REPORT OF THE 2015-2017 TAX REVIEW COMMISSION

1 INTRODUCTION

1.1 The Tax Review Commission's Mandate

In 1978, the people of Hawaii amended their State Constitution to create the Tax Review Commission, which is to be reconstituted every five years, and charged it with the duty to "submit to the legislature an evaluation of the State's tax structure, recommend revenue and tax policy, and then dissolve."[1] The implementing law is Section 232E of the Hawaii Revised Statutes, which directs each Tax Review Commission to "conduct a systematic review of the State's tax structure, using such standards as equity and efficiency."

In addition to the mandate we, the members of the Tax Review Commission of 2015-2017, received four resolutions from the Legislature and a letter from Governor Ige, asking us to examine specific tax issues. Senate Concurrent Resolution (SCR) 58 asked us to examine all income tax credits, exclusions and deductions. SCR 59 asked us to evaluate whether the standard deduction and personal exemption in Hawaii's individual income tax should be increased to conform to those in the Internal Revenue Code (IRC). SCR 138 asked us to study the effects of increasing the general excise tax (GET) to fund public education and long-term care as proposed in recent Senate bills. Finally, Senate Resolution 103 asked us to update a study that was done for the 1989 Tax Review

[1] Hawaii State Constitution, Article VII, Section 3.

Commission on the distribution, by income class, of Hawaii's state and local tax burdens. The letter from Governor Ige asked us to study how the tax brackets in Hawaii's individual income tax could be adjusted to replace the revenue that would be lost if the State's personal exemption and standard deduction were increased to conform to those in the IRC, to recommend an equitable way to allocate the revenues from the transient accommodations tax (TAT) among the counties and the State, to examine whether the structure of the TAT discriminates against investment in hotel capacity in favor of time share units, and to evaluate methods to prevent inflation from eroding the effective rate of the specific taxes levied on liquor, fuel and motor vehicles.

1.2 Focus of the Tax Review Commission's Work

We did our best to fulfill the mandate and to respond to the requests from the Legislature and from the Governor, but given the limited resources at our disposal, we focused our attention on two central goals of tax policy that we believe are of paramount importance for Hawaii. The first goal is tax adequacy. In preliminary investigations, we discovered that the State continues to face budget challenges going forward, largely owing to unfunded or underfunded liabilities for health care and pensions for retired state workers. The second goal is how to make the State's taxes more progressive.

We considered studying the exemptions from Hawaii's GET in response to SCR 58, but decided against it on several grounds. Most importantly, we do not have reliable data on the amount of the exemptions being claimed. The Department of Taxation's Office of Tax Research and Planning has recently compiled data on the exemptions, but complete data are limited to the first six months of 2017.[2] Secondly, Act 177, Session Laws of Hawaii (SLH) 2017 already requires the State Auditor to conduct an extensive review of the costs and benefits of the GET exemptions, as well as other exemptions, exclusions, tax credits and deductions provided under Hawaii's tax laws. Accordingly, we decided to devote our resources to the studies on tax adequacy and on the distribution of the State's tax burdens.

In order to guide our study of Hawaii's taxes, we began by assembling a list of principles of sound tax policy with the goal of shaping a tax system that best serves Hawaii's residents. To aid us in our deliberations, we contracted for a study by PFM (Public Finance Management) Group Consulting LLC. We also received several presentations and studies from staff of the Department of Taxation. The PFM Group's study examined the questions of who bears the burden of Hawaii's taxes, of ways to make the State's taxes less regressive, and of ways to generate more revenue to help meet the obligations to retired State workers without making the tax system more regressive. The presentations by Department of Taxation staff described the State's main taxes, including the individual income tax, the GET, and the transient accommodations tax. The staff also provided studies on the effects of eliminating the individual income tax for those below the poverty level and on the effects of eliminating the corporate income tax. The studies by staff and by the PFM Group are presented in appendixes.

[2] Data on the exemptions are provided in Tax Research and Planning Office, Hawaii Department of Taxation, "Hawaii General Excise & Use Tax Exemptions: Tax Year 2017" (December 2017).

The rest of our report is organized as follows. We begin with a discussion of the principles of sound tax policy. This is followed by a broad review of the State's tax structure and of some of the imminent budget challenges the State faces from liabilities that have accumulated over the years for future health care and pension benefits for retired State workers, but that were not adequately funded. We then present findings from the studies prepared by the consultant and by staff of the Department of Taxation that bear on the goal of achieving tax adequacy or the goal of making the State's taxes more progressive. We conclude with our observations and recommendations.

2 PRINCIPLES OF SOUND TAX POLICY FOR HAWAII

The two basic principles for sound tax policy are that taxes should be fair and they should be efficient. Standards for what makes taxes fair are hard to set, because they are subjective, but it is important that taxpayers generally deem taxes to be fair so that they are more willing to comply with the tax laws. An efficient tax system raises sufficient funds to pay for desired government services and is economical and easy for tax officials to administer and for taxpayers to comply. It also interferes as little as possible with economic decisions of individuals and of businesses.[3] Another basic principle of sound tax policy is that the tax system should be adequate, that is, it should provide enough revenue to fund required government services.

[3] An exception is taxes that provide a public benefit in addition to revenue, as discussed in subsection 2.3.2 below.

"For Hawaii" is added to the title of this section, because it is important to take account of Hawaii's unique characteristics when formulating the State's tax policy. First among these is that visitors and other nonresidents spend large amounts on goods and services that are consumed within the State. For example in 2016, visitors spent more than $15.9 billion in Hawaii, which was about 19 percent as great as the State's gross domestic product.[4] Also, in 2016 there were more than 107,000 military personnel and their dependents in Hawaii,[5] most of whom are nonresidents, as well as other nonresidents who own homes in Hawaii and live here part time. The nonresident spending within the State provides an opportunity to shift (or "export") an important part of the burden of the State's consumption taxes to the nonresidents.

Secondly, because Hawaii is geographically isolated, people have limited ability to avoid the State's consumption taxes by shopping in another state that has lower taxes. This allows Hawaii to rely more heavily than other states on consumption taxes for its tax revenue.

Thirdly, income of Hawaii residents is more evenly distributed compared with other states. For example, in 2016 Hawaii had the sixth highest median household income in the nation at $64,859, but the income threshold for the top 1 percent of earners in

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[4] Data on visitor spending and the State's gross domestic product are from Research and Economic Analysis, Department of Business, Economic Development and Tourism, *2016 State of Hawaii Data Book*, tables 7.26 and 13.03, available at http://dbedt.hawaii.gov/economic/databook/db2016/.

[5] *Ibid*, table 1.24.

Hawaii was the 45th lowest in the country.[6] The relatively even income distribution in Hawaii limits the State's ability to raise revenue by taxing high-income individuals. In contrast, income of nonresidents who are required to file a Hawaii State income tax return is significantly more concentrated in the upper end of the income distribution.[7]

Finally, we note that although income generally is used to measure the ability to pay tax, wealth is an alternative measure that can be used for this purpose. It is important to distinguish between wealth and income. Annual income is the amount earned during the year, whereas wealth is total assets minus total debts. Wealth is a substantial part of the tax base for many other states,[8] but in Hawaii the State is precluded from taxing real property, which is the most common and practical way to tax wealth.[9] This limits the State's ability to shift the burden of its taxes to nonresidents, because nonresidents own a

[6] See Dr. Seth Colby, "The Economic Trade-Offs of Hawaii's Major Tax Types," report prepared for the 2015-2017 Tax Review Commission (September 2017), pages 8 and 9. (*See Appendix B.*)

[7] In tax year 2015, nonresident filers with income of $300,000 or more accounted for about 63 percent of the total income of all the nonresident filers, whereas Hawaii residents in this income class accounted for only about 19 percent of the total income of all residents. See Tax Research and Planning Office, Hawaii Department of Taxation, "Hawaii Individual Income Tax Statistics: Tax Year 2015," (December 2017), pages 22 and 30.

[8] See PFM Group Consulting LLC, "State of Hawaii Tax Review Commission: Study of the Hawaii Tax system," report to the 2015-2017 Tax Review Commission, November 14, 2017, pages 55-56. (*See Appendix A.*)

[9] The State is precluded from taxing real property tax by Article VIII, section 3 of the Hawaii State Constitution. Alternative (but less effective) ways to tax wealth are the estate tax and taxes on personal property.

substantial amount of property in Hawaii but have little income subject to the State's income tax.[10]

What follows is a brief discussion of principles of sound tax policy for Hawaii. A more complete discussion of the principles is given in Appendix E.

2.1 Fairness

Fairness of taxes, or tax equity, usually is measured using two standards: horizontal equity and vertical equity. A third standard sometimes mentioned is the "benefits principle."

2.1.1 Horizontal Equity

Horizontal equity requires that taxpayers in the same situation face the same tax burden. Tax breaks for selected classes of individuals or for selected activities are examples of things that violate horizontal equity.

2.1.2 Vertical Equity

Vertical equity is usually taken to mean that people with higher income should pay tax at a higher rate than people with lower income. The notion is that taxes should be based on the ability to pay, or said another way, that the pain of taxes should be the same for everyone. Graduated income tax rates are often used to help achieve vertical equity.

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[10] It is estimated that nonresidents own 12.4 percent of the total value of homes in Hawaii. See Research and Analysis Division, Department of Business, Economic Development and Tourism, "An Analysis of Real Property Tax in Hawaii," (March 2017), page 44. However, the nonresidents have only 6.7 percent of the total income subject to Hawaii's individual income tax. See Tax Research and Planning Office, Hawaii Department of Taxation (November 2017), *Op. cit.*, pages 30 and 33.

However, vertical equity is hard to measure by objective standards, as no one can say with authority how progressive tax rates should be.

2.1.3 The Benefits Principle

The benefits principle says that those who benefit from the government services should pay for them. At the state level, most government services are provided by government, instead of by the private sector, either because it would be hard to make people who benefit from the services pay for them (such as public safety), or because the services go to people who cannot afford them (such as public welfare). In these cases, the benefits principle can't be applied. However, if the services can be limited to beneficiaries who can afford them, they should be paid for with fees instead of with taxes, because this causes users to take account of the cost of the services, which discourages wasteful overuse.

2.2 Efficiency

The costs of administering and collecting the taxes should be kept as small as possible, but these costs usually are low anyway. The bigger costs of taxes are the costs of complying with the tax laws and the costs that taxes impose by distorting economic decisions.[11] For example, taxes on income discourage people from working and from saving. Most of the other things included in lists of principles of sound tax policy are

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[11] Estimates for the size of the various costs imposed by taxes are given in Dr. Donald J. Rousslang, "Principles of Sound Tax Policy for Hawaii," report prepared for the 2015-1017 Tax Review Commission, December 28, 2017, pages 8-10. (*See Appendix E*.)

things that improve the efficiency of taxes. The following are some attributes that make the tax system more efficient

2.2.1 Simplicity

A simple tax code has the advantages of being easier for tax authorities to administer and to enforce and easier for taxpayers to comply with, which lowers both the cost of tax administration and the cost of tax compliance. Simplicity of taxes also makes them more transparent, so that it is easier to hold accountable the parties responsible for designing and administering the tax system, including legislators.

2.2.2 Stability

Stability of the tax code reduces the costs of tax administration and compliance. It also reduces uncertainty about the future, which helps individuals and businesses to make better plans. Another kind of stability sometimes mentioned in principles of sound tax policy is that tax revenues should be stable. Stability of tax revenues reduces uncertainty in government budget planning, because the State's operating budget is constrained by law to balance.

2.2.3 Tax Neutrality

The standard of tax neutrality requires that a tax be levied uniformly on its base, with no special tax breaks for selected activities or taxpayers. Uniform application of a tax helps minimize the effects on economic decisions. In addition to distorting economic decisions, special tax breaks complicate the tax code and make it harder to administer.

2.2.4 Broad Base, Low Rates

Uniform application of a tax to its base helps keep the base as broad as possible, so that the needed tax revenue can be gotten with the lowest tax rate possible. Keeping the tax rate low is important, because it reduces the costs of economic distortions caused by the tax.

2.3 Other Principles of Sound Tax Policy for Hawaii

2.3.1 Tax Exporting

When designing Hawaii's tax system, tax authorities should be mindful of opportunities to export the burden of local taxes to nonresidents. The ability to export the tax burden varies greatly among Hawaii's taxes.

2.3.2 Taxes That Provide a Public Benefit in Addition to Revenue

Instead of imposing an extra cost by distorting economic decisions, some taxes provide an extra public benefit by discouraging things that are deemed socially undesirable. For example, taxes on tobacco and alcohol discourage smoking and drinking and a carbon tax discourages pollution. Such taxes can be efficient sources of revenue.

2.3.3 Tax Adequacy

A requirement for any tax system is to produce enough revenue to fund government services. The need to provide adequate revenue limits the alternatives available to tax officials. In most cases there are only three tax bases broad enough to support a state government's spending needs: income, consumption and wealth. Hawaii's

Constitution prohibits the State from taxing real property, so income and consumption are the State's main tax base alternatives.

2.3.4 Competitiveness

Helping local businesses compete with businesses in other taxing jurisdictions is often given as the reason for tax breaks for selected activities. The argument is that tax incentives are needed to attract or keep the activities in order to broaden the economy or to create jobs. However, as discussed above, such incentives violate the principle of tax neutrality and may also violate notions of tax equity.

3 HAWAII'S BUDGET AND TAX ADEQUACY

The study by the PFM Group found that Hawaii will continue to face budget challenges going forward.[12] In this section, we describe the nature of the challenges and put them in perspective with the State's economy and overall budget.

3.1 Hawaii's Budget – a Brief Overview

The State's budget is divided into three types of funds, called Fiduciary Funds, Proprietary Funds, and Governmental Funds. The Fiduciary Funds are used to account for resources held for the benefit of parties outside the State. They are not included in the government-wide financial statements, because their funds cannot be used to support the State's own programs. The Proprietary Funds are for the State's activities that resemble

[12] PFM Group Consulting LLC (November 14, 2017), *Op cit*., page 124.

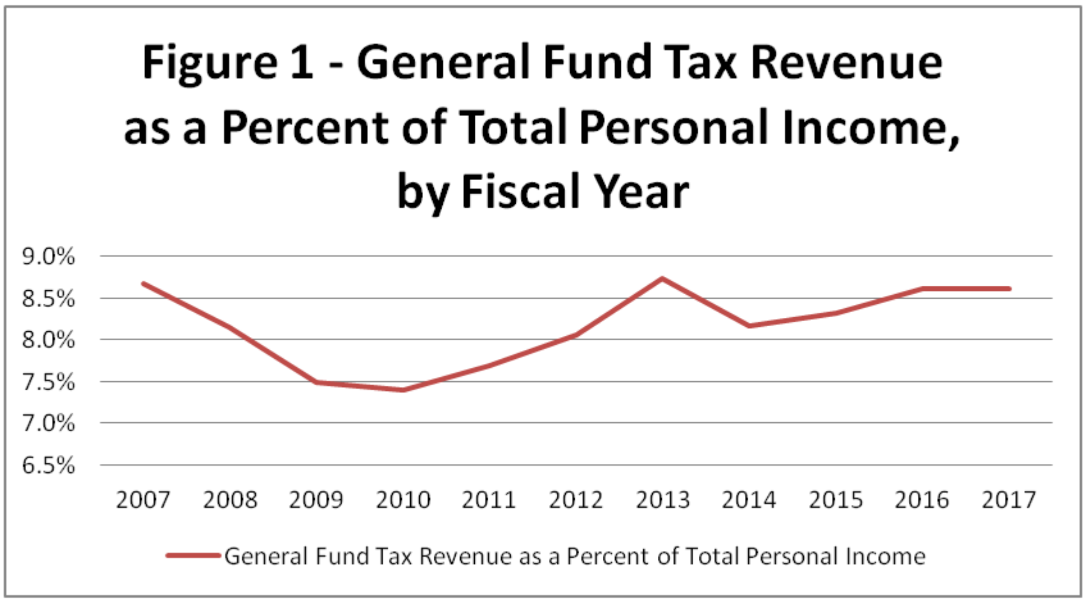
commercial enterprises and include the Unemployment Compensation Fund and funds for the operations of highways, airports, harbors and other business-like activities. The Proprietary Funds have their own dedicated sources of revenue that make them virtually self-supporting and they are budgeted independently from other State government spending. The Governmental Funds are used for most of the State's other activities and are supported mainly by tax revenues and by intergovernmental transfers.

The General Fund is the biggest of the Governmental Funds and gets the bulk of the State's tax revenues. In fiscal year 2017, the State collected a total of $6.9 billion in taxes, of which $6.3 billion, or 91 percent, went to the General Fund. The General Fund also gets some non-tax revenues, but most of its revenues come from taxes: in fiscal year 2017, total General Fund revenues were $7.4 billion, of which $1.0 billion, or 14 percent of the total, came from non-tax revenues, which were mostly charges for services.

The bulk of Hawaii's General Fund tax revenues come from two taxes, the GET and the individual income tax. The GET is Hawaii's biggest tax and accounted for 51 percent of the General Fund tax revenue in fiscal year 2017. The individual income tax is Hawaii's second-biggest tax and accounted for 35 percent of the General Fund tax revenue in fiscal year 2017.[13] These two taxes dominate the General Fund tax collections; the next biggest source of General Fund tax revenue, the TAT, accounted for less than 5 percent of the General Fund tax revenue in fiscal year 2017.

[13] Table 1 in the next subsection shows the contributions to the General Fund from the State's main taxes.

Although the GET and the individual income tax are both relatively stable, the General Fund tax revenues tend to vary more than the economy as a whole. Figure 1 shows how General Fund tax revenues have changed relative to total personal income over the last decade. It is clear from the figure that General Fund tax revenues tend to be less stable than the economy as a whole. In particular, during the Great Recession, General Fund tax revenues as a share of income fell from 8.7 percent in fiscal year 2007 to 7.4 percent in fiscal year 2010, or a decline in the share of about 17 percent.



Notes: The revenue from the individual income tax has been adjusted to remove the effects of a temporary measure to withhold $187.4 million in refunds at the end of fiscal year 2010. Source: Data on total personal income are from the Bureau of Economic Analysis. The General Fund tax revenues are from Monthly Collection Reports produced by the Hawaii Department of Taxation (available at tax.hawaii.gov/stats/a5_3txcolrpt/).

3.2 The State's Future Budget Prospects and Tax Adequacy

According to the latest forecast from the Council on Revenues, the growth in General Fund tax revenues is expected to continue at an annual rate of 4 percent or better over the budget window, although growth in total General Fund revenues is expected to be low in FY 2018, owing to a decline in nontax revenues for that year.[14] Table 1 shows the forecast made by the Council on Revenues for the State's General Fund revenues at its meeting of September 7, 2017 for the period from fiscal year 2018 through fiscal year 2022.

TABLE 1 - FORECASTS OF GENERAL FUND REVENUES, BASED ON THE FORECAST MADE BY THE COUNCIL ON REVENUES AT THE MEETING OF SEPTEMBER 7, 2017

(By Fiscal Year, in Millions of Dollars)

	BASE	**FORECASTS**				
TAX	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
General Excise Tax	$3,239	$3,366	$3,484	$3,607	$3,735	$3,864
Individual Income Tax	2,192	2,285	2,416	2,517	2,634	2,760
Corporate Income Tax	77	91	89	104	106	109
Public Service Company Tax	122	126	130	135	139	144
Tax on Insurance Premiums	165	170	174	178	183	188
Transient Accommodations Tax	292	317	340	361	382	402
All Others	228	231	238	244	251	260
TOTAL TAX	$6,315	$6,587	$6,870	$7,145	$7,431	$7,728
Growth Rate	2.0%	4.3%	4.3%	4.0%	4.0%	4.0%
NONTAX	1,036	776	799	844	880	896
GENERAL FUND TOTAL	$7,351	$7,363	$7,669	$7,989	$8,311	$8,624
Growth Rate	3.8%	0.2%	4.2%	4.2%	4.0%	3.8%

Notes: Tax revenues are General Fund allocations from the tax. The line "All Others" includes the Tobacco Tax, the Liquor Tax, the Franchise Tax, the Estate Tax, the Conveyance Tax and interest, fees and penalties from the various taxes.
Source: Council on Revenues meeting of September 7, 2017, *Op. cit*.

Despite solid growth during the economic recovery from the Great Recession, however, Hawaii faces serious budget challenges going forward, due mainly to the

[14] See the Council on Revenues forecast from the meeting of September 7, 2017, available at http://tax.hawaii.gov/useful/a9_1cor/. Nontax General Fund revenues are expected to drop by about $360 million from fiscal year 2017 to fiscal year 2018. (See Table 2 of Attachment 3 for the meeting.)

growth in health and pension benefits for retired State workers. Over the period from fiscal year 2007 to fiscal year 2017, total General Fund tax revenues grew by 38 percent, while spending from the General Fund for pensions and health care benefits for retired State workers grew by 74 percent.[15] This has put continued pressure on other programs financed with the State's General Fund spending.[16] In their report to the 2010-2013 Tax Review Commission, the PFM Group stated

> *[I]t 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* [health care] *obligations for current employees are inescapable and will grow throughout the period of this analysis.*[17]

Although growth prospects for the future tax revenues appear solid, the budget pressures are expected to continue, because General Fund payments for benefits for

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[15] According to data provided to us by the Department of Budget and Finance, in the period from fiscal year 2007 to 2017, spending from the General Fund on health benefits for retired State workers grew from $174 million to $332 million, and spending from the General Fund on pensions for retired State workers grew from $551 million to $927 million.

[16] A symptom of the budget pressures may be seen by looking at what has happened to wages of State employees, which accounts for the bulk of the General Fund spending. As a typical example, from July of 2007 to July of 2017, pay of mid-level employees (SR-24) in Bargaining Unit 13 ("Professional and Scientific Employees") grew by 14 percent at all levels, while pay of their mid-level managers (EM-7) grew by 26 percent for the entry level and by 47 percent for the senior level. (Pay scales for State employees are available at http://dhrd.hawaii.gov/state-hr-professionals/class-and-comp/salary-schedules/.) Compare these increases with those of all U.S. workers. The U.S. Bureau of Labor Statistics reported (at https://www.bls.gov/oes/oes_arch.htm, accessed on October 22, 2017) that the average hourly wage for all occupations rose from $19.33 in May 2007 to $23.76 in May 2016 (the latest year available), an increase of 23 percent.

[17] PFM Group Consulting LLC, "Study of the Hawaii Tax System: Final Report," September 21, 2012, in Appendix A of the Report of the 2010-2013 Tax Review Commission (November 28, 2012), page 136.

retired State workers are set to increase. Act 268, SLH 2013, and Act 17, SLH 2017, require the State to pay additional amounts toward reducing the unfunded liability for health benefits for retired State workers and to make up for past underfunding of their pensions. Table 2 shows the planned payments for fiscal years 2018 through 2022 to satisfy the Acts.

TABLE 2 - REQUIRED GENERAL FUND CONTRIBUTIONS TO HEALTH CARE AND PENSION FUNDS FOR RETIRED STATE WORKERS
(In Millions of Dollars)

CONTRIBUTIONS	2018	2019	2020	2021	2022
Health Care	297	375	375	354	341
Pensions	74	169	136	31	32
Total	371	544	511	385	373

Notes: The payments to the State retirees' health care fund are set by Act 268, SLH 2013. The payments to the State retirees' pension fund are set by Act 17, SLH 2017.
Source: PFM Group Consulting LLC (November 14, 2017), *Op. cit*., pages 71 and 74.

The required contributions in Table 2 range from 5 percent to 7 percent of the General Fund forecasts shown in Table 1. In their report to us, the PFM Group commented on the requirements set by Act 268, SLH 2013, saying

> *While the State has made progress in working down this funding requirement, it is difficult to construct a logical set of circumstances where that level of funding can be attained without a new source (or sources) of revenue.*[18]

They go on to give other reasons why the State is likely to need additional revenues, including the length of the current business cycle (pointing out that it is only a matter of time before there is another economic contraction) and likely cuts in federal government support, particularly for Medicaid.

[18] PFM Group Consulting LLC (November 14, 2017), *Op. cit*., page 124.

4 COMPARING THE LEVEL AND DISTRIBUTION OF TAX BURDENS IN THE VARIOUS STATES

In this section, we compare the burden of state and local taxes in Hawaii with those in other states. We also compare how the tax burdens are distributed among income classes in Hawaii and in the other states.

4.1 The Level of State and Local Taxes in Hawaii Compared with Other States

In comparisons with other states, Hawaii consistently shows up as having a high burden of state taxes, whether the burden is measured per person or as a share of income. But an important reason for this result is that in Hawaii, the State funds primary education, which is funded mainly by local governments in most other states. In fact, the state tax revenue as a share of the total tax revenues of state and local governments combined is higher for Hawaii than for any other state.[19]

Looking at the total of state and local taxes combined, the burden per person or as a share of income is still high for Hawaii when compared with other states.[20] However, a substantial part of the state and local tax burden in Hawaii is borne by nonresidents, mainly tourists. If one looks at the tax burden on a typical resident family, Hawaii ranks low (in the bottom 20 percent), primarily because property taxes in Hawaii are low.[21]

[19] See Colby (September 2017), *Op. cit*., page 2.

[20] See PFM Group Consulting LLC (November 14, 2017), *Op. cit*., pages 54-5.

[21] *Ibid*, pages 55-6.

4.2 The Distribution of the Burden of Hawaii's Taxes by Income Class

As shown in Table 3, the GET by itself is regressive, but the individual income tax is progressive, so overall the burden of the State's taxes is distributed in a mildly progressive fashion in the lowest income categories (from $25,000 to $50,000), after which the overall State tax burden grows approximately in proportion to income.

TABLE 3 - ESTIMATED BURDENS OF MAJOR STATE TAXES FOR A FAMILY OF THREE, BY INCOME LEVEL

	Household Income Level				
Tax Type	**$25,000**	**$50,000**	**$75,000**	**$100,000**	**$150,000**
GET	$1,281	$1,847	$2,184	$2,598	$3,219
Percent of Income	5.1%	3.7%	2.9%	2.6%	2.2%
Individual Income Tax	$0	$1,858	$3,413	$4,951	$8,499
Percent of Income	0.0%	3.7%	4.6%	5.0%	5.7%
Auto Taxes	$200	$210	$295	$372	$375
Percent of Income	0.8%	0.4%	0.4%	0.4%	0.3%
Total Tax Burden	$1,481	$3,915	$5,892	$7,921	$12,094
Percent of Income	5.9%	7.8%	7.9%	7.9%	8.1%

Notes: Based on data for 2015, but adjusted to include the effects of the State's Earned Income Tax Credit, which was established by Act 17, SLH 2017.
Source: PFM Group Consulting LLC (November 14, 2017), *Op. cit.*, page 48.

4.3 The Distribution the State Tax Burdens in Hawaii Compared with Other States

It is hard to make objective statements about whether the burden of Hawaii's taxes is distributed fairly, but the study by the PFM Group offers some interesting comparisons with other states. They looked at how the average effective rate of tax for all state and local taxes changes as income rises for the biggest city in each state. They found that Honolulu was tied for eleventh place in the nation for most progressive tax structure as income rose from $25,000 to $100,000, and in eleventh place as income rose from $100,000 to $150,000. They conclude:

> *In sum, Hawaii's tax system is mildly progressive. This results mainly from the state's highly progressive individual income tax, partially offset by the very regressive GET. Although the progressivity of Hawaii's system is modest, it is significantly more progressive than other states. In the aggregate, wealthier households tend to pay higher effective tax rates than is the norm in the rest of the country.*[22]

5 TAX REVIEW COMMISSION RECOMMENDATIONS

5.1 Net Income Tax Recommendations

5.1.1 Modernize the individual income tax by increasing the personal exemption and standard deduction. Alter the tax rates and tax brackets to make the modernization revenue neutral. Index the new tax structure for inflation in subsequent years.

<u>*Discussion*</u>

The standard deduction and personal exemption in Hawaii's individual income tax have been eroded over time by inflation and are now outdated. For example, for tax year 2017, for a married couple with one child, Hawaii's standard deduction and personal exemption added up to $7,872. The federal standard deduction and personal exemption for the family added up to $24,850. According to the poverty guidelines issued by the U.S. Department of Health and Human services, the poverty level for a family of three in Hawaii was $23,480.

[22] PFM Group Consulting LLC (November 14, 2017), *Op. cit*., page 57.

Hawaii provides refundable tax credits (the earned income tax credit, the food/excise tax credit and the low-income renters' tax credit) that eliminate the State's income tax for many low-income households. However, there are still instances where people below the poverty threshold are required to pay the tax. An income tax should exempt income below the level deemed required for essential needs. We believe the best way to do this would be to adopt the federal standard deduction and personal exemption for tax year 2017, indexed for inflation in subsequent years. To offset the revenue cost of these changes, we propose changing the tax rates and brackets, and perhaps adjusting some tax credits. The new tax should also have fewer tax brackets.[23] The standard deduction, personal exemption and tax brackets should be indexed for inflation after 2017, so that inflation does not cause the new tax adjustments to become outdated. The proposed income tax modernization would simplify tax administration, as many taxpayers would be exempt from filing a Hawaii income tax return.

The first step in the effort to modernize Hawaii's income tax would be to ask the Department of Taxation's Office of Tax Research and Planning to provide various options from which the Legislature may choose. In assessing the revenue consequences of the proposed tax changes, the effects on wage withholding should be taken into account. Owing to wage withholding, collections of Hawaii's individual income tax typically are greater than the amount of liabilities reported on the income tax returns.

[23] Hawaii's individual income tax has more income brackets than the tax of any other state. See Colby (September 2017), *Op. cit.*, page 24.

5.1.2 Tax Retirement Incomes More Evenly.

Discussion

Retirement income is taxed unevenly by the State of Hawaii.[24] Under current law, Hawaii exempts social security payments and income from employer-provided pensions from the individual income tax, but taxes income from deferred compensation plans whereby taxpayers voluntarily set aside part of their earnings for retirement. The TRC recommends that the Legislature conform to the federal tax treatment of social security income and also conform to the federal treatment of employer-provided pensions, after allowing a deduction for income attributable to employee contributions that were subject to state or municipal taxes. To lessen the burden of the tax change on current retirees, the TRC recommends that it be enacted with a lag, taking effect five years after its enactment in order to give people time to plan for the change.

The TRC recommends this approach, rather than exempting all retirement income up to a base amount per year, because it helps the State meet the goal of tax adequacy. The 2001-2003 Tax Review Commission also recommended taxing all retirement income equally, but with a delayed phase-in period and only after careful study. The 2005–2007 Tax Review Commission also recommended that Hawaii tax employer-provided pensions, but suggested excluding an annual base amount (e.g. $50,000) to ameliorate the

[24] For a comparison of how Hawaii and other states tax retirement income, see PFM Group Consulting (November 14, 2017), *Op. cit*., page 102.

effect of the change on individuals who had planned their retirement assuming the current law exemption would continue.

5.1.3 Allow corporations to expense new investment when calculating the corporate income tax liability.

<u>Discussion</u>

Eliminating Hawaii's corporate income tax could improve Hawaii's reputation as a business-friendly state and attract new corporate investment to Hawaii, which could provide benefits to residents in the form of higher wages for workers and lower prices for consumers. However, as explained in the background study, setting the statutory corporate income tax rates to zero would likely create substantial transfers of income from residents to nonresidents (including the federal government and nonresident shareholders) that would probably outweigh the long-run benefits to residents of greater corporate investments.[25] Allowing C-corporations to expense new investments, instead of requiring them to depreciate the investments over their economic lives, would bring the same advantages in attracting new corporate investment as setting the statutory tax rates to zero, but would avoid the income transfers from residents to nonresidents.

Recent tax reforms at the national level allow corporations to expense new investments. We recommend that Hawaii conform to this provision in the new federal tax law. We realize that the tax change will cost revenue in the short run, but believe it is a

[25] See Donald J. Rousslang and Yvonne Chow (November 6, 2017), "Should Hawaii Tax Corporate Income? A Cost-Benefit Analysis," report prepared for the 2015-2017 Tax Review Commission (November 6, 2017), pages 17-28.

better way to encourage economic growth and development than tax credits targeted to specific industries or activities.

5.2 Recommendations Related to Revenue Adequacy

5.2.1 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.

<u>*Discussion*</u>

E-commerce and other remote sales are growing in importance.[26] When such sales escape the GET, they enjoy an unfair advantage competing with taxed sales. The failure to collect the tax, either because the seller fails to collect and remit the GET or because the buyer fails to remit use tax, may also lead to significant revenue losses.[27] Hawaii should adopt a mandatory reporting requirement for retailers when their sales exceed $100,000, similar to measures that have been adopted by some other states (Colorado, Vermont and Louisiana) and to the measures that were considered by Hawaii's Legislature in 2017 (Senate Bill 620 and House Bill 345).

[26] E-commerce sales have grown from about 3.5 percent of total retail sales in 2008 to about 9.0 percent in 2017 in the second quarter of 2017. See U.S. Census Bureau, "Quarterly Retail E-Commerce Sales," available at https://www2.census.gov/retail/releases/historical/ecomm/17q2.pdf.

[27] See PFM Group Consulting LLC (November 14, 2017) *Op. cit*., pages 110-111.

5.2.2 Tax e-cigarettes at a rate equivalent to the tax on regular tobacco cigarettes.

Discussion

Hawaii should tax so-called e-cigarettes (or more accurately e-liquid, the cartridges used in such devices) at a rate equivalent to the tax on regular tobacco cigarettes. Although the science on the effects of vapor from e-cigarettes is not yet settled, the Commission does not believe there is sufficient reason to encourage their use as a substitute for smoking regular tobacco cigarettes by taxing one and not the other. The revenue from the tax on e-cigarettes could be used to augment the funds from the current tax on cigarettes that go toward cancer research and community health, as well as provide revenue for the State's General Fund. Partly owing to shifts by smokers to e-cigarettes, collections from the cigarette and tobacco tax have declined in recent years, from $143 million in fiscal year 2011 to only $124 million in fiscal year 2017. It is estimated that taxing e-liquid at 95 percent of the wholesale price would yield about $4.5 million annually.[28] The amount would grow as popularity and consumption of e-cigarettes increases.

5.2.3 Establish a "Simpson-Bowles" Commission to examine the unfunded and underfunded liabilities for health care and pension benefits for retired state workers, including measures to raise revenues and to reduce expenditures.

Discussion

The TRC reiterates the recommendation from the previous (2010-13) TRC that the State create a task force mandated to recommend an overall strategy for addressing

[28] See PFM Group Consulting LLC (November 14, 2107), *Op. cit*., page 91.

Hawaii's likely substantial upcoming budget shortfalls through an integrated broad strategy involving both revenue enhancement *and* spending adjustments. The TRC is not empowered to make recommendations related to expenditures, but we believe the budgetary challenge raised by government retiree health care obligations – despite some progress made by the State since the last Commission – remains large enough that expenditure reductions must also be considered in a systematic way.

The 2010-13 TRC's concluding statement, echoed here by this TRC, was as follows:

> *The TRC believes that, given the magnitude of the projected budget shortfall, policy makers should give serious consideration to establishing a commission similar to the National Commission on Fiscal Responsibility and Reform (also known as the "Simpson-Bowles Commission"), which was created at the federal level. Such a commission, with its singular focus, will provide a "drill down" study and recommendations that should be of great value to policy makers.*[29]

5.3 Recommended In-Depth Studies

Owing to constraints on our resources, we were unable to come up with recommendations on some issues that we nevertheless believe deserve consideration. In particular, we recommend that in-depth studies be commissioned on the following measures.

[29] Report of the 2010-2013 Tax Review Commission (November 28, 2012), *Op. cit.*, pages 4-7.

5.3.1 The Legislature should commission an in-depth study on instituting a carbon tax for the State of Hawaii.

Discussion

The largest potential new revenue source listed in the report by the PFM Group is a carbon tax for the State of Hawaii.[30] Currently, other states and some regions have regulated greenhouse gas emissions, yet none have implemented a full carbon or greenhouse gas emission tax.[31] Hawaii could be a leader in this arena and help pave the way for other states. The TRC recommends that the Legislature commission a comprehensive study of a carbon tax and related revenue sources with an organization that is experienced in the areas of energy and the environment, or work with such an organization that independently conducts such a study. The TRC recommends that the commissioned study include the following elements:

1. Overall impact on Hawaii's goals: An assessment of how the carbon tax would interact with, support, change or complement other State of Hawaii goals and laws.

2. Revenue allocation: An assessment of how the revenue from the carbon tax should be used. The TRC recognizes that a carbon tax could increase the cost of electricity and fuel for consumers in the near term, but part of the revenue

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[30] PFM Group Consulting LLC (November 14, 2017), *Op. cit*., pages 88–9.

[31] Jason Bardoff and John Larsen, "U.S. Carbon Tax Design: Options and Implications," Columbia SIPA Center on Global Energy Policy (January 16, 2018). Available at http://energypolicy.columbia.edu/research/report/us-carbon-tax-design-options-and-implications.

from the tax could be returned to residents as dividends to offset the cost increases, while continuing to ensure that polluters pay.

3. <u>Scope of coverage</u>: An assessment of which sectors and which carbon/greenhouse gases would be taxed, and of the amount of Hawaii's total carbon/greenhouse gas emissions that would be taxed.

4. <u>Point of taxation</u>: An assessment of whether the carbon tax should be applied in the same manner as Hawaii's barrel tax, or in a different way. The tax could be applied at the point of import, at the point of fuel consumption, or at a point in between. Reporting requirements and administrative burdens should be considered when assessing the options.

5. <u>Tax rate</u>: An assessment of how much the tax should be to meaningfully impact behavior and investment decisions, and an assessment of the method for setting the tax rate.

6. <u>Recommendations for implementation</u>: The study should provide recommendations for how Hawaii's carbon tax should be structured and for how it should be implemented.

5.3.2 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.

Discussion

Hawaii currently withholds 5 percent of the gross sales price when a nonresident sells his or her real property in Hawaii. The withholding is mainly designed to make sure that nonresidents pay Hawaii income tax on any capital gains that are due on the sale. The maximum rate of tax is 7.25 percent on long-term capital gains and 11 percent on short-term capital gains, whereas the HARPTA withholding is 5 percent of the gross selling price. It is therefore possible for the income tax liability to exceed the HARPTA withholding, particularly in cases where the property has been depreciated over a long period of and the taxpayer has little basis. Furthermore in some cases, the nonresident seller may have been renting the property and neglected to pay TAT and GET on the rental income. In such cases, the HARPTA withholding can be insufficient to cover the tax liability. An increase in the rate of HARPTA withholding to 9 percent (which was the rate in the original legislation)[32] would reduce such occurrences.

[32] Act 213, SLH 1990. The rate of withholding was reduced to 5 percent by Act 279, SLH 1991.

5.3.3 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.

Discussion

Efforts to educate taxpayers about their tax obligations may provide greater tax revenue and at the same time improve services to taxpayers. For example, a substantial number of nonresidents own property in Hawaii[33] and many of them are unaware of their obligations to pay Hawaii taxes on rental income, such as the GET and the TAT. Often, the nonresident property owners only become aware of their Hawaii tax obligations when they try to sell the property, or when they learn by chance of their GET and TAT liabilities and are suddenly faced with potential multi-year filing obligations, and with penalties and interest on top of the underlying tax liability. Also, many providers of transient accommodations, both residents and nonresidents, are not aware that mandatory resort fees are subject to the TAT. The Department should study whether it would be cost effective to devote more resources to educating the public about their tax responsibilities.

[33] See Department of Business, Economic Development and Tourism, "An Analysis of Real Property Tax in Hawaii" (March, 2017) for estimates of nonresident ownership of real property in Hawaii.