Testimony on H.B. 793 S.D. 1 Proposed
Relating to Taxation

Christopher Grandy
grandy@hawaii.rr.com, (808) 956-7060

Senate Committee on Ways and Means
Senator David Y. Ige, Chair
Senator Michelle Kidani, Vice-Chair

April 6, 2011
9:30 a.m., Auditorium

Chair Ige, Vice-Chair Kidani, and members of the Senate Ways and Means Committee:

My name is Christopher Grandy. I am an associate professor in the Public Administration Program at the University of Hawai‘i (Manoa), and a past member of the 2005-2007 Hawai‘i State Tax Review Commission. I write in support of some elements of the proposed S.D. 1 for H.B. 793, relating to taxation, and I have concerns about other elements. My views do not necessarily represent those of the organizations with which I am, or have been, associated.

H.B. 793 S.D. 1 Proposed, is an ambitious measure that temporarily changes several features of Hawai‘i’s tax law, including suspending various exemptions from the General Excise and Use Tax (GEUT), altering income tax provisions so as to lower the burden on low-income taxpayers, and raising the rate of the General Excise and Use Tax and the Public Service Company tax. The tax rate increases would go into effect on October 1, 2011 and expire two years later. The suspension of GET exemptions would be effective in 2012 and expire in 2015, and the income tax changes become effective in 2012 and expire at the end of 2013.

I have three comments on these measures relating to: (1) the proposed GEUT exemptions, (2) the tax rate increases, and (3) the temporary nature of the changes. In general, I intend these remarks to be consistent with principles of taxation that advocate broad bases, low rates, and the application of taxation to final consumers.

First, while I applaud the effort to eliminate exemptions to the GEUT base, this proposal does so in a problematic way. The broad base of the GET permits the rate to remain relatively low while generating substantial revenue. This is a tax design feature widely recommended by economists because it typically minimizes the negative effects of taxation on economic activity. The desirability of eliminating exemptions applies to transactions between businesses and final consumers. Exemptions for some consumer goods and services, rather than others, distorts economic decisions and imposes an economic burden on the economy.

However, the same is not true of business-to-business transactions. Taxing these transactions has
a number of problematic effects: (1) It skews business decisions from what they otherwise would be solely for tax purposes, which is a form of tax-induced inefficiency; (2) it contributes to pyramiding—ultimately raising the rate to consumers in a non-transparent way; and (3) to the extent that taxes are not passed forward to consumers, it raises the cost of doing business in the state, providing an incentive to re-locate. These arguments are more fully expressed by Professor William Fox, in one of the studies he did for the 2005-2007 Tax Review Commission (see Appendix C of the Commission report).

Unfortunately, it appears that some of the activities listed in sections 3 and 4 of the proposed bill are business-to-business transactions in this sense. As such, while suspending the exemptions will likely raise revenue, they are also likely to reduce the efficiency of these activities, perhaps causing firms to reduce production and/or halt operations altogether. Instead, I would urge the Committee to focus the suspension of exemptions on business-to-consumer transactions.

Second, if public program reassessments and expenditure reductions over the last few years have left us with a set of public services we largely agree need to be funded, then the proposal to seek additional revenue by raising the general excise and use tax is appropriate. In general, the economic damage that a tax imposes on the economy rises exponentially with the rate, so it is important to raise needed revenue with low rates. The broad base of the GEUT helps keep the rate low. If we have to raise additional revenue, it is better to raise a low rate on a broad base. This is why I would prefer to raise the GEUT rate rather than, for example, to increase the generally-higher income tax rates.

Third, and finally, problems may arise because of the temporary nature of these measures. In addition to the distortions and potential reduction in activity that the suspension of GEUT exemptions for business-to-business transactions cause, the temporary nature of suspensions may encourage firms to delay economic activity until the exemptions are re-instated. At a period where we are trying to encourage business activity, these delays would work in the opposite direction.

Similarly, the temporary nature of the tax increases may encourage consumers—at least of “big ticket” items—to think about postponing spending. Such postponement would only add to the previously-mentioned incentives to slow economic activity now. For these reasons, it may make more sense to make the tax increases permanent—provided that you feel comfortable that the expenditure reduction efforts of the last two or three years have left us with the set of activities that justify financing with higher tax rates.

These are difficult choices. Thank you for wrestling with them, and for considering this testimony.