# APPENDIX E:

# REPORT OF DR. DONALD J. ROUSSLANG –

# “Principles of Sound Tax Policy for Hawaii”

# PRINCIPLES OF SOUND TAX POLICY FOR HAWAII

## Report Prepared for the 2015-2017 Hawaii Tax Review Commission

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by

Dr. Donald J. Rousslang

Rules Office

Hawaii Department of Taxation*

* The views expressed are those of the author and should not be ascribed to the Hawaii Department of Taxation or to the Tax Review Commission.

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# 1 INTRODUCTION

The two basic principles for sound tax policy are that taxes should be fair and they should be efficient. Standards for what makes taxes fair are hard to set, because they depend on the individual's perspective. For example, a tax that seems fair to one person might look too heavy to some and too light to others. An efficient tax system raises enough money to pay for desired government services, it is cheap and easy for tax officials to administer and for taxpayers to comply with, and it interferes as little as possible with economic decisions of individuals and of businesses. The two basic principles complement each other, because if taxpayers deem taxes to be fair, it is easier to get tax compliance. However, as explained below, they also conflict with each other.

What follows is a more detailed discussion of principles of sound tax policy for Hawaii. In establishing the principles, I took it as my goal to maximize the economic welfare of Hawaii residents. That is why I added "for Hawaii" to the title. In particular, it is important to take account of the large amount of spending by nonresidents on goods and services that are consumed within the State. For example, in 2016, visitors spent more than $15.9 billion in Hawaii, which was about 19 percent as great as the State's gross domestic product.[1] The nonresident spending within the State provides an opportunity to shift (or "export") an important part of the burden of the state's

[1] Data on visitor spending and the state's gross domestic product are from Research and Economic analysis, Department of Business, Economic Development and Tourism, *2016 State of Hawaii Data Book*, tables 7.26 and 13.03, available at http://dbedt.hawaii.gov/economic/databook/db2016/.

consumption taxes to nonresidents. I assume other taxing jurisdictions would take no action in response to any tax changes made by Hawaii.

## 2 FAIRNESS

Fairness of taxes, or tax equity, usually is measured using two standards: horizontal equity and vertical equity. A third standard sometimes mentioned is the "benefits principle."

### 2.1 Horizontal Equity

Horizontal equity requires that taxpayers in the same situation face the same tax burdens. Horizontal equity is important and should be adhered to rigorously. A "tax cliff," where a small change in the tax base leads to a large change in tax liability, is one way to violate horizontal equity. For example, in Hawaii's individual income tax, the itemized deduction for state income taxes is lost for a single taxpayer with federal adjusted gross income of $100,000 or more. For some taxpayers, this means that a few dollars less in income would reduce their Hawaii income tax by more than $600. Those who find themselves in this situation might feel justified in fudging the tax figures. Tax cliffs foster disrespect for tax laws, which leads to noncompliance and makes taxes harder to administer. Another way to violate horizontal equity is to give special tax breaks to selected classes of individuals or for selected activities.

### 2.2 Vertical Equity

Vertical equity is usually taken to mean that people with higher income should pay tax at a higher rate than people with lower income. The notion is that taxes should be based on the ability to pay, or said another way, that the pain of taxes should be the same for everyone. Typically, to help achieve vertical equity, income below an amount deemed necessary to live is exempt from tax and income above this amount is taxed at graduated rates. Vertical equity is hard to measure by objective standards. Most people would agree that income below an amount needed to live should not be taxed,[2] and most would also agree that the rich should pay tax at a higher rate than the poor. But no one can say with authority how much income is needed to live or how progressive tax rates should be.

The goal of vertical equity for an income tax conflicts with the goal of tax efficiency, because the efficiency cost of the income tax (for example, the tendency for the tax to discourage people from working and from saving) depends only on the tax rate on the last dollars earned.[3] This means that a progressive income tax imposes a greater efficiency cost than a proportional income tax that yields the same revenue.

It is hard to design a sales or excise tax that depends on the income of the consumer, so vertical equity is hard to achieve with these taxes. Sometimes, consumption

[2] This is probably the biggest shortcoming of Hawaii's individual income tax, because the standard deduction and personal exemption have not been indexed for inflation. Consequently, the tax starts at a level of income that is much lower than that for the federal income tax, even though Hawaii's cost of living is above the national average. For example, for tax year 2017, for a married couple with one child, Hawaii's standard deduction and personal exemptions add up to $7,872, whereas the federal standard deduction and personal exemptions add up to $24,850.

[3] This is a well-known result in the field of public finance.

of things that are deemed necessities (such as groceries) are exempted from the tax to help achieve vertical equity. However, such exemptions distort consumption choices and increase the costs of tax administration and so conflict with the goal of efficiency. However, it is not necessary that each tax meet a standard of vertical equity on its own, as long as the tax system as a whole meets the public standard for tax equity. For example, Hawaii's general excise tax (GET) is regressive; low-income people tend to save less, so they pay more GET per dollar of income compared to high-income people. But Hawaii's individual income tax is progressive and it also provides refundable tax credits that help reimburse low-income people for the general excise taxes they pay on food and rent. One might presume that Hawaii's current tax structure meets the public desire for a progressive tax system, because it is the product of a democratic process.

### 2.3 The Benefits Principle

The benefits principle says that those who benefit from the government services should pay for them. At the state level, most government services are in the public sector, instead of in the private sector, either because it would be hard to make people who benefit from the services pay for them (such as public highways), or because the services go to people who cannot afford them (such as public welfare). In these cases, the benefits principle can't be applied. However, the benefits principle is useful for determining which government services should be paid for with user fees and which should be paid for with taxes.[4] If the services can be limited to beneficiaries who can afford them, they should be paid for with fees instead of with taxes, because this causes users to take account of the cost of the services, which discourages wasteful overuse.

## 3 EFFICIENCY

Obviously, the costs of administering and collecting the taxes should be kept as low as possible, but these costs are anyway low. For Hawaii, the Department of Taxation administers and collects the great bulk (about 95 percent) of the State's taxes. In fiscal year 2016, it performed this chore with an annual operating budget of about $24 million. Net tax collections by the Department that year were about $6.9 billion, so the administration and collection costs were about 35 cents for each $100 of net tax revenues, or a little more than one third of one percent.[5]

Taxes usually impose a cost on taxpayers in addition to the tax they pay. Part of the extra cost is the cost of complying with the tax laws. Compliance costs are harder to

[4] A tax is a compulsory payment in return for which the taxpayer receives no direct or specific benefit, that is, there is no *quid pro quo*. A fee is a charge for a specific benefit, but if the charge raises more money than needed to cover the cost of the benefit, the extra amount is a tax. For example, Hawaii levies fees on insurance producers for the cost of regulating the insurers. In 2010, the Legislature temporarily doubled the fees (for fiscal years 2010 through 2014) and had the extra amount deposited into the General Fund. The increase in the levy was a tax and not a fee. In general, any payment that goes to the General Fund would be considered a tax.

[5] See the Department of Taxation's *Annual Report: 2015-2016*, page 51. The figure for administration and collection costs does not include the cost of the Department's new Tax System Modernization project, which is estimated to cost about $60 million over several years. However, the cost of the new system must be amortized over its useful life. Even if we included the costs of the new system as they are incurred (in essence, expensing rather than amortizing them), the cost of administering and collecting Hawaii's state taxes would still be little more than one half of one percent.

estimate than the costs of administering and collecting taxes, but the available evidence is that they probably are bigger by an order of magnitude.[6] The biggest cost of taxes, though, and also the hardest to measure, is that they tend to distort economic decisions. For example, taxes on income discourage people from working and from saving. For the federal income tax, these distortions have been estimated to cost between 11 percent and 15 percent as much as the total collections.[7] In fact, most studies of the costs of taxes ("optimal tax theory") focus exclusively on the cost of the economic distortions they cause.[8]

There are two other economic effects that should be considered when designing a tax system, but that usually are not included in lists of principles of sound tax policy. The first is that the burden of a tax can sometimes be exported to nonresidents. The second is that some taxes help offset adverse side effects (called "negative externalities") that arise

[6] For example, Joel Slemrod, "The Compliance Cost of Taxing Business," April 25, 2006 (available at http://webuser.bus.umich.edu/jslemrod/pdf/cost_of_taxing_business.pdf) presents evidence that the compliance burden was about 2.7 percent of the revenue from the federal corporate income tax and about 5.8 percent of the revenue from state corporate income taxes. Scott A. Hodge, "The Compliance costs of IRS Regulations," Tax Foundation *Fiscal Fact*, (June 2016) (available at https://taxfoundation.org/compliance-costs-irs-regulations/) estimates that compliance costs for the federal individual income tax were $99 billion in 2016, which is about 6 percent of the total collections.

[7] See Robert Carroll, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," Tax Foundation Special Report, (August 2009) (available at https://files.taxfoundation.org/legacy/docs/sr170.pdf).

[8] See Jonathan Shaw, Joel Slemrod and John Whiting, "Administration & Compliance," prepared for *Reforming the Tax System for the 21st Century: The Mirrlees Review*, The Institute for fiscal Studies (April 2008) (available at www.ifs.org.uk/mirrleesreview).

when te activities of consumption or production impose costs on society that are not reflected in the private cost to the consumer or producer.

Because the economic effects of taxes typically are much bigger than the costs of tax administration or of tax compliance, we break the principles for sound tax policy that promote efficiency into two categories, depending on whether the principle helps reduce the cost of tax administration or compliance, or whether it addresses the economic effects of taxes.

### 3.1 Principles of Sound Tax Policy to Help Reduce the Costs of Tax Administration and Compliance

The main principles of sound tax policy that help reduce costs of tax administration and compliance are that the tax code should be simple and stable.

*Simplicity*

A simple tax code has the advantages of being easier for tax authorities to administer and to enforce and easier for taxpayers to comply with, which lowers both the cost of tax administration and the cost of tax compliance.[9] Simplicity of taxes also makes

[9] Some compliance costs are self-inflicted and come from an attempt to avoid as much of the tax as possible. Complexity sometimes comes from the need to curtail tax avoidance, but unnecessary complexity helps generate such activities. In this regard, Hawaii's individual and corporate income taxes are burdened with a plethora of tax credits that make the taxes harder to administer and that create opportunities for tax abuse This is especially true of the refundable tax credits. Hawaii's tendency to use income tax credits drew satire from a nationally known tax analyst. See David Brunori, "Hawaii Tax Credit Craziness," *Tax Analysts*, March 24, 2014 (available at https://www.forbes.com/sites/taxanalysts/2014/03/19/hawaii-tax-credit-craziness/#584a87db5269).

them more transparent, so that it is easier to hold accountable the parties responsible for designing and administering the tax system, including legislators.

*Stability*

Stability of the tax code reduces the costs of tax administration and compliance, and it also reduces uncertainty about the future, which helps individuals and businesses to make better plans. Another kind of stability sometimes mentioned in principles of sound tax policy is that tax revenues should be stable. Stability of tax revenues reduces uncertainty in government budget planning, because the State's operating budget is constrained by law to balance. Thus, the State should not rely overly much on taxes that show great volatility in collections over the business cycle, such as the corporate income tax. However, Hawaii's biggest state taxes are on income and consumption of individuals, which raises the question whether it is more important to keep private consumption or public services stable over economic cycles.[10]

## 3.2 Principles of Sound Tax Policy to Help Reduce the Economic Distortions Caused by Taxes

The main principle of sound tax policy to reduce economic distortions caused by taxes is that taxes should be neutral and not favor one economic activity or type of

[10] As Mark Twain quipped, "When everybody has got money they cut taxes, when they're broke they raise 'em. That's statesmanship of the highest order." The result is a more stable government budget, but less stability for private budgets. As shown in section III, in the recent recession, the State's General Fund tax revenues suffered greater declines than income in the economy as a whole.

consumption over another. A close relative to the principle of tax neutrality is the principle that the tax base should be set as broadly as possible so that the desired revenue can be raised with a lower tax rate.

### *Tax Neutrality*

The standard of tax neutrality requires that a tax be levied uniformly on its base, with no special tax breaks for selected activities or taxpayers. Uniform application of a tax helps minimize the effect on economic decisions. For example, it has been argued convincingly that Hawaii's general excise tax is a model of efficiency for other states to follow, because it has a broader base than sales taxes used on other states.[11] The notion is that unfettered private markets are the best way to get the most benefit from economic resources. The consensus among economists is that when tax authorities use tax credits or special tax breaks to encourage selected businesses, they usually reduce the overall economic well-being of residents. In addition to distorting economic decisions, special tax breaks complicate the tax code and make it harder to administer and to enforce.

[11] See Donald J. Rousslang and Jonathan W. White, "Is Hawaii's GET a Good Solution to State Budget Shortfalls?" *State Tax Notes*, March 27, 2017, pages 1127-1134. They provide estimates that the annual efficiency gains from having such a broad base compared to the base of the average state sales tax amount to several times as much as the cost of administering and collecting all of Hawaii's state taxes.

*Broad Base, Low Rates*

Uniform application of a tax to its base helps keep the base as broad as possible, so that the needed tax revenue can be gotten with the lowest tax rate possible. Keeping the tax rate low is important, because it reduces economic distortions caused by the tax.[12]

# 4 OTHER PRINCIPLES OF SOUND TAX POLICY

## 4.1 Tax Burdens That Can Be Exported to Nonresidents

When designing Hawaii's tax system, tax authorities should be mindful of opportunities to export the burden of local taxes to nonresidents. The portion of the tax burden that is exported varies greatly among Hawaii's taxes. For example, the background study on Hawaii's corporate income tax that was prepared for the 2015-2017 Tax Review Commission found that according to recent estimates of the share of "supernormal" profits (such as windfall gains or monopoly profits) in the corporate income tax base, more than 72 percent of the State's tax is exported to nonresidents, versus about 32 percent for Hawaii's individual income tax and 32 percent to 38 percent for Hawaii's GET.[13]

[12] The cost of distortions imposed by a tax tends to grow faster than the tax rate. Thus, exempting part of the tax base and making up the revenue by imposing a higher tax rate on the remainder of the base damages economic efficiency in two ways: it distorts the relative prices of the taxed and untaxed portions of the base and it raises the cost of economic distortions per dollar of revenue.

[13] Donald J. Rousslang and Yvonne Chow, "Should Hawaii Tax Corporate Income? A Cost Benefit Analysis," report prepared for the 2015-2017 Hawaii Tax Review Commission, July 19, 2017. (*See Appendix B.*)

### 4.2 Taxes That Provide a Public Benefit in Addition to Revenue

Instead of imposing an extra cost by distorting economic decisions, some taxes provide an extra economic benefit by helping discourage negative externalities. For example, a carbon tax discourages pollution.[14] Such taxes are the most efficient sources of tax revenue, but unfortunately their bases are too small to fully fund government services.

### 4.3 Tax Adequacy

A requirement for any tax system is to produce enough revenue to fund government services, but there is no way to say definitely how much of such services is enough. People choose the amount of government services they want based on the cost and their budget, just as they do for any other goods or services. In fact, at any time one can say that whatever amount of government services was actually provided must have been adequate, given the choices people faced. Instead of trying to define the amount of needed government services, a common approach to assess tax adequacy is to say that the current level of the services is adequate, either in absolute amount or as a share of the total economy, and then to ask whether the tax system will provide enough money to maintain the same level of services in the future.[15]

[14] Taxes that offset negative externalities are sometimes called Pigou taxes, after the British economist A.C. Pigou.

[15] See, for example, Joshua O. Fujino and Donald J. Rousslang, "Will Hawaii's Tax Structure Prove Adequate in the Future?" in Appendix E, Report of the 2010-2013 Tax Review Commission.

The need to provide adequate revenue limits the alternatives available to tax officials. In most cases there are only three tax bases broad enough to support a state government's spending needs: income, consumption and wealth. Hawaii's Constitution prohibits the State from taxing real property, so income and consumption are the State's main tax base alternatives.

### 4.4 Competitiveness

Helping local businesses compete with businesses in other taxing jurisdictions is often given as the reason for tax breaks for selected activities. The argument is that tax incentives are needed to attract or keep the selected activities in order to broaden the economy or to create jobs. Supporters view such attempts as enlightened industrial policy, but most economists (especially those with formal training in the field of public finance) are skeptical of the notion that policy officials can improve the local economy by distorting its taxes and are apt to view such attempts as akin to trying to pull oneself up by one's bootstraps. Usually, the best way to help local businesses compete is to apply each tax uniformly to its base so as to keep the tax base broad and the rate low.