TAX REVIEW COMMISSION

MINUTES OF THE TENTH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT 830 PUNCHBOWL STREET
DEPARTMENT OF LABOR & INDUSTRIAL RELATIONS ROOMS 310-313
IN THE CITY & COUNTY OF HONOLULU
STATE OF HAWAII, ON THURSDAY, JUNE 21, 2012 AT 9:00 A.M.

The members of the Tax Review Commission (TRC) met at the Department of Labor & Industrial Relations Conference Rooms, in the City and County of Honolulu, State of Hawaii, on Thursday, June 21, 2012.

Members Present: Randall Y. Iwase, Chair
Mitchell A. Imanaka, Vice-Chair
Roy K. Amemiya, Jr.
Michael T. McEnerney
Darryl K. Nitta
Peter S. Ho

Staff: Donald Rousslang Titin Sakata and Sondra Kaawa

Others: John Cape, Public Financial Management
Randall Bauer, Public Financial Management
Phyllis Resnick, Public Financial Management
Randall Nishiyama, Department of the Attorney General
Hamid Jahanmir, Department of Taxation
Lowell Kalapa, Tax Foundation of Hawaii
Ken Takenaka, GCA
Gladys Marrone, BIA
Tom Smyth, Chamber of Commerce
Peter Fritz

CALL TO ORDER

TRC Chair Iwase called the meeting to order at 9:00 a.m.

APPROVE MINUTES FROM PREVIOUS MEETING

Chair Iwase said the first order of business on the agenda was the approval of minutes for the meeting of May 18, 2012. He asked if there were any changes, comments or requests for amendments to the minutes.

Mr. Amemiya noted that on page 2, second paragraph, second sentence, the word "not" should be inserted after the word "and." On page 4, last sentence on the page, the word "revenue" should be inserted after the word "capture" and the word "lost" should be replaced with "loss."

Chair Iwase asked for a motion to approve the amended minutes for the May 18, 2012 meeting. The motion was made by Mr. Imanaka and seconded by Mr. Nitta. The motion carried unanimously.

Chair Iwase noted that the TRC members had been given a notice of the Gift Disclosure Requirements, which were to be filed by July 2, 2012. He said there are three criteria that have to be met in order for a member to be required to file a gift disclosure. He asked Mr. Nishiyama to elaborate.

Mr. Nishiyama said the members must meet all three requirements before they are required to file. He said the most common occurrences where the requirements might be met is where a member is invited to a conference and the conference pays the registration, or where someone takes a member out to lunch or dinner and the TRC is working on a matter the person deals with. Those are the most commonly occurring items where reporting will be required.

Chair Iwase asked Mr. Nishiyama to clarify that the gift has to be in relation to the member's activities as a Tax Review Commissioners and that all three of the criteria must be met.

Mr. Nishiyama said that was correct.

COMMUNICATION TO THE COMMISSION

None

UPDATE OF STUDY BY PUBLIC FINANCIAL MANAGEMENT

Chair Iwase said that representatives from Public Financial Management (PFM) were there to give the TRC the latest progress report and asked them to introduce themselves.

Mr. Bauer passed out handouts and introduced himself along with Mr. Cape as co-leaders of the state management and budget consulting practice at PFM. He said they were joined by Dr. Phyllis Resnick, who has worked with PFM on a variety of past studies dealing with revenue structures in various state or local governments and who most recently was the lead economist on a study commissioned by the Colorado State Legislature to look at issues like sustainability.

Chair Iwase asked PFM to start their presentation and he invited the TRC commissioners to ask pertinent questions during Mr. Bauer’s presentation, rather than wait to the end.

Mr. Bauer said that this would be a chance for the PFM Group to get input from the TRC as well as to present some of their findings. He gave a fifty-six page handout to the TRC. He said his presentation would cover about twenty pages from the handout and that he would reference the page number as he goes.

Mr. Ho asked if PFM was aware of how many other states or legislatures were embarking on similar studies.

Mr. Bauer said Colorado and Kentucky were in the middle of similar studies and that Dr. Fox was involved with the latter study. He said that from time to time, other states either have blue ribbon commissions or do something internally.

Dr. Resnick said that a couple of years ago a local non-profit organizations did a long range sustainability study for Michigan. She said such studies were fairly common right now due to the impact of the recent recession and various state or local governments were asking "What do we need to do to address all of this?"

Mr. Cape said that he thinks North Carolina did a study that focused on revenue and that a number of large metro regional governments have also looked budget issues.

Mr. Bauer said the slide on page 2 of the handout gave the current status of the project. He said the slide lays out, step by step, the activities that PFM will perform for the project. He said that the two first phases, the planning and information gathering, were completed. He said PFM is still in the evaluation phase and is probably within a week or two of the timeline as originally envisioned and that they could probably shorten the time for the project by a month if necessary. He said some of the data issues took a little longer to resolve and some are still being resolved, but that they still plan to complete the draft report at the end of August and the final report by the end of September.

Mr. Bauer said PFM views this as a high level update on the project on status, on the approach PFM is taking and the direction it is headed. He said it was an opportunity for the TRC and PFM to communicate and they were at the midpoint of the project.

Mr. Bauer said PFM has had excellent discussions with stakeholders both within and outside of the state government about the state's characteristics and things that set Hawaii apart. He said PFM has come to recognize that those are important for these areas of discussion that Hawaii's economy is largely focused on a couple of key industries, and that it has its own strengths and weaknesses. He said tourism as a key industry that provides some opportunities like exporting part of the tax burden, but that there are also concerns because of the singular nature of that industry, and about where Hawaii was going in the next ten to twenty years, which is the time frame PFM has been charged to look at.

Mr. McEnerney asked why PFM thinks that tourism is the primary driver when it comprises only about 20% of the state's economy.

Mr. Bauer said from what PFM has found, tourism is a little more than 20% of the economy, perhaps about 25% and that it was one of the state's largest industries.

Mr. McEnerney said he recalls that the single biggest employer category in the state of Hawaii is federal, state and local government, not tourism. He said he believes that tourism has been flat or declining in the last decade and that he is worried about focusing on tourism at the exclusion of most categories.

Mr. Bauer said PFM would not focus on tourism to the exclusion of other categories, but that tourism certainly is a category that is important to the state's economy. He said PFM would also consider the federal, state and local governments as the drivers of the economy. He said there are certainly concerns about state and local governments across the country because of the declines in expenditures, and that there are also big questions about what's going to happen with the federal government and how it would deal with its deficit.

Mr. McEnerney said he thought exporting part of the tax burden to non-residents was a great idea. He said he was concerned about projections forward and that he assumes that PFM has considered that Hawaii will likely see a reduction in federal, state and local spending and that tourism was unlikely to pick up the slack. He said tourism has been constantly declining over the last ten to fifteen years so we can’t gain enough revenue from tourism to offset potential revenue losses caused by declines in government employment.

Mr. Bauer said that would certainly be an area for the TRC to consider.

Mr. McEnerney asked if the models showed tourism perhaps having a very slight decline or staying constant.

Mr. Bauer said the revenue model and its drivers come from the Council on Revenues. He said that whether tourism is going to be flat or not is an open question. He said PFM had discussions with the head of the Hawaii Tourism Authority who suggested that they are having a pretty good year and that there seems to be an updraft in the tourism industry, so those are some things that will have to be analyzed.

Mr. Cape said he that PFM has a baseline for its models and that the kinds of things the TRC is pointing out are going to be important to PFM in developing scenarios. He said one of the things that PFM wants to find is some “what if choices”. For example, what if there is a material reduction in military spending in the islands and at the same time a downturn in tourism as the percentage of the gross state product. If that were to occur, what will the impact be and how would we hedge against that. He said that in the next phase of this project, PFM will develop those scenarios and trends so that the policymakers can weigh them against each other, see the potential implications, and come up with policy choices to address them should they materialized.

Mr. Ho was curious about the third bullet point on page 6.

Mr. Bauer said he thought it relates to discussions PFM had with individuals as it relates to expenditure policy and potential revenue sources. For example, the state has chosen not to pursue gaming revenue which Hawaiians generally do not think of it as a potential revenue source. Whether that is entirely accurate or not, that has been expressed to PFM on numerous occasions. He said he thinks that culture weighs into some of the decisions that are made as to how the state approaches issues like healthcare and how it approaches issues like what revenue sources should be used.

Mr. Cape said on the spending side, there are the Compact of Free Association populations that make Hawaii different from most other states. He said PFM looks at those kinds of issues.

Mr. Bauer said the report talks about some of the benchmarking that PFM is doing, but he didn't want to spend too much time on it and welcomed the TRC to take a look at them and see if there is anything of interest. Hawaii has a diverse and growing population, and that is certainly different from many states across the country. Generally, Hawaii is a higher income state when compared to the other 50 states. It has a high median home value that has its own impacts on different parts of the economy and taxes, high educational attainment in relation to other states and generally low poverty. Those are characteristics that normally look have positive impacts on the economy.

Mr. Bauer said Hawaii also has a high cost of living and that's another factor that has to be weighed, but those are all part of what PFM looks at when benchmarking.

Mr. McEnerney asked if PFM had a chance to speak with Dr. Brewbaker, who is well known local economist, formerly with the Bank of Hawaii.

Mr. Bauer said they did not. He mentioned that they met with members of the Hawaii Chamber of Commerce, the Hawaii Institute for Public Affairs, and the Chair and Vice Chair of the Council on Revenues. He said that they would be happy to meet with Dr. Brewbaker if the TRC found it useful.

Mr. McEnerney said he would recommend it because for many years, Dr. Brewbaker had done the economic report for Bank of Hawaii and had been the Chair of the Council on Revenues.

Mr. Bauer went to page 16 of the handout and said PFM's charge is to study of Hawaii revenues, expenses, and whether the current structure is sustainable or not. He said PFM has been looking at the expenditures and has been able to build the financial models. Taxes and revenue sources are a key aspect of this study. Hawaii's primary source of tax revenues, the general excise tax (GET), generally is a consumption tax, which is similar to sales tax as of the other states. For most states, a personal income tax, it is generally the largest source of their tax revenues. Those two taxes are the key sources of revenues around the country. To the extent that the GET is largely a sales tax and is also a business tax, Hawaii is a little bit more skewed toward that tax source than the personal income tax.

Mr. Bauer pointed to page 19, which compares Hawaii personal income tax against those of other states. It shows that Hawaii has one of the highest marginal tax rates in the country. In There are a couple of states that stand out: (1) California has a top bracket that kicks in at $2 million and (2) Connecticut has a bracket that kicks in at $1 million.

Mr. Bauer referred to page 20 which showed state taxes as a percent of per capita income. He said he doesn't think that is a very effective way of looking at tax burden, because Hawaii is the only state that has essentially full assumption of K-12 education. In most states, K-12 education is primarily financed with local taxes. PFM thinks it's better to combine state and local taxes. In general, Hawaii's tax burden has been above the national average, but not always, and in the last year of the graph (2009), Hawaii fell below the national average.

Mr. Ho said that the top marginal tax rate and bracket is interesting information. He said that it applies to people of wealth and resources, but wondered about the people at the lower end.

Mr. Bauer said Hawaii has more brackets and more lower income individuals that pay personal income taxes than most states. He noted that Hawaii has some tax credits for low income individuals and the issue is something PFM is considering.

Mr. Bauer said that PFM is developing a multi-year financial projection model. He explained that page 23 laid out the methodology for applying growth rates to different areas of expenditures and revenues. He said that the growth rate assumption could be based on CPI, on historical growth rate, or on changes in policy. The assumptions in each year of the model will be clearly identified and can be adjusted accordingly.

Mr. McEnerney asked if PFM is looking at potential cut backs in federal spending.

Mr. Bauer said it is something that will definitely be in the model.

Mr. Bauer said that page 24 shows what PFM sees right now as the baseline assumption, but cautioned that they are still working through some of the significant assumptions with expenditures in the future as it relates to personal services that will be impacted by collective bargaining agreements. Debt service has been built into the model with current schedules for the bonds that have been issued. If there the state expects to make additional debt issuances, then some adjustments will have to be made to future debt services.

Mr. Bauer explained that page 27 shows the current baseline forecast. This is what PFM characterizes as a current level of service model. It shows that the state does fairly well with the revenue projections that were built into the model until 2018. Starting with 2019, the model shows growing deficits and reduction in fund balance. In any of the models, the out years are not very informative because the state has a balanced budget requirement; therefore, the state would not get to the point of dropping off the cliff as shown in 2025. The state would have to take action to balance its budget, but the model suggests that under current assumptions it will be hard to maintain structural balance with the current revenue structure and level of services.

Mr. Bauer said that there are the unknown variables like personal services costs. Based on historic analysis of salary adjustments for bargaining units, the weighted average increase is estimated at 3.05%.

Mr. Bauer discussed health benefits, which is one of the key drivers. The state covers 50% - 60% of healthcare premiums, and the future mix will be an important factor. With the current growth rates as the state forecasts them, there will be an increase of about 43% in the budget up to the fiscal year 2017. The health benefit is a key driver that will significantly impact expenditures.

Mr. Bauer said that the final issue related to the pension system where the state has significant unfunded accrued liability. He said PFM has built in the required contributions as the actuary provided the state. There are a couple of areas of concern, including the assumed return of on assets 7.5%.

Mr. Ho asked whether the 7% growth rate on healthcare costs was a historical average, and if not, he asked how PFM derived the figure.

Mr. Cape said it was a combination of two factors: (1) the historical average, which was higher than 7%, and (2) the forecasted figures that PFM received from the state in terms of expected future premiums. He said that they would like to further refine the figure. He added that the state did not yet determine how it will operate under the Affordable Healthcare Act.

Mr. Bauer discussed future strategic investments, such as school construction and the Honolulu Rail Project.

Chair Iwase asked Mr. Bauer why the rail project was being included in the model, since it is a city project, not a state project.

Mr. Bauer said it was included on the expenditure side and that there was a planned investment from the GET.

Chair Iwase said the legislature passed the GET increase that authorizes the counties to impose the additional 0.5% increase, but in Honolulu, the additional 0.5% is specifically for mass transit and is paid to the city government.

Mr. Cape agreed it is a city project and noted that PFM doesn't include the Honolulu Rail Project on the expenditure side, but PFM includes it in the paper because it is another demand on tax revenues, so when they look at the overall impact of state and local taxes together, the rail project has an impact on the revenue side.

Mr. Bauer said there are a number of pages in the handout that talk about some tax principles and tax theories that he would not discuss but he encouraged the TRC to look at them.

Mr. Bauer said the PFM addresses the balancing act between growth and volatility in a tax structure. Issues of horizontal and vertical equity, tax exportability, and of demographic changes are all factors PFM considers in the analysis.

Mr. Bauer referred to the findings on page 46. He said Hawaii's top two revenue sources are typical for the majority of states and Hawaii is a little bit more weighted by the general consumption tax than in most other states. The GET is the broadest, safest general consumption tax in the country, and a lot of states would like to be in that situation. Sales tax revenue as a percentage of personal income has been declining for fifty years. Therefore, generally, what states have had to do is continually raise their rate to try and keep ahead of the eroding base; however, Hawaii's broad base doesn't show nearly as much erosion as exists with other states. He added that ecommerce will continue to be an issue and a threat to erosion in any state. He said that there will likely be some kind of federal action in that area within the next ten years, but it's still a big unknown as to how it would relate to Hawaii's tax structure.

Mr. Bauer said Hawaii has a number of temporary tax increases that are set to expire some of which cause tax pyramiding but others broaden the tax base.

Mr. Bauer said from what was expressed to PFM, the corporate income tax is very complex but does not generate a lot of revenue for the state whereas the GET captures sales activity for businesses.

Mr. McEnerney asked if PFM had any comparisons on the equitable distribution of taxes in Hawaii as compared with the national average.

Mr. Bauer asked Mr. McEnerney if there was a particular tax that he was interested in.

Mr. McEnerney said he was concerned about the tax burden as a whole.

Mr. Bauer said PFM is doing a tax burden analysis as part of their study. He said the analysis is not included in the presentation.

Mr. McEnerney asked if PFM is looking at the county level because Hawaii funds education causing the state taxes to be higher than the average. He added that Hawaii has low property taxes, and the tax burden as a whole should consider all state and county taxes.

Mr. Bauer said PFM is looking at the tax burden as a whole.

Mr. Bauer referred to page 48. He said that there was an opportunity to raise the TAT and still be competitive with other tourism destinations.

Mr. Bauer said a higher tax rate on prepared foods is used mostly in metropolitan areas. For example, the city of St. Louis adds 1.5% to the tax rate for restaurants, and Denver adds 1% to prepared food and car rentals. He said a higher rate on restaurants is an opportunity for Hawaii because most visitors eat out, and Hawaii can tax rental cars higher because it doesn't have to be concerned about cross border competition.

Mr. Ho asked if there were any cases in which the prepared food tax kicks in at certain dollar amounts.

Mr. Bauer said he was not aware of any place that does that. He said the biggest exemption in sales tax is food, and that it is better off to tax food like Hawaii does and then provide income tax credits for lower income individuals to deal with concerns of equity.

Mr. Imanaka asked if PFM looked at the impacts of adjusting tax rates.

Mr. Bauer said yes. He said the most common areas of research are the elasticity of demand and what happen when price rises because of an increase in tax rate. He said a couple of the studies indicate that a 1% increase in price reduces consumption between 1% and 6%. He added that a lot of the impacts are due to across the border competition where the reduction of consumption on one side of the border ended up as a gain for the other side of the border. He said Hawaii doesn't have that problem.

Mr. Cape noted greater sophistication of cash register operations in food service, grocery stores and restaurants allows us to thin slice the tax policy down to barcodes so we can graduate the tax on food so that caviar is taxed at a higher rate than lettuce. He cautioned it is harder to administer of those kinds of taxes because they are more complex.

Mr. Bauer said federal income tax allows the deduction of state sales taxes so a state can export some of its tax burden to all taxpayers in the country.

Mr. McEnerney said we don't control federal tax and the alternative minimum tax caps the deduction.

Mr. Bauer said if the percent of the state's overall taxes that are deductible is something to consider as a way of exporting the tax burden.

Mr. McEnerney said that he prepares tax returns for clients in the upper tax bracket. He said he saw no benefit if the individual pays more taxes of any kind. He added that individuals at the very low end of the income structure don't itemize deductions and so gain no benefit from the federal deduction.

Mr. Bauer said there are the middle income individuals that would benefit.

Mr. McEnerney referred back to his earlier question regarding "equity". He asked whether it is equitable to increase taxes with the thought that it doesn't hurt so much because of the federal deduction, since is limited to certain individuals.

Mr. Amemiya asked about taxes on amusement and recreation services.

Mr. Bauer said that's an area that states look at as a way of exporting taxes, particularly states like Hawaii that draw activities like sporting events, concerts, plays and those sorts of thing.

Mr. Cape said one of the options is to tax recreation and amusement services at a higher level so as to export some or most of the tax burden. He said things like that are something to consider rather than a large scale tax on the tourism industry.

Dr. Resnick said exporting is one goal but there are also other goals, such as tax equity. She said that the analysis becomes more complex when we start balancing the different goals. She added that there's no perfect system and there will be tradeoffs. She said, for example, attempts to generate more revenue may harm tax equity or the stability of the tax system. She said that PFM will eventually present all of the dimensions and it's a policy decision where the state wants to be.

Mr. Cape said that's why PFM is giving Hawaii the models. He said the models are built in Microsoft Excel. He added that the bar chart shows the surplus and deficit for fiscal year 2012 to 2025, and as we change the assumptions, we can see what that does to the budget. He said PFM will provide the models as deliverables, and they will train staff of the TRC and DOTAX on how to use them so that they will be useful tools.

Mr. Ho asked about PFM’s assumptions. For instance, if they ran healthcare costs at 8% instead of 7%, and instead of 7.5% the return on investment for pension was only 3.25%, which is roughly ten year treasury rates as they are today at 50% of the portfolio and a return of 5% on equity. He asked if those assumptions were placed in the models, what would happen to the budget.

Mr. Bauer said they have not run those types of scenarios yet and that Mr. Ho has pointed out two of the budget areas with the greatest sensitivity.

Mr. Cape said because the bases of those costs are so large that very small deviations on them would drive large changes in the budget.

Mr. Ho asked if PFM looked at how Hawaii’s preliminary base compares to the other forty-nine states.

Mr. Bauer said they had a long discussion about it and he thinks that right now Hawaii benefits from the stability of the GET. He explained that in the long term, as population ages, there is an increase in the share of personal income that goes to healthcare expenses and Hawaii captures that while other states don’t.

Mr. Ho said as people grow older their concept of “equity” changes.

Mr. McEnerney asked if PFM models consider the likely outcomes of different scenarios, based on possibilities.

Mr. Bauer said they generally used a baseline assumption, and included pessimistic and optimictic scenarios, but not the level of sophistication that Mr. McEnerney asked for. He said what Mr. McEnerney asked for would probably run outside the boundaries of the project.

Mr. Amemiya referred back to Mr. Ho's question earlier about PFM's perception of our taxes in comparison to other states and said that according to Forbes magazine, Hawaii is tax hell but PFM reported that Hawaii is in the middle.

Mr. Bauer said PFM hasn't made that type of characterization, but in the final analysis they will go into the issue in some depth. He added that different sources have their own perspective.

Dr. Resnick said she was very surprised to see Hawaii's baseline hold up through 2019 and not so horribly negative by 2025 or 2030. She said when she did the analysis for Colorado, they are negative now and by the year 2025, their trend analysis shows a deficit of about 25% of revenues, which is between $3.5 to $4 billion. She said Colorado's system of funding public schools is broken; the limits they have on property taxes have shifted responsibility to the state without any revenue to support that. She said that Colorado is facing the growth of long term care under Medicaid that has driven the growth for Medicaid up significantly, and they have a sales tax that is about as narrow as it can possibly be because for the past twenty years, they have been living under a limitation that doesn't allow for an increase in tax base without going to the voters. She added Colorado virtually does not tax services including internet sales, and does not tax a significant portion pension income. Colorado has slowed down the growth rates of revenue significantly and the two largest programs are putting pressure on the state. She said with an aging population, Hawaii will have some issues around long term care but because Hawaii captures medical services in the GET, it will hold up better. She suspects that more states are looking like Colorado than Hawaii.

Mr. Cape said Hawaii's tax base is reasonably diverse compared to most states. In New York State, 4% to 10% of the taxpayers pay about 30% of the revenue and they are highly dependent on the financial services sector. He said that on September 11, 2001, about half way through the fiscal year, it blew a $13 billion hole in the state's budget. He said that kind of dependency makes New York much more susceptible to policy changes at the national level, or economic changes and exogenous actions. He said Hawaii is much more diversified and has a broader economy and broader revenue system that could handle a punch better than a lot of states.

Mr. Bauer said Hawaii already has a broad base in the general consumption tax, but as Dr. William Fox reported, internet based commerce and its taxation is a problem all across the country, including Hawaii. He said higher shipping costs in Hawaii may mitigate the revenue loss from purchasing over the internet for Hawaii.

Mr. Bauer said that in terms of rate raising, Hawaii has a low GET rate and they think it is possible to raise the rate. He said raising the rate doesn't necessarily solve a structural problem; it just put the issue off for some period of time. He added that base broadening is usually considered the better approach for tax policy.

Mr. Bauer said another area to consider is ways to grow the economy to generate additional taxes. He said across the country there are examples of targeted types of tax payments that can focus on a specific industry, on a type of job, or some other part of the economy.

Mr. Ho asked if PFM had found that well thought-out tax incentive programs aimed at economic development could be highly effective, whereas not well thought-out tax incentive schemes are highly ineffective.

Mr. Bauer said yes but the finding the ones that are fully thought-out is hard and there are many places where it’s mostly trial and error. He said in his experience with Iowa, they had one area that was very well thought-out, targeting for the insurance industry, and it was very effective. He said Iowa also did a horrible program related to the film industry which has lead to several indictments and prosecutions. He said if it makes sense for the economy, and if we can target it with a rifle shot approach versus the shotgun approach, it could be effective.

Chair Iwase asked whether Iowa has a set of criteria that is institutionalized within the statute to measure and review the effectiveness of the tax credit.

Mr. Bauer said yes. He said measuring the cost and effectiveness of a credit are key things to consider. Policy makers may want also to consider a sunset date although that creates problems because businesses can't plan for it.

Chair Iwase asked if PFM could offer opinions on what kinds of criteria should be applied to tax incentives in the report.

Mr. Cape said another consideration is the difference between tax expenditures and spending. He said there is leakage with tax credits, there are unintended consequences and there are people who will change the nature or structure of their business to quality for the credit. He said grants are easier to administer and enforce. He noted, however, that the drawback is that the spending side can become more political.

Mr. Bauer said PFM has had discussions on potential revenue source such as lottery and other forms of gambling. He said it may be worth analyzing to see what the opportunities are. He said across the country, states are reexamining the exemptions that apply to non-profit organizations, and in his opinion it is one of the new battle grounds for state tax policy.

Mr. Ho asked if they could include the assumptions from the Council on Revenue in their report.

Mr. Amemiya asked about the corporate income tax. He said PFM mentioned that it was a small sliver of Hawaii's revenue but a very complex tax. He asked if there are states that have a significant amount of corporate income tax or whether most states not have a corporate income tax.

Mr. Bauer said it's usually one of the big three taxes, though it is the smallest, but over time it has been declining and it is the most volatile of the big three. He said some research on the elasticity of corporate income tax, both short term and long term, suggests that it varies a lot from year to year. He added the problem here is the GET functions as a form of corporate income tax for the large share of our businesses so we always have to factor that in if we are considering building up the corporate tax to be a bigger component of the tax collections.

Mr. Cape said corporate franchise and corporate income taxes are influenced by other tax expenditures like investment tax credits that state ends up with a lot of disparity. He said there will be very large employers that pay no tax because they have accumulated investment tax credit or other similar incentives that adds to the volatility of the tax and adds to the equity argument.

Mr. McEnerny said that the corporate income tax documents are important not just for revenue tax purposes but also for dealing with issues related to compensation for shareholders and employees. He said if we don’t have a corporate income tax, there would be a significant impact.

Mr. Bauer said an important concept to keep in mind is balancing a tax structure. He said having a personal income tax and GET is a nice balance. He added that the regressive nature of the GET can be ameliorated with tax credits against personal income. He concluded that the taxes complement each other well.

Mr. Cape asked, in general, whether PFM is giving the TRC what it expected. He said if the TRC has further feedback, comments or suggestions, PFM will take them all.

Mr. Ho said his only thought was there is a lot of interest around the assumptions and the outcomes of the model and he would prefer to have more of that and less policy discussion.

Mr. Cape said the final report will have very specific discussions of the assumptions and there will be scenarios developed to cover different assumptions.

Chair Iwase thanked the PFM team for their presentation.

UPDATE OF STUDIES BY DR. WILLIAM FOX

Dr. Rousslang presented the following summary of the studies by Dr. William Fox.

Summary and Overview of the Study submitted by Dr. William Fox, “Selected Issues with the Hawaii General Excise Tax”.
The study provides the following:

1) Comparisons of Hawaii’s GET with the sales taxes in other states, including comparisons of the following:

a) Breadth of the tax bases,
b) The tax rates, and
c) The sales tax revenues as a percentage of total state tax revenues (See pages 2 through 4)

2) GET revenue losses from remote sales, including e-commerce sales. Hawaii's e-commerce sales are estimated based on a national estimate of e-commerce provided by the U.S. Census Bureau. The national total divided among the nation. (The implied share for Hawaii is 0.78%, which is higher than Hawaii's share of the national GDP – about 0.46%). The same method was used to get Hawaii's share of the national remote catalog sales. Dr. Fox concluded that in 2012, Hawaii's GET will be due on $28.1 billion of e-commerce sales (at either the ½% rate or the 4% rate), and that the total Get due will be $112.7 million at the ½% rate and $229.4 million at the 4% rate. He estimates that the total amount of GET lost to e-commerce and to remote catalog sales will be $157 million in 2012. (The findings are summarized on page 5.)

3) A brief summary of federal legislation on e-commerce and on efforts of other states to combat sales tax losses to e-commerce (pages 12 through 14). Federal legislation consists of the following:
   a) The Main Street Fairness Act, which says that when states comply with the SSUTA, they can require vendors to collect their sales tax.
   b) The Marketplace Equity Act, which develops a set of criteria that must be met before state can require firms to collect sales tax. The criteria are a bit different from the SSUTA.
   c) The Marketplace Fairness Act, which mixes the other two approaches by allowing states to comply with the SSUTA or an alternative set of criteria.

   Measures adopted by other states include the following measures:

   a) Broadening the definition of nexus to claim affiliate nexus through relationships with other parties (ownership of related companies, relationship with a contractor.
   b) "Click through" nexus is asserted when an affiliate firm with physical nexus directs a sale to a remote firm.
   c) Several states have required remote vendors to report broad information about sales in the state to alert buyers that they may be subject to use tax.
4) An assessment of the effects of eliminating seven specific GET exemptions:
   a) Gross receipts of non-profit organization,
   b) Sales of prescription drugs,
   c) HMO insurance,
   d) Reimbursement of wages of hotel workers paid to hotel operators,
   e) Leasing of aircraft and aircraft engines,
   f) Aircraft service and maintenance facilities, and
   g) The subcontractors' deduction.

(See pages 15 through 23).

5) An assessment of the effects of eliminating the following taxes and replacing the lost revenue with an increase in the GET:
    a) The individual and corporate income taxes,
    b) Individual income taxes only,
    c) Corporate income taxes only
    d) Income tax for those below the federal poverty level, and
    e) Income tax for the bottom 90% of taxpayers.

   The increase in GET that would be required to replace the revenue losses for each case is given (see Table 9 on page 25).

NEXT MEETING

Chair Iwase set the next meeting on Tuesday, July 24, 2012 at 9:00 a.m.

ADJOURNMENT

The meeting was adjourned at 10:35 a.m.