TAX REVIEW COMMISSION

MINUTES OF THE EIGHTEENTH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT 830 PUNCHBOWL STREET, ROOM 221
IN THE CITY AND COUNTY OF HONOLULU
STATE OF HAWAII, ON TUESDAY, SEPTEMBER 26, 2006

The Commissioners of the Tax Review Commission met at the Department of Taxation, Director Conference Room, in the City and County of Honolulu, State of Hawaii, on Tuesday, September 26, 2006.

Members Present: Chairman Isaac Choy, Manoa Consulting Group, LLC CPA's
Vice-Chairman Ronald Heller, Torkildson Katz Fonseca Moore & Hetherington, AAL, ALC (arrived late)
Carolyn Ching, Carolyn L. Ching CPA
Christopher Grandy, UH Manoa, Public Administration Program
Melanie King, Bank of Hawaii
John Roberts, Niwao & Roberts, CPA's

Members Absent: Lon Okada, Hawaiian Electric Industries, Inc.

Staff: Tu Duc Pham, Donald Rousslang, Cathleen Tokishi

Other: Jeffrey Au, PacifiCap Group
Diane Erickson, Dept. of Attorney General
Lowell Kalapa, Tax Foundation of Hawaii
Johnnell Nakamura, DOTAX
Marilyn Niwao, Niwao & Roberts, CPAs
Tom Smyth, DBEDT
Nicki Thompson, Governor's Policy Office

CALL TO ORDER

Chairman Isaac Choy called the meeting to order at 9:05 a.m. with a quorum present.

APPROVE MINUTES OF AUGUST 29, 2006, MEETING

The Chairman called for any corrections or additions to the minutes; there were none.

<u>It was moved by Ms. Ching and seconded by Ms. King to approve the minutes of August 29, 2006. The motion carried without opposition.</u>

ANNOUNCEMENTS

Meeting on October 6, 2006. A special meeting will be held on Friday, October 6, 2006, at 1:30 p.m., at which Dr. Marcia Sakai and Dr. Bruce Bird will present the findings of external study 2. The meeting is currently schedule for the Director's Conference Room, but the staff will try to get a bigger room; perhaps at the State Capitol. The results of the external studies will be evaluated at the September meeting after the preliminary reports are due, and again at the October meeting after the final reports are due.

Department Tour. A special meeting will be held on October 17, 2006, at 10:30 a.m., for a tour by the Commissioners of the Department. The tour portion will need to be an executive session as the Commissioners will be entering parts of the Department that are not open to the public.

October meeting. The Commission will discuss and accept the external study reports at the October 31, 2006, meeting.

Other. Dr. Pham announced that he will be on vacation and miss the October 6, 2006, meeting. Dr. Rousslang will be temporarily assigned to his position. Mr. Roberts announced that he would be overseas the first three weeks of November.

REVIEW OF PAST TRC RECOMMENDATIONS

RECOMMENDATIONS OF THE 1989 TAX REVIEW COMMISSION (CONT.)

This continues the discussion of the 1989 Tax Review Commission recommendations, which were assigned to Mr. Okada who was not able to attend. The Chairman asked Dr. Rousslang to lead the discussion on the remaining 1989 recommendations.

Income Tax Recommendations:

4. Add back capital gains, dividends, interest, retirement contributions, unemployment and workers compensation payments, public assistance benefits and individual housing account payments to adjusted gross income (AGI) base.

Dr. Rousslang stated that they had been unable to find this recommendation as a recommendation. Mr. Kalapa recalled, however, that it was modified AGI for the determination of the low-income tax credit and he believes that it was contained in the discussion or staff papers on credits. Eligibility for the general excise tax (GET) credit was based on Hawaii AGI, which excluded pension income and therefore allowed wealthy retirees to qualify for this credit and later, for the food tax credit introduced in 1987.

Dr. Pham and the Chairman noted that modifying the Hawaii AGI would make it difficult for the Department to track all the required adjustments. Ms. Tokishi added that it would also be difficult for taxpayers. She cited, as one example, the situation of a resident married to a nonresident who files a joint federal return and a separate state return; the resident taxpayer would have to recalculate his/her federal AGI based on the married filing separate filing status.

Mr. Roberts noted that the definition of state AGI has had a ripple effect at the county level with respect to real property tax exemptions or circuit-breaker benefits. What this Commission does may affect what other less-informed institutions adopt with the same kind of unintended consequences. He noted that he could arrange things so that many of his high-income clients would not have to pay any real property tax.

Dr. Pham, as confirmed by Ms. Nakamura, noted that recent tax credit bills submitted by the Administration to the Legislature have based eligibility for credits on federal AGI rather than a modified Hawaii AGI. That is easier though not perfect, and Ms. Tokishi noted that it still is not that easy for some taxpayers.

The Chairman summarized by stating that it was a good idea to prevent the high-income taxpayer from qualifying for the low-income credits, but that the mechanics may be problematic and there may be unintended consequences.

The Commission declined to put forth a motion regarding this issue since this was not a past recommendation and because of the problems that could arise.

Miscellaneous Tax Recommendations:

8. Reduce top rates.

Dr. Rousslang stated that, although this was adopted, it does not preclude the Commission from recommending that the top rates be further reduced.

Mr. Smyth stated that, as more businesses are established as single-member limited liability companies (LLCs), the current 8.25% top rate also becomes an issue for partners and sole-proprietorships. The corporate income tax rates are more moderate than the higher individual rates. That has become more of an issue for businesses inquiring about a possible relocation to Hawaii, although taxation is not the main issue for them. Therefore, it is now a business tax just as much as it is a personal tax.

Mr. Kalapa stated that, if you use the same logic as that which led to the adoption by Hawaii in 1987 of the 1986 federal tax reform act change to tax capital gains as ordinary income, and to Hawaii taxing it at the lower rate of 7.25%, from his perspective, the 7.25% rate is what the top rate should have been back in 1987.

The Chairman asked Dr. Pham how each percentage drop in tax rate would affect tax collections. Dr. Pham said that the revenue impact estimate is about $150 million.

Dr. Rousslang noted that reducing the top tax rate only affects the top bracket; Dr. Pham pointed out that the Commission has already recommended that the tax rates be indexed to inflation.

The Chairman felt that the 8.25% rate is in line with other states. Dr. Pham noted that Dr. Fox's study and internal studies indicate that the tax could be lowered if the GET is increased. The Chairman asked if it was better to increase the standard deduction and personal exemption instead of lowering the rates. Dr. Grandy noted that the Commission had already made recommendations on those items. He added that the budget is not an issue for the Commission; it is tax policy that is their concern.

Mr. Smyth noted that the 1997 ERTF coupled raising the GET to 5.35% with cutting the income tax to 6% for a net savings of $100 million. He added that there is more talk about the GET than the income tax in campaigns, because the GET is a more politically sensitive issue than the income tax. That is, all taxes are not perceived equally.

The Chairman called for a motion, but none was proffered.

At this time, Dr. Rousslang mentioned income tax recommendation number 21, (replace the medical service credit with one included under itemized medical deductions), which is moot because the medical services excise tax credit was repealed in 1995, and recommendation number 29 (subject nonresident real estate sales to withholding), which was adopted.

<u>3. Transfer transient accommodations tax (TAT) tax authority to the counties.</u>

Dr. Pham stated that 44.8% of the collections are distributed to the counties, each of which gets a fixed percentage, but they don't have the authority to levy the TAT.

Mr. Kalapa stated that this recommendation must be read in the context of 1989. Back then, there was no Convention Center, the State had collected the TAT for 3 years and deposited the proceeds into the general fund, and the counties were at the Legislature asking for grants in aid. Sen. Russell Blair had recommended giving the counties $72 or $100 million in that year, so the Commission may have thought it better to give them this tax instead of them asking for a grant in aid. Currently, a part is dedicated to the Convention Center and part to visitor promotion in addition to the counties. The question is whether it currently is the appropriate thing to do.

Mr. Smyth noted that the counties had never been very happy with the formula allocating fixed percentages to each county as it was tied to the old grant-in-aid formula, which Mr. Kalapa said went back to 1965. It has never been based on the real revenues. Nobody has said much about it recently because revenues are way up.

Mr. Kalapa stated that it was based on the relative fiscal capacity and relative fiscal need; that is, it was dependant on the county valuations, how much a county is projected to receive from property tax, and how much they actually needed to fund their budget. The formula was frozen in 1974.

Oahu and Maui get less than their share, and Hawaii and Kauai gain.

Dr. Rousslang said that those are arguments for adjusting the shares and added that, if the authority is split amongst the counties, there might be a race to the bottom (i.e., lowering the TAT rate to draw tourists to their county rather than another). The counties would be competing against each other for revenues. Mr. Kalapa added that there would also be the challenge of the new county surcharge.

Dr. Grandy stated that there was some basis for keeping the tax at the State level. It may not be best for the counties to compete against each other via the tax rate. Setting one rate statewide may be a better economic decision to allow Hawaii to compete with other tourist destinations rather than pit one county against another.

The Chairman asked if it was worth re-recommending something that was suggested in a pre-Convention Center era given current conditions. He believes that the economic times have changed too much for this to be viable.

Mr. Smyth mentioned that the Hawaii Tourism Authority exceeded its cap the last two years, there is no cap on the 44.8% county share, the Convention Center had its cap increased last year, and the amount that exceeds the caps goes into the general fund, although that amount is rather small and doesn't have much of a revenue impact.

No motion was made to re-recommend this recommendation.

<u>4. Reconcile TAT tax base with DBEDT and HVC estimates.</u>

Dr. Rousslang noted that this had been discussed at the last meeting and that Dr. Pham had said this had been done.

Dr. Pham clarified that the numbers haven't exactly been reconciled, but DBEDT has taken over the research function of the HVC, and DBEDT is also in charge of the gross state product, so it should reconcile. The problem is that the TAT base is about $2.2 billion and the survey of visitor expenditures comes out to $3 or $4 billion. At one time, James Mak questioned the discrepancy, and it appeared that the Department was under-collecting the TAT. Former Tax Director Richard Kahle, Jr., appointed Mr. Richard Chiogioji to reconcile it, and he thinks that DBEDT was able to do so. They now try their best to match it, but it is a research problem. Now DBEDT has a new tourism research office with five or six people in it, more than Dr. Pham's entire staff, just to do this, so he believes that the problem should be solved.

Ms. Tokishi said that there are trends in tourist accommodations (e.g., fractional ownership and vacation clubs, which are not subject to the TAT. Dr. Pham noted that DBEDT's staff will be looking at it, but when the Chairman asked if they are working backwards to match the tax collections rather than auditing those furnishing the transient accommodations, Mr. Smyth said that auditing is a DOTAX function and that DBEDT can't do that. Dr. Pham added that the growth of illegal Bed and Breakfasts (B&Bs) is a hot political topic, but that it is not cost effective for Department auditors to focus on them.

Dr. Pham pointed out that his office has a difficult time with the allocation of the TAT revenues, because the county allocation is based on fiscal year collection numbers while the allocation of the Convention Center and Tourism Authorities is based on calendar year collection numbers.

No motion was made.

5. Continue public service company tax and share receipts with counties.

The chart noted that this provision was adopted but that it was unclear as to whether the counties were collecting their share of the tax or not. Dr. Rousslang noted that it would appear that they are getting their share based his recent work for an internal study. Dr. Pham said that sharing confidential taxpayer information with the counties (e.g., the names of taxpayers subject to the state public services company tax) was not previously allowed, but that a recent law change now permits this (Act 9, Sp. S. 2005).

No motion was made.

5. Consolidate fuel tax at the state level.

Dr. Rousslang explained that there currently are both state and county fuel taxes. The problem, explained Dr. Pham, is that the fuel consumption is rather stable. Since the fuel tax is an ad quantum tax (i.e., based on volume) rather than an ad valorum tax, fuel tax collections do not increase when the prices increase despite increased costs of maintaining roadways. The Department of Transportation needs more money and had asked that the GET collections on fuel sales to go the highways fund. The Department asked that they instead ask for a specific amount of tax or a specific percentage because it would be very difficult to change the forms and the computer system to capture that information and it would make tax reporting more burdensome for businesses.

Mr. Kalapa stated that this is something that will need to be looked at because declining fuel consumption will affect the highways program. This recommendation comes out of a 1974 task force called the Commission on the Reorganization of Government, which proposed consolidating the State and county highway responsibilities. That came from a 1973 report of the Commission on the Operations, Revenues, and Expenditures (CORE). The ad quantum issue with respect to fuel has been revisited several times when inflation was really high in the early 1080's. The Transportation Director at that time, Jack Suo, recommended an ad valorem fuel tax, and had it been in effect today, there would be sufficient money. But it is a per-unit tax that has not been changed since about 1991, which is also when the rental motor vehicle and tour vehicle surcharge tax (RVST) was enacted and the revenue from that tax assigned to the highways fund. However, the RVST on car rentals is going down from $3 per day to $2 per day next year, for a loss of about $10 million in revenue that is not being replaced.

Mr. Kalapa stated that this is something that probably should be "punted" from this commission to the Department of Transportation. Especially with more fuel-efficient cars, the revenue will decrease. Mr. Smyth stated that that would be partially offset because there are more cars, but Mr. Kalapa stated that his point is that someone needs to look at the impact of all these factors. The only reason why the Highway Fund currently has a lot of funds is because it couldn't be moved through the system for maintenance fast enough.

Ms. Ching noted that the sale of fuel is exempt from the GET through the end of the year. But that is, according to Dr. Pham about $32 or $36 million that goes into the general fund. Dr. Pham asked if they recommend that this amount go into the Highways Fund.

The Chairman asked Dr. Rousslang to identify the issues, and they will defer further discussion until then. It is not really a question of whether the taxes should be consolidated at the State level, but appropriate funding for the Highways Fund. This is not another internal study; two paragraphs would be fine. Mr. Kalapa suggested that Dr. Rousslang call the Department of Transportation to look at some of their past studies, including the last one which he thinks was written by Cheryl Soon prior to her becoming the City Transportation Director.

<u>9. Retain liquor and tobacco taxes at state level.</u>

That is currently the case, so no further action was taken.

<u>10. Ensure that liquor and tobacco tax covers cost to government from the use of these products.</u>

There was no interest in this item, so no further action was taken.

<u>13b. Eliminate franchise tax federal income tax deduction.</u>

This was adopted so no further action was taken.

<u>13c. Set franchise tax equal to corporate income tax rate.</u>

Mr. Kalapa stated that this is the bank franchise tax, which is imposed in lieu of the general excise and net income taxes. It is in a separate chapter because not all of a bank's income is really its income (it is their clients'). But they have an exemption from the GET for which the higher tax rate compensates. To reduce the franchise tax rate would mean that the Commission would have to consider eliminating the GET exemptions.

There was no interest in this item, so no further action was taken.

<u>13d. Conform the franchise tax to the corporate income tax rules for the allocation and apportionment of income.</u>

There was no interest in this item, so no further action was taken.

15. Use unrestricted state grants to counties only when necessary.

Mr. Kalapa stated that this had to do with the $100 million in grants that was replaced in counties' budgets with an allocation from the TAT.

Mr. Smyth added that this has some connection to the flow of county money to the State in the form of GET passed on to the counties through the counties' vendors. So there is some history of the State giving grants in aid to the counties in addition to the TAT.

Mr. Kalapa noted that he believed that there was another recommendation to exempt transactions with the counties from the GET, although the legislators seem to err in granting the exemption to the counties instead of to the vendors.

Mr. Smyth stated that this is an important issue that should be settled but which has been highly politicized.

There was no interest in this item, so no further action was taken.

16. Counties should make better use of existing taxing authority: a) property taxes; b) user fees and charges; and c) development fees and exactions.

The Commissioners were generally reluctant to address this issue. Dr. Grandy noted that the county surcharge is limited to transportation projects, although, as Mr. Smyth pointed out, the use of those funds is different for the neighbor islands. However, home rule advocates argue that they should have the authority to impose their own tax in addition to property tax, such as their own GET.

Mr. Smyth and Dr. Grandy stated that the neighbor island counties could join Oahu and impose their own 0.5% GET, but Ms. Tokishi reminded them that the other counties had missed the window for adopting the 0.5% GET surcharge, which Mr. Heller added was the end of 2005.

Dr. Grandy summarized that the counties had the real property tax, various user fees, fuel tax, and the county utility franchise tax. The Chairman had thought that counties could impose whatever tax they wanted, but Dr. Grandy stated that they are creatures of the state and can only impose a tax to the extent the state allows them to.

Dr. Pham asked what tax the Commission would like to recommend the counties have the authority to impose: general excise, net income, etc.

Dr. Grandy stated that, while he is not making this recommendation, the only thing he had in mind for the Commission to consider was whether they should to allow the counties to add a certain amount to the state GET rate.

Mr. Smyth noted that there had been an earlier version of the county surcharge that sat on the books unused for many years. Mr. Kalapa added that the 1989 report had actually recommended that there be no sharing of tax revenue between the State and the counties, except for the utilities franchise tax, for purposes of accountability. The other issue is the same one that arose with respect to the present county surcharge, and that is who is going to collect it.

Mr. Heller recalled that there was a resolution that had come up earlier this year that the Tax Review Commission work with the counties to come up with a combined plan, and that their response had been that the function of the Tax Review Commission was only to study State taxes, although it might be a good idea for the Legislature to create a different commission to do a combined review of state and county taxes.

Mr. Smyth noted that the rise in interest in this matter seems to be when things are not doing well; now TAT revenues and property tax collections are high.

The Chairman stated that they would defer action on this item until further information regarding the status of the resolution is found.

Mr. Kalapa added that, going back to the 1970's, all the counties organized to go to the 1978 Constitutional Convention to ask that they be given full authority over the real property tax in exchange for never bothering the State again.

<u>18. DOTAX to compile more detailed information on the GET.</u>

There was no interest in this item, so no further action was taken.

This largely concluded discussions on past Tax Review Commission recommendations. The Chairman noted that Dr. Rousslang had begun writing up their recommendations and will be e-mailing them drafts. If there is a problem with the wording, etc., they are to let Dr. Rousslang know what their comments are.

Ms. Niwao noted that the past Commission had spent several meetings with all the Commissioners going through the draft line by line. The Chairman would prefer not doing so in favor of each commissioner notifying Dr. Rousslang of any changes they would like made.

Mr. Roberts asked that the report be written at the 10th grade level to ensure readability by a wide range of taxpayers, and that it be brief and tight for the Legislators as they are busy people. Ms. Tokishi noted that the MSWord software has a tool that grades the writing. The Chairman wants to make sure the report has value and is a useful tool.

Mr. Roberts asked if the structure the Chairman had proposed earlier was still being followed; it is – past recommendations, current recommendations, and something for the future. Mr. Roberts also asked if a section on the sound principles of tax policy would be included in the appendix or the report; it will, and the Chairman suggested including the very concise text that Mr. Heller had written and that Mr. Heller would e-mail.

After the report is written, the Chairman would like everyone to explain the report to legislators and others in the community who should know about the report.

The report is being made to the Legislature and is a public document. Ms. Niwao mentioned that they gave the report to everyone, including the media.

Mr. Heller stated that people are asking him when the draft report will be available, and asked if there is any reason why he couldn't give it to someone. The Chairman thinks that they should be able to give it to whomever they want to as long as it says that it is a draft, but he deferred to Ms. Erickson. Ms. Erickson stated that it would be best for the Commission to take formal action and vote on it before making it available to anyone. Dr. Pham asked if that meant that everything should be put on the website. The Chairman said no, but if the Commissioners want to give a copy to someone they should be able to. Ms. Erickson stated that, if anything does go out as a draft, the Commission must ensure that the word, "draft", and the revision date are on every page of the document.

Mr. Heller was going to offer a motion on this issue, but Dr. Rousslang first asked if they were going to distinguish between drafts of the Commission's report and drafts of the studies. The Chairman said that they would not. Ms. Tokishi asked if requests would go to the Tax Research and Planning Office and charges assessed for copies. The Chairman said that requests would go to the Commissioners not to the staff.

Dr. Grandy noted that he had received a number of requests for drafts and asked if he was obligated to give it to them. The Chairman stated that it was up to the individual commissioner, but Dr. Grandy expressed concern over the problem of some commissioners giving out copies and others not.

Dr. Pham noted that drafts are not usually released. The Chairman said that it wouldn't make sense to request drafts of the beginning of the report because it isn't done. A number of the studies, however, are for the most part done.

Mr. Roberts said that giving copies expands the circle of people who could provide input on a draft that was still fluid, but that he would hesitate to facilitate a debate in the public media until they have signed off on it. However, the Chairman stated that, if there were to be a public debate, he would rather have it now than to suddenly present the final report.

The Chairman asked Mr. Heller if he'd be willing to offer a motion with respect to the studies only, and he agreed. Dr. Grandy stated that he would rather they consider putting the draft studies on the website, but Mr. Roberts was concerned about using resources during the limited time to defend or comment on draft studies while they are trying to get the report out.

<u>It was moved by Mr. Heller and seconded by Mr. Roberts, that the members of the Commission may, upon request, give out copies of any and all draft studies. The motion failed with the following votes: 3-Yes 3-No</u>.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	No
Christopher Grandy	No
Melanie King	Yes
John Roberts	No

Mr. Roberts stated that he'd rather the motion be that each of the Commissioners have the discretion to share copies of any drafts with the public.

Mr. Smyth suggested allowing the release of the internal and external studies, which are not subject to any comment, and not drafts of the report, even if the studies are still drafts because the appendix number or format may change.

Mr. Roberts stated that he'd favor allowing the studies to be posted on the website only after they have accepted the report. With respect to the external studies, there may be some contractual issues if the report is released prior to acceptance, and he is reluctant to tie the hands of the Commission's research staff if they needed to tweak a report.

<u>It was moved by Mr. Heller and seconded by Ms. King, that after the Commission votes on and accepts a study, it will be posted on the website and copies made available to the public. The motion passed with the following votes: 6-Yes</u>.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Melanie King	Yes
John Roberts	Yes

REVIEW STATUS OF THE INTERNAL STUDIES, EXTERNAL STUDIES, AND THE TRC'S REPORT

The Chairman stated that they would be going through the listed studies, discuss them, and if the study is complete, vote on accepting them or not. Acceptance means that they will be a part of their report and will be posted on the website. Accepting a report does not preclude the staff from making nonsubstantive changes such as fixing typos or changing the format, but any major, substantive change would require that it be re-reviewed.

Mr. Heller commented that the studies be listed as having been a study for the Tax Review Commission instead of having been written by the Tax Review Commission.

Dr. Grandy pointed out that this is an issue in some of reports when it says in the footnotes, "this is the author's calculation." Therefore, they need to decide whether the author's name will be on the report, whether it will be attributed to the staff of the Tax Review Commission, or something else. Mr. Kalapa noted that precedence was set by the 1989 Commission, which listed the author's name. Dr. Pham asked for some latitude in deciding if the author would be listed or whether it would be a generic attribution to the Tax Research and Planning Office for the Tax Review Commission.

<u>Internal Study – Study on the Question, "Is Hawaii's Tax Structure Adequate?"</u>

Dr. Rousslang stated that this report is complete. Mr. Roberts stated that it answers the question on the second page. The Chairman summarized by saying that the study concludes that tax collections rise in relationship to income such that the tax structure is adequate.

Dr. Rousslang stated that he had learned some new terminology from Dr. William Fox's work after doing this study. There apparently is a difference between "adequacy" and "sufficiency" where "sufficiency" is if it matches one year and "adequacy" is if grows with income. However, he didn't think it was worth explaining the terms.

Dr. Grandy clarified with Dr. Rousslang that the short-term elasticities are one year.

Ms. Ching asked how borrowing in the form of government bonds affect adequacy, and Dr. Rousslang explained that this was a study of tax adequacy as opposed to all revenue, such that borrowing was not considered. Dr. Rousslang explained that the two issues in this study were: (1) whether tax revenues would grow if there were no changes in law from 1972 to the present and (2) have revenues kept up considering the legislative response to changing economic conditions.

Mr. Kalapa added that Ms. Ching's question is addressed in the State's Constitution, which states that no more than 18.5% of the average General Fund revenue for the past three years can go towards debt service, so it's a part of the operating costs that are figured into how much money can be generated to cover the budget. In response to a question from the Chairman, he stated that it currently is about 16%.

The Chairman asked who decides whether to pay for things via borrowing or cash. Mr. Kalapa stated that the Legislature decides and that they went over the General Fund expenditure ceiling by $111 million, primarily for school maintenance and repair. They used about $150 million in cash for capital improvement projects (CIP), which means that current taxpayers are paying for benefits that future taxpayers will enjoy. That means that they are over utilizing current revenues such that there is no opportunity to reduce taxes even though a surplus was generated.

The Chairman asked if CIP includes repairs, to which Mr. Kalapa stated that CIP is only new construction and does not include repairs. Operations and Maintenance (O&M) is separate, and can be paid for with cash or some bonds for major structural repairs.

The Chairman asked if 18.5% was a national standard, to which Mr. Kalapa replied that it was not and that it was adopted in 1978. He noted that the City would have gone over 20% had it not expanded its spending.

Dr. Rousslang asked how they could legally go over the General Fund expenditure ceiling. Mr. Kalapa stated that the ceiling is flexible and can be exceeded by a 2/3 vote. The Governor must only submit a budget that exceeds the ceiling to make a declaration.

Dr. Grandy reiterated that this study does not cover expenditures. It is just the relationship between revenue and personal income.

The Chairman asked if there is a disproportional decrease in revenues when personal income decreases. Dr. Rousslang said that it could because the 110% figure is a long-term average. When you look at the short-term elasticities, you have negative numbers (e.g., 1982).

Dr. Pham pointed out that capital gains are not part of personal income.

The Chairman noted that this study also does not draw any conclusions with respect to the ability of the current tax structure to deliver the same amount of services.

<u>It was moved by Dr. Grandy and seconded by Mr. Heller, that the report, Study on the Question, "Is Hawaii's Tax Structure Adequate?" be accepted. The motion passed with the following votes: 6-Yes</u>.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Melanie King	Yes
John Roberts	Yes

<u>Internal Study – Study on the Question, "Should Hawaii Replace Its Income and Franchise Taxes With an Increase in the General Excise Tax?"</u>

Dr. Grandy noted that this report doesn't actually answer the question. Dr. Rousslang agreed, adding that it is a study on the question. There was some discussion on a more descriptive title, but no change was made.

The Chairman observed that Dr. Rousslang's initial estimate of 6.8% had been increased to 6.9%. Dr. Rousslang said that one question arose with respect to whether something would be done about the franchise tax and another with respect to whether the public service company (PSC) tax would be raised in tandem with the GET, and he had to make a judgment on those issues. Dr. Rousslang had two scenarios in the study.

The first scenario eliminated the individual and corporate income taxes and the insurance premiums tax and substantially reduced the franchise tax from 7.9% to 1.5%, which resulted in an increase in the GET and PSC tax in tandem from 4% to 6.9%. The 1.5% franchise tax rate is about what is left when the corporate income tax portion is eliminated.

The second scenario only eliminated the individual and corporate income taxes, which resulted in an increase in the GET and PSC tax in tandem from 4% to 6.7%. The franchise tax is kept the same based on an assessment of what is fair since they are not subject to the GET on most of their revenue or to the corporate income tax, which has been eliminated while at the same time the GET rate on others is increased.

The Chairman asked if there was something on eliminating just the corporate income tax. This question was addressed beginning on page 24 of the draft, and the effect is negligible because the corporate income tax revenue is so small relative to the GET and PSC tax. The Chairman noted that there was nothing on this in the executive summary, and Mr. Heller suggested that a sentence or two be added to the executive summary.

The Chairman directed attention to page 4 of the draft and stated that he found the third main advantage, improves stability of government revenue, surprising. Dr. Rousslang explained that this is the case simply because it is less variable. Income tax, on the other hand, with capital gains and graduated rates, tends to go up faster with income and go down faster with income.

Ms. Ching pointed out that the third main disadvantage listed, reduces the tendency of the State's taxes to help smooth swings in the business cycle, would seem to be the opposite of the stability advantage. Dr. Rousslang explained that this is Mark Twain's thing about when times are good they lower taxes and when times are tough they raise them; that's statesmanship of the highest order.

When talking about tax stability, there are two sides to that. One is that a tax that is very stable and doesn’t change much with income won't help the private sector when things are going down because they face the same tax bill. For the federal tax, when times are good, revenue accelerates, and when times are bad, revenues decelerate, and that tends to even out fluctuations in the business cycle for the private sector. That is fine for the federal government because it can borrow money pretty cheaply if there is a shortfall.

Ms. Niwao asked if Dr. Rousslang had considered the effect of this on business planning with more and more people forming S-Corporations, LLCs, and other pass-through entities to avoid the corporate income tax. Dr. Rousslang assumed that there would be a backstop to prevent people from forming corporations merely to avoid income tax. He acknowledged that C-Corporations are taxed twice, once at the corporate level and a second time when the dividends were taxed, but they would no longer be subject to the corporate tax. An S-Corporation could become a C-Corporation and then defer distributing dividends for years unless you say that it is automatically passed through. He assumed that the profits would flow through to the shareholders, but since most shareholders would not be in Hawaii, the tax would be negligible. He noted that the corporate income tax formerly was a tax on limited liability, but with recent changes, it is now a tax on being publicly traded.

Mr. Au added that this is a state tax, but that most companies do their planning based on the federal tax. With respect to the small companies his firm invests in, the small companies that either are not profitable or have minimal profits that they reinvest may want to be C-Corporations because the corporate rate is lower. Those with large research losses up front or that have profits to distribute may want to be pass-through entities. Then there are the publicly traded companies that have to be C-Corporations. So the question is whether the State is giving up revenue when it doesn't have to.

Mr. Heller agreed that the State would be giving up revenue from the big publicly traded companies.

Dr. Rousslang said that the theory is that the corporate tax is not going to be paid by external shareholders anyway. The investor is going to invest where the after-tax rate of return is highest. If they can't get the same after-tax rate of return in Hawaii, they're going to invest elsewhere. If you have a corporate income tax, it raises the required pre-tax rate of return; there is a lower level of investment such that it will support the higher pre-tax rate of return. The tax is paid in the form of lower wages, lower land values, less investment, etc. Mr. Heller noted that Dr. Rousslang had made that point in looking at the short-run impact versus the long-run impact.

The Chairman noted that the bottom line is $40 million, which he believes will continue to decline.

Mr. Roberts asked that the number of C-Corporation income tax return filings be provided on page 3 of the report. Dr. Pham said that he has the numbers for the 2002 tax year.

The Chairman pointed out that the first main advantage, reduces the overall burden of the State's taxes on residents by shifting more of the burden to nonresidents, is important since 37% of the GET is exported to tourists and the military. Dr. Rousslang stated that it is only 27% for income tax. He cautioned about the long-range impact of excessive exporting, because the military does consider costs in decisions on where to locate its assets and tourists could decide to go elsewhere.

The Chairman noted that regressiveness is an issue, but asked if the only reason for having an income tax should be to offset the regressiveness of the GET.

It was moved by Mr. Roberts and seconded by Ms. King, that the report, Study on the Question, "Should Hawaii Replace Its Income and Franchise Taxes With an Increase in the General Excise Tax?" be accepted. The motion passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Melanie King	Yes
John Roberts	Yes

Internal Study – Study on the Progressive or Regressive Nature of Hawaii's Taxes

The Chairman asked if anyone has strong feeling about using one tax to compensate for the regressivity of another tax, as the income tax does for the GET. Mr. Roberts says that he opposes using the tax system for this purpose, and believes that inequities in society should be addressed separately.

The Chairman asked Dr. Rousslang if there was a demarcation line as far as a taxpayer's income is concerned, where taxes becomes regressive or progressive or if the GET is regressive just because of the nature of the tax. He referred to an example in the study that compared a single individual with a family of four. Dr. Rousslang stated that there was one exercise doing that comparison but it didn't directly address that question.

The Chairman asked why regressive taxes are bad. Dr. Rousslang stated that it is because they are unfair, which Dr. Grandy stated meant that they violated vertical equity. Mr. Heller stated that it was because they imposed more of a burden on those least able to pay, but that how much progressivity or regressivity is desirable is a judgment call.

Dr. Grandy thought that this was really an optimal tax issue, and that his recollection of that literature is that it is optimal when tax structures are pretty close to being proportional to income rather than being either progressive or regressive. Income is used as a proxy for the taxpayer's ability to pay.

Mr. Roberts stated that the study by Dr. William Fox seemed to indicate that all taxes are regressive and that the lowest rate causes the least disruption.

It was moved by Ms. Ching and seconded by Mr. Roberts, that the report, Study on the Progressive or Regressive Nature of Hawaii's Taxes, be accepted. The motion passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Melanie King	Yes
John Roberts	Yes

Internal Study – Revenue Costs for Selected General Excise Tax and Use Tax Exemptions and Deductions

The Chairman noted that this is primarily statistical. Dr. Grandy asked if this was substantially revised from earlier this year, and Dr. Rousslang stated that some are, though the introduction is the biggest difference.

It was moved by Mr. Heller and seconded by Ms. King, that the report, Revenue Costs for Selected General Excise Tax and Use Tax Exemptions and Deductions, be accepted. The motion passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Melanie King	Yes
John Roberts	Yes

Dr. Pham noted that Rep. Glenn Wakai had asked Director Kurt Kawafuchi for this and that it represents a lot of work by his staff over a long period of time, including Mr. Bernard Wilson, Mr. Robert Hoffman, and Dr. Rousslang.

Internal Study – Review of Past TRC Recommendations

This report is not complete. Further discussion was deferred.

Internal Study – Effects of Increasing the Hawaii Standard Deduction, Expanding the Hawaii Individual Income Tax Brackets, and Enacting a Hawaii Earned Income Tax Credit and Food, Medical Services, and Nonprescription Drug Income Tax Credit

This study was not on the agenda, so Ms. Erickson advised that they amend their agenda.

It was moved by Mr. Heller and seconded by Ms. Ching, to amend the agenda to include the review of the internal study, Effects of Increasing the Hawaii Standard Deduction, Expanding the Hawaii Individual Income Tax Brackets, and Enacting a Hawaii Earned Income Tax Credit and Food, Medical Services, and Nonprescription Drug Income Tax Credit. The motion passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Melanie King	Yes
John Roberts	Yes

Ms. Tokishi explained that they had received the memo version of this report earlier when they were considering raising the standard deduction and expanding the tax brackets.

The Chairman noted that he had not looked at the credit sections at that time. Ms. Tokishi explained that there were no conclusions drawn, and that this study only reports on the revenue impacts that Dr. Pham's statisticians had prepared for the Legislature. Regarding the earned income tax credit (EITC), it was proposed as a percentage of the federal credit. Dr. Pham added that it was quite striking that only 22% of those with Hawaii adjusted gross income under $30,000 qualified for the credit.

The Chairman stated that he attended a session on the EITC at the Tax Administrators conference. Minnesota has a very elaborate EITC, but the recent proposals were tagging on to the federal credit.

The Chairman noted that there is no "draft" and date on this report, but Dr. Pham said that it was data that had already gone to the Legislature and was quite firm.

It was moved by Mr. Roberts and seconded by Ms. Ching, that the report, Effects of Increasing the Hawaii Standard Deduction, Expanding the Hawaii Individual Income Tax Brackets, and Enacting a Hawaii Earned Income Tax Credit and Food, Medical Services, and Nonprescription Drug Income Tax Credit, be accepted. The motion passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Melanie King	Yes
John Roberts	Yes

External Studies – External Studies 1 and 3, "Economic, Revenue and Distributional Impacts of the General Excise and Use Taxes," and "Economic Effects of Certain Possible Changes in Exemptions from the General Excise Tax," by Dr. William Fox

The Chairman noted that this is the only study that they have received a draft of, and that Dr. Fox would be revising it. No further discussion was held as considerable discussion had already occurred at the September 22, 2006, meeting with Dr. Fox.

The Chairman asked if they should take a vote on accepting the study anyway. Mr. Roberts stated that he did not think that a vote should be taken because it is being done externally, is being revised, and acceptance means that they would be posting it on the website. Until Dr. Fox says it is done, he doesn't think it should be accepted and posted on the website.

External Studies – External Study 2, "The Costs and Benefits of Selected Tax Credits," by Dr. Marcia Sakai and Dr. Bruce Bird

The draft report was not received so discussion was deferred.

The TRC's Report – Introduction to the report

The introduction was only half written so discussion was deferred.

The TRC's Report – Statement of the TRC's recommendations

The recommendations section had not yet been drafted. Dr. Grandy asked that the total number of recommendations and the number adopted or something like that be included on the chart of the past TRC recommendations. Ms. Tokishi stated that she had been working on it, but noted that whomever had put the original table together had done some odd things such that it doesn't necessarily correlate one-to-one. In addition, they are attempting to meld this Commission's recommendations into that table, and this Commission combined certain ones as well. As a result, she is not sure how meaningful that will be although they are continuing to look at it.

Mr. Heller noted that some of the recommendations are very specific while others are general themes and it would be hard to count those. Ms. Tokishi added that this Commission also did not address some of the specific recommendations although they were discussed as part of a broader recommendation; for example, not addressing a specific credit or exemption in favor of a broad recommendation to minimize tax preferences.

Further discussion was deferred.

LIST AGENDA ITEMS FOR THE NEXT MEETING

The next regular Tax Review Commission meeting will be on October 31, 2006, at 9:00 a.m. By then, the Commission would have discussed Dr. Sakai's study at the special October 6, 2006 meeting.

The Chairman asked if Dr. Rousslang would have the Introduction and the recommendations drafted by October 6, 2006; Dr. Rousslang said that he hoped to, but that he is having some difficulty with the recommendations. He believes that it might be best to send out a rough draft to all the Commissioners and solicit input, and the Chairman concurred. Ms. Tokishi noted that Dr. Rousslang had recently taken it over, as she had recently assumed administrative duties with the transfer of Ms. Dana Remigio to the Director's Office.

Mr. Roberts commended the Department on their internal studies, which exceeded his expectations.

Ms. Ching noted that a discussion on the Washington credit requirements for collecting data needed for evaluating tax credits and other tax incentives had been deferred. Mr. Roberts stated that he would be e-mailing the information to Dr. Rousslang to get his input with a recommendation and draft motion, and then e-mail it out again. The Chairman noted that Dr. Sakai's report might address some of this issue as well, though they don't have a draft report as yet.

Mr. Au stated that he is part of the Hawaii Science and Technology Council although he was present on his own behalf rather than that of the council. Related to Dr. Sakai's report, his venture capital group has invested in more than a dozen companies. He noted that the industry wanted to work collaboratively with the Commission. One event that may be helpful in presenting a broad perspective is the presentation by Director Kawafuchi at the Hawaii Venture Capital Association lunch on Thursday, September 28, which is being co-sponsored by the Hawaii Science and Technology Council.

He believes that there was some bad press early on, but the companies he has invested in have matured and are not kid.coms. The average age of the CEOs is in the early 50's and they are trying to bring in serious companies including two that are looking for cures for cancer, new treatments for diabetes, etc.

He also noted that Director Kawafuchi has worked hard to overcome the earlier conflicts of 2003. He acknowledged that the State is spending a lot of money on this credit, but hoped that a circus atmosphere can be avoided. Mr. Au noted that people have worked hard to make the credit work, comparing the earlier *Blue Crush* move project with the recent *Lost* project, and extended an invitation to the Commission for discussion and collaboration.

The Chairman asked Mr. Au if his industry would be opposed to more disclosure.

Mr. Au answered that it depends on the type of disclosure. He stated that the problem with disclosure, with respect to the high technology business investment tax credit, is that how much an individual invests is indicative of that person's state tax liability, which is in turn indicative of how much money that person is making – that is a sensitive issue for high net worth individuals. Rich people don't want poor people to know that they have money because they don't want poor people to ask for money and they don't want richer people to know how little money they have.

The other problem is that these companies have trouble raising capital, and they don't want competitors to know how well capitalized they are, or not; this is a very sensitive matter for companies at an early stage. They also want to avoid being tainted by the earlier bad press, which may lead people to view companies benefiting from the high technology investment tax credit as not being legitimate. At the same time, virtually every technology company has needed to use the high technology business investment tax credit to raise money because there is so little capital available.

Mr. Au advised the researchers to base the study on the facts and law, but to avoid press articles. He stated that there was an effort to spin the press a few years ago. A large, public relations firm had advised him that they had been approached by an individual for a campaign against the credit, and against him personally, which the firm had turned down. In his view, the strongest criticisms of this credit have come from outside of the State and from a small group of people. Based on public opinion polls and from people in the industry, there is strong, local, community support.

He also believes that the Commission would find that a short-term cost-benefit analysis would, because of the large TV and film studios that came here, spent hundreds of millions of dollars and, for whatever reason, weren't able to "monetize" probably more than 15% of the credits they were entitled to, conclude that the general excise tax, withholding, and other taxes paid would probably have more than paid for all the other credits.

A longer-term cost-benefit analysis would have to consider the purpose of Act 221, which is a long-term, structural, economic change in comparative advantage analogous to switching from agriculture to tourism; it takes a long time. Any company takes five to seven years to create jobs and reach profitability, particularly during research. Therefore, he asks if a cost-benefit analysis could truly be conducted within a few years of the statute being passed, which in this case was 2001, given that it may take a few years to get investors. Doing a cost-benefit analysis is fine, but the right context and timing must be considered.

ADJOURNMENT

It was moved by Mr. Roberts and seconded by Dr. Grandy to adjourn the meeting at 11:40 a.m. The motion was carried unanimously.