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TAX EXPENDITURES IN PARADISE

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Introduction

This paper examines tax expenditures in Hawaii's General Excise Tax (GET) and net income taxes. A tax expenditure is a tax break, most commonly an exemption, a deduction or a tax credit, that is granted to selected taxpayers or for selected activities. Tax expenditures can be viewed as spending programs implemented through the tax code. The first task is to identify the tax breaks. As we shall see, this is a hard job. In fact, it is sometimes not possible to determine whether a particular feature of the tax code should be considered a tax break. In this endeavor, we shall use as our ultimate guide the notion that taxes should be structured so as to provide the greatest economic benefit possible for Hawaii residents. By residents, we mean legal residents of the State, which excludes those who may live in the State for a transitory purpose, such as military personnel stationed in Hawaii. As in similar exercises, we shall consider only tax breaks and ignore unduly high tax burdens that might exist for some taxpayers or activities,[1] but unlike the usual practice, we will consider opportunities to impose extra tax on some things if doing so improves the economic welfare of Hawaii residents. The exercise is limited to identifying and

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* The views expressed are those of the author and do not reflect the official views of the Hawaii Department of Taxation.

[1] See, for example, the tax expenditures produced by the Office of Tax Analysis, U.S. Department of Treasury and published by the Office of Management and Budget in *Analytical Perspectives, Budget of the U.S. Government for Fiscal Year 2013* (at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/spec.pdf, page 249) and by the Joint Committee on Taxation in Estimates of Federal Tax Expenditures for FY 2009-2013 (at https://www.jct.gov/publications.html?func=startdown&id=3642).

quantifying the tax breaks; no attempt is made to determine whether they achieve their intended goals.

Tax Expenditures in the GET

The GET is a broadly imposed transactions tax that is applied to gross receipts of the business, including any GET that is passed forward and collected from the customer. There are three different rates of GET: A rate of 4.00 percent is applied to retail sales; a rate of 0.50 percent is applied to sales at wholesale; and a rate of 0.15 percent is applied to commission income earned by insurance agents. Since January of 2007, the City and County of Honolulu has also imposed a special surcharge of 0.50 percent on sales to customers on Oahu. The surcharge is applied only to sales that are subject to the retail rate of GET.

The Use Tax complements the GET and is applied to the value of property, services or contracting imported into Hawaii from a seller that does not have a GET license (a seller that is not within the State's taxing jurisdiction and that does not voluntarily obtain a GET license). The Use Tax is imposed in lieu of, and at the same rate as the GET that would be due on the sale if it had been made by a licensed seller. In what follows, the term "GET" will mean the GET and the Use Tax combined.

Before we can identify special tax breaks in the GET, we need to determine what sales should be subject to the tax. The appropriate base for a broadly imposed excise or sales tax is commonly assumed to be either all income of residents or all consumption of residents.[2] In either case, if the tax is applied uniformly to its base, it will not disturb the relative prices of goods or services in the economy. This result is viewed as desirable, under the presumption that

[2] We shall explore later some important conditions under which the tax base should be made broader than all consumption of residents.

the prices set by unfettered markets are the most efficient ones, so if taxes alter market prices they will reduce economic efficiency.[3]

Both taxes on consumption and taxes on income discourage work effort, but taxes on income have the added disadvantage that they discourage saving and investment. Therefore, it is generally regarded as more efficient to tax consumption generally than to tax income. A uniform tax on income would be applied to exports, but not to imports, whereas a uniform tax on consumption would be applied to imports, but not to exports. Because the GET is applied to imports, it will be presumed that the tax is meant to apply to consumption. Accordingly, any exception from a uniform tax on consumption of residents will be deemed to be to be a tax expenditure, where "consumption" means consumption by final consumers; goods or services that are used by business are deemed to be intermediate inputs to production, even if they are entirely consumed in the process.

GET exemptions for business-to-business transactions

The ultimate purpose of business activity is to provide goods and services to the final consumers, so taxes on business-to-business sales become embodied in the taxable price of consumption and cause the GET to pyramid on itself. Such taxes also distort the prices that businesses face when they choose inputs and they encourage businesses to integrate vertically to escape tax. Moreover, if tax pyramiding is uneven, it will distort relative prices faced by consumers. Ideally, the GET would exempt all business-to-business sales.

The bulk of business-to-business sales are subject to GET, but most are eligible for the low rate on sales at wholesale. The wholesale treatment reduces, but does not eliminate the

[3] Optimal taxation theory suggests that if all components of the consumer's utility function cannot be taxed, then a taxable component should be taxed more highly than other components if it is a net complement of the untaxed components, or if it faces a more inelastic demand. We shall disregard this theory, owing to practical difficulties in its application.

problem of tax pyramiding. Because most business-to-business sales are subject to GET, and because tax pyramiding is uneven among consumed goods and services, it is an open question whether exempting a particular type of business-to-business sales would bring greater uniformity to the total taxes embodied in consumption. Therefore, an exemption for selected business-to-business sales will be deemed a possible tax expenditure and it will be measured using the wholesale rate of GET.

The special rate of GET for commissions earned by insurance agents

The GET on commissions earned by insurance agents is only 0.15 percent, which is lower than the wholesale rate of GET. The special rate for insurance commissions appears to have been granted on the grounds that insurance agents were precluded by law from passing the GET on insurance commissions forward to the customer, so they suffered a bigger loss than businesses that were able to pass the tax forward. The loss to businesses able to pass the tax forward was measured on the assumption that they added only $0.04 for each dollar of sales to recoup the GET, which would make the tax liability $0.0416 (= $1.04 X 0.04). (Recall that the GET is levied on the tax-inclusive receipts of the business.) The loss was thus measured as 0.15% of the gross receipts [= ($0.0416 - $0.04)/$1.0416)]. The tax rate on insurance commissions apparently was set to match this loss.[4]

The above logic is flawed for two reasons. First, businesses routinely add 4.166 percent to the sale price (or 4.712 percent for sales subject to the Oahu county surcharge), which accounts not only for the GET, but for the tax on the tax, and even for the tax on the tax on the tax. More fundamentally though, as economists know, the question of who bears the burden of a tax depends on the conditions of supply and demand, not on whether the tax can be visibly

[4] This rationale was presented by Lester Ishado, "A Study of Hawaii's General Excise Tax on Commissions," Legislative Reference Bureau, State of Hawaii, December 1977.

passed forward to the customer. We do not know how the burden of the GET on insurance commissions is divided among the insurance agent, the insurance company, and the customer, but we also do not know how the GET burden is divided between the business and the customer for sales of other things.

In lieu of the GET, insurance premiums are subject to tax at a similar rate under the insurance code. The cost of the commissions earned by insurance agents must be recouped by the insurance companies from the premiums paid by the customers, so one could argue that the insurance commissions should qualify for the wholesale rate of GET.[5] Accordingly, the special rate of GET on insurance commissions is deemed to be a potential tax expenditure and is measured as 0.35 percent (the wholesale rate of 0.5% less the 0.15% GET applied to the insurance commissions).

GET provisions for income splitting

In some cases, taxpayers are allowed to divide their income before GET is assessed. For example, real estate agents are allowed to divide commissions between themselves before GET is applied, and each agent pays GET only on the share of commissions received. As another example, general contractors are allowed to deduct the amounts paid to subcontractors when they calculate their taxable gross receipts.[6] Such treatments, which are sometimes referred to as income splitting, will be deemed to be possible tax expenditures at the wholesale rate of GET.

GET exemptions for sales of exported goods or services, and for sales to the federal government

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[5] There are similar provisions in the GET dealing with other business-to-business sales, where the businesses' sales to final consumers are subject to other taxes in lieu of the GET. For example, section 237-13.5 of the Hawaii Revised Statutes provides the wholesale rate of GET for sales of electricity to businesses that are subject to the Public Services Company Tax.

[6] The subcontractor's deduction was temporarily suspended for fiscal years 2012 and 2013 by Act 105, Session Laws of Hawaii 2011.

The exemptions for gross receipts from exports of goods or services are not deviations from a uniform tax on consumption of residents and therefore are not tax expenditures according to our definition of the term. However, this does not mean that residents would not find it beneficial to these sales. The economic justification for exempting exports is not, as some might believe, to encourage them. If that were the reason for the exemption, then it would be a tax expenditure, just as any other tax break designed to benefit a selected taxpayer or activity. Instead, the reason for exempting exports is that taxing both imports and exports is likely to cause tax pyramiding. As we shall see, if taxing the exports does not lead to tax pyramiding, then it is probably a good idea to tax them.

To see why taxing both exports and imports can cause tax pyramiding, compare the following two sets of transactions. For the moment, assume that the economic burden of the local excise taxes is borne entirely by residents.[7] (We will explore later what happens when this assumption is relaxed.) In the first set of transactions, each of two residents buys and consumes output that was produced entirely within the State by the other resident. Each resident pays tax on the value of his output upon sale, and the consumption of each is taxed exactly once. This is true, regardless of how the burden of the tax on each sale is divided between the buyer and the seller. In the second set of transactions, the residents sell their output to nonresidents and then use the money to buy imports for consumption. Under our assumption that the tax burden is borne by residents, taxing the sales to nonresidents causes each resident's consumption to be taxed twice, once upon the sale to nonresidents, and again on the purchase of the imported

[7] The assumption is not just saying that the resident pays the tax to the government; it is more far reaching than that. It is saying that the tax-inclusive price charged by the seller would be the same with or without the tax. This is more or less what happens with many exporters, who face such close competition that they are unable to pass forward to the customer any additional cost not shared by their competitors. In the argot of economists, the exporters face perfectly elastic demand curves. The assumption is a good approximation for the bulk of imports into Hawaii.

consumption. Thus, taxing both imports and exports has caused double taxation of consumption of residents.[8] The logic of the example also applies to sales to tourists and to the federal government, although there are good reasons to treat sales made to nonresident customers while they are visiting Hawaii differently from sales to out-of-state customers. For one thing, as a practical matter, it would be hard to prevent abuses if sales to tourists were made exempt (residents would be tempted to claim they were tourists).

Contrary to our assumption that the seller bears the full burden of the tax, local businesses may be able to pass some of the tax forward and so force non-resident customers to share part of Hawaii's tax burden. To the extent the tax is paid by the nonresidents, there is no double-taxation of consumption of residents. The argument applies whether the sales to nonresidents are made within or outside of the State; to the extent the tax can be shifted to nonresidents, it is an opportunity to gain tax revenue at the expense of nonresidents without double-taxing consumption of residents.

Unfortunately, it is hard to determine the degree to which Hawaii residents can shift, or "export" the burden of their taxes to nonresidents. Even when the goods or services are consumed within Hawaii, such as sales to tourists or the federal government, the burden of the tax may be borne by the local seller, because the tax will influence the tourist's decision whether to visit Hawaii and the federal government's decision whether to buy from local sellers or import from outside the State.[9] Whether residents would be better off if sales to nonresidents were

[8] U.S. businessmen sometimes complain that the border tax adjustments for European value added taxes, under which the local tax is levied on imports and rebated on exports, provide a special tax break for European exports. However, it is well established in the economics literature, and accepted in international trade agreements, that the border tax adjustments are trade neutral and are not export subsidies. In fact, such border tax adjustments for value added, sales or excise taxes are universally applied internationally and within the United States.

[9] The Use Tax cannot be applied to purchases by the federal government.

exempted from the GET depends on the price responsiveness of the demand for these sales. If the demand is very price responsive, then applying the tax to these sales would not broaden the tax base, but instead would cause tax pyramiding. If the demand of nonresidents is not price responsive, failure to tax these sales would represent lost opportunities to export some of Hawaii's tax burden. Indeed, residents might find it beneficial to tax some sales to nonresidents at a higher rate than that applied to consumption of residents.[10]

In examining the GET exemptions for sales to nonresidents, one gets the impression that they are the result of enlightened responses to economic forces. For example, sales of tangible personal property to the federal government are exempt from GET, but only if the property is not provided in conjunction with a service. When services must be supplied along with the property, the opportunity for the federal government to avoid the GET by buying directly from an unlicensed seller is more limited and it is less likely that the rigors of competition would preclude the local business from recovering the cost of the GET from the customer. Similarly, applying GET to sales to common carriers engaged in inter-state or international travel may merely cause the customers to procure the supplies elsewhere, so the local business may be forced to bear the burden of the tax.

In general, it is reasonable to expect that in cases where the customer is a non-resident, the political pressures for exemption from the GET would be greatest where the local business is least able to recover the cost of the tax from the customer. These are also the cases where

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[10] The Legislature's views on this issue are unclear. For example, an extra tax is levied on hotel rooms (the Transient Accommodations Tax), but there are GET exemptions for sales to foreign diplomats, for sales to the federal government, and for sales to common carriers engaged in inter-state or international commerce. The latter two exemptions were temporarily suspended by Act 105, Session Laws of Hawaii 2011. For evidence on the sensitivity of tourist decisions to taxes in Hawaii, see C. Bonham, E. Fujii, E. Im, and J. Mak, "The Impact of the Hotel Room Tax: An Interrupted Time Series Approach," *National Tax Journal*, Vol. 45 (1992), pp. 433-441 and E. Fujii, M. Khaled, and J. Mak, "The Exportability of Hotel Occupancy and Other Tourist Taxes," *National Tax Journal*, Vol. 38 (1985), pp. 169-177.

eliminating the exemption is most likely to result in tax pyramiding and least likely to result in exporting part of Hawaii's tax burden. This should give reason for pause when considering whether to eliminate existing exemptions for sales to nonresidents.

GET exemptions that are clearly tax expenditures

The clearest tax expenditures in the GET are also the largest ones, namely those for non-profit organizations, including the exemption for health insurance premiums paid to mutual benefit societies and to non-profit health maintenance organizations. The exemption for a nonprofit organization is strictly limited to its program income (income that the organization earns from performing its stated exempt functions) and does not extend to purchases it makes or to any fundraising activities it undertakes, even if the proceeds are used to fund the organization's stated exempt purpose.

To the extent that health insurance payments are prepayments for medical services, one might argue that the insurance companies' payments for medical services should be eligible for the wholesale rate of GET if the medical services are subject to the tax at the retail rate, so the tax expenditure for exempting the premiums should be measured at the wholesale rate of the GET. Of course, not all of the premiums go toward medical services. More importantly, the exemption for health insurance is not generally available; instead, it is available only to the non-profit operations within Hawaii, so it causes the GET to act as a tariff barrier to protect those operations. Therefore, the exemption is deemed to be a tax expenditure at the retail rate of the GET.

The GET exemption for non-profit schools can be justified on the grounds that the schools provide services that would otherwise have to be provided by government, but it will be included among tax expenditures in the present exercise. Non-profit hospitals also are forced to bear some costs of indigent patients who cannot pay for required services, but this is a relatively small part of their total operations.

GET exemptions for sales that are subject to an equivalent tax under another part of Hawaii's tax code

Some sales are exempt from the GET, because they are subject to an alternative tax. Thus, there are GET exemptions for sales subject to the Taxes on Insurance Premiums and for sales subject to the Public Service Company Tax. Sales subject to an equivalent tax in lieu of the GET are not tax expenditures. Not all transactions that are subject to other taxes are exempt from the GET. For example, fuel, alcohol, tobacco, and hotel room charges are all subject to other taxes in addition to the GET. These items are deliberately subject to extra tax burdens, in some cases to account for negative externalities they cause. There are also exemptions for certain transactions of banks and other financial institutions. The reason for exempting these transactions is not that they are covered by an alternative equivalent tax,[11] but because it is impractical to subject them to such a high gross receipts tax.[12]

GET exemptions for sales of things that are not final consumption of goods or services

The GET is worded so broadly that, without explicit exemptions, it would apply to many sales that are not properly part of a broad-based tax on income or consumption. For example, the GET contains exemptions for wages of workers, alimony payments, sales of stocks and bonds,

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[11] The franchise tax levied on bank and other financial corporations is a net income tax and its rate is only slightly higher than the corporate income tax rate paid by other corporations in Hawaii.

[12] There are financial transactions taxes, but these typically are set at very low rates. Such taxes are rare, but they are sometimes proposed as a way to discourage destabilizing speculation in financial instruments. In the present exercise, financial services to business would be considered a possible tax expenditures at the wholesale rate, whereas an exemption for financial services to consumers would be considered a tax expenditures at the retail rate. Although some have questioned whether financial services to consumers should be include in the base of a consumption tax, it is probable that they should be included. See D. Rousslang, "Should Financial Services be Taxed under a Consumption Tax? Probably," National Tax Journal, 55 (June 2002), pp 281-291.

bad debts, gifts and bequests, and sales of land in fee simple. These items have no proper place in the base of a sales or excise tax.

Estimates of the tax expenditures in the GET

The estimate of the revenue cost of a tax expenditure may be greater than the actual revenue to be gained from eliminating the tax expenditure. The reason is that the estimates of the revenue costs may entail some double counting. For example, there is an exemption from the GET for sales of tangible personal property to the federal government and another for shipbuilding and ship repair. Eliminating the exemption for shipbuilding and ship repairs may cause some taxpayers to claim greater exemptions for sales of tangible personal property to the federal government. The revenue estimates for tax expenditures do not account for such behavior. The reason tax expenditures are measured this way is to avoid losing the revenue cost of some tax expenditures. For example, the true revenue gain from eliminating either of two perfectly substitutable exemptions might be zero, even if eliminating both in tandem would produce a substantial revenue gain.

Table 1 provides estimates for the revenue losses from tax expenditures in fiscal year 2011. The Table divides GET exemptions into four groups: (i) possible tax expenditures at the wholesale rate of GET, (ii) tax expenditures at the retail rate of GET, (iii) potential opportunities to export part of Hawaii's tax burden, and (iv) examples of GET exemptions that are neither tax expenditures nor lost opportunities for tax exporting. An estimate of the revenue cost is given for each exemption, except those in group (iv). In most cases, the estimates are based on those in the Report of the 2005-2007 Tax Review Commission, and the reader is advised to take seriously the caveats presented in the Report.[13] The total of the tax expenditures in the GET, including the

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[13] As stated in the Report, "[T]here are problems, sometimes severe, in estimating the revenue cost of the exemptions. In many cases, data needed to produce the estimates are not available, so the estimate is based on very

possible tax expenditures in group (1), is estimated to have been about $387 million in fiscal year 2011.

The groups are somewhat crude and should not be regarded as an authoritative taxonomy. For example, the exemptions for hotel operators or sub-operators, for tour packagers, and for federal cost-plus contractors could also be considered possible lost opportunities to export taxes. To the extent they apply to the tourist industry or sales to the federal government, the exemptions for shipbuilding and ship repair, aircraft leasing, aircraft maintenance, and services related to ships and aircraft (among others) might also be considered lost opportunities to export taxes.

The total revenue cost for the GET exemptions in group (i) is estimated to be about $23 million. The total GET collections at the wholesale rate were about $108 million in fiscal year 2011. In addition, some business-to-business sales are taxed at the retail rate of GET, mainly goods and services that are considered to be part of the business's overhead. Thus, the estimates imply that the exemptions are probably less than a fifth of the total value of business-to-business sales.

The exemptions in group (ii) are tax expenditures at the retail rate of the GET. The biggest of these are the exemptions for non-profit organizations (items 3, 4, 5 and 10). These items sum to an estimated $311 million in fiscal year 2011 and account for about 80 percent of the total for all tax expenditures in the GET, including the possible tax expenditures in group (i).

As already explained, it is hard to determine the extent that eliminating any GET exemption in group (iii) would broaden the tax base and the extent that it would cause tax pyramiding. No doubt some of both effects would occur in each case.

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rough assumptions. Sometimes the estimate is little more than an educated guess." See Appendix H, "Revenue Costs for Selected General Excise and Use Tax Exemptions and deductions," *Report of the 2005-2007 Tax Review Commission,* December 1, 2006.

Tax expenditures covered by Act 105, Session Laws of Hawaii 2011

Act 105 temporarily suspends certain GET exemptions and subjects the sales to the retail rate of GET. The tax expenditures involved amount to about $56 million, or a little less than one-seventh of the total.[14] Most of the suspended exemptions are in group (i). As we have already noted, it is questionable whether the exemptions in this group should be deemed tax expenditures. Suspending them and subjecting the sales to the retail rate of the GET, however, unquestionably increases tax-induced distortions faced by both businesses and consumers. Such treatment does not broaden the base of the GET; instead it merely increases tax pyramiding.

Whether the suspended exemptions in group (iii) broaden the tax base or merely increase tax pyramiding depends on the extent that the tax can be passed forward to the nonresident customers. As pointed out earlier, there is reason to be skeptical about the opportunity to broaden the tax base by eliminating any of the exemptions in this group. Only one of the GET exemptions suspended by Act 105 is in group (ii) and the tax expenditure for that exemption is negligible.

Tax Expenditures in Hawaii's Net Income Taxes

Hawaii relies heavily on the federal definition of taxable income for its net income taxes (the Individual Income Tax, the Corporate Income Tax and the Tax on Banks and Other Financial Institutions), and there are many tax expenditures in the federal income tax code. Lists of the tax expenditures, along with their cost, are published annually by the Joint Committee on Taxation.[15] In what follows, we shall look only at tax expenditures in Hawaii's net income tax

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[14] 12. The revenue from Act 105 exceeds the amount of the tax expenditures, because the Act taxes all income eligible for the suspended exemptions at the retail rate of the GET.

[15] 13. See http://www.jct.gov/publications.html?func=startdown&id=3718 for the Joint Committee's publications and estimates for federal tax expenditures.

statutes that do not come automatically with Hawaii's conformity to the federal income tax code. That is, Hawaii's tax expenditures are defined as tax breaks in addition to any that arise because Hawaii adopts the federal income tax code to measure taxable income. There are two types of net income tax expenditures: tax breaks consisting of credits for selected taxpayers or activities and tax breaks consisting of exemptions, deductions or exclusions from income.

Income tax credits

Hawaii's tax code currently provides sixteen separate income tax credits. Some of the credits were instituted to promote social goals (such as child safety or income redistribution), some to promote selected industries or activities, and some to prevent double taxation. The last category includes the capital goods excise tax credit (which reduces pyramiding of the GET) and the credit for income taxes paid to another state or foreign country. Neither of these credits is a tax expenditure.[16]

Some of the income tax credits can be taken only against the Individual Income Tax, whereas others may be claimed against Hawaii's other net income taxes or against the Tax on Insurance Premiums. For the purposes of the present study, the particular tax against which the credit may be claimed is of little moment, so the estimates of the amounts of the credits are not broken down by tax type.[17]

Deductions and exclusions from Hawaii's net income taxes that are tax expenditures

Hawaii follows the federal income tax code closely in defining taxable income, but certain items that are included in federal taxable income are excluded from Hawaii's net income

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[16] Some may argue that the purpose of the capital goods excise tax credit is to encourage local production and investment, but the economic justification is that the credit reduces pyramiding of the General Excise Tax.

[17] 15. A detailed description of Hawaii's tax credits, along with the amount of each credit claimed by various types of taxpayers, is contained in the Hawaii Department of Taxation report "Tax Credits Claimed by Hawaii Taxpayers," which was produced on an annual basis, but is not available after tax year 2005. The reports are available on the Department's website at http://www6.hawaii.gov/tax/a5_4credits.htm.

taxes. By far the biggest of these (and the only one worthy of note) is the exclusion from the Individual Income Tax for retirement income that is received from employer-provided pensions.

Estimates of the tax expenditures in the net income tax

Table 2 shows the estimates for tax expenditures arising from tax credits, and from income tax deductions or exclusions in Hawaii's net income tax law, for fiscal year 2011. The estimates are based on data for tax year 2009 (the latest year for which data are available). The estimates for the revenue loss from tax credits include the losses in the tax on insurance premiums. Although the tax on insurance premiums is not a net income tax, some of the tax credits can be applied against it. Only currently active tax credits are included, although revenue losses continue for some expired credits. The largest expired tax credit is the high technology business investment tax credit provided by section 235-110.9, HRS, which expired at the end of 2010 and cost an estimated $45 million in tax year 2009.

The currently available tax credits, and deductions or exclusions from net income taxes are divided into four groups: (i) tax credits to promote social goals, (ii) tax credits to promote economic goals, (iii) tax credits to reduce or avoid double taxation, and (iv) items of income that are deductible from Hawaii's net income tax, but not from the federal income tax. Entries in group (i), group (ii) and group (iv) are tax expenditures, whereas entries in group (iii) are not. The total of the tax expenditures in the income taxes is about $221 million.

The revenue losses in Table 2 understate slightly what the cost would be if the tax credits or income exclusions were replaced with budget outlays. For example, a tax saving of $100 realized as a result of the exclusion for certain pension income gives the recipient a net after-tax benefit of $100 and costs the State treasury $100. However if, instead of the income exclusion, the recipient received a direct payment of $100, the net cost to the State treasury would be less than $100, because the payment would be subject to State income tax.[18]

Summary and Conclusions

There appears to be little opportunity to raise more tax revenue by curtailing tax expenditures in Hawaii's GET or net income taxes. The total of the estimated tax expenditures for the GET, including the possible tax expenditures for GET exemptions of business-to-business sales, is about $388 million for fiscal year 2011. The largest potential source of revenue from curtailing these tax expenditures would come from eliminating the exemptions for the non-profit organizations. Some of the programs these organizations support (such as private education) may be deemed worth the cost. Others, (such as the exemption for health insurance premiums) are harder to justify. In the past, the Legislature has been reluctant to tax any of these programs. If we subtract the GET exemptions for non-profit organizations and the exemptions suspended by Act 105, SLH 2011, only about $58 million of tax expenditures, including possible tax expenditures, remain in the GET.

There may be opportunities to export some of the GET burden by suspending exemptions for certain sales to non-residents (including sales to the federal government). As explained earlier, these exemptions are not true tax expenditures and there is reason to be skeptical that eliminating them would do anything more than increase tax pyramiding. The biggest exemption of this type is for exports of tangible personal property to nonresidents.

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[18] 16. To provide a measure of tax expenditures that can be compared more directly to the costs of government direct spending programs, "outlay equivalents" are sometimes calculated. See, for example, Joint Committee on Taxation, "Background Information "On Tax Expenditure Analysis And Historical Survey Of Tax Expenditure Estimates," available here: http://www.jct.gov/publications.html?func=startdown&id=3740http://www.jct.gov/publications.html?func=startdown&id=3740. The Office of Tax Analysis in the U.S. Treasury also provides estimates of outlay equivalents.

The estimate for the total of tax expenditures in the net income taxes (including the revenue losses from tax credits that may be applied against the tax on insurance premiums) is about $281 million. If we subtract the exclusion of employer provided pensions, only about $125 million of tax expenditures remain in the net income taxes.

TABLE 1 - TAX EXPENDITURES IN HAWAII'S GENERAL EXCISE TAX (In $1,000's)			
Item	**Description**	**HRS Section**	**Revenue cost**
	(i) Possible Tax Expenditures at the Wholesale Rate of GET		**Total = 23,047**
1	Contracting Activity in an Enterprise Zone*	209E-11	417
2	Subcontractor Deduction*	237-13(3)(B)	8,329
3	Home Service Providers*	237-13(6)(D)	2,084
4	Tax on insurance commissions at 0.15 percent 1/	237-13(7)	1,750
5	Certain Convention, Trade Show Fees*	237-16.8	340
6	Income Division for Coin Operated Devices	237-18(a)	5
7	Income Division for Producers, Promoters	237-18(b)	10
8	Income Division, Insurance and Realtors	237-18(e)	142
9	Income Division, Tour Packagers	237-18(g)	30
10	Income Division for Motor Carriers	237-18(h)	5
11	Intercompany Charges	237-23.5(a)	(in item 12)
12	Common Paymaster Exception	237-23.5(b)	483
13	Federal Cost-Plus Contractors*	237-13(3)(C)	483
14	Payments to Sugar Cane Producers*	237-24(14)	369
15	Shipping of Agricultural Commodities*	237-24.3(1)	235
16	Maintenance Fees	237-24.3(3), 237-24(16)	1,503
17	Cargo Loading and Unloading*	237-24.3(4)(A)	255
18	Services Related to Ships and Aircraft*	237-24.3(4)(B),(C)	(in item 17)
19	Merchants' Association Dues	237-24.3(9)	1
20	Labor Organizations*	237-24.3(10)	1
21	Aircraft Leasing*	237-24.3(12)	2,430
22	Exchanges*	237-24.5	0
23	Hotel Operator and Sub-operator	237-24.7(1)	227
24	Orchard Operator	237-24.7(4)	30
25	Insurance Proceeds from Natural Disaster	237-24.7(6)	2
26	Reimbursement of Payroll Costs	237-24.7(9)	150
27	Professional Employment Organizations	237-24.75(3)	100
28	Aircraft Service and Maintenance Facility*	237-24.9	501
29	Petroleum Refining*	237-27	33
30	Air Pollution Control Facilities	237-27.5	484
31	Shipbuilding and Ship Repairs*	237-28.1	228
32	Wholesale Transactions	237-29.55	1,092
33	Call Centers*	237-29.8	7
34	Other (TRICARE; Aircraft, Ship Leasing, Aircraft Service Maintenance Facility*; Use of Vessels Made Prior to July 1, 1969*; Use of Pollution Control Facility*)	237-24(17), 238-1, 238-3(h), 238-3(k)	1,319

TABLE 1 (Cont.) - TAX EXPENDITURES IN HAWAII'S GENERAL EXCISE TAX (In $1,000's)			
Item	**Description**	**HRS Section**	**Revenue cost**
	(ii) Tax Expenditures at the Retail Rate of GET		**Total = 364,453**
1	Geothermal Power	182-16	946
2	Enterprise Zones*	209E-11	1
3	Non-Profit Schools	237-23(a)(4)	16,216
4	Non-profit hospitals	237-23(a)(6)	92,817
5	Other non-profit	237-23	62,179
6	Disability Provisions	237-24(13)	4,178
7	Drugs and Prosthetic Devices	237-24.3(7)	31,300
8	Mass Transit Operator	237-24.7(2)	7,873
9	Affordable Housing	237-29	8,240
10	Non-profit health insurance	237-29.7	140,700
11	Senior Citizens' Fair	349-10	4
	(iii) GET Exemptions That May be Foregone Opportunities to Export Taxes to Nonresidents		**Total = 138,982**
1	Foreign Trade Zones	212-8	2,838
2	Sales of Fresh Foods, Liquor, and Tobacco to Common Carriers*	237-24.3(2)	5,621
3	Sales to Diplomats and Consular Officials	237-24.3(11)	231
4	High Technology R&D Grants	237-24.7(10)	5
5	Sales to the Federal Government and Credit Unions*	237-25(a)	34,201
6	Scientific Contracts	237-26	2,198
7	Out of State Sales	237-29.5(1)	89,788
8	Exported Services	237-29.53	4,064
9	Liquor or Tobacco for Resale as Exports or to a Common Carrier*	238-3(g)	35

TABLE 1 (Cont.) - TAX EXPENDITURES IN HAWAII'S GENERAL EXCISE TAX (In $1,000's)			
Item	**Description**	**HRS Section**	**Revenue cost**
	(iv) GET Exemptions that are neither Tax Expenditures nor Lost opportunities for Tax Exporting 3/		**na**
1	Casual Sales	237-2	na
2	Bad Debts, Discounts, Returns	237-3(b)	na
3	Dividends and Distributions	237-3(b)	na
4	Real Estate Sales	237-3(b)	na
5	Stocks, Bonds, Commodity Futures	237-3(b)	na
6	Leases and Subleases of Real Property*	237-16.5	na
7	Federally Preempted Amounts	237-22	na
8	Insurance Proceeds	237-24(3)	na
9	Gifts and bequests	237-24(4)	na
10	Alimony	237-24(7)	na
11	Personal Injuries and Property damage	237-24(5)	na
12	Exemptions for Other Taxes	237-24(8)-(12)	na
13	Foster Parents	237-24(15)	na
14	Employee Benefit Plans	237-24.3(5)	na
15	Food Stamps	237-24.3(6)	na
16	Exemption for TAT	237-24.3(8)	na
17	Exemption for Rental Vehicle Taxes	237-24.7(3)	na
18	Amounts Not Taxable for Financial Institutions	237-24.8	na

Note: "na" means "not applicable"

* Temporarily suspended by Act 105, Session Laws of Hawaii 2011.

1/ The tax expenditure is measured as the collections that would have been realized at a rate of tax equal to 0.5 percent less the actual realization at the rate of 0.15 percent.

2/ Based on predicted sales in fiscal year 2012.

3/ The list of exemptions under this category is not exhaustive. It is taken from the GET exemptions listed in the instructions for Schedule GE.