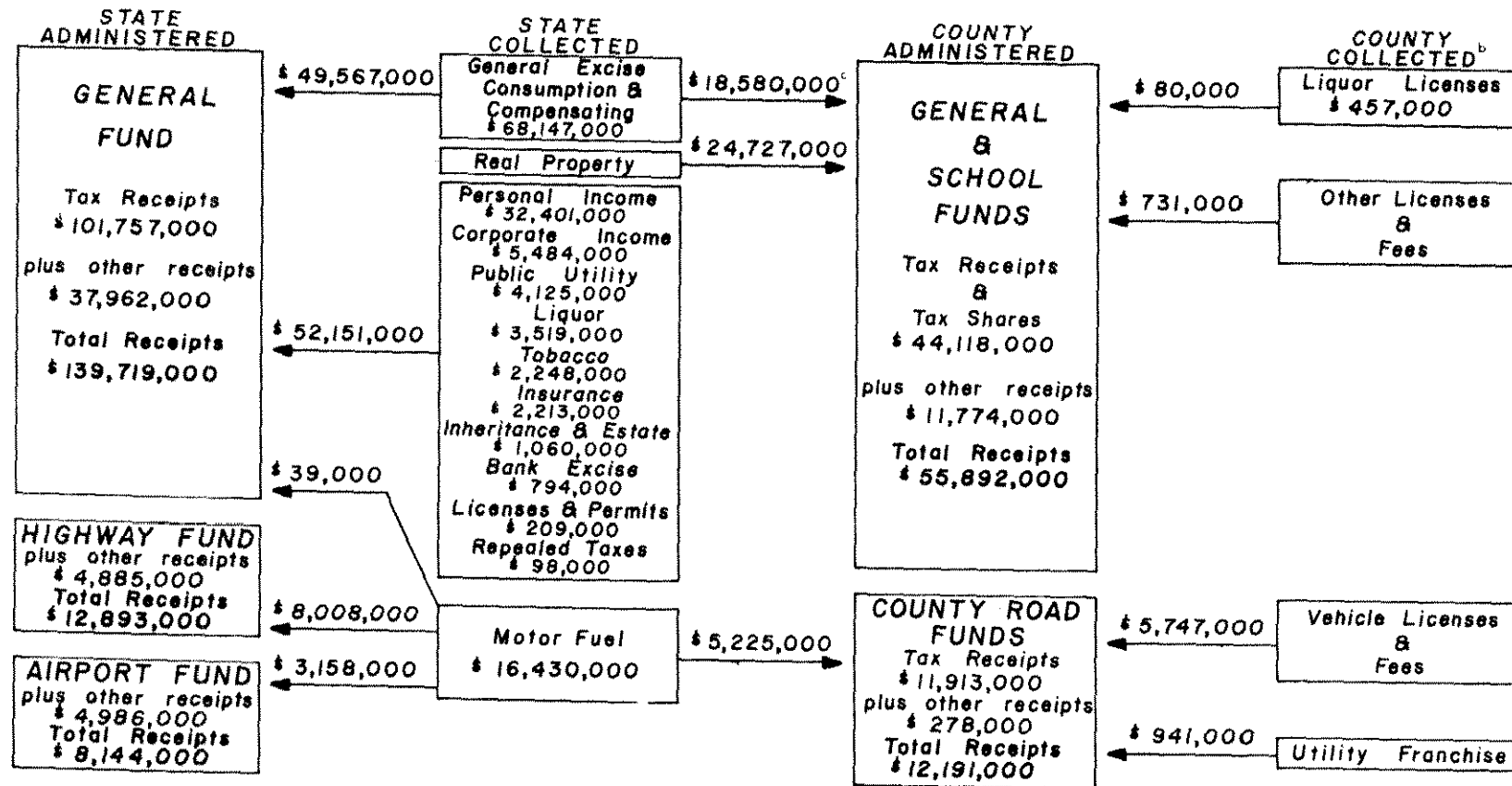


# **FLOW OF STATE AND COUNTY TAX REVENUES<sup>a</sup>** **Fiscal Year 1961**



<sup>a</sup>Excludes unemployment compensation taxes and federal grants for national guard, as well as funds completely supported by non-tax revenues.

<sup>b</sup>During calendar year 1960.

<sup>c</sup>Adjusted to reflect county's share of Hurricane "Dot" remissions.

**TAX PROBLEMS**  
**and**  
**FISCAL POLICY**  
**IN HAWAII**

**by**

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**Report No. 1 • 1962**

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## FOREWORD

The Legislative Reference Bureau was requested to prepare a report on Hawaii's tax structure which would supply a background of fact and analysis which might be useful in legislative consideration of fiscal problems at the 1962 budget session of the first state legislature.

The report which follows was prepared by Professor Kamins, who has broadened and made current his long-range study of Hawaii's financial system, begun in 1947. It is a continuation of his book on the Territory's tax system published in 1952 and his booklet on the same subject published in 1957, but the emphasis in this report is different from that in its predecessors. This study attempts to anticipate specific fiscal issues which the legislature will face in the near future, such as tax reduction for the sugar and pineapple industries and sources of additional revenues for the state government and the counties. Further, the report examines the long-range relationship of revenues and expenditures and sets forth possible approaches to a policy for the management of the state's finances.

The Legislative Reference Bureau acknowledges its debt to the several persons who have provided data for the study or who have critically and helpfully reviewed the manuscript. These individuals include:

Earl Fase, Director of Taxation, and Mrs. Iola Rhyne, Administrative Services Officer, Department of Taxation;  
Nils Ueki, Chief, Budget Division, and Clinton Tanimura and Mrs. Ruby Nicoll, staff members, Department of Budget and Review;  
Richard Takasaki, Finance Director, City and County of Honolulu;  
Fred Bennion, Executive Director, Tax Foundation of Hawaii;  
Thomas Hitch, Vice-President, and Mrs. Nora Kirkpatrick, economist, First National Bank;  
Robert Cushing, Director, Pineapple Research Institute;  
John Butterfield, Treasurer, Hawaiian Sugar Planters Association;

Harry Oshima, Fred Hung, Gary Weaver, and Seiji Naya, staff members, Economic Research Center, University of Hawaii;  
Robert Ellis, Business Manager, Department of Education;  
George Souza, Controller, Department of Health; and  
William Heen, Jr., Administrative Services Officer, Department of Social Services.

Tom Dinell, Acting Director  
Legislative Reference Bureau

January 17, 1962

# TABLE OF CONTENTS

	Page
Foreword . . . . .	iii
Introduction . . . . .	1
Chapter	
1 Overview of Hawaii Tax Structure . . . . .	3
2 Appraising the Tax System . . . . .	9
3 Tax Incentives for Industry . . . . .	19
4 Fiscal Policy Considerations . . . . .	35
5 State Revenue Needs . . . . .	45
6 Alternate Approaches to Tax Adjustments . . . . .	54
Appendix	
Tax Revenues of the Territory and State of Hawaii . . . . .	68
Selected Bibliography . . . . .	70

## CHARTS

### Chart

1	Flow of State and County Tax Revenues Fiscal Year 1961 . . . . .	inside front cover
2	General Excise Tax Rates on Sugar and Pineapple Production, 1947-1961 . . . . .	26
3	Biennial Appropriations for State Capital Improvements: 1947-1961 . . . . .	38
4	General Fund Receipts and Expenditures: Fiscal Years 1957-1972 . . . . .	50
5	County Operating Fund Receipts: 1960 . . . . .	74 and inside back cover

## TABLES

Table	Page
1     State and County Tax Collections in Hawaii, Fiscal Years ending 1960 and 1961 (excluding unemployment compensation taxes) . .	4
2     County Tax Revenues: 1957, 1958, 1959, and 1960 Calendar Years . . . . .	7
3     Measure of Degree of Sacrifice of Income for State and Local Taxes in each of the 50 States..	15
4     Profits and Losses of Sugar and Pineapple Companies in Hawaii, 1960-1961 . . . . .	29
5     Estimated Annual General Excise Savings for Sugar and Pineapple Industries under Alternative Tax Reductions . . . . .	31
6     Relationship between Income Tax Credit and Personal Exemptions. . . . .	60
7     County Revenues from Local Sales Tax Compared with General Excise Shares . . . . .	62
8     Yields of Additional County Fuel Taxes . . . . .	63
9     Additional Property Tax Revenues under Present Rate Maxima. . . . .	63

# INTRODUCTION

There is little by way of novelty to be sought in an examination of Hawaii's tax system. Not that the system lacks unusual features. In the taxation of gross and net income and in the highly centralized tax administration which they establish, Hawaii's revenue laws include many important provisions which are either unique or uncommon in American state fiscal practice.

Hawaii certainly has been an innovator in taxation, from the time of its adoption of the first modern "state" income tax in 1901, at the first meeting of the territorial legislature, exactly a decade before Wisconsin enacted the first mainland state tax on net income. Only now are mainland sales tax states beginning to emulate the wide coverage and high rates of Hawaii's long established general excise tax.

However, the field has been repeatedly examined in the past decade. The writer published a volume on The Tax System of Hawaii in 1952. Two years later a 16-man group filed The Report of the Governor's Advisory Committee on Taxation. Major tax amendments in 1957 were described by the present author in Hawaii's Revised Tax System and, two years later, analyzed in a University of Hawaii research report entitled Some Effects of Hawaii's 1957 Tax Law. In 1960 the Economic Research Center of the University published a report on Tax Burden and the Hawaiian Tax System followed by an examination of the Economic Impact of Tax Reduction legislated that year. Descriptions of Hawaii's taxes repeatedly appear in publications of the state Tax Department, of the state Department of Budget and Review, of the Tax Foundation of Hawaii, and of local banks.

No useful purpose would be served in tracing again the ground covered in a body of literature sufficiently large to make Hawaii's tax system one of the most frequently examined among the 50 states. Particularly, the author has little to add to the perennial question of the fairness or justice of the tax structure. He has the distinct impression that there is at least a temporary truce in the perennial struggle between advocates of the graduated income tax and those who would replace it with heavier taxes on consumption. For the moment the consensus seems to be that

a large income tax and relatively heavy consumption taxation are both necessary.

National trends during the past several years have probably also contributed to a lessening of pressure for basic change in Hawaii tax policy. The 1957 tax revision lifted tax rates in Hawaii, and consequently the average tax burden, towards the top of American states. During the past four years, however, several mainland states have raised their rates--particularly in the sales tax area--to equal or (considering only the retail level) exceed Hawaii's. Higher income tax rates in other states increased their burden appreciably, while Hawaii reduced its income tax load in 1960, when the personal exemption was increased. Several state gasoline, tobacco and liquor taxes were lifted towards or above Hawaii's rates.

The effect is that Hawaii's overall tax burden is no longer conspicuously high. In the post-statehood economic swell, there seems to be far less public discussion of the untoward effects of local taxes than there was in the 1950's.

The spotlight of public policy debate has thus shifted from the issues of tax justice and overall tax burden. Consequently, the discussion which follows is not addressed in the main to these issues. There may be some usefulness, however, in making a critical examination of Hawaii's revenue laws in the light of anticipated future requirements of the state. A major purpose of this study is to determine, from the best available estimates of Hawaii's development over the next decade, if the tax structure is well suited to the needs of the people and of the government which is charged with serving their needs.



## CHAPTER I

# OVERVIEW OF HAWAII TAX STRUCTURE

Hawaii's tax system is among the most comprehensive and productive of the 50 American states. Every major levy imposed in the Union is found here, except for a personal property tax and a severance tax on mineral production, an economic activity which is still only a gleam in the eye of Hawaii's planners and enterprisers. Relatively high taxes on both earnings and spending more than compensate for a comparatively light real property tax. The consequence, contributed to by the high price level which inflates most tax bases in Hawaii, is that per capita tax payments in this state have been among the highest in the nation. In 1960, taxes collected by the state and county governments in Hawaii amounted to 10.5 per cent of personal income received in the Islands. This percentage was exceeded or equalled by only eight states. However, as shown in the next chapter, tax "sacrifice" in Hawaii is about average for the nation.

The bulk of tax moneys supplying the state and its four counties come from the general excise (sometimes called gross income) tax, the net income taxes on individuals and corporations, and the real property tax. During the past two fiscal years, 1960 and 1961, more than three-fourths of all state-plus-county tax receipts have come from these three sources. Levies on motor fuel, motor vehicles, liquor, tobacco, utility companies, insurance companies, plus several miscellaneous payments variously labelled "taxes" and "fees", provide the remaining portion, as Table 1 shows in greater detail.

A basic reason for Hawaii's success in collecting revenue is the broad base of its chief taxes. The general excise applies, with few exceptions, to all goods and services sold in the state, whether by farm or plantation, manufacturer, wholesaler, or retailer. Most state taxes are limited to retail sales, usually excluding services and frequently also exempting some types of goods (food, farm supplies, books, medicines, etc.) as well. Hawaii's general excise not only allows few exemptions,<sup>1</sup> but applies to each sale of a product as it moves from producer to wholesaler to retailer

<sup>1</sup>Sales to government agencies are the most important.

**Table 1**  
**STATE AND COUNTY TAX COLLECTIONS IN HAWAII**  
**Fiscal years ending 1960 and 1961 (excluding unemployment**  
**compensation taxes)**

Tax	1960 <sup>1</sup>		1961 <sup>1</sup>	
	Yield	Per Cent of Total	Yield	Per Cent of Total
<b>STATE-COLLECTED:</b>				
1. General excise, consumption and compensating <sup>2</sup>	\$ 62,195,000	42.2	\$ 68,147,000	40.3
2. Personal income	28,901,000	19.6	32,401,000	19.2
3. Corporate income	5,397,000	3.7	5,484,000	3.2
4. Real property	17,016,000 <sup>3</sup>	11.6	24,727,000 <sup>3</sup>	14.6
5. Motor fuel	14,579,000	9.9	16,430,000	9.7
6. Public utility	4,026,000	2.7	4,125,000	2.4
7. Liquor <sup>2</sup>	3,232,000	2.2	3,519,000	2.1
8. Tobacco <sup>2</sup>	1,971,000	1.3	2,248,000	1.3
9. Insurance company	1,883,000	1.3	2,213,000	1.3
10. Inheritance and estate	587,000	0.4	1,060,000	0.6
11. Bank excise	544,000	0.4	794,000	0.5
12. Licenses and permits	160,000	0.1	209,000	0.1
13. Repealed taxes (compensation- dividends, personal property, and public welfare)	131,000	0.1	98,000	0.1
Subtotal	\$140,622,000	95.5	\$161,455,000	95.4
<b>COUNTY-COLLECTED:</b>				
1. Vehicle licenses and fees	\$ 4,749,000	3.2	\$ 5,747,000	3.4
2. Utility franchise	843,000	0.6	941,000	0.6
3. Liquor licenses	445,000	0.3	457,000	0.3
4. Other licenses and fees	616,000	0.4	731,000	0.4
Subtotal	\$ 6,653,000	4.5	\$ 7,876,000	4.7
<b>GRAND TOTAL</b>	<b>\$147,275,000</b>	<b>100.0</b>	<b>\$169,331,000</b>	<b>100.0<sup>4</sup></b>

**Sources:** Reports of the State Director of Taxation, State Comptroller, and County Auditors.

<sup>1</sup>County data are for calendar years 1959 and 1960, respectively.

<sup>2</sup>Includes license fees.

<sup>3</sup>1961 collections include some payments attributable to fiscal 1960. The 1961 yield is reduced by \$17,839 for Hurricane "Dot" losses.

<sup>4</sup>Subtotals do not add to 100.00 because of rounding.

to consumer. Consequently, the general excise tax base exceeds by more than one-third the value of all goods and services produced in the state. (In 1960, the gross value of such goods and services was about \$1,700 million, while the general excise tax base was \$2,355 million.)

The Hawaii income tax is also unusually broad and goes unusually deep. The personal exemption, even after being increased from \$400 to \$600 by the 1960 legislature, is relatively small, currently exceeded by two-thirds of the other states taxing personal incomes. Only Delaware, Idaho, Minnesota, New York, North Dakota and Oregon (and Alaska, for upper income brackets) impose rates higher than the maximum rate of 9 per cent in Hawaii's income tax rate schedule.<sup>2</sup> Furthermore, Hawaii's tax rates are graduated in rapid steps--3% on the first \$500 of taxable income, 3-1/2% on the next \$500, 4% on the next \$1,000, etc. The effect is to make the higher tax rates, not merely decorative (as in New Mexico where the maximum rate applies only on that portion of taxable income above \$100,000), but effective over a wide range of incomes.

Similarly, the Hawaii corporate net income tax, set at 5 per cent of the first \$25,000 of taxable income and 5-1/2 per cent for larger amounts, exceeds in effective rate about two-thirds of the other 35 state corporate income levies.

## **FLOW OF TAX REVENUES: Funding and Sharing**

One of the strengths of Hawaii's financial structure is that it is comparatively unhindered by the earmarking of tax funds, that is, by legislative requirements that certain tax collections be used for designated purposes. Transportation finance provides the only exceptions: fuel tax receipts are earmarked--to state and county highway funds with respect to the tax on automotive fuel, to the state airport fund, with respect to aviation fuel tax collections. The county motor vehicle weight tax is by law channeled into the county road funds.<sup>3</sup>

Aside from this earmarking, traditional in American states, all other tax receipts of the state and its counties go

<sup>2</sup>The special "commuters' " tax levied by New Jersey on income derived by its residents from New York also ranges up to 10 per cent.

<sup>3</sup>As is the distinctly minor county tax on certain electric and gas companies.

into their general funds, to be spent for whatever purposes the legislature and the county boards make appropriations. This system of general funding reduces the difficulties, experienced in many other states, of finding some special funds bulging from the receipts of the taxes earmarked for their use, while other special funds are running deficits. The frontispiece pictures the funding system of the state government, while a series of charts at the end of this report show the major funds of each of the four counties.

## COUNTY TAX SHARES

A cardinal feature of Hawaii's tax system is the sharing between state and county governments of revenue from the major tax--the general excise and the technical extension of the general excise, the consumption tax.<sup>4</sup> As Table 2 shows, more than a third of county tax revenues comes from the general excise tax share. In the counties of Hawaii, Maui and Kauai, the general excise supplies a larger budgetary income than the property tax. This sharing device transfers a portion of the revenues collected on Oahu, where the greater part of the state's tax base is concentrated, to the counties of Hawaii, Maui and Kauai, thereby supporting higher standards of governmental services than these counties could maintain from their own tax bases--standards which are more uniform throughout the state than they would be without such financial transfers from Honolulu.

The relative degree of fiscal self-support in each county, and the extent of reliance on transfers from the state emerges from an examination of the four charts of county funding, printed at the end of this publication.

The heavy dependence of local governments in Hawaii on state tax revenues is highlighted by national comparisons. U.S. Census Bureau data show that in 1960 Hawaii exceeded all but six states with respect to the proportion of local revenues received from shares of state taxes and from state grants. Local tax collections in Hawaii, expressed as a percentage of state-and-local revenues, were the smallest in the nation.<sup>5</sup>

<sup>4</sup>The primary objective of the 3½ per cent consumption tax is to reach goods, such as those directly purchased from out-of-state sources, which are constitutionally beyond the reach of the 3½ per cent tax on retail sales imposed by the general excise.

<sup>5</sup>Reported in U.S. Advisory Commission on Intergovernmental Relations, *Local Non-Property Taxes and the Coordinating Role of the State*, September 1961, pp. 16 and 19.

**Table 2**  
**COUNTY TAX REVENUES: 1957, 1958, 1959, AND**  
**1960 CALENDAR YEARS**

Tax	1957		1958		1959		1960	
	Revenues	Per Cent of Total	Revenues	Per Cent of Total	Revenues	Per Cent of Total	Revenues	Per Cent of Total
<u>County-administered:</u>								
Vehicle taxes and fees	\$ 5,050,817	12.82	\$ 5,044,551	12.35	\$ 4,749,478	10.60	\$ 5,747,277	11.19
Utility franchise	940,991	2.39	897,546	2.20	842,903	1.88	940,991	1.83
Liquor licenses	418,600	1.06	435,466	1.06	444,708	0.99	456,543	0.89
Other licenses, etc.	484,330	1.23	504,327	1.23	616,113	1.37	731,209	1.42
Sub-total	\$ 6,894,738	17.50	\$ 6,881,891	16.84	\$ 6,653,201	14.84	\$ 7,681,432	15.33
<u>State-administered:</u>								
General excise shares	\$13,082,522	33.20	\$13,655,416	33.42	\$16,081,278	35.88	\$17,888,930	34.84
Real property	15,262,662	38.73	16,209,201	39.67	17,355,122	38.73	20,482,543	39.89
Motor fuel taxes	4,162,872	10.57	4,116,085	10.07	4,726,210	10.55	5,098,934	9.93
Sub-total	\$32,508,056	82.50	\$ 33,980,702	83.16	\$38,162,610	85.16	\$43,470,406	84.66
GRAND TOTAL	\$39,402,793	100.00	\$40,862,593	100.00	\$44,815,811	100.00	\$51,151,838	100.00

Sources: County Auditors' reports, Honolulu Finance Director's reports, State Tax Department reports.

<sup>1</sup>Determination of "tax" revenues follows definitions of U.S. Census Bureau in Compendium of State Government Finances in 1960.

Conversely, the property tax--"the beast of the local tax burden" in other areas of the United States<sup>6</sup>--is not heavily laden in Hawaii. This aspect of Hawaii's tax structure is examined in the next chapter.

<sup>6</sup>Ibid., p. 19.

## CHAPTER 2

# APPRAISING THE TAX SYSTEM

Many factors are involved in formulating a state tax system. The legislature is urged to enact taxes which are just, inexpensive to collect, visible to the taxpayer, not stiffling to business enterprise, not unduly burdensome and yet productive of enough revenue to support government programs. In examining these particular taxes, desirable attributes are not infrequently found to be in mutual conflict. For example, a poll tax is ideally visible, easy to administer, and without cost to business. By the same token it is completely unjust, if one takes ability to pay taxes as the proper measure of fiscal justice. Sole dependence on a graduated income tax, on the contrary, would come closest to satisfying the test of ability-to-pay fairness, but at the same time create so many problems of tax avoidance and evasion that tax administration would become greatly burdensome to tax collector and taxpayer alike.

In practice, state legislatures have effected some sort of compromise between the virtues and faults of different taxes by combining several levies into state tax "systems". Hawaii's tax system is among the more diversified, utilizing, as it does, comprehensive taxation of sales and of income. Among the other 49 states, 22 also impose both sales and broad income taxes, 14 tax sales only, 10 tax incomes only, and 4 levy neither tax, but rely on other sources (and shift a major portion of government activities to local units).

## ABILITY-TO-PAY

Hawaii's reliance on the net income tax (23 per cent of state and county tax collections in 1960) is well above the national average (9.38 per cent of state and local tax revenues). Only a few states--Alaska, Oregon, and Wisconsin--rely on the income tax more heavily, relative to their total state and local revenues.

The income tax, of course, gives to Hawaii's tax structure an important element of justice, in the sense that this portion of the overall tax burden is distributed according to ability to pay taxes. However, sales taxes of various forms (general excise, consumption, fuel, liquor, tobacco, utility,

insurance taxes) together, yield to Hawaii's government about two and one-half times the amount of its income tax collections. It is well known that levies on sales do not distribute the tax burden in accordance with ability-to-pay, and are in that sense unjust.

In balance, and particularly after taking into consideration the impact of the steeply graduated federal income tax, the Hawaii tax system is not outstandingly regressive overall. It benefits, in this respect, by comparison with most mainland states.

## PROPERTY TAXES

Interstate comparisons reveal another basic characteristic of the Hawaii tax system: its relatively slight dependence on property tax revenues. For the entire nation in 1960, property taxes comprised 45 per cent of state-plus-local tax collections; the percentage for Hawaii was 13. Per capita property tax collections averaged \$91 across the nation in 1961; the Hawaii average was \$31.46. This amount was third lowest among the 50 states (the average for Alabama was \$23, South Carolina's was \$29). Alaska's average, \$31.58, virtually equalled Hawaii's.

By way of contrast, Hawaii's per capita collections of all other (i.e., non-property) taxes, grouped together was far and away the highest in the nation--\$205 for Hawaii, compared with a national average of \$110. The second largest average of non-property tax payments was measured in the state of Nevada--\$176.<sup>1</sup>

Several factors help explain the fact that Hawaii is close to the bottom of the list in per capita property taxes, while near the top with respect to other major levies. First, this state taxes only real estate, while many other states levy on some forms of personal property. Further, fully two-fifths of the real property tax base in Hawaii is exempt from taxation, principally because it is owned by the federal government (17 per cent), by the state or its counties (13 per cent), because it is used by private schools, hospitals, churches, charitable institutions, etc. (4 per cent).

<sup>1</sup>U.S. Department of Commerce, *Governmental Finances in 1960* (G-GF60-No. 2), Table 14, p. 26.



Such exemptions are more or less standard in the several states--although an unusually large fraction of land in Hawaii is held by government. On top of these widely used exemptions, Hawaii also grants an unusually large exemption--up to \$3,250 of assessed value--on owner-occupied homes. This exemption removes approximately 5 per cent of the tax base.

Property tax rates in Hawaii, of course, also directly determine the amount of property tax revenues. Hawaii's rates are unusual in two respects--they are the same for rural and urban property, the latter are low when compared with other city rates in the nation.<sup>2</sup>Whereas, typically, the property tax bears the major load of financing local expenditures throughout the United States, in Hawaii each county except Honolulu receives more from its share of the state general excise than from the tax on realty. Honolulu's budget for the past two years shows that property tax receipts constitute less than half of its total revenues.

For all units of local government in the United States, during 1960 the property tax supplied somewhat less than half (46 per cent) of all their general fund revenues.<sup>3</sup>The overall average for the local governments of the state of Hawaii over the past four years has been slightly under 40 per cent. Both interstate comparisons and examination of the Hawaii tax structure itself thus indicate that the property tax in Hawaii--or to be more exact in the urban areas of this state--is relatively under-utilized in the financing of government programs.

## ADMINISTRATIVE CONSIDERATIONS

Considering the efficiency of tax administration, Hawaii again looks well, measured against national standards. Since 1957, the income tax has been collected by withholding

<sup>2</sup>Annual comparisons of American cities published in the *National Municipal Review* until 1956 showed the average *effective* property tax rate in Honolulu to be among the lowest of the cities having populations of 100,000 or more. Discontinuance of this annual survey leaves the researcher without comprehensive data in this area. There is little reason to suppose that Honolulu's relative position has much changed in the past five years. Effective rates have risen here, with increases in the ratio of assessed-to-market prices. However, tax rates have also generally risen across the nation.

See "Tax Rates of Honolulu and Comparable Cities," Research Report No. 15 of the Honolulu Redevelopment Agency, March 7, 1955, for analysis of *National Municipal Review* data.

<sup>3</sup>U.S. Department of Commerce, *Governmental Finances in 1960* (G-GF60-No. 2), Tables 1 and 11.

from payrolls, and by advance estimates of net income from enterprises and investors. The adoption of most federal income tax rules covering the definition of taxable income, deductions, accounting procedures and the like has given state income tax administration in Hawaii a great advantage over mainland jurisdictions which must themselves work out these labyrinthal definitions and procedures.

The comprehensive nature of the general excise makes its enforcement inherently easier than that of most state sales taxes. Since all levels of transactions--producing, wholesaling and retailing--and virtually all kinds of commercial sales are taxable, reporting is unusually complete and consequently evasion is more difficult than under most mainland sales taxes.

Further, the centralized nature of Hawaii's economy greatly eases the collection of taxes. More than five-sixths of all taxes paid to the state are returned in Honolulu. Gasoline sold in the state is wholesaled by only 7 firms, liquor by 29 and tobacco by 23 companies. The respective taxes on these commodities take advantage of the situation by collecting the levies at the wholesale level, so minimizing the number of taxpayers and the problems of tax auditing.

Property tax administration has been given special attention in the recent past, and particularly since 1958 when Public Administration Service filed a report on the subject, prepared at the request of the territorial government. Improvements in assessment practices suggested by the report have been, or are being, implemented.

The Tax Office has not yet been able to place its general excise assessment data on the punch cards it uses to record property tax assessment data. When this is accomplished, it may be possible to subject tax statements to more intensive scrutiny, such as checking the completeness of returns in a given industry. A by-product will be the collation of economic data of inestimable value to business and government in charting the course of Hawaii's economy.

## **COMPARATIVE "TAX SACRIFICE"**

We have yet to examine (in the next chapter) if tax differentials are necessarily critical in the flow of investment between one state and another. Regardless of the economic significance of the outcome, however, there is an

abiding interest in measurements of how heavy the taxes of one's state are compared with levies imposed in other parts of the nation.

The usual method of comparison has been to divide state and local tax payments in each state by the amount of personal income received in that state for the given year. The state with the highest ratio was considered to have the heaviest "tax burden", the one with the lowest ratio the lightest burden. By this measurement, Hawaii had the sixth highest tax burden among the 50 states in 1959 (10.8 per cent of income in this state) and the eighth highest burden in 1960 (10.5 per cent).

However, the "tax burden" measurement does not allow for the difference in "effort" or "sacrifice" required in a low-income state to pay, let us say, 10 per cent of its smaller personal income, than in a high-income state. For example, in 1959 Hawaii and Mississippi had virtually identical tax burdens--10.78 per cent of personal net income in Hawaii, 10.72 in Mississippi. But the average ability to pay taxes in Hawaii, measured by its per capita income that year (\$2,118) was much greater than in Mississippi, where per capita income was only \$1,153.

This consideration, that a more meaningful measure of tax "sacrifice" or tax "effort" should allow for differences in ability to pay taxes, has led to the construction of the following index: state and local taxes as a per cent of personal income (the familiar "tax burden" measure) divided by per capita personal income.<sup>4</sup>

Table 3 presents the calculation of this index for each of the 50 states, showing the "sacrifice" made in each jurisdiction in paying state and local taxes in 1960. Like the old "tax burden" tables, the "sacrifice" index takes no account of the fact that the taxes imposed in one state may be shifted in part to individuals and firms in other states. However, adjustments to reflect such shifting can be made only in a crude way. Furthermore, they are relatively unimportant for the purposes to which this inter-state comparison should be put. The index is not a tool for fine discrimination in comparing the tax systems of any two states which are quite

<sup>4</sup>Suggested by Professor Carl S. Shoup of Columbia University and applied by Henry J. Frank, of Princeton University, in "Measuring State Tax Burden", *National Tax Journal*, June 1959, p. 179.

similar in terms of the tax load they bear. Rather, it is intended to approximate the relative position of any one state among the 50--i.e., whether its tax payments are conspicuously high or low relative to its ability to pay taxes.

With this cautionary note, it can be pointed out that Hawaii's "tax effort" (or "sacrifice") was nineteenth among the 50 states in 1959 and twenty-fifth--squarely in the middle--in 1960. Compared with other states with average or above-average per capita income, Hawaii's ratio of taxes-to-income was not outstandingly large. Hawaii's current tax structure can then be described as highly productive of revenue (eighth in the nation, measured by the ratio of tax collections to personal income) but of middling economic pressure on its population (19th to 25th among the 50 states, measured by ability to pay taxes).

Table 3

**MEASURE OF DEGREE OF SACRIFICE OF INCOME FOR STATE AND  
LOCAL TAXES IN EACH OF THE 50 STATES**

1959 and 1960

State	1959				1960			
	Tax Revenues as Percentage of Personal Income	Per Capita Income	Measure of Sacrifice <sup>1</sup>		Tax Revenues as Percentage of Personal Income	Per Capita Income	Measure of Sacrifice <sup>1</sup>	
			Index	Rank			Index	Rank
Alabama	7.72	\$1,420	5.437	10	8.04	\$1,462	5.499	11
Alaska	6.09	2,546	2.391	49	5.82	2,735	2.128	50
Arizona	9.57	1,912	5.005	20	10.36	2,011	5.152	19
Arkansas	9.02	1,327	6.797	5	9.37	1,341	6.987	3
California	9.46	2,668	3.546	39	10.15	2,741	3.703	38
Colorado	9.88	2,186	4.520	26	9.96	2,320	4.293	30
Connecticut	7.02	2,781	2.524	48	7.44	2,863	2.599	48
Delaware	6.60	2,927	2.255	50	6.59	3,013	2.187	49
Florida	8.92	1,962	4.546	25	9.26	1,988	4.658	24
Georgia	8.42	1,557	5.408	12	8.80	1,608	5.473	12
HAWAII	10.78	2,118	5.090	19	10.54	2,274	4.635	25
Idaho	9.65	1,802	5.355	13	10.52	1,796	5.857	7
Illinois	7.00	2,571	2.723	47	7.88	2,613	3.016	46
Indiana	8.06	2,101	3.836	37	8.24	2,179	3.782	37
Iowa	9.78	1,970	4.964	23	10.26	2,003	5.122	21
Kansas	10.52	1,990	5.286	14	10.54	2,068	5.097	22
Kentucky	7.56	1,514	4.993	21	7.69	1,543	4.984	23
Louisiana	11.29	1,605	7.034	4	11.75	1,604	7.325	2
Maine	9.41	1,800	5.228	16	10.18	1,900	5.358	15
Maryland	7.89	2,326	3.392	41	8.30	2,394	3.467	41

Table 3 (continued)

State	1 9 5 9				1 9 6 0			
	Tax Revenues as Percentage of Personal Income	Per Capita Income	Measure of Sacrifice <sup>1</sup>		Tax Revenues as Percentage of Personal Income	Per Capita Income	Measure of Sacrifice <sup>1</sup>	
			Index	Rank			Index	Rank
Massachusetts	9.30	\$2,437	3.816	38	9.28	\$2,519	3.684	40
Michigan	8.96	2,253	3.977	34	9.34	2,322	4.022	33
Minnesota	10.32	1,971	5.236	15	10.56	2,054	5.141	20
Mississippi	10.72	1,153	9.297	1	11.08	1,173	9.446	1
Missouri	6.60	2,158	3.058	45	6.92	2,199	3.147	45
Montana	10.89	1,978	5.506	8	10.87	2,018	5.386	14
Nebraska	8.82	1,966	4.232	31	8.22	2,113	3.890	36
Nevada	9.05	2,713	3.336	42	9.61	2,844	3.379	42
New Hampshire	8.34	1,980	4.212	32	8.55	2,074	4.122	32
New Jersey	7.66	2,591	2.956	46	7.76	2,665	2.912	47
New Mexico	9.05	1,820	4.972	22	9.67	1,806	5.354	16
New York	9.26	2,709	3.418	40	10.31	2,789	3.697	39
North Carolina	8.18	1,500	5.453	9	8.70	1,574	5.527	10
North Dakota	11.96	1,557	7.681	3	11.38	1,741	6.536	5
Ohio	7.10	2,283	3.110	44	7.90	2,339	3.378	43
Oklahoma	9.32	1,789	5.210	17	9.58	1,848	5.184	17
Oregon	9.34	2,201	4.244	29	9.96	2,259	4.409	27
Pennsylvania	7.25	2,201	3.294	43	7.64	2,266	3.372	44
Rhode Island	8.44	2,166	3.896	36	8.87	2,228	3.981	34
South Carolina	8.35	1,333	6.264	7	9.26	1,397	6.628	4

Table 3 (continued)

State	1959				1960			
	Tax Revenues as Percentage of Personal Income	Per Capita Income	Measure of Sacrifice <sup>1</sup>		Tax Revenues as Percentage of Personal Income	Per Capita Income	Measure of Sacrifice <sup>1</sup>	
			Index	Rank			Index	Rank
South Dakota	12.28	\$1,502	8.176	2	10.76	\$1,842	5.841	8
Tennessee	8.19	1,508	5.431	11	8.70	1,545	5.631	9
Texas	7.76	1,908	4.067	33	8.43	1,924	4.381	28
Utah	9.42	1,848	5.097	18	10.31	1,910	5.398	13
Vermont	11.31	1,798	6.290	6	11.97	1,859	6.439	6
Virginia	6.99	1,792	3.901	35	7.24	1,848	3.918	35
Washington	9.52	2,249	4.233	30	9.84	2,317	4.247	31
West Virginia	7.81	1,635	4.777	24	8.66	1,674	5.173	18
Wisconsin	9.48	2,122	4.467	27	9.93	2,171	4.574	26
Wyoming	9.81	2,240	4.379	28	10.09	2,334	4.323	29
U.S. average	8.92	2,009	4.686		9.26	2,082	4.689	

<sup>1</sup>State and local taxes (U.S. Census Bureau, *Governmental Finances in 1959 ... in 1960*) as percentage of personal income divided by per capita personal income (*Survey of Current Business*, August 1961, p. 13)





## CHAPTER 3

# TAX INCENTIVES FOR INDUSTRY

In the past several years, major studies have been made across the nation of a long-debated question: Do tax differentials have an important influence on the location of industry? Some of the surveys have been focused on manufacturing,<sup>1</sup> some on particular geographical areas,<sup>2</sup> others have been general in scope and application.<sup>3</sup> The consensus, gathered by Professor John Due of the University of Illinois,<sup>4</sup> is that tax factors are distinctly secondary in determining the location of business firms.

A representative statement of the findings of relatively disinterested investigation of this question appears in the recent study of the University of Wisconsin State Tax Study Committee:

The contention that economic growth in Wisconsin or elsewhere has been considerably affected by tax differentials has not been established by credible evidence. Neither has it been disproved, though the general failure to establish correlation between economic development and tax differentials is indicative that at present levels of differentiation effects on economic growth cannot be very serious.<sup>5</sup>

These cautious conclusions can be cautiously applied to Hawaii. In the upward climb of income, investment and employment which this state has enjoyed in the past decade,

<sup>1</sup>Clark C. Bloom, *State and Local Tax Differentials and the Location of Manufacturing*, Bureau of Business Research, State University of Iowa, 1956. W. R. Thompson and J. M. Mattila, *An Econometric Model of Postwar State Industrial Development*, Wayne State University Press, 1959.

<sup>2</sup>W. D. Ross, "Tax Concessions and Their Effect [in Louisiana]," *Proceedings of National Tax Association for 1957*, pp. 216-24; *Industrial Mobility in Michigan*, University of Michigan Press, 1950; Tax Study Committee of Pennsylvania, *The Tax Problem*, 1953; D. B. Yntema, *Michigan's Taxes on Business*, Hope College, Michigan, 1959; A. K. Campbell, "Taxes and Industrial Location in the New York Metropolitan Region," *National Tax Journal*, September 1958, p. 198; J. D. Strasma, *State and Local Taxation of Industry*, Federal Reserve Bank of Boston, 1959.

<sup>3</sup>"Plant Site Preferences of Industry and Factors of Selection," *Business Week Research Report*, 1958; *Effects of Taxation on Industrial Location*, University of North Carolina Press, 1952.

<sup>4</sup>"Studies of State-Local Tax Influences on Location of Industry," *National Tax Journal*, June 1961, p. 163.

<sup>5</sup>*Wisconsin's State and Local Tax Burden*, Madison, 1959, p. 35.

there is no evidence of the repressive effects of taxation. Many students of the problem have pointed out that taxes provide services, as well as costs, to business firms and their personnel. Companies investigating potential investment and production opportunities, in Hawaii or elsewhere, would be interested not only in the local tax level, but in the level of education and training, the quality of health services, the condition of the roads, adequacy of police and fire protection, and the other service levels maintained by state and local governments.

## **TAX EXEMPTIONS IN HAWAII**

The conclusion that tax exemptions have but a limited effect in attracting industry is borne out in Hawaii's experience. Since the days of the Kingdom, Hawaii has proffered exemptions to industries which the government tried to attract or encourage to stay. The catalog of exemptions is a long one, including the operation of railroads, growing tobacco, poi, sandalwood and cotton, the production of movies, oil refining, okolehao distilling, and dozens of other businesses.<sup>6</sup>

On the record, tax exemptions have not been a successful device for stimulating the economic growth of the Islands. Relatively few investors have taken advantage of the exemptions offered; of the takers fewer have survived in competition with non-exempted industries. Here, for example, is a list of the areas of tax exemption granted to local producers by Hawaii statute since World War II and the number of firms now operating in the exempted fields:

1. Certain oil refining (exempted from general excise since 1953) -- one firm;
2. Mayonnaise production (exempted from general excise and property taxes until 1960) -- none;
3. Acerola production (exempted from general excise until 1965) -- one firm;
4. Cellophane and cellulose production (exempted from general excise and property taxes until 1958) -- several companies;

<sup>6</sup>Listed in "Tax Exemptions Granted to Agriculture and to Business in Hawaii," typewritten reports of the Legislative Reference Bureau, University of Hawaii, March 18, 1953 and January 15, 1954.

5. Bagasse paper production (exempted from property and general excise taxes, beginning 1955) -- none;
6. Fuel alcohol production (exempted from property tax until 1947) -- none;
7. Motion picture and television film production (exempted from all taxes until 1960) -- a few local companies, plus activity of mainland and foreign producers;
8. Okolehao distillation (exempted from liquor tax until 1965) -- one firm;
9. Sandalwood production (exempted from property tax until 1959) -- none.

### **Tax Relief for Established Industries**

An examination of the evidence bearing on the use of tax exemptions to attract new industries does not complete the case with respect to tax exemptions or differentials to help sustain long-established industries. It can be argued that the state and its population have an economic interest in going business concerns, an interest proportioned to the pay-rolls and local expenditures of the firms. It may be in this interest to adjust the tax policy of the state to meet the needs of large enterprises when their continuance is threatened.

It is against this background that the attention of the legislature has been repeatedly drawn in the past several years to the problems of the plantation industries, sugar and pineapple, which form such a large part of the Hawaii economy. Both industries have encountered increased market competition from expanded world production -- from beet sugar growers on the mainland United States, from pineapple raisers in Taiwan, Okinawa, the Philippines, South Africa and elsewhere. The closing of pineapple canneries on Kauai and Maui and the continued difficulties of marginal sugar plantations are cited as evidence for the need for tax relief to the two industries.

It lies beyond the scope of this study to investigate the economic health of plantation agriculture in Hawaii, or the extent to which the state's tax policy affects the competitive position of sugar and pineapple.<sup>7</sup> Given the complexity

<sup>7</sup>Studies of both industries are in preparation by the Economic Research Center of the University of Hawaii.

of factors helping shape the national markets for these products -- changes in national income, redistribution of Cuba's former sugar quota, the West German demand for pineapple, increases in ocean freight rates, to name only a few -- it would require not only precision of analysis but also prescience to determine with certainty the results of reducing the state taxes paid by the two industries. However, some relevant things can be said about tax policy issues raised by current developments in Hawaii's chief agricultural industries.

Faced by a possible decline in its major industries, the state could first make sure that its tax laws are not actually discriminating against these industries, and take its stand on the workings of the economic system. If the economy is perfectly (or almost perfectly) competitive, as each marginal firm goes to the wall, its employees and assets will be put to work by other, more efficient, firms in Hawaii or elsewhere. This process is the very metabolism of a highly competitive economy; from it flows the benefits of efficiency and rising living standards claimed for the free enterprise system.

However, the sugar industry does not operate under conditions of textbook competition, but rather under a national price-support program. Hawaiian cane sugar has to meet the price set for beet sugar in the markets of the mainland, but neither price is allowed to fall below the limits administered by the federal Department of Agriculture, which uses a quota system to regulate the volume of sugar reaching the market. Tariffs around the world limit the full play of competition for the pineapple industry. Under such circumstances the traditional economic theorems give no assurance that more efficient industries would replace sugar and pineapple in Hawaii, should they decline.

Even if the tax laws of the state do not discriminate against sugar and pineapple production, the state may want to take fiscal action to sustain them. In this case the next step could be considered: discriminating in favor of these industries through lower tax rates or through special deductions in their tax base.

## **ARE TAXES ON SUGAR AND PINEAPPLE NEUTRAL?**

The first approach suggested is to test the taxation of sugar and pineapple industries for its non-discrimination, or "neutrality". A neutral tax structure would neither favor nor

disfavor any industry, would bear with equal weight on all types of business enterprise, so as not to change the odds of success and failure.<sup>8</sup>

Sugar and pineapple production in Hawaii are taxed under general laws which, for the most part, apply to them as to other industries; the chief of these are the real property, net income and general excise taxes. Not much discussion has been generated recently by the property and income taxes, as they apply to sugar and pineapple, aside from questions concerning the adequacy of plantation land assessments. Rather, attention has been concentrated on the general excise tax, where higher rates have been placed on sugar and pineapple than on other agricultural producers and processors since the tax was first adopted in 1935. Originally, the maximum general excise rate, imposed on sugar and pineapple as well as retailing, services, contracting and a variety of other occupations, was used as a budget-balancing tax; the governor was authorized to raise the maximum rate (then 1-1/4 per cent) by a quarter per cent, or to reduce it without limit, as the needs of the treasury permitted. This delegation to the executive of power to set the tax was repealed in 1945.

Currently, the general excise rate on sugar and pineapple is 2 per cent;<sup>9</sup> the rate paid by diversified farmers, manufacturers, processors and other producers is one-half per cent. It cannot be assumed, out of hand, that the difference between 2 per cent and one-half of 1 per cent is either the proof or the measure of discrimination against plantation agriculture. Two basic factors besides the nominal tax rates must be considered. The first is the organizational structure of the pineapple and sugar industries, which usually combine under one management the production, processing and sale of their output. Thus the general excise applies only once -- when the sugar or pineapple is sold by the processor -- whereas other local products are subject to repeated taxation under the general excise as they are sold in turn by the original

<sup>8</sup>It will be seen that non-discrimination or "neutrality" with respect to the taxation of business is similar to the idea of "equality" or "justice" in comparing the taxation of individuals. However, the idea of "ability to pay," central to comparisons of tax burden among individuals, has no direct application to business enterprises. This follows from the idea of "sacrifice" which underlies the ability-to-pay concept. Sacrifice is a personal attribute, not experienced by legal entities such as a firm--though of course the taxation of a business, through tax shifting, may cause "sacrifice" to the owners, managers, employees, suppliers and debtors of the business which could be considered in the light of *their* ability to pay taxes.

<sup>9</sup>By-products of the industries, such as pineapple bran, are taxed at the regular rate applicable to manufacturers or processors.

grower or producer, by the processor and wholesaler. (All commodities retailed in Hawaii may be subject to the wholesaling rate of one-half of 1 per cent and to the retailing rate of 3-1/2 per cent, and so are on an equal footing.) Thus, milk may be taxed at one-half per cent to the farmer, another one-half per cent to the distributor, and another one-half per cent to the wholesaler. A processed food, such as ice cream, may have additional general excise taxes imposed along the line.

Practice in other American jurisdictions setting rates on highly integrated industries cannot be looked to for comparison, since Hawaii's general excise tax is without close counterpart in the United States.<sup>10</sup> However, it is not uncommon for governments abroad imposing a multiple-stage gross income, or turnover tax, like Hawaii's, to put a higher rate on "integrated" industries, such as sugar and pineapple, than on non-integrated industries.<sup>11</sup> Neutrality in taxation requires a higher rate for such vertical integrations, which would otherwise have a tax advantage over industries where each major step in production and distribution was carried on by independent firms.

If it is not to be arbitrary, the general excise tax rate on a vertically integrated industry should be the sum of the effective rates which would have been paid at each step in the production process, were the industry not integrated. In terms of the sugar and pineapple industries of Hawaii, this calculated rate would include the tax on agricultural production plus the tax on processing the cane into raw sugar, the fruit into canned and frozen products.<sup>12</sup>

To make this calculation, one must know the value of the cane and pineapples as they are harvested and delivered to the mill or cannery, for this is the value that would be the base of the general excise on agricultural production. However,

<sup>10</sup>Indiana's gross income tax, which most closely resembles the Hawaii general excise, has elements of a value-added tax, permitting enterprisers in some occupations to deduct the cost of their purchases.

<sup>11</sup>John F. Due, "Sales Taxation in Western Europe," *National Tax Journal*, June and September, 1955, especially pp. 319-20.

<sup>12</sup>Integration may be most outstanding in the production of sugar and pineapple, but can be found in varying degrees in a wide range of Hawaii industries. A general discussion of the economic effects of the gross income tax, going beyond the limits of this study, might consider several other examples of integrated operations. One such case, examining the influence of milling cooperatives on the tax payments of coffee farmers, is included in *Some Effects of Hawaii's 1957 Tax Law*, University of Hawaii, 1959, pp. 44-46.

these values do not exist, since there is no regular market in Hawaii for sugar cane or pineapple shipped for canning.

Fragmentary data do exist, calculated from sales to sugar mills and canneries by "independent" cane and pineapple growers. They seem to indicate that the value of the field crop in the two industries is in the order of about one-third of the processed (i.e. milled or canned) product -- perhaps somewhat more for cane, somewhat less for pineapple. One-third is taken as the basis for computing a "neutral" tax rate in Chart 2. On this assumption, the 0.5 per cent tax currently imposed on agricultural production would amount to about 0.17 per cent (0.5 multiplied by one-third of the value of raw sugar and canned pineapple). Atop of this estimated rate would be the full 0.5 rate on processing, or a total estimated tax rate of 0.67 per cent.

The same calculation is made in the chart for the period 1947-57, when the rates on production and processing were 1.5 per cent, and for 1957-61, when these rates were set at 1 per cent.

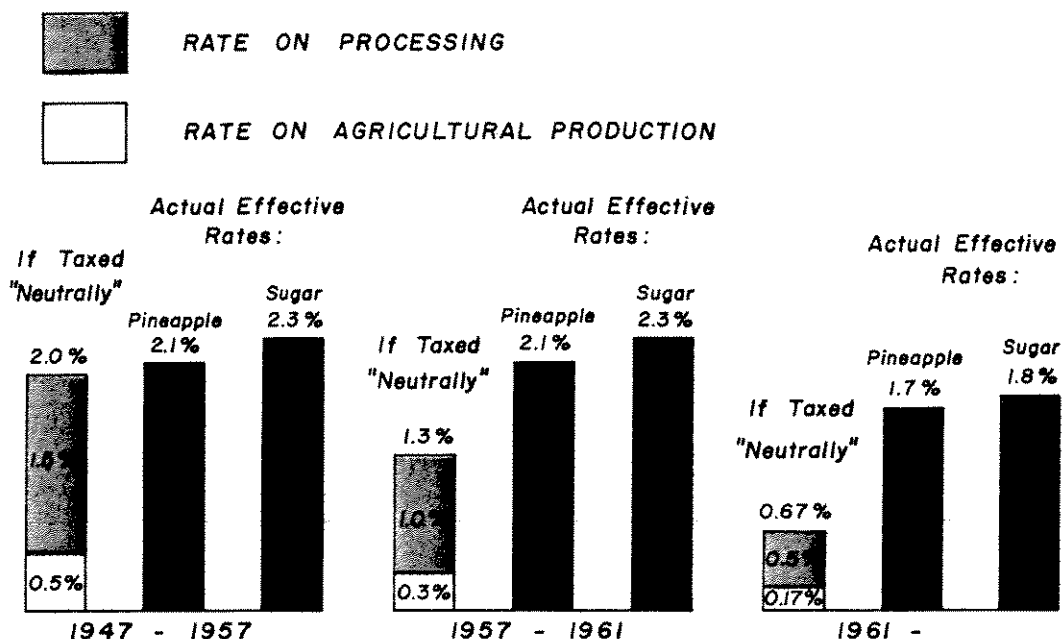
The second factor to consider is that Hawaii's laws have permitted sugar and pineapple companies to deduct certain expenses in computing their general excise tax liabilities, deductions not generally available to other industries. In recent years, pineapple companies have deducted 20 per cent of their gross income to allow for marketing costs, spoilage and shrinking incurred in selling their product on mainland markets and abroad, and, to quote the tax statute, to provide a "reasonable allowance for contingencies."<sup>13</sup> The sugar industry's deduction of about 16 per cent includes freight costs and an allowance for economic contingencies computed with reference to the New York sugar price.

If the two industries were allowed the same deductions as other export industries (to allow for out-of-state shipping costs, for losses and warehousing costs in transit, but not for "contingencies" or promotional expenses), it is estimated that the percentage deductions would be about 5 per cent for pineapple, which is generally sold and taxed F.O.B. Honolulu, and about 8 per cent for sugar. By the same method of estimation, the effective rate of the general excise on pineapple is not 2 per cent but about 1.7 per cent--that is, the nominal rate of 2 per cent applied to a base

<sup>13</sup>Section 117-14(a-4), Revised Laws of Hawaii 1955, as amended in 1960.

Chart 2

# GENERAL EXCISE TAX RATES ON SUGAR AND PINEAPPLE PRODUCTION 1947-1961



Note: See text for assumptions and calculation of rates.

reduced to 85 per cent by special allowances. The effective rate on sugar is estimated at 1.84 per cent (the 2 per cent nominal rate multiplied by a 92 per cent base).

Using such computations, Chart 2 compares the effective general excise tax rates actually imposed on the sugar and pineapple industries between the reformation of the general excise tax in 1947 and the present.<sup>14</sup> It shows a changing pattern. Between 1947 and 1957 the two industries were taxed approximately as they would have been as non-integrated firms, that is with canneries and mills owned,

<sup>14</sup>The chart compares the effective rates imposed with a construct of how the sugar and pineapple industries would have been taxed if they had been taxed like other industries under general provisions of the law. The construct, shown on the left-hand column in each group of three in the chart, is simplified for graphing. It assumes that if the sugar and pineapple industries were *not* integrated all production would go through two taxable stages—growing the crop and a single processing of the crop—taxable by Hawaii on an unambiguous base. Actually, the base for sugar must be calculated from the value of the product refined on the mainland and is inherently subject to error. More important is the warning noted above, that the construct assumes that the value of sugar cane and raw pineapple is one-third the processed value. The evidence supporting this estimate is fragmentary and subject to correction.



operated and taxed independently of the plantations. Since 1957, and particularly since 1961, both industries have been taxed more heavily than the run of industry, and by the same token, more heavily than they would be if processing were divorced from growing and both activities were taxed under the general tax rates.

A proximate approach to neutrality would be achieved if (1) sugar and pineapple enterprises were allowed the same deductions for out-of-state business costs as are allowed other industries; and (2) if the general excise rate on these two industries were reduced to about two-thirds of 1 per cent--the sum of the estimated effective rates on producing and processing. The first step would increase their joint tax base by about \$24 million; the second would cut their nominal tax rate to one-third its present level. In 1962 terms, the two-step change would reduce general excise tax payments for the sugar industry from \$2.2 million to about \$800,000, those of the pineapple industry from \$2 million to approximately \$760,000--an annual revenue loss of some \$2.6 million in all.

It is far from assured that such tax reductions would sustain present levels of output and employment in Hawaii by the sugar and pineapple companies. Some of the tax savings might go into wage increases, leaving the industries in about the same cost-price relationships that are now termed unsatisfactory for marginal firms. Alternately, reduced taxes to the plantations might make possible larger profits for the factors which service, and, in part, own them.

Either channelling of tax reductions would remain, at least initially, in the Hawaii economy and help sustain it. However, it is also possible that some of the savings would be invested by some of the sugar and pineapple firms outside the state, augmenting the trend toward geographical diversification of investment. This is to be expected, since the first duty of an enterprise for profit is to make profit, and not to shape its investment program by considerations of local loyalty.

To the extent that general excise tax cuts increased business profits, the gain would be shared by the stockholders and the Bureau of Internal Revenue. The division would be approximately equal, since the federal corporate income tax rate on taxable income over \$25,000 is 52 per cent.

## STIMULATING LOCAL INVESTMENT

Reducing the general excise tax rate on the sugar and pineapple industries would not, of course, insure the continued operation of marginal firms. The losses recently incurred by some firms exceed the amount of potential tax savings. Furthermore, even with lower general excise taxes it may be more profitable to intensify production on more efficient plantations, in larger canneries, and to close down the marginal enterprises.

The state, however, may have interests somewhat divergent from the industries directly affected. It may be concerned about the level of local employment, or in checking the concentration of population on Oahu by maintaining economic activities in the neighbor islands. From this concern it may, for example, be impelled to support plantation agriculture on the Hamakua Coast of Hawaii, until other industries are developed to use the human and natural resources of that region. This approach would be appropriate only on the assumption that the intervention of the state government would make for better economic and social arrangements than would result from the (otherwise) unimpeded workings of business decisions.

Were the state to intervene, it could fashion more powerful tax incentives for the support of local plantation agriculture than a policy of tax neutrality would permit. To this end, a direct relationship might be established between the amount of tax relief and the amount of local investment in support of sugar and pineapple production. Several basic types of investment can be identified: land, improvements to land, equipment, and research.

Plantations holdings of land in recent years have been relatively stable; additional acreage is not a basic need of the two industries. However, irrigation (in some areas, drainage) is important to more efficient production. So is better equipment--in field and mill, in cannery and refinery. Research finds means of improving the field crop, its processing and its marketing. Tax reductions which encourage investments in land improvements, equipment and research might help sugar and pineapple to maintain their activities in Hawaii. In recent years expenditures for these purposes, combined for both industries, have approximated \$18 million annually, a sum sufficiently large to serve as the basis for major tax relief to the industries.

**Table 4**  
**PROFITS AND LOSSES OF SUGAR AND PINEAPPLE**  
**COMPANIES IN HAWAII**  
**1960-61**

		No. of Firms	
		Sugar	Pineapple
<u>Net Losses</u>			
Over \$400,000		2	-
300,000-400,000		2	-
200,000-300,000		3	-
100,000-200,000		5	-
50,000-100,000		1	1
Under 50,000		<u>2</u>	<u>-</u>
	Total	15	1
<u>Net Profits</u>			
Under \$50,000		1	1
50,000-100,000		3	1
100,000-200,000		2	-
200,000-300,000		2	-
300,000-400,000		1	2
Over 400,000		<u>3</u>	<u>3</u>
	Total	12	7

Source: Compiled by State Department of Taxation  
from 1960 and fiscal 1961 tax returns.

The usual approach to giving such relief is through the net income tax. Thus, the Congress has before it proposals for accelerated depreciation of new capital assets under the corporate income tax, intended to stimulate business investment. However, as Table 4 shows, many sugar plantations have not been earning net incomes; relief under this tax would not help the companies which need it most. (The year used for constructing the table was unusually poor for the sugar industry, but any recent year would show a great variation in profitability among the plantations. Profits and losses from mainland operations may be reflected in the data for pineapple companies taxed under a formula including income from within and without the state.)

All plantations, however, do pay a tax on their gross income, as computed under the general excise tax. It would be possible to devise a program of tax relief for the industries around this levy, more directly stimulating local investment than a reduction in the tax rate.

One possibility would be to allow plantations to charge off, say over a five-year period, their investments in land improvements and equipment as deductions from the general excise tax, and to charge off in full their current research costs. It is doubtful, however, if the granting of tax deductions along the lines just sketched would be a significant stimulus to local investment. A \$100,000 expenditure for land improvement or equipment, for example, could be charged off at \$20,000 per year for five years, leading to an annual tax reduction of only \$400 under the general excise.

More stimulating would be a tax credit<sup>15</sup> of the entire amount of depreciation allowed annually--or \$20,000 in the above example. Over a five-year period, investments eligible for such depreciation would be costless to the firms making the investment.

A mid-way ground, charging off half of the investment as a tax credit, would split the cost between the firm and state government. Under this approach the \$100,000 outlay would entitle the firm to a tax credit of \$10,000 a year for each of five years. This fifty-fifty ratio approximates that of the federal income tax, since the national levy permits

<sup>15</sup>Deductible in full from the computed tax of the firm receiving the credit, in this case the sugar plantation or pineapple cannery.

the deduction of depreciation costs and research charges, among other business costs, from a tax whose average rate is about 50 per cent.

No one can predict how much of the tax savings realized, following the granting of deductions, credits, rate reductions or other tax relief, would be spent in Hawaii. The sugar and pineapple firms enjoying the savings would presumably compare the opportunities available to them in Hawaii and overseas for the investment of net amounts remaining to them after satisfying demands for higher wages, larger dividends or increased commissions that might be stimulated by the tax reduction.

One final alternative may be considered to induce local investment. This approach would make investment above the level maintained by each firm over a base period a requirement for tax reduction. That is, expenditures by a firm for plant or plantation improvements, as well as for research, which were in excess of its expenditures over the base period (say, computed as an average for five recent years) would be allowed as a credit from the general excise. This device would take one still further from the present structure of the general excise levy, but might provide stimulus to new investment and expansion of research.

Costs to the Hawaii government of allowing either general excise tax rate reductions or tax credits for land improvement, equipment and research investments of plantation agriculture are roughly estimated in Table 5. Some or

**Table 5**

**ESTIMATED ANNUAL GENERAL EXCISE SAVINGS FOR SUGAR AND PINEAPPLE INDUSTRIES UNDER ALTERNATIVE TAX REDUCTIONS**

Rate Reduction <sup>a</sup>		Tax Credit on One-Half Present Investment <sup>b</sup>		Full Tax Credit on Additional Investment <sup>c</sup>	
To:		Allowance:		Allowance:	
1-1/2%	\$ 700,000	10%	\$ 900,000	20%	\$ 720,000 to \$1,200,000
1%	1,800,000	20%	1,800,000	33%	1,200,000 to 2,000,000
2/3%	2,600,000	25%	2,250,000	50%	1,800,000 to 3,000,000
1/2%	3,000,000	33%	3,000,000	67%	1,400,000 to 4,000,000

<sup>a</sup>Combined with assessing tax under general provisions of law to eliminate special deductions.

<sup>b</sup>Estimated at \$18 million annually, one-half to be credited.

<sup>c</sup>Assumed to be 20% to 33% of prevailing level, i.e. \$3.6 million to \$6.0 million.

all of the costs would be borne by the state general fund. It would also be possible to construct a credit scheme under the property tax, or a system of rate classification which would lower the property tax payments of plantations. The entire cost, however, would fall on the county governments and they are presently less able to sustain the revenue loss than is the state.

## **ALTERNATIVES TO GENERAL EXCISE**

The problem of taxing integrated and non-integrated industries equally is not completely soluable under the general excise. As noted, many industries are integrated in greater or lesser degree; therefore a solution to the sugar and pineapple case explicitly based on the circumstance that they are highly integrated would raise policy questions concerning the rate applied to other industries.

Two alternatives which would provide more general solutions suggest themselves. One is to avoid the problem by replacing the gross income tax with a retail sales tax, augmented as now by a consumption tax. The price of this solution would be the removal of about one-third of the present tax base. It would require a retail sales tax of about 4 per cent, applied to all goods, services and activities now subject to the 3-1/2 per cent "retail" rate of the general excise, to raise the same amount of revenue as is now produced by the latter tax.

Another possible solution is to replace the general excise with a value-added tax, a relatively new form of taxation now used by Michigan alone among the 50 states. The principle of this tax, which like the general excise could apply to all levels of production and distribution, is that the enterpriser deducts from his gross receipts the costs of goods and materials purchased by him, so reducing his tax base to the value added by his firm in production or distribution.

To compare the workings of a value-added tax and the general excise, assume that Kona coffee is sold by the farmer for \$100 to a miller-roaster, who then sells the processed coffee to a wholesaler for \$225; it then is sold to a retailer for \$250 and finally to consumers for \$300. Under a value-added tax, the farmer would pay on the basis of \$100, the miller-roaster on the \$125 added in processing, the

wholesaler on \$25 and the retailer on \$50--or on \$300 in all, which is final value of the coffee when sold for consumption. Under the general excise tax, however, the full proceeds of each sale are taxable, or an aggregate of \$875 in this hypothetical example.

A variety of value-added tax was imposed by Hawaii between 1932 and 1935 as a "business excise tax", the forerunner of the general excise. At a maximum rate of 2 per cent,<sup>16</sup> it yielded about two-thirds of the amounts produced by the general excise when it replaced the business excise at initial rates ranging from one-fourth of 1 per cent to 1-1/4 per cent. One element of the value-added principle was indeed retained in the general excise tax. Refiners of sugar in Hawaii may deduct from their taxable gross income the value of raw sugar used by them which has already been taxed under the general excise.

A value-added tax would be more difficult to administer than is the gross income tax, since business costs as well as receipts would have to be audited. At this price a substantially greater degree of neutrality could be obtained for the taxation of business in Hawaii.

<sup>16</sup>The rate could be set lower if the budget were balanced, in the manner described earlier in this chapter for the general excise tax in the period between 1935 and 1945.





## CHAPTER 4

# FISCAL POLICY CONSIDERATIONS

The government of Hawaii has the flexibility necessary for a real choice in its overall budget operations. It has a tax structure sufficiently developed to provide a broad tax base which expands with the islands' economy. Possessing this base, relatively small changes in tax rates--particularly of the general excise and income taxes--can produce large increases or decreases in the revenues collected by the state. Through such tax changes, through adjustments in state expenditures and transfers to the county governments, and through its borrowing program, the government at Iolani Palace has the means to implement the fiscal policy it establishes.

## OBJECTIVES OF FISCAL POLICY

A minimal objective of state fiscal policy is to provide efficiency in the gathering and spending of state funds. This objective requires a close integration of the components of the fiscal system--the revenue structure, the expenditure process, state debt management, management of the several funds and other state resources--to make effective use of the financial powers of the government.

Towards this end, in the past several years the state has been drastically reducing the number of special funds. The purpose is not only to place under budgetary and legislative scrutiny the operations of agencies previously financed out of special funds, but also to channel into the general fund many financial reservoirs of the state which had remained full during much of the past decade, while the general fund itself was in frequent danger of drying up.

A second policy objective is financial flexibility. As a huge financial enterprise, the state government requires a cash balance in its funds to permit it to operate without fiscal embarrassment if unexpected lags occur in its revenue receipts. Lack of a cash balance was a serious handicap to the operation of the Hawaii government between 1951 and 1957, diverting much of the attention of territorial officers from the programs of government to a hunt for cash and ways of saving it.

In the past, the government's "till cash" was provided in the general fund balance and in the balances of the special funds, which could be borrowed temporarily. With the abolishment of most special funds, the general fund must be depended on to supply the cash reserve necessary for financial flexibility.

A third objective of state fiscal policy might be taken to be exerting countervailing force against changes in the business cycle, that is, to increase expenditures and cut taxes when unemployment rises, to reduce expenditures and raise taxes when inflationary pressures mount. These goals are widely accepted as the responsibility of the federal government, but the latitude for state action is quite limited. The general economic climate in Hawaii is affected by national trends, but Hawaii can influence national economic fluctuations only in concert with the other states--so that all change their expenditures or tax rates in the same direction--and there is no arrangement for such coordinated state action.

Perhaps the most that Hawaii can do individually is to take care of her own house, and (as a matter of cooperation with the federal government, rather than because of its quantitative importance in the national economy) to try to avoid a fiscal program which goes contrary to the national program, if Hawaii agrees with it. In this spirit, but primarily because of shortages of labor and materials, the Hawaii government deferred public improvements during World War II.

For peacetime, a surplus in government funds plus a debt margin are the chief ingredients for implementing a countercyclical fiscal policy. For at least a short period of high unemployment the state could maintain its regular expenditures and finance job-creating public works from fund balances and by borrowing, without resort to tax increases.

## **ELEMENTS OF FISCAL POLICY**

The state's fiscal program includes several elements, any of which can be varied within limits. They are the revenue sources, taxes and others, which support the general fund and special funds of the state; the capital budget which provides for the acquisition and construction of government buildings, highways, airports, harbors and similar capital

improvements; the operating budget which provides for the financing of all other government costs; the state debt; the balances in the general fund and special funds of the state.

(A separate variable is the amount of tax shares and grants made to the counties, or, what is very similar, state appropriations made to support their programs--such as paying for the construction of county buildings, or for salary increases received by county employees. This financial relationship requires discussion at length to be treated with understanding; it lies outside the scope of this report.)

## RESTRAINTS ON FISCAL POLICY

The limits within which fiscal policy is formed can be sorted into three categories--politico-economic, legal, and traditional. Political-economy considerations determine what programs the government will undertake, how much it will spend on these programs, how much it will tax from its citizens. The law reflects the economic and political limitations by setting restraints on the state government in its fiscal operations.

The restraints pertinent to this study are placed on capital expenditures and debt issue. Under the constitution (Article VI-4) the capital and operating budgets must be set forth separately; under the law (section 137-2, Revised Laws of Hawaii 1955) bonds can be issued only to finance capital improvements;<sup>1</sup> under the constitution, an outdated \$60 million ceiling is placed on bond issues which can be exceeded (up to 15 per cent of the assessed value of real property) only by a two-thirds vote of both legislative houses.<sup>2</sup> The constitution (Article VI-3) also permits borrowing to meet "casual deficits or failures of revenue," but such debt must be payable within one year.

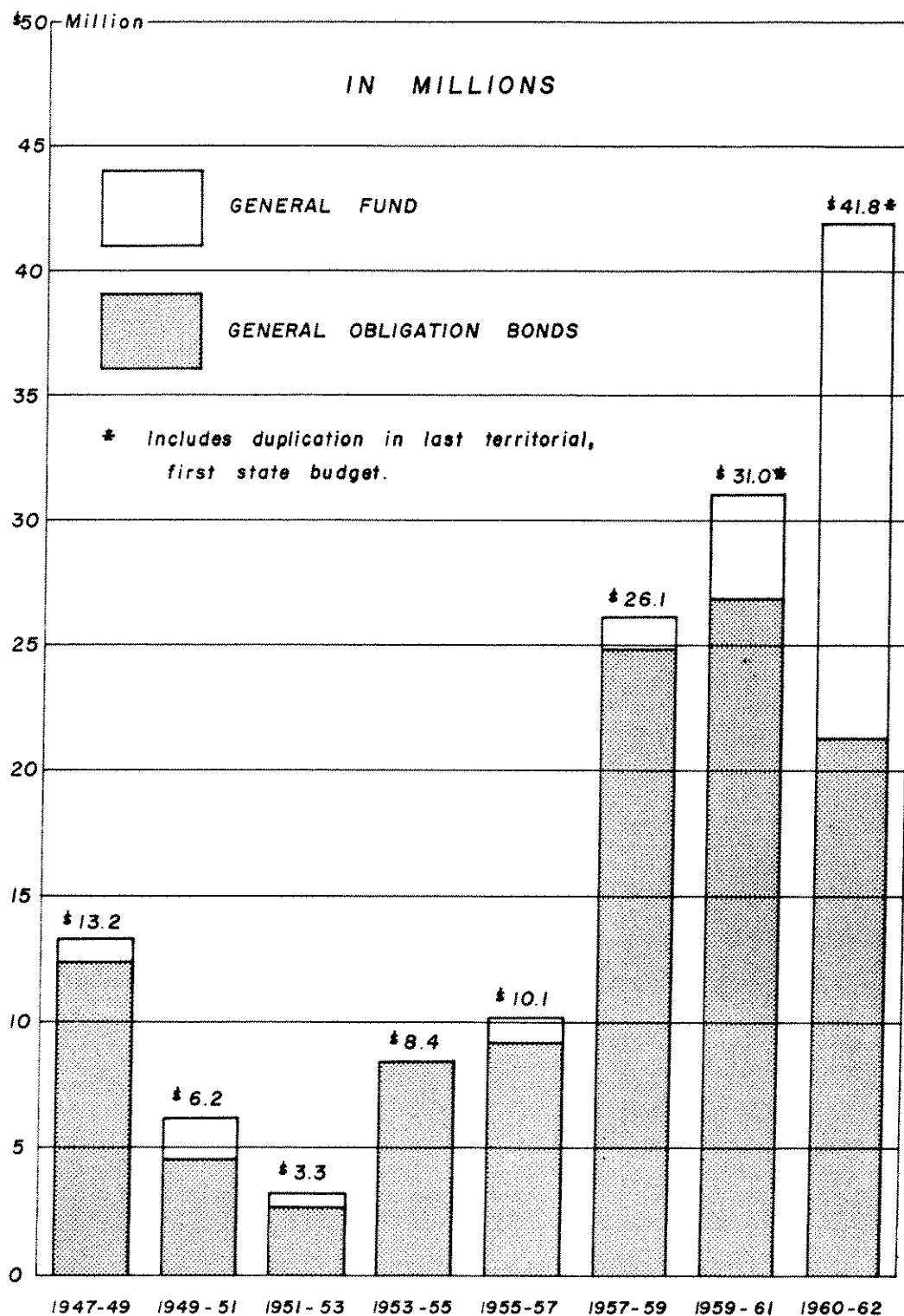
By tradition the budget must be balanced, or over-balanced, each year. However, the tradition is not an im-

<sup>1</sup>An exception are bonds issued to finance veterans' mortgage loans, under Act 192 and 193, Session Laws of Hawaii 1961.

<sup>2</sup>Tradition, rather than rationality, lies behind the constitutional debt limit, since the property tax base in no way measures the state's ability to sustain and repay its debts. However, Hawaii's bond consultants advised the state to adopt this limit to help it market its debt issues on the mainland, apparently because investors are accustomed to property value debt limits for municipalities and other local governments. A more rational debt limit for Hawaii would be related to the level of general fund revenues, which finance payments of interest and principal on general obligation bonds.

Chart 3

# **BIENNIAL APPROPRIATIONS FOR STATE CAPITAL IMPROVEMENTS: 1947-1962** (excluding highways, airports and harbors)



perative in Hawaii, where general fund deficits occurred, with no great public alarm, in five of the past dozen fiscal years.

## **TWO BUDGETS BETTER THAN ONE?**

Separate consideration of the capital budget--not only in Hawaii but commonly in other states--seems to be based on the view that public improvements are infrequently occurring investments in long-term assets. If the government only occasionally was required to build office buildings, schools, courts, public health facilities, etc., there would be good reason to finance the construction with bond issues. The alternative would be to increase tax rates during a period of capital construction, to lower them again when the building program was completed. Such rapid changes in tax rates would unnecessarily add to the uncertainties of economic life in the state.

However, the pattern of public improvements is not that erratic. Each legislative session is faced with the need for new buildings or for extensive improvements to old. As Chart 3 shows, over the past 14 years the Hawaii legislature has appropriated at least \$6 million for the capital budget in each biennium (except for the lean years of 1951-3), and more than \$10 million in each of the past three biennia.

The government at Iolani Palace has increasingly recognized the gap between traditional assumptions (that capital improvements are irregular, non-recurring, appropriately financed by borrowing) and actuality (that in fact capital improvement needs, while fluctuating greatly, come before each legislative session and can be financed, at least in part, as a regularly recurring expense). Each recent, regular legislative meeting but one (1953) has appropriated money from the general fund to cover some or all of the capital budget--e.g., about 5 per cent in 1957-59, approximately one-third in 1961, the entire capital improvements budget in 1960. Some of these appropriations were made as a matter of hard necessity, since the state debt limit did not allow for bond issues to cover the full capital budget. However, the desirability of making regular provision for some payment for public improvements out of the general fund has found acceptance. Current administration policy--suggested by the late Paul J. Thurston, for many years territorial

budget director--calls for the annual appropriation of at least \$5 million of general funds for capital budget needs.<sup>3</sup>

## UNITARY BUDGET CONSIDERATION

Relating the capital budget to the operating budget brings together the elements of the state's fiscal program--all expenditures, tax and other revenue programs, debt management, and the use of fund balances. Over time, all these factors can be changed. As a matter of fact, basic revenue changes are made rarely; since World War II only twice in Hawaii, in 1947 when the personal property and poll taxes were repealed, and 1957, when virtually the entire tax system was reshaped around increased taxes on sales and income.

In a given legislative session, the government is likely to take the revenue sources as relatively fixed, and to shape its expenditure program to fit the anticipated cash resources available. These resources include taxes and other receipts (federal grants, land rents, license fees, a variety of departmental receipts, etc.), borrowing, repayment of debt owed by the counties, and the balances in the general and special funds.

Assuming that it is not convened during one of the rare years of fiscal crisis when tax rates are to be increased, the questions facing the legislature in formulating its financial program include these:

1. Should the budget be balanced out of current revenues?
2. If not, how large a deficit can be prudently incurred?
3. How much of the capital budget should be met from the issue of bonds, how much from the general fund?
4. What balance should be maintained in the general fund?

<sup>3</sup>See also the reports of the Governor's Advisory Committee on Financing, 1958 and 1959.

## **BUDGET BALANCING PERIOD**

The traditional rule of budget balance, established as a chief fiscal virtue for state government in the 19th century, but widely disobeyed or ignored in the recent past, has lost its imperative force in Hawaii, as noted earlier. However, the rationale behind the rule still merits attention.

Its chief justification is that there is no other rule for ordering the relationship between expenditures and revenues; since expenditures cannot continuously outrun revenues, this certainty should be faced up to each year, so that two sides of the budget are constantly being adjusted to each other.

If other rules of thumb can be adopted, the explicit dropping of the budget-balance rule would not leave the state fiscal policymakers without a guide. Given a state government with any reasonable degree of self-discipline, or voter discipline, deficits can be incurred without threatening the fiscal order and stability of the government. This was demonstrated for Hawaii during the decade of the 1950's.

However, even if the rule of annual budget balancing is unnecessarily rigid, some time period is useful for relating governmental income and outgo. Fiscal policymakers need room and flexibility to operate well, but also a frame of reference.

A budget period of four years might be appropriate for Hawaii's circumstances. It is the term of the governor and of the state senators. Over a four-year period unusual fluctuations in economic activity and in government programs can be expected to average out, in approximate terms. If not, if expenditures continue to outrun revenues, there is a clear signal for an increase in taxes, or a reduction in government program; contrarywise for mounting surpluses. The issue would be defined for presentation to the voters at the election of governor and legislators.

## **BONDS AND INFLATION**

The rate of price increases has to be considered as one factor in the state's debt policy. Assuming that the government has a choice of borrowing for capital expenditures or using other funds, what is its best advantage in time of rising retail prices?

Inflation lightens the "real" load of debt, including state debt. Between 1943 and 1961, the Honolulu consumers' price index rose by 70 per cent or, otherwise stated, the purchasing power at retail of a dollar declined by almost 40 per cent. Without discussing the precision of the measure, it is obvious that each dollar borrowed by the Hawaii government in 1943 would be worth appreciably more than each dollar collected in taxes to retire the debt in 1961. By the same token, the "sacrifice" of the taxpayer in paying a dollar to retire debt in 1961 was appreciably less than he would have experienced in 1943, had the territorial government then used current tax collections instead of issuing bonds for capital improvement.

Taxpayers, of course, also have to bear the ultimate burden of interest payments on debt. Whether they will be better off under a program of borrowing or pay-as-you-go financing of capital improvements depends on the relationship between the interest rate and the rate of inflation. By way of example, the state of Hawaii sold a \$10 million bond issue in November 1961 at an effective interest rate of 3.4 per cent. Over its 20-year term, the loan will cost \$3,723,486--that is about 37 per cent of the amount borrowed--as it is repaid by installments. If the purchasing power of the dollar in Hawaii declined by as much as 3.4 per cent annually, there would be no "sacrifice" to taxpayers if the state were to defer their tax payments by borrowing. However, since the rate of inflation has not actually been that rapid, there is a real burden in interest payments. From recent experience, between one-third and two-thirds of the burden of interest payments is diluted away by inflation. The remainder is a real cost to taxpayers in Hawaii.

## **ANNUAL BUDGETING**

The responsible conduct of a four-year budget balancing period would require long-term planning of government programs, as well as continuous calculation of revenue and expenditure trends. The statistical basis for such planning is now being developed, as the various departments of the state government comply with a gubernatorial directive to project their programs and budget needs for the next six years. Revenue projections for the same period are being made.

With such information, modified as necessary to accord with legislative policy on programming, governmental



salaries, taxes and other budget fundamentals, the legislature can determine if it is preferable to balance the budget in the fiscal year, to build up a surplus, or to incur a deficit. Good revenue estimates and expenditure projections would enable the legislature to relate its decision for the pending fiscal year to the balancing requirement for the entire four-year budget cycle.

If the legislature takes the estimated amount of revenue as a given factor, it will have to adjust the expenditure program to that estimate, plus any deficit it is willing to incur in the general fund, plus any bonded indebtedness it is willing to authorize. (Or, less any surplus it wishes to build up, and less any planned reduction in the outstanding state debt.)

## **RULES AS GUIDELINES**

Economics has not yet devised an objective measurement of the value to society of government services. There is yet no way of telling, except at the polls, if a budget is the right size, let alone if it makes the best allocation of money between different government programs.

In the absence of such measurements, and considering how little time the legislature has to examine and change the budget submitted by the governor, some guidelines may be helpful in determining how to relate the current expenditure program to the general fund balance and to the state debt. Such guidelines would seek to give the state financial flexibility, and to adjust its fiscal reserves to changing economic conditions.

Useful and acceptable guidelines can be worked out only after mature consideration by the legislature, the executive and the public. In the interest of illustrating the kind of rules which can be developed, and with no thought of having precisely formulated them, the following approach is put forward:

1. General fund appropriations should provide at least \$8 million annually for state capital improvements, other than highways and airports. (This amount would pay for about half of the average annual cost of such improvements over the next 20 years, as projected by the State Department of Planning and

Research in the General Plan for the State of Hawaii, 1961, pp. 112-113.)

2. The general fund should be maintained so as to have a planned balance (cash surplus, less encumbrances) of at least 3 per cent of appropriated expenditures during the fiscal year.
3. The planned general fund balance should not exceed 10 per cent of appropriated expenditures. Any balance above 10 per cent should be considered available to finance capital improvements.
4. If maintained for more than four years, a general fund balance of 10 per cent or more should be regarded as a signal for tax reduction; conversely if the balance remains below 3 per cent.
5. Within the limits of 3 and 10 per cent, the general fund balance should be built up when unemployment in Hawaii is relatively low (say under 5 per cent), drawn upon to finance current expenditures when unemployment is relatively high (exceeds 5 per cent).
6. The state budget should be balanced, or over-balanced, during each four-year gubernatorial term, except when overspending is indicated to bring the general fund balance within the 3 - 10 per cent range.
7. The amount of state general obligation bonds outstanding should not exceed 90 per cent of the constitutional debt ceiling when unemployment is low (below 5 per cent), leaving a margin to be utilized as necessary in periods of greater unemployment.

Such rules would provide a proximate approach to fiscal policy decisions based on some consideration of economic conditions and the needs of government for financial maneuverability. In time of sustained economic distress, as with other normal rules of financial behavior, they may not apply.

## CHAPTER 5

# STATE REVENUE NEEDS

Hawaii's revenues and expenditures can be expected to rise with the population and personal income of the state, and both have been in a stage of rapid growth. Looking as best one can into the future, the question is which will increase the faster--revenue or expenditures--or will they remain in balance?

Related factors underlie the upswing of tax payments and governmental expenditures. Higher material standards in private living--more automobiles, dwelling space, household furnishing, TV sets, clothing, restaurant meals, insurance policies, etc.--have continued to expand the levels of incomes, sales and property values in Hawaii, and these are the bases of the tax system. At the same time, an expanding population, increasingly concentrated on Oahu, has required more schools, streets, health and sanitation services, recreation and other facilities. The proper care of visitors has been only a minor source of demand for expanded public expenditures until now. An increase for this source might be anticipated in the next decade, when the estimated number of tourists in a year reaches and then exceeds the resident population.

A continuous upward trend in salaries has greatly affected government budgets, as well as those of private firms. So, to a lesser degree, has continued inflation.

The higher material standards of the more affluent society of our times have influenced public expenditures, in Hawaii as across the nation. Schools and other public buildings are now supposed to be handsome, as well as functional. Government offices can frequently be equipped with high-speed calculators and other expensive labor-saving devices, and sometimes even with air conditioning, amenities which would not have survived legislative scrutiny a decade ago. Proposals for the new legislative building--which recognize the need for esthetic satisfaction and adequate parking, as well as the facilities necessary for legislative work--symbolize the change.

It may be useful to examine some projections of Hawaii state government revenues and expenditures over the

next several years. Obviously, there is no certainty that the projections--they are not forecasts--will be actually experienced. They are calculated on the assumption that the recent past is a dependable guide to the near future. Any unexpected gross change in the economy (the development of heavy industry in Hawaii or the closing of Pearl Harbor) would make the revenue projections useless even for illustrative purposes. By the same token, the expenditure projections would go out the window with any fundamental change in state programs--such as having the federal government take over the financing of all public school systems, or having the state of Hawaii provide fallout shelters for the entire population.

Besides this caveat, it should be noted that the projections apply only to the general fund of the state of Hawaii. It would be interesting and useful to project the receipts and expenditures of the special highway and airport funds. Conceivably, these funds might yield surpluses which could be used to support programs now financed only from the general fund, or the special funds might require transfers from the general fund to carry out desirable highway and airport improvements. However, the resources and demands of these special funds are so closely tied in with federal programs that projection into the future becomes hazardous to the point where silence is enjoined. There is additional reason for omitting this important segment of public finance in the fact that covenants included in bonds issues for the construction of highways and airports require the deposit in special funds of the revenues dedicated to the service of the bonds.

## **EXPENDITURE PROJECTIONS**

The long-term continuity of most state government programs makes it possible to project the expenditures of the Hawaii government some span of years into the future without being completely arbitrary. It is reasonable to expect that large and sudden additions to public responsibilities--defenses against nuclear warfare, conversion of the economy in the event of disarmament--would be primarily financed by the federal government. The pattern of state expenditures is less liable to quick change.

On the basis of this assumption of relative stability, the executive office of Hawaii's government late in 1961 directed each department to estimate its general fund requirements five years ahead, through the fiscal year ending in 1967.

Each was instructed to show separately the costs of (1) maintaining its present programs at existing standards, given present workloads, and (2) providing for workload increases, as in the number of pupils enrolled in public schools or the number of patients treated at public health facilities. Annual price increases, varying with the items purchased from 1-1/2 to 2-1/2 per cent, were assumed, but no increase in the salary schedules of the state government.

The Legislative Reference Bureau then requested three of the largest departments--Public Instruction, Public Health and Social Services--to carry their projections forward to 1972, on the identical assumptions. General fund expenditures of the University of Hawaii were projected in proportion to the estimated annual increase in student enrollment, in full-time equivalents. The Department of Budget and Review supplied calculations of the net cost to the general fund of servicing the general obligation bonds outstanding in December 1961. Together, these sources of estimates comprised over two-thirds of the operating costs of the state government financed by the annual general appropriation act. Expenditures for the remaining departments of the state government, and for the legislature, were projected on the assumption that the trend estimated for 1962-67 would continue through 1972. Five million dollars--the minimum required under present executive policy and \$3 million below the level suggested in the preceding chapter--was inserted for the partial financing of capital improvements out of the general fund in each year.

To the aggregate of these figures were added three salary increases over the decade--\$2 million in 1963, an additional \$3 million in 1967, another \$3 million in 1971. The state's contribution to the retirement system on the payroll increase was assumed to be absorbed in the various departmental appropriations and it not included as a net cost to the general fund.

The results of this projection, omitting any new work programs or explicit raising of standards for existing programs, are graphed in the following chart as the "low" series for the fiscal years 1963 through 1972.

Excluded are all expenditures financed by federal grants or other "appropriated receipts", and general fund outlays for interest and principal payments on state general obligation bonds issued on behalf of the counties or of state

special funds, and for which the general fund is reimbursed. Appropriated receipts, estimated at \$19.3 million for 1963, and reimbursable debt service, estimated at \$6.6 million, enter into both sides of the government's financial statement, appearing as expenditures and income to the general fund. Their exclusion from the projections here presented serves to concentrate attention on the fiscal elements which are a net charge on the general fund of the state.

To the "low" expenditure series were added several elements likely to increase actual general fund appropriations above the levels forming the lower boundary of the expenditure projection. These elements include: (1) amounts for program expansion and higher standards of service estimated by the four largest departments of the state; (2) an additional \$5 million (double the amount assumed in the "low" series) for capital improvements in 1964 and thereafter; (3) service charges on \$20 million of general obligation bonds assumed to be issued in 1963 and an annual \$10 million issues thereafter, computed at a 3-1/2 per cent interest rate. Furthermore, it was assumed that subsidies for inter-island transportation, within the general magnitudes outlined in the 1961 General Plan of the State of Hawaii (Department of Planning and Research) would result in an appropriation of \$1 million in 1964, \$2 million in 1965 and 1966, thereafter declining below \$1 million by 1972.

The "high" series also provides for additional expenditures to stimulate local economic expansion. An additional \$500,000 for this purpose was inserted for 1964-67, an additional \$1 million for each of the following years. Finally, it was assumed for this series that salary increases for state employees would be voted four times over the next decade, amounting to \$7 million in 1963, an additional \$1 million in 1965, \$4 million more in 1967, and \$4 million in 1971. Added costs for state retirement contributions required by such wage increases were also included in this series.

No allowances were made for two potential claimants on the state's general fund which were under consideration at the beginning of 1962. One is the cost of constructing public fallout shelters, or subsidizing private shelters. The other is the cost to the state of taking over from the counties part or full financial responsibility for school construction. It is obvious that either could be a substantial budget item, likely to require either bond financing, tax increases, or both.

The "high" series, therefore, is by no means an upper limit to the amount of net spending from the state general fund over the next decade. New programs, a transfer to the state of county programs, could send expenditures beyond that area charted. By the same token, a program of budget retrenchment, particularly in education where so much of recent budget increases have occurred, and complete abstinence from salary increases might--but are not likely to--hold the level of general fund expenditures below the series labelled "low".

## REVENUE PROJECTIONS

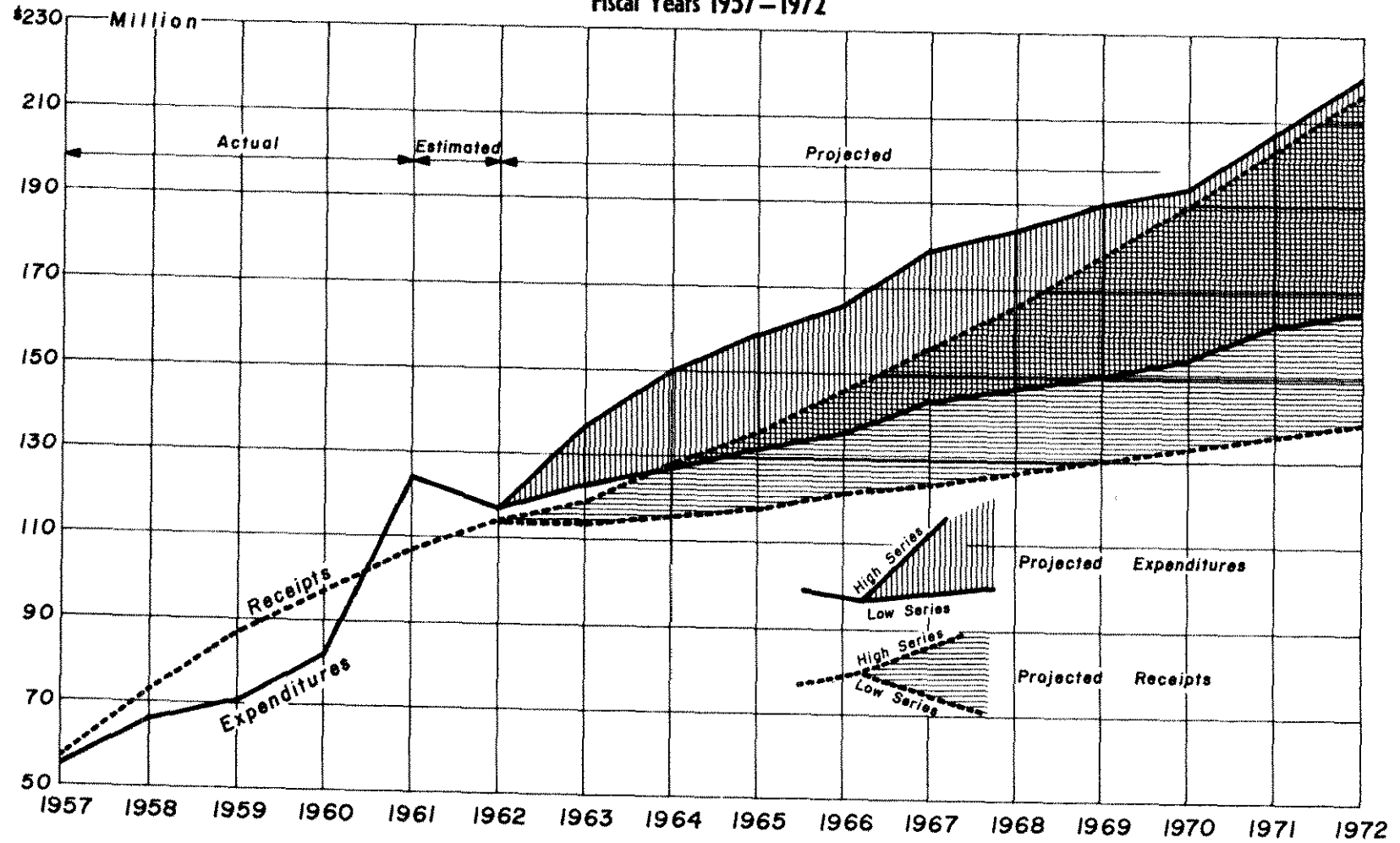
The uncertainties of future trends in general fund receipts are perhaps even greater than for the expenditure programs. Exclusion of federal grants and other appropriated receipts, as well as reimbursed debt service for bonds issued on behalf of other funds, limits the amplitude of variation in the revenues of the general fund. However, on the record of the past several years a wide range of increase in taxes and other revenues supplying the general fund is possible. Between 1959 and 1961, general fund tax receipts rose by about 10 per cent, despite rate reductions enacted in 1960. Between 1961 and 1962, however, these receipts increased by only 2 per cent, and a 4 per cent rise is estimated by the state Tax Department for 1963.

An annual increase of 2 per cent in tax receipts is the basis of the "low" revenue series drawn in the accompanying chart. For the "high" series a growth rate of 7 per cent, compounded annually, is used for the years after 1963. The 7 per cent projection shows a virtual doubling of tax revenues, from \$104 million to \$202 million, in the ten-year period ending in 1972. Such a rate of increase, sustained over a decade, without a boost in tax rates or enactment of new levies, has been realized only once in Hawaii's fiscal history as a territory or state.

The non-tax elements included in the revenue projections are income from the state's lands, and earnings of the various departments going into the general fund, including fees, licenses, rentals, interest on state deposits, proceeds from the sale of meals in public institutions, and the like. The Congressional act admitting Hawaii to statehood requires that rentals and other proceeds from state lands be placed in a trust fund. However, amounts going into the fund have been

Chart 4

# GENERAL FUND RECEIPTS AND EXPENDITURES: Fiscal Years 1957-1972





appropriated to support general fund expenditure needs, and it is assumed that the practice will be continued.

At the close of the calendar year 1961, receipts of the land trust fund approximated \$2 million annually.<sup>1</sup> For the "low" series, it was assumed that this revenue source would increase by \$500,000 every two years; for the "high" series a biennial increase of \$1 million was predicated. It may be noted that much of the productive land owned by the state is leased at long term, an arrangement which limits a rapid increase in revenues from this source.

Departmental earnings earmarked for the general fund averaged \$4 million for 1960 and 1961, are estimated at \$5 million for 1962 and 1963 by the Department of Budget and Review. The latter level is assumed for the "low" projection for 1964 through 1966, and an increase of \$500,000 every two years thereafter. For the "high" series, departmental earnings are projected at \$6 million for 1963 and 1964, thereafter expanding by \$500,000 each biennium. (Many of the fees and charges made by the departments have not been revised in years. A broad legislative review might reveal areas of additional revenues from this source, adding to the possibility of achieving the higher level.)

Overall, the "low" series shows an expansion of \$25 million over the decade from 1962 to 1972.<sup>2</sup> The "high" increases about four times that amount, from \$114 million to \$216 million, almost double the current level of general fund receipts, net of appropriated revenues and reimbursable debt service.

## EXAMINING THE PROJECTIONS

Both the revenue and expenditure projections are bands, relatively narrow for the years immediately ahead, widening thereafter to reflect cumulatively the diverse as-

<sup>1</sup>During fiscal 1962 the general fund received \$4 million from the land trust fund, but about half of this represented an accumulation of receipts and was therefore a non-recurring item.

<sup>2</sup>The projections were calculated as if the level of revenue and expenditures did not influence each other. At the extreme, mutual independence may be a questionable assumption. The "low" revenue series would imply a stagnant local economy with rising unemployment, circumstances which would affect the level of expenditures. However, the ranges of general fund income and outgo shown in the projection are sufficiently broad to cover substantial variations in either side of the budget, whether or not interrelated.

sumptions underlying the "low" and "high" series. The expanding width of each band is also a reminder of the uncertainties inherent in such projections, which increase with each year added to the period covered.

Obviously, the projections do not provide the stuff that responsible predictions can be made from. Nevertheless, there is significance to the bands developed in Chart 4; there are indications relevant to fiscal policy considerations.

For the entire period from 1962 until 1972, the expenditure range lies above the revenue range.<sup>3</sup> There is a considerable degree of overlapping after 1964, but in every year the "high" figure in the expenditure projection lies above the top of the receipts band. Beyond 1965, the degree of overlap is sufficiently great to indicate an increasing possibility that the present revenue structure could support the state's expenditure program, but it would require the combination of tight budget reins and increases in tax revenues sustained at about 7 per cent to achieve a balanced budget.

Even under these circumstances, a general fund deficit for 1963 seems almost certain, and highly likely for 1964 and 1965, given the present revenue structure. The 1963 deficit can perhaps be covered from the surplus, slightly under \$10 million, expected to be in the general fund at the beginning of the next fiscal year. It was the surplus built up between 1957 and 1960 that filled in a \$17 million budget deficiency in 1961, and the \$3 million gap estimated for 1962.

However, by the end of the next fiscal year virtually all of the surplus will have been expended or encumbered. At that point, it would seem, the state government will have to institute austerity controls over expenditures, increase taxes, or both. Unless revenues were to be increased, there appears to be little chance of maintaining a balance in the general fund sufficient to provide the flexibility in budgetary operations suggested in the preceding chapter as an objective of fiscal policy. The greater likelihood is that the state would experience, for at least a few years some of the budgetary stringencies of the 1953-57 period--but without as many special funds to draw upon as existed in the last decade to sustain the general fund over periods of drought.

<sup>3</sup>A projection for all state and local governments in the United States for the decade 1959-1968 showed the likelihood of an increasing gap between expenditures and revenues for the nation as a whole. Otto Eckstein, *Trends in Public Expenditures in the Next Decade*, Committee for Economic Development, 1959.

How much the revenue deficiency is likely to amount to depends on legislative policy decisions--whether to finance capital improvements at least in part out of the general fund, whether to increase government salaries, etc. If as much as \$5 million were to be spent for each of these purpose in 1963 and 1964, it can be estimated that an additional \$4 to \$6 million of new tax revenues will be required to keep the general fund in the black. A revenue increase of the same magnitude, or an equivalent reduction in expenditures, would be needed in the next fiscal year to maintain a prudent reserve in the general fund.

## CHAPTER 6

# ALTERNATE APPROACHES TO TAX ADJUSTMENTS

What emerges from the analysis of expenditure and revenue trends attempted in the preceding chapter is that over the next several years the general fund will probably be hard pressed to support existing state programs in Hawaii, let alone new functions or higher standards for the services now provided by the state. Unless the budget will be geared down to the yields of the existing tax structure, or unless federal grants are sharply increased, it seems likely that the state will be seeking means of raising additional revenue.

How much additional revenue will be sought cannot be predicted with any certainty. The amount will depend on the pull and haul of policy making in Iolani Palace with respect to state program, as well as the tempo of the state's economy. The latter, in turn, may be strongly influenced by decisions in Washington concerning the defense establishment, sugar controls, reciprocal trade agreements affecting pineapple, transportation regulation, etc.

However, the projections of expenditures and of revenues from the present tax structure indicate an annual revenue deficiency of about \$5 million over the next few years, even without regard to program improvements recommended by the departments of the state government. The minimal consequences of failing to provide additional revenues to fill the revenue gap would be to deplete the balance in the general fund to a level which would jeopardize flexibility in the financial operations of the state, as discussed in Chapter 4.

Ultimately, policy decisions of the legislature and the executive will determine the amount of additional tax revenues needed, if any, and so the projection of the revenue gap is by no means a prediction that it will be of the size charted. It is helpful to discussion, however, to work with some given quantity of tax yields. For this purpose, we assume that the state will be seeking ways of increasing general fund tax receipts by about \$5 million annually.

Following the discussion of alternative routes to higher taxes, approaches to tax reduction are considered.

## **NEW TAX SOURCES**

The overview of Hawaii's tax structure which began this report noted that it already includes all major levies imposed by American states for which there is a local base, except for a tax on personal property. Comprehensive sales and income taxes, with broad bases and comparatively high rates, apply to most economic activities. These general levies are supplemented by a group of special taxes--on liquor, tobacco, gasoline, receipts of public utility and insurance companies--traditional among the 50 states.

There are probably no important tax sources untaxed within the area generally regarded as fair game for the state government. It would be possible to enact a poll tax (one was collected in Hawaii until 1948, it still is in 14 mainland states), but this levy would probably be regarded as reactionary, and dismissed for its flagrant violation of the ability-to-pay principle.

Another former Hawaii tax, the levy on personal property, might be resurrected and extended beyond the narrow base it enjoyed before its repeal in 1947, possibly with exemptions for household furnishings and other items difficult for the tax assessor to reach. However, there is no evident support for its re-enactment, in part because of difficulties inherent in its assessment, perhaps also because of its 19th century aura.

A more limited variation of the personal property tax might be more appropriate to the mid-20th century. This is the tax on stocks, bonds, mortgages, bank deposits and other forms of intangible personal property, currently imposed--usually as part of a general property tax--by about half of the states. The volume of bank deposits in Hawaii is more than \$700 million annually, while the value of locally-issued stocks and bonds held in the state exceeds \$450 million. (The complementary estimate of non-Hawaiian securities held locally is not available.) Mortgages on property in Hawaii, the bulk of which are held by local financial institutions, aggregated \$508 million at the beginning of 1961.

The base for a tax on intangibles is obviously substantial,<sup>1</sup> but the desirability of the tax is highly debatable. Some forms of representative wealth, such as bank deposits and recorded mortgages, can be assessed rather easily. However, there is no apparent alternative to self-assessment for assets readily concealed, such as stocks and bonds, and the experience of other jurisdictions gives no grounds for confidence that compliance with the law would be good.

Leaving the search for novelty, and proceeding on the adage that old taxes are good taxes, the present revenue structure offers as many possibilities for revenue expansion as there are taxing devices in use. Policy considerations would shape the choice. Tax policy can be formulated around social objectives, broad or specific, and the tax laws abound with examples, such as property tax exemptions for home owners, private schools, churches, hospitals and other institutions, low general excise rates on sales by blind vendors and extra income tax exemptions for the blind and aged, exemptions for specified new industries, high taxes on liquor and tobacco, presumably to discourage their use, "income-splitting" for husband and wife, presumably to encourage marriage.

For the purposes of this discussion, three alternative approaches to changes in the revenue structure are considered: first, to make the least possible disturbance in the present balance of regressive and progressive taxes; second, to reduce the tax burden on business; third, to increase the use of taxes designed to distribute the tax burden according to ability to pay taxes.

## **STATUS QUO POLICY**

The policy of minimal disturbance to the tax system is the easiest to apply. To use this approach, the legislature could simply increase the general fund taxes by a uniform percentage increase necessary to raise the additional revenue required--estimating a revenue gain of about one million dollars for every percentage point increase in tax rates, across the board. A 5 per cent rate increase would yield about \$5 million.<sup>2</sup> Minor adjustments could be made to avoid numeri-

<sup>1</sup>There is no uniformity among state taxes on intangible property. Several exclude one or another of the foregoing types of property, or, in the case of mortgage, impose a millage tax at the time of recording.

<sup>2</sup>That is, by increasing the retailing rate under the general excise from 3.5 per cent to 3.675 per cent, the initial 5 per cent corporate income tax to 5.25 per cent, etc.

cally awkward rates by rounding them to a convenient percentage point.

Another least-disturbance approach suggests itself: to repeal the tax reductions enacted in 1960, which lowered producing, processing, manufacturing and wholesaling rates under the general excise and raised the personal income tax exemption from \$400 to \$600. This reversal action would increase annual tax revenues by about \$6 million annually.

In favor of such switch-back legislation, it can be pointed out that the Hawaii economy has not fully adjusted to the 1960 amendments. First annual returns under the increased net income tax exemptions will be filed early in 1962 on the previous year's incomes. Only the announcement effects of the general excise tax cuts have had a chance to work themselves out; the volume or pattern of local investments can scarcely yet be much affected by the fractional reductions which became effective in 1961.

Restoration of the old general excise tax rates would not, of course, help the sugar or pineapple industries. It would, however, bring a closer approach to neutrality in the taxation of these two industries (as discussed in Chapter 3) if their rates were kept at 2 per cent and those on production and manufacturing restored to 1 per cent.

## **MINIMAL BUSINESS BURDEN POLICY**

If the legislature were to approach tax adjustments with the goal of keeping to the minimum any levies which might adversely affect business enterprise in the state, a selection among tax increases is required. Those which cut business profits--either because they add to the costs of enterprises, like the general excise on manufacturing, producing and wholesaling activities, or because they reduce net return to the owners, like the corporate income tax and the personal income tax, particularly as it applies to upper income brackets--would be avoided. However, tax increases which would be largely borne by employees and consumers would be compatible with the policy.

The area of availability is thus readily identified as the retail rate under the general excise, the tobacco and liquor taxes (although these might have some adverse effects on the local suppliers of these "luxuries"), and the personal income tax as it applies to lower and middle-income brackets. Within

this area, retail sales provide the largest base--approaching a billion dollars annually. For every one-tenth per cent increase in the general excise on retailing, the general fund would receive approximately an additional million dollars--or about \$5 million for a rate increase of one-half per cent. Liquor and tobacco sales, by comparison, are quite small, about \$33 million at wholesale per year for both combined. It thus requires a 15 per cent increase in the rates of these selective excises to raise as much additional revenue as a rise of one-half per cent in the retailing portion of the general excise.

Boosting the retail rate from 3-1/2 to 4 per cent would again place Hawaii's tax on consumption at the fore among the 50 states. In several states (seven at this writing), the state retail sales tax is set at 4 per cent or equals that level when added to local sales taxes. The number is likely to increase as mainland jurisdictions continue in the universal search for more revenues. However, at present only Indiana, like Hawaii, applies its consumers' tax to virtually all goods and services, and the Indiana rate is 3/8 of one per cent. In other words, a 4 per cent retail tax applied under Hawaii's broad-based general excise, would take a considerably larger portion of the consumer's income than, say, the 4 per cent retail sales tax imposed by the state and cities of California, since the California tax exempts food and services.

It is sometimes argued that a heavy tax on retail sales is bad for business because it reduces the volume of consumption. Hawaii's post-war experience with one of the heaviest retail taxes in the United States does not bear out this contention. Increases in the rate, in 1947 and 1957, did not have an ascertainable effect on the volume of sales--nor did the decision of merchants in the latter year to show the retail tax separately from the price of goods in presenting their bills for payment.

## **ABILITY-TO-PAY POLICY**

If the concern of the state government in seeking additional tax revenues is to spread the burden among the population in accordance with individual ability-to-pay taxes, then the appropriate sources are the personal net income tax and the inheritance tax, since only these among the various levies now imposed are based on the ability principle. Secondly, the corporate income tax could be considered, since it has



only an indirect and erratic relationship to the tax burdens of individuals and their abilities to bear them.

There is not much additional revenue to be derived from the inheritance tax, if the state feels itself limited--because of the weight of the federal estate tax or otherwise--to the range of death taxes presently imposed by American states. Even if Hawaii were to treble its existing inheritance tax rates, only about one million dollars in additional receipts would be received annually. Unless it can be assumed, as it is not here, that rate increases of this magnitude would be considered by the legislature, the death tax cannot be regarded as a source of significant new revenues. Its importance rather lies in the area of social policy, as a means of limiting the accumulation of wealth from generation to generation within families.

The chief potential source of revenue under an ability-to-pay policy is the personal income tax, the ultimate base of which is the net income (in recent years ranging upward from one to one and one-half billion dollars) annually received by residents of Hawaii. The state can divert to its use a larger portion of this income by reducing the exemption allowed, reducing deductions, or increasing rates. Restoring the exemption to \$400 would yield additional tax receipts of some \$4 million annually. Some of this revenue would be raised from low income groups, now outside the scope of the tax because of the \$600 exemption, but as an alternative to higher taxes on consumption, the overall effect would be to add to the progressivity of the tax system.

Even greater progressivity would be attained by substituting a crediting device for the exemption.<sup>3</sup> For example, a credit of \$15 for each taxpayer and dependent would be equivalent to an exemption of \$500 to a man and wife with only \$1,000 of taxable income, while to a two-person family with a taxable income of \$100,000 it would be the equivalent of a \$167 exemption, as the following table shows. The differential results, of course, from the fact that the exemption "comes off the top", that is, reduces the income subject to the largest (marginal) rate--3 per cent in the first case, 9 per cent in the second. Stated the other way around, a flat exemption, as under the present tax, is "worth more" to the taxpayer as you ascend the income scale.

<sup>3</sup>As in Arkansas, Iowa, Kentucky, Minnesota and Wisconsin.

**Table 6**  
**RELATIONSHIP BETWEEN INCOME TAX CREDITS**  
**AND PERSONAL EXEMPTIONS**  
**(for couples filing jointly)**

Taxable Income	Marginal Rate <sup>a</sup>	Tax Credit	Equivalent Exemption <sup>b</sup>
\$ 1,000	3%	\$15 per person	\$500
3,000	4%	15 per person	375
5,000	5%	15 per person	300
8,000	5%	15 per person	300
12,000	6%	15 per person	250
20,000	6%	15 per person	250
50,000	8%	15 per person	188
100,000	9%	15 per person	167

<sup>a</sup>Assuming standard deduction and income splitting.

<sup>b</sup>Computed by dividing the tax credit by the marginal tax rate.

Either a restoration of the \$400 exemption, or the substitution of a \$15 credit for the present \$600 exemption, would yield some \$4 to \$5 million in additional general fund revenues. Alternatively, raising the present income tax rates by about one-sixth, would increase revenues by approximately the same amount. Any number of combinations of changes, involving the size of the income brackets as well as the rates and size of exemptions or credits, could be developed, each yielding approximately \$5 million additional income tax receipts per year. However, the foregoing illustrations may suffice to indicate the order of magnitude of tax changes necessary for larger revenues in this field.

There remains one additional variable in the structure of the income tax: deductions. Hawaii generally adopts federal definitions of personal and business deductions, in the interest of simplifying for the taxpayer the making of income tax returns to two levels of government. However, an abundance of testimony before the Congress indicates that abuses in the claiming of deductions have substantially cut into the federal income tax base--and to the extent this applies to Hawaii taxpayers, into this state's as well. Stricter definitions of allowable expenses, and careful enforcement,

may help shore up the income tax base of the state and thereby increase revenues.

Further, it would be possible to limit under-reporting of income by adopting a procedure long advocated for the federal government, source collection of the tax on dividend income. Until 1958, Hawaii collected from corporations a tax of 2 per cent on the dividends (as well as wages) paid out by them. For 1957, the volume of dividends reported to the Tax Department was some \$46 million. In 1959, most recent year for which such data are compiled, dividends reported for net income tax purposes aggregated \$32 million.

The reduction is by no means conclusive evidence of under-reporting, since the bases of the two years are not comparable,<sup>4</sup> but it is suggestive.

## STATE-COUNTY REVENUE REALIGNMENT

An area not yet explored for possible general fund resources is the county share of the state-collected general excise tax. Approximately \$18 million is paid by the state to its subdivisions from this source annually. Were the counties to develop additional tax sources of their own, some portion of the county share might be retained by the state for its purposes.

As a practical matter, only a few tax bases of significant size are available to the counties. One is the base of the general excise. It would be possible for the local governments to superimpose a retail sales tax for their own benefit on top of the state's, as do local units in a dozen mainland states. For the state of Hawaii as a whole, it would require a tax of more than 1 per cent, placed by the counties on the retail sales base of the state, to yield an aggregate sum equal to the present county share.

<sup>4</sup>Under the former compensation-dividends tax, local corporations had to report dividends paid out to persons residing outside Hawaii. There was, of course, no provision for reporting by mainland corporations of dividends paid to Hawaii residents.

Since 1911, Wisconsin has required corporations licensed to do business in the state to file information returns for dividend payments of \$100 or over, and many other national corporations voluntarily report on dividends paid to Wisconsin residents. The information is then checked by the state tax department against individual tax returns. According to a study of "Taxpayer Compliance in Reporting Dividend Income in Wisconsin", *National Tax Journal* for March 1960, more than 90 per cent of dividends received in the state are reported for state income tax purposes by the recipients.

However, as the following table shows, about seven-eighths of the local sales tax revenues would be collected by the city and county of Honolulu, whereas Honolulu receives only 55 per cent of the present county share. Obviously, the fiscal position of the neighbor islands would be seriously undercut by the substitution--completely or in large part--of a local sales tax for a share of the state general excise, given the present sharing arrangement.

**Table 7**  
**COUNTY REVENUES FROM LOCAL SALES TAX**  
**COMPARED WITH GENERAL EXCISE SHARES**  
**(Based on 1960 calendar year data)**

County	Revenues from 1% Sales Tax* (1)	General Excise Tax Share (2)	Column 1 Minus Column 2
Honolulu	\$14,172,000	\$ 9,782,000	\$4,390,000
Hawaii	907,000	3,646,000	-2,739,000
Maui	612,000	2,704,000	-2,092,000
Kauai	396,000	1,756,000	-1,360,000
Total	\$16,087,000	\$17,888,000	-1,801,000

\*Applied to sales of goods and services, commissions, rentals and other transactions taxed by state at 3-1/2%.

Similarly, the income tax base is highly concentrated in Honolulu. A one per cent personal income tax would raise approximately \$10 million for the city and county, but less than \$600,000 for Hawaii, \$500,000 for Maui and \$400,000 for Kauai. These respective amounts for the neighbor counties are about one-sixth of what they receive as a general excise share.

The base of the motor fuel tax is somewhat more evenly distributed among the four counties; slightly more than three-fourths of taxable fuel is sold in Honolulu, almost one-fourth in the neighbor islands. Table 8 shows the revenues that an additional local tax--added to the present gasoline tax, already among the highest in the nation--would yield in each county.

Table 8

**YIELDS OF ADDITIONAL COUNTY FUEL TAXES**  
(Based on 1961 data)

County	Taxable Fuel* (Million Gallons)	Annual Revenues from Gallonage Tax of:			
		1 Cent	2 Cents	3 Cents	5 Cents
Honolulu	113	\$1,130,000	\$2,260,000	\$3,390,000	\$5,650,000
Hawaii	14	140,000	280,000	420,000	700,000
Maui	11	110,000	220,000	330,000	550,000
Kauai	7	70,000	140,000	210,000	350,000
Total	145	\$1,450,000	\$2,900,000	\$4,350,000	\$7,350,000

\*Gasoline and diesel oil used on highways, including aviation fuel.

One major levy remains to be considered, the real property tax. The base of the tax dwarfs that of any other, but again it is heavily concentrated in Honolulu, the situs of about 85 per cent of all taxable values in the state. By long-established practice, state law sets the ceiling for property tax rates in each county; within this limit the county council or board of supervisors fixes the rate actually to be levied.

Table 9

**ADDITIONAL PROPERTY TAX REVENUES**  
**UNDER PRESENT RATE MAXIMA**

County	1961 Base (Millions) (1)	1961 Tax Revenues:		
		Actually Assessed* (2)	If Full Rate Applied (3)	Column 3 Less Column 2
Honolulu	\$1,661	\$20,530,000	\$26,576,000	\$6,046,000
Hawaii	126	2,020,000	2,268,000	248,000
Maui	107	1,456,000	1,926,000	470,000
Kauai	65	1,004,000	1,170,000	166,000
Total	\$1,958	\$25,010,000	\$31,940,000	\$6,930,000

\*Excluding special levies for Honolulu and Hawaii Redevelopment Agencies.

In recent years, the rates imposed by the counties have been well below the statutory maxima of \$16 for Honolulu and \$18 for the other three counties (exclusive of special levies for the support of Urban Redevelopment Agencies). Were the counties to use their full taxing power by applying the maximum rates, property tax collections would appreciably increase--by almost \$7 million in 1961, for example, as Table 9 shows.

Most of the potential additional revenues would be available to Honolulu; the headroom available to the other counties under the \$18 ceiling is scarcely sufficient to meet their own needs and also replace a portion of their shares of the general excise distribution. It would be possible, however, for Honolulu, by using its present property tax limit to the maximum, to raise sufficient additional revenue to enable it to function with a smaller general excise share--the state to retain the difference for its needs. Were the city and county to be granted and fully use an \$18 tax rate, the present base would yield approximately \$10 million above actual collections in 1961, enough to make possible a significant shift in state-county tax sharing. As developed in Chapter 2, the property tax is the only major levy for which Hawaii's rates are not already comparatively high.

The common thread of this analysis of the possibility of diverting to the state treasury part of the general excise tax now shared with the counties is that most of the burden would have to fall on Honolulu. None of the neighbor counties enjoys a tax base adequate to raise revenues sufficiently large to replace its general excise share.

## **STATE-COUNTY EXPENDITURE REALIGNMENT**

An approach from a different direction would be to reduce the need for state tax revenues by transferring to the counties functions presently performed by the state government, and permitting the counties to use some of the taxing devices just reviewed to support their enlarged programs. Again, the case of Honolulu is sharply different from the other three counties. The city and county has the economic base to sustain a much larger degree of "home rule", but in the foreseeable future the neighboring counties will continue to be reliant in substantial measure on financial support from the state government.

## **SUMMARIZING: ALTERNATIVE TAX INCREASES**

If the state were to increase taxes to raise an additional \$5 million annually, or thereabout, several courses of action are possible. Sorting the alternatives according to the policy which they would most nearly implement, one can list

the following changes:

1. To minimize the disturbance to tax structure:
  - a. Increase all taxes by approximately 5 per cent of the present rate; or
  - b. Reverse the 1960 tax reductions by restoring former general excise tax rates, decreasing the personal income tax exemption to \$400.
2. To minimize the additional burden on business:
  - a. Increase the retail rate under the general excise tax, and the consumption tax rate, from 3-1/2 to 4 per cent; or
  - b. Increase general excise rates by a smaller percentage and raise the tobacco and liquor taxes.
3. To maximize use of ability-to-pay principle:
  - a. Replace the \$600 exemption with a \$15 credit, or reduce the exemption to \$400; or
  - b. Increase income tax rates by average of one-sixth, less in lower brackets, more in middle and upper; and
  - c. Apply standards for deduction of personal and business expenses which are stricter than the federal government's; deduct at source tax on dividends.
4. To shift part of burden to counties:
  - a. Reduce the county share of general excise revenues by \$5 million, primarily from Honolulu; and
  - b. Authorize the counties to impose a one-half per cent tax on retail sales; or
  - c. Induce the counties to make fuller use of present property tax ceilings; increase the Honolulu ceiling; or
  - d. Transfer functions and taxing power from the state to the counties.

## POSSIBILITIES FOR TAX REDUCTION

All the foregoing discussion of tax increases assumed that state expenditures over the next several years would increase faster than general fund revenues, as indicated by the projections of the last chapter. It has been noted repeatedly, however, that the projections are not predictions. Changes either in circumstances (such as a resumption of the rapid growth in economic activity and tax bases which occurred between 1958 and 1961) or in policy (such as a decision to prohibit expansion of educational services or other major programs) could fundamentally change the balance between revenues and costs. Such basic changes are unexpected, but possible. If realized, they might set the stage for tax reductions, going beyond those enacted in 1960.

In considering the possible alternatives, a special case can be made for the reduction of the general excise tax rate on sugar and pineapple processing. It was shown in Chapter 3 that a more "neutral" rate for these industries would be two-thirds of one per cent (one-third of the current rate) on the same base as defined for other industries. The annual revenue loss is estimated at \$2.6 million. Alternatively, tax reductions or credits could be allowed to these industries for improvements in their local plantations and plants, gauged to yield any desired amount of tax reduction, as discussed in the earlier chapter.

Beyond the area of plantation agriculture, the alternative policy approaches utilized in considering tax increases can be applied to reductions. If the chief aim is to encourage economic activity and investment, reductions in these taxes would be appropriate:

- a. In the producing, processing, manufacturing and wholesaling rates under the general excise (or substitution of a low-rate tax on value added in production);
- b. In the personal income tax rates on middle and upper brackets (or, closely equivalent, permitting the deduction of the federal income tax); in the corporate income tax.

If the chief concern of the government is to increase the fairness of its taxes, as measured by the extent to which they are imposed according to each individual's ability to



pay taxes, reductions in the following levies would be indicated:

- a. In the retail rate of the general excise and in the consumption tax;
- b. In the tobacco and liquor taxes;
- c. In the lowest brackets of the personal income tax--by increasing the exemption (or credit), or by reducing the initial rate of 3 per cent.

**APPENDIX**  
**TAX REVENUES OF THE TERRITORY AND STATE OF HAWAII**  
Fiscal Years 1947-1961

Fiscal Year	Real Property <sup>a</sup>	Personal Property <sup>b</sup>	Corporate Income	Personal Income	Estate & Inheritance	Poll <sup>b</sup>	Insurance
1947	\$ 7,490,750	\$4,098,454	\$2,121,961	\$ 938,392	\$ 881,864	\$24,304	\$ 473,735
1948	8,680,378	1,166,075	3,239,473	1,484,829	295,184	21,401	476,277
1949	9,777,269	12,224	3,898,933	1,495,322	310,672	12,020	934,230
1950	10,874,336	6,659	3,440,892	1,381,138	289,566	....	705,055
1951	10,700,761	3,345	3,565,702	1,483,312	211,575	....	783,899
1952	11,151,370	2,471	4,459,059	1,679,105	299,594	....	839,075
1953	6,118,518	4,171	3,216,993	1,670,630	283,037	37	951,420
1954	15,821,334	797	3,098,883	1,683,314	376,151	....	1,019,605
1955	6,646,913	2,124	3,113,376	1,826,796	205,373	....	1,012,265
1956	15,720,840	199	3,487,326	1,876,153	238,994	....	1,095,266
1957	6,604,069	13	4,162,393	2,113,435	426,605	....	1,229,012
1958	22,505,826	67	4,616,399	10,251,367	338,604	....	1,382,782
1959	18,073,709	3	5,600,832	25,680,824	669,810	....	1,683,269
1960	17,016,386	7,454	5,396,914	28,901,335	587,271	....	1,883,186
1961	24,727,297 <sup>1</sup>	0	5,483,897	32,401,452	1,059,904	....	2,213,238

Appendix (continued)

Fiscal Year	Licenses <sup>c</sup>	Public Utility	Bank Excise	General Excise <sup>d</sup>	Compensation & Dividends <sup>e</sup>	Fuel <sup>f</sup>
1947	\$ 69,917	\$1,791,993	\$ 86,700	\$12,684,395	\$ 8,991,980	\$ 3,117,961
1948	79,862	1,784,547	125,000	25,095,544	9,981,803	5,251,951
1949	88,535	1,939,010	125,000	26,889,248	9,798,167	6,216,653
1950	82,458	1,949,337	125,000	25,977,212	9,040,180	5,980,733
1951	73,251	2,007,909	149,178	29,921,162	9,896,583	6,974,165
1952	182,257 <sup>1</sup>	2,144,574	175,823	31,163,198	10,701,507	8,459,460
1953	192,480	2,276,731	177,931	31,841,623	11,147,654	8,731,038
1954	205,599	2,412,909	172,069	32,622,320	11,720,089	8,438,335
1955	214,706	2,388,954	175,000	33,276,218	11,691,260	8,470,017
1956	300,747	2,625,455	132,239	35,287,579	12,337,804	10,928,641
1957	127,586	3,003,093	217,761	38,519,471	13,218,342	11,873,574
1958	304,415	3,382,493	281,610	48,621,625	9,233,208	12,322,899
1959	281,482	3,766,336	465,579	54,623,187	179,661	13,176,192
1960	294,129	4,025,563	543,983	62,195,052	122,672	14,578,901
1961	367,553	4,124,783	794,073	68,146,933	98,155	16,430,474

## Appendix (continued)

Fiscal Year	Liquor <sup>g</sup>	Tobacco <sup>h</sup>	Sub-total	Unemployment Compensation	Grand Total
1947	\$1,424,836	\$ 483,825	\$ 44,681,067	\$1,728,934	\$ 46,410,001
1948	1,630,920	566,923	59,880,167	2,387,410	62,267,577
1949	1,653,057	643,091	63,783,531	2,571,580	66,355,111
1950	1,667,716	945,410	62,465,692	2,498,732	64,964,424
1951	1,911,929	1,099,240	68,782,011	2,479,825	71,261,836
1952	1,934,480	1,119,842	74,209,557	2,473,519	76,683,076
1953	1,980,513	1,143,608	69,736,384	2,175,187	71,911,571
1954	1,989,520	1,115,837	80,676,762	2,239,015	82,915,777
1955	2,065,615	1,216,686	72,305,303	2,263,600	74,568,903
1956	2,101,494	1,264,361	87,397,098	2,401,330	89,798,428
1957	2,173,822	1,249,024	85,140,614	2,835,967	87,976,581
1958	2,750,252	1,698,496	117,385,628	3,104,358	120,489,986
1959	3,003,271	1,823,001	128,745,674	3,496,244	132,241,918
1960	3,231,754	1,971,303	140,461,774	4,485,316	144,947,090
1961	3,518,661	2,248,372	161,247,239	5,333,817	166,581,056

Sources: Reports of State (Territory) Director of Taxation and of State Comptroller.

- a. Includes real property tax appeal deposits; does not adjust for variability in collections after 1953 caused by delays in billing and processing payments at turn of fiscal year, particularly in years of extended legislative sessions.
- b. Repealed effective January 1, 1948.
- c. From business and non-business licenses and permits, but not including licenses for general excise, liquor, or tobacco taxes, which are included in receipts under these tax laws, respectively.
- d. Includes public welfare tax, repealed July 1, 1943. The 1961 figure is reduced by \$1,036,558 for tax remissions on Hurricane "Dot" losses.
- e. Repealed effective January 1, 1958.
- f. Includes fuel retailing permit.
- g. Includes liquor permits.
- h. Includes tobacco licenses.
- i. Receipts from the issuance of regulatory licenses are included for the years 1952-1956. For the years prior to 1952, these receipts were not included.
- j. Reduced by \$17,839 for tax remissions on Hurricane "Dot" losses.

Note: For revenues in earlier periods, see Robert M. Kamins, The Tax System of Hawaii, pp. 164-175.

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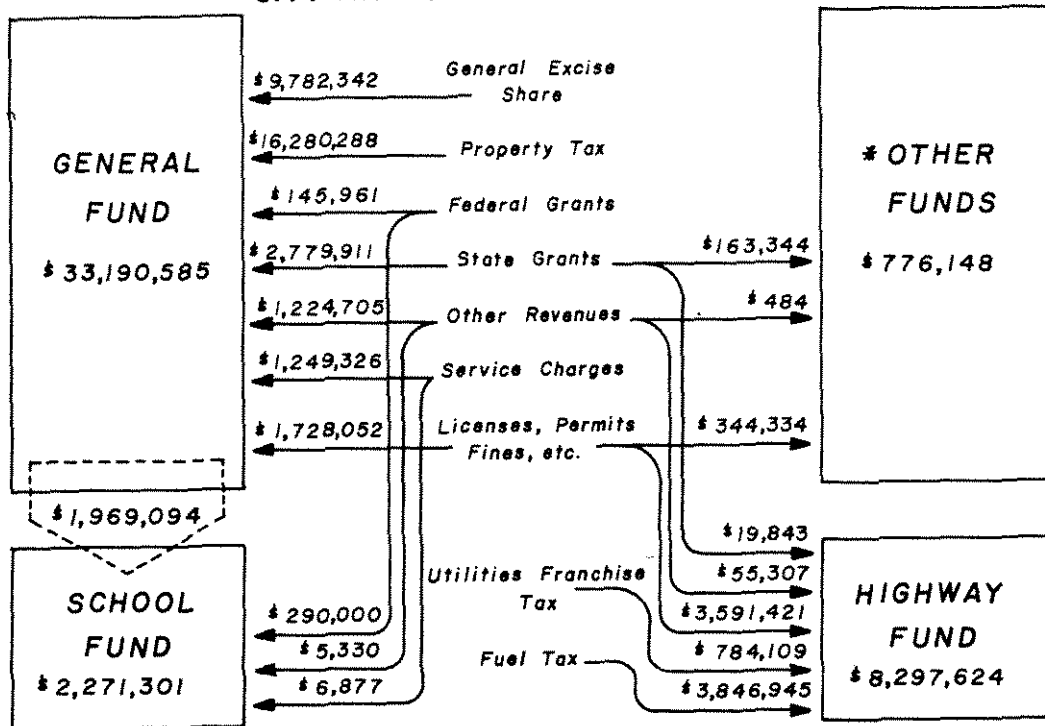
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Chart 5

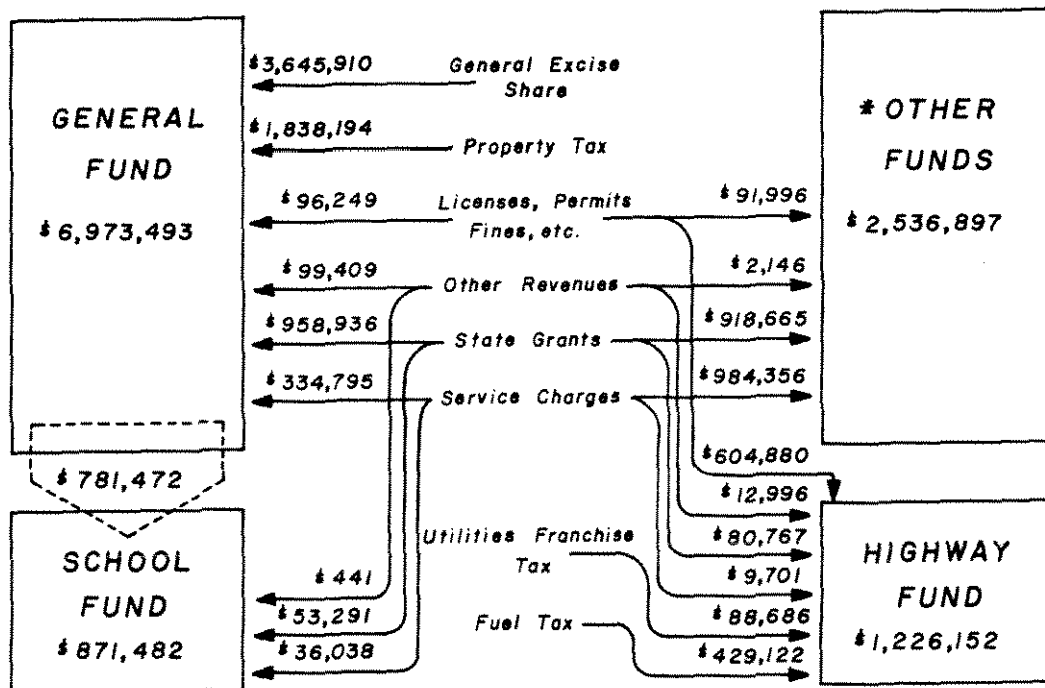
## COUNTY OPERATING FUND RECEIPTS: 1960

## CITY AND COUNTY OF HONOLULU



\*Parking Meter and Pension funds; excludes Urban Renewal Coordinator Fund.

## COUNTY OF HAWAII



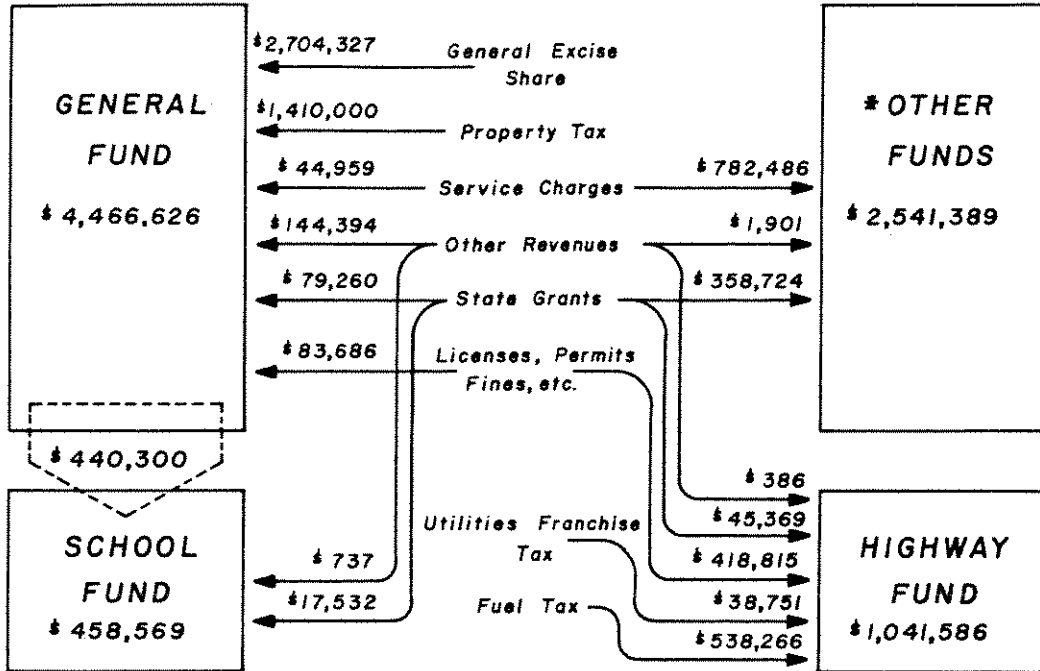
\*Pension, Trust and Agency, Puuamale and Hilo Memorial Hospital, Liquor Commission, Sewer, Motor Vehicle Dealers', Parking Meter funds; Act 225, SLH 1959 Fund. Total includes \$539,735 transferred from General Fund to various special funds.

Sources: Reports of county auditors and city-county finance director for calendar year 1960.



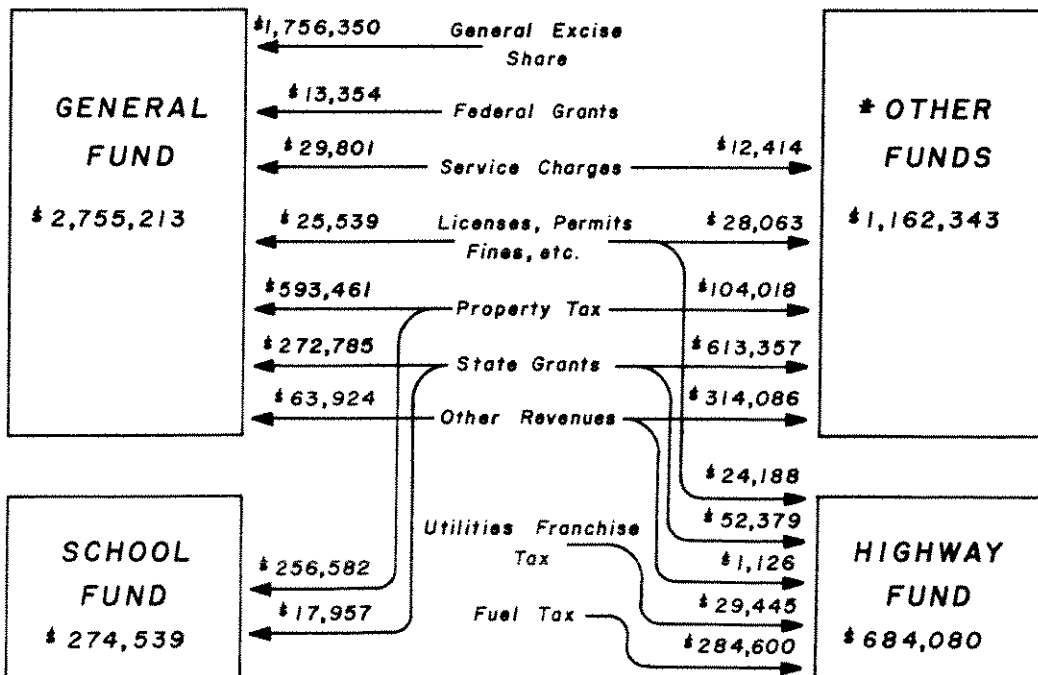
# COUNTY OPERATING FUND RECEIPTS: 1960

## COUNTY OF MAUI



\*Community Hospitals, Maui Police Commission, Trust and Agency, Parks Department funds; excludes General Bonded Debt and interest Fund. Total includes \$1,309,003 transferred from General Fund to various special funds

## COUNTY OF KAUAI



\*Trust and Agency, Water Utility, Revolving, Liquor Commission, Mchelon Memorial Hospital, Motor Vehicle Dealers' funds.

Note: Items may not add to total in any fund because of inter-fund transfers not shown.