March 17, 2021
12 to 2 p.m.
Videoconference

To: 2020-2022 Tax Review Commission
Elizabeth Giesting, Chair
Alton Miyashiro, Vice Chair

From: Grassroot Institute of Hawaii
Joe Kent, Executive Vice President

Comments Only

Dear Chair and Commission Members:

The Grassroot Institute of Hawaii would like to provide information regarding Hawaii state tax policy.

Introduction

First off, we need to recognize that both Hawaii’s economy and its state budget have long been headed in an unhealthy fiscal direction. This is due to policies that increased the state’s levels of taxation, spending and debt, which put Hawaii’s economy in a weakened condition even before the Great Lockdown Crash of 2020.

Since March 2020, when the coronavirus state and county lockdowns were imposed, Hawaii’s economy has worsened significantly. Yet the policies of tax, spend and borrow persist. These policies will not achieve the economic growth — or even the stability — Hawaii needs to recover and even excel after the lockdowns are lifted. Instead, our policymakers need to focus on incentivizing growth and prosperity — through lower taxes, fewer unwarranted regulations and greater opportunities — and thereby organically generate the tax revenues the state needs to meet its obligations to the public.

Hawaii’s economy is fragile

How fragile is the condition of Hawaii’s economy?

Hawaii has the highest unemployment rate in the nation at 10.2%. In 2020, the state’s unemployment rate averaged second-highest nationally at 11.6%, behind Nevada at 12.8%.

This massive unemployment caused by the lockdowns on a tourism-dependent state caused the unemployment fund to drain faster than ever witnessed in the state’s history, prompting the state to borrow $700 million from the federal government to pay for unemployment insurance benefits.

Private sector businesses would typically be on the hook to pay back the $700 million loan for the unemployment insurance fund, but state legislators are choosing to pay back that loan instead, though it is a substantial expense for the state.

In addition to that debt, Gov. David Ige borrowed $750 million from the bond market to fund payroll expenses, but the money needs to be paid back by 2025.

Lawmakers are also planning to skip prefunding the Hawaii Employer-Union Health Benefits Trust Fund, which could save $2 billion in the short run but add $8 billion of debt over the long-term.

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4 Ibid.
“Grassroot Institute of Hawaii analysis of county ARC increase from deferral of 5 years of prefunding,” Grassroot Institute of Hawaii, Jan. 11, 2021. Note: This graph shows the additional amount of annual required contributions required to make up for the deferred $1.8 billion.

These debts were taken out to avoid short-term budget cuts. But budget reductions may be necessary at this time, and may also be a refreshing change to Hawaii’s trend of spending faster than the growth of the economy.

For example, between fiscal years 2010 and 2019, state general fund spending increased by a real average of 3.6%, versus 1.7% for the state’s private sector, as measured by the state’s gross domestic product.
This imbalance is exactly the opposite of what is called for by the so-called golden rule of state budgeting: The private sector should grow faster than the government.\(^6\)

One argument to keep government spending growth high during the current economic crisis is the “multiplier effect” of government spending, which is purported to generate $1.50 for every dollar spent by government.\(^7\)

However, many economists dispute this claim and find that the economic gain of government spending may actually be negative when factoring in the harmful effects of public sector spending, such as taxation, government bureaucracy, heightened regulatory barriers for business, boondoggle mega-projects and the crowding out of private sector investment.\(^8\)

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Suffice to say that there is economic debate about whether the “multiplier effect” of government spending produces economic gain, and that Hawaii’s record of public spending overtaking private sector growth has not resulted in a healthy economy.

Essentially, Hawaii’s state government is growing faster than can be healthfully sustained by the private sector. The private sector is the source of the state’s funding. If the private sector is growing slower than the government, that means private sector taxpayers are able to keep less of their earnings for themselves.

Adhering faithfully to the golden rule of state budgeting means there would be more money for Hawaii residents to invest in new businesses, buy new homes, afford college educations for their children and generally accumulate capital that is essential to a sustainable, healthy and prosperous economy.

A healthy and growing private sector also would organically generate the taxes the government needs to meet its responsibilities to the public, without the need for increased taxes or large amounts of unfunded liabilities.

The current reality is that Hawaii state spending has been outpacing private economic growth for at least a decade. Since fiscal 2012, lawmakers have exceeded the state’s constitutional spending cap by a total of $1.4 billion. Bypassing the spending cap requires a two-thirds vote in both chambers of the Legislature, but all budget bills over the past decade have been approved nearly unanimously.

### Hawaii general fund spending versus legal spending cap, 2010-2020, in millions

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Spending limit (cap)</th>
<th>Total amount spent</th>
<th>Excessive Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>2020</td>
<td>$8,168</td>
<td>$8,034</td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td>$8,012</td>
<td>$7,868</td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>$7,905</td>
<td>$7,701</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>$7,090</td>
<td>$7,555</td>
<td>$465</td>
</tr>
<tr>
<td>2016</td>
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</tr>
<tr>
<td>2015</td>
<td>$6,446</td>
<td>$6,450</td>
<td>$4</td>
</tr>
<tr>
<td>2014</td>
<td>$5,894</td>
<td>$6,213</td>
<td>$319</td>
</tr>
<tr>
<td>2013</td>
<td>$5,596</td>
<td>$5,676</td>
<td>$80</td>
</tr>
<tr>
<td>2012</td>
<td>5,043</td>
<td>$5,474</td>
<td>$431</td>
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</table>

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<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>5,394</th>
<th>$5,039</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2010</td>
<td>5,832</td>
<td>$5,208</td>
</tr>
<tr>
<td><strong>Total excessive spending:</strong></td>
<td>$1,462</td>
<td></td>
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</tbody>
</table>


This excessive spending has been funded by taxes, which have been increased every year over the past decade. This, in turn, has increased Hawaii’s cost of living, which is one reason Hawaii has been suffering a net population loss in recent years. Since 2016, nearly 22,000 residents have moved to the mainland, many of whom have cited Hawaii’s high cost of living and lack of job opportunities as a primary factor.

**Hawaii population decline since fiscal 2016**

![Graph showing Hawaii population decline since fiscal 2016](image_url)


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12 “Hawaii Perspectives,” Pacific Resource Partnership, Spring 2019, p.11
Another measure of Hawaii’s economic health — or its fragility, as the case may be — is the amount of its debt. Over the past decade, bond debt and unfunded liabilities for public pension and health benefits have increased to the point where Hawaii residents are now on the hook for nearly $28,000 per person.

**Hawaii unfunded liabilities and state debt per capita**

These debts and unfunded liabilities, along with Medicaid, now take up 56% of the state general fund, leaving an ever smaller portion to pay for all other state general fund costs.

**Hawaii general fund, fiscal 2022**

Source: “Hawaii State Executive Biennium Budget for fiscal years 2021 - 2023,” Hawaii Department of Budget and Finance, p. 60.

As previously stated, this trend of additional spending, taxation and debt left Hawaii’s economy weak even before the Great Lockdown Crash of 2020. As of fiscal 2019, before the COVID-19 crisis, Hawaii’s gross domestic product was tanking at minus 0.5%, the lowest GDP rate in the nation. In other words, the coronavirus crisis was the straw that broke the camel’s back.

**So here we are, at a crossroads**

Considering the state’s fiscal track record over the past decade and more, you might think advocates of more taxes and spending would be taking pause. Not so.

Incredibly, state lawmakers are considering a bill — SB56, “relating to revenue generation” — that would impose the highest marginal income tax rate in the nation for people making over $200,000. Whether that measure passes or fails, it is an indication that lawmakers are still open to increasing taxes — in this case, drastically.

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Will members of the House follow suit? Thankfully, that is looking like a dim possibility. And there are, after all, a lot of smaller tax bills that they might be able to push through without significant public pushback.

But in any case, the damage from SB56 to some extent has already been done.

**Hello tax increase, goodbye doctors**

In response to the Hawaii Senate approving the bill almost unanimously, 24-1, doctors, among others, have contacted the Grassroot Institute of Hawaii saying the bill could aggravate Hawaii’s already severe doctor shortage.

Radiologist Dr. Scott Grosskreutz, of the Hawaii Physician Shortage Crisis Task Force, said many of the doctors he’s talked with have said they are reevaluating whether they should relocate to the mainland. News of the bill, which made headlines across the country, also could discourage doctors from moving here in the first place.

“Doctors incur huge debts throughout college, medical school, internship, residency and fellowship training,” Grosskreutz said. “When they finally are ready to start practice in their 30s, they often have little or no retirement savings and owe over $200,000 of student debt.”

Not only that, “In Hawaii, our practice start-up costs are often hundreds of thousands,” Grosskreutz said. “The high overhead costs for offices and support staff, high income taxes and very low reimbursements make our state unattractive to most young doctors looking to start up practice.”

He said doctors in Hawaii are frustrated and disappointed because for four years they have been trying to obtain a state general excise tax exemption for medical services. They still haven’t received it, and now they might be facing a large personal income tax increase instead.

Dr. Kyle Varner, a former resident physician at Tripler Army Medical Center in Honolulu, who left Hawaii in 2016, stated, “I moved away because I want to get ahead financially, and I want to be financially independent. That's just not possible in Hawaii, even for somebody with my earning potential.”

He said that after leaving Hawaii, he gained a “$50,000 a year increased salary.”

“The sunshine and the aloha is nice, but it's not worth the price,” said Varner, who now lives in Washington state, which has no income tax.

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15 Personal correspondence with Dr. Scott Grosskreutz, March 15, 2021.
16 Ibid.
Remember the Laffer Curve?

Taxation in Hawaii has likely reached the point where increases in tax rates will cause more harm than good. This can be illustrated on the “Laffer Curve,” named after economist Art Laffer, which represents how much tax revenue can be generated by a government at various tax rates.

If Hawaii’s level of taxation is represented by point B on the Laffer Curve above, then increasing tax rates will result in less revenue, since people will respond by either leaving the state, avoiding taxation or stopping productive work.

If on the other hand, Hawaii’s level of taxation is represented by point A, then an increase in taxation would indeed result in more tax revenues, but the revenues would be minimal since people would be changing their behavior, such as by shutting down or leaving the state. In this scenario, the government would be imposing a lot of economic damage to get very little additional revenue.

Hawaii policymakers should assess where they think Hawaii is on the Laffer Curve, and respond accordingly.

How tax credits could help provide public services, inspire productivity
Not all public services need be funded through taxes. Another way to increase spending for the “public good” would be for the state to increase tax credits for charitable donations to Hawaii nonprofit organizations.

For example, all charitable donations in Hawaii after a taxpayer has paid over $100,000 in state income tax could be eligible for a tax credit or considered deductible.

Such a policy would help individuals direct money to those charitable causes he or she cares about, rather than have the money be spent on questionable causes by the state.

The productivity gains from such a policy are best illustrated by the following chart popularized by Milton Friedman.

The four ways money can be spent

![Diagram of money spending methods](source)


When people spend money themselves, they typically do it with a high concern for quality and cost. When they are spending someone else’s money, the money is generally spent with a low concern for quality and cost.
A policy that incentivizes money to be spent on charity rather than on government programs could see the money better economized, since it would at the very least be done with a high concern for cost, as in quadrant three.

This could result in millions of dollars from Hawaii’s wealthiest going to local charities, and perhaps even inspire more productive economic activity, since the policy would incentivize those with higher incomes to move to the state.

**In sum: No new taxes**

There is precedent for the Hawaii Tax Review Commission to recommend lowering state taxes. It happened in 1989, and it could happen again now.

At the very least, the commission should consider recommending no change in tax rates, since tax stability is also desirable for entrepreneurs trying to plan for the future. Recommending "no new taxes" would send a message to our legislators that the Council wants them to keep their spending under control and at levels that Hawaii taxpayers can afford.

Freezing taxes or providing tax breaks may be just what Hawaii needs to boost its economy, incentivize entrepreneurial activity, keep doctors in the state, inspire charitable donations and pressure state lawmakers to get their spending in order.

It also will give the private sector time to start growing faster than the state government, which is key to putting Hawaii back on the road to opportunity and prosperity.

Thank you for the opportunity to submit our comments.

Sincerely,

Joe Kent
Executive Vice President
Grassroot Institute of Hawaii

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