APPENDIX A:

REPORT OF THE PFM GROUP –

- **“Study of the Hawaii Tax System: Final Report”**
- **“Report Epilogue”**

State of Hawaii
Tax Review Commission

Study of the Hawaii Tax System

Final Report

September 21, 2012

The PFM Group

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Background

In 2012, the Hawaii Tax Review Commission (Commission or TRC) 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, the project team 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. The project team also conducted best practices research and analysis related to tax structure and tax principles. The project team vetted its analysis with key stakeholders and now submits this draft report, with a final report to follow in September 2012.

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.

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

The project team 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, the project team 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 is 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

- 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

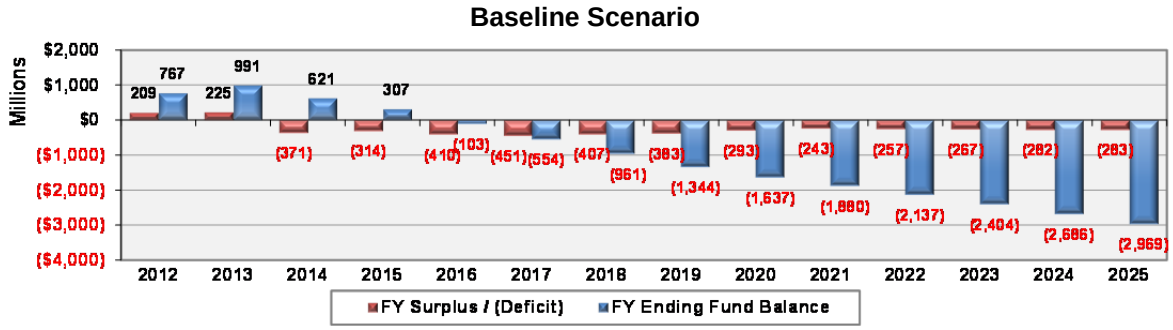
PFM Long Range Financial Forecasting Model

The project team 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. The project team 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, the project team 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.

Baseline Projection and Alternate Scenarios

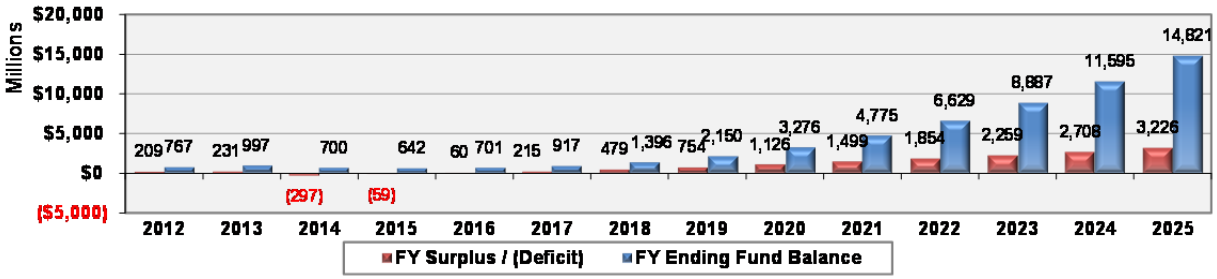
As shown below, diverging revenue and expenditure projections lead to the model forecasting a series of annual budget gaps reaching $283 million by FY 2025 if no corrective action is taken:



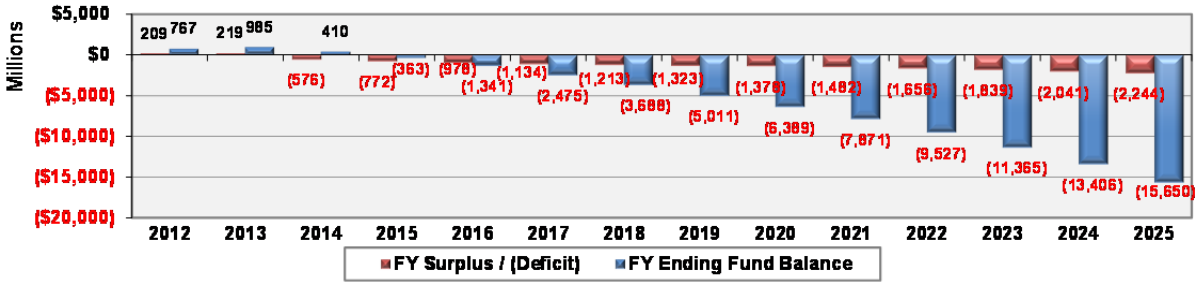
Of course, the magnitude of the budget gaps projected by the model cannot actually occur: As with 48 other states, Hawaii has an obligation to balance its General Fund budget on an annual basis; however, the growing gap between ongoing revenues and expenditures is a sign of a structural issue – which 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

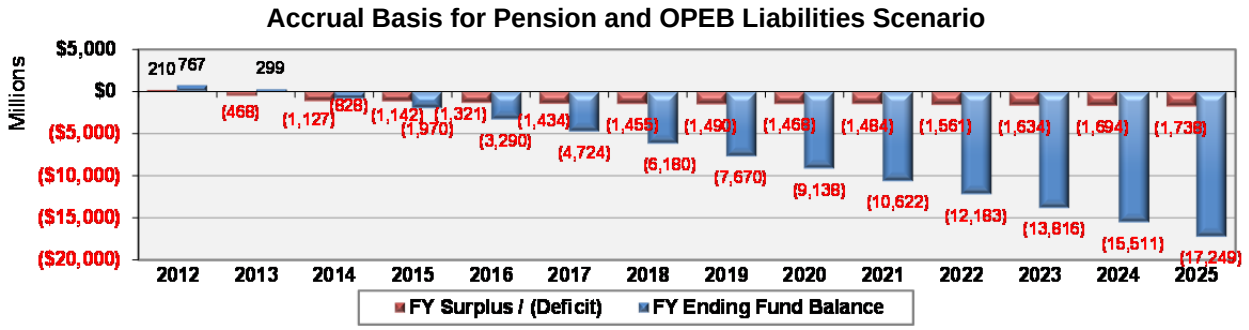


Pessimistic Scenario



The project team 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 the project team develop the model with the ability to view financial results on an Accrual basis (as opposed to the cash basis form of budgeting used 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:



Revenue Alternatives

Tax Policy Principles

The study charge directed the project team 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, the project team 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.

Possible Revenue Strategies/Approaches

The project undertook a preliminary analysis of approximately 100 tax and revenue options used in states throughout the country. The project team 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. The project team 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 project's multi-year financial planning 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.

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

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 expected 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 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 not likely 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 project team 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 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 that is applied to wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale. The recommendations eliminate the 0.5 percent GET rate and makes 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.

Base Expansion

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 all marginal pension income over $25,000. 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.

- **Increase the IIT standard deduction**
  The recommendation increases the IIT standard deduction to $7,500 for single, $15,000 for married or surviving spouse with dependent child and $10,950 for head of household filers. 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 wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale, 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**

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**
  While Hawaii's GET is not a standard sales tax, the State is one of 13 that levy their broad-based consumption tax on the privilege of engaging in business as a vendor. Hawaii is unique in having the broadest base of any state with a broad-based consumption tax (although, as it relates to taxing services, at least a few states are taxing a similar number of them). Part of the overall GET tax burden is mitigated by the fact that the GET rate is among the lowest in the country for states with a broad-based consumption tax. While Hawaii has not raised its rate in over 35 years, over half of the states have raised their 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

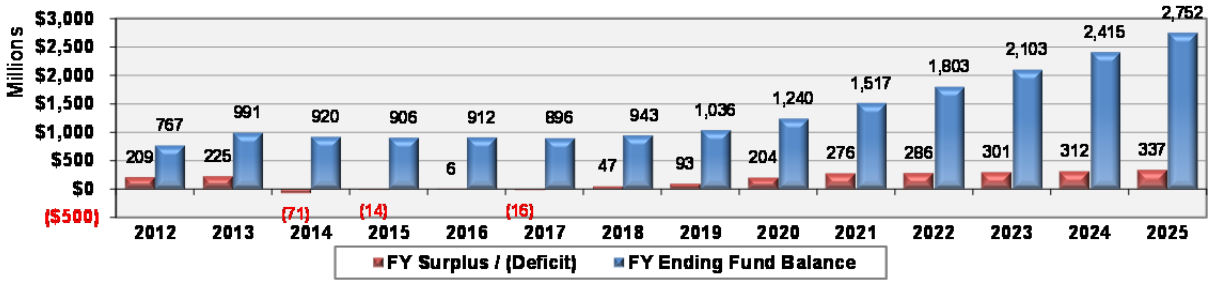
investments would then require a method for tracking performance, with payback to the fund from a portion of the additional revenue received from the initiatives.

- **Provide Tax Expenditure Reports on a scheduled regular basis**
  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 the project team 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	*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

Summary

The study's 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 $3.0 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 $16 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 $17 billion.

The State of Hawaii is at a crossroads: the study's 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, fund an OPEB trust to deal with future obligations or make strategic investments – as in, for example, improving 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.

Introduction and Project Background

Introduction and Project Background

Report Background

In March 2012, the Hawaii Tax Review Commission (Commission or TRC) engaged Public Financial Management, Inc. (PFM) to perform a systematic study of the State's tax structure, with particular emphasis on answering two key questions:

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

The Commission consists of seven members who are appointed by the Governor, with the consent of the Senate. The TRCmeets every five years and is charged with conducting a systematic review of Hawaii's tax structure using such standards as equity and efficiency.[1] While past Commissions have focused generally on issue-specific areas of tax policy, the 2012 TRC sought to take a longer-range approach in evaluating a tax system that has not been substantially modified since the 1970's. Tax policy can be an important social and economic tool; a thorough evaluation of sustainable tax policy in light of developments in the 21st century can help provide direction for policymakers as they seek an equitable tax structure that also allows for economic growth.

In addition to the review by PFM, the Commission has also retained Dr. William Fox to analyze selected issues with the Hawaii General Excise Tax (GET). The study, which is an update of past work Dr. Fox has done for the TRC, was issued on July 22, 2012. That study and other reports generated by the Department of Taxation and previous TRCs were consulting while developing the findings and recommendations within this report.

Methodology

The following were key elements of the project plan, analysis and report. The project was conducted in the following four phases:

Planning Phase

This phase communicated project details, finalized a detailed project plan, organizing, organized, scheduled and conducted a project kick-off and devised reporting and communications protocols.

Information Gathering Phase

To help the project team understand current revenue and expenditure trends, State priorities and likely future performance, the project conducted extensive data gathering as well as interviews with department leaders, subject matter experts and internal and external stakeholders. The team reviewed past research and current modeling and forecasting around key revenue sources (GET, personal and corporate income tax, specific excise taxes) and expenditure drivers (employee pension and benefits, health and human services, K-12 and higher education, transportation, etc.). Recent and past Commission reports were also reviewed and key budget and financial information (proposed and enacted budgets, CAFR's and annual reports) and reports were also reviewed. Workforce information, including pension and other post-employment benefits (OPEB) valuations and reports, collective bargaining agreements and pay

[1] Hawaii Revised Statutes (HRS) Chapter 232E-3.

plans, State statutes, regulations, civil service rules and other legal mandates, benefit schedules, health plans, headcount breakdown and other relevant information was collected and included in this analysis.

Evaluation Phase

Based on the baseline and future year modeling, the team analyzed, reviewed and compared the State's expenditure and revenue trends and performance to determine to what extent the current system could attain and maintain structural balance. The team identified alternative revenue approaches and structures used in other states, analyzed their applicability and appropriateness for the State of Hawaii and quantified, to the extent possible given the available data, changes in revenue bases or rates and their impact on the Hawaii economy in the aggregate and as they may relate to key industries or sectors.

After extensive discussions on the unique characteristics of the State and the difficulty in identifying comparable jurisdictions, the project team benchmarked Hawaii against relevant states in key issue areas. This allowed the team to analyze the comparability and applicability of relevant data at a more granular level. The project team also conducted best practice research and analysis.

Recommendations Phase

The team met with the Tax Review Commission and key contacts within the Department of Taxation on multiple occasions to provide project updates, vet findings and to resolve any outstanding project issues. In late June, the project team provided the TRC and key staff a project update and discussed high level findings based on the data and analysis compiled to date. The team sought feedback on areas for further research and study and carried out follow-up discussions and interviews with key staff and stakeholders. Following the mid-project briefing in late June, the project team spent the next six weeks conducting additional analysis, doing follow-up research to refine revenue projections and assumptions and further developing high level findings. This analysis was used to create the resulting recommendations.

State Background

In many states, the underlying tax structure has evolved over time, taking into account changes within the economy, population and other factors. Hawaii's tax structure has perhaps not exhibited as much change as in other states with, in some cases, hundreds of years of statehood. Of course, Hawaii has a long and storied history prior to statehood, and that history continues to have a profound impact on its social, political and economic culture. This, in turn, influences choices that have been made regarding both expenditures and revenues. The following highlight some of the key historical themes of Hawaii that impact on the following discussion and analysis of its tax structure.

Island Nation

It is generally assumed that Hawaii was discovered by Polynesians between the 3rd and 7th centuries, and Hawaii was relatively isolated until 1778, when British Captain James Cook reached the Islands. Through the published writings of Cook and his crew, the islands became a main destination for other British navigators, followed by ships from France, Russia, America and other countries. The role of Hawaii as a destination or stopping-off point has been an important factor throughout its history. While the world has become more inter-dependent and global travel quicker and more frequent, the State's unique geographic location is still an important feature.

Influence of Hawaiian Culture

During the early period of contact with other nations, King Kamehameha the Great took control of the islands and greatly limited native interactions with Westerners and other foreigners in an effort to protect the Hawaiian religion, beliefs and rituals. It was not until after his death, and the transition of control to his son Kamehameha II, that outside influential presence was established on the islands. While other

developments gradually integrated others into the Hawaiian culture, politics and economy, there are still notable examples of the native Hawaiian culture playing a key role.

Native Hawaiian Population Decline

When Captain James Cook arrived in Hawaii in 1778, there were estimated to be between 300,000 and 400,000 Native Hawaiians living in the Islands. As island visitors became more prevalent, the native economy began to change to accommodate foreigners and foreign goods; new products and materials were brought to the islands for practical use. Not all of these developments were positive, however, as invasive plants and new animals had sometimes devastating impacts.

As examples, the Chinese demand for sandalwood depleted forests controlled by Hawaiian chiefs. Because native Hawaiians had no resistance to influenza, smallpox and measles, disease outbreaks were frequent and deadly – one measles outbreak killed a fifth of Hawaii's people.[2] Largely as a result of these outbreaks, the Native Hawaiian population declined by 80 to 90 percent. By 1878, the native population had dropped to an estimated 40,000 to 50,000 people. At that time, the Native Hawaiians still comprised about 75 percent of Hawaii's total population. While those who are part-Hawaiian or who consider themselves to be Hawaiian, has increased steadily over the last century, there are fewer than 8,000 pure Hawaiians living today.[3]

Public Land Ownership

With a need to find alternatives to thrive and survive on the land, King Kamehameha III instituted a formal change in land tenure in 1848 that allowed private ownership of land for the first time on the islands. Lands controlled by the king were formally divided and commoners were able to claim kaleana, or traditional family lands. While much land was never claimed, foreigners were able to obtain large masses of land resulting in native land dispossession.

Economic Booms and Bust

Over the years, the Hawaii economy has been dominated by one or two industries that have ascended and then declined. The Sandalwood Trade economic cycle was short-lived and followed by American and European whalers that wintered in Hawaii. Many found work as farmers and cattle ranchers in the off-season and settled on land within the islands. As the trade economy was replaced by the cash economy, the farming and fishing economy also eroded.

Abundant sugar cane and pineapple fields led to a dominant new industry that required more than the local source of workers could provide. In 1875, Hawaii secured a trade treaty with the United States that resulted in vast profits for growers. Soon, laborers were recruited from China, Japan, Portugal, Korea and the Philippines, the first Japanese immigrants arrived in Hawaii in 1885.

Annexation by the US provided the markets needed to drive the sugar economy for most of the 20th century. The sugar industry dominated the local economy, with five firms ("Big Five") controlling the planting, harvesting, processing and shipping of the sugar cane. These firms operated large plantations similar to small communities, providing workers with housing, stores, medical care and entertainment.

The firms employed hundreds of workers that worked grueling hours in the sugar cane fields, leading workers to organize strikes against the plantation owners in 1910-1920. These were the first efforts to organize unions, which became (and remains) a driving force in the State economy.

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[2] http://www.digitalhistory.uh.edu/database/article

[3] http://gohawaii.about.com/cs/culture/a/hawaiian_people.htm

The 1920s brought ocean liner travelers to the islands, and regular routes to Honolulu from the west coast of the continental United States spurred the growth of tourism. The 1930s kicked off the service industry economy in Hawaii with travelers coming to Hawaii to enjoy the beautiful beaches, luxury hotels and exotic culture of the Hawaiian Islands. With Hollywood movies showcasing the royal island experience, and radio programs airing Hawaiian music, Waikiki became a sought-after tourist destination.

After World War II, sugar remained the dominant industry within the economy, but the post-war years brought many changes within the labor movement, and the unions became a more prominent voice. The unions were able to obtain major victories in 1949 to improve wages and working conditions. In the 1950s the power of the plantation owners was broken by descendants of immigrant laborers that were born in a U.S. territory and given legal U.S. citizen rights. At that time, what was once the strongly supported Hawaii Republican Party (mainly by plantation owners), was voted out of office. The Democratic Party of Hawaii, supported widely by unions and World War II veterans, went on to dominate politics of that era.

US Annexation and Statehood

While the Provisional Government of Hawaii hoped for a quick annexation by the United States, they were only able to establish the Republic of Hawaii on July 4, 1894 with a government that followed the American model. It took the election of William McKinley as US President in 1896 for Hawaii's annexation to the United States to be discussed again. The previous president, Grover Cleveland, was a friend of Queen Lili‘uokalani, which had limited this opportunity. In June 1897, the United States agreed to a treaty of annexation with representatives of the Republic of Hawaii.[4] The treaty was never ratified by the United States Senate. Instead, despite the opposition of a majority of Native Hawaiians, the Newlands Resolution[5] was used to annex the Republic to the United States, and it became the Territory of Hawaii. In 1900, Hawaii was granted self-governance.

The bombing of Pearl Harbor on December 7, 1941 brought World War II to the forefront for Hawaiians, with significant repercussions. Hawaii became a critical military outpost for the United States as servicemen departed Hawaii on their way to and from battle, and it operated under martial law for the duration of the war. For decades, many Japanese families that settled in Hawaii were impacted by the war.

Hawaii was admitted to the union as the 50th state in March of 1959. Statehood brought many advantages to the islands, building a foundation for economic prosperity through quick modernization to keep up with the tourism industry and new access to federal funds.

Hawaii became the island tourist destination in the 1960s, spurring development and making Waikiki the high-rise village of the islands. While tourism evolved, the pineapple and sugar industries suffered from increased competition from overseas. The plantations slowly closed their doors through the 1970s and 1980s, and the last plantation shut down during the 1990s.

Despite the loss of the plantation lifestyle that was deeply rooted in the island culture, a changing landscape increased the unique cultural appreciation that heightened pride and awareness of traditional Hawaiian practices. The Hawaii State Constitutional Convention of 1978 even incorporated programs

[4] http://libweb.hawaii.edu/digicoll/annexation/pet-intro.html

[5] The Newlands Resolution was a joint resolution written by and named after United States Congressman Francis G. Newlands. It was an Act of Congress to annex the Republic of Hawaii and create the Territory of Hawaii.

such as the Office of Hawaiian Affairs to promote indigenous language and culture[6] and ensure that these traditions remained, in support of maintaining the long-lived traditions and 'Aloha Spirit' of the islands.

In the 1990s, several key state institutions and political leaders were embroiled in controversy. There was concern that programs designed to benefit Hawaiians and their culture would be unfunded and dismantled, leading to popular political dissatisfaction and the election of more Republicans in the late 1990s. After Republican Governor Linda Lingle served two terms (the only Republican Governor since Hawaii gained statehood), Democratic Governor Neil Abercrombie succeeded her in 2010. Governor Abercrombie has made it a priority to shift the State to a more sustainable foundation, including its tax policy.

Summary

Based on this discussion and analysis, the following key themes will be important for the analysis of the Hawaii tax structure, both in how it has evolved and how it might change in the future:

- While the world is growing more interconnected, among the 50 states, Hawaii (along with Alaska) will always be relatively isolated. This can be both an advantage and a disadvantage from a tax policy perspective, but many of the considerations of how to shape a competitive tax structure that exist for mainland states are less compelling for Hawaii;
- There is a deeply-held respect for land – and public access and use – that differs from states where private ownership rights predominate. This can impact on land use, taxation of land and support for tax and expenditure policies related to preservation and sustainability.
- The influx over time of large worker populations to support major industries like sugar cane plantations led to worker and workplace reforms that still impact the State economy. Hawaii is generally perceived to be a pro-union state, and this shapes key expenditure and tax policies.
- There are a variety of factors that have tended to shape the State economy around one or two key industries. While it is possible that economic, demographic and other factors will alter this over time, tax policy should, at least, be structured to minimize adverse impacts on these key economic drivers.

[6] http://hawaii.gov/lrb/concon78/org.pdf

Demographics

Population and Land Mass

The State of Hawaii primarily consists of a group of six major islands: Kauai, Oahu, Molokai, Lanai, Maui and Hawaii. With a population of approximately 1.4 million residents, the State ranks 40th among the 50 states. Between 1960 and 2010, Hawaii more than doubled its population and grew at a much faster rate than the total US population.

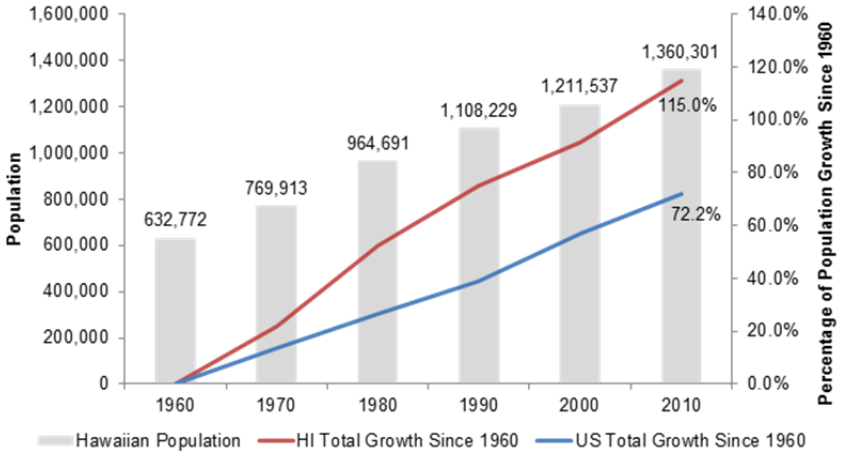
State Population Ranking - 2010

Rank	State	Population
1	California	37,253,956
2	Texas	25,145,561
3	New York	19,378,102
4	Florida	18,801,310
5	Illinois	12,830,632
6	Pennsylvania	12,702,379
7	Ohio	11,536,504
8	Michigan	9,883,640
9	Georgia	9,687,653
10	North Carolina	9,535,483
11	New Jersey	8,791,894
12	Virginia	8,001,024
13	Washington	6,724,540
14	Massachusetts	6,547,629
15	Indiana	6,483,802
16	Arizona	6,392,017
17	Tennessee	6,346,105
18	Missouri	5,988,927
19	Maryland	5,773,552
20	Wisconsin	5,686,986
21	Minnesota	5,303,925
22	Colorado	5,029,196
23	Alabama	4,779,736
24	South Carolina	4,625,364
25	Louisiana	4,533,372

Rank	State	Population
26	Kentucky	4,339,367
27	Oregon	3,831,074
28	Oklahoma	3,751,351
29	Connecticut	3,574,097
30	Iowa	3,046,355
31	Mississippi	2,967,297
32	Arkansas	2,915,918
33	Kansas	2,853,118
34	Utah	2,763,885
35	Nevada	2,700,551
36	New Mexico	2,059,179
37	West Virginia	1,852,994
38	Nebraska	1,826,341
39	Idaho	1,567,582
40	**Hawaii**	**1,360,301**
41	Maine	1,328,361
42	New Hampshire	1,316,470
43	Rhode Island	1,052,567
44	Montana	989,415
45	Delaware	897,934
46	South Dakota	814,180
47	Alaska	710,231
48	North Dakota	672,591
49	Vermont	625,741
50	Wyoming	563,626

Source: US Census Bureau – 2010 Decennial Census

Population Growth in Hawaii: 1960 – 2010



Source: US Census Bureau 1960-2010 Census Data

The Hawaiian Islands have a total land area of 6,423 square miles. Hawaii is by far the largest of the islands,[7] while Oahu is by far the most populous.[8]

Land Area and Population by Island

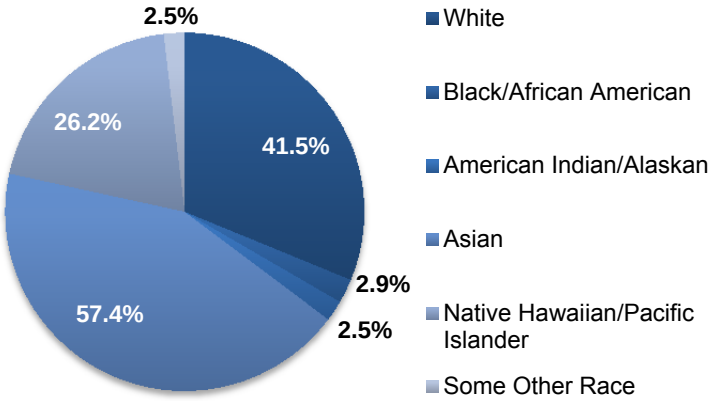
Name of Island	Area (sq. mi.)	Population
Hawaii	4,028.0	185,079
Maui	727.2	144,444
Oahu	596.7	953,207
Kauai	552.3	66,921
Molokai	260.0	7,345
Lanai	140.5	3,135
Niihau	69.5	170
Kahoolawe	44.6	0
TOTAL	**5,822.1**	**1,360,301**

A series of smaller islands, atolls and reefs located west of Ni'ihau form the Northwestern Hawaiian Islands, or Hawaiian Leeward Islands. All of these are uninhabited. The State of Hawaii recognizes 137 islands in the Hawaii chain; this includes all minor islands and islets offshore of the main islands on the map above.

Race and Ethnicity

Over the last 200 years, Hawaii has become home to a very diverse set of ethnic groups, making it one of the most racially diverse places in the world. The largest super-ethnic groupings of race are the East Asians (largest group are Japanese, Chinese, Korean), then Polynesians, then Southeast Asians (largest group are the Filipinos), then Europeans, then Africans, then Native Americans. Native Hawaiians historically made up the ethnic majority until annexation, when people of Eurasian, American (Amerindian) and African descent began migrating to Hawaii. Below is the latest ethnic profile of these consolidated general population characteristics:

Hawaii General Population Characteristics



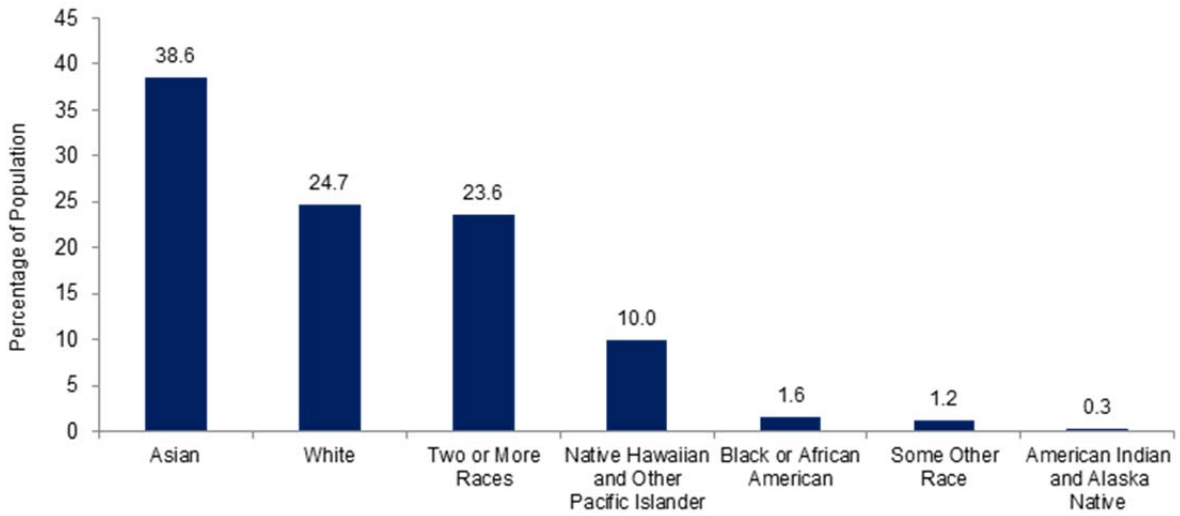
Source: US Census Bureau 2010 Profile of General Population Characteristics

[7] http://geonames.usgs.gov

[8] As of 2010 U.S. Census data.

Hawaii is among the most racially 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. This make-up of multi-ethnic background and identification is greater than in any other state.

Ethnic Diversity of Hawaii's Population – 2010



Source: US Census Bureau – 2010 Decennial Census

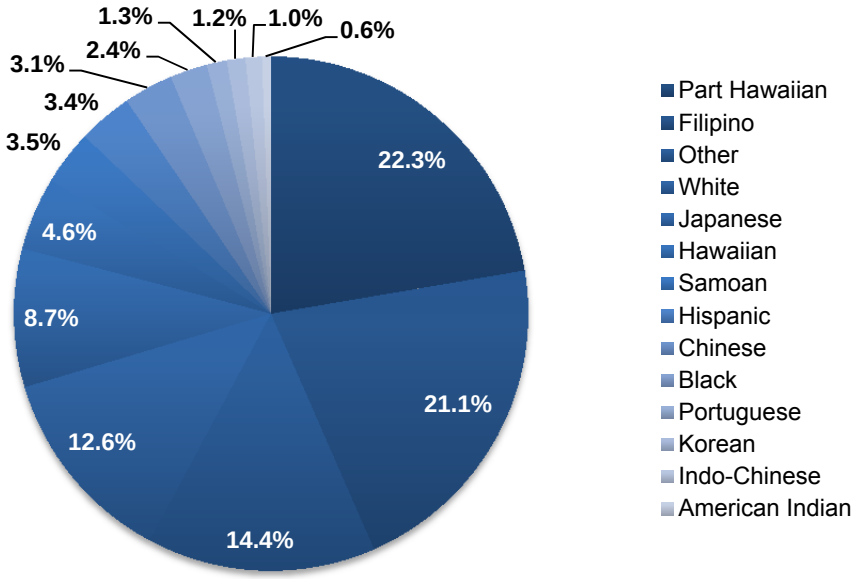
The State Office of Hawaiian Affairs spends millions of dollars each year on programs to benefit Native Hawaiians, promoting the Hawaiian language and pushing for federal recognition of Hawaiians. Most of the funding comes from revenue generated by leasing out land to farmers, developers and harbor users that once belonged to the Hawaiian kingdom.[9]

The State's diversity is also reflected in its public school enrollment. Hawaii's public schools enroll over 178,000 students[10] in grades K-12. A break-down of Hawaii's students by ethnicity can be found below:

[9] Per http://www.oha.org/about/history the establishment of the Office of Hawaiian Affairs set up a public trust as a result of the 1978 Constitutional Convention with a mandate to better the conditions of both Native Hawaiians and the Hawaiian community in general. OHA was to be funded with a pro rata share of revenues from state lands designated as "ceded".

[10] Under Hawaii's Compulsory Attendance Law, children and youth between the ages of six and eighteen years must attend school unless they have an approved exception.

K – 12 Student Population by Ethnicity

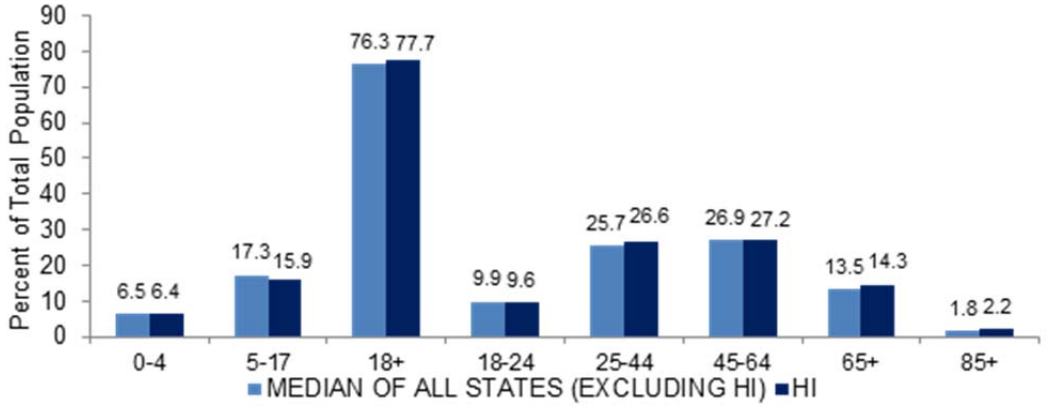


Source: Hawaii State Department of Education, as of 8/31/09

Age of Population

Hawaii's population is older than the United States as a whole. Hawaii ranks 10th of the 50 states in the percentage of population ages 18 and over, and 12th in the percentage of population ages 65 and over. As a result, Hawaii's population ages 24 and under comprises a smaller percentage of its total population. Hawaii ranks 38th of the 50 states in percentage of population ages 18-24 and 44th out of the 50 states in percentage of population ages 5-17.

Age of Population: State Medians



Source: US Census Bureau – 2010 Decennial Census

Educational Attainment

Compared to the 50 states, Hawaii's population is generally well-educated. Hawaii ranks 9th in the percentage of population with a high school diploma or higher (90.2 percent) and 16th in percentage of population with a bachelor's degree or higher (29.2 percent).

While Hawaii's median earnings ranks 16th among states, it is about average for those with bachelor's or advanced degrees. Comparatively, Hawaii has a relatively low percentage of its population who have not achieved at least a high school diploma (9.9 percent) and ranks above average for median earnings for this cohort.

Educational Attainment

	Less than High School Diploma	High School Diploma	Some College (no degree) / Assoc. Degree	Bachelor's Degree	Graduate or Professional Degree
Hawaii	9.9%	28.9%	32.0%	19.5%	9.7%
Rank	41	27	15	12	21
Median Earnings	$20,275	$28,993	$34,694	$45,269	$61,052
Rank	17	13	14	23	22

Source: US Census Bureau 2010 ACS 3-year Estimates

Income

On typical measures, Hawaii is a relatively high income state. As shown in the following table, the State has an above average per capita income, ranking 16th overall among the states. The State's per capita income is over $3,000 greater than the median of all states and almost $1,500 greater than the per capita income of the US as a whole.

Per Capita Income

	Per Capita Income
Hawaii	$28,417
Rank Among States	16
Variance from US ($)	$1,475
Variance from US (%)	5.5%

Source: US Census Bureau 2010 ACS 3-year Estimates

Hawaii has among the smallest percentage of its population living in poverty (10.0 percent), ranking 45th out of the 50 states. Similarly, the percentage of Hawaii residents under age 18 and age 65 and above who live in poverty is among the lowest of the 50 states. The only poverty metric where Hawaii trails the majority of states is percentage of its population in poverty who have a bachelor's degree or higher.

Percent Living in Poverty

	Total Population	Children under 18	Seniors 65 and over
Hawaii	10.0%	12.7%	6.9%
Rank Among States	45	47	46
US (%)	14.4%	20.1%	9.4%

Source: US Census Bureau 2010 ACS 3-year Estimates

Hawaii's median household income ($66,201) ranks as the 5th highest among all states. The state's median household income is over $17,000 greater than the median among the 50 states.[11]

Median Household Income

	Median Household Income
Hawaii	$66,201
Rank Among States	5
Variance from US ($)	$14,979
Variance from US (%)	29.2%

Source: US Census Bureau 2010 ACS 3-year Estimates

[11] US Census Bureau 2010 ACS 3-year Estimates.

Economy

On several key demographic measures, including levels of income and educational attainment, Hawaii scores high relative to all states. These generally translate into a strong state economy. However, some unique State aspects (such as location and distance from mainland supplier and customer markets) may act as a headwind to economic progress.

Economic Diversification

The tourism industry has been a key factor for the State economy. On one measure, employment by industry, the State has a far greater concentration of employment in the leisure and hospitality services category than the rest of the nation. The following table lists employment by industry by location quotient, which is an industry concentration measure of an industry's share of local employment compared to an industry's share of national employment. For these, a location quotient of 1.15 would mean the state is 15 percent more reliant on that industry's employment than is the nation as a whole; a location quotient of 0.85 would mean the state is 15 percent less reliant on that industry's employment than is the nation as a whole:[12]

Employment by Industry

Employment Industry	Location Quotient
Manufacturing	0.24
Information	0.67
Financial Activities	0.80
Professional and Business Services	0.93
Education and Health Services	0.83
Leisure and Hospitality Services	1.74
Other Services	1.06
Government	1.27

While tourism numbers are significant, it may not be an economic engine (given, for example, its relatively low average wage levels and contribution to GDP) that can individually drive the state economy to new heights in the years to come. There are also real concerns about capacity constraints (there are only so many planes that can arrive and depart in a day, and only so many available hotel rooms).

Given these concerns, economic diversification is an important issue, and tax policy can have an impact on it. While there are a number of ways to characterize the diversification of a state economy, at least a couple of methods suggest that there is room for improvement in these measures for the State economy.[13]

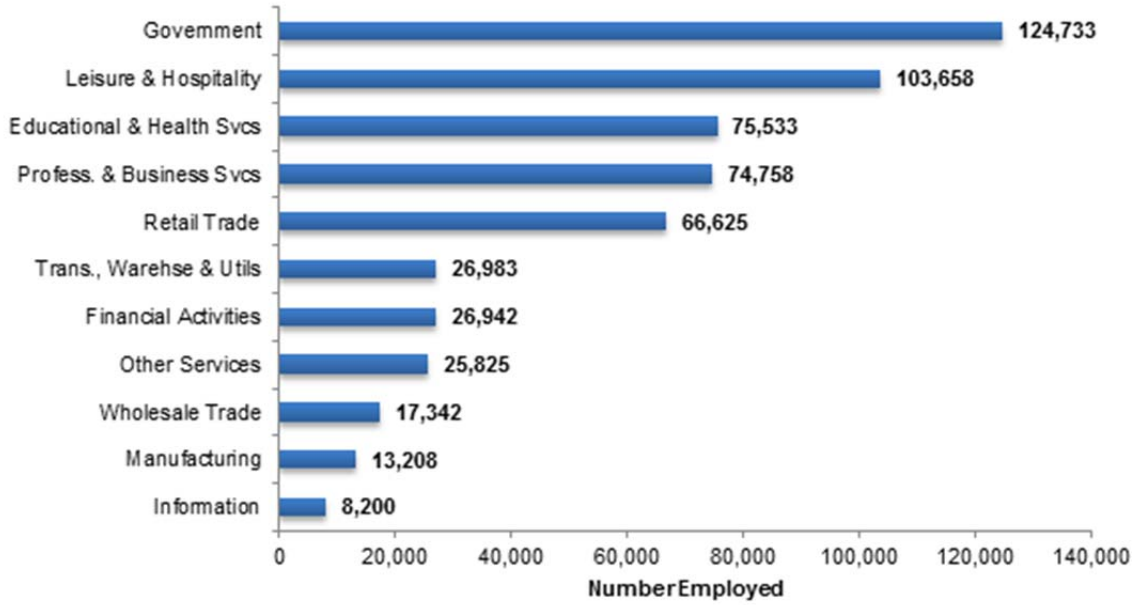
[12] Data from the Federal Deposit Insurance Corporation (FDIC) Regional Economic Conditions (RECON) based on data from the Bureau of Labor Statistics; created 7/24/12 and accessed at: http://www2.fdic.gov/recon/index.asp. According to the FDIC, 'Industry breakouts shown are based on available data only and may exclude certain industries for which LQs are significantly different from 1.0.'

[13] The Research and Economic Analysis Division of the Hawaii Department of Business, Economic Development and Tourism authored a February 2008 report, "Measuring Economic Diversification in Hawaii." This examined economic diversification from a variety of perspectives. Using two common methods, the Hawaii economy ranked in the bottom quintile of states in 1990, 2000 and 2006. At the same time, the study did not find support for a positive association between levels of economic diversity and economic stability and growth. See pages 25-26 and 31-33.

Federal, State and Local Government

As noted in the previous table, government employment in Hawaii is higher than for the nation as a whole, which is impacted by the number of federal workers (largely military personnel) located in the State. The following shows employment by industry for 2011:

Hawaii Year-end Employment by Industry, 2011 (Not Seasonally Adjusted)



Source: Bureau of Economic Analysis (Haver Analytics)

Since World War II, Hawaii has been a key US military location, and its impact on the State economy is profound. In 2009, there were over 75,473 active, reserve and civilian defense personnel[14] and 16,088 military retirees residing in the State.[15] The earnings of these personnel totaled $4.7 billion per year ($5.0 billion when adding retirement benefits paid to retirees).[16] Besides military personnel, defense procurements where Hawaii was the principal place of performance averaged $2.3 billion annually between 2007-2009.[17] As the following demonstrates, Hawaii's per capita federal spending is among the highest in the nation – ranking fifth among the states in FFY2010:

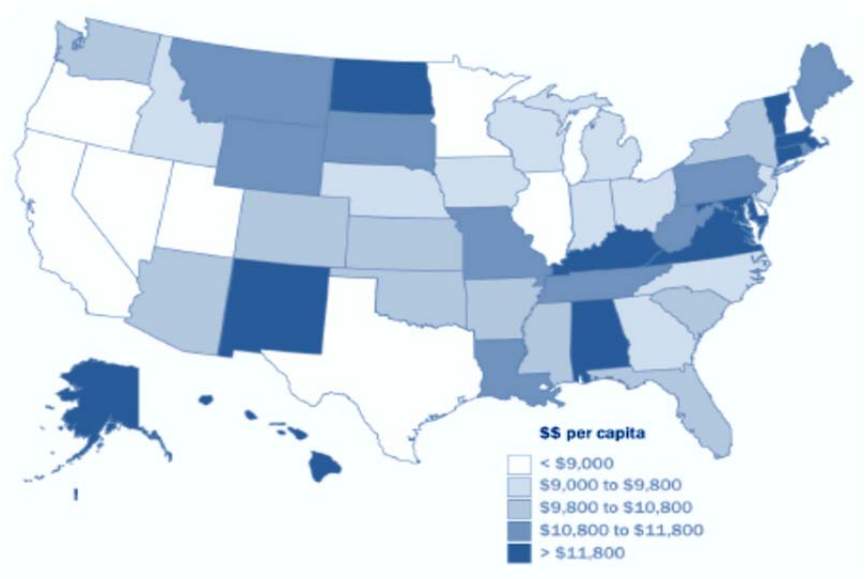
[14] Technical Report, "*How Much Does Military Spending Add to Hawaii's Economy*?", RAND National Defense Research Institute, p.7.

[15] State of Hawaii, "State of Hawaii Data Book", 2009.

[16] Technical Report, "*How Much Does Military Spending Add to Hawaii's Economy*?", RAND National Defense Research Institute, p.5.

[17] Ibid, p.14.

Per Capita Federal Spending, FFY2010



Source: Consolidated Federal Funds Report, US Bureau of the Census

Potential reductions in federal funding resulting from the federal Budget Control Act of 2011 (BCA) could be critical for the State. As a result, it is likely that Hawaii would be more vulnerable to attempts to deal with the nation's deficit than other states.

A recent analysis forecasted possible reductions in federal spending based on the BCA funding sequester requirements. While the spending reductions mandated by the BCA are significant, they are not uniform. For example, almost three-fourths of grant programs are subject to sequester, but they comprise less than 20 percent of grant funding. Several of the largest state grant programs for states, including Medicaid, Temporary Assistance for Needy Families and Federal Aid for Highways, are exempt from the sequester. As a result, the hypothetical reduction for the State of Hawaii based on the covered grant programs would be approximately $20.1 million for FY2013 but would be offset by estimated increases for exempt programs of approximately $35.2 million.[18] As it relates to Hawaii, the defense sequester could be more damaging. According to the analysis, the potential impact for Hawaii of a defense sequester could be approximately $965.6 million.[19]

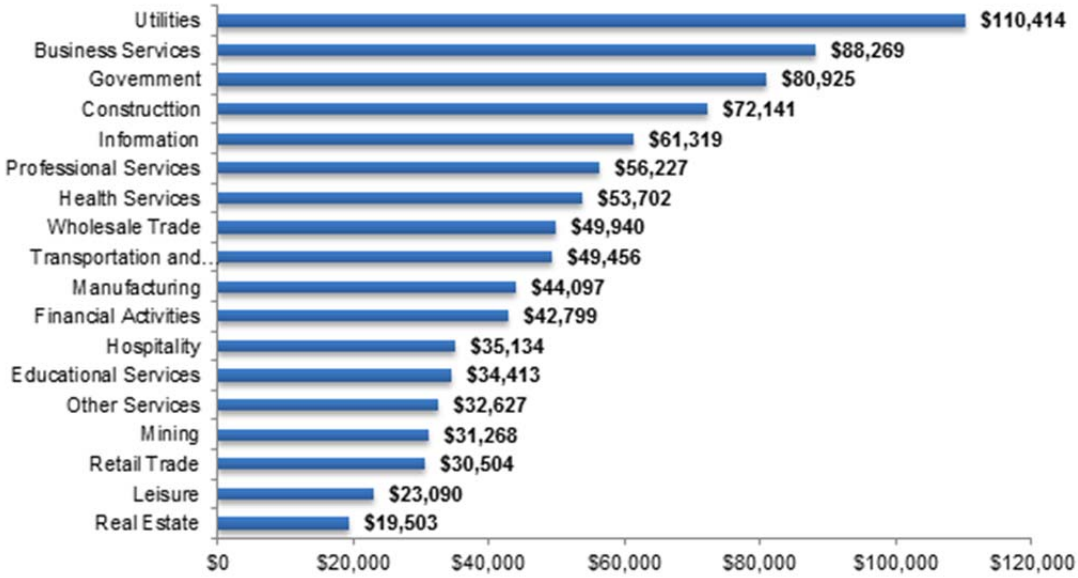
Key Industries for Earnings and Output

While employment numbers are an important measure, it is also useful to examine the typical earnings within the industry. By this measure, the hospitality and leisure industries do not fare as well:

[18] "Potential Impact of BCA Sequester," Federal Funds Information for States, Volume 12, No. 2, June 2012, p. 1-4.

[19] Ibid., p. 7

Hawaii Average Annual Earnings per Employee by Industry, 2010 (Not Seasonally Adjusted)



Source: Bureau of Economic Analysis (Haver Analytics)

Another common method for assessing an industry's importance to the state economy is by analysis of its share of state Gross Domestic Product. Gross Domestic Product (GDP) is the market value of all the goods and services produced by labor and property located in a state for the period in question. The following lists these components by share of the Hawaii economy in 2011. It should be noted that the government category includes federal as well as state and local government, both civilian and military.

Employment Industry by Share of GDP, State of Hawaii

Industry Code	Employment Industry	2011	Percent
101	All Industry Total	66,991	
178	Government	16,548	24.7%
155	Real Estate/Rental/Leasing	10,940	16.3%
174	Accommodation/Food Service	5,416	8.1%
135	Retail Trade	4,649	6.9%
167	Health Care and Social Assistance	4,499	6.7%
111	Construction	3,738	5.6%
158	Professional, Scientific and Technical Services	3,250	4.9%
136	Transportation and Warehousing	2,611	3.9%
150	Finance and Insurance	2,424	3.6%
163	Administrative and Waste Management Services	2,131	3.2%
134	Wholesale Trade	1,986	3.0%
177	Other Services (Ex Gov't)	1,735	2.6%
110	Utilities	1,557	2.3%
145	Information	1,547	2.3%
112	Manufacturing	1,368	2.0%
162	Management of Companies and Enterprises	743	1.1%

Industry Code	Employment Industry	2011	Percent
166	Educational Services	731	1.1%
171	Arts, Entertainment and Recreation	651	1.0%
103	Agriculture, Forestry, Fishing and Hunting	452	0.7%
106	Mining	15	0.0%

Source: Bureau of Economic Analysis (Haver Analytics)

By contrast, the GDP for the US as a whole has a much higher concentration of manufacturing. While government is still the largest sector, the difference between it and other sectors is not nearly as large:

US Employment Industry by Share of GDP

Industry Code	Employment Industry	2011	Percent
101	All Industry Total	14,981,020	
178	Government	1,883,655	12.6%
112	Manufacturing	1,837,031	12.3%
155	Real Estate/Rental/Leasing	1,751,682	11.7%
150	Finance and Insurance	1,256,158	8.4%
158	Professional, Scientific and Technical Services	1,171,145	7.8%
167	Healthcare and Social Assistance	1,151,187	7.7%
135	Retail Trade	916,951	6.1%
134	Wholesale Trade	844,928	5.6%
145	Information	662,324	4.4%
111	Construction	520,340	3.5%
163	Administrative and Waste Management Services	444,313	3.0%
174	Accommodation and Food Services	441,647	2.9%
136	Transportation and Warehousing	418,807	2.8%
177	Other Services (Ex Government)	368,747	2.5%
106	Mining	287,584	1.9%
162	Management of Companies and Enterprises	282,487	1.9%
110	Utilities	250,825	1.7%
103	Agriculture, Forestry, Fishing and Hunting	177,795	1.2%
166	Educational Services	169,315	1.1%
171	Arts, Entertainment and Recreation	144,058	1.0%

Source: Bureau of Economic Analysis (Haver Analytics)

Summary

The benchmarking data supports the general view that Hawaii is an outlier on several common methods for state comparison. The following should be taken into consideration in the following analysis and discussion of revenue structure:

- While not a large state in terms of size or population, Hawaii has exhibited much stronger population growth than the nation as a whole.
- Hawaii's population is older than the nation as a whole, and this trend is likely to continue.
- The State has a high median household income and median home value – indicators of income and wealth.
- Tourism is a key employer in the State, but the jobs are generally not high paying.
- A key driver, in terms of GDP and earnings, is government – both federal and state/local.
- Manufacturing is a much smaller share of the State's GFP than the nation as a whole.

The State's economy shows strengths and weaknesses, both in terms of its composition and unique characteristics. It is likely that tourism will continue to be a key source of jobs for the State, but its contribution to overall economic output is mixed. Government is the predominant sector in terms of output (and generally well paying), but federal and state budget cuts are a major concern. The State has made a variety of investments to spur other parts of the economy, and it is an open question whether the State can achieve a greater level of diversification – which it is mostly lacking at present.

Current Revenue Structure

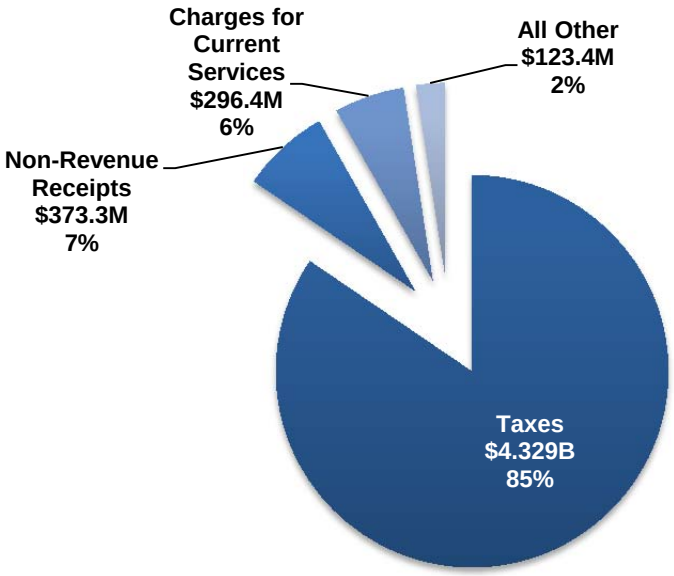
Current Revenue Structure

General Characteristics

As in most states, Hawaii derives the great majority of its revenue from taxes. Other sources, including charges for services and non-revenue receipts (e.g. sales of real property and investments; general obligation and revenue bond proceeds; deposits, gifts, donations, private grants; transfers from other funds; etc.), provide the remaining revenue that funds operations and services.

In Fiscal Year (FY) 2011, Hawaii collected nearly $5.3 billion in revenue.[20] Of that, 85 percent ($4.3 billion) was tax revenue. The remaining 15 percent was from non-revenue receipts (7 percent), charges for current services (6 percent) and all other sources (2 percent).[21]

FY 2011 Revenue Sources

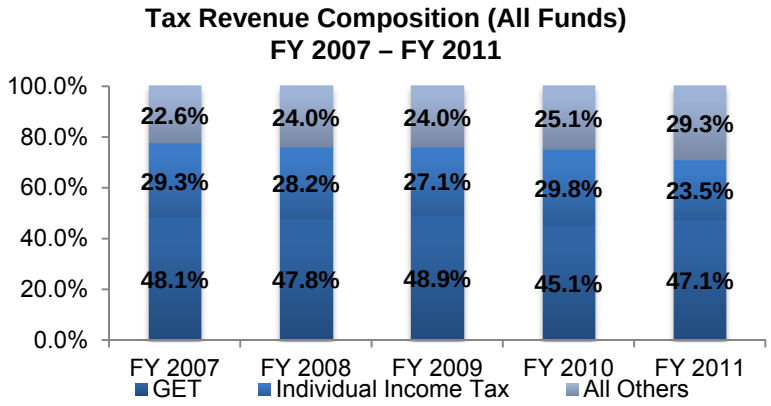


The state's largest revenue source is the General Excise Tax (GET). In FY 2011, it accounted for $2.5 billion of total revenue collected (47.1 percent). The Individual Income Tax (IIT) is the second largest revenue source for Hawaii, generating $1.2 billion in FY 2011 (23.5 percent of total revenue). Taken together, the GET and the IIT accounted for 70.7 percent of total revenues. The remaining 29.3 percent ($1.6 billion) came from many smaller sources.[22]

[20] All funds - includes $199,009,525 in Honolulu County Surcharge receipts.

[21] All specific, historical tax performance data were sourced from Council of Revenue data. All aggregate (all fund) tax data were sourced from the Department of Taxation (DOTAX).

[22] All or portions of several taxes are non-General Fund revenue sources. Individual taxes are detailed in greater depth later in this Chapter.



The following table details the State's tax revenue sources from FY 2007 to FY 2011:

Hawaii Tax Revenues FY 2007 through FY 2011 (All Funds)

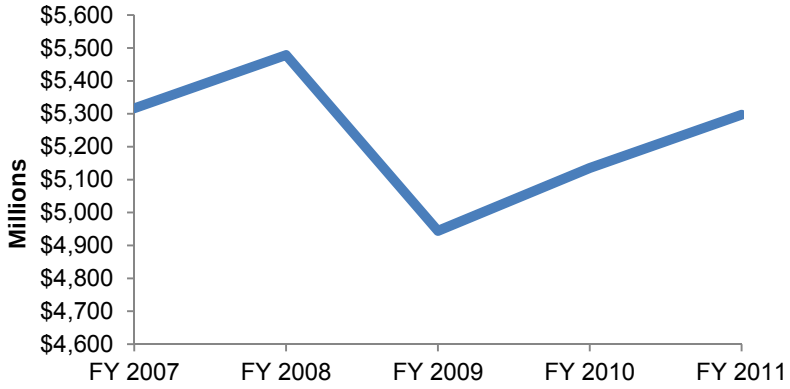
SOURCE OF REVENUE	*FY2007*	*FY2008*	*FY2009*	*FY2010*	*FY2011*
Banks/Financial Corp. 1/	18,598,738	20,212,121	28,075,165	20,666,000	33,677,284
Conveyance 1/	46,886,684	43,421,225	23,772,408	40,633,938	47,905,995
Employment Sec. Contri.	134,611,668	92,279,234	49,071,105	82,016,796	190,511,191
Fuel	169,711,869	169,926,559	165,717,476	155,703,005	195,336,475
GE License/Fees	484,039	486,596	456,584	448,548	478,623
General Excise & Use 2/	2,555,761,657	2,618,786,948	2,417,579,853	2,316,433,716	2,495,807,283
Honolulu County Surcharge 3/	53,804,870	187,903,947	178,728,585	175,061,467	199,009,525
Income-Corp.:					
Decl. of Est. Taxes	138,769,224	131,461,936	97,456,250	96,854,697	109,860,212
Payment W/Returns	22,653,038	21,851,421	23,307,117	18,910,524	13,981,865
Refunds	(79,588,032)	(68,232,077)	(67,241,079)	(56,579,706)	(89,268,832)
Income-Ind.: 1/					
Decl. of Est. Taxes	428,754,210	430,197,009	262,539,789	257,329,246	301,476,121
Payment W/Returns	229,963,690	179,208,886	135,354,155	157,826,746	137,753,689
WH Tax on Wages	1,279,648,612	1,370,853,852	1,398,638,764	1,355,036,369	1,418,156,630
Refunds	(378,080,874)	(435,424,466)	(457,477,181)	(242,082,712)	(610,233,543)
Inheritance/Estate	594,629	164,149	274,164	299	6,899,215
Insurance Fees	0	0	0	292,567	4,869,047
Insurance Premiums	92,195,853	95,742,388	93,720,323	104,721,367	140,456,112
Liquor and Permits	46,034,406	45,620,195	47,242,269	44,073,827	48,053,576
Mtr. Vehicle Tax/Fees 4/	112,411,967	112,447,975	101,991,063	102,319,117	106,165,508
Public Service Co.	124,017,331	127,481,081	126,069,236	157,660,917	117,940,356
Tobacco and Licenses 1/	94,387,367	104,624,254	108,163,771	123,488,876	143,292,924
Trans. Accomm./Time Share Occup. Fees	11,091	9,695	7,855	8,600	9,460
Trans. Accomm. Tax/Time Share Occup. Tax 1/	224,931,245	229,377,993	210,613,996	224,242,539	284,462,891
All Others 5/	29,727	89,614	70,935	33,739	460,026
TOTAL	**5,398,427,239**	**5,563,571,817**	**4,997,654,893**	**5,194,285,994**	**5,331,634,878**

1/ Gross collection - does not reflect allocation to Special Funds.
2/ May also contain some revenue from the Honolulu County Surcharge.
3/ Allocated as of June 30, 2008. Taxpayers whose businesses are located outside of Oahu, but have business activities on Oahu may be subject to Honolulu County Surcharge tax.
4/ Includes State Motor Vehicle Weight Tax, Registration Fees, Commercial Driver's License, Periodic Motor Vehicle Inspection Fees, Rental Vehicle Registration Fees and Rental Vehicle Surcharge Tax.
5/ Includes Fuel Retail Dealer Permits and Penalty & Interest - Fuel.

Since FY 2007, Hawaii's tax revenues have experienced both periods of year-to-year growth (FY 2008; FY 2010; FY 2011) and year-to-year decline (FY 2009). Like many states, Hawaii experienced a decrease in tax revenues in FY 2009 as the effects of the recession reduced consumer and business spending. Hawaii's GET revenue declined 7.7 percent in FY 2009. Additionally, the State's tourism industry experienced decreased consumer spending, which impacted certain sources, such as the State's TAT – with FY 2009 receipts 8.2 percent below the FY 2008 level.

Hawaii has experienced growth in its tax revenues since the decline in FY 2009. Growth in FY 2010 was 3.9 percent, and growth in FY 2011 was 3.2 percent. As with many states during this timeframe,[23] legislated changes helped fuel that growth. The State made several temporary revenue adjustments to taxes to assist in stabilizing revenues.[24] Even with the temporary adjustments, the State's overall tax revenues in FY 2011 were slightly less than in FY 2007.

Hawaii Tax Revenues (All Funds)
FY 2007 – FY 2011



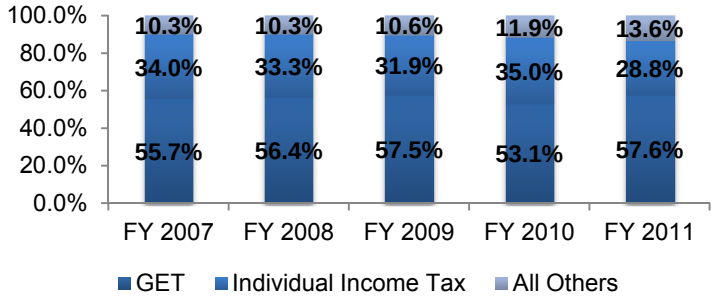
Note: Does not include revenues from Honolulu County Surcharge.

From FY 2007 to FY 2011, the State benefited from double digit compound annual growth rates in certain taxes, including the taxes on banks and other financial corporations (16.0 percent), insurance premiums (11.1 percent) and tobacco/cigarettes (11.0 percent). Others – such as the fuel tax, liquor tax and TAT – exhibited more moderate growth rates. The two largest revenue-generating taxes, the GET and the IIT, experienced negative annual growth rates of -0.6 percent and -5.4 percent respectively. These were the primary reason the State experienced a reduction in revenues available to fund operations and services.

[23]"State Tax Actions 2011, Special Fiscal Report," National Conference of State Legislatures, February 2012, p.3. The report notes that state actions to raise revenue (mostly via tax increases) for all states totaled $3.8 billion in 2008, $28.6 billion in 2009 and an additional $3.0 billion in 2010.

[24] Legislative changes to various taxes discussed in more detail in this Chapter.

Hawaii General Fund Tax Revenue
FY 2007 – FY 2011



2011 General Fund Tax Revenue

Tax	Revenue	% of Total
General Excise and Use Tax	2,495,807,000	57.6%
Individual Income Tax	1,246,672,000	28.8%
Corporate Income Tax	34,573,000	0.8%
Public Service Company Tax	117,940,000	2.7%
Tax on Insurance Premiums	140,456,000	3.2%
Cigarette and Tobacco Tax	106,137,000	2.5%
Liquor Tax	48,054,000	1.1%
Tax on Banks and Other Financial Corps.	31,677,000	0.7%
Inheritance and Estate Tax	6,899,000	0.2%
Conveyance Tax	21,527,000	0.5%
Miscellaneous Taxes	19,812,000	0.5%
Transient Accommodations Tax	59,757,000	1.4%
TOTAL	**4,329,311,000**	**100.0%**

Hawaii's most notable General Fund taxes are discussed below and listed in order of magnitude (percentage of total FY 2011 General Fund revenue).

General Excise Tax (GET)
FY 2011: $2,495,807,000 (57.6 percent of General Fund revenue)

Overview
The GET is a business privilege tax on gross proceeds of sales or income. The rate is 0.5 percent on wholesaling, wholesale services, producing and sugar processing and pineapple canning. All other activities are taxed at 4.0 percent, except insurance commissions (0.15 percent). The City/County of Honolulu levies an additional surcharge of 0.5 percent.[25] The State's General Fund receives 10.0 percent of the City/County surcharge revenue.

The GET is complemented by a use tax levied on tangible personal property imported or purchased from unlicensed sellers for use in the State. The purchase price or value of the tangible personal property is the base for calculating the tax. The use tax rate is 0.5 percent if for resale and 4.0 percent for use or consumption. The tax also applies to services or contracting performed by an unlicensed seller at a point outside the State and imported or purchased for use in the State. The City/County of Honolulu levies an additional surcharge of 0.5 percent.[26]

[25] Hawaii Department of Taxation, "Outline of the Hawaii Tax System as of July 1, 2011."
[26] Ibid.

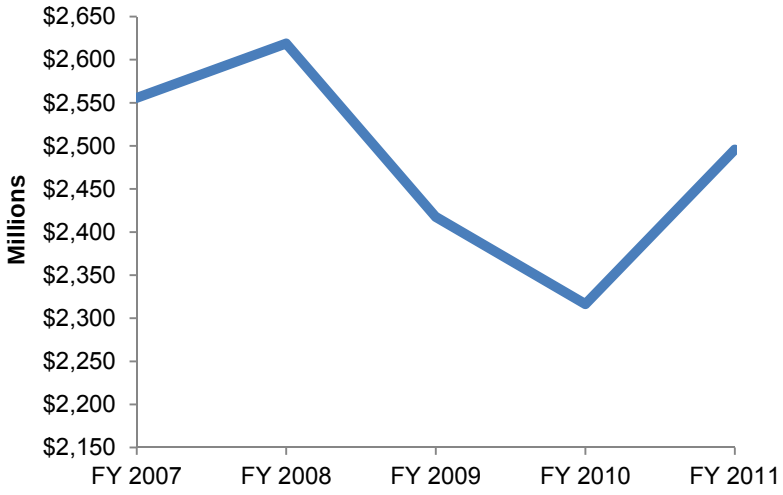
	Rate	Description/Overview	Receiving Fund
General Excise Tax	4.0%	Retail sale of goods, sale of services, contracting, commissions, rent, interest, and other activities. Utilities exempt.	*State General Fund.*
	0.5%	Wholesaling, selected intermediary services, manufacturing, producing, real property subleasing, canning and blind, deaf or totally disabled persons	
	0.15%	Insurance solicitors.	
	Exempted	Gross income from contracting and other services exported out of the state, exports of tangible personal property,	
	0.5%	Resold services and subleases, motor carriers, common carriers by water, and contract carriers formerly taxed under the public service company tax	

General Excise Tax (Use)	4.0%	On tangible personal property imported or purchased from an unlicensed seller. Tax on value of services performed by unlicensed sellers at a point outside the state and imported or purchased for use in the state	*State General Fund*
	0.5%	On goods imported for resale at retail	

Recent Experience

GET revenue declined during the period consistent with the national recession (late 2007 to mid-2009). In FY 2009, GET revenue declined by 7.7 percent and further decreased by 4.2 percent in FY 2010. GET revenue increased by 7.7 percent from FY 2010 to FY 2011, but remained 2.3 percent below its FY 2007 level and 4.7 percent below the peak level reached in FY 2008.

General Excise Tax (General Fund Revenue)
FY 2007 – FY 2011



Note: May also contain some revenue from Honolulu County Surcharge.

Legislative Actions

Effective for FY 2012, GET exemptions were suspended for certain entities and activities (mostly business to business transactions) – which subjected them to the 4.0 percent rate.[27] Suspended exemptions include:[28]

[27] Act 105, SLH 2011.

- Amounts deducted from gross income received by a contractor
- Gross receipts of home service providers acting as service carriers providing mobile telecommunications services to other home service providers
- Gross income of nonprofit organizations from certain conventions, conferences, trade show exhibits or display spaces
- Amounts received from the sale of liquor, cigarettes and tobacco products and agricultural, meat, or fish products to persons or common carriers engaged in interstate or foreign commerce
- Amounts received as high technology research and development grants
- Gross proceeds from the sale of items to the federal government:
    - Liquor
    - Tobacco products and cigarettes
    - Other tangible personal property
- Leasing or renting aircraft or keeping aircraft solely for leasing or renting for commercial transportation of passengers and goods or the acquisition or importation of aircraft or aircraft engines
- Use or sale of liquor, cigarette and tobacco products imported into the State and sold to any person or common carrier for consumption out of State by person, crew, or passengers on shippers vessels or airplanes

The temporary suspension was effective on July 1, 2011 and sunsets on June 30, 2013.

Projected Outlook
GET revenue is projected to grow steadily through FY 2018, with a one-time smaller growth assumption in FY 2014 as special exemptions resume. The average annual growth rate through FY 2018 is projected to be 5.59 percent. Thereafter, the annual average growth rate through FY 2025 is projected to be 5.46 percent.

Individual Income Tax
FY 2011: $1,246,672,000 (28.8 percent of General Fund revenue)

Overview
Hawaii's second largest revenue generating tax, it is levied on individual (or those filing jointly) income. Taxpayers may claim a standard deduction, with the amount subject to marital status and the presence of dependents – currently $4,000 for married filing joint or surviving spouse with dependent child, $2,000 for single or married filing single and $2,920 for head of household. The personal exemption amount is $1,040 per qualified exemption. Hawaii has 12 tax brackets based upon single/joint income with a corresponding specific rate levied for each income bracket, which is shown in the following table.

[28] A complete list of suspended exemptions is available in Appendix B. The State originally projected the exemptions would generate approximately $120 million in tax revenue over the two years, but that has been subsequently revised downward to approximately $70 million due to limitations on the available data and substantial scope for taxpayers to avoid the tax increase.

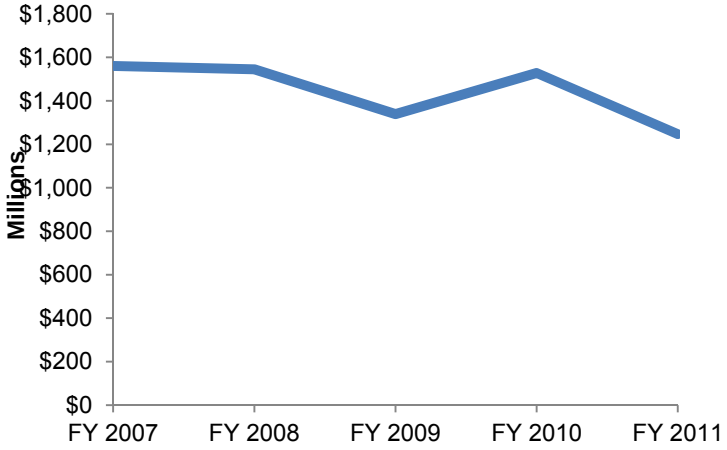
Hawaii Individual Income Tax Bracket (Current)

	Rate	Description/Overview	Receiving Fund
Individual Income Tax	1.40%	on the first $2,400 of taxable income.	*State General Fund and State Election Campaign Fund*
	3.20%	on taxable income between $2,401 and $4,800.	
	5.50%	on taxable income between $4,801 and $9,600.	
	6.40%	on taxable income between $9,601 and $14,400.	
	6.80%	on taxable income between $14,401 and $19,200.	
	7.20%	on taxable income of $19,201 and $24,000.	
	7.60%	on taxable income of $24,001 and $36,000.	
	7.90%	on taxable income of $36,001 and $48,000.	
	8.25%	on taxable income of $48,001 and $150,000.	
	9.00%	on taxable income of $150,001 and $175,000.	
	10.00%	on taxable income of $175,001 and $200,000.	
	11.00%	on taxable income of $200,001 and above.	

Recent Experience

From FY 2007 to FY 2011, the State's IIT receipts declined in all years except for FY 2010. The largest decline occurred in FY 2011, when it was 18.4 percent lower than in FY 2010. Much of this decline is due to a delayed payment in tax refunds, which were withheld in the last half of FY 2010 and paid out in July of 2010 (the first month of FY 2011). During the five-year period, the average annual growth rate was -4.6 percent. The compounded annual growth rate for that period was -5.4 percent.

Individual Income Tax (General Fund Revenue)
FY 2007 – FY 2011



Note: Gross collection – does not reflect allocation to Special Funds.

Legislative Actions

In 2009, the State increased the income tax rate for high-income brackets for tax years 2009 through 2015.[29] The legislation added tier rates for individuals with incomes over $150,000 (single/married filing separately) or $300,000 (married filing jointly), including a top rate of 11.00 percent for those earning over $200,000 (single/married filing separately) and $400,000 (married filing jointly). The State estimates suggested the new income tax brackets will provide nearly $48 million per year in additional revenue.[30]

[29] Act 60, SLH 2009.

[30] Hawaii Income Tax Increases Aimed at State's Richest," Derrick DePledge. Honolulu Advertiser, April 29, 2009.

In 2011, legislation also eliminated the deduction for state taxes paid for taxpayers with income above specified thresholds:

- $100,000 for Single or Married Filing Separately
- $150,000 for Head of Household
- $200,000 for Joint Returns or Surviving Spouse

The legislation also placed temporary limitations on claims for itemized tax deductions and delayed the standard deduction and personal exemption increased under Act 60, SLH 2009 by two years (until tax year 2013). It also made the 10 percent increase in standard deduction and personal exemption permanent.[31] The cap on itemized deductions expires after tax year 2015.

Projected Outlook
Growth in FY 2012 for individual income tax revenue is projected to be 16.29 percent, following the FY 2011 decline of 18.40 percent. Annual average growth in individual income tax revenue through FY 2018 is projected to be 7.96 percent. A slower growth rate is projected for FY 2017 due to expiring income tax adjustments. From FY 2019 through FY 2025, the average annual projected growth rate is 6.44 percent.

Transient Accommodations Tax (Hotel/Motel Tax)
FY 2011: $59,757,000 (1.4 percent of General Fund revenue)

Overview
The tax is levied on hotel rooms, apartments, suites and other rental/transient properties occupied for less than 180 consecutive days. The tax is a significant source of revenue for the State – accounting for almost $284.5 million in FY 2011 (5.4 percent of total revenue and 1.4 percent of General Fund revenue). Much of this tax is exported to tourists and other visitors to the State.

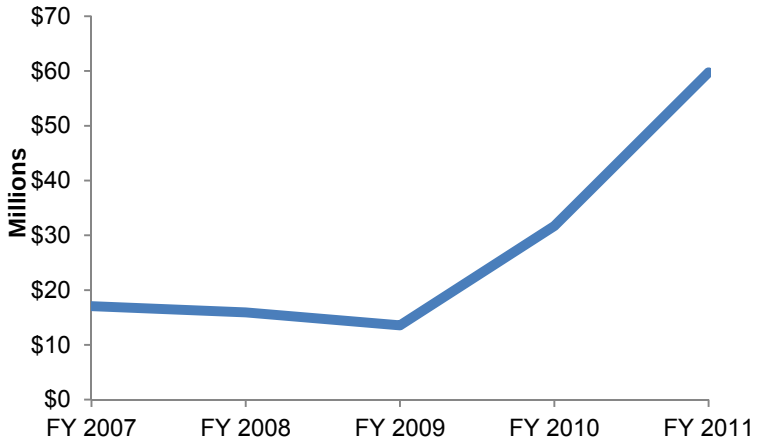
	Rate	Description/Overview	Receiving Fund
Transient Accommodations Tax	7.25% (9.25% through FY 2015)	Rental of such accommodations for less than 180 days excluding taxes collected. Time-share vacation units and plans are subject to the tax.	*Convention center enterprise special fund (17.3%) up to $33 million, after which General Fund*
			Tourism special fund (34.2%) up to $71 million, until FY2015
			Transient accommodations trust fund (0%). If not drawn into Tourism special fund, then reverts to General Fund
			County governments up to $93 million

[31] Act 97, SLH 2011. The effect of this legislation is that for tax years 2011 and 2012, the standard deduction and personal exemptions remain at 2009 amounts, and for tax years 2013 and after, the standard deduction and personal exemptions will increase to levels referenced in Act 60, SLH 2009. Those levels are: $2,200 for individual or married filing separately filers; $3,212 for head of household filers; $4,400 for joint or surviving spouse filers. Personal exemption beginning in tax year 2013 and thereafter: $1,144.

			per fiscal year until FY2015

Recent Experience
TAT revenue grew moderately from FY 2007 to FY 2008 before experiencing an 8.2 percent reduction in FY 2009 as the effects of the recession diminished visits to the State. The TAT rate was temporarily increased in 2009 (through 2015) and assisted the TAT's rebound and growth in both FY 2010 and FY 2011.[32] In FY 2010, the TAT grew 133.7 percent in year-over-year General Fund revenue. In FY 2011, the TAT grew 88.5 percent above its FY 2010 level, to $59.8 million.

Transient Accommodations Tax (General Fund Revenue)
FY 2007 – FY 2011



Legislative Actions
The State's base TAT rate is 7.25 percent. Legislation enacted in 2009 temporarily increased the transient accommodations tax rate for FY 2010 through FY 2015.[33] The legislation added an additional 1.0 percent to the rate from July 1, 2009 through June 30, 2010, and an additional 2.0 percent from July 1, 2010 through June 30, 2015. As a result of these changes, the TAT rate is now 9.25 percent through the end of FY 2015.

Act 103, SLH 2011 temporarily limits the distribution from the TAT to counties and the tourism special fund to a combined total of $162 million. Previously, counties and the tourism special fund received 79 percent of the TAT at the 7.25 percent rate. The Act sunsets on June 30, 2015.[34]

Projected Outlook
The forecast FY 2012 year-over-year growth rate (total TAT revenue) of 89.06 percent inflated the TAT's annual average projected growth rate of 11.52 percent. The additional 2.0 percent surcharge included in 2009 legislation fueled much of the FY 2012 projected growth.[35] Aside from the large growth in FY 2012, the expiration of the temporary surcharge in FY 2016 will eliminate contributions to the General Fund through FY 2025.

<u>Fuel Tax (Gas Tax)</u> (Non-General Fund)
FY 2011: $195,336,000 (3.7 percent of total revenue; no General Fund revenue)

[32] The increase provided an extra $48.3 million in total TAT revenue in FY 2011.

[33] Act 61, SLH 2009.

[34] Act 103, SLH 2011.

[35] According to DOTAX this accounted for approximately $300 million in revenue above baseline for FY 2012.

Overview

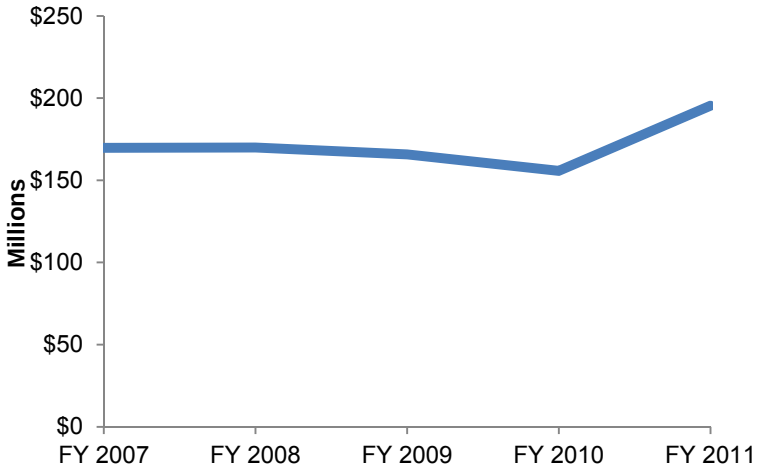
The fuel tax is levied to distributors of various fuels – and is generally passed on to consumers. Based on the type of fuel, the State levies the tax on a per gallon basis at varying rates (shown below). The State also levies an Environmental Response, Energy and Food Security Tax of $1.05 per barrel or fraction thereof that is not aviation fuel sold by a distributor to a retail dealer or end user. In FY 2011, the State collected $195.3 million from the Fuel Tax, accounting for 3.7 percent of total revenue. Counties may levy an additional fuel tax.

	Rate	Description/Overview	Receiving Fund
Fuel Tax	$0.170	Gasoline - Regular and Highway Diesel	*Aviation fuel tax to state airport fund; 1% of state and county fuel tax to boating fund; other state fuel tax revenues to state highway fund; county fuel tax revenues to respective county highway funds.*
	$0.052	Highway LPG	
	$0.020	Non-Highway Diesel, LPG, and Aviation	
Environmental Response, Energy, & Food Security Tax	$1.05	Per barrel or fraction thereof (non-aviation fuel)	*$0.05/barrel – Environmental response revolving fund; $0.15/barrel – Energy security special fund; $0.10/barrel – Energy systems development special fund; $0.15/barrel – Agricultural development and food security special fund; and $0.60/barrel – General Fund*

Recent Experience

The State's Fuel tax revenue decreased slightly from FY 2008 through FY 2010 before increasing 25.5 percent year-over-year in FY 2011. An increase in the Environmental Response Tax (renamed the Environmental Response, Energy and Food Security Tax) was the most significant driver of increased year-over-year fuel tax revenue.

Fuel Tax (Non-General Fund Revenue)
FY 2007 – FY 2011



Legislative Actions

Hawaii temporarily amended §243-3.5, HRS to increase the environmental response tax to $1.05 per barrel of petroleum product sold and changed the name of the tax to the "environmental response,

energy, and food security tax."[36] The Act also deleted a provision that required the Department of Health to notify the Department of Taxation when the fund balance exceeds $20 million, at which time fuel distributors would cease collecting the tax until the balance declined to less than $3 million.

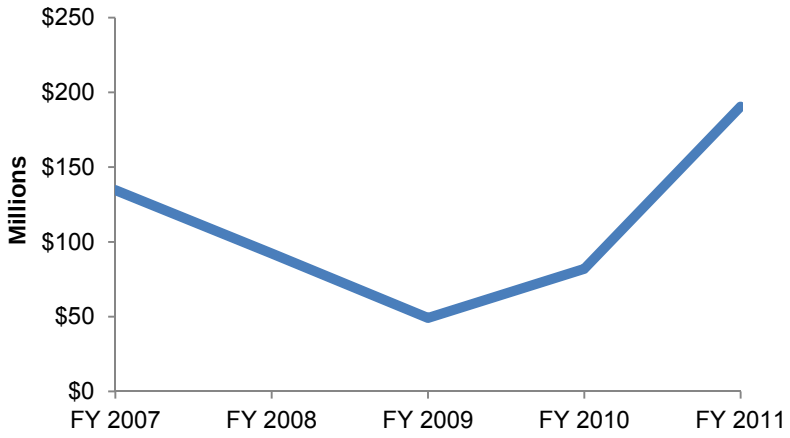
Unemployment Insurance Tax (Non General Fund)
FY 2011: $190,511,000 (3.6 percent of total revenue; no General Fund revenue)

Overview
Hawaii levies a tax on wages paid by employers with one or more employees – with certain exceptions – to fund its unemployment trust fund. The tax rate is determined each year based upon a schedule system. One of eight schedules is used depending on the condition of the Trust Fund. An employer's contribution rate can never be less than 0.0 percent nor greater than 5.4 percent.

	Rate	Description/Overview	Receiving Fund
Unemployment Insurance Tax	0.0% - 5.4%	Employer contribution as percentage of wages (FY 2011 wage base of $34,200)	*Unemployment Insurance Trust Fund and Employment and Training Fund*
	0.02%	Additional Employment and Training Assessment (FY 2011 rate)	

Recent Experience

Unemployment Insurance Tax (Non-General Fund Revenue)
FY 2007 – FY 2011



Cigarette and Tobacco Tax
FY 2011: $106,137,000 (2.5 percent of General Fund revenue)

Overview
Hawaii levies an excise tax on the sale or use of tobacco products and on each cigarette sold, used or possessed. Aside from cigarettes and little cigars, the State levies the tobacco tax on 70 percent of the wholesale price of tobacco products (other than large cigars) and 50 percent of the wholesale price of large cigars. Cigarette and tobacco wholesalers and dealers are required to affix stamps to individual cigarette packages as proof of payment of tax.

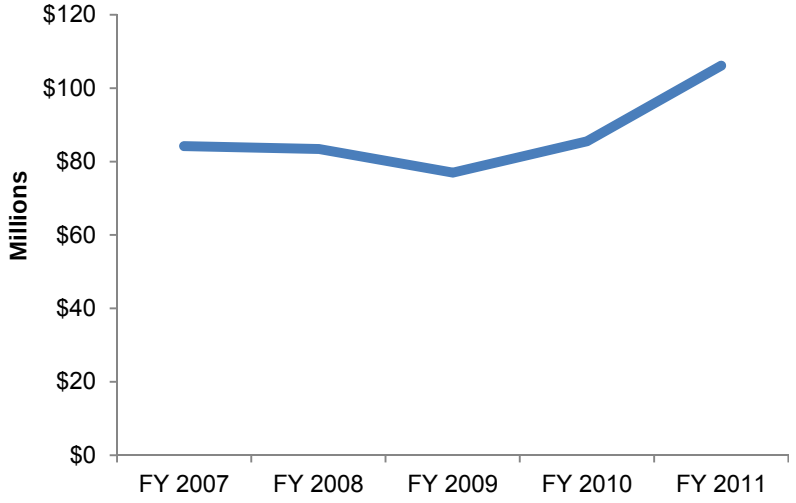
[36] Act 73, SLH 2010.

	Rate	Description/Overview	Receiving Fund
Tobacco Tax	$0.16	per cigarette ($3.20/pack)	*Through June 30, 2013:* *State General Fund ($0.12), Cancer Research Fund ($0.02), Trauma System Fund ($0.0075), Emergency Medical Service Fund ($0.005) and Community Health Center Fund ($0.0075).* *As of July 1, 2013:* *State General Fund ($0.10), Cancer Research Fund ($0.02), Trauma System Fund ($0.015), Community Health Center Fund ($0.0125, Emergency Medical Services Special Fund ($0.0125)*
	50%	on wholesale price for cigars	
	70%	on wholesale price for all other tobacco products	
	1.70%	on denominated value of tax stamp	*State cigarette tax stamp enforcement special fund and State cigarette tax stamp administrative special fund.*
	0.40%	discount on value of required cigarette tax stamps	

Recent Experience

Hawaii increased the per-cigarette tax in all but one year from 2002 through 2011. The State's cigarette tax revenue registered double-digit percentage increases in all but one fiscal year from FY 2007 through FY 2011 (FY 2009 saw 3.4 percent growth). At the same time, the General Fund revenue portion declined in both FY 2008 and FY 2009 before increasing by 11.1 percent in FY 2010 and 24.1 percent in FY 2011. During the five-year period, annual General Fund cigarette and tobacco-related tax revenue grew from $84.2 million to $106.1 million, a 26.0 percent increase. The strongest growth, 24.1 percent, occurred in FY 2011 when the tax rate increased 2 cents per cigarette. This resulted in a General Fund revenue increase of $20.6 million.

Cigarette and Tobacco Tax (General Fund Revenue)
FY 2007 – FY 2011



Legislative Actions

In FY 2007, FY 2008 and FY 2009, the State increased its per-cigarette tax effective September 30 of each year. The tax per cigarette increased by 1 cent in each year – going from 7 cents per cigarette (as of September 29, 2006) to 10 cents (as of September 30, 2008). The rate increased to 13 cents on July 1, 2009, 15 cents on July 1, 2010 and 16 cents beginning July 1, 2011.[37]

Projected Outlook

[37] Act 56, SLH 2009.

FY 2012 projected growth is 12.52 percent for cigarette and tobacco tax revenue due to the 2 cent per cigarette tax increase. In FY 2013, it is projected that growth will be 4.94 percent. A 14.11 percent reduction in revenue from the tax to the General Fund will occur in FY 2014, as revenue from the tax to the General Fund decreases. In subsequent years through FY 2025 – absent an alteration of the per-cigarette tax or other changes to the tobacco tax – the tax is projected to grow an average of 2.40 percent per year.

Insurance Premiums Tax
FY 2011: $140,456,000 (3.2 percent of General Fund revenue)

Overview
The Insurance Premiums Tax is levied on insurance companies (underwriters) based on premiums written in the State. Insurance companies pay the tax in lieu of other taxes (except for property taxes and taxes on purchase, use or ownership of tangible personal property). For FY 2011, the State collected $140,456,000, or 2.7 percent of total revenue (3.2 percent of General Fund revenue) from the Insurance Premiums Tax. A 1.0 percent tax credit is available for qualifying insurers to facilitate regulatory oversight.

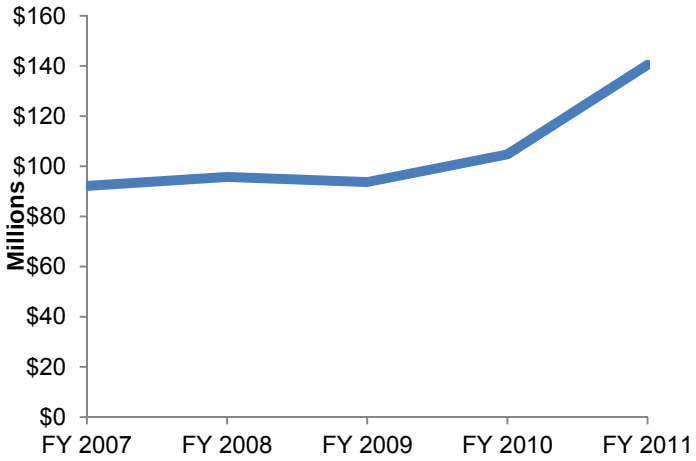
	Rate	Description/Overview	Receiving Fund
Insurance Premiums Tax ***In lieu of General Excise and Net Income Taxes***	2.75%	Life insurance	*State General Fund*
	4.265%	Casualty and all other insurance	
	4.265% of risk premium	Real property title insurance	
	4.68%	Surplus Lines	
	0.8775% of gross underwriting profits	Ocean marine insurance	
Captive Insurance Premiums			
	0.25%	on $0 to $25 million of gross premiums;	*Insurance Administrative Fund*
	0.15%	on more than $25 million to $50 million of gross premiums;	
	0.05%	on more than $50 million of gross premiums;	
	0.00%	on premiums more than $250 million	
Insurance Fees		Rates vary	*50% of increases to the State General Fund until FY2015*

Legislative Actions
Act 59, SLH 2010 temporarily increased certain insurance fees and specified that the increased fees must be deposited equally into the compliance resolution fund and the General Fund as an insurance license and service tax.[38] The temporary increases are scheduled to expire at the conclusion of FY 2014.

[38] Act 59, SLH 2010.

Recent Experience
From FY 2007 to FY 2011, the Insurance Premiums Tax increased by nearly $48.3 million or 52.3 percent. Much of the growth occurred in Fiscal Years 2010 and 2011. FY 2010 growth was 11.7 percent, and FY 2011 growth was 34.1 percent. The FY 2011 growth was partially generated by a one-time $25 million revenue increase by Department of Taxation payments received monthly instead of quarterly.

Insurance Premiums Tax and Insurance Fees (General Fund Revenue)
FY 2007 – FY 2011



Projected Outlook
Tax revenue growth from insurance premiums project to be moderate, with an annual average growth rate of 2.42 percent through FY 2018 and a 2.50 percent annual average growth rate from FY 2019 to FY 2025.

Public Service Company Tax
FY 2011: $117,940,356 (2.2 percent of total revenue)

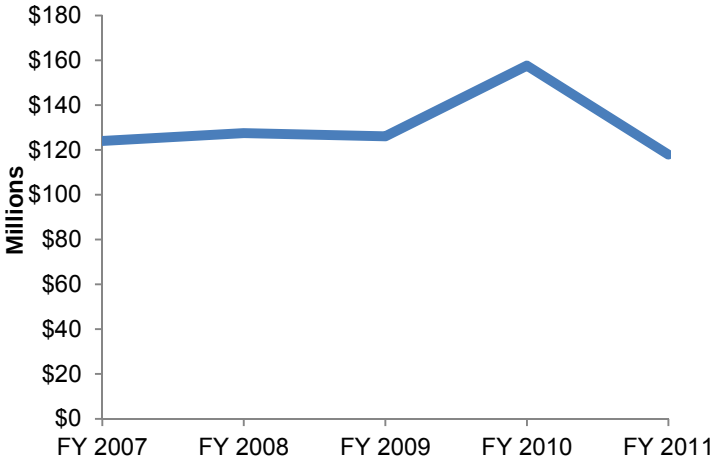
Overview
In lieu of paying the GET, public service companies pay a tax on gross income for their preceding calendar year. For FY 2011, this accounted for $117,940,356, or 2.2 percent of total revenue.

	Rate	Description/Overview	Receiving Fund
Public Service Companies Tax	5.885% - 8.2%	On public utility gross income at graduated rates based on ratio of net to gross income.	*State General Fund and county general funds. (for revenues generated from a rate greater than 4% from utilities that are not taxed under the respective county real property tax)*
	5.35%	Land carriers (public transportation)	

Recent Experience
Revenue from the Public Service Companies Tax remained relatively flat through FY 2009 before sharply increasing in FY 2010 and decreasing in FY 2011.[39] At the end of FY 2011, revenue from the tax was 4.9 percent below its FY 2007 level.

[39] DOTAX estimates portions of the one-year increase were attributable to a spike in oil prices.

Public Service Companies Tax (General Fund Revenue)
FY 2007 – FY 2011



Projected Outlook
Public Service Company Tax annual growth rates project to be 2.78 percent through FY 2018 and 2.50 percent from FY 2019 to FY 2025.

Motor Vehicle Taxes and Fees (Non-General Fund)
FY 2011: $106,166,000 (2.0 percent of total revenue; no General Fund revenue)

Overview
Owners pay an annual fee based on vehicle weight in addition to an annual $45 registration fee. Hawaii counties levy additional fees based on vehicle weight and/or usage. This is also known as the Weight Tax and Rental Motor Vehicle and Tour Vehicle Surcharge Tax. Combined motor vehicle taxes and fees accounted for $106,165,508, or 2.0 percent of total revenue in FY 2011.[40]

Hawaii levies a rental motor vehicle and tour-vehicle surcharge tax – paid via a daily rate for rental vehicles and on a monthly basis for tour vehicles. Lessors pay the tax for rental cars and tour vehicle operators pay the tax on vans and buses.

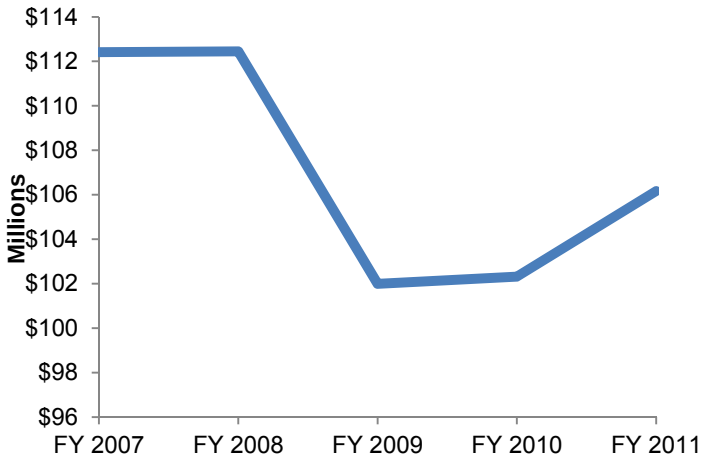
	Rate	Description/Overview	Receiving Fund
Motor Vehicle Weight Tax	$0.01	per lb. for vehicles weighing up to 4,000 lbs.	*State Highway Fund*
	$0.02	per lb. for vehicles weighing over 4,000 to 7,000 lbs.	
	$0.02 25	per lb. for vehicles weighing over 7,000 lbs. to 10,000 lbs.	
	$300	for vehicles weighing over 10,000 lbs.	

Rental Motor Vehicle And Tour Vehicle Surcharge Tax	$7.50	per day for rental vehicles (reverted to $3.00/day as of 7/2012.	***FY2012:*** *State Highway Fund ($3.00), General Fund ($4.50)* ***FY2013:*** *State Highway Fund ($3.00), General Fund ($0)*
	$15	per month for tour vehicles seating eight to twenty-five persons.	
	$65	per month for tour vehicles seating twenty six passengers or more	

[40] This figure includes $62,273,699 of County revenue. State-only revenue totaled: $43,891,809 in FY 2011. All FY 2011 Motor Vehicle Tax and fees were designated to the Highway Special Fund.

Recent Experience
Hawaii's revenue from the motor vehicle tax and rental/tour vehicle surcharge was relatively flat from FY 2007 to FY 2008. Similar to the TAT, the tax revenue from these sources decreased in FY 2009 by 9.3 percent. Small to moderate growth occurred in FY 2010 and FY 2011, but FY 2011 revenue remained below FY 2007 levels by over $6 million.

Motor Vehicle Taxes and Fees (Non-General Fund Revenue)
FY 2007 – FY 2011



Note: Taxes and Fees also include Registration fees, CDL fees, Inspection Fees

Legislative Actions
Effective July 1, 2011, Hawaii increased the annual state motor vehicle weight tax for vehicles.[41] In 2011, the State also increased the rental motor vehicle surcharge tax from $3.00 per day to $7.50 per day for FY 2012. The Legislation deposited a portion of the surcharge ($4.50 per day) in the State's General Fund and suspended the rental motor vehicle customer facility charges for the period of July 1, 2011 to June 30, 2012.

The temporary $7.50 per day surcharge expired on June 30, 2012 and reverted to the $3.00 per day surcharge. The FY 2012 additional surcharge provided a one-year revenue increase of approximately $61 million to the State's General Fund.

Liquor Tax
FY 2011: $48,053,576 (0.9 percent of total revenue)

Overview
Hawaii levies a gallonage tax upon dealers and others who sell and/or use liquor. This accounted for $48,053,576, or 0.9 percent of total revenue, in FY 2011.

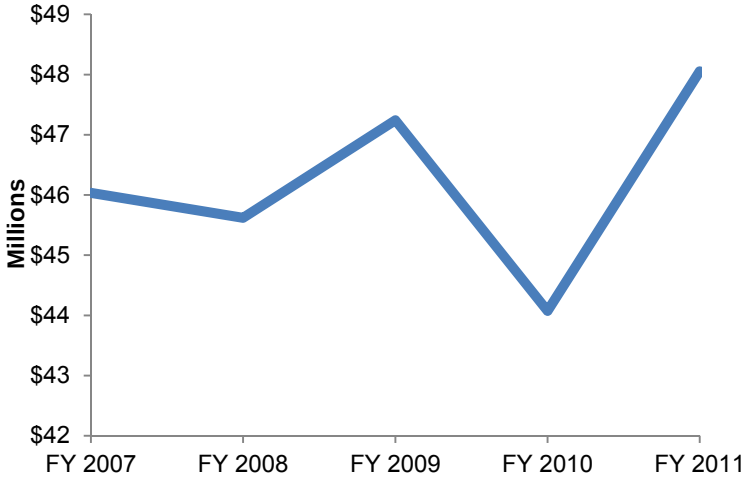
Varying gallonage tax rates apply to wine, distilled spirits, sparkling wine, still wine, cooler beverages, non-draft beer and draft beer. These are detailed in the following table:

[41] Act 86, SLH 2011.

	Rate	Description/Overview	Receiving Fund
Liquor Tax (per gallon)	$5.98	distilled spirits	*State General Fund*
	$2.12	sparkling wines	
	$1.38	still wines	
	$0.85	cooler beverages	
	$0.93	non-draft beer	
	$0.54	draft beer	

Recent Experience
Liquor tax revenue alternated between negative and positive growth during the last five fiscal years – but ended the five-year period with approximately $2.1 million in growth. Revenue decreased by 6.7 percent in FY 2010 before rebounding with 9.0 percent growth in FY 2011. This growth led to the largest revenue collection of the five fiscal years reviewed.

Liquor Tax (General Fund Revenue)
FY 2007 – FY 2011



Projected Outlook
The Liquor Tax tends to correlate with growth or declines in the tourism industry; as that industry continues to rebound from the effects of the 'Great Recession,' projections suggest that liquor tax revenue will do the same. Projections suggest a 2.17 percent average annual growth rate for liquor tax revenue through FY 2018. From FY 2019 to FY 2025, it is projected to achieve an annual average growth rate of 2.02 percent.

Conveyance Tax
FY 2011: $21,527,000 (0.5 percent of General Fund revenue)

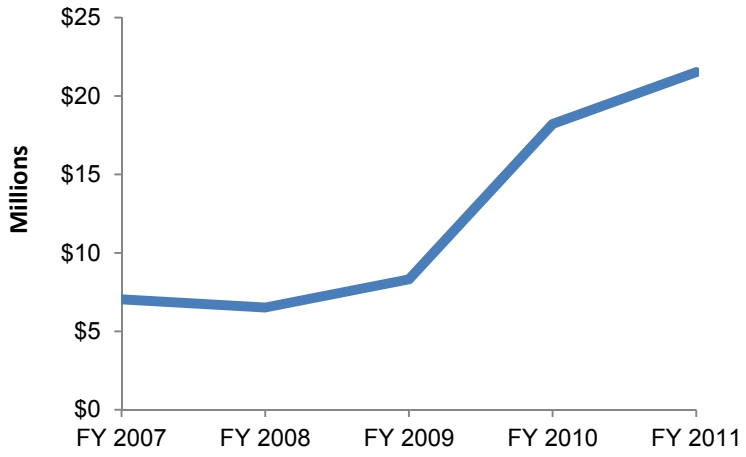
Overview
Hawaii imposes the tax on all documents transferring ownership or interest in real property. For FY 2011 this accounted for $47,905,995, or 0.9 percent (across all Funds) -- $21.5 million of which was revenue for the General Fund. The tax rate paid is determined by the actual and full consideration paid or to be paid and the purchaser's eligibility for a county homeowner's exemption on property tax. The tax is levied at varying rates based on the value of the transaction and whether the property serves as a primary residence or is an investment property.

	Residence Rate	Investment Property Rate	Description/Overview	Receiving Fund
Conveyance Tax	$0.10	$0.15	per $100 for real estate transfers under $600k	***FY 2012:*** *45% to state general fund, 10% to the land conservation fund, 25% into the rental-housing trust fund, and 20% into the natural area reserve fund.* ***FY 2013 and beyond:*** *35% to state general fund, 10% to the land conservation fund, 30% into the rental housing trust fund, and 25% into the natural area reserve fund.*
	$0.20	$0.25	per $100 for real estate transfers under between $600k and $1 million	
	$0.30	$0.40	per $100 for real estate transfers between $1 million and $2 million	
	$0.50	$0.60	per $100 for real estate transfers between $2 million and $4 million	
	$0.70	$0.85	per $100 for real estate transfers between $4 million and $6 million	
	$0.90	$1.10	per $100 for real estate transfers between $6 million and $10 million	
	$1.00	$1.25	per $100 for real estate transfers $10 million or more	

Recent Experience

Conveyance tax revenue decreased from FY 2007 to FY 2008, before increasing each year through FY 2011. Significant increases in revenue occurred in FY 2010 (119.2 percent). Hawaii enacted legislation to temporarily divert a larger portion of Conveyance Tax revenue to the General Fund in FY 2010 and 2011. The Department of Taxation also suggested the federal stimulus First Time Homebuyers Tax Credit spurred additional market activity, increasing tax receipts in these two years.

Conveyance Tax (General Fund Revenue)
FY 2007 – FY 2011



Projected Outlook

Hawaii benefits from having the highest median home value among the states. Higher sale prices can help spur growth in conveyance tax receipts. However, the General Fund portion of the conveyance tax will be reduced to 35 percent beginning in FY 2014. Leading up to this reduction, the tax projects to yield less revenue in FY 2012 and FY 2013. After the General Fund portion reduction in FY 2014, tax revenue projects to increase at an average annual growth rate of 7.95 percent through FY 2018. From FY 2019 to FY 2025, the tax projects to grow at an average annual rate of 5.17 percent.

Legislative Actions

In 2009, HB 1741 temporarily increased the revenue from the conveyance tax to the General Fund.

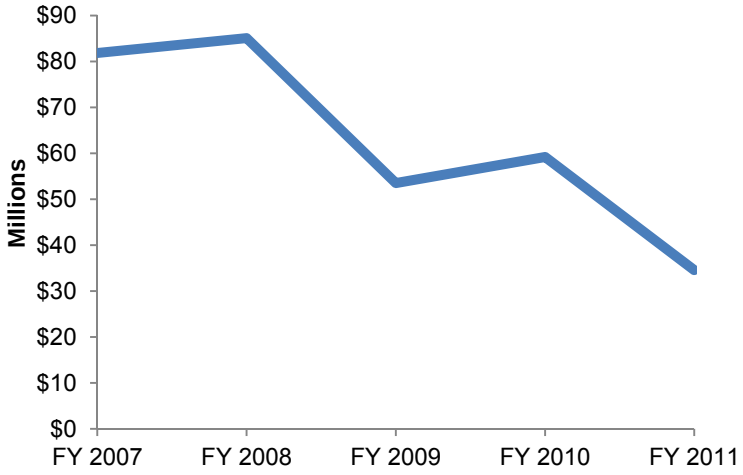
Corporate Net Income Tax
FY 2011: $34,573,000 (0.8 percent of General Fund revenue)

Overview
Hawaii's corporate income tax accounted for 0.7 percent of total revenue in FY 2011 and 0.8 percent of General Fund revenue. Similar to the IIT, the corporate income tax applies rates at differing net income levels.

	Rate	Description/Overview	Receiving Fund
Corporate Income Tax (Net)	4.40%	Up to $25,000	*State General Fund.*
	5.40%	$25k - $100k	
	6.40%	Over $100k	
	4.00%	Capital Gains Rate	

Recent Experience
Corporate net income tax revenue produced approximately $47.3 million less revenue in FY 2011 than in FY 2007. During the five-year period, receipts decreased while refunds increased – resulting in a compound annual growth rate of -19.4 percent. Corporate income taxes are generally considered the most business cycle-sensitive of the major taxes, and during the economic downturn corporate income tax collections fell in many states. Hawaii allows losses to be carried either backward or forward, which can also reduce collections during an economic downturn – and even when the economy begins to improve.

Corporate Income Tax – Net (General Fund Revenue)
FY 2007 – FY 2011



Projected Outlook
Corporate net income tax revenue is projected to increase in FY 2012 (12.39 percent) as net operating losses carried forward slow and revenues begin to stabilize. Thereafter, projections suggest alternating years of decline and growth, with the episodic growth years being greater than the years of decline through FY 2017. From FY 2019 to FY 2025, the average annual growth rate is projected to average 2.40 percent.

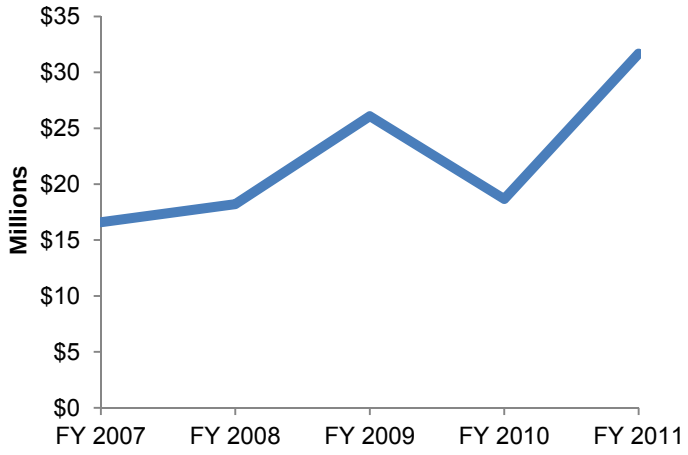
Banks and Other Financial Corporations Tax
FY 2011: $31,677,000 (0.7 percent of General Fund revenue)

Overview
Hawaii levies a franchise tax on banks, build and loan associations, development companies, financial corporations, financial services loan companies, trust companies, mortgage loan companies, financial holding companies, small business investment companies and others in lieu of net income and general excise taxes. The net income for the preceding year (from all sources with certain modifications) serves as the base on which the tax rate is applied. For FY 2011, this accounted for $33,677,000, or 0.6 percent of total revenue, of which $31,677,000 was General Fund revenue (0.7 percent).

	Rate	Description/Overview	Receiving Fund
Banks and Other Financial Corporations Tax	7.92%	On net income of financial institutions in lieu of Excise Tax	*State General Fund; $2 million per fiscal year is allocated to Compliance Resolution Fund.*

Recent Experience
This tax experienced solid growth during the five-year period – growing an average of 17.5 percent This reflected revenue growth of more than $15 million. With the exception of FY 2010, the tax increased each year, including growth of 69.7 percent in FY 2011.

Banks and Other Financial Corporations Tax (General Fund Revenue)
FY 2007 – FY 2011



Projected Outlook
The tax projects to decrease by an annual rate of 11.75 percent in FY 2012 before stabilizing and growing moderately through FY 2018 at an average annual growth rate of 3.53 percent. From FY 2019 to FY 2025, projections suggest the tax will grow at an average annual rate of 2.34 percent.

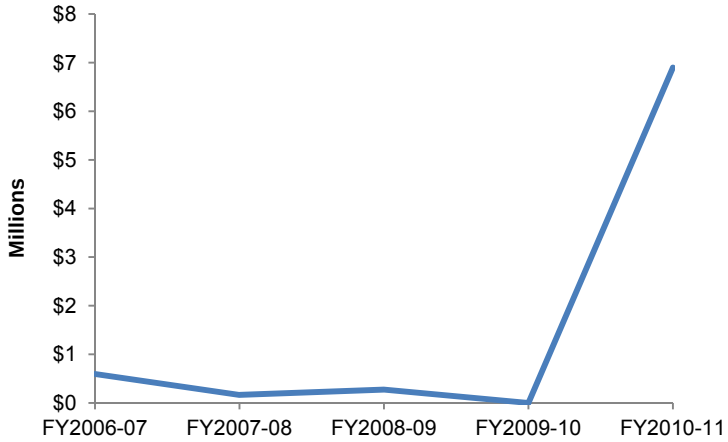
<u>Estate and Transfer Tax</u>
FY 2011: $6,899,000 (0.2 percent of General Fund revenue)

Overview
Hawaii adopted a new Estate and Transfer Tax in 2010. The tax applies to estates with a value of more than $3,500,000. For FY2011, this raised $6,899,215, or 0.2 percent of total revenue.

	Rate	Description/Overview	Receiving Fund
Estate and Transfer Tax	0.8% - 16%	By estate value bracket	*State General Fund*

Recent Experience
During the first year of existence, the Estate and Transfer Tax generated $6.9 million for the State's General Fund.

Estate and Transfer Tax (General Fund Revenue)
FY 2007 – FY 2011



Legislative Actions
Act 74, SLH 2010 reenacted Hawaii's Estate and Transfer Tax for decedents after April 30, 2010.

Projected Outlook
It is projected that the tax will grow at 184.10 percent in FY 2012 and then settle into a moderate rate of annual growth. From FY 2013 to FY 2018 the tax is projected to grow at an average annual rate of 2.59 percent. From FY 2019 to FY 2025, the tax is projected to grow at an average annual rate of 2.50 percent. It should be noted that this tax is difficult to predict, as it relies less on economic or other predictable factors than most taxes.

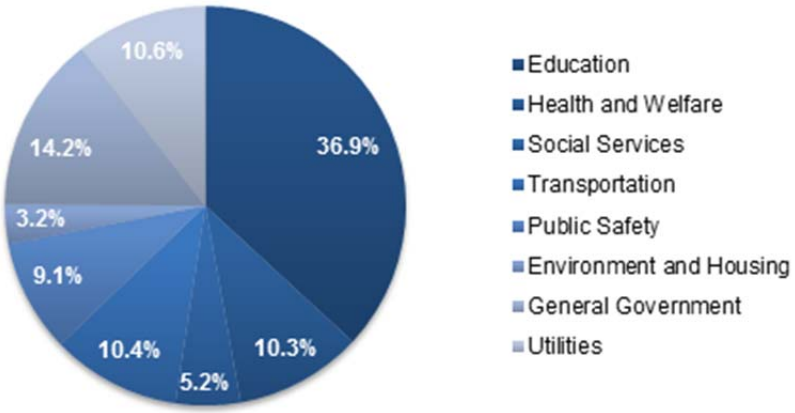
Relationship of State and Local Revenue and Expenditures

While the sufficiency of the Hawaii revenue structure over the next twenty years is the focus of this report, it is also informative to determine how the Hawaii system compares with other states. Given workforce and business mobility and the impacts of e-commerce and globalization, the State should be mindful of the impact of system change on its overall competitiveness with other states.

At the same time, state revenue structures should not be considered in a vacuum; while state taxes impact on a business, family or individual's tax burden, so too do local taxes. Local taxes can vary widely from state to state (and even from city or county within a state), and this can make state to state comparisons alone at best incomplete and at worst meaningless.

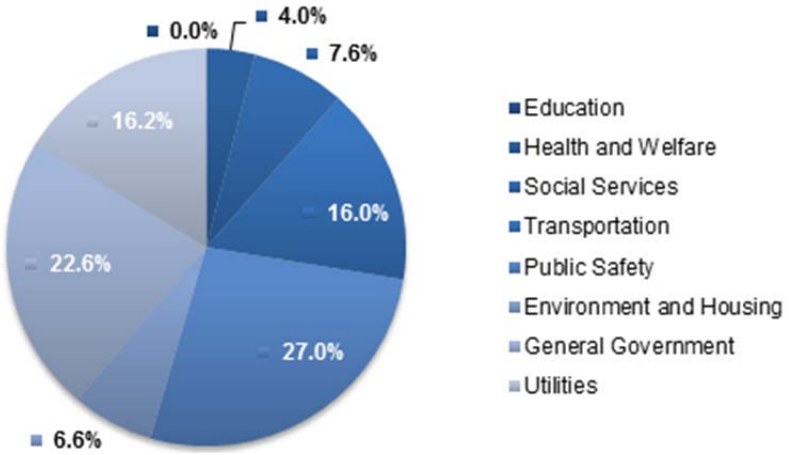
Hawaii is the only state where the public school system operates under a single system administered and funded almost entirely by the State. Nationally, the largest local government expenditure category is to support K-12 education. For all US local governments, direct expenditures for K-12 education average nearly 37 percent, compared to less than 1 percent of local government spending in Hawaii. The following charts highlight this profound disparity:[42]

US Total Direct Expenditures by Function: Local Government Spending (FY 2009)



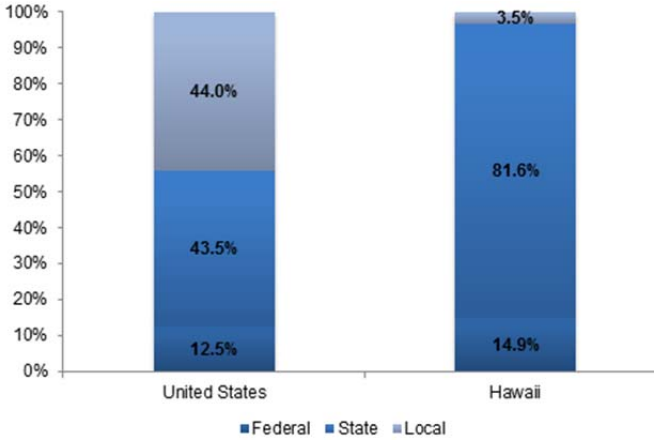
[42] U.S. Census Bureau, 2009 Annual Surveys of State and Local Government Finances, table 1.

State of Hawaii Direct Expenditures by Function: Local Government Spending (FY 2009)



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 critical function. This can be expected to have a direct impact on the level of state expenditures for K-12 education (and, logically, the amount of revenue that must be raised at the state level). In fact, the State of Hawaii provides far more revenue to support this function than nearly any other state. The following chart details the funding difference between Hawaii and the combined 50 states:[43]

Sources of Revenue: K – 12 Education Programming, 2010



Nationally, K-12 education funding is generally a shared function between state and local governments. That is not the case in Hawaii, where nearly all of the revenue for K-12 education comes from state government. Among the states, only Vermont and Alaska contribute more revenue as a share of personal income to K-12 education than Hawaii.[44]

Among US local governments, the primary source of revenue is the property tax. On average, property taxes make up 74 percent of own source tax revenue for all US local governments; that percentage is similar to Hawaii local governments, where property taxes make up 79 percent of own source revenue.

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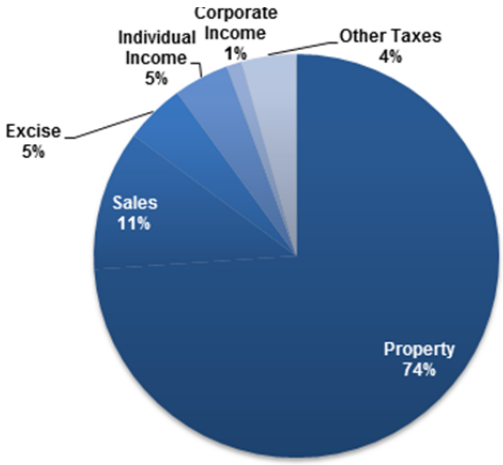
[43]U.S. Census Bureau, "Public Education Finances: 2010", June 2012, p. 5.

[44] U.S. Census Bureau, 2009 Annual Surveys of State and Local Government Finances, table 1 – the full table detailing state and local spending as a share of $1,000 of personal income can be found in the Appendix.

US Total General Revenue from Own Sources: Local Government Taxes, 2010



With a diminished need to fund a primary local government service (K-12 education), it is not surprising that property tax collections in Hawaii would be lower than for the nation as a whole.[45] The following table lists comparable median residential property taxes and property taxes as a percent of home value for selected Hawaii Counties:

Property Tax	US	Hawaii County	Honolulu County	Maui County
Median	$1,917	$671	$1,529	$914
% of Home Value	1.04%	0.19%	0.26%	0.16%

These relatively low property taxes were confirmed by another national survey, conducted by the Lincoln Institute of Land Policy and the Minnesota Taxpayers Association. That study compared 2010 urban city residential property tax bills for homes valued at $150,000 and $300,000. Of the 53 cities surveyed, Honolulu had the second lowest property tax for homes valued at $150,000 and the lowest property tax for homes valued at $300,000.[46]

Urban Cities with Residential Tax Ratings in Top Five or Bottom Five For $150,000 and $300,000 Valued Homes

City, State	$150,000		$300,000	
	Tax	Rank (of 53)	Tax	Rank (of 53)
Detroit, MI	$4,885	1	$9,771	1
Aurora, IL	$3,936	2	$8,332	2
Philadelphia, PA	3,927	3	$7,854	3
Milwaukee, WI	3,452	4	$7,060	4
Buffalo, NY	$3,330	5	$6,835	5
Denver, CO	$779	50	$1,557	52
Washington DC	$646	51	$1,867	49
Honolulu, HI	$219	52	$712	53
Boston, MA	$159	53	$1,686	51

[45] One national survey determined that the median property taxes in 2009 were $1,917.

[46] '50-State Property Tax Comparison Study,' Minnesota Taxpayers Association/Lincoln Institute of Land Policy, April 2011, p. 7.

Commercial property taxes are also low in comparison to other comparable cities. The Lincoln Institute and Minnesota Taxpayers Association study found that of 53 urban cities, commercial property taxes for businesses with a commercial parcel value of $100,000, $1,000,000 and $25,000,000 million respectively ranked Honolulu 49th out of 53 surveyed cities in each category.[47]

Urban Cities with Commercial Tax Rankings in Top Five or Bottom Five for All Values

City, State	$100,000		$1,000,000		$25,000,000	
	Tax	Rank (of 53)	Tax	Rank (of 53)	Tax	Rank (of 53)
Detroit, MI	$4,814	1	$48,141	1	$1,203,536	1
Providence, RI	$4,769	2	$47,695	2	$1,192,373	2
Des Moines, IA	$4,528	3	$45,282	3	$1,132,041	3
Philadelphia, PA	$4,082	4	$40,817	4	$1,020,413	4
New York, NY	$3,968	5	$39,681	5	$992,014	5
Honolulu, HI	$1,061	49	$10,613	49	$265,329	49
Virginia Beach, VA	$965	50	$9,650	50	$241,253	50
Seattle, WA	$939	51	$9,394	51	$234,861	51
Wilmington, DE	$884	52	$8,838	52	$220,957	52
Cheyenne, WY	$782	53	$7,824	53	$195,605	53

This relatively low ranking was also the case for industrial property taxes; Honolulu ranked 51st of the 53 surveyed cities for industrial property taxpayers at the $100,000, $1,000,000 and $25,000,000 levels.[48]

Urban Cities with Industrial Tax Rankings in Top Five or Bottom Five for All Values

City, State	$100,000		$1,000,000		$25,000,000	
	Tax	Rank (of 53)	Tax	Rank (of 53)	Tax	Rank (of 53)
Columbia, SC	$6,305	1	$63,055	1	$1,576,367	1
Detroit, MI	$5,898	2	$58,977	2	$1,474,418	2
Houston, TX	$5,048	3	$50,485	3	$1,262,116	3
Jackson, MS	$4,970	4	$49,702	4	$1,242,554	4
Indianapolis, IN	$4,636	5	$46,63	5	$1,149,064	5
Seattle, WA	$1,301	49	$13,011	49	$325,279	49
Cheyenne, WY	$1,274	50	$12,737	50	$318,435	50
Honolulu, HI	$1,076	51	$10,759	51	$268,987	51
Virginia Beach, VA	$982	52	$9,820	52	$245,503	52
Wilmington, DE	$884	53	$8,838	53	$220,957	53

This is an important consideration for discussions of state taxes and state tax burdens. As is noted in the discussion of state tax benchmarking, Hawaii's tax structure should be viewed in the context of the state

[47] Ibid., p. 9.

[48] Ibid., p. 11.

and local structure and burden. These comparisons tend to mitigate what might otherwise be seen as a high state tax burden.

This should also be considered in the context of other taxes where the State may choose to share revenue with local governments, in particular, the Transient Accommodations Tax (TAT). This has been subject to change over time, and it is worthy of discussion and analysis as to how this tax does (or should) fit into the overall state and local government revenue picture.

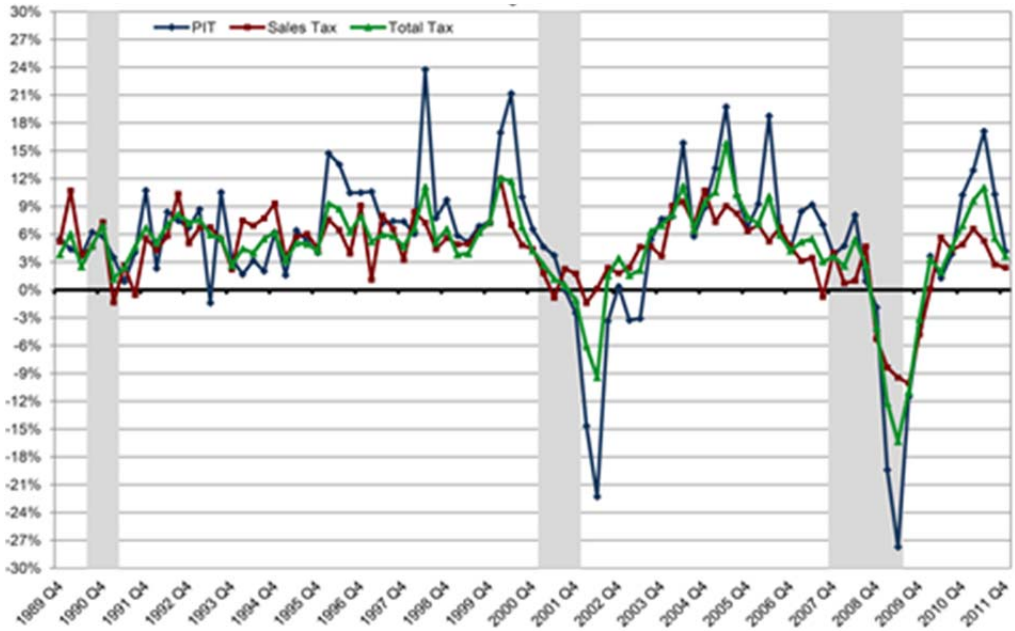
Primary Components and Comparison to Other States

While there are no "perfect twins" among states – and Hawaii's many unique characteristics make this even more challenging - comparisons can provide helpful points of reference in assessing competitiveness. At the same time, evaluations are only meaningful taken in the context of key differences across various states, including:

- Relative state economics and demographics that drive both revenue generation and service demands
- Differences across labor markets
- Comparative financial resources and burdens

According to US Census Bureau data reported by the Rockefeller Institute, as the economy entered a recession beginning in late-2007 and lasting through mid-2009, state revenues declined significantly – bottoming out in the 2nd quarter of 2009.[49] Overall state tax collections grew in the second half of 2009 and largely increased through 2010 and early 2011 before a decline in mid-late 2011.

Year-Over Year Nominal Change in State Tax Collections

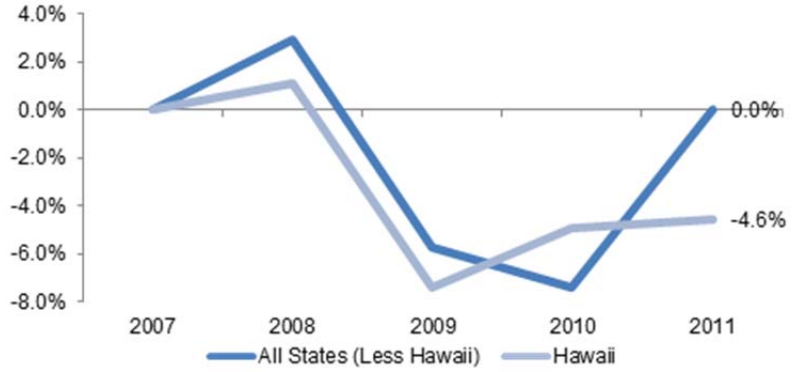


Source: US Census Bureau

In comparison to the states as a whole, by 2009, Hawaii's tax revenues fell slightly more than all states. Hawaii reached a trough of -7.4 percent growth while the average of remaining states saw -5.4 percent growth. Since 2009, Hawaii has experienced slow-to-moderate growth in tax revenues (while remaining below 2007 tax revenue levels), while the average of all states experienced further decline. From 2010 to 2011, average tax receipts for all states grew by 8.0 percent and Hawaii's tax receipts grew by 0.4 percent.

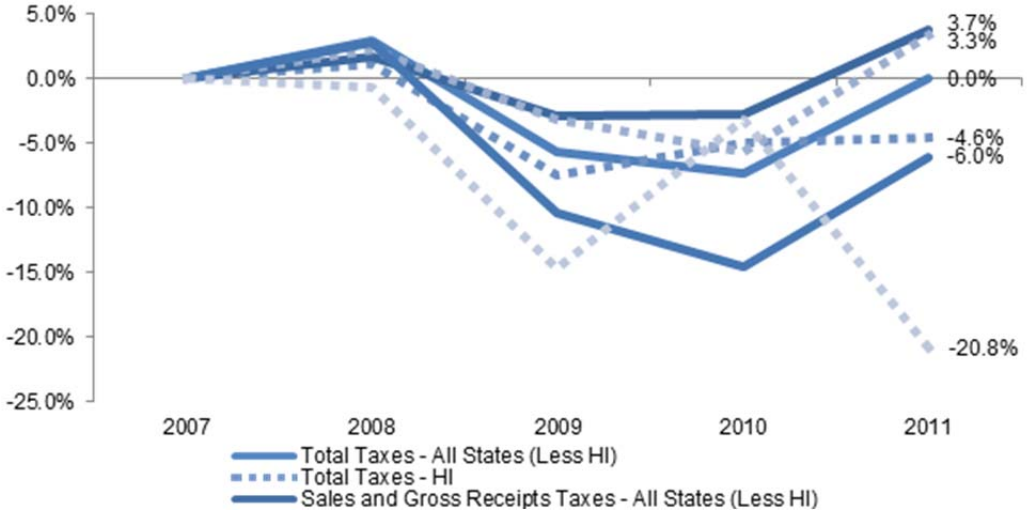
[49] State Revenue Report – April 2012. The Nelson A. Rockefeller Institute of Government.

All States vs. Hawaii Tax Receipts – All Funds (Percent Change)
2007 - 2011



From 2007 through 2011, Hawaii's total tax revenues have decreased by 4.6 percent, while the average of the rest of the states has been flat.[50] Hawaii's GET and other sales/use tax receipts (shown below as sales and gross receipts for standard display) increased by 3.3 percent since 2007 – slightly below the US states average of 3.7 percent. As shown in the chart below, the most significant reason for Hawaii's departure from the US state average is due to its significant decrease in income tax revenue (20.8 percent below 2007 level).

Major Tax Revenue Sources – All Funds
US State Experiences (Less HI) vs. Hawaii Experiences
2007 - 2011



Source: US Census Bureau 2007-2011 data

Importance of GET and Personal Income Tax Revenues

Hawaii's state and local governments generate a significant portion of revenue from so-called 'own-sources' (i.e. taxes, charges and miscellaneous revenues). In 2009, Hawaii state and local governments produced 78.9 percent of total revenues from own-sources.[51] This ranked 19th among the 50 states. On a per capita basis, Hawaii's $6,778 in own-source revenue ranked ninth among all states – underscoring its significant reliance on its two major tax revenue sources: the GET and the personal income tax.

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[50] 2007-2011 Annual US Census Bureau State Government Tax Collections data.

[51] US Census Bureau 2009 Annual Surveys of State and Local Government Finances (published October 2011).

Compared to other states, Hawaii's total tax revenue is somewhat more reliant upon the GET and Individual Income tax. In FY 2011, 77.1 percent of all tax revenue was raised by the two taxes, compared to an average of 65.4 percent for sales tax and IIT revenue in all 50 states.[52]

The GET is applicable to many more goods and services than most other states. According to US Census Bureau data collected and standardized for all 50 states, Hawaii's GET ranked 5th among the 50 states in sales/business privilege tax revenue as a percentage of total tax revenue – trailing only Washington, Florida, South Dakota and Tennessee.[53] It is notable that each of these states does not impose a broad-based IIT.

According to a study by the Federation of Tax Administrators (FTA) that reviewed sales/business privilege taxation of common services, Hawaii's GET was applicable to 160 of the services – ranking first among all 50 states.[54] The table below displays the results of the FTA survey.

FTA Survey of Common Services Taxation by State

	Utilities	Personal Services	Business Services	Computer Services	Admissions / Amusements	Professional Services	Fabrication, Repair & Installation	Other Services	Total
Delaware	9	20	33	6	10	9	19	37	143
Hawaii	**16**	**20**	**34**	**8**	**14**	**9**	**18**	**41**	**160**
New Mexico	16	20	32	8	14	9	18	41	158
South Dakota	14	19	28	8	13	5	18	41	146
Washington	16	20	33	8	13	9	16	43	158
Total Number of Services in Category	**16**	**20**	**34**	**8**	**15**	**9**	**19**	**47**	**168**
HI % of Total Services Taxed	100.0%	100.0%	100.0%	100.0%	93.3%	100.0%	94.7%	87.2%	95.2%

Of course, maintaining a broad base (including minimizing exemptions) can help to moderate tax rate increases. As shown below, among states with a BPT or GRT, Hawaii's 4.0 percent rate is tied for the lowest rate. However, Hawaii's GET generated the second greatest dollar amount, despite the State's comparatively smaller population to the below peer group. This suggests that the breadth of goods and services covered by the GET is likely responsible for the performance and comparative heft of the GET.

[52] Federation of Tax Administrators, accessed at http://www.taxadmin.org/fta/rate/11taxdis.html

[53] 2011 US Census Bureau State Government Tax Collections 2011 data.

[54] Federation of Tax Administrators (FTA) 2007 Tax Survey.

Hawaii GET Comparison to States with Gross Receipts or Business Privilege Taxes (2011)

	Hawaii	Arizona*	Alabama**	New Mexico	Tennessee	West Virginia
Sales Tax Rate	**4.0%**	6.6% + Local Option	4.0%	-	7.0%	6.0%
Sales Tax Exemptions	**Rx**	Food, Rx	Rx	Food, Rx^	Food at 5.5%; Rx exempt	Food at 2%^^; Rx exempt
FY 2011 Sales Tax Revenue	**$2,507,980,000**	$1,493,036,999	$1,933,184,254***	-	$2,649,385,000	$1,654,563,000
BPT or GRT Rate	**-**	-	$0.25 to $1.75 per $1,000 net worth	5.125% + Local Option	.00025% of all sales to .003% of gross income depending upon classification	5.0% on persons providing services in behavioral health and community care
FY 2011 BPT or GRT Revenue	**-**	-	$143,750,000****	$1,634,367,000 (FY10)	$220,484,000	N/A
Total FY 2011 Sales and BPT or GPT Revenue	**$2,507,980,000**	$1,493,036,999	$2,076,934,254	$1,634,367,000	$2,869,869,000	$1,654,563,000

Another measure of breadth of the GET tax base, dividing state tax base by state personal income, shows that Hawaii has by far the broadest base of any state. According to a recent paper for the TRC, in 2010 Hawaii's base was equal to 100.7 percent of personal income. New Mexico ranked second among the states, at 79.1 percent, while the average state base was just 33.0 percent of personal income.[55]

The individual income tax is the other key revenue source for Hawaii. The State currently has 12 individual income tax brackets, an increase from nine brackets in 2000. In 2008, the State changed the highest bracket's income level from over $40,000 to over $48,000. As discussed earlier in the chapter, the State – as a response to the effects of the recession and its slow recovery -- temporarily increased the income tax rate for high-income brackets for tax years 2009 through 2015.[56] The change in the brackets and rates over time is shown in the following table:

Hawaii's Personal Income Marginal Rates and Tax Brackets 2000-2011

Year	Marginal Rates (range)	# of Brackets	Lowest Bracket (under)	Highest Bracket (over)
2000	1.6-8.75%	9	$2,000	$40,000
2001	1.6-8.75%	9	$2,000	$40,000
2002	1.5-8.5%	9	$2,000	$40,000

[55] William Fox, "Selected Issues with the Hawaii General Excise Tax," July 22, 2012, p. 3.

[56] Act 60, SLH 2009.

2003	1.4-8.25%	9	$2,000	$40,000
Year	**Marginal Rates (range)**	**# of Brackets**	**Lowest Bracket (under)**	**Highest Bracket (over)**
2004	1.4-8.25%	9	$2,000	$40,000
2005	1.4-8.25%	9	$2,000	$40,000
2006	1.4-8.25%	9	$2,000	$40,000
2007	1.4-8.25%	9	$2,000	$40,000
2008	1.4-8.25%	9	$2,400	$48,000
2009	1.4-11%	12	$2,400	$200,000
2010	1.4-11%	12	$2,400	$200,000
2011	1.4-11%	12	$2,400	$200,000

Individuals primarily shoulder the majority of Hawaii's income tax burden. In FY 2011, Hawaii's IIT yielded 94.8 percent of all income taxes collected – corporate income tax represented the remaining 5.2 percent. The State IIT's proportion of total income taxes collected was second highest among all 50 states – trailing only Ohio.

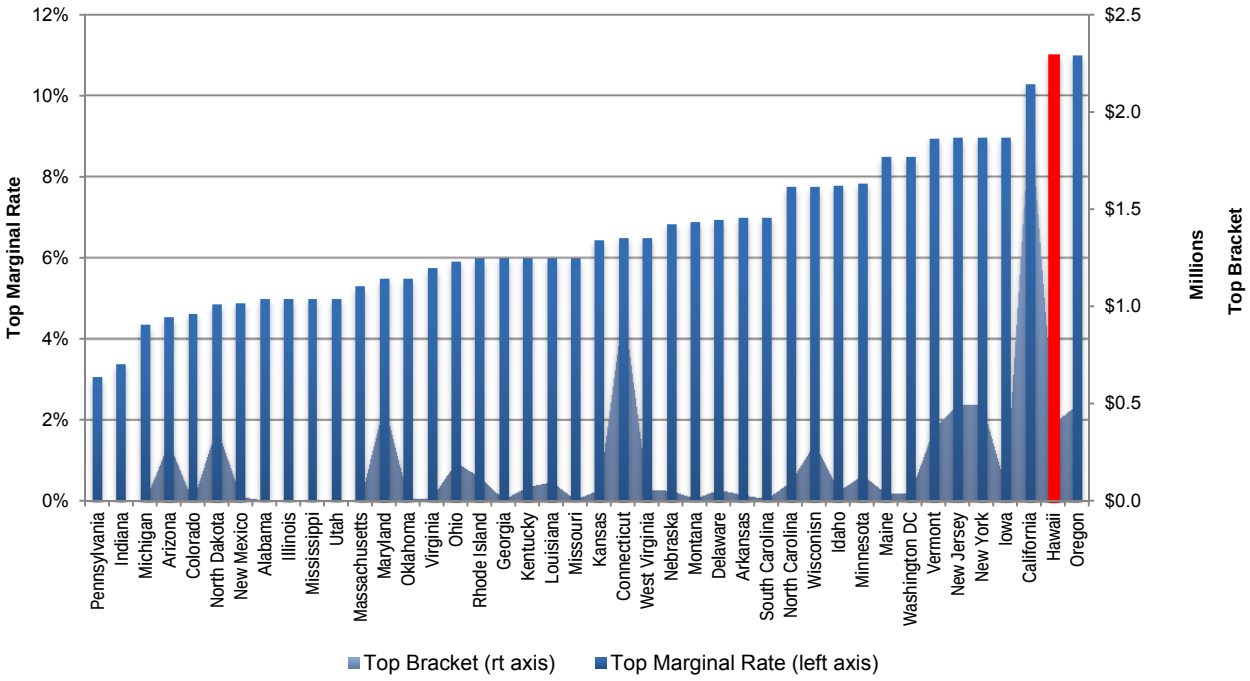
Hawaii's IIT rate as a percentage of income is among the top four of all US states. In 2010, Hawaii's median household income was $63,030. Income at this level (assuming a joint filing) in 2010 was taxed at a rate of 7.6 percent prior to deductions. Using median household incomes for all 50 states, Hawaii's joint filing income tax rate trailed only Oregon, Maine and Iowa.[57]

In 2011, Hawaii had the highest top marginal tax rate among the states (tied with Oregon) at 11 percent. Those with taxable income of at least $200,000 (individual filers) or $400,000 (joint filers) comprise the top bracket.[58] As a result, the State's personal income tax structure may be seen as levying a more significant rate on many comparable income levels (throughout the distribution) as compared to other states

[57] Federation of Tax Administrators (FTA) 2012 data; US Census Bureau 2011 State Government Tax Collections Data; Tax Foundation 2011 data. Note: Iowa and Maine allow for federal deductibility, which dramatically reduces tax burden for high income earners. As such, Hawaii's relative ranking may be even greater viewed in this context.

[58] Center for Colorado's Economic Future – compilation of Tax Foundation data.

Top Marginal Rate and Tax Brackets: 2011 Individual Income Tax



Note: New Hampshire and Tennessee are not included because each only taxes dividends and interest.
Source: Tax Foundation data.

Hawaii's individual income tax structure would generally be classified as progressive. States with progressive income tax structures typically tax higher incomes are higher rates. Other states with progressive income tax structures and a comparatively high top bracket include California, Iowa, New Jersey, New York, Oregon and Vermont.[59] Currently, among states with progressive personal income tax structures, Hawaii has the greatest number of personal income tax brackets (12), the highest marginal rate on its top bracket (11 percent) and the second highest marginal rate on its lowest bracket (1.4 percent).

State	Income Brackets	Personal Exemptions		
Hawaii	12	*Single*	*Married*	*Dependents*
		$1,040	$2,080	$1,040
California	6	*Single*	*Married*	*Dependents*
		$102	$204	$315
Iowa	9	*Single*	*Married*	*Dependents*
		$40	$80	$40
New Jersey	6	*Single*	*Married*	*Dependents*
		$1,000	$2,000	$1,500
New York	8	*Single*	*Married*	*Dependents*
		$0	$0	$1,000
Oregon	4	*Single*	*Married*	*Dependents*
		$183	$366	$183

[59] As mentioned above, some states allow for federal deductibility, which dramatically reduces tax burden for high-income earners.

		Single	Married	Dependents
Vermont	5	$3,700	$7,400	$3,700

Assessment of Tax Burden

A state's tax burden can have a significant impact on its residents' wealth and the state's attractiveness to potential new residents and businesses. It is helpful to compare a jurisdiction's tax burden to other jurisdictions to understand the relative burden shouldered by residents.

There are different ways to conduct a tax burden analysis. Each state and its local governments use an array of taxes and fees to raise revenue to fund government operations. Due to differences in demographics, service provision requirements/expectations, cultural considerations and legal requirements/limitations on spending, comparing one state's tax structure to that of another is generally a complicated discussion.

The project team reviewed three methodologies for determining a state's tax burden. The first, used by the FTA, compares each state's total taxes divided by the state's population to yield a per capita tax burden. Additionally, the FTA analysis calculates the percentage of personal income represented by the per capita tax burden. These data points are compared to relative burdens across states.[60] The second method, used by the Tax Foundation, uses combined state and local tax burdens by calculating the total amount paid by residents (in taxes) of a particular state and dividing that figure by the state's total income.[61] A third method, used by the District of Columbia's annual tax burden assessment, calculates the tax burden for the largest city in each state and uses that product as a comparison point.[62] The estimated burden of major taxes for a hypothetical family of three consists of income taxes, property taxes, sales taxes and auto taxes. The estimated amount of each tax is calculated for each jurisdiction by income level ($25,000, $50,000, $75,000, $100,000 and $150,000).[63]

Each methodology has its proponents and detractors. As there are no perfect taxes, there is likely no perfect way to measure tax burden.[64]

According to the FTA data, in 2011, Hawaii had among the highest tax burdens of all states.[65] The state ranked seventh highest with a per capita tax burden of $3,533 and sixth highest for taxes as a percentage of personal income. For comparison, the average per capita tax burden of all states was $2,456 – accounting for 6.2 percent of personal income.[66]

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[60] Federation of Tax Administrators (FTA) 2011 data.

[61] State-Local Tax Burdens Fall in 2009 as Tax Revenues Shrink Faster than Income, Tax Foundation. February 2011.

[62] Tax Rates and Tax Burdens in the District of Columbia –A Nationwide Comparison 2010; District of Columbia Chief Financial Officer's Office; (Issued September 2011).

[63] The project team reviewed the Hawaii Department of Taxation Tax Research and Planning Office's 2005 "Study on the Progressive or Regressive Nature of Hawaii's Taxes – Appendix D." This Appendix provides a tax burden-calculation methodology. This methodology varies slightly – but importantly – from the methodologies cited by the project team. It is important to note that there have been changes to the State's tax laws since the 2005 study and, as such, data from that report may not be readily comparable to data contained in the project team's work.

[64] One specific note is that some methodologies may not completely disaggregate those taxes primarily paid by non-residents. In Hawaii's case, due to the significant role of tourism in the State's economy, it is likely that taxes such as the TAT and the rental car tax are exported to non-residents and thus do not constitute a significant portion of the tax burden to Hawaiians.

[65] Federation of Tax Administrators 2011 State Tax Revenue Tax Burden Comparison

[66] The median was $2,330 – accounting for 6.3 percent of personal income.

FTA – 2011 Tax Burden – Sorted by Taxes as Percentage of Personal Income

	Total Taxes ($ million)	Per Capita	Rank	% of Pers. Income	Rank
Alaska	$5,538	$7,662	1	17.5	1
North Dakota	3,822	5,589	2	13.2	2
Vermont	2,688	4,291	4	10.7	3
	Total Taxes ($ million)	Per Capita	Rank	% of Pers. Income	Rank
Wyoming	2,462	4,333	3	9.7	4
West Virginia	5,143	2,772	13	8.7	5
Hawaii	**$4,858**	**$3,533**	**7**	**8.6**	**6**
Delaware	$3,018	$3,327	10	8.4	7
Minnesota	$18,953	$3,546	6	8.3	8
Arkansas	$7,738	$2,634	17	8.1	9
California	$123,110	$3,266	11	7.8	10

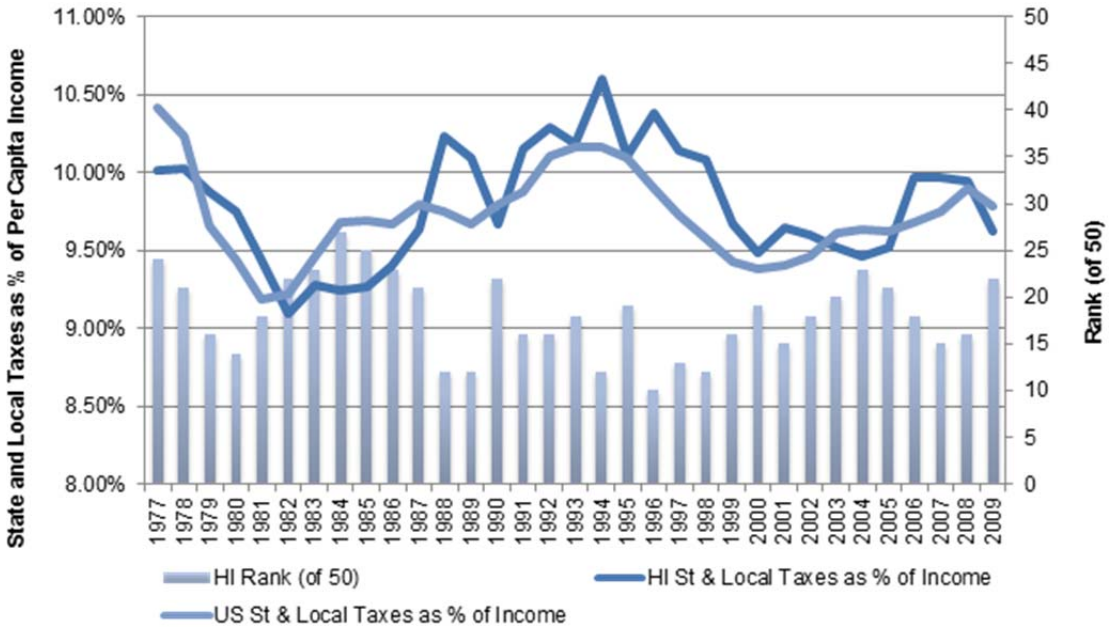
The Tax Foundation analysis shows Hawaii to be more competitive than the FTA. While in past years Hawaii has generally been in the top one-third to one-half by state, that is not the case in its most recent analysis.[67] A notable difference from the FTA analysis, the Tax Foundation includes local taxes. As a result, Hawaii's composite tax burden as a percentage of per capita income (for 2009) was 9.6 percent. By comparison, the average for all states was 9.8 percent.

The Tax Foundation data indicate that Hawaiians paid the 10th highest per capita taxes to their home state and the 27th highest in taxes to other states. Viewing the home state versus other state split as a percentage of total taxes per capita, Hawaiians paid the 4th highest percentage of total taxes to their home state (76.3 percent) and the 4th lowest percentage of total taxes to other states (23.7 percent).

This occurrence is logical, given Hawaii's island status and distance from other US states; its residents do not have readily available alternatives to avoid many consumption-based taxes. Internet shopping may somewhat alter this landscape, though as legislation and tax policy adjusts to increased online shopping, Hawaiians are likely to continue to pay among the highest percentage of total taxes to the State.

[67] Tax Foundation Tax Burden Analysis – 1977 – 2009.

Tax Foundation – Hawaii Tax Burden – 1977-2009



The District of Columbia study is primarily useful in comparing city tax burdens. While it is again important to note that significant variations in tax policy exist across cities and states, Honolulu's relative ranking compared to the largest cities in other states offers some context for the tax environment in Hawaii. As shown below, the $25,000 earner pays significantly more of their income as a share of taxes than the other cohorts.[68]

Honolulu Estimated Burden of Major Taxes as Percentage of Income – For Hypothetical Family of Three - 2010

Annual Income	$25,000	$50,000	$75,000	$100,000	$150,000
Citizens' Combined Taxes Paid as Percentage of Annual Income	12.6%	6.4%	6.9%	7.3%	7.7%
Rank (High to Low) Among States, incl DC (of 51)	9	43	38	37	33

Impacts on differing types of taxpayers (touching on issues of vertical equity) have also been considered in other studies. One by the Institute on Taxation & Economic Policy (ITEP) suggested that Hawaii's tax structure placed the sixth highest tax burden on poor residents.[69] According to the report, the GET accounted for 10.0 percent of income among Hawaii's lowest earners in 2007 (those earning less than $18,000 per year). The GET consumes the greatest share of resident income for income segments less than $85,000. For residents earning $85,000 to $176,000, GET consumed 3.3 percent of income, and income taxes accounted for 4.3 percent of income – the first income threshold at which the GET was a smaller percentage of income than income tax.

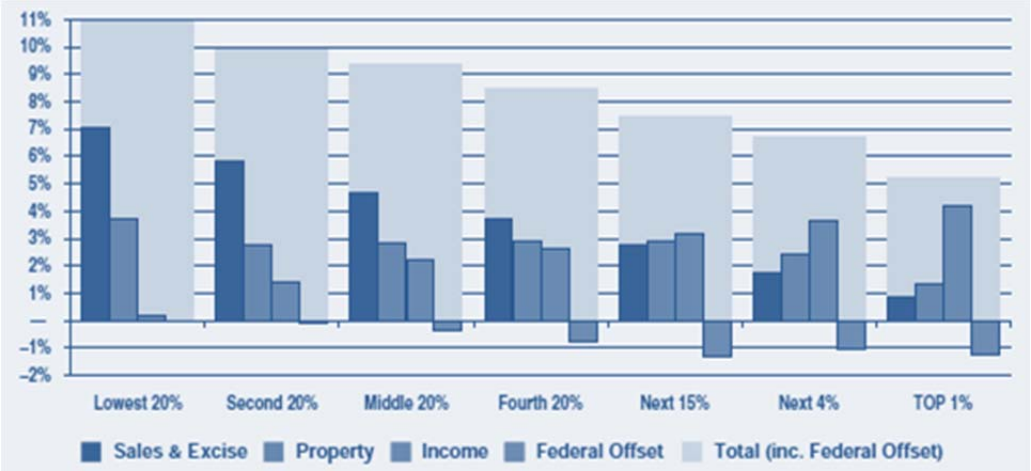
Due to Hawaii's wide application of the GET, ITEP found the State's overall tax structure to have regressive characteristics. The following table shows that higher income earners paid a successively

[68] The GET in Honolulu is 4.5 percent – and includes a 0.5 percent surcharge levied by the City/County of Honolulu and the tax burden of Honolulu citizens differs from that of the remainder of the State.

[69] Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, Institute on Taxation and Economic Policy – Third Edition, November 2009. ITEP generated its data from a micro-simulation model that used a stratified sample of tax returns, micro data sets and aggregated data sources. ITEP's 2009 report is based on 2007 data for federal, state and local governments.

smaller portion of income as State taxes. If federal offsets were included in calculations, the disparity widens even more, with the bottom 20 percent of earners still paying 12.2 percent of income and the top 1 percent of earners paying 6.3 percent of income.

State and Local Taxes in 2007, Shares of Family Income for Non-Elderly Taxpayers



Source: Institute on Taxation & Economic Policy (ITEP).

Transient Accommodations Tax (TAT) and Rental Car Tax

According to a 2009 study, tourism created almost 24 percent of Hawaii's non-farm jobs (over 141,000 jobs in total).[70] The study reports that travelers spent $14.3 billion in the Hawaiian economy in 2009, and the tourism industry had a payroll of $4.2 billion. Additionally, a 2011 study suggested that tourism directly contributed $8.2 billion to Hawaii's Gross State Product (GSP) – with an additional $2.7 billion of indirect contributions to GSP. Taken together, the combined $10.9 billion comprised 16.4 percent of the total GSP and, if including induced effects, the percentage increased to 22.0 percent.

Hawaii is one of the top domestic destinations for US residents and among the top international destinations for international tourists.[71] The project team reviewed the tax structure of the TAT and rental car tax in comparison with other top US tourist destinations in order to provide context. In addition to Oahu and Honolulu, the US Census Bureau identified the following US cities as top travel destinations:

- Boston, MA
- Chicago, IL
- Las Vegas, NV
- Los Angeles, CA
- Miami, FL
- New York, NY
- Orlando, FL
- San Francisco, CA
- Washington, DC

Each city has a different tax rate for hotel stays and rental car use that is comprised of some combination of state, county and/or city taxes. For comparison, the project team used Honolulu as the Hawaiian benchmark. Among the top travel destination cities in the US, Honolulu had the seventh highest hotel tax rate (out of 10 cities). It should be noted that 'travel' and 'tourism' are not synonymous, and several cities

[70] Why Travel Matters to Hawaii, US Travel Association. 2009.

[71] The US Census Bureau combines Oahu and Honolulu as top tourist destinations.

on this list are likely there as much for business travel (particularly Chicago, New York and Washington DC) as tourism. Of course, other destinations, such as Las Vegas and Orlando, are mostly tourist destinations.

City	Tax Structure
Honolulu	**13.962%**
Boston	14.45%
Chicago	16.39%
Las Vegas	12.00%
Los Angeles	15.57%
Miami	13.00%
New York City	14.75% + $3.50/night
Orlando	12.50%
San Francisco	15.57%
Washington, DC	14.50%

Similarly, Honolulu's base rental car tax is comparatively low, but the addition of the temporary surcharge ($7.50 per day) made the per-day taxes and fees noticeably higher. With the expiration of the extra $4.00 per day surcharge in FY 2013, Honolulu's rental tax rate is even more competitive.

City	Tax Structure
Honolulu	4.712% + $3.00/day
Boston	6.25% + $10 surtax (one-time, not per day)
Chicago	11% + $2.75/day
Las Vegas	21.35%
Los Angeles	12.60%
Miami	7.0% + $2.00/day
New York City	15.00%
Orlando	6.5% + $2.00/day
San Francisco	11.10%
Washington, DC	10%

Corporate Income Tax

The corporate income tax is typically considered one of the "big three" taxes for state governments. However, in Hawaii, the corporate income tax is not among the biggest revenue generators. In FY 2011, the corporate income tax accounted for approximately $67.9 million in revenue – 1.4 percent of total tax revenue.[72] The corporate income tax percentage share of total tax revenue ranked seventh lowest among all states and significantly below the US-state average of 5.3 percent. The corporate share of income tax revenue (5.2 percent) ranked sixth-lowest among the 50 states.

Summary

[72] US Census Bureau, State Government Tax Collections 2011. Personal income tax receipts generated approximately $1.25 billion (94.8 percent of total income tax revenue).

The State's tax sources experienced one year of significant decline and three years of moderate growth from FY2007 through FY2011. The State's revenue generation is very dependent upon the GET and the IIT. While other taxes, like the TAT, are important to the State, the performance of its two major taxes generally defines its revenue health.

Hawaii's current tax structure has been characterized as regressive – largely due to the GET. Regardless of which burden methodology is used, the following are key observations:

- The wide application of the GET has regressive characteristics
- There is a comparatively high income tax rate for low wage earners
- The individual income tax brackets grow quickly at comparatively low levels of revenue
- There is a high marginal rate for the top income tax bracket
- The corporate income tax generates a comparatively small amount of revenue
- There is a comparatively lower TAT rate
- Property taxes for all classes of property are among the lowest in the nation

State Taxes Performance

Across the nation, nearly every state has dealt with tax structure issues related to 'the Great Recession.' For most states, FY 2007-08 marked the peak year for nominal general fund revenue collections, with several years of reduced collections occurring after that. While the National Bureau of Economic Research determined that the last recession began in December 2007 and ended in June, 2009, revenues have been slow to rebound in most states.

A recent state survey found that state expectations as to when their state will return to the previous peak revenue collection level vary widely, with 14 states forecasting that to occur during FY 2012, six forecasting the current fiscal year (FY 2013) but another 15 states indicating it will not happen until sometime between FY 2014 and FY 2018. Another 13 states indicate that they do not know when revenues will return to the previous peak.[73]

While circumstances differ from state to state, there are key themes that have and continue to impact on state revenue structures, including Hawaii's. There are other emerging trends that will also have a significant effect on tax collections now and in the future.

For the better part of the last 50 years, most state tax structures have generally been focused around three key taxes: sales and use, personal income and corporate income taxes. Each of these has created challenges for state revenue structures. In many instances, key developments have impacted the way that many states approach their revenue structure. These include:

- **Base erosion.** 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.[74] In the past 20 years, the emergence of the Internet has changed the way that individuals and businesses access goods and services. Consumers are shifting their purchases to catalog, internet, and other e-commerce transactions, which have lower percentages of actual sales and use tax collection. Transactions involving the sale or purchase of taxable items conducted over the internet are subject to state sales and use tax law. However, the 1992 U.S. Supreme Court's ruling in *Quill vs. North Dakota* has made collection of the tax problematic. In *Quill,* the Court held that a state or local government may only require a mail-order catalogue company to collect and remit sales tax to the state in which the consumer resides if the company has an acceptable form of physical presence (nexus) in the state.

  The best-known study on potential revenue loss from this decision was done by Dr. William Fox and Dr. Donald Bruce at the University of Tennessee Center for Business and Economic Research. The Fox-Bruce study was first done in 2001 and updated in 2008. According to that study, the tax loss for the State of Hawaii related to uncollected GET is estimated at $60.0 million for FY2012.[75]

  Recently, Dr. Fox updated his estimates of the loss from e-commerce for the State of Hawaii. Based on more recent data, Dr. Fox estimates that lost state revenue from uncollected GET taxes from e-commerce transactions totaled $144.9 million in FY 2012.[76] This is a significant increase

[73] "State Budget Update: Spring 2012," National Conference of State Legislatures, April 2012, p.24-26. According to the survey, Pennsylvania will return to peak revenue collections in FY2012-2013.

[74] William Fox, "Three Characteristics of Tax Structures have Contributed to the Current State Fiscal Crises." State Tax Notes, August 4, 2003, p. 379.

[75] William Fox, Donald Bruce and LeAnn Lunna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce" April 13, 2009, p. 11

[76] William F. Fox, "Selected Issues with the Hawaii General Excise Tax," July 22, 2012, p.11.

in the estimated revenue loss, which the author attributes to a dramatic rise in e-commerce activity in recent years, as well as better data from the U.S. Economic Census on taxable e-commerce activity.[77]

Base erosion has also been a concern for the other major taxes – for example, aggressive corporate income tax planning combined with a move by many states to a single factor of 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 more pronounced than previous post-world war recessions. In particular, sales and individual income tax collections were harder hit during and after the 'Great Recession' than in previous recessions.[78] This has made it extremely difficult for states to reliably forecast revenue growth or decline for budgeting purposes.

  An influential recent discussion of state revenue structures and revenue estimating noted that in FY 2009, the collective margin of error by states in forecasting personal income, corporate income and sales tax amounted to a $49 billion revenue shortfall, which was a median error of a 10.2 percent overestimate – meaning that half the states overestimated taxes by 10.2 percent that year.[79] This study also suggested that the forecasting trend has been getting worse: errors in revenue estimates have progressively become less accurate in each of the past three economic downturns, and 2009 ended with the largest overestimates in revenue forecasting of any of the 23 years that were included in the study period.[80]

  This increased volatility can be related to the rise, among all states, of the importance of the 'big three' of sales, personal income and corporate income taxes. Because these are economically sensitive, they are generally more volatile than other revenue sources. Together, these three accounted for 38 percent of state tax revenues in 1950 but had grown to 72 percent by 1990 and continue to increase at present. A recent study noted that 'state tax revenues have become far more sensitive to changing economic conditions since 2000' and that 'increasing responsiveness in the individual income tax has been an important source of this increase.'[81] This is due primarily to capital gains and equity market volatility. The table below outlines the percentage of taxes for all states by these three primary sources:

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[77] Ibid., p. 12.

[78] Lucy Dadayan, State Revenue Report, August 2012, Rockefeller Institute of Government, p. 12-13. The report notes that the decline in retail sales in the last recession was deeper than most recessions, although the 1973 and 1980 recessions were somewhat comparable.

[79] "States' Revenue Estimating: Cracks in the Crystal Ball," Rockefeller Institute of Government and Pew Center on the States, October 2011, p. 7-8.

[80] Ibid, p. 8-9.

[81] Report of the State Budget Crisis Task Force, June 2012, p. 15.

Percentage of Total State Government Tax Revenue (%)						
	Highly Economically Sensitive Taxes					
	Personal Income Tax	General Sales Tax	Corporate Income Tax	Sum	Other Taxes	Total
1950	9.1	21.1	7.4	37.6	62.4	100.0
1960	12.3	23.9	6.5	42.6	57.4	100.0
1970	19.2	29.6	7.8	56.5	43.5	100.0
1980	27.1	31.5	9.7	68.3	31.7	100.0
1990	32.0	33.2	7.2	72.4	27.6	100.0
2000	36.1	32.3	6.0	74.4	25.6	100.0
2005	34.1	32.7	5.9	72.7	27.3	100.0
2010	33.6	31.9	5.2	70.8	29.2	100.0

Source: Holcombe & Sobel (1950-1990): Census Bureau (2000-2010).

Among these three key sources, changes in tax collections for the individual income tax are a notable factor. In particular, realized capital gains have become an ever larger component of total tax – and a volatile one, as the following chart shows:

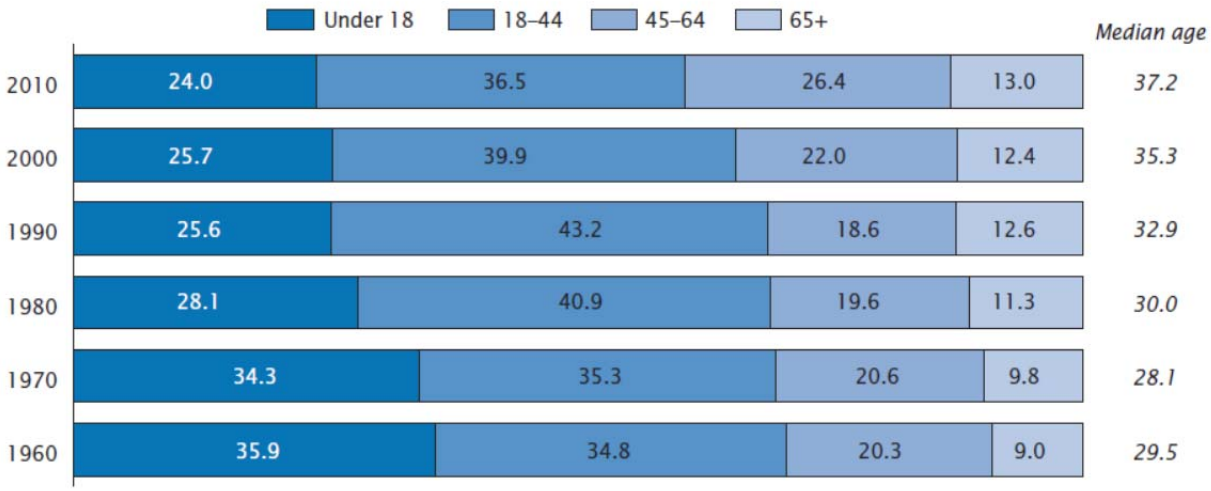
Capital Gains as Percent of GDP, 1954 – 2010

Source: US Department of Treasury and US Bureau of Economic Analysis

- **Demographic shifts.** The US population is getting older – the 2010 Census set the median age at 37.2 years of age, and it has been steadily increasing since 1970. At 38.6, Hawaii's median age is slightly older than the nation as a whole. The following graph details this change over time:[82]

[82] "Age and Sex Composition: 2010," United States Census Bureau, May 2011, p.6.

Age and Sex Composition, 2010

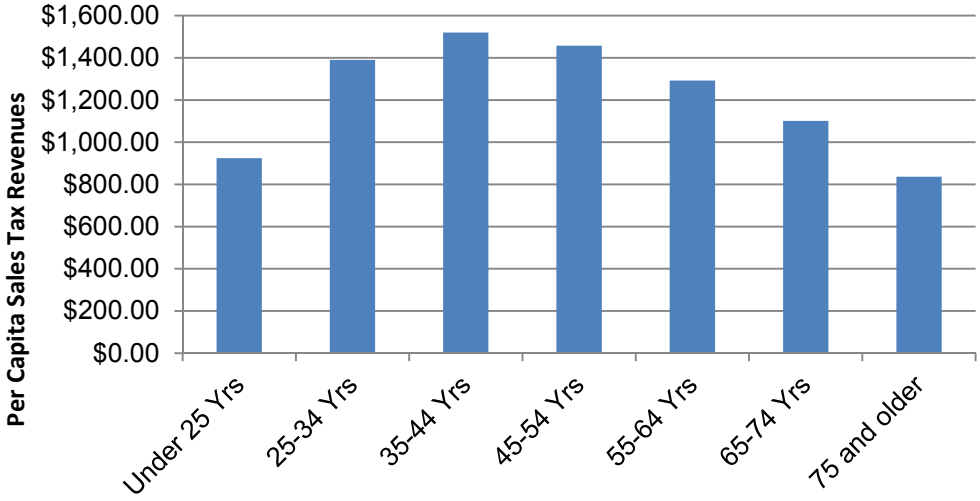


Source: US Census Bureau

The portion of the population over age 65 is increasing in size relative to the population as a whole. The aging of the Baby Boom generation into older age cohorts is contributing to the increase, as are stable birth rates and longer average life spans.

This can have an impact on revenue collections. In general, older population cohorts spend less of their income on taxable purchases, both because their households are smaller and because many of the spending big ticket items have already been purchased. Federal Bureau of Labor Statistics data provides a glimpse at the spending patterns of households at varying ages:

Sales Tax Revenue Profile by Age, 2010



Source: US Census Bureau

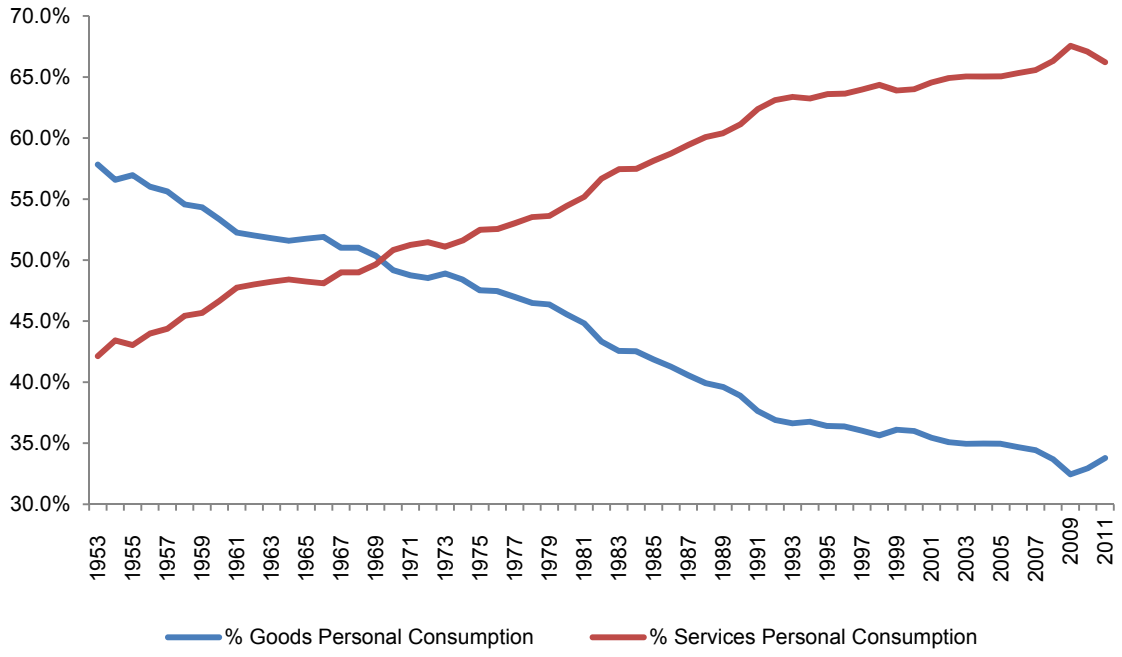
An aging population can impact State revenues (and expenditures) in multiple ways. While these individuals are generally spending less of their income on taxable purchases, they are also able to shield more of their income from individual income taxes. The State of Hawaii fully exempts social security and public and private pension income from the state individual income tax, which

means that as a greater percentage of the state's residents reach retirement age and/or age 65, a greater percentage of income will generally not be taxed.

- **Changes in consumption.** When most sales tax laws were enacted, the economy was based around consumption of tangible goods. Not surprisingly, most of these statutes applied the sales tax the purchase of all tangible goods unless specifically exempted. On the other hand, services were a much smaller part of overall consumption; as a result, services were generally not subject to tax unless specifically enumerated.

  Over the years, personal consumption in the US has gradually shifted from goods to services. The following graph details this steady shift, with services now a clear majority of personal consumption:

Percent of Personal Consumption: Goods and Services

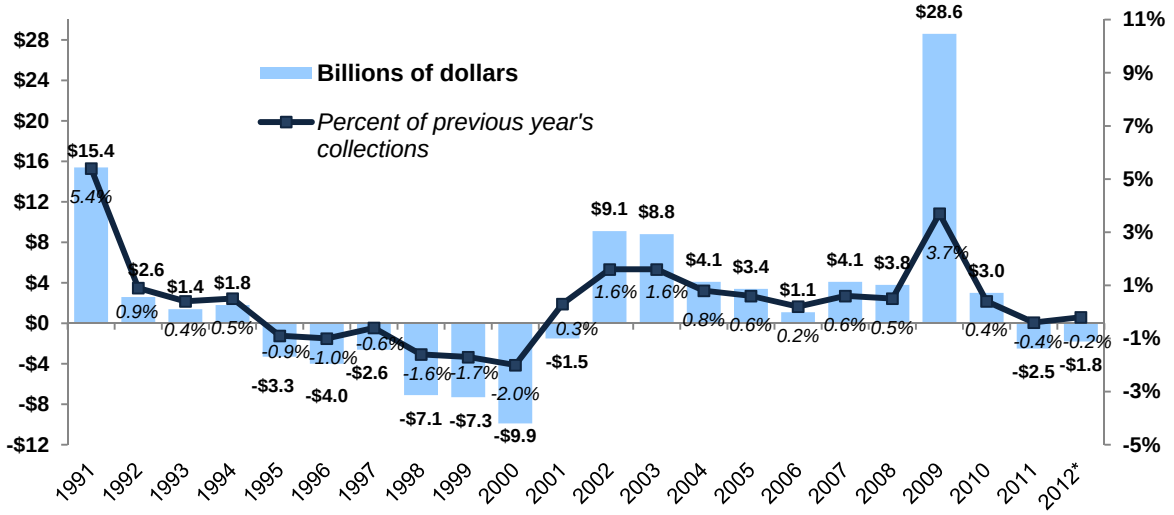


Source: Bureau of Economic Analysis

Given these trends and the spending impacts of the last recession, it is not surprising that states have been raising taxes as a method for dealing with at least some of their budget gaps. In fact, the National Conference of State Legislatures reported that 2011 was the first time in 10 years that states cut taxes more than they increased them. The following chart illustrates this trend over time:[83]

[83] National Conference of State Legislatures, "State Tax Actions 2011: Special Fiscal Report," February 2012, p. 3.

Net State Tax Changes by Year of Enactment, 1991-2011



Source: National Conference of State Legislatures' Survey of Legislative Fiscal Offices, 2011.

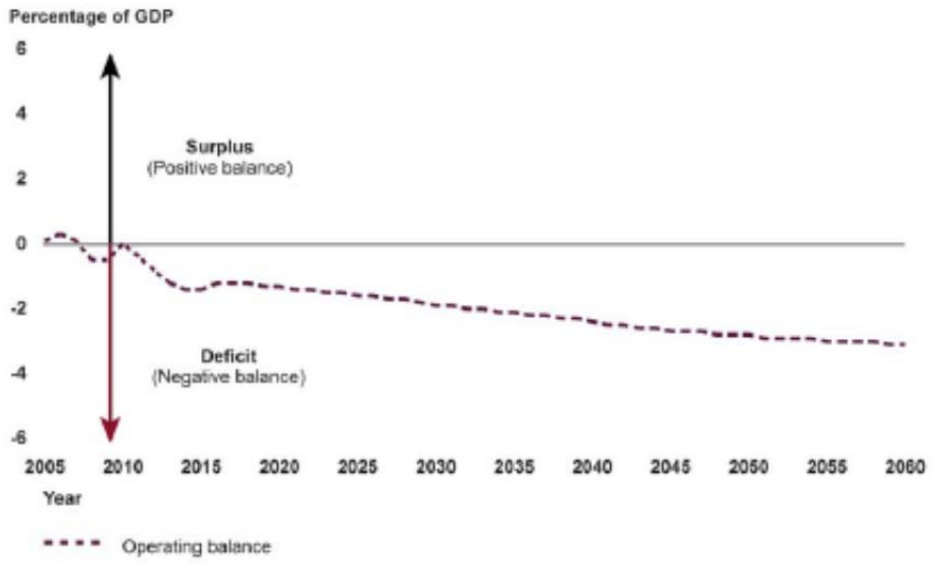
While the 'Great Recession' has exacerbated budget problems for States, many of these trends have developed over a number of years. It is also likely that budget pressures will extend well into the future – and will impact states (including Hawaii) over the entirety of the timeframe under discussion in this report.

At least one prominent budget forecast suggests that state and local government's fiscal outlook will decline throughout the period from 2012 to 2060. Since 2007, the U.S. General Accountability Office (GAO) has published a yearly 'State and Local Governments Fiscal Outlook' that creates long-term fiscal simulations for the state and local government sector. These simulations show that, like the federal government, the state and local government sector faces persistent and long-term fiscal pressures that will grow over time.[84]

The GAO simulation shows that state finances have shown some rebound in the past year, largely because of a return, on average, of revenue growth among the states. That said, the model still forecasts a steady decline in budget balance, primarily driven by the same growth pressures associated by health-related costs of state and local expenditures on Medicaid and the cost of health care compensation for state and local government employees and retirees. The results of this latest GAO simulation are presented in the following graph:

[84] 'State and Local Governments' Fiscal Outlook, April 2012 Update,' United States Government Accountability Office, GAO-12-523SP, p. 1.

State and Local Operating Balance, as a Percentage of Gross Domestic Product



Source: CAO Simulations, updated April 2012

This simulation is enlightening for a number of reasons. First, it examines state and local governments as a whole and from the vantage point of how state and local governments will do across a variety of political, economic and social perspectives. Clearly, the sector as a whole has a serious disconnect between its current revenue and expenditure structures. While there is a case to be made that individual governments could choose to discontinue doing some of what they do (or do it more efficiently), there is little in the simulation data that suggests the current negative trend will not continue into the future.

Strengths, Weaknesses, Opportunities and Threats

A SWOT (strengths, weaknesses, opportunities, threats) analysis generally looks at a system or organization from two perspectives – that of the organization or system (internal) and the environment (external). These perspectives are then grouped by those that are helpful or harmful for the organization or system in attaining its goals. The following represents this analytical framework:

	Helpful to achieving the objective	**Harmful** to achieving the objective
Internal (attributes of the organization)	**Strengths**	**Weaknesses**
External (attributes of the environment)	**Opportunities**	**Threats**

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. This has advantages (and some disadvantages as well). The following are internal advantages of the current tax structure and the taxes and revenues that comprise it:

- **Broad and stable base for the General Excise Tax (GET)**. The GET has proven resistant to much of the base erosion around the rise of services highlighted in the previous section. It is notable that other states, to maintain similar levels of sales tax revenue, have generally had to resort to rate increases. A paper written for the last Tax Review Commission noted that essentially every other state has raised its sales tax rate during the past 25 to 30 years in the face of tax bases that have been eroded.[85]
- **Relatively low tax rate for the GET**. It is a generally accepted tenet of tax policy that a broad base and a low rate will minimize economic disruption. There is no perfect tax – there will be some 'deadweight' loss associated with any tax, as the tax will increase the final cost of goods and services to the consumer and thus reduce overall levels of consumption. The paper cited in the previous bullet notes that for sales taxes in particular, states have been forced to raise rates to maintain a similar share of revenue from their sales taxes. The paper found that the median state sales tax rate rose from 3.25 percent in 1970, to 4.0 percent in 1980, and to 5.0 percent in 1990. In 2006, 21 of the 45 sales taxing states use a rate at or above 6.0 percent. Hawaii has been able to avoid this spiral of a continually narrowing base and rising rate – which can have a significant impact on business and consumer market decisions.
- **Insulation from cross-border competition issues.** In many states, consumer mobility is an important consideration in devising tax policy. Study after study has identified border leakage in

[85] William Fox, "Hawaii's General Excise Tax: Should the Base Be Changed?" Report Prepared for the 2005-2007 Hawaii Tax Review Commission, October 4, 2006, p.1.

sales of a variety of goods and services, including alcohol,[86] cigarettes,[87] motor fuel,[88] and durable goods.[89] This is understandable, as in many places around the country (and particularly metropolitan areas), the next state is just minutes away – and in some places just across the street. As a border state is hours by plane away from the mainland, Hawaii does not have to concern itself with this natural competition.

- **GET is responsive to demographic and economic changes.** As noted above, the base for the GET has remained stable, which has mitigated the need to increase rates over time. While changing demographics were cited as a key revenue issue for states, the GET appears more able to withstand demographic impacts. For example, many sales tax structures do not tax services related to medical and health care. Given the continued growth of the percentage of GDP associated with health services – and the aging population which consumes a very large share of these services – Hawaii's tax structure will be less impacted by these consumption shifts.
- **Ability to export a significant share of state tax burden.** Hawaii regularly attracts millions of non-resident visitors each year. The majority of these visitors are tourists on holiday or vacation. These individuals generally expect to consume a significant amount of goods and services while visiting Hawaii. This is a benefit to the state, as the tax burden is exported to non-residents. One study estimated that most of Hawaii's taxes exported approximately one-third of the burden to non-residents.[90]

Weaknesses

While the GET is an important strength for the tax structure as a whole, as noted above, there are no perfect taxes, and the GET has particular impacts on certain industries that can be seen as a weakness. Other aspects of the tax structure and the way it is administered are also areas of concern for the overall structure.

- **Largely dependent on two primary taxes.** The GET is Hawaii's primary state revenue source. In FY2011, The GET collected 51.4 percent of Hawaii's tax revenues, which is significantly greater than comparable broad based consumption tax collections in the average state, which averages 31.5 percent. Only Washington, Tennessee, Florida, and South Dakota generate a larger percentage of tax revenues from their sales tax than Hawaii – all states without a broad-based individual income tax. Hawaii's second largest source, the IIT, makes up 29.3 percent of state tax revenues. Combined, these total nearly 83 percent of state revenues, significantly greater than the average state, which derives 65.5 percent of its revenue from these two sources.
- **GET results in some tax pyramiding.** The GET is imposed on a broader set of transactions than any other sales tax, and it varies from sales taxes in that it is imposed on many intermediate purchases (business inputs). The 4.0 percent GET rate on some services and the 0.5 percent GET rate imposed on wholesaling, manufacturing, producing, wholesale services, and use tax on

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[86] T. Randolph Beard, Paula A. Gant, Richard P. Saba, "Border-Crossing Sales, Tax Avoidance, and State Tax Policies: An Application to Alcohol," *Southern Economic Journal*, July 1997, p. 300-302.

[87] See for example Patrick Fleenor, "How Excise Tax Differentials Affect Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States," The Tax Foundation, Background Paper No. 26, October 1998.

[88] Mark D. Manuszak and Charles C. Maul, "How Far For a Buck? Tax Differences and the Location of Retail Gasoline Activity in Southeast Chicagoland," January 26, 2009.

[89] See for example Walsh, M. and J. Jones (1988) "More Evidence on the 'Border Tax' Effect: the Case of West Virginia," *National Tax Journal*, Vol. 14, pp. 362-374; F. Steb Hipple, "Retail Sales and Sales Tax Losses from Tennessee to Virginia in the Tri-states Metropolitan Area 1996 and 2003," State of Tennessee Tax Structure Study Commission, November 6, 2003; Rossitza Wooster and Joshua Lehner, "Reexamining the Border Tax Effect: A Case Study of Washington State" September 2008.

[90] Richard L. Bowen and PingSun Leung, "Tax Pyramiding and Tax Exporting in Hawaii: An Input-Output Analysis," University of Hawaii Research Extension Series 102, January 1989, p. 8.

imports for resale gets layered into intermediate activities that get passed along as part of the price of many finished products or service.

This can have some adverse consequences. Taxes on business inputs have the potential to alter business behavior. As firms seek to limit the amount of tax they pay, they will explore a variety of approaches. A common method is to vertically integrate and bring more activities within a single company. For example, a firm that contracts for professional services (finance, IT, legal, marketing) can bring these in-house to eliminate paying the tax. This may also benefit larger firms with more ability to make these changes than smaller firms, which can alter the competitive landscape. Taxes on inputs may also make Hawaii businesses less competitive in the broader market. Hawaii-based firms that use Hawaii-based goods and services in its production will have higher costs than non-Hawaii based firms or Hawaii based firms that import goods or services as part of its production. Further, this pyramiding can raise the relative price of some goods and cause people to purchase less of these goods.

Of course, these factors must be weighed in conjunction with other taxes that businesses pay in Hawaii and other states. The Center on State Taxation, a business-funded group, does a yearly analysis of all taxes paid by businesses and expresses these as a share of gross state product. According to their analysis, in 2011, the State of Hawaii collected state and local taxes that total 5.9 percent of the State GSP. This ranked 11th highest among all the states.[91]

- **Comparatively high Individual income tax rates at high and low income levels.** Hawaii's individual income tax consists of 12 different rates that start at 1.40 percent of $2,400 of taxable income for individual filers and $3,600 for households. This rate rises relatively quickly to 5.50 percent at $4,800/$7,200 of taxable income. This is a higher rate at lower income levels than are generally found in states with multiple rates and income brackets. At the high end, Hawaii's top rate of 11.00 percent at $200,000/$300,000 of taxable income, is the highest rate in the nation. As with the GET, Hawaii is insulated in some respects from residential location decisions because of its distance from other states.
- **Exempts a growing source of income from the individual income tax.** Demographic changes are resulting in an aging of the national (and state) population. As this occurs, retirement income (public and private pensions and social security) becomes a larger component of total income. The State of Hawaii exempts nearly all of this income, regardless of amount, from state individual income tax. This will, over time, erode the tax base for the state individual income tax.
- **Obtains a comparatively small source of revenue from the corporate income tax.** Hawaii's corporate net income tax raises a significantly smaller portion of overall state tax revenue than in the average state. Nationally, corporate net income taxes average over 5 percent of total state taxes; in Hawaii, it totals just 1 percent. Of course, the application of the GET also functions as a form of business tax. Discussions with internal and external stakeholder identified the corporate net income tax as a complicated tax for compliance and administration relative to the revenue it raises.
- **Variety of tax law sunsets in coming years.** During the economic downturn (and the revenue downturn that also resulted), the State enacted a number of temporary tax changes that resulted in a significant increase in tax revenue. These temporary tax law changes will sunset in the next few years, which will (unless extended) result in a permanent loss of state revenues. There are also other taxes approved in years prior to the Great Recession that are also scheduled to sunset, with similar potential impact on revenue collections.
- **Older tax collection systems and processes.** Efficient and effective tax administration is generally necessary to maximize tax compliance and revenue collections. Across the country, states are using a variety of sophisticated technology-driven approaches to improve compliance

[91] "Total State and Local Business Taxes: State by State Estimates for Fiscal Year 2011," Council on State Taxation, July 2012, p.11.

and collections. Mainstream approaches using audits of sales, income and excise tax returns also generally rely on automated systems. The State of Hawaii's tax administration systems are mostly manual systems that do not allow the State to audit a representative sample of returns – and certainly not to use the latest tax gap hardware and software analytical tools.

External Issues

External opportunities and threats are often difficult to identify and/or quantify, as it relies on activities outside the control of the State. The following touch on a couple of key areas that have already been identified within the chapter.

Opportunities

- **Federal solution on e-commerce.** Because of the importance of sales tax as a revenue source, states have undertaken a variety of strategies to establish nexus for businesses for the purpose of enforcing collection of sales taxes on out-of-state purchases. In Hawaii, this is somewhat mitigated, as the GET, in theory, creates economic nexus sufficient to enforce collection of sales taxes. At the same time, there are likely vendors with economic nexus who are not currently collecting GET, and a national solution should increase overall compliance. Currently, there are at least three different bills in the U.S. Congress that would develop a national solution. Governors of both parties have become increasingly supportive of these efforts, often framing this as a 'main street fairness' issue. It is likely that this momentum will lead to a federal solution sometime in the next 4-10 years. Of course, the terms and conditions of any federal legislated solution will impact on the actual revenue benefit for Hawaii and the other 49 states.[92]
- **Voluntary vendor compliance with e-commerce tax collection.** Some large e-commerce retailers are voluntarily remitting sales tax to some states where they otherwise would not be required to do so. Some of this relates to efforts by states to create greater uniformity through the Streamlined Sales Tax initiative[93] while some has been in response to legislative efforts in states to establish nexus for e-commerce collections.[94] In other instances, retailers have deemed it in their best interest to comply, as it provides them some customer service and customer contact opportunities that they could not use without collecting tax. It is possible that this trend will continue to grow in the future and more states will receive voluntary compliance by vendors – although it is an open question as to whether this will be the case in Hawaii.

Threats

- **Continued erosion from e-commerce.** While the previous analysis suggests that there may be a federal solution related to e-commerce sales tax collection, the timing of this federal solution is unclear, and erosion will continue in the meantime. Second, e-commerce also opens markets for providers of goods and services throughout the world. It is likely that some of the business

[92]See William F. Fox, "Selected Issues with the Hawaii General Excise Tax," July 22, 2012, pp. 12-13 for a discussion of the three bills currently before Congress.

[93] The Streamlined Sales Tax Initiative was created by the National Governor's Association and the National Conference of State Legislatures in 1999 to simplify sales tax collection. It is a cooperative effort involving 44 states, the District of Columbia, local governments and the business community to simplify sales and use tax collection and administration by retailers and states. To date, 24 of the 44 states have passed conforming legislation to become full participants in the Streamlined Sales and Use Tax Agreement. The states that have passed legislation to conform to the Agreement are Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming. Conforming legislation has been introduced in Texas, Massachusetts, Florida, Illinois, Virginia, Missouri, Maine, California, and Hawaii. See http://www.streamlinedsalestax.org/

[94] For example, Amazon dropped a 2011 referendum campaign in the State of California aimed at overturning state legislation that requires remote sellers to collect sales tax if they have affiliates or subsidiaries in the state in return for delaying its enforcement by one year.

activity currently done in the State can and will be done remotely in the future; this can impact on Hawaii business activity and other state tax collections.

- **Reductions in federal spending.** The federal budget deficit continues to be a major topic of conversation in Washington DC. Based on past failed budget negotiations and the 'fiscal cliff' that is now facing Congress, major reductions in federal spending would negatively impact Hawaii, given the size of the federal presence (primarily military) in the State. A major force reduction would reduce consumption and income-based taxes for the State.
- **Significant decline in tourism.** The State derives a significant amount of its revenue from taxes paid by visitors to the State. The State has experienced downturns in the industry from time to time – either because of broad based economic downturns or other related shocks (such as the events surrounding September 11, 2001). Given the reliance on these taxes for the state, these occurrences would have a significant impact on the State's revenues.

Structural Sustainability

Structural Sustainability

Exactly what constitutes revenue sufficiency is open to discussion and debate. As directed by the Tax Review Commission, this study is to provide "an analysis of whether the current tax system will provide sufficient revenues to meet near and long term future needs for the 21st Century." As a result, determining whether revenues are sufficient also requires an analysis of the near and long term needs for the State.

Spending Alternatives

States as a whole are facing daunting challenges that will place great financial pressure on the sector in the years to come. In some cases, the costs associated with prior commitments are quantifiable, and in other cases they are less concrete. The following identifies some key challenges where policymakers will have to determine their priority and funding commitment in the future.

Many spending decisions are predicated on making investments that will benefit the state's economy and its citizens. Some of these, related to infrastructure in need of replacement, are most likely going to have to be addressed regardless of the State's budget situation. Other obligations, like the state match for Medicaid funding, will be required because of federal mandate. Finally, state obligations related to pension and retire health care benefits are state legal obligations that will grow in importance as the population ages. In short, there are key issues that the State is likely going to have to address in the next twenty years, and it is likely that they will also impact on state tax policy and the state tax structure. The following address some – but by no means all – of these issue areas.

Schools and Infrastructure

It is generally accepted that the future of the economy will rely heavily on a strong education system. The jobs that are currently demanded by the local economy for tourism, construction and the service industries are generally low-wage and low-skill. Jobs for the 21st century will require innovative industries that apply technology at all levels as technology has fundamentally changed the way people live and thrive and conduct business on a daily basis.

Going forward, the State will need to account for future expenses and strategic investments in schools and infrastructure. According to a September 2011 study done with the Hawaii Institute for Public Affairs, there is a $392 million backlog in repair and maintenance to Hawaii schools alone and over 60 percent of schools are 50 years or older. Overall, aging schools, maintenance backlogs and predicted budget shortfalls will need to be addressed in the future year budgets.

In addition to schools, traditional public infrastructure investment for roads, water and sewer will also be in need of funding to maintain existing systems or build new ones. According to the American Society of Civil Engineer's Report Card for America's Infrastructure, the top three infrastructure needs in the State of Hawaii include Mass Transit, Roads and Schools.[95] The report noted that over 70 percent of Hawaii's interstate pavements are in poor to mediocre condition, and Hawaii had a $187 million backlog of deferred road maintenance as of 2007. These statistics, coupled with a 28 percent increase in vehicle travel on Hawaii highways between 1990-2007, make mass transit and roads a key issue that needs to be addressed to ensure adequate infrastructure for the 21st century.

With the distress and congestion of roads and traffic across the State, development of the Hawaii rail system will increase accessibility and mobility options, addressing a solution to one of the State's top infrastructure needs.

[95] http://www.infrastructurereportcard.org/state-page/hawaii

Rail Project Status, July 2012

HART

HART FACTS

July 9, 2012

HART CEO Dan Grabauskas answers community questions about rail transit.

QUESTION:

It seems like all large government projects have big cost overruns. What makes you think Honolulu's rail project will be any different?

DAN GRABAUSKAS:

Several notable mainland rail projects have come in on time and on budget. Dallas completed a $1.8 billion project, Seattle a $1.7 billion project and Vancouver, B.C. a $2.1 billion (CAD). I'm confident that Honolulu is just as capable of accomplishing this as any major city.

Visit **honolulutransit.org/rail-facts** for more information.

PROJECT REVENUE STATUS How much money is budgeted and has been received	Projections to Date	Collected or Committed to Date	Percentage (of projections)
REVENUE SOURCE:	(in millions)	(in millions)	
General Excise Tax (GET) Surcharge	$3,589	$859	23.9%
Federal New Starts Funds	1,550	120	7.7%
Other Federal Transportation Funds	214	4	1.9%
Interest Income	3	-	0.0%
TOTAL	$ 5,356	$ 983	18.3%

Comment: To date, HART has already received more than 18% of rail transit funding and is on track to meet revenue projections.

PROJECT COST STATUS End of April 2012	Current Budget	Amount Committed[1]	Amount Expended[2]
	(in millions)	(in millions)	(in millions)
Fixed Guideway/Track	$ 1,114	$ 509.74	0.10
Stations, Parking Facility, Elevators/Escalators	422	-	-
Maintenance Yard, Support Facilities	93	80.84	$ 2.73
Rail Vehicles and Systems	408	404.58	-
Sitework and Special Construction	981	453.28	158.60
SUB-TOTAL	$3,017	$1,448.44	$ 161.43
Real Estate/Right-of-Way	$ 197	$ 29.96	$ 26.96
Professional Services (e.g., Planning and Design)	1,090	550.39	240.29
Contingencies	644	-	-
Financing Costs	215	-	-
SUB-TOTAL	$2,146	$580.35	$267.25
TOTAL	$5,163	$2,028.79	$ 428.68

1 - Approved contract value. 2 - Portion of the work that has been paid for.

DID YOU KNOW? The cost of building the rail project will be paid off by the end of 2022. There will be no long-term debt.

Healthcare/Community Well-Being

The 2050 Hawaii Sustainability Plan[96] outlines unique qualities associated with the 'Aloha Spirit' that can be found throughout the State of Hawaii. The report identifies the qualities of the islands as they relate to a multi-cultural community that allows people to live with dignity and respect, and exceed the basic requirements of food, shelter, health care, safety and education. As outlined in the report, these include:

- Safe, caring and engaged communities
- Healthy and sustainable surroundings
- Quality job opportunities for present and future generations
- Access to quality education
- Housing and Health Care
- Adequate and well-maintained infrastructure and governmental services
- Access to recreational facilities and leisure activities
- Positive interaction and respect among citizenry

Needless to say, these goals will generally require both public and private investment, and it is an open question as to whether the growth rate assumptions built into the long range forecasts will be sufficient to meet these goals.

Energy and Import Independence

The cost of importing goods and services impacts Hawaii more than most states due to its isolation; the State is importing nearly 90 percent of goods and services.[97] Since 1977, the annual cost of importing oil has grown from $500 million to over $5 billion.[98] In light of this, it is encouraging that the US Department of Energy has ranked Hawaii among those states best positioned to expand renewable energy opportunities, based on abundant wind, solar, geothermal and other renewable energy resources.[99]

In 2008, the State signed a long-term Memorandum of Understanding (MOU) with the US Department of Energy to establish a partnership called the Hawaii Clean Energy Initiative. The partnership aims to have

[96] Hawaii 2050, Sustainability Task Force, State of Hawaii, January 2008.

[97] 2010 Abercrombie for Governor, "*A New Day in Hawaii*".

[98] Ibid.

[99] http://www.eere.energy.gov/

70 percent of all of Hawaii's energy needs generated by renewable energy sources by 2030[100] by helping Hawaii develop its renewable energy resources, including solar energy, wind power and bioenergy.

Sustainable Natural Resources, Agricultural Renaissance and Local Production/Sustainability
Despite Hawaii's plentiful agricultural land and year-round growing conditions, the State still imports more than 85 percent of food and has less than a 7-day supply of food in stores at any given time. Concerns about community food security, based on the food distribution system's vulnerability to major economic disruptions and environmental disasters have led to the formation of community groups and projects to promote stable and sustainable food production, local agricultural commerce and healthy lifestyles. Additional concerns surrounding the sustainability of local food production include:[101]

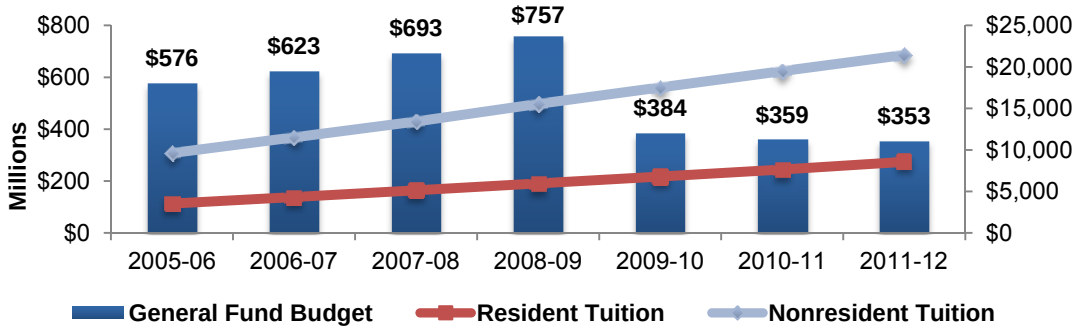
- Low availability and high price of locally grown food in markets and restaurants
- Stagnation of the local agricultural economy due to cheap imports
- Increasingly questionable food safety from imported foods of nearly untraceable origin
- Poor nutrition due to overconsumption of cheap processed foods
- Skyrocketing medical costs due to nutrition related non-communicable diseases

By investing in agriculture and producing more food on the islands, the State may be less vulnerable to economic disruptions, protect valued green space and agricultural lands, spur economic activity in the local economy and reduce the risk of invasive species and non-communicable diseases.

Higher Education
The University of Hawaii is not only the public system of higher education in Hawaii, but some would say the economic, social and cultural pillar of the Islands. The system includes 10 campuses and a number of educational training and research centers across the islands. Total enrollment at the University is over 60,000 undergraduate and graduate students.[102] According to the University's website, 85 percent of the students are residents of Hawaii, almost ten percent from the mainland or a US affiliate and 3.6 percent foreign with 1.4 percent unknown.

As the State continues to face tremendous pressure to reduce spending, it is likely that the traditional General Fund revenue streams going to fund public higher education will also decrease. This is a trend across the country, forcing these institutions to examine operations and maximize resources through cost and program reductions, alternative revenue sources such as research funding and endowments, and increase overall efficiencies. Below is a graphical illustration of the General Fund allocation to higher education in Hawaii, with an overlay of tuition costs for resident and nonresident students.

General Fund Allocation of Higher Education and Tuition Costs



[100] http://www.eere.energy.gov/
[101] http://hawaiihomegrown.net/
[102] http://www.hawaii.edu/about/

Development Incentives
In looking to broaden its economy, the State has undertaken significant efforts to support technology-related business and industry. A prominent example is the High-Technology Business Investment and Research Tax Credits, which were created in 1999 and expanded in 2001 to stimulate the growth and development of high technology industries in the State. It has been estimated that claims for these credits totaled nearly $858 million from tax years 1999 to 2010.[103] While the credits have sunsetted, eligible businesses have five years to claim the credits, and this will continue to impact the State budget in coming years. It is an open question whether this form of tax credit is the most effective method for advancing high-tech businesses and may have a significant impact on overall state tax policy.

Long Range Forecasting Model

To assist in understanding the State's financial position over time, the project team built a multi-year budget forecasting model that projects the State's General Fund revenues, expenditures and resulting financial results through FY 2025. While this does not encompass all of the State's revenues, it covers the vast majority – and it specifically addresses those that are available for appropriation to support general state operations and programs.

The forecasting model uses detailed historic information and management insight to produce a baseline financial projection. A baseline projection assumes maintaining the current level of service for existing programs (as well as any statutorily mandated changes) and the current tax and revenue structure (with any statutorily required changes) through FY 2025.[104] The baseline predicts what the State's financial results are likely to be in the future based on current information. Although the projections assume current service levels will continue, this does not mean that existing, higher or even lower levels of service are recommended. These are policy decisions for State legislators and policy makers. This analysis is undertaken only to estimate the fiscal gap if no major changes are made on either the revenue or expenditure sides of the budget. With that baseline projection in place, State officials and the public can examine choices on both the revenue and expenditure side of the budget to achieve defined outcomes, and the budget model can be adjusted accordingly to group decisions into multiple scenarios.

In constructing the model, historic revenue and expenditure data was provided by the Department of Budget and Finance, and the Council on Revenues General Fund forecasts were also used. Although these projections are on a cash basis, at the request of the TRC, the project team also modeled the financial results when presented on a full accrual basis. This version assumes the State will make pension and retiree health contributions sufficient to fully fund its pension and other post-employment benefit (OPEB) liabilities. Given the current pay-as-you go method of funding for OPEB, the cash-based projection was deemed the most appropriate for the purposes of this report. At the same time, the model can be run on an accrual basis. As the model will be turned over to the State at the end of the project, policymakers can examine this and other 'what if' scenarios in the future.

Based on historical information and interviews with State officials, the project team performed regression analysis against key economic variables for a number of the State's key tax revenue sources. The project team also calculated annual growth rates that project how the State's revenues and expenses will change going forward. In general, the model uses prudent, modestly conservative assumptions. This allows the State to benefit from better-than-anticipated results rather than depending on them to maintain fiscal health.

While the short-term forecasts (FY 2012-2015) are grounded in reasonably reliable statistical relationships among economic variables and tax collections, the longer-term projection (FY 2015-2025) is

[103] "Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits," Auditor, State of Hawaii, Report No. 12-05, July 2012, p. 20.

(understandably) less grounded in these statistical relationships. As in most any forecasting exercise, the degree of statistical confidence in the estimates declines over time.

For these later years, the model relies more heavily on the Department of Economic Development, Business and Tourism's (DBEDT) predicted long-term economic and population growth trends and less on forecasts derived from current economic conditions. The parameters in the model representing these factors were developed based on data trends and patterns and several generally accepted assumptions and predictions. As a result, the longer-term forecast should be viewed as more suggestive and less definitive than the three-year forecast. However, the longer-term forecasts should serve as a useful guide to policy makers and their general conclusions should prove reasonable barring a major unexpected change in economic or population trends.

In addition to the baseline, the project team built two additional scenarios to give the TRC a sense of the range of potential outcomes, using different revenue assumptions. It is important to note that the projection model is a simulation based on a reasonable (but not the only possible) set of assumptions. Any forecast of a gap between revenues and expenditures is not a definitive projected budget deficit, but a theoretical one based on the simulation. In fact, suggestions of a continually growing structural deficit (or surplus) should be tempered by the understanding that policymakers will react to the circumstances and close budget gaps (generally through a combination of revenue and expenditure changes) before a series of yearly deficits can compound themselves.

Given balanced budget requirements, Hawaii (as with most states)[105] is much different than the federal government – it must confront and balance its budget on a yearly basis. To assist with that possibility, the model develops alternate scenarios for changes to the State revenue structure to address any possible deficit. These scenarios can be grouped together as policymakers see fit to determine how they impact on the State's budget picture over time.

An argument can be made that the scenarios developed within the model address only the revenue side of the equation. It is true that most budget deficits are tackled on both the expenditure and revenue sides. At the same time, many of the obligations that will fuel expenditure growth during this timeframe – such as pension and health care obligations – do not readily lend themselves to a solution on the expenditure side. This is a reality that many states are facing – and it is reflected in the GAO model of state and local government budgets discussed in the previous chapter.

The bulk of this chapter will focus on the baseline scenario forecast. At the same time, assumptions in the alternative scenarios will also be discussed.

Revenue Projections

The **General Excise Tax** (GET) is the State's most important revenue source, accounting for 49 percent of General Fund revenues in FY 2011. For the past five years, the General Excise Tax has grown, interrupted by dips in revenue in FY 2009 and FY 2010. By FY 2011, revenue growth resumed at 7.7 percent. Over time, GET growth has tracked closely with Hawaii personal income growth.

The second largest source is the **Individual Income Tax** (IIT), made up 24.3 percent of the General Fund revenue. Unlike the General Excise Tax, over the past five years IIT revenue growth has been more volatile and sensitive to changes in the economy. However over the long term, historically IIT has also tracked closely to personal income growth.

For the GET and IIT projections, the project team retained the Council of Revenue's growth assumptions for the immediate term, while assuming growth in line with the DBEDT personal income growth forecast

[105] Vermont is the only one of the 50 states that does not have a statutory or constitutional annual balanced budget requirement, although the extent of the requirement varies widely among the states.

over the long-term. The projection mirrors the DBEDT's current economic forecast[106] of modest, sustained personnel income growth, with an upward adjustment to incorporate how these taxes typically change with changes in personal income.

Key Revenue Growth Rates[107]

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
General Excise & Use Tax	8.1%	5.8%	3.7%	6.5%	6.0%	5.6%	5.6%	5.6%	5.6%	5.5%	5.4%	5.4%	5.4%	5.4%
Individual Income Tax	23.6%*	6.8%	7.5%	7.6%	7.0%	3.1%	6.6%	6.6%	6.6%	6.5%	6.4%	6.4%	6.4%	6.4%
Total General Fund	**8.0%**	**4.9%**	**3.9%**	**5.7%**	**2.6%**	**4.1%**	**5.2%**	**5.2%**	**5.3%**	**5.2%**	**5.2%**	**5.2%**	**5.2%**	**5.3%**

**Increase attributable to onset of temporary tax deduction repeal and new caps on itemized deductions for high income earners.*

As the dominant sources of revenue in the General Fund, these two taxes have the greatest influence on the overall General Fund growth rate. The project team discussed key revenue growth rate assumptions with the TRC at its August 29, 2012 meeting; Commission members expressed concern with the annual growth rate assumptions for the IIT, suggesting that it was too high. While the assumption has not been changed in the model, this is a valid concern. A review of other state forecasts for IIT growth finds surveyed states generally expecting growth in the range of four to six percent. For the current year, the most recent state revenue analysis by the Rockefeller Institute of Government reported 4.7 percent average growth for the second quarter of 2012, after 4.7 percent average growth in the first quarter of 2012.[108]

For all other tax revenues, the project team retained Council on Revenues projections in the short-term, while using average historical growth and growth rates tied to DBEDT forecasts for the long-term.

- Like the GET and IIT, the **Conveyance Tax** grows along with personal income. Long-term forecasted growth rates range from 5.2 to 5.3 percent annually.
- As taxes that tend to rise with inflation, the **Public Service Company Tax, Tax on Insurance Premiums** and **Inheritance Tax,** grow in line with forecasted CPI growth, about 2.5 percent annually.
- The **Corporate Income Tax** and **Cigarette Tax**, which are sensitive to changes in economic growth, grow in line with forecasted nominal and real GDP growth respectively, about 4.0 and 2.4 percent per year.
- Taxes that tend to correlate with inflation and visitor arrival growth, the **Transient Accommodation Tax, Miscellaneous Taxes** and the **Liquor Tax,** are tied to DBEDT's CPI, GDP Deflator and Visitor Arrival growth forecasts. These increases range from 2.2 to 5.0 percent annually.
- Given the close relationship between construction activity and bank net income, the project team used historical average annual growth in the contracting tax base (since 1982) for the **Tax on Banks and Other Financial Corporations.**[109] This growth rate averages 2.3 percent.
- For **Fee and Charge Revenues**, which include Licenses and Permits, Revenues from Use of Money and Property, Charges for Services and Fines, Forfeits and Penalties, the project team

[106] As of DBEDT's 3rd Quarter 2012 Economic Outlook Report. Rates beyond 2015 are annual extrapolations of 10 year forecasts.
[107] Dips in the GET and IIT in FY2014 and FY2017 are due to the expiration of temporary IIT rate increases and suspended GET exemptions.

[108] Lucy Dadayan, "Growth in State Tax Revenues Continued in the Second Quarter of 2012," The Rockefeller Institute of Government, September 19, 2012, p.2.

[109] This tax had a negative result in FY2012 due to the transfer of proceeds to a non-General Fund escrow account. The projection in FY2013 and beyond assumes restoration of revenues to pre-FY2012 levels and a more typical growth pattern.

assumed growth in line with forecasted population growth. These sources tend to be less related to economic activity and more to the size of the served population.

- As **Federal Revenues** depend on decisions by the federal government and cannot be readily predicted, they are assumed to remain flat. As in other areas, the model can be adjusted to reflect State experience over time.
- For **Other Non-tax Revenues,** the project team retained Council on Revenue projections to incorporate State expectations about scheduled receipts of these revenues for the short-term and population growth forecasts in the long-term. These include Revenues from Other Agencies, Repayments of Loans and Advances, Non-revenue Receipts and Judicial Revenues.

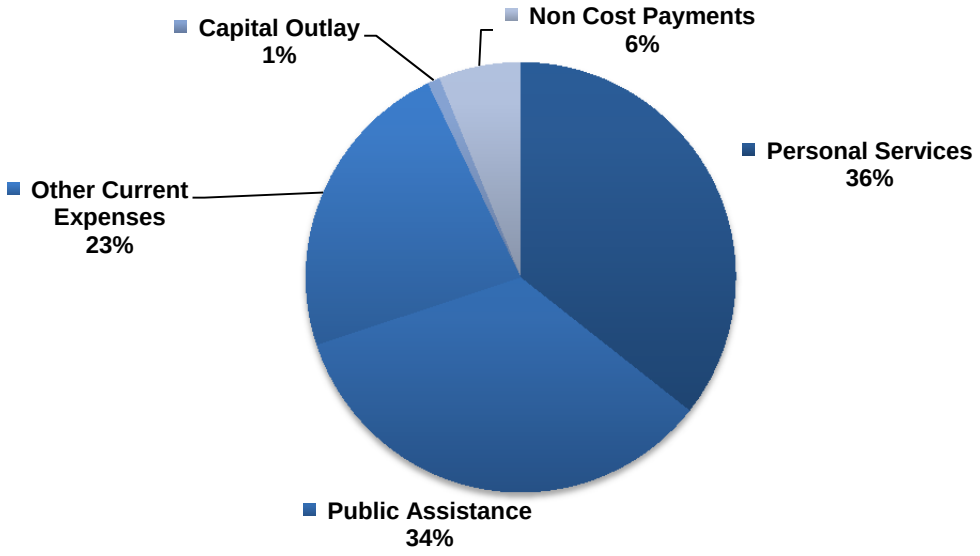
Although these revenue projections are generally conservative, the risk remains that the State's revenue performance will not be as strong as forecasted. The most significant risk appears to be the potential loss of federal revenue and spending cuts from the Budget Control Act of 2011. To address this risk, the project team devised an alternative set of revenue growth assumptions, which assumes federal budget cuts of 10 percent will be put in place in FY 2013. This results in federal revenues in the General Fund falling by 10 percent and economically sensitive revenue sources dropping roughly in proportion to the federal government's reduced contribution to Hawaii's personal income.

Another major risk is a slowdown in the State's economy. While the danger of another near-term national recession has diminished (but is still possible), Hawaii's unique island economy leaves it vulnerable to declines in the tourism industry. If tourism growth forecasts do not live up to expectations and related revenues fall short of expectations, the State's fiscal gap will widen. This event is incorporated into the 'pessimistic scenario' described in the section below.

Expenditure Projections

Hawaii's total expenditures have remained relatively stable over the last five years, declining 0.5 percent from FY 2007 to FY 2011. The major driver of this decline has been reduction in wages and public assistance payments, which were a combined 70 percent of total General Fund expenditures in FY 2011. This section highlights the State's major expenditures and cost drivers and provides a baseline expenditure projection – the forecast of future expenditures through FY 2025 under current trends and applicable laws.

Composition of General Fund Expenditures – FY 2011



Personal Services related costs associated with the State of Hawaii's workforce account for the single largest portion of General Fund spending, at 36 percent in FY 2011. From FY 2007 to FY 2011, personal service costs have decreased by 24.2 percent, largely due to salary and benefit concessions and an active effort to reduce the costs associated with the State workforce.

General Fund Expenditures, FY2007 - 2011

General Fund Expenditures	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	% Δ
Personal Services	$2,334,628,723	$2,093,216,553	$2,237,514,534	$1,915,259,245	$1,769,883,852	-24.2%
Public Assistance	$1,300,092,659	$1,354,773,937	$1,361,546,674	$1,402,592,703	$1,702,517,197	31.0%
Other Current Expenses	$964,702,328	$1,490,460,142	$1,437,742,498	$1,199,544,615	$1,141,619,821	18.3%
Capital Outlay	$63,270,616	$107,132,022	$130,756,551	$57,488,754	$46,727,203	-26.1%
Non Cost Payments	$330,681,788	$395,205,867	$352,582,839	$303,278,487	$307,056,737	-7.1%
Total Expenses	**$4,993,376,112**	**$5,440,788,521**	**$5,520,143,097**	**$4,878,163,804**	**$4,967,804,809**	**-0.5%**

The project team analyzed historical salary adjustments across all bargaining units and calculated a weighted annual average increase of 3.21 percent as a baseline forecast going forward. In addition to the baseline forecast, the project team used a forecasting methodology based on average annual salary and the number of FTEs by individual bargaining units to determine the impact of restoration of salaries to FY 2009 levels occurring in FY 2014 for bargaining units which experienced reductions between FY 2009 and FY 2014. The project team indexed growth in wages beginning in FY 2014 to FY 2009 wages and salaries. The result is a significantly above average growth rate for a number of bargaining units, particularly those that experienced prior wage and benefit concessions. For all other bargaining units, a four percent assumed annual increase going forward was used.

Public Assistance Payments (largely Medicaid) was the second largest expenditure category in FY 2011, accounting for $1.7 billion in costs, or 34 percent of total General Fund spending. Since FY 2007, this category has seen a 31 percent increase in spending, the largest of the five main categories displayed above. For the baseline projection, the project team used budgeted increases in the FY2011–2013 executive biennium budget and the latest FY 2014-2017 projections from the Department of Human Services, which include the estimated cost of Affordable Care Act compliance. For FY 2018 and beyond, the project team included initiatives for future growth in Medicaid based on two historical periods using the Department of Taxation's tax adequacy report from February 2012. In the baseline projection, growth is projected at 9.4 percent, the historical annual average from FY 1968 to FY 2011. For the low end projection, the project team used the average growth rate in expenditures from FY 2006 to FY 2011 (5.9 percent).[110]

Debt Service is also a significant expenditure, totaling $419.4 million, or 8.4 percent of General Fund spending in FY 2011. Since 2007, debt service payments have decreased by 23.2 percent as the State retired existing debt while foregoing new issues. Since then, the State Legislature has approved new bond issuances for FY 2013 through FY 2015, ranging from $700 million to $850 million per year. The associated debt service for these issuances was incorporated into the model projections.

The project team assumed the State will continue to issue debt for capital investments throughout the balance of the projection period. After discussions with officials at the Department of Budget and Finance, beginning in FY 2017, the project team assumed $1 billion of new debt issuance every two years with an average coupon rate of 5.25 percent and a 20 year term. It is likely that these amounts would be sufficient to finance necessary capital expenditures and infrastructure investments over the next 13 years.

[110] "Will Hawaii's Tax Structure Prove Adequate in the Future?", Hawaii Department of Taxation, February 2012, page 16

In other expenditure areas, based on analysis of the data provided by the State, significant volatility exists within a number of categories. In order to mitigate this volatility, the project team used a combination of growth rates, as described below:[111]

- ***Flat Growth (0%)*** was assumed in areas of significant decline in spending or where incomplete historical data was available. Rather than assume significant additional decline in spending based on incomplete data or variance in year to year cost, in these cases, the project team carried forward FY 2011 values.
- ***State CPI vs. Total Personal Income (TPI) Forecast.*** The Budget Model allows for the option to assume expenditures will grow at the rate of CPI or TPI growth. The default option is CPI. For CPI, in order to accurately reflect the unique economy of Hawaii, the project team used the regional Consumer Price Index rather than the national Consumer Price Index for urban areas (CPI-U) chained or CPI-U for the West Urban, which encompasses all West Coast and Midwestern states. For growth in TPI, the project team used growth rates estimated by the Department of Taxation.

State CPI vs. TPI Forecast: FY 2012 – FY 2015[112]

Fiscal Year	2012	2013	2014	2015
Honolulu CPI	2.80	2.60	2.50	2.50
TPI	4.30	4.80	5.20	5.00

- ***Other State Provided Forecasts***. In areas where growth or decline is currently known or forecasted with reasonable confidence (i.e. health benefits, pension contributions and current debt service), the project team used those forecasts.
- ***Blended Average Annual Growth Rate / Compound Annual Growth Rate.*** For expenses with similar average annual growth (AAG) and compound average growth rates (CAGR), these were determined using a blended average of the two measures.

[111] For a compilation of all growth rates used, please refer to Appendix C.
[112] Based on 3rd Quarter Forecast published by Hawaii's Department of Business, Economic Development and Tourism. Rates beyond FY 2015 were calculated by an extrapolation from DBEDT's 2040 Long Range Population and Economic Projections.

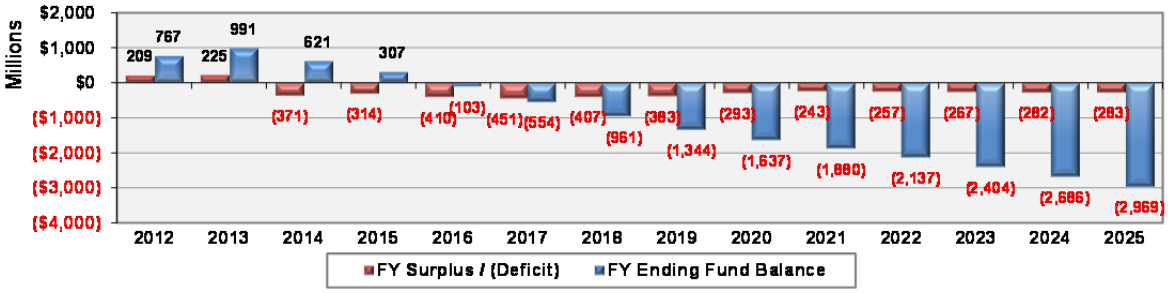
Sustainability Forecast

Baseline Projections

Based on analysis of data provided by the State, current and future economic conditions and input from State agencies, the project team developed a baseline projection for revenues and expenditures going forward to FY 2025. While the short-term forecasts (FY 2012-2015) are grounded in reasonably reliable statistical relationships among economic variables and tax collections, the longer-term projection (FY 2015-2025) is subject to greater variability.

As shown in the chart below, the baseline model forecasts a series of annual budget gaps reaching $283 million by FY 2025 if no corrective action is taken.[113]

FY 2012 – FY 2025 General Fund Budget Projections: Baseline Scenario



By FY 2025, the two major cost drivers – personal services and public assistance – will total $3.1 billion and $5.7 billion, respectively. Based on current financial plan assumptions of full restoration of staffing, wages and salaries to FY 2009 levels, projected growth in wages and salaries will see a significant annual increase beginning in FY 2014.

Pension Funding Issues

Across the nation, there is a growing awareness of the magnitude of future public pension and retiree health benefits obligations. The enhanced accounting and financial reporting rules for disclosure surrounding the Governmental Accounting Standards Board (GASB) approved Statements 67 and 68 will be an important issue in coming years. As part of these rules, employers that sponsor a pension plan must begin reporting pension liabilities and costs under the new standards in FY 2015 in a way designed to reflect a more complete representation of the full impact of pension liabilities. This expanded disclosure, and perhaps even more extensive disclosure will be necessary for the State of Hawaii, given recent comparability metrics released by Fitch in March 2012.[114] According to Fitch's new liability metrics, which measure each state's net tax-supported debt combined with the unfunded actuarial accrued liabilities (UAAL) in its major pension system against the state's wealth base (expressed as personal income), Hawaii's 25.8 percent metric was the worst of the 43 states rated.

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.[115] While legislative changes and improved investment performance resulted in an improved outlook from the 2010 to 2011 report, the future outlook of ERS is still a matter of serious concern.

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[113] Baseline model growth rates and projections are available in Appendix D.

[114] www.fitchratings.com

[115] https://ers.ehawaii.gov/wp-content/uploads/2012/03/2011Valuation.pdf

It should be noted that Acts 152 and 153, Laws of 2012 address contribution rates and funding issues. Among the changes included in these bills are changes to the definition of final average salary for those who become members of the ERS as of July 1, 2012. For these employees, average final salary will not include overtime, supplementary payments, bonuses, lump sum salary supplements, allowances, or differentials.[116] While these changes will help reduce obligations for those employed after July 1, 2012, it does not address funding issues for those employed prior to that date. The State will need to continue its efforts to contain and begin to fund the unfunded liability while also adjusting its assumptions to recent market conditions.

Pension projections are based on scheduled employer contributions as a percentage of payroll, as established by the Legislature. According to an actuarial valuation conducted in July 2011 by Gabriel, Roeder, Smith & Company (GRS), between FY 2008 and FY 2011, actual contributions to the Employees' Retirement System (ERS) increased from $488.8 million to $534.9 million, or 9.4 percent. These amounts include contributions by the State's counties in addition to the State itself. During this time period, the ERS was 99.6 percent funded, with underfunding occurring in FY 2008 and FY 2011 and overfunding occurring in FY 2009 and FY 2010.

Schedule of Employer Contributions (including counties): FY 2008 – FY 2011[117]

Fiscal Year	Annual Required Contribution ($000s)	Actual Contribution ($000s)	% Contributed
2008	$510,727	$488,770	95.7%
2009	$526,538	$578,635	109.9%
2010	$536,237	$547,613	102.1%
2011	$582,535	$534,858	91.8%
Total	**$2,156,037**	**$2,149,876**	**99.7%**

The actuarial analysis determined that the assumed return on investment should be lowered to 7.75 percent from the current 8 percent assumption, despite strong earnings in the years following the severe economic downturn in FY 2009.[118] Based on this analysis, the current unfunded actuarial accrued liability of the system stands at $8.154 billion.[119] It is notable that Moody's Investor Services has proposed using a lower assumed return on investment for analyzing state and local government reported pension data. Under the proposed adjustments, the assumed rate of return would be set at 5.5 percent and, in the future, tie the rate of return to a high-grade corporate bond index.[120] This change, as well as other proposed changes, would, if implemented, further reduce the ERS funded ratio in Moody's calculations.

In the model, State pension contributions fluctuate with forecasted payroll and scheduled increases in contribution percentages. The following table and chart shows growth in employer contributions between FY 2012-2018:

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116 "Pensions and Retirement Plan Enactments in 2012 State Legislatures," National Conference of State Legislatures, August 31, 2012, pp. 4, 10,

117 "Employee's Retirement System of the State of Hawaii: Report to the Board of Trustees on the 86th Annual Actuarial Evaluation for the Year Beginning June 30, 2011", Gabriel Roeder Smith & Company, page 42.

118 Ibid, page 2.

119 Ibid

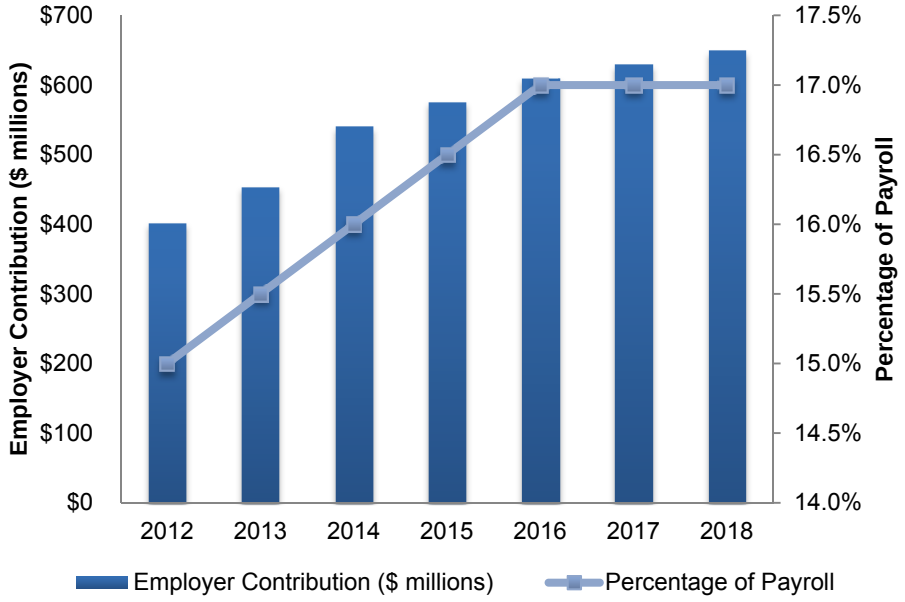
120 "Proposed Adjustments to US State and Local Government Reported Pension Data," Moody's Investors Service, July 10,, 2012, p.12.

Employer Contribution Rate (%)

Fiscal Year	2012	2013	2014	2015	2016	2017	2018
Employer Contribution ($ millions)	$402	$453	$540*	$576	$609	$629	$649
Percentage of Payroll	***15.0%***	***15.5%***	***16.0%***	***16.5%***	***17.0%***	***17.0%***	***17.0%***

**Increase attributed to assumed restoration of wages and headcount to FY2009 levels in FY 2014.*

Growth in Employer Contributions, FY 2012 - 2018



At the current funded ratio of 59.4 percent and the assumed return on investment of 7.75 percent, the pension system will not be fully funded until FY2036.[121]

The project team also used actuarially forecasted growth in employer contributions assuming a 5 percent[122] annual investment return to create an alternative contribution projection. If the pension trust fund earns 5 percent for the next decade (FY 2013-FY 2022) based on the market value of assets as of June 30, 2012, the employer contribution would increase slowly each year to approximately 18.25 percent in FY 2023. The funding period as of June 30, 2022 would be approximately 35 years based on the currently expected 17 percent contribution rate.[123] Growth in employer contributions under this scenario is illustrated in the following table:

Employer Contribution Rate (%) Assuming 5% Investment Return*

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
15.0	15.5	16.0	16.5	17.0	17.0	17.0	17.0	17.3	17.6	17.9	18.3	18.3	18.3

**Preliminary projections, subject to change*

[121] Ibid, Table 9c, page 39.
[122] An analysis based on a 4.5 percent return assumption was requested but not available at the time of publication.
[123] Based on information provided by Hawaii Employee Retirement System and GRS.

Health Insurance

Health insurance projections are derived from growth projections by the Employer-Union Health Benefits Trust Fund (EUTF). Historically, health insurance has been a major cost driver, growing 20.9 percent from FY 2008 to FY 2011. At 9 percent of the General Fund (FY 2011), it also has a significant impact of the State's financial position. Going forward, medical premium costs are expected to grow at 8 percent per year, prescription drug premiums are expected to rise 6 percent annually, while dental premiums grow at 4 percent and vision at 2 percent.

In addition, the project team assumed retiree health benefit subscriber growth of 3 percent per year to capture recent growth in state government retirements. This assumed subscriber growth represents the average annual growth in the number of state retirees and pension beneficiaries since 2000.

With a restoration of wages, benefits and staffing to FY 2009 levels occurring in FY 2014, a significant increase occurs in health care costs – 14.38 percent – and then returns to growth rates more in line with historical growth and projections in the following years.

Projected Health Insurance Growth Rates (%)

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
5.05	4.45	14.38*	9.09	8.60	8.67	8.72	8.78	8.84	8.89	8.94	8.99	9.04	9.09

**Increase attributable to assumed restoration to FY2009 staffing levels.*

Accrual Accounting Method of Calculating the Fiscal Gap

It is generally recognized that the State has a significant unfunded liability related to its pension system and retire health insurance benefits. Accrual accounting methods generally report these liabilities when incurred, as opposed to a cash method, which reports expenditures when they occur. The Governmental Accounting Standards Board (GASB) promulgates accounting rules for public sector entities, and it uses a modified form of accrual accounting that recognizes that public and private sector entities are different and their accounting standards should reflect those differences. Under modified accrual basis accounting, revenues are considered available when collectible either during the current period or after the end of the current period but in time to pay year-end liabilities, and expenditures are recognized when a transaction or event is expected to draw upon current spendable resources rather than future resources. As a consequence, future pension and retiree health care liabilities are not included in determining the balance in a fiscal year. However, as previously noted, GASB is moving toward broader reporting requirements for state and local governments beginning in 2015. As a result, it is useful to understand the implications this will have on the State's financial statements.

At the request of the TRC, the model includes an alternate scenario assuming the State recognizes the full cost of retiree benefits in FY 2013, including the projected cost of current retiree benefits and an amortization of the unfunded actuarial liability. This projection assumes a 4 percent investment return[124] and would require a substantial increase in funding for retiree health benefits each year. Growth in later years would moderate as the unfunded liability is reduced.

Projected Health Insurance Growth Rates – Full OPEB Cost (%)

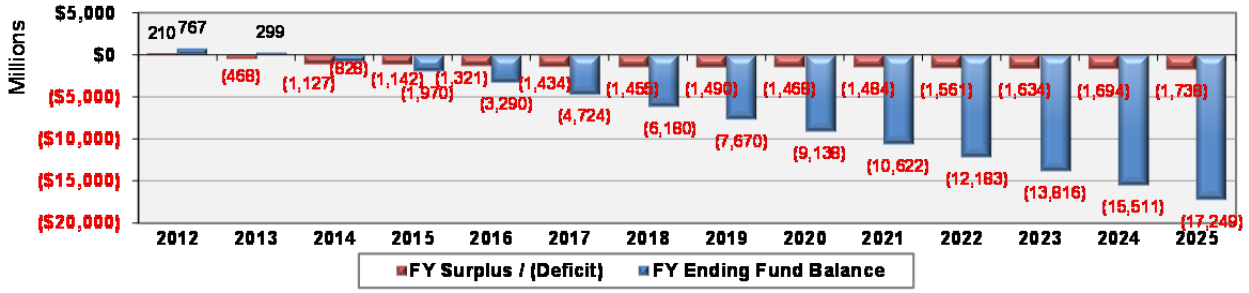
2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
5.04	153.81*	11.34	9.35	9.38	8.23	7.51	7.02	6.62	6.45	6.22	6.19	6.05	5.99

**First year of covering full OPEB cost.*

[124]An analysis based on a 4.5 percent return assumption was requested but not available at the time of publication.

The following presents these assumptions on an accrual basis, with pension and retiree health contributions sufficient to fully fund the State's OPEB and pension liabilities. As can be expected, under this approach, the fiscal gap is considerably worse, as shown in the following graph:

FY 2012 – FY 2025 General Fund Budget Projections:
Accrual Basis Scenario – Full Pension and OPEB Liability



Alternate Scenarios

Alternate scenarios were developed to show the State's projected revenues and expenditures under an optimistic and a pessimistic forecast. Consistent with the results seen under the baseline scenario, a gap between projected expenditures and revenues also exists in each of these alternative scenarios through FY 2015. However in the optimistic scenario, the State returns to fiscal balance beginning in FY 2016. This section discusses the revenue and expenditure assumptions in each of the alternative model scenarios.

Optimistic Scenario

This assumes more robust economic growth than the baseline. It assumes that the State experiences an economic upturn similar to the one that occurred in the mid-2000s. The forecast should be considered optimistic and unlikely. This alternative scenario could more appropriately be viewed as the State following a sustained, steady economic recovery from the recent economic downturn. This scenario provides an upper boundary for the local revenue outcome and assumes increased tourism and convention activity in Hawaii for the entire projection period.

Revenue projections are based on the two strongest years of growth in Hawaii's economy in the last ten years – 2005-2006. Over the longer term, the scenario assumes 6.5 percent personal income growth, affecting the more economically sensitive revenue sources (GET, IIT and Conveyance Tax). This is the personal income growth percentage used in the 'high growth scenario' of the Department of Taxation's February 2012 tax adequacy report.[125] In addition, nominal and real GDP growth is assumed to be one percentage point higher than the baseline scenario, affecting the Corporate Income Tax and Cigarette Tax. Revenue growth for all other sources is the same as the baseline scenario. The projected revenue growth rate increases under this scenario are shown in the following table:

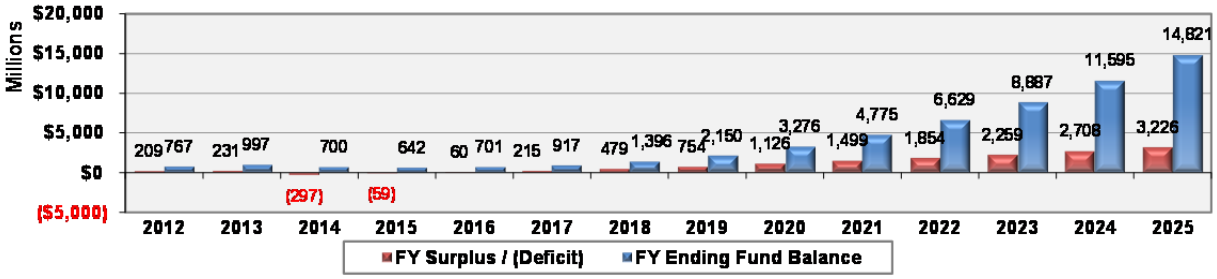
[125] Joshua Fujino and Donald Rousslang. "Will Hawaii's Tax Structure Prove Adequate in the Future?" Tax Research and Planning Office, Hawaii Department of Taxation. February 10, 2012.

Projected Revenue Growth Rates:
Optimistic Scenario

Growth Rate Name	2012	2013	2014	2015	2016	2017	2018
General Excise and Use Tax	8.1%	5.6%	-0.4%	1.6%	4.4%	4.1%	4.1%
Individual Income Tax	23.6%	6.7%	2.5%	1.8%	5.1%	0.9%	4.8%
Corporate Income Tax	111.2%	4.1%	3.7%	3.7%	3.3%	3.0%	3.0%
Public Service Company Tax	27.0%	2.7%	2.6%	2.5%	2.5%	2.5%	2.5%
Tax on Insurance Premiums	-13.4%	2.7%	2.6%	2.5%	2.5%	2.5%	2.5%
Cigarette and Tobacco Tax	-5.4%	24.8%	-14.1%	1.4%	1.4%	1.4%	1.4%
Liquor Tax	1.7%	3.9%	2.5%	2.2%	1.8%	1.5%	1.5%
Tax on Banks and Other Financial Corps.	-102.7%	-3590.3%	1.2%	4.8%	3.3%	2.6%	2.5%
Inheritance and Estate Tax	104.7%	2.7%	2.6%	2.5%	2.5%	2.5%	2.5%
Conveyance Tax	-14.6%	-9.4%	-25.1%	1.5%	4.1%	3.8%	3.8%
Miscellaneous Taxes	331.9%	-77.5%	0.1%	-26.0%	-92.8%	-3.9%	-4.1%
Transient Accommodations Tax	111.4%	8.8%	5.6%	5.1%	-100.0%	3.4%	3.4%
Licenses & Permits	-26.0%	9.4%	1.0%	-80.8%	0.9%	0.7%	0.7%
Revenues from Use of Money and Property	13.9%	-2.7%	-3.2%	-3.7%	-3.7%	0.7%	0.7%
Federal	-65.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Revenues from Other Agencies	77.8%	9.8%	-41.6%	0.0%	-84.4%	0.0%	0.0%
Charges for Current Services	-14.6%	4.1%	1.4%	1.2%	1.1%	0.7%	0.7%
Fines, Forfeits & Penalties	-9.0%	6.9%	-6.5%	6.9%	-6.5%	0.7%	0.7%
Repayment of Loans & Advances	-4.3%	-10.8%	0.1%	3.3%	-2.9%	0.7%	0.7%
Non-Revenue Receipts	-52.2%	-6.1%	3.9%	1.1%	1.1%	1.1%	0.7%
Judiciary	-6.9%	1.7%	1.8%	1.8%	1.8%	1.8%	0.7%
Total General Fund	**8.0%**	**4.8%**	**0.5%**	**1.6%**	**0.9%**	**2.6%**	**3.8%**

The financial results of this scenario are shown in the following chart:

FY 2012 – FY 2025 General Fund Budget Projections:
Optimistic Scenario



Under these assumptions, the gap between revenues and expenditures starts at $297 million in FY 2014. After this brief deficit, surpluses return in FY 2016 at $60 million and could potentially rise to $3.2 billion by FY 2025.

Pessimistic Scenario

The pessimistic forecast assumes that the State experiences an economic downturn similar to the one that occurred in the latter part of the previous decade in 2014 and 2015, largely driven by a decline in tourism activity. As a consequence, revenue projections are based off the two weakest years of growth in

Hawaii's economy in the last ten years – 2009-2010. On a long term basis, it assumes personal income growth, and by extension all tax revenues tied to it, will be 3.2 percent. This is the personal income growth percentage used in the 'low growth scenario' of the Department of Taxation's February 2012 tax adequacy report.[126] Nominal and real GDP growth is assumed to be one percentage point lower than the baseline scenario, affecting the Corporate Income Tax and Cigarette Tax. Revenue growth for all other sources is the same as the baseline scenario. The projected revenue growth rates increases under this scenario are shown in the following table:

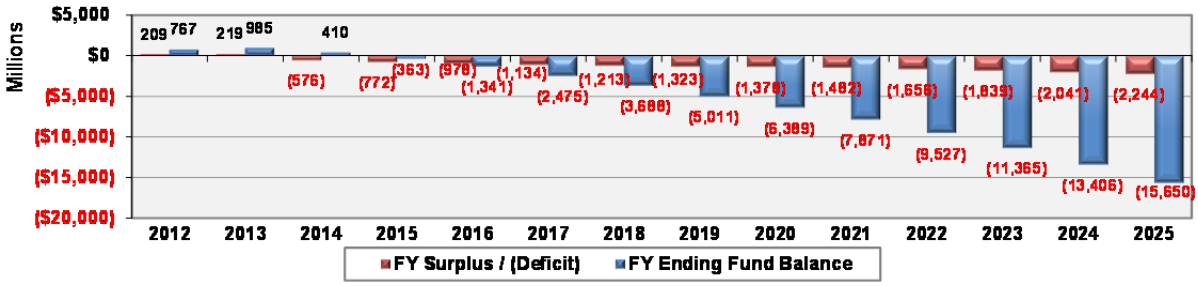
Projected Revenue Growth Rates:
Pessimistic Scenario

Growth Rate Name	2012	2013	2014	2015	2016	2017	2018
General Excise and Use Tax	8.1%	5.6%	-0.4%	1.6%	4.4%	4.1%	4.1%
Individual Income Tax	23.6%	6.7%	2.5%	1.8%	5.1%	0.9%	4.8%
Corporate Income Tax	111.2%	4.1%	3.7%	3.7%	3.3%	3.0%	3.0%
Public Service Company Tax	27.0%	2.7%	2.6%	2.5%	2.5%	2.5%	2.5%
Tax on Insurance Premiums	-13.4%	2.7%	2.6%	2.5%	2.5%	2.5%	2.5%
Cigarette and Tobacco Tax	-5.4%	24.8%	-14.1%	1.4%	1.4%	1.4%	1.4%
Liquor Tax	1.7%	3.9%	2.5%	2.2%	1.8%	1.5%	1.5%
Tax on Banks and Other Financial Corps.	-102.7%	-3590.3%	1.2%	4.8%	3.3%	2.6%	2.5%
Inheritance and Estate Tax	104.7%	2.7%	2.6%	2.5%	2.5%	2.5%	2.5%
Conveyance Tax	-14.6%	-9.4%	-25.1%	1.5%	4.1%	3.8%	3.8%
Miscellaneous Taxes	331.9%	-77.5%	0.1%	-26.0%	-92.8%	-3.9%	-4.1%
Transient Accommodations Tax	111.4%	8.8%	5.6%	5.1%	-100.0%	3.4%	3.4%
Licenses & Permits	-26.0%	9.4%	1.0%	-80.8%	0.9%	0.7%	0.7%
Revenues from Use of Money and Property	13.9%	-2.7%	-3.2%	-3.7%	-3.7%	0.7%	0.7%
Federal	-65.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Revenues from Other Agencies	77.8%	9.8%	-41.6%	0.0%	-84.4%	0.0%	0.0%
Charges for Current Services	-14.6%	4.1%	1.4%	1.2%	1.1%	0.7%	0.7%
Fines, Forfeits & Penalties	-9.0%	6.9%	-6.5%	6.9%	-6.5%	0.7%	0.7%
Repayment of Loans & Advances	-4.3%	-10.8%	0.1%	3.3%	-2.9%	0.7%	0.7%
Non-Revenue Receipts	-52.2%	-6.1%	3.9%	1.1%	1.1%	1.1%	0.7%
Judiciary	-6.9%	1.7%	1.8%	1.8%	1.8%	1.8%	0.7%
Total General Fund	**8.0%**	**4.8%**	**0.5%**	**1.6%**	**0.9%**	**2.6%**	**3.8%**

The financial results of this scenario are shown below:

[126] Joshua Fujino and Donald Rousslang. "Will Hawaii's Tax Structure Prove Adequate in the Future?" Tax Research and Planning Office, Hawaii Department of Taxation. February 10, 2012.

FY 2012 – FY 2025 General Fund Budget Projections: Pessimistic Scenario



Under these assumptions, the gap between revenues and expenditures starts at $576 million in FY 2014 and grows to $2.2 billion by FY 2025.

Summary

Based on current projections for major revenue sources, expenditure drivers and planned initiatives, the State is facing significant structural deficits in the baseline scenario as well as the accrual-based alternative. The restoration of wages to 2009 levels in FY2014, the growing cost of public assistance programs and health benefits for both active and retired are major factors in these structural deficits. Moreover, if the economy continues to lag or remain as it currently stands, it will increase these gaps significantly.

As specific policy decisions are weighed and selected in the model, it will have a direct impact on the forward projections. The project team factored in data, projections and recommendations provided by key stakeholders, particularly staff from the Department of Taxation, Council on Revenues, and other invested state agencies. The result of this collaborative effort is fluid and subject to change, based on the availability of more accurate data and input from key stakeholders.

The model prepared for this study can be used to test alternate scenarios on both the revenue and expenditure side of the budget. In this respect, the report may be seen as a 'point in time analysis' that can be modified through the model to analyze alternate scenarios or track actual performance in the coming years.

Revenue Alternatives

Revenue Alternatives

Tax Policy Principles

There are sometimes widely diverging opinions on what constitutes good tax policy, and in many instances, politics and self-interest enter into the discussion. Various resources examine the issues surrounding tax policy principles in a relatively neutral fashion, and it is useful to review them. The National Conference of State Legislatures (NCSL) represents all 50 state legislatures and provides valuable technical and policy guidance to its members. NCSL has published a frequently-cited list of the "Principles of a High-Quality State Revenue System." Their principles are:[127]

1. A high-quality revenue system comprises elements that are complementary, including the finances of both state and local governments.
2. A high-quality revenue system produces revenue in a reliable manner. Reliability involves stability, certainty and sufficiency.
3. A high-quality revenue system relies on a balanced variety of revenue sources.
4. A high-quality revenue system treats individuals equitably. Minimum requirements of an equitable system are that it imposes similar tax burdens on people in similar circumstances, that it minimizes regressivity, and that it minimizes taxes on low-income individuals.
5. A high-quality revenue system facilitates taxpayer compliance. It is easy to understand and minimizes compliance costs.
6. A high-quality revenue system promotes fair, efficient and effective administration. It is as simple as possible to administer, raises revenue efficiently, is administered professionally, and is applied uniformly.
7. A high-quality revenue system is responsive to interstate and international economic competition.
8. A high-quality revenue system minimizes its involvement in spending decisions and makes any such involvement explicit.
9. A high-quality revenue system is accountable to taxpayers.

From the perspective of tax preparers, the American Institute of Certified Public Accountants has published a Tax Policy Concept Statement that outlines their guiding principles for good tax policy. In many respects, it aligns well with the NCSL principles:[128]

1. **Equity and fairness**. Similarly situated taxpayers should be taxed similarly.
2. **Certainty.** The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.
3. **Convenience of Payment**. A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.
4. **Economy in Collection**. The costs to collect a tax should be kept to a minimum for both the government and taxpayers.
5. **Simplicity**. The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

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[127] National Conference of State Legislatures, "Principles of a High-Quality State Revenue System, Fourth Edition, June 2001.

[128] "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals," American Institute of Certified Public Accountants, 2001, p. 9-10.

6. **Neutrality.** The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.
7. **Economic Growth and Efficiency**. The tax system should not impede or reduce the productive capacity of the economy.
8. **Transparency and Visibility**. Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
9. **Minimum Tax Gap**. A tax should be structured to minimize noncompliance.
10. **Appropriate Government Revenues**. The tax system should enable the government to determine how much tax revenue will likely be collected and when.

The United States General Accountability Office (GAO) has also weighed in on tax policy principles. According to the GAO, '"long-standing" criteria for evaluating tax policy are:[129]

1. **Equity** – including principles of ability to pay (both horizontal and vertical equity) and benefits received.
2. **Economic Efficiency**
3. Combination of **simplicity** (compliance burden), **transparency** (in tax calculations, logic behind rules, tax burden and compliance), and **administratability** (processing returns, enforcing the law, providing taxpayer assistance.

It is also useful to compare principles among groups with differing political views on tax policy. The Tax Foundation, generally considered a conservative-leaning organization, lists the following as its "Ten Principles of Sound Tax Policy:"[130]

1. Transparency is a must
2. Be neutral
3. Maintain a broad base
4. Keep it simple
5. Stability matters
6. No retroactivity
7. Keep tax burdens low
8. Do not inhibit trade
9. Ensure an open process
10. State and local taxes matter

The Institute on Taxation and Economic Policy, generally considered a liberal-leaning organization, has published their own assessment. They identify the following as the building blocks of a sound tax system:[131]

1. Maintain vertical equity (tax systems should not be regressive)
2. Maintain horizontal equity (taxpayers in similar circumstances should pay similar amounts of tax)

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[129] "Factors for Evaluating Expiring Tax Provisions," US General Accountability Office, GAO-12-760T, June 8, 2012, p.4-6..

[130] The Tax Foundation, "Ten Principles of Sound Tax Policy,: http://www.taxfoundation.org

[131] The Institute on Taxation and Economic Policy, "Tax Principles: Building Blocks of a Sound System," p. 1-2.

3. Adequacy (raises enough funds to sustain the level of services demanded by citizens)
4. Simplicity
5. Exportability (individuals and businesses from other locations that enjoy public services should help pay for them)
6. Neutrality (tax system should stay out of the way of economic decisions)

Finally, several studies of state tax structures have devised their own set of guiding principles. For example, the State of Washington conducted a legislatively-required study in 2004 of the state's tax structure based on articulated tax principles. The final report identified these principles as:

Adequacy/Stability/Elasticity: A good tax system is expected to generate sufficient revenue to pay for established public services without the need for continuous or drastic changes in tax rates or in the tax base.

Equity/Fairness: A good tax system should distribute the tax burden across taxpayers in a manner that is consistent with the accepted norms of fairness and equity. These norms typically define fairness according to the relationship between the amount of taxes paid (or borne) by taxpayers and their respective abilities to pay the tax, or to the benefits received by them from government programs. Three widely-accepted norms of fairness considered by the Committee are:

- Vertical Equity. This principle of fairness requires that the amount of tax paid by taxpayers with different income levels should reflect their respective abilities to taxpayers with different income levels should reflect their respective abilities to pay the tax. Specifically, taxes paid as a percentage of income should not unduly burden taxpayers with limited ability to pay the tax. Some would view this principle as satisfied by a proportional tax burden, where taxes paid are the same percentage of income for taxpayers at all income levels. Others believe that the principle requires that taxes paid as a percentage of income should be higher for taxpayers with more income than those with less income (a progressive tax burden). To our knowledge, almost no one believes that taxes paid should be a higher percentage of income for less affluent taxpayers than for those with more income (a regressive tax burden).
- Benefits Received. A tax may be considered fair if the taxes paid are matched by benefits received by a taxpayer from the government. This principle is most relevant when a tax is levied specifically for the purpose of providing a particular government service to a specific group of taxpayers. Such "benefit taxes" are impractical for much of government spending because the "benefits" received cannot be determined for each taxpayer. Therefore, this principle is relevant mainly for certain types of selective excise taxes which act like user fees, such as the motor vehicle fuel tax. It also applies to taxes that have much in common with insurance premiums, such as employment security and industrial insurance taxes.
- Horizontal Equity. According to this principle, taxpayers with similar abilities to pay a tax should pay comparable amounts of the tax. More generally, the principle of horizontal equity enjoins the government from levying taxes that have arbitrary and peculiar distributions of tax burdens across taxpayers or from levying dissimilar tax burdens on taxpayers that are not justified by differences in their ability to pay or by distinctions in the benefits they receive from government programs.

Economic Vitality and Harmony with Other States: A good tax system should not place business enterprises located within the state at a competitive disadvantage relative to similar enterprises located in other states.

Economic Neutrality and Efficiency: A good tax system should not distort economic decisions. Distortions cause a measurable loss in the economic value of production and consumption, which

increases the tax burden on the residents of the state. There are two important methods for minimizing the burden on state residents of raising a given amount of state tax revenue:

Transparency and Administrative Simplicity: People should know when they pay taxes and how much they pay. A good tax system is designed to ensure that the tax burdens on residents are clear and evident. The rules, record-keeping and computation requirements should be simple enough that the tax system can be administered at low cost by the tax collection agency without imposing an undue compliance burden on the taxpayer.

Home Ownership: The tax system should facilitate, or at least not impede, the ability of individuals and families to purchase and maintain a home consistent with their standard of living.

Summary from the Various Approaches

While there is some variation in the terminology, there are some principles that emerge where there is close to complete agreement among the cited sources. These principles are:

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

The analysis that follows will reference these key principles.

Interaction of Principles

While the general principles of taxation are logical – and mostly non-controversial – it should be accepted that 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. For example, a broad sales tax or GET base that taxes goods and services that are perceived to be necessary (rather than optional) purchases will promote revenue sufficiency and stability but have a negative impact on vertical equity. This can occur when the base includes food, healthcare services, utility payments, etc. As another example, some taxes exhibit a trade-off between revenue sufficiency and volatility or stability. Over the years, the personal and corporate income taxes have exhibited significant volatility based on the business cycle and other variables. At the same time, in strong growth periods they have out-performed other revenue sources in terms of levels of growth and 'bounce back.' In general, these trade-offs suggest the need for case-by-case analysis and the use of several forms of taxation to off-set specific impacts or defects in a particular tax.

In seeking a balanced tax structure, complementary approaches can include:

- Broad-based, uniform taxes with fewer exemptions can advance the principles of adequacy, stability, neutrality, and horizontal equity. The broader the tax base, the greater the tendency for revenue to grow and fluctuate in concurrence with overall economic activity. Also, a uniform tax rate structure treats different taxpayers even-handedly while minimizing the distorting impact of taxation on taxpayer decisions.
- A more transparent tax structure may be complementary to increased competitiveness. A major cause of non-transparency occurs when taxes levied on businesses are passed on to consumers in the form of higher prices—the so-called "hidden" taxes. When business taxes cannot be

passed on, competitiveness is reduced. Increasing the fraction of taxes levied on households relative to taxes levied on businesses makes the tax system both more transparent and more competitive.

Revenue Strategies/Approaches

A state's strategic approach to revenue generation is informed and guided by its tax policy principles. Constructing a balanced and equitable tax structure is part 'art' and part 'science' – requiring a state to choose from a variety of tax-related options and decisions as it seeks to raise sufficient revenue to provide services. The following revenue strategies are presented by tax-type, exploring both the pros and cons of various alternatives.

In this analysis, most of the strategies presented are variations on themes of current tax policy. While it is entirely possible that tax policy will be radically altered in the next 20 years, the preceding 50 years do not present a compelling case for this sort of change. While some states raise a majority of their revenue from sources other than 'the big three' of sales, individual and corporate income taxes (primarily states with mineral extraction taxes), there hasn't been a state that radically changed its approach to taxation away from those in general use in decades. As one authoritative source on taxation has noted, "An axiom of public finance is 'an old tax is a good tax' because the marketplace has adjusted to accommodate the tax. In general, improving the equity and neutrality of existing taxes is preferable to introducing a new tax unless the inequities and inefficiencies of the existing taxes are greater than those of a proposed new tax."[132]

General Excise Tax

As already noted, this is the State's largest source of revenue and is a broad-based consumption tax. Generally, existing tax alternatives are focused on either changes to the base or the rate. As a generally accepted tax principle is to maintain as broad as possible a base and as low as possible rate, the analysis will generally favor base-broadening over rate-raising. This key distinction is discussed further in the following analysis.

Alternative One: Broaden the GET Base by Eliminating the Exemption for Non-Profits

While the GET is a broad-based tax on consumption, there are some significant exemptions built into the current law. By far the biggest is for non-profit organizations. While the GET exemption is limited to income generated by the organization in performing the duties that qualify it for non-profit status, the forgone revenue is significant. According to a recent paper, these exemptions amounted to nearly $312 million in tax year 2009.[133]

Sales tax exemptions for the programmatic activities of non-profits are common among the states. The general belief is that the mission of most non-profit organizations supports valued policy objectives, and taxing their purchases would reduce the resources available for these activities. At the same time, there is a growing awareness that non-profit organizations are 'resource consumers' and sometimes in competition with for-profit businesses that provide similar services. If that is the case, it can be argued that horizontal equity would prefer that these non-profits be treated similarly to for-profit businesses related to application of consumption taxes.

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[132] Robert L. Bland, "A Revenue Guide for Local Government," ICMA, 2006, p.33.

[133] "Tax Expenditures in Hawaii," Donald J. Rousslang, Tax Research and Planning Office, Hawaii Department of Taxation, February 14, 2012, p. 17.

In fact, a growing number of state and local governments are re-thinking their approach to taxation of non-profit organizations. At the local level, this has taken the form of alternatives to property taxes, which generally exempt non-profits. The rise of municipal services taxes, assessments and fees that apply to both for-profit and non-profit entities is notable, as is the increased use of 'payments in lieu of taxes' negotiated by local governments with non-profit organizations.

At the state level, tax exemptions are also getting another look and, in a number of states, are being eliminated or scaled back. Current analysis and discussion suggests that this trend will continue.

Those who favor limiting the exemption note that this exemption greatly narrows the tax base and has helped contribute to rate increases. They argue that while the activities that are exempt from tax have public benefit, it would be possible to provide direct appropriations or subsidies that better target the activities that best lead to tangible results. While many non-profits serve an important public purpose, the blanket exemption may also provide tax benefits to those who cannot readily demonstrate positive societal outcomes commensurate with the tax benefits.

Those who oppose eliminating the exemption note the historic commitment to non-profit organizations as a part of the social compact to improve the overall health and welfare of citizens. They also note that changing the tax benefit to appropriations would limit their ability to allocate resources to programs in lean budget years and subject their work to the whims of what can be a political budget allocation process.

Pros	Cons
▪ Broadens the GET base ▪ Subjects the GET to what is generally considered a growing area of consumption ▪ Addresses horizontal equity issues related to for-profit businesses that provide services similar to non-profit entities that are not subject to the GET	▪ Is a fundamental shift away from support for non-profit organizations that often provide services that replace/augment state programs ▪ If tax exemptions are replaced by appropriations can subject non-profits to the political process in determining service provision.

Alternative Two: Eliminate the Sunset on the Application of the GET to Activities in Act 105, Session Laws of Hawaii 2011

Act 105, 2011 Session Laws of Hawaii temporarily suspended a number of GET exemptions and thus subjected those activities to the GET. The temporary suspension of these exemptions is set to expire on June 30, 2013. According to a paper by the Department of Taxation, these suspended exemptions amounted to about $56 million of additional revenue.[134] The bill specifically states that gross income from "binding written contracts entered into prior to July 1, 2011, that do not permit the passing on of increased rates of taxes" will be exempt from the GET even if the amounts would be made taxable by the suspension of an exemption under the bill.

This particular provision is expected to lead to a significant increase in revenue; it would also be expected to broaden the base of GET revenue. On the other hand, most of the activities subject to the tax are business to business transactions; most economists suggest that this leads to pyramiding that has overall negative tax consequences. As previously discussed, contractors may change their operations (through vertical integration) to escape the tax in ways that my not otherwise be considered economically efficient. It is also possible that some economic activity will not take place because of this additional tax. As a result, there is likely some lost business activity as a result of the tax.

[134] Ibid, p. 12.

Pros	Cons
▪ Broadens the GET base ▪ Maintains a source of revenue that is now understood and administered	▪ Creates additional tax pyramiding ▪ May lead to tax avoidance based on vertical integration and other activities that may not be otherwise economically efficient ▪ May reduce business activities because of loss of competition

Alternative Three: Aggressively Pursue Nexus

Across the country, states are adopting new methods so that businesses will have nexus in their state sufficient to require them to collect sales (or in the case of Hawaii, GET) tax. The key battleground on nexus issues for states has been what is called "web nexus." This approach was first developed by the State of New York in 2008, often referred to as the "Amazon tax." Under the statute, a *rebuttable* presumption is created that a nonresident internet seller has nexus with New York for sales/use tax purposes if (i) the nonresident has agreements with in-state companies whereby potential customers are referred to the nonresident, and (ii) the nonresident's gross receipts from customers under such an agreement exceed $10,000 during the previous four quarters.

Since that first state foray – and the litigation that followed – other states have also considered and/or adopted similar legislation. The most prominent of these was California's enactment of its "Amazon Law" and which ended with its temporary repeal.

The latest developments in this area have involved federal action. As was noted in a recent report to the Tax Review Commission,[135] there are at least three bills before Congress that would solve this problem for the states by establishing a requirement for vendors to collect sales tax from out of state sellers. These each carry varying exceptions for tax collection, but they are generally viewed as the states' best opportunity to level the playing field in terms of sales tax collection related to e-commerce and other transactions where vendors cannot be currently compelled to collect sales tax.

This is, of course, a situation that relies on the federal government for action. As a result, it cannot be a state recommendation for a way to broaden its tax base or improve its overall collection rate.

Alternative Four: Increase the GET Rate

While it is accepted that maintaining low rates is a good overall tax policy, the GET is not been raised since 1965, and a small general rate increase may now be appropriate. While accepting the fact that the GET is a business privilege tax with a very broad base, the GET rate is low compared to other states. The median state rate for its primary consumption-based tax is 6.0 percent, and 35 states have local sales tax rates as well.[136] Hawaii's state and local GET rate is the lowest among the states when the state rate is combined with the average local tax rate.[137]

While it is understood that broadening the base is preferable to raising the rate, the State has not undertaken this action for many years. As most states have experienced, there likely comes a time that a higher rate is justified. Given the State's low overall rate compared to other states and its lack of border competition, this becomes a viable option for Hawaii.

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[135] "Selected Issues with the Hawaii General Excise Tax," William F. Fox, July 22, 2012, p. 12-14.

[136] Ibid., p. 3.

[137] Ibid., p. 3

An increase in the GET can also be combined with other changes that can ameliorate negative aspects of the tax structure from a tax policy perspective. For example, the raise in the GET could be coupled with additional low income individual income tax credits related to purchases of food or other critical needs by low income earners. The rise in the GET (understanding that it impacts on businesses, particularly in business to business taxes) could be coupled with a reduction or elimination of Corporate Net Income Tax, which is sometimes a nuisance tax for business taxpayers. Finally, an increase in the GET could be combined with reduction or elimination of the 0.5 percent rate which applies to a variety of business-to-business transactions.

On the other hand, the GET's broad base makes it generally regressive, and any increase will heighten that impact. An increase in the GET may also have a psychological impact, as this is a rate that has not been increased for longer than just about any other state rate for a major consumption tax. It is also a significant tax increase and places even greater reliance on this one revenue source.

Individual Income Tax

In FY 2011, IIT receipts accounted for $1.3 billion, or 28.7 percent of all General Fund tax revenue. Hawaii uses as a starting point for determining state taxable income federal adjusted gross income.[138] From federal adjusted gross income, there are currently 16 total tax expenditures – credits, deductions and exemptions – available to IIT filers. These amounted to approximately $252.7 million in total tax expenditures in TY 2009.[139]

Many tax credits, deductions and exemptions are widely used among the states and are generally believed to serve an important public purpose. At the same time, these tax expenditures generally benefit specific groups of taxpayers, which can raise issues of horizontal equity. To the extent that they reduce overall revenue collection, they also reduce the overall IIT base and may make the system more volatile/less stable. Some tax expenditures may make the tax structure more (or less) regressive. In short, each should be analyzed and weighed on a case-by-case basis. The following exemptions, credits and deductions are potential areas where alternative approaches may be warranted.

Alternative 1: Eliminate or Reduce Exemptions on Pension Income

There is a wide variety of approaches to taxation or exemption of pension income among the states, and this variation extends to types of pensions. Many states treat private pensions differently than state and local, federal civilian and military pension. In general, public pension income is more likely to be excluded, while private pension income is more likely to be taxed.[140] Hawaii is one of ten states – along with Alabama, Illinois, Kansas, Louisiana, Mississippi, New Hampshire, New York, Pennsylvania and Tennessee – that provide full exemption for public pension income.[141] On the other hand, there are nine states that provide no public or private pension exemption (California, Minnesota, Nebraska, North Dakota, Rhode Island, Utah and Vermont). Between these extremes, the majority of states exempt only a certain portion of pension income.[142]

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[138] There are some items that are taxed by Hawaii but not taxed by the federal government, including the provision for bonus depreciation, increased IRC section 179 deduction, and inclusion of off-the-shelf computer software as property qualifying for the IRC section 179 deduction. See State of Hawaii Department of Taxation 2011 N-11 Forms and Instructions, p.11-12.

[139] "Tax Expenditures in Hawaii", Hawaii Department of Taxation, February 2012, Table 2

[140] A commonly cited source for state tax exclusion for pension and retirement income is 'Individual Income Tax Provisions in the States,' Wisconsin Legislative Fiscal Bureau, January 2011. A table from this report, which lists all 43 states with an individual income tax and their treatment of pension income is included in Appendix E.

[141] "State Personal Income Taxes on Pensions & Retirement Income: Tax Year 2010", National Conference of State Legislatures, February 2011, page 3.

[142] This runs the gamut, from Connecticut (which taxes 50 percent of military pensions but 100 percent of all other pensions) to Massachusetts (which taxes 100 percent of private pensions but excludes all public pension income), to Arkansas (which exempts $6,000 of income for all pensions) to Georgia (which exempts $35,000 of income for all pensions).

Until recently, Michigan had fully exempted public pension income from taxation, while exempting only a portion of private pension income. However, effective January 1, 2012, public employee pension income became taxable, with limited exceptions. According to the Michigan State Employees Retirement Association (SERA), the State set up a three-tiered pension tax. Pensioners born before 1945 are exempt from the new tax. Those born in 1946 through 1952 would pay the state's income tax rate on pensions, with $20,000 for individuals and $40,000 for couples exempt. Those born after 1952 would pay taxes on all retirement income other than Social Security. When they reach age 67, they would get the $20,000/$40,000 exemption against all retirement income, including Social Security.[143]

As with many tax policy changes, the Michigan law faced significant opposition. The law, as enacted, was challenged as unconstitutional by SERA and was argued through the courts up to the State Supreme Court. In a 4-3 ruling, the State Supreme Court upheld most of the law, including the taxation of public employee pensions for those individuals born after 1945.[144] SERA estimated that the initial impact would be approximately $40 million in additional revenue to the State.

By eliminating or substantially reducing tax exemptions for federal and state pension income, Hawaii could realize a significant increase in general fund revenue. According to the Department of Taxation, federally taxable pension income not taxed by Hawaii for TY 2009 was $2.4 billion. Additionally, total tax expenditures related to employer-provided pensions were approximately $156 million in TY 2009. These accounted for 98.8 percent of all income not deductible for federal income taxes.[145]

Given the varying tax treatment of pension income among the states, it is not surprising that there are solid arguments that can be made on both sides of this issue. On the side of taxation, reducing or eliminating the exemption helps to broaden the tax base; given that pension income is often paid out in monthly installments of a specific dollar amount regardless of the state of the economy, subjecting it to tax can increase stability and reduce volatility of the IIT. It can also be argued that reducing or eliminating the exclusion improves horizontal equity – for many taxpayers, income is income, regardless of the source; it can be hard to argue that a single head of household with a child earning $35,000 is more able to pay IIT than a single head of household with no dependents and $35,000 in pension income.

There is a long history in this country of favorable treatment for the senior population. In Hawaii, the philosophy of *ku puna* – reverence and respect for the elders of society – is an important consideration. While the public policy implications of this favorable treatment can be debated, there is a general belief that those on a fixed income (generally those of retirement age) are less able to deal with additional costs, including additional taxes. Further, it is often argued that, at least for public pensioners, that exempting this income from tax was a form of compact made between public employees and government – that their tax-exempt pension and benefits would be provided in return for lower public sector wages.

Pros	Cons
▪ Widely practiced among other states ▪ Provides a broader and more stable tax base ▪ Can be tailored in a progressive structure, with various rates based on certain income levels ▪ May improve horizontal equity	▪ May be seen as targeting a specific population ▪ May violate a form of 'social compact' between public workers and government ▪ If enacted on prospective pension filers, would not see benefits for many years. ▪ Potentially subject to extended litigation.

[143] Michigan State Employees Retirement Association, http://www.mi-sera.org/letterspress_archive.html

[144] According to SERA, the court's ruling struck down language in the law that would have provided a phase out of the exemption for high income earners, as it violated Article 9 §7 of the Michigan Constitution of 1963.

[145] Table 2 – Tax Expenditures in Hawaii's Net Income Taxes, "Tax Expenditures in Hawaii", Hawaii Department of Taxation, February 2012

Alternative 2: Eliminate or Reduce Exemptions on Social Security Benefits

Compared to the treatment of pensions, the full exemption of Social Security benefits is a more common practice, with 28 states – including Hawaii – fully exempting these benefits from state income taxes.[146] Federally taxable social security income not taxed by Hawaii in TY 2009 was $905.7 million, according to Department of Taxation.

In recent years, the trend has gravitated towards the full exemption of social security benefits. Beginning in 2008, Wisconsin no longer taxed social security benefits. Iowa has also begun the process of phasing out the taxation of social security benefits, from 2007 to 2014. Missouri is also on the verge of completion of the phase-out of taxing social security benefits through income deductions for taxpayers age 62 whose adjusted gross income is $85,000 or less for single filers and $100,000 or less for married couples filing jointly[147]

As an alternative, Hawaii could adopt the federal standard for exemptions on social security benefits.[148] Eight states follow the federal practice – Connecticut, Minnesota, Nebraska, North Dakota, Rhode Island, Vermont and West Virginia.[149] The advantages and disadvantages to this alternative are similar to those for pension income. However, given that Social Security is seen as the bedrock 'safety net' for seniors on a fixed income, it may be even more difficult to overcome the concern for 'taxing seniors on a fixed income.'

Pros	Cons
▪ Used in other states ▪ May be tailored in a progressive structure, with various rates based on certain income levels ▪ Can mirror federal tax treatment, which is generally the starting point for AGI in Hawaii ▪ Broadens and makes the base more stable ▪ May provide additional horizontal equity	▪ May be seen as targeting a specific population ▪ Erosion of the 'safety net' concerns

Alternative 3: Eliminate or Reduce Specific Credits

According to the Tax Research and Planning Office, Hawaii's tax code currently provides 16 separate income tax credits. Tax credits, like exemptions or deductions, can have positive impacts. At the same time, these tax expenditures generally benefit specific groups of taxpayers, which can raise issues of horizontal equity. To the extent that they reduce overall revenue collection, they also reduce the overall IIT base and may make the system more volatile/less stable. Of the tax credits, the following are warrant further discussion regarding the positive and negative aspects of each, and how other states approach similar situations, where applicable.

Overall, eliminating these specific tax credits would likely produce a significant amount of additional tax revenue. Of course, the general theory for tax credits associated with economic development is that the foregone revenue will generate economic activity sufficient to reduce the overall cost of the specific credit – often by generating additional jobs and income that will then be taxable. Whether this is actually the

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[146] Total includes the District of Columbia

[147] "State Taxation of Social Security and Pensions in 2006", AARP Public Policy Institute, page 4.

[148] No one pays federal income tax on more than 85 percent of Social Security benefits. Individual filers with combined income of between $25,000 and $34,000 may have to pay income tax on up to 50 percent of benefits, and more than $34,000 up to 85 percent may be taxable. Joint filers with combined income of between 432,000 and $44,000 may have to pay income tax on up to 50 percent of benefits, and more than $44,000 up to 85 percent may be taxable. See 'Benefits Planner: Income Taxes and Your Social Security Benefits," U.S. Social Security Administration, accessed electronically at http://www.ssa.gov/planners/taxes.htm

[149] "Ibid, page 3.

case is often the crux of the development tax credit debate. One of the recent examples of significant forgone revenue is the High Technology Business Investment Credit, which provided $857.6 million in tax credits between 1999 and 2010. While the tax credit is no longer available for new investors, according to the Department of Taxation, the additional credits that could be claimed by existing investors is approximately $847.2 million over at least the next four years.[150]

Renewable Energy Technologies Income Tax Credit

Based on current law, taxpayers who have installed a renewable energy technology system and placed it into service after June 30, 2003 may claim this nonrefundable tax credit. The credit is available to all residents of Hawaii and covers a variety of renewable technologies at varying rates, depending on the type of technology. According to the Department of Taxation, tax credits for renewable energy technologies taken in FY 2009 totaled $29.9 million.

Supporters argue that the tax credit is economically advantageous and efficient. As investments by individuals in these technologies increase, the economic impact on Hawaii could be significant, attracting outside investment and creating new jobs. However, investment in these renewable energy technologies is still a fairly expensive upfront cost and may not be a viable option for low income filers, leading to a lack of equity and fairness across tax brackets.

Pros	Cons
▪ Encourages investment in green technologies, thus reducing dependence on other energy sources	▪ Investment in technology is still fairly expensive, raising concerns of equitable application of the tax credit among various classes of income

Motion Picture and Film Production Income Tax Credit

Hawaii taxpayers are eligible for a tax credit for qualified production costs incurred on or after July 1, 2006 and before January 1, 2016. The credit is equal to 15 percent of the qualified costs in the City and County of Honolulu and 20 percent of the qualified costs in Kauai, Maui or Hawaii County. The total tax credits claimed per qualified production are capped at $8,000,000.[151] Based on most recent data available from the 2005 Tax Credit Report, 70 taxpayers claimed the motion picture tax credit in TY 2005 for a total of $2.2 million, compared to $750,748 claimed by 19 taxpayers in TY 2004.[152]

As a popular resort and travel destination for both American and international tourists, Hawaii has long been a location for motion picture and television production. Given this fact, it is unclear whether the credit is really necessary to spur production. There are also horizontal equity issues are raised due to the fact that these credits are aimed at a particular industry, rather than all filers. On the other hand, a variety of states have adopted this form of credit, and there well may be film production 'shoppers' that will seek to locate their productions based on this factor.

Pros	Cons
▪ May spur additional investment in a highly visual industry ▪ May be a tie in with the tourism industry	▪ Is an issue of horizontal equity ▪ Hawaii is a popular film locale; additional incentives for film production are unnecessary

[150] "The Impact of the High Technology Business Investment Tax Credit on Hawaii's Economy for Calendar Year 2009", Hawaii Department of Taxation, December 2010, page 4.

[151] State of Hawaii Department of Taxation, 2011 N-11 Forms and Instructions, p. 23.

[152] "Tax Credits in 2005", Hawaii Department of Taxation, page 15.

Property Tax Credit
Hawaii currently follows the federal guidelines for itemized deductions, including the deduction of property taxes. Property taxes are substantially lower in Hawaii than most other states, and part of the reason for this is the fact that the State bears most of the burden for funding local K-12 public schools – a responsibility that is, in most states, a shared responsibility. Given this fact, one way to balance this would be to remove this deduction, which acts as a benefit for property owners who are already receiving the benefit of reduced property tax bills.

An alternative would be to reduce the exemption to a capped threshold or eliminate the exemption altogether. The increased revenue could be potentially used to supplement the already heavy burden of education funding borne by the state.

Pros	Cons
▪ Eliminates costly tax exemptions and credits	▪ Potentially reduces revenue generated by nonprofits, specifically from high income earners

Alternative 4: Reduce IIT Liability for Low-Income Filers
Hawaii is currently one of ten states that apply an income tax against income earners below the poverty line.[153] According to the Center on Budget Policy and Priorities (CBPP), a Hawaiian two-parent family of four with annual income at the poverty line ($23,018 for a family of that size) owed $331 in 2011, the third highest liability in the nation behind Alabama and Illinois.[154]

During tax year 2009, total taxable income for all filers with an adjusted gross income (AGI) of $20,000 and below was $829.2 million, with a tax liability of 3.5 percent of that - $29.7 million. An opportunity exists to provide tax relief for low income individuals, particularly individuals living in severe poverty.

According to the Department of Taxation, eliminating income taxes on households below the poverty line would reduce individual income tax collections by 7.8 percent. However, other mechanisms, such as increasing the standard deduction, can reduce low income tax liability with a reduced impact on overall revenue collections.

Pros	Cons
▪ Reduces tax burden on low income filers ▪ Eliminates costly tax exemptions and credits	▪ Tax burden would be shifted to high income earners, who already pay substantially high rates at the top end of the bracket

[153] "The Impact of State Income Taxes on Low Income Families in 2011", Center for Budget and Policy Priorities, revised April 17, 2012, page 11.
[154] Ibid, page 1.

Excise Taxes

At its core, an excise tax is a selective sales tax – paid by those who use or consume a specific good or service. Excise taxes can be levied in different manners – either as a 'unit-based' tax (i.e. each gallon of gasoline is taxed at the same amount) or as a percentage of the price of the good or service (i.e. a hotel room is taxed at a given percentage of the per night room rate). Among the major examples of goods/services subject to excise taxes by states are:

- Tobacco
- Alcohol
- Gasoline
- Hotel/motel
- Rental car

Excise taxes are often relied upon to raise revenue dedicated to fund certain governmental services. For instance, in many states, the state's share of gasoline tax is partially or fully dedicated to transportation funding. The revenue generated by a given excise tax is somewhat dependent on the elasticity of demand of the good or service taxed. Excise taxes – like any tax – will generally lower demand for a given good or service.[155] In fact, a rationale for some excise taxes is to reduce consumption of what may be seen as goods with negative externalities – or to pay for the additional societal costs associated with its consumption.[156]

Hawaii's principal excise taxes include:

- Transient Accommodations Tax
- Fuel Tax
- Cigarette and Tobacco Tax
- Insurance Premiums Tax
- Rental Motor Vehicle & Tour Tax
- Liquor Tax

Excise taxes represent an important component of the overall revenue structure for Hawaii. In 2011, the FTA reported that 17.3 percent of Hawaii's total state tax revenue was from excise taxes. Hawaii ranked just above the US state median of 17.2 percent and tied for 22nd largest amount of revenue from excise taxes as a percentage of total tax revenue.[157]

The following are selected excise tax revenue alternatives:

Alternative 1: Increase the Transient Accommodations Tax

The TAT is projected to generate nearly $46.8 million less beginning in FY 2016 after the expiration of the 2.0 percent surcharge.[158] The State could consider making the temporary surcharge permanent to generate additional revenue.

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[155] For a more detailed discussion of excise taxes and their effect on consumption – including discussion of elasticity, see: "Economics and Politics of Excise Taxation" by Sijbren Cnossen in Theory and Practice of Excise Taxation, 2005; and "Excise Taxes in the States" (working paper number 11-27) by Thomas Stratmann and William Bruntrager, Mercatus Center – George Mason University, June 2011.

[156] Excise taxes on items like cigarette and tobacco products and alcohol are often referred to as 'sin taxes' as a way of characterizing this rationale for their higher tax rates. The same argument is made for 'junk food' and sugar taxes.

[157] FTA 2011 State Tax Collection by Source (Percentage of Total) based upon US Census Bureau data.

[158] The State's base TAT rate is 7.25 percent. The 2.0 percent surcharge is effective through FY 2015.

Exporting an increased amount of revenue to primarily non-resident visitors shifts a portion of the tax burden from Hawaiians to visitors. A tax on visitors helps offset costs related to state/local services consumed (use of public roads, police and fire protection, etc.) and negative externalities (increased traffic congestion, pollution, etc.) As discussed earlier in the report, the taxes associated with a stay in Honolulu are lower than average for the top 10 US city tourist destinations, suggesting there is some rate increase opportunity.

Derived from hotel room rentals, time share units and other temporary accommodations, TAT revenue – absent rate changes – tends to rise and fall in relationship to the State's tourism industry. A prior study indicates that Hawaii's tourist demand elasticity for lodging is -1.5 – showing it to be modestly elastic.[159] The report suggests that "hotel room taxes are fully exportable to tourists, but the tax has a relatively large negative impact on the tourist demand for lodging services."[160] An elasticity of -1.5 would suggest that the temporary increase in the TAT should have resulted in less revenue, which did not occur. It may be the case that price elasticity of demand for lodging in Hawaii is slightly more inelastic in present times than estimated by this 1988 study. Of course, there may be other factors, such as generally improved economic conditions, that masked the demand reduction associated with this specific tax increase.

The results follow general logic given Hawaii's unique characteristics, desirability as a vacation destination – both domestically and, increasingly, from abroad – and the relative lack of available substitutes for lodging. As a result, it could be argued that an increase in the permanent TAT rate to the temporary 9.25 percent rate can be sustained without significant impairment to the tourism industry.

It is not surprising that the lodging industry is unlikely to support a permanent 9.25 percent rate, although in other areas they will sometimes support the increased rate if it is dedicated to marketing and promotional activity to attract additional visitors.

Pros	Cons
▪ Significantly exported ▪ Temporary rate will be in place for a total nearly 6 years suggesting market is mostly adjusted to rate ▪ Compared to other major US-city destinations, Honolulu has relatively low hotel/motel tax rate ▪ Provides manner for Hawaii to recover costs associated with providing public services to tourists ▪ Straightforward administration/collection	▪ Lodging industry will likely see little benefit ▪ Failing to sunset taxes that are scheduled to do so may create ill will or distrust among taxpayers or industry groups ▪ This may make future uses of temporary rate increases more difficult

Alternative 2: Institute a Prepared Food Tax

While food is already subject to the GET, an additional excise tax is sometimes levied on food that is prepared onsite (i.e. restaurant, convenience store) for consumption by a customer. Because visitors generally consume more of their meals in restaurants and similar locations, the tax is another way to export the state tax burden. 'Meals away from home' show a somewhat inelastic price elasticity of

[159] "The Incidence and Exportability of Hotel Room Taxes: Some Further Estimates" (Working Paper Number 88-9) by E. Fuji, M. Khaled, J. Mak. 1988. For most products, a basic market principle is that there is a relationship between its price and the quantity that will be demanded. This relationship varies, depending on the perceived necessity of the product or service. The measure of responsiveness of quantities demanded with changes in price is known as the price elasticity of demand. In general, price elasticity of demand is a negative number, and is expressed as the change in quantity demanded in response to a one percent change in price. Elasticities of demand of less than -1.0 in absolute value are generally considered relatively inelastic (changes in demand are less responsive to changes in price), while elasticities of demand greater than -1.0 in absolute value are considered relatively elastic (changes in demand are more responsive to changes in price).

[160] Ibid, p. 9.

demand (approximately 0.7-0.8).[161] This suggests that implementing a tax specifically on prepared foods would not alter consumer behavior to a significant extent. A case can also be made that some of the elasticity of demand in cities and states with these taxes is really cross-border competition, with consumers avoiding the tax by visiting restaurants in surrounding cities or states without the tax. That option is not available with a statewide tax in Hawaii.

One argument against food taxes in general is that they are regressive. According to the US Bureau of Labor Statistics' (BLS) 2010 Consumer Expenditure Survey, the percentage of annual income spent on food away from home decreases as income increases – though the relative difference from the second quintile to the fourth quintile (most likely consisting of the middle class) is only 1.2 percentage points. However, the percentage of total food costs that are spent on food away from home increases as income increases.

BLS Food Expenditures by Income Quintile – 2010

	Lowest Quintile	Second Quintile	Third Quintile	Fourth Quintile	Highest Quintile
Food at Home	$2,270	$2,816	$3,433	$3,917	$5,683
Food Away from Home	$1,039	$1,398	$2,164	$2,926	$4,993
Percentage of Food Costs Spent on Food Away from Home	31.4%	33.2%	38.7%	42.8%	46.8%
Annual Income of Consumer Unit	$9,906	$26,777	$45,552	$72,794	$157,369
Percentage of Annual Income Spent on Food Away from Home	10.5%	5.2%	4.8%	4.0%	3.2%

Pros	Cons
▪ Exports a portion of the tax. ▪ Tourist demand for prepared food is likely more inelastic than resident demand. ▪ Many top tourist destinations (cities) have a prepared meals tax in addition to sales tax	▪ Defining what constitutes a prepared meal may be difficult leading to administrative and collection challenges ▪ While a large amount of tax could be exported, residents could also experience tax increase if dining at restaurant or ordering take-out food ▪ Somewhat regressive, though regressivity may be more muted than other types of sales taxes because of available substitutes

Alternative 3: Increase the Rental Motor Vehicle and Tour Vehicle Surcharge Tax

As of July 1, 2012, the State's temporary, one-year $7.50 per day surcharge reverted to its base of $3.00 per day. Similar to the TAT, rental motor vehicle and tour vehicle tax is very sensitive to the State's tourism industry and tends to perform in similar fashion to the State's tourism industry. Studies vary in estimated price elasticity of demand for rental vehicles. As discussed earlier in the report, the taxes associated with rental vehicles in Honolulu are relatively lower than other top tourist destinations. Since most revenue associated with the tax would likely be generated from non-resident rentals, increasing the tax shifts a portion of the tax burden from Hawaiians to visitors.

[161] 'The Impact of Food Prices on Consumption: A Systemic Review of Research on the Price Elasticity of Demand for Food." Tatiana Andreyeva, Michael W. Long, and Kelly D. Brownell. American Journal of Public Health, February 2010, Vol 100, No. 2, pp. 216-222.

Rental car companies, especially those with significant rental volume from in-state residents, have opposed excise tax increases in other jurisdictions. As noted above, the issue of elasticity of demand (and its likely impact on overall rentals) is an open question – although some studies have also concluded that disparate rental rates leads to cross-border competition (a situation that does not exist in Hawaii).

Pros	Cons
▪ Mostly exported ▪ Some studies suggest demand for rental vehicles is somewhat inelastic ▪ Many top tourist destinations (cities) have higher rental car tax rates ▪ Ease of administration ▪ Provides a way, other than through the gas tax, to recover costs of using the state's roads	▪ While a large amount of tax would be exported, residents would also experience tax increase if renting a vehicle in-state ▪ Some studies suggest demand for rental vehicles is somewhat elastic.

Alternative 4: Levy an Amusement/Recreational Tax

The State could levy an amusement or recreation tax on rentals of recreational equipment and admission fees/charges for recreational activity. Common activities covered by these taxes include:

- Round of golf and driving range usage
- Motorized and non-motorized recreational water vehicle rentals (i.e. jet ski; surfing equipment; kayaks; canoes; etc.)
- Recreational experiences/admissions (i.e. parasailing; harbor cruises; museum admission; sightseeing tours; sporting event admission; etc.)

As with other excise taxes, one of the primary benefits is that a significant share of the tax burden is exported to non-residents. Due to Hawaii's unique geography, climate and cultural history, tourists are likely to seek experiences unlike those available when not on vacation.

The tax may cause some net activity loss because of decreased demand, on the theory that tourists may substitute other activities that are not subject to the amusement/recreation tax. On the other hand, the demand for specialized recreation while on vacation may be relatively inelastic. Of course, residents would also incur the additional tax burden for covered activities as well.

Pros	Cons
▪ Exports a significant share of the tax burden ▪ Tourist demand for unique experiences may be somewhat inelastic, resulting in little drop off in consumption in response to the tax	▪ While a share of the tax would be exported, residents would also experience tax burden increase for recreational activities ▪ If demand is elastic and consumption of covered activities drops significantly, the burden will be borne by the owners of companies selling recreational services

Alternative 5: Raise the Cigarette/Tobacco Tax

Hawaii has the fourth highest per-pack cigarette tax among states – trailing only New York, Rhode Island and Connecticut. At $0.16 per cigarette ($3.20 per pack for a standard 20 cigarette pack), the State's tax is almost $0.10 greater than the US median ($0.0625 per cigarette). From 2002 to 2011, Hawaii increased the per cigarette excise tax in every year but one.

Despite the comparatively high rate of taxation and consistent rate increases, the State experienced yearly revenue growth in each Fiscal Year from 2007-2011; including double digit growth in four years. This aligns with the general research that suggests cigarette demand is somewhat inelastic – which is logical given the addictive nature of smoking. Additionally, there is no cross-border competition among states to sell significant volumes of cigarettes. Consumers in Hawaii cannot readily travel to buy cigarettes in bulk to avoid taxes in their home state. A moderate increase in the cigarette tax will likely result in increased revenue for the State without a significant reduction in sales.

A portion of cigarette tax revenue will be exported as visitors purchase cigarettes for consumption during their stay in the State. Additionally, any increase in this 'sin tax' could result in additional funds to offset the reduction in the General Fund receipt per cigarette ($0.12 through FY 2013 and $0.10 thereafter). Alternatively, the State could dedicate a portion of an increase to the Cancer Research Fund and other dedicated recipient funds from the cigarette tax in lieu of additional contributions from the General Fund.

Pros	Cons
▪ Exports a share of the tax burden ▪ 'Sin tax' dedicates portion of revenue to health-related funds or could offset scheduled decrease in receipts of tax by General Fund (FY2014 and beyond) ▪ Cigarette demand is somewhat inelastic – especially with no cross border competition ▪ Relatively easy administration and collection ▪ Cigarette tax increases have proven to be politically more palatable than other tax increases, as smokers are a minority of the population ▪ Evidence that tax increases reduce purchase of cigarettes by youth[162] and low income individuals[163]	▪ Already among highest per cigarette rates among the 50 States ▪ Other states have begun to see and forecast declines in cigarette tax revenues as a result of tax increases leading to higher prices[164]

Alternative 6: Increase the Liquor Tax (on beer, wine and liquor)

The liquor tax performance has somewhat correlated with the performance of the State's tourism industry. While many factors are unique to the tax's performance and the tourism industry's performance, recent

[162] See, for example, 'Cigarette Taxes and Youth Smoking: New Evidence from National, State, & Local Youth Risk Behavior Surveys," Christopher Carpenter and Philip J. Cook, April 2007, which found that 'the large state tobacco tax increases of the past 15 years were associated with significant reductions in smoking participation and frequent smoking by youths." Accessed at http://web.merage.uci.edu/~kittc/Carpenter-Cook-JHE-Cigarette-Taxes-Youth-Smoking-YRBS.pdf

[163] A recent study found that smokers from lower socioeconomic groups are more price-responsive than those from higher socioeconomic groups, with a 10 per cent increase in taxes causing smoking participation to fall in this category by about 2.3 per cent. See Science Daily, July 11, 2011 Accessed electronically at http://www.sciencedaily.com/releases/2011/07/110713121258.htm

[164] Of course, the counter-argument is that if declines in revenue are due to declines in consumption, there will be positive externalities associated with that decline which may reduce state health care and other costs. Some of the decline in other states is associated with tax avoidance – purchasing cigarettes in states or cities with lower tax rates, on Indian reservations and via the Internet. Some of these options are not as readily available for Hawaii consumers.

growth and recovery in the liquor tax revenues have correlated with the economic recovery and tourism recovery. A portion of this tax is exported to tourists who consume alcohol while in the State.

An increase in the tax would likely lead to some drop-off in consumption of alcohol. There has been extensive research and study done related to the price elasticity of demand for alcoholic beverages. Conclusions have varied from being relatively inelastic to relatively elastic.[165] Studies that differentiate by type of product have also found differing elasticities for beer, wine and distilled spirits, with generally (but not always) lower elasticities of demand for beer and wine than for distilled spirits.[166]

Because this has been an extensive topic for study, additional research has included several 'studies of the studies.' In the case of alcohol price elasticities of demand, three meta-analyses have been conducted.[167] The most recent of these reported average elasticities of -0.46 for beer, -0.69 for wine, and -0.80 for distilled spirits.[168] This analysis, which discussed potential areas of concern with the previous two metastudies, has, of late, become something of a consensus for discussion of elasticities of demand for alcoholic beverages and suggests that alcohol demand is relatively inelastic.

In 2010, Hawaii had the fourth highest gallonage tax on beer, the 11th highest gallonage tax on wine and the 19th highest gallonage tax on spirits.[169] The US BLS data that indicates that the amount spent on alcohol increases as income increases and lower-priced products tend to be purchased by lower-income individuals.[170] Thus, the Liquor Tax as currently constituted is somewhat regressive, because higher value products are taxed the same as lower value products (per gallon), and lower income purchasers are more likely to consumer lower priced wine and spirits. Increasing the liquor tax would exacerbate this regressive feature. To offset some concerns, a portion of a potential increase could be dedicated to enhanced education, health-related initiatives or enforcement activities.

Pros	Cons
▪ A portion of the tax is exported ▪ Relatively easy administration and collection ▪ Tourism consumption likely to help alleviate some level of destruction of sales from in-state residents ▪ Alcohol is relatively inelastic and a tax increase is unlikely to yield a comparable decline in consumption. ▪ Alcohol taxes have proven to be politically more palatable than general increases to broad based taxes such as sales or income taxes	▪ Already among the top beer and wine gallonage tax rates ▪ Efforts to increase the alcohol tax rate were met with opposition in 2011

[165] A meta-analysis of studies from 18 countries, including 46 beer own-price elasticity estimates, 54 wine own price elasticity estimates and 50 spirits own price elasticity estimates ranged from 'highly inelastic (-0.09) to elastic (-1.20) with a mean of -0.38.' James Fogarty, "The Nature of the Demand for Alcohol: Understanding Elasticity," *British Food Journal*, 2006, p. 320.

[166] One frequently cited source, S.F. Leung and C.E. Phelps determined price elasticities of demand to be -0.3 for beer, -1.0 for wine, and -1.5 for distilled spirits. "My Kingdom for a drink..? A review of estimates of the price sensitivity of demand for alcoholic beverages", in M.E. Hilton and G. Bloss "Economics and the Prevention of Alcohol-related Problems: Proceedings of a Workshop on Economic and Socioeconomic Issues in the Prevention of Alcohol Related Problems*",* National Institute on Alcohol Abuse and Alcoholism, 1993, p. 1-31.

[167] The first two studies were by Fogarty, previously cited, and C.A. Gallet, "The Demand for Alcohol: A Meta-Analysis of Elasticities," *Australian Journal of Agricultural Resource Economics,* 2007, (51):p. 121-135.

[168] Wagenaar, Salois and Komro, p. 187.

[169] "State Sales, Gasoline, Cigarette, and Alcohol Taxes as of February 1, 2010. Tax Foundation.

[170] US BLS Consumer Expenditure Survey, 2010. Data indicate that those in the lowest quartile of income spend approximately 1.5 percent of income before taxes on alcohol. At the highest quartile of income, alcohol expenditures account for 0.6 percent of income before taxes. The trend through income levels is that alcohol consumption increases as income increases, but the percentage of income spent on alcohol decreases as income increases.

Alternative 7: Increase the Motor Fuel Tax

Fuel efficiency increases in vehicles and the increased proliferation of hybrid and alternatively fueled vehicles are combining to render the per gallon fuel excise tax less productive. For this reason, states are beginning to consider alternative revenue sources such as vehicle miles traveled fees or taxes.[171] Hawaii may need to consider newer revenue systems than simply increasing the fuel tax in its current form.

At $0.17 per gallon, Hawaii's gasoline tax is sixth-lowest among the 50 states as of January 1, 2012.[172] In addition to the State gasoline tax, Hawaii allows local option taxes of $0.088 to $0.18 per gallon. Motor fuel tax revenue in Hawaii declined in consecutive years during the recession (FY 2009, FY 2010) before recovering in FY 2011 – year-over-year growth of 25.5 percent. While this tax is a non-General Fund revenue source, to the extent it provides more revenue, the General Fund may not have to supplement other funds or projects. Much of the tax's revenue is likely sourced from Hawaii residents.

A study by the National Bureau of Economic Research (NBER) suggested that gasoline demand is more inelastic in recent years than it was in the late 1970's – indicating a societal reliance on automobiles and other vehicles for transportation as well as a shift in lifestyles and land usage/development.[173]

A fuel tax is generally considered a regressive tax and any increase – either directly related to filling the tank of a vehicle or due to increased costs of taxis and mass transportation – would also be regressive as those with lower incomes would pay a greater proportion of their income on transportation expenses.

Pros	Cons
▪ Revising the manner in which a Motor Fuel Tax is calculated allows the State to "get ahead" of decreased efficiency in the current Motor Fuel Tax ▪ Current tax is among the lowest gasoline taxes levied by States ▪ Relatively easy administration and collection ▪ Increased revenue could be dedicated toward renewable energy investment and development ▪ Places the burden on funding the transportation system on users of the system	▪ Existence of local option taxes on top of State tax further increases costs to consumer ▪ Minimally exported ▪ Some consumption decline is likely but given the inability to cross state lines to purchase gasoline and the current relative inelasticity of demand, this may not be significant

Alternative 8: Institute a Snack Food and/or Soda Tax

While approximately half of all states extend their sales tax to soft drinks (including Hawaii where the GET applies), only two states, Arkansas and West Virginia, impose an excise tax on sweetened sodas and other soft drinks.[174] Arkansas' excise tax yields more than $40 million per year in revenue.[175] Additional states have contemplated levying such a tax (including taxes on snack foods), but have not successfully passed legislation. Alternatively, 23 states levy a higher sales tax on soda than on food generally;

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[171] Many states' tax codes tax fuel (gasoline, diesel, aviation, etc.) and do not address alternative fuels. Thus, states often do not capture appropriate revenue from hybrid, electric, biofuel, or other alternative-powered vehicles.

[172] FTA 2012 State Motor Fuel Tax Rates. An alternative means to calculate the gasoline tax is published by the Tax Foundation. The Tax Foundation methodology differs from the FTA and adds other taxes to the calculation to yield their figure.

[173] "Evidence of a Shift in the Short-Run Price Elasticity of Gasoline Demand,(Working Paper 12530)" Jonathan E. Hughes, Christopher R. Knittel and Daniel Sperling. National Bureau of Economic Research, September 2006.

[174] Excise Taxes in the States" (working paper number 11-27) by Thomas Stratmann and William Bruntrager, Mercatus Center – George Mason University, June 2011 and "Tax Sugary Soft Drinks," William Shughart. *Bloomberg Business week*, June 4, 2009.

[175] "Taxing Sugared Beverages Would Help Trim State Budget Deficits, Consumers' Bulging Waistlines, and Health Care Costs," Center for Science in the Public Interest. 2011.

including, California, Colorado, Connecticut, Florida, New Jersey, New York, Pennsylvania and Washington -- and several charge a higher tax on sodas sold from vending machines. [176]

At least 40 states impose a sales tax on snack foods (including Hawaii) – and in several cases the tax rates are greater than the standard sales tax for food.[177] This suggests that some form of state snack taxes exist (if not explicit by name). Maine had a 5.5 percent tax on snacks (including soda, cookies, etc.) from 1991 to 2000, before it was repealed.[178]

Proponents suggest that, in addition to revenue benefits, taxes on sweetened beverages and/or snack foods may alter consumer behavior with positive externalities.[179] The sensitivity of consumer choice and alternate food options would likely result in some level of consumption loss for sweetened drinks and affected snacks. Proponents suggest this serves public health interests – mostly related to obesity and obesity-related health concerns.[180]

Opponents suggest that factors other than soda consumption contribute to and cause obesity. Similarly, opponents indicate that soda and snack taxes would be regressive and disproportionately fall to the poor. Further, they point out that the Center for Disease Control reports that Hawaii's adult obesity rate was 22.7 percent in 2010 – fourth lowest among all states.[181]

Supporters readily acknowledge such taxes would be regressive, but suggest that a portion of the revenue should be used to expand health-related programs – including obesity prevention and intervention programs and alternative food options such as availability of fresh fruit and vegetables – to lessen the perpetual challenges of obesity among lower-income residents. [182]

Pros	Cons
▪ Increased revenue could be dedicated toward alternative, healthy foods and obesity prevention ▪ May be more politically accepted because there is a public health component	▪ Mixed evidence on actual weight and health impact ▪ Significant industry opposition ▪ Minimally exported ▪ Likely regressive ▪ May become administratively difficult to determine what is subject to the tax

[176] "State Sales Tax on Regular, Sugar-Sweetened Soda (as of January 1, 2011)," Bridging the Gap Program, University of Illinois at Chicago. 2011.

[177] "State Snack and Soda Taxes from 2003-2007: A Public Health Policy Approach to Discouraging Consumption of Snacks and Sodas," Shelby Edison, Jamie Chirqui, Hannalori Bates, Frank Chaloupka on behalf of the MayaTech Corporation for the Institute for Health Research and Policy, University of Illinois at Chicago, 2007.

[178] "Snacks – What Happened to my Twinkie?" The Center for Consumer Freedom, 2012.

[179] In the extreme, a tax cannot both change behavior significantly and raise revenue. However, in the short-term, it may be possible to achieve both goals – albeit modestly. While not a precise comparison, there is significant research on plastic bag taxes causing consumer usage to decline. For instance, a 33-cent tax on grocery bags in Ireland caused a 92 percent drop in usage. Thus a temporary increase in revenue may occur in the initial year of implementation and revenue may subside after the first year or two as consumers respond to the price changes associated with the tax. There may be substitution issues associated with plastic bags that would not exist for many consumers as it relates to snack foods and/or sweetened beverages.

[180] West Virginia uses proceeds to fund a portion of West Virginia University medical, dental and nursing schools.

[181] Center for Disease Control 2010 State Obesity Rates.

[182] "Taxing Sugared Beverages Would Help Trim State Budget Deficits, Consumers' Bulging Waistlines, and Health Care Costs," Center for Science in the Public Interest. 2011.

Alternative 9: Increase the Conveyance Tax

Hawaii's conveyance tax is similar to real estate transfer taxes in other states. The tax is levied at increasingly greater rates as the value of the transfer increases – the tax is levied through 7 different brackets according to the value of the transfer.[183] The lowest rate, $0.10 per $100 in transfer price, applies to transfers under $600,000 for buyers not eligible for a homeowner's exemption. As of September 2010, Hawaii's top-level residential conveyance tax rate, $1.00 per $100 of real estate transfers of $10 million or more for buyers not eligible for a homeowner's exemption, is among the highest rates levied by states.[184] The median home value in Hawaii is $534,900.[185] The associated conveyance tax from transfer of a residential (non-investment) property at the median value would be $0.10 per $100 – or $534.90. This rate (0.1 percent per $100), is within the mainstream of other states' real estate transfer tax rates and may be a bit lower than the norm. As currently structured, the conveyance tax is progressive – those purchasing higher-value homes pay a higher tax rate than those who purchase lower-value homes.

Given Hawaii's attractiveness as a second home destination, some portion of this tax is exported. If the state increases the conveyance tax rate (perhaps bumping up the lower level rates), an income tax credit or other adjustment could be allowed for Hawaii residents who purchase a primary home in the state to offset the additional burden. Increasing the bottom rates of the conveyance tax or collapsing several tiers would create a somewhat more regressive tax structure for Hawaii residents without any corresponding offset. Alternatively, since the State already has a differential structure for primary homeowners versus investment property owners, increasing the rate for those ineligible for the homeowner's exemption could have the same effect.

Additionally, an increase in the conveyance tax could be viewed as a means to offset the State's generous support for local services. Conveyance taxes (and real estate transfer taxes) are generally capitalized along with the selling price. They buyer's monthly payments are the combination of the amount amortized over a given number of years plus local property taxes. If the property taxes are lower because of State support for local function, as in the case of Hawaii, some of the foregone revenue could be made up at the time of property transfer through an increased conveyance tax.

The recent recession and its recovery temporarily reduced the revenue associated with the conveyance tax before it rebounded from its FY 2009 low point. The tax remains sensitive to housing prices and shifts in the market. As a result, predicting the base for the tax is difficult in this uncertain real estate recovery.

Pros	Cons
▪ Somewhat exported ▪ Could be structured as only an increase on those ineligible for homeowner's exemption – increasing exportability of the tax ▪ Low-end rates within mainstream to somewhat low compared to other states ▪ Relatively easy administration and collection ▪ Difficult to evade thus compliance costs are low ▪ Comparatively low property taxes in HI suggest that a slightly higher conveyance tax would not unduly burden property relative to other states	▪ Currently structured as more progressive tax, a shift (depending upon composition) could make it more regressive ▪ Somewhat challenging to forecast due to sensitive to the housing market – especially true if market is volatile ▪ High-end rates among higher real estate transfer taxes of all states ▪ Often taxes related to property are the most politically unpopular

[183] For a complete review of the Conveyance Tax and its associated brackets, please see the discussion of the Tax in the Current Revenue chapter of this report.

[184] According to the National Conference of State Legislatures, as of September 2010 Real Estate Transfer Taxes in Delaware, New Hampshire, New Jersey, New York, Pennsylvania, Vermont and Washington top level rates were at or above the level of Hawaii's top level conveyance tax.

[185] US Census Bureau American Community Survey (ACS) 2008-2010 3-year data.

Alternative 10: Raise the Insurance Premiums Tax

Insurance companies, in lieu of GET and income taxes, pay Hawaii's insurance premiums tax. The tax is levied on insurance companies based upon premiums written in the State. A 1.0 percent credit is offered to qualifying insurers to facilitate regulatory oversight. The State levies a 2.75 percent tax on life insurance and 4.265 percent tax for casualty and other types of insurance. Several other states subject insurance companies to a corporate income tax rate as well as a premium tax. Hawaii does not subject insurers to the corporate income tax rate – instead levying only the premium tax and a 0.15 GET.

Hawaii does not have a retaliatory insurance premium tax in place to equalize the rates between higher and lower state tax rates (generally used when the home state imposes a higher tax rate than the taxing state). A retaliatory tax "retaliates" against out-of-state firms doing business in the state by charging them a higher tax rate. The remaining 49 US states have a retaliatory tax in place.

According to a 2010 study, Hawaii's health insurance premium tax is higher than most other states – ranking third highest as a percentage of tax to total premium.[186] However, if raised slightly, it could generate additional revenue. Given that insurers are not subjected to corporate income taxes, there may be additional room for increases on par with those in other states. Additionally, the 2010 study reported Hawaii had the fewest number of residents (one-third) of any state participating in self-insured plans – often exempt from premium taxes. Thus, the State should have a relatively strong base of qualified premiums upon which to levy the tax. However, there is likely an upper limit at which further increases risk eroding the base and harming the taxed entities. At a minimum, the State may consider enacting a retaliatory tax provision.

Pros	Cons
▪ No retaliatory tax provision ▪ Insurers not subject to corporate income tax ▪ Relatively easy administration and collection	▪ Limited exportability ▪ Relatively higher rate compared to other states

Alternative 11: Increase Cell Phone Service Tax

Hawaii imposes the 14th lowest rate for wireless service taxes and fees among all states in 2010. State and local wireless taxes and fees vary greatly with the highest rate of 18.64 percent levied in Nebraska and the lowest rate of 1.81 percent levied in Oregon. Hawaii's 7.75 percent rate is less than the simple average of all US states (9.87 percent), the weighted average of all US states (11.21) and only 1.5 percentage points more than the 6th lowest-rate (Delaware). Viewed another way, Hawaii's wireless tax rate is 3.75 percentage points greater than its GET rate. The difference between the State's wireless tax and its GET (sales-like tax) ranks 21st among state differences and is almost equivalent to the US weighted average (3.80 percent). Several states allow local governments broad latitude to impose fees, while others are more limited. Tax pyramid concerns also arise in some states as wireless consumers pay an excise tax with a sales tax applied on top of it.[187]

Opponents indicate a cell phone tax violates tax neutrality, as the tax affects a taxpayer's market decision on telecommunication method. Opponents also argue that cell phone taxes are regressive.

Several studies conducted in the early-to-mid 2000's suggested that cell phones were relatively elastic in terms of demand and income. As the mobile market continues to gain deeper penetration, some

[186] "Taxing Health Insurance: How Much Do States Earn? Estimates of State Premium-Tax Revenues from Health Insurance and the Potential Cost of a Federal Takeover," John R. Graham. Pacific Research Institute. 2010.

[187] Calls originating and ending in the State are not subject to GET. Calls originating or ending outside of the State are subject to the GET, per Department of Taxation Announcement 2002-17.

speculate that the demand elasticity will shift lower, toward a more inelastic good. While only time will tell, it is likely that consumers will retain some available substitutes for mobile phones (or at least tiers of service) and the good will be somewhat elastic – even if elasticity declines.

The State could slightly increase its wireless tax rate to raise additional revenue. A moderate increase of 2.0 percentage points – just below the US average (9.87 percent) – would boost state revenue but also expand a regressive tax.

Pros	Cons
▪ Relatively low tax rate compared to other states ▪ Easy administration and collection ▪ Expanding market offers broadening base	▪ Negligible exportability ▪ Regressive composition ▪ Neutrality concerns

Corporate Net Income Tax

While the corporate income tax is generally viewed as one of the 'big three' taxes at the state level, for the State of Hawaii it raises a relatively small amount of revenue – less than one percent of general fund revenue in FY 2011. Part of the reason that Hawaii's net income tax is not as considerable in terms of revenue collection as in other states is that the GET is a significant tax on corporations – more so than sales taxes in most other states.

There are a variety of approaches that could be considered to revise the corporate net income tax to achieve tax policy goals. In particular, some of the effects of the GET on business could be ameliorated by involving the corporate net income tax with revisions to the GET. The following detail some of these alternatives:

Alternative 1: Increase Corporate Net Income Taxes and Reduce GET for Business-to-Business Transactions

Application of the GET to business-to-business transactions is commonly raised as a major concern of the current tax structure. This application can lead to pyramiding, which can disrupt markets and motivate businesses to act in ways to escape the tax. The State could use its corporate income tax to mitigate the negative effects of the GET.

This alternative would increase corporate net income tax rates and reduce or eliminate the GET (currently 0.5 percent) applied to wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale. An advantage of this approach (beyond reducing tax pyramiding) would be to tax net income (i.e., profits) as opposed to business activity. A major criticism of gross-receipts taxes is that they have a disproportionate impact on businesses that operate on lower profit margins – a horizontal equity concern.

Of course, an advantage of the current GET is that it raises a significant amount of revenue and is also relatively stable (an advantage of a tax that is based on activity rather than profitability). It would require a significant increase in current corporate net income tax rates to recoup the level of lost revenue, particularly if the goal is to completely eliminate the 0.5 percent rate. Hawaii's current corporate net income tax rates range from 4.4 percent to 6.4 percent, based on the level of net income. Among all states, three states do not have a corporate net income tax or corporate gross receipts tax; at the other end of the spectrum, top corporate tax rates run as high as 12 percent.

A related concern with the current corporate income tax structure is the use of brackets at differing levels of corporate net income. Currently, 31 states have a single corporate tax rate.[188] The argument in favor of a single rate and against differing rates and brackets is that In contrast to the individual income tax, there is no meaningful "ability to pay" concept related to income levels for corporations.[189]

[188] Federation of Tax Administrators, accessed at http://www.taxadmin.org/fta/rate/corp_inc.pdf.

[189] "2012 State Business Tax Climate Index," Tax Foundation, January 2012, p. 12. As the report notes, "Jeffery Kwall, the Kathleen and Bernard Beazley Professor of Law at Loyola University Chicago School of Law, notes that 'graduated corporate rates are inequitable—that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes."

Pros	Cons
▪ Reduces tax pyramiding ▪ Improves horizontal tax equity by focusing on income rather than transactions ▪ Broadens tax collection for a major tax	▪ Less stable and more susceptible to business cycle impacts ▪ Can be seen as an erosion of the GET broad base

Alternative 2: Transition to a Single Factor Corporate Net Income Tax

One of the criticisms of transaction-based corporate taxes is that it can make Hawaii-based businesses less competitive with businesses based outside of the state. This can occur for several reasons. For example, the 0.5 percent GET is applied to many business-to-business transactions involving Hawaii corporations, but the same transaction involving a business not located in Hawaii may not be subject to the tax, which can make Hawaii businesses less attractive. As a result, in cases where pyramiding occurs, Hawaii goods and services may be more costly to produce/provide than those from other states, which can either increase the final price or reduce profit.

In several states with transaction-based corporate tax structures, a balancing act has been to change the method for apportioning corporate income. At one time, most states used a three factor apportionment formula for multi-state corporations consisting of property, payroll and sales/receipts. However, over time, two other apportionment formulas have grown in popularity – a three factor formula that double weigh sales, and a single factor sales formula. The theory of these changes is that multi-state corporations with significant payroll and property in the state may benefit from shifting the apportionment formula to one based solely on sales in the state. Indeed, one influential study found that formula weight placed on payrolls had a substantial impact on the growth of manufacturing employment within states.[190]

On the other hand, the actual impact on a business will vary on a case-by-case basis. For example, companies with little in-state employment and property that sell proportionately more of their products in-state will be negatively impacted by the apportionment change – the impact depends on the importance of the state for the purposes of producing goods and services relative to its importance as a market for those goods and services.

Pros	Cons
▪ May compensate for effects of business to business transactions taxed via GET ▪ May increase competitiveness for some Hawaii companies, particularly in manufacturing ▪ Studies have suggested it increases employment in certain industries	▪ Some corporations will likely have an increased tax burden ▪ Is an erosion of the broader base under the current three-factor apportionment ▪ May create an incentive for some corporations to move employees and facilities out of state to eliminate nexus

Alternative 3: Eliminate Net Operating Loss Carry-Back

Hawaii allows corporations to apply net operating losses (NOL) in a tax year to its returns in following years (NOL carry-forward) or amend its returns for past years and use current losses to offset profits and receive refunds of taxes paid in past years (known as NOL carry-back). Allowing NOL carry-back can create additional instability in the tax structure, particularly during economic downturns.

[190] Austan Goolsbee and Edward L. Maydew, "Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment," NBER Working Papers, 2000, accessed at http://faculty.chicagobooth.edu/austan.goolsbee/research/apport.pdf

It's been noted that corporate net income taxes are a volatile revenue source, and many (if not most) businesses are negatively impacted during recessions and other economic downturns. For businesses that may be in need of cash, using the NOL carry-back provision is a viable option. Unfortunately, for the State, this can come at an inopportune time, as it exacerbates revenue reductions – at a time when states often experience an increased demand for services like Medicaid or other means-tested programs.

Hawaii is currently one of 19 states that allow NOL carry-back deductions. While there are advantages to the State in being able to better forecast its current year revenues and providing some greater stability for a volatile revenue source, it does not impact overall revenues over time – corporations that cannot use the NOL carry-back option will still be able to carry those losses forward.

Pros	Cons
▪ Should make current year revenue estimating more accurate, particularly during economic downturns ▪ Reduces some volatility in the corporate income tax	▪ Does not increase overall corporate income tax revenue over time ▪ Removes a method for corporations to raise cash during a time of stress

Alternative 4: Broaden Nexus Definitions

Generally, corporate taxpayers have nexus in a state when they have physical presence in the state (i.e., property, payroll, and, sometimes, sales). Each state uses its own nexus rules to determine physical presence. In evaluating property, many states consider goods held in a public warehouse, goods held on consignment, leasing of tangible personal property, or the operation of mobile stores as activities that create nexus. Licensing trademarks or software could be a factor that creates nexus under an economic presence standard. Sales activities that create nexus can include activities like having a website accessible in and located on a server in the state. There are a number of factors states consider, including the occasional presence of employees for business meetings and training seminars.

Today, many states are moving toward an economic presence standard for establishing corporate net income tax nexus. Under the economic presence standard, taxpayers no longer need to have a physical presence in the state in order to be subject to a state's income tax. Deriving income from a state alone could create nexus. For example, Connecticut is one state that has recently adopted this economic nexus presence standard. Effective for tax years beginning on or after January 1, 2010, Connecticut will consider a taxpayer to have economic nexus and, thus, require a tax return to be filed if the purposeful direction of business activities in Connecticut produces receipts "attributable" to Connecticut sources of $500,000 or more. The purposeful direction is evaluated based on frequency, quantity and systematic nature of the taxpayer's economic contacts in Connecticut. Although Connecticut has not defined active solicitation for purposes of the economic presence test, other states have identified it as "purposeful" solicitation including mail, telephone, e-mail, advertising or maintenance of a website through which sales transactions occur.

Hawaii could adopt a similar standard and seek broader application of economic presence nexus. This can expand the base for corporate net income taxes and thus expand the reach of the tax structure, which conforms with the principle of broad base, low rates.

On the other hand, Public Law 86-272, a federal law that applies to all states, still provides relief from filing in many states where economic presence is established. Under Public Law 86-272, if a taxpayer's only business activity is the solicitation of sales of tangible personal property when the resulting orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state, the taxpayer is not subject to income tax. It should be noted that Public Law 86-272 does not provide protection for the performance of services or for non-income type taxes such as sales and use tax, gross receipts tax and capital tax.

Pros	Cons
▪ Broadens the tax base by creating nexus for additional corporate net income taxpayers	▪ Broadened definitions are often subject to litigation and are not a dependable source of revenue until legal challenges have been settled

Other Revenue Sources

Alternative 1: Approve a Lottery/Other Forms of Gaming

Across the nation, states have approved a variety of options related to gambling. Nationally, 2.4 percent of state General Fund revenue came from gaming in 2009.[191] Of the forms of legalized gambling, a lottery is the most prominent, with 43 states authorizing one or more forms of a state lottery and total gross sales of over $56 billion in FY2010.[192] Other forms include charitable games/bingo (authorized in 47 states), Slots (39 states), Parimutuel (35 states), and Online Sports Betting (authorized in 4 states and pending in several others).

Lotteries and other forms of gaming have been advanced in recent years as an alternative to more traditional forms of state taxes. Part of their appeal is the fact that they are seen as a form of voluntary tax – individuals choose whether or not to gamble. They have generally been relatively popular with the general public and, in the case of casino forms of gaming, part of a strategy to provide entertainment opportunities within a city or state – locations like Atlantic City and Las Vegas are popular tourism destinations with gaming as a major part of their attraction.

While recent record lottery jackpots have heightened the public's interest (and participation), lotteries and other forms of gaming have their critics. Various studies have found gaming to be a regressive form of 'voluntary taxation.' Unless gaming is attractive to non-residents, it is also likely to reduce sales of other goods and services, particularly for recreation and entertainment activities. Gambling also results in negative externalities, including gambling addiction. Finally, some studies have suggested that dedicating gambling revenues to popular areas of funding (such as K-12 education) can reduce public support for other funding methods – the public perception being that gambling revenue alone should be sufficient to fund their activities.

Pros	Cons
▪ Is a 'voluntary tax' where individuals can choose whether or not to participate ▪ Broadens the revenue base ▪ Wide use, particularly for state lotteries ▪ Has generally been a growing source of revenue for the states as a whole ▪ A portion of the revenue is exported – and can be seen as another attraction for potential visitors	▪ Is a regressive revenue source ▪ Can 'crowd out' consumption of other goods and services ▪ Can lead to negative externalities, including gambling addiction and crime ▪ When dedicated to a specific use, can lessen public willingness to support that activity with other revenues ▪ Is not consistent with Hawaiian culture

[191] "Back in the Black: States Gambling Revenues Rose in 2010," Lucy Dadayan and Robert B. Ward, Rockefeller Institute of Government, June 23, 2011.

[192] "Lottery Sales Rise to Record as Cash-Hungry States Search for More Revenue," Bloomberg.com, November 24, 2011. Accessed at http://www.bloomberg.com/news/2011-11-30/lottery-sales-rise-to-records-as-states-wager-for-more-revenue.html.

Alternative 2: Use 'Tax Gap' and Other Methods to Increase Collections of Taxes Owed to the State

Many states have implemented sophisticated data warehouse systems that assist with identifying non-filers of tax returns and non-payers of taxes. These systems are often augmented with business intelligence software and servers. The State of New York uses data analysis to determine the most likely outliers that are flagged for audit and collection enforcement. This practice can assist states in focusing attention on data-based results yielding enhanced compliance and enforcement. Attention to performance metrics, corporate return data, and abnormalities from strong data analysis software can automate some of the labor intensive processes for staff and result in a stronger return on investment per auditor/collection FTE, without causing an undue burden on taxpayers.

In many instances, vendors are willing to negotiate performance-based solutions, where the newly generated tax revenue is used to pay for the system. As an example, the State of Iowa entered into a three year partnership with a vendor to design, develop and implement a data warehouse solution in November 1999 and realized the first revenues from the program five months later. Within four years, the program had generated over $71 million in new revenue.[193] Of course, these systems require a high level of tax processing system automation. Given the fact that the State is investigating options for new integrated systems, these Tax Gap systems may be a part of an overall approach to funding those systems.

There are other methods for improving overall tax compliance. In many instances, additional auditor positions have been demonstrated to bring in more revenue than the salary, benefit and other costs associated with the new position. In many states, these efforts are coupled with an amnesty period that kicks in before additional audit capabilities and capacity, which helps to improve overall collections. At the same time, it is important to not over-use amnesties, as it has been suggested that some taxpayers will seek to 'wait out' the State in hopes that an amnesty will allow them to reduce penalties or interest payments otherwise owed to the State. The State of Hawaii last undertook an amnesty in May-June 2009, collecting approximately $14 million in revenue.

Given the emerging importance of nexus issues across the states, this would appear to be an area where additional staff resources would prove worth the cost, even when taking into consideration additional current and long-term benefit costs.

In general, it is hard to argue against system changes that heighten overall compliance with tax law. However, there are concerns that auditors may become overly aggressive in pursuing tax law 'gray areas' and that larger staff heightens this possibility. There are also additional compliance costs associated with audits, particularly where no material change in taxes owed occurs. Finally, there is a concern that the additional staff and capital resources necessary for new systems will not actually be made up for by additional revenue generated – to the extent that there are performance clauses written into these capital investments, they can reduce this risk.

[193] A paper describing the State of Iowa program was presented at the FTA Revenue Estimating and Tax Research Conference in September 2006. It can be accessed at http://www.taxadmin.org/fta/meet/06re_data/pres/lipsman.pdf.

Pros	Cons
▪ Focus is on collecting taxes already owed ▪ Increased compliance increases public confidence in the system ▪ Modernized systems can improve overall tax administration performance ▪ Performance clauses can reduce the necessary up-front capital investment for the State	▪ Additional audit activities can increase compliance cost for some taxpayers ▪ Concern that it may spur over-aggressive audits to justify their existence ▪ Generally requires reasonably strong financial systems as a starting point, which may be an issue at present

Observations and Recommendations

Observations and Recommendations

Future Lack of Revenue Sufficiency

Based on the constructed baseline from the long range financial model, the State is expected to experience structural budget deficits based on the current revenue structure and levels of service. The financial picture looks worse 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. In the short term, the general belief, summarized by the title of a recent report, is that 'for state budgets, austerity is here to stay.'[194] The long-term trends are even more sobering. The recent report of the State Budget Crisis Task Force, led by Paul Volcker and Richard Ravitch, noted that 'there can be no doubt that the magnitude of the problem is great and extends beyond the impact of the financial crisis and the lingering recession. The ability of the states to meet their obligations to public employees, to creditors and most critically to the education and well-being of their citizens is threatened.'[195] As previously noted, the GAO model of US state and local governments also suggests a long period of decline for state and local government finances.

Specific to the State of Hawaii, 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.[196] Moody's noted that the funding ratio for the State retirement system had registered a 'decade-long declining trend' and State contributions that had not met the actuarially required contribution had contributed to the low funded ratio.

Hawaii is not alone in grappling with these issues. A variety of respected sources have identified pension system funding challenges as a key issue that will impact the states for years to come. As the Congressional Budget Office noted in 2011, "the recent financial crisis and economic recession have left many states and localities with extraordinary budgetary difficulties for the next few years, but structural shortfalls in their pension plans pose a problem that is likely to endure for much longer."[197] Indeed, the concern for Hawaii and other governments is that while they may be able to make required payments for many years, any period of inaction may make ultimate full funding even harder to achieve.[198]

Given the extent of the funding challenges, it is unlikely that the State can 'solve' its projected budget imbalance 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.

It is evident that the State understands the magnitude of the issues surrounding its OPEB obligation. During the 2012 session, the legislature enacted and the Governor signed into law Act 304, which

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[194] "For US State Budgets, Austerity is Here to Stay," Standard and Poor's, January, 2012. The report cited concerns about federal fiscal consolidation and implementation of the Affordable Care Act as areas of concern for states in the near future.

[195] Paul Volker and Richard Ravitch, chairmen. "Report of the State Budget Crisis Task Force," July 17, 2012, p. 2.

[196] "Moody's Downgrades State of Hawaii's General Obligation Rating to Aa2 from Aa1," Moody's Investors Service, May 17, 2011.

[197] "The Underfunding of State and Local Public Pension Plans," The Congressional Budget Office, Economic and Budget Issue Brief, May 2011, p.1

[198] Ibid., p. 1

authorizes the board of the EUHBTF to create a trust fund to receive employer contributions that will prefund post-employment health and other benefit costs for retirees and their beneficiaries.[199] Establishing and administering an OPEB trust is considered a best practice, and the Governmental Officers Finance Association recommends that governments prefund their obligations for postemployment benefits other than pensions once it has been determined that the employer has incurred a substantial long-term liability. An OPEB trust provides an opportunity for the State to, over time, lower the cost of providing postemployment benefits. Of course, this requires a sustained commitment to building a corpus and not simply providing the current necessary funding for this liability – and this is an appropriate use for additional revenues generated by the following recommendations.

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 also likely that the State will need to build and maintain significant reserves to withstand these inevitable future disruptions.

When weighing risks associated with the baseline projection, it should be noted that the model does not build in variations in the business cycle – it creates a trend line that factors in growth rates both below and above normal. This is the standard approach for a long-range model – there is no realistic way to build the specific timing of business cycles into a model that projects out for 12 years.

At the same time, current professional economic forecasts of the national economy tend to be more pessimistic than optimistic. For example, the 48 professional forecasters surveyed by the Federal Reserve Bank of Philadelphia, on an annual-average over annual-average basis, predict slower real output growth over the next four years. The forecasters see real GDP growing 2.2 percent in 2012, 2.1 percent in 2013, 2.7 percent in 2014, and 3.1 percent in 2015.[200] Other forecasters have increased their projection of the possibility that the national economy could slip into a recession in the near future. For example, Global Insight now predicts that while modest continued growth is the most likely short term scenario, there is a 25 percent risk of an additional recession over the period of their short-term forecast.[201]

The concern is that an additional recession will it make it more difficult to have sufficient above average growth years to meet the baseline projection. This would be particularly difficult should the national economy have a downturn similar in length and severity to the 2007 to 2009 recession. While economic forecasters are generally not predicting this sort of occurrence, most current forecasts place the likelihood of a short-term under-performance of the economy as more likely than one that out-performs the estimates.

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 analysis – and ultimately, recommendations – focused on three key themes:

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

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[199] "Pensions and Retirement Plan Enactments in 2012 State Legislatures," National Conference of State Legislatures, August 31, 2012, p. 24.

[200] "Third Quarter 2012 Survey of Professional Forecasters, Forecasters Revise Downward their Estimates for Growth," Federal Reserve Bank of Philadelphia, August 10, 2012.

[201] "The Economic Outlook," Nigel Gault, HIS Global Insight, National Association of State Budget Officers Annual Meeting, July 30, 2012.

3. Impact on overall tax administration

Key Tax Policy Principles

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. The following provides an analysis of the current system as it relates to each of these principles. Much of this analysis relates to the two key state taxes, the GET and the IIT. This is not surprising, as they make up a large majority of the State's General Fund tax revenue. As a result, they also have the lion's share of the impact on overall state tax policy.

- **Equity.** In general, equity is analyzed on a structure's effect on taxpayers of different income levels. Earlier chapters identify key concerns about vertical equity for both the GET and the IIT. As it relates to the GET, it has a comparatively broad base in terms of its application to goods and services and food – all areas that other states often ignore or exempt from taxation. This advances reliability, stability and sufficiency, but the application to food tends to make the system more regressive, impacting equity, as lower income individuals spend a greater percentage of their income on food, which is generally considered a necessity.[202] The State tax structure also taxes individual income at lower levels than many states.

  There are other state taxes, such as excise taxes, that are generally considered to be regressive. In general, these are considered to be less onerous because the items that are taxed, such as alcoholic beverages, cigarettes and tobacco, hotel rooms and rental cars, are not considered necessities. They also tend to be exported in some degree to non-residents, which reduces their impact on state taxpayers.

- **Efficiency.** As a broad-based tax, there are legitimate concerns that the GET will negatively impact on market decisions. The primary concern is that the GET will be applied to intermediate business activities, and this will lead to tax pyramiding. In particular, there is significant concern related to the 0.5 rate that is applied to many business-to-business transactions.

- **Reliability, Stability, Sufficiency.** The trade-off between tax policy principles is demonstrated by the fact that the GET is a generally reliable and stable revenue source. The broad base that raises some concerns about its equity also helps provide a relatively stable source of revenue throughout most fiscal years. The IIT, on the other hand, because of its progressive nature, is less stable, and some of its exemptions, such as pension income, reduce its overall reliability. In the long run, sufficiency is a matter for the entire structure rather than any individual tax and should be judged in that context.

- **Balanced, Broad Structure.** The State tax structure benefits from a broad based GET. As previously noted its base is the broadest among state general consumption taxes. The IIT is also an important part of the overall tax structure. At the same time, the third leg of the usual 'three legged stool' for many state tax structures, the corporate net income tax, is a minor revenue source for the State. There are many states that substitute another major tax or taxes into their mix – for example mineral extraction taxes in states like Alaska, Texas and Wyoming and gaming taxes in Nevada. In Hawaii, given its significant non-resident population, it makes sense to view excise taxes in the context of the third leg to the revenue structure stool, and taken together, they comprise a significant share of overall State General Fund revenue.

[202] A typical method for determining purchases as a share of income is the Bureau of Labor Statistics' Consumer Expenditure Survey. The latest survey, based on 2010 data, determined that average annual income spent before taxes suggested that lower income individuals spent a declining percentage of their income on food from $10,000 income and beyond. See the latest survey at http://www.bls.gov/cex/#tables

- **Compliance, Ease of Administration.** Concerns have been expressed about the complexity of the State corporate net income tax. It is also worth investigating whether current administrative policies are sufficient to ensure reasonable tax compliance.

The Commission is rightly concerned with determining that any revenue recommendations align, to the extent possible, with accepted principles of taxation. Hawaii Revised Statute lists the principles of equity and efficiency as methods by which to study the State tax system. At the same time, this study cannot solely be an exercise in structural improvements based on tax principles. Taken to its logical extreme, a study of any tax (or tax structure) would find examples of failures on equity and efficiency grounds – and could thus conclude that the only completely equitable and efficient tax (or tax structure) would be no taxes of any kind.

Of course, that is not a realistic study or approach. While there is no perfect tax – they all have disadvantages that, in some way, will reduce economic activity - 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. While there may be genuine discussion and debate about the role that taxes should play in funding what will likely be increasing demands in the coming years, it would be hard to construct a reasonable scenario, given the State’s past history and current practices, where additional tax revenue is not at least part of the solution.

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 include a population that is getting older on average and that includes a growing number of individuals of retirement age. It includes a population that is increasingly purchasing services rather than tangible goods and is doing so through electronic transactions. Finally, all of this is unfolding in a world that is growing more interconnected and mobile.

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 base, and the recommendations reflect that reality. Likewise, the impacts of an interconnected and increasingly electronic marketplace must also be considered. While Hawaii has done a better job than most states of anticipating the rise of services in general consumption, electronic commerce continues to erode GET revenue collections – and is likely to continue to do so in the future. In this area, however, it is likely that a federal solution will be necessary to achieve sufficient vendor compliance related to collection of GET taxes from vendors without nexus in the State.

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.

This focus helps ensure that the discussion and analysis throughout the report and in this section have practical – rather than simply theoretical – value. While it is no doubt important to seek ways to improve

system performance, evolutionary (as opposed to revolutionary) changes are more likely to be considered (and perhaps adopted) than changes that create significant uncertainty in implementation and use.

As an example, the concept of a value-added tax (VAT) is often raised in state revenue studies. A VAT differs from the GET (or sales taxes) in that it taxes only the value that is added by a business to the goods and services it sells, not the gross value. As a result, the VAT avoids the pyramiding that can occur in the GET and traditional sales taxes. The VAT is certainly not just a theoretical approach to taxation – it is widely used throughout the world. Today, it is a key source of revenue in at least 125 countries. The International Monetary Fund (IMF) estimates that about 4 billion people-70 percent of the world's population-live in counties with a VAT.[203] However, the United States is one of the few major countries in the world that has not adopted a VAT. Regardless of the advantages of this form of tax in comparison to GET or sales taxes, the absence of use in other states would pose numerous difficulties and concerns – both as to how to implement the new tax, how to undertake a (likely significant) educational campaign to ensure understanding and compliance and how to transition existing hardware and software programs. It would also make it difficult to model the resulting levels of tax revenue for the State. Given these major concerns, the report does not consider establishing a VAT in the following discussion and analysis.

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 other aspects of the tax system related to reporting, administration and analysis.

Methods to Expand the Tax Base

Expanding the base upon which taxes are applied helps to keep actual tax rates lower. This is important, because low rates generally have less impact on consumer choices and market efficiency. In some situations, base broadening may also support greater horizontal and vertical equity. The following tax changes are recommended and built into the model's 'reformed tax structure scenario.'

- **Reduce the Pension Exemption in the IIT**
  As discussed in the previous chapter, tax treatment of pension income varies widely among the states. It ranges from states that fully exempt to those that fully tax all pension income – with a wide variety of methods between these polar opposites.

  As a starting point, Hawaii breaks with the federal definition of taxable income as it relates to both pension and social security income. The federal government taxes all or a portion of pension or annuity payments from a qualified employer retirement plan.[204] While the State may tax some portion of the payments from a qualified private employer retirement plan, it does not tax pension benefits from public pension systems, including all federal, state/local or out-of-state government pensions.[205] According to a paper presented to the Commission earlier this year, the value of pension exemptions is approximately $156 million for tax year 2009.[206]

  Given the aging of the Hawaii population, it is reasonable to assume that the value of this exemption will grow in coming years. At the same time that the exemption for this income grows, the State's obligations to fund the benefits of its employee retirement system will also grow –

[203] Alan Tait, Robert Ebel and Tuan Minh Le, "Value-added tax," The Encyclopedia of Taxation and Tax Policy, 2005.

[204] See IRS Tax Topics, Topic 410, Pensions and Annuities, at http://www.irs.gov/taxtopics/tc410.html

[205] A listing of all state treatment of taxation of pension income is included in the Appendices.

[206] Donald Rousslang, "Tax Expenditures in Hawaii," Draft, February 14, 2012, Table 2.

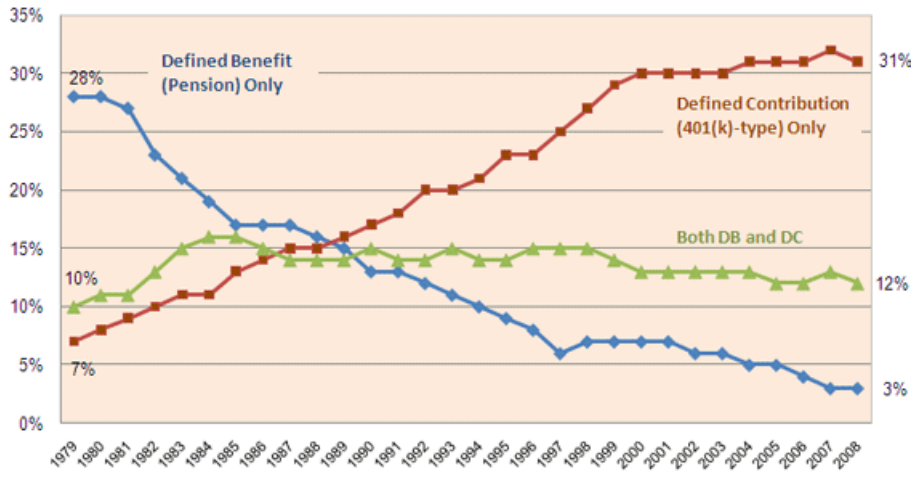
which will increase expenditures at the same time that exempted pension benefits will erode the IIT base.

A common argument against taxing this income is that pension and other benefits are a way to compensate public sector employees for lower wages during their wage earning years. The theory is that public sector employees have accepted lower wages as a sort of trade off for better retirement and other benefits. There are at least three strong responses to this claim.

First, it is far from a settled question that public sector wages are inferior to the private sector. In fact, on average, public sector employment pays wages well above the State median. As was discussed in the Introduction, average earnings in the public sector in Hawaii rank third among all sectors, trailing just Business Services and Utilities. As a sector, Government outperforms what are often considered to be well paying sectors, including Construction, Professional Services and Health Services. Besides wages, public sector employees are generally considered to have other benefits (including paid vacation and sick leave and retiree health care) that are better than their private sector counterparts.

Second, the value of the State's defined retirement benefit is likely to grow in comparison to private sector plans now and into the future. Across the country, private sector businesses are abandoning defined benefit pension plans in favor of defined contribution plans, and the percentage of workers covered by defined benefit pension plans has been declining for over 25 years. From 1980 to 2008, the percentage of private sector workers covered by a defined benefit program was nearly cut in half – from 38 percent to 20 percent. In the same time period, the percentage of workers covered by defined contribution-only pension plans increased from 8 percent to 31 percent.[207] The following graphs this remarkable change in public and private sector retirement plans:

Private Sector Workers Participating in Employment-Based Retirement Plan, by Plan Type 1979 – 2008 *(Among all workers)*



Source: US Department of Labor Form 6600 Summaries for 1979-1998; PBGC, Current Population Survey Data for 1999-2008; Employee Benefit Research Institute estimates for 1999-2008.

[207] Barbara Butrica, Howard Iams, Karen Smith and Eric Toder, "The Disappearing Defined Benefit Pension and its Potential Impact on the Retirement Incomes of Baby Boomers," Social Security Bulletin, Volume 69, No. 3, 2009, p. 1.

Clearly, the decline in defined benefit plans relates to their cost. While public sector commitments to their defined benefit plans are often protected by constitutional and statutory requirements, there have generally been options available to private sector businesses to get out of their defined benefit programs and switch to a defined contribution plan – options that may not be available in the public sector.

Finally, while a strong case can be made for not reducing retiree benefits as part of a compact made with its employees, applying that to taxation of the benefits is a much more tenuous connection. Simply put, tax systems are modified by state legislatures all the time. This should be understood by all who pay taxes – and particularly those who are familiar with the role the Commission plays in Hawaii's tax policy discussions. The Commission exists to examine how the tax structure performs and how it relates to key tax principles, such as equity and efficiency. It makes no logical sense to argue that tax policy decisions made by legislatures from 30 or 40 years ago must remain binding on the current (or future) General Assemblies.

As a result, any assumed 'promise' that the State would never tax public pension income was illusory – there is no ability of a state official or legislator to make that promise – just as no federal official or member of Congress could make that promise to federal workers residing in Hawaii. In short, the changing nature of income and population composition in the State now suggests a different approach to the taxation of pension income.

Besides, taxing public pension income conforms with key tax principles. At its core, pension income is no different than other forms of taxable income – a retiree with a $25,000 annual pension is not all that different that an individual a year or two away from retirement with a $25,000 taxable salary. In this case, similar treatment of that income conforms with the concept of horizontal equity.

At the same time, a case can be made that the income generating potential of retirees is more limited than others pre-retirement age. To adjust for this, the study recommends that a portion of all pension income be exempt from the IIT – the current alternative revenue scenario sets that level at $25,000. It should be noted that a $25,000 pension exemption would be well within the mainstream of states that tax pension income.

- **Eliminate the Deduction for Property Taxes Paid**

  Under the US tax code, any state, local, or foreign taxes on real property levied for the general public welfare are deductible. Most states that use federal adjusted gross income as the starting point for state IIT purposes conform with federal law. However, there are states that do not. Among these states are Minnesota, Nebraska, Wisconsin and, to a limited extent, New Jersey.

  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. Given that K-12 funding is on average the largest expenditure category for local governments in the US, the State is making an extraordinary funding commitment to local schools.

  There are very logical public policy arguments in favor of this funding approach. Many state school finance formulas have been the subject of legal challenges, usually based on equal protection grounds. These lawsuits (which have been successful in several states, including Missouri, Ohio and Texas) generally argue that systems that rely on local school funding based on property tax revenue treat students unfairly, as 'property rich' school districts can more readily obtain the funding necessary to fund local schools. The Hawaii system takes the local property tax base out of the equation and funds all schools from a statewide funding source, the General Fund.

While the public policy case for this funding method is sound, the State is, in essence, replacing funding that would otherwise be raised by property taxes. Property taxes are somewhat unique among taxes, as a local property tax levy is generally determined by calculating the revenue that must be raised to support local services and determining the property tax levy based on the taxable value of the property subject to tax in that local jurisdiction. In that respect, it varies from income or consumption-based taxes that are set prior to determining the income or consumption subject to tax.

In Hawaii, because the General Fund supports local K-12 school budgets, education expenditures do not have to be calculated when determining property tax rates. In essence, those who pay taxes that go into the General Fund are subsidizing property taxpayers by this funding approach. It can be argued that this is an equity issue, as property owners are receiving a benefit that they would not receive in any other state.

The project team recommends that the State eliminate this deduction. By any measure of property tax rates, those in Hawaii are the lowest or among the lowest for every class of property. Further, other recommended state tax changes (such as raising the IIT standard deduction for lower income Hawaiian tax filers will mitigate any impact from loss of this deduction.

- **Cap or Replace with Grant Programs Certain Tax Credits**
  Hawaii has made extensive use of both IIT and corporate net income tax credits, including current credits for Renewable Energy Technologies and Motion Picture, Digital Media and Film Production. While now expired, the High-Technology Business Investment and Research Activities tax credit has been a particularly high profile State effort to attract and incent qualified businesses.

  Established in 1999,[208] the High-Technology Business Investment and Research Activities tax credit was originally equivalent to 10 percent of the investment in each qualified high technology business, with a maximum credit of $500,000 for each tax year. The Act was subsequently modified on multiple occasions, first to seek to make it more effective and later to make it more transparent and accountable.[209]

  According to the Hawaii Office of the Auditor, the High-Technology Business Investment and Research Activities tax credit has resulted in claims by eligible businesses of $857.6 million from 1999 through 2010. Research activities tax credit claims have totaled an additional $112.5 million, for total claims of $970.1 million.

  By any measure, an investment of nearly $1 billion in tax credits over an eleven year period is a significant public policy choice. While this may very well be an enlightened investment that is and will pay dividends for the State now and in the years to come, it is difficult, given the information available, to make this determination. This, of course, is the crux of the debate as it relates to broad-based tax expenditures.

  Policy makers nationwide have committed billions of dollars annually on tax incentives for economic development, and every state has at least one tax incentive program – with most

[208] The tax credit was created in Act 178, Session Laws of Hawaii, 1999, as part of a larger legislative package aimed at developing Hawaii business and industry in the high technology sector.

[209] A discussion of the history and activities associated with the tax credit can be found in a recent audit released by the Hawaii Office of the Auditor. See "Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits," Report No. 12-05, July 2012.

having several.[210] Their widespread use suggests that policymakers believe the investments are worthwhile and advance public policy, particularly related to economic development.

It is beyond the scope of this study to provide an in-depth review of state efforts related to tax credits, but a cursory review of the literature suggests that many states have refined their efforts to better target tax incentives (and other forms of development-related incentives). Among the strategies used are to make incentives dependent upon performance, monitor incentives, evaluate the effectiveness of existing incentives, improve the disclosure of economic incentive terms and packages and build claw-back mechanisms into incentive programs when recipient businesses do not meet performance targets.[211] A particular area of concern for Hawaii and all states is their ability to evaluate state tax incentives for jobs and growth. According to a recent review, there are four key criteria for state evaluation. These relate to the degree to which a state uses data and information related to its development programs to:[212]

1. Inform policy choices
2. Include all major tax incentives
3. Measure economic impact
4. Draw clear conclusions

According to this review, 13 states are 'leading the way' by meeting criteria for scope and quality of evaluation of these criteria, 12 states meet only one of the criteria, and 26 states do not meet any of the criteria for scope or quality of evaluation. Hawaii was ranked as a state that did not meet any of the criteria for scope or quality of evaluation.[213]

Given current issues around overall tax credit reporting, it makes sense for the State to identify other alternatives to limit the extent of the use of tax credits. As was noted in the Auditor's review of the High-Technology Business Investment and Research Activities tax credit, a number of states that provide similar tax credits cap those credits or otherwise limit the state's financial impact. These include the States of Arkansas, Colorado, Illinois, Indiana, New Mexico and Wisconsin. The limits range from less than $1 million a year to $20 million a year.[214]

Currently, these and other tax credits are not capped, which can make it difficult to maintain revenue stability and sufficiency over time. The project team recommends that, in the short term, the State either cap or eliminate broad-based credits and replace them with grant, loan and/or forgivable loan programs.

As opposed to tax credits, which are generally administered by revenue or tax departments, grant, loan or forgivable loan programs can be administered by departments responsible for economic development activities. These departments are more likely to have the experience and expertise to evaluate and manage this type of program. These can be more readily directed at specific types of projects and activities and controlled through the application and approval process.

At the same time, the Legislature should establish criteria that ensure that state funding supports specific public policy outcomes. Examples of these in use elsewhere include Job creation

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[210] "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth, Pew Center on the States, April 2012.

[211] Judy Zelio, "Taking the Measure of State Economic Development, The National Conference of State Legislatures, 2009.

[212] Op Cit., p. 3.

[213] Op Cit, p. 2.

[214] Op cit., p. 15.

refundable credits, which award the credit based on net new jobs created. These can be calculated after income taxes have been withheld by the companies from the new employees, which is generally an improvement on providing a tax credit without regard for whether jobs are actually created. A number of states provide a form of high wages/benefits jobs tax credit to target those types of jobs.

The project team recommends that, in the short run, the State cap development-related credits at a dollar amount that is deemed an acceptable and appropriate use of state tax expenditures. Over the long run, the State may wish to transition to appropriations administered by the Department of Business, Economic Development and Tourism.

Methods to Reduce Regressivity in Certain Taxes

Multiple sources have identified Hawaii's tax structure as regressive – a key equity concern. In particular, the broad reach of the GET is an area of concern. While the GET is a cornerstone of the current (and envisioned) tax structure, there are opportunities to reduce some of its regressive features, particularly by changes to the IIT. The following would address regressive aspects of the two largest sources of General Fund revenue.

- **Increase the Standard Deduction for IIT to $7,500 for single filers, $15,000 for married and $10,950 for head of household filers**
  The State's IIT brackets begin at 1.4 percent on the first $2,400 of taxable income but rise to 7.2 percent at taxable income of 19,201. This is a relatively rapid rise compared to other states. For low income IIT filers (who do not typically itemize deductions), the standard deduction can be used to offset tax liability – while higher income filers will typically itemize anyway. These changes would move the State's current standard deduction, which is in the lower range of all states, to among the leaders among all states, about equal with New York and trailing Connecticut and Wisconsin.[215]

  This would address several policy issues. First, it helps address issues of vertical equity. Second, it ameliorates any concerns that eliminating the deduction for property taxes will negatively impact lower income individuals. Finally, it is one method for addressing concerns about the regressive nature of the GET.

- **Double the refundable Food/Excise Tax IIT credit**
  As has been noted on multiple occasions, the application of the GET to food has both positive and negative impacts. On the positive side, it helps to broaden the tax base and makes it more reliable during economic downturns. On the negative side, it makes the tax structure more regressive, as lower income cohorts generally spend a greater share of their income on food than higher income cohorts.

  Hawaii currently provides a refundable IIT credit 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. The following is the current credit at various income levels:

[215] "Individual Income Tax Provisions in the States," Wisconsin Legislative Fiscal Bureau, January 2011, p. 10.

Adjusted Gross Income	Tax Credit Per Qualified Exemption
Under $5,000	$85
$5,000 under $10,000	$75
$10,000 under $15,000	$65
$15,000 under $20,000	$55
$20,000 under $30,000	$45
$30,000 under $40,000	$35
$40,000 under $50,000	$25
$50,000 and over	$0

As an example, a qualified family of four with an AGI of $20,000 would currently receive an IIT credit of $180. It is notable that, using income shares for similar families around the country, a family with income before taxes of $25,000 would spend approximately 13.7 percent of their income on food. This would equate to approximately $3,425 – and the 4.0 percent GET would total $137.[216]

Were the GET to be increased to 4.5 percent, as the study recommendations suggest, the total GET devoted to food for the family of $25,000 would be $154. Of course, there are other expenditures subject to the GET that impact lower income individuals to a greater extent than higher income taxpayers. However, the combination of the higher tax credit and IIC exempted income should help reduce the impact of any recommended GET rate increase.

Methods to Reduce Pyramiding in Certain Taxes

Economists are nearly uniform in their belief that pyramiding distorts market decisions and reduces overall efficiency. As an example, pyramiding causes businesses to make decisions on how to operate that they might not otherwise make. It can also distort prices paid by certain goods and services and interfere with efficient market decisions.[217] A study for a previous Commission explained that 'the GET is intended as a tax on consumption, but businesses do not consume, they produce.'[218] As a result, taxes applied do not fit within the framework of a tax on consumption.

Because the GET applies a 0.5 percent rate to wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale, pyramiding occurs. This can negatively impact on business decisions about where to locate operations and how to purchase goods and services that are a part of the overall process that leads to a finished product or service. The following adjustments would reduce pyramiding and seek to benefit Hawaii businesses negatively impacted. At the same time, the study recommendations would replace some of the lost income with other business-related taxes.

- **Eliminate the 0.5 percent GET and Use Tax rate**
  As already noted, application of a 0.5 percent rate to many the business-to-business transactions has negative impacts on market efficiency and specific types of State businesses. This is a concern for both horizontal equity and market efficiency principles.

[216] Bureau of Labor Statistics, Consumer Expenditure Survey, Table 46, Income before taxes: Shares of average annual expenditures and sources of income, 2010. Accessed at http://www.bls.gov/cex/2010/share/income.pdf

[217] Donald Rousslang, "Tax Expenditures in Hawaii, Draft" February 14, 2012, p. 3.

[218] William Fox, "Hawaii's General Excise Tax: Should the Base be Changed?" Hawaii Tax Review Commission, October 4, 2006, p.8-9. For another scholarly discussion of tax pyramiding in a state tax structure see Annette Nellan, "Sales and Use Tax Weakness and Possible Remedies: The Pyramiding Nature of the Tax," 2007, accessed at http://www.cob.sjsu.edu/nellen_a/TaxReform/Report2cSUTPyramiding.pdf

The market efficiency concerns have already been discussed at length. There are also issues related to horizontal equity. Any tax based on gross receipts is going to raise issues related to what is the appropriate base for a tax. Differing types of businesses are going to generate different percentages of profit from their sales. There is a legitimate concern that a tax based on gross receipts will penalize firms that operate on a high volume, low profit margin business plan.

While the revenue associated with this tax is significant, it comes, as explained above, at a cost for Hawaii businesses. Given the significant efficiency and horizontal equity concerns, the recommendation is to eliminate this tax and seek to replace a portion of it with other business taxes.

- **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.

  As noted in the analysis in this chapter, business-to-business taxes are generally to be avoided, as they distort efficient market decisions. That said, this report also acknowledges that there are instances where tax policy will have to take a back seat to the requirement that the state balance its annual budget.

  At the same time, this report is focused on longer-term revenue and budget strategies. Given the fact that there are better options to balance the State budget via changes to the tax structure, the GET suspensions should be allowed to sunset as scheduled. Restoring these exemptions will help reduce pyramiding and contribute to a more efficient tax structure.

- **Increase Corporate Net Income Tax revenue**
  The State currently has a three-tiered corporate net income tax structure, with rates of 4.4, 5.4 and 6.4 percent, based on net income. This can be an equity issue, as corporate net income is not necessarily equated with ability to pay.

  Currently, the majority of states use a single corporate income tax rate (29 states). Of the remaining states with a corporate income tax, 12 use varying brackets.

  The project team recommends that 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 eliminating the GET 0.5 percent rate would better align with equity and efficiency principles.

<u>Methods to Export a Share of the Tax Burden to Non-residents</u>

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**
  The State's cigarette tax is already among the highest rates in the country. According to the FTA, Hawaii's rate, at $3.20 per pack, is the fourth highest among the 50 states. Hawaii has a history of raising this tax on a regular basis, and the basis for doing so is understandable.

  First, Hawaii's island location makes it relatively immune from issues of cross-border competition – those who wish to smoke cigarettes in the State have fewer options than in other states for obtaining lower priced cigarettes. Second, there is a logical basis for increased tax rates for cigarettes. While the tax rate is high, the calculations of the negative societal impacts from

cigarette smoking suggest that tax increases are justified. According to the Center for Disease Control (CDC), the health and other societal costs associated with consumption of a pack of cigarettes sold in Hawaii is $10.81, while state and federal taxes per pack total $4.21. Finally, raising the tax has the added benefit of generally reducing smoking for key target populations, such as children. The CDC argues that increasing the price of cigarettes reduces demand and reduces cigarette use in the United States overall, particularly among youths and young adults.[219]

It has generally been concluded that the cigarette tax is a regressive tax. At the same time, research suggests that higher taxes also encourage lower income individuals to stop smoking – which has a large health and economic benefit in the long run. In general, increases in this and other excise taxes also help to maintain a sufficiently broad tax base that also exports a share of that burden to non-residents.

- **Increase gallonage taxes on beer, wine and distilled spirits**
  Current taxes for beer, wine and distilled spirits are generally among the higher state taxes in the nation. The current tax on beer, $0.93 a gallon, is the second highest among the states, trailing only Alaska and well above the median rate of $0.19. The tax on distilled spirits, $5.98 a gallon, is sixth highest among the 31 states that impose a gallonage tax – and well above the median of $3.75 a gallon. Finally, the tax on wine, $1.38 a gallon, is the ninth highest of the 45 states that impose a gallonage tax – again, well above the median of $0.67 a gallon.[220]

  While these tax rates are comparatively high, similar arguments can be made for a moderate increase in these taxes as for the cigarette and tobacco tax: there are health and other positive externalities associated with reduced consumption, and there is little real risk of cross border competition. In this respect, it is notable that the one state that has a higher excise tax on all three categories (beer, wine and distilled spirits) is Alaska – the other U.S. state with little concern for cross border competition.

  During discussions with the Department of Taxation, their regression analysis suggests a connection between performance of the leisure and hospitality industry and General Fund revenue performance from these excise taxes; this suggests that a significant portion of the tax is exported.

  Among other tax principles, while it is often argued that these excise taxes are generally regressive, the BLS purchasing shares data does not support this. According to that data, alcohol purchases for all consumers totaled 0.9 percent of income; at the lower income levels the share of income devoted to alcohol purchases was actually lower (between 0.6 and 0.7 percent at income levels between $5,000 and $29,999), while levels above $30,000 were generally in the range of 0.8 to 0.9 percent.

  The recommendation built into the models alternate revenue structure scenario would increase each of these taxes by approximately 15 percent.

- **Eliminate the sunset on the TAT rate increase**
  Legislation enacted in 2009 temporarily increased the TAT. The legislation added an additional 1.0 percent to the rate from July 1, 2009 through June 30, 2010, and an additional 2.0 percent from July 1, 2010 through June 30, 2015. As a result of these changes, the TAT rate is now 9.25

[219] "State Cigarette Excise Taxes – United States 2010-2011," Centers for Disease Control and Prevention, Morbidity and Mortality Weekly Report, Vol. 61, No. 12, March 30, 2012.

[220] Federation of Tax Administrators, accessed electronically at http://www.taxadmin.org/fta/rate/tax_stru.html.

percent through the end of FY2015. Temporary increases in the TAT are scheduled to sunset on June 30, 2015.

As noted in the discussion of benchmark cities, the current TAT rate places Honolulu in the middle of other popular U.S. destination cities. At the same time, cities with TAT rates in excess of the State rate are generally cities with a significant portion of business travelers, and it can be argued that these travelers are relatively indifferent to the tax rate. On the other hand, leisure travelers or event planners may be more willing to factor this tax rate into calculations of overall costs when choosing a destination.

At the same time, the State is currently charging this higher rate, and the tourism industry is having a strong year – if the tax is having a negative impact on overall travel, it is not readily discernible. Given the experience with the current tax rate, eliminating the sunset will reduce base erosion and continue to export a significant amount of the tax burden.

- **Restore the surcharge on rental cars**
  As with the TAT, the State has raised this tax in the past to assist in closing budget gaps. In 2011, the State increased the rental motor vehicle surcharge tax from $3.00 per day to $7.50 per day from July 1, 2011 to June 30, 2012. The Legislation deposited a portion of the surcharge ($4.50 per day) in the State's General Fund and suspended the rental motor vehicle customer facility charges for the period of July 1, 2011 to June 30, 2012.

  The temporary $7.50 per day surcharge expired on June 30, 2012 and reverted to the $3.00 per day surcharge. The FY 2012 additional surcharge provided a one-year revenue increase of approximately $61 million to the State's General Fund.

  As with the TAT, it is evident that a considerable portion of this excise tax is exported. Restoring the tax to previous levels will also broaden the excise tax base. As with the TAT, there is also a case to be made that the State (and consumers) have experience with the tax – in line with the concept that 'an old tax is a good tax.'

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**
  While it is accepted that maintaining low rates is a good overall tax policy, the GET has not been raised since 1965. While accepting the fact that the GET is a business privilege tax with a very broad base, other states have broadened their base to also tax services, which is a key aspect of the Hawaii GET base. While the GET is a business privilege tax (as opposed to a sales tax), 13 states levy their general consumption tax as a vendor levy.

  A key consideration for broad based tax rates is their impact on efficiency. Regardless of the broadness of the GET base, the rate is low compared to other states' general taxes on consumption. Among all states, only Colorado has a lower general rate (2.9 percent) than Hawaii's 4.0 percent rate (Alabama, Georgia, Louisiana, New York, South Dakota and Wyoming also have a 4.0 percent rate). According to a recent study done for the Commission, the median state rate is 6.0 percent, and 35 states have local sales taxes as well.[221] Local sales taxes are

[221] William Fox, "Selected Issues with the Hawaii General Excise Tax," July 22, 2012, p. 3.

significant in most states; one study found that when average local sales taxes are combined with the state sales tax rate, Hawaii had the lowest combined rate of any state with a broad-based consumption tax (usually a sales tax). By contrast, Colorado's combined rate is 7.44 percent, while the states with a 4.0 state rate have combined rates between 5.34 and 8.85 percent.[222]

While Hawaii has not raised its rate in over 35 years, over half of the states have raised their sales tax rate since 2000 – in many cases multiple times. In many cases, these rate increases were for precisely the reason facing the State in the years to come – a need to restore structural balance.

The recommendation, to increase the GET to 4.5 percent, would still leave the State with the lowest combined state and local rate among the states, at 4.85 percent. Given that the recommendations also include eliminating the 0.5 percent rate, the effective rate of the tax should be less than 4.85 percent.[223] 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.

It is true that the GET raises a substantial amount of revenue at a relatively low rate – and this is largely because of its extremely broad base. The inclusion of items often classified as necessities (food, utilities) in the tax base raises concerns about regressivity of the tax. However, other recommended changes (such as the increase in the refundable food/excise IIT credit and the exclusion of a significant portion of taxable income from the IIT) would reduce some of that impact.

Clearly, this is not a recommendation to be taken lightly – it is a significant increase in the overall tax burden for Hawaii residents. However, in relationship to other states, this action keeps Hawaii's primary consumption tax in the low range nationally while affording the State its best opportunity to restore structural budget balance.

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 have implemented sophisticated data warehouse systems that assist with identifying non-filers of tax returns and non-payers of taxes. These systems are often augmented with business intelligence software and servers. In many instances, vendors are willing to negotiate performance-based solutions, where the newly generated tax revenue is used to pay for the system. As an example, the State of Iowa entered into a three year partnership with a vendor to design, develop and implement a data warehouse solution in November 1999 and realized the first revenues from the program five months later. Within four years, the program had generated over $71 million in new revenue.[224] This effort can be built into current plans to improve the overall financial management systems for the State.

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[222] "State and Local Sales Tax Rates as of January 1, 2012," The Tax Foundation, February 16, 2012 accessed electronically at http://taxfoundation.org/article/state-and-local-sales-tax-rates-january-1-2012.

[223] One study suggested that the effective GET rate on goods and services purchased by Hawaii residents was an estimated 5.3 cents per dollar of final sales. Richard Bowen and PingSun Leung, "Tax Pyramiding and Tax Exporting in Hawaii: An Input-Output Analysis," University of Hawaii Research Extension Service, Series 102, January 1989, p.6.

[224] A paper describing the State of Iowa program was presented at the FTA Revenue Estimating and Tax Research Conference in September 2006. It can be accessed at http://www.taxadmin.org/fta/meet/06re_data/pres/lipsman.pdf.

In general, these approaches align with tax policy best practices – they seek to collect taxes that are rightly due to the State. Taxpayers who make the effort to pay the taxes they are lawfully required to pay should be supportive of these efforts. This can also build confidence in the system and, as compliance increases, heighten the awareness of non-compliant taxpayers that the State is likely to find them and seek payment and penalties.

- **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.

  As an example, the State of Pennsylvania has a dedicated fund (the Enhanced Revenue Collection Account, or ERCA) that is used to augment its tax audit and enforcement efforts. According to their Department of Revenue, ERCA funding of $3.9 million in FY 2011 provided a 2,100 percent return on investment and exceeded revenue generation goals by $35.2 million. The Department of Revenue's current budget proposal expands and extends ERCA funding to $10 million each year through FY 2016-17 and is estimated to generate $100 million in additional tax revenue for fiscal year 2012-13.

- **Provide tax expenditure reports on a scheduled regular basis**
  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.

  Nearly every state now publishes a tax expenditure report on a (generally) regular basis. From review of State reports, at least that 41 states have issued tax expenditure reports (in some cases on an annual or biennial basis) since Hawaii last issued a tax expenditure report.

- **Eliminate net operating loss carry-back**
  Hawaii is one of 19 states that allow net operating losses to be 'carried back' so that businesses can file amended returns and use current losses to offset profits and receive refunds of taxes paid in prior years. While most every state allows a business to carry current year losses forward to be used in future years to offset profits, a majority of states still allow losses to be carried back.

  The project team recommends that the State maintain the ability for corporations to carry losses forward but eliminate the ability to carry losses back. While this will have no material impact on overall tax collections over time, it will provide some greater stability during economic downturns by helping to curtail business tax refunds based on amended returns from prior years.

<u>Alternatives Not Recommended</u>

Many of the alternatives discussed in the prior chapter are not included in the recommendations. There are a variety of reasons for their lack of recommendation. (Policymakers may differ with the analysis, and for that reason the revenue estimates have been built into the model should policymakers wish to consider them.) The following provides a brief explanation for each of the alternatives discussed in the previous chapter:

- **GET exemptions for non-profits.** States and local governments are increasingly re-examining the tax treatment of non-profit corporations. As a recent report to the Commission notes, the exemption is a form of subsidy for these organizations that could be provided via direct payments rather than the indirect method through the tax exemption.[225] In fact, this perspective aligns with the recommendation to cap or curtail economic development tax incentives and replace them with direct grant, loan or forgivable loan programs. The report also notes that many non-profit organizations compete with for-profit firms, which creates horizontal equity issues.

  The potential revenue gain from removing the exemption is significant – projected to be $254.1 million. It is also a fast growing segment – the estimate of potential revenue has grown at a compound annual growth rate of 7.1 percent since a similar estimate from 2006.[226]

  This is certainly a viable revenue option, and there is a rationale based on tax policy as well. Besides the previously mentioned issue of horizontal equity related to the exemption, applying the GET would significantly broaden the base - and likely continue to do so in the future.

  In the end, the project team believed that the GET rate increase was more of a known outcome and thus preferable. The unknown related to how the new tax application might impact smaller non-profit service providers was deemed to be an important factor, but some policymakers may choose to analyze this option as a replacement for other tax changes.

- **GET Nexus.** While some states are aggressively pursuing nexus for consumption tax collection purposes, the possible additional revenue from pursuing these strategies is hard to estimate. Given a variety of opportunities to address administrative and compliance issues – and the possibility that federal action could make these efforts moot – the project team believes the State can better target its limited resources in other areas.

- **Eliminate or reduce the IIT deduction for Social Security benefits.** While the states are evenly split on taxing pension income, there is less division relating to social security income, with a majority of the states deducting this for IIT purposes. While there are eight states that have adopted the federal standard that taxes up to 85 percent of social security income, the project team believes that a reasonable approach is to maintain the deduction for social security as the bedrock safety net for older Hawaiians while taxing a portion of pension income.

- **Prepared Food Tax.** In general, the strategy around changes in excise tax rates was to raise those where there is a strong case that a large percentage of the tax is exported or there are positive externalities associated with higher taxes (as higher tax rates will generally lead to some reduction in consumption). In the case of a prepared food tax, there was less compelling evidence that the tax would be largely exported. It would also be a new tax that would add some additional complexity to the tax system.

- **Amusement or Recreation Tax.** As with the previous example, it was difficult to determine to what extent the tax would be exported and would be a new tax that would add some additional complexity to the tax system. Depending on how amusement or recreation activities were defined, there would also be the possibility of substitution and, as a result, horizontal equity concerns.

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[225] William Fox, "Selected Issues with the Hawaii General Excise Tax," Report Prepared for the 2010-2012 Hawaii Tax Review Commission, July 22, 2012, p. 18.

[226] Ibid. p. 18.

- **Motor Fuel Tax.** It is likely that a majority of the tax increase would be borne by residents. The tax is also a non-General Fund revenue source that would not assist in addressing the coming structural budget gaps.

- **Snack Food/Soda Tax.** It is likely that a majority of the tax increase would be borne by residents. There is also significant disagreement as to whether these taxes reduce consumption or improve health. Finally, this would be a new tax, and definitions of what constitutes a 'snack food' have been difficult to establish in other states.

- **Conveyance Tax.** It is likely that a majority of the tax increase would be borne by residents. Further, this is a relatively small revenue source that would not have a material impact on the State budget situation.

- **Insurance Premium Tax.** This tax is almost entirely borne by residents.

- **Cell Phone Service Tax.** This tax is almost entirely borne by residents.

- **Single apportionment factor for Corporate Net Income Tax.** While some states have shifted to a single factor as a way to attract business and industry (particularly in the manufacturing sector), the project team preferred removing 0.5 percent from the GET rate.

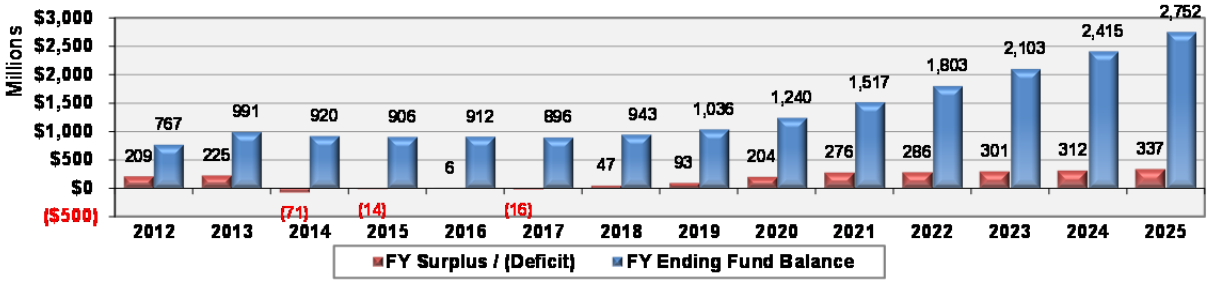
- **Broaden definitions for Nexus.** The project team views this as another largely administrative approach that is less likely to yield additional revenue than other alternatives.

- **Institute a lottery/other forms of gambling.** While the vast majority of states have instituted a lottery, this appears to be an area where there are many with strong cultural and philosophical opposition to State involvement. Given that lotteries raise relatively small amounts of revenue in most states (and can create some belief on the part of taxpayers that these revenues will be sufficient to fund increases in some key program areas), this was viewed as an alternative that would likely create more controversy than benefit. Lotteries and other forms of gaming also tend to be regressive and may create some negative externalities as well.

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 the project team 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	*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

Summary

The 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 $3.0 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 $16 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 $17 billion.

The State of Hawaii is at a crossroads: the 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 the corpus in the OPEB trust 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.

Report Epilogue

After issuing the draft report, the Tax Review Commission solicited and received significant feedback and commentary on the draft findings and recommendations – both positive and negative. This is to be expected, as tax policy changes can have major impacts on individuals and businesses, and many of them weighed into the discussion. It is important to weigh the feedback within the context of individual self-interest and equally important to note that the recommendations relate to an overall tax system. Critiques of individual recommendations often do not address broader system-wide considerations.

In discussing the report, the original study charge should be kept in mind. The charge was to conduct:

- An analysis of whether the current tax system will provide sufficient revenues to meet near and long term future needs for the 21st Century.
- A review of alternate tax structures that could improve Hawaii's ability to generate sufficient revenues.

In conducting its analysis, the project team created a multi-year financial planning model to determine whether expected revenues would be sufficient to provide a current level of services in future years. PFM has built this sort of model for numerous state and local governments around the country. In fact, this long-range financial planning activity is considered a standard practice for state and local governments and has been identified by credit rating agencies and public policy organizations as a best practice.[227] Long-range analysis is critical to assess the State's near and long-term revenue sufficiency as measured against projected expenses associated with current levels of service. This exercise is not only warranted but in many ways necessary for the Commission to fulfill its responsibilities.

The report has been criticized in its approach to the question of 'whether the current tax system will provide sufficient revenues to meet near and long term future needs' because of its focus on the revenue aspect of budgeting. There are differing philosophies and approaches as to how governments should approach and deal with possible budget shortfalls. Many of the revenue-side recommendations in this report could be addressed on the expenditure side as well.[228] However, the focus of the charge from the Tax Review Commission (as its name would suggest) was 'alternate tax structures that could improve Hawaii's ability to generate sufficient revenues.'

The following are brief responses to some of the broad tax policy critiques:

Tax Burden

Hawaii statute suggests that the TRC should view the current and any recommended tax structure changes from the perspective of equity. Many of the critiques of the recommendations have focused on specific recommendations without necessarily examining the impact on the tax structure as a whole. In many respects, these are non-unique criticisms, as other national studies have raised concerns about the equity of the current State tax structure.

The study recommendations, as a whole, decrease the tax burden for lower income taxpayers. According to the study calculations, which use federal Bureau of Labor Statistics data on consumer

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[227] See, for example, "Recommended Budget Practices: A Framework for Improving State and Local Government Budgeting," National Advisory Council on State and Local Budgeting, Governmental Finance Officers Association, 1998, pp.43-51. See also "The Top 10 Management Characteristics of Highly Rated U.S. Public Finance Issuers," Standard and Poor's Rating Services, July 22, 2012, p. 7.

[228] As the report notes, neutral third party analysis (such as that conducted by the GAO) suggests that expenditure solutions are unlikely to be the primary vehicle for solving long-term state budget problems.

expenditures by income levels, the recommendations will reduce the tax burden for lower income cohorts while raising it for high income cohorts.

At the same time, the study recommendations are expected to increase the overall amount of revenue the State collects. As a result, the tax burden for some individuals and businesses must necessarily rise. The study recommendations seek to balance the impact on any particular taxpaying group, which generally supports both equity and efficiency principles.

GET Rate Comparisons

Commentators have suggested that an analysis of the GET rate in comparison to other state sales tax rates is inappropriate, as the GET is not a sales tax and is applied to the gross receipts of virtually all businesses operating in the State. The study acknowledges the broad base of the GET in relationship to other states, quoting from comparisons done by the Federation of State Tax Administrators (FTA) and Dr. William Fox. However, there are other states that impose a business privilege or transaction tax in lieu of a state sales tax – a past paper for the TRC by Dr. Fox notes that "Hawaii is not unique in creating its sales tax through a vendor levy. Thirteen states including Hawaii levy their sales tax on the privilege of engaging in business as a vendor."[229]

Regardless of the nuance of the tax, these thirteen states are regularly compared to states with a more general state sales tax, and it is acknowledged by tax experts that they largely have the same effect – they are primarily taxes on consumption. Dr. Fox discusses the GET and its relationship to other broad-based sales taxes and notes that "An important conclusion of economics is that the economic effects, in terms of whose income ultimately is reduced through payment of the tax and the tax's effects on the product's price and quantity demanded, are the same regardless of whether the tax is legally incident on the seller's receipts or the buyer's purchase."[230]

The July 2012 paper for the TRC by Dr. Fox makes similar comparisons as those done by this study – it examines rates for states with sales taxes and other general consumption taxes and makes the similar point that "The standard GET rate (4.0 percent) is low compared with other states."[231] Granted, the base on which Hawaii applies its GET is broad – the broadest of any state. However, other states do also tax a number of services (which is generally viewed as a key component of the broadness of the base). For example, the FTA state survey found that Hawaii was first among the states in taxing common services, with 160 out of 168 taxed, but New Mexico and Washington were not far behind, both taxing 158 services. South Dakota and Delaware also each tax over 140 services.

The primary purpose for discussion and comparison of state general consumption tax rates relates to issues of efficiency and the axiom of taxation to strive for the broadest possible base and the lowest possible rate. The study's use of rate comparisons is primarily to determine whether in the broad application of the consumption tax a 4.5 percent GET rate would be out of step with other states and thus make the economy less competitive with other states based on this tax rate – and the answer is clearly that it would not.

Tax Pyramiding

The recommendation to increase the GET rate to 4.5 percent has been criticized as leading to additional tax pyramiding. To the extent that pyramiding occurs with the current 4.0 percent GET rate, it is a fact that an increase in the rate to 4.5 percent will have some additional pyramiding impact. However, the study also recommends eliminating the 0.5 percent rate that is applied to wholesaling, manufacturing,

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[229] William F. Fox, "Hawaii's General Excise Tax: Should the Base Be Changed?" Report Prepared for the 2005-2007 Hawaii Tax Review Commission.

[230] Ibid.

[231] William F. Fox, "Selected Issues with the Hawaii General Excise Tax," Report Prepared for the 2010-2012 Hawaii Tax Review Commission, July 22, 2012, p. 3.

producing, wholesale services, and use tax on imports for resale. The taxing of these activities creates significant pyramiding (for example wholesale activities, by definition, are 'middleman' services provided prior to retail sale of a good), and removing the tax will lessen pyramiding.

It is generally accepted by economists that pyramiding has negative consequences – and prior papers for the TRC by Dr. Fox have examined this issue.[232] While it is acknowledged that the GET results in tax pyramiding, the effective GET rate as a result of pyramiding has not been a recent subject of research (and may well be a topic worthy of analysis by the TRC in the future). A 1989 study, which is cited in the report, constructed an input-output model of the State economy and estimated that the effective GET rate (because of pyramiding) was in the range of 5.3 to 5.4 percent.[233] While the study is dated, if this estimate is still reasonable, it suggests that the additional pyramiding impact from raising the GET rate to 4.5 percent will be less substantial than some claim.

While the concept that eliminating the 0.5 percent GET rate will reduce pyramiding is obvious, one local commentator suggested that keeping the 0.5 percent rate was important so as to be able to obtain useful economic information from those subject to this tax. This is a novel theory of taxation – in essence, consumers and businesses should pay for the privilege of providing economic data to the State. However, this theory does not really align with either tax efficiency or equity considerations.

Individual Income Tax

A major consideration in the report's recommendations is to reduce, to the extent possible, the tax burden on lower-income state residents. The study seeks to accomplish this by increasing the IIT standard deduction and doubling the refundable food/excise tax credit. Even when coupled with the increase in the GET rate, this is a net gain for lower income taxpayers – according to the tax burden model constructed for the study, low income taxpayers (in this case, defined as a family of three with income of $25,000) realized in net savings equivalent to 2.3% of their income. Families with income of $50,000 also see some small savings, while those with incomes of $75,000, $100,000, and $150,000 see increases in their tax burden. From the perspective of advancing equity issues, the study recommendations further that important goal.

Summary

Many of the critiques of the report and its recommendations are understandable and expected and all deserve careful consideration. At the same time, the recommendations should be viewed in the broad context of a tax structure that is likely to have to generate additional revenue over baseline assumptions during the next 12 years. The recommendations should be viewed collectively, as individual components will have negative impacts that may be outweighed by other suggested changes. When taken as a whole, the recommendations generally align with equity and efficiency considerations and should help the State achieve structural balance over the entirety of the 2012-2025 timeframe.

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[232] Ibid.

[233] Richard L. Bowen and PingSun Leung, "Tax Pyramiding and Tax Exporting in Hawaii: An Input-Output Analysis," University of Hawaii Research Extension Series 102, January 1989, p.6.

Appendices

Appendices

Appendix A: Interview/Discussion/Presentation Groups

The following is a list of meetings and/or interviews conducted to date:

Agency	Interviewee(s)
Tax Review Commission (TRC) (Initial kick-off meeting, Mid-Project Reporting meeting, and Final Report Draft Presentation)	Randall Iwase, Chair Mitchell Imanaka, Vice Chair Roy Amemiya, Member Peter Ho, Member Mike McEnerney, Member Darryl Nitta, Member Gregg Taketa, Member
Dept. of Taxation (DOTAX) (interviews and Final Report Draft Presentation)	Fred Pablo, Director Randy Baldemor, Deputy Director Don Rousslang, Tax Research and Planning Officer Titin Sakata, TRC Technical Officer / Special Assistant to Director of Taxation
Hawai'i Institute of Public Affairs (HIPA) (interviews)	Bill Kaneko, President & CEO Jeanne Schultz Afuvai, Executive Vice President
House Speaker (meeting)	Representative Calvin Say
House Finance Committee members (meetings)	Representative Marcus Oshiro, Chair Representative Kyle Yamashita Legislative Committee Staff
Dept. of Accounting & General Services (DAGS) (interviews)	Jan Gouveia, Deputy Comptroller Wayne Horie, Accounting Division Administrator Wayne Chu, Audit Division's Administrator
Dept. of Business Economic Development & Tourism (DBEDT) (interview)	Dr. Eugene Tian, Acting Administrator, Research & Economic Analysis Division (READ)
Office of the Governor (interviews and presentation of Draft Report and Baseline Model)	Neil Abercrombie, Governor of Hawaii Blake Oshiro, Deputy Chief of Staff Beth Giesting, Healthcare Transformation Coord.
DBEDT, Energy Office (interviews)	Mark Glick, Administrator Michelle Toma
Employer-Union Health Benefit Trust Fund (EUTF) (interview)	Barbara Coriell, Administrator
Employees' Retirement System (ERS) (interviews)	Wes Machida, Administrator ERS Division Directors Colbert Matsumoto, Chair
Council on Revenues (COR) (interview)	Rick Kahle, Chair Dr. Jack Suyderhoud, Vice Chair
Dept. of Budget & Finance (B&F) (interviews)	Kalbert Young, Director Luis P. Salaveria, Deputy Director Neal Miyahira, Administrator

Agency	Interviewee(s)
Hawai'i Government Employee Association (HGEA) (interview)	Randy Perreira, Executive Director Michele Kurihara, Legislative Specialist HGEA Union Agent
Dept. of Agriculture (DOA) (interview)	Russell Kokubun, Chairperson Ken Kakesako Warren E Takenaka Earl J Yamamoto
Senate Ways and Means Committee (meeting)	Senator David Ige, Chair Legislative Staff
Dept. of Human Resources & Development (DHRD) (interview)	Barbara Kreig, Director Leila Kagawa, Deputy Director
Chamber of Commerce (meeting)	Sherry Menor-McNamara, Chief Operating Officer, Senior VP, Government Affairs Chamber Committee Members
Office of Information Management & Technology (IMT) (interview)	Sanjeev "Sonny" Bhagowalia, State Chief Information Officer IMT Staff
Dept. of Human Services, QUEST and Medicaid Information (interview)	Dr. Kenneth Fink, Administrator Brian Pang

Appendix B: Suspended Exemptions

The following Information is taken from DOTAX Announcement 2011-09, relating to the provisions of Act 105 of 2011, which temporarily suspended certain tax exemptions.

On June 9, 2011, Governor Neil Abercrombie signed into law Senate Bill 754 SD1, HD1, CD1 as Act 105, Session Laws of Hawaii 2011.

This Act suspends temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from the general excise and use tax and requires the payment of both taxes at a four per cent rate. The persons and amounts for which exemption under the general excise tax has been suspended are as follows:

1. Amounts deducted from the gross income received by contractors as described under section 237-13(3)(B);
2. Reimbursements received by federal cost-plus contractors for the costs of purchased materials, plant, and equipment as described under section 237-13(3)(C);
3. Gross receipts of home service providers acting as service carriers providing mobile telecommunications services to other home service providers as described under section 237-13(6)(D);
4. Amounts deducted from the gross income of real property lessees because of receipt from sublessees as described under section 237-16.5;
5. The value or gross income received by nonprofit organizations from certain conventions, conferences, trade show exhibits, or display spaces as described under section 237-16.8;
6. Amounts received by sugarcane producers as described under section 237-24(14);
7. Amounts received from the loading, transportation, and unloading of agricultural commodities shipped interisland as described under section 237-24.3(1);
8. Amounts received from the sale of intoxicating liquor, cigarettes and tobacco products, and agricultural, meat, or fish products to persons or common carriers engaged in interstate or foreign commerce as described under section 237-24.3(2);
9. Amounts received or accrued from the loading or unloading of cargo as described under section 237-24.3(4)(A);
10. Amounts received or accrued from tugboat and towage services as described under section 237-24.3(4)(B);
11. Amounts received or accrued from the transportation of pilots or government officials and other maritime-related services as described under section 237-24.3(4)(C);
12. Amounts received by labor organizations for real property leases as described under section 237-24.3(10);
13. Amounts received as rent for aircraft or aircraft engines used for interstate air transportation as described under section 237-24.3(12);
14. Amounts received by exchanges and exchange members as described under section 237-24.5;
15. Amounts received as high technology research and development grants under section 206M-15 as described under section 237-24.7(10);
16. Amounts received from the servicing and maintenance of aircraft or construction of aircraft service and maintenance facilities as described under section 237-24.9;
17. Gross proceeds from the sale of the following:
    1. Intoxicating liquor to the United States (including any agency or instrumentality of the United States that is wholly owned or otherwise so constituted as to be immune from the levy of a tax under chapter 238 or 244D,

but not including national banks) or any organization to which the sale is permitted by the proviso of "Class 3" of section 281-31 that is located on any Army, Navy, or Air Force reservation as described under section 237-25(a)(1);

2. Tobacco products and cigarettes to the United States (including any agency or instrumentality thereof that is wholly owned or otherwise so constituted as to be immune from the levy of tax under chapter 238 or 245, but not including national banks) as described under section 23725(a)(2); and
3. "Other tangible personal property" to the United States (including any agency, instrumentality, or federal credit union thereof, but not including national banks) and any state-chartered credit union as described under section 237-25(a)(3);

18. Amounts received by petroleum product refiners from other refiners for further refining of petroleum products as described under section 237-27;
19. Gross proceeds received from the construction, reconstruction, erection, operation, use, maintenance, or furnishing of air pollution control facilities, as described under section 237-27.5, that do not have valid certificates of exemption on July 1, 2011;
20. Gross proceeds received from shipbuilding and ship repairs as described under section 237-28.1;
21. Amounts received by telecommunications common carriers from call center operators for interstate or foreign telecommunications services as described under section 237-29.8;
22. Gross proceeds received by qualified businesses in enterprise zones, as described under section 209E-11, that do not have valid certificates of qualification from the department of business, economic development, and tourism on July 1, 2011; and
23. Gross proceeds received by contractors licensed under chapter 444 for construction within enterprise zones performed for qualified businesses within the enterprise zones or businesses approved by the department of business, economic development, and tourism to enroll into the enterprise zone program, as described under section 209E-11.

The persons and amounts for which exemption under the use tax has been suspended are as follows:

1. The leasing or renting of aircraft or keeping of aircraft solely for leasing or renting for commercial transportation of passengers and goods or the acquisition or importation of aircraft or aircraft engines by a lessee or renter engaged in interstate air transportation, as described under paragraph (6) of the definition of "use" in section 238-1;
2. The use of oceangoing vehicles for passenger or passenger and goods transportation from one point to another within the State as a public utility, as described under paragraph (7) of the definition of "use" in section 238-1;
3. The use of material, parts, or tools imported or purchased by a person licensed under chapter 237 that are used for aircraft service and maintenance or the construction of an aircraft service and maintenance facility, as described under paragraph (8) of the definition of "use" in section 238-1;
4. The use or sale of intoxicating liquor and cigarette and tobacco products imported into the State and sold to any person or common carrier in interstate commerce, whether ocean-going or air, for consumption out of State by the person, crew, or passengers on the shipper's vessels or airplanes, as described under section 238-3(g);
5. The use of any vessel constructed under section 189-25 prior to July 1, 1969, as described under section 238-3(h); and
6. The use of any air pollution control facility subject to section 237-27.5 as described under section 238-3(k).

This Act also requires that, beginning July 1, 2011, taxpayers provide information reporting on any general excise or use tax exclusions or exemptions. The Act provides some exceptions to the information reporting requirement. There will be no information reporting on amounts exempt under section 237-24(1) through (7), which includes amounts received from some types of insurance policies, gifts, compensatory tort damages, employee wages, and alimony.

Appendix C: Growth Rates and Model Outputs

Table C-1:
Estimated Revenue Growth Rates, FY2012-13 to FY2024-25:
Baseline Scenario

Growth Rate Name	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
								Beyond Scope of Council on Revenues Forecast						
General Excise and Use Tax	8.10%	5.76%	3.72%	6.46%	5.95%	5.57%	5.57%	5.57%	5.57%	5.50%	5.43%	5.43%	5.43%	5.43%
Individual Income Tax	23.59%	6.80%	7.48%	7.63%	7.03%	3.12%	6.58%	6.58%	6.58%	6.49%	6.40%	6.40%	6.40%	6.40%
Corporate Income Tax	111.23%	4.60%	4.70%	4.70%	4.33%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%
Public Service Company Tax	26.95%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Tax on Insurance Premiums	-13.43%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Cigarette and Tobacco Tax	-5.39%	24.81%	-14.11%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%
Liquor Tax	1.66%	3.93%	2.46%	2.21%	1.85%	1.49%	1.50%	1.50%	1.51%	1.51%	1.52%	1.52%	1.53%	1.53%
Tax on Banks and Other Financial Corps.	-102.70%	-3590.29%	1.24%	4.84%	3.29%	2.58%	2.48%	2.34%	2.34%	2.34%	2.34%	2.34%	2.34%	2.34%
Inheritance and Estate Tax	104.74%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Conveyance Tax	-14.55%	-9.37%	-25.08%	6.12%	5.64%	5.28%	5.28%	5.28%	5.28%	5.21%	5.14%	5.14%	5.14%	5.14%
Miscellaneous Taxes	331.88%	-77.51%	0.09%	-25.97%	-92.82%	-3.91%	-4.07%	1.68%	1.68%	1.68%	1.68%	1.68%	1.68%	1.68%
Transient Accommodations Tax	111.36%	8.75%	5.60%	5.05%	-100.00%	3.36%	3.36%	3.36%	3.36%	3.36%	3.35%	3.35%	3.35%	3.35%
Licenses & Permits	-26.00%	9.41%	0.97%	-80.75%	0.88%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Revenues from Use of Money and Property	13.92%	-2.74%	-3.21%	-3.69%	-3.74%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Federal	-65.61%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Revenues from Other Agencies	77.78%	9.78%	-41.56%	-0.01%	-84.37%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Charges for Current Services	-14.55%	4.10%	1.35%	1.18%	1.09%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Fines, Forfeits & Penalties	-9.00%	6.90%	-6.45%	6.90%	-6.45%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Repayment of Loans & Advances	-4.31%	-10.79%	0.12%	3.34%	-2.86%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Non-Revenue Receipts	-52.22%	-6.10%	3.95%	1.13%	1.13%	1.13%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Judiciary	-6.87%	1.71%	1.76%	1.77%	1.77%	1.77%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%

Table C-2:
Projected General Fund Revenue, FY2012-13 to FY2024-25
Baseline Scenario ($ thousands)

Amounts in $ thousands	FY2012	FY2013	FY2014	Fy2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
Tax Revenues														
General Excise and Use Tax	2,697,951	2,853,432	2,959,716	3,150,924	3,338,538	3,524,623	3,721,079	3,928,486	4,147,453	4,375,541	4,612,920	4,863,177	5,127,011	5,405,158
Individual Income Tax	1,540,730	1,645,534	1,768,546	1,903,405	2,037,178	2,100,805	2,239,017	2,386,323	2,543,320	2,708,414	2,881,848	3,066,387	3,262,744	3,471,675
Corporate Income Tax	73,027	76,386	79,976	83,735	87,357	90,808	94,396	98,126	102,002	106,032	110,221	114,576	119,103	123,808
Public Service Company Tax	149,730	153,773	157,694	161,636	165,677	169,819	174,065	178,416	182,877	187,449	192,135	196,938	201,862	206,908
Tax on Insurance Premiums	121,586	124,869	128,053	131,254	134,536	137,899	141,347	144,880	148,502	152,215	156,020	159,921	163,919	168,017
Cigarette and Tobacco Tax	100,417	125,328	107,639	110,222	112,868	115,576	118,350	121,191	124,099	127,078	130,128	133,251	136,449	139,723
Liquor Tax	48,852	50,773	52,020	53,169	54,151	54,959	55,782	56,621	57,477	58,347	59,232	60,134	61,053	61,990
Tax on Banks and Other Financial Corps.	-855	29,842	30,211	31,674	32,715	33,560	34,391	35,196	36,021	36,864	37,727	38,611	39,515	40,440
Inheritance and Estate Tax	14,125	14,506	14,876	15,248	15,629	16,020	16,421	16,831	17,252	17,683	18,125	18,578	19,043	19,519
Conveyance Tax	18,394	16,670	12,489	13,253	14,001	14,740	15,519	16,338	17,201	18,097	19,027	20,005	21,033	22,114
Miscellaneous Taxes	85,564	19,241	19,258	14,257	1,023	983	943	959	975	991	1,008	1,025	1,042	1,060
Transient Accommodations Tax	126,302	137,353	145,045	152,370	0	0	0	0	0	0	0	0	0	0
TOTAL TAXES	***4,975,823***	***5,247,707***	***5,475,525***	***5,821,148***	***5,993,673***	***6,259,793***	***6,611,310***	***6,983,367***	***7,377,178***	***7,788,711***	***8,218,391***	***8,672,603***	***9,152,774***	***9,660,413***
Non-Tax Revenues														
Licenses & Permits	5,313	5,813	5,869	1,130	1,140	1,147	1,155	1,163	1,171	1,180	1,190	1,200	1,210	1,220
Revenues from Use of Money and Property	27,759	26,999	26,131	25,168	24,227	24,395	24,563	24,733	24,905	25,093	25,300	25,508	25,718	25,930
Federal	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500
Revenues from Other Agencies	25,206	27,672	16,171	16,170	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528
Charges for Current Services	253,305	263,703	267,264	270,424	273,361	275,253	277,157	279,075	281,006	283,135	285,467	287,818	290,188	292,578
Fines, Forfeits & Penalties	435	465	435	465	435	438	441	444	447	451	454	458	462	466
Repayment of Loans & Advances	22,012	19,638	19,662	20,319	19,738	19,875	20,012	20,151	20,290	20,444	20,612	20,782	20,953	21,126
Non-Revenue Receipts	178,338	167,462	174,075	176,038	178,019	180,024	181,270	182,524	183,787	185,180	186,705	188,242	189,792	191,355
Judiciary	38,310	38,965	39,651	40,351	41,065	41,793	42,082	42,373	42,667	42,990	43,344	43,701	44,061	44,424
TOTAL NON-TAX REVENUES	***555,178***	***555,217***	***553,758***	***554,565***	***545,013***	***549,952***	***553,709***	***557,492***	***561,301***	***565,501***	***570,100***	***574,736***	***579,411***	***584,125***
TOTAL GENERAL FUND REVENUES	***5,531,001***	***5,802,924***	***6,029,283***	***6,375,713***	***6,538,686***	***6,809,745***	***7,165,019***	***7,540,859***	***7,938,479***	***8,354,211***	***8,788,491***	***9,247,340***	***9,732,185***	***10,244,538***

Table C-3:
Estimated Revenue Growth Rates, FY2012-13 to FY2024-25:
Optimistic Scenario

Growth Rate Name	FY2012	FY2013	FY2014	Fy2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
								Beyond Scope of Council on Revenues Forecast						
General Excise and Use Tax	8.10%	5.89%	5.09%	9.86%	9.41%	8.23%	8.23%	8.23%	8.23%	8.23%	8.23%	8.23%	8.23%	8.23%
Individual Income Tax	23.59%	6.95%	9.12%	11.64%	11.11%	6.56%	9.72%	9.72%	9.72%	9.72%	9.72%	9.72%	9.72%	9.72%
Corporate Income Tax	111.23%	5.10%	5.70%	5.70%	5.33%	4.95%	4.95%	4.95%	4.95%	4.95%	4.95%	4.95%	4.95%	4.95%
Public Service Company Tax	26.95%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Tax on Insurance Premiums	-13.43%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Cigarette and Tobacco Tax	-5.39%	24.81%	-14.11%	3.40%	3.40%	3.40%	3.40%	3.40%	3.40%	3.40%	3.40%	3.40%	3.40%	3.40%
Liquor Tax	1.66%	3.93%	2.46%	2.21%	1.85%	1.49%	1.50%	1.50%	1.51%	1.51%	1.52%	1.52%	1.53%	1.53%
Tax on Banks and Other Financial Corps.	-102.70%	-3590.29%	1.24%	4.84%	3.29%	2.58%	2.48%	2.34%	2.34%	2.34%	2.34%	2.34%	2.34%	2.34%
Inheritance and Estate Tax	104.74%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Conveyance Tax	-14.55%	-9.37%	-25.08%	9.34%	8.92%	7.80%	7.80%	7.80%	7.80%	7.80%	7.80%	7.80%	7.80%	7.80%
Miscellaneous Taxes	331.88%	-77.51%	0.09%	-25.97%	-92.82%	-3.91%	-4.07%	1.68%	1.68%	1.68%	1.68%	1.68%	1.68%	1.68%
Transient Accommodations Tax	111.36%	8.75%	5.60%	5.05%	-100.00%	3.36%	3.36%	3.36%	3.36%	3.36%	3.35%	3.35%	3.35%	3.35%
Licenses & Permits	-26.00%	9.41%	0.97%	-80.75%	0.88%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Revenues from Use of Money and Property	13.92%	-2.74%	-3.21%	-3.69%	-3.74%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Federal	-65.61%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Revenues from Other Agencies	77.78%	9.78%	-41.56%	-0.01%	-84.37%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Charges for Current Services	-14.55%	4.10%	1.35%	1.18%	1.09%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Fines, Forfeits & Penalties	-9.00%	6.90%	-6.45%	6.90%	-6.45%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Repayment of Loans & Advances	-4.31%	-10.79%	0.12%	3.34%	-2.86%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Non-Revenue Receipts	-52.22%	-6.10%	3.95%	1.13%	1.13%	1.13%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Judiciary	-6.87%	1.71%	1.76%	1.77%	1.77%	1.77%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%

Table C-4:
Projected General Fund Revenue, FY2012-13 to FY2024-25
Optimistic Scenario ($ thousands)

Amounts in $ thousands	FY2012	FY2013	FY2014	Fy2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
Tax Revenues														
General Excise and Use Tax	2,697,951	2,856,838	3,002,275	3,298,324	3,608,816	3,905,942	4,227,531	4,575,598	4,952,322	5,360,063	5,801,375	6,279,021	6,795,994	7,355,531
Individual Income Tax	1,540,730	1,647,830	1,798,189	2,007,483	2,230,541	2,376,908	2,607,900	2,861,340	3,139,409	3,444,502	3,779,244	4,146,517	4,549,483	4,991,609
Corporate Income Tax	73,027	76,751	81,126	85,750	90,317	94,788	99,481	104,406	109,575	115,000	120,694	126,669	132,940	139,522
Public Service Company Tax	149,730	153,773	157,694	161,636	165,677	169,819	174,065	178,416	182,877	187,449	192,135	196,938	201,862	206,908
Tax on Insurance Premiums	121,586	124,869	128,053	131,254	134,536	137,899	141,347	144,880	148,502	152,215	156,020	159,921	163,919	168,017
Cigarette and Tobacco Tax	100,417	125,328	107,639	111,299	115,083	118,996	123,042	127,225	131,551	136,023	140,648	145,430	150,375	155,488
Liquor Tax	48,852	50,773	52,020	53,169	54,151	54,959	55,782	56,621	57,477	58,347	59,232	60,134	61,053	61,990
Tax on Banks and Other Financial Corps.	-855	29,842	30,211	31,674	32,715	33,560	34,391	35,196	36,021	36,864	37,727	38,611	39,515	40,440
Inheritance and Estate Tax	14,125	14,506	14,876	15,248	15,629	16,020	16,421	16,831	17,252	17,683	18,125	18,578	19,043	19,519
Conveyance Tax	18,394	16,670	12,489	13,656	14,874	16,034	17,284	18,632	20,086	21,653	23,341	25,162	27,125	29,240
Miscellaneous Taxes	85,564	19,241	19,258	14,257	1,023	983	943	959	975	991	1,008	1,025	1,042	1,060
Transient Accommodations Tax	126,302	137,353	145,045	152,370	0	0	0	0	0	0	0	0	0	0
TOTAL TAXES	***4,975,823***	***5,253,775***	***5,548,876***	***6,076,120***	***6,463,361***	***6,925,908***	***7,498,186***	***8,120,105***	***8,796,046***	***9,530,790***	***10,329,550***	***11,198,007***	***12,142,350***	***13,169,323***
Non-Tax Revenues														
Licenses & Permits	5,313	5,813	5,869	1,130	1,140	1,147	1,155	1,163	1,171	1,180	1,190	1,200	1,210	1,220
Revenues from Use of Money and Property	27,759	26,999	26,131	25,168	24,227	24,395	24,563	24,733	24,905	25,093	25,300	25,508	25,718	25,930
Federal	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500
Revenues from Other Agencies	25,206	27,672	16,171	16,170	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528
Charges for Current Services	253,305	263,703	267,264	270,424	273,361	275,253	277,157	279,075	281,006	283,135	285,467	287,818	290,188	292,578
Fines, Forfeits & Penalties	435	465	435	465	435	438	441	444	447	451	454	458	462	466
Repayment of Loans & Advances	22,012	19,638	19,662	20,319	19,738	19,875	20,012	20,151	20,290	20,444	20,612	20,782	20,953	21,126
Non-Revenue Receipts	178,338	167,462	174,075	176,038	178,019	180,024	181,270	182,524	183,787	185,180	186,705	188,242	189,792	191,355
Judiciary	38,310	38,965	39,651	40,351	41,065	41,793	42,082	42,373	42,667	42,990	43,344	43,701	44,061	44,424
TOTAL NON-TAX REVENUES	***555,178***	***555,217***	***553,758***	***554,565***	***545,013***	***549,952***	***553,709***	***557,492***	***561,301***	***565,501***	***570,100***	***574,736***	***579,411***	***584,125***
TOTAL GENERAL FUND REVENUES	***5,531,001***	***5,808,992***	***6,102,634***	***6,630,684***	***7,008,373***	***7,475,860***	***8,051,895***	***8,677,597***	***9,357,347***	***10,096,290***	***10,899,649***	***11,772,743***	***12,721,761***	***13,753,448***

Table C-5:
Estimated Revenue Growth Rates, FY2012-13 to FY2024-25:
Pessimistic Scenario

Growth Rate Name	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
								Beyond Scope of Council of Revenues Forecast						
General Excise and Use Tax	8.10%	5.64%	-0.37%	1.56%	4.35%	4.05%	4.05%	4.05%	4.05%	4.05%	4.05%	4.05%	4.05%	4.05%
Individual Income Tax	23.59%	6.65%	2.53%	1.84%	5.14%	0.88%	4.78%	4.78%	4.78%	4.78%	4.78%	4.78%	4.78%	4.78%
Corporate Income Tax	111.23%	4.10%	3.70%	3.70%	3.33%	2.95%	2.95%	2.95%	2.95%	2.95%	2.95%	2.95%	2.95%	2.95%
Public Service Company Tax	26.95%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Tax on Insurance Premiums	-13.43%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Cigarette and Tobacco Tax	-5.39%	24.81%	-14.11%	1.40%	1.40%	1.40%	1.40%	1.40%	1.40%	1.40%	1.40%	1.40%	1.40%	1.40%
Liquor Tax	1.66%	3.93%	2.46%	2.21%	1.85%	1.49%	1.50%	1.50%	1.51%	1.51%	1.52%	1.52%	1.53%	1.53%
Tax on Banks and Other Financial Corps.	-102.70%	-3590.29%	1.24%	4.84%	3.29%	2.58%	2.48%	2.34%	2.34%	2.34%	2.34%	2.34%	2.34%	2.34%
Inheritance and Estate Tax	104.74%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Conveyance Tax	-14.55%	-9.37%	-25.08%	1.47%	4.12%	3.84%	3.84%	3.84%	3.84%	3.84%	3.84%	3.84%	3.84%	3.84%
Miscellaneous Taxes	331.88%	-77.51%	0.09%	-25.97%	-92.82%	-3.91%	-4.07%	1.68%	1.68%	1.68%	1.68%	1.68%	1.68%	1.68%
Transient Accommodations Tax	111.36%	8.75%	5.60%	5.05%	-100.00%	3.36%	3.36%	3.36%	3.36%	3.36%	3.35%	3.35%	3.35%	3.35%
Licenses & Permits	-26.00%	9.41%	0.97%	-80.75%	0.88%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Revenues from Use of Money and Property	13.92%	-2.74%	-3.21%	-3.69%	-3.74%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Federal	-65.61%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Revenues from Other Agencies	77.78%	9.78%	-41.56%	-0.01%	-84.37%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Charges for Current Services	-14.55%	4.10%	1.35%	1.18%	1.09%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Fines, Forfeits & Penalties	-9.00%	6.90%	-6.45%	6.90%	-6.45%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Repayment of Loans & Advances	-4.31%	-10.79%	0.12%	3.34%	-2.86%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Non-Revenue Receipts	-52.22%	-6.10%	3.95%	1.13%	1.13%	1.13%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Judiciary	-6.87%	1.71%	1.76%	1.77%	1.77%	1.77%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%

Table C-6:
Projected General Fund Revenue, FY2012-13 to FY2024-25
Pessimistic Scenario ($ thousands)

Amounts in $ thousands	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
Tax Revenues														
General Excise and Use Tax	2,697,951	2,850,003	2,839,528	2,883,685	3,009,237	3,131,212	3,258,130	3,390,193	3,527,609	3,670,595	3,819,376	3,974,188	4,135,275	4,302,892
Individual Income Tax	1,540,730	1,643,223	1,684,752	1,715,676	1,803,847	1,819,749	1,906,811	1,998,039	2,093,632	2,193,798	2,298,757	2,408,737	2,523,978	2,644,734
Corporate Income Tax	73,027	76,021	78,834	81,751	84,469	86,962	89,528	92,170	94,889	97,689	100,572	103,540	106,595	109,740
Public Service Company Tax	149,730	153,773	157,694	161,636	165,677	169,819	174,065	178,416	182,877	187,449	192,135	196,938	201,862	206,908
Tax on Insurance Premiums	121,586	124,869	128,053	131,254	134,536	137,899	141,347	144,880	148,502	152,215	156,020	159,921	163,919	168,017
Cigarette and Tobacco Tax	100,417	125,328	107,639	109,146	110,674	112,223	113,795	115,388	117,003	118,641	120,302	121,986	123,694	125,426
Liquor Tax	48,852	50,773	52,020	53,169	54,151	54,959	55,782	56,621	57,477	58,347	59,232	60,134	61,053	61,990
Tax on Banks and Other Financial Corps.	-855	29,842	30,211	31,674	32,715	33,560	34,391	35,196	36,021	36,864	37,727	38,611	39,515	40,440
Inheritance and Estate Tax	14,125	14,506	14,876	15,248	15,629	16,020	16,421	16,831	17,252	17,683	18,125	18,578	19,043	19,519
Conveyance Tax	18,394	16,670	12,489	12,673	13,196	13,702	14,229	14,775	15,342	15,931	16,543	17,179	17,838	18,523
Miscellaneous Taxes	85,564	19,241	19,258	14,257	1,023	983	943	959	975	991	1,008	1,025	1,042	1,060
Transient Accommodations Tax	126,302	137,353	145,045	152,370	0	0	0	0	0	0	0	0	0	0
TOTAL TAXES	***4,975,823***	***5,241,603***	***5,270,400***	***5,362,539***	***5,425,154***	***5,577,088***	***5,805,441***	***6,043,469***	***6,291,579***	***6,550,204***	***6,819,798***	***7,100,836***	***7,393,815***	***7,699,249***
Non-Tax Revenues														
Licenses & Permits	5,313	5,813	5,869	1,130	1,140	1,147	1,155	1,163	1,171	1,180	1,190	1,200	1,210	1,220
Revenues from Use of Money and Property	27,759	26,999	26,131	25,168	24,227	24,395	24,563	24,733	24,905	25,093	25,300	25,508	25,718	25,930
Federal	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500
Revenues from Other Agencies	25,206	27,672	16,171	16,170	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528
Charges for Current Services	253,305	263,703	267,264	270,424	273,361	275,253	277,157	279,075	281,006	283,135	285,467	287,818	290,188	292,578
Fines, Forfeits & Penalties	435	465	435	465	435	438	441	444	447	451	454	458	462	466
Repayment of Loans & Advances	22,012	19,638	19,662	20,319	19,738	19,875	20,012	20,151	20,290	20,444	20,612	20,782	20,953	21,126
Non-Revenue Receipts	178,338	167,462	174,075	176,038	178,019	180,024	181,270	182,524	183,787	185,180	186,705	188,242	189,792	191,355
Judiciary	38,310	38,965	39,651	40,351	41,065	41,793	42,082	42,373	42,667	42,990	43,344	43,701	44,061	44,424
TOTAL NON-TAX REVENUES	***555,178***	***555,217***	***553,758***	***554,565***	***545,013***	***549,952***	***553,709***	***557,492***	***561,301***	***565,501***	***570,100***	***574,736***	***579,411***	***584,125***
TOTAL GENERAL FUND REVENUES	***5,531,001***	***5,796,820***	***5,824,158***	***5,917,104***	***5,970,167***	***6,127,040***	***6,359,150***	***6,600,961***	***6,852,880***	***7,115,704***	***7,389,897***	***7,675,573***	***7,973,226***	***8,283,374***

Table C-7:
Estimated Revenue Growth Rates, FY2012-13 to FY2024-25:
Federal Budget Cuts Scenario

Growth Rate Name	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
								Beyond Scope of Council on Revenues Forecast						
General Excise and Use Tax	8.10%	4.24%	1.79%	6.03%	6.01%	5.61%	5.61%	5.61%	5.61%	5.54%	5.46%	5.46%	5.46%	5.46%
Individual Income Tax	23.59%	5.00%	5.12%	7.07%	7.03%	2.97%	6.58%	6.58%	6.58%	6.49%	6.40%	6.40%	6.40%	6.40%
Corporate Income Tax	111.23%	4.60%	4.70%	4.70%	4.33%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%	3.95%
Public Service Company Tax	26.95%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Tax on Insurance Premiums	-13.43%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Cigarette and Tobacco Tax	-5.39%	24.81%	-14.11%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%
Liquor Tax	1.66%	3.93%	2.46%	2.21%	1.85%	1.49%	1.50%	1.50%	1.51%	1.51%	1.52%	1.52%	1.53%	1.53%
Tax on Banks and Other Financial Corps.	-102.70%	-3590.29%	1.24%	4.84%	3.29%	2.58%	2.48%	2.34%	2.34%	2.34%	2.34%	2.34%	2.34%	2.34%
Inheritance and Estate Tax	104.74%	2.70%	2.55%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Conveyance Tax	-14.55%	-9.37%	-25.08%	5.67%	5.64%	5.28%	5.28%	5.28%	5.28%	5.21%	5.14%	5.14%	5.14%	5.14%
Miscellaneous Taxes	331.88%	-77.51%	0.09%	-25.97%	-92.82%	-3.91%	-4.07%	1.68%	1.68%	1.68%	1.68%	1.68%	1.68%	1.68%
Transient Accommodations Tax	111.36%	8.75%	5.60%	5.05%	-100.00%	3.36%	3.36%	3.36%	3.36%	3.36%	3.35%	3.35%	3.35%	3.35%
Licenses & Permits	-26.00%	9.41%	0.97%	-80.75%	0.88%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Revenues from Use of Money and Property	13.92%	-2.74%	-3.21%	-3.69%	-3.74%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Federal	-65.61%	-10.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Revenues from Other Agencies	77.78%	9.78%	-41.56%	-0.01%	-84.37%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Charges for Current Services	-14.55%	4.10%	1.35%	1.18%	1.09%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Fines, Forfeits & Penalties	-9.00%	6.90%	-6.45%	6.90%	-6.45%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Repayment of Loans & Advances	-4.31%	-10.79%	0.12%	3.34%	-2.86%	0.69%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Non-Revenue Receipts	-52.22%	-6.10%	3.95%	1.13%	1.13%	1.13%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%
Judiciary	-6.87%	1.71%	1.76%	1.77%	1.77%	1.77%	0.69%	0.69%	0.69%	0.76%	0.82%	0.82%	0.82%	0.82%

Table C-8:
Projected General Fund Revenue, FY2012-13 to FY2024-25
Federal Budget Cuts Scenario ($ thousands)

Amounts in $ thousands	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
Tax Revenues														
General Excise and Use Tax	2,697,951	2,812,280	2,862,498	3,034,971	3,217,230	3,397,850	3,588,573	3,789,964	4,002,618	4,224,254	4,454,911	4,698,125	4,954,577	5,224,989
Individual Income Tax	1,540,730	1,617,795	1,700,614	1,820,839	1,948,809	2,006,622	2,138,638	2,279,340	2,429,298	2,586,991	2,752,649	2,928,916	3,116,469	3,316,033
Corporate Income Tax	73,027	76,386	79,976	83,735	87,357	90,808	94,396	98,126	102,002	106,032	110,221	114,576	119,103	123,808
Public Service Company Tax	149,730	153,773	157,694	161,636	165,677	169,819	174,065	178,416	182,877	187,449	192,135	196,938	201,862	206,908
Tax on Insurance Premiums	121,586	124,869	128,053	131,254	134,536	137,899	141,347	144,880	148,502	152,215	156,020	159,921	163,919	168,017
Cigarette and Tobacco Tax	100,417	125,328	107,639	110,222	112,868	115,576	118,350	121,191	124,099	127,078	130,128	133,251	136,449	139,723
Liquor Tax	48,852	50,773	52,020	53,169	54,151	54,959	55,782	56,621	57,477	58,347	59,232	60,134	61,053	61,990
Tax on Banks and Other Financial Corps.	-855	29,842	30,211	31,674	32,715	33,560	34,391	35,196	36,021	36,864	37,727	38,611	39,515	40,440
Inheritance and Estate Tax	14,125	14,506	14,876	15,248	15,629	16,020	16,421	16,831	17,252	17,683	18,125	18,578	19,043	19,519
Conveyance Tax	18,394	16,670	12,489	13,198	13,942	14,678	15,453	16,269	17,129	18,021	18,947	19,921	20,945	22,021
Miscellaneous Taxes	85,564	19,241	19,258	14,257	1,023	983	943	959	975	991	1,008	1,025	1,042	1,060
Transient Accommodations Tax	126,302	137,353	145,045	152,370	0	0	0	0	0	0	0	0	0	0
TOTAL TAXES	***4,975,823***	***5,178,817***	***5,310,374***	***5,622,573***	***5,783,937***	***6,038,776***	***6,378,359***	***6,737,793***	***7,118,249***	***7,515,924***	***7,931,104***	***8,369,995***	***8,833,977***	***9,324,510***
Non-Tax Revenues														
Licenses & Permits	5,313	5,813	5,869	1,130	1,140	1,147	1,155	1,163	1,171	1,180	1,190	1,200	1,210	1,220
Revenues from Use of Money and Property	27,759	26,999	26,131	25,168	24,227	24,395	24,563	24,733	24,905	25,093	25,300	25,508	25,718	25,930
Federal	4,500	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050	4,050
Revenues from Other Agencies	25,206	27,672	16,171	16,170	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528	2,528
Charges for Current Services	253,305	263,703	267,264	270,424	273,361	275,253	277,157	279,075	281,006	283,135	285,467	287,818	290,188	292,578
Fines, Forfeits & Penalties	435	465	435	465	435	438	441	444	447	451	454	458	462	466
Repayment of Loans & Advances	22,012	19,638	19,662	20,319	19,738	19,875	20,012	20,151	20,290	20,444	20,612	20,782	20,953	21,126
Non-Revenue Receipts	178,338	167,462	174,075	176,038	178,019	180,024	181,270	182,524	183,787	185,180	186,705	188,242	189,792	191,355
Judiciary	38,310	38,965	39,651	40,351	41,065	41,793	42,082	42,373	42,667	42,990	43,344	43,701	44,061	44,424
TOTAL NON-TAX REVENUES	***555,178***	***554,767***	***553,308***	***554,115***	***544,563***	***549,502***	***553,259***	***557,042***	***560,851***	***565,051***	***569,650***	***574,286***	***578,961***	***583,675***
TOTAL GENERAL FUND REVENUES	***5,531,001***	***5,733,584***	***5,863,682***	***6,176,688***	***6,328,500***	***6,588,278***	***6,931,618***	***7,294,835***	***7,679,100***	***8,080,975***	***8,500,753***	***8,944,281***	***9,412,938***	***9,908,185***

Table C-9:
Projected General Fund Expenditures,
FY2012-13 to FY2024-25 ($ thousands)

Amounts in $ thousands	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
Personal Services														
Personal Services - Payroll	1,718,215	1,723,629	2,164,461	2,239,720	2,300,182	2,374,112	2,450,419	2,529,178	2,610,468	2,694,372	2,780,972	2,870,356	2,962,612	3,057,834
Personal Services - Other	15,171	15,338	15,507	15,678	15,851	16,026	16,203	16,382	16,562	16,745	16,930	17,116	17,305	17,496
Personal Services - Contracted	405	405	405	405	405	405	405	405	405	405	405	405	405	405
Personal Services - Other State Agencies	5,715	5,733	7,200	7,450	7,651	7,897	8,151	8,413	8,683	8,962	9,250	9,548	9,855	10,171
TOTAL PERSONAL SERVICES	**1,739,506**	**1,745,106**	**2,187,573**	**2,263,254**	**2,324,089**	**2,398,440**	**2,475,177**	**2,554,377**	**2,636,119**	**2,720,484**	**2,807,557**	**2,897,424**	**2,990,177**	**3,085,906**
Other Current Expenses														
Operating Supplies	36,047	37,020	37,964	38,913	39,886	40,883	41,905	42,953	44,027	45,127	46,256	47,412	48,597	49,812
Repair and Maintenance Supplies	5,617	5,617	5,617	5,617	5,617	5,617	5,617	5,617	5,617	5,617	5,617	5,617	5,617	5,617
Office Supplies	8,139	8,139	8,139	8,139	8,139	8,139	8,139	8,139	8,139	8,139	8,139	8,139	8,139	8,139
Food Supplies	8,480	8,545	8,610	8,675	8,741	8,808	8,874	8,942	9,010	9,078	9,147	9,217	9,287	9,357
Other Supplies	4,808	4,808	4,808	4,808	4,808	4,808	4,808	4,808	4,808	4,808	4,808	4,808	4,808	4,808
Dues and Subscriptions	6,828	7,012	7,191	7,371	7,555	7,744	7,938	8,136	8,339	8,548	8,762	8,981	9,205	9,435
Freight and Delivery Charges	1,783	1,835	1,888	1,942	1,998	2,056	2,115	2,176	2,239	2,304	2,370	2,438	2,509	2,581
Postage	4,445	4,445	4,445	4,445	4,445	4,445	4,445	4,445	4,445	4,445	4,445	4,445	4,445	4,445
Telephone and Telegraph	8,922	9,169	9,423	9,683	9,951	10,227	10,510	10,800	11,099	11,406	11,722	12,046	12,379	12,722
Printing and Binding	802	802	802	802	802	802	802	802	802	802	802	802	802	802
Advertising	276	276	276	276	276	276	276	276	276	276	276	276	276	276
Car Mileage	1,667	1,667	1,667	1,667	1,667	1,667	1,667	1,667	1,667	1,667	1,667	1,667	1,667	1,667
Transportation, Intra-State	2,565	2,565	2,565	2,565	2,565	2,565	2,565	2,565	2,565	2,565	2,565	2,565	2,565	2,565
Subsistence Allowance, Intra-State	728	728	728	728	728	728	728	728	728	728	728	728	728	728
Transportation, Out-of-State	504	504	504	504	504	504	504	504	504	504	504	504	504	504
Subsistence Allowance, Out-of-State	427	427	427	427	427	427	427	427	427	427	427	427	427	427
Hire of Passenger Cars	396	396	396	396	396	396	396	396	396	396	396	396	396	396
Motor Pool Cars	1,584	1,594	1,603	1,613	1,623	1,633	1,642	1,652	1,662	1,672	1,683	1,693	1,703	1,713
Other Travel	68,562	89,995	92,290	94,597	96,962	99,386	101,871	104,418	107,028	109,704	112,446	115,258	118,139	121,093
Electricity	69,379	71,284	73,242	75,254	77,321	79,444	81,626	83,868	86,171	88,538	90,970	93,468	96,035	98,673
Gas	2,454	2,731	3,040	3,383	3,765	4,191	4,664	5,191	5,777	6,430	7,156	7,965	8,864	9,866

Amounts in $ thousands	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
Water	6,696	7,128	7,587	8,076	8,597	9,151	9,740	10,368	11,036	11,747	12,504	13,310	14,168	15,081
Sewer	10,265	10,501	10,743	10,990	11,243	11,501	11,766	12,036	12,313	12,596	12,886	13,182	13,486	13,796
Other Utilities	695	730	766	804	845	887	931	977	1,026	1,077	1,131	1,188	1,247	1,309
Rental of Land and Building	20,164	20,567	20,979	21,398	21,826	22,263	22,708	23,162	23,625	24,098	24,580	25,071	25,572	26,084
Rental of Equipment	11,730	12,637	13,614	14,667	15,801	17,022	18,339	19,757	21,284	22,930	24,703	26,614	28,672	30,889
Other Rentals	2,042	2,042	2,042	2,042	2,042	2,042	2,042	2,042	2,042	2,042	2,042	2,042	2,042	2,042
Repairs and Maintenance	36,705	36,999	37,295	37,594	37,895	38,198	38,504	38,813	39,123	39,437	39,753	40,071	40,392	40,716
Insurance	474,088	494,716	564,378	614,746	666,743	723,618	785,838	853,926	928,463	1,010,085	1,099,489	1,197,446	1,304,805	1,422,508
Depreciation and Amortization	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Interest on Bonded Debt	256,786	260,828	242,345	223,886	203,225	183,409	163,389	144,715	127,294	113,195	100,344	87,159	73,881	61,068
Other Interest Expense	2	2	2	2	2	2	2	2	2	2	2	2	2	2
Bond Issuance and Redemption Expense	24	24	24	24	24	24	24	24	24	24	24	24	24	24
Intergovernmental Grants-in-Aid	2,837	3,061	3,302	3,562	3,843	4,146	4,472	4,825	5,205	5,615	6,057	6,535	7,050	7,605
Other Grants-In-Aid	4,613	4,613	4,613	4,613	4,613	4,613	4,613	4,613	4,613	4,613	4,613	4,613	4,613	4,613
Public Assistance	2,204,519	2,237,290	2,379,689	2,570,403	2,734,312	2,889,085	3,138,173	3,410,458	3,708,112	4,033,512	4,389,259	4,778,198	5,203,440	5,668,391
Workers' Compensation Payments	18,019	18,142	18,266	18,390	18,515	18,641	18,768	18,895	19,024	19,153	19,284	19,415	19,547	19,680
Judgments and Claims	5,530	5,657	5,788	5,921	6,057	6,196	6,339	6,484	6,634	6,786	6,942	7,102	7,265	7,432
Unemployment Benefits Payments	9,420	9,674	9,921	10,169	10,424	10,685	10,952	11,226	11,507	11,795	12,090	12,392	12,702	13,020
Retirement and Pension Cost	401,599	416,293	539,627	575,840	609,305	628,889	649,102	669,965	691,499	713,724	736,664	760,341	784,779	810,003
Social Security and Medicare	185,790	186,376	234,042	242,180	248,718	256,712	264,963	273,479	282,269	291,342	300,706	310,371	320,346	330,643
Services on Fee Basis (Other than State Employees)	421,473	451,272	467,183	484,090	502,119	521,414	542,146	564,512	588,745	615,116	643,943	675,598	710,519	749,220
Other Current Expenditures	78,296	78,296	78,296	78,296	78,296	78,296	78,296	78,296	78,296	78,296	78,296	78,296	78,296	78,296
Interest on Delinquent Payments	196	202	207	212	217	222	228	233	239	245	251	257	264	270
Redistributed Current Expenses	(1,295,355)	(1,315,591)	(1,401,699)	(1,516,846)	(1,615,910)	(1,709,503)	(1,859,772)	(2,023,994)	(2,203,476)	(2,399,646)	(2,614,068)	(2,848,450)	(3,104,665)	(3,384,756)
TOTAL OTHER CURRENT EXPENSES	**3,090,548**	**3,201,018**	**3,504,633**	**3,682,864**	**3,846,926**	**4,002,257**	**4,203,082**	**4,423,326**	**4,664,627**	**4,930,966**	**5,222,381**	**5,539,627**	**5,885,541**	**6,263,562**
Capital Outlay	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Land and Land Improvements	59	61	62	64	66	67	69	71	72	74	76	78	80	82
Buildings	3,253	3,340	3,426	3,511	3,599	3,689	3,781	3,876	3,973	4,072	4,174	4,278	4,385	4,495
Machinery and Equipment	42,807	44,321	45,889	47,512	49,192	50,932	52,734	54,599	56,530	58,530	60,600	62,743	64,962	67,260
Other Capital Outlay	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088	2,088
Construction in Progress	87	87	87	87	87	87	87	87	87	87	87	87	87	87
TOTAL CAPITAL OUTLAY	**48,294**	**49,897**	**51,552**	**53,262**	**55,032**	**56,863**	**58,759**	**60,720**	**62,750**	**64,850**	**67,024**	**69,274**	**71,602**	**74,011**

Amounts in $ thousands	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
Non Cost Payments	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Payments for Debt Retirements	287,520	374,030	432,315	413,960	408,405	428,200	419,750	372,820	311,960	262,130	277,305	271,955	276,700	248,375
Payment for Loans	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Items for Resale or Reissue	106	106	106	106	106	106	106	106	106	106	106	106	106	106
Refunds	20	20	21	22	23	23	24	25	26	27	28	29	30	31
Agency and Clearing Accounts	237	237	237	237	238	238	238	238	238	238	238	238	238	238
Transfers	155,296	162,384	169,573	177,119	185,099	193,540	202,474	211,934	221,956	232,577	243,839	255,785	268,461	281,919
TOTAL NON-COST PAYMENTS	**443,179**	**536,778**	**602,252**	**591,444**	**593,869**	**622,106**	**622,591**	**585,123**	**534,285**	**495,077**	**521,515**	**528,112**	**545,535**	**530,669**
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
TOTAL EXPENSES	**5,321,526**	**5,532,799**	**6,346,010**	**6,590,824**	**6,819,916**	**7,079,667**	**7,359,609**	**7,623,546**	**7,897,781**	**8,211,378**	**8,618,477**	**9,034,437**	**9,492,855**	**9,954,148**

Appendix D: Tax Burden Model

Current Tax System vs. Recommendations, by Income Class

Aggregate Tax Burden

	Estimated Burden of Major Taxes- Family of Three by Income Level				
	$25,000	$50,000	$75,000	$100,000	$150,000
Baseline	$3,016	$9,121	$14,990	$21,294	$37,821
GET Increase, IIT Adjustments	$2,430	$9,117	$15,256	$21,648	$38,243
Difference	**-$586**	**-$4**	**$266**	**$354**	**$422**
% Increase	**-19.4%**	**0.0%**	**1.8%**	**1.7%**	**1.1%**
Difference % of Income	**-2.34%**	**-0.01%**	**0.35%**	**0.35%**	**0.28%**

Baseline Tax Burden as % of Income	12.1%	18.2%	20.0%	21.3%	25.2%
GET Increase, IIT Adjustments Tax Burden as % of Income	9.7%	18.2%	20.3%	21.6%	25.5%
Difference	**-2.3%**	**0.0%**	**0.4%**	**0.4%**	**0.3%**

State Tax Burden

	Estimated Burden of Major Taxes- Family of Three by Income Level				
	$25,000	$50,000	$75,000	$100,000	$150,000
Baseline	$2,076	$4,053	$6,093	$8,498	$12,859
GET Increase, IIT Adjustments	$1,490	$4,029	$6,381	$8,874	$13,322
Difference	**-$586**	**-$24**	**$288**	**$377**	**$463**
% Increase	**-28.2%**	**-0.6%**	**4.7%**	**4.4%**	**3.6%**
Difference % of Income	**-2.34%**	**-0.05%**	**0.38%**	**0.38%**	**0.31%**

Baseline Tax Burden as % of Income	8.30%	8.11%	8.12%	8.50%	8.57%
GET Increase, IIT Adjustments Tax Burden as % of Income	5.96%	8.06%	8.51%	8.87%	8.88%
Difference	**-2.3%**	**0.0%**	**0.4%**	**0.4%**	**0.3%**

State Taxes % of Tax Burden - Baseline	68.82%	44.43%	40.64%	39.91%	34.00%
State Taxes % of Tax Burden - GET Increase, IIT Adjustments	61.31%	44.19%	41.82%	40.99%	34.84%

Appendix E: State Individual Income Tax Provisions

State	Private	State & Local	Federal Civilian	Military
Alabama	State Calculation	Most Exempt	Exempt	Exempt
Arizona	None	$2,500	$2,500	$2,500
Arkansas	6000	6000	6000	6000
California	None	None	None	None
Colorado	$20,000 / $24,000	$20,000 / $24,000	$20,000 / $24,000	$20,000 / $24,000
Connecticut	None	None	None	50%
Delaware	$2,000 / $12,500	$2,000 / $12,500	$2,000 / $12,500	$2,000 / $12,500
District of Columbia	None	$3,000	$3,000	$3,000
Georgia	$35,000	$35,000	$35,000	$35,000
Hawaii	State Calculation	Exempt	Exempt	Exempt
Idaho	None	$27,876 / $41,814[a]	$27,876 / $41,814	$27,876 / $41,814
Illinois	State Calculation	Exempt	Exempt	Exempt
Indiana	None / $5,200	None / $5,200	$2,000 / $7,200	$5,000
Iowa	$6,000	$6,000	$6,000	$6,000
Kansas	None	Some Exempt	Exempt	Exempt
Kentucky	$41,110	State Calculation	State Calculation	State Calculation
Louisiana	$6,000	$6,000 / Exempt	Exempt	Exempt
Maine	$6,000	$6,000	$6,000	$6,000
Maryland	$24,500	$24,500[b]	$24,500	$24,500
Massachusetts	None	Exempt[c]	Exempt[c]	Exempt
Michigan	$45,120	Exempt	Exempt	Exempt
Minnesota	None	None	None	None
Mississippi	Exempt	Exempt	Exempt	Exempt
Missouri	$6,000	$6,000	$6,000	$6,000
Montana	$3,600	$3,600	$3,600	$3,600
Nebraska	None	None	None	None
New Hampshire	Exempt	Exempt	Exempt	Exempt
New Jersey	$15,000	$15,000	$15,000	Exempt

State	Private	State & Local	Federal Civilian	Military
New Mexico	None	None	None	None
New York	$20,000	Exempt	Exempt	Exempt
North Carolina	$2,000	$4,000 / Exempt	$4,000 / Exempt	$4,000 / Exempt
North Dakota	None	None	None	None
Ohio	$200 credit	$200 credit	$200 credit	Exempt
Oklahoma	$10,000	$10,000	$10,000	$10,000
Oregon	9% credit	9% credit	9% credit / pre-1991 exempt	9% credit / pre-1991 exempt
Pennsylvania	Exempt	Exempt	Exempt	Exempt
Rhode Island	None	None	None	None
South Carolina	$3,000 / $10,000	$3,000 / $10,000	$3,000 / $10,000	$3,000 / $10,000
Tennessee	Exempt	Exempt	Exempt	Exempt
Utah	None	None	None	None
Vermont	None	None	None	None
Virginia	None	None	None	Most Taxable
West Virginia	None	$2,000	$2,000	$22,000
Wisconsin	State Calculation[d]	State Calculation[d]	State Calculation[d]	Exempt

Notes:

[a] Applies only in the case of certain public safety officials.

[b] All pension benefits to police and firefighters (or their beneficiaries) as a result of job related injuries (or death) are exempt.

[c] Only contributory pension income is exempt.

[d] Payments from certain systems are exempt if employed before 1964.

Report Epilogue

After issuing the draft report, the Tax Review Commission solicited and received significant feedback and commentary on the draft findings and recommendations – both positive and negative. This is to be expected, as tax policy changes can have major impacts on individuals and businesses, and many of them weighed into the discussion. It is important to weigh the feedback within the context of individual self-interest and equally important to note that the recommendations relate to an overall tax system. Critiques of individual recommendations often do not address broader system-wide considerations.

In discussing the report, the original study charge should be kept in mind. The charge was to conduct:

- An analysis of whether the current tax system will provide sufficient revenues to meet near and long term future needs for the 21st Century.
- A review of alternate tax structures that could improve Hawaii's ability to generate sufficient revenues.

In conducting its analysis, the project team created a multi-year financial planning model to determine whether expected revenues would be sufficient to provide a current level of services in future years. PFM has built this sort of model for numerous state and local governments around the country. In fact, this long-range financial planning activity is considered a standard practice for state and local governments and has been identified by credit rating agencies and public policy organizations as a best practice.[1] Long-range analysis is critical to assess the State's near and long-term revenue sufficiency as measured against projected expenses associated with current levels of service. This exercise is not only warranted but in many ways necessary for the Commission to fulfill its responsibilities.

The report has been criticized in its approach to the question of 'whether the current tax system will provide sufficient revenues to meet near and long term future needs' because of its focus on the revenue aspect of budgeting. There are differing philosophies and approaches as to how governments should approach and deal with possible budget shortfalls. Many of the revenue-side recommendations in this report could be addressed on the expenditure side as well.[2] However, the focus of the charge from the Tax Review Commission (as its name would suggest) was 'alternate tax structures that could improve Hawaii's ability to generate sufficient revenues.'

The following are brief responses to some of the broad tax policy critiques:

Tax Burden

Hawaii statute suggests that the TRC should view the current and any recommended tax structure changes from the perspective of equity. Many of the critiques of the recommendations have focused on specific recommendations without necessarily examining the impact on the tax structure as a whole. In many respects, these are non-unique criticisms, as other national studies have raised concerns about the equity of the current State tax structure.

[1] See, for example, "Recommended Budget Practices: A Framework for Improving State and Local Government Budgeting," National Advisory Council on State and Local Budgeting, Governmental Finance Officers Association, 1998, pp.43-51. See also "The Top 10 Management Characteristics of Highly Rated U.S. Public Finance Issuers," Standard and Poor's Rating Services, July 22, 2012, p. 7.

[2] As the report notes, neutral third party analysis (such as that conducted by the GAO) suggests that expenditure solutions are unlikely to be the primary vehicle for solving long-term state budget problems.

The study recommendations, as a whole, decrease the tax burden for lower income taxpayers. According to the study calculations, which use federal Bureau of Labor Statistics data on consumer expenditures by income levels, the recommendations will reduce the tax burden for lower income cohorts while raising it for high income cohorts.

At the same time, the study recommendations are expected to increase the overall amount of revenue the State collects. As a result, the tax burden for some individuals and businesses must necessarily rise. The study recommendations seek to balance the impact on any particular taxpaying group, which generally supports both equity and efficiency principles.

GET Rate Comparisons

Commentators have suggested that an analysis of the GET rate in comparison to other state sales tax rates is inappropriate, as the GET is not a sales tax and is applied to the gross receipts of virtually all businesses operating in the State. The study acknowledges the broad base of the GET in relationship to other states, quoting from comparisons done by the Federation of State Tax Administrators (FTA) and Dr. William Fox. However, there are other states that impose a business privilege or transaction tax in lieu of a state sales tax – a past paper for the TRC by Dr. Fox notes that "Hawaii is not unique in creating its sales tax through a vendor levy. Thirteen states including Hawaii levy their sales tax on the privilege of engaging in business as a vendor."[3]

Regardless of the nuance of the tax, these thirteen states are regularly compared to states with a more general state sales tax, and it is acknowledged by tax experts that they largely have the same effect – they are primarily taxes on consumption. Dr. Fox discusses the GET and its relationship to other broad-based sales taxes and notes that "An important conclusion of economics is that the economic effects, in terms of whose income ultimately is reduced through payment of the tax and the tax's effects on the product's price and quantity demanded, are the same regardless of whether the tax is legally incident on the seller's receipts or the buyer's purchase."[4]

The July 2012 paper for the TRC by Dr. Fox makes similar comparisons as those done by this study – it examines rates for states with sales taxes and other general consumption taxes and makes the similar point that "The standard GET rate (4.0 percent) is low compared with other states."[5] Granted, the base on which Hawaii applies its GET is broad – the broadest of any state. However, other states do also tax a number of services (which is generally viewed as a key component of the broadness of the base). For example, the FTA state survey found that Hawaii was first among the states in taxing common services, with 160 out of 168 taxed, but New Mexico and Washington were not far behind, both taxing 158 services. South Dakota and Delaware also each tax over 140 services.

The primary purpose for discussion and comparison of state general consumption tax rates relates to issues of efficiency and the axiom of taxation to strive for the broadest possible base and the lowest possible rate. The study's use of rate comparisons is primarily to determine whether in the broad application of the consumption tax a 4.5 percent GET rate would be out of step with other states and thus make the economy less competitive with other states based on this tax rate – and the answer is clearly that it would not.

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[3] William F. Fox, "Hawaii's General Excise Tax: Should the Base Be Changed?" Report Prepared for the 2005-2007 Hawaii Tax Review Commission.

[4] Ibid.

[5] William F. Fox, "Selected Issues with the Hawaii General Excise Tax," Report Prepared for the 2010-2012 Hawaii Tax Review Commission, July 22, 2012, p. 3.

Tax Pyramiding

The recommendation to increase the GET rate to 4.5 percent has been criticized as leading to additional tax pyramiding. To the extent that pyramiding occurs with the current 4.0 percent GET rate, it is a fact that an increase in the rate to 4.5 percent will have some additional pyramiding impact. However, the study also recommends eliminating the 0.5 percent rate that is applied to wholesaling, manufacturing, producing, wholesale services, and use tax on imports for resale. The taxing of these activities creates significant pyramiding (for example wholesale activities, by definition, are 'middleman' services provided prior to retail sale of a good), and removing the tax will lessen pyramiding.

It is generally accepted by economists that pyramiding has negative consequences – and prior papers for the TRC by Dr. Fox have examined this issue.[6] While it is acknowledged that the GET results in tax pyramiding, the effective GET rate as a result of pyramiding has not been a recent subject of research (and may well be a topic worthy of analysis by the TRC in the future). A 1989 study, which is cited in the report, constructed an input-output model of the State economy and estimated that the effective GET rate (because of pyramiding) was in the range of 5.3 to 5.4 percent.[7] While the study is dated, if this estimate is still reasonable, it suggests that the additional pyramiding impact from raising the GET rate to 4.5 percent will be less substantial than some claim.

While the concept that eliminating the 0.5 percent GET rate will reduce pyramiding is obvious, one local commentator suggested that keeping the 0.5 percent rate was important so as to be able to obtain useful economic information from those subject to this tax. This is a novel theory of taxation – in essence, consumers and businesses should pay for the privilege of providing economic data to the State. However, this theory does not really align with either tax efficiency or equity considerations.

Individual Income Tax

A major consideration in the report's recommendations is to reduce, to the extent possible, the tax burden on lower-income state residents. The study seeks to accomplish this by increasing the IIT standard deduction and doubling the refundable food/excise tax credit. Even when coupled with the increase in the GET rate, this is a net gain for lower income taxpayers – according to the tax burden model constructed for the study, low income taxpayers (in this case, defined as a family of three with income of $25,000) realized in net savings equivalent to 2.3% of their income. Families with income of $50,000 also see some small savings, while those with incomes of $75,000, $100,000, and $150,000 see increases in their tax burden. From the perspective of advancing equity issues, the study recommendations further that important goal.

Summary

Many of the critiques of the report and its recommendations are understandable and expected and all deserve careful consideration. At the same time, the recommendations should be viewed in the broad context of a tax structure that is likely to have to generate additional revenue over baseline assumptions during the next 12 years. The recommendations should be viewed collectively, as individual components will have negative impacts that may be outweighed by other suggested changes. When taken as a whole, the recommendations generally align with equity and efficiency considerations and should help the State achieve structural balance over the entirety of the 2012-2025 timeframe.

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[6] Ibid.

[7] Richard L. Bowen and PingSun Leung, "Tax Pyramiding and Tax Exporting in Hawaii: An Input-Output Analysis," University of Hawaii Research Extension Series 102, January 1989, p.6.

APPENDIX B:

DESCRIPTION OF THE FORECASTING MODEL DEVELOPED BY THE PFM GROUP

Multi-Year Financial Forecasting Model

The broad scope and complexity of state budgets makes current and future year financial forecasting difficult. To assist the Tax Review Commission in its current efforts and the State over the long term, PFM constructed a multi-year financial forecasting model. The model projects the State's General Fund revenues, expenditures and financial results from the current fiscal year through FY 2025. The model can help policymakers identify key issues and trends in the short and long run and allow testing of multiple approaches on both the revenue and spending side of the budget.

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. The project team 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.

The model is designed in Microsoft Excel and is open source – all of its formulas are clearly identified and can be modified should alternate assumptions wish to be used. The model can also be updated as new data becomes available. PFM has provided documentation on the model to the State and is training State employees on its use. The model is licensed to the State for official use in perpetuity, and there is no additional licensing fee charged for its use.

Many state and local governments use PFM models as part of their budget forecasting, development and implementation process. The model can be used to:

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

The model also uses a combination of modules dedicated to key areas of the budget that can also be used for decision-making. For example, the workforce projection module allows state policymakers to isolate the budget impacts from salary and benefit changes for state employees, either in the aggregate or by bargaining unit. Likewise, the regressions used for making revenue estimates can be compared to actual results and further refined over time to assist in improving overall forecasting and budgeting.

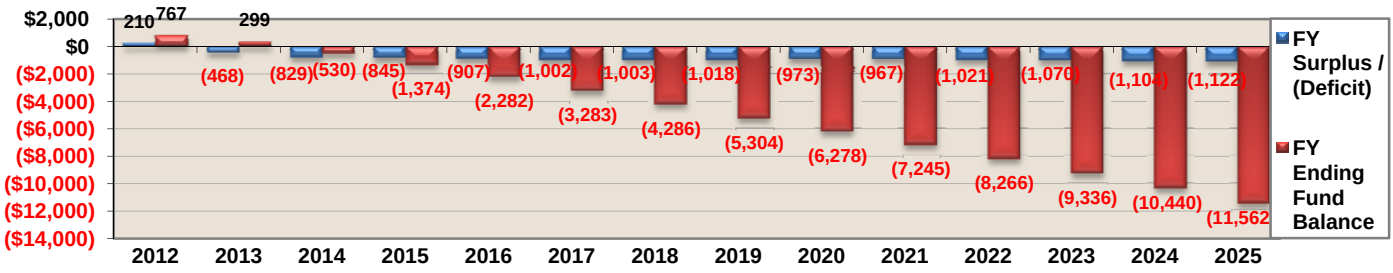
In short, the model is a flexible Excel-based program that can run 'as is' and can also be modified to fit the State's needs, both now and in the future. It is a useful tool that can assist the State in making informed policy choices, both on revenue and expenditure decisions in the short and long run.

APPENDIX C:

ADDITIONAL INFORMATION FROM THE PFM GROUP REQUESTED BY THE COMMISSION

Additional Model Scenario Calculations – Hawaii Budget Projection Model

Accrual Scenario with Recommendation



Budget Results - Accrual Scenario with Recommendation

(in millions)

FY:	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
FY Surplus / (Deficit)	210	(468)	(829)	(845)	(907)	(1,002)	(1,003)	(1,018)	(973)	(967)	(1,021)	(1,070)	(1,104)	(1,122)
FY Ending Fund Balance	767	299	(530)	(1,374)	(2,282)	(3,283)	(4,286)	(5,304)	(6,278)	(7,245)	(8,266)	(9,336)	(10,440)	(11,562)

GET Increase Required to Balance - Accrual Scenario with Recommendation*

	FY2014
Additional Core GET (4% rate) required to close deficit	1.16%
New Rate (w/ recommended 0.5% increase in FY2014)	5.66%
Revenue Yield	**$828,516,174**

*With this increase, each year is balanced with the exception of FY2017. In that year there is a small deficit ($15m) that appears but disappears thereafter, however positive fund balances generated by this rate increase should be sufficient to cover that one-year shortfall.

APPENDIX D:

REPORT OF DR. WILLIAM F. FOX –

“Selected Issues with the Hawaii General Excise Tax”

FINAL REPORT

SELECTED ISSUES WITH THE HAWAII GENERAL EXCISE TAX

Report Prepared for the 2010-2012 Hawaii Tax Review Commission

July 22, 2012

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Mitchell A. Imanaka, Vice-Chair
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Introduction

This report analyzes selected issues with the Hawaii General Excise Tax (GET).[1] Specifically, the report examines the GET revenue lost because of the inability to collect revenue due because of e-commerce and the revenue that is not obtained because of a set of seven specific exemptions. The paper also considers several related issues, including the legislation currently before Congress to allow states to require remote firms to collect their sales tax and the revenue neutral GET rate that could be levied if the personal and corporate income taxes were eliminated.

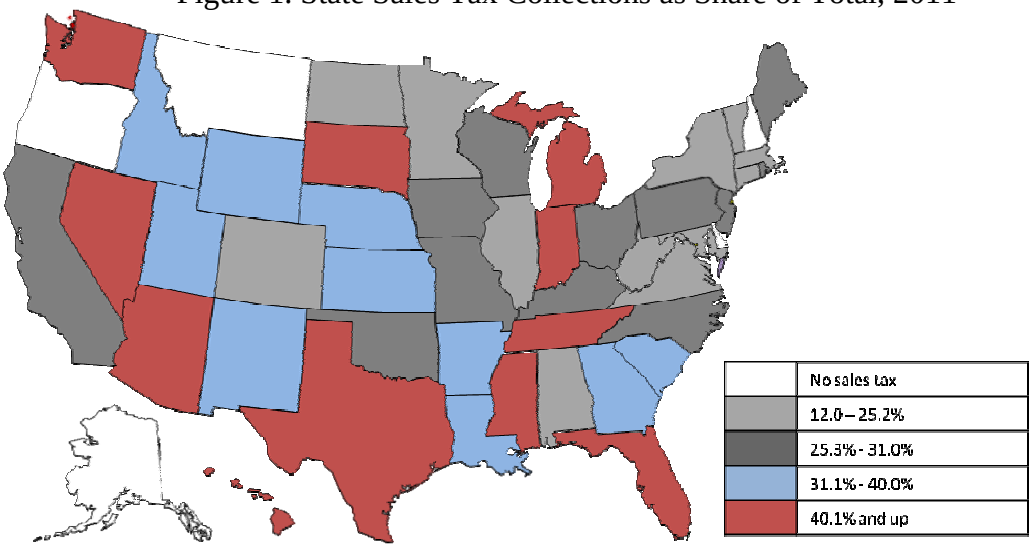
I. An Overview of the GET

In this report the GET is analyzed in the context of state sales taxes.[2] The GET is imposed on a broader set of transactions than any other sales tax, but there is a similar intent to impose a consumption based tax. Nonetheless, state sales taxes differ dramatically from levies on consumption because of the imposition of the taxes on many intermediate purchases (business inputs). The GET is imposed on total gross receipts of businesses, which differs from some but not all states, which generally levy the tax on the total purchase price of consumers. [3]

The GET collected 51.4 percent of Hawaii's tax revenues in 2011, which is considerably greater reliance on the tax than the average state, which raises 31.5 percent of its revenues with the sales tax (see Figure 1 for all states).[4] Only Washington, Tennessee, Florida, and South Dakota generate a larger percentage of tax revenues from their sales tax than Hawaii, and South Dakota is the only one of these states that also has a personal income tax.

[1] See Hawaii Code 237 for GET legislation.
[2] Fox (2002) discusses why the GET can be viewed as a retail sales tax, though the base is much broader than in the average state.
[3] The GET rate is 4.16 by comparison with the rate levied in many other states. The key difference is that the GET is imposed on gross revenues of a business, including any attempt by the vendor to include the GET in the price, while most other states impose the tax on the gross of tax price. The 4.16 percent rate is generally used in the revenue estimates provided below.
[4] See. http://www.taxadmin.org/fta/rate/11taxdis.html

Figure 1. State Sales Tax Collections as Share of Total, 2011



Source: Federal Tax Administrators

Hawaii imposes the GET at four rates: 4.0, 0.5, 0.15 and 0 percent (see section 18-237-13). The zero rate is levied on exempt sales and the 0.15 percent rate is imposed on insurance producers. The 0.5 percent rate is levied on sales by manufacturers, wholesalers, intermediary services, sugar processing, and pineapple canning. The 4.0 percent rate is imposed on all other taxable sales. The use tax is imposed at similar rates as the sales tax (see section 18-238-2). The use tax is 4.0 percent on purchases by individuals and on retailers, wholesalers, contractors, and service providers on purchases that are not for resale and on manufacturers on purchases where the goods do not become component parts of the final product. Purchases for resale are taxed at 0.5 percent when made by wholesalers or manufacturers who act as a retailer and purchases are taxed at 0.5 percent when the item becomes a component part.

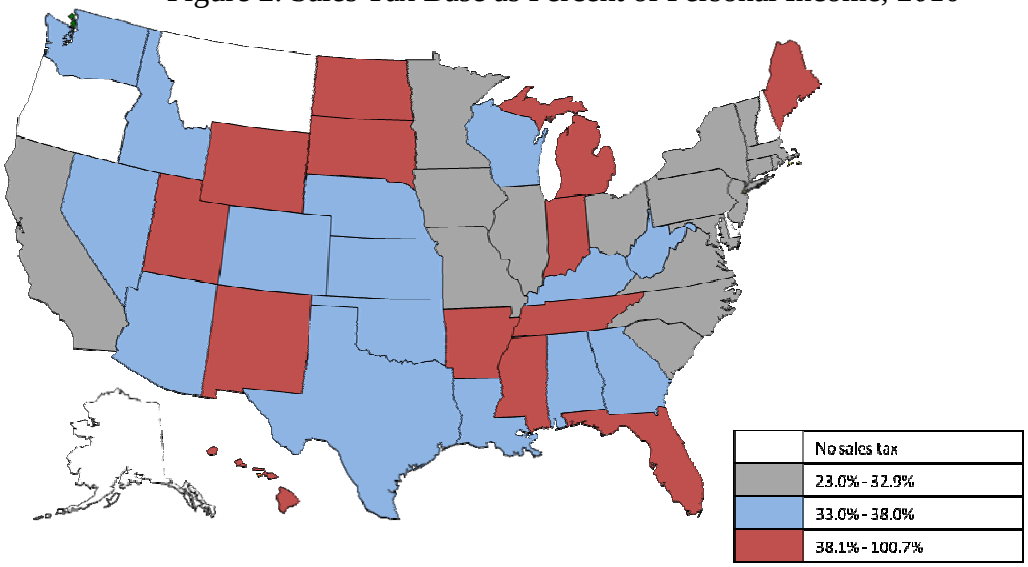
The standard GET rate (4.0 percent) is low compared with other states. The median state levies a 6.0 percent state rate and 35 states have local sales taxes as well.[5] Five states have no sales tax including Alaska, Delaware, Montana, New Hampshire, and Oregon. Among sales taxing states, only Colorado has a lower *state* sales tax rate (2.9 percent) than Hawaii and six states besides Hawaii also have a 4.0 percent state rate. California has the highest state sales tax rate (7.25 percent). Hawaii's state and local rate is the lowest among sales taxing states when the state rate is combined with the average local sales tax rate.[6]

Hawaii obtains a large share of tax revenues from the GET despite the low rate because the GET base is very broad. Hawaii taxes food and nearly all services and grants relatively infrequent exemptions. Dividing states' tax bases by their respective personal

[5] Alaska has no state sales tax rate but has local tax rates up to 7.0 percent.
[6] See http://thestc.com/STrates.stm

income is one means of comparing the relative breadth of state tax bases.[7] Hawaii has the broadest base of any state using this standard, with a base equal to 100.7 percent of personal income.[8] New Mexico is second broadest, at 79.1 percent, and the average state tax has a base equal to 33.0 percent of personal income (see Figure 2). Hawaii's tax base breadth, though very high, has been falling over time.

Figure 2. Sales Tax Base as Percent of Personal Income, 2010



Source: Author's calculations

II. Revenue Losses from Inability to Collect GET on Remote Transactions

This section examines the General Excise Tax (GET) revenue loss because of the inability to collect some revenue associated with remote sales via e-commerce. The section includes six parts. The first is a summary of the findings. Sections on e-commerce in the U.S., e-commerce sales to Hawaiian people and businesses, and the taxability of e-commerce under the GET are next. GET revenues associated with e-commerce sales follow. The final section provides a brief summary of recent bills introduced in Congress that would allow states to require remote vendors to collect their sales tax.

The GET is similar in concept to retail sales taxes that are imposed in other states and is treated as a sales tax in this paper. Hawaii levies a corresponding use tax "on the use in this State of tangible personal property which is imported by a taxpayer in this State whether owned, purchased from an unlicensed seller, or however acquired for use in this State (18-238-2)" and "on the value of services or contracting as defined in section 237-6 that are performed by an unlicensed seller at a point outside the State and imported or purchased for use in this State" (18-238-2.3). Sales tax revenues are generally due on sales of goods and services in Hawaii and use taxes are normally due on goods and services that are purchased (or produced) outside Hawaii for use in Hawaii. This analysis

[7] Personal income is a broad measure of state economies and includes wages and salaries, rents, interest, dividends, earnings of sole proprietors and farmers, and transfer payments.
[8] See John Mikesell.

of revenues lost from e-commerce is primarily a study of use tax though the terms use tax, sales tax and GET are used somewhat interchangeably in this paper.

Hawaii is generally unable to require many e-commerce firms to collect and remit the GET because the firms do not have nexus, or taxable presence, in the state.[9] Hawaii's use tax legislation requires buyers to remit the GET on their own if the vendor did not remit the tax, but voluntary compliance by individuals is generally believed to be very limited. Voluntary compliance by business purchasers is much better than for individuals, though businesses appear to have much lower compliance with the use tax than with the sales tax.[10] In the longer term, GET compliance can be enhanced significantly if remote vendors are required to collect and remit use taxes either because Congress enacts legislation that creates nexus for remote vendors or because the Supreme Court overturns the Quill Case that established sales tax nexus on a physical presence basis.

Findings

Hawaii businesses and people are estimated to make $30.6 billion in e-commerce purchases in 2012 (see Table 1). Of this amount, an estimated $19.2 billion is taxable at either the 4.0 or 0.5 percent GET rate, with the considerable majority taxable at the 0.5 percent rate. Approximately $335.8 million in GET revenues is due on these sales, of which $62.0 million is due on sales that are taxable at the 0.5 percent rate and $273.8 million is based on the 4.0 percent rate. An estimated $144.9 million of the tax due is not being collected either by the vendors or paid in use taxes by the purchasers. The calculations include $38.6 million that is due on business-to-consumer catalog sales, of which $31.1 million goes uncollected.

Table 1. Hawaii E-Commerce Purchases (millions)

	2010	2011	2012	2013	2014	2015
B2B	$22,204	$24,824	$27,039	$29,920	$34,535	$39,989
B2C	$ 1,903	$ 2,191	$ 2,452	$ 2,782	$ 3,286	$ 3,886
Total	$24,107	$27,015	$29,491	$32,702	$37,821	$43,876
Mail Order	$ 998	$ 1,048	$ 1,101	$ 1,156	$ 1,214	$ 1,274
Total With Mail Order	$25,106	$28,063	$30,592	$33,857	$39,035	$45,150

Source: Author's calculations

The following sections describe the methodology for estimating the revenue losses associated with the inability to collect GET that is due on transactions consummated through e-commerce. The general approach involves a number of steps including estimation of:

- the total e-commerce sales for the United States

[9] The U.S. Supreme Court in *Quill, Inc. v. North Dakota* ruled that a state can only require firms with physical presence in the state to collect the sales tax.

[10] For example, in an audit of registered taxpayers Washington State (2010) found 23.0 percent non-compliance with the use tax but only 1.0 percent noncompliance with the sales tax.

- the share of e-commerce sales that is attributable to Hawaii
- the GET due on Hawaii-destined transactions
- the GET that is currently being collected on these transactions
- the currently uncollected GET

E-Commerce in the United States

Total e-commerce sales are first estimated for the U.S. The forecasts are based on U.S. Census Bureau estimates of actual e-commerce for 2000 through 2009 (with some estimates for 1998 and 1999). The Census Bureau provides e-commerce sales by type of vendor, including for manufacturers, wholesalers, retailers and service providers.[11] Total e-commerce sales in 2009 were nearly $2.9 trillion (See Table 2 and Figure 3). The recession caused sales to fall by over $300 billion from 2008, but e-commerce was still 2.7 times higher than 2000, and represented an 11.8 percent compound annual growth rate. Manufacturers dominate e-commerce sales, being responsible for 64.5 percent of 2009 sales (Table 3). The manufacturing share has fallen significantly since 2000 for three main reasons: slower sales growth by manufacturers, very rapid growth in sales by retailers, and strong growth in sales by wholesalers and service providers. Retailers now provide five percent of total e-commerce sales and 4.0 percent of total retail sales. Together, retailers and service providers are responsible for a little over 10 percent of total e-commerce sales.

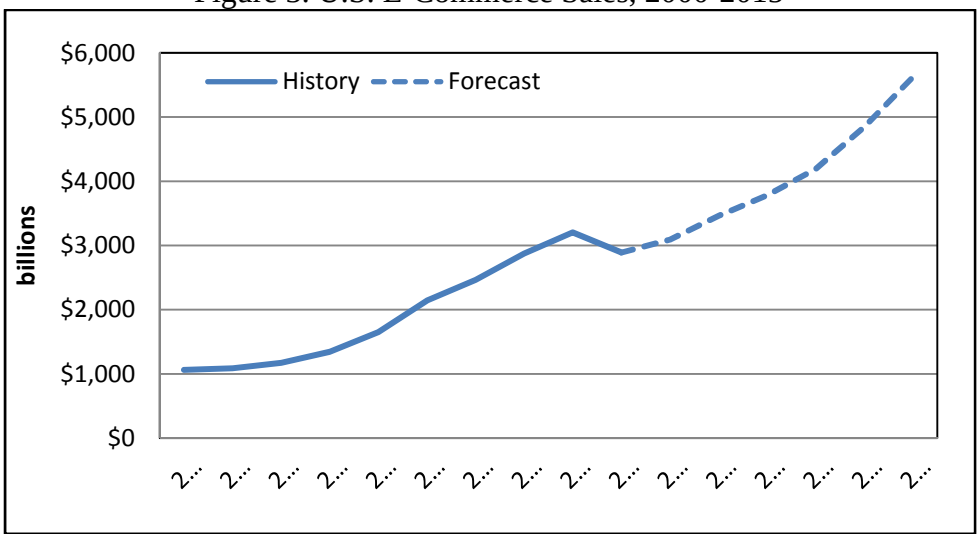
Table 2. U.S. E-Commerce Sales, 2000-2009 (millions $)

Vendor	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Manufacturing	755,807	724,228	751,985	842,666	996,174	1,343,852	1,566,799	1,879,424	2,170,818	1,862,493
Wholesale	277,818	327,693	374,551	441,911	497,961	609,933	669,432	725,141	739,314	728,663
Services	NA	NA	NA	NA	82,103	93,299	110,463	131,553	149,668	153,007
Retail	27,763	34,593	45,212	58,157	74,175	92,804	114,912	138,145	142,281	145,214
Total	1,061,388	1,086,514	1,171,748	1,342,734	1,650,413	2,139,888	2,461,606	2,874,263	3,202,081	2,889,377

Source: U.S. Bureau of the Census

[11] The Census did not report manufacturers' sales for 1998 and did not begin reporting service sales using its current methodology until 2004.

Figure 3. U.S. E-Commerce Sales, 2000-2015



Source: Author's calculations

Table 3. U.S. E-Commerce Sales, Percent Distribution, 2000-2009

Vendor	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Manufacturing	71.2%	66.7%	64.2%	62.8%	60.4%	62.8%	63.6%	65.4%	67.8%	64.5%
Wholesale	26.2%	30.2%	32.0%	32.9%	30.2%	28.5%	27.2%	25.2%	23.1%	25.2%
Services	NA	NA	NA	NA	5.0%	4.4%	4.5%	4.6%	4.7%	5.3%
Retail	2.6%	3.2%	3.9%	4.3%	4.5%	4.3%	4.7%	4.8%	4.4%	5.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: U. S. Bureau of the Census and author's calculations

Table 4 reports a forecast for U.S. e-commerce sales for 2010 through 2015.[12] E-commerce was estimated for business-to-business (defined here as manufacturers and wholesalers) and business-to-consumer (defined here as services and retailers) transactions. The estimates were prepared by first finding the relationship between e-commerce growth and national GDP growth between 2000 and 2009. Then, a forecast of GDP prepared by Global Insights was used to estimate e-commerce during the forecast period.

Table 4. U.S. E-Commerce Sales, 2010-2015 (millions $)

Baseline E-Commerce Growth Scenario						
	2010	2011	2012	2013	2014	2015
Total Business-to-Business E-commerce	2,846,701	3,182,517	3,466,547	3,835,835	4,427,560	5,126,858
Total Business-to-Consumer E-commerce	244,000	280,892	314,378	356,684	421,287	498,221
Total E-Commerce	3,090,701	3,463,409	3,780,925	4,192,520	4,848,848	5,625,078

Source: Author's calculations

[12] It is necessary to forecast 2010 and 2011 because the Census data for these years were not reported as of the preparation of this report.

E-Commerce Purchases by People and Firms in Hawaii

The next step is to estimate the portion of national e-commerce transactions where the goods and services will be used in Hawaii. No consistent data provide the geographic distribution of e-commerce purchases by state, so the sales must be distributed based on an assumption about where the buyers of national e-commerce sales are located. Hawaii's share of e-commerce is assumed to be in proportion to its percentage of national aggregate adjusted state and local sales tax revenues collected in each state.[13] This approach allows the e-commerce share in each state rises with the size of the state's economy, breadth of the adjusted tax base, and level of sales tax rates. The estimated e-commerce share is positively related to the tax rate and base because the incentives for businesses and people to shop online rise with the level of the tax rate and the breadth of the tax base.[14]

Estimates of mail order purchases by Hawaii businesses and consumers are also included in Table 1 and in the tax base and tax revenue estimates provided below.[15]

Taxability of E-Commerce Purchases

Estimated e-commerce purchases by Hawaii buyers do not directly translate into tax liabilities in part because a number of transactions are exempt. More importantly, the GET rate depends on classification of the type of buyer/seller and how the buyer intends to use the purchased items. As noted above, the GET rate is 4.0 percent for consumer purchases and certain business purchases, such as when the item does not become a component part of a manufactured good or constructed unit or when the good is not for resale. The GET rate is 0.5 percent or 0 for other business purchases. The Census e-commerce data from which Hawaii's sales were developed provide information on the sales by category of business vendors, but do not provide information on who the buyers are or how the goods and services will be used.[16] Thus, the Census classifications do not directly allow the e-commerce data to be translated into the various taxable groupings in

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[13] This approach results in Hawaii buyers being estimated to purchase 0.78 percent of national e-commerce sales, which exceeds the 0.46 percent of national personal income that accrues to Hawaii. Arguments can be made that the approach for allocating e-commerce sales to Hawaii understates or overstates Hawaii's actual share for reasons such as the distance from the mainland and unique elements of Hawaii's economy. Still, the approach is used as a reasonable proxy for the share accruing to Hawaii (and as a methodology that is consistent with the one used for other states). The revenues losses would still be large even if a more conservative approach was used to estimate the share of sales going to Hawaii. For example, estimated 2012 GET revenue losses would still be $118 million if Hawaii was allocated a one-fourth lower share of e-commerce sales. See Bruce, Fox and Luna (2009) for a complete description of the methodology.

[14] For example, see Goolsbee (2000) and Ellison and Ellison (2009).

[15] National mail order sales are estimated to be $128.0 billion in 2012.

[16] The Census Bureau provides e-commerce transactions for sales by manufacturing, wholesaling, services and retail businesses. These are summarized as business-to-business (representing manufacturers and wholesalers) and business-to-consumer (representing services and retailers) for preparation of the e-commerce forecast. This B2B and B2C categorizations do not strictly reflect buyers because businesses also purchase from retailers and service providers and consumers make some purchases from manufacturers and wholesalers. Nonetheless, the terminology is maintained to simplify the analysis and discussion.

Hawaii. The remainder of this section briefly describes how the data by type of vendor sale are translated into taxable purchases in Hawaii.

The United States Bureau of the Census also provides limited data on the buyer for certain sales by retail, wholesale and service vendors through the 2007 Economic Census. The data are for all businesses and transactions, not for e-commerce transactions alone, but these are the only generally available data for estimating the tax due at 4.0 percent versus at 0.5 percent or 0 percent. Nonetheless, purchasing patterns may differ between e-commerce and other types of commerce and may have changed over time.

E-commerce and mail order sales are assumed to be distributed across consumer purchases, business inputs, and other business purchases in the same manner as total retail sales reported in the Census. The Economic Census data indicate that on average 86.6 percent of retail sales are to final consumers, 4.9 percent are to businesses to use as inputs that become part of the final product and 8.5 percent are to businesses for other uses.[17] Thus, 86.6 percent of e-commerce sales by retailers are assumed to be taxable at 4.0 percent and 13.4 percent to be taxable at 0.5 percent.

Very limited data are available from the 2007 Census for selected services.[18] For example, individuals purchase 29.6 percent of legal services, various business and farm users buy 65.7 percent and miscellaneous and government users procure 4.7 percent. Businesses purchase 41.1 percent of repair and maintenance services, individuals purchase 52.9 percent and miscellaneous and government users purchase 6.0 percent. These data are for a small set of services but are suggestive that individuals purchase about one-half as large a percentage of the sales by service providers as the sales by retailers. Therefore, individuals are assumed to purchase 43.3 percent of services that are taxable at 4.0 percent, businesses purchase 51.8 percent of services t and the remaining 4.9 percent is non-taxable services. Three-fourths of business services are assumed to be taxable at 4.0 percent and one-fourth at 0.5 percent.

The 2007 United States Economic Census also includes data on the type of purchases and how the goods are used for sales by wholesalers. The Economic Census estimates that 34.3 percent of wholesale sales are for uses that would be taxable at 0.5 percent, such as retailers for resale, restaurants and hotels, and repair shops.[19] An estimated 24.0 percent is taxable at 4.0 percent, including business purchases for their end use and purchases by households. The other 41.7 percent is exports, manufacturers for use as inputs, and wholesalers for resale, all of which are exempt. Data are not available in the Economic Census by type of purchaser for manufacturing vendors. Manufacturers are presumed to sell only one-half as great of a percentage of goods that

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[17] U.S. Bureau of the Census, U.S. Department of Commerce, 2007 Economic Census, Retail Trade, Table 2, Class of Customer by Kind of Business.

[18] U.S. Bureau of the Census, U.S. Department of Commerce, 2007 Economic Census, Professional, Scientific and Technical Services, Receipts by Class of Consumers for Selected Professional, Scientific and Technical Services. http://factfinder2.census.gov/faces/nav/jsf/pages/searchresults.xhtml?refresh=t

[19] U.S. Bureau of the Census, U.S. Department of Commerce, 2007 Economic Census, Wholesale Trade. http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ECN_2007_US_42SXSB01&prodType=table

are taxable at 4.0 percent as do wholesalers. Manufacturers are also assumed to make 41.7 percent of sales to wholesalers, other manufacturers and exports that are subject to a 0 tax rate and the remaining 46.3 percent is assumed to be taxable at 0.5 percent.

GET Revenues and E-Commerce

This section estimates the tax revenue that is due on remote e-commerce purchases, the degree to which these taxes are already being collected, and the amount that is currently uncollected. The GET tax base is estimated using the methodology described above to separate sales for each type of vendor into purchases taxable at 4.0 percent and purchases taxable at 0.5 percent. The narrative focuses on the taxes for 2012, but the Tables provide annual estimates for 2010 through 2015. Revenue losses are estimated to grow rapidly across these years because of the significant forecast growth in e-commerce during this period. Also, estimates for mail order sales are included in the tables.[20]

Table 5 shows estimates of GET revenues based on forecasts of taxable purchases by consumers and businesses at the *4.0* percent GET rate. The combined taxable base for consumers and businesses is $6,682.5 million, which is 21.8 percent of the total estimated value of e-commerce purchases for use in Hawaii.[21] A total of $273.8 million in GET is due on these transactions in 2012.[22]

Table 5. Tax Revenues for Transactions Taxable at 4.0 Percent (millions)

		2010	2011	2012	2013	2014	2015
Tax Due		$ 190.62	$ 214.91	$ 235.95	$ 263.04	$ 305.74	$ 356.34
Mail Order		$ 34.34	$ 36.06	$ 37.86	$ 39.76	$ 41.74	$ 43.83
Total With Mail Order		$ 224.97	$ 250.97	$ 273.82	$ 302.80	$ 347.49	$ 400.17
Compliance		$ 120.93	$ 135.09	$ 147.24	$ 162.89	$ 187.62	$ 216.83
Uncollected Revenues		$ 104.04	$ 115.88	$ 126.58	$ 139.91	$ 159.87	$ 183.34
Source: Author's calculations							

The next step is to estimate compliance with the taxes that are due. Taxes are almost always collected when the selling vendor remits GET to Hawaii but use tax compliance by the buyer is considerably worse. First consider consumer compliance. Consumer use tax compliance is very weak, and little revenue is collected unless it is remitted by the seller. Seller compliance was estimated by examining the website of

[20] Mail order sales are analyzed similarly to retail sales.
[21] A total of 95.4 percent of transactions are estimated to be taxable at either 4 percent or 0.5 percent.
[22] The estimate is much higher than that prepared by Bruce, Fox and Luna (2009). Several explanations for the differences are offered. The analysis presented here is based on more current forecasts of e-commerce. But, a major reason for the difference is that the Bruce, Fox and Luna report determined taxability of e-commerce transactions based on the results of a survey sent to Departments of Taxation in every state. Thirty states complied, but Hawaii did not. For states that did not comply, the authors assume the taxability equals the average of all reporting states. The methodology was used consistently for all non-responding states. This methodology probably works acceptably for most states, but does not work as well for Hawaii because the GET base is so much broader than any other state sales tax. Also, Bruce, Fox and Luna (2009) do not include mail order in their estimates. The estimates provided here are based on very careful Hawaii specific analysis of taxable transactions.

approximately 100 large firms identified by the Internet Retailer Top 500 to determine whether the firms collect GET for Hawaii. Overall, large vendors can be expected to collect tax on 45.4 percent of sales to Hawaii buyers, based on a sales weighted average of the 100 firms. Smaller firms, which represent about 62 percent of e-commerce retail sales,[23] have very limited sales tax compliance since they will seldom have taxable presence in Hawaii. Overall, compliance for sales to individual consumers will only average about 20 percent.

Businesses comply in two ways. First, they comply when the vendor from which they purchase collects and remits the GET. Second, they comply through the use tax remittance system, which they do much more readily than individuals. A report by the Washington State Department of Revenue estimates that businesses remit 77.0 percent of the use tax due on their purchases. Thus, vendors selling to Hawaii firms are assumed to collect about 20 percent of the revenue that is due (this assumes that vendors are as likely to collect the tax due on sales to businesses as to individuals) and Hawaii firms are assumed to remit 77 percent of the amount not collected and remitted by vendors.

In total, compliance is expected to be $147.2 million in 2012, which means Hawaii collects about 55 percent of the taxes that are due at 4.0 percent. This still leaves $126.6 million in uncollected revenues this year.

Table 6 shows that another $62.0 million is due in 2012 on business purchases that are taxable at the *0.5* percent rate. Compliance is much better for these transactions and approximately $43.7 million is collected. Approximately $18.3 million of the tax due at 0.5 percent is uncollected.

Table 6. Tax Revenues for Transactions Taxable at 0.5 Percent (millions)

		2010	2011	2012	2013	2014	2015
Tax Due		$ 50.17	$ 56.18	$ 61.28	$ 67.90	$ 78.47	$ 93.63
Mail Order		$ 0.67	$ 0.70	$ 0.74	$ 0.77	$ 0.81	$ 0.85
Total With Mail Order		$ 50.84	$ 56.88	$ 62.01	$ 68.67	$ 79.28	$ 94.48
Compliance		$ 35.88	$ 40.12	$ 43.72	$ 48.38	$ 55.85	$ 66.65
Uncollected Revenues		$ 14.96	$ 16.75	$ 18.30	$ 20.29	$ 23.43	$ 27.84
Source: Author's calculations							

In total, Table 7 evidences that $335.8 million in GET revenues are due on e-commerce purchases by Hawaii residents and businesses in 2012. The state collects 57 percent of these revenues, but this still leaves $144.9 million in non-compliance with the GET.

[23] See Bailey, et al (2008).

Table 7. Total Tax Revenue Effect (millions)

		2010	2011	2012	2013	2014	2015
Tax Due		$ 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: Author's calculations							

The estimates contained in Table 7 are considerably higher than those prepared by Fox in 2006. Several reasons can be given for the difference. First, Table 1 shows that e-commerce has risen dramatically since 2006. Second, data from the Economic Census indicate that a larger share of e-commerce is likely to be taxable at both the 4.0 or 0.5 percent tax rate than was seen in data available for the earlier analysis.

Federal Legislation and E-Commerce

Three bills to require remote vendors to collect state sales taxes were introduced in the U.S. Congress during 2011: the Main Street Fairness Act,[24] the Marketplace Fairness Act,[25] and the Marketplace Equity Act of 2011.[26] All of the bills allow states that simplify and harmonize their sales taxes to require certain remote vendors to collect their sales tax. Differences between the bills arise mainly in the simplification and harmonization criteria and the small seller exception that determines the sales that a firm must make before it can be required to collect the tax. Much of the current discussion of the legislation focuses on the appropriate small seller exception, and the amount listed in any bill is readily subject to change. But, it is nearly certain that such an exception will be allowed whenever the legislation passes Congress.

The **Main Street Fairness Act** determines that simplification and harmonization have occurred when states become full members of the Streamlined Sales and Use Tax Agreement (SSUTA).[27] Thus, states must comply with provisions of the SSUTA in order to require remote vendors to collect their sales tax.

The **Marketplace Equity Act** develops a unique set of criteria that must be met before states can require remote firms to collect the sales tax. The criteria have some similarities to the SSUTA, but are not precisely the same. Among the criteria are that a state:

- must develop a small seller exception, which would exempt firms with $1 million or less in national sales or $100,000 or less in sales to the state which would require the collection responsibility.

[2424] S. 1452, 112th Cong., 1st Sess. (2011); H.R. 2701, 112th Cong., 1st Sess. (2011).
[25] S. 1832, 112th Cong., 1st Sess. (2011).
[26] H.R. 3179, 112th Cong., 1st Sess. (2011).
[27] See http://www.streamlinedsalestax.org/ for information on the Streamlined Sales Tax Governing Board, Inc. and its provisions.

- must have a remote seller tax return and a single tax authority for remote sellers.
- must have a single set of definitions for taxable items across the state.
- must impose either a blended state and local tax rate, a maximum state rate, or an applicable destination tax rate for each local jurisdiction into which sales are made. The first and second of these alternative rates are not permitted to exceed the average state and local rate applicable to non-remote sellers.
- must publish detailed information about the collection requirements about six months before the collection requirements can be imposed on remote sellers.

The **Marketplace Fairness Act** mixes the approaches of the other two bills by allowing states to either be in compliance with the SSUTA or to comply with a set of other criteria. The alternative criteria include:

- providing a single state agency to administer all sales and use tax legislation, a single audit for all state and local taxing jurisdictions, and a single sales tax return for remote sellers.
- developing a uniform sales tax base for state and local governments.
- requiring remote vendors to collect a destination tax for every jurisdiction.
- providing software and services to facilitate collection by remote sellers.
- relieving sellers from liability for tax collection error resulting from information provided by the state.
- providing at least 30 days notice for local tax rate changes.

State Efforts to Expand Collection of Taxes due on E-Commerce

States have implemented a number of policy changes to enhance their ability to collect revenues due on remote sales. 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.

States have taken two broad approaches to increasing collection of sales tax on remote sales: broadening nexus definitions and imposing reporting requirements. Nexus definitions have been expanded to claim affiliate nexus through ownership of related parties, affiliate nexus by relationship with a contractor, and click through nexus. Nexus through ownership of related companies is asserted when the state argues that one component of an overall firm has nexus because another firm under the same corporate umbrella has nexus. For example, Arkansas asserts nexus over a remote firm if a related business using the same name has physical presence in the same state (such as could be true with Walmart and Walmart.com). Nexus is asserted in some cases for a firm that is represented by a contractor in the state that does activities on its behalf, such as repairing and maintaining equipment.

Click through nexus provisions assert nexus in a state to a remote firm when affiliated Internet-based firms with physical presence in the state direct sales to the remote firm. The legislation normally requires in state buyers to click through from the affiliated firm's website to the remote firm's website to make purchases. The affiliate is normally paid a commission for the sale. A small seller exception of some type might exist for the requirement to come into effect. Arkansas, Connecticut, Illinois, New York, North Carolina, Pennsylvania, Rhode Island, and Vermont assert some version of click through nexus. Most states, such as New York, passed legislation to enact click through nexus legislation, but the Pennsylvania Department of Revenue presumes that click through nexus exists under its existing sales tax statutes. New York prevailed in an initial court challenge on the legislation and the ruling has been appealed.

Several states, including Colorado and Oklahoma, enacted legislation that requires remote vendors (those without physical presence) to report certain broad information about sales into the state and to alert buyers that they may be responsible for use taxes. The Direct Marketing Association sued Colorado arguing that the statute is unconstitutional and the DMA position was upheld in Federal Court. Colorado is appealing the ruling.

III. Assessment of Eliminating Exemptions from the GET

This section of the report examines the revenue consequences associated with a series of exemptions that are allowed for the General Excise Tax (GET). The GET base is very broad compared with other state sales taxes, so the set of exemptions is not as lengthy as those that exist in other states. The report examines a specific set of exemptions that was identified in discussions with the Tax Review Commission.

The section updates estimates that were prepared for the 2006 Tax Commission, but using much better data.[28] The 2007 Economic Census and the Product Line surveys provide much improved and more consistent data for making estimates than was available six years ago. In the past it was often necessary to obtain information from a divergent and less reliable set of sources than is necessary now. The improved data explain much of any differences in the results.

The Tax Review Commission articulated seven types of transactions to identify the revenue consequences of exemption. These currently exempt transactions include:

1. Gross receipts of non-profit organizations

2. Sales of prescription drugs and prosthetic devices by a hospital, infirmary, medical clinic, health care facility, pharmacy, or practitioner licensed to administer the drug or prosthetic device.

3. Health insurance premiums paid to Health Maintenance Organizations (HMO) and mutual benefit societies.

4. Amounts received by hotel operators from hotel owners equal to and disbursed for employee wages, salaries and benefits.

5. Amounts received as rent for the leasing of aircraft or aircraft engines used by the lessee for interstate air transportation of passengers and goods.

6. Materials, parts or tools imported or purchased by a person with a GET license and which are used for certain types of aircraft service and maintenance, or for the construction of a qualified aircraft service and maintenance facility.

7. Offset deductions that a prime contractor is allowed to take from gross income for payments to another contractor or specialty contractor.

The first three exemptions are for items commonly purchased by final consumers and the others are for items that are commonly business-to-business transactions. The consumer purchases should be evaluated in terms of broadening the GET to more consumption items, and the latter four in terms of taxing more business inputs.

[28] See Fox (2006).

All revenue estimates provided below are given for fiscal year 2012, though the underlying data sources are for various earlier years. Estimates for earlier years are adjusted to 2012 terms by assuming the tax base grows at the same rate as Hawaii Personal Income.[29] This places all estimates in comparable terms, but does not account for differences in growth rates across the types of exemptions. Thus, some error is introduced to the extent that the growth rate for a particular exemption diverges from the average economic growth.

The estimates are based on the revenues that Hawaii does not collect given the gross receipts of business transactions for the particular exemption. The estimates are not what the Department of Taxation would collect if these exemptions were eliminated. First, people would respond to the tax by changing their consumption pattern and businesses would alter their practices to avoid the tax. Also, some non-compliance would exist. Nonetheless, the estimates are described as revenue losses in the text.

Revenue estimates are provided in several different ways, including the specific dollar value of the exemption, the revenue neutral GET rate that could be levied if the estimated revenue were collected, and revenues relative to total tax collections and total GET collections. Broadening the base to include all seven exemptions would raise $541.1 million, assuming that there is no behavioral response on the part of buyers and sellers to purchase less of these items (see Table 8 and Figure 4). Alternatively, the revenue neutral GET rate would be 3.46 percent. Together these exemptions represent about one-sixth of current GET collections. As previously noted, the estimates are likely upper bounds to the amount that would actually be collected because both buyers and sellers would alter their behavior to some extent if the transactions were taxable and some non-compliance would occur. On the other hand, the estimates are generally based on data from 2009 and 2010, in the depths of the recession. Estimates are forecast forward to 2012, but the revenue consequences of these exemptions could grow rapidly over time as the economy begins to recover robustly again. This has the effect of making the estimates lower relative to a fully functioning economy. Asterisks are placed next to categories where the revenues are most likely to come in lower than the estimates if the exemption was eliminated because of changes in behavior to avoid the tax.[30]

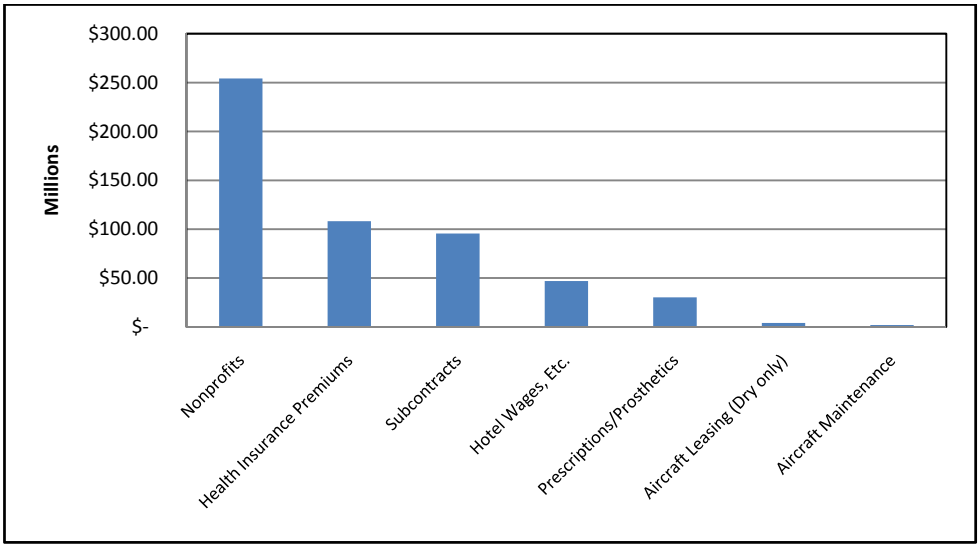
[29] Tax bases are assumed to rise at the compound annual growth rate in state personal income from 2007 through 2011.

[30] Act 105, SLH 2011, on General Excise Tax Liability of Mobile Telecommunications Service Providers has generated much less revenue than anticipated because of behavioral responses to imposition of the GET and provides an example of how revenues can be lower than a static estimate of the type prepared here.

Table 8. Revenue Effects of Removing Selected Exemptions, 2012

	Revenue Gain (millions)	Gain/Total Tax Collections (Percent)	Gain/GET Collections (Percent)	Tax Rate for Revenue Neutral
Nonprofits	$ 254.13	5.23	7.62	3.72
Health Insurance Premiums	$ 108.19	2.23	3.24	3.24
Subcontracts*	$ 95.63	1.97	2.87	3.89
Hotel Wages, etc.	$ 46.29	0.97	1.41	3.95
Prescriptions/Prosthetics	$ 30.27	0.62	0.91	3.97
Aircraft Leasing (Dry only)*	$ 4.05	0.08	0.12	4.00
Aircraft Maintenance*	$ 1.95	0.04	0.06	4.00
Combination of all Listed Exemptions	$ 554.98	11.14	16.22	3.46
Source: Author's Calculations				

Figure 4. GET Gain from Eliminating Selected Exemptions, 2012



Source: Author's calculations

Consumer Exemptions

Broadening the base to more consumer goods and services is generally beneficial to the economy because it (i) eliminates distortions in the consumption of taxable versus non-taxable transactions and (ii) permits a lower tax rate on all taxable transactions because the base is broader, which lessens incentives to shop online and to purchase other non-taxable items. The first three exemptions are considered in this section.

Exemption 1: Gross Receipts of Not-For-Profit Organizations

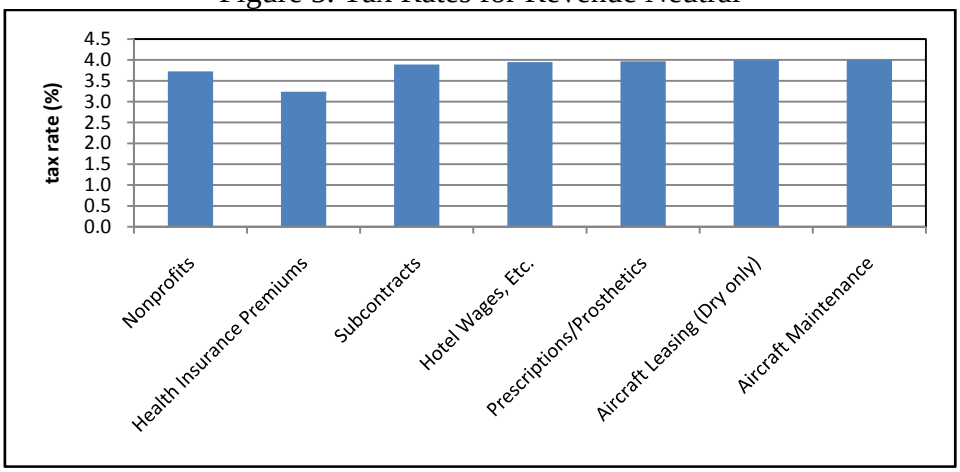
Exemption of non-profit organizations is usually based on the expectation that non-profit organizations provide goods and services that serve the broader good, such as helping low-income individuals or delivering services that the public sector would otherwise provide. The tax exemption is effectively a subsidy to not-for profit organizations which can be questioned despite the benefits that many not-for-profits offer. First, direct cash subsidies could be provided by the public sector rather than the indirect subsidies through the tax system, which would allow the legislature to more carefully evaluate the benefits of each subsidy.

Second, the subsidies advantage not-for-profits in their direct competition with for-profit firms. This explains part of the rapid expansion of the not-for-profit relative to the for profit sector in the U.S. Third, the not-for profit firms determine the size of the subsidy by their level of activity rather than Hawaii determining the size of any subsidies through its budget process. Specifically, not-for-profits have a four percent subsidy on their sales and the more the sales the bigger the subsidy. Fourth, not-for-profit firms receive the subsidies even if the local population does not value the services since no direct evaluation is taking place of the benefits of the not-for-profits. Finally, purchasers of goods and services from not-for profits probably receive most of the benefits through lower prices since the evidence is that and GET is reflected in higher consumer prices.[31] So, the not-for-profits may see only modest additional revenues.

The revenue implications of exempting non-for-profits entities are based on the assumption that the tax would be imposed on sales by not-for-profits, which include revenues associated with net special events, program services and contracts, and dues and net sales. These items account for about 75 percent of the revenue for nonprofit organizations. (see Arnsberger and Graham, 2008). Presumably, no tax would be imposed on gifts, contributions or investment earnings. The estimated GET base from taxing not-for-profit sales would be about $6.4 billion, so taxing these transactions would raise $254.1 million (Table 8 and Figure 4). Alternatively, the GET rate could be lowered to 3.72 percent (Figure 5). The revenue appears to be growing relatively fast since this estimate has risen at a compound annual 7.1 percent since Fox's 2006 estimates.

[31] See Fox (2006).

Figure 5. Tax Rates for Revenue Neutral



Source: Author's calculations

A policy decision could be made that some of these organizations should remain exempt, and this would significantly reduce the revenue potential from changes in the exemption. Health care organizations including hospitals and mental health centers receive 70.3 percent of program service revenues of non-profits around the U.S. (Arnsberger and Graham, 2008); educational institutions obtain 15.8 percent; and human service organizations 10.4 percent. So, the decision to keep any of these groups exempt would have significant implications for the revenues. Alternatively, a maximum amount could be placed on the exemption that is available for nonprofits or Hawaii could limit the exemption to the portion of the organization's activities that meet narrowly defined definitions of public purposes.

Exemption 2: Sales of prescription drugs and prosthetic devices

Many health care related purchases are exempt across the states. Sales of prosthetic devices are surely exempt in most states, though no comprehensive cross state list is available. By comparison, all states except Illinois exempt prescription drugs from the sales tax and Illinois only levies a 1 percent rate on the sales of prescription drugs.[32] As with any base broadening, taxation of drugs and prosthetics would either collect more revenue or allow a lower tax rate. The potential tax base from drugs and prosthetics is estimated to be around $800 million at the 4.0 percent tax rate which would generate $30.3 million. [33] Taxation of these transactions would allow the GET rate to be reduced to 3.97 percent and still raise the same revenue. The estimates are based on taxing retail prescription drugs and prosthetic devices at 4.0 percent.

Consumption of most drugs and prosthetics likely changes relatively little if a 4.0 percent tax is imposed because of the limited substitutes for these items that are often regarded as necessities. The argument for exemption lies mainly in equity, with many people believing that it is unfair to sales tax necessities such as drugs and prosthetics. On

[32] See http://www.taxadmin.org/fta/rate/sales.pdf

[33] No comprehensive data were found for expenditures for prosthesis, so the data are primarily for prescription drugs.

the other hand, Hawaii taxes some other necessities, such as food. Further, not all prescriptions may be viewed as necessities. Thus, the case for exemption presumes that drugs and prosthetics devices are more worthy of exemption than many other possible candidates.

Exemption 3: Health Insurance Premiums paid to HMOs and Mutual Benefit Societies

Health insurance premiums paid to HMOs and mutual benefit societies are exempt from the GET. Three different taxes can be envisioned for health insurance premiums, and estimates are provided for each. First, the GET could be imposed on the premiums. This would be questionable policy because payment of premiums creates a pool to finance health care expenditures; it is not the purchase of health care. Consumption of health care only occurs when the services are provided and paid for with the health insurance revenues. Any tax on health care consumption is better undertaken when the actual services are obtained.

Second, the GET could be levied on the health insurance service. Health insurance companies provide a service when they collect premiums and pay for health care services. The value of this service can be approximated as the difference between total revenues of the insurance firms and the total hospital and medical claims paid by these companies. Third, the insurance premiums tax, currently 3.34 percent, could be imposed on the premiums paid to HMOs and Mutual Benefit Societies.

Data for the six mutual benefit societies and two HMOs are available in the annual Report of the Insurance Commissioner of Hawaii.[34] These eight firms had $3.1 billion in total revenue in 2010. If the GET was imposed on the entire value of premium, tax revenues would have been $135.0 million in 2012 based on the expected growth since 2010. In 2010, HMOs and mutual benefit societies had revenues that were 7.1 percent above the costs for hospital and medical claims. The tax on insurance services would have been $9.7 million in 2012, assuming the value of the service is the revenue above health care costs. Finally, the premium tax would raise $108.2 million in 2012. Only the premium tax, rather than GET revenue, is included in Table 8.

Business Input Exemptions

This section examines eliminating five business input exemptions. Economists generally believe that taxation of business inputs is poor policy and argue against eliminating these exemptions. For example, taxing business-to-business transactions can cascade into higher effective tax rates on final goods consumption, alter the specific inputs that firm's purchase, cause firms to vertically integrate, and lead firms to relocate some production outside of Hawaii. These perverse effects argue for retaining the exemptions. On the other hand, retaining the exemptions requires vendors to separate sales into those to businesses (exempt) versus consumers (taxable), which adds to compliance costs and raises the costs of audit and other administrative functions. This section addresses the effects of eliminating exemptions 3 through 7 above.

[34] See http://hawaii.gov/dcca/ins/reports/2011_ICRPT_.pdf

Exemption 4: Amounts Received by Hotel Operators from Hotel Owners Equal to and Disbursed for Employee Wages, Salaries and Benefits

Exemption of business inputs is generally particularly appropriate in cases where the way in which business is conducted can be altered through imposition of the tax. In such cases, the tax may cause firms to change the way they operate, so that little or no revenue is raised and businesses do not produce their goods and services in the most efficient manner. Taxes on the purchase of temporary employment agency services, which have been subject to the sales tax in Ohio and Pennsylvania, are an example. Imposing the GET on receipts provided to hotel operators by hotel owners for the purpose of paying employee compensation is another example. Levying the GET on these transactions would likely force hotel owners/operators to find another, non-taxable means to pay employee compensation without generating any new tax revenue. For example, hotel operators and owners may be able to renegotiate their agreements so that revenue to pay employees goes directly to the operators.

The potential revenue from eliminating this exemption is difficult to estimate, even assuming that hotel owners do not change their compensation techniques. Two key factors will influence the revenues, but little data are available to estimate these two influences. The first is the extent to which owners operate hotels; the second is the extent to which owners provide revenues to operators to pay employee compensation. It appears that owners operate a relatively small share of Hawaii hotels,[35] so most hotel operations could be structured so that the owners would pass employee compensation to the operators. Based on the assumption that 85 percent of employee compensation is paid by owners who provide the funding to operators, total wages paid to employees at hotels operated by someone other than the owner are estimated to be $1.13 billion in 2012. This would generate $46.9 million in GET revenue if these transactions became taxable. The GET rate could be lowered to 3.95 percent. But avoidance by owners and operators could likely eliminate much of the tax that would be due.

Exemption 5: Amounts received as rent for the leasing of aircraft or aircraft engines used by the lessee for interstate air transportation of passengers and goods, and

Exemption 6: Materials, parts or tools imported or purchased by a person with a GET license and which are used for certain types of aircraft service and maintenance, or for the construction of a qualified aircraft service and maintenance facility

Both, exemptions 5 and 6 relate to operation of air service in Hawaii. These exemptions are likely to encourage economic activity in Hawaii and prevent taxes from altering the way in which business occurs. Elimination of the exemption for leasing equipment could result in more equipment being purchased or could result in the leasing of aircraft through locations outside Hawaii. Similarly, firms would have the incentive to do more servicing and maintenance outside of Hawaii if the exemption for materials and parts used for aircraft maintenance was eliminated. These changes in behavior and tax

[35] A conversation with the Hawaii Hotel and Lodging Association during preparation of the 2006 report indicated that only about 15 percent of Hawaii hotels are owner/operated.

planning might be relatively modest because of the importance of keeping planes in good condition. But, such a tax could lessen the likelihood that a firm would locate important maintenance facilities in Hawaii, if it has the option of choosing a site in alternative states or countries that do not tax the same transactions.

In all likelihood, taxes on air service related activities would be mostly forward shifted to consumers and users because there are no close substitutes for air shipment or travel, so elimination of the exemptions would raise the cost of travel and shipment of goods. Much of the tax would be borne by businesses (who would build the cost into other prices to the extent possible) as they pay for shipment of goods and employee travel. The consumer portion of the tax would probably be borne most heavily by higher income individuals, who do more air travel. Further, the tax will cascade to the extent that final use of the service is also taxed.

Enforcement may be difficult because some firms can report transactions associated with aircraft in more than one state. For example, equipment can be leased in other states. A tax base apportioned across states using a proxy for the proportion of use in each state could be easier to enforce. The tax could be apportioned with the number of passengers or amount of goods departing from each location. Still, firms could also avoid this tax by taking ownership of the aircraft and engines rather than by leasing them.

Hawaii could collect $4.1million in GET by taxing the leasing of aircraft and aircraft engines (exemption 4); assuming firms do not plan their tax liabilities in response to the tax. Elimination of the exemption for material, parts and tools (exemption 5) is estimated to raise about $2.0 million, assuming that no tax planning occurs to avoid the tax. No attempt was made to estimate the potential revenue from the tax on materials used for facility construction.

Exemption 7: Offset deductions that a prime contractor is allowed to take from gross income for payments to another contractor or specialty contractor

Payments to contractors are deductible as prime contractors calculate their GET liability. The extent of tax cascading for construction activities is reduced by this exemption. Tax cascading can impose significant costs on the economy as it distorts how business takes place and what people purchase. Tax cascading raises the effective tax rate above the legislated 4.0 percent rate when tax is collected from both prime contractors and subcontractors. The effective tax rate on construction could be higher than on many other transactions, which would discourage both new construction and renovations relative to purchases where less tax has cascaded. Tax cascading encourages vertical integration (bringing subcontractors inside the prime contractor) to lessen the effective tax. Vertical integration reduces cascading and offsets incentives for less construction to be purchased but also is less efficient if businesses would not otherwise operate in this way. Vertical integration also harms small businesses since they will have fewer opportunities for outsourced work.

An estimated $95.6 million would be raised if the exemption was eliminated and there was no reduction in construction or no additional vertical integration. The foregone

revenue represents 2.9 percent of 2011 GET collections and would allow the GET rate to be reduced to 3.89 percent if the base expansion was revenue neutral. Significant behavioral changes can be expected, so eliminating the exemption would raise less revenue than the estimate. But, the lower GET rate would have some positive effects since it would reduce the incentives to buy non-taxed versus taxed activities.

IV. Elimination of the Corporate and Personal Income Taxes

This section examines the GET tax rate that would be necessary if the personal and corporate income taxes were eliminated and the revenues were replaced with a higher GET rate. The policy changes would represent movement away from the taxation of income and towards taxation of consumption. A series of dynamic, general equilibrium changes in the economy would result from the policy changes and these cannot be fully accounted for in this paper. For example, elimination of the personal income tax could expand work effort and savings and elimination of the corporate income tax could shift firms from the unincorporated to the incorporated sector in Hawaii, and could increase investment. On the other hand, the higher GET rate could alter consumption by encouraging people to purchase items on which the GET cannot always be collected, such as many remote sales. As discussed above, this could lower tax revenues. Also, the GET is imposed on many business purchases and the higher GET rate raises the costs of many input purchases, making it more expensive to do some types of business in Hawaii. Fully accounting for these effects requires a general equilibrium model that is not available for this paper but it is important to consider these effects in assessing the impacts on the rates of altering the mix of tax rates. In total, a shift from income to consumption taxation has been estimated to raise economic output by 2 to 9 percent,[36] but changes to a GET with significant taxation of inputs should lessen the gains.

Five separate policy changes are examined here, each involving elimination of different aspects of the individual income and corporate income taxes. These policies include:

- Eliminating the corporate and personal income taxes entirely
- Eliminating the corporate income tax alone
- Eliminating the personal income tax alone
- Eliminating the personal income tax for people with incomes below the poverty level
- Eliminating the personal income tax for the bottom 90 percent of taxpayers

The revenue neutral rate of undertaking these policy changes and replacing the revenues with a higher GET rate was calculated using actual 2011 revenues.[37] The GET generated $2.496 billion in 2011, the personal income tax raised $1.247 billion and the corporate income tax collected $68.3 million (including the tax on banks). The scenarios involve replacing different aspects of these revenues.

[36] See Sullivan, 2012.

[37] The revenues can be obtained either from the Department of Taxation's website or the data reported to the U.S. Census Bureau. Small differences exist. For example, the Department of Taxation reports corporate income tax collections of $68.3 million and the Census reports $67.9 million. The Department of Taxation revenues are used for the estimates.

Table 9 reports the results from calculation of the revenue neutral tax rates.[38] For example, the GET rate would need to be 6.11 percent to replace both the corporate and personal income tax revenues if no behavioral changes occurred. This scenario involves the largest rate changes because it entails the greatest revenue replacement. A separate set of calculations was made allowing for some response of the GET base to an increase in the rate, which could be a combination of an expansion in the economy but more difficulty in collecting the GET revenues or a reduction in consumption. The GET rate would need to be 6.24 percent if the purchase of items taxable under the GET were to fall 1.0 percent for every 1.0 percentage point increase in the tax rate. Eliminating the corporate income tax alone involves the smallest rate change because of the modest revenues collected by the tax. The rate would only need to rise to about 4.1 percent to replace the lost revenues. Other estimates are contained in Table 9.

Table 9. Tax Replacement Scenarios

	Eliminate Corporate and Personal	Eliminate Corporate	Eliminate Personal	Eliminate Individual Below Poverty	Eliminate Personal Bottom 90%
Required GET Rate	6.108%	4.109%	5.999%	4.156%	4.999%
Behavioral Response	6.240%	4.114%	6.121%	4.162%	5.050%

Source: Author's calculations

[38] The revenues that must be replaced for the last two scenarios are based on estimates prepared by the Department of Taxation on how income tax revenues would be affected by the policies. The Department estimates that eliminating tax on households with incomes below poverty would reduce individual income tax collections by 7.8 percent and for the lowest 90 percent of households would lower collections by 50 percent.

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APPENDIX E:

REPORT OF MR. JOSHUA O. FUJINO AND DR. DONALD J. ROUSSLANG –

“Will Hawaii’s Tax Structure Prove Adequate in the Future?”

Will Hawaii's Tax Structure Prove Adequate in the Future?

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I. Introduction

This paper addresses the question "Will Hawaii's taxes provide enough revenue to fund required government services in the future?" The first task is to determine how much government services will be required. However, even the best economist would find the task impossible, because there is simply no such thing as a required amount of government services. Instead, people balance the amount of government services they want to buy against the cost, just as they do for any other goods or services. In fact, one can say that whatever amount of government services were actually provided must have been adequate, given the choices that people faced.

Instead of trying to determine how much government services are required, the authors of the study done for the 2005-2007 Tax Review Commission deemed the tax structure to be adequate if tax revenues tended to grow automatically at least as fast as

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* The report was compiled in February of 2012, but data on tax collections were updated to fiscal year 2012 in August of 2012. The views expressed are those of the authors and do not reflect the official views of the Hawaii Department of Taxation

total personal income. If the tax structure met this standard, it would allow government spending to grow at the same rate as spending on other goods and services. The approach is arbitrary (why should government grow at the same rate as the rest of the economy?), but it makes the question tractable and we believe it provides useful information. We like the approach, but in light of recent experience, we modified it in three ways.

First of all, we provide projections that allow important parts of the overall State budget, namely spending on pension and health care benefits for retired State workers, and on Medicaid, to grow faster than total personal income. The future costs of pensions for retired State workers are set largely by promises that have already been made. They depend on a number of things that are hard to predict, including future changes in the laws governing employee benefits and contributions, as well as the future returns to pension assets. The State's pension plan now has a large accrued unfunded liability, but the State's contributions to the plan are set to rise in the future to make up for the shortfall.[1] Health benefits for retired State workers are funded on a pay-as-you-go basis. This is deemed unsatisfactory according to standard accounting practices, which would require that the accrued liabilities be amortized over thirty years. The future costs of the Medicaid program are largely determined by federal legislation, health care costs, and changes in the eligible population. Historically, these costs have grown faster than total personal income.

[1] The contribution rates as a fraction of total payroll costs are set to rise through 2016 under Act 163, SLH 2011. However, the rates will prove insufficient if the future returns on pension assets materialize at the rate suggested by the new guidelines set by the Government Accounting Standards Board (GASB).

Secondly, total income in the economy can go down as well as up. When the economy declines, the demand for government services typically rises, because more people need social support. It is not possible to design a sensible tax structure that would provide greater revenue when the economy declines; the best that can be done is to make taxes as insensitive as possible to cyclical fluctuations in income. Therefore, in addition to examining how tax revenues tend to grow with the economy, we also examine the stability of tax revenues in periods of declining income, both for the tax structure as a whole and for the individual taxes.

Finally, there has been concern about how the growth of the Internet affects General Excise Tax (GET) collections. The GET is the largest of Hawaii's taxes, accounting for about 58% of the total tax collections dedicated to the General Fund in fiscal year 2011. Electronic commerce may reduce the GET collections by allowing customers in Hawaii to order goods over the Internet and have them delivered by mail from sellers who are not under the State's taxing jurisdiction. The Internet also allows customers to buy things in electronic form that previously were available only in physical form, such as music and games, and it allows them to more easily avail themselves of services that are performed outside of the State and imported over the Internet, such as accounting services. Such purchases will often escape the GET. Therefore, we look to see if we can discern the effects of the growth of electronic commerce on the GET collections.

We begin our investigation of tax adequacy by looking to see how government spending has grown relative to the economy in the recent past. Then, we examine how tax revenues tend to grow automatically as the economy grows, where growth in the economy is measured as the growth in total personal income. Finally, we look to see if growth in tax revenues, as they would be without any changes in the tax laws, can be expected to keep pace with growth in demand for government spending, including spending on current government services, on Medicaid and on benefits for retired State workers. We focus on the General Fund to judge if the tax system is adequate. The General Fund comprises only part of the State's total budget, but it receives the bulk of the State's tax collections and is used to pay for most government functions. The next section describes the State's budget and the role of the General Fund.

II. Hawaii's Budget – a Brief Overview

The State's total budget is divided into three types of funds, called Proprietary Funds, Fiduciary Funds and Governmental Funds. Proprietary Funds contain the accounts for activities of the State that resemble commercial enterprises. They include the Unemployment Compensation Fund and funds to account for operations of highways, airports, harbors, and other business-like activities. They have their own dedicated sources of revenue and are budgeted independently from other government spending, and they are virtually all self-supporting. The Fiduciary Funds are used to account for resources held for the benefit of parties outside the State. The Fiduciary Funds are not

included in the government-wide financial statements, because their funds cannot be used to support the State's own programs. Governmental Funds contain the accounts for most of the State's activities and are supported mainly by taxes and by intergovernmental transfers. The General Fund is the biggest of the Governmental Funds. In fiscal year 2011, State tax collections totaled $5.3 billion, of which $4.4 billion went into the General Fund. From 1999 through 2011, on average 86% of the State's tax revenue went into the General Fund and 89% of the General Fund revenue came from taxes.

Table 1 provides data on the General Fund revenues and expenditures, on total revenues and expenditures for all the government funds, and on total personal income (TPI) for fiscal years 1970 through 2010. Figure 1 plots the revenues and expenditures in Table 1 as ratios to TPI. The ratios can be interpreted as the shares of total income dedicated to government services. Total spending from all the government's funds varied more widely relative to TPI than did spending from the General Fund, reaching highs of 18% to 22% between fiscal years 1970 and 1979, before declining to a low of about 11% in fiscal year 1989. The lows occurred in fiscal years 1984 through 1990, which was a period of strong economic growth and low unemployment payments.

The General Fund revenues and expenditures have been relatively stable at about 10% of TPI. Expenditures from the General Fund are subject to a constitutionally mandated ceiling, which was set at $919 million in fiscal year 1979 and grows every year by the average increase in TPI over the previous three years. The ceiling may have

helped control government spending throughout the 1980's, but it has not been binding since 1991.

Table 2 shows the total collections for each of the State's taxes and the percentage of the tax that was dedicated to the General Fund in each fiscal year from 1972 through 2011. Revenue is grouped into the following taxes: the General Excise Tax (GET), the Individual Income Tax (Ind), the Corporation Income Tax (Corp), the Public Service Company Tax (PSC), the Tax on Insurance Premiums (Ins), the Tax on Liquor (Liq), the Taxes on Cigarettes and Tobacco (Tob), the Tax on Banks and Other Financial Corporations (Bank), the Transient Accommodations Tax (TAT), the Conveyance Tax (Con), the Estate and Transfer Tax (Est), the Taxes on Liquid Fuels (Fuel), the Taxes on Motor Vehicles (MV) and the Employment Security Contributions (Emp). A miscellaneous category (Misc) is used to summarize all other State tax revenues that go into the General Fund, and includes charges for fuel retail dealer permits, fuel tax penalty and interest payments, general excise license fees, and transient accommodations license fees.

During most of the period covered in Table 2, the Fuel, MV and Emp taxes were dedicated entirely to Proprietary Funds. However, in fiscal year 2011, part of the Fuel taxes went into the General Fund. The Ind, Corp, Est, Liq, and PSC taxes were dedicated entirely to the General Fund throughout the period covered in the table. Distributions to the General Fund from the remaining taxes have varied over time. Most of the revenue

from each of these taxes now goes into the General Fund, except for the TAT and Con, which go primarily to special funds.

III. Measuring Tax Adequacy

We judge the adequacy of the current tax structure by comparing the expected General Fund revenues with the demands for these revenues over the period from fiscal years 2013 through 2022. Our predictions for growth in TPI and other economic variables are based very roughly on the forecasts made by individual members of the Council on Revenues. The members' economic forecasts are translated into General Fund tax collections using the Department of Taxation's econometric model.[2] The model accounts for the future changes in tax laws enacted as of the end of the 2012 legislative session.

Modeling the Demand for Government Spending From the General Fund

We assume 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 that it will grow at the same rate as the overall economy, as measured by the growth of nominal TPI. The costs of Medicaid and of the benefits for retired State workers are expected to grow at their own rates, as explained in more detail below. The model is described more formally as follows.

[2] The Council's forecasts extend only to 2018. We assume the growth rates for the remaining years (2019 through 2022) are equal to the growth rate forecast for 2018.

Let

GFR = General Fund revenue.

GFP = total demand for government payments from the General Fund.

GS = demand for current government services paid from the General Fund.

TPI = total personal income.

PB = the payment from the General Fund required to fund pension benefits of retired State workers.

HB = the payment from the General Fund required to fund health benefits for retired State workers.

M = Medicaid payments from the General Fund.

Then, the demand for total payments from the General Fund is described by the equation

$$GFP = GS + PB + HB + M. \quad (1)$$

We assume desired spending on current government services is proportional to TPI ($GS = \alpha TPI$ where α is a constant $0 \angle \alpha \angle 1$), so GS and TPI grow at the same rate. Thus, we have the following expression for the total demand for payments from the General Fund:

$$GFP = \alpha TPI + PB + HB + M. \quad (2)$$

Since General Fund revenues must be at least as great as the demand for this revenue, we

must have

$$GFR \geq \alpha TPI + PB + HB + M. \quad (3)$$

We will test to see if inequality (3) can be expected to hold in the future.

Hawaii's State Employees Retirement Fund

The Hawaii State Employees Retirement System (ERS) is underfunded according to standard accounting practice. Assuming investment returns of 7.75% (the rate of return chosen by the Legislature),[3] it is estimated that the current assets leave an unfunded balance of $7.7 billion to be covered by employee and employer contributions.[4] According to standard accounting practice, the contributions to the pension system each year (including both employee and employer contributions) should be sufficient to cover the normal cost of the pension plan incurred during the year plus payment sufficient to amortize the unfunded accrued liability over a period of thirty years.[5] However, at the

[3] The expected annual rate of return for investments in the pension fund is set by the State Legislature. Prior to 1985 the expected investment return was set at 7%. In 1985 it was raised to 8%. However, due to disappointing returns in the past decade, in 2010 the Legislature lowered the expected investment return to 7.75%. In our view, this may prove to be too optimistic. The new GASB guidelines suggest using a rate of 4.5%.

[4] See Gabriel Roeder Smith & Company "Employee's Retirement System of the State of Hawaii: Report to Board of Trustees on the 85th Annual Actuarial Valuation for the Year Beginning June 30, 2010," December 20, 2010.

[5] The normal cost is the increase in the present value of all future pension costs incurred during the year.

present rate of contributions, it is estimated that the unfunded liability is being amortized over a period of 41.3 years.[6]

Before 2004, the State's annual required contributions as a percent of payroll were set each year according to actuarial studies from three year before. In 2011, Act 163 specified further increases in the contributions to be put in place through 2016. Table 3 shows the actual employee and employer contributions to the ERS, the total State payrolls, and the required employer contributions to the ERS from 1997 through 2009. The data are plotted in Figure 2. Table 4 shows the total assets, the unfunded accrued liability and the investment yields for the ERS from 1985 through 2009. The unfunded liabilities have increased sharply since 2000, primarily as a result of lower than expected returns to pension assets. The dramatic rise in the unfunded liabilities since 2000 is plotted in Figure 3. [7]

Hawaii's State Employee Health Plan

The health care plans for retired State workers are the Employer-Union Health Benefits Trust Fund (EUTF) and the Voluntary Employees' Beneficiaries Association (VEBA) Trust for the Hawaii State Teachers Association. These plans provide health care benefits to retired state and county employees who are in the ERS pension system,

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[6] Gabriel Roeder Smith & Company, Op. cit.

[7] The Governmental Accounting Standards Board (GASB) of the Financial Accounting Foundation has issued Statements No. 67 "Financial Reporting for Pension Plans" and No. 68, "Accounting and financial Reporting for Pensions," which will require state and local governmental employers to account for pension benefits as they are accrued. Statement No. 67 takes effect for fiscal years beginning after June 15, 2013, and Statement No. 68 takes effect for fiscal years starting after June 15, 2014.

and to their dependents. Both plans are currently structured on a pay-as-you-go basis. Using a rate of 5% to discount expected future liabilities, the present value of the unfunded liability already accrued in the plans was $11.8 billion at the end of fiscal year 2009. If a discount rate of 4% is used, the unfunded liability rises to $14.0 billion.[8]

Because the plans are not prefunded, amortizing payments for the expected future liabilities are not made. Nevertheless, we will provide a scenario in which the liabilities are amortized over a period of thirty years, as suggested by standard accounting practice. As we shall see, this change would have a profound adverse effect on the State's budget. Table 5 shows anticipated payments for health benefits for retired State workers under the current pay-as-you-go plan for fiscal years 2010 through 2024, before reimbursements from the counties and from other State special funds.[9]

Medicaid

The federal government funds about half of the total cost of the Medicaid program in Hawaii, the remainder being paid from the General Fund. The cost of the program has been rising faster than TPI. Increasing Medicaid costs can be traced to rising medical costs per patient. Also, the recent recession has increased the number of people eligible for the program. Part of the increase in the cost of Medicaid in Hawaii is caused by

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[8] See the reports by AON Hewitt, "State of Hawaii Voluntary Employees' Beneficiary Association (VEBA) Trust for the Hawaii State Teachers Association (HSTA): Postemployment Benefits Other Than Pensions Actuarial Valuation Study," March 16, 2011, and "State of Hawaii Postemployment Benefits Other Than Pensions Actuarial Valuation Study," March 16, 2011.

[9] GASB Statement No. 43 and 45 require state and local governmental employers to account for health care benefits to retirees on an accrual basis, but they do not mandate how the employers fund the plans.

immigration from other islands in the Pacific, which has caused Hawaii to petition for more national support for its Medicaid program. Medicaid payments made up 11.2% of the total General Fund expenditures in fiscal year 2010 and this percentage is expected to increase in the coming years. Table 6 shows the Medicare costs for Hawaii's General Fund from 1968 through 2011, and the Governor's requests for fiscal years 2012 and 2013.

Estimating the Total Demand for Government Payments from the General Fund

The future costs of the pension plan for retired State workers that form a liability for the General Fund are estimated by assuming that the employer's annual required contribution rate is a constant fraction of total payroll and that payroll costs will grow by 3.5% annually.[10] The estimate for the annual required contribution as a percent of total payroll in fiscal year 2010 is 16.9%, taken from the report by Gabriel Roeder Smith & Company.[11] The report also calculated that the annual required contribution for fiscal year 2010 was $547.6 million. It is assumed that the counties and other State special funds reimburse the General Fund for 23% of the total cost of the pension payments.

The costs of the employee health benefit plans to be paid from the General Fund are estimated based on the projected benefit payments in the reports by AON Hewitt,[12] assuming 23% will be paid by the counties and other State special funds. In addition to

[10] The assumption of 3.5% annual payroll growth was used in the reports by Gabriel Roeder Smith & Company and by AON Hewitt, Op. cit.

[11] Gabriel Roeder Smith & Company, Op cit.

[12] AON Hewitt, Op. cit.

these projections, we also calculate the required employer contributions from the State's General Fund if the accrued liabilities in the health plan must be amortized over thirty years. In this case, the annual required contributions are calculated using the figure of $1,054 million (taken from the reports by AON Hewitt) [13] for fiscal year 2009, less 23% contributed by the counties and other State special funds, and assuming the contributions grow by 3.5% annually.

The forecasts of future General Fund payments required for the Medicaid program for fiscal year 2013 is based on the Governor's request.[14] For later years, simple trends in the payments for the program are used. In one scenario, future payments are assumed to grow at an average compound rate of 5.9%, which is the average annual growth rate over the last five years (from 2006 through 2011). In a second scenario, the future payments are assumed to grow at 9.4%, which is their average annual rate of growth from 1968 through 2011.

Forecasting growth in TPI and in General Fund Tax Collections

Annual growth forecasts for TPI are subjective averages based on the historic experience and on the forecasts that the individual members of the Council on Revenues supplied to the Office of Tax Research and Planning for purposes of making the General Fund revenue forecasts. For the high growth scenario, 6.5% is used for the annual

[13] The figure of $900 million is the combined annual required contribution for the VEBA and EUTF plans for fiscal year 2010, as estimated by AON Hewitt in the reports cited above, using a discount rate of 4%.

[14] See Department of Budget and Finance, "FY 2013 Executive Supplemental Budget: Budget in Brief," December 2011.

average growth in TPI for fiscal years 2013 through 2018. For the low growth scenario, 3.2% is used for the annual growth in TPI.

In addition to forecasting TPI, the Council members also provide forecasts for other economic variables, including construction spending, visitor arrivals, visitor expenditures, inflation, and total wages. Again, high and low growth scenarios for each of these variables are constructed based very roughly on historic averages and averages of forecasts submitted by the individual members of the Council on Revenues. The high and low average annual growth rates used for each variable were as follows: Construction completed, 12% (high) and 4% (low); Honolulu CPI, 3% and 2%; Visitor arrivals (by air), 5% and 2%; Total wages, 5% and 2%; Visitor expenditures, 10% and 3%; and U.S. GDP, 5% and 3%. The growth rates are used as inputs to the Department of Taxation's econometric model to create high and low scenarios for future tax collections. For the middle scenario, we use the Council's actual forecasts. In each case, we use the growth rate for fiscal year 2018 for fiscal years 2019 through 2022.[15]

Testing for Tax Adequacy

We begin our analysis of tax adequacy by calculating the expenditures on current government services in fiscal year 2011. We define these services as the total expenditures from the General Fund, less the net cost to the General Fund of the employer contributions to the ERS, less the net cost to the General Fund for health

[15] Although based roughly on averages of forecasts provided by individual members of the Council on Revenues, the results of the high growth and low growth scenarios do not correspond to the estimates of any individual Council member and should not be attributed to the Council in any way.

benefits to retired State workers under the EUTF and VEBA plans, and less the cost of Medicaid paid from the General Fund. The total expenditure from the General Fund in fiscal year 2011 was $4,943.3 million.[16] The expenditure on pension benefits for retired State workers in the ERS system is estimated to be $436.9 million,[17] the expenditures for health care benefits for retired State workers covered by the EUTF and VEBA plans is estimated to be $238.4 million,[18] and payments for Medicaid from the General Fund were $606.7 million.[19] Thus, the cost of current government services for fiscal year 2011 is estimated to be $3,687.2 million. The desired level of these services for future years was then assumed to grow at the same rate as TPI.

The forecasts for General Fund tax revenue collections and for TPI were described in the previous subsection. Projections of non-tax revenues to the General Fund for fiscal years 2012 through 2017 were taken from the General Fund budget plan submitted by the Department of Budget and Finance.[20] Projections for later years were calculated

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[16] From the General Fund Financial Plan 2010-2015 prepared by the Department of Budget and Finance, October 2011.

[17] The pension costs were calculated using the figure for pension benefits of employees covered by the ERS for fiscal year 2010 (from the report by Gabriel Roeder & Smith P. cit., $547,613 million), multiplying by 77% to account for reimbursements to the General Fund from the counties and from other State special funds, and assuming growth of 3.5% from fiscal year 2010 to 2011.

[18] The health care benefits for the EUTF and VEBA plans were calculated using the projected costs of the current pay-as-you-go plan in the reports by AON Hewitt, Op. cit. ($281.9 million and $27.7 million, respectively), and multiplying by 77% to account for reimbursements to the General Fund from counties and other State special funds.

[19] Department of Budget and Finance, Op. cit.

[20] Ibid, page 3.

assuming an annual growth rate of 3%.[21]

Only one scenario was used for the cost of future employer contributions to the ERS pension plan from the General Fund. The future payments are estimated assuming employer contributions will be those estimated in the report to the ERS Trustees of December 20, 2010.[22] Two scenarios (mid-range and high) are used for the future costs of the Medicaid plan and of health benefits for retired State works. In the mid-range scenario, the costs of Medicaid are projected to grow at the average rate for the period from 2006 through 2011 (5.9% per year) and the costs of the health benefits for retired State workers under the EUTF and VEBA plans are taken from the reports by AON Hewitt.[23] In the "high" scenario, the cost of Medicaid is projected to grow at 9.4% (its long run average annual growth from 1968 to 2011) and the cost of the health benefits for retired State workers includes payments to fully fund the actuarially accrued costs of the plans (EUTF and VEBA) over a period of 30 years, as required by standard accounting practice.[24]

Table 7 shows our estimates of TPI, of expected General Fund revenues, and of the demand for total government payments to be made from the General Fund under

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[21] These projections may be optimistic. The Department of Budget and Finance projected no increase in these revenues from fiscal year 2012 (when the revenues were forecast to be $561.5 million) through 2015 (when they were forecast to be $560.6 million).

[22] Gabriel Roeder & Smith, Op. cit.

[23] AON Hewitt, Op. cit.

[24] The annual required payments for this scenario are based on the estimated required payments in 2009 in the reports by AON Hewitt, Op. cit., assuming annual increases of 3.5%.

various scenarios for fiscal years 2013 through 2022. The estimates show surpluses in fiscal year 2013 under two of the three growth scenarios if we use the mid-point forecasts for growth in the cost of health benefits for retired State workers (that is, we continue under the current pay-as-you-go plan) and for Medicaid beneficiaries (that is, we assume growth of 5.9% after 2013). If the accrued liabilities in the health benefit plan for retired State workers must be amortized over thirty years, and if Medicaid costs continue to grow at their long-run historic average rate (9.4%), then large deficits are predicted for the mid-range and low growth scenarios for all the years after fiscal year 2015 covered in our forecasts. 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.

Of course, by law the State cannot run an operating deficit.[25] 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 in

[25] For example, in the General Fund Financial Plan for fiscal year 2010 through 2015 produced by the Department of Budget and Finance (B&F) in October of 2011, the same General Fund revenues are used as those in the "mid"

the more pessimistic scenarios.

The results of our tax adequacy tests depend importantly on whether Hawaii continues to fund costs of the health care benefits for retired State workers on a pay-as-you-go plan or amortizes the accrued liabilities over a thirty year period, so it is worth considering whether it is really necessary to prefund the health plans as suggested by standard accounting practice, especially since doing so would have a profound effect on the State's budget. The question is whether prefunding the health care costs (and making the attendant changes to the State's tax and spending plans) is necessary for prudent fiscal planning. One reason for moving to a prefunded health care plan would be to make more transparent the cost of the State's employee benefits. This argument is less compelling the further into the future that the State's budget is projected. However, our projections indicate that the problem will become severe if it is simply ignored until the burden of unfunded or underfunded liabilities begin to appear in the current payments.

IV. Assessing the Stability of General Fund Tax Revenues

Measuring the Constant Law Tax Collections

To measure the stability of General Fund tax revenues, we begin by measuring the constant law tax collections dedicated to the General Fund. The constant law collections are annual tax collections adjusted to reflect the revenues that would have been produced

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scenario in Table 7, but B&F shows estimated revenue shortfalls of $81.1 million in fiscal year 2012, and surpluses of $35.5 million for fiscal year 2013, $0.9 million for fiscal year 2014 and $40.0 million for fiscal year 2015.

by the structure of taxes if the tax rate, the definition of the tax base, and the percent of collections dedicated to the General Fund had been the same for each tax as they were in the base year. We use fiscal year 2010 as the base, because the major changes made by the 2011 Legislature are temporary measures set to expire, most of them by fiscal year 2015. The constant-law collections dedicated to the General Fund are shown in Table 8. The adjustments made to actual collections to arrive at the constant-law collections are described in Appendix A.

Stability of a tax (or of a system of taxes) can be defined in one of two ways. One way is absolute stability, which is simply the extent that revenue from the tax has varied over time. A tax system that provides a very stable, fixed amount of revenue would eventually become inadequate to meet the needs of a growing economy. Therefore, in a secular analysis, it usually is better to define stability of tax revenues in terms of the stability of its growth rate. In addition to examining the absolute and relative stability of taxes, we also look to see how the major taxes have performed during periods of very slow economic growth and during the severe recessionary period of 2008-2010. The results are presented in Tables 9 through 12.

Absolute Stability of the Tax System

Table 9 shows the results from comparing *absolute* stability of the constant law collections for the major tax types, which accounted for over 98% of the total constant law General Fund collections in fiscal year 2011. The largest tax types, the GET plus PSC Tax, and the Individual Income Tax, accounted for 93% of the total General Fund

tax collections in fiscal year 2011. The table shows the mean average of the constant law collections for fiscal years 1972 through 2011, the standard deviation of collections for each of the major tax types (a measure of how widely the collections vary from year to year) and the ratio of the standard deviation to the mean average (a measure of how widely the collections of the tax vary from year to year relative to the average). The GET plus PSC Tax has the lowest year-to-year variation in collections of the major taxes relative to their average, but the variation in the total General Fund collections is smaller, indicating that some of the variations in collections from the different taxes offset each other.

Relative Stability of the Tax System

Table 10 compares the *relative* stability (the stability of the growth rates) for each of the major tax types. The percent variation in growth rates is smallest for the GET plus PSC Tax, which is the same as that for the total General Fund collections. Furthermore, the secular annual average growth rate of the GET plus PSC Tax (6.4%) and the Individual Income Tax (6.5%) are virtually the same as that for total General Fund collections (6.3%) and for growth in TPI (6.4%). Thus, the revenue provided by the tax system as a whole has tended to grow automatically at about the same rate as income over the longer run. The variation in growth rates is smallest for the GET plus PSC Tax and second smallest for the Individual Income Tax.

Tax Revenues in Periods of Slow Economic Growth

Tables 11 and 12 compare the stability of the growth rate of collections among the major taxes in years of slow growth and during the recent severe recession. The results are mixed. Years of slow growth were selected as those during which real growth in TPI (growth after removing the effect of price inflation) was less than 1%. The years in this group were 1975, 1981, 1982, 1993, 1994, 1995, 1996, 1997, 1999, 2001, 2008, 2009, and 2010. The comparisons in Table 11 indicate that the Corporation Income Tax suffered the smallest declines during the slow years relative to its secular growth rate, and the GET plus PSC Tax suffered the second smallest declines in the slow years. The average performance in the slow-growth years, however, does not predict the effects of the recent severe recession. The comparisons in Table 12 indicate that the individual income tax suffered slightly smaller declines in growth from the secular trend during the severe recession of 2008 – 2010 than did the GET plus PSC Tax, while the Corporation Income Tax suffered the largest declines.

The performance of the biggest tax types during the recent severe recession are summarized in Figure 4, which shows the constant law collections for the GET plus PSC Tax, for the Individual Income Tax and for the total of all General Fund collections from 1972 through 2011. All three types of collections declined in tandem during the recession of 2008 – 2010, implying that a different structure of taxes that relied more heavily on one or the other of these taxes would not have done much to alleviate the effect of the recession on the State's budget.

The Effects of E-Commerce on GET Collections

The growth of the Internet and electronic commerce has raised concerns that states may be losing tax revenues as consumers buy from out-of-state retailers and avoid the local sales tax. A recent study has estimated that Hawaii may lose as much $145 million in Use Tax (the GET on imports from a business that is not under Hawaii's taxing jurisdiction) to remote sales in 2012.[26] The Department of Taxation testified in 2009 that Hawaii would gain $25 million annually in additional GET revenue if Congress passed legislation to overturn the *Quill* Supreme Court decision so that companies could be compelled to collect Use Tax even if they had no physical nexus with the State.[27] Both estimates are small relative to the size of total GET collections, which were $2,698 million in fiscal year 2012.

In an effort to verify the revenue loss estimates empirically, we have applied a regression analysis to GET collections. The regression equation we use is derived from the model that the Department of Taxation uses to predict the effects of changes in the economy on tax collections. The model was developed to help the Council on Revenues forecast General Fund tax collections. Despite the relatively small size of the estimates for the effects of electronic commerce on GET collections, we had reasonable hopes of identifying these effects, because the regression equation for predicting GET collections explains a very high portion (99.8%) of the total variation in the collections.

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[26] See William F. Fox "Selected Issues With the Hawaii General Excise Tax," University of Tennessee, July 22, 2012.

[27] See the testimony of Kurt Kawafuchi, Director of Taxation, before the Senate Committee on Economic Development & Technology, regarding SB 1678, Relating to Taxation, February 6, 2009.

The equation we developed to explain the GET collections uses Hawaii TPI, variables for construction spending (CONSTR), visitor expenditures (VISEXP),

electronic commerce purchases as a fraction of total retail purchases (ECOMM), and an autoregressive term (AR) to correct for first-order auto correlation. The regression results, along with the data used in the regression, are shown in Appendix B.

The coefficient of ECOMM is the parameter of interest. Contrary to expectations, it is positive, indicating that the growth of electronic commerce is positively correlated with increased GET collections. The positive correlation could arise, because the variable ECOMM is serving as a proxy for other things that might influence GET collections. In particular, it might be coincident with the electronic modernization of the Department of Taxation's collections and enforcement. That is, growth in the use of computers by shoppers may have happened at the same time that computerized processing changes in the Department of Taxation allowed more efficient monitoring and enforcement of collections.[28]

To investigate the possibility that the coefficient of ECOMM is actually reflecting the effects of computer modernization in the Department of Taxation, we included a variable for delinquent collections (DELCOLL), on grounds that processing of these collections is one of the places where computer modernization was most effective. The

[28] We have observations for the variable ECOMM only from 1999 to 2011. A value of zero was used for the earlier years. However, the results are substantively the same if the regression is limited to the years 1999 through 2011.

regression results (reported in Appendix B) show that including DELCOLL makes the coefficient of ECOMM insignificant, in both the statistical and common meaning of the word. This result is consistent with the notion that the coefficient of the variable for electronic commerce in the original regression was capturing improvements in collection enforcement. The findings do not disprove the notion that electronic shopping by customers in Hawaii has adversely affected GET collections. However, they support the notion that this effect is not large, since the unexplained variation in GET collections is less than 0.2%.

Appendix A

Calculating the Constant-Law Tax Collections for the General Fund

This appendix describes the adjustments that were made to actual tax collections to account for legislative changes to the State's taxes from 1972 to 2011. Collections for each tax were adjusted to the tax law in effect for fiscal year 2010. In addition to changes in the tax law, the tax collections were adjusted to account for the fact that they may not match tax liabilities for the year, because the collection date may fall in a different year. When calculating the aggregate General Fund revenues, it was also necessary to adjust for changes in the proportion of the tax that is dedicated to the General Fund.

Individual Income Tax

Individual Income Tax rates were reduced by Hawaii's tax reform in 1986. Beginning in 1987, the top rate was reduced from 11 percent to 10 percent, the tax

brackets were expanded and the standard deduction was increased. Beginning in 1998, the Individual Income Tax was reduced over a four-year period, during which time the top rate fell from 10 percent to 8.25 percent and the tax brackets were again expanded. To adjust for changes in credits that may be claimed against Individual Income Tax and for tax rebates, all such credits and rebates were added back to the series of actual income tax collections. The constant-law series was then calculated by assuming that, absent any legislative changes, tax credits would have been the same proportion of the Individual Income Tax in each year.

Beginning in 2007, the standard deduction was increased and expansions were made to the tax brackets. In 2009, new 9%, 10%, 11% tax brackets were created. In 2011, the deduction for State income taxes was eliminated and itemized deductions were capped for certain high-income taxpayers.

General Excise and Use Taxes and the Public Service Company Tax

Collection from the General Excise and Use Taxes for various years were adjusted to account for the fact that frequently tax liabilities incurred in one fiscal year were actually collected and reported in another fiscal year. Also, $20 million was added to collections in fiscal year 2002 to account for the increase in filing thresholds that were established by Act 8 in 2001.

Act 9, also enacted in 2001, moved gross income from transportation services out from under the Public Service Company Tax and placed it under the General Excise Tax. To account for the move, we calculate the constant-law collections for both taxes

combined. In addition to shifting the tax collections from one tax to the other, the collections from both taxes combined were reduced by an estimated $4.5 million in fiscal year 2002. Thus, $4.5 million was added to the amount collected from both taxes that year.

Act 209, SLH 2007, exempts alcohol fuel, which reduced GET by $20 million in fiscal year 2007 and by $40 million in fiscal year 2008, so the amounts were added back for those years. Act 155, SLH 2010 denied GET exemptions and deductions if such returns were filed, but the effect of the legislation is probably quite small.

Estate and Transfer Tax

As a result of Hawaii's conformance with the federal Tax Relief Act of 2001, it is estimated that collections of the State's Estate and Transfer Tax were reduced by 25 percent in fiscal year 2003, by 50 percent in fiscal year 2004 and by 75 percent in fiscal year 2005. The State's tax was eliminated for decedents dying after December 31, 2004. The federal act expired at the end of 2010. From Jan 1, 2011 estate taxes were reset with the 2000 tax law in effect by Act 74, SLH 2010. The Act also established a tax for estates in Hawaii held by non-US citizens.

Tax on Liquor

Four large liquor distributors challenged the liquor tax law in 1980. The distributors paid the tax, but the amount was placed in an escrow account pending the resolution of their case. When they lost the case, the monies were paid into the General

Fund.

Taxes on Cigarettes and Tobacco

The rate of tax per cigarette was established at 3 cents in 1993. Prior to that (and since 1939) the tobacco tax had been at 40 percent of the wholesale price. It was raised from 3 cents to 4 cents in 1997, from 4 cents to 5 cents in 1998, to 6 cents in 2002, to 6.5 cents in 2003, to 7 cents in 2004, to 8 cents in 2006, to 9 cents in 2007, to 10 cents in 2008, and to 13 cents in 2009.

Act 58, SLH 2009, caused "little cigars" to be taxed as cigarettes. A 50% tax was also imposed on the wholesale price of cigars and the tax rate for all other tobacco products besides cigarettes, little cigars and cigars was raised from 40% of the wholesale price to 70%.

Tax on Banks and other Financial Corporations

Banks and other financial corporations litigated against claims for tax liabilities, resulting in $16.5 million in taxes being reported in fiscal year 2003 that properly belonged to fiscal year 2004. In addition, collections were adjusted by adding back tax credits claimed by these corporations in each year prior to 2005. The constant-law collections for the earlier years were then imputed by assuming that, absent legislative changes, the credits would have been the same proportion of the tax in each year.

Transient Accommodations Tax

The Transient Accommodations Tax was imposed in 1987 at 5 percent of gross rental income. The rate was increased to 6 percent in 1994 and to 7.25 percent in 1999. In

that same year, the tax was also expanded to apply to time-share units. Since 1990 the bulk of the tax has been allocated to the counties and to special funds, with only a small share of the total collections going into the General Fund.

In 2006 the allocations to the Convention Center were increased by $2 million to $33 million, which reduced the allocation to the General Fund by the same amount. The TAT trust fund was repealed and the allocation to the Tourism Special Fund was increased from 32.6 percent to 34.2 percent in 2007. The net effect was an increase in the allocation to the General Fund of about 2.5 percent. The TAT rate was increased to 8.25 percent in 2009, and to 9.25% for fiscal years 2010 through 2015, with the increase dedicated to the General Fund, except for a small part (12.5%) in fiscal year 2011 which went to the Tourism Special Fund.

Tax on Insurance Premiums and the Corporation Income Tax

The collections of the Tax on Insurance Premiums and the Corporation Income Tax were adjusted to account for changes in tax credits by first adding back tax credits claimed in each year prior to 2005 and then adjusting the collections by assuming that, absent legislative changes, the credits would have been the same in proportion to the taxes as they were in fiscal year 2005. In 2011 filing and payment for insurance premium taxes was changed from quarterly to monthly and the due date was changed from the last day of the month to the twentieth. This moved up the payment due on June 30, 2011 from fiscal year 2012 to fiscal year 2011, resulting in a one-time increase in revenues in 2011.

Conveyance Tax

The rate of the Conveyance Tax rate was changed from 5 cents per hundred dollars of value to 10 cents per hundred dollars of value in 1993. In 2005, the tax rates were increased again based on a sliding scale.

Miscellaneous

Act 74. SLH 2010, increased the environmental response tax from $0.05 to $1.05 per barrel for fiscal years 2011 through 2015 and deposited the increase in the General Fund. The Act resulted in $13.2 million in additional revenue in fiscal year 2011. Act 22, SLH 2010 moved the due date for miscellaneous tax types from the last day of the month to the twentieth day of the month. This moved up the payment due on June 30, 2011 from fiscal year 2012 to fiscal year 2011, resulting in a one-time increase in revenues in fiscal year 2011.

Table 1
Governmental Fund Revenues and Expenditures and Total Personal Income

(Dollar amounts are in millions)

Fiscal Year	General Fund Revenue	General Fund Expenditure	Governmental Revenue	Governmental Expenditure	Total Personal Income*
1970	464	463	596	710	3,873
1971	511	526	665	838	4,210
1972	547	576	723	888	4,640
1973	608	598	814	936	5,159
1974	708	686	940	1,045	5,931
1975	626	557	1,115	1,312	6,472
1976	685	726	1,310	1,491	7,032
1977	737	744	1,388	1,591	7,636
1978	816	849	1,505	1,613	8,462
1979	943	878	1,624	1,683	9,594
1980	1,085	973	1,728	1,775	11,026
1981	1,199	1,146	1,801	1,918	11,968
1982	1,186	1,208	1,669	1,648	12,701
1983	1,253	1,333	1,754	1,923	14,059
1984	1,355	1,379	1,772	1,702	15,325
1985	1,476	1,451	1,880	1,914	16,210
1986	1,605	1,598	2,050	1,901	17,131
1987	1,890	1,688	2,353	2,012	18,281
1988	2,076	1,944	2,590	2,197	19,972
1989	2,341	1,953	2,905	2,349	22,204
1990	2,452	2,624	3,182	2,832	24,294
1991	2,690	2,799	3,510	3,153	25,876
1992	2,708	2,681	3,671	3,686	27,823
1993	2,953	3,063	3,902	4,028	28,812
1994	3,086	3,059	4,163	4,245	29,507
1995	2,969	3,169	4,166	4,364	30,112
1996	3,194	3,124	4,550	4,505	30,399
1997	3,161	3,186	4,567	4,722	31,372
1998	3,232	3,214	4,590	4,485	32,259
1999	3,286	3,251	4,651	4,641	33,244
2000	3,284	3,201	4,840	4,573	35,222
2001	3,442	3,365	5,150	4,703	35,936
2002	3,441	3,656	5,100	5,685	37,475
2003	3,789	3,806	5,370	5,972	39,032
2004	3,908	3,840	5,790	5,972	42,285
2005	4,486	4,185	6,475	6,400	45,332
2006	4,905	4,599	7,030	7,063	49,124
2007	5,104	5,051	7,270	7,888	52,556
2008	5,205	5,438	7,397	8,221	54,701
2009	4,824	5,345	7,193	8,737	54,595
2010	4,812	4,879	7,623	8,430	55,759

Notes:

* Total personal income is for the calendar year.

"na" denotes "not available."

Source: Department of Taxation and Department of Budget and Finance.

Table 2
Tax Revenues and the Percent of Each Tax Dedicated to the General Fund
(Dollar amounts are in millions)

Fiscal Year	GET	%	Ind*	Bank	%	Tob	%	TAT	%	Con	%	Misc	%	Corp*	Est*	Ins*	Liq*	PSC*	Fuel**	MV**	Emp**	Total	%
1972	186	100	120	3.1	100	6.5	100			0.6	100	0.2	100	11.8	3.6	8.3	9.4	15.7	28.3		18.3	412	89
1973	211	100	135	3.7	100	7.1	100			0.9	100	0.2	100	12.9	2.1	9.2	10.2	18.3	29.8		24	464	89
1974	244	100	152	3.6	100	8.3	100			1.0	100	0.3	100	18.2	2.7	9.5	11.4	21.2	29.6		25.2	527	90
1976	310	100	185	2.5	100	9.6	100			0.8	100	0.3	100	32.9	3.3	16.1	15	28.6	41.5		49	695	87
1977	341	100	203	4.9	100	10.3	100			0.9	100	0.3	100	22.7	4.1	13.3	16.2	31.2	44.2		61.4	754	86
1978	367	100	227	5.2	100	11.0	100			1.3	100	0.3	100	23.8	4	15.7	18	33.4	46.1	6.9	73.7	833	85
1979	431	100	265	7.6	100	11.9	100			1.9	100	0.4	100	32.3	4.1	18.5	20.4	33.9	48.3	8	75.5	959	87
1980	498	100	312	7.8	100	12.8	100			2.3	100	0.4	100	42.4	4.3	22.2	13	32.5	51.1	8.4	67.5	1075	89
1981	549	100	335	5.8	100	13.8	100			2.0	100	0.4	100	47	4.6	24	7	50.2	53.1	8.4	58.8	1159	90
1982	577	97	283	3.9	100	14.0	100			4.5	100	0.4	100	39.3	5.1	27.8	7.7	57	52.6	8.5	58.3	1139	88
1983	601	97	347	-2.4	100	17.6	100			4.5	100	0.4	100	24.5	6.4	26.4	9.3	66.4	53.6	8.9	67.6	1231	89
1984	639	98	403	0.6	100	20.0	100			1.8	100	0.4	100	36.4	6.7	26.6	-0.2	59.6	54.9	9.3	76.3	1334	89
1985	684	98	429	3.9	100	19.7	100			1.9	100	0.4	100	44.8	12.3	28.7	20.6	62.3	58.5	9.6	68.7	1444	90
1986	747	98	467	4.9	100	19.7	100			2.0	100	0.4	100	39.6	6	34.6	29.9	70.3	67.5	15.3	67	1571	90
1987	818	99	543	15.3	100	19.1	100	67.7	100	3.6	100	0.4	100	61.5	5.2	36	34.6	61.8	73.3	17.8	76.1	1832	90
1988	920	98	626	12.0	100	21.3	100	67.3	100	4.2	100	0.5	100	66	7.3	38	38.2	63.6	85.2	18.7	77.4	2045	90
1989	1025	99	768	15.8	100	24.4	100	76.0	100	5.2	100	0.5	100	72.3	6.7	33.4	38.6	64.9	91.1	19.4	53.1	2294	92
1990	1177	91	695	19.9	100	23.5	100	82.4	100	8.1	100	3.4	100	74.9	16.3	36.9	40.3	69.6	107.2	20.3	79	2454	87
1991	1279	91	873	20.4	100	26.3	100	79.2	21	5.7	100	0.9	94	95.9	11.9	45.1	40.8	74.9	108.5	21.2	84	2766	86
1992	1295	93	907	24.0	100	27.4	100	80.0	5	4.0	100	0.7	100	43.8	16.4	60.4	41.5	82.3	128.3	40.7	44.7	2796	86
1993	1303	100	923	23.8	100	32.2	100	80.3	5	3.8	100	0.7	100	29.3	11.8	66.9	39.3	86.2	130.5	59.5	65.6	2856	88
1994	1332	100	963	29.4	100	32.7	100	76.5	5	7.7	50	0.7	100	39	28.1	63.7	39	92.3	137.4	57.8	88.6	2988	88
1995	1363	100	926	17.0	100	35.4	100	98.0	4	7.0	50	0.7	100	30.2	16.4	62.3	38.4	100.5	136	61.5	122.8	3015	86
1996	1432	100	1000	17.1	100	39.6	100	115.7	4	5.7	50	0.7	100	48.4	17.5	59.2	37.8	104.1	139.9	61.5	183.5	3263	85
1997	1457	100	976	9.7	100	36.4	100	125.5	4	6.0	50	0.6	100	57.8	22.2	55.8	38.3	114.4	138.6	62.6	170	3272	85
1998	1425	100	1084	15.5	100	36.1	100	127.1	4	6.7	50	0.5	100	46.2	19.6	59.4	38.9	120.3	136	63.6	155.1	3334	86
1999	1447	100	1069	9.8	100	42.3	100	136.5	21	7.7	64	0.6	50	42.6	28.7	52.5	38.5	121.1	136	65.3	149	3347	85
2000	1536	100	1065	7.1	65	42.3	100	168.6	0	9.5	63	0.8	93	68.2	22.8	68.7	39	119.5	136.4	78.1	150	3512	85
2001	1640	100	1105	-0.3	na	55.1	100	177.2	17	10.5	63	0.7	100	60.8	17.5	72.1	37.8	134.6	143	83.4	141.2	3678	86
2002	1612	100	1072	7.2	73	65.5	98	157.6	17	9.8	50	0.6	100	45.5	16.6	67.9	39.1	93.4	144.7	80.6	112	3525	87
2003	1793	100	1038	22.3	91	72.3	99	170.9	1	11.1	50	0.7	100	8.3	15.5	73.2	41.2	114.1	148.7	88.4	136	3734	85
2004	1900	100	1169	1.5	na	79.4	99	181.8	3	15.8	50	0.7	100	56.7	9.8	78.1	41.3	99.5	160.1	92	158.3	4044	85
2005	2137	100	1381	38.5	95	85.2	99	198.8	6	24.6	50	0.8	100	85.6	12.7	83.1	43.7	108.7	162.9	100.3	134.5	4597	87
2006	2355	100	1551	16.3	88	86.8	99	217.0	8	20.7	35	0.5	100	130	4	88.1	46	120.7	166.1	107.5	149.4	5101	87
2007	2556	100	1560	16.6	88	84.2	91	224.9	8	7.0	15	0.5	100	81.8	0.6	92.2	46	124	169.7	112.4	134.6	5317	86
2008	2619	100	1545	18.2	89	83.4	79	229.4	7	6.5	15	0.8	100	85.1	0.2	95.7	45.6	127.5	169.9	112.4	92.3	5478	85
2009	2418	100	1339	26.1	92	77.0	72	210.6	6	8.3	35	0.5	100	53.5	0.3	93.7	47.2	126.1	165.7	102.0	49.1	4944	85
2010	2316	100	1528	18.7	89	85.5	69	224.2	14	18.2	35	0.8	100	57.9	0	104.7	44.1	157.7	155.7	102.3	82	5135	85
2011	2496	100	1247	33.7	94	143.3	74	296.8	20	47.9	45	0.9	100	35.9	6.9	142.8	48.1	117.9	195.3	106.2	190.5	5297	82
Elasticity	**1.02**		**0.97**	**0.98**		**1.08**		**1.18**		**1.15**		**0.75**		**0.60**	**0.37**	**1.05**	**0.79**	**0.90**	**0.88**	**1.18**	**0.97**	**1.01**	

Notes:

"GET" = General Excise and Use Taxes; "Ind" = Individual Income Tax; " "Bank" = Tax on Banks and Other Financial Corporations; "Tob" = Tax on Tobacco and Tobacco Products; "TAT" = Transient Accommodations Tax; "Con" = Conveyance Tax; "Misc" = Miscellaneous Taxes and includes charges for fuel retail dealer permits, fuel tax penaly and interest payments, general excise tax license fees, and transient accommodations license fees; "Corp" = Corporation Income Tax; "Est" = Estate and Inheritance Tax; "Fuel" = Taxes on Liquid Fuels; "MV" = Taxes on Motor Vehicles; "Emp" = Employment Security Contributions.

* 100% of the tax is dedicated to the General Fund throughout the period.

** 100% of the tax is dedicated to Special Funds throughout the period, except in fiscal year 2011, $18.9 million of the Fuel Taxes went into the General Fund.

Source: Department of Taxation.

Table 3

Employer and Employee Contributions to the Hawaii State Employees' Retirement System

(Dollar amounts are in thousands)

Fiscal Year	Annual Required Contribution	Actual Contribution	% of Required Contributed	police & Fire-Fighters Payroll	All Others Payroll	Total Payroll	Police and Firefighters	All Other Employees	Total Employee Contributions
1997	323,188	322,121	99.67	209,958	1,809,310	2,019,268			54,364
1998	307,680	310,627	100.96	210,088	1,925,857	2,135,945			56,168
1999	185,387	154,470	83.32	216,476	1,970,023	2,186,499			55,703
2000	172,255	22,392	13.00	220,697	2,054,600	2,275,298			57,358
2001	164,397	8,132	4.95	239,357	2,110,842	2,350,199			54,490
2002	167,459	167,459	100.00	250,884	2,317,823	2,568,707			55,451
2003	190,586	190,586	100.00	257,496	2,460,939	2,718,436			57,214
2004	235,686	235,686	100.00	277,266	2,478,279	2,755,545	15.75	13.75	55,116
2005	328,717	328,717	100.00	290,173	2,634,375	2,924,548	15.75	13.75	57,055
2006	423,446	423,446	100.00	306,941	2,806,776	3,113,737	15.75	13.75	56,258
2007	476,754	454,494	95.33	325,708	3,014,780	3,340,488	15.75	13.75	144,658
2008	510,727	488,770	95.70	353,377	3,248,345	3,601,772	15.75	13.75	163,376
2009	526,538	578,635	109.89	383,990	3,454,010	3,838,000	19.70	15.00	184,500

Source: Comprehensive Annual Financial Reports from the Employees' Retirement System.

Table 4
State Pension Fund Assets and Accrued Liabilities

(Dollar amounts are in thousands)

Fiscal Year	Total Current Assets	Unfunded Accrued liability	Investment Yield rate (in %)
1985	2,314,334	496,998	10.38
1986	2,690,810	470,119	13.93
1987	3,121,283	469,414	16.02
1988	3,417,241	465,481	9.34
1989	3,677,715	460,597	11.36
1990	3,835,743	455,325	9.29
1991	4,080,784	449,630	8.65
1992	4,241,882	443,480	12.17
1993	4,680,697	436,838	10.02
1994	5,146,827	429,664	7.76
1995	5,615,930	421,917	6.19
1996	6,084,849	413,549	9.99
1997	6,855,389	1,062,122	13.72
1998	7,835,853	593,564	11.68
1999	8,590,807	510,814	12.33
2000	9,204,707	465,580	12.58
2001	9,515,956	990,956	-6.90
2002	9,415,160	1,795,065	-5.85
2003	9,073,960	2,878,097	1.89
2004	8,797,100	3,474,200	16.47
2005	8,914,839	4,071,149	11
2006	9,529,371	5,132,027	11
2007	10,589,800	5,106,800	16.9
2008	11,381,000	5,168,100	-4.14
2009	11,400,116	6,236,317	-18.04

Source: Employees' Retirement System Fiscal Year Reports.

Table 5
Projected Benefit Payments
(In thousands of dollars)

Fiscal Year	VEBA			All Other		
	Medical, Dental, Vision, Life	Medicare Part B	Total	Medical, Dental, Vision, Life	Medicare Part B	Total
2010	20,368	1,992	22,360	215,716	38,654	254,370
2011	25,135	2,585	27,720	241,188	40,670	281,858
2012	30,191	3,497	33,688	268,075	45,054	313,129
2013	35,174	4,650	39,824	294,978	49,785	344,763
2014	40,515	5,837	46,352	323,035	54,329	377,364
2015	46,245	7,193	53,438	351,176	59,168	410,344
2016	52,233	8,613	60,846	378,156	64,313	442,469
2017	58,313	10,159	68,472	403,440	69,772	473,212
2018	64,274	11,852	76,126	427,855	75,432	503,287
2019	70,130	13,624	83,754	451,022	81,331	532,353
2020	76,017	15,302	91,319	472,718	87,426	560,144
2021	82,415	17,060	99,475	494,231	93,649	587,880
2022	89,268	18,867	108,135	515,976	99,954	615,930
2023	96,460	20,741	117,201	538,588	106,399	644,987
2024	104,082	22,722	126,804	561,547	111,883	673,430

Source: AONHewitt, "State of Hawaii: Postemployment Benefits Other Than Pensions, Actuarial Valuation Study," March 16, 2011, and "State of Hawaii: Voluntary Employees' Beneficiary Association (VEBA) Trust for the Hawaii State Teachers Association (HSTA), Postemployment Benefits Other Than Pensions, Actuarial Valuation Study," March 16, 2011.

Table 6
Medicaid Costs

Fiscal Year	Federal Assistance (in %)	Cost to the State	Growth in Cost (%)
1968	50	10,573,770	
1969	50	12,900,000	22%
1970	50.75	16,421,236	27%
1971	50.75	23,652,038	44%
1972	50.83	34,071,802	44%
1973	50.83	35,262,384	3%
1974	50	38,800,000	10%
1975	50	40,900,000	5%
1976	50	60,300,000	47%
1977	50	71,765,181	19%
1978	50	93,339,487	30%
1979	50	104,693,951	12%
1980	50	112,023,669	7%
1981	50	135,541,107	21%
1982	50	143,068,000	6%
1983	50	158,000,000	10%
1984	50	154,587,200	-2%
1985	50	161,416,323	4%
1986	51	179,803,868	11%
1987	51.29	172,965,958	-4%
1988	53.71	192,000,000	11%
1989	53.99	183,600,000	-4%
1990	54.5	213,906,301	17%
1991	54.14	239,169,850	12%
1992	52.57	304,620,513	27%
1993	50	331,292,127	9%
1994	50	346,897,383	5%
1995	50	400,672,952	16%
1996	50	352,659,446	-12%
1997	50	318,172,596	-10%
1998	50	311,412,958	-2%
1999	50	309,603,880	-1%
2000	51.01	311,846,554	1%
2001	53.85	289,166,212	-7%
2002	56.34	315,412,249	9%
2003	58.77	317,019,800	1%
2004	58.9	345,800,000	9%
2005	58.47	377,000,000	9%
2006	58.81	409,000,000	8%
2007	57.55	451,700,000	10%
2008	56.5	479,100,000	6%
2009	55.11	498,200,000	4%
2010	54.24	545,300,000	9%
2011	51.79	606,700,000	11%
2012	na	797,500,000	31%
2013	na	795,600,000	0%

Source: Federal assistance rates are from the Assistant Secretary for Planning and Evaluation, U.S. Department of Health and Human Services. Data for the cost to the State are from Fiscal Reports of the Department of Human Services (1968 through 2003) and from the Department of Budget and Finance Historical Information appendix in the Budget. The figures for the cost to the State for fiscal years 2012 ansd 2013 are the Executive requests, as reported in Department of Budget and Finance, "The FY 2013 Executive Supplemental Budget: Budget in Brief," December 2011.

Table 7
Estimates of the Demand for Government Payments from the General Fund and for General Fund Revenues

(Dollar amounts are in millions)

Column	Variable (and scenario)	Fiscal Year 2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
1	GS (Low)	3,938.4	4,064.4	4,194.5	4,328.7	4,467.2	4,610.2	4,757.7	4,909.9	5,067.0	5,229.2
2	GS (Mid)	4,065.1	4,268.4	4,481.8	4,705.9	4,941.2	5,188.3	5,447.7	5,720.1	6,006.1	6,306.4
3	GS (High)	4,182.1	4,454.0	4,743.5	5,051.8	5,380.2	5,729.9	6,102.3	6,499.0	6,921.4	7,371.3
4	P (Mid)	535.8	554.5	574.0	594.0	614.8	636.3	658.6	681.7	705.5	730.2
5	HB (Mid)	296.1	326.3	357.1	387.6	417.1	446.1	474.4	501.6	529.3	557.5
6	HB (High)	931.4	964.0	997.8	1,032.7	1,068.8	1,106.2	1,144.9	1,185.0	1,226.5	1,269.4
7	M (Mid)	795.6	842.5	892.3	944.9	1,000.6	1,059.7	1,122.2	1,188.4	1,258.5	1,332.8
8	M (High)	795.6	870.4	952.2	1,041.7	1,139.6	1,246.8	1,364.0	1,492.2	1,632.4	1,785.9
9	GFR (Low)	5,692.1	5,790.1	6,011.2	6,108.1	6,279.0	6,464.3	6,645.2	6,841.2	7,032.7	7,240.2
10	GFR (Mid)	5,796.4	6,004.3	6,347.9	6,568.4	6,876.0	7,208.6	7,546.2	7,911.2	8,281.7	8,682.3
11	GFR (High)	5,883.3	6,185.8	6,637.9	6,971.5	7,407.4	7,882.2	8,375.1	8,911.9	9,469.2	10,076.1
Budget Surplus or Deficit											
9 - (1 + 4 + 5 + 7)		126.2	2.3	-6.5	-147.2	-220.7	-288.1	-367.7	-440.4	-527.7	-609.6
9 - (1 + 4 + 6 + 8)		-509.1	-663.3	-707.1	-889.0	-1,011.4	-1,135.2	-1,280.0	-1,427.6	-1,598.8	-1,774.6
10 - (2 + 4 + 5 + 7)		103.7	12.6	42.8	-64.1	-97.8	-121.8	-156.7	-180.6	-217.7	-244.6
10 - (2 + 4 + 6 + 8)		-531.5	-653.0	-657.8	-805.9	-888.5	-969.0	-1,069.0	-1,167.7	-1,288.8	-1,409.6
11 - (3 + 4 + 5 + 7)		73.7	8.5	71.1	-6.9	-5.3	10.1	17.6	41.2	54.5	84.3
11 - (3 + 4 + 6 + 8)		-561.6	-657.1	-629.5	-748.8	-796.0	-837.0	-894.7	-945.9	-1,016.7	-1,080.7

Source: Authors' calculations.

"GS" (expenditures on current government services out of the General Fund) are calculated as total expenditures from the General Fund less the net costs of pension and health care benefits for retired State paid out of the General Fund and less Medicaid payments from the General Fund.

"GFR" (General Fund total revenue) is calculated using forecasts for non-tax General Fund revenues provided by the Department of Budget and Finance for fiscal years 2013 through 2017. For later years, the non-tax revenues are assumed to grow by 3% annuually.

The "Low," "Mid" and "High" scenarios for GFR and GS are calculated assuming constant annual growth of TPI equal to 3.2%, 5.0% and 6.5%. Projections for fiscal years 2019 through 2022 are made by assuming the growth in total General Fund revenues is the same as it was for fiscal year 2018.

"M" (Medicaid payments) are calculated by using the Executive requests for fiscal years 2012 and 2013, then assuming growth of 5.4% for the "Mid" scenario (the average rate of growth over the five-year period from 2006 to 2011) and growth of 9.2% for the "High" scenario (the average rate of growth from 1968 through 2011).

"P" (pension benefits for retired State workers) are calculated using the annual required contribution (ARC) determined in the report to the ERS trustees by Gabriel Roeder Smith & Company, assuming payroll growth of 3.5% per year. To get the cost to the General Fund, it was assumed that 23% of the total ARC would be reimbursed by the counties and other State special funds.

"HB" is health care benefits for retired workers under the Employer-Union Health Benefits Trsut Fund (EUTF) and the Voluntary Employees Beneficiary Associations (VEBAs), as calculated based on projections in the reports by AON Hewitt. The "Mid" scenario is their projected annual payments under the current pay-as-you-go plan provisions, reduced by 23% to account for reimbursements from the counties and from other State special funds. The "High" scenario is calculated using their estimate for the annual contributions that would be required to make the plans fully funded, where the future accrued liabilities are discounted at 4% and it is assumed that the General Fund is reimbursed for 23% of the annual contributions.

Table 8
Constant Law Tax Collections Dedicated to the General Fund
(In millions of dollars)

Fiscal Year	GET+PSC	Ind	Corp	TAT	Ins	Liq	Tob	Bank	Con	Misc	Total
1972	201.7	109.1	8.7	5.0	6.7	9.4	6.0	2.8	7.9	0.8	363.8
1973	229.3	122.7	9.6	5.4	7.4	10.2	6.6	3.3	9.4	0.2	408.3
1974	265.2	138.1	13.5	5.5	7.7	11.4	7.7	3.2	9.2	0.3	468.3
1975	311.7	153.6	23.4	5.9	8.0	12.8	8.1	2.9	8.4	0.3	544.2
1976	338.6	168.1	24.4	6.2	13.0	15.0	8.9	2.2	6.4	0.3	595.5
1977	372.2	184.5	16.9	6.6	10.8	16.2	9.6	4.4	12.5	0.3	642.4
1978	400.4	206.3	17.8	6.9	12.7	18.0	10.2	4.6	13.2	0.3	700.6
1979	464.9	240.8	24.1	7.6	15.0	20.4	11.0	6.8	19.3	0.4	818.4
1980	530.5	283.6	31.7	8.1	18.0	23.4	11.9	6.9	19.9	0.4	946.5
1981	599.2	304.5	35.1	8.3	19.4	25.7	12.8	5.2	14.8	0.4	1,044.4
1982	634.0	257.2	29.5	8.7	22.5	27.4	13.0	3.5	9.9	0.4	1,028.2
1983	667.4	315.4	18.4	9.0	21.3	29.1	16.3	-2.1	-6.1	0.4	1,113.5
1984	698.6	366.3	27.2	9.5	21.5	31.4	18.6	0.5	1.5	0.4	1,214.5
1985	746.3	389.9	33.5	10.6	23.2	28.5	18.3	3.5	9.9	0.4	1,302.7
1986	817.3	424.4	29.8	10.7	28.0	33.5	18.3	4.4	12.5	0.4	1,412.7
1987	879.8	493.5	45.8	10.7	29.1	36.8	17.7	13.6	38.9	0.4	1,580.0
1988	983.6	568.9	49.2	10.7	30.8	38.2	19.8	10.7	30.5	0.5	1,774.7
1989	1,089.9	698.0	54.2	12.0	27.0	38.6	22.6	14.1	40.2	0.5	2,031.7
1990	1,246.6	631.6	56.8	13.1	29.9	40.3	21.8	17.7	50.6	3.4	2,141.9
1991	1,353.9	793.4	72.6	12.6	36.5	40.8	24.4	18.2	51.9	0.8	2,442.7
1992	1,377.3	824.3	33.9	12.7	48.9	41.5	25.4	21.4	61.1	0.7	2,481.2
1993	1,389.2	838.8	23.3	12.7	54.1	39.3	29.9	21.2	60.6	0.7	2,499.9
1994	1,424.3	875.2	30.4	12.1	51.6	39.0	30.3	26.2	74.8	0.7	2,604.3
1995	1,463.5	841.6	23.9	15.5	50.4	38.4	32.8	15.1	43.3	0.7	2,579.7
1996	1,536.1	908.8	37.1	18.3	47.9	37.8	36.7	15.2	43.5	0.7	2,741.7
1997	1,571.4	887.0	44.5	19.9	45.2	38.3	33.8	8.6	24.7	0.6	2,755.7
1998	1,545.3	985.2	51.5	20.2	48.1	38.9	33.5	13.8	39.4	0.5	2,851.2
1999	1,568.1	971.5	50.6	21.6	42.5	38.5	39.2	8.7	24.9	0.6	2,862.9
2000	1,655.5	967.9	66.4	26.7	55.7	39.0	39.2	6.3	18.1	0.7	2,973.9
2001	1,774.6	1,004.2	77.1	28.1	58.8	37.8	51.1	-0.3	-0.8	0.7	3,144.8
2002	1,705.4	974.3	60.3	25.0	60.1	39.1	60.8	6.4	18.3	0.6	3,037.8
2003	1,907.1	943.4	28.8	27.1	70.2	41.2	67.1	19.8	56.8	0.7	3,211.7
2004	1,999.5	1,062.4	65.3	28.8	77.0	41.3	73.7	1.3	3.8	0.7	3,470.2
2005	2,245.7	1,255.1	85.6	31.5	83.1	43.7	79.1	34.3	98.0	0.8	4,036.5
2006	2,475.7	1,409.2	130.0	34.4	88.1	46.0	80.5	14.5	41.5	0.5	4,350.7
2007	2,653.2	1,423.9	81.8	35.7	91.3	45.5	77.3	14.8	42.2	0.5	4,498.7
2008	2,761.9	1,471.7	85.1	36.4	94.7	45.1	77.4	16.2	46.3	0.8	4,669.4
2009	2,584.2	1,254.8	53.5	33.4	93.7	47.2	71.4	23.2	66.4	0.5	4,262.1
2010	2,473.7	1,341.5	57.9	31.7	104.7	44.1	59.2	16.6	18.2	0.8	4,182.8
2011	2,613.7	1,432.8	35.9	32.5	140.5	48.1	73.5	28.2	21.5	0.9	4,427.6

Source: Authors' calculations.

Table 9
Absolute Stability of Constant Law Tax Collections
(Dollar amounts are in millions)

Tax	Actual Collections in FY 2011	Mean Average of Collections FY's 1972-2011	Standard Deviation of Collections FY's 1972-2011	Ratio of the Standard Deviation to the Mean (in %)
GET + PSC	$2,613.7	$1,288.9	$754.7	58.6%
Individual Income Tax	$1,433.2	$713.1	$456.1	64.0%
Corporation Income Tax	$35.9	$43.6	$25.7	59.0%
Tax on Banks and Other Financial Corporations	$28.2	$10.9	$8.3	76.4%
Tax on Insurance Premiums	$140.5	$44.9	$28.5	63.4%
Total General Fund	$4,329.3	$2,255.4	$1,304.7	57.8%

Notes: Mean averages and standard deviations are calculated from the constant law tax collections.
Source: Authors' calculations.

Table 10
Relative Stability of Constant Law Tax Collections
(Dollar amounts are in millions)

Tax	Actual Collections in FY 2011	Average Annual Growth Rate of Collections FY's 1972-2011 (in %)	Standard Deviation of Annual Growth Rates FY's 1972-2011	Ratio of the Standard Deviation to the Mean
GET + PSC	$2,613.7	6.4%	0.06	93.8%
Individual Income Tax	$1,433.2	6.4%	0.10	156.3%
Corporation Income Tax	$35.9	4.9%	0.37	755.1%
Tax on Banks and Other Financial Corporations	$28.2	4.6%	1.13	2456.5%
Tax on Insurance Premiums	$140.5	7.0%	0.14	200.0%
Total General Fund	$4,329.3	6.3%	0.06	95.2%

Notes: Mean averages and standard deviations are calculated from the constant law tax collections.
Source: Authors' calculations.

Table 11
Stability of Constant Law Tax Collections During Slow Growth or Declining Income
(Dollar amounts are in millions)

Tax	Actual Collections in FY 2011	Average Annual Growth Rate of Collections (in %)	Average Growth in Collections, 1972-2011 (in %)	Difference: Average Growth minus Average Growth in the Recession (in %)
GET + PSC	$2,613.7	3.9%	6.4%	2.5%
Individual Income Tax	$1,433.2	0.5%	6.4%	5.9%
Corporation Income Tax	$35.9	8.5%	4.9%	-3.6%
Tax on Banks and Other Financial Corporations	$28.2	-18.9%	4.6%	23.5%
Tax on Insurance Premiums	$140.5	2.2%	7.0%	4.8%
Total General Fund	$4,329.3	2.8%	6.3%	3.5%

Notes: The averages and ratios are calculated from the constant law tax collections. Years of slow or declining growth were the thirteen years between 1972 and 2011 in which real (inflation adjusted) TPI grew by less than 1%.
Source: Authors' calculations.

Table 12
Stability of Constant Law Tax Collections in the Recession of 2008-2010
(Dollar amounts are in millions)

Tax	Collections in FY 2011	Average Annual Growth in Collections During the Recession (in %)	Average Growth in Collections, 1972-2011 (in %)	Difference: Average Growth minus Average Growth in the Recession (in %)
GET + PSC	$2,613.7	-2.6%	6.4%	9.0%
Individual Income Tax	$1,433.2	-2.4%	6.4%	8.8%
Corporation Income Tax	$35.9	-4.5%	4.9%	9.4%
Tax on Banks and Other Financial Corporations	$28.2	8,2%	4.6%	5.0%
Tax on Insurance Premiums	$140.5	4.5%	7.0%	2.5%
Total General Fund	$4,329.3	-2.5%	6.3%	8.8%

Notes: The average growth rates are calculated from the constant law tax collections.
Source: Authors' calculations.

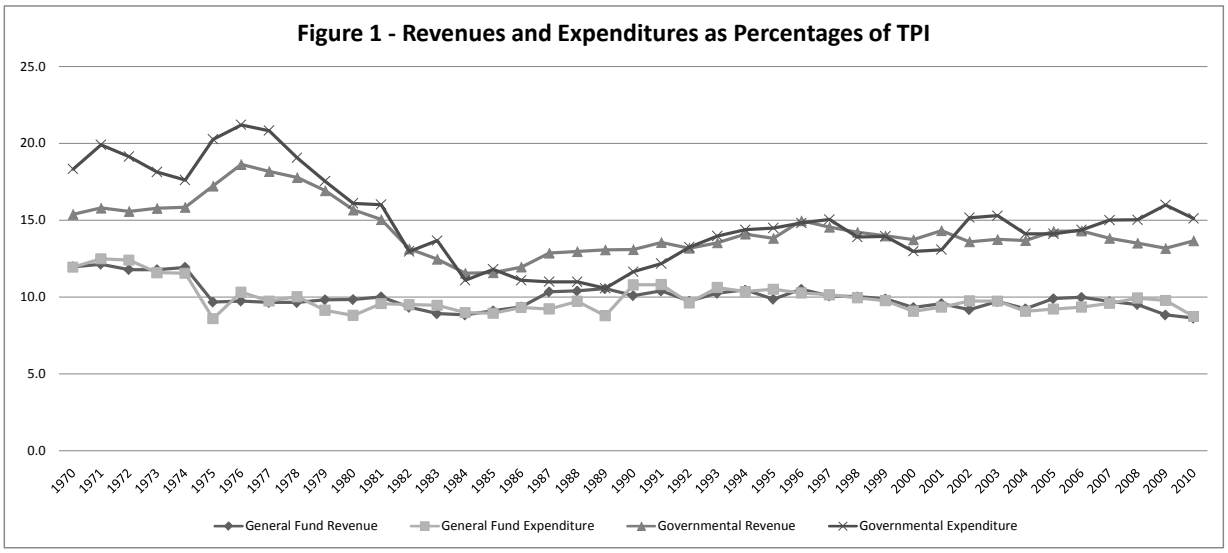


Figure 1 - Revenues and Expenditures as Percentages of TPI
25.0
20.0
15.0
10.0
5.0
0.0
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
General Fund Revenue
General Fund Expenditure
Governmental Revenue
Governmental Expenditure

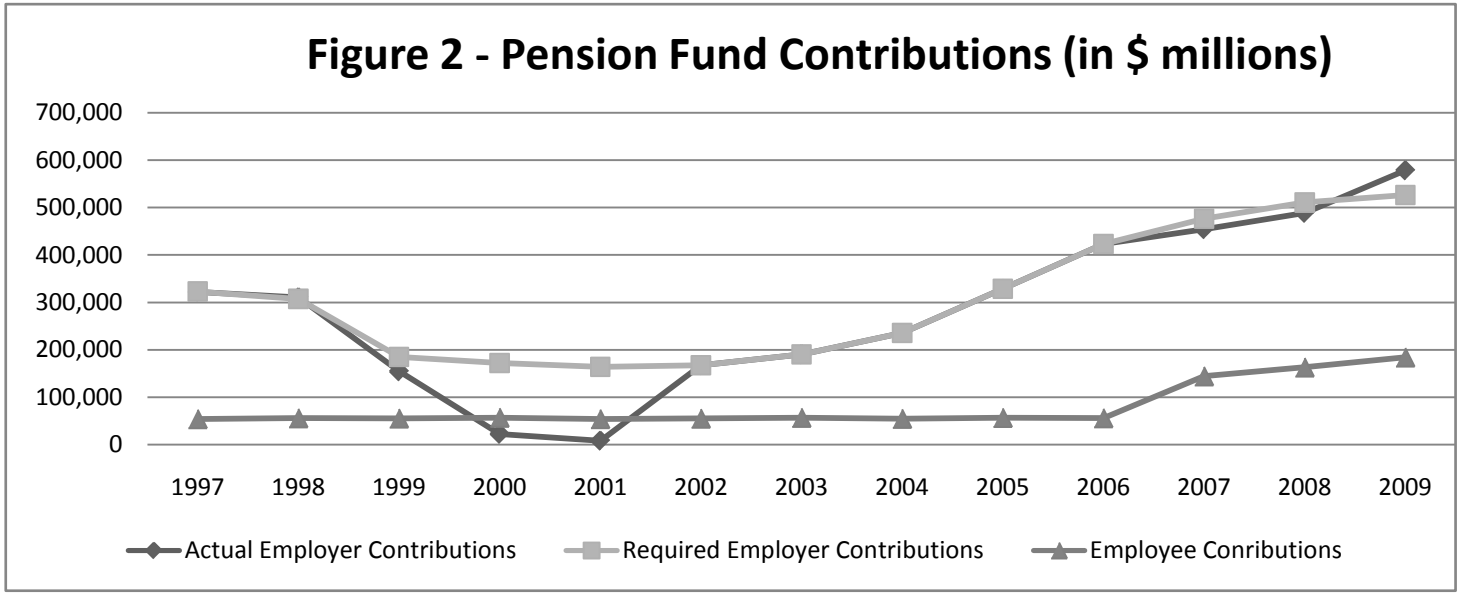


Figure 2 - Pension Fund Contributions (in $ millions)
700,000
600,000
500,000
400,000
300,000
200,000
100,000
0
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
Actual Employer Contributions
Required Employer Contributions
Employee Conributions

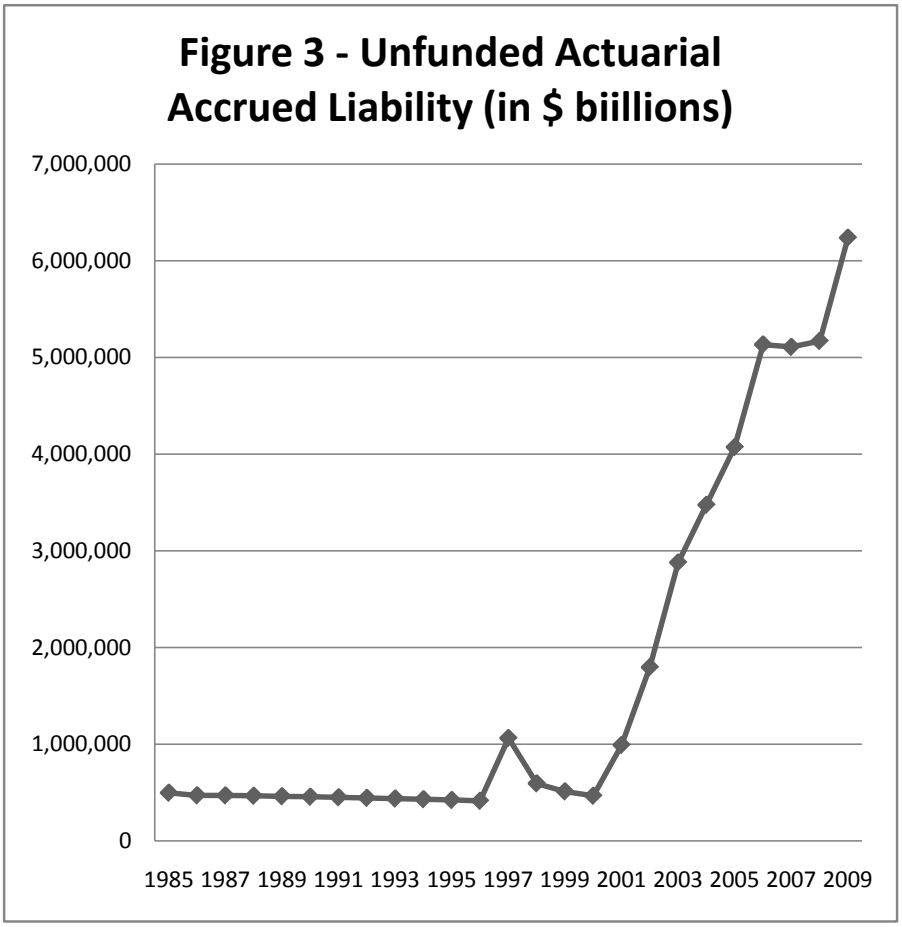


Figure 3 - Unfunded Actuarial Accrued Liability (in $ biillions)
7,000,000
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009

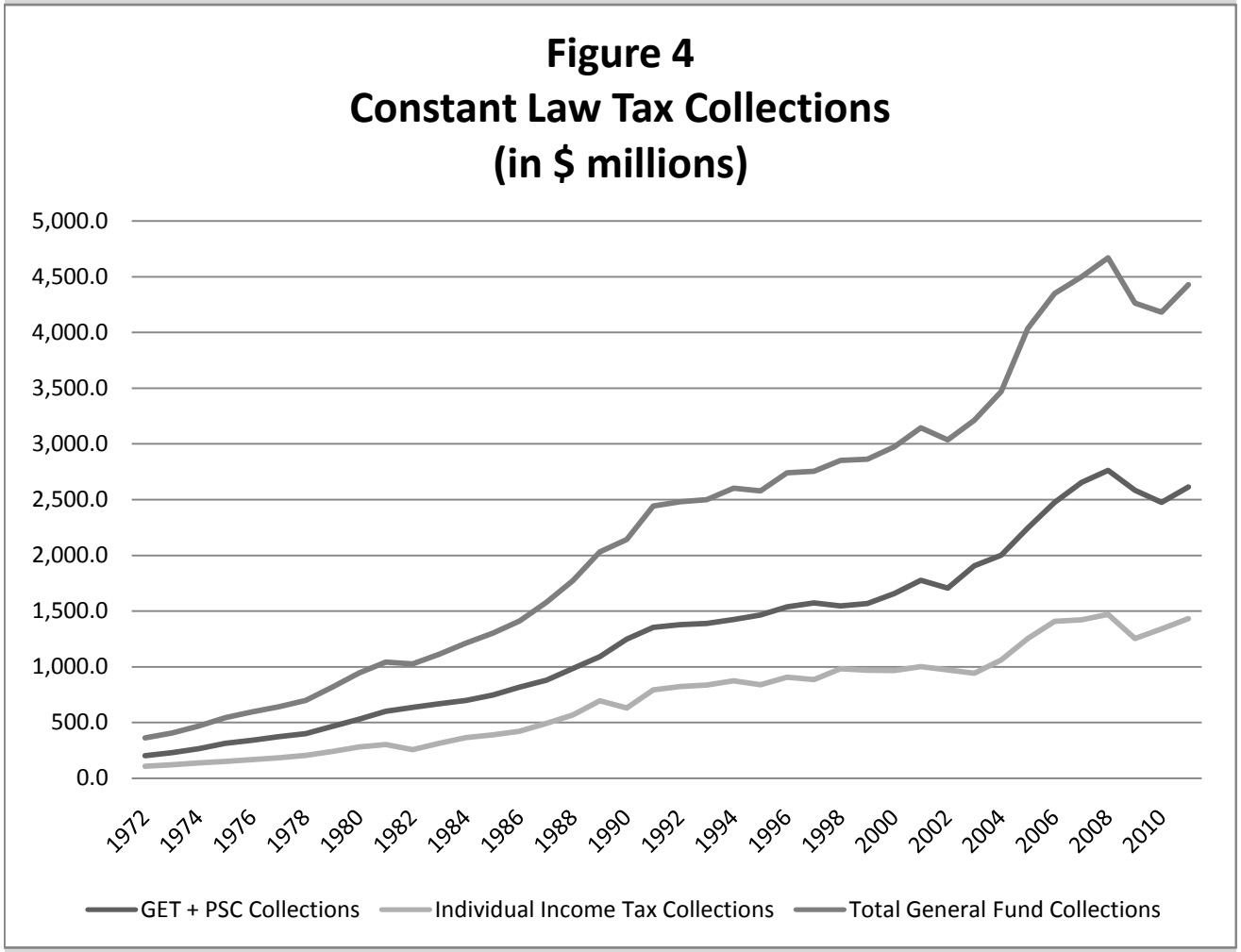


Figure 4
Constant Law Tax Collections
(in $ millions)
5,000.0
4,500.0
4,000.0
3,500.0
3,000.0
2,500.0
2,000.0
1,500.0
1,000.0
500.0
0.0
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
GET + PSC Collections
Individual Income Tax Collections
Total General Fund Collections

Appendix B

Results for Regression Equations Explaining the Effect of Electronic Commerce on GET Collections

Data

FY	GET	TPI*	CONSTR	VISEXP	ECOMM	DELCOLL
1970	163	3,641	749	528		
1971	178	4,053	734	677		
1972	186	4,386	676	779		11.2
1973	211	4,924	820	930		12.2
1974	244	5,482	952	1,137		14.8
1975	287	6,242	1,143	1,286		15.1
1976	310	6,751	1,068	1,488		20.8
1977	341	7,330	924	1,753		19.4
1978	367	7,987	948	1,970		23.6
1979	431	9,035	1,204	2,349		22.9
1980	498	10,301	1,492	2,713		31.7
1981	549	11,660	1,595	3,028		36.6
1982	577	12,194	1,463	3,444		28.6
1983	601	13,387	1,308	3,746		37.3
1984	650	14,673	1,333	4,180		37.7
1985	686	15,836	1,141	4,752		38.9
1986	733	16,605	1,700	5,523		30.1
1987	818	17,647	1,829	6,192		38.5
1988	920	19,091	2,216	7,451		44.6
1989	1,025	21,068	2,835	8,696		46.1
1990	1,177	23,195	3,618	8,977		57.2
1991	1,283	25,192	4,382	9,224		60
1992	1,290	26,844	4,184	9,799		64.2
1993	1,303	28,461	3,848	8,904		65.7
1994	1,332	29,082	3,482	9,278		86.6
1995	1,363	29,950	3,188	10,607		86.1
1996	1,448	30,183	3,246	10,818		94.6
1997	1,441	30,862	3,096	10,251		91
1998	1,425	31,836	2,969	10,474		83
1999	1,447	32,662	2,974	9,785	0.6	99.8
2000	1,536	34,206	3,341	10,088	0.9	66.9
2001	1,660	35,702	3,701	9,797	1.1	103.5
2002	1,647	36,605	4,006	9,595	1.5	113.1
2003	1,763	38,202	4,550	10,024	1.8	161.9
2004	1,900	40,370	4,514	10,290	2.1	156.4
2005	2,137	44,008	5,602	11,025	2.5	234.3
2006	2,355	47,087	6,766	12,077	3.0	263.1
2007	2,596	50,871	7,984	12,453	3.5	202.9
2008	2,579	54,312	7,833	12,305	3.6	186.9
2009	2,418	55,092	7,496	10,220	4.0	178.4
2010	2,316	55,492	5,766	9,992	4.3	218.6
2011	2,496	58,163	5,708	11,902	4.5	239

* Data on TPI are for the calendar year.

Source: Hawaii Department of Taxation and U.S. Department of Commerce.

Electronic commerce sales are sales of goods and services where an order is placed by the buyer or price and terms of sale are negotiated over an Internet, extranet, Electronic Data Interchange (EDI) network, electronic mail, or other online system. Payment may or may not be made online. Data on the variable were collected only in 1999 and later. The data on ECOMM are from the U.S. Department of Commerce, Bureau of the Census (at http://www.census/retail).

Dependent Variable: GET Collections

Method: Least Squares
Date: 12/28/11 Time: 15:05
Sample (adjusted): 1971 2011
Included observations: 41 after adjustments
Convergence achieved after 14 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
TPI	0.020658	0.003412	6.055094	0
CONSTR	0.07664	0.012219	6.27211	0
VISEXP	0.051115	0.009738	5.248931	0
ECOMM	62.69994	21.71051	2.887999	0.0065
AR(1)	0.660385	0.137512	4.802388	0

R-squared	0.998378	Mean dep. Var.	1183.53
Adjusted R-squared	0.998198	S.D. dep. Var.	748.4649
S.E. of regression	31.77614	Akaike info crit.	9.869158
Sum squared resid	36350.03	Schwarz criterion	10.07813
Log likelihood	-197.3177	Hannan-Quinn crit.	9.945254
Durbin-Watson stat	1.943648		
Inverted AR Roots	0.66		

Dependent Variable: GET Collections

Method: Least Squares
Date: 01/09/12 Time: 15:31
Sample (adjusted): 1974 2011
Included observations: 38 after adjustments
Convergence achieved after 32 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
TPI	0.023428	0.003134	7.476115	0
CONSTR	0.072188	0.010699	6.747258	0
VISEXP	0.034366	0.010173	3.378051	0.002
ECOMMERCE	7.544078	24.45721	0.30846	0.7598
DELCOLL	0.633041	0.274675	2.304691	0.028
DELCOLL(-1)	0.728948	0.327123	2.228357	0.0332
AR(1)	0.420142	0.173202	2.425733	0.0213

R-squared	0.998471	Mean dependent var	1261.838
Adjusted R-squared	0.998174	S.D. dependent var	720.7877
S.E. of regression	30.79643	Akaike info criterion	9.857497
Sum squared resid	29401.03	Schwarz criterion	10.15916
Log likelihood	-180.2924	Hannan-Quinn criter.	9.964826
Durbin-Watson stat	1.979896		
Inverted AR Roots	0.42		

APPENDIX F:

REPORT OF MS. TITIN SAKATA –

"Effects of Eliminating the Hawaii Individual Income Tax for Taxpayers with Income Below Poverty Level"

EFFECTS OF ELIMINATING THE HAWAII INDIVIDUAL INCOME TAX FOR TAXPAYERS WITH INCOME BELOW POVERTY LEVEL

Prepared by Titin L. Sakata, Administrative Rules Specialist, Hawaii Department of Taxation

September 17, 2012

I. Introduction

The 2010-2013 Tax Review Commission requested an analysis of the potential revenue impact of eliminating individual income tax for taxpayers with income below poverty level. This paper examines the impact of eliminating individual income tax for those below poverty level by:

1. Determine who is in poverty;
2. Determine who pays Hawaii's individual income tax;
3. Determine current tax reliefs for the poor; and
4. Determine the potential revenue impact of eliminating individual income tax for those below poverty level.

II. Who Is In Poverty?

There are two versions to measure poverty used by Federal government: (1) poverty thresholds and (2) poverty guidelines.

Poverty Thresholds

Poverty thresholds are the original version to measure poverty. They are updated each year by the United States Census Bureau ("Census Bureau"). The Census Bureau measures poverty by "money income" that varies by family size and composition. "Money income" includes "earnings, unemployment compensation, workers' compensation, Social Security, Supplemental Security Income, public assistance, veterans' payments, survivor benefits, pension or retirement income, interest, dividends, rents, royalties, income from estates, trusts, educational assistance, alimony, child support, assistance from outside the household, and other miscellaneous sources." It is before taxes and does not include capital gains or noncash benefits such as public housing, Medicaid, and food stamps. The poverty thresholds as defined by the Census Bureau do not vary by geographical area[1]. Table 1 shows poverty thresholds for 2011.

[1] Source: U.S. Census Bureau, http://www.census.gov/hhes/www/poverty/about/overview/measure.html

Table 1. Poverty Thresholds for 2011 by Size of Family and Number of Related Children Under 18 Years

Size of Family Unit	Weighted Average Thresholds	Related children under 18 years								
		None	One	Two	Three	Four	Five	Six	Seven	Eight or more
One person	11,484									
Under 65 years	11,702	11,702								
65 years & over	10,788	10,788								
Two people	14,657									
Householder under 65 years	15,139	15,063	15,504							
Householder 65 years & over	13,609	13,596	15,446							
Three people	17,916	17,595	18,106	18,123						
Four people	23,021	23,201	23,581	22,811	22,891					
Five people	27,251	27,979	28,386	27,517	26,844	26,434				
Six people	30,847	32,181	32,309	31,643	31,005	30,056	29,494			
Seven people	35,085	37,029	37,260	36,463	35,907	34,872	33,665	32,340		
Eight people	39,064	41,414	41,779	41,027	40,368	39,433	38,247	37,011	36,697	
Nine people or more	46,572	49,818	50,059	49,393	48,835	47,917	46,654	45,512	45,229	43,487

Source: U.S. Census Bureau.

Poverty Guidelines

The poverty guidelines are updated each by the United States Department of Health and Human Services ("DHS"). The poverty guidelines simplified the poverty thresholds for administrative purposes, that is, to determine eligibility for certain federal programs, such as Special Supplemental Nutrition Program for Women, Infants, and Children, Low-Income Taxpayer Clinics, Legal Services for the Poor, Children's Health Insurance Program, and Job Opportunities for Low-Income Individuals.

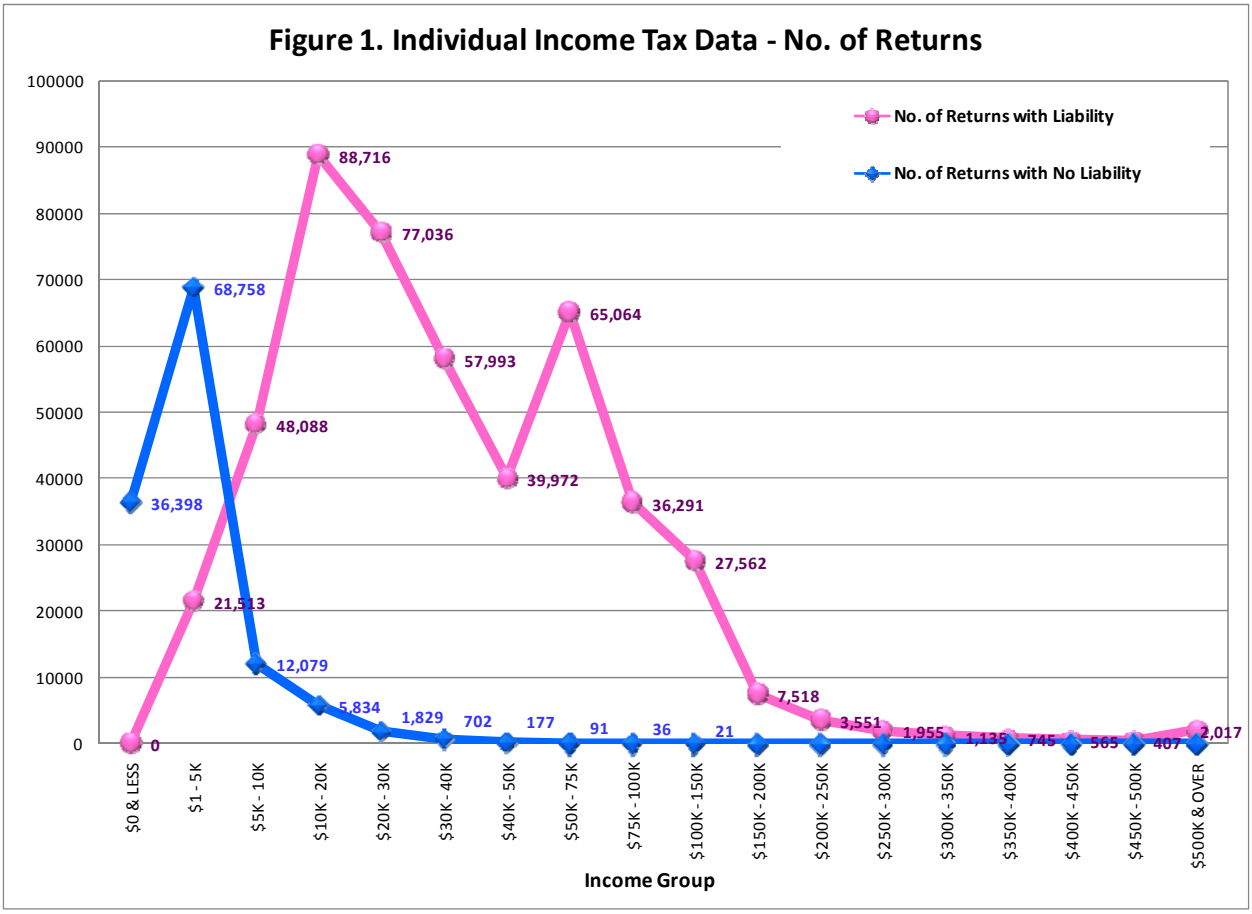
Beginning in the late 1960s, the DHS distinguishes Alaska and Hawaii from the 48 contiguous states. Table 2 shows the poverty guidelines for 2012[2]:

[2] Source: U.S. Department of Health and Human Services, http://aspe.hhs.gov

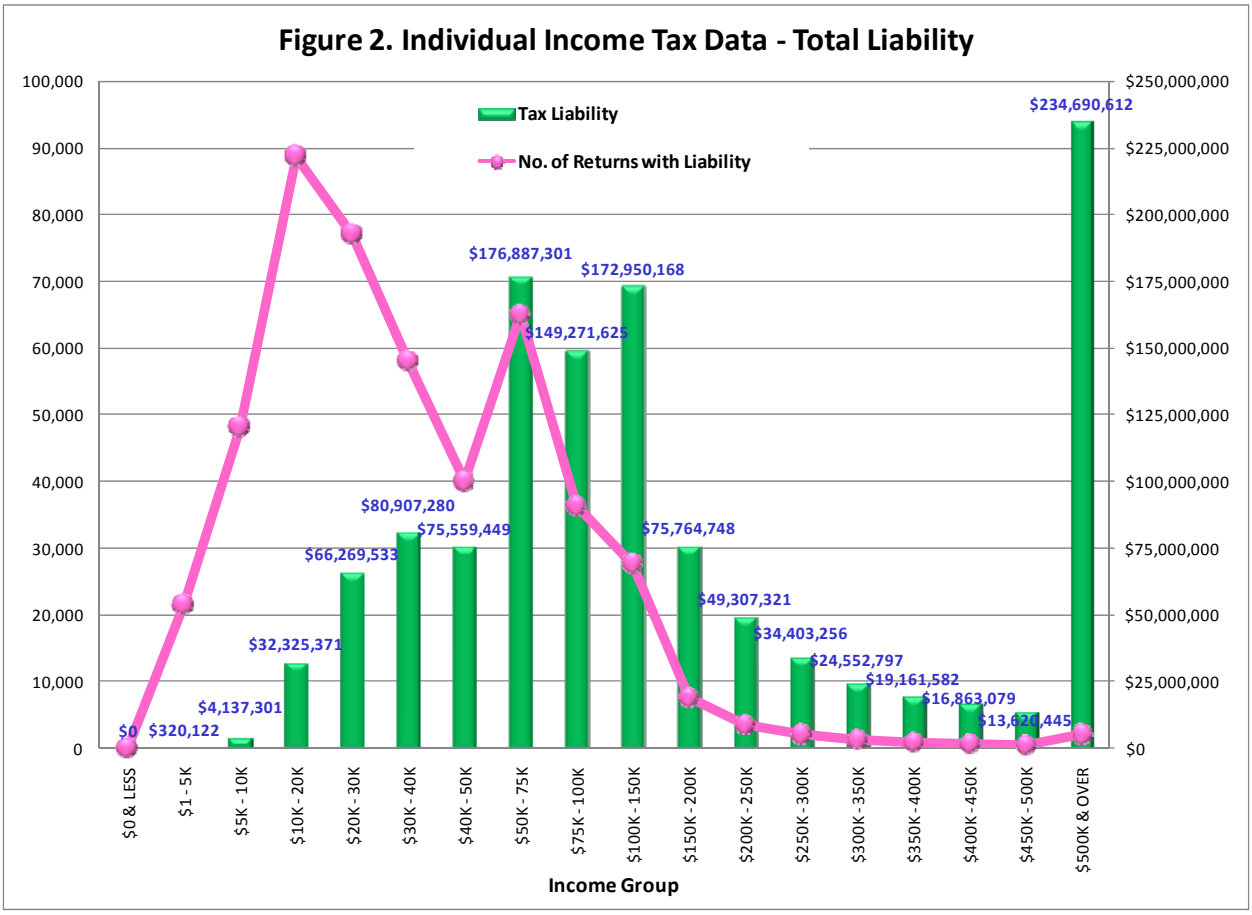
Table 2. Poverty Guidelines for 2012			
Persons in Family/Household	48 Contiguous States and the D.C.	Hawaii	Alaska
1	$11,170	$12,860	$13,970
2	$15,130	$17,410	$18,920
3	$19,090	$21,960	$23,870
4	$23,050	$26,510	$28,820
5	$27,010	$31,060	$33,770
6	$30,970	$35,610	$38,720
7	$34,930	$40,160	$43,670
8	$38,890	$44,710	$48,620
For families with more than 8 persons, add:	$3,960/additional person.	$4,550/additional person.	$4,950/additional person

III. Who Pays Hawaii Individual Income Tax?

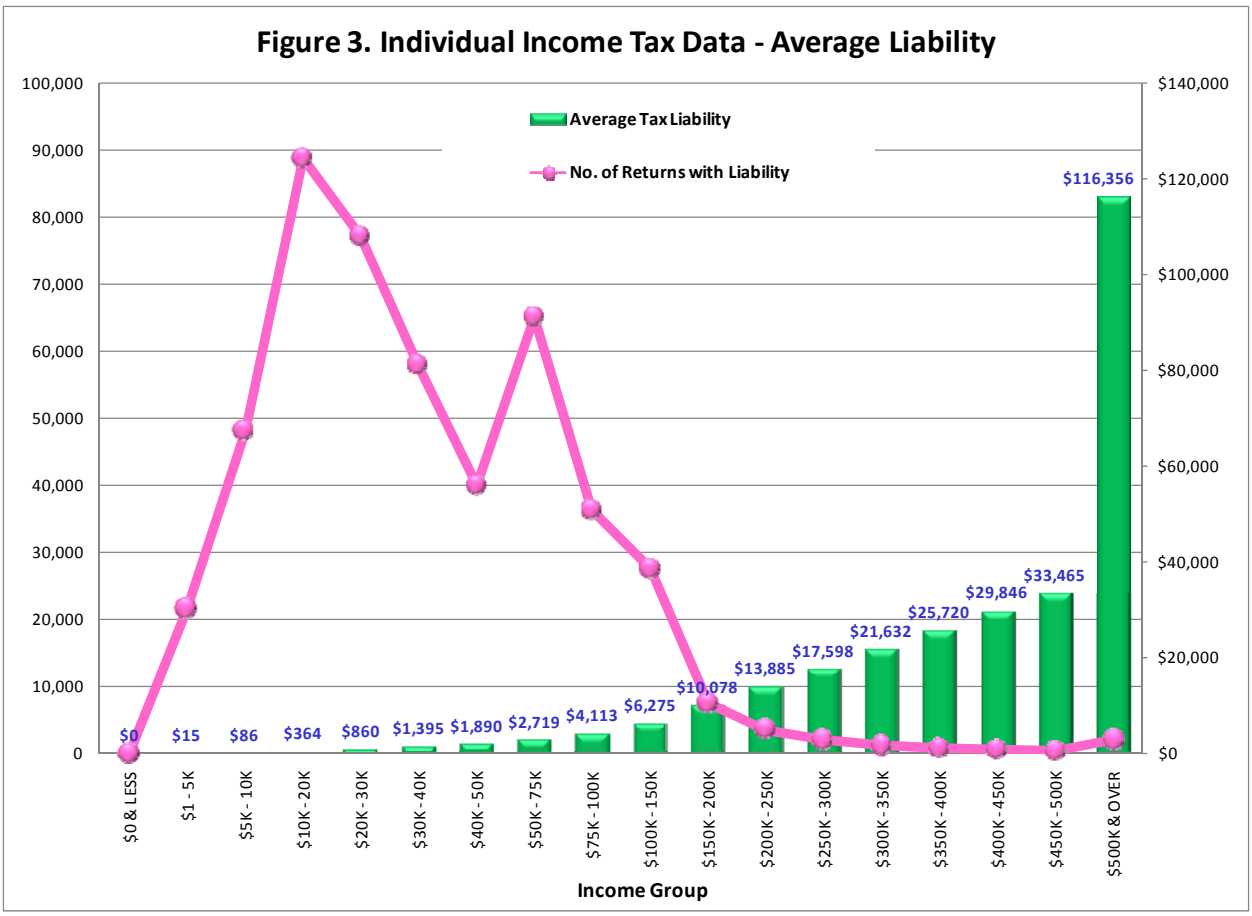
In 2004, for than 600,000 individual income tax returns were filed, with 61% (about 370,000) of returns with tax liability and 39% (230,000) with no tax liability (before applying any tax credits) (see Figure 1).



The total liability was $1.2 billion. Although taxpayers with Hawaii adjusted gross income ("HAGI") of under $50,000 represents a majority (60%) of the number of returns with tax liability, and taxpayers with HAGI of $50,000 or more represents a minority (40%) of the number of returns with liability, of the $1.2 billion tax liability, only 20% ($241.9 million) was borne by taxpayers with HAGI of under $50,000, and 80% ($967.4 million) was borne by taxpayers with HAGI of $50,000 or more (see Figure 2).



The average tax liability within the various income groups ranges from $9 (for those with HAGI of $1,000 to $5,000) to $116,000 (for those with HAGI of $500,000 or more) (see Figure 3). This shows that Hawaii's individual income tax is a progressive tax. The more one makes, the more one pays.



IV. Tax Credits for the Poor

Hawaii provides reliefs to the taxpayers on the lower income level in the forms of income tax credits such as the refundable food/excise tax credit[3] and the income tax credit for low-income household renters[4] to taxpayers making below certain income level.

Food/Excise Tax Credit

The food/excise tax credit is a graduated amount based on income level, which is determined by the FAGI, and the number of qualified exemptions (see Table 3). The credit is a refundable credit which means that the taxpayers do not need to have a tax liability to claim the credit. A family of five with FAGI under $5,000, for example, is entitled to a food/excise tax credit of $425. If this family of five does not have any income tax liability, they will receive a refund of $425.

[3] Act 211, Session Laws of Hawaii (SLH) 2007, replaces the low-income refundable tax credit with the refundable food/excise tax credit and increases the amount of the credit.

[4] Act 15, SLH 1977, establishes the income tax credit for low-income renters. The amount of the credit was $20 per qualified exemption for each taxpayer with an adjusted gross income of less than $20,000.

Table 3. Food/Excise Tax Credit

Federal AGI	Tax Credit Amount for Households of:				
	1	2	3	4	5
Under $5,000	$85	$170	$255	$340	$425
$5,000 - $10,000	$75	$150	$225	$300	$375
$10,000 - $15,000	$65	$130	$195	$260	$325
$15,000 - $20,000	$55	$110	$165	$220	$275
$20,000 - $30,000	$45	$90	$135	$180	$225
$30,000 - $40,000	$35	$70	$105	$140	$175
$40,000 - $50,000	$25	$50	$75	$100	$125
$50,000 and over	$0	$0	$0	$0	$0

Low-Income Household Renters' Credit

The credit for low-income household renters ("renter's credit") is $50 per qualified exemptions, provided that each taxpayer 65 years of age or over may claim double the tax credit (see Table 4). The credit is limited to taxpayer with HAGI of under $30,000[5]. The credit for low-income household renters has not been adjusted for twenty two years.

An elderly couple, both over age 65, who rents, with a HAGI under $30,000, for example, is entitled to a renter's credit of $200. If this elderly couple does not have any income tax liability, they will receive a refund of $200. A family of five with HAGI under $30,000, who rents, for example, is entitled to a renter's credit of $250. If this family of five does not have any income tax liability, they will receive a refund of $250.

Table 4. Renter's Credit

Hawaii AGI	Tax Credit Amount for Households of:				
	1	2	3	4	5
Under $30,000	$50	$100	$150	$200	$250

[5] Act 230, SLH 1981, increases the amount of the low-income renter's credit to $50 per qualified exemption. Act 321, SLH 1989, increases the income threshold for the low-income renters credit to less than $30,000. Act 98, SLH 1990, makes the credit refundable (provides the credit to resident taxpayer who has no income or no taxable income).

V. Estimating the Potential Revenue Impact of Eliminating Individual Income Tax for Those in Poverty

Data and Methodology

The exercise of estimating the potential revenue impact of eliminating individual income tax for those in poverty is accomplished by using historical tax data and applying simulation to the data.

Poverty guidelines rather than poverty thresholds were used to determine those in poverty level as the guidelines distinguish Hawaii from the 48 contiguous states.

Both Federal adjusted gross income and Hawaii adjusted gross income are used to determine income level. FAGI excludes cost-of-living allowances (COLA) for federal employees, contributions to the State employees' retirement system (ERS), and interest on out-of-state bonds, whereas Hawaii adjusted gross income includes those income. HAGI excludes certain pensions, social security benefits, first $5,881 of military reserve or Hawaii national guard duty pay, payments to an individual housing account and other subtractions from Federal adjusted gross income (see Table 5). Therefore, it is determined that to capture the proper income level, both Federal and Hawaii adjusted gross income must be used to determine poverty level.

Table 5. Examples of Differences between FAGI and HAGI

	Federal Adjusted Gross Income	Hawaii Adjusted Gross Income
COLA	Not included	Included
Contribution to State Emplyees' Retirement System	Not included	Included
Out-of-state Bonds	Not included	Included
Employers-funded Pensions	Included	Not included
Social Security Benefits	Included	Not included
First $5,881 of Military Reserve or Hawaii National Guard Duty Pay	Included	Not included
Payments to An Individual Housing Account	Included	Not included

The number of people in a household is determined by the number of exemptions reported in the tax return (self, spouse, children and dependent, but excludes an additional exemption due to age sixty five and over).

To estimate the potential revenue loss of eliminating individual income tax for those with income below poverty level, the ordinary income tax rate is set at zero percent if both the FAGI

and HAGI is less than the 2012 poverty guidelines as established by the U.S. Department of Health and Human Services.

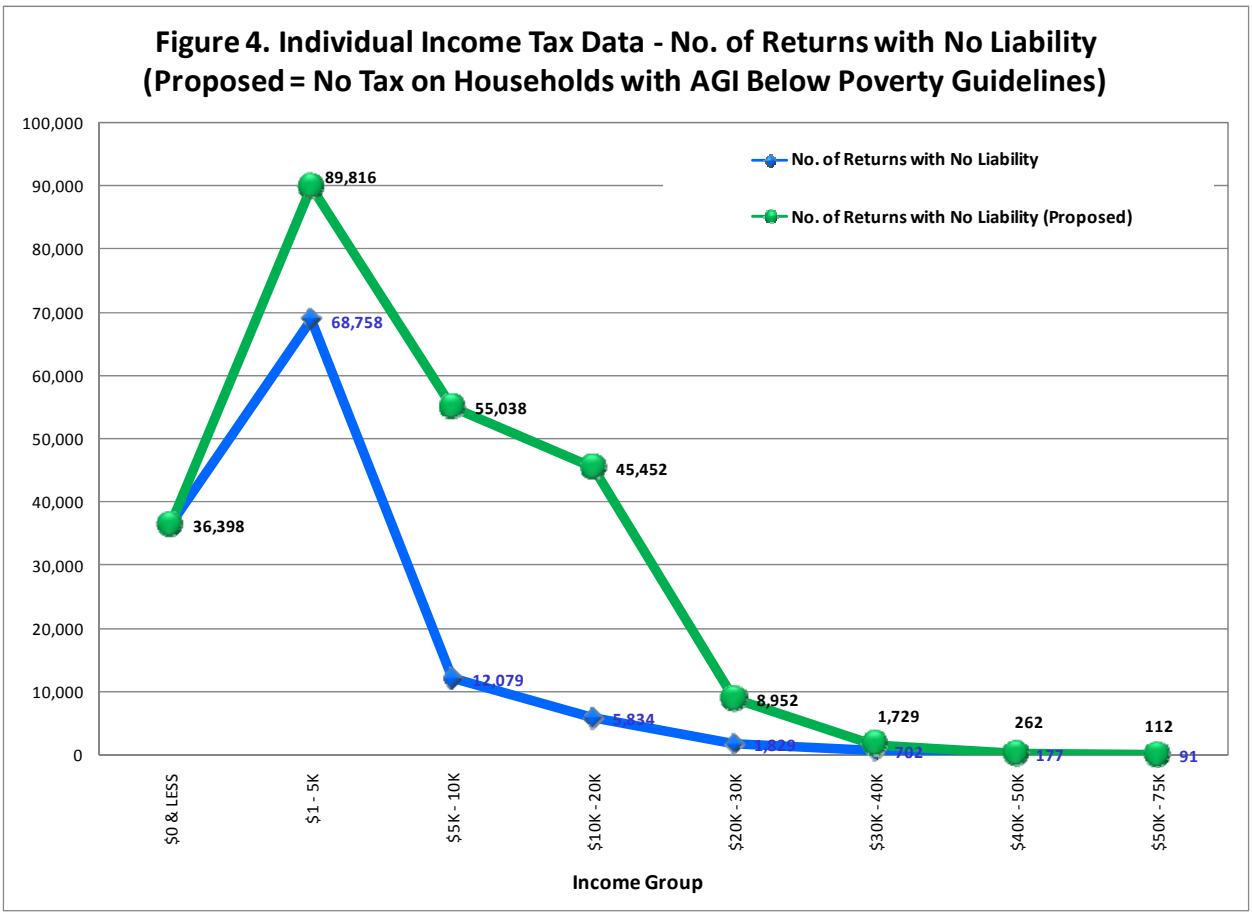
Formula:

IF HAGI < ($8,310 + ($4,550 * Regular Exemption)) AND

FAGI < ($8,310 + ($4,550 * Regular Exemption)) THEN Ordinary Liability = 0

Results

It is estimated that if those with FAGI and HAGI below poverty guidelines were exempted from individual income tax, the number of returns with no tax liability will increase by 111,900 returns (an 89% increase), representing almost 18% of total tax returns (see Figure 4).



The reported liability would decrease by $17.7 million. Using the U.S. Department of Labor, Bureau of Labor inflation calculator, the estimated reduction in reported liability in 2012 would be $21.5 million[6]. However, the revenue loss is likely higher. It could be several times higher than the estimated reduction in reported liability. The Department of Taxation's records

[6] U.S. Department of Labor, Bureau of Labor Statistics at http://data.bls.gov/cgi-bin/cpicalc.pl

showed a 12-years average difference between reported liability and tax collection of $143 million (or about 14% of individual income tax collected). A possible explanation for the difference is that taxpayers who falls below the filing requirement or owes little to no tax that have withholding by their employers, did not file their tax returns[7]. Therefore, the revenue impact of exempting from individual income tax those is poverty is likely much greater than the $21.5 million estimated reduction in reported liability.

IV. Discussion

Defining "income" to determine poverty level is not an easy task. The issue with using adjusted gross income is that it includes business loss, capital loss, depreciation, etc. Taxpayers with low adjusted gross income may not necessarily be poor. It could be that those taxpayers have a big capital loss for the year, for example.

Income tax reliefs, such as the food/excise tax credit and low income household renters' credit are available to lower income households. Alternative options to provide tax reliefs to lower income households are increasing the food/excise tax credit amounts, increasing the credit amount for the low income household renters, indexing/increasing standard deduction, and indexing/increasing personal exemptions. The indexing/increasing standard deduction and personal exemptions are not as targeted to the lower income households as the food/excise tax credit and the renters' credit.

[7] Reported tax liability data are from tax returns, whereby tax collection data include withholding of income tax by employers. If taxpayers below poverty level are exempted from individual income tax, the employers will no longer have to withheld taxes for those with income below poverty level; hence, tax collection will decrease.

APPENDIX G:

COMMUNICATIONS FROM TAX DIRECTOR FREDERICK D. PABLO –

- **Feb. 22, 2012 Regarding Collection of Taxes and Enforcement of Tax Law**

- **Oct. 11, 2012 Regarding Modernization of Operations and Computer System**

NEIL ABERCROMBIE
GOVERNOR

BRIAN SCHATZ
LT. GOVERNOR

FREDERICK D. PABLO
DIRECTOR OF TAXATION

RANDOLF L. M. BALDEMOR
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February 22, 2012

The Honorable Randall Iwase, Chair
Tax Review Commission
830 Punchbowl Street
Honolulu, HI 96813

Dear Mr. Iwase,

At the Tax Review Commission (TRC) meeting on December 22, 2011, the Commission requested information from the Department of Taxation (DOTAX) regarding the collection of taxes and enforcement of tax law.

Our Tax Compliance Division reports that the accounts receivable balance as of September 30, 2011 reflects a total of approximately $1.3 billion, of which the following three categories are not in the collection inventory that is being actively worked:

Suspension for Amounts in Audit/Litigation	$478,802,282
Accounts Pending Resolution	$ 6,764,560
Accounts in Billing Cycle	$ 48,484,930
Sub-total	$534,051,772

The delinquent accounts which are in process or are being worked consist of the following categories:

Bankruptcy Balance	$163,922,260
Pending Write-off Balance	$126,690,439
Collection Balance	$485,222,385
Total including penalties and interest	$775,835,084

Soon after taking office, while reviewing the financial statements in February 2011, I noted the significant total balance of accounts receivables that had increased a billion dollars in the past ten years. We immediately began strategizing the most efficient and effective ways to reduce the amounts in the collection process. Our strategy includes:

- Partnering with other government agencies (e.g. Department of Health and Department of Commerce and Consumer Affairs) to match and update our data;
- Initiating process improvement methodologies to identify changes that will streamline current collection review processes; and
- Collaborating with the Chief Information Officer to utilize computer analytics for prioritization of the caseload.

Due to the existing computer system's limitations, our collection process is still heavily reliant on employees to review the cases. Therefore, our first priority is to ensure that the Department has the support from all facets of the government and community to modernize our computer system in the coming years. Almost equally important is the need to fill vacant positions that had been frozen during FY 2009-2011.

Over the past decade, the collections caseload increased substantially – not only were the pre-2009 staffing levels insufficient to keep up with the increasing collections caseload, the 2009 reduction-in-force (RIF) resulted in an 11% decrease in department staffing. The negative impact of the RIF was further compounded each year when positions that became vacant were frozen, resulting in a vacancy rate of approximately 20%. Furthermore, the furloughs in Fiscal Years 2010 and 2011, reduced the number of operating days each year. The Abercrombie administration has lifted the prior employment restrictions; however, due to the lengthy hiring process, restoring the collections staff back up to sufficient levels will take some time.

Another consequence of insufficient staffing is DOTAX's inability to provide taxpayers with adequate information and assistance. In the last few years, taxpayers have encountered delays in receiving replies to their inquiries. For example, the ability to assist callers to our main taxpayer assistance telephone lines decreased over the last few years; the telephone calls answered rate went from 80% in FY2009, to 61% in FY2010, to 40% in FY2011. When taxpayers cannot receive tax assistance, they are prone to fall into non-compliance with tax requirements.

Tax education and taxpayer assistance are critical for maintaining taxpayer compliance because it reduces the number of cases referred to the collection division. The U.S. census report issued in 2010, shows a significant increase in population over the past twenty years, especially for the outside island districts – Hawaii 54%, Maui 54%, and Kauai 31%. Reviewing the workload for each district and matching the staffing levels needed to address the significant number of new taxpayers, will be critical for keeping taxpayers in compliance.

The reduced staffing levels have had a direct impact on our other compliance efforts in collecting revenue. Our Office Audit productivity decreased 38%; the number of completed audits dropped from approximately 11,600 cases in FY2010 to approximately 7,200 cases in FY2011. The reduced number of cases audited, resulted in a 31% reduction in tax assessments from $42.1 million in FY2010 to $23.6 million in FY2011, or a reduction of approximately $18.4 million in revenue collected.

Similarly, the number of cases closed by Field Audit decreased 31% from 332 cases in FY2010 to 229 cases in FY2011. The reduction in completed cases resulted in a reduction in tax assessments: from $118.9 million in FY2010 to $95.9 million in FY2011, or a reduction of almost $23 million in revenue collected. Moreover, the total cash collections decreased 9.3%, from $239 million in FY2010 to $218 million in FY2011. Reduced staffing translates into reduced revenue to the State of Hawaii.

As you can see, the challenges for DOTAX remain great. It will take time to hire and train personnel, as well as to getting current with the work inventory. Should you need further information, please do not hesitate to contact me.

Sincerely,

FREDERICK D. PABLO
Director of Taxation

NEIL ABERCROMBIE
GOVERNOR

BRIAN SCHATZ
LT. GOVERNOR

FREDERICK D. PABLO
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October 11, 2012

The Honorable Randall Iwase, Chair
Tax Review Commission
830 Punchbowl Street
Honolulu, HI 96813

Dear Chair Iwase,

I am writing to update the Tax Review Commission on the status of the Department of Taxation's (DoTAX) vision to modernize its operations and computer system.

Recently, the Department developed a report entitled the DoTax "SERVICE" Plan (SERVICE Plan), which calls for the modernization of our tax operations. The report addresses the state of our current infrastructure and technology challenges, and outlines the resources needed to allow us to fulfill our enforcement and collection of taxes. A redacted copy of the SERVICE Plan is attached for your review.

The improvements are aligned with our ultimate objective - improved "SERVICE" to the community. "SERVICE" means:

System Reliability & Integrity– We are the custodian of confidential taxpayer information and approximately $6 billion in annual revenue each year. We will modernize our physical and IT infrastructure to strengthen system reliability, external security and internal controls, protecting state revenue and confidential taxpayer information.

Expedited Processing – Over many years, we developed a reputation of long delays in processing returns and remittances, and in issuing refunds. The new system will emphasize electronic filing, expedited system programming changes, and streamlined processing functions.

Robust Collections & Audit Capabilities – Currently, we have limited insight into our data, which impacts our collections capabilities. The new system will be user-friendly and data-centric, allowing us to manage information more effectively and to utilize analytics to score, model and predict taxpayer behavior. With this technology, we will be able to collect substantially more revenue through analytics and automation to ensure everyone is paying their fair share.

Verified Reporting – We have an important responsibility to report revenues and expenditures with accuracy. However, our current IT system is not integrated. It does not capture important data fields, creating limitations on our reporting capabilities. The new system will enable us to report collections and expenditures accurately, and with greater specificity and detail.

Improved Customer Service – We desire to provide prompter, more reliable and more responsive service. The new system will feature, among other things, a more attractive and user-friendly mechanism for electronic filing and payment; self-service and remote access features for tracking account activity; and customer relationship management technology.

Collaboration – The new system will utilize a common business collaboration platform and upgraded integrated voice response (IVR) technology that centralizes critical information and makes it easier for employees to support one another. Our system will be integrated with the State's infrastructure to allow for enterprise-wide efficiencies and greater sharing of information.

Education & Training – As we modernize, there will be changes in our laws, processes and technology. Many employees will need training. Individuals in our community, especially our kupuna, may need help with electronic filing. Taxpayers and tax preparers will need a consistent flow of information on changes within the department. We will provide facilities for training, and utilize email and social media to provide updates on changes in our laws and processes.

As mentioned, challenges which impede the Department's ability to effectively and efficiently carry out its mission, include a computer system with outdated software and technology and limited functionality, a financial reporting system that requires employees to manually reconcile certain accounts, lack of integration of data across functions, and limited data security and internal controls.

The SERVICE Plan proposes to create a data-centered computer system to enhance collaboration amongst employees and maximize its resources. In addition to a new computer system, as part of its effort to enhance security of taxpayer data and collections, the Department plans to seek its own secure facility.

As you can see, the challenges for DoTAX remain great. It will take time to develop the infrastructure, hire and train personnel, and modernize our operations. Should you need further information, please do not hesitate to contact me.

Sincerely,

for FREDERICK D. PABLO
Director of Taxation

APPENDIX H:

SUMMARY OF RECOMMENDATIONS MADE BY TAX REVIEW COMMISSIONS

SUMMARY OF RECOMMENDATIONS MADE BY TAX REVIEW COMMISSIONS

Recommendation	*Commissions* 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	*Implementation and Comments*
Overall Tax Recommendations						
1. Maintain General Fund composite progressivity	X					Various targeted low-income tax credits have, over time, attempted to mitigate the regressivity of the general excise tax. However, the issue requires further analysis.
2. Eliminate or sunset tax exemptions and credits	X				X	Some tax credits have been enacted with sunset dates and have sunsetted or been repealed. In some cases, the sunset or repealed credit was replaced with an alternative. These credits have included the Individual Development Account Contribution Tax Credit (§235-5.6, HRS; allowed to sunset December 31, 2004), the Energy Conservation Credit (§235-12, HRS; allowed to sunset June 30, 2003), which was partially replaced by the Renewable Energy Technologies Credit (Act 70, SLH 2003), and the Residential Construction and Remodeling Tax Credit (§235-110.45, HRS; allowed to sunset June 30, 2003). **Act 105, SLH 2011:** Suspended temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from GET and Use Tax and requires the payment of both taxes at 4%. Effective July 1, 2011, and sunsets on June 30, 2013. For more information on Act 105, see Tax Announcement No. 2011-09 [http://www6.hawaii.gov/tax/announce/ann11-09.pdf]. For additional information on the history of tax credits, see the *Tax Credits Claimed by Hawaii Residents* report published annually by the Department of Taxation's Tax Research and Planning Office, which is available on the Department's website at www.hawaii.gov/tax.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
3. Minimize all tax exemptions and credits		X	X	X	X	The number of exemptions and credits, in general, have expanded. **Act 105, SLH 2011:** Suspended temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from GET and Use Tax and requires the payment of both taxes at 4%.
4. Establish General Fund Stabilization Fund	X	X	X	X		**Act 304, SLH 1999:** Established the Emergency and Budget Reserve Fund.
5. Maximize tax "exporting"	X					Hawaii taxes, including the income tax, GET, transient accommodations tax (TAT), and conveyance tax, are all exported to some extent. For more information, see 2002-2005 Tax Review Commission (TRC) Report, Appendix D, *Study on the Progressive or Regressive Nature of Hawaii's Taxes* .
6. Provide direct expenditure assistance, not narrowly targeted tax preferences	X				X	Narrowly targeted tax preferences have increased. One consideration may be that such preferences are not expenditures subject to the general fund expenditure ceiling established under Article VII, Section 9, of the Hawaii State Constitution.
7. Lower the overall level of state taxes		X	X		X	Tax rates have generally not been reduced, with the exception of the income tax rates for individuals and also for trusts and estates. **Act 157, SLH 1998:** Lowered individual income tax rates as well as the tax rates for trusts and estates, increased the number of tax brackets from 8 to 9, and expanded the tax brackets. **Act 110, SLH 2006:** Increased the standard deduction to 40% of the current federal standard deduction and expanded the tax brackets by 20%. For more information, see Tax Announcement No. 2006-10 [http://www6.hawaii.gov/tax/announce/2004_09/ann06-10.pdf].

Recommendation	*Commissions* 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	*Implementation and Comments*
						Act 60, SLH 2009: Added three new brackets and rates, 9%, 10%, and 11% for the high income taxpayers for taxable years 2009 to 2015. Act 60 also increased the standard deduction and personal exemption by 10% for taxable years 2011 and 2012. For more information, see Tax Announcement No. 2009-04 [http://www6.hawaii.gov/tax/announce/2004_09/ann09-04.pdf]. **Act 97, SLH 2011:** (1) eliminated the deduction for state taxes paid for taxpayers with income above income above specified thresholds, (2) placed temporary limitations on claims for itemized tax deductions by the lesser of the limitation provided in section 68 of the Internal Revenue Code or the limitation as specified under Act 97, and (3) delayed the standard deduction and personal exemption increases approved under Act 60, SLH 2009, by two years while also making those increases permanent. For more information, see Tax Announcement No. 2011-20 [http://www6.hawaii.gov/tax/announce/ann11-20.pdf].
General Excise and Use Tax Recommendations						
1. Maintain the GET structure	X				X	Structure has been maintained except for marginal changes.
2. Do not use exemptions to achieve vertical equity		X				Vertical equity has not been a major consideration in enacting legislation affecting the GET.
3. Limit exemptions to those needed for horizontal equity		X		X		Horizontal equity has not been a major consideration in enacting legislation affecting the GET.
4. Eliminate or limit exemptions intended to effect social policy such as the following:						

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
(a) $2,000 exemption for blind, deaf, or totally disabled persons			X			Not adopted. The exemption was expanded by **Act 110, SLH 2002**, to also include general, limited, and limited liability partnerships all of whose partners are blind, deaf, or totally disabled.
(b) Exemption for Hansen's disease patients			X			Not adopted.
(c) Limiting the 0.5% rate for blind, deaf, or totally disabled persons to the first $30,000 of gross receipts.		X	X			Not adopted.
5. Do not exempt health care services, food, apparel, or shelter from the GET and instead pursue those goals, if desirable, through low-income income tax credits or the appropriation and expenditure process					X	**Act 211, SLH 2007:** Amended the Low Income Refundable Tax Credit provided by §235-55.85, HRS, by (1) eliminating the name of the Low Income Refundable Tax Credit and changed the name to the Refundable Food/Excise Tax Credit; (2) adjusting the Hawaii adjusted gross income (AGI) to Federal AGI and increasing the credit amount per qualified exemption and the AGI that a Hawaii resident can earn in order to claim the credit. The credit amount is on sliding scale based on AGI. For more information, see Tax Annoucement No. 2007-14 [http://www6.hawaii.gov/tax/announce/2004_09/ann07-14.pdf].
6. Eliminate pyramiding on multiple lease transactions		X				**Act 353, SLH 1997:** A sublease deduction is allowed sublessors of real property pursuant to a written lease to effect a reduction in (not a total elimination of) the pyramiding effect of the GET on the amount of lease rent paid to the master lessor on the property, or portion of the property, that is being subleased.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
7. Eliminate pyramiding on inter-company transactions		X		X		All of the following Acts were enacted after the publication of the 1988-1990 TRC report and prior to the publication of the 2001-2003 TRC report. While the legislation reduced the pyramiding of the GET on business-to-business transactions, it did not eliminate all pyramiding at the 4% rate, such that the 2001-2003 TRC recommended codifying the principle that the 4% rate on consumption be applied only once; this recommendation was not adopted. **Act 71, SLH 1999:** Phased-in pyramiding relief to extend wholesale treatment to certain transactions in which the goods, services, amusements, etc., that are identifiable elements of what is resold (i.e., it relaxed the strict no-consumption rule). Qualifying transactions include certain service-to-service, service-to-goods, service-to-contracting, service-to-transient accommodations, goods-to-service, and goods-to-transient accommodations transactions. **Act 173, SLH 1999:** Allows sales of pre-packaged condiments to eating and drinking retailers to be taxed as a wholesale rather than a retail transaction. **Act 27, SLH 2000:** Taxes sales of prepaid calling cards as sales of tangible personal property, such that sales to licensed sellers for resale are taxed as wholesale transactions. **Act 198, SLH 2000:** Expanded Act 71, SLH 1999, to afford phased-in wholesale treatment to amusement-to-service, amusement-to-goods, and amusement-to-transient accommodations transactions. This Act also afforded phased-in wholesale treatment under the public service company (PSC) tax to certain transportation services provided to contractors (see also Act 9, 3rd SpS 2001, below) and to certain sales of telecommunications services by a public utility to an interstate telecommunications provider for resale.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
						Act 271, SLH 2000: Extends wholesale tax treatment to sales by a printer to a publisher of magazines or other printed material containing advertisements when the publisher is contracted by the advertisers to distribute a minimum number of magazines, etc., regardless of whether there is a charge to the persons who actually receive the magazines, etc. (e.g., free tourist magazines). **Act 9, 3rd SpS 2001:** Subjects certain transportation service providers to the GET instead of the PSC tax. Specifies that transportation service providers are service businesses, thus allowing transportation service providers to qualify for the phased-in wholesale rate on transactions other than transportation service-to-contracting transactions.
8. Eliminate or limit gross receipts splitting			X			Not adopted.
9. Subject imported services to the use tax		X	X			**Act 70, SLH 1999:** Subjects imported services to the use tax. **Act 198, SLH 2000:** Subjects imported contracting to the use tax.
10. Exempt residential rental income		X				Not adopted.
11. Eliminate blanket exemptions in favor of specific exemptions		X				**Act 286, SLH 1991:** Subjects insurance companies to the GET on gross income from the rental of real property and to the TAT on gross rental income from the furnishing of transient accommodations. **Act 106, SLH 1992:** Subjects financial institutions to the GET on non-financial services income such as gross income from the rental of real property, parking lot fees, safe deposit fees, tax preparation, payroll services, data processing fees, and seminar fees.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
						Act 116, SLH 1994: Subjects employee benefit plans to the GET on gross income from the rental of real property.
12. Eliminate or limit specific exemptions or special rates for:						
(a) Scientific contracts with the United States			X			Not adopted.
(b) Petroleum products refined in Hawaii			X			Not adopted.
(c) Loading, transporting, and unloading agricultural products			X			Not adopted.
(d) Sugarcane producers			X			Not adopted.
(e) Reimbursements to federal cost-plus contractors and sales of tangible personal property to the federal government			X			Not adopted.
(f) Certain real property rental income received by labor organizations			X			Not adopted.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
(g) Sales of locally produced agricultural, meat, or fish products to common carriers in interstate or foreign commerce for consumption out-of-State.			X			Not adopted. **Act 135, SLH 2003**, amended this provision to remove the limitation to locally produced products. The Hawaii Supreme Court ruled this provision unconstitutional in 1994 (*In Re the Tax Appeal of Hawaiian Flour Mills, Inc.*, 76 Haw. 1). The Department issued Tax Information Release No. 93-4 on November 10, 1993, after the Tax Appeal Court determined that the provision was unconstitutional, such that an exemption under this provision could not be claimed although an exemption for fresh food products shipped out of State continued to apply.
(h) Air pollution control facilities			X			Not adopted.
(i) Solid waste processors (waste-to-energy)			X			Not adopted.
13. Eliminate or minimize all GET exemptions			X		X	**Act 105, SLH 2011:** Suspended temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from GET and Use Tax and requires the payment of both taxes at 4%. Also see Overall Tax Recommendation No. 2.
14. Automatically sunset the following "new industry" development exemptions:			X			The 1995-1997 TRC specifically mentioned the 3 tax exemptions listed to the left. Some recent exemptions have automatic sunset dates. These include: (1) exemption for call centers (Act 195, SLH 2000), which will automatically sunset on June 30, 2010; (2) exemption for public Internet data centers (Act 221, SLH 2001), which sunset on December 31, 2005; and (3) sales of net operating losses by a qualified high technology business (Act 221, SLH 2001), which sunset on December 31, 2005.
(a) Motion picture industry			X			This exemption sunset on July 1, 1976. Act 135, SLH 2003, deleted the obsolete provision.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
(b) Retail sales of alcohol fuel			X			**Act 289, SLH 2000:** Amended §237-27.1, HRS, to repeal this exemption on December 31, 2006. (NOTE: The original legislation, Act 274, SLH 1980, would have sunset this exemption on July 1, 1985. Act 179, SLH 1981, extended the sunset date to June 30, 1992. Act 42, SLH 1988 repealed the sunset date.)
(c) Stock exchange			X			Not adopted. A stock exchange has not been established to date.
15. Clarify exemptions for nonprofit organizations for better compliance:						Nonprofit organizations are not automatically tax-exempt and must apply for tax-exempt status. Not all nonprofit organizations, including a number of categories that qualify for income tax exemption, are eligible for exemption from the GET. If granted an exemption, not all of an organization's income may be exempt; only income that qualifies under §237-23(b), HRS, is exempt.
(a) Require GET licenses for nonprofit organizations			X	X	X	**Act 155, SLH 2010:** Denied GET tax preference to taxpayers who fail to file their GET annual return and reconciliation later than twelfth month following the prescribed due date of the return. Also created a trust fund for the GET due on each business transaction; held an officer, member, manager, or other responsible person liable for the GET due, including any penalty and/or interest. Effective July 1, 2010, applied to gross income or gross proceeds received on or after July 1, 2010. For more information, see Tax Information Releases No. 2010-05 [http://www6.hawaii.gov/tax/tir/tir10-05.pdf].
(b) Require nonprofit organizations to file GET returns if they have more than $30,000 of gross receipts			X	X		
16. Extend tax-exemption to skilled nursing facilities and for-profit hospitals, infirmaries, and sanitaria				X		Not adopted.
17. Eliminate the exemption for nonprofit organizations OR establish a maximum exemption amount					X	The 2005-2007 TRC noted that the elimination of this exemption (§237-23, HRS) would not affect the exemption for donations or gifts pursuant to §237-24(4), HRS.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
18. Exempt inter-affiliate business transactions from the GET	X					**Act 155, SLH 2010:** Denied GET tax preference to taxpayers who fail to file their GET annual return and reconciliation later than twelfth month following the prescribed due date of the return. **Act 175, SLH 1988:** Exempted certain transactions between related entities, including common paymasters. Subsequently amended by Act 178, SLH 1997, Act 165, SLH 1999, and Act 221, SLH 2001. **Act 214, SLH 1998:** Exempts certain employee cost reimbursements received by a management company from related entities providing interstate or foreign common carrier telecommunications services.
19. Clarify the intermediary services provision and expand it to include a wholesale services concept			X			Administrative rules clarifying the application of the services rendered for or to an intermediary wholesale rate provision were adopted, effective January 22, 1999. **Act 71, SLH 1999:** Phased-in pyramiding relief to extend wholesale treatment to certain transactions in which the goods, services, amusements, etc., are identifiable elements of what is resold (i.e., it relaxed the strict no-consumption rule). Qualifying transactions include certain service-to-service, service-to-goods, service-to-contracting, service-to-transient accommodations, goods-to-service, and goods-to-transient accommodations transactions. **Act 198, SLH 2000:** Expanded Act 71, SLH 1999, to afford phased-in wholesale treatment to amusement-to-service, amusement-to-goods, and amusement-to-transient accommodations transactions. This Act also afforded phased-in wholesale treatment under the PSC tax to certain transportation services provided to contractors (see also Act 9, 3rd SpS 2001, which subjects certain transportation services to the GET instead of the PSC tax) and to certain sales of telecommunications services by a public utility to an interstate telecommunications provider for resale.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
20. Price paid by the purchaser for a good or service should be the measure of gross receipts	X					**Act 340, SLH 1986:** Enacted a division of income provision (i.e., income splitting) for tourism-related services (§237-18(f), HRS). The definition of "tourism-related services" was later expanded by Act 287, SLH 1991.
21. Exempt from the GET goods and services shipped out of Hawaii	X	X	X			**Act 239, SLH 1987:** Exempts sales of tangible personal property shipped out of Hawaii. **Act 70, SLH 1999:** Exempts exported services and contracting.
22. Subject public service companies to the GET and eliminate the PSC tax	X					**Act 9, 3rd SpS 2001:** Subjects certain transportation service providers to the GET instead of the PSC tax. Specifies that transportation service providers are service businesses.
23. Consider a sales tax or a value added tax to replace the GET	X					Not adopted. For more information, see 2005-2007 TRC Report, Appendix C, *Hawaii's General Excise Tax: Should the Base Be Changed?*
24. Rewrite the GET law to achieve clarity and transparency				X	X	Not adopted.
25. Remain involved in discussions on the Streamlined Sales Tax Project, but do not make a formal commitment at this time.					X	Various legislative proposals on this topic since 2007.
26. The 3-year statute of limitations on assessment of the GET should start from the filing of the last periodic GET return (Form G-45)					X	Not adopted.
Income Tax Recommendations						

Recommendation	*Commissions* 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	*Implementation and Comments*
1. Maintain existing corporate tax burden		X				Not adopted.
2. Eliminate the corporate income tax and study eliminating the individual income tax.					X	Not adopted.
3. Provide income tax credits to offset the regressive effects of the GET on food and drugs		X	X			At the time the report of the 1988-1990 TRC was issued, sales of food purchased with USDA Food Coupons (i.e., food stamps) and USDA WIC Food Vouchers were exempt from the GET, as were sales of prescription drugs and prosthetic devices and most medical services provided by tax-exempt organizations. A food tax credit had previously been enacted (Act 239, SLH 1987). For additional information about tax credits, see the *Tax Credits Claimed by Hawaii Residents* report published annually by the Department of Taxation's Tax Research and Planning Office, which is available on the Department's website at www.hawaii.gov/tax. **Act 321, SLH 1989:** Enacted a new medical services excise tax credit. The 4% medical services excise tax credit part of this credit was repealed by Act 23, SpS 1995, and the remaining nursing facilities excise credit portion sunset on June 30, 1997. **Act 187, SLH 1990:** Repealed the existing excise tax credit and combined it with an expanded version of the existing food credit to create the food/excise tax credit. The excise tax portion of the credit was repealed by Act 134, SLH 1995. The food credit was repealed by Act 157, SLH 1998. **Act 157, SLH 1998:** Enacted the low-income refundable income tax credit.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
						Act 211, SLH 2007: Amended the Low Income Refundable Tax Credit by (1) eliminating the name of the Low Income Refundable Tax Credit and changed the name to the Refundable Food/Excise Tax Credit; (2) adjusting the Hawaii adjusted gross income (AGI) to Federal AGI and increasing the credit amount per qualified exemption and the AGI that a Hawaii resident can earn in order to claim the credit. The credit amount is on sliding scale based on AGI. For more information, see Tax Annoucement No. 2007-14 [http://www6.hawaii.gov/tax/announce/2004_09/ann07-14.pdf].
4. Adjust the general excise tax credit for inflation		X	X			Not adopted. **Act 187, SLH 1990**, repealed the existing excise tax credit and combined it with an expanded version of the existing food credit to create the food/excise tax credit. The excise tax portion of the credit was repealed by **Act 134, SLH 1995**. **Act 157, SLH 1998:** Enacted the low-income refundable income tax credit. **Act 211, SLH 2007:** Replaced the low-income refundable income tax credit with food/excise tax credit which increases the income threshold and the credit amount.
5. Add back capital gains, dividends, interest, retirement contributions, unemployment and workers compensation payments, public assistance benefits and individual housing account payments to the adjusted gross income base used to determine eligibility for low-income tax credits.		X				**Act 211, SLH 2007:** Replaced the low-income refundable income tax credit with food/excise tax credit and replaced the Hawaii AGI with Federal AGI, which includes retirement income not taxed by the State.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
6. Expand the individual income tax brackets	X	X	X	X	X	**Act 239, SLH 1987:** Reduced the top individual income tax rate from 11% to 10%, reduced the number of tax brackets from 12 to 8, and phased in an expansion of the new tax brackets through 1988. **Act 321, SLH 1989:** Reduced the lowest individual income tax rate from 2.25% to 2% and expanded the tax brackets beginning in 1989. **Act 157, SLH 1998:** Increased the number of individual income tax brackets from 8 to 9; phased in over a 4-year period beginning in 1999 a reduction of the individual income tax rates such that the rates in 2002 were 1.40% to 8.25%; and expanded the tax brackets. **Act 110, SLH 2006:** Expanded the tax brackets by approximately 20% beginning in 2007. **Act 60, SLH 2009:** Added three new brackets and rates, 9%, 10%, and 11% for the high income taxpayers for taxable years 2009 to 2015.
7. Increase the standard deduction	X	X	X	X	X	**Act 321, SLH 1989:** Increased the standard deduction to the following: single - $1,500; married filing joint return and qualifying widow(er) with dependent child - $4,000; married filing a separate return - $950; and head of household - $1,650. **Act 110, SLH 2006:** Increased the standard deduction to the following: single and married filing a separate return - $2,000; married filing joint return and qualifying widow(er) with dependent child - $4,000; and head of household - $2,920. **Act 60, SLH 2009:** Increased the standard deduction and personal exemption by 10%. Standard deduction: single and married filing a separate return - $2,200; married filing joint return and qualifying widow(er) with dependent child - $4,400; and head of household - $3,212. Personal exemption: $1,144. Applied to taxable years 2011 to 2015.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
						Act 097, SLH 2011: Delayed by two years the increase in standard deduction and personal exemption approved under Act 60, SLH 2009, while also made permanent the increases. Applied to tax years beginning after 12/31/10.
8. Provide double the standard deduction to taxpayers over age 65	X					Not adopted.
9. Reduce top individual income tax rates		X				**Act 239, SLH 1987:** Reduced the top individual income tax rate from 11% to 10%; reduced the number of tax brackets from 12 to 8; and phased in an expansion of the tax brackets through 1988. **Act 157, SLH 1998:** Increased the number of individual income tax brackets from 8 to 9; phased in over a 4-year period, beginning in 1999, a reduction of the individual income tax rates such that the rates in 2002 were 1.40% to 8.25%; and expanded the tax brackets. **Act 60, SLH 2009:** Temporarily added three income tax brackets that increased the tax on individuals with high net taxable incomes from a maximum of 8.25% to 11%. Applied to taxable years beginning after 12/30/08, set to sunset on 12/31/15.
10. Increase the personal exemption			X	X	X	**Act 78, SLH 1985:** Increased the personal exemption to $1,040. **Act 60, SLH 2009:** Increased the personal exemption by 10% to $1,144. Applied to taxable years beginning after 12/31/10, and set to sunset on 12/31/15. **Act 97, SLH 2011:** Delayed by two years the increase in personal exemption approved under Act 60, SLH 2009, while also made permanent the increases. Applied to tax years beginning after 12/31/10.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
11. Index the individual income tax standard deduction, personal exemption and tax brackets for inflation					X	Not adopted.
12. Change the maximum net capital gains tax rate			X			Not adopted.
13. Exempt additional types of pension income			X			Not adopted.
14. Phase in taxation of all pension income			X	X		Not adopted. See Recommendation 15 below for the 2005-2007 TRC's recommendation.
15. Conform to the federal tax treatment of retirement income, excluding an annual base amount (e.g., $50,000)					X	Not adopted.
16. Revise the taxation of nonresidents to prorate the standard deduction and personal exemption			X			**Act 281, SLH 1997:** This Act did not directly prorate the standard deduction and personal exemption amounts claimed by nonresident individual taxpayers. However, it changed the method by which the tax liability of nonresidents was computed to one in which the taxpayers' worldwide income was used to compute the nonresident taxpayers' total tax liability and the total tax liability prorated (note that the standard deduction and the personal exemption amounts were therefore deducted from worldwide income in the same manner as Hawaii residents). This was the California model mentioned in the 1995-1997 TRC's report. This proved hugely unpopular, with letters coming in from many quarters including from U.S. Senators and Representatives on behalf of their constituents in the military.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
						Act 253, SLH 1999: Repealed Act 281, SLH 1997, and provided for the apportionment of the standard deduction and personal exemption.
17. Adopt withholding rules for all nonresident taxpayers involved in pass-through entities such as partnerships, S-corporations, and limited liability companies					X	Not adopted.
18. Eliminate military exception for non-recognition of gain from principal residence			X			**Act 113, SLH 1998:** Conformed Hawaii law to §121, Internal Revenue Code (IRC), to exclude the gain on the sale of a residence. This repealed the former deferral of gain provision that included the exception for military personnel.
19. Limit like-kind exchange tax deferrals to situations where the replacement property is in Hawaii		X	X			Not adopted.
20. Require an exchange facilitator or intermediary of a like-kind exchange to withhold and remit the tax on any shortfall of the amount exchanged at the same rate as sales of real property by nonresidents					X	Not adopted.
21. Limit involuntary conversion tax deferrals to situations where the replacement property is in Hawaii			X			Not adopted.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
22. Eliminate National Guard and Reserve exclusion, political contribution deduction, individual housing account deduction, and child passenger safety restraint credit				X		Not adopted. The adjustment to income deduction for those serving in the Hawaii National Guard or in the reserves was increased by **Act 197, SLH 2004**.
23. Conform to federal requirements for an automatic extension of time to file a tax returns			X			The 1995-1997 TRC recommended in its discussion "that the 90% requirement to receive an automatic extension be eliminated". Section 18-235-98, HAR, was amended effective October 6, 2007, to grant an automatic six-month extension. "Property estimated tax liability" (safe harbor) will be presumed if the tax still owing after the due date prescibed by the statute for the filing of a return (determined without regard to any extension) is 10% or less of the total tax shwon as due on the return.
24. Conform to federal filing deadlines			X			Not adopted.
25. Simplify the filing of income tax returns	X					Form N-13EZ was introduced for the 2003 tax year. A short short-form that was roughly equivalent to the federal Form 1040EZ, it was for use by certain Hawaii residents with no dependents and was available for tax years 2003 and 2004. Form N-13EZ was discontinued for the 1995 tax year due to the introduction of the Form N-11 for individuals who were Hawaii residents for the entire year and who filed a federal income tax return using the same filing status as the Hawaii return.
26. Replace the medical services excise tax credit with one included under itemized medical deduction		X				Not adopted. This credit was repealed by Act 134, SLH 1995.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
27. Increase the conformity of the State income tax with the federal income tax	X	X		X		Not adopted.
28. Narrow the gap between taxable income and actual economic income by including portions of pension income and part of social security benefits of high-income taxpayers	X					Not adopted.
29. Conform to federal treatment of capital gains		X				**Act 102, SLH 1988:** Added §235-55.6(f), HRS, implementing a maximum tax rate of 7.25% on net capital gain income.
30. Adopt a Hawaii Alternative Minimum Tax	X					Not adopted.
31. Do not allow special "check-offs" similar to the Hawaii Election Campaign Fund	X					Additional check-offs have been added. Unlike the Hawaii Election Campaign Fund check-off, however, the new check-offs reduce the individual taxpayer's overpayment of tax, thereby reducing the refund the taxpayer would have been entitled to. The new check-offs are: (1) $2 check-off for the Hawaii School-Level Minor Repairs and Maintenance Special Fund, Act 311, SLH 2001; (2) $2 check-off for the State Library Special Fund, Act 193, SLH 2003; and (3) $5 check-off for the Hawaii Children's Trust Fund, Domestic Violence Prevention Special Fund, and Spouse and Child Abuse Special Account, Act 228, SLH 2004.
32. Adjust corporate income tax brackets to increase progressivity	X					**Act 239, SLH 1987:** Expanded the number of corporate tax brackets from 2 brackets (5.85% and 6.435%) to 3 brackets (4.4%, 5.4%, and 6.4%), and added an alternative tax rate for capital gain income (3.08% prior to April 1, 1987, and 4% after March 31, 1987). **Act 10, SLH 1988:** Amended the corporate tax treatment of capital gain income.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
33. Partially "de-couple" from the federal accelerated depreciation rules (ACRS) such that ACRS applies to personal property but not to real property	X					Not adopted.
34. Subject sales of real property by nonresident sellers to withholding						**Act 213, SLH 1990:** Requires purchasers of real property to withhold 9% of the amount realized from nonresident sellers. **Act 279, SLH 1991:** Reduced the amount to be withheld from 9% to the current 5% rate.
35. Increase the withholding rate on sales of real property by nonresident sellers and impose penalties on withholding agents for noncompliance					X	Not adopted.
36. Overhaul the business incentives tax credit process						
(a) Overhaul and update the capital goods excise tax credit			X			Not adopted.
(b) Conduct a cost-benefit study prior to enacting or revising a tax credit program				X		Not adopted.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
(c) Require periodic evaluations of all tax incentive programs				X	X	**Act 206, SLH 2007:** §235-20.5; §235-110.9 (1) Required a qualified high technology business (QHTB) that accepts an investment for which the High Technology Business Investment Tax Credit (HTBITC) may be claimed to complete and file an information survey with the Department before June 30 of each calendar year; (2) Required any QHTB receiving an investment for which a credit may be claimed to waive confidentiality and to allow the Department to disclose that the QHTB is a beneficiary of the HTBITC; (3) Required the Department to prepare a report to the Legislature summarizing the data obtained from the survey by September 1 of each year; and (4) Required the Department to study the effectiveness and impact of the HTBITC and reported to the Legislature by December 1 of each year. For more information, see Tax Announcement No. 2007-11 [http://www6.hawaii.gov/tax/announce/2004_09/ann07-11.pdf].
(d) Require beneficiaries of tax incentive programs to file truth and disclosure reports separately and apart from tax returns and make all aspects of the subsidies public				X	X	**Act 88, SLH 2006:** §235-17 Refundable motion picture production income tax credit - Created prequalification standards and oversight by the Department of Business, Economic Development, & Tourism and the Hawaii Film Office. Each taxpayer must apply through the Hawaii Film Office and have the credits certified. A taxpayer claiming this credit must attach the certification with the taxpayer's tax return. For more information, see Tax Announcement No. 2006-05 [http://www6.hawaii.gov/tax/announce/2004_09/ann06-05.pdf].
(e) Embed tax incentives in strategic plans to leverage scarce State resources				X		Not adopted.
(f) Encourage public participation in and comment on tax incentive use to foster public accountability				X		Incorporated, to some extent, into administrative practices.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
(g) Require sunset provisions to ensure that targeted benefits were realized before extending an incentive.				X	X	Sunset provisions have been incorporated into some tax incentives, such as the motion picture, research, and high technology business investment tax credits.
37. Gain control of the qualified high technology business investment tax credit tax incentive and curb potential abuses by changing it from a tax credit to a program of grants administered by a State agency OR:					X	
(a) Require that the reporting of data be mandatory and expand the types of required data to include sales, employment data on compensation, status, and whether the job was full-time, part-time, or seasonal					X	**Act 206, SLH 2007:** §235-20.5; §235-110.9 (1) Required a qualified high technology business (QHTB) that accepts an investment for which the High Technology Business Investment Tax Credit (HTBITC) may be claimed to complete and file an information survey with the Department before June 30 of each calendar year; (2) Required any QHTB receiving an investment for which a credit may be claimed to waive confidentiality and to allow the Department to disclose that the QHTB is a beneficiary of the HTBITC; (3) Required the Department to prepare a report to the Legislature summarizing the data obtained from the survey by September 1 of each year; and (4) Required the Department to study the effectiveness and impact of the HTBITC and reported to the Legislature by December 1 of each year.
(b) Collect the data by NAICS code and make the data periodically available to the public, but not less than annually					X	
(c) Require a tax confidentiality waiver so that pertinent data can be released to the public					X	

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
(d) Conduct an independent evaluation of the credit prior to enacting any extension of the credit					X	Not adopted.
38. Allow an extension for certification for the high technology credit					X	See **Act 206, SLH 2007** above.
39. Require beneficiaries of tax credits to file truth in disclosure reports in addition to income tax returns					X	
Miscellaneous Recommendations						
1. Ensure that the following special funds are self-supporting						
(a) Highways	X	X				Self-supporting.
(b) Airport	X					Self-supporting.
(c) Harbors	X					Self-supporting.
(d) Parking	X					Self-supporting.
(e) Unemployment Compensation	X					Self-supporting.
(f) Disability Compensation	X					Self-supporting.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
(g) Airport	X					Self-supporting.
2. Establish a TAT without earmarking the resulting revenue	X					**Act 340, SLH 1986:** Enacted a TAT without earmarking. However, subsequent amendments earmarked revenues as follows: **Act 185, SLH 1990:** Earmarked 95% of the TAT collected for the counties. **Act 7, SpS 1993:** Earmarked a portion of the TAT collected for the Convention Center Capital and Operating Special Fund (currently the Convention Center Enterprise Special Fund). **Act 156, SLH 1998:** Earmarked a portion of the TAT collected for the Tourism Special Fund. **Act 210, SLH 2002:** Earmarked a portion of the TAT collected for the State Parks Special Fund, Hawaii Statewide Trail and Access Program (currently the Special Land and Development Fund established for the Hawaii statewide trail and access program), and TAT Trust Fund. **Act 60, SLH 2009:** For the period beginning July 1, 2009 to June 30, 2010, the tax increases by 1%, from 7.25% to 8.25%. For the period beginning July 1, 2010 to June 30, 2015, the tax increases another 1% to 9.25%. Act 61 will be repealed on June 30, 2015, and the TAT rate will be reenacted at 7.25% for the period beginning July 1, 2015, and thereafter. The 1% increases shall be deposited into the general fund, except for FY 2011, 12.5% of the 2% increase deposited into tourism special fund.
3. Transfer TAT taxing authority to the counties		X				Not adopted.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
4. Reconcile the TAT base with the visitor lodging expenditure estimates using data published by the Department of Business, Economic Development and Tourism (DBEDT) and the Hawaii Visitors Bureau		X				Not adopted.
5. Conform to the federal estate tax repeal provisions except the repeal of the state death tax credit				X		Not adopted.
6. Continue the PSC tax and share receipts with the counties		X				**Act 64, SLH 2001:** Effectuated an agreement entered into by the State of Hawaii, the City & County of Honolulu, the County of Maui, the County of Kauai, the County of Hawaii, and a number of public service companies to share PSC tax revenues with counties that establish by ordinances an exemption from real property tax for public service companies.
7. Establish a mechanism to tax commercial airlines	X					Not adopted. Federal law preempts state taxes on gross receipts of airlines. See *Aloha Airlines, Inc. v. Director of Taxation* (464 U.S. 7).
8. Impose fuel and liquor taxes on an *ad valorem* basis rather than on a per unit basis	X					Not adopted.
9 Consolidate fuel tax at the state level		X				Not adopted.
10. Retain liquor and tobacco taxation at the state level		X				Has not been changed.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
11. Liquor and tobacco tax collections should cover government costs resulting from the use of these products		X				Indeterminate. Settlement funds received pursuant to the 1998 Tobacco Master Settlement Agreement in part mitigate government tobacco-related costs.
12. Subject firms taxed under the insurance premiums tax to the GET for rentals and other business receipts.	X					**Act 286, SLH 1991:** Subjects to the GET and TAT the gross rental income received by taxpayers subject to the insurance premiums tax.
13. Subject insurance commissions to the 4% GET rate rather than the 0.15% rate, and concurrently review the insurance premiums tax rates			X			Not adopted.
14. Franchise tax:						
(a) Eliminate the in-lieu taxes on financial institutions and insurance companies and integrate the taxation of these types of taxpayers into the regular tax system after a careful evaluation of such a change	X					Not adopted.
(b) Eliminate the federal income tax deduction from the franchise tax		X				**Act 106, SLH 1992:** Eliminated the deduction for federal income taxes.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
(c) Set the franchise tax rate equal to the corporate income tax rate		X				Not adopted.
(d) Conform the franchise tax law to the corporate income tax rules for the allocation and apportionment of income		X				Not adopted.
15. Allow taxpayers to make a deposit against future tax liability to stop continued accrual of interest					X	Not adopted.
16. Adopt §7430, IRC, to require the Tax Appeal Court to award court fees for actual costs where the position of the Department is found to be "not substantially justified," subject to court approval					X	Not adopted.
17. Establish an Appeals Office modeled after the Appeals Office of the Internal Revenue Service					X	**Act 166, SLH 2009:** Provided the Department with the authority to establish expedited appeals and dispute resolution program. The Director, or designee, shall serve as an independent appeals officer and shall be authorized to compromise, settle, or otherwise resolve any dispute on any basis, including hazards and costs of litigation, considering equally the position of the taxpayer and the department on an impartial basis.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
18. Repeal the part of §232-7, HRS, that states that hearings before the Board of Review are public hearings					X	**Act 166, SLH 2009:** Modified §232-7(b) be inserting "A taxpayer's identity and final documents submitted in support or opposition of an appeal shall be public information; provided that an individual taxpayer is authorized to redact all but the last four digits of the taxpayer's social security number from any accompanying tax return".
19. Establish a state lottery	X					Not adopted.
20. Use unrestricted State grants only when necessary to equalize the fiscal capacity of the counties		X				Not adopted.
21. Counties should make better use of their existing revenue authority (property taxes, user fees and charges, and development fees and extractions)		X				Indeterminate.
22. In addition to its statistical studies of the individual and corporate income tax, the Department should conduct annual statistical analyses of GET data	X					Statistics regarding the GET are released, but an analysis is not being conducted due to insufficient resources.

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
23. The Department should compile detailed information on the GET to better identify the source and nature of the gross receipts		X				This is not being done due to insufficient resources. The reporting of gross income by taxation district was required on a Schedule C pursuant to the 0.5% county surcharge tax enacted in 1990 (Act 184, SLH 1990). However, this reporting requirement was burdensome to taxpayers, and was discontinued after a few years in part because no county passed a surcharge tax. This section, §237-8.5, HRS, was repealed by Act 135, SLH 2003.
24. Give the Department resources to monitor business incentive tax credits				X	X	Budget cuts, reduction in force, and furlough have decreased the Department's ability to monitor business tax incentive tax credits.
25. Give the Department resources to conduct out-of-state audits				X		Out-of-state audits are being conducted, but are limited by staffing and funding constraints.
26. Provide adequate resources to the Tax Research and Planning Office for updating or improving economic forecasting and modeling capabilities for: (a) tax incentives (exemptions and credits); (b) auditing activities; (c) nonprofit organizations; (d) conformity with federal tax laws; (e) equity concerns; (f) bracket creep; (g) administrative costs; and (h) State corporate tax revenue trend analysis				X	X	Resources are still insufficient. One economist position was transferred from DBEDT in 1997, but one statistician position was abolished. Due to budget cuts and reduction in force, the Tax Research and Planning Office is left without any research statistician. In 2009, one (1) permanent research statistician position was eliminated to meet the mandatory reduction in force in FY 2010, and thereafter. In 2010, two (2) permanent and one (1) temporary research statistician positions were eliminated as vacancy reductions in FY 2011, and thereafter

Recommendation	Commissions 1983-1985	1988-1990	1995-1997	2001-2003	2005-2007	Implementation and Comments
27. Provide adequate resources to the Tax Research and Planning Office to analyze specific tax credits such as the following: (a) ethanol investment tax credit; (b) high technology business investment tax credit; and (c) energy conservation tax credit				X	X	Resources are still insufficient. One economist position was transferred from DBEDT in 1997, but one statistician position was abolished. In 2009, 1 permanent research statistician position was eliminated. In 2010, 2 permanent and 1 temporary research statistician positions were eliminated. Note that ethanol investment tax credit was amended by Act 140, SLH 2004, and renamed the ethanol facility tax credit, and that the energy conservation tax credit sunset on June 30, 2003, and was replaced with the renewable energy technologies income tax credit.
28. Consider the needs of the entire Department, not just revenue-producing positions, for adequate funding as a good investment for the State					X	Not adopted.