Should Hawaii Tax Corporate Income?
A Cost-Benefit Analysis

by

Donald J. Rousslang

and

Yvonne Chow

Hawaii Department of Taxation

July 6, 2017

The Basic Exercise

- Study goal: To estimate the costs and benefits to residents of eliminating Hawaii's corporate income tax.
- Method: We perform a proper public finance experiment in which the lost tax revenues are replaced with an increase in the GET or in the individual income tax. The replacement tax is used to avoid confounding the effects of eliminating the corporate income tax with the effects of a general tax cut.

Corporate Tax Liabilities

- For tax years 2013 through 2015, Hawaii's corporate income tax liabilities averaged $134 million annually before tax credits. (We used an average of three years, because the liabilities vary greatly from year to year.)
- During the period, the corporate claims for tax credits averaged $94 million annually, $84 million of which were refundable.
- The net liabilities after all tax credits averaged only $40 million annually. The net liabilities after nonrefundable tax credits averaged $124 million annually.

Liabilities vs. Reported Collections of the Tax

- Net collections of the corporate income tax as reported in the Department's "Monthly Collection Reports" averaged $93 million annually for calendar years 2013 through 2015 and they averaged $77 million annually for calendar years 2014 through 2016.
- The main difference between our figure for net liabilities ($40 million) and the figure for net collections seems to be that the collections include tax payments that are not income tax liabilities of C-corporations, such as payments by S-corporations and partnerships on behalf of nonresident partners, including HARPTA withholding payments.

Accounting for Hawaii's Tax Credits

We assume the refundable tax credits will continue to be claimed after the corporate tax is eliminated. We justify the assumption on several grounds.

1. Corporations can take measures, such as establishing single member entities, to continue claiming the refundable tax credits.
2. The tax credits are refundable, which indicates that they were not meant to depend on tax liability. This is obviously true for the film tax credit, because corporations engaged in film production are exempt from Hawaii's corporate income tax (section 235-9, HRS).
3. The main refundable tax credits claimed by corporations have purposes not related to the corporate income tax: The film tax credit promotes the film industry in Hawaii, the renewable energy tax credit promotes renewable energy, and the capital goods excise tax credit reduces pyramiding of the GET.

The Replacement Taxes

- We assume the replacement tax must produce $124 million per year (the corporate income tax after nonrefundable tax credits).
- This means raising the retail rate of the GET from 4.0% to slightly less than 4.2%, or raising the individual income tax by about 6.6%.
- Previous TRC studies have estimated that about 32% to 38% of the GET is exported to nonresidents (including tourists, nonresident military personnel, and the federal government).
- We estimate that about 32% of Hawaii's individual income tax is exported to nonresidents, including the tax paid by nonresidents and the federal tax offset (the deduction of the state tax from the federal income tax).

Assumptions About Hawaii's Corporate Income Tax

- There is not much in the way of "supernormal" profits (such as windfall gains or monopoly profits) in Hawaii's corporate income tax base. (We will summarize at the end what happens to our calculations if the assumption does not hold.)
- Nonresidents own the great bulk of corporate investment in Hawaii. (This may be viewed as a stylized fact.)

Distributing the Burden of Hawaii's Corporate Income Tax in the Long Run

Total Tax Burden ($124 million)

Federal Offset ($36 million)

Net Burden after the Federal Offset ($88 million)

Burden borne by residents in the form of lower wages and property rents, but mainly as higher consumer prices ($78 million)

Burden exported to nonresidents (tourists and the federal government) in the form of higher prices for things they buy in Hawaii. ($10 million)

Short-Run Effect of Eliminating Hawaii's Corporate Income Tax

- Residents lose the entire corporate tax collections, gross of the federal offset ($124 million, which must be made up with a replacement tax).
- Nonresident shareholders get a windfall in higher after-tax returns ($88 million) and the federal government gets higher corporate tax collections ($36 million).
- Residents gain the tax exporting from the replacement tax.

Long-Run Effects of Eliminating Hawaii's Corporate Income Tax

- Eliminating the tax would encourage corporations to invest in Hawaii. Hawaii residents would benefit, mostly from lower consumer prices, but also from higher wages and property rents.
- Most of the windfall to shareholders ($78 million of $88 million) is transformed into income of residents (higher wages and property rents and lower consumer prices).
- Residents would lose the tax exporting from the corporate income tax (including the federal offset) and gain the tax exporting from the replacement tax.

Adding Up the Components of the Cost-Benefit Calculations

- We estimate that tax exporting is smaller for either replacement tax than for the corporate income tax. The net loss in tax exporting is permanent.
- The loss in tax exporting is bigger than the gain from greater corporate investment. The difference is within the margin of error in our calculations, but when added to the short-run windfall to shareholders, it is clear that residents would be worse off if Hawaii eliminated its corporate income tax.

Effects of Federal Tax Reforms

If the federal government eliminates the deduction for state and local taxes, the federal tax offset for Hawaii's corporate income tax (which we have estimated to be $36 million annually) would disappear. In this case, residents would gain from replacing the state's corporate income tax with an increase in the GET.

Role of "Supernormal" Corporate Profits

- The burden of a corporate tax on supernormal profits is borne entirely by shareholders, so eliminating the tax on these profits is simply a gift from residents to the shareholders, with no effect on investment in Hawaii.
- If Hawaii's tax base includes supernormal profits, the loss to residents from eliminating the corporate income tax is greater than shown in our calculations. If the supernormal profits are as great as one fourth of the total, residents would lose from eliminating the tax, even if the federal offset were gone.

Expensing Corporate Investment – A Silver Bullet?

- Allowing corporations to expense new investments (instead of depreciating them) effectively eliminates the tax on normal corporate profits from new investment, but keeps the tax on supernormal profits and on income from old investments.
- It encourages corporate investment, but avoids the short-run transfer to shareholders that would come from eliminating the statutory corporate tax rates.
- It costs less in foregone revenue, so it is a lower risk strategy in terms of the effect on the budget.