REPORT OF THE
2010 – 2013 TAX REVIEW COMMISSION

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Roy K. Amemiya, Jr.
Peter S. Ho
Michael T. McEnerney
Darryl K. Nitta

November 28, 2012

To the Honorable Members of the Twenty-Seventh Legislature:

The Tax Review Commission is pleased to submit this report, which contains its review of the State of Hawaii's tax structure and recommendations for change. The review and recommendations are submitted in accordance with Act 218, Session Laws of Hawaii (SLH) 1979, as amended by Act 212, SLH 1983.

This report represents the overall sentiment of the Commission. Not every Commissioner may approve of each individual recommendation, as some were decided on majority votes and others may reflect compromise language. However, each of us approves of the report as a whole.

The Commission has dedicated much time and thought to this initiative, and we are proud of our service. We recognize that the report presents difficult choices for the Legislature, but we believe the report reflects the difficult situation facing Hawaii. We hope the analysis and recommendations are useful as the Legislature takes up the task of solving the formidable budgetary challenges facing the State of Hawaii.

Respectfully Submitted,

TAX REVIEW COMMISSION

Randall Y. Iwase, Chair

Mitchell A. Imanaka, Vice-Chair

Roy K. Amemiya, Jr.

Peter S. Ho

Michael T. McEnerney
CONCUR + DISSENT -
SEE STATEMENT

Darryl K. Nitta

REPORT OF THE 2010-2013 TAX REVIEW COMMISSION

CONCURRENCE AND DISSENT OF COMMISSIONER MICHAEL T. McENERNEY

MBA,JD,CPA/ABV/CFF,ASA,CVA

I respectfully dissent from full approval of the report of the 2010-2013 Tax Review Commission.

The commission is charged with a specific task via both the State of Hawaii Constitution and by statute. The constitution provides that the TRC evaluate the State's tax structure, recommend revenue and tax policy, and then dissolve. HRS Section 232E-3 provides in part that the TRC shall conduct a systematic review of the State's tax structure, using such standards as equity and efficiency. In addition, H.R. No. 218 resolved in part that the TRC study the projected net loss to Hawaii residents in their federal tax liability that is attributable to the manner in which the state and county governments are currently funded.

The TRC Observations and Recommendations are contained in the Executive Summary and in section 4 of the report. These can be summarized as follows:

1) That the Forecasting Model be utilized to develop the comprehensive plan necessary to address the huge budget shortfall in a timely and responsive manner.

2) The TRC concurs that taxing retirement income does raise a serious equity issue that must be addressed. The previous two Tax review Commissions have provided sensible recommendation options for policy makers to consider.

3) The TRC agrees with Dr. Fox that enactment of federal legislation is the only viable means to provide states with the authority to collect on remote sales.

4) Eliminate the income tax for those below poverty level.

5) The DoT's collection and enforcement efforts should be augmented.

6) To insure that targeted economic tax incentives are effective, the TRC recommends the following:

If targeted tax incentives are enacted to promote economic activity, then:

Make incentives dependent on performance
Evaluate the effectiveness of the targeted incentives
Build "claw back" mechanisms into incentive programs when the

recipient of the credit does not meet performance objectives
Have a sunset date, with sunset cost/benefit review to determine whether the incentive program should continue
Ensure transparency, including disclosure of economic terms and packages
Place a cap on tax credits

In lieu of such tax incentives, implement grant programs to be administered by the departments primarily responsible for economic development activities

7) Broad mechanism for assessing expenditures along with revenues [with no specific recommendation as to revenue enhancement] the TRC "believes" that, given the magnitude of the projected budget shortfall policy makers should give serious consideration to establishing a commission similar to the National Commission on Fiscal Responsibility and Fiscal reform.

This comprises the entirety of the recommendations of the TRC.

The TRC engaged PFM Group to address several matters. One valuable result was the creation of a model that will allow the Department of Taxation and other authorized users to see the impact of economic and structural changes (changes in rate of tax and coverage of related taxable income) to see the impact on revenues. This is a valuable tool and complies with our mandate to conduct a systematic review of the State's tax structure but does not in and of itself address the issues of equity and efficiency.

I strongly dissent from the inclusion in the in the body of the TRC Report the items, taken from the PFM Report, 3.1.2, Alternate Tax Structure; table 3.1, Summary of PFM Package of Recommended Tax Structure Changes; Table 3.2, PFM Estimates of Fiscal Year 2014 Impact of Recommendations; Figure 3.3, PFM Baseline Scenario with Full Implementation of Recommendations (Cash Basis); Figure 3.4, PFM Baseline Scenario with Full Implementation of Recommendations (Accrual Basis); and, and Table 3.3, List of Alternatives Not Recommended by PFM Group. None of these items provide a direct link to any of the recommendations of the TRC with the partial exception of the small part dealing with retirement income. The inclusion of these items gives the casual reader the impression that the TRC supports these items when in fact we have been clear in not adopting these recommendations, especially the 0.5% increase in the GET, as part of our final recommendations. All of the information contained in these items is included in the body of the PFM Report. The inclusion of these items in our report places undue emphasis on these items to the exclusion of others.

An example of such an exclusion, as pointed out in the Fox study, well over $100 million in potential state revenue is lost to internet sales. These sales are subject to the Hawaii Use Tax which tax is apparently not being paid by the end users purchasing goods for use in Hawaii. I had made a specific recommendation that the state adopt a simple approach to this problem such as that used in Illinois where a section of the Illinois annual net income tax return, form IL-1040, includes a simple Use Tax statement concerning possible use tax if such tax is less than $600. The Illinois rate is 6.25% such that a $600 tax would be $9,600 in out of state, including Internet, purchases. If the taxpayer's liability is over $600 a specific Use Tax form ST-44 is due. This was objected to on two grounds: first, it adds complexity to the Hawaii Individual Return both in filing and accounting for the funds collected; and, second, compliance would be questionable.

As to the first, there is little additional complexity. Many individuals who purchase out of state probably have their returns prepared by professionals who would be very able to handle the complexity. As to accounting, this tax would be on a separate line so easily identified. As to the second, we already have a compliance problem as pointed out in 3.4 of the TRC Report. I am in complete agreement with 3.4's recommendations. In addition, I believe that the under funding of the DoT collections activity leads to non-compliance. The GE/USE Tax issue is a major revenue enhancement for the period prior to the resolution of the E-Commerce issue by federal law. We are losing $145 million in potential revenue now. If a reasonable percent of Hawaii taxpayers voluntarily comply with a Use Tax self assessment on their individual income tax returns significant additional revenue results (remember revenue was advanced as the TRC's designated main task).

There is no doubt that the state is facing a major fiscal cliff of its own. Our task was not to address legislative policy issues rather tax policy issues using such standards as equity and efficiency. The TRC determined that revenue would be a major issue to address. The inability to reach a reasonable consensus on revenue enhancement coupled with the results of the public hearing on the draft PFM Report resulted in the decision to recommend establishing a commission similar to the National Commission on Fiscal Responsibility rather than attempt to deal with specific revenue enhancements other than the ones noted.

If revenue was to be the focus of the report, then all reasonable sources of revenue should have been addressed. By including the noted sections in the report, the TRC appears to have primarily adopted the recommendations of the PFM Group Report and accepted their conclusion at PFM Report pages 151-153 not to recommend 13 separate items of revenue enhancement. If the issue is revenue then the TRC should have considered and recommended several, of these items rather than just dismiss them as the TRC did at 3.1.2 concerning a lottery and converting the GET to a VAT.

More to the point, the PFM Report adopts the easy solution to the revenue issue by recommending an increase in the GE tax rate. This is the easy solution as over half of the state's general fund revenue comes from the GE tax. It is also simple to administer assuming that taxpayers comply with the law. The problem is that the GE tax is very regressive and applies to over 100% of the revenue in the state. This cannot be easily offset by a low income credit. It also increases significantly the cost of business in Hawaii and makes internet based purchases even more attractive.

The objection of resistance to compliance needs to be addressed. We already have a compliance problem both with unreported income and with unpaid taxes. Together these two areas would reduce significantly the revenue shortfall.

There are many reasons for compliance and payment problems. Individuals will tend to comply with laws that they believe are fair and equitable. When a revenue law is fair (equitable), easy to administer and is assured of fair and open implementation (accountable) then compliance will rise. We have significant problems in fairness (equitable) and fair and open implementation (accountability) in our tax system today. It is not difficult to understand why individuals and businesses would not comply with a tax system that allows so many individuals and business taxes to go to collections and sit for years with little actual action.

For the above reasons I concur in part and dissent in part to the adoption of the full report.

Michael T. McEnerney

Michael T. McEnerney

ACKNOWLEDGEMENTS

This is the report of the 2010-2013 Tax Review Commission. The Commission is composed of seven unpaid members (one who resigned and six who served the full period), who have dedicated many hours in an effort help the State evaluate the structure of its taxes.

The Commission wishes to acknowledge the Department of Taxation for technical and administrative assistance. We would like particularly to thank Frederick Pablo, the Director of Taxation, for his active involvement in providing his Department's resources to help the Commission with its work.

We would also like to acknowledge the dedicated performance of the Rules Office and of the Tax Research and Planning Office, which provided technical and administrative support for the Commission. Despite staff shortages and a high rate of turnover during the Commission's tenure, these offices were able to effectively organize and coordinate the Commission's meetings, prepare minutes for its meetings, keep records of its correspondence, arrange travel for its members, solicit proposals for external studies, and conduct several studies requested by the Commission.

And we offer our gratitude for the excellent legal assistance provided by Deputy Attorney General Randall S. Nishiyama.

THE 2010-2013 TAX REVIEW COMMISSION

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Former State Senator, Deputy
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Chairman of Labor Appeals Board

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EXECUTIVE SUMMARY

With the Great Recession of 2008 - 2010, the 2010 – 2013 Tax Review Commission (TRC or "Commission") concluded that a comprehensive review of Hawaii's tax structure was necessary to determine how the structure fared during the recession and whether Hawaii's tax structure was adequate to meet the needs of the 21st century. The TRC commissioned consultants and requested studies from the Dept. of Taxation ("DoTAX").

The "Study of the Hawaii Tax System" by one of the TRC's consultants, The PFM Group, as well as the study "Will Hawaii's Tax Structure Prove Adequate for the Future?" prepared by Joshua O. Fujino and Donald J. Rousslang, PhD ("Fujino-Rousslang") of the DoTAX Tax Research and Planning Office, together presented a very troubling view of the adequacy of the tax structure for the 21st century. Both studies determined that, unless policy changes are made, huge budget shortfalls will likely occur.

The PFM "Baseline Scenario," based on current expenses and cash basis accounting, determined that by the year 2025 the State will face a projected accumulated budget shortfall of nearly $3 billion. The annual budget shortfall beginning in FY 2014 would be $370 million. The shortfall is even worse under the accrual basis, with a projected shortfall in 2025 of $17.25 billion.

The Fujino-Rousslang study determined that "unless we experience economic growth at the high end of the current forecast, the deficits may reach levels of $1.8 billion by 2022."

In short, within two years, the State will face an ever-growing budget gap. Unless action is taken now, the shortfall will be overwhelming and would require ever more burdensome measures that would negatively affect our state, its economy, and its taxpayers.

Article VIII, Section 3 of the Hawaii State Constitution provides that the TRC evaluate "the State's tax structure, recommend revenue and tax policy, and then dissolve." By law, the TRC's jurisdiction is limited to revenue/tax policy. We do not review or make recommendations on the expenditure component of the budget.

However, given the projected budget shortfall – billions of dollars – we believe that both the expenditure and revenue components of the budget must be considered by policy makers. The shortfall cannot be addressed solely by the revenue or expenditure component of the budget.

Accordingly, as part of our report, we recommend the establishment of a commission similar to the Federal "National Commission on Fiscal Responsibility and Reform" (also known as the "Simpson-Bowles Commission"), with authority to review and make recommendations on expenditures and revenue enhancement.

Recommendations/Observations: The magnitude of the projected shortfall by 2022 (Fujino-Rousslang study) or 2025 (PFM study) clearly must be confronted and resolved. If approached solely from revenue enhancement, we believe that the tax burden on Hawaii taxpayers would be severe. The expenditure component must, therefore, be part of the solution.

1. The TRC recommends establishment of a Simpson-Bowles type commission to address both revenue and expenditures. We believe that this is the only viable means to effectively address the huge projected budget shortfall.

2. The TRC recommends that the Multi-Year Forecasting Model ("Forecasting Model") constructed by PFM and licensed to the State for official use, be utilized in developing revenue measures. The TRC believes that, given the size of the shortfall, any revenue enhancement plan must be comprehensive.

   Use of the Forecasting Model will assist policy makers in that regard. As described by PFM, the Forecasting Model projects the State's General Fund revenues, expenditures, and financial results through FY 2025. And the model can help policy makers identify key issues and trends in the short and long run, and allow testing of multiple approaches on both revenue and spending sides of the budget.

3. The TRC recommends that the State urge the Hawaii Congressional delegation to support and enact federal legislation to address the United States Supreme Court decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Federal legislation to effectively address the "nexus" question would allow states to tax e-commerce sales and collect needed revenues.

   The TRC consultant study by Dr. William Fox estimates that Hawaii is now missing out on approximately $145 million in GET taxes annually as of 2012. The revenue loss will only grow as e-commerce sales increase.

4. The TRC recommends addressing the regressivity of Hawaii's income tax on residents below the poverty level by increasing the food/excise and low-income renter's credit, the standard deduction, and/or the personal exemption.

5. The TRC recommends additional resources for DoTAX to improve the Department's collection and enforcement efforts. The TRC supports DoTAX plans to modernize its computer system and the addition of more staff and/or filling of current vacancies. The TRC further believes that increased enforcement should be preceded by a general tax amnesty program.

6. The TRC believes that tax measures can be utilized to help incentivize economic growth or diversification. Growing and diversifying Hawaii's economy is an important part of increasing revenues. The TRC recommends that, if such incentives are enacted, criteria must be in place so that policy makers can determine the efficacy of such incentives.

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1 INTRODUCTION: CONTEXT AND SCOPE OF REPORT

1.1 Historical Economic Context

The Tax Review Commission (TRC) convened at a time when economies throughout the world were struggling with the effects and impacts of the Great Recession, historically unprecedented since the Great Depression. The TRC believed it was necessary and prudent to review the recession's effects on Hawaii's economy in general and on the State's tax structure in particular. Among the major questions raised – to which the Commission wanted answers – were "How did the State's tax structure respond to the Great Recession?" and "Is that tax structure adequate for 21st Century challenges that confront our state – e.g., internet/e-commerce sales?"

1.1.1 The Great Recession of 2008 – 2010

This recession (technically ending in 2009 but by many measures lasting at least into 2010) affected the State of Hawaii's tax revenues more deeply than any downturn in the past four decades. It led to painful layoffs, furloughs, and reductions in public services – all stemming from similar hardship in the private sector.

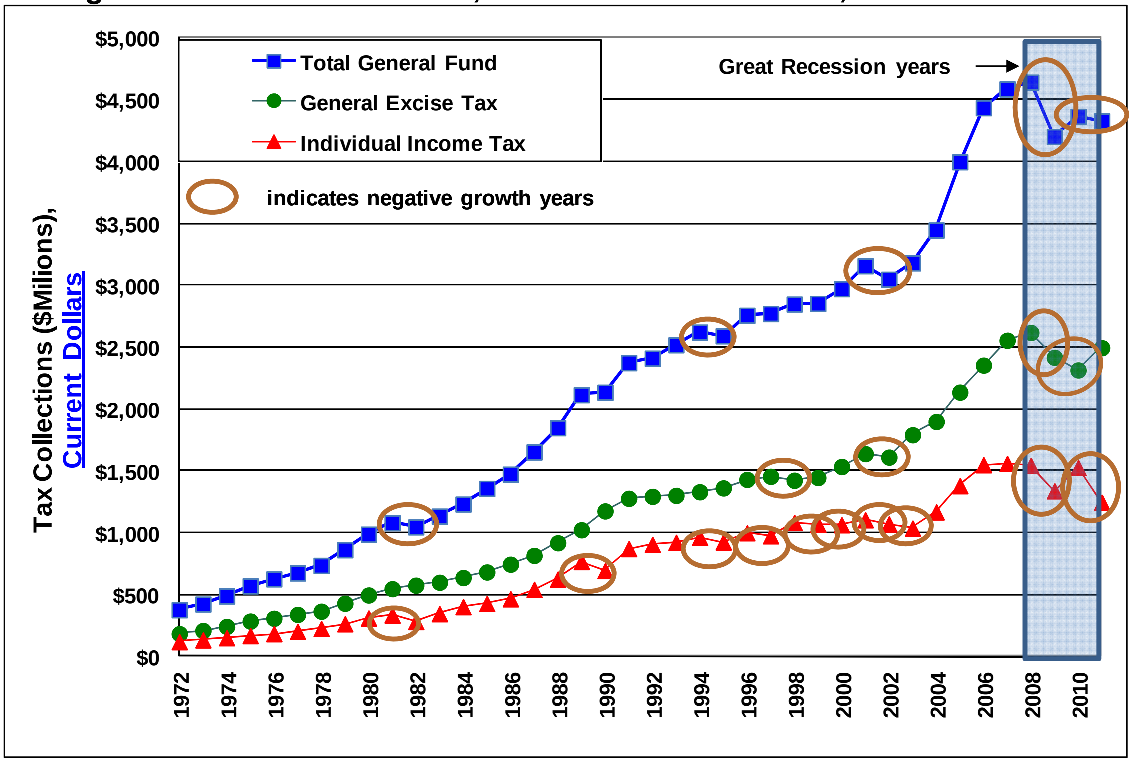
Figure 1.1 on the following page summarizes historical data from Hawaii State Dept. of Taxation (DoTAX) records on tax collections, and the following Figure 1.2 translates these into percentage of total personal income for the state. Shown are total General Fund tax revenues and the largest two components – the General Excise Tax (GET) and individual income taxes – which in recent years together have accounted for 86% to 90% of all General Fund revenues.

- Figure 1.1 indicates total General Fund revenues declined faster and longer in the Great Recession than at any other time in the last four decades. The 2008 – 2009 General Fund revenue decline alone was 9.5%.

- Figure 1.2 shows that, despite some changes in tax laws and other measures taken to augment revenues, [1] total General Fund tax collections declined relative to the rest of the economy since the onset of the Great Recession. This was at a time when the demand for social services was probably growing.

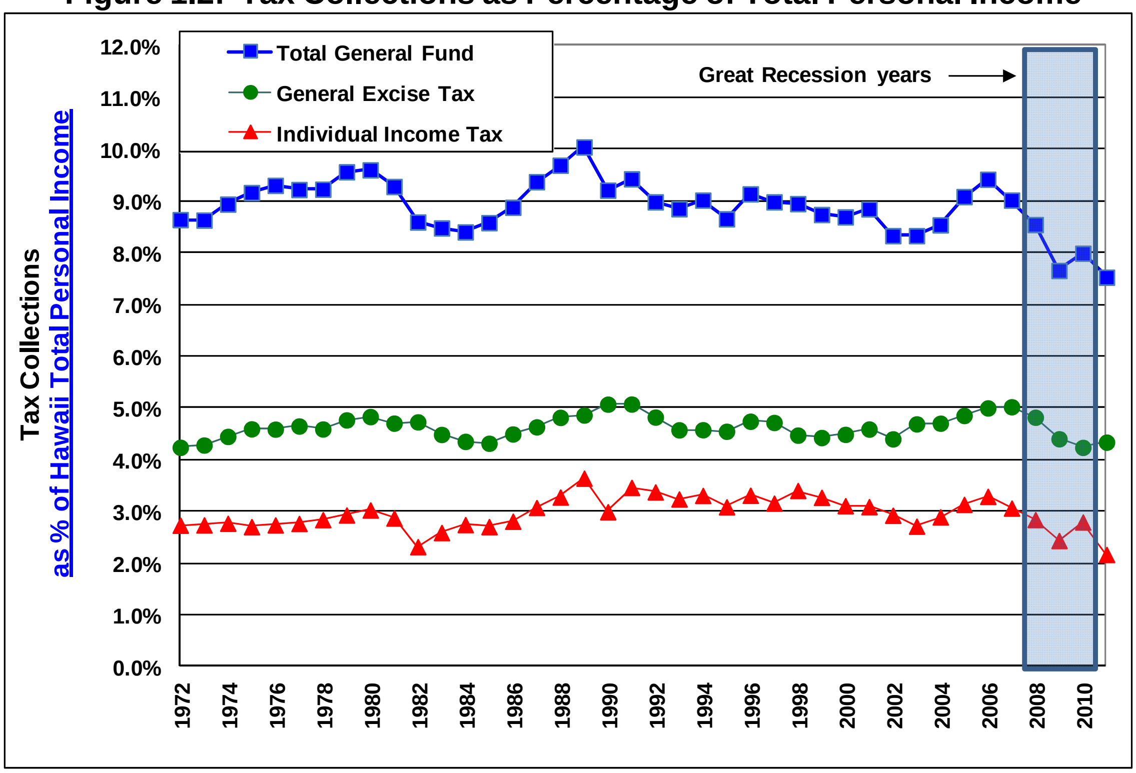
[1] The Legislature increased revenues in various ways – e.g., increasing top tax brackets and phasing out some exemptions/deductions for high-income taxpayers, and increasing the Transient Accommodations Tax rate. In addition, the Administration delayed refunds of taxes at the end of fiscal year 2010, which had the effect of artificially increasing the recorded General Fund collections that year.

Figure 1.1: Tax Collections, Fiscal Years 1972-2011, Current Dollars



Source: Records, Hawaii State Dept. of Taxation

Figure 1.2: Tax Collections as Percentage of Total Personal Income



Source: Records, Hawaii State Dept. of Taxation.

1.1.2 Indications of Probable Serious Budget Shortfalls in Coming Years

Foreseeable critical factors include:

(1) Projected State employer contributions to the Employee Retirement System (ERS), which had a projected "unfunded actuarial accrued liability" (i.e., likely future demand for which no certain payment plan exists) of $8.2 billion as of early 2012;[2]

(2) Similar obligations for State employee health plans – both the Employer-Union Health Benefits Trust Fund (EUTF) and the Voluntary Employees' Beneficiaries Association (VEBA) for the Hawaii State Teachers Association. Based on recent actuarial valuation studies,[3] there was a present value of $11.8 billion unfunded liability at the end of FY 2009.

(3) Rising Medicaid costs, an issue for both federal and state governments (which share the obligation), as costs per patient increase and eligibility numbers go up in softer economies. According to the Henry Kaiser Family Foundation "StateHealthFacts.org" website,[4] 10.3% of Hawaii's FY 2010 General Fund budget went to Medicaid – actually a lower percentage than for most states and for the country as a whole (15.8%).

Studies for this report indicate these factors will generate significant shortfalls fairly soon. For example, the PFM study (Appendix A) suggests that under cash basis accounting, annual shortfalls could start in FY 2014 and reach between $240 million and $400 million per year until FY 2025, with a cumulative FY 2025 ending General Fund Balance of nearly $3.0 billion.[5] The situation is worse under the accrual basis – more than $17 billion by 2025.

Another study for the TRC, by DoTAX economists Joshua Fujino and Donald Rousslang, includes a variety of scenarios, some with major shortfalls as soon as 2013

[2] Gabriel Roeder Smith & Company. "Employees' Retirement System of the State of Hawaii: Report to Board of Trustees on the 86th Annual Actuarial Valuation for the Year Beginning June 30, 2011." Feb. 27, 2012. Accessed Aug. 15, 2012 at http://ers.ehawaii.gov/wp-content/uploads/2012/03/2011Valuation.pdf.

[3] AON Hewitt, "State of Hawaii Postemployment Benefits Other than Pensions, Actuarial Valuation Study," March 16, 2011. Accessed Sept. 13, 2012 at http://eutf.hawaii.gov/Reports/aon-hewitt/2009%20EUTF%20Ret%20Med%20Rpt%202011-05-10%20OPEB%20final.pdf. Also, AON Hewitt, "Voluntary Employees' Beneficiary Association (VEBA) Trust for the Hawaii State Teachers Association (HSTA), Postemployment Benefits Other than Pensions, Actuarial Valuation Study," March 16, 2011.

[4] http://www.statehealthfacts.org/profileind.jsp?rgn=13&ind=33, accessed Aug. 15, 2012.

[5] The PFM Group. "Study of the Hawaii Tax System: Final Report." Prepared for 2010-13 TRC Philadelphia PA and San Francisco CA 2012. P. 101. In addition to the "baseline scenario," the report also presents an "optimistic scenario" in which the economy maintains essentially boom levels and results in surpluses, and as well as a "pessimistic scenario" in which sustained economic reverses produce even greater shortfalls.

and with a projected shortfall $1.8 billion per year, by FY 2022 if Hawaii does not experience economic growth at the high end of current forecasts. [6]

1.2 Scope of Report

1.2.1 Constitutional and Legislative Mandate

Article VII, Section 3 of the Hawaii State Constitution requires creation of a tax commission every five years: "The commission shall submit to the legislature an evaluation of the State's tax structure, recommend revenue and tax policy and then dissolve." The implementing statute (HRS §232E-3) further says the TRC's duties are to "conduct a systematic review of the State's tax structure, using such standards as equity and efficiency."

1.2.2 Additional Perspectives on TRC Scope

The TRC is fully cognizant that in formulating the State's budget, both revenues and expenditures must be considered. However, the Commission's mandate is to make recommendations on the revenue component, not expenditures. We have, in this report, adhered to that mandate.

With limited resources and a limited timeframe to submit its final report, the TRC focused on the following topics:

- Revenue adequacy and policy alternatives, including development of a tax model;
- E-commerce tax revenue approaches;
- Revenue-neutral ways of restructuring GET versus income tax;
- Fiscal implications of DoTAX collection/enforcement budget;
- Potential elimination of income taxes for those below the poverty level;
- Criteria to guide future decisions on tax incentives for economic expansion/diversification.

[6] Fujino, J., and Rousslang, D. "Will Hawaii's Tax Structure Prove Adequate in the Future?" Hawaii State Dept. of Taxation, special analysis for 2010-13 TRC. Honolulu, HI, Aug. 2012. See Appendix E. (Note: The larger shortfalls are for scenarios in which the accrued costs of health benefits for retired State workers are fully funded.)

2 PRINCIPLES OF SOUND TAX POLICY

For nearly 25 years, the most widely recognized set of principles of sound tax policy for state government have been those developed in 1988 by a conference of lawmakers and academics organized by the National Conference of State Legislatures (NCSL) and the Lincoln Institute of Land Policy.

Table 2.1 on the following page summarizes these five principles, based on a review and discussion by David E. Brunori, currently Research Professor of Public Policy and Professorial Lecturer in Law at George Washington University. These NCSL principles, or slight variations of them, have provided evaluation criteria for all Hawaii Tax Review Commissions since 1989.[7]

As acknowledged in the PFM study, "…in a number of cases these general tax principles will conflict, and it will be necessary to weigh the costs and benefits of adhering to the principles."[8]

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[7] All Tax Review Commission reports, beginning with the original 1984 Commission, are available online from DoTAX at http://www6.hawaii.gov/tax/a9_2trc.htm.

[8] The PFM Group. "Study of the Hawaii Tax System: Final Report." Philadelphia PA and San Francisco CA 2012. P. 106. Full study in Appendix A of this report.

Table 2.1: Principles of Sound Tax Policy for State Governments

Principles	Elaboration/Explanation	Additional Points
Raising Adequate Revenue – Assuring funds to meet present and future costs of public expenditures	"Adequacy" has three characteristics – • *Sufficiency:* Enough to balance budget while funding state programs; flexibility as spending needs vary over time • *Stability:* Ensuring consistent revenue through mix of taxes "with some responding less sharply to economic change than others" • *Certainty:* Minimizing frequency of tax changes, so that businesses and individuals may make reliable economic choices and financial plans	A mix of taxes – especially income taxes and consumption taxes – is seen as critical to the historical success of U.S. states in raising adequate revenues without significantly reducing public services. A variety of taxation tools allows lawmakers to selectively raise revenues or cut taxes in response to specific economic changes (i.e., keeping the fiscal house in order would be impossible with just one tool; a saw cannot fix a leak).
Neutrality – Minimizing tax-consequence impacts on market decisions	This is best attained by a broad tax base (few exceptions, deductions, or credits) and low rates.	Most state tax systems have failed at this, due to economic and political pressures. Tax incentives/disincentives typically reflect broad-consensus social goals, though economists question tax breaks as a means to achieve them.
Fairness – Equitable treatment of all stakeholders, a difficult principle to achieve because of subjective differences about what is "fair and equitable"	Fairness has two dimensions – • *Horizontal Equity:* All taxpayers in the same circumstances should bear equal burdens • *Vertical Equity:* If taxpayers differ in their circumstances, ability to pay should be factored in to tax rates	"Progressive" taxes such as income taxes help achieve vertical equity, while "regressive" consumption taxes (such as the Hawaii GET) work against it. This is a dilemma for all states, because consumption taxes have other positive characteristics and have become financially important.
Ease of Administration and Compliance – Keeping the tax system simple and clear	Complicated systems results in more <u>public</u> administrative costs and more <u>private</u> investment in legal/accounting expertise, as well as time burdens in recording and reporting	Well-intentioned tax incentives or disincentives not only violate the Neutrality principle, but also complicate the tax system.
Accountability – Assuring fair and open implementation of the system as intended, including both legislative and administrative processes	States must play three roles to achieve this – • Fair and efficient administration; lack of corruption and incompetence • Actual enforcement of tax laws • Open, transparent tax policies and decision-making processes (legislative and administrative)	In many states, secrecy has been a longstanding problem both in enactment and enforcement. It undermines public faith by obscuring why laws have been passed and who is actually benefitting. Accountability also means regular review and evaluation of tax laws. Many states fail to do this because there is no legal requirement to do so.

Source: Brunori, D. *State Tax Policy: A Political Perspective.* Washington, D.C.: The Urban Institute Press, 2001. Pp. 11-24 (Chapter 2).

3 FINDINGS OF CONSULTANT AND DOTAX STUDIES

3.1 Revenue Adequacy, Policy Alternatives, and Model

To address these critical issues, the TRC engaged the PFM Group,[9] whose full report is attached as Appendix A. Specifically, PFM studied:

1. Whether the current State tax structure can meet 21st-Century needs (a question also addressed by a separate DoTAX study); and

2. Alternate tax structures that could improve the State's ability to generate needed revenues in the future.

In conducting its study, PFM developed a Multi-Year Financing Forecasting Model ("Forecasting Model"), a Microsoft Excel-based model that provides for analysis of various revenue policy scenarios. The model forecasts revenues and expenditures based on detailed input assumptions. The Forecasting Model covers the period from FY 2012 to FY 2025. See Appendix B for description of the Forecasting Model.

PFM's "Baseline Scenario" is based on *current level of services* (but noting cost changes that may accompany these levels in coming years). This assumption is made simply for purposes of illustrating the general concept of "adequacy" in the 21st Century by using a model scenario based on the present – these are *not* target expenditure figures, nor are they recommendations that the State should spend at these levels. Indeed, one of the obvious implications is that expenditures and levels of service may need to be revised, but the specifics of any such changes in expenditures are beyond the TRC's scope. Model assumptions also included current tax laws scheduled to sunset or change in certain future years.

3.1.1 Tax Revenue Adequacy for 21st Century

PFM concluded that Hawaii's revenues will likely be inadequate, due to factors that include unfunded liabilities for employee retirement systems and health plans as the workforce ages and retires, along with increasing Medicaid costs. These factors are somewhat more pronounced in Hawaii than in other states because residents here tend to be older than the national average. Additionally, State workers accepted wage/salary cuts during the Great Recession that are assumed to be restored in the future.

Of all these factors, Hawaii faces a particular challenge due to a history of inadequate funding of its Employee Retirement System (ERS) pension fund. PFM cited March 2012 numbers from the Fitch rating service, as well as other analyses:

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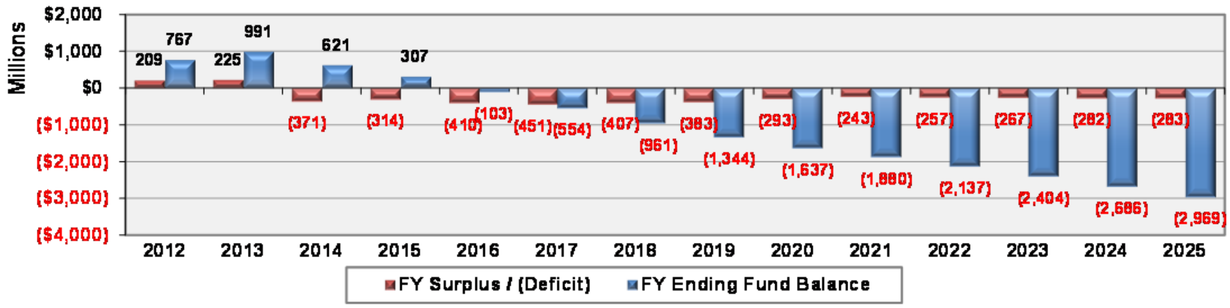
[9] PFM ("Public Financial Management") is a national organization, with offices in 23 states, specializing in services for state/municipal clients in areas such as financial advice, asset management, strategic consulting, etc. Many of the company's staff are former state or municipal directors and top analysts.

> According to Fitch's new liability metrics that measure each state's net tax-supported debt combined with the unfunded actuarial liabilities (UAAL) in its major pension system against … personal income, Hawaii's 25.8 percent metric was the ***worst of the 43 states rated***. [Emphasis added] In its latest actuarial valuation (as of June 30, 2011), the Employees' Retirement System (ERS) has a reported 59.4 percent funded ratio. Based on the most current actuarial analysis, ERS will not realize full funding until FY 2036.[10]

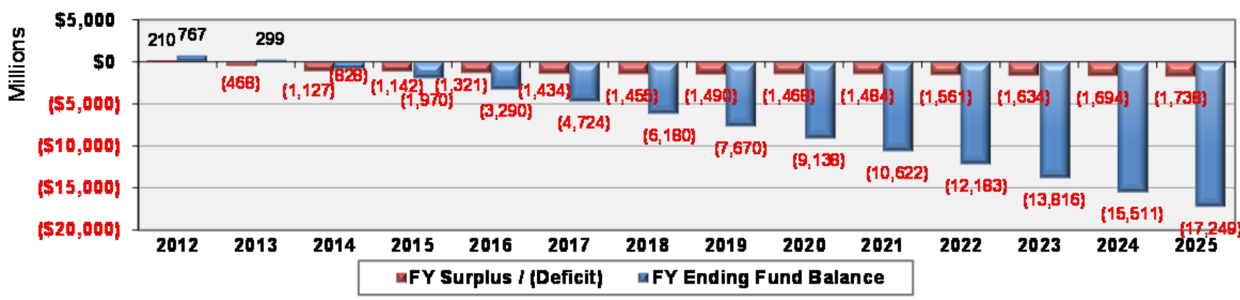
Projected Shortfall Under Cash Accounting Method: The PFM model's "Baseline Scenario" (i.e., most likely scenario) for the State's current cash accounting method indicates a shortfall by Fiscal Year (FY) 2014 and a negative FY Ending General Fund Balance by FY 2016, reaching an accumulated revenue shortfall of nearly $3.0 billion by FY 2025, as shown below:[11]

Figure 3.1: PFM Baseline Scenario – General Fund Projection (Cash Basis)



Projected Shortfall Under Accrual Accounting Method: The "accrual" accounting method adds debts incurred (as well as revenues anticipated though not yet received) into the balance for the accounting period. Under the accrual method, the obligation to make *future* payments of pensions and other post-employment benefits (OPEB) due to activities in the *current* year would actually appear in the current year's budget. By this method of accounting – which gives a better picture of the State's need to set aside funds or otherwise prepare for its eventual obligations – the budget situation is even more grave. The PFM projections under this method[12] are shown below:

Figure 3.2: PFM Baseline Scenario – General Fund Projection (Accrual Basis)



[10] The PFM Group. "Study of the Hawaii Tax System: Final Report." Philadelphia PA and San Francisco CA 2012. P. 95. Full study in Appendix A of this report. Quoted material above cited www.fitchratings.com and https://ers.ehawaii.gov/wp-content/uploads/2012/03/2011Valuation.pdf.

[11] The PFM Group, *op. cit.*, p. 97. In addition to the baseline scenario, PFM also analyzed a very optimistic scenario for a sustained economic boom and a pessimistic scenario assuming a serious tourism decline. Predictably, the figures are much better in the optimistic scenarios and much worse under the pessimistic scenario.

[12] The PFM Group, *op. cit.*, p. 101.

In essence, the accrual chart (Figure 3.2) indicates the reality of the budget crisis may be nearly six times worse by FY 2025 than it appears under the State's normal accounting method (Figure 3.1), and that shortfalls really begin as soon as FY 2013.

3.1.2 Alternate Tax Structures

The PFM analysis includes a broad overview of the most critical aspects of the State's tax structure, including some of the specific topics examined in the rest of this chapter. The study explores pros and cons of a number of alternatives for each of the main tax revenue sources: (1) the General Excise Tax (GET); (2) the Individual Income Tax (IIT), including tax credits to encourage business activity; (3) specific excise taxes (e.g., transient accommodations, fuel, liquor, etc.); (4) the Corporate Net Income Tax; and (5) potential other revenue sources – including a lottery and converting the GET to a Value-Added Tax (VAT), although neither of the latter were included in the final PFM recommendations for various reasons.

PFM Recommendations: PFM made recommendations to the TRC as a "*package*," taking into account key principles of tax policy. For example, some recommendations would *reduce* certain revenues – to lessen unfair or inefficient aspects of the present structure – but these would be offset by other possible changes.

On the following pages:

- Table 3.1 is a summary of PFM's package of recommendations for tax structural changes.
- Table 3.2 is PFM's estimates of revenue effects in FY2014 resulting from its package of recommendations.
- Figure 3.3 is a graph demonstrating the positive effects of fully implementing PFM's recommendations, as applied to PFM's Baseline Scenario, using a cash basis accounting method.
- Figure 3.4 is a graph demonstrating the effects of fully implementing PFM's recommendations as applied to PFM's Baseline Scenario, using an accrual basis accounting method.

In PFM's package, the largest single factor is clearly the proposed increase of the GET from the current 4.0% statewide base rate to a 4.5% rate.[13] The PFM report says the proposal "… is not a recommendation to be taken lightly – it is a significant increase in the overall tax burden for Hawaii residents."[14] However, PFM also observes that the GET's regressive impacts are balanced by certain virtues as a tax source – particularly the stability of its very broad base (i.e., affecting a wide range of transactions, not just selected sales covered by consumption taxes in most other states) – and by other recommendations in the package.

[13] Assuming continuation of the 0.5% transit surcharge for the City and County of Honolulu, O'ahu residents would see their effective GET rates rise from 4.5% to 5.0%.

[14] PFM Group, *op. cit.,* p. 150.

Table 3.1: Summary of PFM Package of Recommended Tax Structure Changes

General Strategy	Specific Methods
Expand the Tax Base	• *Reduce the Pension Exemption in the Individual Income Tax* (but still maintain exemption to a $25,000 level, and also maintain exemption for Social Security income) • *Eliminate Deduction for Property Taxes Paid:* It can be argued that Hawaii property taxpayers currently receive a benefit they would in no other state, where property taxes are for public education • *Cap or Replace Certain Tax Credits with Grant Programs:* Uncapped tax credits make it difficult to maintain revenue stability and sufficiency over time.
Reduce Regressivity *(i.e., disproportionate impacts on lower-income taxpayers)* in Certain Taxes	• *Increase the Standard Deduction for IIT to $7,500 for Single Filers, $15,000 for Married, and $10,950 for Head of Household Filers:* This would help balance other recommendation, such as regressivity of existing and proposed future GET • *Double Refundable Food/Excise IIT Credit:* Again, helps to make up for regressivity of proposed GET increase (below)
Reduce Pyramiding	• *Eliminate 0.5% GET and Use Tax Rate* for business-to-business expenditures, a longtime business community complaint • *Allow Act 105 Temporary Increases to Sunset* as scheduled, as these GET selected business-to-business exemptions help reduce pyramiding and increase efficiency • *Increase Corporate Net Income Tax Revenue* by raising rates to single 9% level to help compensate for eliminating 0.5% GET rate
Export Share of Tax Burden to Non-Residents	• *Further Increase Cigarette/Tobacco Tax Rates,* achieving a variety of social/health goals for residents and getting money from visitors, etc. • *Increase Gallonage Taxes on Beer, Wine, and Distilled Spirits* by about 15%, again obtaining substantial share from visitors • *Eliminate Sunset on TAT Increase*, as the “temporarily” higher Hawaii Transient Accommodation Tax rates (9.25%) are still comparable to other areas and have not demonstrably harmed tourism this year • *Restore Surcharge on Rental Cars* back to the $7.50/day rate in effect for FY2012, from $3.00 rate again now in effect
Restore Structural Balance by Rate Change	• *Increase GET Rate from 4.0% to 4.5%:* The Hawaii rate is among the lowest in the country for broad-based consumption taxes and has not been raised in more than 35 years, while more than half the nation’s other states have raised comparable taxes since 2000, according to PFM
Changes to Improve System Administration	• *Develop Tax Gap Systems to Identify Under-Payment or Non-Payment of Taxes* • *Create Compliance and Productivity Account to Fund Staff/Technology Improvements to Foster Taxpayer Education, Understanding, Compliance* • *Provide Tax Expenditure Reports on Regular Scheduled Basis* • *Eliminate Net Operating Loss Carry-Back*

Source: The PFM Group. “Study of the Hawaii Tax System: Final Report.” Prepared for 2010-13 TRC. Philadelphia PA and San Francisco CA 2012. Pp. 140-151. Full study in Appendix A of this report. **Note:** The summary, and very partial rationale, of “Specific Methods” above is quite abbreviated, and readers are encouraged to examine the cited pages 140-151 of the PFM report for a more complete understanding.

Table 3.2 shows PFM's calculations of the individual revenue impacts of each recommendation for Fiscal Year 2014.

Table 3.2: PFM Estimates of Fiscal Year 2014 Impact of Recommendations

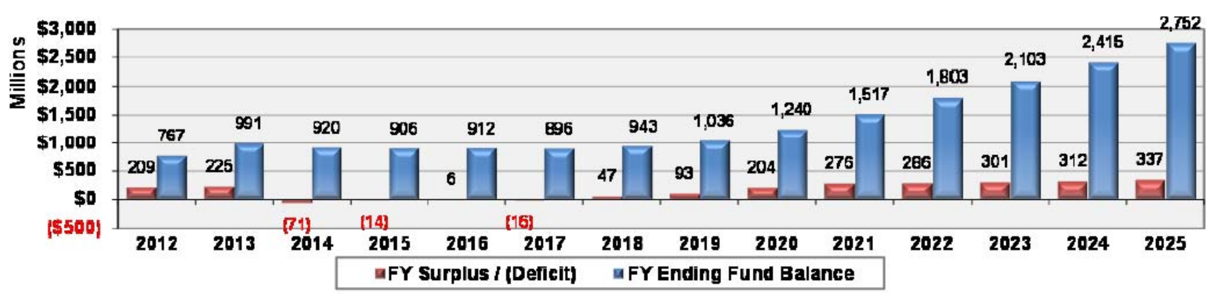
Initiative	*2014*
Base Expansion	
Reduce the pension exemption in the IIT*	17,267,203
Eliminate the deduction for property taxes paid*	12,513,835
Reduce Regressivity	
Increase IIT standard deduction*	(42,495,049)
Double the low-income food credit*	(15,084,986)
Eliminate Pyramiding	
Eliminate the 0.5 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	**299,391,135**

*FY2014 includes a 50% discount for the unique timing of the recommendation

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

Note: A few items show as $0 for 2014 – the TAT sunset would occur later, and the value of administrative reforms was also assumed to materialize in following years.
Source: PFM Group, *op. cit.,* p. 154.

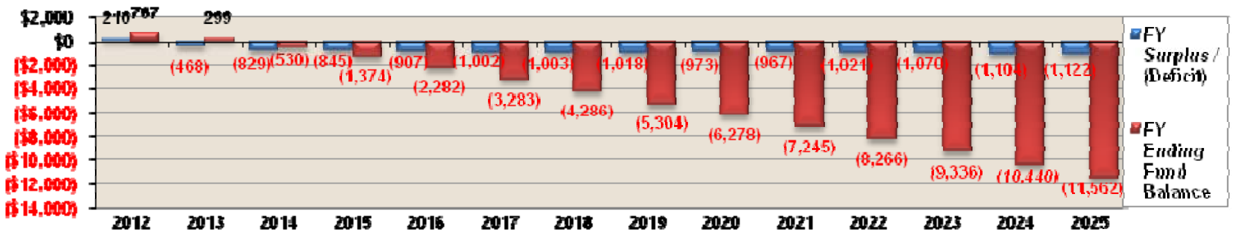
Figure 3.3: PFM Baseline Scenario with Full Implementation of Recommendations (Cash Basis)



Source: PFM Group, *op. cit.,* p. 154.

The TRC requested that PFM provide calculations to determine if full implementation of the recommendations would also address the accrual basis shortfall – and, if not, what GET increase would be required to do so. As seen in Figure 3.4, full implementation would not fully address the shortfall.

Figure 3.4: PFM Baseline Scenario with Full Implementation of Recommendations (Accrual Basis)



Source: PFM Group, Additional Information to TRC, Oct. 29, 2012 (see Appendix C).

PFM determined that a GET increase of 1.16% -- in addition to the 0.5% increase already proposed – would be necessary to fully address the accrual basis shortfall. See Appendix C.

PFM Rejected Recommendations: PFM considered but rejected the potential actions listed below in Table 3.3, though the model provided to the State will allow analysis of their effects if policy makers wish to implement them. See indicated pages of Appendix A ("Source" below) for consultant explanations of why these alternatives were not recommended.

Table 3.3: List of Alternatives Not Recommended by PFM Group

• Replace GET with VAT • Eliminate GET exemptions for non-profits • Establish GET "nexus" for e-commerce • Eliminate/reduce IIT deduction for Social Security benefits • Implement prepared food tax • Amusement or recreation tax • Motor fuel tax	• Snack food/soda tax • Increase conveyance tax • Increase premium tax • Cell phone service tax • Single apportionment factor for Corporate Net Income Tax • Broaden definitions for Nexus • Institute a lottery/other forms of gambling

Source: PFM Group, Appendix A, pp. 140, 151-153.

3.2 <u>E-Commerce and Other GET Issues</u>

The TRC engaged Dr. William F. Fox[15] – of the College of Business Administration and the University of Tennessee, Knoxville – to examine:

[15] Dr. Fox is a national tax expert who also did studies for the two previous Tax Review Commissions.

1. Impacts of E-Commerce on GET Collections in Hawaii; and
2. Effects on GET of Eliminating Exemptions and/or Other Taxes

Dr. Fox's complete study is in Appendix D. It differs from the PFM study in that it provides only information and estimates, not recommendations.

3.2.1 Impact of E-Commerce on GET

Hard data on this topic are somewhat limited, and so some figures in Dr. Fox's study reflect various estimates on topics such as compliance if new laws are passed. The study indicates:

- Internet-based e-commerce sales are continuing to expand across the country. The estimated U.S. total for 2015 will be nearly $6 trillion in current dollars, up from less than $1.1 trillion in 2000.
- Many states, including Hawaii, cannot collect all consumption taxes (such as the GET), due to lack of "nexus," or taxable presence of companies, in the state. This problem also applies to mail-order purchases, though those sales are lower.
- Given that all states and some cities are affected, the U.S. Congress is now considering three different bills requiring "remote vendors" to collect state sales taxes, though no consensus has yet emerged on issues such as the level of sales required before smaller sellers would have to start paying.
- Most potentially taxable Hawaii e-commerce sales are business-to-business transactions.
- In total, Dr. Fox estimates the State is now missing out on about $145 million in GET taxes as of 2012, which will rapidly move up to $211 million in 2015. (See Table 3.4 below.)

Table 3.4: Estimated Remote Vendor GET Revenue Collected and Uncollected

	2010	2011	2012	2013	2014	2015
Tax Due (e-commerce)	$240.80	$271.09	$297.23	$330.94	$384.21	$449.97
Mail Order	$35.01	$36.76	$38.60	$40.53	$42.56	$44.69
Total with Mail Order	**$275.81**	**$307.85**	**$335.83**	**$371.47**	**$426.77**	**$494.65**
Compliance	$156.82	$175.22	$190.96	$211.27	$243.47	$283.47
Uncollected Revenues	**$119.00**	**$132.63**	**$144.88**	**$160.20**	**$183.30**	**$211.18**

Source: Fox, W. "Selected Issues with the Hawaii General Excise Tax." Prepared for 2010-13 TRC. Knoxville, TN 2012. Table 7. Full study in Appendix D of this report.

These numbers are higher than similar estimates in a similar report Dr. Fox made for the 2005-07 TRC, mainly due to rapidly escalating national use of e-commerce.

3.2.2 Effects of Eliminating GET Exemptions and/or Other Taxes

The TRC asked Dr. Fox to estimate how much the present 4.0% GET rate would have to be adjusted up or down in order to generate the same total amount of revenue (i.e., be "revenue-neutral") if certain current exemptions or other taxes were eliminated:

- Selected current exemptions to the GET (*resulting in lower overall GET rate to offset revenue gained by ending the exemptions)*;
- Corporate and/or individual income taxes *(resulting in higher overall GET rate to offset the revenue lost by ending these taxes)*.

Eliminating Selected Exemptions to Payment of GET: This analysis is also an update of a previous similar study by Dr. Fox for the 2005-07 TRC.[16] The 2010 – 2013 TRC asked Dr. Fox to study the seven current GET exemptions listed in Table 3.5.

Table 3.5: GET Exemptions for Potential Elimination in Fox Study

Items Purchased by Final Consumers *(ending exemptions would broaden base to include more consumption items)*	**Items Common in Business-to-Business Sales** *(ending exemptions would result in more taxing of business inputs)*
A – Gross receipts of non-profit organizations*	**D -** Amounts received by hotel operators from hotel owners equal to, and disbursed for, employee wages, salaries, and benefits
B – Sales of prescription drugs and prosthetic devices by health organizations licensed to administer drug or prosthetic device	**E –** Amounts received as rent for leasing of aircraft or aircraft engines used lessee for interstate transportation of passengers and goods
C – Health insurance premiums paid to Health Maintenance Organizations (HMOs) and mutual benefit societies	**F –** Materials, parts, or tools used for certain types of aircraft service/maintenance, or for construction of qualified aircraft service/maint.
	G – Offsetting deductions that prime contractor may take from gross income for payments to subcontractors or specialty contractors

* Note that PFM Group considered this action but did not include it in its recommended package.
Source: Fox, *op. cit.,* p. 15.

Estimated results are in Table 3.6, which re-orders exemptions by size of impact. This analysis is based on assumptions that all organizations now exempt would actually pay the GET tax if the exemptions ended. Dr. Fox notes that ending some of the exemptions would be particularly likely to result in a "behavioral response" – i.e., some companies would adjust business practices to avoid paying the tax. However, for this analysis Dr. Fox did not attempt to estimate how much those behavioral responses would affect the revenue gains and related "revenue-neutral" GET tax rates shown in Table 3.6.

[16] Dr. Fox wrote that data sources have improved since the previous study, suggesting greater confidence in this year's results.

Table 3.6: GET Revenue Effects of Removing Selected Exemptions, 2012

Exemption	Revenue Gain (millions)	Gain (in Total State Tax Collections)	Gain (in GET Collections Only)	Tax Rate for Revenue-Neutral GET Collections
		(Assuming No GET Rate Corrections)		
A Nonprofits	$254.13	5.23%	7.62%	3.72%
C Health Insurance Premiums	$108.19	2.23%	3.24%	3.24%
G Subcontracts*	$95.63	1.97%	2.87%	3.89%
D Hotel Wages, etc.	$46.29	0.97%	1.41%	3.95%
B Prescriptions/Prosthetics	$30.27	0.62%	0.91%	3.97%
E Aircraft Leasing (Dry only)*	$4.05	0.08%	0.12%	4.00%
F Aircraft Maintenance*	$1.95	0.04%	0.06%	4.00%
Combination of All Above	**$554.98**	**11.14%**	**16.22%**	**3.46%**

* For these items, Dr. Fox believes revenue gains would actually be lower due to "behavioral response." On point E, "(Dry only)" means leasing without a pilot.
Source: Fox, *op. cit.,* p. 17.

Eliminating Corporate and/or Individual Income Taxes (IITs): Table 3.7 lists both the options studied at the TRC request and also the "revenue-neutral" results – i.e., increases in the GET rate needed to make up for the lost revenue. For this study, Dr. Fox used actual FY 2011 results and estimated the "behavioral response" effect that would lead to the need for an even higher GET rate.

The results suggest that minimal GET rate increases would be needed to eliminate either the corporate income tax alone or the IIT alone for those below the poverty level. Not surprisingly, eliminating both the IIT and also the corporate income tax would require the largest boost in the GET rate (to 6.1% or 6.2%) to make up for the lost revenues.

Table 3.7: GET Revenue Effects of Ending or Changing Other Taxes, 2011

	Eliminate Both Corporate and IIT Entirely	Eliminate Corporate Income Tax Only	Eliminate IIT Only	Eliminate IIT for Those Below Poverty Level	Eliminate IIT for Bottom 90% of Taxpayers
GET Rate – Initial Estimate	6.108%	4.109%	5.999%	4.156%	4.999%
Behavioral Response Adjustment	6.240%	4.114%	6.121%	4.162%	5.050%

Source: Fox, *op. cit.,* p. 25.

3.3 <u>Impacts of Eliminating Income Tax for Those Below Poverty Level</u>

While Dr. Fox touched on this briefly (Table 3.7), the TRC asked DoTAX to do an independent and more detailed analysis of this possibility. The full report by DoTAX analyst Ms. Titin Sakata is included in Appendix F.

The report used 2004 Individual Income Tax data for its analysis, and looked at implications of exempting taxpayers whose Federal adjusted gross income and Hawaii adjusted gross income both fell below the poverty guidelines (as determined by the U.S. Department of Human Services).

The report concluded that exempting these taxpayers would increase the number of returns with no tax liability by 89% (119,000 returns) and would result in reduction of tax liability of at least $21.5 million in 2012 dollars.

However, the report added that the revenue loss to State coffers could actually be "several times higher" than the reduction in tax liability of $21.5 million because of possible non-filers. That is, the $21.5 million estimate was based only on reported liability from filed returns, but additional and non-measurable losses could also result from eliminating current employer deductions from wages (State tax withholdings) for low-income workers who currently may not file returns.

The report also noted that some taxpayers with a low adjusted gross income in any one particular year may still have substantial assets, and that alternatives to eliminating the income tax would include increasing food/excise and low-income household renters' credits, standard deductions, or personal exemptions.

3.4 DoTAX Assessments, Enforcements, and Collections

What Is At Stake: The need to increase tax revenues to meet looming obligations could be reduced if the "tax gap" – the difference between taxes owed (known and unknown) and taxes actually collected – were closed significantly. There has been no definitive study on exactly how large this gap is in Hawaii, though estimates have varied from $1billion to $2 billion a year.[17] The keys to reducing the tax gap are adequate enforcement staff, up-to-date computerized record keeping, and tax amnesty.

DoTAX Staffing and Performance: Like many other State agencies, DoTAX lost personnel and other budgetary resources during the Great Recession, and some of these losses affected the department's ability to provide services and collect tax revenues. Additionally, new best practices are constantly emerging in regard to administration of tax departments.

Therefore, the TRC asked DoTAX Director Frederick Pablo for data on changes over time in staffing and performance measures.

Director Pablo provided an initial written analysis in February 2012 and also made a personal presentation to the TRC in late August 2012 (see both letter and full set of

[17] The State is currently aware of $1.3 billion in cumulative accounts receivable over the years, but this figure does not include amounts owed by non-filers, some of which could be brought to light by additional staff and/or better computerized record-keeping systems. (DoTAX Director Frederick Pablo, Feb. 22, 2012. Letter to Tax Review Commission. See Appendix E.)

slides in Appendix G). As noted in Table 3.8, authorized positions fell after the economic slump of the early 2000s, revived until the Great Recession, then fell again. The authorized-position numbers overstate reality, as about 20% of the jobs are currently vacant due to hiring freezes. The hiring freeze has, however, been lifted by Governor Abercrombie.

Table 3.8: Authorized Positions for DoTAX Staff Divisions, FY 2002 - 2011

Division Staffing for:	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Tax Services/Processing	99	98	89	89	110	110	138	138	138	123
Compliance	204	195	187	187	190	196	196	188	188	179

Source: Pablo, F. 2012. Presentation to TRC on "Assessments, Enforcement & Collections." Appendix E.

Key performance metrics for these two divisions:

- For Tax Services, the Call Answer Rate – it has declined from a recent peak of 90% in FY 2007 to just 40% in FY 2011, as inquiry calls placed to DoTAX have increased but calls answered generally decreased. "When taxpayers cannot receive tax assistance, they are prone to fall into non-compliance with tax requirements," Director Pablo wrote.[18]

- For Compliance, he presented several metrics – for example, the number of audits completed by the Office Audit branch fell by 38%, from about 11,600 cases in fiscal year 2010 to about 7,200 cases in fiscal year 2011, while their assessments fell by more than $18 million. Similarly, the number of cases closed by the Field Audit branch fell by 31%, from 332 cases in fiscal year 2010 to 229 cases in fiscal year 2011, while their assessments dropped by almost $23 million.

Computerized Record-Keeping: The current DoTAX computer system is outdated and inadequate for supporting the Department's effort to increase enforcement and collection of taxes.

The Department has provided information to the Tax Review Commission on its "SERVICE" Plan,[19] which integrates modernization of both its operations and computer system. The Plan proposes to create a data-centered computer system to enhance collaboration amongst employees and maximize its resources. DoTAX also plans to seek its own secure facility to house the new system, which will enhance security of taxpayer data and collections.

DoTAX is now preparing a Request for Proposals to develop such a system. Therefore, it is unable to discuss estimated costs or return on investment at this time.

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[18] Pablo, F. Feb. 22, 2012. Letter to Tax Review Commission. See Appendix G.

[19] See Oct. 11, 2012 letter from Director Frederick D. Pablo to Tax Review Commission, contained in Appendix G.

Tax Amnesty Programs: Though not mentioned in any of the formal DoTAX submittals appended to this report, the TRC notes the "Fresh Start" amnesty program that the department offered in 2009 likely contributed to reduced tax delinquencies that year and thus has potential for helping to close the tax gap in future years:

> Though the Fresh Start Program was only in effect from May 27, 2009, through June 26, 2009, it resulted in the filing of 2,693 tax returns with the Office Audit Branch of the Compliance Division, and the payment of $14.4 million in additional taxes. Of the total, 1,600 returns and $8.4 million in collections came from taxpayers who qualified for the program; the remainder came from taxpayers who did not qualify, but who nevertheless came forward to file their returns and pay at least a portion of the amounts owed, or were for tax periods ending after December 31, 2007.[20]

[20] Hawaii State Dept. of Taxation. *Annual Report 2008-09.* Honolulu HI 2010. P. 14. Accessed Sept. 19, 2012 at http://www6.hawaii.gov/tax/pubs/annual/09annrpt.pdf .

4 TAX REVIEW COMMISSION OBSERVATIONS AND RECOMMENDATIONS

4.1 Structural Sustainability to Meet 21st Century Needs

Both the PFM and the Fujino-Rousslang studies on the sustainability of Hawaii's tax structure present a very sobering outlook.

The PFM Baseline Scenario assumes maintaining current level of services for existing programs and the current tax and revenue structure. PFM also used modestly conservative assumptions – for example, for its revenue projections for Hawaii's two major tax sources, PFM retained the Council of Revenues' growth assumptions for intermediate term and, for the long term, assumed growth in line with the State Dept. of Business, Economic Development, and Tourism's personal income growth forecast.

Under the Baseline Scenario, Hawaii will experience continuous annual budget shortfalls, starting in FY 2014. On a cash basis, the projection is for an accumulated shortfall of nearly $3.0 billion between FY 2013 and FY 2025. On an accrual basis, the accumulated shortfall is more than $17 billion.

Similar to the PFM study, the Fujino-Rousslang study assumes that the "present level of spending for current government services (government spending other than payments for Medicaid and benefits for retired State workers) is appropriate and will grow at the same rate as the overall economy, as measured by the growth of nominal TPI [total personal income]."[21]

This study noted, according to their own actuarial and accounting studies, that the Employees Retirement System (ERS) is underfunded by standard accounting practices[22] by $7.7 billion, and that the Hawaii State Employee Health Plan had, at the end of FY 2009, an unfunded liability of $11.8 billion. The study further found that, if the accrued liabilities in the health plan must be amortized over 30 years and if Medicaid costs continue to growth at their long-run historical average rate of 9.4%, then large shortfalls are predicted for the mid-range and low-growth scenarios for all the years after FY 2015 covered in its forecast (FY 2013 to FY 2022).

The study then opined, "Unless we experience economic growth at the high end of the current forecasts, the deficits may reach levels of well over $1 billion annually by 2022."[23]

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[21] Fujino and Rousslang, *op. cit.*, p. 7.

[22] There is a possibility that all state and local governmental employers will be required by the U.S. Governmental Accounting Standards Board (GASB) to change accounting systems in order to account for pension benefits as they are accrued. See Fujino and Rousslang, *op. cit.*, footnotes 7 and 9, pp. 10-11.

[23] Fujino and Rousslang, *op. cit.*, p. 17.

There is an urgent need to take steps to address the enormous budget shortfall if we are to maintain a tax system that is reliable, stable, and sufficient. In this regard, PFM constructed a multi-year financial forecasting model that projects the State's General Fund revenues, expenditures, and financial results from the current fiscal year through FY 2025. The model is licensed to the State for official use in perpetuity, with no additional licensing fee charged for its use. For a full explanation of the Forecasting Model, see Appendix B.

The Forecasting Model: In summary, in developing the Forecasting Model, PFM used historical information and management insight to produce a baseline financial projection. The Baseline Scenario "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" (PFM, Appendix C). The Forecasting Model can be updated as new information becomes available and can be used for budget forecasting and development.

PFM has represented that the Forecasting Model can be used to:

- Identify projected short- and long-term General Fund budget surpluses and shortfalls;

- Identify projected short- and long-term trends in key cost drivers and revenue sources;

- Model short- and long-term changes in key cost drivers and revenue sources, and their real-time impact on the budget.

- Save multiple budget scenarios involving combinations of changes to revenues and expenditures, and compare to other combinations for their short- and long-term impact on budget surpluses and shortfalls.

Section 3.1.2 of this report discusses examples of PFM recommendations to comprehensively address the budget shortfall based on both the cash basis and accrual methods of accounting. The Forecast Model provides policy makers with the tools to explore and implement alternative comprehensive revenue measures to address the shortfall.

The TRC recommends that the Forecasting Model be utilized to develop the comprehensive plan necessary to address the huge budget shortfall in a timely and responsible manner.

4.2 The Issue of Reducing Pension Exemptions

Among PFM's recommendations is taxing pension income. The TRC notes that the 2005 – 2007 Tax Review Commission also recommended that Hawaii should conform to the federal tax treatment of retirement income. However, the 2005 – 2007 Commission did opine that taxing retirement income raised an "equity concern." The Commission observed that:

> .. people may have made employment decisions based on the current tax treatment. For example, some may have accepted smaller government pensions on the expectation that they would not be taxed. People have also made decisions on where to live based on the current tax law.[24]

To address this equity issue, the 2005 – 2007 Commission recommended excluding a base amount to "ameliorate the effects of this change on those now receiving tax-free pensions and remove the effect entirely for those with small pensions."[25] They cited as an example base exclusion an annual income of $50,000.

The 2001 – 2003 Commission, in addressing the pension tax issue, stated that any change should be made "with great care."[26] This Commission recommendation included making no change "as the expected tax revenue lost by the expected aging population in Hawaii should be significantly offset by the shift in popularity to taxable 401(k) and similar deferred compensation plans."[27]

The TRC concurs that taxing retirement income does raise a serious equity issue that must be addressed. The previous two Tax Review Commissions have provided sensible recommendation options for policy makers to consider. These include:

1. Continue monitoring and make no changes pending review of the shift to taxable 401(k) and similar deferred compensation plans.

2. If the pension exemption is repealed:

    - Have a delayed phase with grandfather provisions who retire before a date certain; and/or

    - Exclude an annual base amount of at least $50,000.

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[24] State of Hawaii Tax Review Commission (2005-07). *Report of the 2005 – 2007 Tax Review Commission.* Honolulu HI 2006. P. 22. Accessed June 3, 2012 at http://www6.hawaii.gov/tax/a9_2trc.htm.

[25] State of Hawaii Tax Review Commission (2005-07), *op. cit.*, p. 22.

[26] State of Hawaii Tax Review Commission (2001-03). *Report of the 2001 – 2003 Tax Review Commission.* Honolulu HI 2002. P. 17. Accessed June 3, 2012 at http://www6.hawaii.gov/tax/a9_2trc.htm.

[27] State of Hawaii Tax Review Commission (2001-03), *op. cit.*, p. 16.

4.3 E-Commerce and Other GET Issues

The decision of the United States Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), presents a major constitutional restriction on a state's authority to compel e-commerce or mail-order vendors to collect a sales or use tax. The Court held that there must be a finding of "substantial nexus," not merely "minimum contact," for any such state action to be constitutional. The Court opined:

> … the Commerce Clause, and its nexus requirement, are informed not so much by concerns about fairness for the individual defendant as by the structural concerns about *the effects of state regulation on the national economy.* [emphasis added][28]

In his report, Dr. Fox noted that some states have initiated policy changes to enhance their ability to collect revenues due on remote sales but that:

> None of these mechanisms is likely to be very effective, though they may collect some revenues and are ways of increasing pressure for federal legislation. *But, federal legislation (or a reversal of Quill v. North Dakota) is the only effective means of significantly altering states' ability to collect on remote sales*, and the impact of federal legislation will depend on the details of the legislation and *specifically the size of the small seller exception*. [emphasis added][29]

The Fox Report listed three measures currently before Congress. The TRC agrees with Dr. Fox that enactment of federal legislation is the only viable means to provide states with the authority to collect on remote sales. As the U.S. Supreme Court opined:

> … the underlying issue is not only one that Congress may be better qualified to resolve, but also one that *Congress has the ultimate power to resolve*. … Congress is now free to decide whether, when, and to what extent the states may burden interstate mail order concerns with a duty to collect use taxes. [emphasis added][30]

With the growth of internet sales in the 21st century, it is imperative that Congress acts to authorize states to tax internet e-commerce sales. While state efforts can continue to enact state-specific mechanisms to attempt to circumvent the *Quill* ruling, state leaders must work closely to urge and assist our Congressional delegates to enact federal legislation, which is the only comprehensive way to fully address *Quill*.

4.4 Eliminating Income Tax for Those Below Poverty Level

Based on the Sakata study (Appendix F), for individuals with Federal and Hawaii adjusted gross income falling below poverty guidelines as determined by the U.S. Dept. of Human Services, the TRC recommends increasing:

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[28] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), p. 312.

[29] Fox, *op. cit.,* p. 13.

[30] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), p. 318.

- Food/excise and low-income household renter' credits,
- Standard deduction, and/or
- Personal exemption.

4.5 DoTAX Assessments, Enforcements, and Collections

The more that the State can close the "tax gap" by increasing legitimate collection of unpaid taxes, the less the need for new revenues. Therefore, the Commission believes the Department's collection and enforcement efforts should be augmented.

Not only will this help address projected revenue shortfalls, it will also – and perhaps more importantly – make Hawaii's taxes fairer. It is unfair to impose greater tax burdens on those who comply with our tax laws in order to cover revenue shortfalls created by those who do not comply. The TRC supports DoTAX plans to modernize its computer system. The current system is old and outmoded. A new system will help the Department track taxpayer liabilities more efficiently and help the Department prioritize audits.

The Commission makes the following additional recommendations:

1. The Department should be given more staff (including some needed to support the new computer system) and should be allowed to fill its present vacancies.

2. Any increased enforcement effort should be preceded by a general tax amnesty program, in addition to the Department's present voluntary compliance program. In its short, unadvertised one-month window, the amnesty program that the Department conducted in 2009 collected $14.4 million of previously unpaid taxes.

4.6 Economic Development and Tax Credit Incentives for Targeted Businesses

"As you are aware, taxation is one of the most powerful tools available to government to bring about social and economic change …"
– Peter Lewis, Delegate to 1978 Hawaii Constitutional Convention[31]

Hawaii's leaders have long sought to diversify our economy. In its 1985 "Final Report of the Governor's Committee on Hawaii's Economic Future," the committee opined that:

> The lack of diversification of Hawaii economy and slow growth of high paying jobs have also resulted in the relative decrease in Hawaii's wages relative to national standards. We recognize that an improvement in Hawaii's employment opportunities lies in our concerted efforts to diversify Hawaii's economy …[32]

[31] *Proceedings of the Constitutional Convention of Hawaii of 1978, Vol. 2,* p. 465.

[32] "Hawaii's Economic Future: The Final Report of the Governor's Committee on Hawaii's Economic Future." 1985. P. 9.

Over the years, the Legislature has enacted measures designed to stimulate and/or diversify Hawaii's economy. These include the Hotel Remodeling Credit, the Tax Credit for Research Activities, the Ko Olina Resort and Marina Attractions and Educational Facilities tax Credit, the Enterprise Zone Tax Credit, and the Capital Goods Excise Tax Credit.

Hawaii policy makers clearly recognize that tax policy initiatives can help to incentivize and/or diversity Hawaii's economy – and that an improved, healthy economy plays an important role in keeping the State government in fiscal balance. As demonstrated by PFM's "optimistic" scenario model outcomes (see Appendix A, p. 9), with a robust Hawaii economy it is projected that the State would return to fiscal balance by FY 2016.

To ensure that targeted economic tax incentives are effective, the TRC recommends the following:

1. If targeted tax incentives are enacted to promote economic activity, then:

    a. Make incentives dependent on performance.

    b. Evaluate the effectiveness of the targeted incentives.

    c. Build "claw back" mechanisms into incentive programs when the recipient of the credit does not meet performance objectives.

    d. Have a sunset date, with sunset cost/benefit review to determine whether the incentive program should continue.

    e. Ensure transparency, including disclosure of economic terms and packages.

    f. Place a cap on tax credits.

2. In lieu of such tax incentives, implement grant programs to be administered by the departments primarily responsible for economic development activities.

4.7 <u>Broad Mechanisms for Assessing Expenditures Along with Revenues</u>

The TRC is fully aware that the tax increases discussed in this report comprise a difficult proposition for many to embrace. Nobody likes taxes, and increases in taxes affect the pocketbooks of everyone in the state. A shortfall in the year 2025 seems far off in the distant future and hard to grasp in light of the financial challenges that today confront every individual, family, and business on a daily basis.

Yet the looming shortfall is real. Under the Baseline Scenario of the model relied upon by the TRC, annual budget "gaps" are projected to surface by FY 2014 and will continue every year at least up to 2025, the final year of the model.

The TRC's recommendations must, by necessity, address only the revenue and not the expenditure component of the budget equation. The projected budget shortfalls are serious and must be addressed, and expenditure adjustments will present significant challenges to policy makers.

As noted in the Fujino-Rousslang report:

> Of course, by law the State cannot run an operating deficit. Instead, the deficits we measure are the amount that government services would have to shrink relative to the size of the economy if the tax structure is not altered. Most of the reductions would probably occur in current operations, since pension and health benefits for retired workers are, for the most part, liabilities that have already been incurred, and Medicaid benefits are set by federal law. That is, the cost of current operations would need to shrink to a smaller share of the State's economy. Because the bulk of the cost of current operations consists of employee compensation of State workers, this means that pay of the State's workers would have to decline relative to total personal income in the State …[33]

The Fujino-Rousslang report spotlights the draconian option if the enormous budget shortfall is addressed purely from an expenditure side. It highlights the point that if the solution is sought from only revenue enhancement or expenditure cuts, the results are unacceptable.

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

[33] Fujino and Rousslang, *op. cit.*, p. 17.

5 CONCLUDING COMMENTS

> Throughout our nation's history, Americans have found the courage to do right by our children's future. Deep down, every American knows we face a moment of truth once again. We cannot play games or put off hard choices any longer. Without regard to party, we have a patriotic duty to keep the promise of America to give our children and grandchildren a better life.
>
> Our challenge is clear and inescapable: America cannot be great if we go broke. Our businesses will not be able to grow and create jobs, and our workers will not be able to compete successfully for the jobs of the future without a plan to get this crushing debt burden off our backs.
>
> -- Preamble, Report of the National Commission on Fiscal Responsibility and Reform

Our state faces an ever-expanding budget shortfall that, if left untended, will grow to billions and billions of dollars by 2022 and 2025. This report provides recommendations to address the shortfall. Our report may not provide answers to the satisfaction of everyone, but it is and should be a starting point for discussion, because the shortfall is real and it is growing.

Above all else, policy makers must take serious steps to act now and with a sense of urgency. The path will be difficult, but it is one that must be traveled.

As wisely pointed out in the National Commission's Preamble:

> … countless advocacy groups and special interests will try mightily through expensive, dramatic, and heart-wrenching media assaults to exempt themselves from shared sacrifice and common purpose. The national interest, not special interest, must prevail. We urge leaders and citizens … to follow what we call the Becerra Rule: Don't shoot down the idea without offering a better one in its place.