



July 5, 2017

## Memorandum

To: Chair Colleen Takamura, Tax Review Commission  
Vice Chair Vaughn Cook, Tax Review Commission  
Ray Blouin, Tax Review Commission  
Nalani Kaina, Tax Review Commission  
John Knox, Tax Review Commission  
Dawn Lippert, Tax Review Commission  
Billy Pieper, Tax Review Commission  
Titin Sakata, Hawaii Department of Taxation

From: Randall Bauer, PFM

Re: State of Hawaii Tax Study High Level Findings

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### Introduction

PFM Group Consulting LLC (PFM) was retained by the Tax Review Commission (Commission) to study three specific (and often inter-connected) areas of interest for Hawaii tax policy: who bears the burden of Hawaii's taxes; options to reform Hawaii's taxes to make them less regressive; and the best ways to generate more revenue through new and existing sources and through improved compliance with Hawaii's tax laws.

To conduct these studies, the PFM project team held numerous meetings with key Hawaii stakeholders, including elected officials, state government leadership and subject matter experts, all members of the Commission and members of the business and academic communities. PFM also benchmarked and reviewed state taxation trends and best practices around the country and gathered and analyzed economic, demographic and revenue and expenditure data for Hawaii.

As part of the project plan, PFM provides high level findings to assist the Commission in its deliberations and to provide a general perspective on how PFM will shape its final report and recommendations to the Commission. These findings are also made available to assist the Commission in providing feedback on the direction of the PFM final report, which will be provided in approximately one month.

High level findings are primarily findings of fact or supportable conclusions. They do not generally make recommendations or even suggest conclusions. They are also, of course, subject to modification as additional information and analysis is conducted through the remaining weeks of the project.

The findings are organized into the three basic study areas undertaken by the PFM project team:

1. Who bears the burden of Hawaii's taxes?
2. What are ways to reform Hawaii's taxes to make them less regressive?
3. What are ways to generate more revenue through new and existing sources and through improved compliance with Hawaii's tax laws?



## **Who Bears the Burden of Hawaii's Taxes?**

Tax burden is an important consideration, as it impacts on key principles of taxation, particularly equity (both horizontal and vertical) and economic competitiveness. Principles of taxation were discussed at length in the PFM report to the 2012 Commission.

For the following analysis, PFM used State of Hawaii tax data from 2014-2015. It is notable that the higher marginal tax rates that were in place for tax years 2009 to 2015 were allowed to expire for 2016 and 2017. Therefore, the tax burden analysis reflects these higher rates. During the 2017 session, the Legislature reinstated these higher rates for following tax years. As a result, the effective rates and share of Hawaii incomes taxes paid by high income taxpayers would be lower than what is shown, should the Governor not sign those tax changes into law. This will be a settled issue by the time the final report is written. PFM will, where appropriate, discuss the likely impact of those changes in the final report.

***According to a national tax burden analysis, Hawaii's middle and upper income taxpayers have relatively lower tax burdens.<sup>1</sup>***

For tax burden comparison purposes, PFM has used data from an annual study conducted by the Chief Financial Officer for Washington DC.<sup>2</sup> This study compares the tax burden for the District of Columbia and each of the largest cities in all 50 states. It uses a family of three at different income levels for its analysis. The study is useful because it provides a national point of comparison of state and local taxes. PFM has used this study as a starting point in multiple state and local tax projects, including the study for the 2012 Commission.

According to the most recent annual tax rate and tax burden study, Honolulu households with incomes above \$50,000 have low tax burdens relative to most other large cities in the US. Households with incomes between \$50,000 and \$150,000 (the highest income cohort included in the study) on average have tax burdens between 6.1 and 7.5 percent of income – ranking in the lowest 20 percent nationwide, as shown in Table 1.

**Table 1: Honolulu, Hawaii National Tax Burden Ranking, 2015**

Income Level	Taxes					Tax Burden	
	Sales	Income	Property	Auto	Total	Percent	Rank (of 51)
\$50,000	\$823	\$1,293	\$692	\$251	<b>\$3,059</b>	6.1%	46
\$75,000	\$1,105	\$2,443	\$1,178	\$434	<b>\$5,160</b>	6.9%	43
\$100,000	\$1,354	\$3,758	\$1,664	\$555	<b>\$7,331</b>	7.3%	41
\$150,000	\$1,653	\$6,437	\$2,636	\$537	<b>\$11,263</b>	7.5%	40

Source: Washington DC Tax Rates and Tax Burdens 2015

<sup>1</sup> In the study, tax burden attributed to property tax is higher for those at \$25,000 than other households because it is calculated off an assumed rent for a 3-person family rather than off the assumed assessed value of a home. The median rent in Hawaii is approximately 56 percent above the national average, resulting in higher assumed property taxes paid through rent. However, property taxes in Hawaii are relatively low – the median paid residential property tax in Hawaii was over 1/3 below the national average in 2015. Therefore, the project team believes a 20 percent of rent assumption is highly inflated, and therefore that income cohort is not included in this analysis.

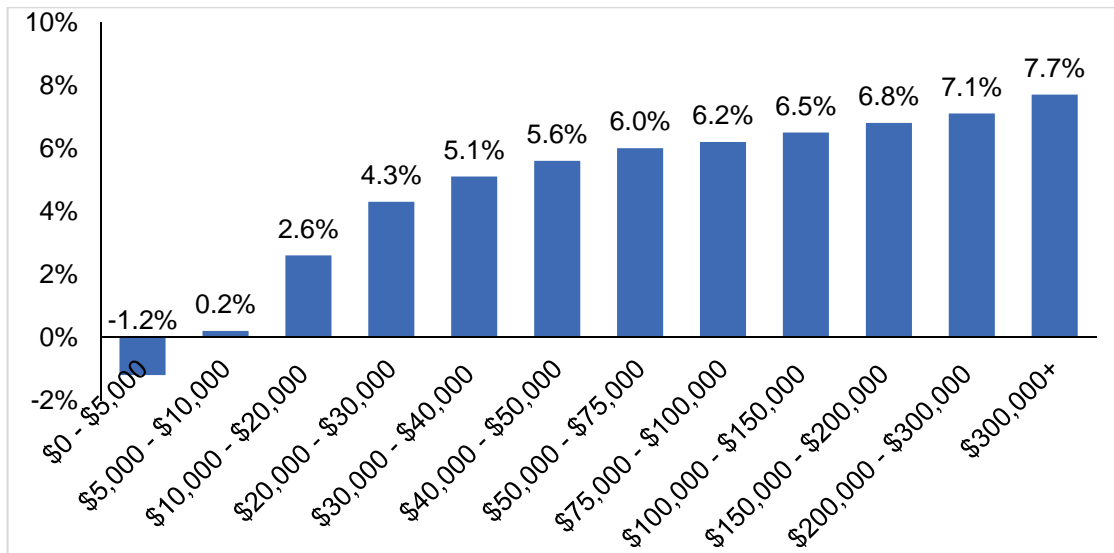
<sup>2</sup> Washington DC Tax Rates and Tax Burdens 2015 – A Nationwide Comparison. Issued December 2016.



**Hawaii's income tax structure is broadly progressive.**

The most significant marginal increases in effective tax rates occur between \$0 and \$40,000. Between \$40,000 and \$200,000, marginal increases are consistent but modest. A more significant rise in the effective tax rate occurs between \$300,000 and \$300,000 and more. Households making over \$300,000 and filing as a head of household pay 11 cents on the marginal dollar, one of the nation's highest marginal tax rates for upper income earners. The very wealthy pay at a significantly higher effective rate than other taxpayers.

**Figure 1: Effective Hawaii Income Tax Rate by Adjusted Gross Income Range, 2014**



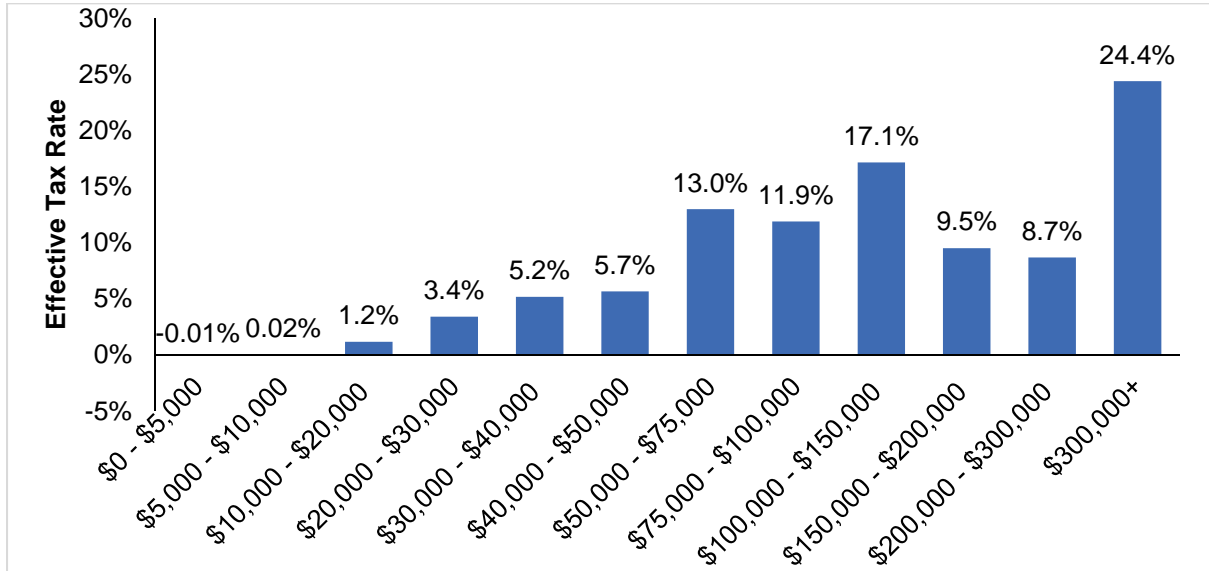
Source: Hawaii Department of Taxation, Hawaii Income Tax Statistics Tax Year 2014

**Upper income households pay most of the Hawaii income tax.**

Households making over \$100,000 pay approximately 60 percent of all Hawaii income taxes. Those making \$300,000 and over pay nearly a quarter of all taxes, despite accounting for only 1.4 percent of all taxpayers. Middle income taxpayers (\$50,000 - \$100,000) pay approximately another quarter. Lower income households shoulder a relatively small percentage of the burden at roughly 10 percent.



**Figure 2: Share of Total Resident Hawaii Income Tax Liability by Adjusted Gross Income Range, 2014**



Source: Hawaii Department of Taxation, Hawaii Income Tax Statistics Tax Year 2014

**Compared to other states, property taxes in Hawaii are relatively low.**

Hawaii has the 19<sup>th</sup> lowest median property taxes and the lowest property taxes in the nation when measured against home values. When measured against homeowner incomes, the property tax burden in Hawaii is the 6<sup>th</sup> lowest of any state. For detailed property tax ranking charts by state, please see **Appendix A**.

**Table 2: Hawaii Property Taxes, 2015**

	Median Property Taxes Paid	Property Tax to Home Value Ratio	Median Property Taxes to Homeowner Median Income Ratio
Hawaii	\$1,482	0.3%	1.6%
Rank	19	1	6

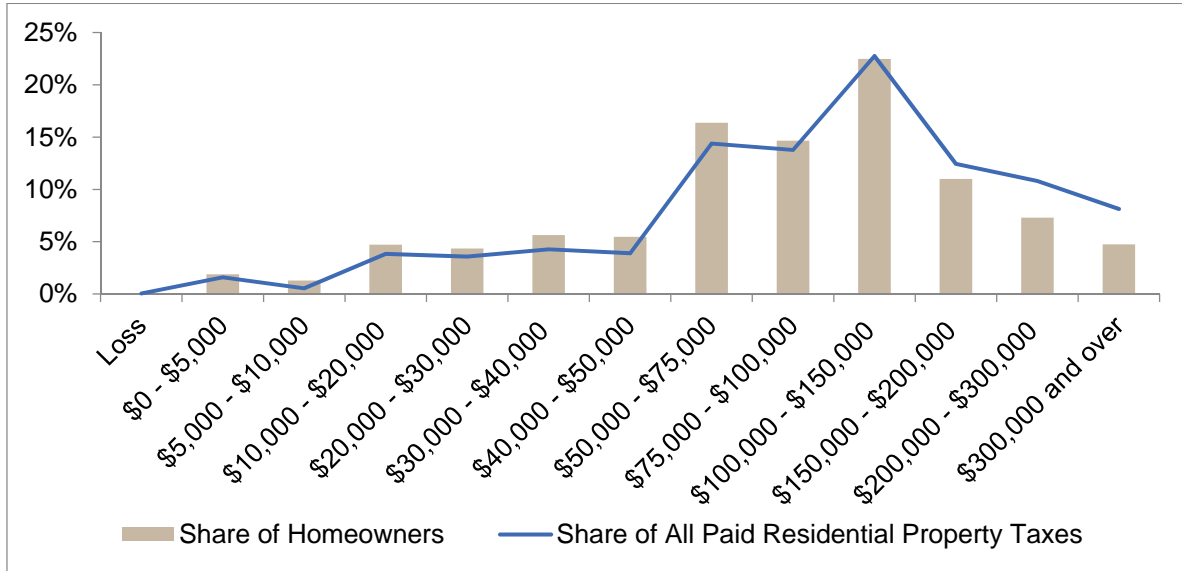
Source: US Census Bureau, American Community Survey 1-Year Estimates

**The residential property tax burden is roughly apportioned by income range.**

Homeowners making over \$50,000 account for 82.3 percent of all residential property taxes. This share of the property tax burden closely mirrors the share of homeowners by income range. No particular income class bears a disproportionate burden relative to its share of homeowners, as shown in Figure 3.



**Figure 3: Share of Homeowners and All Paid Residential Property Taxes by Income Range, 2015**

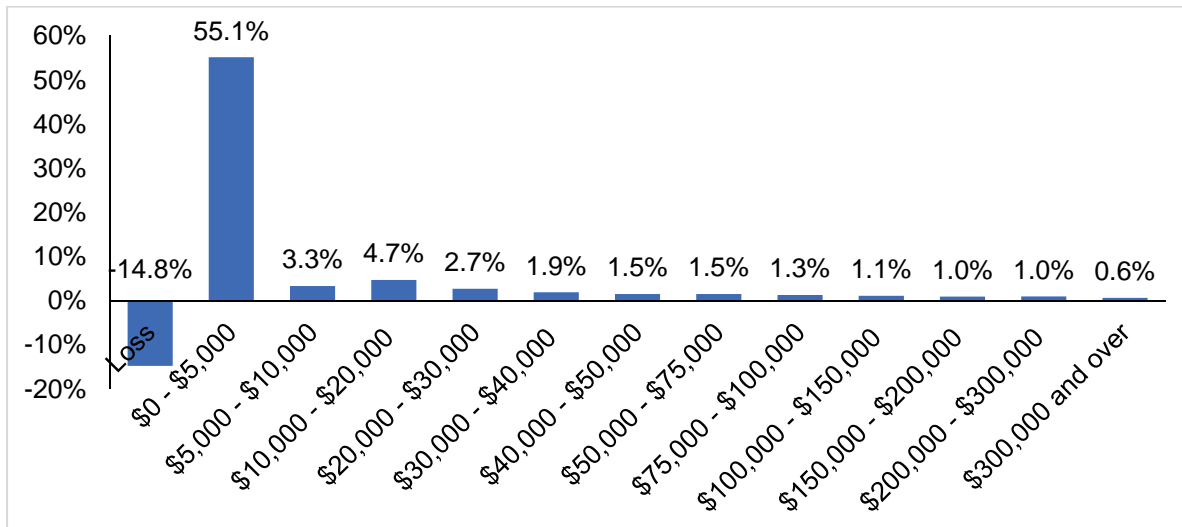


Source: US Census Bureau, American Community Survey 2015 Public Use Microdata Sample (PUMS)

**As a percentage of income, property taxes in Hawaii are clearly regressive.**

The ratio of property taxes to income steadily declines as incomes rise. Although comprising a very small segment of the population, homeowners making below \$5,000 pay an especially large portion of their incomes in property taxes.

**Figure 4: Paid Property Taxes as a Percentage of Homeowner Income by Income Range, 2015**



Source: US Census Bureau, American Community Survey 2015 Public Use Microdata Sample (PUMS)

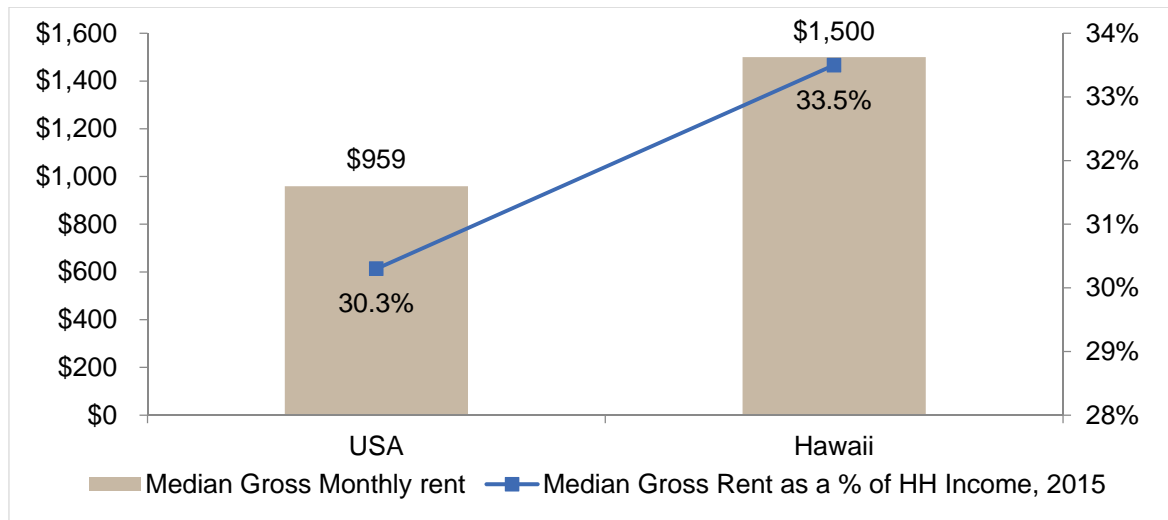


***Renter housing affordability is a challenge in Hawaii.***

Property taxes are generally considered to be a component of overall residential housing costs for home owners. However, affordability issues related to rental housing should also be considered. Rental housing in Hawaii is very expensive; Hawaii’s median gross rent (including utilities) at \$1,500 is more than 56 percent above the national median. The State’s median gross rent-to-household income ratio, a measure of general rent affordability, is over three percentage points above the US average. Renter housing affordability is a particularly severe challenge in Hawaii.

However, for low income households, the challenges are even worse. Nearly nine in ten renter households making less than \$20,000 are rent cost-burdened, paying 30 percent or more of income in gross rent. Although this is slightly lower than the national average, Hawaii has a larger share of such households with **severe** rent burdens (50 percent or more of income) than is the national norm. Hawaii has a tax credit for low income renters; however, it is limited to \$50 per exemption.

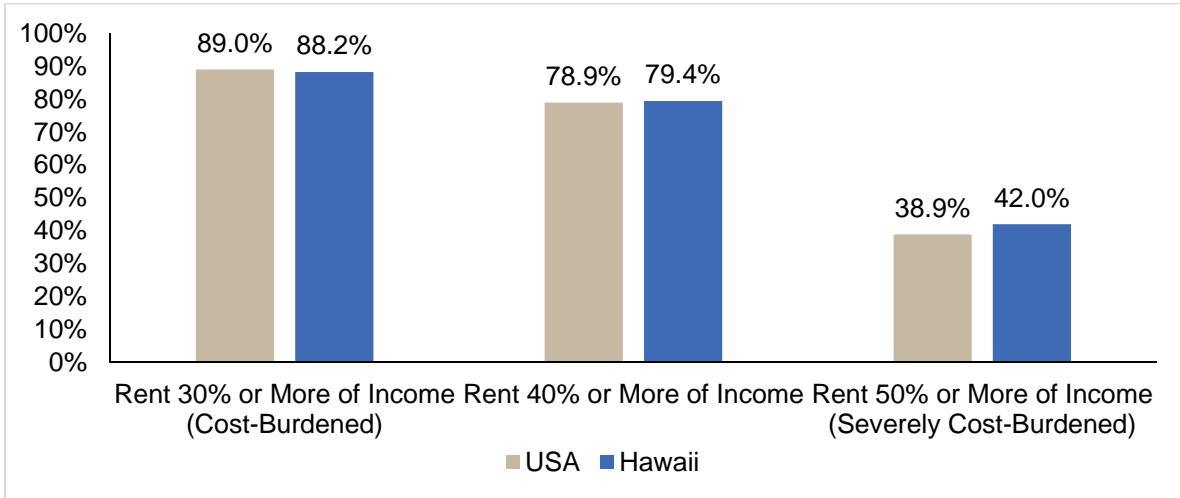
**Figure 5: Median Gross Monthly Rent, 2015**



Source: US Census Bureau, 2015 American Community Survey 1-Year Estimates



**Figure 6: Percent Rent Cost Burdened, Renter Households Making Less than \$20,000, 2015**

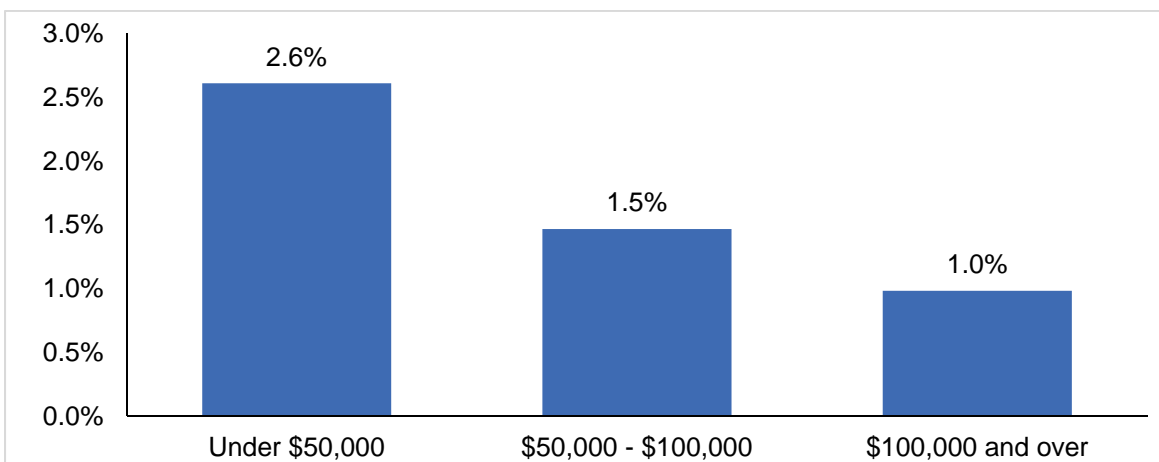


Source: US Census Bureau, 2015 American Community Survey 1-Year Estimates

**The general excise tax (GET) is regressive, with the percentage of income paid as GET steadily rising as incomes decline.**

Hawaii households making less than \$50,000 pay roughly three cents per dollar earned in excise taxes, while those making \$100,000 or more pay about one cent on the dollar. This is largely because lower income households spend more of their income on consumption expenditures subject to the GET.

**Figure 7: Ratio of Excise Taxes to Household Income by Income Range, 2014**



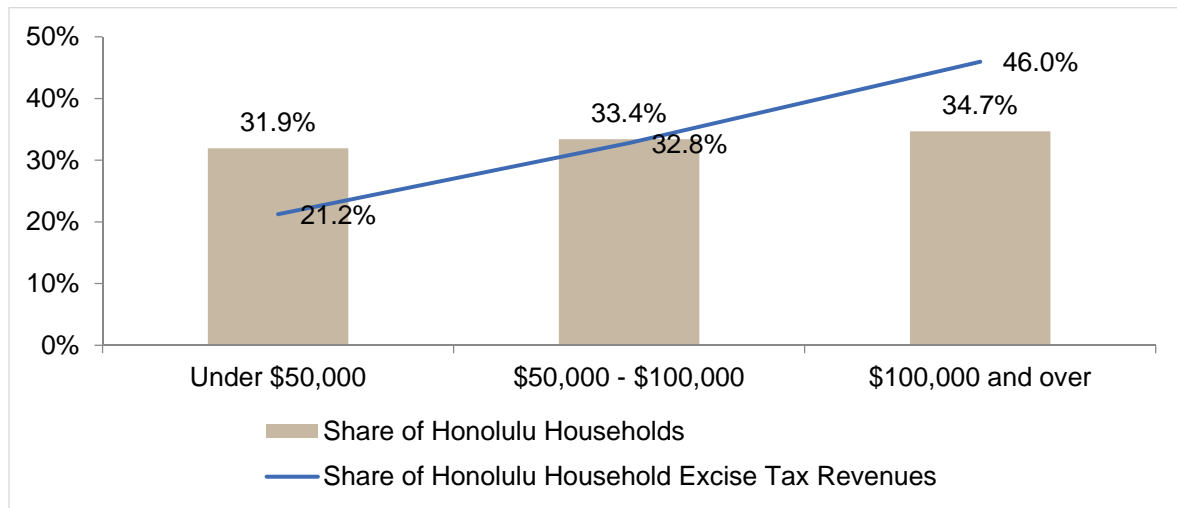
Sources: Hawaii Department of Business, Economic Development & Tourism. Honolulu Consumer Spending: 2013-2014. April 2016; US Bureau of Labor Statistics, 2015 Consumer Expenditure Survey. August 2016; US Census Bureau, American Community Survey 2014 1 Year Estimates.



***In the aggregate, upper income taxpayers pay a disproportionate share of general excise taxes.***

Honolulu households making under \$50,000; between \$50,000 and \$100,000; and \$100,000 and over represent nearly equal shares of Honolulu households. Those making \$100,000 or more pay approximately 46 percent of the GET. This is because these households tend to spend more money ***in the aggregate*** on goods and services subject to the GET.

**Figure 8: Share of Honolulu Households and Total GET Revenues by Income Range, 2013-2014**



*Sources: Hawaii Department of Business, Economic Development & Tourism. Honolulu Consumer Spending: 2013-2014. April 2016; US Bureau of Labor Statistics, 2015 Consumer Expenditure Survey. August 2016; US Census Bureau, American Community Survey 2014 1 Year Estimates.*

A previous study done for the Commission showed that when viewed over a typical taxpayer's lifecycle, Hawaii's general excise tax structure appears less regressive.<sup>3</sup> This occurs because middle-aged adults tend to spend less on consumption than young adults and senior citizens, as they save for retirement. Likewise, many young adults are, because of borrowing, consuming more than their annual income and many seniors are using accumulated savings for consumption. While it's true that there are cases where a lifetime incidence analysis will show a less regressive picture, there are also many highly stressed households (and households who will be living in poverty throughout their lifetime) where, in many years, the regressive nature of the GET is very real.

### **Ways to Reform Hawaii's Taxes to Make Them Less Regressive**

Regressivity is a key tax equity (and tax construction) issue, and it is closely linked with the previous discussion of tax burden. Tax structures and/or individual taxes are often described as being progressive, regressive or proportional. A progressive tax is one that takes a larger percentage of income from high income groups than from low income groups. A proportional tax is one that takes the same percentage of income from all income groups. A regressive tax is one that takes a larger percentage of income from low income groups than from high income groups. In practice, very few

<sup>3</sup>William Fox (2006). Hawaii's General Excise Tax: Should the Base be Changed? Tax Review Commission 2005-2007.





(perhaps no) taxes are designed to impose rates that increase as income decreases (which would mean there are no purely regressive taxes on their face). In practice, however, various taxes are regressive, because a greater proportion of a lower income individual's income is dedicated to paying the tax. For example, it is generally accepted that lower income individuals spend a greater percentage of their income on the tangible goods and services that are subject to the GET. As a result, the GET is considered to be a regressive tax (although the extent of that regressivity is subject to some debate). It is also notable that an overall tax structure can be regressive while some of its components are progressive – which is the case for Hawaii.

State tax structures are often viewed in combination with local taxes. This helps for comparison purposes, as States have made differing determinations of how certain services (such as K-12 education) will be provided and who (state or local governments and taxes) will pay for them. Hawaii is notable in that it is the only state that assumes nearly all the costs of K-12 education at the state level. In other states, this is generally more of a shared state and local funding responsibility.

***Recent changes made by the Hawaii legislature make the State's tax structure more progressive.***

Across the country, the tax that is most frequently identified as a progressive tax is the individual income tax. Most states have a progressive individual income tax, with higher marginal tax rates applying as income increases.

The individual income tax is also often used as a method to ameliorate regressive features of the overall state tax structure. That is the case in Hawaii, where a refundable credit is available to individual income taxpayers who are renters and/or pay the GET.

HB209, currently awaiting Governor Ige's signature, enacts changes to income tax rates after December 31, 2017 that increase the rate for high income taxpayers. This, of course, makes the Hawaii individual income tax more progressive and raises additional tax revenue. Additionally, the bill establishes a state earned income tax credit and repeals the sunset date for amendments made to the refundable food/excise tax credit. These are also progressive features, which are essentially paid for by the higher income tax rates for high income taxpayers.

***Changes to the GET that generally increase revenue would mostly be considered regressive.***

In general, excise taxes apply without regard to the taxpayer's ability to pay the tax. Additionally, the GET is broader based than many similar types of excise taxes (which, for state sales and use taxes, often exempt 'necessities' like food, utility payments and medical services that are taxed by the GET). Of course, part of the reason that the GET has been kept at relatively low rates (compared, again to other state sales and use taxes) is because the base is so broad.

Other possible measures to raise revenue are considered in the following section, in terms of their impact on regressivity.



**Ways to Generate More Revenue through New and Existing Sources, and through Improved Compliance with Hawaii’s Tax Laws**

In general there are four ways to raise additional tax revenue:

1. Create a new tax
2. Expand the base of an existing tax
3. Increase the rate of an existing tax
4. Increase taxpayer compliance of an existing tax

There are advantages and disadvantages to each approach. From a tax burden/regressivity perspective, the final approach (increased compliance) has the benefit of not imposing an additional tax or increasing an existing tax’s base. On the other hand, compliance rates on most major taxes are already relatively high (and further increases can be costly from an administrative perspective). As a result, tax policy changes usually focus on the first three alternatives.

***The additional revenue required to fund the annual required contribution to the Employer-Union Benefits Trust Fund (EUTF) is \$535 million in 2019, growing to \$703 million by 2023.***

In July 2013, Act 268 was signed into law. In addition to establishing the EUTF Task Force to examine further steps to address unfunded liability, the law requires the State to pay additional amounts toward reducing the unfunded liability until 2019, when 100 percent of the annual required contribution must be paid. Commencing in 2019, GET revenues will be used to fund any difference between the annual required contribution (ARC) and the payment made by the State.<sup>4</sup>

With this change in mind, the project team’s charge, as outlined in the scope of the project, is to determine:

*“how much revenue will be needed to maintain the current level of government services (tax adequacy), including unfunded or underfunded liabilities for pension and health care benefits for retired state workers...the study can take as a goal raising enough additional revenue to fund the annual required contribution (ARC) to the Employer-Union Benefits Trust Fund.”*

The State’s 2017-2019 budget includes estimated payments of \$555.9 million each year from 2017-2021.<sup>5</sup> Assuming that amount would have been held flat through 2023 had Act 268 not been signed into law, the additional revenue required is \$535 million in 2019, increasing to more than \$700 million by 2023, as shown in Table 3.

**Table 3: EUTF Retiree Health Care Plan Annual Required Contribution (in Millions)**

	2019	2020	2021	2022	2023
Annual Required Contribution	\$1,091.0	\$1,128.7	\$1,173.7	\$1,215.2	\$1,258.5
Budgeted Contribution	\$555.9	\$555.9	\$555.9	\$555.9	\$555.9
<b>Additional Revenue Required</b>	<b>\$535.1</b>	<b>\$572.8</b>	<b>\$617.8</b>	<b>\$659.3</b>	<b>\$702.6</b>

*Sources: July 1 Actuarial Valuation, State of Hawaii Budget*

<sup>4</sup> State of Hawaii 2016 CAFR

<sup>5</sup> Per 2017-2019 Pension and Other Post-Employment Benefits Liability Table (Budget Appendix 6)



***The project team's proposed revenue initiatives generally align with the goal of making the State's tax structure less regressive.***

An oft-quoted explanation of tax policy was provided by the former French Finance Minister, Jean-Baptiste Colbert: "The art of taxation consists in so plucking the goose as to procure the largest quantity of feathers with the least possible amount of hissing." It goes without saying that any additional tax revenue is going to come with a 'deadweight loss' that will have some negative economic impacts.

As previously noted, some taxes in their application may be regressive while the structure as a whole is progressive or proportional. A well-balanced tax structure applies a variety of taxes based on consumption, income and wealth. This helps create a more stable structure than one that relies on only one primary tax source or one type of tax. It also spreads the impact throughout the economy.

The following are possible revenue raising measures, with a brief description of their overall impact on general tax policy and state tax structure. All revenue estimates are preliminary and subject to revision.

In many instances, the following alternatives were also explored in PFM's report to the 2012 Commission. However, the project team has also chosen to not analyze some of the 2012 alternatives, primarily because of concerns about regressivity.

***Excise Tax Alternatives***

- **Increase cigarette/tobacco tax** to \$4.00 per pack (currently \$3.20). This is an excise tax that is applied in all 50 states. It is considered regressive but is also a 'user tax' that has been shown to decrease consumption, particularly among younger smokers. Estimated annual impact: \$20-25 million.
- **Increase beer/spirits/wine tax** by 10 percent. This is an excise tax applied in all states with a licensed retail market system. It is considered regressive as generally applied (as a tax on volume) but is also a 'user tax' that has been shown to decrease consumption. Estimated annual impact: \$5 million.
- **Increase car rental tax** to \$4.00 per day (currently \$3.00). This is an excise tax applied in all 50 states. A significant portion of the tax is exported to visitors. Estimated annual impact: \$18 million.<sup>6</sup>
- **Sugary beverage tax** of \$0.02 per ounce.<sup>7</sup> This is an excise tax applied in only a few jurisdictions, most notably the City of Philadelphia (1.5 cents per ounce). It is considered a regressive tax but may have health benefits, which is currently a subject of debate. Estimated annual impact: \$50 million.
- **Tax medical marijuana** at 15 percent. This is an excise tax and considered somewhat regressive. Estimated annual impact: \$8-12 million.<sup>8</sup>
- **Institute a carbon tax.** No state has instituted this form of tax, and there is some debate as to whether it is a significantly regressive tax. However, there are positive environmental impacts. Estimated annual impact: up to \$365 million, depending on the nature and extent of the tax.
- **Institute a vapor/e-cigarette tax.** Seven states and Washington DC currently impose a tax on e-cigarettes, and more than 20 others have contemplated legislation. Estimated annual impact: Less than \$5 million.

<sup>6</sup> Revenues from car rental taxes are deposited into a special revenue fund.

<sup>7</sup> Estimate includes a non-compliance adjustment of 20 percent.

<sup>8</sup> Estimate is incremental revenue resulting from taxation at 15 percent instead of 4.5 percent.



### ***Transient Accommodations and Timeshare Occupancy Tax Alternatives***

- **Increase the TAT** to 10.0 percent (currently 9.25 percent after expiration of reduction in 2015). An opportunity to export additional revenue. Estimated annual impact: \$20-25 million.
- **Begin collecting TAT on resort fees.** An opportunity to export additional revenue. Estimated annual impact: \$20-30 million.
- **Begin imposing TOT on Airbnb rentals.** An opportunity to export additional revenue. Estimated annual impact: \$5-10 million.

### ***Income Tax Alternatives***

- **Move to a single 9 percent corporate net income tax rate.** Who pays corporate income tax is a subject of considerable debate. The following corporate income tax initiatives all raise revenue, but the question of who pays for them is subject to debate. Estimated annual impact: \$30 million.
- **Increase corporate net income taxes** by 50 percent. Estimated annual impact: \$42 million.
- **Increase corporate net gains capital rate** to 5.0 percent (currently 4.0 percent). Estimated annual impact: \$5 million.
- **Eliminate exemption for pension income** over \$25,000. Most states provide for some taxation of pension income; with the provision to exempt the first \$25,000 of pension income, this would be considered a progressive tax feature. Estimated annual impact: \$46 million.
- **Eliminate exemption for foreign pension income** over \$25,000. Most states provide for some taxation of pension income; with the provision to exempt the first \$25,000 of foreign (out of state) pension income, this would be considered a progressive tax feature. Estimated annual impact: TBD.
- **Implement a personal income tax rate recapture.** This would implement a top-rate recapture mechanism for high income taxpayers. In this approach, for taxpayers with taxable income above a certain level, which could be \$100,000, the benefit of lower brackets would be phased out, and when income reaches \$150,000, the taxpayer would pay the top rate on the first dollar of income. This would be a highly progressive feature. Estimated annual impact: TBD.

### ***Property Tax Alternatives***

- **Eliminate the Real Estate Tax Deduction.** This effectively reduces property tax burden by providing a deduction against income taxes. To the extent the property tax is regressive, this would increase regressivity. However, for individuals with no state income tax liability (or who do not itemize), there would be no additional tax implications from this change. As a result, it would likely be a progressive feature. Estimated annual impact: \$30 million.
- **Shift certain K-12 education expenses to property taxes to lower State costs.** Because the State Constitution prohibits a state property tax, the only mechanism to increase the use of this tax (and thus reduce the use of other major taxes) would be to shift expenditures from the state to local governments. As mentioned previously, Hawaii is the only state that fully assumes the operational costs of K-12 education at the state level. Of course, any shift to property tax from more progressive taxes (such as the income tax) would be regressive – however, it would be possible to ameliorate some of these impacts through expanding refundable credits such as the GET/renter's credit. Under this initiative, the State could select specific expenditures to shift. As an example, it could shift the DOE's Public Libraries general fund operating costs to property taxes. Estimated annual impact: \$35 million.



### **Compliance Alternatives**

Compliance initiatives are important, because they can increase voluntary compliance and create greater confidence in the system by those taxpayers (who are the vast majority of Hawaiians) who pay their taxes in full and on time.

There are notable instances across the country where taxpayer compliance can be a significant issue for the amount of tax revenue that can be generated. There are taxes where 'black markets' are fostered because of taxes owed on specific products, such as cigarettes. More recently, concerns about payment of sales and use taxes owed because of online purchases has become a prominent issue for States – and also for Hawaii as it relates to the GET.

- **Increase collection of taxes related to e-commerce/online retail taxes.** This is not a new tax – it is a method of enhancing collection of an existing tax. An area with significant legislative action across the country, although the constitutionality of some recently enacted state laws is being challenged in several state and federal court cases. Estimated annual impact: \$30-40 million.

The State is in the process of implementing a data warehouse; in other states, this has provided opportunities to improve compliance and collect additional revenue. These include:

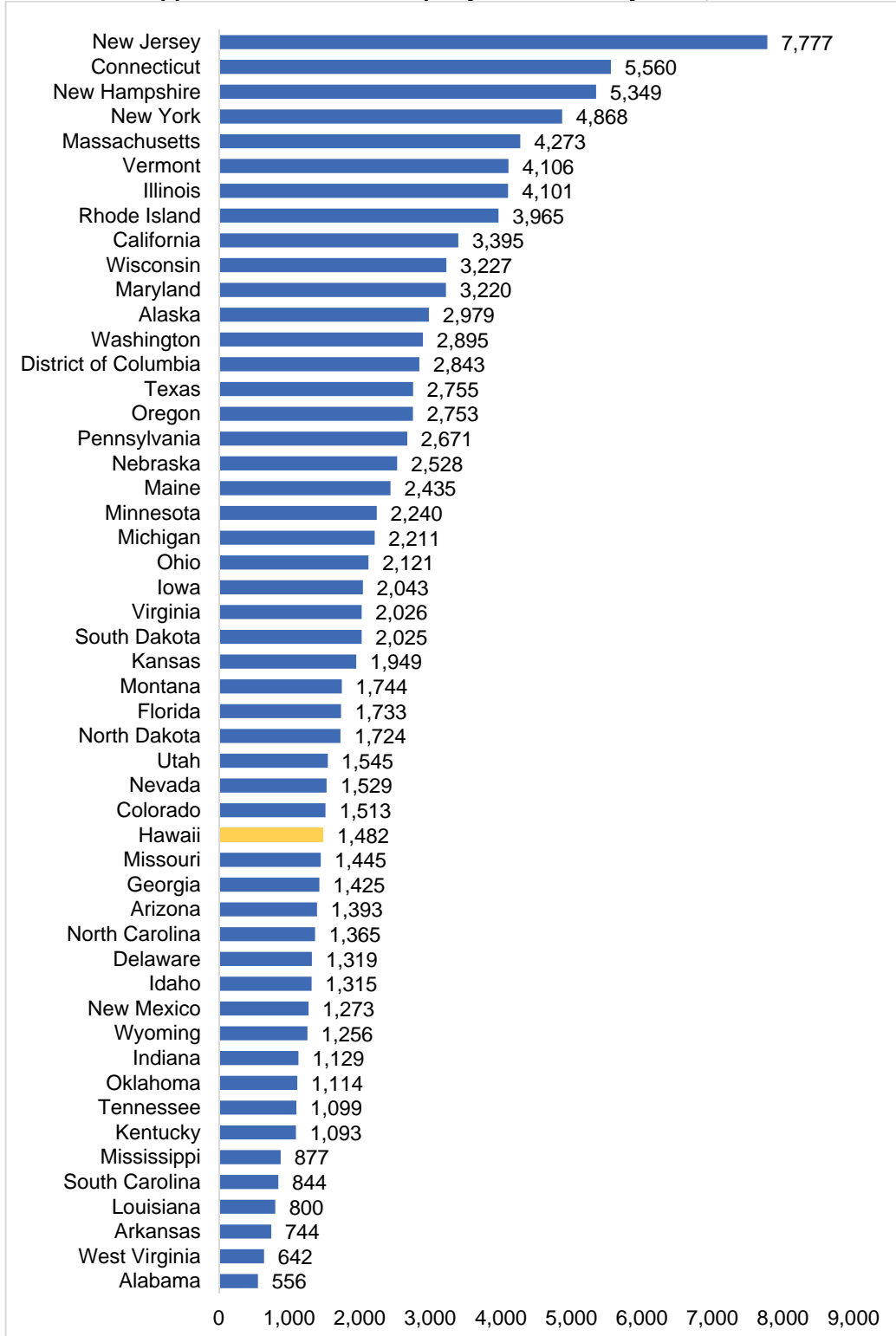
- **Tax gap programs.** Several states have increased revenue collections through use of sophisticated software connected with a fully functional data warehouse.
- **Additional audit programs.** Most studies suggest that additional audit staff is cost effective, both in finding additional tax revenue and in spurring additional voluntary compliance.

### **Summary**

PFM looks forward to discussing these high level findings with the Commission. The PFM project team is beginning the process of creating the final report detailed outline and refining analysis of the revenue measures that are under discussion. The project team is prepared to complete the analysis and provide the written draft report within the timeframe provided to the Commission.

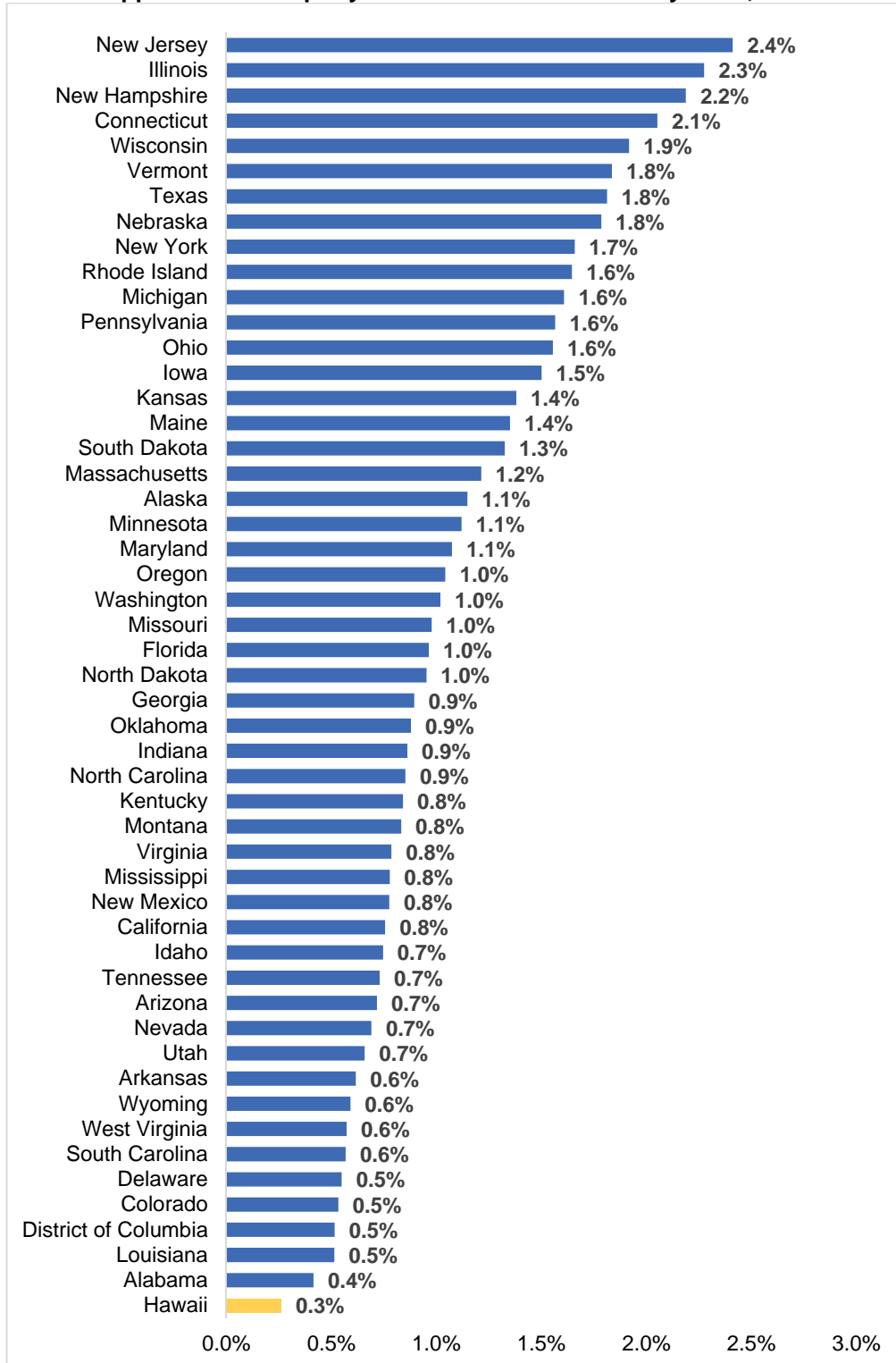


### Appendix A1: Median Property Taxed Paid by State, 2015





**Appendix A2: Property Tax to Home Value Ratio by State, 2015**





**Appendix A3: Median Property Taxes to Homeowner Median Income Ratio by State, 2015**

