EXECUTIVE SUMMARY

We, the members of the 2015-2017 Tax Review Commission (TRC), devoted the bulk of the resources provided to the TRC to study two issues. The first issue is that the State faces budget challenges in the coming years, because retirement benefits that have been promised to the State's employees were not adequately funded. The second issue is how to distribute the burden of the State's taxes more progressively, to lessen the burden on those who can least afford to pay taxes. We commissioned PFM Group Consulting, LLC to study these issues. We also commissioned a study on Hawaii's corporate income tax, which the 2005-2007 TRC had recommended abolishing. In addition, we received studies from the Department of Taxation on the effect of eliminating the State's individual income tax for those in poverty and a study on the trade-offs among the State's main taxes. Following are the main findings from the studies.

- Additional payments needed to fund retirement pension and health care benefits for State employees will average over $400 million annually from 2018 through 2022. In their study, the PFM Group opined that the additional payments will require more revenue than can reasonably be expected to come from Hawaii's current tax structure.
- The average share of income that Hawaii residents pay in state taxes rises from about 6 percent to about 8 percent as annual household income rises from $25,000 to $50,000, but the share is relatively flat as income rises above $50,000. In their study, the PFM Group concluded that although Hawaii's tax system is only

modestly progressive, it is significantly more progressive than that of most other states.

- The study on Hawaii's corporate income tax concluded that the State should not eliminate the statutory tax rates, but that corporations should be allowed to expense new investments (instead of depreciating the investments over their useful life) to encourage business to invest within the State.
- The personal exemption and standard deduction in Hawaii's individual income tax have each been eroded by inflation over time and are now out of date. Although tax credits eliminate the latent tax liability for most households with income below the poverty threshold, there are still instances where they are required to pay the State's income tax.

The TRC's Recommendations

Based on findings from the studies and on our deliberations, we make the following recommendations.

Net Income Tax Recommendations

- Modernize the individual income tax by increasing the personal exemption and standard deduction to the levels in the federal income tax as of tax year 2017 and index for inflation thereafter. Alter the tax rates and tax brackets to make the modernization revenue neutral.

- Tax retirement income more evenly by making social security payments and income from employer-provided pensions subject to the State's income tax. To help current retirees plan for the tax change, enact it with a five year lag.
- Allow corporations to expense new investments when calculating the corporate income tax liability.

Recommendations Related to Revenue Adequacy

- Expand efforts to collect tax on remote sales, including e-commerce and mail order sales, by requiring retailers to report their sales to the Department of Taxation when they have annual sales in Hawaii of $100,000 or more.
- Tax e-cigarettes at a rate equivalent to the tax on regular tobacco cigarettes.
- Establish a "Simpson-Bowles" Commission to examine how to handle the unfunded and underfunded liabilities for health care and pension benefits for retired State workers, including measures to raise revenues and to reduce expenditures.

Recommended In-Depth Studies

In addition to our recommendations, we recommend that in-depth studies be commissioned on the following measures.

- Study whether Hawaii should institute a carbon tax, which our preliminary research revealed could be a major source of revenue. The study should consider the effect on other State goals, on what to do with the revenue, and on the best way to apply the tax.

- Study whether the rate of withholding on sales of real property by nonresidents (HARPTA withholding) should be restored to its original rate of 9 percent from the current rate of 5 percent.
- Study whether it would be cost effective for the Department of Taxation to increase efforts to educate the public in order to improve compliance with Hawaii's tax laws.