TAX REVIEW COMMISSION

MINUTES OF THE SEVENTEENTH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT 830 PUNCHBOWL STREET, ROOM 221
IN THE CITY AND COUNTY OF HONOLULU
STATE OF HAWAII, ON FRIDAY, SEPTEMBER 22, 2006

The Commissioners of the Tax Review Commission met at the Department of Taxation, Director Conference Room, in the City and County of Honolulu, State of Hawaii, on Friday, September 22, 2006.

Members Present: Chairman Isaac Choy, Manoa Consulting Group, LLC CPA's
Vice-Chairman Ronald Heller, Torkildson Katz Fonseca Moore & Hetherington, AAL, ALC (arrived late)
Carolyn Ching, Carolyn L. Ching CPA
Christopher Grandy, UH Manoa, Public Administration Program
Melanie King, Bank of Hawaii
Lon Okada, Hawaiian Electric Industries, Inc.
John Roberts, Niwao & Roberts, CPA's

Staff: Tu Duc Pham, Donald Rousslang, Cathleen Tokishi

Other: William Fox, University of Tennessee
Stanley Baptista, DOTAX
Peter Fritz
Craig Hirai, Bowen Hunsaker Hirai
Al Fernandes, KMH LLP
Sean Hao, Honolulu Advertiser
Lowell Kalapa, Tax Foundation of Hawaii
Ray Kamikawa, Chun Kerr Dodd Beaman & Wong
Kurt Kawafuchi, DOTAX
Titin Liem, DOTAX
Michelle Muraoka, DBEDT
Johnell Nakamura, DOTAX
Marilyn Niwao, Niwao & Roberts, CPAs
Tom Smyth, DBEDT
Nicki Thompson, Governor's Policy Office

CALL TO ORDER

Chairman Isaac Choy called the meeting to order at 1:35 p.m. with a quorum present.

ANNOUNCEMENTS

Secretary. Dana Remigio has been assigned to the Director's Office. Ms. Tokishi is handling most of Ms. Remigio's tasks until a replacement can be found, so any communications or correspondence should be directed to her.

Introduction of Dr. William Fox. The Chairman introduced Dr. Fox, the William B. Stokely Distinguished Professor of Business at the University of Tennessee and a recognized authority on state taxation. He added that Dr. Fox had agreed to answer questions on the Streamlined Sales Tax Project after concluding discussions about the draft report of his study for the Tax Review Commission.

PROFESSOR FOX'S SEMINAR PRESENTION

Dr. Fox distributed copies of his PowerPoint presentation on his study, "Hawaii's General Excise Tax: Should the Base Be Changed?"

There are two main questions that he was asked to address in the study: 1) are there any existing general excise tax (GET) exemptions that should be eliminated and 2) are there any existing transactions that should be exempt from the GET.

He first noted that he thinks of the general excise tax as an economist, and therefore considers the GET as a sales tax even though it is a little different. About 1/3 of the states have a tax similar to the GET. Another third are in-between a tax directly on consumers and the GET.

He next emphasized that Hawaii is fortunate in having a tax structure with such a broad base that generates a huge amount of money at such a low tax rate.

Slide 2 shows that states on average generate about 1/3 of their revenue from sales tax, whereas Hawaii generates almost half.

Slide 3 shows that Colorado has a lower state sales tax rate than does Hawaii, and six others are tied with Hawaii at 4%, but with the local sales tax included, Hawaii has the lowest rate.

The reason why Hawaii can have the lowest rate while generating the highest percentage of revenue is shown on slide 4. If you take the tax and measure it against some broad measure of the economy, in this case personal income, the GET base is bigger than the economy (114.9%). The down side is that this means that Hawaii is taxing things more than once; this is the only way you can get a base that is bigger than the economy.

Wyoming (69%) is a distant #2, and Kansas (44.3%) is the median state. What makes the GET unique is more its broad base than its structure.

Slide 5 shows the 4 criteria most economists use to examine a tax system: 1) Economic efficiency – does the GET change the way people behave (e.g., what people buy and from where) and the way businesses operate; 2) Fairness – horizontal equity (when 2 similarly situated taxpayers pay the same tax) and vertical equity (regressiveness or progressiveness of the tax); 3) Low compliance and administrative cost – the money that is used for the collection of taxes is money that is not available for other government functions or for consumers to spend and 4) Revenues – over time, does the GET collect enough money. Based on what the Commission asked, he focused mainly on economic efficiency, fairness, and revenues.

To examine economic efficiency, he divided the issue into 2 kinds of taxable transaction: sales to businesses (B2B) and sales to individuals (B2C).

In slide 6, the $600 million is an estimate from a study he did with Ernst and Young and represents about 28% of all GET revenues. The tax on B2B transactions is the worst form of sales taxes. Several reasons are listed on the slide.

Note that "vertically integrate" means that the business acquires their suppliers and brings them in-house, which may not be the most efficient. Raising the cost of doing business in Hawaii may result in a business relocating to another location; in addition the $600 million paid by businesses in B2B transactions is much higher than the amount of corporate income tax paid. Director Kawafuchi noted that the $600 million figure was about 10 times more than the corporate income tax revenues. Dr. Fox pointed out that it is the GET, and not the corporate income tax, that is the biggest tax on businesses.

The one good thing is that it allows for a lower tax rate, and that is a good thing in and of itself.

However the latest research done in this area concludes that taxing B2B transactions hurts the overall economy. The negative effect of the first three factors is greater than the lower tax rate and hurts the State's economy on net. He would be hesitant, therefore, to eliminate exemptions currently allowed for certain B2B transactions, but that is not his decision to make.

The Chairman asked if there was a point at which a business would vertically integrate. Big businesses may be able to vertically integrate, but Hawaii has 97% small business and it would be more unlikely for smaller businesses to be able to vertically integrate and, as a CPA, he doesn't see it. Dr. Fox said that he was correct, but that there still may be some large businesses here that would be able to do so. He also noted that vertical integration would hurt the small businesses that previously provided those services. It probably is not a major problem in Hawaii, but it is still a factor.

The Chairman then stated that the B2B taxation would primarily affect manufacturing businesses, but that Hawaii mostly has service businesses with very little manufacturing. Dr. Fox noted that it would increase the cost of doing business if, as he read recently, the service is being done for an out-of-State client as it would make the Hawaii business less competitive, and Hawaii does export a lot of services. Several attendees noted that exported services are exempted. However, Dr. Fox pointed out that he was asked, in part, to see what would happen if exported services were no longer exempt.

Mr. Kalapa added to the Chairman's remark about the lack of vertical integration here, stating that it may have been the case long ago during the time of the "Big Five" economy, but no longer. He also noted that the pyramiding relief enacted in 1999 only applies when the services are resold. Services that are consumed, such as accounting services for the business or janitorial services for the building, are still 4%. Warehousing and rent are major businesses expenditures in Hawaii as few have the means to own their own.

On slide 6 with respect to sales taxes on B2C transactions, are the concerns.

With respect to changing how people buy, Mr. Kalapa noted that the price here tends to be higher even though the tax rate may be low. Also, the perceived rate may only be 4%, but the actual rate may be much higher due to pyramiding. Dr. Fox agreed, and added that even with pyramiding, Hawaii's overall rate may be 5-6% range; it is still low compared to other states, especially once you factor in the local option sales tax. There are 21 or 22 states with about a 6% state rate, and 34 states have a local option.

The Chairman asked if pyramiding was a good way to keep rates low. Dr. Fox stated that it wasn't because pyramiding means that B2B transactions are being taxed. It isn't good because (1) it creates incentives for businesses to change their practices to avoid the tax and (2) it raises the cost of doing business in Hawaii, which everything else being equal, discourages operations in Hawaii relative to someplace else that doesn't tax B2B transactions. He also stated that pyramiding wouldn't be so bad if the pyramiding was even; but it is not. It depends on the complexity of what is being made such that the complex item is taxed more highly than the simple item. It therefore encourages the making of simple things in Hawaii – something with few steps. Simply put, make it inexpensive to do business in Hawaii and impose the tax at the consumption level rather than at the production level, or as restated by Mr. Kalapa, exempt overhead costs from the GET.

Returning to the 114.9% figure on slide 4, Mr. Roberts asked if that percentage was a proxy for the inefficiency of the tax; it is not.

Dr. Pham stated that the percentage would be less than 100% if the gross state product were used instead of personal income. Dr. Fox agreed and stated that gross state product might be a better measure for Hawaii although it would still be high. Dr. Pham also asked if it would be better to combine county and state taxes for the comparison given Hawaii's low property tax. Dr. Fox said that it would be important if he had been asked to do more cross-state comparisons. However, that is not the focus of this paper.

Mr. Kalapa recalled that Dr. Fox had used a figure of 144% in his *Price of Paradise* article 12 or so years ago, and asked what accounted for the difference. Dr. Fox isn't sure and would have to revisit that work, but he noted that Hawaii had since narrowed the tax base, citing the exemption of exported services as an example.

Dr. Fox then moved on to slide 8, which lists the exemptions that he was asked to look at for possible elimination. First two are primarily B2C transactions and the rest are B2B. The two for exported goods and exported services/contracting are those that he has the most concern about.

The two primary questions addressed were: (1) what are the revenues associated with these exemptions and (2) what could Hawaii reduce its tax rate to if those exemptions were eliminated.

Slide 9, column 1, shows the revenue to be gained by eliminating the exemption, and the last column reflects the tax rate should the exemption be eliminated.

The question is: Is lowering the tax rate a good thing? He discussed two of these exemptions beginning with nonprofits. He pointed out that 50% is health care and 20% is education. Eliminating this is not politically popular. However, he would look at whether what the nonprofit is doing is in the public interest and define that in some precise way, and only allow the exemption in that case. Illinois and Washington, for example, have done this by legislating that at least 20% or something of their activity must be in the public interest. Research does not indicate that nonprofit hospitals do more charity care than for-profit hospitals, for example. The Commission could, recommend that the exemption remain, but only to the extent that it applies to something that the government would otherwise have to do or that the public is interested in being done.

Regarding exported goods and services, Dr. Fox stated that he couldn't imagine that Hawaii should eliminate those exemptions. First, the GET really is intended as a tax on consumption in Hawaii so why impose it on the production of things that are sold out-of-State. Second, it raises the cost of doing business in Hawaii.

In response to a question from Dr. Pham, Dr. Fox stated that, if the Streamlined Sales and Use Tax Agreement were adopted, Hawaii would not be able to tax those transactions anyway.

With respect to other exemptions such as the hotel wages and subcontract deductions, Dr. Fox stated that eliminating the exemption would merely cause the business to avoid the tax in a different way. Vertical integration would be one way of doing so.

Mr. Heller explained the way that the subcontractor deduction works, and asked if the numbers assume that the eliminating the exemption would result in the subcontractor paying 0.5% GET and the general contractor paying 4% on the total gross. Dr. Fox was not sure and would have to check on that. He does know that they took materials out of the transaction, but he thinks both contractor and subcontractor transactions were taxed at 4%. If so, then the impact would be smaller.

Slide 10 just shows the relative magnitude of those transactions.

Slide 11 lists the three effects on employment that would result from eliminating the exemptions. Dr. Fox cautioned, however, that there isn't very good data to do this kind of analysis. Having said that, slide 12 shows his results. Mr. Kalapa suggested adding to the chart a statement that this assumes that the tax rates are lowered such that the revenues remain neutral. Dr. Fox agreed.

The other major question addressed was what would happen if Hawaii's GET looked like everybody else's sales tax and additional transactions were exempted. Dr. Fox first clarified that there is no "everybody else's sales tax." For instance, 29 states exempt food, 5 have special tax rates on food, 11 states tax food entirely. Utilities are taxed by some states when individuals have utilities but not businesses; others tax utilities when purchased by businesses but not individuals, etc.

However, he took the 7 categories listed on slide 13 that are often treated differently and asked what the impact on the GET would be if you afforded them exemptions. If you made the GET have the same breadth of base as the median state (Kansas), that is, 44% of the economy, how much revenue would you lose if you cut your base by that much? The answer is $1.2 billion. To make up for the revenue loss, the tax rate would have to increase to 10.9%. However, that assumes that people will not change their buying behavior, and they will. Because people will tend shift their buying to more exempt items than taxable items, Dr. Fox estimates that the rate will actually have to increase to almost 12% to remain revenue neutral.

Returning to the seven selected transactions, the tax rate necessary to replace that income is 6.36%; but it would actually have to be more like 6.5% to accommodate changes in behavior. Dr. Fox feels that if this should occur, the economy would be worse off, the tax rate would be higher, and the State would lose jobs. Taking the broad view, this would not be in the best interest of Hawaii, although people in those selected industries would probably support such a change.

The Chairman asked where the professional services data came from. Dr. Fox stated that it came from the economic census, and includes legal services, accounting services, business services, and computer services, but does not include medical (that is in the health care category).

Slide 16 addresses the fairness issue. This is the GET as a percentage of current and lifetime income. In looking at vertical equity, the question is what income should be used. Young adults spend a lot of their money on taxable items such as refrigerators and stoves setting up their homes, etc., so it is no surprise that they pay more in tax relative to their income at that point in time and their tax burden looks high. However, they know that they will make more money over their lifetime and they can afford to set up their house now. So, comparing them with their lifetime income may result in a different picture. Therefore, the regressivity over a lifetime is not nearly as bad as current income, as shown on slide 17. Either way, it suggests that the tax is regressive.

He notes that many of the people with less than $15,000 income actually spend almost twice their income. How? Many aren't really poor; they are either students or retirees and spending either because they are anticipating more income or because they already made their money and are spending from their savings.

Returning to slide 16, Dr. Fox stated that he is using data for Honolulu that has been tweaked to fit all of Hawaii, from the Consumer Expenditure Survey. It doesn't matter what is exempted, the tax will be regressive either against current or lifetime income. The only things that high-income people spend more of their income on than low-income people are private schools and insurance. Exemptions cannot be used to deal with the regressivity of the GET. At the same time, any exemption will save the low-income person a higher percentage of their income than a high-income person although the high-income person saves more dollars, so there is not much improvement in fairness.

Notice that the tax goes down for everybody with the exemptions. Slide 19 is revenue neutral; that is, the tax rate increases. The tax rate increases although everyone still pays less than they currently are. This is because these exemptions are not for B2B transactions and are for things mostly bought by residents rather than tourists.

While the shift to tourists may not necessarily be a bad thing, it is nevertheless not good for the economy because as noted before, it raises the cost of doing business in Hawaii and costs jobs.

The employment effects are shown on slide 20. Note that the heading of this slide should be "Employment Effects of Adding New Exemptions, 2006" rather than "Eliminating Exemptions, 2006".

Slides 21 and 22 look at the effect of the 0.5% county surcharge tax, which basically is that everything costs more money.

In summary, keep the broad tax base and the many exemptions and deductions for B2B transactions and exported goods and services; limit the exemptions for primarily consumer purchases.

QUESTIONS AND DISCUSSIONS

Dr. Grandy stated that his draft report seems to indicate that most states tax B2B transactions to some extent, and that Hawaii appears to tax B2B transactions less than the average state. Dr. Fox stated that it might appear that way when you look at the tax on B2B transactions as a percentage of the whole, but that since Hawaii taxes far more consumer transactions than the typical sales tax, the relative burden shifts. One of the concerns of taxing services has always been that so many sales of services are to businesses, and Hawaii probably doesn't go as far as it should to exempt those B2B service transactions.

Dr. Pham asked if, with regard to contracting, when one buys a house, it is an investment. However, economists look at it as then renting to yourself. Is that a B2B transaction? Dr. Fox said it isn't within the scope of this discussion.

Mr. Kalapa asked if raising the retail rate without changing the taxation of B2B transactions would result in lower consumption because the cost of goods would go up. Dr. Fox said that the answer would depend on other factors. For example, are you raising the GET rate but lowering another tax? Mr. Kalapa stated that he was thinking more of the county surcharge. Dr. Fox said that his paper was not the place to discuss whether mass transit is a good thing or not, but by itself it is not positive. However, if what is done with the money is positive enough for Hawaii, on net it could be positive. But that money would need a very high rate of return to be positive, and Dr. Fox did not do an analysis of that issue. Mr. Kalapa asked about the effect of the county surcharge on the average family. Dr. Fox acknowledged that it would raise the average family's tax cost and it would raise the cost of doing business in Hawaii, but that the money raised is presumably going to be used for something, and if that something is good enough, it could on net be positive. On the flipside, one could say that lowering the tax from 4% to 3.5% would be positive. However, it would only be positive if that money were unproductive. He did not analyze what gets done with the money – his analysis was revenue neutral.

Mr. Heller asked about the distinction between B2B and B2C transactions. Sale to the same purchaser (e.g., a laptop) could be a B2B or a B2C transaction. How do you know? Dr. Fox stated that you don't, and that is why there will always be some B2B taxation. If all sales to businesses were exempt, everyone would just go out and form a business and there would be no tax. That's why in most countries they have a VAT (value added tax), because then you know it is a business.

Mr. Smyth noted that in many other places, they raise and lower local sales tax rates all the time an entire percentage point sometimes and they don't seem to have any major economic consequences and, even if they may change their economic habits, psychologically they are okay with it. Our 4% rate, on the other hand, seems to be almost sacrosanct. Dr. Fox added that people make judgments about what they are willing to pay for. It may be that the people think that paying for government services for a window of time is worth it. If the rail system is what they want then they will pay for it. Also, the rail issue is an infrastructure project with many other possible business and economic ramifications, so it isn't a simple matter. It isn't just a consumption issue.

The Chairman, referencing chapter 6, noted that Dr. Fox put the effect of the county surcharge at $231 million, but he thought it was $150 million, and asked where he got the $231 million figure. Dr. Fox went to the DOTAX reports and found that 82% of the collections were attributable to Oahu and estimated 0.5% of 82% of all transactions. That means that it should raise about 1/10 of what the GET is generating.

Mr. Kalapa said that doing that isn't correct because businesses that are doing business in multiple counties report all their revenue to Oahu. Therefore, the 82% is an overly inflated figure. Dr. Fox said he'd take another look at it. Mr. Heller commented that the $150 million is probably wrong in the other direction, because the $150 million was computed by taking the 2003 or 2004 figure and projecting a 3% growth rate, and real growth has been more than that. He believes that by the time the tax starts, the figure will probably be more like $180-$190 million. Dr. Pham said that the revised figure is about $200 million – 70% of the total tax is from Oahu, and the share of personal income is about 80-something percent with the share on Oahu about 48%. Dr. Fox will change his figure.

Dr. Rousslang commented that it might be a little unfair given that there are no definitive rules at this time. Dr. Fox noted that should the Streamlined Sales Tax Project become law, Hawaii would need to have destination-based rules that have created problems in many other states such as Tennessee that have local option taxes that are origin-based with resulting "loser" states with cross-county transactions. Mr. Kalapa noted that Dr. Rousslang's comment is well-taken given that the State has had some difficulty with the draft rules for the county surcharge tax for Oahu, particularly with nexus, to make it fair for everyone.

The Chairman asked if building a mass transit system really expands the economy in states that did so. Dr. Fox did look at this a bit in the 1990's while a visiting professor at the University of Hawaii and had some questions about that. He hasn't looked at it more recently and doesn't know.

The Chairman asked if, in doing his statistics and research, whether Dr. Fox isolated Hawaii as a unique place due to its geographic location and time zone, where people couldn't just drive across a border to buy things. He also asked if Dr. Fox skewed his statistics for Hawaii? Dr. Fox stated that most of the numbers were Hawaii specific. That is, he did not take average state statistics and allocate to Hawaii. That wasn't the case when he did his Streamlined Sales Tax Project paper a couple of months ago because there is no state e-commerce data.

Ms. Niwao asked why only nine states tax professional services. Dr. Fox explained that most other states started their tax as a tax on tangible goods and they are now trying to add services. The laws are generally written such that all tangible goods are taxable unless exempted, but services are added individually such that each type of service must be itemized to bring it into the tax structure. This is politically difficult to do.

Mr. Heller asked about B2B professional services, and Dr. Fox stated that he'd support exempting sales of professional services to businesses.

Ms. Ching asked if the State should eliminate the income tax given that the GET is so good. Dr. Fox stated that there are some regressiveness issues that are better dealt with through an income tax so the State may want to keep it, but increasingly weighting the GET and reducing the income tax is probably pretty good policy. Doing so decreases the taxation of work in favor of consumption.

Mr. Smyth stated that a few years ago they did a study of all taxes except the Big 4 personal property, sales, individual income, and corporate income taxes. There were about 20 other categories of tax dealing with businesses, none of which Hawaii has. Hawaii comes out looking like a high-tax state in Milken, Tax Foundation and similar rankings because Hawaii doesn't have those taxes (e.g., extraction taxes in Alaska and Wyoming) and even though some states are getting up to 34% of their revenue from those taxes – almost 100 % in Alaska. Dr. Fox agrees and added that the taxes selected for comparison are carefully chosen.

At this time, the Chairman stated that the discussion would now turn to the Streamlined Sales Tax Project, and asked Dr. Fox to describe his involvement in the issue.

Dr. Fox stated that he has been involved in the discussions on this issue for 8-9 years. He was the president of a national tax association in 1997 or so that formed a committee to look at this issue, and that eventually led to the Streamlined Sales Tax Project.

He thinks that consumption rather than production should be taxed, and that the destination-based model will do that. He believes that something must be done, but that the current voluntary model doesn't go as far as he would like it to go. Conforming to the voluntary agreement will not generate a huge amount of revenue. He estimated $10 million in the paper written for the State Auditor, though the state is probably losing $50-$60 million. But Congress would need to act have a major impact.

The Chairman asked if agreement amongst the states necessary to prevent federal pre-emption. Dr. Fox said that agreement amongst the states is necessary in order for Congress to act.

The Chairman stated that he had heard that major retailers were resistant to the Streamlined Sales Tax Project, but Dr. Fox disagreed, citing Wal-Mart as an example.

Dr. Fox also stated that his original estimates of uncollected revenue were way too high because they hadn't anticipated the number of businesses signing on.

The Amazon v. Ebay battle is over a de minimis rule. The *Quill* case stated that making these remote sellers collect tax for the state to which the goods are being shipped place an undue burden on interstate commerce. If it is no longer an undue burden, then the Supreme Court might reverse its rule. Amazon would like a small de minimis rule while Ebay would like a high de minimis so that its small, individual sellers would not have to comply.

Dr. Grandy asked what could happen if the Streamlined Sales Tax Project is not implemented. Dr. Fox stated that there could be a distortion of the economy. There would be two sets of businesses. The Wal-Marts of the world would be in one and the other would consist of companies like Amazon, which are pure Internet businesses that are not collecting the sales tax for any state other than the one their in. He used as an example Cabela's, an outdoor hunting, fishing, etc. outfitting company that went to Maine and told Maine that it would relocate if Maine didn't exempt it from its taxes since it did not have to collect tax for any other state. The idea is to avoid nexus and set up business in a state without a sales tax or in a really small state.

The Chairman asked why they made all the definitions consistent. Dr. Fox said it was for ease of administration. He cited Maine where he was told that the sale of one egg was taxable but the sale of more than 6 was not. Chocolate covered nuts were taxable but without chocolate covering it was not. Other examples of what was food and what was not such as bubble gum, bottled water, potato chips v. potato sticks, etc. Dr. Fox stated that he does not think it is a good idea to remove food from the tax base, but if it is done, use the uniform definitions.

The Chairman stated that he understood that states could tax something outside the definitions used but that they would have to enact compensating legislation. Dr. Fox concurred, and added that Tennessee will be adding as a separate tax outside of its sales tax statute legislation that do just that. The Chairman asked if that meant that Tennessee would have a sales tax plus a bunch of little taxes outside of the sales tax, and Dr. Fox confirmed that.

The Chairman stated that Bruce Johnson of Utah, an economic forecaster, stated that the probability of the Streamlined Sales Tax passing hinges on the participation of five major states. If these five major states do not participate, he anticipates the demise of the Streamlined Sales Tax in three to five years. Dr. Fox knows him well and says that they are all guessing although at least some of those big states, which would include California, Florida, and New York, would have to participate. He thinks that even if Streamlined Sales Tax fails, there is another recourse, and that is to take it back to the courts.

The Chairman stated that some have said that this is not a tax increase because it is a tax that is already owed and not a new tax, even if many don't pay it. However, others have said that it is a tax increase because it would put more money into state coffers. Dr. Fox does not see collecting money that is due as a tax increase. This issue has never been a revenue issue; it has always been an economic efficiency issue. It is to ensure that people in Honolulu don't buy things online just to avoid the GET as opposed to doing so because they want to shop at 2 a.m. in pajamas or because of product choice.

Ms. Niwao commented that she didn't think that people shop online to avoid sales tax. Dr. Fox stated that he had just read a study – a National Bureau of Economic Research report done by Ellison and Ellison in May 2006 that he had just read – on memory sticks. They concluded that if you leveled out the tax rates, there would be a 30% reduction in shopping online for memory sticks. At least with some products, the impact is significant. Ms. Niwao said that she thought it might be a little less in Hawaii because some vendors won't ship to Hawaii at all and shipping costs are high. Dr. Fox stated that there are shipping costs regardless of whether the goods are first shipped to the store or shipped directly to the consumer. When he did the Streamlined Sales Tax study, he gave a credit card and a shipping address in Hawaii to a student, and asked the student to find out which sellers of the top 35 Internet firms would ship to Hawaii. Of those, four wouldn't ship to Hawaii at all; about half of the remaining companies were collecting the GET.

ADJOURNMENT

The Chairman thanked everyone who attended, reminded everyone that the next meeting would be held the following Tuesday, and asked the Commissioners to start reading the materials for the next meeting.

The meeting was adjourned at 3:55 p.m.

Hawaii's General Excise Tax: Should the Base Be Changed?

Prepared for the 2005-2007 Hawaii Tax Review Commission

William F. Fox

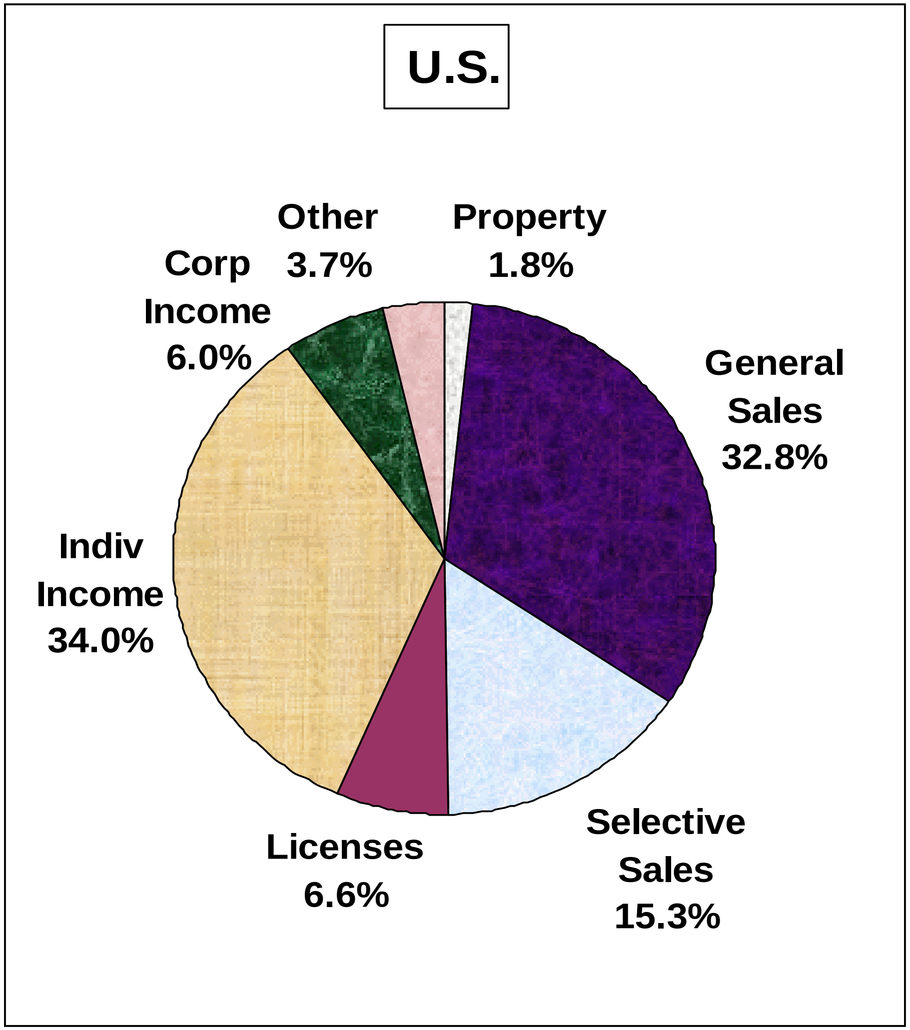
Director

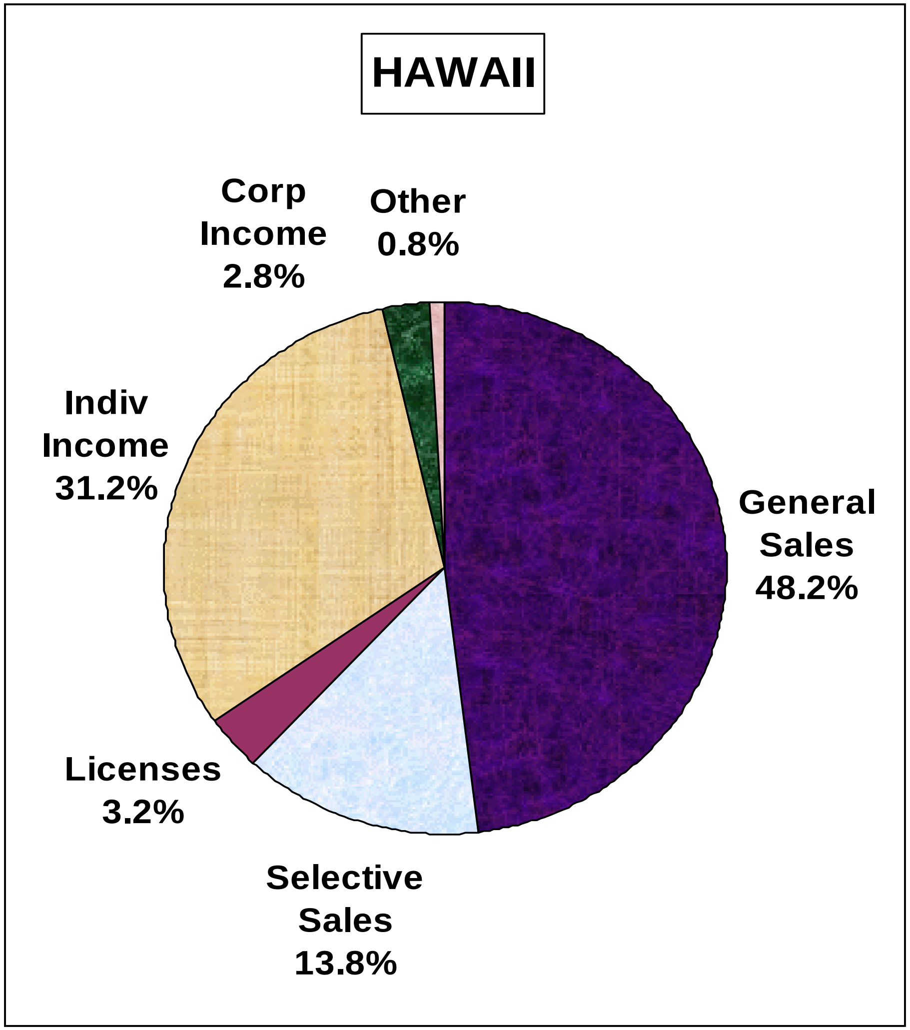
Center for business and economic research

University of tennessee

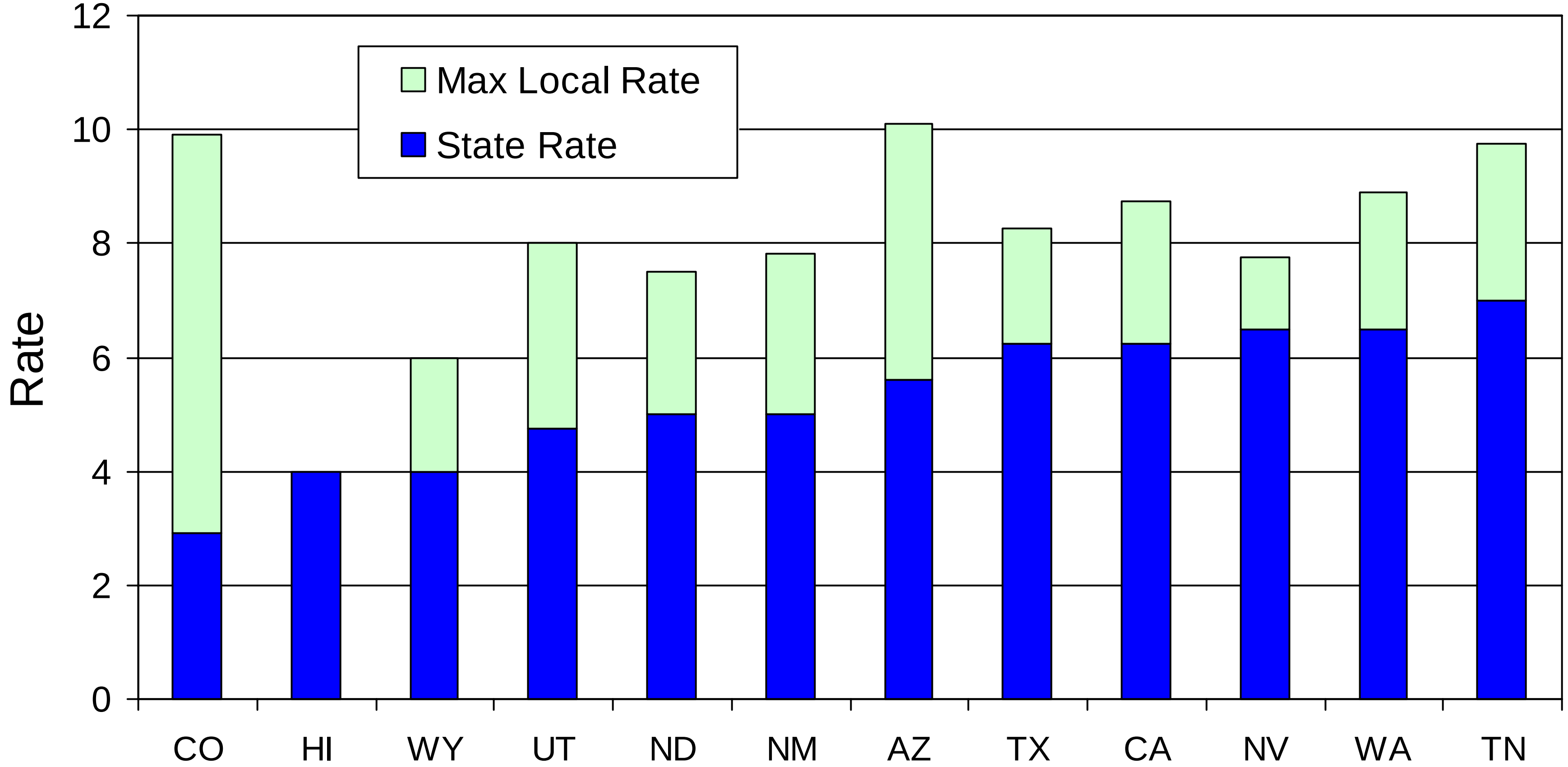
September 2006

STATE GOVERNMENT TAX COLLECTIONS, 2005





SALES TAX RATES, 2006



Sales Tax Base as a Percent of Personal Income

State	Percent		State	Percent
Hawaii	114.9		West Virginia	44.1
Wyoming	69.0		Kentucky	44.1
New Mexico	65.1		Vermont	43.6
Louisiana	62.2		Indiana	43.3
Arkansas	61.2		Alabama	41.6
South Dakota	57.2		Missouri	40.9
Florida	55.2		Colorado	40.9
Utah	52.8		Michigan	40.4
Mississippi	51.8		Virginia	40.4
Arizona	50.6		North Carolina	40.0
New England	50.3		Ohio	37.7
South Carolina	49.8		Oklahoma	37.7
Tennessee	49.0		Iowa	36.8
North Dakota	48.2		California	36.2
Idaho	48.1		Maryland	35.1
Maine	47.9		Connecticut	33.9
Georgia	47.5		Pennsylvania	32.3
Washington	46.8		Rhode Island	32.2
Nevada	46.5		New York	31.7
Wisconsin	45.6		New Jersey	29.7
Minnesota	44.5		Massachusetts	28.6
Texas	44.4		Illinois	26.7
Kansas	44.3			

Goals for the Tax System

- Economic Efficiency
- Fairness
  - Horizontal Equity
  - Vertical Equity
- Low Compliance and Administrative Cost
- Revenues

Economic Effects of Taxing B2B

- Raises $600 million annually in Hawaii
- Change business behavior
  - Substitute non-taxable inputs
  - Vertically integrate
- Raise the cost of doing business in Hawaii
- Cascade into higher sales prices
- Allows lower tax rate

Economic Effects of Taxing B2C

- Research suggests that the GET is primarily paid by consumers
- Changes what people buy – Hawaii's broad base limits these effects
- Changes how people buy – Hawaii's low rate lessens these effects

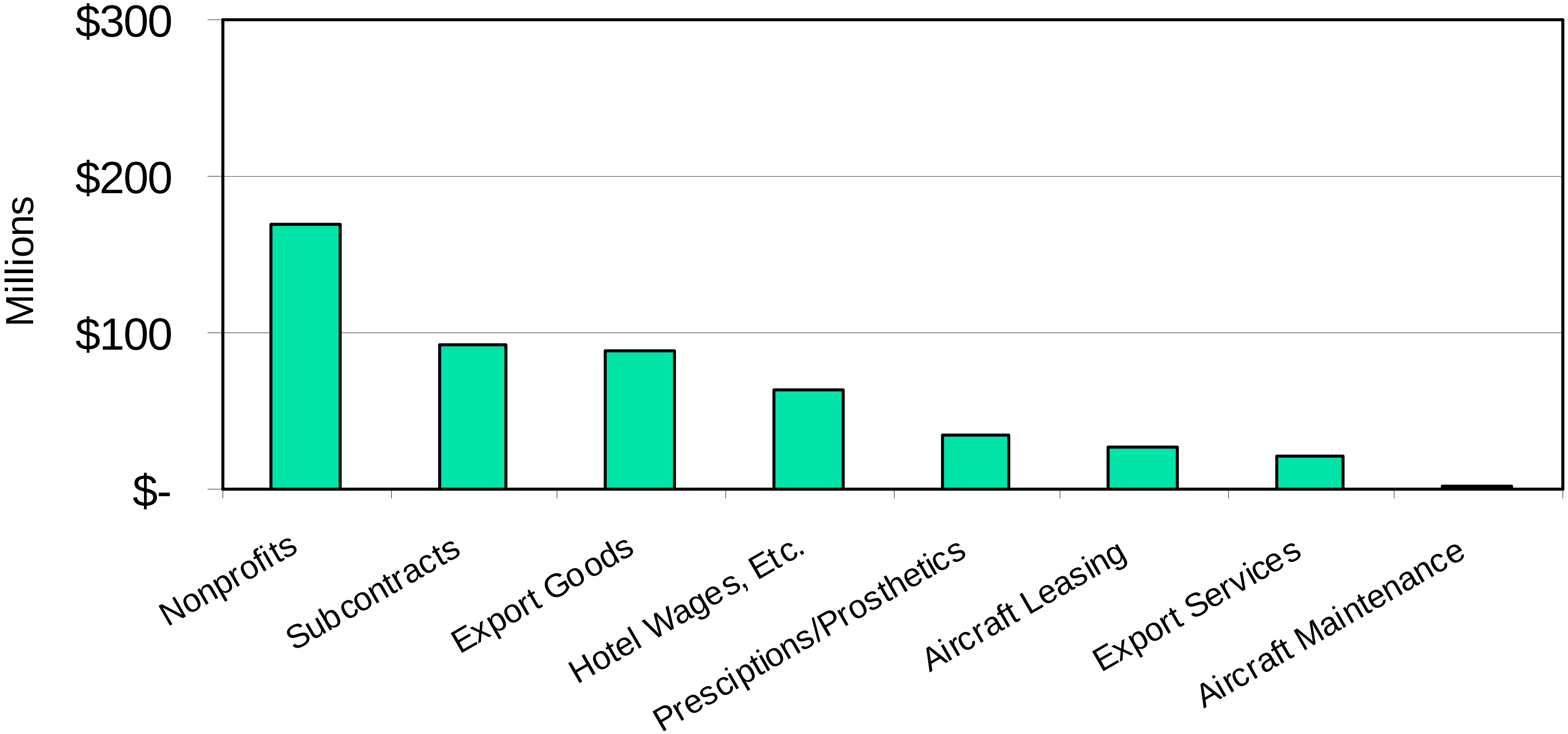
Effects of Eliminating Exemptions

- Gross receipts of non-profit organizations
- Sales of prescription drugs and prosthetic devices
- Hotel operators from hotel owners for employee wages, salaries and benefits
- Rent for the leasing of aircraft or aircraft engines
- Materials, parts or tools used for certain types of aircraft service, maintenance and construction
- Manufacture, production or sale of tangible personal property shipped out-of-state
- Services or contracting that is exported
- Prime contractor payments to another contractor or specialty contractor

Revenue Effects of Removing Selected Exemptions, 2006

	Revenue Gain (millions)	Gain/Total Tax Collections (Percent)	Gain / GET Collections (Percent)	Tax Rate for Revenue Neutral
Nonprofits	$ 168.73	3.86	7.52	3.72
Subcontracts	$ 91.65	2.09	4.08	3.84
Export Goods	$ 88.02	2.01	3.92	3.85
Hotel Wages, Etc.	$ 63.34	1.45	2.82	3.89
Prescriptions/Prosthetics	$ 33.79	0.77	1.51	3.94
Aircraft Leasing	$ 26.44	0.60	1.18	3.95
Export Services	$ 20.34	0.46	0.91	3.96
Aircraft Maintenance	$ 1.78	0.04	0.08	4.00
Combination of All Listed Exemptions	$ 494.09	11.29	22.01	3.28

GET Gain from Selected Eliminations, FY2006



Effects on Employment and Output

- Lower tax rate increasing incentives to buy, buy in Hawaii, and work
- Lower tax on doing business in Hawaii
- Tax on the industry that is no longer exempt

Employment Effects of Eliminating Exemptions, 2006

Exemption	**Effect on Jobs of Eliminating Exemptions**
Nonprofits	2,769
Subcontracts	(369)
Export Goods	(355)
Hotel Wages, Etc.	(258)
Prescriptions/Prosthetics	587
Aircraft Leasing	(110)
Export Services	(84)
Aircraft Maintenance	(15)

Source: Author’s calculations.

Effects of Allowing New Exemptions

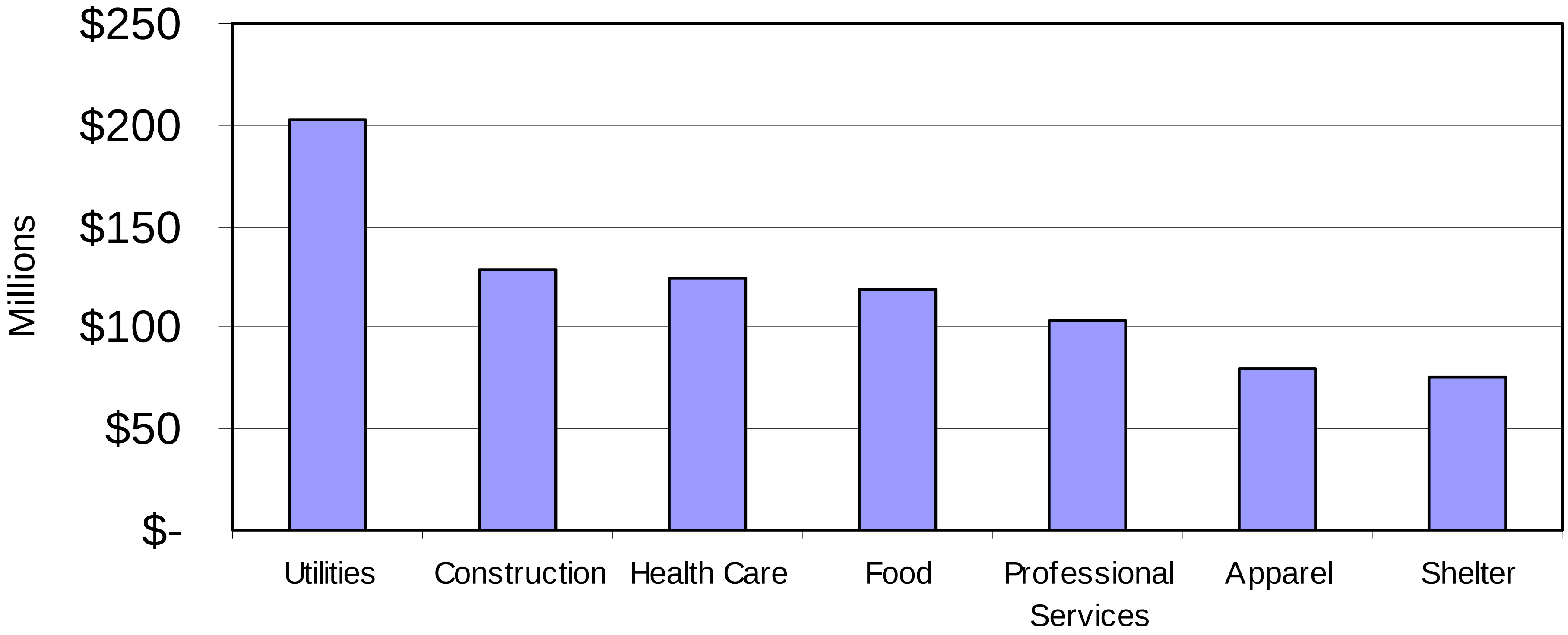
- Utilities – electricity and telephone
- Construction
- Health Care
- Professional services – legal, accounting
- Food for consumption at home
- Housing – rental housing
- Apparel

Revenue Effects of Selected Exemptions, 2006

	Revenue Loss (millions)	Total Tax Collections (Percent)	GET Collections (Percent)	Tax Rate Necessary to Replace Revenue Loss
Utilities	$ 202.97	4.64	9.04	4.40
Construction	$ 128.06	2.93	5.70	4.24
Health Care	$ 124.45	2.84	5.54	4.23
Food	$ 118.91	2.72	5.30	4.22
Professional Services	$ 103.08	2.36	4.59	4.19
Apparel	$ 79.73	1.82	3.55	4.15
Shelter	$ 74.88	1.71	3.34	4.14
Combination of All Listed Exemptions	$ 832.08	19.02	37.06	6.36
Median State Tax Structure	$1,236.47	28.26	55.08	10.89—11.79

Source: Author's calculations.

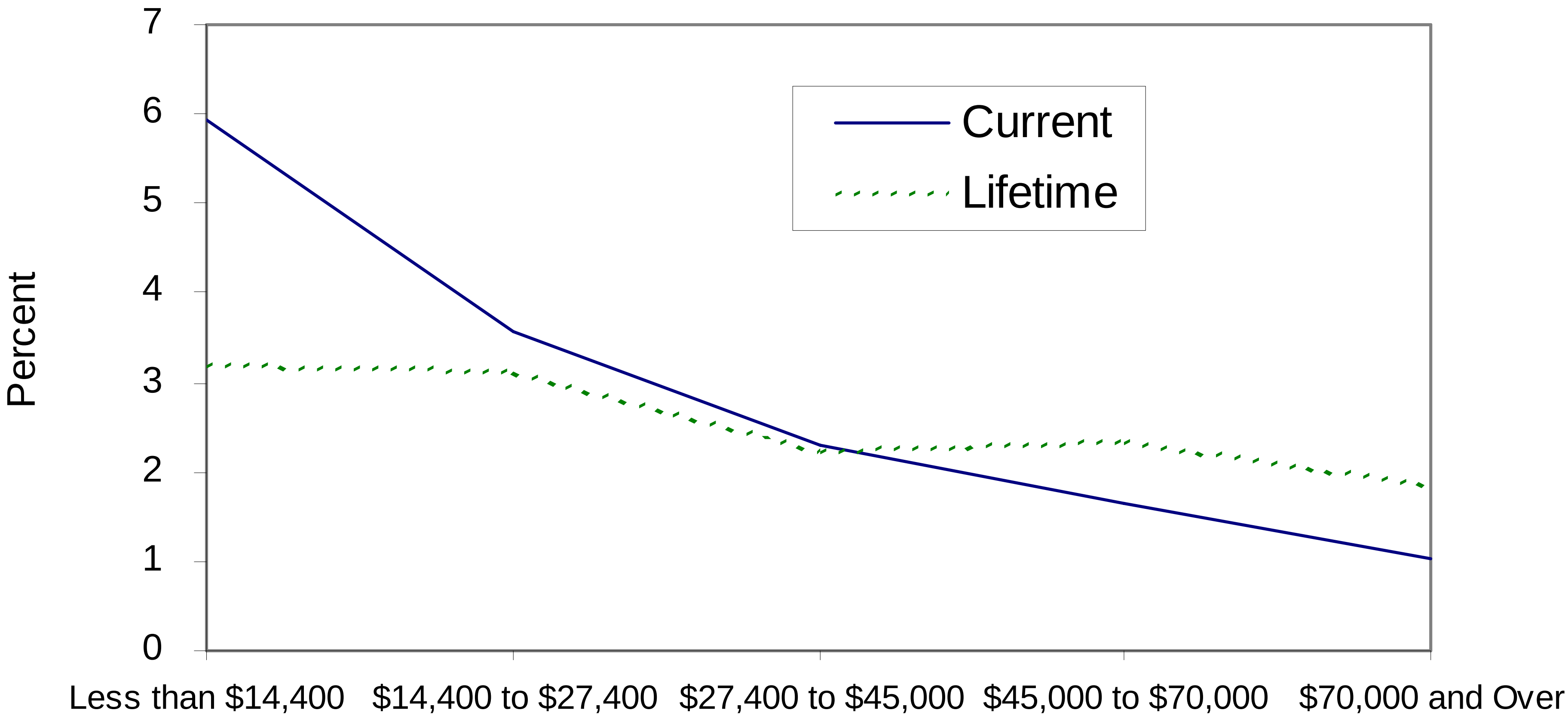
GET Loss from Selected Potential Exemptions, FY2006



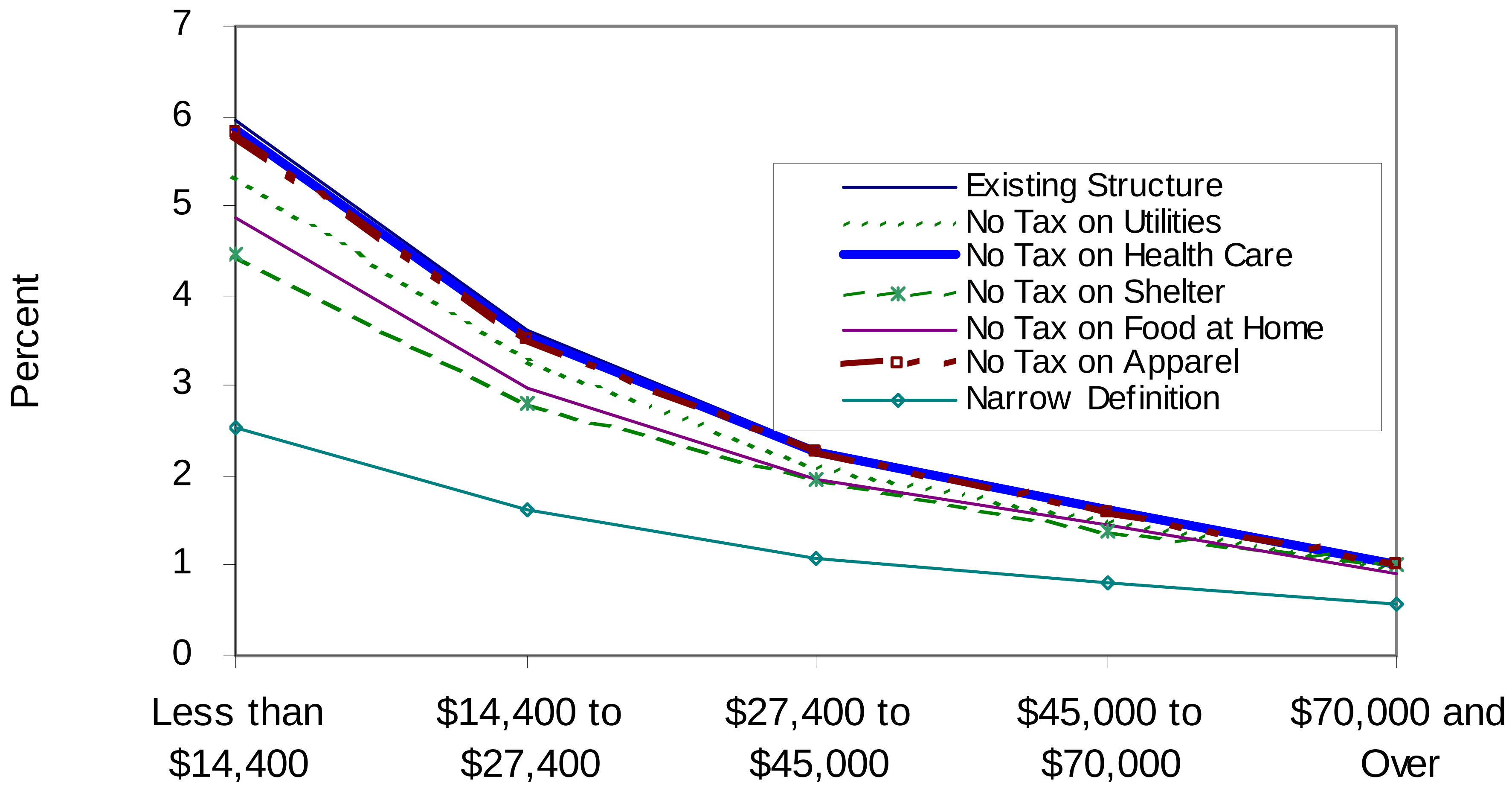
Equity Implications as a Result of Exemptions, 4% Tax Rate

Sales Tax as a Percent of Current Income					
	Income Level				
	Less than $14,400	$14,400 to $27,400	$27,400 to $45,000	$45,000 to $70,000	$70,000 and Over
Existing Structure	5.95	3.63	2.31	1.66	1.05
No Tax on Food at Home	4.88	2.99	1.96	1.44	0.90
No Tax on Shelter	4.46	2.82	1.95	1.38	1.00
No Tax on Utilities	5.36	3.30	2.08	1.50	0.96
No Tax on Apparel	5.80	3.52	2.25	1.59	1.00
No Tax on Health Care	5.83	3.54	2.27	1.61	1.03
Narrow Definition	2.53	1.62	1.08	0.82	0.58
Sales Tax as a Percent of Lifetime Income					
	Income Level				
	Less than $14,400	$14,400 to $27,400	$27,400 to $45,000	$45,000 to $70,000	$70,000 and Over
Existing Structure	3.21	2.99	2.21	2.53	2.07
No Tax on Food at Home	2.63	2.47	1.88	2.20	1.78
No Tax on Shelter	2.40	2.32	1.87	2.10	1.98
No Tax on Utilities	2.89	2.72	1.99	2.28	1.89
No Tax on Apparel	3.13	2.90	2.15	2.43	1.97
No Tax on Health Care	3.15	2.92	2.17	2.46	2.04
Narrow Definition	1.37	1.33	1.03	1.26	1.15

GET as a Percent of Current and Lifetime Income



Tax Burden as a Percent of Current Income



Equity Implications as a Result of Exemptions, Revenue Neutral

Sales Tax as a Percent of Current Income					
	Income Level				
	Less than $14,400	$14,400 to $27,400	$27,400 to $45,000	$45,000 to $70,000	$70,000 and Over
Existing Structure	5.95	3.63	2.31	1.66	1.05
No Tax on Food at Home	5.15	3.16	2.07	1.52	0.95
No Tax on Shelter	4.61	2.91	2.02	1.43	1.04
No Tax on Utilities	5.89	3.62	2.29	1.64	1.05
No Tax on Apparel	6.01	3.65	2.33	1.65	1.04
No Tax on Health Care	6.18	3.74	2.40	1.71	1.09
Narrow Definition	4.03	2.57	1.72	1.31	0.93

Sales Tax as a Percent of Lifetime Income					
	Income Level				
	Less than $14,400	$14,400 to $27,400	$27,400 to $45,000	$45,000 to $70,000	$70,000 and Over
Existing Structure	3.21	2.99	2.21	2.53	2.07
No Tax on Food at Home	2.78	2.60	1.98	2.32	1.88
No Tax on Shelter	2.49	2.40	1.94	2.17	2.05
No Tax on Utilities	3.18	2.99	2.19	2.51	2.08
No Tax on Apparel	3.24	3.01	2.23	2.52	2.04
No Tax on Health Care	3.33	3.09	2.30	2.60	2.16
Narrow Definition	2.17	2.12	1.64	2.00	1.83

NOTE: Heading should read, "Employment Effects of Adding New Exemptions, 2006"

Employment Effects of Eliminating Exemptions, 2006

	Effects on Jobs from Adding Exemptions
Utilities	(3936)
Construction	(2396)
Health Care	(2324)
Food	(2215)
Professional Services	(1906)
Apparel	(1458)
Shelter	(1367)

Source: Author's calculations.

Revenue Effects of Removing Selected Exemptions, 2006
(Includes additional ½% Oahu Tax)

	Revenue Gain (millions)	Total State Tax Collections (Percent)	Gain / GET State & Local Collections (Percent)	Tax Rate for Revenue Neutral
Nonprofits	$ 186.13	4.25	7.52	4.10
Subcontracts	$ 101.10	2.31	4.08	4.24
Export Goods	$ 97.10	2.22	3.92	4.25
Hotel Wages, Etc.	$ 69.87	1.60	2.82	4.29
Prescriptions/Prosthetics	$ 37.27	0.85	1.51	4.35
Aircraft Leasing	$ 29.17	0.67	1.18	4.36
Export Services	$ 22.44	0.51	0.91	4.37
Aircraft Maintenance	$ 1.96	0.04	0.08	4.41
Combination of All Listed Exemptions	$ 545.05	12.46	22.01	3.62

Source: Author's calculations.

Revenue Effects of Selected Exemptions, 2006
(Includes additional ½% Oahu Tax)

	Revenue Loss (millions)	Total State Tax Collections (Percent)	GET State & Local Collections (Percent)	Tax Rate Necessary to Replace Revenue Loss
Utilities	$ 217.21	4.96	8.77	4.84
Construction	$ 141.26	3.23	5.70	4.68
Health Care	$ 137.28	3.14	5.54	4.67
Food	$ 131.17	3.00	5.30	4.66
Professional Services	$ 115.04	2.63	4.65	4.63
Apparel	$ 87.95	2.01	3.55	4.58
Shelter	$ 82.60	1.89	3.34	4.56
Combination of All Listed Exemptions	$ 912.52	20.86	36.85	6.99

Source: Author's calculations.