

TAX REVIEW COMMISSION

**MINUTES FOR THE TENTH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT 830 PUNCHBOWL STREET
DEPARTMENT OF LABOR & INDUSTRIAL RELATIONS ROOM 310-313
IN THE CITY AND COUNTY OF HONOLULU
STATE OF HAWAII, ON MONDAY, APRIL 24, 2017 AT 1:00 PM**

The Commissioners of the Tax Review Commission (TRC) met at the Department of Labor & Industrial Relations Conference Rooms in the City and County of Honolulu, State of Hawaii, on Monday, April 24, 2017.

Members Present: Colleen Takamura, Chair
Vaughn Cook, Vice-Chair
William Pieper II
Nalani Kaina
John Knox
Dawn Lippert

Members Absent: Raymond Blouin

Staff: Ted Shiraishi, Seth Colby, Titin Sakata and Noe Kaawa

Others: Randall Nishiyama, Department of the Attorney General
Randy Bauer, PFM Group Consulting LLC
Daniel Grebence, Tax Foundation of Hawaii
Damien Elefante, Department of Taxation
Donald Rousslang, Department of Taxation
Joshua Lee, Department of Taxation
Jana Moore, CAN
Keith Okuna, CAN
Peter Fritz

CALL TO ORDER:

Chair Takamura called the meeting to order at 1:00 pm.

APPROVAL OF MINUTES:

Chair Takamura said the first order of business was the approval of the minutes from the March 6, 2017 meeting. She asked if there was any motion to amend or approve the minutes. Commissioner Pieper moved the motion to approve the minutes with edits March 6, 2017 and Commissioner Cook seconded the motion. The motion carried unanimously.

UPDATE FRO PFM GROUP CONSULTING LLC ON PROGRESS REPORT ON STUDIES OF HAWAII'S TAX SYSTEM:

Mr. Bauer said at the last TRC meeting, PFM was in Hawaii and had done a series of meetings with stakeholders related to the subjects the TRC hired them to do. Since then, they continued to have follow-up meetings by telephone and had more scheduled. In the meantime, they had also begun the quantitative analysis and built a model to consider what would be the revenue impacts from various changes and using current revenue estimates to the current system, Dr. Wheeler has started on the specifics of the tax burden analysis and they started the regressivity update and analysis from their previous report. They took various changes that were being considered or have been enacted by various states and building that into the benchmark analysis. He felt PFM was in a good place in terms of what they needed to do in order to provide the TRC with the content by the required due date of the project.

QUESTIONS AND ANSWERS FOR THE PFM GROUP CONSULTING LLC ON STUDIES OF HAWAII'S TAX SYSTEM:

Chair Takamura said from the April 15th update, what did assessing options and opportunities mean.

Mr. Bauer said they model various options that may exist in terms of changing the revenue structure for the state of Hawaii and generally when you think of options and opportunities, the thought of actual changes to the tax structure and changing the way you administered the tax structure. They were also looking at what other states had done to improve overall administration and what may be higher collections. The biggest area now even in Hawaii was changes to sales tax structures that legally require E-Commerce types to collect the sales tax.

Chair Takamura asked Mr. Bauer what he meant by administration and did that mean deficiencies within DoTAX to collect.

Mr. Bauer said yes. There was a fair amount of question right now as to whether the changes in the electronic collection system may impact levels of collections as seen in other places too. A general impression was that taxpayers had to get comfortable to the system but usually doesn't have that much of an impact and would look to see if there were other things going on at the same time.

Chair Takamura said the April 15th update mentioned revenue projections and asked if all of the estimates used were going to be from the COR?

Mr. Bauer said yes and from their perspective, they weren't hired by the TRC to do that.

Commissioner Knox said the TRC wanted conclusions that were quantitatively based because the history of legislative adoption of past TRCs specific recommendations was not very encouraging. He felt a great potential value of the study was to draw some more qualitative principles that could be articulated, that if there was some sort of potential future change to the tax structure, the Legislature could have advice on to maintain the same balance of equity,

efficiency, and etcetera that the PFM Study will hopefully suggest in 2018. He was very concerned that the TRC was headed in the direction that the quantitative results would also lead to those types of qualitative conclusions.

Mr. Bauer said the TRC had asked PFM to analyze the regressivity in the current system and options to make it less regressive. Generally, regressivity was seen as the opposite of equity in a system and they did in their last study a fair amount of analysis of equity and the tax burden analysis that was being done by Dr. Wheeler would give a solid foundation for what existed in the current system.

Commissioner Cook asked if the model was part of the deliverables that was going to be handed over to the TRC or was it just part of their analysis as they make their conclusions.

Mr. Bauer said the model that was being done this time which was to take the recommendations or opportunities that was analyzed for the tax structure. The previous model done was much more complex and PFM wanted to make sure the tools they used was included as deliverables.

OVERVIEW OF DEPARTMENT OF TAXATION TAX SYSTEM MODERNIZATION PROGRAM:

Mr. Le said he was the Program Special Assistant for the Tax System Modernization Program (TSM). He was there to update the TRC on the progress of the most recent roll out and how that went from impacts, lessons learned, what went well or not so well, and preparing for the next roll out.

As a quick overview, the TSM program consisted of a series of projects that were mainly focused on tax processing, hardware and networking infrastructure, data warehouse business intelligence, and e-services and customer support. DoTAX had its initial rollout in December, 2015, in which hardware components were changed which included new scanners to replace the aging imaging systems and replaced the old IVR telephone system that had periods of outages and was failing, and was only being supported by the manufacturer till the end of that year.

Since replacing the telephone system, there have been no call center outages.

Last August, the first big piece was implemented within the tax processing area using the new system based on the software product called GenTax made by FAST Enterprises and was used by over twenty other states, state revenue agencies, other countries and big cities. That was implemented on time and within budget for that August roll out. As for how well it was working, it was doing its job by providing a stable platform and DoTAX has been actively processing GET, TAT and RV in that new system.

Processing and operations went well. Most challenging for DoTAX during this transition was for employees now had to learn to use two systems at the same time. For some areas that meant more work than there used to be due to transference and making sure from an audit perspective, knowing where the money was and where it was going. Like going from the old system to the new system or vice versa, making sure it was through a completely sealed and auditable loop making sure the money doesn't get lost going back and forth, especially since taxpayers had

multiple types of accounts like individual income tax and GET, and more significantly corporation income tax, withholding and GET.

From the public facing stand point there hasn't been much difference but DoTAX has experienced a greater influx of calls and has struggled to accommodate that volume. All the systems were working so the programs job of replacing the aging system was successful, but DoTAX continues struggles to answer the high volume of customer inquiries. DoTAX has been trying to better prepare the staff for the volume of calls and that expectation.

DoTAX was currently on track for implementing the next phase that does include most significantly corporate income tax and withholding for August 14, 2017. One challenge here was getting good staff in to test everything and keep it running. There was some very strong staff that was dedicated to this project in the prior roll out and once there was the two system world, those sections had been less willing to lend their best staffs who now know both the new and old systems to keep TSM operations running smoothly. Staffs were coming and going to make sure the quality was there when testing to keep things up and running to have a smooth transition.

Chair Takamura asked Mr. Le when the individual income tax was rolling out.

Mr. Le said roll out four was the individual income tax and should be out by November 2018. It includes individual income tax, partnership, fiduciary, estate and transfer taxes. This roll out would take a little longer than our past roll outs, but the individual income tax was much more complex and was much more in terms of volume.

Chair Takamura asked Mr. Le if the new system was gathering GET data.

Mr. Le said the new system decommissioned the old system for any of those tax types from the last August roll out. What happened in terms of data intake, some was not about the system because the TSM program was about the backend system, but was about the actual forms and what was collected from those forms.

A lot of what has been done so far was straight up replacing exactly what was there and the forms were unchanged therefore the data coming off the forms was also unchanged. Even with the new system since last August, taxpayers were submitting the same tax forms throughout the rest of the year and only the new forms used since January had more information on it and that's when DoTAX started capturing that additional information, but that would be more about the forms than the system itself.

Chair Takamura asked at what point the TRC would be able to get information related to GE income taxed and exemptions taken.

Mr. Le said again, it would need to be a full year of filing that tax type so next year DoTAX would have that. Since August, DoTAX only had information for online submissions because online we had all the fields captured, however it was done on the old forms where that data was not captured. We would only have a complete picture of that tax type beginning this past January.

Commissioner Knox said there was some concern that GET revenue was not growing as fast as the economy would suggest and didn't know if that was unique to Hawaii. He said he had heard some speculation that the modernization might be a factor, any evidence of that at all?

Mr. Le said it wasn't TSM's job to speculate where the revenues were coming from, but GE was unique to Hawaii because a lot of states had a sales tax which operated a little bit differently. From the program perspective, they don't any evidence of that. However, some changes were brought in-house from an external agency that saved the department money like MEF that charged for every return that came in and online taxpayers were charged for paying using ACH. Last fall, there were about 70,000 accounts in the old system that was operated by a third party vendor and was at 90,000 active online accounts in the new system. There was no evidence to suggest that the new system was hard or the transition was too difficult resulting in less filings or anything like that and does not have the same scanning backlog as in the past.

Commissioner Knox said other than not having enough staff to handle calls, were there lessons learned in terms of what people were asking about and if DoTAX had to do it all over again, what would they do differently?

Mr. Le said the one thing unique about this program was the vendor was using an agile software development methodology so compared to the old style of get everything planned, do it once and then it was done, it was a software and because it was software that allowed for changes as we go and was constantly improving things as the department got feedback from taxpayers, whether it was related to the website not that things were broken but common pitfalls for those who misunderstood labels and the very specific terminology used especially for those less familiar and thought it was generic. To help with that, explanatory bubbles were added in places that were suggested by staff and had seen those improvements help people. For example, ninety-five percent of online registrations were being done in less than twenty minutes compared to eighty percent last fall. The little tweaks have helped and were very common in any kind of web development because you get that real time feedback, and we have the ability and agility to do that.

Commissioner Knox asked Mr. Le if he understood correctly that historically DoTAX considered ability to respond to forty percent of phone calls as a satisfactory baseline performance.

Mr. Le said that's where the department was before implementation of the TSM program. It could be seen in the annual report what the call-answer percentages had been over the years and could read the narrative of some explanations for some of the big spikes and drops of phone calls, and when IVR technology was implemented and the impact it had.

Commissioner Knox said forty percent doesn't sound impressive but worrisome. He asked Mr. Le if he knew how that compared to other states.

Mr. Le said no, that was an operational question and that there was dedicated effort being made to look at that more. TSM help facilitate and brought in a business processing engineering consultant that had looked at the call center process and made recommendations, but taking

actions on those recommendation would take time. Recently added was a new administrator that has been looking at that and was considering things like tier-ring it differently for call priority so taxpayers can get to specialized staff that can assist with resolving specific problems.

Commissioner Knox said he did not know of any agency within government that felt they were adequately staffed, but was there a staffing issue in the call center.

Mr. Le said there was clearly a staffing issue, but was not within the purview of the TSM Program itself and if there were more staff then it would be their responsibility to expand the technology to those call agents and that call management was appropriately bolstered to handle that.

Commissioner Knox asked if anyone from DoTAX knew whether there was national data on call centers to which Hawaii could compare itself.

Mr. Bauer asked the TRC what exactly was being thought of in terms of benchmarking data. Information could be provided on benchmarking call centers but it would depend on what kinds of questions were being thought of by Commissioner Knox.

Commissioner Knox said no, but was wondering if someone from DoTAX could follow up because it would have to be adjusted for types of calls and if there could be explanations of what data was kept, how it was kept and what it was about, then maybe PFM could possible say there was a source for a good comparison. Then the TRC could make a case to finance DoTAX for this issue compared to the national data.

Mr. Bauer said the benchmarking data on call centers were wait times, number of call answered immediately and the time to resolution were common measures. He was sure that some of data existed for call centers for revenue issues.

Mr. Shiraishi said this discussion is part of what the DoTAX administrator was looking at as far as improvement, but needs to gather better data and thinking these things out. With the current state's financial situation, DoTAX wouldn't just get employee positions until we thoroughly figure things out on our side first. Simply just plugging in people to in an attempt to improve our rate was not going to work.

Mr. Le said from the DoTAX annual reports that were publicly available:

2014: Call answer rate was 42%

2015: Call answer rate was 43%

2016: Call answer rate was 72%

2014: Call volume was 369,000

2015: Call volume was 417,000

2016: Call volume was 385,000

He said even though there was a perception of getting a lot more calls because we were online, it's the nature of the calls the staff got whether it was questions about the website versus a return. What was also seen was a change in taxpayer behavior like directly calling staff or offices

outside of the call center frequently. These were more of what would be considered inappropriately routed calls; however, the call center was able to handle much more calls than in the past.

Commissioner Cook asked Mr. Le with 70,000 users in the old system and 90,000 in the new, of those users, how many of them were filing electronically versus paper filings.

Mr. Le said that department had that data but he did not know what that number was.

Chair Takamura asked if there was a decrease in time it took a payment to be processed and cleared, was it faster now.

Mr. Le said with the new system there was implementation of Check21 or Deposit21 technology similar to mobile apps that take images of checks and instead of sending the physical checks images of the checks were sent through ACH. He was not sure if it was faster.

Commissioner Pieper said regarding GenTAX software was there any potential for increased or enhanced collection abilities.

Mr. Le said yes, the data warehouse intelligence piece of the program and part of that was the ability to automate more. For example, we started sending out a balance reminder notices on a regular basis. We can track when taxpayers respond since we know what letter the voucher came from and we can know the efficacy of any particular letter or notice, and we were seeing a lot of responses that.

Other things being worked but not being pushed out yet was a non-filer project to identify taxpayers who were dropped off after filing automatically and automatically generating a letter to them to remind what was expected of them to do and keeping doing but if you've gone out of business, you need to let us know so the account could be closed.

Chair Takamura asked if the letters being sent was related to GET.

Mr. Le said it would be across the board. The program was implementing the tools through technology and making them available but was up to operations to determine how it was going to be used or when to turn functions on.

DISCUSSION ON DEPARTMENT OF TAXATION ASSISTANCE ON STUDIES FOR THE COMMISSION:

Mr. Colby said he and Mr. Shiraishi composed the response letter that best supported to the TRC requests and questions. One thing added was a more comprehensive approach that looked at taxes from an economic point of view, looking at tax efficiency and revenue implications of changing those different tax structures. DoTAX has made that offer now that staffing capabilities has been ramped up and was now better prepared to do conduct more studies. The offer to the TRC was something comprehensive and not something piece meal. The study would encapsulate a lot of what the TRC requested instead of just updating different studies, giving

something more holistic in nature and easier to consume, and help with making different recommendations.

The proposal in the letter was that DoTAX would study the GET, TAT, income tax, corporate income tax and property tax, provide the economic background on how they worked within the Hawaiian economy, how Hawaii compares to other states and the revenue implications. This study was being structured to compliment the studies PFM was doing which were focused mainly on tax burden and incidence and, regressivity and progressivity that would be omitted for the different studies. He said the study would also compliment nicely with Dr. Rousslang's study on the effects of eliminating the corporate income tax.

Chair Takamura said from the DoTAX response letter, the "Adequacy of Hawaii Tax Structure" was going to be addressed by PFM. She wanted to know how much of that issue would be addressed by PFM.

Mr. Bauer said the specifics of adequacy PFM would be addressing were identified in the RFP related to specific needs of the state. Those were identified as the pension and retirement, and healthcare benefit called the gap that existed between current funding and what would be necessary to fully fund those. That was the area PFM would be addressing in the revenue alternatives they provide. If there was discussion of overall adequacy of the system that goes beyond that then that's beyond the scope of what PFM would be analyzing.

Chair Takamura said PFM was specific and asked Mr. Colby if DOTAX would be able to do an overall analysis on the adequacy of the tax structure of Hawaii?

Mr. Colby said his first question to Chair Takamura was what she met by adequacy of the tax structure and was it just meeting the unfunded liabilities, the PFM Group was going to meet that and they had a good understanding if the revenues was going to cover the estimated cost. He thought the larger question under the tax structure was is all the services being provided, was it fair, does it support economic growth in the most productive way; those were adequacy questions as well. He wasn't sure specifically what the Chair Takamura had in mind.

Mr. Bauer said that adequacy was the topic of the previous TRC and they had asked PFM to do an analysis on what the state would need to maintain a current baseline level of services, built that into a fairly complex model and suggested alternatives for the tax structure to meet that. What is currently understood now was the TRC wanted a more limited look at alternatives for the tax structure.

Chair Takamura said she wanted an overall picture of was Hawaii at the right place, compared to other states and other tax structures, was the tax structure correct for Hawaii and was it enough. If we were to go into a recession, what would happen to us? Our collections were down and is what we had enough to support the state.

Mr. Bauer said that was a good question and that would be an adequacy analysis that was often done.

Mr. Colby said it was something to think about and would likely address some questions with the DoTAX proposal. The TRC would see the sensitivity of the different tax collections to the economic growth.

Chair Takamura said maybe that could be combined into the DoTAX study. Since collections were down, something was going on. If you look at the COR had dropped the growth rate twice already, so it doesn't look like Hawaii was growing but decreasing our revenue.

Mr. Colby said with the current revenue and COR, he would caution against using one year of data to really rethink about what was going to happen in the state of Hawaii over the next twenty years. DoTAX had presented some findings to the COR and one reason we were receiving lower than expected revenues was if you the adjustment at three point four percent of revenue growth, which falls well within range of what was expected. When thinking of tax adequacy, you're thinking of five, ten, fifteen years down the line and given what's happened since, there isn't enough data to really say we have to rethink the current adequacy structure of the tax system given that we've made three downgrades in nine months time and we're thinking about it twenty years from the time cycle.

Mr. Bauer said he agreed with Mr. Colby in the sense that adequacy was different from a stress test. A stress test would deal with what's happening when there are big ups and downs, and the revenue structures adequacy would be based on a baseline of what was the normal likelihood for expenditures of revenues. Most of the people that do this would say that's why you need a reserve of funds for the ups and downs, and you build the revenue structure around that normal kind of expectations.

Mr. Colby said for the record, Hawaii had a reserve fund.

Commissioner Knox said the statement written here was that the study would examine the economic trade-offs of major revenue sources for the State of Hawaii. What questions would be answered and how would the TRC make use of that information in their final report, which would also include the recommendations that they might make from the PFM study. He asked Mr. Colby if the DoTAX study going to make recommendations or was it just informational. He also said he understood that Mr. Colby was thinking of making presentations rather than a paper document.

Mr. Colby said there were two questions being asked by Commissioner Knox. The first question was what did economic trade-offs mean? He said that there were a lot of economic literature on the cost and benefits on different types of tax and tax affects economic behaviors and economic decision-making in different ways. For example, the individual income tax penalizes work and was an easy way to tax. GET was a tax on consumption, which according to economic theory does not do as much as penalizing investments and things like that. Those were ideas he was hoping to present to the TRC with some intellectual framework on how to approach tax structures and how to think about the trade-offs.

There would not be enough time to do truly in-depth studies on every single tax system because that was outside of what DoTAX could provide. He felt offering to do the independent study would be most beneficial and helpful in understanding the fundamentals of tax since the TRC would be making the recommendations which was not in the purview of DoTAX to make recommendations about the structure of the tax system. DoTAX wanted to provide information so policy-makers and decision-makers like the TRC could make more lucid and evidence based decisions. This was to merely set forth the big ideas when relating to the four or five types of taxes the State of Hawaii depends on and think about what other states were doing and why. Hawaii was a very *suigeneris* case, a very unique state in many ways and help the TRC think about how Hawaii circumstances matches the revenue collections system. The idea of doing three or four different presentations was to stimulate discussion and plays out nicely with the timetable the TRC has.

Commissioner Knox asked what would be in the final paper.

Mr. Colby said the final paper would be a summary of all the presentations and if there was some information that was really needed then it could be added.

Commissioner Knox said it sounded as though this would be a fundamental explanation of how things work, how things trade off, and there would be no suggestions of recommendations to the TRC based on that.

Mr. Colby said everything in policy-making has to do with trade-offs and there was no perfect tax regime. There was a tax regime that fits the political and economic realities of this state and those would be the things that the TRC would have to consider and DoTAX would provide the explanations, thoughts and empirical evidence that would aide you in that decision-making process.

Commissioner Knox said he had expressed to PFM that not only for the TRC but perhaps the legislature itself could use a good reference document on basic principles and decision-making in terms of taxation. Would the DoTAX study help with that?

Mr. Colby said that would be one of the intents and won't know until it's done.

Chair Takamura said besides the trade-off benefits was Mr. Colby going to provide the other side.

Mr. Colby said there was cost. Everything about a tax was cost and the only benefit being provided was the services of the state. There were certain things that people understand about certain taxes that affect economic behaviors more than others. The general approach for an economist would be to propose to a tax system that does as little to distort economic behaviors and decision-making as possible apart from excise taxes on cigarettes, alcohol and others things considered to have negative externalities. There was also the obsession on the exportation of taxes that could be discussed and if Hawaii wanted to be a progressive state that offers higher level services, then there would generally be higher tax rates. It was important to think about when you deal with taxes, you were entering into a social contract with taxpayers on what people want from government.

Commissioner Knox said he was concerned about getting into property taxes, which can be an important source of revenue but in Hawaii is constitutionally designated for the counties. He asked Mr. Nishiyama if there was any constraint on the TRC hearing about property taxes.

Mr. Nishiyama said there would be a constitutional wall for the state to impose property taxes. There would need to be a constitutional amendment. At this point, it would be merely speculation on Mr. Colby's part.

Mr. Colby said to be fair, every new proposal related to tax was mere speculation. The TRC was taking the opportunity to inject new ideas to the legislature. There was a constitutional amendment floating around regarding education funding and as you listen to more and more of the rhetoric conversation surrounding tax policy, more and more people were discussing property taxes. This state lacks think tanks and lacks sources of new ideas that would take years and years to percolate through the legislature. If a committee, like the TRC with no legislative implications and was only a reference source couldn't make recommendations then where would the new ideas come from?

Commissioner Knox said if he understood the situation from both perspectives, it was fine for us to get educated and understand property tax theory but to make an actual recommendation the TRC would not be able to.

Mr. Nishiyama said yes the TRC would be able to.

Mr. Bauer said in terms of benchmarking property taxes, Hawaii was way on one end of the continuum of property tax burden and much farther away in some other areas. If the TRC wanted to discuss different taxes and burdens, that would be something PFM could analyze for the TRC.

Commissioner Pieper said the TRC spent a lot of its time talking about little things that need to be addressed, but at the end of the day, we were a think tank. The tax system would not change overnight. The TRC can't tweak around the edges to address issues. It would require a fundamental shift and felt PFM would really be helpful in identifying new sources of revenue or ways we could better leverage existing sources of revenue to try and address the unfunded liabilities. From the standpoint of looking at that problem, that gap, the previous TRC report authored by PFM showed that it was going to take a miracle to address that. So, without worrying about the miracle, let's worry about things we can control today, hopefully with best practices provided by the consultant to address those things rather than nitpick and see what could be moved around the "desk" to make it cleaner.

Mr. Bauer said he pledged that PFM would work with DoTAX to ensure that the studies blend together.

Commissioner Knox requested Mr. Colby that, if he gets into property taxes, he has communication with the counties to make them aware of it.

Mr. Colby said he wasn't opposed to communicating with the counties.

Commissioner Kaina said she didn't think it was necessary. What the TRC was trying to do was get a fundamental understanding of how everything was integrated and there was not going to be any recommendations about changing the counties. This was about getting a basic understanding of how everything intersects with each other and help the TRC be better informed as we make decisions rather than throwing out ideas without knowing how it was related to and how it was driven.

Commissioner Pieper said he agreed with Commissioner Kaina and that it was not the TRC's job to implement changes. As far as sharing information, it was the liberty of the TRC and should be bold about it.

Dr. Rousslang said he had a remark on what was last discussed if this were another state. He had published an article in Tax Notes with a colleague Jonathan White showing how superior the GET was to the state sales tax, how they could increase revenue and actually reduce excess burden for the equivalent of our state, several times what it costs to administrate and collect all of our taxes. Unfortunately, we've already got that.

DISCUSSION AND ACTION ON ADDITIONAL STUDIES BY THE COMMISSION:

Dr. Rousslang said he was offering to look at Hawaii's corporate income tax and to determine who actually pays the tax and to measure the costs and benefits of eliminating the tax. He said anyone who has studied public finance knows that who bears the burden of the tax has little to do with who pays the tax to the government. How the burden is distributed depends on a number of things. He said only people pay taxes, companies don't pay taxes. The question was who pays the corporate tax.

He said his seminal work on the topic was done by Arnold Harberger at the University of Chicago in the early 60's. He studied the incidence of the tax in a closed economy, one with little cross-border investments, and found that the burden of the tax was borne primarily by shareholders. He said that would be great for Hawaii since the vast majority of Hawaii Corporation shareholders were non-residents.

Harberger later found that in an open economy, one with substantial cross-border investments, the burden of the tax was entirely shifted to local workers. Corporate investors care only about the net after-tax profit on their investments and they have the full array of global investment opportunities to choose from. So if a country raises the tax on pretax income, the corporate investors will require just that much more in pretax returns before an investment opportunity in the economy will be preferred over competing alternatives in other economies.

In order to earn the higher pretax return, the corporation must either charge more for its product, or pay less to its workers. If prices are set by cross-border competition, the full loss in after-tax returns caused by the tax must be made up by cheaper wages. In fact, Harberger found that the burden on workers was bigger than the amount of the corporate income tax, because the tax discourages investment. In this case, replacing the corporate tax with a tax on wages would

cause after-tax wages to rise. The reason is that the full burden of the corporate tax is borne by workers anyway in the form of lower pre-tax wages, so taxing wages directly, instead of taxing corporate income, doesn't reduce after-tax wages, but the tax swap encourages investment, which creates jobs and raises wages.

States are perfect examples of small open economies, because they have substantial cross-border corporate investments. So it should come as no surprise that the available empirical evidence has vindicated Harberger's results, finding that a state's corporate tax causes wages to fall by more than the amount of the tax. The only way a corporate income tax can be justified for a state is if all the states, and any countries that compete for corporate investments, agreed to tax corporate income uniformly.

Currently, various states use a number of methods to compete with each other to attract corporate investments, with the result that the tax has been falling in importance since the mid-1980's. They have variously offered tax breaks to attract new investments, changed the income apportionment formula to emphasize sales, or given tax credits for property taxes or wages paid by the corporation. Companies have also taken measures to reduce their corporate income tax; including shedding the corporate structure and transferring corporate profits offshore, where they avoid U.S. tax until repatriated. Corporations typically do not set aside any moneys for that eventuality, saying in their financial statements that they intend never to repatriate the profits.

So it seems easy to answer the question "should Hawaii tax corporate income." But there are complications. The theory is based on corporate production dominated by tradable goods subject to strong cross-border competition, whereas most of the corporate output in Hawaii may avoid strong direct competition from outside products or services. Without going too far into details, the question becomes whether residents or nonresidents buy the corporate output. There are other questions on how to go about eliminating the tax. In particular, an abrupt elimination of the tax would provide a windfall to current shareholders, the bulk of whom are nonresidents. On the other hand, a slow phase-out of the tax would delay the gains.

Other questions are even harder to answer. How much will the tax change cause investment in Hawaii to increase? How many jobs will it create and how much will workers gain in increased wages? He said he could try to estimate the gains to investment and wages by sector, but a preliminary look at the data has discouraged him from trying to do this in much detail, unless he can get assistance from others in identifying the industries of the corporations, some of which are apparently reported incorrectly. What new industries might be attracted to Hawaii? He said any estimates would be subject to substantial uncertainty.

He said that preliminary investigation indicates that the figures for corporate income taxes in the Department's collection reports might include some revenue items that are not collections of income tax paid by C-corporations. He said he wanted to investigate to determine exactly what is reflected in the corporate income tax statistics.

Dr. Rousslang said that net collections of the corporate income tax are smaller than tax credits. That is, tax credits are more than half as big as corporate income taxes before tax credits. The bulk of tax credits claimed by corporations are refundable. A refundable tax credit (such as the

film credit) makes the effective tax rate negative, so it should be added to the gross corporate tax collections (instead of being subtracted from them) to get a meaningful indicator of the distortions. This means that Hawaii's net corporate income tax collections greatly understate the size of the distortions created by the tax. A better measure of the distortions imposed by the tax would be to add the refundable tax credits to the gross corporate tax collections. The result is somewhere between two to three times as great as the net collections. A similar adjustment is not needed for states that offer tax credits to offset property taxes or wage costs, or that give special tax breaks to attract corporate investments. Therefore, it is extremely misleading to compare the net corporate tax collections as a percent of revenue or as a percent of total state income across states to gauge the extent to which the tax creates distortions or discourages investment.

Mr. Cook asked Dr. Rousslang if he would be analyzing potential positive economic impacts on businesses or corporations outside of the state making decisions to locate here, would that be in the scope of the study.

Dr. Rousslang said the increased investments would definitely be in the scope and had two parts. One was those that were operating here now, how much they would they increase scope of their investments. For example, he recently learned that some corporations had sophisticated software and when they decide to place a new operation or part of their overall operation, they look at what it does to their total tax liabilities across states. This would make it more attractive to do some accounting here, for example, rather than someplace else if we had a zero tax rate.

As far as attracting new businesses that weren't here now, Dr. Rousslang said that would really be tough. To try to put a figure on that would be difficult and he would feel more comfortable in providing some indication for overall acceptable elasticity by sectors and how much could be expected for expansion. He said they would be small numbers, small percentages because corporate tax was a small part of the economy. One other factor was a timing issue and if you eliminated corporate tax tomorrow, the immediate winner would be shareholders, and most of them were non-residents. So it would be something of an investment for the future and maybe phasing it in, and that would be some complicated modeling for the optimum way of phasing it in. The bulk for this type of adjustment can takes something like four to five years to accomplish, but if you had a recession then they hold back investments so it depends on economic circumstances.

Mr. Bauer said on benchmarking nationally and that the common three factor apportionment formula uses payroll, property and sales, and that there were only eight states that still apportion corporate income that way and Hawaii was one of them. What Dr. Rousslang was talking about looking at what was happening across the country for the last ten or twenty years. Most states had moved away from the common three factor formula.

Commissioner Knox said Dr. Rousslang has talked about taking a more sophisticated look at corporate income tax. He distributed charts showing three different metrics over time comparing Hawaii to other states for how important corporate income taxes were in each state's combined state/local tax structures: (1) as a percentage of general revenue, (2) a percentage of the economy measured by GDP, and (3) on a per resident basis. We have had one of the lowest corporate tax rates in the country, though there are four states that have no corporate income tax at all. His interpretation of Commissioner Cook's question was if we went from extremely low

corporate taxes to none at all, would we really gain anything? He thought Commissioner Cook's original question was in terms of business, business reputation and attracting business, and he thought what he was hearing about the question Dr. Rousslang would be answering wouldn't be quite like the original question asked.

Dr. Rousslang said in the first place, this was very misleading because you want to look at the gross and not the net of the tax collections. If you wanted to look at how our corporate tax stacked up against the others, you'd want to use the statutory rate. As far as the effect of corporate taxes on the economy and on wages, there was empirical research that had found it supports the theoretical model. It found wages in states where corporate taxes were lower than they otherwise would have been by more than the amount of the corporate tax revenue. Workers were suffering more by having this corporate tax rather than being taxed directly. He hesitated to lean too much on the empirical studies, though, because it hasn't been peer reviewed and he had questions about it.

Mr. Bauer said when you look at a corporation; they look at a tax structure not just as a corporate tax, but what they pay in all taxes. What they pay in sales, in the case of Hawaii, the GE and property taxes. You can't just separate what part of the tax structure and there was only four states that don't have the corporate income tax and they were not taxing states.

Commissioner Knox said the definitive question may never be answered by Dr. Rousslang's study, but would still be valuable.

Dr. Rousslang said the last part would turn out and be "slim pickings" as to how many businesses and what type of new businesses, would be attracted. He said he could try and give some guesses of what the gross effect would be by sector but that he expected the bulk of the expansion would come from pre-existing businesses.

Commissioner Cook said he appreciated Dr. Rousslang's outlining the study. To him it was intriguing and the factors he mentioned were not always intuitive to us. What perked his interest was looking at past TRC reports and one recommendation from the 2005 TRC which wasn't adopted, but thought it would be helpful to understand the pluses and minuses of such a legislative change would be if we were to do it.

Mr. Bauer said if the TRC was going to look at corporate tax, they should look at changes to the factors too because there were a lot of businesses that were located in a state where their customers were. Weigh in towards sales especially for an island economy like Hawaii makes a lot more sense than just to eliminate it. Target was going to locate stores in Hawaii whether or not you have a corporate income tax.

Chair Takamura asked for a motion to approve the proposed DoTAX independent study.

Commissioner Knox moved the motion and was seconded by Commissioner Cook to approve the DoTAX independent study. The motion carried unanimously.

Chair Takamura asked for a motion to commission Dr. Rousslang to do the study on "Eliminating the Corporate Income Tax".

Commissioner Cook moved the motion and Commissioner Knox seconded to commission Dr. Rousslang to do the "Eliminating Corporate Income Tax study". The vote was five approved, one opposed. The motion carried.

DISCUSSION AND ACTION ON INTERIM REPORT TO THE 2017 LEGISLATURE:

Chair Takamura asked for a motion to approve the amended Interim Report to the 2017 Legislature.

Commissioner Kaina moved the motion to approve the amended Interim Report and Commissioner Cook seconded the motion. The vote was four approved. The motion carried.

WRITTEN COMMENTS ON HAWAII'S TAX STRUCTURE OR ITEMS LISTED ON THE AGENDA:

There were no written comments to the TRC.

PUBLIC COMMENTS ON HAWAII'S TAX STRUCTURE OR ITEMS LISTED ON THE AGENDA:

There were no public comments to the TRC.

NEXT MEETING:

The next meeting was scheduled for Monday, June 5, 2017 at 1:00 PM.

ADJOURNMENT:

The meeting was adjourned at 2:51 PM.