State of Hawaii
Tax Review Commission

Study of the Hawaii Tax System

Final Report

August 28, 2012

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The PFM Group

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Executive Summary

Background

In 2012, the Hawaii Tax Review Commission (Commission) engaged The PFM Group (PFM) to perform a systematic study of the State's tax structure, with particular emphasis on answering two key questions:

1. Will the current tax system provide sufficient revenues to meet near and long term future needs for the 21st Century?
2. Are there alternate tax structures that could improve Hawaii's ability to generate sufficient revenues?

To conduct the study, PFM obtained and analyzed state revenue and expenditure data and forecasts, conducted extensive interviews with stakeholders inside and outside of state government, benchmarked Hawaii with other states, and reviewed numerous prior reports, including studies from past Commissions. PFM also conducted best practices research and analysis related to tax structure and tax principles. PFM vetted its analysis with key stakeholders and now submits this draft report, with a final report to follow in September 2012.

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Overview

Hawaii's unique history, location and demographics are important for understanding how its expenditure and revenue structure have evolved – and may continue to change – over time. Among the key factors:

- **Island state.** While many states must consider consumer mobility in key aspects of its tax structure, it is less of a concern for Hawaii given that it is 2,400 miles from the nearest U.S. state.
- **Cyclical economy.** Over the years, the economy has been dominated by key industries that have generally ascended and then declined. Beginning with Sandalwood and also including sugar cane, pineapple and tourism, the State economy has generally been less diversified than in most states. This can be a risk, as was the case for the State in the aftermath of the terrorist attacks on September 11, 2001.
- **'Aloha spirit.'** While the native Hawaiian population has declined over time, there continues to be great pride in Hawaii history and traditions. A respect for the land and concern for maintaining Hawaii's unique characteristics is important to many residents.

Demographics

Hawaii's demographics are significantly different than the norm in the US in a number of areas. This also helps to explain why some aspects of its tax and expenditure policy are different from other states – and why benchmarking is a challenge. Among key demographics:

- **Ethnic diversity.** Hawaii is among the most diverse states with the greatest percentage of residents in any state identifying as 'Asian' (38.6 percent) and 'two or more races' (23.6 percent). In addition, Hawaii's percentage of citizens who identify as 'white' is the lowest among the 50 states at 24.7 percent.
- **Growing – but aging – population.** While still a relatively small state in terms of population (1.4 million, 40th among all states), Hawaii's population more than doubled between 1960 and 2010 – a much faster rate than the nation as a whole. The state is also getting older – it ranks 10th among the states in the percentage of population 18 and over, and 12th in the percentage of population ages 65 and over.

- **Above average income.** Hawaii ranks 16th overall in average per capita income; its median household income ranks 5th among all states.
- **Above average educational attainment.** Hawaii ranks 9th among states in percentage of population with a high school diploma and 16th in percentage of population with a bachelor's degree or higher.

Economy

Hawaii's economy has, over the years, depended on industries and sectors that capitalize on the State's unique location and other characteristics. That continues to be reflected in many aspects of the economy today:

- **Lack of diversification.** The State generally ranks low in measures of economic diversification, although the connection between diversification and economic stability and growth is less clear.
- **High concentration of employment in travel-related industries.** Hawaii has a far greater concentration of employment in the leisure and hospitality services industry than the nation as a whole. Employment in the leisure and hospitality industry exceeds 100,000 and is second only to federal, state and local government.
- **High concentration of employment and earnings in government.** As noted above, federal, state and local government are the largest employers in Hawaii, nearly 125,000 in 2011. That sector also pays well, with average earnings per employee of nearly $81,000, ranking third (behind utilities and business services).
- **Small concentration of employment, earnings and output from manufacturing.** While manufacturing accounts for over 12 percent of GDP for the nation as a whole, it accounts for just 2 percent of Hawaii's GDP. It employs just over 13,000 and has average wages ($44,097) well below most key industries.

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Revenue Structure

Current Tax Structure

The State tax structure is dominated by two major taxes, the General Excise Tax (GET) and the Individual Income Tax (IIT). The GET is the largest source, making up 58 percent of General Fund tax revenue, while the IIT makes up 29 percent. The next largest source, the Insurance Premiums Tax, makes up just over 3 percent of General Fund tax revenues. Others that make up the bulk of General Fund tax revenue are Cigarette and Tobacco taxes, the Transient Accommodations Tax (TAT) and corporate net income tax. Key characteristics of the current revenue structure are:

- **Greater reliance on two revenue sources.** Hawaii raises 77 percent of its total tax revenue (General and non-General Fund) from the GET and IIT; by contrast, the average for all states that levy these types of taxes is 65 percent.
- **Little reliance on corporate income tax.** While corporate income taxes are generally referred to as one of the three major taxes among all states (along with sales and individual income taxes), in Hawaii it makes up less than 1 percent of total General Fund revenue.
- **Extremely broad base/low rate for the GET.** As a business privilege tax, the GET is applied to a much broader array of goods and services than most sales taxes. Besides applying to food, it also is broadly applied to services. A Federation of Tax Administrators (FTA) survey of services commonly taxed by states found that Hawaii taxes 160 of 168 services, the most of any state. The GET's 4.0 rate is the second lowest state rate in the nation for a broad-based consumption tax (which in most states is a sales and use tax).

- **Progressive and regressive features of the IIT.** Hawaii's twelve income tax brackets are notable at both the low and high end of the income spectrum. At the low end, the income levels between brackets is relatively narrow, meaning lower income individuals move fairly quickly into higher tax rates. On the high end, Hawaii is tied with Oregon for the highest top marginal tax bracket (11 percent) among the states.

Relationship between State and Local Taxes

Across the country, local taxes can vary widely from state to state (and even from city or county within a state). It is often difficult to make accurate comparisons of state taxes without considering local taxes as well. This difficulty in making state tax comparisons is particularly pronounced in Hawaii, because of the manner in which local schools are funded.

Nationally, the largest local government expenditure category is support for K-12 education – averaging nearly 37 percent. By contrast, local governments in Hawaii spend less than 1 percent of their revenue for this purpose. It is a given that if there is little local government funding for K-12 education, the State is the only real alternative to support this function. In fact, the State of Hawaii provides far more revenue to support this function than nearly any other State – 82 percent in Hawaii compared to 44 percent among all states. As a result, property taxes (the primary local revenue source in Hawaii and among all states) are relatively low in Hawaii for all classes of property (residential, commercial and industrial). In effect, there is a trade-off taking place, with what may be seen as higher taxes at the state level supporting what are commonly considered shared state and local funding responsibilities in other states.

Tax Burden

PFM reviewed a variety of methods that are used to measure tax burden. As previously noted, state tax burden should not be considered in a vacuum but combined with local taxes to reflect the unique nature of funding for K-12 education in Hawaii. To adjust for this, PFM generally relied on the combined state and local tax burden calculations done on an annual basis by the Tax Foundation. This calculates state and local taxes as a percent of income. Because the rankings are of tax revenues as a share of income, it's notable that a state's percent share and relative ranking can rise or fall without changes to its underlying tax structure. Over the years, Hawaii has tended to rank in the upper half of states (with state and local taxes consuming a higher than average percent of personal income). However, the last analysis determined that Hawaii's composite tax burden as a percentage of personal income for 2009 was 9.6 percent – below the national average of 9.8 percent.

While aggregate analysis of tax burden is useful, it is also important to examine how the tax structure impacts those at different income levels. Many taxes are considered regressive – where a larger share of total income goes for paying the tax for those at lower income levels. Several tax burden comparisons examine these factors in its analysis. At least two national surveys suggest that Hawaii's overall tax structure is regressive. One, an annual survey by the District of Columbia, compares the burden of major taxes on a hypothetical family of three in the largest city in each state; it found that taxes paid as a percentage of income in Hawaii were low at income levels of between $50,000 and $150,000 (ranking between 43rd and 33rd of the 50 states), but high (ranking 9th) for those at the $25,000 income level.

Tax Performance of All States

Across the nation, nearly every state has had to deal with tax structure fall-out related to 'the Great Recession.' The States as a whole registered negative revenue growth throughout the recession, and revenues were slow to rebound. While circumstances differ from state to state, there are some key themes that have emerged or come into greater focus in recent years. Among them are:

- **Base erosion for key revenue sources.** This has been particularly notable for the sales and use tax, where legislated exemptions and the rise of digital commerce have contributed to a situation where sales tax as a share of personal income has been declining for over 50 years. According to Dr. William Fox, a noted national expert on this topic, the tax loss for the State of

Hawaii related to uncollected GET from e-commerce transactions is estimated at $145 million a year (and growing) for the State of Hawaii. Base erosion has also been an issue for other taxes – for example, aggressive corporate income tax planning and a move by many states to a single sales factor for income apportionment has reduced the taxable base for corporate income taxes.

- **Heightened volatility.** In each of the past two recessions, the depth of the percentage decline in state revenue was much more pronounced than in previous post-world war II recessions. This has made it particularly difficult for states to accurately forecast projected revenues during economic downturns. One survey found that in FY 2009, the collective margin of error by states in forecasting individual and corporate income and sales taxes amounted to a $49 billion shortfall, with a median error of a 10.2 percent overestimate.
- **Changes in consumption.** Most sales tax structures broadly tax goods and more narrowly tax services (in this area, Hawaii is an exception). Over the last 50 years, personal consumption has shifted from 65 percent goods to nearly 60 percent services. In many cases, sales tax structures have not responded to this directly (by adding services to the base) but instead resorted to increases in the sales tax rate – which can create greater economic distortions.
- **Demographic shifts.** The US population is getting older, which also impacts on consumption – and consumption taxes. Nationally, sales tax profile by age cohort indicates that the top age range for per capita sales tax revenues is 35-44 years of age – and steadily declines in each additional age cohort.

These trends, coupled with the severe economic downturn from December 2007 to June 2009 help to explain why the 50 states collectively increased net revenue through tax law changes in each year from 2002 to 2010. While net state tax cuts exceeded tax increases in 2011, the long-term budget outlook for state and local governments is generally not considered to be promising. A model of state and local operating balances maintained by the US Government Accountability Office (GAO) suggests that state and local budget deficits as a percentage of GDP will grow from the years 2015 through 2060 (the entire window of the model).

Hawaii Tax Structure SWOT Analysis

A SWOT (strengths, weaknesses, opportunities and threats) analysis generally looks at a system or organization from two perspectives – that of the internal organization and system (strengths and weaknesses) and the external environment (opportunities and threats). Based on this, the following are identified as key issues in these categories:

Strengths

In many respects, the Hawaii tax structure has been developed to capitalize on the State's unique geographic situation in relation to other states. The following are internal advantages of the current tax structure:

- Broad and stable base for the GET
- Relatively low tax rate for the GET
- Insulation from cross-border competition issues
- GET is responsive to demographic and economic changes
- Ability to export a significant share of the state tax burden

Weaknesses

The prominence of the GET helps to expose some of its weaknesses as well. Other aspects of the tax structure and how it is administered are also areas of concern for the overall tax structure:

- Largely dependent on two taxes (GET and IIT)
- GET results in some tax pyramiding
- Comparatively high IIT rates at the high and low income levels

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- Exempts a growing source of revenue (pension and social security income) from the IIT
- Small source of revenue from the corporate net income tax
- Variety of tax law sunsets in coming years
- Older tax collection systems and processes

Opportunities

- Federal solution on e-commerce tax collection
- Voluntary vendor compliance on e-commerce tax collection

Threats

- Continued erosion from e-commerce
- Reductions in federal spending
- Decline in tourism, either related to broad-based economic downturns or specific shocks

Structural Sustainability

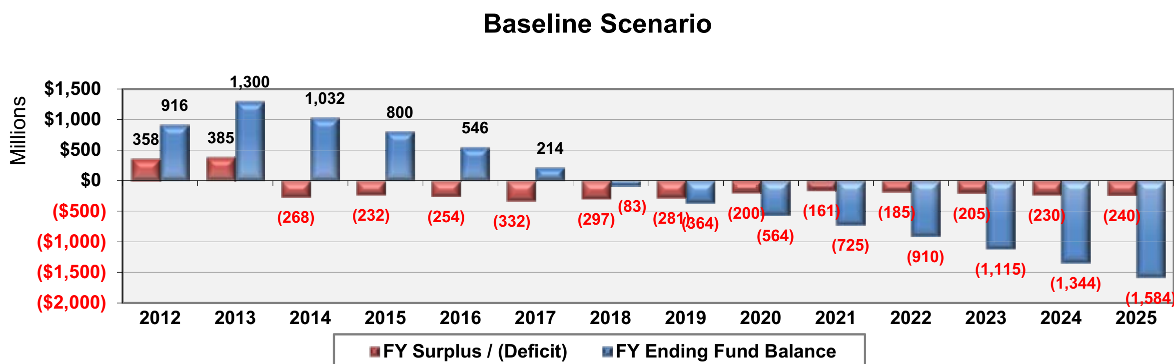
<u>PFM Long Range Financial Forecasting Model</u>

PFM built a multi-year financial forecasting model that projects the State's General Fund revenues, expenditures and financial results through FY 2025. The model uses detailed historic information and management insight to produce a baseline financial projection. The baseline projection assumes maintaining the current level of service for existing programs and mandated (primarily state and federal law) changes as well as the current tax and revenue structure, including any statutorily required changes. In constructing the model, historic revenue and expenditure data was provided by the Department of Budget and Finance, and the Council on Revenue forecasts were also used. PFM performed regression analysis against key economic variables for a number of the State's key tax revenue sources and also calculated annual growth rates that project how the State's revenues and expenditures will change going forward.

In addition to the baseline, PFM built two alternate scenarios to give a sense of the range of potential outcomes, using different revenue assumptions, to create an optimistic and a pessimistic scenario. The following outlines the results under these three assumptions.

<u>Baseline Projection and Alternate Scenarios</u>

As shown below, diverging revenue and expenditure projections lead to the model forecasting a series of annual budget gaps reaching $240 million by FY 2025 if no corrective action is taken:



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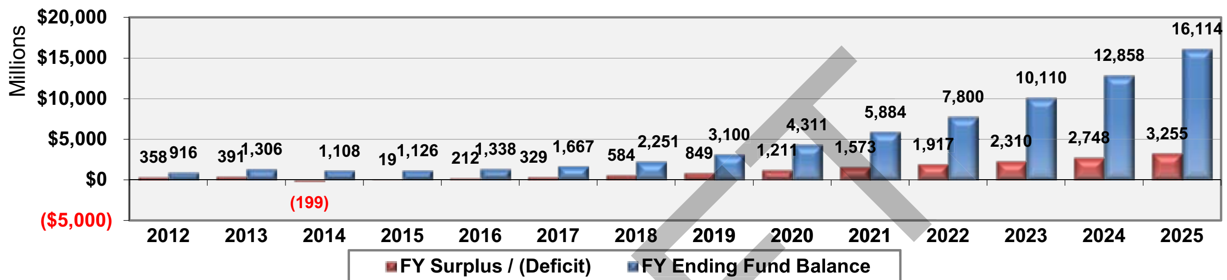
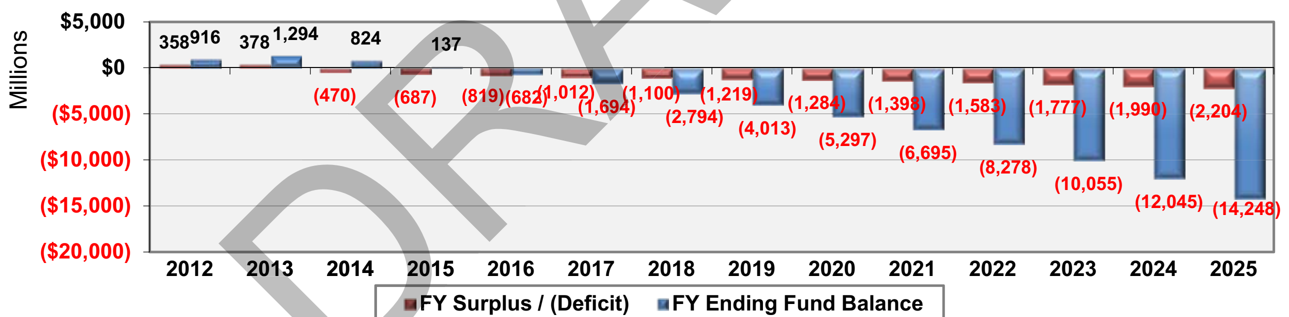
Of course, the magnitude of the budget gaps projected by the model cannot actually occur: As with 48 other states, Hawaii has an obligation to balance its General Fund budget on an annual basis; however, the growing gap between ongoing revenues and expenditures is a sign of a structural issue – which suggests that the current revenue structure is insufficient to meet near and long term needs of the State.

As can be expected, the Optimistic and Pessimistic scenarios diverge from the Baseline in opposite directions. The Optimistic scenario, which assumes that the State experiences a sustained economic upturn similar to the one that occurred in the mid-2000s, allows the State to maintain (and even build) its surplus through most years of the forecast period. The Pessimistic scenario, which assumes that the State experiences an economic downturn similar to the one that occurred in the latter part of the previous decade, creates even larger deficits more quickly than the Baseline projection.

Optimistic Scenario



Pessimistic Scenario



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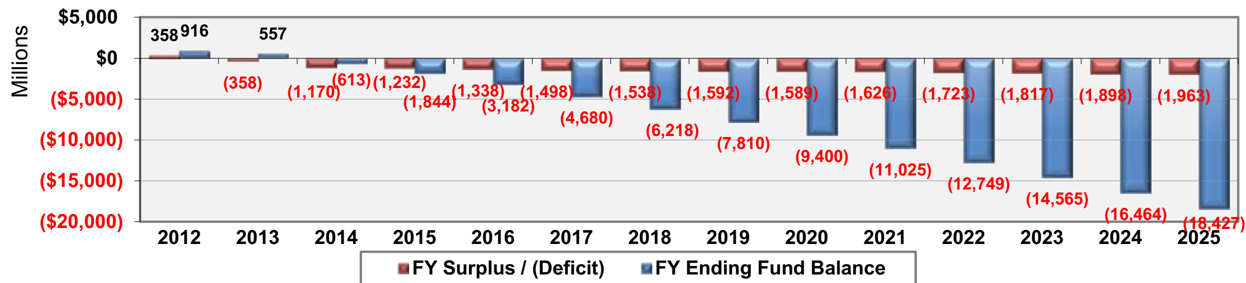
PFM does not view either of these alternate scenarios as particularly likely, and the magnitude of the projected deficits or surpluses would never materialize in the realm of state public policy – in any state. Again, they are provided to determine whether the State finances would be expected to attain structural balance.

Finally, the Commission requested that PFM develop the model with the ability to view financial results on an Accrual basis (as opposed to the cash basis form of budgeting use by the State – and most other states). To do so, the model reflects the full pension and OPEB liabilities. When it does so, the projected deficits in the Baseline projection become significantly larger and harder to manage:

Accrual Basis for Pension and OPEB Liabilities Scenario



Revenue Alternatives

<u>Tax Policy Principles</u>

The charge for the study directed PFM to examine revenue alternatives that would align with generally accepted tax policy principles. Hawaii statute directs the Commission to conduct its review of the State tax structure 'using such standards as equity and efficiency.' These are cornerstone tax principles and were considered in all aspects of the tax structure analysis. In reviewing numerous sources related to tax policy, PFM settled on the following principles, which were identified by multiple sources:

1. The system should be equitable (equity)
2. The system should minimize interference by taxes in market decisions (efficiency)
3. The system should be reliable, stable, and sufficient
4. The system should be simple, allow for compliance, and ease of administration
5. The system should have a balanced variety of sources/broad base

It is important to acknowledge that tax policy principles can and will collide, and a weighing will often be necessary. This is a case-by-case determination – keeping in mind the perspective that there is no perfect tax and all will have some form of negative consequences. The goal of the analysis is to accentuate the positive in the overall structure and minimize or mitigate the negative.

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<u>Possible Revenue Strategies/Approaches</u>

PFM undertook a preliminary analysis of approximately 100 tax and revenue options used in states throughout the country. PFM preferred revenue options that are in general use and, to the extent possible, can be modeled with available data. This created some limitations, as available State tax data has, in many areas, not been updated for as many as 10 years. PFM then analyzed a smaller set of alternatives in greater detail. While not all of those analyzed are included in the recommendations, many are built into the PFM model (which will be turned over to the State upon project completion) and can be developed into alternate scenarios should policymakers wish to consider them.

The following alternatives are listed by type of tax; another way of categorizing them, by approach (base-broadening, rate increases, exportability, etc.), is included in the Appendix to the full report.

General Excise Tax
Alternatives focus on changes to the base or rate. In general, base broadening is preferred, but some rate changes are likely necessary to maintain a reliable, stable and sufficient system.

- Broaden the base by eliminating the exemption for non-profits

- Eliminate the sunset on the application of the GET to activities in Act 105, Session Laws of Hawaii 2011
- Aggressively pursue nexus
- Increase the rate
- Eliminate the 0.5 percent rate, in conjunction with other corporate tax changes

Individual Income Tax
Hawaii uses federal adjusted gross income (AGI) as a starting point for determining state taxable income. There are currently 16 total tax expenditures available to qualifying IIT filers – amounting to approximately $253 million in total tax expenditures in tax year 2009. The following are alternatives to the current structure:

- Eliminate or reduce exemptions on pension income
- Eliminate or reduce exemptions on social security benefits
- Eliminate or reduce specific credits
- Eliminate the deduction for property taxes paid
- Reduce effective tax rates that apply to low-income filers

Excise Taxes
An excise tax is essentially a selective sales tax paid by those who use or consume a specific good or service. Excise taxes often provide an effective strategy for exporting a portion of the tax burden. It is considered theoretically sound to export a portion of the burden because non-resident consumers use state services (roads, police protection) while in the state.

- Increase the TAT
- Institute a prepared food tax
- Restore the temporary surcharge on rental motor vehicles and tour vehicles
- Institute an amusement/recreational activities tax
- Increase the cigarette/tobacco taxes
- Increase taxes on beer, wine and liquor
- Increase the motor fuel tax
- Institute a snack food and/or soda tax
- Increase the conveyance tax
- Increase the insurance premium tax
- Increase the cell phone service tax

Corporate Net Income Tax
While generally viewed as one of the 'big three' taxes among all states, Hawaii raises less than one percent of its general fund revenue from this source. The following alternatives were considered:

- Increase tax rates and combine with reducing/eliminating GET for business-to-business transactions
- Switch to a single factor method of apportionment for multi-state corporations
- Eliminate net operating loss (NOL) carry-back
- Broaden definitions of nexus

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Other Revenue Sources
States use a variety of approaches to raise non-tax revenue or enhance compliance and collection of tax revenue. The following alternatives were considered:

- Approve a lottery or other forms of gambling
- Use tax gap programs and other methods to increase collection of taxes already owed

Observations and Recommendations

Future Lack of Revenue Sufficiency

Based on the constructed baseline from the long range financial model, the State is going to experience structural budget deficits based on the current revenue structure and levels of service. This trend is exacerbated when liabilities for retiree pensions and health care benefits are factored into the model on an accrual basis.

This general view is supported by other recent reports and analysis both for the nation as a whole and specific to Hawaii. As noted, the GAO model of US state and local governments suggests a long period of decline for state and local government finances. For the State, Moody's May 2011 downgrade of the state from Aa1 to Aa2 warned of several financial concerns, including high debt ratios, pension funded ratios that are low relative to other states and growing OPEB expenses.

Further, it is unlikely that the challenges facing the State can be 'solved' with approaches that only focus on expenditures. The State has already cut its workforce and extracted wage and other benefit concessions from workers, limiting its opportunities to further constrain growth in this key area. Meanwhile, the pension and OPEB obligations for current retirees are inescapable and will grow throughout the period of this analysis. Coupled with expected growth in key areas like health care, the expenditure side of the state budget will pose many challenges in the years to come.

At the same time, Hawaii's revenue structure has been shown to be susceptible to economic shocks – both those associated with a deep and prolonged recession and other shocks to key industries, particularly tourism. It is likely that the State will need to build and maintain significant reserves to withstand these inevitable future disruptions.

Framework for Weighing Recommendations

There are literally hundreds of taxes in use and thousands of variations that have been considered or tried in the 50 states. The PFM analysis – and ultimately, recommendations – focused on three key areas:

1. Adherence to the five key tax policy principles (with particular weight attached to equity and efficiency)
2. Revenue generating potential
3. Impact on overall tax administration

Within the five key tax policy principles, the recommendations seek to accentuate the positive features of the State's tax system and minimize or mitigate the negative. For example, the GET has a broad base in terms of its application to goods and services; this advances reliability, stability and sufficiency but makes the system more regressive, impacting equity. The PFM recommendations mitigate some of that impact by changes to the IIT targeted at lower income filers. Likewise, efficiency concerns are raised by some aspects of the GET, including tax pyramiding related to the 0.5 rate for many business-to-business

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transactions. The PFM recommendations eliminate the tax on those business-to-business transactions and make up some of the foregone revenue with changes to the corporate net income tax. While improving efficiency, this also has the advantage of taxing profit, as opposed to simple business activities, which improves horizontal equity.

At the same time, this study cannot solely be an exercise in structural improvements based on tax principles. As has been noted, there is no perfect tax – they all have disadvantages that, in some way, will reduce economic activity. On the other hand, taxes are necessary to fund services that Hawaiians rely upon to maintain or improve their overall quality of life. As Justice Oliver Wendell Holmes noted, “taxes are what we pay for civilized society." The impetus for these recommendations is the need for the State to identify changes that can modify the tax structure in ways that will create sufficient revenue to match the expenditure needs in the coming years.

Within the recommendations, their revenue generating potential is a key area for consideration. As noted throughout the report, there are key demographic and economic changes occurring throughout the nation and State. These changes were factored into recommendations to help ensure that the structure will continue to be sufficient in the future. For example, as the population ages, pension and social security income becomes a larger component of overall income. To maintain a sufficient base for IIT purposes, it is increasingly necessary to include at least some portion of that income in the IIT base, and the recommendations reflect that reality.

There are two other practical implications for focusing on revenue generating potential. First, the recommendations focus on taxes that can have a tangible impact on the state’s structural deficit; taxes with little revenue potential are often little more than nuisance taxes that create unnecessary compliance burdens for taxpayers and collectors alike. Second, the recommendations are focused on revenue modifications that are in use in Hawaii or around the nation. This concept, sometimes expressed as ‘an old tax is a good tax’ is based on the premise that these taxes are generally understood by the market, can be complied with, and their revenue generating potential more accurately modeled.

As previously noted, tax administration and compliance is a valid concern; where possible, recommendations are weighed more favorably that reduce the burden on taxpayers and administrators. Overall, a key goal is to improve system operation and transparency. To that end, some of the recommendations do not make changes to the tax code but touch on ways to improve the overall system of reporting, analysis and administration.

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<u>Base Expansion</u>

As noted, this conforms with the principle of having a broad tax base. This can, in certain situations, also support greater horizontal and vertical equity.

- **Reduce the pension exemption in the IIT**
  The recommendation would tax pension income for taxpayers reporting over $50,000 of AGI. With this as a growing source of income, this base expansion is necessary to maintain stability and sufficiency. The exemption ensures that pension income for lower income filers will still not be subject to tax (a vertical equity issue). At the same time, pension benefits are income, and treating it differently than other forms of income is a horizontal equity issue.
- **Eliminate the deduction for property taxes paid**
  Hawaii is unique among the states in its full state support for K-12 education, which in most states is a shared state-local responsibility, with the local funding primarily supported by property taxes. In essence, the State is subsidizing property taxpayers by this funding approach at the expense of those who do not pay property taxes (an equity issue). Eliminating this deduction helps reduce this disparity by increasing the state tax burden for property taxpayers.
- **Cap or replace with grant programs certain tax credits**

Hawaii has made extensive use of both IIT and corporate net income tax credits, including the Renewable Energy Technologies and the Motion Picture, Digital Media and Film Production tax credits. Currently, these and other tax credits are not capped, which can make it difficult to maintain revenue stability and sufficiency over time. A viable alternative in use in many states is to cap or eliminate broad-based credits and replace them with grant, loan and/or forgivable loan programs. These can be more readily directed at specific types of projects and activities and controlled through the application and approval process.

Reduce Regressivity

Multiple sources have identified Hawaii's tax structure as regressive – a key equity concern. The following changes would address regressive aspects of the two largest sources of General Fund revenue.

- **Exempt the first $20,000 of AGI from the IIT**
  This would address concerns related to the low income levels at which the IIT is applied in Hawaii. It would also ameliorate concerns about the impact on lower income individuals from eliminating the ability to deduct property taxes paid for IIT purposes.
- **Double the refundable food/excise tax IIT credit**
  Hawaii applies its GET to food, which helps to broaden the tax base and makes it more reliable during economic downturns. The current refundable credit is based on income, ranging from $25 per qualified exemption for those with AGI of $40,000 to $50,000 to $85 for those with AGI under $5,000. Doubling this credit will help ameliorate some of the regressive nature of the broad GET base.

Reduce Pyramiding

Economists are nearly uniform in their belief that pyramiding distorts market decisions and reduces overall efficiency. Because the GET applies a 0.5 rate to many business-to-business transactions, pyramiding occurs. The following adjustments would reduce pyramiding and replace some of the lost income with other business-related taxes.

- **Eliminate the 0.5 percent GET and Use Tax rate**
  This would improve overall system efficiency and should also improve horizontal equity – in many instances, certain types of firms can structure their operations to avoid the tax but others cannot.
- **Allow the Act 105 temporary increases to sunset**
  The tax code exempts many business-to-business transactions from the GET. Because of budget concerns, these were temporarily suspended in 2011. The suspensions should be allowed to sunset as scheduled. Restoring these exemptions will help reduce pyramiding.
- **Increase Corporate Net Income Tax revenue**
  Currently, the State has a three tiered structure, with higher tax rates with higher net income. This can be an equity issue, as corporate net income is not necessarily equated with ability to pay. The State should set a single rate in the range of 9 percent. Raising additional revenue from a single tiered corporate net income tax and reducing the GET transaction-related tax would better align with equity and efficiency principles.

Export Tax Burden

Given its destination location and home to thousands of federal civilian and military personnel, the State has an opportunity to export a significant portion of its tax burden. The following recommendations address this approach.

- **Increase cigarette and tobacco tax rates**

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This has the added benefit of generally reducing smoking for key target populations, such as children. While it is a regressive tax, research suggests that higher taxes also encourage lower income individuals to stop smoking – which is a large economic benefit in the long run.

- **Increase gallonage taxes on beer, wine and distilled spirits**
  Revenue growth for these taxes has some connection to the performance of the leisure and hospitality industry, suggesting that a significant portion of the tax is exported. While regressive, higher taxes have also been shown to reduce consumption (which is generally perceived to have positive health benefits).
- **Eliminate the sunset on the TAT rate increase**
  Temporary increases in the TAT are scheduled to sunset on June 30, 2015. Retaining the tax will continue to export a significant amount of the tax burden. Based on travel activity, it does not appear that the temporary tax increase significantly impacted the industry.
- **Restore the surcharge on rental cars**
  A temporary surcharge on rental vehicles was allowed to sunset. Restoring the tax to previous levels will export a significant amount of the tax burden. Based on travel activity, it does not appear that the temporary surcharge significantly impacted the industry.

Rate Change to Restore Structural Balance

With two key revenue sources and no logical major alternatives, the State is primarily reliant on the GET and IIT. Of the two, the IIT already has a rate structure that includes the highest top marginal rate among all states. By contrast, the GET rate has remained constant at 4.0 percent since the 1960s.

- **Increase the GET rate to 4.5 percent**
  Hawaii's GET rate is among the lowest in the country for states with this sort of broad-based consumption tax. While Hawaii has not raised its rate in over 35 years, over half of the states have raised this rate since 2000 – in many cases multiple times. Given the need to restore structural balance, an incremental increase in the GET rate is the logical method to improve the long-term financial outlook. While the GET is considered regressive, other recommended changes would reduce some of that impact.

Changes to Improve System Administration

In the long run, improved technology, processes and reporting can help increase compliance and advance data-driven policy outcomes. The following can assist in advancing those efforts.

- **Develop Tax Gap systems to identify under-payment and non-payment of taxes**
  Many states are using sophisticated data warehouses to analyze tax and other state financial information to uncover possible non-compliance with tax laws, rules and regulations. In many instances, vendors will enter into a performance-based agreement that pays for the necessary system improvements from additional tax revenue achieved because of the system improvements. This effort can be built into current plans to improve the overall financial management systems for the State.
- **Create a compliance and productivity account to fund staff and technology improvements to foster taxpayer education, understanding and compliance**
  In many states, a specific funding stream is established to enhance staff and technology related to education and compliance efforts. The State should capitalize a fund that the Department of Taxation could access for staff and technology upgrades with an expected ROI. These investments would then require a method for tracking performance, with payback to the fund from a portion of the additional revenue received from the initiatives.
- **Provide Tax Expenditure Reports on a scheduled regular basis**

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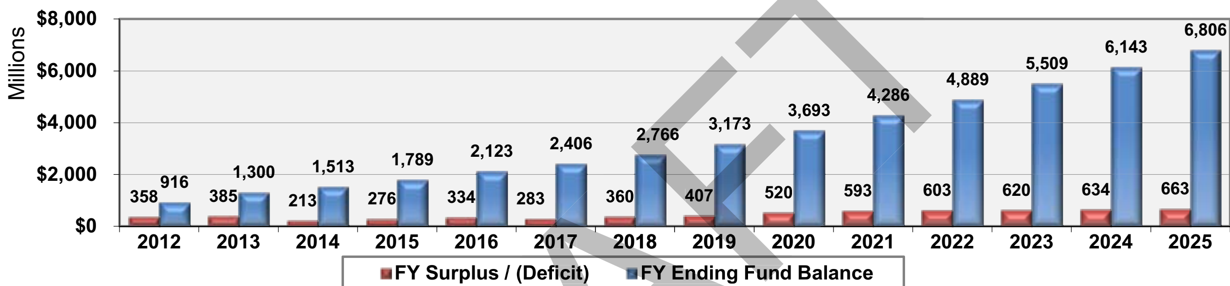
In previous years, the Department of Taxation published tax expenditure reports and other information related to tax collections and taxpayer characteristics. While these were eliminated because of budget issues, they should be restored. The need for transparent data on key tax issues is critical for informed decision making. In many cases, analysis of actual performance of tax law changes – and how they relate to key tax principles – requires the data and analysis that takes place in a tax expenditure report.

Recommendations Fiscal Impact

According to the assumptions currently developed around the recommendations, the end result would be a structurally aligned expenditure and revenue structure through the years the model projects. In some cases, timing of actual implementation might require some adjustment (which the model allows PFM and the State to do on a real time basis). The following illustrates the baseline projection with the tax structure recommendations fully implemented:

Baseline Projection with Full Implementation of Recommendations



The following table summarizes the recommendations and their fiscal impact for 2014:

Summary of Recommendations

Initiative Data Load	*2014*
Base Expansion	
Reduce the pension exemption in the IIT	166,093,162
Eliminate the deduction for property taxes paid	25,027,669
Reduce Regressivity	
Eliminate IIT for Individuals with an AGI of $20,000 or lower	(17,119,736)
Double the low-income food credit	(19,977,459)
Eliminate Pyramiding	
Eliminate the 0.5 percent GET and Use Tax rate	(134,708,410)
Allow the Act 105 temporary increases to sunset*	(74,550,434)
Increase Corporate Net Income Tax revenue	34,822,258
Export Additional Tax Burden	
Increase cigarette and tobacco tax rates	9,838,872
Increase gallonage taxes on beer, wine and distilled spirits	1,886,273
Eliminate sunset on TAT rate increase	0
Restore the surcharge on rental cars	65,451,475
Rate Change to Restore Structural Balance	
Increase the GET rate to 4.5 percent	349,899,664
Changes to Improve System Administration	
Develop Tax Gap systems to identify under-payment and non-payment of taxes	0
Total Fiscal Impact	**481,213,770**

**Already assumed in baseline revenue projection therefore not including in savings total.*

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Summary

The PFM long range financial forecasting model and the resulting analysis of baseline expenditures and revenues conclude that the State faces a significant financial challenge. On a cash basis, the baseline model projects an accumulated shortfall of $1.6 billion between FY 2013 and FY 2025. While an optimistic scenario was created that could allow the State to avoid a structural deficit, an equally likely pessimistic scenario suggests it will be far worse than even the baseline projection – with an accumulated shortfall of nearly $14 billion through FY 2025. If the focus is shifted to an accrual basis to fully account for liabilities associated with pension and OPEB liabilities, the baseline scenario accumulated shortfall balloons to over $18 billion.

The State of Hawaii is at a crossroads: the PFM long range financial forecasting model projects that the State can maintain a positive balance for the next few years under predicted current levels of service and revenue forecasts. However, if the State waits to address the problem, it will lose the opportunity to build reserves and make strategic investments – as in, for example, technology – that can assist it to improve overall productivity of the revenue system as well as financial transparency, accountability and compliance in the years to come.

The recommended initiatives form a comprehensive package that build on current, accepted taxes and modify them in ways that raise additional revenue while also focusing on ways to increase equity and efficiency and further export part of the State tax burden. Regardless of the approach the State takes, this sort of a balanced, long-term approach will be most likely to craft a structure that provides sufficient revenue in a way that minimizes the negative effects of taxes on the economy and taxpayers.

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