is estimated to require an additional $703 million to meet the statutory directive.

  Also, suggest note clarifying if future dollars in Table 3 include estimated inflation or not.

  It will be clarified – the law is written and the table refers to nominal as opposed to real dollars.

- **Revenue Initiatives Section:** Again, I just want to minimize the potential for readers (especially at Legislature) to misinterpret "*The project team's proposed revenue initiatives"* as an integrated package, when they're not. Maybe sneaking the word "menu" or some synonym into that heading or the text would help to clarify.

  Additionally, it might help legislators pick and choose from the "menu" if the various bullet points were slightly re-organized into table format. Seems most things readily fit into three categories/columns: Possible Action, Notes/Explanation, and Estimated Annual Impact (and a single note to the latter could clarify in what year dollars). But it might also be good to break out from the Notes the info about Regressive/ Progressive into a 4th category/column. So the eye could run down the page and see the magnitude of impact and the direction of regressivity linked together.

Yes, these are alternatives rather than recommendations, and it will be clarified as it relates to this memorandum. This document is not intended to be exhaustive in its assessment of the alternatives, and your suggestions will be noted for the draft report.

- **Transient Accommodations Alternatives:** You specify "Airbnb," and I know that company is the market leader and currently has an offer on the table. But are you really thinking more generically of all online-booked vacation rentals?

  Yes, and the point is well taken.

- **Income Tax Alternatives:** I don't think there's any conflict here with Don Rousslang's conclusions, but I'm cognizant that the TRC explored whether to chop the corporate tax entirely and then another one of our consultants raises the possibility of instead increasing it. Automatically makes you think, "Were these two communicating? Should the TRC have had Dr. R instead or also look at the effects of raising the tax?" Just have intuitive feel there should be some cross-referencing, some reconciliation of approaches/findings here. Maybe that can be done in expanded text.

  Dr. Rosslang and the project team have somewhat different takes on corporate tax incidence. These studies are being conducted independently, but we would be happy to seek to integrate his findings and recommendations (to the extent that is possible with differing deadlines and approaches) as best we can. It is notable that there is a lot of disagreement in the literature about corporate tax incidence.

- **Property Tax Alternatives:** The bullet about "Shifting K-12 education expenses to property taxes to lower State costs" could be interpreted as simply shifting costs and responsibilities – but not new revenue – to the counties. If that's what it means, my initial feeling is to delete this item (but would want to hear more about PFM logic). If that's not what it means, then some rewriting would help.

  The project team heard from several stakeholders that shifting State costs to the Counties was an area of interest. It certainly aligns with general rankings of state and local government tax burden – the State tax burden alone is generally on the high end, but the local government tax burden (in the real property tax component in particular) is at the low end. One way to shift some of that burden would be to require local governments to bear a greater share of those costs. If, as a result, the State used the savings to cover the retiree benefit cost funding gap, this may prove to be a more palatable alternative than some others.

- **Compliance Alternatives:** Intuitively, one thinks that DoTax should have an easier time than other agencies getting B&F and the Legislature to fill collections-related staff

positions that appear likely to result in far higher net tax intake than required to pay the salaries of these people. In exchange for such a preferred status – for not treating DoTax staff requests just like those of any other department – it might be reasonable to apply some extra standards such as projected ROI and post-facto checks on how much revenue actually gets brought in. Are you aware of any real-life examples of that being tried, and were they successful enough to be recommended for implementation here?

While the project team shares the logic of treating DoTax differently in relation to staff cuts, the general experience in many governments is to not provide that favored status. There are examples from other states with cuts to revenue collection/enforcement functions that were analyzed as having a negative impact on overall collections. To the extent that compliance and audit functions are meant as a deterrence mechanism, this seems logical and plausible.

From: Billy Pieper, Commissioner

"John had a very comprehensive list so I think we're covered in many respects. The only thing I'm curious is to see the tax burden for the different bands above $300k. I'd like to see how it's broken down (and what tax base) we have in the top threshold since I'd be interested to know what type of opportunity we have to further segment that market. Especially above the $1M threshold."

It is a good question, and there are states that either have or have contemplated a 'millionaire's bracket.' There are limitations from a lack of reported data on consumer expenditures and property taxes at these very high income levels. For this reason, tax burden studies usually do not report estimate sat such high thresholds. However we will see what data is available to conduct that initial analysis.