REPORT OF THE

2020 – 2022 TAX REVIEW COMMISSION

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December 20, 2021

To the Honorable Members of the Thirty-First Legislature:

We are pleased to submit the report of the 2020-2022 Tax Review Commission. The report presents the results of our review of the State of Hawai'i's tax system. We are submitting this report in accordance with Article VII, Section 3 of the Hawai'i State Constitution and Chapter 232E of the Hawai'i Revised Statutes.

This report represents the agreement of the entire Commission. The recommendations were reached through compromise and consensus. Each member supports the set of recommendations as a whole. We are proud of the work we have done and ask that our recommendations be accepted by the Legislature and considered when developing tax policy.

Respectfully submitted,

TAX REVIEW COMMISSION

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EXECUTIVE SUMMARY

We, the members of the 2020-2022 Tax Review Commission convened and completed our work during the COVID-19 pandemic, a period in which many norms and expectations were disrupted. The State's visitor-dependent economy came to a months-long stand-still. Hawaiʻi suffered unprecedented levels of unemployment, and many businesses were permanently shuttered. Although State tax collections dropped dramatically, federal funds provided substantial relief and prevented major government cutbacks. Additional concerns for the future wellbeing of Hawaiʻi that were not directly related to the pandemic included more urgent evidence of the effects of environmental change and global warming, and steeply rising housing costs and inflation that laid bare the stark challenges that low- and middle-income residents face in everyday living. With this sobering backdrop, we considered forward-focused tax issues intended to address Hawaiʻi's changing conditions and emerging needs, including climate change, meeting future obligations, and increasing tax equity and transparency.

Our Recommendations

1. Impose a carbon tax to incentivize moving away from carbon-based fuels and adopting clean energy. We recommend that the majority of the proceeds be rebated as a cashback to the residents of Hawaiʻi, with a disproportionate distribution to low-income households.

2. Develop resources to support a long-term commitment to invest in environmental restoration and protection. We recommend that the Legislature fund development of an implementation plan to collect environmental impact fees and put the plan into practice with all deliberate speed.

3. Ensure that taxpayers comply with requirements and pay the taxes they owe. We recommend that the State maintain and increase as needed its investment in Department of Taxation staff and systems to enhance compliance.

4. Assess and plan for emerging and unfunded government investment needs, and coordinate State and county responsibilities. We recommend the establishment of a Committee on Fiscal Responsibility and Sustainable Government Spending to assist with this task.

5. Increase tax equity and adequacy by taxing defined benefit pension income to the same extent that defined contribution retirement income is taxed. We recommend that the first $25,000 in pension income be exempt from taxation for the next 25 years, but fully taxed thereafter. We further recommend that employee contributions to pension plans be tax deductible.

6. Modernize the State's income tax system and reduce its burden on lower-income taxpayers. We recommend increasing the standard deduction to $3,000 and indexing it to inflation, indexing the personal exemption to inflation, and indexing the individual income tax brackets to inflation.

7. Reduce the complexity of the tax system by eliminating outdated and irrelevant general excise tax exemptions. We recommend repealing three specific little-used exemptions, and note that the Auditor's Office or other analysis may reveal other unused exemptions that should be repealed when identified.

8. Increase the transparency of Hawai‘i's tax system by identifying taxpayers who receive certain tax credits. We recommend that all income tax credits intended to provide business incentives require public disclosure of the name of the claimant and amount of the credit.

Balancing Tax Adequacy with Purpose, Equity and Progressive Change

It was our explicit intention to present our recommendations as an integrated whole that achieves its purposes without sacrificing revenues. For instance, reducing greenhouse gases and imposing environmental impact fees should neither reduce revenues nor increase the tax burden for lower-income taxpayers. Increasing equity in taxing pensions should be mitigated by exempting $25,000 in income and making contributions tax deductible. Linking the standard deduction, personal exemption, and tax brackets to inflation enhances the progressivity of our income taxes, but resulting revenue decreases are offset by revenue enhancements from a new carbon tax and imposing income taxes on pensions of more than $25,000.

The table below provides revenue estimates of each of our recommendations.

General Fund Revenue Estimates ($ millions)

Recommendation:	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 10**
Impose Carbon Tax w/80% Cashback*	92.8	94.4	96.0	97.6	99.2	107.2
Study Environmental Impact Fees	0	0	0	0	0	0
Assess and Enhance DOTAX Budget	0	0	0	0	0	0
Form Committee on Long-Term Fiscal Sustainability	0	0	0	0	0	0
Levy Income Tax on Pension Income Over $25,000	50.0	52.0	54.1	56.3	58.5	69.5
Index Personal Exemption to Inflation	-2.4	-5.1	-7.9	-10.9	-14.0	-30.5
Increase Std Deduction to $3,000 and Index to Inflation	-15.8	-17.9	-20.1	-22.5	-25	-38.5
Index Individual Income Tax Brackets to Inflation	-10.8	-22.6	-34.5	-45.2	-59.8	-124.8
Eliminate 3 GET Exemptions	0.0	0.0	0.0	0.0	0.0	0.0
Increase Transparency of Business Tax Credits	0.0	0.0	0.0	0.0	0.0	0.0
Total Amount	**113.8**	**100.8**	**87.6**	**75.3**	**58.9**	**-17.1**

*Estimate adapted from *Carbon Pricing Assessment for Hawai'i: Economic and Greenhouse Gas Impacts* (April 2021).

REPORT OF THE 2020-2022 TAX REVIEW COMMISSION

INTRODUCTION

The Role and Authorization of the Tax Review Commission

The Tax Review Commission's role is clear: evaluate the State's tax structure and recommend revenue and tax policy to the Hawaiʻi State Legislature. The Tax Review Commission is then dissolved and reconstituted after five years' time.[1] Chapter 232E, Hawaiʻi Revised Statutes, provides further guidance and directs the Tax Review Commission to systematically review Hawaiʻi's tax structure using standards such as equity and efficiency. The Commission is to dissolve upon the adjournment of the legislative session to which it submits its recommendations.[2]

Unlike previous Tax Review Commissions, the 2020-2022 Tax Review Commission (the Commission) received no further guidance from the Hawaiʻi State Legislature or from the Governor of Hawaiʻi. As such, the Commission had full agency to determine its own agenda and priorities. However, other limitations arose.

Historical Economic Context

For the second time in the span of a decade, the Tax Review Commission found itself convening at a time of historic economic insecurity,[3] this time brought on by the COVID-19 pandemic. Commencement of the Commission's work was greatly delayed, not beginning until late into 2020. Furthermore, due to the uncertainty of the State's revenues, the Commission was not appropriated a budget until mid-2021.[4] Due to the strain on public finance brought on by the COVID-19 pandemic, the Commission faced temptation to focus on short-term responses. However, early in its work the Commission made a firm decision to focus on the future rather than on the immediate crisis.

The effect of the COVID-19 pandemic on Hawaiʻi's revenues was severe. The Department of Taxation's latest annual report reveals total tax collections decreased by 1.7 percent during fiscal year 2019-2020.[5] This may seem like a small number, but given the Council on Revenues' forecast of 4.1 percent general fund growth issued just prior to the pandemic,[6] it is a drastic decrease. The Council on Revenues general fund forecast for fiscal year 2019-2020 was $7.4 billion. Actual general fund collections for fiscal year 2019-2020 were roughly $6.9 billion.[7] $500 million disappeared in the final few months of fiscal year 2019-2020 alone. Fiscal year 2020-2021 was a similar story.

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[1] HAW. CONST., art. VII, § 3.
[2] HAW. REV. STAT. § 232E-2.
[3] TAX REV. COMM'N, REP. OF THE 2010-2013 TAX REV. COMM'N 1-1 (2012).
[4] Historically, Tax Review Commissions receive appropriations and begin work by the summer of the year they are formed. In the case of the current Commission, this would have been the summer of 2020.
[5] HAW. DEP'T OF TAXATION ANN. REP. 2019-2020, at 1 (The 1.7% decrease takes into account the shift of income tax payments into fiscal year 2021 by the due date extension).
[6] COUNCIL ON REVENUES, REP. OF THE COUNCIL ON REVENUES (January 10, 2020) (the Council on Revenues only forecasts general fund revenues; the percentage decrease figure earlier cited includes all tax revenues).
[7] HAW. DEP'T OF TAXATION ANN. REP. 2019-2020, at 3.

The fiscal picture turned around sharply, however. Current collections and the most recent Council on Revenues forecast show a return to 2019 levels of total collections and a return to steady and predictable revenue growth.[8] Table 1 below shows that the Council on Revenues projects the State's general fund revenue to have fully recovered by fiscal year 2022-2023. If actual revenues follow the forecast, by 2023 the general fund will be at the level that it would have been if the pandemic and associated economic disruptions had never happened.

Table 1 – Growth Comparisons Pre- and Post-Pandemic

	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 20-26
1/9/2020 Forecast	$7,434,603	$7,731,987	$7,963,947	$8,202,865	$8,530,980	$8,872,219	$9,227,108	$57,963,709
	4.1%	4.0%	3.0%	3.0%	4.0%	4.0%	4.0%	
	FY 2020	**FY 2021**	**FY 2022**	**FY 2023**	**FY 2024**	**FY 2025**	**FY 2026**	**FY 20-26**
9/09/2021 Forecast	$ 6,694,808	$ 7,250,477	$ 7,707,257	$ 8,477,982.8	$ 8,817,102	$ 9,169,786	$ 9,536,578	$57,653,991
	-6.3%	8.3%	6.3%	10.0%	4.0%	4.0%	4.0%	-1%
Difference	**$ (739,795)**	**$ (481,510)**	**$ (256,690)**	**$ 275,118**	**$ 286,122**	**$ 297,567**	**$ 309,470**	**$ (309,718)**

* The 1/9/2020 COR forecast represents the baseline revenue scenario that existed prior to the pandemic.

On top of this rebound, the American Rescue Plan Act[9] (ARPA) provided for significant transfers of funds to the states, including approximately $2 billion of direct assistance to Hawaiʻi. The funds' allowed use is limited but broad enough to address immediate budget shortfalls.

In this context, the Commission was able to look past the current crisis and toward the future in shaping its report and its recommendations.

THE TAX REVIEW COMMISSION'S METHOD AND CRITERIA

Framing the Activity of the Tax Review Commission

The Commission began with a review of Hawaiʻi's tax system and of the extensive work of previous Tax Review Commissions. The current Commission determined to focus on and recommend a relatively small number of specific policy choices, building on research and recommendations from past Commissions where possible.

Principles of Sound Tax Policy

The Commission has been guided by three primary principles of sound tax policy: equity, efficiency, and adequacy.

Tax equity is a measurement of how tax burdens are distributed. It is often divided into two dimensions: horizontal equity and vertical equity.

Horizontal equity looks at how tax burdens are distributed among taxpayers in similar situations. A guiding principle for taxation is that tax systems should prioritize horizontal equity. A tax system with horizontal equity will tax industries and sectors equally and the same level of income will be taxed at the same rate for all taxpayers. Policy makers sometimes elect to violate horizontal equity by giving tax breaks to certain sectors to encourage incipient industries. While these may be

[8] The Commission is aware that despite the rebound in collections and growth forecasts, the State still lost two years of positive revenue growth.

[9] American Rescue Plan Act of 2021, Pub. L. No. 117-2, 135 Stat. 4 (2021).

effective, they should be applied for a limited duration as they are meant to act merely as a catalyst to economic activities. Significant violations of horizontal equity cause greater distortions within the economy and often lead of inefficient allocation of resources.

Economic theory suggests that horizontal equity should be maintained in tax systems as much as possible. Exemptions emerge when all the costs or benefits of an economic transaction are not captured in the price, which is known as an externality in the economic literature. Thus, there is a strong economic justification to levy additional taxes on things like smoking, alcohol, or carbon because all costs to society are not being captured in the price. To ensure these goods are not being overconsumed, governments often elect to levy an additional tax to ensure that both the private and social costs are incorporated in the final price. By creating a mechanism where all the costs and benefits are represented in the price, it allows the market to operate more efficiently and increase the probability that it will produce the socially desirable outcome.

Tax systems that alter incentives to improve the likelihood that economic markets will produce socially optimal outcomes do not necessarily violate horizontal equity. For example, a tax that taxes "sugary drinks" that are known to contribute to obesity and undesirable health outcomes does not favor one type of drink maker over another. All producers face the same tax structure equally. The producers can elect to continue to make sugary drinks and pay the tax, or they can make low-sugar alternatives and avoid the tax. Similarly, a carbon tax does not directly favor one sector over another. It simply raises the price of products that involve high levels of carbon emissions. As the price of carbon-intensive goods and services increases due to the tax, all industries have the incentive to reduce carbon emissions associated with the production of their goods and services.

Vertical equity measures how the tax burden is distributed along the income spectrum. Regressive tax systems are ones where lower-income taxpayers pay a larger share of taxes relative to their income compared to higher-income taxpayers. Neutral equity implies that all taxpayers, regardless of income level, pay the same proportion of taxes relative to their income. A progressive tax system is one where higher-income taxpayers pay a larger share of taxes relative to their income compared to lower-income taxpayers. These are measurements of the relative, not absolute, distribution of burdens. Thus, it can be the case that even in regressive systems higher-income taxpayers may be paying more taxes than lower-income taxpayers in absolute terms, and yet be paying less as a proportion of their income (i.e., relative terms).

Economic theory provides less guidance when it comes to vertical adequacy. While policy makers must consider the incentive structure created by a tax system as it effects overall economic output, the decision about how much redistribution ought to occur in a tax system is primarily a value judgement. Thus, the level of progressivity that exists in a tax system depends on a society's values and priorities more than on economic theory.

Tax efficiency is a measure of the transaction costs of the tax system. An efficient tax system is simple both for taxpayers and tax administrators. An efficient tax system also minimizes distortions of economic decision making.

Tax adequacy is the ability of the tax system to produce enough revenue to fund government spending. The Commission views tax adequacy as more than a mere principle of sound tax policy.

Tax adequacy is a necessity. If the role of government is acknowledged and respected, and if the needs of our society are to be met,[10] then tax adequacy is of the utmost importance.

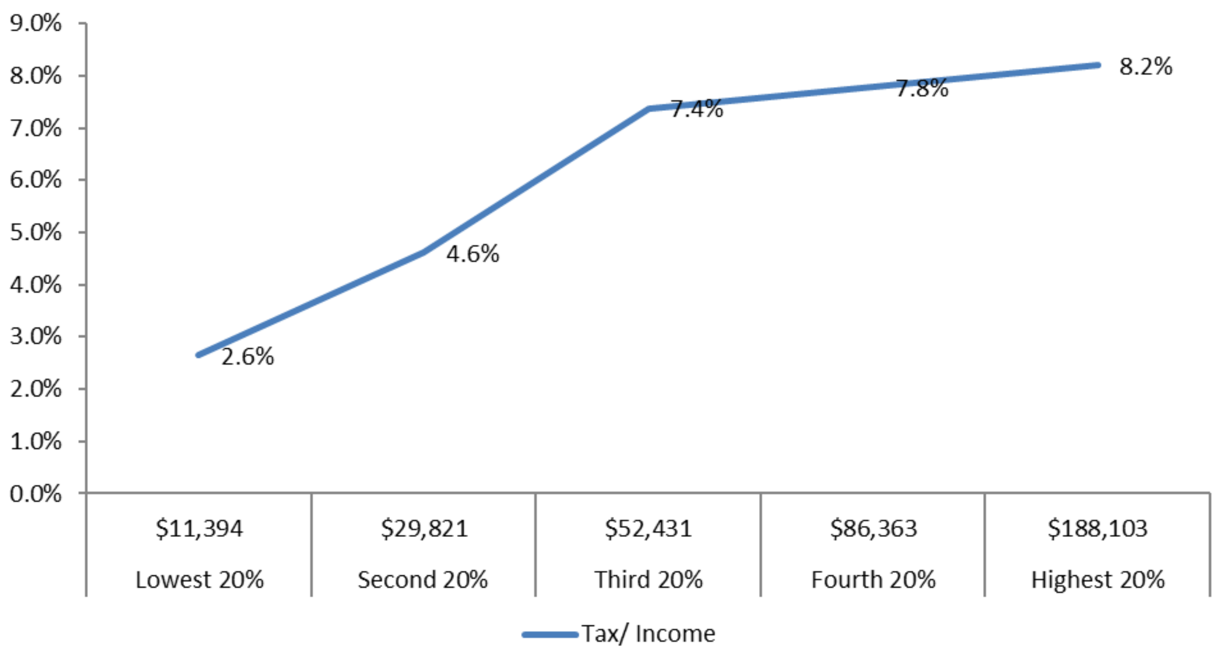
The Commission's vision for and design of its overall package is governed by the principle of tax adequacy. The Commission's specific recommendations are guided by the principles of tax equity and efficiency.

Progressivity of Hawai‘i's Tax System

It is important to evaluate a tax system in its entirety since some taxes will be more regressive or progressive than others. Policy makers often make changes to one type of tax (e.g., adding income tax credits for low-income individuals) to offset perceived regressivity from another type of tax.

Hawai‘i's tax system has both progressive and regressive elements, but it is progressive when considered as a whole. Chart 1 below shows the relative tax burden if all taxes are considered for a family of four across income levels. The chart shows that a family of four in the bottom income quintile pays 2.6 percent of their income in State taxes whereas a family of four in the top income quintile pays 8.2 percent of their income in State taxes. By definition, Hawai'i has a progressive tax system because higher-income households pay a greater share of their income in taxes relative to lower-income households.

Chart 1 – Effective Hawai‘i State Tax Burden by Income Quintile (Family of 4)



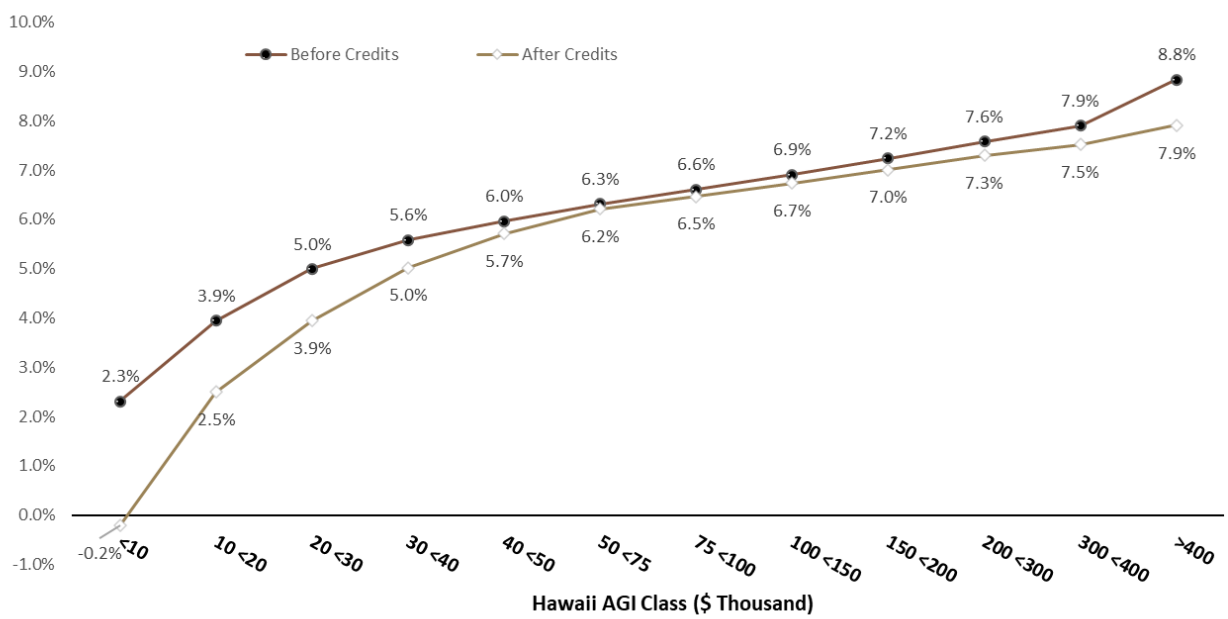
* Provided by Tax Research and Planning, Hawai‘i Department of Taxation.

[10] As mentioned above, the Commission's mandate is clear and limited: to evaluate the State's tax structure and recommend revenue and tax policy to the Hawai‘i State Legislature. The Commission lacks a mandate to consider the State's spending. See recommendation number 4 below.

Hawai‘i's individual income tax is progressive because the percentage of income paid in taxes increases as income increases. Chart 2 below shows the individual income tax by income level and clearly shows an increasing tax burden percentage as income increases.

However, Chart 2 also demonstrates that the lowest-income taxpayers face steeply reduced effective income tax rates, and that the reduction is even steeper after tax credits are considered. After tax credits, the lowest-income taxpayers bear a negative income tax liability, revealing a transfer of resources from the State to these taxpayers.

Chart 2 – Average Effective Income Tax Rates by Income

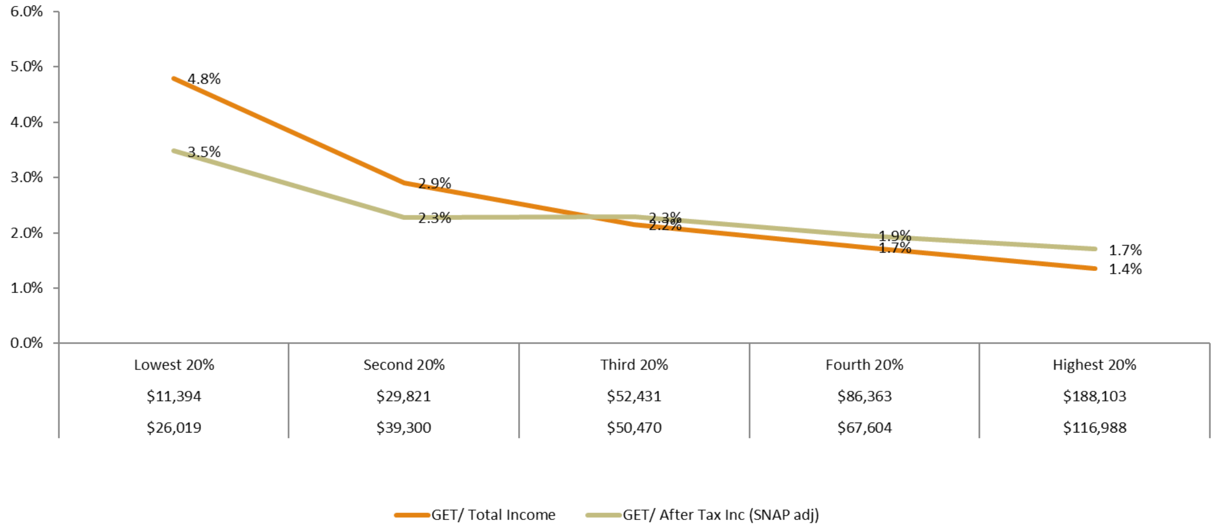


* Provided by Tax Research and Planning, Hawai‘i Department of Taxation.

The general excise tax (GET) is the tax type that generates the greatest amount of revenue for the State,[11] but it has elements of regressivity. Chart 3 below shows a sloping line that goes down and to the right, which is what a regressive tax would look like. The shape is the opposite of the individual income tax shown in Chart 2 above. Even taking into account in-kind transfers, the GET is regressive. One of the major reasons for the regressive nature of the GET is that households at lower-income levels tend to spend a greater share of their income on consumption. In fact, the households at the lowest-income levels tend to consume more than their income. They are able to do this by relying on saving and government transfers. This explains why effective GET tax burden can exceed the actual tax rate of 4.0 percent.

[11] HAW. DEP'T OF TAXATION ANN. REP. 2019-2020, at 4.

Chart 3 – GET Burden by Income and Consumption Quintile



* Provided by Tax Research and Planning, Hawai‘i Department of Taxation.

The differences in the vertical equity of the individual income tax versus the GET highlights the importance of assessing the tax system as whole. Increasing the progressivity of the tax system is easiest to achieve by increasing the progressive nature of the individual income tax, which is easier and less costly than reducing the regressive elements of the GET.

There are two ways to increase progressivity of individual income taxes. One is to raise the tax liability of higher-income taxpayers. The other is to reduce the tax liability of lower-income taxpayers. The former raises revenue; the latter puts money directly into the pockets of the lower-income taxpayers. The Commission chose to focus on the latter method and recommends incremental change to the individual income tax that will increase the progressivity of Hawai‘i's overall tax system.[12]

[12] The Commission's recommendations will empower the lowest-income taxpayers to increase their spending, incurring more GET with unchanged income. It is important to note this change worsens the regressivity of the GET.

THE TAX REVIEW COMMISSION'S RECOMMENDATIONS

1. Impose a Carbon Tax

Finding:	The impact of greenhouse gas emissions in Hawaiʻi is significant, and those who produce them are not bearing the cost.
Recommendation:	Enact a carbon tax that reflects the social cost of carbon. Return 80 percent of the proceeds, other than proceeds from aviation fuel, to households.

Background

Climate change, and the role of greenhouse gas (GHG) emissions in fostering it, cannot be denied. The coming effects of climate change cannot be overstated. The Hawaiʻi Sea Level Rise Vulnerability and Adaptation Report states that expected losses due to climate change are at least $19 billion, and this is solely from sea level rise.[13] That $19 billion figure does not include the cost to fortify, rebuild, or relocate infrastructure.[14] The Hawaiʻi Department of Transportation (HDOT) estimates that as much as 42 percent of the State's total miles of highway are exposed to potential climate change stresses.[15] HDOT has estimated the cost to protect the vulnerable highways and bridgeways at $15 billion, and even this includes only the 15 percent of the State's highways and bridges that HDOT considered immediately vulnerable.[16]

Though moving the needle on global GHG emissions requires large-scale collective action, the Commission believes that Hawaiʻi can and should continue to lead rather than follow. Hawaiʻi has a long history of leading in this regard, through adoption of the 100 percent renewable portfolio standard[17] and committing to the Aloha+ Challenge,[18] among other actions. In addition, the Commission believes the cost associated with carbon should be increased in order to discourage fossil fuel use and GHG emissions in Hawaiʻi.

For the above reasons, the Commission recommends Hawaiʻi become the first U.S. State[19] to adopt a carbon tax specifically designed to reduce carbon dioxide emissions from combustion of fossil fuels.

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13 HIGHWAYS DIVISION, HAW. DEP'T OF TRANSP., HAWAIʻI HIGHWAYS CLIMATE ADAPTATION ACTION PLAN: STRATEGIES FOR A MORE RESILIENT FUTURE 4 (2021).

14 HAWAIʻI CLIMATE CHANGE MITIGATION AND ADAPTATION COMM'N, HAW. DEP'T OF LAND AND NATURAL RESOURCES, HAWAIʻI SEA LEVEL RISE VULNERABILITY AND ADAPTATION REPORT 64 (2017).

15 HIGHWAYS DIVISION, HAW. DEP'T OF TRANSP., *supra* note 13, at 4.

16 Marcel Honore, *A $15 Billion Price Tag to Protect Hawaiʻi Highways from Climate Change*, HONOLULU CIVIL BEAT (April 4, 2018), https://www.civilbeat.org/2018/04/a-15-billion-price-tag-to-protect-hawaii-highways-from-climate-change/.

17 Adopted in 2015 via Act 97, 2015 Haw. Sess. Laws 245, the 100 percent renewable portfolio standard requires all electric utility companies in the State to deliver 100 percent renewable electricity by December 31, 2045.

18 "The Aloha+ Challenge: He Nohona ʻAeʻoia, A Culture of Sustainability," is a commitment to the achievement of various social, economic, and environmental goals by 2030 that has been endorsed by Hawaiʻi's executive, legislative, indigenous, and private sector leadership.

19 Several states have adopted cap and trade systems covering a varying share of overall greenhouse gas emissions.

The previous Tax Review Commission recommended further study of a carbon tax for Hawai‘i.[20] A full study on carbon pricing was commissioned by the Hawai‘i State Legislature in 2019.[21] The current Commission considered the findings of the resulting study[22] and requested targeted updates from the Institute for Sustainability and Resilience and the University of Hawai‘i Economic Research Organization.

The Commission requested three main updates:

(1) The estimated impact on households of various income levels;
(2) The estimated impact of carbon tax cashbacks, or dividends, by income quintile; and
(3) The estimated amount of revenue the State could retain and still make Hawai‘i households whole.

The Commission received the updated study;[23] its findings have been incorporated into the recommended design of a carbon tax below. The full findings of the updated study are included as Appendix A to this report.

Design of a Carbon Tax

First, the carbon tax should be levied as far upstream as possible. This has two benefits. It isolates tax liability in as few taxpayers as possible and it places the tax out of reach of the limits on imposition and allocation of taxes on specific products. For example, federal law requires that revenues from taxing refined aviation fuel be allocated to specific uses.[24] Placing a carbon tax on petroleum products before the product becomes aviation fuel precludes this limitation.

Second, the carbon tax should be measured to reflect the social cost of carbon. The social cost of carbon is the carbon price that forces actors to bear the full private and social costs of GHG emissions.[25] Its measure is an estimate of the economic damage of emitting one additional ton of GHG emissions.[26]

Third, the carbon tax should be designed to mitigate its economic impact on the State. Imposition of a carbon tax has a contractionary impact on the economy.[27] Returning at least a portion of the proceeds of the tax to households mitigates these economic effects.[28] Additionally, returning the proceeds can leave the average household in each income quintile better off economically.[29] The

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[20] TAX REV. COMM'N, REPORT OF THE 2015-2017 TAX REV. COMM'N 25-27 (2018).
[21] Act 122, 2019 Haw. Sess. Laws 443.
[22] MAKENA COFFMAN, PAUL BERNSTEIN, SHERILYN HAYASHIDA, MAJA SCHJERVHEIM, & SUMNER LA CROIX, CARBON PRICING ASSESSMENT FOR HAWAI‘I: ECONOMIC AND GREENHOUSE GAS IMPACTS [hereinafter CARBON PRICING ASSESSMENT] (2021).
[23] MAKENA COFFMAN, PAUL BERNSTEIN, MAJA SCHJERVHEIM, & SUMNER LA CROIX, HAWAI‘I CARBON PRICING STUDY: ADDITIONAL SCENARIOS & ADMINISTRATIVE CONSIDERATIONS [hereinafter CARBON PRICING UPDATE] (2021).
[24] 49 U.S.C. § 47107(b) (2018).
[25] CARBON PRICING ASSESSMENT, *supra* note 22, at 17.
[26] *Id.* at 6.
[27] *Id.* at 53.
[28] *Id*.
[29] CARBON PRICING UPDATE, *supra* note 23, at 25.

expected benefits are steeper for lower-income taxpayers, therefore, returning a portion of the proceeds to households, even in equal shares, makes the carbon tax more progressive.[30]

Fourth, the carbon tax should be designed primarily to disadvantage carbon-intensive activities and not for the purpose of raising revenues. As stated above, significant impact on global GHG emissions takes collective action, and the Commission believes there is value in Hawai‘i taking the lead and setting an example. The carbon tax should be designed to reduce GHG emissions, and therefore should eventually raise no revenue, not due to expiration, but due to obsolescence.

Hawai‘i's Carbon Tax

Basic Design

Given the design considerations above. The Commission recommends a carbon tax of $56 per metric ton of carbon ($56/MT CO_2) be imposed immediately and gradually increased to $79/MT CO_2 over 20 years. The recommended tax rate is based on the social cost of carbon. The modeling received by the Commission assumes an initial tax of $56/MT CO_2 in the first year and a tax of $79/MT CO_2 in the twentieth year.

The Commission recommends returning 80 percent of the carbon tax proceeds to households in equal shares. The mechanism for returning the carbon tax proceeds is termed a "cashback." The remaining 20 percent of carbon tax proceeds should be deposited into the general fund for government expenses.

The Cashback to Households

Returning a portion of the proceeds to households as a cashback can make the carbon tax more progressive[31] and also mitigate its total economic impact.[32] However, the specific design of the cashback requires close consideration of the politics of the carbon tax. The Commission recommends either of two options. Option 1: pay cashback to all households. Option 2: pay cashback to households in the bottom four income quintiles.

Option 1 disadvantages carbon-intensive activities while leaving the average household in all five income quintiles economically better off.[33] This option is also progressive. The progressivity is due to the fact that lower-income households, compared to higher-income households, consume less of the energy-intensive goods and services that drive carbon tax revenue, yet share in the cashback equally.[34]

Option 2 also disadvantages carbon-intensive activities. However, Option 2 compensates only the households in the bottom four income quintiles. Households in the highest income quintile are excluded from the cashback program and are left economically worse off. The advantage of Option 2 is that it is more progressive than Option 1, as restricting cashback to households in the bottom four income quintiles increases the payment each household receives.

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[30] CARBON PRICING ASSESSMENT, *supra* note 22, at 63.
[31] *Id*.
[32] *Id.* at 53.
[33] CARBON PRICING UPDATE, *supra* note 23, at 25.
[34] *Id.* at 23.

The Commission defers to the Legislature to decide between the two options. Ultimately, this decision will depend upon how the Legislature weighs inclusion of all households in the cashback program versus the increase in progressivity brought by restricting the cashback program to households in the bottom four income quintiles.

Though the cashback is to be returned in equal shares across income quintiles, the actual amount of each household's payment could be equal or could be made to vary by household size.[35] This would take into account the expected energy consumption of the average household of a given size. The Commission leaves this sensitive issue to the Hawai‘i State Legislature. However, in any case, the cashback must not be tied to actual household energy usage or GHG emissions.[36] For its purposes, the Commission recommends equal cashback payments across all eligible households.

Mechanism for Returning Cashback to Households

The return of the carbon tax revenue must be on a per household basis and should not leave out any eligible households. The tax administration system is the most obvious method for returning cashback to households. However, the tax administration system may not be the best option to carry out the cashback program because it relies on individual income tax filings.

The issue of individual income tax non-filers, discussed further below,[37] is a major concern if using the tax administration system to return carbon tax revenues. If a taxpayer fails to file a return, there is no way to return that household's portion of the carbon tax revenues.[38] If the tax administration system is used, resources should be devoted to public education and notice to ensure all households file tax returns.[39]

Government Use of Remaining Carbon Tax Revenues

The Commission recommends using the carbon tax primarily to disadvantage carbon-intensive activities rather than as a means to raise money.[40] The carbon tax, at the level recommended, should serve to reduce the amount of GHGs emitted in Hawai‘i. It is not meant to be a perpetual source of revenue. It is meant to do its job to reduce fossil fuel consumption. Thus, by definition, carbon tax revenues will gradually fade away. No agency, project, or set of employees should rely on carbon tax revenues for a budget.

The Commission recommends against earmarking the 20 percent of remaining carbon tax proceeds except to mitigate the effects of climate change. As discussed above, the costs to the State to respond to climate change are immense. The carbon tax revenues alone will not be sufficient but can be a significant start. See recommendation 4 below for more.

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[35] *Id.* at 41.
[36] *Id.*
[37] *See infra* text accompanying notes 60-61.
[38] CARBON PRICING UPDATE, *supra* note 23, at 38.
[39] *Id.* at 39.
[40] *Id.* at 31.

Carbon Tax Revenue Estimate

The Commission's recommendation is expected to generate total revenue of approximately $464 million in the first year, growing to $496 million in the fifth year. Under the Commission's recommendation, 80 percent of this would be returned to households, leaving $92.8 million to be retained by the State in the first year and $99.2 million in the fifth year. Table 2 below summarizes the total carbon tax revenues and the amounts retained by the State.

Table 2 - Revenue Raised and Retained by State Government (in millions)

	Year 1	Year 2	Year 3	Year 4	Year 5
Total Revenue Raised	$464	$472	$480	$488	$496
Revenue Retained by State	$92.8	$94.4	$96.0	$97.6	$99.2

*Estimate adapted from *Carbon Pricing Assessment for Hawai'i: Economic and Greenhouse Gas Impacts* (April 2021).

The annual cashback payments total 80 percent of the total carbon tax revenues. If cashback is paid to all households, each household's cashback payment will equal $744 in the first year. This will grow to $796 in the fifth year. If cashback is paid only to households in the bottom four income quintiles, payments to each household will equal $948 in the first year, growing to $1,009 in the fifth year. Table 3 below summarizes the annual cashback payments made to each Hawaiʻi household.

Table 3 - Annual Cashback per Household

Payments to:	Year 1	Year 2	Year 3	Year 4	Year 5
All Five Quintiles	$744	$757	$770	$783	$796
Bottom Four Quintiles	$948	$964	$980	$996	$1,009

*Estimate adapted from *Carbon Pricing Assessment for Hawai'i: Economic and Greenhouse Gas Impacts* (April 2021).

2. Commit to an Implementation Study to Impose Environmental Impact Fees

Finding:	There is urgent need to address the sustainability of Hawaiʻi's natural ecosystem through statewide initiative. Linking support for Hawaiʻi's natural ecosystem to its use is efficient.
Recommendation:	Commit adequate resources to study and develop a specific design and implementation plan for environmental impact fees that provide sufficient and dedicated revenues in support of conservation and preservation.

Discussion

Hawaiʻi's natural ecosystem is of central importance to not only every resident, but to the State's main industry, tourism. Yet, investments in maintaining and protecting the ecosystem, and repairing damage from overuse, is underfunded in the State's annual operating budgets. The Commission believes that immediate action is needed to support sustainability.

The study commissioned by the 2015-2017 Tax Review Commission estimated that 19 cents of every dollar of GET comes from tourists.[41] With nearly 20 percent of GET revenue coming from tourist activity, and nearly 40 percent of the State's total tax collections coming from the GET,[42] maintaining this industry is critical to Hawai‘i’s long-term tax adequacy.

The natural ecosystem drives Hawai‘i’s tourism industry. Conservation International noted in its 2019 report on visitor green fees that surveys of tourists consistently reveal the natural environment (not the weather) to be the prime component of tourist satisfaction.[43] Thus, sourcing revenue to preserve Hawai‘i's natural ecosystem is a matter of importance not only for the natural ecosystem itself but also for maintaining the efficacy of the State's entire tourism industry.

The 2019 Conservation International Report

The Commission finds the 2019 Conservation International report on visitor green fees to be invaluable as a concept study. The report proves the basic feasibility of visitor green fees but makes no specific policy proposals. Instead, the report surveys multiple options and notes that each requires further legal and policy research. The Commission intends that its recommended study start at that point and conduct the necessary legal and policy research. The Commission emphasizes that it is recommending an *implementatio*n study to develop a plan that can be put into action as soon as possible.

Furthermore, the Conservation International report is an environmental call to action, developed and written with nearly exclusive input by environmental interest groups. As such, it lacked the broader scope needed to develop a specific and actionable plan. The Commission intends that its recommended study be based on diverse inputs, come to a firm conclusion, and make a detailed recommendation.

Outline of the Implementation Study

Determining the best way forward was not possible given the Commission’s limited timeframe and resources. Thus, the Commission recommends that a comprehensive study be commissioned to develop a specific recommendation and implementation plan to impose environmental impact fees. It is imperative that the study be designed as an implementation study focused on concrete action in the shortest term.

The Commission recommends the implementation study address:

1. A permanent commitment to environmental protection and restoration. The following structural issues should be considered:
    - The most effective structure, to potentially include a trust and public-private oversight;
    - Safeguards to ensure that funds are used for environmental preservation and mitigation; and
    - Accountability and transparency of the collection and use of the funds.

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[41] TAX REV. COMM'N, REP. OF THE 2015-2017 TAX REV. COMM'N app’x A, at 51 (2018).
[42] HAW. DEP'T OF TAXATION ANN. REP. 2019-2020, at 3.
[43] CONSERVATION INTERNATIONAL ET. AL., GREEN PASSPORT: INNOVATIVE FINANCING SOLUTIONS FOR CONSERVATION IN HAWAI'I 4 (2019).

2. Means of raising green fees, including such possibilities as:
    - Allocating transient accommodations tax (TAT) revenues;
    - Imposing a TAT surcharge;
    - Imposing a GET surcharge for certain tourism-related activities;
    - Imposing fees for entry to selected areas such as parks, harbors, or beaches; or
    - A combination of these or other approaches.
3. Estimating the likely revenue and adequacy of each strategy.
4. Identifying likely associated positives and negatives, including:
    - Legal challenges to different approaches;
    - Potential impact on visitor spending and arrivals; and
    - Other effects on the State's economy.
5. Specific uses for fees collected, such as:
    - Creating a "conservation corps" to rehabilitate and protect vulnerable outdoor spaces such as watershed, forest, and wetland areas;
    - Funding watershed protection and other current responsibilities of the Department of Land and Natural Resources;
    - Educating visitors about protecting the ‘aina and creating opportunities for them to participate in restoration projects; and
    - Offsetting the costs to administer the program, including fee or tax collection processes and public reporting.
6. Opportunities for aggregating efforts of the State and the county governments, the private sector, and environmental non-profits.
7. Timeline and requirements needed for implementation.
8. Identification of public agencies and their responsibilities.
9. Specific legislative language recommended to initiate and implement an environmental impact fee program.

3. Invest in the Department of Taxation

Finding:	The Department of Taxation collects the revenue that keeps the State running. Reducing the resources of the Department of Taxation as a means of fiscal austerity is counterproductive.
Recommendation:	Assess the Department of Taxation's operational needs. Enhance the Department of Taxation's budget as needed.

Discussion

As discussed above, the Commission considers tax adequacy a necessity. An oft-overlooked concept impacting tax adequacy is growth. The growth of the economy is more important to long-term tax adequacy than any increase in tax rates or tax base. Therefore, the structure of the tax system must encourage economic growth. However, growth is useless for tax adequacy if not matched by corresponding growth of tax collections. Tax administration must capture a steady share of the economy as growth occurs.

Pro-growth policies, as such, are outside the scope of the Commission's work. However, the Commission recommends ensuring that any growth that does occur is matched by tax collections that keep pace. This can be challenging as periods of growth are often periods of innovation. Innovative business models from Airbnb to Turo present novel policy and compliance issues for tax agencies. Ensuring tax collection paces economic growth will require the Department of Taxation (Department) to keep up with the economy. Investment in the Department's personnel as well as its technology is critical.

The Department stated that many of its positions are technical and require specific background and considerable training. The Department stated that for this reason an immediate increase to its budget for staffing may not have an immediate effect. The Department stated that merely ensuring that the Department can continuously recruit and hire well-qualified candidates to fill vacancies even during a general hiring freeze would be greatly effective.

The Department estimates that an additional compliance employee with an annual cost of roughly $70,000 would generate between $2 million and $3 million dollars in additional revenue. This is obviously subject to the law of diminishing returns, and drawing that line is important.[44] However, the Department stated its current staffing is far below the previous equilibrium level, and it is confident additional staffing would provide a net revenue gain. For these reasons, the Commission recommends that the Department's compliance and enforcement functions be bolstered. The Commission recommends that the needs of the compliance and enforcement functions be assessed and any unmet needs be funded.

The Commission also notes that tax compliance is not only a matter of auditing and assessing taxpayers, but also a matter of taxpayers complying voluntarily. Tax collections driven by audit and assessment total only 4 percent of total collections.[45] The remainder of the Department's collections are paid routinely. The Commission believes that while the 4 percent of coerced collection is important to deter tax cheats, the other 96 percent proves that the most efficient collection is through voluntary compliance.

Many taxpayers are willing and ready to file returns and voluntarily pay taxes, but in times of innovation and rapid growth find themselves in new and developing industries where their liabilities are not clearly defined. Timely and fair guidance on new and novel tax issues will encourage voluntary compliance among the high-growth, high-innovation industries that are so often the target of audit and assessment initiatives. For this reason, the Commission recommends the Department's policy and rulemaking functions be assessed and any unmet needs be funded.

Finally, the Commission recognizes the Department has only recently upgraded its computer system. The Commission recommends that similar reinvestment be made to ensure long-term competency and adequacy of the Department's operations.

[44] The Commission does not have an estimate for this. In the Department's estimate, at the current staffing level, the marginal return justifies additional compliance staff.
[45] HAW. DEP'T OF TAXATION ANN. REP. 2019-2020, at 40.

4. Create a Committee on Fiscal Responsibility and Sustainable Government Spending

Finding:	Hawaiʻi must assess its expenditures if long-term fiscal sustainability is to be achieved.
Recommendation:	Form, fund, and empower a committee to recommend detailed plans for long-term control and sustainability of State and county government revenue and spending.

Discussion

The National Commission on Fiscal Responsibility and Reform, also known as the Simpson-Bowles Commission, was formed in 2010 to identify ways to improve the United States' medium- and long-term fiscal strength. The Commission believes a similar exercise would benefit Hawaiʻi.

Although Simpson-Bowles was focused on deficit reduction, the State of Hawaiʻi balances its budget, so there is no deficit to reduce. In addition, the recently passed American Rescue Plan Act[46] and Infrastructure Investment and Jobs Act[47] are expected to bring billions in federal spending to Hawaiʻi. Nonetheless, the Commission believes the State's spending plans and priorities should be reviewed.

The Commission's mandate is limited to the State's tax structure and revenues; it does not extend to spending or to county tax structure. However, the Commission believes a focus on properly defining the required spending side of the equation is imperative.

The Commission thus recommends a dual-objective commission, the "Committee on Fiscal Responsibility and Sustainable Government Spending," or "Spending Committee." Moreover, in order to meet its dual objectives, the Spending Committee should evaluate the revenue potential and spending needs of the counties as well as the State and identify opportunities to coordinate and enhance resources by working together.

State and County Responsibilities

The dynamic between the State and the counties is unique in Hawaiʻi. Public services are heavily centralized, as is the power of taxation. However, the counties hold power over the tax type with the most potential to generate significant additional revenue, the real property tax. The Hawaiʻi State Constitution delegates exclusive control of real property taxation to the counties.[48]

Given this, the Commission believes that close collaboration between the State and the counties is necessary to an appropriate design and adequate level of tax revenue and spending. Government services are provided at both the State and county levels. Both the State and the counties should have adequate autonomy in terms of revenue generation and service provision. In addition, the Commission believes a truly adequate tax system must take account of real property taxes.

[46] American Rescue Plan Act of 2021, Pub. L. No. 117-2, 135 Stat. 4 (2021).
[47] Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, 135 Stat. 429 (2021).
[48] HAW. CONST., art. VIII, § 3.

Ensuring availability of affordable housing through infrastructure development and construction is another crucial objective for the State and the counties. The Commission recommends the Spending Committee assist the State and the counties in identifying and coordinating the resources and responsibilities needed to meet the complex process of developing affordable housing. The Spending Commission can assist in identification of buildable public land, streamlining and coordinating building authorities and contracts, accruing resources through taxation and bond financing, imposing needed restrictions, and other relevant aspects of this long-term process.

The Commission recommends the Spending Committee assess the distribution of government responsibilities between the State and the counties. The Commission further recommends the Spending Committee assess the distribution of taxation authority between the State and the counties.

Unfunded Liabilities
Most states face unfunded liabilities of some form and to some degree. Hawai‘i has one of the largest gaps between dedicated funding and funding needs. The Commission recommends the Spending Committee focus on areas of concern that represent commonly recognized unfunded liabilities as well as some that are less well known. These areas include:

(1) natural disaster preparedness;
(2) public employee healthcare and pension obligations;
(3) maintaining and improving infrastructure; and
(4) promoting economic growth.

Natural disaster preparedness includes accommodation for the effects of climate change. The Commission notes that the Hawai‘i State Legislature has acknowledged that climate change is expected to cost the State at least $19 billion due solely to sea level rise.[49] The Commission recommends the Spending Committee attempt to project the future cost of climate change, particularly that of rising sea levels, and recommend budget options in anticipation of these costs.

Hawai‘i's public employees enjoy vested rights to healthcare and pension benefits. Over the years, liabilities have risen unmatched by resources. Though the State has made significant moves to fully fund these unfunded liabilities,[50] consideration should be given to avoiding incurring more such liabilities. For this reason, the Commission recommends the Spending Committee develop and recommend a long-term financial strategy to prevent accrual of additional unfunded liabilities.

Maintaining and improving State and county infrastructure is critical to the wellbeing and safety of the people of Hawai‘i. It is also closely related to promotion of economic growth. The Commission recommends the Spending Committee consider both statewide and local infrastructure, including water and wastewater systems; air and ocean transportation; and highways, roads, and bridges. The Commission recommends the Spending Committee estimate the cost to maintain and improve Hawai‘i's infrastructure and propose required and dedicated funding sources to cover this cost.

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[49] Act 122, § 1, 2019 Haw. Sess. Laws 443.
[50] *See* Act 268, 2013 Haw. Sess. Laws 794; Act 17, 2017 Haw. Sess. Laws. 62.

Lastly, the Commission believes the Infrastructure Investment and Jobs Act[51] is a critical opportunity to fund infrastructure improvements that will last generations. The Commission recommends that the Spending Committee be given a role in guiding the usage of expected funding from the Act.

5. Tax All Retirement Income Equitably

Finding:	Hawaiʻi taxation of retirement income is neither fair nor equitable. The exemption of large portions of retirement income impairs tax adequacy.
Recommendation:	Tax pension and other retirement income uniformly. Exempt a base amount of pension income initially. Continue to exempt Social Security benefits from income tax.

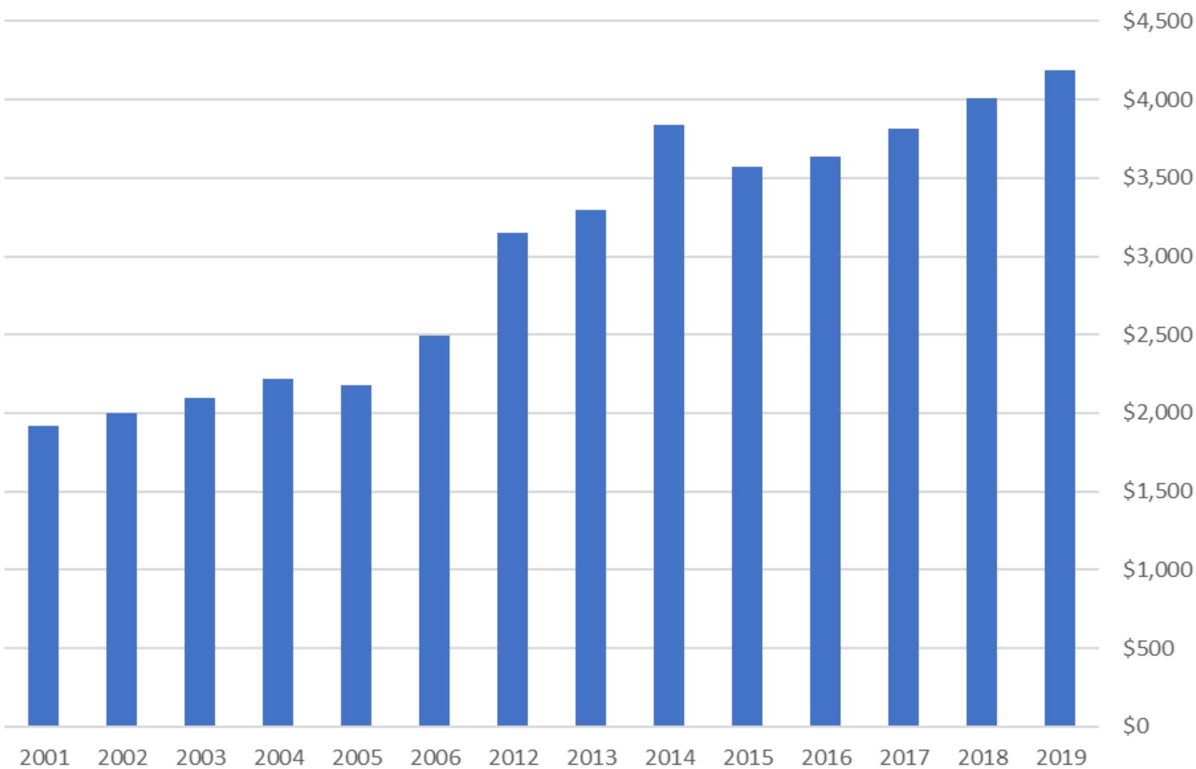
Discussion

Defined-benefit pension income is not subject to Hawaiʻi income tax but defined-contribution retirement income is. There is no economic justification for this. The Commission believes that tax policy and tax equity considerations justify resolving this disparity.

The Commission notes that previous Commissions have stated that untaxed retirement income would shrink in importance as the character of overall retirement income shifts away from defined benefit pensions and toward defined contribution plans.[52] However, the Commission finds that over the past 20 years, the total amount of untaxed retirement income, excluding Social Security, has more than doubled. Chart 4 below demonstrates this trend.

[51] Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, 135 Stat. 429 (2021).
[52] TAX REV. COMM'N, REP. OF THE 2001-2003 TAX REV. COMM'N 16 (2002).

Chart 4 – Tax-Exempt Pension Benefits by Year
(in millions)



* Provided by Tax Research and Planning, Hawai‘i Department of Taxation.

The Commission believes that despite any relative reduction in the share of untaxed retirement income, the growing amount of such income necessitates a change. The Commission believes that rectifying this inequity is important for tax adequacy, as it will raise increasing amounts of additional revenue despite the relative decrease in the importance of untaxed pension income relative to total retirement income.

The Commission recommends immediately imposing a statutory framework to tax retirement income uniformly and give taxpayers clear notice. The Commission recommends taxation be imposed the following year. For previously untaxed contributory pensions, the Commission recommends exempting a base amount of $25,000 per recipient for an additional 25 years.

The Commission's recommendation would do the following:

(1) Tax previously untaxed retirement income.
(2) Allow deductions for contributions to previously untaxed pension plans.
(3) Exempt the first $25,000 of contributory pension income received per recipient for 25 years after taxation of pensions begins.

Justification and Further Detail

The 2001-2003 Commission recommended that only pensions being drawn after the law change should be subject to tax, along with a phase-in of the taxation itself.[53] The 2005-2007 Commission recommended taxing pensions but only after exempting the first $50,000 received.[54] The 2015-2017 Commission recommended the same but with the allowance of deductions for contributions to previously untaxed pension plans.[55] This Commission agrees with these prior recommendations in principle, but provides its own recommendation in greater detail and with firm revenue estimates.

The Commission's proposal and revenue estimates include the allowance of deductions for currently non-deductible contributions, such as contributions into the State's Employees' Retirement System (ERS). Deductions for ERS and similar contributions would begin immediately.

Current contributors into the ERS and similar systems have not been allowed deductions for their contributions. Due to the lack of deductions for contributions, taxing withdrawals would expose pensioners to double taxation of their retirement principal. If the Commission recommends this, it would be trading one inequity for another. Deductibility of contributions ensures that retirement principal is taxed only once. As stated above, the Commission is making its recommendation to further tax equity.

However, allowing deductions for contributions made after the enactment of the Commission's proposal will offer little relief to an employee that is only a few years from retirement. Such an employee has likely been making non-tax-deductible contributions for many years. As such, taxing their pension would be taxing their retirement principal twice. Accordingly, the Commission proposes a continuing exemption of $25,000 per year per retiree for 25 years. This exemption will ensure that employees who are close to retirement, and therefore receive little relief from the newly allowed deductibility of contributions, will not be taxed twice on their principal. The 25-year period, plus the 1-year notice period, provides a total of 26 years before full implementation. The Commission believes this schedule provides ample notice and opportunity for adjustment.

Finally, the Commission recommends maintaining the current exemption of Social Security benefits. The Commission believes that Social Security benefits provide a needed base of support for some of Hawaiʻi’s most vulnerable citizens. Furthermore, because practically all Hawaiʻi residents will receive Social Security benefits, exempting those benefits raises no issues of horizontal tax equity.

Tax Revenue Details

Equalizing the taxation of retirement income, with a $25,000 per year continuing exemption, will raise $50 million in the first year and an average of $54 million per year for the first five years.

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[53] TAX REV. COMM'N, REP. OF THE 2001-2003 TAX REV. COMM'N 17 (2002).
[54] TAX REV. COMM'N, REP. OF THE 2005-2007 TAX REV. COMM'N 22 (2006).
[55] TAX REV. COMM'N, REP. OF THE 2015-2017 TAX REV. COMM'N 21 (2018).

The Commission did not request a revenue estimate for years after the continuing exemption is repealed. As recommended, the exemption continues for 25 years beyond the date pensions are initially taxed and is therefore too remote to determine a reasonably accurate estimate.

While the Commission does not propose taxing Social Security benefits, the Commission did request a revenue estimate. Taxing Social Security benefits fully would raise an average of $165 million per year for the first five years.

6. Modernize the Standard Deduction, Personal Exemption, and Income Tax Brackets

Finding:	Hawai‘i's individual income tax is progressive, but more can be done. Hawai‘i's standard deduction and personal exemption fail to provide consistent relief.
Recommendation:	Modernize Hawai‘i's individual income tax by increasing the standard deduction to $3,000 and indexing it to inflation, indexing the personal exemption to inflation, and indexing the individual income tax brackets to inflation.

Discussion

Nearly every previous Commission has recommended modernizing the standard deduction and personal exemption. The standard deduction has not been increased since 2013, when it was increased by 10 percent for all filers.[56] The personal exemption, too, has not been increased since 2013, when it was also increased by 10 percent, from $1,040 to $1,144.[57] Neither number is indexed to inflation, nor are the income tax brackets. The Commission is once again recommending adjusting the standard deduction and personal exemption, as well as the income tax brackets.

The Commission believes that increasing the standard deduction will provide needed relief to lower-income taxpayers. As is discussed in greater detail below, the standard deduction is disproportionately claimed by taxpayers with lower incomes. This ensures that though the revenue cost may be high, the benefit will be concentrated among lower-income taxpayers.

Additionally, the Commission believes that adjusting the standard deduction and personal exemption will have greater effect if translated into additional monthly income rather than merely a larger annual tax refund. This requires adjustment of the withholding rates, which are based on the personal exemption. If the personal exemption is increased, withholding will be adjusted accordingly, and more income will be retained by taxpayers. Unlike the standard deduction, the personal exemption is claimed by all taxpayers. Thus, the cost of increasing the personal exemption will not be concentrated among lower-income taxpayers. Nevertheless, the Commission believes that reducing monthly withholding for lower-income taxpayers is worth this cost.

[56] *See* Act 60, 2009 Haw. Sess. Laws 134; Act 97, 2011 Haw. Sess. Laws 256.
[57] *See* Act 60, 2009 Haw. Sess. Laws 134; Act 97, 2011 Haw. Sess. Laws 256.

Hawaiʻi's individual income tax has never contained an inflation adjustment. This is consistent with many states[58] but is still undesirable. Lack of an inflation adjustment creates a more regressive tax system that eventually imposes income taxes on earners well below the poverty line.[59] For these reasons, the Commission recommends indexing the standard deduction, personal exemption, and individual income tax brackets to inflation. Indexing these to inflation will ensure that the real income tax burden will not increase each year as it currently does.

The Problem of the Filing Threshold

Any individual taxpayer whose income is below the filing threshold has no obligation to file an income tax return.[60] Increasing the standard deduction and personal exemption will make the filing threshold higher, increasing the number of taxpayers who will not be required to file a tax return. However, a taxpayer whose income is below the filing threshold may have had income tax withheld from their pay and may be entitled to refundable credits. Such a taxpayer, though not required to file, must file an income tax return to claim these benefits.

The Commission notes that the State collects more individual income tax each year than is reported as tax liability on filed tax returns.[61] A likely explanation for this phenomenon is that many low-income taxpayers have failed to file returns, and thus leave taxes withheld from their wages, in excess of their actual liability, deposited with the State. For this reason, a higher filing threshold may result in more taxpayers not filing and thus forgoing refunds of excess withholding or refundable credits. For these reasons, the Commission believes the filing threshold should be deemphasized and all wage earners encouraged to file returns.

Tax Revenue Details

Increasing the standard deduction to $3,000 will incur an average revenue loss of approximately $20 million per year for the first five years. Indexing the personal exemption to inflation will incur an average revenue loss of approximately $8 million per year for the same period. Indexing the individual income tax brackets to inflation will incur an average revenue loss of $35 million per year for the first five years. Table 4 below summarizes the costs of the Commission's specific recommendation.

Table 4 – Forecasted Cost of the Commission's Recommendation (in millions)

	Increase Standard Deduction to $3,000*	**Index Personal Exemption to Inflation**	**Index Brackets to Inflation**	**Total**
5-Year Average	-$20	-$8	-$35	-$63

*Inclusive of annual inflation adjustment.

[58] DAVID BRUNORI, STATE TAX POLICY: A POLITICAL PERSPECTIVE 91 (3d ed. 2011).
[59] *Id*.
[60] The filing threshold is defined in the instructions to the Form N-11 as the sum of the standard deduction and personal exemption.
[61] *See* HAW. DEP'T OF TAXATION, *Hawaii Individual Income Tax Statistics, Tax Year 2019*, at 5; *see also* HAW. DEP'T OF TAXATION, *State Tax Collections and Distribution Year Ending December 31, 2019* (comparing the total tax liability after credits to the total of tax collections reveals this surplus).

The individual income tax revenue loss is important, but just as important is the distribution of that revenue loss. The standard deduction is used disproportionately by lower-income taxpayers, while higher-income taxpayers are more likely to itemize deductions that exceed the standard deduction. As a result, the benefit of increasing the standard deduction is concentrated among low-income taxpayers.

Moreover, due to the allowance of an itemized deduction for Hawaiʻi income taxes paid,[62] the effect of increasing the standard deduction is even more concentrated in lower-income groups. The required Hawaiʻi income tax withholding on total income of only $77,000 exceeds the standard deduction for joint filers.[63] Thus, many lower-income taxpayers itemize deductions in Hawaiʻi. This further isolates the effect of increasing the standard deduction to Hawaiʻi's lowest-income taxpayers.

The distributive effect of indexing the personal exemption and tax brackets to inflation is much simpler. All taxpayers can claim a personal exemption and will benefit from indexing the tax brackets to inflation. As the withholding rates are based on the personal exemption, lower-income taxpayers will benefit from the adjustment to the personal exemption through reduced withholding. Additionally, large families will benefit to a greater extent than small families from the adjustment of the personal exemption.

The Commission considered several alternatives. The Commission provides estimated revenue costs for alternative scenarios below.

Table 5 – Forecast of Alternative Scenarios (in millions)

	Index Standard Deduction to CPI	**Double Standard Deduction***	**Triple Standard Deduction***	**5x Std Ded No Personal Exemption***
5-Year Average	-$4.46	-$63.31	-$144.20	-$232.94

*Inclusive of annual inflation adjustment.

The Commission recommends increasing the standard deduction to $3,000 over the other options because this will provide immediate relief but allow space for inflation adjustments to both the standard deduction and personal exemption. While immediately doubling, tripling, or quintupling the standard deduction would provide greater immediate relief, it would also cost more, and may preclude allowing for ongoing inflation adjustments.

[62] Per the Form N-11 instructions, taxpayers deduct the amount of Hawaiʻi income taxes withheld, as reported on the Form W-2. The deduction decreases the amount of taxes owed. This reduces the amount of allowable deduction, increasing the amount of taxes owed, which increases the amount of the deduction, which reduces the amount of taxes owed. The wisdom of this circular deduction is a topic for a future Tax Review Commission.

[63] *See* HAW. DEP'T OF TAXATION, *Booklet A: Employer's Tax Guide* 20 (required withholding on $97,000 would exceed the $6,000 standard deduction for joint filers proposed by the Commission).

The Commission is tempering its desire to maximize immediate relief to instead recommend comprehensive, incremental, forward-looking relief. The combination of increasing the standard deduction, indexing both the standard deduction and personal exemption to inflation, and indexing the tax brackets to inflation will provide comprehensive relief that will benefit taxpayers into the future.

7. Repeal Certain General Excise Tax Exemptions

Finding:	Many general excise tax exemptions are outdated and irrelevant or limited in value and insignificant.
Recommendation:	Repeal the general excise tax exemption for blind, deaf, and totally disabled taxpayers. Repeal the general excise tax exemption for independent sugar cane farmers. Use the Office of the Auditor's reports to identify other general excise tax exemptions that no longer provide significant value.

Discussion

Abundant exclusions, exemptions, and credits have been created over the years. Most are designed to promote social welfare, encourage certain industries or economic activities, or avoid double taxation or tax pyramiding.[64] Despite these good intentions, GET exemptions impair tax equity and narrow the tax base. GET exemptions should not be provided lightly.

The Commission recommends the GET exemption for blind, deaf, and totally disabled people be repealed.[65] The $2,000 exemption was established in 1947 and has not increased since. In that same year, legislation that would become section 237-17, Hawai‘i Revised Statutes (HRS), was enacted. That section allowed the same set of taxpayers to pay no more than one percent of their gross revenue in GET. Therefore, in 1947, the value of the $2,000 exemption was $20 (1 percent of $2,000), which is the equivalent of approximately $242 in 2021. Currently, section 237-17, HRS, allows a rate no higher than 0.5 percent. Thus, 75 years after adoption, the annual value of the exemption has shrunk to $10 (0.5 percent of $2,000).

The Commission recommends the GET exemption for amounts received by independent sugar cane farmers be repealed.[66] The State Auditor’s report found that so few taxpayers utilized this exemption that even aggregated data could not be released for risk of identifying the claimants.[67] The Commission believes this exemption benefits so few taxpayers, and likely exempts so little income, that even the admittedly small revenue cost is outweighed by the costs to tax equity.

[64] HAW. DEP'T OF TAXATION, *Tax Credits Claimed by Hawai‘i Taxpayers, Tax year 2018 (January 1, 2018 – December 31, 2018)* Figure 4, at 9 (Sept. 2020).
[65] HAW. REV. STAT. § 237-24(13).
[66] HAW. REV. STAT. § 237-24(14).
[67] HAW. OFFICE OF THE AUDITOR, *Review of General Excise and Use Tax Exemptions and Exclusions Pursuant to Section 23-73, Hawaii Revised Statutes* 29 (Report No. 21-07, Apr. 2021).

The Commission recommends the exemption for amounts received by securities exchanges or exchange members be repealed.[68] According to the State Auditor's report, few taxpayers claim this exemption.[69] The Commission recommends repealing the exemption immediately.

The Commission recommends the simple analysis above be considered for all GET exemptions and other tax incentives as they are reported on by the State Auditor.

8. Increase Transparency of Income Tax Credits

Finding:	Income tax credits provide special benefits to select groups of taxpayers, violating the principle of horizontal equity. The people of Hawaiʻi should know where and how these special incentives are used.
Recommendation:	Require public disclosure of the identity of the claimant and amount of credit claimed for all existing and new business incentive income tax credits.

Discussion

Taxpayers must pay taxes but face no obligation to claim tax credits. As such, the Commission believes the State is justified in abrogating a taxpayer's confidentiality right with respect to tax credit claims. The Commission recommends authorization of disclosure of the amount of the claim and identity of the claimant of any new or existing business incentive income tax credit.

The Commission feels strongly that voluntary compliance is crucial to tax administration, and that voluntary compliance relies in part on confidentiality. Therefore, the Commission strongly suggests that any disclosure be strictly limited to the identity of the claimant and the amount of the tax credit claimed. The disclosure must not reveal additional information about the claimant's underlying business or tax status.

Information to be protected from disclosure includes, but is not limited to:

(1) the business-level details of the credit claim, for example, the specific number of renewable energy systems a taxpayer installed should remain confidential;
(2) how much of a credit claim was used in the current year (except in the aggregate across all taxpayers claiming the credit); and
(3) whether a credit was taken as a refundable or nonrefundable credit if there is an option between the two.

[68] HAW. REV. STAT. § 237-24.5.

[69] HAW. OFFICE OF THE AUDITOR, *Review of General Excise and Use Tax Exemptions and Exclusions* 25 (Report No. 20-09, June 2020).

CONCLUSION

The 2020-2022 Tax Review Commission performed its work during a unique time. The COVID-19 pandemic delayed our commencement and forced us to meet virtually but did not define our work. Fortunately, we were not diverted by the immediate question of 'how does the State recover from the COVID-19 pandemic?' but were instead able to focus on the future.

Our recommendations are a mix of revenue raisers and revenue costs. Overall, we consider our recommendations balanced as a package both in terms of revenue impact and in terms of economic and societal impacts. Several of our recommendations are substantively interrelated. For example, the carbon tax, the recommendation on environmental impact fees, and the recommended Spending Committee all intersect with and complement one another in terms of future tax revenue adequacy and environmental stewardship. Ultimately, we believe our recommendations are balanced, responsible, and achievable as a package.

Table 6 below provides revenue estimates of each of our recommendations.

Table 6 – General Fund Revenue Estimates ($ millions)

Recommendation:	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 10**
Impose Carbon Tax w/80% Cashback*	92.8	94.4	96.0	97.6	99.2	107.2
Study Environmental Impact Fees	0	0	0	0	0	0
Assess and Enhance DOTAX Budget	0	0	0	0	0	0
Form Committee on Long-Term Fiscal Sustainability	0	0	0	0	0	0
Levy Income Tax on Pension Income Over $25,000	50.0	52.0	54.1	56.3	58.5	69.5
Index Personal Exemption to Inflation	-2.4	-5.1	-7.9	-10.9	-14.0	-30.5
Increase Std Deduction to $3,000 and Index to Inflation	-15.8	-17.9	-20.1	-22.5	-25	-38.5
Index Individual Income Tax Brackets to Inflation	-10.8	-22.6	-34.5	-45.2	-59.8	-124.8
Eliminate 3 GET Exemptions	0.0	0.0	0.0	0.0	0.0	0.0
Increase Transparency of Business Tax Credits	0.0	0.0	0.0	0.0	0.0	0.0
Total Amount	**113.8**	**100.8**	**87.6**	**75.3**	**58.9**	**-17.1**

*Estimate adapted from *Carbon Pricing Assessment for Hawai'i: Economic and Greenhouse Gas Impacts* (April 2021).

This concludes the formal report of the 2020-2022 Tax Review Commission. We are honored to have had this task entrusted to us and sincerely hope you find our recommendations useful to your consideration of tax policy.